

**Monographic November 2004:**

**Household Economies**

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**1.- U.S.A.**

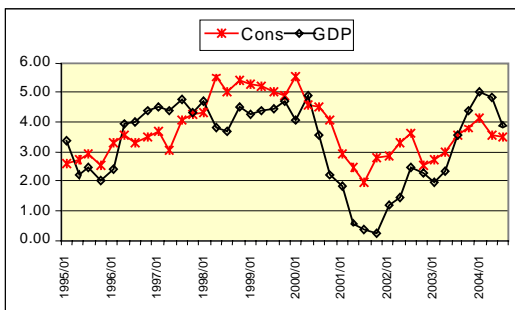
**Household economies, the expansion's unbalanced support**

**a.- Consumption and GDP**

Private consumption accounts for 70% of GDP in the United States, measured by demand components. This percentage makes underlining this item's importance in terms of overall growth unnecessary.

Notwithstanding, the consumption pattern played a particularly important role in making the recession in 2001 considerably brief and light and in fuelling the hesitant recovery. As can be observed in Figure 1, private consumption growth already outpaced that of GDP during the long expansive period before the crisis, and this situation continued throughout the crisis and the subsequent recovery, up to the second half of 2003 (in fact from 2001:I to 2003:III, the contribution of household consumption represented 120% of total GDP growth<sup>1</sup>).

Figure 1: Annual Growth in GDP and Private Consumption (%; seasonally adjusted data)

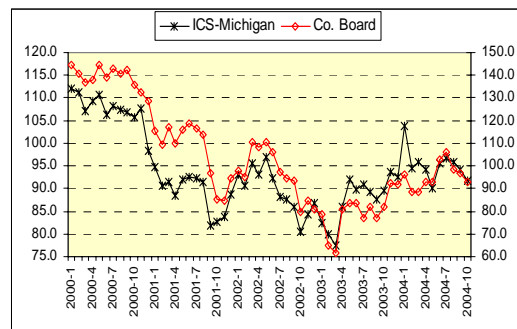


Source: own elaboration with data from the US Bureau of Economic Analysis (BEA)

<sup>1</sup> Since then the figure has dropped to a still impressive 83% in 2004:III.

The sustained expansion in consumption has borne the burden of the substantial loss of confidence at the end of the past decade (Figure 2), with a fall – clearly before September 11 – characterised by the weakness of the labour market, which only began to revert halfway through 2003. The recent setback is linked to inflation, which is outpacing wages and to the doubts over job creation that persist.

Figure 2: Consumer Confidence Indicators (University of Michigan – left axis, Conference Board – right axis)



Source: own elaboration with data from the University of Michigan and the Conference Board.

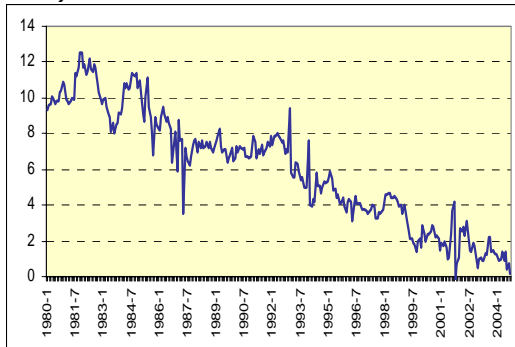
**b.- What this effort costs**

The growth in consumption described in the previous section which has not been backed by factors that are crucial to personal income (as will be analysed later in this report), has led US households to a double imbalance of unheard of proportions: a freefall in the savings rate and a spiral of borrowing.

The data from the two series most commonly used to monitor these two variables speaks volumes (Figures 3 & 4). The personal savings rate has fallen almost continuously over the past two decades to unthinkable lows (0.2% of disposable income in the second

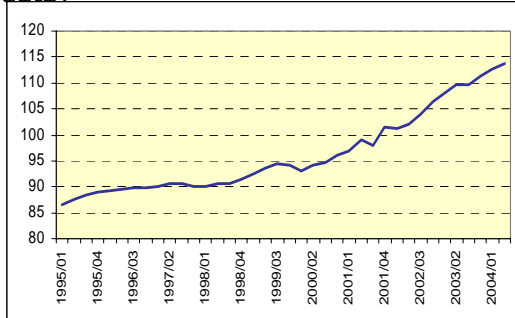
quarter of 2004). Furthermore, the volume of household borrowing has risen – as a percentage of disposable income – by more than 25% in less than a decade.

Figure 3: Personal Savings Rate (% of disposable income; seasonally adjusted data)



Source: own elaboration with data from FRED II

Figure 4: Household Borrowing (% of disposable income; seasonally adjusted data)



Source: own elaboration with data from the Federal Reserve Bank

Despite the severity of these trends, we must add a good deal of extra details that will help to understand and brighten up the panorama.

As far as the sinking savings rate is concerned, the fact that it coincides with the deterioration of the Federal Government budget is almost unanimously considered to be a very

serious problem for the US economy. Nevertheless, households' performance by itself can be to a great extent justified by the combination of a series of factors<sup>2</sup>: the perception of houses, which are strongly revalued, as a means of saving; inflation control, a source of income and wealth decay in previous periods; or the steady reduction in household liquidity restrictions over the past two decades, as a result of the increase in market efficiency and the development of financial innovations. In this new scenario, the decrease in the savings rate becomes logical, although probably not to the current extreme.

As regards to borrowing, the first point to take into account is that despite its widespread use, the data series presented in Figure 4 is not particularly suitable, as it connects a flow (disposable income) with a stock (borrowing). If we use two flows, where the debt service is the numerator, we once again hit all-time highs, but as a result of the extremely low interest rates, the rate has remained stable since 2002 (Figure 5)<sup>3</sup>.

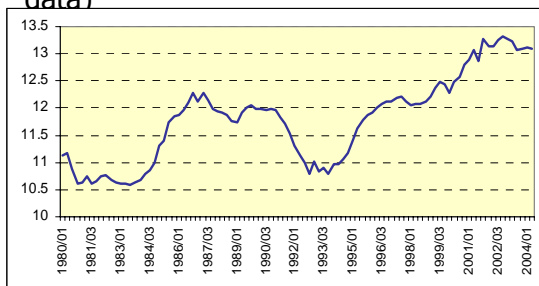
Just how this ratio would vary in light of a steady increase in interest rates is logically still uncertain. In this case, and as opposed to European countries, the characteristics of the US credit market

<sup>2</sup> To see these and further complementary ideas expanded, consult, for example, Ferguson, R. W. (2004); "Questions and reflections on the personal saving rate", remarks to the National Bankers' Association, 06/10/2004, or Debelle, G (2004); "Macroeconomic implications of rising household debt", BIS WP 153.

<sup>3</sup> If we opt for two stock magnitudes, the percentage of borrowing over total household assets is below 20%.

are relatively comforting. More than 70% of debt are mortgages, and around 80% of these have a fixed interest rate, thereby curbing the impact of the Federal Reserve's tougher monetary policy on households. Furthermore, interest rate movements have not yet been transferred completely to consumer credit. This slowed its recovery during the period of most accommodating monetary policy, but will also do so when reference interest rates are raised.

Figure 5: Household Debt Service (% of disposable income; seasonally adjusted data)



Source: own elaboration with data from the Federal Reserve Bank

Finally, even when taking the deterioration of debt over disposable income into account, US households are less in debt than their British, Australian and above all Japanese counterparts, although they are more in debt than households in the large economies of the Euro-zone.

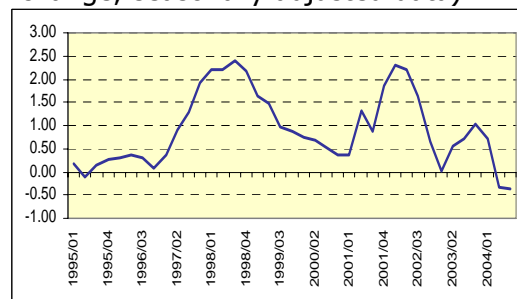
### c.- The factors behind growth in consumption

A large number of factors underlie the sustained growth in the US consumer's spending<sup>4</sup> in recent years. The labour

<sup>4</sup> Some authors say the sociological factor is crucial, which could be summarised as the

market, however, is certainly not one of them. The negative pattern in employment has already been analysed in detail in our reports. Growth in real wages over the past three years (except for 2002) has not been buoyant either, let alone in 2004 with negative rates to face up to an upturn in inflation (Figure 6).

Figure 6: Real Wages (Annual % change; seasonally adjusted data)



Source: own elaboration with data from the BLS

If the main source of income for the private sector – wage volume – is not favourable, there must be significant elements to comfortably offset this situation to be able to understand the strong growth in consumption.

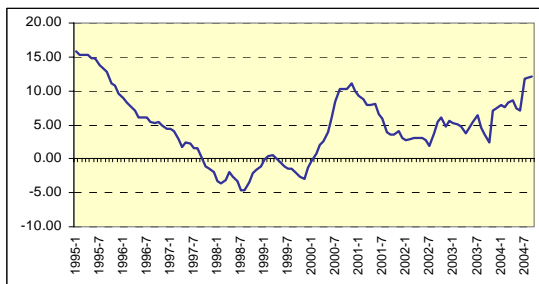
Interest rates at all-time lows undeniably have a lot to do with it. Firstly, they have boosted growth in consumer credit (Figure 7), which is still a long way off the levels registered halfway through the 1990s, but which is picking up speed and has registered double-digit growth rates in recent months.

More importantly, they have stimulated activity (Figure 8) and prices (Figure 9) in the real estate market. At the same time, this boom has partially offset the loss of wealth due to the stock market

predominance of a "consumer mentality" in the United States.

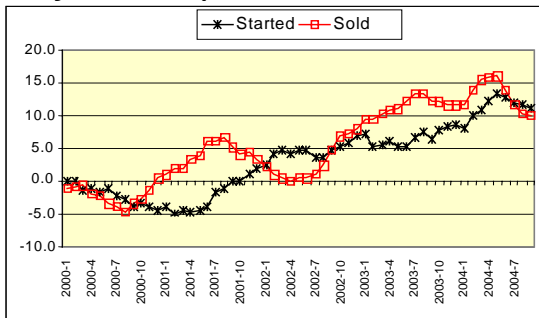
crisis in 2000<sup>5</sup>. Moreover, it has also boosted consumption, as a result of mortgage refinancing at considerably lower interest rates and with a greater guarantee due to the increase in the value of the asset<sup>6</sup>.

Figure 7: Consumer Credit (annual % change; seasonally adjusted data)



Source: own elaboration with data from FRED II

Figure 8: Private Dwellings (% change; 12-month moving average; seasonally adjusted data)

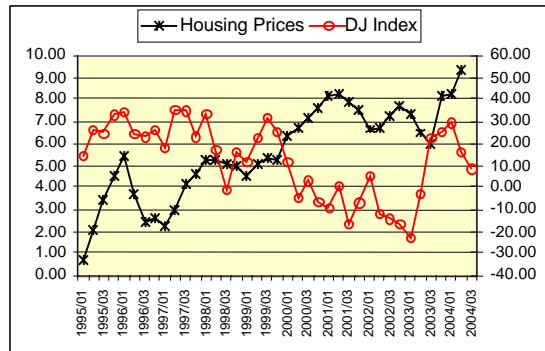


Source: own elaboration with data from FRED II

<sup>5</sup> Furthermore, empirical research shows that the impact of changes in real estate wealth on consumption is greater than that of changes in other assets, as people consider them to be more longer lasting.

<sup>6</sup> Therefore, resources which were previously channelled to mortgage payments are leftover and, parallel to this, more loans can be taken out with the guarantee of the increasing value of the house.

Figure 9: Housing Prices (left axis) and Dow Jones Industrial Index (right axis). Annual % change



Source: own elaboration with data from the Office of Federal Housing Enterprise Oversight and FRED II

The last element that should be highlighted as having stimulated consumption in recent years is supposedly the much-publicised tax cuts carried out by the Bush Administration. However, the bias towards the most privileged incomes casts a certain amount of doubt over whether or not these are capable of stimulating the consumption of the majority of households<sup>7</sup>. Recent research by the Economic Policy Institute<sup>8</sup> shows that the percentage of middle class families whose real income after tax has improved between 2000 and 2003 is a minority.

<sup>7</sup> Esto aun aceptando que los sujetos no reservan parte de los recortes fiscales para hacer frente a un potencial aumento de impuestos con el que financiar el creciente déficit público (en otros términos, que no rige la Proposición de Barro-Ricardo).

<sup>8</sup> "Less cash in their pockets. Trends in incomes, wages, taxes and health spending of middle-income families, 2000-2003".

#### d.- Can this situation continue?

Let's quickly see whether the above mentioned "consumption accelerators" can foreseeably continue their work in the immediate future.

In the first place, monetary policy is toughening up. Despite the fact that this process is gradual and not very pronounced (given the considerable control of inflationary tensions), interest rates are stimulating expenditure less and less. It is however true, as explained previously, that the impact of higher interest rates should not be too much of a health risk for household economies in the United States.

Furthermore, it will be difficult for tax cuts to be as large as in the last term of government (although the tax cuts with sunset clauses will be prolonged into the future, in an act of complete disregard to budget rebalancing). Really, the anxiety over sufficient public funding of social protection systems could lead households to increase their savings in detriment of their consumption.

With regard to the sustainability of growth in asset prices (and therefore the increase in household wealth), there is a generalised perception that they are overvalued. Firstly, this is obvious in the bond market. Secondly, even including the downward correction for the period from 2000-2002, the stock market is not exactly cheap<sup>9</sup>. As

far as housing is concerned, which has been a key area in recent years, as pointed out in this report, generally speaking a potential real estate bubble is not expected to reach similar proportions to those in other OECD countries. Demographic and sociological trends in the United States justify the best part of the strong buoyancy of the market. However, refinancing mortgages to obtain funds for consumption is unlikely to be sustained. History provides us with examples of very favourable periods for this situation, which are followed by marked slumps. This is what happened in the United Kingdom and Scandinavian countries (at the end of the 80s and beginning of the 90s respectively) or in the Netherlands (1998-2000 for good years and 2001-2003 for the bad years).

Finally, we will conclude this report with its favourite section (and that of most analysts): the labour market. The only way to guarantee the sustainability of consumption, and through this, of economic growth in forthcoming quarters is the recovery of employment and real wages<sup>10</sup>. A challenging task.

Vicente J. Pallardó  
Valencia, November 24, 2004

<sup>9</sup> Although the price to earnings ratio has dropped to the vicinity of 21 – half that of 2000 and 2002 – the lack of buoyancy in corporate profits in forthcoming quarters and the doubts over the soundness of the

recovery should lead to a parallel restraint in listings.

<sup>10</sup> Increases in real wages should be sufficient but moderate to avoid additional inflationary pressures.

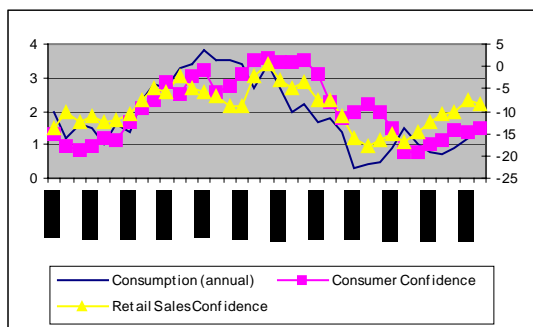
## 2.- Euro-zone

### Private Consumption Structure:

Private consumption, which accounts for approximately 57% of GDP in the Euro-zone, remains somewhat lethargic. Growth this year has been similar to that observed in 2003, with annual rises of 1%. Despite the recent publication of the first GDP growth estimate for the third quarter of this year, the breakdown by components had not been released when this report was written.

Figure 1 shows how consumer and retail sales confidence indicators fit the pattern of private consumption in the Euro-zone quite nicely, a few quarters in advance. The trend observed in recent quarters can be expected to improve in the near future.

Figure 1: Pattern of Private Consumption and Confidence Indicators



Source: Eurostat and own elaboration

Regardless of whether or not confidence indicators anticipate a recovery in private consumption, the performance of this variable is closely related, in theory, to a series of factors.

These factors are as follows:

- a) Labour market situation and gross disposable income
- b) Household expectations
- c) Asset Wealth
- d) Inflation

### a) Labour market situation and gross disposable income:

Net job creation in the Euro-zone this year has been disappointing with a practically token annual rise of 0.1%, identical to that registered the previous year. The unemployment rate remains entrenched at 9%, thanks to the large amount of part-time employment, which accounts for 16.9% of the overall figure.

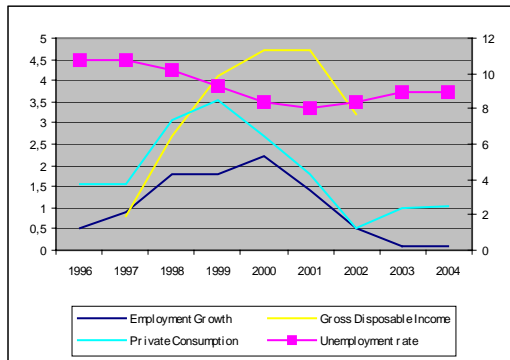
Table 1: Part-time and Temporary Employment

Year	Part-time work (% of total employment)	Temporary work (% of total employment)
1996	15	12,1
1997	15,6	12,6
1998	16,1	13,6
1999	16,5	14,6
2000	16,3	15,4
2001	16,5	15,7
2002	16,9	15,5

Source: Eurostat

Nevertheless, the latest survey carried out by the European Commission on the outlook for employment in the Euro-zone indicates an improvement in all sectors except services, which remains unchanged. The PMI employment surveys register an improvement in the services sector and a slight downturn in the manufacturing sector. Broadly speaking, all roads appear to lead to an improvement in the labour market.

Figure 2: The Relationship of Private Consumption with other variables



Source: ECB and own elaboration

Should the labour market improve, this would lead to more growth in gross disposable income and, in turn, more private consumption. Banesto forecasts a growth rate of 1.5% for 2004 with respect to the previous year, albeit well below the rates observed in 2000 and 2001, which were above an annual 2%.

The strong correlation between net employment growth and gross disposable income and private consumption can be appreciated in Figure 2.

**b) Household expectations:**

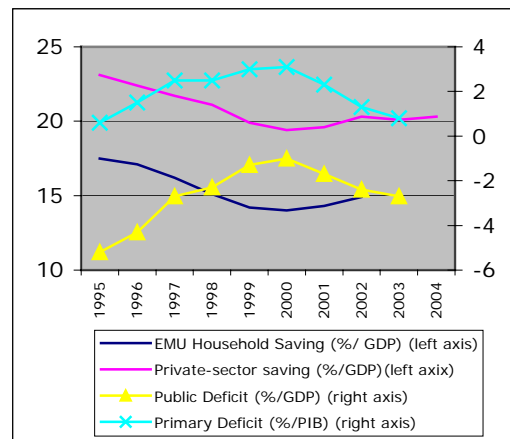
As mentioned earlier in this report, the outlook for consumption has improved with respect to the previous year, in light of the consumer confidence surveys that are elaborated. Indexes have risen from -20 to -14, compared to a long-run average of -9.

The savings rate has grown since 2000 and this has increased the share of private saving in terms of GDP by almost one per cent (from 19.4% in 2000 to 20.3% in 2004). Household savings also increased their contribution

to GDP from 14% in 2000 to 14.9% in 2002.

In Figure 3 we can see how, in the Euro-zone as a whole, public deficits and private and household savings have followed the same pattern. That is, the improvement in the public deficit over the period from 1995 to 2000 coincided with a reduction in the weighting of private savings; and the deterioration of the public deficit between 2000 and 2003 has been almost offset by the increase in private saving. In any case, private consumption comes out on top, as during the first period the decrease in private saving is less than the decrease in the public deficit and over the second period, the increase in the public deficit was greater than the increase in private saving.

Figure 3: Ricardian Neutrality



Sources: ECB, Organisation for Economic Co-operation and Development (OECD), Citigroup and own elaboration

One could, therefore, say that in aggregate terms, there is a certain Ricardian Neutrality in the Euro-zone.

If countries in the Euro-zone such as Germany and France are studied

individually, over longer periods of time (since 1980) such neutrality seemingly vanishes. With regards to Germany, the reason is an ageing population and the increased saving on behalf of business, while in France monetary policy and credit growth are mainly responsible.<sup>1</sup>

The increase in household saving over the most recent period must be attributed to families' concerns about future uncertainties (cautious behaviour on behalf of consumers, despite the recent improvement), the impact of the structural reform carried out in some countries and industrial off-shoring itself, apart from the labour market situation.

Table 2. A Comparison of Private Saving in the US and the Euro-zone

Year	EMU Saving	USA Saving
1995	17,5	6,9
1996	17,1	6,2
1997	16,2	5,2
1998	15,1	6,6
1999	14,2	4,6
2000	14	4,6
2001	14,3	4
2002	14,9	4,5

Source: Citigroup

If the household saving rate in the Euro-zone is compared to that of the United States, figures are seen to be very different. Apart from factors related to the greater or lesser pessimism with regards to the future, the differences in the tax or pension systems explain part of these differences. Moreover, in the case of

<sup>1</sup> Why has Ricardian neutrality disappeared? Patrick Artus. Economic Research N° 2004-255. 8<sup>TH</sup> September 2004. CDC-Ixis.

the US, consumption is currently excessive and, therefore, so is household borrowing.<sup>2</sup>

### c) Asset Wealth:

The third factor that influences consumption is the change in the value of household assets. These assets can be divided into two groups: real estate and financial assets.

Theoretically speaking, the wealth effect implies that people perceive themselves to be richer or poorer due to the change in the value of their assets, which provokes an increase or a decrease in the propensity to consume. However, people with buying a house in mind would possibly decrease their consumption in the present if there were an increase in housing prices to meet higher payments in the future. This is why the strength of the wealth effect is uncertain.<sup>3</sup>

Furthermore, consumers (particularly in the Netherlands) are increasingly using the rise in the price of their house to take out a second mortgage in order to raise consumption, as the cost of consumer loans is greater than mortgage loans. The effect this will have on private consumption will obviously vary depending on how each financial system works.

With regards to the gross savings generated by households each year, the purchase of financial and non-

<sup>2</sup> *¿Por qué la tasa de ahorro es mayor?* (Why is the saving rate higher?) José Luis Martínez Campuzano. 18th of June, 2004. Citigroup.

<sup>3</sup> WP 279 "House Prices and Economic Activity". N. Girouard and S. Blöndal. OECD. Economic Department.

financial assets accounts for approximately 10% of an individual's gross disposable income and is financed separately by credit, which represents 5% of disposable income.

Table 3: Housing Price Index by Euro-zone Member State

HOUSING PRICE INDEX. THE ECONOMIST

	1997-1	2003	2004
Spain	12,3	18,7	17,2
France	7,7	12,9	14,5
Italy	7,1	10,6	10,8
Belgium	6,0	4,8	8,2
The Netherlands	8,2	0,5	3,9
Denmark	-0,4	-4,5	-1,7
<b>Weighted Average</b>	<b>5,4</b>	<b>6,2</b>	<b>7,7</b>

Source: ABSA and own elaboration

The average annual increase in the weighted average (GDP) of housing prices in the Euro-zone now stands at 5.4% over the period from 1997 to 2004, with considerable differences across countries. In Spain prices have risen at an annual rate of 12.3%, while in Germany prices have dropped by an annual 0.4%. The average increase housing prices for the past year in the Euro-zone was 7.7%.

Private Consumption elasticity with respect to real estate wealth for an advanced economy is 0.05%, according to the International Monetary Fund (IMF). In other words, a 7.7% increase in housing prices generates a 0.39% annual increase in private consumption, which is very important.

As far as Euro-zone households' financial wealth is concerned, shares account for 25% (40% in the US) and life insurance and retirement funds account for a further 25% (30% in the US). The wealth effect of this type of

asset on private consumption is a lot less significant, according to the IMF report. The elasticity for shares is 0.006%, which means that a 2.8% downturn on the stock market would only hold private consumption back by an annual 0.02%.

Table 4: Euro-zone Stock Market Indexes

Change in Stock Market Indexes  
(Annual Average 1999-2004)

EUROSTOCK	-3,3
CAC	-0,6
DAX	-4,8
MIBTEL	-1,9
IBEX	-3,6

Source: Citigroup and own elaboration

#### d) Inflation:

Whether or not the inflation perceived by the consumer is greater than the inflation rate that is actually published has more of an impact on private consumption than the potentially negative impact of inflation itself on private consumption. This phenomenon, which occurred when the euro came into being as a physical currency, has re-emerged in some member states such as Italy and France, where there even been demonstrations seconded by consumers themselves.

#### Private Consumption Structure:

This section synthesizes household consumption patterns in the Euro-zone according to profession, age, income and household consumption structure.

If average household spending levels are compared, measured by the Purchasing Power Standard (PPS) for 1999, professionals and self-employed

workers consume more than tradespersons, the retired or the unemployed.

**Table 5: Consumption and Age**  
**Average Household Cons. by Age**  
**(1,000s of PPS) 1999**

Under 30	19,86
30-40	25,90
45-59	28,10
Over 60	18,81

Source: Eurostat

If the same analysis is carried out by age, spending depends on the income life cycle. In the initial stages of a person's working life, less money is earned and, therefore, consumption is less. As time goes by up to the last few years of one's working life, wages and consumption are much higher and, finally, when the working life is left behind, income and, therefore, consumption, declines.

If expenditure is broken down into items, households are seen to spend the most on gas, electricity and water supplies and the house (26.73% of the total), followed by food (14.92% and transport (13.43%).

When this average household spending structure is compared to that of lower income earning households, some significant differences can be observed. The overall importance of food (+5.21%) and gas, electricity and water supplies and the house (+2.32%) are well above the average, offset by less spending on recreation, transport and equipment.

**Table 6: Consumption Items**

<b>Household Consumption Structure (%)</b>	
Food	14,92
Alcohol & Tobacco	2,61
Clothing and Footwear	6,29
Supplies and House	26,73
Equipment	7,09
Health	3,91
Transport	13,43
Communication	2,34
Recreation & Culture	8,84
Education	0,76
Restaurants & Hotels	6,06
Miscellaneous Expenses	7,01
<b>TOTAL</b>	<b>100,00</b>

Source: Eurostat

### Household Borrowing and Housing

Household borrowing accounts for 23.1% of total debt in the Euro-zone. Over the period from 1999 to 2004 (first quarter), this figure has grown by almost four percentage points.

The weighting of household debt in relation to gross disposable income has also climbed markedly since 1991, from 60.1% to 80.3% (2001), perhaps as a result of the interest rate pattern or the progress in the credit market, particularly in terms of mortgages. The weighting of household debt is considerably lower than in the US and the United Kingdom, where it is over 100%.

Households mainly seek financing from bank loans (85%). In some countries, such as the Netherlands, Austria and Belgium, more than 25% of loans are given by insurance companies.<sup>4</sup>

<sup>4</sup> "El endeudamiento de los hogares españoles." (Spanish Household Borrowing) by Ana del Río. Working Paper Nº 0228 of

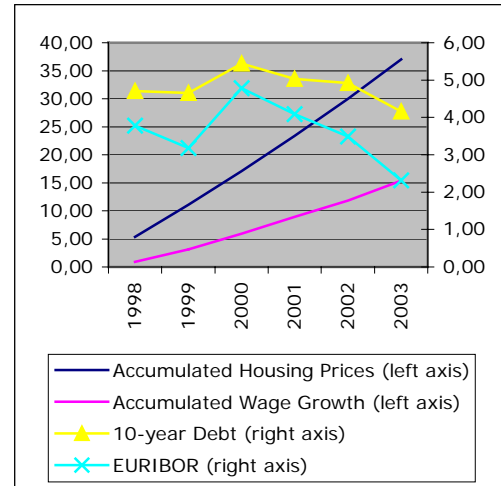
Borrowing is mainly channelled to finance housing (60.1%), while that used for consumption only represents 16.2%. While in France consumption financing is higher (20%), in Austria and Italy, housing financing is quite a bit below the average.

Despite the pattern of household borrowing in the Euro-zone, particularly where housing loans are concerned (mortgage/GDP ratio up by 10%), its importance is still a long way from that observed in the United States and the United Kingdom, where the figure is almost twice as high.

The characteristics of mortgages vary according to the country in the Euro-zone. Mortgages with a variable interest rate account for 54%, although by country this figure ranges from 20% in France to 97% in Finland; the ratio between the mortgage and the value of the house ranges from 50% in Italy and Greece and 90% in the Netherlands. Furthermore, cross-border mortgaging represents less than 1% of the overall figure for the Euro-zone. The European mortgage market is fragmented.<sup>5</sup>

In order for the banking system to continue meeting the strong demand for mortgage loans, progress in mortgage debenture and security markets is a key factor. Mortgage debentures and securities currently account for more than 17% of all mortgage loans, although this figure is climbing.

Figure 4: Interest Rates, Wages and Housing Prices



Source: ECB, The Economist, OECD and own elaboration

Finally, with regard to housing, 60% of houses occupied are owned and they are directly proportional to the economic situation of the household. On a European Union scale, 17.4% of families that buy a house (2001) have very high service to debt burdens. This figure was 20.1% in 1994.

Nicolás Jannone  
Valencia, November 24, 2004

the Servicio de Estudios del Banco de España (Bank of Spain Research Service).

<sup>5</sup> Informe mensual de la Caixa. Julio y Agosto de 2003.

### 3.- Spain

#### Household behaviour throughout the current economic cycle

Household behaviour, particularly in terms of consumption, has been a key factor behind the pattern of the current economic cycle and also explains why the Spanish economy has adjusted so smoothly. For this reason it is worth delving into the reasons for this behaviour on behalf of households, with our eyes on its possible performance over the next few months.

Economically speaking, households offer a myriad of analysis possibilities. We are going to look at its consumer facet; in other words, what role have households played in terms of aggregate demand? We proceed, therefore, to study private consumption and the factors that explain it. The first step consists in calculating the importance of household consumption.

If data from the demand side of the 2003 national accounts and its largest components is used, household consumption together with that of non-profit making organisations serving households (NPOSH) represents no less than 60% of GDP. As a result, whatever happens to these two items, or in other words, whatever determines whether or not household consumption remains stable, is essential for explaining the future performance of GDP.

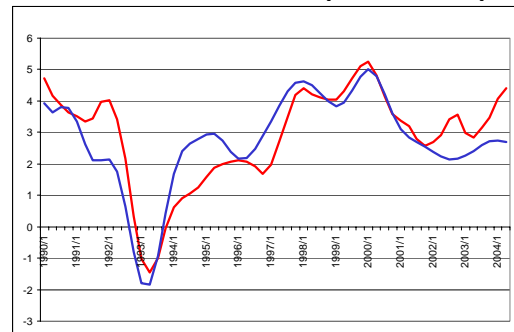
Consumption in Spain (unlike in other countries) has remained relatively stable throughout the cycle and has limited the fluctuations in GDP.

Table 1: Spanish GDP Structure–Demand

Trend Cycle at 1995 prices	2003	
Demand	Milliones of €	%
Final Consumption	446,398	78.2
House holds	337,039	59.1
Non-profitmaking Orgs. Serving Homes	4,174	0.7
Public Administration	105,185	18.4
Gross Fixed Capital Formation	140,956	24.7
Capital Goods	38,974	6.8
Construction	79,708	14.0
Other goods	22,274	3.9
Change in Inventories (1)	2,265	0.4
Domestic Demand*	589,619	103.3
Exports of Goods and Services	173,998	30.5
Exports of Goods (fob)	123,814	21.7
Exports of Services	50,184	8.8
Imports of goods and services	193,061	33.8
Imports of Goods (fob)	161,670	28.3
Imports of Services	31,391	5.5
Foreign Demand*	-19,063	-3.3
<b>GDP at Market Prices</b>	<b>570,556</b>	<b>100.0</b>

Source: National Institute of Statistics (INE)

Figure 1: Final Domestic Consumption of Households and GDP (annual rate)



Source: INE.

While in the previous cycle (1993) final domestic consumption of households (red line) plummet to an all-time low, dragging GDP (blue line) down with it, in the current cycle consumption has grown steadily above the 2.5% mark in annual terms, making GDP movements much smoother.

The key question is simple. Why has private consumption remained stable on this occasion? There are, as ever, a variety of reasons, but it is worth

exploring those which are the most common and representative. To this aim, the possible effects in consumption have been divided into three groups.

### 1. Income Effect

The first set of explanations derive from the income effect on consumption demand. It seems logical for households to increase their consumption when they enjoy an increase in income. Therefore, the first factor to take into account when explaining household consumption is household disposable income (HDI). Consequently, what happens to HDI will be decisive for the performance of household consumption, as this income is channelled to either consumption or saving. Data corresponding to households and NPOSHs revealed the following results for 2003.

Table 2: Net Disposable Income of Households and NPOSHs. 2003 (1000's of euros)

INCOME	
Net HDI	447,181
Pension plan adjustments	<u>2,298</u>
TOTAL INCOME	449,479
EXPENDITURE	
Final Consumption	430,398
Net Saving	<u>19,081</u>
TOTAL EXPENDITURE	449,479

Source: INE.

As can be appreciated in Table 2, Spanish households channelled 96% of their net disposable income into consumption and the remaining 4% to saving. Our next step must therefore be to study what items HDI is made up of. According to the INE, households received net income (income minus

expenditure and payments) from the following sources over 2003:

Table 3: Net Disposable Income Components (1,000s of euros)

Wage earners' pay	369.790
Property income	14.896
Excluding operating or mixed income	123.138
Social benefits	101.177
Other current transfers	<u>4.874</u>
TOTAL INCOME	613.875
- Social Security	113.531
- Income and Property Tax	<u>53.163</u>
TOTAL EXPENDITURE	166.694
TOTAL NET HDI	447.181

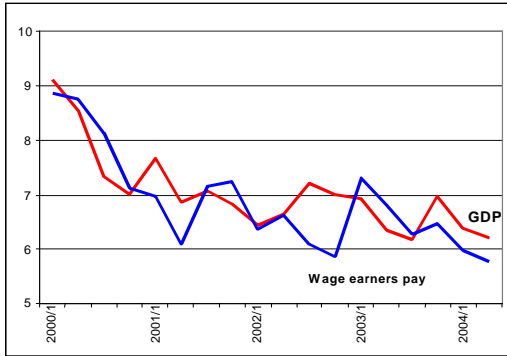
Source: INE.

Wage earners' pay represents 60% of household income. Property income barely accounts for 2.4% of total income, mixed income a further 20% and, finally, the remaining 17.4% corresponds to social benefits and other current transfers. As far as spending is concerned, social security contributions and income and property tax figure prominently.

Any analysis of household consumption in the past and in the future means studying what can happen to the main sources of income and expenditure. In this sense, for example, wage earnings represent 60% of total income and, at the same time, 96% of net HDI is used for consumption. Therefore, this item must be studied in order to be able to explain and forecast household consumption.

Figure 2 shows the pattern of wage earners' pay and GDP and confirms the fact that the former has developed in line with GDP, thereby helping to sustain growth.

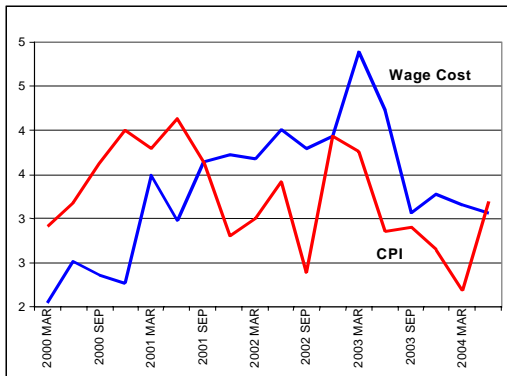
Figure 2: Growth Rate of Nominal GDP and Wage Earners Pay



Source: INE.

While also recognising the fact that many variables influence the growth in wage earners pay received by households (wages, employment, overtime, taxation, etc), all these could be grouped into two categories: growth in total wages, which has been in line with the inflation rate, as can be appreciated in Figure 3, providing households with real and job creation (Figure 4), which, through growing strongly over the entire the economic cycle has meant new sources of income for households.

Figure 3: Total Monthly Wage Cost per Employee and the CPI

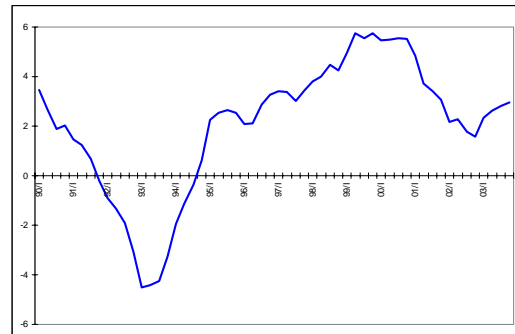


Source: Banco de España

Figure 3 shows how total monthly wage costs per employee (therefore including

possible overtime) have progressed in line with inflation or slightly above it. Wages have, in this way, maintained their purchasing power in real terms and, as a result, their capacity to buy and consume.

Figure 4: Employment Rate



Source: INE. Encuesta de la Población Activa (EPA)<sup>6</sup>

Figure 4 displays the Employment rate pattern according to the EPA. Strong growth is confirmed in job creation, which is maintained throughout 2004, and which even picks up speed with respect to 2003.

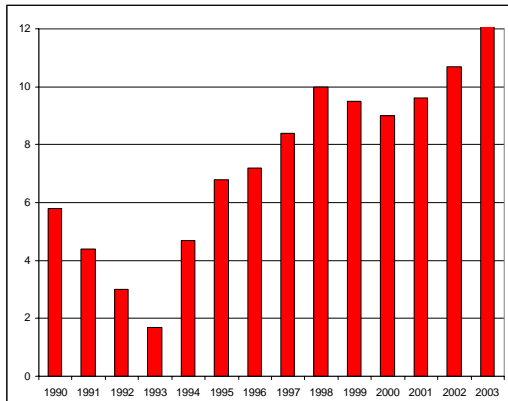
These two variables together determine whether or not the tendency in wage earners pay, a key part of Net Household Disposable Income and Private Consumption, is sustained throughout the entire economic cycle.

Apart from the above-mentioned item, we must also add net mixed income. This can be given by the production activity carried out by households themselves or they may have their own business, in which case it is difficult to distinguish which part of income is directly linked to wage earnings and which part is linked to business profits, which have performed equally as favourably. Property income has also

<sup>6</sup> Labour force survey

performed favourably, boosted by the favourable pattern in business profits.

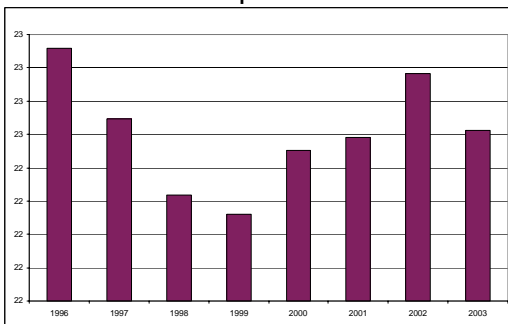
Figure 5: Ordinary Profitability of Non-Financial Institutions' Equity



Source: Banco de España

Finally, social benefits have also risen considerably both due to the constant growth in the number of pensioners and also to the amounts received being updated. Proof of this marked growth is the fact that in spite of the substantial growth observed in the rest of items over recent years, the importance of social benefits which are not social cash transfers in net household disposable income has remained unchanged.

Figure 6: Weighting of Social Benefits in Net Household Disposable Income

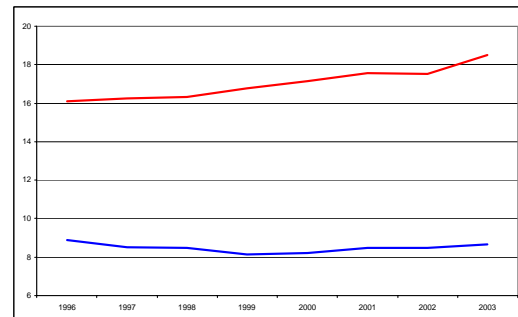


Source: Banco de España

With regard to expenditure, the two main items that use funds and reduce net household disposable income are

social security payments and income and property tax. In terms of total household disposable income, these two variables have performed differently. While social security contributions have increased their proportion, accompanying the rise in employment and the number of people registered, direct taxation has seen its weighting drop slightly, as a result of the successive tax reform bills being applied. Together, these two items went from subtracting 25% from total household income in 1996 to 27.2% in 2003%.

Figure 7: Weighting of Social Contributions and Direct Taxation in total household income



Source: Banco de España

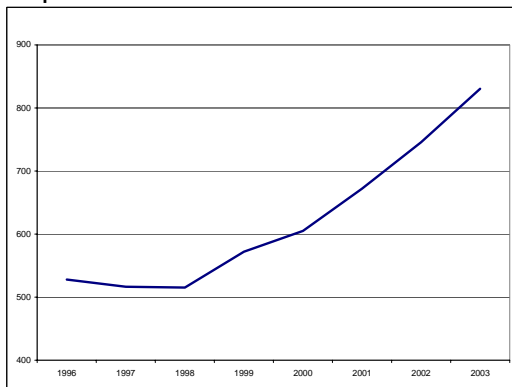
In short, net household disposable income has risen by an average 2.5% over the entire period dating from 1996 to 2003. Moreover, large changes have not been observed in the weighting of the income and expenditure components, that most affect private consumption (income effect). Therefore, everything seemingly indicates that household consumption will continue to grow in future quarters in real terms at a rate of 2.5%.

## 2. Wealth Effect

Private consumption can receive an extra boost from the wealth effect. If household assets increase in value over a certain period of time, for whatever reason, households may believe that part of that increase is permanent. This leads them to alter their consumption habits by increasing propensity to consume. In other words, at a given level of income, the increase in the value of assets can bring about an increase in consumption. This is the so-called wealth effect.

Household assets are made up of two basic components: real assets (mainly in the housing sector, such as land or installations) and financial assets of all shape and size. The latter have to be measured in net terms, which means after taking into account financial liabilities.

Figure 8: Housing Stock Value with respect to Net HDI

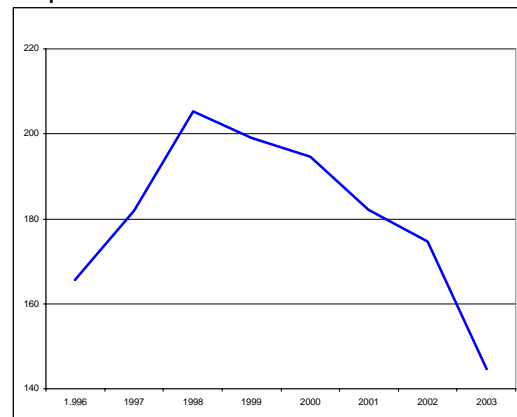


Source: Caixa de Catalunya

As shown in Figure 8, over the past five years household wealth in terms of housing has risen dramatically as a result of the hike in housing prices, up to the point where the value of housing stock with respect to net HDI went from 515% in 1998 to 830% in 2003.

However, when the pattern of financial assets is analysed, the results are quite different. While the best part of these assets reached the figure of 205% of net HDI in 1998, this ratio had fallen to 144% only five years later. In this case, the reasons behind this tendency include the fall in stock market prices and the depreciation of certain financial assets on the one hand, and on the other hand, the strong upturn in households' financial liabilities.

Figure 9: Net Financial Assets with respect to net HDI

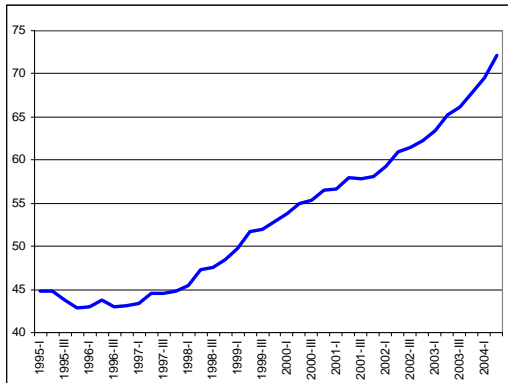


Source: Banco de España

The decrease in the profitability of fixed income securities, caused by the decrease in interest rates, together with the decrease in the price of variable income assets up to 2003, has dragged the real profitability of many of these assets into negative figures. Households in this environment chose to alter the composition of their portfolios, replacing financial assets (which were very little or not at all profitable) with real assets (whose prices were climbing at a fair pace), going into debt on the way at a time when interest rates were low, despite markedly increasing their financial liabilities. The choice was highly favourable, and the only significant risk

was for those who had borrowed at variable interest rates.

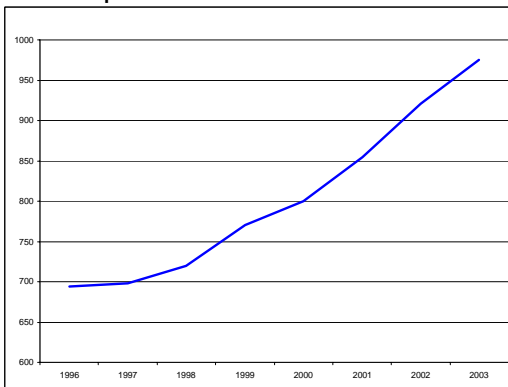
Figure 10: Household Financial Liabilities in terms of Net HDI



Source: Banco de España

If both financial and real assets are totalled (only houses), we can see that the overall balance is clearly positive. Households have seen their overall wealth increase from 700% of net HDI in 1997 to no less than 975% in 2003.

Figure 11: Overall Household Wealth with respect to net HDI



Source: Banco de España

Considering that housing prices have not slumped in 2004 (a growth rate of 17% was recorded in the third quarter) and that the stock market has risen by 10% since January, overall household wealth could be growing at a rate of close to 15%.

In conclusion, everything appears to indicate that the wealth effect is in fact playing an important role in the growth and stability of household consumption. The negative counterpoint is none other than the decrease in the household saving rate. Between 1998 and 2003, the household saving rate fell by more than four points with respect to their net HDI, reaching the figure of 4%. Assuming that this bullish trend in household wealth could continue in the short term, we can conclude that the wealth effect will remain a key factor in future years, even though the drop in the saving rate prevents between 0.5% and 1% being added to consumption, as was the case in the past. We tend to believe that its contribution will be more in the line of between 0.1 and 0.3%.

### 3. Substitution Effect

Any upward movement in interest rates can generate a substitution effect. Households that have gone into debt in large numbers at variable rates to be able to buy their house, must face larger interest payments with the subsequent effect on net HDI and consumption. However, an increase in the euro's interest rate does not seem likely in the next few months (the appreciation of the euro with respect to the dollar is a further obstacle for this possibility). Even if there were an increase, its effect would be minimal in view of the information currently available.

At the same time, households, together with financial liabilities (credits and loans), still have a large amount of liquid financial assets and fixed income securities, that are vulnerable to changes in interest rates, making the

net effect of such changes on net HDI unclear. It could provoke an interhousehold redistribution and if interest rate rises were significant, it would certainly have a negative effect on real estate wealth and the stock market. However, this does not appear to be the scenario in the short term, which is why we do not believe that the substitution effect will play a particularly important role in the short term.

In conclusion, in light of the information available, the foreseeable growth rate in household consumption for the next few quarters will be between 2.5% and 3% with the subsequent impact on the GDP growth pattern, in keeping with results from recent quarters.

Dr. Aurelio Martínez  
Valencia, November 24, 2004  
Professor of Applied Economics  
University of Valencia

*This article is the author's personal opinion and not necessarily that of the Instituto de Crédito Oficial.*

#### 4.- Germany

##### 1) Average Saving and Consumption Propensity

The first variable to be analysed when studying households is the value of consumption and/or saving. Private consumption is the most important GDP item as it represents between 60 and 70%, depending on the country in question. In Germany, the components that make up GDP have registered the following contributions over the past three years:

Table 1: Contributions to GDP

	2001	2002	2003
Consumption	0.56	0.55	0.55
Govt. Spending	0.19	0.20	0.20
GFCF	0.21	0.20	0.20
Trade Balance	0.03	0.03	0.05

Source: DESTATIS. Provisional data

This table displays one of the main features of the performance of the German economy in this area: private consumption accounts for a relatively low percentage of overall GDP. In Spain, private consumption represented almost 60% of GDP. Moreover, private consumption displays a downward pattern, even though this analysis only covers a short period of time.

The pattern of this contribution is traditionally associated to social development, whereby an increase in this variable leads to a decrease in the contribution of private consumption. Without detracting from this explanation, it is rather simplistic when we consider that in a country as wealthy as the United States private consumption accounts for nearly 70% of GDP.

This leads us to one of the most important differences in the Germany economy today, which many experts on the topic have shed light on: the relatively high saving rate. Börsch-Supan and Essig (2003) discover an extraordinarily stable saving pattern in the German economy, which is relatively independent of economic ebbs and flows<sup>1</sup>. The differences between Germany and the United States are striking and significant:

Table 2: Net Savings Rate

	France	Germany	USA
1986	8.1	12.8	8.2
1987	6.4	12.9	7.0
1988	6.9	13.2	7.3
1989	7.2	12.7	7.1
1990	7.8	13.9	7.0
1991	8.7	13.1	7.3
1992	9.7	13.0	7.7
1993	10.4	12.3	5.8
1994	9.8	11.6	4.8
1995	11.2	11.2	4.6
1996	10.0	10.8	4.0
1997	11.3	10.4	3.6
1998	10.8	10.3	4.3
1999	10.4	9.8	2.4
2000	11.0	9.8	2.3
2001	11.5	10.3	1.7
2002	12.1	10.6	2.3
2003	11.1	10.8	2.1

Source: OECD

Firstly, observe the enormous difference between the saving rate in the United States and that in France or Germany, particularly at the end of the period under study, in light of the *annihilation* of the US saving rate. Furthermore, the composition effect

<sup>1</sup> Börsch-Supan, A. and L. Essig (2003): "Household Saving in Germany: Results of the First Save Study", NBER Working Paper Series, nº 9902.

between East and West Germany means that data after the reunification must be examined with the necessary reservations. In other words, the saving rate in East Germany was supposedly a lot lower than in West Germany at the time of the reunification and there is no reason that leads us to believe that the gap has closed, but rather quite the opposite, in view of the marked differences between the two regions. So, the overall saving rate in Germany today is deceiving, as it must conceal a considerably higher rate in West Germany that might well be above 12%, and a lower rate in the former East Germany that could be below 10%. This is the only way to reconcile this information with other statistical information, such as that analysed in the paper by Börsh-Supan and Essig (2003), quoted earlier, and the comparison to the pattern of France's saving rate.

This issue is of utmost importance, as a higher saving rate means a lower multiplier effect linked to the increase in aggregate demand. Therefore, more effort must be made in terms of financial policy to achieve the same effect as in other economies like the United States.

## 2) Population Structure

Given the importance of issues relating to the life cycle in determining consumption and saving, it is essential to analyse the structure of Germany's population with the aim of drawing conclusions about its foreseeable evolution.

Table 3: Population Structure by Age Group and Marital Status

	2001	2002	2003
By age group:			
Under 6	0.06	0.06	0.06
6-15	0.10	0.09	0.09
15-25	0.11	0.12	0.12
25-45	0.30	0.30	0.30
45-65	0.26	0.26	0.26
Over 65	0.17	0.17	0.18
By marital status:			
Single	0.40	0.41	0.41
Married	0.46	0.46	0.45
Div. o sep.	0.14	0.14	0.14

Source: DESTATIS

The most characteristic feature of the structure of Germany's population by age is that it is a mature population that is clearly ageing further. This is important, as the youngest segment of the population, ie. Under 40 years old, is normally the group that displays the highest consumption propensity. In this sense, the ageing of the German population over the next 20 years will foreseeably be accompanied by an increasing tendency towards frugality. This goes against the basic life cycle proposals that advance an increase in consumption alongside age<sup>2</sup>. Nevertheless, in light of the array of papers that tackle this problem that have been published, even this increase in saving will be not be enough to avoid the welfare crisis that pessimists say will occur around 2030, or even earlier<sup>3</sup>.

<sup>2</sup> Börsch-Supan, A. and J. K. Winter (2001): "Population Aging, Savings Behavior and Capital Markets", NBER Working Paper Series, nº 8561, predict Germany's saving rate will increase between 2015 and 2025 to later decrease.

<sup>3</sup> See Sim, H.W. and S. Ueblemesser (2001): "When the Germans Get Trapped in their Pension System?". NBER Working Paper Series, nº 8503, y Börsh-Supan, A. and C.B. Wilke (2004): "The German Public

Furthermore, data concerning marital status also evinces Germany as a modern society in which there are less people married than not married. One last figure of interest is that in 2003, the legal foreign population represented 9.8% of the total, which shows Germany to be multicultural society that is open to foreign influence.

### 3) Classification of Households

German society is also seen to modern in terms of household structure. The following table shows how practically 70% of all German households have one or two members. The tendency of the average number of members per household is falling, which is common in advanced societies. However, at the same time it means a less consumption-orientated society, according to what has been previously verified.

Table 4: Household Structure

	2000	2001	2002
1 member	0.36	0.37	0.37
2 members	0.33	0.34	0.34
3 members	0.15	0.14	0.14
4 members	0.12	0.11	0.11
Over 5 mem.	0.04	0.04	0.04

Source: DESTATIS

### 4) Wealth and Borrowing

One last variable that can contribute to research on German household behaviour is the wealth and borrowing ratio. Households' net wealth was more than 5.3 times greater than disposable income in 1992. Seven years later, this ratio had risen to almost six. From this moment onwards, the economic crisis is

crudely reflected by the drastic fall in this variable, which was dragged below five. Therefore, taking into account the pattern displayed by this variable, the lethargy of the German economy during the economic crisis is not at all surprising.

Table 5.- Household Wealth and Borrowing

	NW	NFW	NFA	FA	L	Mor
1992	530.8	124.1	341.4	209.9	85.7	50.3
1993	547.5	133.7	347.4	224.7	91.0	53.8
1994	553.3	130.3	356.2	227.3	97.0	58.0
1995	563.1	135.6	360.6	236.2	100.6	61.0
1996	570.8	140.5	362.3	245.2	104.8	64.5
1997	579.3	149.2	360.8	256.8	107.6	67.1
1998	585.4	155.2	360.3	266.2	111.0	68.5
1999	591.0	165.8	355.5	280.0	114.2	71.9
2000	583.9	162.9	351.0	277.3	114.4	72.5
2001	568.5	159.0	340.4	270.9	112.0	72.1
2002	495.3	155.0	340.3	267.2	112.1	73.0

Source: OECD

Note: Figures at the end of the year in question as a percentage of nominal disposable income

NW: Net wealth

NFW: Net financial wealth

NFA: Non-financial assets

FA: Financial assets

L Liabilities

Mor: Mortgages

A breakdown of this pattern component by component reveals that the fall is due to the combined reductions in both financial and non-financial wealth. The decrease in this last wealth component is particularly significant and indicates the seriousness of the crisis that the German economy is suffering. It is not unusual for people to sell part of their most liquid financial assets in times of economic crisis, but when non-financial assets are sold, as is the case, it means that things are not going well at all.

The rate of borrowing is also quite high. In fact, it is similar in both level and pattern over the same period to

Pension System: How it Was, How it will Be". NBER Working Paper Series, nº 10525.

the United States, which is well-known for its high degree of indebtedness. The mortgage rate is not small either, particularly if we take into account that the German economy has not experienced a serious upturn in housing prices that we know of, as is the case in Spain or Great Britain for example. But the ratio is still comparable in value and pattern to that of the United States, which is in turn well above those displayed by France. In fact, the increase in the ratio between 1992 and 2003 is greater than in Great Britain and the United States, although the latter displays a higher rate at the beginning and end of the period.

Figures on household wealth do not suggest consumption will increase in the short or the medium term, but rather quite the opposite. These figures lead us to believe that the increase in saving is the rational reaction on behalf of households when facing a seemingly difficult situation. If this is added to the not particularly favourable developments in the labour market, the lack of buoyancy in German consumption can be expected to continue in the future.

Antonio Cutanda  
Valencia, November 29, 2004

## 5.- France

### 1) Average Propensity to Consume and the Saving Rate

The average propensity to consume in the French economy is relatively low, as is the case in Germany. In fact, it is even marginally smaller. As mentioned in the report on Germany, this is one of the features that most distinguishes France and Germany from the United States, in terms of the behaviour of household economies.

Table 1: Contributions to GDP

	2002	2003
Consumption	54.25	54.85
Govt. Spending	23.64	24.08
GFCF	19.99	19.91
Trade Balance	1.37	0.53

Source: INSEE.

The result is a high saving rate. When this variable is analysed some differences are observed between the two neighbouring European states. Firstly, the French saving rate was much lower than Germany's in the second half of 1980s. In addition to this, while the German saving rate increased, the French saving rate decreased, as was the case with the United States, quite possibly due to the fact that French households used their savings to finance the very high growth rates in consumption observed throughout this period.

Nevertheless, since the 1990s this tendency has been inverted, as opposed to the situation in the US at the same time as Germany's saving rates began to fall. Germany's reunification is more than likely behind the divergence between the two

countries' savings rates, as is explained in the report on the German economy.

Table 2: Net Saving Rates

	France	Germany	USA
1986	8.1	12.8	8.2
1987	6.4	12.9	7.0
1988	6.9	13.2	7.3
1989	7.2	12.7	7.1
1990	7.8	13.9	7.0
1991	8.7	13.1	7.3
1992	9.7	13.0	7.7
1993	10.4	12.3	5.8
1994	9.8	11.6	4.8
1995	11.2	11.2	4.6
1996	10.0	10.8	4.0
1997	11.3	10.4	3.6
1998	10.8	10.3	4.3
1999	10.4	9.8	2.4
2000	11.0	9.8	2.3
2001	11.5	10.3	1.7
2002	12.1	10.6	2.3
2003	11.1	10.8	2.1

Source: Organisation for Economic Co-operation and Development (OECD)

Therefore, France and Germany show similar saving habits, without ignoring the fact that the saving rate in the former East Germany was almost certainly higher than France's.

### 2) Population Structure

Studying the age structure of the French population is unavoidable in order to analyse savings. France, like Germany, is a clear example of a mature society that is clearly growing older. The fact that the average age of the population has steadily increased over a period of barely three years is proof of this. In fact, the age breakdown of both the Germany and French populations are considerably similar. In this sense, the financial consequences linked to the social

welfare state that this tendency brings are all too well known. As in the case of the German economy, the largest saving rate is insufficient to resolve a problem that could well begin to rear its ugly head within 20 or 30 years.

Table 3: Structure by Age Groups

	2000	2003p	2004p
By age group:			
Under 20	25.6	25.1	25.1
20-59	53.8	54.3	54.2
Over 60	20.6	20.6	20.7
Div. or sep.	38.7	39.2	39.3

Source: INSEE

Furthermore, the number of legal foreigners in France rose to 5.6% of the overall population, which, while still a large number, is not as significant a percentage as in other EMU countries.

### 3) Classification of Household Economies

The structure of household economies also demonstrates the features of a developed economy, even though the French economy does have a slightly higher birth rate than other neighbouring countries. The percentage of households with only one or two members is very high, although the percentage for households with three members is higher in France than in other similar societies. This is particularly relevant, given that the structure of a household undoubtedly conditions its spending and saving patterns.

Table 4: Household Economy Structure

	1990	1999	2003
1 member	0.27	0.31	0.29
Single parent	0.07	0.07	0.07
2 members	0.24	0.25	0.28
3 members	0.36	0.31	0.32
4 or more	0.06	0.05	0.03

Source: INSEE.

### 4) Wealth and Borrowing

As far as net wealth is concerned, data shows this variable to be somewhat dependent on the economic cycle, which is, on the other hand, to be expected. In any case, this variable has performed outstandingly in the French economy, reaching six times disposable income from 1999 onwards, although the economic crisis reduced this figure substantially. This decrease is only observed in financial wealth, while non-financial wealth is kept safe from economic ebbs and flows, as is logical.

Table 5: Household Wealth and Borrowing

	NW	NFW	NFA	FA	L	LPL
1992	510.4	173.1	337.3	253.4	80.3	53.0
1993	516.0	188.9	327.1	271.4	82.6	54.7
1994	494.8	166.5	328.4	251.1	84.6	53.7
1995	507.7	195.0	312.7	262.9	67.9	51.6
1996	533.7	220.2	313.5	288.9	68.7	52.2
1997	557.6	241.6	316.0	310.8	69.2	52.6
1998	578.0	262.2	315.8	336.0	73.8	52.9
1999	643.9	310.5	333.4	385.8	75.3	55.0
2000	630.2	282.6	347.6	359.2	76.6	55.2
2001	616.1	255.2	361.0	336.7	81.7	55.6
2002	605.6	225.6	380.1	308.4	81.8	56.9

Source: OECD

Note: Figures at the end of the year in question as a percentage of nominal disposable income

NW: Net wealth

NFW: Net financial wealth

NFA: Non-financial assets

FA: Financial assets

L Liabilities

LTL: Long-term Loans

As far as borrowing is concerned (liabilities) the French economy displays a markedly lower rate than other economies such as Germany's or that of the USA. Moreover, the fraction of disposable income accounted for by liabilities is practically the same at the beginning of the period as it is at the end. Finally, long term loans, including mortgages, also display a much lower rate than in other developed economies.

In light of this scenario, French households are, financially speaking, quite well off, which explains why consumption has been so buoyant up to precisely the third quarter of this year. In my opinion, there is no serious reason, with the permission of expectations, why households should not once again begin to consume in the immediate future, thereby boosting growth.

Antonio Cutanda  
Valencia, November 24, 2004

## 6.- United Kingdom

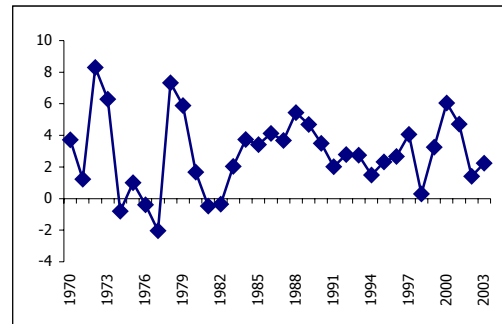
### Analysis of British Households: income, wealth, consumption, savings and borrowing

This section briefly analyses various aspects related to British households. In the first place, the current income and wealth distribution is described. Following this, we analyse the recent pattern in the savings rate. Thirdly, we look into the high level of borrowing on behalf of British households and the possible macroeconomic impact on consumption and inflation. This report does not tackle the pension issue. Those interested in this topic may consult the OCEI's October report for the UK, where the conclusions of the Pensions Commission with regard to the future of Britain's pension systems are analysed.

### The UK is one of the European countries where income and wealth are most concentrated

Disposable income is the money that is left after taxes and is used for either consumption or saving. Real disposable income per capita in the UK has risen from £5,240 in 1971 to £12,214 in 2003. Real disposable income has registered positive growth rates over the entire period from 1970 to 2003, with the exceptions of 1974, 1976, 1977, 1981 and 1982. In 2003 the growth rate was 2.24% and in the first two quarters of 2004 it has increased slightly to 3.9% and 3.2% respectively.

Figure 1: Annual Growth Rate of Disposable Income at 1995 Constant Prices (millions of pounds)



Source: ONS

Figure 2 shows the pattern of income per capita across population strata. The purchasing power of the poorest 10% of families has increased between 1971 when they received £100/week and 2002 when they received £160/week. Meanwhile, the purchasing power of the richest 10% has risen from £310/week in 1971 to £630/week in 2002. This means that the gap between the purchasing power of the rich and the poor has widened by 25%: in 1971 the ratio was 3.1 and in 2002 it was 3.9.

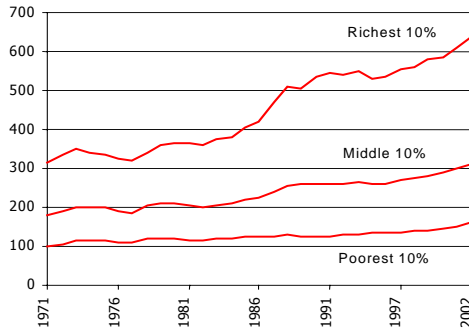
Wealth is always less evenly distributed than income. This can be appreciated in Table 1: 1% of the British population has 23% of the country's wealth, while 50% of the population has only 5% of total wealth.

Table 1: Distribution of Household Wealth (percentage of total wealth)

	1976	1986	1996	2001
The richest 1%	21	18	20	23
The richest 5%	38	36	40	43
The richest 10%	50	50	52	56
The richest 25%	71	73	74	75
The richest 50%	92	90	93	95

Source: ONS

Figure 2: Distribution of Real Disposable Income of British Households (weekly income in pounds from 2001)

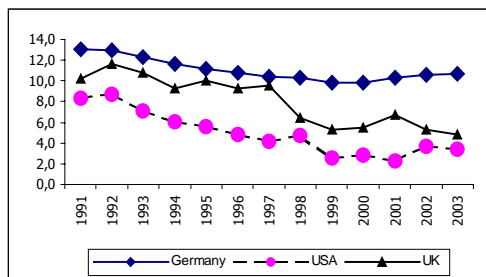


Source: Institute for Fiscal Studies

**British households show a low savings rate and scarce financial liquidity**

The savings rate is defined as the ratio between household savings and disposable income. Data from the Organisation for Economic Co-operation and Development (OECD) shows that savings rates across countries fell throughout the 1990s. Substantial differences between countries' ratios can also be appreciated. In 2003, Germany had a ratio of 10.7, while the United States and the UK registered 3.4 and 4.8 respectively.

Figure 3: Household Savings Rate by Country (%)



Source: OECD<sup>1</sup>

<sup>1</sup> Note: Although the OECD strives to make the series consistent, savings rates are not always the same. All countries except for

The savings rate in the UK hit an all-time low in 2003 at 4.8% of disposable income, well below the 12.4% figure registered in 1980 and the 8% average over the years dating from 1963 to 2002. The savings rate in the UK is one of the lowest in the European Union. The savings rates in Germany, France and Italy in 2002, for example, were 10.6%, 12% and 15.9% respectively.

A strong correlation can be seen over history between the savings rate and the inflation rate. Households save more in periods of high inflation and high interest rates, whereas they save less in periods of low inflation and low interest rates. The savings rate is also seen to fall when the economy is booming and increase when the economy goes into recession and unemployment is high. Finally, a negative correlation is also observed between the savings rate and housing prices. For example, the savings rate was very low between 1987 and 1989 and between 1999 and 2003. This relationship demonstrates the importance of the real estate market in the United Kingdom. A marked rise in housing prices increases household wealth and gives them confidence to reduce the amount of current income they save. The opposite occurs when housing prices fall, provoking strong saving on behalf of families as a way of offsetting the loss of wealth.

Do the British save a lot? Statistics show that British households are not great savers. The financial wealth of the average British household was £750

the UK, Spain and Italy, use a net savings rate, which means household fixed capital consumption is excluded.

in 2000, in terms of money in the bank, shares and investment funds. Most wealth is invested in not very liquid assets, such as pension plans, housing and life insurance policies...three forms of very long term saving that are clearly oriented towards retirement.

The financial wealth that households have accumulated is what can be used to face unexpected changes in income or unforeseen expenses. With regards to saving incentives, the tax system stimulates saving by means of contributing to pension plans. The current debate over the future of the pension system includes whether or not the tax system should be so biased towards long term saving, as British households save very little in liquid assets and this could have negative consequences in light of a possible change in the cycle.

While in recent years new financial products have sprung up all over, some of which are tax deductible such as Personal Equity Plans (PEPs), Tax Exempt Savings Accounts (TESSAs) and Individual Savings Accounts (ISAs), most household savings are still kept in banks in current and savings accounts. The new products seem to have attracted only the wealthy. For example, the average wealth of people with PEPs or TESSAs in 2000 was in the vicinity of £16,000. While PEPs and TESSAs had a minimum period of investment, ISAs have been more popular amongst young people and low income earners due to the fact that they are extremely liquid.

Ten per cent of British households have no savings whatsoever. This is paradoxical considering that at the same time the number of households

that buy share or a house does has not stopped growing. The best part of the households without savings are young, which makes this situation temporary. Changes in education, the labour market and in the attitude towards having a family means that people become capable of saving later and later in life. At the same time, the widespread use of credit reduces the need to save liquid assets for precaution. However, the second largest group of households without savings are over 65 years old and are not capable of accumulating wealth in the future. They depend on the social benefit system to face possible pecuniary difficulties.

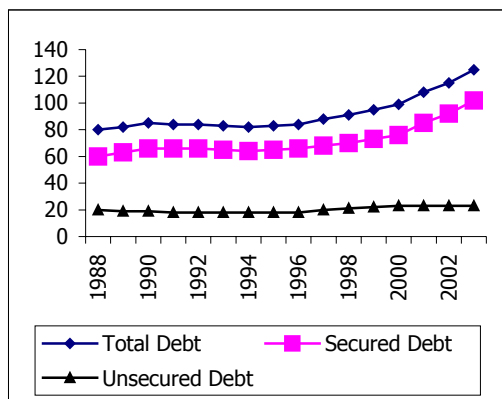
### **Household borrowing soars to 125% of disposable income in 2003**

The amount of borrowing on behalf of British households has increased considerably over the last five years from 95% to 125% of disposable income. A high debt/income ratio can be interpreted as an improvement in household wealth, as more consumers are able to soften short-term falls in disposable income or increase their consumption to satisfy the expectations of more income in the future. However, greater borrowing can also mean difficulties for households, as they may well have borrowed more than they are capable of paying back. The amount of household borrowing has an influence on mechanism that transfers shocks in the economy as it affects households' capacity to respond and therefore also has an impact on consumption and inflation.

The marked imbalance in households' financial structure has been considered

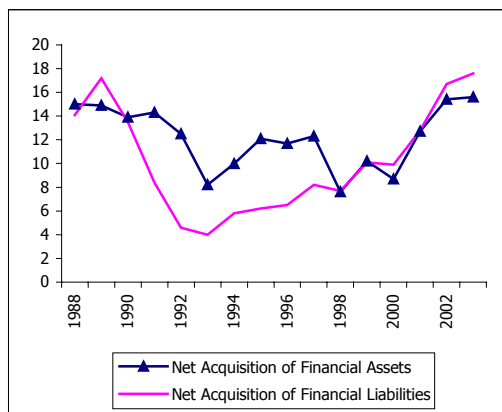
one of the reasons behind the seriousness of the economic recession in the United Kingdom at the beginning of the 90s. It aggravated the fall in consumption on behalf of households in debt following the rises in interest rates and unemployment.

Figure 4: Household Borrowing (debt as a percentage of disposable income)



Source: Bank of England and ONS

Figure 5: Aggregate Financial Position of British Households



Source: ONS

As the saving rate has remained relatively stable since 1998, consumption has risen in line with disposable income. The increase in debt does not, therefore, appear to be related to greater consumption, but rather to acquiring more financial

assets (Figure 5). But those accumulating debt and those accumulating financial assets may not necessarily be the same people. For example, some households may have bought a house with a mortgage loan while others might have decided to buy financial assets with the proceeds of the sale of their house.

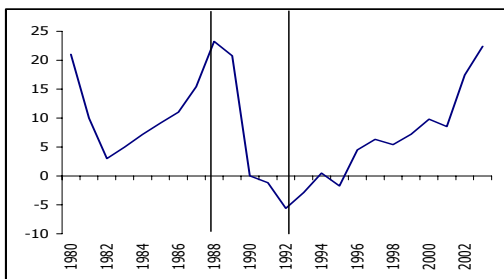
Although the increase in borrowing has not led to an abrupt expansion in current consumption, this indebtedness could have affect consumption and inflation in the future through "collateral and cash-flow" effects. These two effects could amplify a potential shock in the British economy – although it is always difficult to accurately calculate its impact.

The collateral effect occurs when households with collateral of great value to pledge against borrowing, normally a house, go too deeply into debt, taking advantage of initially favourable interest rates due to using that asset as a guarantee. A sharp fall in the value of their collateral (in our case, the house) provokes a decrease in homeowners' consumption, in an attempt to regain lost savings. At the same time, these households are less able to borrow, and the financial burden if they did borrow would be greater as interest rates on that borrowing would be higher.

The cash-flow effect arises when an upturn in interest rates encourages people to save more and consume less in the present, in order to spend more in the future. The magnitude of the effect also depends on the extent to which a household is in debt. Households in debt are obliged to repay part of the loan capital every month,

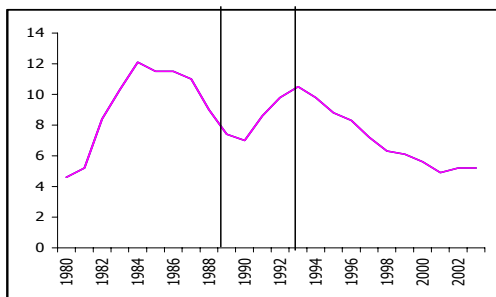
together with the corresponding interest. A change in interest rates affects monthly payments and, therefore, disposable income and consumption. Households that cannot borrow any more and lack the necessary liquid savings, will react by firstly altering their consumption habits and some may even end up having to sell their house.

Figure 6: Housing Inflation Rate



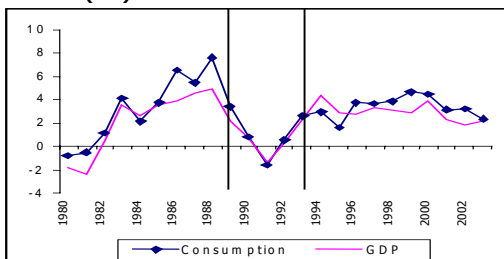
Source: Nationwide

Figure 7: Unemployment Rate (%)



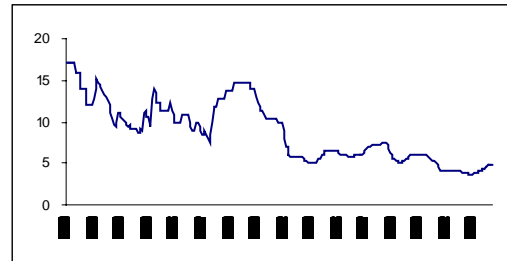
Source: ONS

Figure 8.- Annual Growth Rate in Real Consumption and Real GDP at Market Prices (%)



Source: ONS

Figure 9: Official Interest Rate



Source: Bank of England

Figures 6 to 9 compare the current situation to the scenario at the end of the 80s and beginning of the 90s when the debt/income ratio was high and the fall in nominal housing prices, real GDP and real consumption coincided with an increase in the unemployment rate and soaring interest rates, which reached a peak of 15%. The collateral and cash-flow effects were particularly strong over this period. Parallel to this, the increase in unemployment and interest rates and the slump in GDP growth also contributed to the decrease in consumption, as they encouraged borrowers to reconsider their expectations of future income and, therefore, the desired level of debt.

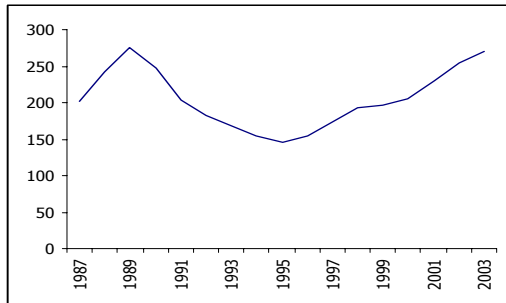
While the macroeconomic scenario appears to be similar to the current situation in terms of the high inflation rate in housing and the upturn in household borrowing, the rest of the macroeconomic variables are in quite different shape, particularly as far as the unemployment rate and interest rates are concerned.

Although the current collateral position of British Households is similar to that witnessed at the end of the 80s (Figure 10), the distribution of debt among new borrowers suggests that if there were a given fall in house prices, fewer households than in the 1980s would be

likely to face problems borrowing and the number of households experiencing negative equity would be lower<sup>2</sup>. Similarly, due to the fact that there have been less transactions over recent years than during the late 1980s, there are likely to be fewer borrowers who could be at risk of falling into negative equity in light of a sharp downturn in housing prices (figure 11).

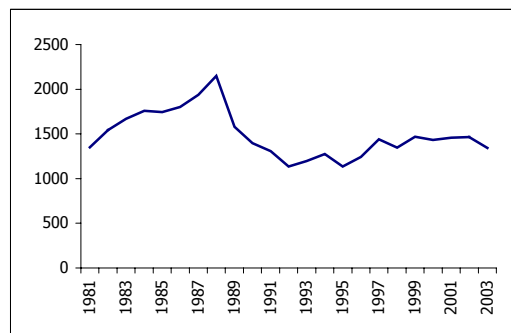
Figure 12 shows how the cash-flow effect or the possible cash-flow difficulties of households due to an increase in mortgage interest rates is also less likely to have as significant an effect as it did at the end of the 80s.

Figure 10: Net Housing Value Ratio as a Proportion of Annual Disposable Income (%)



Source: ONS

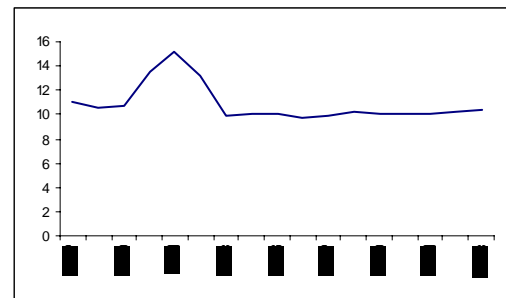
Figure 11: Number Transactions on the Real Estate Market



Source: Inland Revenue

<sup>2</sup> Bank of England, Financial Stability Review, June 2004.

Figure 12: Financial Cost and Payment of Loan Capital as a Percentage of Household Disposable Income



Source: Bank of England and ONS

The families that have recently bought a house are the most vulnerable to a rise in interest rates. Research carried out by the Bank of England on this issue reveals that loan to income ratios (LTIs) have increased significantly, particularly among new mortgagors, and that the proportion of disposable income needed to meet repayments on debt and pay interest is more vulnerable to changes in interest rates now than in the 80s, and more so for new borrowers.<sup>3</sup>

To conclude, there is a smaller proportion of new homeowners in recent years in comparison to the late 1980s, and we have seen that generally speaking, that they are less vulnerable to a drop in housing prices, an unforeseen increase in interest rates or a rise in unemployment than their counterparts at the end of the 80s.

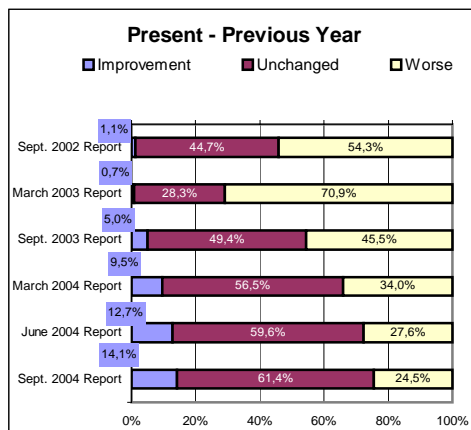
Francisco Requena  
Valencia, November 23, 2004

<sup>3</sup> Hancock, M. (2004), "Household Secured Debt", Bank of England Quarterly Bulletin, Summer, 291-301)

## 7- Japan

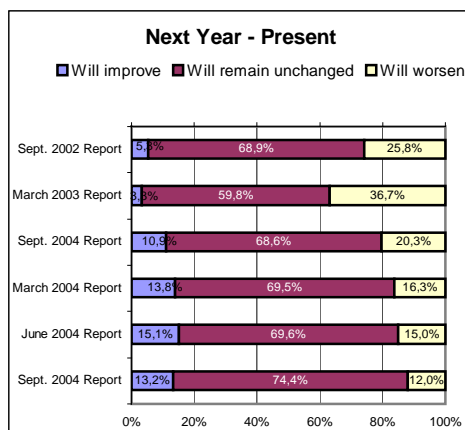
Generally speaking, private consumption data is still mixed at best. Retail sales increased by a monthly 0.1% in September, which meant an annual decrease of 0.3%.

Figure 1: Current Economic Environment with respect to the Past



Source: "Opinion Survey on the General Public's Mindset and Behaviour", Bank of Japan

Figure 2: Future Economic Environment with respect to the Present



Source: "Opinion Survey on the General Public's Mindset and Behaviour", Bank of Japan

More importantly, average worker spending (a fundamental indicator for

the analysis of personal consumption) registered a disheartening 1% decrease in September, while consumption propensity plummeted to 71.6, compared to the previous figure of 75.4. The consumer confidence indicator also fell by 3.1 points to 46.1, recovering slight in October and climbing to 47.7. Recent surveys carried out by the Bank of Japan indicate a slight downturn in the proportion of interviewees who believe the current economic environment will improve next year, although the proportion of those who consider the situation will deteriorate also declines (see Figures 1 & 2).

When analysing household economies, it is worth remembering that corporate profits have risen throughout the expansive period, while wages have recorded a significant increase. In terms of income distribution, this results in the current percentage of the wage mass over income being below the average registered for the 1980s. Wages have under control and profit margins have risen, which has helped businesses to tackle their liabilities and enlarge their investment projects. However, this situation is not likely to continue indefinitely without economic growth suffering due to the lack of buoyancy in workers' average spending. This is much more the case when the current international scene is cooling off and means that domestic demand must take over as the main driving force behind the economy. In spite of this, the Government insists on carrying out its tax reform and the increase in indirect taxation. The weakness displayed by the economy over the past half year creates a dilemma in this area that will be difficult to solve in the short term. On the one hand, more tax on

consumption could hold back private consumption, which is already showing signs of weakness, forcing growth in the short term to depend to an even greater extent on the performance of the external sector, when the world economy is steadily slowing down. On the other hand, the high debt burden and the excessive public deficit, which is still loathe dipping below 7% of GDP, meaning that the structure of the tax system needs to be changed in order to ensure sound growth in the long term.

Luis M. Granero  
Valencia, November 24, 2004

## 8.- China

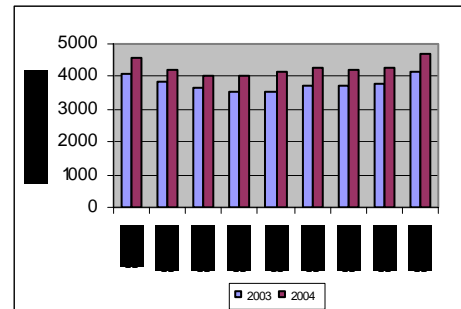
Economic growth in China over recent years is generating the emergence of a blooming middle class. Today more than 80 million people can be considered part of this sector of the economy. They are concentrated in coastal areas, where the economy is growing more quickly and are normally private small or medium-sized business owners, rural business people and specialists in high technology. In this way, the middle class is helping to reduce the enormous differences between the rich and the poor in China.

### a) Income

The Government has developed various policies designed to improve rural living conditions in China in 2004 obtaining the success expected. The National Bureau of Statistics recently published income per capita data for the first nine months of the year. Rural income per capita had risen by 11.4%, while the average wage had increased by 13.8%.

The Chinese Federation of Commerce and the China National Commerce Information Center recently Publisher a White Book on Retail Sales which reveals that GDP per capita in 2003 in China was over 1,000 dollars per annum. This has caused a substantial change in consumer habits. The Chinese currently place more importance on development and comfort than on covering basic necessities (clothing and food) in order to demand a higher standard of living (accommodation, travel, recreation, tourism).

Figure 1: Retail Sales of Consumer Goods



Source: own elaboration with data from the National Bureau of Statistics

### b) Saving

China has a high household saving rate that was in the vicinity of 40% of GDP in 2003, compared to 14% in the USA and 27% in Japan. This saving rate would be enough to finance household investment but the inefficiency of the country's financial system impedes transferring saving into investment.

The government is trying to develop the Shanghai and Shenzhen stock markets, thereby giving rise to new ways of saving that do not involve the traditional financial institutions. Nevertheless, the increases in interest rates at the end of October have created a certain amount of anxiety in the stock market, causing the Shanghai index to fall by 1.7% at the beginning of November and possible further movements related to suspicion over interest rate movements in the near future.

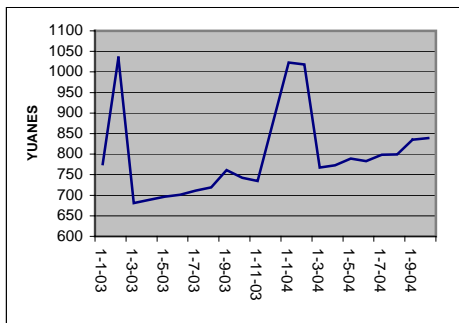
### c) Consumption

Research carried out by the China Brand Strategy Association indicates that 13% of the Asian country's overall population prefer to consume luxury articles (cosmetics, perfumes or

watches) than western consumers, who prefer houses, cars or family holidays. Chinese consumers, whose average income per annum is \$30,000US, are expected to increase by up to 20.3% by 2010.

Average disposable income per capita of Chinese urban dwellers reached \$850US over the first nine months of 2004, up by 7% in real terms in comparison to the same period in 2003 (see Figure 2). At the same time, urban dwellers also spent 10.9% more in comparison to last year, without taking inflation into account, where transport and health figured prominently with price hikes of 40% and 41% respectively.

Figure 2: Urban Income Per Capita



Source: own elaboration with data from the National Bureau of Statistics

#### d) Housing

The number of households lacking sufficient space in their houses has dropped 1.56 million (1.1% of the total). This figure is insignificant if we take into account that in 1978, close to 47.5% of families living in cities were either homeless or lacked sufficient space. Currently, the surface area per capita of a dwelling in the city is 21m<sup>2</sup> while in rural areas it is 25m<sup>2</sup>.

Housing prices rose by 9.9% in 35 important cities in China in the third quarter of 2004. Property prices also rose by 11.6% and leasing prices by 2.1% in relation to the same period the previous year.

The construction sector is ranked fourth in terms of its contribution to China's GDP, behind industry, agriculture and trade. It is expected to become one of the cornerstones of the national economy. This is mainly due to the urbanisation the country is currently undergoing. The rapid economic growth has provoked a significant migratory flow of rural labour to cities. The latest figures to be published indicate that 520 million inhabitants, which is approximately 40.5% of the population, lived in cities in 2003 compared to 28% in 1993.

M<sup>a</sup> Luisa Martí  
Rosa Puertas  
Valencia, November 24, 2004

## 9.- Argentina

The recovery that the country is undergoing can be clearly seen in the developments of the main macroeconomic components. But what about households? Is this economic boom spreading to Argentinian households? This microeconomic area will be dealt with in the rest of this report.

### Crisis devastates households

In order to obtain an overall picture of the current situation for households we must go back to the recent economic and financial crisis and study its impact on households.

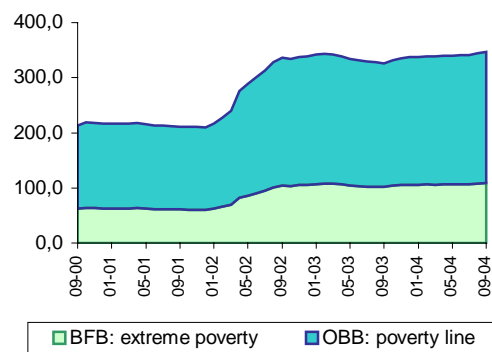
Well, data shows that the recession which began in 1998 witnessed a persistent deterioration in the situation of households, which got out of hand in 2001 and 2002. the unemployment rate jumped from the already high rate of 12.9% in 1998 to 19.7% according to data from October 2002. Real wages shrank by more than 20% between 2001 and 2002. Moreover, household wealth fell as a result of the "Corralito" and the return to the peso. In other words, savings and current accounts were frozen for a year from December 2001 and, once freed, these funds in dollars were automatically converted into pesos at an arbitrary rate of 1.4 pesos to the dollar, well below market prices.

The combination of these two factors and the upturn in the price of basic goods and services provoked a dramatic increase in poverty and homelessness.

In Figure 1 we can appreciate the enormous hike in the price of the basic

food basket, which includes the basic food necessary to cover the energy needs of an average adult and the overall basic basket, which incorporates other goods and services such as clothing, transport, education, health and others (see footnote).

Figure 1: Basic Food Basket Prices and Overall Basic Basket prices per equivalent adult<sup>1</sup>



Source: INDEC

<sup>1</sup> Households and people below the poverty line are calculated from the database built by the Permanent Household Survey ("Encuesta Permanente de Hogares" in Spanish) using household income as a basis, households are studied to ascertain whether or not they are capable of satisfying (by means of purchasing goods and services) a series of dietary and non-dietary needs that are considered essential. The procedure is based on a Basic Food Basket, enlarged to include non-dietary goods and services (clothing, transport, education and health, etc.) aimed at obtaining the value of the Overall Basic Basket. In order to calculate poverty, the households unable to afford the OBB are analysed; in the case of extreme poverty, those unable to afford BFB are analysed.

Table 1: Percentage of Households below the Poverty Line and in Extreme Poverty in Urban Clusters

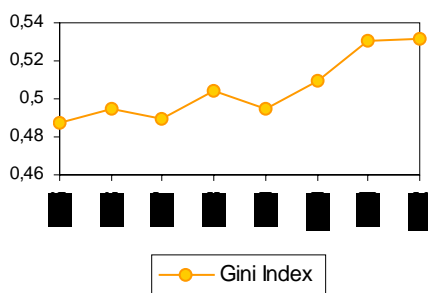
%	In extreme poverty		Below the poverty line	
	Households	People	Households	People
May-01	8.3	11.6	26.2	35.9
Oct-01	9.4	13.6	28.0	38.3
May-02	18.0	24.8	41.4	53.0
<b>Oct-02</b>	<b>19.5</b>	<b>27.5</b>	<b>45.7</b>	<b>57.5</b>
May-03	17.9	26.3	42.6	54.7
1st half 03	20.4	27.7	42.7	54.0
2nd half 03	15.1	20.5	36.5	47.8
1st half 04	12.1	17.0	33.5	44.3

Source: Indec

The highest level of poverty was reached in October 2002 with 45.7% of households and 57.5% of the population below the poverty line. In October 2001, shortly before the devaluation and the default, 28% of households were poor. At that time the percentage of the population in extreme poverty stood at 19.5% of city dwellers.

While most families got poorer and poorer, a small group benefited from increases in income. This was one of the most perverse effects of the crisis. Household income concentration is captured by the pattern of the Gini index, which rose substantially between 1999 and 2001 (Figure 2).

Figure 2: Income Distribution Pattern per Household



Source: SIEMPRO

The Individual Household Survey ("Encuesta Puntual de Hogares" in Spanish) elaborated by the INDEC reveals that when income concentration was at its highest, in October 2002:

- The poorest 10% of households obtained only 1.4% of total income, while the richest 10% chalked up 37.9% of the total.
- The richest 20% of the population earned 14 times as much as the poorest 20%.
- 70% of the population totalled 33.7% of overall income, which was still less than the richest 10% (37.9%).

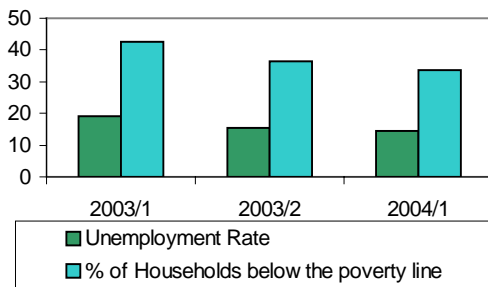
However, the Human Development Index elaborated by the United Nations portrays the social impact of the crisis to be less dramatic. The index, based on three indicators (life expectancy, level of education and income per capita), ranked Argentina 34 in the latest report on human development with an HDI value of 0.853, considerably higher than for the rest of South America as a whole and the Caribbean (0.777). Moreover, the index's temporal series, whose last figure dates back to 2002, shows progressive improvements in human development in the country and the collapse at the end of 2001 and in 2002 is barely noticeable.

**Strong economic recovery, modest improvement in household well-being**

The economy began to recover at the end of 2002, but improvements are not appreciated in the economic condition of households until halfway through 2003. The data series presented in Figure 3 show the decrease in

unemployment and poverty in an environment of rising real wages.

Figure 3: Unemployment and Poverty

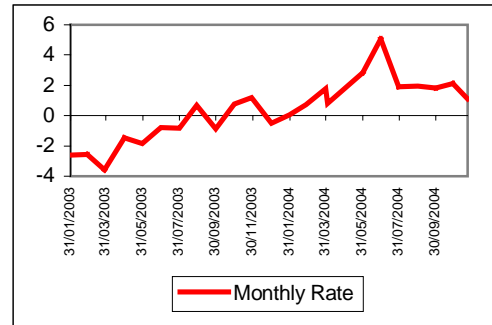


Source: INDEC

While recent social progress has been made, it is worth mentioning that the decrease in poverty and unemployment does not match the buoyancy of the economy, which grew 8.8% in 2003.

As expected, the current upturn and the improvements mentioned above, together with the fact that the financial system has recovered its role as an intermediary, thereby allowing an increase in household credit, have led to greater private consumption. This GDP item has grown 20% over the past six quarters (up to the second quarter of 2004). Household consumption will continue to increase in the short and medium term, if we take into account the consumer optimism that can be deduced from the Consumer Confidence Index elaborated by the University of Torcuato di Tella.

Figure 4: Loans from Financial Institutions to the Private Sector



Source: Bank of Argentina

**Conclusion**

Argentina, as mentioned in the section on the current economic environment in the country, has some outstanding features, which include a bulging financial surplus, a lack of inflationary pressure, and increasing consumption and investment. Moreover, household income, unemployment and poverty have been in keeping with the economic cycle, although they deteriorated more quickly in the recession and are recovering later and more slowly.

Furthermore, we mentioned that Argentina now boasts GDP that is close to the level registered in 1998. However, the number of Argentinians who today suffer from unemployment (14.8% of the labour force) and poverty (44% of total urban population) means that the comparison above cannot be extended to include the well-being of Argentinian households.

Julia Torrecabota  
Valencia, November 24, 2004

## 10.- Brazil

### 1) Income inequality, a 40-year long problem!

Table 1: Gini Index and Annual GDP Growth Rate<sup>1</sup>

Period	Gini	Annual GDP
1975-1978	0.62	5.7
1979-1983	0.59	1.74
1984-1988	0.60	4.94
1989-1993	0.61	0.94
1994-1998	0.60	3.24
1999-2003	0.60	1.58
Quarter 1&2 average 2004	-	4.12

Source: IPEA, World Bank and own elaboration

Brazil is today the third-ranked country in the world in terms of income distribution inequality. Brazil's inequality problem can be seen through the GINI index, which remained stable at around 0.60 between 1976 and 2003. This degree of inequality contrasts with the economic growth registered in the first half of 2004 that has averaged 4.12% and the favourable performance of the labour market as unemployment is dropping, employment continues to grow, and real wages are increase in annual terms.

The Human Development Index (HDI) also demonstrates the degree of inequality and displayed an upward trend from 1970 to 1996, rising from 0.494 to 0.830. From then onwards, the HDI has witnessed a decrease that has taken the index to 0.775 in 2002, an

<sup>1</sup> Both the Gini index and the annual GDP change have been calculated as five-year averages. We must underline the fact that due to data unavailability, the average for the Gini index in some five-year periods was taken over four years.

unusual decrease on an international scale for countries with a certain level of development.

Table 2: Human Development Index

Year	HDI
1970	0,494
1980	0,734
1991	0,787
1996	0,830
2001	0,777
2002	0.775

Source: UNDP

These income inequalities are by no means related to current economic conditions, as they have existed for more than 40 years, due to government policy systematically favouring the sector of the population with the most purchasing power.

The income inequality in Brazil has quite singular characteristics:

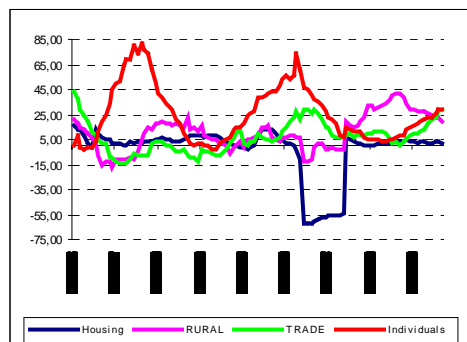
- 1) According to data from the National Household Sample Survey elaborated by the Brazilian Institute of Geography and Statistics (IBGE), the richest 10% earn close to 50% of total household income, while the poorest 50% earn little more than 10%. This leaves a middle class (around 40%) who earn 40% of total income.
- 2) Income inequality in Brazil is high due to the shortage of qualified labour together with minimal technological development. Some factors that would explain this include the relatively low level of school-goers, as technology advances a lot more quickly, the few qualified people tend to receive higher salaries and the wage mass becomes concentrated.

3) The role of the Brazilian Government in the state education system together with financial policy has maintained this inequality for more than 40 years. In fact, a tax system where indirect tax accounts for a greater proportion than direct tax increases the degree of inequality even further and indicates the lack of action on behalf the pertinent authorities in the interests of those with the least purchasing power.

In short, income inequality has been a reality in Brazil for more than 40 years. The qualifications required enter the labour market and inexistent progressive financial policy could be behind the increase in the GINI index. Unless Lula's government takes appropriate action now that the macroeconomic situation is favourable, inequality will persist. It is difficult to understand the intention to boost domestic demand and stop relying on the external sector's performance without first solving this type of structural problem.

## 2) Brazilian borrowing

Figure 1: Annual Change in Credit by debtor. 1996-2004



Source: Central Bank of Brazil

The concession of loans on behalf of the Brazilian financial system between 1994 and 1998 was markedly conservative in both the public and private sector. This was due to the problems institutions had to obtain external resources and the changes in the international economic scenario. During this period, 85% of housing loans were financed by the public sector and the rest by the private sector. This meant that when the number of loans conceded fell, the annual rate in housing loans dropped from 16.15% in 1996 to -1.79% at the end of 1999. Rural loans registered a similar pattern, as they are also mainly financed by the public sector (80% and the remaining 20% is financed by the private sector). The annual change rate for these loans fell from 21.11% in 1996 to 2.65% in 1999.

On the contrary, business and personal loans over this period are mainly financed by the private sector (about 75% for both types of credit). As in the previous case, there is a downward trend in loans, although those financed by the private sector and those related to business activity displayed smaller decreases.

In 1999 and to a greater degree in 2000, credit policy was reoriented to favour the final borrower's access to loans. Loans conceded increased over that period thanks firstly to banking transparency on behalf of financial institutions, the decrease in the reference interest rate from 45% at the beginning of 1999 to 19% in 2000 and domestic macroeconomic stability. At the end of 2000, housing and rural loans grew by 5.61% and 6.51% respectively, boosted by the private sector, while trade and personal loans

rose by 11.44% and 52.76% respectively, significantly higher than the aforementioned and financed mainly by the private sector.

The deterioration in expectations and the external sector in Brazil in 2001 up to half way through 2002 reduced the demand for consumption and investment resources thereby increasing financing costs and financial institutions were more conservative when it came to conceding loans. In fact, housing loans dropped by up to 54% with respect to the previous year, as the public sector, in light of the economic environment, decided to drastically reduce the number of housing loans drastically. This decrease was not so severe in rural, trade and personal loans.

Despite fluctuations in GDP, loan concessions have displayed an upward trend since the end of 2002, even though some differences are observed between the various types of credit. On one hand, housing loans registered the lowest growth rates (around 2% in annual terms), although it is true that the public sector conceded the most loans, registering growth rates between 5% and 6%, boosted by economic growth and foreign inflows, particularly in the first two quarters of 2004.

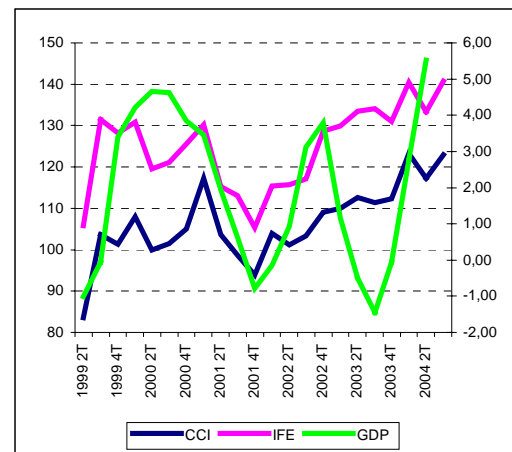
On the other hand, growth in the number of loans conceded in trade, to individuals and farming has been significant, with the private sector being the main source of financing.

### 3) Optimism in Brazil

In Figure 2 the pattern of the consumer confidence index can be observed, together with the Index of Future

Expectations. The annual GDP pattern registers a similar pattern.

Figure 2: Consumer Confidence Index and the Index of Future Expectations (right axis) and annual GDP change (left axis)



Source: Central Bank of Brazil

Four stages can be observed on comparing the two graphs:

- 1.- The stage is between 1999 and 2000, when the Brazilian economy was expanding due mainly to the favourable performance of the external sector and the strong growth in employment, which boosted consumer confidence and expectations with respect to the future.
- 2.- The second stage takes place in 2001, when both consumer confidence and future expectations fell, as Brazil's excessive dependence on the external sector, the imbalance in Argentina's economy and its negative impact on exports, along with international uncertainty caused the Brazilian economy to slow down.
- 3.- Following the slump in the economy, 2002 saw the beginning of a recovery, thereby boosting

Brazilians' expectations and confidence. This can be mainly explained by the positive performance of the external sector together with the depreciation of the Real and the increase in the number of people in employment.

- 4.- Lula's election victory increased uncertainty in Brazil, pushing up its country risk. With less foreign resources available confidence fell at the end of 2002 and 2003, but to a lesser extent than in the previous period. Perhaps the favourable performance of the labour market was in some way responsible for maintaining expectations and confidence in Brazil during that time when GDP slumped.

Currently, maximum growth in exports, increasing investment, continuous job creation and the decrease in unemployment seems to be fostering Brazilian confidence and expectations as to the future of their country.

M<sup>o</sup> Jesus Herrerías  
Valencia, November 24, 2004

