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THE SPANISH ECONOMY

Monthly Report

PRIVATE CONSUMPTION, PILLAR OF THE ECONOMY

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2009	2010	2011	2010				2011	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	–2.6	2.9	2.6	2.4	3.0	3.2	2.8	2.3	2.6
Japan	–6.3	4.0	–0.9	5.5	3.3	4.8	2.4	–0.7	–1.7
United Kingdom	–4.9	1.3	1.6	–0.4	1.5	2.5	1.5	1.8	1.4
Euro area	–4.1	1.7	1.9	0.8	2.0	2.0	2.0	2.5	1.7
Germany	*–4.7*	*3.5*	*3.3*	*2.3*	*3.9*	*3.9*	*3.8*	*4.8*	*3.2*
France	*–2.6*	*1.4*	*2.2*	*1.0*	*1.5*	*1.6*	*1.4*	*2.2*	*2.2*
Consumer prices									
United States	–0.3	1.6	3.2	2.4	1.8	1.2	1.2	2.2	3.5
Japan	–1.4	–0.7	0.8	–1.1	–0.9	–0.8	0.1	0.0	0.5
United Kingdom	2.2	3.3	4.3	3.3	3.4	3.1	3.4	4.1	4.4
Euro area	0.3	1.6	2.6	1.1	1.5	1.7	2.0	2.5	2.8
Germany	*0.4*	*1.1*	*2.4*	*0.7*	*1.0*	*1.2*	*1.5*	*2.1*	*2.3*
France	*0.1*	*1.5*	*2.1*	*1.3*	*1.6*	*1.5*	*1.6*	*1.8*	*2.1*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	–4.3	1.3	0.4	–0.3	2.1	1.5	1.6	0.7	–0.6
Government consumption	3.2	–0.7	–0.2	–1.1	–0.1	–0.7	–0.9	1.1	–0.6
Gross fixed capital formation	–16.0	–7.5	–4.4	–10.5	–6.7	–6.7	–6.1	–5.8	–6.0
Capital goods	*–24.8*	*1.9*	*1.5*	*–4.6*	*8.7*	*2.4*	*1.2*	*0.3*	*–2.7*
Construction	*–11.9*	*–11.1*	*–8.3*	*–11.4*	*–11.3*	*–11.2*	*–10.6*	*–10.2*	*–9.5*
Domestic demand (contribution to GDP growth)	–6.4	–1.2	–0.8	–3.1	–0.3	–0.7	–0.6	–0.6	–1.9
Exports of goods and services	–11.6	10.3	13.1	9.4	11.9	9.4	10.5	11.2	13.3
Imports of goods and services	–17.8	5.5	7.4	2.0	9.6	5.0	5.3	5.2	3.8
Gross domestic product	**–3.7**	**–0.1**	**0.5**	**–1.4**	**0.0**	**0.2**	**0.6**	**0.8**	**0.5**
Other variables									
Employment	–6.6	–2.3	–0.7	–3.9	–2.4	–1.6	–1.4	–1.4	–0.8
Unemployment (% labour force)	18.0	20.1	20.8	20.0	20.1	19.8	20.3	21.3	20.8
Consumer price index	–0.3	1.8	3.2	1.1	1.6	1.9	2.5	3.5	3.6
Unit labour costs	1.0	–1.5	–0.5	–0.9	–0.9	–1.9	–2.3	–1.2	
Current account balance (% GDP)	–5.5	–4.5	–4.3	–6.0	–5.1	–3.7	–3.2	–5.1	
Net lending or net borrowing rest of the world (% GDP)	–5.1	–3.9	–3.7	–5.3	–4.4	–3.1	–2.6	–4.6	
General government financial balance (% GDP)	–11.1	–9.2	–6.4						
FINANCIAL MARKETS			Forecast						Forecast
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.2	1.0	1.4	1.0	1.0	1.0	1.0	1.0	1.3
10-year US bonds	3.2	3.2	3.4	3.7	3.5	2.8	2.8	3.4	3.2
10-year German bonds	3.3	2.8	3.4	3.2	2.8	2.4	2.6	3.2	3.3
Exchange rate									
$/Euro	1.39	1.33	1.41	1.38	1.27	1.29	1.36	1.37	1.44

Contents

Private consumption, pillar of the economy

If there's one thing that characterizes advanced economies it's an extensive middle class. This group's lifestyle includes aspects such as the benefits of housing, access to educational services and health, the chance to take advantage of retirement, a life that combines moments of leisure (including holiday periods) with others of work, etc. The middle class lifestyle is related to certain levels of income. A recent study by the Organization for Economic Cooperation and Development (OECD) chooses to define middle class as the one made up of those households where daily consumption is at least 10 US dollars per person (in purchasing power parity). In a household with four members, this would mean a consumption threshold of around 15,000 dollars a year.

In fact, one of the characteristics of the middle classes is their high propensity to consume. And since the middle classes make up the largest component in countries with the highest income, it can be said that a large part of their consumption moves the economy. In most OECD countries, private consumption expenditure accounts for between 50% and 60% of the annual gross domestic product. Of note is the case of the United States, where consumption accounts for more than 70% of the product, while at the other extreme are the European Nordic economies, where this does not reach 50%. It's clear that consumer decisions are crucial to how an economy evolves.

Whereas, until recently, the existence of a significant middle class was an almost exclusive privilege of developed economies, the situation is changing quickly. In the last two decades we have witnessed the appearance of a new contingent of middle classes in the emerging economies. According to OECD projections, by 2020 two thirds of the middle class will live in areas other than North America and Europe. These 2,200 million people will be responsible for 54% of the total consumption by the world's middle class. In short, this is a hugely significant change in scenario as, for the first time since the industrial revolution, most of the world's consumption will have shifted from west to east, both in terms of the number of consumers and in spending capacity.

On the other hand, in advanced countries the prospects for private consumption expenditure are somewhat more subdued. The crisis and the recession have uncovered the excesses of the previous economic expansion, including a certain excess consumption. In general, this spending spree arose out of the boom in the economy and employment, but also from lax financial conditions and generous liquidity. Some studies point to a direct link between the degree of household indebtedness and the severity of the crisis and the rise in unemployment. High consumption also helps to explain other imbalances suffered by some economies, such as the deficit in the current balance of payments.

Will these excesses of the past have to be purged in the coming years? In the short term, a hangover from the crisis will be noticed in households' spending on consumption, affected by various factors that keep it in check, such as the withdrawal of fiscal stimuli (subsidies for buying a car, etc.), the slow improvement in the labour market and a low level of confidence. The unavoidable reduction in household indebtedness won't encourage any fast improvement in current expenditure either. Nevertheless, in the medium term consumption should regain its traditional role as the driving force in developed countries. However, in order for it to be sustainable, it must keep in line with the real possibilities of the economy.

EXECUTIVE SUMMARY

The Greek crisis increases uncertainty

The world economy suffers a slight dip in the second quarter.

The advanced economies' growth figures for the second quarter are being somewhat disappointing and the emerging economies have also slightly moderated their rate of expansion. However, the global recovery is still on course and is expected to continue along the right path in the second half of the year, achieving the annual growth forecast, which is slightly above 4%. Among the different risks to this happening, of particular importance is the uncertainty generated by the Greek crisis, with great doubts hovering over its resolution.

Growth forecasts reduced for the United States.

In the United States, the growth forecasts for this year are tending to be lowered. The International Monetary Fund (IMF) did so in mid-June by three tenths of a percentage point, down to 2.5%, adducing temporary factors such as high commodity prices, the bad weather and alterations in the supply chain after Japan's earthquake. Nonetheless, it's clear that this recovery phase is turning out to be much slower than in the prior recessions that have occurred since the end of the Second World War. One of the reasons behind this is the heavy borrowing of households (114% of their disposable income) and of the public sector (close to 100% of the gross domestic product), within a situation of banking and financial restructuring. Job creation is progressing slowly, with a 9.1% unemployment rate in May, and any significant improvement in employment is unlikely throughout 2011.

The Federal Reserve undertakes to maintain the lax profile of its monetary policy for a long time to come.

Within this context, the Federal Reserve, the central bank of the United States, has maintained its official interest rate at minimum levels (0%-0.25%), as well as maintaining its commitment to continue with the lax profile of monetary policy for a long time to come. In his appearance in June, Ben Bernanke, Fed Chairman, repeated the intention not to renew the quantitative easing scheme (QE2), which finalizes at the end of June. Moreover, he made it clear that the central bank intends to keep the size of its balance sheet constant until conditions warrant otherwise.

In short, Bernanke stated that it was still not the time to profile the «exit strategy», but neither was it the time to adopt a new quantitative easing scheme. He did warn of the need to redirect fiscal policy, expressing his concern given the situation of heavy borrowing that threatens the US economy if there are no substantial budgetary changes. In the short term, he asked for prompt negotiation in the Congress regarding legal debt limits which would provide the central bank with more room to manoeuvre. The markets have accepted the message given by the country's top monetary authority and do not expect the first rise in the official interest rate until well into 2012, although we still think this will happen in the first quarter of the year.

Japan is another economy seeing cuts in its growth figures due to the natural catastrophe it suffered in March. However, the most recent business indicators are favourable and confirm the expectation that, throughout the second half of the year, the country will manage to sort out its production and largely get back to the previous levels.

The emerging economies' problems are of a different nature and are more related to inflation and the consequent tougher monetary measures. In China, activity looks to be slowing up slightly, although capital goods and machinery investment are still growing strongly. The problem is that the consumer price index also rose by 5.5% year-on-year in May, the highest rise since July 2008. Given this persistent inflationary pressure, the monetary authority once again raised the cash reserve ratio, the sixth increase this year and the second in just over a month, placing it at 21.5% for large banks. Something similar is happening in India, whose 9.1% inflation is the reason why the central bank has once again raised its official interest rate to 7.5%, accumulating an increase of 275 basis points since March 2010. Brazil has also opted to toughen up its monetary policy and, in June, once again raised the Selic rate by 25 basis points to 12.25%, given that inflation is above 6% and in spite of activity looking likely to slow up over the coming months.

On the other hand, the emerging economies are being forced to tighten up their monetary policies.

In the euro area, and unlike most of the rest of the advanced economies, growth forecasts have been increased slightly thanks to the good performance by Germany and France. It should be noted, however, that indicators are pointing towards a slight slowdown in activity in the second quarter compared with the surprising growth of the first. This does not alter the belief, however, that the recovery is consolidating in the euro area, although there are still significant geographical disparities within the zone. The greatest risk over the coming months lies in the peripheral countries and, in particular, in Greece.

In fact, the Greek situation has once again focused attention on the euro area. The slowness of negotiations among the members of the European Union (EU) regarding Greece's solvency crisis, together with the paralysis of the Greek parliament, have led to further disruption in the financial markets.

Moreover, this might affect the real economy as a result of greater uncertainty over the coming quarters. The EU has conditioned the fifth payment of the financial bail-out (12 billion euros) and a second bailout plan, which would include a gentle, voluntary rescheduling of the Greek debt, on Greece's parliament passing the medium-term fiscal strategy. This is a programme of privatization and additional fiscal austerity measures, with larger cuts in government spending. After proposing a unity coalition government, which was rejected, changing the finance minister and overcoming a vote of no confidence, the Greek prime minister, Papandreou, has finally managed to get the adjustment package approved, which will help the new measures to be adopted that are aimed at stabilizing the Greek problem over the next few months.

Growth prospects improve for the euro area but Greece complicates the panorama.

The worsening of the Greek sovereign debt crisis and fears of this possibly affecting other countries is causing a «flight to quality» in investor preferences, widening the differential between the debt of the countries of peripheral Europe and German debt. In the case of Spain, the complication of the Greek crisis, speculation regarding the cost of a possible rescheduling of its debt for the European banking sector as a whole, plus the climate of impasse perceived in Spain's economic and political situation lie behind its sovereign debt climbing above 275 basis points. However, in spite of these notable upswings, the performance of Spain's sovereign bonds still appears to be relatively more stable than for the rest of the countries of peripheral Europe.

This better rating for Spanish debt results from the good performance by its public finances, presenting a 25% reduction over

Spain's sovereign bond risk premium shoots up again but is looking more robust.

Developments in the public accounts are being followed with great interest.

the first five months of the year in the central government's deficit compared with the same period a year before, while Social Security is still posting a surplus. Nonetheless, some concern can be seen regarding the accounts of the autonomous communities. Given the risk of diverting the direction of fiscal consolidation, the European Commission presented a series of recommendations as part of its review of the 2011-2014 Stability Programme. Among these, of note is greater control of the autonomous communities' public accounts and the establishment of a spending limit to improve the sustainability of Spain's debt. In this respect, the Spanish government has undertaken to include, in its Budget Stability Act, a rule that prevents increases in public spending from exceeding the growth expected for the economy in the medium term.

The government approves the collective bargaining reform.

The IMF has also pointed out the need to meet public deficit targets and to increase the transparency of autonomous community accounts. Moreover, its preliminary report on the Spanish economy sets out the points still pending in the reforms of the financial system and employment regulations. In the former, it recommends that those institutions that do not achieve the minimum capital requirements should be quickly restructured, and encourages banks to continue recapitalizing and improving their liquidity and reserves. With regard to labour market reforms, it notes the appropriateness of decentralizing collective bargaining to the level of the firm, doing away with wages linked to inflation and replacing this with productivity, as well as reducing severance pay to the EU level.

In fact, in June the government pushed through the collective bargaining reform. This reduces the prevalence of provincial agreements on the firm, although sector agreements can prevent company agreements from developing a large number of areas. Similarly, firms can also adjust to the economic cycle by making available 5% of the annual work day, and an attempt has been made to limit ultra-activity, i.e. the indefinite extension of agreements when collective bargaining has not been successful. In other provision, firms with temporary losses can file for an official redundancy plan.

For the moment, the labour market can't seem to achieve positive figures. Although the number of people registering as employed rose in May, such improvement was largely due to the seasonal factor of the period as, once corrected, this positive result disappears. Although the total number of employed rose by 117,990 people, very slightly reducing the fall in this figure to 1.0% year-on-year, this rise evaporates when the seasonal effect is taken into account.

Growth prospects are slight but the foreign sector's good performance and easing commodity prices give grounds for hope.

The poor job creation figures are related to the fragile progress being made by the economy, clearly lower than that of the euro area as a whole. Available indicators suggest that, over the coming months, this rate of growth will not improve and that, in fact, it will probably slow up slightly. In particular, the contribution of domestic demand is expected to be negative during the second quarter, so that the support provided by the foreign sector will continue to be crucial. Actually, the good pace of growth enjoyed by Spain's main trading partners will keep the foreign sector's contribution positive for the remainder of the year, helping to offset the weak domestic demand. Contained prices for oil and other commodities will also help to improve domestic income and will alleviate the currently high inflation rate. Lastly, the possible resolution of the current negotiations regarding the Greek crisis should sort out economic prospects in the medium term and will ease the financing costs that are now hitting Spanish debt hard.

29 June 2011

CHRONOLOGY

2010

June	**17**	The European Council decides to publish the **stress tests** for the main European banks, to levy a **new tax on banks** and improve the **budget discipline and macroeconomic standards**.
	22	The Spanish parliament **approves a Decree-Law with urgent measures to reform the labour market**, proposed by the government.
	26	One year after the Fund for Orderly Bank Restructuring (FROB) was set up, the Bank of Spain considers the **process of restructuring savings banks** in Spain to be almost complete.
	27	The **G-20** summit decides to halve the deficits of advanced economies by 2013.
July	**1**	**Rise in the general VAT** rate from 16% to 18%, and the reduced rate from 7% to 8%.
	9	The government approves the **reforms of the Savings Bank Governing Body Act**.
	22	The Ministry of Public Works specifies its **cuts in public works spending**.
	23	The Committee of European Banking Supervisors publishes the results of the **stress tests** on European banks.
September	**9**	The Spanish lower house passes the **labour reforms**.
	24	The government passes the bill for the **2011 General State Budget**, involving strong adjustments aimed at reducing the public deficit.
	29	**General strike**, called against the labour reforms.
October	**20**	Extensive reshuffle in the **Spanish government**.
November	**19**	The government establishes a **legislative calendar** that includes **pension and collective bargaining reforms**.
	24	**Ireland** presents an **adjustment plan** with tough measures to cut its public deficit in order to receive **financial aid** from the EU and the IMF.
December	**3**	The government approves a package of **economic policy measures** that includes, among others, the partial privatization of the state lotteries management body and the public corporation AENA, as well as raising taxes on tobacco.
	16	The European Council agrees to create a **European Stability Mechanism** in 2013, which will replace the current bailout fund, as well as to enlarge the capital of the European Central Bank.

2011

January	**1**	Estonia joins the **euro area**, which grows to seventeen member states.
	14	Ben Ali's regime in Tunisia falls, the first in a chain of **political changes** in North Africa and the Middle East, with repercussions for oil prices.
February	**2**	Signing of the **Social and Economic Agreement** by the government, trade unions and employers, including pension reform.
	18	The government passes a Decree-Law to reinforce the solvency of **financial institutions**.
March	**25**	The **Euro Plus Pact** is approved and the foundations are laid to set up the **European Stability Mechanism** in the European Council.
April	**7**	The **European Central Bank** raises the official interest rate to 1.25%.
May	**17**	The Council of Economic and Finance Ministers of the European Union approves the **financial bail-out plan for Portugal**, totalling 78 billion euros.
	22	**Elections** are held in thirteen autonomous communities and in the municipalities.
June	**10**	The government approves a Decree Law that **reforms collective bargaining**.

AGENDA

July

4 Registration with Social Security and registered unemployment (June).
6 Industrial production index (May).
7 Governing Council of the European Central Bank.
13 CPI (June).
14 EU HICP (June).
20 Foreign trade (May).
22 Producer prices (June).
26 Government revenue and expenditure (June).
29 Labour force survey (second quarter).
Balance of payments (May). Flash CPI (July).
US GDP (second quarter).

August

2 Registration with Social Security and registered unemployment (July).
4 Governing Council of the European Central Bank.
5 Industrial production index (June).
9 Fed Open Market Committee.
12 CPI (July).
16 GDP flash estimate (second quarter).
17 EU GDP flash estimate (second quarter).
25 Foreign trade (June). EU HICP (July).
26 Producer prices (July).
30 Quarterly national accounts (second quarter).
31 Flash CPI (August).
Balance of payments (June).
Government revenue and expenditure (July).

INTERNATIONAL REVIEW

The United States: less growth and slightly more inflation

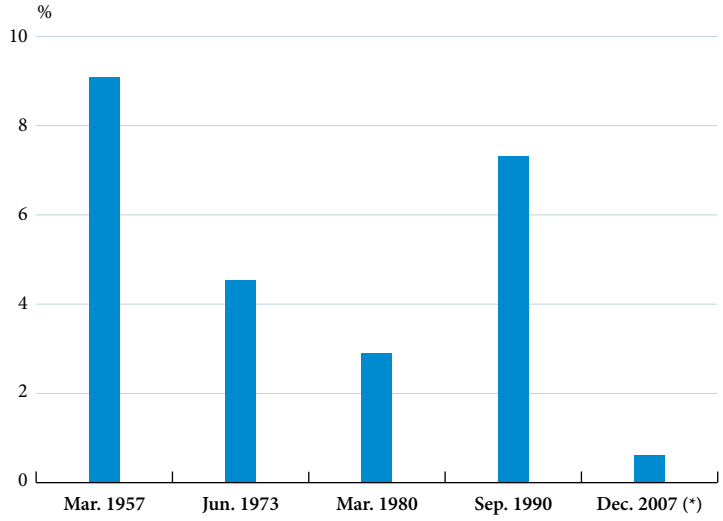
The United States gets back to pre-crisis levels but its growth is insufficient.

The US economy is going through its most problematic recovery since 1945. The growth forecast for gross domestic product (GDP) for the whole of 2011 is a little above 2.5%, clearly below what was expected in April and utterly insufficient for significant improvement to be seen in the labour and housing market. The reason for this slowdown in activity is partly due to temporary factors such as rising oil prices and the interruption of supply chains in industry because of Japan's earthquake. Now that oil is likely to fall in price and Japan to regain its industrial rhythm, activity should be expected to improve its performance somewhat during the second half of year.

However, the weakness of the recovery is not only due to temporary factors. Proof of this is the fact that the US economy has taken three years to regain its pre-recession level. GDP for the first quarter was 0.6% above the level of October-December 2007, the last quarter of positive growth prior to the recession. This cumulative growth three years after the start of the recession is higher than the rates of Western Europe and Japan but far behind the rate in the United States in the four previous recessions since the end of the Second World War. The most comparable case is the 1982 recession, when

THE UNITED STATES: AN INSUFFICIENT RECOVERY

Cumulative growth in GDP three years after the start of the recession



NOTE: (*) Last quarter of growth before the recession, basis for calculating the cumulative growth.
SOURCES: Bureau of Economic Analysis, Thomson Datastream and own calculations.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
Real GDP	–2.6	2.9	3.0	3.2	2.8	2.3	–	...
Retail sales	–7.0	6.4	6.8	5.6	7.7	8.2	7.3	7.7
Consumer confidence (1)	45.2	54.5	58.2	50.9	57.0	66.9	66.0	60.8
Industrial production	–11.2	5.3	6.5	6.9	6.2	5.3	4.7	3.4
Manufacturing (ISM) (1)	46.3	57.3	57.6	55.2	57.9	61.1	60.4	53.5
Housing construction	–38.4	5.6	12.7	–0.7	–5.1	–5.3	–21.3	–3.4
Unemployment rate (2)	9.3	9.6	9.6	9.6	9.6	8.9	9.0	9.1
Consumer prices	–0.4	1.6	1.8	1.2	1.3	2.1	3.2	3.6
Trade balance (3)	–381.3	–500.0	–457.2	–489.1	–500.0	–521.2	–523.4	...
3-month interbank interest rate (1)	0.7	0.3	0.5	0.3	0.3	0.3	0.3	0.3
Nominal effective exchange rate (4)	77.7	75.6	77.9	76.1	73.2	72.1	69.8	69.9

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

unemployment also exceeded 10% but, nevertheless, the strength of the recovery meant that the cumulative growth three years after the start of the recession was 2.9%, much higher than today's figure.

Heavy borrowing by various sectors in the economy is the main difference contributing to the weakness of the recovery. Household debt is still high at 114.1% of disposable income in the first quarter, while gross public debt is more than likely to exceed 100% of GDP in 2011, with a public deficit that will remain above 10% for the year as a whole. Debt and the credit crisis have helped to produce a vicious circle between the weakness of the labour market, which increases doubtful debt and boosts the excess supply of housing, and house prices, which have yet to bottom out. The Case-Shiller index for second hand house prices in March posted its ninth consecutive month of falls, although the rate of decrease is getting smaller.

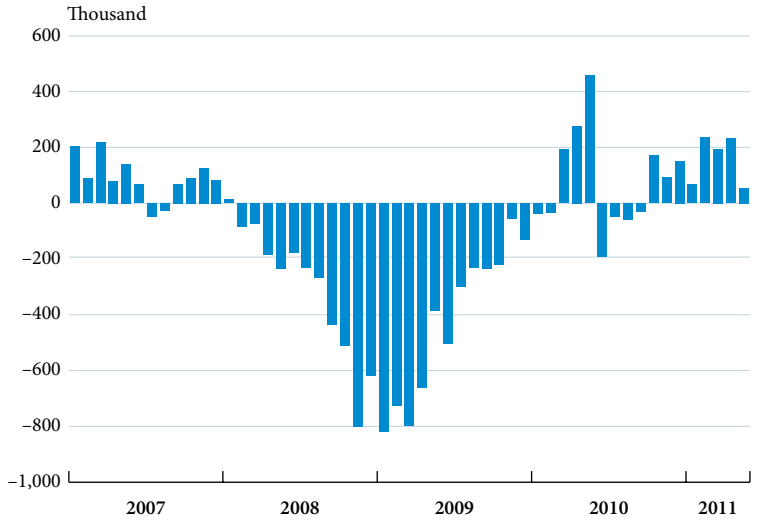
The labour market has a long way to go before it recovers all it lost during the recession. Job creation is slow and significant improvements in employment are unlikely to be seen throughout 2011, with a high proportion of long-term unemployed who are difficult to relocate and a large contingent of discouraged workers who will absorb a great part of the demand for jobs as these are created. May was a bad month for the labour market, with the creation of 54,000 new jobs, far below the figure posted for the previous two months, and with another slight rise in the unemployment rate, which at 9.1% was three tenths of a percentage point above the level of December 2010, without showing any signs of improving. The budget restrictions caused by the high public deficit are another big spanner in the works for the recovery in employment, with a cumulative loss of 853,000 public jobs in the last twelve months.

Debt is hindering the recovery in the housing and labour market.

Unemployment stands at 9.1% while the number of discouraged workers and the long-term unemployed make improvement difficult.

THE UNITED STATES: JOB CREATION IS GOING SLOWLY

Monthly net creation (+) or loss (–) of non-agricultural jobs



SOURCES: Department of Labor and own calculations.

Business sentiment matches the economy's weak growth.

By sector, construction has not created jobs for the last year, while the aforementioned interruption in production chains due to Japan's earthquake has helped to halt the relatively good run of manufacturing employment. Within this situation, the business sentiment index for manufacturers of the Institute for Supply Management abruptly halted its positive trend, falling from 60.4 points to 53.5 points. For its part, the index for services, which accounts for 83.5% of all private employment, remained at 53.7 points. In both indices, especially in services, these levels are consistent with modest growth rates in the economy as a whole.

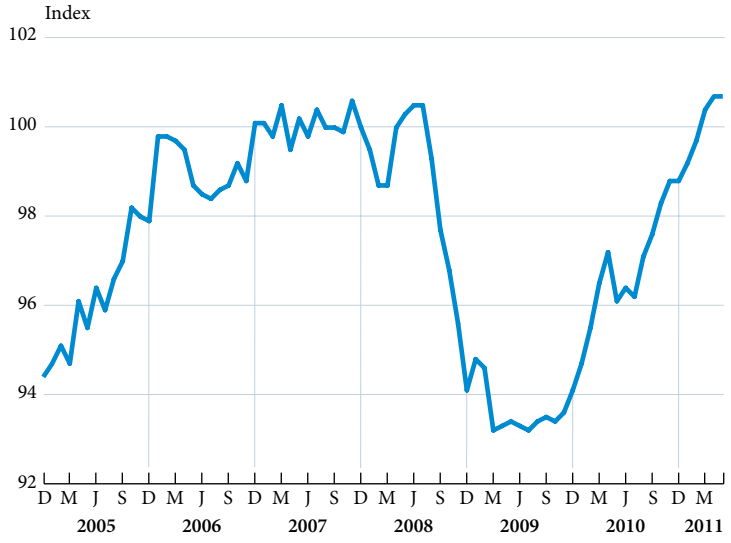
The positive note continues to be the fundamental strength in private consumption, within the context of a slowdown.

The best news for the month came from private consumption, which once again showed fundamental strength that is helping to maintain the overall tone although growth is weakening. Consumer activity, which accounts for 71.1% of GDP, suffered a considerable slowdown in the first quarter which pulled the economy's growth forecasts down for 2011. The good performance by retail sales in May is therefore welcome, these rising 6.4% year-on-year, excluding cars and petrol. Along the same lines, the savings rate once again fell to 4.9% of disposable income, the lowest level since October 2008.

Rising commodity prices, more expensive Chinese imports and the effect on supply of Japan's earthquake have all pushed up prices more than expected at the start of the year. The general consumer price index (CPI) rose by 3.5% year-on-year in April, when in January it only rose by 1.6%. But more significant is the upswing in the core CPI, which excludes energy and food prices, speeding up to 1.5% year-on-year when in October 2010 it had reached a record low of 0.6%. The growth-inflation relation has therefore worsened but the situation is nothing like the one in the 1970s, characterized by the phenomenon of stagflation.

THE UNITED STATES: PRIVATE CONSUMPTION STANDS FIRM

Real retail sales without vehicles or petrol. Base 100 = December 2007 (*)



NOTE: (*) Data adjusted by the consumer price index without energy or foods.
SOURCES: Department of Trade and own calculations.

Unlike then, the greatest risk now is insufficient growth while, although prices have been a surprise, the weakness in the labour market and the temporary nature of certain factors in this upswing in prices suggest that inflationary pressures should die down in the second half of the year. The rise in underlying prices is partly due to the increase in commodities being passed on to some products included in the core CPI. Should commodity prices continue to fall, the pressure on core inflation should also ease. The increase in rented housing, which in the United States has a considerable effect on the CPI, was another inflationary element at the beginning of year, but in the last few months this trend has been reversing. Lastly, the rising price of durables is a third factor that played a large part in May's upswing but this is due to temporary causes, such as the effects of Japan's earthquake and vehicle prices getting back to normal after the end of aggressive discounts.

The CPI is up by 3.5% and core inflation by 1.5% due to rising prices in commodities and durables...

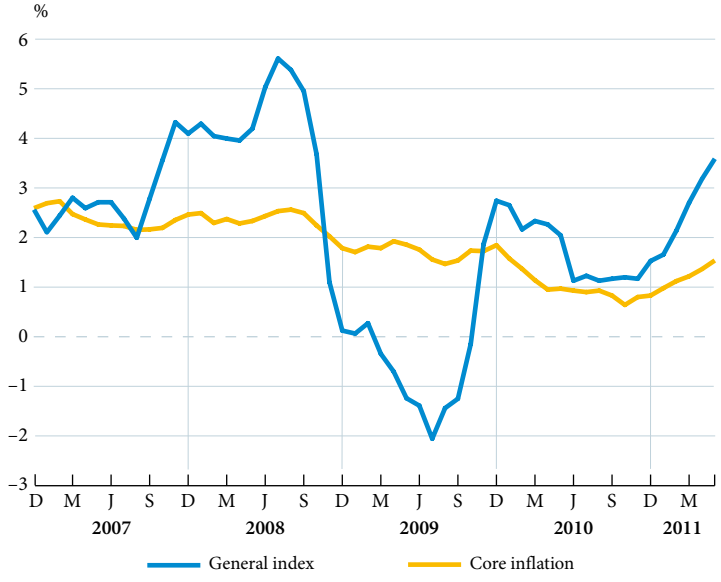
In the foreign sector, April's deficit improved thanks to cheaper oil. The balance that excludes oil and its derivates, which indicates the underlying trends in the trade balance, deteriorated slightly due to a worse bilateral balance with China. Nevertheless, this did not stop the trade deficit without oil for the last three months as a whole from reaching a figure 30.9% lower than the one for the second quarter of 2008, the last prior to the drop in trade flows. The positive note is that, since then, exports have been growing, on average, slightly above imports, although April was a month of slowdown. Nonetheless, in the short term, continuing high oil prices will make it difficult for this positive trend to lead to any rapid reduction in the trade deficit and to contribute to growth.

...but the Federal Reserve still has room to go on boosting demand, if required.

The foreign sector maintains its corrective trend but expensive oil makes it unlikely to contribute to growth.

THE UNITED STATES: THE CORE CPI IS ALSO RISING

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



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

Japan: reconstruction starts, which is quite a feat

Japan's economy will shrink in 2011 but a recovery is expected for the second half of the year.

After a very weak first quarter and the additional effects of March's earthquake, growth for 2011 as a whole will probably be negative, with the first six months in contraction, in which the effects of the earthquake are added to the weak situation the Japanese economy was already going through, and a second half of the year of strong recovery. The main risk for the Japanese economy is still whether this recovery will actually materialize in the second half of the year, and this will depend on the power cuts due to the Fukushima power plant crisis not lasting until the summer months.

Industrial production and machinery orders are showing an incipient recovery.

In this respect, the latest indicators are not as bad as expected and make recovery in the second half of the year look more likely. Firstly, GDP for the first quarter was revised upwards slightly because of a somewhat lower negative contribution from inventories, affected by the earthquake. Similarly, April's indicators, which contain the effects of the earthquake, confirm some recovery. Industrial production, which in Japan is closely linked to GDP, saw a slight rise of 1.6% compared with March, a month with record falls. Equally, private machinery orders, a leading indicator of investment, grew by 3.6% in April if we exclude singular projects. It was not the same situation for construction, however, as new houses started have yet to bottom out, with a slight fall in April after the sharp drop in March.

There are also signs of improvement in the area of households. The consumer confidence index, which had fallen in April although remaining above the minimum of December 2008, rose in May by 33.1 to a level of 34.2 points.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
Real GDP	–6.3	4.0	3.3	4.8	2.4	–0.7	–	...
Retail sales	–2.3	2.5	3.7	3.2	–0.4	–3.0	–4.8	...
Industrial production	–21.8	16.6	20.5	13.3	6.8	–2.5	–12.3	...
Tankan company Index (1)	–40.8	0.0	1.0	8.0	5.0	6.0	–	...
Housing construction	–27.7	2.7	–0.8	13.7	6.8	3.2	0.4	...
Unemployment rate (2)	5.0	5.1	5.1	5.0	5.0	4.7	4.7	...
Consumer prices	–1.3	–0.7	–1.0	–0.8	0.1	0.0	0.3	...
Trade balance (3)	4.0	7.9	7.4	8.1	7.9	6.5	5.1	...
3-month interbank interest rate (4)	0.6	0.4	0.4	0.4	0.3	0.3	0.3	0.3
Nominal effective exchange rate (5)	98.6	106.0	102.8	109.1	111.0	110.6	106.9	110.1

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

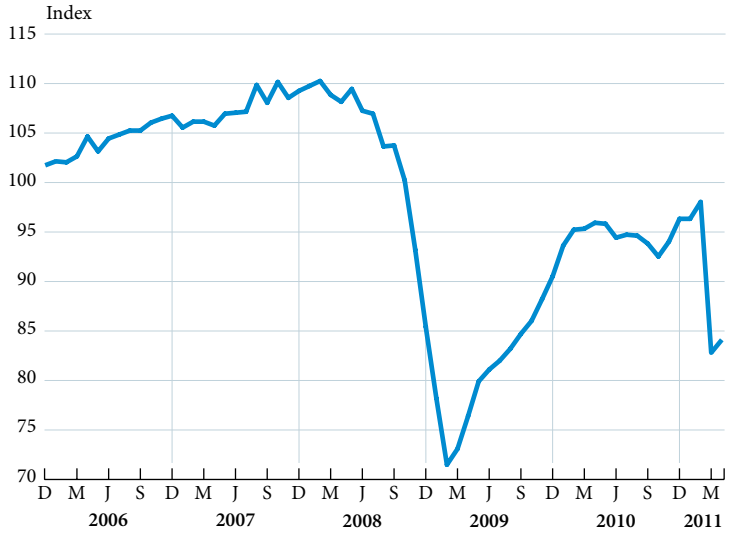
Similarly, whereas April's automobile sales were practically half those of the same month a year ago, in May they came very close to two thirds of May 2010.

There is a similar pattern in prices. Whereas, at first, deflationary effects dominated due to the stoppage in consumption, in April the trend has

Consumer confidence and car sales also improve moderately.

JAPAN: INDUSTRIAL PRODUCTION HITS BOTTOM

Industrial production index



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

The earthquake will speed up the end of deflation, with the CPI rising 0.3% while the trade balance ends up in deficit.

reversed and inflationary effects dominate, due to the interruption in supply chains. Japan came momentarily out of deflation, with its CPI rising 0.3% year-on-year. Similarly, the core CPI, the general index without energy or food, bottomed out and remained only 0.1% below the figure for the same period last year, whereas in March it had fallen by 0.7% year-on-year. For its part, April's trade balance showed a deficit due to the drop in exports.

Facing high inflation: another cash ratio increase for China and a hike in interest rates for India in just over a month.

China: inflation and tougher monetary conditions, the Asian duo for 2011

Once again, inflation and tougher monetary conditions are news in the two Asian giants, China and India. For China, the consumer price index increased by 5.5% year-on-year in May, the highest rise since July 2008. Although the price of food, up 11.7% year-on-year that same month, is still a key element in the country's rising inflation as it accounts for 30% of the shopping basket, the growing trend in the component without food adds pressure to the risk of overheating. Similarly, inflation in India (in the wholesale price index) stood at 9.1% in May, compared with 8.7% in April, also supported by the component without food (see the graph below).

Given this persistence of inflationary pressure, China once again raised its cash reserve ratio, the sixth rise in the year and the second in just over a month, placing it at 21.5% for large banks. This is in addition to two hikes in the reference rate up to 6.31% in 2011. In a similar situation to its neighbour in the north, India's central bank has also once again raised its official interest rate to 7.5%, now accumulating a hike of 275 basis points since March 2010.

Slight moderation in some of May's business indicators.

Within this context of rising prices, China's slight moderation in several of the most recent indicators of activity, for the month of May, has relieved fears of a hard landing for the time being. Retail sales grew in current terms by 16.9% year-on-year, slightly below the figure for the previous month. Industrial production advanced by 13.3%, practically the same rate as April and below the figure of almost 15% for the first quarter of the year. Along the same lines, the purchasing managers' index (PMI) once again fell slightly to 52 points.

CHINA: MAIN ECONOMIC INDICATORS

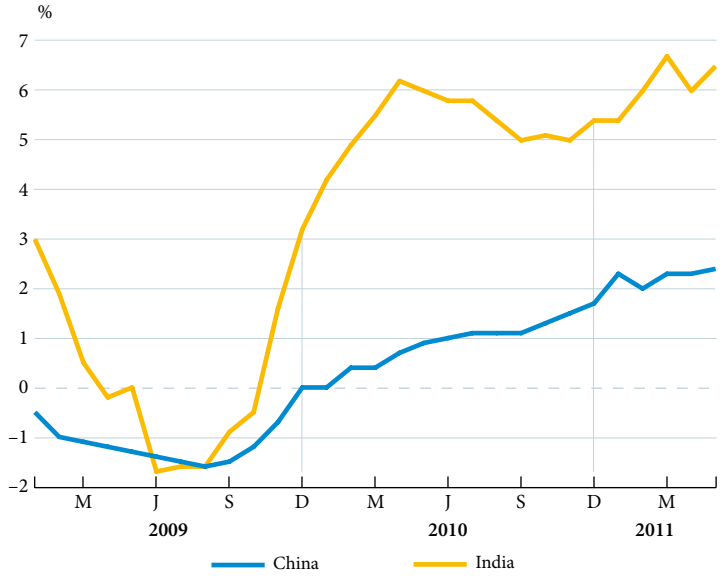
Percentage change over same period year before, unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
Real GDP	9.2	10.3	10.3	9.6	9.8	9.7	–	...
Industrial production	12.5	14.5	16.0	13.5	13.3	14.9	13.4	13.3
Electrical power generation	6.8	14.0	17.8	11.8	6.2	12.1	10.5	10.9
Consumer prices	–0.7	3.3	2.9	3.5	4.7	5.1	5.3	5.5
Trade balance (*)	196	184	155	182	184	169	179	173
Reference rate (**)	5.31	5.81	5.31	5.31	5.81	6.06	6.31	6.31
Renminbi to dollar	6.8	6.8	6.8	6.8	6.7	6.6	6.5	6.5

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

CHINA: CORE INFLATION ACCELERATES IN THE LARGE EMERGING ASIAN ECONOMIES

Year-on-year inflation



NOTE: India's data correspond to the wholesale price index.
SOURCES: Thomson Reuters Datastream and own calculations.

Still without showing any signs of easing back, fixed capital investment continued to grow strongly with cumulative increases from January to May of 25.8% year-on-year. Externally, imports remained dynamic with growth of 28.4% year-on-year in May, exceeding April's figure of 21.8%. For their part, exports advanced a restrained 19.4% year-on-year, indicating a certain weakness in global demand and placing the trade surplus at 13 billion dollars. In the last 12 months, the trade surplus for goods has accumulated a balance equivalent to 2.6% of GDP.

In spite of inflationary tensions still being very much present, as well as the dynamism of some leading indicators, the International Monetary Fund, in June's review of its «World Economic Outlook» (WEO), kept its forecasts unchanged for the Asian giant at 9.6% and 9.5% for 2011 and 2012, respectively, slightly above our own estimates.

This shows some confidence in the policies implemented by the government to promote domestic consumption as the driving force behind the country's progress.

The IMF maintains its growth forecasts for the Asian giant at around 9.5%.

Brazil: focusing on moderation

In line with expectations, the Brazilian economy grew by 4.2% year-on-year in the first quarter of 2011 and 1.3% compared with the previous quarter. At the same time, the figure for quarter-on-quarter growth for the last quarter of 2010 was revised upwards from 0.7% to 0.8%.

An analysis by component makes it clear that Latin America's leading power is still benefiting from the powerful push provided by domestic demand. Although it's still following the path of moderation started in mid-2010, consumption and investment confirmed their place in the

Brazil's economy grows by 4.2% in the first quarter of 2011, in line with expectations.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
Real GDP	–0.7	7.5	9.1	6.8	5.0	4.2	–	...
Industrial production	–7.3	10.5	14.1	8.0	3.6	2.5	–0.1	...
Consumer confidence (*)	138.3	157.9	154.6	159.5	159.3	160.1	158.4	...
General unemployment rate (**)	8.1	6.7	7.3	6.6	5.7	6.3	6.4	6.4
Consumer prices	4.9	5.0	5.1	4.6	5.6	6.1	6.5	6.6
Trade balance (***)	25.3	20.2	19.3	16.8	20.2	22.5	23.1	23.2
Interest rate SELIC (%)	9.92	10.00	10.25	10.75	10.75	11.75	12.00	12.00
Reales to dollar (*)	2.3	1.8	1.8	1.7	1.7	1.6	1.6	1.6

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

Domestic demand confirms its key role but increases pressure on prices.

driving seat with advances year-on-year of 5.9% and 8.9%, respectively. With regard to public consumption, this posted a slight upswing due fundamentally to base effects, up by 2.2%. For their part, exports slowed down their growth, rising 4.3%, while growth in imports once again saw double digits, up 13.1% (see the graph below).

Brazil's economic expansion continues apace thanks to the push from credit, the good performance of the labour market and the high price of commodities, but signs of restraint are starting to appear. In April, industrial production fell by 0.1% year-on-year and posted its worst month-on-month drop since December 2008 (2.1%). Similarly, retail sales, excluding automobiles, also surprised with a 0.2% drop compared with March, basically because of rising fuel and food prices.

Monetary and fiscal policies will have to prolong their restrictive tone to bring prices into line again.

And, although this rise is expected to be temporary, the change in direction of economic policies will remain over the coming months, suggesting that 2011 and, especially, 2012 will focus on moderation. A moderation that the IMF has already included in its new forecast scenario, reducing its growth forecast for the Brazilian economy in 2011 by four tenths of a percentage point to 4.1%, and by five tenths of a percentage point for 2012, to 3.6% (both changes compared with its April scenario). On the other hand, this moderation is crucial given the marked upswing in prices and growing demand pressures on installed production capacity. In May, inflation slowed up its rise a little but the year-on-year figure is already at 6.6% and is still far from the central bank's target (4.5% ± 2pp). Base effects will play against this at least until August, so that inflation might reach 7% before starting to fall again at the end of the summer.

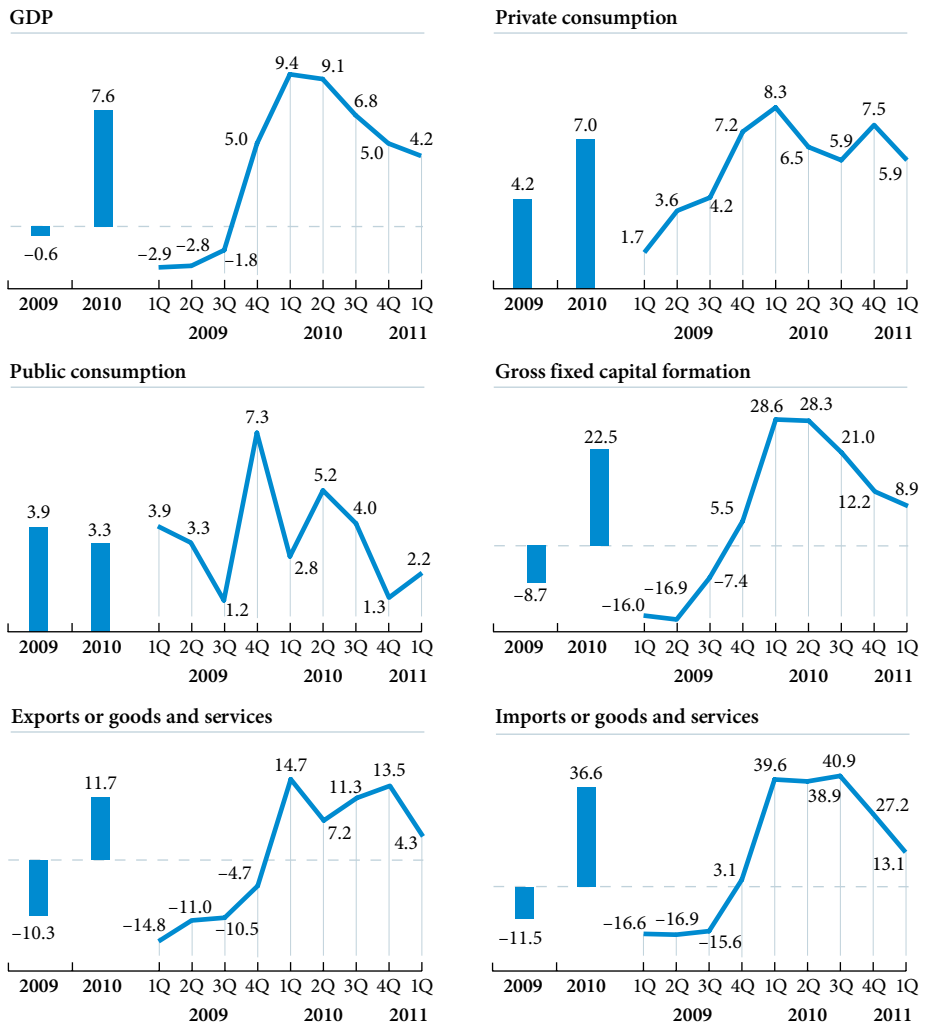
Nonetheless, we do not expect cumulative inflation at the end of 2011 to be lower than 6.3% and therefore anticipate another inflationary source when, at the beginning of 2012, the minimum wage will be adjusted according to the cumulative inflation figure for the previous year (in accordance with a law passed in February). Given this panorama, the Monetary Policy

Committee chose to raise the Selic rate by 25 basis points in June to 12.25%. Although this increase was less than in previous hikes and might suggest that a pause is imminent, the Committee stressed its intention to maintain the restrictive tone of monetary policy until prices are back on a stable path.

Dilma Rousseff has also repeated her intention to intensify the fight against overheating based on a fiscal and macroprudential approach. However, some are concerned that this commitment might be upset by the recent loss of her Chief of Staff and main supporter of macroeconomic orthodoxy in the cabinet, Antonio Palocci, due to a possible case of corruption. Nonetheless, all crises are also opportunities and this could be the chance the Brazilian president was waiting for to demonstrate her skill as a leader and her firm grip on the rudder; vital when the going gets tough.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

Mexico: *carpe diem*

Mexico appears to remain on the sidelines of the slowdown in the world economy.

In the latest forecast scenario by the International Monetary Fund, Mexico is one of the few economies whose growth forecasts for 2011 have been revised upwards (one tenth of a percentage point compared with its April scenario, placing growth for the year as a whole at 4.7%). Certainly, Mexican economic activity seems to have remained on the sidelines of the current global slowdown in growth. Something that comes as a surprise if we remember that the paradigm of this slowdown is the United States and that the Mexican economy is closely tied to the economic performance of its neighbour to the north.

Mexico's rate of inflation falls to 3.2%.

Nonetheless, the explanation can be found, on the one hand, in the fact that Mexico is a net exporter of oil and has therefore benefited from the high price of crude and, on the other hand, in the fact that the Latin American economy has two key engines. Although its recovery was supported by its external engine and by exports of manufactured goods to the United States, the recent consolidation of the expansionary phase in the economic cycle is being boosted by the gradual recovery in domestic expenditure, helping to offset a certain shrinkage in foreign demand.

Mexico must take advantage of the occasion to push forward with reforms.

Thanks to this rebalancing, the first quarter of 2011 was better than expected for the Mexican economy in terms of economic activity and the latest indicators point to the rate of growth not altering too much in the second quarter from the first, in spite of some negative figures in April (employment and consumer confidence). And if activity is on the right track, prices are performing equally well. While some of its more renowned neighbours are battling to contain rising price, Mexico is seeing its rate of inflation fall (3.2% in May). The peso was the only thing that dared to slightly unsettle this panorama: the delay in resolving the Greek crisis and doubts regarding the strength of the US economic cycle made foreign exchange markets more volatile.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
Real GDP	–6.2	5.4	7.3	5.1	4.2	4.4	–	...
Industrial production	–7.3	6.0	7.6	6.5	4.7	4.9	2.8	...
Consumer confidence (*)	80.5	86.3	84.9	89.2	89.6	92.1	89.7	89.3
Leading business index (*)	110.5	116.6	116.4	117.3	118.1	119.8	...	...
General unemployment rate (**)	5.5	5.4	5.2	5.6	5.3	5.1	5.1	5.2
Consumer prices	5.0	3.9	4.0	3.7	4.2	3.5	3.4	3.2
Trade balance (***)	–4.7	–3.0	–2.6	–2.0	–3.0	–1.5	–0.8	–0.4
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.2	12.3	12.8	12.6	12.3	11.9	11.5	11.6

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

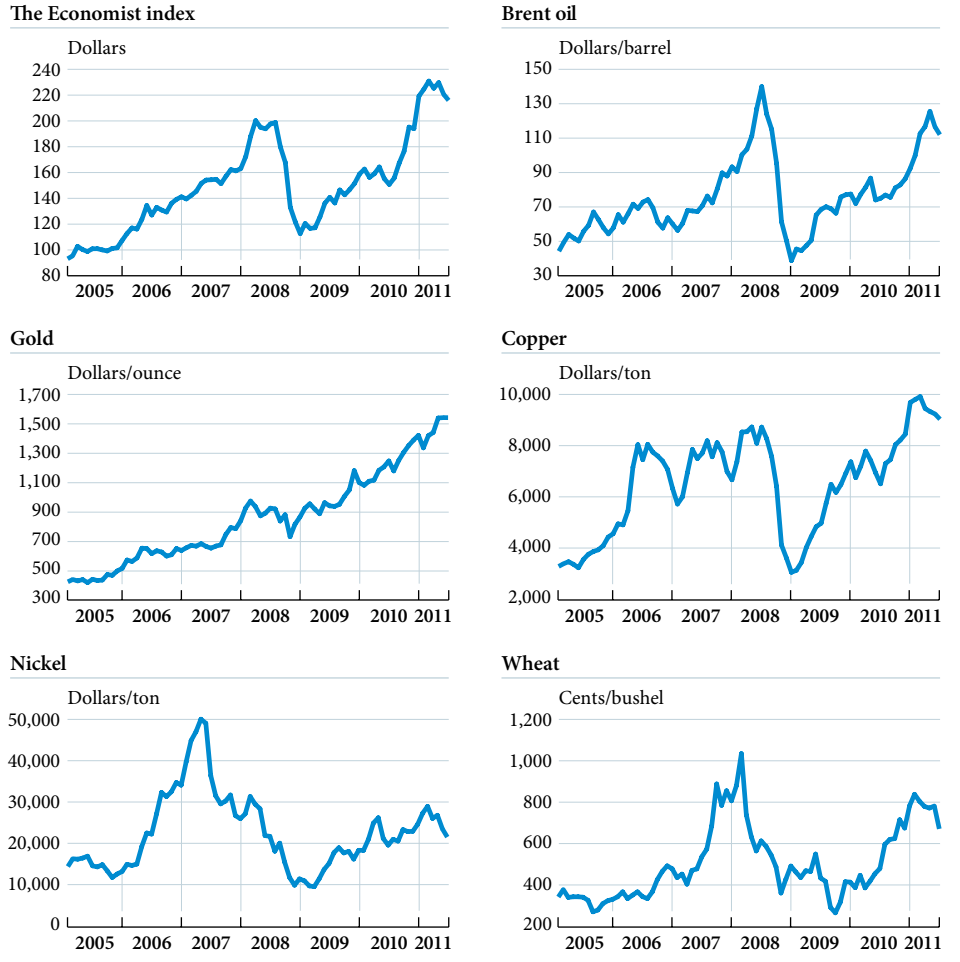
Although this volatility might continue while external doubts persist, it's true that Mexico is, for the time being and in relative terms, a peaceful backwater, economically speaking. It must take advantage of this calm period to push forward with crucial reforms in order to cement growth in the medium and long term. This involves reducing the public coffers' dependency on oil, promoting competition, reducing the weight of the informal economy and improving the educational system.

Change in direction for oil prices

Oil falls to 103 dollars per barrel thanks to the IEA releasing reserves.

Between 20 May and 20 June, the price of crude rose by 2.7%, reaching 112.32 dollars per barrel (Brent quality, for one-month deliveries), a 21.3% rise since start of year. As this Report was going to press, the International Energy Agency (IEA) released 60 million barrels of strategic reserves to offset OPEC's lack of agreement to increase production, pushing the price down to 102.72 dollars per barrel, the lowest level since

TREND IN VARIOUS COMMODITIES (*)



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

The trend in commodities is downwards but rice and sugar rise, while gold remains high.

11 February, at the start of the escalating Libyan crisis.

This action, agreed by the United States, Japan, South Korea and Germany, was approved by Saudi Arabia, although we have yet to see how the OPEC will react. The IEA has been preparing this action for the last three months given the restrictions imposed by the Libyan crisis, rising world demand and the threat posed to world growth by oil prices higher than 100 dollars per barrel.

The rest of the commodities saw moderate drops and The Economist index fell by 1.6% between 20 May and 20 June. Base metals saw widespread declines, especially nickel. In foods, although wheat and coffee were clearly on a downward path, rice and sugar bucked the trend with increases of 12.0% and 18.5%, respectively. For its part, gold continued to capitalize on the uncertainty in the global economy, remaining above 1,500 dollars per ounce and very close to its record high.

Emerging middle classes: the consumer of the future?

When we think about an archetypal world consumer, we most probably associate him or her with the middle class of advanced countries. This group's lifestyle includes aspects such as the benefits of housing, access to educational services and health, the chance to take advantage of retirement, a life that combines moments of leisure (including holiday periods) with others of work... All this seems the exclusive right of the most developed countries in the world. However, this stereotype, which was true just a few decades ago, might be taking giant steps towards becoming obsolete, if it's not practically obsolete already. Can we really say that consumers are still almost entirely located in Europe, North America, Japan and Oceania?

In order to answer this question, first we have to think about what we mean by middle class. In public debate, and as perceived by citizens, the middle class is difficult to define precisely. However, academic literature has opted for different focuses, one of the most widely accepted being the one that associates the middle class lifestyle (demonstrated through their consumption preferences) with certain levels of income. A recent study by the Organization for Economic Cooperation and Development (OECD) chooses to define middle class as the one made up of those households where daily consumption is at least 10 US dollars per person (in purchasing power parity).[1] In short, in a household with four members we would be talking about a consumption threshold of around 15,000 dollars a year.

So, how many people are in the middle class thus defined and where are they located geographically? According to OECD data, in 2009 the middle class was made up of 1,845 million people. Although most are still located in advanced countries, as 54% of them live in North America and Europe, it's still surprising to see that 46% of the middle class is located in areas where it used to be practically non-existent. This figure is more than significant, over 840 million people, and already accounts for a large proportion of the consumption carried out by the world's middle class, in the order of 35% of the total.

Given that the appearance of this new middle class has been due to strong growth in the emerging economies over the last two decades, we should ask ourselves how the world's middle class might evolve if the growth

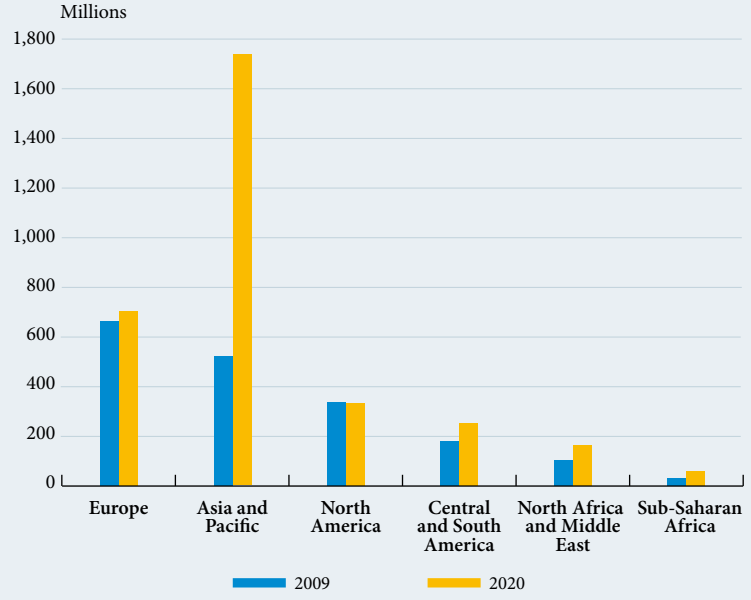
(1) Kharas, H. (2010), «The Emerging Middle Class in Developing Countries», Working Paper 285, OECD Development Centre, Paris.

forecasts for these countries actually come about. Always according to OECD projections, in 2020 the global consumption scenario will be substantially different from now. At the beginning of the next decade, two thirds of the middle classes will be living in areas other than North America or Europe. These 2,200 million people will be responsible for 54% of the total consumption by the world's middle class. In short, this is a hugely significant change in scenario as, for the first time since the industrial revolution, most of the world's consumption will have shifted from west to east, both in terms of the number of consumers and in spending capacity.

If the consumer of the future will largely be from the middle classes living in the emerging economies, one way of visualising this situation is by examining this group in China, the leading country in this worldwide consumption shift. According to the aforementioned OECD criteria, the Chinese middle class is already numerically important: it has reached 160 million people, becoming the second largest, at a national level, behind that of the United States. So what are these Chinese consumers like? First of all, fundamentally urban, as although half the households in China live in cities and other half in rural areas, almost all the middle class live in the country's urban areas. However, in spite of their urban habitat, we must move away from our perception of the lifestyle that characterizes the prosperous middle classes in advanced countries. A middle class Chinese home concentrates practically one third of its consumption on food, a much higher proportion than what is usual in the West. The other large items of expenditure are transport (17% of total household consumption), leisure, culture and education (13%), clothes (10%) and housing (9%).[2] Given that more than 50% of the consumption is focused on essential needs (food, clothes and housing), we can see that the Chinese middle class is different from its counterparts in advanced countries.

THE MIDDLE CLASS OF THE FUTURE IS VEERING TO THE EAST

People within the middle class (*)



NOTE: Definition of middle class in the text.
SOURCE: OECD (2010).

(2) These data and those of the number of consumer durables in the next paragraph are from the China Statistical Yearbook, 2010.

This conclusion remains if we analyze which consumer durables can be found in middle class Chinese households, a quick and intuitive way of comparing disparate situations. In China, the typical middle class household is equipped with the usual mod cons for domestic life (a fridge and washing machine are present in every home). The advantages of information technology are also present, as almost all families have a computer. Although the penetration of mobile phones is lower than the usual figure for our homes, with two mobile phones for the three members in an average urban household, the situation looks comparable. Far from our standards, however, fewer than a third of these households have a car. Television is also practically universal, although in leisure it's surprising to see that 5% of middle class households have a piano (and an additional 2% have other instruments).

We cannot dismiss this last piece of data as merely anecdotal as it points to a second big difference between the Chinese and our middle classes. Chinese consumers do not stand out purely for what they buy but also for why and how they buy. Although these aspects are more difficult to ascertain than the ones mentioned previously, marketing studies tend to conclude that a significant part of the consumption of the Chinese middle classes is aspirational in nature: it's the way in which the palpable desire is materialized to access a level and way of life that had traditionally been barred to them. This new status takes shape via consumer goods and leisure and cultural activities, such as having a piano.

Together with this desire to project a status and social position, Chinese consumers also stand out because they consider the very act of buying as central to their lifestyle. In a recent study, no fewer than 41% of those interviewed stated that going shopping was their favourite leisure activity. As befits their preferences, Chinese consumers dedicate close to 10 hours a week to visiting shopping centres and stores, far outstripping the 3.6 hours a week invested by North American consumers.[3] If these characteristics of the Chinese middle class are the result of a certain stage of socio-economic development or are more idiosyncratic in nature, only time will tell. What is unquestionable is that, given their current and future importance, scrutiny of the emerging consumer has only just begun.

(3) Chan, W. C. and A. TSE (2007), «The Consumer Trap: Retailers Need to Adapt to Entice Fickle Chinese Shoppers into Their Stores», McKinsey & Company.

This box was prepared by Àlex Ruiz
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EUROPEAN UNION

The Euro area: moderate slowdown

The Greek situation is once again the focus of attention in the euro area. The slowness of negotiations among the members of the European Union regarding Greece's solvency crisis, together with the paralysis of the Greek parliament, have led to further disruption in the financial markets. Moreover, this might affect the real economy as a result of greater uncertainty over the coming quarters.

The Greek situation can be summed up in a few words. The European Union postponed the fifth payment of the financial bail-out (12 billion euros) while calling upon the Greek parliament to pass its medium-term fiscal strategy, consisting of a programme of privatization and additional fiscal austerity measures, supposing larger cuts in government spending. The Greek prime minister, Papandreou, proposed a unity coalition government, which was rejected, changed the finance minister to Evangelos Venizelos and overcame a vote of no confidence. He also proposed a national referendum to calm down the rest of Greek society. This referendum, which will be in the autumn, will propose, among other measures, a change in the constitution to cut back the privileges of the political class, alter the party funding system and reduce the size of the public sector.

Fortunately, this crisis is occurring within a scenario of economic recovery, as highlighted by the breakdown in growth of gross domestic product (GDP) for the first quarter in the euro area. Given the good figures for economic activity, several financial organizations have upped their GDP estimates in 2011 for the euro area. For example, the International Monetary Fund (IMF) has raised its forecast by four tenths of a percentage point to 2%, and the European Central Bank (ECB) has increased growth by two tenths of a percentage point to 1.9%.

The Greek crisis continues to be the focus of attention in the euro area.

In fact, private consumption has consolidated its growth around 1.0% in the last quarter. Although this is still slow, it must be interpreted as positive within the context of household deleveraging. Gross fixed capital formation has picked up more strongly. Thanks to manufacturing orders, European investment grew by 4.2% year-on-year in the first quarter. Curiously, and in spite of the fiscal austerity plans, public consumption has also picked up to 1.1%. Public consumption will have to take a more moderate path over the coming quarters to comply with the fiscal consolidation in which most European countries are currently immersed.

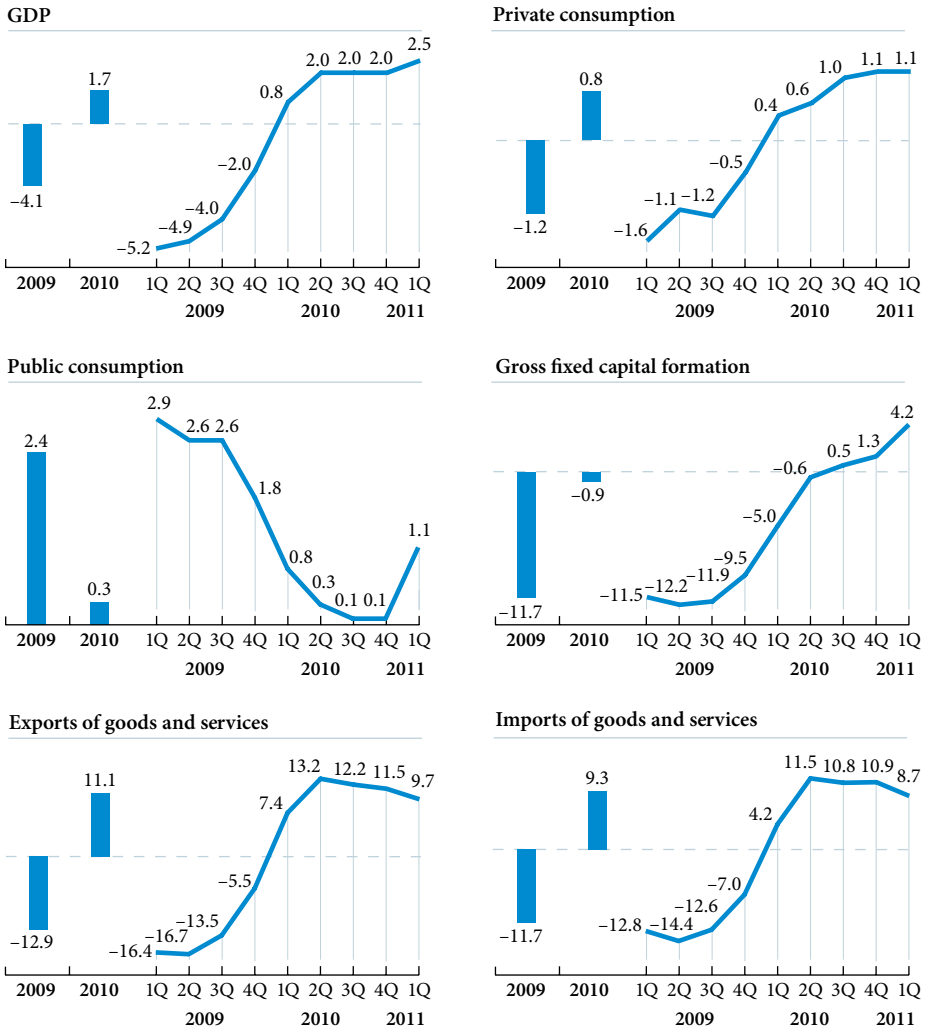
Economic recovery consolidates in the euro area.

All this is happening within an environment where leading macroeconomic indicators point to a slight slowdown in the pace of growth for the euro area as a whole. This situation is due to two reasons. Firstly, some countries have seen extraordinary growth in the first quarter that is not sustainable in the long term. This is the case, for example, of Germany, announcing 4.9% growth year-on-year in the first quarter.

In addition to the improvement in investment is the consolidation of consumption and good performance by net exports.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCES: Eurostat and own calculations.

Industrial production continues at cruising speed.

On the other hand, the slowdown in growth that has also been seen in the United States, Japan and China, as well as in most emerging countries, should slow up the rate of net exports from Europe. This slight slowdown is not worrying but merely a fall towards more reasonable growth rates given the current situation.

For example, industrial production advanced by 0.2% in April in quarter-on-quarter terms and its figure for the previous month was also raised. This leaves the year-on-year rate at 5.2%, slightly below the figure posted for the first quarter (6.6%). If we analyze the breakdown by sector, all show slight quarter-on-quarter growth, such as capital goods(0.5%) and durables (1.3%), the only exception being the energy sector, down –3.7%). The reason behind this fall is partly the relatively warm temperatures in April in Europe.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
GDP	–4.1	1.7	2.0	2.0	1.9	2.5	–	...
Retail sales	–2.5	0.8	0.7	1.5	0.6	0.0	1.1	...
Consumer confidence (1)	–24.8	–14.0	–16.7	–12.1	–10.4	–10.6	–11.6	–9.9
Industrial production	–14.7	7.5	9.3	7.1	8.1	6.6	5.2	...
Economic sentiment indicator (1)	80.7	100.8	99.2	102.3	105.7	107.4	106.1	105.5
Unemployment rate (2)	9.4	10.0	10.1	10.1	10.0	9.9	9.9	...
Consumer prices	0.3	1.6	1.6	1.7	2.0	2.5	2.8	2.7
Trade balance (3)	10.7	4.6	20.0	8.2	4.6	–9.7	–17.1	...
3-month Euribor interest rate	1.2	0.8	0.7	0.9	1.0	1.1	1.25	1.4
Nominal effective euro exchange rate (4)	111.7	104.7	103.2	102.3	104.4	103.7	107.0	106.0

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

In summary, manufacturing production has remained at a high level and it's normal that, after the upswing in 2010, this should fall back to levels more consistent with the growth in the world and the euro area itself. The effect of this good performance by the industrial sector can be seen in the business sentiment surveys which remain at high levels, in spite of falling slightly compared with the previous month, affected by rising oil prices and Greek instability.

However, consumer confidence, although improving on its figure for May, has stabilized in a narrow range since the middle of last year and has still not reached its pre-crisis level. The higher optimism among entrepreneurs than consumers is due to the good performance by exports of European manufacturers. In contrast, the slowness in the unemployment rate falling continues to dampen the confidence of households.

In April, the unemployment rate remained unchanged compared with the figure for the previous month, namely 9.9%. Until the trend in job creation improves, European consumers are unlikely to abandon their caution. And the official statistics office, Eurostat, estimates that there were 15.5 million people unemployed in the euro area in April, although the number of unemployed has fallen by 457,000 people in comparison with the same period a year ago.

Fortunately, for consumers in a situation of wage restraint, the good news is the moderation in inflation in May, down by one tenth of a percentage point compared with the previous month, to 2.7%. While fruit, milk and meat continue to push up inflation, only vegetables fell in price, perhaps due to the food contamination experienced especially in Germany. We have perhaps hit the peak for inflation this year, providing there is no upswing in oil prices or other food commodities like the one occurring over the last 12 months.

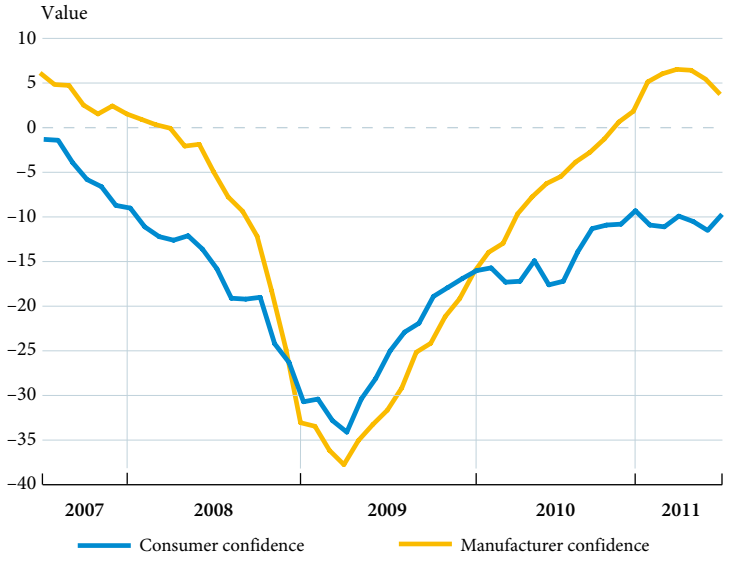
Entrepreneurs seem optimistic thanks to exports.

The slowness in creating jobs places a ceiling on the improvement in consumer confidence.

Inflation easing is good news for households.

ENTREPRENEURS ARE MORE OPTIMISTIC THAN CONSUMERS

Surveys carried out by the European Commission



SOURCE: Bloomberg.

Net exports reduce their contribution to European growth.

On the other hand, the downward trend in the foreign sector's contribution to European growth continues. This can be seen in the figures for the euro area's trade deficit in April, rising to 4.1 billion euros, a sharp rise compared with the same period last year, when it had a surplus of 0.7 billion euros. One of the main reasons behind this change is the large increase in imports due to higher oil prices.

Summarizing, economic indicators point towards a slight slowdown in economic activity for the second quarter compared with the surprising growth of the previous quarter. But this in no way raises doubts regarding the economic recovery of the euro area as a whole, although geographical disparities remain within the zone. The greatest risk over the coming months lies in the peripheral countries and in particular in Greece.

Economic indicators point to a slight slowdown in the second quarter.

If the Greek crisis takes much longer to resolve and a high level of uncertainty remains, this could affect economic activity resulting from higher financing costs via wider public debt differentials for those countries with a doubtful fiscal situation. We should remember that, over the next few quarters, the contribution of public expenditure will fall in contrast to the growth seen in the first quarter. For this reason, any factor slowing up the consolidated trend in consumption or reducing investment would also reduce the euro area's growth.

However, our main scenario, which contemplates a resolution of the Greek crisis, supports the higher growth forecasts given by supranational organizations, as the rate of growth for the euro area this year and leading indicators point to growth being around 1.9%.

The key to a negotiation lies in all participants feeling they have improved their position, in contrast to the alternative scenario of not reaching an agreement. There's a lot at stake for

Europe, given the possible scenarios for resolving the Greek financial crisis. Greek politicians are also aware that their country's future will be decided over the next few months. Faced with such challenges, in the past Europe has proven its ability to deal with public issues by achieving the best outcome. This crisis should not be any different to the previous ones.

The Greek challenge will be a significant factor that will determine the path taken by growth.

The German economy loses a little steam

The trend in economic sentiment indicators points to a moderation in German growth after the strong boost to GDP in the first quarter. Domestic demand continues to take over the reins. On the other hand, the negative output gap has narrowed; i.e. GDP is now at the level of its non-inflationary potential.

With regard to domestic demand, consumption continues to be boosted by job creation and rising income. In fact, the unemployment rate fell again in April and looks likely to continue falling. However, in May the BA-X indicator for employment demand slipped slightly. Within this context, in the same month car sales were up 22% compared to twelve months ago, the highest year-on-year rate since October 2009. Consumer confidence improved slightly in May, consolidating at high levels, suggesting that consumption will continue to expand considerably.

For its part, investment looks dynamic in general. Production capacity utilization is above the long-term average, there are good profit expectations and low interest rates are encouraging investment in capital goods. Investment in construction is also looking vigorous.

The negative output gap narrows in the German economy.

With regard to the foreign trade of goods, this will probably slow down its growth after reaching a peak in March. In fact,

GERMAN CONSUMER CONFIDENCE REMAINS AT A HIGH LEVEL

Consumer confidence

SOURCE: European Commission.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
GDP	–4.7	3.5	3.9	3.9	3.8	4.8	–	...
Retail sales	–3.2	1.4	0.5	2.6	1.1	0.4	0.6	...
Industrial production	–15.4	10.1	12.1	10.3	11.7	13.0	9.6	...
Industrial activity index (IFO) (*)	90.7	107.8	106.3	111.1	113.3	114.8	114.2	114.2
Unemployment rate (**)	8.1	7.7	7.7	7.6	7.4	7.3	7.1	
Consumer prices	0.4	1.1	1.0	1.2	1.5	2.1	2.4	2.3
Trade balance (***)	138.7	154.5	152.2	155.9	154.5	157.5	155.2	...

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

Good prospects for construction.

in April both the exports of goods and imports fell compared with the previous month, once adjusted for seasonal and calendar effects. Exports are aiming increasingly towards the more dynamic emerging economies, rising by 13.4% compared with April 2010. However, the rise in imports was notably higher in the same period, namely 20.1%.

From the point of view of supply, industrial production saw a slight decline in April but its year-on-year rate of change was high. Moreover, industrial orders were up in the same month. However, on the whole industrial production is likely to slow down in the next period. For its part, construction looks healthy. Both building permits for housing and new orders are growing, suggesting sustained activity for this sector in the future.

The trend in wage increases gets stronger in Germany but is offset by growth in productivity.

The economy's dynamism is accentuating the trend in wage increases. However, for the time being this is not worrying, due to the growth in productivity. The rate of inflation has remained below the average for the euro area and fell by one tenth of a percentage point in May to 2.3% year-on-year, posting the first drop in 9 months, mostly due to the fall in energy prices. Nevertheless, the rate of inflation is now above 2%, although this can fundamentally be put down to rising energy commodity prices in the last period. Our forecast for the coming year is of a certain slowdown in inflation.

In summary, for the second quarter we expect more moderate quarter-on-quarter growth of around half a point and we keep to our forecast of a 3.3% annual rise in GDP for 2011. Strong inertia ensures a long expansion. However, downward risks can also be seen due to possible financial disruption.

France: improvement in the labour market confirms its economic expansion

After strong growth in the first quarter, the French economy seems to be continuing its expansion in the second, albeit at a slower rate. The push is coming mostly from private

consumption and investment. Available indicators are compatible with the quarter-on-quarter growth forecast of half a percentage point. We have therefore not altered our forecast of a 2.2% annual rise in gross domestic product for 2011.

In April, the consumption of manufactured goods by households fell notably compared with the previous month, due to durables and particularly cars. However, in May consumer confidence improved slightly thanks to the sustained dynamism of the labour market and inflation easing back. Passenger car registrations therefore accelerated and posted a year-on-year rise of 6.5%.

With regard to the foreign sector, in April the current account deficit widened after its improvement in March. The deterioration in the trade balance was greater than the slight improvement in the services surplus. This record trade imbalance was pressurized by rising prices for energy products but also reveals problems of competitiveness, brought into sharper relief by a strong euro.

On the supply side, industrial production fell slightly in April and the year-on-year rate of change slowed up to 2.6%. Similarly, new industrial orders fell in March. However, the level of order portfolios was above the long-term average, ensuring a notable pace of activity in the secondary sector over the coming months. For its part, construction is looking extremely lively. Lastly, although the climate for services worsened slightly in May, its level was optimistic, pointing to expansion but to a lesser degree.

The economy's dynamism is reflected in the labour market. In the first quarter, salaried employment in the market sectors rose by 1.1% compared with the same period the previous year. In April, the number of people looking for employment posted a drop for the fourth consecutive month, confirming the exit from the crisis, and the unemployment rate fell slightly to 9.4%. In line with this, wages have picked up their rate of increase. However, consumer price inflation fell by one tenth of a percentage point in May to 2.0% due to the turnaround in energy prices that month.

The French economy continues to expand, albeit at a slower rate.

Record trade deficit in April partly due to competitiveness problems.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
GDP	–2.6	1.4	1.5	1.6	1.4	2.2	–	...
Domestic consumption	–0.4	1.7	0.8	2.6	0.9	4.0	1.4	...
Industrial production	–12.4	5.1	7.2	4.3	4.5	4.8	2.6	...
Unemployment rate (*)	9.5	9.8	9.8	9.8	9.6	9.5	9.4	...
Consumer prices	0.1	1.5	1.6	1.5	1.7	1.8	2.1	2.0
Trade balance (**)	–44.4	–51.4	–46.1	–50.9	–51.4	–58.8	–61.3	...

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

The European Commission recommends the French authorities rigorously apply measures to correct the excessive public deficit.

Other indicators also show the improved tone of the French economy. There's a downward trend in the number of business failures and, in May, the number of new start-ups picked up. Similarly, in April the recovery in credit to non-financial firms consolidated, of note being the large growth in credit to SMEs. Within this context of economic improvement, the bill was presented to rectify Social Security for 2011, containing a lower deficit than the one projected in the initial proposal. On the other hand, this law establishes that employees in firms with more than 50 people on the payroll and whose shareholder dividends have increased compared with the last two years can benefit from a premium that would be set in line with collective bargaining.

Nonetheless, the European Commission, in its recommendations regarding the 2011-2014 stability programme, believes that the macroeconomic scenario on which the budget projections are based is too optimistic and recommends rigorously implementing the measures to correct the excessive public deficit by 2013 at the latest. In this respect, it states that the viability of the pension system needs to be examined. Moreover, it encourages the country to combat the segmentation of the labour market and to promote access to training in order to help older workers remain in active employment.

Italy: timid signs of recovery in household consumption

The detailed figures from the National Accounts system for the first quarter confirmed modest quarter-on-quarter growth in GDP of 0.1%, the same as in the previous quarter. Household consumption contributed one tenth of a percentage point to this increase, public consumption another tenth and investment's contribution was zero, while inventory changes subtracted 0.3 percentage points. For its part, foreign demand contributed two tenths of a percentage point, after having subtracted six in the fourth quarter of 2010.

Italian consumer confidence improves in May as inflation becomes contained...

The latest indicators available for the second quarter point to some recovery in household consumption. In April, the production of consumer goods posted a positive year-on-year rate for the first time in seven months. Automobile sales

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
GDP	–5.2	1.2	1.5	1.4	1.5	1.0	–	...
Retail sales	–1.7	0.0	–0.3	0.5	0.0	–0.3	...	...
Industrial production	–18.7	6.5	8.9	7.5	5.3	2.4	3.7	...
Unemployment rate (*)	7.8	8.4	8.5	8.4	8.5	...	–	...
Consumer prices	0.8	1.5	1.4	1.6	1.7	2.3	2.6	2.6
Trade balance (**)	–5.9	–29.3	–16.3	–22.5	–29.3	–34.9	–37.3	...

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

also posted a year-on-year rise in May for the first time in fourteen months. And this movement might continue, looking at the improvement in consumer confidence in May. This trend was boosted by contained inflationary pressures in the same month. However, the seasonal situation of the labour market does not give much room for consumer optimism.

However, business sentiment saw a slight drop in May in almost all sectors. Given that industrial capacity utilization is also lower than the long-term average, growth in investment will probably be slow.

On the supply side, industrial production increased in April and in the first quarter posted a year-on-year increase of 2.5%, after adjustment for calendar effects. For its part, order books increased by 15.2% in the period January-April compared to twelve months earlier. In April, the highest increases went to chemical and metal products, thanks to the boost provided by foreign demand. Although industrial confidence fell a little in May, the level of orders guarantees a period of expansion in the secondary sector.

In all, it seems that Italy's economic growth for 2011 will be similar to that posted in the first quarter, namely 1.0% year-on-year. This low rate of growth in activity and the high level of public debt are causing some concern in the markets. At the end of the fourth week of June, the risk premium for Italian public debt measured in terms of its differential with German ten-year bonds stood at 199 basis points, the highest since the start of the euro, although affected by the Greek crisis.

Within this context, the ratings agency Standard & Poor's changed its outlook for Italian debt from stable to negative on 20 May. Similarly, in mid-June the agency Moody's warned that it might cut the rating of Italy's long-term debt, placing it at Aa2. In fact, the setbacks suffered lately by the government in the municipal elections at the end of May and in the referendums in mid-June are not helping it to undertake the reforms being demanded by the markets.

...but business sentiment worsens.

Within the framework of its review of Italy's updated 2001-2014 Stability Programme and National Reform Programme, the European Commission made a series of recommendations to improve the economy. Firstly, it stressed the need to ensure the planned fiscal consolidation. Among other reforms, it has pointed out the appropriateness of combating the segmentation in the labour market and matching wage rises to productivity more closely. It also suggests that services should be more liberalized and private sector investment in R&D encouraged, as well as reducing the persistent disparities between regions.

Ratings agencies give Italian debt a negative outlook.

The United Kingdom: a languid summer

The Met Office of the United Kingdom used to provide a forecast of the weather that could be expected throughout the summer. It only recently withdrew this service after announcing a «barbeque summer» in 2009 (because of the good weather the country would enjoy), which ended up being one of the rainiest summers since official records began. We don't dare give a weather forecast for those planning a visit to the United Kingdom but we can confirm that macroeconomic indicators point towards a languid summer in terms of economic activity.

Macroeconomic indicators point to a weak recovery.

The IMF believes that the United Kingdom is applying the right economic policy.

Moreover, the United Kingdom is at a disadvantage in its recovery because, after analyzing the composition of growth in the first quarter, this turns out to be disappointing in quality terms. In fact, although the year-on-year rate remained at 1.8%, the breakdown by component is of some concern. Private consumption fell by 0.6% quarter-on-quarter, reflecting the weak domestic demand while investment also shrank by 4.4% quarter-on-quarter. In fact, it was the expansion in exports (3.7%) that boosted GDP, together with the fall in imports (2.3%), another symptom of weak domestic demand.

Even the UK's central bank, in the minutes of its meeting held in June, recorded the disappointment of the members of the monetary committee that the weakness in demand would last longer than initially expected. Certainly, the macroeconomic data point to this situation. Firstly, we have the slowdown in retail sales in May, with the month-on-month figure falling by 1.4%, placing the year-on-year rate at 0.2%, compared with 1.5% in April. May's figure is the worst in the last year and a half. And May's inflation remains anchored at 4.5% year-on-year, reducing the net disposable income of British consumers within a context of strong wage restrictions.

On the other hand, manufacturing production also fell sharply in April by 1.5% month-on-month, although special effects such as Japan's tsunami harmed the figures and these will probably see some recovery in the next few months. But, on the whole, all economic indicators are discreet and suggest that the recovery in the British economy will take its time to get going.

However, one piece of good news is the consensus in the different supranational organizations, such as the International Monetary Fund, recognizing that the economic, fiscal and monetary policies being applied are appropriate, although the medicine has yet to have an effect on the organism. Irrespective of the weather this summer in the United Kingdom, this holiday period is a time when not only students who need to review the subjects they have failed but even good students

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010			2011		
			2Q	3Q	4Q	1Q	April	May
GDP	–4.9	1.3	1.5	2.5	1.5	1.8	–	...
Retail sales	1.0	0.4	0.8	0.7	0.0	2.3	2.5	0.2
Industrial production	–10.1	2.1	1.7	3.1	3.3	1.9	–1.1	...
Unemployment rate (1)	4.7	4.7	4.6	4.6	4.5	4.5	4.6	4.6
Consumer prices	2.1	3.3	3.4	3.1	3.4	4.2	4.5	4.5
Trade balance (2)	–82.4	–96.4	–85.8	–91.1	–96.4	–98.4	–97.9	...
3-month Libor interest rate (3)	1.2	0.7	0.7	0.7	0.7	0.8	0.8	0.8
Nominal effective pound exchange rate (4)	73.9	80.4	78.2	81.5	79.3	79.2	78.6	79.0

NOTES: (1) Percentage of labour force.
(2) Cumulative balance for 12 months. Billion pounds.
(3) Average for the period.
(4) Index weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCES: OECD, Bank of England, ONS, European Commission and own calculations.

could take advantage of the time to further their training. The United Kingdom is a good student because it's doing its homework, although it's not getting such good marks at present. However, the secret of students who really apply themselves is perseverance.

Emerging Europe: resisting the ravages of slowdown, inflation and financial contagion

For the moment, emerging Europe is managing to elude a growing phase of economic and financial uncertainty. When we look at three vital issues – the scope of the global slowdown in growth, the degree of financial contagion from the Greek sovereign debt crisis and the inflationary trend – in all three cases we end up concluding that this region has avoided an openly negative impact so far. Let us look individually at these three fronts in the global economic situation.

With regard to the slowdown in activity, the figures point to a moderate and probably temporary effect on the countries of central and eastern Europe. One initial element in their favour within this sphere has been the excellent rate of growth in GDP for these economies in the first quarter, exceeding the forecasts given, in themselves positive. Specifically, the five states we usually monitor in this report (Poland, Hungary, the Czech Republic, Slovakia and Romania) have posted higher growth figures compared with the fourth quarter of 2010. The main support for this expansion, in general terms, comes from strong exports.

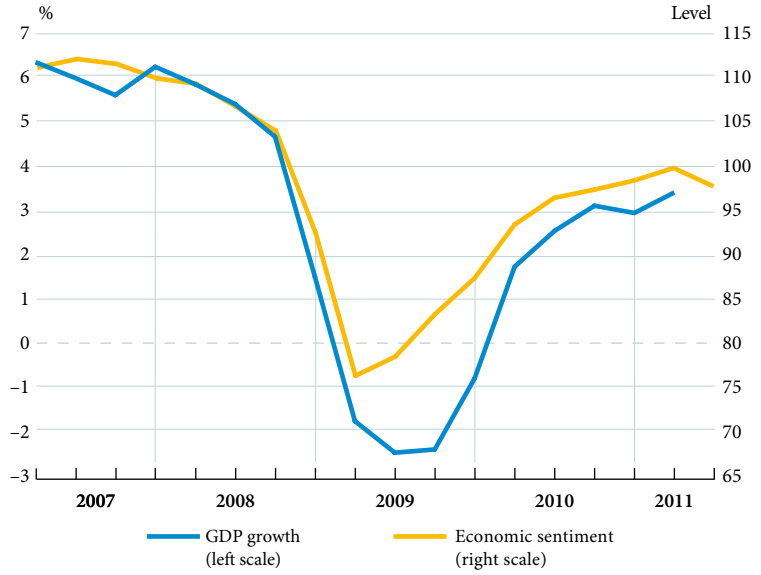
To date, emerging Europe has escaped the global slowdown in activity...

Going forward in time, we should ask ourselves whether the second quarter can maintain this upswing in activity. Indicators of economic sentiment, highly sensitive to cyclical changes, suggest that, up to May, activity has remained along the same lines as the first quarter. Slovakia

...as can be seen in the good activity figures for the first quarter and indicators of economic sentiment in April-May.

PROSPECT OF A SLIGHT MODERATION IN ACTIVITY ON THE HORIZON

Indicator of economic sentiment and year-on-year change in real GDP (*)



NOTE: (*) Weighted average for Poland, Hungary, Czech Republic, Slovakia and Romania. The data on the economic sentiment for the second quarter are the average for April and May.
SOURCES: Eurostat, European Commission, Thomson Reuters Datastream and own calculations.

Little evidence of financial contagion by Greek debt, in any case limited to Romania and Hungary.

and Romania have recorded advances in these indicators, while in Poland, Hungary and the Czech Republic the average levels for April and May point to a very restrained slowdown in activity. Adding these trends to the forecasts we have for the euro area, and particularly Germany, which point to a clearly expansionary 2011, we believe that the main scenario for emerging Europe will remain the same as for the last few months: it will be a positive year with growth speeding up in all economies and, in some cases, such as Poland and Slovakia, reaching notable figures, above 4%.

The second of the points demanding attention at the moment refers to developments in the Greek sovereign debt crisis and its repercussions on the financial markets of emerging Europe. Looking at the values of national currencies and Credit Default Swaps for sovereign debt (which measure the cost of insuring a hypothetical default on these bonds), there is no evidence of contagion in the case of Poland, Slovakia and the Czech Republic, and any effect is small in the case of Romania and Hungary.

In these last two countries, the markets are probably concerned about two very different sources of contagion. In Romania there is a direct channel whereby it could be affected by the financial crisis, as approximately 20% of the country's banking market is dominated by subsidiaries of Greek credit institutions. Given this fact, there is the concern that any possible harm to the balances of these banks' parent companies due to the hypothetical rescheduling of public debt might end up affecting the subsidiaries' capitalization. Hungary, however, continues to be burdened by the perception that the government has yet to fully regain its fiscal credibility after a 2010 with excessive ups and downs in this sphere.

We repeat, however, that both countries are facing a situation of contained financial repercussions, far from what is being experienced by other nations.

Although inflation is still high, close to 5% in May, it is expected to ease over the coming months...

Lastly, the third of the aspects we mentioned previously, namely inflation, might be on the brink of being redirected, although we cannot say it has been resolved. And although the latest figures available are far from encouraging (in May, the average harmonized inflation in the five economies in question stood at 4.6% year-on-year, the highest since mid-2008), the forecasts suggest we might be close to the start of a gradual slowdown in prices. The downward trend in food commodity prices over the last few months will help the food component in the consumer price index (CPI) to ease back. This is a significant development, especially as it is precisely this component that is being more expansionary (this aggregate reached 9.1% of the year-on-year increase in May).

Beyond expectations of an imminent improvement in the CPI, this inflationary episode is occurring within a context that reduces the situation's significance. In contrast with other emerging economies, the ones mentioned here are showing few signs of economic overheating. With the exception of Poland, the recovery in domestic demand has hardly started. Neither does there seem to be a problem of scarce resources in the factor markets, as the labour market continues to have relatively high levels of unemployment while the degree of available production capacity utilization is still extensive. The absence of tension in terms of sharp appreciations in national currencies completes our diagnosis of a lack of economic overheating. This should mean that monetary policy can get back to normal gradually, without the demands being forced upon other emerging economies.

...which, added to the absence of signs of overheating, mean that monetary policy can gradually get back to normal.

FINANCIAL MARKETS

Monetary and capital markets

Turbulence returns

Four important factors have coincided between May and June to cause quite significant falls in stock markets and other risk assets, as well as a drop in yields of high yield sovereign bonds (in particular, those of the United States and Germany). Firstly, the shock regarding the United States' rate of growth within a difficult fiscal situation. Secondly, the sequence of restrictive economic policy measures applied in the emerging countries. Thirdly, the deterioration in the Greek sovereign debt crisis and, with regard to Spain, the impasse in the political and economic situation. And fourthly, the presentation of various proposals to tighten up regulations for the financial sector, in particular banking. The combined influence of these factors might be felt for some time yet but it should dissipate in the medium and long term, allowing the stock markets and interest rates to pick up again.

With an imminent second hike in interest rates in the euro area, the Fed is maintaining its position

Evaluated as a whole, economic indicators for the last few months make it clear that the world economic expansion is going through a slowdown, albeit temporary in principle. Inflationary risks resulting from rising commodity prices seem to have abated but not entirely. The intensity and context of this episode of economic moderation are very different depending on the geographical area and, consequently, so are the responses by the respective central banks. The Federal Reserve has opted to keep to its strategy of extreme lassitude, the ECB has implied that it will raise its official interest rate again in July and the authorities of the emerging countries have continued to apply a range of restrictive measures. For all of them, the challenge lies in finding the formula that provides sustainable economic growth rates and inflation in the medium and long term.

A convergence of negative factors is punishing the markets.

In the United States, the Federal Reserve (Fed) publicly announced its analysis of the economic scenario and its monetary policy strategy after its meeting held on 22 June. The institution's chairman, Ben Bernanke, acknowledged the importance of the current difficulties faced by the US economy, largely caused by the impact of Japan's earthquake and by rapidly rising commodity prices in the previous quarters. According to the assessment of the Fed's members, the influence of these elements should be temporary, resulting in economic activity reviving in the second half of the year. However, Bernanke also mentioned the structural problems that make this cycle very unusual: the deleveraging of households and the financial sector, as well as the paralysis in the real estate sector. In this respect, he acknowledged that the labour market is still refusing to show any sign of significant improvement, the main reason for the decision to keep the official interest rate at a minimum (0%-0.25%) and the commitment to continue with lax

Disparate strategies among central banks.

The Fed keeps on course, acknowledging that growth has slowed down.

Bernanke repeats that, once the QE2 ends, he does not intend to extend quantitative easing measures.

monetary policy for a long period of time. Similarly, Bernanke also repeated the institution's intention to terminate its quantitative easing scheme (QE2) at the end of June. To some extent, the new element in his speech was the announcement that, for the moment, the Fed will not extend the quantitative easing measures, thereby dissipating expectations of a possible QE3. However, what was very clear was the central bank's intention to keep the size of its balance sheet constant (reinvesting the interest and principal of public debt and mortgage bonds in portfolios) until conditions warrant otherwise. In short, Bernanke stated that it was still not the time to spell out its «exit strategy» but neither was it the time to adopt a new quantitative easing scheme. He did warn of the need to redirect fiscal policy, expressing his concern given the situation of heavy borrowing that threatens the US economy if there are no substantial budgetary changes. In the short term, he asked for prompt negotiation in the Congress regarding legal debt limits which would provide the central bank with more room to manoeuvre.

The Fed asks the Congress to negotiate the legal debt limit soon.

In the euro area, at its meeting on 9 June the European Central Bank (ECB) kept the official interest rate at 1.25%, as had been expected by analysts and economists. As has happened for several months now, the main focus of the monetary authority's message was its clear commitment to guarantee price stability in the region. Specifically, Jean-Claude Trichet stated that the institution is exercising «strong vigilance» regarding trends in inflationary variables, an expression the institution tends to use as an advance announcement of imminent interest rate hikes. Given this circumstance, and in view of the policy normalization started by the ECB in April, the consensus of analysts estimates that, in July, there will be a second hike in the official interest rate up to 1.5%. With regard to non-conventional monetary policy measures, the ECB decided to retain unlimited one- and three-month liquidity facilities in response to the funding difficulties still faced by some banks in the region. With regard to its role in Greece's sovereign debt crisis, the ECB has adopted a flexible stance, accepting, together with the European Commission and the IMF, a possible solution consisting of public aid to Greece being complemented with the «voluntary involvement» of private investors.

The ECB has adopted a posture of «strong vigilance» regarding inflationary variables.

For their part, the monetary policy situation of the emerging countries is marked by their advanced stage in the economic growth cycle. The economies of these nations, characterized by achieving high rates of activity in the last few years, are suffering from the side effects of overheating: inflationary pressures, excessive growth in credit and the threat of asset bubbles (real estate and financial). Because of this, for months now these countries' central banks have been engaged in tightening up their monetary and financial policies, and there have been several signs of this once again in the month of July. Of note are the hikes in the official interest rate in Brazil and India, as well as the increase in the mandatory reserve ratio for commercial banks in China. The authorities' aim is to achieve a «soft landing» for their economies: reduce inflationary pressures without harming growth too much. There are still too few elements to judge whether these policies are having the desired effect but the most recent figures suggest this might be the case, so that the

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2010									
May	1.00	0.70	1.26	0.25	0.54	0.25	0.50	0.71	0.13
June	1.00	0.77	1.31	0.25	0.53	0.24	0.50	0.73	0.28
July	1.00	0.90	1.42	0.25	0.45	0.24	0.50	0.75	0.42
August	1.00	0.89	1.42	0.25	0.30	0.24	0.50	0.73	0.59
September	1.00	0.89	1.43	0.25	0.29	0.22	0.50	0.73	0.32
October	1.00	1.03	1.52	0.25	0.29	0.20	0.50	0.74	0.23
November	1.00	1.03	1.53	0.25	0.30	0.19	0.50	0.74	0.20
December	1.00	1.01	1.51	0.25	0.30	0.19	0.50	0.76	0.20
2011									
January	1.00	1.07	1.64	0.25	0.30	0.19	0.50	0.78	0.26
February	1.00	1.09	1.77	0.25	0.31	0.19	0.50	0.80	0.10
March	1.00	1.24	2.00	0.25	0.30	0.20	0.50	0.82	0.28
April	1.25	1.35	2.12	0.25	0.27	0.20	0.50	0.82	0.24
May	1.25	1.43	2.14	0.25	0.25	0.20	0.50	0.83	0.26
June (1)	1.25	1.53	2.15	0.25	0.25	0.20	0.50	0.83	0.27

NOTES: (1) June 23.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 6-11-08 (3.25%), 4-12-08 (2.50%), 5-3-09 (1.50%), 2-4-09 (1.25%), 7-05-09 (1.00%), 7-4-11 (1.25%).

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

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

(5) Interbank rate.

SOURCES: National central banks, Bloomberg and own calculations.

process of adopting restrictive measures is likely to ease gradually.

Under the scenario described of disparate monetary policy strategies between the United States and the euro area, interest rates in interbank markets have moved in line with the trends in investors' expectations regarding the actions of the respective central banks. It's important to note other actions that were decisive in the past for interbank market volatility: namely the trend in risk premia for credit and liquidity. However, over the last few weeks the serious deterioration in the sovereign debt crisis in Greece has hardly led to rises in these premia, a remarkable and satisfactory state of affairs. Consequently, and as expected, the Libor interest rate in dollars has continued at rock bottom (in fact, setting a new record of 0.72% for 12-month maturities) as a consequence of the Fed's ultra-lax monetary policy continuing. Meanwhile, in the euro area, the statements made by Trichet and the almost certain rise in official interest rates in July have led to an upswing in the 3-month Euribor interest rate to 1.50%. On the other hand, the official rate for the 12-month Euribor remained stable at around 2.10%.

A repetition of the Greek crisis does not lead to rises in the risk premia of interbank rates.

The expectation that the ECB will raise the interest rate in July has pushed up the three-month Euribor rate.

The bad economic figures for the United States lie behind the further fall in yields for the country's sovereign debt.

Rating agencies warn of the impact resulting from Congress not reaching an agreement regarding the debt ceiling.

The Greek sovereign debt crisis has led to a «flight towards quality».

Economic growth

The domestic yield rates for highest quality public debt (specifically of the United States and Germany, but also of other developed countries such as the United Kingdom and Canada) continued their downward slide in June. In the case of United States, yields for two and ten-year bonds fell to 0.38% and 2.90%, respectively. Of note among the factors underlying this new downturn in yields is the drop in activity for the second quarter of the year, greater than expected by analysts. This has aroused doubts in some investors regarding the economy's future growth. Secondly, the downturn in commodity prices has also been relevant, reacting to a series of factors, including some related to supply. In principle, both forces are temporary in nature, so that the fall in yields over the last few months is likely to revert in the medium term.

In addition to these considerations related to the traditional duo of growth-inflation, in the US market scenario there are two special aspects of great relevance which, besides causing episodes of greater volatility, will also affect the steepness of the interest rate curve. On the one hand, there is the imminent end to the Fed's quantitative easing scheme (QE2) and, at an uncertain later date, the specifying of the «exit strategy» to be adopted by the Fed to normalize monetary and financial conditions. On the other hand, there is the pressing agreement regarding the legal debt limit for the US Treasury. Given the importance of this issue, the three main credit rating agencies (S&P, Moody's and Fitch) have warned of the serious consequences of Congress not reaching an agreement on raising the expenditure ceiling, not only from the point of view of its public debt rating but (and even more importantly) regarding the US and the world economies.

In the case of the euro area, yields of German sovereign debt performed similarly to that of the United States. The yields of two and ten-year bonds fell to 1.40% and 2.85% respectively, the latter being the lowest level since the beginning of the year. The euro area's current economic situation, seriously affected by the worsening of the Greek sovereign debt crisis and fears of this infecting other countries, is causing a «flight to quality» in investor preferences. This behaviour should be temporary, giving way to the influence of a medium and long-term economic scenario with favourable foundations for growth and inflation for the area. In terms of the debt markets, this would result in a rise in yields for the central countries' bonds.

For its part, the deterioration in the sovereign debt crisis in Greece has led to further increases in the spread between the debt of the countries of peripheral Europe and German debt. The complex nature of the agreements between the troika (IMF, ECB and the EU) and the Greek government when designing the aid package, and the delicate domestic situation of the Greek parliament, are the main obstacles to emergency funding arriving quickly. The issue most extensively debated by these authorities is the possible application of a «reprofiling» of Greek sovereign debt, allowing the private sector to take part.

In the case of Spain, the complication of the Greek crisis, speculation regarding

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
2010								
May	2.66	2.92	4.26	4.14	3.28	1.27	3.58	1.54
June	2.58	3.05	4.56	4.09	2.93	1.09	3.36	1.48
July	2.67	2.95	4.21	3.95	2.91	1.07	3.33	1.46
August	2.12	2.47	4.05	3.83	2.47	0.97	2.83	1.13
September	2.28	2.66	4.12	3.88	2.51	0.94	2.95	1.40
October	2.52	2.91	4.21	3.94	2.60	0.94	3.08	1.49
November	2.67	3.15	5.50	4.67	2.80	1.19	3.23	1.56
December	2.96	3.36	5.45	4.82	3.29	1.13	3.40	1.72
2011								
January	3.16	3.53	5.37	4.72	3.37	1.22	3.66	1.87
February	3.17	3.55	5.39	4.84	3.43	1.26	3.60	1.90
March	3.35	3.71	5.30	4.82	3.47	1.26	3.69	1.96
April	3.31	3.64	5.47	4.74	3.41	1.24	3.58	2.06
May	3.02	3.39	5.36	4.78	3.06	1.17	3.29	1.82
June (*)	2.83	3.30	5.77	5.05	2.86	1.10	3.12	1.63

NOTE: (*) June 27.
SOURCE: Bloomberg.

the cost of a possible rescheduling of its debt for Europe's banking sector as a whole, plus the climate of impasse perceived in Spain's economic and political situation have helped to push its sovereign risk premium above 275 basis points. However, in spite of these notable upswings, Spanish debt still enjoys a relatively more stable performance in comparison with the rest of the countries of peripheral Europe.

The spread between Spain and Germany's sovereign yields registers tensions, albeit contained at present.

Volatility dominates the dollar-euro exchange rate

The aspect that has characterized the dollar exchange rate against the euro in spring has been high volatility. Throughout this period, the exchange rate fluctuated within a range of 5%, the highest being 1.49 dollars and the lowest 1.40. This performance is the result of several factors occurring together. Initially, factors that pushed up the euro dominated, such as the interest rate hike by the ECB, the capital inflows in euros and the worrying situation of the legal debt limit in the United States. Subsequently, the worsening of the Greek debt crisis, the fear that this situation would infect other economies in the euro area and the drop in price of some commodities have acted as a catalyst for the dollar to appreciate. In any case, in the medium term, and once the current ups and downs have been overcome, the most probable course of action is for the dollar to appreciate gradually as the differential between the Fed and ECB interest rates narrows.

Once the current ups and downs have been overcome, the dollar is likely to appreciate against the euro.

EXCHANGE RATES OF MAIN CURRENCIES

June 23, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	80.7	–1.6	–0.5	–11.3
Pound sterling	0.626	–0.9	2.2	6.4
Swiss franc	0.842	–5.0	–11.1	–31.3
Canadian dollar	0.978	0.0	–2.0	–6.3
Mexican peso	11.886	1.2	–3.8	–6.4
Against euro				
US dollar	1.417	–0.9	–5.9	–15.1
Japanese yen	114.3	–0.8	5.1	3.3
Swiss franc	1.192	–4.1	–4.9	–14.1
Pound sterling	0.887	1.8	3.3	7.2
Swedish krona	9.195	2.8	2.3	–4.0
Danish krone	7.458	0.0	0.1	0.2
Polish zloty	4.005	1.4	1.0	–1.5
Czech crown	24.36	–0.9	–2.7	–5.6
Hungarian forint	269.4	–0.3	–3.4	–3.9

NOTE: (*) Plus sign indicates appreciation of dollar (first group) or euro (second group).
SOURCES: Bloomberg and own calculations.

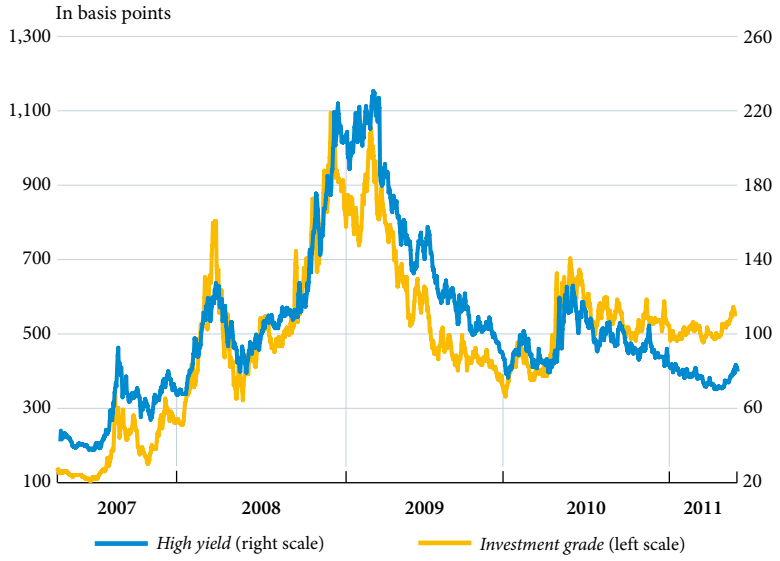
Corporate bonds attempt to withstand adversity

Corporate bonds continue to perform well in spite of successive adverse shocks.

Although they have not been immune to the four negative factors mentioned previously, corporate bonds continue to perform relatively well. In fact, during the last quarter this market showed commendable strength given its successive adverse shocks (including Japan's earthquake and the Middle East conflicts). In June, the balance is still acceptable thanks to the rises in risk premia being partly offset by the fall in official interest rates (i.e. those of high yield public debt), resulting in moderate losses in the extensive corporate bond indices. However, as a consequence of the globalization of the economy, financial markets are not entirely impervious to what is happening elsewhere, so some signs of contagion in the credit markets have been observed. In the case of the euro area, the sharp rise in sovereign debt risk premia of the peripheral countries has affected credit spreads in the financial sector, which is highly exposed to Greece's problems. But in spite of this movement in the sector's spreads, we must insist that the price variation in corporate bond indices has hardly moved. A similar situation has occurred in the high yield bond sector, mainly in the United States: the rise in risks resulting from a possible slowdown in economic growth has widened spreads, although without harming the indices. Within such an environment, and apparently as a reaction to the deterioration in the global situation, two facts have occurred that are certainly temporary in nature. The first is the reduction in issuance for developed markets in the last few weeks of June. And the second is the gradual

TRENDS IN CORPORATE RISK PREMIA IN THE EURO AREA

5-year Markit Itraxx indices



SOURCE: Bloomberg.

reduction in flows of funds towards corporate bonds, given the prudential action of managers who are opting to increase the liquidity positions in their portfolios.

Correction in the stock markets

The main international stock market indices have continued to perform weakly throughout June and we can clearly observe the negative effects of the different factors mentioned previously in these markets.

Confident that the obstacles to the current financial situation are temporary in nature and can be resolved relatively satisfactorily, the outlook for the stock markets in the medium and long term is favourable. The main arguments that will serve as support for equity revolve around world and business growth picking up again and credit risk falling. But in the short term, the stock market scenario is showing signs of weakness and volatility which, combined with seasonal factors, might result in further corrections throughout the summer.

Although stock markets remain weak in June, the medium and long-term outlook is good.

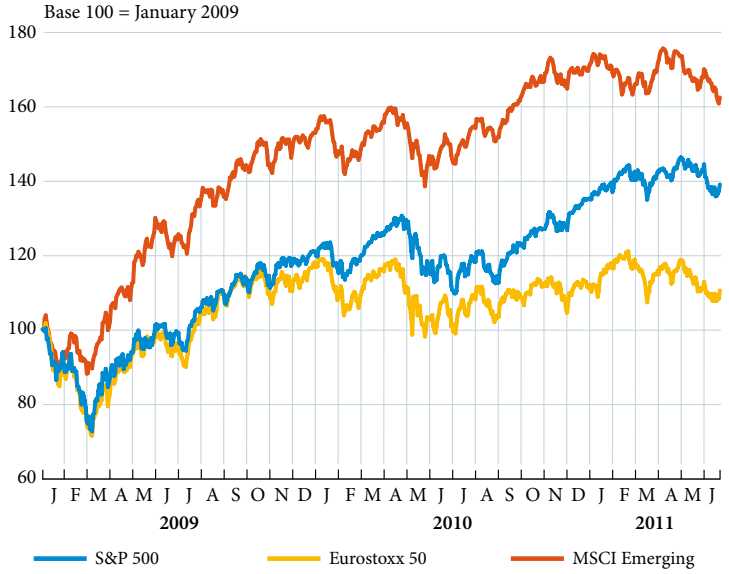
The most evident case is that of the United States. In addition to the symptoms of overbuying identified in US stock markets in spring, we should also add the decline observed in economic, sentiment and flow indicators. Moreover, the trends in these stock markets might be temporarily affected by the end of the QE2 and, logically, by the political negotiations on budgetary adjustment, which might lead to a drop in «risk appetite» among investors.

In the case of the euro area, although the future prospects look good, the deterioration in the Greek sovereign debt crisis and the complex search for solutions are increasing the feeling of uncertainty and fear of possible contagion to other economies in the region. Given this situation, the financial sector is currently

In the euro area, the financial sector is being strongly affected by European banking's high exposure to Greek sovereign debt.

TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

June 28, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,109.7*	*–2.2*	*4.6*	*17.6*
Standard & Poor's	*1,287.1*	*–2.3*	*2.3*	*17.9*
Nasdaq	*2,669.2*	*–3.3*	*0.6*	*18.4*
Tokyo	9,596.7	1.4	–6.2	–3.3
London	5,696.9	–2.4	–3.4	10.0
Euro area	2,743.3	–1.8	–1.8	1.4
Frankfurt	*7,176.7*	*0.8*	*3.8*	*15.7*
Paris	*3,806.2*	*–2.6*	*0.0*	*4.5*
Amsterdam	*329.0*	*–3.9*	*–7.2*	*–1.8*
Milan	*19,568.5*	*–4.7*	*–3.0*	*–3.9*
Madrid	*9,990.9*	*–0.9*	*1.3*	*1.1*
Zurich	6,041.7	–6.2	–6.1	–5.3
Hong Kong	21,759.1	–4.2	–5.5	4.3
Buenos Aires	3,333.6	0.3	–5.4	43.3
São Paulo	61,194.1	–1.8	–11.7	–6.1

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

the most severely hit in the markets, due to European banking's high exposure to peripheral public debt. Another factor also weighing heavy on the banking sector is the intense flow of news and rumours regarding regulation reform, particularly concerning solvency and liquidity requirements. In this respect, capital increases and the containment of dividends are elements that, at least in the short term, are having a negative effect.

Lastly, the stock market situation of the emerging economies over the last few months has been characterized by a downward trend, the consequence of tightening up monetary and fiscal policies. Although inertia is still negative in the short term, in the medium term the confirmation of these economies enjoying a soft landing and a reduction in inflationary pressures will be positive for their equity.

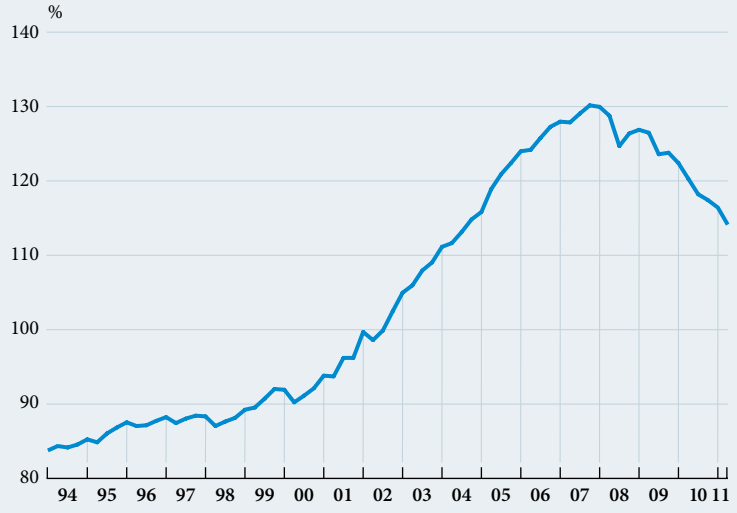
Emerging stock markets post a downward slide due to monetary and fiscal normalization.

Debt and recession in the United States

The US recession of 2008 and the first half of 2009 has been the deepest and longest lasting since 1945. In the two-year period of 2008-2009, 8.75 million jobs were lost, durable consumption plummeted (as shown by the 24.4% drop in auto sales throughout the second half of 2007 and the whole of 2008), doubtful loans reached record highs and house prices have fallen by 31.7% since April 2006. In addition to this severe recession, the recovery is also turning out to be much more problematic and feeble than those following previous crises. Of these four indicators, only durable consumption seems to have recovered, thanks largely to massive government aid. On the whole, private consumption is currently at the level of the end of 2007.

EXCESSIVE INDEBTEDNESS THAT MUST CONTINUE TO FALL

Gross household debt as percentage of disposable income



SOURCES: BEA, Federal Reserve and own calculations.

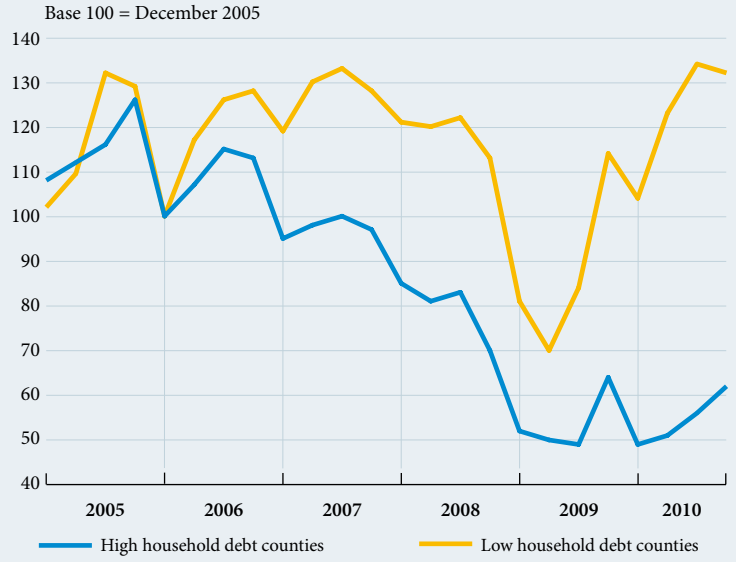
Finding out why the recession has been so severe and the recovery so slow is the million dollar question. One hypothesis blames the situation on the excessive indebtedness of US households and its impact on net financial and non-financial wealth when the value of assets falls. As explained by Fisher in his classic article on debt and deflation in 1933, the greater the leveraging, the larger the fall in net wealth caused by loss in asset value and, consequently, the greater the deterioration in the net wealth-income ratio and the sharper the drop in consumption. In the years prior to the crisis, the gross debt of households went from 90.1% of disposable income in the first quarter of 2000 to a peak of 130.2% in the third quarter of 2007. Similarly, the savings rate fell to an annual minimum of 1.4% of the disposable income of households in 2005, when the average for 1990-1995 had been over 6%. This increasing indebtedness occurred within a context of sharp rises in asset values, especially real estate, obscuring the risks involved. As a matter of fact, the relationship between indebtedness and prices was more causal than casual. The consequence was that, from the end of 2005 to the beginning of 2009 and with the fall in asset prices, net household wealth fell from a level equivalent to 448% of GDP to 352% of GDP.

However, in addition to indebtedness, there are other factors that might also have contributed to making the recession worse. Firstly, the lower availability of credit on the part of the financial sector, hard hit by the Lehman Brothers going bankrupt and the difficulties encountered by many other institutions. We also need to take into account the relative weakness of investment in production goods, which in the pre-recession years was already growing less than in previous expansionary periods.

One way of isolating the pre-crisis rise in indebtedness from other factors underlying the crisis is by using data broken down by county. Among the 3,143 counties of the United States, there are significant differences regarding the growth in leveraging in the years before the crisis, while the availability of credit from institutions

INDEBTED AND NON-INDEBTED CONSUMERS

Trends in automobile sales



SOURCES: Atif Mian and Amir Sufi, FRBSF Economic Letter 2011-02, 18 January 2011.

is much more homogeneous, as national financial institutions are present in most counties. If those counties with the highest levels of indebtedness have been harder hit by the crisis, this might suggest that debt has really been a key factor.

This suspicion has been confirmed. As shown by Mian and Sufi (2009),[1] two economists from the San Francisco Fed, pre-crisis household leveraging is an accurate indicator of the variation in the recession's severity among counties. Mian and Sufi's sample is made up of the 450 counties with the highest number of households, accounting for more than 70% of the population, divided into deciles based on the growth in indebtedness compared with income. The top decile is made up of the 10% of counties where growth in the indebtedness-income ratio between 2002 and 2006 was the highest. The bottom decile corresponds to the 10% of counties where the indebtedness-income ratio grew the least. They then compare these top and bottom deciles, noting the variables that indicate the severity of the recession, such as unemployment, durable consumption (for which they use auto sales), house prices, building permits and the default rate.

The findings by Mian and Sufi differentiate between two periods. In the first phase of the recession, which runs from the last quarter of 2006 to the second of 2008, the counties in the decile with the highest growth in indebtedness were much harder hit by the crisis than the national average, while the counties with a low rise in indebtedness were almost unaffected. Counties in the indebted decile suffered a 40% drop in house prices between the second quarter of 2006 and the second of 2009, their default rate rose by 12 percentage points and auto sales fell by 40% compared with 2005. On the other hand, the counties in the decile where indebtedness had grown the least saw a 10% rise in house prices, while their default rate rose by a mere 3 percentage points and auto sales in the third quarter of 2008 were 20% above the level of 2005. Similarly, between the end of 2005 and the third quarter of 2008, the unemployment rate of high debt counties grew by 2.5 percentage points while that of low debt counties scarcely changed.

In a second phase, as from the third quarter of 2008, the severity of the recession starts to be felt in all counties. This is explained, on the one hand, by the weakness that had affected those counties most in debt being transmitted to other counties. Moreover, of course, the bankruptcy of the Lehman Brothers was a shock that affected the economy as a whole, paralyzing the flow of credit overall.

The conclusion is that the recession started sooner and was more severe in those counties where, in the years prior to the crisis, indebtedness had risen the most. In the second half of the recession, the effects of economic decline, added to the impact of the Lehman Brothers crisis, made the economic recession more widespread. In the future, the strength of the recovery will depend very much on the behaviour of household debt that is still above its long-term trend, although it had fallen to 114.1% of disposable income at the beginning of 2011 from a peak of 130.2% in the third quarter of 2007.

(1) Atil, Mian, and Amir Sufi. 2010. «Household Leverage and the Recesion of 2007 to 2009,» IMF Economic Review 58, pp. 74-117.

This box was prepared by Jordi Singla
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SPAIN: OVERALL ANALYSIS

Economic activity

Very gradual progress for Spain's economy

Growth will remain very weak in the second quarter.

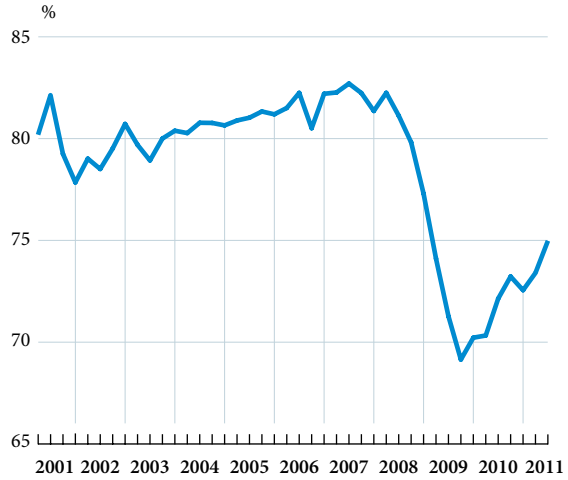
Although the Spanish economy exited the recession more than a year ago, the rate of progress since then has been very slow, clearly less than the countries in the euro area as a whole. Available indicators suggest that the rate of growth in activity will not improve over the coming months and might even slow down a little. In particular, the contribution of domestic demand is expected to be negative during the second quarter, so that the foreign sector's support will continue to be crucial. So, on average, the outlook is for growth in the second quarter of 2011 to remain relatively stagnant.

Household consumption will improve very slowly...

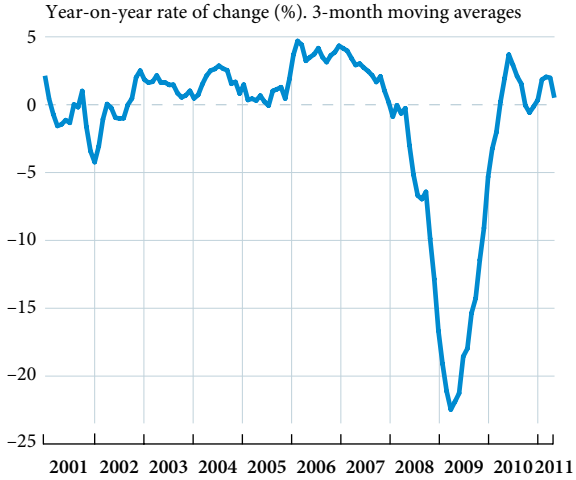
In fact, from the point of view of domestic demand, an interpretation of the indicators for private consumption points to slow progress in the period from April to June, with growth only slightly higher than the figure recorded during the previous quarter. Variables are showing divergent signs. On the positive side, of note is the slowdown in the drop in retail sales as, in April, the general retail trade index, adjusted for calendar effects, fell by 2.0% year-on-year, six and a half points below the decrease recorded in March. Sales were boosted by the good performance of large chains and department stores but fell in other distribution channels. One positive consequence of the trend in retail trade is the improvement in the rate of the year-

MIXED SIGNALS REGARDING TRENDS IN ACTIVITY

Industrial capacity utilization



Industrial production



NOTES: The industrial capacity utilization series has been adjusted for seasonal variations and the industrial production series for calendar effects.
SOURCES: Ministry of the Treasury, National Institute of Statistics and own calculations.

on-year drop in the employment index for this sector, approaching a change in trend.

Consumer confidence also improved in the month of May, although still below its long-term average. Less favourable are the figures for vehicle registrations in May, which remain at a standstill, as well as the fall in consumer goods imports in April.

On the other hand, public consumption is expected to decrease significantly during the second quarter. After the surprising upswing in the previous period, now it should fall to meet the deficit targets announced for 2011. Investment won't contribute positively to growth either this quarter, although investment in capital goods will perform very differently to investment in construction.

In the first case, indicators are giving off mixed signals and, as a whole, point to a very slight growth in investment in capital goods. On the not so optimistic side, of note is the sharp drop in industrial production that, once adjusted for calendar effects, fell substantially in April, placing the year-on-year growth rate at –1.6%, more than one point lower than the figure recorded for March. This sharp fall, widespread throughout all economic areas, puts an end to the positive trend seen at the beginning of the year. Capital goods, in spite of falling sharply in April, were the only group to maintain a positive year-on-year rate of growth.

Another variable that was not very favourable was the purchases of industrial vehicles, which also fell in April. On the other hand, industrial confidence improved in the month of May and so did industrial capacity utilization, although both indicators are quite a lot lower than their average long-

...and public expenditure is likely to fall this quarter.

Investment will continue to deduct from growth due to construction performing badly.

DEMAND INDICATORS

Percentage change over same period year before

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	1Q	April	May
Consumption									
Production of consumer goods (*)	–8.2	0.8	0.4	2.5	0.4	0.1	–1.5	–3.3	...
Imports of consumer goods (**)	–6.1	–10.2	–10.8	2.8	–16.2	–15.1	–1.8	...	...
Car registrations	–17.9	3.1	44.5	35.3	–25.0	–29.3	–27.3	–23.3	–23.3
Credit for consumer durables	–11.5	–12.3	–5.6	–9.8	–19.2	–14.6	...	–	...
Consumer confidence index (***)	–28.3	–20.9	–18.2	–22.9	–21.5	–21.0	–19.6	–21.0	...
Investment									
Capital goods production (*)	–22.1	–3.3	–2.4	–1.7	–6.3	–3.2	2.9	0.2	...
Imports of capital goods (**)	–27.0	6.0	–1.2	13.0	5.8	6.5	3.4	...	...
Commercial vehicle registrations	–40.0	6.4	8.5	24.2	–9.3	1.4	–2.2	–11.9	–8.2
Foreign trade (**)									
Non-energy imports	–17.5	9.2	10.4	18.1	5.1	4.2	7.0	...	...
Exports	–9.8	14.5	17.4	14.9	11.7	14.1	15.8	...	...

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

The capacity to recover will depend on the foreign sector.

term level. In the case of construction, the most recent information still points towards the adjustment process continuing and it will go on deducting from GDP growth next year.

The foreign sector is therefore likely to continue being crucial for the Spanish economy as a whole to keep up its rate of recovery in the second quarter. In this respect, tourism will make a significant contribution, which is looking healthy. In April it actually speeded up its rate of recovery as the number of visitors grew by 20.9% year-on-year. These figures confirm the good performance by the tourism sector, which received a million tourists more in the first four months of the year than in the same period in 2010. The recovery in the European economy and the political tensions in North Africa are expected to sustain this trend for the remainder of the year.

In short, in view of the trend in the various indicators available, the prospect is for the revival in the economy to lose steam somewhat in the second quarter. Firstly, household consumption will grow little as it is still suffering from a lot of pressure, especially if inflation continues or the recovery in the labour

SUPPLY INDICATORS

Percentage change over same period year before

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	1Q	April	May
Industry									
Electricity consumption (1)	–4.8	2.5	2.5	3.3	1.8	2.5	0.5	–1.2	0.2
Industrial production index (2)	–15.8	0.8	0.3	2.9	–0.2	0.4	1.9	–1.6	...
Confidence indicator for industry (3)	–30.8	–13.8	–18.4	–13.9	–13.5	–9.2	–8.6	–10.6	–11.9
Utilization of production capacity (4)	71.2	72.0	69.5	71.8	73.9	72.9	72.6	...	–
Imports of non-energy intermediate goods (5)	–21.6	22.2	26.9	28.4	18.8	15.8	11.6	...	...
Construction									
Cement consumption	–32.3	–15.5	–20.7	–12.3	–13.6	–16.1	–2.6	–16.2	...
Confidence indicator for construction (3)	–32.3	–29.7	–25.6	–24.0	–27.8	–41.5	–54.1	–52.2	–58.1
Housing (new construction approvals)	–58.1	–17.3	–24.4	–10.3	–13.2	–20.3	–7.4	...	...
Government tendering	–8.2	–37.9	–52.2	–18.1	–36.6	–34.8	–44.5	...	...
Services									
Retail sales (6)	–5.4	–1.0	0.7	–0.2	–2.5	–1.9	–5.9	–1.4	...
Foreign tourists	–8.8	0.9	0.3	–3.1	4.2	1.4	2.9	20.9	...
Tourist revenue inflows	–9.0	3.9	0.4	0.8	7.0	5.4	6.7	...	...
Goods carried by rail (ton-km)	–28.4	6.4	4.5	20.9	5.9	–4.2	8.2	–0.4	...
Air passenger traffic	–7.9	2.9	3.9	–0.6	4.2	4.3	5.0	20.3	6.4
Motor vehicle diesel fuel consumption	–5.1	–1.2	–0.5	–0.5	–2.1	–1.6	0.7	...	...

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

market comes to a halt, as both factors will reduce disposable income. The expected gradual rise in interest rates won't help to speed up consumption either. The data also highlight the fact that investment will not make a positive contribution to growth. But one of the factors that will most condition the slowdown in the recovery in the second quarter is the trend in public expenditure. This will actually reflect the commitment of all public administrations to reduce the deficit.

In fact, among the European Commission's recommendations for Spain, published in June with the aim of advising on this country's programme of reforms and fiscal stability for 2011, of note is its request for a strict application of the mechanisms to control the deficit and debt in regional governments. This organisation also recommends reducing social security contributions and raising VAT to boost competitiveness. In the employment area, it defends a reform of collective bargaining that links wages to productivity and proposes reviewing the results of the labour reform at the end of 2011. Lastly, regarding the financial system, it is in favour of continuing to promote the current restructuring of savings banks.

The European Commission estimates that the Spanish economy will grow by 0.8% in 2011.

Outlook of household consumption in Spain

Private consumption was one of the supports for growth in the Spanish economy during the last expansionary cycle. The numbers speak for themselves. Between 1995 and 2007, the average growth rate was 3.8%, almost two percentage points above the rate for the euro area as a whole. Given its significant weight in the overall economy, accounting for 59% of the gross domestic product (GDP), the performance of private consumption was fundamental to keep the growth rate of the Spanish economy on the right track. However, its role in the recovery is not clear, at least if we look at the forecasts of the main institutions, both national and international. While the IMF expects 1.3% growth for 2011, the consensus of analysts places this at 0.3%. The forecasts of the Bank of Spain, the OECD and "la Caixa" lie between these two values (see the table below). Why such disparity? And, particularly, what is the most likely path?

GROWTH FORECASTS FOR PRIVATE CONSUMPTION IN SPAIN

%

	2011	2012
Bank of Spain	0.7	1.0
Spanish government	0.9	1.4
IMF	1.3	1.4
OECD	0.4	1.6
Consensus of analysts	0.3	0.9
"la Caixa"	0.4	1.3

Its good performance seen throughout 2010, advancing 1.3% in real terms, could allow us to be optimistic to some extent. But as can be seen in the table above, few predict an improvement for this year. This is fundamentally because last year's figure is above all due to a significant reduction in the savings rate. Savings had remained stable during the years of expansion at around 11% of households' gross disposable income (HGDI), but when the international financial crisis erupted, this figure rocketed, reaching 18% in 2009. An abnormally high value but reasonable given the sharp increase in uncertainty and the deterioration in the labour market. In 2010, as the global economy started to recover and the Spanish economy was showing signs of stabilizing, the savings rate began a rapid drop until it reached 13% at the end of the year. The contribution of this factor was therefore fundamental. If the savings rate had remained constant, private consumption would have fallen approximately 4.7% in real terms.

After the strong correction in savings in 2010, its downturn is now more limited. The current level is close to the one during the years of expansion but uncertainty still remains high. The push it might give to consumption will therefore be much lower.

In addition to the little room for manoeuvre of the savings rate, there are other factors that also limit consumption's capacity to recover, with the VAT hike and rising commodity prices being the two main ones.

As is well known, in June last year the lower VAT rate rose from 7% to 8%, and the general rate from 16% to 18%. Although it's true that this tax hike boosted consumption in the first half of the year because it encouraged people to bring forward some purchases, especially those of durables, the impact it had on households' purchasing power overall cannot be ignored. To get an idea of its size, we only need to remember that VAT revenue accounts for approximately 6% of the HGDI. An increase in this tax such as the one occurring last year therefore represents around 0.8 percentage points of the HGDI. However, it's important to remember that, in terms of growth, the effect is spread over last year and this, as the increase occurred in June 2010. Moreover, the VAT hike was crucial for the government to get the public deficit down to 9.2% and thereby to maintain the confidence of the international financial markets.

The effect of rising commodity prices in general, and oil in particular, on the purchasing power of Spanish households isn't marginal either. The relative weight of fuels in household expenditure is large and, in general, demand for this product does not respond much to price variations in the short term. Specifically, the year-on-year growth rate in the price of Brent quality oil stood at 50% in May. In Europe, however, this increase has been lower, namely 30%, thanks to the appreciation of the European currency. Moreover, not all the rise in the price of crude has been passed on to prices at the pumps. In fact, this only represents 35% of the final price, approximately. As fuel expenditure accounts for 6% of expenditure on final consumption, the rise in price reduces the consumption capacity by 0.6 percentage points.

Given this scenario, the trend in household consumption is unlikely to be a source of much joy in the short term. It's difficult to estimate the final impact of each of the factors mentioned and this is probably one of the reasons why the forecasts from different institutions are so disparate. But although part of the effects may be offset by the increase in households' gross disposable income, this probably won't be enough to stop consumption from posting a substantially lower rate to the one last year. In fact, signs of a downward trend could already been seen in the last quarter. After posting a 2.2% year-on-year change rate in the second quarter of 2010, this dropped to 0.7% in the first quarter of 2011.

But it's not all bad news. It's important to stress that these factors are temporary. The effect of VAT on the growth rate will disappear during the second half of this year and oil prices are likely to stabilize gradually over the coming months. This will provide some support during the second half of the year and will help consumption to pick up somewhat more strongly in 2012. Moreover, consumption is also likely to receive support from the labour market by that time. This is a fundamental aspect for household income as a whole to grow again and thereby strengthen the recovery in private consumption and in the economy in general.

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

Labour market

The favourable seasonal effect provides the labour market with some breathing space.

Job creation is concentrated in the services sector...

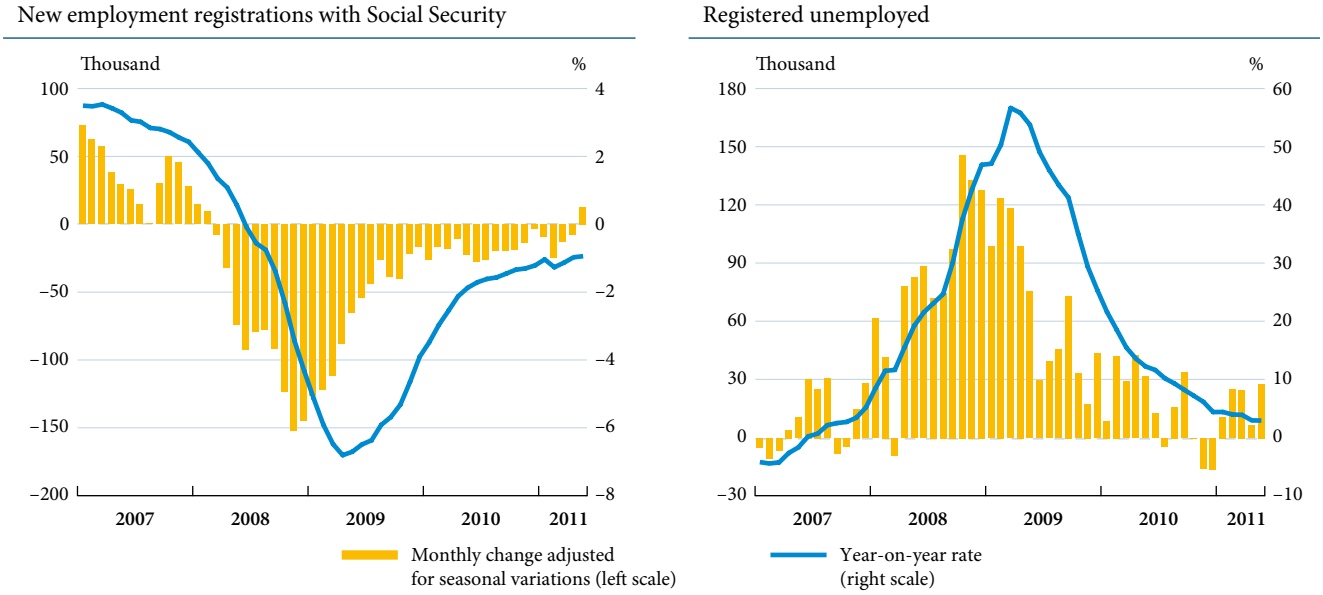
The deterioration in the labour market slows up but a change in trend has yet to appear

As expected, the situation of the job market improved in the month of May. In fact, the data for those people registered as employed and unemployed that month showed an increase and decrease, respectively. However, this better performance was partly due to the favourable seasonal effect for the period as, once the figures have been corrected for this, the positive result disappears. Although the total number of employed rose by 117,990 people, very slightly reducing the fall in this figure to 1.0% year-on-year, this rise evaporates when the seasonal effect is taken into account.

The same thing happens with the number of registered unemployed as, although this fell by 79,701 people in May, keeping the year-on-year growth rate unchanged at 3.0%, the seasonally adjusted figure shows a rise. Therefore, the trend in the seasonally adjusted data highlight that, although the rate of the decrease in employment and of the increase in unemployment has slowed up, a definitive change in trend in the labour market has yet to appear.

The slowdown in job losses is highly disparate among the different economic sectors. In fact, job losses in the construction industry have speeded up over the last few months, partly due to the end of deductions for acquiring housing

THE FAVOURABLE SEASONAL EFFECT IS NOT ENOUGH TO REVERSE THE NEGATIVE TREND IN THE LABOUR MARKET



SOURCES: Ministry of Labour and Immigration, Public Employment Offices and own calculations.

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2009	2010	2010				2011		
			1Q	2Q	3Q	4Q	1Q	April	May
Persons registered with Social Security (1)									
Sectors of activity									
Industry	*–10.6*	*–4.8*	*–7.2*	*–4.9*	*–3.8*	*–3.2*	*–2.8*	*–2.5*	*–2.5*
Construction	*–23.1*	*–13.4*	*–16.4*	*–13.1*	*–12.5*	*–11.3*	*–9.6*	*–10.5*	*–11.5*
Services	*–2.6*	*0.0*	*–0.8*	*0.1*	*0.4*	*0.4*	*0.3*	*0.5*	*0.6*
Job situation									
Wage-earners	*–6.0*	*–1.8*	*–2.8*	*–1.7*	*–1.4*	*–1.2*	*–1.1*	*–0.9*	*–0.9*
Non-wage-earners	*–4.8*	*–2.8*	*–4.0*	*–3.0*	*–2.4*	*–1.9*	*–1.6*	*–1.3*	*–1.1*
Total	**–5.8**	**–2.0**	**–3.0**	**–1.9**	**–1.6**	**–1.3**	**–1.2**	**–1.0**	**–1.0**
Persons employed (2)	**–6.8**	**–2.3**	**–3.6**	**–2.5**	**–1.7**	**–1.3**	**–1.3**	**–**	**–**
Jobs (3)	**–6.6**	**–2.4**	**–3.9**	**–2.4**	**–1.6**	**–1.4**	**–1.4**	**–**	**–**
Hiring contracts registered (4)									
Permanent	–31.0	–6.4	–11.9	–5.6	–7.6	0.0	–1.8	–6.5	–4.7
Temporary	–13.5	3.8	3.7	5.2	3.5	2.8	0.7	–0.5	10.4
Total	**–15.5**	**2.8**	**2.0**	**4.2**	**2.6**	**2.5**	**0.4**	**–1.1**	**9.0**

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

by the government. However, the trend was more positive in industry and services. In the first case, the seasonally adjusted data show that the industrial sector is not destroying jobs but neither is it creating any. It is likely, however, that the expected growth in non-peripheral Europe over the next few months will boost the sale of Spanish products and thereby improve the progress of industry. With regard to the group of services, this sector has been creating jobs for the last year but more intensely in the last two months, thanks to the good performance by tourism. It is very likely that employment in this sector will continue to grow over the coming months thanks to the arrival of the holiday period.

Another indicator of the improvement in the job market in the second quarter is the trend in contracts registered, up 9.0% year-on-year in the month of May. However, this rate breaks down into a fall of 4.7% for permanent contracts and a rise of 10.4% for temporary ones. Such an uneven trend suggests that the labour reform in force since September 2010 is not enough to encourage employers to offer permanent contracts. In fact, precisely one of the core measures of this reform was to encourage the use of Contracts to Encourage Permanent Employment, whose severance pay for unfair dismissal on objective grounds totals 33 days per year worked in the firm (instead of the previous 45 days for permanent contracts).

...and in temporary contracts.

Within this context of legislative changes to boost employment contracts, of note is the reform in collective bargaining

The Spanish cabinet approves collective bargaining reform by royal decree law.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

May 2011

	No. of unemployed	Change over December 2010		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	136,103	9,274	7.3	12,932	10.5	3.2
Industry	490,417	–1,221	–0.2	–17,858	–3.5	11.7
Construction	738,993	–14,074	–1.9	–22,471	–3.0	17.6
Services	2,447,807	75,868	3.2	109,186	4.7	58.4
First job	376,339	19,739	5.5	41,668	12.5	9.0
By sex						
Males	2,064,581	11,393	0.6	27,389	1.3	49.3
Females	2,125,078	78,193	3.8	96,068	4.7	50.7
By age						
Under 25 years	450,937	17,163	4.0	–10,485	–2.3	10.8
All other ages	3,738,722	72,423	2.0	133,942	3.7	89.2
TOTAL	**4,189,659**	**89,586**	**2.2**	**123,457**	**3.0**	**100.0**

SOURCES: Public State Employment Service and own calculations.

Labour costs pick up.

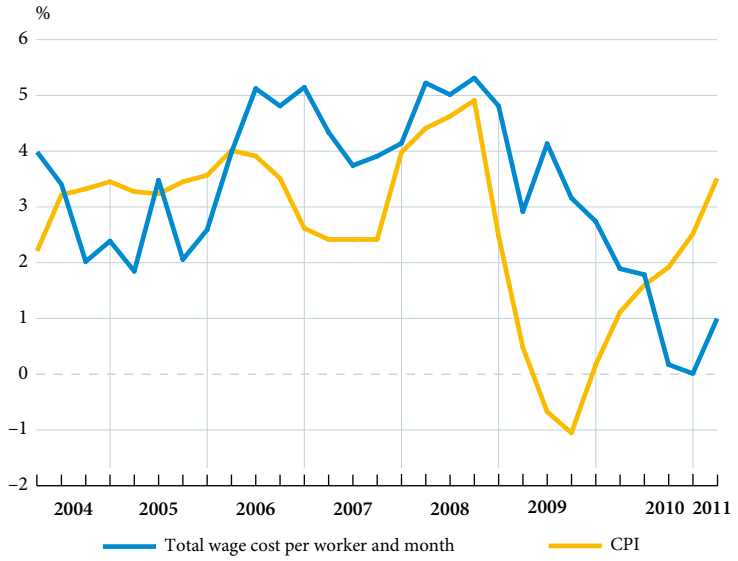
approved on 10 June. This reform reduces the prevalence of provincial agreements on the firm, although sector agreements can still prevent company agreements from developing a large number of areas. Similarly, it is now easier for firms to adjust to the economic cycle by making available 5% of the annual work day, and an attempt has been made to limit ultra-activity, i.e. the indefinite extension of agreements when collective bargaining has not been successful. To this end, the negotiation time has been limited to a period of between 8 and 14 months and, if no agreement is reached after this period, arbitration mechanisms must be employed. However, the parties can previously and voluntarily decide whether they are going to go to arbitration should collective bargaining fail. Moreover, the time for arbitration to reach a decision is not clear.

One of the most extensively discussed aspects in drawing up this reform has been the process to determine wages as, in Spain, these tend to react very moderately in recessionary periods. This leads to relatively high employment volatility with regard to movements in gross domestic product because adjustments are made through job losses rather than wage variations. This characteristic of the Spanish labour market is highlighted in the following graph which shows that, since the start of the economic recession, real wage costs per worker did not moderate until the third quarter of 2010.

Within this context, it should be noted that, after two consecutive periods of negative changes, labour costs per worker rose again by 0.8% year-on-year in the first quarter of 2011. This rise in wages was particularly due to the growth in the wage component, although other costs

LABOUR COSTS PICKS UP

Year-on-year change



SOURCES: National Institute of Statistics and own calculations.

also increased, such as company benefits and compensation. The upswing in wage costs points to the possible end of strong wage containment. One consequence of this change in trend could be a slowdown in Spain's improving competitiveness recorded over the last few months, thanks partly to the fall in labour costs.

Prices

The drop in oil prices interrupts the inflationary trend

The rate of inflation drops by three tenths of a percentage point to 3.5% in May...

The year-on-year rate of change in the consumer price index (CPI) fell by three tenths of a percentage point to 3.5% in the month of May, reversing the inflationary trend starting at the end of 2010. This reversal was to be expected as the rise in inflation over the previous months had a large temporary component, resulting from the sharp increases in commodity prices and hikes in indirect taxes occurring in the second half of 2010. In fact, the halt in rising prices in May mainly reflects the fall in fuel prices.

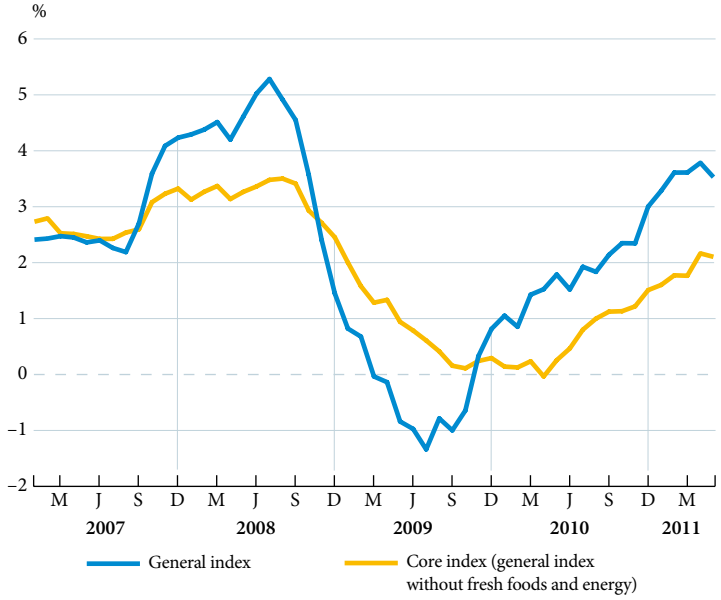
...thanks to the moderation in oil prices.

Therefore, as expected, inflation peaked in April and, from now on, will gradually fall back down, with a slightly more pronounced drop at the beginning of summer when the temporary base effects of indirect tax hikes disappear. This gradual drop might place inflation at least one point below its current level by December. For this to occur, it's vital that oil prices gradually fall and reach around 110 dollars/barrel by the end of the year.

An example of how the trend in fuel costs has played a fundamental role in the recent fall in prices is the fact that core inflation, which excludes unprocessed

MAY'S DROP IN INFLATION IS PROBABLY A TURNING POINT

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

foods and energy products, remained stable at 2.1%. Another example of how inflation actually remained at a lower level after discounting those items with a high contribution to the general rate can be seen when we look at the index for services and non-energy industrial goods, whose rate of growth did not exceed 2.0%. This reflects the weakness in domestic demand, partly due to the high unemployment rate that prevents any second-round effects. The relapse in service prices in May was to be expected due to the fall that month in transport and package holiday prices, resulting from lower pressure from fuels and the adjustment in the rise of the previous month because of Easter.

Core inflation remains at 2.1%.

Easing energy prices have also helped to slow up inflation in the rest of the euro area, in May standing at 2.7%, one tenth of a percentage point below the rate recorded the previous month. In spite of this change in trend, inflation for the euro area as a whole is still quite a bit higher than the target set by the European Central Bank (ECB) and, therefore, at its next meeting in July it will very likely decide to raise the official interest rate by 25 basis points to 1.50%. Given the ECB's commitment to keep inflation at a moderate level, its actions are likely to help to force inflation down over the coming months.

Price trends are crucial to evaluating the Spanish economy's prospects for recovery. On the one hand, when inflationary pressures persist, households lose purchasing power and this could reduce their propensity to consume. On the other hand, notable price rises could hinder gains in competitiveness in the Spanish economy, especially if inflation here greatly exceeds that recorded in the rest of the euro area, its main trading partner. Therefore, an important variable to measure the competitiveness of the Spanish economy is provided by the differential between its inflation and that of the euro area. According to Eurostat data, the year-on-year change in the harmonized price index for the euro area stood at 2.7%, while the figure for Spain was 3.4%. This shows that the inflation

The euro area's inflation also reverses.

CONSUMER PRICE INDEX

	2010			2011		
	% monthly change	% change over December 2009	% annual change	% monthly change	% change over December 2010	% annual change
January	–1.0	–1.0	1.0	–0.7	–0.7	3.3
February	–0.2	–1.2	0.8	0.1	–0.6	3.6
March	0.7	–0.5	1.4	0.7	0.1	3.6
April	1.1	0.6	1.5	1.2	1.4	3.8
May	0.2	0.8	1.8	0.0	1.3	3.5
June	0.2	1.0	1.5			
July	–0.4	0.6	1.9			
August	0.3	0.8	1.8			
September	0.1	0.9	2.1			
October	0.9	1.8	2.3			
November	0.5	2.4	2.3			
December	0.6	3.0	3.0			

SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

May

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	109.7	0.0	0.3	–0.9	0.8	–1.4	2.5
Alcoholic beverages and tobacco	148.7	0.0	0.0	3.0	2.5	12.1	14.7
Clothing and footwear	106.2	2.0	2.1	–2.1	–2.2	–0.5	0.5
Housing	123.9	0.3	–0.1	2.3	4.1	3.8	7.6
Furnishings and household equipment	108.9	0.2	0.4	0.0	0.4	0.2	1.4
Health	96.2	–0.7	–0.1	–0.6	–0.1	–0.4	–0.7
Transport	117.5	0.5	–0.8	5.4	4.1	7.9	7.9
Communications	98.6	0.0	0.0	–0.9	0.0	–1.2	0.3
Recreation and culture	96.4	–0.6	–1.7	–1.7	–1.2	–1.7	–0.6
Education	117.1	0.0	0.0	0.1	0.0	2.6	2.2
Restaurants and hotels	114.8	0.0	–0.1	0.9	0.9	1.0	1.8
Other goods and services	115.2	0.2	0.2	1.7	2.0	2.1	3.1
By group							
Processed food, beverages and tobacco	116.5	0.0	0.2	–0.5	1.6	0.9	4.7
Unprocessed food	109.4	0.0	0.4	–0.2	–0.1	–0.8	2.7
Non-food products	111.7	0.3	–0.1	1.2	1.4	2.1	3.4
Industrial goods	110.1	0.7	0.1	1.9	2.0	3.3	4.8
Energy products	*134.7*	*0.7*	*–1.3*	*8.9*	*8.7*	*16.4*	*15.3*
Fuels and oils	*131.8*	*0.9*	*–1.8*	*11.6*	*8.9*	*20.9*	*15.5*
Industrial goods excluding energy products	*101.8*	*0.6*	*0.6*	*–0.6*	*–0.5*	*–1.1*	*0.9*
Services	113.5	–0.1	–0.3	0.5	0.9	1.0	2.0
Underlying inflation (**)	109.8	0.2	0.1	–0.1	0.5	0.2	2.1
GENERAL INDEX	**112.5**	**0.2**	**0.0**	**0.8**	**1.3**	**1.8**	**3.5**

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

The inflation differential compared with the euro area remains at seven tenths of a percentage point.

differential is still quite significant. However, since part of this gap is due to the taxation changes introduced in Spain during the second quarter of 2010, this differential should fall once the base effect disappears. The gap will also tend to narrow if oil prices slow up their upward trend, as the trend in the price index in Spain is more sensitive to changes in oil prices than the euro area on average.

Another decisive variable in evaluating the competitiveness of the Spanish economy is the producer price index. It is therefore important that, after months of continual rises, the year-on-year growth rate of this index fell by 0.5 percentage points in April to 7.3%, a consequence of the slowdown in prices for energy and intermediate goods. The general index without energy recorded a 4.1% year-on-year rate, four tenths of a percentage

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2010											
March	5.6	2.3	–0.1	0.0	0.4	10.1	7.4	1.2	0.5	4.3	–
April	2.8	3.7	0.1	–0.1	2.4	13.1	8.5	2.1	0.7	6.7	–
May	13.7	3.8	0.2	–0.1	3.5	12.0	10.2	4.2	1.6	9.9	0.5
June	8.6	3.2	0.3	0.1	3.7	8.7	10.1	5.3	2.0	10.9	–
July	4.5	3.3	0.2	0.2	3.2	9.8	9.3	4.9	2.0	10.5	–
August	5.1	2.7	0.0	0.5	3.4	7.0	8.7	6.0	1.8	10.2	1.3
September	8.0	3.4	0.2	0.5	4.0	9.1	9.2	6.9	1.8	10.7	–
October	10.3	4.1	0.6	0.5	4.3	10.5	8.6	6.4	1.7	10.5	–
November	10.3	4.4	0.9	0.6	5.1	10.7	9.2	7.7	2.2	11.0	1.4
December	8.5	5.3	1.3	0.7	5.7	13.5	10.3	8.1	2.4	11.8	–
2011											
January	3.7	6.8	1.5	1.0	6.8	17.3	11.9	7.6	2.0	12.4	1.8
February	1.3	7.6	1.9	1.0	7.9	18.3	11.1	6.3	1.4	13.1	–
March	...	7.8	2.1	1.2	8.0	18.8	10.7	5.5	1.1	11.9	–
April	...	7.3	2.5	1.3	7.1	17.4	10.0	3.9	1.5	10.3	–

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

point less than in March. This reversal in production costs could help to improve the competitiveness of the Spanish economy.

In short, for the remainder of 2011, inflation is likely to fall steadily towards levels close to 2.4% by December, thanks to the moderation in oil prices and to the disappearance of base effects due to the hikes in indirect tax carried out in 2010. The fall in oil prices should also ease production costs. This reversal in the inflationary trend in consumer and industrial prices, probably greater in Spain than in other countries in the euro area, should help to restore some of the Spanish economy's competitiveness.

Production costs fall after several consecutive months of rises.

Foreign sector

The good performance by exports reduces the trade deficit

Trade deficit falls by 20.8% year-on-year in April.

In April, the trade deficit posted a correction of 20.8% year-on-year. This decrease, the largest in the last year, occurred within a context of sharp growth in exports, which rose in this period by 18.6% compared with the 8.5% for imports. In spite of this improvement, the cumulative data over the last twelve months show a standstill in the imbalance, which is slightly over 50 billion euros this year so far. The return to a corrective trend in the trade balance will depend on Spanish consumption's rate of recovery and the trend in oil prices.

In fact, the slow recovery in Spain's domestic demand reduced real imports of goods, i.e. net of the price effect, by 2.2% year-on-year. This fall in the volume of imports occurred both in the case of energy and non-energy goods. However, the high oil prices compared with April

FOREIGN TRADE

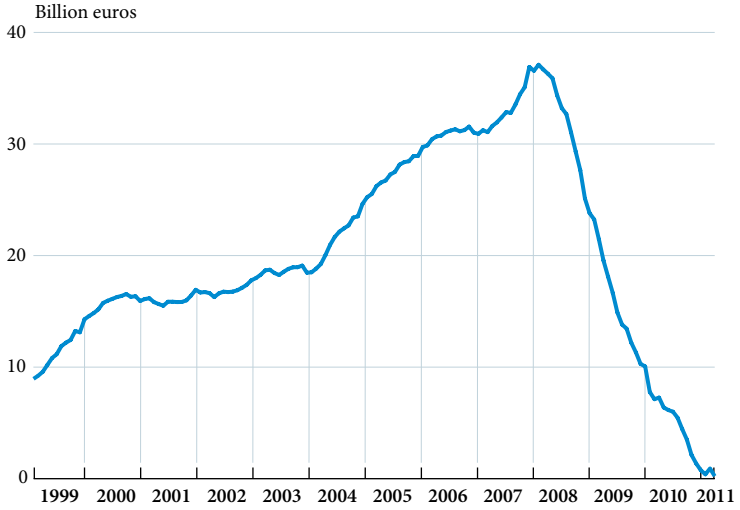
January-April 2011

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	18,419	34.5	21.2	4,093	89.8	5.8	–14,326	22.2
Consumer goods	19,751	5.1	22.8	23,473	14.2	33.5	3,722	118.8
Food	*4,976*	*9.0*	*5.7*	*8,882*	*11.6*	*12.7*	*3,906*	*178.5*
Non-foods	*14,776*	*3.9*	*17.0*	*14,591*	*15.7*	*20.8*	*–185*	*98.7*
Capital goods	5,648	0.9	6.5	6,170	34.4	8.8	522	109.2
Non-energy intermediate goods	42,995	17.3	49.5	36,345	21.0	51.9	–6,649	84.5
By geographical area								
European Union	46,169	10.3	53.2	46,820	18.0	66.8	652	101.4
Euro area	*37,653*	*11.4*	*43.4*	*37,713*	*15.3*	*53.8*	*60*	*100.2*
Other countries	40,645	23.6	46.8	23,261	31.6	33.2	–17,384	57.2
Russia	*2,961*	*96.8*	*3.4*	*745*	*46.1*	*1.1*	*–2,216*	*25.2*
United States	*3,631*	*26.9*	*4.2*	*2,796*	*49.0*	*4.0*	*–835*	*77.0*
Japan	*1,182*	*–3.1*	*1.4*	*581*	*23.4*	*0.8*	*–601*	*49.2*
Latin America	*5,429*	*29.1*	*6.3*	*4,045*	*40.4*	*5.8*	*–1,384*	*74.5*
OPEC	*9,046*	*25.2*	*10.4*	*2,607*	*26.5*	*3.7*	*–6,439*	*28.8*
Rest	*18,397*	*15.9*	*21.2*	*12,487*	*26.4*	*17.8*	*–5,910*	*67.9*
TOTAL	**86,813**	**16.2**	**100.0**	**70,081**	**22.2**	**100.0**	**–16,732**	**80.7**

SOURCES: Ministry of the Economy and own calculations.

THE TRADE IMBALANCE WITH THE EURO AREA FALLS PRACTICALLY TO ZERO

Trade deficit



SOURCES: Ministry of the Economy and own calculations.

2010 continued to push up the energy deficit accumulated over the twelve months. This increase up to 38,227 million euros accounts for 74% of the total imbalance. Nevertheless, its contribution to the deficit is expected to ease as from the third quarter this year, when the price differential compared with a year ago gradually narrows.

Consequently, the reduction in the trade deficit was entirely due to the good performance of the non-energy component. This improved again for the ninth consecutive month, with a 66.3% correction in the deficit, now standing at levels similar to those of 1998.

An analysis by geographical zone shows a sharp upswing in exports to countries outside the European Union, particularly the American continent. Demand for Spanish goods rose in the United States and Latin America, in year-on-year terms, by 50.4% and 56.6% respectively. On the other hand, as can be seen in the graph above, the trade deficit with the euro area almost fell to zero. The good performance by exports and the stagnation in imports from this region were the main reasons.

Looking to the future, the good pace of growth enjoyed by Spain's main trading partners, higher than that of the Spanish economy, will help to correct Spain's trade imbalance. This improvement will intensify as from September 2011, when the pressure from the energy component starts to lose steam.

The current deficit falls in March

In spite of April's smaller trade imbalance, the current account figures for the first quarter of 2011 show a slight increase in the deficit. The cumulative current deficit between April 2010 and March 2011 increased by 8.7% year-on-year, up to 49,672 million euros. This deterioration was widespread among the balance's different components. In addition to the greater imbalance in

Real imports fall by 2.2% compared with April 2010.

Strong upswing in trade with the United States and Latin America.

The cumulative current deficit between April 2010 and March 2011 rises to 49,672 million euros.

the balance of goods, the increase in the income deficit for this period is also of note. This is due to the rising cost of financing Spanish debt.

Only the tourist component of the services balance posted a substantial improvement during this period, with the rise in the number of foreign visitors boosting tourism revenue. May's figures suggest this upward trend will continue, partly due to the political conflicts in North Africa. Nevertheless, rising oil prices and interest rates, within a context of heavy borrowing on the part of the Spanish economy, are limiting the external deficit's room for correction.

This outlook coincides with the one published by the Bank of Spain in its last Annual Report. According to this institution, the Spanish economy's high dependence on imported goods, particularly energy, and the financial burden entailed in its heavy borrowing are hindering the correction of the deficit. The Report points out several solutions to overcome this obstacle: securing gains in competitiveness via prices, opening up more to foreign markets and reducing the dependency on imports. The impact of these three measures would boost the correction in the deficit by an additional 0.7 percentage points in 2011 and 1.6 percentage points in 2012.

BALANCE OF PAYMENTS

March 2011

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–11,914	9.4	–48,121	–5,641	13.3
Services					
Tourism	*4,873*	*10.6*	*27,426*	*1,409*	*5.4*
Other services	*–508*	*158.0*	*676*	*1,136*	–
Total	4,365	3.7	28,102	2,545	10.0
Income	–6,026	19.9	–22,695	1,912	–7.8
Transfers	–4,140	–2.0	–6,958	1,932	–21.7
Total	**–17,715**	**11.2**	**–49,672**	**747**	**–1.5**
Capital account	**1,579**	**–16.6**	**6,147**	**1,037**	**20.3**
Financial balance					
Direct investment	–4,234	–	–13,089	–29,851	–
Portfolio investment	33,863	–	69,978	37,142	113.1
Other investment	–5,309	–	–18,655	–7,451	66.5
Total	**24,321**	**76.2**	**38,233**	**–161**	**–0.4**
Errors and omissions	1,863	–	2,788	10,132	–
Change in assets of Bank of Spain	–10,047	–	2,503	–11,501	–82.1

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

With regard to financial flows, a rise has been observed in short-term financing in March, although portfolio investment is still the main source of financing from abroad in the last twelve months. However, the upsurge in tensions in international debt markets and the rise in institutions resorting to the European Central Bank could alter the sources of financing in the second and third quarter.

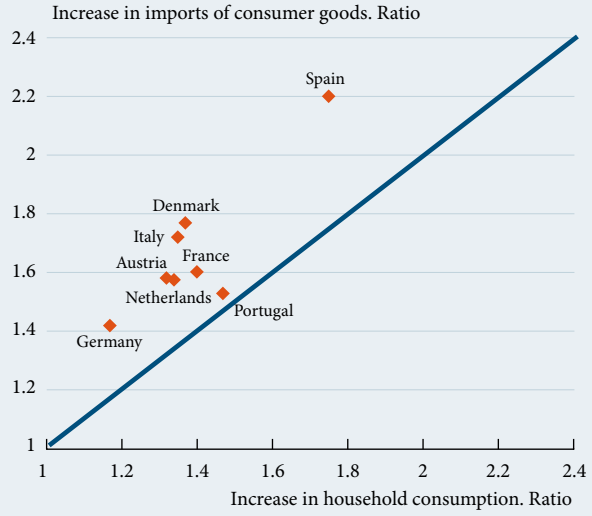
Dependence on oil and a heavier financial burden will hinder the deficit correction.

Consumption and imports: two sides of the same coin?

Private consumption was one of the launch pads for growth in many developed countries during the last expansionary cycle. In fact, in most of them its relative weight in gross domestic product (GDP) exceeds 50%. However, in some countries this process was accompanied by a sharp rise in imports, thereby raising doubts as to its sustainability. This is the case of the Spanish economy. Intense growth in consumption led to the relative weight of private consumption reaching 60% of GDP, a slightly higher level than in most developed countries. But this process was accompanied by incredibly intense growth in imports that helped to push the current account deficit to 10% of GDP in 2008, a rate difficult to sustain over the long term. Now that the economy is starting to recover, it's important to ask whether the new expansionary cycle will be based on a more balanced growth in consumption.

THE SPANISH CONSUMPTION OF NATIONAL AND FOREIGN GOODS GREW MORE THAN IN OTHER COUNTRIES

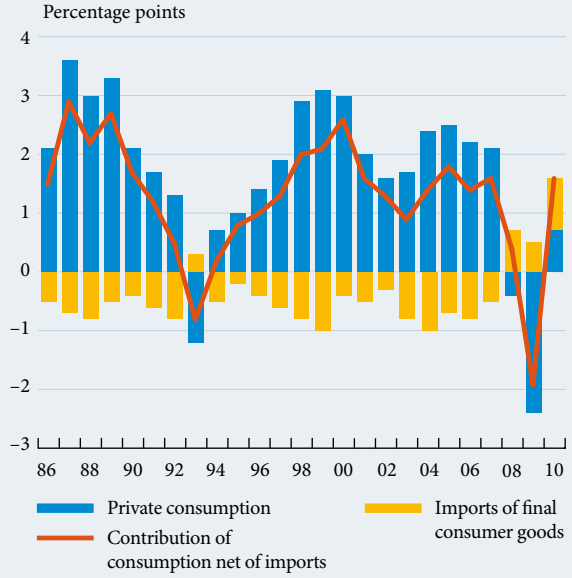
Quotient between consumption and imports in 2007 compared with those of 1999



SOURCES: Eurostat and own calculations.

GREATER CONSUMPTION IS PARTLY NEUTRALIZED BY RISING IMPORTS

Contribution to GDP growth



SOURCES: Ministry of the Treasury, Bank of Spain and own calculations.

Usually, the variation of the domestic demand and the imports of a country are closely interrelated. The push from consumption during the pre-crisis years and the good performance of international trade in the last expansionary period, as well as the consolidation of the single market (particularly in the European case) boosted imports of goods and services even further. As can be seen in the graph on the left on the previous page, growth in imports of consumer goods between 1999 and 2007 was greater than the growth in total household consumption in the main European countries. As a consequence, the percentage of consumer goods imported (known as the import share of consumption) also grew during this period.

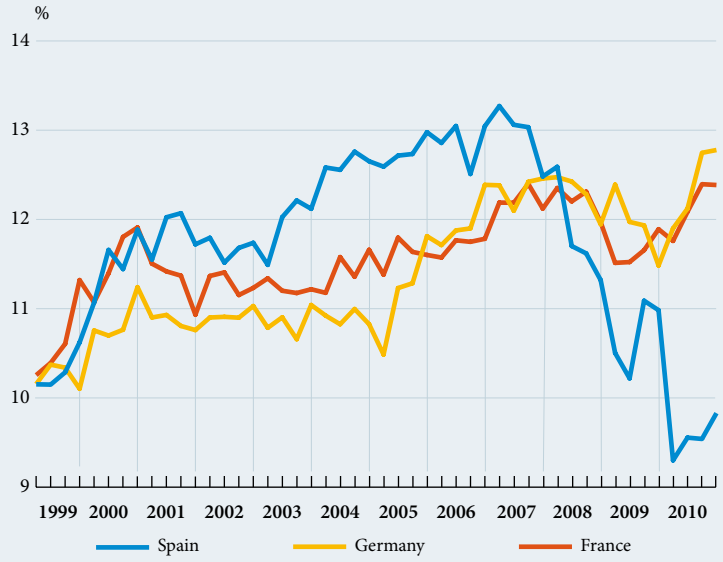
The case of Spain particularly stands out, where both consumption and imports of final consumer goods posted higher growth than any other European country. Between 1985, one year before Spain joined the European Economic Community (EEC), and 2007, imports of consumer goods multiplied by 26.4. This figure contrasts with the overall growth in imports (10.1 times) and consumption (5.4 times). As a consequence, goods from abroad accounted for 12.8% of Spanish household consumption in 2007, more than 10 percentage points above the figure recorded 22 years previously.

A breakdown by economic sector shows the important role played by durables in this sharp rise in imports of consumer goods. In fact, households' greater purchasing power boosted the penetration of imports from those sectors with the highest technology. Moreover, the upsurge in the real estate market during this period also helped this process. As a result, the rise in imports of cars, domestic appliances and furniture exceeded the average of the rest of imports during the last expansionary cycle.

In terms of growth, this greater share of imports partially offset the contribution of consumption to Spanish GDP. The graph on the right on the previous page shows the opposing trends in both series. Between 1986 and 2007, the average contribution of consumption to growth, namely 2.1 percentage points per year, was reduced by

THE SHARE OF SPANISH IMPORTS IN CONSUMPTION IS FALLING

Imports of final consumer goods in proportion to household consumption



SOURCES: Eurostat, Bank of Spain and own calculations.

0.6 percentage points due to imports of consumer goods, a brake that reached 0.8 percentage points on average during the years prior to the start of the crisis.

The gradual recovery in consumption will once again boost imports and their negative contribution to growth. However, the bulk of the evidence available suggests that this brake on growth will not be so big in the future. There are mainly two reasons for this. Firstly, because the recovery in private consumption will be very gradual in the coming years (see the Box «Outlook of household consumption in Spain» for a more detailed explanation) and, therefore, also the rise in imports of final consumer goods. But especially because it will be more difficult for consumer durables to boom again. This has been the usual picture throughout the cycle in all countries throughout history. Consumer durables tend to grow above average at boom times and usually see weaker growth rates at difficult times. However, in the case of Spain, this will be augmented by the significant adjustment in the real estate sector. In short, given the high relative weight of consumer durables in imported consumer goods as a whole, the share of consumer goods from abroad is very likely to fall in the coming years.

In the previous graph, we can already see a fall in the relative weight of imports of consumer goods. Since the peak reached in March 2007, the percentage of consumer goods from other countries has fallen by 3 percentage points, stabilizing close to 10% at the end of 2010. This trend contrasts with the one seen in the French and German economies. Both countries have recorded lower growth in the import share in consumption than in Spain since the beginning of the century, but the adjustment during the years of recession has also been less.

Consequently, the weak recovery in private consumption in the next few years will be partly offset by fewer imports of consumer goods. A simple numerical exercise can help us to estimate the impact this might have. We assume the relative weight of imports of consumer goods is converging gradually towards 11.5%, an intermediate level between the peak reached in 2007 and the current level, and that the average rate of growth for consumption in the next 5 years is 2.0% (1.7 percentage points lower than in the pre-crisis period). In this case, the contribution of consumption to GDP growth would fall by 8 tenths of a percentage point, to 1.3 percentage points. However, the lower growth in imports of consumer goods would place the contribution of consumption net of imports at 1.0 percentage points, only 5 tenths of a percentage point below the figure recorded in the expansionary period.

In short, although the process of recovery will be slow, it does seem that the dependency of growth in consumption on imports will partially correct itself in the coming years. In terms of growth this is good news, but we must continue to monitor the ultimate size of this adjustment, as it's very important not to go back to the imbalances of the past.

This box was prepared by Joan Daniel Pina
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Public sector

The tension in Greece is affecting Spanish debt

Tensions in the sovereign debt markets increase investor uncertainty regarding Spain's public accounts.

The events of June have once again increased uncertainty in European sovereign debt markets. The lack of agreement regarding the payment of aid to Greece and the second bail-out scheme for this country continued to be the main catalyst for this instability. The consequent reaction of investors towards safer assets, such as German debt, raised the interest rates for the debt of the peripheral countries, including Spain. In any case, uncertainty regarding future developments in fiscal adjustment is still considerable. Given this situation, international organisations and the Bank of Spain itself have recommended new measures to establish solid bases for fiscal consolidation and debt control in the medium and long term.

In fact, the sovereign debt crisis pushed Spain's risk premium slightly above 270 basis points during the second half of June. As a consequence, the interest rate for Spanish 10-year bonds reached the upper level, close to 5.7%. These tougher financial conditions also affected the take-up of debt in the Treasury auctions. However, the risk premium is expected to fall again over the next few months. How far it falls will depend on improving the uncertainty in debt markets, as well as regaining investor confidence in the process of fiscal consolidation.

Cash deficit falls by 50.4% year-on-year in the first four months of the year.

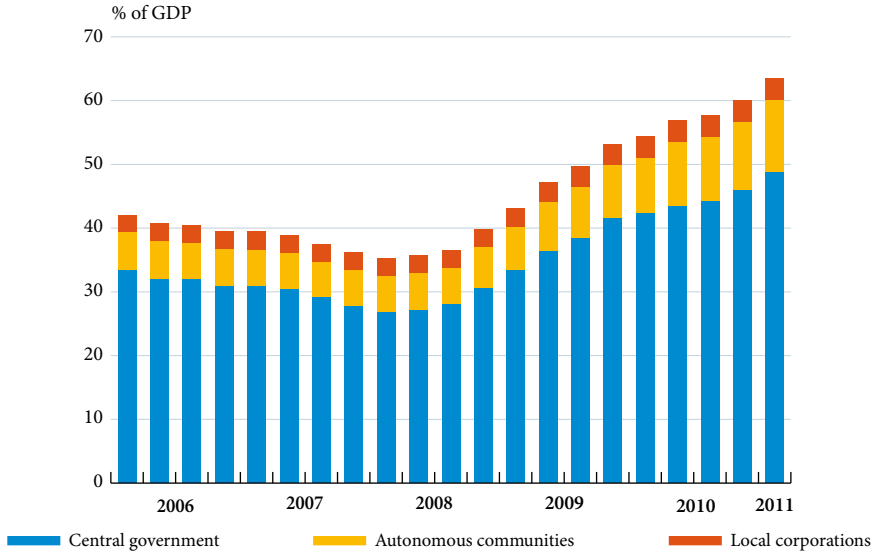
In this last case, the latest data available regarding the central government's cash accounts look promising. During the first four months of the year, the deficit fell by 50.4% to 6.14 billion euros. A figure that is much lower than the cash deficit forecast in the government's 2011 stability programme (close to 44 billion euros). This improvement has occurred within a context of reductions both in central government revenue and expenditure due to the application of the new financing system for the autonomous communities. Something which makes it difficult to compare the two years.

Analysing the aggregate cash flows of the central government and the autonomous communities, we can see the effect of the measures contained in the government's stability plan. Tax revenue for the first four months of the year was up by 4.3% year-on-year. Particularly of note is the rise in indirect tax, boosted by the 11.9% increase in value added tax (VAT) over the same period. With regard to payments accumulated between January and April 2011, the government's austerity measures led to a reduction in real estate investment and current expenditure on goods and services, with falls of 28.2% and 5.9% respectively. Public employee wages also fell by 4.9% year-on-year, although this decrease was offset by the rise in employee benefits, increasing personnel expenditure by 1.2%.

In spite of the good trend set by the central government deficit, some concern has been noted regarding the accounts of the autonomous communities. The deficit here was 0.46% of the national gross

CENTRAL ADMINISTRATION DEBT ACCELERATES THE GROWTH IN PUBLIC DEBT

Public administration debt by percentage of GDP



SOURCE: Bank of Spain

domestic product (GDP) in the first quarter of 2011. Should this trend continue over the coming quarters, the limit established in the fiscal stability programme of 1.3% of GDP will be slightly exceeded. During the same period, public debt accelerated its rate of growth, reaching 63.6% of GDP, 3.6 percentage points more than at the end of 2010. As can be seen in the graph above, the 2.8 percentage point rise in central government debt is the main reason for this increase.

Given the risk of deflecting fiscal consolidation, the European Commission presented a number of recommendations as part of its review of the 2011-2014 stability programme. One particularly important recommendation is greater control of the public accounts of the autonomous communities, as well as the establishment of a limit to expenditure to improve the sustainability of Spain's debt. In this respect, the Spanish government has undertaken to include, in its Budget Stability Act, a rule that does not allow central government or local administration expenditure to exceed the growth forecast for the economy in the medium term.

Providing this rule is successful, and given the structural reforms carried out over the last few months, the doubts regarding the medium and long-term sustainability of public debt should dissipate.

Autonomous communities post a 0.46% of GDP deficit in the first quarter.

The government will include a limit to expenditure in its Budget Stability Act.

Savings and financing

The stress test results on European banks will be published in July.

A crucial summer for restructuring the banking market

This summer will be key for the configuration of the new structure of the Spanish banking system. Throughout July the results of the new stress tests carried out on European banks will be published. The same month two financial institutions, Bankia and Banca Cívica, are expected to raise capital through initial public offerings. These events will condition the recapitalization of the rest of the institutions, which must achieve the new capital limits set by the Bank of Spain in order to guarantee the sector's solvency. All this will take place within a context once again affected by tensions in the sovereign debt markets and by Spanish private sector deleveraging. Both forces will maintain the downward slide observed in credit over the last few months.

Next 30 September, a little more than a year after the Savings Bank Act was passed, the new panorama for Spain's financial sector will become clear. This has taken longer than in many other countries that injected public resources into bank institutions. In the words of the governor of the Bank of Spain, this slower rate of recapitalization is due to a more extensive and longer lasting transformation that involves the institutions themselves in designing

FINANCING OF NON-FINANCIAL SECTORS (1)

April 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,183,462	–28,561	–0.4	76.4
Non-financial corporations	1,296,497	–17,063	–0.1	45.4
Resident credit institution loans (3)	*878,769*	*–18,699*	*–1.7*	*30.8*
Securities other than shares	*66,734*	*2,183*	*4.5*	*2.3*
External loans	*350,993*	*–546*	*3.1*	*12.3*
Households (4)	886,966	–11,498	–0.7	31.0
Housing loans (3)	*676,811*	*–3,057*	*0.2*	*23.7*
Other (3)	*206,781*	*–8,495*	*–3.9*	*7.2*
External loans	*3,373*	*54*	*6.1*	*0.1*
General government (5)	673,880	35,281	13.7	23.6
TOTAL	**2,857,343**	**6,720**	**3.1**	**100.0**

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

their restructuring. Somewhat beneficial in the medium and long term as it will make the new projects more stable and will involve lower costs for taxpayers. In fact, institutions' preferential shares are expected to generate revenue of more than 750 million euros in the Fund for Orderly Bank Restructuring (FROB) in 2011, compared with 65 million last year.

The restructuring of Spain's banking sector should reduce the current uncertainty among investors. This and the tensions in the sovereign debt markets have pushed up the funding costs of financial institutions in the wholesale markets, so that more institutions are resorting to the European Central Bank (ECB). May's figures confirm this phenomenon, placing it at levels similar to those of January this year. Tougher funding is also expected to have an effect on interest rates for new credit operations. Something already observed in April, with a rise of almost 0.2 percentage points.

Within this context, private sector deleveraging has remained on course. Both non-financial firms and households reduced their financing in April by 28,561 million euros compared with the end of 2010. This fall, which contrasts with the higher debt in the public sector over the same period, is due to a decrease in loans. In fact, credit to resident sectors in April shrank by 0.27% compared with the same month last year. At the same time, doubtful debt rose by 25 basis points to 6.36%, increasing again after the slight drop recorded in March.

The broken down figures on credit point towards this squeeze becoming widespread in the first quarter of the year. Those sectors with the highest doubtful debt ratio were also the ones posting the highest falls in the outstanding credit balance. For example, the construction sector, with a doubtful debt rate of 13.3%, experienced a fall in credit of 13.3% year-on-year. On the other hand, credit to the

Debt market tensions force more institutions to resort to the ECB.

CREDIT TO PRIVATE SECTOR BY PURPOSE

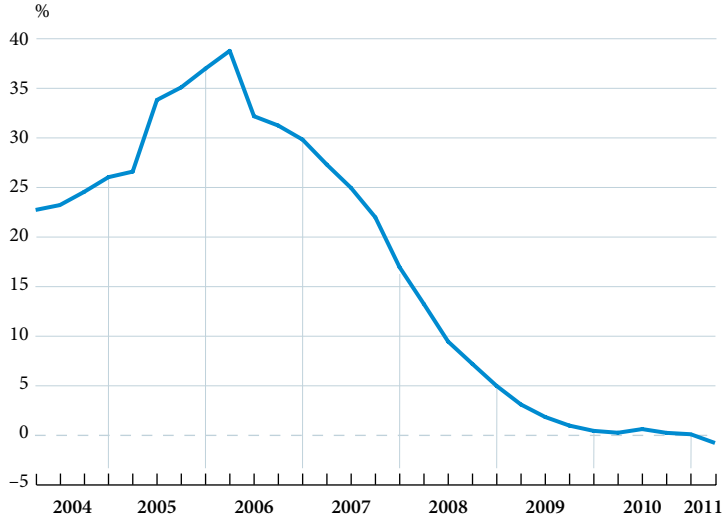
First quarter of 2011

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	22,615	–513	–2.2	–176	–0.8
Industry	145,788	–6,588	–4.3	–3,580	–2.4
Construction	109,669	–4,851	–4.2	–16,795	–13.3
Services	693,469	–1,665	–0.2	6,895	1.0
Total	**971,540**	**–13,617**	**–1.4**	**–13,656**	**–1.4**
Financing to individuals					
Acquisition and renovation of own home	658,133	–4,665	–0.7	2,659	0.4
Acquisition of consumer durables	41,303	–766	–1.8	–6,413	–13.4
Other financing	104,607	–3,309	–3.1	–3,446	–3.2
Total	**804,043**	**–8,739**	**–1.1**	**–7,200**	**–0.9**
Other	**48,688**	**2,674**	**5.8**	**18,040**	**58.9**
TOTAL	**1,824,271**	**–19,682**	**–1.1**	**–2,816**	**–0.2**
Acquisition of housing and real estate activities	***940,764***	***–7,468***	***–0.8***	***–7,913***	***–0.8***

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

HOUSING LOANS FALL FOR THE FIRST TIME

Year-on-year growth rate in credit to acquire housing and credit for developers



SOURCE: Bank of Spain.

Doubtful debt increases and credit falls in April.

services sector, with the lowest doubtful debt rate, posted an increase of 4.7% compared with the first quarter of 2010. Similarly, credit to households fell by 0.9% in the same period. Also similar was credit for consumption, with a higher doubtful debt rate than housing credit, which caused this fall.

As can be seen in the graph above, real estate credit (which includes credit to developers and households to acquire housing) fell for the first time since the start of the recession, down 0.8% year-on-year. This component accounts for more than half the total outstanding balance. This trend is expected to continue throughout the year, encouraged by the gradual fall in credit to developers. To this we should also add the weakness of the mortgage market over the next few months due to demand for housing being brought forward given the end of tax deductions in December 2010.

Growth in credit is expected to be weak over the coming years.

As a consequence, the underlying factors point towards a credit squeeze this year, which might even be greater than the one recorded in 2009, namely 1.8%. Private sector deleveraging is expected to continue over the next few years. This means that, unlike what happened in the last expansionary cycle, Spain's economic recovery will take place within a context of weak credit growth.

Deposit interest rates are set to rise in the short term

Within this context of private sector deleveraging, deposits of households and firms grew by 2.0% in April compared with the same month last year. An analysis of the different bank liabilities shows that this increase was across the board. However, of note is the acceleration in the growth of sight deposits compared with the slowdown in term deposits. This is due to the maturities for term deposits, received one year later.

The tougher conditions for funding in the wholesale markets over the last month are likely to increase the need to attract

customer deposits. This will encourage competition for retail liabilities between institutions (known generally as a deposit war). This stronger competition and the gradual rise in official interest rates will push up the interest rates for new deposit operations. April's figures are in line with this situation and show an increase of four basis points compared with the previous month, standing at levels close to the maximums of 2010.

The coming into force last June of the Decree Law that regulates interest rates for sight deposits and accounts in financial institutions is expected to ease any rise in the rates being offered. This would permit a gradual improvement in bank margins, as the growth in interest rates would be higher than that for deposit rates. Something that already happened during the first four months of the year, with a lower rise in deposit interest rates, namely 64 basis points, than the rise in credit interest rates.

In May, the uncertainty regarding how the Greek crisis will turn out had a negative effect on mutual funds, with net withdrawals totalling 1.5 billion euros. Mutual fund assets therefore suffered a monthly drop of 1.1%, although they are still above the levels for December 2010.

The deposits of households and firms rise by 2.0% year-on-year in April.

The Decree Law governing the interest rates offered by banks will prevent sharp rate rises.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

April 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	263,184	1,418	0.5	10,588	4.2	18.7
Savings deposits	210,774	–513	–0.2	6,904	3.4	15.0
Term deposits	728,488	–15,079	–2.0	22,423	3.2	51.7
Deposits in foreign currency	19,702	320	1.6	–2,273	–10.3	1.4
Total deposits	**1,222,148**	**–13,855**	**–1.1**	**37,641**	**3.2**	**86.8**
Other liabilities (*)	**186,168**	**–16,844**	**–8.3**	**–9,842**	**–5.0**	**13.2**
TOTAL	**1,408,316**	**–30,699**	**–2.1**	**27,799**	**2.0**	**100.0**

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

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As of December 31, 2010

FINANCIAL ACTIVITY	Million euros
Total customer funds	247,897
Receivable from customers	189,546
Profit attributable to Group	1,307

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	28,651
Branches	5,409
Self-service terminals	8,181
Cards (million)	10.3

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2011	Million euros
Social	335
Science and environmental	68
Cultural	64
Educational and research	33
TOTAL BUDGET	**500**

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