MAY 2009

THE SPANISH ECONOMY

Monthly Report

NUMBER 324

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2007	2008	2009	2008				2009	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	2.0	1.1	–2.4	2.5	2.1	0.7	–0.8	–2.6	–3.0
Japan	2.4	–0.7	–5.9	1.4	0.5	–0.2	–4.3	–6.8	–6.7
United Kingdom	3.0	0.7	–2.9	2.6	1.7	0.3	–1.8	–2.9	–3.2
Euro area	2.6	0.9	–2.8	2.1	1.4	0.6	–0.5	–3.2	–3.3
Germany	*2.6*	*1.0*	*–3.1*	*2.8*	*2.0*	*0.8*	*–1.6*	*–4.0*	*–3.8*
France	*2.1*	*0.7*	*–2.1*	*2.0*	*1.2*	*0.6*	*–1.0*	*–2.2*	*–2.5*
Consumer prices									
United States	2.9	3.8	–1.0	4.1	4.4	5.3	1.6	–0.1	–2.0
Japan	0.1	1.4	–1.5	1.0	1.4	2.2	1.0	–0.3	–1.3
United Kingdom	2.1	3.6	1.8	2.4	3.3	4.9	3.9	3.0	1.7
Euro area	2.1	3.3	0.4	3.4	3.6	3.8	2.3	0.7	0.4
Germany	*2.3*	*2.6*	*0.8*	*2.9*	*2.9*	*3.1*	*1.6*	*0.9*	*0.4*
France	*1.5*	*2.8*	*0.4*	*2.9*	*3.3*	*3.3*	*1.8*	*0.6*	*0.0*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	3.4	0.1	–2.6	2.0	0.8	–0.2	–2.3	–4.3	–2.8
Government consumption	4.9	5.3	4.3	3.7	5.0	6.1	6.3	5.2	4.8
Gross fixed capital formation	5.3	–3.0	–12.3	2.4	–0.8	–4.1	–9.3	–12.4	–15.5
Capital goods	*10.0*	*–1.1*	*–13.0*	*5.2*	*1.8*	*–1.3*	*–9.7*	*–13.0*	*–13.0*
Construction	*3.8*	*–5.3*	*–14.5*	*0.2*	*–3.1*	*–7.3*	*–10.9*	*–14.1*	*–19.6*
Domestic demand (contribution to GDP growth)	4.4	0.1	–4.2	2.6	1.2	–0.2	–3.0	–5.2	–5.2
Exports of goods and services	4.9	0.7	–6.2	4.8	4.4	1.5	–7.9	–11.6	–6.9
Imports of goods and services	6.2	–2.5	–11.2	3.6	1.8	–2.0	–13.2	–18.4	–13.2
Gross domestic product	**3.7**	**1.2**	**–2.3**	**2.7**	**1.8**	**0.9**	**–0.7**	**–2.2**	**–2.8**
Other variables									
Employment	2.9	–0.6	–5.0	1.6	0.1	–0.9	–3.1	–5.1	–5.6
Unemployment (% labour force)	8.3	11.3	17.6	9.6	10.4	11.3	13.9	17.4	17.4
Consumer price index	2.8	4.1	0.1	4.4	4.6	4.9	2.5	0.5	–0.4
Unit labour costs	2.9	3.4	–0.3	4.2	3.6	3.4	2.6		
Current account balance (% GDP)	–10.1	–9.5	–7.1	–12.1	–9.5	–8.7	–7.9		
Net lending or net borrowing rest of the world (% GDP)	–9.7	–9.1	–6.5	–11.2	–9.0	–8.4	–7.6		
Government balance (% GDP)	2.2	–3.8	–7.8						
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	5.0	2.0	0.3	3.2	2.1	2.0	0.9	0.3	0.3
ECB repo	3.8	3.9	1.2	4.0	4.0	4.2	3.4	1.8	1.1
10-year US bonds	4.6	3.6	2.9	3.6	3.9	3.8	3.2	2.6	2.9
10-year German bonds	4.2	4.0	3.0	3.9	4.3	4.3	3.5	3.1	3.1
Exchange rate									
$/Euro	1.37	1.48	1.28	1.50	1.56	1.51	1.34	1.30	1.29

Contents

Is the age of excess over?

One peculiarity of the current world economic recession is how fully it has been a sychronized process, that is, the large number of countries that have undergone a drop in economic activity practically at the same time. Such a synchronized world recession is a very unusual phenomenon and to find precedents we must go back to 1975, 1980 and 1992, which were «oil shock» years. If we apply the criteria of the number of countries in recession, the International Monetary Fund calculates that the current total is the worst in 50 years.

Few people will be surprised by the present spread of recessive trends. For some years we have seen the accumulation of major imbalances at a world level. Economies such as those of Germany, Japan, China and other Asian countries have recorded persistent surpluses due to their orientation toward exports and a relatively low level of domestic consumption, with a subsequent greater capacity for saving. At the other extreme we find economies such as those of the United States, Australia, Spain, New Zealand and the United Kingdom with balances of payments that have shown persistent trade deficits arising from high spending levels that meant low levels of saving. Furthermore, they are exporters of commodities for which until recently buoyant sales have provided high trade surpluses and abundant reserves. The growing trade inter-connection of many economies, in which distance barely matters, is a distinctive phenomenon of the wave of globalization that came strongly onto the scene as of the Eighties.

The increase in trade was made possible and has been supported by financial globalization, a result in turn of the liberalization of capital movements and the sophistication of financial systems. As in the area of trade, the world has become split into two parts – the «savers», that is, those exporting commodities along with those that are net exporters of manufactured goods and the «spenders», headed by the United States. The US has been absorbing a good part of world savings in recent years through the issue of government bonds and other assets expressed in dollars. This is a situation that broke with the traditional scheme of things under which those in deficit were the emerging countries while those enjoying a surplus were their developed counterparts. This was the case in the earlier globalization wave between the end of the 19th century and the beginning of the 20th, when the United Kingdom, then the leading world power, came to record a surplus of 9% of gross domestic product.

The geographical imbalances in current accounts and savings flows at a time of very low interest rates, the reduction of risk premiums, the rise in asset prices and the increase in high-risk investment have been troubling for some considerable time. Attempts to explain this phenomenon began an interesting debate about its nature and persistent character, its causes and its consequences. With the onset of the recession, the risks being incurred by the world economy have become clear. When, as of the second half of 2007, serious upsets occurred in the financial systems and international capital flows came to a halt, those economies with current account deficits were obliged to quickly adjust their levels of spending to national savings. At the same time, the collapse of world trade as of the end of 2008 had devastating direct consequences for net exporters who were obliged to rapidly adjust their level of economic activity. In fact, global imbalances have worsened during the current economic recession so that this seems like a good moment to reflect on why we are where we stand and what are the prospects for the future.

EXECUTIVE SUMMARY

At the bottom

We may be going through worst moment of current recession...

The first half of 2009 marks the low point in the deepest recession since World War II. This is suggested by some indicators which at the same time show that the economic situation is beginning to ease and that the health of the international financial system is giving off signs of improving. Nevertheless, everyone feels that the risks are downward and that the exit from this recession will be slow and long drawn out.

...but risks still point downward and exit will be slow.

In its April report on world economic prospects the International Monetary Fund (IMF) again lowered its growth forecasts, noting that the world economy is engulfed in a severe recession. The world economy is expected to contract by 1.3% in 2009 while macroeconomic policy measures and attempts to restore normalcy to the financial sector could help bring about a recovery in 2010 that could be slower than on other occasions with growth of 1.9%. Guaranteeing access to liquidity for financial institutions, cleaning up losses arising from assets of doubtful quality and recapitalizing the weaker but still viable entities are essential conditions for the success of the fiscal and monetary stimulus measures being undertaken.

Growth forecasts still being cut both for 2009 and 2010.

The recession is showing sharpest in the advanced economies which as a whole contracted by a never-before- seen 7.5% quarter-to-quarter rate annualized in the final quarter of 2008. In turn, the emerging economies dropped by a moderate 4.0%. By country, prospects for the United States are getting worse with a 2.8% contraction expected in 2009 to be followed by nil growth in 2010. In the advanced economiess, Japan shows the worst picture for 2009 with a drop of 6.2% expected. Nevertheless, the forecast for 2010 is better with a 0.5% increase. China, while showing a clear downturn compared with previous years, is escaping from the widespread contractions noted among Asian exporters.

In Europe as well forecasts for nearly all countries have been revised downward. In the Euro Area, decreases of 4.2% in 2009 and 0.4% in 2010 are expected. Germany is the country coming off worst with drops in its economy of 5.6% and 1.0% in 2009 and 2010 respectively.

In this context of pessimistic expectations, most economic indicators continue to show the depth of the drop, which would seem somewhat less severe compared with the sharpness noted at the end of 2008.

In the United States, consumer confidence remains weak although slightly above the all-time low. Retail sales in March broke away from their incipient recovery although the first quarter average indicates some stabilization. The March index of economic activity and business sentiment put out by the Institute for Supply Management, while remaining at levels correct for a deep recession, stayed above all-time lows. Industrial production, however, was down by two digits while utilization of production capacity hit a new all-time low. Some 5 million jobs have been lost since January 2008 and the unemployment rate is now 8.5% of the labour force, its highest level since 1983.

In Japan, the indicators are undoubtedly negative. Retail sales in February were down 5.7% year-on-year, the worst figure since 2002 while consumer confidence, although recovering slightly from an all-time low, continues to show exceptionally low levels. The labour market also showed a poor performance in February with the unemployment rate going close to 4.4% of the labour force and 380,000 jobs lost. But it is the foreign sector that has become the weakest point in Japan's economy. The biggest problem remains the drop in exports which were down by 45.8% year-on-year.

The foreign sector has also turned out to be the Achilles heel of the Euro Area. The weight of exports, similar to that of Japan's economy and higher than that of the United States, means that the drop in these in year-on-year terms (24.6% in January) came as a very negative figure. Furthermore, domestic demand is not taking the place of exports. Retail sales in February, for example, were down for the fifth month in a row. Nor did consumer confidence hit bottom in March and is continuing its free fall. On the supply side, the drop in industrial production hit a new all-time low going to 18.4%. The unemployment rate in the Euro Area rose to 8.5% in February, 1.3 percentage points higher than the low recorded in March 2008. Nevertheless, in most countries, including the three main economies, Germany, France and Italy, the increase is very weak, especially if we compare it with the sharp decreases in production and demand. This suggests that the worsening of the labour market still has some way to go in coming quarters, a factor which will keep consumer spending weak.

In view of the worsening economic situation, the European Central Bank (ECB) decided to cut its reference rate by 25 basis points putting it at 1.25%. The ECB chairman insinuated the possibility of a further cut at the next meeting of the Governing Council on May 7 and announced that it would present a series of quantitative easing measures at that meeting. Following the ECB cut, interest rates in the interbank market in the Euro Area have maintained a downward trend marking up all-time lows. For example, the 12-month Euribor rate, one of the main reference rates for loan transactions, stood at 1.76% the same day.

On the other hand, returns being offered by medium and long-term government bonds have tended to rise. This movement is due to the fact that part of the «flight to quality» has ebbed. Since the beginning of the recession and in view of increased risk aversion, investors have reduced the level of high-risk assets in their portfolios and moved into assets of high credit rating such as government bonds. Now, in view of investor expectations about the economy and the positive performance on other markets, such as the share markets, April brought an orderly selling situation in government bond markets.

In Spain, the rapid worsening of economic indicators has meant a notable downward revision of growth forecasts. The Bank of Spain and the IMF are in agreement in anticipating a drop of 3% in gross domestic product (GDP) in 2009 and a further decrease of between 0.7% and 1.0% in 2010. This scenario was unthinkable until very recently and underlines the seriousness of the economic situation. Furthermore, the IMF feels that the exit from the recession will be very slow, with low GDP growth over the medium term.

If these forecastss seem overly pessimistic, the figures from the Labour Force Survey for the first quarter of 2009 have far exceeded expectations and suggest a very serious labour market situation. The number of unemployed

Euro Area showing very clear drop but rise in unemployment generally still weak.

ECB will again cut interest rates and could adopt quantitative easing measures.

Forecasts for drop in Spain's economic activity now stand at 3% for 2009.

Unemployment rises by 800,000 persons in first quarter going above 17% of labour force.

has gone above 4 million, an all-time high that until recently was thought to be far off. In the first three months of the year, more than 800,000 persons joined the ranks of the unemployed putting the rate at 17.4% of the labour force, a figure higher than expected in the forecasts by the Bank of Spain as the 2009 average. The unemployment rate is the highest in the European Union and the Organization for Economic Cooperation and Development (OECD). In any case, it should be pointed out that three-quarters of the unemployed registered at public employment offices are receiving unemployment benefits.

Production and consumption indicators keep bringing bad news.

Before publication of the figures from the Labour Force Survey at the end of April, economic activity indicators were already noting the progressive worsening of the economic situation. In the area of production, the industrial production index was down 22.0% in February compared with the same month one year ago. Furthermore, the drop in electrical power consumption (10.2% in March, the biggest decrease in recent decades) may be explained by the sharp drop in industrial activity. The weakness will continue over coming months in line with the 31.9% drop in orders received in February and the dip in the industrial confidence indicator in March putting it at its lowest level since 1993.

Construction is still engaged in a sharp process of adjustment because of the real estate crisis. In February there were 34,669 housing sales, 37.5% less than in the same month in 2008 and prices were down 6.8% in the first quarter compared with 12 months earlier.

New Minister of Economy and Finance announces higher public spending and trusts in dialogue between trade unions and business organizations.

The recession is also hurting companies supplying services whose total billing dropped 18.7% in February compared with the same month in 2008. All sub-sectors were affected, especially wholesale/retail trade and transport. Tourism, in turn, was down 12.3%.

On the demand side, consumption remains depressed. Production of consumer goods reported a year-on-year decrease of more than 10% by volume. Retail sales were also weak in February with a drop of 7.6%, especially notable in home goods and appliances. In turn, car registrations were down 43.1% year-on-year in the first quarter. In any case, it should be noted that the consumer confidence indicator for March showed an improvement.

With regard to the foreign sector, initial figures for January and February indicate that its positive contribution to GDP growth will continue. In fact, in spite of the fact that both exports and imports are dropping, imports are ahead in this regard.

In this situation, at the end of March the central government approved a new series of measures to deal with the economic situation. It simpified the law on insolvencies, revived credit insurance and set in motion the EU Services Directive. April saw a change of ministers and the course of action announced by the new Minister of Economy set out increased public spending and better dialogue with trade unions and business organizations. The government also announced the creation of a public fund to aid financial entities having problems. The latest measures set in motion by the government are aimed at easing the effect of slow payment of company invoices by local councils. All these measures are on top of those adopted in previous months whose breadth and results are still too early to measure.

April 27, 2009

CHRONOLOGY

2008

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.
	28	IBEX 35 index for **Spanish stock exchange** marks up lowest level (7,905.4) since 2004.
	29	**Federal Reserve** cuts reference rate to 1.00%.
November	6	**European Central Bank** lowers official interest rate to 3.25%.
	15	Meeting of G-20 in Washington to **reform international financial system**.
	20	Dow Jones index for **New York stock exchange** records lowest level since 2003 (7,552.3).
	28	Government announces 8 billion-euro **public works plan** for municipalities and 3 billion-euro plan for investment in various sectors and economic spheres.
December	4	**European Central Bank** lowers official interest rate to 2.50%.
	16	**Federal Reserve** reduces reference rate to band between 0%-0.25%.
	24	Brent quality **oil** price drops to lowest level since July 2004 (37.23 dollars a barrel).

2009

January	1	Further enlargement of **Euro Area** with entry of Slovakia making total of 16 member states.
	15	**European Central Bank** lowers official interest rate to 2.00%.
	20	Barack Obama sworn in as **President of the United States**.
March	5	**European Central Bank** lowers official interest rate to 1.50%.
	6	Central government announces measures to **facilitate financing of working capital for medium-sized companies** and to **revive employment** and ease effects of **unemployment**.
	27	Spanish government approves series of **measures to promote economic activity** throuch changes in law on insolvencies, revival of credit insurance and introduction of EU Services Directive.
April	2	**European Central Bank** lowers official interest rate to 1.25%. G-20 meeting in London aimed at **reform of international financial system**.

AGENDA

May

- **5** Registrations with Social Security and registered unemployment (April).
- **6** Industrial production index (March).
- **7** Governing Council of European Central Bank.
- **13** CPI (April). Harmonized CPI for EU (April).
- **14** Flash GDP (1st Quarter).
- **20** Quarterly National Accounts (1st Quarter). Foreign trade (March).
- **25** Producer prices (April).
- **26** Central government revenue and spending (April).
- **28** Flash HCPI (May).
- **29** Balance of payments (March).

June

- **2** Registrations with Social Security and registered unemployment (May).
- **4** Governing Council of European Central Bank.
- **5** Industrial production index (April).
- **10** CPI (May).
- **16** CPI harmonized with EU (May).
- **18** Labour cost (1st Quarter).
- **23** Fed Open Market Committee.
- **24** Foreign trade (April).
- **25** Producer prices (May).
- **29** Flash HCPI (June).
- **30** Central government revenues and spending (May). Balance of payments (April).

INTERNATIONAL REVIEW

IMF expecting world contraction of 1.3% in 2009 and rise of 1.9% in 2010.

United States and Japan expected to contract 2.8% and 6.2% in 2009 while China to grow by 6.5%.

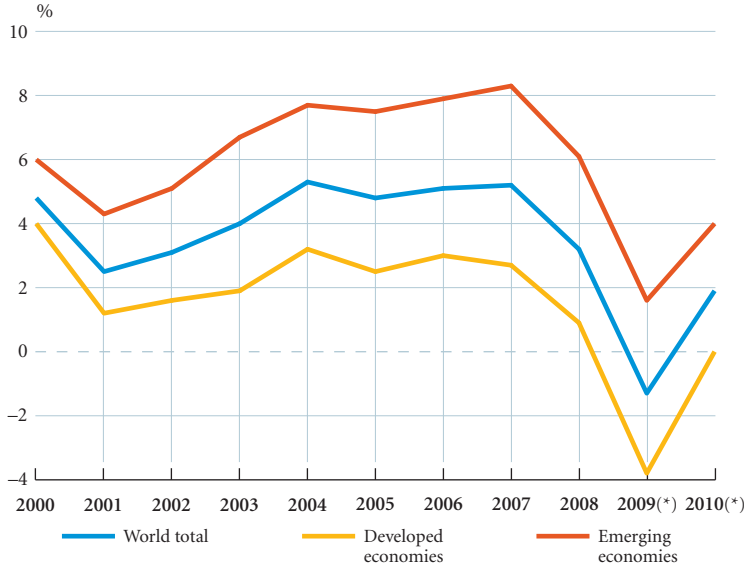
IMF forecasts: world recession difficult to resolve

In its report on world economic outlook for April, the International Monetary Fund (IMF) again lowered its growth forecasts compared with those put out in March for the G-20 summit. The IMF notes that the world economy is immersed in a severe recession. Its basic cause was a financial crisis that brought about losses in assets that in the 2007-2010 could amount to 4,000 billion dollars, of which 2,700 billion were for assets originating in the United States. The initial widespread result was a sharp loss of confidence that gripped economic activity. According to the IMF, the world economy will contract by 1.3% in 2009 while macroeconomic political measures taken and attempts to reestablish normalcy in the financial sector could bring some recovery in 2010 which will be slower than on other occasions. Guaranteeing access to liquid funds for financial institutions, establishing losses arising from assets of doubtful credit rating and recapitalize the weaker but still viable financial institutions are essential conditions for the success of fiscal and monetary policies to stimulate the economy.

At country level, prospects for the United States were worse with a contraction of 2.8% expected for 2009 to be followed

A COORDINATED RECESSION

Year-on-year change in gross domestic product



NOTES: (*) 2009 and 2010 are forecasts.
SOURCE: International Monetary Fund.

by nil growth in 2010. In recent months, the exporting economies are the ones to suffer the biggest downturn due to the major contraction in the volume of trade. Among the developed economies, Japan has the worst picture for 2009 with an expected drop of 6.2%. China, while suffering from a clear downturn compared with previous years, is escaping the general decreases seen among Asian exporters. A major fiscal stimulus plan,with investment in infrastructures, will contribute to expected growth of 6.5% in 2009 and 7.5% in 2010.

In Europe as well forecasts for nearly all countries have also been revised downwards. In the Euro Area, decreases of 4.2% in 2009 and 0.4% in 2010 are expected. It is however Germany that shows up as the worst hit country with contractions in its economy of 5.6% and 1.0% in 2009 and 2010, respectively. Italy and the United Kingdom are following a trend similar to the Euro Area as a whole while France is expecting somewhat more moderate decreases. For Spain's economy, the IMF is expecting a relatively moderate drop of 3.0% in 2009 but for 2010 it is forecasting a decrease of 0.7% which indicates that we shall have to wait for recovery.

Among the emerging economies, the good performance of emerging Asia, expected to grow by 4.8% in 2009, runs in contrast to the rapid worsening of the economies of Eastern and Central Europe which are suffering from a contraction of 3.7%. Latin America will stand in a middle ground with an expected decrease of 1.5%.

Euro Area expected to drop by 4.2% in 2009 while Germany to go down 5.6% and Spain 3%.

Uncertainty high while risks show downward bias.

IMF FORECASTS

Annual change as percentage (*)

	GDP		Consumer prices		Unemployment rate (**)	
	2009	2010	2009	2010	2009	2010
United States	–2.8	0.0	–0.9	–0.1	8.9	10.1
Japan	–6.2	0.5	–1.0	–0.6	4.6	5.6
Germany	–5.6	–1.0	0.1	–0.4	9.0	10.8
France	–3.0	0.4	0.5	1.0	9.6	10.3
Italy	–4.4	–0.4	0.7	0.6	8.9	10.5
United Kingdom	–4.1	–0.4	1.5	0.8	7.4	9.2
Spain	–3.0	–0.7	0.0	0.9	17.7	19.3
Euro Area	**–4.2**	**–0.4**	**0.4**	**0.6**	**10.1**	**11.5**
Advanced economies	**–3.8**	**0.0**	**–0.2**	**0.3**	**8.1**	**9.2**
Developing countries	**1.6**	**4.0**	**5.7**	**4.7**	**...**	**...**
Latin America	*–1.5*	*1.6*	*6.6*	*6.2*	...	...
Eastern and Central Europe	*–3.7*	*0.8*	*4.6*	*4.2*	...	...
Emerging Asia	*4.8*	*6.1*	*9.3*	*5.7*	...	...
World Total	**–1.3**	**1.9**	**2.5**	**2.4**	**...**	**...**
World trade by volume (***)	**–11.0**	**0.6**				

NOTES: (*) Forecasts at October 2008.
(**) Percentage of labour force.
(***) Goods and services.
SOURCE: International Monetary Fund.

United States: recovery will be slow

United States: economic weakness to continue.

The US gross domestic product (GDP) showed a drop of 1.8% in the second half of 2008 thus beginning a recession characterized by extreme weakness in private consumption. Despite the fact that indicators for the early months of 2009 suggest some moderation in the rate of downturn that may also be reflected in the gross domestic product (GDP) for the first quarter, the downward trend will continue. The current recession is the result of a financial crisis and has a world-wide spread affecting most economies at the same time. According to the International Monetary Fund (IMF), this could prolong the period of decreases up to two years, reduce the GDP by 4.8% and make the later recovery rather modest.

Financial crisis and international recession in synchrony make for difficult recovery.

The sharp growth of credit in recent years raised private consumption above its long established growth trend, with a marked decrease in household savings and gross borrowing at the end of 2007 that reached 98.1% of nominal GDP with a sharp rise in the price of assets. The turnaround in these trends would lead consumers into a process of reducing their debt, a process that is still incipient. A large part of future household income, either coming from private activities or government sources, will go to replenishing savings thus leaving the recovery of private consumption until a later date. In the meantime, as this is a simultaneous world recession, growth through exports will be limited by weak world demand.

What is to be done in this situation? The effectiveness of conventional monetary policy has shown up very much reduced. But the recovery of credit markets is an essential condition for recovery. This underlines the importance of the success of the Geithner plan to buy doubtful

UNITED STATES: MAIN ECONOMIC INDICATORS

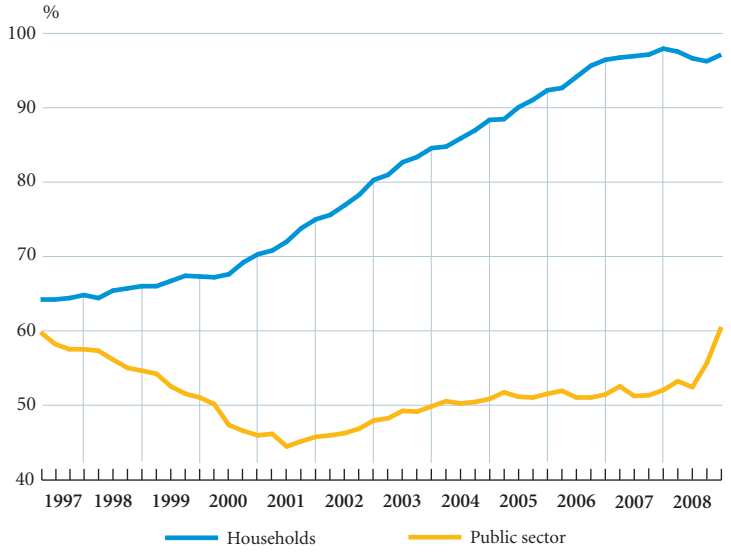
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	2.0	1.1	2.5	2.1	0.7	–0.8	–	...	–
Retail sales	4.2	–0.5	3.1	2.6	0.6	–8.0	–8.9	–7.9	–9.4
Consumer confidence (1)	103.4	58.0	76.5	57.3	57.3	40.7	37.4	25.3	26.0
Industrial production	1.5	–2.2	1.4	–0.4	–3.2	–6.7	–10.7	–11.8	–12.8
Manufacturing (ISM) (1)	51.1	45.5	49.5	49.1	47.4	36.1	35.6	35.8	36.3
Sales of single-family homes	–26.8	–37.2	–33.1	–39.1	–36.7	–40.5	–46.1	–41.1	...
Unemployment rate (2)	4.6	5.8	4.9	5.4	6.1	6.9	7.6	8.1	8.5
Consumer prices	2.9	3.8	4.1	4.4	5.3	1.6	0.0	0.2	–0.4
Trade balance (3)	–700.3	–681.1	–699.2	–701.8	–714.5	–681.1	–658.2	–622.3	...
3-month interbank interest rate (1)	5.3	2.8	3.0	2.8	3.2	2.2	1.2	1.3	1.2
Nominal effective exchange rate (4)	77.9	74.4	72.0	70.9	73.5	81.3	81.0	83.1	83.9

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

UNITED STATES: AN ANNOYING DEBT

Gross debt of households and public sector as percentage of nominal GDP



SOURCE: Federal Reserve and own calculations.

assets from the banking system. In order to aid aggregate demand fiscal policy also should have a fundamental role. The IMF is expecting that fiscal deficit of the US economy for 2009 will reach 7.7% of GDP, 4.8 percentage points above that in 2007. But the limit here is set by the level of borrowing by government finances which in 2008 went from a relatively low 52.1% to 60.6% of GDP, a level at which the effectiveness of fiscal expansion policies begin to be somewhat low.

On the demand side, the latest indicators point to a possible end to the drastic drops seen in the second half of 2008 although the downward trend is clearly persistent. The consumer confidence index put out by the Conference Board for March held at 26.0 points, very close to the all-time low in February. In March, retail sales broke with their incipient recovery and, if we exclude cars and petrol, dropped by 3.9% compared with the same period last year, in real terms, although the February figures were revised slightly upward.

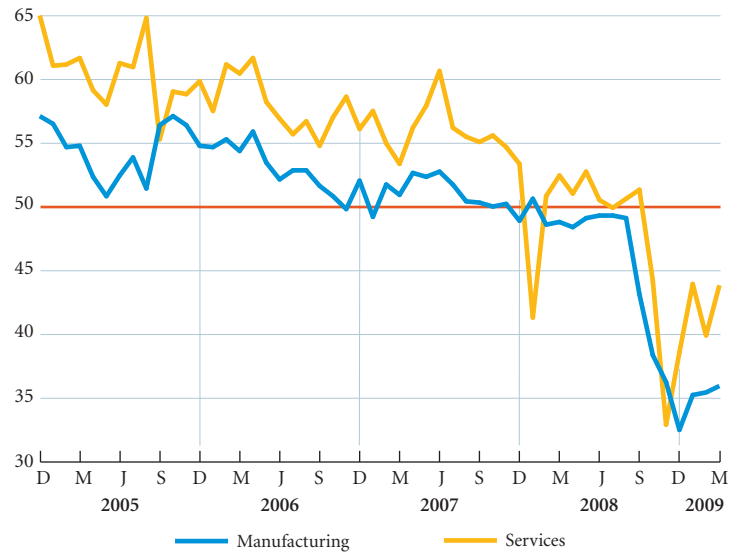
Consumer confidence still close to all-time lows but retail sales show more stable decreases.

In supply indicators, the March index for economic activity and business sentiment put out by the Institute for Supply Management, while in line with the levels expected in a situation of deep recession, held above all-time lows and also pointed to lower decreases. The manufacturing index show a third month of increases (although these were moderate) and went to the 36.3 points level, still well below the balance level of 50.0 points considered the threshold signalling risks of recession. The services index recovered going to 44.1 points. The negative point, however, was to be seen in industrial production, which in March showed a drop of 12.8% year-on-year while utilization of production capacity in the same period went down to 69.3%, thus hitting a new all-time low since introduction of this index in 1967.

Business executives less pessimistic but industrial activity still at low levels.

UNITED STATES: BUSINESS OPINION LEAVING LOWS BEHIND

Level of ISM indices (*)



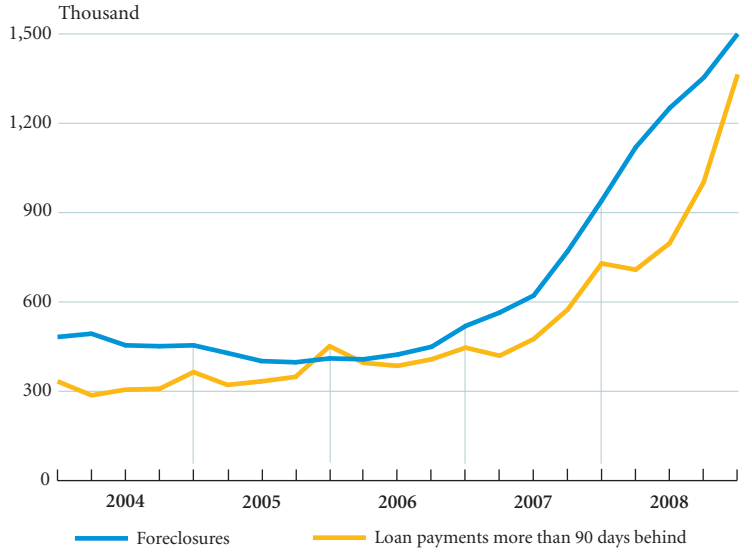
NOTES: (*) A level of 50 implies as many optimistic as pessimistic responses.
SOURCE: Institute for Supply Management and own calculations.

Real estate prices dropping while default on increase and housing starts remain very low.

Housing is still failing to show any sign of recovery. Real estate prices continue to reduce the property situation of households and the Case-Shiller index for January showed a cumulative drop of 28.3% compared with the high in June 2006. With the credit crisis, at the end of 2008 auctions resulting from foreclosures

UNITED STATES: MORE AND MORE DEFAULT

Number of mortgage loans foreclosed and loans more than 90 days behind in payments



SOURCE: Mortgage Bankers Association and own calculations.

for mortgage payments not met went as high as 1.5 million, including an increasing proportion of mortgages not considered subprime, but simply of poor credit rating. This figure should increase in coming months given that the number of loans with payments 90 days in arrears rose to 1.4 million, twice that at the end of 2007. The performance in supply is coherent with these figures and housing starts in March again dropped going to 510,000, in annual terms, thus losing all that was recovered the month before and staying far from the 2,200,000 figure that was typical of 2006.

If housing represents household wealth, the labour market determines income and here the drop continues to grow worse. Some 663,000 non-farm jobs were lost in March. As a result, since January 2008, the month when these decreases began, some 5,133,000 jobs have been lost, a decrease that represents 3.9% of all non-farm jobs. The unemployment rate also reflects this situation and went to 8.5% of the labour force, the highest level since 1983.

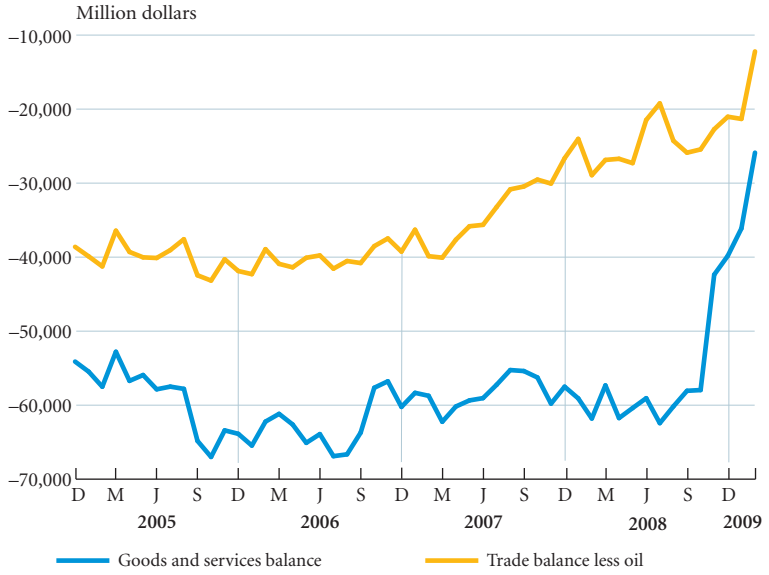
Labour market shows 5.1 million jobs lost since January 2008.

In prices, there is still a fight going on between the high risk of inflation or deflation, although the latter risks are weakening. The general consumer price index (CPI) for March dropped by 0.4% year-on-year, which was the first decrease in 55 years while the price of oil and weakness in economic activity mean that these decreases will continue in 2009. Nevertheless, in spite of the historical notes and taking into account that deflation could be worse than inflation, the risks of a deflationary scenario (understood as continuing widespread decreases in prices) are less than they were at the end of 2008. In spite of the weakness in consumption and the low utilization of production capacity, the underlying index (the general index less food and energy) in March showed its

Prices drop 0.4% because of oil.

UNITED STATES: TRADE BALANCE NOW BEING RAPIDLY CORRECTED

Monthly goods and services balance



SOURCE: Department of Trade and own calculations.

Trade deficit being corrected because of oil, weakness in consumption and lower volume of trade.

third consecutive month with an increase of 1.8% year-on-year, which for now wards off signs of any deflationary trend.

The foreign sector remains troubling, not because of the persistent deficit but rather the reduced levels of trade. The trade deficit in goods and services continued to drop going to 25.96 billion dollars in February. As a result, since August 2008 the foreign deficit has shown a reduction of 34 billion dollars, of which 22 billion were from the drop in oil prices while the remaining 12 million dollars was mainly due to the drop in trade. This puts in doubt any continuation of the correction of the foreign deficit once there is a recovery of US domestic demand and world trade.

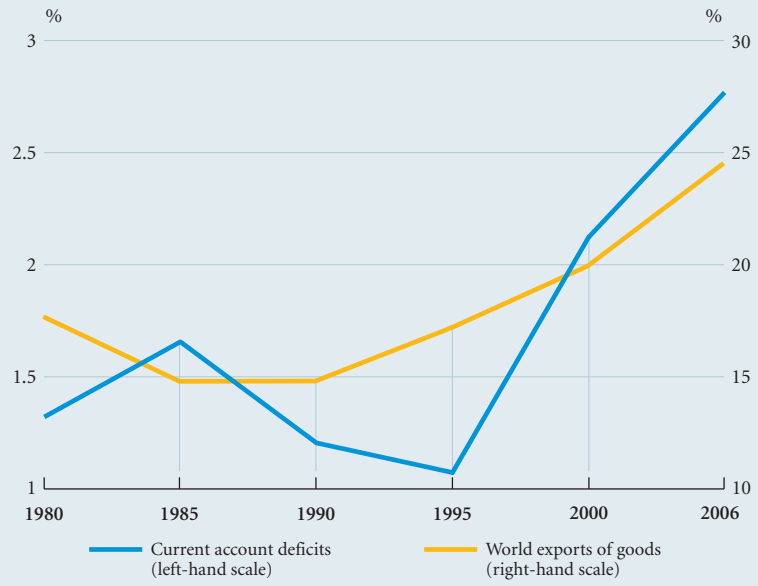
Is globalization causing the balances of payments imbalances?

Since the Nineties world imbalances in balances of payments have increased to the highest levels in recent decades, not only in absolute terms but also in relation to gross domestic product (GDP). As a result, the global total for current account deficits went from representing 1.3% of world product in 1980 to more than twice that figure (2.8%) in 2006. This imbalance was troubling, not only for its sheer size but because it showed signs of continuing and posed risks for the world ecomomy.

The biggest current account deficit in absolute values was that of the United States which made up 60% of the world total in 2006. Put another way, this meant that it was absorbing this proportion of the world surplus,

INCREASE IN WORLD IMBALANCES IN BALANCE OF PAYMENTS UP TO THE RECESSION

Percentage of world product in current dollars



SOURCE: International Monetary Fund, World Bank and own calculations.

which underlines the low level of savings in that country. At the same time, the US current account deficit represented 6% of its GDP. But it was also high in relative terms and recurring in other countries such as Iceland, Latvia, Bulgaria, Estonia, Lithuania, Romania, Greece, Portugal, Spain, New Zealand, Hungary, Slovakia, Croacia, Turkey and Australia. On the other hand, the biggest surpluses were concentrated in countries like China, Japan and Germany.

The increase in imbalances in current account balances in recent times coincided with a new wave of globalization, characterized among other things by an increase in world trade flows, as may be seen in the accompanying graph. This new globalization wave began around 1980 and, as in other such waves, was brought about by the decrease in transportation costs and the reduction of customs duties and other barriers to world trade. Among its notable characteristics we may mention the sharp increase in intra-industrial trade that largely takes place among developed countries and the important role of multilateral organizations in achieving increased economic integration.

The increase in international trade generally was accompanied by financial globalization which facilitated that trade. The decrease in costs of telecommunications and the technological development of these means, along with the progressive liberalization of capital movements, gave a major push to such international flows. In turn, investors were able to increasingly diversify their portfolios. As a result, current account deficits were easier to finance and this allowed them to go to relatively high levels.

Also at the time of the first major globalization (in the period 1870-1913), which were also years of great economic growth, there was a big increase in capital flows in a context of freedom of movement. At the same time, the imbalances in current account recorded relatively high levels. The United Kingdom came to reach a surplus of 9% of GDP while other countries showed deficits of more than 5% of GDP.

Nevertheless, as opposed to the first globalization, in recent times capital flows showed a marked bi-directional character with significant gross figures. On the other hand, the distribution of imbalances was very different given that in the 1870-1913 period the main developed countries showed major current account surpluses while the new countries, such as Argentina, Australia and Canada, which then would have corresponded to today's emerging countries, showed deficits.

Furthermore, the adjustment mechanism was different although, as happens today, it was based largely on the real foreign exchange rate. At the time of the classical gold standard, nominal exchange rates were fixed while prices and wages were flexible in a social and political environment quite different from that of today. Nowadays, exchange rates are generally flexible. Nevertheless, some countries intervene in foreign exchange markets to prevent free flotation of their currencies, thus making adjustments difficult. Furthermore, domestic prices and wages are often adjusted quite slowly.

The case of China, in spite of reforms aimed at greater exchange rate flexibility passed in July 2005, is a paradigm. The Asian giant, with its model of economic growth driven by exports, obtained a current account surplus of 11% of GDP in 2007. A large part of this was the result of maintaining the yuan exchange rate undervalued, which is possible only through control of capital movements. In this way, China has accumulated a huge amount of currency reserves which it largely invests in funding US government borrowing. On the other hand, it is obliged to defuse the effect of the increase in foreign currency reserves through the domestic money supply in order to avoid an undesirable rise in inflation. Up to now this has not meant too many problems for the Chinese monetary authorities.

In recent months the correction of current account imbalances has been stepped up with the case of the United States being notable. In 2008 it reduced its current account deficit to 4.7% of GDP. But this was at the cost of a sharp world economic recession set off by an international financial crisis. In fact, these are complex matters in which many factors come into play. Nevertheless, it may be stated that financial globalization contributed to the increase in imbalances in balances of payments as it acted as the necessary instrument of that process. The question remains to what extent the world financial crisis will bring about a cut-back in globalization. Over the short term, the level of world trade has been drastically reduced and it remains to be seen if earlier tendencies will recover once the crisis is over.

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Japan drops by 4.3% because of foreign sector and investment.

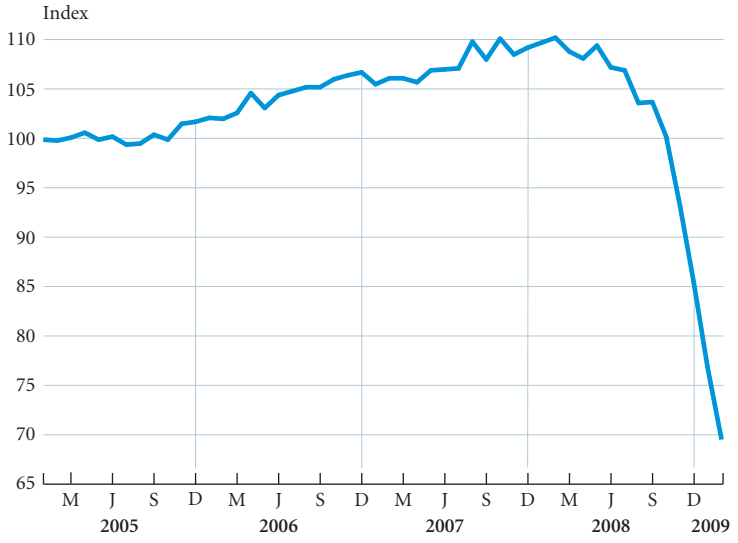
Japan: On the edge of an abyss

The year 2009 will be very difficult for Japan's economy with an expected drop that could go above 5%. The GDP in the fourth quarter of 2008 had dropped by 4.3% year-on-year (12.1% in quarter-on-quarter terms annualized) because of the decrease in exports and capital goods investment which is largely carried out by export-oriented companies. World trade was affected by the synchronized nature of the recession which has reduced aggregate world demand and which, with the increase in insurance costs for credit and guarantees, has broken a key part of supply chains. Japan has been affected by the reduction in trade seeing that, with exports noted for their high value added and that include the most productive sectors of the economy, Japan is losing in those areas where it had been doing better. It is not surprising that, on top of the fiscal deficit of 8.1% of nominal GDP forecast for 2009, the government has decided to add a further stimulus of 3% of GDP that includes aid for buying capital goods and shares.

Japan is an economy where producers come before consumers and, as a result, it is the supply indicators thast show this situation most. Industrial production in February continued its downward spiral with a drop of 36.9% year-on-year concentrated in the past four months. This correction, the sharpest since 1945, may be compared with the drop in industrial production in the United States in the recession in the Thirties with the difference that in the case of Japan the process has been much faster. There has also been a sharp drop in machinery orders, an early indicator for investment which in February went down 50.4% year-on-year. The sharpest decreases again took place in the export sector (practically half of the total) which was down 74.5% year-on-year. On top of this weak state came publication of the Tankan index for business activity prepared by the Bank of Japan for the first quarter, showing that this index for large manufacturing companies was down from –24 points to the –58 points level, thus disappointing earlier expectations that in themselves were pessimistic.

JAPAN: SHARP DROP IN INDUSTRIAL PRODUCTION

Industrial production index



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

Demand, even without going to excess in view of the credit crisis, has also joined the downturn with retail sales dropping by 5.7% year-on-year in February, the worst figure since 2002 while consumer confidence that, although recovering slightly from an all-time low, is still running at exceptionally low rates. This

Industrial production down 37% while Tankan drops to minus 58 points.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	2.4	–0.7	1.4	0.5	–0.2	–4.3	–	...	–
Industrial production	2.9	–3.4	3.5	1.6	–3.3	–15.0	–30.0	–36.9	...
Tankan company Index (1)	22.0	–2.8	11.0	5.0	–3.0	–24.0	–	–58.0	–
Housing construction	–17.2	2.4	–8.8	–11.1	40.3	3.9	–18.7	–24.9	...
Unemployment rate (2)	3.9	4.0	3.8	4.0	4.0	4.0	4.1	4.4	...
Consumer prices	0.1	1.4	1.0	1.4	2.2	1.0	0.0	–0.1	...
Trade balance (3)	12.6	4.0	11.7	10.3	7.4	4.0	2.7	2.2	...
3-month interbank interest rate (4)	0.7	0.8	0.8	0.8	0.9	0.8	0.7	0.7	0.7
Nominal effective exchange rate (5)	77.1	86.6	83.4	82.6	81.9	98.5	105.1	103.5	97.7

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.

Domestic demand down and underlying CPI stays in negative ground.

weakness ended up being passed through to price where the danger of deflation is real. The February CPI recorded a nil increase compared with the same period the year before when it was close to 2.1% four months ago, whereas the underlying index (the general index less energy and food) was down 0.1% year-on-year. The continuing weakness of demand in coming months and the drop in the Tokyo CPI in March indicate downward prospects that likely will put the 2009 CPI on negative ground. The labour market also showed a poor performance in February with an unemployment rate going up to 4.4% of the labour force and the loss of 380,000 jobs.

Exports down 46% while imports drop 40%.

The foreign sector has come to be the weakest point in Japan's economy and continued to drop in February. The trade balance was practically nil although this was the seventh deficit in a row. The biggest problem, however, continues to be the drop in exports which were down 45.8% year-on-year. Imports were down 39.9%. The current account balance went back onto positive ground in February following the deficit in January but this recovery could be turned around because of lower returns on foreign investments and the downward trend in exports.

China slows down to growth of 6.1% with lower exports while investment moves up.

China's slowdown hits bottom

China's GDP grew by 6.1% year-on-year in the first quarter, a clear slowdown from the 9.1% seen in 2008 and 13.0% in 2007. This should put 2009 growth to rates below 7%, well below the government's objective of 8%. For this reason, with its relatively small automatic stabilizers, China's fiscal stimulus moves are especially strong with additional spending on infrastructures of 4.5% of nominal GDP for both 2009 and 2010.

Without ignoring the major risks for China's economy, there are signss of stabilization more convincing now than at the beginning of the year. To begin with, the slowdown in growth compared with the fourth quarter of 2008 is not as sharp as in previous periods. What is more, under the investment heading, fixed capital formation in current terms rose to show growth of 28.8% year-on-

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	13.0	9.1	10.6	10.1	9.0	6.8	–	6.1	–
Industrial production	17.1	13.0	16.5	15.9	13.0	6.4	8.4	11.0	8.3
Electrical power generation	15.7	6.7	16.0	11.9	6.7	–6.0	–14.1	4.8	0.6
Consumer prices	4.8	5.9	8.0	7.8	5.3	2.5	1.0	–1.6	–1.2
Trade balance (*)	262.4	295.2	256.5	247.3	257.0	295.2	314.9	311.5	316.9
3-month interbank interest rate (**)	3.6	4.2	4.6	4.6	4.4	3.2	2.5	1.3	1.5
Renminbi to dollar	7.6	6.9	7.1	6.9	6.8	6.8	6.8	6.8	6.8

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

year, partly thanks to strong government efforts in the rural areas.

The most recent indicators also suggest that the economy may have hit bottom. Industrial production grew by 8.3% year-on-year in March and, following the hiatus of the Lunar New Year, this confirms something of a recovery trend. National electrical energy production also showed some rise in March although overall growth in the past 12 months was well below what was normal in 2007. In prices, some risks of deflation persist but these are not increasing. The general CPI dropped by 1.2% year-on-year in March while food prices were down by a slight 0.7%.

The weakness of the foreign sector could be hurting the Chinese economy less than expected. While exports make up more than 30% of total GDP, as distinct from Japan, the Chinese add-on in terms of value added to imported products that are transformed and later exported is much lower. The effects of a reduction in exports are thus more limited and may be compensated by lower imports, as is shown by the trade surpluss which, in the past 12 months ending in March, rose to 316.89 billion dollars, a new all-time record. Trade also stabilized its decreases and March exports were down by 17.1% year-on-year while imports dropped by 25.1%. China is moderating its risks but stabilization of the economy does not imply a sustained recovery because what is still needed is the consolidation of domestic consumption that scarcely amounts to 40% of GDP. With regard to the world economy, it should be borne in mind that for the moment the Chinese economic engine cannot compensate for the weakness in demand now existing in the United States.

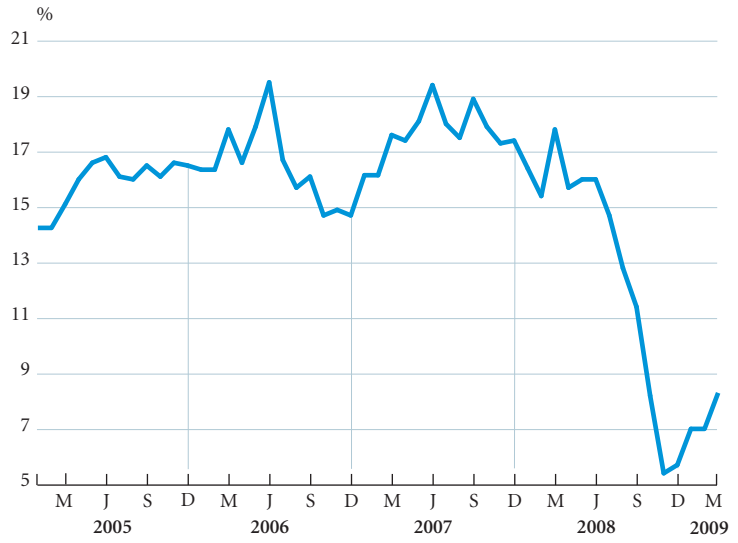
Industrial production recovers with growth of 8%.

CPI eases drop and shows decrease of 1.2%.

Exports down 17% while imports drop 25%.

CHINA: INDUSTRY HITS BOTTOM AND STARTS RECOVERY

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



NOTES: (*) Figures corrected for calendar effects of Chinese Lunar New Year.
SOURCE: Chinese National Statistics Office and own calculations.

Global adjustments: the role of foreign exchange flexibility

In the past decade major imbalances have been accumulated at the international level that pose a risk for world financial and economic stability. Economies such as those of Germany, Japan, China and other Asian countries (see following graph) have recorded persistent surpluses due to their higher propensity to save. These savings have been channeled into deficit economies, mainly the United States but also Australia, Spain, New Zealand and the United Kingdom.

In previous decades, the current account deficit was characteristic of emerging economies. Often, the deficit was financed with short-term borrowing in foreign currency. When access to refinancing was cut off, exchange rates underwent sharp depreciations and the country had difficulty in meeting loans repayments. This was the moment when the IMF moved onto the scene. This situation changed radically as a result of the 1997 Asian crisis.

The traumatic experience of the 1997 crisis meant that a number of Asian economies decided to maintain very competitive foreign exchange rates in order to stimulate growth and accumulate reserves avoid another crisis. This made it possible to generate major surpluses in their foreign balances, which turned into a giddy accumulation of international reserves, mainly in US dollars (see Box «Is globalization causing imbalances in balances of payment?»). More recently, since 2004 the oil exporting countries have added notably to the widening of world imbalances. These countries have saved a good part of the increase in revenues arising from the spectacular increase in oil prices.

The high level of savings in the emerging economies and oil exporting countries has had major repercussions in the developed countries. For example, it has contributed to the fact that interest rates and risk premia in corporate markets held at excessively low levels, especially between 2004 and 2006, which in turn made it possible for bubbles to develop in the prices of some assets such as housing. Another negative result of these global imbalances is the risk they represent for world economic stability if there were to be a sudden halt to financial flows toward those economies with higher deficits, specifically the United States. If this risk materialized it would bring about a sharp depreciation of the dollar and an increase in long-term interest rates.

How should these imbalances be reduced? The answer is not simple and inevitably it causes controversy. The solution of such a complicated problem definitely depends on reaching a world consensus on matters of economic policy. The governments of the emerging economies are aware that they must formulate policies to stimulate the growth of investment and domestic consumption, policies that stimulate the growth of domestic demand and reduce their dependence on foreign demand. Furthermore, the authorities know that it is important to make their exchange rate regimes more flexible although they may prefer that these changes be gradual. China, for example, has allowed a 16% appreciation of the yuan against the dollar since it eased it exchange system in July 2005. On the other hand, it is important that the developed economies with major deficits encourage long-term savings although it is logical that in the current economic situation their main concern is to avoid an excessive adjustment in private savings over a short period of time. In this respect, the budgetary adjustment in the United States over the medium-long term, which is crucial for increasing savings in the economy as a whole, looms up as one of the keys for reducing the US deficit and therefore world imbalances.

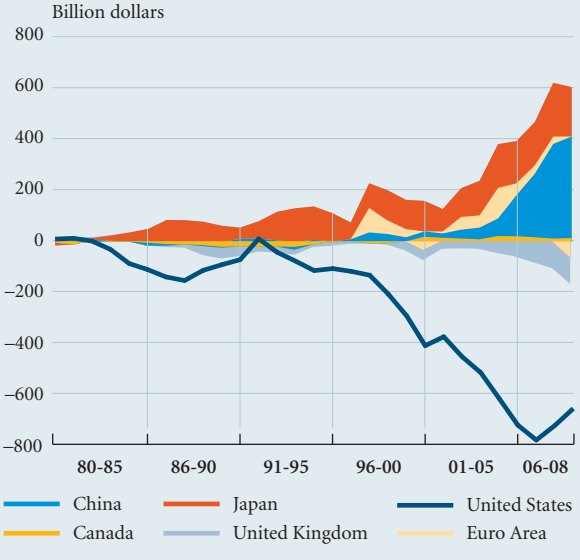
In any case, we cannot deny that the process of reducing the US trade deficit is already taking place. From the high point in the third quarter of 2006 to the fourth quarter of 2008, the US deficit has dropped by one percentage point going to 3.5% of GDP, in spite of the boost in oil prices. If we exclude oil imports, the deficit has been reduced from 3.7% to 2.1% of GDP. The depreciation of the dollar, which lost 18% in real effective terms between 2003 and 2006-2008. Has contributed to this reduction. Given the delayed impact of foreign exchange rates on the trade deficit, the deficit in 2008 is basically related to the dollar exchange rate in the preceding two years.

Must the dollar continue to depreciate in order to complete adjustment of the US foreign deficit? Not necessarily. According to the estimates of some economists,[1] the depreciation of the dollar since 2004 would be enough for the US trade deficit to continue gradually reducing to a sustainable level of 1.5%-3% of GDP. In bilateral terms, we may expect that over the medium-long term the dollar will continue to weaken against the Asian currencies (especially against the renminbi) and that it would appreciate slightly against the euro. This would maintain the exchange rate for the dollar at a level similar to that now in effective terms (on average) and would lead to a gradual adjustment of the US deficit and therefore of global imbalances.

What shall we see over the short term? In coming quarters the rate of adjustment of world imbalances could temporally increase. This increase would have a strong cyclical component related to the current economic

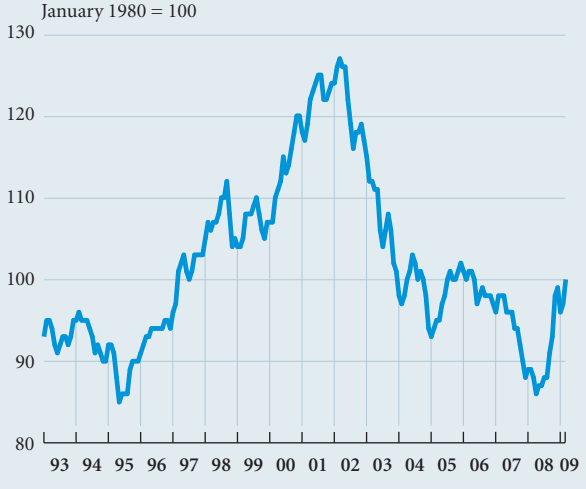
AS WORLD IMBALANCES BUILT UP... THE DOLLAR DROPPED TO CORRECT THEM

Current account balance



SOURCE: International Monetary Fund.

Index of effective real exchange rate of dollar against main currencies



SOURCE: Federal Reserve.

(1) See Enric Fernández, «La sostenibilidad del déficit exterior de Estados Unidos», "la Caixa" Economic Document April 2007 and Maurice Obstfeld and Kenneth Rogoff, «Global Current Account Imbalances and Exchange Rate Adjustments», Brookings Papers on Economic Activity, Volume 1, 2005, Pages 67-146.

recession, the intense weakness of US domestic demand and the contraction in world trade. Nevertheless, once these cyclical factors ease and for the gradual process of adjustment to continue it is fundamental that China and the main Asian economies continue to facilitate the appreciation of their currencies. This is an essential ingredient to end the world imbalances and lay the bases for more sustainable world growth than what we have seen in recent years.

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Weakness in consumption, investment and labour market indicate that Brazil began 2009 undergoing contraction.

Trade surplus thanks to bigger drop in imports.

Brazil: The signs not raising hopes

The economic indicators suggest that Brazil showed further contraction in the first quarter of 2009 although the drop would have been below the 3.6% quarter-on-quarter dip seen in the fourth quarter of 2008. The weakness of domestic consumption due to the poor situation in the labour market and prospects of a further drop in household incomes will be key in setting the bottom for the current contraction. Investment is continuing its trend to adjustment while foreign demand is providing some slight support to growth, thanks to depreciation of the Brazilian real.

Domestic consumption continues to slow down. The year-on-year growth rate of retail sales dropped to 3.8%, well below the rates of around 9% that were common in 2008. On the other hand, car sales were up in March putting up the growth rate to 8.7%, thanks to tax incentives introduced by the government at the beginning of the year.

The labour market continues to worsen and unemployment stood at 12.3% in February, more than one point above the rate reported in January. Given that the unemployment rate grows in a delayed manner (first economic activity is adjusted and then unemployment) the number of unemployed will continue to grow in coming months. This situation will have a negative effect on household Incomes and therefore consumption will tend to contract even more.

Investment also presents a dark horizon. In spite of the increase in activity in the motor vehicle industry, industrial production was down 13.5% in February compared with the same period the year before. The drop in utilization of installed capacity associated with this situation suggests a drop in investment demand in coming quarters. Industrial production of capital goods in February was already showing a contraction of 24.4%.

Foreign demand brings a slightly optimistic note and the monthly trade balance was again positive in March going to 1.77 billion dollars. In spite of the fact that exports were down 6.4% year-on-year, the drop in imports (13.7%) was much greater. The change in relative prices brought about by the depreciation of the Brazilian real (more than 45% against the dollar between August 2008 and February 2009) has been one of the factors in reducing the rate of decrease in exports.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	5.7	5.1	6.1	6.3	6.8	1.2	...	...	...
Industrial production	5.9	2.9	6.7	5.2	6.4	–6.2	–15.3	–13.5	...
Consumer confidence (*)	132.3	140.4	146.0	146.5	136.3	132.9	124.4	132.9	128.2
Unemployment rate São Paulo (**)	15.0	13.0	13.8	13.7	12.7	11.6	11.2	12.3	...
Consumer prices	3.6	5.7	3.7	4.6	5.1	4.5	5.8	5.9	5.6
Trade balance (***)	40.0	24.7	34.1	30.8	28.7	24.7	23.3	24.2	25.0
Interest rate SELIC (%)	12.75	11.25	11.25	12.25	13.75	13.75	12.75	12.75	11.25
Reales to dollar	2.1	1.8	1.8	1.6	1.9	2.3	2.3	2.4	2.3

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

The weakness in demand has counteracted inflationary pressures that could have come from depreciation of the real. In March, inflation dropped by three decimals going to 5.9%. Underlying inflation held at 4.9% for the third month in a row.

In this context, it is very likely that the first quarter of 2009 could be the low point in the cycle, a time when the Brazilian economy will begin to turn around its negative trend. However, recovery will not be consolidated until the end of 2009 to the extent that world demand begins to recover. As in other countries, recovery is likely to be slow and long drawn out.

Mexico: weak growth but secure finances

The sharp contraction of exports to the United States and the drop in remittances continue to affect the Mexican economy. Domestic demand is being weakened by credit restrictions, low consumer confidence and worsening of the labour market. On the financial front, the granting of a line of credit by the IMF must be seen as positive.

Domestic consumption is not showing any signs of improvement which is reflected in the 8.6% year-on-year drop in retail sales in March, the biggest contraction since 1996. Three factors have been eating away at Mexican household finances, namely, the increase in unemployment to 5.3% in February (3.9% in February 2008), the drop in remittances (5% lower in February than one year ago) and finally difficulties in obtaining credit. To complete the poor picture in domestic consumption, consumer confidence has dropped to 78.9 points, the lowest figure since April 2001.

In inflation, the general CPI moderated the year-on-year rate in the first three months of 2009 (from 6.5% in December 2008 to 6.0% in March 2009). In turn, the underlying CPI seems reluctant to drop and is swinging around 5.7% year-on-year.

Consumption and retail trade drag down growth of Mexico's GDP in first quarter of 2009.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	3.3	1.4	3.3	2.3	1.7	–1.7	...	...	...
Industrial production	2.4	–1.0	2.0	0.0	–1.5	–4.4	–10.1	–9.6	...
Consumer confidence (*)	104.9	92.2	102.4	94.2	88.9	83.3	81.9	78.9	...
General unemployment rate (**)	3.7	4.0	3.9	3.5	4.2	4.3	5.0	5.3	...
Consumer prices	–22.7	–11.8	4.0	4.0	3.8	4.7	6.3	6.2	6.0
Trade balance (***)	–10.1	–17.3	–9.3	–7.8	–11.9	–17.3	–17.1	–16.4	...
Official Banxico rate (%)	7.00	7.50	7.50	7.75	8.25	8.25	7.75	7.50	6.75
Mexican pesos to dollar (*)	11.0	10.6	10.6	10.3	11.0	13.9	14.4	15.1	14.2

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

IMF agreement brings financial calm and stability.

In the foreign sector, Mexico's trade deficit worsened going to 16.4 billion dollars in February, well above the 11 billion dollars on average in 2008. This figure reflects a contraction of 30.7% year-on-year in imports, which was bigger than the drop in exports. Specifically, Mexico's exports of non-oil products (a component with considerable weight in the GDP) dropped by 24.1% year-on-year in February due to the weakness of US demand.

With the approval of an IMF line of credit on April 17, 2009, the Mexican government took a fundamental step in stabilizing and strengthening its surplus. The amount of the credit (of a preventive nature) was 47 billion dollars. This, together with the 30 billion dollars available through a swap line with the US Federal Reserve, gives Mexico a foreign financial cushion equal to 9.6% of GDP. Furthermore, Mexico holds 85 billion dollars in international reserves.

April oil price maintains most of March gain.

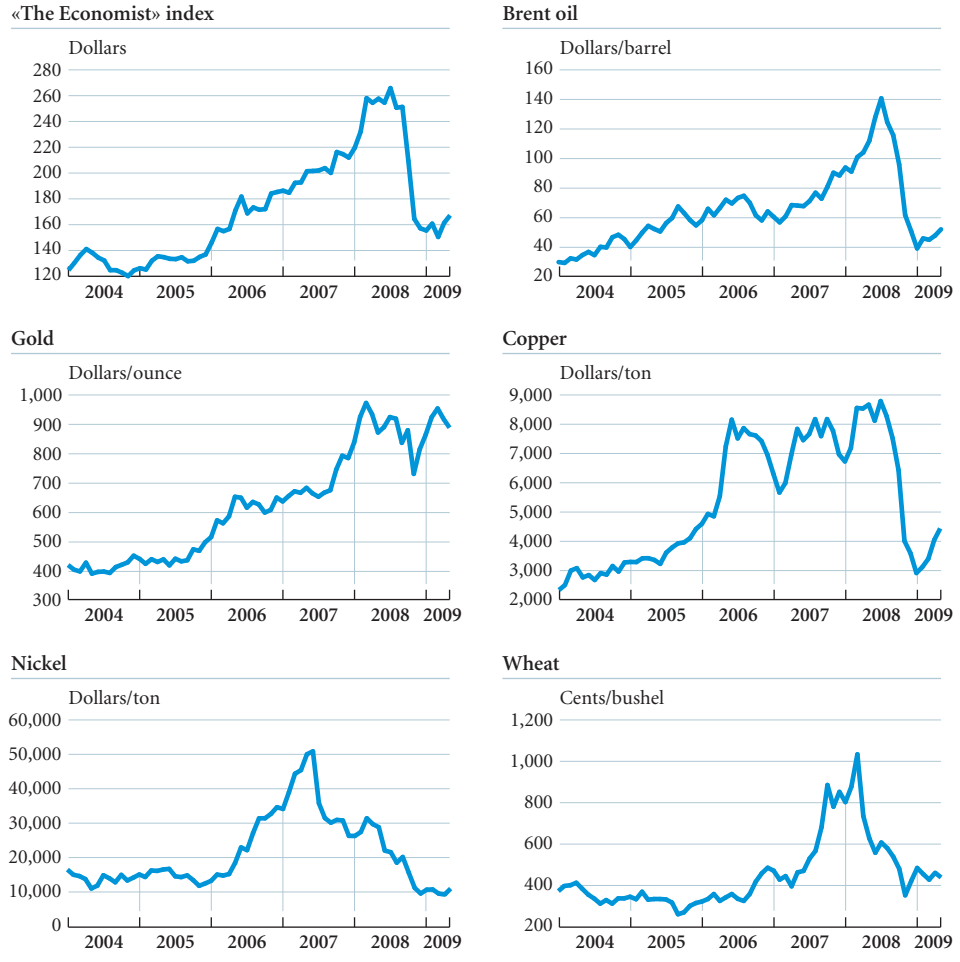
To conclude, in spite of the fact that Mexico's growth during 2009 will be negative, through the instruments described here, the government has been able to more than comfortably cover the financial needs of its economy. This solid situtation will help ease pressure on the Mexican peso.

Drop in oil prices while China pushes up metals

The price of oil maintained most of its gains seen the month before. Between March 20 and April 22 crude oil dropped by a low 2.2% to 49.79 dollars a barrel (one-month delivery Brent quality) putting the cumulative increase for the current year at 27.4%.

The decrease in oil inventories was higher than expected but this was compensated by a bigger drop in demand. While downturn has predominated during the past month, we should note the relative stability in the price of crude which could move up as soon as the first signs of recovery are seen in the United States.

TREND IN VARIOUS COMMODITIES (*)



NOTES: (*) Figures for last day of month (latest figure, April 23).
SOURCE: «The Economist», Thomson Reuters Datastream and own calculations.

In the first 20 days of April, base metals moved up as commodity markets began to bet on a recovery of China's economy. This is a bet that continued to be supported by the accumulation of copper and nickel reserves by the Chinese authorities.

The Economist commodities index rose by 7.8% between March 20 and April 22 so that copper (which had moved up 12.6% in that period) has now shown a total increase of 51.7% during the current year. A continuation of the price rise in metals will depend on the performance of China's economy although, with the recovery of the Asian giant being discounted so soon, increases in coming months surely must be limited. Gold, in turn, saw some profit-taking and dropped by 7.5% but failed to show any clear direction in view of the uncertainties that exist regarding world recovery.

Chinese demand continues to keep up base metal prices while gold undergoes profit-taking.

EUROPEAN UNION

European economy not showing any convincing signs of recovery.

Euro Area: no sign of recovery

In the *Monthly Report* for April we examined the trend in the various components of the gross domestic product (GDP) in the fourth quarter of 2008. The conclusion we reached could not have been more pessimistic. The downward trend had touched all components and sectors of the economy on the Old Continent. Furthermore, the more frequent indicators suggested that the same trend would continue in the first quarter of 2009. Unfortunately, one month later the situation remains exactly the same. While other economies such as that of the United States have begun to show some positive signs, the Euro Area economy is not giving off any convincing indications of recovery. Rather to the contrary, as everything indicates that the downturn seen in the first quarter of 2009 has been very severe.

The savageness with which the Old Continent economy is slowing down has caught most analysts by surprise. The effect of the world financial crisis in countries that had enjoyed a boom in the real estate sector, such as Ireland, Spain and the United Kingdom, was anticipated fairly soon. But few analysts correctly foresaw that the most vulnerable economies would be those that were most dependent on the foreign sector. The decrease in consumption in the main world economies, along with the effect of credit restrictions on export

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
GDP	2.7	0.7	2.2	1.5	0.6	–1.4	–	...	–
Retail sales	1.3	–0.2	1.0	0.6	–0.2	–1.9	–2.2	–4.2	...
Consumer confidence (1)	–4.9	–17.9	–11.9	–14.6	–19.2	–26.1	–30.5	–32.5	–33.7
Industrial production	3.5	–1.7	2.5	1.1	–1.4	–8.8	–15.9	–18.4	...
Economic sentiment indicator (1)	108.9	91.1	101.4	97.5	89.9	75.8	67.2	65.3	64.6
Unemployment rate (2)	7.4	7.5	7.2	7.4	7.5	8.0	8.3	8.5	...
Consumer prices	2.1	3.3	3.4	3.6	3.8	2.3	1.1	1.2	0.6
Trade balance (3)	20.1	–1.2	24.4	13.8	–11.4	–31.7	–33.5	–37.5	...
3-month Euribor interest rate	4.3	4.6	4.5	4.9	5.0	4.2	2.9	2.1	1.8
Nominal effective euro exchange rate (4)	107.9	113.0	113.0	116.0	114.0	109.1	111.9	110.4	...

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.

business, is causing a severe contraction in world trade.

In this respect, the European economy has everything to lose seeing that exports hold a very important weight in the overall economy. In 2008, the ratio of exports of goods and services to countries outside the EU in terms of the GDP reached 16.8%, a level similar to that for Japan's economy and above that for the United States. Furthermore, the greater part of the trade of the various countries in the Euro Area takes place internally. The case of Germany is well-known with exports making up 39% of GDP in 2008. But other countries, such as Austria, Ireland, Netherlands and Belgium, have a significantly higher ratio.

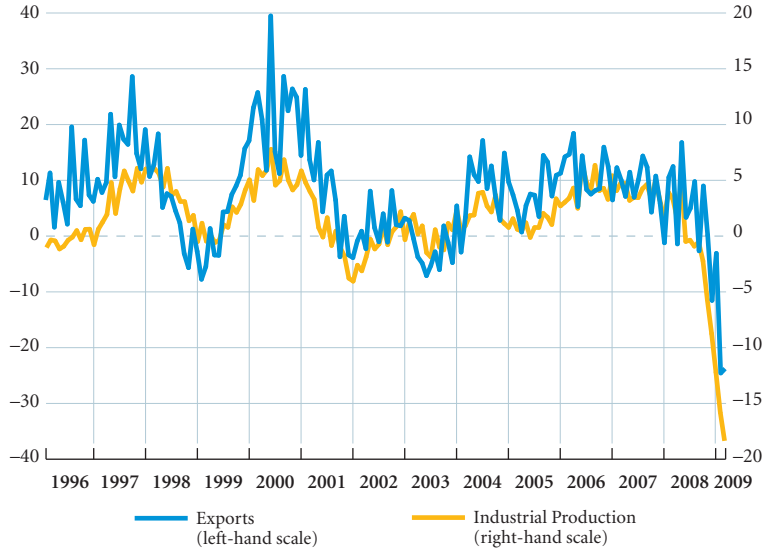
For the Euro Area as a whole, the drop in exports in year-on-year terms was 24.6% in January (see graph below). While the rate of decrease eased slightly in February, it is still holding above 20%. Given the volatility of the statistical series over the short term, it is still too early to conclude that the decrease may have hit bottom. But we should keep in mind that the negative effect of exports has been partly compensated by the drop in imports. Due to the weakness in domestic demand, imports continued to drop sharply, at 21% in year-on-year terms.

A look over the indicators, both those for demand and supply, does no more than confirm a pessimistic picture for the future of the European economy. With regard to demand indicators, all these continue to show signs of weakness. Retail sales, for example, fell for the fifth month in a row. The year-on-year change rate marked up a new all-time low in February going to 4.2%. Nor did consumer confidence, for which the March figure is now available, establish any floor and continues its sharp downward swing.

Vulnerability of economy suffering from drop in exports becoming evident...

FOREIGN SECTOR BRINGS SLOWDOWN IN EUROPE

Percentatge change over same period year before



SOURCE: Eurostat and own calculations.

...which means economic contraction will keep on for another quarter.

Supply indicators also are failing to show any sign of improvement. In February, the year-on-year change also marked up an all-time low going to 18.4%. Economic sentiment indicators for March, both general and sectorial, also keep dropping although they are doing so at a lower rate.

The steep drop in trade and the decreases hitting retail sales and industrial production (two good indicators of the trend in consumption and investment respectively) suggest that the main GDP components will drop sharply in the first quarter of 2009. It is highly probable that all of this will mean that that the overall economy of the Euro Area will show a similar, if not greater, drop than that seen in the final quarter of 2008.

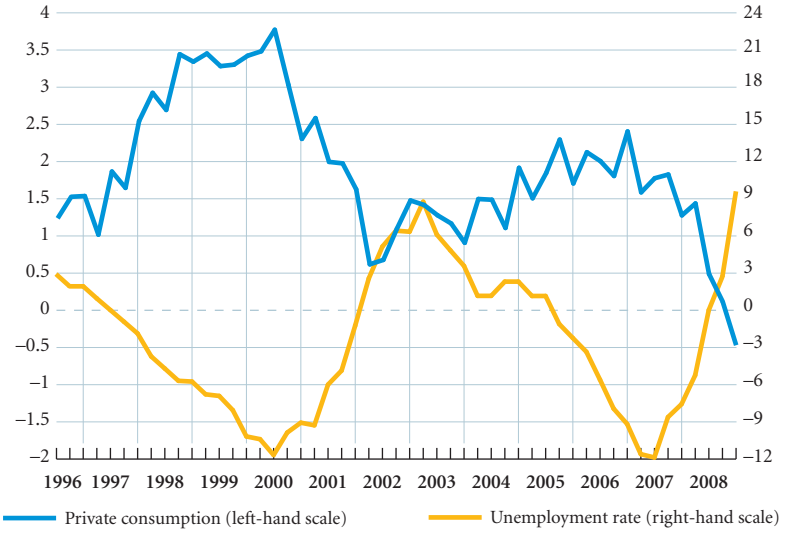
Worsening labour market will also mean very weak medium-term growth.

As if this were nothing, the medium-term prospects are also fairly sombre. In fact, the worst may be still to come. This fear is partly based on the future performance of the labour market. As is logical, there is a close relationship between the trend in consumption and the unemployment rate (see following graph). But it is interesting to point out that the movements in both statistics have been very consistent over time. The upward stages have lasted for several years as has been the case in downward stages.

The current upward stage began in the second quarter of 2008 and was largely brought about by the worsening of the labour market in Spain and Ireland. This put the unemployment rate in the Euro Area up to 8.5% in February, 1.3 points above the low recorded in March 2008. Nevertheless, in most countries, including the three main economic powers (Germany, France and Italy), the increase is still very gentle, especially if we compare it with the sharp decreases in production and demand. This makes

WORSENING LABOUR MARKET WEAKENS CONSUMPTION

Percentage change over same period year before



SOURCE: Eurostat and own calculations.

one think that the worsening of the labour market may still have some way to go in coming quarters, which would help maintain the weakness of consumption.

For the moment, the front most actively fighting against the recession is to be found in Frankfurt. With inflation well below 2% (in March it was 0.6%), the European Central Bank continued to make use of its remaining slender margin for manoeuvre to stimulate the economy. At its April meeting it again lowered the reference rate by 0.25 points putting it at 1.25%. As usual, it also reduced the deposit facility rate by 25 basis points. This now stands at 0.25% and has used up its course. While the governor of the top monetary authority did not rule out further decreases in the reference rate, these will have to be very modest as they will reduce the ECB's intervention margin. Nevertheless, governor J.C. Trichet pointed out that they still had a wide range of instruments at their disposal. In this respect, he announced that at the May meeting he would make public a package of non-conventional measures in order to stimulate the economy.

The trend in the labour market and the foreign sector will be among the keys that set the depth and duration of the recession. If it is confirmed that the drop in exports has found its floor downward pressures would be reduced. But the worsening of the labour market could make economic recovery slower than expected.

According to this scenario, the International Monetary Fund (IMF) has again revised substantially downward its growth forecasts for the Euro Area. In 2009, it foresees that the economy will contract by 4.2% and, moreover, it does not expect that there will even be a recovery in 2010 given that it is anticipating a drop of 0.4%.

ECB to announce package of unconventional measures to keep stimulating economy.

Germany: Europe's leading economy in trouble

Barely six months ago, when the impact of the financial upsets began to make big inroads on the growth of the advanced economies, Germany seemed to present sufficient economic strength to allow it to suffer a less severe recession than that in other economies. This idea was based on the fact that Germany was not showing the main risk factors that had drawn others into the recession such as excessive private borrowing, a very high current account deficit and a real estate bubble.

In spite of earlier good prospects, the new IMF forecasts put the German economy as the second leading developed economy with the biggest downturn in 2009, behind Japan, and the one that will suffer a harsher recession in 2010. In view of this change, we may ask what are the causes bringing this about.

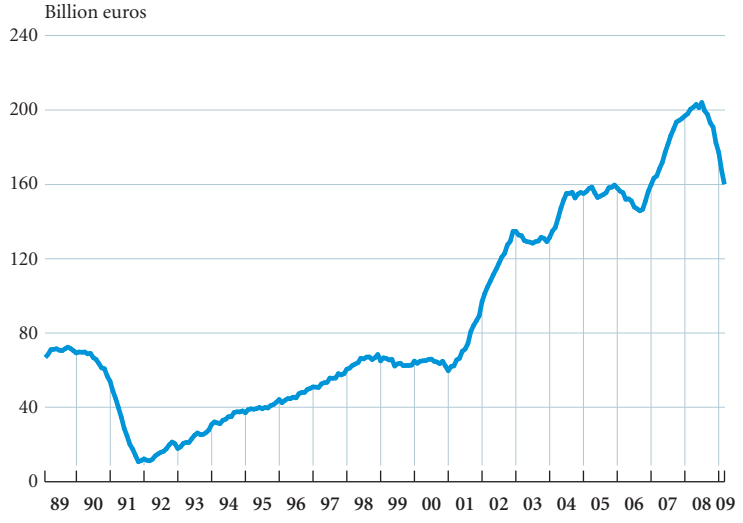
IMF forecasts 4.2% contraction this year in Euro Area.

Growth of Germany's economy is mainly dependent on exports and investment. Nevertheless, the worsening of the economy in its main trading partners in recent months brought a contraction in exports which were down 21.5% in February. As a result, the surplus in the trade balance accumulated over the past 12 months was down in February to levels similar to 2006. The 6.2% drop in retail sales in March shows that the decrease in foreign demand was not compensated by higher demand from households. In the present situation and in view of uncertainty about the labour situation, household confidence kept getting worse and marked up new lows.

New forecasts see drop in Germany's GDP for next two years.

GERMANY: TRADE SURPLUS DROPPING FAST

Cumulative 12-month figure for trade balance



SOURCE: Deutsche Bundesbank.

Industrial activity keeps recording new lows.

If we look at supply indicators, the prospects are not much brighter. The drop in demand meant that production and industrial orders held to the trend in recent months showing new lows of 20.3% and 37.8% respectively in February. As a result, utilization of production capacity continued to drop while the unemployment rate maintained moderate growth going to 8.1% in March. These indicators taken together allow us to estimate that the quarter-on-quarter drop in GDP in the first quarter of 2009 was even greater than that in the previous quarter. As a result, government forecasts will put the drop in the economy in 2009 at very high levels.

Weak signs of moderation in drop in economic activity.

In this unflattering context, we can note some signs of an easing of the economic contraction. Some lower quarter-on-quarter drops are to be seen in industrial orders and production along with a low level of inflation. And it is expected that the business confidence index will show an increase in April for the first time so far this year. Nevertheless, these signs are still weak and do not make it possible to state that the worst moment of the recession is now over.

On the demand side, car registrations showed a big increase in February and March under the effect of fiscal incentives to take old cars off the road. In view of the good response to this measure and the large number of applications, the German government has decided to double the budget allowed for. This increase in car registrations has brought a much higher level of sales in the lower price range which are largely produced outside the country so that the bigger number of vehicle registrations has not meant an increase in industrial production of cars.

Prospects for the German economy are making it more and more difficult to maintain the reticence of Angela Merkel's political party to apply a new fiscal plan to stimulate the economy, especially following the announcement by the SPD

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
GDP	2.6	1.0	2.8	2.0	0.8	–1.7	–	...	–
Retail sales	–3.0	–0.5	–1.2	–0.8	0.1	–0.5	–2.1	–6.2	...
Industrial production	5.8	0.0	4.8	2.8	0.0	–7.5	–17.9	–20.3	...
Industrial activity index (IFO) (*)	106.1	96.8	104.0	102.1	94.8	86.2	83.1	82.6	82.1
Unemployment rate (**)	9.0	7.8	8.1	7.9	7.7	7.6	7.8	8.0	8.1
Consumer prices	2.3	2.6	2.9	2.9	3.1	1.6	0.9	1.0	0.7
Trade balance (***)	181.5	195.3	199.5	202.3	196.3	183.0	167.3	159.5	...

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.

(the other party in the coalition) of a reduction in taxes with a view to the upcoming elections to take place in September.

France: the worst of the recession could be over

For the first time in months, some economic activity indicators, especially for industry, are suggesting that the recession in France may have hit bottom in the first quarter of 2009. Although industrial production was down 0.4% in February compared with the month before, the drop was much lower than that recorded in previous months putting the decrease at 15.5% year-on-year.

In the same way, economic sentiment indicators for March show a small decrease compared with that noted in previous months. According to the report on the economic situation put out by the Bank of France on April 8, the index for industrial business climate rose slightly in March going to 73 points. There was also an improvement in the overall industrial orders index which rose from –28 to –18 points.

The *Pacte automobile*, set out in the French government's budget on March 4th following the agreement of the European Commission, likely contributed to make the results for industry in March relatively more favourable. The number of car registrations that month was up considerably (7.0% month-on-month) and this suggests that the series of measures to stimulate the motor vehicle sector is indeed having results.

Fiscal measures boosting car registrations.

Nevertheless, remaining indicators show a less positive result. On the demand side, available indicators suggest that investment will keep shrinking although to a lesser degree. Companies are still showing prospects of weak demand as well as under-use of production capacity. In fact, the rate of utilization of production capacity dropped by a half-point in March. Nevertheless, we should point out that the decrease last month was less than in previous months.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
GDP	2.1	0.7	2.0	1.1	0.6	–0.9	–	...	–
Domestic consumption	4.4	1.1	2.4	1.5	0.9	–0.2	1.8	–2.0	...
Industrial production	1.5	–2.5	1.6	–0.4	–2.2	–8.9	–14.5	–15.5	...
Unemployment rate (*)	8.3	7.8	7.6	7.6	7.8	8.2	8.5	8.6	...
Consumer prices	1.5	2.8	2.9	3.3	3.3	1.8	0.7	0.9	0.3
Trade balance (**)	–33.3	–48.1	–41.5	–45.5	–50.4	–54.8	–54.2	–55.4	...

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

In France, inflation stood at 0.3% year-on-year in March.

On the other hand, French household consumption is weak and dropped by 2.0% year-on-year in February and this likely showed up in the moderate performance in inflation. It is expected that household consumption remained low in March given that price rises that month were even lower (0.3% year-on-year), the lowest rate since June 1999.

In turn, the unemployment rate rose by one decimal in February to stand at 8.6%. We should point out that unemployment is most severely affecting those under 25 years of age. As a result, on April 24 French president Nicolas Sarkozy presented an emergency plan to fight against youth unemployment.

Finally, available indicators suggest that, while the situation is not very favourable, the recession in France is closer to turning around. In the same way, the figures show that France is probably resisting the economic decline better than its neighbours. Contributing to this is the fact that generally it is less exposed to world trade and the real estate crisis.

Italy showing no signs of improvement

The Italian economy continued to show no signs of improvement in the first quarter of 2009 and looked like going into its fourth quarter-on-quarter drop in GDP in a row. While some opinions in April gave out a degree of optimism, with the belief that the worst moments of the recession had been left behind, the revised forecasts by the International Monetary Fund (IMF) putting the drop in Italy's GDP for 2009 at 4.4% soon dispersed hopes of a rapid recovery. This downward revision was based on a bigger drop in demand, both domestic and foreign, and in investment.

IMF foresees 4.4% drop in Italy's GDP in 2009.

On the demand side, consumer confidence keeps dropping and went to a new low for the past 15 years, the result of uncertainty in households about employment. This pessimism, which supposes a drop in consumption, was not evident in the motor vehicle sector due to government incentives for taking old cars off the road. As a result, car registrations in March were 29.6% higher than in the month before

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
GDP	1.5	–1.0	0.4	–0.4	–1.3	–2.9	–	...	–
Retail sales	–4.2	–0.3	1.4	–0.7	0.1	–1.7	0.7	...	...
Industrial production	2.1	–3.4	0.9	–0.2	–4.0	–10.5	–16.9	–20.0	...
Unemployment rate (*)	6.2	6.7	6.6	6.8	6.7	6.9	–	...	–
Consumer prices	1.8	3.3	3.1	3.6	4.0	2.8	1.6	1.6	1.2
Trade balance (**)	–12.8	–10.0	–8.5	–8.6	–10.8	–12.3	–11.0	–11.4	...

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

following 14 months of drops in a row. In this context, prices rose by 1.2% in March, the lowest increase in the last 40 years.

The contraction in demand was also seen in the February trend in imports which were down 23.7% compared with the same month last year. Nevertheless, the bigger drop in exports (25.3%) meant an increase in the trade deficit that month. In view of this situation, industrial production was down 20.0%, the biggest drop ever. Together with under-utilization of production capacity, the drop in industrial confidence and the increase in credit restrictions by financial entities, these factors make it possible to estimate that investment in Italy in first quarter would have continued to contract.

In view of the high government debt, which has refrained the government to adopt major fiscal measures, the new IMF chairman forecasts that net government debt will go above 120% of GDP in 2010, climbing to debt levels similar to those in 1996.

United Kingdom: some economic activity indicators show more moderate drops

Industrial production collapses indicating drop to come in investment.

The British economy continues to be deep in recession with all activity indicators in the red. Nevertheless, the most recent figures show that the decreases are somewhat less sharp, at least on the supply side. Industrial production was down 0.1% in February putting the drop at 12.4% year-on-year. This decrease, along with that in January, was lower than that noted in previous months. A similar trend was seen in the industrial orders index which was down 4 points in March, less than the 16 point drop in February. At the same time, there was a lower drop in the industrial confidence index.

On the demand side, the prospects are slimmer. We should point out the weak performance in private demand. As a result, retail sales rose by 0.5% year-on-year, well below growth rates in preceding months. At the same time, consumer confidence continued to drop in March to stand at negative levels (–28 points). The same weakness in

British industrial production down 12.4% in February 2009.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
GDP	3.0	0.7	2.6	1.8	0.4	–2.0	–	...	–
Retail sales	4.4	3.5	5.3	4.3	2.3	2.5	3.7	0.5	...
Industrial production	0.1	–2.8	0.5	–1.3	–2.5	–7.5	–11.5	–12.4	...
Unemployment rate (*)	2.7	2.8	2.4	2.5	2.8	3.4	3.9	4.3	4.5
Consumer prices	2.3	3.6	2.4	3.3	4.9	3.9	3.0	3.1	2.9
Trade balance (**)	–83.5	–93.2	–91.3	–93.4	–94.5	–93.4	–92.7	–92.2	...
3-month Libor interest rate	5.3	6.0	6.0	6.0	5.9	6.3	2.8	2.2	2.0
Nominal effective pound exchange rate (***)	103.9	97.6	97.6	92.6	92.8	89.4	73.7	77.0	77.8

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.

March inflation stands at 2.9%, higher than expected.

consumption showed up in the drop in car registrations in March (31% year-on-year). Nor did foreign demand offer much of a breather. In spite of the depreciation of the pound sterling, the trade deficit is not being corrected given that the world dimensions of the recession are reducing foreign demand for British products.

With such an adverse economic situation, it is surprising that inflation was down only 3 decimals in March to stand at 2.9% year-on-year, well above expected. Much of the reason for this is the fact that the weakness of the pound puts up the price of consumer goods which contain a high proportion of imported products. In fact, since the beginning of 2008, the pound has depreciated by a quarter of its real value. Nevertheless, the prospects are for inflation to continue dropping over coming months.

General budget for 2009-2010 foresees 12.4% deficit in GDP.

In this very unfavourable framework, government policies to stimulate the economy have raised great interest. It is therefore not surprising that the British budget presented on April 22 by Chancellor of the Exchequer Alistair Darling has been followed with great attention. The budget was prepared on the supposition that economic activity in the United Kingdom would drop by 3.5% in 2009, its worst result since 1945, with growth of 1.25% to come in 2010.

Under the 2009-2010 budget estimates, the British government will apply a total amount equivalent to 4% of GDP to fiscal amplification. This will mean that the deficit for this year will reach 12.4% of GDP.

In addition, the budget summary states that it will be necessary to implement tax changes so that fiscal spending is sustainable. For example, as of April 2010 income tax will be raised to 50% on annual incomes over 150,000 pounds. Taxes will also go up on drinks, tobacco and petrol. At the same time, it is planned to save 15 billion pounds through gains in the efficient management of resources, for example, by hunting down tax evasion.

Emerging European countries: some relief on financial front but economic activity sinking

Since last March quotes for financial assets of emerging European countries have appreciably recovered. For example, after showing annual lows, the main stock markets in the region have piled up increases of more than 20%. Currencies have shown a similar trend and, after a long period on a depreciation path, have tended to recover since the end of February. At the same time, another aspect of finance that has caused concern, country risk, has also partly diminished, as seen in decreases in risk premiums on sovereign bonds and default risk on those bonds. What is to be learned from all this? Can it be said that the economic crisis is over?

Unfortunately, everything suggests that the emerging European economies still have some way to go until the recession is beaten. This explains why in April new downward revisions were announced for growth in 2009 and 2010 covering various countries in the region. Among the most significant were those published by the IMF which forecast that the GDP for the region as a whole will drop by 3.7% in 2009 as against a drop of 0.4% expected last January. That this is not a matter of a dip for just a few quarters is shown by the fact that the IMF forecasts growth of only 0.8% in 2010, well below the growth potential of these economies.

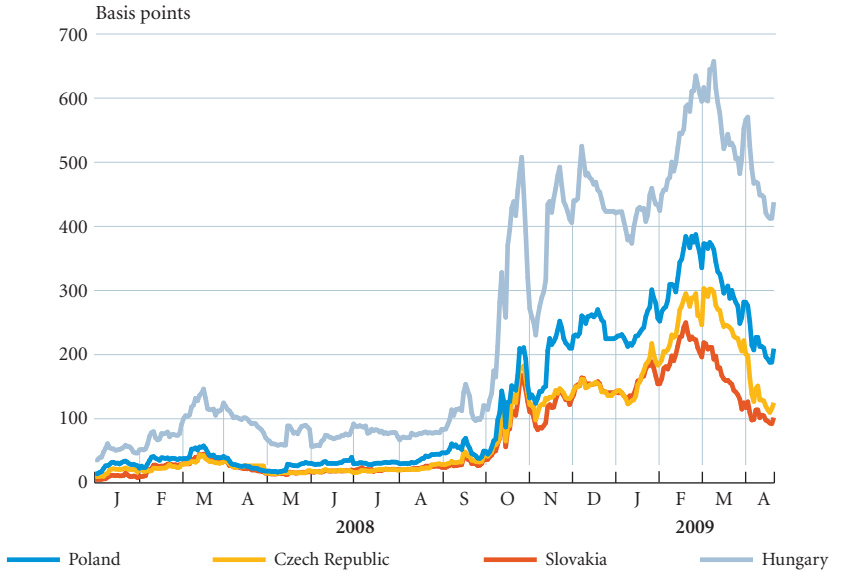
Good performance in financial markets of emerging European countries...

Latest economic activity indicators support this view. Economic sentiment, an indicator that comes close to the overall rate of activity, was down more than 20 points in Hungary and Romania in the first quarter while the drops in Poland and Slovakia were close. This poor situation arises both from the loss

...although prospects for economic activity in 2009 still slim.

FINANCIAL MARKETS BEGINNING TO SEE FEWER RISKS IN EMERGING EUROPEAN COUNTRIES

Cost of default risk insurance on sovereign bonds (*Credit Default Swaps* on 3-year government bonds)



SOURCE: Thomson Reuters Datastream.

International financial aid keeps possibility of regional collapse further away.

of strength in domestic demand and in the foreign sector and was a logical result of the growing restriction of credit which especially has an impact on consumption and investment. It also came from the sharp contraction in world trade, a critical factor for economies as notably open as the emerging group in Europe.

Therefore, if it is not a cyclical improvement, what are the factors underlying financial recovery? Basically, there are two factors, one of a world nature and the other strictly regional. The first is lower risk aversion that financial players have been demonstrating at the world level following the lows in March. That there is no specific element in central Europe is evident from the fact that the other two large emerging economic regions (Asia and Latin America) have shown comparatively better gains on the stock market.

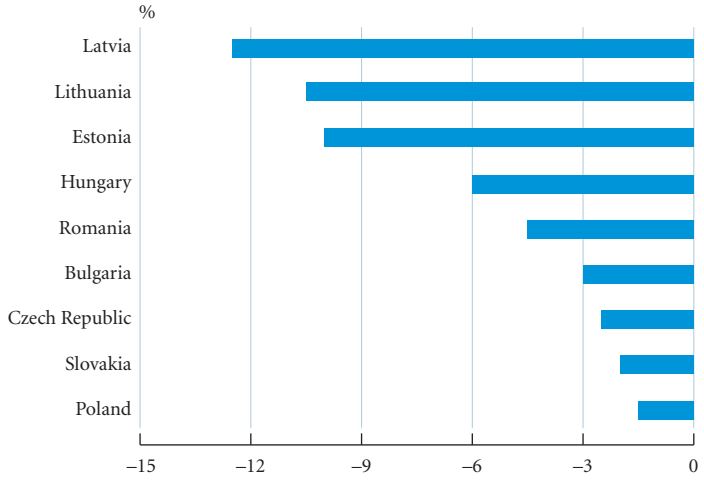
Major risks remain including big international financial deficit...

The second factor has a definite regional dimension. The injection of funds from international multilateral organizations has reduced the likelihood that default in international obligations on the part of one of these countries could «contaminate» the region as a whole. Specifically, it has been announced that Romania will benefit from a credit of 20 billion euros, mainly provided by the IMF, and that Poland will get 16 billion euros from the IMF's so-called Flexible Credit Fund. The fact is that the reduction of regional risk has been picked up by the markets, as shown by the decrease in country risk, measured by the differentials in sovereign bonds, which have been greater in the emerging region of Europe than in Asia or Latin America.

In spite of the fact that the scenario of regional collapse has turned out to be unlikely, we should not forget that the area is still facing various risks. The most pressing is precisely that it is trying to contain the negative effects of the drop in foreign financing through international financial aid. According to some estimates, the main economies of the emerging regions of Europe will have

SOMBRE PROSPECTS FOR EMERGING EUROPEAN ECONOMIES IN 2009

Real change in gross domestic product foreseen for 2009



SOURCE: Own calculations.

foreign deficits of approximately 460 billion dollars in 2009, of which about half may have to be covered through aid from international bodies.

Given that these countries hold a significant part of company and household debt denominated in foreign currency (naturally with major national differences from 25% in Poland and Slovakia to 90% in Latvia), a second risk is exchange rate risk. While the appreciation of national currencies seen in recent weeks brought some relief, this is far from having fully turned around the loss of value in recent months and, what is more troubling, the depreciatory pressure that could return in the future.

...a latent exchange rate risk partly arising from excessive debt in foreign currency...

This explains why at different times there have been proposals for the rapid adoption of the single currency as a way to eliminate exchange rate risk. In April an IMF report became public supporting the rapid adoption of the euro with this meaning full membership in the Euro Area (especially without involving participation in the governing council of the ECB). The strong refusal of the ECB to consider the proposal, arguing risks for the stability of the euro, does not mean that the debate is not still going on. For the moment, Poland has stepped up preliminary technical work for the zloty to join the Exchange Rate Mechanism in 2009. The ERM is the system of fluctuation bands limiting exchange rates that precedes adoption of the euro.

Finally, a third risk is that further worsening of the foreign situation involves social pressures that may be difficult to deal with. Two governments committed to make economic reforms, those of Hungary and Czech Republic, have had to resign because of the impossibility of carrying forward their proposals and because of popular discontent. While in the case of Hungary the new government, made up largely of technocrats, has put forward a major programme of fiscal adjustments, the fact is that, if the recession in the European Union turns out to be longer and sharper than expected, political uncertainty could end up bringing about greater financial volatility or affecting the confidence of companies and consumers. This could be an explosive cocktail.

...and political impact of crisis that increases uncertainty.

FINANCIAL MARKETS

Monetary and capital markets

Trend to reduction of interest rates continues in interbank market

ECB cuts interest rate by 25 basis points to 1.25%.

In view of the worsening economic situation, the ECB decided to cut its reference rate by 25 basis points putting it at 1.25%. It was something of a surprise, not for the continuation of the downward trend begun in October 2008 but for its amount. The market was expecting a drop of 50 basis points. Nevertheless, at the press conference the ECB chairman insinuated the possibility of a further cut at the next meeting of the Governing Council on May 7.

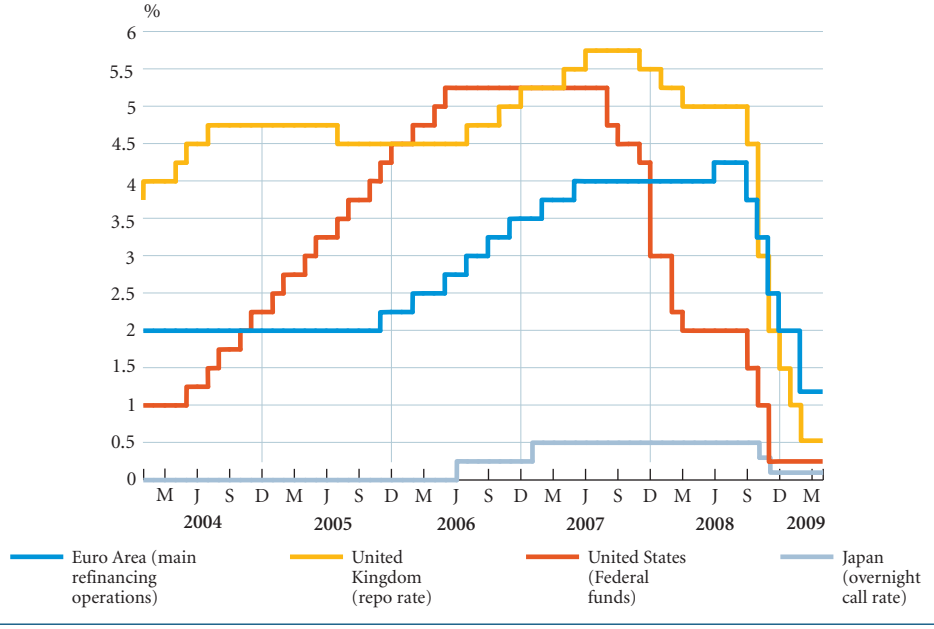
Various members of ECB disagree on subsequent monetary policy measures to be taken.

Jean-Claude Trichet stated that the ECB would introduce a series of quantitative easing measures at its May meeting. Without going into details on these steps, it seems that one of the decisions that could be taken would be to lengthen the period of liquidity auctions for trading banks held by the ECB.

In April, a number of ECB members expressed different positions with regard to coming decisions to be made on monetary policy. For example, Axel Weber, chairman of the Bundesbank, was against cutting the reference interest rate below 1% and the acquisition of government bonds. The governors of the central banks of Greece and Cyprus preferred to keep both options open. While the governor of Austria's central

ECB CUTS OFFICIAL RATE TO 1.25%

Reference interest rates of central banks



SOURCE: Central banks.

bank adopted a mid-way position rejecting cuts below 1% but approving the purchase of government bonds. In fact, the diversity of opinions within the Euro Area central bank was evident. These diverse opinions must converge into a single strategy at coming meetings.

In the case of the Federal Reserve, it put out its Beige Book on April 15. This report, published by the US central bank system eight times a year, gives a qualitative analysis of the country's economic situation. In this issue, it recognized a reduction in the rate of the economic contraction in the United States. This improvement was included in public statements by the Fed governor, Ben Bernanke, in which he drew attention to the first positive signs presented by the US economy in many months. At the same time, he considered that there was a reasonable chance that the current recession could end in 2009 and that 2010 could become a year of recovery.

The news from the Bank of Japan was not as bright as the bank had to revise downward its economic forecasts due to the contraction of consumption and the sharp drop in investment. Japan's central bank is now considering a capital increase that will allow it to absorb possible losses brought about by private bonds and commercial paper it had acquired in order to provide liquidity to the private sector.

Fed treats first signs of stabilization with cautious optimism while Bank of Japan revises growth forecast downward.

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)
2008									
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	3.75	4.76	4.87	1.00	3.03	0.94	4.50	5.84	2.43
November	3.25	3.85	3.95	1.00	2.22	0.93	3.00	3.91	1.23
December	2.50	2.89	3.05	0.25	1.43	0.10	2.00	2.77	0.75
2009									
January	2.00	2.09	2.27	0.25	1.18	0.10	1.50	2.17	0.70
February	2.00	1.83	2.03	0.25	1.26	0.10	1.00	2.05	0.75
March	1.50	1.52	1.81	0.25	1.19	0.10	0.50	1.65	0.63
April (1)	1.25	1.41	1.76	0.25	1.11	0.10	0.50	1.52	0.75

NOTES: (1) April 17.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 3-07-08 (4.25%), 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-4-09 (1.25%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 04-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

Interest rates in interbank markets in Euro Area go down to all-time lows.

Following the ECB cut, interbank market rates in the Euro Area have taken on a downward trend, marking up all-time records. For example, the 3-month Euribor marked up a low of 1.41% on April 20. The same happened with the 12-month Euribor which, as one of the reference rates for loan operations, was quoted at 1.76% the same day. It is interesting to point out that since the launching of the euro the average differential in basis points (100 basis points is 1%) between the 12-month Euribor and the ECB reference rate has been 43 basis points. After going to very high levels (174 basis points) at peak points of the crisis last Autumn, it now stands at an acceptable level of 51 basis points. That is to say, it may now be stated that, from a price point of view, the normalization of the interbank markets in the Euro Area is now a fact.

In United States, Japan, United Kingdom and Switzerland, interbank interest rates have remained stable.

In the case of the United States, Japan, United Kingdom and Switzerland, interbank market rates have held at around the levels reached the month before. It may be expected that for some time these rates will hold stable or drop further due to their link with official interest rates practically at zero and the quantitative easing programmes of the central banks in those countries. Some further reduction in risk premiums is possible to the extent that fears about the solvency of banks ease off. In this respect, much will depend on the results of «stress tests» the US central bank is now carrying out on 19 leading banks.

The price of long-term government bonds has dropped and as a result the yield offered by bonds has gone up. This movement is due to the fact that part of the phenomenon known as «flight to quality» has gone. Since the

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2008								
April	4.12	4.33	4.39	4.58	3.73	1.59	4.67	3.12
May	4.41	4.59	4.62	4.86	4.06	1.76	4.99	3.19
June	4.62	4.81	4.90	5.17	3.97	1.60	5.13	3.29
July	4.36	4.53	4.67	4.90	3.95	1.54	4.81	3.05
August	4.18	4.38	4.55	4.82	3.81	1.42	4.48	2.89
September	4.02	4.35	4.60	4.90	3.82	1.47	4.45	2.61
October	3.90	4.30	4.61	5.15	3.95	1.48	4.52	2.84
November	3.26	3.68	3.89	4.46	2.92	1.40	3.77	2.28
December	2.95	3.41	3.81	4.38	2.21	1.17	3.02	2.10
2009								
January	3.30	3.81	4.39	4.71	2.84	1.30	3.70	2.18
February	3.11	3.66	4.28	4.68	3.01	1.28	3.62	2.24
March	3.00	3.55	4.05	4.39	2.66	1.35	3.17	2.10
April (*)	3.21	3.68	4.07	4.34	2.87	1.48	3.31	2.13

NOTES: (*) April 20.
SOURCE: Bloomberg.

beginning of the crisis, in view of the rise in risk aversion, investors reduced the weight of high-risk assets in their portfolios in favour of assets such as government bonds with maximum credit rating. In view of improved investor expectations about the economy and the positive performance of other markets such as the stock market, April saw an orderly process of selling in government bond markets.

Taking into account growth and inflation forecasts, it is likely that in coming months US long-term bonds will be quoted within a range of 2.5% and 3%, levels at which they have held since the end of February. With regard to the Euro Area, the yield on long-term government bonds could be around 3.10%, somewhat lower than current levels.

Improvement in performance of other more risky assets slightly pushes up yield on long-term government bonds.

Currencies reflect varied economic prospects

In the month of April, whereas in the United States the flow of macroeconomic and corporate news has been surprising everyone because of figures less negative than expected, in the Euro Area the economic news has strongly confirmed the contraction trend. The foreign exchange market reflected this different trend in a gradual depreciation of the euro against the main currencies.

The following table shows how in one month the euro has depreciated by 5.0% against the dollar, 3.5% against the Japanese yen and 5.2% against the pound sterling. On the other hand, the dollar has strengthened not only against the euro but also against the Swiss franc and the Canadian dollar. The exception was against the Mexican peso which strengthened nearly 7% against the dollar.

Euro depreciates due to run of negative news about economy.

The reason behind the better performance of the Mexican peso in terms of the US currency was the proactive attitude adopted by the Mexican authorities to defend their currency. Among the main measures taken was the announcement by the Mexican Foreign Exchange Commission to ask the IMF for a line of contingent financing for an amount of 47 billion dollars. This line of credit is part of the new supports offered by the international body known as its Flexible Credit Line. According to the IMF, Mexico is the first country to show interest in this instrument which was created by the international body in March to provide preventive aid to countries with solid economies to help them deal with the repercussions of the world crisis.

In addition, Mexico's central bank, along with other central banks, has an agreement with the Fed under which it can call on a line of credit of up to 30 billion dollars in the case it needs funds to aid local companies affected by the world crisis. All these measures have calmed international investors, who, in keeping with the opinion of Strauss-Kahn, director of the IMF, regarding Mexico's solid macroeconomic trend, feel that these measures guard the country against any future event that could restrict market liquidity.

Mexico adopts prudent policies to defend its currency.

EXCHANGE RATES OF MAIN CURRENCIES

April 21, 2009

	Exchange rate	% change (*)		
		Monthly	Over December 2008	Annual
Against US dollar				
Japanese yen	98.3	1.4	7.8	–5.0
Pound sterling	0.685	–0.2	0.0	26.3
Swiss franc	1.167	3.6	8.4	13.6
Canadian dollar	1.235	1.1	1.3	18.6
Mexican peso	13.372	–6.7	–2.3	21.2
Against euro				
US dollar	1.298	–5.0	–7.6	–22.6
Japanese yen	127.7	–3.5	0.7	–28.7
Swiss franc	1.515	–1.2	1.5	–5.9
Pound sterling	0.889	–5.2	–7.4	9.6
Swedish krona	11.126	2.3	1.6	15.7
Danish krone	7.449	0.0	0.1	–0.2
Polish zloty	4.417	–2.8	6.1	22.7
Czech crown	27.05	1.0	0.8	7.2
Hungarian forint	298.9	–1.0	11.1	15.6

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

Recovery of shares continues

Stock markets begin quarter on revovery streak.

In April, international share indices continued on the upturn that started at the beginning of March. In spite of the fact that current levels of the main indices in the United States and Europe were still holding in the low range for the past decade, revaluations seen in the S&P 500 and the Eurostoxx 50 have gone above 30% in just a few weeks. This is the biggest upward movement since the beginning of the financial crisis in 2007.

As well as the positive impact resulting from the measures taken by the central banks and international bodies, there were various determining factors at work during the month. First, corporate news was somewhat better than the markets had expected. Secondly, there were some slight signs of recovery in the macroeconomic figures in the United States. Thirdly, there have been some improvements in key indicators for the stock markets with regard to liquidity and volatility.

Financial sector getting most attention from investors.

The drive on the stock market came from the financial sector although during the month there was some sector rotation toward other groups, such as commodities and motor vehicle production which in previous months had practically disappeared from investor buying lists.

News on the financial sector was what took up the attention of investors, thus bringing about the biggest moves. An especially significant factor was the modification of accounting evaluation criteria for «toxic assets» held by US banks. This has widened and made more

flexible the possibility of valuing these assets according to that determined by the internal models of the financial institutions instead of having to do so at market prices. This news was given a positive reception seeing that the estimated impact on profits could mean increases of close to 20% and as these values may be applied retroactively to the first quarter.

Publication of favourable news about the main banks was also one of the points helping the stock markets. Entities such as the Bank of America and JP Morgan announced that the growth of customer deposits had gone above expectations in the early months of the year. In addition, the first-quarter profits of Goldman and JP Morgan were above the most optimistic forecasts and there was talk that these entities were ready to return to the government the funds they had received under the TARP programme in November.

The high note of this cautious current of optimism in the financial sector came from the US Secretary of the Treasury when he announced operating details of a private-public programme (PPIP) with the task of buying «toxic assets» now included in the balance sheets of national banks.

The perception of an incipiant improvement in the macroeconomic scenario of the United States and some emerging countries such as China was another decisive factor behind the boost in the stock market. In the United States, the first signs of a start toward recovery have been noted precisely in corporate confidence indices. This has greatly

Corporate news and economic figures sketching out more favourable scenario.

US Treasury Secretary firms up details of programme aimed at acquisition of «toxic assets».

INDICES OF MAIN WORLD STOCK EXCHANGES

April 20, 2009

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*8,125.4*	*9.9*	*–7.4*	*–35.6*
Standard & Poor's	*865.3*	*11.2*	*–4.2*	*–36.6*
Nasdaq	*1,670.4*	*14.2*	*5.9*	*–28.7*
Tokyo	8,907.6	12.1	0.5	–33.5
London	4,080.4	5.8	–8.0	–31.8
Euro Area	2,328.6	15.7	–4.9	–37.5
Frankfurt	*4,652.2*	*16.7*	*–3.3*	*–30.4*
Paris	*3,075.4*	*11.1*	*–4.4*	*–36.7*
Amsterdam	*241.3*	*14.4*	*–1.9*	*–47.8*
Milan	*18,499.0*	*31.4*	*–4.9*	*–44.2*
Madrid	*8,911.6*	*16.6*	*–3.1*	*–34.3*
Zurich	5,198.3	8.0	–6.1	–27.5
Hong Kong	15,601.3	21.1	8.4	–35.7
Buenos Aires	1,254.7	19.3	16.2	–42.0
São Paulo	46,024.8	16.5	22.6	–28.7

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.

Various technical share indicators now showing improvement...

helped cyclical sectors on the stock exchange. In addition, figures for the housing sector added further increases in sales in February. Collateral factors, such as the drop in interest rates for refinancing mortgages and the tendency for housing prices to stabilize, helped to define a scenario with better options for recovery. The construction sector on the stock exchange showed the benefit. In turn, commodity sectors were given a boost by some indicators that anticipated an improvement in the economy of China, which represents a big demand for those products.

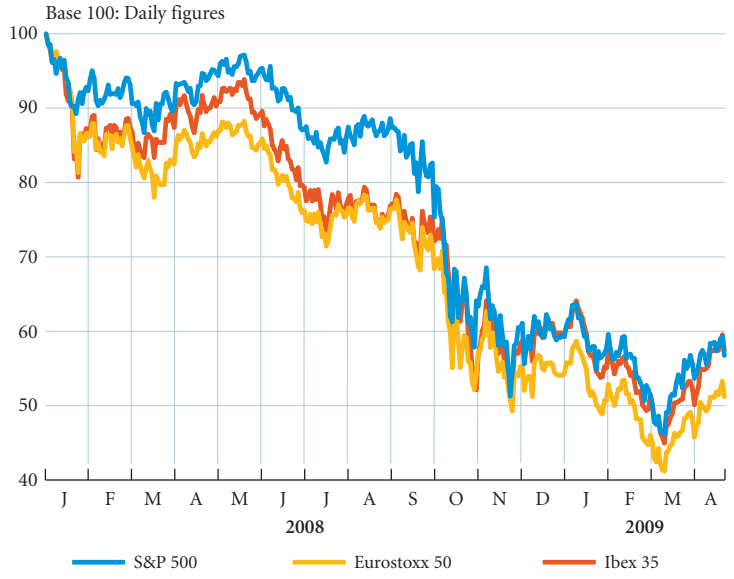
Finally, various technical indicators for the stock market have gone in a very favourable direction in terms of quotes. There has been a notable phase of volatility with a rapid drop reflecting less risk aversion that can start a virtuous circle. With regard to liquidity, conditions are ripe for investors to withdraw a large part of their assets now held in bank deposits and monetary funds, which leaves ample margin for future share buying. In fact, statistics on recent capital movements point to the stabilization of withdrawals of assets from share-based mutual funds. Finally, as noted in last month's *Monthly Report*, downward positions (selling short) in the first quarter reached an extreme level, an all-time high, so that the later settling of these positions is giving support to shares.

...although share market still on a fragile base.

With regard to coming months, it must be recognized that share markets still have a fragile base which will only improve if economic recovery is confirmed and the predisposition of investors to assume risks again becomes stable. In this respect, as well as looking at the efficacy of economic policy measures applied and the flow in economic situation indicators, it is important to examine the prospects shown by companies in this period of

STOCK MARKETS SHOW RECOVERY TREND SINCE MARCH

Stock market quotations



SOURCE: Bloomberg and own calculations.

publishing results for the first quarter about to begin. Analysts have sharply reduced their estimates of profits for the quarter and for the year as a whole so that there may be room for some positive surprises.

Signs of improvement in corporate bond market

Corporate bond markets continued to show signs of a slight but constant improvement in April in spite of the fact that receiverships in large companies reached their highest level since the Great Depression.

From an historical perspective, interest rates on corporate bondss are holding at very high levels due to the high risk premiums demanded by investors. Nevertheless, the improvement in recent weeks, which has even reached companies with a high probability of failure to pay, could be the start of some normalization so long as the various determining factors become consolidated.

The stabilization of the financial system is a key factor, both because of the heavy weight of banks among bond issuers and because of the indirect general effects arising from adequate financing of economic activity. In this respect, credit risk in the financial sector continues to show a positive trend compared with other sectors, thanks to three basic factors. First, the banks continued the process of deleverage, controlling the volume of their assets and limiting those of greatest risk. Second, there was a continuation of the strengthening of their capital base by taking advantage of the favourable contribution of government aids. Third, the application of plans to buy «toxic assets» and guarantees for bank bonds by central banks and governments.

Drop in risk premiums shows up as key to recovery in loan markets.

The improvement in credit also took place in the non-financial corporate sector. In the first quarter, those companies with good credit rating were able to place a high volume of issues in the market which were well received by investors due to their attractive yields. In the corporate sector, companies of high solvency presented a more positive trend in credit risk due to two factors. First, at this time of gradual return of any willingness to take risks, institutional investors prefer issues of proven solvency. Secondly, central banks are either buying or discounting corporate bonds of high quality in their monetary policy operations.

Corporate bond interest rates remain at very high levels.

Another segment in which there has been a notable improvement is in mortgage lending. The intervention of governments and central banks has been crucial in this process because they consider that a key factor for consolidating the exit from the recession involves stabilizing the mortgage market. In this area, some important objectives have been met. In the United States, reference mortgage interest rates have dropped to all-time lows of around 4.5% and there has been a huge boost in refinancing volume. The lower cost of credit, legal aspects and government aid seems to be stabilizing the sector.

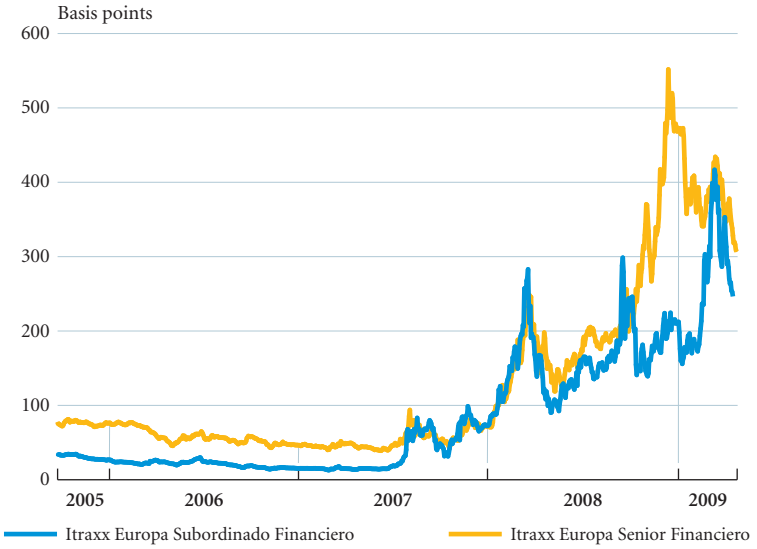
Stabilization of financial system is key for normalizing private bond market.

The forecast for loan markets is for a continuation of the progressive reduction of risk. In this respect, there has been a somewhat more positive attitude on the part of investors who are holding large sums of liquid assets that could be channeled into bond markets.

Loan market forecast is for reduction of differentials.

RISK PREMIUMS BEING ADJUSTES

Itraxx Europe Financial Senior and Subordinated



NOTES: Latest figure: April 20, 2009.
SOURCE: Bloomberg.

Over short term, ECB decision on its rediscount policy will be important for loan markets.

The excellent yields being offered by the high credit quality segment present a good investment opportunity to the extent that there are signs of an end to the economic recession. Because of this what will be a determining factor is the trend in macroeconomic variables and publication of corporate profits for the first quarter. An important short-term event will be the ECB decision on its rediscount policy. The market has begun to anticipate an extension of terms and an increase of the list of assets acceptable as guarantee for the inclusion of more corporate bonds.

Global imbalances, interest rates and the financial crisis

The financial system plays a very important role in the process of economic globalization that has taken place in recent years. On the one hand, the internationalization of financial markets facilitates all kinds of economic interchange between countries and regions that previously had no connection. On the other hand, so-called global imbalances (see Box «Global adjustments: the role of foreign exchange flexibility» for an explanation of this concept) may have distorted the proper functioning of capital markets. In fact, according to one interpretation commonly heard, the international capital flows that go with these imbalances (massive buying of US assets) have been one of the underlying causes of the financial crisis we are now suffering from, in as much as they contribute to reducing the level of real long-term interest rates and raising the price of stock market and real estate assets, while at the same time weakening the balance sheets of many financial intermediaries (in terms of liquidity and leverage).

The debate around this question is of great significance given that it has implications for the design of the economic policies that will make it possible to overcome the current crisis and avoid a repetition in the future. In this respect, discussion of the financial effects of world imbalances closely interacts with another two areas for which the authorities are responsible, namely, monetary policy and policy on financial regulation and supervision.

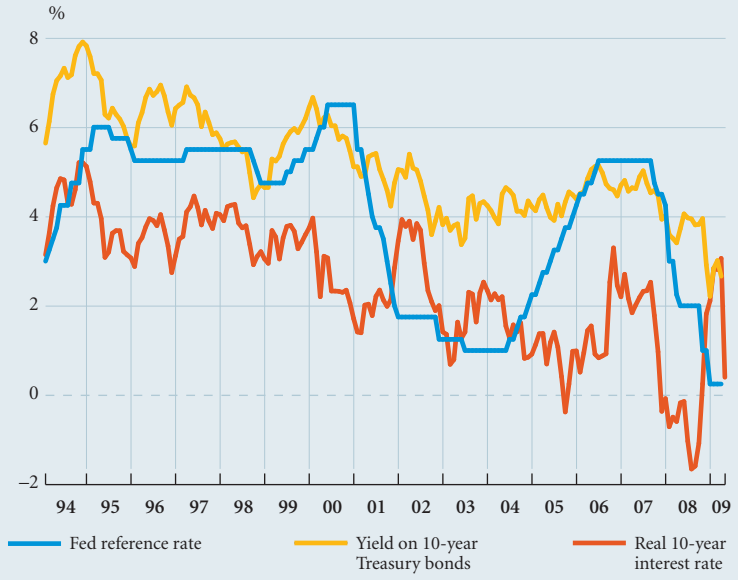
One of the most significant contributions to this debate was made back in 2005 by the current chairman of the Federal Reserve, Ben Bernanke, who proposed the so-called «hypothesis of a savings glut» according to which the origin and persistence of the global imbalances was due to the increase in savings in the emerging countries, especially China, and the commodity-exporting countries. These savings were channelled into bond markets in the United States thus reducing interest rates and raising the price of assets. This in turn brought about an increase in consumer spending and the US current account deficit. Finally, the low level of savings in the United States was therefore a passive response to the abundance of available foreign savings.

Following this argument, in recent years various viewpoints or theories have been put forward in support of the hypothesis of a «savings glut» and its relation to financial markets.

An early view[1] was that the international financial system involving world capital flows was intrinsically stable, a kind of Bretton Woods II. According to this view, Asia was adopting a mercantilist strategy based on savings and exports, boosted artificially by depreciated foreign exchange rates. In order to maintain their currencies

GOVERNMENT BONDS FAILED TO REACT TO INCREASES IN OFFICIAL INTEREST RATES IN 2004-2006

Nominal and real interest rates on 10-year government bonds and US reference rate



SOURCE: Bloomberg.

(1) Dooley, Michael; D. Folkerts-Landau; P. Garber (2004): «The Revised Bretton Woods System». International Journal of Finance and Economics, vol. 9, Page 307-313.
Dooley, Michael; P. Garber (2009): «Global imbalances and the crisis: A solution in search of a problem», on www.voxeu.org.

depreciated, these countries buy large amounts of US government bonds and other assets. The United States is ready to tolerate the system because this allows it to finance itself comfortably as well as covering large amounts of spending at low interest rates. Finally, the system may continue to function for a long time without producing instability. According to those in agreement with this viewpoint, the current crisis cannot be blamed on global imbalances or on easy monetary policy but rather is due to other factors, namely, deficiencies in financial regulation and supervision.

Another viewpoint[2] takes the position that the cause of the heavy flows of capital to the United States lies in the underdevelopment of the financial systems in the emerging countries. That is to say, the factor underlying the world imbalances is the high structural demand coming from Asia for Treasury bonds and those issued by the mortgage lending agencies Fannie May and Freddie Mac in the United States, given that that region is not able to offer financial assets that are secure and liquid. So long as the United States sells its government bonds to Asia, the US banks increase their leverage through higher-risk assets. According to this view, global imbalances and low interest rates run together but, as opposed to the earlier view, in this case a fragile financial system is created with a propensity to result in bubbles in various asset markets.

Both theories rationalize Bernanke's «savings glut» hypothesis so that the imbalances in current account and resulting flows of capital are not, in fact, unsustainable imbalances but rather phenomena that could be long-lasting. Another view,[3] that may be considered traditional or standard, does contemplate a situation such as an imbalance on the way to correction, that has already had an influence on the current crisis and may continue to be a source of instability. This view holds that Bernanke's hypothesis is only a partial and asymmetrical explanation of events and complements it with other macroecoomic and financial factors.

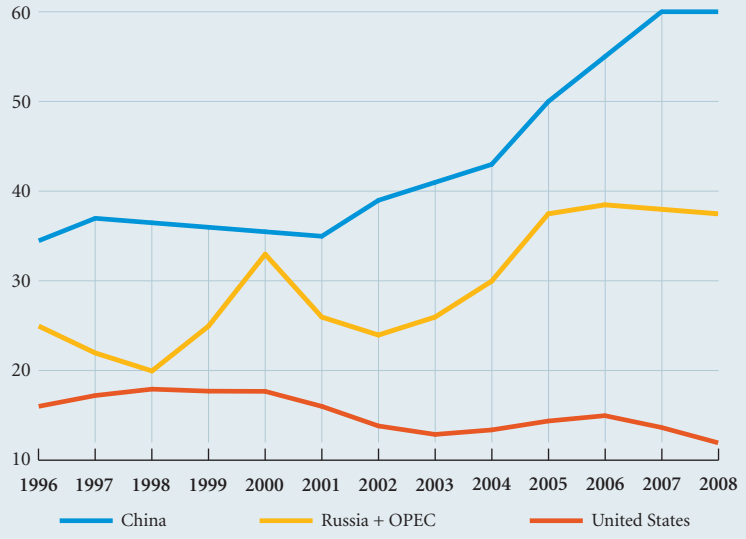
It is recognized that in fact the emerging countries raised their net savings in recent years, basically as a prudent defensive reaction following the difficult balance of payments crisis in 1997-1998 and, in the case of household savings, because of the absence of a public network of unemployment and pensions coverage. It was also crucial that the United States had adopted monetary and fiscal policies that were too lax, that created excessive domestic demand under the headings of consumption and residential investment. According to this view, there was no clear causal relation between one or the other approach but it is convincing the idea that the combination of a super-abundance of savings in the emerging countries plus an easy monetary policy in the United States were the cause of the low real interest rates in recent years. In turn, the reduced level of interest rates fostered the increase in high-risk investments, the reduction of risk premiums and the rise in asset prices, particularly in real estate prices, in the United States. In this respect, it may be said that global imbalances lay at the root of the current crisis, interacting with the laxness of monetary policy along with deficiencies in financial regulation and supervision.

Two other points of relation between global imbalances and the financial markets lend support to this statement. First, the monetary effects of the accumulation of reserves in those countries with surpluses which helped to increase world liquidity and aggregate credit figures. Second, the persistance and continuity of international capital flows to the United States, which meant a major decrease in the volatility of financial markets.

(2) Caballero, Ricardo; E. Farhi; P-O. Gourinchas (2008): «An Equilibrium Model of "Global Imbalances" and Low Interest rates». American Economic Review, vol. 98, Pages 358-393.
(3) Portes, Richard (2009): «Global Imbalances». London Business School and CEPR, on www.voxeu.org.

SHARP INCREASE IN SAVINGS IN CHINA AND OIL-EXPORTING COUNTRIES

Savings as a percentage of GDP



SOURCE: Thomson Reuters Datastream.

Today, new challenges are arising for those who manage world economic policy. Due to the seriousness of the situation, the government deficit in the United States has shot up and in a number of countries quantitative easing monetary policies have been put into practice which have helped reduce interest rates to all-time low levels. Once recovery begins, excess liquidity will have to be carefully reabsorbed in order to neutralize an undesired increase in inflation or the appearance of new bubbles, while at the same time avoiding any diversion of the recovery process in the world economy.

Over the medium term, the objective of economic policy is quite clear. It is essential to limit global imbalances and the fragility of financial markets. But is essential that, in order to achieve this, we do not fall into the temptation of suppressing the forces of financial integration, development and innovation that lie at the base of the increase in global wealth. As all the international financial bodies have warned, it would be very dangerous to introduce protectionist policies (in the trade and financial spheres) that might end up impoverishing the whole world.

This box was prepared by Alejandro Gisbert
Financial Markets Department, "la Caixa" Research Department

SPAIN: OVERALL ANALYSIS

Economic activity

Bank of Spain revises downward its growth forecasts for Spanish economy.

Recession sharpens in first quarter

Within the framework of an international financial crisis and a global recession, available economic indicators for the early months of the year suggest further sharpening of the recession the Spanish economy moved into as of the third quarter of 2008. This picture has brought a notable downward revision of the growth forecast for Spain's economy by the Bank of Spain putting it at a drop of 3% in 2009. While it foresees that government aid plans may contribute to stabilize the situation, it expects a drop of 1% in gross domestic product (GDP) for 2010 as a whole.

The recessive economic situation meant that company accounts made a sharp turnaround in 2008. The early quarterly company balances published by the Bank of Spain referring to last year as a whole makes possible an evaluation. The decrease in economic activity showed up in a drop in the value of production which recorded an annual change of 3.4%. Given that intermediate consumables rose more, gross value added was down 1.8% compared with 2007.

Personnel costs show more moderate growth both because of a drop in average earnings and the drop in job creation. Nevertheless, the operating surplus went from growth of 5.6% in 2007 to a drop of 5.9% in 2008.

PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES

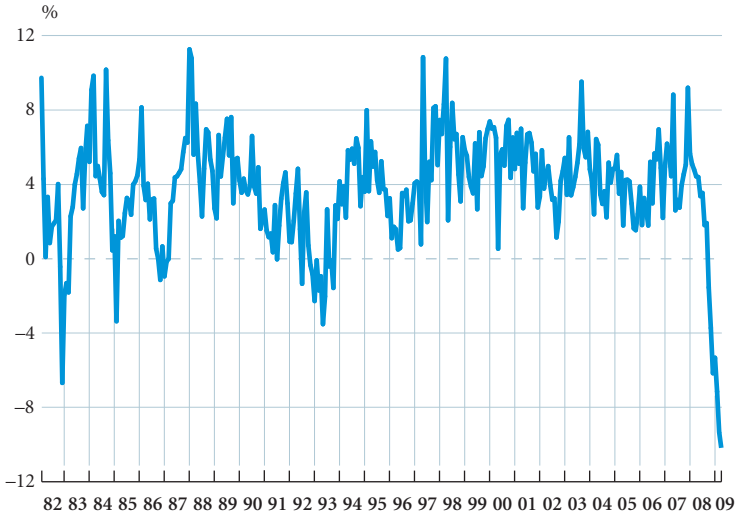
Annual change rates

	2006	2007	2008
Value of production	10.3	5.8	3.4
Intermediate consumables	12.2	6.1	5.9
Gross value added (GVA)	**6.8**	**5.2**	**–1.8**
Personnel costs	5.3	4.7	3.9
Gross operating profit	**7.9**	**5.6**	**–5.9**
Financial income	13.4	34.6	2.3
Financial costs	39.6	37.5	18.9
Depreciation and provisions	2.0	0.1	0.2
Net ordinary profit	**4.9**	**9.5**	**–15.4**
Extraordinary income and costs	–	79.5	–61.9
Provisions and tax	91.7	60.0	–43.8
Net profit	**10.2**	**12.0**	**–24.0**

SOURCE: Bank of Spain (Quarterly Company Accounts).

ELECTRICAL POWER CONSUMPTION SHOWS BIGGEST DROP IN RECENT DECADES

Year-on-year change in electrical power consumption



NOTES: Adjusted for effect of working hours and temperature.
SOURCE: Red Eléctrica Española.

Financial costs rose more than financial income under the effect of lower dividends from foreign subsidiaries. As a result, ordinary net profit increased its drop to 15.4%. Nor did any help come from extraordinary income or costs nor from provisions so that net profit was down 24.0% compared with the year before after having increased by 12.0% in 2007. In spite of the unfavourable trend in corporate profits, ordinary return on net assets stood at a notable 7.9% while ordinary return on equity stood at 10.7%, some 2.2 points less than in 2007.

Net profit of companies in 2008 down 24% but return on equity stood at 11%.

Returning to the indicators, on the supply side we note that industry continued to adjust to the contraction of demand, both domestic and foreign. The industrial production index adjusted for calendar effects was down 22.0% in February compared with the same month the year before. The decreases in production were across the board. The branches most affected by the slump in production were motor vehicle and tractor-trailer manufacturing, non-coal mining and processing of non-metallic minerals which showed year-on-year drops of more than 40%. The lowest annual decrease came in the food industry (down 1.7%) as this involves basic necessities that cannot be put off. The big drop in electrical power consumption (10.2% year-on-year in March), the biggest decrease in recent decades, confirms the sharpness of the downturn in industrial activity.

This situation of weakness likely will continue over the short term, if we are to judge by the collapse of new industrial orders at 31.9% in February. The dip in the March industrial confidence indicator to the lowest level since 1993 confirms this impression.

Industrial production adjusts to contraction in demand and drops by 22% in February compared with same month year before.

Construction is also involved in a sharp adjustment process because of the real estate crisis. Some 34,669 house sales were effected in February, 37.5 % less

SUPPLY INDICATORS

Percentage change over same period year before

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
Industry									
Electricity consumption (1)	5.2	1.0	4.8	3.8	0.7	–5.1	–7.1	–9.3	–10.2
Industrial production index (2)	2.0	–7.3	–0.8	–5.4	–6.3	–16.6	–20.9	–22.0	...
Confidence indicator for industry (3)	–0.3	–18.0	–7.0	–13.7	–18.7	–32.7	–33.0	–37.0	–40.0
Utilization of production capacity (4)	81.3	79.5	81.3	80.3	79.3	76.9	–	72.8	–
Imports of non-energy intermediate goods (5)	8.0	–0.7	11.4	6.9	–2.1	–18.2	–35.3	–32.3	...
Construction									
Cement consumption	0.2	–23.6	–13.3	–19.6	–25.2	–37.5	–51.1	–46.0	–36.5
Confidence indicator for construction (3)	9.3	–22.6	–14.7	–17.3	–23.7	–34.7	–38.0	–35.0	–37.0
Housing (new construction approvals)	–24.7	–59.4	–59.8	–56.0	–62.4	–60.2	–66.6	...	...
Government tendering	–15.0	3.3	27.7	–29.9	6.4	13.5	–20.6	...	...
Services									
Retail sales (6)	2.3	–6.3	–4.0	–6.3	–7.1	–7.7	–4.2	–7.6	...
Foreign tourists	1.1	–2.4	5.2	1.4	–5.1	–9.0	–9.8	–15.9	–20.8
Tourist revenue inflows	3.3	–0.4	5.4	1.3	0.2	–8.0	–13.3	...	...
Goods carried by rail (ton-km)	–3.7	–7.7	–2.5	–3.5	–1.7	–23.0	–39.7	–36.1	...
Air passenger traffic	9.0	–3.1	7.9	–0.7	–4.9	–12.7	–17.1	–18.4	–19.0
Motor vehicle diesel fuel consumption	4.9	–3.8	–0.9	–2.8	–3.7	–9.6	...	...	...

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.

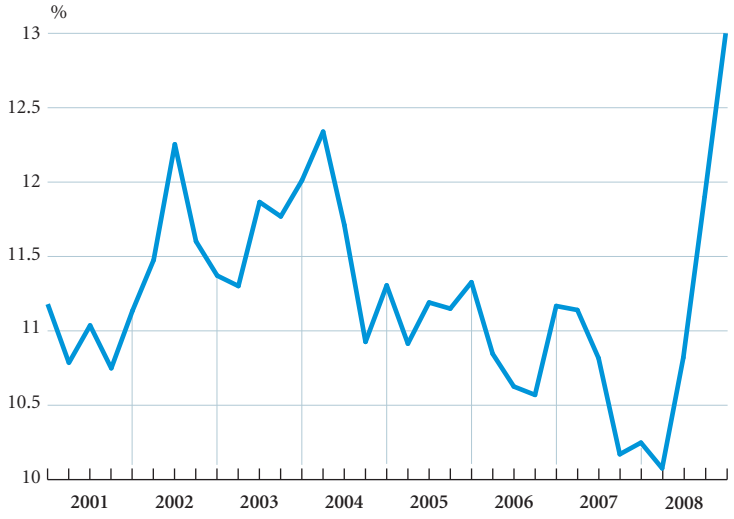
Services not escaping the recession.

than in the same month in 2008 while prices were down 6.8% in the first quarter compared with 12 months earlier, according to figures from the Ministry of Housing. Cement consumption was down 44.7% in the first quarter compared with the same period last year. This situation looks like continuing for some time if we are to go by the 66.6% reduction in new building permits for housing in January and a year-on-year drop in public works tendering of 20.6% that same month.

The recession is also affecting services which are suffering the impact of the drop in activity in construction and industry in various ways, such as a decrease in employment and in induced demand. The figure for business volume in the tertiary sector was down 18.7% in February compared with the same month in 2008. All sub-sectors were affected, especially retail selling and transport. Tourism, in turn, showed a drop of 12.3%. Among the various branches, only security and investigation obtained positive growth.

RECOVERY IN HOUSEHOLD SAVINGS

Gross savings over disposable income of households and non-profit bodies serving households (*)



NOTES: (*) Four quarter moving averages.
SOURCE: INE and own calculations.

On the demand side, consumption remained depressed. Production of consumer goods presented a year-on-year drop of more than 10% by volume. Retail sales also were slack in February with an annual decrease of 7.6%. In turn, car registrations were down 43.1% year-on-year in the first quarter, a little less than in the previous quarter. On the other hand, white-goods appliance units were down 27.2% in the first quarter compared with the same period the year before, according to Anfel, the association of manufacturers. At the same time, domestic sales of services in large companies were down 12.3% year-on-year in February. Nevertheless, the March consumer confidence indicator showed an improvement, possibly brought about by the decrease in interest rates and government plans to stimulate the economy.

Consumption remains depressed but consumer confidence index shows improvement in March.

The other side of the drop in consumption was the increase in household savings in recent quarters. In view of the increase in economic uncertainty, the rise in unemployment and more restrictive borrowing terms, households are restraining their spending and increasing their savings. As a result, in 2008 as a whole the savings rate for households rose by 2.8 points going to 13.0% of disposable income.

In response to the drop in demand, the decrease in corporate profits and more restrictive financing terms, investment is also going down. In the early months of the year both production and imports of capital goods showed year-on-year decreases of more than 30% by volume. At the same time, load-carrying vehicles were down 52.4% in the first quarter compared with the same period in 2008 although less than in the preceding quarter. In turn, equipment and software sales in large companies were down 25.8% in February compared with the same month the year before.

Sharp drop in investment.

DEMAND INDICATORS

Percentage change over same period year before

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
Consumption									
Production of consumer goods (*)	1.7	–4.7	0.3	–4.4	–4.5	–10.3	–12.9	–11.0	...
Imports of consumer goods (**)	5.1	–7.7	–1.2	–6.9	–4.1	–17.2	–16.4	–3.5	...
Car registrations	–1.2	–28.1	–15.3	–19.6	–32.5	–46.6	–41.6	–48.8	–38.7
Credit for consumer durables	10.0	3.6	8.8	7.1	3.4	–4.2	–	...	–
Consumer confidence index (***)	–13.3	–33.6	–20.0	–31.3	–38.3	–44.7	–44.0	–48.0	–43.0
Investment									
Capital goods production (*)	4.6	–8.8	–0.3	–6.1	–8.0	–20.8	–30.6	–30.2	...
Imports of capital goods (**)	9.8	–19.6	–16.0	–16.4	–15.9	–28.8	–32.3	–35.4	...
Commercial vehicle registrations	0.3	–43.6	–29.5	–34.1	–50.1	–61.3	–53.5	–58.8	–44.7
Foreign trade (**)									
Non-energy imports	7.3	–4.9	4.3	0.2	–4.1	–19.0	–29.5	–24.0	...
Exports	4.2	1.9	2.2	6.6	7.8	–8.4	–23.6	–20.7	...

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.

Central government's new economic team faces complicated situation.

With regard to the foreign sector, early figures available for January and February seem to indicate that the positive contribution to GDP growth will continue. In fact, in spite of the fact that exports and imports are slackening, imports are doing so to a greater extent.

In this situation, at the end of March the central government approved a new package of measures to deal with the economic situation. It made the bankruptcy law more flexible, revived credit insurance, lowered the legal interest rate to 4% and put into effect introduction of the EU Services Directive. At the same time, it brought forward approval of a new line of credit at the Official Credit Institute (ICO) making it possible to give guarantees to companies and self-employed workers with debts falling due for a total amount of up to 3 billion euros. In addition, April saw a government shuffle of ministers in which the Minister of Economy and Finance, Pedro Solbes, was replaced by Elena Salgado.

Seven of Spain's Autonomous Communities show per capita GDP above EU average

The situation of sharp economic downturn seen in 2008 resulted in a wider spread in growth rates of the various autonomous communities. The community to show the biggest increase in gross domestic product (GDP) was the Basque Country with an annual rise of 2.1%. At the other end of the classification scale, the Valencian

GROSS DOMESTIC PRODUCT BY AUTONOMOUS COMMUNITY

Year 2008

	Gross domestic product (*)		% real change		GDP per person
	Million current euros	% of total	2008	2000-2008	Current euros
Andalusia	149,910	13.7	0.8	3.3	18,507
Aragon	34,372	3.1	1.1	3.2	26,323
Asturias	23,877	2.2	1.2	2.8	22,559
Balearic Islands	27,473	2.5	1.8	2.4	25,967
Canary Islands	43,480	4.0	1.3	3.1	21,105
Cantabria	14,052	1.3	1.3	3.2	24,508
Castile-La Mancha	36,949	3.4	0.7	3.2	18,471
Castile-Leon	58,515	5.3	0.9	2.9	23,361
Catalonia	204,128	18.6	0.7	2.9	28,095
Valencian Community	106,209	9.7	0.5	3.0	21,468
Extremadura	18,158	1.7	1.8	3.4	16,828
Galicia	56,419	5.2	1.8	3.1	20,619
Madrid Community	194,180	17.7	1.6	3.4	31,110
Murcia	28,160	2.6	1.5	3.6	19,692
Navarre	18,674	1.7	1.9	3.1	30,614
Basque Country	68,669	6.3	2.1	3.0	32,133
La Rioja	8,120	0.7	1.5	3.0	25,895
Ceuta	1,614	0.1	1.8	3.0	22,320
Melilla	1,489	0.1	1.2	3.2	21,493
Total	**1,095,163**	**100.0**	**1.2**	**3.1**	**24,020**

NOTES: (*) Total does not coincide with sum of all Autonomous Communities because it includes GDP figures which cannot be broken down by region.
SOURCE: National Institute of Statistics.

Community grew by a mere 0.5%, under the effect of the weight of construction in its economy.

If we examine average economic growth over the decade, the classification varies. Murcia heads the list with an average annual increase of 3.6% whereas the Balearic Islands is at the tail-end with 2.4%.

In 2008, seven autonomous communities recorded a per capita GDP higher than the average of the European Union of 27 countries, amounting to 25,100 euros. These were the Basque Country, Madrid Community, Navarre, Catalonia, Aragon, Balearic Islands and La Rioja.

Recession bringing about wider spread in growth rates of various Autonomous Communities.

Labour market

Number of those registered with Social Security down 6.5% in March 2009 compared with 12 months ago.

Adjustment in labour market still as sharp

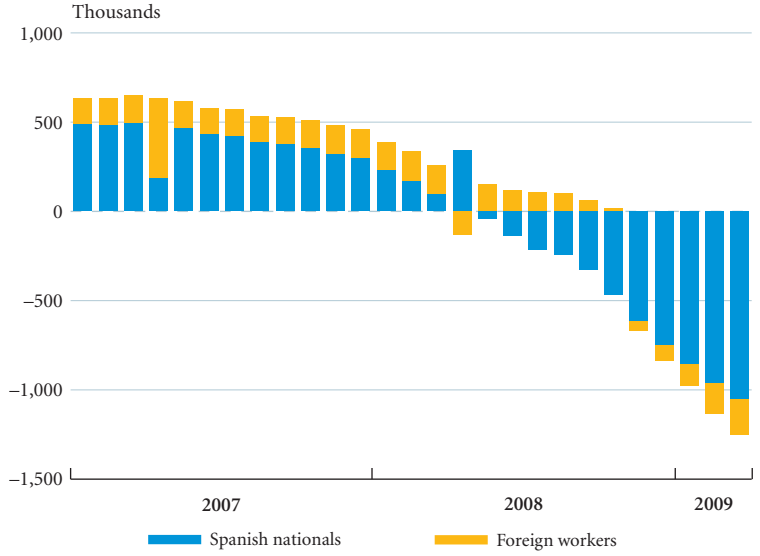
For the tenth month in a row the number of those registered with Social Security dropped by 6.5% in year-on-year change in March. As a result, on monthly average the number of those registered in March stood at 18,058,122. Some 54,489 jobs were lost that month while the figure for the last 12 months was 1,256,282. Of these, 1,051,539 were Spanish nationals and 204,743 were foreign workers, which meant year-on-year decreases of 6.1% and 9.8% respectively.

While the decrease in the number of those employed in March was somewhat lower than that reported in previous months, the figures suggest that the loss of jobs has probably not yet hit bottom. Generally, March is considered a good month for employment. It is therefore possible that the figure for those registered in April will drop somewhat more unless the Easter Week holiday period has given something of a push in hotel trade employment.

While all production sectors reported decreases in March, the drop was relatively sharper in industry, in keeping with the sharp adjustment in this sector since mid-2008. In March, the biggest drop in absolute terms showed up in industry. In any case, at annual rate construction continued to lead in loss

JOBS LOST STILL NOT HITTING BOTTOM

Year-on-year change in number of those registered with Social Security



SOURCE: Ministry of Labour and Social Affairs and own calculations.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2007	2008	2008				2009		
			1Q	2Q	3Q	4Q	January	February	March
Persons registered with Social Security (1)									
Sectors of activity									
Industry	*2.4*	*–2.1*	*0.8*	*–1.1*	*–2.6*	*–5.6*	*–8.2*	*–9.3*	*–10.4*
Construction	*3.6*	*–10.3*	*–2.2*	*–7.0*	*–12.4*	*–19.6*	*–24.3*	*–25.7*	*–26.0*
Services	*3.4*	*1.5*	*2.9*	*2.2*	*1.4*	*–0.4*	*–1.7*	*–2.3*	*–3.0*
Job situation									
Wage-earners	*3.1*	*–0.7*	*1.6*	*0.3*	*–1.1*	*–3.7*	*–5.5*	*–6.3*	*–6.9*
Non-wage-earners	*2.8*	*0.4*	*2.5*	*1.3*	*–0.1*	*–1.9*	*–3.2*	*–4.0*	*–4.5*
Total	**3.0**	**–0.5**	**1.7**	**0.5**	**–0.9**	**–3.4**	**–5.1**	**–5.9**	**–6.5**
Persons employed (2)	**3.1**	**–0.5**	**1.7**	**0.3**	**–0.8**	**–3.0**	**–**	**–**	**–**
Jobs (3)	**2.9**	**–0.6**	**1.7**	**0.1**	**–0.9**	**–3.1**	**–**	**–**	**–**
Hiring contracts registered (4)									
Permanent	2.0	–14.3	–11.8	–5.6	–13.8	–26.0	–39.4	–37.8	–27.9
Temporary	0.3	–10.4	–6.5	–7.4	–9.4	–17.9	–27.3	–27.4	–15.9
Total	**0.5**	**–10.9**	**–7.2**	**–7.2**	**–9.9**	**–18.9**	**–28.8**	**–28.8**	**–17.5**

NOTES: (1) Average monthly figures.
(2) Estimate by Labour Force Survey.
(3) Equivalent to full-time work. National Accounting estimate; figures adjusted for seasonal effects and number of working days.
(4) At INEM.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, Employment Institute and own calculations.

of jobs showing a figure of 26.0%. In industry, the contraction was 10.4% while services recorded a negative rate of 3.0%.

By sex, the contraction in employment over the past 12 months continued to hit the male group hardest with a year-on-year drop of 9.1%. Nevertheless, the loss of jobs among females reached a year-on-year drop for the fifth month in a row (down 3.0%).

On the other hand, the decline in the labour market in March was not reflected in the number of labour contracts, given that the total number of contracts arranged through the public employment service showed an increase of 44,344 to stand at 1,061,112. In any case, the number of contracts was down 17.5% compared with the same month last year. Those contracts showing the biggest drop were permanent hiring contracts (down 27.9%) while temporary hiring contracts dropped by 15.9%.

Industry leads in jobs lost in March.

Sharp increase in registered unemployment in last 12 months still continuing

The number of unemployed registered at public employment service offices reached 3,605,402 persons at the end of March, some 123,543 more than in February. As a result, the year-on-year change rose to 56.7%, the highest figure in the past three decades. By sector,

Registered unemployment up 57% in one year.

Spending for unemployment benefits up 71% in one year.

construction continued to lead in loss of jobs with year-on-year growth of 128.2%. It was followed by industry, services and agriculture with rates of 67.2%, 49.9% and 23.8% respectively. In addition, the group seeking a first job showed a drop of 3.3% in the past 12 months.

By sex, since March last year the number of unemployed has grown more for males (with an increase of 88.0%) than for females, whose year-on-year rate of increase rose by 33.9%. By age bracket, registered unemployment continued to grow most among those under 25 years than among all others and showed a year-on-year rate of 71.4% and 54.7% respectively.

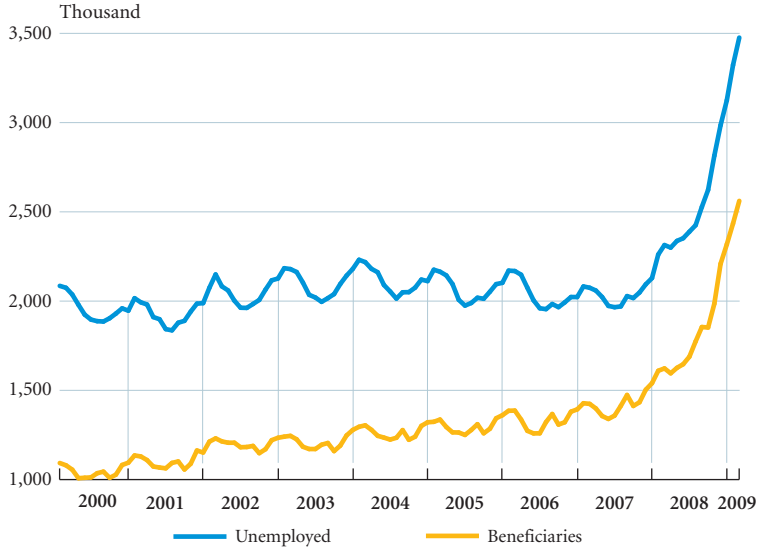
Especially notable was the number of foreign workers registered at public employment offices. Registered unemployment in this group rose by 106.9% in the 12 months ending in March. As a result, the number of foreign workers unemployed now represents 13.8% of the total.

The increase in registered unemployment in March was general across all autonomous communities with above average increases in Aragon, Canary Islands, Castile-La Mancha, Catalonia, Valencian Community, Madrid Community, Murcia, Basque Country and La Rioja.

Finally, we should mention that the increase in registered unemployment has been comparable with the rise in the number of those drawing benefits and therefore the rate of coverage so far has not undergone any decrease. The rate of coverage in mid-2007, just before unemployment began to rise, was 71.6%. In February 2009, the rate stood at 73.6%. Naturally, the fact that the rate of coverage has held relatively stable has meant that spending under this heading has risen by 71.1% in the past 12 months, going to 2.61 billion euros in February.

RATE OF COVERAGE BEING MAINTAINED IN SPITE OF RISE IN REGISTERED UNEMPLOYMENT

Registered unemployed and those drawing benefits



SOURCE: Government employment service and own calculations.

Prices

CPI marks up negative annual rate for first time in recent decades

The downward trend in inflation seen in recent months continued in March and the year-on-year change rate in the consumer price index (CPI) dropped by 0.1%. As a result, it showed a negative annual rate for the first time since the CPI has been prepared. We have to go back to September 1961 to find a negative figure linked to the earlier National Urban Index. Annual inflation in March was down 7 decimals, making a drop of 5.3 points in the past eight months. This growing downturn may be explained by the collapse in commodity prices in recent time and the contraction in consumer demand.

Year-on-year CPI change rate drops 7 decimals in March to 0.1%...

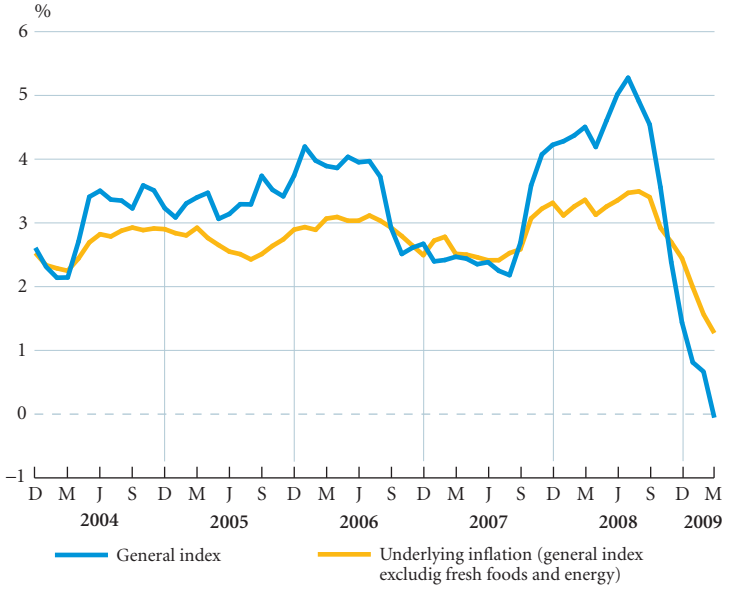
Out of the 7 decimals drop in the year-on-year inflation rate in March, 4 decimals came from fuels and fuel-oils which recorded an annual change rate of 18.4%. The annual drop in fuels and fuel-oils was even bigger at 22.4%. Another volatile factor of the CPI, unprocessed foods, contributed one decimal to the annual drop in the general index. This was mainly due to fresh fish, fresh fruit, chicken and mutton.

...largely due to downward move in fuels and fuel-oils...

The more stable core of inflation, so-called underlying inflation, that excludes energy products and fresh foods, continued to drop in March and contributed 2 decimals to the dip in the year-on-year inflation rate in the general index. Underlying inflation was down

WIDENING DIFFERENCE BETWEEN GENERAL AND UNDERLYING INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2008			2009		
	% monthly change	% change over December 2007	% annual change	% monthly change	% change over December 2008	% annual change
January	–0.6	–0.6	4.3	–1.2	–1.2	0.8
February	0.2	–0.5	4.4	0.0	–1.2	0.7
March	0.9	0.4	4.5	0.2	–1.1	–0.1
April	1.1	1.5	4.2			
May	0.7	2.2	4.6			
June	0.6	2.8	5.0			
July	–0.5	2.3	5.3			
August	–0.2	2.1	4.9			
September	0.0	2.0	4.5			
October	0.3	2.4	3.6			
November	–0.4	2.0	2.4			
December	–0.5	1.4	1.4			

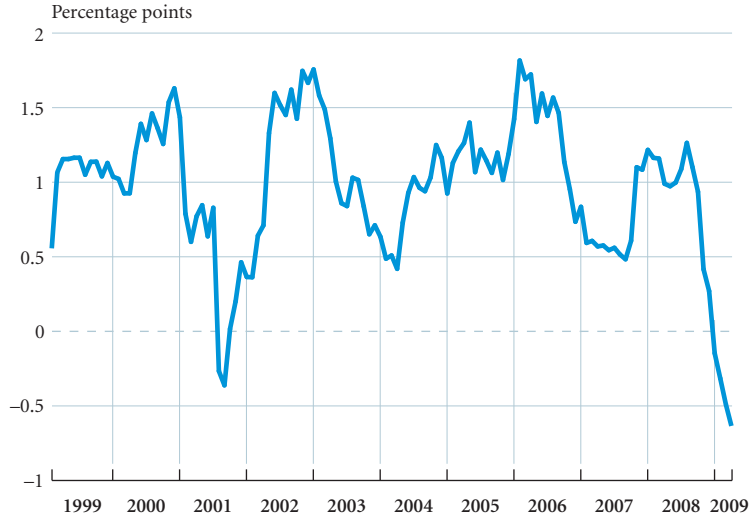
SOURCE: National Institute of Statistics.

3 decimals to 1.3%. As a result, it stood 2.2 points below the figure seven months earlier and also recorded a low for recent decades.

Processed foods added nearly one decimal to the drop in year-on-year inflation in March. Here, the year-on-year change was down 0.6 points to 1.2%. The price of cooking oils has dropped by

INFLATION DIFFERENTIAL WITH EURO AREA MARKS UP RECORD NEGATIVE FIGURE

Difference between Spain and Euro Area in year-on-year change in harmonized CPI



SOURCE: Eurostat, National Institute of Statistics and own calculations.

CONSUMER PRICE INDEX BY COMPONENT GROUP

March

	Indices (*)	% monthly change		% change over previous December		% monthly change	
		2008	2009	2008	2009	2008	2009
By type of spending							
Food and non-alcoholic beverages	109.5	0.3	–0.7	0.6	–1.1	6.9	0.6
Alcoholic beverages and tobacco	115.6	0.2	0.1	3.3	3.5	4.0	4.1
Clothing and footwear	95.6	3.4	3.4	–10.0	–12.2	0.8	–1.8
Housing	112.7	0.7	0.0	2.8	0.9	5.4	4.0
Furnishings and household equipment	106.4	0.5	0.3	0.4	–0.2	2.5	2.0
Health	99.0	–1.2	–0.1	–0.4	0.2	0.9	0.9
Transport	98.8	1.7	–0.5	2.1	–0.7	7.5	–8.2
Communications	99.7	0.1	0.0	0.3	0.1	–0.5	–0.5
Recreation and culture	98.7	1.2	0.2	0.0	–1.0	0.2	–0.8
Education	111.7	0.0	0.1	0.2	0.2	3.8	4.0
Restaurants and hotels	111.2	1.0	0.2	2.3	0.6	5.2	2.4
Other goods and services	109.2	0.4	0.3	2.1	1.5	3.1	3.0
By group							
Processed food, beverages and tobacco	111.1	0.3	–0.3	1.8	0.0	7.4	1.2
Unprocessed food	108.3	0.1	–1.3	–0.9	–1.7	4.7	0.8
Non-food products	104.4	1.1	0.4	0.3	–1.2	3.8	–0.4
Industrial goods	99.3	1.4	0.5	–1.2	–3.1	3.7	–3.4
Energy products	*99.2*	*2.8*	*–1.1*	*4.3*	*–0.6*	*14.1*	*–11.6*
Fuels and oils	*93.0*	*3.7*	*–1.4*	*4.7*	*–2.0*	*17.8*	*–18.4*
Industrial goods excluding energy products	*99.0*	*0.9*	*1.0*	*–3.1*	*–4.0*	*0.3*	*–0.6*
Services	109.9	0.8	0.3	1.8	0.8	4.0	2.7
Underlying inflation (**)	106.2	0.7	0.4	0.1	–1.1	3.4	1.3
GENERAL INDEX	**105.8**	**0.9**	**0.2**	**0.4**	**–1.1**	**4.5**	**–0.1**

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

10.3% in the past 12 months. The year-on-year change in bread prices was down 4 decimals to 0.5%.

On the other hand, there was a halt to the downward trend in non-energy industrial products. In any case, the change rate of these continued to be negative (–0.6%), thanks to pressure from international competition.

Prices for services showed a year-on-year change rate of 2.7% in March, a half-point less than in the month before thus showing the lowest level in recent decades. Part of this drop was due to the fact that the prices of some services usually record seasonal increases in Holy Week and this year, as opposed to last year, showed up in April. In any case, in recent months the pressure of reduced demand has also been noted in services for which the annual change rate has dropped by 1.4 points in the past 6 months.

...but underlying inflation also drops 3 decimals to 1.3%, lowest level in recent decades, reflecting contraction in consumer spending.

Prospect of negative inflation rates in coming months but with rise at end of year.

The consumer price index harmonized with the European Union also showed a year-on-year decrease of 0.1%. As a result, the negative differential with the Euro Area widened to 0.6 percentage points, setting a new record. This may partly be attributed to a larger share for fuels and lubricants in the Spanish index but, in fact, the differential in terms of underlying inflation was also negative.

With regard to inflation prospects, in April it may hold at around the March level although in following months the decrease will be greater mainly due to high petrol prices in the first half of last year. Nevertheless, mainly because of this factor, it will likely rise at the end of the year.

Producer prices down 1.1% in last 12 month ending in February.

Wholesale prices continue to drop

Wholesale prices continued to show negative year-on-year change rates in February, thus reflecting the collapse in commodity prices and the drop in demand. As a result, the general producer price index has dropped by 1.1% in the past 12 months. Both intermediate goods and energy show negative year-on-year change rates. Consumer goods and capital goods reported positive annual change rates but with a downward trend. In turn, import prices were down 5.6% compared with February 2008, some 0.7 points more than in the month before.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2007											
December	17.6	5.7	4.8	3.2	5.0	10.2	5.2	1.0	0.1	0.8	–
2008											
January	11.1	6.3	5.4	2.9	5.5	11.1	7.0	1.1	0.4	1.9	–
February	7.3	6.3	5.6	2.6	5.9	11.0	7.0	1.4	0.2	1.9	3.2
March	10.5	6.6	5.4	2.5	5.9	12.4	6.9	0.7	–0.3	2.3	–
April	8.5	6.6	5.1	2.5	5.8	13.3	6.9	0.6	–0.4	2.3	–
May	15.2	7.4	5.1	2.3	5.9	17.4	9.2	0.7	–0.1	2.5	3.1
June	8.6	8.4	5.2	2.3	6.2	21.1	10.4	1.1	–0.2	2.6	–
July	14.1	10.2	5.1	2.5	7.3	27.4	10.4	0.5	–0.2	3.7	–
August	6.9	9.2	4.8	2.5	7.6	23.2	9.6	1.3	0.3	5.0	3.4
September	–2.3	8.3	4.1	2.4	7.1	19.9	8.5	1.9	0.6	5.9	–
October	–8.2	6.1	2.8	2.4	5.3	14.9	5.2	3.2	1.3	5.1	–
November	–11.4	2.9	2.1	2.3	2.9	4.3	0.9	4.3	1.9	5.0	2.5
December	–9.7	0.4	1.6	2.3	0.9	–3.7	–3.9	2.6	1.6	2.0	–
2009											
January	...	–0.5	0.9	1.9	–1.6	–2.2	–4.9	2.9	1.9	0.5	–
February	...	–1.1	0.4	1.5	–3.2	–1.9	–5.6	3.1	2.4	–1.1	...

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

Foreign sector

Foreign trade: major reduction in deficit

The trade deficit for January 2009 was down 50.8% compared with the same month last year, recording the lowest figure since March 2004 at 4.5 billion euros. This reduction was largely brought about by the contraction of the deficit in the energy component which was down 56.2% that month due to the trend in oil prices. As a result, the total of the cumulative deficit for 12 months was down by 11.0%, thus maintaining the trend begun in 2008.

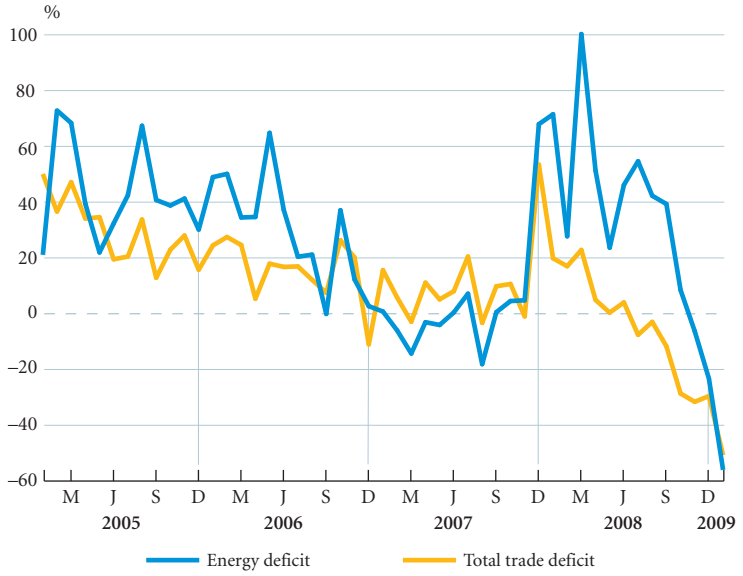
In the present context of a collapse in world trade, the improvement in this imbalance was brought about by an increased contraction of national demand. Imports reported a drop of 35.3%, nearly ten percentage points higher than the reduction of 25.7% in exports, thus raising the export/import ratio to levels similar to those in 2004 (71.1%). Nevertheless, if we take into account the real change in imports and exports, this difference goes down to 6.5 percentage points as a result of the bigger drop in import prices, particularly for energy products.

A more detailed analysis of trade flows shows how the value of exports to countries in the European Union, that represented 71.9% of the total in January was down 25.5% year-on-year, the biggest drop since creation of the EU.

Trade deficit for January records 50% drop.

TRADE DEFICIT BEING REDUCED WITH ENERGY COMPONENT IN LEAD

Year-on-year change in trade deficit



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

FOREIGN TRADE

2009

	Imports			Exports			Balance	Export/ Import ratio (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	2,486	–51.7	15.9	564	–25.6	5.1	–1,922	22.7
Consumer goods	4,961	–13.5	31.8	4,557	–16.3	41.1	–404	91.9
Food	*1,123*	*–6.8*	*7.2*	*1,881*	*0.6*	*17.0*	*758*	*167.4*
Non-foods	*3,838*	*–15.3*	*24.6*	*2,676*	*–25.1*	*24.1*	*–1,162*	*69.7*
Capital goods	1,313	–37.5	8.4	788	–36.2	7.1	–525	60.0
Non-energy intermediate goods	6,831	–38.5	43.8	5,183	–30.8	46.7	–1,648	75.9
By geographical area								
European Union	8,487	–32.5	54.4	7,976	–25.5	71.9	–511	94.0
Euro area	*7,202*	*–31.1*	*46.2*	*6,671*	*–22.6*	*60.1*	*–531*	*92.6*
Other countries	7,104	–38.3	45.6	3,116	–26.1	28.1	–3,987	43.9
Russia	*370*	*–56.4*	*2.4*	*89*	*–52.5*	*0.8*	*–281*	*24.0*
United States	*732*	*–28.9*	*4.7*	*467*	*–21.1*	*4.2*	*–265*	*63.8*
Japan	*253*	*–51.4*	*1.6*	*87*	*–24.2*	*0.8*	*–166*	*34.5*
Latin America	*743*	*–45.2*	*4.8*	*487*	*–25.0*	*4.4*	*–257*	*65.5*
OPEC	*1,194*	*–50.4*	*7.7*	*381*	*–1.9*	*3.4*	*–813*	*31.9*
Rest	*3,811*	*–28.7*	*24.4*	*1,606*	*–29.8*	*14.5*	*–2,206*	*42.1*
TOTAL	**15,591**	**–35.3**	**100.0**	**11,092**	**–25.7**	**100.0**	**–4,498**	**71.1**

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

Exports to European Union keep losing steam.

Exports to the United Kingdom and Italy suffered the biggest year-on-year drops, at 44.1% and 32.3% respectively. In turn, France, which was still Spain's main trading partner, showed a 16.9% drop in demand for Spanish products, which was lower than the decrease for the EU. The motor vehicle sector suffered most from the contraction in exports with a reduction of 45.3% compared with January 2008, along with exports of durable goods which were down 38.2%.

In view of the current economic situation, it is expected that over the short term these trends in trade will continue dragged down by the general drop in demand. Furthermore, the year-on-year reduction in oil prices in coming months will mean a drop in Spain's energy deficit thus sharpening the contraction of imports and favouring a decrease in the trade deficit during this period.

Current account deficit continues to drop...

Balance of payments: progressive adjustment of deficit

The current account balance showed a deficit of 6.6 billion euros in January 2009, 45.3% less than that reached in the same month last year. The major improvement in the trade balance that month was the main reason for the reduction of that imbalance. Over a longer time frame, the cumulative deficit for the last 12 months was down by

BALANCE OF PAYMENTS

January 2009

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–4,116	–52.2	–83,154	9,341	–10.1
Services					
Tourism	*1,451*	*–11.7*	*27,874*	*101*	*0.4*
Other services	*–152*	*–38.9*	*–1,466*	*2,921*	*–66.6*
Total	1,299	–6.9	26,407	3,022	12.9
Income	–3,259	–7.5	–33,790	–2,574	8.2
Transfers	–508	–60.5	–8,472	–701	9.0
Total	**–6,584**	**–45.3**	**–99,008**	**9,088**	**–8.4**
Capital account	**53**	**–95.7**	**4,370**	**–177**	**–3.9**
Financial balance					
Direct investment	–3,673	–	–22,083	15,505	–41.3
Portfolio investment	10,629	–	15,972	–72,454	–81.9
Other investment	3,622	–	76,825	42,496	123.8
Total	**10,578**	**128.1**	**70,714**	**–14,453**	**–17.0**
Errors and omissions	–1,025	–	2,310	2,712	–
Change in assets of Bank of Spain	–3,021	–	21,613	2,830	15.1

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.

5.4 billion euros, going to a total of 99 billion euros, with improvements in all components except in the services balance which held close to the level of the month before.

As a result of the improvement in the current account deficit, the cumulative deficit for Spain's economy in the past 12 months was reduced by 8.9 billion euros, thus gradually adjusting the major imbalance that reached its highest level in the early months of 2008. It is expected that this trend will continue because of the major contraction in investment, well above that for savings, thus reducing the deficit in 2009.

The Spanish economy's lower deficit is reflected in a reduction in financial liabilities accumulated last year. Net foreign portfolio investment was down 72.5 billion euros, partly compensated by lower direct investment abroad and an increase in funding through short-term financial instruments (loans, deposits and repos). The latter heading, which has been gaining greater importance in recent months, demonstrates the change in coverage of liquidity needs in the case of Spain's financial institutions.

...slightly easing Spain's deficit.

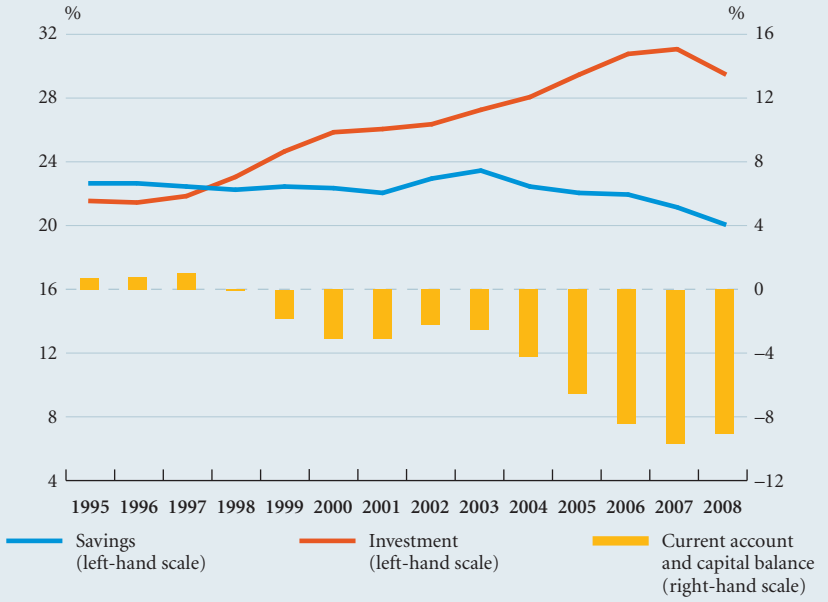
Adjusting Spain's deficit: Where did we hide the piggy-bank?

In his novel *David Copperfield*, Charles Dickens wrote that the difference between happiness and misery in a person depended on not always spending more than he earned. If we apply this to the national level it would be the same as saying that Spain's economy has reduced its happiness over the past 10 years. In this time, Spain has shown growing current account deficits, thus recording an all-time high of 10.5% of GDP in the second quarter of 2008, and putting it among the developed economies with the highest deficits, well above the 5.0% in the United States. This imbalance raised Spain's net foreign borrowing up to 80% of GDP in 2008.

The current account and capital balance equals net foreign financial flow, that is, the difference between national savings and investment. As may be seen in the graph, the gap between both series has considerable increased in the past 10 years due to the strong drive in investment which generated a substantial foreign deficit in Spain's economy. In turn, aggregate savings have remained fairly stable in spite of a reduction in household savings that was partly compensated by increased savings in general government. This sequence is considerably different from that seen in the United States where the deficit was brought about by a drop in savings both in households and general government.

INCREASE IN INVESTMENT HAS RAISED DEFICIT

Flows in terms of GDP



SOURCE: Eurostat and own calculations.

Spain's expansionist cycle in recent years, driven by investment in construction and consumer durables, has therefore rested on borrowing by the various economic agents, especially companies and households, which were able to enjoy easy financing almost without limit.

Is this high deficit of Spain's economy sustainable? A current account deficit may have positive effects on the development of an economy if the resources obtained are used to generate future income that makes it possible to repay debts and obligations acquired, or, in other words, if it is sustainable over the long term.

Given that the current account deficit tends to increase foreign debt, one way of judging the sustainability of the deficit is to evaluate the borrowing involved. In simple terms, the sustainability of the debt and the annual deficit depends on the nominal growth rate of the economy and the interest rate applying to cumulative debt.[1] Spain's joining the European Monetary Union (EMU) and the increase in world savings in recent years generated an upward revision of expectations for Spanish growth as well as a reduction in interest rates and the risk associated with investment in the country which reduced the debt load.

Nevertheless, a hypothetical exercise shows that, given the present current account deficit, for Spain's net cumulative debt to stabilize at around 80%, in nominal terms it would be necessary to have GDP growth of more than 10% and an interest rate of 1.5% on the debt, both unlikely suppositions. This exercise, by using more plausible hypotheses (nominal growth of 5.5% and an interest rate of 4.5%), we would obtain borrowing at a very high level (six times the country's GDP). In both cases, the cost of interest on net debt takes on great significance as, with the current net level of borrowing, this goes to 3.6% of GDP, a situation that makes it even more difficult to compensate the imbalance.

This high level of debt is a very important risk factor for Spain's economy given that it leaves it vulnerable, as well as to an increase in interest rates, to an economic slowdown or stagnation in international capital flows, both situations taking place at this time and that were unthinkable only two years ago. As a result, the high imbalance shown in Spain's economy with the rest of the world must be corrected over the next few years.

The outbreak of the financial crisis in the third quarter of 2007 brought with it an increase in uncertainty involving greater risk aversion along with more difficult access to credit and the need for liquidity. This situation has meant a freezing in capital markets which, together with the wearing out of Spain's growth model, has reduced the attraction of investment in Spain, bringing about a drastic contraction of foreign capital inflows. The heading to show the biggest reduction is foreign portfolio investment which has been partly offset by growth of other investments, reflecting the new methods of covering the liquidity needs of financial institutions through a big increase in short-term financing.

In view of this situation involving the restriction of foreign financing, Spain's economy is facing a sharp adjustment of its current account deficit and, as a result, a major adjustment of domestic spending. Figures for the cumulative deficit over 12 months now show a reduction of one percentage point in the deficit over the past two quarters. This drop would have been greater but for the possibility of recourse to the liquidity auctions of the European Central Bank (ECB) which made it possible to meet part of the foreign deficit, although at the cost of an increase in the load of short-term funding.

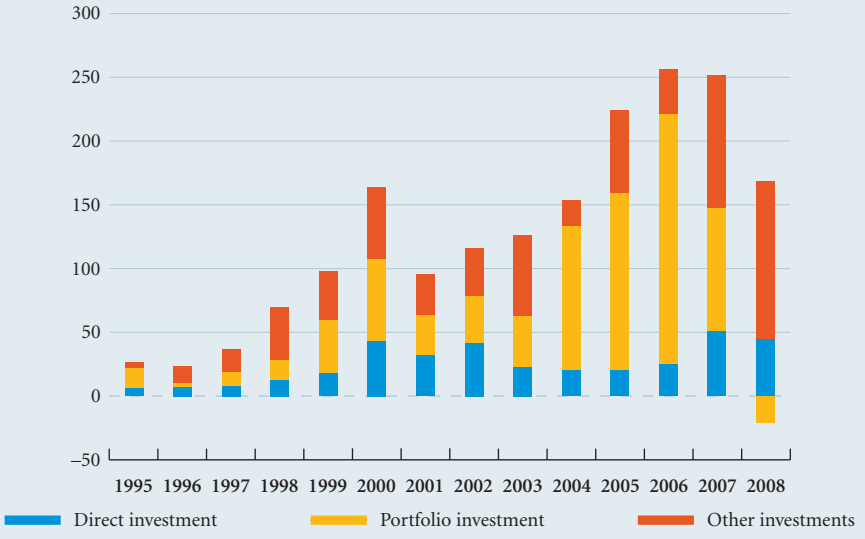
Correction of the foreign imbalance is taking place through the lower deficit for the private sector which compensates heavier borrowing by the central government due lower tax collections and the increase in spending owing to fiscal plans to stimulate the economy. Everything indicates that this trend will continue with a reduction in the deficit which, according to our forecasts, could stand at around 5% in coming years.

(1) Fernández, E.: «La sostenibilidad del déficit exterior de los Estados Unidos». Economic Documents (2007).

Nevertheless, in the new framework in which private capital will be less willing to buy foreign assets, these levels will continue to be very high. This means that, after the recent cycle of excessive borrowing, Spain's economy, especially households and companies, should take note of Dickens' words. It is time to bring back the piggy-banks.

FOREIGN CAPITAL INFLOWS DOWN

Billion euros



SOURCE: Bank of Spain.

This box was prepared by Joan Daniel Pina
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Public sector

Recession has unfavourable impact on central government accounts

The recessive situation in Spain's economy continues to have a negative effect on the government accounts. In the first two months of 2009 central government revenues in Treasury terms, that is, according to monetary flows recorded, amounted to 38.18 billion euros, before taking into account amounts ceded to autonomous communities and local governments under the current financing system.This amount represents a decrease of 6.1% compared with the same period the year before. This decrease is greater than that for the nominal gross domestic product (GDP).

Collections for direct taxes in the January-February period showed a year-on-year decrease of 6.9%. Under this heading, the biggest category (that for personal income tax) was down 10.0% in the past 12 months mainly as a result of the trend in hold-backs on wages following the drop in employment and the early deduction of up to 400 euros that was not applicable in the early months of 2008. Collections for company tax were up 7.3% over the first two months of 2008 largely because of the change in the calendar of hold-backs for interest on government bonds. Adjusted for this effect and the calendar for rebates meant that collections for this tax in comparable terms were down 17.1% year-on-year.

Central government revenues show 6% year-on-year drop in first quarter...

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

February 2009

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**18,279**	**–2.8**	**28,656**	**–9.4**
Non-financial revenue adjusted (*)				
Personal income tax	4,424	–11.0	14,848	–10.0
Corporate tax	791	–	1,343	7.3
VAT	13,321	–15.5	14,094	–16.7
Special taxes	1,465	–18.1	3,222	–3.3
Other	3,038	292.5	4,669	77.1
Total	**23,039**	**–1.1**	**38,176**	**–6.1**
Non-financial spending	**15,991**	**65.2**	**28,726**	**3.3**
Treasury balance	**2,288**	**–74.9**	**–70**	**–**
Surplus (+) or deficit (–) (**)	***4,606***	***–42.7***	***5,325***	***–43.7***

NOTES: (*) Includes tax segments ceded to regional and local governments under current financing system.
(**) In terms of National Accounting.
SOURCE: Ministry of Economy and Finance and own calculations.

...due to decreased tax collections, both direct and indirect.

Indirect taxes, which were affected by the drop in consumption and investment, were down 14.4%. The biggest heading in this group, value added tax (VAT), showed a drop of 16.7% as a result of increased deferments of tax owing.

Special taxes were down 3.3% mainly due to the 5.5% drop in the largest heading in the group (fuel taxes) under the effect of lower consumption of fuels and fuel-oils. Another important heading, tobacco tax, was down 1.0% while taxes on alcohol and alcholic drinks dropped by 20.6%.

Central government spending up 3% compared with first two months of 2008.

Other collections showed an extraordinary year-on-year rise of 77.1%. This was largely due to the increase in revenues because of differences between asset recoveries and government bond issues, to a recovery because of cancellation of the early payment to the European Union budget based on gross national income and new commissions on guarantees of issues by financial entities under the Concerted Action Plan of the Euro Zone countries.

European Commission warns that government deficit must be brought below 3% of GDP in 2012.

On the other hand, non-financial payments by the central government in the first two months of the year amounted to 28.73 billion euros, an increase of 3.3% compared with the same period last year. Current spending was down 3.8%. Staff costss rose by 4.0% while current spending on goods and services was down 12.8% and financial costs dropped by 18.0%.

Capital costs amounted to 5.25 billion euros, a year-on-year increase of 54.7%. Real investments rose by 2.3% while capital transfers were up 138.2%.

Because of the trend in collections and spending, the central government accounts showed a public deficit of 70 million euros in the first two months of 2009 as opposed to a surplus of 3.83 billion euros in the same period last year. In National Accounting terms, that is, taking into account rights and obligations generated, there was a surplus of 5.32 billion euros but this was 43.7% lower than the figure for the same period in 2008.

Given the trend in government revenues and spending and measures to stimulate the economy taken both by the central government or other levels we forecast that the government deficit in 2009 will be of the order of 8% of GDP. In addition, the European Commission has issued a warning that Spain's economic authorities must prepare a scenario for correcting the government deficit to put it again below 3% of GDP in 2012. The governor of the Bank of Spain also recently warned against excessive expansion of government spending.

Savings and financing

Financing granted to companies and households continues to slow down

The economic recession, on the one hand, is causing deleverage in the private sector with a drop in demand for financing from companies and households and the tightening of borrowing terms. On the other hand, the worsening of the economic situation is causing a sharp rise in public borrowing because of the drop in tax collections and the increase in government spending on unemployment benefits and measures taken to stimulate the economy. As a result, the year-on-year change rate for total funding rose in February for the first time since January 2008 to stand at 6.7%.

Financing granted to the private sector thus rose by 5.2% in February compared with the same month last year, a rate 4 decimals lower than one month earlier and nearly one point less than in December. The drop in financing showed up both for companies and households although it was more severe in the latter case.

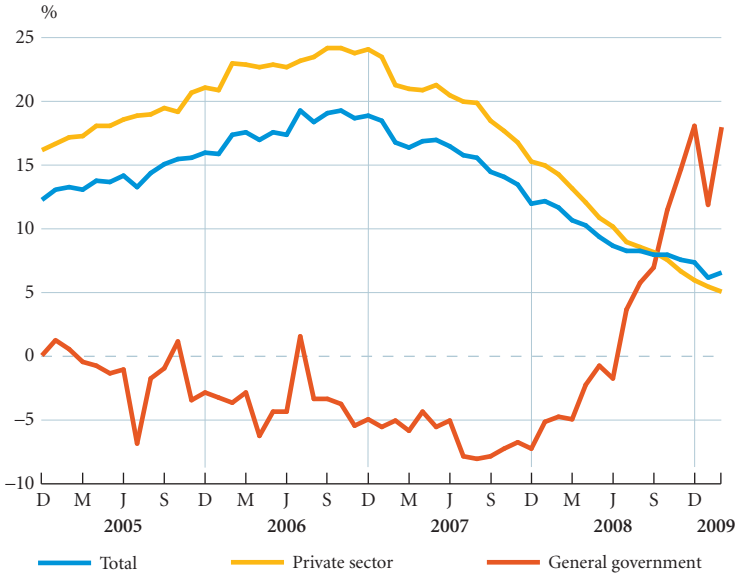
Deleverage of private sector with drop in demand for financing and tightening of borrowing terms.

Funding granted to non-financial companies was up 6.7% in the 12 months ending in February although this rate was 10 points lower than that one year ago. Company bond issues were up notably marking up a year-on-year change rate of 21.9%, although this represents only a small part of the total

Drop in household borrowing sharper than that of companies.

DELEVERAGE OF PRIVATE SECTOR BEING COMPENSATED BY PUBLIC SECTOR BORROWING

Year-on-year change in borrowing



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

February 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	64,631	–9,583	–12.9	–24,110	–27.2	3.5
Secured loans (*)	1,102,625	–6,171	–0.6	24,586	2.3	59.3
Other term loans	521,220	–8,237	–1.6	16,463	3.3	28.0
Demand loans	49,688	560	1.1	9,443	23.5	2.7
Leasing	43,369	–1,859	–4.1	–2,619	–5.7	2.3
Doubtful loans	77,653	14,596	23.1	57,536	286.0	4.2
TOTAL	**1,859,187**	**–10,695**	**–0.6**	**81,300**	**4.6**	**100.0**

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

Household borrowing down for third month in a row.

available only to large companies. The contribution from foreign loans was greater at 2.1 points making a year-on-year change rate that moved up to 9.2%, some 8 decimals more than in the previous month.

On the other hand, loans by resident banks and savings banks continued to ease. Commercial credit, used to finance working capital, continued to drop going to a year-on-year change rate of 27.2%. Demand for funding for investment purposes was also weak, as shown by the year-on-year drop of 5.7% in leasing.

Loans granted to households also continued to ease and showed year-on-year growth of 3.0% at the end of February as against 11.8% twelve months earlier. This rapid drop may be attributed both to housing loans and other funding. In fact, total funding granted to households in absolute terms was down in February for the third month in a row. The year-on-year change rate for housing loans has dropped by 9 points over the past 12 months going to 3.2%, in spite of the 2.2 points decrease in the 1-year Euribor rate (widely used as a reference rate) in this period. This interest rate continued to drop on monthly average in March going to 1.909%, while reflecting the prospect of further official interest rate cuts by the European Central Bank and reduced pressures in the interbank market.

The sharpening of the economic recession and the rise in unemployment continued to bring about an increase in default. As a result, the rate for doubtful loans at financial institutions as a whole stood at 4.2% in February, more than 3 points above the February 2008 level. The rise in default also brought with it an increase in the number of mortgage foreclosures. In 2008, these were more than twice those recorded the year before, according to figures from the Justice Council.

Public sector deficit up 18% in past 12 months.

With regard to general government, deficits for the previous 12 months amounted to 18.1%, as against a negative rate of –4.6% in February 2008. The biggest increase in funding showed up in short-term instruments (such as Treasury bills) with a year-on-year rise in balance of 67.6%. In turn, medium-term and long-term bonds were up 13.2%.

Bank deposits move up more than loans

In recent months, there has been a notable improvement in the liquidity situation of financial institutions thanks to the gradual normalization of interbank markets, auctions held by the Financial Asset Acquisition Fund introduced by the central government and government guarantees applied to new issues. In any case, the financial institutions continued their active promotion campaigns to attract customer deposits although, naturally, they reduced returns offered in line with the official interest rate cuts by the European Central Bank. In any case, average return on deposits remained substantially higher than inflation.

As a result, in the past 12 months ending in February, private sector deposits at financial institutions rose by 132.85 billion euros, going above the corresponding change in loans. This meant that the gap between total loans and deposits was somewhat closed.

The biggest increase over the past 12 months took place in term deposits which were up 21.7% although this rate was lower than that recorded in previous months. On the other hand, on-sight accounts and savings accounts were more active and the year-on-year increase in balances of the former moved into the positive.

In this context, another broadly used savings product, participations in mutual funds, continued to suffer from the competition coming from deposits. In March, net withdrawals amounted to 1.84 billion euros. Nearly all types showed net withdrawals with the exception of guaranteed bond-based funds, international bond-based funds and US share-based funds.

The improved situation in international financial markets in March, especially in share markets and in emerging markets, gave a breather and meant that average monthly return was 0.29%. Nevertheless, average annual return was still negative at –3.6% but showed a very wide spread. Returns swung between 3.7% on international bond-based funds and capital losses of 42.1% on emerging economy share-based. As a result, mutual fund assets showed a monthly decrease

Notable improvement in liquidity of financial entities.

Gap between total credits and deposits somewhat less.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

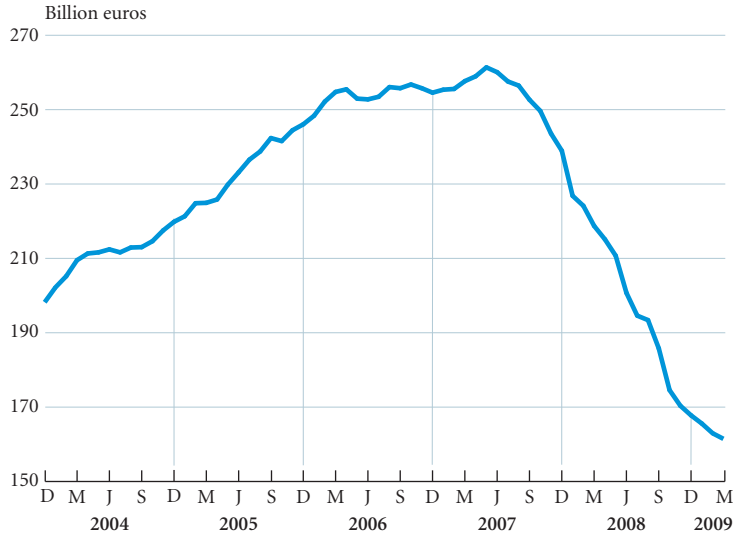
February 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	244,491	–321	–0.1	1,130	0.5	17.3
Savings deposits	180,565	788	0.4	5,747	3.3	12.7
Term deposits	729,091	–181	0.0	130,162	21.7	51.5
Deposits in foreign currency	29,741	423	1.4	–4,192	–12.4	2.1
Total deposits	**1,183,889**	**710**	**0.1**	**132,849**	**12.6**	**83.6**
Other liabilities (*)	**232,857**	**–15,772**	**–6.3**	**–40,956**	**–15.0**	**16.4**
TOTAL	**1,416,745**	**–15,063**	**–1.1**	**91,892**	**6.9**	**100.0**

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

DROP IN ASSETS OF MUTUAL FUNDS SLOWS DOWN

Total mutual fund assets



SOURCE: Inverco.

Return on mutual funds improves in March.

of 1.49 billion euros, substantially below previous months, going to 161.32 billion euros, which meant a year-on-year drop of 26.2%.

Assets of hedge funds continued to decrease, going to 1.09 billion euros.

Nor have real estate mutual funds been able to ride out the recession and their assets dropped by 300 million euros during the month, going to 6.77 billion euros. Average weighted yield on these funds in the past year was negative at –5.6%.

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FINANCIAL ACTIVITY	Million euros
Total customer funds	238,407
Receivable from customers	176,100
Profit attributable to Group	1,802

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	27,818
Branches	5,530
Self-service terminals	8,113
Cards (thousands)	10,344

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2009	Million euros
Social	310
Science and environmental	81
Cultural	79
Educational	30
TOTAL BUDGET	**500**

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