JUNE 2009

THE SPANISH ECONOMY

Monthly Report

NUMBER 325

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2007	2008	2009	2008				2009	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	2.0	1.1	–2.9	2.5	2.1	0.7	–0.8	–2.6	–3.7
Japan	2.4	–0.7	–7.4	1.3	0.6	–0.2	–4.5	–9.1	–8.6
United Kingdom	3.0	0.7	–4.6	2.6	1.7	0.3	–1.8	–4.1	–5.3
Euro area	2.6	0.7	–4.5	2.1	1.4	0.6	–1.4	–4.6	–5.0
Germany	*2.6*	*1.0*	*–5.6*	*2.8*	*2.0*	*0.8*	*–1.6*	*–6.9*	*–6.5*
France	*2.1*	*0.7*	*–3.0*	*2.0*	*1.2*	*0.6*	*–1.7*	*–3.2*	*–3.3*
Consumer prices									
United States	2.9	3.8	–1.0	4.2	4.3	5.2	1.5	–0.2	–1.4
Japan	0.1	1.4	–1.0	1.0	1.4	2.2	1.0	–0.2	–0.3
United Kingdom	2.1	3.6	1.8	2.4	3.3	4.9	3.9	3.0	1.8
Euro area	2.1	3.3	0.4	3.4	3.6	3.8	2.3	1.0	0.3
Germany	*2.3*	*2.6*	*0.5*	*2.9*	*2.9*	*3.1*	*1.6*	*0.9*	*0.4*
France	*1.5*	*2.8*	*0.4*	*2.9*	*3.3*	*3.3*	*1.8*	*0.6*	*0.0*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	3.4	0.1	–3.1	2.0	0.8	–0.2	–2.3	–4.1	–3.9
Government consumption	4.9	5.3	4.3	3.7	5.0	6.1	6.3	5.4	4.5
Gross fixed capital formation	5.3	–3.0	–15.4	2.4	–0.8	–4.1	–9.3	–13.1	–15.4
Capital goods	*10.0*	*–1.1*	*–22.2*	*5.2*	*1.8*	*–1.3*	*–9.7*	*–18.6*	*–25.0*
Construction	*3.8*	*–5.3*	*–14.2*	*0.2*	*–3.1*	*–7.3*	*–10.9*	*–12.4*	*–12.7*
Domestic demand (contribution to GDP growth)	4.4	0.1	–5.4	2.6	1.2	–0.2	–3.0	–5.3	–5.8
Exports of goods and services	4.9	0.7	–14.4	4.8	4.4	1.5	–7.9	–19.0	–16.7
Imports of goods and services	6.2	–2.5	–17.0	3.6	1.8	–2.0	–13.2	–22.3	–18.8
Gross domestic product	**3.7**	**1.2**	**–3.7**	**2.7**	**1.8**	**0.9**	**–0.7**	**–3.0**	**–4.2**
Other variables									
Employment	2.9	–0.6	–6.6	1.6	0.1	–0.9	–3.1	–6.0	–7.5
Unemployment (% labour force)	8.3	11.3	18.4	9.6	10.4	11.3	13.9	17.4	18.7
Consumer price index	2.8	4.1	–0.2	4.4	4.6	4.9	2.5	0.5	–0.7
Unit labour costs	2.9	3.4	–0.5	4.2	3.6	3.4	2.6	0.8	
Current account balance (% GDP)	–10.1	–9.5	–6.1	12.1	9.5	8.7	7.9	8.7	
Net lending or net borrowing rest of the world (% GDP)	–9.7	–9.1	–5.5	–11.2	–9.0	–8.4	–7.6	–8.5	
Government balance (% GDP)	2.2	–3.8	–8.3			–1.0	–17.0		
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	5.0	2.0	0.3	3.2	2.1	2.0	0.9	0.3	0.3
ECB repo	3.8	3.9	1.2	4.0	4.0	4.2	3.4	1.8	1.1
10-year US bonds	4.6	3.6	2.9	3.6	3.9	3.8	3.2	2.6	2.9
10-year German bonds	4.2	4.0	3.0	3.9	4.3	4.3	3.5	3.1	3.1
Exchange rate									
$/Euro	1.37	1.48	1.32	1.50	1.56	1.51	1.34	1.30	1.33

Contents

Corporate profits have own dynamic

Since the end of Seventies or the beginning of the Eighties the proportion of income applied as return on capital has increased both in the United States and the European Union. Nor was Spain left outside this dynamic. This was a world-wide trend that went beyond the cyclical fluctuations of the economies. What lay behind this trend? The factors operating in the distribution of product between wages and profits are technological innovation and globalization, while the evidence related to institutional changes (labour deregulation, level of trade union membership and the state of wage negotiations) is less conclusive.

With regard to technological progress, it is felt that this began to change in character and rate in the Eighties, mainly from the impact of the new information and knowledge technologies. The effect of these became clearly evident as of the mid-Nineties. These technological changes tend to strengthen the capital factor to the extent that rapid innovation generates transitory extraordinary income up to the point where new products or processes are imitated or copied by new competitors and prices come down. Furthermore, technological change increases relative demand from that segment of the population that is highly-skilled. Given that in nearly all industrialized countries the proportion of highly-skilled workers around 1980 was relatively low, the process of innovation raised the proportion of income going into these wages while the bulk of workers became relatively less in demand.

At the same time, globalization of the economy has reinforced the change in distribution between wages and profits. The move into world trade by countries that traditionally were excluded (the so-called emerging economies led by China) is tending to bring about a decrease in the share of labour in the income of countries where there is abundant capital, a situation to be found in the advanced industrialized countries.

The tendency to growth of profits coincided with an extraordinary period of increases in prosperity and world employment. The present economic recession has meant a difficult trial for these trends. To begin with, corporate profits are going through a giddy fall due to their sharp cyclical nature. That is to say, when demand drops sharply, the different speed of adjustment between product prices and production costs (especially wage costs), brings about a rapid reduction in profits. In the United States, total corporate profits dropped 24% annual at the end of 2008. The collapse was still sharper for listed companies due to the bigger relative weight of the financial sector. Between the second quarter of 2007 and the fourth quarter of 2008 the gains of companies listed in the S&P 500 index showed a drop of 82%, although it is true that in the summer of 2007 profits stood at exceptionally high levels.

As the recessive stage is overcome and the mechanisms of technical change and globalization are again operating normally, the above trends will likely return. This would be an advantageous situation given that, when all is said and done, the maxim cited by former German chancellor Helmut Schmidt remains valid: «today's profits are tomorrow's investment and the jobs of the day after».

EXECUTIVE SUMMARY

Signs of improvement easing worst recession in half a century

Worst of recession may be over but uncertainty still very high.

Over the past month figures have become available regarding growth in the first quarter of 2009. Growth is a word that has now become a euphemism rather than a description of reality seeing that for most countries these figures were the worst in decades. At the same time, some positive indicators have come out that show improvements in certain spheres, a fact that has created some springtime expressions, such as «green shoots», in referring to a hypothetical end to the recession. The fact is that the world economy is going through the worst situation in many a decade but the worst of the recession may have occurred between the end of last year and the beginning of this. From now on we can expect figures that are not quite so negative although we may have to wait for recovery. We cannot even rule out repeat performances. Uncertainty is very high and reaching the end of the tunnel will not be a bed of roses.

First quarter results show sharp drops in main economies.

Japan and Germany, among the big economic powers, are the most affected. Their heavy orientation toward international trade and their specialization in exporting capital goods of high value added has worked against them because of the collapse of trade at the end of last year. Year-on-year growth of Japan's economy underwent a drop of 9.1% in the first quarter. The downturn in the German economy was somewhat less dramatic at 6.9%. Compared with these figures, the results for the European Union as a whole, the United Kingdom and especially the United States even seem acceptable. In these cases, the year-on-year decrease in GDP in the first quarter was 4.6%, 4.1% and 2.6% respectively.

Some real economy indicators raise hopes of gradual easing of recession.

This trend, which was worse than expected, makes it necessary to revise growth forecasts for 2009 substantially downward. We expect that, following the sharp drop in the first quarter of 2009, the rate of contraction in the main economies will gradually moderate. In the second half-year we could see positive quarter-on-quarter growth rates being reached in the United States, the Euro Area and Japan. This does not mean that results for this group will not be negative by nearly 3% in the United States, 4.5% in the Euro Area and 6% in Japan. In 2010 there will be a return to positive figures as there is a settling in of recovery that, in any case, will still be below existing long-term growth potential.

How can we be confident there will be a recovery scenario? There are two main factors which indicate that the main advanced economies will start on a growth track – the improvement in economic sentiment indices and the normalization of financial markets.

In the United States, the consumer confidence index published by the Conference Board for May continued to move away from the all-time low in February although it is still far from levels appropriate for a recovery. The April index for economic activity and business sentiment of the Institute for Supply Management also continued to gradually come close to the threshold that marks the beginning of expansionist stages.

The main economic sentiment indicators for the Euro Area follow similar lines. The Purchasing Managers Index has now shown improvement three months in a row and the general economic sentiment index prepared by the European Commission also showed a notable improvement in April.

With regard to Japan, it is worth pointing out the recent trend in exports as the worst decreases now seem to have past. Between the end of September 2008 and January 2009 exports dropped by 46.9% but in March they moved up by 5.3% following the moderate decrease in February. Industrial production in March, while showing a modest gain over the previous month, also put an end to the spate of decreases.

The second factor that will bring about a change in the rate of decreases in coming months is the normalization of the financial system. In interbank markets the premiums on liquidity and risk coverage are continuing to shrink. The stock markets keep showing a good performance. With consolidation of the sharp increases in March and April, volatility is lessening and trading volume is firm. The issue of corporate bonds has somewhat eased off but continues at healthy levels.

The effect on the real economy will not be immediate but gradually we should note that credit to companies and households is beginning to recover. In the Euro Area, for example, interest rates on credit to companies and households are rapidly dropping as a result of the reference interest rate cuts being announced by the European Central Bank since October last year. In May, the European monetary authority again made a cut of 0.25 percentage points putting the rate at 1%. The method of stimulating the economy through interest rate cuts is nearing its end. Because of this, at the last meeting of the Governing Council, chairman Jean-Claude Trichet announced new measures to continue facilitating and broadening the liquidity base of the economy.

Financial economy indicators also point to progressive normalization.

In any case, it is important to underline that uncertainty about the course that will be followed in coming out of the world recession is still very high. The speed with which the financial system is able to pass through its recovery to the real economy is quite unclear given that the restructuring of the international banking system is far from concluded. It is also difficult to evaluate the effects of fiscal expansion plans which, while they have somewhat eased the recession, at the same time have generated very high government deficits whose effects on future economic activity may result in a heavy burden. Another factor to bear in mind is the extent of the worsening of the labour market which will make recovery of consumption very slow and limit the capacity of the overall economy to recover. The final factor introducing a high level of uncertainty is the tightening of monetary policies at the moment when economic activity will return to close to normal levels, given that the massive injections of liquidity going into halting the worsening of the economies could mean a danger for the stability of prices and a risk of setting off new speculative bubbles.

Risks still remaining: normalizing banking sector, government deficits, labour market and liquidity bubble.

Spain's economy cannot extract itself from this framework of international financial crisis and sharp world slowdown. The accounts for the first quarter show a quarter-on-quarter decrease in gross domestic product (GDP) of 1.9%. This is the third consecutive quarter to show a drop in economic activity. In these first three months of the year the GDP recorded the biggest year-on-year drop in recent decades (3.0%), even above the worst quarterly figure in the previous recession in 1992-1993. Nevertheless, this decrease was lower than that for the European

In Spain, economy down 3% in first quarter, less than in Euro Area.

Marked contraction in household consumption.

Union as a whole or that of the Euro Area.

The sharp drop in GDP was due to the sharpening decrease in national demand. Household consumption showed a further contraction in the first quarter putting the year-on-year decrease at 4.1%. This decrease was due to the reduction in disposable income with the decrease of 6.0% year-on-year in employment, to the adverse effect of the lower value of stock market and real estate assets and the increased propensity to save as a precaution in view of increasing unemployment, along with the tightening of borrowing terms. All components of consumption showed negative change rates, including food and services which in the fourth quarter of 2008 still held positive. The drop was greater in the case of consumer durables although it was not worse than in the previous quarter.

Collapse in investment as opposed to improvement in foreign sector.

The marked drop continued in April in the case of cars which brought approval of a plan offering subsidies for purchase. Government plans to stimulate the economy, the drop in interest rates and the recovery of the stock markets in recent weeks may be behind the recovery of consumer confidence in March and April which, nevertheless, still stands at very low levels.

With regard to investment, all components sharpened their decreases, particularly capital goods, especially in machinery. Weakness in demand, both domestic and foreign, the drop in corporate profits and uncertainty about economic prospects were behind the slump in investment. Nevertheless, utilization of production capacity showed a very slight rise in the second quarter, which could foster something of a brake on the downturn in this demand component. So far as concerns construction investment, this continues to show two-digit negative rates because of the correction in the real estate market although works for infrastructures showed some recovery, mainly thanks to the local works programme and works related to the high-speed train system.

Recession continues in second quarter but not as sharp.

In the foreign sphere, both imports and exports sharpened their slowdown in a situation of reduced world trade. Nevertheless, the year-on-year decrease in imports (22.3%) was greater than that for exports (19.0%) and, along with the favourable trend in prices, is making possible a rapid decrease in the trade deficit and offering some relief from the large deficit the Spanish economy has run up until now.

In this situation, the central government has launched new economic policy measures to deal with the recession. Prominent among these is the removal of the tax credit for home purchase for those in higher income levels as of January 1, 2011, the subsidies mentioned above for purchase of cars, tax reductions for small and medium-sized businesses and self-employed workers that maintain their workforces, wider application of new technology in schools and a budget cut of 1 billion euros.

The few indicators available for the second quarter suggest a continuation of the recession. Nevertheless, the downward profile is beginning to ease which makes it possible to put forward that the point of greatest weakness was recorded in the first quarter and that in coming months the recession will keep easing. Toward the end of the year economic activity will stabilize and the following year we shall begin to again see positive rates. That is, so long as the international economic situation allows.

May 26, 2009

CHRONOLOGY

2008

July	**3**	**European Central Bank** raises official rate to 4.25%.
	11	One-month forward price of *Brent* quality **oil** goes up to all-time high of 146.6 dollars a barrel.
	15	**Euro** exchange rate hits 1.599 dollars, highest value since launching of European Single Currency at beginning of 1999.
August	**14**	Government puts into effect its **programme of 24 economic measures** for 2008 and 2009.
September	**19**	US government presents **bailout plan for country's banking system** amounting to 700 billion dollars.
October	**7**	Spanish government announces creation of **fund for purchase of financial assets** of financial institutions up to maximum of 50 billion euros and raises guarantee on deposits and investments to 100,000 euros.
	8	**European Central Bank**, **Federal Reserve** and **Bank of England** cut official interest rates by 50 basis points in joint move with other central banks.
	12	Euro Area countries agree on **joint action** to strengthen financial system up to end of 2009.
	13	Government authorizes granting of **government guarantees** up to 100 billion euros in 2008 on new financial transactions of financial institutions with possible extension to 2009.
	28	IBEX 35 index for **Spanish stock exchange** marks up lowest level (7,905.4) since 2004.
	29	**Federal Reserve** cuts reference rate to 1.00%.
November	**6**	**European Central Bank** lowers official interest rate to 3.25%.
	15	Meeting of G-20 in Washington to **reform international financial system**.
	20	Dow Jones index for **New York stock exchange** records lowest level since 2003 (7,552.3).
	28	Government announces 8 billion-euro **public works plan** for municipalities and 3 billion-euro plan for investment in various sectors and economic spheres.
December	**4**	**European Central Bank** lowers official interest rate to 2.50%.
	16	**Federal Reserve** reduces reference rate to band between 0%-0.25%.
	24	Brent quality **oil** price drops to lowest level since July 2004 (37.23 dollars a barrel).

2009

January	**1**	Further enlargement of **Euro Area** with entry of Slovakia making total of 16 member states.
	15	**European Central Bank** lowers official interest rate to 2.00%.
	20	Barack Obama sworn in as **President of the United States**.
March	**5**	**European Central Bank** lowers official interest rate to 1.50%.
	6	Central government announces measures to **facilitate financing of working capital for medium-sized companies** and to **revive employment** and ease effects of **unemployment**.
	27	Spanish government approves series of **measures to promote economic activity** throuch changes in law on insolvencies, revival of credit insurance and introduction of EU Services Directive.
April	**2**	**European Central Bank** lowers official interest rate to 1.25%. G-20 meeting in London aimed at **reform of international financial system**.
May	**7**	**European Central Bank** lowers official interest rate to 1.00% and announces measures to facilitate liquidity in banking system.
	12	In parliamentary debate on state of nation, prime minister announces **further economic policy measures**: partial removal of tax credits for purchase of main residence as of 2011, subsidies for buying cars, reduced taxation for small and medium-sized business and self-employed, etc.

AGENDA

June

- **2** Registrations with Social Security and registered unemployment (May).
- **4** Governing Council of European Central Bank.
- **5** Industrial production index (April).
- **10** CPI (May).
- **16** CPI harmonized with EU (May).
- **18** Labour cost (1st Quarter).
- **23** Fed Open Market Committee.
- **24** Foreign trade (April).
- **25** Producer prices (May).
- **29** Flash HCPI (June).
- **30** Central government revenues and spending (May).
  Balance of payments (April).

July

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

INTERNATIONAL REVIEW

United States: moving toward stability, prices permitting

United States: economy down 6.1% because of collapse of investment...

The gross domestic product (GDP) in the first quarter of 2009 was down 2.6% year-on-year, or 6.1% quarter-on-quarter annualized, which was practically a repeat of the decrease in the final quarter of 2008. Investment in capital goods showed a sharp drop (33.8% in quarter-on-quarter terms annualized) while construction was down a severe 38.0%. The other components, which make up 85% of the economy, showed a somewhat better picture than the aggregate figure and would indicate an end to the sharp drops in economic activity.

...but private consumption stabilizing and public consumption expected to move up.

The economy could hit bottom in the second quarter and then start out on a path of recovery which, however, is expected to be weak and uncertain.

Where is the positive side of the sharp drop in GDP to be found? First, the reduction of inventories contributed 2.7 percentage points to the total quarter-on-quarter decrease. While this adjustment was coherent with the reduction in demand, it is also to be hoped that the sharpness of this drop will ease in coming months. Secondly, private consumption moved up by 2.2% quarter-to-quarter in annual terms as a reaction to two quarters in a row

UNITED STATES: MAIN ECONOMIC INDICATORS

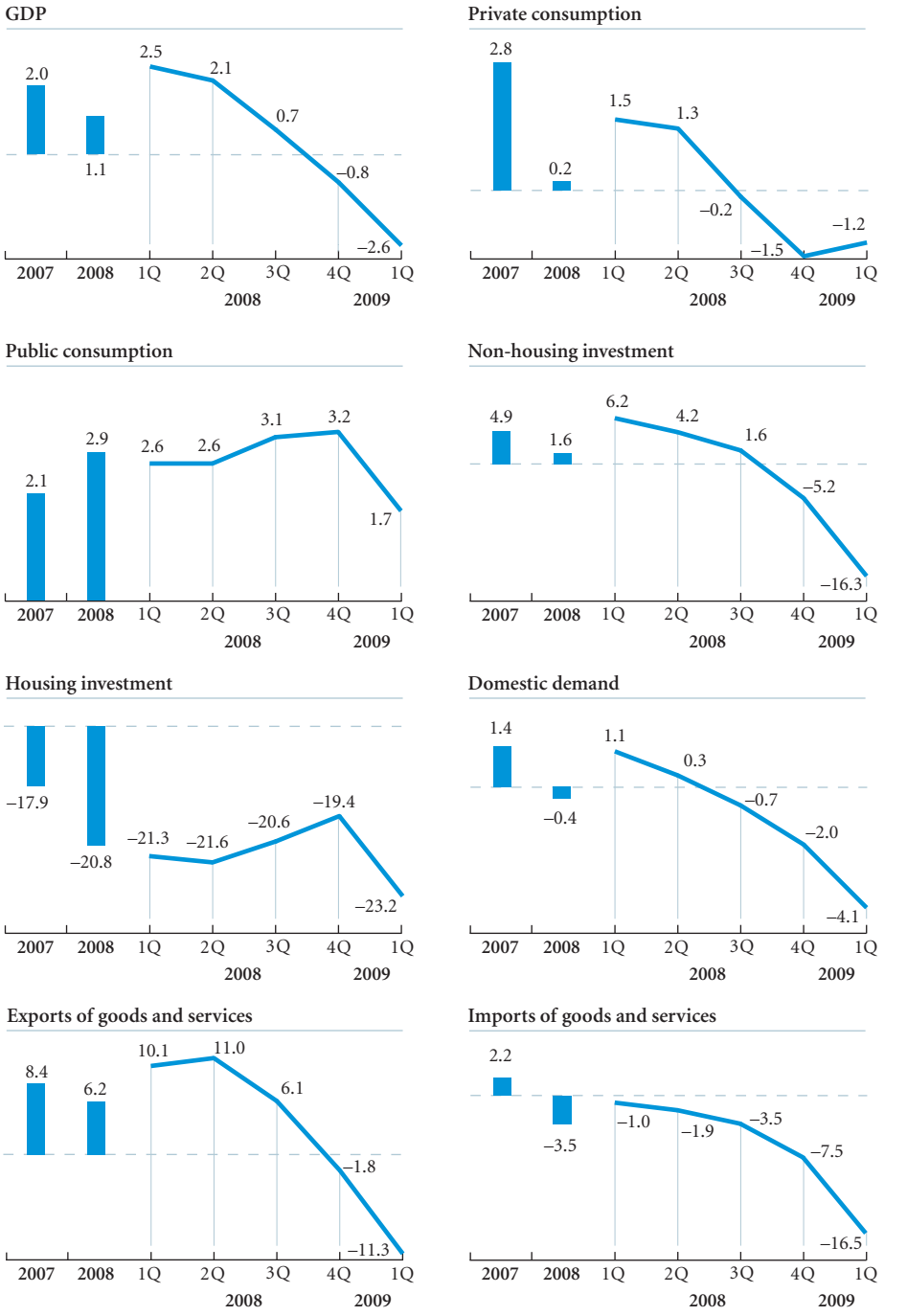
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	2.0	1.1	2.5	2.1	0.7	–0.8	–	–2.6	–	–
Retail sales	3.3	–0.7	2.6	2.4	0.4	–8.0	–9.1	–8.0	–9.6	–10.1
Consumer confidence (1)	103.4	58.0	76.5	57.3	57.3	40.7	37.4	25.3	26.9	39.2
Industrial production	1.5	–2.2	1.4	–0.4	–3.2	–6.7	–10.7	–11.4	–12.6	–12.5
Manufacturing (ISM) (1)	51.1	45.5	49.5	49.1	47.4	36.1	35.6	35.8	36.3	40.1
Sales of single-family homes	–26.8	–37.2	–33.1	–39.1	–36.7	–40.4	–44.6	–37.4	–30.6	...
Unemployment rate (2)	4.6	5.8	4.9	5.4	6.1	6.9	7.6	8.1	8.5	8.9
Consumer prices	2.9	3.8	4.1	4.4	5.3	1.6	0.0	0.2	–0.4	–0.7
Trade balance (3)	–700.3	–681.1	–699.2	–701.8	–714.5	–681.1	–658.2	–622.4	–592.6	...
3-month interbank interest rate (1)	5.3	2.8	3.0	2.8	3.2	2.2	1.2	1.3	1.2	1.0
Nominal effective exchange rate (4)	77.9	74.4	72.0	70.9	73.5	81.3	81.0	83.1	83.8	82.3

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

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Bureau of Economic Analysis and own calculations.

Economy could hit bottom in second quarter but recovery likely to be modest.

showing sharp drops. Finally, public consumption, which in the United States includes government spending on infrastructures, was abnormally low in the first quarter and should move up, especially from the summer on when the effects of the Obama plan begin to be felt. These include spending on infrastructures for an amount equal to 2% of GDP, split between 2009 and 2010.

Consumer confidence improving although retail sales again moving down.

Why will recovery be weaker than in previous cycles? Because the increase in private consumption cannot go higher. Households must reduce their gross debt which is still at levels close to 100% of GDP, whereas in 2000 it was 60%. Between January 2005 and September 2008 US households saved a slim 0.7% of their disposable income whereas in the first three months of 2009 the average ratio was 4.2. The loss of household wealth, which between June 2007 and the end of 2008 also came close to total GDP, combining tangible assets and financial assets, is also working against a recovery in consumption. Transfers and tax cuts under the Obama plan may cushion these effects but will not fully compensate them.

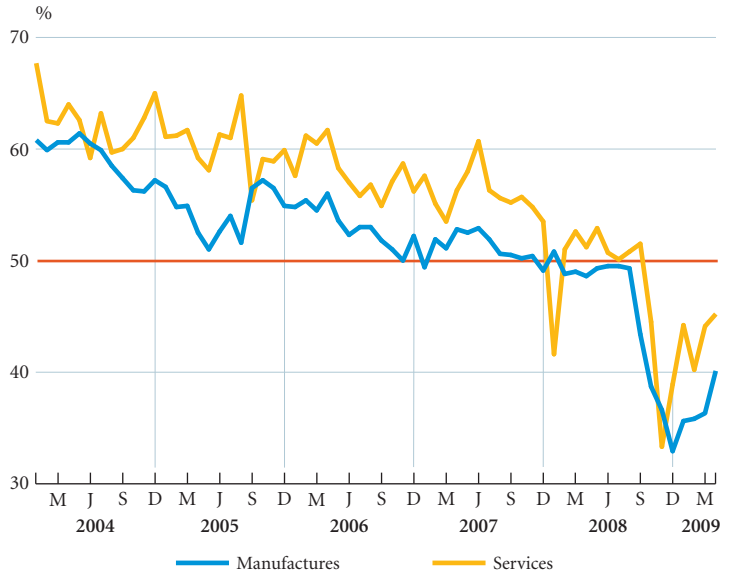
Latest demand indicators confirm that the increase in consumption is losing strength. Retail sales in April were down for the second month in a row following a positive start to the year. Excluding cars and petrol, retail sales were down 5.7% year-on-year in real terms. The consumer confidence index of the Conference Board in April went up from 26.9 points to 39.2 points thus moving away from the all-time low in February but still far from levels indicative of recovery.

Business executives less pessimistic and industrial activity still very weak.

On the supply side, the index of economic activity and business sentiment put out by the Institute for Supply Management for April continued

UNITED STATES: ON ROAD TO RECOVERY?

Level of ISM indices (*)



NOTES: (*) A level of 50 implies that there were as many optimistic responses as pessimistic ones.
SOURCE: Institute for Supply Management and own calculations.

gradually moving toward the 50 points level which is considered the threshold marking the beginning of growth stages. The manufactures index showed its fourth month of advances in a row, putting the figure at 40.1 points, while the services index recovered to 45.2 points. The negative counterpart showed up in industrial production which dropped by 12.5% year-on-year in April while utilization of production capacity marked up a new all-time low since the index was started in 1967 dropping to 69.1%.

Housing continues to give signs of having hit bottom, both in demand and supply. Real estate prices continue to worsen the property situation of households and the Case-Shiller index for February showed a drop of 31.6% compared with the high in June 2006. Sales of existing houses were down 7.1% year-on-year and marked up a new low given that foreclosures for default on mortgage loans and lack of buyer confidence continued to weigh more than the temptation of more reasonable prices.

Real estate prices continue to drop while construction still not hitting bottom.

One difficulty working against a recovery of housing prices is uncertainty about the labour market. The unemployment rate in April went to 8.9% of the labour force and in coming months could continue to move up to a figure of 10.0%.

Labour market remains weak with unemployment rate hitting 8.9%.

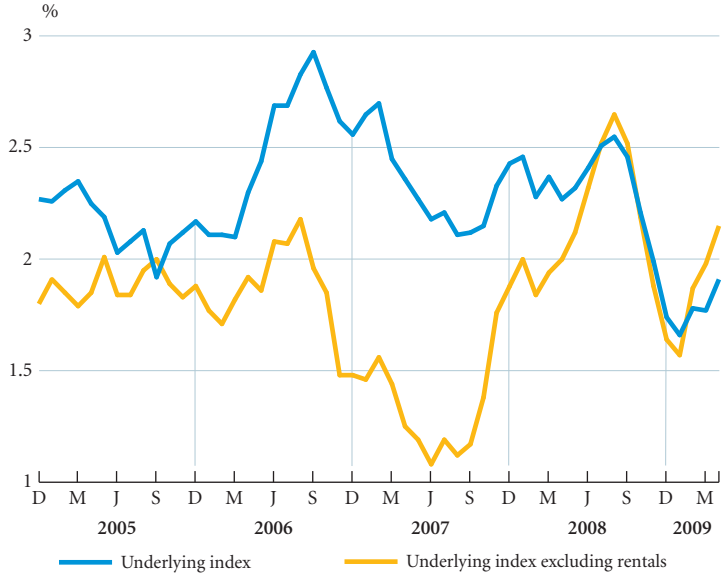
The uncertain struggle between inflation and deflation risks is leaning toward the former. The general consumer price index (CPI) for April was down by 0.7% year-on-year but underlying inflation (the general index less food and energy) added its third month in a row showing month-on-month increases, reporting an increase of 1.9% year-on-year which, excluding home rentals, amounted to 2.2%.

CPI down by 0.7% but underlying trend is upward.

In the foreign sector, the drop in trade was more moderate although it is still too early to confirm that this has hit bottom. While showing more moderate

UNITED STATES: PRICES RISING AGAIN

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



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

Trade deficit stops decreasing as result of drop in volume of trade.

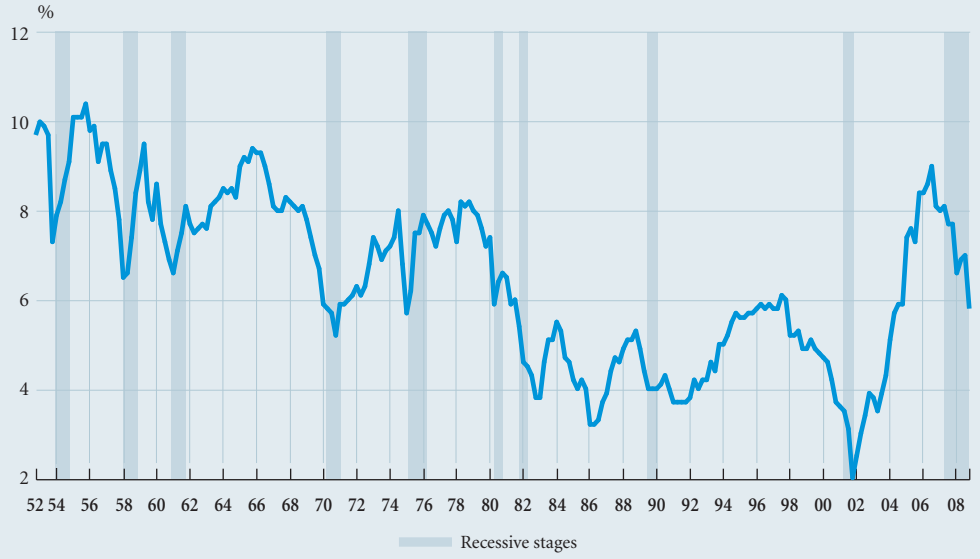
decreases, exports and imports in March were 17.4% and 27.0% lower than in the same period the year before, respectively. In spite of this, the trade deficit in March was up slightly, especially in non-oil products with the figure going to 27.58 billion dollars. This level is close to half that in 2008 but it is difficult to see the correction in the trade imbalance continuing in coming months.

Recovery in the United States? The role of investment

The bursting of the real estate bubble and the posterior collapse of the financial system put the US economy in an historic recession. For the moment, the impact of the economic contraction on households as well as its possible consequences is attracting most of the attention. Their high level of leverage and the growing unemployment rate indicate that consumption, the main driving force in the economy, will remain very weak over the medium term. This will make recovery slower than in a typical cycle. On the other hand, the situation in which the corporate sector is immersed has received less attention although it is just as important. If firms find its investment capacity limited, the downward stage will be deeper and recovery even slower.

RECESSIONS GO HAND-IN-HAND WITH SHARP DROPS IN PROFITS

Ratio of profits over GDP (*)



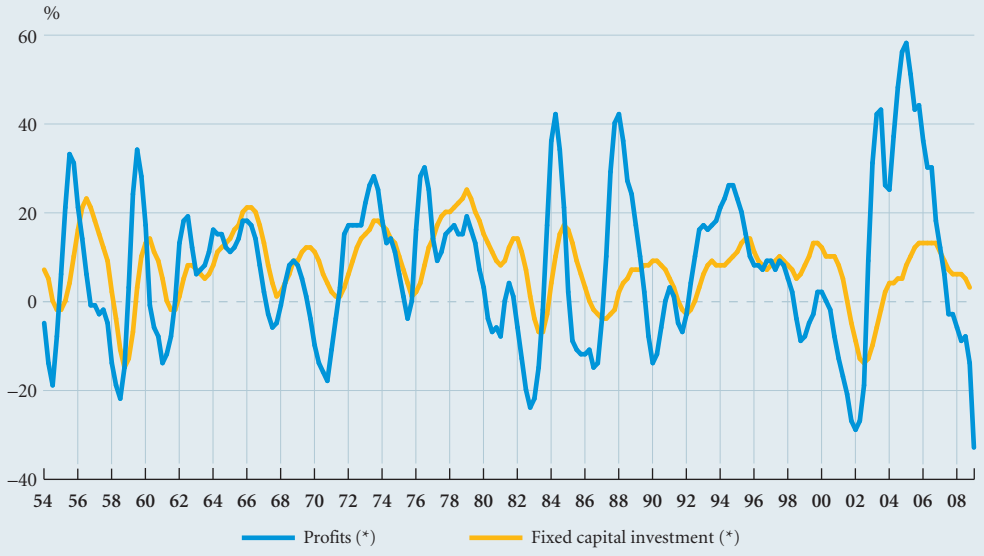
NOTES: (*) Profits before tax of non-financial and non-agricultural companies.
SOURCE: Federal Reserve, NBER and own calculations.

The results for the final quarter of 2008 point out that the corporate sector has not managed to escape the downturn that is affecting the other components of the economy. In this period, the profits of non-financial and non-agricultural companies recorded a drop of 24% compared with the same quarter the year before. Furthermore, a quick review of the performance of profits during recent cycles show that this dynamic could

become sharper over the short term. As shown in the above graph, corporate profits are not only pro-cyclical but are more volatile than the economy as a whole. They grow at a rate higher than that of the gross domestic product during expansionary periods and mark up sharp contractions during periods of recession.

INVESTMENT CAPACITY CLOSELY LINKED TO PROFITS

Change in cumulative balance for four quarters over the same period the year before



NOTES: (*) Figures for non-financial and non agricultural companies.
SOURCE: BEA, Federal Reserve and own calculations.

The markedly pro-cyclical nature of profits is largely the result of the asymmetric adjustment of operating costs and prices during the cycle. While prices adjust relatively rapidly, the lower flexibility of costs linked to capital and the labour force tends to carry companies to excess capacity during recessionary periods and to the opposite during expansions. This means that profit per unit produced rises during periods of high growth and drops in recessions. Given that business volume is pro-cyclical, this would explain the higher volatility of profits during the cycle.

One of the immediate consequences of the drop in profits in recessive periods is that companies may see their investment capacity limited. An analysis of the historical trend in profits and investment provide us with an indirect example. As may be seen in the above graph, both series have followed parallel paths during recent cycles so that it would seem that the investment capacity of companies is closely linked to the trend in profits. For the moment, in the first quarter of 2009 gross private investment in the United States has dropped by 24% compared with the same quarter the year before.

Furthermore, there is one factor that means that the decrease in profits will reduce the investment capacity of companies more than in previous episodes. During a typical recessive cycle companies normally go to the financial sector to obtain credit. This enables them to partly cushion the effect of the drop in profits so that the drop in investment is more moderate. But high risk premiums and the tighter credit standards that the

financial sector must set to deal with the present situation of high uncertainty may shut the door on companies.

On the other hand, there are two factors pointing in the opposite direction which could help ease the contraction in investment. As may be seen in the above graph, growth of investment has held substantially below historic levels during the past expansionary cycle (2001-2007). Therefore, the risk of over-investment is more limited than in previous cycles. This means that the excess capacity that exists among US companies in the current recessive stage may be more moderate. The second factor to keep in mind is the level of leverage that exists in the US corporate sector. As may be seen in the following graph, the ratio of debt over net equity reached its peak at the beginning of the Nineties and has been progressively moderating since then.

LEVERAGE RATIO OF BUSINESS SECTOR STANDS AT RELATIVELY MODERATE LEVELS

Ratio of non-financial and non-agrarian company borrowing over net equity

SOURCE: Federal Reserve and own calculations.

To sum up, the contraction in profits of US companies will reduce its investment capacity. Over the short term it is difficult for the financial sector to help ease the drop in view of the problems this sector is going through. Nevertheless, when confidence is re-established in the markets, the corporate sector will be able to get back in step fairly quickly given that its the leverage ratio is more moderate than in earlier recessive cycles.

This box was prepared by Oriol Aspachs-Bracons
European Economy Department, "la Caixa" Research Department

Japan: a very sharp drop that could revert

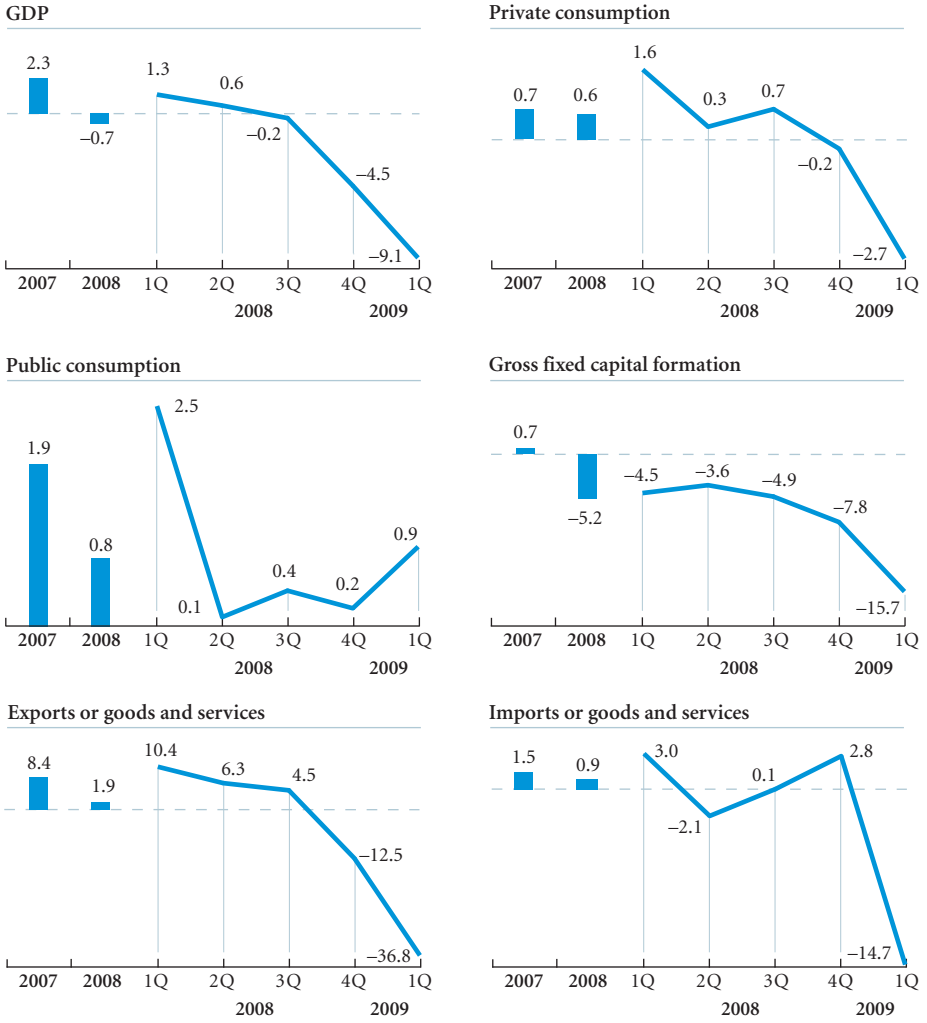
In the first quarter of 2009, Japan's economy contracted by 9.1% year-on-year, 15.2% in quarter-on-quarter terms annualized. This drop was a record since 1945 and may be almost entirely accounted for by the drop in exports which skidded down by 36.8% year-on-year. Investment in capital goods, which dropped by 22.4%, also made a major negative contribution. The third downward element was the sharpening decrease in private consumption which dropped by 2.7% year-on-year and which because of its own inertia will make any early recovery more difficult.

Japan's exports were negatively affected by three simultaneous factors. First, the synchronization of the recession has reduced world demand, including demand for Japanese goods. Secondly,

Japan shows decrease of 9.1% because of drop in exports.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

Heavier weight of capital goods in exports adds to drop...

the credit crisis has brought about a distortion in world trade on the supply side which has pushed up costs of credit insurance and guarantees, which has brought about many breaks in the supply chain. Thirdly, capital goods are of a more fluctuating nature than consumer goods, as may be seen in the sharp drops in investment in the GDP of the main economies in the first quarter of 2009. As Japan's exports have a major weight in capital goods of high value added, in recent months they have increased the already deep slump in the volume of world trade.

...but some signs of stabilization noted in foreign sector.

Nevertheless, the worst drops seem to have passed. From the end of September 2008 to January 2009, inclusive, Japan's exports were down 46.9% but in March they were up by 5.3% following the moderate decrease in February. According to figures for the balance of payments, in February and March the surplus in the balance of goods was back following a series of significant deficits. The sharp decreases in exports could now be coming to an end to take the economy to figures more in keeping with the trend in recent years. There is a real likelihood that the same volatility seen in the decreases will also show up in the recovery of the foreign sector following the slump in recent months. While the prospects for the first half of 2009 are somewhat more sombre than a month ago, in the second half of 2009 and the beginning of 2010 we could see a revival of Japan's economy.

Industrial production breaks away from sharp decreases.

In Japan, producers take precedence over consumers and, therefore, the supply indicators are those most showing the weakness in recent months. But, just as in the case of exports, here too the drastic drops are easing off although the most recent Tankan figures for corporate confidence in the first quarter are still very low. Industrial production in March, while it showed only a modest

JAPAN: TRADE HITTING BOTTOM

Month-on-month change in exports and imports

SOURCE: Japan's Ministry of Economy, Trade and Industry and own calculations.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	2.3	–0.7	1.3	0.6	–0.2	–4.5	–	–9.1	–	–
Industrial production	2.9	–3.4	3.5	1.6	–3.3	–15.0	–30.0	–36.9	–35.1	...
Tankan company Index (1)	22.0	–2.8	11.0	5.0	–3.0	–24.0	–	–58.0	–	–
Housing construction	–17.2	2.4	–8.8	–11.1	40.3	3.9	–18.7	–24.9	–20.5	...
Unemployment rate (2)	3.9	4.0	3.8	4.0	4.0	4.0	4.1	4.4	4.8	...
Consumer prices	0.1	1.4	1.0	1.4	2.2	1.0	0.0	–0.1	–0.3	...
Trade balance (3)	12.6	4.0	11.7	10.3	7.5	4.0	2.6	2.1	1.4	...
3-month interbank interest rate (4)	0.7	0.8	0.8	0.8	0.9	0.8	0.7	0.7	0.7	0.6
Nominal effective exchange rate (5)	77.1	86.6	83.4	82.6	81.9	98.5	105.1	103.5	97.7	95.9

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

gain over previous months, put an end to four months of decreases in a row.

Demand continued its downward trend. Retail sales in March were down 3.8% year-on-year and in the 12 months ending in April some 28.7% fewer cars than the top figure in 2005. As a result of the weakness in demand, prices in March were down 0.3% year-on-year, the first negative increase since September 2007. The drop in prices was more consistent in the underlying CPI (the general index excluding energy and food) which also was down by 0.3% year-on-year but show the third month of decreases in a row. The weakness in prices will grow worse in coming months because of weak demand and the first proof of this is the Tokyo CPI which in April was down 0.4% year-on-year. Suffering from the weaknesses in Japan's economy, the labour market in March again showed the decreases seen the month before with an unemployment rate that went from 4.4% to 4.8% of the labour force, the highest since 2004. With the loss of 450,000 jobs, this puts the number of jobs lost since May 2008 at 1,930,000.

Consumption down, CPI drops 0.3% and unemployment reaches 4.8%.

China needs to put accent on domestic demand

With an economy that is growing at 6.1%, China presents enviable prospects for 2009 which, nevertheless, are not without their risks, including an excessive foreign surplus and a falling real estate market. The rural population continues to generate a huge pool of labour which obliges China to grow by more than 8%, which is the government objective. With relatively small automatic stabilizers, China's fiscal stimulus measures must be strong, with additional spending on infrastructures at 4.5% of GDP for 2009 and 2010. Nevertheless, its implementation through a maze of local governments is not easy.

China slows down to growth of 6.1% with lower exports but more investment.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	13.0	9.1	10.6	10.1	9.0	6.8	–	6.1	–	–
Industrial production	17.1	13.0	16.5	15.9	13.0	6.4	8.4	11.0	8.3	7.3
Electrical power generation	15.7	6.7	16.0	11.9	6.7	–6.0	–14.1	4.8	–2.2	–3.6
Consumer prices	4.8	5.9	8.0	7.8	5.3	2.5	1.0	–1.6	–1.2	–1.5
Trade balance (*)	262.4	295.2	256.5	247.4	257.0	295.2	314.9	311.6	317.0	313.7
3-month interbank interest rate (**)	3.6	4.2	4.6	4.6	4.4	3.2	2.5	1.3	1.5	1.7
Renminbi to dollar	7.6	6.9	7.1	6.9	6.8	6.8	6.8	6.8	6.8	6.8

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

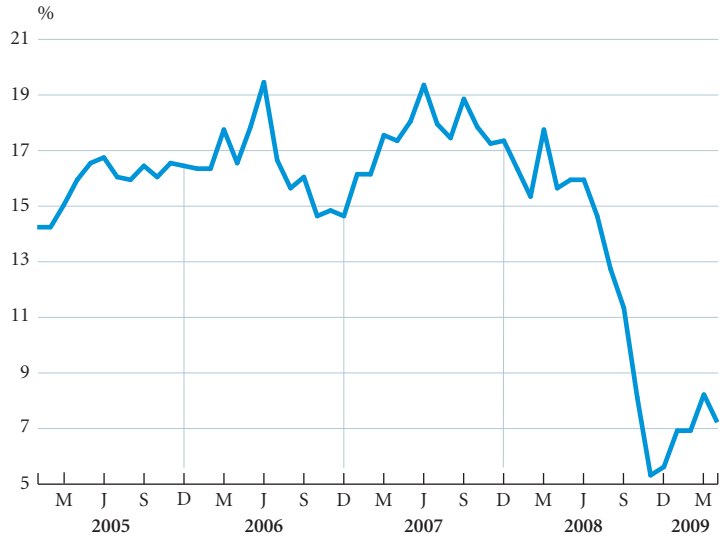
Industrial production up 7.3% and prices down by 1.5%.

Recent indicators show a somewhat hesitant recovery. Industrial production in April grew by 7.3% year-on-year, a respectable rate but a slowdown from March and far from the 15% that has been the norm in recent years. National production of electrical energy also took a step backwards in April with negative growth. Prices, on the other hand, continue to drop. The general CPI in April was down 1.5% year-on-year, while the food index dropped by 1.3%.

The weakness in world trade is hurting China's economy less than expected. Exports make up 29.8% of GDP but are not highly intensive in capital goods not do they have high value added so that the drop is less abrupt and is being compensated by lower imports. The

CHINA: VERY EARLY SIGNS OF RECOVERY

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



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

trade surplus for the past 12 months ending in April held at 313.66 billion dollars, close to the all-time record, with exports down 22.6% year-on-year and imports down 23.0%.

While China is maintaining its surplus in these times of recession, there is a consensus that growth should be concentrated on domestic demand. Foreign surpluses have led to an accumulation of reserves in dollars which makes China vulnerable to an expansionist monetary policy of the U.S. Federal Reserve. But domestic growth depends on raising the propensity to consume. On this point, public expenditure on education and especially on health are essential to reduce risk aversion of households. The recently announced health plan budgeted at 850 billion renminbi to provide basic medical coverage will increase disposable income of households and may be more effective than many infrastructure projects.

Mexico: severe impact of world recession

Exports down but trade surplus continues.

The Mexican economy is being hit by a sequence of negative events without precedent in recent times. The contraction of Mexico's GDP has been brought about by the deep world financial crisis and the deep recession in the United States. Furthermore, the appearance and rapid spread of the A/N1H1 or A-type influenza germ (ill-named «Pig Flu») in April this year has aggravated the situation.

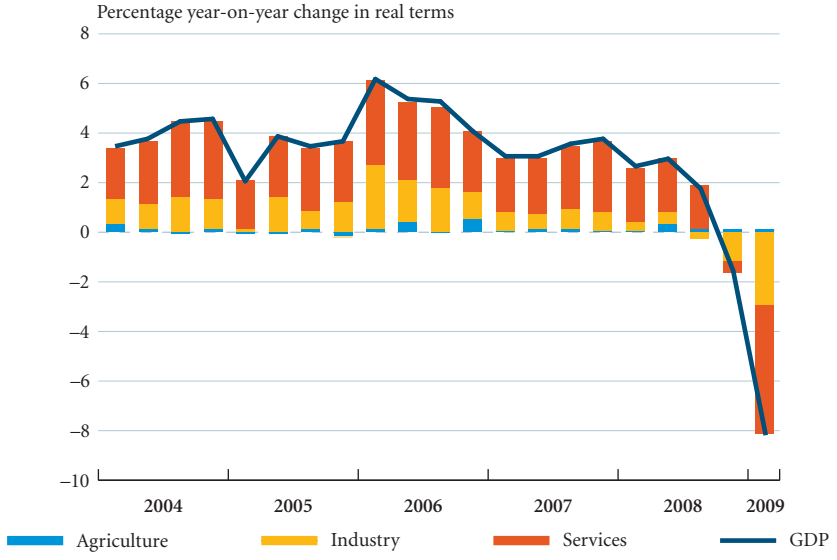
Introduction of health spending could boost private consumption.

Mexico's GDP contracted by 8.6% in year-on-year rate in the first quarter of 2009. The size of the drop in the economy may be seen in the Global Indicator of Economic Activity which showed a drop of 10.8% year-on-year in February. Mexico's Finance Minister Agustín Carstens has stated that the poor figures for the first quarter will mean a downward revision of official forecasts for a contraction in GDP for 2009 as a whole from 4.1% to 5.5%.

Mexican economy navigating in unknown waters.

COLLAPSE IN INDUSTRY AND SERVICES

GDP by segment of economic activity



SOURCE: Bank of Mexico.

Sharpness in drop in industrial production is like that in «Tequilazo».

The figures by sector of economic activity show a sharp contraction in the industrial sector and in services. Value added for the industrial sector as a whole was down 9.9% year-on-year. This sector had not reported such a sharp drop since the «Tequila Crisis» in 1995. Under industry, manufactures (highly linked to foreign demand) reported a drop of 13.8%. Specifically, motor vehicle production slumped by 38.3% year-on-year because of the retraction of demand from the United States. The construction sector was down 7.7%. The GDP for the services sector lost 7.8% year-on-year dragged down by a spectacular drop in retail trade (17.2%) and transport services (10.3%).

In spite of the fact that Mexico's GDP on the demand side has still not been published, some indicators shed light about the trend in the various components. Private consumption is being affected negatively by the lower disposable income of households and, since April, by the impact of Type-A influenza. This drop in income is linked to the worsening of the labour market which has brought about a rise in the unemployment rate from 4.3% in the final quarter of 2008 to 5.0% in the first quarter of 2009 and a drop in remittances from abroad of 4.9% year-on-year between January and March. In this situation, retail sales, which dropped by 0.4% year-on-year in March, could record a substantially worse performance in April due to the impact of Type-A flu. The very slight improvement in confidence of households and companies in April must be interpreted with care and not as «green shoots» seeing that the survey is made in the first two weeks of the month and therefore does not reflect the impact of Type-A flu on economic activity.

In spite of the context of weakness, inflation resists any drop. The CPI rose by 6.2 % year-on-year in April as against 6.0% in March because of the rise in foods. Even though the underlying CPI was reduced slightly to 5.8% year-on-year in April, it is holding above the 4.9% average in 2008 due to the price increase

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	3.3	1.4	3.3	2.5	1.5	–1.7	...	–8.6	...	...
Industrial production	2.4	–1.0	1.9	0.1	–1.4	–4.4	–9.6	–9.2	...	...
Consumer confidence (1)	104.9	92.2	102.4	94.2	88.9	83.3	81.9	78.9	79.4	82.1
General unemployment rate (2)	3.7	4.0	3.9	3.5	4.2	4.3	5.0	5.3	4.8	...
Consumer prices	–22.7	–11.8	4.0	4.0	3.8	4.7	6.3	6.2	6.0	6.2
Trade balance (3)	–10.1	–17.3	–9.3	–7.8	–11.9	–17.3	–17.1	–16.4	–17.5	...
Official Banxico rate (%) (4)	7.00	7.50	7.50	7.75	8.25	8.25	7.75	7.50	6.75	6.00
Mexican pesos to dollar (1)	11.0	10.6	10.6	10.3	11.0	13.9	14.4	15.1	14.2	13.8

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion dollars.
(4) On May 21 Banxico was lowered by 75 basis points to 5.25%.
SOURCE: Banco de México and own calculations.

of imported products brought about by the depreciation of the peso.

The foreign sector continues in negative terrain with a deficit of 17.5 billion dollars in March, an increase of 60% compared with the 2008 average. One good bit of news was that oil exports slowed their drop in March (15.7% year-on-year) compared with the previous month (24%).

In a context marked by a poor first quarter and the impact of Type-A flu, the downward revision of growth put out by Finance Minister Carstens may not have been enough. Given that the flu is likely to prolong the weakness seen in the second quarter, limiting the contraction of the GDP to 5.5% in 2009 as a whole would imply a sharp rebound in economic activity in the second half-year, something that seems rather optimistic, given the prospects of a long drawn out recovery of the US and world economy. On the other hand, the effect of the flu could be worse than expected. The World Bank has estimated that it could take off between 0.5% and 5.3% of GDP on 2009 depending on whether the situation is average or severe. The current scenario drawn by the government and most economists is the more optimistic one, therefore, the risks are downside biased.

Government revises growth forecasts downward.

Oil goes back to upward course

The price of oil has moved up again after taking a slight breather. Between April 20 and May 22, crude oil rose by 17.9% going to 59.18 dollars a barrel (one-month forward Brent) after having momentarily passed the 60-dollar barrier. The cumulative rise for the current year has now reached 51.4%.

The price of oil continued to bet on a scenario of economic recovery on the optimistic side and on the weakness of the dollar. The forecast, for lower oil demand in 2009 announced by the International Energy Agency had only a slight effect on prices which were supported by two other factors. First, OPEC increased its output by 220,000 barrels a day, very little in view of the total of 25.8 million barrels a day and much below the expected increase of 800,000 barrels. One additional factor in favour of an oil price increase was the announcement by the Chinese authorities regarding the continuation of controls on domestic fuel prices, which stimulates demand by the second largest world consumer and puts upward pressure on prices.

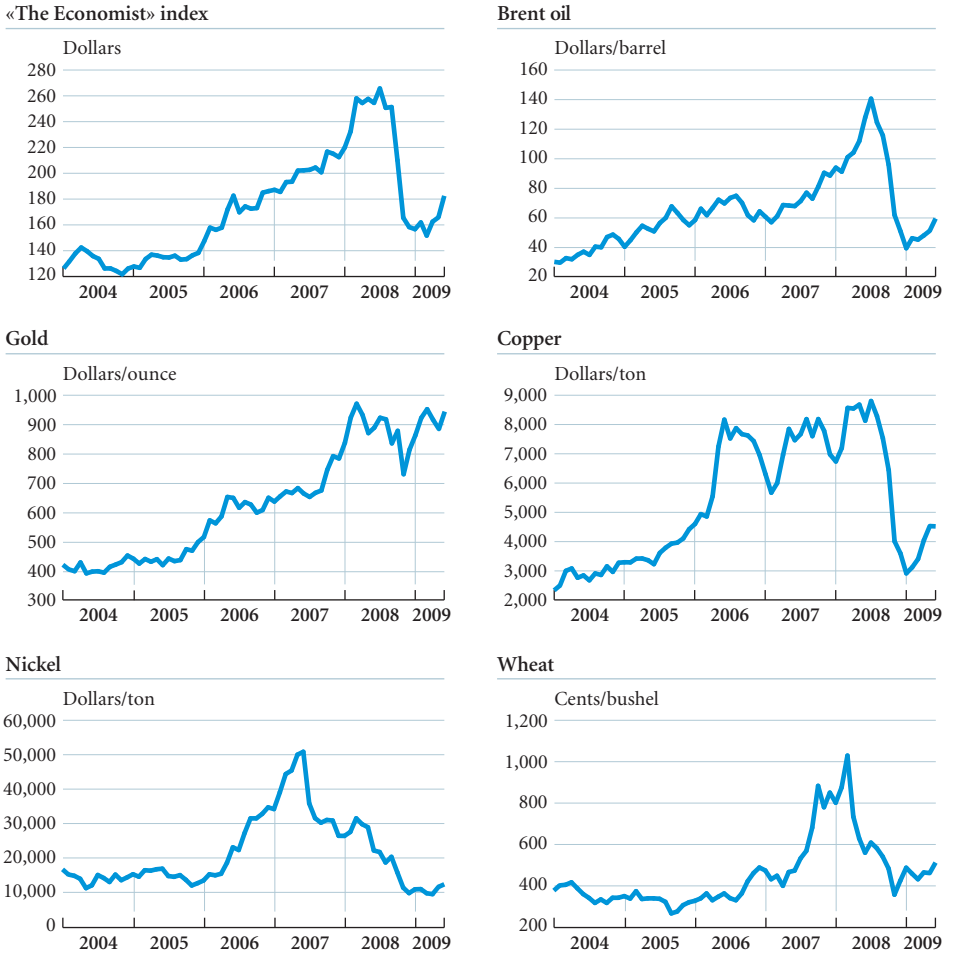
Oil price again rising with cumulative increase of 51%.

Commodities continue to rise, led by food.

Commodities generally followed the course set by oil. Base metals took a breather after the increases the month before. Gold moved up moderately while the main increases were concentrated on foods. *The Economist* commodities index rose by 6.9% between April 20 and May 22 with a cumulative increase of 16.8% in the current year while wheat rose by 23.2% following decreases in previous months.

Modest increase in OPEC production and Chinese demand buoying up oil prices.

TREND IN VARIOUS COMMODITIES (*)



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

EUROPEAN UNION

Euro Area: change of trend but much uncertainty

In our *Monthly Report* for May we drew attention to the extreme depth to which the world economic contraction was affecting the Euro Area, especially because of its exposure to the collapse in world trade. For this reason we concluded that in all probability the drop in growth in the first quarter of 2009 would be greater than in the final quarter of 2008. This is what has happened. Both the Euro Area and the European Union as a whole marked up negative growth of 2.5% compared with the previous quarter, some 0.9 percentage points above the figure recorded in the final quarter of 2008. This reduced year-on-year growth to a negative rate of –4.6% for the Euro Area and –4.4% for the European Union as a whole.

A breakdown of the figures by component has still not been published but the high frequency indicators give the alert that the drop was general in all components. Retail sales, a good indicator of the trend in consumption, recorded a drop of 3.5% compared with the same quarter last year. The rate of contraction in industrial production, a good indicator of investment, rose to 20.2% in March. Figures for foreign trade, on the other hand, seem to have hit bottom. Exports in March marked up a positive growth rate compared with the month before for the second time in a

Growth of economy suffers sharp drop in first quarter of 2009.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
GDP	2.7	0.7	2.2	1.5	0.6	–1.4	–	–4.6	–	–
Retail sales	1.3	–0.2	1.0	0.6	–0.2	–1.9	–2.7	–3.9	–4.0	...
Consumer confidence (1)	–4.9	–17.9	–11.9	–14.6	–19.2	–26.1	–30.5	–32.5	–33.7	–31.3
Industrial production	3.5	–1.7	2.5	1.1	–1.4	–8.8	–16.5	–19.1	–20.2	...
Economic sentiment indicator (1)	108.9	91.1	101.4	97.5	89.9	75.8	67.2	65.3	64.7	67.2
Unemployment rate (2)	7.4	7.5	7.2	7.4	7.5	8.0	8.4	8.7	8.9	...
Consumer prices	2.1	3.3	3.4	3.6	3.8	2.3	1.1	1.2	0.6	0.6
Trade balance (3)	20.1	–1.2	24.4	13.8	–11.4	–31.7	–33.5	–37.5	...	...
3-month Euribor interest rate	4.3	4.6	4.5	4.9	5.0	4.2	2.9	2.1	1.8	1.5
Nominal effective euro exchange rate (4)	107.9	113.0	113.0	116.0	114.0	109.1	111.9	110.4	113.3	112.5

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion euros.
(4) Change weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCE: Eurostat, European Central Bank, European Commission and own calculations.

Our forecasts scenario revised downward...

row. This put the year-on-year decrease at 17%. While this is 6 percentage points below that recorded in February, it is still well above that for the final quarter in 2008.

New figures available have led us to revise growth forecasts for the Euro Area. Following a sharp drop in the first quarter of 2009, the rate at which the economy keeps contracting will gradually moderate. In the final quarter of this year we shall very likely see positive quarter-on-quarter growth rates. In spite of this, the drop felt by the economy for the year as a whole will be 4.5%. Growth forecast for 2010 is put at 0.5%. This will confirm the process of economic recovery in spite of the fact that growth will still remain below potential.

...although signs indicate a change in trend is taking place...

There are two main factors that indicate for us that the economy has moved into a gradual process of recovery, namely, the improvement in economic sentiment indices and the normalization of financial markets.

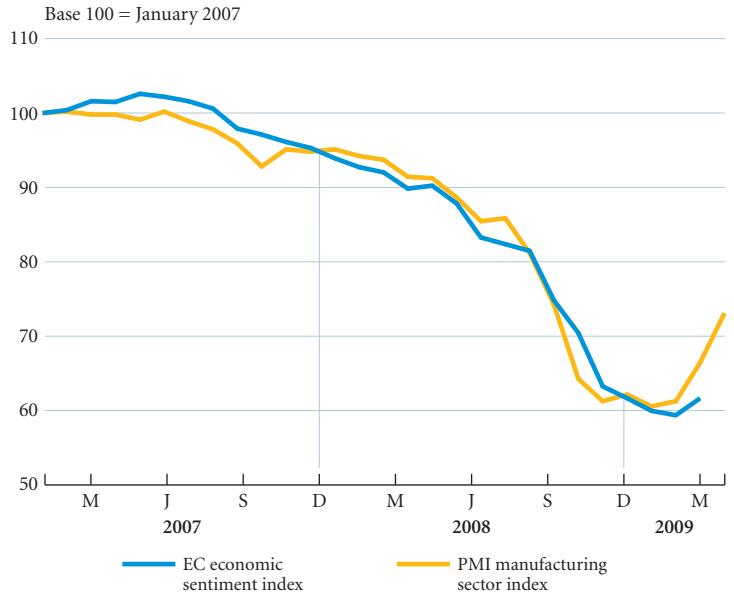
...economic sentiment indices have risen sharply...

As may be seen in the following graph, the main economic sentiment indicators seem to have hit bottom in recent months. The *Purchasing Managers Index* (PMI), that summarizes changes in production, orders, inventories and employment, has been improving over the past three months in a row. The general index of economic sentiment drawn up by the European Commission that summarizes conditions in the main economic sectors, after some months of stagnation, also recorded a notable improvement in April.

The second factor that will move forward the change in rate of decreases in coming quarters is the normalization of the financial sector. As mentioned in the chapter on financial markets, the reduction of risk aversion has made it possible for risk premiums and therefore

ECONOMIC SENTIMENT INDICES MARK CHANGE IN TREND

Economic sentiment indices



SOURCE: Bloomberg, Eurostat and own calculations.

the cost of financing to go down in recent months. This is turning into normalization of bond issues and is opening the doors to the much-awaited recapitalization of the sector.

The effect on the real economy will not be immediate but we certainly will see credit to companies and households gradually recovering. For the moment, interest rates on both types of credit are fast moving down in response to the sharp drop in reference rates that the European Central Bank has been following since October last year. In May, it again cut the rate by 0.25 percentage points putting it at 1%.

In any case, it is important to underline that uncertainty about the speed with which the economy will recover is still very high. The speed with which the financial system will be able to pass through recovery to the real economy is quite unknown. Nor do we know exactly what impact the fiscal expansion plans will have. According to estimates by the European Commission (EC) presented in its Spring report, their effect on the GDP will be between 0.5% and 1% in 2009 and between 0.4% and 0.7% in 2010.

Another factor to keep in mind is the extent of the worsening of the labour market over coming years. In March the unemployment rate again rose by two percentage points and now stands at 8.9%. According to the report on EC forecasts, employment will contract by 2.5% both in the Euro Area and the European Union as a whole in 2009 and in 2010 it will continue to decrease going to 1.5%. This means that eight and a half million people will lose their jobs in the European Union over these two years. Should these forecasts be met the recovery of consumption will be very weak and this will limit the ability of the economy as a whole to recover.

A final factor that introduces a high level of uncertainty in the forecasts is the future trend in inflation. For the moment, this is showing a clearly downward trend given that in April it held at 0.6% and could reach negative rates over the short term because of the effect of the drop in commodity prices. Over the medium term, however, there are two forces pushing in opposite directions. On the one hand, the weakness in consumption will slow down any recovery in inflation but, on the other hand, it could go up strongly if the enormous amounts of liquidity that the ECB has injected into the system are not recovered in an orderly fashion.

Finally, there are some convincing signs that the worst of the recession may now have passed. But the path that will take us to positive growth rates is plagued by elements that introduce a high level of uncertainty which we must keep watching closely.

...and financial markets returning to normalcy.

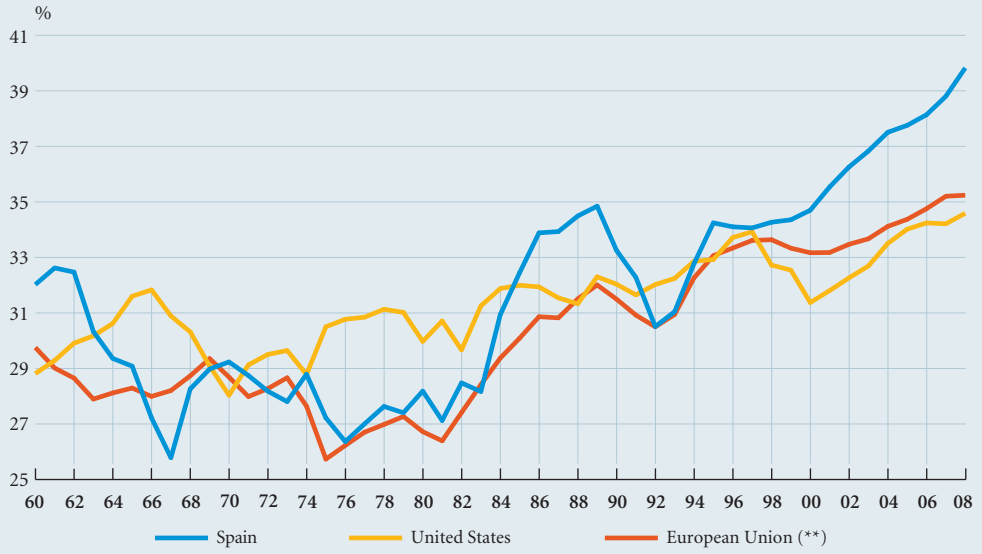
Uncertainty still very high.

Why profits have increased over the long-term: innovation and globalization

At the beginning of the 19th century the classical economist David Ricardo considered that the fundamental question in economics was how to determine the distribution of income between the factors of production, capital and labour. This interest was a reflection of the fierce debate that then-called «political economy» was going through at its outset. Nevertheless, the question failed to attract attention. For a long time economists accepted that Nicholas Kaldor's thesis that the remuneration of the factors of production were stable (two-thirds of income went to labour and the rest to capital) adequately reflected reality. The statistics certainly showed cyclical swings but in terms of tendency the proportion profits/wages was maintained. Nevertheless, after more than two decades in which the remuneration of capital has been gaining weight the debate has come back.

GLOBAL TREND TO RECOVERY OF CORPORATE PROFITS

Share of profits as proportion o gross domestic product (*)



NOTES: (*) Share of corporate profits calculated as 100 less share of all remuneration for labour factor (wages and employers' social contributions, all divided by GDP at factor cost).
(**) European Union (EU-15).
SOURCE: AMECO Database.

Available figures, in fact, indicate that since the end of the Seventies or the beginning of the Eighties the proportion of income going into remuneration of capital has increased both in the United States and the European Union. Spain was not outside this trend nor were such countries as Canada and Australia. Indeed, this was a world-wide trend and one that had a second moment showing an upward trend as of the second half of the Nineties. It remains to be seen, however, if it can take on a cyclical nature, given that it is not to be ignored that precisely since the 1993 recession the world went through a long stage of economic growth that continued until 2008. When we apply various methods of removing the effect of the cycle, the results coincide. The increase in the share of profits in income is upward, well above cyclical fluctuations.

Therefore, in order to explain this trend we must look for factors of a structural and global nature that began to show up around 1980. The candidates usually mentioned in the literature are technological innovation, globalization and institutional changes. Technological progress began to change in nature and dynamism in the Eighties. While it is not limited to the impact on the economy of new information and knowledge technology, these do represent the more evident appearance of technological change. Its effect was clearly evident as of the mid-Nineties.

Economic theory indicates that technological change may benefit both capital and labour. In the case of the revolution in information and knowledge technology this has come to pass largely in data-processing capital goods and others, which in turn has meant that technological capital has seen its return increased and, as a result, it share of income. At the same time, given that each type of technology is associated with a specific type of worker profile, if rapid technological advances take place this will increase relative demand for a highly-skilled group of workers for two different reasons. First, because some advanced technologies intrinsically involve the need for more highly-skilled professional workers. This process also takes place because workers with higher preparation in general are more «adaptable» to the new technologies.

This theoretical premise is supported by empirical evidence which tends to underline that the appearance of new technology is complementary to skilled labour but substitutes the unskilled segment. Given that in nearly all industrialized countries the proportion of highly skilled workers around 1980 was low, the process of innovation tended to cause an increase in the proportion of income going into remuneration of capital, given that only a fraction of all workers benefited from the higher demand (and for higher remuneration, as a result), whereas the bulk of workers were relatively less in demand.

A second factor in operation was globalization. The move into the international economy of countries that traditionally were on the outskirts (the so-called emerging economies, with China in the lead) came about sharply as the Nineties progressed and, especially, in the early years of the 21st century. While the effects of globalization on the mix of profits/wages are complex, it is generally accepted that a process of trade liberalization tends to bring about a decrease in the share of work in income if the country is capital-abundant compared with other economies (a situation in which the industrialized countries currently stand).

Institutional changes, as opposed to those of technology and globalization, tend to have an impact that is not so clear. For example, while some authors point out that the increase in weight of the remuneration of capital is due to the deregulation of labour and the process of reducing trade union membership, the fact is that the country in the European Union to show itself most active in this sphere, the United Kingdom, has recorded practical stability in the proportion profits/wages over the past two decades. Another institutional aspect that is mentioned at times is that some processes of wage negotiation tend to make wages grow above productivity, thus giving incentive to the substitution of labour over capital. While this is a plausible explanation for some countries (France, for example), in other countries such as Austria and Finland this pressure from wages did not exist while the increase in the share of profits out of income was sharp.

To sum up, two trends that shape the current economy (rapid technological change and globalization) lie behind the increase in the share of remuneration of capital since 1980 while this effect was increased in some cases by institutional factors. To what extent does each of those factors explain the trend to the increase in weight of profits? Empirical studies available coincide in showing that technological change is the main cause,

while the aspects of economic globalization carry less weight.[1] We stated earlier that Ricardo discovered the importance of this matter nearly two centuries ago. This was no accident. Then, as today, the world was going through a stage of progressive increase in trade and financial flows along with an industrial revolution. While history never repeats itself, at times there are echoes from one epoch to another. This should give us confidence at a moment of uncertainty such as the present, given that, not for nothing, Ricardo was a contemporary of the beginning of a stage of prosperity that would last for nearly a century.

(1) See, as a representative example of empirical studies carried out, Florence Jaumotte and Irina Tytell, «How has the globalization of labour affected labour income share in advanced countries», IMF Working Paper No. 07/298, December 2007.

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

Germany: worsening of economy could be starting to end

German economy undergoes biggest contraction since World War II.

In the first quarter of 2009, the German economy underwent its biggest contraction since World War II with a 6.9% year-on-year reduction of GDP. This reduction was largely due to the sharp drop in economic activity in the first three months of the year, which was down by 3.8% compared with the final quarter of 2008. This figure was in line with the forecasts by the main international bodies and the German government itself which all anticipate an economic contraction of 5.4% and 6.0% in 2009.

It is not by chance that the German and Japanese economies are being severely affected by the present economic situation. The collapse of foreign trade, a result of the world recession and financing problems, has severely hurt those countries where foreign demand was a key factor in growth. Furthermore, in view of Germany's specialization in capital intensive goods, the drop in exports has brought with it a sharp contraction in investment making these, along with domestic consumption, the three components that have dragged down the GDP, only partly compensated by increased government spending.

Indicators show unprecedented drops in first quarter.

The exceptional nature of the recession as experienced in the first quarter of 2009 is reflected in the performance of the most frequent indicators which in this period reported the biggest decreases in the past 60 years. Among these drops what stands out is the German foreign sector which shows a decrease in the trade surplus of more than 50% year-on-year in the first three months of 2009 due to a contraction of 21.3% in exports. Industrial production and orders were down 19.7% and 35.7% respectively. Along with lower utilization of production capacity, this makes it possible to estimate that investment in the first quarter has continued to contract very sharply. Furthermore, on the demand side, retail sales showed a reduction of 3.0%.

In spite of these uninspiring figures, it would seem that some signs of improvement are beginning to show up that would suggest, even though very

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
GDP	2.6	1.0	2.8	2.0	0.8	–1.8	–	–6.9	–	–
Retail sales	–3.0	–0.5	–1.2	–0.8	0.1	–0.5	–2.1	–6.2	–1.0	...
Industrial production	5.8	0.0	4.8	2.8	0.0	–7.5	–18.1	–21.0	–20.3	...
Industrial activity index (IFO) (*)	106.1	96.8	104.0	102.1	94.8	86.2	83.1	82.6	82.2	83.7
Unemployment rate (**)	9.0	7.8	8.1	7.9	7.7	7.6	7.8	8.0	8.1	8.3
Consumer prices	2.3	2.6	3.0	3.0	3.1	1.6	0.9	1.0	0.5	0.6
Trade balance (***)	181.5	195.3	199.5	202.3	196.3	183.0	168.8	161.0	152.4	...

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

weakly, some reduction in the contraction in coming months. If we look at the monthly figures, we note how, in spite of the sharp drop in production and industrial orders in the first quarter, the figures for March show something of a rise that was also reflected in the improvement in the IFO index of industrial activity for April, both in its present and future components. We also note some hopeful signs in the trend in exports and retail sales in March, while car registrations continued to increase that month as a result of the tax incentives aimed at getting old cars off the road, following two quarters reporting decreases.

Nevertheless, these slight improvements in the monthly figures coincide with great uncertainty in the labour market. The unemployment rate in April rose for another month going to 8.3% of the labour force.

Our reading of the various trends shown in the figures is that we stand at a turning point where the German economy, in spite of still going to contract in coming months, will gradually show less of a drop and could even reach positive quarter-on-quarter growth rates at year-end. This easing would come about through an improvement in exports and investment while we expect that private consumption will follow the trends seen in recent quarters due to the continuing downturn in the labour market. The latter factor keeps up uncertainty about the trend in the inflation rate which, although it could continue to drop in coming months, as of the second half will be subject to two factors coming from opposite directions. On the one hand, the weakness in domestic demand will continue to drive it down while the fiscal measures taken and the cuts in interest rate by the European Central Bank will push in the opposite direction.

Weak signs of some easing of economic slump.

Recession in France: less severe than in other countries

Figures for national accounting in France show a drop in GDP of 3.2% year-on-year in the first quarter of 2009. Nevertheless, the indicators for April

French GDP down by 3.2% year-on-year in first quarter of 2009.

Domestic consumption holding at positive rates.

suggest that the most critical moment of the recession probably took place in the first quarter of 2009. The economic sentiment index has thus risen slightly. Figures for confidence and industrial orders also showed some recovery in April.

On the demand side, the indicators point to a sharp slowdown in domestic consumption. Nevertheless, we should point out the increase in consumption in the first quarter of 2009. According to national accounting figures, private consumption grew by 0.6% year-on-year, a rate above the 0.2% reported in the fourth quarter of 2008.

France's figures for investment and exports are more troubling. National accounting figures show that the situation of decreases in gross capital formation continued in the first quarter of 2009, with a negative year-on-year rate of –7.0% following the –3.9% figure marked up in the previous quarter.

French exports collapse by 12.9% year-on-year.

At the same time, the figures also reflect very weak foreign demand given the fact that the drop in exports sharpened in the first quarter of 2009 with a negative year-on-year rate of 12.9%. This was in contrast to growth of 4.2% in the same quarter in 2008. Therefore, economic recovery in France is subject to whatever trend takes place among its trading partners. Furthermore, it will depend on its capacity to implement reforms that could contribute to improving its competitiveness. According to a recent report by the Organization for Economic Cooperation and Development (OECD), France should remove barriers in many sectors, especially in electrical goods, which makes its foreign competitiveness difficult.

On the other hand, the number of unemployed has substantially increased in recent months going to 8.8% in March. The worsening of the labour market has had a worse effect on young people, especially those in less favourable situations. The same OECD report underlined that problem and proposed certain reforms aimed at improving employment for the younger group. For example, it suggests emphasis on university/company training and removal of the duality of hiring contracts between temporary and permanent.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
GDP	2.3	0.3	1.9	1.0	0.1	–1.7	–	–3.2	–	–
Domestic consumption	4.4	1.1	2.4	1.5	0.9	–0.2	1.8	–1.9	0.6	...
Industrial production	1.4	–2.5	1.6	–0.3	–2.2	–9.0	–14.6	–15.9	–16.1	...
Unemployment rate (*)	8.3	7.8	7.6	7.6	7.8	8.2	8.4	8.6	8.8	...
Consumer prices	1.5	2.8	2.9	3.3	3.3	1.8	0.7	0.9	0.3	0.1
Trade balance (**)	–33.3	–48.1	–41.6	–45.6	–50.5	–54.8	–54.1	–55.2	–55.8	...

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

Italy showing no sign of improvement

As noted by the main international bodies, in the first quarter the Italian economy underwent a further quarter-on-quarter drop of 2.4%. This contraction, the result of a major drop in demand, both domestic and foreign, meant a 5.9% drop in GDP compared with the same period in 2008. This figure, along with the trend in the more frequent indicators, points to the prospect of rather unfavourable economic activity in Italy for the first half of 2009.

The sharp contraction in industrial production in March and industrial orders in April suggest that investment will continue on a downturn in coming months, a result of uncertainty about the duration of the recession, financing difficulties and low utilization of production capacity. In turn, exports in the first quarter of 2009 were down 22.8% compared with the same period in 2008, thus recording the biggest drop in decades. Nevertheless, the slight increase in exports in February and March, along with the drop in commodity prices, resulted in a surplus in the trade balance in the latter month, and this showed signs of some stabilization over the short term.

Prospects for Italian economy in first half of 2009 unfavourable.

What is more, in spite of tax cuts by the government and the historically low inflation, private consumption still failed to take off. Uncertainty about the worsening of the labour market has resulted in an increase in the savings rate of households which is expected to continue all this year. As a result, prospects for 2009 are for a continuing drop in Italy's GDP although it will gradually keep losing strength.

Private consumption holding at very low levels.

Lower tax collections, a result of the drop in economic activity and higher public spending to stimulate the economy have increased Italy's government deficit. The new forecasts by the European Commission put this at around 4.5% for the next two years, raising the government debt to above 110%, a level similar to that at the end of the Nineties. In view of this picture, the Berlusconi government faces the difficult challenge of limiting the contraction of Italy's economy and maintaining the public finances under control. This is a more and more difficult task in view of the many voices now asking for increased government investment.

Recession pushes Italian deficit above 3% of GDP.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
GDP	1.5	–1.0	0.4	–0.3	–1.3	–3.0	–	–5.9	–	–
Retail sales	1.3	–0.3	1.4	–0.7	0.1	–1.7	0.4	–4.7	–5.2	...
Industrial production	2.1	–3.3	0.9	0.1	–3.9	–10.6	–17.1	–21.3	–25.1	...
Unemployment rate (*)	6.2	6.7	6.6	6.8	6.7	6.9	–	...	–	–
Consumer prices	1.8	3.3	3.1	3.6	4.0	2.8	1.6	1.6	1.2	1.2
Trade balance (**)	–12.8	–10.0	–8.5	–8.6	–10.8	–12.3	–11.0	–11.4	–10.8	...

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

United Kingdom: economic recession may have hit bottom

British GDP down 4.1% year-on-year in first quarter of 2009.

According to British national accounting figures, the contraction in GDP in the first quarter of 2009 was very sharp putting the drop at 4.1% year-on-year. By component, there was a notable drop in investment (8.3% year-on-year) a result of the weakness and uncertainty of demand and the restriction of credit.

Private consumption showed a drop of 2.8% year-on-year, well above the drop of 0.8% recorded in the previous quarter. One important factor in the trend in consumption, household income, was depressed by the moderation in wages and the increase in unemployment. In fact, the registered unemployment rate was up two decimals in April going to 4.7% while the number of those employed dropped by 295,000 in the year ending in March.

Registered unemployment moves up two decimals to 4.7%.

As was to be expected, the only positive contribution to gross domestic product came from public consumption which was up by 3.5% year-on-year. On the other hand, both exports and imports were down significantly by 11.0% and 12.8% year-on-year respectively.

In spite of the sharp slowdown in economic activity reflected in national accounting figures for the first quarter of 2009, it should be noted that, after various months of poor indicators, some figures reflect a change of trend and, to some extent, show some light at the end of the tunnel. In March there was something of a halt to the contraction in industrial production. In the same way, total orders and indicators of economic sentiment and confidence in April show some improvement.

On the other hand, the increase in prices was higher than was forecast some months back, partly due to the effect of depreciation of the pound. The inflation rate thus stood at 2.3% year-on-year in April following the 2.9% marked up the month before. Nevertheless, as indicated in the *May Inflation Report* of the Bank of England, it is very likely that inflation

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009			
			1Q	2Q	3Q	4Q	January	February	March	April
GDP	3.0	0.7	2.6	1.8	0.4	–2.0	–	–4.1	–	–
Retail sales	4.4	3.5	5.3	4.4	2.3	2.5	3.6	0.9	1.7	2.7
Industrial production	0.1	–2.8	0.5	–1.3	–2.5	–7.5	–11.6	–12.3	–12.4	...
Unemployment rate (*)	2.7	2.8	2.4	2.5	2.8	3.4	3.9	4.3	4.5	4.7
Consumer prices	2.3	3.6	2.4	3.3	4.9	3.9	3.0	3.1	2.9	2.3
Trade balance (**)	–83.2	–93.0	–90.9	–93.1	–94.3	–93.6	–92.8	–91.9	–91.0	...
3-month Libor interest rate	5.3	6.0	6.0	6.0	5.9	6.3	2.8	2.2	2.0	1.6
Nominal effective pound exchange rate (***)	103.9	97.6	97.6	92.6	92.8	89.4	73.7	77.0	77.8	76.9

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

will settle below 2% at the end of this year due to the moderation in prices in the food and energy sectors.

Finally, it should be pointed out that most bodies estimate there will be a severe slowdown in the United Kingdom economy in 2009 and out the first quarter as the point of greatest decrease. Along these lines, in its April report, the International Monetary Fund (IMF) forecasts a drop of 4.1% in the British GDP in 2009 with a gradual recovery during 2010. The IMF mentions that the correction will be slow due to the high debt level of banks and households. On the other hand, it also emphasizes that both the fiscal measures to stimulate the economy and the depreciation of the pound are acting favourably in the process of revitalizing the British economy.

Inflation stands at 2.3% in April.

Emerging Europe: economic activity sinks in first quarter

The recent economic trend in Emerging Europe has been subject to two key factors. First, economic activity dropped sharply in the first quarter. Second, the trend in financial markets, which has been markedly positive since the end of February and the beginning of March in terms of the assets to which we now refer. Some analysts have interpreted these figures as if the bottom had now been reached and recovery was about to begin.

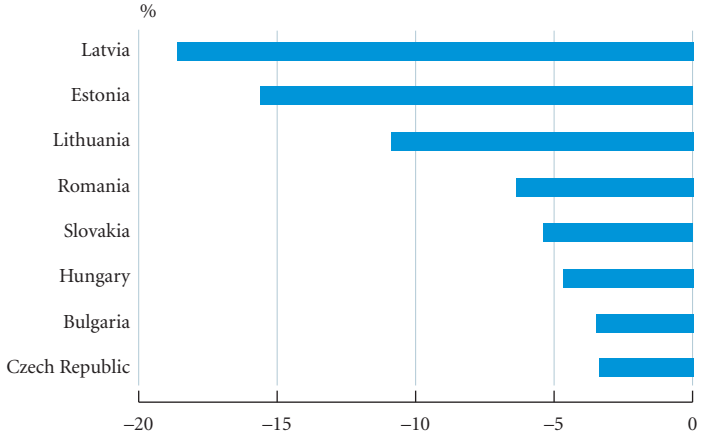
In our opinion, this evaluation is incorrect. Neither has a minimum of economic activity been reached nor is the macroeconomic situation the main determinant of financial recovery. Furthermore, the balance of risks has rapidly modified so that perhaps we are concentrating our attention on the wrong point. A starting factor in formulating our point of view is the correct interpretation of what has taken place in the first three months of 2009.

Undoubtedly, in this period the countries of Emerging Europe have undergone a sharp drop in GDP in year-on-year terms. While figures so far available stand in a wide range the runs from a year-on-

Despite sharp adjustment in economic activity in first quarter, Emerging Europe still not hitting bottom.

DRASTIC DROP IN ECONOMIC ACTIVITY IN EMERGING EUROPE

Year-on-year change in gross domestic product (1st quarter of 2009)



SOURCE: Eurostat.

Domestic demand suffering restriction of credit, pressure of debt and pro-cyclical fiscal policy.

year drop of 3.4% in the Czech Republic to a decrease of 18.6% in Latvia (see details in previous graph), in most cases it is a matter of figures that lower the forecasts put out before. In any case, what is most likely is not that the GDP will go back to growth as of the second quarter but simply that it will drop at a lower rate during this period.

With regard to the trend in the macroeconomic figures, without having details of the components at hand, the monthly indicators clearly suggest that the drop in GDP will be due not only to the decrease in exports but also to the worse situation in all domestic demand components.

Improvement in financial markets reflects lower world risk aversion and reduced likelihood of international default.

As a result, the figures for the first quarter suggest that, with the help of exports, investment and consumption should become firmer before they can reach figures showing any appreciable strength. The recovery of exports and investment will critically depend on a better situation in the Euro Area, a situation that will be difficult to see happening before well into 2010. In turn, private consumption depends on variables that will take time to improve (such as employment) so that we must also exclude any big drive from household spending in the near future.

Concern about banking and political risks.

The prospects look even slimmer if we consider the factors underlying this depression in economic activity. To a large extent it is the effect of the draining away of international financing, a factor arising from the world liquidity crisis. On top of this financial restriction come other aspects such as efforts to limit fiscal deficits being carried out in many countries, the collapse of exports because of the depression in foreign markets and the effect on borrowing, both household and corporate, of the sharp currency depreciations between the Summer of 2008 and February of the current year. Furthermore the beneficial effect of the substantial lowering of intervention rates has lessened because, in view of the increase in risk premiums, market interest rates that face companies and consumers do not reflect these reductions.

These are trends that will be slow to improve. The improvement in financial markets cannot be explained so much as a matter of a scenario of recovery as because of a combination of a world-wide reduction of risk aversion and a lower possibility of international default or «contagion» of the region, thanks to financial aid from the international bodies. All of this has gone in favour of a recovery of stock markets, the appreciation of currencies and a reduction in country-risk indicators.

In addition, while the possibility of a conventional crisis in the balance of payments has been reduced and much of the foreign exchange risk is now reflected in current quotes, these are two factors that could still hold some surprises of a negative kind. Nevertheless, the trend in the banking sector would seem to be key. While the drop in economic activity is beginning to recover, bank default rates will tend to rise and the need for recapitalization will still be present. Finally, another risk is of a political nature given that the harshness of the economic measures taken has already brought about the fall of governments in Hungary and Czech Republic. In fact, until recovery takes place (and this is still some way off) the road ahead will be a difficult one.

FINANCIAL MARKETS

Monetary and capital markets

Interbank market interest rates continue downward trend

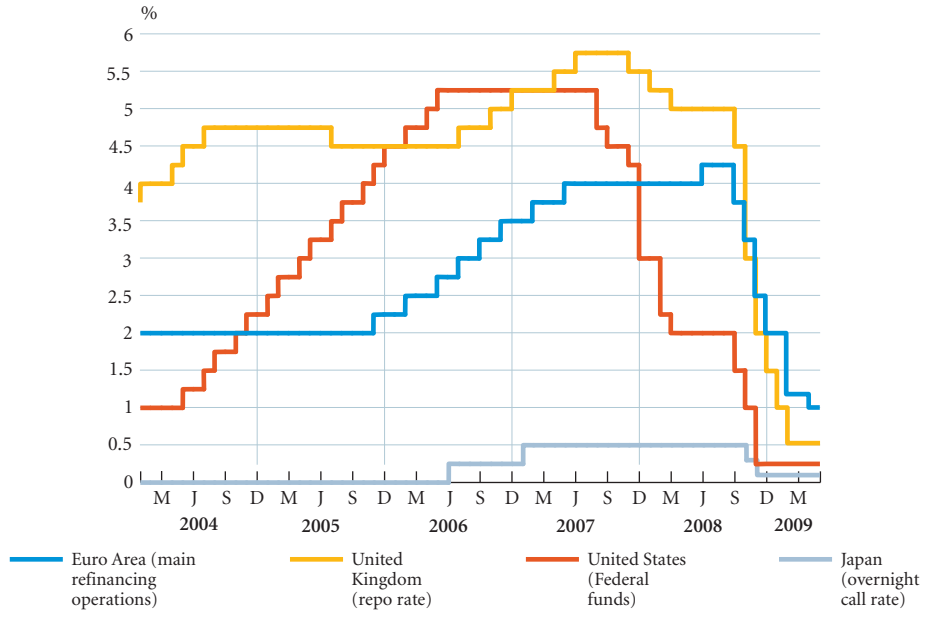
The European Central Bank (ECB) did not disappoint the financial markets. At its meeting on May 7 it decided on a further cut in the reference rate of 25 basis points putting it at 1%. This is the lowest level reached since the creation of the ECB ten years ago. Central bank chairman Jean-Claude Trichet refused to put this level as the final floor for rates but nor did he indicate there would be a further cut, thus reflecting the division of opinions regarding this matter among members of the ECB council.

The central bank of the Euro Area took advantage of that meeting to announce unconventional monetary policy measures. In the first place, it was decided to maintain the present range of assets as those acceptable as collateral for financial operations with the ECB up until December 2010. One of the measures that the market was expecting and that the ECB confirmed was the continuation of liquidity auctions for an unlimited amount up to 12 months. Up to this time, auctions were carried out for a maximum period of 6 months. Finally, the most novel decision was the announcement of the purchase in the

ECB cuts interest rate by 25 basis points to 1% and announces unconventional monetary policy measures.

ECB CUTS OFFICIAL RATE TO 1%

Central bank reference rates



SOURCE: National central banks.

Federal Reserve lowers growth forecast but maintains inflation forecast for 2009 almost intact.

secondary market of covered bonds or bonds backed by mortgage assets issued in euros up to a total amount of 60 billion euros. This measure is aimed at reducing the differentials in interest rates that investors are asking for this type of financial asset.

There was also a significant change at the Federal Reserve which on May 20 released the minutes of the last meeting on monetary policy. The minutes set out the latest estimates for growth and inflation for 2009 and 2010. With regard to growth in 2009, it lowered its key estimate from a drop of 0.9% to 1.7%. On the other hand, it revised growth for 2010 downward only four decimals to 2.5%. With regard to inflation, it made no substantial change in its forecast for underlying inflation for 2009 which was put at 1.3%. In this context it is foreseeable that the reference rate will hold within the range of 0%-0.25% all through 2009.

Bank of England raises amount for purchase of government bonds and Bank of Japan becomes more optimistic.

In turn, the Bank of England maintained its reference rate unchanged at 0.5%. In its official press release it underlined the significant slowdown in recent months and the high inflation rate as a result of the sharp depreciation of the pound sterling. Furthermore, the central bank announced an extension of the plan to buy government bonds in the secondary market, increasing its budget for buying bonds to 50 billion pounds sterling.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro Area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2008									
May	4.00	4.86	5.10	2.00	2.68	0.92	5.00	5.87	2.78
June	4.00	4.95	5.39	2.00	2.78	0.93	5.00	5.95	2.73
July	4.25	4.97	5.37	2.00	2.79	0.90	5.00	5.78	2.78
August	4.25	4.96	5.34	2.00	2.81	0.88	5.00	5.75	2.70
September	4.25	5.27	5.50	2.00	4.05	1.02	5.00	6.30	3.00
October	3.75	4.76	4.87	1.00	3.03	0.94	4.50	5.84	2.43
November	3.25	3.85	3.95	1.00	2.22	0.93	3.00	3.91	1.23
December	2.50	2.89	3.05	0.25	1.43	0.10	2.00	2.77	0.75
2009									
January	2.00	2.09	2.27	0.25	1.18	0.10	1.50	2.17	0.70
February	2.00	1.83	2.03	0.25	1.26	0.10	1.00	2.05	0.75
March	1.50	1.52	1.81	0.25	1.19	0.10	0.50	1.65	0.63
April	1.25	1.37	1.73	0.25	1.02	0.10	0.50	1.45	0.66
May (1)	1.00	1.27	1.63	0.25	0.66	0.10	0.50	1.28	0.60

NOTES: (1) May 26.

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

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

(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 04-12-08 (2.0%), 7-01-09 (1.5%), 05-02-09 (1.0%), 5-03-09 (0.50%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

Finally, the Bank of Japan was less pessimistic and improved its forecasts for the first time in the past three years. According to the central bank, the worsening of the economy will moderate although it is likely that deflation measured by the consumer price index will be maintained. In addition, it sees a sharp improvement in the surpluses of Japanese companies. Nevertheless, in spite of these measures, Japan's central bank continues to examine the possibility of introducing new measures to keep helping the financial system. Among these measures, the latest is a study of the possibility of accepting US Treasury bonds along with other foreign government bonds as collateral in the open market. If this measure is finally approved, through the widening of the range of acceptable collateral, the Bank of Japan would be providing greater flexibility for obtaining access to its credit facility, offering yen in exchange for bonds in other currencies.

The massive injection of liquidity by the ECB and the new cut in the reference rate has made it possible to mark up new all-time lows in the interbank market of the Euro Area. For example, on May 19 the 3-month Euribor rate went to an all-time low of 1.24%. That same day, the 12-month Euribor was quoted at 1.60%. The margin for further reduction of differentials in interbank market rates is now slim but this will happen as the quantitative easing measures announced by the central bank come into effect. Important among these measures will be the facility of 12-month loans that will contribute to increasing the security of financial institutions with regard to their financing and this will have a positive effect on further reductions in the 12-month Euribor rate.

12-month Euribor interest rate quoted at 1.6%, an all-time low.

Result of «stress test» for US banks calms down investors.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2008								
May	4.41	4.59	4.62	4.86	4.06	1.76	4.99	3.19
June	4.62	4.81	4.90	5.17	3.97	1.60	5.13	3.29
July	4.36	4.53	4.67	4.90	3.95	1.54	4.81	3.05
August	4.18	4.38	4.55	4.82	3.81	1.42	4.48	2.89
September	4.02	4.35	4.60	4.90	3.82	1.47	4.45	2.61
October	3.90	4.30	4.61	5.15	3.95	1.48	4.52	2.84
November	3.26	3.68	3.89	4.46	2.92	1.40	3.77	2.28
December	2.95	3.41	3.81	4.38	2.21	1.17	3.02	2.10
2009								
January	3.30	3.81	4.39	4.71	2.84	1.30	3.70	2.18
February	3.11	3.66	4.28	4.68	3.01	1.28	3.62	2.24
March	3.00	3.55	4.05	4.39	2.66	1.35	3.17	2.10
April	3.18	3.59	3.92	4.28	3.12	1.43	3.50	2.14
May (*)	3.58	3.90	4.26	4.40	3.42	1.45	3.69	2.41

NOTES: (*) May 26.
SOURCE: Bloomberg.

Slight rise in yield on government bonds, reflecting improvement in early economic indicators.

The drop in yield has been very sharp in the interbank market in the United States where the 3-month Libor was quoted at 0.66%. In this case, not only the injection of liquidity by the Fed but also the calming result of the «stress test» of 19 large US banks helped bring about this reduction. The test indicated that these bank groups will have to increase their ordinary capital by a total of 75 billion dollars in order to deal with the present crisis. This was a substantially lesser amount than the markets were expecting. Many of these bank groups carried out capital increases to improve their strength. These new capital issues were picked up favourably by investors.

Dollar depreciates against euro because of lower risk aversion and weak measures adopted by ECB.

The improvement in economic prospects and the performance of financial assets with greatest risk has brought about a slight increase in the returns offered by government bonds. As may be seen in the previous table, this movement has been shared by bonds issued by governments on both sides of the Atlantic. This increase may be accounted for by a rise in real interest rates that reflects the improvement in early economic indicators. On the other hand, the risk premium for default demanded for government bonds has decreased and compensation required for the inflation expected by investors has not significantly changed nor have expectations of the maintenance of inflation at present levels.

Dollar depreciates against other currencies

In May the dollar depreciated against the euro and on May 25 reached a quote of

EXCHANGE RATES OF MAIN CURRENCIES

May 27, 2009

	Exchange rate	% change (*)		
		Monthly	Over December 2008	Annual
Against US dollar				
Japanese yen	95.4	–1.5	5.0	–9.3
Pound sterling	0.625	–9.3	–9.6	19.0
Swiss franc	1.085	–6.5	1.5	4.7
Canadian dollar	1.112	–9.8	–9.6	10.6
Mexican peso	13.173	–6.7	–3.8	21.2
Against euro				
US dollar	1.395	6.6	–0.1	–12.5
Japanese yen	133.1	5.2	4.8	–22.9
Swiss franc	1.514	0.5	1.4	–7.1
Pound sterling	0.872	–2.1	–9.6	8.9
Swedish krona	10.688	0.3	–2.4	12.9
Danish krone	7.445	–0.1	0.0	–0.2
Polish zloty	4.433	–2.8	6.4	23.4
Czech crown	26.76	0.1	–0.3	6.0
Hungarian forint	281.3	–4.9	5.6	13.1

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

1.40 dollars to the euro. Two factors were behind this move. First, there was a reduction in risk aversion. Many investors had protected their portfolios by acquiring US government bonds which at times of crisis are considered as one of the assets of highest quality for protecting the capital of investors. The improvement in prospects made it possible to halt the flight to quality. Secondly, the wariness of the ECB in its quantitative easing measures compared with that of the Fed favoured the euro over the dollar.

Nevertheless, it should be borne in mind that there are two medium-term risks about the dollar: the loss of the confidence of international investors in view of the worse situation in the public finances and in view of the inflationary risk as a result of the aggressive monetary policy employed by the Fed. But economic recovery will be faster in the United States than in the Euro Area so that over the medium term the dollar should strengthen.

The dollar has depreciated not only against the euro but also against other key currencies, including the pound sterling and the Swiss franc as may be seen in the above table, with drops of around 8% in the past month. Furthermore, the greenback has depreciated against the currencies of the more important emerging countries, including the Mexican peso, the Brazilian real and the Russian rouble. The only currency to remain stable against the dollar was the Chinese yuan which since August last year has been running at 6.84 yuan to the dollar. China's central bank intervened in the market to prevent its currency from appreciating and so avoid a bigger drop in export demand for its companies in a situation of world recession.

Dollar also depreciates against emerging country currencies except Chinese yuan.

Recovery of shares moderating

In May world stock markets again showed a generally good level. In spite of the fact that the revaluation of the main indices (S&P 500 and Eurostoxx 50) were more modest than those seen in the two previous months, the stabilization of volumes traded and the progressive affluence of investors are a sign that the market is anticipating a world economic scenario that is not as serious as was feared at the beginning of the year.

The stock market situation is showing a series of signs that point toward an increase in the degree of stabilization. These signs were articulated through three areas already well known – corporate news, the macroeconomic figures and technical market indicators. In addition, we should refer to the positive impact that the exceptional measures announced by the ECB had on shares, as well as the broadening of facilities for financing adopted by the Federal Reserve.

Stock markets ease growth rate.

The constant flow of news from the US business world was a key factor at stock market sessions. First of all, we should point out the campaign telling about the first-quarter results of S&P 500 companies. Following sharp downward revisions made by analysts in their estimates of profits at the beginning of the year, mainly those related to the financial sector, 65% of those companies reported profits better than expected by the consensus of analysts. The financial sector presented the best results since the beginning of the credit crisis. In spite of the fact that a large part of income was due to the revaluation of bond assets, what became clear was the effectiveness of the rescue measures decided on by the monetary authorities as well as the application of accounting modifications

Profits reported by companies go above estimates by analysts.

Economic figures contributing to improved confidence.

related to the valuation of certain assets in the balance sheets of banks. In Europe, the reading of profits was more modest but did not disappoint the expectations of most investors.

Secondly, the conclusions of the «stress test» carried out by the US Treasury on 19 of the largest banks was made public. The final result indicated that 10 of those banks faced the need to recapitalize by 75 billion dollars with Bank of America, Wells Fargo and Citigroup taking up more than 70% of the total. The options for carrying out this increase in capital would involve three instruments – new share issues, the conversion of preference shares into common shares and the sale of assets. The backing of the markets to the Treasury's move has gained in strength thanks to two factors. The first was that it showed a banking system less in trouble than that, for example, seen by the IMF (which calculated an injection of capital between 200 and 300 billion dollars). Second, that a number of the banks analyzed could restore their image in the world and even declare themselves ready to return the public funds received through the TARP aids.

Those sectors that showed the best performances and acted as a motor for the recovery of the stock markets were the financial sector and automobiles. In the market, a gradual increase in flows can be seen from defensive sectors to cyclical sectors, discounting a macroeconomic sector involving less risk.

INDICES OF MAIN WORLD STOCK EXCHANGES

May 26, 2009

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*8,277.3*	*2.5*	*–5.7*	*–33.7*
Standard & Poor's	*887.0*	*2.4*	*–1.8*	*–35.5*
Nasdaq	*1,692.0*	*–0.1*	*7.3*	*–30.8*
Tokyo	9,347.0	7.3	5.5	–33.3
London	4,365.3	5.0	–1.6	–28.3
Euro Area	2,433.5	4.9	–0.6	–34.7
Frankfurt	*4,918.8*	*5.2*	*2.3*	*–29.2*
Paris	*3,228.0*	*4.0*	*0.3*	*–34.6*
Amsterdam	*260.1*	*8.7*	*5.8*	*–45.6*
Milan	*20,007.0*	*7.3*	*2.8*	*–39.1*
Madrid	*9,308.6*	*4.7*	*1.2*	*–31.4*
Zurich	5,409.3	5.8	–2.3	–27.5
Hong Kong	17,173.3	12.5	19.4	–30.5
Buenos Aires	1,562.4	24.1	44.7	–30.1
São Paulo	50,568.5	8.1	34.7	–29.2

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

Another crucial aspect for the recovery in the indices were the macroeconomic figures. While the real estate sector confirmed the slowdown in the rate of decrease in its key variables, the main interest was centred on early indicators of economic activity and confidence. Surveys of corporate confidence continued to improve from all-time low levels which helped establish a floor both for industrial prospects and for the markets. It should be kept in mind, however, that continued improvement of business sentiment faces the obstacle of a worsening of the labour market and high indebtedness of households, factors the could limit the recovery potential of sales and margins.

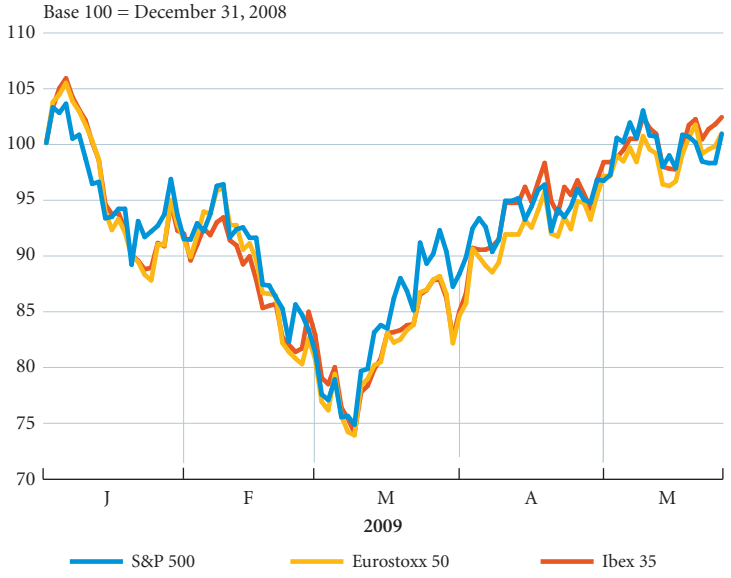
The technical indicators of the market were another important aid in the boost on the stock markets. Volatility, which is a reflexion of risk aversion, moderated and settled at levels close to those seen just days before the bankruptcy of Lehman Brothers last September. At the same time, liquid positions held at very high levels in investor portfolios, particularly in the case of US investors. There came about a situation not seen for 16 years in which the positions of households in monetary funds went above investments in share-based funds. This indicates that there still exists a broad potential for a shift of funds to the stock market.

The prospects for coming months, based always on the assumption that the likelihood of a worsening of the economic scenario is diminishing, will depend on the time profile for the improvement of confidence among the economic agents and, when all is said and done, on the increase in investor willingness to take risks. In this respect, it remains to be seen how the various increases in the capital of US banks needed following the «stress test» actually develop and if finally liquidity continues to be channelled toward share-based funds.

Positive prospects in scenario showing lower risks.

TREND TO RECOVERY IN STOCK MARKETS SINCE MARCH STILL CONTINUING

Main stock market indices



SOURCE: Bloomberg.

Broad reduction of risks in credit markets

Decrease in risk in credit market continues.

The improvement in credit markets continued at a good rate in May thanks to a more positive economic environment and to the actions of the central banks which continued to increase their balance sheets through the purchase of government bonds and high-quality private bonds.

Among the economic factors contributing to a favourable trend in credit spreads the following stood out – the relatively scarce demand for credit by the private sector, the greater willingness of investors to take risks and the high starting level in portfolios of positions in low-risk liquid assets which gradually stop being the refuge of investors.

Economic environment and greater acceptance of risk work in favour of lower differentials.

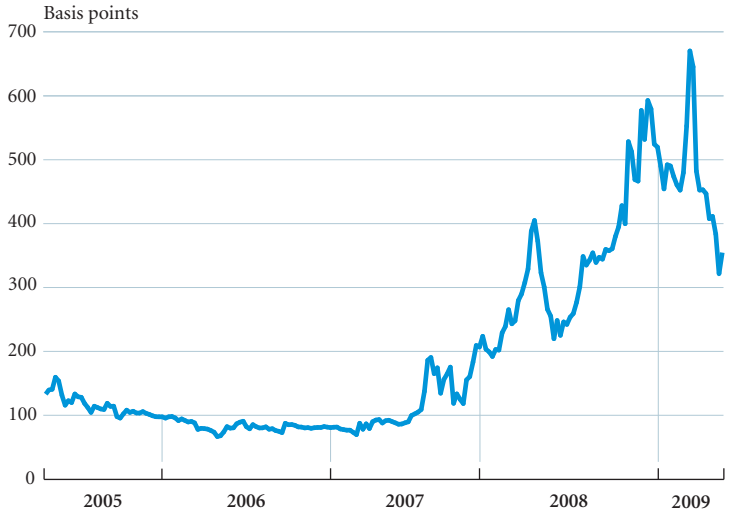
Over the past two months various surveys have been published on the trend in demand for credit by companies and households, characterized by the weak need for funding of the private sector. By sector, May saw a slowdown in bond issues by highly solvent companies which took advantage of the first quarter to cover a large part of their funding needs for the whole year. On the other hand, high credit risk companies have increased their bond issues in recent weeks.

Another determining aspect in the past month was the increase in investor willingness to take risks attracted by high differentials in interest rates offered by bonds of private issuers.

This increased willingness to take risks has brought changes in the make-up of portfolios. In the final months of 2008 and the early months of 2009 a high volume of resources went into monetary funds which now is a potential source of flows to other risk assets that offer higher yields as is the case of corporate bond markets or the stock market.

NOTABLE DECREASE IN CREDIT RISK

Credit spreads in United States stand at same level as in August 2008



SOURCE: Bloomberg.

As well as steps taken by private economic agents, what stood out were the measures carried out by the central banks. The announcement by the ECB that it would buy covered bonds for an amount up to 60 billion euros and the extension of the period for rediscount auctions from six months to one year were key measures in reducing the cost of credit and risk premiums. In the United States, the Federal Reserve proceeded with its objective of programmed buying of financial assets, mainly US Treasury bonds and those of mortgage agencies. At the same time, the US Treasury made known the results of its «stress tests» which were well received by investors as these would mean capital increases and sales of assets that are easily manageable and that can be handled by the markets. The Bank of Japan was also active and surprised everyone by announcing it was studying the possibility of accepting bonds issued by other governments as collateral at its regular liquidity auctions.

High interest rates attracting investors.

This series of measures is facilitating the process of deleverage of the banking system to the extent that it is the central banks that are increasing their balance sheets at the cost of the assets of the commercial banks and these, in turn, are reducing their risks. The result is an improvement in solvency and liquidity ratios to levels sufficient to put a brake on quick forced sale of their assets.

Purchase of assets by central banks brings down risk premiums.

Profits and the stock market

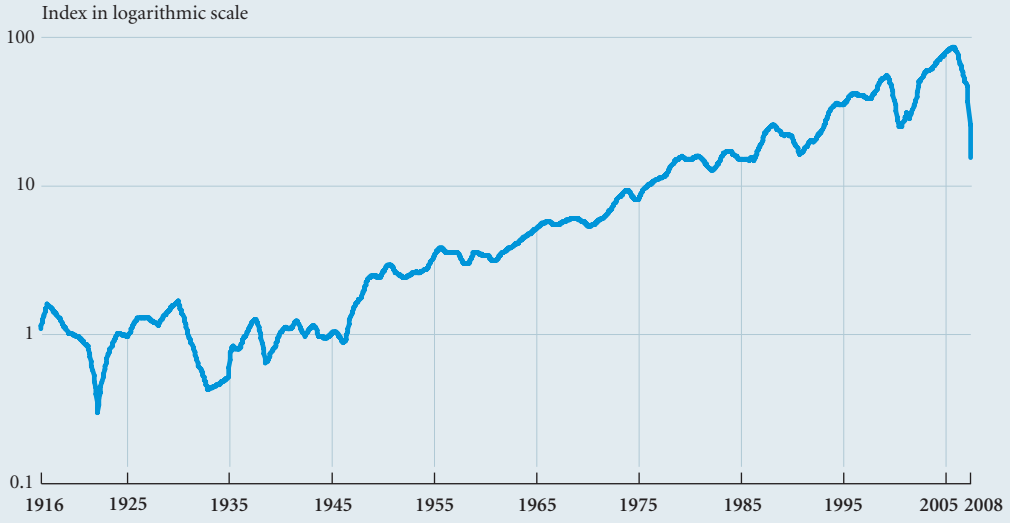
In the situation of widespread recession over the past two years, the performance on the stock markets has been especially negative. The emblematic S&P 500 index showed a cumulative drop of nearly 60% between October 2007 and March 2008. The profits of those companies making up that index were down by an even greater proportion, specifically 82%[1] between the second quarter of 2007 and the fourth quarter of 2008. The financial nature of the crisis was a determining factor in reaching those spectacular figures, given that the banks have suffered massive losses because of the depreciation of so-called «toxic assets». The big unknown is how to work out if the adjustment in profits and equity prices may have now ended.

As may be seen in the graph, profits have historically swung around their age-old tendency although since the Thirties we have not seen such sharp changes as those in the present cycle. In the summer of 2007, corporate profits in the United States stood at especially high levels. Since the end of the 2001 recession, growth of profits showed very high figures of around 20% annual. The contribution of the financial sector was very important, the result of major growth in mortgage loans by commercial banks and the sharp increase in risks taken by investment banks. The proportion of financial profits[2] over the total for all sectors of the economy reached 45% in 2001 and later stood at 33%, notably above the historical average, as may be seen in the second graph on the next page. In other sectors, the growth of profits was also notable largely thanks to increased financial

(1) The figure corresponds to quarterly operative profit per share, according to statistics drawn up by Standard & Poor's.
(2) According to figures from National Accounting referring to the country as a whole.

TREND IN PROFITS OF S&P 500 COMPANIES

Net profit per share



SOURCE: Robert Shiller.

and operating leverage by companies. In the last two years of the upward period (2006 and 2007) there arose a whole series of pro-cyclical factors, such as growth of production at the international level, the historical drop in risk premia and the containment of interest rates, broad programmes for repurchase of shares set up by companies and a big increase in remuneration formulas in favour of book profits, such as stock options and pension funds.

WEIGHT OF FINANCIAL SECTOR IN TOTAL PROFITS

Figures for economy of United States as a whole

SOURCE: Bloomberg and Bureau of Economic Analysis.

Some signs of weakness could be noted in the profit and loss accounts of companies even before the harsh blow at the end of 2008. In fact, the worsening of profits began some quarters before in non-financial and non-energy companies, as may be seen from the drop in margins brought about by the sharp rise in commodity prices and the increased cost of credit (the construction sector was one of the first to get into difficulties). Later on, with the worsening of the financial crisis in the Autumn of 2008, the huge write downs in bank balance sheets brought about an historical drop in profits in the financial sector. Finally, those companies with the greatest exposure to the foreign sector that had managed to maintain a high level of profits for some time longer thanks to their foreign subsidiaries, suffered in the last quarter of 2008 and the first quarter of 2009 the consequences of the internationalization of the crisis.

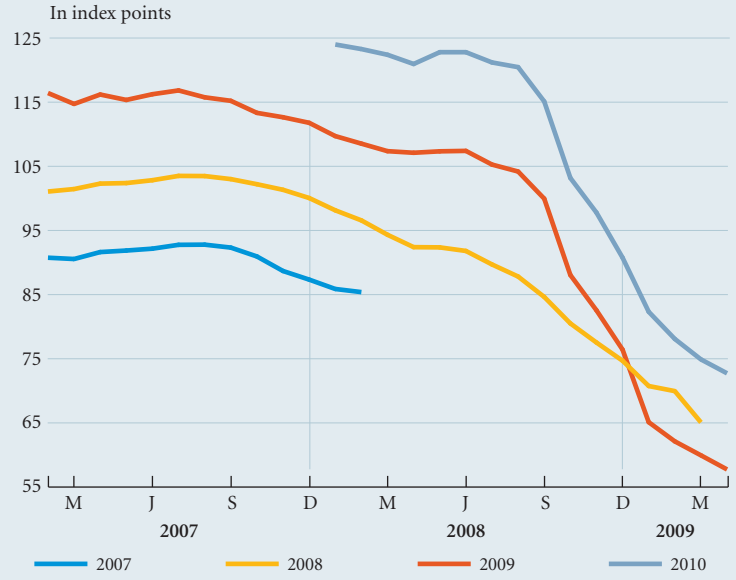
The downward cycle in profits, both in its moderate and quiet initial stage and in the spectacular losses of the financial institutions, was not adequately foreseen by financial analysts. The development of a feed-back boom in the economy and the markets from 2003 to 2007 produced an inertia among analysts and investors that sent many forecasts and valuations to extreme levels.

In financial circles people were ready to ignore figures for over-borrowing by households and many companies. The latter were even rewarded in the markets when they took on merger or take-over operations, normally through borrowing. The «consensus»[3] of the analysts during this process did not question the model and they constantly adapted their estimates according to the results published by the companies.

When the crisis began the direction of revised estimates was modified, this time downward. The analysts were caught by surprise by corporate results that were nearly always worse than their own estimates. Between the

TREND IN CONSENSUS OF PROFITS FORECASTS

Figures relating to operating profit per share for S&P 500



SOURCE: Ecowin.

(3) The term «consensus» refers to the average of estimates of profits made by financial analysts as a whole.

summers of 2007 and 2008 it was a slow and gradual process of recognizing a new reality but events that Autumn (bankruptcy of Lehman Brothers among others) speeded this up at a giddy and dramatic rate.

The process took place at a critical moment last March. The «consensus» of analysts drastically reduced their estimates of profits for 2009 and 2010 from levels already very low just before the appearance of the first signs of an improvement in the situation in financial markets and some areas of economic activity. Later on, the downward revisions were slowed and for two months the S&P 500 led a very significant rally of 40%. This opens up the question whether there might already have been an episode of capitulation by the analysts that often precedes upward moves in the profits cycle, in the same way as extreme complacency often comes before the peak moment.

Following the drastic cuts in recent months, at the beginning of May the «consensus» of the analysts showed forecasts that could be called conservative and even rather pessimistic under an scenario of progressive stabilization of the banking sector recovery of the economy as a whole. Specifically, for 2009 they expect drops of 12.4% in S&P 500 operating profit per share, a figure that would be much more negative if it were not for the base effect on the financial sector. For 2010 the forecasts for an increase in profits go as high as a notable 28.1%, so long as there is a general recovery of sectors as a whole and again with a substantial contribution from the financial sector. In spite of this figure, the expectations of the «consensus» for 2010 suppose a notably lower level of profits than that reached in 2007.

If, as often happens,[4] the analysts have overreacted in recent months in lowering their estimates, it could easily happen that we shall soon see a new cycle of upward revisions, along with and, to some extent, strengthening the improvement in financial and economic conditions we are now beginning to see.

CONSENSUS FORECASTS OF PROFITS FOR S&P 500 COMPANIES

Annual growth as %

Sectors	2008	2009	2010
Cyclical consumption	–52.0%	–14.0%	129%
Non-cyclical consumption	–2.0%	–3.0%	10%
Energy	22.0%	–59.0%	43%
Financial	–	–	75%
Health	8.0%	0.0%	10%
Industry	–2.0%	–31.0%	10%
Materials	–16.0%	–63.0%	88%
Technology	3.0%	–16.0%	22%
Communications	–2.0%	–6.0%	6%
Utilities	3.0%	–3.0%	9%
S&P 500	**–23.9%**	**–12.4%**	**28.10%**

SOURCE: Thomson Reuters.

(4) For an overall view of studies analyzing the systematic errors in analysts' forecasts, see, for example, Ramnath, S., Rock, S. and Shane, P., «The financial analyst forecasting literature: a taxonomy with suggestions for further research», *International Journal of Forecasting*, 24 (2008).

This box was prepared by Fernando San José
Financial Markets Department, "la Caixa" Research Department

SPAIN: OVERALL ANALYSIS

Economic activity

All-time drop in GDP in first quarter of 2009

Figures for National Accounting in the first quarter supplied by the National Institute of Statistics show a quarter-on-quarter drop in gross domestic product (GDP) of 1.9%, in line with available economic indicators. Spain's economy thus noted a drop in economic activity for the third quarter in a row and went deeper into the recession that began in mid-2008. As a result, within the framework of an international financial crisis and a sharp world slowdown, the GDP recorded its biggest year-on-year drop in recent decades (3.0%), even greater than the worst quarterly figure in the previous 1992-1993 recession. Nevertheless, the total aggregate GDP figure for the European Union dropped even more (4.4%) and the Euro Area figure still more, showing 4.6% in the same period.

Drop in economic activity for three quarters in a row and recession growing deeper although drop is less than in Euro Area.

The sharp drop in GDP was due to the sharper decrease in national demand for which the negative contribution to the change in GDP rose by 2.3 points to 5.3. In turn, the contribution of the foreign sector remained positive, holding at 2.3 points.

Household consumption showed a sharper contraction in the first quarter with a year-on-year drop of 4.1%. This decrease was due to the reduction in disposable income with the 6.0% year-on-year drop in employment, to the adverse effect of the drop in value of

Contribution of foreign sector to growth of gross domestic product holds at 2.3 points...

BIGGEST DROP IN GDP IN RECENT DECADE

Year-on-year change rate in gross domestic product in real terms (Quarters)

NOTES: Figures adjusted for seasonal and calendar changes.
SOURCE: INE and own calculations.

...while consumption and investment report sharp drops.

stock market and real estate assets and the increase in a propensity to save as a precaution in view of the rise in unemployment along with the tightening of borrowing terms. All consumer components showed negative change rates, including food and services, which in the fourth quarter of 2008 were still holding positive. The drop was greater in the case of consumer durables, although not worse than in terms of the previous quarter.

The sharp drop continued in April in the case of cars, which recently brought about a direct plan to aid purchase. Government plans to stimulate the economy, the drop in interest rates and the recovery on the stock markets in recent weeks would have contributed to improve consumer confidence in March and April which, however, still stood at low levels.

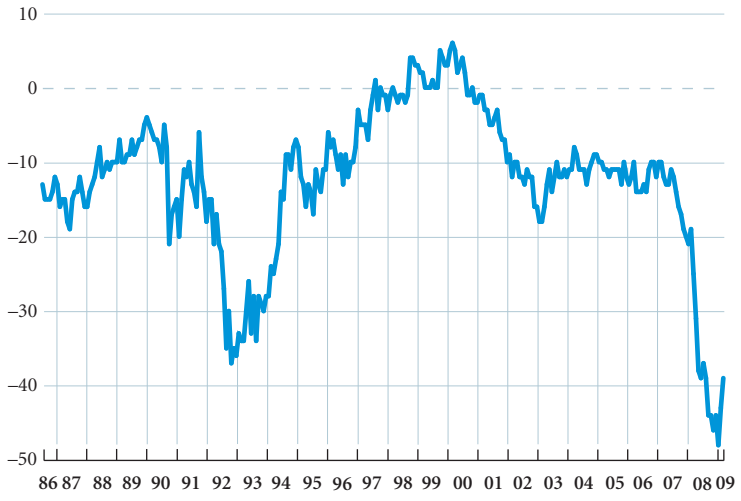
Recovery in infrastructure construction.

With regard to investment, all components sharpened their downturn, especially capital goods and, in this category, especially machinery. The weakness in demand, both internal and foreign, the drop in corporate profits and uncertainty about economic prospects lay behind the slump in investment. Nevertheless, the utilization of production capacity showed a very slight rise in the second quarter, which could foster a halt to the worsening state of investment. In fact, investment in transportation equipment eased its drop from 8.9% quarter-on-quarter in the fourth quarter of 2008 to only 0.5% in the first quarter.

With regard to investment in construction, this dropped by 12.4% compared with the first quarter of 2008, some 1.5 points more than in the previous quarter. Investment in housing continued to drop sharply (down 23.8%) adjusting in this way to the crisis in the real estate market. On the other hand, infrastructure works showed some recovery going from a drop of 1.4%

CONSUMER CONFIDENCE IMPROVES IN RECENT MONTHS

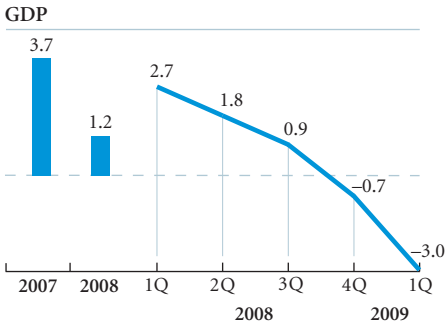
Net percentage figure for consumer confidence indicator

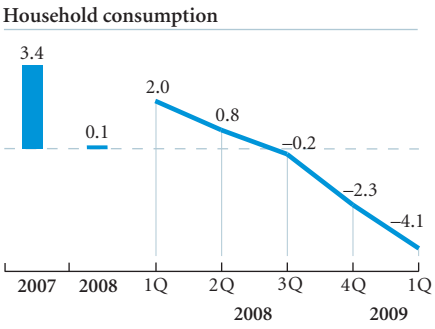


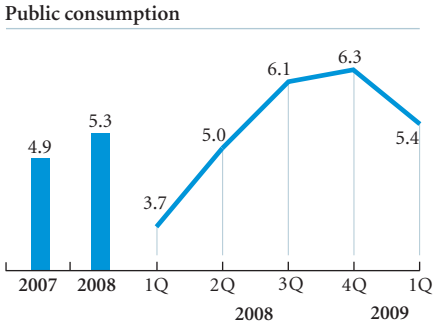
NOTES: Adjusted for seasonal changes.
SOURCE: European Commission.

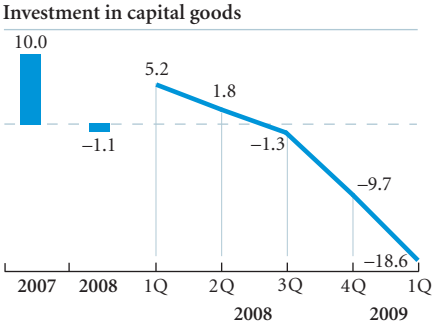
TREND IN SPAIN'S GDP BY COMPONENT

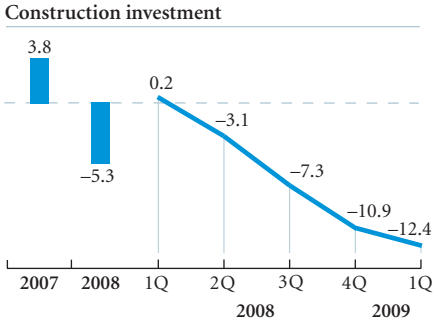
Percentage year-on-year change (*)

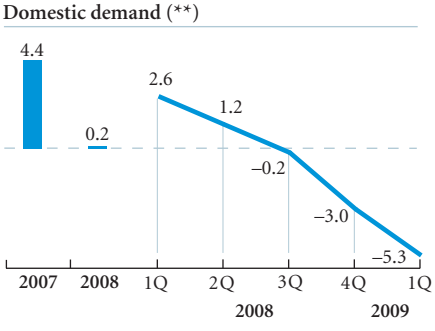


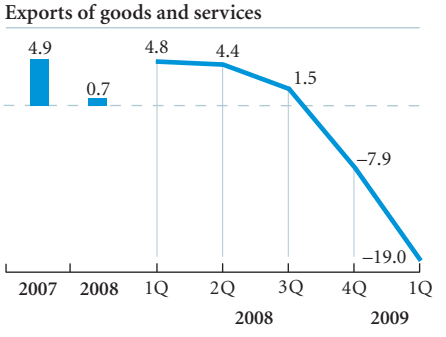


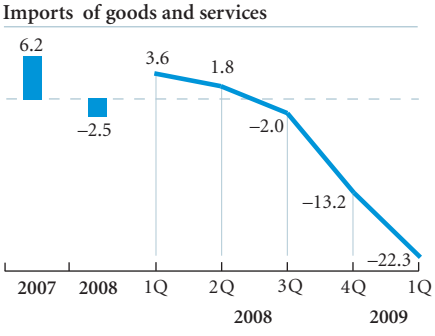












NOTES: (*) Figures adjusted for seasonal and working days effects.
(**) Contribution to GDP growth.
SOURCE: National Institute of Statistics.

Recession having harsh effect on consumer durables industry and capital goods sector.

in the fourth quarter of 2008 to an annual decrease of 0.6% in first quarter of 2009, largely thanks to the plan for local government works and work related to the high-speed train system.

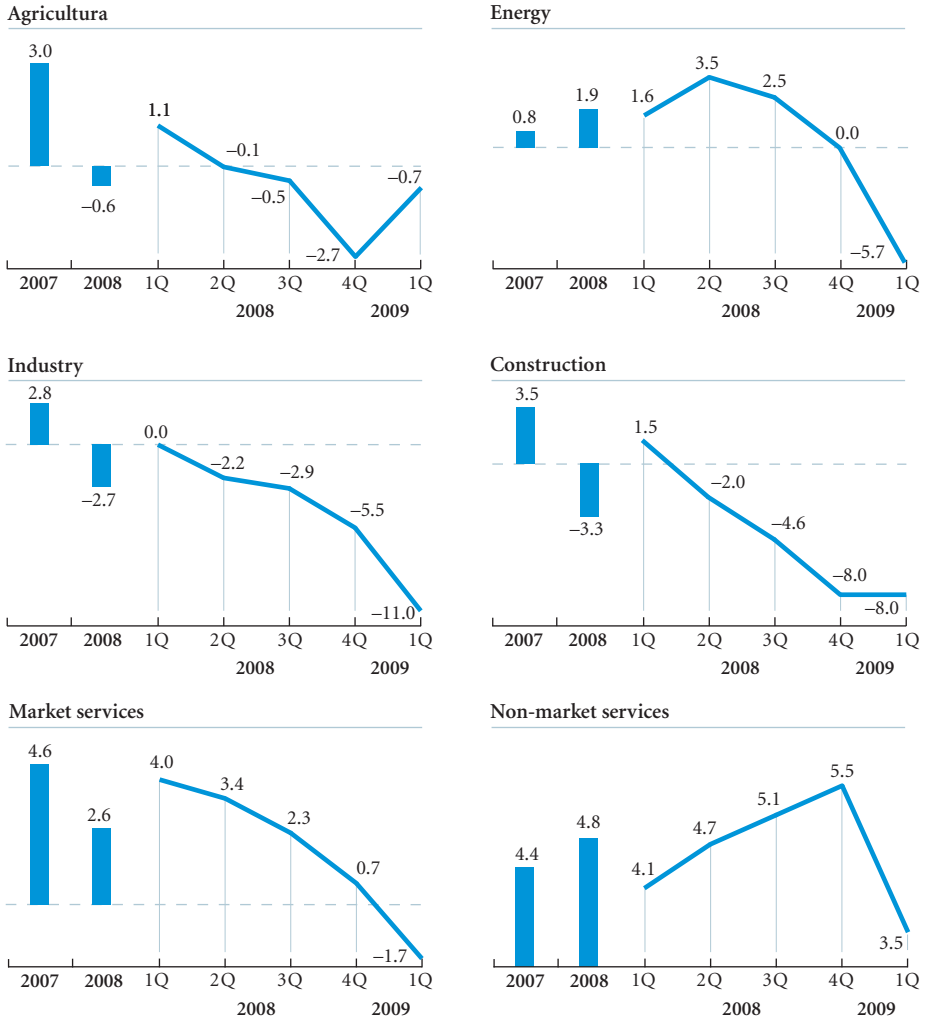
In the foreign sector, both imports and exports showed an increased slowdown within the framework of a reduction in world trade. Nevertheless, the year-on-year drop in imports (22.3%) was higher that for exports (19.0%).

On the supply side, all branches showed year-on-year decreases in value added, except public services which rose by 3.5%. Nevertheless, the decrease was lower than in the previous quarter in the case of the primary sector (agriculture and fishing) whereas the drop in construction held at 8.0%.

On the other hand, industrial branches sharpened their downturn to 11.0% year-on-year. The sub-sectors most

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



NOTES: (*) Figures adjusted for seasonal and working days effects.
SOURCE: National Institute of Statistics.

affected were consumer durables and capital goods. The drop of 30.5% in new orders in the first quarter does not point to recovery over the short term. Nevertheless, we should mention that the sector confidence index showed some improvement in April.

With regard to private services, in the first quarter of 2009 these showed a year-on-year reduction of 1.7% in value added as against an increase of 0.7% in the final quarter of 2008. Those branches reporting a more unfavourable trend included the sale of vehicles and fuels, the selection and placement of personnel and travel agencies, while information and communications technology were those to best weather the storm.

With regard to incomes, total wages dropped by 2.1% compared with the first quarter of 2008, as against a year-on-year increase of 1.6% in the previous quarter, the result of the 5.9% contraction in wage employment and a drop in average wages to 4.0%. Gross operating surplus was also down notably to show an annual increase of 1.6%.

As a result, apparent productivity of the labour factor continued on a substantial recovery going to 3.1% year-on-year, the highest figure in recent years, reflecting the very high increase in the construction sector. In turn, labour cost per product unit decreased its growth rate to 0.8% year-on-year, below the implicit deflator for the economy which stood at 1.3%.

Substantial increase in productivity at expense of 6% drop in employment.

In this situation, the central government put forward a new package of economic policy measures to deal with the recession. Notable among these measures was the announcement of removal of the tax credit for home purchase as of January 1, 2011 without retroactive effect and only for higher income brackets. The aim was to stimulate home buying before this date and thus boost the real estate sector. Measures include subsidies for buying cars, tax reductions for some small and medium-sized businesses under certain conditions and widening of the introduction of new technology in schools and a budget cut of 1 billion euros. At the same time, the Minister of Housing launched a new line of guarantees to facilitate access to mortgage loans for buying subsidized housing that would cover 50% of the amount of loans.

New package of political economy measures to deal with recession.

The few indicators yet available for the second quarter point to a continuation of the recession. In April, electrical power consumption underwent its biggest drop in recent decades and the construction confidence indicator recorded its lowest level since 1994. Nevertheless, as mentioned earlier, other indicators raise some hope for an improvement in the situation in coming quarters as the monetary and fiscal measures taken to stimulate the economy began to take effect. As a result, we foresee that the GDP will decrease by 3.7% for 2009 as a whole but that recovery will make it possible for this drop to disappear in 2010, so long as the international environment likewise improves.

We forecast 3.7% drop in gross domestic product in 2009.

Coping with the economic downturn: each sector fights its own war

As the financial crisis spilled over into the real economy many companies have seen a rapid drop in the demand for their products. In sectors such as motor vehicles, for example, this contraction is turning into an erosion of corporate profits and a reduction in workforce. Fortunately, not all sectors will have to face such sharp drops in demand nor will they make readjustments only through reductions in workforce. If we classify the various economic sectors according to the risk they face of a drop in demand and the competitive environment in which they operate, it is possible to provide some indication of the adjustments they may undertake in order to limit the impact of the crisis.

Consider first the demand side. Demand largely depends on income and in this respect the biggest drops will take place among those consumers suffering most from the increase in unemployment, namely those under 25 years, adults with only secondary school record and immigrants. Nevertheless, the rest of the population may also depress their demand for goods and services. Negative expectations generated by the current situation regarding future income and the drop in prices in the real estate sector, which reduces wealth, would explain this behaviour. We should also point out the situation of those sectors linked to durable goods. In recent months, these sectors have had to face a particularly difficult situation because of the tightening of credit terms. For them, the good news is that the worst may already have passed given that the situation in consumer credit is beginning to reflect both the decrease in interest rates and the improved liquidity conditions of financial institutions.

To assess how the demand for a product can respond to decreases in customer incomes it is useful to compute the income elasticity of demand. This measures the percentage change in the demand for a good due to a 1% change in consumer income. Demand for so-called «essential goods», whose elasticity is under 1, responds only moderately to changes in consumer income. This is the case with food and drink, energy and home goods. On the other hand, «luxury goods» (leisure products, holidays and domestic service and other home services) react more sharply. In the following table, the various sectors are arranged vertically from lower to higher income elasticity.

With regard to the second classification variable, the competitive environment faced by companies within the same sector determines how they will share the drop in demand. In those sectors where there is strong competition, the drop in sales will be borne by the least efficient companies, that is to say, those showing the highest costs. This is because the characteristics of the sector are such that the market can be supplied only by those companies offering the lowest price. Many other sectors in fact show characteristics that allow those companies with higher costs to continue supplying part of the market. These companies are under less pressure to lower prices and are said to enjoy a certain degree of market power. In these cases, the drop in sectoral demand is borne by the companies according to criteria related to the origin of that market power and not based on production costs.

The fact that a company enjoys a certain degree of market power may be due to various factors. For example, the existence of barriers to the entry of new companies, as in the case of the electrical power sector, limits the number of competitors and facilitates a certain coordination in order to prevent aggressive competition. Another possibility is that the products or services provided by the various companies show, in the view of consumers, some differentiation according to certain features. Just as one man's meat is another man's poison, each company may have its own market niche more or less isolated from other competitors. A result of this

differentiation is the appearance of commercial brand names, which exist in such different sectors as food, footwear and telecommunications. In any case, companies in these sectors have at their disposal more variables to compete in a changing environment than simply prices.

RISK TABLE FOR VARIOUS ECONOMIC SECTORS (*)

		Competitive pressure (Lerner index) (**)		
		High (<10%)	**Moderate (between 10% and 20%)**	**Low (>20%)**
Income elasticity of demand (**)	**Essential goods (<0.7)**	Wholesale trade in food and tobacco Non-specialized retail trade Food industry Wood and cork industry Appliance manufacture Furniture manufacture	Food retail trade (specialized) Drinks Tobacco Cutlery manufacture Lighting manufacture	
	Normal goods (between 0.7 and 1.3)	Passenger transportation Fuel retail sale Wholesale trade in non-food consumer goods Other retailers Textile and clothing industry Leather and footwear industry Motorcycle and bicycle manufacture Jewelry manufacture	Restaurants Retail trade in pharmaceutical and beauty products Gas production and distribution Water storage and distribution Cleaning articles	Commercial intermediaries Production and distribution of electrical power
	Higher goods (>1.3)	Travel agencies Sports activities Motor parts and accessories Motorcycle repair and parts Motor vehicle manufacture Motor vehicle sales Audiovisual equipment manufacture	Hotels Postal activities Laundry, cleaning and dyeing Other personal services Repair of personal and domestic effects Paper and cardboard industry Publishing Graphic arts and materials Motor vehicle repairs Radio and television equipment manufacture Manufacture of sports and games articles Artistic and theatrical activities	Telecommunications Various recreational activities Hairdressing and beauty Funeral services

NOTES: (*) Non-exhaustive classification of economic sectors linked to goods and services of final demand. Sectors grouped to 2 and 3 digits of the Spanish CNAE classification.

(**) Index drawn up from figures published in Annual Survey of Services, Annual Survey of Trade and Industrial Survey of Companies. The index is computed as the value of production (sales, change in inventories and other operating income) net of intermediate consumption (consumption and work done by other companies) and personnel expenses, all divided by the value of production.

SOURCE: Own calculations based on data from INE and Luengo-Prado, M. J. and J. Ruiz-Castillo (2004), «Demand patterns in Spain», DEMPATEM Working Paper No. 4.

The competitive pressure faced by a company can be approximated by the so-called «Lerner Index», which is calculated as the contribution margin divided by price.[1] Higher indices thus correspond to greater market power. The above table shows the various economic sectors arranged horizontally according to this index.

Those sectors located at the lower left-hand part of the table (travel agencies, manufacture of sports articles and audiovisual equipment) are exposed to a severe contraction of demand in a very competitive environment. Companies in those sectors must adjust themselves by means of major cost cuts if they want to stay in the market. In this respect, those companies with high fixed costs in relation to variable costs will have a hard time reducing them. The same applies to highly leveraged companies, given the financial charges they have to bear.

Companies in the central section of the table could benefit from strategies such as improving their product differentiation or loyalty programmes for their customers, since both strategies would soften price competition. They could also benefit from greater customer segmentation, through the design of products or specific tariffs for particular groups. As in the case of «store brands» in supermarkets, the idea is to resort to tough price competition only for those consumers who are most sensitive to this variable. Telecommunications companies, for example, in spite of their market power, aim at this when they offer special tariffs for unemployed persons.

To sum up, the biggest adjustment and perhaps the most distressing in terms of employment will have to be carried out by companies that produce goods or services that are non-essential and that operate in very competitive environments. Other companies have more margin for manoeuvre but will have to adopt diversification and differentiation strategies in order to minimize the effects of the recession.

(1) The theoretical index is calculated as the difference between price and marginal cost divided by price. Given the difficulty of measuring marginal costs, the approach proposed is appropriate if we can assume that marginal cost is constant.

This box was prepared by Sandra Jódar
Office of Economic Analysis, "la Caixa" Research Department

Labour market

Decline in labour market continuing but at slower rate

Figures from the Labour Force Survey carried out by the National Institute of Statistics confirm the sharp decline in the labour market in the first quarter of 2009, both in loss of jobs and the rise in number of unemployed. In the past 12 months, the number of those employed dropped by 1,311,500 persons, 6.4% year-on-year, putting the total at 19,090,800. By sex, the drop was greater among males (9.1% year-on-year) than among females (2.6%) although the figures show an increase in loss of jobs among females.

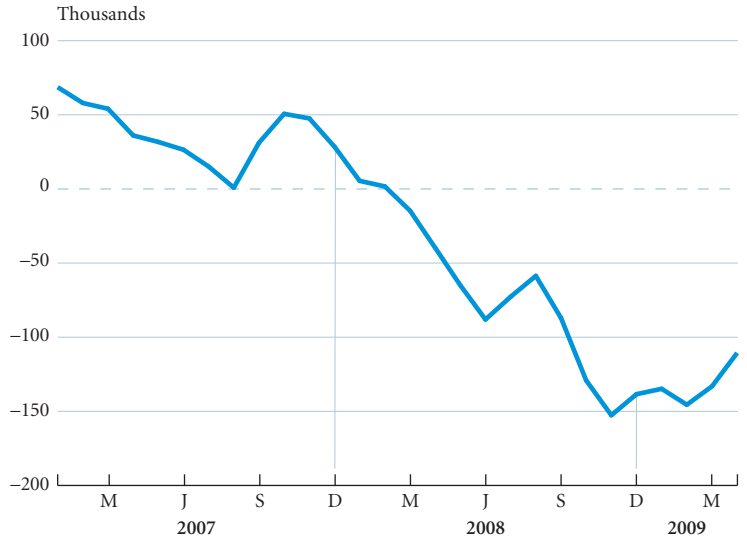
It should be pointed out that the loss of jobs in the first quarter of 2009 was especially sharp among the immigrant worker population. The number of Spanish nationals employed dropped by 6.0% year-on-year whereas the decrease among immigrant workers was 9.3%. This reduces the percentage of foreign workers employed out of the total number employed by 6 decimals, putting the figure at 14.0%.

In addition, the loss of jobs was concentrated in those workers with temporary hiring contracts which showed a year-on-year drop of 20.6%. To a lesser extent, the decrease among

1.3 million jobs lost in last 12 months.

LOSS OF JOBS SLOWING DOWN

Monthly change in number of those registered with Social Security



NOTES: Statistical series adjusted for seasonal changes.
SOURCE: Ministry of Labour and Social Affairs and own calculations.

ESTIMATED EMPLOYMENT

First quarter 2009

	No. of employees (thousands)	Quarterly change		Cumulative change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	837.8	–25.6	–3.0	–25.6	–3.0	–84.6	–9.2	4.4
Non-farm	18,253.0	–740.3	–3.9	–740.3	–3.9	–1,226.9	–6.3	95.6
Industry	*2,900.1*	*–159.5*	*–5.2*	*–159.5*	*–5.2*	*–438.4*	*–13.1*	*15.2*
Construction	*1,978.0*	*–157.0*	*–7.4*	*–157.0*	*–7.4*	*–642.3*	*–24.5*	*10.4*
Services	*13,374.9*	*–423.8*	*–3.1*	*–423.8*	*–3.1*	*–146.2*	*–1.1*	*70.1*
By type of employer								
Private sector	16,061.3	–766.0	–4.6	–766.0	–4.6	–1,467.8	–8.4	84.1
Public sector	3,029.5	0.0	0.0	0.0	0.0	156.3	5.4	15.9
By work situation								
Wage-earners	15,843.0	–465.2	–2.9	–465.2	–2.9	–974.4	–5.8	83.0
Permanent contract	*11,817.3*	*63.4*	*0.5*	*63.4*	*0.5*	*70.2*	*0.6*	*61.9*
Temporary contract	*4,025.7*	*–528.6*	*–11.6*	*–528.6*	*–11.6*	*–1,044.6*	*–20.6*	*21.1*
Non-wage-earners	3,240.5	–294.5	–8.3	–294.5	–8.3	–334.2	–9.3	17.0
Entrepreneurs with employees	*1,100.3*	*–65.0*	*–5.6*	*–65.0*	*–5.6*	*–39.2*	*–3.4*	*5.8*
Entrepreneurs without employees	*1,956.1*	*–216.6*	*–10.0*	*–216.6*	*–10.0*	*–262.2*	*–11.8*	*10.2*
Family help	*184.1*	*–12.9*	*–6.5*	*–12.9*	*–6.5*	*–32.8*	*–15.1*	*1.0*
Other	7.2	–6.4	–47.1	–6.4	–47.1	–3.0	–29.4	0.0
By time worked								
Full-time	16,667.9	–709.9	–4.1	–709.9	–4.1	–1,284.5	–7.2	87.3
Part-time	2,422.9	–56.1	–2.3	–56.1	–2.3	–27.0	–1.1	12.7
By sex								
Males	10,830.9	–509.7	–4.5	–509.7	–4.5	–1,093.0	–9.2	56.7
Females	8,259.9	–256.3	–3.0	–256.3	–3.0	–218.5	–2.6	43.3
TOTAL	**19,090.8**	**–765.9**	**–3.9**	**–765.9**	**–3.9**	**–1,311.5**	**–6.4**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

Loss of jobs concentrated in workers on temporary hiring contracts.

self-employed workers was also sharp, at 9.4%. On the other hand, the group of workers on permanent hiring contract showed a slight rise of 0.6%. This meant that the temporary work rate went down by 2.52 points compared with the previous quarter, going to 25.4%.

Nevertheless, the April figure for those registered at Social Security as now working shows a slight change in trend in the process of job loss. The number registered was down by 110,000 in seasonally-adjusted terms (23,939 in raw figures). This increase, while fairly negative, was below the decreases recorded in previous months. It is therefore possible that the biggest job losses may have already taken place in the first quarter of 2009.

Figures from National Accounting show a similar state of job loss. As a result, in the first quarter of 2009 jobs equivalent to full-time work were down by 6.0% year-on-year, some 2.9 points more than in the previous quarter. This meant the loss of 1.15 million net full-time jobs in

one year. By sector, the figures show that the sharpest decreases continue to turn up in construction with a decrease of 26.0% compared with the first quarter last year.

Looking again at the Labour Force Survey for the first quarter, we note some slowing down of the increase in the total number in the labour force, as was to be expected given that economic slowdowns usually reduce the incentive to actively look for work among those in the working age group. If the increase in the labour force continues to thus moderate this could have a palliative effect on the unemployment rate.

In any case, the figures point to a sharp increase in the unemployed population group. In the past 12 months the number of unemployed rose by 1,836,500 persons, an increase of 84.5% year-on-year, putting the total at 4,010,700. The unemployment rate thus went to 17.4%, the highest since the fourth quarter of 1998. In the first quarter, unemployment was up more among males than among females, putting the unemployment rates at 16.9% and 18.0% respectively. This means that in recent months these two rates have progressively become more equal. At the same time, in the first quarter the increase in the number of unemployed was notably sharper among the foreign worker population. For this group, following an increase of 7.13 points, the unemployment rate stood at 28.4%.

By sector, the figures show that the increases in unemployment were across the board. While construction continues to head the loss of jobs over the past year, industry was the sector to show the biggest increase in the first quarter of 2009.

All autonomous communities noted an increase in unemployment in the past year. Heading the list were Aragon, Catalonia and Murcia with a year-on-year increase of more than 100%. In addition, those autonomous communities to show the least increase

Number of unemployed up by 1.8 million in one year putting unemployment rate at 17.4%.

Aragon, Catalonia and Murcia double number of those unemployed in just one year.

ESTIMATED UNEMPLOYMENT

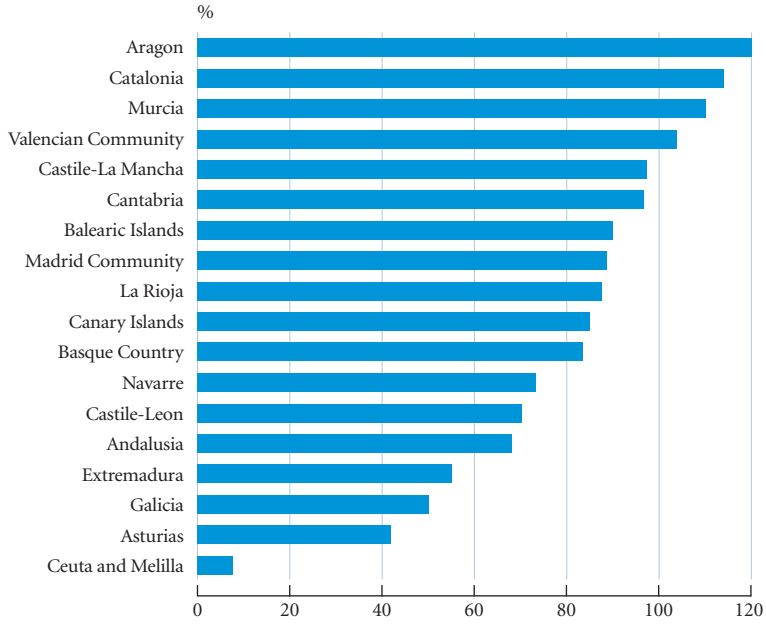
First quarter 2009

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	2,195.8	507.0	30.0	1,177.2	115.6	54.7	16.9
Females	1,814.9	295.9	19.5	659.3	57.1	45.3	18.0
By age							
Under 25 years	808.5	–1.4	–0.2	199.6	32.8	20.2	35.7
Other	3,202.2	804.3	33.5	1,636.9	104.6	79.8	15.4
By personal situation							
Long-term unemployment	977.5	188.4	23.9	420.3	75.4	24.4	–
Seeking first job	299.4	50.1	20.1	101.6	51.4	7.5	–
Other	2,733.8	564.4	26.0	1,314.6	92.6	68.2	–
TOTAL	**4,010.7**	**802.9**	**25.0**	**1,836.5**	**84.5**	**100.0**	**17.4**

SOURCE: National Institute of Statistics and own calculations.

ARAGON, CATALONIA AND MURCIA HEAD RANKING FOR INCREASE IN UNEMPLOYMENT IN PAST YEAR

Year-on-year change in estimated unemployment by Autonomous Community



SOURCE: National Institute of Statistics and own calculations.

Notable increase in those affected by proceedings by companies to readjust their labour force.

in unemployment were Asturias, Galicia and Extremadura.

Finally, we should mention that both the Labour Force Survey and registrations at public employment service offices do not include those affected by proceedings initiated by companies to readjust their labour force (known as ERE in Spain). The increase in such proceedings in recent months adds to the rather unfavourable view of the labour market shown in the figures for persons unemployed. Nevertheless, while the total number of such proceedings has increased significantly in recent months, it is important to keep in mind that this group is still very small compared with the total number of unemployed. On the other hand, the change in the number of such proceedings may be illustrative of the trend in economic activity. In this respect, March brought a decrease in the total number affected in this way and this may indicate some stabilization in the worsening of the economic situation.

Prices

Prices dropping

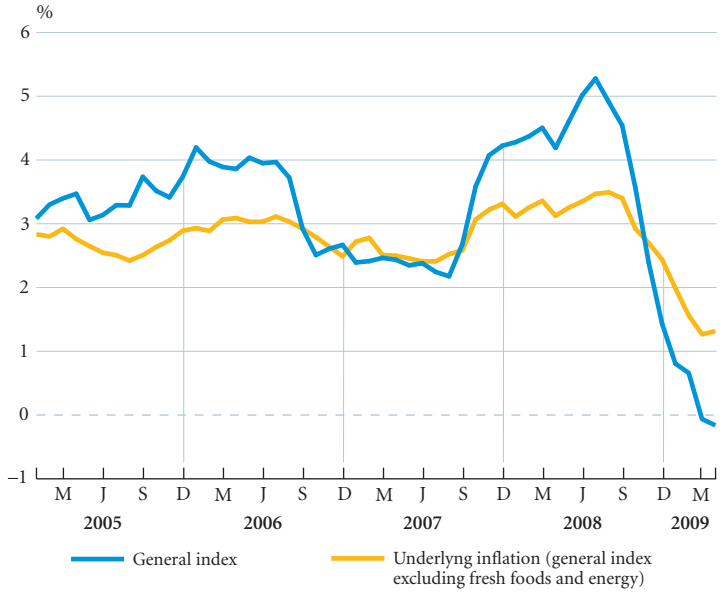
In April, the trend in consumer prices (CPI) continued on the downturn begun in August 2008 with an easing of the rise in commodity prices, especially for oil. At the end of the first four months, the year-on-year change rate in the CPI was negative for the second consecutive month showing an annual decrease of 0.2%. This is the lowest rate in recent decades and reflects the deflationary pressures arising from the sharp contraction in demand.

Nevertheless, the 1-decimal reduction in the year-on-year inflation rate in April may be attributed to the more volatile elements in the CPI. To be specific, energy products contributed nearly one decimal to the decrease in year-on-year inflation and the annual change rate dropped to 12.4%. This time, however, it was not due to fuel and fuel-oils that added an increase of one decimal, but to gas, which contributed more than two decimals to the decrease and, to a much lesser extent, due to heating fuel. In turn, unprocessed food prices stood at the same level as 12 months earlier and contributed half a decimal to the decrease in annual inflation due mainly to poultry and fresh fruit.

CPI marks up biggest year-on-year drop in recent decades because of decreased commodity prices and contraction in demand.

CPI ON NEGATIVE GROUND FOR SECOND MONTH IN A ROW

Year-on-year change in CPI



SOURCE: National Institute o Statistics.

CONSUMER PRICE INDEX

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

SOURCE: National Institute of Statistics.

Year-on-year change rate in services goes up to 3.1% but this is mainly due to calendar effect of Easter Week.

The more stable core of inflation, so-called underlying inflation that excludes energy products and unprocessed foods, held at 1.3%. We should mention the trend in services for which the year-on-year change rate rose by 4 decimals to 3.1%. This increase may largely be attributed to organized tours, whose prices rose by 12.4% in the past year due to the fact that in 2009 Easter Week was held in April whereas last year it fell in March.

Food prices ease and car prices move down.

On the other hand, the other large components of underlying inflation eased. The year-on-year change rate for processed foods was thus down by a half-point to 0.7%. Among these goods we should mention the sharper drop in prices of cooking oils to 12.2% year-on-year.

Prices expected to sharpen drop in coming months but likely will rise by year-end.

In turn, industrial goods prices, excluding energy products, increased their drop to 0.7% midst sharp pressure from international competition. It was notable that the price of cars has dropped by 2.6% in the past year due to an industry attempt to revive sales through discounts.

The consumer price index harmonized with the European Union also recorded a year-on-year decrease of 0.2%. As a result, the negative differential with the Euro Area rose to 0.8 percentage points, a new record. This was partly due to the greater weight of energy products and foods in the Spanish index but, in fact, the differential in terms of underlying inflation was also negative.

Inflation prospects for coming months are for a sharper downward trend largely because of the high prices for commodities in the first half of 2008. Nevertheless, as of mid-summer annual inflation will tend to rise and will probably again stand on positive ground toward the end of the year.

CONSUMER PRICE INDEX BY COMPONENT GROUP

April

	Indices (*)	% monthly change		% change over previous December		% monthly change	
		2008	2009	2008	2009	2008	2009
By type of spending							
Food and non-alcoholic beverages	109.1	0.3	–0.3	1.0	–1.4	6.6	–0.1
Alcoholic beverages and tobacco	115.7	0.2	0.0	3.4	3.5	4.1	4.0
Clothing and footwear	104.6	9.3	9.4	–1.7	–3.9	0.8	–1.7
Housing	111.1	0.9	–1.4	3.7	–0.5	6.0	1.6
Furnishings and household equipment	106.9	0.7	0.5	1.1	0.3	2.5	1.8
Health	99.4	0.6	0.3	0.2	0.6	1.1	0.7
Transport	100.1	0.6	1.4	2.7	0.7	6.7	–7.5
Communications	99.7	0.0	0.0	0.3	0.1	–0.3	–0.5
Recreation and culture	100.0	–1.1	1.4	–1.0	0.3	–1.5	1.6
Education	111.7	0.1	0.0	0.2	0.2	3.8	3.9
Restaurants and hotels	111.9	0.5	0.6	2.8	1.3	4.5	2.4
Other goods and services	109.4	0.3	0.2	2.4	1.7	3.1	2.8
By group							
Processed food, beverages and tobacco	110.8	0.2	–0.2	2.1	–0.3	7.4	0.7
Unprocessed food	107.9	0.4	–0.4	–0.4	–2.0	4.0	0.0
Non-food products	105.8	1.3	1.3	1.6	0.1	3.5	–0.4
Industrial goods	101.3	2.4	2.1	1.2	–1.1	3.5	–3.7
Energy products	*99.5*	*1.2*	*0.3*	*5.6*	*–0.3*	*13.3*	*–12.4*
Fuels and oils	*93.3*	*1.6*	*0.4*	*6.3*	*–1.6*	*16.7*	*–19.3*
Industrial goods excluding energy products	*101.7*	*2.9*	*2.7*	*–0.3*	*–1.4*	*0.2*	*–0.7*
Services	110.5	0.2	0.6	2.0	1.4	3.5	3.1
Underlying inflation (**)	107.5	1.1	1.2	1.2	0.1	3.1	1.3
GENERAL INDEX	**106.8**	**1.1**	**1.0**	**1.5**	**–0.1**	**4.2**	**–0.2**

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

Producer prices record biggest drop in recent decades

In general terms, wholesale prices continued to drop in March thus reflecting the drop in commodity prices and the weakness in demand. The general industrial price index went down by 2.4% compared with March 2008, marking up the lowest level in recent decades. All the main components of producer prices eased and what stood out were the year-on-year decreases in energy and intermediate goods.

In turn, the general import price index was down 6.9% in the 12 months ending in March largely due to the collapse in energy prices and to a lesser extent in prices of intermediate goods. Prices of capital goods, however, rose by 2.8% year-on-year, partly due to the depreciation of the euro in the past year.

Import prices down 7% in 12 months ending in March.

Farm prices rose slightly at the beginning of the year, although they continued to stand below the level 12 months earlier marking up a year-on-year decrease of 7.2% in January. This drop was largely due to livestock products, such as milk, and to a lesser extent to agricultural products. On the other hand, market livestock rose by 6.7% compared with January 2008.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2008											
January	11.2	6.3	5.4	2.9	5.5	11.1	7.0	1.1	0.4	1.9	–
February	7.8	6.3	5.6	2.6	5.9	11.0	7.0	1.4	0.2	1.9	3.2
March	9.0	6.6	5.4	2.5	5.9	12.4	6.9	0.7	–0.3	2.3	–
April	7.8	6.6	5.1	2.5	5.8	13.3	6.9	0.6	–0.4	2.3	–
May	16.3	7.4	5.1	2.3	5.9	17.4	9.2	0.7	–0.1	2.5	3.1
June	9.2	8.4	5.2	2.3	6.2	21.1	10.4	1.1	–0.2	2.6	–
July	12.6	10.2	5.1	2.5	7.3	27.4	10.4	0.5	–0.2	3.7	–
August	6.0	9.2	4.8	2.5	7.6	23.2	9.6	1.3	0.3	5.0	3.4
September	–0.8	8.3	4.1	2.4	7.1	19.9	8.5	1.9	0.6	5.9	–
October	–7.6	6.1	2.8	2.4	5.3	14.9	5.2	3.2	1.3	5.1	–
November	–10.5	2.9	2.2	2.3	2.9	4.3	0.9	4.3	1.9	5.0	2.5
December	–10.3	0.4	1.6	2.3	1.0	–3.7	–3.9	2.6	1.6	2.0	–
2009											
January	–7.2	–0.5	1.0	2.0	–1.6	–2.2	–4.9	2.8	1.9	0.4	–
February	...	–1.1	0.5	1.6	–3.3	–1.9	–5.6	3.1	2.4	–1.2	1.3
March	...	–2.4	–0.3	1.3	–4.5	–4.6	–6.9	2.7	2.8	–2.7	–

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

Foreign sector

Foreign trade in slump

The worsening economic situation and the effects of the financial crisis have brought about a major contraction of world trade and Spain has not gone untouched. In the first three months of 2009, the volume of Spain's trade dropped sharply with decreases of 31.0% in imports and 21.6% in exports compared with the same period the year before. As a result, the trade deficit in March 2009 showed its ninth contraction in a row going to 14.02 billion euros in the first three months of the year, some 47.7% less than in 2008.

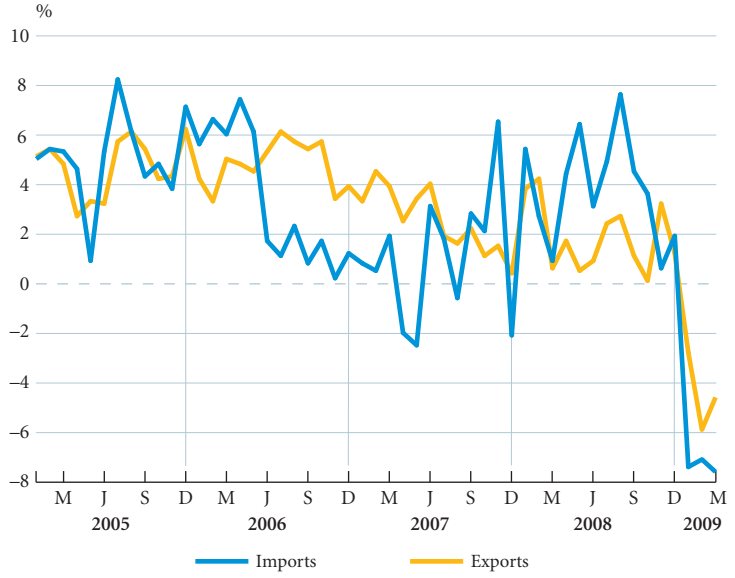
The contraction in value of trade may largely be explained by the sharp drop in the real component. In March, real imports and exports were down 26.2% and 9.5% year-on-year respectively. In the case of exports, the lower volume exported was a result of the contraction of demand from Spain's main trading partners which was down drastically in March. Exports to the European Union, which that month made up 69.9% of the total, were down more than average (with a drop of 17.5%) whereas exports to Africa, Asia and Latin America reported slight increases. The sectors most affected by the reduction in

Spain's exports undergo biggest contraction in recent years...

...due to drop in foreign demand from main trading partners.

DROP IN PRICES SHARPENS REDUCTION IN TRADE

Change in prices compared with same month year before



SOURCE: Department of Customs and Special Taxes and own calculations.

exports in the first quarter were cars and durable goods with decreases of 35.2% and 33.4% respectively. On the imports side, the drop in domestic demand mainly showed up in a reduction of more than 30% in imports of capital goods and intermediate goods as well as energy products.

As well as a contraction in demand, the trend in prices is having as direct effect on the changes in trade. As may be noted in the above graph, the drop in import prices was more than 7.0% in the first three months of 2009, largely the result of the energy component. On the other hand, export prices, after recording the biggest drop in the past 20 years in February, were down by 4.6% in March, showing a major contraction in prices of industrial products.

Adjustment of deficit expected to be maintained in coming months.

The economic figures for the first quarter of 2009 show a major contraction in European countries which would indicate that the reduction in trade will continue over the short term although it could stabilize in the second half-year. The sharp year-on-year drop in the price of energy products that will be noted in coming months will add even more to these trends, especially in the case of imports, thus improving Spain's trade imbalance although it will still remain at high levels.

FOREIGN TRADE

January-March 2009

	Imports			Exports			Balance	Export/ Import ratio (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	8,283	–45.3	16.2	1,596	–34.2	4.3	–6,688	19.3
Consumer goods	16,982	–4.4	33.1	15,418	–13.3	41.4	–1,564	90.8
Food	*3,419*	*–7.5*	*6.7*	*5,640*	*–2.6*	*15.2*	*2,222*	*165.0*
Non-foods	*13,563*	*–3.6*	*26.5*	*9,778*	*–18.5*	*26.3*	*–3,786*	*72.1*
Capital goods	4,336	–33.4	8.5	3,070	–20.2	8.3	–1,266	70.8
Non-energy intermediate goods	21,629	–37.9	42.2	17,123	–26.7	46.0	–4,506	79.2
By geographical area								
European Union	29,328	–28.7	57.2	26,087	–24.2	70.1	–3,241	88.9
Euro area	*24,855*	*–28.0*	*48.5*	*21,437*	*–21.9*	*57.6*	*–3,418*	*86.2*
Other countries	21,902	–33.9	42.8	11,120	–14.5	29.9	–10,782	50.8
Russia	*966*	*–58.7*	*1.9*	*331*	*–44.5*	*0.9*	*–635*	*34.3*
United States	*2,470*	*–18.2*	*4.8*	*1,455*	*–16.2*	*3.9*	*–1,015*	*58.9*
Japan	*733*	*–52.1*	*1.4*	*274*	*–16.7*	*0.7*	*–459*	*37.3*
Latin America	*2,538*	*–27.9*	*5.0*	*1,825*	*–10.2*	*4.9*	*–713*	*71.9*
OPEC	*4,225*	*–34.4*	*8.2*	*1,566*	*16.9*	*4.2*	*–2,659*	*37.1*
Rest	*10,970*	*–32.7*	*21.4*	*5,669*	*–18.7*	*15.2*	*–5,301*	*51.7*
TOTAL	**51,230**	**–31.0**	**100.0**	**37,207**	**–21.6**	**100.0**	**–14,023**	**72.6**

SOURCE: Department of Customs and Special Taxes and own calculations.

Balance of payments: deficit being corrected

In spite of the improvement in the trade balance, the deficit in the current account balance in February was 10.16 billion euros, 13.3% more than in the same month the year before, thus ending a period of eight consecutive months with year-on-year reductions. This increase may be explained by the growing deficit in the incomes and current transfers balance and, to a lesser extent, by the lower surplus in the services balance which was down 29.3%. As a result, the drop in the cumulative balance for the past 12 months was 6.8%, more than one percentage point less than in January.

Figures from National Accounting show that the cumulative deficit in the past four quarters went down to 8.4% of the GDP in March 2009, far from the 10.0% reported in the second quarter of last year. This confirms the progressive adjustment of the foreign imbalance which is expected to continue in coming quarters.

With regard to financial flows, in spite of the fact that the main inflow of capital in February was through short-term instruments (loans, deposits and repos), this was 79.9% less than in the same month in 2008, which would indicate a change in trend in these flows. The trend in the cumulative figures for the past 12 months shows how net inflows related to portfolio investment continue recovering, to the detriment of short-term financing.

Current account deficit up slightly in February.

Deficit reduced.

BALANCE OF PAYMENTS

February 2009

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–9,607	–40.6	–81,088	12,278	–13.2
Services					
Tourism	*2,510*	*–13.0*	*27,691*	*–83*	*–0.3*
Other services	*–432*	*11.2*	*–1,606*	*2,432*	*–60.2*
Total	2,078	–16.8	26,085	2,349	9.9
Income	–6,519	50.1	–36,231	–6,038	20.0
Transfers	–2,692	–9.5	–8,965	–1,317	17.2
Total	**–16,740**	**–20.3**	**–100,200**	**7,271**	**–6.8**
Capital account	**286**	**–84.6**	**3,978**	**–1,057**	**–21.0**
Financial balance					
Direct investment	–4,073	–	–21,458	17,836	–45.4
Portfolio investment	7,699	–	24,843	–32,491	–56.7
Other investment	7,857	–55.9	58,571	–777	–1.3
Total	**11,484**	**–19.7**	**61,956**	**–15,432**	**–19.9**
Errors and omissions	2,801	–	7,663	9,223	–
Change in assets of Bank of Spain	2,170	–62.0	26,603	–5	0.0

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

Public sector

Notable central government deficit in first quarter

Impact of economic recession shows up as drop in central government revenues because of lower tax base.

The impact of the economic recession is still showing up in the central government accounts. On the one hand, revenues are down because of the drop in incomes, consumption and investment while, at the same time, unemployment benefit costs are rising. On the other hand, fiscal measures to aid the economy are reducing revenues while increasing spending. As a result, in the first quarter central government revenues assessed according to the criteria of the cash methodology, that is to say, according to actual monetary flows, amounted to 45.55 billion euros before taking into account amounts ceded to autonomous communities and local authorities under the current financial system. This figure means a drop of 11.9% compared with the same period last year. This decrease is higher than that of the nominal gross domestic product (GDP).

Revenues from direct taxes were down 10.7% in the January-March period compared with one year earlier. Collections under the biggest heading, personal income tax, were down 9.7% under the effect of the drop in employment and moderation in wages, along with the early deduction of up to 400 euros in wage hold-backs and partial payments by individual business operators and professionals, given that these were not applicable in the same

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

March 2009

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**2,613**	**–60.1**	**31,269**	**–18.1**
Non-financial revenue adjusted (*)				
Personal income tax	4,155	–8.4	19,003	–9.7
Corporate tax	–320	–	1,023	–32.3
VAT	180	–92.5	14,274	–26.2
Special taxes	1,324	–10.1	4,546	–5.4
Other	2,035	–14.2	6,704	33.8
Total	**7,374**	**–33.3**	**45,550**	**–11.9**
Non-financial spending	**13,888**	**52.5**	**42,614**	**15.5**
Treasury balance	**–11,275**	**340.6**	**–11,345**	**–**
Surplus (+) or deficit (–) (**)	***–12,911***	***112.4***	***–7,586***	**–**

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

period in 2008. At the same time, revenues from corporate tax were down 32.3%, although this decrease was affected by the early payment of rebates and the different calendar for hold-backs on interest on government bonds.

The collapse in indirect taxes (21.8%) was even greater compared with the same quarter of 2008. Collections under the biggest heading, value added tax (VAT), were down 26.2%, partly because of more time payments, the bringing forward of rebates and the new system for monthly rebates.

Special taxes showed a drop of 5.4% largely brought about by the decrease of 7.9% in taxes on oil-based products because of lower consumption. The tax on tobacco recorded a drop of 3.9% while that on alcohol was down 17.7%.

On the other side of the accounts, non-financial spending reported a cumulative year-on-year rise of 15.5% up to March. Spending for current operations rose by 13.2% in the past year. Within this figure, personnel costs were up 5.2% while purchases of goods and services dropped by 5.0%. Current transfers rose by 13.2% and involved a transfer of 2.01 billion euros to the Government Public Service.

Capital costs were up 72.5%. Real investments rose by 8.1%. In turn, capital transfers were up 158.4% largely because of application of the Government Fund for Local Investments.

The trend in central government revenues and spending meant a non-financial Treasury deficit of 11.34 billion euros in the first quarter of 2009 as against a surplus of 1.27 billion euros in the same period of 2008. In terms of national accounting, that is, according to rights and obligations acquired, there was a deficit of 7.59 billion euros, 0.7% of GDP.

Various regulatory measures to aid liquidity of companies and households also reducing tax collections.

The central government deficit, which results from adding the change in financial assets to the Treasury deficit, amounted to 28.69 billion euros in the first three months of the year as against a surplus of 4.52 billion euros in 2008. Notable under the change in financial assets was the payment of 9.5 billion euros to the Fund for Acquisition of Financial Assets which was set up to aid the liquidity of financial institutions. This deficit was largely financed through government bonds and obligations and Treasury bills.

In first quarter, central government records deficit while Social Security shows surplus although this is decreasing.

On the other hand, the accounts of Social Security are also showing the effects of the worsening economic situation. Revenues received by the Social Security system were down 2.5% in the January-March period. At the same time, spending rose by 8.7%. As a result, the surplus (8.25 billion euros) was down by 24.2% in the past 12 months.

The tendency of the government accounts to grow worse has meant revision of the forecast deficit for general government for 2009. We are therefore forecasting that the deficit will go up to 8.3% of GDP for the current year with 9.2% for 2010.
As a result, at the end of next year the gross government deficit will have gone up to 59% of GDP, coming close to t he limit of 60% set under the Stability and Growth Pact.

Our forecast is for government deficit of 8.3% of GDP in 2009 and 9.2% in 2010.

Savings and financing

Interest rates keep dropping.

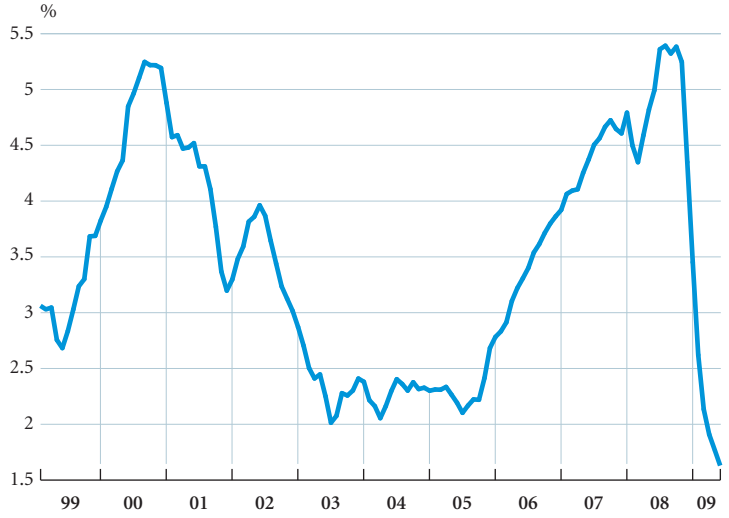
Financing granted to private sector slowing down

The 1-year Euribor, commonly used as a reference for interest rates, continued to drop in recent months. The sharp downturn began in October 2008 and since then it has been reflecting the official rate cuts by the European Central Bank. The risk premium incorporated in the rate has also dropped progressively as the interbank market has tended to normalize although this still stands above the usual level. The 1-year Euribor thus stood at 1.77% on monthly average in April, some 305 basis points below 12 months earlier. Nevertheless, inflation was down more in the same period so that in real terms there was no decrease in the interest rate. In any case, the 1-year Euribor continued to drop in the early weeks of May going to close to 1.6%, thus marking up a new all-time low level.

Interest rates on new loan operations for the private sector continued on a course similar to the 12-month Euribor starting to move down as of last October. The average interest rate on loans and credits thus stood at 4.20% in March, some 175 basis points less than one year earlier. The lower decrease in the 1-year Euribor may largely be explained by the increase in credit risk premium for the private sector as a result of the economic recession.

1-YEAR EURIBOR DROPS TO ALL-TIME LOW

12-month Euribor



NOTES: May 23.
SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

March 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	59,827	–14,388	–19.4	–23,830	–28.5	3.2
Secured loans (*)	1,103,621	–5,175	–0.5	17,917	1.7	59.3
Other term loans	528,721	–736	–0.1	16,951	3.3	28.4
Demand loans	47,210	–1,918	–3.9	3,140	7.1	2.5
Leasing	42,922	–2,307	–5.1	–3,658	–7.9	2.3
Doubtful loans	79,448	16,391	26.0	57,870	268.2	4.3
TOTAL	**1,861,749**	**–8,133**	**–0.4**	**68,391**	**3.8**	**100.0**

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

Total financing granted to resident sectors in March held at year-on-year growth of 6.4% as higher borrowing by the public sector was compensated by deleveraging in the private sector. Both the year-on-year change in funding granted to non-financial companies and that going to households dropped compared with the month before. This decrease may be explained by lower demand, given the recessive situation of the economy and the subsequent worsening of economic expectations, as well as some tightening of borrowing terms, as shown by the Bank of Spain survey of bank loans.

Higher public sector borrowing compensated by deleveraging in private sector.

In fact, funding granted to companies rose by 6.1% in the 12 months ending in March, some 4 decimals less than in February and 9.4 points below March 2008. This slowdown was due to loans by resident credit institutions, given that both bond issues and foreign loans showed an increase.

With regard to loans by resident institutions, commercial credit (used to finance working capital) continued to drop, going down 28.5% year-on-year. Leasing, closely linked to financing investment, increased its drop to 7.9% over the past 12 months.

Total funding granted to households continued to decrease in March for the fourth month in a row, as opposed to the year before. Nevertheless, it showed year-on-year growth of 2.2%, some 6 decimals less than in February and 2.2 points below December 2008. Demand for credit from households was down as a result of the worse economic picture and the subsequent increase in unemployment. Housing loans show a year-on-year of 2.5% while other credit was up by 1.3%.

Total funding granted to households down for fourth month in a row.

The recessive economic situation has brought an increase in default as a result of the worse situation in company balance sheets and the rise in unemployment. At the end of March the doubtful loan rate in the private sector stood at 4.3%, one decimal more than the month before. In addition, according to Bank of Spain figures, in December 2008 the default rate on mortgage loans to foreign residents came to 12.5%, nearly 8 times more than such loans to national residents, although loans in this category represent a small proportion of the total, somewhat more than 6% of home-purchase loans.

Default rate on mortgage loans to foreign residents stands at 12.5%.

Gap between loans and deposits getting smaller.

Withdrawals from mutual funds slow down

The state of liquidity of financial institutions has improved considerably in recent months due to the gradual normalization of interbank markets, the contribution of the Fund for Acquisition of Financial Assets and the granting of government guarantees for various bank bond issues. On the other hand, in March interest on private sector deposits continued to drop and on average stood at 1.77%, some 106 basis points lower than 12 months earlier while standing substantially above inflation.

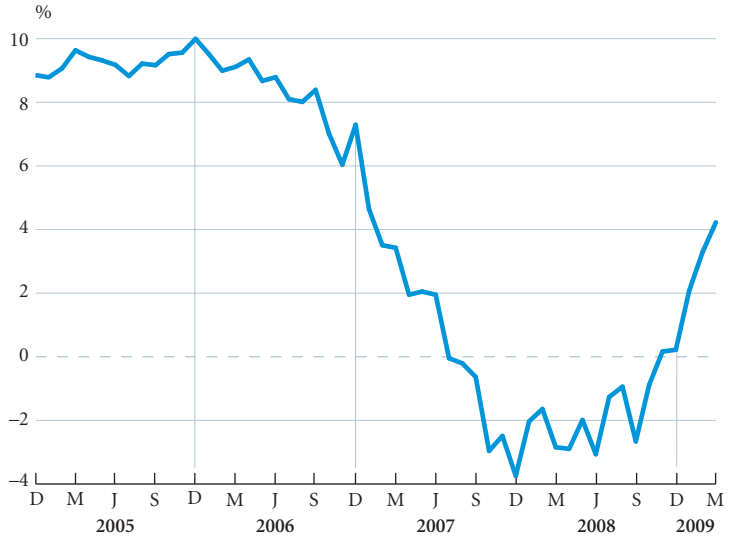
In this context, competition among financial entities to attract deposits began to wane along with their attraction for customers. As a result, total private sector deposits amounted to 11.7% in the 12 months ending in March, some 9 decimals less than in February but significantly more than loans. This may be explained by the fact that in the present economic situation the private sector must undergo deleveraging and increase its savings. In this way, the gap between loans and deposits is being reduced.

By type of deposit, we should mention the slowdown in growth of time accounts in March to annual growth of 20.2%. Total on-demand deposits, under the effect of lower incomes, dropped by 0.8% over the past 12 months. On the other hand, savings accounts continued to recover and showed year-on-year growth of 4.2%. The need for more liquidity and the decrease in interest rate differentials with time deposits were behind this trend.

In this context, mutual funds were subject to somewhat less competition from bank deposits, which, along with an improvement in the state of international financial markets, meant that mutual funds showed an increase in assets for the first time in nearly two

RECOVERY IN PRIVATE SECTOR SAVINGS DEPOSITS

Year-on-year change in private sector savings deposits in euros



SOURCE: Bank of Spain and own calculations.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

March 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	245,834	1,022	0.4	–1,932	–0.8	17.3
Savings deposits	181,625	1,848	1.0	7,371	4.2	12.8
Term deposits	735,022	5,750	0.8	123,755	20.2	51.8
Deposits in foreign currency	28,465	–853	–2.9	–4,016	–12.4	2.0
Total deposits	**1,190,947**	**7,768**	**0.7**	**125,179**	**11.7**	**83.9**
Other liabilities (*)	**228,078**	**–20,552**	**–8.3**	**–47,545**	**–17.2**	**16.1**
TOTAL	**1,419,025**	**–12,783**	**–0.9**	**77,635**	**5.8**	**100.0**

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

years. Total mutual fund assets at the end of the first four months of the year stood at 161.95 billion euros (0.3% higher than the month before), although this was a decrease of 24.6% compared with 12 months earlier. Nevertheless, there continued to be net withdrawals that month amounting to 950 million euros, although this was less than in previous months. What stood out were net inflows to guaranteed fixed income funds, which shows the risk aversion existing among savers.

Pension fund assets at the end of the first quarter stood at 76.24 billion euros, which meant a drop of 7.9% compared with 12 months earlier. This decrease was largely due to the poor situation in international financial markets. Furthermore, gross additions in the first quarter were lower than benefits paid out. The number of participant accounts rose by 1.7% over the past year going to ten and a half million. Average return over the past year was negative (–6.4%) but, considering the past 19 years as a whole which is more suitable in evaluating this product, the return was 5.3% annual, substantially above inflation during that period.

In addition, in the first quarter, total direct insurance premiums rose by 1.2% compared with the same period in 2008, although, considered by branch, the performance was varied. Life insurance premiums were up 4.9% while other-than-life premiums were down by 1.7%. The biggest drop came in car insurance, down 7.3%. Nevertheless, health and multi-risk insurance branches showed annual increases of 5.7% and 4.7% respectively.

Mutual funds show increase in assets for first time in nearly two years.

Financial wealth of households shows biggest drop in recent decades

Bank deposits were the type of household financial assets to show bigger annual growth in 2008 at 11.9%. Last year deposits proved more attractive as, up to October, interest rates rose and deposits acted as a refuge in view of the unfavourable trend in shares. Deposits thus increased their participation in the total going to 42.7%, although this percentage was far from the 54.0% recorded at the end of 1990, before the process of reducing financial margins began.

Deposits increase share of total financial assets of households to 43% in 2008.

NET HOUSEHOLD FINANCIAL WEALTH (*)

	2008			Annual change		Change over 5 years	
	Million euros	Structure as %	%/GDP	Million euros	%	Million euros	%
Financial assets							
Cash	91,435	5.4	8.3	2,398	2.7	33,652	58.2
Deposits	717,634	42.7	65.5	76,207	11.9	276,906	62.8
Instruments other than shares	40,244	2.4	3.7	–12,685	–24.0	2,599	6.9
Shares and participations in mutual funds	527,091	31.3	48.1	–282,164	–34.9	21,644	4.3
Insurance premium reserves	250,520	14.9	22.9	–8,326	–3.2	59,007	30.8
Other	55,616	3.3	5.1	–5,846	–9.5	15,834	39.8
Total	**1,682,539**	**100.0**	**153.6**	**–230,416**	**–12.0**	**409,642**	**32.2**
Financial liabilities							
Loans	914,145	95.8	83.5	35,974	4.1	462,997	102.6
Other	40,498	4.2	3.7	–4,072	–9.1	–11,635	–22.3
Total	**954,642**	**100.0**	**87.2**	**31,902**	**3.5**	**451,362**	**89.7**
Net financial wealth	**727,896**	**–**	**66.5**	**–262,319**	**–26.5**	**–41,720**	**–5.4**

NOTES: (*) Includes non-profit institutions serving households.
SOURCE: Bank of Spain and own calculations.

Drop in household borrowing in terms of disposable income.

Share portfolios, including participations in investment funds, underwent a decrease of 34.9% in 2008, largely because of capital losses in share markets. Nevertheless, there were notable net sales of 40.92 billion euros in participations issued by investment funds which largely moved to bank deposits.

Insurance products were down for the first time in recent decades showing an annual decrease of 3.2%. Nevertheless, their weight in the total rose to 14.9% as they dropped less than average assets.

Cash in hand was up 2.7% in 2008. As a result, its position rose to 5.4%, a level below the 7.7% reported at the end of 1991.

On the other side of the financial balance sheet of households, financial liabilities were down notably but in any case they rose by 3.5%. Most of these liabilities were made up of loans which came to represent 127.4% of gross disposable income, 3.6 points less than the year before.

Finally, in 2008, net financial wealth of households, defined as their assets less financial liabilities, marked up the biggest drop in recent decades (26.5%). As a result, this wealth went to 727.90 billion euros, 66.5% of gross domestic product.

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CAJA DE AHORROS Y PENSIONES DE BARCELONA

Research Department

Av. Diagonal, 629,
torre I, planta 6
08028 BARCELONA
Tel. 34 93 404 76 82
Telefax 34 93 404 68 92
www.laCaixa.es/research

e-mail:
For enquiries regarding The Spanish Economy Monthly Report:
informemensual@lacaixa.com

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As of December 31, 2008

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

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

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

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