NOVEMBER 2008

THE SPANISH ECONOMY

# Monthly Report

NUMBER 318



RESEARCH DEPARTMENT

"la Caixa"

# Forecast

**% change over same period year before unless otherwise noted**

| | 2007 | 2008 | 2009 | 2007 | 2008 | | | |
|---|---|---|---|---|---|---|---|---|
| | | | | 4Q | 1Q | 2Q | 3Q | 4Q |
| **INTERNATIONAL ECONOMY** | | Forecast | | | | | | Forecast |
| **Gross domestic product** | | | | | | | | |
| United States | 2.0 | 1.5 | 0.1 | 2.3 | 2.5 | 2.1 | 0.8 | 0.6 |
| Japan | 2.0 | 0.5 | 0.6 | 1.4 | 1.2 | 0.8 | 0.3 | –0.1 |
| United Kingdom | 3.0 | 1.2 | 0.3 | 2.9 | 2.3 | 1.5 | 0.3 | 0.4 |
| Euro area | 2.6 | 1.1 | 0.2 | 2.1 | 2.1 | 1.4 | 0.7 | 0.2 |
| *Germany* | *2.6* | *1.4* | *0.1* | *1.7* | *2.6* | *1.7* | *0.8* | *0.4* |
| *France* | *2.1* | *0.9* | *0.5* | *2.2* | *2.1* | *1.1* | *0.3* | *0.1* |
| **Consumer prices** | | | | | | | | |
| United States | 2.9 | 4.2 | 1.3 | 4.0 | 4.1 | 4.4 | 5.3 | 3.1 |
| Japan | 0.1 | 1.3 | 0.5 | 0.5 | 1.0 | 1.4 | 2.2 | 0.6 |
| United Kingdom | 2.3 | 3.8 | 2.9 | 2.1 | 2.4 | 3.3 | 4.9 | 4.5 |
| Euro area | 2.1 | 3.4 | 1.8 | 2.9 | 3.4 | 3.6 | 3.8 | 2.6 |
| *Germany* | *2.3* | *2.8* | *1.9* | *3.1* | *2.9* | *2.9* | *3.2* | *2.4* |
| *France* | *1.5* | *3.1* | *1.9* | *2.3* | *2.9* | *3.3* | *3.3* | *2.7* |
| **SPANISH ECONOMY** | | Forecast | | | | | | Forecast |
| **Macroeconomic figures** | | | | | | | | |
| Household consumption | 3.4 | 1.1 | 0.4 | 2.9 | 2.2 | 1.2 | 0.7 | 0.2 |
| Government consumption | 4.9 | 4.0 | 4.1 | 4.4 | 3.6 | 3.8 | 4.4 | 4.3 |
| Gross fixed capital formation | 5.3 | –1.0 | –5.1 | 4.5 | 2.5 | –0.2 | –2.4 | –4.1 |
| *Capital goods* | *10.0* | *1.5* | *–3.8* | *7.1* | *5.2* | *2.3* | *0.5* | *–2.2* |
| *Construction* | *3.8* | *–3.5* | *–7.7* | *2.9* | *0.3* | *–2.4* | *–5.1* | *–6.7* |
| Domestic demand (contribution to GDP growth) | 4.4 | 1.1 | –0.5 | 3.8 | 2.8 | 1.5 | 0.5 | –0.3 |
| Exports of goods and services | 4.9 | 3.8 | 2.1 | 4.0 | 4.3 | 4.1 | 3.5 | 3.1 |
| Imports of goods and services | 6.2 | 2.2 | –0.2 | 4.9 | 4.1 | 2.3 | 1.5 | 0.9 |
| **Gross domestic product** | **3.7** | **1.4** | **0.1** | **3.3** | **2.6** | **1.8** | **0.9** | **0.2** |
| **Other variables** | | | | | | | | |
| Employment | 2.9 | –0.1 | –1.5 | 2.2 | 1.4 | 0.4 | –0.8 | –1.3 |
| Unemployment (% labour force) | 8.3 | 10.9 | 13.6 | 8.6 | 9.6 | 10.4 | 11.3 | 12.1 |
| Consumer price index | 2.8 | 4.2 | 2.1 | 4.0 | 4.4 | 4.6 | 4.9 | 2.9 |
| Unit labour costs | 2.9 | 3.4 | 2.7 | 3.0 | 3.9 | 3.6 | | |
| Current account balance (% GDP) | –10.1 | –10.2 | –10.0 | –10.5 | –12.0 | –9.5 | | |
| Net lending or net borrowing rest of the world (% GDP) | –9.7 | –9.6 | –9.4 | –9.6 | –11.2 | –9.0 | | |
| Government balance (% GDP) | 2.2 | –1.5 | –2.8 | | | | | |
| **FINANCIAL MARKETS** | | Forecast | | | | | | Forecast |
| **Interest rates** | | | | | | | | |
| Federal Funds | 5.0 | 2.1 | 1.2 | 4.5 | 3.2 | 2.1 | 2.0 | 1.2 |
| ECB repo | 3.8 | 3.9 | 2.5 | 4.0 | 4.0 | 4.0 | 4.2 | 3.4 |
| 10-year US bonds | 4.6 | 3.7 | 3.7 | 4.3 | 3.6 | 3.9 | 3.8 | 3.5 |
| 10-year German bonds | 4.2 | 4.1 | 3.5 | 4.2 | 3.9 | 4.3 | 4.3 | 3.8 |
| **Exchange rate** | | | | | | | | |
| $/Euro | 1.37 | 1.46 | 1.29 | 1.45 | 1.50 | 1.56 | 1.51 | 1.29 |

## Contents



# United States: beyond the storm

The United States is facing one of the most complicated moments in its history. The country is suffering a deep real estate recession that looks like becoming one of the worst ever experienced. Closely linked to this, a financial crisis has broken out that puts the survival of the existing financial system in doubt. On top of all this, the prospects of a recession are getting stronger and stronger.

In the face of this situation, the whole world is becoming worried. The old saying that when the United States sneezes the planet catches cold again comes to the fore. For a period, it seemed reasonable to believe that a decoupling could take place between the US economy and the world economy. The strength of the emerging countries, with China in the lead, suggested a new dynamic in which these countries could come to play the role of economic engine traditionally reserved to the American colossus. After all, the so-called BRICs (Brazil, Russia, India and China) make up 21.5% of world gross domestic product, in purchasing power parity equal to the United States. However, the upsets in financial and commodity markets over the past two months have left various emerging countries in serious straits, putting the decoupling theory in question. All of a sudden, it seems that no one is escaping from the world economic recession.

Because of this, all eyes are on the United States, on its capacity to stabilize an economy that represents a paradigm of progress under a free market. It is not only a question of knowing when we shall see a return to the prosperity now put in doubt but how this could happen. The drastic measures adopted to deal with the collapse of the monetary and credit system go counter to the tradition of liberalization introduced in the Eighties which laid the basis for the prosperity of the Nineties and the beginning of the current decade which spread around the world. The management of economic policy is now being looked at under bright lights following two consecutive speculative bubbles (high-tech and real estate) and a succession of regulatory loopholes that came to light with Enron and ended up in the subprime mortgage scandal.

Furthermore, the elections have put US citizens in the position of having to choose between two radically different proposals on tax matters and public spending. Those who have placed their confidence in Barack Obama have opted for increased redistribution of income and an increase in investment in infrastructures and research. Those who would have preferred John McCain, on the other hand, were opting for a reduction of the distortions created through taxes and a major reduction in public spending. In other questions, such as energy policy, the environment and health care, both candidates proposed a notable change from the policies followed by President Bush although, again, they espoused different approaches in carrying out reforms.

This is a critical moment but the United States has always shown a strong capacity for overcoming adversity and for hard work to achieve personal and community goals. It enjoys an enviable production base and potential, with flexible and adaptable markets, an education system and scientific base that generates a majority of the Nobel prizes awarded each year and an entrepreneurial mentality supported and admired within the society. It is to be hoped that the change in the presidency will contribute to generating a leadership capable of facing the challenges. May it be something like that of the presidency of Franklin D. Roosevelt (elected in 1932) right in the worst moments of the Great Depression, which in his 12-year mandate made him the most popular president in history.

# EXECUTIVE SUMMARY

## From world financial crisis to risk of recession

**Beginning of October sees orchestration of biggest financial bailout in history...**

At a meeting in honour of Milton Friedman's 90th birthday, Ben Bernanke, then a member of the Board of Governors of the Federal Reserve, in making reference to the classical thesis of the father of monetarism that the increase in interest rates by the central banks in the 1930's had contributed to convert a conventional depression into the Great Depression, stated: «You are right (referring to Friedman and co-author Anna Schwartz), we did it. We are sorry. Thanks to you, it won't happen again». These were not empty formal words. They were a complete doctrine whose application has remained clear. The central banks, and by extension governments, were not going to ever again let the banking system become bankrupt.

**...while central banks coordinate cut in intervention rates.**

This October we saw the biggest financial bailout in history. It was a matter of dealing with the risk of insolvency of the system and solving the troubling lack of interbank liquidity. On October 2, the US Congress approved a package of financial aid amounting to 700 billion dollars. Shortly after, on October 7, the Council of Ministers of Economy and Finance of the European Union finally worked out directives for saving the European banks which, while leaving details in the hands of each of the EU countries, had the broad objective of avoiding the bankruptcy of European financial institutions while broadening guarantees for bank deposits. In order to add weight to the coordinated international response, the next day (October 8) most of the main national central banks cut their official intervention rates by a half percentage point.

Over following weeks, a number of national measures were announced that included the injection of public funds into the capital of financial institutions, various types of loan, the setting up of funds to acquire bank assets and the public guarantee of bank bond issues. Up to the end of the month national plans had been drawn up in the Euro Area for recapitalization moves equivalent to 2% of the Euro Area gross domestic product, as well as being able to count on 1,600 billion euros in guarantees for bank bond issues. In the case of Spain, on October 10 the government approved the creation of a fund set at 50 billion euros for the acquisition of financial assets and three days later came a line for granting guarantees for a total of 100 billion euros to cover new transactions for funding financial institutions. Parallel to these measures, the provision of liquidity by the national central banks was broadened still further.

**Effects of these measures begin to show up in interbank market.**

As these measures became public and the first financial institutions benefited from those plans, the wholesale financial markets began to react favourably. While we are still some distance from normalcy, some easing of interbank interest rates (the Euribor fell below 5% at the end of October) and a slight decrease in risk premiums in the private bond market indicate that the effect of these extraordinary government measures is going in the right direction. Nevertheless, the sharp correction on the stock markets and the continuing drop in return on government bonds

implies that investors are still following a «flight to quality» on a notable scale. What are they fleeing from?

Once the system risk aspect of the crisis seems to be on the way to being resolved, the threat is being seen in terms of the real economy. Fears of a world recession have taken the place of the threat of a general collapse of the banks. Here we must make a point quite clear. The expression «world recession» does not refer to a contraction in world gross domestic product (GDP). The meaning we should give this expression is of weak growth, in line, for example, with the usage by the International Monetary Fund (IMF) in referring to a situation of world recession as one where world economic growth drops below 3%. This implies technical recessions (that is to say, a drop in GDP and employment in various consecutive quarters) in the advanced economies and sharp slowdowns in economic activity in the developing economies.

Well then, are we likely to see this become a reality, this scenario of a halt in growth that the markets seem to be discounting? While the reaction in the financial sphere took place mainly in October, the fact is that available figures for economic activity and prices confirm that the economic contraction had already begun in the United States and Europe. In the third quarter, at quarter-to-quarter rate annualized, the GDP in the United States fell by 0.3% whereas in the United Kingdom it went down by 2.0%. Available indicators of economic activities suggest that the British pattern will be repeated in the Euro Area as a whole. Behind these poor results on both sides of the Atlantic lies the weakness of domestic demand, with consumers making downward adjustments to their spending and investment.

In Spain, estimates for the third quarter point to a 0.2% contraction of economic activity compared with the previous quarter. The indicators for the period are conclusive: there has been a drop in economic confidence to levels similar to those for in the 1992-1993 recession, the state of non-financial companies has weakened and consumption (especially in the durable goods segment) is undergoing a sharp adjustment. That is without mentioning housing construction. We should point out the improvement in the foreign sector but this is clearly not enough support to compensate for the weakness of domestic demand.

**Relief on financial front blurred by prospects of sharp worsening of world economic activity...**

Perhaps where the extent of the economic crisis shows up most clearly is in the trend taking place in the labour market. According to the Labour Force Survey, the third quarter saw the first year-on-year drop in employment levels since 1994. Some 164,000 jobs were lost over the past year, mainly as a result of the worse work situation in the construction sector and, to a lesser extent, in industry and agriculture. The unemployment rate, in turn, moved up to 11.3% of the labour force.

**...a situation confirmed by contraction of GDP in Europe and United States.**

In this rather bleak scene, inflation offers some relief. As has happened in the main advanced economies, Spain's inflation has been dropping fairly sharply following the annual highs obtaining last July (a moment when it went above 5% year-on-year). In October, in keeping with the increase in harmonized inflation, this stood at 3.6% year-on-year. This movement was largely due to the easing of pressures in energy. Prospects for coming months in Spain and the rest of Europe as well as in the United States are for a notable containment of inflation.

The change in inflation expectations in recent months eases the way for the central banks to continue with cuts in official rates. These measures will likely be needed for some time given that in

**Spain will not escape recession.**

**On top of problems in industrialized countries comes rapid drop in emerging economies...**

the last period of October a new concern came to the fore, namely that of the emerging economies. While the crisis in the emerging countries has been developing since the summer months, it was in October that it fully blossomed. As in earlier episodes that took place in the Eighties and Nineties, the heavy pressure in the markets has not discriminated between objectively different economies. The «flight to quality» mentioned earlier has brought about a notable shifting of capital away from emerging economies and sharp pressures on the financial front, reflected in major depreciation of currencies and increased differentials in public debt. As a result of this change in investor perception, emerging stock markets have suffered major losses.

**...limited to date to financial sphere but now showing troubling trend.**

In spite of this overall movement, there are specific factors that will likely play a role in their future macroeconomic development. One group of emerging countries have seen their growth prospects weakened due to the drop in commodity prices. This is the case with a large number of Latin American economies and certain African exporters of basic commodities and energy products. A second group may be seen in the economies of Eastern Europe. These are countries that are heavily dependent on the development of the Euro Area whose credit boom has obliged them to have recourse to foreign financing. Both of these factors put them in a delicate economic situation.

Finally, the move to take funding out of the emerging countries has raised doubts in countries like North Korea and China. Both the Asian giant and South Korea are economies notably integrated in global flows of capital and goods and are suffering from the cooling off of the world economy. In the case of China, the drop in GDP in the third quarter, when it slowed by nearly one percentage point to stand at 9.1% year-on-year, indicates that its cycle does not lie outside the world economic crisis.

**Banks rescued from match ball in October but game continues.**

All of this reminds us that, in a globalized world, the possibility of escaping unscathed from the global crisis is limited and that the perception that the emerging countries can not only weather the storm but compensate for the loss of economic activity in the industrialized countries was false. In this respect, the IMF has returned to the arena coming to the rescue of some of those economies most affected. In turn, the Federal Reserve, as well as leading the coordination of the central banks (including that of China) in cutting interest rates, has established measures to provide liquidity in dollars to the central banks of Brazil, Mexico, South Korea, New Zealand and Singapore. The United States may be an economic leader in difficulties but at this time no replacement can be made out on the horizon.

October, a month that brings back some bad memories in financial markets, brought its quota of concern, surprises and relief. It began with the threat of bankruptcy of an appreciable part of the banking system but extraordinary moves by the central banks and governments were able to contain this first assault. Practically at the same time as we had the impression of being saved from a «match ball» came the equally disturbing threat of a world-wide recession. The confirmation that the advanced economies are headed into some rather lean quarters has been made worse by the rapid drop in the perception of the emerging economies. October is ending with many fronts still open and with notable pessimism about the future but perhaps the lessons of the Great Depression may have avoided worse calamities.

October 31, 2008

## CHRONOLOGY

### 2007

| | | |
|---|---|---|
| **October** | **9** | Dow Jones index for **New York stock exchange** marks up all-time record (14,164.5), a rise of 13.7% compared with end of 2006. |
| | **19** | European Council agrees to adopt the **Treaty of Lisbon** in place of the European Constitution. |
| | **31** | **Federal Reserve** cuts reference rate to 4.50%. |
| **November** | **8** | IBEX 35 index for **Spanish stock market** marks up all-time high (15,945.7) with cumulative gains of 12.7% compared with end of December 2006. |
| **December** | **11** | **Federal Reserve** cuts reference rate to 4.25%. |
| | **13** | Central banks in United States, Euro Area, United Kingdom, Switzerland and Canada announce plan for **coordinated measures to relieve difficulties in monetary markets** brought about by financial upsets. |

### 2008

| | | |
|---|---|---|
| **January** | **1** | Further enlargement of **Euro Area** with entry of Cyprus and Malta, making 15 member states. |
| | **22** | **Federal Reserve** reduces reference rate to 3.50%. |
| | **30** | **Federal Reserve** reduces reference rate to 3.00%. |
| **March** | **9** | Spanish Socialist Workers Party wins **general elections**. |
| | **18** | **Federal Reserve** cuts reference rate to 2.25%. |
| **April** | **18** | Government approves a **Plan for measures to stimulate the economy**. |
| | **30** | **Federal Reserve** reduces reference rate to 2.00%. |
| **July** | **3** | **European Central Bank** raises official rate to 4.25%. |
| | **11** | One-month forward price of *Brent* quality **oil** goes up to all-time high of 146.6 dollars a barrel. |
| | **15** | **Euro** exchange rate hits 1.599 dollars, highest value since launching of European Single Currency at beginning of 1999. |
| **August** | **14** | Government puts into effect its **programme of 24 economic measures** for 2008 and 2009. |
| **September** | **19** | US government presents **bailout plan for country's banking system** amounting to 700 billion dollars. |
| **October** | **7** | Spanish government announces creation of **fund for purchase of financial assets** of financial institutions up to maximum of 50 billion euros and raises guarantee on deposits and investments to 100,000 euros. |
| | **8** | **European Central Bank**, **Federal Reserve** and **Bank of England** cut official interest rates by 50 basis points in joint move with other central banks. |
| | **12** | Euro Area countries agree on **joint action** to strengthen financial system up to end of 2009. |
| | **13** | Government authorizes granting of **government guarantees** up to 100 billion euros in 2008 on new financial transactions of financial institutions with possible extension to 2009. |
| | **27** | Dow Jones index for **New York stock exchange** records lowest level (8,175.8) since 2003. |
| | **28** | IBEX 35 index for **Spanish stock exchange** marks up lowest level (7,905.4) since 2004. Price of Brent quality **oil** drops to lowest level (60.84 dollars a barrel) since March 2007. |
| | **29** | **Federal Reserve** cuts reference rate to 1.00%. |

## AGENDA

### November

- **4** Registrations with Social Security and registered unemployment (October).
- **6** Industrial production index (September). Governing Council of European Central Bank.
- **12** CPI (October).
- **13** Advance GDP (3rd Quarter).
- **14** EU GDP (3rd Quarter). Harmonized CPI for EU (October).
- **19** Quarterly National Accounts (3rd Quarter).
- **25** Producer prices (October). Central government revenue and spending (October).
- **26** Foreign trade (September).
- **28** Balance of payments (September). Advance harmonized CPI (November).

### December

- **2** Registrations with Social Security and registered unemployment (November).
- **4** Governing Council of European Central Bank.
- **5** Industrial production index (October).
- **12** CPI (November).
- **16** Fed Open Market Committee.
- **17** Harmonized CPI for EU (November).
- **18** Labour cost survey (3rd Quarter).
- **23** Central government revenue and spending (November). Foreign trade (October).
- **29** Producer prices (November).
- **30** Balance of payments (October).

# INTERNATIONAL REVIEW

**IMF reduces growth forecast for 2009 to 3% for whole world and to 0.5% for advanced economies.**

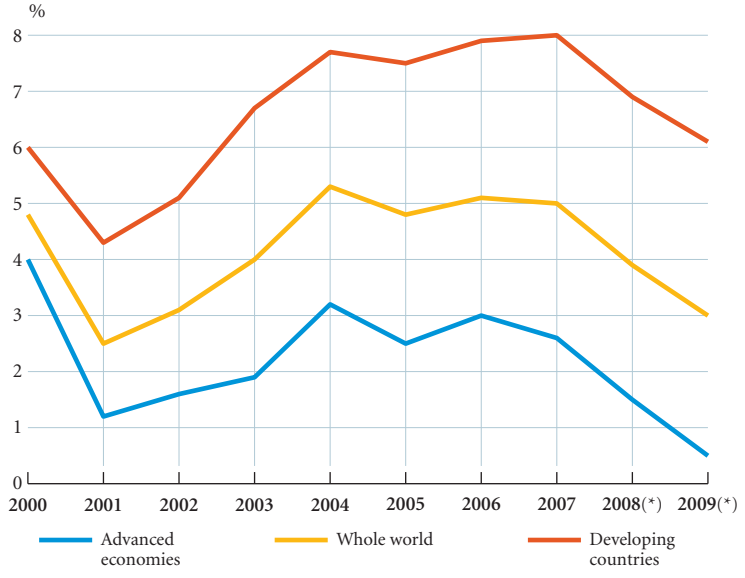
## IMF cuts forecasts for 2009

In its October report on world economic prospects, the International Monetary Fund (IMF) reduced its world growth forecasts for 2009 from 3.9% to 3.0% because of the financial crisis that has turned out to be more serious than many people expected. Its pressures are having major effects on economic activity in general with increasing risks of insolvency and a collapse of confidence. The monetary authorities have made heavy injections of liquidity and changes in legislation to shore up the financial system are expected.

The slowdown has been more pronounced in the advanced economies for which expected growth is put at 1.5% in 2008 and 0.5% in 2009. In the case of the emerging economies, initially less affected by the credit upsets, these are holding to an increase of 6.9% for 2008 but the growth forecast for 2009 drops to 6.1%. The direct effects of financial instability have been eased more in previous crises thanks to fiscal consolidation and vigorous domestic demand. It is expected that the emerging economies will continue to give support to global economic activity but if the weakness of the advanced economies is long-lived growth rates will slide down.

**WORLD GROWTH TURNING DOWN**

Year-on-year change in gross domestic product




NOTES: (*) 2008 and 2009 are forecasts.
SOURCE: International Monetary Fund.

## IMF FORECASTS

Annual change as percentage

| | 2006 | 2007 (1) | 2008 (1) | 2009 (1) |
|---|---|---|---|---|
| **GDP** | | | | |
| United States | 2.8 | 2.0 | 1.6 | 0.1 |
| Japan | 2.4 | 2.1 | 0.7 | 0.5 |
| Germany | 3.0 | 2.5 | 1.8 | 0.0 |
| France | 2.2 | 2.2 | 0.8 | 0.2 |
| Italy | 1.8 | 1.5 | –0.1 | –0.2 |
| United Kingdom | 2.8 | 3.0 | 1.0 | –0.1 |
| Spain | 3.9 | 3.7 | 1.4 | –0.2 |
| **Euro Area** | **2.8** | **2.6** | **1.3** | **0.2** |
| **Advanced economies** | **3.0** | **2.6** | **1.5** | **0.5** |
| **World total** | **5.1** | **5.0** | **3.9** | **3.0** |
| *Developing countries* | *7.9* | *8.0* | *6.9* | *6.1* |
| *Latin America* | *5.5* | *5.6* | *4.6* | *3.2* |
| *Eastern and Central Europe* | *6.7* | *5.7* | *4.5* | *3.4* |
| *Russia* | *7.4* | *8.1* | *7.0* | *5.5* |
| *China* | *11.6* | *11.9* | *9.7* | *9.3* |
| **Consumer prices** | | | | |
| United States | 3.2 | 2.9 | 4.2 | 1.8 |
| Japan | 0.3 | 0.0 | 1.6 | 0.9 |
| Germany (2) | 1.8 | 2.3 | 2.9 | 1.4 |
| France (2) | 1.9 | 1.6 | 3.4 | 1.6 |
| Italy (2) | 2.2 | 2.0 | 2.5 | 1.9 |
| United Kingdom (2) | 2.3 | 2.3 | 3.8 | 2.9 |
| Spain (2) | 3.6 | 2.8 | 4.5 | 2.6 |
| **Euro Area** (2) | **2.2** | **2.1** | **3.5** | **1.9** |
| **Advanced economies** | **2.4** | **2.2** | **3.6** | **2.0** |
| *Developing countries* | *5.4* | *6.4* | *9.4* | *7.8* |
| **Unemployment rate** (3) | | | | |
| United States | 4.6 | 4.6 | 5.6 | 6.9 |
| Japan | 4.1 | 3.8 | 4.1 | 4.5 |
| Germany | 9.8 | 8.4 | 7.4 | 8.0 |
| France | 9.2 | 8.3 | 7.7 | 8.3 |
| Italy | 6.8 | 6.2 | 6.7 | 6.6 |
| United Kingdom | 5.4 | 5.4 | 5.4 | 6.0 |
| Spain | 8.5 | 8.3 | 11.2 | 14.7 |
| **World trade by volume** (4) | **9.3** | **7.2** | **4.9** | **4.1** |
| **Oil price ($ per barrel)** (5) | **20.5** | **10.7** | **50.8** | **–6.3** |

NOTES: (1) Forecasts at October 2008.
(2) Harmonized consumer price index.
(3) Percentage of labour force.
(4) Goods and services.
(5) Average spot prices for Brent, Dubai and West Texas Intermediate oil. Average oil price in dollars per barrel forecast at $107.25 in 2008 and $100.50 in 2009.
SOURCE: International Monetary Fund.

## US economy: strength behind the wreckage

Stock markets the world over are falling and prospects for the global economy have grown dark. It will be difficult for the United States to avoid a recession and there is the risk that it will be one of the worst in the past 75 years. At times like this, it is easy to lose sight of the strong points of the US economy. Nevertheless, a sober analysis of its fundamentals reveals a picture of relative strength. This is a dynamic, productive and flexible economy, all qualities that allow us to be optimistic about its ability to overcome the financial and economic crisis it now faces.

Among the world's large economies, the economy of the United States is by far the most productive. Last year, per capita GDP reached 45,600 dollars. According to figures from the University of Groningen, at purchasing power parity exchange rates, Japan, France, Germany and United Kingdom stood between 25% and 30% below the United States, a gap that has remained relatively stable in recent years. Spain's per capita GDP stood at less than 65% of the US level. The superiority of the United States in this respect may be explained by its greater and better utilization of the labour factor. The employment rate is higher, those employed work more hours and, moreover, hours worked are more productive (see accompanying graph).

Nearly 75% of working age Americans are employed, a much higher percentage than in the large European economies. In Germany, the so-called employment rate is approximately 70% while in France it barely reaches 65%. Between these two countries, after undergoing a substantial improvement in recent decades, we find Spain. In Japan, Canada and the United Kingdom employment rates are very similar to that in the United States. The high employment rate in these economies may be explained both by the higher rate of activity (more people ready and willing to work) and by the lower unemployment rate (the proportion of those in the labour force but unemployed) The unemployment rate is especially low among young Americans. In recent years this has stood at around 8%-9%, some 6 percentage points below the rate in the EU-15.

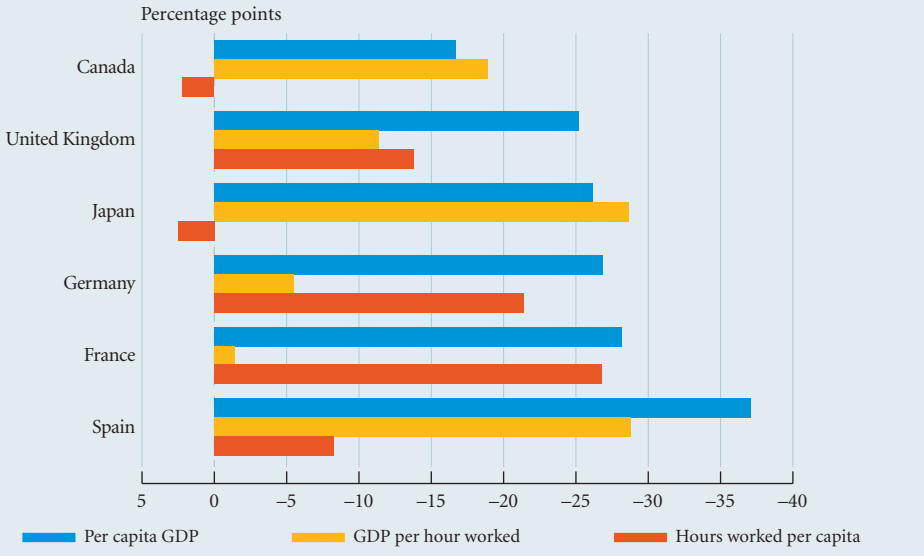
The average number of hours worked per employee in the United States is relatively high and stands at 275 hours a year more than in Germany and 153 hours more than in France. It is not usual in the United States to have four or five weeks of holidays and this is reflected in the higher number of hours worked. Curiously, whereas the number of hours worked in most countries has dropped significantly in the past 40 years (20% in Japan, 22% in France and 27% in Germany) the decrease experienced by the United States has been only 5%.

With regard to productivity, a worker in the United States produced per hour products valued at 53 dollars in 2007, substantially more than a Japanese worker (37 dollars) although only slightly higher than the 51 dollars and 49 dollars in France and Germany respectively. These figures also come from the University of Groningen and are in parity of purchasing power. In part, this is due to the fact that average productivity in Europe is relatively high because countries use fewer low-productivity employees, not because there are none but because it is more likely that they do not join the labour force or that, if they do, they remain unemployed.

What are the fundamental factors behind all these differences? Among various factors, we can mention three: the flexibility of the labour market, rules that facilitate and provide incentives for innovation and entrepreneurial activity in general, and an excellent level of a major part of the education system, especially at

**CONTRIBUTION OF PRODUCTIVITY AND HOURS WORKED TO THE DIFFERENTIAL IN PER CAPITA GDP WITH UNITED STATES**

Differential with the United States (2007)




SOURCE: University of Groningen (www.ggdc.net).

the university level. These are the factors that most often place the United States at the top of international competitiveness rankings.

According to a classification carried out by the World Bank on ease of doing business[1], the labour market in the United States is the most flexible in the world. While the regulations affecting the labour market vary from state to state, in many jurisdictions there are no legal limits to the use of temporary contracts or part-time work. No minimum level is set for holidays or the maximum number of hours worked. Firing costs are negotiated freely between the worker or the union and the company and unemployment payments are not very generous. This regulatory environment creates great mobility of employment. Only 60% of people in the United States were born in the state where they currently reside and between 2% and 2.5% of the population of working age change from one state to another each year. This figure is in contrast to the 0.1% in the European Union, where linguistic and cultural differences in general constitute an additional barrier to mobility. The flexibility of the labour market facilitates the growth of the most productive companies, sectors and regions while at the same time simplifies the adjustments in industries that have lost competitiveness. It is important to underline that flexibility also has its costs in terms of equity and welfare and this is why many countries, in Europe for example, limit this through legislation. For example, higher labour turnaround may have a negative effect on equity and reduce incentives to invest in training.

Also according to the World Bank, the cost of setting up a company in the United States is one of the lowest in the world. It takes 6 days and costs little more than 300 dollars (0.7% of gross per capita income). In Spain,

(1) Figures are available on www.doingbusiness.org

it is estimated to take 47 days of procedures and nearly 15% of gross per capita income to carry out the same task. In general, the bureaucratic formalities a company must follow are less costly in the United States than in most OECD countries. The level of taxes is also relatively low (especially for individuals and small companies although not so much in the case of large companies) and this fosters the entrepreneurial spirit and the creation of companies, which are often born small but in time may turn into large corporations.

Finally, it would be difficult to understand the leadership of US companies in terms of innovation if it were not for the level of excellence at many of its universities. These institutions, which are able to attract the best professionals from around the world, are characterized by a large degree of management autonomy and a highly competitive environment. According to the classification drawn up by the Jiao Tong University of Shanghai, among the 50 best universities of the world some 36 are in the United States. Eight out of the 10 best are also there. The areas around many of these universities have become true breeding grounds for companies wishing to exploit research carried out on their campuses and to take advantage of the high concentration of human. All this helps to explain why the level of R&D in the United States (close to 3% of GDP) runs well ahead of the level in the European Union, where it does not reach 2% of GDP. Furthermore, this investment seems to bear fruit. Last year the United States was responsible for one out of every three patents registered in the world.

Of course, not everything is positive. Some of the most notable weaknesses include a health-care system that is high-cost and inefficient, which reduces competitiveness, a tax system that is excessively complex, especially for large companies, and a low-quality public education system, especially in the large cities and the poorer municipalities (in part, because most funding for public schools comes from local property taxes).

There is no doubt that a recovery of solvency and profitability of US financial institutions will be needed to recover from the current growth slump, as a strong financial system is one of the most important fundamentals of a modern economy. But when that happens, the United States should be able to recover its role as engine of the world economy. Beyond the wreckage, the fundamentals are strong.

## United States: drastic drop in consumption

**US GDP down in third quarter confirming weak cycle that could be long-lasting.**

The US gross domestic product (GDP) grew by 0.8% year-on-year in the third quarter and in quarter-on-quarter terms annualized the economy dropped by 0.3%. At this time, the weak point in economic activity is what until recently was its main driving force, private consumption. In the third quarter this dropped by 3.1% in quarter-on-quarter terms. In keeping with the current state of weakness, the drop in consumption in absolute terms has taken away from growth the very same energy that was boosting it in 2007.

Another factor cutting the strength of total growth (0.5% in quarter-on-quarter terms annualized) is capital goods investment which dropped by 5.5% in quarter-on-quarter rate annualized. On the one hand, investment in construction took off the same figure from growth of the economy but, what is more relevant, is that it broke with its course of stabilization dropping by 19.1% quarter-on-quarter annualized. Faced with this

## UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | | | 2008 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | 2Q | 3Q | 4Q | 1Q | 2Q | July | August | September | October |
| Real GDP | 2.8 | 2.0 | 1.8 | 2.8 | 2.3 | 2.5 | 2.1 | – | 0.8 | – | – |
| Retail sales | 5.8 | 4.1 | 4.0 | 4.2 | 4.7 | 3.0 | 2.6 | 2.0 | 1.5 | –1.0 | ... |
| Consumer confidence (1) | 105.9 | 103.4 | 106.7 | 105.7 | 91.2 | 76.5 | 57.3 | 51.9 | 58.5 | 59.8 | 38.0 |
| Industrial production | 2.2 | 1.7 | 1.4 | 1.8 | 2.1 | 1.9 | 0.3 | –0.5 | –1.4 | –4.5 | ... |
| Manufacturing (ISM) (1) | 53.1 | 51.1 | 53.0 | 51.3 | 49.6 | 49.2 | 49.5 | 50.0 | 49.9 | 43.5 | ... |
| Sales of single-family homes | –18.0 | –26.8 | –22.1 | –27.3 | –33.7 | –33.1 | –39.1 | –34.7 | –35.6 | 33.1 | ... |
| Unemployment rate (2) | 4.6 | 4.6 | 4.5 | 4.7 | 4.8 | 4.9 | 5.3 | 5.7 | 6.1 | 6.1 | ... |
| Consumer prices | 3.2 | 2.9 | 2.7 | 2.4 | 4.0 | 4.1 | 4.4 | 5.6 | 5.4 | 4.9 | ... |
| Trade balance (3) | –753.3 | –700.3 | –730.7 | –701.4 | –700.3 | –697.8 | –699.6 | –703.5 | –707.4 | ... | ... |
| 3-month interbank interest rate (1) | 5.2 | 5.3 | 5.4 | 5.4 | 4.9 | 3.0 | 2.8 | 2.8 | 2.8 | 4.1 | ... |
| Nominal effective exchange rate (4) | 82.5 | 77.9 | 79.3 | 77.0 | 73.3 | 72.0 | 70.9 | 70.9 | 74.0 | 76.0 | 80.1 |

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

drop in domestic demand, the foreign sector continues to be the component giving support to economic activity but it is lacking in strength. Whereas exports offered only half the drive seen in the previous quarter (a result of the weakness of world demand), imports did not drop as much so that the contribution to economic growth was cut by half. With this weakness in private consumption, followed by that in investment, the United States may find itself at the start of a recession with prospects for 2009 pointing to practically nil growth, a low profile that could extend into 2010.

Supporting this scenario of prolonged slowdown is consumer sentiment, whose indicator most closely followed is the consumer confidence index of the Conference Board dropped in October from 61.4 points to 38.0 points, an all-time low in the 40-year existence of this indicator. Retail sales in September also stood on negative ground. Excluding cars and petrol, the most volatile components, retail consumption showed two consecutive months of decreases that put year-on-year growth at a slim 1.5%. Discounting price changes this turns out to be a drop of 0.7%. Furthermore, car sales in the same period showed a drop of 18.5% year-on-year. Considering these factors, sales managers are predicting a poor buying season over Christmas.

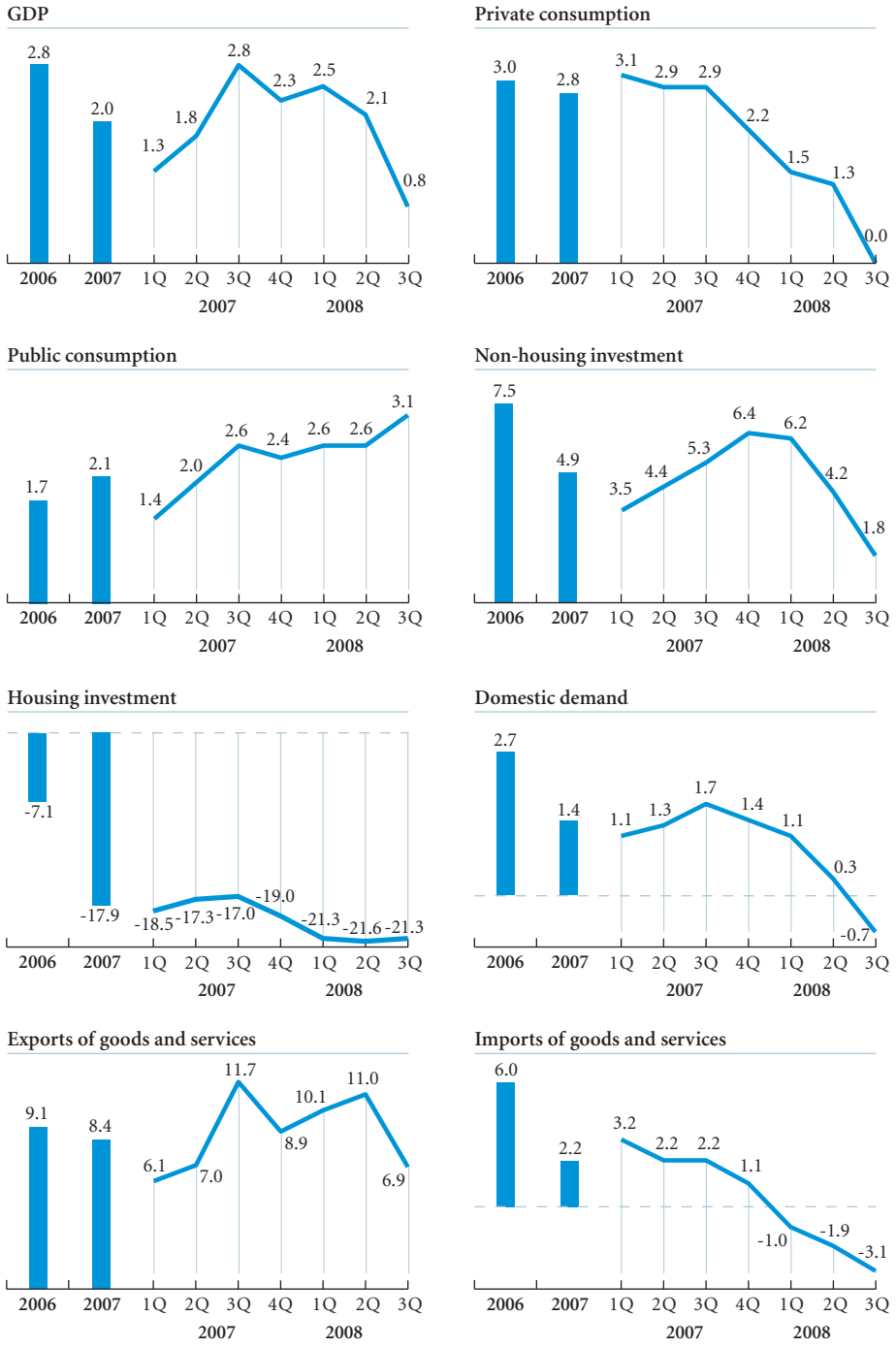
**Weakness in private consumption for some time.**

The business outlook reflected in the business activity index of the Institute for Supply Management in September showed two different pictures over the short term. On the one hand, the manufacturing index dropped from the 49.9 points level to 43.5 points, which is quite a long way from the balance level of 50.0 points when there are as many optimistic responses as pessimistic ones. The services index rose slightly to 52.1 points. Nevertheless, the differences end

**Consumer pessimism reaches all-time lows.**

## TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms




SOURCE: Bureau of Economic Analysis and own calculations.

there seeing that in both cases there was a clearly downward trend that was better defined than in previous downward cycles. In both cases, there was a continuation of the moderation in price indices and, in manufactures the sharp worsening of the new orders component still held.

The housing sector is still unable to see light at the end of the tunnel which might help domestic demand whether through construction spending or, through the wealth effect, might improve consumer prospects. Latest supply indicators show bigger drops. As a result, housing starts dropped by 31.1% compared with the same period last year. Pointing in the same direction, building permits (to some extent an early indicator of starts) were down by an even sharper 37.0%. The level of housing starts is difficult to recover given the large number of houses unoccupied and repossessions so that there is no demand for new houses and, in this respect, the drop in demand is acting as an adjustment mechanism.

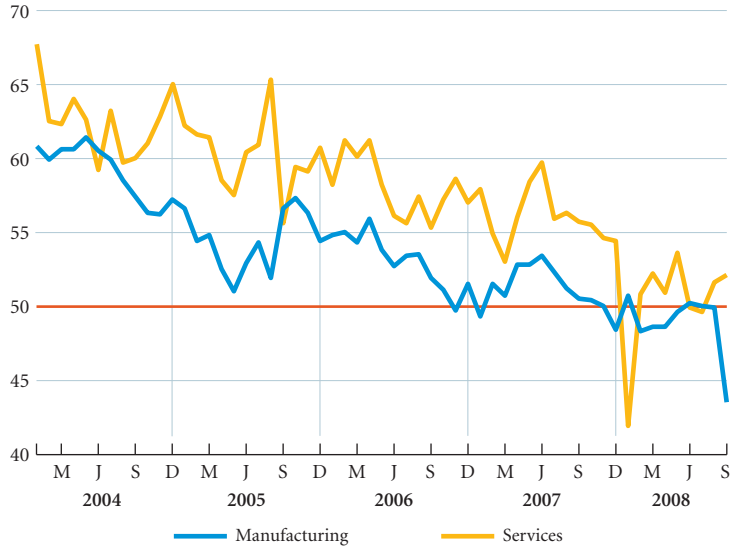
On the demand side, real estate prices continue to reduce the perceived wealth of many consumers and in August the Case-Shiller index continued to drop with a cumulative decrease of 22.0% compared with the high in June 2006. The best news from the sector in September was that existing housing sales (90% of the total) were up by 1.4% year-on-year, something that has not happened since November 2005. Apart from this specific figure, housing sales are now showing a tendency to stabilize, if not to recover, which indicates that the adjustment through the volume of sales has now ended. Now we must wait for the moment when the price adjustment comes to an end.

**Business executives see downturn scenario with lower price pressures.**

**Housing market remains weak but drop in sales now hitting bottom.**

**UNITED STATES: BUSINESS EXECUTIVES DOWNCAST**

Level of ISM indices (*)




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

## 2008 presidential elections: And the winner is...

When this issue comes off the press the winner will already be known. Nevertheless, it will still be early to know what reforms are going to be carried out by the new US Administration. The programmes of the two candidates, which have some points in common but important differences as well, may be an indication of the direction to be taken by US economic policy. There is no doubt that for the economy a presidency under Obama would be very different from one under McCain. Nevertheless, the new president will have his hands somewhat tied by the bailout plan for the financial system and will have to put aside some of his promises.

The elections have put the US citizens in the position of having to choose between two radically different proposals in terms of taxation and public spending. Those who have confided in Obama have bet on increasing income redistribution and greater investment in infrastructures and research. Those who preferred John McCain, on the other hand, wanted a reduction in the distortions created by taxes and a major decrease in non-productive public spending. In other matters, such as energy policy, the environment and health policy, both candidates proposed a notable change from the policies of President Bush although, here again, they differed in the way they would tackle reforms.

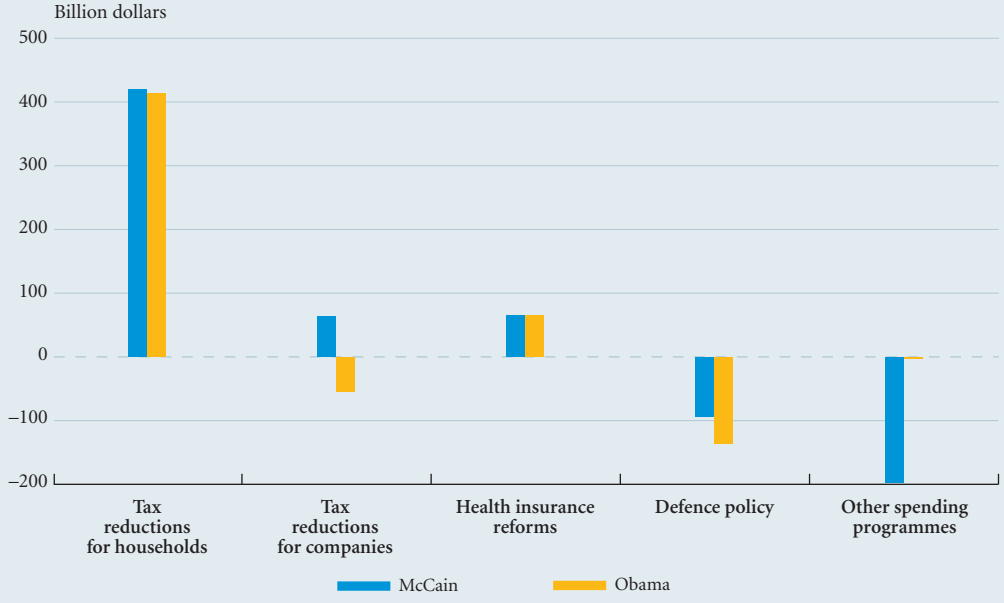
First, let us make a brief review of the two candidates on tax matters. The question is not insignificant given that the sharp cuts in tax rates approved in 2001 and 2003 expire halfway through the legislature term. Both candidates have proposed maintaining these cuts permanently with the exception of tax rates for incomes above 250,000 dollars, which the Democrat senator wants to return to higher levels. Obama would thus put the maximum marginal rate for income tax at 39.6%, whereas McCain would keep it at 35%. As well as a heavier tax load for those enjoying higher incomes, Obama has proposed a block of tax advantages for the middle class and for those with lower resources. These proposals are aimed at encouraging those groups to work, save and invest in education.

McCain's tax proposals, on the other hand, have largely been aimed at the business sector. With the idea of attracting investment to the United States, the Republican senator proposed a significant profits tax reduction with the maximum rate going from 35% to 25%. On the other hand, he proposed the ending of aid to the manufacturing sector, thus removing one of the biggest distortions in the business sector, and to the oil companies. The main problem with McCain's tax reforms was their cost in terms of lost revenue, which would raise the already high US deficit. To prevent this, the Republican senator would carry out a reduction in public spending on a number of programmes that were of doubtful effectiveness.

Reform of the medical care system was another key matter during the campaign. As opposed to other industrialized countries, the United States does not provide universal health coverage so that 18% of the population under 65 years of age has no medical insurance. Public health programmes are directed exclusively to those over 65 years of age *(Medicare)* and to those with few resources *(Medicaid)* but their cost is growing at an unsustainable rate. The rest of the population must have recourse to private insurance whether under individual contracts or obtained through non-salary compensations. As they enjoy exclusive tax advantages, medical insurances offered by employers have distorted both the insurance market and the labour market, penalizing individual insurance and tying workers to their companies for fear of losing their medical coverage.

Senator McCain's proposals on health coverage have concentrated on eliminating tax advantages for companies that offer medical insurance to their employees and increasing tax deductions for individuals to freely purchase their preferred health insurance. This would largely remove the abovementioned distortions. However, some simulation exercises suggest that the increase in health coverage would be limited, since the increase obtained among some of the today uninsured population would be partially offset by the decrease in the number of companies offering health coverage to their employees. Senator Obama, on the other hand, has proposed the creation of a health insurance market which would include new public insurance plans and plans offered by private insurers. The participation of companies and individuals in this market in order to purchase their insurances would be guaranteed under new regulations. The insurers would not be able to reject anyone because of their health condition, companies would be compelled to offer health insurance and parents would be obliged to insure under-age children. This new system would be rounded out with broader coverage offered by the *Medicaid* programme. Under this scheme, coverage of the health system would be larger than under the Republican plan although it would still be far from universal coverage. Some studies suggest that the best solution would involve a combination of the Democrat and Republican plans[1], that is to say, a new insurance market, the obligation to be insured and the elimination of tax advantages for companies that offer medical coverage.

**MEDIUM-TERM IMPACT ON FISCAL DEFICIT OF PLANS PROPOSED BY BOTH PRESIDENTIAL CANDIDATES**




NOTES: Estimated impact on fiscal deficit forecast by Congressional Budget Office according to current law.
SOURCE: US Budget Watch (2008), «Promises, promises: A fiscal voter guide to the 2008 election».

With regard to energy and environmental policy, high oil prices obliged both candidates to put forward plans to contain the price of petrol, which undoubtedly had an influence on both candidates «going greener» than their predecessor. In spite of this, there were notable differences in the way each candidate proposed to deal with the problem. As opposed to the regulation of consumption standards for vehicles and direct subsidies for

(1) Gruber, J. (2008), «Covering the uninsured in the United States», Journal of Economic Literature, vol. XLVI (3).

bio-fuels proposed by the Democrat candidate, the Republican side preferred to eliminate restrictions on the extraction of oil on the US coastline and to offer tax incentives for research and promotion of renewable energy. Similarly, both candidates proposed to limit $CO_2$ emissions by establishing a market for emission permits although Obama was in favour of auctioning them all instead of distributing part at no cost, as McCain would do in order to reduce the transition costs to the new model.

These three areas made up a good part of the main promises put forward by the candidates during this long campaign. The magnitude of the financial crisis and its impact on the real economy, however, obliged them to modify their economic plans toward the end. Obama has proposed a recovery plan for the economy that includes tax advantages for the middle class and small companies which, while temporary, would reduce government revenue even more. In order to ease the mortgage crisis both candidates were in favour of using public funds to rewrite mortgages with high variable interest rates converting them to mortgages with more reasonable fixed interest rates. Finally, both candidates were in agreement on the need for toughening the regulation of financial institutions.

The decision has now been taken and Americans have expressed their preferences between McCain's style (lower taxes and lower public spending) and Obama's approach (greater redistribution, more public investment and more regulation). What the financial crisis has decided for the voters is a larger intervention of the public sector in the economy. What remains to be seen is how far the new US president can let this intervention reach and for how long he can maintain it.

**Labour market continues to worsen while inflation drops to 4.9%.**

A fundamental aid to the recovery of real estate prices and consumption in general is the labour market and here the signs of weakness are continuing. The downturn in the labour market continues to grow worse. September saw the loss of 159,000 jobs which puts the total number of jobs lost this year at 760,000. In line with this sombre picture, the unemployment rate held at 6.1% of the labour force, with a tendency to keep increasing, whereas wages, in spite of a very small gain in September, have lost 1.9% of purchasing power in one year and are running at levels in 2001.

**Trade deficit puts off awaited correction.**

With regard to prices, the September consumer price index (CPI) rose by 4.9% year-on-year whereas the key variable, the underlying component (the general index less food and energy) held at 2.5%.

In the foreign sector, now acting as an aid to growth, the trade balance in goods and services showed a deficit of 59.14 billion dollars in August. This was an increase of 6.9% in spite of the moderation of oil prices because of the worsening of the trade balance excluding oil and derived products. The correction in commodity prices, especially in the case of oil, should brighten prospects for the foreign sector over the short term although the weakness in world demand is acting in the other direction.

**UNITED STATES: HOUSING SALES HITTING BOTTOM**

Sales of existing houses in annual terms


SOURCE: Federal Housing Board, National Association of Realtors and own calculations.

## Where is US housing market headed?

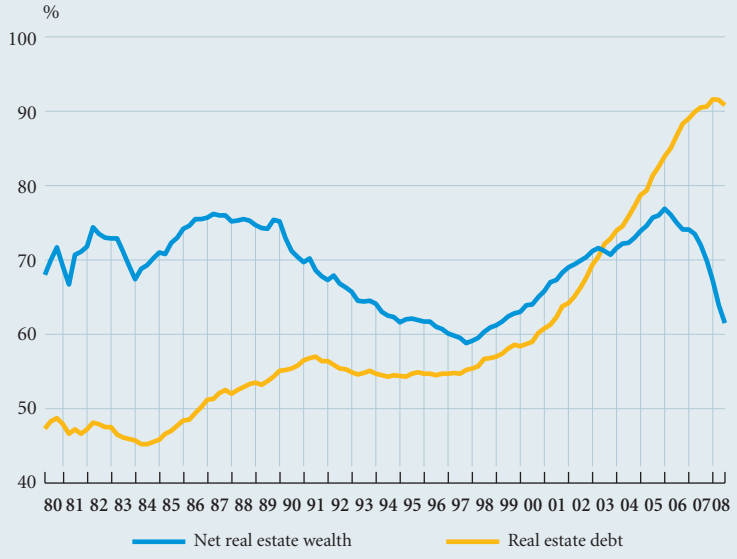
Real estate is the most important form of wealth, one that everyone understands and the one most widely owned. It is said that the stock market is for the sophisticated and those who are ready to run risks but we all live in houses, whether we buy or rent. Even in the United States, a country with a highly developed financial culture, the value of household real estate property is notably high. It is precisely the US housing sector, on account of its huge size, that has been the epicentre of the financial crisis that is now leaving its wreckage over the global economy. The problems began just over a year ago with subprime mortgages granted to borrowers with a history of low credit rating which generally meant persons of low income. Exotic names like *ninja* loans (from the terms no income, no job, no assets) underlined the nature of the beneficiaries of such loans. At the peak of their growth these loans came to represent some 14.0% of mortgages granted.

The US real estate crisis started around the beginning of 2006 when demand definitely turned downward and prices reached their peak and began a downward course. At that moment, the number of housing starts reached a high of 2.3 million in annual terms. In September 2008 housing starts amounted to barely a third of that figure. At the beginning of 2006, on average it took five months to sell a house. Today it takes twice as long. This is so in spite of the drop of more than 20% in real estate prices. The million-dollar question is when will the crisis end?

In trying to find an answer to this question, this box adopts a focus based on housing prices and their relation to household debt and income. We should remember that real estate in the United States is undergoing a sharp price correction following the unprecedented increase in real estate wealth that was based on a rise in

## SHARP INCREASE IN HOUSEHOLD REAL ESTATE DEBT

Net real estate wealth and real estate debt of households as percentage of GDP (*)

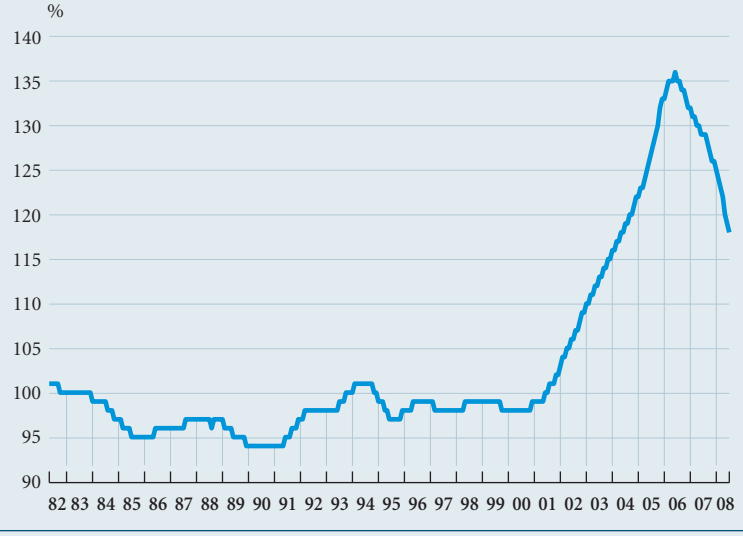



NOTES: (*) Net real estate wealth is total real estate wealth less relevant debt.
SOURCE: Federal Reserve, Bureau of Economic Analysis and own calculations.

borrowing. The ratio between real estate wealth and the GDP reached an all-time high very rapidly. Between the beginning of 1998 and the second quarter of 2007 it went from 115.2% to 162.7%. This came about thanks, among other factors, to the easy availability of credit to households.

## HOUSING PRICES HAVE SHOT UP

Average price of existing housing in terms of average household income (*)




NOTES: (*) Moving average for 12 months. 1982-83 average = 100.
SOURCE: OFHEO, National Association of Realtors and own calculations.

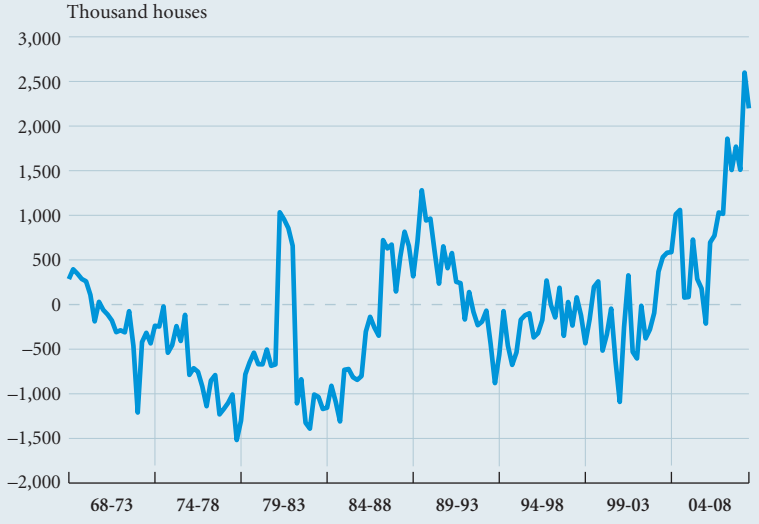
As a result of this easy access to credit, borrowing rose more than net real estate wealth, that is to say, the difference between the value of the real estate and the amount of the mortgage still unpaid. As a result, while total debt went from 55.7% to 91.7% of the GDP between 1998 and 2007, real estate wealth rose from 59.5% to 76.1%. With the drop in housing prices wealth diminished but this did not happen in the case of borrowing. Today, Americans own only 40.4% of the value of their real estate free of debt. This is an all-time low that stands five percentage points below the level at the beginning of 2007.

Is housing costly? Is such a sudden correction justified? Average household income, defined as that with greater income than half the population but less than the other half, is a variable that for a long time had evolved in step with real estate prices and in a more consistent way than the GDP, employment or the stock market. Nevertheless, the rise in indebtedness broke this relation as of 1999, as may be seen in the above graph. Since then real estate prices shot up in relation to income until this trend turned around in 2006. With the correction taking place since then, and converting the gap still to be filled to a much-used price index such as the Case-Shiller index, we can estimate that real estate prices still need to be corrected 10%-15% in real terms (taking into account general inflation). This would result in a total drop of 40% in real terms from the high levels in 2006.

At the present rate of price decreases, this perspective would make any recovery before 2010 rather difficult. We come to a similar conclusion if we consider trends in household formation, the number of houses per household and the current over-supply of houses (something more than 2 million, 1.7% of total stock). Some authors, like Shiller[1] and Zandi[2], coincide in delaying recovery to well into 2010. In fact, there is some consensus in that this real estate crisis is one of the longest in history. It remains to be seen if the measures adopted to stimulate the mortgage market and those related to the financial sector, fiscal policy or a possible improvement in economic sentiment (under a new president) are able to break the current slump and cut short this long and difficult course.

**A LOT TOO MANY HOUSES**

Over-supply in US real estate market




SOURCE: US Census and own calculations.

(1) Shiller, Robert (2008) *The Subprime Solution*, Princeton University Press, Princeton, NJ.
(2) Zandi, Mark (2009) *Financial Shock*, FT Press, Pearson Education, Upper Saddle River, NJ.

## Japan: fewer exports, less growth

**Japan's GDP grows by 0.8% weakened by dependence on exports in situation of world downturn.**

Japan's GDP grew by 0.8% year-on-year in the second quarter, thus sharpening the downturn that many already see as a recession seeing that there have been two negative quarters in a row. Taro Aso, the new prime minister, is putting into effect a fiscal stimulus plan to foster private consumption. But Japan is heavily dependent on the foreign sector. With all these problems, the stock market is at a low ebb but the yen remains in the clouds. Nevertheless, Japan has two short-term advantages – the low borrowing by companies, financial and non-financial and their competitiveness, although at present this is made more difficult by the sharp appreciation of the yen.

**Industry showing drastic downward trend.**

In the most recent demand indicators, however, there is no light at the end of the tunnel. Consumer confidence in the third quarter went from 32.3 points to the 31.2 points level, setting a new all-time low. In turn, retail sales were again down in September after showing great weakness in August. Car sales, another early indicator of demand, lost all the strength seen in the mild recovery in June and in the 12 months ending in September stood 14.6% below the high in 2005. Nor does the supply side offer any joy. Industrial production was down sharply in August by 4.7% year-on-year. In turn, industrial production of consumer goods was down 4.3% in the same period thus leaving aside a brief rise. In the area of capital formation, prospects for coming months remain rather sombre with machine orders down 9.3% year-on-year and a situation where in general terms weakness is spread equally between the export sector and domestic demand.

The real estate market, which could give some strength to consumption through the wealth effect, continues to give clear signs of weakness. Prices in the Tokyo area have rapidly gone into negative

**JAPAN: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | | | 2008 | | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | | | 2Q | 3Q | 4Q | 1Q | 2Q | July | August | September |
| Real GDP | 2.4 | 2.0 | 1.8 | 1.8 | 1.4 | 1.2 | 0.8 | – | ... | – |
| Industrial production | 4.2 | 2.9 | 2.4 | 3.1 | 2.7 | 2.5 | 1.0 | 1.2 | –4.7 | ... |
| Tankan company Index (1) | 22.5 | 22.0 | 23.0 | 23.0 | 19.0 | 11.0 | 5.0 | – | –3.0 | – |
| Housing construction | 4.5 | –17.2 | –2.8 | –36.9 | –27.1 | –8.9 | –10.9 | 19.2 | 53.5 | ... |
| Unemployment rate (2) | 4.1 | 3.9 | 3.8 | 3.8 | 3.8 | 3.8 | 4.0 | 4.0 | 4.1 | ... |
| Consumer prices | 0.2 | 0.1 | –0.1 | –0.1 | 0.5 | 1.0 | 1.4 | 2.3 | 2.1 | ... |
| Trade balance (3) | 9.4 | 12.5 | 11.1 | 12.3 | 12.5 | 11.7 | 10.2 | 9.7 | 8.2 | ... |
| 3-month interbank interest rate (4) | 0.3 | 0.7 | 0.7 | 0.8 | 0.9 | 0.8 | 0.8 | 0.9 | 0.9 | 0.9 |
| Nominal effective exchange rate (5) | 81.1 | 77.1 | 75.7 | 76.9 | 78.4 | 83.4 | 82.6 | 80.6 | 80.7 | 84.4 |

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

figures and in September dropped by 0.3% year-on-year. In turn, the volume of sales, which has been acting as an early indicator of the former, continued to show sharp drops. In the January-September period these amounted to 41.3% year-on-year. On the supply side, housing starts from January to August were down 1.8% year-on-year which, while relatively moderate, shows that there are no signs of recovery from the low level reached in the third quarter of 2007.

**Real estate market remains paralyzed.**

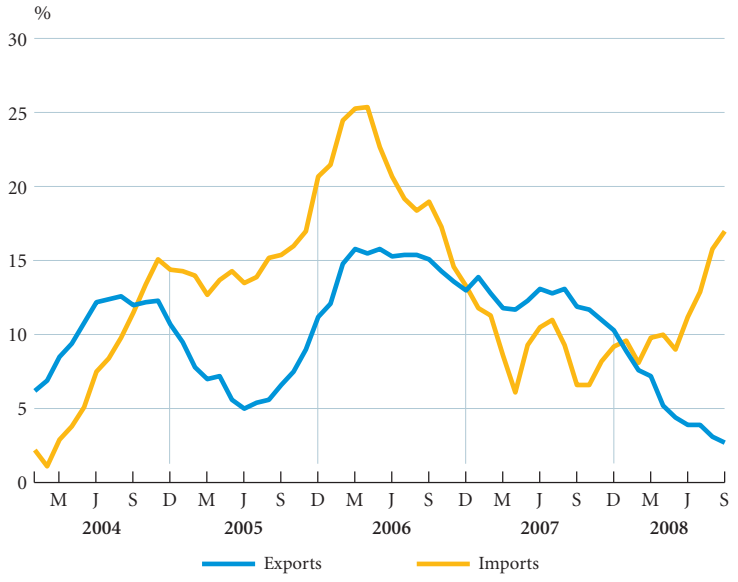
On the inflation front, the increases in the general index were brought about more by the hangover of the rise in commodity prices (that is, oil) than by the strength of domestic demand. The CPI rose by 2.1% year-on-year in August. Nevertheless, prices could soon moderate given that the underlying index (the general index excluding energy and food) recorded a nil year-on-year increase. This suggests that in coming months, in view of the easing in commodity prices, Japan's inflation should tend to values closer to zero without discounting dips into the negative range with a drop in prices. In turn, the August unemployment rate rose to 4.2% of the labour force.

**Inflation holds above 2% but prospects are for price stagnation.**

In the foreign sector, the trade surplus continues a rapid decrease. In the 12 months ending in August, the surplus dropped to 8,200 billion yen, some 30.2% below the level in the same period last year although what is most significant is that customs figures for September and August show a deficit, something that has not happened since 1980. The main reason was stagnation in exports. In this respect, more than the drop exports to the United States the most significant was the sharp dip in those going to the rest of Asia (half the total) which grew by a slim 2.9% year-

**JAPAN: EXPORTS STAGNANT**

Year-on-year change in exports and imports (*)




NOTES: (*) Series trend.
SOURCE: Ministry of Economy, Trade and Industry and own calculations.

**Exports stagnant because of lower world demand.**

on-year in September. Japan depends on decoupling, on the ability of the Asian economies to grow in a situation of weakness in the United States and the problem of the Japanese economy is that this seems more difficult than it did a few weeks ago.

## Chinese engine lowers speed

**Chinese economy grows by 9% but showing clear signs of a slowdown.**

The Chinese economy, which in 2008 arose as the main contributor to world growth, is showing clear signs of slowing down. In the third quarter the GDP grew by 9.0% year-on-year which while still robust falls below the 10.1% in the previous quarter. On the supply side, the biggest part of the slowdown is concentrated in industry to go by the trend by sector in nominal terms. Whereas as agriculture grew by 4.5% year-on-year, recovering strength in terms of previous years, and services moved up by 10.3%, the secondary sector reduced its growth rate from 11.3% to 10.5%. The slowdown was mainly brought about by the weakness in world economic activity, although there may have been something of a let-down following the Olympic Games, and it does coincide with some easing of inflationary pressures.

**Industrial production slows to growth of 11% but retail consumption holding up.**

The most recent economic activity indicators provide a clearer idea of the reduced drive in the Asian giant. On the supply side, industrial production grew by 11.4% year-on-year in September which, excluding the distorting effects of the lunar calendar of the Chinese New Year, is the lowest growth rate since the beginning of 2002.

On the demand side, economic activity continues to maintain a high level and shows that Chinese consumption, starting out at very low levels, still has a long way up ahead of it. Retail sales in September, discounting price increases, continued to move up going to 17.8%. Here, the strongest recovery was in the rural areas and in food consumption, thanks to the stabilization of prices. In turn, the real estate sector was showing signs of weakness. Housing prices were

**CHINA: MAIN ECONOMIC INDICATORS**

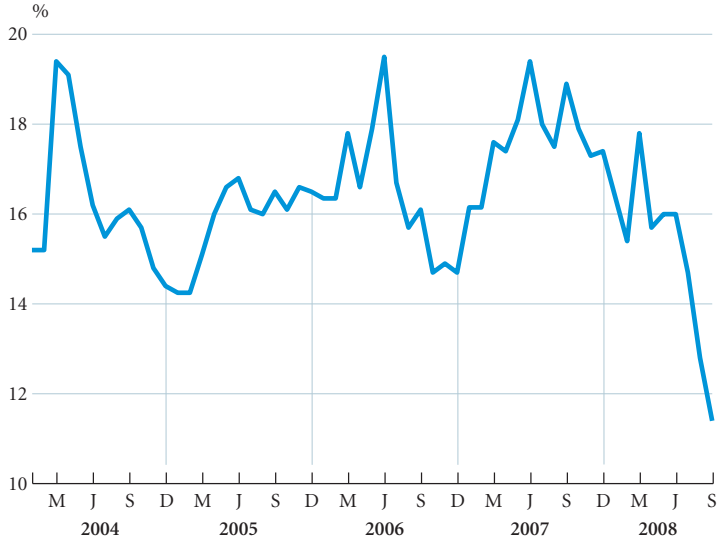
Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | 2008 | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | July | August | September |
| Real GDP | 10.7 | 11.6 | 11.2 | 10.6 | 10.1 | 9.0 | – | 9.0 | – |
| Industrial production | 16.4 | 17.1 | 17.5 | 16.5 | 15.9 | 13.0 | 14.7 | 12.8 | 11.4 |
| Electrical power production | 14.7 | 15.7 | 16.1 | 16.0 | 11.9 | 6.7 | 9.6 | 5.7 | 4.8 |
| Consumer prices | 1.5 | 4.8 | 6.6 | 8.0 | 7.8 | 5.3 | 6.3 | 4.9 | 4.6 |
| Trade balance (*) | 177.5 | 262.2 | 262.2 | 256.8 | 248.2 | 258.0 | 249.1 | 252.7 | 258.0 |
| 3-month interbank interest rate (**) | 2.8 | 3.6 | 4.7 | 4.6 | 4.6 | 4.4 | 4.4 | 4.3 | 4.4 |
| Renminbis to dollar | 8.0 | 7.6 | 7.4 | 7.1 | 6.9 | 6.8 | 6.8 | 6.8 | 6.8 |

NOTES: (*) Cumulative balance for 12 months. Billion dollars.
(**) Percentage.
SOURCE: National Statistics Office of China, Thomson Financial Datastream and own calculations.

## CHINA: SLOWDOWN IN INDUSTRY

Year-on-year change in industrial production (*)




NOTES: (*) Figures adjusted for calendar effects of Chinese lunar new year.
SOURCE: Chinese National Office of Statistics and own calculations.

down in the second quarter leaving behind part of the recovery begun in 2007 and returning to 2004 levels, while in September prices of real estate for commercial use were down by 15.5% year-on-year.

The positive note in this slowdown is that inflationary problems continue to ease. The general CPI grew by 4.6% year-on-year in September whereas in April it reached 8.5%. The food component, which has special importance in China as a cost of living indicator, also returned to calm waters with increased rapidity (if this were possible) to show an increase of 9.7% year-on-year, which was well below the 23.3% seven months earlier.

**Inflation eases to 4.6% while foods rise by 9.7%.**

In the foreign sector, the surplus for the last 12 months up to September again followed an upward path going to 258 billion dollars. Nevertheless, this was due more to the slowdown in imports than to the strength of exports.

In September exports grew by 21.5% year-on-year, slightly below the norm in recent months while imports increased by 21.3%, well below the increases of more than 30% predominating up to July. By geographical areas, exports to the United States (17.8% of the total in August) continued to ease growth along with those going to Europe (24.0% of the total), although here the slowdown has begun later. Only exports going to Asia (half the total) maintained growth of more than 20%.

Under imports, what stands out is the cooling down of China's demand for raw materials. In terms of volume, oil imports in the past 12 months ending in August were up by 8.8% year-on-year showing a clear downward trend. Purchases of aluminium and copper from abroad were down. In the case of steel imports, decreases continued to show although the drastic drops seen in 2007 were now more moderate.

**Exports slowing down advance while imports drop sharply.**

## Mexico: an impasse in the slowdown

**Mexico shows 2.6% growth along with slowdown in investment and consumption.**

The slowdown in the economy took a slight breather in the second quarter. The GDP grew by 2.8% year-on-year thus slightly improving on the figure for the previous quarter. Nevertheless, the march of the economy will be set by private consumption which sharpened its slowdown with growth of 3.2% year-on-year, the smallest increase since 2003. The main factor in maintaining the rate of economic activity was the recovery of investment that moved up to growth of 8.1%, a strong resurgence following an abnormally poor first quarter. In turn, the foreign sector remained weak with imports moving ahead at a higher rate than exports while public consumption continued listless.

**Industrial production down and retail sales showing drop.**

Among the most recent economic indicators, downward prospects continue to dominate reflecting the influence the weakness of its northern neighbour. On the supply side, general industrial production showed a drop of 1.5% year-on-year, thus making the fourth consecutive month to show decreases. In turn, manufacturing production was down 2.1%. Demand held up somewhat better with retail sales showing growth of 2.9% year-on-year in July, a better rate than in the month before.

**Inflation hits 5.5% in spite of slowdown but unemployment holds below 4%.**

On the inflation front, price pressures are continuing although it would seem they will not get worse. The September general CPI was up 5.5% year-on-year, just below the August figure. In this situation, unit labour costs seem to follow in the wake of oil and are beginning to slow down with an increase of 7.3% year-on-year in July. In turn, the general unemployment rate rose to the still reasonable rate of 4.3% of the labour force.

The foreign sector, the weak point in growth in recent years, continued to increase the deficit in spite of lower level of private consumption. Given the Mexican economy's dependence on oil, at this time of lower commodity prices the direction in coming months will continue to be downward. The trade deficit in the past 12 months ending in August was up again going to 9.4 billion dollars. If we exclude oil, the drop in

**MEXICO: MAIN ECONOMIC INDICATORS**

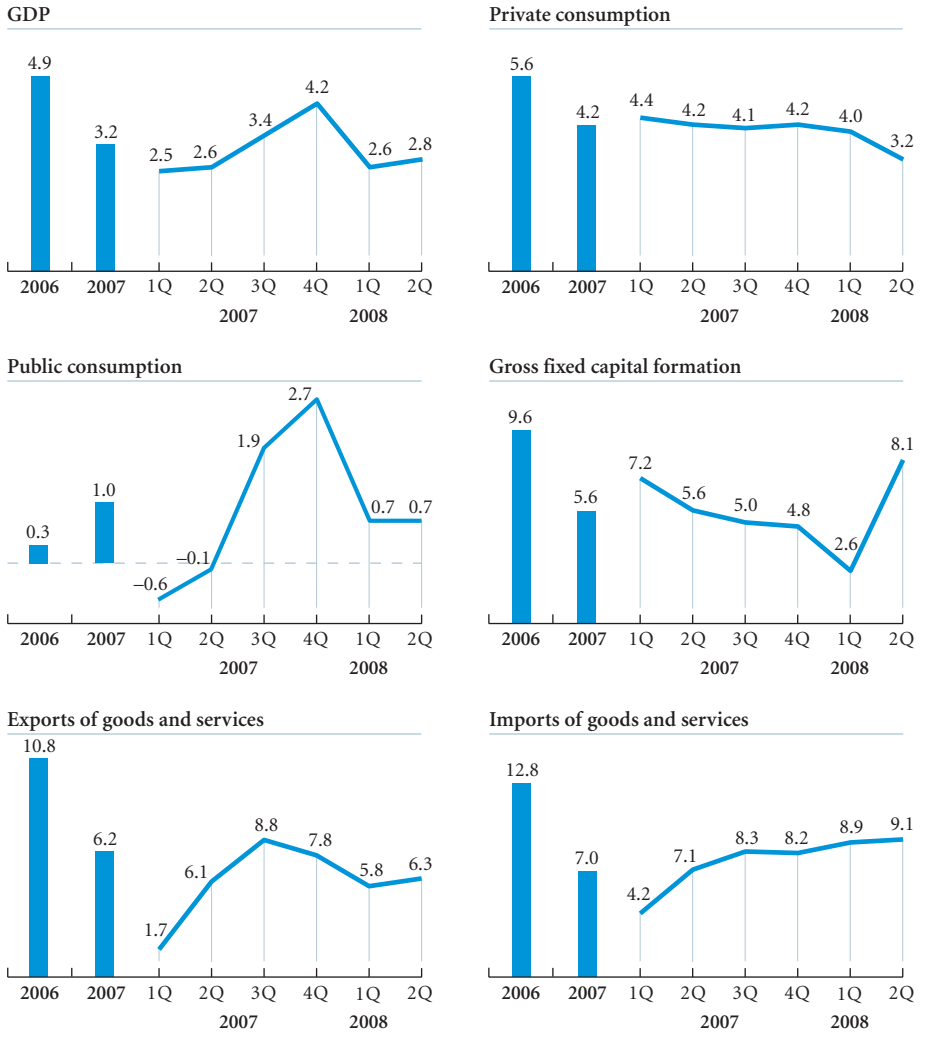
Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | 2008 | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | July | August | September |
| Real GDP | 4.9 | 3.2 | 4.2 | 2.6 | 2.8 | ... | – | ... | – |
| Industrial production | 5.4 | 1.9 | 3.1 | 1.0 | 1.3 | ... | –0.4 | –1.5 | ... |
| General unemployment rate (*) | 3.6 | 3.7 | 3.6 | 3.9 | 3.5 | 4.2 | 4.2 | 4.2 | 4.3 |
| Consumer prices | 3.6 | 4.0 | 3.8 | 3.9 | 4.9 | 5.5 | 5.4 | 5.6 | 5.5 |
| Trade balance (**) | –6.1 | –10.1 | –10.1 | –9.3 | –7.8 | ... | –8.2 | –9.4 | ... |
| 3-month interbank interest rate (***) | 7.3 | 7.2 | 7.2 | 7.2 | 7.2 | 7.2 | 7.2 | 7.2 | 7.2 |
| Mexican pesos to dollar | 10.9 | 10.9 | 10.8 | 10.7 | 10.4 | 10.4 | 10.0 | 10.3 | 11.0 |

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
(***) Percentage.
SOURCE: Central Bank of Mexico and own calculations.

## TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-on-year change in real terms




SOURCE: Central Bank of Mexico and own calculations.

exports continued along with the gradual increase in imports, which raised the deficit to 65.81 billion dollars, some 32.1% above the same period last year.

### Commodities: general drop in prices

Oil continued to lead the sharp drop in prices. In October, a barrel of Brent quality oil (at one-month forward price) dropped by more than 35% going from levels of the order of 95 dollars a barrel to 62 dollars. Since the annual highs in July oil prices have been corrected by practically 60%. In view of the sharp drop in prices, on October 24 the Organization of Petroleum Exporting Countries (OPEC), decided to cut its production by 1.5 million barrels a day as of November 1. Following this

**Commodity prices down sharply in October.**

**OIL PRICES CONTINUE ON DOWNARD TRACK**

One-month forward per barrel price of Brent quality oil


SOURCE: Thomson Financial Datastream.

**Common factor following correction in prices for oil, metals and basic commodities is prospect of downturn in world demand.**

announcement, the market not only failed to react by raising prices but quotations dropped further.

The lack of response by the market in the face of this adjustment in supply suggests that the factor dominating the trend in oil at this time is fear of a contraction in world demand. In fact, many analysts consider that the cut in supply by OPEC is small if we look at the macroeconomic picture. In line with this view, the scenario of world recession that the stock markets and bond markets seem to be discounting corresponds with commodity quotations lower than those seen some months ago.

The trend in other commodities is consistent with this analysis. In October, *The Economist* commodities index dropped by 21%. As opposed to other times, this downturn was due to decreases of a similar size in the three major commodity groups (food, non-food farm commodities and metals) which indicates that the correction in quotations is a movement with a very broad scope. This implies that there may be common factors acting on the drop in commodity prices with the correction of demand being the most likely candidate.

In this respect, it would seem that the role played at certain times by oil and various commodities as a refuge asset has fallen out in recent weeks. For example, gold, a refuge asset par excellence, dropped by more than 17% in October. With regard to other commodities, we should mention the sharp drops recorded between these dates in quotations for copper (down 37%), rubber (drop of 32%), wheat (dip of 23%), cocoa (decrease of 18%) and coffee (drop of 14%).

As a necessary counterpart to this extraordinary correction in prices now

being noted, we should mention that, if we shift our point of view from the present to the long term, current analyses suggest that the oil market will continue to show the narrow gap between supply and demand that has characterized it in recent years. In this respect, a recent report by the International Energy Agency (IEA) suggests that prospects up to 2030 are for a gradual drop in oil production. If there is no appreciable increase in investment, production trend will drop by the order of 9% a year, a figure that could go down to 6% if there is increased investment in extraction operations of around 360 billion dollars a year. In spite of the fact that the IEA states that over the long term world oil consumption may be less than previously estimated, with this reduction trend in supply the price picture this implies is one of high quotes.

**Over long term, background trend in oil supply is downward.**

# EUROPEAN UNION

## Euro Area: financial impact on the real economy

**In Euro Area, impact of financial crisis means lower growth of credit...**

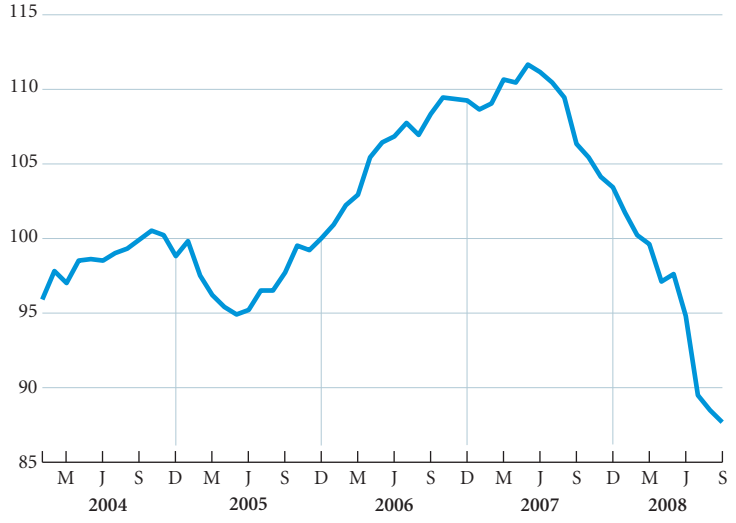
The severe financial crisis that has been developing since the summer of 2007 has reached such a level that it is fair to ask how this is being passed through to the real economy. In principle, there are two major avenues through which the crisis may affect macroeconomic trends. First, there is the avenue of credit, a variable whose increased cost or restraint directly affects the ability of households and companies to finance current costs and investments. Second, there is the avenue of confidence, that is to say, the changes in perception by the main players (again, consumers and companies) about the economic situation and how that perception corresponds with spending and investment decisions.

How are these two avenues operating in practice? Consumption in the Euro Area is substantially moderating its growth rate, which in fact had not been excessively buoyant even at the highest moments of the cycle. For example, retail sales (a key consumption indicator), on average for July and August, dropped by 1.7% year-on-year, to show a worse figure than the poor result in the second quarter (year-on-year drop of 1.6%).

In broad terms, this trend runs parallel to the decrease in credit granted to households, which dropped from growth

**EURO AREA LOSING DRIVE**

Economic sentiment index in Euro Area




SOURCE: European Commission.

## EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | | 2008 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 3Q | 4Q | 1Q | 2Q | July | August | September |
| GDP | 3.0 | 2.6 | 2.6 | 2.1 | 2.1 | 1.4 | – | ... | – |
| Retail sales | 1.6 | 0.9 | 1.3 | –0.3 | –0.2 | –1.6 | –1.6 | –1.9 | ... |
| Consumer confidence (1) | –9.1 | –4.9 | –3.9 | –7.7 | –11.9 | –14.6 | –19.7 | –19.2 | –18.9 |
| Industrial production | 4.0 | 3.4 | 3.9 | 3.0 | 2.5 | 1.1 | –1.2 | –0.7 | ... |
| Economic sentiment indicator (1) | 106.3 | 108.4 | 108.7 | 104.3 | 100.5 | 96.5 | 89.5 | 88.5 | 87.7 |
| Unemployment rate (2) | 8.3 | 7.4 | 7.4 | 7.3 | 7.2 | 7.4 | 7.4 | 7.5 | ... |
| Consumer prices | 2.2 | 2.1 | 1.9 | 2.9 | 3.4 | 3.6 | 4.0 | 3.8 | 3.6 |
| Trade balance (3) | –10.4 | 20.1 | 31.4 | 34.3 | 23.4 | 11.5 | –3.7 | –14.9 | ... |
| 3-month Euribor interest rate | 3.1 | 4.3 | 4.5 | 4.7 | 4.5 | 4.9 | 5.0 | 5.0 | 5.0 |
| Nominal effective euro exchange rate (4) | 103.6 | 107.7 | 107.7 | 110.6 | 112.8 | 115.6 | 115.8 | 113.5 | 111.6 |

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

of close to 11% year-on-year in the first quarter of 2006 to less than 4% year-on-year in August as well as to the worsening of consumer confidence, which in the 12 months ending in September was down by more than 13 points. While there are other factors pushing in the same direction such as, for example, the pass-through of stock market losses to lower consumption (the opposite of the wealth effect), in its latest quarterly report the European Commission estimates that the wealth effect is of a low level in the case of the Euro Area (not as it is, for example, in the United States).

Investment is also suffering from the impact of the financial crisis. Both in the level of the quarterly macroeconomic figure and in monthly indicators, investment is showing clear signs of decrease. As is also happening in household spending, both corporate confidence (whether in services or industry) and the drop in credit granted to companies are following downward paths roughly equivalent to that seen in investment.

**...and drop in confidence, two factors bringing adjustments in consumption and investment.**

We may therefore conclude that the crisis is having an appreciable impact on economic activity at the domestic level. This leaves public consumption and foreign demand as the only means of compensating the slowdown. With regard to public consumption, latest available figures (for the second quarter) point to a clear upturn. Foreign demand, on the other hand, is suffering more and more as the year 2008 advances. In August, the trade balance in cumulative figure for 12 months showed a deficit of 14.9 billion euros, which means two consecutive months with negative results.

This situation arises from the fact that exports have tended to slow down whereas for the moment imports continue to run at higher growth rates. A key factor behind the increasing export problems is the rise in prices due to the

**Exports showing appreciable slowdown.**

**Complicated prospects for months ahead.**

effect of the appreciation of the euro. In spite of the correction taking place in recent months, in September the effective nominal exchange rate for the single currency showed a level 3% higher than one year ago.

A second factor constricting Europe's export capacity is the clear slowdown in certain traditional markets that up until recently had maintained their strength, such as the United Kingdom, Switzerland and Sweden. This is leaving European exports very much dependent on emerging markets (exports to China and Russia are still growing by two-digit figures), destinations that, if forecasts are right, will be less dynamic in a few months time.

Starting out from this situation, immediate prospects are not very positive. Monthly indicators available for the third quarter (industrial production, economic sentiment, composite index of early indicators, etc.) point rather clearly to the fact that gross domestic product (GDP) may have again dropped for the second consecutive quarter. The move into technical recession could be the prelude to some difficult quarters ahead.

**German economy suffers from loss of strength in investment and domestic demand.**

While the unemployment rate is still holding relatively low (7.5% of the labour force in August) and the worst of the inflationary boost now seems to be a thing of the past (inflation in September slowed to 3.6% thanks to the containment of energy and food), these factors are not enough to counteract the considerable negative factors in an economy running at low levels. Nor can we expect immediate results from the various aid programmes the countries of the Euro Area are putting forward to save their respective financial systems and whose impact on economic activity will not become evident for some months.

## Germany: Europe's economic engine catches cold

The German economy is rapidly losing the supports that allowed it to move ahead into a period of good economic performance in 2006 and 2007. Those were years when the combination of strong investment together with rising foreign demand helped create a strength that had not been seen for some time. Up until the first quarter of 2008 these trends were still holding up but in the

**GERMANY: MAIN ECONOMIC INDICATORS**

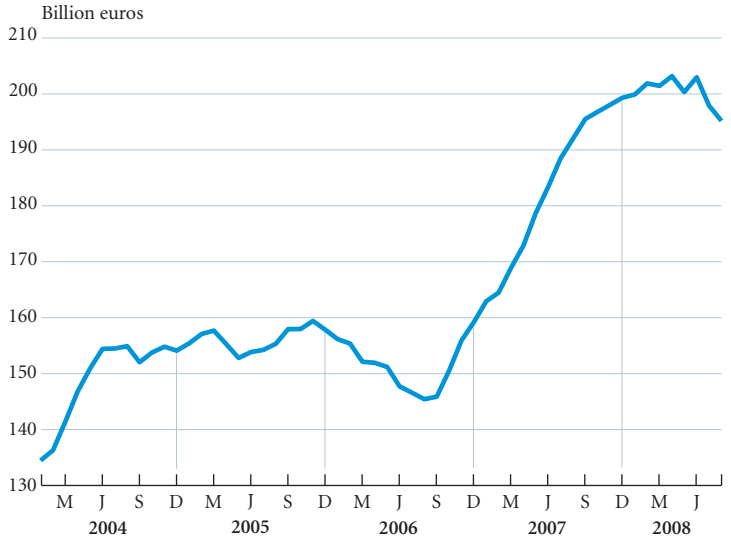
Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | | 2008 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 3Q | 4Q | 1Q | 2Q | July | August | September |
| GDP | 3.2 | 2.6 | 2.4 | 1.7 | 2.6 | 1.7 | – | ... | – |
| Retail sales | 6.1 | –7.6 | –7.5 | –8.8 | –0.7 | –0.1 | 0.6 | –3.0 | ... |
| Industrial production | 6.0 | 5.9 | 5.7 | 5.0 | 5.0 | 3.0 | 0.1 | 1.7 | ... |
| Industrial activity index (IFO) (*) | 105.5 | 106.2 | 105.6 | 103.7 | 104.0 | 102.2 | 97.4 | 94.8 | 92.9 |
| Unemployment rate (**) | 10.7 | 9.0 | 8.9 | 8.5 | 8.1 | 7.9 | 7.8 | 7.7 | 7.6 |
| Consumer prices | 1.6 | 2.3 | 2.3 | 3.1 | 2.9 | 2.9 | 3.3 | 3.1 | 2.9 |
| Trade balance (***) | 151.5 | 183.5 | 192.0 | 198.1 | 201.1 | 202.2 | 198.0 | 195.2 | ... |

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

## GERMAN FOREIGN SECTOR: A KEY SUPPORT GROWS WEAKER

Trade surplus as cumulative figure for 12 months




SOURCE: Federal Statistics Office and own calculations.

second quarter these showed a sharp break. Investment (to a greater extent) and the foreign sector (to a lesser degree) eased off their drive and pushed the German economy into a quarter-to-quarter drop in GDP for that period.

As the third quarter advanced, the situation grew worse. Various indicators suggest further weakening of investment in capital goods. Foreign demand also keeps losing steam. In August, exports (in cumulative figure for 12 months) grew by 5.2% year-on-year, approximately half that one year earlier. Given that imports are still holding in the area of a 6% year-on-year increase, the result has been a reduction of the trade surplus to 195.3 billion euros. This is the second consecutive month this has happened.

In this situation, only consumption could act as a support for growth. Unfortunately, not even in the strongest moments of the last growth cycle did this variable show notable drive. Because of this, while the labour market is still enjoying good times (the unemployment rate went down to 7.6% in September), consumer indicators (retail sales and consumer confidence in particular) reported a worse performance in household spending in the third quarter. In this context, the good news comes from inflation seeing that its containment (a rise of 2.9% year-on-year in September, two decimals less than in August) is contributing to improve the purchasing power of households.

**Households keep tightening their spending.**

The three-way combination of a drop in consumption, investment and exports is reflected in the state of supply. The IFO indicator of business activity, a faithful guide to the cyclical strength of the German economy, dropped in October to the 90.2 points level, its worst figure since April 2003. This is a perception strongly based on reality, that of the business executives who reply to this survey. The fact is industrial production

**IFO indicator continues to drop.**

**Budgetary stability being left for later.**

is advancing at a substantially lower rate than that noted in the second quarter (1.7% year-on-year as opposed to 3.0%) and confidence in services stands at its lowest level since 2005.

In view of this situation, the government announced that the objective of a fiscal balance in 2011 appeared to be unattainable and it adopted an ambitious fund for stabilizing the financial markets (set at 500 billion euros) and it became known that growth officially foreseen for 2009 could run within the range of 0%-0.5%.

**In France, weakness in consumption is drag on economic possibilities.**

## France: imminent recession

First it was the National Institute of Statistics and Economic Studies and then the Bank of France. Both bodies announced in October that the GDP could have dropped by one decimal in the third quarter so that the economy would have gone into a technical recession. If this forecast is confirmed, it would be the first recession in France in 15 years. Where do the problems of the French economy lie? The most recent indicators make it clear: households are not spending and companies are seeing their profits eroded.

With regard to household spending, consumption in the third quarter was up by a slender 1.0% year-on-year while in the same period consumer confidence (an indicator with something of a forward-looking nature) held in the area of –24 points. Neither the gradual slowdown in consumer prices (down to 3.0% year-on-year in September) nor the fact that the unemployment rate held relatively low (at 8.0% of the labour force in August), both tendencies running in favour of consumption fundamentals, seems to be enough to counteract the weakness in the main figure for domestic demand.

**Companies restricting investments and expecting lower profits.**

In turn, corporate activity is suffering from the adverse economic situation. Industrial production was down 2.6% year-on-year in August while confidence in the services sector dropped by eight decimals in September. This performance underlines the poor state of both the secondary and tertiary sectors. Furthermore, the Economic Situation Bulletin published by the Bank of France in September points to other trends in the business sector. In the third quarter, French companies have reduced their investments, have seen their cash-flow reduced and have shown a reduction in their profit margins.

**FRANCE: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | | 2008 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 3Q | 4Q | 1Q | 2Q | July | August | September |
| GDP | 2.4 | 2.1 | 2.4 | 2.2 | 2.1 | 1.1 | – | ... | – |
| Domestic consumption | 3.3 | 4.4 | 4.9 | 3.8 | 2.4 | 1.5 | 1.4 | 0.1 | 1.5 |
| Industrial production | 0.9 | 1.3 | 2.0 | 2.3 | 1.7 | –0.4 | –1.8 | –2.6 | ... |
| Unemployment rate (*) | 9.2 | 8.3 | 8.1 | 7.9 | 7.7 | 7.6 | 7.8 | 8.0 | ... |
| Consumer prices | 1.7 | 1.5 | 1.3 | 2.3 | 2.9 | 3.3 | 3.6 | 3.2 | 3.0 |
| Trade balance (**) | –27.3 | –32.9 | –33.5 | –37.9 | –41.2 | –45.5 | –48.6 | –51.1 | ... |

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

## Italy: the worst may be yet to come

The International Monetary Fund has given its verdict on the immediate prospects for the Italian economy and this has been something of a sentence: in 2008 the GDP will fall by one decimal and in 2009 the situation will be worse with a further drop in growth (–0.2%). This opinion comes on top of others given recently such as that of the European Commission and, at the national level, that of Cofindustria, the business organization, which is also predicting a period of weak economic activity in Italy.

The latest indicators definitely tend to confirm this poor prospect. Consumption continues very slack, as shown by the fact that consumer confidence in September stood at the –22 points level. At a more fundamental level, another burden affecting household spending is the continuing increase in the unemployment rate which went to 6.8% in the second quarter (a rise of 7 decimals in one year).

On the supply side, the situation looks equally serious. Industrial production in August was down by 2.6% year-on-year. This poor performance may be linked to the low state of exports. In August, as a cumulative figure for 12 months, exports were up 4.6% year-on-year, a rate four percentage points less than that recorded at the beginning of the year. All of this leaves the correction of inflation in September as practically the only positive indicator. In line with the main economies on the Continent, the CPI for that month was up by 3.8% year-on-year, a drop of three decimals compared with August.

**Italy expecting two consecutive years with GDP on downward slide.**

## United Kingdom: consumption affected and perhaps sunk

**Consumption still in trouble and increased unemployment no help.**

The frenzied activity of the Gordon Brown government to shore up the banking system and the fact that the British model for saving the system (characterized by the State buying bank shares along with other measures) has been adopted *de facto* as a reference by the countries of the European Union, may have created the impression that the British economy is being guided with an iron hand toward a way out of the crisis. The truth is that, from a macroeconomic point of view, the situation remains extremely complicated. According to

**Industrial production hurt by drop in exports.**

**ITALY: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | | 2008 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 3Q | 4Q | 1Q | 2Q | July | August | September |
| GDP | 1.9 | 1.4 | 1.6 | 0.1 | 0.3 | –0.1 | – | ... | – |
| Retail sales | 1.2 | 0.5 | 0.2 | 0.5 | 0.9 | –1.7 | 2.1 | –1.3 | ... |
| Industrial production | 2.4 | 0.0 | 0.8 | –2.9 | –1.4 | –1.7 | –3.1 | –2.6 | ... |
| Unemployment rate (*) | 6.8 | 6.2 | 6.2 | 6.3 | 6.6 | 6.8 | – | ... | – |
| Consumer prices | 2.1 | 1.8 | 1.6 | 2.4 | 3.1 | 3.6 | 4.1 | 4.1 | 3.8 |
| Trade balance (**) | –17.6 | –13.7 | –11.3 | –8.9 | –9.1 | –8.6 | –9.0 | –10.5 | ... |

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

**British economy on edge of technical recession.**

preliminary figures, the GDP in the third quarter reported 0.5% quarter-on-quarter so that the country stands at the gates of a technical recession, while at the same time inflation broke the psychological barrier of 5% in September (specifically 5.2% year-on-year).

**Serious problems on private consumption front...**

The main factor showing a major drop in recent quarters is private consumption. Whereas this bastion of growth began to slow down in the second quarter, it was in the third quarter that the loss of drive became more apparent. In September, retail sales grew by 1.7% year-on-year, some 2.6 percentage points less than in the second quarter. In the months to come, things are likely to get worse. In September, consumer confidence stood at the level of –23 points, some 7 points below the poor figure for the second quarter.

**...result of drop in real estate prices, tighter credit and worse labour situation.**

The decision of households to contain spending basically arises from the combination of three factors. First of all, the drop in real estate prices (according to Halifax, the decrease between August 2007 and August 2008 was more than 13%) is having a negative effect on consumption. A second factor is the reduced availability of bank credit to fund household spending.

Finally, the British labour market, which had shown exceptional strength in previous years, has begun to worsen. Last September, the unemployment rate rose to 2.9% while in the three months from June to August some 122,000 net jobs were lost. At the same time, average wage incomes have been easing since last May, a trend that sharpened in July and August. While Britain's macroeconomic problems do not stop here (for example, industrial production slid down by 2.3% year-on-year in August), the fact is that, unless the leak in consumption is clearly stopped, British economic prospects look quite complicated.

**UNITED KINGDOM: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2006 | 2007 | 2007 | | 2008 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 3Q | 4Q | 1Q | 2Q | July | August | September |
| GDP | 2.8 | 3.0 | 3.3 | 2.9 | 2.3 | 1.5 | – | 0.3 | – |
| Retail sales | 3.1 | 4.4 | 5.0 | 3.9 | 5.4 | 4.3 | 2.0 | 3.2 | 1.7 |
| Industrial production | 0.7 | 0.4 | 0.3 | 1.0 | 0.6 | –1.1 | –1.9 | –2.3 | ... |
| Unemployment rate (*) | 2.9 | 2.7 | 2.6 | 2.5 | 2.5 | 2.6 | 2.7 | 2.8 | 2.9 |
| Consumer prices | 2.3 | 2.3 | 1.8 | 2.1 | 2.4 | 3.3 | 4.4 | 4.8 | 5.2 |
| Trade balance (**) | –72.5 | –83.2 | –84.7 | –88.4 | –90.9 | –92.9 | –94.3 | –95.0 | ... |
| 3-month Libor interest rate | 4.6 | 5.3 | 6.0 | 6.3 | 6.0 | 6.0 | 5.9 | 5.8 | 5.7 |
| Nominal effective pound exchange rate (***) | 98.0 | 103.9 | 104.3 | 102.2 | 97.6 | 92.6 | 92.8 | 92.5 | 88.2 |

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion pounds.
(***) Change weighted for foreign trade flows. Higher values imply currency appreciation.
SOURCE: OECD, Bank of England, ONS, European Commission and own calculations.

# FINANCIAL MARKETS

## Monetary and capital markets

### Central banks and governments facing world financial crisis

«Big ills need big remedies». Never has that saying been more appropriate. Faced with the most serious financial crisis in 75 years, the reaction of the economic and monetary authorities has been drastic and bold, as we shall see on the following pages. The fact is that the seriousness of the situation in the financial markets has reached such a magnitude that it has made it necessary to use every means at their disposal to avoid an involution and collapse of national credit systems.

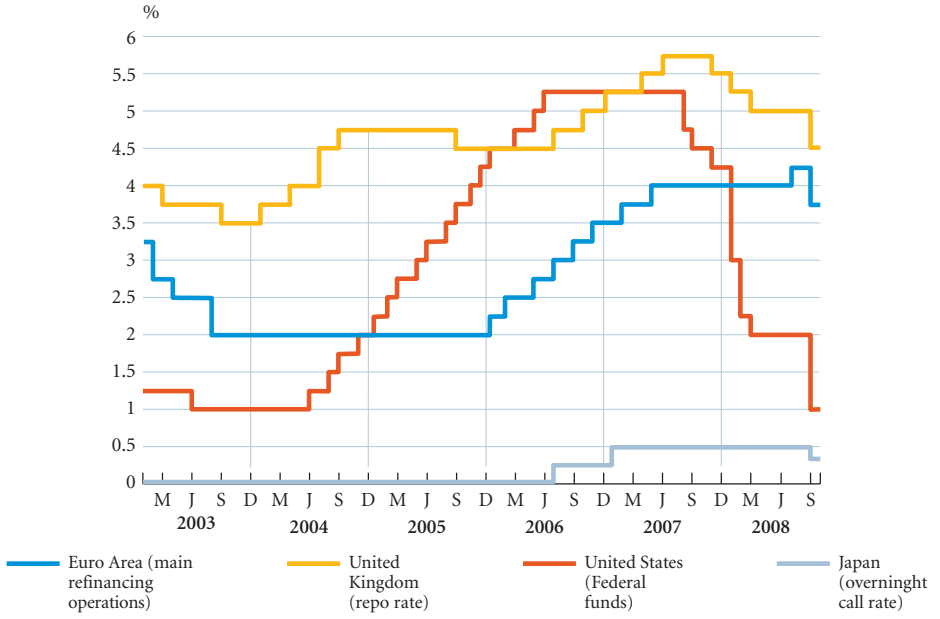
Right from the beginning of the financial storm, the central banks began interventions in keeping with the orthodox manual on resolving financial crises. With their lessons well learned from the 1929 Great Depression, the first move they took was to inject liquidity in order to relieve the pressures in interbank markets following the brutal contraction of credit between banks. This was motivated by a crisis of confidence that turned into a crisis of solvency in the international financial system.

In view of the increase in financial pressures as of September and in an

**In view of seriousness of crisis, governments and central banks take tough action.**

**COORDINATED CUT IN OFFICIAL INTEREST RATES**

Central bank reference rates




SOURCE: Central banks.

**Coordinated cuts in reference rates of main central banks...**

exceptional situation of forced bailouts of credit institutions by the public sector, the main central banks opted for cutting their official interest rates in a coordinated manner on October 8. The central banks of the United States (the Fed), the United Kingdom, China, Canada, Switzerland, Sweden and the European Central Bank (ECB) agreed to cut their reference rates. As may be seen in the above graph, the Fed, the Bank of England and the ECB lowered the official price of money by 0.5%.

**...and maximum injection of liquidity.**

On October 29, the Fed again cut the reference rate on Federal Funds by another half-point while Japan cut their rate by 20 basis points. It was expected that the Bank of England and the ECB would follow the same route.

**National plans include purchase of financial assets included in balance sheets of entities, guarantees of bond issues and even taking part in capital of banks with problems.**

Furthermore, the Fed adopted measures that go outside the monetary orthodoxy followed in recent decades, such as the creation of a fund to acquire commercial paper directly from issuers or in the secondary market, as well as the buying of assets of monetary funds, both measures aimed at relieving liquidity problems affecting non-financial companies. The ECB also put in motion various extraordinary measures, although much less far-reaching, aimed at facilitating the obtaining of higher liquidity levels at the periodic auctions of funds.

**In case of Spain, customer deposit guarantee increased, fund created for acquisition of high quality assets and guarantee set up for bond issues by credit institutions.**

But the matter does not end here. The dimension of the crisis has obliged governments to increase the guarantee on bank deposits. In the case of the European Union, after some initial lack of coordination and when the various countries had unilaterally announced the widening of this deposit guarantee, it was decided to increase the minimum guarantee to 50,000 euros per customer and institution although most countries in the Euro Area had raised it to 100,000 euros.

As this was not enough and the risk of a system collapse remained, the authorities began to take a series of more heterodoxical anti-crisis measures. The first was the creation of specific funds to buy financial assets appearing in the balance sheets of the banks. In the United States, on October 3 the Secretary of the Treasury finally managed to carry forward a bank bailout plan which could reach a maximum figure of 700 billion dollars. In spite of this, the financial markets were still unsettled as it was considered that these measures did not cover the entire problem created by the crisis.

It was the British government that very soon after on October 8 would present a plan that later was taken up as a reference for other national plans. In this case, the total figure was 400 billion pounds sterling and it included the possibility that the public sector could directly take part in the capital of those entities having problems. Another relevant point was to grant guarantees to back bank bond issues. The ministers of finance of the European Union picked up the British proposals and the respective national governments drew up their corresponding plans.

Overall, interventions have been announced for a value of nearly 4,000 billion euros, four times Spain's gross domestic product. Out of this, some 1,900 billion euros would go into guarantees, 1,000 billion euros into funds for the acquisition of bank balance sheet assets and finally approximately another 1,000 billion euros to recapitalize banks through injections of capital or through loans.

In the case of Spain, the anti-crisis plan is made up of four main elements. The first is the increase of guarantees on deposits and investment funds from 20,000 to

100,000 euros. The second element is creation of a fund for buying high quality bank assets up to 50 billion euros. Another key factor of the plan is a public guarantee for new bond issues by credit institutions (with 5 years maximum maturity) for a maximum amount of 100 billion euros, valid until December 31, 2009. The Spanish plan includes the possibility of extending the guarantee to the country's interbank market and the possible acquisition of bonds to strengthen the equity of credit institutions.

### Reduced pressures in interbank market but private bond market responding worse

The coordinated cut in central bank reference rates mentioned above had a definite impact on interest rates in the interbank market. In the Euro Area, the 3-month Euribor that was running at 5.27% at the end of September went down to 4.92%, still above the ECB official rate but clearly on a downward course. The 12-month interbank rate in the Euro Area, which went to a level of 5.51% on October 2, began to ease and was quoted at 5.0% on October 27. In the United States, the 3-month interbank rate dropped from 4% to 3.53% on October 27. In the United Kingdom, the 3-month interest rate dropped from 6.30% at the end of September to 5.98% at the end of October.

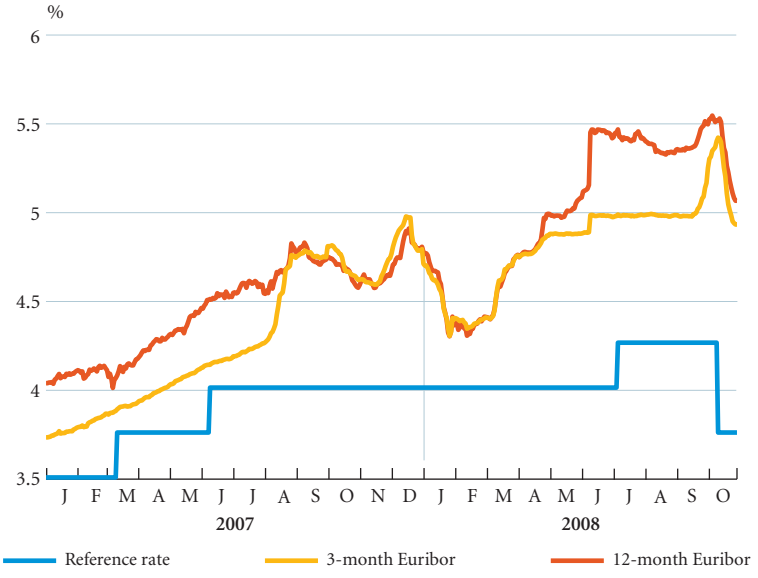
**Central banks coordinate cut in official interest rate and measures for injecting liquidity manage to somewhat ease interbank markets...**

In spite of these reductions, we still cannot state that the situation has now normalized. Differentials between the interest rates in the interbank market and the reference rates of the central banks are still higher than the historical average and in some cases these differentials even widened during the month of October. The margin between

**...although much still remains to be done to bring about complete normalcy.**

**INTERBANK MARKETS SLIGHTLY EASE PRESSURE**

Official ECB interest rate and Euro Area interbank market rate




NOTES: Latest figure is for October 27.
SOURCE: Bloomberg.

**Yield on long-term government bonds still tending downward...**

the ECB official rate and the 3-month Euribor in September was 1.02% whereas on October 27 it stood at 1.17%. That is to say, the decreases in interest rates in the interbank market were lower that the cut in the reference rate.

In the matter of long-term government bond interest rates there is still a tendency for these to drop in many countries. In the United States, the interest on 10-year government bonds dropped by 18 basis points (100 points equals 1%) from 3.82% at the end of September to 3.64% on October 25. The sharpest drop came in the Euro Area where long-term government bonds went to 3.72%, some 30 basis points below the yield being offered at the end of September. The reason for this was the change in trend in prospects for the official ECB interest rate. While up until only a few months ago increases were expected in this rate, with the initial cut on October 8 and indications of other bigger cuts to come by the ECB chairman, prospects of new cuts have become well consolidated.

The improvements in the interbank market have not been passed through to the private bond market. In capital markets for private corporate bonds,

## SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

| | Euro area | | | United States | | Japan | United Kingdom | | Switzerland |
|---|---|---|---|---|---|---|---|---|---|
| | ECB auctions (2) | Euribor (5) 3-month | Euribor (5) 1-year | Federal Reserve Board target level (3) | 3-month (5) | 3-month (5) | Bank of England repo rate (4) | 3-month (5) | 3-month (5) |
| **2007** | | | | | | | | | |
| September | 4.00 | 4.79 | 4.73 | 4.75 | 5.23 | 1.03 | 5.75 | 6.30 | 2.82 |
| October | 4.00 | 4.60 | 4.60 | 4.50 | 4.89 | 0.90 | 5.75 | 6.28 | 2.68 |
| November | 4.00 | 4.81 | 4.69 | 4.50 | 5.13 | 0.99 | 5.75 | 6.61 | 2.62 |
| December | 4.00 | 4.68 | 4.75 | 4.25 | 4.70 | 0.90 | 5.50 | 5.99 | 2.63 |
| **2008** | | | | | | | | | |
| January | 4.00 | 4.37 | 4.32 | 3.00 | 3.11 | 0.87 | 5.50 | 5.58 | 2.59 |
| February | 4.00 | 4.38 | 4.38 | 3.00 | 3.06 | 0.96 | 5.25 | 5.74 | 2.72 |
| March | 4.00 | 4.73 | 4.73 | 2.25 | 2.69 | 0.91 | 5.25 | 6.00 | 2.78 |
| April | 4.00 | 4.86 | 4.96 | 2.00 | 2.85 | 0.92 | 5.00 | 5.84 | 2.86 |
| May | 4.00 | 4.86 | 5.10 | 2.00 | 2.68 | 0.92 | 5.00 | 5.87 | 2.78 |
| June | 4.00 | 4.95 | 5.39 | 2.00 | 2.78 | 0.93 | 5.00 | 5.95 | 2.73 |
| July | 4.25 | 4.97 | 5.37 | 2.00 | 2.79 | 0.90 | 5.00 | 5.78 | 2.78 |
| August | 4.25 | 4.96 | 5.34 | 2.00 | 2.81 | 0.88 | 5.00 | 5.75 | 2.70 |
| September | 4.25 | 5.27 | 5.50 | 2.00 | 4.05 | 1.02 | 5.00 | 6.30 | 3.00 |
| October (1) | 3.75 | 4.92 | 5.04 | 1.50 | 3.52 | 1.00 | 4.50 | 5.98 | 2.34 |

NOTES: (1) October 27.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 5-10-06 (3.25%), 7-12-06 (3.50%), 8-3-07 (3.75%), 6-6-07 (4.00%), 3-07-08 (4.25%), 8-10-08 (3.75%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%).
(4) Latest dates showing change: 10-5-07 (5.50%), 5-7-07 (5.75%), 6-12-07 (5.50%), 7-2-08 (5.25%), 10-4-08 (5.00%), 8-10-08 (4.5%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

where companies issue bonds to obtain financing, there has been a substantial increase in price because of the lack of investors interested in acquiring this type of asset.

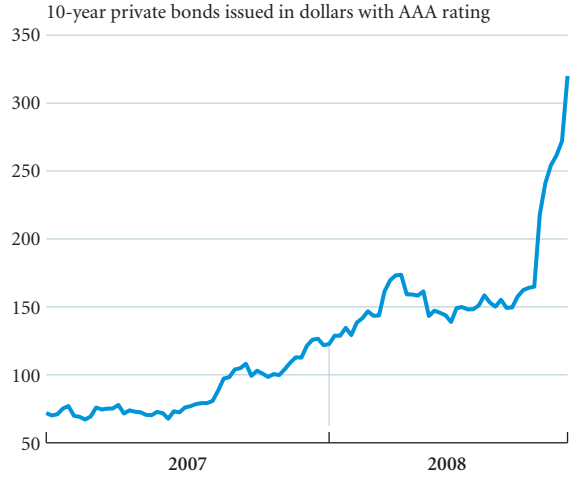
In the case of bonds in dollars issued by companies in the US market with 10-year maturity and maximum credit rating, these are paying 319 basis points above government bonds with this maturity. That is to say, a company that decides to issue a 10-year bond with an AAA rating must offer a return of 6.83%. This is an outrageous rate that indicates the difficulty financial managers are having to obtain funding at reasonable prices. Investment portfolio managers are continuing to reduce risk in their portfolios and are not interested in buying commercial paper with the uncertainty involved in the current situation. The main reason is the drastic decrease in capacity to generate corporate profits. In this situation, it is likely that some downward trend will continue in the credit profile of the business sector and this could potentially result in lower credit ratings and in the price of assets issued by these companies, whether these are bonds or shares.

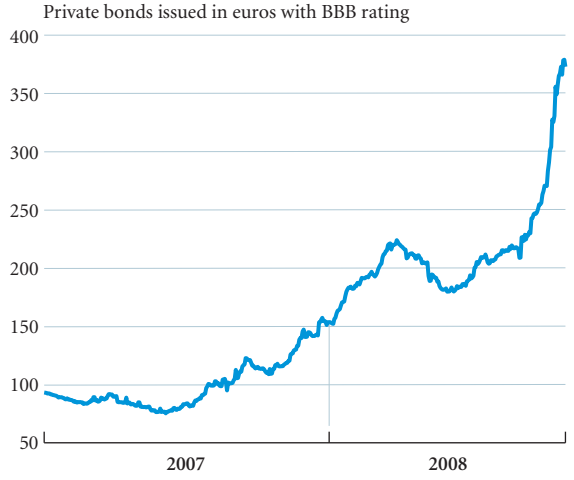
In the Euro Area, the situation is very similar seeing that a business executive desiring to make a capital issue in the private bond market finds that this has become substantially more costly. In this case, a private company bond in euros with 10-year maturity and a BBB rating must offer a yield of 7.50%. To sum up, current quotes indicate that in practice capital markets for the business sector are out of reach and are unable to offer funding at reasonable prices.

**...but improvements not yet passed through to private bond market.**

## CREDIT RISK PREMIUMS ON RISE

Credit differentials in basis points




NOTES: Latest figure is for October 27.
SOURCE: Bloomberg and own calculations.

## LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

| | 2005 | 2006 | 2007 | | 2008 | |
|---|---|---|---|---|---|---|
| | | | September | December | September | October (*) |
| United States | 4.39 | 4.70 | 4.59 | 4.02 | 3.82 | 3.64 |
| Japan | 3.31 | 1.69 | 1.69 | 1.51 | 1.47 | 1.48 |
| Euro Area | 1.48 | 3.95 | 4.33 | 4.33 | 4.02 | 3.72 |
| United Kingdom | 4.10 | 4.74 | 5.01 | 4.51 | 4.45 | 4.33 |
| Switzerland | 1.97 | 2.52 | 3.01 | 3.05 | 2.61 | 2.73 |

NOTES: (*) October 25.
SOURCE: Bloomberg.

### Dollar recovers role as safe haven

**Excessive volatility of yen troubles G-7.**

The foreign exchange market experienced October as a month of major convulsions. Japan's currency stood out with very sharp changes to the point where on October 27 the G-7, the group of the world's richest countries, warned about the excessive volatility of the Japanese yen. As may be seen in the following table, the yen appreciated 11.2% against the dollar in one month. At month-end, one dollar would buy only 93.7 yen. We must go back to 1995 to see the same level in the exchange rate between the Japanese currency and the US dollar.

## EXCHANGE RATES OF MAIN CURRENCIES

October 27, 2008

| | Exchange rate | % change (*) | | |
|---|---|---|---|---|
| | | Monthly | Over December 2007 | Annual |
| **Against US dollar** | | | | |
| Japanese yen | 93.7 | –11.2 | –19.3 | –22.4 |
| Pound sterling | 0.647 | 17.0 | 28.4 | 33.4 |
| Swiss franc | 1.160 | 6.1 | 2.3 | –0.4 |
| Canadian dollar | 1.286 | 18.7 | 22.4 | 25.8 |
| Mexican peso | 13.268 | 16.8 | 17.9 | 19.3 |
| **Against euro** | | | | |
| US dollar | 1.243 | –13.9 | –14.8 | –13.9 |
| Japanese yen | 116.4 | –22.6 | –28.6 | –29.6 |
| Swiss franc | 1.442 | –8.3 | –12.8 | –14.2 |
| Pound sterling | 0.804 | 0.7 | 9.3 | 14.9 |
| Swedish krona | 10.070 | 2.8 | 6.7 | 9.3 |
| Danish krone | 7.452 | –0.1 | –0.1 | 0.0 |
| Polish zloty | 3.843 | 13.1 | 6.9 | 6.0 |
| Czech crown | 24.87 | 0.7 | –6.3 | –7.8 |
| Hungarian forint | 271.8 | 11.4 | 7.5 | 8.3 |

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

There are a number of factors behind this change. One of the most important is the end of what in financial jargon is known as the «carry trade» which involves borrowing in one currency with low interest rates and simultaneously investing in other currencies that are offering a high interest rate. At this time, we are seeing a reduction of indebtedness in investment portfolios all over the world. Investors who had borrowed in yen are closing out these positions. That is to say, there has been an increase in demand for yen to pay off loans granted as funding. The yen has appreciated most sharply against the euro with a gain of 22.6% in value against the single currency in the past month. One euro now buys only 116 yen compared with a level of 156 yen on September 25.

In addition, the euro has depreciated sharply against the dollar. On September 26, one euro was worth 1.46 dollars whereas on October 27 it could buy only 1.24 dollars, a depreciation of 15%. The reason for this was the change in expectations of further cuts by the ECB that had sharpened in recent weeks. The pound sterling depreciated very sharply against the dollar following publication of negative growth in the third quarter, something that had not happened since the last recession seen in the United Kingdom in 1991.

Other currencies that have also seen major changes are those in Eastern Europe. Many of these countries, including Hungary and Ukraine, had increased their debt in other than their own currencies. Companies and households asked for loans in currencies such as the euro, the yen or the dollar, seeing that interest rates were lower than those for national loans. When the financial upsets began to affect the emerging countries, the drop in the national currency revealed the currency risk and made it clear that the situation was unviable. Foreign investors have since taken out their positions, exports have dropped and risk in the banking sector has increased because of the worse level of default.

**Prospect of further cuts in official interest rate by ECB and Bank of England hurts euro and pound sterling which depreciate against dollar.**

In the Ukraine, the drop in world steel demand has directly affected the balance of payments as this product is its largest export. This has meant a sharp increase in current account deficit that has put its currency under enormous pressure. The country's currency, the grivnia, has devalued 25% against the dollar in the past month. The risk of a collapse in the financial system has obliged the country to negotiate an aid package with the International Monetary Fund (IMF) amounting to 13 billion euros in order to avoid the risk of insolvency.

**Currencies of East European countries severely hurt by financial crisis.**

Hungary has also suffered from a similar situation in which its currency has depreciated 11.4% against the euro in one month because of doubts about its ability to refinance its huge level of debt in foreign currencies. The IMF has indicated is willingness to help the country, a decision following on the aid provided by the ECB for an amount of 5 billion euros placed at the disposal of Hungary's central bank in order to shore up its currency. This is the first time in the history of the European Union that a member state has sought aid from the IMF.

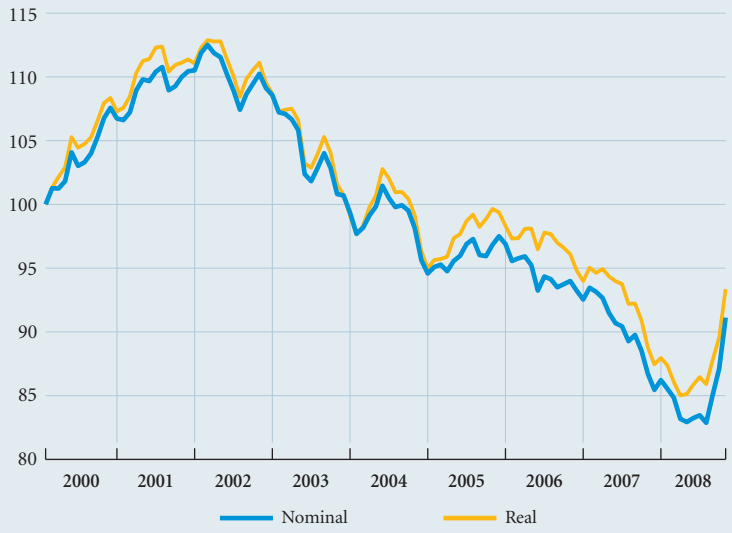
**Sharp drop in share markets brings spectacular lows to some quotes.**

## Rebound of dollar: a new trend or a temporary jump?

The dollar's downward trend of the past 6 years seems to have ended. In only three months the greenback has appreciated 10% on average against the currencies of its main trading partners, thus recovering the levels held in the first quarter of 2007. The biggest changes have come against the South Korean won, the peso and the Canadian dollar against which the dollar has appreciated 40%, 28% and 29% respectively since the beginning of summer. Its appreciation against the euro (20%) has been more moderate. Has the depreciation of the dollar thus hit bottom? Or are these changes merely a temporary phenomenon?

**SHARP RECOVERY OF DOLLAR PUTS IT AT LEVELS AT START OF 2007**

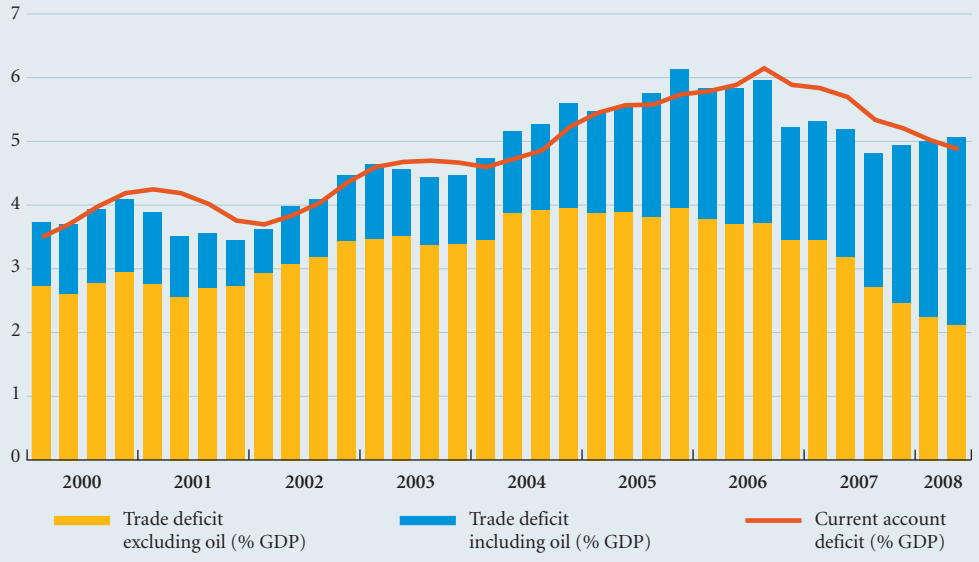
Index of dollar exchange rate against currencies of main trading partners
(An increase indicates appreciation)




SOURCE: Thomson Financial Datastream and own calculations.

In order to determine if the recent appreciation of the dollar represents a change in trend we must analyze if the factor that caused its depreciation between 2002 and 2008 is still at work, namely the foreign imbalance of the US economy. In fact, before the financial crisis took over the newspapers and the economic debate, the sustainability of the current account deficit (dominated basically by the trade deficit) was one of the hottest questions in the international economy. Over the long term, a trade deficit of 6%, as recorded by the United States in 2005-2006, is not sustainable because it would increase the net debt of the country exponentially. In this context, the sharp depreciation of the dollar (24% in real effective terms between 2002 and 2008) has been a key factor in ensuring that the trade deficit excluding oil was reduced by approximately 2 percentage points of the GDP. The reduction of the trade deficit including net oil imports has been more moderate (see following graph), but this has been a result of the sharp rise in oil prices.

## INCREASE IN OIL PRICES MAINTAINING TRADE DEFICIT HIGH




SOURCE: Thomson Financial Datastream and own calculations.

Over the medium term the trade deficit should continue to moderate as a result of the depreciation that dollar experienced up to the middle of this year. Available estimates indicate that both exports and imports react to changes of the exchange rate with a delay of about two years. This trend will be reinforced by the drop in crude oil prices. If prices hold at around 80-90 $/barrel, the current account deficit would be reduced to 2.5%-3% of the GDP, but if they fall to 50-60 $/barrel, the deficit could go down to 1.5%-2% of the GDP, figures that are compatible with a sustainable level of debt.[1] Therefore, if the price of oil does not shoot up again, the stabilization of the dollar at the levels seen in June 2008 would be sufficient for the trade deficit to reach sustainable levels over the long term. In any case, its sharp appreciation of the recent weeks seems premature from a structural point of view.

The reasons for the recent appreciation of the dollar must be looked for in the determinants of the exchange rate over the short term. One of these determinants is the expectation of the differential in interest rates between countries. On the one hand, the reference rate set by the Federal Reserve now stand at 1% and these cannot go down much more to help ease the slowdown in the US economy. On the other hand, interest rates in its main trading partners, as for example the Euro Area, United Kingdom, Canada and Mexico, still have a wide downward course that they may take now that inflationary pressures have moderated and as they see how the international financial crisis also affects their domestic economies. The anticipation of a reduction in the differential in short-term interest rates partly explains the recent appreciation of the dollar. Another factor to keep in mind is the increase in risk aversion and the preference for liquidity among US investors who, on seeing that the economic slowdown was stretching beyond the United States, have liquidated their investments abroad and brought their capital back home.

(1) See, for example, Enric Fernández, 2007, «La sostenibilidad del déficit exterior de Estados Unidos», "la Caixa" Economic Document.

**CURRENT EXCHANGE RATES AND PURCHASING POWER PARITY**

| | Exchange rates 27-10-08 | PPP |
|---|---|---|
| $ / Euro | 1.24 | 1.14 |
| $ / Pound Sterling | 1.55 | 1.54 |
| Canadian dollar / $ | 1.29 | 1.21 |
| Yen / $ | 93.28 | 129.55 |
| Renminbi / $ | 6.85 | 3.45 |

NOTES: PPP: purchasing power parity.
SOURCE: World Bank and Datastream.

Up to this point we have looked at the global position of the dollar with regard to the currencies of its main trading partners but the dynamics of bilateral exchange rates could be different. A relatively simple way of seeing against which currencies the dollar will tend to depreciate or appreciate over the long term is to compare the current exchange rate with the exchange rate according to purchasing power parity (PPP), the rate that would make it possible to buy the same basket of goods in different countries with the same amount of money. This indicator must be considered a long-term reference seeing that in practice the differences in prices between countries tend to disappear gradually. As may be seen in the above table, in spite of the sharp appreciation of the dollar against the euro, the current exchange rate still stands above the PPP exchange rate and therefore suggests that the appreciation of the dollar still has some distance to cover. Following its sharp depreciation in recent weeks, the pound sterling stands very close to its balance value over the long term. The situation of the yen is somewhat more complicated given that, on the one hand, the differential between the current exchange rate and that of the PPP suggests that the dollar should appreciate. Nevertheless, the major recurring trade surpluses of the Japanese economy, a situation totally opposed to that of the United States, suggests that the dollar should depreciate against the yen. Given that over the mid-term this is the dominant force, the convergence to the PPP exchange rate will be even more delayed. Finally, the case of the renminbi is clearer given that both the PPP exchange rate and the foreign position of the Chinese economy, a substantial current account surplus, indicate that the dollar should depreciate.

To conclude, the recent appreciation of the dollar seems to be due to temporary causes and therefore we may expect that over the short term it will return to the levels reached before the summer. Over the medium term, the dollar will again gain strength against the euro but should depreciate against the Asian currencies, specially against the renminbi.

**In US stock market drop is sharpest since 1929.**

## Very poor October on stock market

There are not enough adjectives to describe the very sharp drops on the stock market in October. At certain times, it would be no exaggeration to talk about a selling panic. The fact that the price of some of the biggest companies quoted in the indices fell below the book value of those companies is an indication of the pressures existing in the share markets. In the above box we see how all indices in Western stock markets lost around 25%-30%.

As opposed to other times when we could point out specific factors in some countries to explain moves on the stock markets depending on the greater or

lesser weight of some economic sectors, in the indices or position in the economic cycle the country was in, at this time the fundamental factor common to these movements is strong risk aversion on the part of investors.

There is no doubt at all that the current crisis is the worst since the 1929 crack. In the case of the Standard & Poor's index for the United States, if we compare the 12 biggest drops since 1929, we note that the present correction is the biggest in percentage, keeping in mind that it has been scarcely a year since this one began.

The question that now arises: where is the bottom? That is to say, how far down could it go? To answer this question we can make use of various methodologies. From these we can deduce that current quotations now incorporate in those share prices the reduction in profits as a result of the sharp world slowdown expected in coming quarters.

Nevertheless, until the situation in the international financial system returns to normal is it very difficult to see investors deciding on a massive return to buying shares. For this reason, the easing in the interbank market is a hopeful sign because at least we can say that, following the measures taken by governments and central banks, the banks are slightly less afraid of lending to each other.

**Normalization of banking system needed to lay basis for recovery.**

**INDICES OF MAIN WORLD STOCK EXCHANGES**

October 28, 2008

| | Index (*) | % monthly change | % cumulative change | % annual change |
|---|---|---|---|---|
| New York | | | | |
| *Dow Jones* | *8,298.8* | *–25.5* | *–37.4* | *–39.9* |
| *Standard & Poor's* | *858.5* | *–29.2* | *–41.5* | *–44.1* |
| *Nasdaq* | *1,523.8* | *–30.2* | *–42.5* | *–45.7* |
| Tokyo | 7,621.9 | –35.9 | –50.2 | –53.8 |
| London | 3,946.4 | –22.4 | –38.9 | –40.8 |
| Euro Area | 2,339.4 | –25.9 | –46.8 | –47.3 |
| *Frankfurt* | *4,609.0* | *–24.0* | *–42.9* | *–42.0* |
| *Paris* | *3,114.7* | *–25.2* | *–44.5* | *–46.3* |
| *Amsterdam* | *239.7* | *–32.4* | *–53.5* | *–56.2* |
| *Milan* | *19,069.0* | *–29.8* | *–50.5* | *–52.4* |
| *Madrid* | *8,024.7* | *–29.5* | *–47.1* | *–48.6* |
| Zurich | 5,604.5 | –17.8 | –33.9 | –37.5 |
| Hong Kong | 12,596.3 | –32.6 | –54.7 | –58.6 |
| Buenos Aires | 844.2 | –50.1 | –60.8 | –63.7 |
| São Paulo | 30,294.6 | –40.3 | –52.6 | –52.9 |

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

# SPAIN: OVERALL ANALYSIS

## Economic activity

**GDP likely dropped in third quarter despite improved foreign sector.**

### International financial crisis making economic slowdown worse

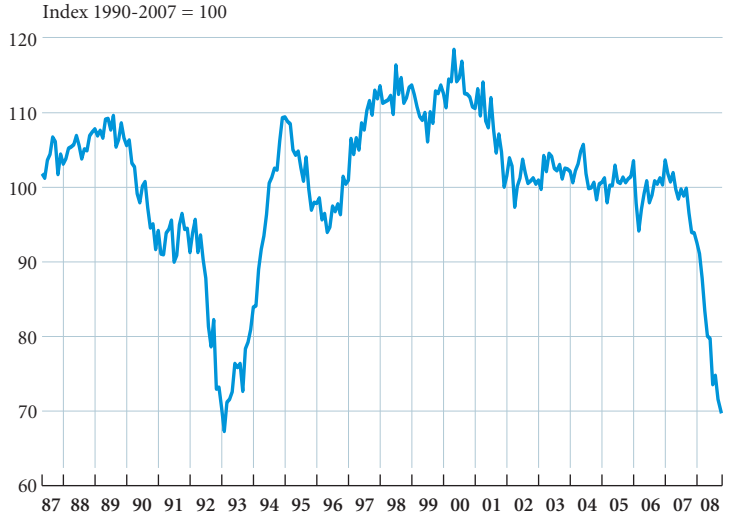
Although the inflationary shock from commodities has partly eased, recent months have brought a worsening of the international financial crisis. In spite of government efforts, this world shock has tended to sharpen the economic slowdown largely due to the loss of drive in housing construction.

As a result, the confidence of economic players has continued to drop putting the economic sentiment indicator at its lowest levels since the last recession in 1992-93. After having marked up quarter-on-quarter growth of only 0.1% in the second quarter, gross domestic product likely contracted slightly in the third quarter, as forecast by the European Commission, in spite of an improvement in the foreign sector.

In this situation, it is worth looking at the economic situation of companies, given that a good part of the trend in investment and employment depends on this. Figures from the quarterly survey of balance sheets carried out by the Bank of Spain relating to the second quarter confirm the economic slowdown in this recent period. Value added of companies included in the sample (which is obtained by subtracting intermediate consumption from the value of production) rose by 2.1% in the first half-year in year-on-year terms, as

**CONFIDENCE DROPS TO LOWEST LEVEL SINCE LAST RECESSION**

Economic sentiment indicator (*)




NOTES: (*) Made up of confidence indicators for industry, services, consumers and retail trade. Seasonally adjusted.
SOURCE: European Commission survey.

## PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES

Annual change rates

| | 2007 | First half-year | |
|---|---|---|---|
| | | 2007 | 2008 |
| Value of production | 5.8 | 3.9 | 9.9 |
| Intermediate consumption | 6.2 | 3.0 | 13.8 |
| **Gross value added (GVA)** | **4.9** | **5.7** | **2.1** |
| Wage costs | 4.4 | 4.7 | 5.2 |
| **Gross operating profit** | **5.2** | **6.3** | **0.0** |
| Financial income | 38.5 | 16.8 | 40.4 |
| Financial costs | 36.5 | 37.8 | 28.3 |
| Depreciation and provisions | –1.3 | –1.0 | 0.1 |
| **Net ordinary profit** | **10.3** | **4.4** | **4.2** |
| Extraordinary income and costs | 121.4 | –42.3 | – |
| Provisions and tax | 89.9 | –12.1 | 3.7 |
| **Net profit** | **11.7** | **3.0** | **67.3** |

SOURCE: Bank of Spain.

against 5.7% recorded in the first half of 2007.

On the other hand, wage costs tended to rise due to the increase in average wages, given that the growth rate of job creation eased. As a result, gross operating profit did not increase in relation to the first six months of last year but rather was stagnant.

Financial income rose more than financial costs. This came about, on the one hand, thanks to high dividends received from foreign subsidiaries of large Spanish multinational groups and, on the other hand, due to lower borrowing by companies in recent months. As a result, net ordinary profit showed a year-on-year increase of 4.2% although this was 2 decimals below one year earlier.

Continuing the breakdown of results, extraordinary income showed a spectacular rise mainly due to capital gains obtained from the sale of shares and other assets. As a result, net profit was up by 67.3% compared with the same period last year. We should point out that this atypical figure may largely be attributed to sales agreed upon in the process of the purchase of a majority holding in a large Spanish power company by a foreign operator. If the extraordinary income from this transaction is ignored, the net result would have increased by 12% in the first half-year.

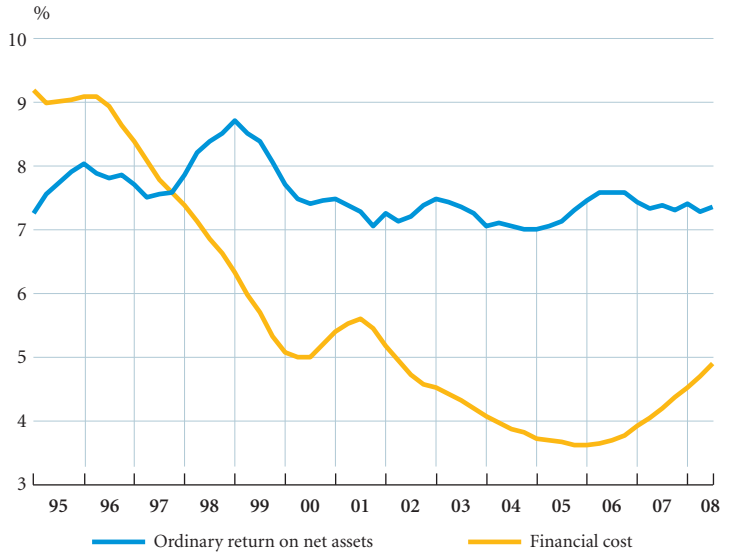
As a result, ordinary return on net assets held at previous levels. Nevertheless, with the pass-through of interest rate increases to companies, financial cost continued to rise. The differential between the ratios of return on assets and financial cost thus remained positive but went down to 2.6%, slightly more than a half-point below the level seen in the first half of last year.

Returning to the economic situation, latest available indicators suggest that

**Gross operating profit of companies stagnant in first half-year.**

**DIFFERENCE BETWEEN RETURN AND FINANCIAL COST NARROWING**

Moving average for four quarters




SOURCE: Bank of Spain and own calculations.

**No let-up in weakness of consumption...**

consumption is continuing to drop, especially in consumer durables. Passenger car registrations dropped by 32.2% in September compared with the same month last year. In turn, retail sales continued to slacken with year-on-year drops of close to 6% in July and August. Naturally, both production and imports of consumer goods continued to show negative change rates in the early summer months as these were adjusted to a demand adversely affected by negative economic prospects, reflected in a consumer confidence index at all-time lows. Nor does consumption of services seem to be enjoying a good situation, if we are to judge by a year-on-year decrease of 4.2% in domestic sales by large companies in August.

**...or investment.**

With regard to investment, nor is this showing a good situation. In August, domestic sales of capital goods and services by large companies reported a year-on-year drop of 7.1%.

**Industrial confidence indicator continues to drop.**

Production of capital goods reported a drop of 12.9% compared with August 2007. Registrations of commercial vehicles were down 48.1% in September compared with 12 months earlier. So far as concerns construction investment, cement consumption was down 26.1% in the third quarter, which indicates a sharp reduction in housing investment.

On the supply side, the worsening of prospects for domestic and foreign demand continues to severely affect industry for which the confidence indicator continued to drop in September. Industrial production suffered a year-on-year decrease of 7.0% in August. The sub-sectors reporting the biggest drops were consumer durables and capital goods. In turn, after a recovery in July, new industrial orders were down 6.6% in August compared with the same month last year. Nevertheless, we may reasonably

## DEMAND INDICATORS

Percentage change over same period year before

| | 2006 | 2007 | 2007 | | 2008 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 3Q | 4Q | 1Q | 2Q | July | August | September |
| **Consumption** | | | | | | | | | |
| Production of consumer goods (*) | 2.3 | 1.2 | 0.9 | –2.7 | –0.8 | –5.6 | –2.3 | –6.2 | ... |
| Imports of consumer goods (**) | 8.9 | 5.1 | 8.4 | 7.7 | –1.2 | –6.9 | –4.0 | ... | ... |
| Car registrations | –0.9 | –1.2 | –2.9 | 1.3 | –15.3 | –19.6 | –27.4 | –41.3 | –32.2 |
| Credit for consumer durables | 14.5 | 10.0 | 6.9 | 9.9 | 8.8 | 7.1 | – | … | – |
| Consumer confidence index (***) | –12.3 | –13.3 | –12.3 | –17.3 | –20.0 | –31.3 | –39.0 | –37.0 | –39.0 |
| **Investment** | | | | | | | | | |
| Capital goods production (*) | 8.4 | 5.9 | 6.3 | 3.3 | 2.0 | –3.1 | 1.7 | –12.9 | ... |
| Imports of capital goods (**) | 3.2 | 9.8 | –0.6 | 9.0 | –16.0 | –16.4 | –7.8 | ... | ... |
| Commercial vehicle registrations | 1.5 | 0.3 | –3.0 | 4.7 | –29.5 | –34.0 | –46.6 | –57.0 | –48.1 |
| **Foreign trade** (**) | | | | | | | | | |
| Non-energy imports | 9.0 | 7.3 | 7.6 | 7.5 | 4.3 | 0.2 | –2.7 | ... | ... |
| Exports | 5.6 | 4.2 | 6.7 | 4.6 | 2.2 | 6.6 | 9.5 | ... | ... |

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

expect that the recent drop in the euro will mean some relief for the situation in the secondary sector.

With reference to construction, its performance continues to be affected by the crisis in the real estate market. Housing sales were down 26.3% in July compared with the same month the year before. The large number of housing units still unsold has a depressing effect on prices. According to the new price index harmonized with that of the European Union and based on notary records, published by the National Institute of Statistics, housing prices showed a year-on-year drop of 0.3% in the second quarter. Within this framework, supply was adjusting to demand and approvals for new housing units dropped by 58.5% compared with one year earlier. On the other hand, government tendering for public works is not moving and recorded a year-on-year drop of 9.4% in July.

**Housing prices record slight year-on-year drop in second quarter, according to latest INE statistics index.**

With regard to the tertiary sector, the volume of business of services companies was down 4.6% in August compared with last year. The branches showing the biggest decreases were vehicle sales (22.7%) and selection and placement of personnel (11.0%). Tourism reported a drop of 2.3%, reflecting a very modest season. Nevertheless, some sub-sectors, such as air transport, research and security showed notable strength with increases of 7%.

Within this overall picture, the International Monetary Fund recently published its forecasts for Spain's economy and made a notable reduction of its growth forecast for 2009 to a drop of 0.2% as against an increase of 1.2%

**International Monetary Fund forecasting slight drop in GDP in 2009.**

## SUPPLY INDICATORS

Percentage change over same period year before

| | 2006 | 2007 | 2007 | | 2008 | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 3Q | 4Q | 1Q | 2Q | July | August | September |
| **Industry** | | | | | | | | | |
| Electricity consumption (1) | 4.0 | 4.6 | 2.5 | 4.9 | 2.1 | 2.7 | 3.0 | 3.0 | 0.7 |
| Industrial production index (2) | 3.9 | 1.9 | 1.1 | –0.2 | –0.5 | –5.1 | –3.0 | –7.0 | ... |
| Confidence indicator for industry (3) | –2.7 | –0.3 | –0.7 | –3.3 | –7.0 | –11.9 | –16.0 | –18.0 | –22.0 |
| Utilization of production capacity (4) | 80.5 | 81.3 | 82.1 | 81.1 | 81.3 | 80.3 | – | 79.3 | – |
| Imports of non-energy intermediate goods (5) | 10.5 | 8.0 | 8.7 | 7.1 | 11.4 | 6.9 | –1.2 | ... | ... |
| **Construction** | | | | | | | | | |
| Cement consumption | 8.5 | 0.2 | –1.1 | –1.9 | –13.3 | –17.8 | –23.8 | –30.2 | –24.8 |
| Confidence indicator for construction (3) | 14.2 | 9.3 | 12.0 | –1.3 | –14.7 | –17.3 | –30.0 | –15.0 | –26.0 |
| Housing (new construction approvals) | 18.6 | –24.7 | –50.7 | –33.6 | –59.8 | –56.0 | –58.5 | ... | ... |
| Government tendering | 31.3 | –14.9 | –30.0 | –33.1 | 27.8 | –32.2 | –9.4 | ... | ... |
| **Services** | | | | | | | | | |
| Retail sales (6) | 2.1 | 2.4 | 3.1 | –0.3 | –3.6 | –5.6 | –6.1 | –5.9 | ... |
| Foreign tourists | 4.1 | 1.4 | 1.2 | 1.6 | 5.3 | 0.9 | –8.0 | –1.8 | –5.9 |
| Tourist revenue inflows | 5.6 | 3.6 | 3.3 | 4.5 | 5.2 | 1.0 | 1.1 | ... | ... |
| Goods carried by rail (ton-km) | –1.2 | –4.4 | –1.4 | –5.3 | –2.7 | –0.7 | –0.7 | –17.8 | ... |
| Air passenger traffic | 6.8 | 9.0 | 10.6 | 8.6 | 7.9 | –0.7 | –3.7 | –2.4 | –8.8 |
| Motor vehicle diesel fuel consumption | 5.5 | 4.8 | 4.3 | 4.7 | –0.9 | –2.8 | –0.9 | ... | ... |

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

**Spanish government passes financial measures to avoid worsening of economic slowdown.**

forecast in July. This international body indicates a gradual recovery due to the weakness of the real estate market and Spain's dependence on foreign financing.

In the face of this situation, the Spanish government has adopted a series of measures to stimulate the economy along with the joint plan agreed on by the Euro Area countries adopted in October to strengthen the financial system and avoid any worsening of the slowdown in the real economy. With this in mind, it established a fund to buy financial assets of credit institutions up to 50 billion euros in order to facilitate the funding of companies and households. Among other things, it also approved the authorization of guarantees up to an amount of 100 billion euros in 2008, which could be extended to the end of 2009, for bond issues of financial institutions.

# Labour market

## Employment showing downward trend

The sharp slowdown in economic activity has brought about a major worsening of the labour market to the point where the third-quarter Labour Force Survey (the most reliable indicator for the labour market) already had shown a year-on-year drop in employment levels. In fact, in the July-September period the number of persons working, according to the survey estimates, was 20,346,300, some 78,800 less than in the previous quarter whereas, in the same period in 2007, there was a quarterly increase of 143,300. This meant a year-on-year drop of 0.8%, the first decrease since the third quarter of 1994.

In the past 12 months some 164,300 jobs were lost. The sector losing most jobs was construction with a drop of 354,200 employees, or 13.0%. In agriculture the reduction was 36,300, or 4.1%. In industry, the drop in number of employees was 31,200 (1.0%). Only services showed an increase in employment (1.9%) with 257,600 more persons joining its ranks.

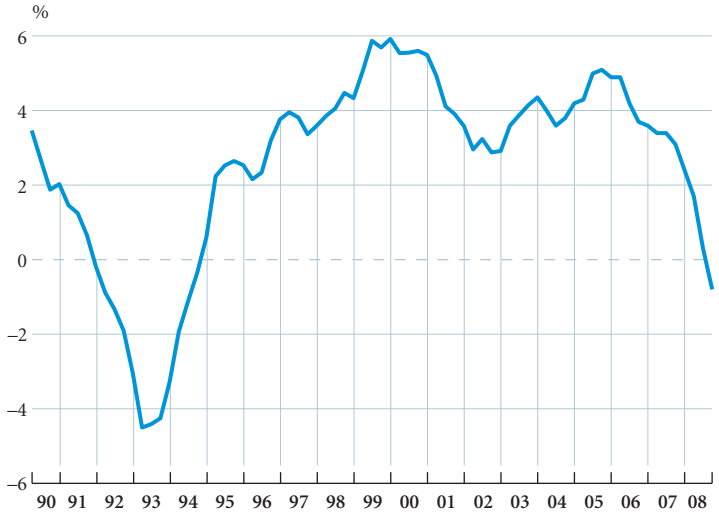
In spite of the loss of industrial employment, some sub-sectors have raised their employment levels in the past 12 months. The manufacture of transport material increased the number of employees by 17,800 while the paper industry and graphic arts reported a rise of 12,200. On the other hand, various

**Number of persons employed down 78,800 in third quarter compared with quarterly increase of 143,300 one year ago.**

**Year-on-year increase in employment reported only in services.**

**FIRST YEAR-ON-YEAR DROP IN EMPLOYMENT IN 14 YEARS**

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




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

## ESTIMATED EMPLOYMENT

Third quarter 2008

| | No. of employees (thousands) | Quarterly change | | Cumulative change | | Annual change | | % share |
|---|---|---|---|---|---|---|---|---|
| | | Absolute | % | Absolute | % | Absolute | % | |
| **By sector** | | | | | | | | |
| Agriculture | 849.0 | –31.9 | –3.6 | –56.8 | –6.3 | –36.3 | –4.1 | 4.2 |
| Non-farm | 19,497.4 | –46.8 | –0.2 | –73.7 | –0.4 | –127.8 | –0.7 | 95.8 |
| *Industry* | *3,227.7* | *–45.6* | *–1.4* | *–51.4* | *–1.6* | *–31.2* | *–1.0* | *15.9* |
| *Construction* | *2,363.3* | *–134.8* | *–5.4* | *–330.2* | *–12.3* | *–354.2* | *–13.0* | *11.6* |
| *Services* | *13,906.4* | *133.4* | *1.0* | *307.9* | *2.3* | *257.6* | *1.9* | *68.3* |
| **By type of employer** | | | | | | | | |
| Private sector | 17,356.3 | –127.0 | –0.7 | –207.3 | –1.2 | –222.4 | –1.3 | 85.3 |
| Public sector | 2,990.1 | 48.3 | 1.6 | 76.8 | 2.6 | 58.2 | 2.0 | 14.7 |
| **By work situation** | | | | | | | | |
| Wage-earners | 16,746.2 | –106.8 | –0.6 | –130.5 | –0.8 | –123.6 | –0.7 | 82.3 |
| *Permanent contract* | *11,801.4* | *–99.1* | *–0.8* | *143.2* | *1.2* | *320.2* | *2.8* | *58.0* |
| *Temporary contract* | *4,944.7* | *–7.7* | *–0.2* | *–273.7* | *–5.2* | *–443.8* | *–8.2* | *24.3* |
| Non-wage-earners | 3,584.9 | 22.9 | 0.6 | –8.3 | –0.2 | –48.3 | –1.3 | 17.6 |
| *Entrepreneurs with employees* | *1,181.5* | *6.0* | *0.5* | *45.2* | *4.0* | *39.8* | *3.5* | *5.8* |
| *Entrepreneurs without employees* | *2,183.2* | *–5.2* | *–0.2* | *–71.4* | *–3.2* | *–103.1* | *–4.5* | *10.7* |
| *Family help* | *220.2* | *22.0* | *11.1* | *17.9* | *8.8* | *15.0* | *7.3* | *1.1* |
| Other | 15.3 | 5.2 | 51.5 | 8.2 | 115.5 | 7.6 | 98.5 | 0.1 |
| **By time worked** | | | | | | | | |
| Full-time | 18,022.5 | 46.5 | 0.3 | –71.3 | –0.4 | –211.4 | –1.2 | 88.6 |
| Part-time | 2,323.9 | –125.3 | –5.1 | –59.2 | –2.5 | 47.1 | 2.1 | 11.4 |
| **By sex** | | | | | | | | |
| Males | 11,758.9 | –100.5 | –0.8 | –238.2 | –2.0 | –330.7 | –2.7 | 57.8 |
| Females | 8,587.4 | 21.7 | 0.3 | 107.6 | 1.3 | 166.5 | 2.0 | 42.2 |
| **TOTAL** | **20,346.3** | **–78.8** | **–0.4** | **–130.5** | **–0.6** | **–164.3** | **–0.8** | **100.0** |

SOURCE: National Institute of Statistics and own calculations.

**Number of those employed under permanent hiring contract up compared with year before.**

manufactured products showed an employee cut of 17,100 while the chemical industry was down 14,200.

In a similar way, the trend in the various services branches over the past year has been uneven, although most branches increased employment. The most expansionist was retail trade (with an increase of 71,600 persons) and company services which reported a rise of 63,800. On the other hand, the hotel and restaurant trade showed a drop of 10,200 in the number of those employed.

In the past year, the total number of wage-earners was down by 123,600 (0.7%). The wage employment rate rose by 2 decimals to 82.3%. Those on permanent hiring contract rose by 320,000 whereas the total for temporary workers was down by 443,800. Nevertheless, in the third quarter the temporary employment rate was up one decimal compared with the previous quarter going to 29.5%. In the past 12 months, the number of self-employed workers was down by 48,200 (1.3%). This drop may largely be explained by

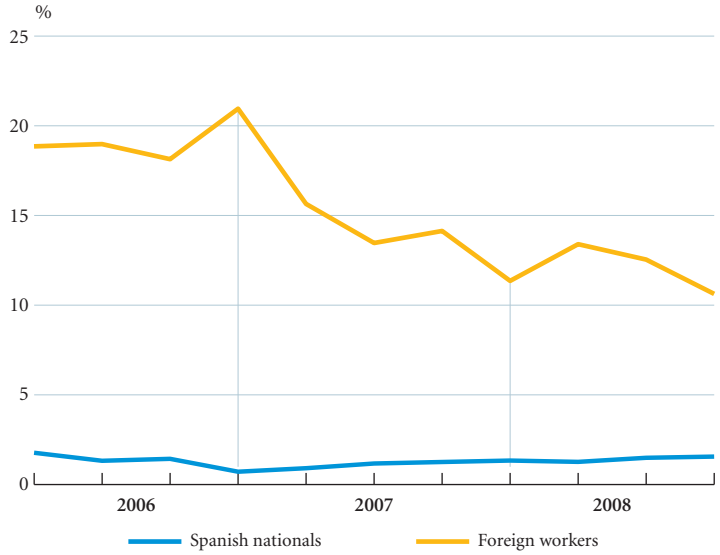
the decrease in the number of business entrepreneurs with no employees or independent workers (with a drop of 4.25%) whereas the number of employers rose by 3.5%.

By nationality, the number of Spanish nationals employed was down 1.5% compared with the third quarter of 2007 whereas the number of foreign workers was up 3.6%. As a result, the proportion

**Employment of Spanish nationals down 1.5% while foreign workers move up 3.6%.**

## LABOUR FORCE GROWTH SHOWING SCARCELY ANY SLOWDOWN

Year-on-year change rate in labour force




SOURCE: INE and own calculations.

## ESTIMATED UNEMPLOYMENT

Third quarter 2008

| | No. of unemployed | Quarterly change | | Annual change | | Share % | Unemployment rate over labour force % |
|---|---|---|---|---|---|---|---|
| | | Absolute | % | Absolute | % | | |
| **By sex** | | | | | | | |
| Males | 1,353.6 | 170.7 | 14.4 | 552.6 | 69.0 | 52.1 | 10.3 |
| Females | 1,245.2 | 46.6 | 3.9 | 254.2 | 25.7 | 47.9 | 12.7 |
| **By age** | | | | | | | |
| Under 25 years | 613.0 | 39.1 | 6.8 | 154.9 | 33.8 | 23.6 | 24.2 |
| Other | 1,985.8 | 178.2 | 9.9 | 652.0 | 48.9 | 76.4 | 9.7 |
| **By personal situation** | | | | | | | |
| Long-term unemployment | 609.5 | 22.9 | 3.9 | 147.8 | 32.0 | 23.5 | – |
| Seeking first job | 257.3 | 34.9 | 15.7 | 47.2 | 22.5 | 9.9 | – |
| Other | 1,732.0 | 159.6 | 10.2 | 611.9 | 54.6 | 66.6 | – |
| **TOTAL** | **2,598.8** | **217.2** | **9.1** | **806.9** | **45.0** | **100.0** | **11.3** |

SOURCE: National Institute of Statistics and own calculations.

**Reduction in employment and growth of labour force raise unemployment 45% in past 12 months.**

of the latter reached 14.5% of the total. Most foreign workers were employed in services (63.6%). In construction, foreign workers made up 20.0%, a proportion nearly twice the weight for the sector (11.9%). Some 11.3% of all immigrants worked in industry while 5.1% were working in agriculture.

The worse situation in the labour market scarcely slowed down the increase in the labour force which went up 0.6% in the quarter and 2.9% over the past year, 2 decimals less than in the previous quarter. The increase in the labour force was affected by the arrival of foreign workers, who made up 34.6% of the quarterly increase, and 53.6% of the increase over the past 12 months. The male activity rate rose by 2 decimals to 60.0%. Both the male and female activity rates were up 2 decimals during the quarter. The former stood at 69.8% while the latter was 50.5%. The activity rate among the foreign worker population was down 4 decimals during the quarter but held at more than 18 points above the Spanish worker rate. This difference may largely be explained by the different age structure.

**Unemployment rate goes up 9 decimals to 11.3%.**

The combined change of a reduction in the number of those employed and an increase in the labour force resulted in a sharp rise in unemployment (217,200 in the quarter and 896,900 since the third quarter of last year) putting the total at 2,598,800, an annual increase of 45.0%. The unemployment rate rose by 9 decimals to 11.3%. Both

## LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Third quarter 2008

| | In work force | | | Employed | | | Unemployed | | | Unemployment rate (%) |
|---|---|---|---|---|---|---|---|---|---|---|
| | Total (thousands) | Annual change | % annual change | Total (thousands) | Annual change | % annual change | Total (thousands) | Annual change | % annual change | |
| Andalusia | 3,845 | 152 | 4.1 | 3,140 | –88 | –2.7 | 705 | 240 | 51.8 | 18.3 |
| Aragon | 659 | 7 | 1.0 | 618 | –3 | –0.4 | 41 | 9 | 29.4 | 6.2 |
| Asturias | 501 | 25 | 5.2 | 463 | 21 | 4.8 | 38 | 3 | 10.2 | 7.5 |
| Balearic Islands | 590 | 27 | 4.9 | 534 | –3 | –0.5 | 55 | 30 | 121.0 | 9.4 |
| Canary Islands | 1,046 | 25 | 2.4 | 863 | –49 | –5.3 | 183 | 73 | 67.0 | 17.5 |
| Cantabria | 282 | 5 | 1.9 | 264 | 3 | 1.1 | 18 | 3 | 16.1 | 6.3 |
| Castile-Leon | 1,190 | 19 | 1.6 | 1,078 | –10 | –0.9 | 111 | 29 | 35.2 | 9.3 |
| Castile-La Mancha | 957 | 34 | 3.7 | 849 | –10 | –1.1 | 109 | 44 | 68.3 | 11.3 |
| Catalonia | 3,839 | 58 | 1.5 | 3,495 | –30 | –0.9 | 344 | 88 | 34.4 | 9.0 |
| Valencian Community | 2,525 | 81 | 3.3 | 2,213 | –18 | –0.8 | 313 | 99 | 46.6 | 12.4 |
| Extremadura | 487 | 11 | 2.2 | 416 | –2 | –0.4 | 71 | 12 | 20.7 | 14.6 |
| Galicia | 1,327 | 24 | 1.9 | 1,215 | –1 | 0.0 | 112 | 25 | 28.5 | 8.5 |
| Madrid Community | 3,370 | 102 | 3.1 | 3,087 | 15 | 0.5 | 283 | 87 | 44.1 | 8.4 |
| Murcia | 721 | 32 | 4.6 | 620 | –13 | –2.0 | 102 | 45 | 78.9 | 14.1 |
| Navarre | 312 | 9 | 3.1 | 290 | 1 | 0.2 | 22 | 9 | 66.8 | 7.1 |
| Basque Country | 1,074 | 22 | 2.0 | 1,007 | 18 | 1.8 | 67 | 4 | 5.8 | 6.3 |
| La Rioja | 160 | 8 | 5.1 | 147 | 3 | 1.7 | 13 | 5 | 65.1 | 8.3 |
| Ceuta and Melilla | 60 | 3 | 4.3 | 48 | 2 | 3.5 | 12 | 1 | 7.9 | 20.4 |
| **TOTAL** | **22,945** | **643** | **2.9** | **20,346** | **–164** | **–0.8** | **2,599** | **807** | **45.0** | **11.3** |

SOURCE: National Institute of Statistics and own calculations.

in the quarter and the past year unemployment has increased in all sectors, including among those seeking a first job. In absolute figures, unemployment among males rose to the point where it was higher than that among females, although the respective unemployment rates stood at 10.3% and 12.7%, although there was a progressive narrowing of the difference between the two rates. By nationality, the unemployment rate for Spanish nationals rose to 10.2% whereas the rate for foreign workers moved up to 17.5%.

By autonomous community, the trend in the labour market was very uneven. Over the past year, employment has increased notably in Asturias (up 4.8%), the Basque Country (1.8%) and La Rioja (1.7%), whereas there were notable decreases in Canary Islands (down 5.3%), Andalusia (2.7%) and Murcia (2.0%). Andalusia and Canary Islands headed the unemployment rate list going above 17% whereas the lowest unemployment showed up in Aragon, Basque Country and Cantabria with rates close to 6%.

**Andalusia and Canary Islands head unemployment list with rates above 17%.**

## Registered unemployment substantially worse in September

The number of unemployed registered at public employment services rose to 2,625,368 at the end of September. This figure meant a year-on-year increase of 30.1%, with a tendency to a rise in unemployment. The monthly increase of 95,367 unemployed persons in September this year stands in contrast to the monthly drop of 183 persons in September 2007.

On the other hand, to relieve the unemployment problem, the government put into force a plan for the voluntary return of non-EU foreign workers legally registered as unemployed whose countries of origin have Social Security agreements with Spain and who agree not to return within three years. Under this plan, these foreign workers may receive accumulated unemployment benefits ahead of time.

**Plan for voluntary return of non-EU foreign workers.**

**REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE**

September 2008

| | No. of unemployed | Change over December 2007 | | Change over same period year before | | % share |
|---|---|---|---|---|---|---|
| | | Absolute | % | Absolute | % | |
| **By sector** | | | | | | |
| Agriculture | 85,591 | 16,779 | 24.4 | 20,433 | 31.4 | 3.3 |
| Industry | 329,286 | 49,305 | 17.6 | 59,369 | 22.0 | 12.5 |
| Construction | 443,301 | 159,434 | 56.2 | 204,409 | 85.6 | 16.9 |
| Services | 1,518,162 | 233,912 | 18.2 | 296,702 | 24.3 | 57.8 |
| First job | 249,028 | 36,391 | 17.1 | 27,092 | 12.2 | 9.5 |
| **By sex** | | | | | | |
| Males | 1,218,732 | 333,593 | 37.7 | 431,381 | 54.8 | 46.4 |
| Females | 1,406,636 | 162,228 | 13.0 | 176,624 | 14.4 | 53.6 |
| **By age** | | | | | | |
| Under 25 years | 319,643 | 79,260 | 33.0 | 85,224 | 36.4 | 12.2 |
| All other ages | 2,305,725 | 416,561 | 22.1 | 522,781 | 29.3 | 87.8 |
| **TOTAL** | **2,625,368** | **495,821** | **23.3** | **608,005** | **30.1** | **100.0** |

SOURCE: INEM and own calculations.

# Prices

## CPI moving down

**CPI down 4 decimals to 4.5% in September...**

The downturn in inflation of consumer prices that began in August was confirmed in September. This was after having reached the highest level in the last 15 years in July. The annual change rate in the consumer price index (CPI) thus went to 4.5%, some 4 decimals less than in the month before. The downward trend in inflation was largely due to the drop in oil and other commodity prices which had reached all-time highs at the beginning of summer. In any case, it is worth noting that in September inflation in the more stable core of prices (so-called underlying inflation) was down one decimal to 3.4% following four months of increases.

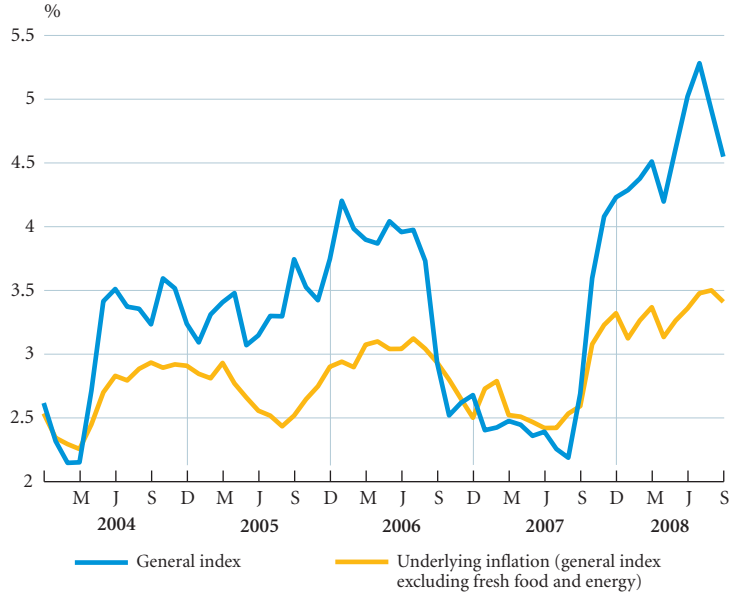
**...largely thanks to drop in fuel prices...**

The greater part of the decrease in the inflation rate in September may be attributed to the reduction in year-on-year inflation in fuels and lubricants which went down from 20.0% in August to 15.7% in September as a result of the big drop in crude oil prices. Another volatile component of inflation, fresh foods, also contributed slightly to the easing of inflation due to the drop in year-on-year inflation in poultry that went down 1.8 points to 3.4%.

The one-decimal drop in underlying inflation in September was largely due

**UNDERLYING INFLATION EASES AFTER FOUR MONTHS OF INCREASES**

Year-on-year change in CPI




SOURCE: National Institute of Statistics (INE).

## CONSUMER PRICE INDEX

| | 2007 | | | 2008 | | |
|---|---|---|---|---|---|---|
| | % monthly change | % change over December 2006 | % annual change | % monthly change | % change over December 2007 | % annual change |
| January | –0.7 | –0.7 | 2.4 | –0.6 | –0.6 | 4.3 |
| February | 0.1 | –0.6 | 2.4 | 0.2 | –0.5 | 4.4 |
| March | 0.8 | 0.1 | 2.5 | 0.9 | 0.4 | 4.5 |
| April | 1.4 | 1.5 | 2.4 | 1.1 | 1.5 | 4.2 |
| May | 0.3 | 1.8 | 2.3 | 0.7 | 2.2 | 4.6 |
| June | 0.2 | 2.0 | 2.4 | 0.6 | 2.8 | 5.0 |
| July | –0.7 | 1.3 | 2.2 | –0.5 | 2.3 | 5.3 |
| August | 0.1 | 1.4 | 2.2 | –0.2 | 2.1 | 4.9 |
| September | 0.3 | 1.7 | 2.7 | 0.0 | 2.0 | 4.5 |
| October | 1.3 | 3.0 | 3.6 | | | |
| November | 0.7 | 3.8 | 4.1 | | | |
| December | 0.4 | 4.2 | 4.2 | | | |

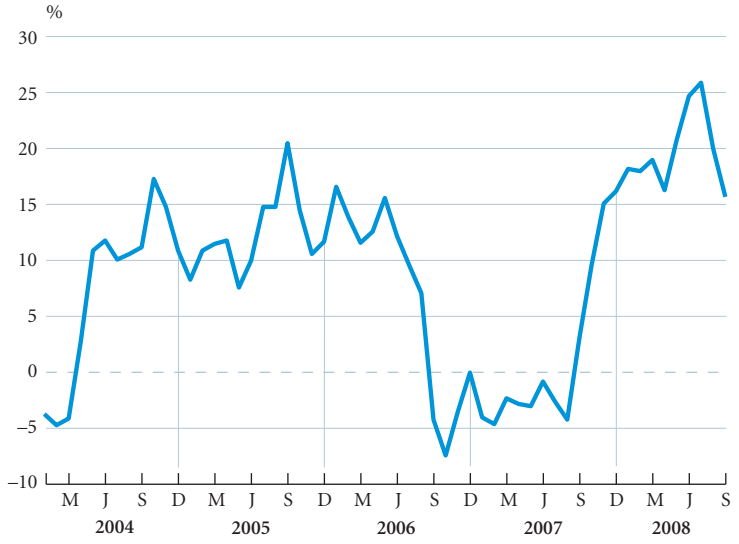
SOURCE: National Institute of Statistics.

to milk. Annual inflation in this product continued to ease and went to 12.3% in September, less than half of the 31.7% figure reported in December 2007, once supply became more normal. Bread, another basic processed food, also helped ease inflation, reflecting the drop in wheat prices in world markets in recent months.

**...and some basic foods.**

## FUELS AND LUBRICANTS PUSH INFLATION DOWN

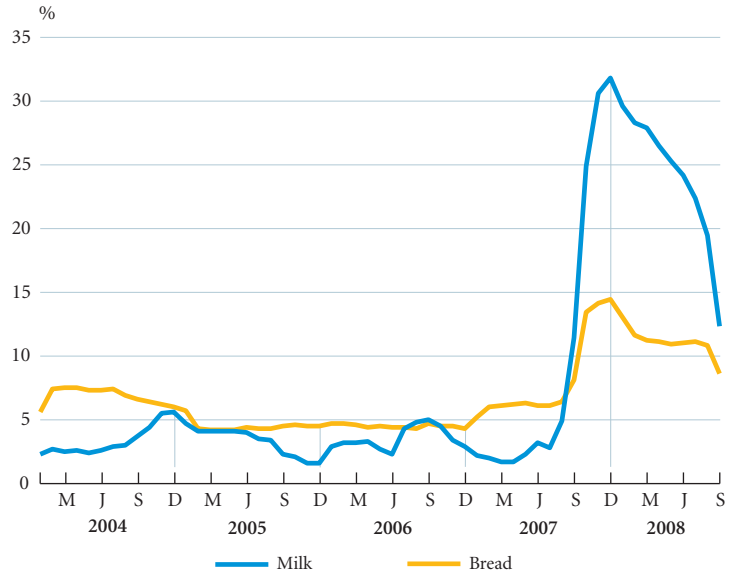
Year-on-year change in prices of fuels and lubricants




SOURCE: INE.

## MILK AND BREAD HELP REDUCE INFLATION

Year-on-year change in prices




SOURCE: INE.

**Services continue to show inflationary pressures.**

Industrial goods, excluding energy products, maintained the change rate in prices at 0.5% thanks to strong competition in international markets. The containment of prices is also a result of weak demand. Prices of motorcycles and bicycles were down by 3.0% over the last 12 months.

Nevertheless, services (being more sheltered from foreign competition) continue to show inflationary pressures. The year-on-year change rate rose by one decimal to stand at 4.1%. Over the past year ending in September child education rose by 5.8% while medical consultations were up 5.0%.

**Inflation could end year below 3%.**

The price index harmonized with the European Union reported a year-on-year increase of 4.6% in September, 4 decimals less than the month before. Given that inflation in the Euro Area was down less, the differential was cut by two decimals to 0.9 percentage points. The narrowing of the gap was partly due to the higher proportion of fuels in the Spanish shopping basket and that taxes on these products carry less weight, so that the drop in fuel prices has a bigger impact on national consumer price index.

The present situation with a sharp drop in demand and the low level reached in oil prices promise a continuation of the downward trend in inflation in coming months. As a result, annual inflation could stand below 3% at year-end if there is no halt in the downward course of commodity prices.

## CONSUMER PRICE INDEX BY COMPONENT GROUP

September

| | Indices (*) | % monthly change | | % change over previous December | | % annual change | |
|---|---|---|---|---|---|---|---|
| | | 2007 | 2008 | 2007 | 2008 | 2007 | 2008 |
| **By type of spending** | | | | | | | |
| Food and non-alcoholic beverages | 110.6 | 0.9 | 0.2 | 2.8 | 2.3 | 3.4 | 6.1 |
| Alcoholic beverages and tobacco | 111.5 | 0.0 | 0.1 | 5.6 | 3.7 | 6.4 | 4.2 |
| Clothing and footwear | 97.7 | 3.5 | 3.6 | –9.2 | –9.8 | 1.0 | 0.5 |
| Housing | 112.3 | 0.0 | 0.0 | 3.4 | 6.5 | 3.2 | 7.9 |
| Furnishings and household equipment | 105.5 | 0.3 | 0.4 | 1.5 | 1.6 | 2.5 | 2.6 |
| Health | 98.6 | 0.0 | 0.1 | –2.5 | 0.1 | –2.2 | 0.6 |
| Transport | 110.1 | 0.3 | –1.1 | 4.5 | 4.5 | 2.6 | 7.2 |
| Communications | 100.1 | 0.0 | 0.0 | 1.1 | 0.2 | 0.4 | –0.1 |
| Recreation and culture | 99.8 | –1.7 | –1.7 | –0.6 | 0.4 | –1.0 | 0.2 |
| Education | 108.9 | 0.7 | 1.2 | 1.3 | 1.6 | 4.5 | 4.4 |
| Restaurants and hotels | 110.9 | –0.9 | –0.9 | 4.6 | 4.5 | 4.9 | 4.8 |
| Other goods and services | 107.3 | 0.1 | 0.3 | 2.6 | 3.2 | 3.0 | 3.6 |
| **By group** | | | | | | | |
| Processed food, beverages and tobacco | 111.1 | 0.9 | 0.2 | 3.5 | 3.0 | 3.7 | 6.9 |
| Unprocessed food | 109.8 | 0.7 | 0.4 | 2.3 | 1.3 | 4.0 | 3.9 |
| Non-food products | 106.5 | 0.2 | –0.1 | 1.3 | 1.9 | 2.3 | 4.1 |
| Industrial goods | 104.3 | 0.9 | 0.3 | –0.7 | 0.3 | 1.0 | 4.1 |
| *Energy products* | *117.8* | *0.6* | *–1.8* | *6.4* | *9.5* | *2.3* | *14.8* |
| *Fuels and oils* | *119.0* | *0.7* | *–2.4* | *7.6* | *9.3* | *2.1* | *16.2* |
| *Industrial goods excluding energy products* | *99.9* | *1.0* | *1.1* | *–3.0* | *–2.8* | *0.4* | *0.5* |
| Services | 108.8 | –0.6 | –0.5 | 3.3 | 3.6 | 3.7 | 4.1 |
| Underlying inflation (**) | 106.1 | 0.3 | 0.2 | 1.1 | 1.2 | 2.6 | 3.4 |
| **GENERAL INDEX** | **107.5** | **0.3** | **0.0** | **1.7** | **2.0** | **2.7** | **4.5** |

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

### Wholesale prices now passing through recent drop in commodity prices

The drop in commodity prices in recent months, especially in oil since July, continue to be passed through to wholesale prices in which inflation had reached the highest levels in recent years. Behind this drop lie a number of supply and demand factors. One of the biggest factors has been the slowdown in the real economy that is showing the effects of the world financial crisis in recent times.

The annual inflation rate for producer prices continued to drop in September, going to 8.1%, some 1.1 points below the month before and 2.2 points less than the highest figure since 1984 recorded in July. All components contributed to the downward slide, energy being the most notable with an annual change rate that went down by

**Growth of producer prices slowing down but still holding at 8.1% at annual rate.**

## INFLATION INDICATORS

Percentage change over same period year before

| | Farm prices | Producer price index | | | | | Import prices | | | | GDP deflactor (*) |
|---|---|---|---|---|---|---|---|---|---|---|---|
| | | General index | Consumer goods | Capital goods | Intermediate goods | Energy goods | Total | Consumer goods | Capital goods | Intermediate goods | |
| **2007** | | | | | | | | | | | |
| July | 2.5 | 2.3 | 1.9 | 3.1 | 5.6 | –2.6 | 0.7 | 0.9 | –0.2 | 4.3 | – |
| August | 5.1 | 2.3 | 2.4 | 3.1 | 5.4 | –2.9 | 0.7 | 1.4 | 0.2 | 3.8 | 3.0 |
| September | 12.1 | 3.4 | 3.2 | 3.2 | 5.4 | 0.8 | 2.0 | 1.0 | 0.3 | 3.1 | – |
| October | 13.8 | 4.7 | 4.2 | 3.2 | 5.3 | 6.1 | 3.1 | 0.6 | 0.0 | 2.0 | – |
| November | 15.7 | 5.4 | 4.5 | 3.1 | 5.1 | 9.8 | 4.1 | 0.7 | 0.0 | 0.7 | 3.0 |
| December | 17.6 | 5.9 | 4.8 | 2.9 | 5.0 | 11.6 | 4.9 | 1.1 | –0.1 | 0.7 | – |
| **2008** | | | | | | | | | | | |
| January | 11.1 | 6.6 | 5.4 | 2.7 | 5.9 | 13.3 | 6.7 | 1.1 | 0.4 | 1.8 | – |
| February | 7.3 | 6.6 | 5.4 | 2.5 | 6.0 | 13.3 | 6.8 | 1.4 | 0.3 | 1.8 | 3.2 |
| March | 10.5 | 6.9 | 5.5 | 2.3 | 6.3 | 14.6 | 6.7 | 0.7 | –0.2 | 2.1 | – |
| April | 8.5 | 7.2 | 5.3 | 2.3 | 6.0 | 16.5 | 6.8 | 0.6 | –0.2 | 2.2 | – |
| May | 15.2 | 7.9 | 5.3 | 2.0 | 5.9 | 21.2 | 9.1 | 0.7 | –0.1 | 3.0 | 3.4 |
| June | 8.6 | 9.0 | 5.4 | 2.1 | 6.3 | 25.5 | 10.3 | 1.1 | –0.3 | 3.4 | – |
| July | 14.1 | 10.3 | 5.2 | 2.3 | 7.4 | 30.3 | 10.6 | 0.5 | –0.1 | 4.7 | – |
| August | ... | 9.2 | 4.9 | 2.3 | 7.5 | 25.6 | 8.6 | 0.6 | 0.0 | 5.2 | ... |
| September | ... | 8.1 | 4.2 | 2.1 | 7.1 | 21.6 | ... | ... | ... | ... | – |

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

**Livestock products prices moderating but some agricultural products rise.**

3.7 points, although it still stood at the high level of 21.6%, with the possibility of further decreases.

Looking at the various branches, the most inflationary over the past year were energy and metallurgy, which reflect the earlier price increases in commodities. On the other hand, the manufacture of office machines and computer equipment showed an annual drop of 1.8% in price levels due to sharp competition in world markets and gains in productivity. At the same time, motor vehicle manufacture showed little annual inflation at 1.0%.

With regard to import prices, the year-on-year inflation rate also began to ease in August after having recorded a high level of 10.6% in July. The downward drive came in energy for which the annual change rate dropped by 12 points to 41.4%. On the other hand, annual inflation on consumer goods, capital goods and intermediate goods rose slightly, under pressure from a euro dropping in value.

With regard to prices obtained by farmers, these continued to be erratic in July with a rise of annual inflation taking it to 14.1%, although this rate was lower than the annual high in May. The rise was due to farm products, which rose by 20.9% in the past 12 months, given that inflation on market livestock was down to 2.0% while livestock products were also lower with a drop to 10.0%.

# Foreign sector

## Trade deficit easing

For the period between January and August 2008, the trade deficit stood at 67.11 billion euros, a level 7.0% higher than that recorded in the same time frame one year earlier. As a cumulative balance for 12 months, the trade deficit in August was 103.37 billion euros, a figure that represents an increase of 10.1% year-on-year. Taken together, these figures suggest that the trade deficit is beginning a stage of lower growth although this correction is coming about at a very gradual rate. In turn, the export/import ratio stood at 65.4%.

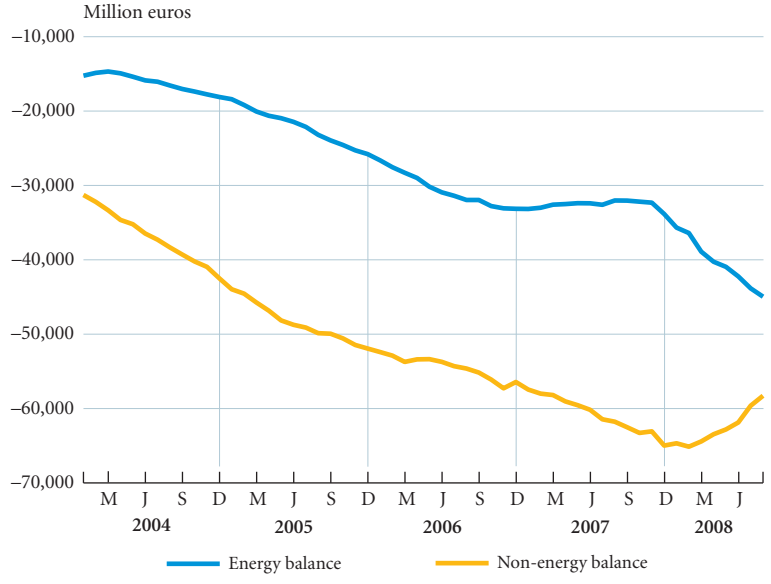
If Spain's economy is reducing the sharp rate seen in recent months, why is the trade deficit still increasing? To a large extent this is due to the role being played by energy products in the trade deficit. If we compare the energy deficit in the January-August period of 2008 with the same months one year earlier, we find that energy products are responsible for 70% of the increase in Spain's trade deficit.

The fact that up to July imported oil prices continued to rise helps explain why Spain's trade imbalance continues to be so high. In this respect, the correction taking place in energy

**Trade deficit continues to grow although at lower rate.**

**ENERGY DEFICIT EATS UP IMPROVEMENT IN NON-ENERGY IMBALANCE**

Trade balance by product type (*)




NOTES: (*) Total for last 12 months.
SOURCE: Department of Customs and Special Taxes and own calculations.

## FOREIGN TRADE

January-August 2008

| | Imports | | | Exports | | | Balance | Export/ Import rate (%) |
|---|---|---|---|---|---|---|---|---|
| | Million euros | % annual change by value | % share | Million euros | % annual change by value | % share | Million euros | |
| **By product group** | | | | | | | | |
| Energy products | 40,440 | 53.6 | 20.9 | 7,836 | 61.5 | 6.2 | –32,605 | 19.4 |
| Consumer goods | 46,745 | –6.6 | 24.1 | 44,574 | 3.8 | 35.2 | –2,171 | 95.4 |
| *Food* | *10,378* | *3.1* | *5.4* | *14,779* | *7.2* | *11.7* | *4,401* | *142.4* |
| *Non-foods* | *36,367* | *–9.5* | *18.8* | *29,794* | *–1.4* | *23.5* | *–6,573* | *81.9* |
| Capital goods | 16,178 | –14.1 | 8.3 | 11,032 | 1.4 | 8.7 | –5,146 | 68.2 |
| Non-energy intermediate goods | 90,539 | 4.5 | 46.7 | 63,350 | 4.8 | 50.0 | –27,190 | 70.0 |
| **By geographical area** | | | | | | | | |
| European Union | 105,659 | –1.5 | 54.5 | 87,885 | 4.6 | 69.3 | –17,774 | 83.2 |
| *Euro area* | *88,071* | *–2.2* | *45.4* | *70,090* | *3.6* | *55.3* | *–17,982* | *79.6* |
| Other countries | 88,244 | 18.4 | 45.5 | 38,906 | 10.9 | 30.7 | –49,338 | 44.1 |
| *Russia* | *5,937* | *10.9* | *3.1* | *1,901* | *48.8* | *1.5* | *–4,035* | *32.0* |
| *United States* | *7,694* | *20.9* | *4.0* | *5,057* | *–0.8* | *4.0* | *–2,637* | *65.7* |
| *Japan* | *3,621* | *–11.1* | *1.9* | *969* | *8.1* | *0.8* | *–2,652* | *26.8* |
| *Latin America* | *10,682* | *12.7* | *5.5* | *6,129* | *–10.2* | *4.8* | *–4,554* | *57.4* |
| *OPEC* | *20,081* | *43.0* | *10.4* | *4,438* | *29.6* | *3.5* | *–15,643* | *22.1* |
| *Rest* | *40,228* | *14.3* | *20.7* | *20,412* | *16.2* | *16.1* | *–19,816* | *50.7* |
| **TOTAL** | **193,903** | **6.7** | **100.0** | **126,791** | **6.5** | **100.0** | **–67,112** | **65.4** |

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

**Reduction of non-energy imbalance compensated by bigger deficit in energy balance.**

markets at origin as of mid-July, which is reflected in the easing of oil import prices in August, opens the door to a correction of the energy deficit in coming months. Added to the likely continuation of the reduction in the non-energy deficit (a trend begun in March 2008), this change allows us to expect a significant change in direction in Spain's trade deficit.

With regard to the breakdown by product group in January-August, we should point out the major year-on-year increase in energy product exports (above 60% year-on-year), a rate that may be explained only by the small total figure involved. The two most important segments of Spain's exports in quantitative terms showed less strength. These were non-energy intermediate products (increase of 4.8% year-on-year) and consumer goods (increase of 3.8% year-on-year). In turn, energy imports and non-energy intermediate goods were the most dynamic while we should point out that both consumer goods and capital goods were down in year-on-year terms during the January-August period.

### Balance of payments: correction of current account deficit

The current account deficit stood at 7.38 billion euros in July representing an appreciable correction over the figure

of 10.03 billion euros one year earlier. Various headings contributed to this correction (trade, services, transfers and incomes) although in different degrees. The reduction in the deficit of the latter was the main reason for the drop in the current account deficit, followed by the correction of the trade deficit and the transfers deficit. Some distance behind came the increase in the services surplus.

Over a long-term perspective, we note that the current account imbalance, while not major in size, is tending to be corrected. For the 12 months ending in June this imbalance was 113.51 billion euros and one month later the figure was 110.98 billion. Approximately half the total improvement arises from the reduction in the incomes deficit whose negative contribution is getting lower and lower. The other 50% of the drop in the cumulative current account deficit for 12 months may be accounted for in approximately equal parts by the reduction in the transfers deficit and the trade deficit.

**Current account deficit corrected thanks to less negative figure for incomes balance.**

With regard to financial flows, the most notable factor is that net portfolio investment has become negative. As an indication of international investor behaviour and the flight to refuge assets, in just one year there has been a change from a net positive balance in portfolio investment of 162.67 billion euros to a negative figure of 5.56 billion euros. In turn, direct investment showed a drop in balance to 7.14 billion euros.

**Portfolio investment shows negative as result of financial upsets.**

## BALANCE OF PAYMENTS

July 2008

| | Cumulative for year | | Last 12 months | | |
|---|---|---|---|---|---|
| | Balance in million euros | % annual change | Balance in million euros | Annual change | |
| | | | | Absolute | % |
| **Current account balance** | | | | | |
| Trade balance | –53,916 | 9.2 | –94,344 | –8,419 | 9.8 |
| Services | | | | | |
| *Tourism* | *15,734* | *3.1* | *28,278* | *804* | *2.9* |
| *Other services* | *–2,391* | *–29.1* | *–4,677* | *425* | *–8.3* |
| Total | 13,343 | 12.2 | 23,600 | 1,229 | 5.5 |
| Income | –19,037 | 4.2 | –32,281 | –5,126 | 18.9 |
| Transfers | –6,415 | 21.5 | –7,868 | –606 | 8.3 |
| **Total** | **–66,026** | **8.2** | **–110,892** | **–12,922** | **13.2** |
| **Capital account** | **4,016** | **103.0** | **6,553** | **910** | **16.1** |
| **Financial balance** | | | | | |
| Direct investment | 10,256 | – | –7,140 | 40,198 | –84.9 |
| Portfolio investment | 1,077 | –99.0 | –5,563 | –168,230 | – |
| Other investment | 28,031 | – | 58,318 | 55,717 | – |
| **Total** | **39,364** | **–48.9** | **45,616** | **–72,316** | **–61.3** |
| Errors and omissions | 3,831 | 9.7 | 4,083 | 793 | 24.1 |
| Change in assets of Bank of Spain | 18,815 | – | 54,639 | 83,534 | – |

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

# Public sector

## Central government budget for 2009

**Budget macroeconomic scenario foresees GDP growth of 1.0% in 2009.**

The central government presented for debate and approval its Budget for the year 2009 in the middle of an unfavourable situation of change in business cycle. After it was made public, the international financial crisis obliged the government to adopt measures to strengthen the financial system that would force it to make changes in the course of parliamentary debate. From a comfortable surplus of 2.2% of gross domestic product (GDP) in 2007 the sharp economic slowdown will mean adoption of an appreciable deficit in 2008 and an even higher one in 2009, as recognized in the new Budget, especially because of the operation of automatic stabilizers (lower tax collections for progressive taxation, increased benefits for unemployment, etc.) whereas the 2008 Budget forecast a government surplus of 1.15% of GDP for this year.

We should point out that the 2009 Budget estimates were drawn up in reference to a macroeconomic situation in July which foresaw GDP growth of 1.6% in 2008 and 1.0% in 2009. The impact of the international financial

**CONSOLIDATED 2009 BUDGET FOR CENTRAL GOVERNMENT, AUTONOMOUS BODIES, SOCIAL SECURITY AND OTHER BODIES**

Million euros

| EXPENDITURES | Central government | Autonomous bodies | Social Security | Other bodies | Total consolidated | % change over initial budget |
|---|---|---|---|---|---|---|
| **Current transactions** | | | | | | |
| Staff costs | 26,833 | 2,045 | 2,453 | 1,727 | 33,058 | 5.6 |
| Current goods and services | 3,499 | 2,307 | 1,995 | 740 | 8,540 | 2.0 |
| Financial costs | 17,124 | 31 | 19 | 0 | 17,174 | 3.0 |
| Current transfers | 85,657 | 36,307 | 113,332 | 775 | 217,219 | 5.4 |
| **Total** | **133,113** | **40,690** | **117,799** | **3,242** | **275,991** | **5.2** |
| **Capital transactions** | | | | | | |
| Contingency fund | 3,471 | | | | 3,471 | 12.0 |
| Real investments | 10,413 | 2,168 | 515 | 590 | 13,685 | –2.7 |
| Capital transfers | 10,608 | 2,130 | 1,115 | 125 | 10,968 | 10.0 |
| **Total** | **21,021** | **4,298** | **1,629** | **715** | **24,652** | **2.6** |
| **Total non-financial transactions** | **157,604** | **44,988** | **119,428** | **3,957** | **304,114** | **5.0** |
| Financial assets | 14,275 | 937 | 10,567 | 3 | 25,782 | 4.1 |
| Financial liabilities | 33,973 | 326 | 0 | 8 | 34,307 | –1.7 |
| **Total financial transactions** | **48,248** | **1,263** | **10,567** | **11** | **60,089** | **0.7** |
| **TOTAL** | **205,852** | **46,251** | **129,996** | **3,968** | **364,203** | **4.3** |

SOURCE: Ministry of Economy and Finance and own calculations.

crisis in recent months has thrown these projections out of kilter given that they were optimistic. As a result, they are now below the consensus of most analysts.

Consolidated expenditures forecast in the 2009 Budget for the central government public sector (excluding public enterprises) is given as 329.90 billion euros, that is to say, 29.0% of forecast GDP, some 4 decimals more than in 2008. This figure represents 4.9% more than the 2008 Budget and 1.4 points more than estimated nominal growth of the economy. This consolidated growth excludes the change

**Consolidated spending up 4.9%, 1.4 points more than nominal growth of economy.**

**CENTRAL GOVERNMENT BUDGET FOR 2009: SUMMARY BY POLICY**

Million euros

| | 2009 budget | % of total | % annual change (*) | % of estimated GDP | |
|---|---|---|---|---|---|
| | | | | 2009 | 2008 |
| Pensions | 106,099 | 32.2 | 8.3 | 9.33 | 8.92 |
| Transfers to other public administrations | 66,393 | 20.1 | 0.2 | 5.84 | 6.03 |
| Unemployment | 19,616 | 5.9 | 24.3 | 1.73 | 1.44 |
| Public debt | 17,100 | 5.2 | 3 | 1.50 | 1.51 |
| Other financial payments | 14,973 | 4.5 | 6.3 | 1.32 | 1.28 |
| Infrastructures | 13,168 | 4 | –10.4 (**) | 1.16 | 1.34 |
| Management and administration of Social Security | 12,920 | 3.9 | 15 | 1.14 | 1.02 |
| Services of general nature | 9,241 | 2.8 | 2.3 | 0.81 | 0.82 |
| Agriculture, fishing and food | 8,835 | 2.7 | –0.1 | 0.78 | 0.81 |
| Police and penitentiaries | 8,647 | 2.6 | 2.3 | 0.76 | 0.77 |
| Civil research, development and innovation | 8,192 | 2.5 | 6.7 | 0.72 | 0.70 |
| Defence | 7,832 | 2.4 | –3.9 | 0.69 | 0.74 |
| Job creation | 7,584 | 2.3 | –1.3 | 0.67 | 0.70 |
| Health | 4,622 | 1.4 | 4.3 | 0.41 | 0.40 |
| Foreign policy | 3,676 | 1.1 | 6 | 0.32 | 0.32 |
| Education | 2,988 | 0.9 | 1.9 | 0.26 | 0.27 |
| Industry and energy | 2,856 | 0.9 | 22.9 | 0.25 | 0.21 |
| Social services and social promotion | 2,472 | 0.7 | 8 | 0.22 | 0.21 |
| Transport subsidies | 1,913 | 0.6 | –15.6 | 0.17 | 0.21 |
| Justice | 1,658 | 0.5 | 6 | 0.15 | 0.14 |
| Trade, tourism, small/medium businesses | 1,626 | 0.5 | 36 | 0.14 | 0.11 |
| Access to housing | 1,607 | 0.5 | 16.6 | 0.14 | 0.13 |
| Financial and tax administration | 1,597 | 0.5 | –1.9 | 0.14 | 0.15 |
| Military research, development and innovation | 1,459 | 0.4 | –12.1 | 0.13 | 0.15 |
| Culture | 1,226 | 0.4 | 0.5 | 0.11 | 0.11 |
| Other programmes of economic nature | 832 | 0.3 | –5.1 | 0.07 | 0.08 |
| Top management | 764 | 0.2 | –0.7 | 0.07 | 0.07 |
| **TOTAL** (***) | **329,896** | **100.0** | **4.9** | **29.01** | **28.61** |

NOTES: (*) Over initial homogeneous budget for 2008, taking into account extraordinary credit for immigration (RDL 1/2008).
(**) If Public Enterprise Sector included, investment in infrastructures grows by 4.5%.
(***) Includes change in financial assets.
SOURCE: Ministry of Economy and Finance and own calculations.

**Staff costs up 5.6% in spite of some containment.**

in financial liabilities and does not include that carried out by territorial governments (autonomous communities and local government) nor the activities of the public enterprise sector or other public entities such as the RTVE Corporation (Spanish Television).

Consolidated current non-financial expenditures is up 5.2%. The heading to show the biggest increase is staff costs which goes up 5.6%. The increase in pay involves only monetary updating and improvements in extra pay of a general nature. Nevertheless, the salaries of top officials are frozen. Filling of staff vacancies is also restricted to 30% with some exceptions. In turn, financial costs go up 3.0% to 17.17 billion euros, 1.5% of GDP.

**Priority given to social spending whose weight amounts to 53% of budget.**

In turn, consolidated capital costs are up 2.6% some 0.9 points less than the nominal GDP. Real investment is down by 2.7% to where it makes up 1.2% of GDP, although capital transfers rise by 10.0% to 1.0% of GDP.

Financial assets total 25.78 billion euros, an annual increase of 4.1%. This heading includes the allocation to the Social Security Reserve Fund for an amount of 8.02 billion euros. Nevertheless, some headings seem closer to spending than to financial investment, such as in the case of 2.09 billion euros going into credits of the Development Aid Fund.

From another point of view, by expenditure policy, we note the priority firmly established by the government in terms of social expenditure. In fact, social expenditure as a whole is up 9.5%, substantially above the nominal GDP, so that in relation to this there is an increase of 8 decimals to 15.3%. At the same time, its weighting in the total consolidated Budget goes up 2.2 points to 52.8%.

**Pensions and unemployment benefits take up 38% of total spending.**

Under social expenditure, the main heading is pensions which make up nearly one-third of the consolidated Budget with an increase of 8.3%. Expenditure for pensions represents 9.3% of GDP. The increase in this heading comes from maintaining the purchasing power of pensions, an improvement of an average of 6% in the lowest pensions and a larger number of pensioners, among other factors. The other large heading for social expenditure, namely unemployment, shows a still bigger increase (24.3%) to meet an economic situation that will bring about a major increase in the number of unemployed. Pensions and unemployment together make up 38.1% of total spending. Nevertheless, job creation policies are down 1.3% to 7.58 billion euros, due to a reduction in spending on hiring contract incentives.

Among other social expenditure, the heading to increase most is access to housing with a rise of 16.6%. Nevertheless, the amount is relatively modest at 1.61 billion euros, or 0.5% of the total. At a more broken down level, however, aid to dependent persons goes up by 33.0%.

Another clear government priority is infrastructures. In the consolidated Budget, expenditure on infrastructures stands at 13.17 billion euros, 4.0% of the total and 1.16% of GDP, with a decrease of 10.4% compared with the year before. Nevertheless, this decrease involves a change in the financing of infrastructures managed by public enterprises such as ASIF (responsible for railway infrastructures) and SEITTSA (that carries out and/or exploits road and rail infrastructures). In fact, if we

include the public enterprises sector, investment in infrastructures is up 4.5%.

Expenditure on R&D was also given priority. Civil research, development and innovation goes up by 6.7% to make up 2.5% of the total. Nevertheless, this increase is considerably less than last year's 17.4%. With regard to military research, development and innovation, the Budget allocation is down by 12.1% to 0.4% of the total. Overall, civil and military R&D in the consolidated Budget represents 0.85% of GDP, the same level as in 2008 but below the level of investment in the most developed countries.

Basic public services are up by only 0.8% because of the austerity wave, representing a negative rise in real terms, that is to say, discounting the inflation rate. Nevertheless, two headings (justice and foreign policy) are up by 6.0%. Justice is given some priority in view of the current restructuring process. Policing and penitentiaries, on the other hand, is up by only 2.3%. The biggest cut appears in defence which is down by 3.9% to 2.4% of the total and 0.69% of GDP.

**Total R&D&I maintains relation to GDP.**

On the other side of the budgetary balance sheet, it is expected that receipts will drop by 2.3% to 301.43 billion euros (26.5% of GDP) while non-financial receipts will drop by 2.2% in terms of the initial Budget estimates. In the initial Budget estimates, the tax load (direct taxes, indirect taxes and social security contributions) stands at 23.4% of GDP in 2009, one point less than in the initial 2008 Budget estimates, which is largely due to the economic slowdown. We should point out that the upward trend in the tax load of public

**Tax load down one point after having gone above OECD average.**

**CONSOLIDATED 2009 BUDGET FOR CENTRAL GOVERNMENT, AUTONOMOUS BODIES AND SOCIAL SECURITY AND OTHER BODIES**

Million euros

| RECEIPTS | Central government | Autonomous bodies | Social Security | Other bodies | Total consolidated | % change over initial budget |
|---|---|---|---|---|---|---|
| **Current transactions** | | | | | | |
| Direct taxes and social insurance contributions | 77,041 | 26,703 | 112,437 | – | 216,181 | –1.8 |
| Indirect taxes | 50,202 | – | – | – | 50,202 | –5.9 |
| Fees and other revenue | 3,732 | 1,540 | 1,056 | 242 | 6,570 | 29.2 |
| Current transfers | 5,807 | 11,104 | 11,306 | 2,844 | 12,208 | –3.5 |
| Property earnings | 3,181 | 791 | 2,715 | 35 | 6,722 | 15.4 |
| **Total** | **139,962** | **40,138** | **127,513** | **3,121** | **291,882** | **–1.7** |
| **Capital transactions** | | | | | | |
| Disposal of real investments | 120 | 247 | 1 | 0 | 368 | –35.7 |
| Capital transfers | 1,028 | 2,933 | 1,164 | 573 | 2,687 | –34.0 |
| **Total** | **1,148** | **3,180** | **1,165** | **573** | **3,055** | **–34.2** |
| **Total non-financial transactions** | **141,110** | **43,318** | **128,678** | **3,694** | **294,937** | **–2.2** |
| Financial assets | 2,340 | 2,567 | 1,318 | 273 | 6,498 | –6.4 |
| **Total financial transactions** | **2,340** | **2,567** | **1,318** | **273** | **6,498** | **–6.4** |
| **TOTAL** | **143,450** | **45,885** | **129,996** | **3,968** | **301,435** | **–2.3** |
| *Gross borrowing requirement* | *–62,402* | *–366* | – | – | *–62,768* | *54.4* |

SOURCE: Ministry of Economy and Finance and own calculations.

**Notable drop expected in collections for company tax.**

administrations took it above the average for countries of the Organization for Economic Cooperation and Development (OECD) in 2006 and in 2007 in spite of the last fiscal reform, according to figures prepared by that international body.

In tax collections, the main heading (personal income tax) is expected to go up by 6.7% compared with the increase in collections in 2008. It should be noted that, as opposed to the year before, in 2009 the tax rate will not be changed (not even by only 2%) neither in the case of personal or family minimum amounts nor reductions for work earnings, which in itself means a *de facto* increase in the tax load of this tax.

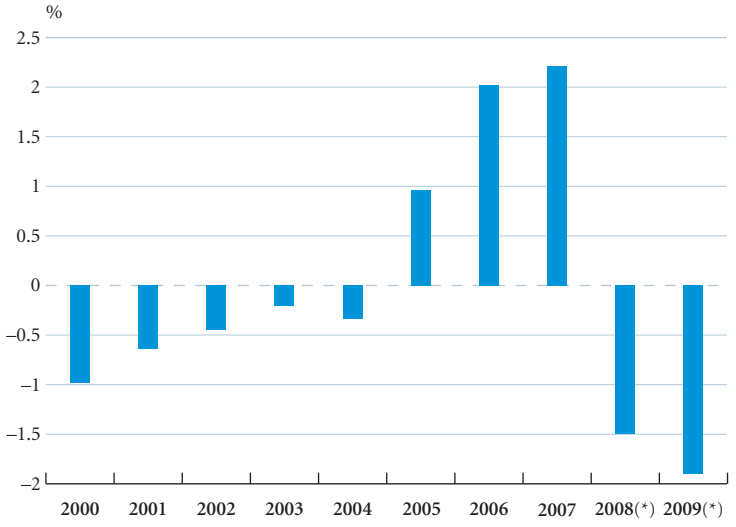
Company tax goes down 15.1% in terms of early figures for collections in 2008 because of the unfavourable trend in corporate profits. Social Security contributions go up by 7.5% due to an increase of 7.2% in payments by companies and employed workers and 10.4% in the case of unemployed persons. Nevertheless, the size of the former rate seems to be rather the product of optimistic calculations still taking into account the increase in contribution bases, given that the macroeconomic picture for the 2009 Budget involves a drop of 0.5% in employment.

**Government deficit goes up to 1.9% of GDP in 2009.**

The 2009 Budget shows a consolidated deficit in terms of National Accounting equivalent to 1.9% of GDP, 4 decimals more than that forecast for 2008. This is the result of a deficit in central government of 1.5% of GDP, a surplus of 0.8% in Social Security and a deficit of 1.0% in the Autonomous Communities and 0.2% in local governments. As a result, the debt ratio of general government in terms of GDP goes up to 38.8% of GDP, some 2.6 points above that in 2007.

**GOVERNMENT DEFICIT RETURNS WITH CHANGE IN STAGE OF BUSINESS CYCLE**

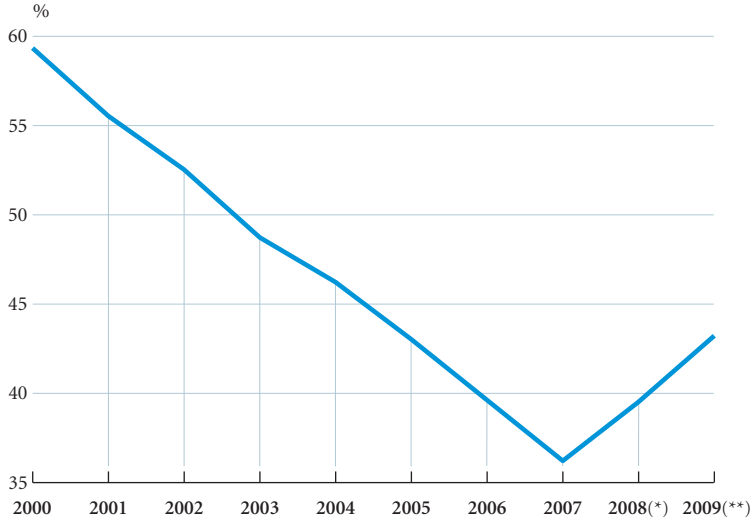
Surplus (+) / or deficit (–) of general government in relation to GDP




NOTES: (*) Official forecasts.
SOURCE: Ministry of Economy and Finance.

## INCREASE IN GOVERNMENT DEBT

Debt of general government as percentage of GDP




NOTES: (*) Budget forecast plus funding of 30 billion euros for Fund for Acquisition of Financial Assets.
(**) Budget forecast plus funding of 50 billion euros from Fund for Acquisition of Financial Assets.
SOURCE: Ministry of Economy and own calculations.

Nevertheless, this figure in the initial budget estimates must be raised to 43.2% of GDP if we take into account the deficit of 50 billion euros in the Fund for the Acquisition of Financial Assets created by the government in October in view of the worsening of the international financial crisis. This is without taking into account the eventual cost of the extraordinary program for authorizing guarantees for bond issues by financial institutions. Nevertheless, the corresponding ratio of European Union government debt now stands considerably higher.

**Aid plan for financial sector will raise government debt above 40% of GDP.**

# Savings and financing

## Private sector demand for credit weakens

**Credit demand and supply contracting.**

Funding granted to companies and households continued to ease in August. The year-on-year change rate went to 8.7%, less than half that one year before, although in line with credit granted in the Euro Area. The drop in credit to the private sector was due both to a general tightening of loan terms and a contraction in demand. This may be seen from the survey of bank loans for the second quarter and prospects for the third quarter recently published by the Bank of Spain.

**Funding for housing mortgages down 33.2% in past 12 months.**

While the drop in funding affected both companies and households, annual growth in the former case was still higher than in the case of individuals. Funding obtained by non-financial companies was up 8.7% in the past 12 months ending in August. Commercial credit, used to finance working capital, recorded a year-on-year drop of 5.9%.

Loans to households continued to reduce growth rate going to an annual change of 7.2%. There was a notable drop in housing loans which recorded an annual rise of 6.8% as against 13.2% in December. Figures for housing mortgages signed supplied by the National Institute of Statistics also support this. The number of homes mortgaged in July was 72,968, some 28.6% less than one year earlier. Capital borrowed (10.24 billion euros) was 33.2% lower than in July 2007.

**MAJOR DROP IN HOUSING LOANS**

Year-on-year change in housing loans to households


SOURCE: Bank of Spain.

## CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

August 2008

| | Total | Change this year | | Change over 12 months | | % share |
|---|---|---|---|---|---|---|
| | Million euros | Million euros | % | Million euros | % | |
| Commercial credit | 82,484 | –8,358 | –9.2 | –5,138 | –5.9 | 4.5 |
| Secured loans (*) | 1,104,070 | 35,698 | 3.3 | 72,583 | 7.0 | 59.9 |
| Other term loans | 518,465 | 20,582 | 4.1 | 43,762 | 9.2 | 28.1 |
| Demand loans | 43,524 | 2,952 | 7.3 | 10,879 | 33.3 | 2.4 |
| Leasing | 47,532 | 1,239 | 2.7 | 2,918 | 6.5 | 2.6 |
| Doubtful loans | 46,125 | 29,874 | 183.8 | 32,052 | 227.8 | 2.5 |
| **TOTAL** | **1,842,200** | **81,987** | **4.7** | **157,057** | **9.3** | **100.0** |

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

Household demand for loans has dropped in recent months with the collapse of consumer confidence to all-time low levels in a context of increasing unemployment.

Other funding granted to households also slowed, although to a lesser extent, going from annual growth of 11.2% in December to 8.0% in August. The figure for new household consumer credit transactions in January-August dropped by 18.6% compared with the same period in 2007.

Loans in default continued to rise reaching more than three times the figure in August 2007. Nevertheless, the doubtful loans rate went up to only 2.5%, a relatively modest level seeing that it starts off from all-time lows. We should point out that Spanish financial institutions have a substantial provisions cushion to meet possible instances of failure to pay.

On the other hand, September saw the 1-year Euribor (used as a reference rate for many transactions) go to 5.38% as monthly average, very close to the all-time high in July, and on October 2 marked up a record going to 5.53%.

**1-year Euribor eases slightly after marking up record on October 2.**

Following the half-point cut announced by the European Central Bank on October 8, along with prospects of further cuts, widespread major injections of liquidity and all the measures worked out by the European governments to restore confidence in the financial system, the 1-year Euribor eased slightly in mid-October but continued to show the continuing lack of confidence among credit institutions. In this context, the average interest rate on loans and credits granted to the private sector continued to rise going to 6.55% in August, the highest level in recent years, representing an annual increase of 69 basis points.

In a framework of financing problems in wholesale markets, the Spanish government adopted a series of measures aimed at restoring confidence in the financial system in order to provide liquidity to companies and households. On October 10 it announced the creation of a fund for the acquisition of top quality financial assets from credit institutions up to a maximum amount of 30 billion euros, which could be increased to 50 billion. At the same time, under the joint action plan of the Euro Area countries, it authorized the granting of guarantees of up to 100 billion euros

**Government takes various measures to strengthen confidence in financial system in coordinated Euro Area plan.**

**Savings rate for past 12 months up 7 decimals to 10.7% of disposable income.**

for financing transactions in 2008, which may be extended to the end of 2009. In addition, in order to strengthen the equity of financial institutions, the government authorized the acquisition of bonds issued by banks, as well as preferred shares and participations.

## Deposits gain favour of savers

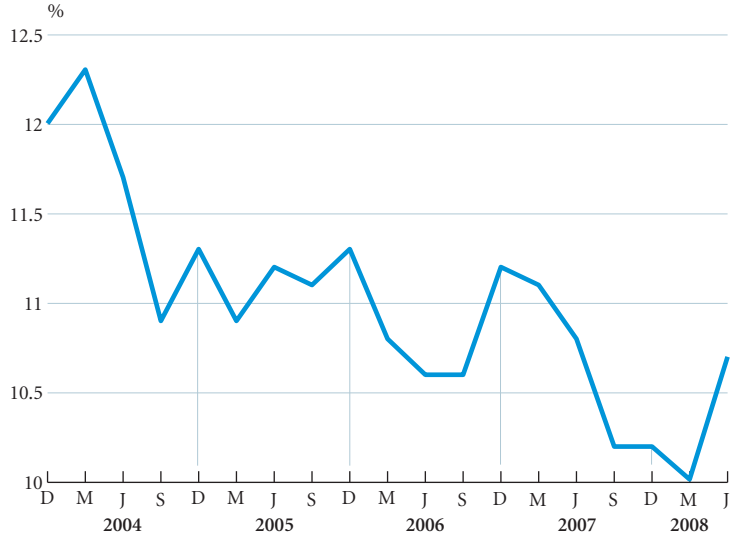
Household savings recovered in the second quarter moving up from very low levels. In the April-June period consumption rose less than disposable income (4.8% as against 8.1%) in year-on-year terms. As a result, the savings rate stood at 14.0% of disposable income, some 2.7 points more than in the same period the year before. Savings generated and capital transfers were sufficient to finance investment, mainly in housing, which was 5.0% lower than in the same period in 2007. As a result, this meant a surplus of 0.6% in the quarterly gross domestic product. There had not been a positive figure in the second quarter since 2005. If we look at movable periods of four quarters, the savings rate rose to 10.7% of disposable income, some 7 decimals more than in the previous period. This recovery in savings is logical in a period of sharp slowdown in economic activity and forms part of the adjustment now underway.

**Time deposit accounts up 49% since August 2007.**

The higher return on bank deposits reported in recent months may have contributed to the recovery of savings. The financing problems seen in bond markets led credit institutions to intensify their campaigns to attract deposits by the private sector. The yields reporting the biggest increase showed up in time deposits which stood at 4.8% for individuals in August, some 87 basis points more than 12 months earlier. Time deposits up to two years thus reported strong annual growth of 49.1%. On the other hand, sight deposits and savings deposits recorded an annual drop in totals due to their low returns. We

**HOUSEHOLD SAVINGS RECOVER STARTING FROM VERY LOW LEVELS**

Savings rate of households and non-profit institutions serving households (*)




NOTES: (*) In terms of gross disposable income. Moving average of four quarters.
SOURCE: National Institute of Statistics and internal figures.

## DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

August 2008

| | Total | Change this year | | Change over 12 months | | % share |
|---|---|---|---|---|---|---|
| | Million euros | Million euros | % | Million euros | % | |
| Overnight deposits (*) | 417,787 | –20,270 | –4.6 | –8,000 | –1.9 | 30.0 |
| Up to 2 years | 466,724 | 114,018 | 32.3 | 153,692 | 49.1 | 33.5 |
| More than 2-year term | 397,028 | –4,946 | –1.2 | 6,230 | 1.6 | 28.5 |
| Repos | 66,669 | –18,923 | –22.1 | –20,225 | –23.3 | 4.8 |
| **Total** | **1,348,208** | **69,879** | **5.5** | **131,696** | **10.8** | **96.8** |
| **Deposits in currencies other than euro** | **44,947** | **1,103** | **2.5** | **–381** | **–0.8** | **3.2** |
| **TOTAL** | **1,393,155** | **70,982** | **5.4** | **131,315** | **10.4** | **100.0** |

NOTES: (*) Includes deposits redeemable at notice, according to ECB definition.
SOURCE: Bank of Spain and own calculations.

should note that, in keeping with similar measures taken in the European Union, the government raised the guarantee on bank deposits and investments to 100,000 euros from the previous 20,000 euros.

The sharp competition for bank deposits and the upsets in financial markets continued to undermine another favourite product of savers, namely participations in mutual funds. In September, assets of these funds stood at 185.61 billion euros, showing a year-on-year drop of 26.5%. In September there were net withdrawals for a total of 5.02 billion euros. This showed up in all categories except guaranteed bond-based funds, which indicates current risk aversion levels.

Average yields varied greatly according to the various types. Money-market funds showed an average annual return of 2.68%, whereas emerging country share-based funds fared worst recording capital losses of 34.2%. Average annual weighted return over the past 17 years stood at 4.15%.

In spite of the fact that at the international level September was a poor month for hedge funds in the Spanish market, these funds continued to rise with assets going up to 1.37 billion euros. Part of the explanation is to be found in the fact that these funds are still in the early stages of development.

**Guarantee for bank deposits and investments raised to 100,000 euros.**

# "la Caixa" RESEARCH DEPARTMENT

## Publications

**All publications are available on Internet:**
**www.laCaixa.es/research**
**E-mail: publicacionesestudios@lacaixa.es**

### THE SPANISH ECONOMY MONTHLY REPORT

Report on the economic situation (available also in Spanish version)

### ANUARIO ECONÓMICO DE ESPAÑA 2008

**Selección de indicadores**
Complete edition available on Internet

### COLECCIÓN COMUNIDADES AUTÓNOMAS

**1. La economía de Galicia: diagnóstico estratégico**

**2. La economía de Illes Balears: diagnóstico estratégico**

### DOCUMENTOS DE ECONOMÍA "la Caixa"

**1. El problema de la productividad en España: ¿Cuál es el papel de la regulación?** Jordi Gual, Sandra Jódar Rosell y Àlex Ruiz Posino

**2. El empleo a partir de los 55 años** Maria Gutiérrez-Domènech

**3. *Offshoring* y deslocalización: nuevas tendencias de la economía internacional** Claudia Canals

**4. China: ¿Cuál es el potencial de comercio con España?** Marta Noguer

**5. La sostenibilidad del déficit exterior de Estados Unidos** Enric Fernández

**6. El tiempo con los hijos y la actividad laboral de los padres** Maria Gutiérrez-Domènech

**7. La inversión extranjera directa en España: ¿qué podemos aprender del tigre celta?** Claudia Canals y Marta Noguer

**8. Telecomunicaciones: ¿ante una nueva etapa de fusiones?** Jordi Gual y Sandra Jódar-Rosell

**9. El enigmático mundo de los *hedge funds*: beneficios y riesgos** Marta Noguer

**10. Luces y sombras de la competitividad exterior de España** Claudia Canals y Enric Fernández

**11. ¿Cuánto cuesta ir al trabajo? El coste en tiempo y en dinero** Maria Gutiérrez-Domènech

### "la Caixa" ECONOMIC PAPERS

**1. Vertical industrial policy in the EU: An empirical analysis of the effectiveness of state aid** Jordi Gual and Sandra Jódar-Rosell

**2. Explaining Inflation Differentials between Spain and the Euro Area** Pau Rabanal

**3. A Value Chain Analysis of Foreign Direct Investment** Claudia Canals, Marta Noguer

**4. Time to Rethink Merger Policy?** Jordi Gual

**5. Integrating regulated network markets in Europe** Jordi Gual

### "la Caixa" WORKING PAPERS

**Only available in electronic format at: www.laCaixa.es/research**

**06/2006. Inflation Differentials in a Currency Union: A DSGE Perspective** Pau Rabanal

**01/2007. Parental Employment and Time with Children in Spain** Maria Gutiérrez-Domènech

**02/2007. Trade Patterns, Trade Balances and Idiosyncratic Shocks** C. Canals, X. Gabaix, J. Vilarrubia and D. E. Weinstein

**03/2007. Non Tradable Goods and The Real Exchange Rate** Pau Rabanal and Vicente Tuesta

**04/2007. European Telecoms Regulation: Past Performance and Prospects** Jordi Gual and Sandra Jódar-Rosell

**01/2008. Offshoring and wage inequality in the UK, 1992-2004** Claudia Canals

**02/2008. The Effects of Housing Prices and Monetary Policy in a Currency Union** Oriol Aspachs and Pau Rabanal

**03/2008. Cointegrated TFP Processes and International Business Cycles** P. Rabanal, J. F. Rubio-Ramírez and V. Tuesta

### ECONOMIC STUDIES

**35. La generación de la transición: entre el trabajo y la jubilación** Víctor Pérez-Díaz y Juan Carlos Rodríguez

## Advisory Council

The Advisory Council guides the Research Department in its work of analyzing economic and social policy that may be most effective for the progress of Spanish and European society. The Council is made up as follows:

- Carles Boix
  University of Princeton
- Antonio Ciccone
  ICREA-Universitat Pompeu Fabra
- Juan José Dolado
  Universidad Carlos III
- Jordi Galí
  CREI and Universitat Pompeu Fabra
- Mauro F. Guillén
  Wharton School, University of Pennsylvania
- Inés Macho-Stadler
  Universitat Autònoma de Barcelona
- Víctor Pérez Díaz
  Universidad Complutense
- Ginés de Rus
  Universidad de Las Palmas de Gran Canaria
- Robert Tornabell
  ESADE Business School
- Xavier Vives
  IESE Business School and UPF

## General Manager

- Jordi Gual
  Chief Economist of "la Caixa"

THE SPANISH ECONOMY
**MONTHLY REPORT**
November 2008

**CAJA DE AHORROS Y PENSIONES DE BARCELONA**

**Research Department**

Av. Diagonal, 629,
torre I, planta 6
08028 BARCELONA
Tel. 34 93 404 76 82
Telefax 34 93 404 68 92
www.laCaixa.es/research

e-mail:
For enquiries regarding The Spanish Economy Monthly Report:
informemensual@lacaixa.com

For subscriptions (new, cancellations, etc.):
publicacionesestudios@lacaixa.es

## "la Caixa" GROUP: KEY FIGURES

**As of December 31, 2007**

| FINANCIAL ACTIVITY | Million euros |
|---|---|
| Total customer funds | 223,850 |
| Receivable from customers | 161,789 |
| Profit attributable to Group | 2,488 |

| STAFF, BRANCHES AND MEANS OF PAYMENT | |
|---|---|
| Staff | 26,342 |
| Branches | 5,480 |
| Self-service terminals | 8,011 |
| Cards | 9,809,909 |

| COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2008 | Million euros |
|---|---|
| Social | 306 |
| Science and environmental | 83 |
| Cultural | 79 |
| Educational | 32 |
| **TOTAL BUDGET** | **500** |

## SERIES OF TALKS - COSMOCAIXA Barcelona

## Social Sciences *vs.* Experimental Sciences: Dialogue


### EFFICIENCY *VS.* RISK

*Juan Luis Arsuaga and Anthony J. Venables*
November 25, 2008

**Series directors:**

*Jordi Gual, economist, general manager of Research and Economic Analysis Department, "la Caixa"*

*Jorge Wagensberg, physicist, general manager of Environmental and Science Department, "la Caixa" Foundation*

**Coordination: "la Caixa" Research Department**

**For more information: www.laCaixa.es/ObraSocial**

**Admission free**



Design and page make-up: www.cege.es - Ciutat d'Asunción, 42 - 08030 Barcelona
Internet edition: www.comunicacions.com - Travessera de Dalt, 30 - 08024 Barcelona
D. L.: B. 21063-1980 ISSN: 1134-1920