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THE SPANISH ECONOMY

Monthly Report

EURO AREA BAIL-OUTS

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						
Gross domestic product									
United States	–3.5	3.0	1.7	2.2	3.3	3.5	3.1	2.2	1.5
Japan	–6.3	4.0	–0.4	5.5	3.3	4.8	2.5	–0.7	–0.9
United Kingdom	–4.9	1.3	1.6	–0.4	1.5	2.5	1.5	1.6	1.4
Euro area	–4.1	1.7	1.7	0.8	2.0	2.0	2.0	2.5	1.7
Germany	*–5.1*	*3.6*	*2.9*	*2.4*	*4.1*	*4.0*	*3.8*	*4.6*	*2.8*
France	*–2.6*	*1.4*	*1.7*	*1.0*	*1.5*	*1.6*	*1.4*	*2.1*	*1.6*
Consumer prices									
United States	–0.3	1.6	3.0	2.4	1.8	1.2	1.2	2.2	3.3
Japan	–1.4	–0.7	0.3	–1.1	–0.9	–0.8	0.1	0.0	0.1
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	2.5	1.1	1.5	1.7	2.0	2.5	2.7
Germany	*0.4*	*1.1*	*2.2*	*0.7*	*1.0*	*1.2*	*1.5*	*2.1*	*2.3*
France	*0.1*	*1.5*	*2.0*	*1.3*	*1.6*	*1.5*	*1.6*	*1.8*	*2.1*
SPANISH ECONOMY			Forecast						
Macroeconomic figures									
Household consumption	–4.3	1.3	0.7	–0.3	2.1	1.5	1.6	0.7	–0.2
Government consumption	3.2	–0.7	–0.3	–1.1	–0.1	–0.7	–0.9	2.6	–1.0
Gross fixed capital formation	–16.0	–7.5	–5.0	–10.5	–6.7	–6.7	–6.1	–6.0	–6.7
Capital goods	*–24.8*	*1.9*	*0.8*	*–4.6*	*8.7*	*2.4*	*1.2*	*0.3*	*–3.7*
Construction	*–11.9*	*–11.1*	*–8.2*	*–11.4*	*–11.3*	*–11.2*	*–10.6*	*–10.4*	*–9.3*
Domestic demand (contribution to GDP growth)	–6.4	–1.2	–0.8	–3.1	–0.3	–0.7	–0.6	–0.4	–1.9
Exports of goods and services	–11.6	10.3	9.7	9.4	11.9	9.4	10.5	12.1	8.4
Imports of goods and services	–17.8	5.5	3.2	2.0	9.6	5.0	5.3	6.3	–1.7
Gross domestic product	**–3.7**	**–0.1**	**0.8**	**–1.4**	**0.0**	**0.2**	**0.6**	**0.9**	**0.7**
Other variables									
Employment	–6.6	–2.3	–0.8	–3.9	–2.4	–1.6	–1.4	–1.4	–1.0
Unemployment (% labour force)	18.0	20.1	20.8	20.0	20.1	19.8	20.3	21.3	20.9
Consumer price index	–0.3	1.8	3.2	1.1	1.6	1.9	2.5	3.5	3.5
Unit labour costs	1.0	–1.5	–1.0	–0.9	–0.9	–1.9	–2.3	–1.5	–1.5
Current account balance (% GDP)	–5.5	–4.5	–4.3	–6.0	–5.1	–3.7	–3.2	–6.4	–2.9
Net lending or net borrowing rest of the world (% GDP)	–5.1	–3.9	–3.7	–5.3	–4.4	–3.1	–2.6	–5.9	–2.4
General government financial balance (% GDP)	–11.1	–9.2	–6.4						
FINANCIAL MARKETS			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	1.3	1.0	1.0	1.0	1.0	1.0	1.3
10-year US bonds	3.2	3.2	2.9	3.7	3.5	2.8	2.8	3.4	3.2
10-year German bonds	3.3	2.8	2.8	3.2	2.8	2.4	2.6	3.2	3.1
Exchange rate									
$/Euro	1.39	1.33	1.41	1.38	1.27	1.29	1.36	1.37	1.44

Contents

Euro area bail-outs

Greece, Ireland and Portugal have received financial support from the rest of the European Union and from the International Monetary Fund, given their impossibility to access private financing under reasonable conditions. In exchange, they have to apply adjustment plans to sort out their public accounts and get back on the path to growth. Should the economic and financial deterioration of these countries be stopped and reversed, the crisis's contagion to other members of the euro area should be contained, thereby preventing it from jeopardizing the euro's survival.

The starting point dates back to autumn 2009, when it was realized that the budget figures provided by Greece's government did not add up. The unsustainable situation of the public accounts was hidden via accounting irregularities. When the truth came out, doubts soared regarding the capacity of the Greek economy to meet its public debt payments. Given the dead-end in which Greece found itself, at the beginning of May 2010 a bail-out was established totalling 110 billion euros. In exchange, Greece undertook to adjust its economy and its public accounts: raising taxes, cutting the wages and numbers of civil servants, reducing pensions and combating tax fraud. Numerous general strikes have accompanied the implementation of these measures.

In spite of the efforts made to put an end to the crisis, the Greek case led to a lack of confidence in financial markets regarding those economies of the euro area in the worst situation. The next victim was Ireland which, in November 2010, had to be bailed out. Unlike the case of Greece, Ireland's problems came from the maladjustment of its real estate sector and its overlarge banking sector. The 85 billion euros of financial aid are aimed fundamentally at recapitalizing, restructuring and reducing the size of its banking sector. In exchange: tax hikes, job cuts in the public sector, cuts in social spending, etc. The next domino to fall was Portugal when, at the beginning of April 2011, it asked for the financial support mechanism to be activated: 78 billion euros. The deterioration of its public accounts, its gradual loss of competitiveness over the last few years and growing external imbalance had turned the Portuguese economy into another propitiatory victim of the financial turbulences.

These plans to sort out and rescue economies have had differing results. In the case of Portugal, it's still too early to say, as the plan wasn't implemented until May 2011. Ireland is doing well, having stabilized its financial system and making progress in the macroeconomic area. Greece is the most problematic case, given that its economy has hardly improved and access to the capital market is still blocked, so that another aid programme has had to be set up, this time totalling 109 billion euros.

Many wonder whether the tough adjustment conditions demanded by these bail-outs are merely deteriorating the economy even further, thereby complicating the adjustment of the public accounts. What is true is that any adjustment must necessarily weigh heavily on the real economy, as members of the euro area lack any monetary or exchange rate instruments. But even with monetary and exchange rate autonomy, under the current conditions real adjustment is inevitable, as illustrated by the British case and even in the United States. A reasonable, realistic, balanced plan of adjustments and reforms that emphasizes the recovery of competitiveness is the best formula to restore investor confidence and repair imbalances that should never have occurred in the first place.

EXECUTIVE SUMMARY

A hot August in the financial markets

The sovereign debt crisis and the cooling down of growth prospects reign supreme in August.

The latest onslaught by Europe's sovereign debt crisis and the cooling down of growth forecasts have reigned supreme in August's economic situation. Given the uncertainty resulting from this scenario, investors have opted to look for safe havens, leading to large losses in the stock markets. These tensions might persist for some time yet but it seems reasonable to expect them to diminish, so that the medium and long-term prospects should see a return to positive expansionary rates and restored investor confidence.

A new bail-out is worked out for Greece in July...

In July, the European Union (EU) decided to sort out a second bail-out programme for the Greek economy, given that the first (activated in May 2010) was not achieving the objectives set. The financing offered to Greece on this occasion totals 109 billion euros, added to the 110 billion of 2010, and the International Monetary Fund is also involved. The conditions of the loans have also been improved, the EU promises to increase investment in Greece from structural funds and the private sector has offered to take part voluntarily in the bail-out. This decision benefitted the risk premia of the peripheral countries, which started to fall.

...but there's no end to the turbulences.

But the truce didn't last long. Uncertainty regarding the effective implementation of these agreements led to the fear of contagion once again taking hold of market sentiment, with all eyes on Italy and Spain. In both cases, the gradual increase in financing costs in international markets pushed risk premia to the highest levels since the euro was created and yields exceeded 6% in the case of ten-year bonds. The need to stop the dangerous trajectory of risk premia for the debt of countries in the euro area led the European Central Bank (ECB) to intervene in the secondary markets, buying up the bonds of Italy and Spain. Such bond purchases had already taken place in the cases of bailed-out countries and is controversial in the ECB, as some dispute the use of such measures. However, there doesn't seem to be any alternative as no other institution can take on this role.

In the political sphere, in mid-August the leaders of the two main economies in the euro area put forward ambitious proposals to increase European economic coordination. Merkel and Sarkozy proposed a budgetary golden rule so that all member countries of the euro area would include a public deficit limit in their constitutions. Moreover, France and Germany undertook to harmonize their corporate tax rates as from 2013. Lastly, the creation of an economic government for the euro area was proposed, made up of government heads and run by a permanent president. These proposals for greater economic coordination in the euro area received a cool response from the markets and reservation from the rest of the countries, reluctant to give up budgetary sovereignty to a possible European economic government.

Growing uncertainty due to the possible contagion of the crisis to other economies

and the difficult implementation of the bail-outs for countries already affected have continued to weaken investor sentiment. Within this context, the financial sector is the most negatively affected, even though the second round of stress tests carried out in the euro area was more satisfactory than the one carried out last year. Aspects such as banking's high exposure to peripheral debt and the news regarding regulatory reforms (which will lead to greater solvency and liquidity requirements) are harming bank share prices. However, those assets traditionally considered to be a «safe haven» in turbulent times have accumulated large gains, such as gold and the Swiss franc. US and German public debt have also benefitted from the demand for safe assets, with their yields falling to almost 2% in the case of ten-year bonds, between three quarters and one percentage point below the level of the beginning of the year.

Bank shares have been hit hard, while investors look for safe havens.

However, trends in financial markets in the last few weeks have been the result not only of the uncertainty regarding peripheral sovereign debt in Europe but also to growing uncertainty regarding the cyclical trends of the leading economies. After a relatively satisfactory first quarter of the year in growth terms, the results of the second have been disappointing and indicators for the third, still few and far between, do not point to any clear improvement.

In August, developments in the world's leading economy were affected by the realization that growth is weaker than initially believed. This has led the Fed, the US central bank, to explicitly announce that it plans to keep interest rates at their current level, practically 0%, until at least mid-2013, without ruling out the possibility of a third round of quantitative easing. This announcement occurred after it was published that growth in the gross domestic product (GDP) for the second quarter was 0.3% quarter-on-quarter, 1.6% year-on-year. This modest rise, together with the drastic downward revision of the growth figures for the first quarter from the previously announced rate of 0.5% to a minimum of 0.1% quarter-on-quarter, has forced us to change our forecast for the whole of 2011, which is now around 1.6%. We should remember that, at the beginning of this year, the consensus for 2011 exceeded 3.0%, giving an idea of the change in macroeconomic scenario taking place over the last few months.

In the euro area, GDP grew by 0.2% quarter-on-quarter in the second quarter, lower than the first quarter's figure of 0.8% and reducing year-on-year growth from 2.5% to 1.7%. The breakdown for growth is still not available but, geographically, stagnation in France and Germany's lower than expected growth (0.1%) have been decisive in this result. To some extent, a slower rate of growth was expected, as the rate recorded in the first quarter was exceptionally high. However, the slowdown has been more intense than we expected and has forced us to revise downwards our growth forecast for the whole of the year by two tenths of a percentage point, to 1.7%. We have also altered our forecasts for the interest rate scenario, anticipating a pause in the reference interest rate hikes by the ECB until mid-2012. In any case, we expect financial tensions to gradually ease as Greece's new aid package is implemented and the European Financial Stability Facility becomes more flexible.

We have revised our growth forecast for the United States downwards...

In the case of Spain, GDP figures for the second quarter have also revealed a certain cooling down of the economy, although this was already expected. In fact, the performance of the foreign sector has been better than we expected, leading us to raise our growth forecast for 2011 as

...as well as for the euro area.

The Spanish economy's growth in the second quarter is weak and concentrated on the foreign sector.

a whole to 0.8%, a forecast close to the one we published at the start of the year.

The quarter-on-quarter advance in GDP in the second quarter was 0.2%, one tenth of a percentage point below the figure for the first quarter, slowing up the year-on-year rate by one tenth of a percentage point to 0.7%. This weakening of activity was to be expected after interpreting the different supply and demand indicators for the second quarter and the worsening of the sovereign debt crisis in the euro area. The slowdown in activity is due to a significant decline in domestic demand, sharper than the one recorded in the previous period and subtracting almost two percentage points from GDP. Within this context, the concentration of expenditure in the second quarter of 2010 due to household purchases being brought forward before the VAT hike in July and the imminent end of direct subsidies for purchasing vehicles explain why the year-on-year rate for private consumption in the second quarter was around –0.2%. On the other hand, net foreign demand increased its positive contribution to quarterly GDP from 1.3 to 2.6 points. Therefore, the foreign sector was once again the driving force behind growth in this second quarter, although it should be noted that both exports and imports of goods and services slowed up, more sharply in the case of the latter.

Job losses continue but inflation is improving.

In the second quarter, employment grew by around 150,000 people, largely due to the seasonal characteristics of the period (start of the tourist season), bringing the year-on-year rate close to –1%. This means that, in the last year, around 170,000 jobs have been lost and only the market services sector is generating net jobs. With regard to the unemployment rate, this stands at 20.9%. It should be noted that long-term unemployment continues to rise, already accounting for 48% of the total unemployed. This figure is quite negative as, all things being equal, this group has a substantially lower possibility of finding employment compared with other unemployed people.

Slight prospects for the second half of the year.

One positive note over the last few months is the moderation in inflation. The year-on-year rate of change in the consumer price index (CPI) fell by one tenth of a percentage point to 3.1% in July, dropping back notably from the 3.8% of April. The absorption of the impact on prices of the VAT hike in July last year and the relative moderation of oil prices in the last few weeks lie behind this development. Core inflation, which excludes unprocessed food and energy, stood at 1.6%.

The information available on the third quarter is very limited but it all points to no improvement occurring in activity's rate of growth over the coming months. The widespread decline of confidence indicators in July, especially industry but also the purchasing managers' index, is significant. The lower growth now forecast for the main advanced economies is jeopardizing the highly favourable contribution made by the foreign sector to GDP growth. In short, economic developments of the last few months are delineating a fragile recovery in the second half of the year. The new economic policy decisions, adopted at the end of August, regarding public finances and the labour market, as well as the proposal to include the principle of budgetary stability in the Constitution, should boost confidence in the economy and help to take on 2012 with a firmer pulse.

26 August 2011

CHRONOLOGY

2010

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**.
July	**21**	The countries of the euro area approve a second **bail-out plan for Greece** totalling 109 billion euros, among other measures to tackle the sovereign debt crisis.
August	**16**	The leaders of Germany and France, Angela Merkel and Nicolas Sarkozy, propose that **the euro area's institutions should be reinforced** by a series of mechanisms to improve coordination of economic policy.
	19	The government approves a package of **economic policy measures**, advancing the payment of corporate tax for large firms, rationalizing pharmaceutical expenditure and a temporary reduction in VAT for new housing.
	30	The Congress agrees to reform the Constitution to introduce the principle of **budgetary stability**.

AGENDA

September

2 Registration with Social Security and registered unemployment (August).
8 Industrial production index (July).
Governing Council European Central Bank.
13 CPI (August).
15 EU HICP (August).
16 Quarterly labour cost survey (second quarter).
20 Fed Open Market Committee.
22 International trade (July).
23 Producer prices (August).
27 Government revenue and expenditure (August).
29 Flash CPI (September).
30 Balance of payments (July).

October

4 Registration with Social Security and registered unemployment (September).
6 Industrial production index (August).
Governing Council European Central Bank.
11 CPI (September).
14 EU HICP (September).
20 International trade (August).
25 Producer prices (September).
Government revenue and expenditure (September).
27 GDP flash estimate of the United States (third quarter).
28 Labour force survey (third quarter).
Flash CPI (October).
31 Balance of payments (August).

INTERNATIONAL REVIEW

The United States: anaemic growth in spite of aid

The United States disappoints and grows a modest 1.5% in the second quarter.

In August, developments in the world's leading economy were affected by the realization that growth is weaker than initially believed and by US public debt being downgraded by the ratings agency S&P. Of the two, the real fundamental problem is weak growth, which has led the Federal Reserve (Fed) to explicitly announce that it will keep interest rates at their current level until at least mid-2013, without ruling out the possibility of a third round of quantitative easing.

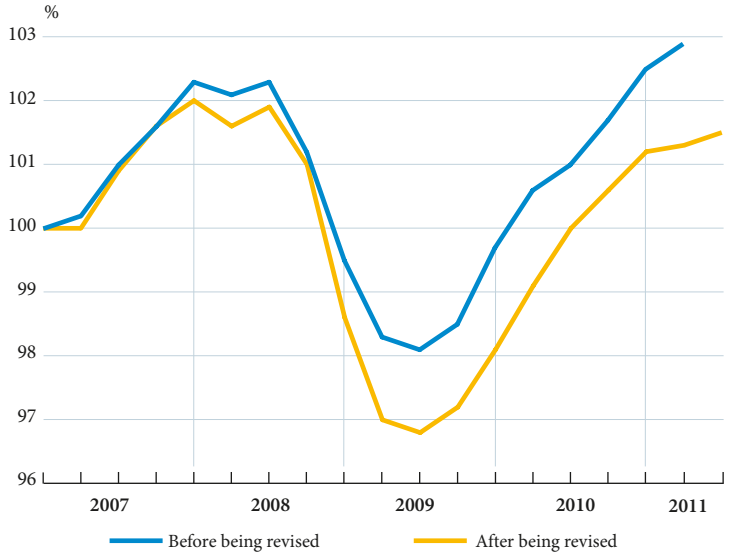
The downward revision of the first quarter reduces the growth forecast for 2011 to clearly below 2%.

After the revisions, since July, of the national accounts by the Bureau of Economic Analysis, growth in gross domestic product (GDP) for the second quarter was 0.2% quarter-on-quarter, 1.5% year-on-year. This modest rise, together with the drastic downward revision of the growth figures for the first quarter from the previously announced rate of 0.5% to a minimum of 0.1% quarter-on-quarter, means that the forecast for the whole of 2011 is around 1.7% in the best of cases. We should remember that, at the beginning of this year, the consensus for 2011 exceeded 3.0%, giving an idea of the change in macroeconomic scenario taking place over the last few months. The new figures also show that the recession was more severe than previously estimated.

The corollary is that private consumption, the main engine of growth in the years prior to the crisis,

THE UNITED STATES: LESS THAN BELIEVED

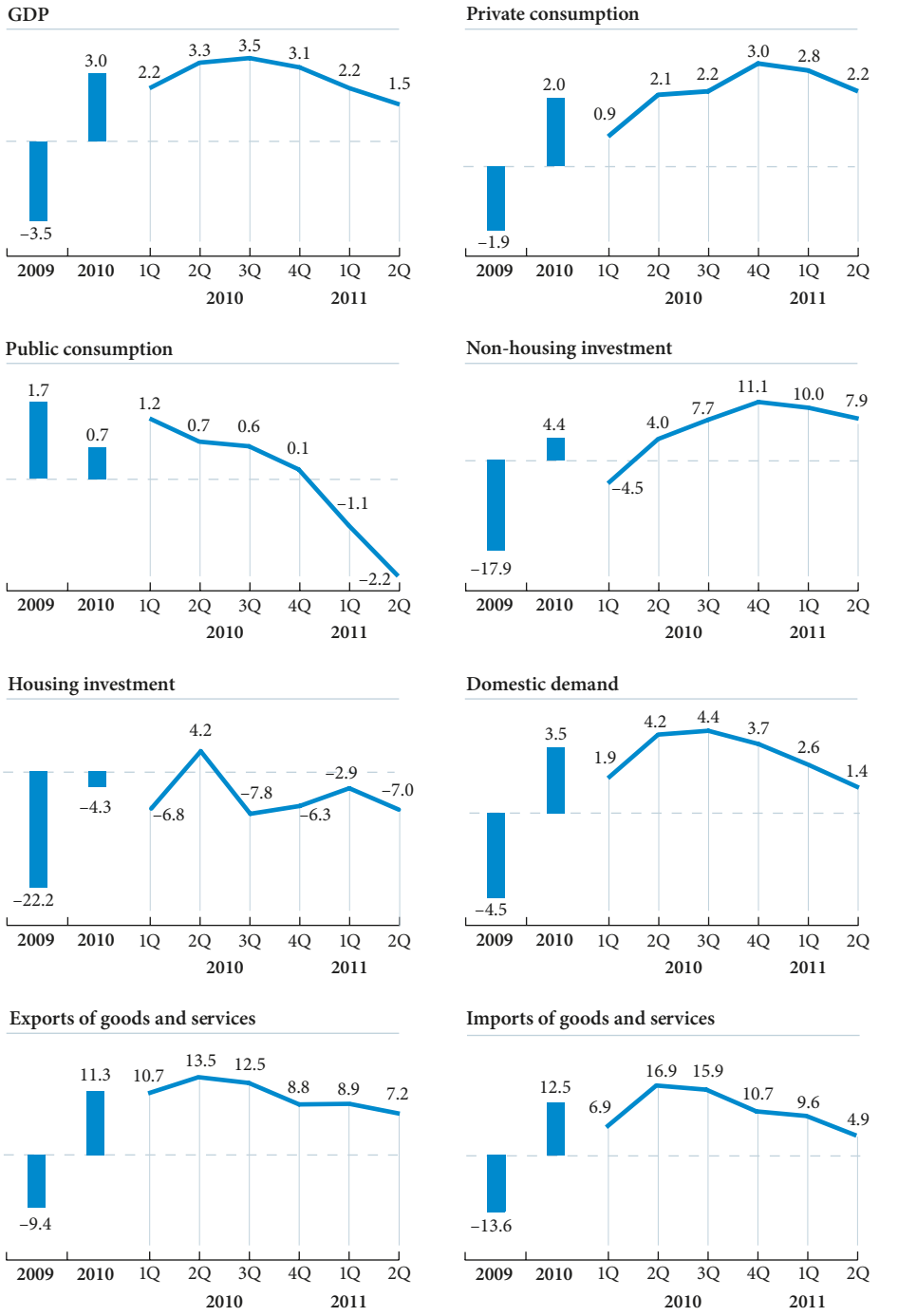
Real GDP of the United States before and after revision. Base 100 = December 2006



SOURCES: Bureau of Economic Analysis and own calculations.

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Bureau of Economic Analysis and own calculations.

Fiscal and monetary stimuli aren't managing to revive consumption.

is practically stagnant, although the United States has been the economy, among all advanced countries, that has enjoyed greater fiscal and monetary stimuli. Given this situation, there is the real likelihood of a double-dip recession. This pessimistic view is supported, firstly, by the persistence of growth rates under 2.0% and a high unemployment rate that historically pushes growth down. Secondly, fiscal policy has gone from stimulating to hindering activity due to the savings imposed by budgetary restrictions in order to tackle the public debt accumulated, which will almost certainly exceed 100% of GDP in 2011. In this respect, the agreement reached between Democrats and Republicans on 2 August to raise the legal debt ceiling and avoid a suspension of payments entails significant cuts in public expenditure in the medium term. As part of this agreement, a bipartisan committee must make proposals for savings within the different budgetary items.

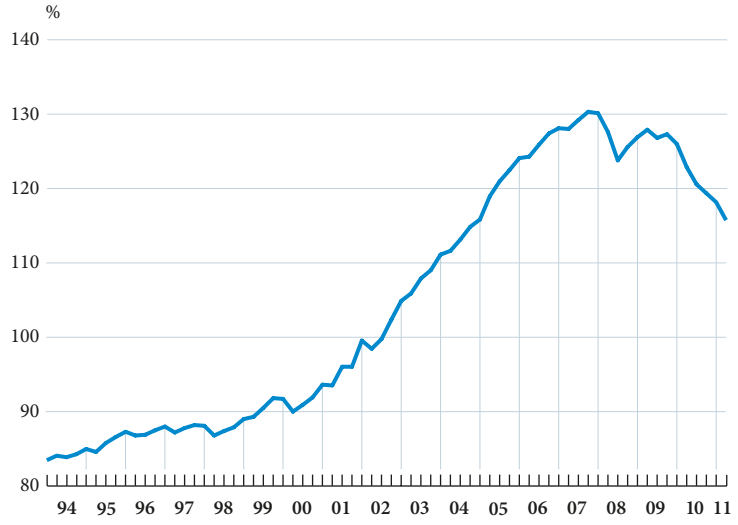
Low growth hinders fiscal consolidation.

However, recession is not our main scenario as, in this second half of the year, private consumption might have two considerable supports. First is the falling price of oil which, although this drop has been less than expected, should end the year below the average figure of 117.15 dollars per barrel for the second quarter. If the price remains within the current range of 105-110 dollars per barrel, this will give a shot in the arm worth approximately 0.4% of GDP, as cheap petrol would release part of household income for other items of expenditure.

The second factor to take into account is the gradual fall in household debt, which has been and continues to be the main burden threatening the recovery in private consumption. The gross debt of households has gone from a peak of 130.2% of their disposable income in September 2007 to 115.7% in the first quarter of 2011. This fall is largely due to inflation, which helps to increase the

THE UNITED STATES: HIGH BUT FALLING INDEBTEDNESS

Gross household debt as percentage of disposable income



SOURCES: BEA, Federal Reserve and own calculations.

nominal value of disposable income and has accounted for almost 40% of the reduction in indebtedness in terms of household disposable income since the end of 2008. This lower debt should provide another boost for consumption. In this respect, retail sales figures for July were somewhat better than expected, with a year-on-year growth of 4.6%, not including automobiles or petrol, and with a revision upwards of the figure for June, indicating that private consumption still has resilient foundations.

But being able to avoid a second recession would not put an end to the country's problems. Indebtedness continuing to approach normal levels and improvements in the labour market will not come about thanks to growth in two quarters but to the average progress made over the next few years which, after the revision, is less than expected. The latest figures show that real GDP in June 2011 was still below its level reached in September 2007. Similarly, the purchasing power of an average household has amassed a decade of stagnation and reversals of the like not seen since before the Second World War.

Continuing with longer lasting ills, the labour market is the key indicator for the fortunes of the middle class. Of the 8.75 million jobs lost between February 2008 and February 2010, only 1.8 million have been recovered. The lower growth expected for 2011 and 2012 means that the unemployment rate is unlikely to fall from July's rate of 9.1% until well into 2013. Similarly, the large number of discouraged workers, or those working part-time involuntarily, will absorb a significant proportion of any jobs that might be created in the next two years.

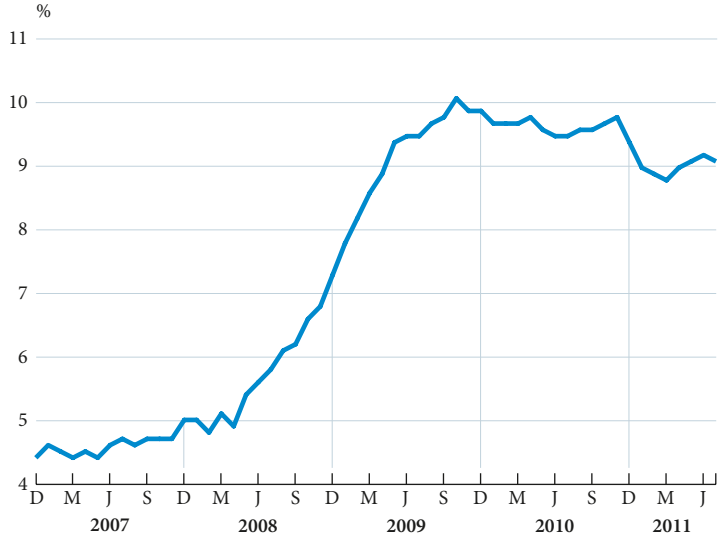
Continuing weakness in the labour market is perpetuating the excess supply of housing. The excessive number of vacant properties might continue for two to five years as high unemployment is slowing up the creation of new homes,

Cheaper oil and less relative debt should boost consumption.

The lower growth forecast for the next few years means unemployment and the surplus of housing for sale will continue.

THE UNITED STATES: PERSISTENT UNEMPLOYMENT

Unemployment rate in terms of the labour force



SOURCES: Department of Labor and own calculations.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
Real GDP	–3.5	3.0	3.5	3.1	2.2	1.5	–
Retail sales	–7.0	6.4	5.6	7.7	8.2	7.8	8.5
Consumer confidence (1)	45.2	54.5	50.9	57.0	66.9	61.8	59.5
Industrial production	–11.2	5.3	6.9	6.2	5.4	3.9	3.7
Manufacturing (ISM) (1)	46.3	57.3	55.2	57.9	61.1	56.4	50.9
Housing construction	–38.4	5.6	–0.7	–5.1	–5.3	–5.0	9.8
Unemployment rate (2)	9.3	9.6	9.6	9.6	8.9	9.1	9.1
Consumer prices	–0.4	1.6	1.2	1.3	2.1	3.4	3.6
Trade balance (3)	–381.3	–500.0	–489.1	–500.0	–521.2	–538.2	...
3-month interbank interest rate (1)	0.7	0.3	0.3	0.3	0.3	0.3	0.3
Nominal effective exchange rate (4)	77.7	75.6	76.1	73.2	72.1	69.8	69.3

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

The CPI rises by 3.6% while core inflation is up 1.6% due to the price of rent.

which are absorbing the excess of vacant properties, as well as leading to more mortgage foreclosures, swelling the excess supply. One positive point, however, is that housing prices seem to have touched bottom. After almost a year of consecutive falls, albeit at a declining rate, the Case-Shiller index of second-hand housing for May maintained the prices for April, which were revised upwards.

Prices continued to surprise by rising somewhat more than expected, with a general consumer price index (CPI) that rose in July to 3.6% year-on-year and an underlying CPI, which excludes energy and food prices, that rose by 1.6%, pushed up by house rents due to the greater demand for family homes, predominantly rented properties, as a result of the crisis. However, the weak economy and lower oil prices should make price rises ease in the second half of the year.

Japan: recovery is closer

The Japanese economy is handling the effects of March's earthquake and tsunami better than expected. Second quarter GDP fell by 0.4% quarter-on-quarter, 0.9% year-on-year, a clear improvement on the 0.9% year-on-year decrease of the first quarter. Although state aid is playing an important role in this recovery, helping private consumption to bottom out, the replacement of stock and the upward trend in exports point to the economy growing in the second half of year, suggesting a decline of 0.4% for the whole of 2011, significantly less than what had been forecast a couple of months ago.

Japan falls by a minimal 0.4% in the second quarter thanks to state aid and the recovery of its industry.

Although second quarter exports fell by 4.9% quarter-on-quarter, hit resoundingly by the effects of the earthquake, the decline was concentrated in the months of April and May, while

in June there was a recovery which suggests that the foreign sector will make a positive contribution to growth in the third quarter. This trend in exports is in line with the improvement in industrial production which, after suffering a record drop of 15.5% in March, has recovered two thirds of what it lost in the second quarter and looks likely to speed up. Private machinery orders, which are a leading indicator of capital goods investment, also performed well.

Although the housing sector is still sluggish, there are also signs of improvement in demand, albeit more moderate, seen in the retail sales for June and automobile sales for July. Similarly, consumer confidence reached 37.1 points in July, up four points on the minimum level in April.

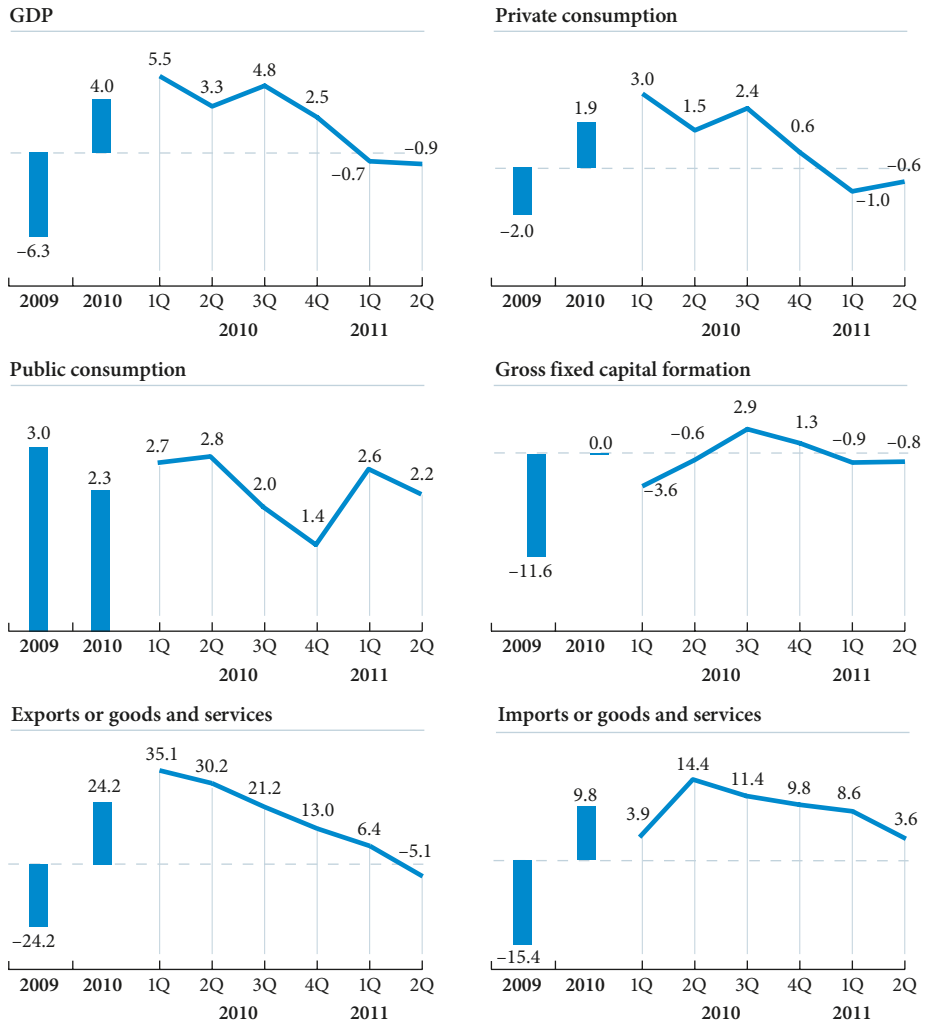
Industry and exports are embarking on the road to recovery and augur a good third quarter.

In the case of prices, the inflationary effects of the earthquake and nuclear crisis continue to ease. The CPI fell by 0.4% year-on-year in June while core

Demand indicators show moderate advances.

TREND IN JAPAN'S GDP BY COMPONENT

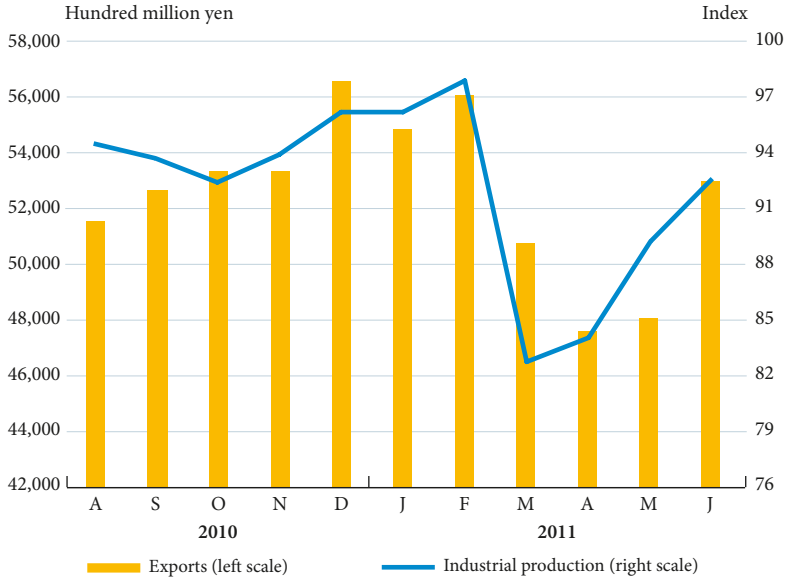
Percentage year-on-year change in real terms



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

JAPAN: LIGHT AT THE END OF THE TUNNEL

Japan's monthly exports and industrial production



SOURCES: Japanese Ministry of Communications and own calculations.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
Real GDP	–6.3	4.0	4.8	2.5	–0.7	–0.9	–
Retail sales	–2.3	2.5	3.2	–0.4	–3.0	–1.7	...
Industrial production	–21.8	16.6	13.3	6.8	–2.5	–7.0	...
Tankan company Index (1)	–40.8	0.0	8.0	5.0	6.0	–9.0	–
Housing construction	–27.7	2.7	13.7	6.8	3.2	4.3	...
Unemployment rate (2)	5.0	5.1	5.0	5.0	4.7	4.6	...
Consumer prices	–1.3	–0.7	–1.0	–0.3	–0.5	–0.4	...
Trade balance (3)	4.0	7.9	8.1	7.9	6.5	3.4	...
3-month interbank interest rate (4)	0.58	0.39	0.37	0.34	0.34	0.34	0.34
Nominal effective exchange rate (5)	98.6	106.0	109.1	111.0	110.6	109.3	112.6

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.

The earthquake's inflationary effects seem to be limited.

inflation, the general index without energy or food, dropped by 0.8% year-on-year, practically maintaining the levels of March. This moderate price rise is a good sign insofar as the overheating due to bottlenecks and interruptions in supply chains resulting from power cuts caused by the

Fukushima nuclear crisis seems to be less serious than previously believed.

China withstands the decline in the West's growth prospects

China advanced by a robust 9.5% year-on-year in the second quarter of the year, slightly below the 9.7% of the previous quarter although still more than consensus forecasts. In spite of this slight moderation, the Chinese economy is withstanding the recent difficulties in the United States and Europe, two of its largest export markets, and we expect it will keep up this considerable momentum in the second half of 2011 and in 2012.

In this situation of slight moderation within overall robustness, inflation picked up again in June and July, to 6.4% and 6.5% year-on-year, respectively, once again boosted by food prices. However, after adjusting for seasonal factors, the monthly growth in the consumer price index shows a clear slowdown in the month of July.

While, at the beginning of July, China's central bank reacted by raising the official interest rate by 25 basis points to 6.56% for the third time in 2011 and the fifth since the hikes started in October 2010, the expectation at the end of August is that the end of monetary tightening is close. At present, the decline in the West's growth prospects is more worrying than the country's ever-present inflationary tensions or possible bubbles in the real estate sector.

In line with this moderation in growth and easing fears of an abrupt landing for the Asian economy, several business indicators are now available for the month of July. Retail sales pushed forward in nominal terms by 17.2%, below the figure posted the previous month. The purchasing managers' index (PMI) fell again to 50.7 points, compared with the more than 53 points it achieved in March. For its part, bank credit grew by 16.6% year-on-year, clearly below the figure of 20% for the end of 2010.

On the other hand, and still far from the expected slowdown, fixed capital investment continued to grow, up to 25.4% year-on-year accumulated from January to July. Similarly, on the external front, the strong growth in exports, up

China advances a robust 9.5% year-on-year in the second quarter and withstands the battering affecting the West.

Possible pause in the inflationary upswing and in restrictive monetary measures.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
Real GDP	9.2	10.3	9.6	9.8	9.7	9.5	–
Industrial production	12.5	14.5	13.5	13.3	14.9	13.9	14.0
Electrical power generation	6.8	14.0	11.8	6.2	12.1	12.0	12.6
Consumer prices	–0.7	3.3	3.5	4.7	5.1	5.7	6.5
Trade balance (*)	196	184	182	184	169	175	178
Reference rate (**)	5.31	5.81	5.31	5.81	6.06	6.31	6.56
Renminbi to dollar	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.

The high indebtedness of local governments is a risk to be considered.

20.4%, was reflected in July's sturdy trade surplus which reached almost 31.5 billion dollars. A huge change if we remember that the Asian giant closed the first quarter of the year with a slight trade deficit. This surplus, together with the persistence of expansionary monetary measures in the United States, add to pressure on the renminbi to appreciate further.

Lastly, we must look at the consequences of the high indebtedness of local governments on the banking sector. Official sources have estimated that local administration debt totals between 10.7 and 14.2 trillion renminbi (between 27% and 36% of GDP, respectively), which would be in addition to the public debt recognized to date, equivalent to 18% of GDP. Uncertainty regarding the exact level is due largely to this indebtedness being channelled through bank loans granted to special investment vehicles sponsored by local governments although, in some cases, without their explicit guarantee.

Brazil's economy might be slowing up more than expected.

Doubts regarding the profitability of investment projects in infrastructures developed by these special vehicles have revived warnings related to the likelihood of some of these loans being repaid, which would put the banks under pressure. However, the productivity of past investments, together with the good prospects for growth in the country, confirm the more positive view of a modest risk for the financial sector, in spite of medium-term pressures that will surely affect the ability of some of these vehicles to pay back their loans.

The Brazilian government extends regulations in derivative markets in an attempt to slow up the real's appreciation and boost manufacturing exports.

Brazil: «greater Brazil», less growth

In the last few months, more than one analyst (including ourselves) has revised downwards their economic forecast for Brazil in 2011 and 2012. However, these revisions might fall short if the scenario of slowdown is confirmed, more severe than expected, which seems to be suggested by the latest macroeconomic indicators.

In June, the activity index published every month by Brazil's central bank fell in month-on-month terms for the first time since December 2008. That same month, industrial production also provided an unpleasant surprise by falling month-on-month and moderating its year-on-year growth to 0.7%. For their part, retail sales and particularly durables continue to show signs of coming to a halt, in line with consumer confidence that is much lower than a year ago and at a level not seen since the end of 2009.

The moderation in Brazil's growth is not only due to the somewhat more sombre perspective closing in on the world economy; the restrictive tone of domestic economic policies is also having an effect, although not necessarily the desired one. Growth has moderated in the last few months but the main aims of these policies, namely to put a brake on rising inflation and the real's appreciation, are far from being achieved. In the area of prices, inflation has not halted, reaching 6.9% in July. Given this situation, the central bank once again raised the reference rate by an additional 25 basis points the same month, leaving the SELIC rate at a high 12.5%. The real doesn't seem to have come to the end of its appreciation either and has been approaching 1.5 reais/dollar, even when the Brazilian economic authorities, in their desire to slow up the currency's appreciation and boost exports' competitiveness, introduced a new package of measures at the end of July to put off speculation, including: a

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
Real GDP	–0.7	7.5	6.8	5.0	4.2	...	–
Industrial production	–7.3	10.5	8.1	3.6	2.5	0.7	...
Consumer confidence (*)	138.3	159.7	161.4	159.9	161.8	155.4	...
Unemployment rate (**)	8.1	6.7	6.6	5.7	6.3	6.3	...
Consumer prices	4.9	5.0	4.6	5.6	6.1	6.6	6.9
Trade balance (***)	25.3	20.2	16.8	20.2	22.5	25.3	27.1
Interest rate SELIC (%)	9.92	10.00	10.75	10.75	11.75	12.25	12.50
Reales to dollar (*)	2.32	1.78	1.69	1.66	1.63	1.56	1.55

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.

transaction tax of 1% on new currency derivative operations with a notional value higher than 10 million dollars; legislative changes that would allow this rate to be raised up to 25% if necessary; and the requirement to register OTC currency transactions.

Certainly, although the external appetite for Brazilian commodities has helped to swell the trade surplus for the year, the strength of the real has not only harmed the competitiveness of manufactured exports but has also allowed more competitive imports to penetrate the country, especially from Asia. This has led to a growing concern among industries to which the government responded in August with a new economic plan: «greater Brazil». Its aim is, precisely, to strengthen industry and its export potential, and the plan includes: tax advantages, stricter supervision of imports (including anti-dumping measures), incentives for innovation and credit facilities for investment. Although we will have to wait and see the results of this plan in the medium term, initially it implies a certain protectionism and has raised doubts among some sectors regarding its effectiveness.

Given the symptoms of slowdown in the economy and anticipating that base effects should help to moderate the price rises as from the autumn, the central bank has hinted that it might give up on interest rate hikes for the remainder of the year. Nonetheless, at the beginning of 2012 the readjustment of the minimum wage, corrected by cumulative inflation in 2011, will result in a new inflationary hotspot, so that such this monetary pause would more than likely end in the near future, if it actually comes about.

A new economic plan, the «greater Brazil plan», also aims to increase efforts to boost foreign sales.

Mexico: on the alert

The Mexican economy grew by 3.3% year-on-year in the second quarter of 2011, 1.1% compared with the previous quarter, benefitting from the progress made by industry and services.

Latin America's second economic power continues to show signs of strength and the bulk of the evidence suggests that the

Mexico seems to remain apart from the slowdown in the world economy.

robust growth started by the Mexican economy in 2010 will continue to make progress in what remains of the year and also in 2012. Not only is the country still avoiding excessive price pressures, the peso is also remaining stable (in spite of the depreciation following the rating downgrade of the United States and the upswing in global risk aversion), credit is rising and the confidence of Mexican consumers in their economy is at levels not seen since before the crisis started.

Nonetheless, the risks resulting from the world's economic decline have become stronger after the confirmation of a slower recovery in the large advanced economies and especially, and particularly relevant for Mexico, in the United States. Close to 80% of Mexico's exports, especially manufactured goods, go to its neighbour to the north, so that Mexican industrial production provides a very close reflection of the trends in this output on the other side of the Río Grande. Consequently, although the good performance of domestic expenditure has alleviated the impact of the US economic slowdown for the moment, should this last a long time or get worse, it will end up restricting the recovery in Mexican growth.

With inflation once again surprising by falling and the Fed's change in position, Banxico will probably prolong its monetary pause until well into 2012.

Given the lower external dynamism, Mexican authorities will have to keep on maximum alert and cautiously measure out adjustments by domestic economic policies. Fiscal consolidation is already underway but monetary policy has a wide margin to administrate changes in the interest rate, according to requirements: inflation is still very restrained, without demand pressures, and the reference interest rate has remained the same since July 2009. We therefore predict that this monetary pause will continue even longer than expected (we do not expect Banxico to make a move until at least the second half of 2012), in line with the recent change in position of the Federal Reserve and with the change in expectations regarding the trend in global recovery.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
Real GDP	–6.2	5.4	5.1	4.4	4.6	3.3	–
Industrial production	–7.3	6.0	6.5	4.7	4.8	3.8	...
Consumer confidence (*)	80.5	86.3	89.2	89.6	92.1	90.7	95.5
Leading business index (*)	110.5	116.6	117.2	118.1	119.9	118.8	...
Unemployment rate (**)	5.5	5.4	5.6	5.3	5.1	5.2	...
Consumer prices	5.0	3.9	3.7	4.2	3.5	3.3	3.5
Trade balance (***)	–4.7	–3.0	–2.0	–3.0	–1.5	0.0	...
Official Banxico rate (%)	6.75	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	14.18	12.33	12.60	12.35	11.90	11.72	11.73

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

Drops in oil prices are limited

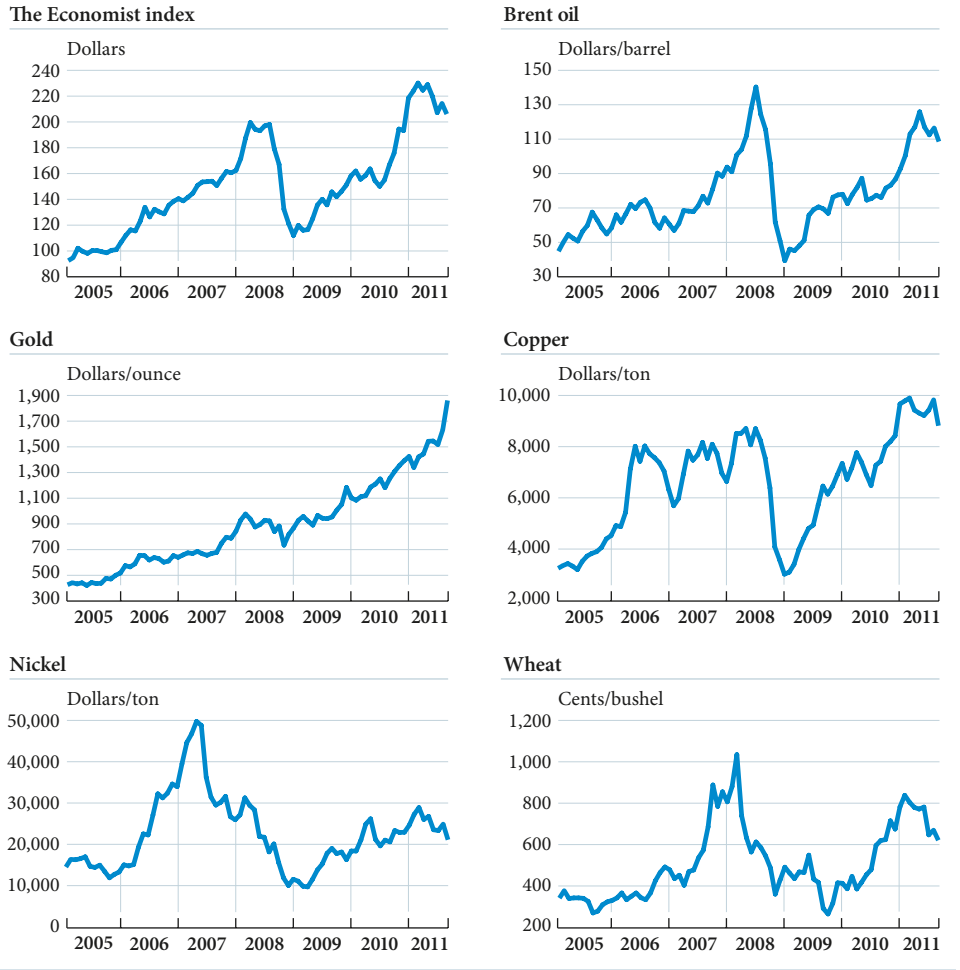
Between 20 July and 19 August, the price of crude fell by 8.3%, reaching 108.48 dollars per barrel (Brent quality, for one-month deliveries), 17.1% above its level at the start of the year and 43.9% higher than its level a year ago.

This drop in oil prices is due to expectations of lower world growth. However, the solidity of the growth of emerging economies, which use oil more intensively, and the persistence of idiosyncratic factors such as political unrest in North Africa and the Middle East, mean that the price of crude is unlikely to fall below 100 dollars per barrel over the coming months. The end of armed conflict in Libya, however, would help to stabilize oil prices close to this level.

The rest of commodities were also affected by lower growth prospects and saw moderate falls, apart from gold. The Economist index fell to 3.1% between 20 July and 19 August.

Oil drops to 108 dollars due to doubts regarding world growth.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date August 19).
SOURCES: The Economist, Thomson Reuters Datastream and own calculations.

Commodities tend to fall but gold reaches new highs.

Base metals saw widespread drops, of note being the continued fall of nickel and aluminium, which are more affected by trends in oil prices due to the intensive use of energy in their production. Basic foods also fell, led by wheat, although sugar and coffee saw a rise. The exception was once again provided by precious metals. Gold continued to capitalize on the uncertainty of the global economy, exceeding its reference rate of 1,800 dollars per ounce and setting a new record high and equalling the price of platinum, something that had only previously happened in 1991 and in the inflationary period of the 1970s and early 1980s.

Latin American lessons for a European crisis

The intensity of the euro area's sovereign debt crisis has led to a logical examination of preceding episodes that might throw some light on a way out of the complicated situation being faced today. Frequently mentioned among those experiences from which we might learn the most is the Latin American debt crisis of the 1980s. A good choice as its similarities with the European crisis, and particularly that of Greece, are renowned.

Let's briefly review the origins of the Latin American crisis. The strong accumulation of debt in Latin America was due to the convergence of three factors: the abundance of capital resulting from the revenue generated in oil exporting countries by rising oil prices in the 1970s, the fall in the real interest rate and a change in expectations regarding Latin America's growth prospects as it was modernizing faster than had been expected.

As a result, during the 1970s total debt (public and private) grew by more than 20% year-on-year, cumulative. Half this debt was concentrated in Brazil and Mexico and 80% of it was sovereign, typically financed via US bank loans made out in dollars and whose interest rate reviewed every six months. The region was hugely exposed to US large banking, with its top 8 banks providing approximately 23% of the region's credit.

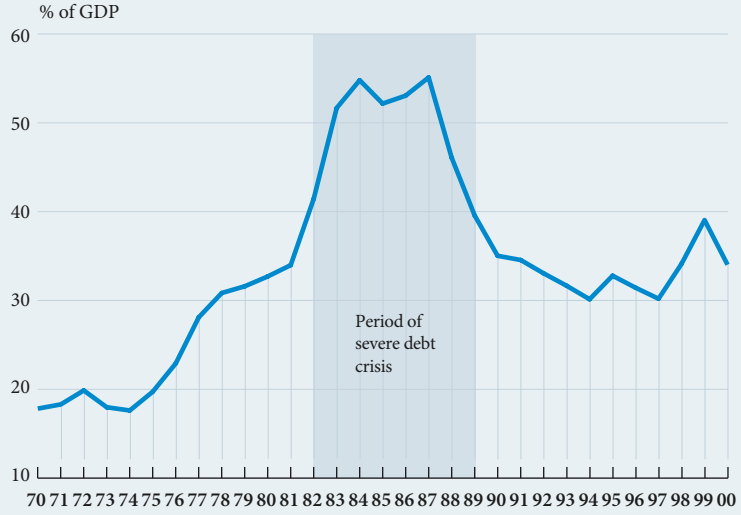
This period of intense growth in debt came to an abrupt halt, the main cause being external to the region and macroeconomic in nature: the beginning of a policy of high interest rates by the Federal Reserve led to strong appreciation in the dollar and a notable increase in the interest rate that had to be paid by the countries in debt. In 1982, Mexico declared that it was unable to meet the interest payments for its external debt, starting a cascade of similar decisions that would end up dragging along 27 industrializing countries, mostly in Latin America.

Up to this point, the similarities between the background to the European debt crisis (and more strictly the Greek debt crisis) and the Latin American crisis are appreciable, as both involve cheap, abundant financing (with the petro-dollars of the 1970s being replaced by euros from Germany and other countries with excessive savings in Europe) as well as strong, sustained future growth prospects, notable bank exposure of the countries in debt, a debt in a currency that cannot be controlled (the euro in Greece, the dollar in Latin America) and a macroeconomic trigger to the crisis. Now let us see whether any parallels can be deduced from the solutions tried in the 1980s.

The crisis was handled in three clearly differentiated stages. The first, between 1982 and 1985, focused on providing extraordinary but short-term financing measures (with public and private participation), restructuring part of the

LATIN AMERICA WAS ABLE TO NOTABLY IMPROVE THE SUSTAINABILITY OF ITS EXTERNAL DEBT IN THE 1980s CRISIS

External debt, sum of Argentina, Brazil, Mexico, Peru and Venezuela



SOURCES: World Bank, Economist Intelligence Unit and own calculations.

debt (i.e. modifying the maturity profile for the principal and the interest repayment schedule) and requiring extensive macroeconomic adjustment in those countries in debt. This is a logical response to a situation seen as a problem of liquidity. Legislative measures were also adopted in the United States so that banks would not have to fully recognize expected losses due to default.

At the end of 1985, it was clear that the short-term timescale of this strategy to resolve the crisis was not appropriate and that the recessive consequences of the adjustment also needed to be included. A second stage began (1986-1988) in which the proposals made by James Baker in September 1985 were applied. Under the motto of «structural adjustment with growth», the aforementioned aspects were reinforced (further restructuring of the debt and more public and private credit) but these actions now focused on more structural goals, also requiring economic reforms.

Lastly, in 1989, the new Treasury Secretary, Nicholas Brady, proposed notable changes to the «Baker Plan». The «Brady Plan» recognized that the crisis had originated in a lack of solvency and not in mere problems of liquidity. This entailed the need to reduce debt (and not only to change the maturity profile), so this was the focus of the Brady Plan's different instruments. Firstly, financing of multilateral international bodies was extended but, unlike in the previous stages, this was fundamentally aimed at allowing creditor governments to buy back debt and other financial activities aimed at reducing this debt.

The second broad feature of the plan was the so-called Brady Bond. This operation aimed to reduce debt but with the creditor being certain that the remaining amount would remain under guarantee. This worked typically as follows. As a result of negotiations between creditor banks and debtor governments, a certain remission was decided on the debt. The rest of the debt was recognized by the debtor government issuing a bond whose main characteristic was that the bond holder was guaranteed payment of the principal sum (and sometimes the

interest). This guarantee was applied by the debtor government acquiring a US Treasury bond with the same maturity, financed with the multilateral loan. This collateral was deposited with the Federal Reserve. Consequently, the bank guaranteed that its creditor would be paid and could obtain liquidity by selling the bond on the secondary market. Between 1989 and 1997, 17 countries took out Brady agreements, 10 of them in Latin America and the Caribbean. In these economies, the average remission was around 30%, 12% in the case of Mexico and 14% for Brazil.

What were the results of this strategy to resolve the Latin American crisis? We could say that any solution to an external debt crisis should ideally achieve three goals: a) avoid an international banking crisis; b) help countries in debt to return to international capital markets; and c) help countries in debt to get back to economic growth. Right from the start, the strategy proved to be useful in avoiding a widespread banking crisis, a hugely important achievement in its own right, as we are reminded by the tragic lessons from the Great Depression. However, only the Brady solution helped to lay the foundations for Latin America to access international financing again and get back to economic growth.

Now let us return to the lessons that might be learned from this solution for the European crisis. Without forcing any comparison, it seems clear that there are two applicable conclusions. The first is that the period of time required to resolve the debt crisis is likely to be very long. This obvious point results not only from the nature of the problem (deleveraging develops slowly) but also from difficulties in handling the crisis per se. Finding a solution requires time as the diagnosis may have to be adjusted and agreed (in the American case, it took six years to realize that the problem was actually one of solvency and not liquidity). Also requiring time are the negotiations between the affected parties, both public and private, national and foreign. Lastly, the solution might also entail lengthy implementation periods. For example, in the case of Latin America, debt relief was not possible until the international banking system was strong enough to handle it.

In addition to time, another lesson to be learned is the ideal way to get rid of a debt crisis. Once it had been determined that the problem was one of solvency, as also seems to be the case with Greece, the solution to the Latin American crisis went through a combination of debt reduction and strong recovery of growth. We should also remember that the public authorities played a vital role in the solution as guarantors of private sector risk. In short, and by way of conclusion, if we are to learn anything from the hardship suffered by Latin America three decades ago, it's that the solution must be through adjustment that does not strangle growth, as well as requiring a lot of patience.

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EUROPEAN UNION

The Euro area: the slowdown is confirmed

The school year normally begins in September. Most students will have new teachers or will even start new subjects. However, those repeating the year will be able to use the same text books and will probably have the same teachers as last year. The same thing is happening with the European Union (EU) as, although it's done its homework, its marks weren't good enough to pass its September retake and it will face the same problem of handling sovereign debt as some EU Member states.

In fact, far-reaching decisions were taken at the summit of the heads of state or government of the euro area held in July. Firstly, the second bailout plan for Greece was agreed, totalling 109 billion euros. This plan will be implemented through the European Financial Stability Facility (EFSF) as the financial vehicle for the next payout. In the same summit statement, it's calculated that, in the case of Greece's bailout, the net total contribution from the private sector will be around 50 billion euros for the period 2011-2014. Part of this aid is due to the financial sector which, voluntarily, might support Greece in order to reinforce the overall sustainability of the new plan.

Secondly, it was decided to extend the maturity schedule for future EFSF loans to Greece from the current period of 7.5 years to a minimum of 15 years and up to 30 years, with a 10-year grace period. On the other hand, the interest rate was lowered that is required by loans close to the EFSF funding cost, without going below it.

Lastly, authorization was given for the EFSF and the European Stability Mechanism to intervene in buying up sovereign debt in secondary markets. The only requirement is a preliminary analysis by the European Central Bank acknowledging the existence of exceptional circumstances in the financial markets that warrant such intervention, although this last measure won't come into force until the 27 EU Member states approve it in their respective parliaments.

Important decisions taken at the summit of European Union heads of state.

Since the start of this crisis, two lines of action can be observed on the part of those managing European economic policy. On the one hand, the urgent solutions that must be presented given the problems diagnosed, for example a financial bailout plan or regulations in financial markets to prevent short selling, etc. On the other hand, more extensive structural reforms of the architecture and governance of European institutions have also been considered and positions taken. Of note for this last context is the Franco-German summit of 16 August in terms of pushing the European project forward.

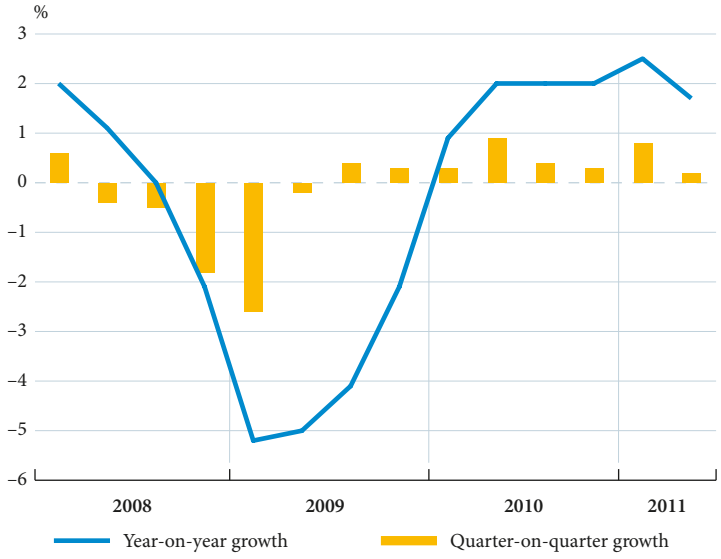
Greece's second bailout plan is approved.

In fact, at the summit held between Sarkozy and Merkel, ambitious proposals were noted to increase European economic coordination. Firstly, a budgetary golden rule so that all

Proposals continue regarding reforms of the institutional architecture.

THE SECOND QUARTER CONFIRMS THE SLOWDOWN IN THE ECONOMY

Change in GDP



SOURCE: Eurostat.

The second quarter's GDP figures confirm the slowdown in the economy.

countries in the euro area include a public deficit limit in their constitutions. Moreover, France and Germany undertook to apply a common corporate tax to their companies as from 2013. Lastly, the creation of an economic government for the euro area was proposed, made up of government heads and run for two and a half years by a permanent president.

These new proposals have arisen within a context of economic slowdown, confirmed by the figures for the euro area's gross domestic product (GDP) from the second quarter. GDP grew by 0.2% quarter-on-quarter, lower than the previous figure of 0.8% and reducing year-on-year growth from 2.5% to 1.7%. The breakdown for growth is still not available but, geographically, the flat growth of France (0.0%) and the lower than expected growth of Germany (0.1%) have negatively affected data on economic activity in the second quarter. We should remember that, together, Germany and France's GDP accounts for 48% of the euro area as a whole.

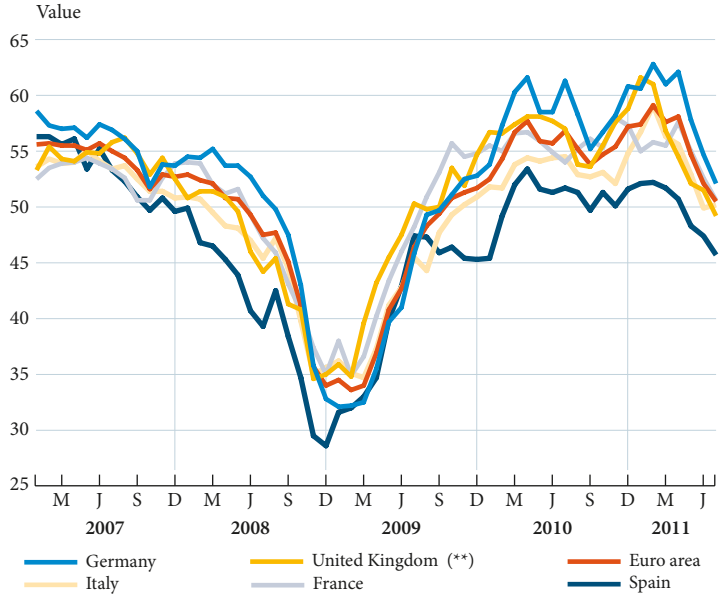
To some extent, a slower rate of growth was expected, as the rate recorded in the first quarter was exceptionally high. However, the slowdown has been more intense than predicted by the consensus of economists' forecasts. These figures are cause for concern as growth is the best antidote for those countries with problems of fiscal consolidation. And leading economic indicators point to very modest growth for the third quarter.

Leading indicators suggest modest growth in the third quarter.

For example, the Purchasing Managers' Index continues its downward slide started in February this year. The index is similar to a business confidence indicator. Values over 50 imply expanding economic activity whereas values under 50 suggest shrinkage. This index suggests that business confidence is still in decline and the implications for job creation are not positive.

BUSINESS CONFIDENCE INDICES ADJUST

PMI index (*)



NOTES: (*) Purchasing Managers' Index: opinion of purchasing managers.
(**) June 2011.
SOURCE: Bloomberg.

The main macroeconomic data, such as consumer confidence, point in the same direction. The figure for July fell slightly to –11.2, a level at which consumer confidence has remained stuck since August 2010. Economic sentiment surveys also continued to fall from the peak reached in February this year. Growth in the euro area's industrial production also continues to decrease.

Business and consumer confidence indices continue to decline.

On the other hand, this European economic situation is occurring within a context of lower world growth, both in emerging countries and also in the rest of the EU's main trading partners.

This situation is important because a large part of the dynamism in Europe's current economic cycle comes from exports, whose growth levels are likely to fall over the coming months.

Given the consolidated growth data for the first half of this year, together with economic indicators that point to modest GDP growth in the third quarter, our 1.9% growth estimate for the whole of 2011 in the euro area has been revised downwards by two tenths of a percentage point to 1.7%. Although the slowdown during the central part of this year is temporary, tensions in the financial markets, with the rise in risk premia for sovereign debt and the acceleration of fiscal adjustment plans, for example in Italy and France, could keep growth at a very gentle pace over the coming quarters.

The context of global economic slowdown damages European exports.

In summary, the slowdown in the euro area's economy has been confirmed

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
GDP	–4.1	1.7	2.0	2.0	2.5	1.7	–
Retail sales	–2.5	0.8	1.5	0.6	0.0	–0.6	…
Consumer confidence (1)	–24.8	–14.0	–12.1	–10.4	–10.6	–10.4	–11.2
Industrial production	–14.7	7.5	7.1	8.1	6.5	4.1	…
Economic sentiment indicator (1)	80.7	100.9	102.3	105.7	107.4	105.7	103.2
Unemployment rate (2)	9.6	10.1	10.1	10.1	10.0	9.9	…
Consumer prices	0.3	1.6	1.7	2.0	2.5	2.8	2.5
Trade balance (3)	10.7	4.6	8.2	4.6	–9.9	–15.6	…
3-month Euribor interest rate	1.2	0.8	0.9	1.0	1.1	1.4	1.6
Nominal effective euro exchange rate (4)	111.7	104.7	102.3	104.4	103.7	106.4	105.2

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.

Our growth forecast for the euro area is revised downwards from 1.9% to 1.7%.

and moderate growth is expected for the third quarter of this year. And all this within a context of world economic slowdown that is damaging European exports, while the sovereign debt crisis is a subject that still has to be passed at the start of this school year in September.

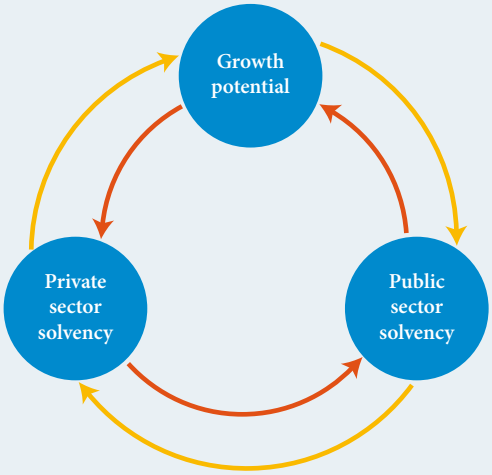
The bail-out plans for Greece, Portugal and Ireland

Pharmacology is the study of the effects of drugs on people and its clinical application is used to diagnose and relieve the symptoms of an illness. Sometimes to start a fast treatment. Other times, when the origin of the pathology is unknown, broad-spectrum drugs are used to eliminate a wide range of factors that might be causing the illness. This is the case, for example, of antibiotics, although sometimes these treatments are harsh and cause unwanted side effects.

An analogy can be drawn between pharmacology and the financial bail-out plans for Greece, Portugal and Ireland, as these have been tailor-made to apply their beneficial effects and thereby get the countries back on the track of sustainable growth as soon as possible. As sometimes happens in pharmacology, the remedy used has had to be quite general because, when intervention occurred, the crisis had already spread to the economy as a whole.

In Greece, for example, the trigger to the crisis was the sharp deterioration in public accounts. After significantly revising the level of public debt in January last year, at the end of 2010 this stood at 143% of GDP. As a reference we

THE VICIOUS CIRCLE OF THE SOVEREIGN DEBT CRISIS



SOURCES: Own calculations.

can use the limit established by the Maastricht Treaty, namely that public debt should not exceed 60% of GDP. The austerity measures required by this situation and the increased uncertainty it generated affected private sector solvency and the economy's growth capacity as a whole, which was already quite weak. This, in turn, made fiscal adjustment even more difficult, forcing Greece into a vicious spiral from which it was practically impossible to escape without external financial aid.

In Ireland, the origin of the crisis was the bursting of a real estate bubble combined with an overbloated financial system. For example, in 2009 credit represented 270% of GDP in Ireland while in Greece and Portugal this figure was 90% and 174%, respectively. The Irish financial system had to take on huge losses from its mortgage loans. These losses had to be nationalized, changing banking risk into sovereign risk. This year public debt, which in 2007 accounted for 25% of GDP, is expected to reach 111% according to the International Monetary Fund. In this case, economic decline in the private and public sector also ended up affecting the economy's capacity to recover as a whole, aggravating the situation for the real estate and financial sectors. Ireland therefore also ended up in a vicious circle and was forced for ask for financial aid.

Lastly, in the case of Portugal, the low productivity of its economy and the sharp increase in wages over the last fifteen years harmed the country's competitiveness, which led to a loss of export market share and a growing current account deficit. Between 2002 and 2007, Portugal's average rate of growth in GDP was 1.0% and in 2010 the current account deficit reached 10.3%. Although public debt was at relatively lower levels than those in Greece, in 2008 this represented 71.6% of GDP, with the recession also pushing this up. The IMF expects this figure to be 111% of GDP in 2011. Given the lack of growth capacity shown over the last decade, the economy looked unlikely to recover without far-reaching reforms and doubts regarding the sustainability of public debt increased accordingly. As in the previous two cases, this also forced Portugal into a vicious circle from which the only means of escape was external financial aid.

Each aid programme has therefore had to stress different aspects because each country has different weaknesses. At the same time, however, many of the measures recommended are the same since, ultimately, the overall economy of each country was affected. Fiscal consolidation is one objective for all of them and, therefore, all are taking measures to achieve this, although it's a particularly important challenge for Greece, as it has to reduce its fiscal deficit from 15.5% of GDP in 2009 to 2.6% in 2014. To this end, numerous painful measures are being taken to reduce public spending, such as drastically cutting the number of civil servants and their wages, cutting social expenditure and increasing revenue, eliminating several tax deductions and raising VAT. The package also includes an important company privatization plan which the government hopes will help to considerably reduce its financing needs.

The main goals of Ireland's package are to restructure the financial system, reduce its size, recapitalize it and improve banking regulation. All these initiatives are already underway and, for the moment, are progressing satisfactorily. The central bank of Ireland is working hard to create two large banks, one based on the Bank of Ireland and the other focused on Allied Irish Banks. The recapitalization carried out has managed to give the sector a good level of solvency, as shown by the results of the stress tests published in July, as the Irish banks passed these with ease. Moreover, an aggressive divestment plan has been established to get the sector back to a sustainable size.

Lastly, the measures agreed in the Portuguese bail-out plan particularly aim to improve the country's competitiveness, as well as strengthen its financial system and balance public accounts in the short-term. Given the impossibility of improving the country's export capacity by devaluing its currency, Portugal will carry out an internal devaluation. To this end it will lower company social security payments to reduce the cost of labour and consequently make the price of Portuguese products more competitive. At the same time indirect taxes will be increased, such as VAT, to ensure the public coffers don't lose any revenue. The Portuguese government has also proposed an ambitious liberalization and privatization plan for industrial sectors, key to improving their efficiency. Lastly, also of note are the far-reaching labour market reforms to be carried out by the country.

In short, these bespoke economic bail-out plans are beneficial for the countries implementing them, just as some medicines are more suitable than others, depending on the patient and the illness in question. Obviously, as in medical science, a bad diagnosis will mean that the recommended drugs will not help the patient to recover. In other words, the economic policy measures proposed in the financial bail-out plans may be well designed but if the initial hypotheses are incorrect or too optimistic, these measures will be of doubtful efficacy.

This box was prepared by the European Unit,
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Abrupt halt to the German locomotive

A slowdown was predicted in the German economy after an extraordinarily good first quarter. However, the initial estimate of second quarter GDP was worse than expected, providing a quarterly increase of just 0.1%. Similarly, the quarter-on-quarter rate for the first quarter of 2011 was revised slightly downwards to 1.3%.

The second quarter's meagre growth was affected by a certain slowdown in the global economy over the last period and the foreign sector, which had made a notable contribution in the last quarter, contributed negatively as imports rose more than exports. However, part of the rise in imports was due to an increase in stocks. On the other hand, the slowdown in the second quarter can be explained by the effect of construction being brought forward to the first quarter due to an abnormally mild winter. Consumption stalled noticeably, however, partly due to higher inflation.

In spite of the brakes being put on in the second quarter, the likelihood of the economy derailing is small, as although most of the trend indicators have weakened, the German economy shows a solid foundation that suggests this is more of a dip than actual stagnation. In fact, in year-on-year terms, which approximate the trend, the expansion in German GDP stood at 2.8%. Moreover, its level was equal to the historical peak of the first quarter of 2008, before the Great Recession.

At the start of the third quarter, tourism sales rose by 9.9% compared with July 2010, after a year-on-year drop in June. However, consumer confidence fell back, affected by debt crisis of the euro area's peripheral countries, albeit remaining at a high level. With regard to investment, industrial capacity utilization stayed

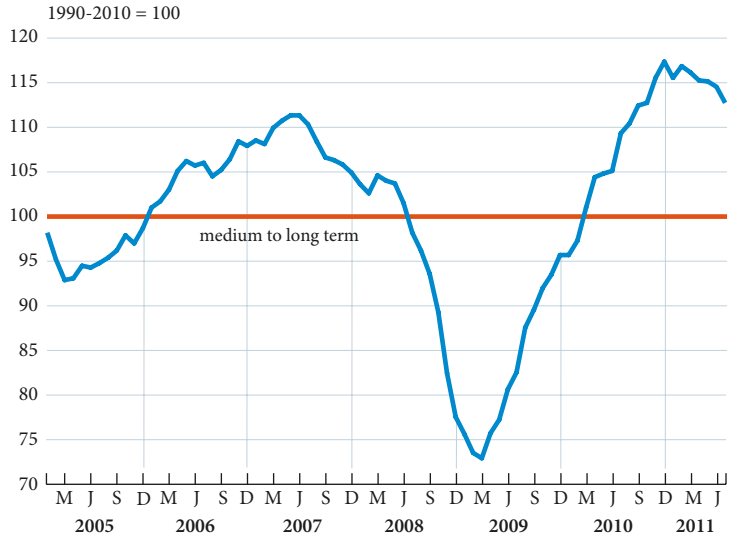
The meagre 0.1% growth of the German economy in the second quarter is disappointing...

...although it can partly be explained by the extraordinary expansion of the first quarter.

Rather than derailing, the economy is going through a dip.

ECONOMIC SENTIMENT IS MARRED IN GERMANY

Indicator of the long-term average economic climate



SOURCE: European Commission.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
GDP	–5.1	3.6	4.0	3.8	4.6	2.8	–
Retail sales	–3.2	1.3	2.3	1.0	0.7	2.2	...
Industrial production	–15.4	10.1	10.2	11.7	12.8	7.7	...
Industrial activity index (IFO) (*)	90.7	107.8	111.1	113.3	114.8	114.3	112.9
Unemployment rate (**)	7.7	7.0	6.9	6.6	6.4	6.1	...
Consumer prices	0.4	1.1	1.2	1.5	2.1	2.3	2.4
Trade balance (***)	138.7	154.5	155.9	154.5	157.5	...	...

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

Our growth forecast for the German economy in 2011 has been revised downwards to 2.9%.

relatively high so that, together with low real interest rates, this suggests expansion will continue, albeit at a slower rate, given the change in overall economic sentiment in the last few months.

A similar view is provided by supply. Industrial confidence lost steam in July but was slightly above the long-term average and the order portfolio was robust. Confidence in services also lost ground but was also higher than the historical average. With regard to construction, permits to build housing increased by 27.9% in the first half of the year compared with the same period a year ago and the sector's confidence indicator showed an improvement at the start of the third quarter.

On the other hand, the trend in the labour market continues to support consumption. After a 1.4% year-on-year rise in employment in the second quarter, unemployment fell in July, in seasonally adjusted terms, compared with the previous month. However, the BAX employment demand indicator fell slightly in July, although remaining at a high level. On the other hand, although consumer price inflation increased slightly in July to 2.4%, the sixth consecutive month above 2%, this was primarily due to energy and the phenomenon is likely to reverse.

Because of the new macroeconomic figures, we have revised our growth forecast for the German economy downwards to 2.9%, 4 tenths of a percentage point less than before. It should be noted that there are still risks related to developments in the sovereign debt crisis of the peripheral countries of the euro area and also of a more extensive slowdown in the global economy.

French gross domestic product stabilizes in the second quarter

Consumption performs worse than expected in the second quarter in France.

After a pleasant surprise in the first quarter, in which the French economy posted strong growth of 0.9% quarter-on-quarter in revised figures, the initial estimate for the second quarter disappointed, recording stagnation compared with the preceding quarter. The negative effect came from household

consumption, down 0.7% after a quarterly increase of 0.4% in January-March.

This fall was partly due to the withdrawal of subsidies for renewing vehicles, which led to a sharp drop in car registrations. Moreover, both public consumption and total investment slowed up. The contribution of domestic demand to GDP quarterly growth was therefore –0.2 points. On the other hand, and as a positive note, foreign demand contributed 0.3 points to quarterly growth after having subtracted half a point in the first quarter. Compared with the same period a year ago, GDP growth slowed up to a rate of just 1.6%.

Available economic indicators for the third quarter do not give much cause for celebration and have got worse in general. However, they are compatible with modest quarter-on-quarter growth. Tourism sales practically stood still in July compared with the previous month, seasonally adjusted. Consumer confidence fell below its historical average at the start of the year due to concern about a future rise in unemployment. With regard to investment, industrial capacity utilization fell slightly, as well as confidence in industry, although the level of the order portfolio was slightly higher than a year ago in terms of value. Similarly, construction confidence improved in July. On the whole, the indicator for economic sentiment weakened in July but remained above the long-term average.

In the first six months, the government deficit fell by 0.5% compared with the same period the previous year, standing at 61.4 billion euros. Spending was 5.3% down year-on-year, in line with the forecast. For its part, revenue decreased by 1.5%, affected by changes in the tax calendar. In spite of this moderation in the public deficit, the risk premium of France's sovereign debt underwent an upswing in the first few weeks of August as rumours spread of it possibly losing its top rating within the context of the sovereign debt crisis in the periphery of the euro area. The spread between interest rates for France's ten-year bonds and German bonds went from 40 basis points at the end of the first half of 2011 to a peak of 79 on 9 August, although it subsequently eased.

Downward turn in the French GDP growth forecast in 2011 to 1.8%.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
GDP	–2.6	1.4	1.6	1.4	2.1	1.6	–
Domestic consumption	–0.4	1.7	2.6	1.0	3.5	1.2	...
Industrial production	–12.4	5.2	4.3	4.8	4.8	2.1	...
Unemployment rate (*)	9.5	9.8	9.8	9.7	9.7	9.6	...
Consumer prices	0.1	1.5	1.5	1.7	1.8	2.1	1.9
Trade balance (**)	–45.1	–52.2	–51.9	–52.2	–59.7	–65.0	...

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

The Italian economy grows slightly more than the euro area in the second quarter but the outlook is not very buoyant.

Given this situation, on 10 August, at an extraordinary meeting, the French government announced that it was preparing new adjustment measures to confirm the credibility of the fiscal consolidation process, which must reduce the public deficit to 3.0% of GDP by 2013. On 24 August, the French government specified its plan to reduce the public deficit by 12 billion euros between 2011 and 2012. The proposals include the creation of a special contribution from the highest income earners, the withdrawal of a tax deduction on property gains and raising the tax on capital gains, as well as on alcoholic and sweetened drinks. The French government is also continuing to promote the constitutional mandate of equilibrium for public finances, to which end it must secure the support of three fifths of the two parliamentary chambers.

As a consequence of the slowdown in the global economy and in particular of the sovereign debt crisis in the periphery of the euro area, as well as after the national accounts figures for the second quarter, the pessimism of French consumers and tighter budgets, we have revised our 2011 forecast for France's economic growth downwards, placing it at a moderate 1.7%, in line with the euro area as a whole.

Economic growth revives slightly in Italy

After coming close to stagnation in the first quarter, the Italian economy picked up again slightly in the second. GDP rose by 0.3% compared with the previous quarter, slightly above the rate for the euro area. This recovery was boosted by industry and services, as the value added of agriculture fell. In any case, the year-on-year rate fell by two tenths of a percentage point to a modest 0.8%.

The overall situation does not look like improving in the third quarter. Automobile sales fell in July by 10.7% compared with the same month the year before. Consumer confidence weakened again given the economic uncertainty and gloomy outlook for the labour market. The fall in industrial capacity utilization does not point towards vigorous investment. Industrial and

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
GDP	–5.2	1.2	1.4	1.5	1.0	0.8	–
Retail sales	–1.7	0.0	0.5	0.1	–0.2	...	...
Industrial production	–18.7	6.5	7.6	5.2	2.2	2.0	...
Unemployment rate (*)	7.8	8.4	8.3	8.3	8.1	8.0	–
Consumer prices	0.8	1.5	1.6	1.7	2.3	2.6	2.7
Trade balance (**)	–5.9	–29.3	–22.5	–29.3	–34.9	–36.1	...

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

services confidence also fell in July, although it rose in the retail trade. On the whole, the indicator for economic sentiment fell in July to slightly below its long-term average.

Italy's central government accounts seem to have improved during 2011. However, the slow rate of expansion in activity and the high level of public debt continued to raise concern among the markets given the sovereign debt crisis in the periphery of the euro area. As a result of tensions related to its sovereign debt risk premium, at the end of June the Italian government presented a new adjustment plan and speeded up its passing through parliament, so that it was approved by mid-July.

This package finally set the reduction in net borrowing at around 80 billion euros but relegated the main part of the adjustment to 2013 and 2014, establishing budgetary equilibrium for the latter year. Among other measures, there was the rationalization of healthcare expenditure with co-payment in some cases, various adjustments in pensions, some tax hikes such as on fuels, a reduction in fiscal benefits, as well as promoting a programme to sell shares held by the state. However, as most of the consolidation has been postponed until after the general elections in 2013, this plan was not seen as credible by the financial markets.

Although the five Italian banks that took part directly in the European Banking Authority stress tests published mid-July were correctly capitalized, the risk premium continued to rise and, on 4 August, the spread of interest rates for ten-year bonds with their German equivalents set a record of 386 basis points. Within this context, on 12 August the Italian government passed a new package of measures that went on to be debated in parliament.

The risk premium of Italian debt sets a record at the beginning of August...

The aim of the new plan is to bring budgetary equilibrium forward to 2013. These measures include the simplification of the central and local administrative structure with a reduction in operating costs, a wage cut for members of parliament of between 10% and 20% and the introduction of a solidarity contribution for the next three years of between 5% and 10% from the highest income bracket. Similarly, it also proposes the liberalization of professional activity as well as the privatization of local public services.

The European Central Bank's intervention by buying up Italian public debt and the presentation of a new adjustment plan contained the rise in the risk premium, which fell to around 270 basis points by mid-August. However, this level is relatively high and slightly exceeds that of Spanish debt. Given this situation, it's unlikely that GDP growth will exceed 1% in 2011.

...and its rise is only contained by the European Central Bank intervening and by the Italian government presenting a new adjustment plan.

A Greek tragedy?

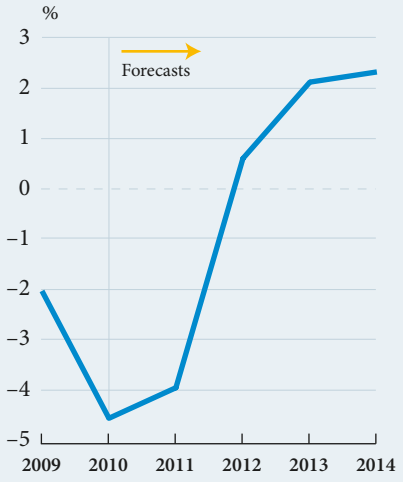
If a bond has a yield of 30% it's because the debtor is very likely not to pay on time or to pay back only part of the debt. This was the approximate yield offered by the Greek government's two-year bonds at the end of June. At that time, and for many even a long time before, it was completely obvious that the bail-out programme of May 2010 was not enough to resolve the Greek crisis. In July this year, the EU Council proposed a new package of financial aid that gives the Greek economy more time to sort itself out. Uncertainty, however, persists.

Tough, optimistic and naive are adjectives that could be used to define the 110 billion euro bail-out approved by the IMF and the EU in May 2010. Tough because it requires the fiscal deficit to be cut by 13 points of GDP between 2009 and 2014 (from 15.5% of GDP to 2.6% of GDP), with a large part of this adjustment concentrated in the first two years. Also because, originally, the aid funds were offered at a high interest rate (in the case of euro area loans, at 3.5 percentage points above the 3-month Euribor). The plan was optimistic because it underestimated the difficulties the Greek economy would face in returning to growth within a context of strong fiscal adjustment. For example, although it was forecast that GDP would fall by 2.6% in 2011, the Greek government itself now believes that this drop might reach 4.0%. Lastly, the plan was naive insofar as it supposed that Greece would be able to finance itself again in the private capital markets by 2012, even though the weight of its public debt is estimated to be equivalent to 150% of GDP at that time. The yields recently exhibited by Greek debt make it clear that Greece is far from being able to access private financing at a reasonable price. So an alternative was required to cover the more than 125 billion euros that Greece had hoped to secure from private investors between 2012 and 2014.

The new bail-out hopes to meet these financing needs at the same time as improving the financial conditions of the official loans. This is a package totalling 109 billion euros (of which 80 billion correspond to the euro area and the rest to the IMF) which will be offered at a lower interest rate (in the case of the European funds, at the issue

THE PROLONGED RECESSION OF THE GREEK ECONOMY...

GDP growth



...MAKES IT DIFFICULT TO REDUCE THE DEFICIT...

Fiscal balance

...AND DECREASE PUBLIC DEBT

Gross public debt

SOURCE: International Monetary Fund (July 2011).

cost of the European Financial Stability Facility, EFSF) and over a longer term. This improvement to conditions will also be applied to the previous package, reducing interest rates to 3.5% approximately and extending payback periods from 7.5 years to 30 years. Similarly, to facilitate Greece's economic recovery, the EU has also undertaken to increase investment financed by structural funds.

Moreover, and due to the insistence of Germany, the governments of the euro area have managed to secure from the private sector an offer to voluntarily take part in financing Greece to the tune of around 50 billion euros. This offer includes a menu of options to replace bonds maturing in the next few years with new debt at 15 and 30 years, as well as interest rates averaging 5.5%. Consequently, the private sector could contribute around 37 billion to Greek net borrowing between 2011 and 2014. On the other hand, there's also a plan to set up a fund to buy back Greek debt on the secondary market (with the private sector contributing approximately 13 billion euros to this programme). With these bond exchanges, which in some options will involve a discount on the debt's nominal value, and the buying back of bonds under par, it is estimated that Greece might be able to reduce its debt by around 27 billion, equivalent to 12% of GDP.

On the whole, this is quite a generous package, even more so than expected. However, five weeks after the European Council's announcement, the yield on 2-year Greek bonds exceeded 40%. Why has this new plan not dispelled the uncertainty? There are several reasons: the new package is still not in operation and some countries, such as Finland, are reluctant to take part if they're not guaranteed should Greece default the EFSF (a requirement that does not reveal much confidence in the success of the bail-out plan); in spite of restructuring part of the debt, its weight will still be very high (gross debt is expected to be around 160% of GDP in 2014), so that many believe future debt haircuts will be difficult to avoid; the fiscal deficit targets haven't been altered either and are still difficult to achieve, both for political and economic reasons; and, lastly, there is still scepticism regarding the euro area's system of economic governance, which is incomplete, whichever way you look at it.

In this respect, and together with Greece's bail-out, the European Council approved a series of measures to prevent contagion from the Greek crisis, but these haven't gone far enough to dispel doubts affecting those countries with high levels of debt or deficit. Specifically, the EFSF has been made more flexible so that it can buy up public debt from any country in the euro area on the secondary market under certain conditions (an undertaking that, at present, the ECB carries out only reluctantly) and finance the recapitalization of financial institutions, even in countries not subject to a bail-out programme. Unfortunately, the Council did not increase the EFSF's size, making these reforms less credible. Neither has it considered, for the time being, the possibility of issuing joint bonds to finance the different Member states (so-called Euro bonds). It's not difficult to comprehend the political resistance of the richer countries in the euro area to greater fiscal integration, no matter how reasonable this may be from a conceptual point of view.

In short, the Greek crisis is far from over. There are still huge challenges facing the country and the EU's support requires a loss of fiscal sovereignty which is tough to manage politically. Further debt restructuring is more than likely to be required, with substantial relief. A more remote possibility, due to the costs both for Greece and also for the euro area as a whole, is a disorderly default and Greece leaving the euro. That would be an ending befitting a Greek tragedy.

This box was prepared by Enric Fernández
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The United Kingdom: social unrest within a complicated economic scenario

Britain's growth figures for the second quarter are weak.

The social unrest experienced by the United Kingdom has surprised everyone and has raised doubts as to the leadership skills of the British prime minister at a time when leadership is vital in order to redirect the course of the economy. The fact is that economic figures are still doggedly pointing towards an economic slowdown in the United Kingdom, a situation that had already been ruled out months ago by the consensus of economic forecasts.

Even the Bank of England, in its August Inflation Report, revised the country's growth prospects downwards, while the governor of the reserve bank, Mervyn King, warned of the risk of inflation being temporarily above 5% over the coming months. For the moment, the latest data on the CPI for July remain at a stubborn 4.4%. In the minutes of the meeting on 3 and 4 August, the members of the central bank's Monetary Policy Committee stated unanimously that they would keep the official interest rate at 0.5% given the deterioration in the economic outlook. We should remember that, in previous meetings, some members had even voted in favour of a rise in the nominal reference interest rate. Something that, today, appears very remote.

The scenario of fiscal adjustment and the deterioration in households' disposable income augur moderate growth for the remainder of the year.

Certainly second quarter GDP growth slowed up to 0.2% quarter-on-quarter from the 0.5% of the first quarter, while year-on-year growth went from 1.6% to 0.7%. These figures reinforce the theory that the recovery will continue to be very gradual. Such slowness is weighing heavy on households and is hindering the recovery in private consumption. Whereas the sales animated the British in June, in July the figures for retail and consumer goods once again looked very weak. Moreover, the labour market is still failing to show any clear signs of improvement and unemployment actually increased slightly to 4.9% in July.

In short, the economic situation is moving within parameters of great weakness: between tough fiscal

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
GDP	–4.9	1.3	2.5	1.5	1.6	0.7	–
Retail sales	1.0	0.4	0.6	–0.1	2.2	0.9	0.1
Industrial production	–10.1	2.1	3.1	3.3	1.9	–0.8	...
Unemployment rate (1)	4.7	4.7	4.6	4.5	4.5	4.7	4.9
Consumer prices	2.1	3.3	3.1	3.4	4.2	4.4	4.4
Trade balance (2)	–82.4	–96.4	–91.1	–96.4	–98.4	–98.6	...
3-month Libor interest rate (3)	1.2	0.7	0.7	0.7	0.8	0.8	0.8
Nominal effective pound exchange rate (4)	73.9	80.4	81.5	79.3	79.2	78.6	77.2

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.

adjustment and poor performance by the net disposable income of households due to rising unemployment and the high level of inflation, which is rising faster than wages. A complicated scenario which means that we will probably have to revise our 2011 GDP growth forecast downwards for the United Kingdom, currently at 1.6%. However, we keep to our forecast of 4.3% inflation in 2011 as, in spite of the increases in basic energy service prices, which will be passed on to consumers in their electricity and gas bills over the coming months, we believe that inflation will fall subsequently due to the disappearance of several temporary effects that have raised British prices over the last few periods.

Emerging Europe: towards a change of scenario?

At the start of the summer, three aspects of the macroeconomic situation in emerging Europe were cause for concern. Perhaps the most pressing was the drift in prices, which were threatening to push inflation to high levels. Secondly, the financial developments were being followed with some concern, accompanying the sovereign debt crisis in the peripheral economies of the euro area. Lastly, a third issue was to gauge the extent of what was, at that time, perceived as a certain moderation in activity. The events of July and August have tended to give more weight to the last of these trends, although the other two are still far from resolved.

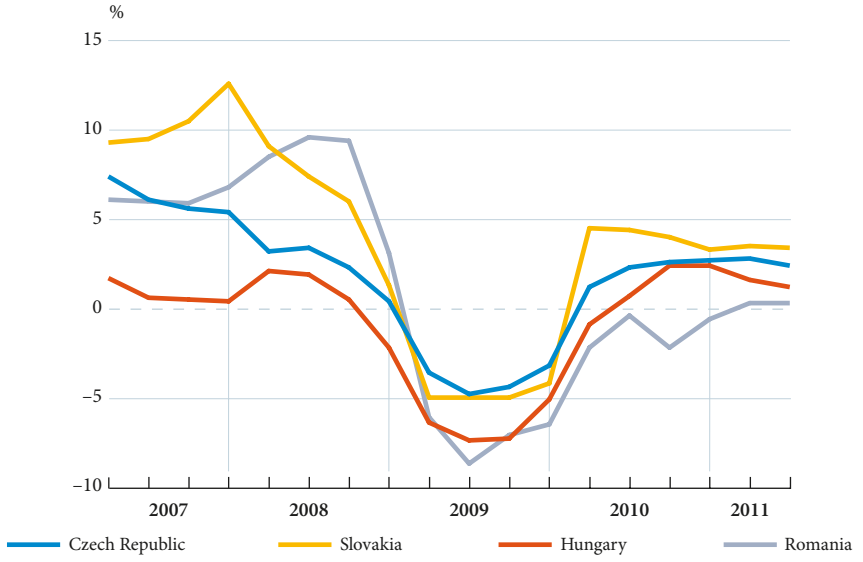
The loss of pace in growth becomes the most pressing concern in emerging Europe.

Although data on Poland are not available, the economic growth figures for the second quarter have been lower than expected. While forecasts predicted the rate would speed up, the reality has been that, in Hungary, the Czech Republic and Slovakia, GDP growth has slowed down in year-on-year terms, while in the case of Romania it has maintained the weak figure posted in the first quarter. The common element lying

In the second quarter, the predominant trend is a slowdown in activity.

THE RECOVERY LOSES PACE IN EMERGING EUROPE

Percentage year-on-year change in real GDP



SOURCES: Eurostat and Thomson Reuters Datastream.

Growth is weaker in Romania and Hungary, the two countries going through macroeconomic adjustment.

behind this slowdown is the worsening of activity in Germany and in other economies of the European Union which concentrate the majority of exports from central and Eastern Europe.

As can be seen in the graph, growth has been moderate in Romania and Hungary, two states that are undergoing macroeconomic adjustment and whose main source of activity is exports. However, the latest GDP flash estimate was particularly better in the Czech Republic and Slovakia, two countries that have been able to partly assuage the decline in exports with more dynamic domestic demand.

Inflation starts to moderate.

Apart from this moderation in growth in the second quarter, what can be expected in the coming months? The few indicators available for activity in the third quarter, and particularly figures on economic sentiment for July, point to the slowdown continuing during this period. This trend is consistent with that of activity indicators in the euro area, which are also falling, suggesting there will be moderate activity in the second half of the year in those countries that share the single currency. Given this situation, it would be surprising if growth in emerging Europe accelerated appreciably in the remainder of the year.

There is no widespread financial contagion from the debt crisis, although Hungary's public debt is cause for concern.

The bad news of this loss in economic dynamism has been offset by two developments that can be seen in a positive light. Inflation, which last May reached levels of close to 5% year-on-year, therefore starting to threaten the achievement of the inflation targets set by the region's central banks, has fallen to the zone of 3.5% in just two months. This development is due to the slowdown in energy and food prices, two trends that are expected to continue in the coming months.

A second front whose development is less worrying than expected a few months ago concerns the repercussions for the region of the European sovereign debt crisis. Trends in the risk premia of the five economies we usually cover in this report (Poland, Hungary, the Czech Republic, Slovakia and Romania) show that investors have only perceived an increase in public solvency risk in Hungary's case.

This position is based on the fact that Hungary has a slightly higher public debt than is usual in the region: equivalent to 80% of GDP in Hungary compared with values in the region of 30%-40% in the case of Romania, the Czech Republic and Slovakia, and 55% in Poland. This clear discrimination of risk by the financial markets means that we can rule out the most negative hypothesis for the time being, namely widespread regional contagion.

In summary, emerging Europe, a region closely related commercially and financially to the central countries of the European Union, is accompanying these countries in a period of lower economic growth. For the moment, the most likely scenario is of a temporary slowdown and moderate intensity, which will fundamentally affect the second half of 2011. This depends, however, on the financial markets continuing to make a fine distinction when discriminating risk in geographical terms, as well as on Germany quickly overcoming its unexpected cyclical weakening.

FINANCIAL MARKETS

Monetary and capital markets

The storm becomes a gale

Since the beginning of the second quarter, the international financial situation has been determined by the convergence of several factors whose repercussions on the markets are characterized by a brusque movement of «flight to quality» on the part of investors, with sharp falls in the stock markets. Of note among these factors is, firstly, the slowdown in economic growth, mainly in the United States. Secondly, the restrictive nature of economic policy in the emerging countries given the risk of overheating. Thirdly, the persistence of the sovereign debt crisis of peripheral Europe, both in terms of time and in the number of countries affected. And lastly, the unfinished process of regulating the financial sector.

In August, these disturbances become more intense, at times reminiscent of the drama of autumn 2008. Without doubt, the effects of these factors and the different actions carried out to handle them will continue to set the pace for the financial markets for some time yet; but it seems reasonable to expect them to gradually fade, so that the medium and long term outlook should see a return to positive expansion rates and investor confidence restored.

The Federal Reserve and the ECB, two different ways of tackling the crisis

In the last two months, several symptoms have been noted that confirm the moderation in the pace of growth of the economy at a global level. The adverse shocks occurring in March (such as Japan's earthquake and the socio-political unrest in the Middle East) helped to trigger a phase of moderation in activity, although this should be temporary in principle. Given that this process differs depending on the geographical area, as is happening with inflationary risks linked to rising commodity prices, the decisions of monetary authorities have also been disparate depending on the country. For example, while the Federal Reserve has guaranteed that its monetary policy will remain lax for the next two years, the European Central Bank has once again opted to raise the official rate, like the People's Bank of China and the central banks of other emerging countries.

The slowdown in growth affects market performance.

Monetary policy strategies differ depending on the geographical area.

In the United States, after the Monetary Policy Committee's meeting held on 9 August, the Federal Reserve (Fed) explained in no uncertain terms the main conclusions of its analysis of the current economic scenario and the guidelines agreed for monetary policy strategy. Under the shadow of the poor growth figures published in July, the Fed chairman, Ben Bernanke, admitted that the extent of the slowdown in the economy throughout this year was greater than initially expected. Relevant indicators, such as household consumption and non-residential investment, have been showing weakness and the activity of some sectors, such as residential, remains decrepit. Within this context, the Fed believes that the prospects for the labour market are still very fragile and this is basically why it

Bernanke admits that the rate of growth has slowed up more than expected.

The Fed announces it will keep interest rates at their current level for the next two years.

has decided to keep the official interest rate as low as possible (0%-0.25%).

Regarding future monetary policy strategy, the Fed made an extraordinary announcement: according to its economic estimates for the coming quarters, and taking into account the possible impact on growth of applying the fiscal deficit reduction plan approved in Congress (whose aim is to reduce the deficit by 2.8 trillion dollars), the monetary authority promised to keep official rates within the minimum range of 0% and 0.25% until mid-2013. In the words of Bernanke, the purpose of this unusual decision is for the Fed to do all it can to ensure economic recovery, given that the risks of inflation are believed to be limited. The Fed will also continue to reinvest the interest and principal of public debt and the mortgage bonds it holds in portfolio. Regarding the issue of possible additional measures of quantitative monetary policy (the so-called Quantitative Easing 3 or QE3), although he did not explicitly mention such measures, Bernanke did state that the Fed was prepared to act decisively should it believe the economic and financial conditions required such action. In short, the bulk of the evidence available suggests that, in the short term, the Fed's focus is to provide extremely lax conditions and that the debate on the «exit strategy» has once again been put on the back burner.

Bernanke does not rule out a new quantitative easing programme (QE3).

In the euro area, the European Central Bank (ECB), as part of its normalization strategy started in April, increased its reference interest rate by 25 basis points to 1.5% at its meeting in July, subsequently keeping it the same at its meeting in August. This movement, which had already been hinted at by the EBC chairman, Jean-Claude Trichet, was justified as a response to persistent and significant inflationary risks in the medium term. In fact, the bias of the message in both meetings was clearly dominated, as in previous months, by the objective of ensuring price stabilization in the region, considering that, in the opinion of the ECB, the underlying economic fundamentals warranted a progressive normalization of monetary conditions. However, in the last few weeks, and given the moderation in growth and falling commodity prices, market expectations regarding future actions by the ECB have undergone a dramatic change to the extent that no more interest rate hikes are expected during the rest of the year.

The ECB raises interest rates and stresses surveillance on inflation.

With regard to unconventional monetary measures, the ECB decided to keep the existing measures (unlimited liquidity facilities at 1 and 3 months). In its meeting on 4 August, the ECB extended these with a liquidity auction with the same characteristics as previous ones but maturing at 6 months, in response to the difficulties being encountered by some of the region's banks in securing funding due to the sovereign credit crisis. The ECB has adopted a very active role in attempting to resolve the sovereign debt crisis, always with the aim of reducing tension in the credit markets and sustaining investor confidence. On the one hand, the ECB suspended the application of the minimum rating threshold for assets issued by the government of Portugal at the same time as receiving them as collateral for its loans. On the other hand, it took part in negotiating the second financial bail-out for Greece and in the agreement to make the powers of the European Financial Stability Fund more flexible. In the first few weeks of August, and given growing uncertainty due to contagion of the sovereign debt crisis, once again the ECB resolutely started

buying up bonds of countries in difficulty, specifically those issued by the Treasuries of Spain and Italy.

For its part, the tone of the monetary policy of emerging countries continues to be restrictive, in response to the advanced phase of the economic cycle they currently find themselves in. The fast pace of activity achieved over the last two years has given rise to signs of economic overheating. Elements such as increased inflationary pressure on basic consumer products, excess credit and the formation of bubbles with some assets are more than enough for the monetary authorities of these countries to continue to adopt restrictive monetary policy measures. The most representative example has been the People's Bank of China, which agreed its fifth rise in interest rates in eight months (raising the official rate by 25 basis points to 6.56%), as a measure to slow up an inflation rate that had gone too high. However, in the last few months some moderation has already started to be seen in the expansion of credit and activity, which would be compatible with the start of a «soft landing» and, possibly, the end of the monetary tightening phase.

The ECB buys the sovereign debt of countries in the periphery of the euro area.

Within this situation of disparate monetary policy strategies between

Emerging countries continue to restrict their monetary policy.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		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									
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	1.25	1.55	2.16	0.25	0.25	0.20	0.50	0.83	0.28
July	1.50	1.61	2.18	0.25	0.26	0.20	0.50	0.83	0.24
August (1)	1.50	1.53	2.07	0.25	0.30	0.19	0.50	0.87	–0.15

NOTES: (1) August 22.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 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%), 4-8-11 (1.50%).
(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.

Europe's interbank market suffers a modest outbreak of tension.

the United States and the euro area, interest rates in the interbank markets have developed in line with investors' expectations regarding the actions by the respective monetary authorities, as well as according to the events taking place in the sovereign debt crisis and the repercussions for bank funding.

In the case of the US market, interbank rates rose slightly between July and August as a result of the uncertainty regarding negotiations on the debt ceiling and due to concern for the health of the international banking sector. But this increase, attributable to risk premia, has been very modest when compared with what happened in autumn 2008 after the collapse of the Lehman Brothers. In this respect, the Fed's announcement that it would delay any interest rate hike for two years is key to preserving stability in this market.

Standard & Poor's downgrades US debt.

Developments have been somewhat more agitated in the case of the European interbank market. The one-year Euribor interest rate moderated its rise in July, coming close to 2.20%, as a result of the increasingly clearer signs of moderation in world growth. During August, it fell for the first time this year, a movement that also hides notable divergence between the different components of this interest rate. On the one hand, the risk-free component fell considerably in response to investors' expectations that the global slowdown would end up affecting Europe and would lead the ECB to halting its strategy of gradually raising the official interest rate. On the other hand, risk premia (of credit and liquidity) rose notably, as an increase in the deterioration of the sovereign debt crisis was confirmed and due to a certain lack of confidence among financial institutions when lending each other funds. At the same time, this circumstance led to banks demanding more funding from the central bank.

Yields on United States and German debt fall again.

Investors look for a safe haven in the debt of the United States and Germany

Domestic yields for the public debt of the main western economies, in particular the United States and Germany, were still immersed in their downward slide that started in the spring. Very low rates have been reached in historical terms. In the case of the United States the yield for two and ten-year bonds fell to 0.20% and 2.10%, respectively. Among those factors that lie behind this new episode of falling yields is, above all, the gradual deterioration in the main macroeconomic indicators and a drop in consensus expectations of growth. In addition, the new budgetary adjustment plan agreed in the US Congress has reduced the possibility of a «technical default». The plan includes the reduction of public deficit by 2.8 trillion dollars over the next decade. One event that made a lot of noise in the media but had little impact on the market was the downgrading of US debt by Standard & Poor's. The agency withdrew its AAA rating and replaced it with AA+, given that it believes the agreement to reduce the deficit agreed by Congress is not enough and it has reservations regarding the high level of debt the country must face in the medium term. However, it seems that investors are still completely confident in US debt and its risk premium remains at a low level. Another factor that has not prevented a fall in yields has been the end of the Fed's second Quantitative Easing programme (QE2). The active presence of the central bank provided some support to the debt market but it's true that, since it withdrew on the last day

of July, the ten-year bond's yield has fallen further and the rise in volatility has not been too intense.

In the case of the euro area, the yield on German sovereign debt has performed similarly to that of the United States. The yields on German two and ten-year bonds fell to 0.60% and 2.12%, respectively. Once again, the deterioration in the peripheral sovereign debt crisis and fear of contagion to other economies in the region has led to a change in investor preference, choosing assets with a lower risk or higher quality, as is the case of German debt. Although this has been happening since the spring, it should be temporary if notice is taken of the favourable information coming from a fundamental economic analysis of the area.

For their part, the risk premia of the peripheral countries have performed extremely erratically and unevenly. Once the agreement was signed for Greece's second bail-out between the EU, ECB and the IMF (which will provide financing of 109 billion euros, including the participation of the private sector to the tune of 37 billion) and after having agreed to improve the effectiveness of stabilization instruments (European Financial Stability Fund), the sovereign risk premia of those countries in difficulty climbed back down. This truce did not last long, however, as uncertainty regarding the effective implementation of these agreements led to the fear of contagion once again taking hold of market sentiment, with all eyes on Italy and Spain. In both cases, the gradual increase in financing costs in international markets (exceeding 6% for ten-year bonds) led the ECB to intervene in the secondary markets, buying up the bonds of both countries. Thanks to this action, and to the additional structural

German sovereign debt is benefitting from being seen as a safe haven.

Fear of contagion by the sovereign debt crisis pushes up risk premia for Italy and Spain.

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								
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	3.03	3.41	5.45	4.88	3.16	1.14	3.38	1.73
July	2.54	3.23	6.08	5.87	2.80	1.08	2.86	1.36
August (*)	2.12	2.79	4.96	4.93	2.10	0.99	2.38	0.92

NOTE: (*) August 22.
SOURCE: Bloomberg.

The dollar's exchange rate continues to be highly volatile.

measures taken by governments, the high level of tension in the debt markets fell in the second half of August, although the situation is still far from normal.

Lack of definition continues to reign in the dollar-euro exchange rate

Under the scenario described in previous sections, the exchange rate between the dollar and the euro has continued to be highly volatile and lacking in any clear direction. The range of fluctuation throughout the summer has been 5%, the maximum being 1.47 dollars and the minimum 1.40. Several factors lie behind this volatile behaviour. Throughout July, the euro benefitted from the approval of the second financial bail-out for Greece, the ECB's interest rate hike and fierce debate regarding the debt ceiling in the United States. Subsequently, the resurgence of fears regarding the contagion of the debt crisis to other European economies and the US reaching an agreement to raise its debt ceiling provided a shot in the arm for the dollar's recovery. After this fluctuation, the final variation was small. In the short term, this erratic performance by the dollar exchange rate will surely continue, caused by factors related to the perception of risks affecting one area or the other. But in the medium term, the key factor that is appearing will be how the macroeconomic situation develops in the United States: as it is expected to avoid a double dip recession, the dollar will probably be more solid than in the recent past.

The Chinese yuan speeds up its appreciation.

In other area of the foreign exchange markets, the appreciation of the Chinese

EXCHANGE RATES OF MAIN CURRENCIES

August 22, 2011

	Exchange rate	% change (*)		
		Monthly	Over December 2010	Annual
Against US dollar				
Japanese yen	76.7	–2.4	–5.8	–11.0
Pound sterling	0.607	1.1	5.3	5.9
Swiss franc	0.786	–4.2	–19.0	–32.4
Canadian dollar	0.987	3.9	–1.2	–6.7
Mexican peso	12.271	5.2	–0.6	–5.2
Against euro				
US dollar	1.440	–0.3	–7.6	–13.8
Japanese yen	110.4	–2.1	1.8	2.4
Swiss franc	1.132	–3.9	–10.5	–16.4
Pound sterling	0.874	–0.8	1.9	6.6
Swedish krona	9.167	0.8	2.0	–2.2
Danish krone	7.449	–0.1	–0.1	0.0
Polish zloty	4.169	4.4	4.9	3.6
Czech crown	24.48	0.5	–2.2	–1.3
Hungarian forint	272.9	1.7	–2.1	–3.7

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

yuan is particularly of note. Its rate of appreciation intensified over the summer in what already seems to be a clear reorientation of economic policy and growth model for the Asian country.

High quality corporate bonds hold firm, but high yield debt does not

As has already happened in previous quarters, the investment grade private bond market has shown commendable resistance during the summer given the bad news coming from the economic situation overall and the sovereign risk on both sides of the Atlantic. After the slight dip suffered by the main corporate bond indices in June, these got back on the road to recovery in July and August, thanks to the fact that the rise in risk premia was offset by a drop in reference interest rates. As a result of economic globalization, and given the intensification of the «flight to quality» of capital flows, large areas of the corporate credit markets have become more attractive as safe havens, behind gold and good quality public debt. Specifically, US investment grade corporate bonds and the corporate debt of some emerging economies have seen an increase in demand, pushing down their yields. In the case of the euro area, this phenomenon has occurred to a lesser extent thanks to the strong presence of the financial sector, which continues to suffer from investor mistrust. In fact, the rise of risk premia due to the worsening of the sovereign debt crisis has continued to harm financial sector spreads on the old continent, highly exposed to the sovereign debt of the countries affected. For their part, performance by high yield bonds has been more lacklustre, influenced by the downward revision of economic growth forecasts, mainly in the United States.

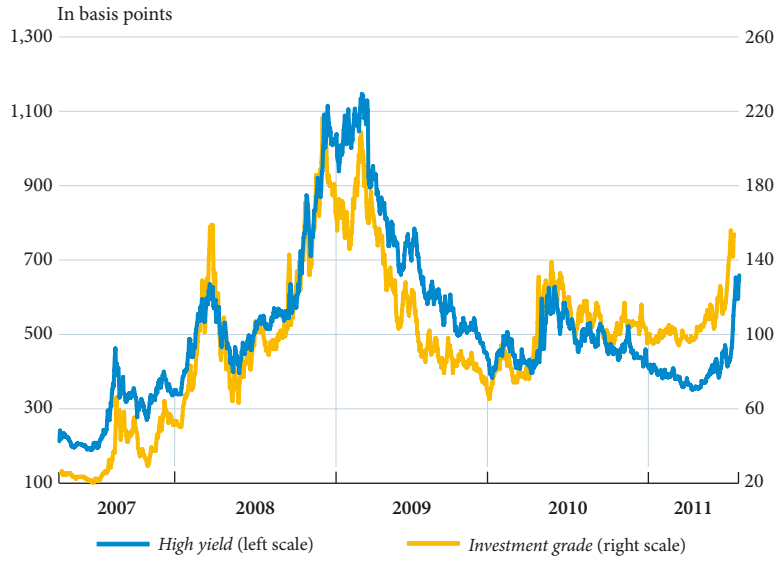
Investment grade corporate bonds have become a safe haven.

Given this financial situation, issuances have remained stable in the emerging

The bonds of European banks are being hard hit.

TRENDS IN CORPORATE RISK PREMIA IN THE EURO AREA

5-year Markit Itraxx indices



SOURCE: Bloomberg.

The lower economic growth expectations are putting a brake on issues of high yield bonds.

markets thanks to the relatively favourable perspectives for economic growth in the medium and long term. On the other hand, in developed markets doubts regarding the European crisis and the pace of economic activity in the United States have put a brake on issuances.

Setback in international stock markets

Uncertainty leads to extensive losses on the world's main stock markets.

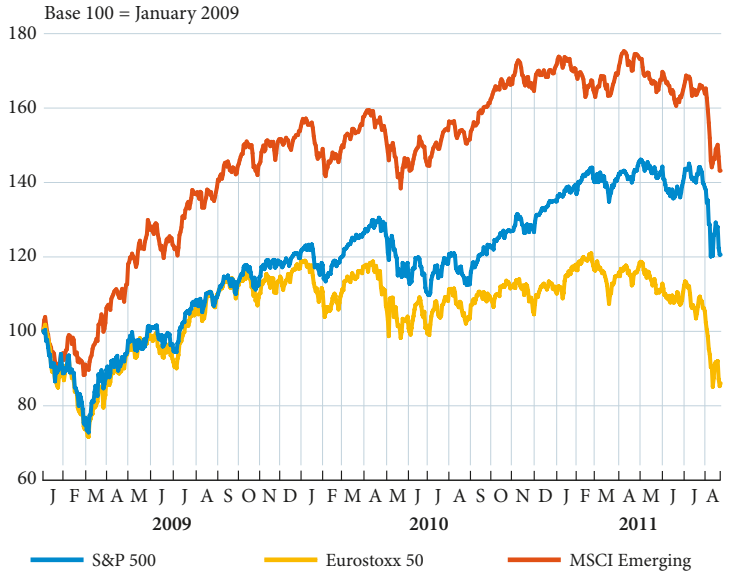
The weak tone exhibited by international stock markets since the spring has led to extensive losses in August. The weakening of the world's economic growth prospects and the perception of a vulnerable financial scenario have been reflected in a pronounced rise in volatility indicators and a decreasing «appetite for risk». The tensions dominating the world's financial markets have led to increased doubt among investors, who prefer to go for assets with a less risky profile, such as gold, investment grade corporate bonds and US and German public debt.

Under the scenario that the current risks in the financial context are going to be gradually and satisfactorily resolved, the stock market outlook for the medium and long term is clearly favourable. The recovery of global economic growth, the continuing expansionary business cycle and a reduction in sovereign credit risk are the main arguments expected to push up the world's stock markets in the future. Unfortunately, in the short term the stock market scene is still subject to the interaction of the aforementioned negative factors which are hindering any potential gains.

Over the last few months, the worsening of economic indicators in the United States, the downgrade of its credit rating and its political difficulties in negotiating the debt ceiling have relegated to second place the satisfactory corporate earnings season of the second quarter. Specifically,

TRENDS IN THE MAIN INTERNATIONAL STOCK MARKETS

Stock market indices



SOURCE: Bloomberg.

91% of S&P 500 companies have already published their accounts and 71% of these have exceeded the expectations of the consensus of analysts. Profit per share in the quarter also exceeded the figure reached in the same period last year by 17%.

In the euro area, the growing uncertainty of possible contagion of the crisis to other economies and the difficulty in implementing bail-outs for the countries already affected have continued to weaken investor sentiment. Within this context, the financial sector is the most negatively affected, even though the second stress test carried out in the euro area was more satisfactory than the one carried out last year. Aspects such as banking's high exposure to peripheral debt and the news regarding regulatory reforms (which will lead to bigger solvency and liquidity requirements) are hitting bank shares.

Lastly, the stock market indices of the emerging economies have also fallen sharply over the last few weeks. The stock markets of these economies were already immersed in consolidation resulting from the tightening up of their economic policies and now, in August, the world's economic and financial situation has damaged even further the expectations of any gains in the short term.

The corporate expansionary cycle is a fundamental support for stock market gains in the medium term.

The sovereign debt crisis weighs heavily on the share prices of Europe's banks.

INDICES OF MAIN WORLD STOCK EXCHANGES

August 22, 2011

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*10,817.7*	*–14.7*	*–6.6*	*5.9*
Standard & Poor's	*1,123.5*	*–16.5*	*–10.7*	*4.8*
Nasdaq	*2,341.8*	*–18.1*	*–11.7*	*7.4*
Tokyo	8,628.1	–14.8	–15.6	–6.0
London	5,095.3	–14.1	–13.6	–1.9
Euro area	2,182.9	–21.3	–21.8	–17.4
Frankfurt	*5,482.4*	*–25.2*	*–20.7*	*–8.7*
Paris	*3,050.6*	*–20.6*	*–19.8*	*–13.5*
Amsterdam	*276.8*	*–18.3*	*–21.9*	*–13.0*
Milan	*14,924.9*	*–23.3*	*–26.0*	*–24.9*
Madrid	*8,248.3*	*–18.0*	*–16.3*	*–18.3*
Zurich	5,141.3	–14.8	–20.1	–16.9
Hong Kong	19,486.9	–13.2	–15.4	–7.1
Buenos Aires	2,825.4	–15.8	–19.8	15.8
São Paulo	52,447.6	–13.0	–24.3	–21.3

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

The Irish financial system: from hero to villain

Between 1990 and 2007, Ireland was dubbed «the Celtic Tiger» as the paradigm for fast economic development. Significant aid from European Union (EU) funds, tax benefits for multinationals and companies in general and the rapid tertiarization of the economy led to dizzying growth that was widely admired: between 1990 and 2007, Irish GDP grew by 6.3% in annual average terms.

But less than five years later the «tiger» has been tamed. GDP has fallen by 4.1% annually between 2008 and 2010 and the unemployment rate has risen by 10 percentage points compared with the minimum reached in 2001 (to 13.6%). By December 2010, the Irish government had lost 35.7 billion euros in its attempts to rescue the financial system (23.2% of GDP in 2010), more than any other country in the European Union. Moreover, it has accumulated contingent liabilities[1] totalling 192.8 billion euros (125% of GDP in 2010).Consequently, in November 2010, the EU and the International Monetary Fund (IMF) had to agree a bail-out for the country.

IMPACT ON PUBLIC ACCOUNTS OF EUROPEAN UNION FINANCIAL SYSTEM BAIL-OUTS

Cumulative 2007-2010

	Net Revenue/Cost (cumulative 2007-2010)		**Contingent liabilities** (2010)	
	Million euros	% GDP 2010	Million euros	% GDP 2010
Ireland	–35.722	–23.2%	192,781	125.1%
Germany	–16.559	–0.7%	71,232	2.8%
United Kingdom	–15.026	–0.9%	417,261	24.6%
Netherlands	–3.440	–0.6%	39,948	6.8%
Portugal	–2.214	–1.3%	5,425	3.1%
Austria	–1.435	–0.5%	22,170	7.8%
Latvia	–430	–2.4%	356	2.0%
Luxembourg	–36	–0.1%	1,333	3.2%
Lithuania	–32	–0.1%	0	0.0%
Hungary	12	0.0%	0	0.0%
Slovenia	28	0.1%	2,200	6.1%
Cyprus	30	0.2%	3,000	17.2%
Italy	128	0.0%	0	0.0%
Belgium	199	0.1%	55,829	15.9%
Sweden	349	0.1%	19,670	5.7%
Greece	405	0.2%	57,834	25.1%
Denmark	724	0.3%	26,028	11.1%
Spain	1.455	0.1%	59,506	5.6%
France	2.399	0.1%	90,579	4.6%
Euro area (EU-17)	**–69.165**	**–0.6%**	**1,065,152**	**8.7%**

SOURCES: European Commission - Eurostat (Eurostat supplementary table for the financial crisis; April 2011); International Monetary Fund (WEO database) and own calculations.

(1) Contingent liabilities are those whose existence depends on whether a certain event occurs. In the case of Ireland, they depend on whether guaranteed entities go bankrupt or they do not.

What has happened to the «tiger»? Strong growth in GDP for two decades in a row together with lax financial supervision hid the imbalances on which economic development was being built. Rising asset prices and low interest rates encouraged private debt and the huge demand for financing led to unprecedented growth in the banking business. From 2004 to 2007, credit for the resident private sector grew by 24% annually, driven by the real estate sector. Resident private sector deposits did not keep up with this pace and the ratio of credit to deposits went from 140% in 2003 to 202% in 2007. During Ireland's boom, a huge financial system was constructed (at its peak, the system's assets totalled eight times the country's GDP) which, in addition, was significantly concentrated in 6 banks[2] and its funding sources highly dependent on foreign savings and the European Central Bank (ECB).[3]

In September 2008, the Lehman Brothers' bankruptcy in the United States strangled the international interbank market and funding stopped arriving to Ireland. The Irish government reacted quickly: it created the Credit Institution Financial Support Scheme (CIFSS), with the state guaranteeing all system's liabilities (approximately 400 billion euros), except for intragroup loans and liabilities with the ECB. The CIFSS helped to mitigate investors' leaks but pressure on liquidity for Irish banks remained very high. Furthermore, it created an impossible fiscal burden for the central government. Irish bank funding from the ECB went from 28 billion euros in December 2007 to 132 billion in December 2010. Given these tensions, in December 2009 the Eligible Liabilities Guarantee Scheme (ELG) was set up to guarantee new debt issues and combat market closure.

But the international financial crisis was accompanied by a fast deterioration in the economy. Moreover, in the case of Ireland the significant correction in the real estate market since mid-2006 resulted in an increase in non-performing loans for the financial system (10.4% in 2010). The problem was no longer one of liquidity but also of solvency. The deterioration in assets was particularly severe in the Anglo Irish Bank (Anglo) and the Irish Nationwide (INBS) due to their high exposure to construction and property development. Given the risk of systemic contagion, the Irish government was forced to recapitalize them with 4 billion and 2.7 billion euros, respectively, throughout 2009 (4.0% of GDP).

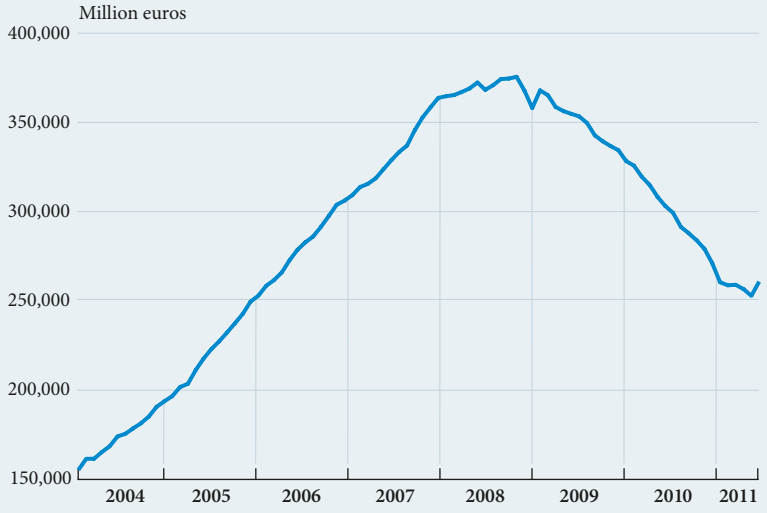
The bail-out of two individual banks was not enough and, given the continuing slump in real estate prices, at the beginning of 2010 the Irish government created the National Asset Management Agency (NAMA). Its aim was to acquire high risk loans from the 6 main banks (essentially property development loans) to eliminate uncertainty from banks' balances, reduce their leverage and get credit flowing again to the economy. Although, up to March 2011, the NAMA acquired assets totalling 72.3 billion euros (17% of the outstanding credit balance for the resident private sector; 43.9% of GDP in 2010), from credit figures it is clear that the NAMA has not achieved its goal. On average, 3 billion euros of credit a month have been granted to households and firms in the first half of 2011. In December 2008 this figure was 12 billion. Why? Mainly because of the large discounts applied in the acquisitions by the NAMA. Assets were acquired at a 58% discount, double the figure initially forecast, which produced a hole in the banks' capital. Given this situation, there was just one solution: a further injection of public capital, totalling 46 billion euros since the crisis began (27.9% of GDP in 2010).

Given the negative spiral in which the Irish economy was immersed, the continuous financial bail-outs weakened public accounts without restoring confidence: Irish public debt represents 96% of GDP. In November 2010, the EU and the IMF had to intervene in Ireland and set up a bail-out plan for the economy which includes 35 billion euros

(2) The 6 largest banks in Ireland are: Bank of Ireland (BOI), Allied Irish Banks (AIB), Anglo Irish Bank (Anglo), Irish Life and Permanent (ILP), Irish Nationwide Building Society (INBS) and The Educational Building Society (EBS).
(3) In December 2007, Ireland accounted for 8.6% of the ECB's resources, while its GDP was less than 2% of the euro area.

DELEVERAGING: SINCE THE PEAK IN 2008, THE CREDIT BALANCE HAS FALLEN BY 30%

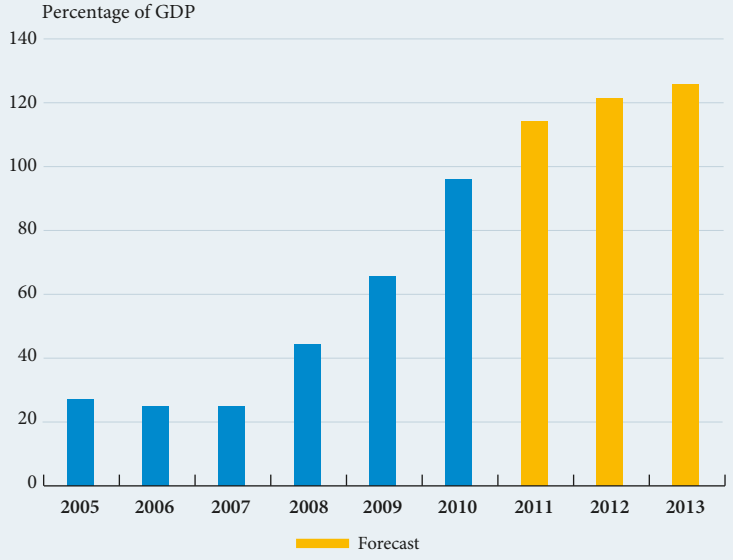
Outstanding credit balance for the resident private sector



SOURCES: Central Bank of Ireland and own calculations.

TRENDS IN IRELAND'S GROSS DEBT

Gross debt



SOURCE: International Monetary Fund (IMF).

for the financial system and two requirements: carry out stress tests and downsize the system by selling off non-core assets.

In March 2011, the tough stress tests carried out concluded that 24 billion euros of additional capital were needed for the 4 banks analysed.[4] This amount comes from estimating portfolio losses and from an aggressive divestment plan for the banks.[5] Specifically, the credit to deposit ratio must reach 122.5% by 2013, which means reducing credit by 72.6 billion euros (–27.5%). As a result of this divestment, the Irish Central Bank developed a restructuring plan for the system that includes the creation of two large franchises: one related to BOI and the other one resulting from the merger between AIB and EBS.

After investing lots of money and completely transforming the system, the bases for recovery seem to be finally laid. Recent European stress tests (carried out by the European Banking Authority) demonstrate this because, considering the latest recapitalization, Irish banks are solvent even in the most adverse scenarios. However, the situation is still open to risks and actions such as the country rating downgrade by Moody's on 12 July might jeopardize the progress made.

(4) The AIB, BOI, EBS and the ILP were included in Ireland's stress tests. Anglo and INBS were not included in the analysis as they were being wound up at that time.
(5) With a minimum core capital requirement of 6.0% in the adverse scenario and of 10.5% in the base one and, in both cases, an additional buffer of 3.8%.

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Economic Analysis Unit, Research Department, "la Caixa"

SPAIN: OVERALL ANALYSIS

Economic activity

The weakening of economic activity is confirmed

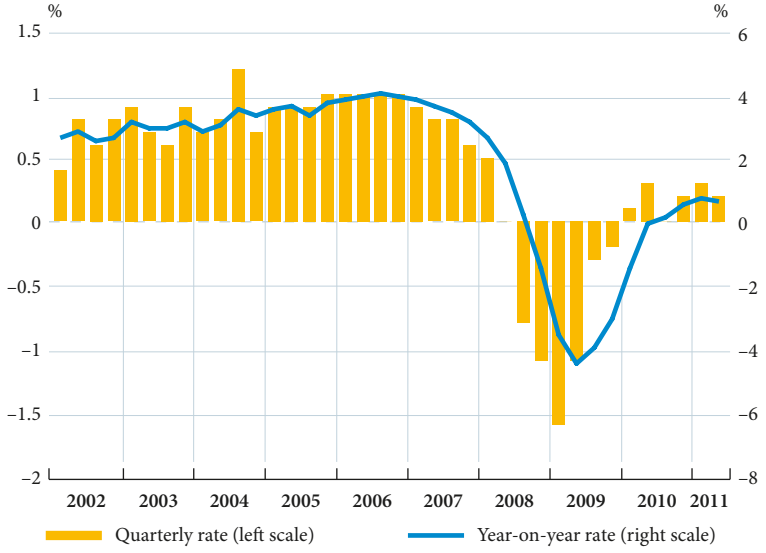
GDP grows by 0.2% in the second quarter compared with the previous period.

The Spanish economy continued its moderate recovery in the second quarter of 2011 with quarter-on-quarter growth in gross domestic product (GDP) of 0.2%, according to the flash figures from the Spanish Statistics Institute (INE). This progress was two tenths of a percentage point less than the figure recorded in the previous period, slowing up the year-on-year growth rate by two tenths of a percentage point to 0.7%. This weakening in activity was to be expected, based on an interpretation of the different supply and demand indicators for the second quarter and the worsening of the sovereign debt crisis in the euro area.

Although the breakdown of GDP trends is still not available, estimates by the Bank of Spain point to a slowdown in activity due to the significant decline in domestic demand, sharper than the one recorded in the previous period. Within this context, it's important to bear in mind the fact that the concentration of expenditure in the second quarter of 2010 in anticipation of the value added tax (VAT) hike in July and the end of direct subsidies for purchasing vehicles might affect the year-on-year rates for private consumption in the second quarter and, consequently, provide relatively low figures. On the other hand, the flash figures from the INE point to net foreign demand increasing its positive contribution to GDP growth, possibly helped by the good

SLIGHT SLOWDOWN IN ECONOMIC ACTIVITY

Change in gross domestic product



NOTES: Data adjusted for seasonal and calendar effects. The figure for the second quarter of 2011 corresponds to the GDP flash estimate for the quarter.
SOURCES: National Institute of Statistics and own calculations.

performance by tourism. Therefore, the foreign sector was once again the driving force behind growth in this second quarter.

There is only limited information available on the third quarter but everything points to no improvement in the intensity of growth in activity over the coming months. Of note is the worsening sovereign debt crisis. A new phase seems to have begun after the episodes of Greece, Ireland and Portugal. At the beginning of August, it was the turn of Spain, Italy and France to suffer significant movements in their risk premia, leading to widespread losses in the main European stock markets. Although these risk premia dropped back significantly during the second half of August, volatility remains at a relatively high level and this might eat away at the confidence of the different agents. In this respect, July's generalized decline in confidence indicators is significant. Particularly important is the drop in confidence of industry, returning to the levels of last summer.

Moreover, there has been a change in international economic conditions that does not benefit the interests of the Spanish economy either. The bulk of the evidence available suggests that growth in the main advanced economies will be less than expected in the second half of the year. This is reflected in the lower GDP growth forecast for the United States and the euro area. For the United States, for example, in January 2011 the consensus of analysts predicted that GDP would grow by 3.1% in 2011. In July this figure had fallen to 2.5%, while in August it stood at 1.8%. Without doubt, this is resulting in a smaller boost from global trade and might therefore weaken the contribution of Spain's foreign trade.

The worsening of the sovereign debt crisis could have a negative effect on spending in the third quarter.

DEMAND INDICATORS

Percentage change over same period year before

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
Consumption							
Production of consumer goods (*)	–8.2	0.8	0.4	0.1	–1.5	–1.0	...
Imports of consumer goods (**)	–6.1	–10.2	–16.2	–15.1	–1.8	...	...
Car registrations	–17.9	3.1	–25.0	–29.3	–27.3	–26.4	–4.0
Credit for consumer durables	–11.5	–12.3	–19.2	–14.6	–13.9	...	–
Consumer confidence index (***)	–28.3	–20.9	–21.5	–21.0	–19.6	–16.1	...
Investment							
Capital goods production (*)	–22.1	–3.3	–6.3	–3.2	2.9	2.3	...
Imports of capital goods (**)	–27.0	6.0	5.8	6.5	3.4	...	...
Commercial vehicle registrations	–40.0	6.4	–9.3	1.4	–2.2	–11.2	–0.5
Foreign trade (**)							
Non-energy imports	–17.5	9.2	5.1	4.2	7.0	...	...
Exports	–9.8	14.5	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.

Excellent tourism season in 2011.

For the moment, the sector that continues to offer the best news is tourism. In fact, in June visits by foreign tourists maintained the good rate achieved in previous months, with a rise of 8.5% year-on-year, and this trend is expected to continue for the remainder of the year, in spite of signs of an economic slowdown in the euro area. With this figure, 24.8 million tourists have now visited Spain in the first half of 2011, 7.5% more than in the same period in 2010.

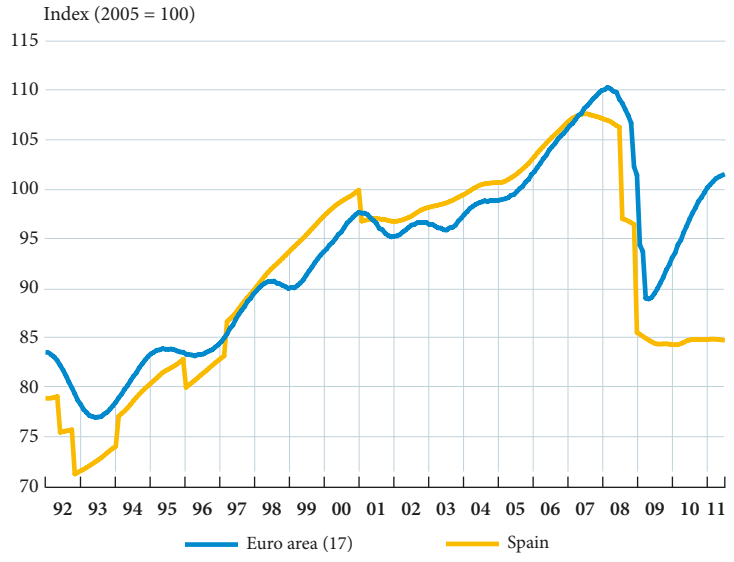
The revival in industrial production fails to appear.

So far, this recovery in the foreign sector has yet to be reflected in a rise in industrial production. Although this index stopped falling two years ago, it has remained almost static since then. This is partly due to the low utilization of production capacity which, although increasing slowly, is still at a relatively low level. In July, however, and due to greater uncertainty at an international level, the industrial production index fell notably. The same thing happened in the euro area as a whole where, after several months of strong recovery, the upward swing seems to be running out of steam. For the coming quarters, the adjustments and gains in productivity of the foreign sector should gradually boost the recovery in industrial production, although recent events might delay this a little longer.

In short, economic developments over the last few months point to a weak recovery. The GDP flash estimate confirms that economic activity lost steam somewhat in the second quarter, as suggested by the different indicators, although the contribution made by the foreign sector remains strong. For the second half of the year, developments in the sovereign debt crisis will have to be monitored closely. Although a new package of aid was approved for Greece and the Franco-German axis, as required, seems finally to be taking hold of the reins and has proposed far-reaching reforms, the situation is far from resolved. In this

SPAIN'S STAGNANT INDUSTRIAL PRODUCTION

Trend in industrial production



NOTE: The figures show the cycle trend.
SOURCES: Eurostat and own calculations.

SUPPLY INDICATORS

Percentage change over same period year before

	2009	2010	2010		2011		
			3Q	4Q	1Q	2Q	July
Industry							
Electricity consumption (1)	–4.8	2.5	1.8	2.5	0.5	–0.3	–1.4
Industrial production index (2)	–15.8	0.8	–0.2	0.4	1.9	–1.2	...
Confidence indicator for industry (3)	–30.8	–13.8	–13.5	–9.2	–8.6	–10.9	...
Utilization of production capacity (4)	71.2	72.0	73.9	72.9	72.6	74.7	...
Imports of non-energy intermediate goods (5)	–21.6	22.2	18.8	15.8	11.6	...	...
Construction							
Cement consumption	–32.3	–15.5	–13.6	–16.1	–2.6	–16.6	...
Confidence indicator for construction (3)	–32.3	–29.7	–27.8	–41.5	–54.1	–55.4	...
Housing (new construction approvals)	–58.1	–17.3	–13.2	–20.3	–7.4	...	...
Government tendering	–8.2	–37.9	–36.6	–34.8	–44.5	...	...
Services							
Retail sales (6)	–5.4	–1.0	–2.5	–1.9	–5.9	–5.0	...
Foreign tourists	–8.8	0.9	4.2	1.4	2.9	10.4	...
Tourist revenue inflows	–9.0	3.9	7.0	5.4	6.7	...	...
Goods carried by rail (ton-km)	–28.4	6.4	5.9	–4.2	8.2	...	...
Air passenger traffic	–7.9	2.9	4.2	4.3	5.0	10.6	...
Motor vehicle diesel fuel consumption	–5.1	–1.2	–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.

respect, the new measures proposed by the Spanish government, such as reforms to pharmaceutical expenditure and to the Constitution to limit the public deficit, should boost the confidence of international investors in the Spanish economy.

Labour market

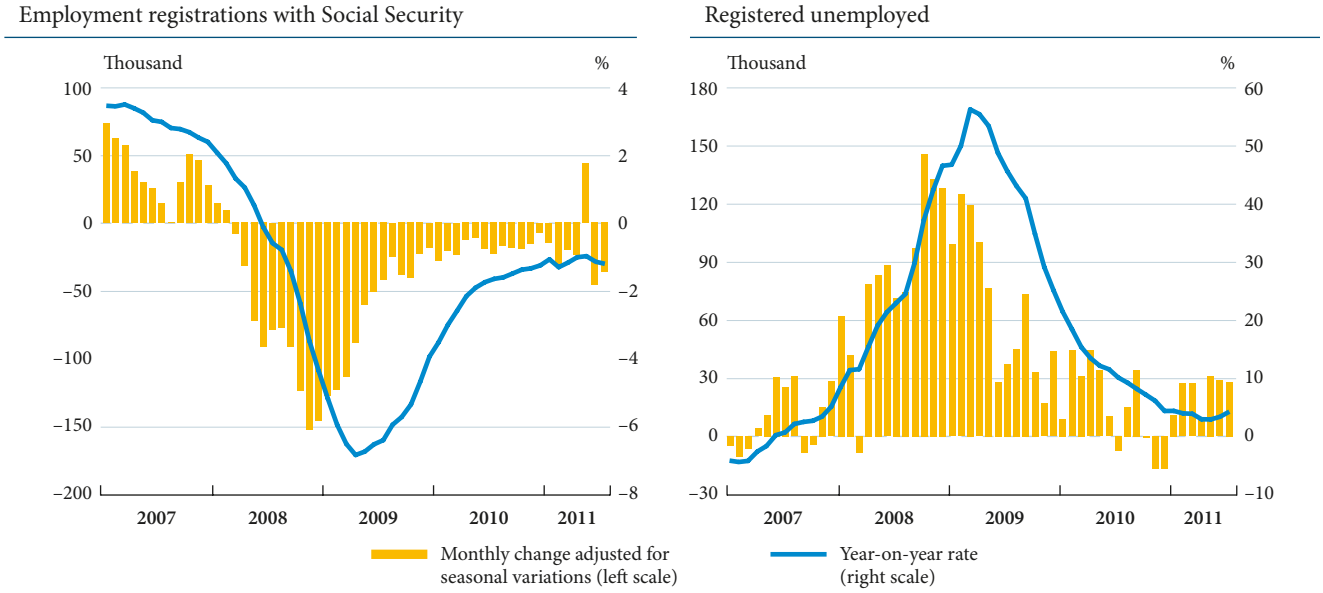
The pace of recovery in the labour market comes to a standstill.

The favourable season provides some break

The outlook for the job market in the third quarter is not very encouraging, as highlighted by the most recent data for July. In fact, although the total number of people registered as employed with Social Security increased this month by 50,773, this rise was quite a lot lower than expected and worsened by one tenth of a percentage point, for the second month in a row, the rate of decrease in registered workers to 1.2% year-on-year. The stagnation and even reversal of the reactivation in employment becomes even more evident when we look at data adjusted for seasonal effects, as this rise in the number of employed becomes a fall of close to 35,000. Over the next few months, employment is expected to fall again, coinciding with the end of the summer season and the slowdown in the progress being made by the world economy. Should this trend continue, the year will very probably end with a decline in employment of at least 0.8% year-on-year.

Similarly, registered unemployment revealed an adverse trend in July as, although it fell by 42,049 people, the year-on-year growth rate grew substantially for the second month in a row, to 4.4%. This suggests a slowdown in the improvements made in unemployment, which saw its year-on-year rate of change rise again.

NO IMPROVEMENT IN EMPLOYMENT'S RECESSIVE TREND



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

Another sign of deterioration in the labour market in the second half of the year can be seen in the figures for the number of contracts recorded. In July, not only did permanent contracts fall, as has been happening most months since the start of the recession, but also temporary contracts. The latter had grown significantly in the period May-June, boosted by the tourist season, and their decrease now signals the end of this seasonal effect on the labour market.

July's figures therefore show a significant halt in the recovery which, although weak, had taken place during the period April to June. The employment data from the Labour Force Survey (LFS) for the second quarter of the year also show a slight improvement taking place during the second quarter, but the rate is still very slow.

According to the flash figures from the National Statistics Institute (INE), the Spanish economy grew by 0.2% in the second quarter compared with the previous period. After the 0.3% recorded in the first quarter, this rate shows a slight weakening in economic activity,

Employment contracts decrease in July, including temporary.

ESTIMATED EMPLOYMENT

Second quarter 2011

	No. of employees (thousands)	Quarterly change		Accumulated change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	741.2	–42.0	–5.4	–63.3	–7.9	–37.0	–4.8	4.0
Non-farm	17,561.8	193.3	1.1	–41.8	–0.2	–136.9	–0.8	96.0
Industry	*2,577.7*	*36.9*	*1.5*	*–45.1*	*–1.7*	*–41.2*	*–1.6*	*14.1*
Construction	*1,430.2*	*–63.8*	*–4.3*	*–142.3*	*–9.0*	*–269.5*	*–15.9*	*7.8*
Services	*13,553.9*	*220.2*	*1.7*	*145.6*	*1.1*	*173.8*	*1.3*	*74.1*
By type of employer								
Private sector	15,085.5	119.7	0.8	–154.2	–1.0	–305.8	–2.0	82.4
Public sector	3,217.5	31.6	1.0	49.0	1.5	131.9	4.3	17.6
By work situation								
Wage-earners	15,292.4	171.6	1.1	–21.8	–0.1	–71.0	–0.5	83.6
Permanent contract	*11,389.6*	*14.8*	*0.1*	*–124.3*	*–1.1*	*–151.7*	*–1.3*	*62.2*
Temporary contract	*3,902.9*	*156.9*	*4.2*	*102.6*	*2.7*	*80.8*	*2.1*	*21.3*
Non-wage-earners	3,002.2	–22.6	–0.7	–81.9	–2.7	–101.7	–3.3	16.4
Entrepreneurs with employees	*952.7*	*–21.7*	*–2.2*	*–60.5*	*–6.0*	*–84.0*	*–8.1*	*5.2*
Entrepreneurs without employees	*1,905.7*	*9.0*	*0.5*	*–27.6*	*–1.4*	*–9.3*	*–0.5*	*10.4*
Family help	*143.8*	*–9.9*	*–6.4*	*6.2*	*4.5*	*–8.4*	*–5.5*	*0.8*
Other	8.4	2.3	37.7	–1.5	–15.2	–1.2	–12.5	0.0
By time worked								
Full-time	15,715.0	129.7	0.8	–218.7	–1.4	–263.2	–1.6	85.9
Part-time	2,588.0	21.6	0.8	113.5	4.6	89.4	3.6	14.1
By sex								
Males	10,066.8	7.8	0.1	–142.9	–1.4	–267.1	–2.6	55.0
Females	8,236.2	143.5	1.8	37.7	0.5	93.3	1.1	45.0
TOTAL	18,303.0	151.3	0.8	–105.2	–0.6	–173.9	–0.9	100.0

SOURCES: National Institute of Statistics and own calculations.

The LFS confirms job creation in the second quarter but with a strongly seasonal component.

moreover within a context affected by the worsening of the sovereign debt crisis in the euro area. In these circumstances, employment stabilized in quarter-on-quarter terms with an increase of 151,400 people, reducing the year-on-year drop by four tenths of a percentage point to 0.9%. This was due to the good performance by employment in the services sector, boosted by tourism, which increased notably in this period. The secondary sector also contributed to rising employment, albeit to a lesser degree.

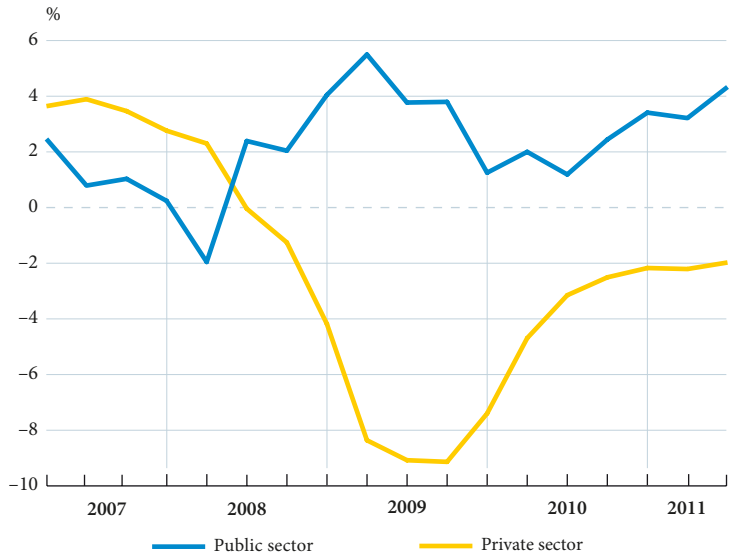
Both the LFS figures and those for registered employed, particularly in the breakdowns by sector, point to the improvement in employment in the second quarter having a markedly seasonal nature and, when this favourable context disappears, we will more than likely see falls in the total number of employed.

In the second quarter of 2011, private sector employment is down 2.0% year-on-year while public employment increases by 4.3%.

Another sign that the labour market is still very listless and will probably get worse in the third quarter is the trend in the number of employed by employee. The private sector employs the largest number of people and better reflects the dynamism of the economy, so that its trends are very important for gauging how the labour market is performing. Although employment in this sector increased during the quarter, in year-on-year terms it continued to fall significantly. On the other hand, public administrations and corporations continued to create jobs, a somewhat disconcerting fact considering the government's commitment to cut spending. In this respect, public sector employment is not expected to keep up this pace of growth over the coming months. This last factor, together with the already mentioned end of the tourist season, augurs a drop in employment for what remains of the year. The only possible means of escaping this scenario would be a very strong push from sectors oriented towards exports, which does not

THE PUBLIC SECTOR GENERATES EMPLOYMENT WHILE THE PRIVATE SECTOR CONTINUES TO DESTROY JOBS

Year-on-year change in employment estimates



SOURCES: National Institute of Statistics and own calculations.

seem very likely given the slowdown in international economic activity.

With regard to unemployment, the rise in the total number of employed in the second quarter translated into a small drop in the unemployment rate to 20.9% as the labour force also grew at the same time, this being rather unexpected given the very moderate growth rates at present. The trend in unemployment has been quite disparate among the different population segments. It should be noted that long-term unemployment will continue to rise, already accounting for 47.8% of the total unemployed. This figure is quite negative as studies show that, all things being equal, this group has a substantially lower possibility of finding employment compared with other unemployed people.

In summary, given the latest figures on the labour market and the prospect of a certain slowdown in the world's economic activity, employment is only expected to progress very gradually. Employment is very unlikely to pick up again before 2012.

Unemployment stands at 20.9%.

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Second quarter 2011

	In work force			Employed			Unemployed			Unemployment rate (%)
	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	
Andalusia	3,968	–7	–0.2	2,789	–81	–2.8	1,179	75	6.8	29.7
Aragon	652	6	1.0	538	–16	–2.8	114	22	24.0	17.4
Asturias	484	4	0.9	401	0	0.0	83	5	5.7	17.2
Balearic Islands	593	–12	–2.0	478	–7	–1.5	116	–5	–4.3	19.5
Canary Islands	1,115	38	3.6	783	24	3.1	332	15	4.6	29.8
Cantabria	277	–3	–1.1	236	–5	–2.2	41	2	5.1	14.8
Castile-Leon	1,184	–5	–0.4	991	–4	–0.4	193	–1	–0.4	16.3
Castile-La Mancha	1,003	21	2.2	772	0	0.0	231	21	10.1	23.0
Catalonia	3,826	9	0.2	3,135	–6	–0.2	691	15	2.2	18.1
Valencian Community	2,501	–24	–1.0	1,909	–14	–0.7	591	–10	–1.7	23.6
Extremadura	496	–5	–0.9	381	–7	–1.8	115	3	2.2	23.1
Galicia	1,311	16	1.2	1,091	–2	–0.2	220	18	8.8	16.8
Madrid Community	3,412	–21	–0.6	2,867	–2	–0.1	545	–19	–3.3	16.0
Murcia	734	0	–0.1	555	–24	–4.1	180	24	15.0	24.5
Navarre	310	–1	–0.4	270	–7	–2.5	40	6	16.7	12.8
Basque Country	1,052	–3	–0.3	930	–16	–1.7	122	13	11.5	11.6
La Rioja	155	–2	–1.0	130	–8	–5.9	26	7	34.0	16.5
Ceuta and Melilla	64	3	4.3	47	2	3.5	17	1	6.4	26.2
Total	**23,137**	**14**	**0.1**	**18,303**	**–174**	**–0.9**	**4,834**	**188**	**4.1**	**20.9**

SOURCE: National Institute of Statistics and own calculations.

Prices

The start of downward inflation has been confirmed

The rate of annual inflation drops by one tenth of a percentage point to 3.1% in July...

The year-on-year rate of change in the consumer price index (CPI) fell by one tenth of a percentage point to 3.1% in July. Consequently, with three consecutive months of drops, a change in the inflationary trend has been confirmed. Also confirmed is the temporary nature of some of the price rises in the second half of 2010 and early 2011, resulting from sharp increases in commodity prices and hikes in indirect taxes. In fact, the halt in rising prices in July partly reflects the absorption of the impact on prices of last July's value added tax (VAT) hike.

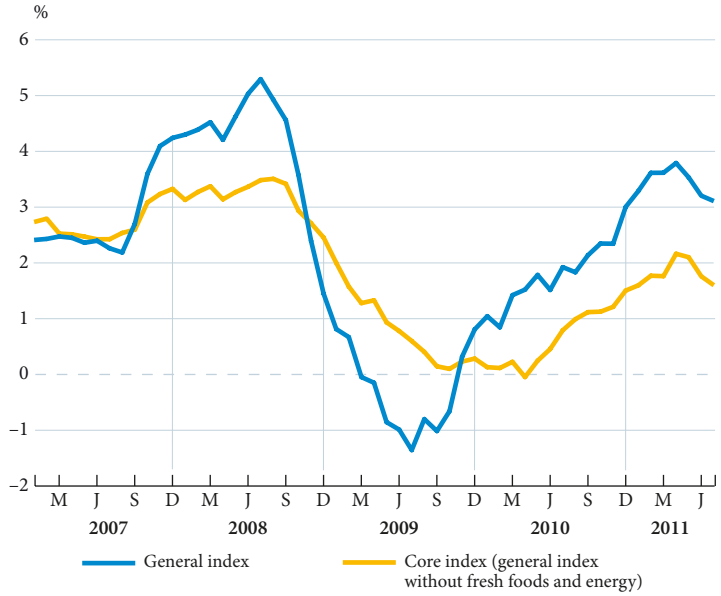
This can be seen in the drop of one tenth of a percentage point in core inflation, which excludes unprocessed food and energy products, standing at 1.6%.

...thanks to the disappearance of VAT's base effect and the intense sales period.

However, in July, and unlike the previous two months, this price moderation was not a direct consequence of the performance by fuels and oils, as the price of these rose that month. On the other hand, apart from the already mentioned base effect of VAT, the sales period also played a decisive role in pushing down inflation because it was perhaps more intense than the sales period in the previous season.

HALT IN INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

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	–0.1	1.2	3.2
July	–0.4	0.6	1.9	–0.5	0.7	3.1
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.

Inflation's downward slide will more than likely continue over the coming months as the temporary effects of indirect taxes disappear. This progressive drop might place inflation almost one point below December's level. However, for this to happen, oil prices need to fall gradually and stand at around 105 dollars/barrel by the end of the year. Nonetheless, the risks in the medium term are still likely to push inflation up, related to possibly higher than expected rises in energy prices, although it's also true that the slowdown in the global economy will reduce pressure on the price of crude.

For the moment, the contribution of fuels and oils to the general inflation rate as a whole continues to be very high, as shown in the graph on the next page. Discounting these items, inflation continued at a relatively low level with rates no higher than 2.0%. This reflects the weakness in domestic demand, partly due to the high unemployment rate that prevents any second-round effects.

High contribution of fuels to the general inflation rate.

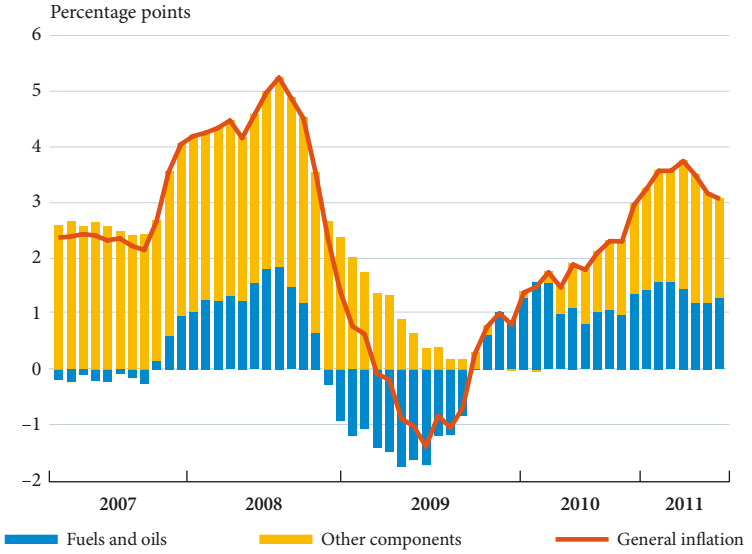
The price moderation due to a vigorous sales season has also helped to slow up inflation in the rest of the euro area, standing at 2.5% in July, two tenths of a percentage point below the rate recorded the previous month. The slowdown in Europe's economic activity is very likely to have hampered the desire to consume, something that may have played a notable role in this reversal in inflation. This change in the inflationary trend reduces the likelihood of inflation remaining too high in terms of the target set by the European Central Bank (ECB) and makes any immediate changes in the official interest rate unlikely. In fact, after two interest rate rises of 25 basis points in the months April and July, respectively, the ECB kept its reference rate at 1.50% in August. Neither does it look like raising rates again before the end of the year, especially if the slowdown in economic activity is confirmed in the euro area as a whole.

Inflation in the euro area also falls to 2.5%.

Returning to the case of Spain, the trend in prices is crucial to evaluating the

THE DIRECT CONTRIBUTION OF FUELS AND OILS TO GENERAL INFLATION IS STILL SIGNIFICANT

Contribution to the year-on-year change in CPI



SOURCES: National Institute of Statistics and own calculations.

The inflation differential compared with the euro area is now five tenths of a percentage point.

economy's prospects for recovery. On the one hand, when inflationary pressures persist due to reasons unrelated to domestic demand such as rising crude prices, household purchasing power falls and this reduces their capacity to consume. On the other hand, if Spain's inflation is much higher than the rate in the rest of the euro area, its main trading partner, then the Spanish economy loses competitiveness. One important variable to gauge the performance of the Spanish economy is therefore the differential between its inflation and that of the euro area. According to Eurostat figures, the year-on-year change in the euro area's harmonized price index stood at 2.5%, while the rate recorded in Spain was 3.0%. This shows that the inflation differential is still quite significant. However, the gap has partly narrowed thanks to the absorption of the tax changes introduced in Spain during the second quarter of 2010. This differential should also narrow if oil prices fall over the coming months, given that the trend in Spain's price index is more sensitive to these than the euro area on average.

In addition to the inflation differential compared with the rest of the countries in the euro area, another key variable to gauge the competitiveness of the Spanish economy is the producer price index, as industrial prices can affect its export capacity. After two substantial and consecutive falls in the year-on-year growth rate of this index in April and May, as a consequence of the slowdown in the prices of energy and intermediate goods, in June it remained stable at 6.7%. This rate is still quite high, above its historic average of 5.9%, calculated as from when the series started in 1975.

In summary, inflation is expected to fall slowly towards levels closer to 2%

CONSUMER PRICE INDEX BY COMPONENT GROUP

July

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2010	2011	2010	2011	2010	2011
By type of spending							
Food and non-alcoholic beverages	110.0	0.2	0.2	–0.5	1.1	–0.3	2.4
Alcoholic beverages and tobacco	144.6	0.5	2.0	8.6	–0.4	8.7	5.6
Clothing and footwear	92.8	–11.7	–12.0	–14.0	–14.6	–0.2	0.0
Housing	125.1	1.3	1.1	3.5	5.2	4.3	7.4
Furnishings and household equipment	108.2	–0.4	–0.8	–0.4	–0.2	0.7	1.1
Health	96.2	0.0	–0.1	–0.6	–0.1	–0.4	–0.7
Transport	117.9	0.7	0.6	5.9	4.4	6.2	7.7
Communications	97.6	0.5	–1.0	–0.5	–1.0	–0.6	–1.2
Recreation and culture	99.0	1.6	2.3	0.5	1.5	–0.7	–0.1
Education	117.2	0.0	0.0	0.1	0.1	2.6	2.3
Restaurants and hotels	116.0	0.9	0.7	2.0	2.0	1.2	1.6
Other goods and services	115.2	0.0	–0.2	1.9	2.0	2.4	3.0
By group							
Processed food, beverages and tobacco	116.3	0.1	0.6	0.6	1.4	0.7	3.4
Unprocessed food	109.4	0.6	0.1	0.8	–0.1	1.1	1.6
Non-food products	110.8	–0.6	–0.8	0.5	0.6	2.2	3.2
Industrial goods	107.4	–2.1	–2.2	–0.5	–0.6	3.0	4.6
Energy products	*136.2*	*1.1*	*1.6*	*9.6*	*9.9*	*11.8*	*16.0*
Fuels and oils	*133.3*	*0.9*	*1.8*	*11.8*	*10.0*	*14.9*	*16.5*
Industrial goods excluding energy products	*97.8*	*–3.3*	*–3.8*	*–4.0*	*–4.4*	*–0.1*	*0.4*
Services	114.5	0.8	0.6	1.6	1.7	1.4	1.7
Underlying inflation (**)	108.8	–0.7	–0.9	–0.5	–0.5	0.8	1.6
GENERAL INDEX	**111.7**	**–0.4**	**–0.5**	**0.6**	**0.7**	**1.9**	**3.1**

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

in December 2011 thanks to the disappearance of the base effects due to the indirect tax hikes carried out in 2010 and to a moderation in the price of crude. The latter should also help to contain production costs. Both factors will help Spain's economy to become somewhat more competitive and improve the purchasing power of households, thereby contributing positively to the recovery in economic activity.

Production costs fall in the second quarter of 2011 but are still historically high.

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											
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	2.1	11.0	1.4
December	8.5	5.3	1.3	0.7	5.7	13.5	10.4	8.1	2.5	11.8	–
2011											
January	3.7	6.8	1.5	1.0	6.8	17.3	11.7	7.3	2.0	12.2	–
February	1.3	7.6	1.9	0.9	7.9	18.5	11.1	6.2	1.4	13.1	1.8
March	–5.2	7.8	2.1	1.2	8.0	18.6	10.8	5.4	1.5	11.6	–
April	–4.7	7.3	2.5	1.3	7.1	17.1	10.0	3.9	1.6	10.3	–
May	...	6.7	2.6	1.3	6.5	15.4	8.6	3.0	0.8	8.2	...
June	...	6.7	2.6	1.2	6.4	15.4	7.7	2.3	0.6	6.8	–

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

(**) Except energy.

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

Foreign sector

Foreign demand sustains Spanish growth

The Spanish economy grew by 0.2% quarter-on-quarter between April and June 2011. As already occurred in the previous quarter, this weak recovery was mainly supported by dynamic foreign demand. The external contribution to growth was five tenths of a percentage point during this period. The strong push from tourism exports and the lethargy of domestic demand, with the consequent slowdown in imports, lie behind this good performance. All this is occurring, however, within a context of a slowdown in exports, in line with the weaker drive from world trade. Whether this positive contribution by exports continues depends on how global activity develops. In this respect, the loss of dynamism in the European economy seems to be the main risk in the short term.

The European Union is still the main destination for Spanish exports, accounting for 66.5% of the total in the first half of 2011. An analysis

Spain's recovery is being kept going by the foreign sector.

FOREIGN TRADE

January-June 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	27,551	29.0	21.1	6,326	72.9	5.9	–21,225	23.0
Consumer goods	29,354	1.3	22.5	35,196	13.4	33.1	5,842	119.9
Food	*7,665*	*6.7*	*5.9*	*13,108*	*10.0*	*12.3*	*5,443*	*171.0*
Non-foods	*21,689*	*–0.5*	*16.6*	*22,088*	*15.5*	*20.8*	*399*	*101.8*
Capital goods	8,495	–1.2	6.5	9,289	20.6	8.7	794	109.3
Non-energy intermediate goods	65,030	13.9	49.9	55,553	17.3	52.2	–9,477	85.4
By geographical area								
European Union	69,107	6.3	53.0	70,695	14.9	66.5	1,587	102.3
Euro area	*56,109*	*7.6*	*43.0*	*56,836*	*12.0*	*53.4*	*726*	*101.3*
Other countries	61,322	20.2	47.0	35,668	26.2	33.5	–25,654	58.2
Russia	*4,760*	*68.1*	*3.6*	*1,161*	*42.7*	*1.1*	*–3,599*	*24.4*
United States	*5,295*	*18.9*	*4.1*	*4,244*	*40.8*	*4.0*	*–1,051*	*80.2*
Japan	*1,659*	*–10.3*	*1.3*	*878*	*25.0*	*0.8*	*–781*	*52.9*
Latin America	*8,212*	*23.8*	*6.3*	*5,979*	*31.0*	*5.6*	*–2,234*	*72.8*
OPEC	*13,349*	*21.9*	*10.2*	*3,958*	*23.5*	*3.7*	*–9,391*	*29.7*
Rest	*28,047*	*15.5*	*21.5*	*19,447*	*21.8*	*18.3*	*–8,600*	*69.3*
TOTAL	**130,430**	**12.4**	**100.0**	**106,363**	**18.5**	**100.0**	**–24,067**	**81.5**

SOURCES: Ministry of the Economy and own calculations.

The cumulative trade deficit for the last year falls to 4.1% year-on-year in June...

of the cumulative data for the last twelve months shows that, in this market, the trade balance posted its first surplus since records began. This helped to reduce the total trade deficit accumulated over this period to 50.1 billion euros, 4.1% lower than the same month a year ago. This adjustment is due to exports being more dynamic than imports since July 2010, with year-on-year rises of 18.5% and 13.2%, respectively.

The differential between both trade flows is even greater if we look at the real data. The sharp rise in oil prices pushed the energy deficit over the last twelve months up to nearly 39 billion euros. However, as from April, the volume of energy goods imported started to shrink gradually. The maladjustment of the energy balance is expected to ease as from the fourth quarter, once the price differential compared with a year ago starts to narrow.

...due to the good performance by the non-energy deficit, which speeded up its rate of decrease.

With regard to the rest of the products, the cumulative non-energy deficit over the last year speeded up its rate of decrease in June with a fall of 44.7% year-on-year. Of note is the good performance by consumer durables and the automobile industry. Meanwhile, the food alert that erupted in the European Union dealt a heavy blow to food exports. In June, these posted a fall in the trade surplus of 91.1%.

In the future, the slowdown in growth in the main European economies will also slow up the correction in the trade imbalance during the third quarter. However, as from October, less pressure from the energy component is expected to boost the pace of adjustment again.

The current deficit falls to 29.2% in May, boosted by the services balance.

The current deficit falls in March

With regard to the current account balance, May's figures show a 29.2% decrease in the deficit year-on-year. As a consequence, the cumulative imbalance for the last twelve months speeded up its decrease, down to 46.5 billion euros. This improvement was almost widespread, the good performance by the services balance undoubtedly becoming the main factor behind this reduction in the current deficit.

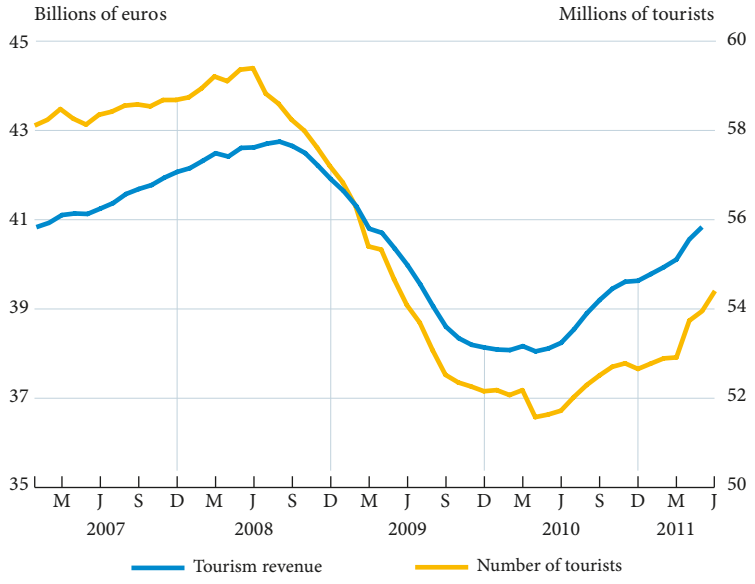
In fact, the surplus of the services balance accumulated since June 2010 was 4.5 billion euros higher than the figure twelve months ago. This improvement is due to both the increase in tourism revenue and the rest of services. With regard to the former, the graph shows that visits by foreign tourists to Spain picked up even faster during the second quarter of 2011. This upswing was the result of the favourable economic situation in European countries and the geopolitical instability in North Africa. Should this trend continue, it would mean more than 56 million tourist visits.

Only the income balance posted an increase in the deficit during this period. This was due to the higher cost of financing Spanish debt. In this respect, the recent tensions in government bond markets will remain the same in the short term.

In fact, the uncertainty in financing markets has been reflected in the fall of direct foreign investment in Spain in May and the net exit of portfolio investment. The main sources of financing this month were short-term investment and the European Central Bank.

RISING TOURIST VISITS BOOST THE CURRENT BALANCE

Number of tourists and tourism revenue accumulated over the last twelve months



SOURCES: Ministry of the Economy and own calculations.

BALANCE OF PAYMENTS

May 2011

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change Absolute	Annual change %
Current account balance					
Trade balance	–18,148	–7.6	–45,645	542	–1.2
Services					
Tourism	*9,783*	*14.7*	*28,209*	*2,289*	*8.8*
Other services	*404*	–	*1,628*	*2,193*	–
Total	10,188	25.0	29,837	4,482	17.7
Income	–11,149	20.6	–23,842	–106	0.4
Transfers	–4,961	–5.6	–6,819	1,592	–18.9
Total	**–24,071**	**–7.4**	**–46,469**	**6,510**	**–12.3**
Capital account	**2,404**	**–31.0**	**5,215**	**–427**	**–7.6**
Financial balance					
Direct investment	–8,171	–	–13,205	–28,407	–
Portfolio investment	16,758	–	57,272	27,859	94.7
Other investment	12,403	–	16,021	55,432	–
Total	**20,989**	**–**	**60,088**	**54,884**	**–**
Errors and omissions	–1,173	–64.4	–330	7,495	–95.8
Change in assets of Bank of Spain	1,850	–94.9	–18,505	–68,206	–

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

Public sector

Uncertainty reigns supreme in government bond markets

Intervention by the ECB temporarily neutralizes the sharp upswing in Spain's risk premium.

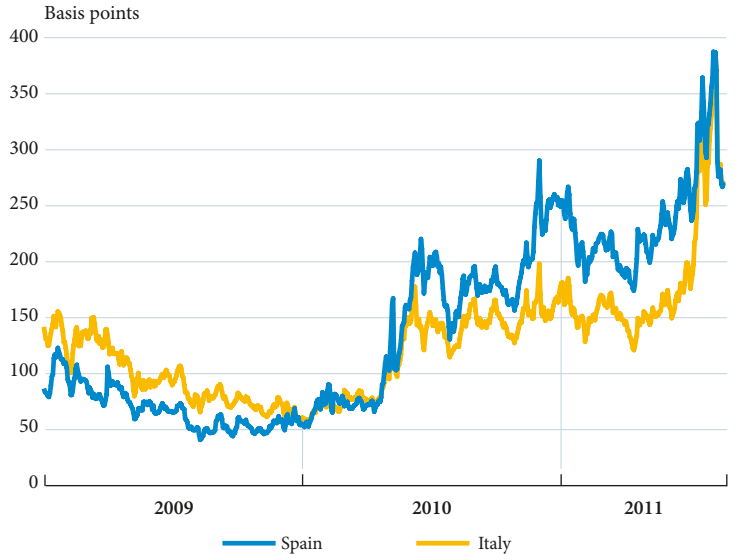
In six months, the average interest rate for debt rises by two tenths of a percentage point to 3.9%.

Public debt has monopolized the front pages of the key economic press during the summer. Doubts regarding the possible restructuring of Greek debt and the delay in approving this country's second bail-out plan spread to the sovereign debt markets. Moreover, the measures announced in July by the Eurogroup were not enough to calm the tension intensified by the slowdown in Europe's economic growth. Spanish and Italian bonds were affected by a sharp upswing in their risk premium. Intervention by the European Central Bank (ECB) in mid-August by purchasing debt helped to stabilized sovereign debt yields. However, this support looks like being temporary. It's still fundamental for measures to be adopted at a European and national level to dispel uncertainty in the debt markets.

In fact, Spain's risk premium increased to 400 basis points, a new high since the euro was adopted. Fast action by the ECB neutralized this upswing, reducing the spread to 270 basis points. Nevertheless, the higher cost of issuing debt demanded over the last few months continues to push the average interest rate up for debt in circulation. This stood at 3.9% in June 2011, two tenths of a percentage point above the figure six months ago. This

INTERVENTION BY THE ECB NEUTRALIZES THE UPSWING IN ITALIAN AND SPANISH RISK PREMIA

Spread between yields of ten-year bonds with the German bund



SOURCES: Thompson Reuters Datastream and own calculations.

trend will continue, approaching the 4.6% recorded in the first decade of the century.

This higher sovereign risk does not only affect Spain. Italy, as well as other countries such as France and Belgium, recorded a significant deterioration in their risk premia. Given this situation, several of them have adopted new fiscal adjustment measures to calm the markets anxious about the state of their public accounts.

In this respect, the Spanish government agreed to bring forward the payment of Corporate Tax for large firms and the rationalization of pharmaceutical expenditure. With both measures, the Ministry of the Treasury predicts that close to 5 billion will be gained this year, between additional revenue and cuts in spending. In the case of Corporate Tax, however, this will be in exchange for lower revenue in 2012.

Procedures have also been speeded up to privatize the airports of Madrid and Barcelona by November, as well as 30% of the National Lottery. According to the Ministry, all these privatizations will lead to an additional 12 billion euros for the public sector coffers. On the other hand, it also approved a six-month extension to the 400 euros received by the unemployed that have run out of contributions, slightly increasing public expenditure by about 240 million euros. The tax rate for buying new housing was also halved, from 8% to 4%, until the end of 2011.

These measures attempt to help meet the deficit target contained in the Stability Plan, namely 6.0% of GDP for 2011. The most recent monthly figures regarding the central government's actual budget seem to be largely on target.

The cumulative cash deficit for the first half of the year was 23.5 billion euros, 23.7% lower than the same period in 2010. Analyzing aggregate cash flows of the central government and the autonomous communities, we can see an increase in tax revenue of 4.2% year-on-year for this period. Of note is the good performance by personal income tax (IRPF) and value added tax (VAT), up 6.5% and 9.4% year-on-year respectively.

The new measures approved in August will lead to savings of 5 billion euros.

In the case of payments, the government's austerity measures helped to squeeze real investment by 26.8% compared with the first half of 2010. Public employee wages also fell by 5.2% year-on-year. Should this trend continue for the rest of the year, the central government will reach its cash deficit target for 2011 of 44 billion euros.

However, meeting the targets set by the Stability Plan is not without its risks. There are doubts regarding the speed of recovery of the Spanish economy and of the autonomous communities deviating from their target deficits. The publication of the latter's public accounts for the second quarter at the end of August will provide relevant information on this area.

The cash deficit falls by 23.7% year-on-year in the first half of the year.

In conclusion, tensions remain in the European government bond market, highlighting the fact that the measures taken to date have not had the desired effect. Measures are still required to restore confidence in the solvency of public accounts, in the short and also in the medium and long term. Particularly important in the long term, at a national level, is the introduction of a new rule in the Constitution that limits structural deficit to 0.4% of GDP. This directive is in line with the proposals made by the French and German leaders.

A new rule is introduced that links the increase in public expenditure to medium-term growth in the economy.

Savings and financing

The banking sector is strengthened by the stress tests

The process of recapitalizing the Spanish banking system finalizes in September.

The financial sector is facing the start of the academic year with renewed confidence. On the one hand, it got good marks in the stress tests coordinated by the European Banking Authority (EBA). Moreover, in September the period ends for Spain's banks to achieve the new minimum capital requirements demanded by the banking regulator. Behind this lie six months of sweeping transformations, focusing principally on the savings bank sector. Lastly, only four of the thirteen banks that needed additional capital in March have asked for public aid to recapitalize. This implies an improvement in the transparency and solvency of Spain's banking sector. However, tensions in financing markets and weak activity are creating demanding challenges in the short and medium term. All this within a context of private sector deleveraging which will keep credit on a downward path.

Financial institutions resort more to the European Central Bank in July.

In fact, the solvency of Spain's banking system was strengthened after the results were published of the stress tests on Europe's banks. There are essentially three reasons for this. Firstly, transparency. The analysis of Spain's banking sector included all listed savings banks and banks, accounting for more than 50% of the total assets of the system required by the EBA. Secondly, greater severity. The macroeconomic scenarios included in the exercise were tougher for Spain and were less likely to occur than in other countries. Lastly, additional capital. The generic provisions of Spain's financial institutions, which help to absorb losses, were not included within the definition of capital used in the tests. The publication of the results revealed five Spanish banks that had not met the required level of minimum capital, a figure that falls to zero when generic provisions and mandatory convertible bonds are added to the capital.

This good result should help to reduce uncertainty regarding the solvency of the Spanish banking system. However, after the failure to detect the Irish case last year, markets have interpreted this year's results with a great deal of scepticism. Moreover, turbulence in the sovereign debt markets has kept the cost of bank financing high. Given these difficulties, the sector's dependence on the European Central Bank's resources increased again in July to more than 52 billion euros. Although this figure is still far from the peak reached a year ago, namely 130.2 billion euros, the inaccessibility of wholesale markets points to this trend continuing over the next few months. According to the maturity schedule for bank debt, the sector's refinancing needs will increase considerably in 2012 and it is therefore vital for tension in these markets to ease.

Doubtful loans fall by seven basis points to 6.42%.

Undoubtedly, an upswing in the pace of growth of the Spanish economy would help towards achieving this goal. To date, the weak dynamism of the economy is not enough to create jobs. Within this context, the doubtful debt rate was 6.42% in July. In spite of a slight reduction,

down 7 basis points compared with the previous month, this figure is still high and reduces the quality of the credit portfolio of financial institutions.

But the tightening up of banks' financing terms was not passed on to retail business in June. After several months of rises, the interest rate for new credit operations was down on the previous month. In the case of households, the drop of 5 basis points can be explained by the sharp fall in the cost of loans for consumption and other purposes. This offsets the rise in rates to acquire housing. This drop was even bigger for firms, namely 16 basis points.

This performance by interest rates coincides with the findings of the Bank Loan Survey for July. As predicted in April, the criteria for granting loans to firms and households for consumption and other purposes remained stable during the second quarter of 2011. Only credit to acquire housing got slightly tougher during this period. The expectations of participant institutions point to these credit conditions continuing over the next few months.

The criteria to grant loans to firms and for household consumption remain the same in the second quarter.

Nevertheless, the number of new loans granted fell by 5.7% in June compared with the same month last year. Of note is the sharp fall in credit to households, namely 30.1% in the same period. As a consequence, private sector financing shrank at a faster rate, with a 1.1% drop year-on-year. Private sector deleveraging in the first half of 2011 was the main reason. Non-financial firms and households reduced their stock of debt by 34.4 billion euros, although this phenomenon was offset by the rise in indebtedness of the public sector, almost 63 billion euros between January and June 2011.

Private sector deleveraging will gradually correct the excessive debt accumulated during the last expansionary period.

Private sector debt continues to fall in the second quarter.

FINANCING OF NON-FINANCIAL SECTORS (1)

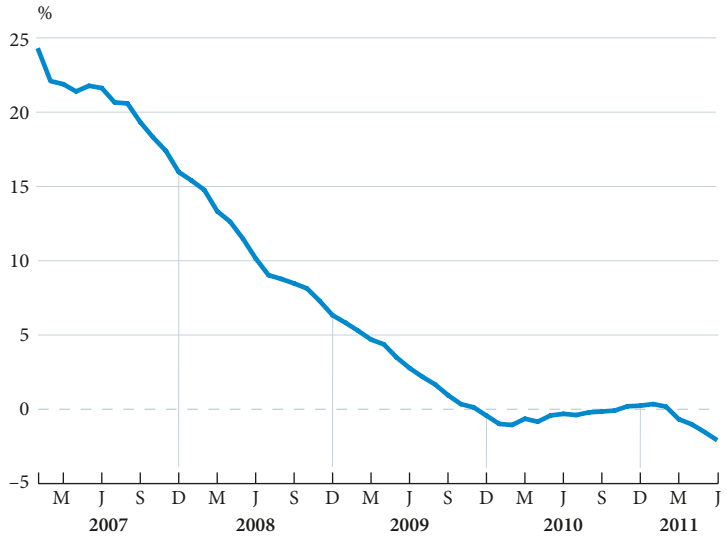
June 2011

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,177,571	–34,443	–1.1	75.6
Non-financial corporations	1,290,608	–22,842	–0.6	44.8
Resident credit institution loans (3)	*870,711*	*–26,764*	*–2.7*	*30.2*
Securities other than shares	*67,139*	*2,703*	*5.2*	*2.3*
External loans	*352,759*	*1,219*	*3.9*	*12.3*
Households (4)	886,963	–11,601	–1.9	30.8
Housing loans (3)	*671,042*	*–8,916*	*–1.1*	*23.3*
Other (3)	*212,531*	*–2,754*	*–4.3*	*7.4*
External loans	*3,389*	*69*	*6.6*	*0.1*
General government (5)	701,502	62,903	13.7	24.4
TOTAL	**2,879,072**	**28,460**	**2.7**	**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.

PRIVATE SECTOR FINANCING SPEEDS UP ITS RATE OF DECLINE

Year-on-year percentage change



SOURCE: Bank of Spain.

However, as indicated by the International Monetary Fund in its Annual Report on the Spanish economy, this process will be slow. Spanish private debt, measured as a percentage of the gross domestic product, is gradually converging towards levels similar to those in the rest of Europe.

The new decree will slow up the rise in interest rates

In the first quarter of 2011, the household savings rate maintained its downward slide started a year ago, reaching 12.2% of disposable income in cumulative terms for the four quarters. This figure is moving away from the peak reached in 2009 when the rise in household savings was more than 18% due to the negative economic situation. Throughout this year, the savings rate is expected to approach the levels recorded before the recession, slightly above 11%.

Growth in bank liabilities in the hands of households and firms continues to slow up.

The year-on-year growth of bank liabilities in the hands of households and firms slowed up again in June, standing at 1.3%. This slowdown, widespread among the different liability instruments, took place within a period of stagnation in interest rates. Only the yield on term deposits posted a significant increase in June, namely 8 basis points compared with the previous month.

In this respect, turbulence in the sovereign debt markets during the summer months increased the need to attract customer deposits and this should push up interest rates. However, the approval, on 4 July, of the decree limiting interest rates offered by deposits could put a brake on this rise. This measure might lead to bank deposits fleeing towards other financial instruments with higher yields, such as sovereign debt. This scenario also benefits investment funds, once volatility returns to more moderate levels. For the moment, however, July's figures recorded net withdrawals totalling 570 million euros.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

June 2011

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	271,004	9,238	3.5	5,642	2.1	19.0
Savings deposits	208,284	–3,003	–1.4	–5,494	–2.6	14.6
Term deposits	732,412	–11,237	–1.5	18,018	2.5	51.4
Deposits in foreign currency	20,491	1,108	5.7	–1,934	–8.6	1.4
Total deposits	**1,232,191**	**–3,894**	**–0.3**	**16,233**	**1.3**	**86.4**
Other liabilities (*)	**193,305**	**–9,706**	**–4.8**	**–6,932**	**–3.5**	**13.6**
TOTAL	**1,425,496**	**–13,600**	**–0.9**	**9,301**	**0.7**	**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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