

# Monthly Report



## COMPETITIVENESS, THE MAGIC WORD

*Recipes for competitiveness: similar ingredients, different cuisine* [Page 18](#)

How do countries try to improve their competitiveness?

*Private equity and competitiveness* [Page 40](#)

A developed venture capital market means greater innovation and more start-ups

*A silent devaluation?* [Page 50](#)

Job losses in Spain seem to result in improved productivity and competitiveness abroad

*Exporting firms: scarce and valuable* [Page 60](#)

Exporting firms differ, and substantially, from non-exporting firms

# Forecast

% change over same period year before unless otherwise noted

	2008	2009	2010	2009			
				1Q	2Q	3Q	4Q
<b>INTERNATIONAL ECONOMY</b>				<b>Forecast</b>			
<b>Gross domestic product</b>				<b>Forecast</b>			
United States	0.4	-2.4	2.8	-3.3	-3.8	-2.6	0.1
Japan	-1.2	-5.3	1.3	-8.6	-6.0	-4.7	-1.7
United Kingdom	0.5	-4.8	1.2	-5.2	-5.8	-5.1	-3.2
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
<b>Consumer prices</b>				<b>Forecast</b>			
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	2.2	2.3	3.0	2.1	1.5	2.1
Euro area	3.3	0.3	1.2	1.0	0.2	-0.4	0.4
Germany	2.6	0.3	1.1	0.8	0.3	-0.2	0.4
France	2.8	0.1	1.2	0.7	-0.2	-0.3	0.2
<b>SPANISH ECONOMY</b>				<b>Forecast</b>			
<b>Macroeconomic figures</b>				<b>Forecast</b>			
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
<b>Gross domestic product</b>	<b>0.9</b>	<b>-3.6</b>	<b>-0.4</b>	<b>-3.2</b>	<b>-4.2</b>	<b>-4.0</b>	<b>-3.1</b>
<b>Other variables</b>				<b>Forecast</b>			
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	18.8
Consumer price index	4.1	-0.3	1.3	0.5	-0.7	-1.1	0.1
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	-11.4	-9.9	-0.5	-15.1	-7.1	
<b>FINANCIAL MARKETS</b>				<b>Forecast</b>			
<b>International interest rates</b>				<b>Forecast</b>			
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	3.4
10-year German bonds	4.0	3.3	3.4	3.1	3.4	3.3	3.2
10-year bonds	4.4	4.0	3.8	4.1	4.1	3.9	3.7
<b>Exchange rate</b>				<b>Forecast</b>			
\$/Euro	1.48	1.39	1.41	1.30	1.36	1.43	1.48

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## Competitiveness, the magic word

When a businessman was asked what the term «competitiveness» meant, his reply was simple but accurate: it's the difference between being in or out of the market. In the past, a large array of regulations and economies with much more state intervention meant that not very competitive firms could survive, even with brilliant results. This is no longer possible in market economies that are increasingly more open to international competition and the effort to remain competitive is undoubtedly the main thing that keeps business managers awake at night.

How can a firm manage to keep ahead of the competition? To start with, by optimizing costs, investment and production processes, as well as having suitable financing and human resource policies. But that's not enough. Nowadays, innovation is increasingly vital, both via research and development to generate new goods and services as well as by promoting new management or business focuses. Apple or Google would now be the paradigms of innovative firms and bear out the fact that, to remain at the top, you have no choice but to lead in terms of innovation, so as not to be devoured by your rivals.

But you don't have to be one of the technological elite to be the best in terms of competitiveness. Export capacity is perhaps the most visible sign of a company's competitive strength. And it's not easy. In the United States, scarcely 4% of its five and a half million firms are capable of exporting, while in Germany this figure rises to 12% and in Spain it's around 6%. These are delicate comparisons as the figures are affected by an economy's size and openness. However, exporting firms differ in that they are larger than average, are more capital-intensive, have higher productivity and pay better wages. These characteristics can also be found in firms that are perhaps less oriented towards foreign markets or in service companies, but whose competitiveness still stands out.

Can we extend this idea of corporate competitiveness to countries? Nobel prizewinner Paul Krugman believes we can't, and that the growing obsession of advanced countries with international competitiveness is misguided because a country can't evaluate itself based simply on its global market share and because, if it does, this can lead to flawed or even dangerous policies. But in practice the preoccupation with international competitiveness is more than present on finance ministers' agendas. Moreover, analyses regularly appear on the competitive capacity of economies, such as those produced by the World Economic Forum, the Institute for Management Development and the European Commission, which grab the headlines and are a kind of assessment of government management.

However, these rankings go way beyond the recording of a country's exports and global market share, analyzing a whole range of elements that underpin a nation's competitive capacity: the quality of its institutions, health, education, macroeconomic stability, capacity to innovate, the quality of its infrastructures and the efficiency of its financial sector, etc. Ultimately, if a country gets good marks in the chosen parameters, then a breeding ground is very likely to have formed within this country that encourages the emergence of firms of excellence that, whether or not they export, will boost the income, wealth and prosperity of everyone.

## EXECUTIVE SUMMARY

### **The US economy consolidates its recovery...**

**...although evidence suggests it will be quite fragile.**

### **The euro area's exit from recession is following a similar course.**

#### **One recovery, different speeds**

The crossroads at which the economies of the main developed countries find themselves is certainly complex. On the one hand, evidence suggests that the economic recovery largely started in the third quarter of 2009 will consolidate throughout 2010. But this message does not reflect either the whole situation or the risks entailed by the path the main economies must take over the next few quarters. Recovery is a fact and this offers us a more hopeful future, particularly compared with the situation we were facing just a year ago. However, there are many elements that lead us to expect quite a flat exit from the recession, with numerous risks of reversals and a variety of speeds, depending on the country in question.

A good example of this is the US economy. The figures showing growth in gross domestic product (GDP) came as no surprise and confirm that the recovery is still on course. In the fourth quarter of 2009, GDP grew by 1.4% compared with the previous quarter. This leaves the fall in GDP for 2009 as a whole at 2.4%, quite a moderate figure if we consider the collapse in the world's leading economy during the first half of the year, resulting in comparisons with the Great Depression of the thirties.

In any case, the most frequent indicators continue to point to a rather anaemic recovery. Progress in private consumption, fundamental as it accounts for close to 70% of GDP,

somewhat lost its head of steam in the month of December. Retail sales declined after four months of rises and the Conference Board Consumer Confidence index continued to at a very low level. Added to this is a housing market that's no longer in decline but is still stuck in a trough, as well as a job market that, although it has stopped deteriorating, has accumulated a record percentage of long-term unemployed.

The view provided by the main European economies is of a similar vein. We now know about Germany's overall fall of 5.0% in GDP for 2009, resulting in a totally flat economy in the fourth quarter. The British economy, in recession up to now, started on the road to recovery in the last quarter of 2009 with quarter-on-quarter growth of 0.1%. Indicators for the euro area as a whole suggest that the recovery will consolidate throughout 2010 but at a very slow pace. Demand is still burdened by high unemployment and the deleveraging being carried out in households. But the news isn't all bad. The figures appearing for supply are somewhat more encouraging. The industrial production index has recovered significantly and both industrial capacity utilization and industrial orders are now embarking on an upward trend.

The fate of the main emerging economies is rather more solid. China put its foot on the accelerator and returned to a GDP growth rate of double figures. In the fourth quarter, this

rose 10.7% year-on-year, placing the overall gain for the year at 8.5%. At present there are no signs of this dizzying pace of growth slackening off, in fact quite the opposite. The increase in credit remains around 30%, the industrial production index was up 18.5% year-on-year in December and the rise in retail sales was barely one percentage point lower. These figures are spectacular but even more so the data for the foreign sector. In December, exports posted their first year-on-year rise in thirteen months, this being 17.7%, while imports rose an impressive 55.9%. This momentum is so strong that it has raised certain fears about the risk of overheating and the Chinese authorities have adopted measures to slow up the rise in bank credit and to restrict liquidity.

While the emerging countries have returned to high rates of growth, the main risk in developed economies is still the delicate balance that must be struck in order to withdraw the expansionary measures of fiscal and monetary policies without harming the recovery. In both cases it will be vital for institutions to maintain good communications with the rest of the agents, as this will determine whether the transition is gradual or not. With regard to monetary policy, both the communications from the European Central Bank and the Federal Reserve maintain that the current interest rates are appropriate for today's economic conditions. Seeing as inflation continues to be comfortable for both economies, and given a scenario in which inflation is unlikely to liven up in the short term, there is broad consensus among analysts regarding the future behaviour of interest rates: they are not expected to rise until at least the end of the year and, when they do, it's more than likely that such a rise will be very gradual.

In financial markets, attention has focused on the difficulties faced by the Greek economy, whose budget situation and lack of convincing corrective measures have led to it being strongly penalized by the debt markets.

A penalization that has spread, to a lesser degree, to other economies in the euro area and has affected the value of the single currency, falling considerably against the dollar. Stock markets have been somewhat infected by this trend but have been particularly affected by president Obama's proposal to impose restrictions on the size and activities of banks. The measure, which aims to prevent banks from taking on risks in the future that endanger the stability of the financial system, is not free from controversy.

The situation of the Spanish economy is closely following that of the rest of developed economies but one step behind. As of today, there are few indicators that have yet to touch bottom and most are now on the road to recovery. Recent trends in economic activity are a good example of this. The industrial production index, a key indicator in the cycle, slowed up its decline to 5.7% year-on-year in November, less than half the fall of the third quarter. Moreover, the industry confidence index continues to gain ground and reflects less gloomy perspectives than those a few months ago.

Demand indicators follow the same lines. The gains in workers' purchasing power, containment of job losses and improved confidence have helped to revive consumption, although still at low levels. Retail sales in December therefore took a positive turn, while automobile sales have kept their energy of previous months, supported by state aid.

**China, however, is advancing strongly.**

**The difficulties faced by the Greek economy are altering markets and the euro's value.**

**The Spanish economy is on the road to recovery...**

**...with low inflation and drastic adjustments in its foreign imbalance.**

From another perspective, core inflation, which in a way reflects the basic trends in demand, also seems to have bottomed out. After its record low of 0.1% in October, it has picked up slightly to 0.3% in December. Trends in the consumer price index continue the same, moderately positive trend but this index is also affected by trends in fuel prices. Its year-on-year change was 0.8% in December, 5 tenths of a percentage point more than the previous month. This means that the average inflation for 2009 was negative, at 0.3%, the lowest since the start of the fifties.

Support from the foreign sector is still a positive element in the current situation. In the month of November, the year-on-year change in the volume of exports and imports was positive for the first time in 2009, which means they are gradually getting back to normal after the huge slump recorded between the end of 2008 and the beginning of 2009. But the most remarkable result is the sharp fall in external financing needs of the Spanish economy, going from 9.1% of GDP in 2008 to close to 5% in 2009, a trend that will remain throughout 2010.

In spite of the overall improvement in tone of activity indicators, the labour market situation is still negative and far from stable. The Labour Force Survey for the fourth quarter shows that the number of workers fell again, down to 18.65 million, with a considerable year-on-year drop of 6.1% that is nonetheless lower than the figure for the third quarter. The number of unemployed reached 4.33 million, 1.12 million more in one year, pushing the unemployment

rate up to 18.8%. Job losses would be greater if it weren't for so many people giving up actively looking for a job, reflected in a 0.4% year-on-year decrease in the labour force in the fourth quarter, the first recorded this cycle.

The other point of concern in the current economic situation relates to trends in public accounts. The fall in tax revenue resulting from the drop in taxable income, together with higher costs caused by the rise in unemployment benefit and other measures aimed at slowing up the recession, are taking their toll on the general government deficit. In spite of the surplus that will be achieved by Social Security, this deficit reached 11.4% of GDP in 2009, higher than even the worst forecasts.

Although the situation of the Spanish economy is favourable in terms of public debt compared with the rest of the countries in the euro area, the economic authorities have undertaken a series of actions to reverse the trends in general government deficit. Consequently, the budgets for 2010 include measures to contain expenditure as well as tax hikes. Moreover, at the end of January the government presented a new austerity plan that includes cuts in public expenditure of 50,000 million euros over three years and plans to raise the retirement age. These actions should ensure the country meets its commitment to reduce public deficit to 3% of GDP by 2013 without disturbing the improvements in business which will gradually come about.

29 January 2010

**The job market is slowing up its decline but still produces worrying figures.**

**New austerity measures in public expenditure aimed at balancing the deficit.**

## CHRONOLOGY

### 2009

<b>January</b>	<b>1</b> Further enlargement of <b>euro area</b> with entry of Slovakia making total of 16 member states. <b>15</b> <b>European Central Bank</b> lowers official interest rate to 2.00%. <b>20</b> Barack Obama sworn in as <b>President of the United States</b> .
<b>March</b>	<b>5</b> <b>European Central Bank</b> lowers official interest rate to 1.50%. <b>6</b> Central government announces measures to <b>facilitate financing of working capital for medium-sized companies</b> and to <b>revive employment</b> and ease effects of <b>unemployment</b> . <b>27</b> Government approves series of <b>measures to boost economic activity</b> : reform of law on meetings of creditors, revival of credit insurance and introduction of EU directive on services.
<b>April</b>	<b>2</b> <b>European Central Bank</b> lowers official interest rate to 1.25%. G-20 meeting in London aimed at <b>reform of international financial system</b> .
<b>May</b>	<b>7</b> <b>European Central Bank</b> lowers official interest rate to 1.00% and announces measures to facilitate liquidity in banking system. <b>12</b> Government announces <b>new economic policy measures</b> : 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.
<b>June</b>	<b>12</b> Government <b>increases taxes</b> on tobacco, petrol and diesel fuel for motor vehicles. <b>26</b> Government establishes <b>Fund for Orderly Restructuring of Banks</b> .
<b>September</b>	<b>26</b> The Spanish government passes the <b>2010 State General Budget</b> , 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.
<b>November</b>	<b>27</b> The central government presents its draft bill for the <b>Sustainable Economy Act</b> .
<b>December</b>	<b>1</b> The <b>Lisbon Treaty</b> comes into force, reforming certain aspects of the European Union.

### 2010

<b>January</b>	<b>29</b> The government approves an <b>austerity plan for public expenditure</b> and proposes to raise the <b>retirement age</b> to 67.
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## AGENDA

### February

- 2** Registration with Social Security and registered unemployment (January).
- 4** Governing Council of the Central European Bank.
- 5** Industrial production index (December).
- 11** GDP flash estimate (fourth quarter).
- 12** CPI (January).
- 17** Quarterly national accounts (fourth quarter).
- 23** International trade (December). Government revenue and expenditure (December 2009 and January 2010).
- 25** Producer price index (January).
- 26** EU HCPI (January). CPI flash estimate (February). Balance of payments (December).

### March

- 2** Registration with Social Security and registered unemployment (February).
- 4** Governing Council of the Central European Bank. EU GDP (fourth quarter).
- 5** Industrial production index (January).
- 12** CPI (February).
- 16** EU HCPI (February). Fed Open Market Committee.
- 17** Labour costs (fourth quarter).
- 23** Government revenue and expenditure (February).
- 24** International trade (January).
- 25** Producer price index (January).
- 30** CPI flash estimate (March).
- 31** Balance of payments (January).

## INTERNATIONAL REVIEW

**United States grows 5.7% in the fourth quarter, expecting to consolidate its recovery in 2010.**

### United States: a weak, erratic recovery

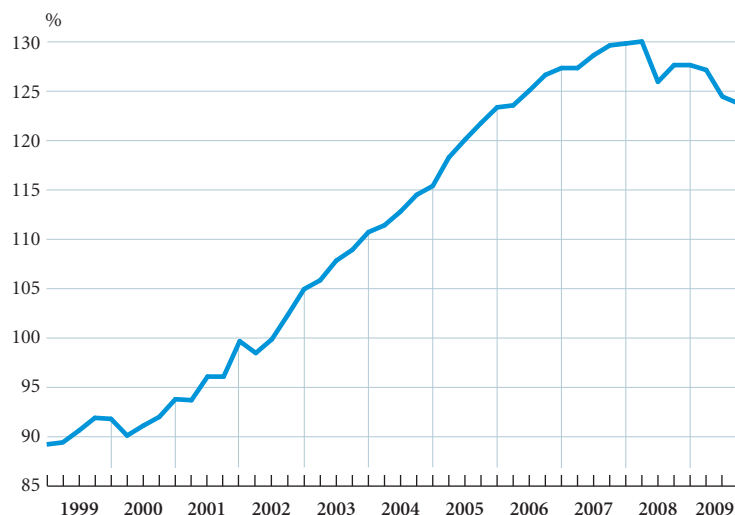
The economy is recovering, the housing market has bottomed out and there are no more huge job losses. However, the recovery will be influenced by the debt reduction process the United States is currently immersed in, like most developed economies on the planet after the financial crisis erupted. To date, the greatest deleveraging has occurred in financial institutions, thanks to state aid. But households, whose consumption accounts for 70.8% of the total gross domestic product (GDP), face a long road to replenish savings that will lead to lower rates of economic growth. The US government has offset these falls in

debt with expansionary fiscal policies supported by the Federal Reserve, raising public debt to 69.1% of GDP. But the deleveraging process may last for several years yet. With a fiscal deficit approaching 12.0% of GDP and inflation that might already be showing the first warning signs, the key to recovery will still lie in how consumers behave. At the time of writing this report, the Department of Trade announced that the US economy had grown by 5.7% quarter-on-quarter in the fourth quarter.

The latest demand indicators suggest that the recovery in private consumption is losing force, with retail sales, without cars or petrol, falling back in December

### UNITED STATES: HOUSEHOLDS UNDERTAKE THE ARDUOUS ROAD TO SAVINGS

Gross household debt as percentage of disposable income



SOURCES: BEA, Federal Reserve and own calculations.

## UNITED STATES: CONSUMPTION STILL HAS A LONG WAY TO RECOVER

Real retail sales without vehicles or petrol



NOTE: (\*) Data deflated by the consumer price index without energy or food.

SOURCES: Department of Trade and own calculations.

after four consecutive months of gains. Retail sales, adjusted for the effect of price variations, exceeded the level of the same period last year when consumption was at its lowest, but were 4.5% lower than the level of December 2007, representative of the situation before the crisis. Along similar lines, the Conference Board Consumer Confidence index is still at a very low level, with a perception of the current situation that continues to set new record lows.

In the case of non-financial firms, which in pre-crisis years had been relatively prudent, the urgent need to reduce debt is not so great. As a result of this situation, throughout the second half of 2009 the business view has been more positive than the consumer view, although without giving up caution altogether. In December, the slight clouds of doubt of the previous month dissipated and the business sentiment index of the Institute for Supply

Management for manufacturing enjoyed a moderate advance that took it up to 55.9 points, a level befitting expansionary phases. With a lower profile, the services index picked up to 50.1 points, more in line with a context of weak growth. For its part, industry maintained its gains in December, although the recovery started in June is losing force, with a production index that is still 10% below its level at the start of 2008, prior to the crisis. Industrial capacity utilization continued a similar profile, increasing up to 72.0% of the total.

The housing market has said goodbye to its decline but is still immersed in a trough. After three years of continual decline, real estate assets are no longer losing value but no clear upward trend can be seen. The recovery seen in the Case-Shiller housing price index has lost energy. The increase in October was a meagre 0.4%, seasonally adjusted, leaving the rise accumulated since May

**Recovery in private consumption stagnates and there's no improvement in confidence.**

**The business sector sees the situation a little more clearly and industry continues its slow recovery.**

## 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	December
Real GDP	2.1	0.4	-1.9	-3.3	-3.8	-2.6	—	0.1	—
Retail sales	3.3	-0.8	-8.4	-8.9	-9.5	-6.7	-2.0	2.5	5.4
Consumer confidence (1)	103.4	58.0	40.7	29.9	48.3	51.8	48.7	50.6	52.9
Industrial production	1.5	-2.2	-6.7	-11.6	-12.9	-9.3	-6.7	-4.9	-2.0
Manufacturing (ISM) (1)	51.1	45.5	36.1	35.9	42.6	51.5	55.7	53.6	55.9
Sales of single-family homes	-26.7	-37.4	-41.0	-40.0	-27.1	-11.6	-2.2	-9.0	...
Unemployment rate (2)	4.6	5.8	7.0	8.2	9.3	9.6	10.1	10.0	10.0
Consumer prices	2.9	3.8	1.6	0.0	-1.2	-1.6	-0.2	1.8	2.7
Trade balance (3)	-701.4	-695.9	-695.9	-605.7	-504.1	-415.5	-389.3	-382.5	...
3-month interbank interest rate (1)	5.3	2.8	2.2	1.2	0.8	0.4	0.3	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.

### Housing is no longer losing value but the excess supply of property will hinder recovery in construction.

at 3.9%. On the other hand, recovery differs depending on the geographical area. In the last six months, the conurbation of San Francisco has accumulated a recovery of 12.3%, after having lost 45.3%, but significant areas such as Chicago and Los Angeles have hardly surpassed 4.0% and New York does not exceed 1.4%. Among the weakest zones, Las Vegas has merely bottomed out.

State aid for first-time home buyers has led to an upswing in sales that is unlikely to continue. The sector's recovery will continue to be hindered by excess supply, made worse by defaults on mortgages that returned to new record highs in the third quarter. Consistent with this state of affairs, supply is still practically frozen. New homes started in December did not go beyond a fourth of the pre-crisis levels and, in spite of the rise in building permits in the same period, which are its leading indicator,

we expect the lethargy in construction to continue throughout most of 2010.

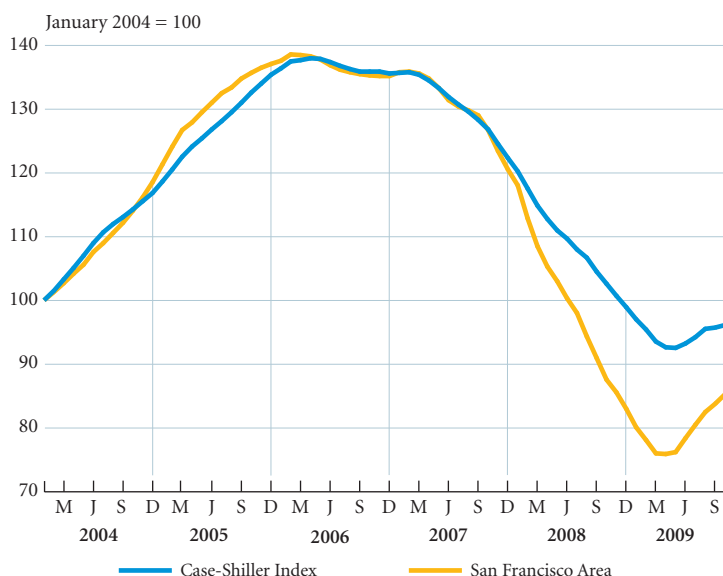
The job market is in a similar situation to housing, now leaving behind the phase of huge job losses but facing a problematic recovery. The labour market is usually a step behind the rest of the economy, with recoveries that arrive when general activity has already enjoyed several quarters of expansion. But this time the delay could be even more marked. Job losses since the end of 2007, totalling 7.2 million jobs, have been the highest since the Great Depression of the thirties. December's unemployment rate remained unaltered at 10.0% and is unlikely to improve noticeably over the coming months.

Firstly, there's a significant contingent of discouraged workers that might gradually join the job market as the recovery becomes effective. Moreover, the share of long-term unemployed,

### The labour market has almost bottomed out but improvements will have to wait with unemployment at 10%.

## UNITED STATES: AN INCREASINGLY GRADUAL RECOVERY

Value of the Case-Shiller housing price index



SOURCES: Standard and Poor's and own calculations.

much more difficult to place in new jobs, is 39.2%, a record that doubles the percentage of 1982, the last period when the unemployment rate was higher than 10%. The net loss of 85,000 jobs in December, after a minimal gain in November, shows that, although the downward trend has disappeared, we cannot rule out odd moments of deterioration over the coming months, with a recovery that will only begin to take hold as from the second half of the year.

In December, prices took a slight upturn that arrives earlier than expected and somewhat compromises the stability of what, to date, had been an appreciable aid to recovery. The general consumer price index (CPI) picked up to 2.7% year-on-year due to the base effect of oil. The core CPI, the general without food or energy, rose 1.8% year-on-year, thereby maintaining the stable trend of the last few months, although this

moderation was due to a delay in rental attributed to home owners. Without shelter, core inflation rose 2.9% year-on-year, with the trend hovering around 2.5% over the last three months. This figure coincides precisely with the inflation forecasts implicit in bonds indexed at 10 years.

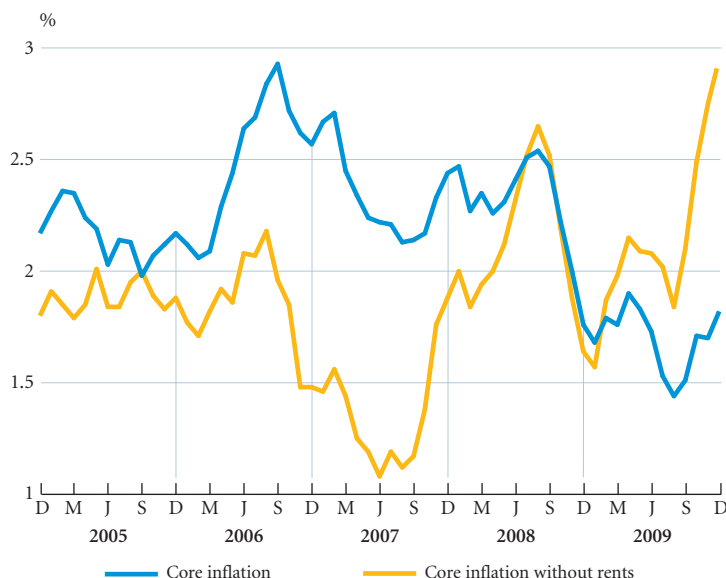
No great contributions to growth can be expected over the coming months from the foreign sector. The trade deficit of goods and services for October was 36,402 million dollars, 3,213 million higher than the balance for October. This deterioration was due only in part to fluctuating oil prices. The deficit excluding oil and its derivatives also increased by 1,126 million dollars and reached its highest level since January 2009. The recovery in exports continued to consolidate but was surpassed by imports, which continue to gain strength due to the gradual recovery in domestic demand.

**CPI rises 2.7% and prices pick up.**

**Trade deficit increases due to growth in imports.**

## UNITED STATES: WARNING SIGNS FROM INFLATION

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



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

**Japan continues to suffer, affected by weak domestic demand.**

### Japan: lethargy broken by the upswing in industry

The Japanese economy is suffering from very weak domestic demand while its foreign sector is still unable to capitalize on the recovery of other Asian economies. Since the previous deflationary period, which went from 1998 to early 2006, Japan is one of the economies with the highest levels of debt on the planet, with a gross debt that is 4.7 times its GDP. More than 40% of this debt corresponds to a public sector with a limited capacity to support demand effectively.

The latest supply indicators show, however, signs of slight improvement. Industrial production, which in Japan is closely related to the rest of the sectors of economic activity, awoke from its lethargy and reactivated its recovery, with a general index that, in December,

rose 2.2% compared with the previous month, seasonally adjusted, and reduced to 5.5% the loss accumulated since the same period a year ago. On the negative side, the outlook for investment has not sustained its improvement noted in November, after severe corrections in accounts for the third quarter. The rises in machinery orders in November were downgraded with fewer purchases destined for the domestic market and with investment demanded by exporting firms not managing to take off.

On the side of demand, December's car sales fell back after the end of the effect of government aid, with total sales that, during 2009, were 23.6% below the total for 2005, the year before the downward trend started. For its part, the housing market still does not offer any convincing signs of strength. Sales in the Tokyo area declined in December by

**Industry's recovery is gaining strength but the investment panorama is still uncertain.**

## JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008	2009					
			4Q	1Q	2Q	3Q	October	November	December
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	-1.1	...
Industrial production	2.9	-3.4	-15.0	-34.0	-27.6	-19.7	-14.0	-5.5	...
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	-19.1	...
Unemployment rate (2)	3.9	4.0	4.0	4.4	5.2	5.5	5.1	5.2	...
Consumer prices	0.1	1.4	1.0	-0.1	-1.0	-2.2	-2.5	-1.9	...
Trade balance (3)	12.6	4.0	4.0	1.4	1.0	1.7	2.4	3.4	...
3-month interbank interest rate (4)	0.7	0.8	0.8	0.7	0.6	0.5	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	100.0

NOTES: (1) Index value.

(2) Percentage of labour force.

(3) Cumulative balance for 12 months. Trillion yen.

(4) Percentage.

(5) Index weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.

SOURCES: OECD, national statistical bodies and own calculations.

13.1% year-on-year, while homes started in November, although moving away from the record low of August, remained 19.1% below the same level last year.

The labour market joins the faint breeze of recovery. Although the unemployment rate rose slightly in November up to 5.2%, a high level for

**Consumption is still sluggish while housing has bottomed out.**

## JAPAN: INDUSTRY'S RECOVERY IS GAINING STRENGTH

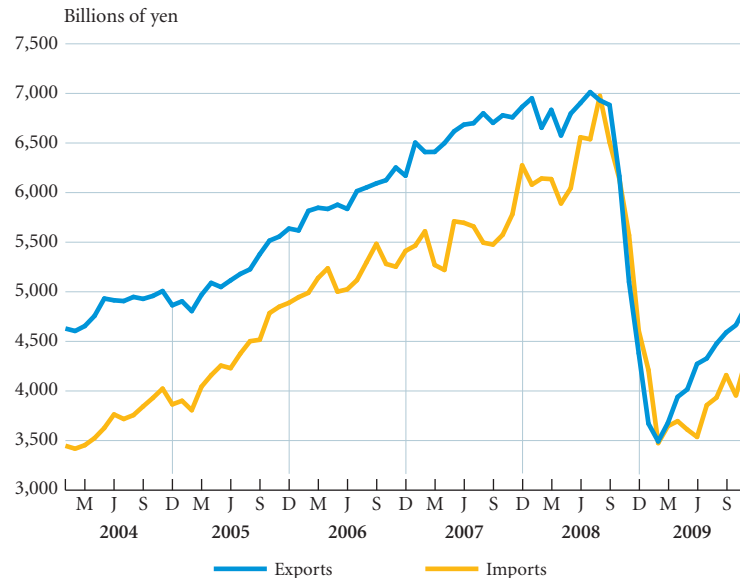
Industrial production index



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

## JAPAN: A RECOVERY THAT STILL HAS A LOT OF GROUND TO COVER

Exports and imports (\*)



NOTE: (\*) Monthly data, seasonally adjusted.

SOURCES: Japanese Ministry of Communications and own calculations.

**The CPI is down 1.9% year-on-year, unemployment is at 5.2% but employment is rising in manufacturing.**

**Exports are recovering but are still far from their pre-crisis levels.**

**China advances a spectacular 10.7% in the fourth quarter of 2009.**

the Japanese economy and close to the record high reached in July, the positive note was provided by the manufacturing sector, which gained 130,000 net jobs, thereby following the trail left by industrial production. In prices, weak demand will ensure that deflationist trends will continue during 2010. Consequently, November's CPI recorded a drop of 1.9% year-on-year and core inflation, the general index without energy or food, dropped 1.0% year-on-year, accumulating its eleventh consecutive month of falls.

In the foreign sector, November's trade surplus slipped back slightly after its upswing in October. The recovery in exports gained certain strength but was obscured by the upswing in imports, accelerating in spite of weak domestic demand. The strength of the yen and the loss of market share to other Pacific coast countries mean that the

road to return to pre-crisis export levels is still a long one.

### China: rebirth of the Silk Route?

As was expected, China grew 10.7% year-on-year in the fourth quarter and ends the year with an estimated advance of 8.7%, higher than the promised 8%. Moreover, the country is also starting the year along the same lines as it ended 2009. Firstly, by showing its strong capacity for recovery, the result of expansionary fiscal and monetary policies implemented by its authorities. Furthermore, the strategy to support the foreign sector has also continued.

Although we do not expect any huge surprises in 2010, certain changes are already in the making. Firstly, monetary conditions have started to get tougher. This will also be the year when the largest

## CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2009				
			1Q	2Q	3Q	4Q	December
Real GDP	13.0	9.6	6.2	7.9	9.1	10.7	—
Industrial production	17.5	12.6	9.7	9.0	12.3	17.9	18.5
Electrical power generation	15.7	6.7	−4.3	−0.4	8.0	24.3	27.7
Consumer prices (*)	4.8	5.9	−0.6	−1.5	−1.3	0.7	1.9
Trade balance (**)	262	298	319	296	252	198	198
Reference rate (***)	7.47	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

NOTES: (\*) Average.

(\*\*) Cumulative balance for 12 months. Billion dollars.

(\*\*\*) Percentage at end of period.

SOURCES: National Statistics Office, Thomson Reuters Datastream and own calculations.

free trade area is created, in terms of population, after the oncoming agreement between China and ASEAN (Association of South East Asian Nations), which will help provide an additional boost to the already important Asian intra-regional trade.

January has been a month of negotiations, sometimes complicated, for this new large trade area. This zone is being set up as the third largest trade area in terms of transaction value, after the European Union and NAFTA and, with a population of 1,900 million people, it doubles the population of the first two areas combined. The most recent trade data already point towards a greater presence of the Asian giant in the new «Silk Route». More specifically, in 2009 Chinese sales to ASEAN grew faster than all Chinese exports and accounted for 9% of all Chinese exports.

Continuing with the foreign sector, and not forgetting that part of the rise is a direct consequence of the minimums a year ago, in December exports saw the first year-on-year increase in thirteen months, whose value totalled 17.7%.

Meanwhile, imports rose a resounding 55.9% year-on-year. The renewed vigour of demand from the United States and Europe (destinations for 40% of Chinese exports) has been decisive in the upswing in exports. As trade flows gradually get back to normal, this should result in a return to appreciation for the renminbi over the coming months, after more than a year and a half of it standing still against the dollar.

The rest of the leading indicators, also with an upward trend, point towards the Chinese economy continuing to recover. To start with, the purchasing managers' index (PMI) for December reached 56.6 points, higher than the 55.2 points of November and the threshold between recession and expansion marked by 50 points. Industrial production grew again by a solid 18.5%, above the 18% average of the last quarter. For its part, credit was up 31.7%, placing the annual average at a spectacular 31%. This exuberant expansion in credit has been key to boosting GDP growth in 2009, although it has also involved the risk of a possible asset bubble. Because of this, at the beginning of 2010 the central bank

**2010 brings the largest free trade area.**

**Exports up 17.7% year-on-year, the first rise in 13 months.**

**Credit achieves a growth rate of 31% in 2009.**

**The CPI increased by 1.9% year-on-year, due directly to the rebound effect.**

raised the cash ratio by 50 basis points, the first step towards normalization in the monetary area.

For its part, domestic demand continues to grow although it is still dominated by capital investment, which, in turn, continued its rise and, with a 29.7% increase year-on-year in December, places the year's average at 31.7%, well above the 20% of the last three years. Similarly, retail sales in December were up 17.5% year-on-year, clearly above the 15.5% average for the year but quite a bit lower than the investment rates.

Inflation rose, although largely due to the base effect of a year ago, influenced by food and energy. Specifically, the year ends with a 1.9% year-on-year increase in the CPI in December after having experienced negative values for a large part of 2009. Beyond the base effect there is the risk, over the coming months, of genuine inflationary tensions arising, given the impressive monetary expansion.

Once again, China appears to be an energetic country with a strong capacity for development. Nonetheless, this capacity needs new dynamics to be adopted, particularly those that boost domestic demand, but it is still too soon to talk of a change in the sources of growth.

### **Brazil: tranquillity at carnival time**

2010: electoral year. February: carnival month. This is a combination of ingredients that, traditionally, have not been associated with an image of tranquillity and calm. However, that is how Brazil's economic panorama appears in this month of sambas and parades; particularly serene when compared with its most prominent neighbours. Leaving the crisis behind it, the Brazilian economy continues to climb towards growth that's more in line with its potential. Meanwhile its main stumbling block, an inconvenient appreciation of the real that was threatening the export sector, points

**Brazil is burning rubber in its recovery process.**

### **BRAZIL: MAIN ECONOMIC INDICATORS**

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008	2009					
			4Q	1Q	2Q	3Q	October	November	December
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	-8.6	-2.9	4.0	....
Consumer confidence (*)	132.3	140.4	132.9	128.5	128.4	141.9	154.3	153.1	155.2
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	4.3
Trade balance (***)	40.0	25.0	25.0	25.2	27.6	26.5	26.5	25.5	25.4
Interest rate SELIC (%)	12.75	11.25	13.75	11.25	9.25	8.75	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	1.7

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.

towards withdrawal or at least a prized truce.

Given the scenario of relative calm and with almost one million more formal jobs in 2009, Brazilian consumers continue to trust in the favourable evolution of their economy. This is demonstrated by the index that measures this sentiment, with another rise and new record in December; and it is also reflected in the continued progress of retail sales that, although less than expected, grew by 5.8% year-on-year in November and 1.1% compared with October. The good results in the retail sector also benefited from the fiscal aid still in force and from credit that is still vigorous. This increased 14.9% year-on-year in November and its outstanding balance has already reached 44.9% of GDP, much higher than the 38.9% of 2008. Of note among the sectors most favoured by these stimuli is the automobile industry, which set a sales record in 2009 of 3.1 million vehicles, 11.4% more than in 2008.

Industry confidence also ended 2009 at its highest all year and, in November, industrial production recorded its first year-on-year gain since the crisis started (4%). However, it grew less than expected and ended up losing ground compared with the previous month. Automobile production also fell 1% in 2009, this very much in spite of the annual sales record. In view of the impetus provided by domestic demand, this lingering supply could be attributed to the relative weakness of the export sector which, due to the global slump at the beginning of 2009 and the recently strong real, recorded a drop in sales abroad of 22% in 2009. Nonetheless, the trade surplus closed the year with 25,400 million dollars and growth of 1.6% compared

with 2008. Although there was a current account deficit for the second consecutive year, this did not deteriorate at all.

Some see the risk of overheating in the impressive recovery of the Brazilian economy. However, most are still positive and agree with President Lula, who predicts a comfortable economic situation for his last year of mandate. It may even be more comfortable than expected if the expectations of Brazil's central bank are confirmed. Its most recent forecasts upgrade growth in 2010 to 5.8%, the highest rise in three years, which might be a bit optimistic. Greater inflationary pressures are also expected, placing inflation at around 4.6% at the end of 2010, above the 4.3% of 2009 and around the established target (4.5%).

The Brazilian authorities are expected to maintain their commitment to economic stability so that, if the scenario predicted by the central bank is confirmed, this commitment will require the monetary policy to be restricted in 2010. Even more so if we consider that fiscal containment will more than likely be delayed until 2011. Ultimately, and in spite of relative calm, 2010 is an electoral year and, as such, a certain permissiveness is to be expected. Whether or not it's carnival time.

### **Mexico: exports... heaven-sent!**

Mexico's minister for Labour, Javier Lozano, recently declared that the Aztec economy is fully on the road to recovery and in a position to grow again. The latest economic data tend to support his hypothesis although the road is likely to be long and not exactly smooth. With domestic demand still intimidated, the

**Consumer and business sentiment at record highs.**

**Growth and inflation on the up.**

**Mexico, a prolonged recovery, dependent on improved domestic demand.**

## MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008	2009					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	3.3	1.4	-1.7	-9.0	-8.9	-6.3	-	...	-
Industrial production	2.4	-1.0	-4.6	-10.0	-9.9	-6.8	-5.0	-1.7	...
Consumer confidence (*)	104.9	92.2	83.3	80.1	80.5	83.0	77.0	78.2	80.1
Leading business index	116.7	118.3	118.3	105.9	107.8	111.7	115.0	...	...
General unemployment rate (**)	3.7	4.0	4.3	5.0	5.2	6.3	5.9	5.3	...
Consumer prices	-22.7	-11.8	6.2	6.2	6.0	5.1	4.5	3.9	3.6
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	4.50
Mexican pesos to dollar (*)	11.0	10.6	13.9	14.2	13.2	13.5	13.1	12.9	13.1

NOTES: (\*) Value.

(\*\*) Percentage of labour force.

(\*\*\*) Cumulative balance for 12 months. Billion dollars.

SOURCES: Banco de México and own calculations.

### Exports continue to lead the way.

driving force behind Mexican growth continues to be of a foreign nationality.

Certainly the Mexican economy, just like the global one, showed encouraging signs of improvement at the end of 2009 and, as this improvement consolidates both within and outside the country, consumers are getting their confidence back. This is shown by the indicator that measures this sentiment in Mexico with a rise in December up to 80.1 points, from 78.2 in November. In all probability, part of this gain can be attributed to the better tone of the labour market, with an unemployment rate that eased back slightly in November. Overall, retail sales continue to lag behind and once again lost ground in October, both in year-on-year terms, by 4.6%, as well as in comparison with the previous month, by 0.5%. For its part, investment continues to fall by double figures, 14% this same month.

### The rise in taxes and public tariffs will push up inflation.

While domestic demand is reluctant to stir from its lethargy, exports took another big step forward and, in

November, posted their first year-on-year gain (of 10%), after fourteen consecutive months of falls thanks, in addition to the base effect, to the push of the US. A push that has also helped Mexican industry which, in spite of continuing in negative figures, notably moderated its decline in November, losing 1.7% year-on-year but only 0.2% compared with October. This incipient recovery of industry reflects, to a great extent, the upswing in the automobile industry, one of the most benefitted by industrial activity becoming re-established in the United States. In December, its production increased 25.4% compared with 2008, thanks to exports, which rose by 26.8% and in spite of the decline in domestic demand, down 9.2%. Nevertheless, it ended 2009 with a fall in annual production of 28.3% compared with 2008.

In spite of the growing signs of improvement in the economy as a whole, leading indicators of the Mexican Institute of Finance Executives (IMEF in Spanish) point towards a gradual

recovery at a moderate pace. However, it remains to be seen how this rate of growth will fit with the monetary policy of Mexico's central bank which, if the forecasts are right, will have to tackle an inflation rate of around 5% in 2010. This figure is much higher than the target set ( $3\% \pm 1$  p.p.), so that Banxico is very likely to make its move in 2010; if possible, when domestic demand has already made its own move forward.

## Greater moderation

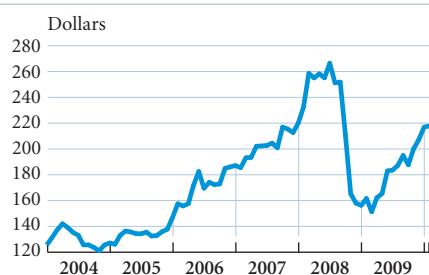
Oil prices are affecting the recovery of the dollar and remain in the region of 75 dollars. Between 21 December 2009 and 21 January 2010, crude rose 1.9%, arriving at 75.22 dollars per barrel (Brent quality, for one-month deliveries). This means that crude has accumulated an increase of 92.4% since its recent record lows at the end of 2008 and a year-on-year rise of 66.2%.

**Crude remains at 75 dollars and accumulates a rise of 92% since the end of 2008.**

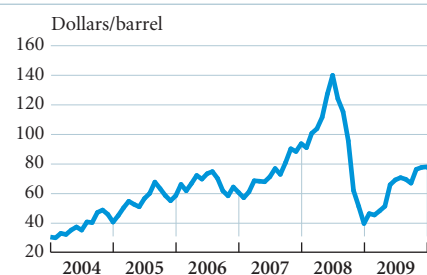
**Oil expected to rise moderately in 2010.**

## TREND IN VARIOUS COMMODITIES (\*)

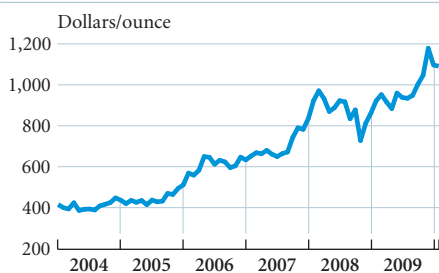
«The Economist» index



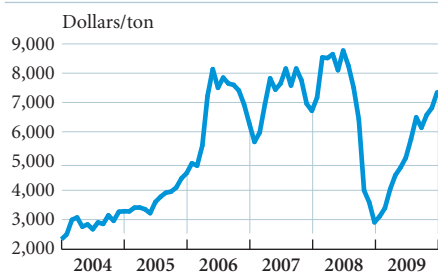
Brent oil



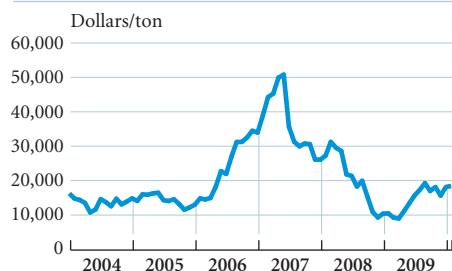
Gold



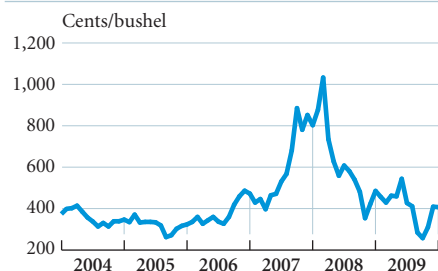
Copper



Nickel



Wheat



NOTE: (\*) Figures for last day of month (last date January 21).

SOURCES: «The Economist», Thomson Reuters Datastream and own calculations.

### Metals continue on the up while profits are harvested in foods.

The stronger dollar and better expectations regarding oil supplies, with greater extraction capacity in large oil-producing countries in the Middle East, suggest that the price hikes of 2009 will not continue into 2010. However, global demand is expected to go on increasing. According to the December report by the International Energy Agency, 2010 will see 86.3 million barrels a day, in comparison with 84.9 million in 2009, which would limit the room for any appreciable price reductions and would end up defining a scenario of greater stability than last year.

The rest of the commodities saw moderate increases in January, with *The Economist* index rising 1.9% between 21 December and 21 January. But while foods generally fell, with the exception of sugar, metals continued their upward trend. Although, up to just a few weeks ago, basic metals such as copper and aluminium took pride of place, in the last two weeks precious metals such as palladium and platinum have come to the fore, hitting record highs.

## Recipes for competitiveness: similar ingredients, different cuisine

Voltaire used to say that the true way to achieve happiness is precisely by not pursuing it. Something similar seems to be the case with competitiveness. Some of the most competitive countries in the world have nothing that resembles a national policy aimed at extending the country's competitiveness. For instance, if we take one of the most typical competitiveness rankings used today, the *Global Competitiveness Report* (GCR) by the World Economic Forum, among the 25 leading nations we find that, for example, the United States, which in 2009 was in the enviable position of being the second most competitive country in the world, does not use a single national strategy to promote competitiveness. However, within this group of highly competitive economies we can also find states that actively intervene in the pursuit of competitiveness. Such are the cases of Finland and Canada, leaders in actively promoting competitiveness and with their own recipes to achieve their goals.

Recipes for competitiveness? The culinary metaphor is appropriate. Those countries that promote competitiveness policies must decide not only the right ingredients and make sure that these are top quality; the expert hand of the chef also comes into play. In other words, deciding which are the ideal actions to improve a country's competitiveness is as important as how these actions are carried out. In short, what to do and how to do it. Success, i.e. achieving a longed-for advanced position in competitiveness terms, will be determined by a combination of both dimensions of competitiveness policies, the substantive («the what») and the procedural («the how»).

Before going into details regarding the nature of these policies, this article must define what it understands as competitiveness. In line with how most economists interested in this area see the concept, the Organization for Economic Cooperation and Development (OECD) defines it as the degree to which a country can, under free and fair market conditions, produce goods and services which meet the test of international markets, while simultaneously maintaining and expanding the real incomes of its people over the long term. In short, a competitive economy must show the capacity to maintain or increase, in a sustained way, its share of international markets for goods and services.

Applying this criterion, competitiveness rankings merely need to monitor indicators such as a country's overall share of exports. However, what these rankings actually do is evaluate not competitiveness per se but the determining factors of this attribute. For example, the above-mentioned GCR evaluates 12 pillars (or areas) to organize the determining factors that underpin a nation's capacity to compete. Some are basic in nature, almost prerequisites for competitiveness, such as having good institutions, infrastructures, health and education, or benefiting from macroeconomic stability. Others, however, are more sophisticated, such as the capacity to innovate or technological skills. Similar determining factors are used by another reference in this area, the ranking published by the Swiss business school IMD.

From this broad range of determining factors, competitiveness policies must understandably choose those on which the country should focus. Continuing the culinary metaphor, those states that opt for a comprehensive focus of the issue and decide to use a national strategy must specify which ingredients go to make up their recipe. A recent study by the Reut Institute, comparing the national strategies of different countries, provides us with some clues.<sup>(1)</sup> If we take five countries that score high in the competitiveness rankings (Finland, Canada, Taiwan, United Kingdom and Ireland, all among the top 25 in the GCR ranking), it can be seen that, except for the last country, they have all opted to focus on those determining factors of competitiveness usually identified as fundamental in the literature and in reference competitiveness reports (see table below). For example, having infrastructure, particularly in terms of information and communication technologies, is central in the cases of Ireland, Taiwan and Finland. Other aspects shared by some of these countries concern the advancement of human capital and improving the competitive environment in which firms operate. It should be noted that, even in the case of Canada, which explicitly states different objectives, some of the determining factors established by the remaining countries in the study as benchmarks lie behind these objectives.

In contrast to this relative similarity in the substantive dimension of competitiveness policies, the procedural dimension reveals greater differences, a reflection of disparate public cultures. Consequently, and always according to the aforementioned study, an initial key decision that determines how to implement national competitiveness strategies is whether to appoint a single authority dedicated to promoting the policy. This is usually the preferred option and it is followed by Ireland, United Kingdom, Taiwan and Finland. Once again, Canada is the exception.

Another decision to be taken concerns the identification of areas that must be dealt with as a priority. Except for Finland, which opts not to specify critical areas, the rest of the countries do establish priorities. A third instrumental aspect of national strategies is the dilemma of whether to establish operational goals in the areas of interest (such as allotting specific purposes for the funding of federal research and development programmes). The majority choose not to fix such targets, a position not taken by Canada, which prefers to establish them. One last aspect in which there are differences concerns the publication of recommendations. Only the Irish National Competitiveness Council publishes every year what it calls its «Competitiveness Challenge», in which it formulates recommendations. At a more operational level, all the countries that follow national competitiveness strategies choose to establish a battery of indicators and a series of benchmark countries or groups of countries. Logically, the idea is to look at clear benchmarks in the area of competitiveness, although it is still surprising that, albeit in a global world, Finland should opt to focus its attention on European countries.

(1) The Reut Institute (2007): *Competitiveness indices. Tools for Policy Design*.

## COMPARISON OF NATIONAL COMPETITIVENESS STRATEGIES

Country	Substantive dimension		Procedural dimension			
	National goals	Key issues	Existence of a formal competitiveness body with authority in the area	Identification of areas requiring development	Setting operational goals	Providing recommendations
Ireland	Sustainable growth and improved quality of life	Sustainable growth, business environment, physical and knowledge infrastructure	National Competitiveness Council	Yes, in its Annual Competitiveness Report	No	Yes, in its Competitiveness Challenges
United Kingdom	Productivity and competitiveness	Investment, innovation, skills, business, competition	Department of Trade and Industry	Yes, in its publication Productivity and Competitiveness Indicators	No	No
Taiwan	Information and communication Technological training	ICT infrastructures, government, business and society	National Information and Communication Initiative	Yes	No	No
Finland	Not explicit	Government, institutions, innovation, human and social capital, information infrastructure	Government Institute for Economic Research	No	No	No
Canada	Employment, growth and prosperity	Employment, public finance	No	Yes	Yes	No

SOURCES: The Reut Institute and own elaboration.

At the beginning we said that Voltaire believed happiness would result from doing things other than searching for it. Competitiveness, and this would also be true of other variables such as productivity (intrinsically linked, by the way, to competitiveness), is the observable outcome of doing many things well. Some countries do them, others don't. Some countries promote them actively, others more passively. And a few, moreover, including those we have analyzed, pursue them with coordinated, global institutional mechanisms. The most substantial effect of these strategies is most likely to be actually intangible, namely keeping competitiveness central to the political agenda as an instrument to guarantee future prosperity. If this helps them to continue doing well what they already do, then that's a good thing.

*This box was prepared by Àlex Ruiz  
International Unit, "la Caixa" Research Department*

# EUROPEAN UNION

## Euro area: the recovery takes a breather

The situation in which the euro area's economy finds itself is certainly complex. On the one hand, evidence suggests that the economic recovery started in the third quarter of 2009 will consolidate throughout 2010. But if we only looked at this, the message would be too optimistic. It would not reflect either the whole situation or the risks entailed by the path the main economies must take over the next few quarters. Recovery is a fact and this offers us a more hopeful future, particularly compared with the situation we were facing just a year ago. However, there are

many elements that lead us to expect quite a flat exit from the recession, with numerous risks of reversals. That's why, although the rate of economic growth for the year as a whole will be clearly positive, it will more than likely be only around 1.2%.

In this respect, it's worth noting that the main indicators of economic sentiment are flagging. The PMI (purchasing manager index) for January, which summarizes the perceptions of entrepreneurs concerning the volume of business, recorded a slight drop. This was due to the drop in the sub-index for the service sector since the industrial sector continued to improve strongly.

**Some indicators are moderating the speed of recovery.**

## 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	December
GDP	2.7	0.5	-1.8	-5.0	-4.8	-4.0	-	...	-
Retail sales	1.6	-0.7	-1.8	-3.3	-2.5	-2.1	-1.1	-3.8	...
Consumer confidence (1)	-4.9	-18.0	-27.1	-32.5	-27.9	-21.3	-17.7	-17.3	-16.0
Industrial production	3.5	-1.7	-8.9	-18.5	-18.6	-14.5	-10.9	-6.9	...
Economic sentiment indicator (1)	108.9	91.1	75.6	65.7	70.2	79.9	86.1	88.8	91.3
Unemployment rate (2)	7.4	7.5	8.0	8.8	9.3	9.6	9.9	10.0	...
Consumer prices	2.1	3.3	2.3	1.0	0.2	-0.4	-0.1	0.5	0.9
Trade balance (3)	20.1	-1.2	-31.7	-36.3	-31.2	-5.3	6.5	17.4	...
3-month Euribor interest rate	4.3	4.6	4.2	2.0	1.3	0.9	0.8	0.7	0.7
Nominal effective euro exchange rate (4)	106.3	110.6	107.0	109.9	111.0	112.1	114.3	114.0	113.0

NOTES: (1) Value.

(2) Percentage of labour force.

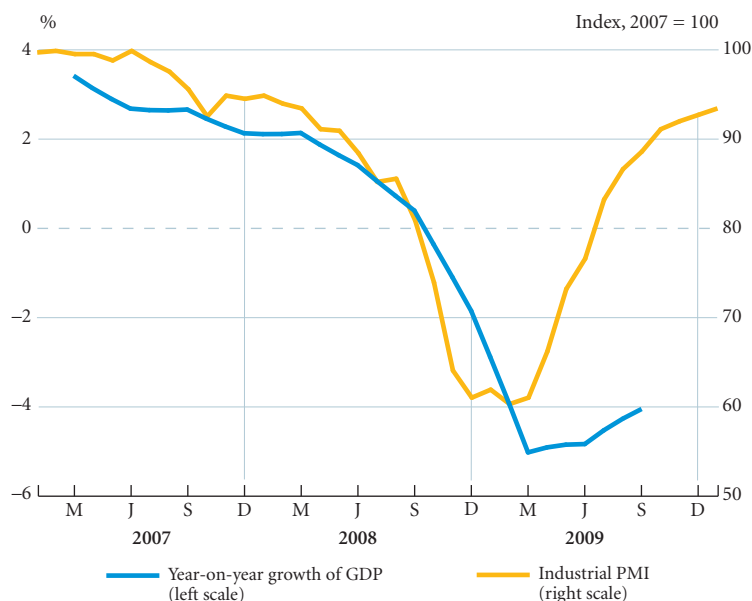
(3) Cumulative balance for 12 months. Billion euros.

(4) Change weighted for foreign trade flows. Higher values imply currency appreciation.

SOURCES: Eurostat, European Central Bank, European Commission and own calculations.

## RECOVERY IN THE EURO AREA WILL CONTINUE

### GDP and business sentiment



SOURCES: Bloomberg, Eurostat and own calculations.

### Retail sales suffer another relapse.

In any case, both indices are still at levels compatible with expansion in business and the reduction in their upward trend confirms that it will take some time to fully exit the recession.

The publication of the growth rate for the German economy also shows quite a flat exit from the recession. According to the German statistics institute, the leading European economy fell by 5% in 2009. We can therefore deduce that the growth rate for the fourth quarter, which will not be published until February, will be very weak.

The conclusions that can be made from reviewing the high frequency indicators are very similar. With regard to demand, retail sales still do not offer any signs of recovery; in fact, quite the opposite. In the month of November, the year-on-year rate of change not only continued in negative figures but even fell to 3.8%.

### Consumption will continue very weak.

It's true that this series is quite volatile and, at present, there is no reason to think that consumption is suffering another relapse. Consumer confidence, for example, continues to recover slowly. However, only one larger fall has been recorded since the start of the series in 1995, that of February 2009.

Just as there is no reason to believe that consumption has suffered another relapse, neither is there any reason to expect it will become strong in the medium term. It will continue to be very weak throughout the first half of 2010 and it won't be until the second half of the year that it might really take off again. There are two fundamental reasons for this. First, the necessary process of deleveraging being carried out in households. One reflection of this is the significant adjustment in credit to households, which is still essentially stagnant. The second reason concerns

the prospects offered by the job market at present. Unemployment reached 10% in the month of November and it is very likely to go on rising over the coming months, reaching values close to 10.5%. It shouldn't go up any more during the second half of the year but won't start falling until 2011.

The figures for supply are somewhat more encouraging and the clearest example is the significant recovery seen in the industrial production index. In the month of November, the year-on-year drop in the rate of change stood at 6.9%. This decrease is still large but reflects the slump suffered by the index in spring 2009. The other element to take into account is the percentage of industrial capacity utilization. This is also still at record low levels, standing at 70.7% in the fourth quarter of 2009, but after the sharp falls recorded during the rest of the year, a change in trend has been seen for the first time. This change in trend can also be observed in

industrial orders and the economic sentiment index.

The recovery in activity is somewhat more marked than consumption, mainly thanks to the revived foreign sector. Exports, whose year-on-year rate fell 26.1% in April, recorded a fall of just 5.3% in the month of November. Imports are also recovering but at a slower pace. The contribution made by the foreign sector to economic growth was already 2 tenths of a percentage point in the third quarter and this will continue during the first half of the year, at least. Moreover, it will now be boosted by the euro's depreciation against the dollar, which has reached 6.5% since its maximum value recorded in the month of December.

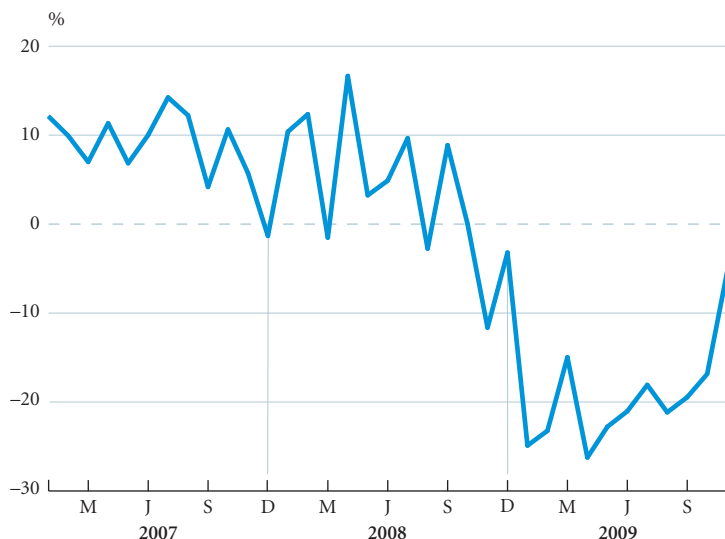
The main risk for recovery in the euro area is the *tempo* of the withdrawal of expansionary fiscal and monetary policy. In both cases it will be vital for institutions to maintain good

**Industrial production continues to recover quickly...**

**...boosted by the foreign sector.**

## EXPORTS LEAD THE RECOVERY

Year-on-year change in exports



SOURCES: Eurostat and own calculations.

**The main risk is the tempo of fiscal and monetary policy.**

communications with the rest of the agents, as this will determine whether the transition is gradual or not. With regard to budgetary policy, at present attention is focused on the new Greek executive's ability to react. After admitting a public sector deficit that is much higher than the forecast for 2009, now it is attempting to gain credibility and confidence by presenting a rigorous adjustment plan that should reduce the deficit to 8.7% this year. However, it is not at all clear that this will be enough and, moreover, it could weaken the economy even further.

Looking at monetary policy, the European Central Bank (ECB) insists in its communications that interest rates are at the right level for the current economic conditions. Moreover, inflation continues to be comfortable. In the month of December this stood at 0.9% and, although it will continue to rise a few tenths of a percentage point over the coming months, it's difficult to imagine it going above 2%, the reference limit set by the senior monetary authority. That's why there is broad consensus among analysts concerning

the future behaviour of interest rates: they are not expected to rise until at least the end of the year and, when they do, it's more than likely that such a rise will be very gradual.

In short, after a few months of relative optimism, the process of recovery in the euro area is at a critical stage. The most difficult tasks have been achieved: slowing up the negative spiral that threatened the economy during the first half of 2009. In 2010 the recovery will consolidate but the road will be slow and is not devoid of risk.

**The German economy takes its foot off the accelerator**

In 2009, the German gross domestic product (GDP) shrank further than at any other time since the Great Depression, with a 5.0% year-on-year drop. This figure reflects the deterioration in the main pillars of the German economy during the last expansionary cycle: exports and investment, with reductions of 14.7% and 20.0%, respectively. Only the rise

**The German economy shrinks by 5% in 2009.**

**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	-0.1	0.5	-2.4	-1.3	-1.6	-0.8	-2.5	...
Industrial production	5.9	-0.1	-7.5	-19.9	-19.2	-15.5	-12.4	-8.0	...
Industrial activity index (IFO) (*)	106.2	96.8	86.1	82.6	84.7	89.8	92.0	93.9	94.7
Unemployment rate (**)	9.0	7.8	7.6	8.0	8.2	8.2	8.1	8.1	8.1
Consumer prices	2.3	2.6	1.7	0.9	0.3	-0.3	0.0	0.4	0.9
Trade balance (***)	181.5	195.0	182.8	160.2	140.4	131.0	123.6	129.8	...

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.

in public expenditure aimed at reactivating the economy, 2.7% in 2009, prevented an even greater recession, which forecasters thought, in the middle of the year, might go above 6.0%.

This annual growth implicitly entails stagnation in the economy in the fourth quarter, thus decelerating the recovery started in the second quarter of the year. Such a halt in growth comes as no surprise in periods of economic recovery, especially if we consider the high growth recorded during the previous two quarters and the gradual withdrawal of economic stimulus measures. A clear example is the end of incentives to buy automobiles, which led to a 4.6% year-on-year drop in registrations in the month of December, after ten consecutive months with increases of more than 20%.

Available indicators point to this loss of impetus during the last few months

of 2009, mainly with regard to private consumption. Consequently, together with the fall in car registrations, retail sales for November also recorded a further drop of 2.5% compared with the previous month. However, this did not stop consumer confidence from improving slightly in December thanks, in part, to the robustness of the unemployment rate, which had only increased 0.5 percentage points since the start of the recession, reaching 8.1% that month. Part of this achievement must be attributed to the German short term working scheme (*Kurzarbeit*), which allows adjustments to employment by changing the hours worked, thereby guaranteeing a higher number of jobs.

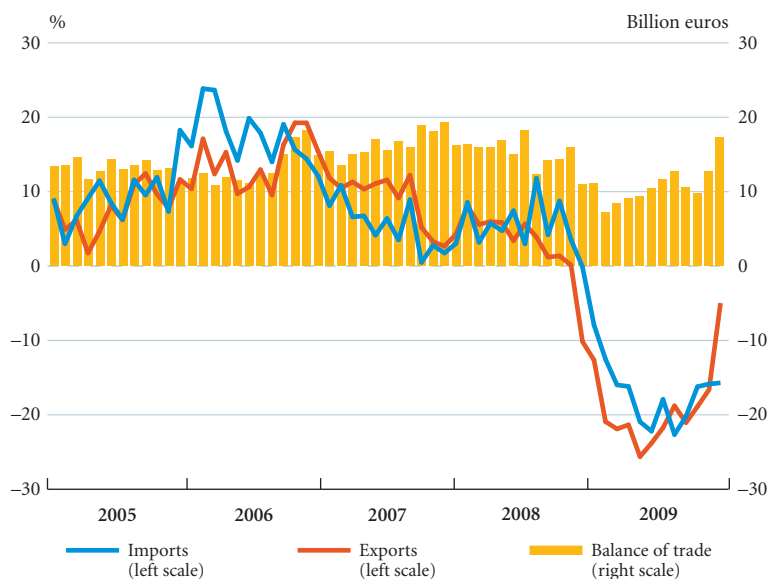
On the supply side, industrial production and orders grew by 0.7% month-on-month in November, although they are still at lower levels than those reached in September.

**Private consumption loses its impetus in the last few months of 2009.**

**The foreign sector takes the reins for German growth.**

## THE GREATER DROP IN IMPORTS RAISES THE GERMAN TRADE SURPLUS

Year-on-year changes in trade flows and monthly balance of trade data



SOURCES: Deutsche Bundesbank and own calculations.

**The German government raises its forecast for GDP growth for 2010 to 1.5%.**

In December, the business confidence index and industrial capacity utilization grew, slowly approaching their historical average. Within this context, it is expected that investment in 2010 will continue to grow gradually, mainly during the last quarters of the year, once the excess capacity has been absorbed.

Given the stagnation of domestic consumption and the measured growth in supply and investment, evidence suggests that it will be the foreign sector that takes the reins for German growth. Increased economic activity at a global and particularly European level led to a new month-on-month increase in German exports of 1.6% in November. Imports, however, fell again for the second consecutive month, with a 5.9% reduction month-on-month. The graph above shows how this difference in trend between both series led to a further increase in the balance of trade, reaching similar levels to those of 2007. This upswing, however, does not seem to be enough to prevent China from taking over from Germany as the world's greatest exporter in 2009.

The recovery in the German foreign sector, together with a deterioration in the labour market that was less than expected, led to the growth forecasts for 2010 by the government being revised, placing them at 1.5%, three percentage points higher than the previous forecast. This recovery, however, will not have the same intensity throughout the year, so the start to 2010 is expected to be very weak, with almost zero quarter-on-quarter growth in the first quarter.

That's why, given the prospect of a public sector deficit above 5.0% of GDP in 2010, a lot higher than the 3.2% estimate reached in 2009, the main party

in government (CDU) has decided to postpone part of the tax cuts announced during the electoral campaign until economic stability and fiscal consolidation are well underway. A decision that has not pleased the other party in the coalition, the FDP, whose main electoral card was precisely these cuts.

**France faces the new year with optimism**

In the fourth quarter of 2009, the second economy in the euro area confirmed its recovery, which had started two quarters before. The French central bank estimates that growth in GDP between the months of October and December was 0.5% quarter-on-quarter, the highest in the last seven quarters. This figure would mean that the French economy shrank in 2009 by 2.3%, improving on the forecasts made by leading international bodies at the start of the year. Given the good results achieved in the second half of 2009, the minister for the Economy, Christine Lagarde, announced that the growth forecast for 2010 would be upgraded, setting it at 1.4%, almost double the previous forecast.

During this period of recovery, what certainly stands out is the important role played by the public aid plan for automobile purchases. The announcement of the gradual reduction in these incentives as from 2010 led to vehicle registrations rising 21.3% quarter-on-quarter during the last three months of 2009, accumulating an annual sales volume that is 11% higher than the figure for 2008. This boost, together with the effect of incentives established in other countries, helped industrial production to grow 3%

**Angela Merkel's party postpones new tax cuts.**

**The French government raises its GDP growth forecasts to 1.4% in 2010.**

## FRANCE: 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	2.3	0.3	-1.7	-3.5	-2.8	-2.3	—	...	—
Domestic consumption	4.8	-0.6	-2.6	-1.0	0.4	-0.2	3.6	3.2	...
Industrial production	1.2	-2.4	-8.8	-15.8	-14.9	-11.2	-8.0	-3.8	...
Unemployment rate (*)	8.3	7.9	8.3	8.9	9.3	9.6	9.9	10.0	...
Consumer prices	1.5	2.8	1.8	0.6	-0.2	-0.4	-0.2	0.4	0.9
Trade balance (**)	-33.9	-48.9	-55.7	-55.1	-52.8	-44.8	-40.6	-40.4	...

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion euros.

SOURCES: OECD, Eurostat, INSEE, European Commission and own calculations.

month-on-month in November, driven by its motor vehicle component.

In spite of this increase in automobile sales, the most frequent indicators point to a significant slowdown in the rise in private consumption. The deterioration of the labour market, with another rise in the unemployment rate in December, placing it at 10.0%, and the sudden increase in the rate of inflation, by 0.9% in the same month, caused household consumption to stand still in the last few months, as shown by the data for November. With regard to the foreign sector, the rise in imports in the same month widened the trade deficit compared with that of October, so that this component is expected to contribute less to GDP growth.

Within this context, it will be public expenditure and investment that drive the French economy in 2010. Analyzing supply indicators, we can see a gradual recovery that will remain throughout 2010, leaving 2009 behind with an accumulated fall in investment of more than 7%. Consequently, the already mentioned rise in industrial production in November was followed, in the next month, by an improvement in industrial

orders and industrial capacity utilization, moving away from the minimum reached in the third quarter. Given these data, the industrial confidence index increased considerably in the last month of the year.

In spite of these improved prospects for 2010, the largest shrinkage in the economy of the last few decades will have left a few loose ends in the short term. Consequently, the French public deficit reached 8.2% of GDP in 2009, significantly higher than the 3.4% of 2008, due to the economic stimulus measures undertaken by the government. This means that a credible fiscal consolidation plan is required to return to the level of 3% by 2013, as demanded by the European Commission.

### Italy has faith in its recovery

Italy left the recession in the third quarter of 2009, with a 0.6% quarter-on-quarter change in GDP. As this recovery is expected to continue, several growth estimates for the Italian economy in 2010 were revised in the first month of the year. Consequently, both the International Monetary Fund and the

**The contribution from private consumption starts to slacken off.**

**Supply indicators suggest a gradual recovery in investment in 2010.**

**Growth prospects improve for the Italian economy.**

## ITALY: 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	1.5	-1.0	-2.9	-6.0	-5.9	-4.6	-	...	-
Retail sales	1.3	-0.3	-1.7	-2.9	-1.2	-2.3	0.5	...	...
Industrial production	2.2	-3.4	-10.7	-21.1	-22.9	-15.9	-12.7	-9.1	...
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	1.0
Trade balance (**)	-12.8	-10.0	-12.3	-11.1	-9.1	-5.3	-4.6	-4.3	...

NOTES: (\*) Percentage of labour force.

(\*\*) Cumulative balance for 12 months. Billion euros.

SOURCES: OECD, national statistical bodies and own calculations.

### Deterioration in the labour market may cause private consumption to stand still in 2010.

Bank of Italy predict a rise of close to 1.0% during this year, far from the almost zero growth predicted in the summer. However, now the discussion is centred on the sturdiness of this recovery.

One of the main doubts concerning its robustness is the behaviour of Italian household consumption. Should the gradual deterioration of the labour market continue throughout 2010, placing the unemployment rate above the 7.8% of September, it would weaken the purchasing power of families, which already posted a drop of 1.5% during the first nine months of the previous year. International trade would not offset this lower domestic demand, as the improvement recorded in the trade deficit in November 2009 was the result of a larger drop in imports than exports, which fell 3.1% month-on-month that month.

Given these demand perspectives, investment is not expected to take the reins of economic growth in Italy, particularly due to the lower utilization of industrial production capacity which stood at 66.4% in the third quarter, more than ten percentage points below its historic average. In spite of this, both

industrial production and orders kept growing in November and December 2009, although they're still at similar levels to those of 1993. Supply is expected to continue advancing in the medium term.

In spite of the risks hovering over the growth of the Italian economy, the industrial and consumer confidence indices left 2009 on the rise, so that the new year can be faced with certain optimism. Moreover, in order to underpin the economy's recovery, the Italian government decided to pass new measures of economic stimulus. Consequently, the so-called «Legge Finanziaria 2010» increased the forecasts for public expenditure and revenue by a little more than 3,000 million euros but without affecting the high Italian debt, which according to the Bank of Italy will reach 117% of GDP in 2010.

### The Italian government approves new economic stimuli for 2010.

### British GDP falls 3.2% year-on-year in the last quarter of 2009.

### The United Kingdom sees an end to recession

Initial estimates indicate that the British economy started its recovery in the last quarter of 2009 with a quarter-on-quarter growth in GDP of 0.1%,

## 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	December
GDP	2.6	0.5	-2.1	-5.2	-5.8	-5.1	–	-3.2	–
Retail sales	4.2	2.6	1.7	0.4	0.9	2.5	3.5	2.7	2.1
Industrial production	0.3	-3.1	-8.1	-12.5	-11.9	-10.8	-8.4	-6.0	...
Unemployment rate (1)	2.7	2.8	3.4	4.2	4.7	4.9	5.0	5.0	5.0
Consumer prices	2.3	3.6	3.9	3.0	2.1	1.5	1.5	1.9	2.9
Trade balance (2)	-83.4	-93.7	-94.0	-91.9	-88.4	-83.6	-82.2	-81.2	...
3-month Libor interest rate (3)	6.0	5.5	4.6	2.1	1.4	0.8	0.6	0.6	0.6
Nominal effective pound exchange rate (4)	103.9	97.6	89.4	73.9	77.0	83.7	79.0	80.1	80.0

NOTES: (1) Percentage of labour force.

(2) Cumulative balance for 12 months. Billion pounds.

(3) Average for the period.

(4) Index weighted for foreign trade flows (January 2005 = 100). Higher values imply currency appreciation.

SOURCES: OECD, Bank of England, ONS, European Commission and own calculations.

representing a 3.2% drop year-on-year. The six quarters of recession left behind represent an accumulated reduction in GDP in the order of 6%. Discussion now centres on the strength of the recovery's foundations and on the possible risk of relapse.

On the side of demand, there is evidence of a certain weakness. After the significant upswing in savings in the third quarter, consumption has seemed to falter in the last few months of the year, when purchases were expected to increase given the raise in value added tax in January. Consequently, retail sales only managed to grow 0.3% month-on-month in December. However, the stabilization of employment suggests that adjustment in the labour market is coming to an end, which should have a positive effect on families' disposable income.

Looking at supply, industrial production is taking its time to recover. In November, British industry only produced 1.5%

more than in August, when production bottomed out with an accumulated drop of 16%. Manufacturers have met their orders by extensively reducing their stocks, without needing to produce more. However, as stocks fall and foreign demand increases (thanks to the global recovery and the pound's depreciation), production will build up again.

The credit situation getting back to normal has partly helped the construction sector. More mortgages are being granted and house prices are expected to improve. However, the sector is still under tension.

Given this situation of weak economic recovery, the public deficit supposes an additional risk for the quality of the country's sovereign debt. The elections in spring will determine which party will be in charge of tackling the problem, but they will have little room to manoeuvre when implementing measures to correct this deficit without harming the recovery. Our forecasts predict a

**Symptoms of weakness in domestic consumption.**

**Foreign demand and the reduction in stock will boost industrial production.**

**Little room to manoeuvre when increasing British public stimuli.**

**In emerging Europe, business is recovering thanks to foreign demand, risk aversion is falling and public adjustment continues.**

**In 2010 the economy should continue to revive, although at a slow rate of growth...**

scenario of 1.2% growth in 2010 but with little to shout about.

The costs of an unorthodox monetary policy, with historically low interest rates, are also starting to take their toll. Inflation in December was at 2.9% year-on-year, nine tenths of a percentage point above the target established by the Bank of England. A large part of this increase is due to the base effect caused by extraordinarily low prices in December 2008, due to energy and VAT cuts. Nonetheless, inflationary risks will be present throughout 2010 and the Bank of England is likely to start withdrawing monetary stimuli in the second half of the year, whether or not the recovery has consolidated.

### **Emerging Europe: 2010, the year of transition**

In times of uncertainty, it is vital to differentiate correctly between what is known, the incipient signs of the future and what is frankly unknown. Specifically, we can ask three big questions that, in turn, will allow us to clarify a little the horizon for 2010, which is plagued with questions: what do we know, what do we think we know and what don't we know?

What do we know? The only thing we know for certain is the past and present situation. Of all indicators that are available, four facts stand out due to their importance in shaping the near future. The first is that business is continuing to recover throughout the region. A second outstanding fact is that the improvement in foreign demand plays an important role in this economic reactivation. This swing towards the foreign sector means that domestic demand is still not reflecting, in any appreciable way, the improved economic scenario. Thirdly, we can see a clear decline in regional risk aversion among investors, partly protected by the financial commitment to the area acquired by the International Monetary Fund and international institutions. A last relevant development is that fiscal policy prioritizes the containment of costs and an increase in revenue above all other considerations. Although certain differences can be observed between countries, this is quite a widespread trend, as can be seen in the table below.

What do we think we know? Based on these four realities, we can plausibly conjecture how the economy will develop in 2010. First, it seems that the recovery in business should continue

### **MEASURES CONTAINED IN THE STATE BUDGETS FOR 2010**

	Pensions		Public wages		Higher revenue		
	Frozen	No change	Frozen (or cut)	No change	Value added tax	Direct taxation	Other
Bulgaria	✓		✓				✓
The Czech Republic	✓		✓		✓	✓	✓
Estonia		✓	✓				✓
Latvia	✓		✓			✓	✓
Lithuania	✓		✓				✓
Hungary	✓		✓			✓	✓
Poland		✓		✓	✓		✓

SOURCES: World Bank and own production.

into this year and beyond. However, little dynamism in domestic demand leads, over time, to a slower overall pace in activity and a higher degree of volatility than would otherwise be the case within a context of, for example, strong growth in consumption (a more inertial macroeconomic aggregate than exports).

With regard to the assessment of international investors, it is likely that, with the logical fluctuations inherent in financial markets, the levels of risk aversion will not go above those of the worst moments in 2008 and 2009. Lastly, it is plausible to expect a moderate braking effect from public accounts on activity, given the pro-cyclic focus governments have decided to adopt in their 2010 budgets because of the economic situation.

What don't we know? The whole scenario above is based on a series of assumptions that, although reflecting the scenario currently believed to be the most credible, still has a high degree of uncertainty. Firstly, the expected developments in 2010 depend critically on the forecasts being accurate concerning the revival of key markets (in other words, the euro area) and international trade. It makes sense to see both trends as probable but we must remember that there are still doubts regarding the recovery of industrialized countries, partly due to questions regarding whether the private sector can withstand a situation where the exceptional measures of public aid are expected to be withdrawn.

Other areas, although not so fundamental, are also laced with

uncertainty. Developments in private credit will be determined not only by domestic demand but also by the decisions taken by parent banks. These supply decisions are conditioned by factors outside the region, such as the bank situation in western Europe. Overall, we need to remember that there are public commitments, explicit and credible, of banks with interests in the region to keep their subsidiaries capitalized and fully operational.

Also uncertain is investors' attitude towards what might be perceived as deviations in macroeconomic orthodoxy on the domestic front. In particular, one source of concern emerging recently is related to the situation of public finances. Although for the moment countries such as Poland, which the international community believes could have been stricter in cutting its growing general government deficit, has not had too many problems in placing its international issuances of public debt, we cannot assume such tolerance will continue.

In short, adding together the certainties displayed by the current situation with the different degrees of uncertainty surrounding key aspects, the resulting scenario for 2010 augurs a year of transition. Transition from a 2009 of deep recession and adjustment of some of the most severe macroeconomic imbalances of the boom period (particularly excessive dependence on international financing) towards a 2011 that sees a return to rates close to the growth potential in many of the region's countries.

**...always provided industrialized countries actually recover and there are no problems of credibility with fiscal policy or international credit.**

**2010 will be a transitional time between a 2009 of intense recession and a 2011 with returns to potential growth.**

# FINANCIAL MARKETS

## Monetary and capital markets

**The European Central Bank keeps its reference rate at 1%.**

At its meeting at the start of January, the European Central Bank (ECB) decided to hold its official interest rate at 1.0%, as the markets had supposed. Regarding the withdrawal of non-conventional stimuli, more specifically the end of six-month loans, the ECB President, Jean-Claude Trichet, stated that this would not be discussed until the meeting in March. One point to highlight is the recognition, by those in charge at the ECB, of the simultaneous fall in monetary supply and credit to the private sector (0.3% and 0.7% year-on-year respectively in November).

**China's central bank starts a restrictive cycle of monetary policy.**

But the most relevant news from January concerning monetary policy comes from the Asian front. On 7 January the Chinese central bank raised its interest rate for 3-month bills by four basis points (100 basis points is 1%) up to 1.37%. However, this modest measure by the reserve bank may have been the starting point of a restrictive cycle as, on 12 January, the Chinese monetary authority issued the surprise announcement of an increase in the required reserve ratio for small and large financial institutions, except rural cooperatives, by 50 basis points up to 14% and 16%, respectively. This decision by the Chinese authorities is because of concern regarding the rapid growth in bank credit and high level of liquidity in the financial system, a situation that might lead to inflationary pressures through a sudden rise in the price of financial assets and the real estate sector.

**Central bank independence is an asset that must remain separate from political interests.**

At the end of January, the Federal Reserve (Fed) held the official federal fund rate at 0.25%. Moreover, as it was its first meeting in 2010, the members who vote on monetary policy decisions were rotated (Federal Open Market Committee). In 2010, the voting members will be: James Bullard (St. Louis), Thomas Hoenig (Kansas City), Sandra Pianalto (Cleveland) and Eric Rosengren (Boston), replacing Charles Evans (Chicago), Jeffrey Lacker (Richmond), Dennis Lockhart (Atlanta) and Janet Yellen (San Francisco). Other FOMC members are Fed chairman (Ben Bernanke) and president and CEO of the New York Fed (William Dudley), who always vote and do not rotate.

The Fed's current approach to monetary policy, in the short and medium term, is unlikely to be affected by this new composition of its main committee. However, there is another factor that might negatively affect the decisions taken throughout the year, namely the political initiatives aimed at reducing the Fed's independence. On the one hand, the House of Representatives passed a bill so that the reserve bank's decisions can be audited by a parliamentary body, while the Senate is considering the possibility of taking away the central bank's role as banking supervisor.

The possible loss of independence for the Fed has huge repercussions. Firstly, greater political dependence would undoubtedly go hand in hand with a loss of credibility in the markets. It's

important to remember that credibility has a direct effect on the formation of expectations among agents and these expectations affect price stability in the medium and long term. Consequently, should such proposals be successful, the Fed's lesser independence might ultimately result in a loss of welfare.

To date, the financial markets have hardly reacted to this news as it is supposed that good sense will prevail among the legislators and that the proposals will go the way of most good intentions.

On the other hand, expectations regarding official interest rates remain unaltered. Analysts expect the ECB and Fed to keep the current levels of interest rates well into the second half of 2010, as well as discounting that the withdrawal of measures to support liquidity and credit will begin in the short term.

The expectations of a moderate, controlled monetary restriction are reflected in the relative stability shown by the interbank markets of the United States and euro area. However, in January

**The enormous liquidity of the financial system is pushing down EMU and US interbank interest rates.**

## SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
<b>2008</b>									
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
<b>2009</b>									
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	1.00	0.71	1.24	0.25	0.25	0.28	0.50	0.60	0.31
<b>2010</b>									
January (1)	1.00	0.67	1.23	0.25	0.25	0.26	0.50	0.62	0.22

NOTES: (1) January 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.

**Expectations of monetary policy getting back to normal affect the price of long-term public debt.**

(as also happened in December), there was a reduction of around eight basis points in the long tranche of the US curve (7-12 months), whereas there has been no substantial change in the interest rate curve for the EMU interbank market.

The main factor affecting interbank curves is the huge liquidity continuing in the global financial system. Along these lines, the increase observed in the use of ECB deposit facilities, from 66,000 million euros to 139,000, can be explained by the high volume of the last 12-month loan operation, carried out on 16 December 2009.

**Greater volatility in government bond markets**

In international government bond markets, the period of transition between 2009 and 2010 was characterized by greater instability, in general contained

although with some episodes of notable severity, for example Greece.

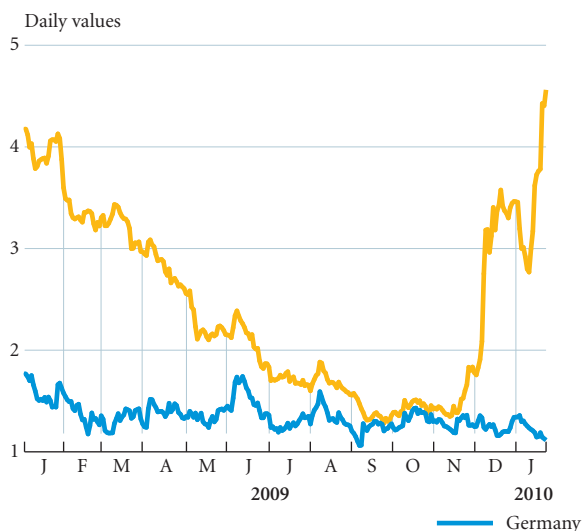
In the case of the United States, while interest rates for shorter maturities remain anchored due to the large volumes of liquidity injected by the Fed, long-term public debt has recorded notable fluctuations following surprises in data on economic growth and inflation. Specifically, in the last part of 2009 there was a sharp upswing in long-term rates (10-year bonds closed at 3.84%) due to an expected rise in inflation. A large part of this rise was subsequently rectified throughout January but within a climate of instability that will probably dominate throughout the rest of 2010. One factor that will feed this instability are doubts regarding the impact of withdrawing non-conventional monetary policy measures on the real economy.

Another notable development in sovereign bond markets is what is taking

**Markets are demanding a higher risk premium for Greek public debt given the increased uncertainty of its fiscal future.**

**MARKETS DEMAND A BETTER RETURN FROM GREEK PUBLIC DEBT**

Public debt with 2-year maturity



Public debt with 10-year maturity



SOURCE: Bloomberg.

place in the euro area with Greek public debt. Under market pressure, the Greek government presented an austere budget plan to redirect the fiscal deficit from 12.7% of GDP in 2009 to 3% by the end of 2012. This ambitious plan aroused moderately positive comments from the finance ministers of the euro area. But these, together with ECB President, Jean-Claude Trichet, made it clear that the Greek economy faces a huge challenge.

Due to greater uncertainty concerning how Greece will consolidate its fiscal situation, investors now demand a higher differential compared with German public debt. In the above graphs we can see how the interest rate for Greek debt has increased significantly. Specifically, the differential for Greek 10-year debt compared with the German has reached levels close to the maximums since Greece joined the euro area on 1 January 2001, while the differential for Greek bonds compared with German bonds, with a two-year maturity, has hit a record high since the country formally joined the euro area.

Given this situation, the Greek finance minister has declared that, in February, an official delegation will be sent to the United States and Asia to explain the situation to institutional investors and that alternative means of financing are being examined.

Largely infected by the situation in Greece, in the sovereign market as a whole there has been a movement that should adjust itself in the medium-term: sovereign risk premium has surpassed corporate risk premium. Credit Default Swap (CDS) is a financial instrument equivalent to insurance against non-payment. The buyer ensures that, should the company for which it has taken out

the insurance go bust, it will receive the money from the seller of this product. So, during the month of January, the paradox occurred that CDSs from different European countries were higher than listed CDSs for firms from these same countries. Everything suggests that this is due to a temporary movement of flows, insofar as countries cannot represent a greater risk than their business sector given that, in the last resort, states have the ability to collect funds by force.

### **The challenge of fiscal consolidation in the euro area reinforces the dollar**

The fiscal imbalance in countries on the periphery of the euro area has also affected the euro, which has weakened against the dollar. While, at the beginning of December, one euro was worth 1.51 dollars, on 21 January it was exchanged for just 1.40 dollars, a depreciation of 7%. In this case the greater perception of risk from the public debt of some countries in the euro area has reinforced the dollar as a safe haven currency. This movement has originated due to a negative effect but, if it continues, it should have a positive effect on firms exporting from the euro area.

Another two currencies that have strengthened against the euro are the pound sterling and yen. In the first case, the appreciation of the British currency is also supported by the inflation figure for December, reaching 2.9% year-on-year. The Bank of England itself recognised that inflation might exceed the higher limit of its target range for inflation, set at 3%, over the next few months. The markets expect the UK central bank to stop its quantitative expansion programme in the month of February, forcing up the yield

**Investment flows produce the paradox that covering sovereign risk is more expensive than company risk.**

**The dollar continues to appreciate against the euro due to doubts regarding the euro area's fiscal situation.**

**The pound sterling gains in strength due to worse inflation figures.**

## EXCHANGE RATES OF MAIN CURRENCIES

January 21, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	90.9	−0.3	−2.3	1.6
Pound sterling	0.619	−0.7	0.1	−15.7
Swiss franc	1.047	0.1	1.1	−10.1
Canadian dollar	1.050	−1.1	−0.3	−19.5
Mexican peso	12.761	−1.3	−2.6	−7.8
Against euro				
US dollar	1.405	−1.6	−2.0	7.3
Japanese yen	127.7	−1.9	−4.3	8.8
Swiss franc	1.471	−1.6	−0.9	−2.1
Pound sterling	0.870	−2.4	−2.0	−7.3
Swedish krona	10.158	−2.7	−1.0	−5.0
Danish krone	7.442	0.0	0.1	−0.1
Polish zloty	4.073	−3.0	−0.7	−6.1
Czech crown	26.05	−0.6	−1.5	−5.7
Hungarian forint	271.2	−1.4	0.3	−4.0

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

SOURCE: Bloomberg.

### The yen gains in strength after Japan Airlines goes bust.

offered by this country's public debt and helping the pound sterling to appreciate.

On the other hand, and in spite of the initial declarations made by the new Japanese finance minister, Kan, concerning the need for a weaker yen to boost Japanese exports, the opinion grew that the bankruptcy of the country's major airline, Japan Airlines, could produce a flow of yen repatriation, ultimately strengthening the Japanese currency against the euro and the dollar.

### Sovereign risk slows up its positive tone in private bond markets

In private bond markets the year started with a lot of bond issues, especially in the financial sector, although it should

be noted that issuance in the high risk bond segment has also hit a record high.

Within this context of large issuance volumes, corporate bond indices have become more volatile with some signs of exhaustion in the upward trend that dominated 2009.

In relative terms, the financial sector has performed less positively. After starting the year with notable gains it lost ground in subsequent sessions, recording negative figures in the last few days. Two factors explain this change in trend: firstly, the placing on the market of large volumes of paper, anticipating upcoming maturities, and secondly the rapid deterioration in sovereign debt, which has had a greater effect on bonds in the financial sector than on the other sectors.

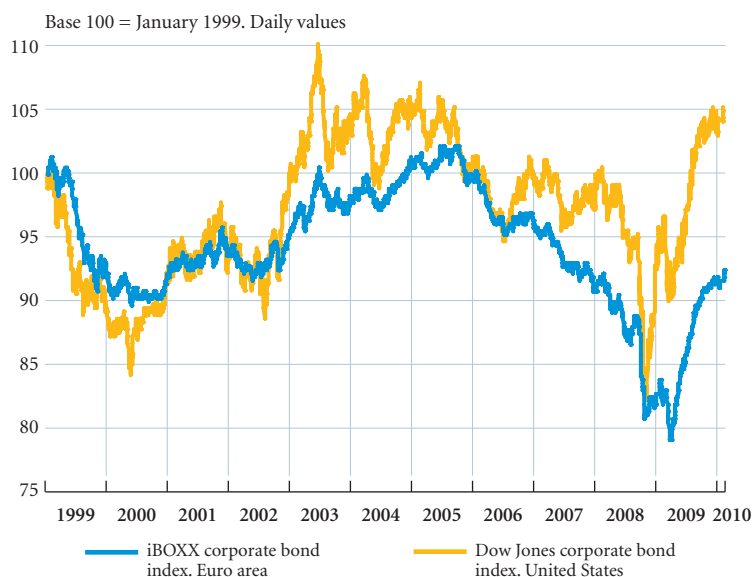
### Corporate bond markets slacken off.

The issuers that have cornered the primary markets during the first few weeks of the year are mainly financial institutions and firms with low credit

ratings, presumably taking advantage of the chance offered to them by the markets, with high levels of liquidity and interest rates at record low levels.

## TRENDS IN CORPORATE BONDS IN THE UNITED STATES AND EURO AREA

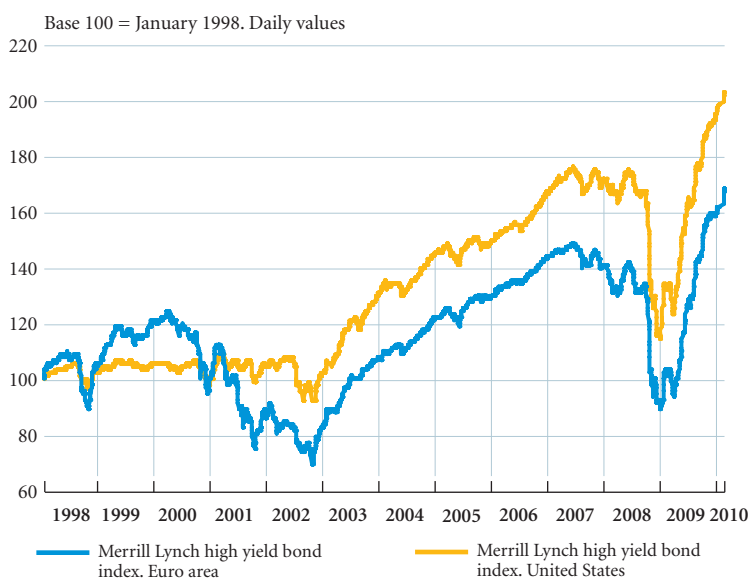
Indices for corporate bond revaluation



SOURCE: EcoWin.

## TRENDS IN HIGH YIELD BOND INDICES IN THE UNITED STATES AND EURO AREA

Indices for high yield bond revaluation



SOURCE: EcoWin.

**Equity experiences moderate gains during the first few weeks of January.**

Nonetheless, these sectors are not expected to maintain the flow of issues at the same rate over the coming months.

However, firms are still looking for greater stability in the structure of their external financing and are therefore increasing financing periods by issuing bonds, as well as reducing their dependence on bank credit. This trend is spreading to a large number of firms, with the market opening up to SMEs.

**But this positive trend was truncated by the increase in uncertainty...**

On the other hand, the low returns on risk-free assets suggests that private and institutional investors will continue to be pushed to look for financial assets with higher returns, finding an attractive alternative in corporate bonds. The scenario of low interest rates in government curves is likely to remain for some time yet and, consequently, flows of savings are expected to continue throughout the year towards private bonds, including those of lower quality that offer a slightly higher yield.

**...causing widespread falls in equity indices.**

Rating agencies have also started to improve the credit rating of many firms, which should make it easier to reduce the cost of financing by issuing medium and long-term bonds. These rating upgrades are ultimately due to the improved expectations of economic growth with positive repercussions on company profits.

### **Goodbye to stock market gains**

The new stock market year started with a less solid trend than the one observed since spring 2009. The trend towards revaluations continued unequally during several sessions, until the convergence of several different circumstances regarding

regulations and the debt situation of some European countries led to a sharp upswing in risk premia and uncertainty.

During the first two weeks of the month, markets belonging to developed economies witnessed moderate gains. The main reason was containment in expectations of economic recovery given a slower rate of growth than initially forecast. For its part, emerging countries' equity, in spite of continuing to rate the process of economic growth, also revalued very cautiously given the possible toughening up of monetary policies in several of these countries.

The placid trend in equity markets in the first few weeks of January was cut short by the emergence of several factors that might threaten economic recovery, leading to higher risk premia and volatility. This meant that indices went into the red in the second part of the month, undoing a large part of the gains of the last few months.

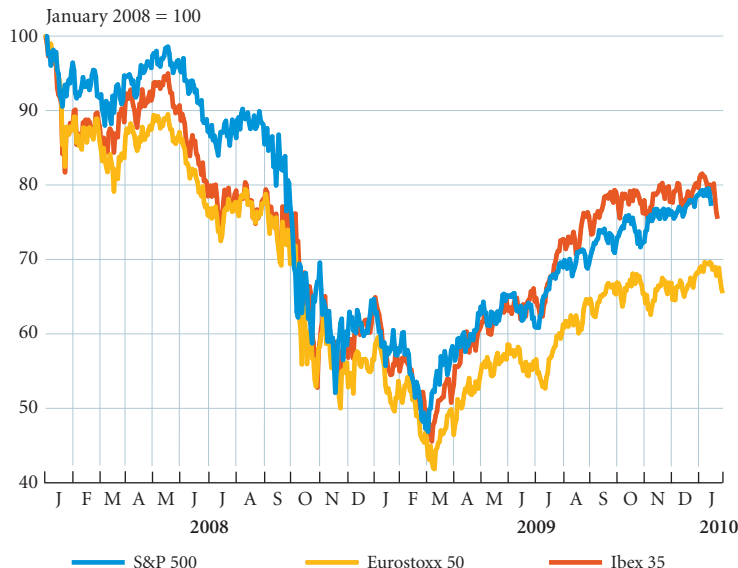
These factors were: firstly, the higher risk of sovereign debt from some countries in the euro area, such as Greece, Ireland, Portugal and Spain. Secondly, the measures imposed by the Bank of China in order to restrict the mass of credit and prevent any kind of financial bubble from occurring due to excessive liquidity. And, thirdly, the proposal by Obama's administration of a series of regulatory measures for the banking sector of the United States.

Given the nature and impact of this on risk asset markets, it is worth elucidating this last point. In order to make sure the country's investment banks do not take on excessive and unnecessary risks in the future, in turn endangering financial

**Sovereign risk has led to the appearance of losses.**

## STOCK MARKET INDICES POST FALLS

Stock market indices



SOURCE: Bloomberg.

stability, the president of the United States, B. Obama, announced a series of proposals to restrict the size and activities of banks. Specifically, commercial banks would not be allowed to carry out trading operations on their own behalf with funds from customers' savings, or to advise, take part or invest in venture capital or hedge funds.

At the same time as this piece of news, in January the corporate results campaign started for the fourth quarter of 2009 in the United States and Europe. The consensus of analysts estimate that the average profit of non-financial S&P500 companies might have increased 8% compared with the previous quarter, even with the possibility that, at year-end, overall profit might be positive for the first time in two years.

Given that banks are usually among the first to publish their figures, investor

attention has focused on the income and turnover of the financial sector more than on net profits. It should be remembered that, in the fourth quarter of 2009, most banks returned the aid they had received to the Treasury, carried out capital increases and tackled important processes of divestment, which all distorts the representativeness of the final profit of a single quarter. In any case, investors were not very enthusiastic, and in some cases were even disappointed with the accounts presented by banks overall, on both sides of the Atlantic, this contributing to the generally weak tone of the stock markets.

Insofar as these negative factors will not disappear easily or quickly and given that notable revaluations were accumulated in 2009, it would not be surprising if the adjustments started in January continue for some time yet.

**Obama regulates investment bank activity.**

**There is the risk that adjustments in equity will spread.**

## INDICES OF MAIN WORLD STOCK EXCHANGES

January 22, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
<i>Dow Jones</i>	10,389.9	-0.7	-0.4	27.9
<i>Standard &amp; Poor's</i>	1,116.5	-0.1	0.1	34.9
<i>Nasdaq</i>	2,265.7	0.6	-0.2	54.6
Tokyo	10,590.6	2.0	0.4	31.5
London	5,304.3	-0.5	-2.0	30.9
Euro area	2,841.6	-3.5	-4.2	31.6
<i>Frankfurt</i>	5,709.9	-4.0	-4.2	35.3
<i>Paris</i>	3,834.9	-1.6	-2.6	33.6
<i>Amsterdam</i>	330.2	-0.7	-1.5	40.2
<i>Milan</i>	22,734.4	-1.1	-2.2	30.9
<i>Madrid</i>	11,322.1	-4.8	-5.2	38.8
Zurich	6,513.8	-1.0	-0.5	22.2
Hong Kong	20,726.2	-1.7	-5.2	63.7
Buenos Aires	2,340.2	4.4	0.8	121.2
São Paulo	66,270.1	-1.7	-3.4	74.9

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.

## Private equity and competitiveness

The leading role played by the financial sector in the intense economic crisis of the last two years augurs far-reaching and long-lasting changes in its future make-up. Financial regulation, the behaviour of organizations as well as public attitudes will be altered by this traumatic experience. The initial reaction is already moving towards reinforcing those elements that make the system more stable. But it will be important not to underestimate those norms, institutions and practices that have shown themselves capable of improving the efficiency and growth potential of the economy as a whole. One outstanding area in this respect is that of private equity<sup>(1)</sup> and venture capital<sup>(2)</sup> organizations and markets.

Throughout the last few decades, numerous empirical studies have been carried out on the relationship between the degree of development of a country's financial system and its results in terms of long-term economic growth and social welfare. Not devoid of nuances or controversy, the evidence overall<sup>(3)</sup> suggests that how financial markets and brokers function is actually a significant determining factor in economic growth.

(1) Financial activity that consists of providing capital in the form of equity to firms that are not quoted on a stock market.

(2) This is the sub-component of private equity that is characterized by providing capital for business projects in their early stages.

(3) Among the most cited references are: R. Levine, «*Finance and Growth: Theory and Evidence*», NBER Working Paper no. 10766, 2004 and R. Rajan and L. Zingales, «*Financial Dependence and Growth*», American Economic Review, 88 (3), 1998.

This link is based on two basic features. First, its effect on the accumulation of capital: agile, effective financial intermediation means that a larger volume of savings can be mobilized towards projects with higher rates of return. Second, its effect on technological innovation and higher productivity: a developed, efficient and stable financial system improves the allocation and management of resources as well as the distribution of risk in the economy as a whole.

This relationship between a financial system and productivity is recognised by most applied studies that assess the degree of competitiveness of different countries. The table below contains such considerations made by the most prominent reports. Of particular note is the outstanding role given to private equity (PE) markets and in particular venture capital (VC).

#### THE IMPORTANCE OF THE FINANCIAL SYSTEM FOR COMPETITIVENESS

Report	Considerations regarding the financial system
World Economic Forum «The Global Competitiveness Report»	The eighth of twelve competitiveness pillars is called: «Financial market sophistication».
IMD «World Competitiveness Yearbook»	The following are included among factors affecting competitiveness: the efficiency of the banking sector and that of stock markets, as well as the degree of development of corporate bond markets and the venture capital market.
European Commission «European Competitiveness Report»	Among the variables used to assess the competitiveness of each region and country are some from the area of financial markets, of note being the degree of development of venture capital activities.

SOURCE: Own production.

Although they can sometimes be accused of being biased and partial, a number of empirical studies have accumulated over time concerning different countries that consistently show PE/VC organizations as managers that improve the access to financing and productivity in the companies in which they participate, leading to improvements in levels of employment and social welfare.

Various studies<sup>(4)</sup> have found a significant correlation between the existence of a developed VC market and the creation of new firms in the most dynamic economic sectors, with high percentages of investment in research and innovation, which have been key factors in economic growth in the last two decades (such as high tech or biotechnology firms). For the most part, innovation (measured, for example, through patents) has been present in enterprising firms, which have been the basic pillars to achieving higher levels of productivity. However, it should be noted that, in the area of innovation-patents, VC organizations stand out from other kinds of financing more in terms of quantity rather than the quality of results; i.e. the presence of these organizations results in higher ratios of successful innovations as a consequence of greater specialization, better qualified staff and financing that is better suited to the projects in question. The data show better results for the United States than for Europe, although it does not mean that VC organizations are less effective managers in Europe but rather highlights the less flexible labour market, more restrictive legislation and less developed markets.

(4) For example: A. Popov and P. Roosenboom, «Does Private Equity Investment Spur Innovation? Evidence from Europe», European Central Bank Working Paper no. 1063, 2009. Also: M. Mollica and L. Zingales, «The impact of Venture Capital on Innovation and the Creation of New Business», University of Chicago Working Paper, 2007.

From the point of view of business restructuring, several studies<sup>(5)</sup> also show positive results from the presence of PE organizations on productivity, employment, sales and corporate investment during the years after their intervention and subsequent sale or separation. According to a large number of these analyses, the activity carried out by the PE was decisive in improving the US manufacturing system, particularly as from the eighties when PE was at its peak, making the Schumpeter principle of creative destruction come true. In many large American firms it was noted that, when there were major technological changes, their governing bodies prevented innovations from being properly incorporated. As a consequence, investment slowed down and the levels of productivity dropped. Finally the profit ratios also fell, making it more difficult and costly to fund new investment projects. Many firms became projects that were relatively unviable in the medium term. The entrance of venture capital funds and the incorporation of new management via LBOs (leveraged buyouts) resulted in a larger number of small firms that were more efficient, productive and profitable. Moreover, and in contrast to a somewhat widely held opinion, in subsequent years, the firms benefitting from these funds had much higher ratios of employment, productivity, sales and investment than the rest of the companies (particularly in the service sector).

It is particularly important to bear in mind the overall findings of these studies in the current post-crisis scenario, where some financial institutions are burdened with a complex situation in terms of net lending and the assumption of risk. Specifically, this reinforces the conclusion that the existence of a powerful PE/VC sector is a highly positive factor in facilitating access to financing for firms, especially enterprising, innovative SMEs. This highlights just how advisable it is to encourage, at a public and private level, the carrying out of PE/VC activities, which seem destined to play a very important role in the new upcoming business cycle.

(5) For example: S.N. Kaplan and P. Stromberg, «Leveraged Buyouts and Private Equity», Journal of Economic Perspectives, vol. 23 (1), 2009.

*This box was prepared by Fernando San José  
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# SPAIN: OVERALL ANALYSIS

## Economic activity

### Noticeable improvement in the overall situation

The easing of the economic recession, visible as from the second quarter of 2009, continued in the fourth quarter in line with the economic indicators available. This improvement can be put down to the effect of the economic stimulus measures implemented and to progressive recovery in the international economy. With regard to demand, consumption trends have been more favourable than those of investment. From the point of view of supply, there are more evident signs of recovery in industry and services.

The rise in the purchasing power of workers, the slowdown in job losses and

the enriching effect of rising stock markets have all helped to revive consumption, albeit still at a low level. There has therefore been notable improvement in the consumer confidence index, although it is still slightly below its historic average. Also of note is the upswing in car sales, rising 29.3% in the fourth quarter compared with the same period the previous year, after having recorded year-on-year falls since the first quarter of 2008. This change is due to the direct aid contained in the Plan 2000E. However, registrations for 2009 as a whole totalled 952,772 units, an annual drop of 17.9%, returning to the levels of 1996.

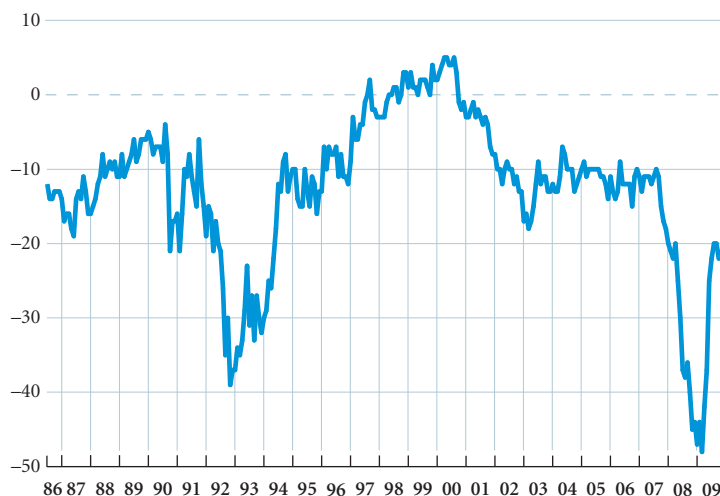
The slump in investment in capital goods also eased back. Registrations of load-

**Workers' increased purchasing power, the slowdown in job losses and rise in stock markets are tending to revive consumption.**

**Car sales down to 1996 levels.**

### CONSUMER CONFIDENCE IMPROVES

Net balance in percentage of consumer confidence indicator



NOTE: Adjusted for seasonal variations.

SOURCE: European Commission.

## Industrial production cuts back its decline.

bearing vehicles still fell 7.8% compared with twelve months before in the fourth quarter of 2009 but the year-on-year drop was less than 1% in November and December. The production of capital goods also slowed up its decline, to 10.6% year-on-year in November. With regard to investment in construction, one leading indicator such as cement consumption reveals a slowdown in the decline in the fourth quarter.

In the foreign sector, improved demand has led to growth being recorded in November for both exports and imports, measured in terms of volume, although a greater overall improvement was seen in exports in the two first months of the fourth quarter. Consequently, the foreign sector probably made a positive contribution to growth in gross domestic product.

From the point of view of supply, activity in industry has cut back on its decline. Electricity consumption suffered a 1.4% annual drop in the fourth quarter but recorded a rise of 0.6% in December, breaking a series of fifteen consecutive falls. However, the decrease for 2009 as a whole was 4.3%, not only the largest but the first for several decades. The industrial production index also put a brake on its decline, at 5.7% year-on-year in November, less than half the fall of the third quarter. Moreover, the outlook is no longer as gloomy as months ago. New orders fell by 1.5% in November compared with the same month in 2008 but they compare favourably with the accumulated annual drop of 24.0%. The industrial confidence indicator also recovered its level of fifteen months ago.

## DEMAND INDICATORS

Percentage change over same period year before

	2007	2008	2008 4Q	2009 1Q	2Q	3Q	October	November	December
<b>Consumption</b>									
Production of consumer goods (*)	1.7	-4.7	-10.3	-12.6	-9.4	-8.6	-5.1	-0.9	...
Imports of consumer goods (**)	5.1	-7.7	-17.2	-9.4	-14.9	-3.4	6.5	11.1	...
Car registrations	-1.2	-28.1	-46.6	-43.1	-33.7	-0.6	26.7	37.3	25.1
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	-17.9
<b>Investment</b>									
Capital goods production (*)	4.6	-8.8	-20.8	-30.5	-24.7	-20.2	-12.8	-10.6	...
Imports of capital goods (**)	9.8	-19.6	-28.8	-31.3	-35.1	-23.4	-25.1	-5.3	...
Commercial vehicle registrations	0.3	-43.6	-61.3	-52.5	-51.9	-30.8	-19.2	-0.7	-0.9
<b>Foreign trade (**)</b>									
Non-energy imports	7.3	-4.9	-19.0	-26.0	-26.8	-13.4	-6.2	7.8	...
Exports	4.2	1.9	-8.4	-17.9	-14.7	-9.6	-4.2	7.7	...

NOTES: (\*) Adjusted for public holidays.

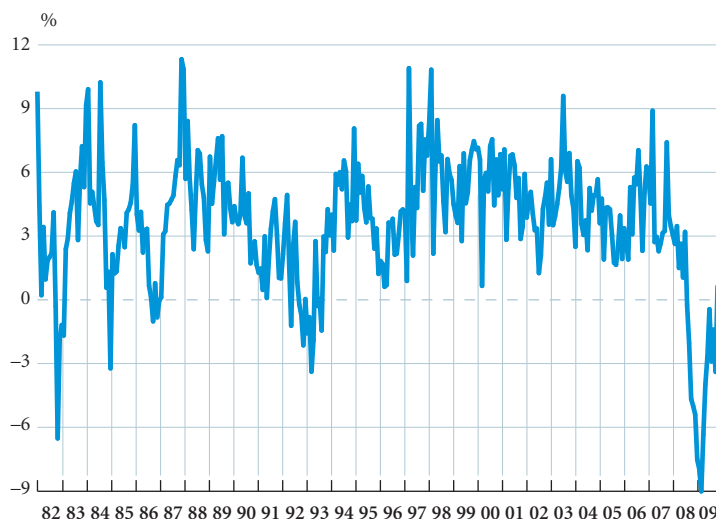
(\*\*) By volume.

(\*\*\*) 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.

## ELECTRICITY CONSUMPTION RECOVERS FROM THE BIGGEST FALL OF THE LAST FEW DECADES

Year-on-year change in electricity consumption



NOTE: Adjusted for the effects of work days and temperature.

SOURCE: Red Eléctrica Española.

With regard to construction, the residential sector continues to adjust, with a 44.5% year-on-year slump in the number of approvals for new housing in October, although the fall in the number of housing sales has slowed up over the last few months, recording a year-on-year drop of 2.6% in November. On the other hand, the construction confidence indicator improved significantly in the fourth quarter, although still below its historic average.

This improvement has also reached the services sector, which cut back its annual drop in its turnover to 6.5% in November, adjusted due to calendar effects. However, all the key sub-sectors recorded year-on-year falls. The highest were in corporate services, 10.4%, and transport, 6.4%, while the lowest falls were in information technology, 6.0% and tourism, 5.2%.

Looking at this last branch of services, the sharp falls recorded both in hotel

stays and in the arrivals of foreign visitors at the start of the year have eased back. Consequently, in December 2009 hotel stays equalled the figure recorded in the same month of 2008, but in the year as a whole they were 6.6% lower, due particularly to the national and international economic situation but also to a certain extent because of competition from other destinations, benefitting from the euro's appreciation. It should be noted that this slump has also eased off partly because of lower hotel prices, 5.6% on average. For their part, the arrivals of foreign tourists were down 3.5% year-on-year in the fourth quarter and 8.7% in 2009.

Another sign of the recession's loss of virulence has been the gradual reduction in the default rate on negotiable instruments, going from 6.4% in January to 4.4% in November 2009. However, the weak pulse of the economy as a whole could be seen in a 26.1% year-on-year drop in the number of companies set up

**Hotel stays stagnate in December but fall by 7% in 2009.**

**Fewer firms are being set up, while the number of wind-ups increases.**

## SUPPLY INDICATORS

Percentage change over same period year before

	2007	2008	2008	2009					
			4Q	1Q	2Q	3Q	October	November	December
Industry									
Electricity consumption (1)	4.4	0.6	-4.1	-7.0	-6.6	-2.1	-1.5	-3.5	0.6
Industrial production index (2)	2.0	-7.3	-16.6	-22.6	-18.6	-14.6	-9.2	-5.7	...
Confidence indicator for industry (3)	-0.3	-18.0	-32.7	-36.7	-35.5	-29.0	-24.0	-25.0	-23.4
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	-9.3	8.4	...
Construction									
Cement consumption	0.2	-23.8	-38.1	-46.1	-36.0	-26.4	-21.1	-9.3	-20.0
Confidence indicator for construction (3)	9.3	-22.6	-34.7	-36.7	-35.0	-26.3	-29.0	-20.0	-24.4
Housing (new construction approvals)	-24.7	-59.4	-60.2	-64.1	-62.8	-52.2	-44.5	...	...
Government tendering	-15.0	3.0	12.4	-5.3	-8.3	-1.1	-33.4	...	...
Services									
Retail sales (6)	2.3	-6.3	-7.7	-6.3	-4.2	-2.8	-2.0	-5.0	...
Foreign tourists	1.1	-2.5	-9.0	-16.2	-8.2	-7.8	-3.6	-3.1	-3.6
Tourist revenue inflows	3.3	-0.4	-8.0	-14.3	-8.0	-9.0	-6.5	...	...
Goods carried by rail (ton-km)	-3.7	-7.7	-23.0	-34.1	-34.9	-32.4	-19.8	-3.1	...
Air passenger traffic	9.0	-3.0	-12.7	-18.2	-8.7	-5.2	-2.7	-0.8	2.0
Motor vehicle diesel fuel consumption	5.1	-3.8	-7.7	-10.3	-5.2	-3.0	-3.4	...	...

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.

### The way out from the recession is in sight but will be very gradual.

and 43.9% of capital subscribed in November. The number of company wind-ups also rose to 5.7%.

In short, economic activity shows some signs of improvement although the overall tone is still weak. Without doubt, the reactivation of the economy in 2010 will be supported by the pull of the international economy and particularly by the current resurgence of the

European Union, its main trading partner. On the other hand, although monetary stimulus remains at present, there are some raises in taxes and certain imbalances are still evident. We therefore predict that the way out from the recession is in sight but that this will be very gradual and not without risk. Consequently, economic growth is likely to continue slightly negative for 2010 as a whole.

## Labour market

### Slowdown in job losses

The monthly average number of people registered as employed with Social Security fell by 43,830 in December, totalling 17,803,839 people. However, this drop was less than expected and slightly lower than the fall in the same month of 2008, with job losses continuing to slow up. In 2009 as a whole, Social Security registrations fell by 727,473, down 3.9%. This decrease was less than the 4.3% recorded in December 2008. In fact, since the end of 2008, the fast pace of job losses has tended to ease, helped by government measures to boost the economy.

Although the annual fall in the number of registered employed in 2009 was lower

than in 2008, in the last two years this figure has decreased by more than a million and a half workers, more than double the equivalent figure in the previous recession of 1992-1993. The lion's share of job losses in 2008-2009 went to construction, more than half, due to sharp adjustments in the real estate sector. But there were also significant job losses in industry, accounting for more than a quarter of the overall figure.

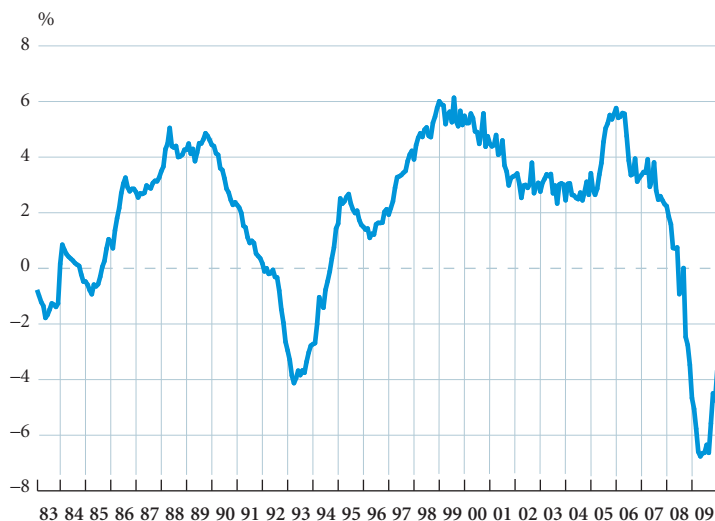
Given that males predominate in these sectors, it is no surprise that registrations have fallen more sharply among men. In fact, in 2009 the number of male registrations dropped 5.5% compared with 1.9% for women. Consequently, female workers will reach 44.6% of total

**In the last two years, the number of people registered as employed with Social Security has fallen by more than one and a half million...**

**...the lion's share of this loss being in construction, due to sharp adjustments in the real estate sector.**

### SLOWDOWN IN THE BIGGEST DROP IN EMPLOYMENT OF THE LAST FEW DECADES

Year-on-year change in Social Security registrations at month-end



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	December
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	-9.2
Construction	3.6	-10.3	-19.5	-25.2	-25.4	-22.0	-20.1	-18.6	-17.9
Services	3.5	1.7	-0.2	-2.1	-3.1	-3.0	-2.6	-2.1	-1.5
Job situation									
Wage-earners	3.1	-0.7	-3.7	-6.3	-7.0	-6.2	-5.4	-4.6	-3.8
Non-wage-earners	2.8	0.4	-1.9	-3.9	-5.0	-5.3	-5.1	-5.0	-4.7
Total	3.0	-0.5	-3.4	-5.9	-6.7	-6.0	-5.3	-4.7	-3.9
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	-16.7
Temporary	0.3	-10.4	-17.9	-23.9	-17.8	-9.4	-12.3	6.1	3.7
Total	0.5	-10.9	-18.9	-25.4	-19.9	-11.4	-14.3	3.6	1.8

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 State Employment Service and own calculations.

### Women reach a record share in overall employment.

registrations in December, a record figure.

Similarly, registrations among foreign workers, with a relatively higher representation in construction, also fell further than for Spanish workers. Consequently, in 2009 the number of foreigners registered as employed fell by 4.7%, compared with 3.8% for Spaniards.

In December, the number of contracts recorded saw positive year-on-year growth for the second consecutive month. This increase was due to temporary contracts rising 3.7%, while permanent contracts fell by 16.7%. However, in 2009 as a whole, accumulated employment contracts fell by 15.5%, totalling 14,021,837.

On the other hand, at the end of December the President of the Spanish government, José Luis Rodríguez Zapatero, confirmed his intention to boost social dialogue between entrepreneurs, trade unions and the government to help reach an agreement concerning the job market during the first quarter of 2010. He explained that reforms in the labour market would focus on collective bargaining, on promoting employment contracts for young people and on tackling job security.

### Registered unemployment reaches record levels at the end of 2009

In line with the fall in employment, the number of registered unemployed

## REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

December 2009

	No. of unemployed	Change over December 2008		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	106,133	30,122	39.6	30,122	39.6	2.7
Industry	508,802	95,377	23.1	95,377	23.1	13.0
Construction	781,724	124,288	18.9	124,288	18.9	19.9
Services	2,241,065	450,790	25.2	450,790	25.2	57.1
First job	285,879	94,063	49.0	94,063	49.0	7.3
By sex						
Males	2,012,536	436,069	27.7	436,069	27.7	51.3
Females	1,911,067	358,571	23.1	358,571	23.1	48.7
By age						
Under 25 years	446,769	61,639	16.0	61,639	16.0	11.4
All other ages	3,476,834	733,001	26.7	733,001	26.7	88.6
TOTAL	3,923,603	794,640	25.4	794,640	25.4	100.0

SOURCES: Public State Employment Service and own calculations.

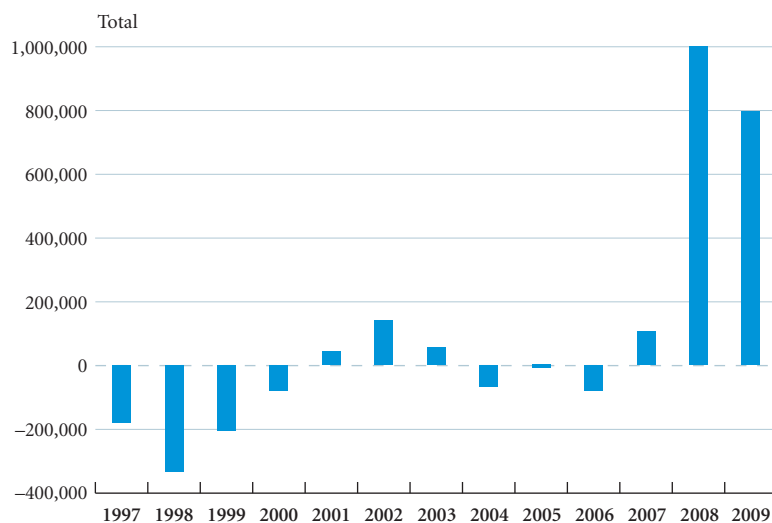
with the state employment service continued to rise in December, up to 3,923,603 people, 25.4% more than twelve months before. This figure represents a record and a rise of 794,640

unemployed people in one year. However, since the end of 2008, soaring unemployment has tended to ease off and its growth was less than forecast in December 2009.

**Although unemployment is tending to ease, registered unemployment has risen by 1,794,056 people in two years.**

## REGISTERED UNEMPLOYED WITH EMPLOYMENT SERVICE

Annual change



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

**In 2009, the segment with the highest rise in registered unemployed is men aged over 25.**

In 2009, the rise in unemployment was widespread in all large sectors, although to differing degrees. The increase was greater in the group of first-time jobseekers, namely 49.0%, and less in construction, with a rise of 18.9%. However, over the last two years as a whole, unemployment grew more in construction, by 142.7%, while this increase was less in services, up 72.0%.

From another perspective, the segment with the highest rise in unemployment in 2009 was men aged over 25, with an annual increase of 30.2%, while the group less affected by unemployment was men under 25, posting a rise of 12.7%.

The impact of unemployment is also evident throughout all autonomous communities and, in 2009, there was actually a sharp rise in unemployment in all regions. Murcia saw the highest increase, up 34.4%, while the lowest was in Extremadura, up by 15.1%.

The outlook for unemployment is not encouraging, given that it will probably continue to increase over the coming months as no significant economic growth is expected. However, unemployment will continue to slow up as the economic situation gradually improves.

## A silent devaluation?

When Spain joined the euro area, it gave up its own currency, thereby giving up the chance to implement an independent exchange policy. Many have been reminded of this situation at a time of crisis like the present since, if we didn't form part of the monetary union, we would have another instrument of economic policy to tackle it, namely competitive devaluation. However, as we will see below, in practice there has been devaluation, albeit of a very different nature to what we are used to.

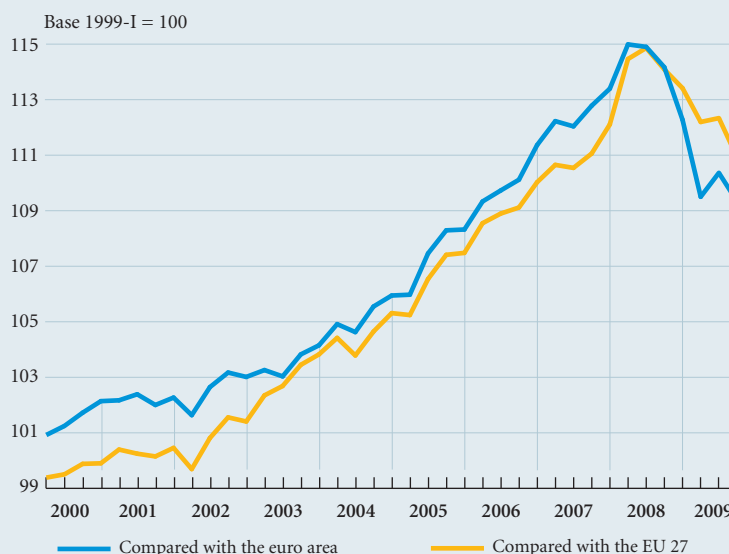
How can there have been devaluation if there is no autonomy in exchange rates? We can understand this apparent paradox more readily if we see devaluation as a change in relative prices. If A devalues 10% compared with B, it means that A's prices and costs will become 10% lower than B's. A gains in price competitiveness, i.e. it can sell more cheaply to B and therefore gain market share. At the same time, products imported from B will become relatively more expensive and will lose market in A. Ultimately, devaluation allows A to produce more than before and thereby increase its product. But we can see that, for competitive devaluation to have the same outcome, the internal prices of each country cannot vary. If A devalues 10% and its inflation immediately rises by 10%, the devaluation will have been to no avail. The same thing will happen if, after A's devaluation, B's internal prices fall by 10%.

Taking devaluation as a relative modification in prices, we can see that, although two countries may share a single currency, the different routes taken by their respective inflation rates determine an exchange rate, called the real exchange rate, whose effects, in terms of price competitiveness, are comparable to those caused by movement between two different currencies. The graph below shows the trends in this variable, taking unit labour costs as a measurement of inflation, i.e. labour costs adjusted by the level of productivity. As can be seen in the graph, up to 2008 the index tended to rise, i.e. there was a loss of competitiveness comparable to a currency appreciation, while in the last year there has been a 5% decline – gain in competitiveness – compared

with the euro area. We can therefore conclude that, since early 2008, we have undergone a 5% depreciation and that this will help to recover the competitiveness lost and will also help us to leave the recession behind.

### SPANISH FOREIGN COMPETITIVENESS IMPROVES

Spain's competitiveness index with unit labour costs



SOURCE: Bank of Spain.

However, before we start shouting from the rooftops, there are several important points to be taken into consideration. Firstly, the improvement achieved through relative unit labour costs is only one aspect of the many involved in establishing competitive capacity with regard to other countries. Other elements, such as the capacity to innovate, productive specialization, efficiently functioning markets and the characteristics of corporate organizations are as or more important, given that they ultimately determine how costs and productivity evolve.

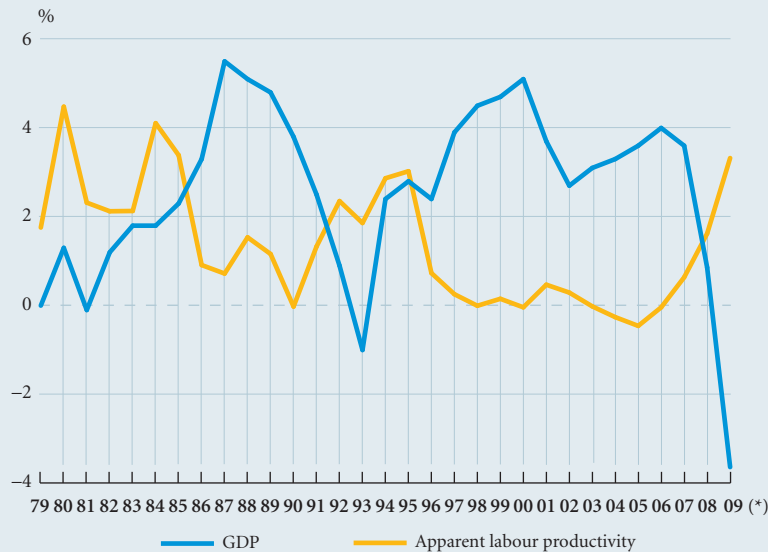
Secondly, gains in competitiveness through relative unit labour costs only minimally offset the loss suffered in recent years, as can be seen from the above graph.

Thirdly, this may be very difficult to sustain. This is due to the fact that, in the case of the Spanish economy, such improvement in relative costs comes almost exclusively from the job losses occurring even before the recession officially began. The total labour cost has fallen because there are fewer people working, but the average salary per employee has hardly changed. This peculiar adjustment in the Spanish economy also explains the sudden improvement in apparent labour productivity (measured as the ratio between the gross domestic product and employment), which has gone from being almost flat for many years to 3% growth in just a short period of time. This trend is not new, as productivity measured in this way has shown anti-cyclic behaviour in the last few cycles of the Spanish economy. This can be explained by firms resorting particularly to dismissing workers on temporary contracts in periods of recession. In this way, adjustments made

due to declining sales are mostly based on reducing employment rather than slowing up wage increases. Consequently, apparent labour productivity rises sharply in recessions, as employment falls more than product, whereas the opposite is true in expansive phases, when the Spanish economy creates a lot of employment at the expense of gains in apparent productivity.

#### APPARENT LABOUR PRODUCTIVITY IN SPAIN CONTINUES ITS ANTI-CYCLIC TREND

Year-on-year rate of change



NOTE: (\*) 2009, own estimate.

SOURCES: Bank of Spain, National Institute of Statistics and own calculations.

A sustained advance in productivity is vital for foreign competitiveness to improve. That is why, beyond today's transitory improvement in apparent labour productivity, it's advisable to adopt measures to increase this productivity. To this end, improved efficiency must be promoted at all levels of companies and public administration. New technologies play an important role but they must be used efficiently. Improvement in education is also vital, as is research and investment in innovation. In this way, we'll be able to take advantage of the opportunities offered by global markets.

If improved competitiveness is limited to a readjustment in the labour market, it is clear that any gain in terms of the foreign competitiveness of «exportable» sectors (manufacturing and certain branches of services) will be very short-lived. If nothing else is done, the variables will return to their habitual state: labour costs will again rise more than the EU average and productivity will return to its traditional stagnation. The end result will have been a spurious, fleeting improvement, almost bereft of any medium-term consequences, like devaluations that are followed by higher inflation, in which any gains achieved disappear without trace in no time at all.

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

## Prices

### Inflation ends 2009 at 0.8%, the lowest in the last few decades

The year-on-year change in the consumer price index (CPI) was 0.8% in December, 5 tenths of a percentage point more than the previous month. This upswing can be put down to fuels and oils, which also had a strong effect on the consumer price inflation profile throughout the year, in turn reflecting trends in oil prices in Europe.

Consequently, inflation fell slightly in the first half of the year, reaching a year-on-year drop of 1.4% in the month of July, the highest for several decades. Inflation then started to turn around but, overall, posted the lowest year-on-year rise in the last few decades at year-end. Average

annual inflation was negative at 0.3%, the lowest value since 1952.

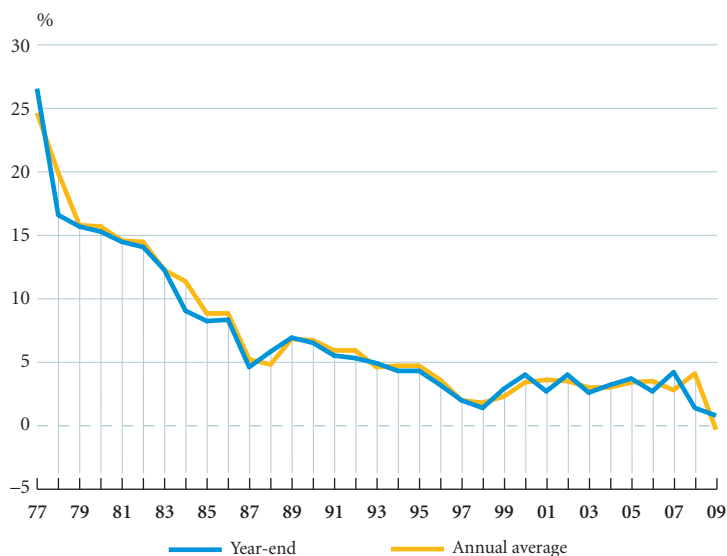
The prices of fuels and oils, which had ended 2008 with a year-on-year drop of 12.9%, intensified their plunge in the first few months of the year, posting an annual decrease of 22.8% in the month of May. Since then, the year-on-year rate of change reversed and ended up at 7.9% in December.

The low levels of inflation in 2009 are also due to the squeeze in consumption. Within a recessive context, most firms tend to contain or reduce prices in order to boost sales. Consequently, the most stable core of inflation, also called underlying inflation, which excludes

**In 2009, consumer prices fall 0.3% on average, the lowest value since 1952...**

#### NEGATIVE AVERAGE INFLATION IN 2009

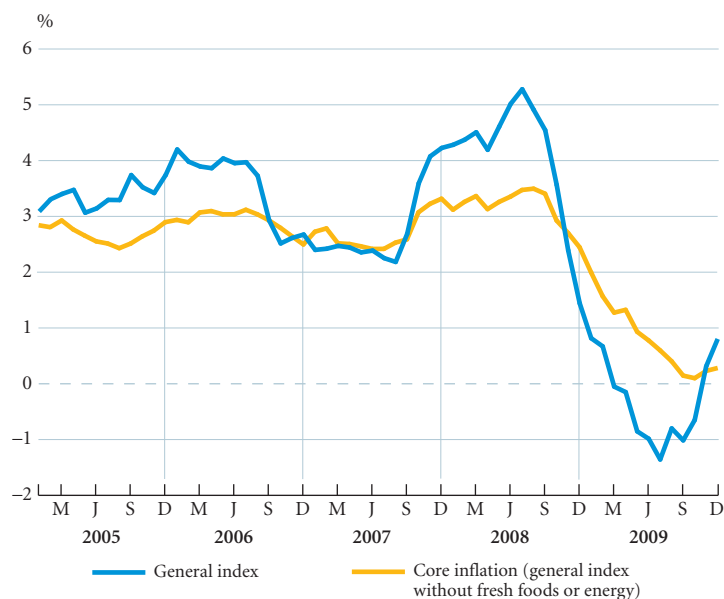
% annual change in the general consumer price index



SOURCES: National Institute of Statistics and own calculations.

## THE SHIFT IN CORE INFLATION IS CONFIRMED

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

**...because of the strong squeeze in consumption...**

fresh foods and energy products, posted a record minimum in the month of October of 0.1% and only recovered very slightly later on, standing at 0.3% in December.

For their part, processed food prices tended to fall early on in 2009 and posted zero annual change in the month of May. However, they picked up in the following months and ended up with an

## 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	0.0	0.8	0.8

SOURCE: National Institute of Statistics.

annual increase of 0.7% in December. In fact, this rise is attributable to tobacco, whose special taxes were raised in the month of June, recording a year-on-year increase of 17.7% in December. The prices of basic foods such as potatoes, milk, oil and bread ended the year with annual drops.

Strong competition in international markets held the prices of non-energy industrial products in check, with a

record year-on-year drop of 2.1% in September. In the last few months, and within a context of an improved international situation, they moderated their annual decrease to 1.7% in December.

Although more protected from competition abroad, services cannot avoid the downward pressures resulting from weak demand. The annual rate of change in their prices therefore fell more

**...and in spite of the rise in some indirect taxes.**

## CONSUMER PRICE INDEX BY COMPONENT GROUP

December

	Indices (*)	% monthly change		% annual change	
		2008	2009	2008	2009
By type of spending					
Food and non-alcoholic beverages	108.1	0.2	0.2	2.4	−2.4
Alcoholic beverages and tobacco	126.0	0.0	−0.1	3.9	12.7
Clothing and footwear	108.0	−1.3	−1.2	0.5	−0.8
Housing	112.5	−0.5	0.0	5.9	0.8
Furnishings and household equipment	107.5	0.2	0.1	2.6	0.8
Health	97.5	−0.1	0.0	0.3	−1.3
Transport	103.3	−3.4	−0.5	−5.6	3.9
Communications	99.3	−0.5	0.0	−0.3	−0.3
Recreation and culture	98.6	1.4	1.4	0.3	−1.1
Education	114.5	0.1	0.0	4.0	2.7
Restaurants and hotels	111.8	0.0	0.0	4.0	1.2
Other goods and services	109.8	0.1	0.1	3.5	2.1
By group					
Processed food, beverages and tobacco	111.9	−0.1	0.1	3.0	0.7
Unprocessed food	106.8	0.6	0.2	1.6	−3.1
Non-food products	106.9	−0.7	−0.1	1.1	1.1
Industrial goods	103.2	−1.7	−0.5	−1.5	0.7
Energy products	107.2	−5.8	−0.6	−7.2	7.5
Fuels and oils	102.3	−7.9	−0.8	−12.9	7.9
Industrial goods excluding energy products	101.4	−0.5	−0.4	0.4	−1.7
Services	110.8	0.3	0.3	3.8	1.6
Underlying inflation (**)	107.7	0.0	0.0	2.4	0.3
GENERAL INDEX	107.8	−0.5	0.0	1.4	0.8

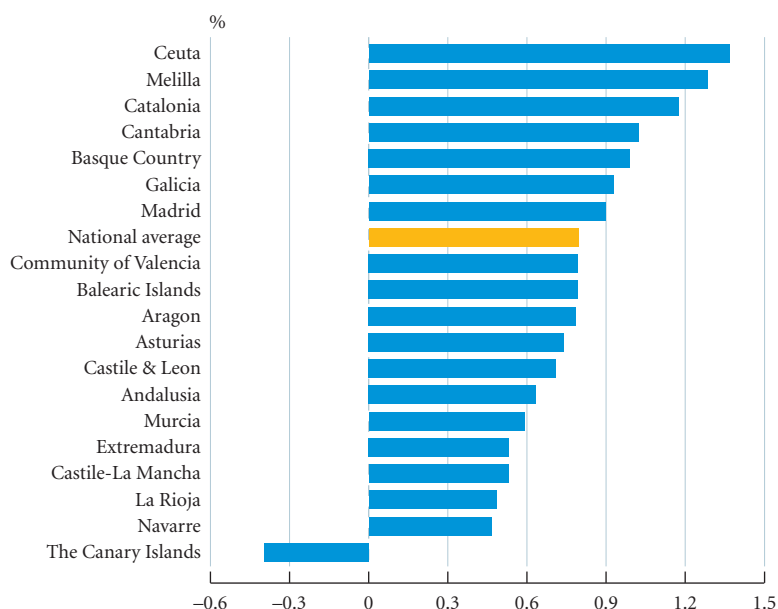
NOTES: (\*) Base 2006 = 100.

(\*\*) General index excluding energy products and unprocessed food.

SOURCE: National Institute of Statistics.

## ONLY THE CANARY ISLANDS POSTS NEGATIVE INFLATION IN 2009

Change in CPI between December 2008 and 2009



SOURCES: National Institute of Statistics and own calculations.

### Favourable inflation differential with the euro area falls away in December.

than half throughout 2009 and ended up at 1.6%, the lowest rate in the last few decades.

Inflation varied significantly between autonomous communities. The range of the year-on-year rate of change widened up to 1.8 points, compared with 1.2 points last year. Only the Canary Islands posted a negative year-on-year rate of change, of 0.4%. The highest inflation rates were recorded in Ceuta, Melilla and Catalonia, of 1.4%, 1.3% and 1.2%, respectively.

### Inflation will tend to rise over the coming months but will remain contained.

The EU harmonized inflation differential (HCPI), which had reached a record 0.9% in Spain's favour in the

month of May, fell in December to 0.05%. This was partly due to the greater weight of fuels and oils in the Spanish basket, as well as lower indirect taxes in Spain, making the end sales price more sensitive to trends in oil prices. However, the core inflation differential was still negative in December, reflecting the adjustment in Spanish prices to correct an accumulated loss in competitiveness.

In 2010, we expect inflation to remain low in spite of it receiving a certain boost in July due to the hike in value added tax. This containment will be due particularly to a gradual exit from the recession. Consequently, inflation will probably be around 1.5% at year-end.

## Foreign sector

### The trade deficit adjustment eases

November's trade deficit was 4,855 million euros, 18.4% less than the same month in 2008, this being its seventeenth consecutive fall, the longest period of shrinkage since data became available. Although this latest reduction was considerably more moderate than those recorded during the previous months, the accumulated trade deficit for the first eleven months of the year fell 47.1% compared with the same period a year ago, totalling 46,111 million euros.

As in previous months, this shrinkage in deficit occurred within a context of

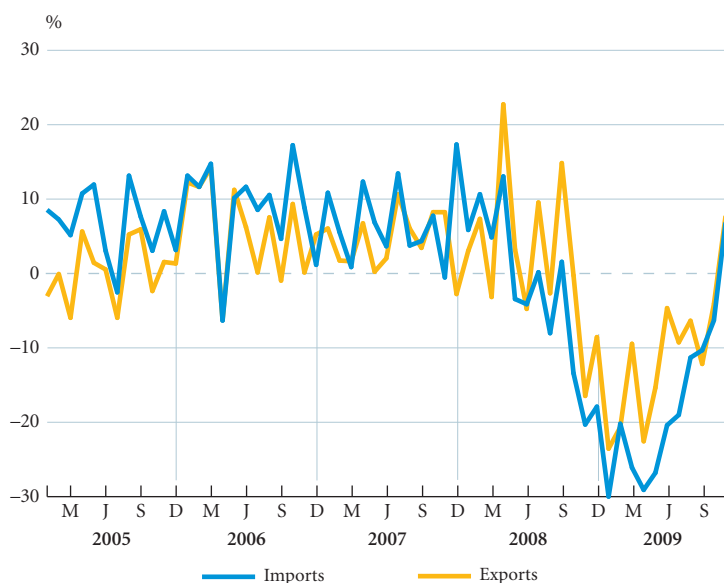
falling trade flows. More specifically, accumulated imports over the first eleven months of 2009 fell 27.3% compared with the same period in 2008, whereas exports were down 17.4% in the same period. This pushed up the rate of cover (ratio of exports to imports) to 75.8% in this period, nine percentage points higher than last year's figure.

However, a more detailed analysis of these series shows that November's fall in value for trade flows was only due to price reductions. Consequently, as can be seen in the graph below, the year-on-year change in the volume of exports and imports in this month returned to growth for the first time in 2009.

**Trade deficit moderates its decline with an 18.4% drop year-on-year in November.**

### TRADE VOLUMES GROW AGAIN

Year-on-year change in real monthly data



SOURCES: Ministry of Economy and own calculations.

**In November, the volume of trade flows grows for the first time in 2009.**

The real change in exports in the penultimate month of 2009 was 7.7% year-on-year, 9.2 percentage points higher than its nominal variation. Similarly, real imports in the same month grew by 6.8% year-on-year, 13.3 percentage points higher than the variation in their value. Growth in trade flows is therefore likely to be positive over the coming months.

A breakdown of international trade by economic sector shows significant differences in November. The most outstanding piece of data is the dynamism in the automobile sector, with year-on-year growth in exports and imports of 19.2% and 13.1%, respectively, a difference that widens

if we only consider finished vehicles, with exports up 21.2% year-on-year, 18 percentage points higher than imports.

On the other hand, it should be noted that 70% of Spanish exports in November were destined for the European Union, France being the main trading partner and with Spanish imports up 10.0%.

However, the reduction of fiscal stimuli by governments during 2010 and the rising trend in real imports allows us to predict that, over the coming months, the rate of shrinkage in the trade deficit will continue to slow up.

**The automobile sector is the most dynamic.**

## FOREIGN TRADE

January-November 2009

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	31,243	-41.4	16.4	6,217	-43.3	4.3	-25,026	19.9
Consumer goods	59,490	-8.6	31.2	57,648	-8.1	39.9	-1,842	96.9
Food	13,345	-8.9	7.0	19,301	-5.6	13.3	5,955	144.6
Non-foods	46,145	-8.5	24.2	38,348	-9.2	26.5	-7,797	83.1
Capital goods	15,112	-31.6	7.9	11,997	-20.0	8.3	-3,115	79.4
Non-energy intermediate goods	84,860	-30.2	44.5	68,731	-20.4	47.5	-16,128	81.0
By geographical area								
European Union	111,367	-22.6	58.4	100,144	-17.3	69.3	-11,223	89.9
Euro area	91,741	-23.8	48.1	82,505	-15.1	57.1	-9,236	89.9
Other countries	79,337	-32.9	41.6	44,449	-17.6	30.7	-34,889	56.0
Russia	4,225	-41.3	2.2	1,369	-48.9	0.9	-2,856	32.4
United States	7,861	-22.9	4.1	5,297	-24.1	3.7	-2,564	67.4
Japan	2,858	-39.0	1.5	1,097	-18.1	0.8	-1,761	38.4
Latin America	9,830	-32.7	5.2	7,052	-17.2	4.9	-2,779	71.7
OPEC	15,617	-39.3	8.2	5,750	-8.5	4.0	-9,867	36.8
Rest	38,947	-30.4	20.4	23,885	-15.1	16.5	-15,062	61.3
TOTAL	190,704	-27.3	100.0	144,593	-17.4	100.0	-46,111	75.8

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

## Balance of payments: financing needs are still adjusting

This smaller trade imbalance led to a 43.7% correction in the balance of goods deficit for the month of October compared with the same month in 2008. Similarly, the income balance deficit fell yet again, due to the drop in payments for investment income. These figures, together with the slight rise in the balance of services surplus, resulted in a further improvement in the current account deficit, falling 46.7% year-on-year and totalling 4,151 million euros. Only the balance of current transfers bucked this trend with a sharp increase in its negative balance.

The reduction in current deficit in October maintained the balance's trend accumulated over the last twelve months, with a fall of 43.6% compared with the same period a year ago. The lower current deficit significantly offset

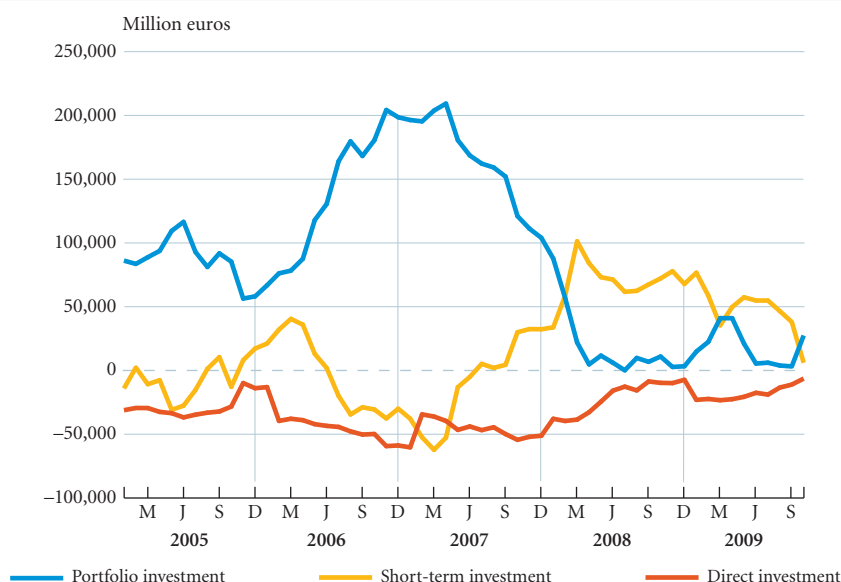
the reduction in the capital account surplus and placed financing needs accumulated over the last twelve months at 61,107 million euros, a similar level to the one recorded four years ago. The new international trade data available for the month of November suggest further shrinkage in the deficit of the balance of goods in the coming months, although increasingly less so.

With regard to financial flows, the reduction in financing needs led to a fall in foreign capital inflows for the year. As can be seen in the graph below, short-term investment was the most affected, with its accumulated balance over the last twelve months down 61,648 million euros compared with October 2008. This meant that it was no longer the main source of funding in the last year, giving way to portfolio investments, which received significant investment from abroad. On the other hand, meeting financing needs by

**The current account deficit continues to fall in October.**

### SHORT-TERM INVESTMENT IS NO LONGER THE MAIN SOURCE OF FINANCING

Cumulative data over 12 months



SOURCES: Bank of Spain and own calculations.

**Portfolio investment is once again the main source of financing.**

increasing the Bank of Spain's liabilities continued to lose weight, in response to the less frequent use of the Eurosystem's

liquidity auctions, thanks to more relaxed liquidity conditions in the financial system.

## BALANCE OF PAYMENTS

October 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	-37,328	-50.6	-49,434	42,926	-46.5
Services					
<i>Tourism</i>	23,601	-7.1	26,253	-2,053	-7.3
<i>Other services</i>	-793	-52.8	-914	1,709	-65.1
Total	22,808	-3.9	25,339	-345	-1.3
Income	-22,315	-19.9	-28,230	5,544	-16.4
Transfers	-9,090	-4.8	-8,781	-797	10.0
<b>Total</b>	<b>-45,925</b>	<b>-48.5</b>	<b>-61,107</b>	<b>47,329</b>	<b>-43.6</b>
Capital account	2,771	-45.1	3,231	-3,268	-50.3
Financial balance					
Direct investment	-1,920	-33.8	-5,932	2,263	-27.6
Portfolio investment	33,148	270.6	27,965	20,730	286.5
Other investment	2,403	-96.3	6,435	-61,648	-90.5
<b>Total</b>	<b>33,630</b>	<b>-52.3</b>	<b>28,468</b>	<b>-38,656</b>	<b>-57.6</b>
Errors and omissions	-1,407	220.0	2,468	215	9.5
Change in assets of Bank of Spain	10,930	-22.6	26,940	-6,352	-19.1

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.

## Exporting firms: scarce and valuable

An alarm clock made in China goes off; he opens his eyes and, almost immediately, turns a German tap on. He comes out of the shower wrapped in Egyptian cotton and puts on a Spanish designed suit made in Turkey. He then goes into a kitchen equipped with Swedish fittings to drink Colombian coffee and leaf through an English newspaper. With a Finnish mobile in his pocket and a Mexican lunch box, he jumps into a Japanese car and heads off for his office where he finds a Korean computer, a North American photocopier and a Belgian director all awaiting him. This might be a script for a film but, for many, it's merely the start of any day. Without the good work of exceptional firms, capable of successfully navigating foreign seas, this would never have seen outside the realms of fiction.

In spite of their importance, in both everyday and macroeconomic terms, firms that export are relatively few in number. Of the five and a half million companies operating in the United States in the year 2000, only 4% exported and, among these, the first 10% were responsible for 96% of total US exports. In Germany, until very recently the country that exported the most, this activity also lies in the hands of a minority of firms: in 2006, only 12% of German companies sold their products abroad. The figures for Spain uncover a similar pattern: in 2007, only 6.3% of firms with one or more employees exported. Moreover, the top 10 firms by foreign shipments accounted for 17% of all Spanish exports, revealing once more how concentrated exporting is.

#### SPANISH EXPORTS ARE CONCENTRATED IN A SMALL NUMBER OF FIRMS

Spanish exporting firms by the value of their annual exports (2007)

Value of annual exports	No. of exporting firms	% total of exporting firms	% total exported
< €5,000	38,566	39.6	0.03
€5,000-€50,000	23,324	23.9	0.23
€50,000-€5 million	31,173	32	13.91
€5-€50 million	3,870	4.0	29.14
> €50 million	485	0.5	56.69
<b>Total</b>	<b>97,418</b>	<b>100</b>	<b>100</b>

SOURCES: Consejo Superior de Cámaras de Comercio and own calculations.

This rare nature, and the lack of data at the firm level, explain why, historically and very much in spite of their relevance, economic research on international trade flows has paid little attention both to the activity and also the traits of exporting firms. However, since the middle of the nineties, a new line of study has focused on these companies' role as mediators of trade. Among other questions, it aims to find out what determines whether a firm exports or not and, to do so, attempts to ascertain first what, if anything, distinguishes an exporting firm from the rest.

The bulk of the evidence available on this matter suggests that firms that sell internationally are indeed different from their non-exporting compatriots, and substantially so. Most studies conclude that exporting companies tend to be larger, more capital intensive, with a more skill-intensive workforce, higher productivity and better wages. Moreover, although large firms are more likely to export, it is not simply a matter of size, since the main conclusions remain true when comparing companies of a similar size. In particular, empirical evidence overall suggests that, on average, firms that export are 5% more productive and obtain 10% more value added per worker than non-exporting firms (see table below). In the case of Spain, a study by Miguel A. Delgado, José Fariñas and Sonia Ruano<sup>(1)</sup> estimates that the average productivity of exporting firms also exceeds, by 7%, that of their non-exporting compatriots.

The finding that exporting firms are systematically more productive than the rest raises another question: were they more productive before undertaking their foreign adventure or does their productivity improve as they export? Or put another way: is high productivity a requirement *sine qua non* for exporting or merely a consequence of it? There are logical and theoretical lines of reasoning to support both hypotheses, although

(1) «Firm productivity and export markets: a non-parametric approach», *Journal of International Economics* (2000).

available empirical studies mostly corroborate the former: firms that, *ex ante*, are more efficient are more likely to succeed in foreign markets. With regard to Spanish firms, the results of the aforementioned study by Delgado, Fariñas and Ruano also support the hypothesis that the productivity premium of Spanish exporting firms precedes their decision to export and only in the case of recently established firms is there evidence of gains in productivity from exporting.

#### EXPORTING FIRMS DIFFER SIGNIFICANTLY FROM NON-EXPORTING FIRMS

Factor by which a typical exporting firm differs from a non-exporting firm	Exporting firms exceed non-exporting firms by...	Differential in favour of exporting firms, isolating the effect of size
Employment	97%	—
Shipments	108%	8%
Value-added per worker	11%	10%
Total factor productivity	3%	5%
Capital per worker	12%	4%
Proportion of skilled workers out of total	11%	19%
Wages	6%	6%

SOURCES: Bernard, Jensen, Redding and Schott (*Firms in International Trade*, Journal of Economic Perspectives, 2007). Estimates based on data from US firms in 2002 from the US Census of Manufactures, controlled for industry effects.

This difference in productivity preceding a firm's entry into export markets points to the existence of some sort of fixed entry cost and to more ferocious competition in export markets relative to domestic markets. It also reveals a process of self-selection among firms as only the most efficient can take on such costs.

The next step consists of determining where this greater efficiency comes from. In this respect, recent research points towards firms' innovative activity, resulting from R&D or investment in new technologies, as a decisive factor. On the other hand, it is suspected that the greater difficulties in knowing a foreign market and a more limited financial capacity are additional obstacles for SMEs wishing to export.

Different economic policies can help boost the export sector although, in view of the above-mentioned data, those attempting to promote innovation or investment in R&D appear to be most appropriate. On the other hand, resorting to an industrial policy that promotes specific sectors («picking winners») raises more doubts: not only can such policies take too long to have an effect and might also introduce unnecessary inefficiencies in the correct allocation of resources, but economic authorities are also very unlikely to be able to predict accurately which sectors have a better future both for exports and also for the economy as a whole. After all, who would have anticipated, twenty years ago, that one of the most emblematic firms for Spanish exports today would come from what was, at the time, a textile industry in decline and a region, namely Galicia, with little tradition in the sector?

In any case, promoting exports is crucial for all open economies and this is done by promoting the work of their flagships: exporting firms. With a domestic market burdened by the crisis and foreign demand more essential than ever, the course of the Spanish economy, at least in the short term, will be set by the rudder of this select group of firms.

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

## Public sector

### Government deficit increases fivefold up to November

Public accounts are being strongly affected by the economic crisis. The so-called «automatic stabilizers» are not the only reason for the fall in revenue as a result of the reduction in taxable income and the rise in expenditure on unemployment benefits. The discretionary measures undertaken to ease the recession have also contributed significantly to reducing revenue and raising payments.

Consequently, non-financial revenue for the central government in the first eleven months of 2009 measured in Treasury terms, i.e. according to the monetary flows recorded, totalled 150,754 million

euros (before payments to autonomous communities and local governments). This amount represents a year-on-year decrease of 13.9%.

Direct taxation in January-November rose to 82,938 million euros, with a fall of 13.7% compared with the same period in 2008. Revenue from the main item, personal income tax, totalled 59,809 million euros, a year-on-year drop of 10.9%. However, this rate falls to 7.7% if the differential effect of the 400-euro deduction is discounted, as this came into force in the middle of 2008, longer deferment periods are eliminated and adjustments are made for earlier rebates on annual tax returns. Employment withholding tax fell 3.3% as a consequence

**«Automatic stabilizers» and economic stimulus measures inflate the government deficit.**

### CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

November 2009

	Month		Cumulative for year	
	Million euros	% change on year ago	Million euros	% change on year ago
<b>Non-financial revenue</b>	<b>5,575</b>	<b>-25.8</b>	<b>95,092</b>	<b>-15.6</b>
<b>Non-financial revenue adjusted (*)</b>				
Personal income tax	5,467	-18.6	59,809	-10.9
Corporate tax	-560	24.2	19,947	-23.2
VAT	1,668	-39.1	32,299	-29.7
Special taxes	1,636	-3.1	17,758	-1.5
Other	2,125	55.1	20,941	16.6
<b>Total</b>	<b>10,336</b>	<b>-14.3</b>	<b>150,754</b>	<b>-13.9</b>
<b>Non-financial spending</b>	<b>16,481</b>	<b>40.5</b>	<b>163,600</b>	<b>24.7</b>
<b>Treasury balance</b>	<b>-10,906</b>	<b>158.4</b>	<b>-68,508</b>	<b>269.4</b>
<b>Surplus (+) or deficit (-) (**)</b>	<b>-12,214</b>	<b>123.5</b>	<b>-71,524</b>	<b>412.1</b>

NOTES: (\*) Includes tax segments ceded to regional and local governments under current financing system.

(\*\*) In terms of National Accounting.

SOURCES: Ministry of Economy and Finance and own calculations.

**Income from personal income tax falls 7.7% in homogeneous terms.**

of the drop in employment. Withholdings on investment shrank more intensively to 9.7% due to lower dividends and bank interest paid out, while withholdings on real estate leases and mutual funds fell 3.4% and 49.3%, respectively.

For its part, corporate tax was down 23.2%. This drop was due to the slide in corporate profits but also because of some regulatory changes.

Shrinking consumption and investment had a perceptible effect on indirect taxation, down 21.3%. Value added tax brought 32,299 million euros, with an annual drop of 29.7%. However, we should remember the effect of a sharp rise in rebates on this drop. For their part, special taxes decreased 1.5% in spite of the rise in interest rates levied on tobacco and hydrocarbons mid-June.

The rest of non-financial income rose by 16.6%. This increase was helped by commissions on guarantees granted for issues by financial institutions as part of the Joint Action Plan for Eurozone Countries.

On the other side of the balance sheet, non-financial payments rose to 163,600 million euros, an annual increase of 24.7%. This significant rise was mostly due to greater transfers, both current and capital.

Under current spending, personnel costs increased 5.3%, goods and services rose 12.4% and financial costs were up 10.4%.

But the highest increase came from current transfers, up 28.5%. Particularly of note are the payments of 17,767 million euros to the State Employment Service, mostly to cover unemployment benefit.

Payments for real investment increased 3.1%, thanks in particular to the Ministry of Public Works. Capital transfers were more than double the figure recorded in the same period in 2008, of which 5,500 million corresponded to the State Local Investment Fund, to finance municipal building projects.

Because of these trends in central government revenue and spending, an accumulated non-financial cash deficit was posted in the first eleven months of 2009, totalling 68,508 million euros, more than six times higher than that for the same period the previous year. On a national accounts basis, i.e. taking into account the rights and obligations generated, the government deficit totalled 71,524 million euros, a figure that is five times the one for the same period in 2008 and equivalent to 6.8% of the gross domestic product.

Social Security budgets also tightened due to the impact of the crisis, but managed to remain positive. In January-November 2009, income fell 0.8% compared with the same period a year ago, while costs rose 5.5%. The surplus totalled 14,800.6 million euros, with an annual drop of 28.8%.

**Transfers boost costs.**

**Reduction in Social Security surplus.**

## Savings and financing

### Private sector financing falls slightly

The 12-month Euribor reference rate picked up very slightly in its monthly average for December after having hit a series of record lows in the previous months, standing at 1.242%. It was therefore 221 basis points below the figure of twelve months before. This drop reflected the lowering of the official European Central Bank interest rate in the first half of 2009 and the gradual reduction in risk premium as the interbank market tends to get back to normal. The slight rise in the one-year Euribor in December can be explained by expectations that the European monetary authority's next move will be in an upward direction, although

nothing is expected over the coming months. However, in the first few weeks of January, the 12-month Euribor relaxed slightly and came close to the record daily low of 16 November 2009.

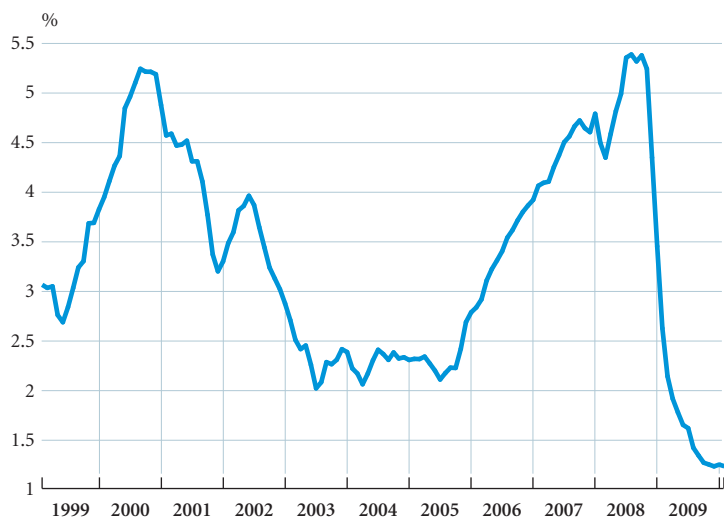
For their part, interest rates for loans and credit to firms and families continued to ease in November. The average interest rate fell to 3.39%, 292 basis points less than the same month one year ago.

In spite of the fall in nominal interest rates, private sector financing fell slightly compared with November 2008, by 0.3%. In fact, in November 2009 an effective flow was recorded of 6,281 million euros, higher than the month

**One-year Euribor stands at 1.24% in December, with an annual drop of 221 basis points.**

### THE ONE-YEAR EURIBOR STABILIZES

12-month Euribor rate



NOTE: At 21 January 2010.

SOURCE: Bank of Spain.

## FINANCING OF NON-FINANCIAL SECTORS (1)

November 2009

	Balance	Change this year	Change over 12 months		% share
	Million euros	Million euros	Million euros	% (2)	
Private sector	2,222,224	5,222	3,304	-0.3	84.4
Non-financial corporations	1,313,952	7,487	10,382	-0.2	49.9
<i>Resident credit institution loans (3)</i>	918,577	-35,557	-34,006	-3.2	34.9
<i>Securities other than shares</i>	55,074	14,011	13,889	33.7	2.1
<i>External loans</i>	340,301	29,033	30,499	4.3	12.9
Households (4)	908,272	-2,265	-7,078	-0.3	34.5
<i>Housing loans (3)</i>	677,227	-1,221	-1,725	-0.1	25.7
<i>Other (3)</i>	228,374	-1,339	-5,665	-1.1	8.7
<i>External loans</i>	2,671	295	312	13.2	0.1
General government	411,000	80,912	112,639	37.8	15.6
<b>TOTAL</b>	<b>2,633,224</b>	<b>86,133</b>	<b>115,943</b>	<b>4.2</b>	<b>100.0</b>

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.

### Housing loans fall for the first time this cycle.

of October but lower than the previous year's figure. This occurs within a context of deleveraging for firms and families, which had reached high levels of debt.

The financing of non-financial firms was down 0.2% in November compared with the same month in 2008. The effective flow recorded, totalling 1,182 million euros, was lower than the figure recorded twelve months previously. The 3.2% year-on-year drop in credit to resident organizations couldn't be offset entirely by the 33.7% year-on-year rise in bond issuance or the 4.3% growth in foreign loans.

On the other hand, trade credit, aimed at financing firms' working capital, was still weak. Financial leases, used to fund investment, also recorded a notable drop.

### Bad debt exceeds 5% for the first time since 1996.

Loans to households also showed a slight year-on-year decrease of 0.3%. Financing for housing dropped for the first time this cycle, although this was very slight, namely 0.1%. This partly reflects the weak demand, in spite of lower interest rates, due to the uncertainty caused by rising unemployment and an unfavourable economic climate, although it is also due to tougher financing terms. The rest of credit to individuals fell further, with a year-on-year decrease of 1.1%.

Within this context, bad debt continued to grow, recording a rate of 5.05%, not seen since 1996. However, in the last few months there has been a perceptible slowdown, helped by a more demanding risk management policy.

Meanwhile, numerous small and medium-sized savings banks are immersed in a process of concentration,

which the Fund for Orderly Bank Restructuring (FROB) was created to support. Once the European Commission approves the FROB aid programme, the announced or predicted operations are expected to speed up.

On the other hand, public sector financing continued to expand at an extraordinary rate, with a year-on-year increase of 37.8% in November. However, the total financing to non-financial sectors continued to slow up and recorded an annual increase of 4.2%, 3.4 points less than a year earlier.

### Slowdown in bank deposits

The mood of precaution due to the economic situation and rising unemployment continues to boost family savings. Consequently, in the third quarter of 2009 the rate of savings compared with disposable income rose to 18.7%, taking into account the last four quarters, 1.1 points more than the previous moving period. The household savings rate therefore reached its highest figure for several decades.

And where are these family savings going? Investment having fallen in housing, a large part is going towards bank deposits. However, the low nominal returns, reflecting an official European Central Bank interest rate of 1% since May 2009, together with low levels of economic activity, have led to a slowdown in the pace of growth of bank deposits. Consequently, the year-on-year rate of change, including non-financial firms, stood at 2.4% in November 2009, 1.6 points less than in October.

Savings deposits have shown the greatest annual growth, of 14.3% in November. This rise shows savers' greater preference for liquidity given the economic uncertainty. The biggest annual drop corresponded to accounts in foreign currency, affected in general by an adverse differential interest rate and by the euro's appreciation.

An alternative to deposits are collective investment institutions. At the end of 2009, the volume of assets for collective investment companies and funds totalled 224,667 million euros, a similar level to one year ago.

**Likelihood of concentration in the savings bank sector.**

**Savings rate for households reaches its highest level in the last few decades.**

## BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

November 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	255,798	10,986	4.5	13,906	5.7	18.3
Savings deposits	201,160	21,383	11.9	25,140	14.3	14.4
Term deposits	713,269	-16,004	-2.2	-537	-0.1	51.1
Deposits in foreign currency	21,922	-7,396	-25.2	-10,878	-33.2	1.6
<b>Total deposits</b>	<b>1,192,148</b>	<b>8,969</b>	<b>0.8</b>	<b>27,631</b>	<b>2.4</b>	<b>85.5</b>
<b>Other liabilities (*)</b>	<b>202,884</b>	<b>-45,745</b>	<b>-18.4</b>	<b>-41,431</b>	<b>-17.0</b>	<b>14.5</b>
<b>TOTAL</b>	<b>1,395,032</b>	<b>-36,776</b>	<b>-2.6</b>	<b>-13,800</b>	<b>-1.0</b>	<b>100.0</b>

NOTE: (\*) Aggregate balance according to supervision statements. Includes asset transfers, hybrid financial liabilities, repos and subordinated deposits.

SOURCES: Bank of Spain and own calculations.

## SPECTACULAR GAINS IN EQUITY INVESTMENT FUNDS IN 2009

Annual yield on mutual funds in 2009



SOURCES: Inverco and own calculations.

### Average annual yield for all mutual funds is positive in 2009 and above inflation.

Mutual fund assets totalled 162,567 million euros at the end of 2009, with an annual drop of 5,077 million, representing 3.0%. This fall was concentrated in the first six months due particularly to significant withdrawals of money from funds. Subsequently, the improvement in stock markets and the brake on net withdrawals enabled the volume of assets to recover to a certain extent. For the year overall, the largest outflows corresponded to short-term mixed Euro bonds, to guaranteed equity and monetary funds, recording below average yields, whereas the highest net subscriptions favoured long-term Euro bonds and mixed Euro bonds.

### Notable drop in real estate funds in 2009.

However, the highest average annual yield was for emerging markets equity, achieving extraordinary gains of 71.6%

after having suffered the biggest disaster in 2008, of 53.8%. It's worth pointing out that the average annual yield for all mutual funds in 2009 was 4.9%, more than 4 points above the rate of inflation. Moreover, the average yield for all categories was positive and above the rate of inflation. On the other hand, the number of participants was 5,608,725 at the end of 2009, 456,689 fewer than the start of the year, although this drop was mostly concentrated in the first quarter.

With regard to real estate funds, assets totalled 6,465 million euros at year-end, a drop of 12.7%. The weighted average annual yield was negative at 8.2%, affected by the crisis in the real estate market. However, the average annual yield in the last ten and five years was 4.45% and 1.6%, respectively.



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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
<b>TOTAL BUDGET</b>	<b>500</b>



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