NUMBER 331 • JANUARY 2010

THE SPANISH ECONOMY

# Monthly Report

## OUTLOOK FOR 2010: SUNNY SPELLS



RESEARCH DEPARTMENT

"la Caixa"

# Forecast

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

| | 2008 | 2009 | 2010 | 2009 1Q | 2009 2Q | 2009 3Q | 2009 4Q |
|---|---|---|---|---|---|---|---|
| **INTERNATIONAL ECONOMY** | | Forecast | | | | | Forecast |
| **Gross domestic product** | | | | | | | |
| United States | 0.4 | –2.6 | 2.4 | –3.3 | –3.8 | –2.6 | –0.4 |
| Japan | –1.2 | –5.3 | 1.3 | –8.6 | –6.0 | –4.7 | –1.7 |
| United Kingdom | 0.5 | –4.7 | 1.1 | –5.2 | –5.8 | –5.1 | –2.8 |
| Euro area | 0.5 | –3.9 | 1.2 | –4.9 | –4.8 | –4.1 | –1.9 |
| *Germany* | *1.0* | *–4.8* | *1.5* | *–6.7* | *–5.8* | *–4.8* | *–2.0* |
| *France* | *0.3* | *–2.3* | *1.3* | *–3.5* | *–2.9* | *–2.4* | *–0.4* |
| **Consumer prices** | | | | | | | |
| United States | 3.8 | –0.3 | 2.2 | –0.2 | –0.9 | –1.6 | 1.5 |
| Japan | 1.4 | –1.4 | –0.5 | –0.1 | –1.0 | –2.2 | –2.2 |
| United Kingdom | 3.6 | 2.1 | 2.2 | 3.0 | 2.1 | 1.5 | 1.8 |
| Euro area | 3.3 | 0.3 | 1.2 | 1.0 | 0.2 | –0.4 | 0.4 |
| *Germany* | *2.6* | *0.3* | *1.0* | *0.8* | *0.3* | *–0.2* | *0.3* |
| *France* | *2.8* | *0.1* | *1.2* | *0.7* | *–0.2* | *–0.3* | *0.3* |
| **SPANISH ECONOMY** | | Forecast | | | | | Forecast |
| **Macroeconomic figures** | | | | | | | |
| Household consumption | –0.6 | –4.9 | –0.2 | –5.4 | –6.0 | –5.1 | –3.2 |
| Government consumption | 5.5 | 5.0 | 1.4 | 6.4 | 5.2 | 4.9 | 3.3 |
| Gross fixed capital formation | –4.4 | –15.3 | –5.8 | –15.1 | –17.2 | –16.2 | –12.3 |
| *Capital goods* | *–1.8* | *–23.2* | *–7.5* | *–24.4* | *–28.9* | *–24.3* | *–15.0* |
| *Construction* | *–5.5* | *–11.6* | *–7.0* | *–11.3* | *–11.8* | *–11.5* | *–11.7* |
| Domestic demand (contribution to GDP growth) | –0.5 | –6.1 | –1.3 | –6.2 | –7.4 | –6.5 | –4.3 |
| Exports of goods and services | –1.0 | –12.3 | 2.4 | –16.9 | –15.1 | –11.1 | –6.2 |
| Imports of goods and services | –4.9 | –17.8 | –1.4 | –22.6 | –22.0 | –17.0 | –9.7 |
| **Gross domestic product** | **0.9** | **–3.6** | **–0.4** | **–3.2** | **–4.2** | **–4.0** | **–3.1** |
| **Other variables** | | | | | | | |
| Employment | –0.6 | –6.7 | –2.2 | –6.3 | –7.2 | –7.2 | –6.0 |
| Unemployment (% labour force) | 11.3 | 18.0 | 20.1 | 17.4 | 17.9 | 17.9 | 19.0 |
| Consumer price index | 4.1 | –0.3 | 1.4 | 0.5 | –0.7 | –1.1 | 0.2 |
| Unit labour costs | 4.6 | 0.1 | –0.9 | 1.2 | 1.4 | 0.4 | |
| Current account balance (% GDP) | –9.5 | –5.9 | –3.8 | –7.9 | –4.5 | –3.9 | |
| Net lending or net borrowing rest of the world (% GDP) | –9.1 | –5.5 | –3.4 | –7.6 | –4.0 | –3.6 | |
| General government financial balance (% GDP) | –4.1 | –10.9 | –9.9 | –0.5 | –15.0 | | |
| **FINANCIAL MARKETS** | | Forecast | | | | | Forecast |
| **International interest rates** | | | | | | | |
| Federal Funds | 2.1 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| ECB repo | 3.9 | 1.2 | 1.0 | 1.8 | 1.1 | 1.0 | 1.0 |
| 10-year US bonds | 3.6 | 3.2 | 3.5 | 2.7 | 3.3 | 3.5 | 3.3 |
| 10-year German bonds | 4.0 | 3.3 | 3.3 | 3.1 | 3.4 | 3.3 | 3.2 |
| **Exchange rate** | | | | | | | |
| $/Euro | 1.48 | 1.39 | 1.44 | 1.30 | 1.36 | 1.43 | 1.48 |

## Contents



# Outlook for 2010: sunny spells

The dark storm clouds are moving away, barometers are rising and patches of blue are breaking through. So has the good weather arrived? The most serious moments of the worst recession in decades are now behind the international economy. A phase in which catastrophe was almost upon us and we were forced to take measures that had been unthinkable just a short time before. Now economic indicators are already hinting at the end of the worldwide economic crisis but coming out of such a situation is still a risky business.

The storm may have passed but the terrain ahead is still complex. The outlook for the main countries, both developed and emerging, is growth in 2010 but with some exceptions. The starting point for emerging countries is somewhat more solid, as they suffered a less spectacular tumble in 2009. Developed economies are starting to benefit from the flows of international trade re-establishing themselves at the same time as consumer «shock» is starting to ease up. Firms are beginning to believe that 2010 is going to be better and are once again considering the possibility of undertaking some investment.

But in addition to the encouraging figures there are also some worrying elements. The most notable is high unemployment, a burden for any recovery that must be based at least on domestic demand. In spite of the inklings of recovery, the ranks of the unemployed are still swelling, although this should stabilize in 2010. However, within the normal cyclical movement of an economy, unemployment is a deferred phenomenon, i.e. it doesn't improve until recovery is well underway.

The most delicate issue revolves around the aid provided by economic and monetary policies that have helped to slow up economic decline; stimuli that make this incipient recovery precarious in nature, insofar as their premature withdrawal might lead to a relapse in the recession, while if they are maintained they could destabilize public accounts and encourage a new liquidity bubble. Some central banks have already started to raise their reference interest rates from the record minimums, something that should become more widespread in 2010, as well as withdrawing exceptional measures to inject liquidity. In general, governments are maintaining measures to stimulate business but, in 2010, they will have to spell out just how these will be withdrawn, as their effect in terms of deficit and debt makes them unviable for much longer.

The financial sector does not seem overly concerned about the deleveraging of families and firms nor about the deterioration in public accounts. Its recovery as from the second quarter of 2009 anticipated the improvement in real activity by several months, but the powerful rise in stock market indices has not managed to match up with the figures for gross domestic product. In fact, credit is still not flowing readily to the private sector, while episodes such as Dubai World and Greece warn of the risks that still exist in the bond market.

In short, the recovery is still fragile due to dependence on government stimuli and the still incomplete restoration of balances in the private sector, firms and families. Growth figures are positive again thanks to them being compared with the worst points in the recession but a return to pre-crisis levels of income and wealth will take a long time. The outlook is clear but our eyes are still drawn to the sky with some trepidation.

# EXECUTIVE SUMMARY

## Encouraging prospects for the world economy

**The prospects for 2010 are much better than those for 2009.**

The world economy is taking on 2010 in much better shape than 2009. A year ago the financial crisis was at its peak, business was plummeting at an exceptional rate that had not been seen for decades and the job market was starting to deteriorate seriously. The world was struggling between recession and depression and the diagnosis was clear: a decisive, coordinated response from all institutions and countries was required to avoid the worst-case scenario.

**Recovery will consolidate both in the United States and in the euro area...**

This has been achieved to a large extent. The response of the main developed countries and the measures taken by their central banks have made the grade. Their action was decisive so that, between the second and third quarter of 2009, the quarter-on-quarter growth rate for most economies was back in the black. The most difficult task, namely turning around the spiral of decline, was also achieved. But what is still pending, to consolidate recovery, is no easy undertaking either.

**...but there are still many risks that suggest prudence is required.**

For the moment, and awaiting the data on growth for the fourth quarter, the high frequency data continue the promising trends seen in the third quarter. In the United States, the labour market is showing signs of bottoming out with 11,000 jobs lost in the month of November, a small figure compared with the losses of the last few months. Demand figures also indicate that a crucial element for recovery to become firmly established, namely private consumption, is looking stronger than expected after the end of government aid.

In the euro area, however, consumption has still not reacted: in the third quarter it fell two-tenths of a percentage point compared with the previous quarter. It has now been a year and a half without any positive growth and no change is in sight for this trend for the present. Both retail sales and core inflation, two good indicators of the demand's state of health, continue to be very weak. In this case recovery is being driven by the foreign sector and also by economic stimulus measures. Private consumption and investment will not take over until the second half of the year. The euro area will then have to start consolidating its new expansionary cycle.

However, although recovery is already underway in most developed economies, the depth of the recession suffered in 2009 has left its mark and may ensure that any recovery is slow and fragile. Record high unemployment; a financial sector that, although it is now back to normal, is still delicate; developed countries' greater dependence on the good performance of emerging economies; and heavy borrowing by households and the public sector go to make up the Achilles heel of recovery. An unexpected decline in any of these elements in 2010 could set the alarm bells ringing.

In this respect, throughout the year some countries may feel more pressure to carry

out far-reaching reforms. The sharp drop in fiscal revenue, together with higher public expenditure related to automatic stabilizers and stimulus plans, have led to record high levels of public deficit and debt and few countries have escaped the spiral of deteriorating public accounts.

**Concern due to the extent of deterioration in public accounts.**

Doubts regarding the fiscal sustainability of some economies in the euro area have helped the dollar to appreciate against the euro after months of sharp falls. Whereas, at the end of November, one euro was exchanged for 1.51 dollars, in the last week of December the exchange rate was under 1.45 dollars, an appreciation of 5%. The good macroeconomic figures for the United States, slightly better than expected by the market, and the end of speculative carry trade positions have also boosted the dollar. Throughout 2010, the greenback may appreciate moderately against the euro and, for this to happen, the key factor will be the start of the monetary normalization cycle in the United States.

How emerging countries perform is increasingly important when studying the global economic panorama. Unlike previous episodes, this time they have become one of the key points in the recovery process. China will end 2009 with 8% growth, a direct consequence of policies for investment and to inject liquidity. India surprised with growth of 6.7% year-on-year in the third quarter and Brazil continues to inspire admiration among analysts. It is starting the New Year with solid domestic demand, record high confidence levels, expanding industry and an economy that is far removed from inflationary pressures.

**Emerging countries will continue to be one of the key points in recovery.**

The changes occurring in the financial markets reflect a scenario of gradual recovery but with certain risks to bear in mind. The measures announced by the Federal Reserve and the European Central Bank (ECB) after their respective meetings in December are a good example of this. The ECB announced the withdrawal of special one-year operations and stated that the last six-month refinancing operation would take place on 31 March. The US central bank also announced the gradual withdrawal of some special measures, such as the currency swap lines it holds with the main central banks in the world and the special lines of liquidity for banks.

**The ECB and the Fed are starting to withdraw some extraordinary measures.**

The good performance of the private bond market is another example of economic recovery. This is reflected in the widespread improvement in rating agencies' debt ratings of firms, unlike what is happening lately with the public debt of some countries. This trend appears to be very positive in the United States, while in the euro area and in South East Asia the improvement is still in its early stages.

The Spanish economy is also showing clear signs of improvement in economic activity, although it will take longer to come out of the recession than the rest of the developed countries. Available indicators for the fourth quarter in 2009 suggest that the economy is still in a phase of gradual moderation in its decline.

Consequently, consumers are still afflicted by the uncertainty created by soaring unemployment, leading to cutbacks in expenditure and considerable increases in savings. However, figures show that the worst is now behind us. In October, retail sales continued to slow up their decline. Another good reference for the movements underlying demand, the

**For Spain, all indicators suggest a progressive moderation in its decline.**

consumer confidence index, stabilized at a level slightly higher than that of the first half of the year, although it is still below its historical average. Vehicle registrations show much more positive progress. These have speeded up to a rise of 37.3% in November, albeit resulting from the direct subsidies of the plan promoted by the central government and most of the autonomous communities.

It's a similar story with corporate business. The fragile «green shoots» of domestic demand are combining with a demand for exports that has also improved thanks to the better situation of the international economy. This explains the slight upswing in industrial capacity utilization in October and the lower deterioration in variables related to investment. However, construction continues to be affected by changes in the real estate sector and the effects of public works investment plans.

**Deterioration in the job market is slowing up and inflation is returning to positive figures.**

The change in trend can also be seen in most indicators for the labour market, the moderation in the decline in Social Security registrations being one of the clearest examples. Registered unemployment for November also gave us a pleasant surprise, increasing in line with job losses but less than initially predicted. In spite of this, Spanish unemployment continues to be the highest in the European Union after Latvia and Spain is one of the member states with the highest number of job losses in the last twelve months. In contrast to this deterioration in the job market, labour costs have continued to rise clearly above the average of the euro area.

**In the second half of 2010, the exit from recession will become firmly established.**

In this respect, it is worth mentioning the central government's announcement of labour market reforms. Among the series of proposals announced, of note is promoting the use of shorter working days as a temporary measure to adjust employment, as well as changes in the collective bargaining system to improve firms' internal flexibility and the revision of the employment contract rebate policy.

Another indicator that would suggest a certain improvement in consumer spending is the stabilization of the underlying core of the consumer price index (CPI). Although, until the second half of 2008, this group grew more than 3% yearly, in September the annual rate reached 0.1%, but in November it picked up slightly to 0.2%. This stabilization in core inflation, together with the trends in hydrocarbon prices, means that, after eight months of negative year-on-year changes, the CPI returned to positive figures in November.

The improvement in key indicators has led us to slightly upgrade our predictions for GDP growth for the four quarter in 2009. We expect a slight quarter-on-quarter decline that would place the year-on-year rate close to a drop of 3%, compared with a fall of 4.0% in the third quarter. The annual fall in GDP for 2009 would therefore be 3.6%. The prospects for 2010 are for the economy to continue improving so that, in the second half of the year, positive year-on-year growth might be recorded. This recovery will go hand in hand not only with the contribution made by the foreign sector but also with the recovery in consumption. Although recovery will be slow, and a relapse cannot be ruled out, if the response of the main countries and central banks continues to be in keeping with the circumstances, the turnaround of the world economy throughout the second half of 2009 invites us to be optimistic.

23 December 2009

## CHRONOLOGY

### 2008

| | | |
|---|---|---|
| **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** | Government approves series of **measures to boost economic activity**: reform of law on meetings of creditors, revival of credit insurance and introduction of EU directive on services. |
| **April** | **2** | **European Central Bank** lowers official interest rate to 1.25%. G-20 meeting in London aimed at **reform of international financial system**. |
| **May** | **7** | **European Central Bank** lowers official interest rate to 1.00% and announces measures to facilitate liquidity in banking system. |
| | **12** | Government announces **new economic policy measures**: partial removal of tax deduction for buying normal residence as of 2011, aids for buying cars, reduced taxes for some small and medium-size businesses and self-employed persons, etc. |
| **June** | **12** | Government **increases taxes** on tobacco, petrol and diesel fuel for motor vehicles. |
| | **26** | Government establishes **Fund for Orderly Restructuring of Banks**. |
| **September** | **26** | The Spanish government passes the **2010 State General Budget**, which eliminates the deduction of 400 euros from income tax, raises the duty on capital income and also the general and low VAT rates as from July 2010. |
| **November** | **27** | The central government presents its draft bill for the **Sustainable Economy Act**. |
| **December** | **1** | The **Lisbon Treaty** comes into force, reforming certain aspects of the European Union. |

## AGENDA

### January

- **5** HCPI flash estimate (December).
- **8** Industrial production index (November).
- **14** CPI (December). Governing Council Central European Bank.
- **15** EU HCPI (December).
- **25** Producer prices (December).
- **26** Fed Open Market Committee.
- **28** HCPI flash estimate (January).
- **29** Labour Force Survey (fourth quarter).
- **30** Balance of payments (November).

### February

- **4** Central European Bank's Governing Council.
- **5** Producer price index (December).
- **8** Industrial production index (December).
- **11** GDP flash estimate (fourth quarter).
- **12** CPI (January). EU GDP (fourth quarter).
- **17** Quarterly National Accounts (fourth quarter).
- **26** EU HCPI (January).
- **30** Balance of payments (December).

# INTERNATIONAL REVIEW

**The United States grows by 2.2% annualized quarter-on-quarter and improves its short-term prospects thanks to private consumption.**

## The way ahead is a little clearer for the United States

The US is leaving behind the worst recession since 1945. Private consumption has withstood the end to government aid better than expected, the labour market is showing signs of bottoming out and real estate is no longer losing value. Price stability is also reinforcing a more optimistic scenario than the one perceived just two months ago. However, the obstacles to recovery are still the same. Reducing heavy household borrowing will still require higher rates of saving by families, recovery in the labour market will be hindered by the high number of long-term unemployed and housing will continue to suffer from significant over-supply.

The latest demand indicators show that a crucial element in consolidating recovery, namely private consumption, is looking stronger than expected after the end of the «cash for clunkers» scheme. This included aid totalling 3,000 million dollars for the purchase of automobiles and initially lasted from July to November but public demand had already exhausted the budget by the end of August. In such a setting, in November retail sales without

**UNITED STATES: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| Real GDP | 2.1 | 0.4 | –1.9 | –3.3 | –3.8 | –2.6 | – | ... |
| Retail sales | 3.3 | –0.8 | –8.3 | –8.9 | –9.5 | –6.7 | –2.0 | 1.9 |
| Consumer confidence (1) | 103.4 | 58.0 | 40.7 | 29.9 | 48.3 | 51.8 | 48.7 | 49.5 |
| Industrial production | 1.5 | –2.2 | –6.7 | –11.6 | –12.9 | –9.5 | –7.1 | –5.1 |
| Manufacturing (ISM) (1) | 51.1 | 45.5 | 36.1 | 35.9 | 42.6 | 51.5 | 55.7 | 53.6 |
| Sales of single-family homes | –26.7 | –37.4 | –41.0 | –40.0 | –27.1 | –10.2 | 5.1 | ... |
| Unemployment rate (2) | 4.6 | 5.8 | 6.9 | 8.1 | 9.3 | 9.6 | 10.2 | 10.0 |
| Consumer prices | 2.9 | 3.8 | 1.6 | 0.0 | –1.2 | –1.6 | –0.2 | 1.8 |
| Trade balance (3) | –701.4 | –695.9 | –695.9 | –605.7 | –504.1 | –415.5 | –389.1 | ... |
| 3-month interbank interest rate (1) | 5.3 | 2.8 | 2.2 | 1.2 | 0.8 | 0.4 | 0.3 | 0.3 |
| Nominal effective exchange rate (4) | 77.9 | 74.4 | 81.3 | 82.7 | 79.4 | 75.4 | 73.6 | 73.8 |

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

automobiles or petrol saw their fourth consecutive month of rises. Car sales also remained lively after a drop in September due to the subsidies ending. The good performance of retail purchases contrasts with the weakness in the Conference Board Consumer Confidence index. In November, this indicator was still immersed in the lethargy of the last few months but with a component of expectations that set a new record low, proving that, although consumption has a solid base, attitudes will be slow and erratic in their recovery to pre-crisis levels.

On the supply side, industrial perception continues optimistic, although less than in previous months. The Institute for Supply Management index for November fell for manufacturing and also services, where pessimistic responses once again outnumbered the optimistic. In both cases, the indices' current levels are coherent with weak economic growth, particularly in services. For its part, industry picked up somewhat in November, with advances both in industrial production and industrial capacity utilization which, at 71.3% of the total, was three percentage points above the record low in June. In spite of November's good figures, industry's recovery is rather precarious, temporarily fed by the need to restock after continual months of reductions.

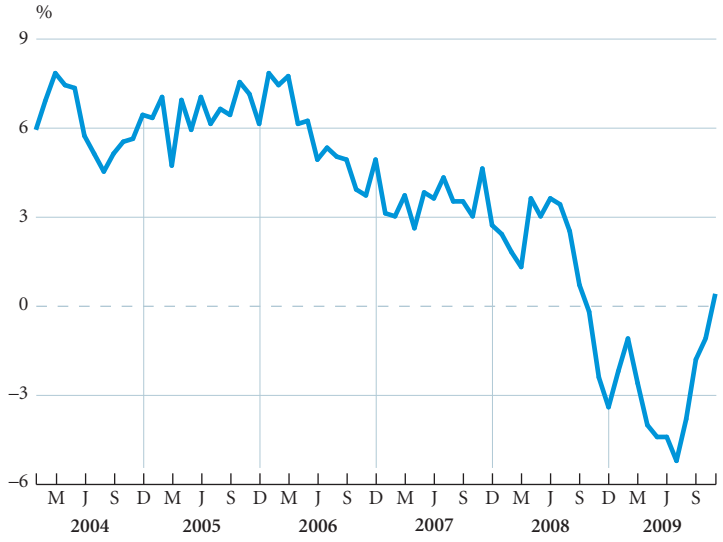
**Private consumption is showing signs of strength but consumer expectations are still low.**

The housing market continues to confirm that it has bottomed out but recovery is still not firmly established. The biggest difference with the first half of the year is that real estate assets have stopped losing value, leaving behind three years of continual falls. In September, the Case-Shiller price index saw its fourth consecutive month of advances, accumulating a rise of 3.7% since the minimum in May, seasonally adjusted. Recovery is unequal in geographical terms. The area of San

**Entrepreneurs moderate their optimism but industry picks up in February.**

**UNITED STATES: THERE'S LIFE IN CONSUMPTION AFTER AID**

Retail sales without automobiles or petrol, year-on-year change




SOURCES: Department of Trade and own calculations.

**UNITED STATES: CONSTRUCTION CONTINUES IN THE DOLDRUMS**

Homes started in annual terms


SOURCES: Department of Commerce and own calculations.

**Housing is no longer losing value but the over-supply of property will hinder the recovery in construction.**

Francisco has accumulated a recovery of 10.9% after having lost 45.3%, while New York, which had fallen 20.7%, has not gone above 1.4% and Las Vegas has still to hit bottom. The recovery in the number of homes sold, which in October reached the highest level since February 2007, was boosted by state aid for first home buyers in 2009. However, mortgage foreclosures, which again hit record highs in the third quarter, will continue to feed the over-supply in the sector and will hinder recovery. The good figures for homes started in November does not change this situation as, although the signs are still that it has bottomed out, there has not been any significant upswing on the supply side.

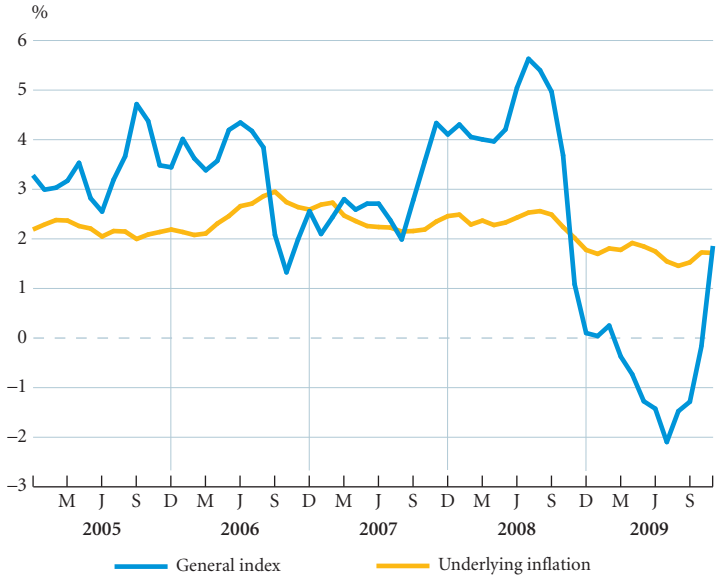
The job market, one of the US economy's weak points, continues close to its lowest point since the end of the Second World War. However, after the good figures for November, it seems about to bottom out. 11,000 jobs were lost in November, a very small figure compared with the losses of the last few months, which might signal the end of the mass destruction of employment with the loss of 7.2 million jobs in its wake. Improvements came in the private sector and were accompanied by upgrades of figures from previous months, underpinning the good performances. The unemployment rate also fell two-tenths of a percentage point to 10.0%. Overall, caution must rule the day. The number of long-term unemployed continued to rise to a record 38.3% of all unemployed, reminding us that recovery in the labour market might still take some time to consolidate.

**The labour market might be bottoming out with unemployment at 10%.**

Prices continued to play a significant part in the recovery, keeping themselves at a prudent distance from the deflationist abyss without showing, however, any inflationary tendency that would put a spanner in the works of an economy attempting to leave the crisis behind it. During the recession, the

## UNITED STATES: UNDERLYING STABILITY

Year-on-year change in components of the general and core consumer price index (*)



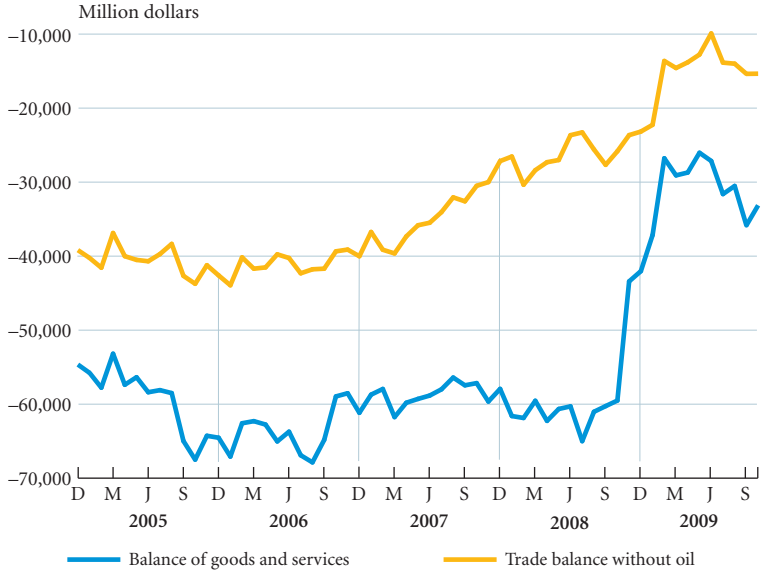

NOTE: (*) Underlying inflation excludes food and energy.
SOURCES: Department of Labor and own calculations.

sharp fluctuations in oil prices have not been passed on to other business sectors. Consequently, although in November the general consumer price index (CPI) regained up to 1.9% year-on-year due to the base effect of oil, the underlying CPI,

**Prices remain stable. The CPI gains 1.9% and its underlying component 1.7%.**

## UNITED STATES: A PERSISTENT TRADE DEFICIT

Monthly balance of goods and services




SOURCES: Department of Trade and own calculations.

**Deterioration in the trade deficit eases off due to fewer oil imports.**

the general index without food or energy, repeated its 1.7% rise year-on-year of the previous month, maintaining the stable trend of the last few months. In spite of higher consumption and the persistence of expansionary policies, inflationary tensions are not expected in the short term, although we can't rule out their appearance towards the end of 2010.

October's trade deficit in goods and services was 32,936 million dollars, around 2,700 million below the balance for September and due almost entirely to fewer oil imports. Excluding oil and its derivates, October's deficit remained above 15,000 million dollars, the highest level since January 2009. However, the relatively weak dollar should help to gradually adjust foreign deficits throughout 2010.

**Japan downgrades growth because of the fall in capital goods investment.**

## Japan: the end of a mirage

The revision of its estimated national accounts confirmed that the Japanese economy grew a meagre 1.2% annualized quarter-on-quarter in the third quarter and not the 4.8% previously announced. This correction was due almost entirely to the reduction in capital goods investment, falling back 17.6% annualized quarter-on-quarter, a drop that had not been counted in the first release of GDP estimates. This lower growth in the economy is, however, more consistent with the deflationary situation of domestic demand reflected by indicators over the last few months.

The main weaknesses in the Japanese economy continue to lie in domestic demand, with private consumption still depending on fiscal stimuli that are unlikely to continue, given the fact that

**JAPAN: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| Real GDP | 2.3 | –1.2 | –4.4 | –8.6 | –6.0 | –4.7 | – | ... |
| Retail sales | –0.1 | 0.3 | –1.5 | –3.9 | –2.8 | –1.9 | –1.0 | ... |
| Industrial production | 2.9 | –3.4 | –15.0 | –34.0 | –27.6 | –19.7 | –14.0 | ... |
| Tankan company Index (1) | 22.0 | –2.8 | –24.0 | –58.0 | –48.0 | –33.0 | – | –24.0 |
| Housing construction | –17.2 | 2.4 | 3.9 | –21.4 | –32.0 | –35.8 | –27.0 | ... |
| Unemployment rate (2) | 3.9 | 4.0 | 4.0 | 4.4 | 5.2 | 5.5 | 5.1 | ... |
| Consumer prices | 0.1 | 1.4 | 1.0 | –0.1 | –1.0 | –2.2 | –2.5 | ... |
| Trade balance (3) | 12.6 | 4.0 | 4.0 | 1.4 | 1.0 | 1.7 | 2.4 | ... |
| 3-month interbank interest rate (4) | 0.7 | 0.8 | 0.8 | 0.7 | 0.6 | 0.5 | 0.5 | 0.5 |
| Nominal effective exchange rate (5) | 77.1 | 86.6 | 98.5 | 102.1 | 95.7 | 97.0 | 99.0 | 99.9 |

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

public debt is now close to 200% of GDP. On the other hand, the upswing in the economies of Eastern Asia is not helping to boost Japanese exports as much as had been hoped.

However, the latest supply indicators have shown signs of slight improvement. On the positive side, investment prospects have improved after the corrections of the third quarter. Machine orders in October saw their second month of advances thanks to exporters' demand for investment. The Tankan index for large manufacturing firms, published by the Bank of Japan, also followed the same trend with improvements in the fourth quarter. This improvement in sentiment was not supported, however, by small and medium-sized firms. On the negative side is the persistent slowdown in industrial recovery, still a long way below pre-crisis levels. Consequently, between the minimum of February and November, industrial production had regained 15.2 percentage points of the 36.4 it had lost since May 2008, but progress has slowed up over the last three months.

**The foreign sector is not offsetting weak domestic demand.**

In terms of demand, retail sales fell back in October by 1.0% year-on-year, while government aid continued to boost the recovery in automobile sales, albeit still 25.7% below 2005 levels. For its part, the housing market still fails to show any convincing signs of strength.

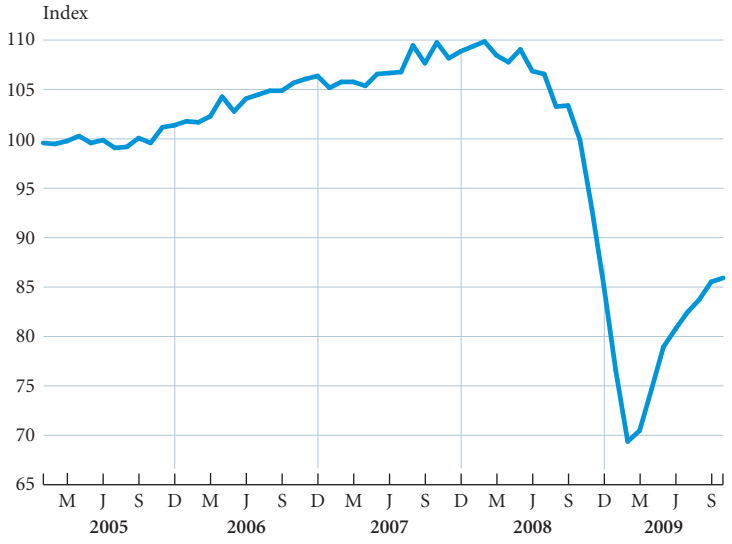
**Investment prospects improve for the fourth quarter but industry weakens.**

The labour market also gave a slight impression of recovery but is still generally weak. Unemployment continued to moderate in October, down to 5.1% after a record high of 5.7% in July. 200,000 net jobs were lost in the same period, more than half of these from manufacturing, which left behind its Indian summer of September and started to weaken again. This weak demand means that deflationary trends will continue during 2010.

**Consumption still sluggish while housing bottoms out.**

**JAPAN: INDUSTRIAL RECOVERY IS RUNNING OUT OF STEAM**

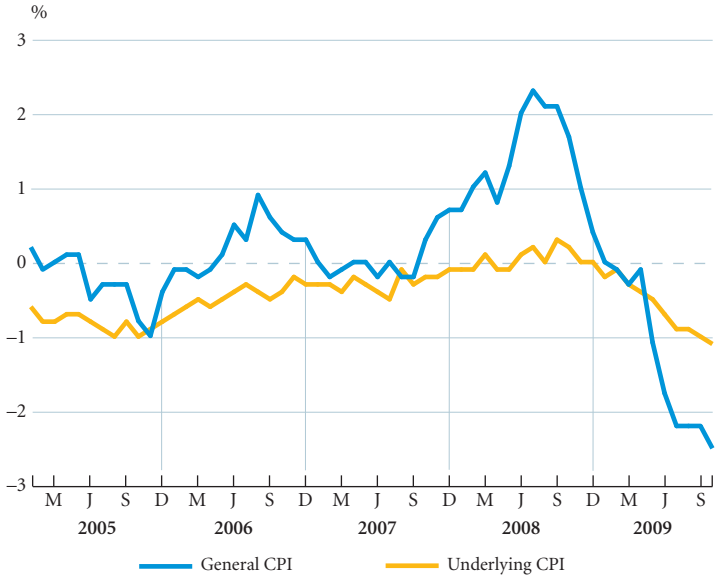
Industrial production index




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

**JAPAN: THE FACE OF DEFLATION**

Year-on-year change in the consumer price index




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

**CPI falls 2.5%, unemployment stands at 5.1% and deflation will continue in 2010.**

Consequently, the CPI for October posted a drop of 2.5% year-on-year, the biggest fall since the indicator was established in 1971. Underlying inflation, the general index without energy or food, also lost 1.1% year-on-year, accumulating its tenth consecutive month of decline.

**The foreign sector is not capitalizing on the vitality of Eastern Asia.**

In the foreign sector, October's trade surplus recovered from its levels in September thanks to lower imports, resulting from weak domestic demand. However, the recovery in exports is still not gaining in strength. In October, exports were up 1.8% month-on-month, seasonally adjusted. The strength of the yen and the loss of market share to other Pacific coast countries mean that gains in exports are lower than in the United States whose foreign sales, although dropping sharply in the first half of 2009, had not suffered the considerable adjustments of the Japanese exports.

**China's en route to 8% growth in 2009.**

## China: persevering, persisting and performing

Following the trends of the last few months, China will end the year with its highly promising growth of 8%, a direct consequence of the investment policies and liquidity injection deployed by the authorities and the recovery in global demand. It might also leave 2009 with a record number of trade disputes brought against the United States which, given the lack of movement of the renminbi against the dollar, is threatening protectionist measures.

Riding the same wave as the Asian giant, India posted a surprising advance of 6.7% year-on-year in the third quarter, better than the generally agreed forecasts and the 6% posted in the second quarter and in spite of bad results from the agricultural sector.

## CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| Real GDP | 13.0 | 9.0 | 6.8 | 6.1 | 7.9 | 8.9 | – | ... |
| Industrial production | 17.5 | 12.6 | 6.4 | 9.7 | 9.0 | 12.3 | 16.1 | 19.2 |
| Electrical power generation | 15.7 | 6.7 | –6.0 | –4.3 | –0.4 | 8.0 | 18.0 | 27.3 |
| Consumer prices (*) | 4.8 | 5.9 | 2.5 | –0.6 | –1.5 | –1.3 | –0.5 | 0.6 |
| Trade balance (**) | 262 | 298 | 298 | 319 | 296 | 251 | 240 | 218 |
| Reference rate (***) | 7.47 | 5.31 | 5.31 | 5.31 | 5.31 | 5.31 | 5.31 | 5.31 |
| Renminbi to dollar (*) | 7.6 | 6.9 | 6.8 | 6.8 | 6.8 | 6.8 | 6.8 | 6.8 |

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

Although part of this rise is due directly to the rebound effect of comparisons with the minimums of a year ago, leading indicators for November once again revealed the strength of China. On the supply side, industrial production grew in November by a solid 19.2% year-on-year, compared with 16.1% in October and the average of 12.3% for the third quarter. Inventory restocking might be behind part of this rise. The PMI for November stabilized at 55.2, above the level of 50 points which is the turning point between contraction and expansion. On the other hand, the abundance of liquidity continues to boost growth in credit, advancing 33.8% year-on-year in November.

With regards to demand, supported largely by the large volumes of credit, fixed capital investment rose 31.5% year-on-year in November, in line with what has been observed throughout the year and, curiously, at a faster rate than that of the previous two years. Similarly, retail sales for the period grew by 15.8% year-on-year, below the 16.2% for October but surpassing the average for 2009. For yet another month, vehicle sales continued solid, practically double the figure for a year ago.

The foreign sector is also consolidating its recovery. With a minimum fall of 1.2% year-on-year, exports were practically at the same level as a year ago. For their part, imports grew by 26.7%, in line with the recovery in domestic demand and the already mentioned possible accumulative effect of inventories. Consequently, November's trade balance posted a surplus of 19 billion dollars and, once again, the biggest trade deficit is to be found in the United States, its main trading partner, whose monthly average is just touching 19 billion dollars. Hence the constant disputes brought by both parties before the World Trade Organization which have intensified since September given China's resistance to the appreciation of the renminbi. Tyres, car parts, steel pipes and even chicken products have been the object of these disputes.

The economy's vigour, although also helped by the base effect of the previous year, has seen inflation return to positive

**Domestic demand still on the rise.**

**CPI rises 0.6% in November, the first year-on-year gain since January.**

figures after nine months. Specifically, the CPI for November, up year-on-year by 0.6%, is moving away from the annual negative average of 1%. With the appearance of the new monthly figures and given Chinese dynamism, inflation looks set to reach between 2% and 3% by the end of 2010.

Lastly, the Shanghai stock market has slowed the surge started in September. In the first two weeks of December, the *Composite* index fell by 3.7%, a similar pattern to the world stock market in general. Reversal has become more concentrated after the uncertainty caused by Dubai's debt problems and, although this has been very slight, it has helped to revive voices warning of a possible speculative bubble.

## Brazil: rising GDP, falling euphoria

**Although less than expected, Brazilian GDP continues to improve and is on the road to recovery.**

«Slow and steady wins the race». A great piece of advice that encourages prudence, highly opportune given the recent disappointment of those who, erring on the side of euphoria, expected a much livelier recovery for the Brazilian economy. However, although recovery may not be so lively, that doesn't mean it's not true: in the third quarter of the year, Brazilian GDP grew 1.3% compared with the previous quarter, its second rise after the crisis. A recovery that is gaining in pace as it advances and whose driving forces bear out its local nature.

In fact, domestic expenditure has once again confirmed its position as the mainstay of Brazil's recent growth, although it has changed its leader: in the third quarter it was investment that, rising 6.5% between June and September, took over the baton from consumption and stepped in as the driving force. Consumption was up 2% compared with the previous quarter but slightly moderated its upswing, insofar as state expenditure rose 0.5% compared with June. The greatest disappointment came from the external flank, the main victim of the strong real, with a trade balance suffering from the bitter taste of a lethal concoction: the fall in exports (8%) and rise in imports (7%).

**BRAZIL: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| Real GDP | 6.1 | 5.1 | 0.9 | –1.8 | –1.7 | –1.5 | – | ... |
| Industrial production | 5.9 | 2.9 | –7.2 | –13.8 | –11.3 | –8.7 | –3.0 | ... |
| Consumer confidence (*) | 132.3 | 140.4 | 132.9 | 128.5 | 128.4 | 141.9 | 154.3 | 153.1 |
| Unemployment rate São Paulo (**) | 15.0 | 13.0 | 11.6 | 12.6 | 13.9 | 13.1 | 12.0 | ... |
| Consumer prices | 3.6 | 5.7 | 6.2 | 5.8 | 5.2 | 4.4 | 4.2 | 4.2 |
| Trade balance (***) | 40.0 | 24.8 | 24.8 | 25.0 | 27.4 | 26.4 | 26.5 | 25.5 |
| Interest rate SELIC (%) | 12.75 | 11.25 | 13.75 | 11.25 | 9.25 | 8.75 | 8.75 | 8.75 |
| Reales to dollar (*) | 2.1 | 1.8 | 2.3 | 2.3 | 2.0 | 1.8 | 1.8 | 1.8 |

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

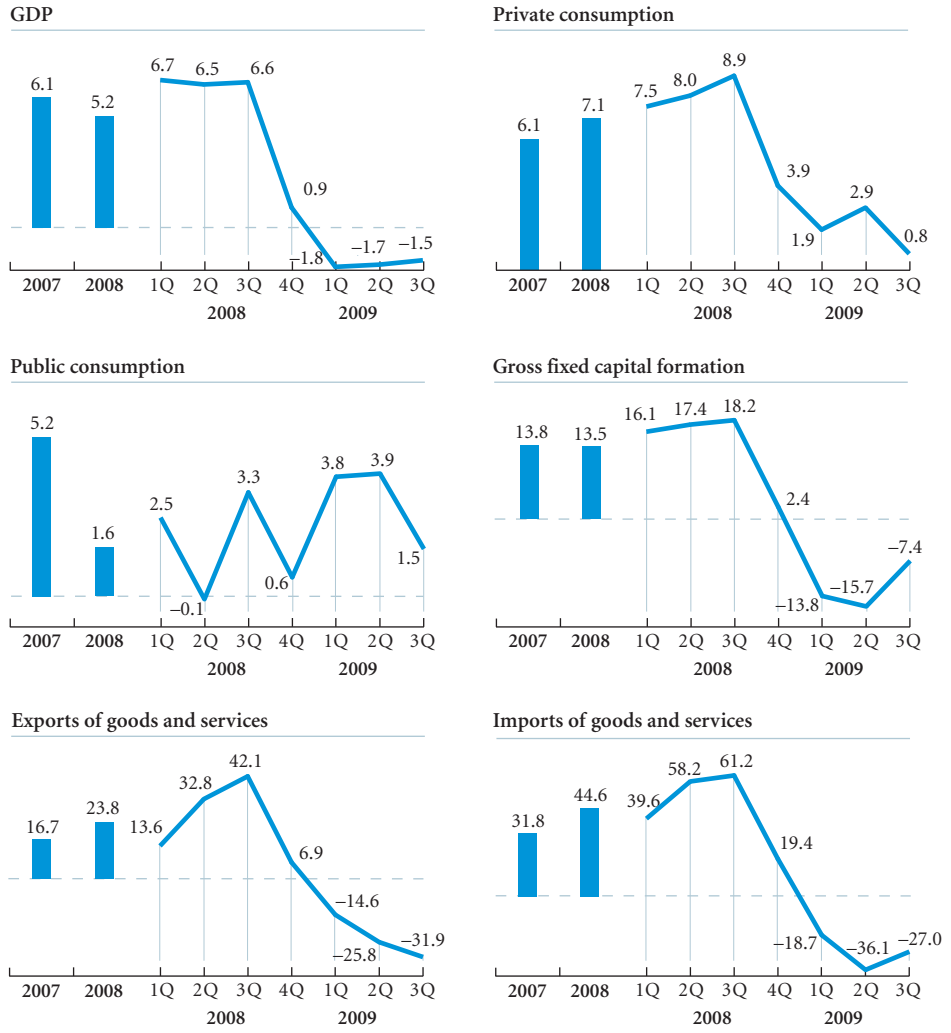
In year-on-year terms, growth has once again slowed up its decline but has not yet managed to turn it round, falling 1.5% compared with the third quarter of 2008. Once again, the blame lies with the foreign sector, with exports down 32% compared with the same period in 2008, followed by investment, down 7.4%. For its part, consumption rose again, up 0.8% and being supported by the push from credit and fiscal stimuli. Stimuli that explain, in turn, a large part of the growth in public expenditure, 1.5% year-on-year.

In any case, although third quarter growth did not meet the expectations of the consensus, there's no cause for alarm as the most recent figures from leading indicators continue to anticipate steady improvement in Brazil's economy. To start with, consumer confidence, although easing slightly in November, remains at historically high levels.

**Investment is acting as a driving force with external demand suffering from the strength of the real.**

## TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms




SOURCES: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

**Leading indicators anticipate steady improvement.**

Similarly, retail sales grew by 7.3% year-on-year in October, boosted by the continued progress in both the credit and labour markets, with unemployment falling to 12%.

On the supply side, industrial production in October increased 2.2% compared with September and notably reduced its year-on-year drop, going from a fall of 7.7% in September to just 3% the following month. This was partly helped by an automobile industry whose production was up 15.7% compared with September (6.3% year-on-year). For its part, the purchasing managers' index (PMI) reached its highest level in the last two years, namely 55.5 points, clearly above the threshold of 50 that indicates expansion.

**Mexico views 2010 with more optimism.**

In short, the recipe chosen by Lula's government, namely more credit and fewer taxes, has had the desired effect. Brazil is taking on the New Year with solid domestic demand, record high confidence levels, expanding industry and safe from inflationary pressure. Now all that's left is for foreign demand to pick up and, in this respect, more contained euphoria and less pressure on the real is good news.

**The pace of recovery is expected to be moderate.**

## Mexico: goodbye 2009... welcome 2010!

In all probability, 2009 will be remembered in Mexico as a bad year and not just because of the H1N1 'flu epidemic but also due to the poor performance of a Mexican economy, which has suffered more than most from the ravages of the worldwide economic crisis and is preparing itself for a fall in GDP of more than 7%. Fortunately, and although Mexico has a number of structural reforms still pending which, if they are not carried out, may complicate its economic future more in the long term, the forecasts for 2010 are much more encouraging thanks particularly to the steady drip of positive news from the north.

**MEXICO: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| Real GDP | 3.3 | 1.4 | –1.7 | –9.0 | –8.9 | –6.3 | – | ... |
| Industrial production | 2.4 | –1.0 | –4.5 | –9.9 | –9.9 | –6.8 | –4.9 | ... |
| Consumer confidence (*) | 104.9 | 92.2 | 83.3 | 80.1 | 80.5 | 83.0 | 77.0 | 78.2 |
| Leading business index | 116.7 | 118.3 | 115.2 | 105.9 | 107.8 | 111.7 | ... | ... |
| General unemployment rate (**) | 3.7 | 4.0 | 4.3 | 5.0 | 5.2 | 6.3 | 5.9 | ... |
| Consumer prices | –22.7 | –11.8 | 6.2 | 6.2 | 6.0 | 5.1 | 4.5 | 3.9 |
| Trade balance (***) | –10.1 | –17.3 | –17.3 | –17.6 | –15.9 | –12.6 | –9.3 | ... |
| Official Banxico rate (%) | 7.00 | 7.50 | 8.25 | 6.75 | 4.75 | 4.50 | 4.50 | 4.50 |
| Mexican pesos to dollar (*) | 11.0 | 10.6 | 13.9 | 14.2 | 13.2 | 13.5 | 13.1 | 12.9 |

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

This is true even having accumulated, in a few weeks, two downgrades in its sovereign debt rating. Both Fitch and S&P attributed their respective decisions to Mexico's excessive dependence on oil as public revenue, its excessive dependence on events in the United States and the impact of the economic and financial crisis of the last year. However, both agencies maintained the degree of investment and changed its outlook to stable. This might be why this downgrading has had a limited effect to date and has not reversed the growing optimism that is gradually taking root in Mexico.

As the signs of recovery become consolidated both within and outside its borders, economic sentiment is also expected to improve. In this respect, although leading indicators anticipate that this recovery, although premature, will advance in the coming months, its relative anaemia also suggests its pace will be moderate. So, while in November Mexican consumer confidence picked up slightly from its record low in October and business sentiment returned to the levels of fourteen months before, both retail sales and gross fixed investment continue to fall. Similarly, the IMEF manufacturing index in November stood at 52.6 points, an increase in year-on-year terms but a slight reversal compared with the previous month. In spite of this, it's still above the threshold of 50 points that indicates expansion and its non-manufacturing equivalent did continue its rise of the last six months.

Continuing on this positive note, one of the most encouraging figures from the last month was the upswing in October's balance of trade with exports reaching their highest level for the last twelve months, while imports continued to lag behind due to the weakness in domestic demand, heavily affected by the crisis. Furthermore, although both manufacturing and industrial production continued to fall compared with the previous year, by 5.2% and 5.9% respectively, they did so at their slowest rate for 12 months, partly explained by the upswing in automobile production, rising for the first time in 2009 (2.9% year-on-year). On the other hand, and surprisingly, unemployment fell slightly in October, down 6%, although this does not mean that the recovery in employment will be any less slow or dependent on the reactivation of the world economy.

**A surprising rise in the balance of trade.**

Given this scenario of incipient recovery and anticipating the forthcoming tax rise contained in the recently approved fiscal reform, Banxico upped its inflation forecasts for 2010. In any case, and particularly now there is a change in leadership at the Bank, changes in monetary policy are not expected until the second half of 2010, even though they may be desirable if recovery is weaker than predicted. On the other hand, although the Mexican government has promised to sort out the structural weaknesses pointed out by rating agencies, no substantial changes are expected in this area either although... in this case change would definitely be desirable.

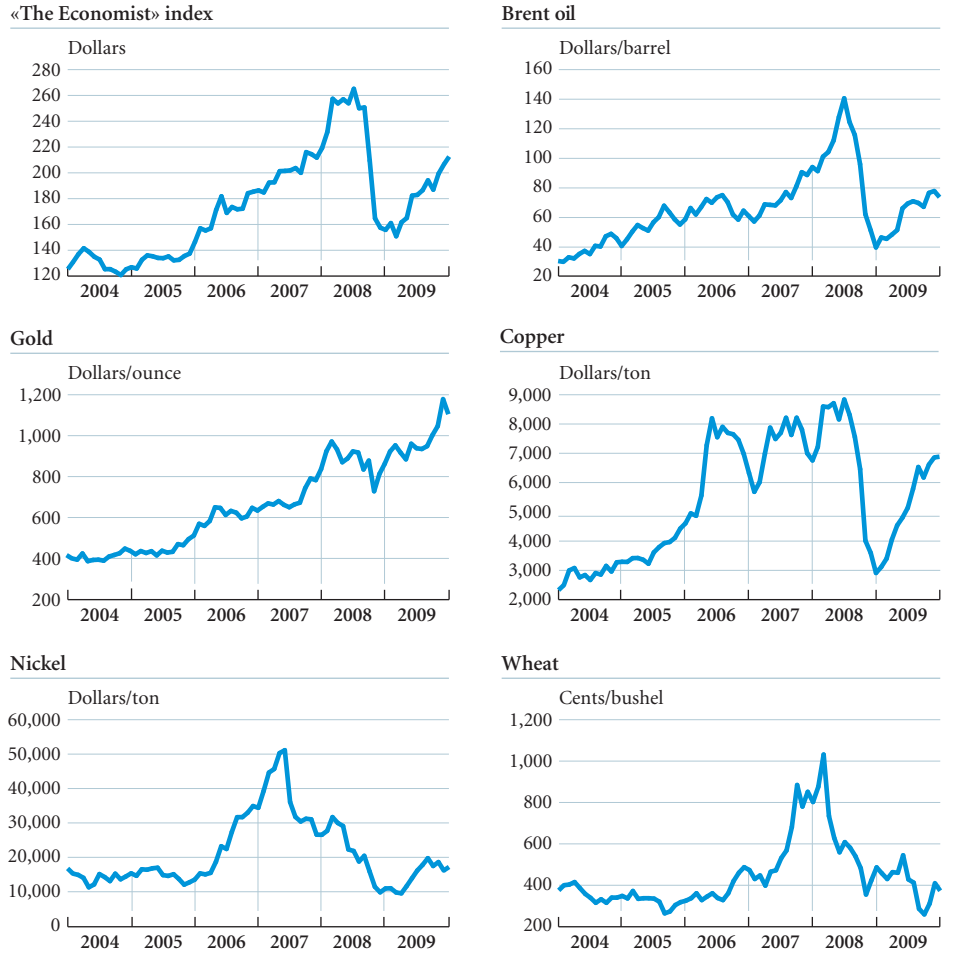
**Crude oil prices remain between 70 and 75 dollars, accumulating an increase of 87% for 2009.**

## Expectant oil

Oil prices have stopped their upward trend and are now fluctuating between 70 and 75 dollars. Between 20 November and 18 December, crude oil lost 5.5%, reaching 73.16 dollars per barrel (Brent quality, for one-month deliveries). The accumulated rise for crude is therefore 87.2% in the current year with a preliminary year-on-year figure of 66.0%.

**Economic recovery works in favour of rising commodity prices.**

## TREND IN VARIOUS COMMODITIES (*)




NOTE: (*) Figures for last day of month (last date December 18).
SOURCES: «The Economist», Thomson Reuters Datastream and own calculations.

**Demand for oil is expected to continue rising in 2010.**

Oil and other commodities rose during most of 2009, relying on an economic recovery that was gaining ground first in Eastern Asia then in other emerging and advanced economies. The central banks maintaining lax policies also helped to boost commodity prices. However, the levels reached seem to have caused a certain fatigue in these increases. The recovery in the US economy and the Fed possibly withdrawing its exceptional quantitative monetary policy measures is providing a different scenario from the one predominating in 2009.

Consequently, oil continued to fluctuate within a certain range without showing any clear signs for the coming months, although demand for 2010 still increased. In general, commodities continued to rise, with *The Economist* index up 4.8% between 20 November and 18 December, taking the current year's rise to 36.9%. Metals rose in general, the price of gold reaching another historic high in the first week of December while copper and aluminium stood out among the base metals. In foodstuffs, wheat fell while sugar, rice and coffee all rose.

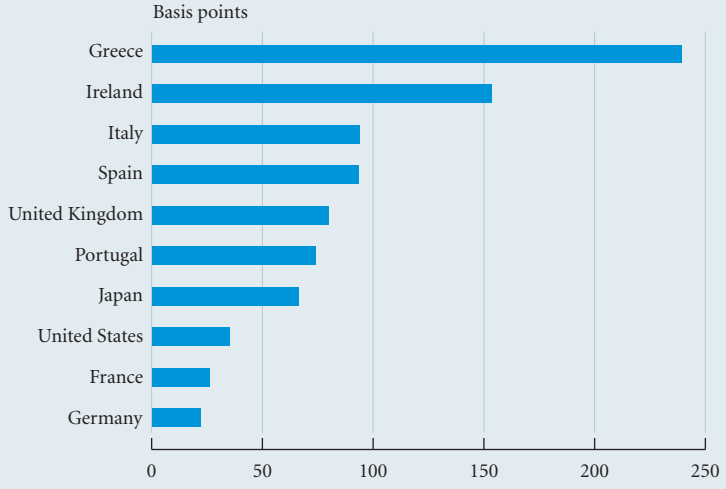
## Risk of relapse

A year ago, the world economy was struggling between recession and depression. Finally, and this seemed to become clear as from spring, the worst-case scenario was avoided thanks to public support for financial systems and extraordinary measures of fiscal and monetary stimulus carried out almost universally. Now, at the start of 2010, the outlook is one of recovery. Most economies are already showing some positive quarter-on-quarter growth, a trend that should become more established throughout the year and which Spain will join sooner rather than later. However, it would be naive to ignore the risk of a relapse.

The uncertainty we are currently facing has little in common with that of a year ago, when the world economy was teetering on the edge of a precipice, but it is still significant. This is reflected by indicators such as risk premia in financial markets and the wide-ranging forecasts by different analysts. For example, in the December 2009 issue of *Consensus Forecasts*, a monthly publication that collates the opinions of different institutions regarding trends in the main economies, the standard deviation for GDP growth forecasts for 2010 was 50% greater than usual on average. This is substantially better than during the times of maximum uncertainty, when this measurement of spread was double its historical average, but it's clear that things are not quite back to normal yet.

**DIFFERENT PERCEPTIONS OF SOVEREIGN RISK**

5-year CDS values of sovereign debt at 16-12-2009 (*)




NOTE: (*) The CDS provides the cost of insuring the debt against default risk. 100 basis points represent a cost of 10,000 euros to insure a principal of 1 million euros.
SOURCE: Thomson Reuters Datastream.

The main risks for 2010 are related to the exit strategies for the fiscal and monetary policies that have been key to starting up the recovery. The margin of error for economic authorities is unquestionably narrow and the rate at which stimuli are withdrawn must be precise. Not too fast, as this would derail the recovery; not too slow, so as not to scare off investors. The problem is that this is no easy task in practice, as there are no useful precedents for the current situation (Japan in the nineties is an example not to be followed). The

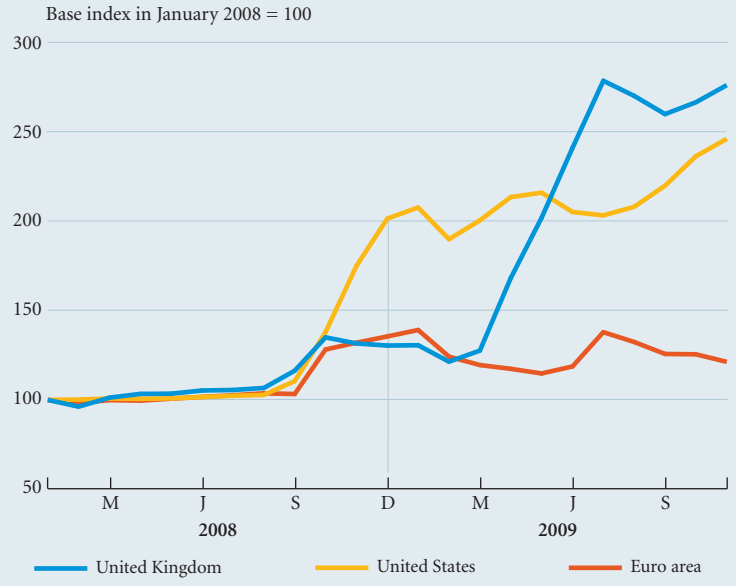
optimum strategy depends on the individual circumstances of each country and it is therefore impossible to design a general pattern for adjustment. Lastly, it is also difficult to quantify how policy normalization will affect growth, just as we no precise idea of the effect of fiscal deficit, monetary expansion and low interest rates on the level of economic activity over the last few quarters. Moreover, we cannot rule out the possibility that, without the anabolic effect of the stimuli, economies won't relapse under the burden of deleveraging, weak job markets and excess capacity in some sectors. The margin for a new round of stimuli in this situation would be limited, particularly in those countries with higher debt and worse growth potential in the medium term.

Recently, the case of Greece has provided us with an example of what might be the biggest risk for 2010: the possible loss of investor confidence in the country's capacity to carry out the necessary fiscal consolidation to avoid negative public debt dynamics. In such a scenario with a lack of confidence, investors demand a higher risk premium for public debt issues and therefore higher interest rates. These higher rates are passed on to the economy as a whole, as it is rare for a firm to be able to get cheaper funding than its government, and might derail the recovery. Neither must we forget that sovereign risk premia have benefitted from the growing amount of liquidity inundating the financial markets over the last few months and that, even so, there are significant differences between countries (see previous graph). As this liquidity is withdrawn, sovereign risk premia (and those of other assets, such as mortgage-backed securities in the United States) will also tend to rise again.

To avoid a sharp increase in interest rates, governments must go to great pains to clarify their strategy for fiscal consolidation and, obviously, this strategy must be credible. Doubts and imprecision can be costly, as has become evident in the Greek case. Although the global repercussions have been limited in this case, if there

**MORE OR LESS DRAMATIC MONETARY EXPANSION**

Monetary base




SOURCE: Thomson Reuters Datastream.

were doubts regarding a much more important economy, such as the United Kingdom or United States, the rest of the world would be in substantial danger of contagion.

Regarding monetary policies, there is the risk that, if their expansive bias is maintained for too long, they will end up boosting inflationary pressures (see previous graph). In the short term, deflationary pressures will continue to reign supreme, particularly in those economies where domestic demand has been harder hit by the crisis, either due to higher unemployment or excess debt. But as the recovery gains momentum, and this might be stronger than expected, the expectations for future inflation might pick up, especially if investors believe that the central banks are more concerned about keeping public debt interest rates low (something the Fed has explicitly targeted in the last few months) than ensuring a situation of low, stable inflation. These revised expectations would lead to higher interest rates in the long term, which might endanger recovery. In addition to the gradual tightening of monetary conditions, another of the keys to minimizing the likelihood of this occurring will be good communication policy by the central banks, a highly important instrument to pin down inflation prospects. Clarity regarding the central banks' exit strategies is as vital as in the case of fiscal consolidation.

In short, we cannot assume that recovery is certain. Although it is the most likely scenario, we still face considerable uncertainties. The most obvious are those related to exit strategies in fiscal and monetary areas and the underlying robustness of the private sector. The time has come to adopt a cure for addiction to stimuli... and to hope that, when treatment starts, the withdrawal symptoms are slight.

*This box was prepared by Enric Fernández*
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# EUROPEAN UNION

## Euro area: consolidating recovery

**In 2010 the euro area will consolidate its recovery...**

The euro area is facing 2010 in much better shape than it started 2009. At that time the financial crisis was at its peak and business was plummeting further than it had in decades. It was difficult to imagine that such a change could come about in just one year. The financial sector has stabilized significantly, there has been a sharp upswing in confidence and economies are growing again. In the third quarter, the euro area posted quarter-on-quarter growth of 0.4%. In year-on-year terms, however, the rate of growth is still being hindered by the strong setbacks it experienced a year ago, so that year-on-year growth is still negative, specifically 4.1%.

**...but we don't expect growth to be too vigorous.**

This trend will continue in the short term, with year-on-year growth getting back into positive figures in the first quarter. Recovery, however, will be slow. In 2010, the gross domestic product (GDP) of the euro area will find it hard to grow much more than 1% and we don't expect growth rates of between 1.5% and 2%, more in line with its growth potential, to be achieved until 2011. Such a slow recovery will mean that the euro area will take several years to return to its pre-recession levels in terms of GDP.

A breakdown by growth component in the third quarter reflects the strengths and weaknesses of this recovery. Coming out of recession depends fundamentally

**EURO AREA: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| GDP | 2.7 | 0.5 | –1.8 | –5.0 | –4.8 | –4.1 | – | ... |
| Retail sales | 1.8 | –0.6 | –1.7 | –3.1 | –2.3 | –2.2 | –1.8 | ... |
| Consumer confidence (1) | –4.9 | –18.0 | –27.1 | –32.5 | –27.9 | –21.3 | –17.7 | –17.3 |
| Industrial production | 3.5 | –1.7 | –8.9 | –18.5 | –18.6 | –14.5 | –11.0 | ... |
| Economic sentiment indicator (1) | 108.9 | 91.1 | 75.6 | 65.7 | 70.2 | 79.9 | 86.1 | 88.8 |
| Unemployment rate (2) | 7.4 | 7.5 | 8.0 | 8.8 | 9.3 | 9.6 | 9.8 | ... |
| Consumer prices | 2.1 | 3.3 | 2.3 | 1.0 | 0.2 | –0.4 | –0.1 | 0.5 |
| Trade balance (3) | 20.1 | –1.2 | –31.7 | –36.3 | –31.2 | –4.6 | 10.0 | ... |
| 3-month Euribor interest rate | 4.3 | 4.6 | 4.2 | 2.0 | 1.3 | 0.9 | 0.8 | 0.7 |
| Nominal effective euro exchange rate (4) | 107.9 | 113.0 | 109.1 | 111.9 | 113.2 | 114.3 | 116.6 | 116.3 |

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

on the foreign sector and economic stimulus plans. An example of this is the upswing in the volume of trade, which hadn't seen positive quarter-on-quarter growth for more than a year. Exports are pushing forward with 2.9%, 5 tenths of a percentage point above the rise posted by imports, while the foreign sector's net contribution to growth was 2 tenths of a percentage point.

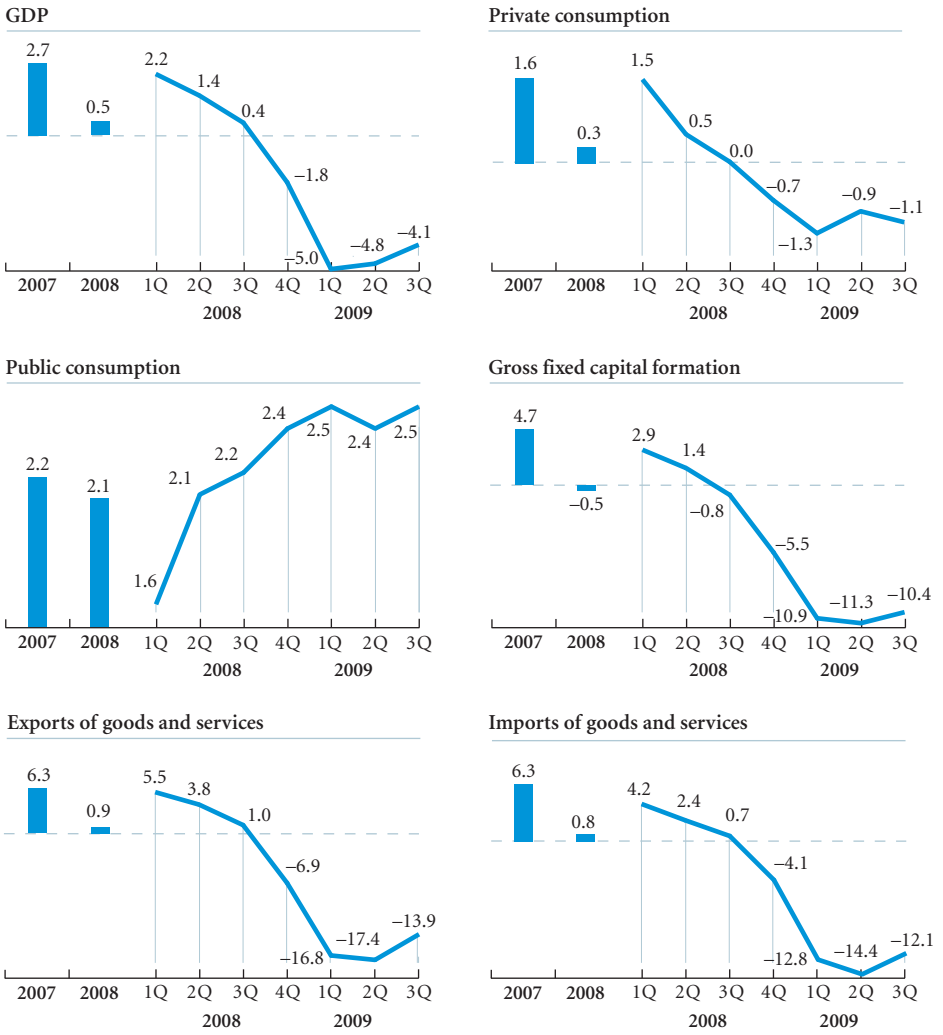
The effect of economic stimulus measures is more difficult to determine. These are partly behind the 0.5% rise in expenditure on public consumption, which contributed one tenth of a percentage point to growth. But these measures have also helped to curb the drop in investment. After losing 4.9% in the first quarter and 1.7% in the second, in the third quarter this only fell by 0.4%,

**The process of coming out of recession is supported by the foreign sector...**

**...and economic stimulus measures.**

## TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change




SOURCES: Eurostat and own calculations.

**Consumption continues to show signs of weakness.**

less than initially forecast. We expect this trend to continue in the short term. For example, this is indicated by the PMI (purchasing managers' index) which, although slowing up the rate at which it was increasing, continued to improve in December.

The downside still lies with consumption, falling two tenths of a percentage point compared with the previous quarter and with no positive growth for the last 6 quarters. This weakness in consumption is reflected in poor retail performance which, after a 3.1% fall year-on-year in the first quarter, has fallen by more than 2% in both the second and third quarter. In the month of October retail sales fell by 1.8%, so that no change in trend can be seen for the moment. Another indicator of weak demand is core inflation. In the month of November this continued its slow but substantial downward slide, now standing at 1%, particularly due to the fall in food prices, down 1.2%.

**Public accounts will deteriorate significantly in 2010.**

Throughout the year, the strong and weak points of the economy in the euro area will gradually swap over: first investment and then consumption will start to take over the economy. Trade volumes will continue to rise but improved consumption will mean that imports grow faster than exports, so the net contribution of the foreign sector will become negative.

On the other hand, the effects of economic stimulus measures will still be positive, although the sharp deterioration in public accounts in 2009 means that these won't be extended much further. In fact, it is very likely there will be increasing pressure for far-reaching reforms to be carried out in some countries. The sharp drop in fiscal revenue, particularly in countries that were highly dependent on just a few sectors, together with higher expenditure related to automatic stabilizers, has raised public deficits and public debt to historic levels.

**Greece and Ireland are the most heavily affected.**

The countries most affected at present are Greece and Ireland. Greece has seen its two main sources of revenue plummet: tourism and trade. The government has had to revise its deficit estimates for 2009 from 6% to 12.7% and the Commission predicts that it will remain at this level in 2010 and 2011. For the first time in 10 years, the Fitch rating agency gave Greece a rating of BBB+, a lower level that reflects its worsening sovereign risk. Its starting point for public finances was not so good either. Greece's level of public debt as a percentage of GDP has not fallen below 100% for the last decade and the European Commission's forecasts place it above 120% in 2010.

The starting point for Irish public finances was better, as its level of public debt as a percentage of GDP in 2007 was 25%. Thanks to this, the Irish economy has been able to better withstand a threefold collapse: that of the financial system, which has been nationalized, that of the real estate sector and that of international trade. The extent of the impact was perfectly reflected in the falling GDP, this reaching 9.1% year-on-year in the first quarter. The consequent deterioration in public accounts has also been historic: public debt as a percentage of GDP exceeded 50% in 2009 and the European Commission predicts it will be around 80% in 2010.

The level of debt alone does not tell us whether a country can repay its debts or not. Another figure to take into account is the growth forecast for the coming years, but this does not promise to be

## PUBLIC ACCOUNTS AND GROWTH

| | Deficit (% GDP) | | | Debt (% GDP) | | | GDP | | |
|---|---|---|---|---|---|---|---|---|---|
| | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 | 2009 | 2010 | 2011 |
| Germany | –3.4 | –5.0 | –4.6 | 73.1 | 76.7 | 79.7 | –5.0 | 1.2 | 1.7 |
| Austria | –4.3 | –5.5 | –5.3 | 69.1 | 73.9 | 77.0 | –3.7 | 1.1 | 1.5 |
| Belgium | –5.9 | –5.8 | –5.8 | 97.2 | 101.2 | 104.0 | –2.9 | 0.6 | 1.5 |
| Cyprus | –3.5 | –5.7 | –5.9 | 53.2 | 58.6 | 63.4 | 0.7 | 0.1 | 1.3 |
| Slovakia | –6.3 | –6.0 | –5.5 | 34.6 | 39.2 | 42.7 | –5.8 | 1.9 | 2.6 |
| Slovenia | –6.3 | –7.0 | –6.9 | 35.1 | 42.8 | 48.2 | –7.4 | 1.3 | 2.0 |
| Spain | 11.2 | –10.1 | –9.3 | 54.3 | 66.3 | 74.0 | –3.7 | –0.8 | 1.0 |
| Finland | –2.8 | –4.5 | –4.3 | 41.3 | 47.4 | 52.7 | –6.9 | 0.9 | 1.6 |
| France | –8.3 | –8.2 | –7.7 | 76.1 | 82.5 | 87.6 | –2.2 | 1.2 | 1.5 |
| Greece | –12.7 | –12.2 | –12.8 | 112.6 | 124.9 | 135.4 | –1.1 | –0.3 | 0.7 |
| Netherlands | –4.7 | –6.1 | –5.6 | 59.8 | 65.6 | 69.7 | –4.5 | 0.3 | 1.6 |
| Ireland | 12.5 | –14.7 | –14.7 | 65.8 | 82.9 | 96.2 | –7.5 | –1.4 | 2.6 |
| Italy | –5.3 | –5.3 | –5.1 | 114.6 | 116.7 | 117.8 | –4.7 | 0.7 | 1.4 |
| Luxembourg | –2.2 | –4.2 | –4.2 | 15.0 | 16.4 | 17.7 | –3.6 | 1.1 | 1.8 |
| Malta | –4.5 | –4.4 | –4.3 | 68.5 | 70.9 | 72.5 | –2.2 | 0.7 | 1.6 |
| Portugal | 8.0 | –8.0 | –8.7 | 77.4 | 84.6 | 91.1 | –2.9 | 0.3 | 1.0 |
| **Euro area** | **–6.4** | **–6.9** | **–6.5** | **78.2** | **84.0** | **88.2** | **–4.0** | **0.7** | **1.5** |
| **EU-27** | **–6.9** | **–7.5** | **–6.9** | **73.0** | **79.3** | **83.7** | **–4.1** | **0.7** | **1.6** |

SOURCE: European Commission.

very buoyant in either case. Analysts are also keeping their eye on other countries, such as Italy and Portugal, both expected to enjoy moderate growth but with a high level of public debt.

In fact, the level of debt in the different countries of the euro area will be the focus of many economic debates throughout 2010. But other points will also be of interest that we have already discussed in previous issues of the Monthly Report, such as the possible surge in unemployment and the process of withdrawing monetary expansion policies. In short, there is no doubt that the euro area as a whole is facing 2010 with significantly better prospects than it had a year ago, although its recovery promises to be complicated and will surely provide us with a surprise or two.

### Germany: Europe's engine is pulling again

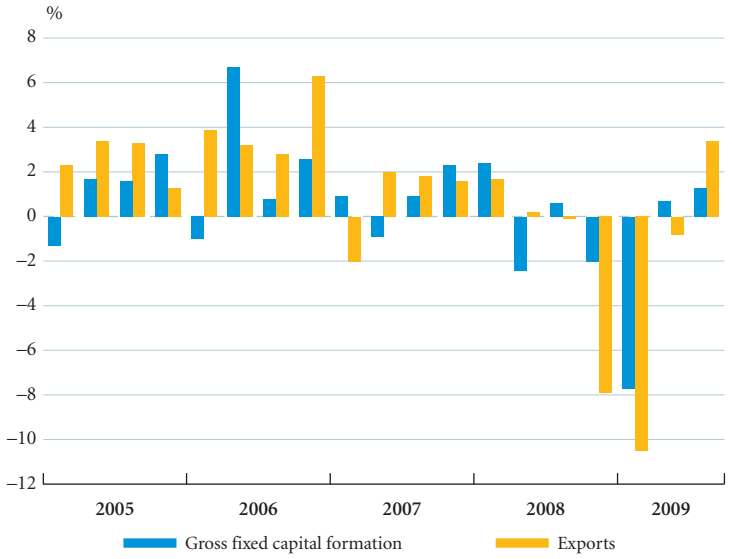
**Germany starts 2010 confidently but with doubts concerning its recovery.**

Germany faces the new year with greater optimism. The road to recovery followed by the German economy since the second quarter of 2009 contrasts sharply with the situation experienced a year ago. Then, the country said goodbye to 2008 with a record fall of 2.4% quarter-on-quarter and forecasts predicted an even greater deterioration in the first quarter of 2009. Now the economy is expected to grow year-on-year in the first three months of 2010, after drops in GDP during five consecutive quarters. However, there is some uncertainty regarding the strength of this recovery.

The German economy grew 0.7% quarter-on-quarter in the third quarter

## INVESTMENT AND EXPORTS LEAD THE GERMAN RECOVERY

Quarter-on-quarter change




SOURCES: Deutsche Bundesbank and own calculations.

**The Bundesbank predicts 1.6% growth in 2010.**

of 2009, driven by investment and exports. As seen in the above graph, both series took over the role they had held during the last period of economic expansion, once again becoming the main engines in the recovery. This was the result of very different reasons.

So while the reactivation of global trade led to growth in German exports, the government's economic stimuli caused public investment to rise.

In spite of recovery in the main pillars of the economy, its growth is expected

## GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | | |
|---|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November | December |
| GDP | 2.6 | 1.0 | –1.8 | –6.7 | –5.8 | –4.8 | – | ... | – |
| Retail sales | –1.2 | 0.0 | 0.6 | –2.4 | –1.2 | –1.7 | –1.6 | ... | ... |
| Industrial production | 5.9 | –0.1 | –7.5 | –20.0 | –19.3 | –15.5 | –12.4 | ... | ... |
| Industrial activity index (IFO) (*) | 106.2 | 96.8 | 86.1 | 82.6 | 84.7 | 89.7 | 92.0 | 93.9 | 94.7 |
| Unemployment rate (**) | 9.0 | 7.8 | 7.6 | 8.0 | 8.2 | 8.2 | 8.2 | 8.1 | ... |
| Consumer prices | 2.3 | 2.6 | 1.7 | 0.9 | 0.3 | –0.3 | 0.0 | 0.4 | ... |
| Trade balance (***) | 181.5 | 195.0 | 182.8 | 160.2 | 140.4 | 131.0 | 123.8 | ... | ... |

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

to slacken off in the coming quarters. This is the direction taken by the latest forecasts by the German Bundesbank, which estimates a rise in GDP of 1.6% and 1.2% in 2010 and 2011 respectively. The lower growth predicted for 2011 is due to the end of the government's economic stimuli and the future squeeze on public expenditure because of fiscal consolidation.

One of the key factors affecting the performance of the German economy in the short term will be how private consumption performs. Although it did not decline significantly during the period of greatest recession, this posted a quarter-on-quarter fall of 0.9% in the third quarter of 2009. This trend is expected to continue in 2010 due to the end of tax incentives for the purchase of automobiles and the uncertainty hovering over the labour market. This is reflected in the fall in consumer confidence in October after six months of rises, due to greater pessimism regarding the future. Consequently, inflation, which had returned to positive figures in November, will continue to grow weakly.

Trends in private consumption will be closely linked to those of the labour market. After another fall in unemployment in the month of November, standing at 8.1%, and the reactivation of German business, the Bundesbank improved its unemployment forecast. The unemployment rate is therefore expected to reach a maximum of 10.1% in 2011 (4.2 million workers) and, as a result, household consumption will not start to grow until 2011. That's why, in order to relieve this decline, the German government has decided to postpone cutbacks in public expenditure until 2011.

**Rising unemployment postpones recovery in private consumption until 2011.**

The fall in domestic consumption was offset by a rise in exports. This is shown by the figures for October 2009, with a 2.5% growth month-on-month. In spite of this, both production and industrial orders fell this same month, with month-on-month drops of 1.8% and 2.6% respectively. Greater activity in the automobile sector was one of the main reasons. This, together with the still limited utilization of production capacity in Germany in the fourth quarter, suggests that investment will continue at a low level. However, everything points to industrial activity clearly rising, as reflected in the growth in the IFO business climate index in November, reaching similar levels to August 2008.

**Industrial activity will continue to grow in spite of its stumble in October.**

Given this outlook, Angela Merkel's government is disposed to maintain its expansionary fiscal policy throughout this year. This means a deficit of 6% in 2010, placing debt at historic levels of 75% compared with GDP. The state of public accounts has led to harsh criticism from the German Court of Auditors. However, the Finance Minister considers that, thanks to the economic recovery and the efforts made in terms of fiscal consolidation as from 2011, the country's public deficits will fall below 3% again in 2013.

**The fiscal deficit will shoot up to 6% in 2010.**

### France embarks upon a fragile recovery

«The French economy will continue to grow at a moderate rate during the first half of 2010». This is the message transmitted by the French Statistics

**French growth will be moderate during 2010.**

**The rise in unemployment may hinder growth in private consumption.**

Institute (INSEE) in its latest report on the quarterly situation. France was one of the first developed countries to come out of recession, specifically in the second quarter of 2009, and one of the least affected by it. However, the weakness of the factors underlying this upswing has led to doubts regarding whether recovery can be sustained.

Unlike other European economies such as Germany, during the last expansionary period France based its growth on solid domestic demand. In the coming quarters, this is expected to take a leading role in growth, particularly regarding public and private consumption. Consequently, according to the INSEE, public consumption will grow in the first half of 2010 to levels similar to those seen in the third quarter last year, namely 0.7% quarter-on-quarter.

With regard to private consumption, the most frequent indicators available in the last quarter of 2009 show clear improvement and household consumption was up 1.1% month-on-month in October. It is worth noting the important role played by automobile registrations in this period, with year-on-year increases of 25% and 42% in October and November respectively. Given this situation, consumer confidence improved again in November, both in its present and future component, indicating the increase in private consumption in the last quarter of 2009. However, this recovery is not trouble-free. The decline in the French labour market, reaching an unemployment rate of 10.1% in October, might be an additional obstacle to growth in household consumption.

**Private investment will remain limited in the coming quarters.**

On the other hand, foreign demand made a significant contribution to economic growth in the third quarter of 2009. However, everything suggests that this will continue to lose significance in the coming year. The end of stimuli for the purchase of automobiles in some European countries and the tardy recovery of two of France's main trading partners, namely Spain and the United Kingdom, widened the trade deficit in October 2009.

Given this weak demand, supply indicators have not managed a strong upswing. Consequently, in October industrial production fell for the second

**FRANCE: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| GDP | 2.3 | 0.3 | –1.7 | –3.5 | –2.9 | –2.4 | – | ... |
| Domestic consumption | 4.8 | –0.6 | –2.5 | –1.0 | 0.2 | –0.2 | 3.5 | ... |
| Industrial production | 1.2 | –2.4 | –8.7 | –15.7 | –15.1 | –11.4 | –8.4 | ... |
| Unemployment rate (*) | 8.3 | 7.9 | 8.3 | 8.9 | 9.4 | 9.8 | 10.1 | ... |
| Consumer prices | 1.5 | 2.8 | 1.8 | 0.6 | –0.2 | –0.4 | –0.2 | 0.4 |
| Trade balance (**) | –33.7 | –49.0 | –55.6 | –55.0 | –52.8 | –45.2 | –41.1 | ... |

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

consecutive month, down 0.8% month-on-month, pressurized by the slump in automobile production. In spite of this, industrial confidence grew again in November, although this will not prevent further reductions in private investment throughout 2010 due to the low utilization of production capacity in France.

In order to avoid stagnation in investment, Sarkozy's government decided to allocate 35,000 million euros to promote research and innovation projects that would otherwise have problems securing private funds in the present climate. However, this undertaking must not be seen as the same as other economic stimulus measures announced to date, as its aim is to increase economic growth in the long term. This, however, has not saved it from the criticism of different supranational bodies such as the Organization for Economic Cooperation and Development, which believes such action has come too late and is too imprecise. Moreover, most of this plan will be financed by issuing new debt, which will harm the French public accounts even further, endangering the fiscal consolidation in 2013 that has been demanded by the European Union.

### Italy starts the new year with the same old problems

Italy came out of recession in the third quarter of 2009 after suffering one of the greatest declines accumulated among the G-7 economies, only exceeded by Japan. Recovery was spread among the different GDP components and only public expenditure posted a fall in this period, down 1.2% quarter-on-quarter. However, the structural weakness of the Italian economy suggests that it will grow at a slower rate in the coming quarters.

Indicators published for the fourth quarter of 2009 confirm these forecasts. On the side of demand, consumer confidence continues at very low levels. One of the main reasons is uncertainty concerning unemployment, particularly after another rise in the third quarter of 2009, up to 7.8%. This trend is expected to continue during the year. Only vehicle registrations still grew strongly, thanks to tax incentives for the purchase of automobiles. However, there are doubts concerning the extension of these plans during 2010. Moderate future growth is therefore predicted in private consumption, lower than the 0.4% quarter-on-quarter recorded in the third quarter of 2009. In spite of this, the rise in oil prices boosted inflation to 0.7% in November, far from the stagnation of July last year.

With regard to the foreign sector, data from October showed further deficit in the trade balance, with exports the same as the previous month. Given this situation, it's no surprise that industrial production in the month of October was up just 0.5% month-on-month, much lower than expected. However, this did not prevent a further improvement in industrial confidence in November, although the low utilization of production capacity and the expected weakness in demand in the short term suggest private investment will remain the same in 2010.

The Italian's government's deep debt means that it won't be able to offset this slowdown in recovery in the private sector through greater public consumption. That's why the International Monetary Fund believes public expenditure should be re-focused,

**French public accounts will continue to decline in 2010.**

**The Italian economy comes out of recession but still has structural problems.**

**The rise in consumption, up 0.4% in the third quarter, will slow down in 2010.**

## ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| GDP | 1.5 | –1.0 | –2.9 | –6.0 | –5.9 | –4.6 | – | ... |
| Retail sales | 1.3 | –0.3 | –1.7 | –2.9 | –1.2 | –2.2 | ... | ... |
| Industrial production | 2.2 | –3.4 | –10.7 | –21.1 | –22.9 | –15.8 | –13.0 | ... |
| Unemployment rate (*) | 6.1 | 6.7 | 7.0 | 7.4 | 7.5 | 7.8 | – | ... |
| Consumer prices | 1.8 | 3.3 | 2.8 | 1.5 | 0.8 | 0.1 | 0.3 | 0.7 |
| Trade balance (**) | –12.8 | –10.0 | –12.3 | –11.1 | –9.1 | –5.3 | –4.6 | ... |

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

**The incipient recovery in British domestic consumption may be cut short in the medium term.**

aiming it at research, education and innovation in order to solve the economy's structural problems. However, the 2010 government budgets, passed by parliament in December, do not appear to follow these recommendations.

### United Kingdom: budgets for an electoral year

The United Kingdom is the only G20 economy that is still in recession and it won't be until the end of 2009 when recovery will finally materialize. Domestic consumption has stabilized and is starting to show signs of strength, as indicated by the high growth rates in retail sales and vehicle registrations. However, higher value added tax and the end of aid for the automobile industry at the start of the year will harm the expenditure of households, increasingly eager to save. On the other hand, there are better prospects for foreign demand, with exports growing substantially thanks to the weaker pound.

**The government prioritizes a tax hike over cutting costs to reduce its fiscal deficit.**

Trends in the labour market were a pleasant surprise due to lower unemployment than expected, 5.0% in November, reinforcing the idea that British firms are reacting by moderating wages and not destroying jobs. Industrial production, an indicator of supply, continued stable in October, contradicting analysts' optimistic forecasts and reminding us that the fragile economic context might last for some time yet.

In December, the main focus of attention was not what the Bank of England might announce, finally maintaining its expansionary monetary policy, but rather the pre-budget report presented every year by the Chancellor of the Exchequer, currently Alistair Darling, containing the fiscal policy for the coming year.

Darling announced that the government had decided to increase taxes instead of reducing expenditure in an attempt to correct the high general government deficit (12.6% of forecast GDP for 2009) without harming recovery. The measures proposed are not far-reaching and public accounts will not be balanced until 2017, but these plans must be considered within the pre-electoral context, where budget cuts entail political costs.

## UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| GDP | 2.6 | 0.5 | –2.1 | –5.2 | –5.8 | –5.1 | – | ... |
| Retail sales | 4.2 | 2.6 | 1.8 | 0.5 | 0.9 | 2.6 | 3.7 | 3.1 |
| Industrial production | 0.3 | –3.1 | –8.1 | –12.5 | –11.9 | –10.8 | –8.4 | ... |
| Unemployment rate (*) | 2.7 | 2.8 | 3.4 | 4.2 | 4.7 | 4.9 | 5.0 | 5.0 |
| Consumer prices | 2.3 | 3.6 | 3.9 | 3.0 | 2.1 | 1.5 | 1.5 | 1.9 |
| Trade balance (**) | –83.4 | –93.7 | –94.0 | –91.9 | –88.4 | –83.6 | –82.3 | ... |
| 3-month Libor interest rate | 6.0 | 5.5 | 4.6 | 2.1 | 1.4 | 0.8 | 0.6 | 0.6 |
| Nominal effective pound exchange rate (***) | 103.9 | 97.6 | 89.4 | 73.9 | 77.0 | 83.7 | 79.0 | 80.1 |

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

The budget contained an increase of 0.5 percentage points in National Insurance contributions for those workers earning more than 20,000 pounds, which will come into force as from 2011. Value added tax will return to its previous level in January, up 2.5 percentage points to 17.5%. Lastly, a 50% tax will be levied on bonuses in the financial sector. This will be applied immediately, as from April 2010, and the first 25,000 pounds of the bonus will be exempt. Although, as yet, we don't know how effective this last tax will be, we should remember just how important the financial sector is for the British economy: solid, sustainable growth will not be achieved until this sector has completely recovered.

**A tax will be created that will only affect the British financial sector.**

### Emerging Europe: single region, different futures

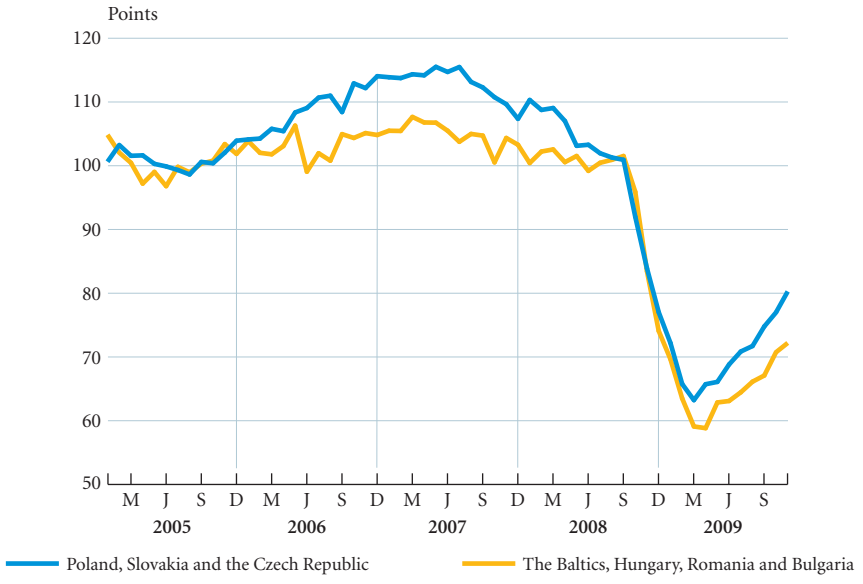
2009 ends much better than it began in emerging Europe. And if the 2010 forecasts remain on track, we'll be able to repeat as much in twelve months' time. Overall, beyond the generally agreed view that the acute phase of the crisis seems to be over, the pace of activity currently enjoyed by different countries and the growth prospects announced are neither similar nor comparable. With regard to indicators that take the pulse of the economy, and looking at one that provides the best summary, namely that of economic sentiment, two large groups of countries need to be distinguished. The first, made up of Poland, the Czech Republic and Slovakia, has been in recovery for more than half a year. In contrast, the group made up of the remaining economies in the region (the Baltic countries together with Hungary, Romania and Bulgaria), hit bottom much later and had fallen further. Since this low point in the cycle, their activity has recovered with a similar intensity to that of the first group although the current levels are lower.

The current economic situation indicates that this second group of countries is starting from a disadvantaged position, jeopardizing a dynamic recovery. In fact, if current growth forecasts for 2010 are right,

**Emerging Europe leaves the worst behind it but its prospects for 2010 are disparate.**

## TWO-SPEED RECOVERY IN EMERGING EUROPE

Index of economic sentiment




SOURCES: European Commission and own calculations.

**It will be difficult for Baltic countries to avoid a second year without sharp falls in GDP.**

this description might even be seen as too benign. One part of the second group (Estonia, Lithuania and Latvia) will continue in sharp recession in 2010, while the other three (Hungary, Romania and Bulgaria) will probably escape a second year with declining GDP by the seat of their pants (and provided there are no nasty surprises). In contrast to such meagre prospects, Poland, the Czech Republic and Slovakia will grow, if not dynamically then at least quite comfortably. So why are there such differences within the region?

Firstly, we should note the similarities shared by these economies. With few differences, all have benefitted appreciably from recovery abroad which, combined with the drop in imports due to very weak domestic demand, has helped to turn around the huge deficits in current accounts accumulated during the period of expansion. A second aspect in which these economies resemble each other is that the severity of the crisis has allowed them to redirect their previously recorded excessive inflationary tensions.

If these are the two big similarities, the key differences come from a combination of three factors: the resistance of the national banking system, the monetary policy followed and the fiscal adjustment required. In general terms, the bigger the macroeconomic imbalances accumulated during the period of expansion that ended in 2008, the more complicated it has been to strike a balance between attempting to alleviate the drop in business and sort out these prior excesses. An extreme case of this can be found in the Baltic countries, three economies that combine a weak banking system (seasoned with excesses in household and company debt in foreign currencies), the need to follow a monetary policy of high interest rates

to underpin their currency exchange systems and a slight adjustment in public accounts (in the case of Latvia, related to its programme with the International Monetary Fund).

Given this triple combination of recessive factors, international investors have been very cautious when assessing the risks of the Baltic countries, assigning them the highest country-risk levels of all emerging Europe. As a recent example of this unease, when the news broke of the problems of Dubai's debt on 25 November, two of the three central governments in emerging Europe that suffered an appreciable increase in tension in their CDS (Credit Default Swaps, an asset that reflects the likelihood of non-payment of public debt) were Latvia and Lithuania. With such a frame of mind, improvement in the international scenario will only partially lead to greater activity, and a renewed fall in growth in 2010 cannot be avoided.

The third country was Hungary. This actually represents several countries found in emerging Europe that have accumulated fewer imbalances and particularly those with a banking system that's under less pressure but which have had to battle fundamentally with the difficulty of handling the recession with restrictive fiscal policy. The extreme case has been, in fact, that of the Hungarian economy, a country that, in full recession, has still been able to post a positive primary public sector surplus, a result that should be interpreted within the context of its commitment to the IMF. Although the cases of Romania (which also benefits from the Fund's financial aid) and Bulgaria are not so extreme with regard to adjustments in public expenditure, all three are economies that will find it hard to grow strongly in 2010.

**With a bit of luck, Hungary, Romania and Bulgaria may grow again.**

The last situation that can be identified in emerging Europe is the one shared by economies with relatively smaller macroeconomic imbalances. This is the situation of Poland, the Czech Republic and Slovakia. These three countries are in a position to take advantage of the improvement in their key export markets (principally the euro area) without having to page the toll of pro-cyclic monetary or fiscal policy. This will allow them to enjoy positive growth rates of a certain size in 2010.

**Poland, the Czech Republic and Slovakia, clear beneficiaries of a globally balanced macroeconomic situation and of the euro area's recovery.**

## 2010, the year of decoupling?

One of the issues that might affect 2010 in economic terms is the role to be played by emerging economies. During the difficult years of 2008 and 2009, debate raged concerning the capacity of China and the main emerging economies to sustain their expansion when the United States and other industrialized countries were entering recession. This phenomenon became known as decoupling. This issue is still relevant and the question now is whether this decoupling will intensify in 2010 and beyond. To answer this question thoroughly we must look at three stages. Firstly, defining precisely what decoupling is and isn't. Secondly, measuring the phenomenon. Then, and only then, will we be able to plausibly predict future decoupling trends.

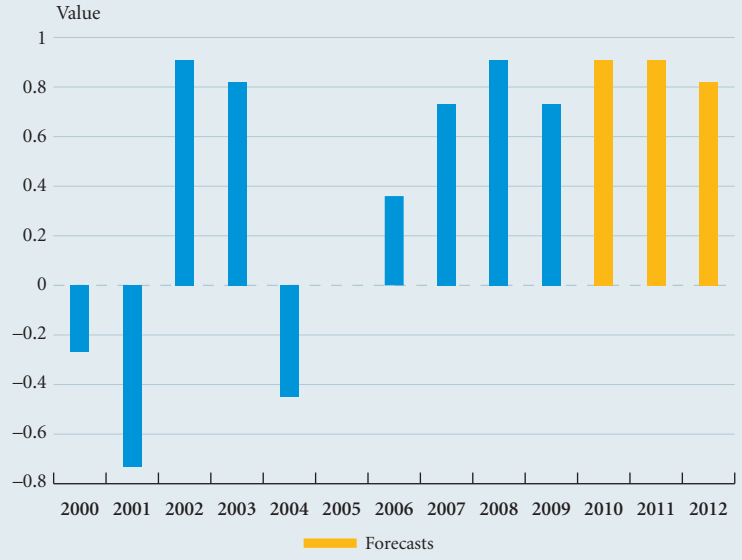
In its strictest sense, the decoupling of two economies or groups of economies means that both exhibit a limited degree of cyclic synchronization. Defined thus, decoupling combines two complementary aspects. First we must understand what academic literature has come to call pure synchronicity. Behind this somewhat cryptic expression lies the simple fact that two economies can be situated in the same phase of the cycle (expansion or contraction) or not. A second aspect of decoupling concerns the distance separating the cycle positions of two economies.[1]

The importance of this distinction can be appreciated by means of a simple numerical example. The starting point must be some measurement of an economy's cyclic position. The most usual measurement is the so-called output gap, i.e. the distance between the gross domestic product (GDP) of an economy at a specific point in time and the trend in or potential GDP. Potential GDP is the GDP that is compatible with the full use of output factors. Economic cycles are therefore defined by alternate positive and negative output gaps.

Based on these measurements, two economies will therefore record decoupling when either there is a positive output gap in one and a negative gap in the other (i.e. an absence of strict synchronicity) or the distance in absolute terms between both output gaps is significant. In order to use more direct terminology, we will call the first case «sign» decoupling (as we are comparing the positive or negative sign of the output gaps) and the second case «intensity» decoupling, as in this case the distance between output gaps is compared. The results of these two measurements are presented in the two graphs below.

**GREATER SIMILARITY IN THE CYCLIC PHASE IN 2010 AND 2011 BUT LESS RESEMBLANCE IN 2012**

Indicator of decoupling synchronicity based on output gaps (*)

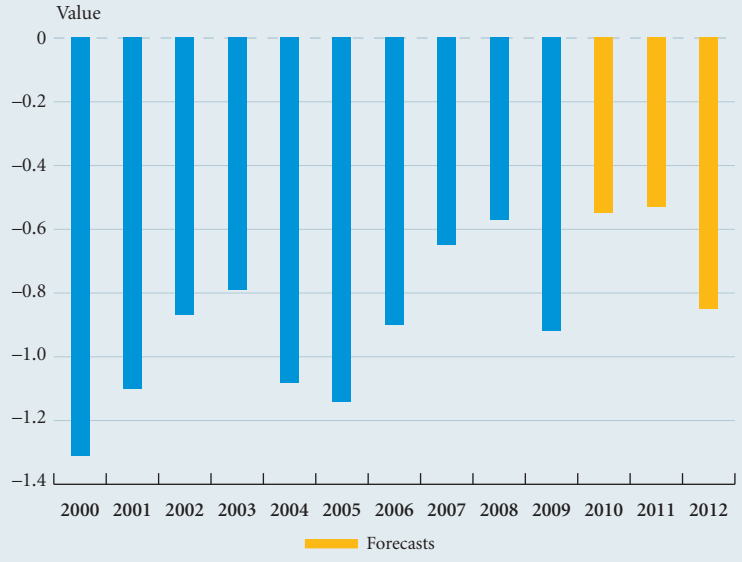



NOTE: (*) When the signs of the output gap in the emerging country and the developed economy coincide, the indicator is +1 and when they don't, it's –1. For every year, all pairs of signs are calculated for each of the 22 emerging countries with the average of 18 industrialized countries and the average is obtained.
SOURCES: Own calculations based on data from the International Monetary Fund.

(1) For a complete explanation of the methodology and an example of its application, see Mink, M., Jacobs, J.P.A.M. and J. De Haan (2007). «Measuring synchronicity and co-movement of business cycles with an application to the euro area», CESifo Working Paper, no. 2112.

**DECOUPLING WILL DECLINE OVER THE NEXT TWO YEARS BUT THEN RETURN AGAIN**

Indicator of decoupling amplitude based on output gaps (*)




NOTE: (*) Sum of the absolute values of the differences between the output gap for each of the emerging countries and the average of the developed economy, divided by the sum of the absolute values of the output gaps of the emerging countries. The result is multiplied by –1 to make it comparable with the «sign» decoupling indicator.
SOURCES: Own calculations based on data from the International Monetary Fund.

In the first of these graphs, an indicator of «sign» decoupling has been calculated so that, when two economies record an output gap of the same sign, the indicator gives a result of +1, while if the sign of the gaps is different, the result is –1. A comparison is made between the average of 24 industrialized economies and a set of 22 emerging economies. As can be seen, the degree of «sign» synchronicity has tended to fluctuate during the current decade up to the outbreak of the worldwide economic crisis. In fact, two clearly different patterns of behaviour can be distinguished. Between 2000 and 2005, the degree of sign synchronicity was highly volatile, alternating years with the greatest synchronicity in the decade and others with the least. Since 2006, the overall trend has been towards greater synchronicity, fluctuating within a narrower range. This structural change has been related to the advance of globalization throughout the first decade of the millennium.

Focusing now on the recent crisis, during its early stages (2006 and 2007) an increase was noted in cyclic synchronicity between industrialized and emerging economies. In 2008, synchronicity intensified when the worsening of financial tensions coincided with the entry into recession of numerous economies at the end of the year. Only in 2009, when the crisis was probably in its most extreme phase, did «sign» decoupling increase. From then on, and based on the growth forecasts given by the International Monetary Fund (IMF) for the period 2010 to 2012, we will have two years of another decline in «sign» decoupling and then, in 2012, it will return again.

The «intensity» decoupling indicator, a less volatile and more accurate measure of decoupling, provides similar findings. First off, it also shows a trend towards less decoupling between 2006 and 2008, as well as confirming the slight increase in 2009. Based on the IMF forecasts, the phenomenon should subside in 2010 and 2011 but in 2012 should return to similar decoupling levels as in 2009. In short, the answer to whether 2010 will be a

year of decoupling is in the negative. Provided the world economy takes the route expected by the Fund, neither the «sign» nor the «intensity» indicator supports the notion of a year of intense decoupling. What might be behind this predicted trend?

The discussion of the determining factors that lie behind the degree of cycle synchronicity between economies is not fully conclusive as results depend on the interaction of many different factors, such as the type of economic shock experienced (particularly whether it is global or specific to a country or sector) and the type of transmission channel between economies. However, there are three factors that may lead to lesser decoupling in 2010. Firstly, it seems that, in the second half of 2009, emerging countries have «advanced» in the cycle, a circumstance that is likely to abate in 2010 when industrialized economies improve their rate of business. A second factor that might contribute to greater global synchronicity is the recovery in international trade, partly due to credit gradually getting back to normal, making it easier for the push made by some economies to be passed on to others more intensely and rapidly. Lastly, this same improvement in credit should boost the incipient recovery in the global investor cycle. In 2011, these three trends will intensify but afterwards... afterwards the emerging countries will probably go back to their old ways again. In summary, the decoupling debate, like the phenomenon itself, seems destined to go through numerous appearances and disappearances.

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# FINANCIAL MARKETS

## Monetary and capital markets

### The ECB and the Fed confirm the withdrawal of non-conventional measures

At the start of December, the European Central Bank (ECB) focused its attention on the markets. On the one hand, there was no doubt that the decision regarding the official interest rate would be to keep it the same. On the other hand, however, the announcement concerning the details of the exit strategy for non-conventional measures was awaited with baited breath. With regard to the first point, the ECB confirmed expectations and kept the reference rate at 1.0%. With regard to the second point, ECB President, Jean-Claude Trichet, did not disappoint the markets and explained in great detail the gradual withdrawal of measures that had been introduced exceptionally during the crisis.

The steps to be taken by the ECB show that the strategy will focus on restoring the system for ensuring liquidity that was in place prior to the financial crisis. The institution's decision to withdraw special 12-month operations (LTRO) came as no surprise and the LTRO of 16 December was therefore the last. In this operation, the ECB allotted 96,000 million euros to 224 banks at an interest rate that is the average of the minimum bid accepted in the weekly auctions (MRO) held until maturity. Regarding six month refinancing operations, the ECB announced that the last will be held on 31 March 2010, covering the whole demand and at a fixed interest rate. Non-regular monthly auctions will continue at least during the first quarter of 2010. The ECB also confirmed that MRO conditions will not be altered until at least April 2010, i.e. all liquidity required will continue to be provided at the fixed interest rate of 1.0%.

**The ECB and the Fed provide details on their exit strategies...**

In addition to the announced measures, we should also underline the last paragraph of the ECB's communication. This contains an indirect reference to the possibility of a specific operation being carried out to drain liquidity related to one-year operations that mature during the second half of 2010.

By the middle of December, the markets' attention shifted to the United States due to the meeting of the Federal Open Market Committee (FOMC). After this meeting, on 16 December, the Federal Reserve Chairman, Ben Bernanke, announced that the official rate would remain within the range of 0.00%-0.25%. But here also the most eagerly awaited announcement was the one concerning non-conventional monetary measures. In this respect, the Fed confirmed that most special liquidity facilities will mature on 1 February 2010. With this decision, the Fed acknowledges that the improvement in credit markets can be sustained.

**...while making it clear that this does not involve raising interest rates in the short term.**

Among the special facilities maturing in February are the lines for Asset Backed Commercial Paper Money Market Mutual Fund Liquidity, Commercial Paper Funding Facility (CPFF), Primary Dealer Credit Facility (PDCF) and the Term Security Lending Facility (TSLF).

**In spite of the central banks taking a firm stance, the steps taken will be gradual.**

**Cutting back the Fed's independence might affect price trends.**

Moreover, the Fed also announced its plans to close down the currency swap lines held with the main central banks in the world, these being created temporarily because of the crisis.

The monetary authority will also continue to gradually reduce the Term Auction Facility (TAF) throughout the first quarter of 2010. However, the commercial mortgage-backed Term Asset-Backed Securities Loan Facility (TALF) will be kept until 30 June, and up to 31 March 2010 for non-mortgage-backed loans.

**Interbank interest rate reflects the market's great liquidity.**

In spite of the Fed indicating the firmness and confidence of its Committee members in its communication, significant room for manoeuvre has also been provided as a precaution. Consequently, the Fed explicitly stated that it is prepared and ready to modify any plan in order to maintain financial and economic stability.

Another issue of great interest to the markets are the initiatives to audit the Fed's decisions, to limit its capacity to supervise banks and to allow politicians to vote for the chairmen of the regional banks that form part of the Federal Reserve System. These initiatives are creating uncertainty since the markets believe they would weaken one of the

## 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** | | | | | | | | | |
| 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 | 0.67 | 1.50 | 2.17 | 0.70 |
| February | 2.00 | 1.83 | 2.03 | 0.25 | 1.26 | 0.64 | 1.00 | 2.05 | 0.75 |
| March | 1.50 | 1.51 | 1.81 | 0.25 | 1.19 | 0.60 | 0.50 | 1.65 | 0.63 |
| April | 1.25 | 1.37 | 1.73 | 0.25 | 1.02 | 0.55 | 0.50 | 1.45 | 0.66 |
| May | 1.00 | 1.27 | 1.63 | 0.25 | 0.66 | 0.52 | 0.50 | 1.28 | 0.60 |
| June | 1.00 | 1.10 | 1.50 | 0.25 | 0.60 | 0.46 | 0.50 | 1.19 | 0.33 |
| July | 1.00 | 0.89 | 1.36 | 0.25 | 0.48 | 0.41 | 0.50 | 0.89 | 0.41 |
| August | 1.00 | 0.82 | 1.30 | 0.25 | 0.35 | 0.39 | 0.50 | 0.69 | 0.30 |
| September | 1.00 | 0.75 | 1.24 | 0.25 | 0.29 | 0.35 | 0.50 | 0.54 | 0.31 |
| October | 1.00 | 0.72 | 1.24 | 0.25 | 0.28 | 0.33 | 0.50 | 0.59 | 0.34 |
| November | 1.00 | 0.72 | 1.23 | 0.25 | 0.26 | 0.30 | 0.50 | 0.61 | 0.32 |
| December (1) | 1.00 | 0.71 | 1.24 | 0.25 | 0.25 | 0.28 | 0.50 | 0.60 | 0.25 |

NOTES: (1) December 21.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).
(5) Interbank rate.
SOURCES: National central banks, Bloomberg and own calculations.

most highly valued aspects in a central bank: its independence. Greater or lesser independence in the area of monetary policy is associated with greater or lesser credibility, the fundamental basis for forming and anchoring the expectations of economic agents. Attacking this principle might damage the stability of inflation in the medium and long term and therefore economic performance.

The details revealed by the central banks regarding their exit strategies have not altered the relative stability noted in the interbank markets (of the United States and the euro area) throughout the last month. Once again, December saw a reduction of around five basis points in the 7-12 month tranche of the US curve.

When interpreting the stability of the interbank curve in the euro area, we must take into account the fact that the volume of operations is still very low. This, in turn, is influenced by the huge liquidity maintained by institutions due to operations carried out by the ECB with different maturities. Ultimately, the low level of the EONIA, at around 0.35%, is a reflection of the excess liquidity in the banking system of the euro area as a whole.

## Discrimination of sovereign risk in the euro area

During the last month of the year, stability was maintained in the US government bond market. 10-year US government bonds currently offer a return of 3.58%. This stability is a reflection of two elements remaining unaltered. The first factor is the purchase of public debt by the Fed and commercial banks. The second is that economic agents expect inflation to remain steady.

**The United State's public debt has maintained stability over the last few months.**

**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** | | | | | | | | |
| 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 | 3.18 | 3.59 | 3.92 | 4.28 | 3.12 | 1.43 | 3.50 | 2.14 |
| May | 3.59 | 3.95 | 4.29 | 4.48 | 3.46 | 1.49 | 3.75 | 2.41 |
| June | 3.39 | 3.73 | 4.13 | 4.43 | 3.53 | 1.36 | 3.69 | 2.32 |
| July | 3.30 | 3.57 | 3.85 | 4.16 | 3.48 | 1.42 | 3.80 | 1.97 |
| August | 3.26 | 3.54 | 3.78 | 4.08 | 3.40 | 1.31 | 3.56 | 2.03 |
| September | 3.22 | 3.54 | 3.81 | 4.02 | 3.31 | 1.30 | 3.59 | 1.99 |
| October | 3.23 | 3.53 | 3.79 | 4.07 | 3.38 | 1.42 | 3.62 | 2.02 |
| November | 3.16 | 3.42 | 3.75 | 4.02 | 3.20 | 1.27 | 3.52 | 1.84 |
| December (*) | 3.25 | 3.47 | 3.83 | 4.03 | 3.58 | 1.27 | 3.90 | 1.88 |

NOTE: (*) December 16.
SOURCE: Bloomberg.

**Debt differentials increase for the periphery countries in the euro area.**

In the euro area, the government bonds issued by Germany, France and Italy have hardly undergone any significant variation. However, doubts concerning the fiscal sustainability of periphery countries such as Greece and Portugal have significantly increased their interest rate differentials with Germany. Investors believe these periphery countries have a worse credit profile and therefore demand a better yield from the public debt they issue. So the market is discriminating between the sovereign risk of the different countries in the euro area.

Certainly, reducing public deficit is the main challenge facing the economic managers of developed countries in the coming years, these fiscal deficits being the result of the intense expenditure carried out to stabilize the economies. For this reason, rating agencies have decided to reflect this deterioration and have downgraded or revised the credit ratings of several countries in the euro area.

**Rating agencies downgrade Greece's credit rating.**

The country that has suffered most from such changes is Greece. Fitch and Standard & Poor's (S&P) have downgraded Greece's debt rating from A– to BBB+. Moreover, S&P has kept Greece's rating under review and with a negative perspective. Finally, doubts regarding the Greek government's shock plan, designed to avoid excessive rises in debt, has greatly affected the country's government bond market and the markets of the region as a whole. While Germany can finance itself by issuing 10-year bonds offering a yield of 3.25%, investors require 5.76% from Greek public debt, i.e. 251 additional basis points.

**The dollar appreciates strongly against the euro.**

In the case of the United States and Germany, the expectation that economic recovery will continue over the coming months helps to explain the absence of significant changes in the value of their public debt. Compared with those euro area countries that are suffering wider interest rate differentials with Germany, future developments will depend critically on the solidity and viability of the fiscal consolidation plans published. As usual, the markets are not showing much patience and time is running out.

### The dollar appreciates strongly against the euro

During the month of December, the most significant change in the currency market has been the appreciation of the dollar compared with the euro. While, at the end of November, one euro was worth 1.51 dollars, on 16 December this had fallen to 1.44 dollars. This means that the dollar has appreciated 5%.

This movement has been surprising due to its intensity but there is consensus regarding its causes. The combination of three factors has boosted the dollar. Firstly, the good macroeconomic figures published for the United States, slightly better than the market expected, in particular in terms of the job market and real estate sector. Secondly, the growing doubts, already mentioned, regarding the fiscal sustainability of some countries in the euro area. Lastly, the dollar has also been boosted by the end of speculative positions in carry trade, given the likely interest rate rises in the United States. Carry trade is a financial operation where debt is bought in currencies with lower interest rates and the money then invested in financial assets issued in other currencies with higher returns.

## EXCHANGE RATES OF MAIN CURRENCIES

December 17, 2009

| | Exchange rate | % change (*) | | |
|---|---|---|---|---|
| | | Monthly | Over December 2008 | Annual |
| **Against US dollar** | | | | |
| Japanese yen | 89.8 | 0.6 | –0.9 | 2.9 |
| Pound sterling | 0.616 | 3.5 | –11.1 | –4.4 |
| Swiss franc | 1.047 | 2.9 | –2.1 | –2.4 |
| Canadian dollar | 1.068 | 1.6 | –14.1 | –11.6 |
| Mexican peso | 12.759 | –2.2 | –7.2 | –3.1 |
| **Against euro** | | | | |
| US dollar | 1.439 | –3.4 | 2.9 | –0.2 |
| Japanese yen | 129.3 | –2.7 | 2.0 | 2.7 |
| Swiss franc | 1.506 | –0.3 | 0.9 | –2.6 |
| Pound sterling | 0.887 | 0.3 | –7.6 | –4.6 |
| Swedish krona | 10.418 | 1.9 | –5.1 | –5.3 |
| Danish krone | 7.442 | 0.0 | 0.0 | –0.1 |
| Polish zloty | 4.185 | 2.3 | 0.9 | 1.8 |
| Czech crown | 26.27 | 2.9 | –2.2 | –0.6 |
| Hungarian forint | 278.1 | 4.7 | 4.5 | 4.3 |

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

These factors have not only strengthened the dollar against the single European currency but have also boosted its appreciation against the rest of the important currencies, such as the Japanese yen, the Pound sterling and the Swiss franc.

Throughout 2010, the dollar should appreciate moderately against the euro and, for this to happen, the key factor will be the start of the cycle of monetary normalization in the United States. How exchange policy is handled in China will also be important, apparently keen to allow the yuan to start appreciating again. In any case, although the news of economic improvement in the United States may have advanced the dollar's appreciation, after such an intense, fast episode we cannot rule out the possibility of a certain reversal, just because of profit-taking by investors.

**Expectations of US monetary policy getting back to normal boost the dollar.**

### New boost to corporate bond markets

After several months of consolidation, private bond markets picked up again in December. Credit spreads fell back below the thresholds in place when the Lehman Brothers went bust and were approaching the levels prior to the Bear Stearns bankruptcy. The announcement by the central banks that they would start to withdraw temporary measures to support liquidity and credit has not significantly affected the positive tone of this market. Neither are the tensions in the government bond markets of Dubai, Greece and, to a lesser extent, Portugal having a negative effect.

**Corporate bond markets on the up again.**

**Economic recovery is the decisive factor.**

The decisive factor in this good phase for private bond markets is the economic recovery that, to a greater or lesser extent, is spreading throughout all geographic regions and almost all economic sectors. This is reflected in the widespread improvement in the debt rating of firms by rating agencies, unlike what has been happening recently with the public debt of some countries. This process has developed most positively in the United States, while in the euro area and South-East Asia improvement is still in its infancy.

The positive tone of indices has been accompanied by constant growth in the volume of corporate debt issues, which continue to break records.

Expansion in the private bond market is following a trend supported by several factors. Firstly, banks have made an effort to contain their risk positions in order to comply with the new and more demanding capital ratios. Secondly, after the seriously high cost of borrowing suffered by firms, they have decided to resort to the capital markets, sometimes by way of prevention or experiment. They have therefore relegated bank funding to a secondary level, as well as diversifying their sources of financing and extending maturities. Thirdly, numerous end investors, both institutional and private, with high levels of liquidity have found investments in this market with a very reasonable return to risk ratio.

In summary, the demand for private bond assets is growing steadily and this is expected to continue in the future. Private and institutional investors still have high liquidity and, due to the lack of return from other investments (such as monetary assets or public debt), the flow towards markets with higher yields and risk is likely to continue. Within this context, it is very likely that corporate

**CREDIT SPREADS CONTINUE TO DECREASE**

Credit spreads in the euro area


SOURCE: Bloomberg.

debt credit spreads will continue to reduce, albeit moderately given the amount they have already fallen and logically with the possibility of temporary corrections.

## 2009 has ultimately been a good year for the stock markets

2009, which started dominated by a scenario of risk and business losses, ended positively with an average stock market revaluation of more than 15%. The main gains in the stock market at a global level were concentrated between March and October, with a notable slowdown in the rate of rises in the year's home straight. Stock markets performed irregularly in December depending on the economic area in question. While indices resisted breaking the records made in the previous month in developed countries, in emerging economies the incipient shift in monetary policy towards a scenario of rising interest rates led to revaluation slowing up.

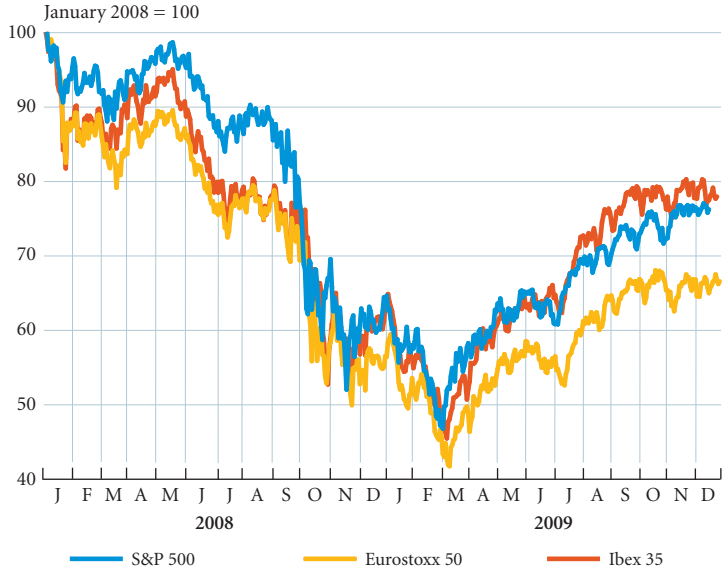
It should be noted that, in spite of equity markets in the United States and the euro area being reluctant to reach higher values, in both cases investor take-up was satisfactory for the capital increases carried out by companies, particularly those issued by US banks in order to achieve financing to return the aid received from the American Treasury via the TARP.

There are two aspects of stock market trends in December that are worth highlighting. The first is the apparent changeover of the factor that boosts share value. Up until a few months ago, the aspect of primary importance in the markets was an abundance of liquidity, as this situation minimized credit risk. But now that the ECB and the Fed have revealed the details of their exit

**The stock markets' annual balance is positive, although the rate of increase is slowing up.**

**THE PACE OF STOCK MARKET RISES STABILIZES**

Stock market indices




SOURCE: Bloomberg.

**Stock markets value the improved perspectives for economic growth.**

strategies, investors have started to prioritize a purely economic aspect: the expected growth in GDP and profits. This is the main variable that has allowed stock markets to consolidate their gains in the home straight of 2009.

The second relevant fact was the break with the negative correlation between the dollar's value and the US stock market. Historically, there has been a high negative correlation between trends in the dollar and the S&P 500, i.e. the stock market rises when the dollar weakens, and vice versa. In December this relationship became positive, something that had not happened since the period 1997-2000.

**The dollar exchange rate and the S&P 500 are moving in synch.**

It is also worth mentioning the effect of a series of factors that had aroused doubt among investors but which ended up being fleeting, showing that the market's foundations are now stronger. On the one hand, the request for deferral by Dubai World, the real estate holding owned by the Dubai government, in repaying its debt totalling 60,000 million dollars. This piece of news revived doubts concerning the possibility of another corporate bankruptcy that would seriously affect the balance sheets of many international banks. On the other hand, the downgrade carried out by the rating agency Standard & Poor's for the debt issued by some governments in the European Union.

In general, everything suggests that, once all these factors have been taken into account, equity is seen as an attractive alternative investment, as are corporate

**INDICES OF MAIN WORLD STOCK EXCHANGES**

December 17, 2009

| | Index (*) | % monthly change | % cumulative change | % annual change |
|---|---|---|---|---|
| New York | | | | |
| *Dow Jones* | *10,352.9* | *–0.8* | *18.0* | *17.3* |
| *Standard & Poor's* | *1,100.4* | *–0.9* | *21.8* | *21.7* |
| *Nasdaq* | *2,185.7* | *–0.8* | *38.6* | *38.4* |
| Tokyo | 10,163.8 | 4.5 | 14.7 | 18.0 |
| London | 5,233.4 | –2.1 | 18.0 | 21.0 |
| Euro area | 2,889.6 | –0.6 | 18.1 | 18.2 |
| *Frankfurt* | *5,850.6* | *1.2* | *21.6* | *24.3* |
| *Paris* | *3,830.0* | *0.0* | *19.0* | *18.1* |
| *Amsterdam* | *326.3* | *1.6* | *32.7* | *31.7* |
| *Milan* | *22,653.8* | *–3.1* | *16.4* | *17.1* |
| *Madrid* | *11,671.3* | *–2.4* | *26.9* | *26.9* |
| Zurich | 6,483.3 | 1.7 | 17.1 | 16.9 |
| Hong Kong | 21,347.6 | –6.8 | 48.4 | 38.1 |
| Buenos Aires | 2,202.0 | –3.5 | 104.0 | 91.8 |
| São Paulo | 67,697.3 | 0.4 | 80.3 | 69.5 |

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

bonds, where the potential revaluation can still provide profitable margins in the medium term. However, in the short term we must still be cautious, as we cannot rule out the emergence of risks associated with the withdrawal of liquidity. Neither can we rule out those aspects that limit the rate of recovery in economic growth and that therefore reduce the potential of stock market indices.

## Stock market prospects: keeping a watchful eye on portfolios

The climate among investors was radically different at the close of the 2009 stock market year from what it was twelve months earlier. The fear of total financial collapse, depression and deflation dissipated as the year advanced, driving revaluations that, considering March's minimums, must be classed as extraordinary (in round numbers, 80% for Spain's Ibex 35, 60% for the S&P 500 of the United States and Eurostoxx 50 of the euro area, 40% for the Japanese Nikkei and 70% for the MSCI-Emerging Markets).

With all eyes on the new year, the challenge is to identify which elements might have a decisive effect on equity markets and future prospects. But first of all it's useful to examine the road taken by markets within a broader timeframe and to weigh up some basic indicators of the current situation. This information, sensibly, calls us to curb the feeling of euphoria that might be generated by the aforementioned spectacular figures.

The graph below illustrates that, for the main international stock market indices, 2009's gains have merely served to recover part of the losses suffered in the second half of 2007 and in 2008. Moreover, the S&P 500, Eurostoxx 50 and Ibex 35 all closed 2009 below their levels of 1999, thereby constituting a «lost decade» for stock market investors.[1] And in the case of the Nikkei, at year-end its levels were the same as in 1984, evidence of particularly adverse conditions in this stock market. The counterpoint lies in the markets of emerging countries that, although they have not completely escaped periods of downward trends, have accumulated notable gains over the last ten years.

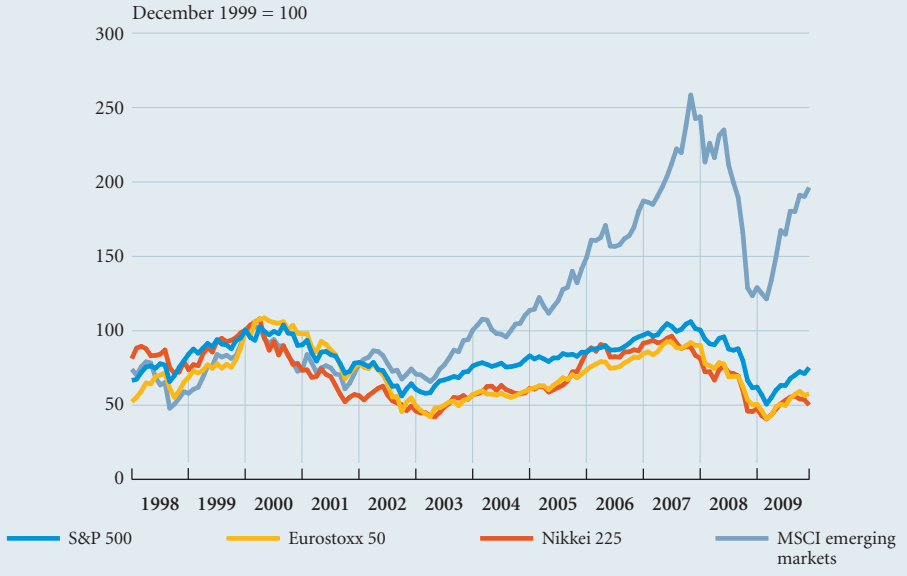
This extensive period of poor performance on the part of western stock markets begs the question of whether they are now in a particularly attractive situation for long-term investors. We should note that the interpretation of valuation indicators based on «price/earnings» (PER) ratios is particularly problematic in periods of macroeconomic instability such as the present, with the added factor of uncertainty surrounding the structural transformation of the financial sector and of high weighting in reference stock market indices. In any case, the graphs below show that, at the end of 2009, cycle-adjusted PER figures[2] suggest that valuation is correct in the United States (which is perhaps a bit disappointing) and slightly undervalued in the euro area, balanced interpretations compared with the extremes of the end of 1999 (overvaluation) and March 2009 (undervaluation).

With such a starting point, and employing the most likely scenario of gradual economic recovery and the absence of sustained financial tension, these two indices might reasonably perform in line with the current

(1) The calculation of the three indices mentioned do not include dividends that nonetheless contribute to the total return on investment.
(2) PER using the average earnings over the last ten years as a measure of «earnings».

**THE STOCK MARKET RECOVERS PART OF ITS LOSSES FROM 2007 AND 2008**

Trends in some stock market indices




SOURCE: Bloomberg.

predictions by stock market analysts: revaluation in the order of 10% for the S&P 500 and 15% for the Eurostoxx 50. These figures are somewhat on the optimistic side but, even so, they are much lower than the gains over the last nine months. And, even more importantly, they are projected within a context where very high risks still hover over equity, either due to a relapse in economic activity or an upswing in inflation and interest rates.

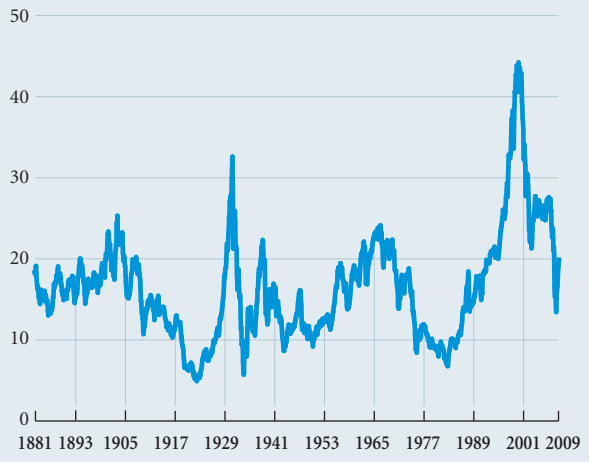
Logically, the potential revaluation (and risk incurred) differs depending on the portfolio choices made, according to criteria such as geography, sector or investor profile (e.g. company size). In fact, in macroeconomic contexts that are dominated by uncertainty, as in the current post-financial crisis, the spread or divergence of returns depending on this choice tends to increase.[3] Signs of this could already be seen in the last few months of 2009 and it is very likely to continue for some time yet. It is therefore useful to examine a few aspects that are important when selecting a portfolio for 2010.

With regard to the geographical criterion, there is still the basic dilemma between developed and emerging countries. The phenomenon of globalization boosted global GDP growth in the years of economic boom but has also been a means of passing on systemic risks. Thanks to each country maintaining its own economic characteristics related to its degree and model of development, the economic and financial crisis has not had the same impact on all countries. In turn, these differences are becoming crucial now that we are coming out of

(3) See for example: Nicholas Bloom, *The Impact of Uncertainty Shocks*, Econometrica, May 2009.

**THE US STOCK MARKET DOES NOT COME CHEAP**

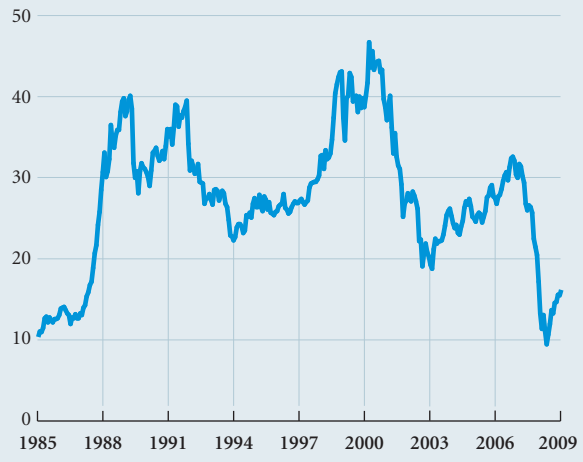
PER ratio adjusted to the S&P 500 cycle




SOURCE: R. Shiller.

**VALUATION IS SOMEWHAT MORE ATTRACTIVE IN THE EURO AREA**

PER ratio adjusted to the euro area stock market cycle




SOURCES: Datastream and own calculations.

recession. Emerging economies, and specifically those of the BRIC (Brazil, Russia, India and China), have shown a lower level of deterioration during the global economic crisis and their activity has also shown a greater capacity to recover than the North American and European blocs. Forecasts also predict that these economies will head the process of growth over the coming years. Such aspects have taken priority in stock markets during the last year, leading to greater advances in the indices of emerging countries than those in developed countries, and this pattern is likely to continue throughout 2010.

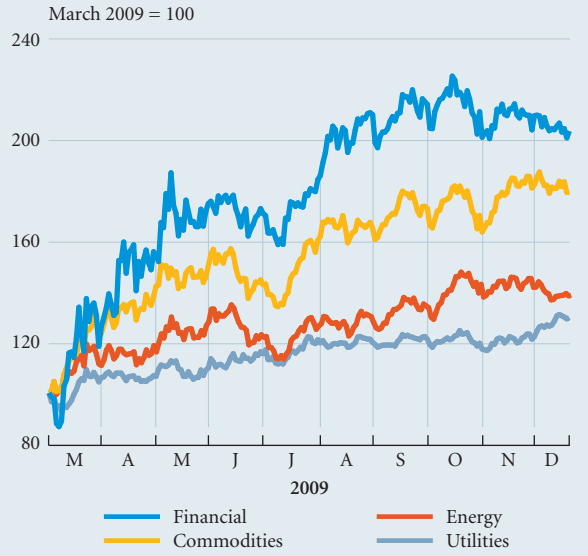
Another notable element in the recent revaluation of equity is unequal sector trends. The shift in analysts' consensus estimates towards a scenario of a slow recovery in business margins, as well as the stabilization of economic data, led to a sector revaluation that was out of proportion. A clear example can be seen in a sector analysis of the S&P 500, especially (see the left-hand graph below) the recoveries throughout 2009 in the financial sector, benefitted by the actions of central banks, and in other cyclical elements such as commodities and information technology, closely linked to the point in the business cycle. In 2010, and in general, the sectors that led this recovery are likely to give way to other alternative sectors and areas. After notable rises in valuations, and given that global risks still exist, one option that will probably gain in popularity is the search for safer rates of return via dividends, particularly through defensive sectors (e.g. energy and utilities).

Thirdly, choice according to the criterion of company size might take on particular importance in stock markets such as the one in Spain. As can be seen in the right-hand graph below, since the start of the crisis the Ibex 35 (made up of the largest companies with the greatest stock market liquidity) has performed manifestly better than the Ibex Small Cap index (made up of the smaller firms on the stock market). Apart from the factor of size in its purest sense (with considerations of company quality and security), the divergence between these two indices actually includes other, even more powerful effects. One that is particularly significant is the

degree of exposure to international demand[4] (i.e. the percentage of turnover and/or profit gained abroad), which is much higher in the Ibex 35. The relative tardiness and weakness of the Spanish economy's recovery lies behind this pattern and it's likely to continue for some time yet. But throughout 2010 we must watch out for a likely change in forces, as investors start to perceive the reactivation of the Spanish economy and this is reflected in share prices.

**NOTABLE SECTOR DIFFERENCES**

Stock performance in some sectors of the S&P 500




**INTERNATIONAL EXPOSURE IS KEY**

Spanish equity indices


SOURCE: EcoWin.

(4) Another is the weighting of the financial sector, much higher in the Ibex 35.

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# SPAIN: OVERALL ANALYSIS

## Economic activity

### The squeeze eases

Economic indicators available referring to the fourth quarter of 2009 suggest that the economy is continuing to moderate its decline. Both consumption and investment show signs of improvement although the general tone is still negative in hue. We have therefore modified our forecast of a year-on-year decrease in gross domestic product (GDP) for the fourth quarter from 3.4% to 3.1%. The annual fall in GDP for 2009 would therefore be reduced by one-tenth of a percentage point compared with the previous forecast, to 3.6%.

Within this context, the figures from the Quarterly Composite Balance Sheet of the Bank of Spain are interesting as they throw light on the situation of firms, since net employment can only start to be created once this situation improves significantly. According to the results of the third quarter of 2009, the accumulated gross value added by non-financial firms in the sample, obtained by deducting intermediate consumption from the value of production, fell by 13.1% compared with the same period the previous year, and all sectors shrank in general. However, this decline appears to have slowed up to some extent.

**Growth forecast improves for the fourth quarter of 2009.**

Staff costs fell 1.1% in the first three quarters of 2009 in year-on-year terms. This was due both to lower salary increases and a fall in employment.

**Corporate results continue to decline.**

**PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES**

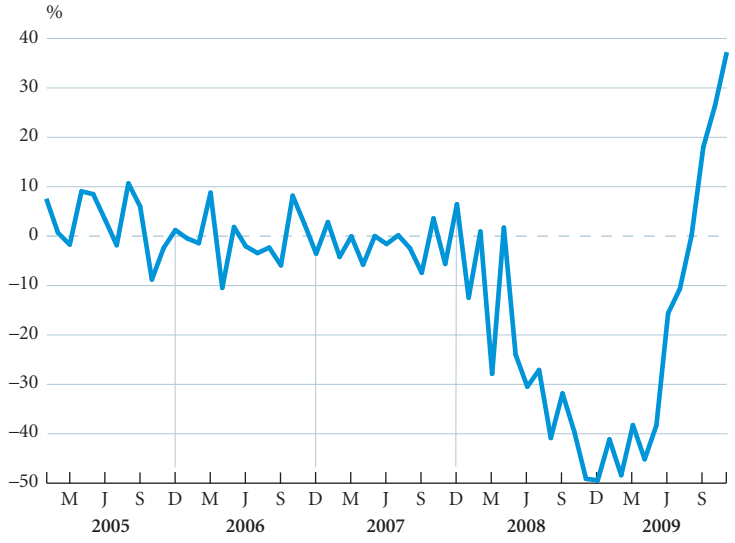
Annual rates of change

| | 2008 | Quarters: 1-3 | |
|---|---|---|---|
| | | 2008 | 2009 |
| Value of output | 0.3 | 7.3 | –17.8 |
| Inputs | 1.9 | 10.6 | –20.3 |
| **Gross value added (GVA)** | **–2.9** | **1.5** | **–13.1** |
| Personnel costs | 3.2 | 4.7 | –1.1 |
| **Gross operating profit** | **–9.4** | **–0.8** | **–22.0** |
| Financial revenue | 12.6 | 18.0 | –10.6 |
| Financial costs | 15.8 | 19.8 | –28.6 |
| Depreciation and provisions | 16.2 | –2.8 | –2.4 |
| **Ordinary net profit** | **–22.1** | **–1.3** | **–21.8** |
| Gains/losses from disposals and impairment | –36.8 | 19.5 | –42.4 |
| Changes in fair value and other gains | – | 62.8 | –31.7 |
| Corporate income tax | –68.9 | 8.8 | –19.0 |
| **Net profit** | **–48.2** | **12.7** | **–29.7** |

SOURCE: Bank of Spain.

**BIG BOOST FOR AUTOMOBILE SALES THANKS TO DIRECT SUBSIDIES**

Year-on-year change in car registration




SOURCES: ANFAC and own calculations.

**Retail sales slow up their fall...**

In spite of this containment, however, corporate surpluses continue to decline.

Financial income fell because of lower interest rates and fewer dividends, while financial expenditure fell further due to less debt. Subsequently, net income fell 21.8% compared with the same period in 2008.

Non-recurring income also fell, as there were no strong gains due to sales of shareholdings, which had taken place in the same period in 2008. Consequently, net profit fell by 29.7%.

Ordinary return on investment was 5.6%, 1.7 percentage points less than in the same period in 2008. Ordinary return on equity was 7.4% as a consequence of leverage, although 1.9 percentage points less than a year before.

**...and consumer confidence rises.**

Returning to the overall situation, retail sales continued to slow up their decline in October. For their part, automobile registrations speeded up, with a rise of 37.3% in November thanks to direct subsidies from the plan promoted by the government and most autonomous communities. The consumer confidence indicator stabilized in October and November at a level slightly higher than the one recorded in the first half of the year and in 2008, but below the historic average.

With regard to investment, we should note the slight improvement in load-carrying vehicle registration, which moderated its decline to 0.6% year-on-year in November, helped by the Plan 2000E. In investment in construction, cement consumption slowed up its decline to 9.3% in November compared with twelve months before.

From the point of view of supply, industry put a brake on its decline in October. Industrial capacity

## DEMAND INDICATORS

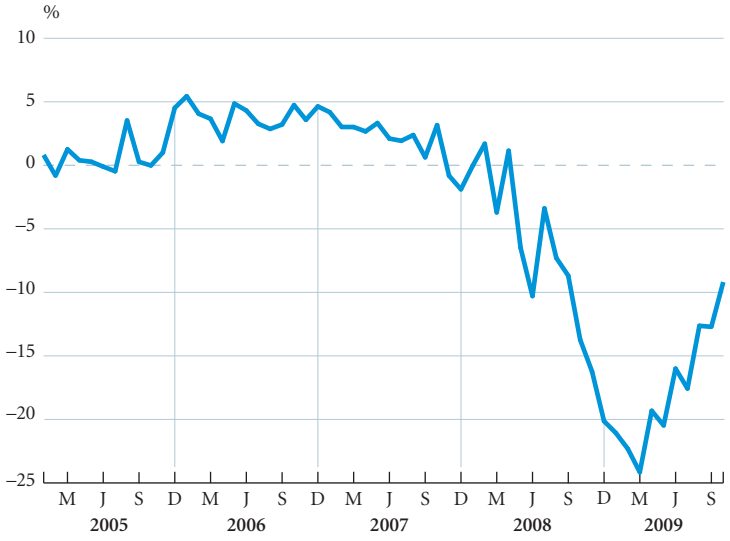
Percentage change over same period year before

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| **Consumption** | | | | | | | | |
| Production of consumer goods (*) | 1.7 | –4.7 | –10.3 | –12.6 | –9.4 | –8.6 | –5.3 | ... |
| Imports of consumer goods (**) | 5.1 | –7.7 | –17.2 | –9.4 | –14.9 | –3.4 | ... | ... |
| Car registrations | –1.2 | –28.1 | –46.6 | –43.1 | –33.7 | –0.6 | 26.4 | 37.3 |
| Credit for consumer durables | 10.0 | 3.6 | –4.2 | –11.9 | –14.1 | –10.8 | – | ... |
| Consumer confidence index (***) | –13.3 | –33.8 | –45.3 | –44.7 | –28.0 | –20.7 | –21.0 | –21.0 |
| **Investment** | | | | | | | | |
| Capital goods production (*) | 4.6 | –8.8 | –20.8 | –30.5 | –24.7 | –20.2 | –12.4 | ... |
| Imports of capital goods (**) | 9.8 | –19.6 | –28.8 | –31.3 | –35.1 | –23.4 | ... | ... |
| Commercial vehicle registrations | 0.3 | –43.6 | –61.3 | –52.5 | –51.9 | –30.8 | –19.1 | –0.6 |
| **Foreign trade** (**) | | | | | | | | |
| Non-energy imports | 7.3 | –4.9 | –19.0 | –26.0 | –26.8 | –13.4 | ... | ... |
| Exports | 4.2 | 1.9 | –8.4 | –17.9 | –14.7 | –9.6 | ... | ... |

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

## THE FALL IN INDUSTRIAL PRODUCTION SLOWS UP

Year-on-year change in the general index for industrial production (*)




NOTE: (*) Adjusted for public holidays.
SOURCE: National Institute of Statistics.

## SUPPLY INDICATORS

Percentage change over same period year before

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| **Industry** | | | | | | | | |
| Electricity consumption (1) | 4.4 | 0.6 | –4.1 | –7.0 | –6.6 | –2.1 | –1.3 | –3.6 |
| Industrial production index (2) | 2.0 | –7.3 | –16.6 | –22.6 | –18.6 | –14.6 | –9.2 | ... |
| Confidence indicator for industry (3) | –0.3 | –18.0 | –32.7 | –36.7 | –35.5 | –29.0 | –24.0 | –25.0 |
| Utilization of production capacity (4) | 81.3 | 79.5 | 76.9 | 68.8 | 69.5 | 68.5 | – | 69.9 |
| Imports of non-energy intermediate goods (5) | 8.0 | –0.7 | –18.2 | –32.9 | –31.1 | –17.1 | ... | ... |
| **Construction** | | | | | | | | |
| Cement consumption | 0.2 | –23.8 | –38.1 | –46.1 | –36.0 | –26.4 | –21.1 | –9.3 |
| Confidence indicator for construction (3) | 9.3 | –22.6 | –34.7 | –36.7 | –35.0 | –26.3 | –29.0 | –20.0 |
| Housing (new construction approvals) | –24.7 | –59.4 | –60.2 | –64.1 | –62.8 | –52.2 | ... | ... |
| Government tendering | –15.0 | 3.0 | 12.4 | –5.3 | –8.3 | –1.1 | ... | ... |
| **Services** | | | | | | | | |
| Retail sales (6) | 2.3 | –6.3 | –7.7 | –6.3 | –4.2 | –2.8 | –1.8 | ... |
| Foreign tourists | 1.1 | –2.5 | –9.0 | –16.2 | –8.2 | –7.8 | –3.6 | –3.1 |
| Tourist revenue inflows | 3.3 | –0.4 | –8.0 | –14.3 | –8.0 | –9.0 | ... | ... |
| Goods carried by rail (ton-km) | –3.7 | –7.7 | –23.0 | –34.1 | –34.9 | –32.4 | –19.8 | ... |
| Air passenger traffic | 9.0 | –3.0 | –12.7 | –18.2 | –8.7 | –5.2 | –2.7 | –0.8 |
| Motor vehicle diesel fuel consumption | 5.1 | –3.8 | –7.7 | –10.3 | –5.1 | –3.0 | ... | ... |

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for public holidays.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
(6) Index (without petrol stations) deflated and corrected for calendar effects.
SOURCES: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of Economy and Finances and own calculations.

**Industrial capacity utilization picks up.**

utilization picked up slightly. The prospects for the secondary sector are less morose than a few months ago but are still hindered by low demand and the accumulated problems of competitiveness, made worse by the appreciation of the euro.

The real estate sector is still sluggish. According to figures from the Ministry of Housing, the average price of urban land fell 7.5% in the third quarter compared with the same period of the year before.

Sales of new homes slackened in October. However, the confidence indicator in construction improved in November, although still slightly below the historic average.

With regard to services, recovery in the markets of origin has curbed the decline in the tourist industry. The transport sector also seems to have lessened its drop in business.

The government passed the draft bill for the Sustainable Economy Act, which

aims to promote a change in Spain's economic model over the next decade. It includes a fund of 20,000 million euros to finance the private sector for R&D projects, company internationalization, energy savings and efficiency and the development of social and health services. The Official Credit Institute will provide 10,000 million and financial institutions will be able to fund up to 50% of sustainability projects.

**New Sustainable Economy Act.**

This new Act includes a reform of regulatory bodies, improvements to the supervision of the financial sector, reform of public employment, simplified administration, a reduction in public administration late payments and a number of fiscal measures, of note being the improvement in the fiscal treatment for renting and also reconditioning homes.

Within this context, the prospects for 2010 are that the economy will continue to improve, with positive year-on-year growth possibly appearing by the second half of year. This recovery will be the result not only of the contribution made by the foreign sector but also by the resurgence in consumption. For its part, investment will continue to reduce its rate of decline.

**Economic growth expected to improve.**

# Labour market

## Job losses are slowing up

**Employment is back on the road to recovery.**

After two months in which the fall in unemployment slowed up, in November it was back on the road to recovery. In this month, the number of people registered as employed with Social Security totalled 17,847,669 as a monthly average. This represents a month-on-month drop of 61,276 people but compares favourably with the fall of 197,087 in November 2008.

Overall, in the last twelve months the number of people registered as employed with Social Security fell by 4.7%, a lower figure than that posted in the preceding months. Most employment sectors recorded annual decreases in workers. However, both the special group of self-employed farm workers and that of household workers increased their number of registered workers over the last year, by 7.4% and 1.1%, respectively.

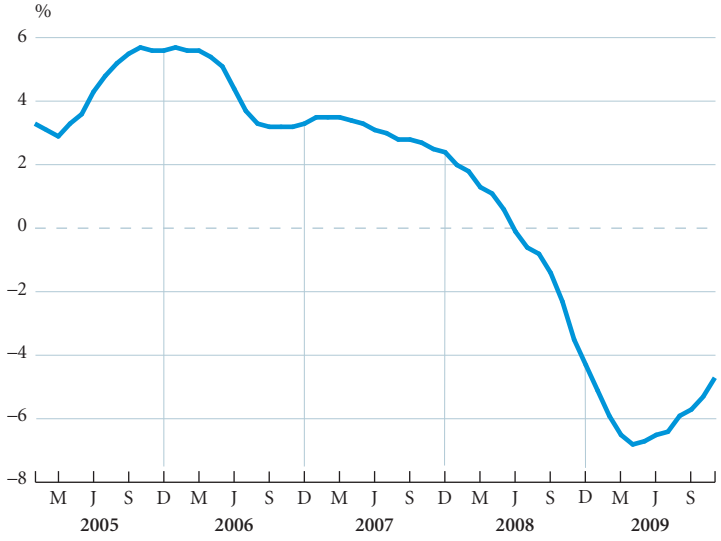
**In November, the subsector creating most jobs is education.**

In November, the subsector creating most jobs was education, up year-on-year by 3.3%, but other branches such as extra-territorial organizations and bodies, public administration, information and communications, electricity and gas, health and social services and scientific and technical professions also grew.

In the last twelve months, apart from farming, which increased its number of workers by 3.9%, the only subsectors posting growth were some branches of services such as extra-territorial organizations and bodies, health and

**THE FALL IN SOCIAL SECURITY REGISTRATIONS IS EASING UP**

Year-on-year change in monthly average of people registered as employed with Social Security




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

## EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

| | 2007 | 2008 | 2008 | 2009 | | | | |
|---|---|---|---|---|---|---|---|---|
| | | | 4Q | 1Q | 2Q | 3Q | October | November |
| **Persons registered with Social Security** (1) | | | | | | | | |
| Sectors of activity | | | | | | | | |
| *Industry* | *2.4* | *–2.1* | *–5.6* | *–9.3* | *–11.5* | *–11.5* | *–10.8* | *–10.0* |
| *Construction* | *3.6* | *–10.3* | *–19.5* | *–25.2* | *–25.4* | *–22.0* | *–20.1* | *–18.6* |
| *Services* | *3.5* | *1.7* | *–0.2* | *–2.1* | *–3.1* | *–3.0* | *–2.6* | *–2.1* |
| Job situation | | | | | | | | |
| *Wage-earners* | *3.1* | *–0.7* | *–3.7* | *–6.3* | *–7.0* | *–6.2* | *–5.4* | *–4.6* |
| *Non-wage-earners* | *2.8* | *0.4* | *–1.9* | *–3.9* | *–5.0* | *–5.3* | *–5.1* | *–5.0* |
| **Total** | **3.0** | **–0.5** | **–3.4** | **–5.9** | **–6.7** | **–6.0** | **–5.3** | **–4.7** |
| **Persons employed** (2) | **3.1** | **–0.5** | **–3.0** | **–6.4** | **–7.2** | **–7.3** | **–** | **–** |
| **Jobs** (3) | **2.8** | **–0.6** | **–3.2** | **–6.3** | **–7.2** | **–7.2** | **–** | **–** |
| **Hiring contracts registered** (4) | | | | | | | | |
| Permanent | 2.0 | –14.3 | –26.0 | –35.4 | –35.3 | –28.6 | –29.8 | –16.8 |
| Temporary | 0.3 | –10.4 | –17.9 | –23.9 | –17.8 | –9.4 | –12.3 | 6.1 |
| **Total** | **0.5** | **–10.9** | **–18.9** | **–25.4** | **–19.9** | **–11.4** | **–14.3** | **3.6** |

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

social services, public administration, domestic services and education. The biggest year-on-year falls were recorded in construction, namely 18.6%, with manufacturing industry down 10.5%.

Employment registrations fell in the month both for men and women, but more markedly for the former. The share of women out of the total employed is therefore still rising, posting a record 44.4%. The same trend has been seen over the last twelve months, namely a drop of 2.4% in women employed and of 6.4% in men, more concentrated in those sectors most affected by the economic crisis. This also meant that the number of foreign nationals registered as employed suffered its biggest annual drop of 6.6%, while Spanish registrations fell by 4.4%.

The easing in the recession led to a 3.6% year-on-year increase in the number of contracts registered in November, the first rise in nineteen months. This was due to a 6.1% annual rise in temporary contracts, since permanent contracts fell by 16.8%.

Employment is expected to improve gradually over the coming months although, overall, it is unlikely to grow until gross domestic product posts significant increases.

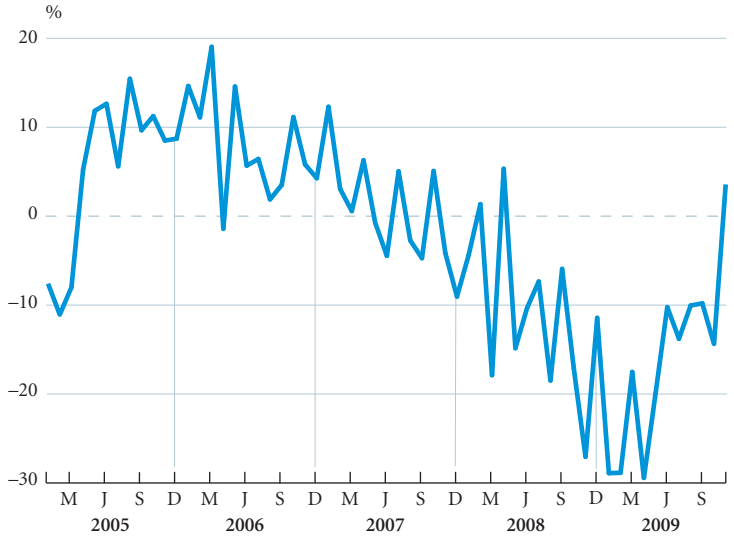
At the beginning of December, the central government announced its intention to promote reforms in the job market as part of social dialogue, including: encouraging shorter working days as an instrument to temporarily adjust employment; changes in the

**Record proportion of women registered as employed with Social Security, at 44.4%.**

**Temporary contracts show positive trends.**

**SIGNS OF DYNAMISM IN THE JOB MARKET**

Year-on-year rate of change in the number of contracts registered at the public employment offices




SOURCES: Public Employment Offices and own calculations.

**Reforms likely in the job market.**

collective bargaining system to improve firms' internal flexibility; revision of the employment contract rebate policy; measures to reduce temporary employment rates and the introduction of effective incentives to prolong working life.

## Less registered unemployment than expected in November

In line with the job losses in November, the ranks of registered unemployed swelled by 60,593 people, up to 3,868,946. However, the monthly rise was lower than expected and slightly less than one year earlier, indicating that unemployment is slowing up. In year-on-year terms, registered unemployment continued to slacken, posting a percentage change of 29.4%.

According to Eurostat data, the unemployment rate continued to rise in October to 19.3% in homogenized terms. Consequently, unemployment in Spain was more than double the average for Europe, placing it second, behind only Latvia.

**The rate of cover for unemployment rises to 75.3%.**

Rising unemployment has led to expanding costs in order to protect the unemployed and these totalled 2,664 million euros in October, an annual increase of 33.0%. The rate of cover rose to 75.3%. On the other hand, foreign beneficiaries accounted for 73.2% of all foreign job-seekers.

## Modest slowdown in labour costs

Statistics from the quarterly labour cost survey for the period July-September show that companies' labour costs have continued to ease. However, this slowdown can be classified as slight, considering the disinflation of prices and rising unemployment. Average labour costs for firms stood at 2,429 euros a month, a rise of 3.3% compared with the same period the previous year.

## REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

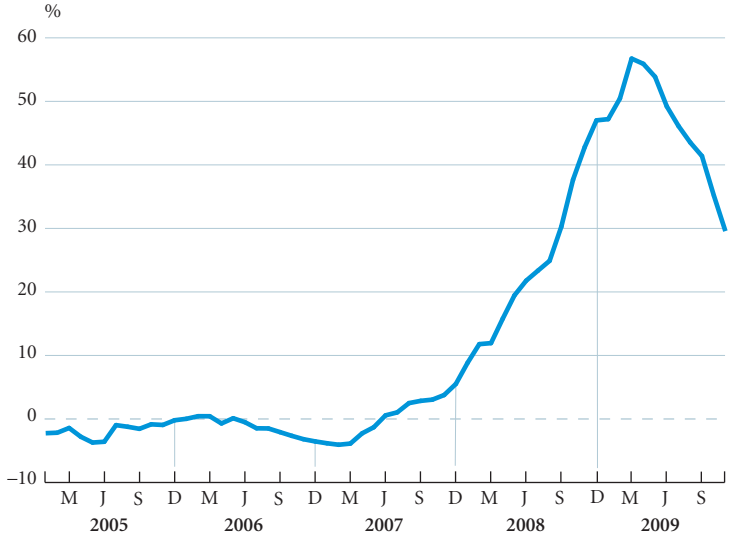
November 2009

| | No. of unemployed | Change over December 2008 | | Change over same period year before | | % share |
|---|---|---|---|---|---|---|
| | | Absolute | % | Absolute | % | |
| **By sector** | | | | | | |
| Agriculture | 110,067 | 34,056 | 44.8 | 33,842 | 44.4 | 2.8 |
| Industry | 497,325 | 83,900 | 20.3 | 112,230 | 29.1 | 12.9 |
| Construction | 726,788 | 69,352 | 10.5 | 143,031 | 24.5 | 18.8 |
| Services | 2,240,863 | 450,588 | 25.2 | 497,693 | 28.6 | 57.9 |
| First job | 293,903 | 102,087 | 53.2 | 92,881 | 46.2 | 7.6 |
| **By sex** | | | | | | |
| Males | 1,940,401 | 363,934 | 23.1 | 492,621 | 34.0 | 50.2 |
| Females | 1,928,545 | 376,049 | 24.2 | 387,056 | 25.1 | 49.8 |
| **By age** | | | | | | |
| Under 25 years | 464,339 | 79,209 | 20.6 | 79,147 | 20.5 | 12.0 |
| All other ages | 3,404,607 | 660,774 | 24.1 | 800,530 | 30.7 | 88.0 |
| **TOTAL** | **3,868,946** | **739,983** | **23.6** | **879,677** | **29.4** | **100.0** |

SOURCES: Public Employment Offices and own calculations.

## THE RISE IN REGISTERED UNEMPLOYMENT SLOWS UP

Year-on-year rate of change in the total number of registered unemployed




SOURCES: Public Employment Offices and own calculations.

Salary costs totalled 1,776 euros on average, a year-on-year increase of 3.1%. Ordinary salary, excluding extraordinary and deferred payments, was 1,622 euros per worker and month, 3.0% more than in the third quarter of 2008. Non-salary

## WAGE INDICATORS

Percentage rate of change over same period year before

| | 2007 | 2008 | 2008 | | 2009 | | |
|---|---|---|---|---|---|---|---|
| | | | 3Q | 4Q | 1Q | 2Q | 3Q |
| **Increase under general wage agreements** (*) | **3.1** | **3.6** | **3.5** | **3.6** | **2.7** | **2.7** | **2.6** |
| **Wage per job equivalent to full-time work** (**) | **4.5** | **6.1** | **6.2** | **6.0** | **4.5** | **4.7** | **3.9** |
| **Quarterly labour cost survey** | | | | | | | |
| Wage costs | | | | | | | |
| Total | 4.0 | 5.1 | 5.3 | 4.8 | 2.9 | 4.1 | 3.1 |
| *Industry* | *3.4* | *4.8* | *4.5* | *4.5* | *1.2* | *2.5* | *2.0* |
| *Construction* | *4.6* | *6.3* | *6.1* | *6.6* | *4.5* | *5.8* | *4.8* |
| *Services* | *4.2* | *5.0* | *5.4* | *4.7* | *3.0* | *4.3* | *3.2* |
| Average wages per hour worked | 4.5 | 4.9 | 6.0 | 2.7 | 2.4 | 9.8 | 3.9 |
| Other labour costs | 4.1 | 4.1 | 3.5 | 5.8 | 7.8 | 3.6 | 3.9 |
| Work day (***) | –0.5 | 0.1 | –0.6 | 2.0 | 0.4 | –5.1 | –0.8 |
| **Farm wages** | **3.1** | **5.1** | **6.1** | **4.5** | **3.2** | **4.0** | **0.3** |
| **Labour cost in construction** | **2.4** | **5.7** | **7.6** | **7.9** | **7.5** | **4.3** | **3.7** |

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

**Construction posts the highest increases in labour costs.**

costs rose 3.9% year-on-year while their main component, mandatory Social Security contributions, increased by 2.8%. Non-salary payments were up 12.0% due to the rise in redundancy pay and company benefits paid by employers.

Construction was the sector with the highest increases, both in terms of labour costs and ordinary wages and redundancy costs and compensation for terminated contracts. Industry posted the lowest salary growth of 2.0% due mostly to the high number of temporary measures to adjust employment conditions that are taking place in the sector.

Labour costs per effective hour worked totalled 19.55 euros, a year-on-year increase of 4.2%, slightly higher than in the European Union. This increase, greater than the rise in cost per worker, is due to a 0.8% fall in the number of effective hours worked.

The average gain per worker and month of 3.1% was notably higher than inflation for the period and workers' purchasing power therefore increased by 4.2% in annual and real terms, 6 tenths of a percentage point more than in the previous quarter.

Other salary indicators, such as raises contained in labour agreements and labour costs in construction, also show signs of deceleration in the third quarter. However, this slowdown is very moderate, with the exception of the daily wages for farm workers, which posted an annual rise of 0.3%, 3.7 points less than in the previous quarter.

# Prices

## Inflation returns to positive figures

After eight months of negative year-on-year change, the consumer price index (CPI) increased 0.3% in the month of November 2009 compared with the same month the year before. This year-on-year rate therefore rose by one percentage point compared with the previous month, thereby fulfilling the forecasts that inflation would return to positive figures towards the end of the year.

The upswing in inflation in the last few months was boosted by the energy component. Specifically, fuels contributed 9 tenths of a percentage point to the increase in the year-on-year percentage change in the CPI in November, rising 2.6% this month compared with a fall twelve months before.

**The upswing in prices is boosted by fuels and oils.**

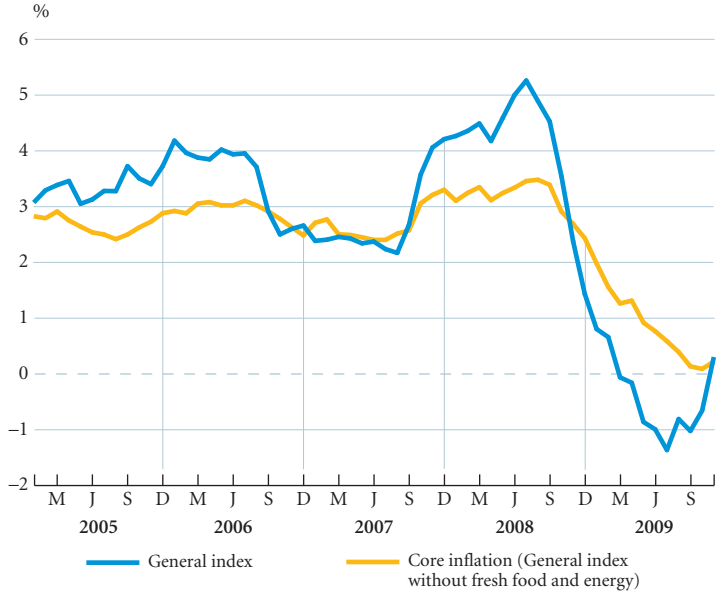
However, the contribution of the other volatile component of the CPI, fresh foods, was marginally negative. Their year-on-year percentage change fell 0.15 percentage points, posting a drop of 2.7%. In fact, the rises in some foods such as pork and fish were counteracted by falls in others, such as lamb and mutton, chicken and fresh fruit.

The most stable core of inflation, also known as underlying inflation,

**Slight decline in fresh foods.**

**GENERAL INFLATION IS HIGHER THAN CORE INFLATION FOR THE FIRST TIME IN MORE THAN ONE YEAR**

Year-on-year rate of 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 | 1.0 | –0.1 | –0.2 |
| May | 0.7 | 2.2 | 4.6 | 0.0 | –0.1 | –0.9 |
| June | 0.6 | 2.8 | 5.0 | 0.4 | 0.3 | –1.0 |
| July | –0.5 | 2.3 | 5.3 | –0.9 | –0.5 | –1.4 |
| August | –0.2 | 2.1 | 4.9 | 0.3 | –0.2 | –0.8 |
| September | 0.0 | 2.0 | 4.5 | –0.2 | –0.4 | –1.0 |
| October | 0.3 | 2.4 | 3.6 | 0.7 | 0.3 | –0.7 |
| November | –0.4 | 2.0 | 2.4 | 0.5 | 0.8 | 0.3 |
| December | –0.5 | 1.4 | 1.4 | | | |

SOURCE: National Institute of Statistics.

**Slight upswing in core inflation to 0.2%.**

which excludes unprocessed foods and energy products, rose by one tenth of a percentage point in November and stood at 0.2% year-on-year. It therefore increased for the first time in half a year. To a certain extent, this turnabout reflects the improved economic situation as the recession eases.

**Inflation would be flat without the higher taxes.**

The slight upswing in core inflation is actually attributable to non-energy industrial products. These prices slowed up, although their year-on-year decrease was 1.7%, 3 tenths of a percentage point less than one month earlier. This slowdown was mostly due to clothing and footwear, which contributed almost one tenth of a percentage point to the increase in the CPI year-on-year rate, picking up after sharper falls than those of a year ago.

**Favourable inflation differential with the euro area falls to 0.1%.**

On the other hand, processed foods accelerated very slightly, with a moderate annual increase of 0.5%. Rises in oils and milk were largely offset by other falls, such as dairy products. For their part, the year-on-year change in service prices held steady at 1.6%, the lowest for the last few decades.

It should be noted that prices would have remained at the same level as last year had it not been for special tax increases on tobacco and hydrocarbons in June 2009. This is deducted from the percentage annual change in the harmonized consumer price index for constant taxes, which in September and October was 3 tenths of a percentage point different from the harmonized general index.

The EU harmonized consumer price index (EU HCPI) increased 0.4% in 12-month terms, a rise of one point compared with the previous month's rate. Consequently, the differential with the euro area, favourable to Spain, fell to one tenth of a percentage point, 0.8 less than the maximum recorded in the month of May.

## CONSUMER PRICE INDEX BY COMPONENT GROUP

November

| | Indices (*) | % monthly change | | % change over previous December | | % monthly change | |
|---|---|---|---|---|---|---|---|
| | | 2008 | 2009 | 2008 | 2009 | 2008 | 2009 |
| **By type of spending** | | | | | | | |
| Food and non-alcoholic beverages | 107.8 | 0.0 | 0.0 | 2.2 | –2.6 | 3.1 | –2.4 |
| Alcoholic beverages and tobacco | 126.1 | 0.1 | 0.0 | 3.9 | 12.8 | 4.0 | 12.8 |
| Clothing and footwear | 109.3 | 3.4 | 4.5 | 1.8 | 0.4 | 0.8 | –0.9 |
| Housing | 112.5 | –0.2 | 0.3 | 6.4 | 0.8 | 6.6 | 0.3 |
| Furnishings and household equipment | 107.4 | 0.4 | 0.2 | 2.5 | 0.7 | 2.8 | 0.9 |
| Health | 97.5 | 0.1 | 0.0 | 0.4 | –1.3 | 0.5 | –1.4 |
| Transport | 103.8 | –4.1 | 1.1 | –2.3 | 4.4 | –1.5 | 0.9 |
| Communications | 99.3 | –0.1 | 0.0 | 0.2 | –0.3 | 0.0 | –0.8 |
| Recreation and culture | 97.3 | –0.9 | –0.7 | –1.1 | –2.5 | 0.3 | –1.1 |
| Education | 114.4 | –0.4 | 0.1 | 3.9 | 2.6 | 4.0 | 2.7 |
| Restaurants and hotels | 111.8 | –0.3 | –0.3 | 4.0 | 1.2 | 4.5 | 1.2 |
| Other goods and services | 109.7 | 0.0 | 0.1 | 3.4 | 2.0 | 3.6 | 2.1 |
| **By group** | | | | | | | |
| Processed food, beverages and tobacco | 111.7 | 0.0 | 0.1 | 3.1 | 0.6 | 3.6 | 0.5 |
| Unprocessed food | 106.5 | 0.1 | –0.1 | 1.0 | –3.3 | 2.5 | –2.7 |
| Non-food products | 106.9 | –0.6 | 0.7 | 1.8 | 1.2 | 2.1 | 0.5 |
| Industrial goods | 103.6 | –0.9 | 1.5 | 0.3 | 1.1 | 0.4 | –0.6 |
| *Energy products* | *107.9* | *–6.6* | *1.9* | *–1.6* | *8.2* | *–0.5* | *1.9* |
| *Fuels and oils* | *103.1* | *–8.8* | *2.6* | *–5.4* | *8.8* | *–4.0* | *0.1* |
| *Industrial goods excluding energy products* | *101.8* | *1.0* | *1.4* | *0.9* | *–1.3* | *0.6* | *–1.7* |
| Services | 110.4 | –0.2 | –0.2 | 3.4 | 1.3 | 4.0 | 1.6 |
| Underlying inflation (**) | 107.6 | 0.3 | 0.4 | 2.5 | 0.2 | 2.7 | 0.2 |
| **GENERAL INDEX** | **107.8** | **–0.4** | **0.5** | **2.0** | **0.8** | **2.4** | **0.3** |

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

### The fall in wholesale prices eases

The year-on-year fall in wholesale prices has slowed up over the last few months. This reflects the trend in commodity prices that, after plummeting in 2008, have seen a moderate upswing.

Import prices slowed down their year-on-year drop to 7.2% in October, 2 points less than the previous month, in spite of the appreciation of the euro. This slowdown was due to lower drops in energy prices and intermediate goods. Meanwhile capital equipment prices moderated with a slight year-on-year rise of 0.9% and consumer goods accentuated their fall to 2.1% annual.

Lastly, in September farm prices at source continued to put the brakes on their year-on-year drop after having

**Slight recovery in prices for agricultural and animal products.**

slumped at the start of the summer. This was due to arable and animal products such as milk, since meat products increased their decline to 3.6% year-on-year.

**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 (**) | |
| **2008** | | | | | | | | | | | |
| September | –0.8 | 8.3 | 4.1 | 2.4 | 7.1 | 19.9 | 8.5 | 1.9 | 0.6 | 5.9 | – |
| October | –7.6 | 6.1 | 2.8 | 2.4 | 5.3 | 14.9 | 5.2 | 3.2 | 1.3 | 5.1 | – |
| November | –10.5 | 2.9 | 2.2 | 2.3 | 2.9 | 4.3 | 0.9 | 4.3 | 1.9 | 5.0 | 1.7 |
| December | –10.3 | 0.4 | 1.6 | 2.3 | 1.0 | –3.4 | –3.9 | 2.6 | 1.6 | 2.0 | – |
| **2009** | | | | | | | | | | | |
| January | –7.2 | –0.5 | 0.9 | 1.9 | –1.6 | –2.2 | –4.9 | 2.8 | 2.0 | 0.4 | – |
| February | –5.4 | –1.1 | 0.4 | 1.6 | –3.2 | –1.9 | –5.6 | 3.0 | 2.6 | –1.2 | 1.4 |
| March | –7.1 | –2.5 | –0.4 | 1.3 | –4.3 | –5.0 | –6.9 | 2.6 | 3.1 | –2.7 | – |
| April | –7.7 | –3.4 | –0.8 | 1.2 | –5.5 | –6.8 | –7.4 | 2.5 | 3.1 | –3.7 | – |
| May | –15.1 | –4.4 | –1.1 | 1.1 | –6.3 | –9.8 | –9.9 | 1.7 | 2.5 | –5.4 | 0.2 |
| June | –17.2 | –4.9 | –1.3 | 0.9 | –6.9 | –10.1 | –10.8 | 1.3 | 2.4 | –5.9 | – |
| July | –17.9 | –6.7 | –1.3 | 0.5 | –7.8 | –16.0 | –11.4 | 2.0 | 2.3 | –7.0 | – |
| August | –14.8 | –5.5 | –0.9 | 0.3 | –7.7 | –11.5 | –9.8 | 0.6 | 2.0 | –7.2 | –0.4 |
| September | –14.0 | –5.4 | –0.7 | 0.4 | –7.5 | –11.5 | –9.2 | –0.5 | 1.6 | –7.5 | – |
| October | ... | –4.2 | –0.6 | 0.2 | –6.3 | –8.2 | –7.2 | –2.1 | 0.9 | –6.6 | – |

NOTES: (*) Data adjusted for seasons and public holidays.
(**) Except energy.
SOURCES: National Institute of Statistics, Ministry of Economy and own calculations.

## Moderate price rises in Spain

The average inflation for consumer prices in 2009 will be negative for the first time in the last few decades, compared with the 4.1% average of last year. But this average obscures the marked fluctuation occurring throughout 2009. The slowdown in prices started in August 2008 continued during the early part of 2009, up to the biggest year-on-year drop in consumer prices of recent decades, namely 1.4% in July 2009. But from then on there was an upswing so that, in November, year-on-year inflation returned to positive figures at 0.3%. Will it also be negative in 2010? No, as discussed in the rest of the box, but it will remain at a low level.

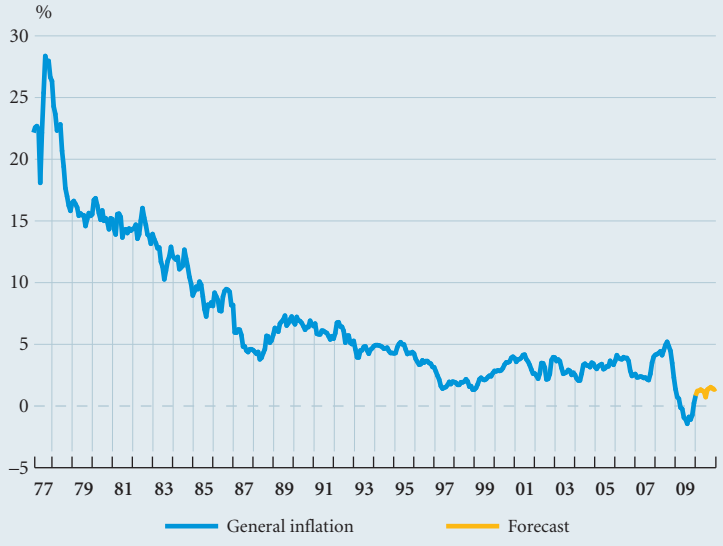
The ups and downs of the inflation rate have been strongly affected by the trends in the energy component, which closely mirrors variations in oil prices. After a record high of 147 dollars per barrel in July 2008, the price of crude slumped to 37 dollars in December of the same year, but since then has tended to pick up again,

going above 70 dollars per barrel in November and December 2009. It's reasonable to predict a rise in the price of this black gold in 2010 due to the surge in the world economy. However, this recovery will probably be gradual and, given the worldwide surplus capacity in crude production, we don't expect any sharp rises in oil prices. Overall, energy prices will probably boost the general consumer price index.

But energy isn't the only component that introduces an element of uncertainty into the inflation trends for 2010, as unprocessed food prices are also a highly volatile component, being strongly affected by international commodity markets. With the information currently available, it seems that these prices will continue to recover, albeit moderately.

**INFLATION AT LOW LEVELS AFTER ITS RECORD LOW FOR THE LAST FEW DECADES**

Year-on-year change in the general index




NOTE: Real data up to November 2009.
SOURCES: National Institute of Statistics and own calculations.

And what's happening with the more stable core of prices, also known as underlying inflation, which excludes unprocessed foods and energy products? Throughout 2009 this has gradually fallen to close to 0% in September and October, forced down by the squeeze on family consumption. However, in November it picked up to 0.2% and might have bottomed out with the slight improvement in the economic situation. In 2010 it will probably recover slightly.

Another element to take into account in price trends for 2010 is the expected rise in value added tax as from July. An increase of 2 points from 16% to 18% in the general rate and of one point in the reduced rate, from 7% to 8%, represents a theoretical increase in inflation for consumer prices of 1.2 points, if these rises are passed on to prices in their entirety. However, this is not likely to happen given the weakness of demand, so the effect will probably only be half this figure, the rest being absorbed by smaller business margins.

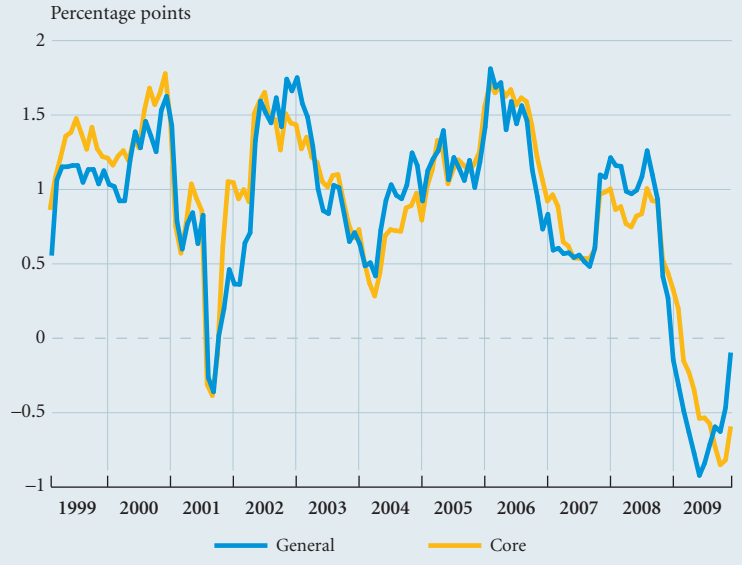
From the point of view of costs, competitive pressure in an environment of decreasing consumption has led to the diminished business margins, as many companies have decided to cut prices to stop their sales from falling. Salary statistics also show a slowdown, although this is very slight considering the extent of the recession and rising unemployment. So what will happen in 2010? The weak economy will continue to restrain companies' margins, while salaries will probably slow up, especially taking into account the fact that they will be based on a lower past inflation rate.

Consequently, more moderate costs, together with improved productivity, might mean that the inflation differential with the euro area, Spain's main trading partner, will not deteriorate noticeably. This differential has been favourable for the Spanish economy since December 2008, representing a gain in price competitiveness. However, after a record 0.9 percentage points in May, this differential has tended to shrink.

In conclusion, although prices have picked up since July 2009 and will probably end the year at around 1%, competitive pressure in international markets within a context of globalization and surplus industrial capacity, and also the slight improvement in the economy, will keep inflation restrained. Consequently, and as part of the adjustment in the Spanish economy, prices will continue to reflect the weakness in demand and inflation will continue at low levels, although the trends in commodity prices are somewhat uncertain.

**THE CORE INFLATION DIFFERENTIAL WITH THE EURO AREA IS NEGATIVE**

Difference in the year-on-year rate of change in harmonized CPI between Spain and the euro area




NOTE: Up to November 2009.
SOURCES: National Institute of Statistics, Eurostat and own calculations.

*This box was prepared by Pere Miret*
*European Unit, "la Caixa" Research Department*

# Foreign sector

## Current deficit continues to fall

The current deficit for the month of September was 4,400 million euros, 45.6% lower than the same month in 2008, representing the fourteenth year-on-year drop in fifteen months. This meant that the current imbalance accumulated over the last twelve months fell by 40.6% compared with the previous year, totalling 65,270 million euros, equivalent to 6.2% of gross domestic product (GDP). Although still high, this figure is more than four percentage points lower than the maximum reached in June 2008. This falling trend in the deficit is expected to gradually diminish over the last months of 2009, ending up between 5.0% and 5.5% of GDP.

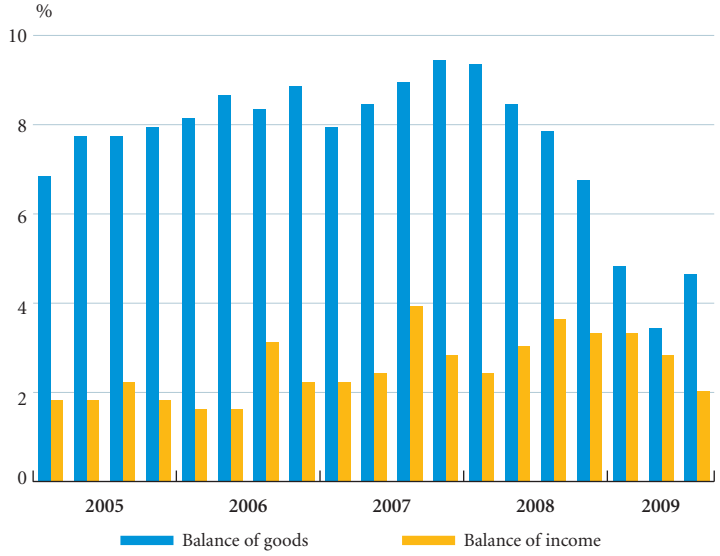
**Current balance deficit falls in September to 6.2% of GDP.**

Although this new drop in the current balance is in line with the others recorded in 2009, differences can be observed in how its components have fared. During the first half of the year, the drop in current imbalance was caused almost entirely by changes in the trade deficit. However, the reduction in the income balance deficit in the third quarter, namely 4,803 million euros, accounted for more than a third of the adjustment in the current imbalance thanks to the strong reduction in salary paid abroad. The following graph clearly shows this shrinkage in the income balance in the third quarter.

**Income balance deficit is lower in the third quarter.**

**INCOME BALANCE DRIVES THE CHANGES IN THE CURRENT DEFICIT IN THE THIRD QUARTER**

Accumulated quarterly deficit related to GDP




SOURCES: Ministry of the Economy and own calculations.

## BALANCE OF PAYMENTS

September 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 | –33,847 | –51.3 | –52,045 | 42,834 | –45.1 |
| Services | | | | | |
| *Tourism* | *21,090* | *–7.7* | *26,295* | *–2,118* | *–7.5* |
| *Other services* | *–944* | *–42.1* | *–1,116* | *1,679* | *–60.1* |
| Total | 20,147 | –5.1 | 25,180 | –439 | –1.7 |
| Income | –21,340 | –14.0 | –30,297 | 2,171 | –6.7 |
| Transfers | –7,342 | –13.3 | –8,107 | –31 | 0.4 |
| **Total** | **–42,382** | **–48.0** | **–65,270** | **44,535** | **–40.6** |
| **Capital account** | **2,653** | **–45.1** | **3,325** | **–3,812** | **–53.4** |
| **Financial balance** | | | | | |
| Direct investment | –227 | – | –8,832 | –637 | 7.8 |
| Portfolio investment | 20,623 | 3.2 | 4,394 | –2,842 | –39.3 |
| Other investment | 2,620 | –92.2 | 37,509 | –30,574 | –44.9 |
| **Total** | **23,016** | **–58.4** | **33,071** | **–34,053** | **–50.7** |
| Errors and omissions | 195 | – | 4,405 | 2,151 | 95.5 |
| Change in assets of Bank of Spain | 16,518 | –25.5 | 24,470 | –8,822 | –26.5 |

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

**Financing needs at similar levels to 2005.**

In addition to the smaller fall in the deficit for the balance of goods, due to a similar decline in both imports and exports, and to the compensating effect of the income balance, of note is the 3.3% reduction in the surplus of the services balance compared with September 2008. This is the result of the decline in the tourism component, where the drop in revenue was greater than the drop in payments, although they posted lower year-on-year falls of 10.0% and 16.0% respectively.

In spite of the shrinkage in the capital account surplus, which came very close to zero, the improved current deficit reduced financing needs by 43.2% in September 2009 compared with the same month last year. Over a timescale of twelve months, financing needs fell by 39.7%, reverting to levels similar to those of 2005 in relation to GDP (5.8%). From the perspective of institutional sectors, this reduction was caused by trends in household and corporate net savings, which offset the higher government debt over the last year.

Consequently, the economy's two main sources of financing saw significant reductions. On the one hand, the net liabilities of the Bank of Spain fell during the first nine months of the year by 25.5% due to banks resorting less to the liquidity auctions of the European Central Bank.

However, funds taken up by resident sectors fell further in this period, by 58.4%. The biggest change was in short-term investment with a drop of 92.2%. This highlights how traditional credit markets are getting back to normal, leaving behind the financial turbulence that appeared as a result of the subprime crisis. The main net inflows of capital in this period came from portfolio investments due to the increase in entries of funds from abroad.

**Short-term investment falls 92% in the first nine months of 2009.**

# Savings and financing

**12-month Euribor hits a new record low in its monthly average for November and may have touched bottom.**

## Families and firms are coming out of debt

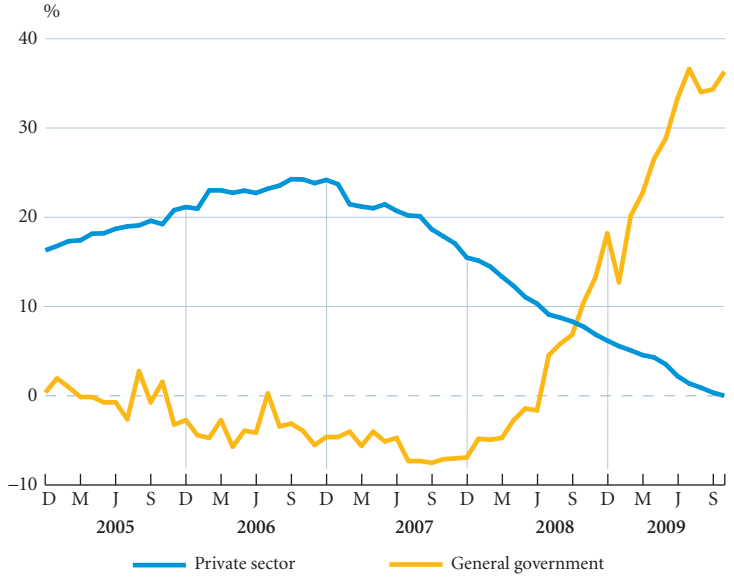
The 12-month Euribor, widely used as a reference rate, set a new record in the month of November by falling to 1.23%, one basis point less than the previous month and 312 less than a year earlier. The 12-month Euribor therefore reflects the progressive fall in the official European Central Bank interest rate to 1% last May and the gradual reduction in interbank risk premium as markets tend to get back to normal. However, during the first few weeks of December and after the announcement that the European monetary authority will gradually withdraw its extraordinary measures to inject liquidity, the 1-year Euribor has wavered a little above November's rate.

Interest rates for loans and credit in the private sector continued to fall in October in line with the drops in interbank interest rates. Consequently, the average interest rate stood at 3.44%, 312 basis points less than twelve months before.

However, the financing of firms and families was still weak due to the recessive economic situation and balance adjustments, as debt had reached very high levels. Consequently, and for the first time in this cycle, the year-on-year

**SLIGHT DROP IN PRIVATE SECTOR FINANCING**

Year-on-year percentage change in the financing of non-financial resident sectors




SOURCE: Bank of Spain.

## FINANCING OF NON-FINANCIAL SECTORS (1)

October 2009

| | Balance | Change this year | Change over 12 months | | % share |
|---|---|---|---|---|---|
| | Million euros | Million euros | Million euros | % (2) | |
| Private sector | 2,206,321 | –10,833 | –3,969 | –0.1 | 84.7 |
| Non-financial corporations | 1,302,937 | –3,682 | 2,075 | 0.0 | 50.0 |
| *Resident credit institution loans (3)* | *922,762* | *–31,373* | *–30,041* | *–2.8* | *35.4* |
| *Securities other than shares* | *50,839* | *9,776* | *11,577* | *29.5* | *2.0* |
| *External loans* | *329,336* | *17,915* | *20,539* | *5.0* | *12.6* |
| Households (4) | 903,385 | –7,152 | –6,043 | –0.2 | 34.7 |
| *Housing loans (3)* | *676,774* | *–1,675* | *–641* | *0.1* | *26.0* |
| *Other (3)* | *223,923* | *–5,790* | *–5,743* | *–1.2* | *8.6* |
| *External loans* | *2,688* | *313* | *341* | *14.6* | *0.1* |
| General government | 398,826 | 68,680 | 106,396 | 36.4 | 15.3 |
| **TOTAL** | **2,605,148** | **57,848** | **102,428** | **4.2** | **100.0** |

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

financing rate for the private sector was slightly negative. This situation is similar to that of the euro area as a whole, where private sector loans fell 0.8% year-on-year in October.

The financing of non-financial firms saw no change in October compared with twelve months before, while resident financial institution loans fell by 2.8% compared with a year ago. This drop was offset by the 29.5% year-on-year rise in bond issuance and 5.0% rise in foreign loans. Large firms continued to take advantage of improved market conditions to obtain funding.

Credit trade, aimed at financing firms' working capital, continued weak, with a year-on-year drop of 32.7% in October. Financial leases, used to fund investment, did not perform well either, with a drop of 16.6% compared with October 2008.

By sector, with data covering up to the end of the third quarter, it can be seen that the slowdown in credit is widespread. Construction is the sector with the highest year-on-year drop, down 14.3%, followed by the primary sector with a fall of 11.3%. Credit to industry, strongly affected by the crisis, was also down 1.6% compared with twelve months ago whereas credit to services was 2.8% higher than twelve months ago, although this rate of change is still 9.5 points lower than last year. In the tertiary sector, real estate showed similar annual growth of 2.9%, 5 points less than twelve months before.

**Credit trade still sluggish.**

The effective flow of financing to households in October was positive, totalling 776 million euros, although this still fell slightly in year-on-year terms with a drop of 0.2%. Credit to housing was up a little by 0.1% compared with twelve months before, while the rest of

**Credit is shrinking in all large sectors except services.**

## CREDIT TO PRIVATE SECTOR BY PURPOSE

Third quarter of 2009

| | Balance (*) | Change this year | | Change over 12 months | |
|---|---|---|---|---|---|
| | Million euros | Million euros | % | Million euros | % |
| **Financing of production activities** | | | | | |
| Agriculture, livestock raising and fishing | 23,576 | –2,668 | –10.2 | –3,017 | –11.3 |
| Industry | 153,070 | –3,071 | –2.0 | –2,411 | –1.6 |
| Construction | 134,045 | –17,803 | –11.7 | –22,318 | –14.3 |
| Services | 685,959 | 3,244 | 0.5 | 18,727 | 2.8 |
| **Total** | **996,650** | **–20,297** | **–2.0** | **–9,020** | **–0.9** |
| **Financing to individuals** | | | | | |
| Acquisition and renovation of own home | 652,434 | –2,711 | –0.4 | 476 | 0.1 |
| Acquisition of consumer durables | 49,840 | –4,336 | –8.0 | –6,019 | –10.8 |
| Other financing | 107,719 | –2,373 | –2.2 | –1,219 | –1.1 |
| **Total** | **809,993** | **–9,419** | **–1.1** | **–6,762** | **–0.8** |
| **Financing to private non-profit institutions** | **5,457** | **–634** | **–10.4** | **–606** | **–10.0** |
| **Other unclassified** | **33,910** | **6,479** | **23.6** | **9,835** | **40.9** |
| **TOTAL** | **1,846,010** | **–23,872** | **–1.3** | **–6,553** | **–0.4** |

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

**Consumption credit down more than 10%.**

financing fell by 1.2%. The larger credit squeeze was for the purchase of consumer durables, such as automobiles, motorbikes, furniture, etc., which fell 10.8% in September compared with the same month in 2008. This is the result of lower demand together with relatively high interest rates of 11.0% that include a higher risk premium due to the rise in bad debt, although these fell to 10.2% in October.

The default rate for credit institutions has tended to rise since 2007 and reached 5.0% in the month of October. By component, and with data covering up to September, it can be seen that the default rate for mortgage-backed housing purchases fell to 3.0%. However, both the rate for real estate activities, namely 8.7%, and that for consumer durable acquisitions, 7.8%, were above the average.

**Default rate up to 5% in October.**

Lastly, net financing for general government continued to expand strongly, posting a year-on-year increase of 36.4% in October. However, this rise only partially offset the slowdown in the private sector, so that the overall financing to non-financial sectors continued to slow up to 4.2% year-on-year.

### On demand deposits perk up

The yields on bank deposits in the private sector stood at 1.27% on average in October, 2 basis points higher than the previous month but 208 less than twelve months before, reflecting the cuts in the official interest rate for the euro area. However, the average return was slightly above inflation for the period.

## BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

October 2009

| | Total | Change this year | | Change over 12 months | | % share |
|---|---|---|---|---|---|---|
| | Million euros | Million euros | % | Million euros | % | |
| On demand deposits | 256,352 | 11,540 | 4.7 | 21,379 | 9.1 | 18.3 |
| Savings deposits | 200,143 | 20,366 | 11.3 | 27,473 | 15.9 | 14.3 |
| Term deposits | 714,612 | –14,660 | –2.0 | 8,292 | 1.2 | 51.0 |
| Deposits in foreign currency | 23,684 | –5,633 | –19.2 | –11,399 | –32.5 | 1.7 |
| **Total deposits** | **1,194,791** | **11,612** | **1.0** | **45,744** | **4.0** | **85.3** |
| **Other liabilities** (*) | **206,237** | **–42,392** | **–17.1** | **–44,741** | **–17.8** | **14.7** |
| **TOTAL** | **1,401,028** | **–30,781** | **–2.1** | **1,003** | **0.1** | **100.0** |

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

Within this context, and given the weak economy, bank deposits continued to moderate slightly to a year-on-year rate of 4.0%. On demand deposits soared with a year-on-year rise of 9.1%, 5.9 points more than in September. This acceleration can be explained by a greater preference for liquidity by savers, given the uncertainty regarding how the economy will perform in the future and rising unemployment. Savings deposits also rose 15.9% compared with twelve months before whereas time deposits, directly affected by competition from other financial products, slowed down to a growth of just 1.2%.

In November, mutual fund assets continued to rise, totalling 163,026 million euros at the end of the month with a 0.6% year-on-year increase. This can be attributed to the gains generated by the good performance of the financial markets, as net withdrawals were recorded totalling 382 million euros, albeit the lowest for the year. However, the number of participants rose for the second consecutive time in the year, up to 5,617,987, and the average annual yield went up to 4.4%.

**Mutual fund assets continue to rise and their average annual return goes up to 4.4%.**

On the other hand, direct insurance premiums increased by 0.6% in January-September compared with the same period the previous year. This increase was due to premiums from the life assurance branch, up 4.9% in year-on-year terms, as premiums from the other branches fell 2.9%, of note being the drop of 6.2% for vehicles.

**Slight growth accumulated for direct insurance premiums up to September.**

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**As of December 31, 2008**

| 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 and research | 30 |
| **TOTAL BUDGET** | **500** |





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