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THE SPANISH ECONOMY

Monthly Report

SPAIN'S EXTERNAL SECTOR

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2010	2011	2012	2011 1Q	2011 2Q	2011 3Q	2011 4Q	2012 1Q	2012 2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	3.0	1.7	2.1	2.2	1.6	1.5	1.6	2.0	2.1
Japan	4.5	–0.7	2.1	–0.1	–1.7	–0.6	–0.5	2.7	3.1
United Kingdom	2.1	0.7	0.6	1.5	0.4	0.3	0.5	–0.1	0.6
Euro area	1.8	1.5	–0.5	2.4	1.6	1.3	0.7	–0.1	–0.6
Germany	*3.6*	*3.1*	*0.8*	*4.6*	*2.9*	*2.7*	*2.0*	*1.2*	*1.0*
France	*1.6*	*1.7*	*0.1*	*2.4*	*1.7*	*1.5*	*1.2*	*0.3*	*0.3*
Consumer prices									
United States	1.6	3.1	2.1	2.1	3.3	3.8	3.3	2.8	1.9
Japan	–0.7	–0.3	0.2	–0.6	–0.4	0.2	–0.3	0.3	0.3
United Kingdom	3.3	4.5	2.7	4.1	4.4	4.7	4.7	3.5	2.9
Euro area	1.6	2.7	2.2	2.5	2.8	2.7	2.9	2.7	2.4
Germany	*1.1*	*2.3*	*1.8*	*2.1*	*2.3*	*2.4*	*2.4*	*2.1*	*1.9*
France	*1.5*	*2.1*	*2.1*	*1.8*	*2.1*	*2.1*	*2.4*	*2.3*	*2.0*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	0.7	–0.1	–1.3	0.4	–0.3	0.5	–1.1	–0.6	–1.4
Government consumption	0.2	–2.2	–6.3	0.6	–2.1	–3.6	–3.6	–5.2	–5.7
Gross fixed capital formation	–6.2	–5.1	–9.2	–4.9	–5.4	–4.0	–6.2	–8.2	–9.3
Machinery and capital equipment	*5.5*	*1.6*	*–7.6*	*5.7*	*1.1*	*2.2*	*–2.7*	*–6.0*	*–6.3*
Construction	*–10.1*	*–8.1*	*–10.9*	*–9.2*	*–8.1*	*–7.0*	*–8.2*	*–10.2*	*–11.7*
Domestic demand (contribution to GDP growth)	–1.0	–1.8	–4.0	–0.8	–1.9	–1.4	–2.9	–3.3	–4.0
Exports of goods and services	13.5	9.1	0.5	13.1	8.8	9.2	5.2	2.2	1.0
Imports of goods and services	8.9	–0.1	–7.4	6.0	–1.3	0.9	–5.9	–7.2	–7.4
Gross domestic product	**–0.1**	**0.7**	**–1.5**	**0.9**	**0.8**	**0.8**	**0.3**	**–0.4**	**–1.3**
Other variables									
Employment	–2.6	–2.0	–4.3	–1.6	–1.3	–2.0	–3.3	–3.8	–4.9
Unemployment (% labour force)	20.1	21.6	24.7	21.3	20.9	21.5	22.9	24.4	24.6
Consumer price index	1.8	3.2	1.8	3.5	3.5	3.1	2.8	2.0	2.0
Unit labour costs	–2.6	–1.9	0.1	–2.0	–1.7	–1.5	–2.5	–2.5	–3.0
Current account balance (% GDP)	–4.5	–3.9	–2.4	–6.6	–3.2	–2.9	–2.8	–5.5	–1.7
Net lending or net borrowing rest of the world (% GDP)	–4.0	–3.4	–1.9	–6.1	–2.7	–2.4	–2.3	–5.3	–1.1
General government financial balance (% GDP)	–9.3	–8.5	–6.4	–5.4	–9.8	–6.2	–12.7	–5.5	
FINANCIAL MARKETS			Forecast						Forecast
International interest rates									
Federal Funds	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	1.0	1.3	0.9	1.0	1.3	1.5	1.3	1.0	1.0
10-year US bonds	3.2	2.8	1.8	3.4	3.2	2.4	2.0	2.0	1.8
10-year German bonds	2.8	2.6	1.7	3.2	3.1	2.3	2.0	1.9	1.5
Exchange rate									
$/Euro	1.33	1.39	1.24	1.37	1.44	1.41	1.35	1.31	1.28

Contents

The external sector, key to the recovery

Throughout the boom years that preceded the current economic crisis, the Spanish economy witnessed an extraordinary increase in its current account deficit. As from the end of the 1990s, the surplus gave way to increasing deficits, reaching a peak of 10% of gross domestic product (GDP) in 2007. Spain thereby became the second country in the world with the greatest external imbalance in absolute terms, only exceeded by the United States. The economic recession has given rise to an abrupt and substantial correction in this deficit. Last year it fell to 3.5% of GDP and this year we expect it to be close to 2%. What has changed?

Firstly, the slump in imports. The extreme weakness of domestic demand, both for consumption and particularly for investment, has brought about almost a complete halt in the purchase of goods from abroad. Secondly, we should also note the good performance by exports. This is due both to the improved real exchange rate, a relevant indicator of trends in external competitiveness, and the efforts being made by firms to diversify towards more dynamic markets with great economic potential. The real exchange rate grew by 5% between 2008 and 2011 but still has a long way to go before the current weaknesses can be corrected. Lastly, the improved surplus in the services balance has also contributed to the compensation provided by the external sector, both by exporting tourism services and also corporate services.

Maintaining this push from exports will be key to exiting the crisis. Within a context of macroeconomic adjustments and the deleveraging of households and firms, good performance on the part of exports of goods and services is crucial for growth in GDP and employment. To do so, exports need to grow at approximately 7% annually. As Spain can't resort to exchange rate, monetary or trade policies, it is vital to encourage the structural reforms required to improve competitiveness via flexibility, innovation and human capital.

This is a difficult but attainable feat. We must not forget that, to date, Spanish exports have performed better in world trade as a whole than the euro area on average. However, Spain's share is still very small considering the size of its economy, so the potential level is significantly higher than the current figure.

It is also fundamental to improve the external sector in order to break the vicious circle that has emerged between liquidity problems and doubts regarding the country's solvency. Successive current deficits have been financed via growing external debt. At the end of 2011, this debt totalled the equivalent of 221% of GDP. The net debt, i.e. deducting foreign assets, was 92% of GDP. This is one of the highest debtor positions in the world in terms of GDP, only surpassed in the euro area by Ireland and Portugal. Containing the current deficit has helped to stabilize the net debt over the last few years but, in order to reduce it, substantial surpluses will be required in the trade of goods and services over the coming years. Only in this way will we be able to reduce the debt, contain the cost of financing it and recoup the confidence lost among international investors.

EXECUTIVE SUMMARY

The euro crisis is jeopardizing the global recovery

Global growth loses steam.

International economic activity is showing some weakness in these central months of the year. Reports on the manufacturing sector highlight that growth in the United States, China and other emerging countries is more fragile than expected, while the euro area is still under the effects of the recession. One sign of this cooling off in expectations is the fall in the price of a barrel of crude to 90 dollars, almost 30% lower than the annual peak reached in March. However, the main concern is still the euro crisis, both with regard to growth prospects and also sovereign debt tensions, the impact of fiscal adjustment and the capacity of governments and European institutions to arrive at effective solutions. Within this context, investors have reacted with differing degrees of sensitivity, in general opting for caution.

The US recovery weakens and the Fed forces more relaxation in interest rates.

With regard to the US economy, this is on its way to a weaker scenario than the consensus had expected at the end of April, after the publication of the gross domestic product (GDP) flash estimate for the first quarter. The main reason for this cooling off lies in the loss of dynamism in the labour market's recovery. A weaker labour market inevitably leads to a standstill in household income, which ends up affecting private spending on consumer goods, the driving force behind activity. However, our forecast for the GDP flash estimate for the whole of 2012 remains close to 2% as the improvement in the housing market and particularly the drop in oil prices could offset a large part of these weaknesses. The risk, nevertheless, is of worse figures as the euro area crisis and the gradual slowdown in some emerging countries could continue for some time yet.

The Federal Reserve (Fed), the central bank of the United States, recognizes that the economy has become weaker and has lowered its growth forecasts. As a consequence, the Fed has decided to keep interest rates within the range of 0%-0.25% and, moreover, to extend the period of application for the so-called «Operation Twist» up to the end of 2012. With this programme, which was originally planned to end in June, the authority aims to continue extending the average duration of its debt portfolio and reduce long-term interest rates even further, if necessary. By buying long-term US Treasury bonds and selling those with a maturity of less than three years, the Fed aims to make the financing conditions more flexible for the private sector and dispel any deflationary threat to the economy.

China, like other emerging countries, is applying stimulus measures to contain the slowdown in activity.

Indicators point to a slowdown in activity for China. However, May's figures were better than had been expected by analysts and are in line with a soft landing, in accordance with our growth forecast of around 8% in 2012. Moreover, the inflation figures, below the government's target of 4%, have allowed it to continue with its expansionary policies. Along the same lines is the reduction in the official interest rate of 25 basis points, down to 6.31%, at the beginning of June, and the cut of 50 basis points in the cash reserve ratio mid-May. For the remainder of the year, we predict further reductions in the cash reserve ratio of between 100 and 150 basis points, as well as a further cut in interest rates at the beginning of the third quarter.

With regard to Brazil, the growth figures for the first quarter were a disappointment, with GDP growing by a mere 0.2% compared with the previous quarter, which represents a meagre advance of 0.8% in year-on-year terms. The economy is immersed in very low growth without there being any sign of the upswing it so desires, at least for the time being. Given this evidence, the Brazilian authorities quickly announced further measures to boost their economy, including greater credit facilities, barriers to imports and a new line of credit available to the states. However, the Mexican economy has remained vigorous thanks to renewed strength in domestic expenditure in an environment of price moderation.

But the main problem worrying the world economy is still the situation of the euro area. Investor uncertainty seems to be unjustified. The good news from the Greek elections has hardly made any impact on this lack of confidence. Prior to the elections, most people thought that Greece would leave the euro area. But the outcome has been a tripartite government between the conservatives of the New Democracy, the socialists of Pasok and the Democratic Left party, all of them pro-Europe, it having been announced that the European Union might allow Greece more time to reduce its fiscal deficit.

Neither did the announcement of financial aid for Spain of up to 100 billion euros to recapitalize its banking system serve to calm the markets. The punishment of sovereign debt of countries on the periphery of Europe, and specifically Spain, has not been contained. Another factor leading to this penalization are the credit downgrades applied by the main ratings agencies to the Kingdom of Spain as well as a large part of its national financial institutions. Yield on Spanish 10-year bonds therefore broke through the barrier of 7% and stayed there for various sessions, and their spread with the German bund once again exceeded 500 basis points, the highest since the country joined the euro. Under these conditions it is obvious that non-official external financing, both for the public and private sector, has fallen to minimal levels.

The euro area crisis becomes the main problem for the world economy.

The summit held by the European Council at end of June is a new opportunity to adopt viable solutions to put a stop to the current regression. This month, Cyprus has announced its request for emergency funding from European bail-out funds, thereby joining Greece, Ireland, Portugal and Spain. With the perception that the markets could cause solvency problems in Spain and with Italy in the firing line, ultimately what is at stake is the very survival of the single currency, a key pillar to the current construction of Europe.

Neither the acceptable outcome of the Greek elections nor the announcement of a financial bail-out for Spain dispels the uncertainty.

The heads of government and state that are meeting in Brussels will propose steps towards closer financial, fiscal and budgetary integration, including some kind of supranational bank supervision, a common mechanism to guarantee deposits and resolve bank crises and a communitarization of sovereign debt. But these reforms require a lengthy schedule and very solid political commitment, making them medium or long-term solutions. However, market uncertainty demands fast, decisive solutions to stop the situation from deteriorating to such an extent that it becomes irreversible, aimed at hiving off sovereign risk from banks or at the financing capacity of bail-out funds. At the time of writing this edition, the initial news points towards significant progress in this direction.

Another measure being considered by European leaders is the launch of policies aimed at growth, with sizeable

Will the European Council manage to achieve effective solutions?

The Spanish economy falls further into recession.

investment plans. The fact is that, whereas the euro area economy had zero growth during the first quarter of the year, it may have shrunk considerably in the second quarter, according to leading economic indicators. This constitutes another source of pressure on the bailed-out economies, which have less room to expand in external markets.

In the case of the Spanish economy, its recessionary profile is similar, insofar as it is estimated that activity has fallen more in the second quarter than in the first (–0.3% quarter-on-quarter). On the supply side, in addition to the slump in the construction and real estate sector, manufacturing is still contracting, while the public sector is cutting spending, beset by demands to reduce its deficit.

Widespread economic weakness and constant deterioration in the labour market.

Most indicators, both for supply and demand, have remained negative and are worse than in previous months. This is the case of the consumer confidence index and the construction confidence index, as in May both fell by 5 and 6 points respectively compared with the previous month. In addition to consumer confidence falling to the level of spring 2009 is the drop in sales of retail and consumer goods, down in April by 9.5% year-on-year. With regard to the foreign sector, the latest figures for April reveal that exports dropped by 0.8%, although May's external tourism indicators were positive. Economic weakness is a characteristic shared with most of Europe, so exports to our main trading partner fell by 4.6%.

The effects of the recession can be clearly seen in the labour market. Although the number of people registered as employed and unemployed in May showed some improvement, this was thanks to the seasonal nature of the period as, once the figures had been adjusted, the result was a substantial deterioration in the variables. The adjustment in the labour market is being carried out mainly via the number of employees although wages are also responding to the weaker economic activity, albeit to a lesser extent. The quarterly labour cost survey for the first quarter of 2012 shows greater wage containment with wage costs per worker rising by 1.2% year-on-year, a rate slightly slower than the one recorded the previous quarter. Similarly, wage moderation helped labour costs per worker to slow up considerably, with a year-on-year growth rate of 1.1%.

Non-compliance of the target public deficit demands an ambitious political response.

In turn, the decline in domestic demand is leading to a larger drop in tax revenue than expected, jeopardizing the capacity to achieve the public deficit target accepted for this year, namely 5.3% of GDP. In spite of the reforms undertaken to date and the effort being made by public administrations to tackle budget deviations, it is true that, as stated by the preliminary report by the International Monetary Fund, additional measures must be urgently taken. These must be capable to tackling the challenges of a double-dip recession, unacceptably high unemployment, a public debt that is rocketing up to unsustainable levels and a financial sector that needs to recapitalize some of its elements. The next few weeks will be decisive in this respect, both in terms of possible new packages of economic policy and also the response and effectiveness of European institutions.

28 June 2012

CHRONOLOGY

2011

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

2012

January	**25**	Social agents sign a **wage moderation agreement** valid from 2012 to 2014.
February	**3**	The government approves a Decree-Law to **sort out the financial sector**.
	10	The government approves a Decree-Law of urgent measures to **reform the labour market.**
March	**2**	Twenty-five European Union countries sign the **Treaty on Stability, Coordination and Governance** to strengthen fiscal discipline.
	14	The Eurogroup approves the financing of **Greece's second adjustment programme**.
	30	The government approves the proposal for its **2012 Budget**, which contains a total adjustment of 27.3 billion euros.
April	**2**	The government approves a **pharmaceutical co-payment scheme for pensioners and a rise in university** fees to cut 10 billion euros from healthcare and education.
May	**11**	The government agrees to **raise provisions for banks' non-problematic real estate assets** to ensure the financial system is robust.
June	**25**	The government asks **the Eurogroup for financial aid for Spanish banks** after independent auditors estimate capital requirements of up to 62 billion euros in the most adverse scenario. **Cyprus asks the euro area for financial** aid and, two days later, also asks for aid from the International Monetary Fund.
	29	The European Council and the Eurogroup adopt relevant measures to **redirect the euro crisis**.

AGENDA

July

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

August

2 Registration with Social Security and registered unemployment (July).
Governing Council European Central Bank.
8 Industrial production index (June).
14 CPI (July). EU GDP flash estimate (second quarter).
16 Foreign trade (June).
EU HICP (July).
24 Producer prices (July).
28 Quarterly national accounts (second quarter).
30 Flash CPI (August).
31 Government revenue and expenditure (July).
Balance of payments (June).

INTERNATIONAL REVIEW

The United States' expansion loses steam due to the weak recovery in employment.

The United States: diminishing growth

The US economy is leaving behind its vigorous start to the year and is on way to a weaker scenario than the consensus had expected at the end of April, after the publication of the gross domestic product (GDP) flash estimate for the first quarter. The main reason for this weaker tone lies in the loss of dynamism in the labour market's recovery. A weaker labour market inevitably leads to a standstill in household income, which therefore ends up affecting private spending on consumer goods, this being the driving force behind activity, especially considering its strong contribution to growth in the first quarter. However, our forecast for the GDP flash estimate for the whole of 2012 remains close to 2.0% as the improvement in the housing market and particularly the drop in oil prices could offset a large part of these weaknesses. The risk, nevertheless, is of worse figures as the euro area crisis continues to encumber the US recovery and oil prices are still subject to notable uncertainty.

Low growth in household income and indebtedness affect the recovery.

Private consumption is unlikely to maintain its rate in the first quarter. Household disposable income grew in real terms by 0.9% year-on-year in April, far below the rise of 2.1% occurring in private consumption. With income

UNITED STATES: MAIN ECONOMIC INDICATORS

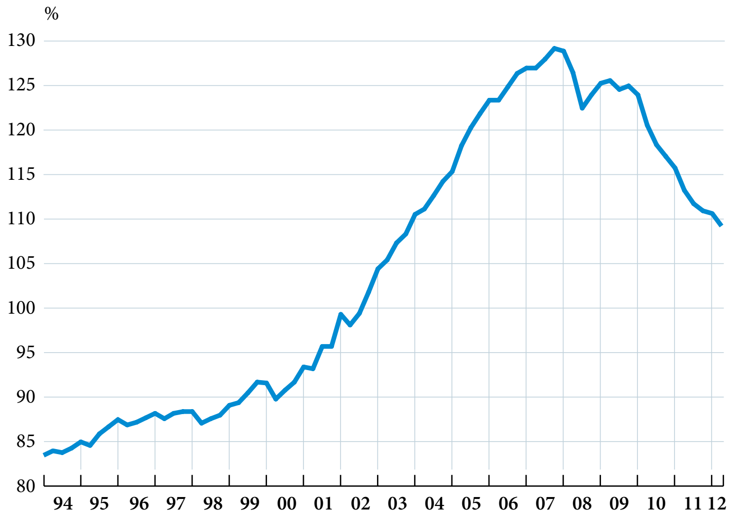
Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012			
			2Q	3Q	4Q	1Q	April	May	June
Real GDP	3.0	1.7	1.6	1.5	1.6	2.0	–	...	–
Retail sales	5.5	8.0	8.0	8.5	7.4	6.6	5.6	5.3	...
Consumer confidence (1)	54.5	58.1	61.8	50.3	53.6	67.5	68.7	64.9	...
Industrial production	5.4	4.1	3.6	3.3	4.1	4.4	5.1	4.7	...
Manufacturing (ISM) (1)	57.3	55.2	56.6	52.1	52.4	53.3	54.8	53.5	...
Housing construction	5.7	4.5	–4.9	5.9	25.1	22.5	34.8	28.5	...
Unemployment rate (2)	9.6	9.0	9.0	9.1	8.7	8.3	8.1	8.2	...
Consumer prices	1.6	3.2	3.4	3.8	3.3	2.8	2.3	1.7	...
Trade balance (3)	–494.7	–559.9	–527.9	–533.6	–559.9	–573.7	–580.2	...	...
3-month interbank interest rate (1)	0.3	0.3	0.3	0.3	0.5	0.5	0.5	0.5	...
Nominal effective exchange rate (4)	75.4	70.9	69.6	69.8	72.4	72.9	72.8	73.9	75.2

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 UNITED STATES: HOUSEHOLD DELEVERAGING: HALFWAY THERE

Gross household debt as percentage of disposable income



SOURCES: BEA, Federal Reserve and own calculations.

Retail sales are still slowing up but lower petrol prices could boost consumer spending.

almost at a standstill, the other means of sustaining growth in consumption is through debt but this is limited by households' asset situation. Although it's true that families' financial wealth had been recovering over the last few months, their real estate wealth, which is the main tangible asset for households, is still below the secular trend. The main problem for households' asset balance is still the high level of debt, which has managed to get halfway back to normal. Household debt rose to 109.2% of disposable income in the first quarter of 2012. This represents a reduction of 19.9 percentage points from the peak of September 2007 but is still 17.8 points above the level of 91.4%, the average for 2000, one year before the start of the real estate bubble.

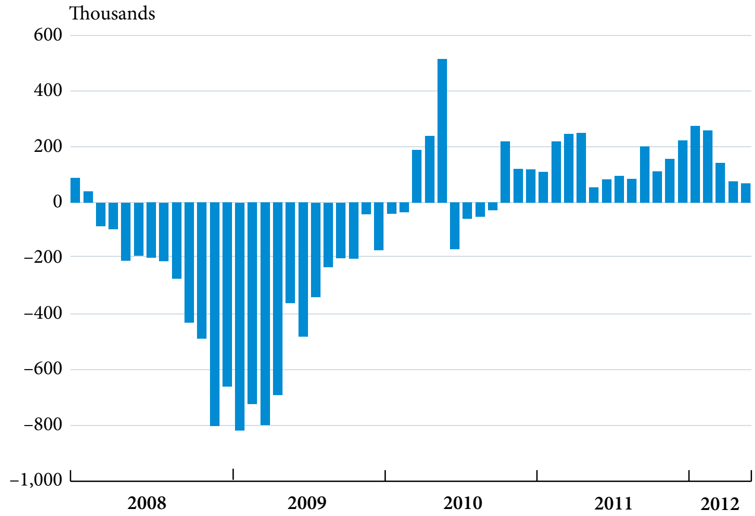
Retail sales confirm this slowdown in consumption compared with the first quarter, aided by an abnormally mild winter. In May, retail trade, excluding the fluctuating cars and petrol, posted its second month of decline, taking year-on-year growth in real terms to 2.3% when this figure was 3.4% in March. Similarly, the Conference Board consumer confidence index fell by 6.8 points between February and May, standing at 29.4 points below its historical average. One support for consumption could come, however, from falling oil prices. A drop of 10 dollars in the price of a barrel of crude supposes, via savings in petrol, a larger budget for the rest of the shopping basket equivalent to around 0.3% of GDP. The average price of oil in the first four months of 2012 was 118.6 dollars per barrel, so that the level of 90 dollars per barrel when this report was being written, should it continue, would lead to savings equivalent to 0.8% of GDP in one year. Consequently, although the fluctuating nature of oil prices means we should remain cautious, the scenario has certainly changed.

The labour market loses steam while the slowness of the recovery runs the risk of perpetuating lower participation in the labour market.

The slowdown in the recovery of the labour market is the factor that best explains this slump in consumption. In May, 69,000 net jobs were created,

THE UNITED STATES: JOB CREATION LOSES STEAM

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



SOURCES: Department of Labor and own calculations.

The 8.2% unemployment rate is partly due to a lower activity rate.

a very modest figure that follows on from the bad figures for April. Similarly, the hours worked and weekly wages also fell. The recovery is too slow and the level of employment prior to the crisis is unlikely to be reached before the end of 2014. This lingering unemployment means that the proportion of long-term unemployed will remain at record levels. Hiring workers who have been unemployed for more than six months entails problems due to lack of suitability, as the market believes their skills are out of date. This leads to discouraged workers who end up leaving the labour market, reducing the labour force and helping to turn a cyclical phenomenon into a structural one.

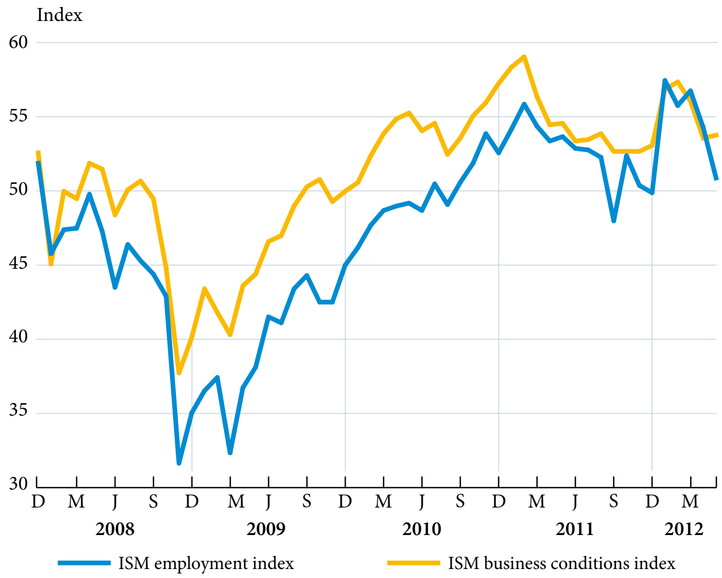
The fall in the labour force means that weak growth accompanied by insufficient job creation can exist side by side with a drop in the unemployment rate. May's unemployment stood at 8.2%, 0.8 percentage points below the figure for the same period last year. However, excluding the workers who have left the market due to non-demographic reasons, the unemployment rate would easily exceed 10.0%. In addition to this unemployment there is also under-employment, the contingent of workers who are working part-time involuntarily, which has halted its improvement seen over the last few months.

Investment remains moderately optimistic but entrepreneurs are still cautious in employment terms.

Unlike this weak employment and the incipient slowdown in consumer spending, the investment sector is performing better. Although May's business climate index of the Institute for Supply Management (ISM) for manufacturing fell by 54.8 points to 53.5, this level still coincides with robust economic growth in the economy as a whole of more than 3.0%. With a somewhat less expansionary tone, the ISM services index, which rose minimally up to 53.7 points, points to growth of 2.0%. The other side of the coin was provided by the employment component, accounting for 86.4% of total private employment, which showed a marked decline.

THE UNITED STATES: EMPLOYMENT LAGS BEHIND GROWTH

ISM service index



SOURCES: ISM, Thomson Reuters Datastream and own calculations.

There are some signs of improvement in investment in construction. On the supply side, new houses started in May maintained part of April's upswing and were 28.5% higher than the same period a year ago. Similarly, the rise in building permits, which are its leading indicator, suggest this progress will continue. For its part, the Case-Shiller index for second-hand homes for the twenty main cities was still rising slightly in March, while sales of second-hand housing continued to liven up in May. All this points to the sector contributing to growth throughout 2012 although its influence will initially be limited due to the low starting levels. The weaknesses of housing are far from being averted, nevertheless, with 12 million households facing negative equity, although the latest figures point to a timid reduction in mortgage default.

Construction confirms its improvement but it starts from a low level.

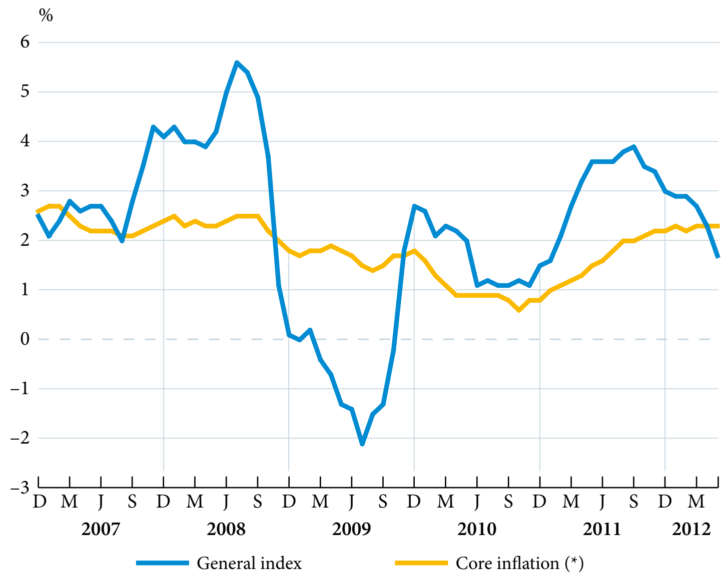
To boost the mortgage market and create jobs, in May the Federal Reserve started up its long-term debt purchase programme again, financed by selling short-term debt. And inflation is giving the Fed even more room for additional expansionary measures, should they be deemed necessary. The consumer price index (CPI) has slowed up, rising by 1.7% year-on-year in May and 2.3% in April, due to the base effects of oil prices. Core CPI, which excludes energy and food prices, repeated its rise of 2.3% year-on-year but the trend is one of moderation as price increases centred on components that do not reflect the underlying trend, such as clothing.

With regard to the external sector, April's trade deficit decreased by 8.0% to 50 billion dollars. Lower oil prices, which account for 55.9% of the total trade imbalance, lie behind just under half this improvement but will continue to reduce the deficit over the next three months. On the other hand, exports maintained part of their upswing in March and point to the

The 1.7% CPI leaves the Fed room for expansionary policies.

THE UNITED STATES: A CPI THAT LEAVES SOME ROOM

Year-on-year change in the CPI by component



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

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

sector's positive contribution to growth in GDP in the second and third quarter.

Japan: bad times for exports and investment

The upward revision of GDP figures for the first quarter, which left growth at 1.2% quarter-on-quarter and 2.7% year-on-year, has increased doubts as to whether expansion will continue in the rest of the year. The economy bases its growth on the accumulation of stock, fluctuating by nature, and particularly on private consumption encouraged by expansionary policies that will not continue, with a government that is looking to increase the tax on consumption. However, the two traditional pillars of Japanese growth are looking weak. Capital goods investment is falling and its leading indicator in April, machinery orders, continue to show declines. For their part, exports were still submerged in lethargy in May.

Japan grows by 2.7% thanks to private consumption.

May's trade balance showed a deficit again, for the fifteenth month, due to higher energy costs resulting from the nuclear stoppage and bottlenecks in production that are harming the competitiveness of exports. In this respect, industrial production, which has a greater influence on GDP in Japan than in other advanced economies, fell in April. The recovery of the second half last year has faded, with cumulative growth at a meagre 0.4% in the four first months of 2012, leaving the index 3.1% below the level prior to the catastrophe of March 2011.

Private consumption offsets industry's bottlenecks.

However, April's retail sales and May's vehicle registrations point to the rise in consumption continuing for the moment. Similarly, the consumer confidence index rose in May to 40.7 points, now close to

JAPAN: MAIN ECONOMIC INDICATORS

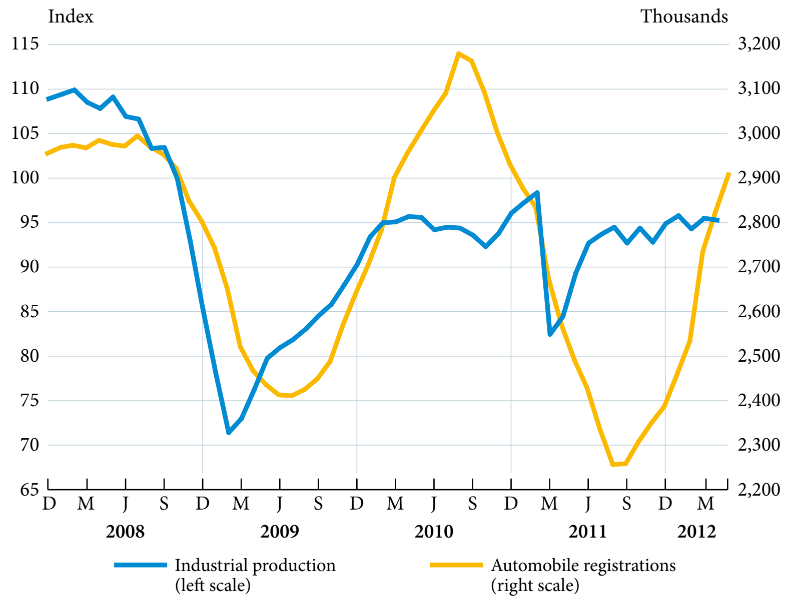
Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
Real GDP	4.5	–0.7	–1.7	–0.6	–0.5	2.7	–	...
Retail sales	2.5	–1.2	–1.7	–1.0	0.8	5.2	5.7	...
Industrial production	16.6	–2.3	–6.7	–0.6	0.0	2.7	12.9	...
Tankan company Index (1)	0.0	–1.3	–9.0	2.0	–4.0	–4.0	–	...
Housing construction	2.7	2.6	4.6	8.0	–4.8	3.6	10.5	...
Unemployment rate (2)	5.1	4.6	4.7	4.4	4.5	4.5	4.6	...
Consumer prices	–0.7	–0.3	–0.4	0.1	–0.3	0.3	0.5	...
Trade balance (3)	7.9	–1.6	3.4	1.3	–1.6	–3.6	–3.7	...
3-month interbank interest rate (4)	0.39	0.34	0.34	0.34	0.3	0.3	0.3	0.3
Nominal effective exchange rate (5)	106.0	113.5	109.3	115.5	118.6	116.5	113.3	117.0

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

JAPAN: PRODUCTION AND SALES, DIFFERING FORTUNES

Industrial production index and automobile sales (*)



NOTE: (*) Sum of the last twelve months. Excluding vehicles under 600 cc.
SOURCES: Japanese Ministry of Communications, National Statistics Office and own calculations.

But growth will not improve. Industrial production is falling and exports will suffer from the global weakness.

the levels of February 2011. This strength being shown by private consumption will not be able to dispel the threat of deflation however. In April the CPI rose by 0.5% year-on-year thanks to the effects of expensive oil that, more recently, has changed direction and whose downward effects will be seen in the coming months. The core CPI, the general index without energy or food, continued at a standstill, accumulating a drop of 0.3% year-on-year while prices in Tokyo, which fell again in May, also point to a return to deflation.

Oil, the reason for price rises at the beginning of the year, might help a return to deflation.

China: moderation in the economic slowdown

Inflation has fallen within a context of a slowdown in activity. May's CPI slowed up from 3.4% year-on-year to 3.0%, helped both by the food component, which accounts for more than one third of the general price index and continued to moderate its advance from 7% to 6.5%, and also by the non-food component, which went from the 1.7% in April to 1.4%.

China's low inflation, 3% in May, helps cut the official interest rate by 25 basis points.

The rise of prices below the government's target of 4% has created further room for expansionary policies. Hence the government cut the official interest rate by 25 basis points, down to 6.31%, at the beginning of June, and reduced the cash reserve ratio by 50 basis points in mid-May. For the remainder of the year, we predict further reductions in the cash reserve ratio of between 100 and 150 basis points, as well as a further cut in the interest rate at the beginning of the third quarter.

The announcement of the reduction in interest rates just before the monthly activity indicators are released suggested a bad May. However, the slower rate of decline in some of these indicators and the improvement in others surprised a large number of analysts. May's figures are consistent with a soft landing, in line with our growth forecast close to 8% in 2012. Industrial production grew by 9.6% year-on-year, 0.3 percentage points above April's figure although still far from its potential of 15%. Regarding demand, retail sales pushed forward with 13.8% growth year-on-year, slightly below the 14.1% of the previous month, while cumulative fixed capital investment from January to May grew by 20.1% year-on-year, 0.1 points below the cumulative figure up to April.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
Real GDP	10.4	9.2	9.5	9.1	8.9	8.1	–	...
Industrial production	15.7	13.7	13.9	13.8	12.8	11.6	9.3	9.6
Electrical power generation	14.0	10.9	12.0	10.8	8.9	6.5	1.5	3.3
Consumer prices	3.3	5.4	5.7	6.2	4.6	3.8	3.4	3.0
Trade balance (*)	184	156	172	170	156	160	167	172
Reference rate (**)	5.81	6.56	6.31	6.56	6.56	6.56	6.56	6.56
Renminbi to dollar	6.8	6.5	6.5	6.4	6.4	6.3	6.3	6.3

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

On the external front, both exports and imports surprised on the upside, unlike in April and in spite of the fragility of advanced economies. In particular, exports grew by 15.3% year-on-year in current terms, far above April's figure of 4.9%, and did so throughout all destinations. And imports grew by 12.7% year-on-year, compared with 0.3% in the previous month, placing the trade surplus at 18.7 billion dollars. Part of this strength in imports was due to the upswing in foreign demand, as indicated by the growth in exports for processed and assembled products, although imports of final goods also rose considerably. Nonetheless, we must be cautious in our interpretation of the foreign trade figures as they are highly volatile from month to month.

Once again, May's figures are still symptomatic of a slowdown in the Chinese economy. However, May's figures, the expansionary monetary measures and the government's capacity and willingness to support growth are dispelling fears of a hard landing for the country.

Brazil: more disappointment

Although macroeconomic indicators were already pointing to a slowdown in Brazil's economy, the growth figures for the first quarter were a disappointment for both Brazilians and foreigners alike. GDP grew by a mere 0.2% compared with the previous quarter, which represents a meagre advance of 0.8% in year-on-year terms. Moreover, if we take into account the fact that, in the fourth quarter of 2011, quarter-on-quarter growth was already 0.2% and 0.3% in the third, it is evident that Latin America's leading economy has run aground among pyrrhic growth without there being any sign of the upswing it so desires.

By component and in year-on-year terms, of note is the debacle of investment, down 2.0%, and the 3.2% upswing in public expenditure. Regarding consumption, this picked up slightly compared with the previous quarter, boosted by the good tone in credit and employment. Exports also improved their figures compared with the fourth quarter of 2011 but this was not enough to offset the advance of

Although still weak, May's business indicators are better than expected.

Exports and imports pick up in May relative to a weak April.

Brazil's economy continues to slow down more than expected.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
Real GDP	7.6	2.7	3.3	2.2	1.4	0.8	–	–
Industrial production	10.6	0.4	0.7	0.4	–1.7	–3.2	–2.7	...
Consumer confidence (*)	159.7	156.4	155.4	153.2	155.2	164.3	165.0	163.0
General unemployment rate (**)	6.7	6.0	6.3	6.0	5.2	5.8	6.0	5.8
Consumer prices	5.0	6.6	6.6	7.1	6.7	5.8	5.1	5.0
Trade balance (***)	20.1	29.8	25.2	30.5	29.8	29.1	28.1	27.5
Interest rate SELIC (%)	10.00	11.79	12.25	12.00	11.00	9.75	9.00	8.50
Reales to dollar (*)	1.78	1.63	1.56	1.88	1.86	1.83	1.91	2.02

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.

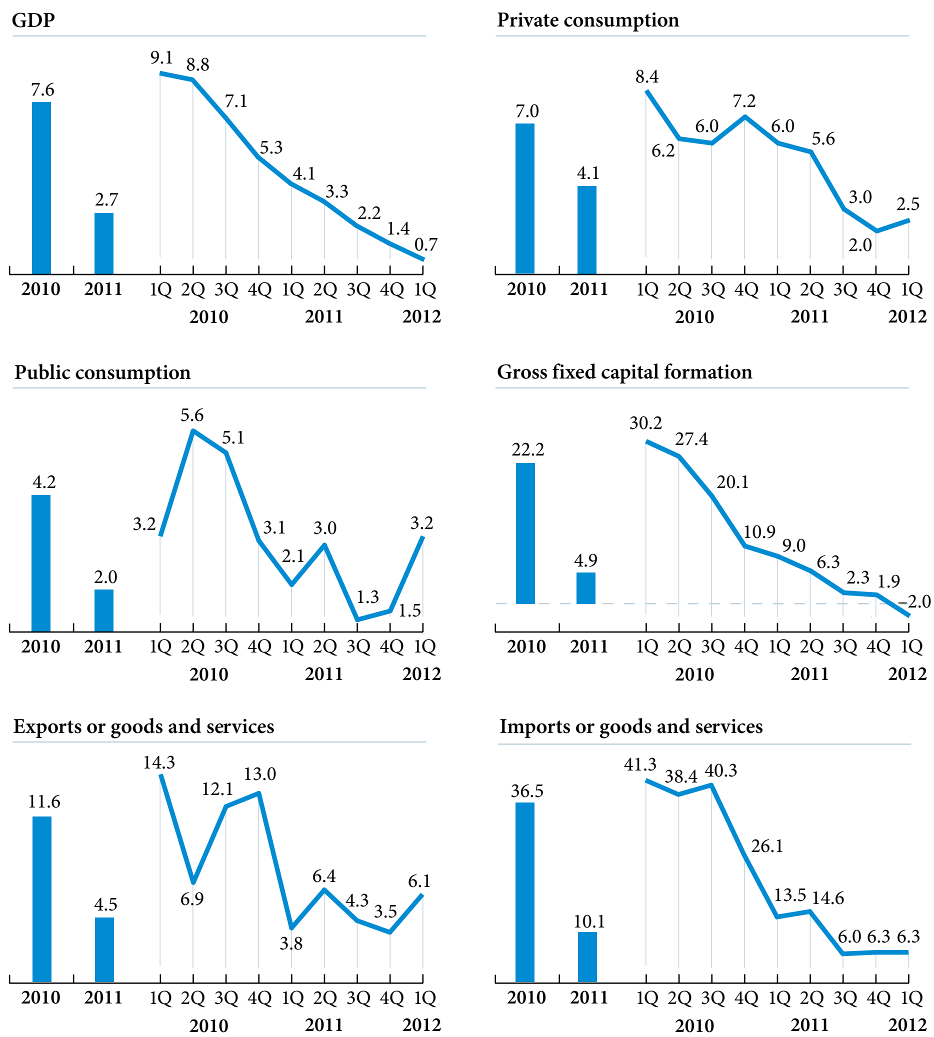
Stimuli are yet to have an effect.

imports (see the graph below). On the whole, we can observe both a marked decline in private domestic expenditure as well as an increasing lethargy in net exports, in line with the world's failing appetite for commodities.

Brazil has therefore joined the widespread deterioration of global economic prospects and the latest activity figures merely increase doubts concerning the immediate future of the Amazonian giant. Although the confidence of Brazilian consumers and employment are holding firm, industrial production is still in negative terrain and the index produced by Brazil's central bank as an approximation of GDP posted a minimal increase of 0.22% compared with the previous month, in year-on-year terms representing a drop of 0.02% and its worst figure since the end of 2009. It's true that

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Instituto Brasileiro de Geografia e Estatística and own calculations.

this indicator is not precise and usually differs from the definitive GDP growth figure but, even so, it is indicative of the significant downward risk for growth in the second quarter.

This, together with the disappointing growth figures for the first quarter and the expectation that the slowdown in world economic growth will continue for a few months yet, has led us to revise downwards our growth forecasts for Brazil's economy both in 2012 and in 2013. Although we still think that economic activity will pick up in the second half of the year, when we expect the stimuli applied almost a year ago to start to have an effect, we have reduced our growth forecast from 2.5% to 1.6% for this year and from 4.1% to 3.8% for 2013.

Given this evidence, the reaction of the Brazilian authorities was not slow in coming, quickly announcing further measures to boost their economy. These measures include greater credit facilities, barriers to imports and a new line of credit available to the states totalling 20 billion reais (around 7.7 billion euros) to be invested in projects related to highways, transport and infrastructure in general. The moderation in inflation will also help stimuli in the area of monetary policy (we expect a further reduction in interest rates in July), although the real's continuing weakness, hit by the rise in global risk aversion, will stop prices from correcting, keeping the increase at around 5% in 2012.

The real continues to depreciate.

Mexico: changing times?

The breakdown by GDP component for the first quarter of 2012 confirms that the recent dynamism of Mexico's economy comes from renewed strength in domestic expenditure. Private consumption was the area that contributed the most to economic growth (2.9 percentage points), with year-on-year growth of 4.3%, followed by gross fixed capital formation, which contributed

The strength of domestic expenditure protects the Mexican economy from the global slowdown.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
Real GDP	5.6	3.9	3.8	4.2	3.9	4.7	–	–
Industrial production	6.2	4.0	3.8	3.6	3.7	3.1	4.2	...
Consumer confidence (*)	86.3	91.7	90.7	93.7	90.3	94.1	97.2	96.3
Leading business index (*)	117.1	117.1	121.0	122.8	123.8	124.4	126.0	...
General unemployment rate (**)	5.4	5.2	5.2	5.7	4.8	5.0	4.9	4.8
Consumer prices	3.9	3.2	3.3	3.4	3.5	3.9	3.4	3.9
Trade balance (***)	–3.0	–1.5	–0.1	–1.8	–1.5	–1.6	–1.7	–1.8
Official Banxico rate (%)	4.50	4.50	4.50	4.50	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	12.33	11.90	11.72	13.78	13.94	12.81	13.00	14.32

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

The peso, however, is at the mercy of the turbulences.

1.9 percentage points to the growth in GDP and increased by 8.6% compared with the first quarter of 2011. Public expenditure advanced by 2.9%. Exports recorded growth of 5.1% while imports rose by 8.1%. In net terms, exports deducted 0.6 percentage points from growth.

In spite of the good rate of economic growth, prices continue to rise moderately. Although the weak peso, resulting from the problems in Europe, is expected to introduce some inflationary pressure, it is also predicted that the world slowdown in economy and particularly in the United States will end up affecting the domestic economy, pushing down this pressure. This has been endorsed by the decision taken by the Monetary Policy Committee to keep official interest rates at the same rate for another month, albeit explicitly changing the tone of their position from pro-expansion to neutral.

Oil falls to 90 dollars per barrel, the lowest since December 2010.

More than just changes in posture are expected from the government. At the time of writing this report, just a few days before the presidential elections, Enrique Peña Nieto (PRI) looked like being the new President of Mexico. The polls also suggest that he more than likely won't be able to govern alone, so he will have to secure the opposition's support to promote the reforms required by the Mexican economy in order to gain in solidity and guarantees for the future.

Arab production and the economic slowdown push down oil prices and the rest of commodities.

Oil prices in free fall

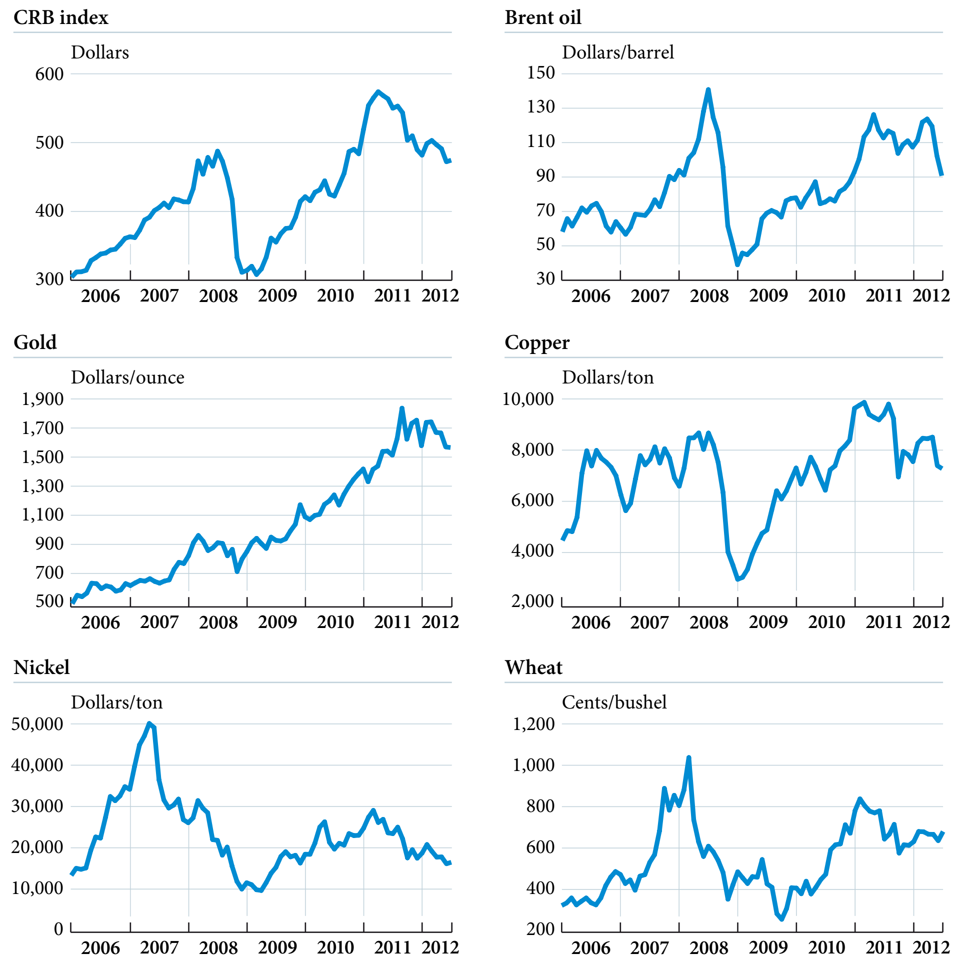
Oil is intensifying its descent. Between 18 May and 22 June, the price of crude fell by 15.8% to 90.49 dollars per barrel (Brent quality, for one-month deliveries), its lowest level since December 2010. Oil price is therefore 15.5% below its level at the start of 2012 and 16.4% lower than its level one year ago, which will pull down the CPI for May and June for most economies.

Oil prices are falling due to a combination of three factors: the euro area crisis, the slowdown in China and other emerging economies and the increased production by Saudi Arabia, which remains at the record level of 10 million barrels a day, one third of the total production of all OPEC countries. As from 2013, should there be a recovery in world growth, there should also be a change in the trend for oil prices with moderate rises.

The rest of commodities continued to join the downward slide of crude, albeit not so sharply. The CRB index fell by 1.2% between 18 May and 22 June. Among metals, of note was the 10.0% drop in aluminium, particularly affected by energy prices given its energy-intensive production process. Copper, nickel and steel saw minimal drops after their falls in May. Among precious metals, silver was down 5.9% while gold lost 2.1%, standing at 1,562 dollars per ounce. Falls were also prevalent among foods, with wheat losing 5.2%, sugar 3.8% and coffee 14.0%.

Metals most affected by China's slowdown.

TREND IN VARIOUS COMMODITIES (*)



NOTE: (*) Figures for last day of month (last date June 22).
SOURCES: *The Economist*, Thomson Reuters Datastream and own calculations.

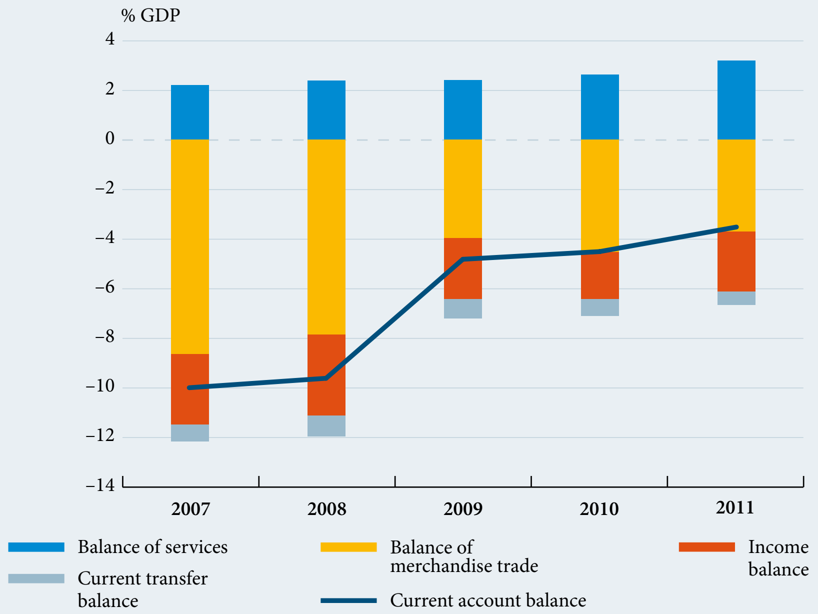
Target surplus: reality or mirage?

During the economic boom before the crisis, Spain multiplied its current account deficit by four, from 25 billion euros (4% of GDP) in the year 2000 to 105 billion (10% of GDP) in 2007, the world's second largest current account deficit after the United States. Then the crisis came and brought with it an abrupt, substantial correction of this deficit, pushing it back down to 3.5% of GDP (38 billion euros) by 2011. Undoubtedly, this correction makes a significant contribution to the Spanish economy's cherished external sustainability but will it be maintained or will we return to the previous trend once growth picks up again? Above all else, in order to answer this question we need to know what has brought about this correction and this is precisely the aim of this box.

In this respect, the graph below is revealing in itself: if we break down the current account balance into its different components, we can readily see that the adjustment in the external balance between 2007-2011 was particularly

THE IMPROVEMENT IN THE TRADE BALANCE HAS HELPED TO CORRECT THE CURRENT ACCOUNT DEFICIT

Components of the current account balance



SOURCES: Bank of Spain and own calculations.

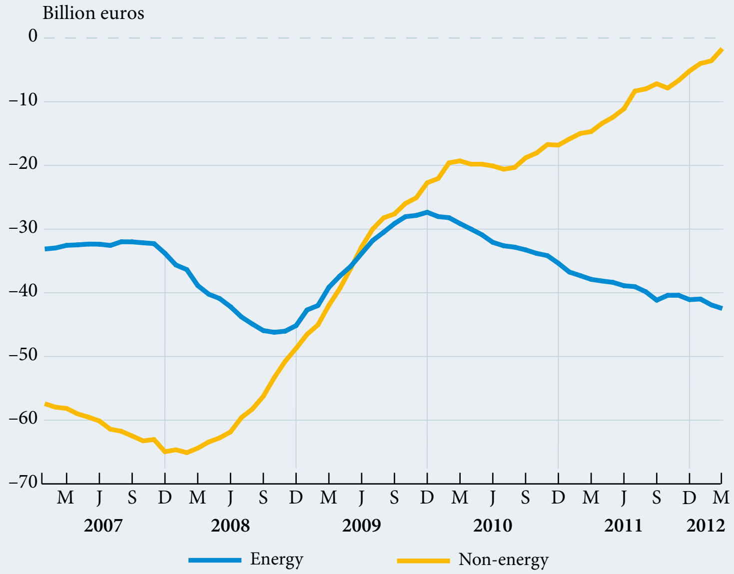
due to a sharp drop in the balance of trade in goods deficit and, to a lesser extent, to an increase in the positive balance in services. The current transfers and income balances also helped but to a much smaller extent and, in fact, the latter has deteriorated again due to the continued financial tensions in the euro area and their repercussions on the cost of financing Spain's debt.

Entering into more detail, the improvement in the trade balance of goods and services, which went from a deficit of 6.5% of GDP to one of 3.5% of GDP, was essentially due to the improved trend in the trade in goods: out of the 6 percentage points corrected, 5 correspond to the adjustment in the goods deficit and 1 percentage point to the improvement in the services surplus. Given this situation, the question arises as to whether the adjustment in the goods trade deficit reflects a better performance by exports or a sharp drop in imports, in line with the trend in domestic spending.

In fact, the dive taken by imports in 2008 and 2009 and their moderate recovery since then have made a significant contribution to this improvement. In particular, total imports fell by almost 20 billion euros between 2007 and 2011, with capital goods, consumer durables, the automobile industry and that of semi-manufactured non-chemical products being the items shrinking the most. This undoubtedly reflects the weakness in spending by Spanish households and firms, undergoing a deleveraging process that is reducing their expenditure on investment and durables, as well as the lower activity in construction, the main destination for semi-manufactured non-chemical imports, and also the collapse in residential investment, a sector with a high import content and which went from representing 12.4% of GDP in 2007 to just 6.9% in 2011. Lower spending on imports has also been due, in part, to the gradual recovery in competitiveness of the domestic market: import penetration[1] has gone from 26.5% in 2007 to just over 23% in 2011.

ADJUSTMENT IN THE BALANCE OF TRADE IN GOODS, IN SPITE OF THE ENERGY BALANCE

Cumulative over 12 months



SOURCES: Ministry of the Economy and own calculations.

The decline in goods imports would have been even greater if oil prices hadn't risen sharply during the period analysed (from 72 dollars per Brent barrel in 2007 to 108 in 2011). This explains why energy imports went from almost 42 billion in 2007 (15% of all imports) to 56 billion in 2011 (22% of the total), making the energy deficit shoot up to 3.8% of GDP in spite of the slower pace of domestic activity (see the graph above). In this respect, the recent fall in oil prices is likely to correct this trend in the short term, particularly given the double-dip recession in Spain although, in the medium term, it is vital for industry to become less energy-intensive.

And although the decline in imports (of goods) has made a significant contribution to correcting the trade deficit, the good performance by exports has also contributed as much, or more. In fact, the trend in exports of Spanish goods has been admirable since the beginning of the last decade. During the boom, Spanish goods managed to keep their worldwide share relatively stable in spite of facing sustained losses in price competitiveness and the overwhelming appearance of emerging economies in world trade (see the box «The external sector: driving the recovery» and «Gains in competitiveness to restart the external engine») and, once the crisis erupted, although they were not immune to the collapse of world trade in 2008-2009, Spanish exports, together with those of Germany, were the first to recover from this slump.

(1) Measured as the ratio of imports to expenditure on private consumption, public consumption, investment and exports, as a percentage.

This strength has been boosted by an export sector that is competitive not only in price terms, by the gradual recovery in external competitiveness (see the box «Gains in competitiveness to restart the external engine»), as well as a conscious effort to diversify towards more dynamic markets with great economic potential. In spite of the still broad export bias towards the euro area, the destination for 53% of all goods exports in 2011, its importance has waned in favour of, for example, China, India and Russia. This, together with the drop in imports and the correction in competitiveness terms is largely the reason for the change in direction of the trade balance with the euro area and also with the EU-27: while, in 2007, bilateral deficits were recorded with both zones of 3.7 billion and 3.8 billion respectively, in 2011 both achieved surpluses, of 1.6 billion with the euro area and 4.1 with the EU-27.

Leaving the balance of goods to one side, it should be noted that the increase in the trade surplus in services, which went from 23 billion euros in 2007 to 34 billion in 2011, has also helped to improve the current account balance, albeit to a lesser extent. In this case, imports have fallen very slightly while exports, once again with the exception of 2009, have steadily improved. By sector, although tourism services continue to be the main item within this balance, the balance of non-tourism services has also improved considerably. This is a very positive figure as business services have great growth potential, both in terms of employment and also wealth.

Lastly, the income balance and the current transfers balance have also made their own small contribution to the correction of the current account deficit but no more than this (5 billion euros between 2007 and 2011). With regard to the income balance, basically interest rates and dividends, its adjustment has been hindered by the sovereign debt crisis in Europe: the improvement that would have resulted from low official interest rates has been eroded by the rise in Spain's risk premium. Moreover, given the persistence of tensions, this balance is likely to continue to deteriorate in the short term. For its part the transfer balance, which includes funds sent by emigrants, donations and transfers from the European Union, has almost remained the same and the small correction observed can be attributed to a drop in payments related to the reduction in economic activity, from a deficit of 0.3% of GDP in 2007 to a little less than 0.15% of GDP in 2011.

In short, the recent correction in the current account deficit can be mainly put down to the better performance by the balance of trade in goods and in services. In order to maintain this trend once economic activity picks up, the correction achieved, both in terms of imports and exports, will have to be based on gains in competiveness, as well as requiring greater commitment to diversifying exports towards more dynamic markets and progressing towards industries that have greater added value, a lower import content and are less energy-intensive.

This box was prepared by Claudia Canals
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EUROPEAN UNION

The Euro area: where is the road map?

After the first six months of the year, it's time to think about the current situation of the economy and its prospects for the second half of the year. There are two main lines along which the euro area's activity is running. Firstly, the consensus that its institutional design is not enough to tackle the challenges posed by the current crisis. The absence of the instruments required to stop the problems often leads to new instruments being proposed. Over the last few months, the need for further fiscal union, as well as the possibility of a banking union with a single supervisor for all the financial systems of the euro area member states are two of the proposals receiving most attention.

The European Union's institutional design does not seem to be enough to tackle the crisis.

In any case, these proposals are still at a very early stage and, for the moment, they just raise further questions: Is there enough consensus to carry them out? How long would it take to implement them? Would it be enough?

Within this context, the risk premia of some countries have increased, particularly in Spain and Italy. Neither the outcome of the Greek elections, which have led to the formation of a tripartite government between the conservatives of the New Democracy, the socialists of the Pasok and the Democratic Left party, all of them pro-euro, combined with the announcement that the European Union might revise the adjustment calendar to grant more time in order to help Greece with its fiscal commitment, have managed to quell the flames of uncertainty.

On the other hand, the announcement of aid totalling up to 100 billion euros to recapitalize Spanish banks did not manage to calm the uneasy spirits of investors, who are unwilling to acquire public debt from peripheral countries.

Investors remain uneasy.

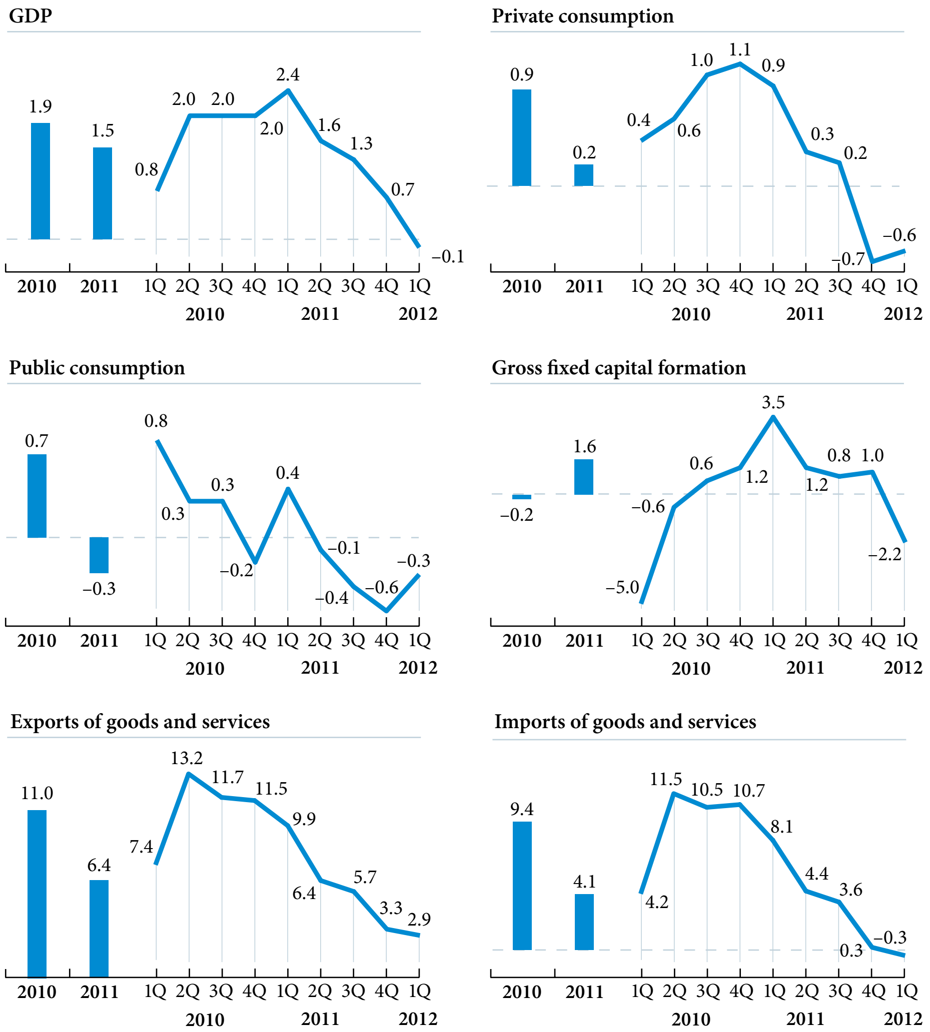
The second broad aspect is the worsening of the economic situation overall. Advance data highlight that, while the economy reported zero growth in gross domestic product (GDP) in the first quarter, its contraction could be substantial in the second quarter. Moreover, advance economic indicators suggest that the second half of the year is unlikely to provide any pleasant surprises.

Economic slowdown is difficult to stabilize within a context of rising uncertainty that hampers aggregate demand. Economic activity slowed down in the first quarter of the year with negative growth of 0.1% year-on-year, as shown by the detailed figures for gross domestic product in the first quarter. Private consumption continues to adjust, shrinking by 0.6% year-on-year. Gross fixed capital formation has also decreased sharply, contracting at a rate of 2.2%, while at the end of last year it was growing at 1.0%. On the other hand, fiscal adjustment continues in the euro area with a slight shrinkage in public consumption of 0.3% year-on-year.

Growth in the euro area stalls.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCES: Eurostat and own calculations.

The slowdown in global growth is hurting European exports.

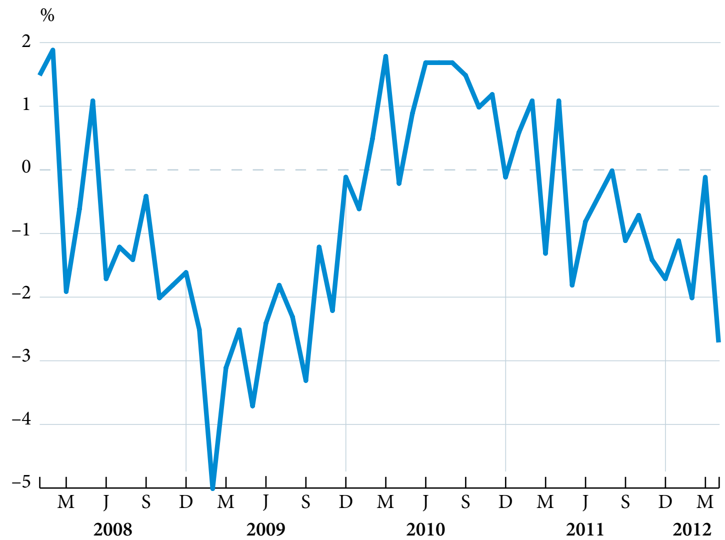
Moreover, the cuts in the public expenditure should intensify over the coming quarters.

On the other hand, the moderate slowdown in the rest of the world can be seen in the drop in the growth rate for exports (2.9%), while the decline in imports (–0.3%) reflects the euro area's weak aggregate domestic demand. However, we need to point out that these GDP figures hide great geographical differences. For example, while Germany reported year-on-year growth of 1.2%, Italy saw a year-on-year contraction of 1.3%.

Unfortunately, leading economic indicators suggest that the euro area's GDP growth in the second and third quarter will be negative. From the point of view of demand, sales of retail and

SHARPER FALL IN SALES OF RETAIL AND CONSUMER GOODS

Year-on-year change in sales of retail and consumer goods



SOURCE: Bloomberg.

consumer goods still show a clearly downward trend. In April they fell by 1.0% compared with the previous month, bringing the year-on-year rate of change into the negative zone, reaching –2.5%. This drop is generalized throughout all components of the index, falling more than 2.0% in year-on-year terms, but is particularly sharp in the sale of fuels, down by 9.8%.

This trend in sales of retail and consumer goods is a good indicator of how dynamic the economic situation is. Unlike the GDP figures, here the differences between the figures for retail sales in the different countries that make up the European Union are smaller. A breakdown by country shows an abrupt slowdown in the case of Germany, whose sales of retail and consumer goods in April went from growth of 1.6% the previous month to just 0.6% month-on-month. French households don't provide a very cheerful scenario either, with a sharp month-on-month fall of 1.5%, although Spain beats both countries contracting by 2.4%.

This slowdown is likely to continue or, in the best scenario, there will be a certain lethargy in household decisions to consume due to the weakness of the labour market and uncertainty regarding the outcome of the European crisis. In fact, April's unemployment rate in the euro area was 11.0%, having revised the figure for the previous month from 10.9% to 11.0%. This is the highest figure since 1990. In April, the number of unemployed rose by 110,000 people and the total reached 17.4 million unemployed. Differences between countries have widened, ranging from the minimum reported by Austria, with unemployment at 3.9%, to Spain, with a rate of 24.3%.

Despite the increase in the consumer confidence index for the euro area from –19.9 points in April to –19.3 in May, this is a minimal change and the index

Macroeconomic indicators point to a slowdown in activity.

Retail sales intensify their fall.

The unemployment rate remains at its highest level since 1990.

Industrial production falls in April.

is still below its historical average. This level suggests that families will continue to be prudent when taking spending decisions.

From the point of view of supply, April's industrial production in Germany and Italy fell by 0.7% and 8.8% year-on-year, respectively. In the case of Germany, this is the first drop since 2009. Taking into account the fact that approximately 45% of German exports are for the euro area and that its economy accounts for around 27% of the whole of the euro area, this figure is a further sign of the increasing economic slowdown and points to a clear contraction in Europe's economy in the second quarter. The industrial production index for the whole euro area fell by 0.8% month-on-month and the year-on-year rate worsened compared with the previous month, standing at –2.3%.

In May, inflation decreases by two tenths of a percentage point to 2.4%.

Within this context, entrepreneurs are likely to downgrade their investment decisions again, as shown by the decline in business confidence. Uncertainty regarding Greece and Spain, as well as news of China's slowdown in growth, have hurt both their perception of the current situation and expectations for the coming months. For example, the purchasing managers' index (PMI) for manufacturing in the euro area has fallen to 45.0 points while the PMI for services fell to 46.4 points, in both cases below 50 points, indicating economic contraction.

Within this context of economic weakness, it is normal for May's consumer price index (CPI) in the euro area to show growth of 2.4% year-on-year, two tenths of a percentage point less than the figure posted for the previous month. A breakdown of this figure indicates that the slowdown is due to a halt in rising prices for foods and energy. According to the forecast of the European Central Bank, the CPI will remain above 2% and, given the

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
GDP	1.9	1.5	1.6	1.3	0.7	–0.1	–	...
Retail sales	0.9	–0.6	–0.5	–0.5	–1.3	–1.0	–2.7	...
Consumer confidence (1)	–14.2	–14.6	–10.7	–15.9	–20.6	–20.0	–19.9	–19.3
Industrial production	7.4	4.7	4.0	3.9	–0.2	–1.6	–2.3	...
Economic sentiment indicator (1)	100.5	101.0	105.2	98.4	93.6	94.1	92.9	90.6
Unemployment rate (2)	10.1	10.2	10.0	10.2	10.6	10.9	11.0	...
Consumer prices	1.6	2.7	2.8	2.7	2.9	2.7	2.6	2.4
Trade balance (3)	4.6	–20.6	–17.8	–23.1	–20.6	1.6	17.3	...
3-month Euribor interest rate (%)	0.8	1.4	1.4	1.6	1.5	1.0	0.8	0.7
Nominal effective euro exchange rate (4)	103.7	103.4	105.2	103.5	102.1	99.5	99.5	98.0

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

slowdown in the economy, further pressure on inflation seems unlikely.

In short, a route map would be of great use that could broadly outline the sequence of steps required to achieve the target of overcoming the crisis. The absence of this strategic plan is causing more uncertainty which has a negative effect on the slowdown in the economy in a vicious spiral.

Germany withstands the European recession

The slowdown in world trade and increasing tension in the euro area have hit the recovery of the German economy over the last few months. Numerous indicators, both real and based on opinion, have worsened. Economic growth is therefore likely to moderate in the second quarter after an expansionary quarter-on-quarter of 0.5% in the period of January-March. For 2012, we forecast an annual increase in GDP of 0.8%, which contrasts with a decline in the euro area.

Growth in the German economy is supported by domestic demand. Household consumption remains firm due to job creation and the prospect of an increase in disposable income. In fact, in April the level of employment continued to rise and the unemployment rate fell to 5.4%, the lowest figure for the last few decades. Demand for jobs, measured by the BA-X indicator, shows some loss of steam but is still at a high level. Also inflation, which fell below 2% in May for the first time since December 2010, was well received. Consumer confidence therefore improved a little in May and consolidated at a figure slightly above its historical average.

Retail sales rose by 0.6% in April compared to the previous month in real

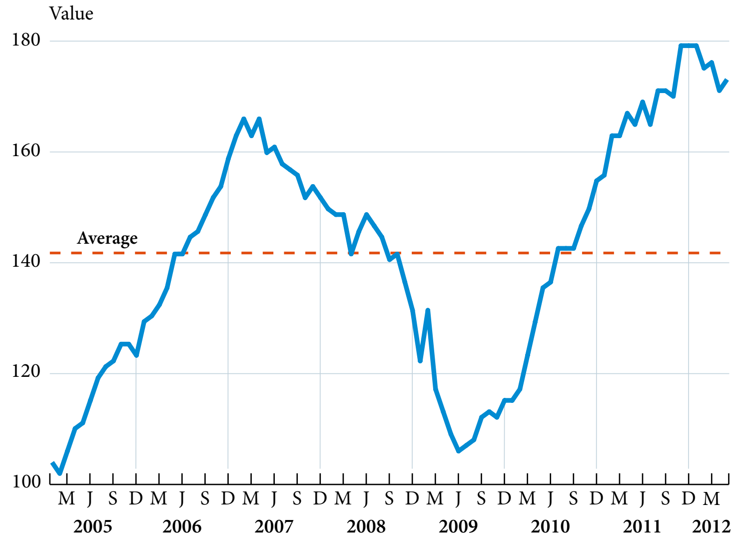
The absence of a route map for the euro area increases uncertainty regarding the economic future.

The German economy is likely to slow up noticeably in the second quarter.

Germany's inflation rate falls to below 2% and reinforces consumer confidence.

EMPLOYMENT DEMAND LOSES STEAM BUT CONTINUES TO SUPPORT CONSUMPTION

BA-X employment index (*)



NOTE: (*) Data seasonally adjusted.
SOURCES: Bundesagentur für Arbeit and own calculations.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
GDP	3.6	3.1	2.9	2.7	2.0	1.2	–	...
Retail sales	1.5	1.2	2.4	0.9	0.7	2.5	0.9	...
Industrial production	10.1	8.0	8.0	8.2	3.4	1.0	–0.7	...
Industrial activity index (Ifo) (*)	107.8	111.3	114.1	109.7	106.9	109.3	109.9	106.9
Unemployment rate (**)	7.1	6.0	6.0	5.9	5.6	5.5	5.4	...
Consumer prices	1.1	2.3	2.3	2.4	2.4	2.1	2.1	1.9
Trade balance (***)	154.9	158.1	158.7	159.0	158.1	162.7	166.3	...

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.

Higher wage rises in Germany could help to restart European growth.

terms, seasonally adjusted and corrected for calendar effects. However, automobile sales fell by 4.8% in May compared with the same month last year. On the whole, household consumption is expected to continue growing, albeit at a slow pace. With regard to investment, although it is being stimulated by the low interest rates, increasing uncertainty over the last few months is slowing this up. In April, the industrial production of capital goods posted a year-on-year rise of 1.3%, with a slowing trend.

The foreign sector continues to reflect the competitive strength of Germany's economy, helped by the reforms undertaken over the last few years. In April, goods exports increased by 3.4% year-on-year, compared with a drop of 1.0% for imports. Compared with the previous month, foreign sales fell by 1.7% seasonally adjusted and corrected for calendar effects, while purchases dropped by 4.8%. The trade surplus was therefore 14.4 billion euros for the month, a year-on-year rise of 33.3%. For its part, the current account surplus increased by 49.3% compared to April 2010.

From the point of view of supply, April saw a contraction in industrial production compared to the preceding month. In the two month period of March-April, secondary sector production rose by 0.4% compared with the same period last year. For their part, new orders dropped by 1.9% in April compared with the previous month, but in March-April they posted an increase of 2.6% on the two previous months, thanks particularly to demand from outside the euro area. Construction in April dropped by 6.0% compared with March, after a strong upswing that month. However, new orders in March recorded a year-on-year rise of 6.0% in real terms. In May, confidence deteriorated both in industry and in construction and services. However, it remained above normal levels in all these sectors.

On the other hand, in the last few weeks analysts have been suggesting that the German economy should contribute more to restarting European growth which, in turn, will also benefit Germany. Greater wage rises have been proposed, insofar as permitted by increased productivity, to boost demand and thereby raise the sales of products of its trading partners in the euro area.

Change in direction for French economic policy

Opinion indicators have tended to worsen over the last few months, affected by uncertainty surrounding the resolution of the euro area crisis, the largest trading partner for the French economy. Business confidence weakened slightly in June, moving further away from its average long-term level. Within this context, after the stagnation of French GDP in the first quarter, in the second we expect a similar situation, at the most with very modest growth. We maintain our forecast of slight expansion for the year as a whole.

With regard to demand, household consumption looks weak in the first months of the second quarter. The consumption of goods rose by 0.6% in real terms in April compared with the previous month but this was due to energy, as the manufacturing component fell by 1.3% quarter-on-quarter. In May, sales of retail and consumer goods fell by 0.6% compared with the preceding month in constant values, and in the same month vehicle registrations were down 11.0% compared with twelve months before. However, consumer confidence, helped by the gradual drop in inflation, continued to improve in May, albeit below its normal level. On the other hand, investment prospects are not so good, given that the rate of production capacity utilization also continued to fall in the second quarter.

French household consumption looks weak in the first few months of the second quarter but confidence picks up.

Regarding the foreign sector, demand for exports was particularly supported by non-European countries. In the period of February-April, foreign sales of goods rose by 0.3% compared with the three previous months. However, the corresponding rate recorded by imports was 2.5%. Nevertheless, compared with a year ago, exports over the last three months available rose by 5.8% compared with 3.4% for imports.

The panorama is similar from the point of view of supply. Industrial production increased by 1.5% in April compared with the previous month but the manufacturing component fell by 0.7%. In the period of February-April,

Demand for French exports is supported particularly by non-European countries.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
GDP	1.6	1.7	1.7	1.5	1.2	0.3	–	...
Domestic consumption	1.7	1.6	2.1	–0.2	0.3	–2.4	–1.8	...
Industrial production	4.6	2.4	1.9	2.9	0.4	–1.6	0.9	...
Unemployment rate (*)	9.8	9.6	9.6	9.6	9.8	10.1	10.2	...
Consumer prices	1.5	2.1	2.1	2.1	2.4	2.3	2.1	2.0
Trade balance (**)	–52.2	–70.6	–65.4	–69.7	–70.6	–68.4	–68.3	...

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

Credit to non-financial firms continues to decelerate in France.

manufacturing production also shrank by 0.7% compared with the preceding three months. Industrial orders posted a quarter-on-quarter increase of 1.7% in April thanks mainly to foreign demand, but deteriorated in May. Construction production rose by 2.3% in April compared with March but the sector's confidence continued to decline in June. For their part, new houses started in April recorded a year-on-year drop of 25.0%. The confidence of services worsened in June and widened its differential with its historical average. The outlook for industry and services was only moderately favourable in the short term.

Complicated balance between growth-oriented policies and achieving the target public deficit.

Within this context, unemployment continued to rise. The unemployment rate reached 10.2% in April. On the other hand, wage costs in the private non-agricultural sector slowed up, posting a year-on-year rise 2.1% in the first quarter.

It should be noted that the intensification of the debt crisis for the peripheral countries of the euro area has hardly affected France's sovereign debt recently. At the end of the fourth week of June, the spread between French 10-year sovereign debt and its German equivalent was around 110 basis points, quite a long way below the level at the start of the year and far from the peak of 189 basis points set in November 2011. However, credit to non-financial firms in general continued to slow up and, in April, posted year-on-year growth of 3.2%, 0.7 points less than in March.

Economic indicators are worse and we revise slightly downwards our forecast for Italian GDP in 2012 to –1.8%.

The large parliamentary majority achieved by the government in the legislative elections reinforces the economic policy announced, emphasizing reorientation towards growth. However, there is the problem of balancing this with meeting the target public deficit of 3.0% in 2013 and 0% in 2017. A new financing policy has been proposed for the economy to boost growth, based on three main factors: the creation of a public investment bank, as well as reforming regulated savings and the banking system. But on the other hand, entrepreneurs have shown their concern that the tax hikes planned and possible restrictions on companies might jeopardize investment.

Exports slow up the drop in activity in Italy

Detailed figures from Italy's national accounts system for the first quarter confirmed a quarter-on-quarter drop of 0.8%, although the year-on-year rate of change was revised downwards by one tenth of a percentage point to –1.4%. Domestic demand contributed –1.7 percentage points to the quarter-on-quarter change in GDP. Within this, investment was responsible for –0.7 points and household consumption –0.6 points. However, public consumption contributed 0.1 points. Nevertheless, the greatest contribution came from foreign demand, totalling 0.9 points.

Over the last few months there has been a generalized deterioration in the economic indicators. The economic climate worsened in May, down to its lowest level since April 2009. The recession is therefore expected to continue. Given this situation, we have revised our forecast slightly downwards for the change in GDP for 2012, to –1.8%.

With regard to the trend in domestic demand, household consumption continues to appear weak. Automobile

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
GDP	1.8	0.5	1.0	0.4	–0.5	–1.4	–	...
Retail sales	0.1	–1.1	–0.4	–1.5	–1.9	–0.1	...	...
Industrial production	6.7	0.3	2.0	–0.2	–3.1	–5.4	–8.8	...
Unemployment rate (*)	8.4	8.4	8.1	8.5	9.1	9.8	10.2	...
Consumer prices	1.5	2.7	2.6	2.8	3.4	3.3	3.3	3.2
Trade balance (**)	–30.0	–24.6	–34.1	–32.1	–24.6	–14.9	–12.3	...

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

sales fell by 14.3% in May compared with the same month the year before. Moreover, consumer confidence continued to fall in June, setting a new record low for the last few decades. This deviation can be explained by concerns regarding how the labour market is performing. In April, employment fell by 0.1% compared with the previous month, seasonally adjusted, and the unemployment rate continued to rise to 10.2%. In line with this, wages paid per hour worked are tending to slow up and their year-on-year change stood at 1.4% in April. The outlook for investment isn't favourable in the short term either, as company confidence is going through a slump.

Italy's sub-balance of goods posts a surplus in April.

Within this environment, the foreign sector is taking on the role of saviour but structural problems for the Italian economy's competitiveness are limiting its capacity to boost the economy. In April, the deficit of the current account balance of payments totalled 1.14 billion euros, down 76.5% compared to twelve months before. It should be noted that the sub-balance of goods posted a surplus of 596 million euros, compared with a deficit of 2,066 in April 2011.

On the other hand, towards the middle of June the yield on ten-year government bonds returned to above 6% and the spread with German bonds increased, due to contagion from Greece and Spain. However, EU measures reduced tension and, by the end of the fourth week of June, the risk premium stood at 411 basis points, far from the record of 550 reached in November 2011. It's important for public debt yield not to rocket as the burden due to interest payments could be unsustainable.

New package of economic policy measures to achieve the budget targets and bring about growth.

To help achieve the budget targets and boost economic growth, with the aim of gaining market confidence, the government presided over by Mario Monti approved a new package of measures on 15 June. The following were among their decisions: company and real estate privatization, tax deductions for firms that require highly qualified workers, facilities to boost construction, relaxation of the law on creditors' meetings, facilities to finance infrastructures, reinforcement of the energy sector, greater transparency of public expenditure and making judicial procedures more agile.

The UK: purchases of financial assets by the central bank?

The deterioration of the United Kingdom's economy is confirmed.

The publication of the breakdown for gross domestic product of the first quarter of the year led to doubts regarding the recovery of economic activity in the United Kingdom. GDP was revised downwards by one tenth of a percentage point to –0.3% quarter-on-quarter, leaving the year-on-year growth rate at –0.1%. The breakdown for this figure indicates that private consumption is slowing down from 0.4% quarter-on-quarter in the previous quarter to 0.1%. The surprise was caused by the rise in public expenditure, at 1.6% quarter-on-quarter. This situation should be reversed over the coming quarters due to the austerity policies implemented by the government.

One worrying aspect is the drop in gross fixed capital formation of –0.3% quarter-on-quarter. Investment has now been in decline for two consecutive quarters in the United Kingdom. Nonetheless, exports provided a pleasant surprise with an increase of 0.1% quarter-on-quarter, in spite of the strong pound and the decline in growth in the main trading partners of the United Kingdom. However, imports grew by 0.4% quarter-on-quarter.

Taking a look at the last four quarters, the economy of the United Kingdom has experienced a moderate recession. The fall in GDP reflects not only domestic obstacles (such as fiscal adjustment and the reduction of disposable income for households, among others) but also the impact of the situation in the European Union and the slowdown in the economy at a global level. With regard to the economic sectors, manufacturing and construction are the weakest, while services contributed to growth in the last quarter.

Some economic indicators provide some hope, such as the sales figures for retail and consumer goods in May which, after a disastrous April, posted growth of 1.4% month-on-month. However, this improvement is unlikely to be sustainable as most leading indicators point in the opposite direction. One good example of this is the purchasing managers' index

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
GDP	2.1	0.7	0.4	0.3	0.5	–0.1	–	...
Retail sales	–0.3	0.7	0.4	–0.5	1.1	1.7	–1.1	2.4
Industrial production	1.9	–1.2	–1.4	–1.6	–2.9	–3.0	–1.0	...
Unemployment rate (1)	4.5	4.7	4.6	4.8	4.9	4.9	4.9	4.9
Consumer prices	3.3	4.5	4.4	4.7	4.7	3.5	3.0	2.8
Trade balance (2)	–96.3	–101.1	–98.7	–100.7	–101.1	–101.3	–105.0	...
3-month Libor interest rate (3)	0.7	0.9	0.8	0.9	1.0	1.1	1.0	1.0
Nominal effective pound exchange rate (4)	80.4	78.4	78.6	77.1	79.4	80.4	81.5	82.7

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.

of manufacturers (PMI) for May, which fell to 45.9 points, below the level of 50 and indicating economic contraction. In fact, if the macroeconomic indicators as a whole maintain their current trend, we would be forced to adjust downwards our growth forecast for GDP for this year, which is currently at 0.6%. Given the seriousness of the economic deterioration, the British government, in combination with the Bank of England, announced plans to create a line of 10 billion pounds sterling to support credit to small and medium-sized firms and households.

On the other hand, two decisions were taken in the monetary policy meeting of the Bank of England. The first, to keep the official interest rate at 0.5%. Second, five of the nine members voted against a proposal made by the governor of the central bank, Mervyn King, to increase the quantitative easing programme. The minutes recorded that most members believe that more monetary stimulus will be required over the coming months but they also highlighted that they would prefer to wait for the outcome of the legislative elections in France and Greece. All agree that one of the most serious threats to the British economy is the interaction between the uncertainty caused by the European crisis and its impact on the financial markets which, ultimately, could lead to a credit squeeze for firms and families.

The members of the Monetary Policy Committee will have lots of margin to increase the quantitative easing programme as May's inflation figures reveal that the trend is still downwards. The consumer price index fell by two tenths of a percentage point, totalling 2.8% year-on-year, this being the lowest level in the last two and a half years.

Emerging Europe: three critical issues halfway through 2012

With half of 2012 already gone, three issues continue to be fundamental in order to strike some sort of balance in the situation for emerging Europe: the intensity of the financial contagion entailed by the debt crisis, Hungary's situation and the extent of the slowdown in activity.

In emerging Europe, the contagion of the debt crisis, Hungary's situation and economic slowdown are all of concern.

Starting with the first of these issues, the trend in risk premia, measured by the value of credit default swaps for three-year sovereign bonds, indicates that the high financial stress caused by the combination of doubts regarding the Greek elections and the uncertainty regarding the situation of Spain and Italy (therefore between the beginning of May and now) has been more appreciable in the case of Hungary and Romania and more moderate in the case of Poland, the Czech Republic and Slovakia. The situation of these last three countries reflects minimal concern in terms of public sector solvency and few direct links (commercial or financial) with Greece. Romania contrasts precisely in this last aspect as the notable importance of Greek banks in its national banking market and close commercial ties are being reflected negatively in the country's risk premium.

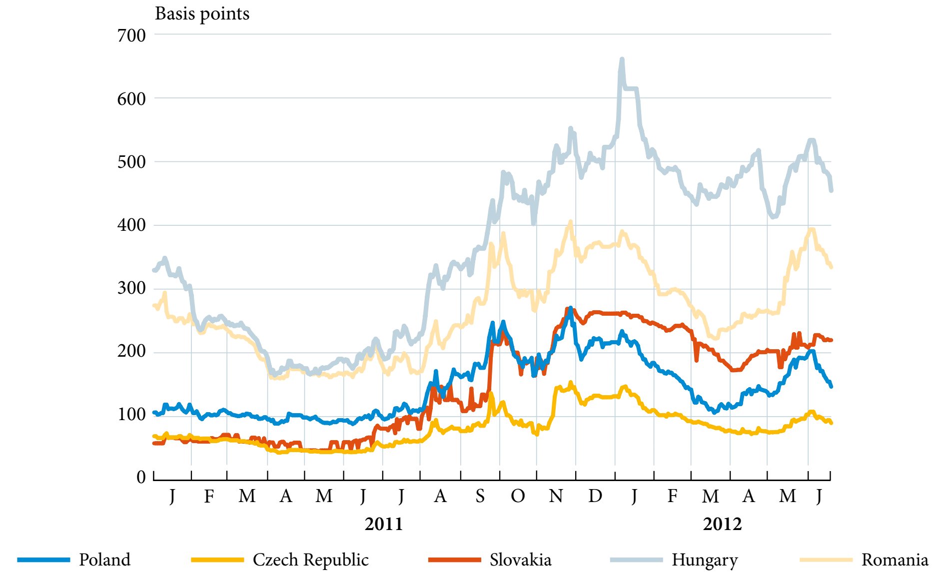
Hungary and Romania are most affected by the episodes of financial stress occurring after the first Greek elections.

The case of Hungary is more complex. As is already known, because of relatively high external financing needs for 2012 (albeit far from any immediate inability to meet these needs), last November the government asked the European Union and the International Monetary Fund (IMF) for financial assistance. Moreover, in the longer term, the financial markets were concerned about one of the highest public debt situations in the region (in the order of 80% of GDP).

Hungary's negotiations with international bodies may be about to start...

EUROPE'S DEBT CRISIS AFFECTS THE COUNTRY-RISK OF HUNGARY AND ROMANIA

Credit Default Swap prices for sovereign debt at 3 years



SOURCE: Thomson Reuters Datastream.

...after legal changes related to the central bank and the announcement of new fiscal adjustment measures.

After requesting multilateral financing, negotiations broke down when, at the end of 2011, the government took everyone by surprise and adopted a new regulation restricting the independence of Hungary's central bank. There were also signs that the budget was not being adjusted so that the European institutions, via an excessive deficit procedure, decided to withdraw part of the cohesion fund as from 1 January 2013.

After months without details being given out, over the last few weeks two relevant events have occurred that could pave the way towards financial aid. Firstly, conversations between the central bank and the government have given rise to an amendment of the legislation that will be sent to the Hungarian parliament by early July at the latest. This legislation restores key powers to the central bank regarding monetary policy. Without waiting for this new regulation to be completely adopted, the government will immediately ask the IMF and European institutions for formal negotiations to be restarted.

The second relevant change is the announcement of a series of budget measures for 2012 and 2013 that the Commission believes are adequate to ensure public deficit falls to a level lower than 3% of GDP. As a consequence, it has recommended that the excessive deficit procedure be suspended and the fine not be applied. All this explains the prevalent perception among financial investors, namely that, by the end of the summer, Hungary will have received international financial assistance.

Activity still falls in the second quarter, intensifying the recession in Romania, Hungary and the Czech Republic.

According to this interpretation, it is logical why, from mid-March (when the financial markets ruled out the possibility of negotiations starting up again) and up to 7 May, the Hungarian risk premium fell by almost 100 basis points. Unfortunately, on this date the result of the first Greek elections was announced, starting a period of strong risk aversion. Within this context, the trend in the risk premium indicates that investors include Hungary in the group of weak EU economies. This is due not only to the country's fiscal situation but also to expectations of a double dip recession.

This last factor leads us to the third issue we mentioned at the beginning of this section. Given the notably uncertain macroeconomic scenario in the euro area, and with business indicators in the Union's main economies clearly deteriorating, the issue of determining the extent of the slowdown in activity in emerging Europe has become particularly difficult. It should be noted that the growth figures for the first quarter place Romania and the Czech Republic in recession (understood as two consecutive quarters with GDP in decline) and Hungary practically in this situation. Only Poland and Slovakia manage to escape this weak scenario.

The latest activity indicators suggest that the second quarter is unlikely to improve on the first three months of the year. The most inclusive indicator of all, namely that of economic sentiment, worsened in April and May in all the countries we cover here, with the exception of Romania, which posted a moderate improvement. Deterioration is greatest in the case of Hungary and the Czech Republic. All this suggests that, in the second quarter, the Czech Republic will continue in recession while Hungary will enter into the same situation. Romania could be coming out of recession in this second quarter, while Poland and Slovakia will grow in quarter-on-quarter terms but at a low rate. From now on, a gradual improvement should be expected (certainly slow) in all these countries, with the probable exception of Hungary, which should fully experience the effects of its fiscal adjustment underway during the second half of 2012.

Gains in competitiveness to restart the external engine

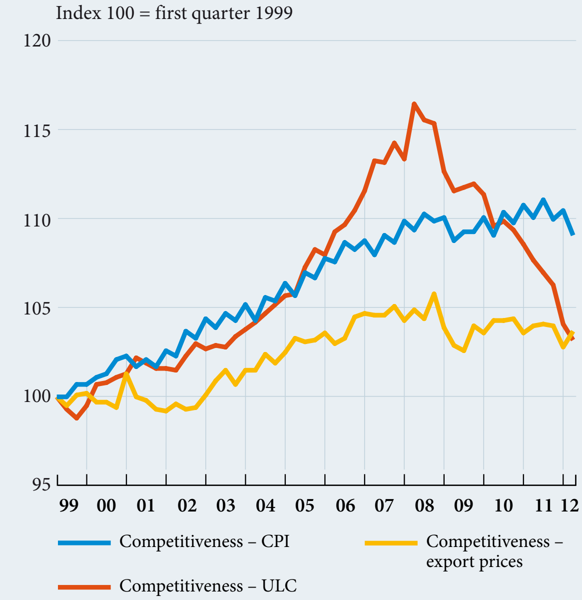
Given the weak domestic demand foreseen for the coming years, all eyes are focused on how Spain's export industry is performing. Its dynamism will determine the economy's ability to recover. Undoubtedly, in an increasingly globalized market, gains in competitiveness will be a key factor in boosting exports. After years of marked deterioration, some progress has recently been seen in this respect. But there is a still a long way to go to improve competitiveness. So how far can these gains in competitiveness boost exports?

The most frequent competitiveness indicators are usually calculated based on the trends in prices or the cost of labour per unit of output. An increase in these variables above the figure reported for other economies damages a country's ability to export and helps foreign products enter its domestic market. As a consequence, its relevance in terms of international trade can decline in the long term.

This was the case of Spain's competitiveness from the time it joined the euro area. As can be seen in the left-hand graph below, both the price and cost-based indices coincide in pointing to a clear loss of competitiveness with regard to the rest of the countries in the European Monetary Union (EMU) between 1999 and 2008. However, some differences can be observed between them. In particular, the trend in relative unit labour costs (ULC) is clearly more volatile than that of the price indicators. With regard to the latter, the increase in the price of Spanish goods was 10% higher than the rise for European goods up to 2008. This differential fell to 5% in the case of the

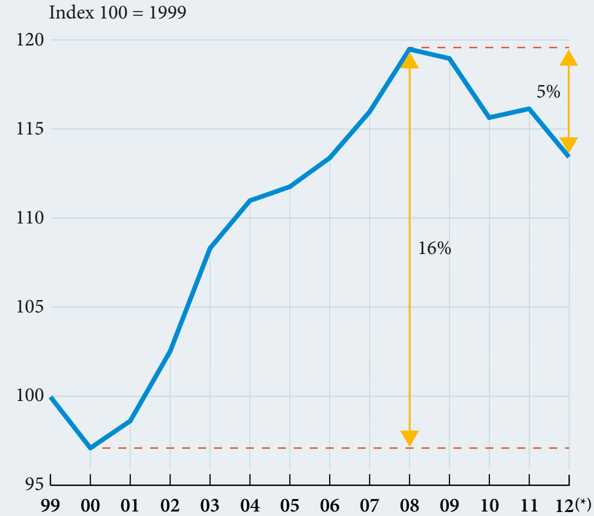
LOSS OF COMPETITIVENESS FOR SPAIN'S ECONOMY SINCE IT JOINED THE EMU

Competitive indicators compared with the euro area



SOURCE: Bank of Spain.

Real effective exchange rate based on the CPI compared with industrialized countries



NOTE: (*) The figure for 2012 shows the fall recorded in the month of January.
SOURCE: Bruegel.

price of exported goods, so that the loss of competitiveness among non-tradable goods was greater than among tradable goods during the boom years.

That's why, given the importance of being able to reflect an economy's real competitiveness more accurately, some studies propose using disaggregate competitiveness measures that take into account the different composition of the goods being traded.(1) Other procedures also help to refine the calculation of competitiveness as they differentiate between the destinations of a country's exports and its rivals in these countries. This is the case of real effective exchange rates that weigh up relative prices, or costs, and exchange rates according to each country's presence in the main export destinations. The trend in these more complex measurements also reveals a loss of competitiveness during a large part of the last decade.

But, within this context, the relatively favourable trend in Spain's share of exports in world trade as a whole still comes as some surprise. Since Spain joined the European Monetary Union in 1999, its export presence in global trade has fallen by just 2 tenths of a percentage point, down to 1.7%. This contraction, close to 10%, was practically half the one recorded by the export share of the euro area as a whole which, in 2011, stood at 26.3% compared with 32.7% a decade ago. This better performance could be due to the existence of other factors, in addition to price-

(1) See Crespo Rodríguez, A *et al.* (2011), «Indicadores de actividad: la importancia de la asignación eficiente de los recursos», Bank of Spain, Boletín Económico, December, and De Broeck, M. *et al.* (2012), «Assessing Competitiveness Using Industry Unit Labor Costs: an Application to Slovakia». IMF Working Paper.

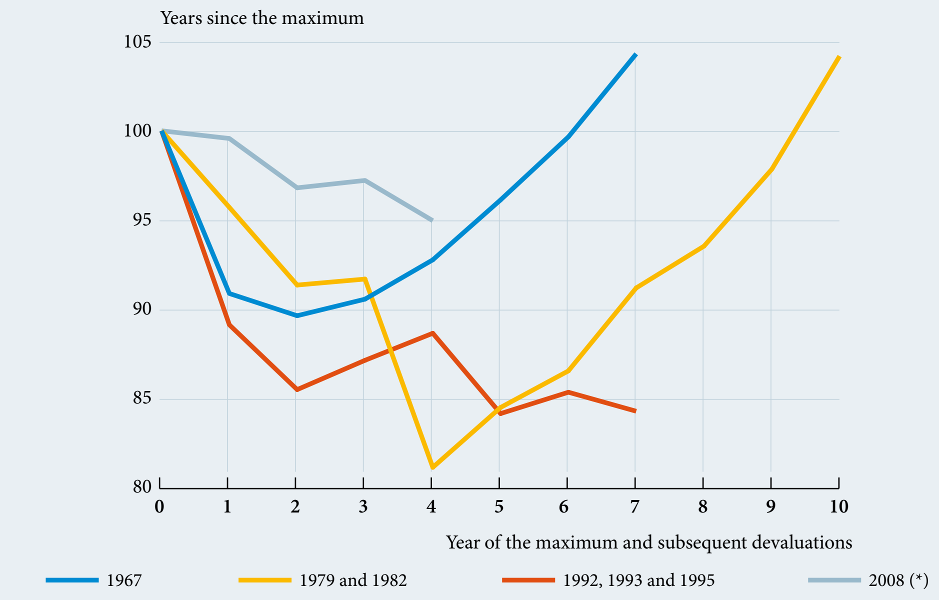
competitiveness, which also influence a country's export share, such as the quality of its exports, sector specialization or geographical destination.

This result, however, cannot hide the fact that Spain's sales abroad are performing below their potential. One clear example is the low relative weight of our goods exports in relation to GDP, specifically 20.6% in 2011. This figure is the lowest among the four main economies of the euro area, far from the 43.0% in Germany or the 34.0% for the monetary union as a whole.

Our exports therefore have plenty of room to grow. And improved competitiveness would undoubtedly help to achieve this. Actually, according to the main econometric models, after the trend in world trade, competitiveness is one of the main factors underpinning the performance of Spanish exports.(2) In fact, according to these estimates, a 1% increase in competitiveness compared with industrial countries, measured using the real effective exchange rate based on prices, represents a long-term rise in the level of real exports of between 0.6% and 1.3%. This means, for example, that if the competitiveness index returned to its level before Spain joined the euro area, real exports would increase by between 8.4% and 18.3% compared with the level of 2011. In this case, the relative weight of goods exports would rise to a range of between 22.3% and 24.4% of GDP, a level higher than France's and on a par with Italy's.

COMPETITIVENESS IMPROVES MORE SLOWLY THAN IN PREVIOUS EPISODES

Real effective exchange rate based on the CPI compared with industrialized countries (index, 100 = maximum value)



NOTE: (*) The last figure for 2012 shows the fall recorded in the month of January.
SOURCE: Bruegel.

(2) See García C. *et al.* (2009), «Una actualización de las funciones de exportación e importación de la economía española», Bank of Spain. Documento de trabajo 0905.

This scenario is based on a 16% improvement in competitiveness compared with 2008's level. But is such a large correction possible? Over the last 50 years, reductions in the competitiveness index of over 15% have been observed. On some occasions preceding the current decline, these decreases were the result of devaluations of the peseta, specifically in 1967, 1979 and 1992. However, these gains in competitiveness were transitory. In the medium term they were wiped out by the high inflation resulting from the currency's loss of value. This phenomenon can be clearly seen during the years after the devaluations of 1967 and 1982. After the devaluation of 1995, however, this effect is not observed. This would be due to inflation being controlled at comfortable levels as a result, largely, of greater fiscal discipline.

Today, the presence of an independent European monetary authority means that devaluations cannot be used as a means of quickly improving competitiveness. Reductions in the indicator are therefore slower than they used to be. The above graph confirms this. Between 2008 and January 2012, the correction in the effective exchange rate was 5%, far from the falls observed previously. However, the effect of this correction is likely to last longer as it is due to structural factors.

In short, there is a lot of room for improvement. However, structural reforms have to be undertaken in order to make progress in this direction. The latest reports by the European Commission and the International Monetary Fund place particular emphasis on this aspect. Among the measures they propose, of note are those that increase competition in the markets of goods and services, facilitate the reassignment of resources towards the sectors of tradable goods, boost innovation, help firms to grow and eliminate frictions in the labour market. Undoubtedly this is no easy task but its benefits, by consolidating the export industry as the driving force behind Spain's economy, could be great.

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

FINANCIAL MARKETS

Monetary and capital markets

The difficulties continue

The first half of the year has ended and the key aspects to the international financial markets are the same as at the beginning: the multifaceted crisis in the euro area and the poor rate of growth in the world's economy. These two fronts have been alternating for some time now between phases of pessimism and hope, at an irregular pace and both saw worrying developments in the last month. In the case of the euro area, the ups and downs of the presidential elections in Greece and developments in Spain's banking system have captured the headlines. But in the background economic risks are increasing for the whole region and there is a sensation of a lack of direction among politicians in order to resolve the crisis. In this respect, throughout June there were even more meetings between the leaders of the different countries, with all eyes fixed on the European Council on 28 and 29 June. Regarding the dynamism of activity in the world's main economies, unpleasant surprises have been the order of the day. Investors have reacted cautiously and moderately, partly thanks to the monetary authorities employing expansionary policies to reduce the likelihood of a sharp drop in growth.

Attention is focused on uncertainty regarding the euro area.

The central banks, once again centre stage

Within the developing global economic scenario, the role of the monetary authorities is once again gaining significance. However, and given the exceptional situation in terms of the accumulation of debt in some countries, the respective governments need to develop policies to ensure financial, monetary and economic stability. To this end, the central banks of key regions such as the United States and the euro area are conveying to the markets a clear message of commitment and a desire to adapt their measures to the environment, but at the same time they are also urging political leaders to tackle their own challenges.

The role of the central banks is crucial within the current context.

In the case of the euro area, the attitude of the European Central Bank (ECB) is notably one of caution. Statements made by ECB members concentrate on explaining and defending the current strategy of monetary policy and on continuous calls for governments to make progress with the region's bank and fiscal integration. This was precisely the message that ECB President, Mario Draghi, wished to convey at the institution's regular meeting. In this respect, Draghi's speech met the expectations generated, given that it served to repeat, with details, the firm, clear message of the last few weeks. He said that, based on an analysis of the region's economic and monetary situation, the ECB had decided there was no reason to alter the official interest rate, currently at 1%. However, although the central bank's growth estimates for this year remain unaltered from March, those in charge at the ECB are aware of the

The ECB remains firm when explaining its position regarding the sovereign crisis.

The ECB fails to disclose if it will buy up peripheral sovereign debt again.

existence of several risks that threaten stability. Among these, of note is the rising tension in financial markets (higher due to uncertainty regarding the recapitalization needs of Europe's banks) and possible rises in commodity prices in the medium term. That's why Draghi stated that «we monitor all developments closely and we stand ready to act». However, a cut in interest rates does not seem very likely in the short term, given that it would hardly affect the situation in which the region's economy is currently immersed. With regard to the ECB's participation in the secondary debt market, the central bank maintained its position of abstaining unless the euro area's financial situation becomes extremely negative. It also ruled out another 3-year liquidity auction but, on the other hand, extended the 1 and 3-month financing facilities for Europe's banks up to January 2013.

The ECB encourages the union of Europe's banks.

Regarding the events of the last few weeks related to the banking sector, the ECB has encouraged the creation of bank union and a unified deposit guarantee fund in the region which would help to tackle future credit adversities and restore investor confidence in the system's solvency. It is also asking for the powers of the European bail-out funds (EFSF and ESM) to be made more flexible, injecting funds directly into banks and avoiding the involvement of governments and the impact on public accounts. The ECB acknowledges that these steps are not easy given that they require political leaders to adopt political ambitious measures and to develop strategies with long-term objectives.

The Fed hopes to stimulate the economy by extending its «Operation Twist».

In the United States, the Federal Reserve (Fed) has settled the debate regarding the need for further monetary stimuli, extending the life of its «Operation Twist». The modest performance by the main components of gross domestic product (GDP) over the last few months and the weakness perceived in the world economic and financial context have lowered the estimates made by the institution for growth over the coming quarters (from 2.7% to 2.2% in 2012). The Fed notes that, within such an environment, the labour market is also likely to be negatively affected, with the unemployment rate remaining above 8% throughout the year. Based on these projections, the Fed has kept interest rates within the range of 0%-0.25%. It also decided to extend the life of the so-called «Operation Twist», up to the end of 2012. With this scheme, which was meant to end in June, the central bank hopes to continue extending the average duration of its debt portfolio and lower (even further, if necessary) long-term interest rates. By purchasing long-term US Treasury bonds and selling those with a maturity of less than 3 years, the Fed aims to make financing conditions more flexible for the private sector. It is also attempting to dispel any deflationary threat to the economy. Use of this instrument means that the Fed can maintain the size of its balance, avoiding the increases that would occur if it applied other measures of a quantitative nature.

Looking at the emerging countries, the slowdown affecting most of their economies is pushing those in charge at their central banks to convey more aggressive messages to the financial markets than in the case of the Fed or ECB. This orderly, predictable action taken by the authorities is being welcomed by investors, who can adapt their expected yields based on the economic information received. The publication of weak activity figures

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2011									
May	1.25	1.43	2.14	0.25	0.25	0.20	0.50	0.83	0.26
June	1.25	1.55	2.16	0.25	0.25	0.20	0.50	0.83	0.28
July	1.50	1.61	2.18	0.25	0.26	0.20	0.50	0.83	0.24
August	1.50	1.54	2.09	0.25	0.33	0.19	0.50	0.89	0.10
September	1.50	1.55	2.08	0.25	0.37	0.19	0.50	0.95	0.15
October	1.50	1.59	2.12	0.25	0.43	0.20	0.50	0.99	0.57
November	1.25	1.47	2.04	0.25	0.53	0.20	0.50	1.04	0.77
December	1.00	1.36	1.95	0.25	0.58	0.20	0.50	1.08	0.92
2012									
January	1.00	1.13	1.75	0.25	0.54	0.20	0.50	1.08	0.47
February	1.00	0.98	1.61	0.25	0.48	0.20	0.50	1.06	0.57
March	1.00	0.78	1.42	0.25	0.47	0.20	0.50	1.03	0.35
April	1.00	0.71	1.31	0.25	0.47	0.20	0.50	1.01	0.54
May	1.00	0.67	1.23	0.25	0.47	0.20	0.50	0.99	0.13
June (1)	1.00	0.66	1.21	0.25	0.47	0.20	0.50	0.92	0.14

NOTES: (1) June 22.

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

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

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

(5) Interbank rate.

SOURCES: National central banks, Bloomberg and own calculations.

for the last few weeks and the gradual moderation in inflation are the main arguments that justify the continuing expansionary nature of these countries' monetary measures. In June, new movements occurred in two of the major emerging economies, China and Brazil. For the first time since the relaxation phase began (to date involving quantitative measures), China's central bank cut its official interest rate by 25 basis points to 6.31%, in an attempt to combat the economy's decline and to boost flows of credit to the private sector. Brazil's authority also adjusted interest rates, for the seventh time in a row, down to a low of 8.5%.

Within this context, interbank interest rates for the United States and the euro area hardly recorded any notable variations. In Europe, the disturbances resulting from political uncertainty in Greece and the need for Spain's banks to recapitalize have been offset by the safety net provided by the ECB (through its LTROs in December and February) and governments. Thanks to this protection, 12-month Euribor interest rates have continued to fall slightly, returning to the levels of April 2010 (before the ECB communicated the start of monetary normalization, which was later abandoned).

China lowers interest rates for the first time in four years.

Interbank interest rates look very stable.

Yields on Spanish and Italian debt on «red alert»

Tough pressures on Spain's sovereign debt.

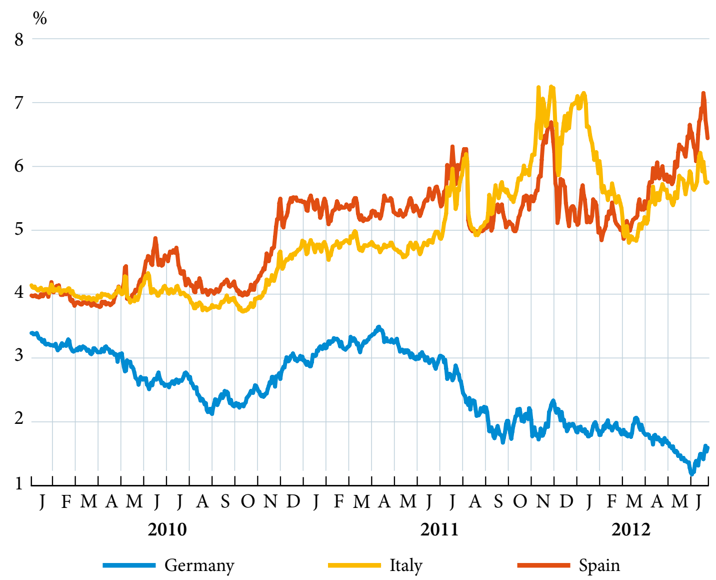
As was already happening in May, doubts regarding the solidity and stability of the euro area have dominated investor sentiment throughout a large part of June. The month started with an abrupt rise in tension due to Greece possibly leaving the euro and growing mistrust regarding the health of Spain's banking system. Over these weeks, and throughout the many different political meetings that were held, the degree of nervousness has fluctuated but has always remained high. With regard to Greece, the party that won the elections has managed to form a coalition government that supports the country remaining within the Monetary Union. With regard to Spain, the government has been supported by the Eurogroup to tackle the recapitalization needs of its banking sector. The credit agreed totals 100 billion euros, under terms that will be determined throughout July. Although both events involve overcoming obstacles that initially appear problematic, the markets' positive reaction was actually temporary and tensions (in the form of rising risk premia) soon returned. This can be explained by the lack of confidence that continues to plague the long-term viability of the Monetary Union. Hence the importance acquired by the debate on how to improve how it works, in particular proposals to progress towards fiscal union, bank union and, ultimately, political union.

Spain continues to suffer rating downgrades.

Logically, within this context, investor mood has been notably cautious, ending up by punishing, once again, the sovereign debt of countries on Europe's periphery, specifically Spain. This penalization has also been due to the downgrades in credit ratings made by the main agencies both for the Kingdom

THE YIELD ON SPAIN'S DEBT HITS A RECORD HIGH

Yield on 10-year public debt



SOURCE: Bloomberg.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2011								
May	3.0	3.4	5.4	4.8	3.1	1.2	3.3	1.8
June	3.0	3.4	5.4	4.9	3.2	1.1	3.4	1.7
July	2.5	3.2	6.1	5.9	2.8	1.1	2.9	1.4
August	2.2	2.9	5.0	5.1	2.2	1.0	2.6	1.1
September	1.9	2.6	5.1	5.5	1.9	1.0	2.4	0.9
October	2.0	3.1	5.5	6.1	2.1	1.0	2.4	1.0
November	2.3	3.4	6.2	7.0	2.1	1.1	2.3	0.9
December	1.8	3.1	5.1	7.1	1.9	1.0	2.0	0.7
2012								
January	1.79	3.05	4.97	5.95	1.80	0.97	1.97	0.72
February	1.82	2.88	4.99	5.19	1.97	0.96	2.15	0.72
March	1.79	2.89	5.35	5.12	2.21	0.99	2.20	0.87
April	1.66	2.96	5.77	5.51	1.91	0.90	2.11	0.72
May	1.20	2.36	6.56	5.90	1.56	0.82	1.57	0.55
June (*)	1.60	2.68	6.74	5.78	1.63	0.82	1.74	0.60

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

of Spain and a large proportion of its financial institutions. Yield on Spanish 10-year bonds therefore exceeded 7% for several sessions and their spread with the German bund went way beyond 500 basis points, the highest since Spain entered the euro.

As a result of investors looking for security, yields on the sovereign debt of more solvent economies, such as the United States, Germany and the United Kingdom, continued their downward slide started several quarters ago, setting new record minimums. In the case of US 10-year bonds, yields fell to 1.60%. In addition to the preference of private investors for financial assets that are considered safe this is also due to other factors such as central banks buying up debt (both of developed and emerging countries) and the change in the financial sector's regulatory framework, promoting policies that delimit risks.

Risk aversion reduces the yields of more solvent countries.

The euro, at the centre of all debates

As has already been noted, developments in Greece's political events, the bail-out of Spain's banking system and the debate regarding the reformation of the EMU have fuelled fluctuations in the risk premia of many different financial assets, clearly reflected in the euro's exchange rate. Over the month, the euro's exchange rate moved around 1.25 dollars with an overall weak tone, thereby consolidating the sharp depreciation suffered in May. In fact, taking a wider view of the trend for Europe's currency we can clearly see that, since February, the euro's downward slide against the dollar has intensified. Several factors have contributed towards

The euro fails to recover from its sharp depreciation in May.

EXCHANGE RATES OF MAIN CURRENCIES

June 22, 2012

	Exchange rate	% change (*)		
		Monthly	Over December 2011	Annual
Against US dollar				
Japanese yen	80.3	0.5	4.3	0.0
Pound sterling	0.641	–1.1	0.3	–3.1
Swiss franc	0.956	0.9	1.9	12.2
Canadian dollar	1.028	0.7	0.6	5.2
Mexican peso	13.836	–0.5	–0.7	14.8
Against euro				
US dollar	1.256	1.0	3.1	12.5
Japanese yen	100.9	–0.5	1.2	–14.2
Swiss franc	1.201	0.0	–1.3	–0.3
Pound sterling	0.806	0.1	–3.4	–10.9
Swedish krona	8.801	–3.3	–1.3	–3.8
Danish krone	7.434	0.0	0.0	–0.3
Polish zloty	4.255	–2.3	–5.0	6.4
Czech crown	25.77	1.9	0.7	5.7
Hungarian forint	287.1	–4.3	–9.7	6.8

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

The upswing in tensions in Europe leads to fears among investors and issuers of corporate bonds.

the euro's loss of value, such as risk aversion related to the euro area's debt crisis, the exit of capital flows for assets in euros and the comparative improvement in economic forecasts for other geographical areas.

In other areas of the foreign exchange market, of note is the continuing depreciation against the dollar of most emerging currencies, which can be put down to the economic slowdown and monetary relaxation they are currently going through. In one particularly remarkable event, the Chinese authorities placed the official yuan-dollar exchange rate at levels that are clearly lower than those prevailing at the start of the year.

The corporate bond markets suffer from the crisis

As in the previous two months, the climate in the private debt markets continues to be dominated by instability in peripheral Europe. As was to be expected, the upswing in tensions in the euro area was initially followed by an increase in credit spreads at a global level. These then gave way to a phase of moderate relaxation in the main indices, after some favourable developments. Two combined trends have come together within this scenario. On the one hand, investors have been confused regarding the flow of news from the euro area. On the other, companies are reluctant to resort to the markets in search of funds as they fear facing high financing costs. This situation has led, in turn, to two effects. The first has been the net withdrawal of capital flows in European bonds towards other markets that are less exposed to the sovereign crisis situation. And the second, the large number of issuers in US markets, attracted by the low financing interest rates that are prevalent there.

From a sector point of view, once again Europe's financial sector has been the greatest victim of the current situation. In addition to the credit difficulties caused by the region's crisis and tougher regulations for the sector are the rating downgrades for many institutions in the euro area, of note being those for Spanish banks.

The other side of the coin is represented by the corporate bonds of countries in South East Asia. The impact of the ups and downs in the euro area crisis and fear of declining economic growth in the United States and China has been relatively modest. These markets' resistance has led to a large number of foreign investors attracted by the yields and security offered by new issuances, both in sovereign and corporate bonds.

Rating agencies downgrade the credit rating for Europe's banking sector.

Stock markets only just manage to dodge adversity

Although the first half of the year has ended with a negative balance for most international stock markets, the month of June has been characterized by a relative improvement in indices. The reduction in fears that Greece will leave the euro and the euro area's assistance in recapitalizing Spain's banking system marked a turning point in the trend for investors' appetite for risk. Although particularly important aspects have yet to be resolved in the euro area, agents have valued the efforts being made by political leaders in the fiscal and financial areas. This consideration has largely offset the negative effect of

International stock markets gain ground, albeit precariously.

EUROPE'S BANKS CONTINUE TO BE PUNISHED ON THE STOCK MARKETS

Eurostoxx 50 and EuroStoxx Banks

SOURCE: Bloomberg.

Investors closely watch the bail-out of Spain's banks.

deteriorating figures for the world's economic activity.

The trend for stock market indices has varied depending on the exposure of listed companies to the effects of the European crisis. The S&P 500 managed to stabilize its trend thanks to the continued good prospects for corporate earnings and the Fed's guarantees of liquidity. In the case of the emerging stock markets, their trends have been related to the different episodes of monetary flexibilization within their economies and the search for safer returns on the part of foreign investors.

With regard to the euro area, June saw a net improvement in most of the indices, albeit from capitalization levels that are still very low. The Ibex 35 rose by almost 10% since its minimum in May, something that has not prevented investors from being extremely careful. In addition to the deteriorating confidence in the capacity of Spain's economy to meet the budget commitments imposed by the European Union were the damage caused to the balance sheets of local financial institutions (where the presence of public debt and real estate assets is very high) and the credit downgrades for Spain and a large proportion of its banks. However, the confirmation of support for Spain's banking system from its EU partners with a loan of up to 100 billion euros and the subsequent announcement of capitalization requirements in the sector by external audit firms of 62 billion euros provided a breath of fresh air for the sector's long-suffering share prices.

INDICES OF MAIN WORLD STOCK EXCHANGES

June 22, 2012

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,573.6*	*0.6*	*2.9*	*3.8*
Standard & Poor's	*1,325.5*	*0.7*	*5.4*	*3.0*
Nasdaq	*2,859.1*	*0.7*	*9.7*	*7.1*
Tokyo	8,798.4	0.8	4.1	–8.6
London	5,524.6	2.2	–0.9	–4.3
Euro area	2,195.4	0.1	–5.2	–21.5
Frankfurt	*6,297.9*	*–2.1*	*6.8*	*–13.5*
Paris	*3,098.0*	*0.5*	*–2.0*	*–20.0*
Amsterdam	*299.1*	*1.1*	*–4.3*	*–10.5*
Milan	*13,816.9*	*2.7*	*–8.4*	*–31.0*
Madrid	*6,891.0*	*3.4*	*–19.6*	*–32.6*
Zurich	5,995.2	1.4	1.0	–1.9
Hong Kong	18,995.1	–0.2	3.0	–13.1
Buenos Aires	2,311.4	3.2	–6.1	–30.7
São Paulo	55,957.4	1.7	–1.4	–8.6

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.

SPAIN: OVERALL ANALYSIS

Economic activity

Bail-out?

According to the Spanish Royal Academy, «rescatar» or bail out in Spanish is to release from danger, harm, trouble or oppression. Given the misgivings that the outcome of the Greek elections might lead to the country leaving the euro, something that would have hindered the considerable financing needs of Spain and Italy over the coming months, the Eurogroup welcomed the Spanish request and decided to provide a loan up to 100 billion euros to recapitalize Spanish banks and thereby dispel at least the other big source of uncertainty in Europe: the capacity of Spain's financial system to tackle an adverse scenario.

The Eurogroup loan releases Spain from having to provide banks that need capital with such a large sum itself. Moreover, in the hypothetical case of Spain having done this by itself, it would probably have had to resort to the markets. Given the uncertainty regarding the Greek elections and the capital requirements of Spanish banks, before the bail-out the central government would have had to pay a very high interest rate. For example, the interest rate for 10-year bonds is above 6%, a prohibitive level should it remain this high for some time. Hence the link between the needs of the private sector (banks) and the public sector (central government).

Europe provides a loan to recapitalize Spanish banks.

DEMAND INDICATORS

Percentage change over same period year before

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
Consumption								
Production of consumer goods (*)	0.8	–1.0	–0.8	0.7	–2.2	–3.6	–7.7	...
Imports of consumer goods (**)	–9.5	–2.2	–8.7	1.2	0.4	–6.1	...	...
Car registrations	3.1	–17.7	–26.4	–0.7	–5.5	–1.9	–21.7	–8.2
Credit for consumer durables	–12.3	–9.9	–10.1	–4.4	–10.4	–12.8	–	...
Consumer confidence index (***)	–20.9	–17.1	–16.1	–15.8	–16.8	–24.6	–28.6	–33.2
Investment								
Capital goods production (*)	–3.3	0.8	2.5	2.6	–4.8	–10.3	–14.9	...
Imports of capital goods (**)	6.5	–3.1	–4.9	–1.5	–7.2	–11.5	...	...
Commercial vehicle registrations	7.0	–6.6	–11.2	5.8	–15.1	–19.1	–25.1	–28.4
Foreign trade (**)								
Non-energy imports	10.3	1.0	–0.7	0.8	–3.1	–8.7	...	...
Exports	15.6	10.1	9.0	10.9	5.4	–0.3	...	...

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

The lack of detail regarding the agreement means that uncertainty still exists.

One of the great advantages of the loan is that, in principle, the interest rate set will be significantly lower, between 3% and 4%. However, if this is finally carried out through Spain's Fund for Orderly Bank Restructuring (FROB), it would be classed as public debt (as the Kingdom of Spain would be the ultimate guarantor) and the interest would be counted as deficit (although a grace period might be given during which no interest is paid for the first few years). Seeing as debt and deficit are actually two of the key variables in determining a country's solvency, investors demanded higher interest for Spanish bonds (more than 7%) and the risk premium increased to 575 basis points, making the upcoming debt issuances by Spain much tougher.

The previous paragraph illustrates the importance of the agreement's small print, that will likely be announced on July 9. However, what does seem clear, according to analyses by the European Commission and the International Monetary Fund (IMF), is the need to sever the connection between private and public debt. At least uncertainty should decline in principle, as in Greece the

SUPPLY INDICATORS

Percentage change over same period year before

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
Industry								
Electricity consumption (1)	2.9	–1.1	0.5	–1.1	–4.0	–2.1	–1.0	–3.2
Industrial production index (2)	0.8	–1.4	–1.1	–1.4	–5.0	–5.8	–8.3	...
Confidence indicator for industry (3)	–13.8	–12.5	–10.7	–14.4	–16.5	–14.8	–17.5	–15.6
Utilization of production capacity (4)	72.0	73.3	74.7	73.3	72.7	72.5	73.4	–
Imports of non-energy intermediate goods (5)	24.6	3.1	3.8	0.9	–4.0	–9.6	...	...
Construction								
Cement consumption	–15.4	–16.2	–15.7	–21.0	–26.8	–31.3	–41.1	...
Confidence indicator for construction (3)	–29.7	–55.4	–55.4	–58.6	–53.6	–50.4	–50.9	–56.6
Housing (new construction approvals)	–17.3	–14.6	–19.5	–5.3	–26.1	–35.2	...	...
Government tendering	–38.0	–46.2	–35.0	–45.2	–59.7	–50.6	...	...
Services								
Retail sales (6)	–1.0	–5.4	–5.1	–4.2	–6.5	–4.9	–9.5	...
Foreign tourists	1.0	7.2	9.6	8.5	6.1	2.6	–1.7	...
Tourist revenue inflows	3.9	8.6	12.2	8.8	5.7	0.5	...	...
Goods carried by rail (ton-km)	6.4	2.0	1.8	7.7	–9.8	–12.6	–8.9	...
Air passenger traffic	2.9	6.0	10.6	6.2	1.5	–5.4	–7.2	–3.8
Motor vehicle diesel fuel consumption	–1.2	–3.7	–4.6	–3.1	–5.6	–4.6	...	...

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.

parties in favour of remaining within the euro formed a government and the two independent audits on the state of Spain's financial system set the capital needs for all its banks in a highly adverse scenario at a maximum of 62 billion, a significantly lower figure than the 100 billion of the loan.

Within this context, economic activity is still showing signs of weakness. Industry's Purchasing Managers' Index has been below the threshold of 50 for more than one year now, indicating that manufacturing is still shrinking, and it is falling away from similar indicators for Italy, France and Germany. Another indicator, the industrial production index, also certified the sector's difficulties, shrinking by 8.3% year-on-year in April.

Most indicators, both supply and demand, continued their negative tone and were worse than the previous month. In this respect, of note is the consumer confidence index as well as that for construction, since both fell in May by 5 and 6 points compared with the previous month. This fall places consumer confidence at the level of spring 2009 and is in addition to the drop in retail and consumer goods, down in April by 9.5% year-on-year.

With regard to the foreign sector, the latest figures for April reveal that exports fell by 0.8%. Economic weakness is a characteristic shared with most of Europe, so that exports to our main trading partner dropped by 4.6%.

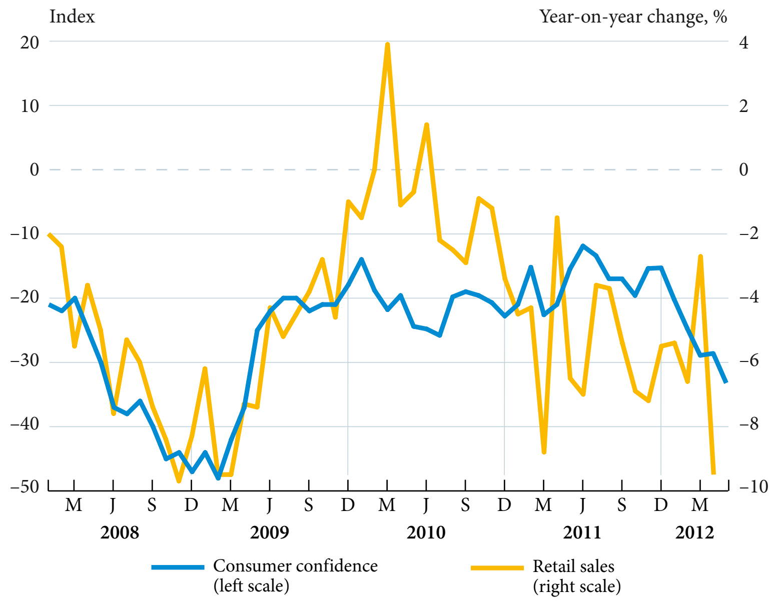
If domestic demand is incapable, at present, of reviving activity, the foreign sector will have to drive growth. To this end, not only does Europe need to specify the details of its financial agreements but also make progress both in the institutional sphere and in the process of fiscal integration. The

Most supply and demand indicators are getting worse as the months progress.

Exports fall due to Europe's weakness.

RETAIL SALES WITHSTAND THE LACK OF CONSUMER CONFIDENCE

Consumer confidence index and retail sales



SOURCES: National Institute of Statistics, European Commission and own calculations.

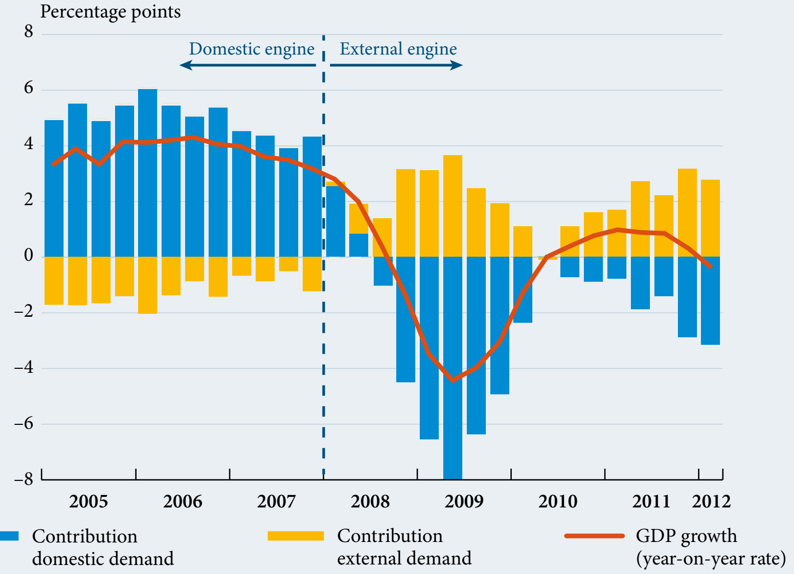
advances made in this respect will have a positive effect both on growth in Spain and in Europe. According to the Royal Academy's dictionary, another meaning of the verb «rescatar» is to recoup lost time or opportunities. The time has come for Spain and Europe to recoup themselves.

The external sector: driving the recovery

The outlook for the Spanish economy in 2012 does not invite optimism. Households, firms and public administrations must not only push forward with their deleveraging but must also do so within a double-dip recession. These adjustments will continue to hinder domestic demand for several years, so that any redirection towards a recovery that helps to create jobs will necessarily involve exports. But can the external engine restart this recovery all on its own?

CHANGE OF ENGINE: THE CRISIS IMPOSES A NEW GROWTH MODEL

Contribution to GDP growth



SOURCES: National Institute of Statistics and own calculations.

To answer this question, first we need to clarify how fast exports need to increase for the economy to grow at a pace that supports job-creation. Traditionally, any sustained recovery in employment in Spain has required GDP growth rates of around 2% and this will be the figure we will use in the simulation that follows. Assuming that the contribution from domestic expenditure is completely null, this 2% needs to come entirely from an increase in net exports (net of the import content; i.e. the part of the value of goods and services exported that corresponds to the intermediate consumption of imports and that, as such, does not contribute to growth in domestic production). The Bank of Spain estimates that this import content of Spanish exports accounts for 39% of their value. So, for the contribution of net exports to the final growth in GDP to be 2 percentage points, their gross contribution needs to be 3.3 percentage points: 2 points in order to contribute to economic growth plus 1.3 points to offset the 39% of the value exported that is imported. Given that the relative weight of exports in Spain's GDP stood at 30.5% in 2011, this contribution requires a 10.8% growth in the foreign sale of Spanish goods and services. If this happened, total imports would grow by 4.2% (resulting from the combination of a 10.8% growth in imports related to exports and 0% in imports related to domestic demand).

In short, to grow by 2% without any assistance from domestic expenditure, exports must increase by almost 11% in real terms (see the table below). Taking into account the fact that, during the boom prior to the crisis (2000-2007), exports grew at an annual average rate of just 5.4%, this 11% seems excessively ambitious. However, when we take into account the fact that, in 2011, exports grew by 9% and in 2010 by 13.5%, it no longer seems so exaggerated. Moreover, if domestic demand contributed something to growth, even if this were modest, exports could grow a little less and GDP growth would still reach 2%.

For example, if domestic expenditure grew by 1% it would contribute 1 percentage point to growth in GDP (as the relative weight of domestic demand for GDP is close to 100%), so the contribution required from net exports would fall by 1 percentage point. In this scenario, the rise in imports would not only correspond to the imported content of exports but also to the imported content of the different components of domestic expenditure (private consumption, public consumption and investment) and to final domestic expenditure on imported goods and services.(1) In this case, the rise required in the foreign sale of goods and services would be less than in the previous scenario, down to 6.9%, with a consequent increase in imports of 3.6% (see the table below).

Is it, then, reasonable to expect exports to grow by almost 7% per year? As we argue below, it is. Past experience, the tried and tested know-how of Spanish exporters, gains in competitiveness and the potential of as yet unexploited markets all support this conclusion. To begin with, we should cast our eyes back again: we have already said that, before the crisis, the volume of exports grew by almost 6% year-on-year. Although this figure might not seem very spectacular at first sight, it should be seen as a success when we take into account the fact that it was achieved within a doubly adverse context: on the one hand, cost competitiveness was being lost (between 10% and 14% depending on the indicator chosen), (see the box «Gains in competitiveness to restart the external engine» on page 33)

HOW FAST MUST EXPORTS GROW TO SUSTAIN THE RECOVERY?

Growth and contribution to GDP (% and percentage points, respectively)

	Scenario 1		Scenario 2	
	Growth	Contribution △ GDP	Growth	Contribution △ GDP
Domestic demand	0.0%	0.0 p.p.	1.0%	1.0 p.p.
Exports	10.8%	3.3 p.p.	6.9%	2.1 p.p.
Imports	4.2%	–1.3 p.p.	3.6%	–1.1 p.p.
Net contribution Foreign demand		2.0 p.p.		1.0 p.p.
△ *GDP* = +2%				

SOURCE: Own estimates.

(1) The estimated import content of private consumption is 29%, for public consumption it's 13% and for investment it's 36%.

and, on the other hand, it coincided with the entrance of large emerging economies in world trade; for example, China went from exporting 3% of world trade in 1999 to 8% in 2008. In spite of facing this double challenge, Spanish exports managed to keep their share of global exports almost stable, both in goods (around 1.7%) and in services (around 3.5%).

This was achieved, on the one hand, thanks to the positioning of Spanish exports in goods from medium-high technology sectors, where competition is not so much driven by price as by brand or quality. On the other hand, Spanish exporters managed to maintain a higher level of competitiveness than the average for the country (the loss of competitiveness measured in terms of export prices was 5%, almost one third of its equivalent in terms of unit labour costs) and a similar level of productivity to their foreign competitors (see the box «Strong exports, weak competitiveness: an odd couple?» from June 2011).

These signs of strength endorse the capacity of our export sector to drive the recovery. Even more so when the advances being made in the area of competitiveness are substantial (see the box on page 33) and when a weak euro (compared with the pre-crisis period or even 2011) will also help to improve trading conditions outside the euro area.

This improvement is particularly welcome given that the greatest market potential for Spain's exports is located outside Europe. Most of the world's growth is currently concentrated, and will continue to be so, in the emerging economies and in some advanced countries where Spanish exports still have a long way to go. In fact, recent foreign trade figures reveal that it is precisely the weak economy both in Spain and the euro area that has provided the necessary push for many Spanish firms to finally take on these markets and take advantage of their great potential. In China, India and Russia, for example, the share of Spanish exports has been rising since the year 2000 while those of its most direct rivals have lost ground; Italy has lost share in all of them while Germany has seen its share fall in India; in Brazil, all of them, including Spain, have lost market share.

In summary, in a situation such as the present, where growth in domestic expenditure is being restricted by adjustments, the recovery needs to be supported by exports, making the most of business opportunities in other more dynamic markets. Spain cannot devalue nor can it resort to monetary or commercial policies to improve its competitiveness but it does have room to pursue structural reforms that boost such competitiveness via efficiency, investment, innovation and the quality of human capital, and strengthening its appeal as an exporting base. The areas for such reforms range from improving regulation and bureaucracy to increasing competition or facilitating foreign trade by investing in infrastructures.

And although the institutional sphere may carry out initiatives to promote this internationalization, its true driving force lies in companies themselves and their directors. In the short term, the engine for Spain's recovery is also in their hands... and it would be difficult to find a better place for it.

This box was prepared by Marta Noguer
International Unit, Research Department, "la Caixa"

Labour market

Not even the seasonal boost can revive employment

The effects of the double dip recession can be clearly seen in the labour market. Although the number of people registered as employed and unemployed in May showed some improvement, this was thanks to the seasonal nature of the period as, once the figures had been adjusted, the result was a substantial deterioration in the data. The total rise in the numbers registered as employed, namely 77,431 people, was very small for a month that is traditionally good for employment and this meant that this variable's rate of descent sharpened by two tenths of a percentage point to 3.4% year-on-year. It's the same situation with the number of registered unemployed, whose drop of 30,113 people meant that the year-on-year growth rate increased to 12.5%, a level it has not reached since May 2010. The trend in the seasonally-adjusted figures for the labour market therefore suggests that the drop in economic activity during the second quarter of 2012 has been sharper than the one recorded in the previous quarter.

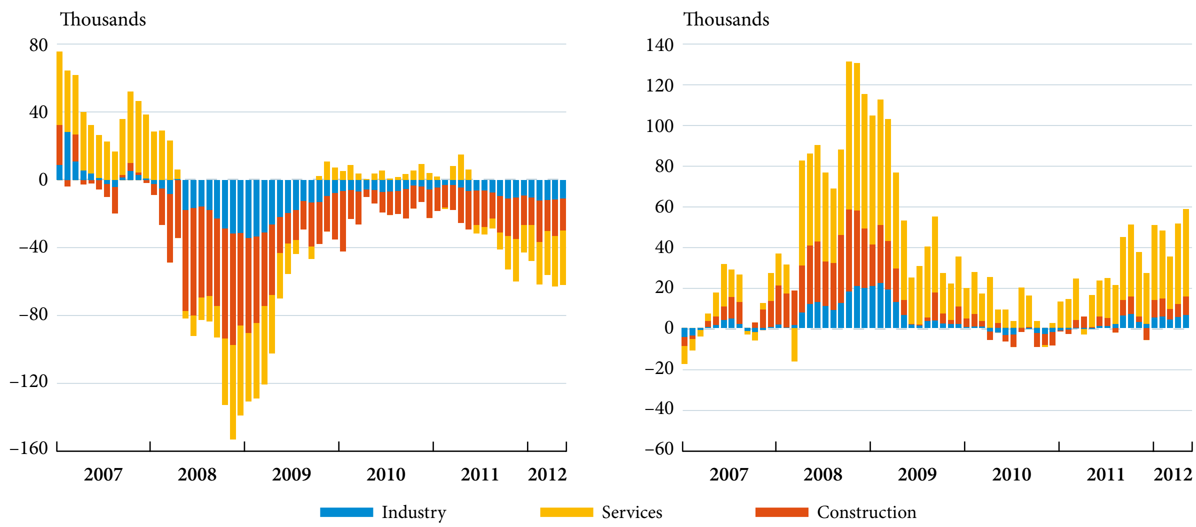
Unemployment once again grows at the rates of 2010.

This weak tone is also affecting the tourism industry and therefore the services sector in general, which until a few months ago had seemed quite resistant. In the month of May, the number of employees in the services

THE LABOUR MARKET CONTINUES TO SINK IN ALL SECTORS

Monthly change in the number of employed registered with Social Security (*)

Monthly change in the number of registered unemployed (*)



NOTE: (*) Seasonally adjusted monthly change.
SOURCES: Ministry of Labour and Immigration, Public Employment Offices and own calculations.

The services sector performs badly.

sector fell by 1.8% year-on-year, 0.3 percentage points below the figure posted for the previous month. These figures are in contrast to the growth seen last year, which reached 0.6% year-on-year in May. The lower economic dynamism in the main countries that visit Spain as tourists, mainly European countries, and the stabilization of the conflicts in North Africa makes a similar tourist season to last year highly unlikely. However, both the number of tourists that will visit Spain plus the income generated by tourism should remain at a relatively high level over the coming months.

The adjustment process is gaining speed in the other two sectors. Although the number of employees in construction fell by 12.2% last year, this sector has yet to touch bottom. Until the stock of finished but unsold homes reduces considerably, construction will remain very weak. A good example of this is the clearly downward trend for new homes started, which between April 2011 and March 2012 hardly reached 80,000. A figure that is clearly lower than the one in 2009 and 2010, which were 159,000 and 124,000, respectively.

The manufacturing industry, which had stabilized in 2010 and the first half of 2011, is once again going through a significant relapse. In May, the number of employees fell at a rate of 5.1%, 0.1 percentage points more than the previous month.

The second quarter's decline in the labour market is also evident in the trend for contracts registered, down by 6.6% year-on-year in May. This contrasts with the 9% rise in employment contracts in the

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2010	2011	2011			2012		
			2Q	3Q	4Q	1Q	April	May
Persons registered with Social Security (1)								
Sectors of activity								
Industry	*–4.8*	*–2.7*	*–2.4*	*–2.4*	*–3.3*	*–4.2*	*–5.0*	*–5.1*
Construction	*–13.4*	*–12.2*	*–11.4*	*–13.0*	*–14.9*	*–16.4*	*–17.3*	*–17.3*
Services	*0.0*	*0.2*	*0.5*	*0.3*	*–0.3*	*–0.9*	*–1.5*	*–1.8*
Job situation								
Wage-earners	*–1.8*	*–1.4*	*–1.0*	*–1.3*	*–2.1*	*–2.9*	*–3.6*	*–3.8*
Non-wage-earners	*–2.8*	*–1.2*	*–1.2*	*–1.0*	*–1.0*	*–1.2*	*–1.3*	*–1.4*
Total	**–2.0**	**–1.3**	**–1.0**	**–1.2**	**–1.9**	**–2.6**	**–3.2**	**–3.4**
Persons employed (2)	**–2.3**	**–1.9**	**–0.9**	**–2.1**	**–3.3**	**–4.0**	**–**	**–**
Jobs (3)	**–2.6**	**–2.0**	**–1.3**	**–2.0**	**–3.3**	**–3.8**	**–**	**–**
Hiring contracts registered (4)								
Permanent	–6.4	–9.6	–5.0	–8.4	–22.8	–19.3	–6.4	–7.0
Temporary	3.8	1.0	3.9	0.9	–1.2	–6.7	–5.9	–6.5
Total	**2.8**	**0.1**	**3.1**	**0.2**	**–3.0**	**–7.8**	**–6.0**	**–6.6**

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

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

May 2012

	No. of unemployed	Change over December 2011		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	160,200	14,239	9.8	24,097	17.7	3.4
Industry	538,339	28,869	5.7	47,922	9.8	11.4
Construction	796,569	20,641	2.7	57,576	7.8	16.9
Services	2,805,203	192,674	7.4	357,396	14.6	59.5
First job	413,811	35,340	9.3	37,472	10.0	8.8
By sex						
Males	2,337,116	127,378	5.8	272,535	13.2	49.6
Females	2,377,006	164,385	7.4	251,928	11.9	50.4
By age						
Under 25 years	490,329	29,768	6.5	39,392	8.7	10.4
All other ages	4,223,793	261,995	6.6	485,071	13.0	89.6
TOTAL	**4,714,122**	**291,763**	**6.6**	**524,463**	**12.5**	**100.0**

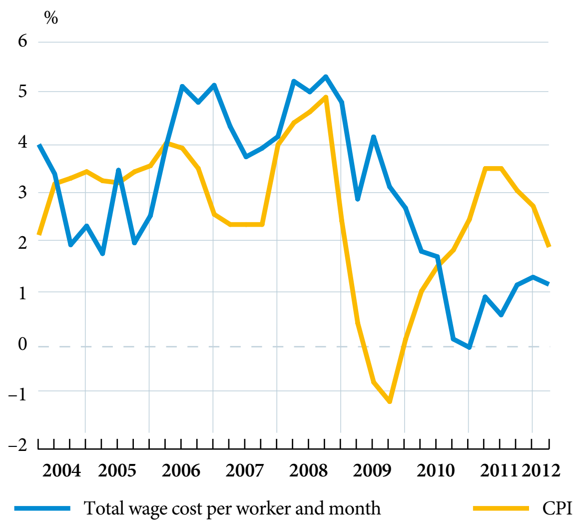
SOURCES: Public State Employment Service and own calculations.

same month a year ago. The decline was more extensive among permanent contracts, which fell by 7% year-on-year, while temporary contracts fell by 6.4% compared with the same month last year. However, we should note the fact that the rate of decline in temporary contracts is reaching levels similar to those of

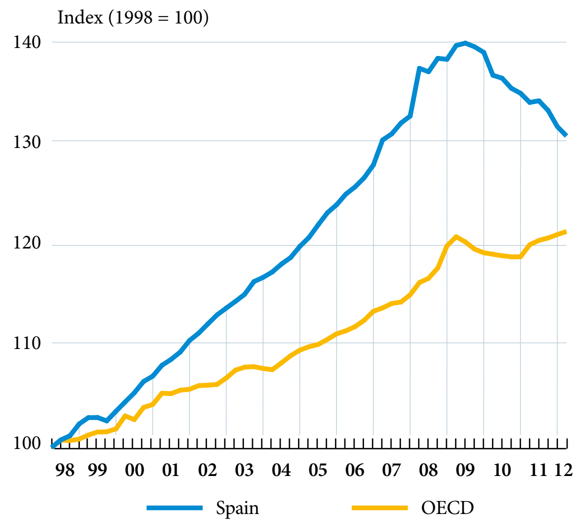
Contracts registered fall by 6.6% year-on-year in the month of May.

WAGE CONTAINMENT HELPS TO IMPROVE COMPETITIVENESS LEVELS

Year-on-year change



Unit labour costs (*)



NOTE: (*) Seasonally adjusted monthly change.
SOURCES: National Institute of Statistics, OECD and own calculations.

Labour costs slow up their growth.

permanent contracts, an outcome that is very different from the one recorded during the previous two years, when temporary contracts were growing.

The adjustment in the labour market is being carried out mainly via the number of employees although wages are also responding to the weaker economic activity, albeit to a lesser extent. In fact, coinciding with the double dip recession, the quarterly labour cost survey (ETCL in Spanish) for the first quarter of 2012 shows greater wage containment after two periods in which this trend had slowed up. Wage costs per worker therefore rose by 1.2% year-on-year, a rate slightly slower than the one recorded the previous quarter. Similarly, wage moderation helped labour costs per worker to slow up considerably, with a year-on-year growth rate of 1.1%.

Given that wage costs continued to grow less than inflation in the first quarter, wages lost purchasing power. In this respect, it seems as if the arduous process of domestic devaluation, which is necessary to improve production levels, is being carried out. Another sign of this is the trend in the index of labour costs per production unit, or unit labour costs, which is published every quarter by the OECD for all its member states. The trend in this variable is positive in the OECD as a whole, while Spain has accumulated falls over ten quarters.

WAGE INDICATORS

Percentage rate of change over same period year before

	2010	2011	2011				2012
			1Q	2Q	3Q	4Q	1Q
Increase under general wage agreements (*)	**1.5**	**2.3**	**3.1**	**2.7**	**2.6**	**2.3**	**2.2**
Wage per job equivalent to full-time work (**)	**0.0**	**0.8**	**0.6**	**0.5**	**1.2**	**1.1**	**0.9**
Quarterly labour cost survey							
Wage costs							
Total	0.9	1.0	1.0	0.6	1.2	1.4	1.2
Industry	*2.9*	*2.8*	*3.0*	*3.1*	*2.8*	*2.3*	*1.9*
Construction	*0.8*	*2.5*	*2.3*	*3.2*	*1.9*	*2.4*	*1.3*
Services	*0.5*	*0.5*	*0.3*	*–0.2*	*0.8*	*1.1*	*1.0*
Average wages per hour worked	1.1	2.1	0.2	1.3	4.5	2.2	1.5
Other labour costs	–1.1	1.6	0.4	1.5	2.2	2.2	0.9
Work day (***)	–0.3	–0.9	0.8	–0.6	–3.2	–0.8	–0.3
Farm wages	**2.9**	**1.9**	**1.7**	**1.9**	**1.7**	**2.3**	**0.3**
Labour cost in construction	**1.0**	**1.9**	**1.3**	**2.0**	**2.0**	**2.1**	**0.8**

NOTES: (*) Does not include wage revision clauses. Cumulative figures.
(**) Quarterly National Accounts: data adjusted for seasons and public holidays.
(***) Effective hours worked per worker per month.
SOURCES: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fisheries and Food, Ministry of Public Works and own calculations.

Prices

A question of balance

After a rise of two tenths of a percentage point in April, inflation was back at 1.9% in May. Although the components that justified the latest upswing in the consumer price index (CPI) were still pushing up inflation, the drop in oil prices as well as food offset this effect and pushed the annual CPI rate down by two tenths of a percentage point.

April's upswing was atypical as the rise in inflation was not due to economic activity but the government's intervention in electricity, gas and tobacco prices. Given that part of the tax hike was passed on to consumers via prices, in May these three elements joined together to push up inflation by almost one tenth of a percentage point.

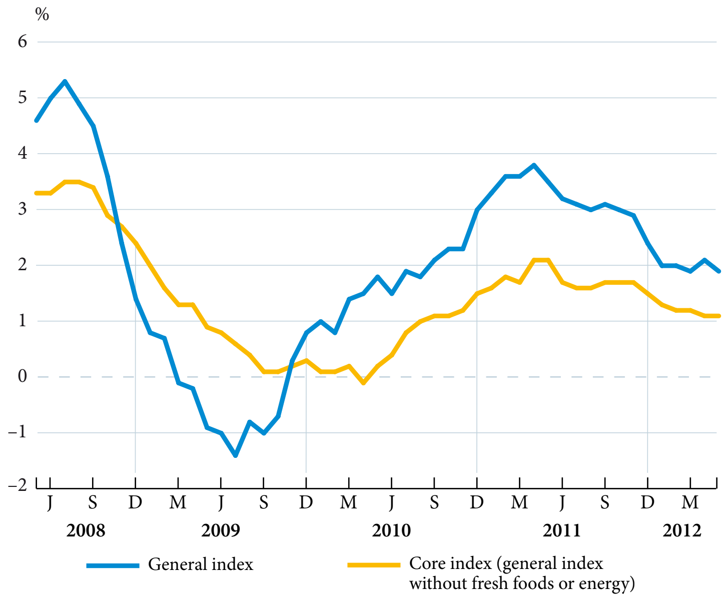
However, two of the most volatile elements within inflation, oil and food, played a decisive role and posted significant drops, which ended up determining the drop in the CPI's annual rate of change. In just one month, May, the price of Brent quality oil fell by 14% and came close to 100 dollars per barrel. However, due to the 7% depreciation in the euro/dollar exchange rate in the same period, Spanish consumers only benefitted from an 8% drop in oil prices. Nevertheless, although the euro's weakness is making crude imports more

The CPI falls by two tenths of a percentage point, reaching 1.9%.

The price of crude in euros falls by 8% in one month.

OIL AND FOOD PUSH INFLATION DOWN

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

May

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2011	2012	2011	2012	2011	2012
By type of spending							
Food and non-alcoholic beverages	101.6	0.3	–0.2	0.8	0.5	2.5	1.8
Alcoholic beverages and tobacco	106.7	0.0	1.1	2.5	4.5	14.7	6.2
Clothing and footwear	106.8	2.1	2.1	–2.2	–2.0	0.5	0.5
Housing	104.7	–0.1	0.3	4.1	3.5	7.6	5.1
Furnishings and household equipment	101.0	0.4	0.3	0.4	0.0	1.4	0.7
Health	97.6	–0.1	0.0	–0.1	–0.1	–0.7	–2.8
Transport	104.2	–0.8	–1.4	4.1	3.4	7.9	4.2
Communications	96.8	0.0	0.1	0.0	–2.2	0.3	–3.8
Recreation and culture	99.3	–1.7	–1.6	–1.2	–2.1	–0.6	0.4
Education	102.1	0.0	0.0	0.0	0.1	2.2	2.9
Restaurants and hotels	100.7	–0.1	–0.2	0.9	0.7	1.8	0.9
Other goods and services	101.7	0.2	–0.1	2.0	1.0	3.1	1.7
By group							
Processed food, beverages and tobacco	102.9	0.2	0.3	1.6	1.4	4.7	3.0
Unprocessed food	101.0	0.4	–0.6	–0.1	0.3	2.7	1.1
Non-food products	102.3	–0.1	–0.2	1.4	0.9	3.4	1.8
Industrial goods	103.8	0.1	–0.1	2.0	1.5	4.8	2.5
Energy products	*108.1*	*–1.3*	*–1.9*	*8.7*	*6.6*	*15.3*	*8.3*
Fuels and oils	*107.9*	*–1.8*	*–2.6*	*8.9*	*6.1*	*15.5*	*7.8*
Industrial goods excluding energy products	*102.0*	*0.6*	*0.7*	*–0.5*	*–0.7*	*0.9*	*0.2*
Services	100.8	–0.3	–0.3	0.9	0.3	2.0	1.1
Underlying inflation (**)	101.6	0.1	0.2	0.5	0.2	2.1	1.1
GENERAL INDEX	**102.3**	**0.0**	**–0.1**	**1.4**	**0.9**	**3.5**	**1.9**

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

The largest monthly drop in fuels since 2008.

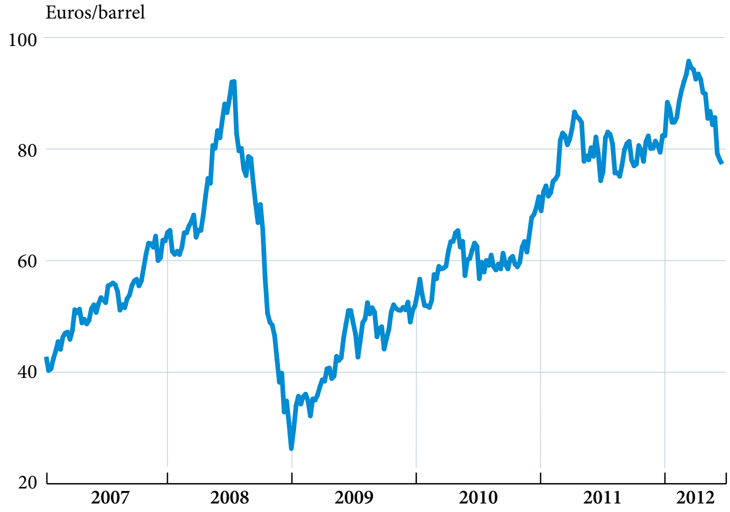
expensive, the size of the decrease in the price of this fuel is enough not only to overcome this effect but also to become the component that contributed the most to the drop in inflation.

The monthly drop in fuels and oils reached 3.7%, the largest fall in this component since December 2008. However, while the annual rate of change for fuels and oils fell by almost two points, the component that contains these items, namely transportation, scarcely dropped by 0.6 percentage points. This is due to higher prices in other transport services, whose annual rate rose by more than 10 points, boosted by the increase in combined tickets. For the year, urban public transport has risen by 7.8%.

Over the coming months oil will play a fundamental role in pushing down inflation. This downward slide is justified

OIL WILL PLAY A DECISIVE ROLE IN INFLATION OVER THE COMING MONTHS

Price of a barrel of Brent quality oil



SOURCE: Thomson Reuters Datastream.

not only by the crisis in the euro area but also by the lower growth than expected in China, the weakness of some emerging markets such as Brazil and India and the bad employment figures in the United States. In fact, in the first 20 days of June, the price of Brent quality oil in dollars fell a further 6%, a drop of 8% when valued in euros.

The other large component responsible for the fall in inflation is food, whose annual rate of change decreased by five tenths of a percentage point and is now at 1.8%. Food is notably an item made up of some extremely volatile components. While egg prices have risen by 18.3% in the last 12 months, the price of potatoes and their derivatives has fallen by 15.2%. Another example is the price of legumes and fresh vegetables, which in monthly terms has fallen 4.2%, revealing that the volatility of some food prices is even greater than that of oil.

Given that the drop in general inflation is due largely to energy and fresh foods, core inflation, which excludes these two components, remained stable at 1.1%. In the short term the forecast is for general inflation to continue falling, pushed down by both falling oil prices and weak domestic demand. According to our forecasts, inflation will come close to 1.6% by the end of year while the average for 2012 will be around 1.8%.

Inflation will remain around 1.8% for the whole of 2012.

However, this inflation forecast may vary a lot if the current situation alters considerably. The risk lies in both a deviation in the oil price forecast and also a deterioration in economic activity that is greater than predicted, in addition to the effect of regulatory changes on price formation.

In this respect, of note is the recommendation by the International Monetary Fund, which has urged Spain to carry out a peremptory hike in value added tax (VAT), and thereby meet the target deficit for 2012 and speed up the recovery of the Spanish economy. In a hypothetical year, an attempt can be

CONSUMER PRICE INDEX

	2011			2012		
	% monthly change	% change over December 2010	% annual change	% monthly change	% change over December 2011	% annual change
January	–0.7	–0.7	3.3	–1.1	–1.1	2.0
February	0.1	–0.6	3.6	0.1	–1.0	2.0
March	0.7	0.1	3.6	0.7	–0.3	1.9
April	1.3	1.4	3.8	1.4	1.1	2.1
May	0.0	1.3	3.5	–0.1	0.9	1.9
June	–0.1	1.2	3.2			
July	–0.5	0.7	3.1			
August	0.1	0.8	3.0			
September	0.2	1.0	3.1			
October	0.8	1.8	3.0			
November	0.4	2.2	2.9			
December	0.1	2.4	2.4			

SOURCE: National Institute of Statistics.

made to estimate the effect of a further rise in inflation.

Estimates show that the increases in 1995 of one point in general VAT (from 15% to 16%), the reduced rate (from 6% to 7%) and the minimum rate (from 3% to 4%) led to an increase in inflation of 0.25 percentage points. However, although in 2010 the minimum VAT rate was not altered, the general rate was increased by two points to 18% and the reduced rate by one point to 8%. It is estimated that this tax hike brought about an increase of 0.5 points in inflation. Past experience suggests that it is very difficult to anticipate the effect on inflation of a hypothetical increase in VAT, as prices are very sensitive both to the extent of the tax hike and the different rates (general, reduced and minimum) to which it may be applied.

Foreign sector

Weak European demand reduces exports

The slowdown in Europe's economy in the second quarter of 2012 is taking its toll on the foreign sector. The Old Continent's weak demand once again dragged April's exports down towards negative rates, specifically 0.8% year-on-year. However, a larger decline in imports means that the foreign sector's net contribution is still positive and the trade deficit is continuing to shrink.

The export and import figures for April have undoubtedly been affected by the weakness in demand, both at a global level and in Spain. On the one hand, real exports recorded their third consecutive drop in April, by 0.5% year-on-year. Leading activity indicators, particularly in the European market, do not suggest any change in direction of export trends in the short term. In the same period, the drop in real imports was considerably higher, specifically 7.2% year-on-year.

April's exports fall by 0.8% year-on-year.

FOREIGN TRADE

January-April 2012

	Imports			Exports			Balance	
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	Export/ Import rate (%)
By product group								
Energy products	21,391	16.1	25.0	4,721	15.4	6.6	–16,669	22.1
Consumer goods	18,913	–4.2	22.1	23,625	0.6	33.0	4,712	124.9
Food	*4,897*	*–1.6*	*5.7*	*9,592*	*8.0*	*13.4*	*4,695*	*195.9*
Non-foods	*14,016*	*–5.1*	*16.4*	*14,033*	*–3.8*	*19.6*	*16*	*100.1*
Capital goods	5,012	–11.3	5.9	5,743	–6.9	8.0	731	114.6
Non-energy intermediate goods	40,343	–6.2	47.1	37,554	3.3	52.4	–2,789	93.1
By geographical area								
European Union	42,971	–6.9	50.2	46,566	–0.5	65.0	3,595	108.4
Euro area	*34,732*	*–7.8*	*40.5*	*37,160*	*–1.5*	*51.9*	*2,428*	*107.0*
Other countries	42,688	5.0	49.8	25,078	7.8	35.0	–17,611	58.7
Russia	*2,591*	*–12.5*	*3.0*	*907*	*21.7*	*1.3*	*–1,684*	*35.0*
United States	*3,371*	*–7.2*	*3.9*	*2,716*	*–2.9*	*3.8*	*–655*	*80.6*
Japan	*1,051*	*–11.0*	*1.2*	*670*	*15.3*	*0.9*	*–382*	*63.7*
Latin America	*7,638*	*40.7*	*8.9*	*4,206*	*4.0*	*5.9*	*–3,432*	*55.1*
OPEC	*10,697*	*18.3*	*12.5*	*3,141*	*20.5*	*4.4*	*–7,556*	*29.4*
Rest	*17,339*	*–5.8*	*20.2*	*13,438*	*7.6*	*18.8*	*–3,901*	*77.5*
TOTAL	**85,659**	**–1.3**	**100.0**	**71,644**	**2.2**	**100.0**	**–14,015**	**83.6**

SOURCES: Ministry of the Economy and own calculations.

The weakness of imports reduces the deficit to 43.6 billion euros.

In the case of nominal trade flows, the squeeze in imports also exceeded that of exports. This led to a further correction in the trade balance of 15.3% year-on-year, reducing the cumulative deficit for the last twelve months to 43.6 billion euros, rewinding to the levels of 2003. A more detailed analysis of these series can help us to determine the underlying factors that will determine the trend in the foreign sector over the coming months.

Once again, the deterioration in exports to the European Union, 4.6% lower than in April 2011, concealed the good performance of trade with the rest of the world. Of note was the sharp fall in demand from countries such as Portugal, the United Kingdom and Italy. This contraction means that the relative importance of exports aimed at the EU market continues to decrease, currently accounting for 65% of Spanish goods compared with 75% eight years ago. This ratio is still high, so that the squeeze in Europe's economy will keep export trends in the negative.

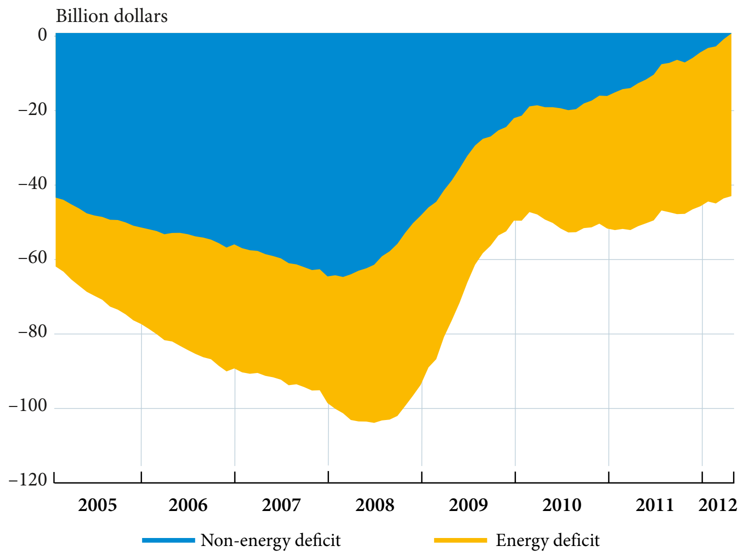
Exports to the European Union account for 65% of the total.

However, the trend in the correction of the balance of goods deficit is unlikely to reverse. On the one hand, the drop in Spanish domestic demand will continue to improve the non-energy balance, which remained almost the same in April, something that hasn't happened since 1986. With regard to the energy deficit, this increased again in April, coming close to the peak reached in 2008.

However, we predict that the fall recorded in oil prices in May and June will correct this imbalance over the next few months. Something that already happened in 2009, when the fall in energy prices, 44.2% between the maximum and the minimum, led to a 40.8% correction in the deficit from the maximum. Between February and June 2012, oil prices in euros have fallen by 26.2%. This means that, should the relation observed in the past continue, the energy deficit might

THE TRADE DEFICIT IS CORRECTED BY A BALANCED NON-ENERGY BALANCE IN APRIL

Cumulative figures over the last twelve months



SOURCES: Ministry of the Economy and own calculations.

decrease by around 8 tenths of a percentage point of gross domestic product (GDP).

This good performance by the balance of goods could help to improve the current deficit, taking over from the balance of services. In fact, according to data from the Bank of Spain, revenue from foreign tourism stood still, remaining at 2.9% of GDP in the month of May. However, the upswing in the number of tourists entering Spain in May, 5.8% year-on-year, invites optimism. Should further increases be recorded over the coming months, the improvement in the services balance could neutralize the progressive rise in the income deficit. This is due to the higher cost of financing Spanish debt within a context of a severe lack of confidence on the part of international investors.

The recent fall in oil prices could reduce the trade deficit by 8 tenths of a percentage point.

In fact, within this tense situation, the composition of Spanish financing has undergone a significant change. As can be seen in the financial account, the Eurosystem has become the main source of the net inflow of capital during the first quarter of the year, up by over 101 billion euros. This increase is due to the high liquidity injections carried out by the European Central Bank in the banking system. As a consequence, net borrowing via other, more traditional channels has fallen dramatically.

The ECB's liquidity injection shifts financing through other channels.

BALANCE OF PAYMENTS

March 2012

	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	–8,832	–20.7	–37,394	10,439	–21.8
Services					
Tourism	*5,061*	*3.7*	*30,786*	*3,335*	*12.2*
Other services	*862*	*–*	*4,925*	*4,783*	*–*
Total	5,923	40.7	35,711	8,138	29.5
Income	–7,464	27.2	–27,730	–6,253	29.1
Transfers	–4,477	10.4	–6,348	772	–10.8
Total	**–14,850**	**–11.9**	**–35,760**	**13,096**	**–26.8**
Capital account	**630**	**–59.7**	**4,554**	**–1,402**	**–23.5**
Financial balance					
Direct investment	7,940	–	5,033	14,515	–
Portfolio investment	–34,385	–	–81,150	–137,847	–
Other investment	–70,646	–	–117,168	–105,068	–
Total	**–97,091**	**–**	**–193,285**	**–228,400**	**–**
Errors and omissions	5,738	5.4	–1,274	–7,550	–
Change in assets of Bank of Spain	105,572	–	225,765	224,255	–

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.

Is Spain's external position sustainable?

Since the euro was adopted, Spain has accumulated 666 billion euros in external deficits. In fact, we have to go back to the mid-1980s to find the last trace of a surplus. Inevitably, these deficits have been financed with foreign capital, causing a considerable increase in liabilities vis-à-vis the rest of the world, mostly in the form of debt. This external position currently constitutes one of the key vulnerabilities of the Spanish economy as it raises doubts regarding the country's solvency and also requires constant access to international financing markets.

At the end of 2011, Spain's net international investment position (NIIP) reached a net negative balance equivalent to 92% of GDP. This position combines foreign assets equivalent to 129% of GDP and liabilities of 221% of GDP (see the table below). This figure could be worrying for various reasons: it is one of the highest debtor positions in the world, only surpassed in the euro area by Ireland and Portugal, so we must wonder whether Spain can afford it; a high proportion of the total liabilities are in the form of debt and this, as it requires regular payments for interest and amortization, entails greater vulnerability than other kinds of liabilities, such as shares and other forms of participation in corporate capital; and, lastly, the net liability position has tripled since the euro was adopted, which might suggest that an explosive dynamic is at work. However, all these concerns can be qualified.

INTERNATIONAL INVESTMENT POSITION OF SPAIN

December 2011, as % of GDP

	Assets	Liabilities	Net position
Total excluding the Bank of Spain	120	205	–84
Direct investment	46	45	2
Portfolio investment (shares, bonds, commercial paper, etc.)	24	81	–57
Other investments (loans, deposits, etc.)	37	66	–29
Financial derivatives	13	13	0
Bank of Spain	9	16	–8
Total	**129**	**221**	**–92**

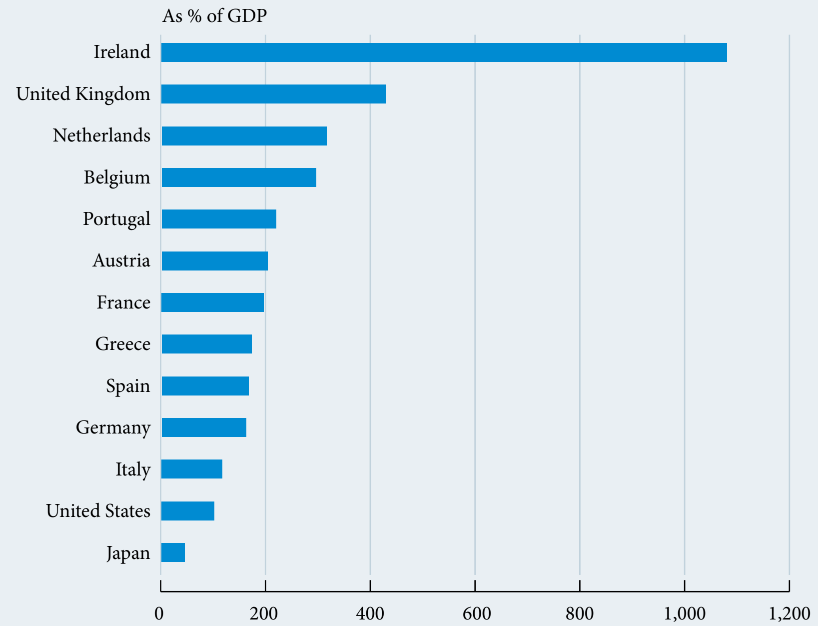
SOURCE: Bank of Spain and own estimates.

Firstly, although the NIIP is relatively high, the cost of financing it is relatively modest. The income account of the balance of payments, which mostly reflects net payments for interest and dividends, only had a deficit equivalent to 2.4% of GDP in 2011, a figure similar to the average for the previous five years. The average cost on liabilities was limited to 2.9% thanks to low official interest rates, which affect the short-term rates to which a significant proportion of external debt is indexed, and also thanks to the moderation in dividend payments. Moreover, the impact of the higher risk premium was limited as the pass-through to the average cost is very gradual (the pace is determined mainly by the proportion of debt that matures and is refinanced). For their part, external assets received an average yield of 3.0%, slightly more than that of liabilities, thanks to the earnings of Spanish multinationals.

Secondly, although it's true that three quarters of all liabilities are in the form of debt, Spain's level of external debt, equivalent to 165% of GDP, does not compare unfavourably with other European countries (see the graph below). In particular, the external debt of public administrations (26% of GDP) is one of the lowest in the euro area. Private external debt (139% of GDP) is comparatively higher but its share in GDP is similar to that of France and Austria and lower than that of Portugal and other countries where the financial system involves considerable international activity (United Kingdom, Ireland, Belgium, Netherlands).

THE LEVEL OF SPAIN'S EXTERNAL DEBT DOES NOT COMPARE UNFAVOURABLY

External debt. 2011 or latest available figures



SOURCE: National central banks and own calculations.

Lastly, the net investment position seems to have stabilized over the last few years. Since 2009, net liabilities have remained at around 90% of GDP while external debt has fluctuated around 165% of GDP. This has been mainly the result of the sharp adjustment in the trade deficit, which declined from 6.5% of GDP in 2007 to 0.5% of GDP in 2011 (allowing the current account deficit to fall from 10.0% of GDP to 3.5% of GDP, see the box «Target surplus: reality or mirage?» on page 17). However, the effects of revaluing assets and liabilities have also played a significant part. In particular, the relatively greater losses in the Spanish stock exchange and the higher risk premium have reduced the market value of liabilities vis-à-vis non-residents, helping to contain the increase in net liabilities.

Given that we can't expect revaluation effects to help to sustain the level of liabilities year after year, the external deficit will have to continue its adjustment to ensure the long-term stabilization and, even better, the reduction of the net debt position of Spain. The adjustment required will largely depend on the interest rate paid by Spain for its external debt.[1] For example, in a scenario where the average yield demanded for net liabilities increases to 4.0% (as a consequence, for example, of a continually high risk premium) and if the nominal growth in GDP were 3.0% (a conservative assumption if we take into account the potential growth of the Spanish economy in the medium term), a trade surplus of 0.9% of GDP would be required to stabilize the net debt position at 90% of GDP. This requirement is not a tall order as, for 2012, we are already predicting that the trade surplus will come close to this figure. However, to reduce the net debt position to 70% of GDP within 10 years, we would have to post a trade surplus of practically 3% of GDP every year. Therefore, the correction undertaken by the trade balance in the last few years must continue, also taking into account the fact that the larger the differential between the interest rate paid for external debt and the economy's rate of growth, the greater the trade surplus required to stabilize or reduce external debt.

The dynamics of the investment position, virtually stabilized, and the cost of servicing the debt, which Spain can bear if the risk premium doesn't increase further, suggest that the main problem of Spain's external position is more related to issues of liquidity than solvency. But liquidity and solvency are very closely connected concepts: a liquidity crisis that pushes up risk premia and forces rapid deleveraging limits the ability to refinance debt and thereby raises doubts regarding the debtor's solvency; on the other hand, within an environment of widespread risk aversion as the present, a few doubts regarding the solvency of a debtor could lead to a liquidity crisis.

Investor expectations need to be turned around in order to break the vicious circle between problems of liquidity and doubts regarding solvency, and this can only be achieved by acting simultaneously on both fronts. Acting on the liquidity front involves someone exercising the role of lender of last resort, with the capacity to inject liquidity into financial institutions and acquire public debt. This must necessarily be complemented by actions that dispel doubts regarding the solvency of the country's public and private sectors and, in this respect, the key lies in: making the deficit reduction targets more credible; speeding up the clean-up and restructuring of the financial system; and continuing to improve the competitiveness of our economy. Although it's true that the progress made in strengthening both fronts –liquidity and solvency– has been substantial, there's undoubtedly still a long way to go.

(1) The equation that describes the dynamic of the external debt position is: $d_t = \frac{(1+i)}{(1+g)} d_{t-1} - p_t$, where d represents the debt position as a percentage of GDP (within the period given by the subindex); i refers to the average yield to be paid; g is the nominal growth in GDP; and p is the trade balance for goods and services plus net current and capital transfers. In Spain, p was equivalent to –0.6% of GDP in 2011 (basically coinciding with the trade balance for goods and services as the surplus in capital transfers was practically wiped out by the deficit in current transfers; consequently, in the text we refer to p as the trade balance).

This box was prepared by Enric Fernández
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Public sector

Europe to the rescue

On 18 June, the yield demanded for Spain's public debt reached its highest since the country first joined the euro area. Since then, the decision by the Eurogroup to approve Spain's request for financial aid, totalling a maximum of 100 billion euros, to recapitalize those banks that need it as well as the formation of a pro-European government in Greece have eased tensions a little. The results of the intense institutional agenda over the coming weeks and new figures on the degree of compliance of Spain's fiscal adjustment will determine whether this respite is temporary or whether we are just starting to get back to normal.

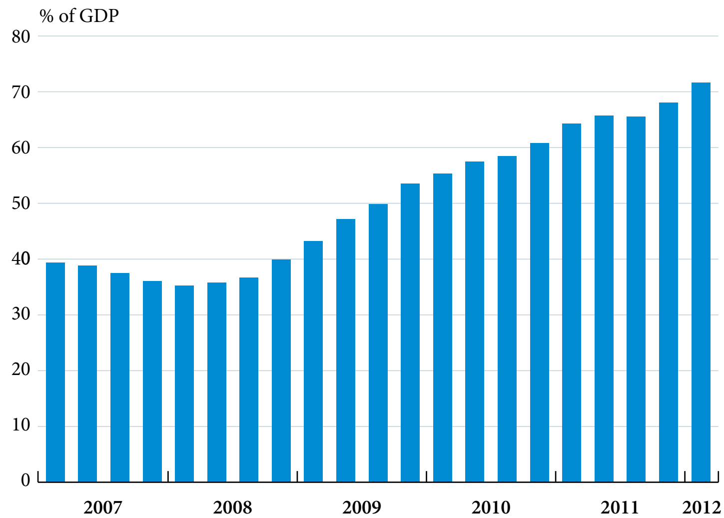
Once again, the European Council meeting at the end of June has raised huge expectations. Issues as delicate but important as banking and fiscal union are going to be treated with increasing seriousness. This process is unlikely to be completed in the short term but small advances that demonstrate a greater will to shore up the euro area's foundations could have a big impact on confidence.

The aid given to banks to meet their recapitalization needs should also help to restore some confidence in the solvency of Spain's public debt. Details of just how the aid will be given to those banks that require it are still unknown but this is likely to guarantee their solvency without entailing an excessively costly burden for the public coffers. The interest rate will very probably be around 3%, a figure that is much lower than the current financing cost for public debt. Specifically, if we

The euro area loans 100 billion euros to guarantee the solvency of Spain's banks.

PUBLIC DEBT HAS DOUBLED SINCE MARCH 2008

Public debt with regard to GDP



SOURCE: Bank of Spain.

The risk premium reaches a peak of 575 basis points in June.

look at 10-year bonds, their yield reached 7.2% in June, 575 basis points above the German bund.

The latest events have helped to reduce this spread to 483 basis points at the time of writing this report. A figure that is still abnormally high, however. The maturities of public debt for the second half of the year, totalling almost 83.7 billion euros with public debt only, will keep average financing rates growing. Additionally, there will also be greater public indebtedness. In just 4 years, the debt has doubled for the public sector as a whole, going from 35.5% of the gross domestic product (GDP) to 72.1% of GDP in March 2012. We expect this figure to be slightly above 85% of GDP by the end of the year, boosted by the deficit, of 6.4% of GDP and the effect of the bank bail-out on public debt. All this will keep Spain's financial burden growing and will make the fiscal consolidation process even more difficult.

Public debt will reach 85% of GDP by the end of 2012.

Central government expenditure reflects this rising cost. According to data from the National Accounts system, expenditure on interest payments rose by 1.3 billion euros between January and April, 18.4% more than in the same period of 2011. Similarly, higher wage costs and current transfers to other public administrations grew by 2.3% and 30.7% year-on-year respectively. However, the latter is due mostly to transfers to the autonomous communities and Social Security being brought forward. In addition to the increase in central government spending, revenue also fell by 4.8% year-on-year in the first four months.

The government deficit reaches 1.4% of GDP in April and raises doubts as to whether the target deficit can be reached.

As a consequence, the cumulative government deficit for the first four months of the year accounted for 2.4% of the GDP expected for 2012. According to the government's calculations, if we exclude the early transfers to other public administrations, this ratio falls to 1.4% of GDP, 2 tenths of a percentage point less than last year. However, to date this improvement does not seem to be enough to achieve the target deficit for the central government established in the stability programme, namely 3.5% of GDP by the end of year, 1.6 percentage points below the level of 2011.

Similarly, the Social Security and autonomous community balances are also far from their targets. In the first case, having excluded the faster rate of transfers received from the central government, the surplus deteriorated slightly due to a drop in Social Security contributions. For their part, the autonomous communities and Social Security adjusted their deficit by 0.3 percentage points to 0.45% of GDP in the first quarter. In spite of this improvement, they are unlikely to manage to reduce their fiscal balance by more than half, from 3.3% in 2011 to the 1.5% established for this year.

In short, and as concluded by the International Monetary Fund and the European Commission, the target deficit, namely 5.3% of GDP, will probably not be achieved this year. In this respect, the monthly tax revenue report shows a clear drop in revenue during the first four months, namely 3.3% year-on-year. Weak domestic demand reduced revenue from value added tax (VAT) by 8.2% year-on-year in this period. Only corporate tax rose slightly, due to the fiscal adjustment measures passed this year. According to the Tax Agency, fiscal changes have resulted in additional revenue of 1.3 billion euros up to April. A figure that is insufficient, whichever way you look at it. That's why supranational bodies are proposing that further measures be adopted, especially a hike in indirect taxes.

Savings and financing

A blast of oxygen for Spain's banks

On 25 June, the government asked the Eurogroup for financial aid to recapitalize those banks that needed it. This request marks the end of a first six months of the year packed with regulatory changes in Spain's financial framework. Previously, the bank reforms passed in February and May, with the aim of sorting out the banks' real estate portfolio, were not enough to dispel doubts regarding the sector's solvency. There are many questions raised by this new scenario. Over the coming weeks, we hope to find out the details of aid that will determine the future for the country's banking sector.

Aid to the sector will arrive via a line of credit to the Orderly Bank Restructuring Fund (FROB in Spanish) for up to 100 billion euros. Awaiting more details regarding the terms of this aid, the loans will most likely be long-term and at an interest rate of between 3% and 4%; i.e. lower the cost of financing 10-year public debt.

The main focus of attention is still the amount required to recapitalize Spain's banks. According to the reports drawn up by the two external evaluators, the capital requirements of Spain's banks within a scenario of severe economic deterioration would range from 51 to 62 billion euros. These figures are far below the maximum amount granted for the line of credit. However, the final amount could vary depending on the results of more detailed audits of each bank's balance sheet, which will be presented on 31 July.

In this respect, both the external evaluators and the International Monetary Fund agree that the larger banks are sufficiently capitalized. The rest will very probably need public aid. Those banks currently bailed out by the FROB and nationalized institutions will require the greatest injection of capital. In exchange for financial assistance, the Eurogroup will impose conditions for the sector as a whole and particularly for those banks that have been bailed out. Among the most likely measures is the creation of an entity («bad bank») to hive off troubled real estate assets from the banks' balance sheets.

Europe could force the creation of a «bad bank» in exchange for bailing out the banking sector.

The impact of this bail-out has two clear sides to it: on the one hand, it will increase the public debt and deficit, the latter through interest payments for the line of credit. In the long term, however, the effect on the public treasury will not necessarily be negative, as the gains from the positive spread between the loan's interest rate and the rate paid by the FROB could be substantial. Something similar happened in the United States with its programme to relieve troubled assets (TARP). On the other hand, the conditions imposed on banks could lead the sector to a new restructuring process.

This uncertainty regarding the capital requirements and aid conditions is also likely to speed up the rate that credit is granted over the coming months, especially in the case of the bailed-out banks. In this respect, credit to the private sector fell by 3.5% year-on-year in April, intensifying the deleveraging

Credit to the resident private sector falls by 3.5% year-on-year in April.

FINANCING OF NON-FINANCIAL SECTORS (1)

April 2012

	Balance	Change this year	Change over 12 months	% share
	Million euros	Million euros	% (2)	
Private sector	2,103,202	–25,791	–2.1	73.3
Non-financial corporations	1,247,362	–10,644	–1.6	43.4
Resident credit institution loans (3)	*825,451*	*–15,436*	*–4.0*	*28.7*
Securities other than shares	*68,012*	*2,904*	*8.4*	*2.4*
External loans	*353,899*	*1,888*	*2.7*	*12.3*
Households (4)	855,840	–15,147	–2.9	29.8
Housing loans (3)	*660,098*	*–6,768*	*–2.2*	*23.0*
Other (3)	*192,642*	*–8,423*	*–5.5*	*6.7*
External loans	*3,100*	*45*	*5.1*	*0.1*
General government (5)	768,035	33,074	13.7	26.7
TOTAL	**2,871,237**	**7,284**	**1.6**	**100.0**

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

The financing of real estate activities falls by 12.2% year-on-year in the first quarter of 2012.

process. According to the bank loan survey for the first quarter, this drop is also due to demand factors as, between January and March 2012, the number of applications for credit decreased significantly.

A breakdown of the credit by sector and activity shows that this drop was virtually widespread. In the first quarter of the year, credit to households fell by 2.7% year-on-year, boosted by the drop in financing for the consumption of durables, namely 12.8% in the same period. For their part, bank loans to firms were down 3.8% compared with the first quarter of 2011. Of note is the sharp contraction in financing for real estate activities, i.e. construction and development, down 12.2% year-on-year, whereas credit to the services sector, excluding real estate development, remained practically stable.

Doubtful loans increase to 8.72% in April.

This fall in credit has been accompanied by a further rise in doubtful loans in April, to 8.72%, 36 basis points above March's level. A breakdown by sector shows that those areas where doubtful loans have increased the most over the last year are also the areas with the highest drop in financing. Undoubtedly, of note is the severe decline in the development portfolio, the Achilles heel of Spain's banks, which in March had already reached a non-performing loan (NPL) rate of 22.1%, 7.4 percentage points above its level a year ago. This is followed, albeit at a long distance, by agriculture, with an NPL rate of 7.0%, representing a rise of 2.7 percentage points in one year.

With regard to household credit, its NPL rate reached 3.8% in March. This ratio is relatively low, especially if we take into account the severe deterioration in the labour market. One of the reasons could be the renegotiation of mortgage terms to

CREDIT TO PRIVATE SECTOR BY PURPOSE

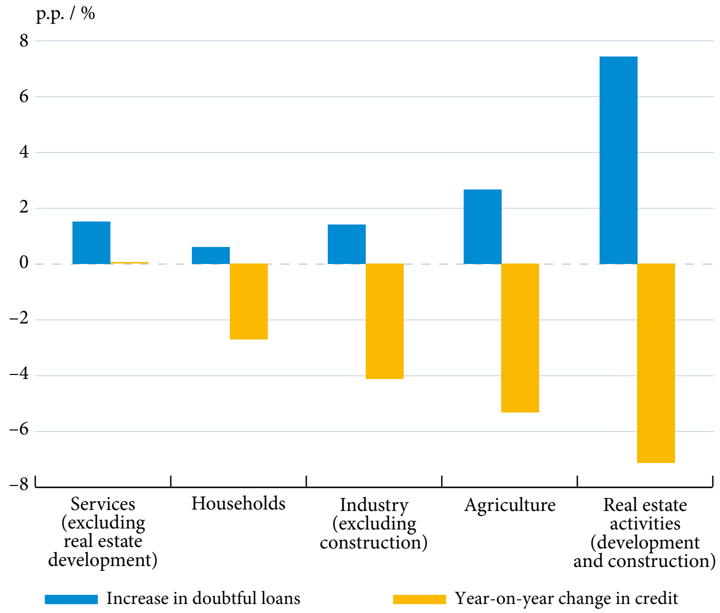
First quarter of 2012

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	21,416	–341	–1.6	–1,202	–5.3
Industry	139,850	–3,380	–2.4	–5,945	–4.1
Construction	96,193	–2,312	–2.3	–13,389	–12.2
Services	677,716	–2,497	–0.4	–16,250	–2.3
Total	**935,176**	**–8,530**	**–0.9**	–36,786	–3.8
Financing to individuals					
Acquisition and renovation of own home	649,602	–6,929	–1.1	–8,531	–1.3
Acquisition of consumer durables	35,835	–1,850	–4.9	–5,237	–12.8
Other financing	97,004	–2,494	–2.5	–7,819	–7.5
Total	**782,441**	**–11,273**	**–1.4**	**–21,587**	**–2.7**
Other	**50,836**	**5,708**	**12.6**	**2,572**	**5.3**
TOTAL	**1,768,454**	**–14,095**	**–0.8**	**–55,802**	**–3.1**
Acquisition of housing and real estate activities	***915,878***	***–9,018***	***–1.0***	***–24,412***	***–2.6***

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

THE FALL IN CREDIT AFFECTS THOSE SECTORS WITH THE FASTEST RISING NPL RATES

Change in credit and doubtful loans between March 2011 and March 2012



SOURCES: Bank of Spain and own calculations.

The outstanding bank bond balance multiplies by 2.6 between September and April.

thereby make it easier for this debt to be repaid. According to data from the National Institute of Statistics, the number of mortgages that altered their terms in April rose to 26,494, 16.4% more than in the same month of 2011. Of these, 36.4% changed the interest rate conditions, presumably downwards.

In this respect, the trend for the 12-month Euribor rate, the reference rate for most mortgages in Spain, has also helped to keep household bad debt at a controlled level. In May, this indicator stood at 1.27%, very close to the minimum recorded in 2010.

In spite of this lower mortgage burden for households, deposit figures have failed to increase. In April, the bank deposits of households and firms had fallen by 5.4% compared with the same month in 2011. Of note was the drop in term and sight products, by 5.6% and 7.3% year-on-year respectively. However, this drop does not necessarily mean that savings have fallen, as there is also greater competition from products offering higher returns, such as public debt or bank bonds.

In this last case, according to figures from the Bank of Spain, the outstanding balance for bank bonds has multiplied by 2.6 between September 2011 and April 2012, totalling just over 43 billion euros. This increase partly offsets the fall in bank liabilities. However, we expect the additional rises in the yield on Spanish sovereign debt over the last few months to continue to encourage the replacement of deposits with other, short-term products.

In summary, Spain's banks are undergoing far-reaching renovation but the aid provided by Europe will help to tackle this successfully. It is a long road but, at its end, Spain will be able to benefit from a wholly solvent banking sector.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

April 2012

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	262,713	–6,998	–2.6	–472	–0.2	19.7
Savings deposits	195,471	–7,478	–3.7	–15,303	–7.3	14.7
Term deposits	687,845	–9,892	–1.4	–40,580	–5.6	51.6
Deposits in foreign currency	16,166	–1,553	–8.8	–3,536	–17.9	1.2
Total deposits	**1,162,194**	**–25,921**	**–2.2**	**–59,891**	**–4.9**	**87.2**
Other liabilities (*)	**171,133**	**–13,831**	**–7.5**	**–16,114**	**–8.6**	**12.8**
TOTAL	**1,333,328**	**–39,751**	**–2.9**	**–76,005**	**–5.4**	**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, 2011

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

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

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

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