SEPTEMBER 2009

THE SPANISH ECONOMY

Monthly Report

NUMBER 327

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						
Gross domestic product									
United States	2.1	0.4	–2.6	2.0	1.6	0.0	–1.9	–3.3	–3.9
Japan	2.3	–0.7	–5.3	1.5	0.6	–0.3	–4.5	–8.3	–6.5
United Kingdom	3.0	0.7	–4.8	2.6	1.7	0.3	–1.8	–4.9	–5.6
Euro area	2.6	0.7	–4.0	2.2	1.5	0.5	–1.7	–4.8	–4.7
Germany	*2.6*	*1.0*	*–5.2*	*2.8*	*2.0*	*0.8*	*–1.8*	*–6.7*	*–5.9*
France	*2.1*	*0.7*	*–2.3*	*2.0*	*1.2*	*0.6*	*–1.6*	*–3.4*	*–2.6*
Consumer prices									
United States	2.9	3.8	–0.6	4.2	4.3	5.2	1.5	–0.2	–0.9
Japan	0.1	1.4	–1.2	1.0	1.4	2.2	1.0	–0.1	–1.0
United Kingdom	2.1	3.6	1.9	2.4	3.3	4.9	3.9	3.0	2.1
Euro area	2.1	3.3	0.4	3.4	3.6	3.8	2.3	1.0	0.2
Germany	*2.3*	*2.6*	*0.4*	*2.9*	*2.9*	*3.1*	*1.6*	*0.8*	*0.3*
France	*1.5*	*2.8*	*0.3*	*2.9*	*3.3*	*3.3*	*1.8*	*0.6*	*–0.2*
SPANISH ECONOMY			Forecast						
Macroeconomic figures									
Household consumption	3.6	–0.6	–3.1	2.1	0.2	–1.3	–3.3	–5.1	–5.9
Government consumption	5.5	5.5	4.3	4.6	5.1	5.8	6.3	6.4	5.1
Gross fixed capital formation	4.6	–4.4	–15.4	1.3	–1.9	–6.0	–10.9	–15.2	–17.0
Capital goods	*9.0*	*–1.8*	*–22.2*	*5.0*	*2.9*	*–3.0*	*–11.6*	*–24.2*	*–28.9*
Construction	*3.2*	*–5.5*	*–14.2*	*–0.5*	*–4.2*	*–7.2*	*–10.3*	*–11.5*	*–12.0*
Domestic demand (contribution to GDP growth)	4.4	–0.5	–5.4	2.5	0.6	–1.4	–3.9	–6.1	–7.3
Exports of goods and services	6.6	–1.0	–14.4	3.9	2.4	–2.9	–7.1	–17.6	–15.7
Imports of goods and services	8.0	–4.9	–17.0	3.1	–1.3	–7.6	–13.5	–22.9	–22.3
Gross domestic product	**3.6**	**0.9**	**–3.7**	**2.5**	**1.7**	**0.5**	**–1.2**	**–3.2**	**–4.2**
Other variables									
Employment	2.8	–0.6	–6.6	1.5	0.3	–1.0	–3.2	–6.3	–7.1
Unemployment (% labour force)	8.3	11.3	18.2	9.6	10.4	11.3	13.9	17.4	17.9
Consumer price index	2.8	4.1	–0.1	4.4	4.6	4.9	2.5	0.5	–0.7
Unit labour costs	3.8	4.6	–0.5	4.9	5.0	4.7	3.8	1.0	1.4
Current account balance (% GDP)	–10.0	–9.5	–6.1	–12.2	–9.3	–8.6	–8.1	–8.1	–4.5
Net lending or net borrowing rest of the world (% GDP)	–9.6	–9.1	–5.5	–11.4	–8.8	–8.4	–7.9	–7.8	–3.9
Government balance (% GDP)	2.2	–3.8	–9.5						
FINANCIAL MARKETS			Forecast						
Interest rates									
Federal Funds	5.0	2.1	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	3.2	3.6	3.9	3.8	3.2	2.7	3.3
10-year German bonds	4.2	4.0	3.2	3.9	4.3	4.3	3.5	3.1	3.4
Exchange rate									
$/Euro	1.37	1.48	1.36	1.50	1.56	1.51	1.34	1.30	1.36

Contents

Gradually getting back to normal

After more than two years of world financial crisis and the biggest recession since the Thirties of last century, we are finally beginning to see the first signs that the worst may now be over. The coming of the crisis awakened the whole world from a dream state in which financial risk was almost irrelevant, liquidity was unlimited, any imbalance was easily sustainable and economic-financial cycles had passed into history. In this state of Nirvana, investors were paying minimum risk premiums and taking on high risks, the stock markets were rising, households went into debt and the public sector accounts were obtaining satisfactory results.

The awakening has been especially severe. Companies, households and governments suddenly found themselves with huge financial problems with the halt to the flow of credit and the spread of uncertainty about the viability of the financial system. Practically without interruption, the sudden brake on the world economy between the end of 2008 and the beginning of 2009 led to a situation that threatened a total collapse. The measures taken by the authorities probably avoided a replay of the Great Depression but getting back to normal is still some distance away.

One reason for fearing that the recovery is going to be slow is the rearrangement that will be needed in the balance sheets of both consumers and companies. As set out in boxes in this *Monthly Report*, household indebtedness was a key factor in the growth years as it financed increased spending. When this exceptional situation was substituted by a brake on incomes, loss of wealth, an increase in unemployment and uncertainty about the future, the reaction was a halt to consumption and an increase in savings. This was a logical and rational response from the point of view of households but inevitably it meant lower aggregate demand and therefore much lower potential growth than what we had become accustomed to, at least to the point where households felt that their financial situation had got back to being satisfactory. The fiscal supports provided by governments may have eased the cut in consumer spending but sooner or later these aids will have to be withdrawn.

A similar thing took place in companies which, as well as needing to adapt their balance sheets to the current situation, must deal with more difficult financing terms. Getting back to normal will not be fast in this sphere either. Risk premiums are being eased little by little but investor sensitivity will take time to ease off and even when the world economy settles into a recovery we cannot expect that risk premiums will go to the abnormal lows seen in 2006. Investors, both private and institutional, will be much more selective in the type of asset and the issuer. Awareness of liquidity risk will be much greater. Caution exercised when dealing with financial innovation or complex assets will make these more difficult to place. The rise in public sector borrowing and difficulties in reducing fiscal deficits in a context of slow recovery could harden financial terms for economic agents as a whole.

Looking back to the moments of greatest splendour of growth at the beginning of the present century, the current situation seems almost like a punishment for past excesses. It is more likely, however, to be a return to normalcy, to good sense and a realistic evaluation of risks and the compensations that come from economic activity.

EXECUTIVE SUMMARY

Is recovery imminent?

Japan, Germany and France resume growth in second quarter of 2009...

At last we have the first convincing proof of economic recovery. Growth estimates for the second quarter of 2009 show positive quarter-on-quarter rates in three of the world's biggest economies. The gross domestic product (GDP) of Japan, France and Germany rose by 0.9%, 0.3% and 0.3% respectively, whereas the consensus of experts and the national authorities themselves were expecting negative results. The advances made by the main engines of the European economy meant that the Euro Area GDP dropped by a mere 0.1%. This broke with the ideas of most analysts who felt that the US economy would lead the recovery process. The United States showed a notable slowdown in the rate of economic contraction (0.3% as against 1.6% in the first three months of the year) but it is fully expected that the rate in the third quarter will be positive for the first time since the second quarter of 2008.

...while United States must wait until third quarter.

The contribution of the foreign sector has been key in the recovery of the economies in Japan, Europe and the United States. The details are important. In the case of Japan, the recovery in exports was 80% the result of stronger demand from Asia where half of this was due to imports by China. On the other hand, in the European economy exports showed slight improvement but, above all, the contribution to growth from the foreign sector was the result of a continuation of the drop in imports.

Emerging economies hold key role in improving economic prospects...

Will recovery be based on the foreign sector? If domestic demand in the developed countries is weakened by the worse state of the labour market and the process of deleveraging of households, to whom will they be able to export? The answer may be in Asia, especially in China, which showed surprising growth of 7.9% year-on-year in the second quarter. The sources of China's growth, however, are also limited. A fiscal stimulus amounting to 7% of annual GDP in 2009 and a sharply expansionist monetary policy lay behind its rapid recovery. Development of domestic consumption remains a key to China's future and for this it will need to make structural changes. China, of course, is a market with huge potential but its export capacity is well-known. At mid-2009 the value of its exports exceeded those of Germany which until now has been the world's leading exporter.

In any case, the strength of the emerging Asia economies is turning out to be a very effective cushion against the weakness of the West. Apart from China, the economies of Indonesia, South Korea and Singapore showed sharp growth figures in the second quarter and not only have they made it possible to contain the current recession in the world economy but they also have strengthened hopes of an early end to this situation.

Returning to the developed countries, another factor explaining the improvement in the second quarter is the various economic stimulus measures taken. Their effect on the economy varies from one country to another but in general they are contributing to halt

the drop in demand and improving the situation in the key motor vehicle sector. The most notable case is that of Japan, given that approval of a fiscal package of 2,000 billion yen in cash paid out to households has managed to revive private consumption.

In any case, we should not forget that the effects of these economic stimulus plans are limited over time and that the heavy borrowing being accumulated by most governments makes their continuation difficult. Furthermore, their effect on domestic demand is dampened by the worsening of the labour market which always depends on the state of economic activity. In the United States, the recent increase in the proportion of long-term unemployed and the large number of workers being put onto part-time work against their wishes add up to a situation demanding attention. Prospects in the other developed countries are no different. In Japan, the unemployment rate in June kept rising and went to 5.4%, the highest since 2003, while in the Euro Area it reached 9.4%, which puts the number of unemployed persons at close to 15 million.

It is in the financial markets that optimism is bubbling. Revaluation of stock market indices compared with the low recorded in March has continued to the point where it reached levels close to 50% in the case of S&P 500 and the Eurostoxx 50. Deserving special mention is the extraordinary course followed by the IBEX 35 which since March has shown a revaluation of more than 60%. One relevant aspect of the rise in the stock markets was corporate profits in the second quarter. Out of all 500 companies listed in the S&P, some 73% of results announced were higher than forecasts. In Europe, the results were more modest in view of a financial sector that was still greatly hurt by the crisis. Credit markets also showed a more positive behaviour with a reduction in risk premiums to levels operating before the Lehman Brothers crisis.

...but recovery still very fragile.

This does not in any way mean that the crisis is over, given that the flow of credit in the main economies is still very low in spite of efforts by the central banks to increase liquidity. In any case, the monetary authorities are no longer concentrating on finding new instruments to stimulate the economy but rather the debate has shifted to when and how to end their easy monetary policies. For the moment, interest rates stand at all-time lows. In August, the 3-month Euribor rate went to a low of 0.87% while the 12-month Euribor was quoted at 1.34% in mid-August.

Stock market keeps up optimistic tone.

The improvement in the international sphere has also been noted in Spain's economy. The GDP was down 1.1% in the second quarter compared with a drop of 1.6% three months earlier. The improvement in the quarterly figures does not show up in the year-on-year rate, which marked up the biggest drop in recent decades (4.2%), one of the worst figures in the Euro Area.

The improvement in the foreign situation meant a slightly bigger contribution to the GDP from the foreign sector. This came about because imports of goods and services were down more than exports, which shows the state of weakness being felt in domestic demand. Apart from the improvement in the international economic situation, the lower drop in the growth indicator may be attributed to the impact of the central government's economic stimulus programmes.

Spain's economy showing worse results than Euro Area in second quarter but improves on early months of year.

The easing of the recession also reached the labour market which halted its

Drop in employment being contained but unemployment rate goes up to nearly 18%, twice Euro Area average.

downturn. According to the Labour Force Survey, some 145,800 net jobs were lost in the second quarter, which, in seasonally-adjusted terms, was substantially less than in previous quarters. In any case, in the past 12 months the level of employment has dropped by nearly a million and a half persons (7.2%). The municipal works programme financed by the central government has eased the collapse of employment in construction, which marked up a lower quarterly drop than industry that is also is undergoing a sharp correction.

In this labour environment, the number in the labour force dropped for the first time in recent years because many people were discouraged about finding work. This contributed to moderating the rise in the unemployment rate. The figure for those unemployed rose by 3.2% in the quarter going to 4,137,500 persons. The unemployment rate rose by 6 decimals to 17.9%, the highest in the European Union and twice the average.

Private consumption collapses and prices drop while foreign imbalance greatly improves.

One of the most relevant factors in the present economic situation is the drop in private consumption. In the second quarter, consumption spending of households at annual rate was down 5.9% in real terms (a drop of 7.1% at current prices). This explains the strong containment of prices. In July, the consumer price index recorded a year-on-year drop of 1.4%, the fifth negative year-on-year rate in a row and the biggest drop in the index in recent decades. In any case, this drop would not have occurred but for the decrease in commodity prices and especially in oil in recent months in spite of the latest increase. Because of this, while it will continue to show negative year-on-year rates, the most likely to happen is that prices will return to positive ground toward the end of the year.

Government deficit shoots up but authorities continue to apply fiscal stimulus policies.

The recession is helping the correction of the foreign imbalance so that the deficit dropped to 7.0% of GDP in the second quarter (average for the four previous quarters) as against 9.1% recorded in 2008 as a whole. On the other hand, the recession has made the public accounts rapidly worse. Revenues are dropping sharply because of the lower taxable bases for various taxes and the increase in spending related to higher unemployment. The erosion of the public accounts, however, is also due to the impact of the various fiscal measures adopted by the central government to ease the recession. Only in the first half-year the government deficit rose by 3.6% of GDP with a subsequent increase in central government borrowing. Nevertheless, during the summer the credit rating agencies Moody's and Fitch maintained the top rating for Spain's sovereign bonds. In fact, while the situation of the public accounts has rapidly worsened, the starting point was notably favourable.

In this framework, the economic authorities have continued to adopt support measures for those economic sectors affected by the recession, such as aid for the purchase of motorbikes and the assumption of half the risk of new mortgage loans for subsidized housing. Measures were also approved to ease the effects of rising unemployment, such as removal of the need to wait one year to be able to recover pensions in case of those unemployed having no unemployment contribution record and the creation of a new temporary aid for those unemployed who have used up their unemployment benefits quota. The growing cost of these measures presents a major challenge for government finances that must show up in the central government budget for 2010, the presentation of which in coming weeks promises to bring about passionate debate.

August 28, 2009

CHRONOLOGY

2008

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	Government approves series of **measures to boost economic activity**: reform of law on meetings of creditors, revival of credit insurance and introduction of EU directive on services.
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	Government announces **new economic policy measures**: partial removal of tax deduction for buying normal residence as of 2011, aids for buying cars, reduced taxes for some small and medium-size businesses and self-employed persons, etc.
June	**12**	Government **increases taxes** on tobacco, petrol and diesel fuel for motor vehicles.
	26	Government establishes **Fund for Orderly Restructuring of Banks**.
August	**25**	IBEX 35 index for **Spanish stock market** marks up annual high (11,427.8) with cumulative gains of 24.3% compared with the end of December 2008.
	26	Dow Jones index for **New York stock exchange** records annual high (9,543.5), a rise of 8.7% compared with the end of 2008.

AGENDA

September

2 Registrations with Social Security and registered unemployment (August).
3 Governing Council European Central Bank.
8 Industrial production index (July).
11 CPI (August).
18 Quarterly labour cost survey (2nd Quarter).
20 Fed Open Market Committee.
23 Foreign trade (July).
25 Producer prices (August).
29 Central government revenue and spending (August). Flash HCPI (September).
30 Balance of payments (July).

October

2 Registration with Social Security and registered unemployment (September).
5 Industrial production index (August).
8 Governing Council European Central Bank.
14 CPI (September).
15 EU HCPI (September).
22 Foreign trade (August).
23 Labour force survey (3rd Quarter).
26 Producer prices (September).
27 Central government revenue and spending (September).
29 Flash HCPI (October). US GDP (3rd Quarter).
30 Balance of payments (August).

INTERNATIONAL REVIEW

United States coming out of worst recession but still faces uphill road

United States: economy down 1.0% with lower drops in investment and exports and weak consumption.

The United States economy is bordering the end of the deepest and longest recession since World War II and faces a recovery that could be weak and erratic. The gross domestic product (GDP) in the second quarter of 2009 dropped to 3.9% year-on-year although, in quarter-on-quarter terms annualized, the drop stood at a low of 1.0%. Following the usual revision in July, we note that the weakness in economic activity began before what had previously been published. As a result, growth for 2008 as a whole went from 1.1% to 0.4%, while the figures for the first quarter were also revised downward, especially those referring to private consumption, which continued to drop. Under investment, construction continued to show no signs of recovery while the foreign sector and capital goods investment, although still losing ground, moderated the huge losses seen in the previous quarter.

Economy coming out of recession but household debt could make recovery difficult.

The recession and the worst drops have now been left behind but recovery is not going to be easy. High household debt means that a good part of incomes goes into reducing debt or into savings. As a result, in the first six months of 2009

UNITED STATES: MAIN ECONOMIC INDICATORS

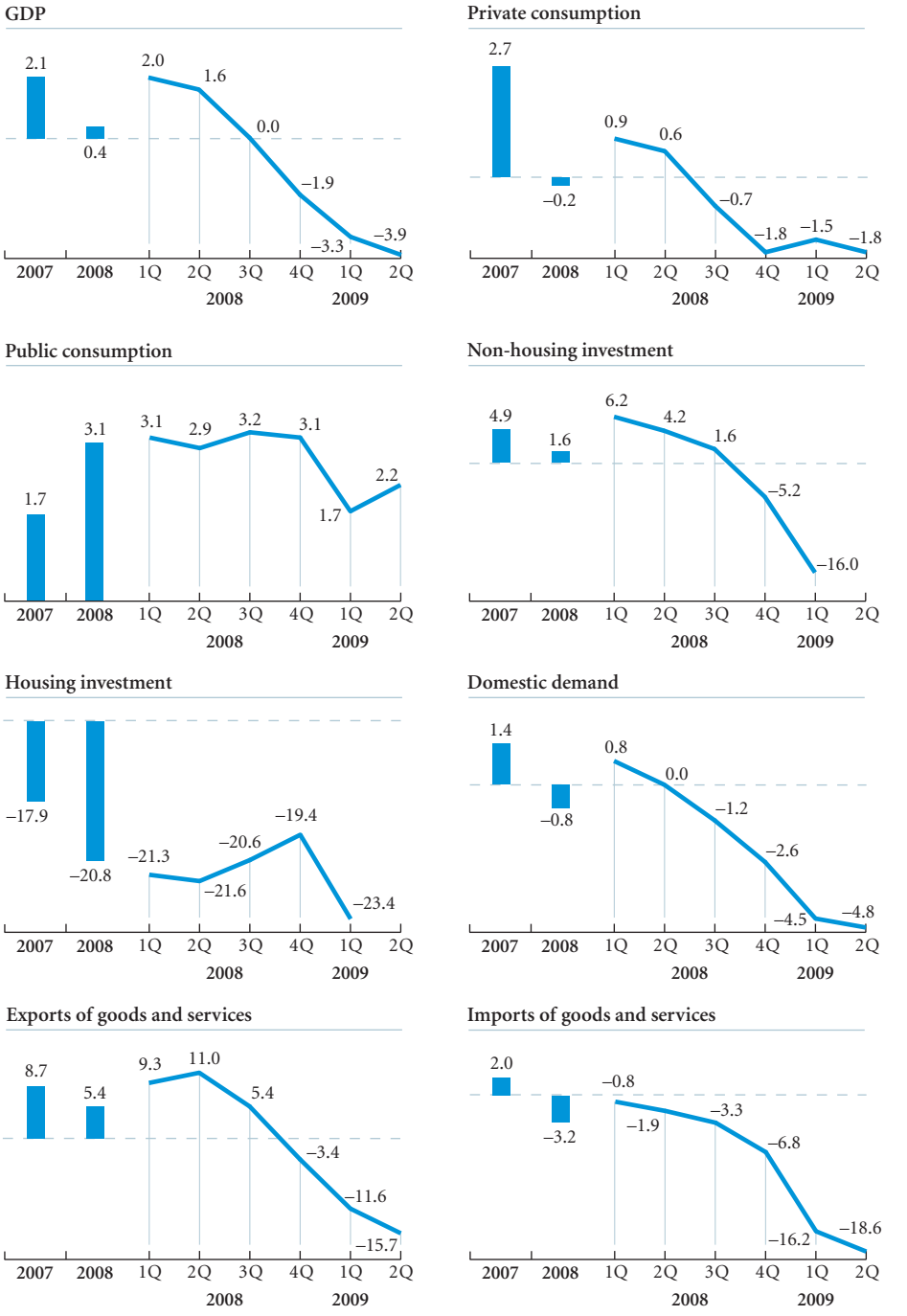
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009		
			3Q	4Q	1Q	2Q	July
Real GDP	2.1	0.4	0.0	–1.9	–3.3	–3.9	–
Retail sales	3.3	–0.7	0.4	–8.0	–8.9	–9.6	–8.3
Consumer confidence (1)	103.4	58.0	57.3	40.7	29.9	48.3	46.6
Industrial production	1.5	–2.2	–3.2	–6.7	–11.6	–13.2	–13.1
Manufacturing (ISM) (1)	51.1	45.5	47.4	36.1	35.9	42.6	48.9
Sales of single-family homes	–26.7	–37.4	–36.2	–41.0	–40.0	–30.2	...
Unemployment rate (2)	4.6	5.8	6.1	6.9	8.1	9.3	9.4
Consumer prices	2.9	3.8	5.3	1.6	0.0	–1.2	–2.1
Trade balance (3)	–701.4	–695.9	–725.8	–695.9	–604.5	–503.4	...
3-month interbank interest rate (1)	5.3	2.8	3.2	2.2	1.2	0.8	0.5
Nominal effective exchange rate (4)	77.9	74.4	73.5	81.3	82.7	79.4	76.5

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

Consumer confidence and retail sales again on downward track.

households saved 4.6% of disposable income whereas in the three-year period 2005-2007 the average had been 1.8%. If we add to this the loss of household wealth, which between June 2007 and the end of 2008 came close to total GDP (combining tangible assets and financial assets), we may deduce that private consumption will continue to need fiscal stimuli in coming months.

Latest demand indicators confirm this weakness in consumption. Retail sales, excluding cars and petrol, were down 5.5% year-on-year in July thus showing a step back from the month before. The consumer confidence index of the Conference Board followed a similar pattern and in July was down for the second month in a row going from 49.3 to 46.6 points.

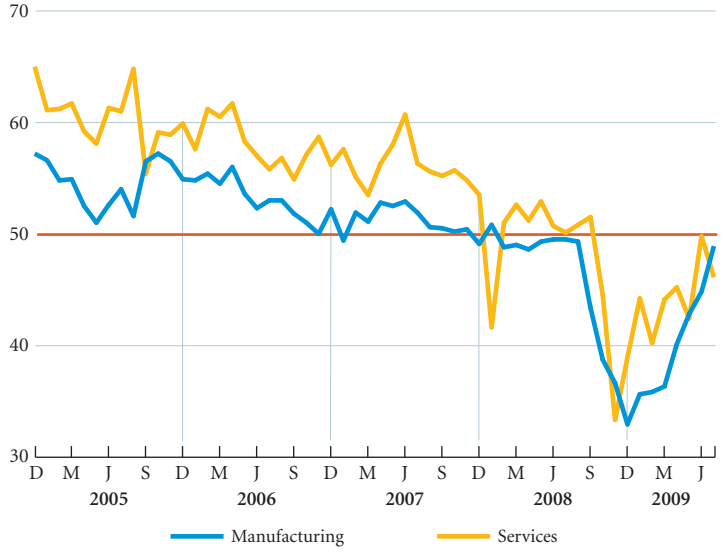
Business executives not now as pessimistic but industrial activity still at low levels.

It is supply that is showing the most visible signs of recovery although, for the moment, these are limited to confidence indicators rather than real figures for economic activity. The business sentiment index put out by the Institute for Supply Management in July continued to slowly approach the level of 50 points which is considered the watershed marking the beginning of expansionist stages. The manufacturing index showed its seventh month of increases in a row, going to 48.9 points, while the services index held at 46.1 points. In slower time, industrial production in July recorded a modest advance over June thus putting an end to decreases although it was still clearly below the levels for the same period the year before. In a similar way, the utilization of production capacity remained very low.

Housing is hitting bottom but fails to give off any sign of recovery. Real estate sales have found a stable level and the drop in prices has taken a brief respite although the Case-Shiller index for May

UNITED STATES: BUSINESS EXECUTIVES NOT AS PESSIMISTIC

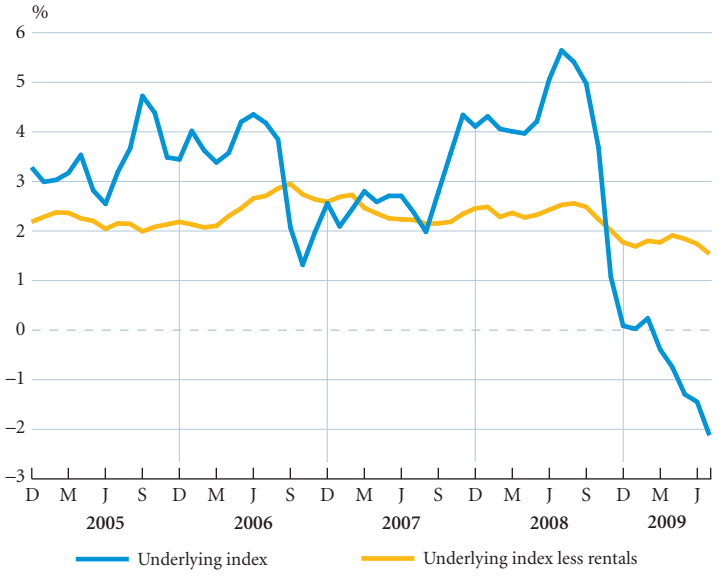
Level of ISM indices (*)



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

UNITED STATES: UNDERLYING STABILITY

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



NOTES: (*) Underlying index does not include food and energy.
SOURCE: Department of Labor and own calculations.

showed a cumulative decrease of 33.0% compared with June 2006. The improvement in construction company sentiment had little tangible results given that housing starts in July remained below normal levels, probably because, with foreclosures for non-payment of mortgage loans at their height, the excess of homes on the market looks like continuing for some time.

Housing hits bottom but default making recovery difficult.

Nor is the labour market helping and the weakness of this market will continue to mark the rate of the US economy over coming months. Just 247,000 jobs were lost in July, less than in previous months, while the unemployment rate momentarily broke with its upward trend to stand at 9.4%. Nevertheless, the recent increase in requests for unemployment benefits, the proportion of long-term unemployed (which continues to reach new highs) and the large number of workers involuntarily going onto part-time work add up to a sombre picture.

Labour market still weak with unemployment rate at 9.4% and more long-term unemployment.

Poor demand and free-time resources available mean that inflationary trends are not showing up. The general consumer price index (CPI) for July went down 2.1% year-on-year and the underlying index (the general index less food and energy) moderated their increases showing a rise of 1.5% year-on-year which, excluding home rentals, held at 2.0%.

In turn, the trade deficit for goods and services in June was 27.01 billion dollars, slightly above the figure for the month before, because of the increase in oil prices. Nevertheless, the deficit excluding oil products was reduced to 9.8 billion dollars, a fifth of the high in January 2006 thanks to the modest rise of exports and the continuing drop in

CPI drops 2.1% while underlying rate moves up 1.5%.

High-cost oil prevents bigger correction of trade deficit.

imports. In spite of the improvement, it should be borne in mind that trade remains at very low levels with exports and imports 22.2% and 31.1% below the same month last year, respectively.

In coming months, a lower drop in domestic consumption, normalization of trade and the latest increases in crude oil prices could make correction of the trade deficit more difficult.

The cost of risk: neither too much nor too little

Just before the economic crisis, investors seemed ready to accept the slight compensation for including bonds not issued by a solvent government, the closest to a no-risk asset. Those were the days when a subprime mortgage backed security was paying a handful of basis points more than a US Treasury bond. Following the start of the crisis, the situation has been quite different and, in some cases, it seems to have shifted to the other extreme, especially at moments of extreme conditions. How can we explain these fluctuations in risk premia? Are we facing a change that is going to last beyond the crisis or is this just a temporary phenomenon?

In the fullest sense of the term, the risk premium on a financial asset involves the compensation demanded by an investor for the uncertainty affecting the final profitability of such investment. In general, to put the matter simply, an investor prefers a secure return rather than an uncertain one of equal expected value. In order to induce an investor to include such a risky asset in his portfolio the yield on that investment must include a risk premium, a positive differential relative to what would be paid on a government bond.[1]

In the case of a bond, for example, there is the risk of default, known as credit risk, which may change the return on the investment. In the case of shares, future dividends and possible capital gains are subject to the uncertain development of the company issuing the shares and other factors that may affect their price (this is the so-called equity risk). For any type of asset there also exists the so-called liquidity risk, a concept that may be defined as the difficulty of selling an asset at a price close to its fundamental value. Liquidity risk tends to be lower for standardized assets listed on organized markets with a high volume of trading. On the other hand, instruments such as CDO and CDS, complex and traded over the counter (not in an organized market) show high liquidity risk.

Many ideas have been put forward to explain the low risk premia just before the crisis. On the one hand, there was the abundance of liquidity flooding international financial markets. The origin of this liquidity was threefold: China's savings aimed at buying low-risk assets may have induced other investors to go after more risky assets, thus reducing their risk premium; low official interest rates in the main advanced economies; and certain financial innovations that facilitated the leverage of investors through, for example, off-balance-sheet accounting vehicles. In addition, some innovative assets, such as CDOs, that enjoyed the backing of the rating agencies, could also have contributed to hiding the real risk of investments because of their complexity. Also contributing to low risk premia was the good state of the world economy and the belief that traditional economic cycles were beginning to be a thing of the past. It seems that investors tend to believe

(1) The reality is more complex and the risk premium may be negative if the return on the asset tends to be high when other assets drop in price. Thus, an investor bears in mind not only expected return and the volatility of various assets but also how yields tend to move together.

that seven good years will be followed by seven equally bountiful years, which leads to underestimating investment risk.

After the crisis had begun, the mirage of a world almost without risk came to its inexorable end. The liquidity that had brought about the drop in risk premia suddenly dried up. The worsening economic situation and uncertainty about the extent of the recession increased credit risk and made the future of companies more uncertain. In this context, the revaluation of risk on certain assets, especially their vulnerability to liquidity risk, recognizing the mistakes of rating agencies and risk managers, led to a rise in risk premia. The psychology of investors, who, after initial losses increased their aversion to risk, also played an important role in fluctuations in the cost of risk.

RISK PREMIUM INDICATORS

Type of asset	Definition of indicator	Average January-June 2007	Maximum since July 2007	Final figure (August 20, 2009)
Bonds - United States	Differential of industrial sector BBB bonds with 10-year Treasury bonds (basis points)	123	471	232
Bonds - Euro Area	Differential of industrial sector BBB bonds with 10-year German government bonds (basis points)	84	485	269
Shares - United States	VIX index of volatility implicit in S&P 500 options	13.2	80.9	25.1
Shares - Euro Area	VDAX index of volatility implicit in DAX options on German stock exchange	15.9	74.0	26.1
Government bonds - emerging countries	Differential in yield on government bonds in dollars with a basket of emerging countries with US bonds (basis points)	169	891	393
Government bonds - Spain	Differential in yield with German 10-year bond (basis points)	5	126	50

SOURCE: Bloomberg and Datastream.

What will the future bring? Following the foreseeable overreaction of the markets in the heat of the financial crisis and the recession, it would seem logical to expect some normalization of risk premia in coming months. This process has already begun with the aid of measures taken by governments and central banks but it is also true that this will take time given the stress the real economy is still being subjected to and increased investor sensitivity to risk (see above table). A full return to normalcy will require a certain confidence that the main economies have recovered a sustainable growth rate, something that certainly will not come about until the end of 2010 or 2011 when we see the beginning of the process of removing the exceptional fiscal and monetary policy measures to stimulate the economy. Even then, we cannot expect that risk premia will reach the abnormally low levels noted in 2006. There will be greater discrimination by type of asset and issuer, thus penalizing complexity, lack of transparency, absence of standardization or not being listed in organized markets. There will be much greater awareness of liquidity risk. Furthermore, it is foreseeable that the rating agencies will avoid making judgments or, at least, not such clear judgments on newly created assets, as in the past, which will increase their risk premia.

Paradoxically, the risk premia on bonds of some governments could rise in coming years. An increase in the size of government debt and difficulty in reducing fiscal deficits in those cases where economic recovery is slow could sow doubts about the credit risk of some countries. After all, assets free of all risk have yet to be invented.

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Japan makes uncertain exit from recession

Japan grows by 3.7% with recovery of exports and fiscal stimulus measures.

Japan's economy grew by 3.7% quarter-on-quarter annualized in the second quarter thus putting an end to four consecutive decreases in a row. Nevertheless, the sharp drop in the first quarter, although eased in the subsequent revision, meant that a year-on-year drop of 6.5% was recorded. The biggest contribution to growth came from the foreign sector with exports up 27.9% quarter-to-quarter annualized after having shown the biggest drops since 1945. Domestic demand was down because of the persistent drop in investment and the reduction of inventories. Nevertheless, the rise in private consumption, which grew by 3.1% quarter-on-quarter annualized, and heavy public investment meant that the general balance ended up on the rise.

High level of government debt and dependence on China make for lower risks.

The risks for growth, however, remain on the downside. To begin with, the recovery in exports may be explained 80% by increased demand from Asia where half were accounted by imports by China, whose growth based on strong fiscal stimuli and increases in credit still presents some doubts. On the other hand, the rise in Japanese private consumption is largely due to a fiscal package of 2,000 billion yen, in the shape of cash for households, which amounts to 2.8% of current private consumption in one quarter. However, with government debt close to double the nominal GDP, fiscal expansion has little scope left in Japan whether in the form of stimuli for consumption or public investment.

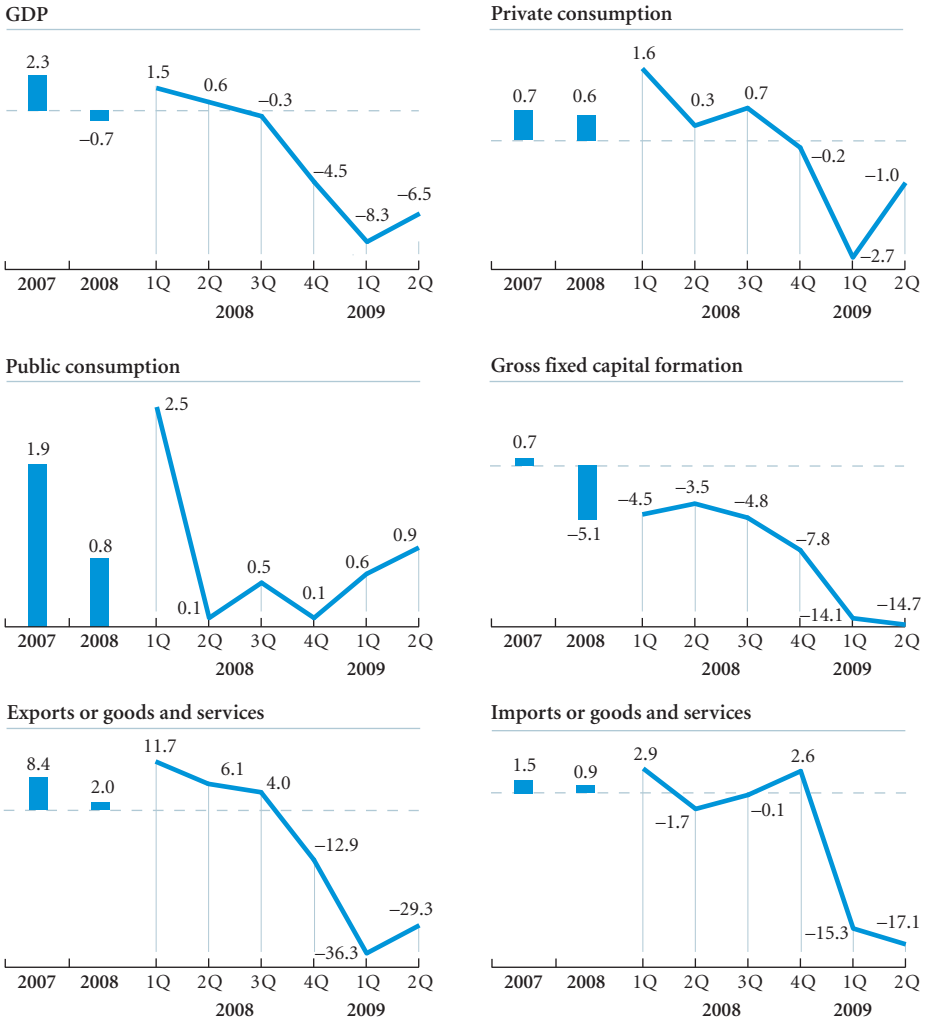
Industrial production recovering but investor pessimism still persists.

Latest demand indicators do not point to a continuation of the rise in consumption. While the consumer confidence index moved up in the second quarter, the level remains very low in terms of the historic average. Retail sales in June also continued their downward trend while car sales in July indicate that government incentives have managed to halt the drop but have not brought about an upturn in demand.

On the supply side, there are signs of recovery although the size of the drops in the Autumn and last Spring will make it difficult to get back to the levels seen in June 2008. In this context, industrial production in June continued upward to stand 16.4% above the low in February but showing a 24.5% year-on-year drop. In the same way, the Tankan index for large manufacturing companies published by the Bank of Japan indicates that business sentiment remains at a very low level in spite of the improvement in the second quarter. Also along these lines, investment spending is still not

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.

showing any sign of recovery although the early indicator (machinery orders) may have hit bottom in the second quarter.

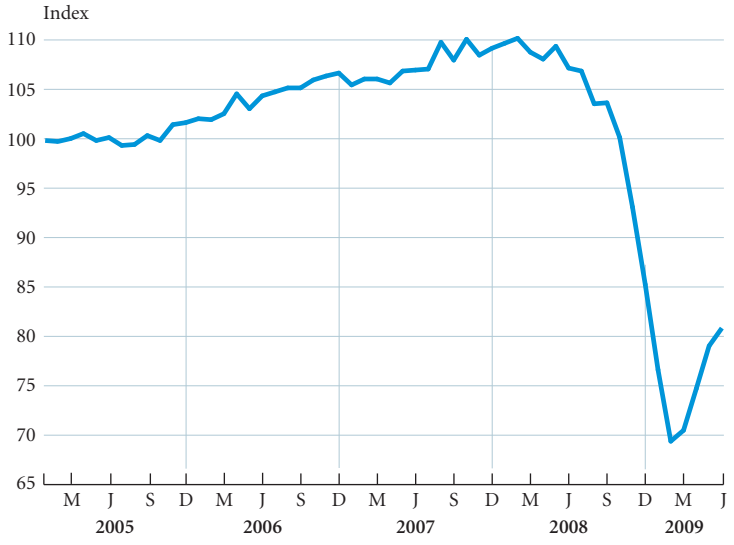
In the housing market weakness is still the predominant sign. July sales in the Tokyo area settled on a modest recovery that is not being joined by any recovery of prices. Supply seems to be taking note of prices and housing starts in June were very close to the lowest level in the past 45 years.

Because of the weakness in demand the labour market today is one of the softest points in Japan's economy. The June unemployment rate continued to rise going to 5.4%, the highest since 2003 but the worst news came in wages which were down 9.8% year-on-year going to the lowest figure in the past 20 years. The biggest

Unemployment reaches 5.4%, wages dropping sharply and CPI down 1.8%.

JAPAN: INDUSTRIAL PRODUCTION BEGINS DIFFICULT RECOVERY

Industrial production index



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

losses in employment continued to be in manufacturing which in the first six months of 2009 went from making up 18.6% of all jobs to show only 17.4%.

The weakness in employment and domestic demand helped increase deflationary trends. In June, the CPI showed a decrease of 1.8% year-on-year

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009		
			3Q	4Q	1Q	2Q	July
Real GDP	2.3	–0.7	–0.3	–4.5	–8.3	–6.5	–
Retail sales	–0.1	0.3	0.8	–1.5	–3.9	–2.8	...
Industrial production	2.9	–3.4	–3.3	–15.0	–34.0	–27.6	...
Tankan company Index (1)	22.0	–2.8	–3.0	–24.0	–58.0	–48.0	–
Housing construction	–17.2	2.4	40.3	3.9	–21.4	–32.0	...
Unemployment rate (2)	3.9	4.0	4.0	4.0	4.4	5.2	...
Consumer prices	0.1	1.4	2.2	1.0	–0.1	–1.0	...
Trade balance (3)	12.6	4.0	7.5	4.0	1.4	1.0	...
3-month interbank interest rate (4)	0.7	0.8	0.9	0.8	0.7	0.6	0.6
Nominal effective exchange rate (5)	77.1	86.6	81.9	98.5	102.1	95.7	96.9

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

while the underlying index (the general rate excluding energy and food) dropped by 0.7% year-on-year thus accumulating six months of decreases in a row. The poor prospects for a recovery in demand will keep price decreases taking place, as indicated by the 1.8% year-on-year drop in the Tokyo CPI in July.

The foreign sector is still recovering from the sharp drops in the first quarter although trade figures continue to be well below the levels seen last year. Japan's exports, which have a heavy component of capital goods with high value added, had added to the drop in world demand and the distortion of world trade because of increased costs of credit insurance and guarantees. According to customs figures, in the final quarter of 2008 and January-February 2009, exports were down 38.4% while, from then until June, they recovered by a comparatively modest 7.0%. This change in trend, aided by the persistent weakness of imports, meant that the figure for the trade balance in goods for the past three months ending in June showed a surplus of 909 billion yen, close to the 1,100 billion yen in the same period last year.

Exports recover and trade surplus consolidating but still some way to go.

Emerging Asia: decoupling again?

Whereas at the beginning of the year the theories predicting a process of decoupling between developed emerging economies were put on hold, new figures from emerging Asia have meant a renewal of the decoupling hypothesis. China surprised everyone with growth of 7.9% year-on-year in the second quarter, well above the 6.1% in the first quarter and the predictions of the general consensus. North Korea grew by 2.3% in the second quarter compared with the first quarter, although it still shows a year-on-year drop of 2.5%.

China shows surprising growth of 7.9% in second quarter.

A fiscal stimulus equivalent to 7% of annual GDP in 2009 and a strongly expansionary monetary policy based on liquidity injections are behind China's rapid recovery. The authorities have spent somewhat more than 60% of the annual budget on public investment. In the first five months of 2009 this meant a 32.9% growth in investment compared with the same period last year. Furthermore, bank credit increased by 33.9% year-on-year in July and, while showing a downward trend as indicated

Fiscal package and monetary policy behind sharp recovery.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2008		2009		
			3Q	4Q	1Q	2Q	July
Real GDP	13.0	9.0	9.0	6.8	6.1	7.9	–
Industrial production	17.5	12.6	13.0	6.4	9.7	9.0	10.8
Electrical power generation	15.7	6.7	6.7	–6.0	–4.3	–0.4	4.7
Consumer prices (*)	4.8	5.9	5.3	2.5	–0.6	–1.5	–1.8
Trade balance (**)	262	296	258	296	317	295	280
Reference rate (***)	7.47	5.31	7.20	5.31	5.31	5.31	5.31
Renminbi to dollar (*)	7.6	6.9	6.8	6.8	6.8	6.8	6.8

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

Industrial production and retail sales confirm recovery.

by latest figures for new loans published by the central bank, in the seven first months of the year the growth of bank credit was 29.1%, almost doubling last year 15.3%.

The most recent indicators confirm the rebound of the Asian giant. Industrial production in June grew by 10.7% year-on-year, higher than the 8.9% in May and closer and closer to the rate of 15%-16% we were wont to see in prior years. The purchasing managers index (PMI) in July stood at 53.3% (above the 50 points level) indicating a growth period for the fifth month in a row. Growth of 15.2% year-on-year in retail sales in July, while well below the 23.3% seen last year, comes as another sign of strength in China's economy.

Fear of deflation disappearing.

Figures for international trade are still not exhibiting such clear signs of recovery although they suggest something of an improvement. Both exports and imports have risen considerably in recent months, with recovery reaching 80% of the value seen in mid-2008, just before the collapse. Nevertheless, that drop is still keeping year-on-year growth rates in negative terrain. Specifically, exports were down 21.3% and 22.9% year-on-year in June and July respectively as against 26.5% in May. The halt to the drop in imports is more evident given that the year-on-year decrease in July was 14.9% which, although somewhat higher that the June dip, was well below the 25.2% recorded in May. The current account surplus will move down thanks to the bigger recovery in imports.

Increasing significance of domestic consumption still to be dealt with.

The CPI dropped by 1.8% as against 1.7% and 1.4% in June and May respectively. Parallel to this, the producer price index stood 8.2% below the value it held one year earlier. The decrease in the price of food and the major increase in mid-2008 in supply prices were behind the drop in price indices. In spite of available data, the risks of deflation are disappearing in the face of the strength of economic activity.

Positive growth expected in Brazil in second quarter.

Finally, the Shanghai stock market seems to be following the path shown by the more optimistic indicators. So far this year the Composite index has revalued by around 60% as against a drop of 65% last year. Nevertheless, this strong rise has not been without fear of a new speculative bubble. In fact, in the first three weeks of August the index dropped by 20%.

In any case, we still feel that the development of domestic consumption is the key to China's future. While heavy investment in infrastructures carried out by the government and the provision of credit have been useful in helping the economy rapidly leave behind the world recession and revive employment, there is a need for more structural changes in order to continue along a path of strong growth.

Brazil: «green shoots» in Amazonia

Only a few days after publication of definitive figures for the second quarter, everything indicates that, boosted by strong domestic consumption, the good state of the financial system and China's renewed appetite for commodities from the region, the Brazilian economy has resumed a growth path. Even so, the sharp drop in the early months of the year will count in the final figures for 2009.

If this early recovery is confirmed, part of the success must be attributed to the good work done in recent years in designing a macroeconomic framework

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009		
			3Q	4Q	1Q	2Q	July
Real GDP	5.6	5.1	6.8	1.1	–1.6	...	–
Industrial production	5.9	2.9	6.4	–6.2	–13.9	–11.5	...
Consumer confidence (*)	132.3	140.4	136.3	132.9	128.5	128.4	139.9
Unemployment rate São Paulo (**)	15.0	13.0	12.7	11.6	12.6	13.9	...
Consumer prices	3.6	5.7	6.3	6.2	5.8	5.2	4.5
Trade balance (***)	40.0	24.8	28.7	24.8	25.0	27.5	27.1
Interest rate SELIC (%)	12.75	11.25	13.75	13.75	11.25	9.25	8.75
Reales to dollar (*)	2.1	1.8	1.9	2.3	2.3	2.0	1.9

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion dollars.
SOURCE: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

that would make it possible to better face any outside adversity. The strong financial position of the government has given it the credibility and the resources needed to ease with discretionary countercyclical policies the impact of a recession that has sharply hit Brazil's industry, investment and exports.

In contrast to foreign demand, domestic consumption has shown firm strength and this is more than confirmed by the most recent figures. Consumer confidence has returned to levels before the recession and retail sales grew again in June by 5.6% year-on-year and 1.7% monthly annualized since May. Consumption has been supported by bank credit for which the outstanding balance grew by 19.7% in June compared with the same month in 2008, thus reaching all-time highs as a percentage of GDP (43.7% pf GDP).

On the supply side, the weakness in industry compared with 2008 remains evident although the rate of decrease has been easing largely thanks to fiscal stimuli provided to the motor vehicle sector. The purchasing managers index (PMI) rose slightly in July while industrial production rose in June for the sixth month in a row (0.2% monthly annualized) although down 12.4% in year-on-year rate. Government stimuli gave fresh air to the domestic car market but the collapse of exports in July ended up dragging the sector toward a new drop. Registrations were down 0.9% while production slipped by 11.5% compared with July 2008.

Consumption maintains strength while foreign sector is hit by crisis.

The rise in capital inflows and the stock market in the second quarter reflect the renewed interest of international investors in Brazilian assets and this continues to appreciate the real. In turn, inflation continues on a downward path and is holding within foreseen targets. This made it possible to reduce the SELIC rate by 50 basis points in July (the fifth in a row) and put the reference rate at an all-time low of 8.75%.

In spite of the fact that the latest press release by the Banco Central do Brasil left all doors open, there is a feeling that the end of the cuts, if not already

Foreign sector confidence gives real a boost.

reached, is very close. If these «green shoots» keep showing up and China's recovery does not turn out to be a mirage, the winds in Brazil would seem to be blowing in favour of monetary restriction in 2010.

Mexico: economic recovery not in sight yet

Mexico's GDP suffers worst drop in three decades.

Following a disastrous year and the crossing of the half-way mark in 2009, the storm seems to be letting up in Latin America although the situation is more or less clear depending on what coordinates one adopts. With Peru as the only country expecting positive growth in 2009 and Brazil taking the reins toward recovery, we may firmly state that Mexico is the Latin American country to suffer most from the world recession and does not expect a change of this trend until the fourth quarter.

Demand giving weak signs of stabilization.

Mexico's GDP contracted 9.7% year-on-year in the second quarter of 2009, the biggest drop since these statistics have been recorded. Nevertheless, the quarter-on-quarter change (1.1%) was lower than in the first quarter so that the adjustment seems to be moderating. The contraction of economic activity between March and June is attributed, on the one hand, to the fact that domestic demand is still weak, with no significant improvements in consumer or producer confidence, to higher unemployment and the restriction of credit. On the other hand, blame is being put on a new round of contagions: the propagation of A-type flu with an adverse calendar effect from the Easter Week holidays along with the problems facing the North American motor vehicle sector.

With confirmation of the worsening of the economy in the first half of 2009, some improvement is expected in the third quarter. As well as signs of improvement in the United States and the slight recovery in remittances in June, domestic demand is also showing signs of stabilizing. Consumer confidence in July reached its high for 2009 while investment, although down by 15.8% year-on-year in May, reduced its rate of decrease in relative to April.

MEXICO: MAIN ECONOMIC INDICATORS

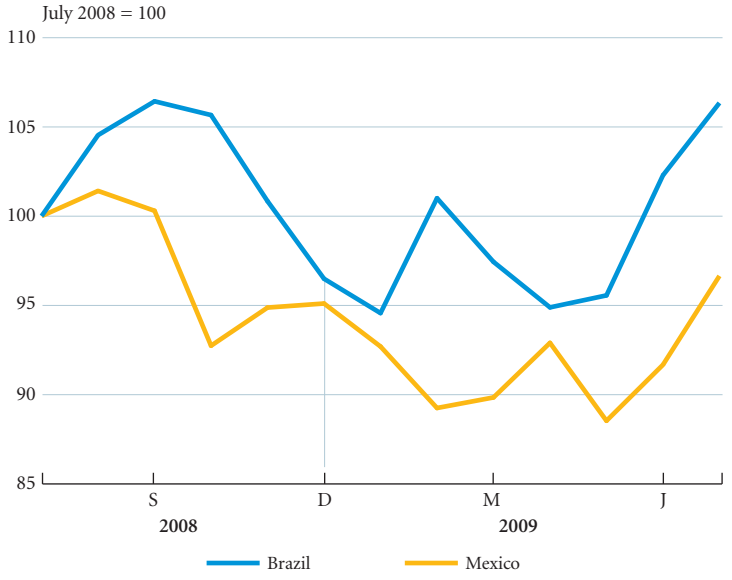
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009		
			3Q	4Q	1Q	2Q	July
Real GDP	3.3	1.4	1.5	–1.7	–8.4	–9.7	–
Industrial production	2.4	–0.9	–1.4	–4.4	–9.9	–10.2	...
Consumer confidence (*)	104.9	92.2	88.9	83.3	80.1	80.5	85.4
General unemployment rate (**)	3.7	4.0	4.2	4.3	5.0	5.2	6.1
Consumer prices	–22.7	–11.8	5.5	6.2	6.2	6.0	5.4
Trade balance (***)	–10.1	–17.3	–11.9	–17.3	–17.5	–16.0	–16.0
Official Banxico rate (%)	7.00	7.50	8.25	8.25	6.75	4.75	4.50
Mexican pesos to dollar (*)	11.0	10.6	11.0	13.9	14.2	13.2	13.2

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

CONSUMER CONFIDENCE RECOVERS IN BRAZIL AND MOVES UP IN MEXICO

Consumer confidence index



SOURCE: INEGI, Banco Central do Brasil and own calculations.

On the supply side, industrial production continues to be tied to the fortunes of the manufacturing sector in the United States and showed a drop of 11.3% year-on-year in June, a two-digit figure for the second consecutive month. At the same time, unemployment reached 6.1% in July, its highest level in 13 years.

In spite of this, purchasing manager sentiment livened slightly that same month. If this continues, it usually anticipates an improvement in the level of economic activity.

Also in July, in view of the general situation, Banxico not only reduced the reference rate to 4.5% but also its economic forecasts for 2009. It is expecting a drop in GDP between 6.5% and 7.5%. In any case, if the relative improvement in the US economy and domestic economic sentiment is consolidated, it is likely that growth will return at the end of 2009 and along with it the start of a round of increases in official interest rates in order to halt possible inflationary pressures.

Industrial production in «free fall» and hopes put on fourth quarter.

Oil and metals continue to rise

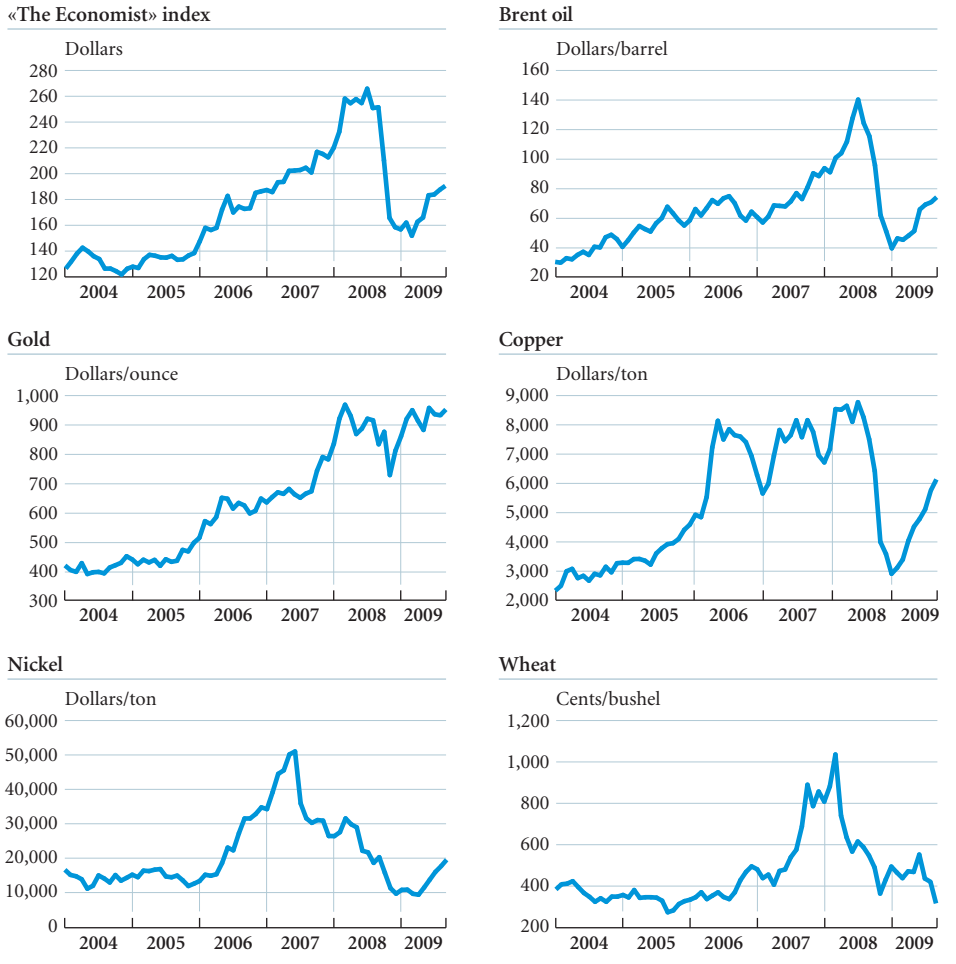
The price of oil has risen again although less sharply than the month before. Between July 20 and August 21 crude oil moved up 12.4% going to 73.91 dollars a barrel (one-month forward price for Brent quality). Following this new upward move, the cumulative rise this year amounts to 89.1%, although it is still below the level one year ago.

Oil prices again rising with cumulative increase of 89%.

The price of oil went up thanks to the expansionist policy of the Federal Reserve and demand from emerging economies, especially China and its Asian neighbours. In the case of China, record imports in June and July meant that the total for the first seven months of 2009 rose by 5.8% year-on-year in

Crude oil price supported by lax monetary policies and strength of emerging economies.

TREND IN VARIOUS COMMODITIES (*)



NOTES: (*) Figures for last day of month (last date August 21).
SOURCE: «The Economist», Thomson Reuters Datastream and own calculations.

Commodities continue to rise but base metals should ease upward drive.

volume. On top of these upward factors, July brought an unexpected drop in the level of inventories.

Commodity prices followed in the wake of oil. *The Economist* commodity index rose by 6.3% between July 20 and August 21, an increase of 22.0% this current year.

Gold continued its increases, foods kept correcting downward and base metals stayed on the rise. Copper has gained a total of 111.4% this year while aluminium and nickel have also shown considerable advances. These gains come from the source as that of oil although, in the case of base metals, some moderation in the increases may be expected. The recovery of industrial activity should facilitate an increase in output of scrap metal which makes up an important supply of base metals, thus reducing the need to maintain the import boom seen in the first half of the year.

EUROPEAN UNION

Euro Area: notes of recovery

In the *Monthly Report* for July-August we indicated that the Euro Area economy had notably reduced its rate of contraction. In any case, the growth figures for gross domestic product (GDP) in the second quarter surprised even the most optimistic. In the first quarter this figure showed a drop of 2.5% compared with the previous quarter, while in the second quarter it dropped by only 0.1%. The return to positive figures could be close but this will depend on the strength of those factors driving the change in trend. This is precisely what we shall try to clarify.

To determine the factors that have made the change in trend possible we must examine the most frequent statistics seeing that we do not yet have breakdowns by component and sector. In any case, the indirect information obtained from these is usually fairly reliable. The foreign sector is the main factor to explain the good growth results of the Euro Area economy. As may be seen from the graph on the next page, the trade balance in the second quarter clearly recovered positive terrain. This was the result of a modest recovery of exports which, following the drop of 18% in the first quarter compared with the previous quarter, in the second quarter showed a rise of 1.5%.

Growth figures for second quarter bring pleasant surprise.

EURO AREA: MAIN ECONOMIC INDICATORS

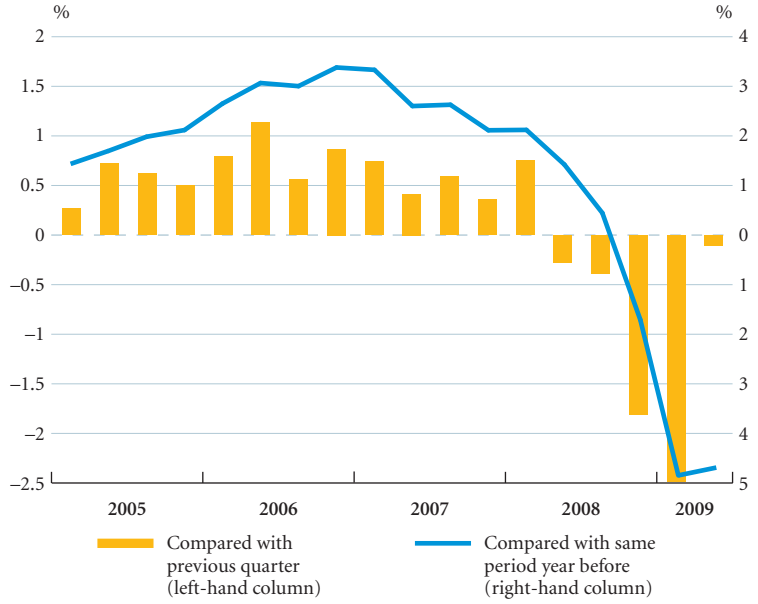
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009		
			3Q	4Q	1Q	2Q	July
GDP	2.7	0.6	0.5	–1.7	–4.9	–4.7	–
Retail sales	1.4	–0.7	–1.0	–1.9	–3.2	–2.4	...
Consumer confidence (1)	–4.9	–18.0	–19.1	–27.1	–32.5	–27.9	–23.0
Industrial production	3.5	–1.7	–1.5	–9.0	–18.4	–18.6	...
Economic sentiment indicator (1)	108.9	91.1	89.9	75.6	65.7	70.2	76.0
Unemployment rate (2)	7.4	7.5	7.6	8.0	8.8	9.3	...
Consumer prices	2.1	3.3	3.8	2.3	1.0	0.2	–0.7
Trade balance (3)	20.1	–1.2	–11.4	–31.7	–35.3	–29.8	...
3-month Euribor interest rate	4.3	4.6	5.0	4.2	2.0	1.3	1.1
Nominal effective euro exchange rate (4)	107.9	113.0	114.0	109.1	111.9	113.2	113.8

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

GROWTH SHOWS SURPRISINGLY GOOD RESULT

Change in gross domestic product in real terms



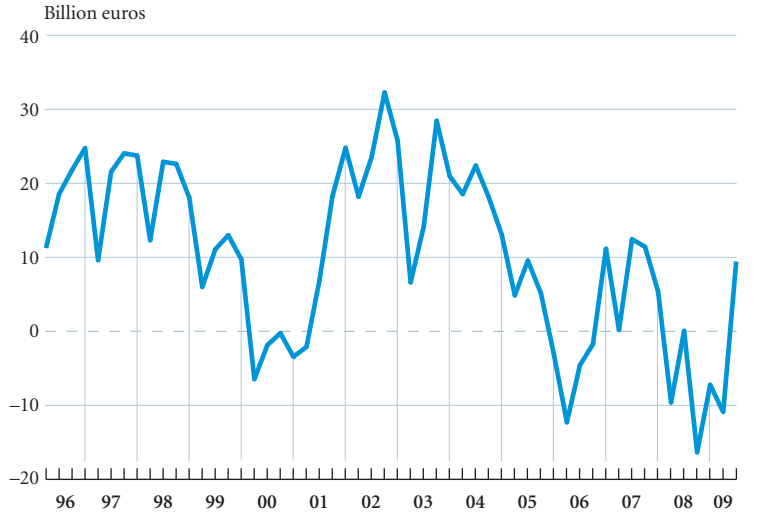
SOURCE: Eurostat and own calculations.

Foreign sector one of main sources of change in trend.

Furthermore, imports that had also dropped sharply in the first quarter were down 5% in the second quarter. This would likely have meant that the net contribution of the foreign sector to growth was positive.

TRADE BALANCE RECOVERS

Balance of exports less imports



SOURCE: Eurostat and own calculations.

Another factor that could be behind Europe's economic recovery is the effect of programmes to stimulate the economy. As is well-known, one of the sectors that received an important amount of government aid the motor vehicle sector and this showed a spectacular rebound in the second quarter. Car sales have gone from showing historically low levels to values above the historical average in the second quarter of this year (see following graph). In any case, the effects of programmes to stimulate the economy have not been able to revive private consumption in general. Retail sales, for example, are still dropping but at a more moderate rate. Specifically, they went from a drop of 3.2% year-on-year in the first quarter to mark up a drop of 2.4% in the second quarter.

The effect of programmes to stimulate the economy is partly limited by the poor trend in the labour market. The unemployment rate hit 9.4% in June and stands a long way from the 7.2% it reached in March 2008. This puts the number of persons unemployed close to 15 million. In just one year the number of unemployed has gone up by more than 3 million persons. Furthermore, over the short and medium term the prospects are not very favourable seeing that everything indicates that the unemployment rate will continue to rise up until next year.

Economic stimulus programmes help ease drop in consumption.

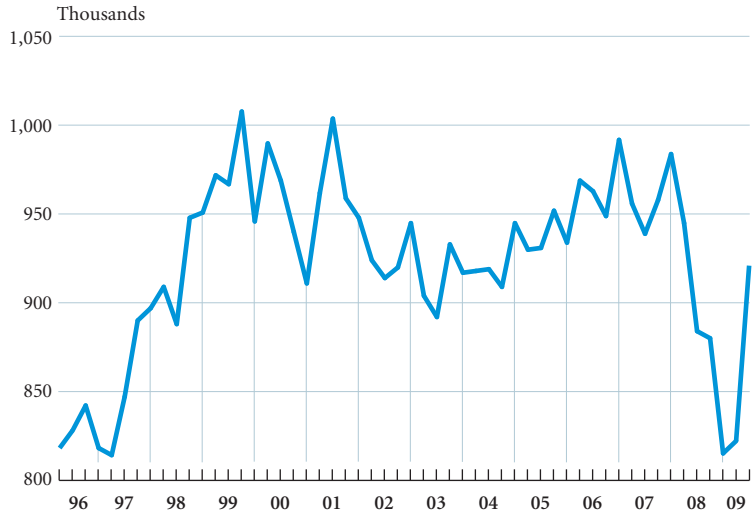
On the supply side, the most frequent indicators are beginning to show a slight change of trend so that it is likely that investment remains very weak. Proof of this is industrial production. In the second quarter this reported a year-on-year drop of 18.6%, two decimals below the figure seen in the first quarter. Utilization of production capacity, which was down to 69.5% in the second quarter, more than a half-point less compared with the first quarter, is one more sign of this.

Another factor to point out is that the improvement is not the same in all

Recovery not equal in all countries.

CARS STEP ON THE ACCELERATOR

Car sales in Euro Area



SOURCE: Eurostat and own calculations.

Inflation drops sharply but could recover in second half-year.

countries. Only France, Germany, Greece and Portugal have showed positive quarter-on-quarter growth rates and all of these have held close to zero. Spain, the Netherlands and Italy stand on the opposite side with drops of 1%, 0.9% and 0.5% respectively.

Having reviewed the various forces driving the European economy, the conclusions are not all that inspiring. The foreign sector seems to have been the main contributor to the change in trend but it is important to underline that this is the result of a drop in imports, reflecting the weakness of domestic demand. Furthermore, it will be difficult for exports to head up a process of rapid recovery seeing that domestic demand in the main developed economies is also very weak. To trust in the recovery of exports through the growth of demand in China, the only large economy that is showing strong growth, is too risky. On the other hand, the effects of programmes to stimulate the economy have helped to halt the drop in consumption but it should be borne in mind that this source of growth is not sustainable over the medium term.

In the face of this none too optimistic scenario, it may be worth noting the trend in economic sentiment indicators. That prepared by the European Commission for July continued to improve for the fourth month in a row. The purchasing managers index (PMI) for which figures for August are now available also continued to advance. Furthermore, this index left behind levels that indicate a contraction of the economy. Those factors driving recovery are not yet strong enough to soon carry us to a growth rate such as existed before the recession. Nevertheless, in the third quarter this rate could stand slightly above zero after being five quarters in the red.

As pointed out in earlier numbers of the *Monthly Report*, the speed with which prices recover remains unknown. In July, the year-on-year change in the consumer price index (CPI) again marked up a sharp drop going to a negative rate of –0.7%, which meant a new all-time low. On the other hand, underlying inflation was down only one decimal and held at 1.3%. This would indicate that the drop in inflation has been mainly due to the decrease in commodity prices. As a result, we can expect that in coming months this figure will go on gradually recovering to the point where it ends the year with rates close to 1%. Nevertheless, uncertainty remains high. On the one hand, a slower than expected recovery in demand could mean lower inflation. On the other hand, however, there is concern about how the European Central Bank (ECB) will withdraw the huge amount of liquidity it has introduced into the markets, something that presents a future inflation risk.

Consolidation of recovery still far off and not without its risks.

To sum up, in the second quarter the Euro Area economy has been on the point of showing positive growth but the consolidation of recovery is still far off and is not without its risks.

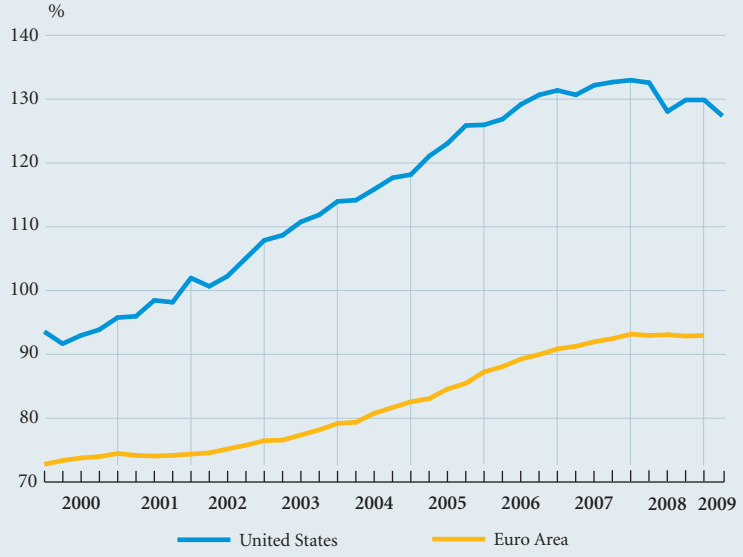
Household debt forces belt tightening

The progressive indebtedness of households has been fundamental for the increase in spending and generally for the growth of the developed economies over the past decade. This is so much so that the financial crisis unleashed in 2008 and the subsequent contraction of the credit market meant a sudden end to the long boom cycle. It remains to be seen how significant the process of deleveraging households becomes and what its final impact on economic growth will be in terms of consumption.

A brief review of what has taken place in recent years may help to clarify the future course of consumption. Between 2002 and 2007, household spending shot up largely due to higher borrowing, a recourse that was made more attractive by low interest rates and the revaluation of assets. As it may be seen in the graph, both US and European households jumped on the borrowing bandwagon thus reaching all-time highs in 2007. In the US case, debt came to represent more than 130% of gross disposable income.

RAPID GROWTH OF HOUSEHOLD DEBT

Credit over gross disposable income of households



SOURCE: European Central Bank and Federal Reserve.

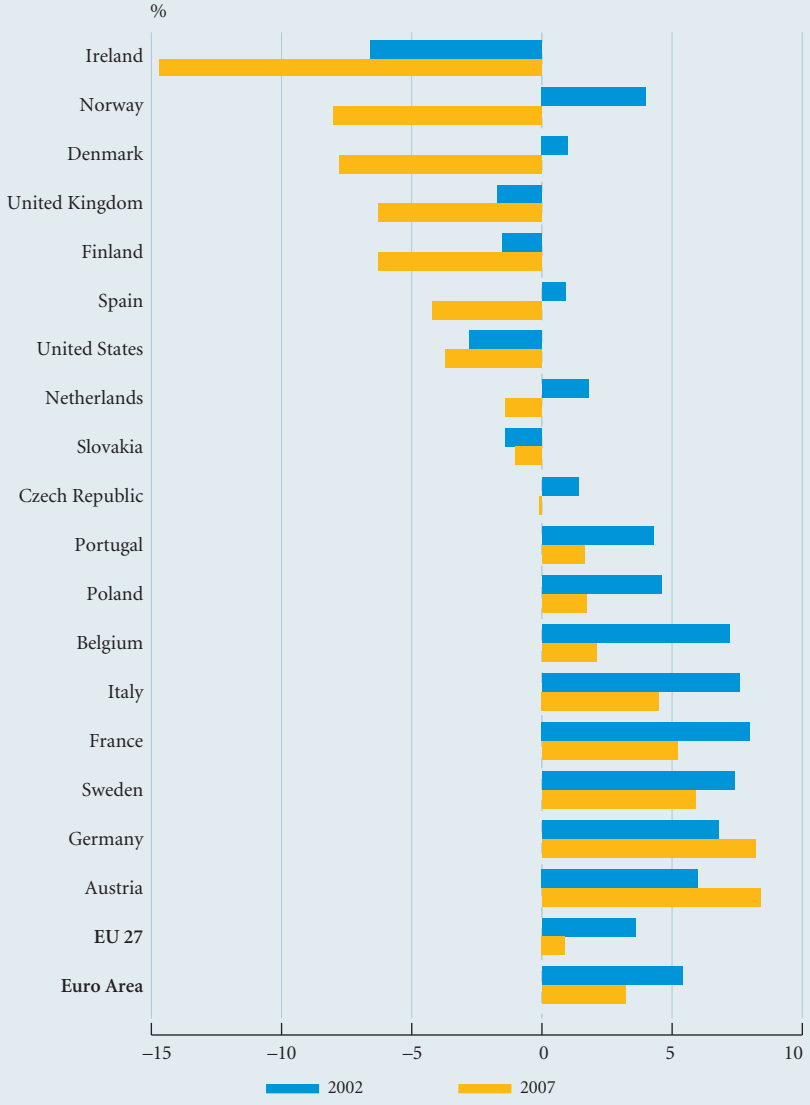
While the heavy indebtedness of households and the reduction in savings rate seemed sustainable in a favourable economic situation, the fact is that they significantly increased the vulnerability of households in the case of an eventual contraction in the price of assets and a rise in interest rates. Unfortunately, these risks became a reality with the outbreak of the financial crisis. In 2008, the value of household assets showed a drastic drop. On the one hand, the value of housing real estate suffered a substantial reduction, especially in those countries where it had recorded major increases. In addition, the trend in the stock markets since mid-2007 to the first quarter of 2009 (with a drop of close to 50% in the Standard & Poor's index) brought about a

sharp depreciation of household financial assets with reductions of 19.3% in the United States, 8.2% in the Euro Area and 10.2% in Japan in this period.

In view of the rapid drop in wealth and increasing uncertainty as a result of the world economic contraction, households have again moved toward savings which, in the first quarter of 2009, returned to levels similar to those seen in 2004, both in the United States and in the Euro Area. Furthermore, the composition of household financial portfolios has also changed. Safer and more liquid assets have gained in weight to the detriment of those that are more subject to risk.

FINANCIAL POSITION OF HOUSEHOLDS HAS WORSENED

(Savings-investment) as proportion of gross disposable incomes of households

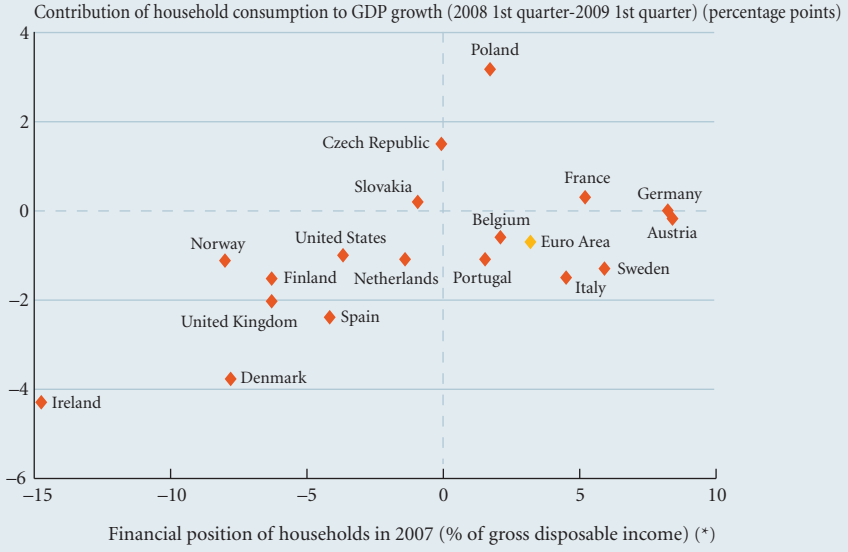


SOURCE: Eurostat.

While progressive borrowing by households has been common among the advanced economies, we should point out the differences that exist among them. As a result of these differences, the future behaviour of private consumption and its impact on growth may also vary between countries.

To begin with, the financial position of households (the difference between savings and investment) provides a clear example of those divergences. Keeping in mind that a negative value implies a financial deficit in households, covered by the other sectors of the economy or by foreign sources, previous graph shows how, in nearly all countries in the sample, households increased their financial dependence between 2002 and 2007. This was due to both a lower savings rate and a substantial growth of investment. Only German and Austrian households held apart from this drop thanks to the increase in their savings during this period. On the other hand, the households of those countries that, in the first half of the decade, had recorded a bigger increase in home real estate prices and residential investment showed a substantial deficit. For this reason, they were more exposed to increases in interest rates or the tightening of lending terms.

FINANCIAL WEAKNESS OF HOUSEHOLDS AFFECTS ECONOMIC GROWTH



NOTES: (*) Savings-investment.
SOURCE: Eurostat and own calculations.

Secondly, the uneven composition of household wealth in one or another country also creates divergences in the evolution of their respective private consumption figures. For example, in 2007 households in the United States and Japan showed a weight in financial wealth in relation to real estate wealth that was considerably higher than that in the United Kingdom and the Euro Area. Therefore, taking into account the recent stabilization of the stock markets and a delayed recovery in real estate asset prices due to greater inertia, everything would indicate that the recovery of household consumption in the Euro Area and the United Kingdom could be slower.

The figures confirm the suspicion that the differences in financial position of households at the beginning of the downturn period has shown up as different trends in consumption and savings and, therefore, the impact of the crisis on the real economy will also be varied. In the previous graph we see how those countries showing a worse financial position in 2007 have had to reduce consumption and hence increase their savings rate over the past year, clearly decreasing its contribution to GDP growth. In addition, those economies that have suffered a bigger depreciation of real estate assets over the past two years are also those that have most reduced private consumption. This is the case in countries such as Ireland, Denmark, Spain and United Kingdom.

In conclusion, deleveraging and a return of households to saving has meant a major drop in private consumption in most of the advanced economies, mainly those with higher household indebtedness, with a negative impact on growth. Given the size of this indebtedness, it is to be expected that this trend will continue over the short and medium term so that in coming years consumption will not be able to take on the same importance it has had in the past growth cycle.

This box was prepared by Joan Daniel Pina
European Economy Department, "la Caixa" Research Department

Germany: end of the recession?

German GDP growing after four quarters with consecutive drops.

Against all predictions, Germany's economy grew by 0.3% between April and June 2009 compared with the previous quarter, thus leaving behind four quarters with decreases in a row. As a result, year-on-year contraction was reduced by eight percentage points to 5.9%. This figure diverges from the German government's forecast which, in spite of foreseeing some easing in the rate of economic contraction, did not expect a growth scenario until the second half of the year and thus foretelling the worsening of the economy in 2009 at 6.0%.

Foreign sector and private consumption leading this recovery.

We may ask what made it possible for the German economy to develop so favourably. In spite of not having a breakdown of the GDP, everything points to the foreign sector and, to a lesser extent, to private consumption as the main factors responsible for this recovery, compensating for the weakness in investment and the reduction in inventories during this period.

The improvement in the foreign trade balance in the second quarter of 2009 was notable following the low figure obtained in March. This recovery came about in a context of trade contraction in which both exports and imports recorded year-on-year drops of close to 20% putting the figures at levels similar to those in 2005. Nevertheless, for the first time since 2007 we note that recovery has been faster in exports than in imports, thanks to trade with countries such as China and the lower drop in demand from the countries in the Euro Area, the latter being its main trading partners.

Notable increase in passenger car sales.

Private consumption also recorded a slight improvement, helped by the stagnation in prices and government programmes to stimulate the economy.

Retail sales in the second quarter thus grew by 5.6% quarter-on-quarter while, thanks to government aids for buying cars, registrations rose by 26.6% in the first seven months of the year. The 0.6% drop in prices in July, the biggest in the past 20 years, and the rise in consumer confidence could indicate a slight recovery in domestic demand which, however, still stands far from levels one year ago.

In turn, supply has left behind the historic decreases recorded the previous quarter. There was notable growth of 5.0% quarter-on-quarter in industrial orders with a reduction in the year-on-year drop to 32.1%. As opposed to these figures, industrial production continued to drop in the second quarter although at a lower rate, thus reflecting the adaptation of industrial inventories to the new economic situation. As a result, utilization of production capacity in this period hit a new low thus indicating a further drop in investment. Nevertheless, latest figures show a slight increase in this variable in July, coming from the motor vehicle sector, and a further increase in industrial confidence.

First signs of recovery in supply now appearing.

The improvement in the foreign sector and the rise in domestic demand may continue to contribute favourably to economic recovery in the second half of 2009. Nevertheless, in spite of the fact that Germany has stood out for its rapid exit from recessions over the past 50 years, there are reasonable doubts about the strength of these two support pillars. As a result, some risks are showing up that could mean that this time recovery may be slower.

First, the severe recession being felt by most European countries and the deleveraging of households on a world scale, especially in the United States, put a limit on the extent of German exports. Furthermore, the end of fiscal stimulus programmes in these countries in 2010 will not help to maintain foreign demand. In view of this situation, growing demand from China may not be enough to maintain the importance of the foreign sector in Germany's economy.

Some doubt about strength of recovery.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009		
			3Q	4Q	1Q	2Q	July
GDP	2.6	1.0	0.8	–1.8	–6.7	–5.9	–
Retail sales	–3.0	–0.5	0.1	–0.5	–2.7	–1.6	...
Industrial production	5.8	0.0	0.0	–7.5	–19.6	–19.3	...
Industrial activity index (IFO) (*)	106.2	96.8	94.8	86.2	82.6	84.7	87.3
Unemployment rate (**)	9.0	7.8	7.7	7.6	8.0	8.3	8.3
Consumer prices	2.3	2.6	3.1	1.7	0.9	0.3	–0.6
Trade balance (***)	181.5	195.3	196.3	183.0	159.6	138.9	...

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.

Heavy debt could restrict new government's margin for manoeuvre.

Secondly, German household consumption could contract in 2010 due to the end of government supports and the worsening of the labour market which, due to employment adjustment plans *(kurzarbeit)* has not been greatly affected up until now. Furthermore, the contraction of government spending due to heavy borrowing will not push the economy toward its growth potential.

As a result, in spite of the good results for Germany's GDP in the second quarter, the government coming out of the September elections must deal with these risks in the economy over the medium term although with a smaller margin for action in matters of public spending.

French GDP recovers in second quarter of 2009...

France leaves recession behind

In the second quarter of 2009 the French economy grew by 0.3% thus leaving behind four quarters in a row reporting quarter-on-quarter decreases. As a result, the year-on-year reduction in GDP in this period went down by nearly one percentage point to stand at 2.6%. With this increase, France, together with Germany, heads the recovery of the main European economies. Nevertheless, both countries have shown major differences in this period of recession. France's lower dependence on the foreign sector and the strength of domestic demand meant that the contraction in the economy was less sharp than that recorded in Germany.

...thanks to rise in domestic and foreign demand.

A breakdown of the trend in France's GDP into its main components confirms that the recovery has come on the demand side. As a result, strong private consumption recorded further quarter-on-quarter growth of 0.3% boosted by government fiscal stimulus programmes through tax cuts or aid to increase demand as in the case of the programme to replace older cars. Furthermore, the mechanisms for social supports meant stabilization of incomes while the drop in prices aided consumption. In the second quarter this drop stood at 0.2%, which also helped to increase the purchasing power of households.

Exports underwent a surprising turnaround in this period with an increase of 1.0% quarter-on-quarter which, combined with the drop in imports, improved the trade balance.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009		
			3Q	4Q	1Q	2Q	July
GDP	2.3	0.3	0.1	–1.6	–3.4	–2.6	...
Domestic consumption	4.8	–0.6	–0.9	–2.5	–1.0	0.2	...
Industrial production	1.2	–2.5	–2.3	–9.0	–15.9	–15.0	...
Unemployment rate (*)	8.3	7.9	7.9	8.3	8.8	9.3	...
Consumer prices	1.5	2.8	3.3	1.8	0.6	–0.2	–0.7
Trade balance (**)	–33.4	–48.0	–50.6	–54.4	–54.4	–53.2	...

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

Finally, the continuing increase in government spending over the past year played a important role in the recovery of the economy. Only private investment made a negative contribution to the trend in GDP with a drop of 1.0%, a value that shows some easing of the contraction.

A review of the more frequent figures seems to confirm that the recovery will go on over coming months although to a gradual extent. As a result, both consumer confidence and economic sentiment of business executives improved in June and July leaving behind the lows recorded in March. On the other hand, industrial production in June grew for the second month in a row thus reflecting a renovation of France's industrial fabric, which should mean an increase in private investment over the short term.

Nevertheless, there is some fear about the sustainability of this recovery which is supported by a temporary drop in inflation and a fiscal boost whose duration is necessarily limited. Furthermore, the worsening of the unemployment rate in June, now up to 9.4%, has led the Minister of Economy Christine Lagarde to express some prudence about the current situation given that a way out of the recession is not expected until the second half of 2010.

End of recession in France not expected until 2010.

Italian economy showing no clear signs of improvement

As opposed to some European economies, in the second quarter of 2009 Italy's GDP recorded its fifth quarter-on-quarter contraction in a row to show a drop of 6.0% compared with the same period in 2008. Nevertheless, this figure means a slowdown in the worsening of Italy's economy that is expected to continue during the second half of 2009. In spite of there being no breakdown of the various components of the GDP, the monthly figures point to a widespread contraction.

As a result, in spite of the stagnation in prices in July, the lowest inflation rate in the past half-century, domestic demand continues to show no clear signs of improving, recording a drop in retail sales of 2.9% year-on-year in May. Furthermore, figures for economic sentiment are not showing any clear recovery of consumer confidence which, in spite of leaving behind the low figures

Italy's GDP records fifth quarter-on-quarter drop in a row.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009				
			2Q	3Q	4Q	1Q	April	May	June	July
GDP	1.5	–1.0	–0.3	–1.3	–3.0	–6.0	–	–6.0	–	–
Retail sales	1.3	–0.3	–0.7	0.1	–1.7	–2.9	–0.2	–2.9	...	...
Industrial production	2.2	–3.4	0.0	–3.9	–10.6	–21.0	–24.5	–21.9	–22.9	...
Unemployment rate (*)	6.2	6.7	6.7	6.8	7.0	7.3	–	...	–	–
Consumer prices	1.8	3.3	3.6	4.0	2.8	1.5	1.2	0.9	0.5	0.0
Trade balance (**)	–12.8	–10.0	–8.6	–10.8	–12.3	–11.1	–10.0	–8.8	...	...

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

Industrial production in Italy still showing no signs of life.

reached in March, are holding at very low levels largely due to the uncertainty hanging over the labour market. Foreign demand is also showing signs of weakness with a contraction of 27.0% compared with the same month last year.

The weakness in demand brought about a further reduction in industrial production in June with a year-on-year drop of 22.9% thus reflecting the process of reduction of inventories taking place in Italian industry at this time. Industrial orders in July show the maintenance of this trend with a reduction of 63.8% year-on-year.

Debt growing rapidly.

In view of this situation, Italy's cumulative government debt as of July rose by more than twice that for the same period last year due to the fiscal stimulus measures introduced by the government and lower tax collections. This figure is in line with government forecasts for 2009 which foresee a deficit equivalent to 5.9% of GDP at the end of the year. The forecasts also indicate a maximum debt level of 118.6% in 2010 which will be difficult to correct due to the endemic weakness of the Italian economy, the already high tax levels, the burden involving current debt and political resistance to any cut in public spending.

Poor growth figure in second quarter, especially compared with Germany and France.

United Kingdom stays out of European recovery

Growth in the United Kingdom in the second quarter presented an unpleasant surprise both because of the figure itself and the fact that it was so much in contrast to the higher positive growth of reference economies such as Germany and France. Whereas most economists were predicting a year-on-year decrease of around 5%, the figures showed a drop of 5.6%, equivalent to a quarter-on-quarter drop of 0.8%. Among the countries of the Old Continent, leaving aside the emerging economies of Eastern Europe, only Spain and the Netherlands showed worse quarter-on-quarter decreases than the United Kingdom. The contrast, however, is especially notable when we compare the United Kingdom with Germany and France, two countries

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
GDP	2.6	0.7	0.5	–1.8	–4.9	–5.6	–	...
Retail sales	4.2	2.7	1.3	1.8	0.5	1.2	3.3	...
Industrial production	0.3	–3.1	–3.1	–8.1	–12.5	–11.8	...	...
Unemployment rate (*)	2.7	2.8	2.8	3.4	4.2	4.7	4.9	...
Consumer prices	2.3	3.6	4.9	3.9	3.0	2.1	1.7	...
Trade balance (**)	–83.1	–93.3	–94.9	–93.6	–91.3	–87.8	...	...
3-month Libor interest rate	5.3	6.0	5.9	6.3	2.8	1.6	1.2	0.9
Nominal effective pound exchange rate (***)	103.9	97.6	92.8	89.4	73.7	76.9	83.5	84.2

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.

where the GDP in the second quarter grew by 0.3% quarter-on-quarter.

Nevertheless, these bleak figures may represent the low point in the current cycle. Since the end of the second quarter we have begun to see improvements in nearly all areas of economic activity. On the demand side, retail sales marked up two months in a row (June and July) with growth of more than 3% year-on-year, which could be indicative of some recovery in household spending. The fact that in those two months consumer confidence rose by more than four points would suggest that the better tone in consumption could extend into coming months. In any case, while the labour market still fails to leave behind its current tendency to grow worse (in July the unemployment rate rose by one decimal to 4.9%), households will find themselves without any clear support.

Supply indicators also are showing signs of a change in trend. Industrial production in June added its third month in a row showing a reduction in the rate of year-on-year drop (although the June levels were 11% lower than those one year earlier). Services, in turn, may be at the threshold of a recovery of some significance, as suggested by the notable boost in sector confidence which stood at levels 30 points above those for last March when it marked up an all-time low.

These incipient signs of recovery help to explain why at the beginning of August the Bank of England decided to limit its programme of acquiring government bonds to a further increase of 50 billion pounds sterling as against the position of the governor Mervyn King and another two members of the Monetary Policy Committee for it to go to 75 billion pounds. In this first monetary policy decision without full consensus since February this year the arguments for prudence at the threshold of recovery carried more weight than the beginning of any new rise in inflation. It should be remembered that, even in the worst recession since World War II, inflation continues at 1.7% year-on-year (July figure) in open contrast to the deflation operating in most European countries.

Recovery could take shape in third quarter.

Emerging Europe: it's better but is it doing well?

The rate of economic activity is beginning to recover in Emerging Europe. As this is an area where manufactured exports, especially automotive exports, hold significant weight at a time when their main destination (the Euro Area) has returned to growth, industrial production and exports have begun to leave the road of sharp collapse seen in previous months. This change shows up more clearly in indicators for the third quarter although some variables have already begun to point to a change in trend in the second quarter.

Bank of England avoiding extremely easy monetary policy positions.

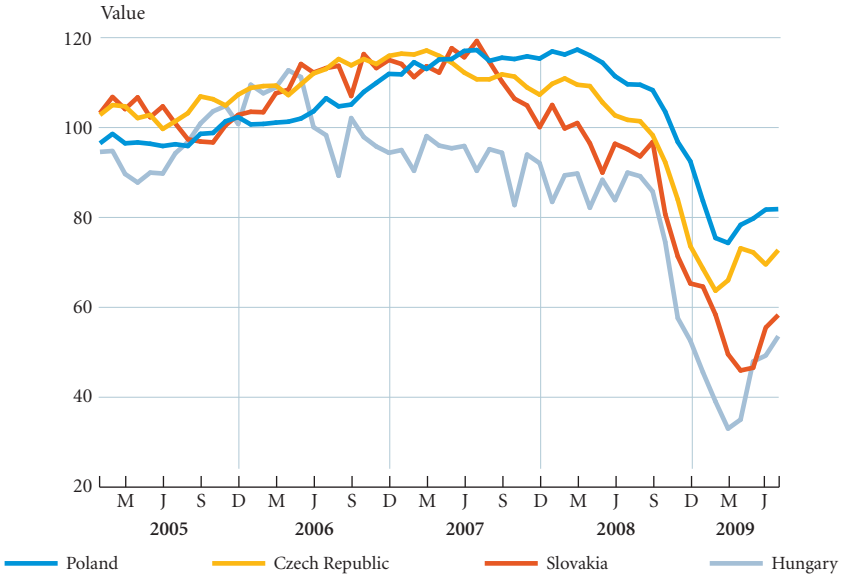
The improved state of the international picture, however, is unevenly reflected in the region. It is benefiting those countries whose macroeconomic imbalances were more contained, such as Poland, Czech Republic and Slovakia (the latter being in the Euro Area). On the other hand, the Baltic countries, Hungary and Romania are still immersed in a process of sharp domestic adjustment aimed at correcting the excess borrowing, discretional public spending and international financial dependence seen in recent years.

In this respect, it is illustrative to compare the situation in the Czech Republic with that in Hungary. In both

Improvement in Euro Area coming from exports...

RECOVERY IN THE MAKING

Economic sentiment index



SOURCE: European Commission.

...helping recovery in Poland, Czech Republic and Slovakia.

cases, the weight of exports in the gross domestic product (GDP) is similar of the order of 80%. Because of this the recovery in the Euro Area helped to reduce the year-on-year rate of decrease in exports in May and June (latest figures for decrease are of the order of 30% year-on-year, some 10 percentage points less than in earlier months). This, along with the sharp downward adjustment in imports, has meant an increase in the trade surplus.

Nevertheless, preliminary figures for the second quarter indicate that, as against positive quarter-on-quarter growth in the Czech Republic (increase of 0.3%), Hungary underwent a further drop of 2.1% in GDP compared with the previous quarter. Without a breakdown of components of national accounting for the second quarter, available indicators suggest that the tendencies shown in the first quarter have been maintained in the April-June period. In the Hungarian economy, private and public consumption and investment are contracting sharply whereas in the Czech Republic private consumption has not dropped and investment has done so to a lesser extent. It is the domestic reflection of the economic adjustment effort being carried out in Hungary, that is taking its clearest shape in the reduction of public spending, which, if carried out as planned, will reach a figure equal to 3% of GDP in 2010.

Various countries continue making necessary economic adjustments thus slowing their coming out of recession.

Beyond the current situation, what may be said of the short and medium term prospects of the region? Up to the end of 2009 we may expect that the improvement in the international sphere will continue to aid economic activity. In particular, in the third quarter it is likely we shall see a clear recovery of industrial production and exports of manufactured goods, which will lead to a further increase in trade surpluses. The build-up of trade surpluses, along with the reduction in international payments in dividends and increased transfers

from the European Union, is bringing about a rapid readjustment of current account imbalances, thus reducing regional dependence on international financing.

Nevertheless, a continuation of these two positive trends could have its problems. To begin with, the sustainability of recovery in Germany and the main economies of the Euro Area is not without its doubts. If consumption and investment in the Euro Area do not take off strongly, it is possible that at the beginning of 2010 the industrial recovery cycle will loose steam. But, even given a fair scenario with the consolidation of growth, the negative counterpart could be a further worsening of balances of payments in the region unless domestic demand recovers.

Other risks existing in Emerging Europe relate to the possibility of regional «contagion», to the situation of the banking system and political instability and its consequences for economic policy. With regard to the first of these risks, while it seems that decided measures taken by international bodies, particularly the International Monetary Fund and the EU, have served to ensure that the markets discriminate more clearly between the various countries, we cannot discount the possibility that a local event could again sharpen risk aversion in the region as a whole. In this respect, if finally speculative pressure were to cause the devaluation of the Latvian lat, this could act as the detonator of a process of «contagion».

Recovery will depend on how Euro Area consolidates the end of its recession.

The second of these risks, that linked to the international bank situation, seems to have lost part of its strength in recent times. Nevertheless, the restriction of credit remains appreciable and there are still notable doubts about the consequences the crisis could end up having on subsidiaries in Emerging Europe of the large banks operating in the region.

Bank risk seems to have eased in recent months.

Finally, the degree of political commitment to policies of macroeconomic stability is uncertain. For the moment, three governments (those of Hungary, Latvia and Czech Republic) have fallen or undergone major changes in make-up. All of these factors put these countries in a pre-electoral period and could make options of a more populist orientation more attractive. Furthermore, as growth begins to show up more strongly, probably toward mid-2010, this could be a time when they should begin to seriously face up to reducing the growing public deficits reached in the most difficult stage of the crisis and begin to turn around the easy monetary policies they have been following up until this summer. To sum up, the region has improved its balance of short-term risks but at the price of moving some of them to 2010.

Concern remains about political risk of some governments.

FINANCIAL MARKETS

Monetary and capital markets

Central bank in United Kingdom pessimistic about weakness of financial sector and extends its programme of buying financial assets.

How and when to end easy monetary policies

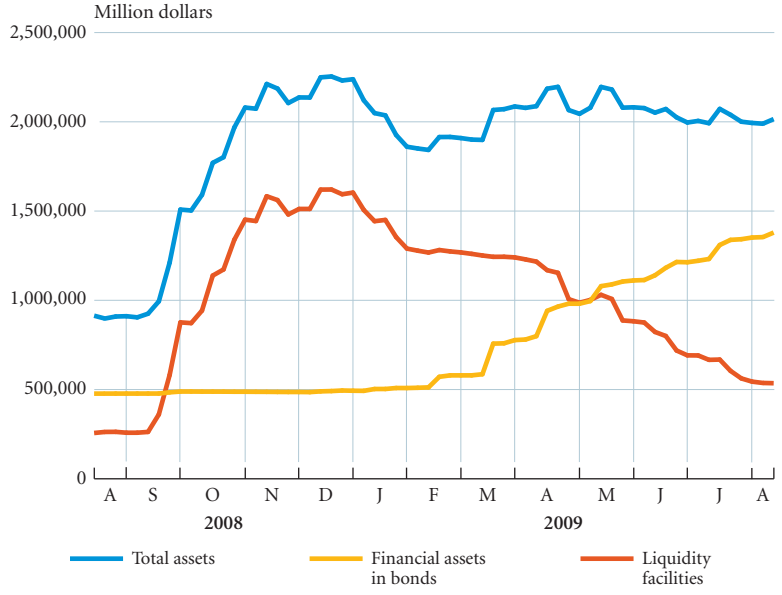
The Bank of England published its periodical report on inflation on August 12. At the time, governor Mervyn King stated that inflation in the United Kingdom could drop below 1%. The British central bank's objective is inflation of 2% within a range of 1% and 3%. King indicated that the financial system in the United Kingdom remained in a very delicate situation and, furthermore, that the banks would need several years to repair the damage caused in their balance sheets by the financial crisis. He even stated that the banks had to be aware that they will need more capital.

In view of a low inflation level and uncertain recovery, the central bank decided to extend its programme of buying assets for an amount of 50 billion pounds to reach a total figure of 175 billion pounds. The bank was aware, however, that over the medium term this extraordinary policy of monetary stimulus would have to be withdrawn. According to the central bank, it will be the level of inflation that will show the normalization of monetary policy in the United Kingdom. The central bank's analysis, however, suggests that this will not happen at least for several more quarters.

Precisely, the stabilization of some economies and the upward revision of

BOND ASSETS GAIN WEIGHT IN FED BALANCE SHEET

Federal Reserve balance sheet



SOURCE: Federal Reserve.

growth forecasts by various international bodies have obliged the central banks to reflect on their strategies and the final timing of the easy monetary policies now being applied.

In this respect, Ben Bernanke, governor of the Federal Reserve, published an article in the financial press titled «The Fed's Exit Strategy». He argued for the need to maintain the present monetary policy for an extended period of time. In addition, he indicated that the Fed's strategy was closely linked to its balance sheet. He considered that the central bank had two tools to be able to tighten monetary policy. The first was to pay an interest rate on the reserves the commercial banks had on deposit at the Fed and, secondly, to reduce available reserves. Payment of an interest rate on the deposits the commercial banks had available in the central bank would set a floor on short-term interest rates in the United States. As a result, the banks would not be willing to lend to each other at an interest rate lower than what they could obtain on their reserves at the central bank without risk.

At the monetary policy meeting held on August 12, the Fed decided to maintain the official rate in the range between 0%-0.25%. While it confirmed the existence of signs of stabilization in the economy, it foresaw maintenance of this interest level for an extended period of time. Due to the improved situation and to foster

Fed governor publishes article on strategy for putting end to present expansionist monetary policy.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro Area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2008									
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	0.86	2.00	2.77	0.75
2009									
January	2.00	2.09	2.27	0.25	1.18	0.67	1.50	2.17	0.70
February	2.00	1.83	2.03	0.25	1.26	0.63	1.00	2.05	0.75
March	1.50	1.52	1.81	0.25	1.19	0.60	0.50	1.65	0.63
April	1.25	1.37	1.73	0.25	1.02	0.55	0.50	1.45	0.66
May	1.00	1.27	1.63	0.25	0.66	0.52	0.50	1.28	0.60
June	1.00	1.10	1.50	0.25	0.60	0.46	0.50	1.19	0.33
July	1.00	0.89	1.36	0.25	0.48	0.41	0.50	0.89	0.41
August (1)	1.00	0.82	1.30	0.25	0.35	0.39	0.50	0.69	0.30

NOTES: (1) August 31.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

ECB maintains reference rate at 1% but notes improvement in flow of credit granted to households.

a gradual transition in the markets, it announced an easing of its programme of buying Treasury bonds which it expected to finalize at the end of October.

At the meeting of the Governing Council on August 6, the European Central Bank (ECB) decided to maintain the reference rate at 1%. Even taking into account the delayed negative effects of a foreseeable increase in unemployment in the Euro Area as a whole, it considered the present level correct. At the following press conference, ECB chairman Jean-Claude Trichet explained that the flow of credit to small and medium-sized companies was going down but that, on the other hand, credit granted to households had recovered compared with the month before.

ECB monthly report states that world recession has hit bottom.

Furthermore, Trichet announced that at the next meeting in September he would present the new forecasts by the ECB economists. These could be revised slightly upward although he very carefully avoided quantify the changes. Nevertheless, he reminded everyone that in any case there would still be a high level of uncertainty about the future course of the economy during which he did not discount ups and downs. In its monthly report for August the ECB announced that, in its opinion, the world recession had hit bottom and that the rate of contraction was clearly easing. Publication of positive growth figures in France and Germany in the second quarter confirmed the position taken by the ECB.

Massive liquidity injections allow interbank market rate to continue downward trend.

In monetary markets, the strong moves taken by the central banks in injecting liquidity have led to all-time lows in reference levels. The 3-month Euribor rate, for example, went to 0.82% while the 12-month Euribor showed 1.30% at the end of August. The same thing happened in the United States, Japan, United Kingdom and Switzerland.

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								
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	3.59	3.95	4.29	4.48	3.46	1.49	3.75	2.41
June	3.39	3.73	4.13	4.43	3.53	1.36	3.69	2.32
July	3.30	3.57	3.85	4.16	3.48	1.42	3.80	1.97
August (*)	3.26	3.70	3.94	4.21	3.40	1.31	3.56	2.03

NOTES: (*) August 31.
SOURCE: Bloomberg.

From now on, it will be difficult for the speed of the drop in interest rates seen in recent months to be maintained. The desire of the central banks to maintain reference rates low for a long time, however, in order to support recovery would indicate that interest rates in the interbank market will stay close to present levels over coming months.

The trend in interest rates in the long-term government bond market has been quite different. In August, interest rates offered on long-term government bonds in most countries have increased. But this has not been because of an increase in inflationary risk because inflation prospects are firmly anchored, as has been recognized by various central banks in their monthly reports.

In fact, this movement should mean a substantial improvement in economic prospects. Certainly, the programmes of the central banks for buying government bonds have prevented that movement from being sharper. While it would be logical to maintain the tendency toward a slight increase with year-end government debt showing higher interest rates, they could not be substantially higher than present levels given that the consensus of economic opinion is expecting a slow feeble recovery.

On the other hand, improved economic prospects push up interest rates on long-term government bonds.

Exchange rates: stability seen in recent months continues

Following the sharp movements in foreign exchange markets since the beginning of the financial crisis in August 2007, the more important currencies have shown great stability in recent months. The exchange rate between the euro and the dollar, for

Stability in quotations for euro, dollar and yen in recent months continues.

EXCHANGE RATES OF MAIN CURRENCIES

August 8, 2009

	Exchange rate	% change (*)		
		Monthly	Over December 2008	Annual
Against US dollar				
Japanese yen	96.4	3.5	5.9	–13.7
Pound sterling	0.603	–2.2	–13.6	11.3
Swiss franc	1.074	–0.8	0.5	–1.0
Canadian dollar	1.084	–6.1	–12.4	2.0
Mexican peso	12.886	–6.4	–6.1	21.2
Against euro				
US dollar	1.427	2.1	2.1	–4.5
Japanese yen	137.5	5.5	7.9	–18.8
Swiss franc	1.533	1.3	2.6	–5.6
Pound sterling	0.860	–0.1	–11.0	7.3
Swedish krona	10.209	–7.9	–7.2	8.2
Danish krone	7.445	0.0	0.0	–0.2
Polish zloty	4.113	–6.4	–0.9	19.7
Czech crown	25.75	–1.1	–4.3	6.5
Hungarian forint	268.2	–3.0	0.9	11.3

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

Some Asian countries concerned about relative appreciation of their currencies against dollar.

example, has moved within a narrow range of approximately 4% since June. The range has fluctuated between 1.38 and 1.44 dollars to the euro but without any clear direction. In mid-August the euro was running at around 1.42 dollars.

The same thing has happened with the exchange rate between the Japanese yen and the dollar while in this case the range has been wider at around 8% between the maximum and minimum since February this year. At the same time, the dollar was running between 93 and 101 yen. Nor does the graph for this quotation show any clear trend.

On the other hand, some Asian countries (except China) have been concerned about the relative appreciation of their currencies. Among these countries we find South Korea, Indonesia and Malaysia. The reason is the loss of competitiveness this means for their exports, keeping in mind that China has maintained its exchange rate steady at 6.8 yuan to the dollar since July last year.

Stock markets hit new highs

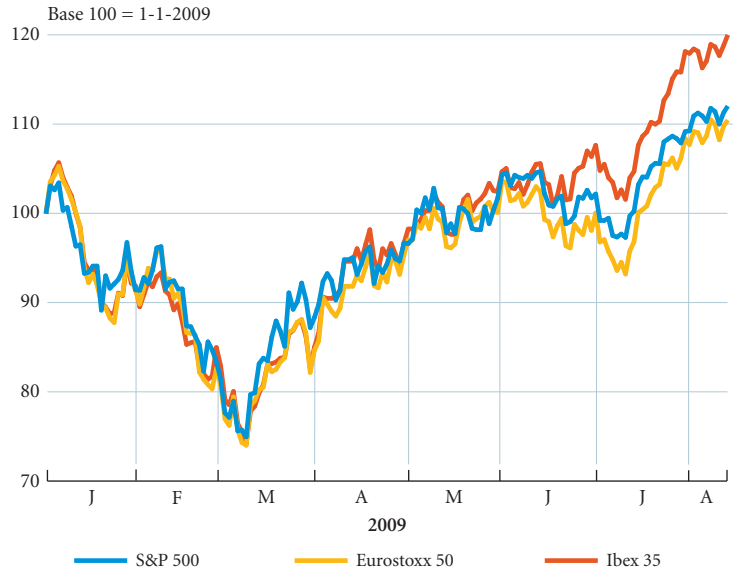
Stock markets gain 50% since lows reached in March.

In July and August share markets showed a good performance, a reflection of an economic scenario of lower risk on a world level. The process of revaluation of stock market indices compared with the lows reached in March continued to the point where it came to levels close to 50% for the S&P 500 and the Eurostoxx 50. Deserving special mention is the extraordinary course of the Ibex 35 which, while gaining a revaluation of more than 60% since March, so far this year has added an increase in value of close to 20%.

The very gradual recovery of early economic indicators, as well as constant expectations of economic recovery, brought about movements adjusting risk

IBEX 35 BEATS ITS COMPETITORS

Main stock market indices



SOURCE: Bloomberg.

premiums as well as the normalization of volatility indicators. The immediate reflection of this was an increase in investor flows from low-risk money market assets to the stock market attracted by better returns. Investors maintained their preferences for the financial sector and for industries undergoing recovery from the economic cycle, such as natural resources and cars.

The continuation of the upswing on the stock markets was brought about, as well as by the economic data for the main economies, by the series of corporate results of listed companies for the second quarter. In addition, the central banks had maintained their commitment to apply unconventional monetary policy measures aimed at boosting the flow of credit to the private sector.

Unconventional monetary policies aiding rise on stock markets...

From the sphere of economic data, in spite of there continuing to exist a wide differential between early indicators of corporate expectations and figures for the real economy, there was a gradual improvement in the latter indicating an economic framework of decreasing weakness. This has been confirmed by early figures for economic activity in the United States and the Euro Area between April and June which show an incipient recovery in industry. Other relevant macroeconomic aspects are the progressive stabilization of the US residential sector. The rise in sales and prices of housing from the lows in the last three decades, along with the drop in mortgage loan rates, is playing a key role in the consolidation of bases for growth. The bittersweet note comes from the US labour market. On the one hand, there

...as in case of economic indicators...

INDICES OF MAIN WORLD STOCK EXCHANGES

August 21, 2009

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*9,350.1*	*4.9*	*6.5*	*–18.2*
Standard & Poor's	*1,007.4*	*5.5*	*11.5*	*–21.2*
Nasdaq	*1,989.2*	*3.8*	*26.1*	*–16.4*
Tokyo	10,238.2	6.1	15.6	–19.7
London	4,760.5	6.2	7.4	–11.4
Euro Area	2,667.6	5.9	9.0	–17.9
Frankfurt	*5,318.0*	*4.4*	*10.6*	*–14.7*
Paris	*3,510.3*	*6.3*	*9.1*	*–18.5*
Amsterdam	*288.9*	*6.7*	*17.5*	*–27.8*
Milan	*21,418.1*	*8.0*	*10.1*	*–22.8*
Madrid	*10,935.4*	*8.0*	*18.9*	*–2.5*
Zurich	6,070.0	7.7	9.7	–13.3
Hong Kong	20,199.0	3.6	40.4	–0.9
Buenos Aires	1,766.9	6.9	63.7	1.2
São Paulo	56,831.5	6.8	51.3	1.6

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.

...corporate results in second quarter brought positive surprise.

has been a moderation in loss of jobs while, on the other hand, the labour force ratio showed its biggest decrease since April 1984.

Another relevant aspect in the rise of the stock markets was the series of corporate results in the second quarter. In the United States, following the surprising first quarter, when companies showed results a lot less weak than expected, the second quarter ended with an even more hopeful result. Out of a total of 500 companies quoted in the S&P, 73% of announcements were better than expected, a result of the good news on discretional consumption, on industry and the financial sector. In the latter group, the large investment banks, after having carried out major capital increases, were able to boost their incomes thanks to an increase in business volume in financial markets and they proceeded to return part of the government aid received some months ago. In Europe results were more modest with the presence of a financial sector very much hurt by the crisis.

Upward trend in stock markets will be confirmed if improvement in real indicators continues.

In coming months, the process of revaluation of share markets will largely be determined by confirmation of the recovery of the world economic and financial scenario. The main factors that will help determine this trend may be summed up as follows: i) the correlation between economic data and early indicators of economic activity; ii) the increase in household consumption of US households, something key for economic growth and thus corporate growth; iii) the trend in the emerging economies with special emphasis on China and iv) the effectiveness of monetary policies of the various central banks on credit markets.

Improvement in credit markets spreading with record drop in financing cost and all-time high in corporate bond issues.

Major improvement in credit markets

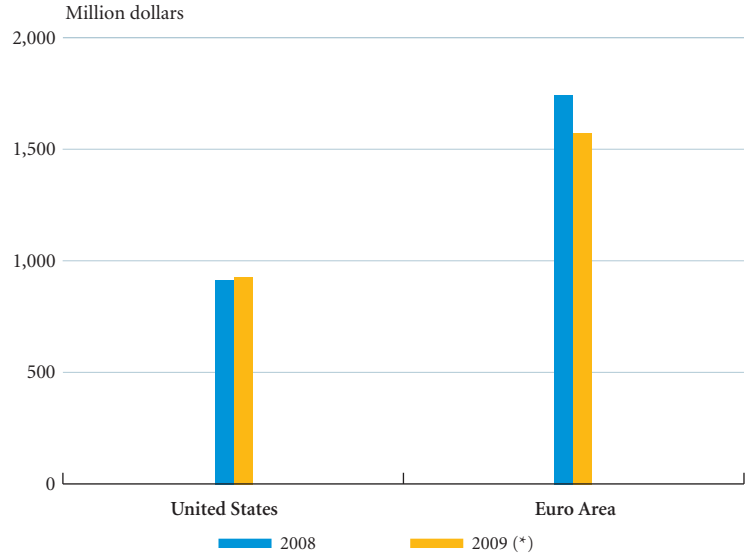
In the past two months credit markets have shown a very positive performance with a reduction in risk premiums to levels before the Lehman Brothers crisis. The improvement began in credit segments of high quality and now has spread to very high risk sectors such as the high-yield bond markets. The reduction of risk premiums has been accompanied by major issues of bonds in an environment in which returns being offered by some corporate bonds stand at very low levels. Companies are taking advantage of this situation to stretch out borrowing maturities. This phenomenon is a trend taking place since before the crisis. In credit markets this is bringing about a continuing substitution of credit or loans with bond issues with average maturities of five years. The improvement in activity in primary markets is now spreading to secondary markets.

It is a notable fact that, in spite of the sparse need for new financing of companies, they are being very active in issuing bonds. This may be due to the bitter experience seen in credit markets in the final quarter of 2008 and the first quarter of this year when the financial system was practically closed and many companies came close to closing down, not because of insolvency but simply because of a lack of liquidity.

Other factors are having an influence in the same direction of increasing borrowing maturities of companies through the issue of corporate bonds: i) central banks are carrying out monetary policy by buying high quality financial assets, this is provoking the need to have a high rating and thus be

GOOD RATE OF PRIVATE BOND ISSUES REFLECTS IMPROVEMENT IN CREDIT MARKETS

Private bond issues



NOTES: (*) From January 1 to August 21.
SOURCE: Bloomberg.

able to benefit from these lines of financing; ii) following the crisis, the rating agencies are being more demanding with solvency and liquidity ratings of companies; iii) commercial banks have been obliged to reduce their credit mass in order to adjust their solvency ratios but, furthermore, the process of disintermediation, especially in US banks, remains intact and everything would seem to indicate that the US financial authorities are betting on its continuation.

Those factors that affect demand for corporate bonds are attractive returns and the solvency offered by many issuers. Furthermore, after two years in which savers have spectacularly increased their preference for liquidity, the volume in investment funds of low risk, that is, invested in government bonds, stand at all-time highs and since April we note an increase in flows toward assets of higher risk whose main instruments are corporate bonds. As an extraordinary factor temporarily putting pressure on demand for these assets is the policy of central banks to buy financial assets which come into competition with private investors and push down interest rates in the markets. A final factor, and perhaps the most determinant over the long term, is that following the crisis there has been an increase in the world level of household savings. This trend has been notable in the United States and in other countries affected by the crisis.

Rating agencies and banks more demanding while companies lengthening average maturity of bonds issued.

While the reduction of risk premiums has been very pronounced since last April, many variables strongly indicate that this trend will continue. The most important is the continuing improvement in the economic indicators and expectations of a recovery in corporate profits. Also over the short term the carrying out of quantitative expansion measures of the central banks will be positive. However, this factor

Most relevant variables pushing up credit markets in spite of restrictions in China.

Higher levels applied by rating agencies helping positive tone of credit markets.

depends in each country. Whereas in the United Kingdom, the Euro Area and the United States the tendency is to maintain or expand liquidity, in China the process is now the opposite and this is having negative effects in financial markets that are most visible in the stock markets.

The positive trend in credit markets also shows up in the improved credit levels applied by the rating agencies. The main rating agencies, Moody's and S&P, have made public a substantial improvement in credit ratings so far in the third quarter following three consecutive quarters with drastic reductions in corporate ratings.

Normalization of credit markets reaching final stage.

The final stage in the improvement of credit markets is beginning to show up in the reduction of commercial bank requirements in making loans available and in the incipient recovery of demand for credit by companies and households. This is due to the improvement in bank balance sheets and the economic recovery that may now be seen in many countries, something more notable in certain sectors.

Stock markets and saver preferences

The proportion of share in the financial property of households over the years has swung in response to a broad range of factors notable among which are economic prospects and expected return on capital. Situation such as the present with sharp upsets and a high level of uncertainty cause changes in the patterns of financial behaviour of economic agents which, in the case of individuals, shows up as a shift of financial savings in shares toward assets of less risk.

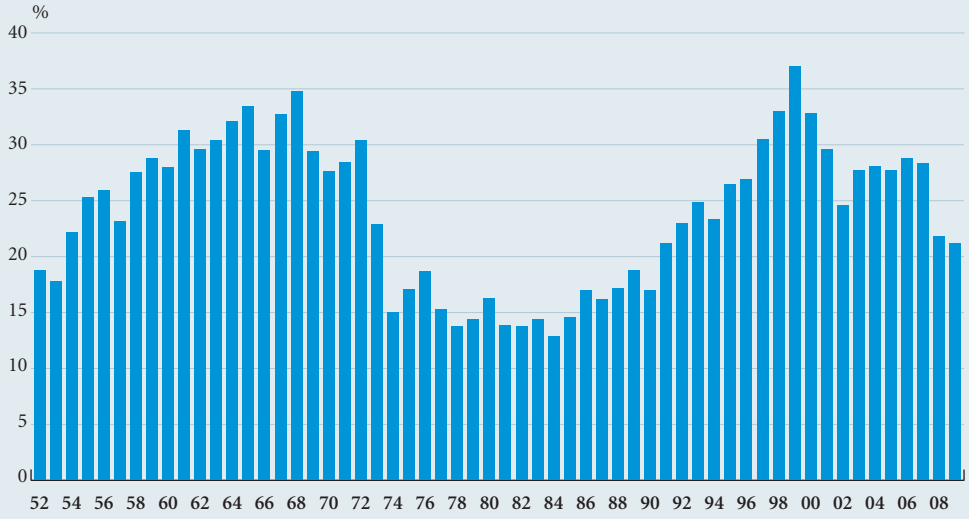
Investing in the stock market is associated with taking risk so that when those risks are felt to be high or are difficult to evaluate the average investor tends to avoid such investments. Furthermore, if there is a stock market crash causing losses in the investment portfolio of individuals, those persons tend to withdraw from investing in shares for some considerable time until the memory of the disaster fades or until the economic prospects substantially improve and new opportunities to obtain high returns show up.

This pattern of behaviour may be seen in the following graph which shows the weight of shares in the financial portfolios of US households although this weighting is also subject to relative swings in prices of the various assets. The energy crisis and recession in the Seventies put a brake on and pushed back the growing volume of share in portfolios which until then had been encouraged by the course of stock market quotations which doubled in the Sixties. In spite of that fact that in the Seventies there was no real stock market crash, the long drawn out economic crisis did nothing to stimulate investment in shares. The drop in disposable income of households and the poor prospects for corporate profits lay behind the fact that the weight of shares in household portfolios went to very low levels. On the other hand, in spite of its severity, the 1987 stock market crash lasted only a short time and did not affect the course of the real economy so that its effects were of short duration. The big rise in shares held by individuals came in the Nineties and reached its peak at the moment when the crisis broke out in high-tech shares. This crash had a sharp impact on the preferences of individuals with regard to risk and, in spite of the fact that in the early years of the current decade the stock markets showed a notably upward course and the economy reached spectacular growth, reticence when it came to

increasing the weight of shares slowed down their advance. The serious crisis set off in 2007 has again cut that weight and, because of its characteristics, it could mean major resistance to increasing shares in household property.

UNITED STATES: HOUSEHOLDS REDUCING STOCK MARKET HOLDINGS

Weight of equity in households assets



SOURCE: Federal Reserve.

In Europe, the behaviour of households as a result of the crisis is not substantially different, if we leave aside the fact that the tendency here is much lower. As may be seen in the following graph, in the case of Spain we also note the effect of the crisis in high-tech shares and, in the case of the current recession, we see a drop in the participation of shares in investment funds held by households to the lowest levels in the past 12 years.

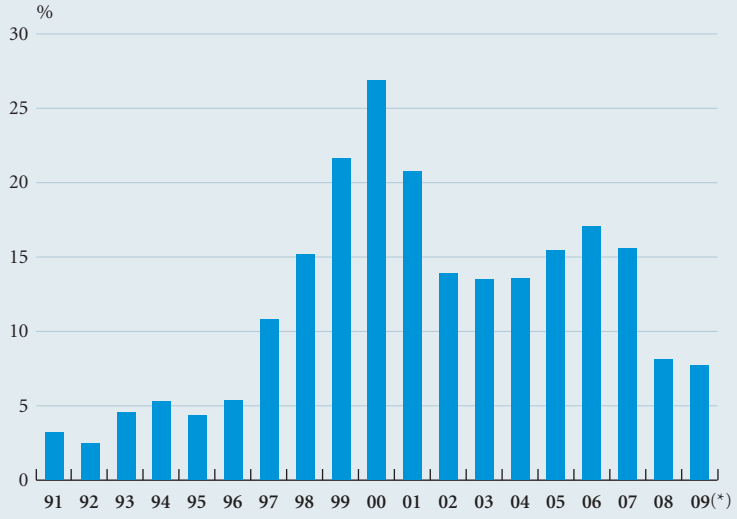
In both economic areas, United States and Europe, there are notable differences in the participation of individual investors in financial markets. The profile of the US investor is historically characterized by maintaining an average proportion of around 20% of shares out of total financial property and, secondly, for establishing a long-term return objective. On the contrary, the European investor does not only show a lower predisposition to maintain a proportion of shares in total savings but has reacted more sharply in view of the crisis by reducing exposure in the stock market by nearly 50% compared with previous years.

What has been the reaction of investors following the world crisis over the past two years? Up until now, behaviour has been that expected in a sharply recessive cycle. In recent months, the publication of more favourable economic figures, along with an easing of volatility, have brought an increase in confidence and tolerance toward risk. This new scenario of recovery, while weak, brought about a change in direction for the Standard & Poor's 500 index in March and in the participation of individual investors. Revaluation of the stock market by nearly 50%, however, has taken place with trading levels lower than the average for the past decade. In spite of this fact and thanks to increasing economic stability, since Spring we note an increase in

willingness of individual investors to take risks. This has made possible a gradual increase in the proportion of household incomes invested in the stock market over the total of capital saved going into investment funds.

SPAIN: INVESTMENT IN SHARES DOWN

Weight of equity in investment funds



NOTES: (*) June.
SOURCE: Inverco.

It is at this time that specific factors of investor behaviour may play a relevant role in boosting the process of participation in risk asset markets. Elements such as the financial experience of investors, improved economic prospects and the easing of risk premiums should contribute over the medium term to an increase in the proportion of savings invested in shares by households. In any case, this development will be slow due to the trauma of savers following the sharp drops on the stock market in the deepest recession since the Great Depression.

This box was prepared by the Financial Markets Department,
"la Caixa" Research Department

SPAIN: OVERALL ANALYSIS

Economic activity

Recession moderating

The increase in the gross domestic product (GDP) in the second quarter given out by the National Institute of Statistics confirmed that the rate of decrease in economic activity eased in the April-June period with an estimated quarter-on-quarter drop of 1.1% as against a revised decrease of 1.6% in the first quarter. This moderation in the recession may be attributed to an improvement in the international economic situation, the impact of the central government's programmes to stimulate the economy and the trend to normalization of financial markets. In any case, the quarter-on-quarter contraction of Spain's economy was substantially higher than that estimated for the Euro Area (0.1%) as opposed to earlier quarters.

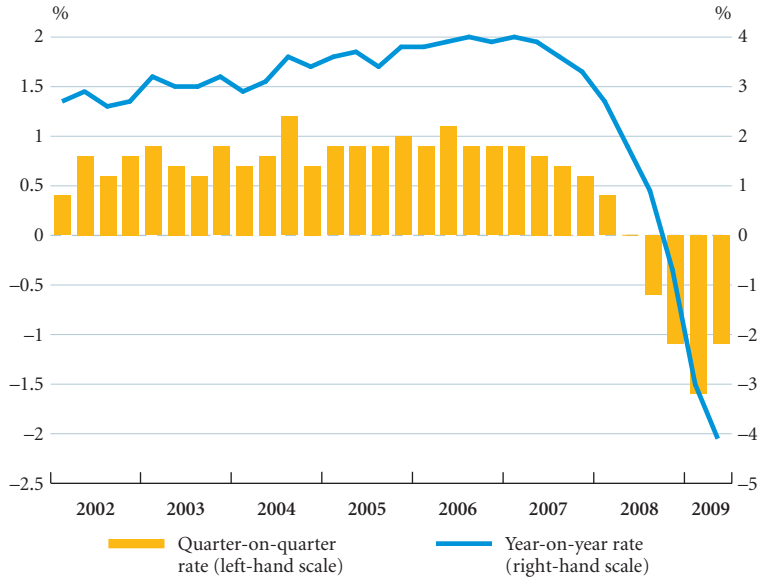
Naturally, the improvement in the quarterly trend was not noted in the year-on-year rate which recorded its biggest drop in recent decades at 4.2% although this was less than in the Euro Area which reported 4.6%. The year-on-year drop in GDP may be explained by the larger negative contribution coming from domestic demand, in spite of the bigger figure from the foreign sector.

With regard to consumption, available indicators point to an easing of the sharp contraction see in recent quarters. The improvement in consumer confidence,

GDP of Spain's economy down 1.1% in second quarter, less than in first quarter but more than in Euro Area.

GROSS DOMESTIC PRODUCT SHOWS LOWER QUARTER-ON-QUARTER DROP

Change in GDP



SOURCE: National Institute of Statistics.

DEMAND INDICATORS

Percentage change over same period year before

	2007	2008	2008			2009				
			2Q	3Q	4Q	1Q	April	May	June	July
Consumption										
Production of consumer goods (*)	1.7	–4.7	–4.4	–4.5	–10.3	–12.6	–11.1	–10.6	–7.0	...
Imports of consumer goods (**)	5.1	–7.7	–6.9	–4.1	–17.2	–9.4	–17.1	–19.8	–7.4	...
Car registrations	–1.2	–28.1	–19.6	–32.5	–46.6	–43.1	–45.6	–38.7	–15.9	–10.9
Credit for consumer durables	10.0	3.6	7.1	3.4	–4.2	–12.0	–	...	–	–
Consumer confidence index (***)	–13.3	–33.8	–30.7	–38.0	–45.3	–44.7	–37.0	–25.0	–22.0	–20.0
Investment										
Capital goods production (*)	4.6	–8.8	–6.1	–8.0	–20.8	–30.5	–22.3	–27.1	–24.0	...
Imports of capital goods (**)	9.8	–19.6	–16.4	–15.9	–28.8	–31.3	–37.6	–32.3	–35.2	...
Commercial vehicle registrations	0.3	–43.6	–34.1	–50.1	–61.3	–52.4	–58.5	–53.4	–41.7	–37.8
Foreign trade (**)										
Non-energy imports	7.3	–4.9	0.2	–4.1	–19.0	–26.0	–30.2	–29.3	–20.6	...
Exports	4.2	1.9	6.6	7.8	–8.4	–17.9	–22.6	–15.4	–4.7	...

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

Contraction in consumption very deep but now easing.

which must have been helped by the rise in stock market indices and government economic stimulus programmes, somewhat halted the drop in consumption. As a result, production of consumer goods in June showed a year-on-year drop of 7.0% as against 12.6% in the first quarter. Large company domestic sales of consumer goods eased their year-on-year decrease in the second quarter although sales of services rose slightly. Retail sales also showed an easing of the drop in consumption in recent months.

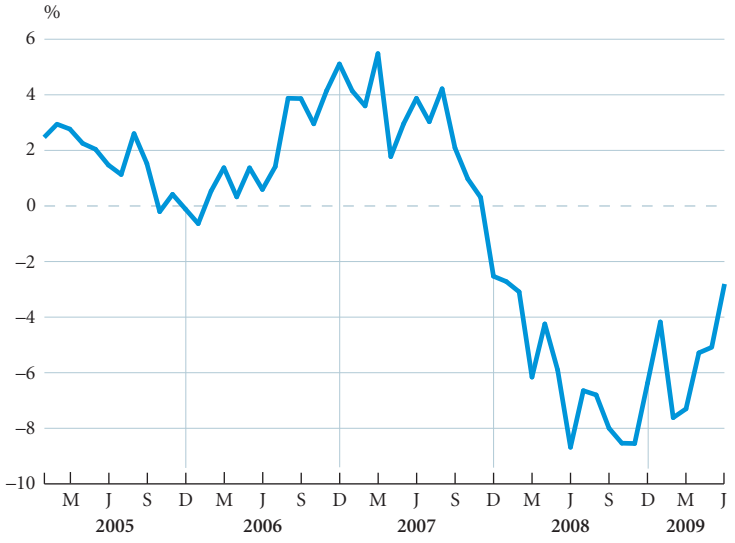
With regard to consumer durables, which are carrying the worst part of the collapse in consumption, it may be stated that the increase in car sales as of May has been confirmed. This is a result of the coming into force of direct aids under Plan 2000-E for replacing cars pushed ahead by the central government and most of the autonomous communities. As a result, purchases by individuals in July were up 16.5% compared with the same month last year.

The counterpart of the drop in consumption is the recovery of savings. In the period from the second quarter of 2008 to the first quarter of 2009 the savings rate of households rose to 14.1% of disposable income, 1.1 points more than in the previous moving period and the highest for the decade. The recovery in savings is linked to the increased prudence of households in view of the rise in unemployment. Tighter financial terms have also induced an increase in savings. In the second quarter the trend to a rise in the savings rate will likely continue.

With regard to investment, this is feeling the drop in corporate profits and unfavourable prospects for returns. Furthermore, the utilization of

DROP IN RETAIL SALES SLOWING DOWN

Year-on-year change in general retail trade index at constant prices (*)



NOTES: (*) Index (without service seasons) deflated and adjusted for calendar effects.
SOURCE: National Institute of Statistics and own calculations.

production capacity keeps getting lower thus reflecting weaker demand. Nevertheless, in spite of the collapse in investment in capital goods, there are some hopeful signs. Production of these goods was down 24.4% in the second quarter compared with one year earlier but this major drop was lower than that recorded in the first quarter. In addition, registrations of commercial vehicles showed a year-on-year drop of 51.9% in the second quarter but eased this drop to 37.8% in July.

Construction investment continues its correction in the residential sector. Go-aheads for new housing construction were down 58.5% in May compared with the same month in 2008 although this was slightly less than in preceding months. In fact, housing sales have slightly eased their descent following announcement of a limitation of allowable tax deductions. Nevertheless, housing completions continue to be higher than new housing sales so that the stock of housing still unsold keeps increasing with the resulting downward pressure on prices. On the other hand, the trend in civil works is better thanks to the 5 billion euros already spent out of the 8 billion euros budgeted for under the public works programme carried out by municipalities with financing from the central government. In turn, government tendering in May rose by 47.8% over the same month in 2008 following several months of reductions.

Housing completions remain higher than new housing sales.

On the supply side, industry continues to suffer from a sharp drop in demand. Nevertheless, the drop is easing. The year-on-year drop in electricity consumption in July was 3.4% as against a decrease of 7.0% in the first quarter. In spite of this relative increase, figures for new orders indicate that this period of weakness in industry will be long drawn out. The secondary sector has seen the adding of problems of demand to those of competitiveness. With regard to the services sector, in spite of some easing of

Drop in industrial production easing.

SUPPLY INDICATORS

Percentage change over same period year before

	2007	2008	2008			2009				
			2Q	3Q	4Q	1Q	April	May	June	July
Industry										
Electricity consumption (1)	4.5	0.6	2.3	0.9	–3.6	–7.0	–9.1	–6.5	–4.1	–3.4
Industrial production index (2)	2.0	–7.3	–5.4	–6.3	–16.6	–22.6	–19.4	–20.5	–16.2	...
Confidence indicator for industry (3)	–0.3	–18.0	–13.7	–18.7	–32.7	–36.7	–36.0	–35.0	–34.0	–32.0
Utilization of production capacity (4)	81.3	79.5	80.3	79.3	76.9	68.8	–	69.5	–	68.5
Imports of non-energy intermediate goods (5)	8.0	–0.7	6.9	–2.1	–18.2	–32.9	–35.1	–33.4	–24.5	...
Construction										
Cement consumption	0.2	–23.8	–19.6	–25.2	–38.1	–44.7	–45.2	–39.1	–20.6	...
Confidence indicator for construction (3)	9.3	–22.6	–17.3	–23.7	–34.7	–36.7	–40.0	–31.0	–34.0	–32.0
Housing (new construction approvals)	–24.7	–59.4	–56.0	–62.4	–60.2	–64.1	–68.7	–58.5	...	...
Government tendering	–15.0	3.0	–29.9	6.4	12.4	–5.1	–49.1	47.8	...	...
Services										
Retail sales (6)	2.3	–6.3	–6.3	–7.1	–7.7	–6.3	–5.3	–5.1	–2.8	...
Foreign tourists	1.1	–2.4	1.2	–5.2	–9.0	–16.3	–1.7	–11.7	–10.0	–6.1
Tourist revenue inflows	3.3	–0.4	1.3	0.2	–8.0	–14.3	–3.6	–10.1	...	...
Goods carried by rail (ton-km)	–3.7	–7.7	–3.5	–1.7	–23.0	–34.1	–43.1	–34.7	–24.6	...
Air passenger traffic	9.0	–3.1	–0.6	–4.9	–12.7	–18.2	–5.0	–11.9	–8.8	–4.8
Motor vehicle diesel fuel consumption	5.1	–3.8	–2.8	–3.7	–7.7	–10.3	–10.3	–7.5	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for difference in number of working days.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
(6) Index deflated and corrected for calendar effects.
SOURCE: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of Economy and Finances and own calculations.

Improvement in confidence indicators for economic agents.

the drop in economic activity in recent months, in June all of the main branches showed year-on-year decreases in volume of business figures of 8% or more.

In this framework, the central government continued to adopt measures to aid those sub-sectors affected by the economic recession. Early in July it approved the Moto-E Plan aimed at granting direct subsidies for the purchase of velocipedes and motorbikes. At the middle of the same month, the Ministry of Housing announced that it would assume 50% of the risk of new mortgages on subsidized housing up to a maximum of 6 billion euros. In July, it also launched the Futur-E Plan to strengthen sustainability of energy in the tourist sector.

The improvement in the international economic situation will make it possible for the Spanish situation to keep recovering. Confidence indicators available go in the same direction. Nevertheless, most indicators remain negative and the correction of cumulative imbalances would suggest that, while Spain's economy is on its way out of the recession, it will come out gradually.

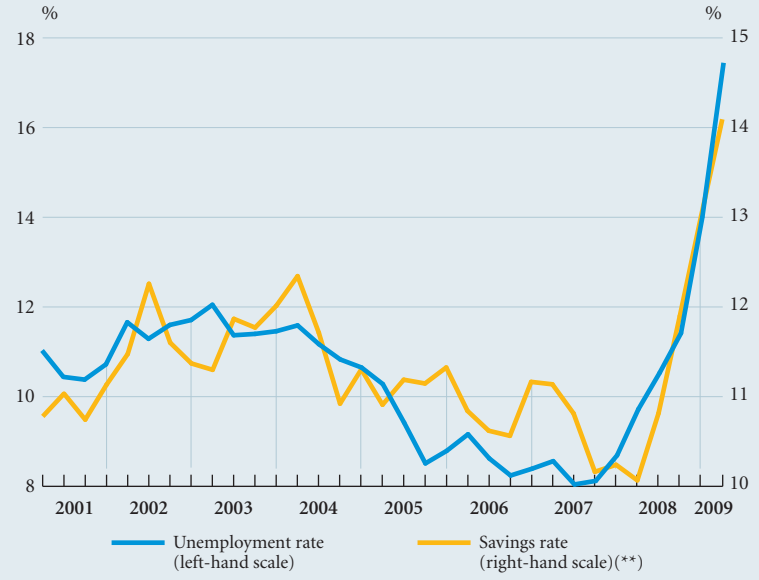
Spanish households spending and saving: the end of a cycle

The severity of the economic and financial crisis affecting companies, banks and governments is also having its impact on the economic situation of households. In the case of Spain, the change in the patterns of spending and saving of family units is quite notable. This box reviews the changes that have taken place in consumption, savings, investment in fixed assets and financial investments for 17 million households as a whole, in an attempt to indicate the future direction of these variables.

First of all, there has been a notable increase in savings, that is to say, in that part of disposable income that is not for consumption. In recent years this variable had dropped to very low levels going to around 11%, thus reflecting an exceptional state of affairs in terms of growth of income and household wealth. While in some quarters concern has been expressed about the low level of household savings, the fact is that in prosperous times savings often drops and vice versa, thus reflecting expectations for future household incomes. At the present time, when, according to sociological surveys, the biggest concern of households is loss of jobs, uncertainty about the economic future is very high. As a result, from a gross savings rate of 10.2% in 2007 the figure went to 13.1% in 2008 and we expect that in 2009 it will go above 16%, as a consequence of the high level of uncertainty in which Spanish families find themselves.

UNCERTAINTY ABOUT EMPLOYMENT AFFECTING HOUSEHOLD SAVINGS

Unemployment rate over labour force and savings rate of households (*)



NOTES: (*) Includes non-profit institutions serving households.
(**) Moving average for four quarters.
SOURCE: National Institute of Statistics, Bank of Spain and own calculations.

Unemployment, however, is not the only threat hanging over household budgets. A second element is the loss in value of household property. Both financial assets and real estate property have undergone a major cut in value which the Bank of Spain put at 12.1% and 8.7% respectively in 2008. The drop in the stock markets over

that year alone took away more than 250 billion euros from the financial property of households. If we add up the value of all financial assets held by households and take off liabilities (mainly mortgage loans), the result is that, in just one year, net financial wealth in 2008 collapsed to 2001 levels. With regard to the value of real estate property, the Bank of Spain estimate indicates a loss of 500 billion euros. To sum up, the decrease in book value of household wealth last year was on an amount higher than disposable income for the year, which gives some idea of the size of the collapse in the aggregate balance sheets of Spanish households.

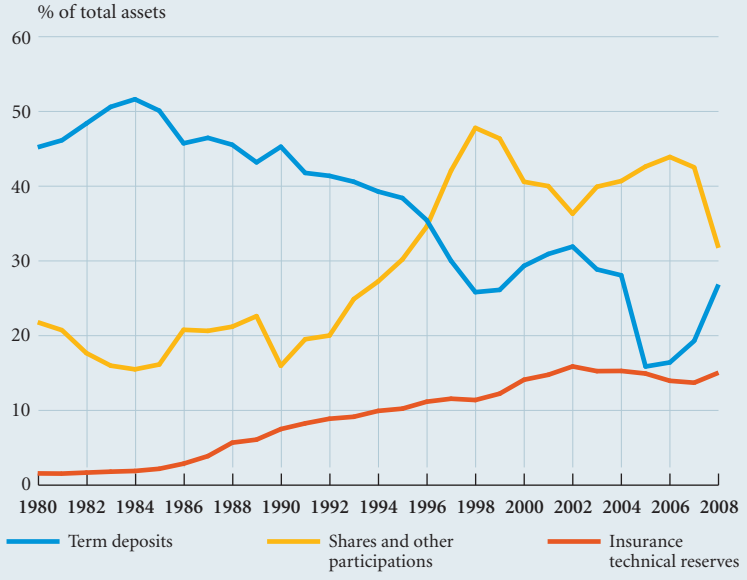
What can we expect in 2009 and 2010? The course of the markets in the first nine months of 2009 makes it possible to believe that the drop in value of assets is a thing of the past and that part of the value lost is now beginning to be recovered. Nevertheless, present prospects for real estate prices and the importance of this property in the total wealth of households will continue to have its effect on the economic behaviour of households.

Inevitably, if household savings is relatively high, consumer spending (the other destination of disposable income) moves in the opposite direction. In fact, in the first half-year consumption was down 6% in nominal terms compared with the same period the year before, in spite of a situation where household incomes rose by 1.5% in the first quarter. As may be expected in these cases, the biggest cut in household consumption came in spending on durable goods (cars, appliances and furniture) and luxury goods whereas non-durable goods held up better against the situation.

Where is this growing savings going to end up? From the point of view of the national accounts, part will go into fixed asset investment (that is, the buying of real estate) while the rest means a change in financial position. With regard to the buying of houses and flats, the sharp drop in the market is the keynote of the

INVESTORS AVOID RISK IN 2008

Financial assets of households and ISFLSH (*)



NOTES: (*) Non-profit institutions serving households.
SOURCE: Bank of Spain.

present situation. This has meant the end of an exceptional stage in which households each year spent more and more resources in the purchase of housing. This may be explained by the definite desire to own one's own home, substantial tax incentives, low interest rates and favourable loan terms during this period which did not scare people off because of the rise in prices. In any case, we should point out that, after reaching all-time highs, the weight of long-term debt in household income has shown a clear downturn in a process of deleveraging that is tending to increase.

With regard to the financial position of households, this also made a turnaround in 2008. Whereas between 2004 and 2007 spending on the buying and paying off of real estate was above current savings of households, in 2008 gross savings had already exceeded investment, a trend that will be even sharper in 2009. At this time, the household sector is a net saver and this makes it possible to ease the funding deficit of other sectors of the economy, especially the public sector, while at the same time contributing to reduce the current account deficit of Spain's economy with abroad.

The preferences of households when it comes to placing its financial savings also clearly express the change in the economic situation. Whereas at the beginning of the Eighties, preferring security, most savings were placed in bank term deposits, in the Nineties investor preferences began to be concentrated in risk assets, with direct acquisition of company shares or through participations in investment funds. The stock market crisis at the beginning of decade 2000 marked a limit to the relative increase in risk investments in household asset portfolios. Since then, their relative weight swung around 40% up until last year when the negative trend in the stock markets brought about a substantial shift of funds from risk products to fixed-term deposits to the point where their weight in the investment portfolio of households was nearly equal. So far in 2009 this process of a shift in funds has virtually stopped given that the stabilization of the financial markets has somewhat eased aversion to risk that is a product of any financial shock.

In many respects, the year 2008 meant the end of a very special cycle in savings and investment preferences of Spanish households. It was a cycle that began in the mid-Nineties and was very much marked by the coming of the euro and the period of a lowering of inflation and interest rates in a context of relative macroeconomic stability. Both in the growth stage and in the current contraction of the economy the behaviour of households may have shown some excesses but overall it fell into line with rational economic criteria in terms of the incentives operating at all times.

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Labour market

Worsening of labour market slows down

Municipal works programme eases collapse in construction employment.

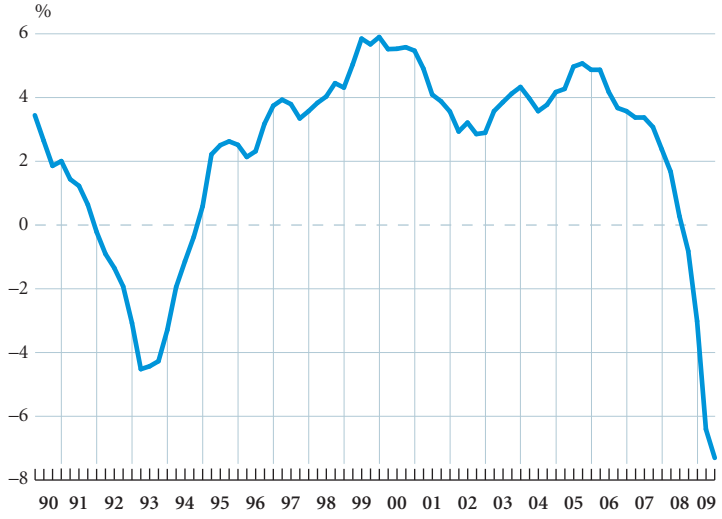
According to figures from the Labour Force Survey, which is considered the most reliable indicator for overall monitoring of the labour market, some 145,800 jobs were lost in the second quarter representing 0.8%. As a result, the total number of persons employed went down to 18,945,000. In the past 12 months nearly a million and a half jobs have been lost, or 7.2%. Nevertheless, in the last quarter some moderation was to be seen in the rate of decrease in employment. This may be attributed to an easing of the economic recession to which the programme of municipal works financed by the central government is contributing, a programme which up until mid-July had given temporary employment to more that 400,000 workers.

Number employed in public sector up 3.7% in past year whereas private sector employment down 9.1%.

As a result, this eased the collapse of employment in construction which was down 24.6% in the past year, the biggest drop in any sector. In the second quarter the decrease in the number of those working in construction (2.8%) was lower than that for industry, which is also undergoing a sharp correction, along with agriculture. Services was the only big sector to raise the level of employment in the second quarter (up 0.5%) although it showed a year-on-year decrease of 2.7%. On the other hand, the public sector continued

LOSS OF JOBS SLOWING DOWN

Year-on-year change rate in number employed (*)



NOTES: (*) Figures adjusted for impact of methodological changes introduced in first quarter of 2005.
SOURCE: INE and own calculations.

ESTIMATED EMPLOYMENT

Second quarter 2009

	No. of employees (thousands)	Quarterly change		Cumulative change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	786.6	–51.1	–6.1	–17.2	–2.1	–34.1	–4.2	4.2
Non-farm	18,158.4	–94.6	–0.5	–894.6	–4.7	–1,445.9	–7.4	95.8
Industry	*2,799.4*	*–100.8*	*–3.5*	*–243.3*	*–8.0*	*–445.0*	*–13.7*	*14.8*
Construction	*1,922.1*	*–55.9*	*–2.8*	*–258.6*	*–11.9*	*–627.4*	*–24.6*	*10.1*
Services	*13,436.9*	*62.0*	*0.5*	*–392.7*	*–2.8*	*–373.7*	*–2.7*	*70.9*
By type of employer								
Private sector	15,893.9	–167.4	–1.0	–933.4	–5.5	–1,589.4	–9.1	83.9
Public sector	3,051.1	21.6	0.7	21.6	0.7	109.3	3.7	16.1
By work situation								
Wage-earners	15,736.8	–106.2	–0.7	–571.4	–3.5	–1,116.2	–6.6	83.1
Permanent contract	*11,765.3*	*–52.0*	*–0.4*	*11.4*	*0.1*	*–135.2*	*–1.1*	*62.1*
Temporary contract	*3,971.5*	*–54.2*	*–1.3*	*–582.8*	*–12.8*	*–981.0*	*–19.8*	*21.0*
Non-wage-earners	3,196.0	–44.5	–1.4	–339.0	–9.6	–366.0	–10.3	16.9
Entrepreneurs with employees	*1,080.1*	*–20.2*	*–1.8*	*–85.2*	*–7.3*	*–95.3*	*–8.1*	*5.7*
Entrepreneurs without employees	*1,948.8*	*–7.3*	*–0.4*	*–223.9*	*–10.3*	*–239.6*	*–10.9*	*10.3*
Family help	*167.1*	*–17.0*	*–9.2*	*–29.9*	*–15.2*	*–31.1*	*–15.7*	*0.9*
Other	12.2	5.0	69.6	–1.4	–10.3	2.0	20.2	0.1
By time worked								
Full-time	16,494.4	–173.5	–1.0	–883.4	–5.1	–1,481.5	–8.2	87.1
Part-time	2,450.6	27.7	1.1	–28.4	–1.1	1.3	0.1	12.9
By sex								
Males	10,700.9	–130.0	–1.2	–639.7	–5.6	–1,158.5	–9.8	56.5
Females	8,244.1	–15.8	–0.2	–272.1	–3.2	–321.6	–3.8	43.5
TOTAL	**18,945.0**	**–145.8**	**–0.8**	**–911.8**	**–4.6**	**–1,480.2**	**–7.2**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

to increase employment, 0.7% in the second quarter, and showed a rise of 3.7% year-on-year, while private employment marked up a drop of 9.1%.

By sex, the loss of jobs continued to affect males much more than females. As a result, whereas over the past year 9.8% of males lost their jobs only 3.8% of females were affected, which partly explains why the latter are less represented in those sectors worst hit by the recession, such as construction.

The recession is affecting all age groups although to varying degrees. In general terms, loss of jobs over the past year has been higher the lower the age group involved, with a drop of 36.0% in the 16-19 age group and 1.4% in the over-fifty group. In the second quarter, employment increased only among those persons aged 35-39 and those over 45.

In addition, figures from the Labour Force Survey show that the economic recession is having a greater effect on

Following sharp drop in temporary work, permanent jobs show a year-on-year decrease for first time since beginning of 1995.

Boost in part-time work.

those self-employed (with an employment level dropping 10.3% in the past 12 months) than those on wages for whom employment was down 6.6%. Significant among the latter is the drop of 19.8% in temporary jobs while permanent jobs were down 1.1%. Nevertheless, the reduction of jobs in the second quarter was similar for both types of hiring contract (more than 50,000) although the percentage of temporary jobs (1.3% quarterly) was still higher. In fact, there was a year-on-year decrease in permanent jobs for the first time since the beginning of 1995.

Another result of the recession is the boost in part-time work. In fact, whereas full-time work contracts were down 8.2% in the past year, those working part-time rose by 0.1%, thanks to the quarterly increase of 1.1% in the second quarter. Nevertheless, the level of this category in the total is modest at 12.9%, mostly females.

Reduction of labour force for first time in recent years because of lack of interest.

By nationality, there are also differences in employment trends. Whereas the number of workers of Spanish nationality was down 6.9% in the past 12 months, foreign workers dropped by 9.2%. Nevertheless, in the second quarter the immigrant population employed rose by 0.2% while the figure for those of Spanish nationality dropped by 0.9%.

Figures for those registered with Social Security in July confirm a relative improvement in employment compared with the first four months of the year. The average number of those registered rose by 45,568 although the year-on-year rate was down by 6.4%.

Figures from the Labour Force Survey in the second quarter also confirm a change in trend in the labour force. In fact, there was a drop for the first time in recent years and the year-on-year change rate went down 1.1 points to 1.2%. This may be attributed to a lack of interest because of the difficulty in finding work. In the second quarter both Spanish nationals and the immigrant worker group in the labour force dropped although in the past year the latter group rose by 5.3% as against only 0.5% in the Spanish nationals group.

ESTIMATED UNEMPLOYMENT

Second quarter 2009

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	2,289.1	93.3	4.2	1,106.2	93.5	55.3	17.6
Females	1,848.4	33.4	1.8	649.7	54.2	44.7	18.3
By age							
Under 25 years	855.2	46.7	5.8	281.3	49.0	20.7	38.1
Other	3,282.3	80.1	2.5	1,474.7	81.6	79.3	15.7
By personal situation							
Long-term unemployment	1,094.6	117.0	12.0	507.9	86.6	26.5	–
Seeking first job	286.6	–12.8	–4.3	64.1	28.8	6.9	–
Other	2,756.3	22.6	0.8	1,184.0	75.3	66.6	–
TOTAL	**4,137.5**	**126.7**	**3.2**	**1,755.9**	**73.7**	**100.0**	**17.9**

SOURCE: National Institute of Statistics and own calculations.

As a result of movements in employment and the labour force, unemployment continued to rise although it showed its rate of increase. The figure for unemployed rose by 3.2% in the quarter and by 73.7% in the past year going to a total of 4,137,500 persons. The unemployment rate rose by 6 decimals to 17.9%, the highest in the European Union and twice the average.

Unemployment rate goes up to 17.9% but rate of increase drops.

Unemployment continued to increase more among males than among females so that the respective unemployment rates became closer. In addition, the number of households with all members unemployed rose to 1,118,300.

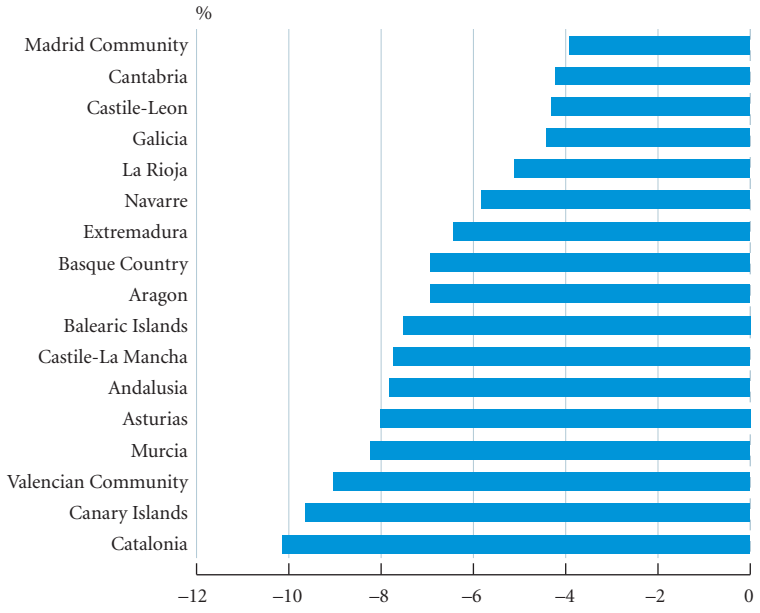
With regard to location, it is noted that the drop in employment in the past 12 months took place in all autonomous communities, although to a greater extent in Catalonia, Canary Islands and Valencian Community. Nevertheless, the biggest unemployment rates showed up in Andalusia, Canary Islands and Extremadura.

In another sphere, the social dialogue (involving government, business and trade unions) ended with no agreements. Nevertheless, this summer the central government approved measures aimed at easing the effects of rising unemployment. It removed the required one-year wait to be able to recover pension funds for those unemployed not contributing to unemployment insurance. It also facilitated the collection of unemployment benefits as a single payment in the case of members of cooperatives. At the same time, it established a 50% bonus in normal Social Security payments by companies that give a permanent hiring contract for the first wage-job of a self-employed worker. Finally, the central government set up new temporary aids to unemployed persons who have exhausted their unemployment benefits.

New temporary aid for unemployed persons who have used up unemployment benefits.

EMPLOYMENT DOWN IN ALL AUTONOMOUS COMMUNITIES IN PAST YEAR

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



SOURCE: National Institute of Statistics and own calculations.

Prices

Year-on-year drop in CPI for fifth month in a row especially reflects drop in commodities.

CPI marks up biggest year-on-year drop in recent decades

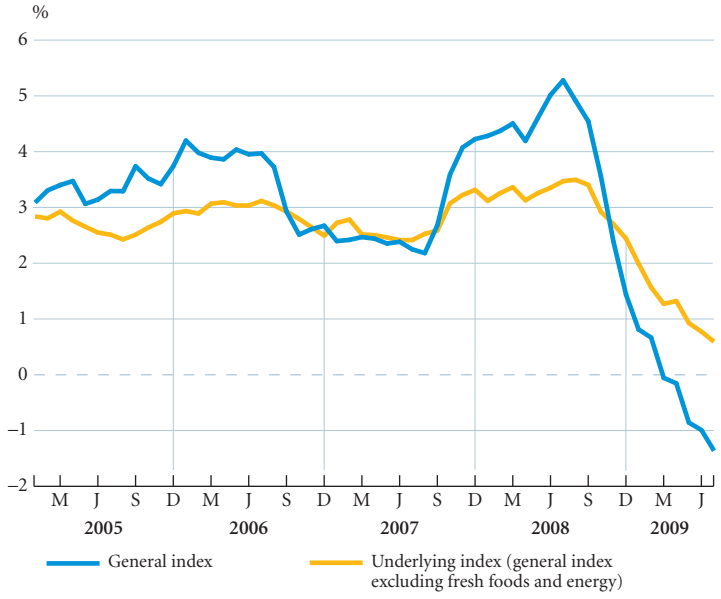
As expected, the consumer price index (CPI) recorded a year-on-year drop of 1.4% in July, the biggest dip in recent decades. This was the fifth consecutive negative year-on-year rate. In just 12 months it went from inflation of 5.3% (the highest since December 1992 when the price of oil reached an all-time high) to the drop in current prices. This turnaround was partly due to the drop in commodity prices, especially in crude oil, in spite of the rise in recent months. Nevertheless, the contraction of consumption also made a significant contribution to this, driving companies to make discounts or moderate their prices.

Fuels and fuel-oils have gone down 22.5% in price in the 12 months ending in July. This year-on-year decrease is slightly lower than that noted in May partly due to the increase in the special tax on fuels in force as of June. Nevertheless, energy products as a whole recorded the biggest year-on-year drop in recent decades in July (15.9%) thanks to the fact that electricity rose less that month than in the same month last year. In the early summer months fresh food prices showed the biggest year-on-year drop in recent years thus contributing to the drop in price levels.

The most stable core of the CPI, underlying inflation, continued to grow but showed a tendency to slow down

UNDERLYING INFLATION CONTINUES TO DROP

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

going to 0.6% in July, the lowest level in recent decades and 2.9 points less than 12 months earlier. This lower growth was partly due to the drop in the cost of commodities but it also reflects the deflationary pressures brought about by the economic recession. Nevertheless, the differential with general inflation widened to mark up the highest level in recent years.

Underlying inflation eases to 0.6%, lowest in recent decades, as result of contraction of consumption.

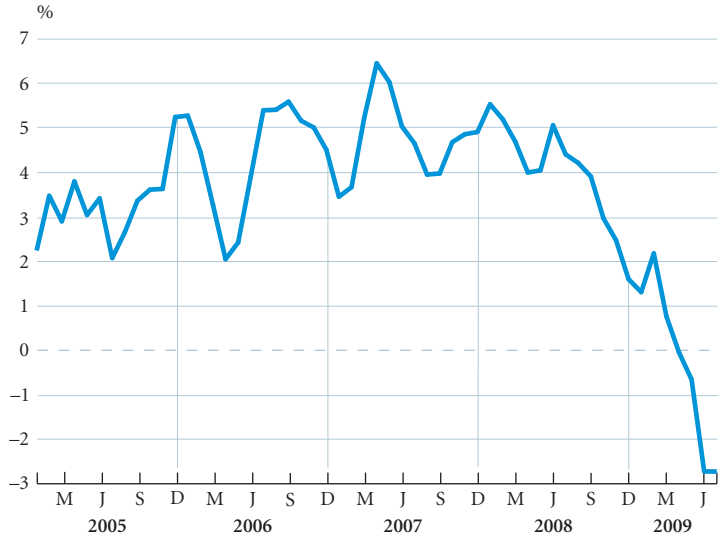
CONSUMER PRICE INDEX

	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	0.0	–0.1	–0.9
June	0.6	2.8	5.0	0.4	0.3	–1.0
July	–0.5	2.3	5.3	–0.9	–0.5	–1.4
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.

FRESH FOODS CONTRIBUTE TO DROP IN PRICES

Year-on-year change in unprocessed food prices



SOURCE: National Institute of Statistics.

Inflation differential with Euro Area narrowing but still remains favourable.

Prices of processed foods showed an increase at the beginning of summer which may be accounted for by the rise in tax on tobacco in June. In turn, prices of non-energy industrial goods were down 1.5% in the past 12 months ending in July within the framework of heavy competition in international markets. Services, which are more sheltered from world competition, showed a year-on-year price increase of 2.1% in July. Nevertheless, this increase was the lowest in recent decades.

The consumer price index harmonized with the European Union (HCPI) also underwent a year-on-year decrease (1.4%) in July. As a result, the negative differential with the Euro Area stood at 0.7 percentage points, two decimals less than the record in May following the increase in special taxes in June.

Will prices continue to drop until we go into deflation, that is to say, a general and persistent decrease in level? In coming months we shall continue to see negative

CONSUMER PRICE INDEX BY COMPONENT GROUP

July

	Indices (*)	% monthly change		% change over previous December		% monthly change	
		2008	2009	2008	2009	2008	2009
By type of spending							
Food and non-alcoholic beverages	107.8	0.1	–0.2	1.9	–2.6	7.0	–2.1
Alcoholic beverages and tobacco	125.9	0.0	4.3	3.6	12.6	4.0	13.0
Clothing and footwear	92.9	–11.3	–11.8	–12.3	–14.6	0.4	–2.1
Housing	111.8	1.7	0.3	6.9	0.1	8.4	–0.8
Furnishings and household equipment	106.3	–0.6	–0.9	1.2	–0.3	2.5	1.2
Health	97.3	0.3	0.0	0.0	–1.5	0.5	–1.2
Transport	103.0	0.7	–0.1	8.1	3.6	10.6	–9.5
Communications	99.4	0.0	0.0	0.3	–0.3	–0.2	–0.9
Recreation and culture	99.8	1.1	0.8	0.7	0.1	0.1	–0.3
Education	111.7	0.1	0.0	0.4	0.2	3.9	3.8
Restaurants and hotels	112.7	1.0	0.7	4.6	2.0	4.8	1.5
Other goods and services	109.3	–0.1	–0.2	2.9	1.6	3.5	2.2
By group							
Processed food, beverages and tobacco	111.7	0.2	0.6	2.7	0.5	7.8	0.9
Unprocessed food	106.4	–0.1	–0.1	0.9	–3.4	4.4	–2.7
Non-food products	105.1	–0.6	–1.2	2.3	–0.5	4.8	–1.7
Industrial goods	99.7	–2.0	–2.8	1.2	–2.8	5.6	–5.3
Energy products	*105.1*	*2.3*	*0.3*	*16.1*	*5.3*	*21.4*	*–15.9*
Fuels and oils	*99.6*	*1.1*	*–0.4*	*18.0*	*5.0*	*25.1*	*–22.5*
Industrial goods excluding energy products	*97.5*	*–3.6*	*–3.9*	*–3.7*	*–5.5*	*0.3*	*–1.5*
Services	111.0	0.7	0.5	3.5	1.8	4.0	2.1
Underlying index (**)	106.2	–0.9	–1.1	0.8	–1.1	3.5	0.6
GENERAL INDEX	**106.3**	**–0.5**	**–0.9**	**2.3**	**–0.5**	**5.3**	**–1.4**

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

year-on-year change rates in the CPI. Nevertheless, it is most likely that the drops will be lower and lower and that positive results will show up again toward year-end, given the trends in prices and especially the recovery in commodities in recent times.

Sharp easing in wholesale prices

In June, the annual change rate of industrial prices was negative (–5.0%) thus recording the lowest level in recent decades. This drop was largely due to the decrease in commodity prices over the past year as well as the major weakness in demand. All the main components of industrial prices eased, especially notable being the substantial drops in energy goods and intermediate goods.

The trend in import prices has also been downward with a year-on-year drop even higher at 10.7% in June due to the appreciation of the euro during the period. Farm prices at origin also showed a substantial year-on-year drop pf 14.5% in May, the biggest in recent years. The biggest year-on-year decrease was seen in agricultural farm products (20.6%) followed by livestock products. Market livestock prices were also down compared with May 2008 but to a much lesser degree at 1.9%.

Drop in CPI has likely hit bottom.

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											
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	–3.4	–3.9	2.6	1.6	2.0	–
2009											
January	–7.2	–0.5	0.9	1.9	–1.6	–2.2	–4.9	2.8	2.0	0.4	–
February	–5.4	–1.1	0.4	1.6	–3.3	–1.9	–5.6	3.0	2.6	–1.2	1.3
March	–7.1	–2.5	–0.4	1.3	–4.4	–5.0	–6.9	2.6	3.1	–2.7	–
April	–7.7	–3.4	–0.8	1.2	–5.5	–6.8	–7.5	2.5	3.1	–3.6	–
May	–14.5	–4.4	–1.1	1.1	–6.3	–9.8	–9.8	1.8	2.5	–5.4	...
June	...	–5.0	–1.3	0.9	–6.9	–10.2	–10.7	1.3	2.4	–6.0	–

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

Foreign sector

Trade deficit continues on downward track

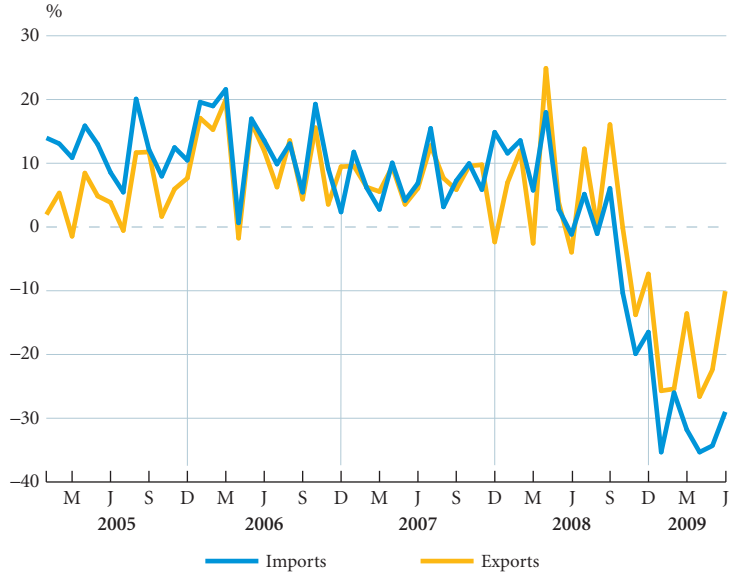
June trade deficit registers biggest drop in more than 20 years.

The trade deficit for the first half-year stood at 24.16 billion euros, some 53.1% lower than for the same period last year. This drop is still not showing any signs of letting up and the 62.7% decrease in the deficit in June was the biggest in more than 20 years. This reduction, the twelfth in a row, showed up in the energy component but also especially in the non-energy component which meant that the cumulative trade deficit for the past 12 months stood at around 6.1% of Spain's GDP, more than four percentage points below the high reached in June 2008.

This period has been characterized by a sharp contraction of trade on a world level, from which Spain has not been exempt. In the first half of the year Spain showed a drop in exports of 20.8% compared with the first six months of 2008. On the other hand, the drop in Spain's domestic demand reduced imports by 32.0%. which once more reflects the strong reaction of Spanish demand to foreign products when faced with changes in income. A major part of this contraction in trade (approximately a quarter) was brought about by the drop in goods prices, especially in energy products, as a result of the reduction in oil prices. As a result, the export-import ratio rose to 76.2%, ten percentage points higher than last year.

CONTRACTION IN FOREIGN TRADE EASING

Year-on-year change in imports and exports



SOURCE: Ministry of Economy and Finance and own calculations.

FOREIGN TRADE

January-June 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	16,290	–45.3	16.1	3,329	–39.1	4.3	–12,961	20.4
Consumer goods	32,158	–9.9	31.7	31,578	–10.0	40.9	–580	98.2
Food	*7,106*	*–7.5*	*7.0*	*11,237*	*–3.1*	*14.6*	*4,131*	*158.1*
Non-foods	*25,052*	*–10.5*	*24.7*	*20,342*	*–13.4*	*26.4*	*–4,711*	*81.2*
Capital goods	8,374	–34.9	8.3	6,208	–25.5	8.0	–2,165	74.1
Non-energy intermediate goods	44,527	–37.0	43.9	36,073	–25.8	46.7	–8,454	81.0
By geographical area								
European Union	59,591	–28.0	58.8	53,908	–22.1	69.8	–5,682	90.5
Euro area	*50,074*	*–28.1*	*49.4*	*44,492*	*–20.0*	*57.6*	*–5,582*	*88.9*
Other countries	41,758	–36.9	41.2	23,280	–17.7	30.2	–18,478	55.8
Russia	*1,947*	*–58.4*	*1.9*	*691*	*–49.8*	*0.9*	*–1,256*	*35.5*
United States	*4,614*	*–21.3*	*4.6*	*2,939*	*–20.3*	*3.8*	*–1,675*	*63.7*
Japan	*1,462*	*–51.0*	*1.4*	*573*	*–12.9*	*0.7*	*–889*	*39.2*
Latin America	*5,024*	*–34.7*	*5.0*	*3,742*	*–16.2*	*4.8*	*–1,282*	*74.5*
OPEC	*8,138*	*–41.4*	*8.0*	*3,244*	*9.8*	*4.2*	*–4,894*	*39.9*
Rest	*20,574*	*–33.8*	*20.3*	*12,091*	*–20.1*	*15.7*	*–8,483*	*58.8*
TOTAL	**101,349**	**–32.0**	**100.0**	**77,189**	**–20.8**	**100.0**	**–24,160**	**76.2**

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

Nevertheless, as may be seen in the above graph, June showed a slowdown in the contraction of trade. This was especially noted in the case of exports with a revival of Spain's sales to its main trading partners in the Euro Area, with exports dropping by 9.6% year-on-year, well below the 22.6% recorded in May. From a sector point of view, chemical and food products partly revived both imports and exports while durable goods and commodities continued their own decreases. Car exports, in turn, were down 8.8%, the lowest drop in recent months thanks to plans for the purchase of new vehicles implemented in countries such as France and Germany.

Trade flows easing contraction.

Economic recovery in these two countries and, to a lesser extent, in Portugal will make it possible to maintain this trend in exports over the short and medium term, thus reducing Spain's trade deficit. Nevertheless, the rate of this contraction will be gradually slower largely due to the stabilization of oil prices with the result that imports will drop less over coming months.

Worsening of trade deficit expected to run at lower rate in coming months.

Balance of payments: deficit continues to be corrected

The improvement in the trade balance in recent months and, to a lesser extent, that in the transfers balance meant that

Current account deficit continues to drop in May.

May trade deficit reaches 2006 levels.

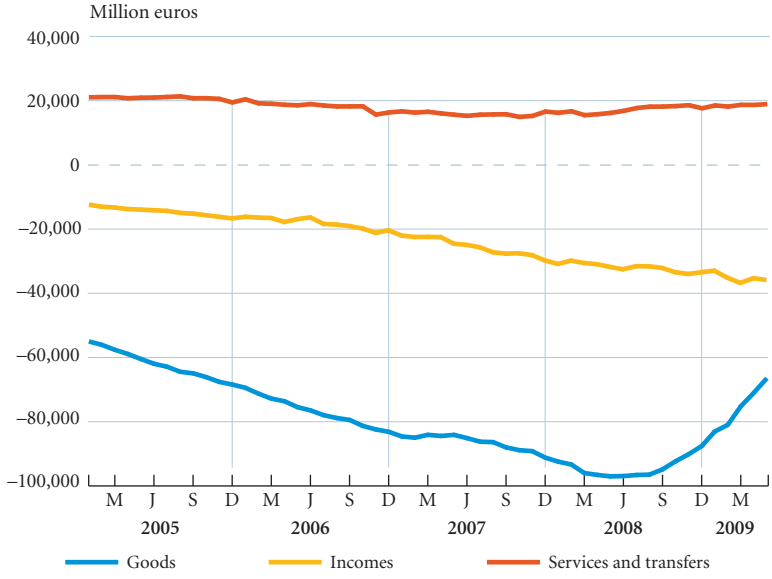
the deficit in the current account balance in May showed a reduction of 45.8% compared with the same month in 2008, going to 4.98 billion euros. Only the incomes balance increased its negative figure that month while services held practically the same in spite of a slight drop in the tourism surplus. As a result, the drop in the cumulative balance for the past 12 months was 25.6%, more than four percentage points higher than in April.

The lower current account deficit compensated the reduction in the capital account surplus in May reducing the Spanish economy's 40.8% deficit compared with the same month in 2008. As a result, the cumulative deficit for the past 12 months stood below 8% of Spain's gross domestic product, far from the levels reached in the second quarter of last year. This confirms the progressive correction of Spain's foreign imbalance which very likely will be maintained over coming months, although less and less sharply.

With regard to financial flows, the main entry of capital in May came through short-term instruments (loans, deposits and repos) and to a lesser extent through direct investment. Portfolio investment showed a notable net flow abroad. As a result, an analysis of cumulative figures for the past 12 months shows that short-term investment and portfolio investment continue to be the main sources of foreign financing although the latter heading has lost some importance in recent months.

GOODS BALANCE LEADS RECOVERY IN CURRENT ACCOUNT DEFICIT

Contributions to cumulative balance over past 12 months



SOURCE: Bank of Spain and own calculations.

BALANCE OF PAYMENTS

May 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	–18,972	–52.6	–66,624	30,424	–31.3
Services					
Tourism	*8,398*	*–8.0*	*27,334*	*–765*	*–2.7*
Other services	*–354*	*–75.3*	*–720*	*2,927*	*–80.3*
Total	8,044	4.5	26,614	2,162	8.8
Income	–14,689	19.7	–36,202	–4,049	12.6
Transfers	–5,126	–15.6	–8,290	581	–6.5
Total	**–30,742**	**–39.3**	**–84,501**	**29,117**	**–25.6**
Capital account	**1,982**	**–42.9**	**4,015**	**–2,386**	**–37.3**
Financial balance					
Direct investment	–9,216	–	–18,157	5,968	–24.7
Portfolio investment	6,416	–	21,176	9,059	74.8
Other investment	33,690	–21.5	59,268	–14,549	–19.7
Total	**30,890**	**–9.0**	**62,287**	**479**	**0.8**
Errors and omissions	1,280	29.6	3,728	2,636	241.4
Change in assets of Bank of Spain	–3,411	–	14,472	–29,846	–67.3

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

Public sector accounts feeling impact of recession and government relief measures.

Public finances heavily strained in first half-year

The impact of the economic recession is having a sharp effect on the public accounts. First of all, this is because of the sharp drop in revenues as a result of lower taxable income levels for various taxes and the increase in spending related to higher unemployment. The worsening of the central government accounts is also due to the impact of the various measures taken by the government to ease the recession by injecting liquidity into the economic system and aimed at stimulating the economy.

In this context, in cash-flow terms, that is to say, according to cash flows that have actually taken place, total non-financial government revenues, including those amounts ceded to other levels of government under the current financial system, were down 19.1% in the first half-year compared with the same period in 2008. Direct taxes showed a year-on-year drop of the same dimensions as the total while indirect taxes were down 27.5%.

Collections for the main tax, personal income tax, showed a drop of 19.2% due to the drop in hold-backs on wages because of the lower level of employment and the easing of wages. Furthermore, hold-backs on leasing and capital gains on mutual funds were also down. Nevertheless, if adjustments are

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

June 2009

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**672**	**–88.2**	**46,352**	**–29.4**
Non-financial revenue adjusted (*)				
Personal income tax	1,584	–58.1	29,276	–19.2
Corporate tax	194	–68.5	5,548	–24.7
VAT	211	–92.2	18,632	–35.8
Special taxes	1,515	–7.2	9,138	–4.9
Other	1,929	31.5	12,321	18.0
Total	**5,433**	**–46.8**	**74,915**	**–19.1**
Non-financial spending	**18,389**	**67.9**	**83,171**	**22.9**
Treasury balance	**–17,717**	**237.5**	**–36,819**	**–**
Surplus (+) or deficit (–) (**)	***–19,064***	***152.3***	***–38,607***	***739.3***

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.

made for the effects of the early deduction of up to 400 euros against wage hold-backs and partial income tax payments, as well as more deferments and faster rebate payments, the year-on-year decrease comes to 5.9%. In turn, corporate taxes were down by 24.7% because of lower company taxes and faster rebates.

The contraction in consumption and real-estate sales had a significant role in the 35.8% drop in value added tax (VAT) in the first half-year as against the same period last year. Nevertheless, in homogeneous terms, after removing the effect of earlier rebates, the increase in monthly rebates and longer deferrals, the year-on-year change rate stood at 16.2%.

Nor were special taxes free from the impact of the recession and collections for these were down by 4.9%. The most important, taxes on fuels, showed a drop of 7.8% under the effect of lower fuel consumption. Nevertheless, the biggest year-on-year drop came in taxes on alcohol and alcoholic beverages which were down 17.3%.

On the other side of the scale, central government non-financial spending rose by 22.9% in the January-June period compared with the same months last year. This increase was due both to current transactions (which were up 14.4%) and capital transactions, which showed an increase of 90.3%.

Under current transactions, personnel costs were up 4.8%, while goods and services were down 0.9% and financial transactions dipped by 1.4%. The biggest increase showed up under current transfers (21.4%), especially under the effect of payments to the Central Government Public Service.

Capital transfers grew by three times the amount in the first half of 2008 largely because of payment of 5 billion euros to the Central Government Local Investment Fund. On the other hand, real investment rose by 10.4%.

Because of the severe drop in revenues and the increase in spending the government deficit in the first half stood at 36.82 billion euros as against 2.06 billion euros in the first half of 2008. In national accounting terms, that is, according to existing rights and obligations, there was a deficit of 3.64% of the gross domestic product.

Cumulative public deficit in first quarter stands at 3.6% of gross domestic product.

Nor could the accounts of Social Security stay outside the impact of the recession. In the first half-year, the Social Security system showed a surplus of 11.80 billion euros, a drop of 29.5% compared with the same period the year before.

Reform of financing model for autonomous communities operating under common system.

With regard to other levels of government, in mid-July the Fiscal and Financial Policy Council approved a new model for the financing of those autonomous communities operating under the common system. With the new model, the autonomous communities will receive a higher percentage of taxes ceded by the central government as well as increased regulatory powers.

In another sphere, at the end of July Moody's credit rating agency maintained its top qualification for Spanish sovereign bonds. The agency considered that, while the situation of Spain's public accounts had worsened, it had started out from a favourable situation.

Moody's credit rating agency maintains top qualification for Spanish sovereign debt.

Savings and financing

Drop in interest rates continues

One-year Euribor interest rate at low levels.

The 12-month Euribor, an interest rate widely used as a reference in loan transactions, showed a new all-time low in July going to 1.41% on monthly average, 398 basis points less than in the same month in 2008. In August, it continued to drop slightly going go a new low of 1.32% at the beginning of the fourth week. Nevertheless, in real terms, that is to say taking inflation into account, the 1-year Euribor stood both above June and July last year, given the bigger decrease shown by the inflation rate, thus going to negative levels in the past year.

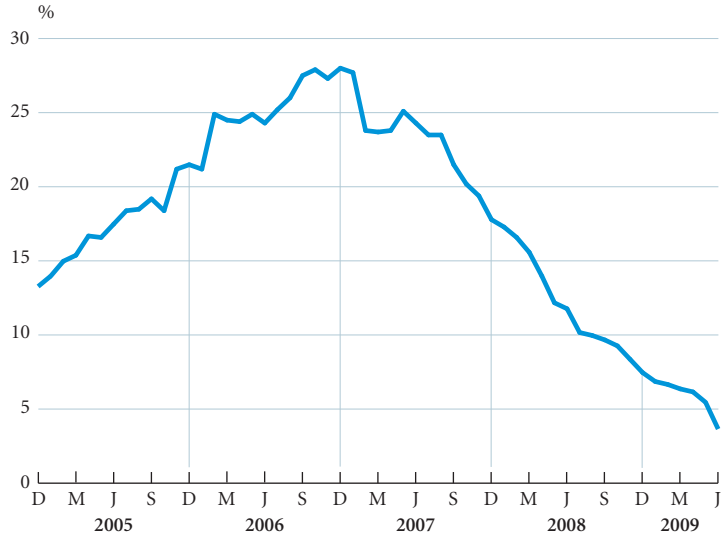
Growth of financing granted to private sector stands below Euro Area figure.

Lending institutions continued to shift the cuts in the European Central Bank official rate to interest rates on loans and credits granted to companies and households. The average interest rate for new loan transactions granted to the private sector in June dropped to 3.74%, some 243 basis points less than 12 months earlier. The lower decrease in interest rates on loans in terms of the official interest rate may be explained by the rise in risk premium due to the sharp increase in default.

Weakness in demand for funds because of the contraction of consumption and investment and the tightening of financing terms meant that credit granted to the private sector continued to ease. In July, funding granted to companies and households rose by 2.3% compared with the same month last year,

SHARP DROP IN CORPORATE FINANCING

Year-on-year change rate in funding granted to resident non-financial companies



SOURCE: Bank of Spain.

a rate 1.9 points lower than two months earlier and 3.8 points below December. This shows some increase in the process of deleveraging of the private sector after having reached high debt levels before the recession. This growth stood slightly below that for the Euro Area as a whole.

In fact, the slowdown in funding to the private sector in recent months was largely due to companies, with a year-on-year change rate that dropped to 3.6% in June, some 2.5 points less than in April. The main contribution to annual growth came from foreign loans amounting to 2.3 points. Loans of resident credit institutions contributed 0.9 points while bond issues provided 0.4 points.

Financing granted to households showed a year-on-year increase of only 0.4% in June, the lowest in recent years. As a result, the recent process of deleveraging continued. It should be remembered that in June 2008 loans to households amounted to 132% of gross disposable income, substantially more than the Euro Area average. Since then this ratio has tended to drop going to 126% at the end of the first quarter of 2009 although still significantly above the Euro Area average of 92%. The total figure for funding to households rose in June following a monthly drop in May. At the end of the first half-year housing loans were up 0.9% compared with June 2008 while other loans dropped by 1.0% as a result of the decreased demand for consumer credit.

Default showed some let-up for lending institutions in June with a slight decrease in default which went to 4.6%. This decrease, the first in two years, may be attributed to some improvement in the economy and the efforts of default managers. Nevertheless, it is most likely that the upward trend will return in coming months. Because of this, financial institutions are making substantial provisions.

In this environment, in line with measures adopted in other European countries and on the other side of the Atlantic, the end of June saw approval of the setting up of Orderly Bank Restructuring Fund which, along with the three existing Deposit Guarantee Funds for Credit Institutions, will work in favour of an eventual restructuring of Spain's banking system with the aim of

Boost in foreign loans for funding companies.

Household debt moderating but still stands notably above that in Euro Area.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

June 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	54,653	–19,561	–26.4	–26,508	–32.7	2.9
Secured loans (*)	1,107,918	–878	–0.1	6,571	0.6	59.5
Other term loans	517,819	–11,638	–2.2	–4,544	–0.9	27.8
Demand loans	54,079	4,951	10.1	–576	–1.1	2.9
Leasing	40,938	–4,291	–9.5	–6,490	–13.7	2.2
Doubtful loans	85,597	22,540	35.7	54,377	174.2	4.6
TOTAL	**1,861,005**	**–8,877**	**–0.5**	**22,830**	**1.2**	**100.0**

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

Creation of Orderly Bank Restructuring Fund.

increasing its strength and solvency. The Fund will also take on the strengthening of equity in certain merger processes.

Under Royal Decree Law 8/2009 setting up the fund it is considered that «Those institutions that may be considered as more responsible for the health of the system because of their size, maintain a solid position that allows them, with a reasonable degree of certainty, to continue to deal with the crisis without the need for public aid. This point is essential because it puts the Spanish banking sector in a very favourable position with regard to those of the large advanced economies. Among those entities of medium or small size there are also entities that are maintaining a solid position, however, there may be some that could see their viability under threat…». As a result, before the summer there took place the intervention of the Caja Castilla-La Mancha and at this moment there are various merger processes involving some small savings banks.

Growth of funding granted to public sector goes above 30%.

With regard to net financing granted to general government, this continued to rise in recent months and in June ended up with year-on-year growth of 31.3%.

As a result, Public borrowing partially compensated the trend to deleveraging in the private sector. As a result, total financing in June showed an annual rate of increase of 5.6%, some 3.2 points less than one year ago.

Improved return on deposit products

Returns on bank deposits also reflected the cuts in official interest rates of the European Central Bank in recent times although not as sharply seeing that in June rates stood at 1.41% on average, a drop of 163 basis points in the past 12 months. In the past year there was a bigger drop in return on term accounts of individuals (230 basis points) but this stood at a higher level (2.34%) with the improvement in the liquidity situation in financial markets and lower pressure on entities to obtain deposits. Nevertheless, in real terms, that is discounting inflation, the interest rate on bank deposits showed a notable increase.

In this framework, total bank deposits continued to ease in keeping with the trend in economic activity but to a lower extent than loans. As a result, the gap between the two tended to narrow.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

June 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	257,927	13,116	5.4	8,592	3.4	18.0
Savings deposits	198,817	19,040	10.6	18,193	10.1	13.9
Term deposits	730,543	1,271	0.2	69,697	10.5	51.1
Deposits in foreign currency	25,842	–3,475	–11.9	–7,537	–22.6	1.8
Total deposits	**1,213,130**	**29,951**	**2.5**	**88,945**	**7.9**	**84.8**
Other liabilities (*)	**217,339**	**–31,291**	**–12.6**	**–41,875**	**–16.2**	**15.2**
TOTAL	**1,430,468**	**–1,340**	**–0.1**	**47,070**	**3.4**	**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.

By type, on-demand savings accounts increased their growth rate with the reduction of the differential in rates by term and an increasing preference for liquidity on the part of savers. Savings accounts thus moved up by 10.1% in the past year ending in June. On the other hand, term accounts slowed their advance to 10.5% year-on-year.

On-demand and savings accounts boost growth rate.

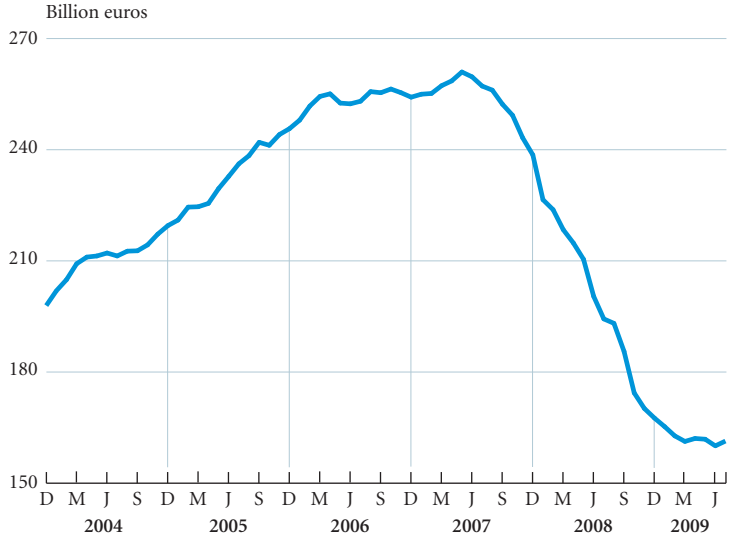
Competition for bank deposits and uncertainty about trends in financial markets meant that July still saw withdrawals of participations in mutual funds. Nevertheless, net sales amounted to 196 million euros, the lowest figure since April 2007. In fact, thanks to capital gains generated by the good state of the financial markets, the volume of assets in mutual funds at the end of July showed a monthly increase of 1.26 billion euros, the biggest monthly increase in 27 months, putting the figure at 161.37 billion euros. The annual return on long-term bond-based funds thus stood at 5.4%.

With regard to pension funds, at the end of the first half-year these showed a volume of assets amounting to 78.52 billion euros, a slight increase over December. Net returns in the second quarter were 36 million euros. Net weighted yield for the past 19 years was 5.3%, substantially above inflation for that period.

Slight increase in volume of pension fund assets in first half-year.

ASSETS OF MUTUAL FUNDS AGAIN GROWING

Total assets of mutual funds



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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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