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THE SPANISH ECONOMY

Monthly Report

RISK AND INSURANCE

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2010	2011	2012	2011				2012	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	3.0	1.7	2.1	2.2	1.6	1.5	1.6	2.1	2.2
Japan	4.5	–0.7	2.1	–0.1	–1.7	–0.5	–0.5	2.6	3.0
United Kingdom	2.1	0.7	0.6	1.5	0.4	0.3	0.5	0.0	0.6
Euro area	1.8	1.5	–0.5	2.4	1.6	1.3	0.7	0.0	–0.8
Germany	*3.6*	*3.1*	*0.6*	*4.6*	*2.9*	*2.7*	*2.0*	*1.2*	*0.9*
France	*1.6*	*1.7*	*0.1*	*2.4*	*1.7*	*1.5*	*1.2*	*0.3*	*0.3*
Consumer prices									
United States	1.6	3.1	2.3	2.1	3.3	3.8	3.3	2.8	2.2
Japan	–0.7	–0.3	0.4	–0.6	–0.4	0.2	–0.3	0.3	0.5
United Kingdom	3.3	4.5	2.7	4.1	4.4	4.7	4.7	3.5	2.9
Euro area	1.6	2.7	2.2	2.5	2.8	2.7	2.9	2.7	2.4
Germany	*1.1*	*2.3*	*1.9*	*2.1*	*2.3*	*2.4*	*2.4*	*2.1*	*1.9*
France	*1.5*	*2.1*	*2.1*	*1.8*	*2.1*	*2.1*	*2.4*	*2.3*	*2.2*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	0.7	–0.1	–1.3	0.4	–0.3	0.5	–1.1	–0.6	–1.4
Government consumption	0.2	–2.2	–6.3	0.6	–2.1	–3.6	–3.6	–5.2	–5.7
Gross fixed capital formation	–6.2	–5.1	–9.2	–4.9	–5.4	–4.0	–6.2	–8.2	–9.3
Machinery and capital equipment	*5.5*	*1.6*	*–7.6*	*5.7*	*1.1*	*2.2*	*–2.7*	*–6.0*	*–6.3*
Construction	*–10.1*	*–8.1*	*–10.9*	*–9.2*	*–8.1*	*–7.0*	*–8.2*	*–10.2*	*–11.7*
Domestic demand (contribution to GDP growth)	–1.0	–1.8	–4.0	–0.8	–1.9	–1.4	–2.9	–3.2	–4.0
Exports of goods and services	13.5	9.1	0.5	13.1	8.8	9.2	5.2	2.2	1.0
Imports of goods and services	8.9	–0.1	–7.4	6.0	–1.3	0.9	–5.9	–7.2	–7.4
Gross domestic product	**–0.1**	**0.7**	**–1.5**	**0.9**	**0.8**	**0.8**	**0.3**	**–0.4**	**–1.3**
Other variables									
Employment	–2.6	–2.0	–4.3	–1.6	–1.3	–2.0	–3.3	–3.8	–4.9
Unemployment (% labour force)	20.1	21.6	24.7	21.3	20.9	21.5	22.9	24.4	24.6
Consumer price index	1.8	3.2	1.8	3.5	3.5	3.1	2.8	2.0	2.0
Unit labour costs	–2.6	–1.9	–2.8	–2.0	–1.7	–1.5	–2.5	–2.5	
Current account balance (% GDP)	–4.5	–3.9	–2.4	–6.6	–3.2	–2.9	–2.8	–5.5	–1.7
Net lending or net borrowing rest of the world (% GDP)	–4.0	–3.4	–1.9	–6.1	–2.7	–2.4	–2.3	–5.3	–1.1
General government financial balance (% GDP)	–9.3	–8.9	–6.4	–5.3	–9.9	–6.1	–14.4		
FINANCIAL MARKETS			Forecast						Forecast
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.0	1.3	1.0	1.0	1.3	1.5	1.3	1.0	1.0
10-year US bonds	3.2	2.8	2.1	3.4	3.2	2.4	2.0	2.0	1.9
10-year German bonds	2.8	2.6	1.6	3.2	3.1	2.3	2.0	1.9	1.4
Exchange rate									
$/Euro	1.33	1.39	1.23	1.37	1.44	1.41	1.35	1.31	1.27

Contents

The silent economic and social value of insurance

After its rapid expansion worldwide over the last few years, the insurance industry has become a leading component of the social, economic and financial panorama. By way of example, it is estimated that insurance companies currently manage assets valued at around 23 trillion dollars, far more than twice the total volume of international reserves. This strong development is essentially based on a very dynamic life-savings segment and a growing contribution from the emerging countries. Demographic and economic prospects suggest that both factors will continue to boost insurance business over the coming years. For example, insurance penetration, measured as the percentage of GDP represented by the total annual premiums, stands at 3% in the emerging markets, still far from the 8.7% of advanced countries.

However, to duly exploit this potential, insurance companies will have to offer products with a large degree of innovation and adaptability, as well as diversify their distribution channels and, of course, ensure they keep a solid balance sheet.

The capacity to innovate when covering both individual and collective risks is one of the most outstanding features underlying the industry's expansion. An illustrative example of this is the new range of products that allow authorities of developing countries to manage the risk of natural catastrophes. The warm welcome these products are receiving in terms of demand acknowledges their significant economic and social benefits. Firstly, if the natural disaster actually occurs, they soften its impact on the public coffers as the risk is passed on to the international reinsurance or capital market. As a result, governments can offer assistance to the population and reconstruct the damaged infrastructures. Secondly, and more subtly, less fiscal uncertainty is an incentive for authorities to invest in better social services and to develop production infrastructures that encourage long-term growth.

Another element that will be crucial for the insurance industry to maintain its rate of growth and its contribution to society is related to the different areas of regulation. In the European Union, the prudential regulations for the insurance sector are currently being revised in-depth (Solvency II), in parallel with those for banking (Basel III). The traumatic financial crisis has highlighted the need to preserve stability, both individual and of the system as a whole, requiring greater levels of capital and better governance, so that this is a welcome initiative; but it is important for the incentives that finally come out of this regulation not to impinge upon the sector's own efficiency and long-term view.

Regulating products and contracts is another important front, albeit more diverse and difficult to evaluate. On the whole, regulations focus on protecting society from the large amount of asymmetrical information in insurance transactions. However, consumer protection from a number of inherent cognitive biases (the difficulty of establishing the fair value of the insurance and other biases related to taking decisions under uncertain conditions) is far from being a habitual practice. To advance in this field, regulation needs to incorporate the considerations and teachings of the «behavioural economy» in order to mitigate the imperfect rationality of members of our society.

EXECUTIVE SUMMARY

Uncertainty returns

The economic-financial scenario deteriorates in May.

In April, the pillars that seemed to underpin the improvement in the economic-financial scenario started to wobble. In May, far from stabilizing, this situation has merely got worse. Two factors have had a combined effect: a more agitated political and economic climate in the euro area and poor economic activity figures in the emerging countries, in particular China.

The uncertainty generated by Greece's political situation is keeping the whole euro area on tenterhooks...

After the elections on 6 May, Greece's political crisis, reflecting the country's hesitant support for the adjustment plan, is jeopardizing the euro area as a whole. Speculation that Greece might leave the euro, together with wariness regarding the health of Spain's banking system, have sent risk premia soaring in peripheral Europe. Debate on the design, orientation and functioning of the Economic and Monetary Union has entered a decisive phase, just at a time of elections to provide the big decisions coming up with democratic legitimacy. France's change in government entails a notable alteration in the correlation of forces within Europe, initially adding to the uncertainty.

...and is starting to hit economic activity.

The evident risk is that, should this uncertainty consolidate over several months, it might harm economic activity. The publication of the euro area's gross domestic product (GDP) figures for the first quarter is not particularly encouraging. With a quarter-on-quarter growth rate of 0.0%, activity remained completely at a standstill. Technically it avoided recession, as there have not been two consecutive quarters with negative growth (in the last quarter of 2011, GDP fell by 0.3%), but this was thanks to the good performance by the German economy, whose GDP advanced by 0.5%. In France growth was zero while in Spain and Italy there was a notable drop, namely 0.3% and 0.8% respectively. Moreover, leading indicators from the second quarter point to this weak tone increasing, particularly if far-reaching measures are not taken to put a stop to the current uncertain context.

In this respect, the most relevant element of the last few weeks in terms of the euro area's monetary policy is probably related to the Bundesbank. The President of the German Central Bank, Jens Weidmann, stated that it would be appropriate to let the German inflation rate remain above the euro area average, as a measure to help correct the imbalances in competitiveness between Germany and countries in the south of Europe. The German Finance Minister, Wolfgang Schäuble, also supported this position, specifying that an inflation range of between 2% and 3% for Germany would be desirable and confirming that there was enough margin for wage rises in the country. Should it come about, Germany's more flexible stance on inflation is another ingredient in the formula leading to the region's economic and financial stabilization.

In the international macroeconomic context, the publication of poorer activity figures than expected in key countries such as China has also marred global growth prospects. Although the most probable scenario for the Asian giant is still that of a soft landing, these events call for more forceful monetary and fiscal

policy to support growth. The rate of growth of another large emerging country, Brazil, is also somewhat disappointing. A continual decline in industrial production and perceptible drop in employment are clear signs of moderation in the pace of economic growth, a greater moderation than expected, especially taking into account the marked expansionary tone of economic policies since last autumn, which has led Brazil's Central Bank to revise downward its own growth forecast for 2012.

Within this context, the financial markets, reflecting investors' hopes and fears, are going through a period marked by uncertainty and the search for safe options. The yield on Spain's 10-year bonds went through the barrier of 6% and their spread with Germany reached 490 basis points, the highest since 1995. Italy's debt also performed badly, although still far from the peaks reached a few months ago.

In spite of the difficult situation, the ECB has still not intervened, nor has it declared any intention of doing so, in the secondary market by buying up Spain and Italy's debt to contain this upswing in yields. In any case, debt issuances in the primary market have offered a less dramatic view as the respective Treasuries have managed to place securities with different maturities, registering good demand at higher interest rates which they've had to accept.

Germany's sovereign bonds were once again benefitted by more investors opting for safety, pushing the 10-year yield down to 1.41%, a record low. On the other side of the Atlantic, US sovereign bonds have performed similarly to their German peers. In addition to being supported by relatively better economic expectations than those of the euro area, US debt is also helped by a very lax monetary policy. This, together with the security provided by a country with a very high rating and the expectation that the Federal Reserve could implement, if necessary, another round of quantitative easing, has meant that investors have pushed down yields on ten-year US debt from 1.95% to levels of around 1.70%.

The US economy's expansion is being supported by falling oil prices, the possible expansionary effects of the electoral year and strong consumption. GDP for the first quarter grew by an expected 0.5% quarter-on-quarter and by 2.1% year-on-year. Consequently, a large part of the upswing from the end of last year has remained and everything points to a slight advance of more than 2.0% for the whole of 2012, more than expected two months ago. However, the composition of GDP did cause some surprise, revealing the modest nature of this recovery. Growth was mostly based on private consumption, which increased by 0.7% and exceeded expectations that had already been optimistic. The second contribution in terms of importance for growth came from the accumulation of stocks, which was also higher than expected. The other side of the coin was provided by capital goods investment, which unexpectedly fell. Although this component should pick up in the second quarter, the end of the rising cycle for stock and the slowdown in private consumption point to a relatively flat growth trend throughout 2012.

In the case of Spain, the GDP growth figures for the first quarter are not exactly encouraging. A breakdown of the National Accounts system confirms that the 0.4% fall in GDP in year-on-year terms is particularly due to a large drop in domestic demand, deducting 3.2 points from growth, a figure three tenths of a percentage point higher than that of the previous quarter. All the components of domestic demand are in negative figures.

China's activity figures are weaker than expected.

Spain's spread with Germany for 10-year bonds reaches its highest level since 1995.

German and US bonds are the big winners from the search for safety.

Domestic demand continues to hinder Spain's GDP growth.

Household consumption fell by 0.6% in year-on-year terms, public administration expenditure on final consumption by 5.2% and investment by 8.2%.

In addition to weak domestic demand, there is now a significant slowdown in foreign demand. The economic slowdown of our main trading partners has damaged exports, down 0.9% quarter-on-quarter in the first three months of 2012. But, unlike what happened one quarter ago, this fall was exclusively due to the decline in the services component. Specifically, this fell by 5.0% quarter-on-quarter after two years of continuous increases. The moderation in the number of foreign visitors to Spain largely explains this fall, which is unlikely to change its tone over the coming months.

Controlling the public deficit is crucial to restoring confidence.

Looking to the future, two elements are still crucial: achieving the goals of reducing the public deficit and dispelling doubts regarding the health of the banking sector. In this respect, the revision made by some autonomous communities of their 2011 deficit made it difficult to achieve the first goal. Moreover, the efforts being made to adjust the central government deficit are having a limited impact at present. The hike in direct taxes, the cutbacks in investment, intermediate consumption and wages have helped these items to fall by 1.9 billion euros in the first quarter of 2012. However, this adjustment was totally wiped out by the rise in interest payments and lower revenue from indirect taxes, particularly value added tax (VAT). The cumulative government deficit for this period reached 1.2% of the GDP expected for 2012, a figure that is 4 tenths of a percentage point higher than the one posted for the first quarter of 2011.

The new financial reform does not manage to answer all the questions hovering over the financial system.

On the other hand, investors had to interpret the financial reform announced by Spain's government. Whereas the main aim of February's reform was to raise the level of coverage for problematic real estate portfolios, May's reform has focused on increasing the generic provisions for non-problematic assets from the real estate development and construction sector. The aim of these new provisions is to prepare the financial system to withstand an extremely adverse scenario and thereby dispel doubts regarding its capacity to resist.

Two additional far-reaching measures were also introduced. The first establishes that those institutions not supported by the FROB will have to create asset management companies to which they can transfer their foreclosed real estate assets once the relevant provisions have been made. Secondly, two independent evaluations will be requested of the risk of the financial sector's whole asset portfolio. These evaluations will be supervised by the European Central Bank and the Bank of Spain and their aim is to settle doubts regarding the balance sheets of financial institutions.

They therefore cover important issues related to the institutions' degree of solvency but also generate uncertainty associated with the findings to be presented by the two external evaluators and, if necessary, how the government would tackle the requirement to recapitalize the banking system. This new source of uncertainty has been added to a list that has been growing over the last few months and which must be remedied as soon as possible. To this end, tough decisions will have to be taken which will probably transform the current design of Europe's monetary union. If we truly believe in this, then decisive steps must be taken.

29 May 2012

CHRONOLOGY

2011

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

2012

January	**25**	Social agents sign a **wage moderation agreement** valid from 2012 to 2014.
February	**3**	The government approves a Decree-Law to **sort out the financial sector**.
	10	The government approves a Decree-Law of urgent measures to **reform the labour market.**
March	**2**	Twenty-five European Union countries sign the **Treaty on Stability, Coordination and Governance** to strengthen fiscal discipline.
	14	The Eurogroup approves the financing of **Greece's second adjustment programme**.
	30	The government approves the proposal for its **2012 Budget**, which contains a total adjustment of 27.3 billion euros.
April	**2**	The government approves a **pharmaceutical co-payment scheme for pensioners and a rise in university** fees to cut 10 billion euros from healthcare and education.
May	**11**	The government agrees to **raise provisions for banks' non-problematic real estate assets** to ensure the financial system is robust.

AGENDA

June

4 Registration with Social Security and registered unemployment (May).
6 Industrial production index (April).
Governing Council European Central Bank.
13 CPI (May).
14 EU HICP (May).
15 Labour costs (first quarter).
20 International trade (April).
Fed Open Market Committee.
25 Producer prices (May).
26 Government revenue and expenditure (May).
28 CPI flash estimate (June).
29 Balance of payments (April).
30 Balance of payments (March).

July

3 Registration with Social Security and registered unemployment (June).
5 Governing Council of the European Central Bank.
6 Industrial production index (May).
13 CPI (June).
16 EU HICP (June).
17 Foreign trade (May).
24 Producer prices (June).
27 Labour force survey (second quarter).
US GDP (second quarter).
30 Flash GDP (second quarter). Flash CPI (July).
31 Government revenue and expenditure (June).
Balance of payments (May).
Fed Open Market Committee.

INTERNATIONAL REVIEW

The United States: more consumption than income

The United States maintains its tone of recovery and grows by 2.1%.

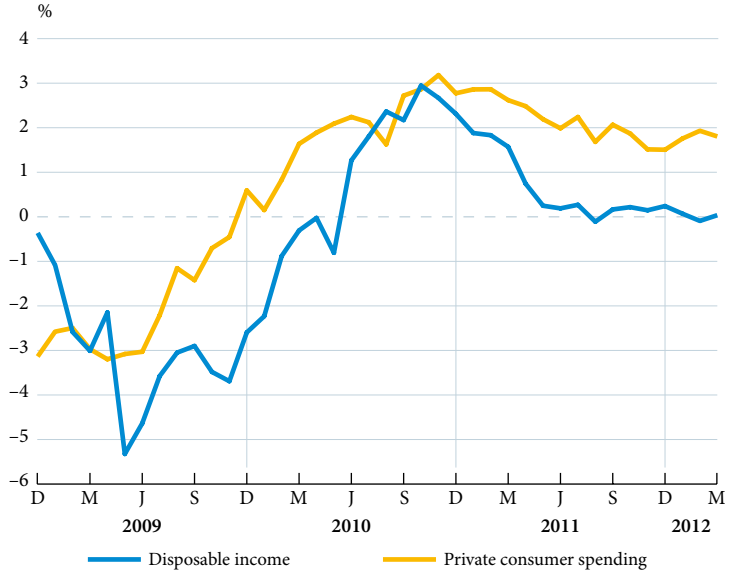
The expansion is consolidating and the downward risks are abating. The Falling oil prices, possible expansionary effects due to the electoral year and the strength of consumption are offsetting the negative consequences that might result from the lack of a credible route map for fiscal consolidation and a potential deterioration in the euro area debt crisis.

Growth is supported by private consumption and stocks but capital goods investment falls.

Gross domestic product (GDP) of the first quarter grew by an expected 0.5% quarter-on-quarter and 2.1% year-on-year. Consequently, a large part of the upswing from the end of last year has remained in place and everything points to an advance slightly over 2.0% for the whole of 2012, more than predicted two months ago. However, the composition of GDP did cause some surprise and underlined the modest nature of the recovery. Growth was mostly based on a private consumption that increased by 0.7% and exceeded even optimists' expectations. The second contribution in terms of importance for growth came from the accumulation of inventories, which was also higher than expected. The other side of the coin was provided by capital goods investment, which unexpectedly fell. Although this component should pick up in the second

THE UNITED STATES: MORE CONSUMPTION AND LESS INCOME

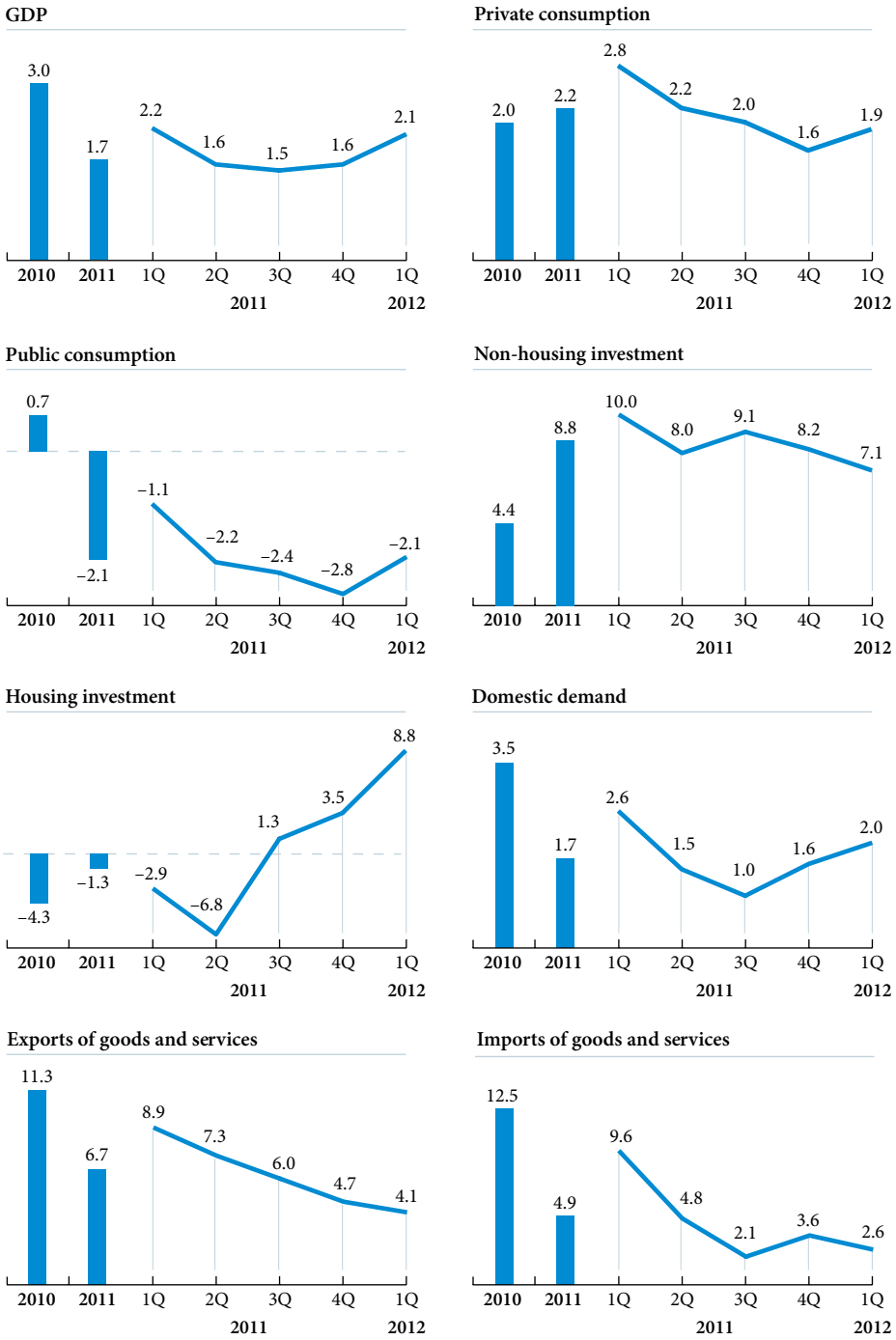
Year-on-year change in consumption and disposable income of households in real terms



SOURCES: Federal Reserve and own calculations.

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Bureau of Economic Analysis and own calculations.

Private consumption exceeds income and savings return to minimum levels.

quarter, the end of the upward cycle for inventories and the slowdown in private consumption point to a relatively flat growth trend throughout 2012.

Private consumption should lose steam in the second quarter because debt and wage rises, which are its main sources, are limited. The boost for the first quarter came from a fall in the savings rate, which fell to 3.9% of disposable income, the lowest for the last four years. Household debt has fallen by 17.3 percentage points in terms of disposable income since September 2007 but, nonetheless, the 112.7% of disposable income of December 2011 seems too high, so the savings rate should rise again above 4.0% of disposable income, with the consequent effect of slowing down consumption.

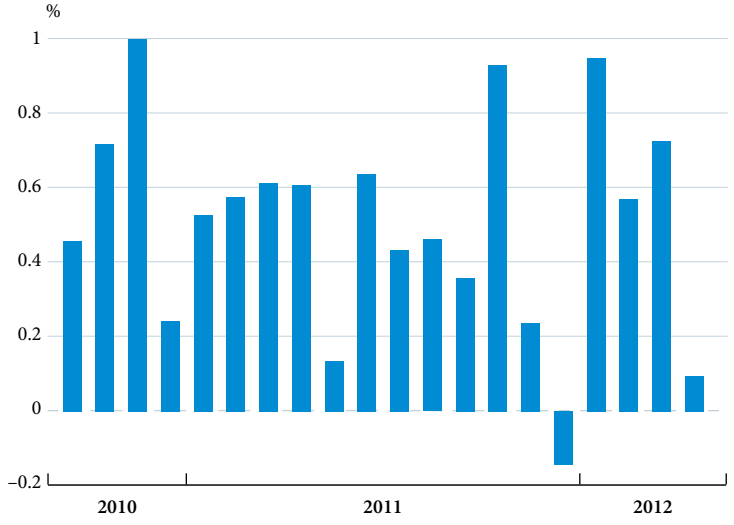
The recovery in the labour market progresses but wage rises will take some time to arrive.

The latest figures for retail trade suggest this is already happening. Excluding the fluctuating figures for cars and petrol, in the first three months of 2012 the average month-on-month growth in retail sales was 0.8%, while in April this hardly reached 0.1%. The slowdown throughout 2012 should be more gradual, however, as part of April's deceleration was due to strong consumption in the first quarter, boosted by an abnormally mild winter. The recovery in the consumer confidence index of April's Conference Board followed a similar pattern, counting two consecutive months of stagnation at a level that is clearly below the historical average.

If the debt option is complicated for consumers, it's the same situation with income. Household disposable income in real terms is practically at a standstill, with a minimal increase of 0.1% year-on-year in March. Households get 64.2% of their income from employment but the trend in the labour market does not indicate much liveliness in wages, in other words household income. In a typical expansion, an increase in employment and the hours worked precedes wage rises but the former is happening slowly and the latter will take

THE UNITED STATES: GOODBYE TO THE CONSUMERIST UPSWING?

Monthly change in retail and consumer goods without cars or petrol



SOURCES: Department of Trade, Datastream and own calculations.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
Real GDP	3.0	1.7	1.6	1.5	1.6	2.1	–
Retail sales	5.5	7.9	7.9	8.5	7.4	6.7	6.4
Consumer confidence (1)	54.5	58.1	61.8	50.3	53.6	67.5	69.2
Industrial production	5.4	4.1	3.6	3.3	4.0	4.3	5.2
Manufacturing (ISM) (1)	57.3	55.2	56.6	52.1	52.4	53.3	54.8
Housing construction	5.7	4.5	–4.9	5.9	25.1	22.1	29.9
Unemployment rate (2)	9.6	9.0	9.0	9.1	8.7	8.3	8.1
Consumer prices	1.6	3.2	3.4	3.8	3.3	2.8	2.3
Trade balance (3)	–500.0	–560.0	–534.0	–537.6	–560.0	–570.8	...
3-month interbank interest rate (1)	0.3	0.3	0.3	0.3	0.5	0.5	0.5
Nominal effective exchange rate (4)	75.4	70.9	69.6	69.8	72.4	72.9	72.8

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.

its time to arrive. 688,000 net jobs were created in the first quarter of the year, a monthly average of 229,000. The 115,000 jobs created in April supposed a return to normality that, as with retail sales, is excessively abrupt in compensation for the strength of the previous months. The cruising speed of job creation should be around halfway, about 175,000 jobs per month, so that a little more than two years would be required to reach the levels of December 2007. The weekly hours worked remained close to the historical average but the fall in under-employment, which includes workers working part-time involuntarily, was interrupted momentarily in April.

The most positive indicator for the labour market is still the unemployment rate, down one tenth of a percentage point to 8.1%, nine tenths of a percentage point below the level of the same period a year ago. However, two thirds of this improvement can be attributed to a drop in the activity rate and only one third to job creation. Most of the forecasts see the unemployment rate remaining unchanged until well into 2013.

Whereas consumption is likely to slow down, the business activity indices of the Institute for Supply Management (ISM) point to capital goods investment rectifying its decline in the first quarter. April's manufacturing ISM index rose to 54.8 points, consistent with robust economic growth. This recovery is also suggested by the services ISM as, although it fell, its level of 53.5 points is suggestive of modest growth but not declines.

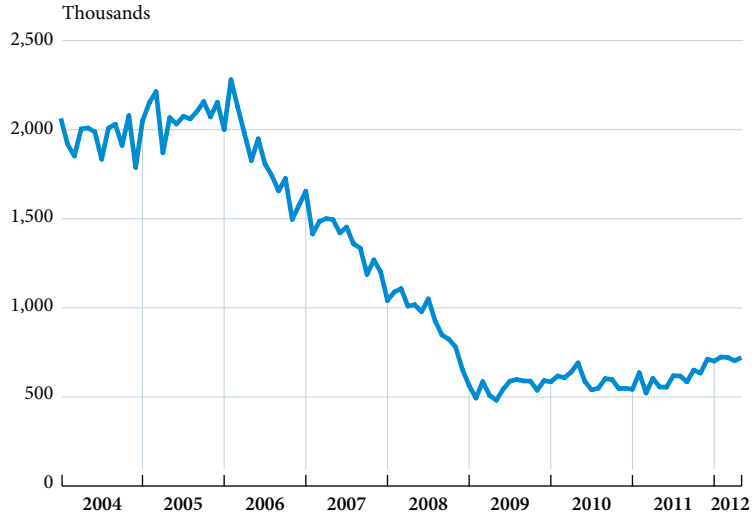
Investment must recover in the second quarter.

Similarly, construction activity over the last few months is looking stronger than expected. The 4.5% quarter-on-quarter growth should continue, given the 717,000 new homes started in April, in annual terms, supposing a year-on-year increase of 29.9%. However, the exceptionally low starting levels mean that its contribution to growth is low and

Construction improves but 12 million households are facing negative equity.

THE UNITED STATES: THE RECOVERY IN CONSTRUCTION, EARLY DAYS

Homes started in annual terms



SOURCES: Department of Commerce and own calculations.

The CPI stands at 2.3% but lower oil prices will push it down.

underlines the fact that the sector has yet to see the light at the end of the tunnel. Oversupply will continue until 2013, although prices might have bottomed out. The Case-Shiller index for second-hand housing in February for the twenty main cities put an end to its series of falls with a slight rise and business sentiment has improved to some extent. However, the sector's true stimulus comes from the Administration being able to achieve the restructuring of the debt of the 12 million homes with an outstanding mortgage worth more than the value of their property.

Stability is the order of the day for prices. The consumer price index (CPI) rose by 2.3% year-on-year in April (2.9% in March) due to the base effects of oil prices. However, the core CPI, which excludes energy and food prices, seems reluctant to confirm its expected slowdown and repeated the 2.3% year-on-year rise of the previous month, supported by an upswing in the price of durables. The balance is being broken and pushed down by oil prices as, if their downward trend continues, the CPI should remain close to 2.0% by the end of 2012. In any case, prices leave room for monetary policy to continue supporting growth.

The trade balance will benefit from cheaper oil in the second quarter.

With regard to the foreign sector, March's trade deficit increased to 51.8 billion dollars, 6.4 billion more than in February, which had been abnormally low due to the Chinese New Year celebrations. Most of the increase is centred on the deterioration in its trade balance with the Asian giant. However, March offered two potentially positive notes. Firstly, exports picked up in spite of weak global demand and the relative strength of the dollar. Secondly, the trade imbalance in nominal terms should adjust over the coming months as the effects of falling crude prices, which accounts for 55.1% of the trade deficit, were not included in March's figures.

Japan: an upswing without a continuing solution

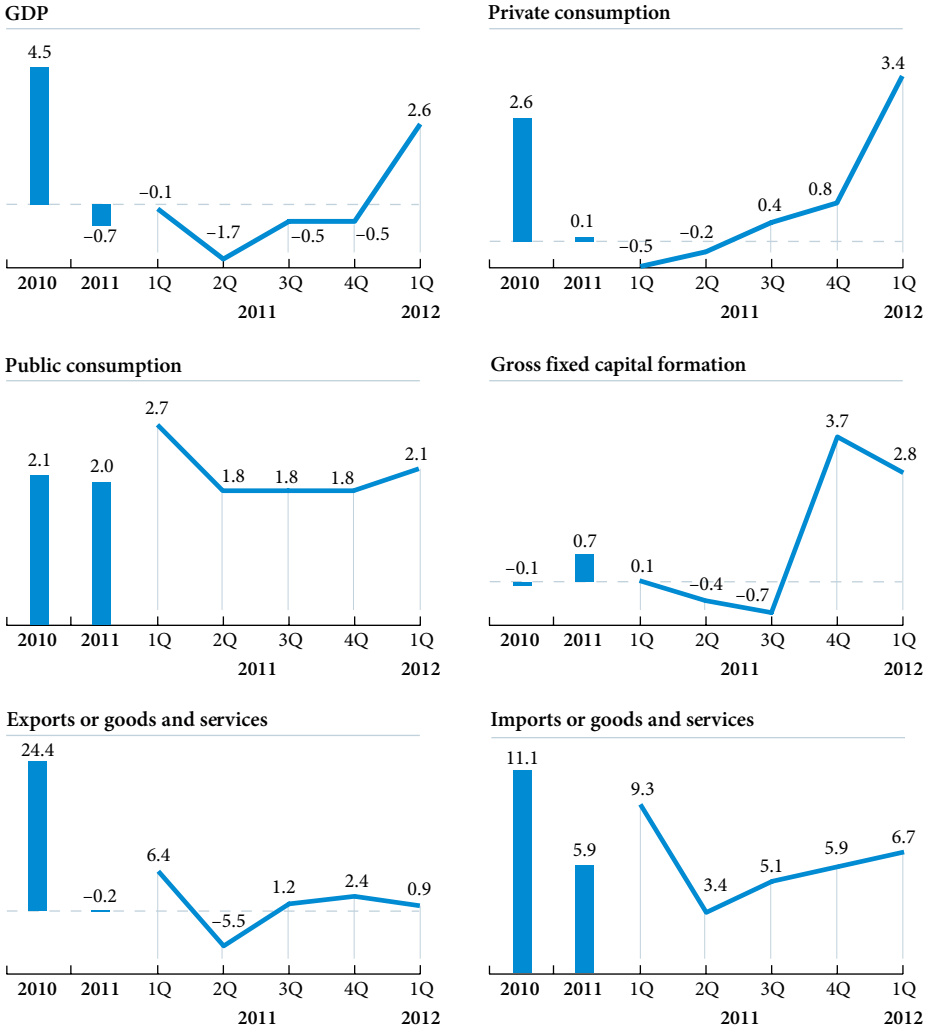
The upswing exceeded expectations with a first quarter GDP that grew by 1.0% quarter-on-quarter and 2.6% year-on-year. This momentarily places Japan at the head of advanced economies in terms of growth. However, the forecast for the whole of 2012 hardly reaches 2.5%, as the composition of the national accounts raises doubts regarding the sustainability of the upswing.

Unusually, the growth of the first quarter was based on private consumption, which grew faster than the rest of the components, on the accumulation of stock and public investment which, in the Japanese economy, is particularly fluctuating. However, capital goods investment fell by 3.9% quarter-on-quarter and showed that, the recovery from the tragedy of March 2011 still has a lot of loose ends, to which we should also add Thailand's floods in summer 2011.

Japan grows by 2.6% in the first quarter thanks to private consumption.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

But the fall in investment and the need for fiscal stimuli raise questions regarding whether this upswing will continue.

Energy deficiencies due to the nuclear stoppage and bottlenecks in production are a spanner in the works for the recovery. This can be seen in industrial production, which in Japan has a greater influence on GDP than in other advanced economies. The industrial production index has regained 82.1% of what was lost in the tsunami and is 2.9% below the level of February 2011, prior to the catastrophe. However, the pace of the recovery has diminished, with March's index being lower than January's level, in line with the deterioration in the investment in national accounts. Similarly, machinery orders, a leading indicator of capital goods investment, fell in March, especially those destined for export.

Demand indicators confirm the boost provided by consumption but confidence retreats.

The latest demand indicators confirm the strength of consumption. March's retail sales rose by 10.3% year-on-year and vehicle registrations in April continued to recover. However, the need for fiscal stimuli for consumption by the public sector, which is the most in debt of the advanced economies, is leading to doubts regarding whether the upswing will continue. Following these expectations, the consumer confidence index fell in April to 40.0 points, somewhat below the level of February 2011.

There are also doubts regarding the momentary halt in the deflationary dynamic. March's CPI rose by 0.4% year-on-year but without the effects of the higher oil prices in the first quarter of the year while core CPI, the general index without energy or food, stalled, accumulating a drop of 0.4% year-on-year. Fuelling this scepticism, Tokyo's prices fell in April. For its part, the trade balance has seen an uninterrupted deficit since October 2011 to March 2012, an accurate reflection of the difficulties in supply and the costs suffered by export firms, particularly those from the consumer electronics sector.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
Real GDP	4.5	–0.7	–1.7	–0.5	–0.5	2.6	–
Retail sales	2.5	–1.2	–1.7	–1.0	0.8	5.2	...
Industrial production	16.6	–2.3	–6.7	–0.6	0.0	2.7	...
Tankan company Index (1)	0.0	–1.3	–9.0	2.0	–4.0	–4.0	–
Housing construction	2.7	2.6	4.6	8.0	–4.8	3.6	...
Unemployment rate (2)	5.1	4.6	4.7	4.4	4.5	4.5	...
Consumer prices	–0.7	–0.3	–0.4	0.1	–0.3	0.3	...
Trade balance (3)	7.9	–1.6	3.4	1.3	–1.6	–3.6	...
3-month interbank interest rate (4)	0.39	0.34	0.34	0.34	0.3	0.3	0.3
Nominal effective exchange rate (5)	106.0	113.5	109.3	115.5	118.6	116.5	113.3

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: INDUSTRIAL PRODUCTION, A RECOVERY AT A STANDSTILL

Industrial production index

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

China: the slowdown has yet to endanger the soft landing

The weakness in most business indicators and the deterioration in the foreign sector during April have surprised most analysts following the Asian giant as they expected a somewhat more moderate slowdown. And although our main scenario still contains a soft landing for the country, these events, together with the possible worsening of the euro area crisis, call for greater forcefulness in monetary and fiscal policy to support growth.

Industrial production exemplifies this slowdown, contrary to what had been suggested by the purchasing managers' index (PMI), which rose for the fifth consecutive month to 53.3 points. Industrial production grew by 9.3% year-on-year in April, below the 11.9% of March and of the consensus forecasts, which had placed it at 12.2%. Similarly, retail sales grew by 14.1% year-on-year in current terms, one point below March's figure and consensus forecasts. For its part, investment in fixed capital for the first four months grew by 20.2% year-on-year, 0.7 points below the cumulative figure up to March.

Slowdown in most activity indicators in April for China.

With regard to exports, these grew by a meagre 4.9% year-on-year compared with March's figure of 8.9%, due to the fragility of advanced economies. The disappointment was even greater for imports, which hardly increased in year-on-year terms (0.3%) and saw a new record drop in monthly terms, placing the trade surplus at 18.4 billion dollars. Weak imports are a consequence of the moderation in foreign demand, as shown by the sharp drop in exports of processing and assembly, although this is also indicative of easing private consumption and investment.

Within this environment of moderate activity and lower risk of overheating (inflation fell slightly to 3.4% compared with the high 6.5% of last July), the executive will have to speed up its policies of monetary relaxation and proactive

Weak imports indicate a weakening both in the foreign sector and consumption and investment.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
Real GDP	10.4	9.2	9.5	9.1	8.9	8.1	–
Industrial production	15.7	13.7	13.9	13.8	12.8	11.6	9.3
Electrical power generation	14.0	10.9	12.0	10.8	8.9	6.5	1.5
Consumer prices	3.3	5.4	5.7	6.2	4.6	3.8	3.4
Trade balance (*)	184	156	172	170	156	160	167
Reference rate (**)	5.81	6.56	6.31	6.56	6.56	6.56	6.56
Renminbi to dollar	6.8	6.5	6.5	6.4	6.4	6.3	6.3

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

Monetary relaxation and proactive fiscal policy are required.

fiscal policies as announced at the last National Congress in March. In particular, we predict further falls in the reserve ratio, which will be added to the recent cut of 50 basis points in mid-May, and more effort devoted to increasing access to credit for small and medium-sized firms. Fiscally, the Chinese government, in addition to continuing with its plan to reinforce welfare benefits, the construction of subsidized housing and improving infrastructures, also aims to stimulate private consumption with lower taxes and subsidies.

In short, given the moderation in most supply and demand indicators, and the weakness in the foreign sector, it is clear that it is still far too soon to talk of changes in the country's growth engines towards domestic consumption and private investment. And as we mentioned last month, we will have to wait and see how the main indicators evolve over the coming months and how the mix of monetary and fiscal policies affect China's economic activity.

Brazil: fruitless stimuli

Brazil's economy is slowing up more than expected.

Of the events occurring recently on the world economic scene, three have significantly affected the current fate of Brazil's economy. On the one hand, the confirmation of China's economic slowdown in the first quarter; on the other, the progress made in correcting commodities markets and, lastly, more intense tensions in the euro area's debt markets are causing a marked upswing in global aversion to risk.

We hardly need mention that China's slowdown and the lukewarm commodities markets are having a significant effect on Brazil's economic activity as they reduce its main foreign market. This would explain, in part, the disappointing growth rate of the Brazilian economy this year so far, as can be seen by leading macroeconomic indicators. Just a few days before the official data from the national accounts confirm this, the latest figure given for the monthly activity index suggests that gross domestic product (GDP) will have fallen by 0.35% in March compared with February, limiting year-on-year growth for the first quarter to little more than 1%, in line with the figure posted in the last quarter of 2011.

These figures, together with the persistent decline in industrial production and the

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
Real GDP	7.6	2.7	3.3	2.2	1.4	...	–
Industrial production	10.6	0.3	0.6	0.2	–1.9	–3.3	...
Consumer confidence (*)	159.7	156.4	155.4	153.2	155.2	164.3	165.0
General unemployment rate (**)	6.7	6.0	6.3	6.0	5.2	5.8	6.0
Consumer prices	5.0	6.6	6.6	7.1	6.7	5.8	5.1
Trade balance (***)	20.1	29.8	25.2	30.5	29.8	29.1	28.1
Interest rate SELIC (%)	10.00	11.79	12.25	12.00	11.00	9.75	9.00
Reales to dollar (*)	1.78	1.63	1.56	1.88	1.86	1.83	1.91

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.

perceptible weakening of employment reveal a clear moderation in Brazil's rate of economic growth. A greater moderation than expected, particularly taking into account the marked expansionary tone of economic policies since last autumn, leading Brazil's own Central Bank to revise downwards its growth forecasts for 2012. Given these circumstances, the Brazilian economic authorities have reacted quickly and have already announced a new package of fiscal stimuli to support demand. This package includes both tax cuts (on financial transactions and vehicle purchases) as well as credit facilities for corporate investment in capital goods and for purchasing automobiles. For its part, the central bank has also hinted that the tax cuts might continue for longer than expected, so that we do not rule out the SELIC rate going below 8% this year.

With regard to exposure to the European turbulences, the real is still one of the most vulnerable currencies to upswings in global risk aversion and, since early May, has already depreciated more than 8% against the dollar and more than 4% against the euro. At the beginning, the authorities did not disapprove of this trend as they considered it to be beneficial for a manufacturing export sector that had been hard hit by the strong real of late. However, Brazil's Central Bank has just intervened, and forcefully, in the exchange markets in order to stop the local currency from depreciating to below the threshold of 2 reais/dollar, a level that seems to be proposed as a new minimal support.

The stimulus tap is still running.

Whether the current scenario of a slowdown and depreciation continues will largely depend on how long it takes to resolve the outbreak of tension regarding the euro area's debt crisis and whether this ends up reducing the confidence of economic agents in Brazil. In any case, we should expect Brazil's authorities to continue making use of stimuli but these might not bear fruit, at least in terms of growth, in 2012 but rather in 2013.

Mexico: a tail wind... but on the alert

In the first quarter of 2012, Mexico's GDP provided a pleasant surprise

The real, at the mercy of global risk aversion.

The Mexican economy advances at a firm pace with 4.6% growth in the first quarter of 2012.

and grew by 1.3% compared with the previous quarter and 4.7% with regard to the same quarter in 2011, posting advances in all branches of activity. The gradual consolidation in consumer confidence, solid growth in credit and the good tone of employment, remittances and wage rises continue to augur good prospects for domestic expenditure over the coming months. However, the latest macroeconomic indicators indicate some moderation.

On the one hand, retail sales grew less than expected in March and less than in February (4.5% in year-on-year terms versus 7.6% the previous month); on the other hand, industrial production fell in February by 1.7% compared with January, in spite of still increasing in year-on-year terms. Similarly, in the foreign area, there is still a risk of worse figures than expected resulting, on the one hand, from the possibility that economic growth in the United States will be less vigorous than expected and, on the other, of continuing excessive financial tension in the euro area.

Given this scenario, the latest communiquè from the Monetary Policy Committee has yet to draw the line under greater lassitude in its policy if circumstances so require. Nonetheless, given a relatively stable domestic expenditure, inflation still above the central goal of the objective range and renewed tension in the world's financial markets, we still don't expect any changes in Banxico's monetary policy in 2012.

Where we do expect changes is in the government. The latest polls continue to point to the PRI winning the elections and give increasingly fewer possibilities to the PAN candidate, the party currently in power. In any case, it is very unlikely that the winner will be able to govern alone, so that pushing forward the pending reforms will require the opposition's support. In this area of reforms, it should be noted that, in April, the government introduced some measures to simplify the tax system, increase revenue and reduce fraud. A step in the right direction but

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
Real GDP	5.6	3.9	3.8	4.2	3.9	4.7	–
Industrial production	6.2	4.0	3.8	3.6	3.7	3.2	...
Consumer confidence (*)	86.3	91.7	90.7	93.7	90.3	94.1	97.2
Leading business index (*)	117.1	117.1	121.0	122.8	123.8	124.4	...
General unemployment rate (**)	5.4	5.2	5.2	5.7	4.8	5.0	4.9
Consumer prices	3.9	3.2	3.3	3.4	3.5	3.9	3.4
Trade balance (***)	–3.0	–1.2	0.0	–1.5	–1.2	–1.3	–1.7
Official Banxico rate (%)	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	12.33	11.90	11.72	13.78	13.94	12.81	13.00

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

the new legislature will have to give more.

Widespread drops among commodities

Oil intensified its correction and, between 20 April and 21 March fell by 10.7%, reaching 109.10 dollars per barrel (Brent quality, for one-month deliveries). Crude was therefore 1.1% above its level at the start of 2012 but 2.1% below its level of a year ago, which will pull down April and May's CPI in most economies.

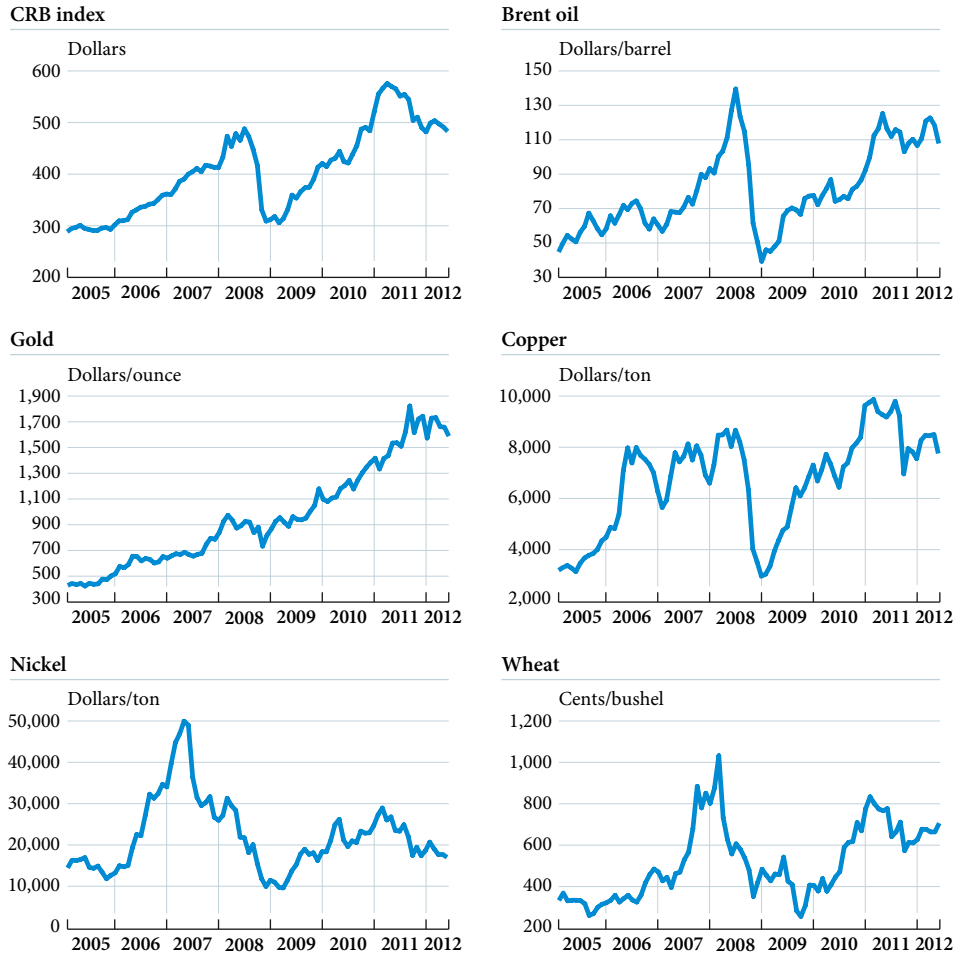
Oil prices confirm that they are following the downward trend due to Saudi Arabia's increased production and the effects on the demand for crude of the euro area's weakness. Its journey along this downward path will keep to 2012, as the long-term trend in supply and demand, particularly in the emerging economies, would support moderate increases in oil prices as from 2013.

The rest of commodities joined crude's downward slide, particularly metals, affected by China's slowdown. The CRB index fell by 1.6% between 20 April and

We still don't expect any changes in the monetary policy.

Oil drops by 10.7% in one month and is still below its level last year.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date May 20).
SOURCES: The Economist, Thomson Reuters Datastream and own calculations.

Drops in the rest of commodities are concentrated in metals, affected by China's slowdown.

21 May and, in the year-to-date, loses everything it had gained up to the start of March. Among metals, of note is the 7.3% fall in iron and 6.6% fall in copper, which has accumulated a loss of 9.7% since its peak at the beginning of March. Aluminium and nickel second the drop.

Even sharper is the correction among precious metals, with large falls in silver, platinum and palladium. Among foods, the trend is uneven, with rises in wheat and falls in sugar. For its part, gold was down a relatively modest 4.1%, standing at 1,590 dollars per ounce.

The rise of the international insurance market

In the last few decades, the world's insurance industry, which already handles around 23 trillion dollars in assets, has undergone an unprecedented expansion. In 2010 it totalled no less than 4.3 trillion in premiums, almost 80% more than in 2000, thanks primarily to the dynamism of the life segment and the growing contribution of emerging markets, whose total premiums increased by more than 150% (in real terms) throughout this period. In 2010 alone, it grew by 11%, with Asia and Latin America contributing the most, up by 19% and 8% respectively, compared with 1.4% in industrialized countries.

Nevertheless, insurance penetration, measured as the ratio of total premiums over gross domestic product (GDP), is still very modest in these emerging markets: 3% compared with 8.7% in advanced countries in 2010. This is also the case of insurance density, measured in premiums per capita: 111 dollars *versus* 3,527 dollars per year in advanced countries in 2010. These figures suggest that there is a huge potential in emerging economies. But which factors might help to realize this potential?

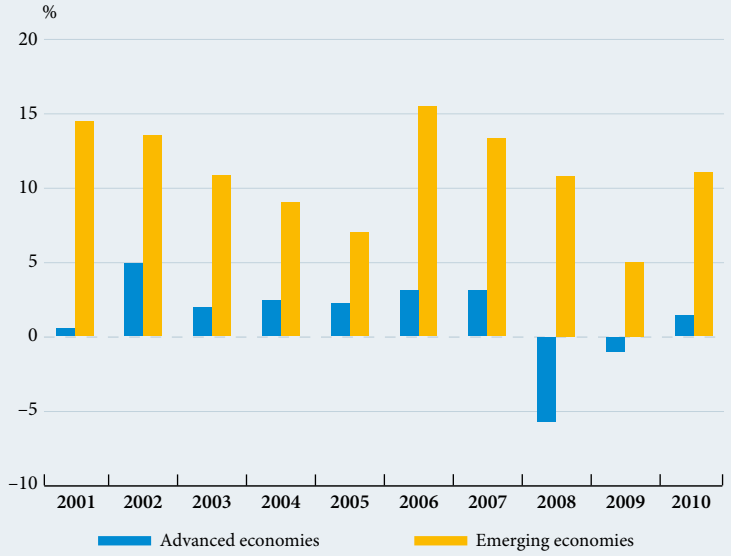
Essentially, the factors fostering insurance market development vary by segment: life versus non-life. However, in general, their development is closely linked to the fundamentals of the real economy and particularly to the average income level. As illustrated in the graph below, the relationship between income and insurance density is markedly positive. The greater the income level, the higher the insurance density. Consequently, it comes as no surprise that, given their fast rate of expansion and their increasing contribution to global growth, emerging economies are also the ones that have most boosted growth in insurance business over the last few years. While their contribution to global GDP has increased from 21% in 2001 to 34% in 2010, their overall share of life premiums has gone from 5% to 14% and non-life from 7% to 16%.

In the non-life segment, the main driving force is definitely economic growth. It has been estimated that a 1% rise in GDP per capita would be associated with a 1.3% rise in insurance density (premiums per capita). Apart from that, institutional quality has also been found to exert a significant influence, particularly contract enforcement. The number of automobiles, population density and the volume of foreign trade also seem to foster thethe development of this segment.[1] Nonetheless, the evidence available for this area is still limited as, to date, the vast majority of the empirical studies have focused on the life segment.

(1) See, for example, Feyen, Lester and Rocha (2011) «What drives the development of the insurance sector?», World Bank Policy Research Working Paper 5572.

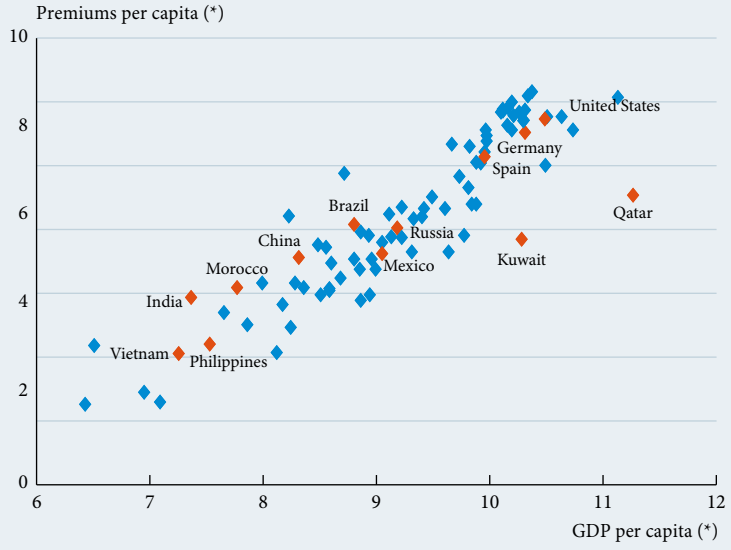
GREATER DYNAMISM IN EMERGING MARKETS

Growth in total insurance premiums



SOURCES: Swiss Re and own calculations.

INSURANCE MARKET DENSITY RELATIVE TO GDP PER CAPITA



NOTE: (*) Insurance premiums per capita and GDP per capita in purchasing power parity, both in logarithms.
SOURCES: Swiss Re, IMF WEO and own calculations.

With regard to the life segment, its progress is also positively and significantly linked to economic prosperity but as from a certain threshold. Its rise requires a minimum level of development that ensures the emergence of a middle class and sufficiently liquid capital markets. It therefore tends to develop later than the non-life branch, when a suitable number of households achieve a reasonable level of income, which is estimated at a GDP per capita of between 5,000 and 8,000 dollars (in dollars from 2007)[2] and regulations and the local capital market have sufficiently matured. From this point on, when it becomes profitable, it usually grows faster than the non-life segment, with an income-elasticity (where income is measured as GDP per capita) estimated at around 2. In other words, a 1% rise in GDP per capita would be associated with growth in premiums per capita of around 2%.

In addition to economic growth and credit market development, progress in the life branch also depends crucially on other elements, including the existence of a public pension system, demographic factors and elements of a cultural or religious nature. A wide-ranging social security system (measured in terms of contributions) tends to lower the demand for life assurance, both because it reduces the need and also because it reduces the level of disposable income after tax and contributions. A longer life expectancy also has a negative effect on the demand for life assurance, which suggests there is less demand for life insurance when there is less likelihood of a premature death. A larger proportion of Muslims in the population also reduces the demand for life insurance. This relationship can be explained by the fact that, in some Islamic countries, life insurance is seen as not compliant with Sharia law. Life insurance is also less in demand with a higher rate of inflation, since a highly inflationary environment reduces the value of life policies. On the other hand, it has been observed that a larger population pushes up demand for life insurance, reflecting the positive effect of a larger client base, which facilitates risk pooling and economies of scale.

In short, the findings suggest there is some margin to speed up the development of the insurance sector from the institutional sphere: by promoting a solid economic environment and lower inflation; establishing a robust legal framework; encouraging the development of credit and capital markets; and by liberalizing the insurance market to enhance competition and productivity. On the other hand, insurance firms can also boost their penetration in emerging markets by diversifying their distribution channels, reaching a broader section of the population (there is a lot of room for exploitation in the bankassurance business in particular); innovating in products (as already done with new insurance policies against climate risks for agriculture or micro-insurance) or by adapting them to the cultural and religious background of each country (such as Takaful products, adapted to be compliant with Islamic Sharia law).

On balance, development in the insurance sector can bring about substantial benefits: it reduces the uncertainty and impact of large losses, allows risk to be managed more efficiently, supports commercial activity and thereby fosters investment, innovation and competition. In short, it constitutes a fundamental pillar in a country's financial and economic development, so that it is really worth laying the foundations to promote its growth and sustainability.

(2) See Lester (2009), «Introduction to the Insurance industry», Primer Series on Insurance Issue 1, The World Bank.

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EUROPEAN UNION

The Euro area: remaining in a zone of turmoil

Two political events, due to the elections in France and Greece, will have important economic repercussions over the coming months. Firstly, the recently invested president of France, François Hollande, met with the German chancellor, Angela Merkel, to agree the new European mantra: austerity with growth. The aim is to curb cuts in order to avoid the risk of economic activity contracting, which would jeopardise the financial viability of member states.

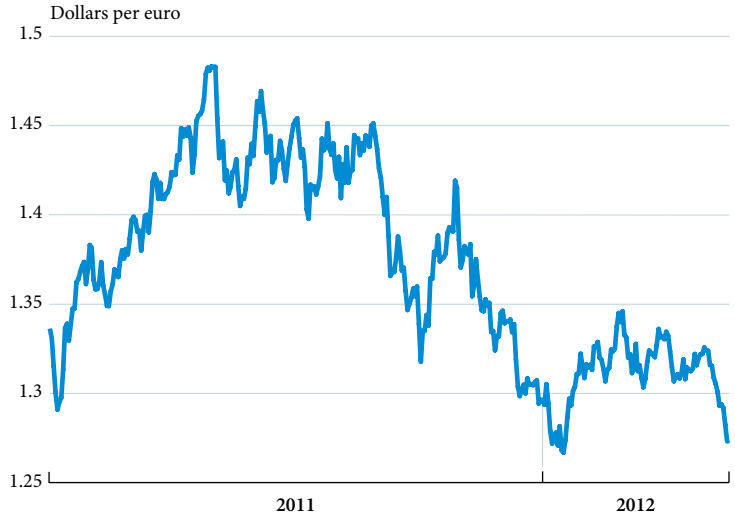
For the moment, no specific measure has been announced that helps to formalize the new European consensus and move towards solving the crisis that is gripping Europe. However, some members of the European Commission, such as the European Commissioner for Economic and Monetary Affairs and the Euro, Olli Rehn, has shown themselves to be in favour of encouraging public investment in key areas. In this respect, the structural and cohesion funds, together with reinforcement from the European Investment Bank, might serve to implement this policy without violating the fiscal compact.

Secondly, Greece's elections resulted in a split parliament. Due to their differences on the financial bail-out plan, the Greek parties were incapable of coming to an agreement to form a government and

The new European mantra is austerity with growth.

UNCERTAINTY REGARDING GREECE TAKES ITS TOLL ON THE EURO

Euro-dollar exchange rate



SOURCE: Bloomberg.

Growth in Germany stops the euro area from entering into recession.

new elections are to be held on 17 June. Given that the polls favour the parties that reject the current bail-out conditions, some European economic specialists have reflected on the possibility of Greece leaving the euro. To date, the official position of the European Union is that the Greek republic will remain in the euro area, although the final decision of whether to leave the single currency will be down to the Greeks themselves.

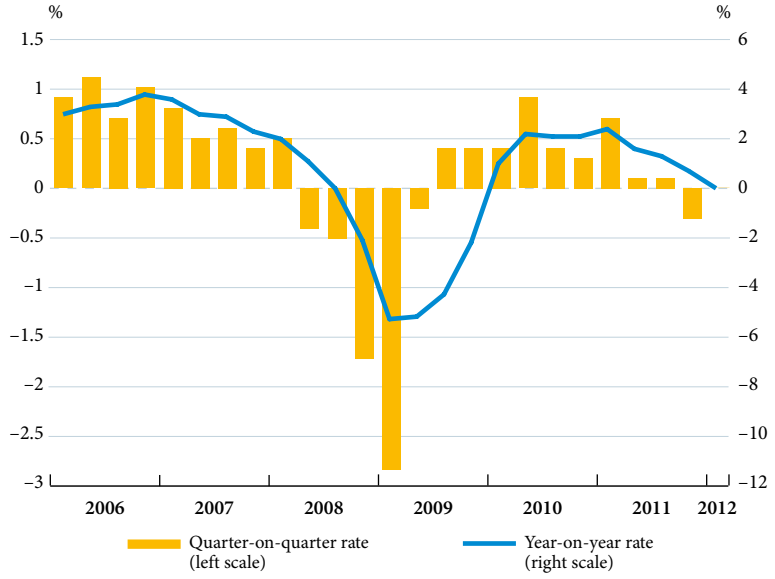
In short, the announcement of the date of the elections has not extinguished the hotspots in the financial markets. Rumours and denials, normal in all confused situations, are also combined with an absence of effective leadership and continue to cause turmoil that is difficult for the European economy to digest.

Given the political and economic uncertainty, deposits are leaving Greek banks as a precautionary measure, which ultimately increases the fragility of the whole system. At the same time, the doubts of international investors as to whether Greece is the only country that might leave the euro increased the pressure on the rest of the Member states. Moreover, the nationalization of Spain's fourth largest bank created uncertainty regarding the state of the country's financial system and the government's capacity to restructure its bank sector, if necessary. Both circumstances have caused the latest financial turbulences in Europe.

The evident risk is that, should this uncertainty continue over several months, it might harm economic activity. And the latest figures on gross domestic product (GDP) for the first quarter are not particularly encouraging either. Economic activity remained at a standstill in the first quarter, as GDP had zero quarter-on-quarter growth.

EUROPE'S ENGINE CATCHES A COLD

Change in GDP



SOURCE: Eurostat.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
GDP	1.9	1.5	1.6	1.3	0.7	0.0	–
Retail sales	0.9	–0.6	–0.5	–0.5	–1.3	–1.0	...
Consumer confidence (1)	–14.2	–14.6	–10.7	–15.9	–20.6	–20.0	–19.9
Industrial production	7.4	4.7	4.0	3.9	–0.1	–1.9	...
Economic sentiment indicator (1)	100.5	101.0	105.2	98.4	93.6	94.1	92.8
Unemployment rate (2)	10.1	10.2	10.0	10.2	10.5	10.8	...
Consumer prices	1.6	2.7	2.8	2.7	2.9	2.7	2.6
Trade balance (3)	4.6	–19.6	–16.9	–22.1	–19.6	2.8	...
3-month Euribor interest rate (%)	0.8	1.4	1.4	1.6	1.5	1.0	0.8
Nominal effective euro exchange rate (4)	103.7	103.4	105.2	103.5	102.1	99.5	99.5

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.

The economy therefore avoided going into recession after the 0.3% decrease recorded in the fourth quarter last year. Strong GDP growth in Germany (0.5%) was hindered by zero growth in France (0.0%) and falls in Spain (–0.3%) and Italy (–0.8%). In other words, Germany's strong growth avoided the recession in the euro area. However, a clear slowdown in economic activity can now be seen, as reflected in the year-on-year rate, down 0.7% to 0.0%.

From the point of view of demand, March's retail and consumer goods figures reported month-on-month growth of 0.3%. With this rise, the year-on-year rate improved from –2.1% to –0.2%. However, retail sales are the perfect reflection of Europe's economic situation with vast discrepancies between the weakness of the peripheral countries and the strength of the central states. Germany and France posted month-on-month growth of 0.8% and 0.9% respectively, while Spain posted a fall of –0.5% and Portugal –2.2%.

However, European consumer confidence, standing at –19.9 points in April, remains below its historical average and even worsened compared with the figure for March, namely –19.1 points. There are two factors that are holding back the recovery in household consumption, hindered by the lack of confidence. The first is the weakness of the labour market, posting a further increase in the unemployment rate in the month of March to 10.9% and producing the highest unemployment rate for the last fifteen years.

The weakness of the labour market and political uncertainty do not augur a recovery in consumption.

The second factor is political uncertainty regarding the outcome of the future Greek elections. Both factors are increasing uncertainty and this is very likely to make households reluctant to consume over the coming months.

Fiscal austerity plans are stopping public spending from boosting the economic recovery. However, the component of net exports continues to contribute positively to GDP growth. The trade balance figures

Exports continue to contribute to the growth of the euro area.

Industrial production in the euro area continues to contract.

for March reported a surplus of 4.3 billion euros compared with the previous figure 4 billion. Imports dropped by 1.1% month-on-month while exports shrank by 0.9% month-on-month. By country, of note is the large German trade surplus of 10.5 billion euros.

From the point of view of supply, the euro area's industrial production fell by 0.3% month-on-month in March, increasing the fall in the annual indicator from –1.5% to –2.2%. In spite of Germany's 1.3% month-on-month rise in industrial production, this was not able to offset the falls in France, –1.8%, and Spain, –0.9%. By subsector, the largest drop was in the energy sector, with a month-on-month decline of 8.5%. Unfortunately, the business confidence figure, which fell again in April, does not indicate any upswing in industrial activity over the coming months.

Inflation is under control.

One of the consequences of the lack of activity in Europe can be seen in the lower rise in prices. April's consumer price index increased by 2.6% year-on-year, one tenth of a percentage point lower than the figure for the previous month, as suggested by the preliminary data. For its part, core inflation, excluding the most volatile components of food and energy, remains at 1.6%. The most inflationary items in April were clothing and footwear, energy for transportation and electricity. Inflation is approaching the forecast by the European Central Bank (ECB), which estimates that it will end up close to 2.3% by the end of the year. However, the fall in oil prices, started in April and speeding up in May, might be partially offset by the euro's depreciation due to the latest turmoil. Nonetheless, inflation will continue to fall over the next few months.

In May, Germany's leading indicators post an abrupt fall, affected by Europe's uncertainty.

In short, the lack of resolution for the Greek situation and its impact on the financial markets continues to grip economic agents and is leading to consumption and investment decisions being put off. Last year, vacillation in the euro area's political management proved to be the economy's worst enemy. In terms of the future economic trend, it is important to avoid a repeat of the hesitation in taking decisions and to commit to definitive solutions for a financial crisis that has already gone on for five years, since its beginnings in the summer of 2007.

GDP provides a pleasant surprise in the first quarter in Germany

The GDP figures for the first quarter confirm that the decline in activity in the fourth quarter of 2011 was a temporary bad patch and that the German engine has started to move ahead again. In fact, the 0.5% quarter-on-quarter growth exceeded expectations and placed the year-on-year rate of change at 1.2%, nevertheless a sign of a slowing trend. In May many opinion indicators, such as the ZEW and Ifo, recorded an abrupt fall, affected by the intensification of the uncertain climate in the euro area. We have therefore raised our average growth forecast for the year only slightly to 0.6% in 2012 as a whole.

The rise in GDP in the first quarter was particularly helped by the foreign sector. In fact, the 1.7% increase quarter-on-quarter in exports, due especially to demand from the emerging countries, and stagnated imports led to a contribution of 0.9 points to the quarter-on-quarter expansion. Also private consumption, which rose by 0.4% in the quarter, provided a positive contribution. However, investment, both of capital goods and construction, which suffered from the bad weather in February, saw a drop.

Regarding the second quarter, the outlook for consumption is quite favourable, supported by the expectation of a rise in disposable income and in the level of employment. In fact, the labour market continues to perform well. In the first quarter employment was 1.5% above the level for a year earlier, while the number of unemployed people fell. Both the greater flexibility achieved after the labour reforms and the moderate behaviour of wages have boosted the labour market.

In fact, there are even signs of unfilled job vacancies in some branches. For this reason, in mid-May the German government passed another law to help qualified immigrants from other countries in the European Union enter the country by creating the so-called «blue card».

From the point of view of supply, industrial production rose in March and posted a 2.2% increase in orders, improving the outlook. The euro's recent depreciation might also act as a boost for the sector. With regard to construction, February's slump due to the bad weather picked up again in March. Orders increased by 10.0% in February compared with twelve months before and in real terms, a sign of a favourable trend in the future.

Although it's true that the increase in German imports helps to reduce current account deficits with its EU partners and boosts growth, more voices have started to be heard pointing to its insufficiency and suggesting that more stimuli might be needed for German growth. Higher wage increases have therefore been proposed. Moreover, the relative defeat of the Christian Democrat party in the regional elections of North Rhine-Westphalia could be put down to the government's austerity policy. In spite of these signs, no clear change in direction for economic policy can be seen.

Some of the new elements in the proposed budget for 2013 approved by the government in May are the reduction in the obligation to conserve tax and accounting documentation from ten to eight years, extendable to seven in the future. It is calculated that firms will save 1.7 billion euros in the first phase of this new measure. On the other hand, the tax

The favourable performance by the labour market and the rise in disposable income continue to support private consumption.

Germany's 2013 budget reduces the bureaucratic burden for firms but does not show any clear change in direction to stimulate growth.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
GDP	3.6	3.1	2.9	2.7	2.0	1.2	–
Retail sales	1.5	1.2	2.4	0.9	0.7	2.5	...
Industrial production	10.0	8.0	7.9	8.2	3.5	1.0	...
Industrial activity index (Ifo) (*)	107.8	111.3	114.1	109.7	106.9	109.3	109.9
Unemployment rate (**)	7.1	5.9	6.0	5.8	5.6	5.6	...
Consumer prices	1.1	2.3	2.3	2.4	2.4	2.1	2.1
Trade balance (***)	154.9	158.1	158.7	159.0	158.1	162.8	...

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

France's economic climate cools down in May due to the rise in economic uncertainty.

regime for electric cars has also been improved, with deductions on the cost of batteries, to boost their development.

After stagnation, a change of scene for French economic policy?

France's statistics institute confirmed the French economy's stagnation in the first quarter and the year-on-year rate of change stood at 0.3%. In April, the economic climate indicator worsened and, in May, most leading indicators showed this decline getting worse, affected by the economic uncertainty, particularly due to the euro area crisis. The economy is therefore likely to continue slowing down in the second quarter or even decline slightly. We have kept to our forecast of 0.1% growth for the whole of the year.

French manufacturing entrepreneurs expect investment to grow by 6% this year.

However, the formation of a new government in May after the victory of the presidential candidate from the socialist party, François Hollande, more inclined towards relaunching the economy, could lead us to revise our forecast upwards. However, the outcome of June's legislative elections will affect economic policymaking. On the other hand, François Hollande agrees with the targets to reduce the public deficit in the long term, albeit with the proviso that these won't be reached unless the economy grows sufficiently. The problem is that there is little room to manoeuvre due to the existing conditioning factors.

Returning to the GDP figures for the first quarter, the zero quarter-on-quarter growth was due to the negative contribution of one tenth of a percentage point by the foreign sector, offset by a contribution by domestic demand of equal size but in the opposite direction. The component that increased the most quarter-on-quarter was public consumption, which speeded up before the presidential elections and rose by 0.5%. Private consumption increased more moderately, by 0.2%, while investment fell notably.

Within this context, employment in the private non-agrarian sector increased slightly by 0.1% in the first quarter after two consecutive quarters of job losses, standing at the same level as a year earlier. On the other hand, inflation started to fall again in April, reaching 2.1% year-on-

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
GDP	1.6	1.7	1.7	1.5	1.2	0.3	–
Domestic consumption	1.7	0.9	1.3	–0.9	–0.3	–3.3	...
Industrial production	4.6	2.5	1.9	2.9	0.5	–1.3	...
Unemployment rate (*)	9.8	9.7	9.6	9.7	9.8	10.0	...
Consumer prices	1.5	2.1	2.1	2.1	2.4	2.3	2.1
Trade balance (**)	–52.3	–70.7	–65.5	–69.8	–70.7	–68.6	...

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

year. In this way, consumer confidence picked up slightly in April but is still slightly below its normal level. With regard to investment, in the second quarter industrial capacity utilization relaxed to some extent and sharpened its deviation from the historical average. In April, manufacturing entrepreneurs revised downwards by one point the increase in their expansion expected for 2012 to 6%, compared with January's previous surveys.

From the point of view of supply, the panorama is similar. Manufacturing production was up by 1.4% month-on-month in March after contracting in February. Orders rose by 1.6% in the first quarter compared with the three previous months and posted a 0.7% increase year-on-year. In April the activity of the secondary sector looked rather stable, as the decline in automobiles, metallurgy and rubber was offset by the progress made in other branches. With regard to construction, demand for new homes weakened in April to a level considerably below the long-term average.

With regard to the risk premium for French sovereign bonds compared with German bonds at ten years, on 17 March this reached an annual peak at 153 basis points but was below the record of 189 points recorded in November 2011, and at the end of the fourth week in May fell back to a lower level on the eve of the presidential elections, which was also lower than at the start of the year, in spite of tensions in the euro area. On 24 May, Moody's decided to keep its top rating for French sovereign debt although it still gave it a «negative outlook» due to the euro area's difficult economic climate.

Regarding companies, their number increased by 0.8% in the period of February-April compared with the same period the previous year, indicating that the French economy is fundamentally strong. On the other hand, credit to non-financial firms continued to slow up in March, with a year-on-year rise of 4.0%.

Moody's keeps its top rating for French sovereign debt but with a negative outlook.

The recession gets deeper in Italy

As was expected, Italy saw a considerable drop in its GDP in the first quarter, namely 0.8%, higher than the one recorded in the last two quarters. This suggests that the recession is biting deeper and shows just how deep. The year-on-year rate of change in GDP therefore fell to –1.3%. This contraction in the level of the activity can be explained by the effect of rigorous budget policies, financial tensions and the world economic slowdown. In spring, leading indicators continue to get worse. We have not varied our forecast of a 1.5% drop in GDP for the whole of 2012.

In spring, Italy's leading indicators continue to get worse.

Consumption, affected by less disposable income, the bad performance of the labour market and continuing inflation, looks weak. April's automobile sales recorded a drop of 18.0% compared with the same month last year. Consumer confidence continued to fall in May to its lowest level for the last few decades. In fact, employment fell by 0.2% in March, seasonally adjusted, compared with February and showed a year-on-year decrease of 0.4%. At the same time, the unemployment rate rose to 9.8% and the number of unemployed increased by 23.4% compared with twelve months before. For its part, inflation held steady at 3.3% in April for the third consecutive month, due partly to tax hikes and higher official prices.

Italy's consumer confidence slumps to its lowest for the last few decades.

However, not everything is negative. Over the last three months up to April, exports to countries outside the European Union posted a rise of 2.6% compared with the three previous months, while imports

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
GDP	1.8	0.5	1.0	0.4	–0.4	–1.3	–
Retail sales	0.1	–1.1	–0.4	–1.5	–2.0	...	...
Industrial production	6.7	0.2	1.9	–0.3	–3.1	–5.2	...
Unemployment rate (*)	8.4	8.5	8.2	8.4	9.1	9.6	...
Consumer prices	1.5	2.7	2.6	2.8	3.4	3.3	3.3
Trade balance (**)	–30.0	–24.6	–34.1	–32.1	–24.6	–14.9	...

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

The foreign sector offsets the slump in domestic demand but only partially.

only rose by 0.5%. Similarly, in April sales to non-EU countries were up 2.3% on the same month in 2011, compared with a fall of 8.1% in purchases from this group of countries. It therefore seems as if the foreign sector will be able to continue compensating, albeit only partially, the slump in domestic demand.

From the point of view of supply, of note is the fall in industrial production in the first quarter. However, in March industrial orders were up 3.5% month-on-month, although they were 14.3% lower than twelve months before. The deterioration in confidence in the secondary and tertiary sector in April did not leave much room for optimism in the short-term from the point of view of supply either. However, the already approved structural reforms, such as liberalizations and administrative simplification, as well as the proposed changes such as labour reform, will noticeably improve the Italian economy's growth potential.

On the other hand, in mid-May the differential between yields of Italian and German sovereign bonds at ten years came close to 450 basis points a relatively high level, affected by contagion from the Greek crisis. However, this then fell again slightly. In any case, this level is slightly lower than the 530 basis points recorded in January and the record of 550 reached in November 2011. This improvement is due to the market acknowledging the government's budget consolidation measures, presided over by Mario Monti, although also to intervention by the European Central Bank.

The United Kingdom enters into recession.

The United Kingdom: readjustment in the economy

The United Kingdom is continuing its delicate balancing act between declining public and private consumption and stimulating investment and exports and drivers of growth. This process is slow and painful, as highlighted by the figures for gross domestic product (GDP) for the first quarter of 2012. This fell by 0.2% quarter-on-quarter and is the second consecutive quarter of negative growth, because the fourth quarter last year recorded a fall of 0.3%. The economy of the United Kingdom has therefore technically entered recession, although the year-on-year growth rate for GDP has yet to enter negative terrain, standing as it does at 0.0%.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012	
			2Q	3Q	4Q	1Q	April
GDP	2.1	0.7	0.4	0.3	0.5	0.0	–
Retail sales	–0.3	0.7	0.4	–0.5	1.2	1.9	–1.1
Industrial production	1.9	–1.2	–1.4	–1.6	–2.9	–3.0	...
Unemployment rate (1)	4.5	4.7	4.6	4.8	4.9	4.9	4.9
Consumer prices	3.3	4.5	4.4	4.7	4.7	3.5	3.0
Trade balance (2)	–96.3	–101.1	–98.7	–100.7	–101.1	–101.0	...
3-month Libor interest rate (3)	0.7	0.9	0.8	0.9	1.0	1.1	1.0
Nominal effective pound exchange rate (4)	80.4	78.4	78.6	77.1	79.4	80.4	81.5

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.

There is no breakdown available of the GDP figures by item of expenditure but there is one by economic sector. Although the data are preliminary and subject to revision, it seems that the construction industry was the main culprit in this fall, down 3.0% quarter-on-quarter, its largest drop since the first quarter of 2009. Manufacturing shrank by 0.1% while services grew by a slight 0.1%, boosted by the sector of transportation, storage and communication.

From the point of view of demand, household consumption is still weak, as shown by the figures for retail and consumer goods in April, down 2.3% month-on-month and taking the year-on-year rate to 0.4%, this being the lowest growth since January 2010. As well as households being careful with their spending there is an additional factor as sales were hindered by the rain, with April registering the largest rainfall for the month since records began in 1910, according to the country's meteorological office. This factor affected purchases of clothes and petrol, down 5.2% and 3.4% in year-on-year terms, respectively.

Part of the lethargy in household consumption can be explained by the weak labour market and the deterioration in disposable income for households, as wages are still growing less than inflation and have been for the last four years. Fortunately, the latest inflation figures have been positive insofar as April's consumer price index slowed up, reaching 3.0%, with the previous month recording a rate of 3.5%. We must remember that inflation peaked in the United Kingdom at 5.2% September last year due to the higher energy prices and hikes in indirect taxes. The price index should therefore fall over time due to base effects. The very weakness in demand should also help as it eliminates part of the price fixation power of firms, which need to give discounts and special offers to avoid a greater fall in sales.

The central government is continuing with its austerity programme, as highlighted by the fiscal deficit figures

Leading indicators point to a moderate improvement in economic activity.

In emerging Europe, while Poland and Slovakia are handling the crisis better, Hungary, the Czech Republic and Romania are suffering more.

in April, the start of the tax year in the United Kingdom. Specifically, the deficit stood at 16.5 billion pounds sterling when experts expected this to be higher than 20 billion pounds. The target for the tax year, according to the country's budget, is a deficit of 6.4% of GDP.

From the point of view of supply, industrial production contracted in April by 0.3% month-on-month and –2.6% year-on-year. However, it's interesting to note the data from the purchasing managers' indices (PMI) both for construction and services, which are at 55.8 and 53.3 points. In both cases they have been above 50 points since the start of the year, a level that indicates expansion of the sector. These data on the economic situation point to moderate growth and suggest that the GDP figures for the first quarter might be revised upwards.

In short, the economy of the United Kingdom has fallen back into recession and the Bank of England itself predicts that second quarter GDP will fall slightly due to the holding of the Diamond Jubilee celebrations for Queen Elisabeth II. Nevertheless, the Olympic Games will boost economic activity in the third quarter. However, as we are reminded by the International Monetary Fund in its annual report on the United Kingdom, although the economy is expected to consolidate as the year passes, the risks are still markedly downwards.

Greater falls in GDP than expected in the first quarter in Hungary and the Czech Republic.

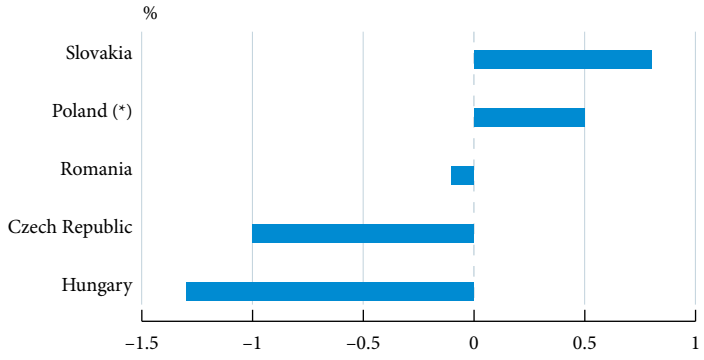
Emerging Europe: at two speeds

As the year advances, it seems to confirm that the EU economies of emerging Europe are moving at two speeds, as is also the case of the European Union as a whole. Focusing on the five countries we usually review in this report (Poland, Slovakia, Hungary, Romania and the Czech Republic), the first two are keeping up a slightly faster pace in activity than the last three.

In fact, with the data of National Accounts system for the first quarter now available, it has been confirmed that Romania has entered into recession, this being defined as two consecutive quarters of quarter-on-quarter falls in gross domestic product (GDP), as its economy shrank by 0.1% in the first three months of 2012 (in the fourth quarter, the fall was 0.2%). The Czech Republic, for its part, has been in this sad state since the third

NOTABLE GROWTH DIFFERENCES IN EMERGING EUROPE

Quarter-on-quarter change in real GDP, first quarter of 2012



NOTE: (*) Own forecast.
SOURCES: Eurostat and own calculations.

quarter of 2011. Nonetheless, we should note that its rate of descent had been minimal, 0.1% in the third and fourth quarter of 2011, until this got slightly worse in the first quarter of 2012, when the economy shrank by 1% quarter-on-quarter. Lastly Hungary, after not growing in the fourth quarter, posted the worst growth figures of the European Union, with a quarter-on-quarter decline of 1.3%.

As we already mentioned, on the positive side we find Poland and Slovakia. Although we still don't have the growth figures for Poland, monthly activity indicators point to GDP possibly having grown by 0.5% in the first quarter. Slovakia, for its part, came as a pleasant surprise with a 0.8% increase in these first three months of the year (an identical figure to the one recorded in the last quarter of 2011).

By way of summary, and lacking details on the components, it can be noted that those economies in recession or almost in recession tend to combine weak domestic demand, procyclical fiscal policy and an appreciable decline in exports. Poland and Slovakia are practically in the opposite situation, with a more relaxed fiscal policy and a more appreciably dynamic domestic demand (particularly in the Polish case).

What can be expected for the rest of the year? These figures, worse than expected in the case of the Czech Republic and Hungary and better than predicted for Slovakia, without essentially altering the scenario we hold for 2012, have forced us to revise somewhat the cases mentioned. In the Czech Republic, the breakdown of supply components, which is available, provides us with a clue as to the sector that has individually pushed down the forecasts, namely finance. Although there were signs that the financial pressures seen since last November had affected the generation of added value in the sector, the drop exceeded expectations. Nevertheless, we believe that, as suggested by the figures on industrial activity, the stamina being displayed by German demand will be a positive factor in the second quarter. In short, we have revised slightly downwards our growth forecast for 2012, from 0.4% to 0.2%.

With regard to Hungary, the toll taken on growth for the whole of the year by a weaker first quarter than expected means that the annual forecast must be revised downwards, from a drop of 0.4% to one of 1.0%. Lastly, and in the opposite direction, the unexpectedly good figures for the first quarter from Slovakia suggest that it might end the year above the 1.4% we had predicted to date. Although it's difficult to imagine equally intensive quarter-on-quarter growth as that of the last two quarters, the current inertia should help annual growth to reach around 1.6%. For Romania and Poland we keep to our forecasts, with annual growth of 1.1% and 2.5%, respectively.

The main risks to these forecasts coming about are almost exclusive to how the euro area's dual crisis develops, namely economic and financial. Should the recession in the euro area not end by the last quarter of the year, as we predict, or should the situation of financial stress increase slightly (to date, with the exception of Hungary and Romania, the region has remained relatively isolated from events in the peripheral countries of the euro area), the remaining four countries (not including Poland) would probably slide towards the recessionary zone (or deeper recession in the case of Hungary).

Slovakia comes as a pleasant surprise and Poland is expected to resist without too much difficulty.

The 2012 growth forecasts for Hungary and the Czech Republic are revised downwards, and upwards in the Slovak case.

The main risk is still the cycle of weakness deteriorating, due to a worsening of the euro area crisis.

Mitigating the risk of natural disasters to promote stability

There are two faces to natural disasters and neither of them is friendly. On the one hand is the bitterest face, the one that is irretrievable, none other than the loss of human life. To get an idea of the extent of this drama, we only need to remember that, between 1970 and 2010, natural disasters took away the lives of 3.3 million people.[1] Then there are the material losses which, although costly, can be recovered in the medium and long term. Over the same period of time, it's estimated that nature has caused damage to the tune of 3.2 billion dollars (more than 20% of the United States' nominal GDP).

The economic impact of a natural disaster, as well as the effort involved in the subsequent recovery work, differs substantially depending on whether it has occurred in a developing or a wealthy country. In general, the impact on emerging countries is much more negative. However, developing countries are only covered by some kind of insurance for 3% of their potential losses, compared with 45% in more industrialized countries.

INCREASE IN THE FREQUENCY AND COST OF NATURAL DISASTERS

		Loss	Insured Loss	Uninsured Loss	
		Billion dollars	% Loss	% GDP	% Public budget
Earthquake *Marmara (1999)*	Turkey	22.0	5%	5%	21%
Hurricane *Katrina (2005)*	USA	1,380	49%	0.5%	1.5%
Floods *(1997)*	Poland	3.5	6%	3%	11%
Earthquake *Gujart/Bhuj (2001)*	India	0.6	2%	1%	7%
Earthquake *Northridge (1992)*	USA	43.0	47%	0.3%	2%
Earthquake *Sichuan (2008)*	China	85.0	0.4%	1.8%	15%
Hurricane and floods *(1999)*	France	6.2	100%	–	–

SOURCE: World Bank, MultiCat Program, October 2010.

In August 2005, hurricane Katrina battered the south and centre of the United States, producing a huge amount of damage in Florida, Louisiana and Mississippi. In spite of its seriousness, this disaster hardly affected the country's potential growth as a whole and things got back to normal within a short period of time. Undoubtedly this was possible thanks to the enormous resources available to the United States. We can find the other side of the coin in many developing countries. For example, the earthquake recorded in Haiti in January 2010 caused huge damage was structural in nature, cutting short the already poor economic growth and making the country almost totally dependent on humanitarian and financial aid provided by the international community. This is not an isolated case as, in general, when a natural disaster occurs in a poor country, external aid, for reasons of solidarity or charity, constitutes the basic pillar to alleviate the damage and subsequently reconstruct the country.

(1) «Disaster Risk Management: Building a Safe and Resilient Future for All», The World Bank, September 2011.

In order to improve this situation, important multilateral institutions (such as the World Bank) have worked on developing programmes[2] aimed at providing technical and financial assistance so that those countries more likely to suffer the impact of devastating climate-related phenomena can develop Disaster Risk Management or DRM strategies. The idea is to design instruments that help these countries to protect themselves, at least economically, from events that have been seen as fatal to date but that, with suitable preparation, can be turned into manageable misfortunes.

The development and implementation of a DRM provides governments with significant economic and social advantages. Firstly, they reduce the public accounts' exposure to the occurrence of a natural disaster, as certain risks are passed on to the international reinsurance markets or capital markets. Secondly, lower fiscal uncertainty improves the environment for authorities to help the population access better social services, as well as developing production infrastructures that can boost growth in the long term. Lastly, governments make sure that, in an emergency situation, they will have immediate access to the necessary funds to provide the population with aid and to rebuild the damaged infrastructures. A brief review of the experiences of two countries as different as Mexico and Malawi can help to clearly illustrate the potential benefits that can be gained from such strategies.

In 1985 Mexico suffered two earthquakes of 8.0 and 7.5 on the Richter scale, causing more than 10,000 deaths and destroying 100,000 homes. This situation forced the government to reallocate resources that had been aimed at developing public infrastructures to be able to meet the costs of rebuilding the private sector. In order to avoid a similar situation in the future, in 1996 the Mexican government decided to create the Natural Disaster Fund (FONDEN) at the same time as developing an institutional framework aimed at diminishing and reducing the risks associated with natural disasters. In order to achieve its goals, the FONDEN uses several instruments including CAT Bonds (catastrophe bonds). A Cat Bond (see the figure below) is a bond that pays periodic coupons to investors during the bond's life and that covers the sponsor against a number of natural disasters (earthquakes, hurricanes, etc.). If any of the events covered occurs during the life of the bond, the sponsor country retains the principal to finance payments for aid to the population and reconstruction work.

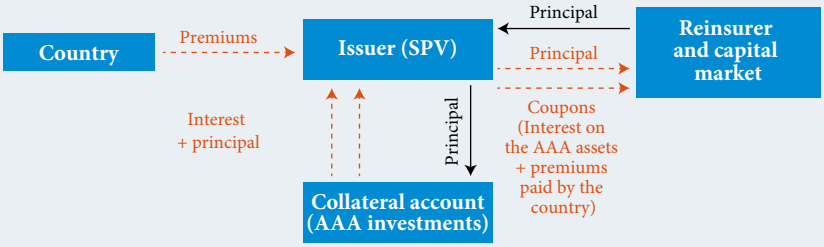
In 2006, the FONDEN issued CatMex bonds totalling 160 million dollars to transfer the risk of a possible earthquake to international financial markets. This was the first time an instrument of this nature had been issued by a government. In 2009, after the CatMex matured, Mexico decided to diversify its coverage further by issuing parametric bonds maturing in October 2012, along the lines of a programme designed by the World Bank. The amount place was 290 million dollars and demand by investors reached very high levels, with private entities of the stature of Swiss Re and Goldman Sachs taking part. With this issuance, the Mexican government has partly passed on the risk of a climate-related or geological disaster to the market, ensuring pluriannual coverage at a reasonable cost. The appeal for private agents acquiring the bond lies in the possibilities for diversification, as these are assets that do not depend on the economic or financial performance of a government or firm and are therefore uncorrelated with the rest of securities.

Malawi is other example of a country that has benefitted from disaster risk management strategies. This is a poor nation located in southern Africa, highly vulnerable to drought and where 38% of its GDP depends on agriculture. In 2005 the country had a severe drought that forced the government to allocate 200 million dollars to alleviate the hunger suffered by millions of farmers. Although the international community collaborated with a similar amount, the effects were considerable. As a result of this situation, the government of Malawi, advised by

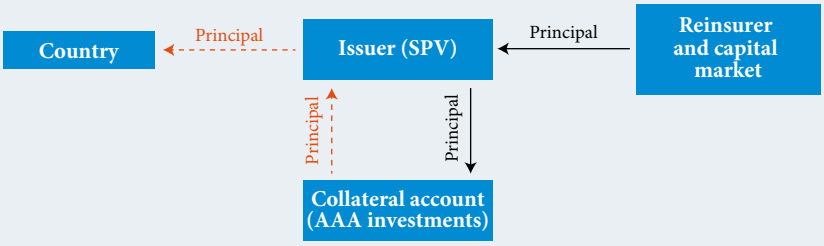
(2) In 2006, the Global Facility for Disaster Reduction and Recovery (GFDRR) was set up. The main mandate of the GFDRR is to collaborate in developing strategic policies aimed at reducing the risk of disaster (DRR or Disaster Risk Reduction) and adaptation to climate change (CCA or Climate Change Adaptation).

STRUCTURE AND FLOWS OF A CAT BOND

A: The SPV (Special Purpose Vehicle) receives the principal of the bond paid by investors and invests the funds in AAA-rated assets. If no disaster occurs, the investors receive the interest paid on the AAA-rated assets plus the premiums. When it matures, the SPV returns the principal to the investors.



B: The SPV receives the principal of the bond paid by the investors and invests the funds in AAA assets. If a disaster occurs, the SPV liquidates the AAA assets from the collateral account and gives part or the entire principal to the country (based on the conditions stipulated in the bond).



Date issued
Future flows

SOURCE: FONDEN.

multilateral bodies, developed a strategy to pass on part of the risk to the capital markets and thereby mitigate the negative impact of another similar event on the economy and the government's budget. The main aim was to ensure fast access to funds to help reduce the country's dependence on international humanitarian aid. To this end, the Malawi government bought, in 2008-2009, 2009-2010 and 2010-2011, an index-based weather derivative contract (a six-month put option). This index associates rainfall with the production of corn so that, if this falls below a certain level (10% of the historical average), the contract offers protection for any crops that might be lost. In 2009-2010 the dreaded drought occurred but, thanks to this coverage, the Malawi government received a payment which it allocated to buying corn on the international futures market, thereby ensuring the cost of supply for the country.

These are simply two experiences of countries that, making use of novel instruments, have managed to partly and effectively pass on the risk of a natural disaster to the international financial and insurance markets. These strategies are clearly not a complete solution but they undoubtedly promote greater stability in public budgets and long-term growth.

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FINANCIAL MARKETS

Monetary and capital markets

Uncertainty takes hold of the financial scene

The world's financial markets have gone through a complicated period in May. Two factors have had a combined effect: a more agitated political and economic climate in the euro area and poor economic activity figures in the emerging countries, in particular China. After the elections on 6 May, Greece's political crisis, a reflection of the country's hesitant support for the conditions imposed by Brussels, is jeopardizing the whole of the euro area. Speculation that Greece might leave the euro, together with the mistrust caused by the state of health of Spain's banks, have sent risk premia soaring in peripheral Europe. The debate on the design, orientation and functioning of the Economic and Monetary Union is entering a decisive phase, just at a time of elections to provide the approaching big decisions with democratic legitimacy. France's change in government entails a notable alteration in the correlation of forces within Europe, initially adding to the uncertainty. In addition, within the international macroeconomic context, the publication of weaker activity figures than expected in key countries such as China has harmed global growth prospects. Given this situation, the financial markets, reflecting investors' hopes and fears, are still enduring a period marked by uncertainty and the search for safe options.

Expectation regarding the actions of the monetary authorities

Doubts regarding Greece and Spain dominate investor sentiment.

Because of the upswing in credit tensions within the euro area and the worsening expectations of world economic growth over the last few weeks, investors are following the movements and statements given by the main central banks very closely. Although it's true that the Federal Reserve and the European Central Bank have always stated they are prepared to use additional monetary stimuli if necessary, neither of the two authorities has officially announced any future actions as yet.

Investors examine the statements made by central banks.

In the case of the United States, debate centres on the possible approval of a third round of public bond purchases (quantitative easing or QE) by the Federal Reserve (Fed). As explained in the minutes of the last Federal Open Market Committee meeting, the authority estimates that the US economy's near future will be characterized by a moderate but sustainable rate of growth that will provide the right conditions to create jobs. This suggests that those in charge at the Fed largely believe it won't be necessary to employ additional quantitative measures to those already in place but they have left the door open. The authority has expressed its satisfaction with the current monetary policy strategy and with the effectiveness of the instruments being used. The core elements are the commitment to keep interest rates as low as possible, at the

The Fed keeps to its strategy but does not rule out further stimuli.

The Fed identifies risks that threaten economic growth.

level of 0%-0.25%, until the end of 2014, and the proposal to maintain, in its portfolio, the more than two billion dollars in US Treasury bonds and mortgages it has gradually acquired over the last four years. However, the Fed has also stated that it is prepared to introduce new extraordinary measures (without giving any clues as to which) if, contrary to its main forecast, the economy relapses. In fact, at the committee's last meeting, there were more members acknowledging an increase in risks that could compromise the recovery process.

The ECB does not announce whether it will buy up more peripheral sovereign debt.

The two most notable risks are the threat posed by the upswing in credit tensions in the euro area and the possibility of an abrupt fiscal contraction in the United States. Related to this very issue, the Federal Reserve Chairman, Ben Bernanke, has encouraged policymakers to adopt fiscal consolidation measures while taking into account their effects on the private sector's capacity for spending and investment. In his opinion, excessive austerity might hit hard the potential expansion of households and firms and therefore the economy as a whole.

In the euro area, the actions and statements given by representatives of the European Central Bank (ECB) are also being exhaustively studied by the financial markets. In this case, these

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2011									
April	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.24
May	1.25	1.43	2.14	0.25	0.25	0.20	0.50	0.83	0.26
June	1.25	1.55	2.16	0.25	0.25	0.20	0.50	0.83	0.28
July	1.50	1.61	2.18	0.25	0.26	0.20	0.50	0.83	0.24
August	1.50	1.54	2.09	0.25	0.33	0.19	0.50	0.89	0.10
September	1.50	1.55	2.08	0.25	0.37	0.19	0.50	0.95	0.15
October	1.50	1.59	2.12	0.25	0.43	0.20	0.50	0.99	0.57
November	1.25	1.47	2.04	0.25	0.53	0.20	0.50	1.04	0.77
December	1.00	1.36	1.95	0.25	0.58	0.20	0.50	1.08	0.92
2012									
January	1.00	1.13	1.75	0.25	0.54	0.20	0.50	1.08	0.47
February	1.00	0.98	1.61	0.25	0.48	0.20	0.50	1.06	0.57
March	1.00	0.78	1.42	0.25	0.47	0.20	0.50	1.03	0.35
April	1.00	0.71	1.31	0.25	0.47	0.20	0.50	1.01	0.54
May (1)	1.00	0.68	1.26	0.25	0.47	0.20	0.50	1.00	0.43

NOTES: (1) May 23.

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

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

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

(5) Interbank rate.

SOURCES: National central banks, Bloomberg and own calculations.

measures have a dual function: to encourage growth in the euro area and relieve tension in the sovereign credit markets. At the ECB's last regular meeting, its Governing Council decided to keep the official interest rate at 1%. The stabilization of business indicators, albeit at low levels, and the equilibrium of long-term inflationary expectations are the main arguments justifying this decision, according to its accompanying analysis. Similarly, Mario Draghi, the ECB President, referred to the good performance of the financial markets after the implementation of the extraordinary measures agreed to date (principally the two three-year LTROs), this circumstance being the reason why further monetary stimuli had been ruled out. Investors' reaction to this message of continuation reveals some disappointment, in particular due to the lack of clues regarding the ECB's actions as a buyer of public debt from peripheral Europe (specifically Spain), given the recent rises in risk premia.

However, possibly the most relevant element of the last few weeks in terms of the euro area's monetary policy has concerned the Bundesbank. The President of the Bundesbank, Jens Weidmann, stated that it would consider it appropriate for inflation to be above the euro area's average for the German economy, as a measure to help correct the imbalances of competitiveness between Germany and the countries in the south of Europe. Similarly, the German Finance Minister, Wolfgang Schäuble, supported this position, specifying that an inflation range of between 2% and 3% for Germany would be desirable and confirming that there was enough margin for wage rises in the country. Should this come about, Germany's more flexible stance on inflation represents a very powerful ingredient in the formula that should lead to the region's economic and financial stabilization.

The Bundesbank takes a more flexible approach to inflation.

With regard to the emerging countries, the expectation generated by the actions of its central banks is less intense than that seen in the developed countries. Their monetary policies have been easing for months now and May was no exception. The response of the monetary authorities to the slowdown in activity in their economies is being carried out in an orderly, prescient manner. This is their approach to achieve the objective of a soft landing for growth rates, as well as greater control over inflation. The means employed rely simultaneously on interest rate cuts and quantitative measures, which vary depending on the country. The latest sign of this kind of action was the third consecutive lowering of the reserve ratio required for banks, carried out by the Chinese monetary authority. The Asian giant's economic trend has caused some concern over the last few weeks with figures being surprisingly low and some fear an abrupt slowdown. These fears seem exaggerated, given that this weakness is more temporary in nature and related to the change in the pattern of development, from exports to domestic demand.

The central banks of the emerging countries continue to relax their monetary policy.

In this scenario, interbank markets in the United States and in the euro area have been dominated by stability. In Europe's case, in spite of the political turmoil in Greece and the increase of fears regarding Spain's banking system, the huge liquidity provided by the ECB with its three-year auctions has continued to facilitate a reduction of the Euribor interest rates. In any case, this circumstance is not, in itself, a sign of a normalized market. On the other hand, there are still signs of dysfunction, such as banks' intensive use of the ECB deposit facility and the very

Interbank interest rates look very stable.

Spain's sovereign debt is severely punished.

high risk premia demanded in operations with peripheral institutions. These obstacles will probably diminish as the different solvency tests and valuations are satisfactorily resolved that are being carried out on the financial institutions of beleaguered countries.

Same tension, new record lows for German and US debt

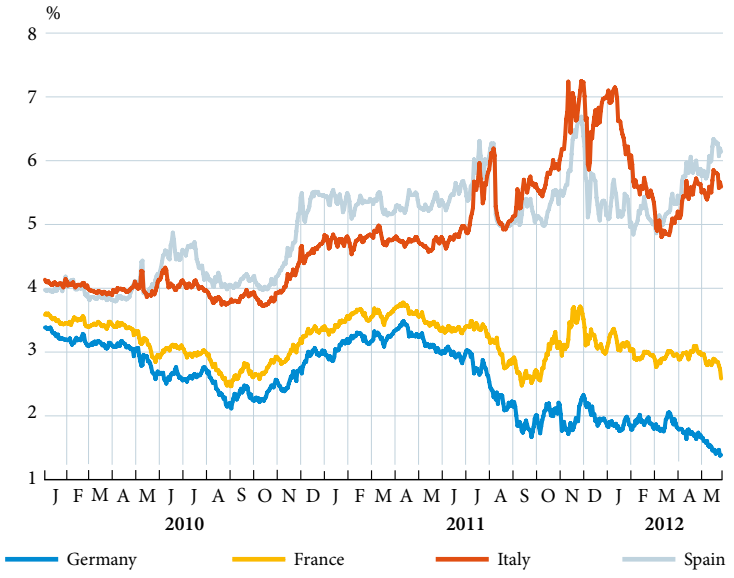
Throughout the month of May, in addition to the doubts regarding Spain's ability to meet its deficit reduction targets, which had already emerged in April, were two events that intensified financial tensions even further. On the one hand, the holding of new elections in Greece (for the 17 June), given the inability of political leaders to form a coalition government after May's general election. Polls show a complex electoral map where we cannot rule out extreme scenarios. On the other hand, investors had to interpret the financial reform announced by the Spanish government. Although important issues are covered related to the degree of solvency of the institutions, what is true is that some uncertainty has been created associated with the findings to be published by the two external evaluators and, if necessary, how the government would tackle the requirement to recapitalize the banking system. Within this context, investors once again hit lower credit quality debt hard, taking refuge in bonds issued by Germany and the United States, prioritizing safety over yields.

Investors differentiate France from the peripheral countries.

The increase in political and financial tension had a very negative effect on yields for peripheral Europe's sovereign debt. The yield on Spain's ten-year bonds broke the barrier of 6% and its differential with Germany reached 490 basis points, the highest since 1995. Italy's debt also

SPAIN AND ITALY ARE STILL UNDER PRESSURE

Yield on 10-year public debt



SOURCE: Bloomberg.

performed badly, albeit still far from the peaks reached a few months ago.

In spite of the difficult situation, the ECB has still not intervened in the secondary market, nor has it shown any signs of doing so, by buying up Spain and Italy's debt in order to contain this upswing in yields. In any case, debt issuances in the primary market have offered a less dramatic view as the respective Treasuries have managed to place securities with different maturities, registering good demand at higher interest rates that they've had to accept.

It's interesting to note the favourable performance of France's sovereign debt, whose yield at 10 years fell from a level of almost 3.0% down to 2.75%. Unlike what happened in November, this time investors are positively differentiating French debt. In other words, the investor community believes that the risk taken on with French debt is closer to that of Germany's than the peripheral countries. In any case, Germany's sovereign bonds benefitted, once again, from a lot of investors opting for safety, resulting in yields at ten years falling to the level of 1.41%, a record low.

On the other side of the Atlantic, US sovereign bonds have performed similarly to their German peers. In addition to being supported by relatively better economic expectations than those of the euro area, US debt is also helped by a very lax monetary policy. This, together with the security provided by a country with a very high rating and the expectation that the Federal Reserve might implement, if necessary, another round of quantitative easing, has meant that investors have

Debt interest rates for Germany and the United States are at a record low.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

10-year government bonds at end of period as annual percentage

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2011								
April	3.3	3.6	5.5	4.7	3.4	1.2	3.6	2.1
May	3.0	3.4	5.4	4.8	3.1	1.2	3.3	1.8
June	3.0	3.4	5.4	4.9	3.2	1.1	3.4	1.7
July	2.5	3.2	6.1	5.9	2.8	1.1	2.9	1.4
August	2.2	2.9	5.0	5.1	2.2	1.0	2.6	1.1
September	1.9	2.6	5.1	5.5	1.9	1.0	2.4	0.9
October	2.0	3.1	5.5	6.1	2.1	1.0	2.4	1.0
November	2.3	3.4	6.2	7.0	2.1	1.1	2.3	0.9
December	1.8	3.1	5.1	7.1	1.9	1.0	2.0	0.7
2012								
January	1.79	3.05	4.97	5.95	1.80	0.97	1.97	0.72
February	1.82	2.88	4.99	5.19	1.97	0.96	2.15	0.72
March	1.79	2.89	5.35	5.12	2.21	0.99	2.20	0.87
April	1.66	2.96	5.77	5.51	1.91	0.90	2.11	0.72
May (*)	1.44	2.77	6.13	5.64	1.75	0.87	1.82	0.64

NOTE: (*) May 23.
SOURCE: Bloomberg.

The euro suffers from an economic, institutional and sovereign debt crisis.

pushed down yields on ten-year US debt from 1.95% to levels of around 1.70%.

The euro loses ground

The threat to the euro area as a whole caused by the uncertain political future of Greece, greater risks in the euro area's debt markets and poor growth prospects for the region are pushing down the euro. In May its exchange rate fell by 5% against the dollar, leaving the exchange rate between both currencies at 1.25 dollars per euro. Downward pressures on the single currency have also been notable in relation to currencies such as the pound sterling, the Japanese yen, the Danish krone and the Swiss franc. Some of these countries have reacted with measures aimed at slowing up the appreciation of their currencies, revealing the destabilizing effects and distortion created by the euro area crisis. The fear of extreme scenarios of a break-up or prolonged recession is pushing many international investors to reduce their positions in euros, in a process that appears somewhat hasty and would not be reasonable much beyond what has already been observed, at least in the medium term.

The emerging currencies also look weak.

The currencies of the emerging countries have also been affected by the repercussions of the European crisis, as risk aversion has intensified and financing flows have been hindered. Moreover, the unpleasant surprises given by recent figures for several emerging economies have also had a similar effect. In fact, the currencies of these countries

EXCHANGE RATES OF MAIN CURRENCIES

May 23, 2012

	Exchange rate	% change (*)		
		Monthly	Over December 2011	Annual
Against US dollar				
Japanese yen	79.4	–2.3	3.1	–3.3
Pound sterling	0.637	–2.7	1.0	–2.7
Swiss franc	0.953	4.1	1.6	7.3
Canadian dollar	1.026	3.4	0.5	4.7
Mexican peso	13.975	5.7	0.3	16.0
Against euro				
US dollar	1.260	4.2	2.8	10.3
Japanese yen	100.0	–6.8	0.4	–15.2
Swiss franc	1.201	–0.1	–1.3	–3.4
Pound sterling	0.803	–1.6	–3.8	–8.6
Swedish krona	9.049	1.8	1.4	1.2
Danish krone	7.432	–0.1	0.0	–0.3
Polish zloty	4.371	3.8	–2.2	9.7
Czech crown	25.53	2.0	–0.2	3.8
Hungarian forint	302.8	1.4	–4.0	10.7

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

have looked particularly weak, recording a sharp depreciation against the dollar and a moderate one against the euro. The decision of the Chinese authorities to no longer put a stop to its currency's appreciation against the dollar but even to partially reverse this has contributed to this process, recalling the «currency war» but with different characters.

Issuances slow up in the corporate bond markets

The worsening climate in peripheral Europe has affected the corporate bond markets. Whereas, during the previous months, this market stood out for its remarkable ability to resist the adversities of the euro area crisis (from the point of view of issuances and the extent of capital flows), in May investor mood and the issuance of corporate bonds had been fully infected. In addition, over the last few weeks this sentiment has been furthered by the widespread deterioration in macroeconomic expectations at a global level.

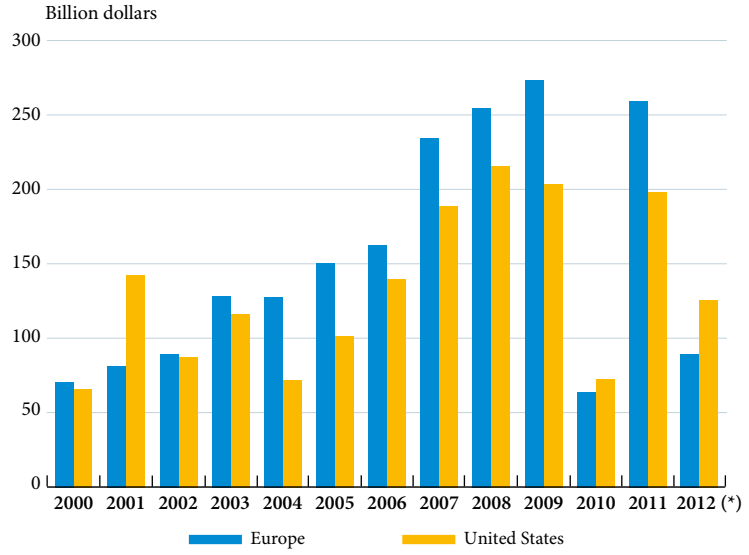
Logically, these factors have different repercussions on bonds depending on the geographical area and sector. Specifically, the sector most severely affected by the current situation is banking. The outcome of the credit problems resulting from the European crisis, the tougher regulations for the sector and consequent deleveraging of institutions is being reflected in a slowdown in issuances of these bonds at a global level. In the first four months of the year, the total volume of these issuances was the lowest since 2005. In the case of the euro area, this process intensified after the two three-year liquidity auctions by the ECB. Many European institutions have managed to cover a large proportion of their funding requirements for this year, thereby

Global uncertainty affects corporate bonds.

The volume of corporate bond issuances slows up.

CORPORATE BOND ISSUANCE IN EUROPE AND THE UNITED STATES

Figures from 1 to 31 May



NOTE: (*) From 1 to 24 May 2012.
SOURCE: Bloomberg.

US investment degree bonds stand firm.

reducing their dependence on covered bonds. Part of these effects has also been passed on to the US market. The recent downgrade in credit quality for banks on the periphery of the euro area (Spain and Italy) has led to more expensive risk premia in the negotiation with European banks.

The bonds of non-financial firms in Europe have also deteriorated significantly, affected by the worsening macroeconomic conditions in the region and greater risk aversion. Performance has not been so negative in the United States, at least in the investment degree segment. This is partly due to the boost from US sovereign debt which, as has already been mentioned, has acted as a safe haven, a role that is also being played, to some extent, by large US companies with healthy balance sheets.

The fall in the Ibex 35 is due to many different factors of a financial and real nature.

Uncertainty hits the stock markets

Once again, the main international stock market indices were in the red last month. The financial instability dominating the euro area, with its epicentre in Greece and aftershocks in Spain, and the moderate figures for activity worldwide have provided powerful reasons to ruin investors' appetite for risk. Over the last two months, most indices have seen a large part of the gains disappear that they had accumulated since the start of the year, with notable exceptions such as the S&P 500. In the euro area, the largest stock markets have fallen by more than 5% since January, although it is the Spanish index that heads the list. The value of Spanish stocks and shares is in the firing line of investors, both institutional and private. In addition to Greece's uncertain future, there is also a loss of confidence regarding the Spanish economy's ability to meet the fiscal targets set by Brussels and the degree of solvency of its banking sector. Regarding this issue, the government approved a new royal decree that requires banks to increase provisions for their exposure to the real estate sector, as well as a valuation of the sector's total assets by two independent experts. Although these measures meet the requirements being made by the financial markets regarding the transparency of bank balance sheets, there are fears that this might have a big impact on the profit and capital of many institutions in the sector. These events coincided with the government's intervention in the BFA-Bankia group, pushing the Ibex down even further, which has returned to its 1997 level.

Improved corporate earnings in the United States boost the stock markets.

On the international stock market scene, in addition to believing that the risks of euro area contagion have increased, investors are also taking other elements into account. In the case of the United States, the relative strength of corporate earnings during the first quarter of 2012 and the continually favourable profit projections by analysts have had a positive effect that has offset the negative to some extent. Another notable fact providing a certain degree of support for these indices is active involvement in investment funds, guided by strategies based on the return by dividend of shares. In the area of the emerging countries, although the last month has seen some downward movement in the main indices, the fact that most of these economies are implementing more flexible monetary measures is encouraging expectations of a medium-term recovery.

INDICES OF MAIN WORLD STOCK EXCHANGES

May 23, 2012

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,389.8*	*–4.2*	*1.4*	*0.1*
Standard & Poor's	*1,308.5*	*–4.3*	*4.0*	*–0.7*
Nasdaq	*2,814.8*	*–5.2*	*8.0*	*2.0*
Tokyo	8,556.6	–10.3	1.2	–9.6
London	5,305.8	–6.3	–4.8	–9.1
Euro area	2,145.7	–4.4	–7.4	–23.2
Frankfurt	*6,322.2*	*–3.1*	*7.2*	*–11.2*
Paris	*3,019.4*	*–2.5*	*–4.4*	*–22.7*
Amsterdam	*290.4*	*–3.6*	*–7.1*	*–15.2*
Milan	*13,055.0*	*–5.7*	*–13.5*	*–36.4*
Madrid	*6,499.3*	*–5.1*	*–24.1*	*–35.5*
Zurich	5,846.8	–4.4	–1.5	–9.2
Hong Kong	18,786.2	–8.9	1.9	–17.3
Buenos Aires	2,239.2	–3.1	–9.1	–32.6
São Paulo	54,646.3	–11.2	–3.7	–12.3

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.

Insurance for a slightly irrational world

Insurance business is important. And so it should be, as it allows us to protect ourselves against large losses associated with events that, although infrequent, cannot be ruled out from our lives. Logically, this importance is translated into monetary terms: in 2010, insurance premiums represented the equivalent of 7% of the world's GDP, being most important in regions such as Europe, North America and Japan. Given its social and economic relevance, it's no surprise that insurance has been accompanied by a huge regulatory effort. Because of this situation, we might expect everything related to the insurance sector to be supported by the best economic theory available. But is this actually the case? Unfortunately the answer is probably in the negative.

To bring some order to such a broad field, we propose two fundamental questions that any theory must be able to answer: why does insurance exist and why does insurance regulation exist? Traditional economic theory provides us with an answer to both questions that serves as a starting point. Insurance exists because it has value for individuals. This value comes from the fact that it helps to transfer money from times when it is not very necessary to others when it might be much more so. The alternative, individual savings, is less efficient as it reserves money

THE INSURANCE BUSINESS IN 2010: GEOGRAPHICAL DISTRIBUTION	
Insurance premiums as percentage of GDP	
America	6.71
North America	7.90
Latin America	2.68
Europe	7.47
Western Europe	8.44
Central and Eastern Europe	2.62
Asia	6.16
Japan and new industrialized economies	10.64
East Asia	3.66
Middle East and Central Asia	1.51
Africa	3.86
Oceania	5.82
World	**6.89**

SOURCES: Swiss Re, Sigma Report, World Insurance in 2010.

for needs that might not occur in the future.[1] Thus far, the issue appears simple but it starts to get more complicated if we take into account the fact that there are information problems.

In any contractual relationship between the insured and the insurer, the information available to both parties is clearly asymmetrical. It's difficult for the insurance company to have information on the insured and to monitor the insured's behaviour after the insurance contract has been signed. Those who want to insure themselves are likely to take more risks than the average for the population and, once insured, tend to be less careful than those not covered by insurance. These are, known as problems of adverse selection and moral hazard, respectively.

Of course information problems are not limited to the area of insurance companies. Policyholders must also face a notable lack of information regarding aspects such as the solvency of insurers and the specific terms of their contracts. In short, the great risk for policyholders is whether, when they need it, they will actually get the promised payment (either because the company has gone bankrupt or because clauses which they were unaware of mean they are not entitled to any payout).

These problems of information are the customary justification for regulation. Regulation attempts to reduce the information problems that cannot be eliminated by the market itself. While the information problems faced by companies tend to be resolved reasonably efficiently in the private area (for example, by means of corporate policies for exemptions or overpricing certain groups that are more likely to take excessive risks), those affecting consumers usually require public regulation. In short, it is a question of helping the «private» information of

(1) In academic terms, consumers take out insurance because they are adverse to risk and because insurance is a more efficient instrument against potential losses than savings, as a means to equalize the marginal utility of consumption over time.

companies to become public (or of reducing the effort required by consumers to have this information).[2] The regulation governing most countries aims to ensure the solvency of insurers and a certain quality of contracts and their fulfillment. Some of the most usual instruments are the requirement to use standardized contracts, conditions for joining the sector, limitations to price fixing and solvency rules (usually in the form of capital requirements and other financial conditions).

All these practices would be enough if consumers, the cornerstone which the regulator is attempting to protect, behaved with the rationality expected by the theory. But we know this is not the case. In the insurance business, as in other markets, anomalies are frequent. When a high demand for insurance would be expected due to catastrophic accidents (precisely the kind of large but infrequent loss that would best warrant an insurance policy), the reality is that there is an excessively low demand for this kind of product. For example, in New Orleans only 40% of households had some kind of insurance against floods, a situation that proved to be disastrous after hurricane Katrina. However, other types of less rational situations are usually more in demand than their theoretical optimum. Frequently mentioned are insurance policies with deductibles that are too low or the extension of cover for certain consumer durables.

These anomalies are essentially due to two categories of limitations suffered by consumers. Firstly, consumers are influenced by a series of biases that affect how the value of insurance is perceived, either by underestimating it (producing a demand below the optimum level) or by overvaluing it (thereby leading to excessive demand for insurance). The first of these cases occurs due to two biases detected in the literature: what is called hyperbolic discounting (or an irrationally high preference for money in the present rather than the future) and what is known as the over-optimism bias (the ill-founded belief that negative events won't happen to us). Other biases have also been detected that can lead to consumers overvaluing insurance, such as those based on superstition (the belief that, if you take out insurance against an accident, it won't happen to you), on copying the decisions of others («herd behaviour») and an excessive emotional tie to the object or person (which is consequently over-insured).

Together with these difficulties in perceiving the right value of insurance, a second group of limitations results from the cognitive difficulty in taking decisions based on situations of risk and uncertainty. In addition to the classic behavioural regularities often mentioned in various transactions,[3] in insurance an aversion to taking certain events into account has been noted as particularly relevant (including death and other stigmatized taboos), as well as an aversion to complexity. In general terms, the outcome of these limitations to being able to process information is that people too often decide not to take out an insurance policy.

In short, in the slightly irrational (or, more accurately, imperfectly rational) world we alluded to in the title, regulation tends to defend society from the excessive presence of private information surrounding insurance transactions. However, protecting consumers from all these biases we have just mentioned is far from commonplace. One of the problems is that, as we are reminded by Baker and Siegelman, two key authors in this debate, although consumer «errors» can be detected, adequate regulation is far from easy.[4] This is because, in behavioural

(2) Nonetheless, it should be noted that, on certain occasions, these private practices end up blocking some groups out of the market. In order to avoid this situation of some people not being able to take out insurance, under certain circumstances regulation forces insurers to insure these groups.
(3) The classic reference is Kahneman, D. and A. Tversky (1979), «Prospect theory: An analysis of decision under risk», Econometrica, vol. 47, pp. 263-291.
(4) See Baker, T. and P. Siegelman (2011), «Law and Economics after the Behavioral Turn: Learning from Insurance», Flom Petrie Health Policy Workshop.

economics, the link is weak between behaviour and welfare (in the usual economic sense). For example, and remembering one of the biases mentioned above, how could regulation protect me from the fact that I get satisfaction (or reduce my anxiety) from being superstitious?

Although this issue has started to be explored academically for certain types of insurance, in general for those policies that suffer from too low or too high a demand, and which are easier to handle, the findings are a long way from being conclusive. To give an example, in 2003 in the United Kingdom, the case was studied of additional cover for electronic products. It was concluded that, in effect, this was requested to a greater extent than was rationally desirable and a proposal was made to increase competition in the sector (the report was by the Competition Reform Commission). The «behavioural» proposal which was put forward in some academic circles was to protect consumers from themselves, since they were too emotional regarding the insured object, by making it impossible to offer such extensions to cover. Clearly not a very satisfactory solution. However, as behavioural economics advances, it should be better equipped to help this world made up of the imperfectly rational consumers we are.

This box was prepared by Àlex Ruiz
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SPAIN: OVERALL ANALYSIS

Economic activity

Confidence and credibility

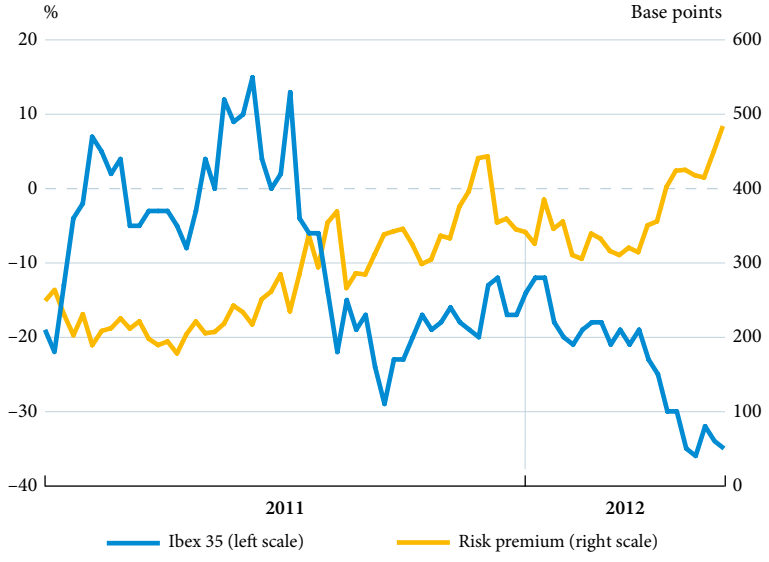
«Self-trust is the first secret of success». This quote, by Ralph W. Emerson, US poet and thinker, forces us to wonder whether Spain and Europe really believe in themselves and in each other. To date, the euro area has not been able to solve a problem affecting 2% of its economy, namely Greece, or to use all the mechanisms within its grasp, including the European Central Bank (ECB), to dispel doubts regarding the rest of the Member states. For its part Spain, after passing the fourth financial reform in less than three years, asked external consultants to evaluate the capital requirements of its banks and revised 2011's public deficit upwards. Both these facts led to a drop in confidence in Spain's public accounts and financial system.

The nationalization of the country's fourth largest financial institution one week after its financial plan was approved by the Bank of Spain eroded the regulator's credibility and speeded up approval of a new financial decree. The new capital requirements maintain provisions for toxic assets and increase the general coverage for healthy ones. However, the reform did not manage to get investor confidence back and the risk premium rose to levels close to 500 basis

In the first quarter, GDP shrinks by 0.4% quarter-on-quarter.

THE FINANCIAL TURMOIL HARMS BOTH THE PUBLIC AND PRIVATE SECTOR

Year-on-year change in the Ibex 35 (left scale). Yield differential between Spanish and German 10-year bonds (right scale)



SOURCES: Bloomberg, Reuters Datastream and own calculations.

The new financial reform does not resolve investor doubts.

points (forcing the central government to pay for increasingly expensive financing), as well as the Ibex 35 falling by 7.2% in seven days.

One week after this financial reform, the government approved the budgets for the autonomous communities except for Asturias, whose deadline was extended, to ensure the fiscal consolidation established for 2012. However, the upward revision of 4 tenths of a percentage point for 2011's deficit due to deviations from Madrid, Valencia and, to a lesser extent, Castile and Leon, means that an additional effort will have to be made to go from the current deficit of 8.9% to the promised figure of 5.3%. Although it's true that adjustments are more difficult to achieve in a recessionary context (the deficit is calculated as a ratio of gross domestic product), the adjustment plans already take into account the recessionary scenario.

The government revises 2011's deficit by 4 tenths of a percentage point up to 8.9%.

Confidence is crucial for growth. A credible economy leads to confidence in its payment obligations and it manages to finance itself at lower interest rates (lower risk premium). This less costly financing is passed on to the rest of the system and, under normal conditions, improves credit flows. Credit boosts consumption and investment and, in short, gross domestic product (GDP).

However, uncertainty in the financial system stops banks from lending to each other and raises the cost of financing; uncertainty in the public accounts pushes up the risk premium and the remaining credit fails to flow due to increased requirements on banks. At the same time as this process, adjustment plans are produced that cut public spending. If consumption, investment and public spending decrease, only the foreign sector can stop GDP from falling. But as our trading partners are also suffering, to a greater or lesser extent, from this process of a lack of confidence and fiscal adjustment, foreign demand's contribution is less than in previous quarters.

Lower investment affects the contribution made by domestic demand.

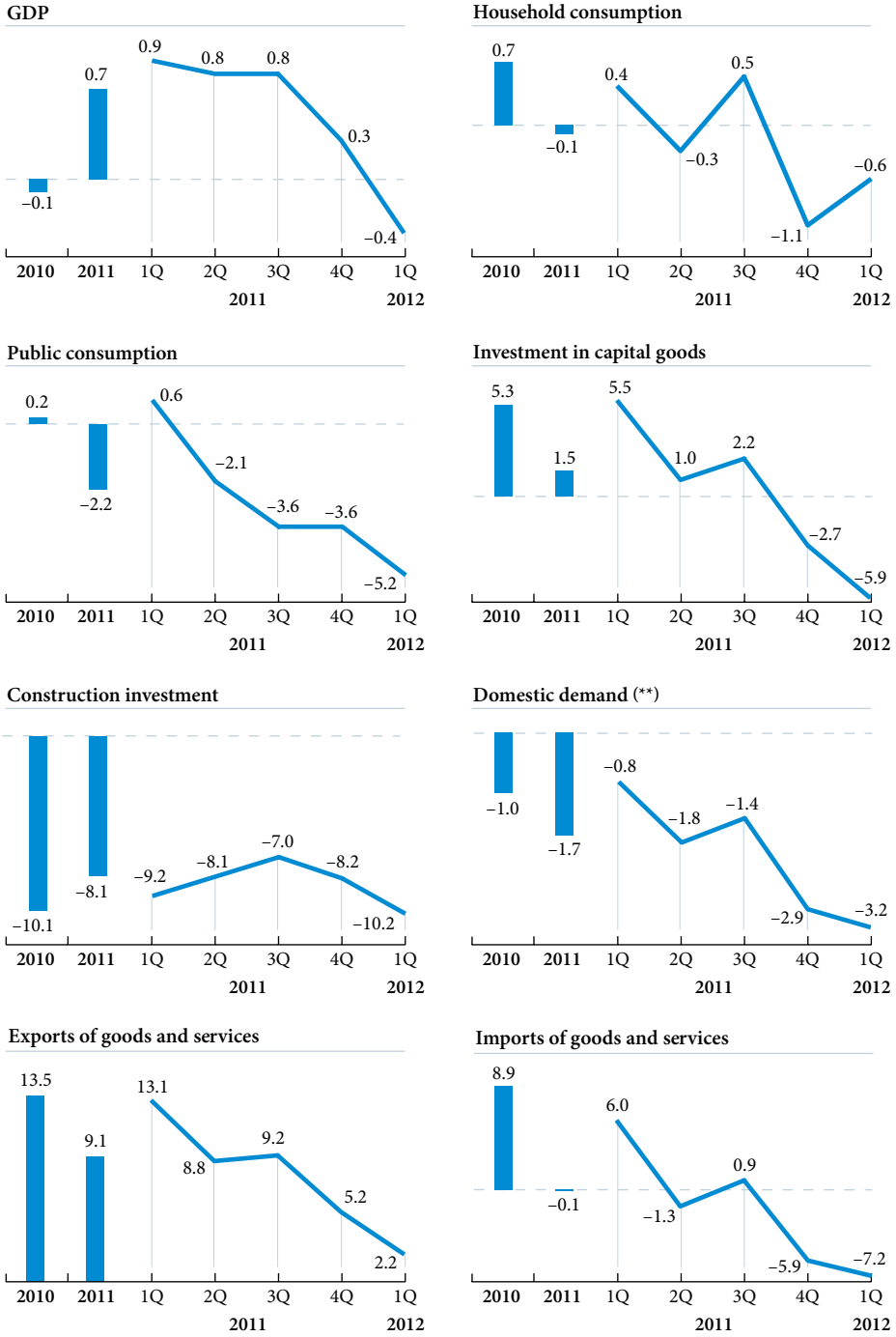
A breakdown of the National Accounts system confirms this and reveals that the decline in GDP in the first quarter of the year was 0.4% year-on-year. The drop in activity in the first quarter of the year was due to the deterioration in domestic demand, contributing -3.2 percentage points to growth, three tenths of a percentage point more negative than in the previous quarter. On the other hand, exports were the only motor of growth, adding 2.8 points to GDP. However, the foreign sector is showing signs of a slowdown with its contribution dropping by four tenths of a percentage point compared with the previous quarter.

This more negative contribution by domestic demand is entirely due to investment speeding up its rate of contraction as spending on end consumption has remained the same as the previous quarter. This is because households are offsetting the cuts in public consumption. In year-on-year terms, household consumption was down 0.6%, a slower rate than in the previous quarter. The cause lies mainly in the loss of confidence and purchasing power. With regard to the first point, consumer confidence worsened in the first quarter of the year and stands at 11 points away from its historic average and 5 points lower than last year. The latest figures, corresponding to April, show hardly any improvement over the previous month.

On the other hand, wages rose by 0.9% year-on-year while inflation increased by 2.0% in the same period. This meant that most households saw their potential to

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



NOTES: (*) Data adjusted for seasonal and calendar effects.
(**) Contribution to GDP growth.
SOURCE: National Institute of Statistics.

DEMAND INDICATORS

Percentage change over same period year before

	2010	2011	2011				2012	
			1Q	2Q	3Q	4Q	1Q	April
Consumption								
Production of consumer goods (*)	0.8	–1.0	–1.5	–0.8	0.7	–2.2	–3.7	...
Imports of consumer goods (**)	–9.5	–2.2	–1.1	–8.7	1.2	0.4	...	...
Car registrations	3.1	–17.7	–27.3	–26.4	–0.7	–5.5	–1.9	–21.7
Credit for consumer durables	–12.3	–9.9	–13.9	–10.1	–4.4	–10.4	...	–
Consumer confidence index (***)	–20.9	–17.1	–19.6	–16.1	–15.8	–16.8	–24.6	–28.6
Investment								
Capital goods production (*)	–3.3	0.8	3.0	2.5	2.6	–4.8	–10.2	...
Imports of capital goods (**)	6.5	–3.1	2.3	–4.9	–1.5	–7.2	...	...
Commercial vehicle registrations	7.0	–6.6	–2.2	–11.2	5.8	–15.1	–19.1	–25.1
Foreign trade (**)								
Non-energy imports	10.3	1.0	7.4	–0.7	0.8	–3.1	...	...
Exports	15.6	10.1	16.0	9.0	10.9	5.4	...	...

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

The foreign sector is showing signs of less dynamism.

consume fall. Moreover, in the last year 655,500 full-time equivalent jobs were lost, helping to reduce the wages of employees in general. The positive note is that unit labour costs are falling at a rate of –2.5% year-on-year and worker productivity is increasing (although this is because jobs are being lost faster than the decline in GDP).

In the last year, austerity plans have cut public spending by 5.2%. According to the 2012 budget and the stability plan announced by the government, this trend will get worse over the year and will remain in negative terrain until 2015.

However, the aspect of demand most sorely affected by the crisis is investment, which has seen negative figures for the last four years. In the first quarter of 2012, this fell by 8.2% year-on-year, pushed by the drop in material assets and investment in construction. Investment is crucial to stimulate future growth but, for the moment, this is contracting at a faster pace than in the previous quarter. Tensions in the financial sector and a lack of public investment and short-term expectations are ensuring this continues to be the case. April's decline in the industrial confidence indicator seems to confirm that this trend will continue over the coming quarter.

Lastly, the foreign sector started to show signs of running out of steam. Exports shrank compared with December and the year-on-year rate of change fell by 3 points to 2.2%. Europe's slowdown led to lower demand, especially for services, and more moderate tourism. For their part, imports fell by 7.2%, a figure in line with the lower level of activity, but they are slowing up their rate of decrease.

The government's stability plan acknowledges that the reforms will have

an effect in the medium term. Consequently, in the short term Europe is the only one that can help to restructure Spain's economy. The proposals range from a renegotiation of the fiscal adjustment schedule, mobilizing European funds to encourage investment or providing mechanisms to reduce the cost of debt (a more active role by the European Central Bank or some kind of debt mutualization such as Euro bonds). Whatever the initiatives taken, Europe must prove that it believes in itself and, therefore, in Spain.

Europe can help Spain to restructure its economy.

Labour market

The number of unemployed increases to 5,639,500 and the unemployment rate to 24.4%.

How far? How long?

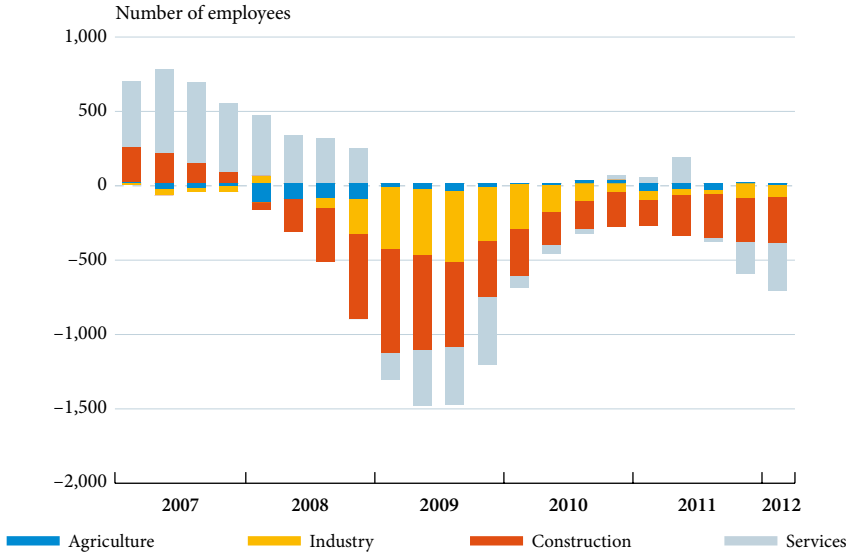
Some of the most frequent questions in the last few months have attempted to find out how long the current economic crisis will last and what the consequences will be for the real economy. Applied to the labour market, this question can be seen in the demand to know when jobs will start to be created, how many will have been lost by then and what the labour market will be like in the future. The Labour Force Survey (LFS) for the first quarter provides a view of today's labour situation while the stability programme presented recently by the government provides some answers regarding the future.

The number of people who want to work but can't get a job rose by 365,900 in the first quarter of the year, bringing the total number of unemployed to 5,639,500. This figure is 6.9% higher than the previous quarter but 14.5% higher than the figure for the first quarter of 2011. Given that the labour force remained practically the same during the first three months of the year, the unemployment rate stood at 24.4%, 1.6 points more than at the end of December. The highest figure in the past, at the beginning of 1994, is just 11 tenths of a percentage point different.

The deterioration in the real economy could be seen in the 0.3% quarter-on-quarter drop in gross domestic product

SERVICES AND CONSTRUCTION ACCOUNT FOR 88% OF JOB LOSSES

Contribution to the net creation of jobs in the last year



SOURCES: LFS and own calculations.

ESTIMATED EMPLOYMENT

First quarter 2012

	No. of employees (thousands)	Quarterly change		Accumulated change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	776.2	–32.2	–4.0	–32.2	–4.0	–7.0	–0.9	4.5
Non-farm	16,657.0	–342.1	–2.0	–342.1	–2.0	–711.5	–4.1	95.5
Industry	*2,459.3*	*–67.0*	*–2.7*	*–67.0*	*–2.7*	*–81.5*	*–3.2*	*14.1*
Construction	*1,186.7*	*–90.2*	*–7.1*	*–90.2*	*–7.1*	*–307.3*	*–20.6*	*6.8*
Services	*13,011.0*	*–184.9*	*–1.4*	*–184.9*	*–1.4*	*–322.7*	*–2.4*	*74.6*
By type of employer								
Private sector	14,329.1	–342.3	–2.3	–342.3	–2.3	–636.7	–4.3	82.2
Public sector	3,104.1	–32.0	–1.0	–32.0	–1.0	–81.8	–2.6	17.8
By work situation								
Wage-earners	14,411.2	–418.0	–2.8	–418.0	–2.8	–709.6	–4.7	82.7
Permanent contract	*10,986.4*	*–138.3*	*–1.2*	*–138.3*	*–1.2*	*–388.4*	*–3.4*	*63.0*
Temporary contract	*3,424.8*	*–279.6*	*–7.5*	*–279.6*	*–7.5*	*–321.2*	*–8.6*	*19.6*
Non-wage-earners	3,014.9	46.2	1.6	46.2	1.6	–9.9	–0.3	17.3
Entrepreneurs with employees	*909.9*	*6.3*	*0.7*	*6.3*	*0.7*	*–64.5*	*–6.6*	*5.2*
Entrepreneurs without employees	*1,976.8*	*41.6*	*2.1*	*41.6*	*2.1*	*80.1*	*4.2*	*11.3*
Family help	*128.2*	*–1.7*	*–1.3*	*–1.7*	*–1.3*	*–25.5*	*–16.6*	*0.7*
Other	7.1	–2.5	–26.0	–2.5	–26.0	1.0	16.4	0.0
By time worked								
Full-time	14,927.2	–421.8	–2.7	–421.8	–2.7	–658.1	–4.2	85.6
Part-time	2,506.0	47.5	1.9	47.5	1.9	–60.4	–2.4	14.4
By sex								
Males	9,527.3	–278.3	–2.8	–278.3	–2.8	–531.7	–5.3	54.7
Females	7,905.9	–96.0	–1.2	–96.0	–1.2	–186.8	–2.3	45.3
TOTAL	**17,433.2**	**–374.3**	**–2.1**	**–374.3**	**–2.1**	**–718.5**	**–4.0**	**100.0**

SOURCES: National Institute of Statistics and own calculations.

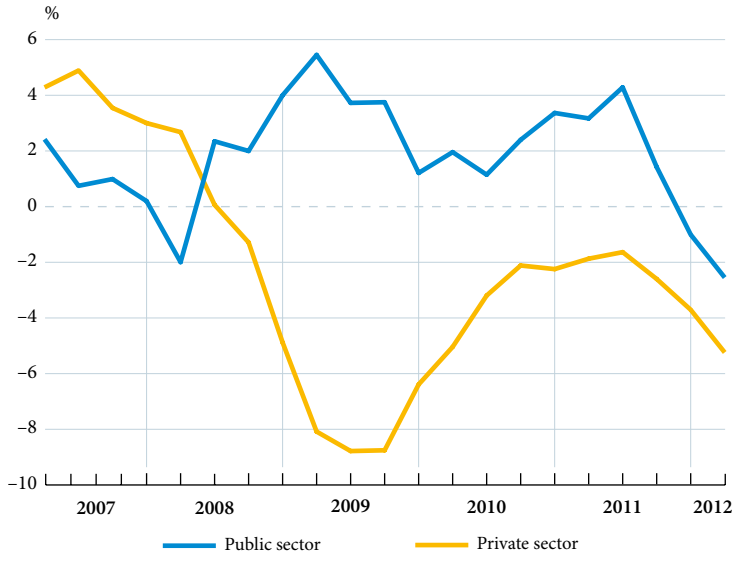
(GDP), leading to the loss of 223,300 jobs during the same period according to figures from the National Accounts system. If we use the LFS estimates, more than half the jobs lost last year took place between January and March 2012. Seasonal factors play a key role as jobs are lost in the first quarter even during boom times, accentuating the consequences of the bad economic situation. The number of employed is therefore estimated at 17,433,200 people.

If we analyze the figures by sector, in the last quarter the drop in workers in the services sector accounted for almost half the total job losses. However, given that 75% of the population work in this sector, services was actually the economic activity where the fewest jobs were lost, namely 1.4%. On the other hand, employment in construction accelerated its rate of decline to 7.1% quarter-on-quarter, with a cumulative drop of 20.6% over the last year. The relative weight of

The services sector loses 1.4% of its employees compared with 7.1% in construction.

PUBLIC JOB LOSSES SPEED UP

Number of employees. Year-on-year change



SOURCES: LFS and own calculations.

The private sector is responsible for 92% of the drop in employees.

construction in our labour market is now half of what it was in 2007, when it reached its peak. The sharp fall in investment in construction in the first quarter, 10.2% year-on-year, together with the 34.6% cut in the budget for the Ministry of Public Works planned for this year, suggest that this trend will continue in the future.

The private sector is still the main reason for the fall in employees, as it is responsible for 92% of this reduction. However, budget cuts are starting to have an effect and the number of public employees has fallen for the second consecutive quarter and at a faster rate, namely 3% year-on-year. To date, the entire adjustment in public employment has been made with temporary staff, whose number fell by 8% compared with the previous quarter and by 10% compared with the first quarter of 2011. Temporary public employees account for 22% of public employment and total 690,000 people.

The fact that there are currently net job losses does not mean, however, that no jobs are being created but rather that, in Spain, more jobs are being lost than those being created. In fact, in the first quarter of the year 845,100 people found a job, 11% fewer than at the start of 2009, the worst moment in the crisis when the economy was down 1.6% compared with the previous quarter. However, the few jobs being created are mostly unskilled, with a high presence in wholesale and retail trade (15% of the jobs created in the first quarter), agriculture (12%) and, surprisingly, construction (12%).

The number of first-time job seekers rises by 22% year-on-year.

The number of contracts registered with the State Employment Service, 6% fewer in April compared with the same month last year, also shows the significant difficulty in finding work. In the last year, the number of unemployed who stated they were looking for work for the first time has grown by 22% and young people aged between 20 and 24 are the most affected by the unsuccessful search for

ESTIMATED UNEMPLOYMENT

First quarter 2012

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	3,023.8	183.7	6.5	388.8	14.8	53.6	24.1
Females	2,615.7	182.1	7.5	340.5	15.0	46.4	24.9
By age							
Under 25 years	921.8	37.6	4.3	54.6	6.3	16.3	52.0
Other	4,717.7	328.3	7.5	674.7	16.7	83.7	22.1
By personal situation							
Long-term unemployment	2,822.5	184.5	7.0	535.8	23.4	50.0	–
Seeking first job	456.0	12.8	2.9	82.2	22.0	8.1	–
Other	2,361.0	168.6	7.7	111.3	4.9	41.9	–
TOTAL	**5,639.5**	**365.9**	**6.9**	**729.3**	**14.9**	**100.0**	**24.4**

SOURCES: National Institute of Statistics and own calculations.

a job. Since the first quarter of 2010, those seeking their first job have grown by 41%, double the number of unemployed excluding this group, accounting for 15% of the unemployment created over these two last years.

Given the scant job opportunities, the labour force seems to have embarked on the road towards entrepreneurism. In the first quarter of the year, the number of business and self-employed people rose by 46,300 and has remained almost the same as the previous quarter. Should this trend continue, in spite of the credit squeeze and weak demand, such entrepreneurism might be able to alleviate, to some extent, the significant deterioration in the labour market expected for this year.

At the same time as jobs were being lost, wages rose in the first quarter by 0.9% year-on-year. Given that the inflation for this period was 2.0%, households have been losing purchasing power via wages for the last two years. Consequently, unit labour costs kept to their year-on-year decrease of 2.5%.

In order to regain competitiveness via wages, the stability plan produced by the government predicts that wages will grow by 0.2% in 2012 and fall by 0.4% in 2013, both figures below its forecast for inflation. In addition to the loss of purchasing power, such a wage adjustment also aims to reduce unit labour costs by 1.7% in 2012 and by 1.0% in 2013. However, this wage containment does not stop the government from forecasting a 3.7% drop in full-time jobs for 2012, with this continuing in 2013 and jobs starting to be created in 2014.

The unemployment rate achieved by the economy over the coming years will largely depend on the trend in the labour force. In addition to the job losses, the number of unemployed will grow in line with the number of first-time job seekers and those stopping work (activity rate), as well as due to worker emigration. According to our forecasts, the deterioration in the economy will push the unemployment rate beyond 25% in 2013 and the number of unemployed will approach 6 million.

Labour costs will continue to fall in the future.

Prices

Spurious upswing in inflation

Inflation is up by two tenths of a percentage point and stands at 2.1%.

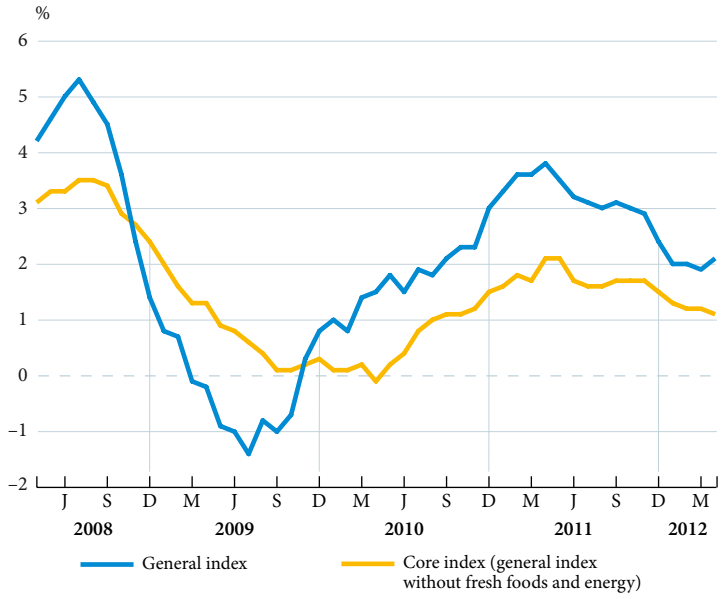
Inflation is the most frequently used term to refer to the variation in the consumer price index (CPI), which is based on the trends in the price of consumer goods and services acquired by households resident in Spain. The price fluctuation is normally compared with the previous month or the same month in the previous year and is closely related to the dynamism in economic activity. However, April's upswing in inflation is not associated with an upswing in activity but rather, and as we anticipated last month, with the government's intervention in the price of electricity, gas and tobacco.

This rise is due to intervention in gas, electricity and tobacco prices.

After seven consecutive months of falls, the year-on-year rate of change in the CPI increased by two tenths of a percentage point in April compared with the previous month and stood at 2.1%. An increase of this size has not been seen since precisely a year ago, when the quarter-on-quarter growth in the economy was 0.2%. On the other hand, in the first quarter of this year the economy shrank by 0.3% compared with the previous quarter and forecasts by the consensus of economists point to even greater contraction in the second quarter. So the main reason for this upswing can be found in the 9.4% year-on-year change in the price of electricity, the 8.5% rise in gas and the 6.5% in tobacco.

GENERAL INFLATION PICKS UP BUT CORE INFLATION CONTINUES TO FALL

Year-on-year change in CPI



SOURCE: National Institute of Statistics (INE).

CONSUMER PRICE INDEX BY COMPONENT GROUP

April

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2011	2012	2011	2012	2011	2012
By type of spending							
Food and non-alcoholic beverages	101.8	0.3	0.2	0.6	0.7	2.2	2.3
Alcoholic beverages and tobacco	105.6	–0.1	2.9	2.5	3.4	14.7	5.1
Clothing and footwear	104.5	9.6	9.9	–4.1	–4.0	0.4	0.4
Housing	104.4	0.7	2.2	4.3	3.2	8.0	4.7
Furnishings and household equipment	100.7	0.5	0.4	0.0	–0.3	1.2	0.9
Health	97.6	–0.1	–0.1	0.0	–0.1	–1.3	–2.9
Transport	105.7	1.0	0.6	4.9	4.9	9.3	4.8
Communications	96.8	0.2	–0.4	0.1	–2.3	0.3	–3.9
Recreation and culture	100.9	1.5	1.0	0.6	–0.5	0.6	0.3
Education	102.1	0.0	0.0	0.0	0.1	2.2	2.9
Restaurants and hotels	100.9	0.6	0.7	1.1	0.9	1.9	1.0
Other goods and services	101.8	0.2	0.2	1.8	1.1	3.2	1.9
By group							
Processed food, beverages and tobacco	102.6	0.4	0.6	1.4	1.2	4.5	2.9
Unprocessed food	101.7	–0.1	0.6	–0.5	0.9	2.4	2.1
Non-food products	102.5	1.5	1.6	1.5	1.1	3.8	1.9
Industrial goods	104.0	2.5	2.8	1.9	1.6	5.4	2.7
Energy products	*110.2*	*1.7*	*2.9*	*10.2*	*8.7*	*17.7*	*8.9*
Fuels and oils	*110.8*	*2.3*	*1.1*	*10.9*	*9.0*	*18.7*	*8.7*
Industrial goods excluding energy products	*101.3*	*2.9*	*2.7*	*–1.2*	*–1.3*	*0.9*	*0.1*
Services	101.1	0.5	0.5	1.2	0.6	2.2	1.1
Underlying inflation (**)	101.5	1.3	1.2	0.4	0.0	2.1	1.1
GENERAL INDEX	**102.5**	**1.2**	**1.4**	**1.4**	**1.1**	**3.8**	**2.1**

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

Regarding electricity, and in addition to the adoption of other measures related to the distribution, capacity and transport of electricity firms, the 7% increase in last resort tariff (TUR) for domestic consumers, 4.1% for small and medium-sized firms, 2.8% for medium-sized industries and 0.9% for large industries led to a monthly increase of 8.1% of its price. The only other time such a large increase has been seen in the last decade was in April 2011. The government also increased the official gas tariff by 5%, leading to a 1.0% rise in its month-on-month rate of change.

On the other hand, the modification of the special taxes applicable to tobacco products led to a month-on-month rise in its price of around 3.9%. If we add to these three items the contribution made by clothing and footwear, whose monthly inflation rate can be explained by the start of the new spring season, we find the main reasons for the percentage month-on-month change in the CPI in April

Monthly inflation reaches 1.4%, the highest rate for the last 6 years.

Core inflation falls by one tenth of a percentage point and stands at 1.1%.

reaching 1.4% and being the highest it's been for the last 6 years.

If we exclude the most volatile elements from our analysis, namely fresh foods and energy, underlying inflation saw a year-on-year change of 1.1% in April, one tenth of a percentage point less than the previous month. Weak household consumption, down 0.6% year-on-year in the first quarter, will keep the variation in core inflation very contained.

Given the temporary nature of April's rise, any containment in inflation over the coming months will largely be determined by the trend in oil prices. In fact, in April transportation was the item that pushed down the annual CPI rate the most, as this includes the price of vehicles, down 0.2% compared with the previous month, and fuels and oils, which rose less than in the same month last year.

Although, in the first two weeks of May, the price of Brent quality oil in dollars fell by 5.8%, its price in euros only decreased by 3.5% due to the depreciation of the euro/dollar exchange rate. As the euro continues to lose value compared with its US peer, Spanish households will be less able to take advantage of the lower oil prices and inflation for fuels and oils, currently standing at 8.5% year-on-year, will moderate to a lesser extent.

With regard to an analysis of the competitiveness of Spain's economy, the inflation differential compared with the euro area decreased in April by three tenths of a percentage point. In principle, this means that our cost structure, which is passed on to the market through prices, has improved at a slower rate than in March compared with our main trading partner.

However, if we exclude energy from the basket of goods in our analysis (which includes electricity and gas), as well as food, tobacco and alcohol (the two latter items subject to highly disparate tax rates in the different European countries), then the differential remains constant at 1.0%.

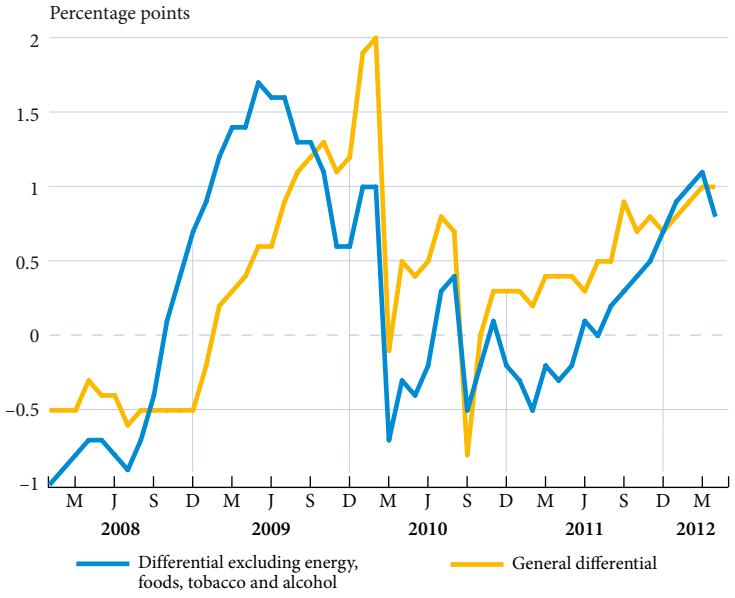
CONSUMER PRICE INDEX

	2011			2012		
	% monthly change	% change over December 2010	% annual change	% monthly change	% change over December 2011	% annual change
January	–0.7	–0.7	3.3	–1.1	–1.1	2.0
February	0.1	–0.6	3.6	0.1	–1.0	2.0
March	0.7	0.1	3.6	0.7	–0.3	1.9
April	1.3	1.4	3.8	1.4	1.1	2.1
May	0.0	1.3	3.5			
June	–0.1	1.2	3.2			
July	–0.5	0.7	3.1			
August	0.1	0.8	3.0			
September	0.2	1.0	3.1			
October	0.8	1.8	3.0			
November	0.4	2.2	2.9			
December	0.1	2.4	2.4			

SOURCE: National Institute of Statistics.

SPAIN CONTINUES TO GAIN COMPETITIVENESS IN EUROPE

Inflation differential between the euro area and Spain



SOURCE: Eurostat.

The graph above shows how, if these elements are excluded, the Spanish economy is continuing to gain in competitiveness with regard to Europe at the same pace as last month.

Apart from fleeting rises in inflation, the worsening condition of the economic situation will stabilize inflation at around 2.0% in 2012 and, unless there is an unexpected fast recovery in the economy, the annual rise in prices will be around 1.4% for the whole of 2013. One positive note is that, over the next two years, Spain's economy will continue to gain in competitiveness, key to improving the foreign sector and the foundations for future growth.

The economy will continue to regain competitiveness in the coming years.

Foreign sector

Exports lose steam

Foreign demand's contribution to GDP growth drops in the first quarter of 2012.

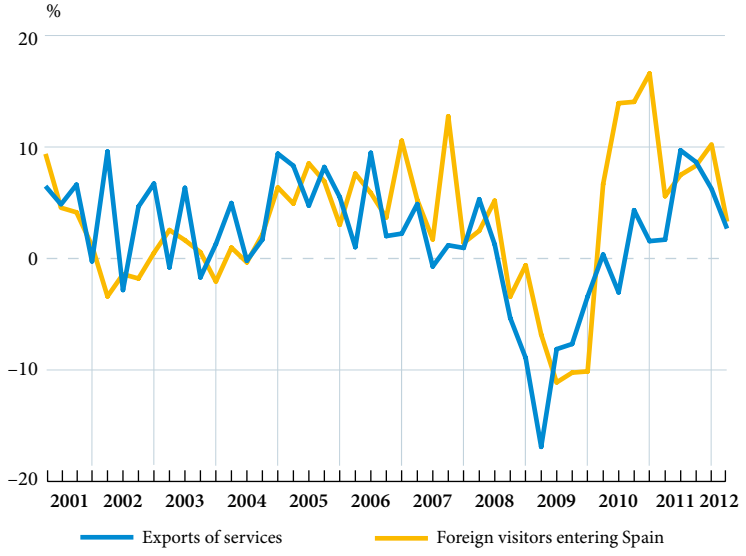
The figures from the National Accounts system for the first quarter confirmed the signs of a slowdown in foreign demand suggested by higher frequency indicators. The foreign sector's contribution to quarterly growth in gross domestic product (GDP) fell sharply in this period. A contraction in exports lies behind this lower contribution by what has been the main engine of the economy over the last two years. But within a scenario of weak domestic demand in the medium term, the trend in the foreign component will be crucial in determining the pace of the economy's recovery, as well as the extent of correction in the current imbalance.

Service exports fall sharply.

In fact, the slowdown in the economy of our main trading partners weakened the performance of exports, down 0.9% quarter-on-quarter in the first three months of 2012. But unlike what happened one quarter ago, this fall was exclusively due to a decline in the services component. Specifically, this fell by 5.0% quarter-on-quarter, after two years of continuous increases. As can be seen in the graph below, the slowdown in the number of tourists visiting Spain is the main reason for this drop. In this respect, April's figures, with 1.7% fewer arrivals than the same month in 2011, does not augur any recovery in service exports in the short term.

THE LOSS OF DYNAMISM IN TOURISM WEAKENS SERVICE EXPORTS IN THE FIRST QUARTER OF 2012

Year-on-year change in the quarter-on-quarter figures



SOURCES: National Institute of Statistics and own calculations.

We expect this loss of dynamism in exports to be accompanied by further falls in imports, caused by the weakness in domestic demand. As a consequence, the foreign sector's contribution to economic growth will remain in positive terrain over the next few months, although at a relatively low level. This was the case of the first quarter of 2012, when the contraction in imports, namely 1.3% quarter-on-quarter, placed the contribution by foreign demand to GDP at 2 tenths of a percentage point. A figure that is far from the previous quarter's contribution of 1.4 percentage points.

Within this context of diminishing trade flows, we can see further advances in the correction of the external imbalance between January and March. The cumulative figures for the last four quarters show an improvement in the current account deficit of 0.3 percentage points, to 3.6% of GDP. A level that has not been reached since 2000 and which represents a contraction of 7.1 percentage points compared with the maximum reached in 2008. The extensive adjustment in the balance of goods, and more specifically in non-energy goods, lies behind most of this correction.

According to the data from the Customs department, the correction in the balance of non-energy goods was still the main source of adjustment in the current deficit in the first quarter of 2012. Of note is the further increase in the trade surplus with the rest of the countries in the European Union, which nearly reached 6.7 billion

The current deficit falls by 0.3 percentage points to 3.6% of GDP in March.

FOREIGN TRADE

January - March 2012

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	16,109	16.7	24.7	3,712	32.5	6.8	–12,397	23.0
Consumer goods	14,693	–1.3	22.6	18,108	0.4	33.3	3,416	123.2
Food	*3,663*	*–0.6*	*5.6*	*7,348*	*9.1*	*13.5*	*3,685*	*200.6*
Non-foods	*11,030*	*–1.6*	*16.9*	*10,761*	*–4.8*	*19.8*	*–270*	*97.6*
Capital goods	3,783	–11.5	5.8	4,324	–6.8	7.9	541	114.3
Non-energy intermediate goods	30,520	–6.2	46.9	28,300	3.8	52.0	–2,220	92.7
By geographical area								
European Union	32,707	–6.1	50.2	35,526	0.8	65.3	2,819	108.6
Euro area	*26,449*	*–6.9*	*40.6*	*28,333*	*–1.1*	*52.0*	*1,884*	*107.1*
Other countries	32,398	5.6	49.8	18,920	8.2	34.7	–13,478	58.4
Russia	*1,877*	*–16.3*	*2.9*	*683*	*20.4*	*1.3*	*–1,194*	*36.4*
United States	*2,499*	*–9.1*	*3.8*	*2,033*	*–0.9*	*3.7*	*–465*	*81.4*
Japan	*792*	*–14.1*	*1.2*	*485*	*10.5*	*0.9*	*–306*	*61.3*
Latin America	*5,752*	*51.5*	*8.8*	*3,157*	*5.2*	*5.8*	*–2,595*	*54.9*
OPEC	*8,219*	*20.0*	*12.6*	*2,314*	*25.9*	*4.3*	*–5,905*	*28.2*
Rest	*13,260*	*–6.0*	*20.4*	*10,246*	*6.8*	*18.8*	*–3,013*	*77.3*
TOTAL	**65,105**	**–0.6**	**100.0**	**54,445**	**3.2**	**100.0**	**–10,659**	**83.6**

SOURCES: Ministry of the Economy and own calculations.

The trade surplus with the European Union approaches 6.7 billion euros in March.

euros in March 2012 in cumulative terms over twelve months.

Looking to the future, we have kept to our forecast of a current deficit at 2.4% of GDP by the end of 2012. However, there are two factors that might slow up this rate of correction. Firstly, a loss of dynamism in exports of goods and services towards the euro area would affect the trade balance. Secondly, an upswing in tension in the financing markets could continue to push up the cost of financing Spain's external debt. As a consequence, the deficit in the income balance, which had already increased by 7 tenths of a percentage point in 2011, would continue to rise.

The ECB's injection of liquidity boosts financing via the Eurosystem.

In fact, this turbulence has led to a change in the composition of Spain's financing. As can be seen in the financial account, the Eurosystem became the main source for the net inflow of capital, increasing by 38.8 billion euros. This rise was due to the extensive liquidity injections carried out by the European Central Bank into the banking system and contrasts with the sharp fall in portfolio and other types of investment, totalling 11.0 and 25.0 billion euros respectively.

BALANCE OF PAYMENTS

February 2012

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–6,196	–13.0	–38,778	8,890	–18.7
Services					
Tourism	*3,206*	*6.3*	*30,794*	*3,563*	*13.1*
Other services	*394*	–	*4,188*	*3,696*	–
Total	3,600	37.6	34,982	7,259	26.2
Income	–5,331	49.0	–27,886	–7,111	34.2
Transfers	–3,686	8.9	–6,228	881	–12.4
Total	**–11,612**	**1.3**	**–37,910**	**9,919**	**–20.7**
Capital account	**184**	**–87.1**	**4,241**	**–1,936**	**–31.3**
Financial balance					
Direct investment	5,072	–	–945	4,583	–82.9
Portfolio investment	–10,954	–	–61,294	–122,722	–
Other investment	–25,009	138.7	–59,462	–38,735	186.9
Total	**–30,891**	**–**	**–121,701**	**–156,874**	**–**
Errors and omissions	3,480	12.6	–1,178	–1,888	–
Change in assets of Bank of Spain	38,839	–	156,549	150,780	–

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

Public sector

The slow pace of adjustment lowers confidence regarding public debt

Tensions in Europe's sovereign debt markets grew in May, especially in the so-called peripheral economies. Increasing rumours regarding Greek's possible exit from the euro area have played a significant part. In Spain, this escalation has been sharpened by further capital requirements for banks and the increasingly widespread doubts as to whether the fiscal deficit targets will be met, particularly after the upward revision of the final deficit for 2011 by 4 tenths of a percentage point to 8.9% of gross domestic product (GDP). The data available for the first quarter have not provided any arguments to oppose this view. It is therefore necessary for the fiscal consolidation policies adopted by the government to start to bear fruit.

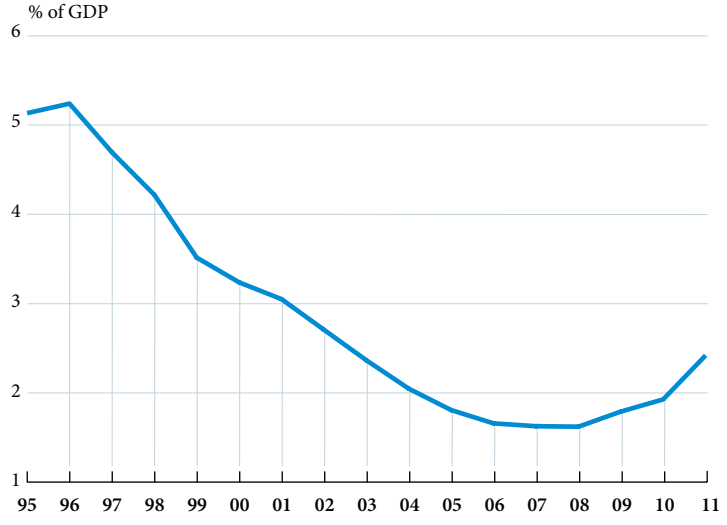
In fact, the yield on Spain's 10-year bonds reached 6.3% in May, exceeding its German equivalent, the bund, by more than 500 basis points. This differential, a mesure of the risk premium, is a new record since the start of the financial turmoil. During the last month, the increase in yield was actually generalized among all Spain's debt securities, irrespective of their maturities. As a consequence, the interest rates demanded for new debt issuances carried out by the Treasury have increased significantly.

This higher cost of financing, together with the progressive increase in public debt, will continue to swell the interest

The risk premium goes above 500 basis points in May.

THE INTEREST BURDEN INTENSIFIES ITS ASCENT

Spending on interest payments in relation to GDP



SOURCE: Ministry of Finance.

The interest burden rises rapidly to 2.4% of GDP.

burden, defined as the interest paid by the public sector in relation to the country's GDP. As can be seen in the graph above, interest payments reached their lowest level in 2008, when they represented just 1.6% of GDP. Since then, this ratio has risen noticeably, reaching 2.4% in 2011. The government's forecasts state that this trend will continue and the interest burden will go above 3% of GDP in the coming years. This level is similar to that of the euro area as a whole and significantly lower than the level recorded in the mid-1990s.

However, the increased spending on interest payments is an additional obstacle to meeting the ambitious public deficit targets contained in the 2012-2015 Stability Programme. According to this, the public imbalance will be 5.3% of GDP in 2012, a target that has not altered in spite of the recent increase of 4 tenths of a percentage point in the final deficit for 2011, to 8.9% of GDP, due to the revision of the figures for the autonomous communities.

Efforts to reduce the government deficit are wiped out by the worsening economic situation.

For the moment, the efforts being made to adjust the government deficit are having a very limited impact. The hike in direct taxes and cuts in investment, intermediate consumption and wages have helped these items to decrease by 1.8 billion euros during the first quarter of 2012. However, this adjustment was totally wiped out by the decline in the cyclical component of the budget flows, specifically higher interest payments and lower revenue from indirect taxes, especially value added tax (VAT). If, moreover, we include advances of current transfers to the autonomous communities and Social Security, the cumulative government deficit for this period reached 1.2% of the GDP expected for 2012. This figure is 4 tenths of a percentage point higher than the one recorded for the first quarter of 2011.

We predict that the public deficit will reach 6.4% of GDP by the end of the year.

Social Security accounts have also seen a drop in company contributions of 1.5% year-on-year during the first quarter. The trend in the main source of income for the government is therefore moving away from the increase expected for the year as a whole, namely 0.9%, which is vital in order to achieve the balanced budget agreed in the Stability Programme.

In addition, the autonomous communities are likely to find it difficult to correct their deficit by 1.8 percentage points. According to the Fiscal and Financial Policy Council, the consolidation measures contained in the economic-financial plans of these communities, totalling almost 18.4 billion euros, will be enough to achieve the target deficit. But there are doubts regarding whether this adjustment can be achieved.

Given this context, we have revised our forecast for 2012's public deficit by 4 tenths of a percentage point up to 6.4%, the same level as established by the European Commission. However, this same body has kept its projected fiscal imbalance for 2013 almost the same, as its forecasts are made according to the measures approved by the government. In this respect, the Stability Programme contains the fiscal strategy prepared to attempt to reduce the deficit to 3% of GDP. Its most outstanding feature is a further reduction in wages and intermediate consumption, namely 0.6 percentage points for each heading, and an increase in revenue from indirect taxes, valued at 8 tenths of a percentage point of GDP. This increase would open the door to a rise in the VAT rate in the coming year.

Savings and financing

Another turn of the screw for Spanish banks

Confidence is the basic pillar supporting the banking system. In Spain's case, this support has deteriorated over the last few months, at the same rate as the system has become increasingly dependent on Eurosystem funding. However, it was at the beginning of May, with the government's intervention in the country's fourth largest financial institution, when doubts intensified regarding the solvency of the banking system. The government's response was rapid, announcing a new financial reform that reinforces the write-down of the sector's real estate portfolio. This is the second reform in just three months. However, the financial markets did not give it an entirely warm welcome and the next few months will therefore seal the fate of Spain's financial system.

Whereas the aim of February's reform was to raise the level of coverage for toxic real estate portfolios, May's reform forces an increase in generic provisions for non-toxic assets of the real estate development and construction sector. In December 2011, these assets totalled 123 billion euros or the equivalent of 40% of all credit to these sectors. Specifically, the new royal decree requires the average coverage for this non-toxic credit to be around 30% before the end of the year, 23 percentage points above the level established after the reform announced in February. This coverage ratio changes depending on the nature of each asset. For loans to acquire land, either backed by personal guarantees or second mortgages that are not problematic, coverage must be 52%. For developments underway and finished homes, the minimum coverage required is 29% and 14%, respectively.

The aim of these new provisions is to prepare the financial system to withstand an extremely adverse scenario and thereby dispel doubts regarding its capacity to survive. For example, according to the Ministry of Finance, even if three quarters of non-toxic development and construction credit migrated to toxic loans, the coverage rate of the latter's final stock would still be 50%. Economic activity is not expected to deteriorate to such an extent but the financial sector will be tested. The non-performing loan ratio for developers and builders rose non-stop throughout 2011 until it reached 20.9%, 7.9 percentage points above the level recorded a year earlier. The increase in the NPL ratio of all credit portfolios is lower but still significant. In the first quarter this rose by 5 tenths of a percentage point, reaching 8.37%.

According to the Spanish government's calculations, May's reform requires additional provisions totalling approximately 28 billion euros. An amount that must be added to the almost 54 billion euros required to meet the measures adopted in February, which will help to place the coverage for development portfolios as a whole at around 45%. However, with revenue at a relative standstill, high provision

The government approves its second financial reform in just three months...

...and increases the coverage for non-toxic real estate development credit to 30%.

The aim of the new reform is to dispel doubts regarding the financial system's ability to resist.

FINANCING OF NON-FINANCIAL SECTORS (1)

March 2012

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,114,532	–14,463	–2.1	73.2
Non-financial corporations	1,254,995	–2,984	–1.7	43.5
Resident credit institution loans (3)	*829,881*	*–10,980*	*–4.8*	*28.7*
Securities other than shares	*70,314*	*5,208*	*13.0*	*2.4*
External loans	*354,800*	*2,789*	*3.6*	*12.3*
Households (4)	859,538	–11,479	–2.7	29.8
Housing loans (3)	*659,870*	*–6,969*	*–2.0*	*22.9*
Other (3)	*196,575*	*–4,548*	*–5.3*	*6.8*
External loans	*3,093*	*37*	*4.8*	*0.1*
General government (5)	773,104	38,142	13.7	26.8
TOTAL	**2,887,636**	**23,679**	**1.5**	**100.0**

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

The new requirements demand even greater effort.

requirements in just twelve months represent another turn of the screw for the income statements of financial institutions. In fact, not all of them are expected to be able to cover the new write-down with the profits made during the year. Capital gains, with the sale of holdings, or the use of surplus capital may also be employed for this purpose. Those institutions that still don't achieve the necessary coverage will have to look to the market to get capital or to the Fund for Orderly Bank Restructuring (FROB in Spanish) by issuing convertible bonds.

However, the difficulties of funding Spanish banks through traditional channels mean that this last option is gaining momentum. In fact, over the last few months, the Eurosystem has become the main source of funds for Europe's banks in general and particularly in Spain, with net Eurosystem loans to Spanish credit institutions rising by 194.2 billion euros between September 2011 and April 2012.

Credit falls by 3.1% year-on year in March.

Private debt continued to fall within this situation of tense finance markets and a weak economy. During the first three months of the year, this drop was most acute for households, reducing their financial liabilities by 11.5 billion euros, compared with the almost 3.0 billion euros in company deposits. The credit squeeze for the private sector largely explains this development. Specifically, in March 2012, the outstanding credit balance was 3.1% lower than the figure recorded a year ago. This trend contrasts with the increasing indebtedness of the public sector over the last few years. In the first quarter alone, the consolidated liabilities of the public sector increased by 38.1 billion euros.

In addition to increased provisions for the healthy portfolio of development loans, May's financial reform also contains two

far-reaching measures. The first establishes that those institutions not supported by FROB will have to create asset management companies to which they can transfer their foreclosed real estate assets once the relevant provisions have been made. According to the Ministry of Finance, this separation will allow credit institutions to focus on their banking business. The value at which these assets will be moved under the umbrella of real estate companies will be the result of subtracting the provisions from their book value. The government's decree also leaves the door open to private investors becoming involved and does not rule out the establishment of public support instruments, if necessary.

Institutions must create real estate asset management companies.

Secondly, two independent evaluations will be requested of the risk of the financial sector's whole asset portfolio. These evaluations will be supervised by the European Central Bank and the Bank of Spain. The aim is to settle doubts regarding the balance sheets of financial institutions.

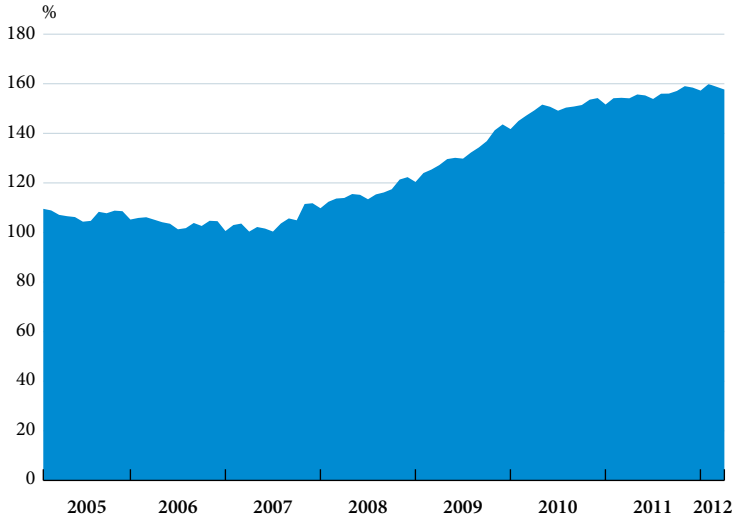
This exercise is similar to the one carried out in other countries such as Portugal and Ireland, although the outcome was very different for the two cases. While the evaluation of the credit portfolio in Portugal resulted in a minimal reclassification of assets to toxic loans, in Ireland this led to significant injections of public capital in banks. This divergence increases doubts regarding the repercussions of the external valuations of Spain's banking system, although it is very unlikely to be prescribed the tough conditions required in Ireland's case.

Another condition proposed to the financial sectors of these two European countries was the start of an orderly deleveraging process. In both cases, the ratio of loans to deposits in the system must decrease to levels close to 120% within 4 years, starting from levels above

The trend in the total credit portfolio could push up the capital requirements for Spain's banks.

FINANCIAL SECTOR LEVERAGING REMAINS VERY HIGH

Leverage ratio of the financial sector measured as loans to deposits



SOURCE: Bank of Spain.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

March 2012

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	269,236	–475	–0.2	5,884	2.2	19.7
Savings deposits	197,542	–5,407	–2.7	–12,938	–6.1	14.4
Term deposits	697,967	230	0.0	–41,537	–5.6	51.0
Deposits in foreign currency	15,913	–1,806	–10.2	–3,773	–19.2	1.2
Total deposits	**1,180,657**	**–7,458**	**–0.6**	**–52,364**	**–4.2**	**86.3**
Other liabilities (*)	**187,106**	**2,142**	**1.2**	**–6,906**	**–3.6**	**13.7**
TOTAL	**1,367,763**	**–5,316**	**–0.4**	**–59,270**	**–4.2**	**100.0**

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

Deposits continue their downward slide.

150%. As can be seen in the previous graph, in Spain's case this ratio reached 157.5% in March 2012. Consequently, a similar requirement for our banks would intensify the credit squeeze in Spain, especially if we take into account the gradual decrease in bank deposits over the last few months.

In March, the bank deposits of households and firms had fallen by 4.2% compared with the same month in 2011. There are many factors underlying this trend. On the one hand, there is the reduction in savings in an adverse macroeconomic context; on the other, greater competition with products providing a higher return, such as Treasury bills or commercial paper from banks.

In this respect, according to the Financial Stability Report drawn up by the Bank of Spain, the outstanding balance of the commercial paper issued by financial institutions stood at more than 50 billion euros in March 2012. This figure is more than three times the one recorded half a year earlier. In fact, according to this report, the overall trend in deposits and commercial paper shows a much more moderate fall. However, the latest upswings in yields on Spain's sovereign debt over the last few months will ensure that deposits continue to be replaced by other products in the short term.

In summary, May's new financial reform and the external evaluations will require a renewed effort from Spain's banking sector. All this within a context of marked macroeconomic weakness that will continue to damage the income statements of financial institutions. The road towards the sector's recovery will be tough but it must be taken as soon as possible. Only that way will confidence be restored in the financial system, so necessary for it to work well.

The future of Spain's insurance industry

At the current time of economic difficulties, the levels of capital, prudent risk management and productivity of Spain's insurance industry have helped to make the financial system more stable and have significantly aided the Spanish economy. By way of example, in 2011 the insurance industry demonstrated its strength by means of an estimated volume of direct insurance premiums issued totalling 60,592 million euros, with a growth of 4.13% compared with 2010 despite the shrinking economy. However, notwithstanding its commercial strength, the industry is also going through a decisive and redefining period and it will face significant challenges in the coming years.

STRUCTURE OF THE SOLVENCY II REGULATION FOR THE INSURANCE INDUSTRY

Solvency II		
Pillar 1	**Pillar 2**	**Pillar 3**
Equity requirements	**Supervisory processes**	**Market discipline**
• Minimum capital required • Valuation of assets and technical provisions • Internal models	• Corporate governance • Internal control • Supervisory review process	• Transparency • Reporting to the supervisor • Information on competition • Public information

SOURCE: Own calculations.

Solvency II regulations, equivalent to those of Basel II for the financial system, together with the necessary review of bank insurance agreements as a consequence of the numerous mergers between savings banks, represent two critical points in defining Spain's insurance industry of the future. Moreover, the slowdown in economic activity and the credit squeeze, with a deterioration in the sovereign debt of almost all European countries, represent a challenge to managing investment in the sector.

At a European level, a new regulatory framework is being proposed for the industry, known as Solvency II, which raises capital requirements and is provoking debate regarding some of the criteria adopted. Solvency II is a regulatory proposal that will probably come into force in 2014 and that, emulating the regulation of the financial sector, is divided into three fundamental pillars. The first pillar is quantitative in nature and establishes the minimum capital requirements for insurance companies. The other two pillars are qualitative in nature and affect governance (industry supervision) and market discipline (information transparency).

In general terms, Solvency II is a positive development in regulation for the sector as it modifies the powers of the supervisory regime, giving it a dynamic, prospective view that allows it to anticipate potential crisis situations. It also encourages a more transparent organisational structure among insurance companies, separating functions more appropriately and with improved communication channels. With regard to the quantitative part of capital requirements, this model is based on establishing criteria to value assets and liabilities and thereby determine the risks managed by each entity and the minimum capital it requires. According to the latest calculations carried out with individual figures for entities by the Basel Committee (QIS5), the impact for the sector is significant in this respect as, for Spanish insurance companies, this raises their capital requirements by 10,277 million euros to

17,205 million euros. An amount that does not entail global bankruptcy for the industry, as it has an excess of solvency, but which, on the other hand, should make the system more secure.

However, as a result of the QIS5, points of disagreement have arisen related to long-term products. The debate revolves around the method chosen to value assets and liabilities on the companies' balance sheets. Solvency II proposes that this should be mark-to-market. But in a sector such as the insurance industry, where portfolios are held long term, this methodology increases the procyclicality of the requirements and could put the wrong incentives in place.

Insurance risk is long term due to its very nature. More than 20 years might pass from when a client takes out, for example, a life-savings policy to when this is cashed in. Consequently, the insurer must invest in long-term secure assets to be able to ensure that the client will receive what has been guaranteed in the future. The assets and liabilities of an insurance company should therefore not be valued as if they were going to be sold tomorrow, which is what happens with the mark-to-market model, as this might result in a short-term management focus that would not be suitable for insurance business.

This debate becomes highly significant at times such as the present, so that work is being carried out on measures to resolve this problem. In this respect, there is the option of a countercyclical premium or matching adjustment, which means that adjustments can be made to the valuation of assets and liabilities at times of stress and thereby avoids the procyclicality caused by stressful discounting. However, its design needs to be studied in depth to make sure it does not encourage companies to invest in riskier assets. Moreover, the conditions under which this premium could be applied must be made very clear, without this limiting its applicability to any great extent.

Anyway, in today's complex and changing economic and financial environment, the risks for the insurance industry are not limited to regulatory aspects but are also related to business. Up to 12 insurance companies have alliances with banks, a sector that distributes 73% of life assurance premiums and is also gaining presence in non-life insurance branches, where it accounts for 10% of the premiums. But the strong process of concentration in the financial system, with numerous mergers between savings banks, means that these bank insurance agreements need to be reviewed. It therefore becomes necessary to establish a single bank insurance operator (to broker the sale), although the same financial institution can sell insurance from several different companies through its network, if so agreed. This process won't be simple as the current bank insurance agreements are private insurance policies between entities with large amounts of compensation should they be broken, established during an economic boom but difficult to afford in the current environment.

And we also need to add into the mix the slowdown in economic activity in Spain, which is clearly having a detrimental effect on business volumes and new operations in the risk business, as well as the fall in the savings rate, which harms savings products. In addition, the high volatility of the markets and the uncertainty regarding sovereign debt of most European countries make it difficult to manage the risk of entities.

In short, over the last few years Spain's insurance industry has shown itself to be strong at a commercial level and also solvent but it's not free from regulatory or business pressures. The coming months will be important in terms of defining the regulatory model to ensure the right incentives are established and to make progress in drawing up a new competitive map in bank insurance.

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As of December 31, 2011

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

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

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

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