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THE SPANISH ECONOMY

Monthly Report

MONETARY POLICY: LOOKING FOR THE EXIT

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2008	2009	2010	2009 3Q	2009 4Q	2010 1Q	2010 2Q
INTERNATIONAL ECONOMY			Forecast			Forecast	
Gross domestic product							
United States	0.4	–2.4	2.8	–2.6	0.1	2.5	3.3
Japan	–1.2	–5.1	1.8	–4.9	–0.9	2.8	1.7
United Kingdom	0.5	–5.0	1.2	–5.3	–3.3	–0.3	1.0
Euro area	0.5	–4.0	1.2	–4.0	–2.1	0.7	1.2
Germany	*1.0*	*–4.9*	*1.6*	*–4.8*	*–2.4*	*1.7*	*1.7*
France	*0.3*	*–2.2*	*1.3*	*–2.3*	*–0.3*	*1.3*	*1.3*
Consumer prices							
United States	3.8	–0.3	2.4	–1.6	1.5	2.9	2.3
Japan	1.4	–1.4	–0.5	–2.2	–2.2	–1.4	–1.0
United Kingdom	3.6	2.2	2.5	1.5	2.1	3.2	2.8
Euro area	3.3	0.3	1.2	–0.4	0.4	1.0	1.2
Germany	*2.6*	*0.3*	*1.1*	*–0.2*	*0.4*	*0.8*	*0.9*
France	*2.8*	*0.1*	*1.3*	*–0.4*	*0.4*	*1.1*	*1.3*
SPANISH ECONOMY			Forecast			Forecast	
Macroeconomic figures							
Household consumption	–0.6	–5.0	–0.1	–5.0	–3.5	–0.8	0.8
Government consumption	5.5	3.8	–0.2	4.1	0.8	–0.4	–0.4
Gross fixed capital formation	–4.4	–15.3	–5.7	–16.0	–12.9	–8.0	–6.3
Capital goods	*–1.8*	*–23.1*	*–0.7*	*–23.8*	*–15.3*	*–2.0*	*–1.0*
Construction	*–5.5*	*–11.2*	*–7.6*	*–11.4*	*–10.2*	*–9.6*	*–7.9*
Domestic demand (contribution to GDP growth)	–0.5	–6.4	–1.5	–6.6	–5.3	–2.5	–1.2
Exports of goods and services	–1.0	–11.5	2.2	–10.8	–2.9	–0.7	1.1
Imports of goods and services	–4.9	–17.9	–2.3	–17.0	–9.6	–5.1	–2.3
Gross domestic product	**0.9**	**–3.6**	**–0.4**	**–4.0**	**–3.1**	**–1.4**	**–0.4**
Other variables							
Employment	–0.6	–6.7	–2.3	–7.2	–6.1	–3.9	–2.4
Unemployment (% labour force)	11.3	18.0	20.1	17.9	18.8	20.5	20.4
Consumer price index	4.1	–0.3	1.3	–1.1	0.1	1.0	1.0
Unit labour costs	4.6	0.2	–0.9	–0.1	–0.1		
Current account balance (% GDP)	–9.5	–5.1	–2.8	–3.8	–4.2		
Net lending or net borrowing rest of the world (% GDP)	–9.1	–4.7	–2.4	–3.6	–3.7		
General government financial balance (% GDP)	–4.1	–11.4	–10.3				
FINANCIAL MARKETS			Forecast			Forecast	
International interest rates							
Federal Funds	2.1	0.3	0.3	0.3	0.3	0.3	0.3
ECB repo	3.9	1.2	1.0	1.0	1.0	1.0	1.0
10-year US bonds	3.6	3.2	3.8	3.5	3.4	3.7	3.7
10-year German bonds	4.0	3.3	3.3	3.3	3.2	3.4	3.4
Exchange rate							
$/Euro	1.48	1.39	1.41	1.43	1.48	1.40	1.42

Monetary policy: looking for the exit

Contents

On 18 February, half an hour after the markets closed, the Federal Reserve, the US central bank, raised the interest rate of its «discount window» from 0.50% to 0.75%. In its subsequent statement, the Fed insisted that the raise in the rate charged by banks for emergency loans did not imply any change in the outlook for the economy or in its monetary policy. But in actual fact something is changing. A few days earlier, Ben Bernanke, the Fed chairman, had already announced that the extraordinary monetary measures implemented to tackle the Great Depression would start to be withdrawn, in a gradual return to normality.

Jean-Claude Trichet, president of the European Central Bank, has yet to give any explicit indications concerning the end of the lax monetary policy applied by the euro system. The outlook for recovery is more uncertain than on the other side of the pond and the peripheral sovereign debt crisis of the last few weeks has not made such announcements any easier. But changes in auctions to inject liquidity have already been brought forward and, at their next meeting in March, the Council will take decisions regarding the withdrawal of extraordinary liquidity deployed during the recession.

All this goes to make up a substantial change in the monetary situation created to tackle the worldwide economic crisis. It won't be sudden – quite the opposite. There are clear signs that the worst is now behind us but, as we explain in the Executive Summary of this Report, exiting the recession won't be a bed of roses. This is precisely the challenge facing those in charge of monetary policy and what has triggered debate concerning «exit strategies», i.e. how and when to withdraw the stimulus, not just monetary but also fiscal, which has served to cushion the fall.

This Monthly Report deals with some of these considerations. The action taken by some central banks by spectacularly expanding their balance sheets to inject liquidity and slashing official interest rates to minimum levels has avoided deflation and laid the foundations for recovery. However, maintaining this situation in the medium term would involve high inflationary risks. Excessive liquidity must be withdrawn and interest rates must get back to normal, but we must also make sure that banking systems can handle the new scenario without any hitches, that financial conditions don't deteriorate in the private sector, which is still fully immersed in deleveraging, and that the financing of growing public debt is not disrupted. Advances in fiscal consolidation are extremely vital at this point. Expansive public budgets combined with restrictive monetary policy would complicate recovery in the private sector and an additional dilemma is provided by the euro area, where the application of a single monetary policy in economies at different points in their cycles might complicate the exit from the recession.

It could be thought that the solution would be to maintain lax monetary policy until business shows clear signs of improvement, but the risk of unleashing inflation is too high. Moreover, we mustn't forget that many believe the period of cheap money before the crisis swelled the asset bubble and made it lethal. Because of all this, 2010 will be a complicated year in which the correct application of exit strategies will be key to recovering balance in monetary markets and to ensuring that money and credit once again flow consistently throughout the economy.

EXECUTIVE SUMMARY

The recession is over. What comes next?

The recession is becoming a thing of the past but the recovery is having its ups and downs.

Data for the fourth quarter of 2009, published in the last few weeks, confirm the improvement in economic activity, the exit from the recession on the part of most developed economies and the good performance of the emerging economies. However, many doubts still remain concerning the immediate outlook in developed countries. High levels of unemployment, historical imbalances in public accounts with growing volumes of debt and as yet incomplete private sector deleveraging do not go to make up the best environment for an obstacle-free recovery.

Emerging countries are leading the growth, while figures from the United States show gradual improvement...

The best trends can be found in a select and significant group of emerging countries, especially Brazil and China. In this last country, lax monetary and fiscal policy has permitted growth rates of close to 10%, so high they have led to fears of the economy overheating. Credit continues to rise at a rate approaching 30% year-on-year, although inflation remains at moderate levels, 1.5% in January. For the moment, the Chinese government's actions have focused on withdrawing liquidity from the financial system and it's practically a given that the reference rate will rise in the second quarter.

...as in Japan, but progress is far from vigorous.

A second group of countries, led by the United States, are on the way to consolidating their recovery. In the fourth quarter the US economy grew 5.7% annualized quarter-on-quarter, leaving its decline for 2009 as a whole at 2.4%. The bad news is that most of this growth is due to strong advances in stocks. But a positive note is provided by the unexpected strength of private consumption, up 2.0%. Moreover, the latest demand indicators point to this advance remaining in the first quarter of 2010, with capital goods investment and exports also showing signs of relative strength. However, increasing growth is limited by the high unemployment rate and the process of deleveraging in households and the housing market. All this means that the recovery will be slow and probably somewhat erratic.

The Japanese economy grew 4.6% annualized quarter-on-quarter in the fourth quarter, boosted equally by private consumption, capital goods investment and the foreign sector. This could have warranted the country being placed in the group that is consolidating recovery but, in spite of the strength of this upswing, the Japanese reaction is far from vigorous. Firstly, a large part of the latest quarter-on-quarter rise is due to two successive downgrades in growth figures for the previous quarter, from 4.8% to 0.0%. Moreover, the strength in private consumption of the last few months comes principally from massive state aid for consumer durables, and the indebtedness of the Japanese public sector is the highest among the rich economies.

The group of countries that is finding it most difficult to leave the recession behind is fundamentally made up of members of the European Union (EU).

The euro area continued to grow in the fourth quarter of 2009: gross domestic product (GDP) increased 0.1% quarter-on-quarter and there has now been positive growth for the last two quarters. This means that, technically, the euro area is no longer in recession although its exit looks to be very flat. The lack of detail in data for the fourth quarter makes it difficult to clearly identify those factors that are weakening the recovery and those that are keeping it going. But the bulk of the evidence available suggests that both private consumption and investment are lagging behind more than expected, so that recovery is still highly dependent on trends in the foreign sector. We maintain our growth forecast for 2010 at 1.2% but the risk of this being lower is increasing, particularly considering the withdrawal of expansive fiscal policy, if this is carried out earlier than planned and more quickly than would be desirable.

Given this scenario, the stance just taken by the European Central Bank (ECB) becomes particularly relevant. We still predict that the reference rate will remain at its current level until the fourth quarter but, if some countries have to withdraw their expansive fiscal measures earlier than planned, this might force the ECB to postpone any interest rate hikes until next year.

How these risks are appraised has determined the trends in financial markets throughout the last month. Higher uncertainty led to a rapid rise in volatility and risk premia at a global level. For the main stock market indices, this resulted in average losses, for 2010 so far, close to 12% in Europe, 10% in China and 1% in the United States. The value of the euro has also been affected, weakening against the dollar to levels close to 1.35.

The greatest volatility has been seen in government bond markets. Growing doubts regarding Greece's fiscal situation resulted in a notable toughening up of conditions demanded from sovereign bonds, sounding the alarm concerning default risk and tainting the debt of other countries with high public imbalances, such as Spain. Given the risks, the EU undertook to support Greece, although the mechanisms to be used have yet to be spelled out. In March, the Greek government will send a report to the European Commission and the ECB on the progress achieved. If this is not deemed enough, the Finance ministers of the euro area can force the Greek government to adopt additional measures to consolidate their public accounts.

With regard to the Spanish economy, data for the fourth quarter of 2009 show improvements in the overall situation, although without sufficient impetus as yet to post positive figures. Compared with the previous quarter, the drop was 0.1%, better than the 0.3% drop in the previous period, and the year-on-year rate went from –4.0% in the third quarter to –3.1% in the fourth. As a whole, 2009 ended with a 3.6% fall in GDP, the worst result in more than half a century.

However, the decline in the Spanish economy in 2009 was less than that of the main economies in the European Union, with the exception of France. But its recovery is slower, so we'll have to wait until the first half of 2010 for positive figures. In fact, some elements already stand out in the composition of GDP growth for the fourth quarter that confirm the upward trend in private sector spending and in the foreign sector, the two pillars that must take over from the public sector to ensure sustained business recovery.

The slowest exit is occurring in Europe, still at risk of relapse.

Financial markets are feeding off those euro area countries with the greatest public imbalances.

Spain suffers its worst recession in more than half a century...

...but a slightly better tone can be detected in private consumption...

Firstly, it's worth noting the growth in private consumption in October-December, after six quarters of decline and the stagnation of the previous quarter. Family expenditure on consumption has been severely punished in the recession so that such figures suggest the culmination of the adjustment in household budgets, which has led to a swing from a pre-crisis savings rate of 11% to a rate of little more than 19% for 2009 overall, according to our estimates. The prospect, however, is a highly restrained recovery in terms of consumption spending, as we must bear in mind the fact that, in 2010, some fiscal stimuli will be withdrawn that have encouraged household spending (subsidies for buying vehicles, reduction in direct taxes) and, moreover, there will be a hike in value added tax in the middle of the year. The trend in employment isn't going to favour the economic situation of families either, as we expect there to be further job losses in 2010, although at a slower rate than the 1.2 million of last year.

...in certain areas of corporate investment and in the foreign sector.

At a secondary level, also notable is the growth, for the second quarter in a row, in capital goods investment. Although it's true that its levels had plummeted to those recorded back in 2003, the slight growth seen since the middle of last year suggests that certain segments of demand are starting to get going again and the few indicators available for 2010 confirm these trends. Overall, total recovery in investment is still quite remote, due mainly to the component of construction and, more specifically, the real estate branch, which at the end of 2009 had declined almost 25% year-on-year. However, the branches related to public works rose slightly, thanks to the municipal works plan and railway infrastructures. Nevertheless, the announced cut in public investment in 2010 will probably slow up this trend.

Another promising element is provided by data from the National Accounts system for the fourth quarter regarding the positive contribution of the foreign sector to GDP growth, this occurring for the eighth consecutive quarter. In spite of foreign sales of goods and services falling 11.5% in 2009, exports of goods have been positive quarter-on-quarter since the second quarter. Imports of goods and services slumped 17.9% last year and, although this decline also seems to have slowed up throughout the year, they still fell more than exports. The constant improvement in the foreign imbalance has meant that the economy's financing needs have fallen spectacularly, which in terms of GDP have gone from 9.1% of GDP in 2008 to almost half this figure in 2009, namely 4.7%.

Adjusting a public expenditure that has served to alleviate the recession in 2009 is the most immediate challenge.

Lastly, the macroeconomic situation for the last quarter of 2009 presents a marked slowdown in public consumption. This trend is in line with the plans to contain public expenditure presented in the last few weeks, where the aim is to correct the imbalance in the public accounts in the coming years in order to achieve a deficit of 3% of GDP by 2013, down from the 11.4% recorded in 2009. Correcting this high imbalance, which has helped to mitigate the seriousness of the slump in activity in 2009 and to considerably improve the financial situation in the private sector (households and firms), will be possible if the trends seen in private sector growth consolidate and international trade continues its progression of the last few quarters.

25 February 2010

CHRONOLOGY

2009

March	**5**	**European Central Bank** lowers official interest rate to 1.50%.
	6	Central government announces measures to **facilitate financing of working capital for medium-sized companies** and to **revive employment** and ease effects of **unemployment**.
	27	Government approves series of **measures to boost economic activity**: reform of law on meetings of creditors, revival of credit insurance and introduction of EU directive on services.
April	**2**	**European Central Bank** lowers official interest rate to 1.25%. G-20 meeting in London aimed at **reform of international financial system**.
May	**7**	**European Central Bank** lowers official interest rate to 1.00% and announces measures to facilitate liquidity in banking system.
	12	Government announces **new economic policy measures**: partial removal of tax deduction for buying normal residence as of 2011, aids for buying cars, reduced taxes for some small and medium-size businesses and self-employed persons, etc.
June	**12**	Government **increases taxes** on tobacco, petrol and diesel fuel for motor vehicles.
	26	Government establishes **Fund for Orderly Restructuring of Banks**.
September	**26**	The Spanish government passes the **2010 State General Budget**, which eliminates the deduction of 400 euros from income tax, raises the duty on capital income and also the general and low VAT rates as from July 2010.
November	**27**	The central government presents its draft bill for the **Sustainable Economy Act**.
December	**1**	The **Lisbon Treaty** comes into force, reforming certain aspects of the European Union.

2010

January	**29**	The government passes a package of **budget austerity measures** and proposes to raise **the retirement age** to 67.
February	**9**	Agreement for employment and **collective bargaining 2010, 2011 and 2012** between representatives of employers and trade unions.

AGENDA

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).

April

6 Registration with Social Security and registered unemployment (March).
8 Industrial production index (February). Governing Council Central European Bank.
14 EU HCPI (March).
15 CPI (March).
20 International trade (February).
23 Producer prices (March).
27 Government revenue and expenditure (March). Fed Open Market Committee.
28 Retail sales (March).
29 HCPI flash estimate (April).
30 Labour Force Survey (first quarter). Balance of payments (February). EU GDP flash estimate (first quarter).

United States: the recovery takes shape but with fluctuations

The United States grows by 5.7% thanks to the end of stock adjustments and...

The dark days seem to have faded away for the US economy. Gross domestic product (GDP) for the fourth quarter of 2009 grew by 5.9% annualized quarter-on-quarter, so that the drop for 2009 as a whole was 2.4%. The first thing of note in the GDP data is that the change in stocks accounted for 60% of the upswing quarter-on-quarter. One positive note was the unexpectedly strong private consumption, up 1.7%, as well as the recovery in capital goods investment and healthy exports, with the foreign sector once again contributing positively to growth after its hiatus in the previous quarter. Among the weaknesses, residential investment halted its recovery, revealing the difficulties in the housing market.

...to healthy private consumption.

The composition of national accounts for the fourth quarter can be interpreted in two ways. On the one hand, the high contribution to growth of stock changes indicates that this rate of progress will not continue. This push provided by stocks was not due to them increasing because of strong demand but to the end of a series of quarters with sharp drops caused partly by public subsidies for consumer durables that had emptied the warehouses of stocks. However, the 2.0% quarter-on-quarter growth in the economy without this atypical contribution from stocks occurs within a clear context of recovery, with private consumption that, after the withdrawal of stimuli, is proving to be stronger than expected. However, even taking into account the positive nature of these figures, the world's leading economy still faces a difficult recovery hindered by household debt, a weak job market and the hangover from its real estate bubble.

The recovery in private consumption gains momentum but confidence is still low.

This recovery in private consumption has been verified by the latest demand indicators. In January, retail sales, without cars or petrol, made up for its fall in December, rising 2.3% year-on-year, 0.8% discounting the effect of price variations, although this level is still clearly below that of December 2007, representative of the situation before the crisis. Showing greater weakness, the Conference Board Consumer Confidence index continued at very low levels, with a perception of the current situation that was still close to record lows in spite of January's improvement.

With regard to producers, there isn't so much urgency to reduce the debt of non-financial firms as they had been relatively prudent in the years before the crisis. As a consequence, throughout the second half of 2009 business perception has been more positive than consumer perception and this trend continued in January, particularly in manufacturing. Consequently, the business sentiment index of the Institute for Supply Management for manufacturing rose from 54.9 to 58.4 points, a level befitting clearly expansionary phases. With a lower

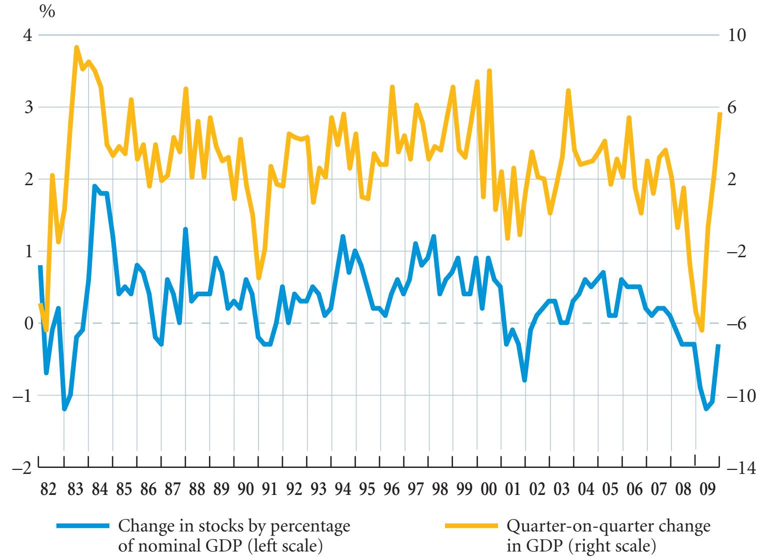
TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms

SOURCES: Bureau of Economic Analysis and own calculations.

UNITED STATES: STOCKS FOLLOW GROWTH

Change in stocks and GDP growth



SOURCES: Bureau of Economic Analysis and own calculations.

The business sector, particularly manufacturing, sees clear signs of recovery.

profile, the services index remained at 52.2 points, consistent with weaker growth. Consequently, industrial production, which in January rose 0.9% year-on-year, has already recovered a third of the ground it had lost. For its part, industrial capacity utilization continued a similar pattern, achieving 72.6% of the total, the highest level since the end of 2008 although far from its historical average of 81.0%.

Excess supply in the real estate market is hindering the recovery in prices and construction.

The housing market is watching its recovery lose momentum. The Case-Shiller index for housing prices rose in November by a modest 0.2%, seasonally adjusted, with an accumulated rise since May's minimum of 3.8%. With the disappearance of state aid for first-home buyers, the volume of sales once again reflects the weakness of a sector that is still dominated by an excess supply that will continue to hinder its recovery. In line with this state of affairs, supply is still static. Homes started in January, although picking up, did not exceed a quarter of their pre-crisis levels, while the setback in planning permission, their leading indicator, ended up painting a lethargic scenario which is not expected to improve during the first half of 2010.

The labour market is no longer in decline but is facing a problematic and lengthy recovery process. In January, the unemployment rate fell from 10.0% to 9.7%, while only 20,000 net jobs were lost. But the usual February revision by the Bureau of Labor Statistics established that, for 2009 as a whole, 4.8 million jobs were lost, 617,000 more than previously estimated. The labour market usually lags behind the rest of the economy and starts to recover once the economy has already expanded for several quarters. Consequently, numerous discouraged workers might

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
Real GDP	0.4	–2.4	–3.3	–3.8	–2.6	0.1	–	...
Retail sales	–0.8	–6.0	–9.1	–9.5	–6.7	2.0	4.7	...
Consumer confidence (1)	58.0	45.2	29.9	48.3	51.8	51.0	55.9	...
Industrial production	–2.2	–9.7	–11.6	–12.9	–9.4	–4.7	0.9	...
Manufacturing (ISM) (1)	45.5	46.2	35.9	43.0	51.4	54.6	58.4	...
Sales of single-family homes	–37.4	–22.6	–40.0	–27.1	–11.7	–4.5	...	...
Unemployment rate (2)	5.8	9.3	8.2	9.3	9.6	10.0	9.7	...
Consumer prices	3.8	–0.4	0.0	–1.2	–1.6	1.4	2.6	...
Trade balance (3)	–695.9	–380.7	–605.7	–504.0	–415.4	–380.7	...	...
3-month interbank interest rate (1)	2.8	0.7	1.2	0.8	0.4	0.3	0.2	...
Nominal effective exchange rate (4)	74.4	77.8	82.7	79.4	75.4	73.6	74.5	76.1

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.

gradually join the job market as the recovery starts to be felt, while the share of long-term unemployed, for whom it's difficult to find a job, doubles that of 1982, when the unemployment rate also exceeded 10%, this being an additional difficulty. Because of this, any noticeable improvement is not expected until the second half of 2010.

The labour market is just about touching bottom but, with unemployment at 10%, it will take its time to improve.

The rising trend in prices took a break in January, thereby helping to maintain stability, an appreciable aid to the recovery that momentarily gives the monetary policy some margin, although the basic trend is still moderately upwards. The general consumer price index (CPI) rose 2.6% year-on-year, 2.7% in December, still affected by the base effects in oil prices. The core CPI, the general index without food or energy, fell compared with the previous month, seasonally adjusted, and moderated its progress to 1.6% year-on-year. Without rent attributed to home owners, core inflation increased by 2.8% year-on-year, also somewhat less than in December.

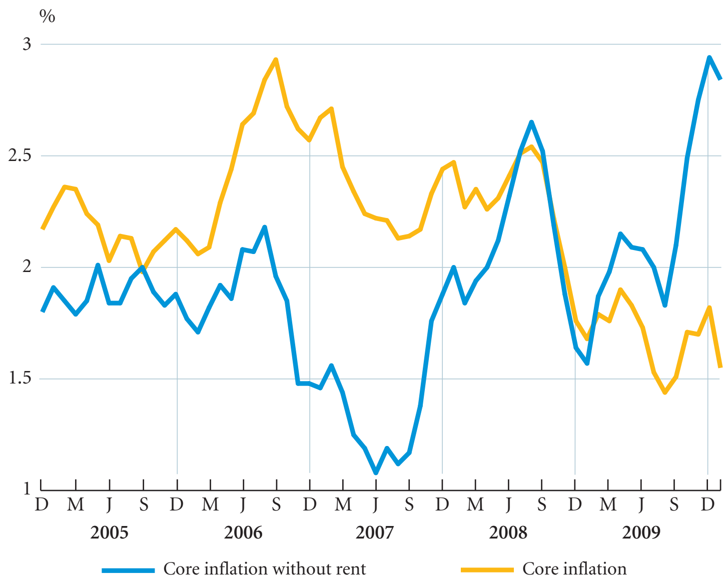
CPI is up 2.7% and prices are on the rise.

The trade deficit in goods and services for December was 40,181 million dollars, 3,794 million higher than the previous month due to fluctuating oil prices. The deficit excluding oil and derivates also increased but to a much smaller extent. With the recovery in trade flows and domestic demand, the trade deficit has risen 14,000 million dollars since its lowest level in May 2009. However, this return to normality is unlikely to take us back to the pre-crisis levels of 60 billion dollars because there is an underlying trend of deficit correction.

Trade deficit increasing due to growth in imports.

UNITED STATES: INFLATION TAKES A BREAK

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



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

Monetary policy: operation return

Desperate situations require desperate measures. And classifying the actions of some central banks over the last two and a half years in this way is no exaggeration. On the one hand, official interest rates have dropped to minimum levels. On the other hand, massive injections of liquidity have led to huge expansion in the balance sheets of central banks, particularly in the case of the United States and the United Kingdom. All this has helped to avoid a deflationary scenario and to lay the foundations for recovery but such enormous monetary expansion, if maintained over the medium term, would result in strong inflationary pressures. To stop this from happening, we need to think about getting monetary policy back to normal.

The United States has been the country, together with the United Kingdom, where monetary expansion has been most aggressive. Since the end of 2007, the size of the Fed's balance sheet has multiplied by 2.5, a similar rise to that of the Bank of England's balance sheet but substantially greater than that of the ECB, which has only grown around 40%. The Fed's assets therefore reached 2.25 billion dollars by February 2010, equivalent to 15.5% of American GDP. The counterpart for these assets is mostly made up of the monetary base, namely the sum of money in circulation and Fed bank reserves. When the central bank provides or acquires a debt instrument, it does so by starting up the money-making machine.

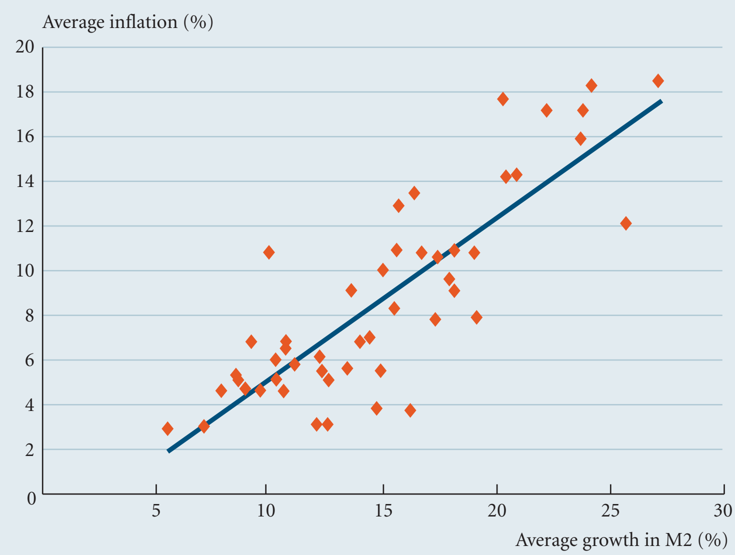
Expansion of the Fed's balance sheet has been the result of two kinds of measures. On the one hand, in its role as a lender of last resort, the central bank implemented a series of programmes in order to cover the huge gap created by the hoarding of liquidity on the part of the private sector. Among these: a term auction facility

(TAF) to provide financial institutions with liquidity without the stigma associated with a discount window; a primary dealer credit facility to grant credit to organizations without access to the aforementioned window; and various credit programmes (of note being the Term Asset-backed Loan Facility or TALF) for bank and non-bank institutions (such as hedge funds, mutual funds, etc.) in order to inject liquidity into key markets, such as that of commercial paper and different types of securitization. The outstanding balance of credit granted through these credit windows was around 110 billion dollars in February 2010[(1)]. Related to its function as a lender of last resort, in its day the Fed also provided funds to the investment bank Bear Stearns and the insurer AIG to avoid them going bankrupt. These loans account for a total of 116 billion on its balance sheet.

On the other hand, the Fed has swollen its balance sheet by means of what has been called a «quantitative expansion» strategy: the purchase of public debt and mortgage-backed securities guaranteed by the public organizations Fannie Mae, Freddie Mac and Ginnie Mae. With this strategy, combined with the reduction in official interest rates in the short term, the central bank aimed to inject liquidity into the economy as a whole, avoiding intermediation by a banking sector that had been hit by losses, and thereby reduce interest rates in the long term. Particular emphasis has been placed on reducing mortgage interest rates (in the United States, most mortgages are fixed rate and over 15 to 30 years) and thereby support the recovery in the housing market. Under this programme, the Fed has acquired 300 billion in Treasury bonds and is close to reaching its target for March of 1.25 trillion dollars in mortgage-backed securities and 175 billion in public agency debt. This is therefore the main reason for the Fed's swollen balance sheet.

THE INFLATIONARY DANGERS OF MONETARY EXPANSION

Averages for inflation and growth in M2 in 49 countries (1970-2008)



SOURCE: World Bank.

(1) By mid-2009, this balance had reached 1.5 trillion dollars but fell as the financial situation gradually got back to normal and some of these loan programmes came to an end. Only the TAF and the TALF remain in place (they are expected to finish at the end of March, with the exception of the TALF for mortgage-backed loans for shopping malls).

Aware that the monetary expansion resulting from all these interventions poses risks for price stability over the medium term, Ben Bernanke took advantage of his recent appearance before the House of Representatives to outline the Fed's exit strategy. He made it clear that the central bank has a wide enough range of instruments available to ensure the exceptional increase in the monetary base (basically the huge amount of excess reserves kept by the banks at the Fed) does not lead to excessive expansion in credit or monetary aggregates (such as M2), thereby igniting inflation.

Firstly, it can raise the interest rate used to remunerate the reserves held by banks with the Fed. This would force up interest rates throughout the economy and consequently curb the demand for credit. Another instrument would be to directly reduce bank reserves via regular operations to drain liquidity (with reverse repos). In these operations, the central bank sells Treasury bills, promising to buy them back within a certain period of time (normally a few days). A similar alternative to these operations, and one which the Fed is studying, would be to offer fixed term deposits to financial institutions. In this way, the reserves deposited in these accounts would not be available to expand credit in the economy as a whole. Lastly, the Fed could withdraw money from circulation by selling the assets that form part of its balance sheet (open market operations).

Bernanke gave clues as to the probable sequence of steps to be taken over the coming months, although he didn't give any specific schedule. First, ending the asset purchase programmes on the planned date, so the balance sheet will stop growing in March. Second, warning of an interest rate hike in a few months' time (this warning might come around June). Third, and at the same time as the previous step, starting operations to drain reserves (through reverse repos and term deposits). Four, starting, very slightly, to raise interest rates (towards the end of the year). And five, towards the second half of 2011, when the economy is expected to be up to cruising speed, the Fed might start the direct sale of assets on its balance sheet.

The exit strategy has been outlined but it's not free from risk. Firstly, it remains to be seen whether the financial system is healthy enough to handle the monetary system getting back to normal. Moreover, there are some fears that the end of asset-backed security purchases would lead to a rise in mortgage rates (estimated at 25-75 basis points), as an effect towards the top end of this estimate might complicate the recovery in the real estate market. Another possible risk comes from the government bond market, where a loss in investor confidence, in absence of a credible adjustment plan, would lead to a rise in interest rates in the long term. This would cool down the recovery and might force the Fed to rethink its normalization plans. And a delay would make it more likely for inflation expectations to lose their anchor, something that must be avoided at all costs. Did anyone think that the exit would be easy?

This box was prepared by Enric Fernández
International Unit, "la Caixa" Research Department

Japan: not as good as it looks

Japan grows 4.6% thanks to exports and state aid but...

In the fourth quarter, the Japanese economy grew 4.6% annualized quarter-on-quarter, boosted equally by private consumption, capital goods investment and the foreign sector, while the slump in GDP for 2009 as a whole stood at 5.1%. However, in spite of the strength of the upswing, the Japanese recovery is far from vigorous. Firstly, a large proportion of the latest quarter-on-quarter rise is due to two successive downgrades in growth for the previous quarter, from 4.8% to 0.0%. Similarly, the decline for 2008 as a whole was altered from 0.7% to 1.2%.

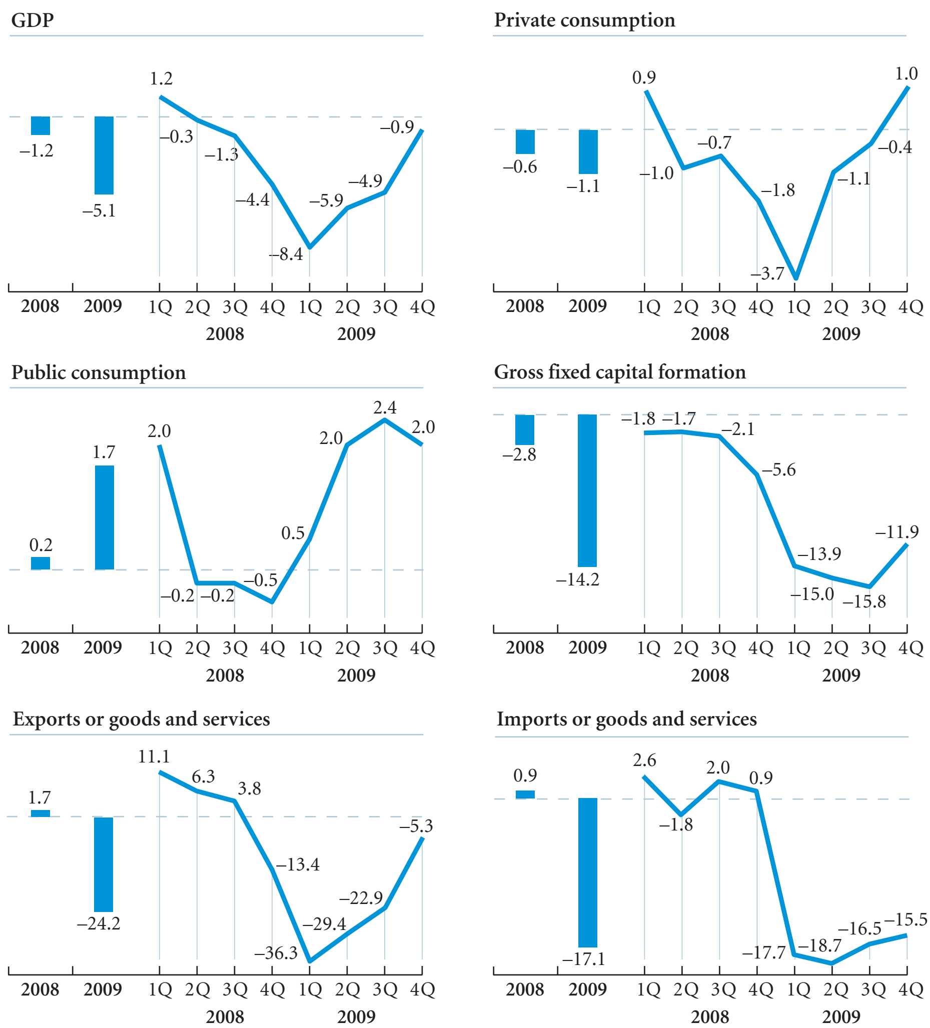
The Japanese economy is suffering from weak domestic demand, immersed in a deflationist context. Consequently, a large part of the strength in private consumption over the last few months is due to the massive state aid given for consumer durables. The debt being garnered by the Japanese government is the highest among rich economies. The fact that creditors for the public sector are largely Japanese might, to a certain extent, help to avoid financial difficulties but it does not change the fact that public debt has limited sustainability and that high debt seriously compromises the effectiveness of fiscal policy.

The latest supply indicators show that improvement is limited to industry and

...it downgrades previous growth rates and is still afflicted by weak domestic demand.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCES: Institute of Economic and Social Investigation and own calculations.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009 1Q	2009 2Q	2009 3Q	2009 4Q	2010 January
Real GDP	–1.2	–5.1	–8.4	–5.9	–4.9	–0.9	–
Retail sales	0.3	–2.3	–3.9	–2.8	–1.9	–0.7	...
Industrial production	–3.4	–22.3	–34.0	–27.6	–19.7	–5.3	...
Tankan company Index (1)	–2.8	–40.8	–58.0	–48.0	–33.0	–24.0	–
Housing construction	2.5	–27.6	–21.5	–31.9	–35.9	–20.7	...
Unemployment rate (2)	4.0	5.1	4.4	5.2	5.5	5.1	...
Consumer prices	1.4	–1.4	–0.1	–1.0	–2.2	–2.0	...
Trade balance (3)	4.0	4.1	1.4	1.0	1.7	4.1	...
3-month interbank interest rate (4)	0.8	0.6	0.7	0.6	0.5	0.5	0.5
Nominal effective exchange rate (5)	86.6	98.6	102.1	95.7	97.0	99.6	99.3

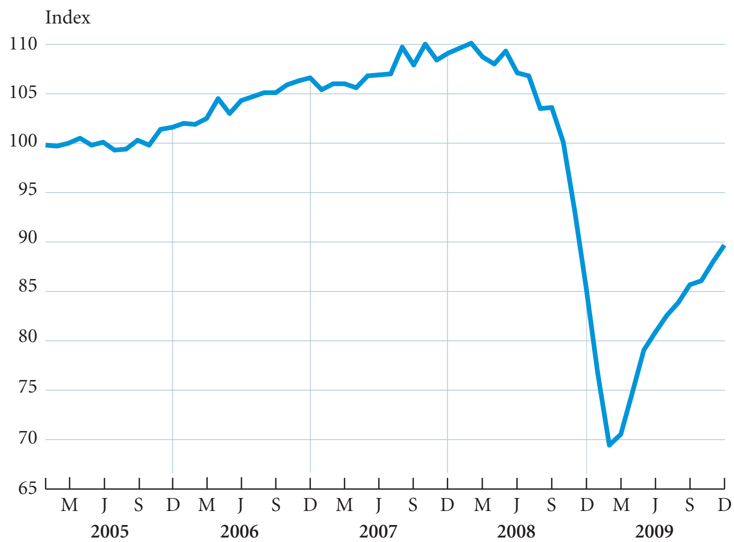
NOTES: (1) Index value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Trillion yen.
(4) Percentage.
(5) Index weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.
SOURCES: OECD, national statistical bodies and own calculations.

Industry's recovery is consolidated.

exports. Industrial production, which in Japan is closely linked to GDP, kept up the intensity gained the month before. The general index for January was up 1.9% compared with December, seasonally adjusted, with 5.3% growth year-on-year, the first since June 2008. The outlook for investment also

JAPAN: INDUSTRY'S RECOVERY CONTINUES TO GAIN STRENGTH

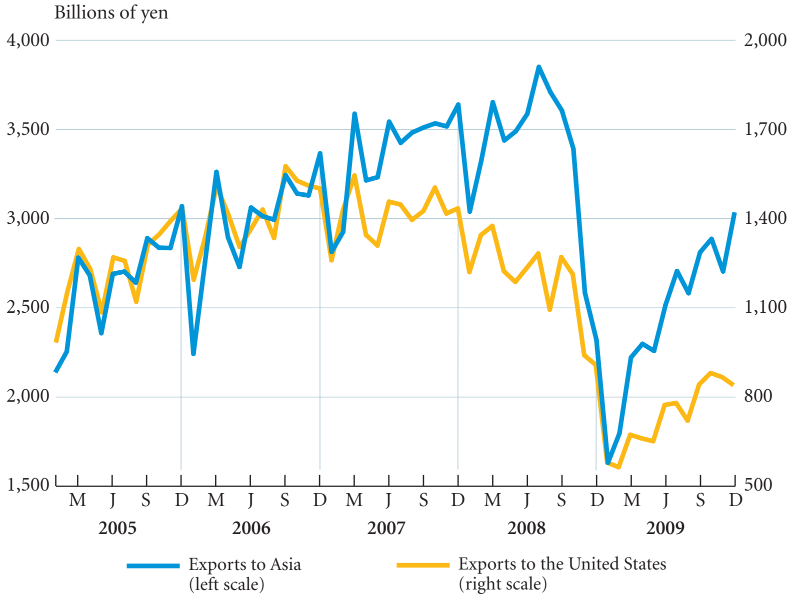
Industrial production index



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

JAPAN: AN UNEQUAL RECOVERY IN EXPORTS

Japanese exports to Asia and to the United States



SOURCES: Japanese Ministry of Communications and own calculations.

improved in December with machinery orders on the up, both in purchases aimed at the domestic market as well as investment demand on the part of exporters.

The housing market, however, still fails to offer any convincing signs of strength, with land prices in the six key cities overall accumulating a 13.3% drop since March 2008 and the number of homes started still being low. On a more positive note, the labour market continued to show a slight recovery with a minimal drop in the unemployment rate in December, down to 5.1%, and with a manufacturing sector that maintained its gains in employment of the previous month, in the wake of the industrial recovery.

Regarding prices, the weak demand will mean that deflationist trends will continue during 2010. Consequently, December's CPI posted a drop of 1.7% year-on-year and core inflation, the general without energy or food, was down 1.2% year-on-year, accumulating a year of consecutive falls. In the foreign sector, the trade surplus for December was still stuck at levels close to half the balance before the financial crisis. In this respect, although the recovery in Asian exports, half the total, continues to gain in momentum, this is not the case with the rest. A paradigmatic example is the case of exports to the United States, which are not on the way to regaining the ground lost. And the recent problems for Toyota, the world's main car manufacturer, have not helped the situation in the United States.

China puts its monetary policy on a diet

With the arrival of the year of the Tiger mid-February, a second hike was announced in the cash reserve ratio

Housing hasn't found a stable base but manufacturing employment keeps up its progress.

The CPI is down 1.7% and the foreign sector is recovering thanks to exports to Asia.

China tightens up its monetary conditions.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2009				2010
			1Q	2Q	3Q	4Q	January
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	–
Electrical power generation	15.7	6.7	–4.3	–0.4	8.0	24.3	...
Consumer prices (*)	4.8	5.9	–0.6	–1.5	–1.3	0.7	1.5
Trade balance (**)	262	298	319	296	252	198	173
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.

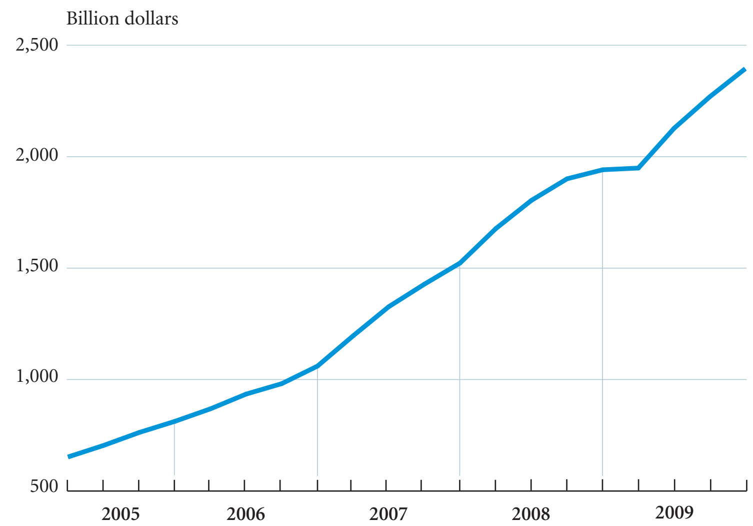
Most analysts expect a rise in interest rates in the second quarter.

in the last two months. After a year of growth supported by expansionary monetary and fiscal policies, the time has come to go on a diet and thereby avoid inflationist pressures and asset bubbles.

In the first quarter of the year, the tightening up of monetary conditions has focused on withdrawing liquidity. After a hike of 100 basis points, the cash reserve ratio stands at 16.5% for large banks and 14.5% for smaller institutions. Most analysts also expect the one-year reference rate to rise in the second quarter by 27 basis points, up to 5.58%. In this way, the central bank aims to reduce the pace of growth

CHINA CONTINUES TO ACCUMULATE RESERVES

International reserves



SOURCES: Thomson Reuters Datastream and own calculations.

in credit, which reached 29.3% in January.

In spite of controls on capital inflows, which are not infallible, the expected appreciation of the renminbi and higher interest rates provide a highly attractive combination for foreign investors. This results in continued financial inflows that, combined with the trade balance surplus, have forced the authorities to continue to accumulate international reserves: these totalling 2.4 billion dollars at the end of 2009 (see graph above).

The change in monetary direction has still not made its mark on the business indicators available for January, which continue to point to the Asian giant's recovery. However, we should take care when analyzing data for the start of the year due to the jump in the Chinese calendar of its New Year from January 2009 to February 2010, and also due to the base effects of one year ago. Regarding the foreign sector, and for the second month in a row, exports enjoyed a year-on-year rise whose value increased to 21%, higher than the 17.7% in December. Meanwhile, imports were up 85.5% year-on-year, compared with 55.9% the previous month, as a consequence of the minimums recorded a year ago and the restocking of manufacturing firms. Consequently, the trade balance surplus has fallen from 18,400 million dollars in December to 14,200 million dollars in January.

On the supply side, the purchasing managers' index (PMI) continued well above 50 points, the threshold between recession and expansion. For its part, domestic demand was still supported by capital investment, sustained by credit and the state investment plan. Once again vehicle sales were solid and grew by 126% year-on-year in January.

Most leading indicators continue to point towards recovery.

Lastly, the consumer price index (CPI) has started the year with a 1.5% rise year-on-year, somewhat less than expected and lower than the 1.9% of December but a long way from the negative figures reached in the midst of the global crisis. This upward trend is also reflected in real estate prices, in December rising 7.8% year-on-year, the highest in seventeen months.

The CPI and real estate prices continue to rise.

For the moment, at least, no clear inflationist tension can be seen. Stopping this from appearing and preventing asset bubbles will largely depend on the government's skill in withdrawing monetary and fiscal stimuli at the right time.

Brazil: Rousseff and inflation are stepping on the gas

Carnival is over but the party goes on. The Brazilian economy continues to show signs of strong recovery although both monetary and fiscal policy are still as expansionary as when they were used to boost the country's exit from the crisis. Something that has been passed on to inflation, which is starting to have an undesired effect on inflation expectations over the medium term. It's no surprise that the markets have ruled out the possibility of Brazil's Central Bank being one of the first to raise interest rates and to do so before the summer. This is supported by the recent upgrading of the reserve requirements by Brazil's Central Bank and the little chance of adjustment on the fiscal side, in view of the presidential elections in October. Elections in which Dilma Rousseff, the Workers' Party candidate, is the favourite thanks to her being effectively backed by the economic situation and the charismatic Lula da Silva.

Brazil's economic recovery boosts the chances of Dilma Rousseff.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2009				2010
			1Q	2Q	3Q	4Q	January
Real GDP	6.1	5.1	–1.8	–1.7	–1.5	...	–
Industrial production	5.9	2.9	–13.7	–11.3	–8.7	5.7	...
Consumer confidence (*)	132.3	140.4	128.5	128.4	141.9	154.2	158.7
Unemployment rate São Paulo (**)	15.0	13.0	12.6	13.9	13.1	11.8	...
Consumer prices	3.6	5.7	5.8	5.2	4.4	4.2	4.6
Trade balance (***)	40.0	25.0	25.2	27.6	26.5	25.4	25.7
Interest rate SELIC (%)	12.75	11.25	11.25	9.25	8.75	8.75	8.75
Reales to dollar (*)	2.1	1.8	2.3	2.0	1.8	1.7	1.9

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.

Inflation prospects are worse for 2010.

Most analysts estimate that Brazil's gross domestic product will grow by around 5% in 2010, thanks to the significant base effect and the impact of fiscal and semi-fiscal stimuli. Although exports are expected to gain momentum and the recent depreciation of the real encourages this trend, the main driver for the Brazilian economy will continue to be local thanks mostly to consumers still having complete confidence in their economy. This is indicated by the index that measures this sentiment, with another rise and another record high in January (see graph below). The progressive improvement in the job market also helps this confidence and this, in turn, is reflected in retail sales that, although dropping back slightly compared with the previous month, were up 8.7% in November compared with the same month in 2008.

Business sentiment is still very positive, in line with industrial production which increased 18% year-on-year in December and with a purchasing managers' index of 57.8 points in January, a level indicating expansion and the highest since February 2006. Overall, industrial capacity utilization is around 82% of the total and still rising.

This has not prevented the economy's robust reactivation, the boost in credit that has already reached 45% of GDP and the continuation of fiscal support on the eve of elections from creating pressures on inflation. According to data from Brazil's Central Bank, the consumer price index rose 4.6% in January and the prospects for inflation for 2010 continue to decline although, as the Bank itself sees it, not in any alarming way. In spite of this, monetary conditions will probably soon be restricted so as not to deviate too far from the target set and so stop the party from going out of control.

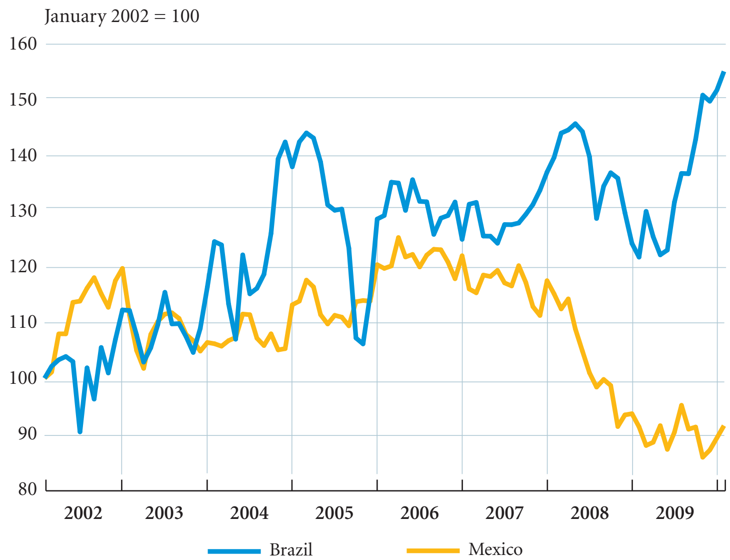
Mexico: coming out of the tunnel

Mexico leaves 2009 with a 6.6% decline in GDP while its recovery advances.

Confirmed: 2009 was an *annus horribilis* for the Mexican economy. In spite of countering with growth in the third quarter of the year, Mexican GDP posted

CONSUMER CONFIDENCE STILL INCREASING IN BRAZIL AND STARTING TO RECOVER IN MEXICO

Consumer confidence index



SOURCES: Thomson Reuters Datastream and own calculations.

its worst figure in 30 years with a drop of 6.6%. However, data from the fourth quarter reported a 2% rise compared with September, verifying that the recovery is continuing and progress is being made towards business levels that are more in line with its potential. The economic panorama in 2010 therefore looks much more favourable and this is indeed the view of the International Monetary Fund, Banxico and the Secretary of Finance herself, whose

Foreign demand continues to drive recovery.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2009				2010
			1Q	2Q	3Q	4Q	January
Real GDP	3.3	1.5	–9.1	–8.5	–6.1	–2.4	–
Industrial production	1.8	–0.9	–9.7	–9.6	–6.5	–2.0	...
Consumer confidence (*)	104.9	92.2	80.1	80.5	83.0	78.4	82.1
Leading business index	116.7	117.9	109.5	108.2	110.8	112.2	...
General unemployment rate (**)	3.7	4.0	5.0	5.2	6.3	5.3	...
Consumer prices	–22.7	–11.8	6.2	6.0	5.1	4.0	4.5
Trade balance (***)	–10.1	–17.3	–17.6	–15.9	–12.6	–4.7	–3.5
Official Banxico rate (%)	7.00	7.50	6.75	4.75	4.50	4.50	4.50
Mexican pesos to dollar (*)	11.0	10.6	14.2	13.2	13.5	13.1	13.0

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

Domestic demand starts to show signs of improvement.

recent upgrades bring the expected growth close to our forecast of 4%.

If Mexico can already see the tunnel of the crisis in its rear-view mirror it's basically thanks to the push from foreign demand, which continues to feed on the gradual recovery in consumption and industrial activity in the United States. The Mexican GDP growth between September and year-end therefore reflects the continued push from industry, which grew by 3% compared with the third quarter and whose production recorded, in December, its first year-on-year rise after seventeen months of decline (of 1.3%). This can be explained by the extraordinary improvement in its flagship: the automobile industry, greatly benefitting from the recovery in US industry and from exports, which continued to pick up in December, up 22.8% compared with the same month in 2008. Both services and primary activities also contributed to growth, with advances of 1% and 0.9% (quarter-on-quarter figures), respectively.

The bulk of the evidence available suggests that its recovery will gain momentum as the year goes on. In December, the index of general economic activity (IGAE in Spanish), a leading indicator of how the Mexican economy is performing, was up 0.5% year-on-year. However, for growth in Mexico to consolidate, its domestic mainstay will have to be replaced, so we will have to wait for the timid optimism imbuing some indicators to be confirmed. On the one hand, retail sales grew by 1.7% in November compared with October, in spite of their year-on-year figures still being negative (1.5%). On the other hand, Mexican consumer confidence once again advanced in January (see graph above), thanks largely to improvements in the labour market, with unemployment falling to 4.8% in December and in spite of the recent hike in taxes and tariffs.

Although this rise pushed inflation up to 4.5% in January, no inflationary risks can be observed at present. Industrial capacity utilization is still relatively low, around 70%, and credit to the private sector, although slowing up its decline, is still falling (3.4% year-on-year in December and 7.5% in 2009). Within this context, and given the evident fragility of domestic demand, Banxico seems unlikely to move the interest rate at least until the end of 2010. With regard to structural reforms, the wait looks to be even longer.

EUROPEAN UNION

The euro area is coming out of recession but very slowly.

Euro area: the recovery loses momentum

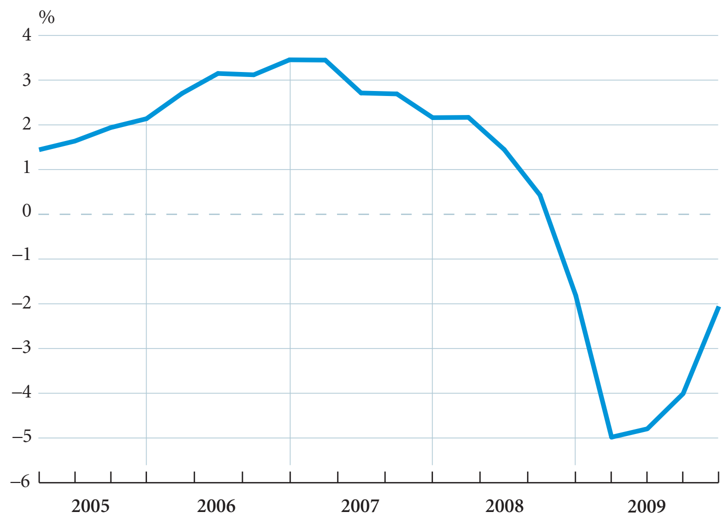
The fourth quarter of 2009 is gradually falling behind us and with practically all the data available we can reach two conclusions, one positive and the other negative. The positive conclusion is that the economy continued to grow for the second consecutive quarter and this means we can now state that the euro area has come out of the recession. Gross domestic product (GDP) increased 0.1% compared with the previous quarter, so that the decline for the year as a whole reached 4.0%. But the negative conclusion is that the exit is looking very flat. At present, we are keeping our growth forecast for the whole of 2010 at 1.2%, but the risk of a downgrade is clearly increasing. If there are no pleasant surprises over the coming months, we might be forced to cut our forecast by a few tenths of a percentage point.

Although we still don't have any details regarding the trends in the different GDP components, high frequency series give us some idea of the factors that are weakening the recovery and those that are keeping it going. As explained in detail below, the bulk of the evidence available suggests that both consumption and investment remained very weak, while the foreign sector still holds the reins of growth.

As far as private consumption is concerned, its weakness is perfectly reflected in the poor performance of

THE EURO AREA CONTINUES TO RECOVER, BUT SLOWLY

GDP year-on-year growth rate



SOURCE: Eurostat and own calculations.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010
			1Q	2Q	3Q	4Q	January
GDP	0.5	–4.0	–5.0	–4.8	–4.0	–2.1	–
Retail sales	–0.7	–2.3	–3.3	–2.5	–2.1	–1.4	...
Consumer confidence (1)	–18.1	–24.7	–32.5	–27.9	–21.3	–17.0	–15.8
Industrial production	–1.7	...	–18.5	–18.6	–14.5	–7.7	...
Economic sentiment indicator (1)	93.5	80.8	65.7	70.2	79.9	91.9	95.7
Unemployment rate (2)	7.5	9.4	8.8	9.3	9.6	9.9	...
Consumer prices	3.3	0.3	1.0	0.2	–0.4	0.4	...
Trade balance (3)	–1.2	–14.4	–36.3	–31.2	–5.3	15.2	...
3-month Euribor interest rate	4.6	1.2	2.0	1.3	0.9	0.7	0.7
Nominal effective euro exchange rate (4)	110.6	111.7	109.9	111.0	112.1	113.8	110.8

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.

Consumption is still the Achilles heel for recovery.

retail sales throughout the fourth quarter. After the nasty surprise they provided in the month of November, a figure that was subsequently upgraded slightly, they recovered a little in the month of December. But, on the whole, no convincing signs can be seen of retail sales starting to come out of their slump. On the other hand, consumer confidence continues to improve. This is good but the problem is that it comes from record lows. It is now at a similar level to the minimum reached in 2003, so that it still has a long way to go. The last element that stops us from being too optimistic about consumption's recovery is the labour market. In the month of December, the unemployment rate rose again by one tenth of a percentage point and has now reached 10.0%. It's true that its rate of decline has eased off in the last few months but it more than likely won't stabilize until the second half of the year.

Industrial production picks up but investment will remain weak.

To predict trends in investment it's always very useful to analyze the behaviour of the industrial production index, and this is actually still recovering quite quickly. In the month of December, the year-on-year rate of change stood at –4.8%. A significant fall but, just three months earlier, this drop had reached –12.7%. However, these data must be interpreted with caution. The low utilization of production capacity, currently at 71.2%, will slow up the recovery in investment. Moreover, the purchasing managers' economic sentiment index (PMI), now available for the month of February, points to a possible slow-up in the speed of recovery for the first quarter of 2010. This would be particularly due to the services sector, while manufacturing seems to continue rising.

The good news continues to come from the foreign sector and this time for two reasons. On the one hand, exports continued to grow strongly in December. Given that they also performed quite well in the months of October and November, the year-on-year rate of change has gone from –19.3% for the third quarter to –7.9% in the fourth quarter. Imports also notably reduced their decline but to a lesser extent. That's why the foreign sector will most probably once again have contributed positively to GDP growth in the fourth quarter. Moreover, throughout the last few months exports have been getting an additional boost: the cheaper euro. In little more than just two months, its exchange rate against the dollar has gone from 1.50 to a level close to 1.35, and this trend might continue for a while yet.

The foreign sector still holds onto the reins of growth...

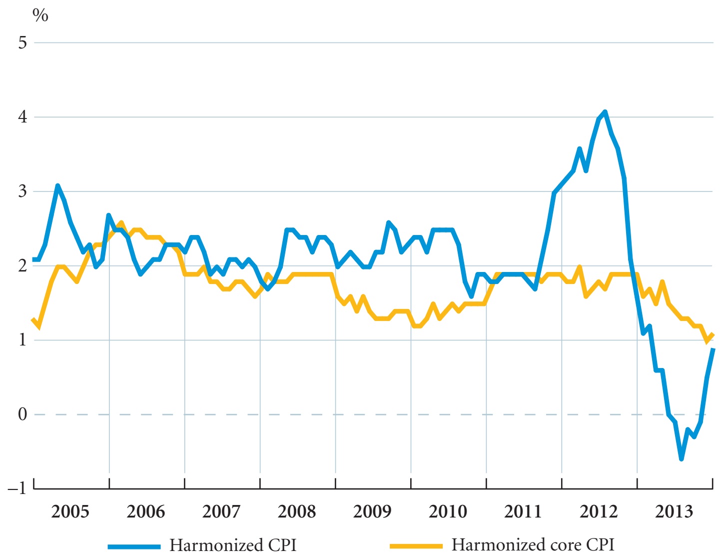
However, it's important to stress that this rapid correction in the euro partly reflects a downgrade in the growth prospects of the euro area on the part of the markets. In addition to weak consumption and the slow-up in the recovery for business, as mentioned above, there is also a higher risk that expansive fiscal policy will have to be withdrawn sooner than planned and more quickly than desired. The markets' concern regarding the rapid rise in debt in some euro area countries became evident with the upswing in the risk premium for sovereign bonds from Greece, Portugal and Ireland. But throughout the month of February there has been a highly significant fall in the yield of the 10-year German bond, now below 3.19%. The Bund, as this asset is known, is one of the main safe havens and this movement must therefore be interpreted as a widespread reassessment of country-risk.

Given this scenario, the position taken lately by the European Central Bank has become particularly important. At present, its president, Jean-Claude Trichet, continues to insist that the

...and will become stronger due to the euro's depreciation.

INFLATION IS NOT A PROBLEM IN THE EURO AREA

Year-on-year change



SOURCES: Eurostat and own calculations.

But the risk of relapse has increased.

current level of the reference rate, namely 1%, is appropriate. Without doubt, the consumer price index (CPI), which in January held steady at 1%, does not pose any risk at all. Core inflation has also settled at a comfortable level and does not show any signs of a risk of inflation or deflation increasing. That's why, for the present, we are keeping to our prediction that the reference rate will remain at its current level until the fourth quarter. But if some countries are forced to withdraw their expansive fiscal measures earlier than planned, this might compel the ECB to postpone any interest rate hike until next year.

In short, the euro area continues to advance but it seems to be doing so at a slower rate than expected. This makes the present time particularly delicate. The recovery is not in any danger but is still fragile. If, over the coming months, there are no pleasant surprises, we may have to wait until next year for it to consolidate.

One for all and... all for one?

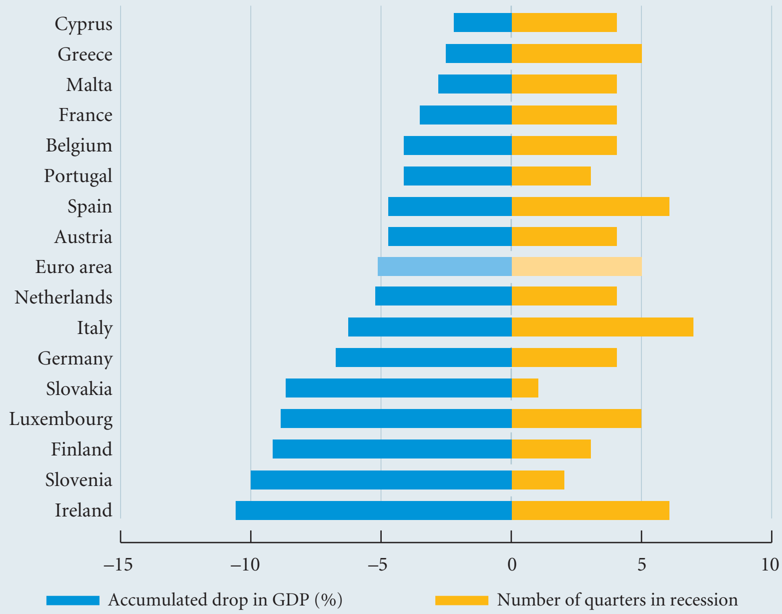
When the countries in the euro area agreed to create one central bank for all of them, they knew that there would be difficult times when they would all have to pull together as one. Such a time might soon arrive. The actions of the European Central Bank (ECB) have always created an intense debate as it's a major influence on economic activity and employment, but the debate that will probably be generated in the coming quarters might be particularly controversial. The reason is that, although in 2009 all countries needed an extraordinarily expansive monetary policy as all entered recession during the year, their exit paths are very diverse. The euro area as a whole will probably need interest rates to go up between the end of 2010 and the beginning of 2011, but this might harm the fragile recovery in those countries that are lagging most behind.

The existence of different speeds of recovery has been confirmed by growth data for the fourth quarter. Gross domestic product (GDP) for the euro area grew 0.1% compared with the previous quarter and continued to move further away from the shadow of recession which, in total, has left behind an accumulated drop in GDP of 5.1%. The dynamics of the euro area summed up quite well the performance of its two main engines, France and Germany, but the economic situation in the rest of the countries is highly diverse. In some, the slump has been more moderate, such as Malta and Cyprus, with GDP falling little more than 2%. In Slovenia and Slovakia, however, the adjustment has been very large but has happened quickly, lasting little more than a quarter, so that these countries are already back on the road to recovery. At the other end of the spectrum is Ireland, which has spent a year and a half in recession and, so far, its accumulated decline is already 10.5%. Lastly, there's a group of countries with a relatively moderate adjustment in GDP but which have yet to come out of recession. This would be the case of Spain and Italy.

Given this scenario, the ECB still insists that the reference rate is appropriate. This has now stayed at 1% for nine months, quite a record. But given that the recovery is being quite anaemic, that the risk of relapse is still considerable and that inflation is remaining stable (in January it was at 1%), at present there is no reason to

EURO AREA: A DISPARATE RECESSION

Duration and depth of the recession in the euro area



SOURCES: Eurostat and own estimates.

implement an interest rate hike. This scenario, however, might change over the coming months. The recovery is expected to gather momentum as from the middle of 2010, when consumption and investment start to contribute positively to growth. If this happens, there will be marked discrepancies concerning what kind of policy the ECB should follow. Those economies leading the growth in the euro area might be suffering from higher inflationary pressures and, in this case, would require a higher interest rate. But those still in recession or just starting to come out of it will need interest rates to remain low.

This debate is not new. In fact, during the years prior to the launch of the single currency system, the main fear was precisely that, if the different countries' economic cycles didn't coincide, the costs of monetary union could be greater than the benefits. However, it was argued that the introduction of the single currency would increase trade links between the different countries in the euro area and that this would, in turn, result in greater coordination of their economic cycles.

After more than a decade of common monetary policy, numerous economists have studied whether this synchronization has actually increased and the conclusions are not very encouraging. In fact, in a recent article, M. Camacho, G. Pérez-Quirós and L. Saiz show that the differences between cycles in the different countries might be increasing.(1)

(1) *Do European business cycles look like one?*, Journal of Economic Dynamics & Control, 32, 2008.

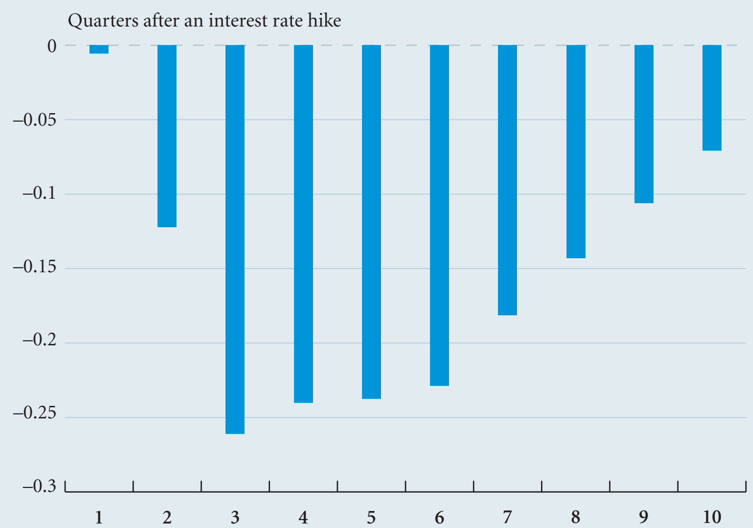
An additional conditioning factor will join this debate. If the ECB starts to raise the reference rate at the end of the year, those countries that still need some stimulus to revive activity will not be able to resort to greater expansive fiscal policy. After the huge effort made by the public sector to minimize the effects of the recession, most countries' public debt is over 60% of GDP and their public deficit is above 3% of GDP, the maximum set by the Maastricht criteria. Unsurprisingly, the European Commission has already started proceedings for these countries to ensure that, in the coming years, their public accounts will be sorted out.

The Spanish economy will be immersed in this debate because, as is well-known, a rise in the reference rate would affect the rate of recovery. In general, a higher interest rate gradually reduces the rate of growth in GDP. As can be seen in the graph below, a rise of 1 percentage point reduces the year-on-year growth in GDP by approximately 25 basis points after three quarters, when the effect is at its greatest. A rather significant cost that must only be incurred if inflation threatens to pick up, as this usually results in greater economic instability. But those countries coming out of recession and under no inflationary pressure should not have to endure this cost.

That's why the dilemma facing European institutions might end up being a very tough one. However, if this occurs, they wouldn't be at a dead end. The solution: keep a relatively lax monetary policy and ensure that those countries leading the recovery speed up the withdrawal of their fiscal expansive policies if their inflation starts to hot up. In this way, the recovery in those countries lagging most behind would not be harmed and, at the same time, neither would there be problems of overheating in those countries whose recovery is at a more advanced stage.

TIGHTENING UP MONETARY CONDITIONS HAS A PRICE

Impact on the year-on-year change in GDP of an interest rate rise of 1 percentage point



SOURCE: Own estimates for a group of developed countries.

If it ends up being needed, the recipe exists and is technically simple but politically complex. A high degree of coordination will be vital between all European countries and institutions for it to be carried out. Monetary policy is centralized in the ECB but greater coordination of fiscal policy will be required both between the different countries and also with the highest monetary authority. If we want a central bank for all, then all must be as one.

This box was prepared by Oriol Aspachs-Bracons
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The German economy stagnates in the fourth quarter

The German economy stagnates in the last quarter of 2009...

Stagnation. This has undoubtedly been the most widely used term over the last few days to describe the trend in the German economy in the fourth quarter of 2009. The publication of zero quarter-on-quarter growth in GDP for this period represented a brake on the upswing recorded in the previous two quarters (with rises of 0.4% and 0.7% respectively). Consequently, the economy slumped by 4.9% in 2009 as a whole, the biggest fall since the Great Depression.

This halt in the upward trend surprised analysts who, although agreeing that the economy would weaken during the last few months of the year, did not expect it to stagnate. The breakdown of GDP by component, published by the German statistics institute, pointed to consumption and stocks as the main reasons behind this loss of economic impetus. Their fall was only offset by the improvement in the foreign sector. Consequently, and for the second month in a row, the trade balance increased in December compared with the same month in 2008. This was due to a year-on-year increase in exports of 1.2%, the

...in spite of recovery in the foreign sector.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010
			1Q	2Q	3Q	4Q	January
GDP	1.0	–4.9	–6.7	–5.8	–4.8	–2.4	–
Retail sales	0.0	–1.7	–2.4	–1.3	–1.7	–1.5	...
Industrial production	–0.1	–16.1	–19.9	–19.2	–15.5	–9.2	...
Industrial activity index (IFO) (*)	96.8	87.7	82.6	84.8	89.9	93.5	95.8
Unemployment rate (**)	7.8	8.1	8.0	8.2	8.2	8.1	8.2
Consumer prices	2.6	0.4	0.9	0.3	–0.3	0.4	0.8
Trade balance (***)	195.0	140.2	160.2	140.4	131.0	129.5	...

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.

Weak consumption entails weak growth at the start of 2010.

first in more than one year, at the same time as imports posted a fall of 7.9%.

Given this situation, we need to ask ourselves to what extent the slowdown in the German recovery was due to something circumstantial or whether, on the contrary, it represents the start of a period of zero (or even negative) growth. It's evident that the economy's upswing in the middle of last year was partly due to the increase in stocks and the measures to stimulate the economy adopted by the government. Among these measures, of note was the incentive to purchase cars, ending in November 2009, which encouraged consumers to buy sooner than they had intended. As a result, vehicle registrations fell as from this date, down 4.6% and 4.3% in December and January, respectively.

Supply indicators point to recovery in German activity.

These macroeconomic measures led to a higher growth rate in the German economy in the second and third quarter of 2009, in exchange for lower future growth. A more moderate increase in the economy is therefore expected over the next few quarters, with the foreign sector once again being the country's main source of growth. For its part, domestic demand will remain weak, particularly during the first half of 2010, due to consumption's weak performance.

2010 is expected to end with a self-sustained recovery.

Trends shown by the most frequent indicators point in this direction. On the side of demand, retail sales continued to fall in December, down 1.8% compared with the same month in 2008. In spite of January's unemployment rate standing at 8.2%, only half a percentage point higher than the minimum reached in 2008, the expected decline in the job market over the coming months will uphold this drop in consumption. This is indicated by the fall in consumer confidence in January, motivated both by its present and future component. As a consequence of this lower consumption, price variations are expected to remain moderate throughout 2010.

On the supply side, the figures lead us to predict a recovery in activity in the short term. The upswing in foreign demand strengthened industrial orders which once again posted positive year-on-year growth in December 2009, after eighteen months of decline. As trends in industrial orders change before those in industrial production, the latter is expected to return to growth in the first quarter of 2010. Moreover, both the improvement in the IFO index for business activity in January and the new growth in industrial capacity utilization for February point to a gradual recovery in investment.

In short, the stagnation in the economy in the last quarter of 2009 shows the difficulties that still exist until the country is on the road to self-sustained growth. However, the German economy is expected to end the year showing clear signs of year-on-year growth, which both the German Bundesbank and the International Monetary Fund place at around 1.5%. This figure would mean ending 2010 with more robust growth.

France takes over the helm of European recovery

The French economy speeds up its growth in the fourth quarter...

The French economy grew for the third consecutive quarter in October-December 2009, with a rise of 0.6% quarter-on-quarter. This rate was higher than the 0.2% recorded in the previous period and confirmed the recovery started in the second quarter of the year. The accumulated decline for the year as a whole therefore stood at 2.2% compared with 2008, the smallest

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	–2.7	–2.3	–	–0.3	–
Domestic consumption	4.8	–0.6	–2.5	–0.8	0.6	0.0	3.6	3.5	5.9
Industrial production	1.2	–2.4	–9.0	–15.7	–15.2	–11.2	–8.1	–3.8	–2.3
Unemployment rate (*)	8.3	7.9	8.3	8.9	9.3	9.6	9.9	10.0	10.0
Consumer prices	1.5	2.8	1.8	0.6	–0.2	–0.4	–0.2	0.4	0.9
Trade balance (**)	–33.8	–48.8	–55.4	–55.0	–52.5	–44.4	–40.1	–40.1	–42.4

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

among the main European economies, making France the driving force for the euro area.

...boosted by private consumption and stocks.

The provisional breakdown in the different GDP components shows that this growth was driven mainly by private consumption and changes in stocks, with contributions to quarterly GDP of 0.7 and 0.9 percentage points respectively. The impetus provided by both components was partially offset by the negative contribution of foreign demand, at 0.8 points, motivated by the 3.5% upswing quarter-on-quarter in imports, higher than the 0.9% for exports. On the other hand, the contribution made by public consumption (0.2 points) and investment (–0.2 points) was similar to the levels in the previous quarter.

However, the French economy's growth will lose momentum in the coming quarters as a result of the lower contribution of stocks and the reduction in government measures to stimulate the economy. Among these measures, of note are incentives for the purchase of cars that, given the prospect of these gradually disappearing as from January 2010, greatly boosted registrations in the last few months of 2009. In spite of this, the French economy will keep up a good rate of growth that, according to the government's forecasts, will be around 1.4% in 2010, above the average for Europe.

Indicators available for the beginning of 2010 point to this situation. On the demand side, it's important to analyze the trends in French private consumption, as this accounts for more than 60% of GDP. The significant improvement in consumer confidence in the month of January suggests that private consumption will continue to grow moderately during the coming months, even within a context of rising unemployment in the short term, after this had remained stable in December at 10.0%. This slow recovery in consumption places forecasts for French inflation at around 1.2% in 2010, still below the average of the last few years although much higher than the 0.2% minimum reached in 2009.

For its part, foreign demand for French products will continue to grow over the coming months. This will be possible thanks to the economic recovery of the main trading partners for France and

Private consumption will continue to grow albeit at a slower pace.

French investment will not recover until the end of 2010.

the fall in the euro-dollar exchange rate, making the demand for goods on the part of non-EU countries more attractive.

This recovery in demand continuing throughout the year will allow French industrial production to continue its slow improvement. This, however, will not result in growth in investment until industrial capacity utilization reaches rates higher than 80%, more than five percentage points above the latest figures available (74.7% in the first quarter of 2010). Consequently, investment will not begin to make a positive contribution to the economy until well into the second half of the year.

The Italian economy shrank 0.2% quarter-on-quarter in the fourth quarter of 2009.

The French regional elections will take place within this context of economic recovery. As tends to happen, polls suggest that the results will not be favourable for the party in power, with the Socialist Party being the winner and the consequent new political environment for the last two years of president Sarkozy's mandate.

The Italian recovery is still very fragile

After a third quarter in which the Italian economy seemed to come out of its recession, with 0.6% growth quarter-on-quarter, the last three months of 2009 highlighted the fragility of this recovery, with a 0.2% fall in GDP compared with the previous quarter. As a consequence, the decline accumulated over the year as a whole was 4.9%, the highest recorded since 1971. However, the economy is expected to grow again in the coming quarters, albeit at a very moderate pace, a result of the weakness in its different components.

Italian domestic consumption remains very weak.

One of the main reasons for this shrinking of the economy in the fourth quarter can be found in supply. During this period, industrial production fell 0.8% quarter-on-quarter, compared with the 4.4% growth posted in the previous quarter. Given this situation, the positive trend in industrial orders in the month of December and January shows a certain degree of improvement, albeit moderate, in the first quarter of 2010. Investment is therefore expected to remain weak in the first half of the year.

The loss in momentum of activity can be explained by the trend in the different demand indicators. The 6.7% fall month-on-month in retail sales in November, together with a reduction in the subsidies for vehicle purchase, weakened consumption during this period. Moreover, the decline in the job market, with more than two million people unemployed at the end of 2009 and an unemployment rate close to 8.5%, led to deterioration in Italian consumer confidence in January. This means that we cannot expect consumption to recover in the short term, with the Italian rate of inflation remaining below the average of the last few years.

Neither is a rise in demand for Italian goods expected on the part of the foreign sector. In spite of the latest improvement in the trade deficit for December, exports still showed no sign of improvement, with a 0.5% fall in December compared with the previous month.

The forecasts by the IMF and the Italian government place the economy's growth in 2010 at around 1.0%, slightly less than what is predicted for the euro area. However, this growth is expected to remain at low levels over the coming years. That's why the Italian minister for

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	–	–2.8	–
Retail sales	1.4	–0.3	–2.3	–3.1	–1.2	–2.3	0.4	–1.3	...
Industrial production	2.2	–3.4	–10.6	–21.3	–22.9	–15.9	–12.7	–9.0	–5.7
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	–4.4	–4.1

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

the economy announced that the new measures to stimulate the economy will be aimed at sectors that improve the future competitiveness of the Italian economy, in detriment to other sectors such as the automotive.

According to the IMF, the Italian economy will grow by 1.0% in 2010.

The United Kingdom: a bad start to the year

The revision of GDP for the fourth quarter last year indicates that the British economy came out of the recession with quarter-on-quarter growth of 0.3%, an upgrade of the initial estimate. Nonetheless, it will take some time to regain its pre-crisis levels and the risk of a relapse has not disappeared completely, due to the withdrawal of a large number of government stimuli in 2010. Along the same lines, forecasts by the International Monetary Fund predict timid growth of 1.3% for the current year, a figure very similar to that of the main European economies.

The British economy comes out of recession.

The climate of weak consumption worsened at the start of 2010. In January, value added tax (VAT) went back to its previous level of 17.5% after thirteen months at 15%, encouraging households to bring their purchases forward before the end of the year. Moreover, the impact of record snowfalls on distribution channels may also have played a part in the drop in spending at the start of the year. Accordingly, retail sales fell 1.8% month-on-month in January, the worst drop since June 2008. The labour market, a more structural factor in household consumption, has reversed its positive trend of the last few months: the number of registered unemployed increased unexpectedly in January, meaning that adjustment in the labour market has yet to end.

Consumption hindered by macroeconomic and structural factors.

The foreign sector has been a key element in reactivating the economy, even more so than public spending, with an average contribution of 0.7 percentage points to GDP growth in 2009. The trend in this component will be determined by the recovery of economies in the euro area, the destination for half British exports, as well as how the pound sterling behaves.

Inflation rose to 3.5% year-on-year in January, a markedly higher rate than the target of 2%. This rise is not surprising as it is due to temporary causes, such as exceptionally low energy prices in

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010
			1Q	2Q	3Q	4Q	January
GDP	0.5	–5.0	–5.4	–5.9	–5.3	–3.3	–
Retail sales	1.5	0.5	–2.4	–1.4	2.8	3.2	0.8
Industrial production	–3.1	–10.2	–12.5	–11.7	–10.6	–5.9	...
Unemployment rate (1)	2.8	4.7	4.2	4.7	4.9	5.0	5.0
Consumer prices	3.6	2.2	3.0	2.1	1.5	2.1	3.5
Trade balance (2)	–93.7	–86.6	–91.9	–88.5	–83.9	–82.1	...
3-month Libor interest rate (3)	5.5	1.2	2.1	1.4	0.8	0.6	0.6
Nominal effective pound exchange rate (4)	97.6	73.9	73.9	77.0	83.7	79.0	80.4

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.

Prices pick up to 3.5% year-on-year in January due to higher VAT.

January 2009 and the already mentioned hike in VAT. This temporary upswing will not speed up the withdrawal of monetary stimuli by the Bank of England which, for the moment, is waiting to see how the economy recovers. Uncertainty regarding this recovery and the low utilization of installed capacity, a factor that usually restrains prices, might give rise to new injections of liquidity in the short term. However, the risk of inflation, resulting from the accumulated depreciation of the pound and the huge monetary expansion carried out, has not disappeared and the monetary authority is likely to raise interest rates at the end of the year.

Quo vadis, emerging Europe?

The recovery is going at very different speeds in emerging Europe...

Although the member countries in central and eastern Europe are usually grouped together under the label of emerging Europe, their economies show clearly different traits. The extent of the world credit crisis has blurred this fact but now, when they are all embarking on the road to recovery, it is once again becoming clear that, while some are being a bit slow to take off, others have soared. It is therefore advisable to attempt to identity, individually, the current situation and outlook for these countries.

Poland stands out on its own merits. The biggest economy in the region has been the only central government belonging to the European Union capable of growing in 2009. We can see why if we analyze its growth: in the last year, its 1.7% growth was due to the fact that the notable contribution by the foreign sector (2.6 percentage points) more than offset the fall in domestic demand. And even this fall in domestic demand obscured a composition that was not as unfavourable as expected, since private consumption was capable of growing, a none too usual occurrence in Europe in such a complicated year as 2009. Where does this Polish singularity come from? From its own particular combination of fewer excesses in the earlier boom period (most clearly reflected in it being less dependent on foreign financing), greater margin in economic policy and fewer banking problems.

Based on these Polish strong points, we can define two different groups of economies. The first would be made up of Slovakia and the Czech Republic. Although they are benefitting from a limited accumulation of imbalances during the boom and from a banking sector without too many difficulties, like Poland, these two countries show specific traits that condition their cyclic trends. The Czech Republic has very important trade links with the euro area (70% of its exports go to this market, the highest percentage in all emerging Europe). For its part, Slovakia is strongly specialized in the motor vehicle industry and investment goods. This explains why, compared with positive Polish growth in 2009, Slovakia's GDP fell in the order of 5% last year and that of the Czech Republic dropped by 4% approximately. Given the meagre prospect for recovery in the single currency area for 2010, their exit from the recession won't be explosive, with an expected rise in GDP of slightly more than 2%.

Compared with this group of countries with acceptable macroeconomic bases but strongly exposed to the European Union or highly specialized in particular industries, the Baltic economies, Romania and Hungary are suffering from a combination that is practically the opposite to Poland. In all cases these are countries that accumulated marked macroeconomic imbalances during the expansion, most clearly reflected in their strong dependence on international financing. This situation affected their credit system to a greater or lesser extent. Moreover, these countries have notable ties with the European Union, both financial and commercial.

As we know, all this led to the need to make a big adjustment to their economies that crushed their activity in 2009. The fall in GDP was approximately 7% in Romania and only a little less in Hungary, and between 15% and 18% in Estonia, Lithuania and Latvia. Additionally, in the cases of Latvia, Hungary and Romania, international financing had to be guaranteed via aid from the International Monetary Fund and other multilateral bodies. Now the worst has passed and the very intensity of this adjustment will actually help them to make huge leaps in terms of activity in 2010 (not enough, however, for GDP in the Baltic countries to return to growth this year).

This segmentation of the region into different groups of countries is shared by international investors. Although media attention has focused on how far the Greek debt crisis has affected the country-risk levels of the Mediterranean countries in the euro area, we should ask ourselves whether this has also infected the economies of emerging Europe. The answer is that the markets have clearly identified those countries with lower foreign financing needs (one of the aspects mentioned above), «isolating them» from the Greek phenomenon, while others with greater foreign financing needs or less rigorously managed public accounts have suffered more. All this, however, without the country-risk levels getting dangerously high in any economy in the region.

So, for example, taking the cost of insuring the non-payment of public debt (Credit Default Swap) at five years as an indicator of country-risk, in mid-October

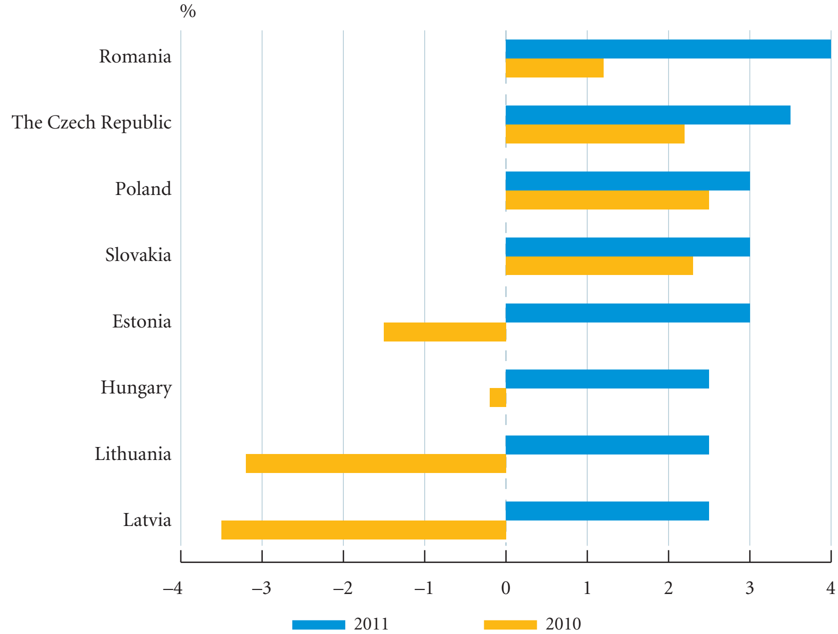
...with Poland standing out as particularly dynamic.

The Czech Republic and Slovakia reveal good macroeconomic foundations...

...while the Baltic countries, Hungary and Romania will suffer more in 2010.

FROM A DISPARATE 2010 TO A MORE SIMILAR 2011

Forecast for real GDP growth



SOURCES: National statistics offices, Eurostat and own calculations.

The Greek debt crisis has not significantly affected the region.

2009 the level of Greece and Poland was practically identical. Between this moment and the beginning of February 2010, when investor uncertainty peaked, Greece saw the cost of insuring its debt rise by more than 300 basis points, while Poland's hardly rose by 50 basis points. And the increases were even less for the Czech Republic and Slovakia, two very prudent countries in managing their budgets. Even Hungary, one of the countries whose country-risk suffered the most, did not exceed 100 basis points, a smaller rise, for example, than the one recorded for Spain in the same period.

And beyond 2010, where is emerging Europe going? The story of «one region, many different economic paths» that we expect for 2010 will give way to a greater degree of cycle synchronization in 2011. As the expansion gains momentum, the growth differentials between the region's countries will narrow. Unfortunately, in most cases this convergence in the pace of activity will occur below the growth potential, confirming that the huge crisis in 2009 has left a toll that cannot be settled within a short period of time.

FINANCIAL MARKETS

Monetary and capital markets

Non-conventional measures are being withdrawn but interest rate hikes will take their time in coming

At the end of January, the Federal Reserve (Fed) decided to keep the official rate at 0.25%. Although this decision came as no surprise to the markets, it should be noted that it was not unanimous, something that hasn't happened since August 2008. Thomas Hoening, Fed president for Kansas City, voted against. In statements prior to the meeting, Hoening pointed out that the monetary market should get back to normal «sooner rather than later», being in favour of a more restrictive policy to stop inflation from taking off.

The relevant news related to non-conventional monetary policy came on 10 February, during the appearance of Ben Bernanke, the Fed president, before the US House of Representatives. In his speech, Bernanke detailed the sequence of actions to be followed by the Fed. Broadly speaking, the Fed has three options: to drain off liquidity and then raise interest rates, raise interest rates and then drain or do both at the same time. Possibly, and reading between the lines of Bernanke's words, the sequence to be implemented by the Fed will resemble the third type: first drain off part of the excess reserves (by using instruments such as reverse repo agreements and term deposits) and then immediately afterwards raise interest rates, even if reserves are still too high (by using another powerful instrument, such as the capacity to reimburse these reserves).

The Fed decides to keep the reference rate the same.

Reducing the size of the institution's balance sheet and changing its composition, i.e. selling Treasury stock, is another relevant aspect in the exit strategy to be followed by the Fed. Regarding this point, Bernanke explained that, in the immediate future, the sale of assets is not considered to be an appropriate option but noted that, in order to help reduce the balance, the Fed is allowing agency debt and mortgage-backed securities (MBS) to mature. The minutes from the last Fed meeting reveal that there is no complete consensus regarding the right time to start selling assets, although all the evidence suggests that Bernanke's opinion will take priority.

Bernanke clarifies the sequence the Fed will follow to withdraw non-conventional monetary stimuli.

The passive nature of the exit strategy, the natural maturing of facilities, continues its course. This was made clear by Bernanke on stating that the TAF line (Term Auction Facility) and the TALF (Term Auction Lending Facility) would mature on 8 and 31 March, respectively.

On 18 February, the Fed took a step forward in getting the situation back to normal on announcing that it was raising the discount window interest rate by 50 basis points to 0.75%. Previously, in January, the reduction in the maximum maturity for the window came into effect, from 90 to 28 days.

The Fed believes that the weak economy makes it inadvisable to start selling assets.

The ECB maintains its road map and, when some of the special loans mature, will take its second step by tightening its lax monetary policy.

On the old continent, there's also been news regarding monetary policy, although not all has been completely verified. The month of February started with the announcement that the European Central Bank (ECB) was keeping the official rate at 1.0%. As happened in the United States, analysts' attention focused on the possibility that Trichet, the ECB president, would reveal details regarding conditions for special loans (LTRO). However, Trichet limited himself to saying that this decision would be taken at the meeting on 4 March.

Months ago, Jean-Claude Trichet announced that the last six-month LTRO would be in March 2010, something that might be considered as the second step in the passive withdrawal of stimuli.

The ECB has the option of carrying out the last 6-month LTRO with an additional premium to the official interest rate of 1.0% or it can simply use the same scheme as for the last 12-month LTRO, i.e. charging an interest rate linked to the weekly auctions (MRO) until maturity. Regarding 3-month LTROs, the institution might announce the end of full allotment for loans granted during the second quarter of 2010 but setting a sufficiently high amount so that, in practice, no tension would be generated in the interbank market.

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						
2009									
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
2010									
January	1.00	0.67	1.23	0.25	0.25	0.26	0.50	0.62	0.37
February (1)	1.00	0.66	1.23	0.25	0.25	0.25	0.50	0.64	0.23

NOTES: (1) February 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.

However, and in spite of a lack of specific details, in the days following the ECB meeting, two leading members of the ECB Council, Axel Weber and Athanasios Orphanides, made statements indicating the path the monetary authority will probably follow. Weber implied that the hike in interest rates will be preceded by a withdrawal of surplus reserves. For his part, and following the same line of argument, Orphanides noted that the gradual maturity of non-conventional stimuli must not be interpreted as the imminent start of the restrictive cycle in terms of interest rates.

In general, both the Fed and the ECB are pursuing the same goal: to generate a suitable financial context that encourages banks to go back to financing themselves through the markets and rely less on central bank facilities. In order for this process to be ordered, it's crucial for the upward trend in interbank interest rates to develop gradually. This will not only help to improve the situation of financial institutions but will also have a positive effect, with credit once again flowing normally towards firms and households.

It's important to stress that the decisions taken by the monetary authorities are being communicated adequately, a fundamental factor for the normalization process to occur without generating tension in the interbank market. For this reason, throughout the month of February the variations occurring both in the US market and in the European, whether short-term or long-term, are less than 1 base point on average.

Episodes of instability in some government bond markets

Throughout 2010, the key elements to explain the variations in value in the government bond market will be the extent and schedule for tightening up monetary and fiscal policies in the main countries because it will be in this year that managers of economic policy, with the worst of the economic recession behind them, will have to withdraw the exceptional stimuli introduced in 2008 and 2009, whose aim was to avoid a repetition of the Great Depression of the nineteen thirties.

But added to this factor is the uncertainty regarding the medium and long-term fiscal plans of countries on the periphery of the euro area. Investors' greater or lesser risk aversion in the last few weeks has pivoted precisely on these two issues.

In the case of the United States, after the Fed announced its rise in the discount interest rate, the yield on 10-year government bonds reached 3.80%, the highest level since the start of January, with the market interpreting this movement as a decisive step forward in the long process of getting US monetary policy back to normal.

But it has been on the other side of the pond, in the euro area, where volatility in government bond markets has been most intense. Doubts concerning Greece's fiscal situation meant that, at the end of January, investors required a yield of 7.16% from long-term Greek bonds. Given this situation, an extraordinary

In 2010, the tightening up of economic policy is a key factor behind the movements in government bond markets.

In the United States, the Treasury bond market takes note of the Fed's latest movement.

The Greek drama ends its first act but as yet no-one knows how the play will end.

Investors once again have confidence in Spain's solvency.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2009								
February	3.11	3.66	4.28	4.68	3.01	1.28	3.62	2.24
March	3.00	3.55	4.05	4.39	2.66	1.35	3.17	2.10
April	3.18	3.59	3.92	4.28	3.12	1.43	3.50	2.14
May	3.59	3.95	4.29	4.48	3.46	1.49	3.75	2.41
June	3.39	3.73	4.13	4.43	3.53	1.36	3.69	2.32
July	3.30	3.57	3.85	4.16	3.48	1.42	3.80	1.97
August	3.26	3.54	3.78	4.08	3.40	1.31	3.56	2.03
September	3.22	3.54	3.81	4.02	3.31	1.30	3.59	1.99
October	3.23	3.53	3.79	4.07	3.38	1.42	3.62	2.02
November	3.16	3.42	3.75	4.02	3.20	1.27	3.52	1.84
December	3.39	3.59	3.98	4.14	3.84	1.30	4.02	1.90
2010								
January	3.20	3.46	4.12	4.12	3.58	1.33	3.91	2.00
February (*)	3.28	3.56	4.03	4.10	3.80	1.34	4.16	1.97

NOTE: (*) February 19.
SOURCE: Bloomberg.

The European Union takes on the commitment to support Greece.

meeting was called of the EU heads of state and government in which an agreement was reached to support Greece. This decision temporarily allayed fears in the financial markets and the interest rate for Greek public debt fell to 6.51%. On 16 March, the Greek government will send a report on the progress achieved to the European Commission and the ECB. If deemed insufficient, the finance ministers of the euro area might force the Greek government to adopt additional measures to consolidate their public accounts.

In 2010, the trend in government bond yields will be slightly upwards but dotted by moments of instability.

Another focus of tension in the euro area has been Spain. The high pressure felt by its public debt market has eased after the success of the joint mission by the Ministry of the Economy and the Treasury to London and Paris to communicate their plans to investors and the international economic press. Both have acknowledged the solvency of Spanish debt and the plus points of the government's austerity plan. As evidence of this the Treasury promptly issued debt totalling 12,500 million euros, which was well received by investors.

In any case, the questions that still hover over the fiscal situation of countries in southern Europe, together with the weak growth figures for the last quarter for the euro area as a whole, have led to doubt in the markets regarding whether the region's economic recovery might take longer than initially expected. As a result, the average interest rates for public debt in the euro area have remained at low levels, particularly in the short tranche of the curves.

However, during this year, as the world economic recovery consolidates, the returns offered by sovereign bonds are expected to rise slightly, although periods of great volatility are likely to occur over the coming months. These movements, which might be erratic, are likely to reflect the uncertainty regarding the timing and intensity of the tightening up of monetary and fiscal policies.

The dollar maintained its trend of appreciation

The euro has been weak against the dollar since the start of 2010, largely due to the prospect of tougher monetary conditions beginning sooner in the United States, the fact that China has already started and also due to the rise in sovereign risk premia in countries on the periphery of the euro area.

However, it's important to remember that, during the last month, the dollar has appreciated against all leading currencies. For example, the dollar has risen 5.9% against the pound sterling and 4.9% against the Swiss franc, also rising 2% against the Canadian dollar and Mexican peso.

This widespread strengthening of the dollar is partly due to higher risk aversion and the use of the North American currency as a safe haven. After this strong, rapid rise in the dollar, there might be some profit-taking in the short term which will weaken the currency to a certain extent.

In any case, the movement in the dollar against the euro is in line with the expected trend for the dollar in 2010, based on the faster rate of growth

The dollar is appreciating due to the prospect of tougher monetary conditions and as a safe haven against the rise in sovereign risk premia.

This year, the euro-dollar exchange rate is likely to reflect the higher growth for the United States compared with the euro area.

EXCHANGE RATES OF MAIN CURRENCIES

February 19, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	91.8	0.7	–1.3	–2.6
Pound sterling	0.650	5.9	4.8	–7.7
Swiss franc	1.086	4.9	4.6	–8.1
Canadian dollar	1.050	1.8	–0.3	–19.8
Mexican peso	12.895	2.0	–1.5	–14.5
Against euro				
US dollar	1.350	–5.9	–6.1	6.1
Japanese yen	123.9	–5.1	–7.5	3.7
Swiss franc	1.465	–0.7	–1.3	–1.5
Pound sterling	0.877	0.4	–1.2	–1.1
Swedish krona	9.844	–2.5	–4.2	–12.3
Danish krone	7.443	0.0	0.1	–0.1
Polish zloty	3.999	–0.1	–2.5	–20.0
Czech crown	25.64	–0.6	–3.1	–12.8
Hungarian forint	271.1	1.4	0.3	–12.0

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

Temporary correction in private bond markets. Investors are taking advantage of this opportunity.

predicted for the United States compared with the euro area, the consequent normalization of monetary policy by the Fed and the expected revaluation of the Chinese yuan.

The sovereign debt crisis in Greece has affected private bond markets

Corporate bond markets have recorded a small correction throughout the last few weeks.

However, high risk private bond funds have performed notably and have therefore managed to withstand the situation quite well. Such good performance for high risk bonds suggests that this unstable episode is merely financial, given that these assets are issued by medium-sized or small companies closely related to the real economy. On the other hand, bonds issued by financial institutions have been harder hit due to their greater exposure to public debt and, therefore, the possible economic consequences of worsening financial instability.

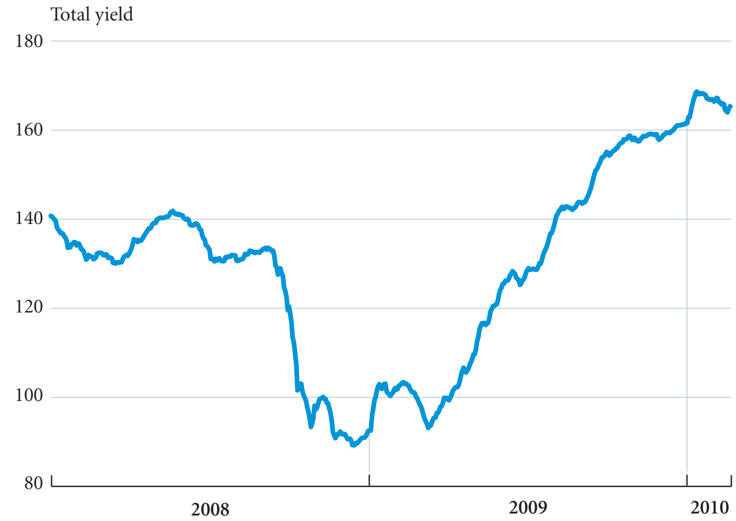
Bonds from financial institutions are harder hit by sovereign debt risk.

In any case, the correction in private bonds represents an adjustment in the consolidation process and not a change in trend.

In spite of the instability of the last few weeks, investors have not significantly lost their appetite for these assets. On the one hand, these funds have recorded net capital inflows similar to those in previous months. On the other hand investors have been seen to accept lower quality securities in order to meet their yield targets, and increasingly so. Throughout the last few months, this buyer pressure has cut the yield on new bond issues to the extent that they have started to lose their appeal compared with other alternative investments, such as sovereign bonds or the stock market, where yield

TRENDS IN THE HIGH RISK BOND INDEX IN EUROPE. MERRILL LYNCH

High yield bond index. Merrill Lynch. Europe



SOURCE: EcoWin.

TREND IN RISK PREMIA OF BONDS FROM THE FINANCIAL SECTOR AND HIGH RISK FIRMS

SOURCE: Bloomberg.

per dividend is approaching the rates offered by corporate bonds. Given this situation of more similar values, it's not surprising that corporate bond markets have been affected by the turbulence originating in other markets, in this case that of government bonds.

Accumulated figures since the start of the year for the volume of issues show a record high level. The most active sector is still that of high risk firms (including those without a rating). This trend, highly consolidated in the United States, has shifted to the euro area in the last quarter of 2009 and all the evidence suggests that it will continue during 2010. The significant lowering in value of the cost of funding via markets has meant that firms are continuing to replace bank loans with debt issues in the medium term.

Another factor helping funds in the corporate bond market to perform well is that the economic cycle is in a phase of recovery, a situation that improves the expected default rate in most sectors and firms. This is shown by the fact that credit rating agency reports have recorded an increase in the ratio between rises and falls in ratings, indicating greater financial solvency among firms.

In short, the general view is that the panorama in private bond markets is positive and in line with the recovery phase of the world economy, although we must not rule out possible negative episodes such as those occurring recently, due to the emergence of new financial tensions.

Sharp fall in expectations for bad debt due to improved confidence in the economy.

The uncertainty generated by Greece has harmed the world's equity, and also European.

Estimates of gains for European firms slow up compared with North American.

On balance, positive news from the campaign of fourth quarter company results in the United States.

Greek risk forces corrections in equity

In February, equity markets were dependent on events related to the fiscal situation of some countries in southern Europe. Greater uncertainty among investors, principally concerning the Greek problem and its possible effects on the rest of the economies in the euro area, led to a sharp increase in volatility and risk premia at a global level.

In terms of the main stock market indices, this situation led to average losses, for 2010 so far, of close to 12% in Europe, 10% in China and 3% in the United States. In terms of investment flows, this situation led to net outflows from equity funds in developed economies totalling 18,000 million dollars.

During this period, in which global managers' attention was focused on how the Greek case was evolving, the reaction of the stock market had a more negative effect on European equity than on that of the rest of the world. This might be because the Greek problem has highlighted some weaknesses in the European economic model, causing a reduction in the expectations of economic recovery, at least compared with the United States and Asia. Moreover, if we add to this the fact that bank credit for the private sector, according to the ECB, has remained weak over the last few months, the prospect of improved business margins in Europe is less certain.

As the same time as this situation was occurring in the euro bloc, listed companies published their results on both sides of the Atlantic. With figures from more than 80% of the S&P 500, the balance is good in the United States, both from the point of view of sales, which were 6% higher than last year, and in terms of net profit. Positive surprises account for 72%, with technology firms particularly standing out, benefitted by regulatory changes. One of the figures that best reflects the US recovery in business margins is the progressive improvement in estimates by the consensus of analysts regarding profit per share, placed at 17.39 dollars for the fourth quarter of 2009.

Looking at the financial sector, after a year-end subjected to exceptional conditions, these results have exceeded the forecasts by 63% in the case of the United States. However, at a global level, the accounts presented have not had such an impact on sector postings as in other quarters. This is a consequence of growing expectations regarding a more restrictive monetary policy and of the lack in specificity in regulatory measures for the financial sector that are supposed to be applied internationally. Additionally, doubts generated by sovereign risk weigh heavy in the euro area, given that many financial institutions hold large amounts of public debt from the countries affected.

INDICES OF MAIN WORLD STOCK EXCHANGES

February 22, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*10,402.1*	*2.3*	*–0.2*	*41.2*
Standard & Poor's	*1,108.3*	*1.5*	*–0.6*	*43.9*
Nasdaq	*2,243.9*	*1.7*	*–1.1*	*55.7*
Tokyo	10,400.5	–1.8	–1.4	40.2
London	5,358.9	1.1	–1.0	37.8
Euro area	2,783.3	–1.9	–6.1	38.4
Frankfurt	*5,705.5*	*0.2*	*–4.2*	*42.1*
Paris	*3,760.8*	*–1.6*	*–4.5*	*36.7*
Amsterdam	*325.5*	*–1.2*	*–2.9*	*42.0*
Milan	*21,755.6*	*–3.6*	*–6.4*	*40.1*
Madrid	*10,570.3*	*–7.1*	*–11.5*	*39.0*
Zurich	6,691.5	3.0	2.2	37.9
Hong Kong	20,377.3	–1.7	–6.8	60.5
Buenos Aires	2,352.0	0.9	1.3	124.3
São Paulo	67,789.1	2.4	–1.2	75.1

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.

They took away the punch bowl... but not the champagne

William McChesney Martin, Chairman of the United States Federal Reserve between 1951 and 1970, summed up his take on what should be the central bank's job in a single sentence: «to take away the punch bowl just as the party gets going». His famous metaphor refers to the need to raise the reference rate when the economy is booming in order to stop it from overheating with the subsequent inflationary pressures. After the recent economic and financial debacle, the effectiveness of this maxim has been questioned and not only by those accusing the Fed of taking away the punch bowl too late but especially by those who are once again wondering whether it's really enough to take away the punch bowl when the champagne and all its bubbles are left on the table.

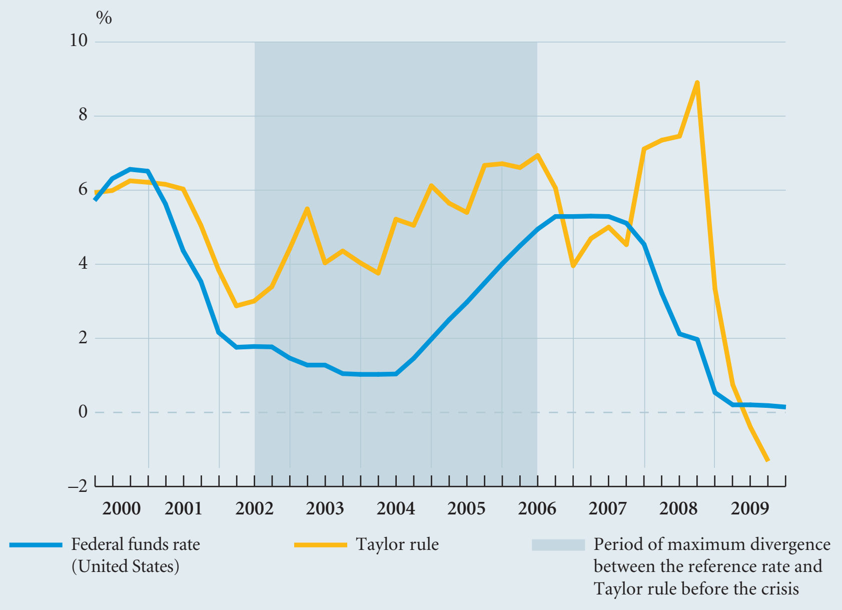
The crisis and the nature of its trigger, a real estate bubble, have revived an old debate: should central banks, as managers of monetary policy and custodians of financial stability, explicitly uphold asset market stability? At this stage of the game, no-one doubts just how destabilizing an economic bubble can be, an abnormal and prolonged rise in the price of an asset that, sooner or later, ends up plummeting downwards. And the risks involved are particularly harmful when the bubble in question blows up in the housing market. According to the estimates in Aspachs-Bracons (2008), on average real estate deflation lasts 5 years and leads to the economy shrinking for a year, with an average drop in GDP of 1.5%[1]. The International Monetary Fund (IMF) estimates that, after a stock market bubble has burst, both the length and the fall in GDP are quite a lot less.

Supporters of a monetary policy that attacks asset bubbles have been warning of these risks for years and the crisis has merely swelled their arguments. In view of what has occurred, they accuse the Federal Reserve not only of not reacting to a housing market that was out of control but also of directly contributing to the bubble with an excessively lax monetary policy. Their accusation is based on the discrepancy, from 2002 to 2005, between the reference rate and the rate dictated by the Taylor rule; a simple guideline designed by John Taylor, a professor from Stanford University, which stipulates the appropriate interest rate given certain targets for inflation and employment. Based on this rule, the interest rate was too low for too long (see the graph below), reducing the cost of leveraging by too much and boosting the real estate boom. According to Taylor himself, all you had to do was realize that the actual interest rate was negative for most of the period in question to reach this conclusion.[2]

On the other side of the debate is the notion defended by most central bankers, including the current Fed Chairman, Ben Bernanke. This camp favours an approach to monetary policy that ignores asset market fluctuations unless a bubble bursts or the pressures in these markets start to affect consumer price stability. This is known as a reactive attitude towards monetary policy: if the bubble bursts, we pick up the pieces; if not, we remain impassive, unless economic stability is compromised. But why? Why, when they are aware of

A MONETARY POLICY THAT WAS TOO LAX FOR TOO LONG?

Reference rate and interest rate given by the Taylor rule



NOTE: Estimated Taylor rule based on CPI and output gap data following the specification in Rabanal (2008),«Should the ECB target employment», "la Caixa" *Economic Papers*, N° 6.
SOURCES: Thomson Reuters Datastream and own calculations.

(1) Aspachs-Bracons (2008) «Consecuencias económicas de los ciclos del precio de la vivienda», "la Caixa" Documentos de Economía N° 12.
(2) See «The Fed and the Crisis: A Reply to Ben Bernanke» by John Taylor in the *Wall Street Journal*, 10 January 2010.

the risks, do central banks opt to do nothing to stop a bubble? Basically two arguments are put forward. Firstly, the difficulty in knowing how much an asset is essentially worth and therefore of verifying the existence of a bubble. And, secondly, the ineffectiveness of the interest rate as a shield against bubbles.

Without doubt, it's impossible to be absolutely certain how much an asset is really worth. Any alterations in its price may reflect speculation but also changes in underlying fundamentals, such as demographic or in productivity. Moreover, neither GDP nor inflation, both key monetary policy targets, necessarily behaves abnormally in a bubble-related emergency. However, after numerous attempts, a number of indicators have been identified that do behave atypically during the two or three years before a bubble bursts: an extraordinary and sustained increase in credit, an upswing in residential investment and current account deficit and, of course, growth in the assets' price. As shown in the graphs below, all these took place in the United States before the crisis hit. However, their capacity to predict a bubble is highly limited. It is estimated that, out of every 100 occasions on which these indicators rise abnormally and simultaneously, only 56 will precede a real estate slump in the short term. Also, in half of the crises, these indicators would not give any warning(3).

With regard to the second argument, most evidence suggests that resorting to the interest rate to reign in asset bubbles is too costly to be effective. Even if the monetary authority could verify the emergence of a real estate bubble, which is not necessarily the case, the movement required in the interest rate in order to put a stop to this would be of such magnitude that the costs involved in terms of economic growth or inflation would violate the mandate of most central banks. Some experts calculate that the rise in interest rate required to prick a real estate bubble where, for example, the actual price of housing is overvalued by 15%, would lead to an actual fall in GDP of around 5%(4). An extraordinarily high figure considering that the potential growth of the US economy is around 2.5%!

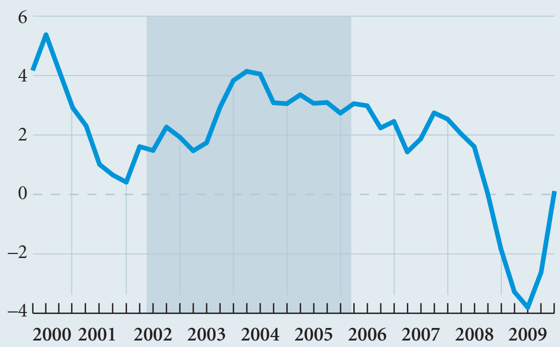
In short: did they wait too long to take away the punch bowl? They probably did. Could the hangover have been avoided by taking it away sooner or by removing the champagne as well? Most probably not. With the interest rate as the only instrument, the party would have broken up, starting up again somewhere else a day or two later. So is there any formula for stopping bubbles from giving us a headache without spoiling the party? Almost certainly by giving the central bank more weapons. On the one hand, a more complete and accurate battery of indicators; in this respect, the European Central Bank's double pillar, which complements its analysis of the actual economy by also taking into account the growth in different monetary aggregates, might be a step in the right direction. On the other, greater regulatory power over credit markets to reduce the risk of systemic threats. Bernanke himself has opted for greater regulation over risk-taking, although this might require that asset market stability be included within the Fed's mandate. Something that, until very recently, he had always ruled out.

It remains to be seen how this regulation might be implemented and some doubt its effectiveness but, given the consequences, any option warrants appraisal. When all's said and done, at any party achieving just the right touch of moderation is complicated, but that doesn't mean it isn't worth trying.

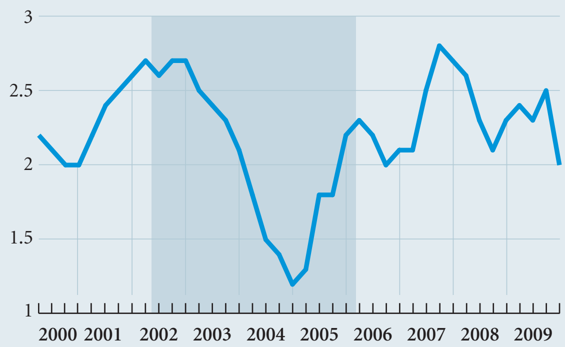
(3) See, for example, Fatás, Kannan, Rabanal and Scott (2009), «*Lessons for Monetary Policy from Asset Price Fluctuations*», *World Economic Outlook*, IMF, October 2009.
(4) «*Can monetary policy really be used to stabilise asset prices?*», Assenmacher-Wesche and Gerlach, VoxEU.org (2008).

AFTER THE 2001 RECESSION, NEITHER THE GROWTH NOR INFLATION IN THE UNITED STATES GAVE ANY PARTICULAR CAUSE FOR ALARM...

Real GDP growth (% year-on-year change)

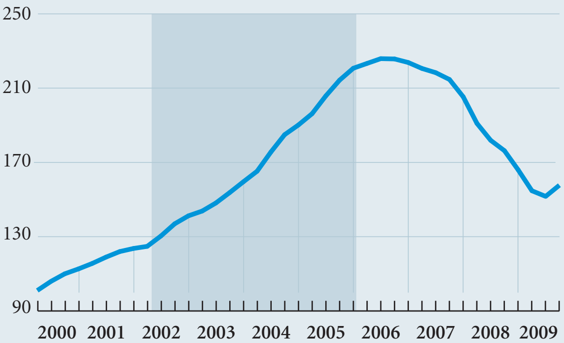


Core inflation rate (% year-on-year change)

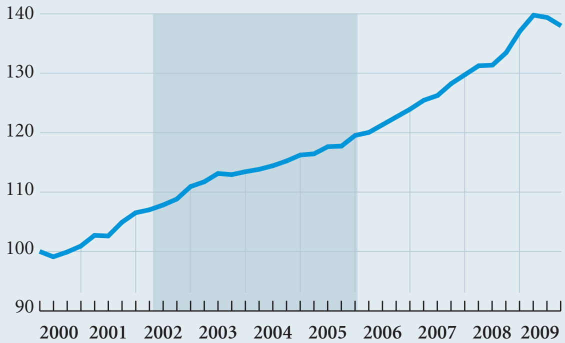


...BUT CREDIT, THE CURRENT ACCOUNT DEFICIT AND REAL ESTATE MARKET, PERHAPS THEY DID?

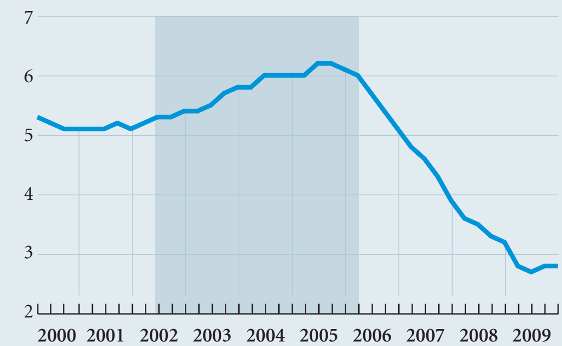
Housing prices, Q1 2000 = 100



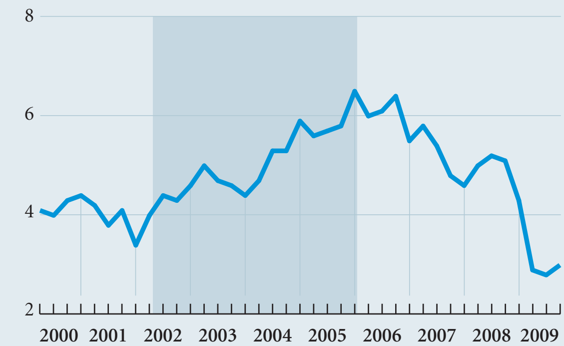
Credit over GDP, Q1 2000 = 100



Residential investment over GDP (%)



Current A/C deficit over GDP (%)



SOURCES: Thomson Reuters Datastream and own calculations.

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

SPAIN: OVERALL ANALYSIS

Economic activity

Improved consumption and investment in the fourth quarter

In 2009, gross domestic product (GDP) totalled 1,051,151 million euros, a drop of 3.6% year-on-year in real terms and the highest annual fall since the middle of last century. In nominal terms it fell 3.4%, the first time since the beginning of the National Accounts system series. However, in the fourth quarter GDP fell less year-on-year in real terms, namely 3.1%, 0.9 points lower than in the third quarter. Although GDP saw seven quarters in a row of negative quarter-on-quarter growth, at the end of 2009 it only fell by 0.1%, pointing towards an end to the recession in the near future. This improvement is thanks to monetary and fiscal stimuli, as well as to the recovery in the international economy and particularly the financial markets.

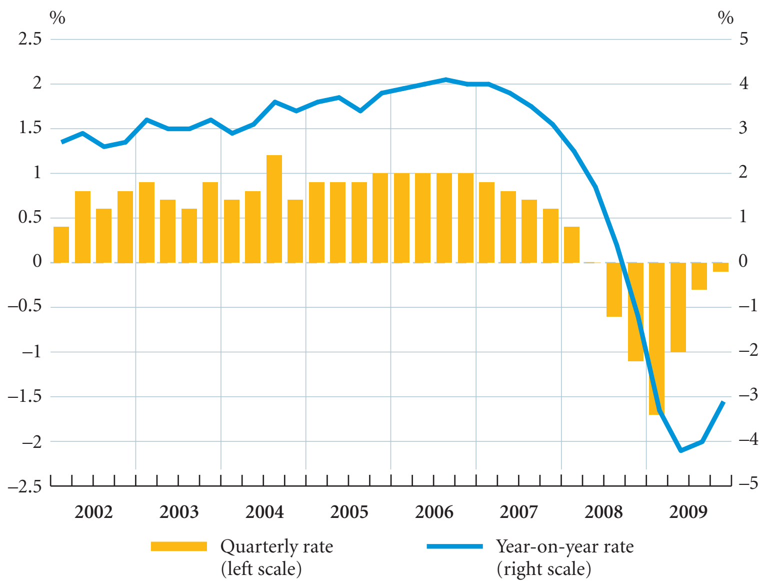
The fall in GDP was due to the squeeze in domestic demand predominating over the foreign sector's positive contribution to growth. Domestic demand deducted 6.4 points from GDP growth in 2009, 5.9 points more than the previous year while, for its part, the foreign sector contributed 2.8 points, 1.4 points more than in 2008. However, the adjustment process also involved some positive aspects, such as the correction of some imbalances. Consequently, there was a notable reduction in external financing

GDP falls by 3.6% in 2009, the biggest drop since the middle of last century.

Domestic demand deducts 6.4 points from GDP growth.

THE RECESSION EASES UP

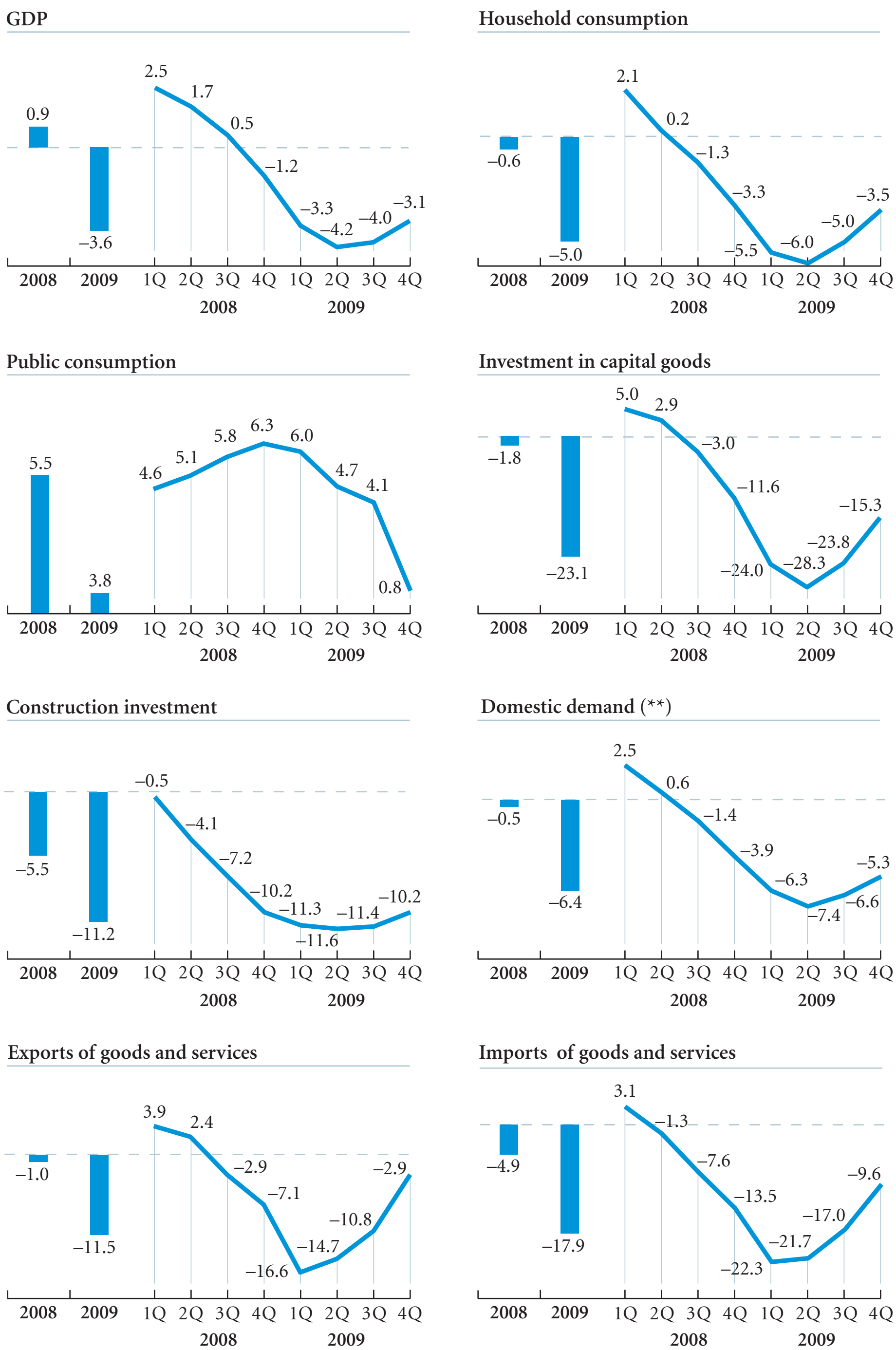
Change in GDP



SOURCES: National Institute of Statistics and own calculations.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



NOTES: (*) Data adjusted for seasons and public holidays.
(**) Contribution to GDP growth.
SOURCE: National Institute of Statistics.

needs and the GDP deflator. Moreover, productivity increased considerably, although at the cost of job losses.

The main component in domestic demand, household consumption, fell by 5.0% in 2009. However, in the fourth quarter this rose 0.3% after seven consecutive quarterly drops. This improvement was possible due to a moderation in the fall in employment, gains in the purchasing power of those in employment and the wealth effect associated with the rise in stock markets. The rise in consumer durables was significant with car purchases shooting up thanks to the 2000E direct subsidy plan. Consumer confidence continued to improve slightly in January 2010, suggesting that an upswing in consumption is underway. In any case, the consumer confidence index was still slightly below its historic average.

The upswing in consumption is confirmed.

On the other hand, public consumption increased 3.8% in 2009, 1.6 points less than the year before, although it should be noted that this slowed up considerably in the fourth quarter, to 0.8% year-on-year, particularly due to fewer purchases of goods and services.

This reactivation in demand also led to an improvement in investment, which slowed up its rate of decline in the fourth quarter. Overall, investment fell 15.3% in 2009, the highest decrease since 1959, with investment in capital goods plummeting 23.1%. However, investment consolidated its recovery in the fourth quarter and increased 3.1% compared with July-September, with transport materials performing better than machinery. This trend continued into January 2010, as the registration of load-bearing vehicles posted a year-on-year fall of 4.6%, comparing favourably with the 7.8% fall in the fourth quarter.

Investment falls 15.3% in 2009, the biggest drop since 1959.

Investment in construction was down 11.2% after having decreased 5.5% in 2008. This decline was due to the 24.5% slump in housing, a result of the crisis in the real estate sector. In 2009, the number of housing transactions fell by 24.9% although this seems to have eased off in the last few months, with a 0.3% drop in December. This is largely due to the substantial reduction in the theoretical effort required to buy a home as prices and interest rates fall. On the other hand, investment in the rest of construction rose 1.6% in 2009, thanks chiefly to the municipal works plan and railway infrastructures related to the high-speed train network.

Investment in housing plummets 24.5% due to the crisis in the real estate sector.

The rest of investment, in IT software, mining and petrol prospection, etc. also felt the effects of the crisis. Consequently, this fell 17.2% in 2009 as a whole and 18.5% year-on-year in the fourth quarter.

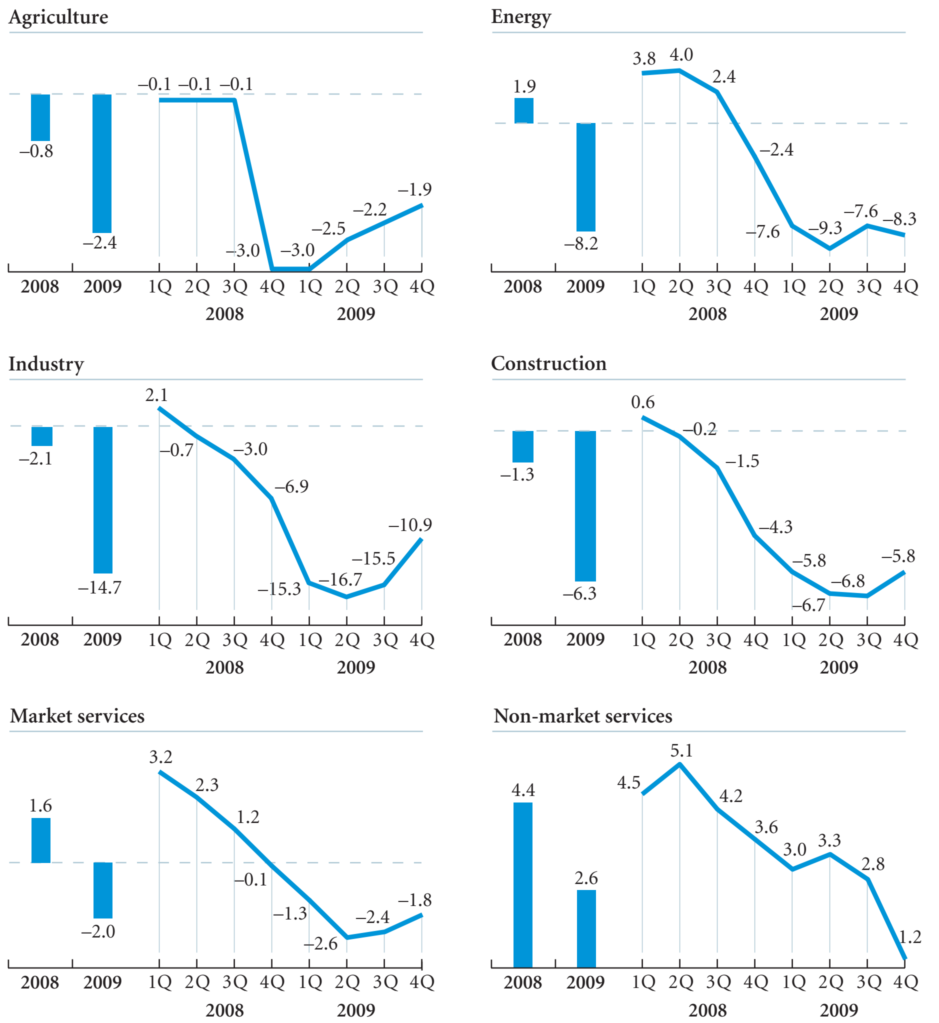
The reactivation of foreign demand encouraged a gradual recovery in exports. In spite of foreign sales of goods and services being 11.5% down in 2009, the year-on-year drop decreased to 2.9% in the fourth quarter. Exports of goods managed to increase 1.3% over the last three months of 2009 compared with the same period in 2008 while imports of goods and services plummeted 17.9% last year and, although they also seem to be slowing up in terms of their decline throughout the year, they fell more than exports. Consequently, the foreign sector contribution was positive for the eighth consecutive quarter. Similarly, external financing needs in 2009 totalled 4.7% of GDP, substantially lower than the 9.6% of 2007.

External financing needs fall substantially.

From the point of view of supply, it can be seen that the crisis punished all sectors without exception in 2009,

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



NOTE: (*) Data adjusted for seasons and public holidays.
SOURCE: National Institute of Statistics.

Productivity advances 3.3%, 1.8 points more than in 2008.

although public services grew. Industry suffered the worst annual shrinkage in value added of 14.7%, followed by energy, down 8.2%, construction, 6.3%, agriculture, 2.4% and private services, 2.0%. However, improvements started to reach industry and private services in the fourth quarter.

Industrial value added posted its worst fall in the last few decades, as did industrial production, falling 15.8% under the same calendar terms. All components saw decreases but the highest fall went to consumer durables, whose production was down 27.7%. However, the value added of the secondary sector posted a growth of 0.5% in the fourth quarter after six negative postings. This improvement seems set to continue, given the upswing in new orders for industry, growing by

6.2% in December compared with twelve months before, after sixteen months of negative figures.

The notable fall in value added for market services for the first quarter of 2009 gradually gave way to improvement, resulting in a quarter-on-quarter increase of 0.2% in the fourth quarter. However, most subsectors presented negative rates. The best performing branches were related to trade while information and communication technologies, as well as corporate services were at the opposite end of the scale.

According to data from the National Accounts system, equivalent full-time jobs fell by 6.7% in 2009. However, employment slowed up its deterioration in the last few months of the year with a year-on-year decrease of 6.1% in the fourth quarter, 1.1 points less than the previous quarter. As the decrease was greater in employment than in product, apparent labour productivity rose slightly in 2009 to 3.3%, 1.8 points more than in 2008. By sector, productivity saw greater progress in construction, which dismissed 23.4% of its workforce, followed by market services, while wages per employee fell back. Consequently, unit labour costs rose 0.2%, as did the implicit GDP deflator.

On the other hand, the consequences of the crisis were reflected in the sharp rise in creditors' meetings (taking over from suspensions of payments). Consequently, 4,984 firms requested creditors' meetings in 2009, a year-on-year rise of 72.2%. Dynamism in business was also affected, with the number of new trading companies falling by 24.5% and the average capital also down 21.3%. Similarly, the number of trading companies wound up rose by 7.2%.

The agencies Moody's and Fitch maintain their top rating for Spanish sovereign bonds.

However, the economic outlook is tending to improve. The solid base of the economy was reinforced in February by the agencies Moody's and Fitch, which have maintained their top rating for Spanish sovereign bonds. We predict that the economy will continue to recover, boosted by the foreign sector and consumption but with investment lagging behind. However, the contribution made by the foreign sector is expected to continue easing up, whereas budgetary austerity plans and the correction of some accumulated imbalances are not expected to have a positive effect on economic activity over the coming months, so that, on the whole, GDP should still see some negative growth in 2010.

Labour market

Employment falls by 1.8 million in the last two years.

The labour market continues to go downhill

18,645,900 people were employed in the fourth quarter of 2009 according to the Labour Force Survey (LFS) of the National Institute of Statistics. This figure is 224,200 lower than the previous quarter while, compared with a year earlier, the drop in employment was 1,210,800 people, and 1,831,000 in the last two years. However, in relative terms, the annual fall was 6.1%, 1.2 points lower than the rate recorded in the third

ESTIMATED EMPLOYMENT

Fourth quarter of 2009

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	782.6	45.5	6.2	–21.2	–2.6	4.2
Non-farm	17,863.3	–269.7	–1.5	–1,189.7	–6.2	95.8
Industry	*2,680.9*	*–38.6*	*–1.4*	*–361.7*	*–11.9*	*14.4*
Construction	*1,802.7*	*–47.7*	*–2.6*	*–378.1*	*–17.3*	*9.7*
Services	*13,379.7*	*–183.4*	*–1.4*	*–449.9*	*–3.3*	*71.8*
By type of employer						
Private sector	15,580.2	–188.1	–1.2	–1,247.1	–7.4	83.6
Public sector	3,065.7	–36.2	–1.2	36.2	1.2	16.4
By work situation						
Wage-earners	15,492.6	–157.5	–1.0	–815.5	–5.0	83.1
Permanent contract	*11,606.4*	*2.3*	*0.0*	*–147.5*	*–1.3*	*62.2*
Temporary contract	*3,886.2*	*–159.8*	*–3.9*	*–668.0*	*–14.7*	*20.8*
Non-wage-earners	3,140.6	–69.0	–2.1	–394.4	–11.2	16.8
Entrepreneurs with employees	*1,051.0*	*–10.6*	*–1.0*	*–114.3*	*–9.8*	*5.6*
Entrepreneurs without employees	*1,930.7*	*–37.2*	*–1.9*	*–242.0*	*–11.1*	*10.4*
Family help	*158.9*	*–21.1*	*–11.7*	*–38.1*	*–19.4*	*0.9*
Other	12.6	2.1	20.4	–0.9	–6.9	0.1
By time worked						
Full-time	16,175.2	–378.8	–2.3	–1,202.6	–6.9	86.7
Part-time	2,470.7	154.6	6.7	–8.3	–0.3	13.3
By sex						
Males	10,440.6	–172.6	–1.6	–900.0	–7.9	56.0
Females	8,205.3	–51.6	–0.6	–310.8	–3.7	44.0
TOTAL	**18,645.9**	**–224.2**	**–1.2**	**–1,210.8**	**–6.1**	**100.0**

SOURCES: National Institute of Statistics and own calculations.

quarter. In the last few quarters the fall in employment has eased off, affected by the municipal works plan financed by the central government.

Data from the National Accounts system regarding trends in jobs equivalent to full-time employment show a very similar pattern of employment. Consequently, in the fourth quarter there was a year-on-year decrease of 6.1%, 1.1 points less than in the previous quarter.

However, the slow-up in job losses did not continue into January 2010, judging by the figures from Social Security registrations. In the first month of the year, the number of people registered as employed with Social Security fell by 257,828 compared with the previous month, a slight escalation in the drop. However, it should be noted that adverse weather conditions affected these figures and that the 3.5% year-on-year rate of fall was slightly lower than a year earlier, namely 5.1%.

Returning to the LFS, job losses could be seen in all sectors in 2009, given the breadth of the economic crisis although, in relative terms, the sector that continued to lose most jobs was construction, with an annual reduction of 17.3%, as adjustments continued.

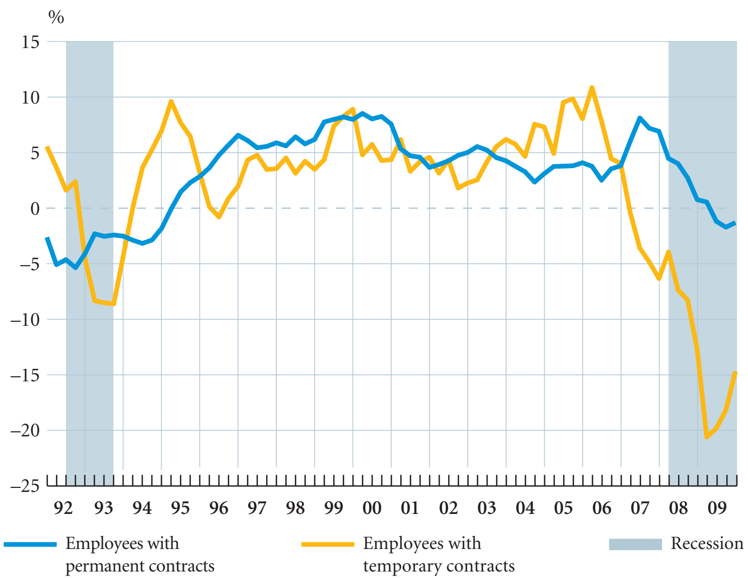
Construction continues to lose a lot of jobs due to the adjustments underway.

Job losses were also severe in industry, affected by the slump in demand and by accumulated problems of competitiveness, down 11.9% in the last year. Most industrial sub-sectors lost jobs although not all at the same rate. However, the level of workforce increased in some branches, such as in the manufacture of pharmaceutical products.

Far fewer jobs were lost in services, down 3.3%, although in absolute terms these recorded the biggest drop, namely 449,900 people. In the tertiary sector, trends by branch were highly disparate with the greatest job losses being recorded in real estate, down 26.9%, while in health and social services

JOB LOSSES SLOW UP

Year-on-year change



SOURCES: National Institute of Statistics and own calculations.

The number of public sector employees rises by 1% in 2009.

employment rose by 0.9% and by 5.2% in public administration.

The number of employees in the public sector as a whole rose by 1.2% in 2009 whereas employment fell by 7.4% in the private sector. This rise in the public sector can be put down to autonomous and local government, as well as public companies and institutions.

Workers on temporary contracts suffer an annual drop of 15%.

The total number of employees was down 5.0%. This adjustment was felt particularly by workers on temporary contracts, down 14.7%, while the number of employees with permanent contracts fell by 1.3%, a similar pattern to that recorded during the previous recession of 1992-93. The proportion of temporary workers fell to 25.1%. On the other hand, the crisis is hitting full-time employment much harder than part-time, which is more flexible. Consequently, the number of full-time employees fell by 6.9% in 2009, while part-time employees only dropped 0.3%.

Self-employed workers are also hit hard by economic crisis. The number of employers fell by 9.8% in the last twelve months, while self-employed workers reduced their numbers by 10.3%.

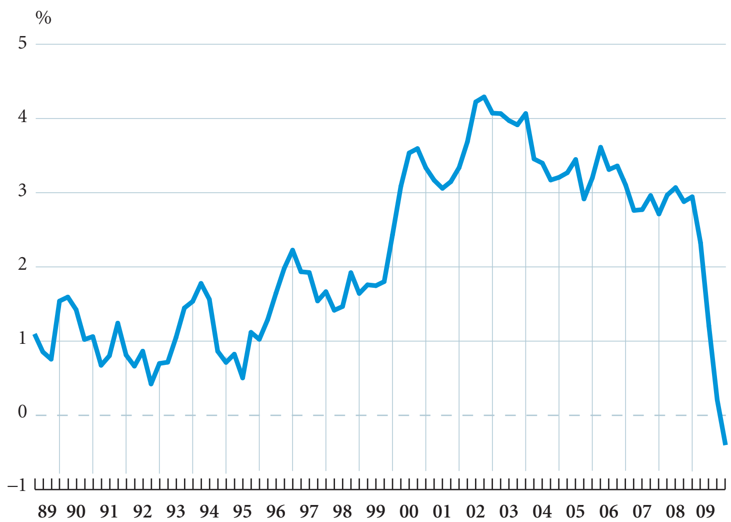
Male employment falls further than female.

The fall in employment for women, who are less present in those sectors most severely affected by the economic crisis, was half that for men. In fact, women aged between 40 and 44 increased their level of employment by 1.1% and those over 50 by more than 4%. However, the number of younger female workers dropped substantially. The level of employment fell among males of all ages in 2009, with the biggest drops among younger workers.

The crisis is also hitting the foreign population harder than the Spanish population, the former being employed more extensively in construction. Consequently, in 2009 the number of Spanish employed fell by 5.1% while the figure for foreign workers was more than double, at 11.8%. The

FIRST YEAR-ON-YEAR DROP IN THE LABOUR FORCE IN THE LAST FEW DECADES

Year-on-year change in the labour force



SOURCES: National Institute of Statistics and own calculations.

ESTIMATED UNEMPLOYMENT

Fourth quarter of 2009

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	2,392.5	101.7	4.4	703.7	41.7	55.3	18.6
Females	1,934.0	101.5	5.5	415.0	27.3	44.7	19.1
By age							
Under 25 years	816.4	–69.4	–7.8	131.4	19.2	18.9	39.1
Other	3,510.2	272.6	8.4	987.3	39.1	81.1	16.8
By personal situation							
Long-term unemployment	1,477.2	270.0	22.4	688.1	87.2	34.1	–
Seeking first job	299.8	–14.6	–4.6	50.6	20.3	6.9	–
Other	2,549.5	–52.3	–2.0	380.0	17.5	58.9	–
TOTAL	**4,326.5**	**203.2**	**4.9**	**1,118.6**	**34.9**	**100.0**	**18.8**

SOURCE: National Institute of Statistics and own calculations.

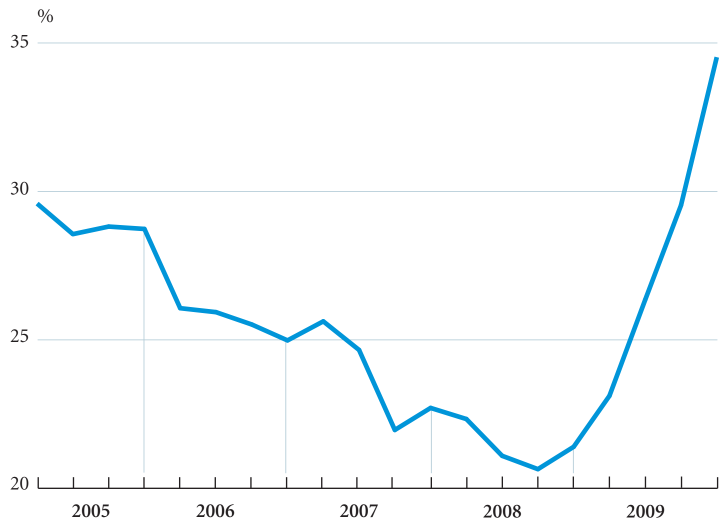
percentage of foreigners in employment therefore stood at 13.7%, 9 tenths of a percentage point less than a year earlier but much higher than the figure of 0.4% for 1990.

The active population estimated by the LFS was up 0.2% in 2009, due both to a 0.2% growth in the Spanish population and a 0.4% growth in the foreign population. However, for the first time in this cycle and in the last few decades, the labour force posted a negative annual rate of change. This fall can be put down to people becoming discouraged, given the difficulty of finding a job. The drop

The proportion of foreign workers to people in employment as a whole falls to 14%.

SHARP RISE IN LONG-TERM UNEMPLOYMENT

Proportion of unemployed who lost their job more than one year ago out of the total unemployed



SOURCE: National Institute of Statistics.

Unemployment rises to 18.8%.

in the labour force was sharper among the foreign population, namely 1.2%, than among the Spanish, at 0.3%. On the other hand, this drop in the labour force was due to men, as the female workforce rose by 1.0%.

As a result of the trends in employment and the labour force, the number of unemployed continued to swell, up to 4,326,500 in the last quarter of 2009. Last year, the number of unemployed increased by 1,118,600, a rise of 34.9% but a rate, however, that indicates the growth in unemployment is easing. Unemployment increased by 9 tenths of a percentage point compared with the previous quarter, up to 18.8%, the second highest rate in the European Union and doubling the European average. In the last two years, the number of unemployed rose by 2,398,900 people.

In the last year, unemployment increased more sharply among men, at a rate of 41.7%, than among women, at 27.3%. By age, there was a notable rise in unemployment among people under 25, up to 39.1%. For their part, the long-term unemployed, i.e. those who lost their job more than one year ago, increased to 34.1% of all those unemployed.

Job losses in 2009 were widespread throughout Spain and affected all autonomous communities, with the exception of the autonomous city of Melilla. The rises in unemployment

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Fourth quarter of 2009

	In work force			Employed			Unemployed			Unemploy-ment rate (%)
	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	
Andalusia	3,928	23	0.6	2,894	–161	–5.3	1,034	184	21.6	26.3
Aragon	654	–11	–1.6	567	–34	–5.6	87	23	36.7	13.3
Asturias	481	–10	–2.1	413	–30	–6.8	69	20	40.2	14.2
Balearic Islands	575	11	2.0	463	–32	–6.4	112	43	61.7	19.5
Canary Islands	1,092	37	3.5	798	–34	–4.0	294	70	31.4	26.9
Cantabria	277	–4	–1.6	242	–14	–5.6	35	10	39.6	12.6
Castile-Leon	1,176	–10	–0.9	1,010	–44	–4.1	167	33	25.1	14.2
Castile-La Mancha	978	13	1.3	790	–31	–3.8	188	44	30.7	19.2
Catalonia	3,780	–75	–2.0	3,136	–263	–7.7	643	187	41.1	17.0
Valencian Community	2,553	–17	–0.7	1,977	–211	–9.7	576	194	50.9	22.6
Extremadura	484	0	0.1	381	–16	–4.0	103	16	18.5	21.3
Galicia	1,307	–17	–1.3	1,139	–56	–4.7	168	39	30.5	12.9
Madrid Community	3,396	–6	–0.2	2,898	–159	–5.2	499	153	44.4	14.7
Murcia	719	–6	–0.9	557	–55	–9.0	162	49	43.4	22.5
Navarre	306	–3	–1.0	274	–10	–3.6	32	7	28.4	10.5
Basque Country	1,048	–16	–1.5	925	–50	–5.2	123	35	39.1	11.7
La Rioja	159	–2	–0.9	137	–8	–5.2	22	6	38.8	13.7
Ceuta and Melilla	60	2	3.1	46	–3	–5.3	14	4	45.8	23.3
TOTAL	**22,972**	**–92**	**–0.4**	**18,646**	**–1,211**	**–6.1**	**4,327**	**1,119**	**34.9**	**18.8**

SOURCES: National Institute of Statistics and own calculations.

were also very high in all autonomous communities. The highest rates were to be found in the Canary Islands, 26.9% and in Andalusia, 26.3% while, at the opposite end of the table, the lowest unemployment rates were in Navarre, 10.5%, and the Basque Country, 11.7%.

Registered unemployment continues to rise and now tops four million

Registered unemployment continued to increase in the first month of 2010, in line with forecasts, standing at 4,048,493 people. This figure represents a year-on-year rise of 21.7% although it is more moderate compared with the previous rates.

Given this unfavourable panorama for the job market, at the end of the first week of February the government presented a proposal to reform the labour market to social representatives, business people and trade unions. The main lines of action proposed aim to reduce the dual and temporary nature of the labour market, encouraging employment among young people, improving labour intermediation, revising rebates for employment contracts and promoting the use of shorter working days as an instrument to temporarily adjust employment.

On the other hand, in the second week of February business organisations and trade unions signed an «Agreement for employment and collective bargaining 2010, 2011 and 2012», which establishes criteria to determine wage increases: for 2010, up to 1%; for 2011, between 1% and 2%; and for 2012, between 1.5% and 2.5%, with a wage revision clause linked to the inflation rate recorded throughout the period. A clause was also agreed establishing that this wage system did not apply to firms whose economic stability could be affected as a consequence of its application.

Unemployment in the Canary Islands and Andalusia is over 26%.

The government presents a proposal to reform the labour market and employers and trade unions sign a collective bargaining agreement.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

January 2010

	No. of unemployed	Change over December 2009		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	106,699	566	0.5	25,996	32.2	2.6
Industry	517,675	8,873	1.7	74,993	16.9	12.8
Construction	788,760	7,036	0.9	110,619	16.3	19.5
Services	2,343,195	102,130	4.6	406,899	21.0	57.9
First job	292,164	6,285	2.2	102,185	53.8	7.2
By sex						
Males	2,060,207	47,671	2.4	386,972	23.1	50.9
Females	1,988,286	77,219	4.0	333,720	20.2	49.1
By age						
Under 25 years	456,386	9,617	2.2	41,545	10.0	11.3
All other ages	3,592,107	115,273	3.3	679,147	23.3	88.7
TOTAL	**4,048,493**	**124,890**	**3.2**	**720,692**	**21.7**	**100.0**

SOURCES: Public State Employment Service and own calculations.

Prices

Inflation rises slightly up to 1% in January

Fuels and oils boost prices in January.

Inflation in consumer prices continued to rise in the first month of 2010 but only moderately, with the general consumer price index (CPI) posting a year-on-year change of 1.0% in January, 2 tenths of a percentage point more than the previous month. Once again the push came from fuels and oils.

In fact, fuels posted a 13.9% year-on-year rise in January, 6.1 points more than the previous month, and contributed almost 4 tenths of a percentage point of growth in the year-on-year rate of change. This was due to the rise in the price of fuel and oils in January 2010 compared with a fall twelve months before.

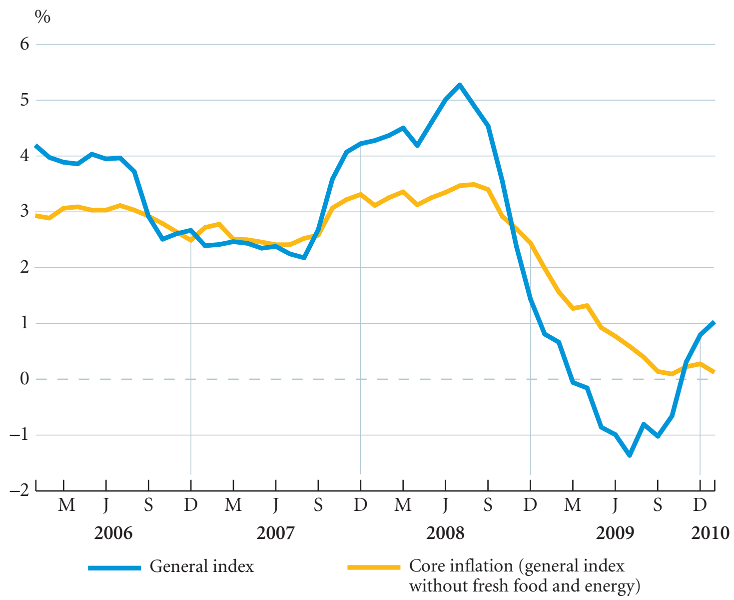
For their part, the other most erratic component of the CPI, fresh foods, slightly accentuated their year-on-year drop to 3.2%, with the prices of most unprocessed foods falling year-on-year.

The drop in core inflation reflects downward pressure from weak consumption.

The most stable core of inflation, also known as underlying inflation, which excludes energy products and fresh foods, cut short its upswing in January and fell back to 0.1%, close to its record minimum of October. The drop of

DOWNSWING IN CORE INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2009			2010		
	% monthly change	% change over December 2008	% annual change	% monthly change	% change over December 2009	% annual change
January	–1.2	–1.2	0.8	–1.0	–1.0	1.0
February	0.0	–1.2	0.7			
March	0.2	–1.1	–0.1			
April	1.0	–0.1	–0.2			
May	0.0	–0.1	–0.9			
June	0.4	0.3	–1.0			
July	–0.9	–0.5	–1.4			
August	0.3	–0.2	–0.8			
September	–0.2	–0.4	–1.0			
October	0.7	0.3	–0.7			
November	0.5	0.8	0.3			
December	0.0	0.8	0.8			

SOURCE: National Institute of Statistics.

2 tenths of a percentage point in January shows that many firms have cut their prices to boost sales and it's notable that the annual fall in prices of the leisure and culture group intensified by half a point to 1.6%.

The core inflation component with the greatest moderation in inflation was services, whose prices posted an annual rate of change of 1.2%, 4 tenths of a percentage point less than in December. Many services tended to ease back their prices due to the weak demand. Consequently, for example, organised travel fell 6.3% last year.

Processed food as a whole also slowed down, with an annual rise of 0.5%, 2 tenths of a percentage point less than the end of 2009. Bread and processed foods made from pulses and vegetables intensified their annual drop and tobacco slowed up its rise. This offset some contrasting movements, such as those of milk and oils.

Industrial goods without energy products kept their year-on-year drop at 1.7%, pressurised by strong competition in international markets. The winter sales for clothing and footwear were a little more intense than a year earlier, this offsetting the upswing in other goods.

The Monetary Union harmonised inflation differential, after thirteen months of being favourable for the Spanish economy, was once again slightly positive in January. However, the core inflation differential was still negative.

Over the coming months, we expect inflation to stay at moderate levels. It might fall in February but will tend to rise in summer as a result of the rise in value added tax. However, weak consumption will continue to restrain prices so that inflation will probably be around 1.5% at the end of the year.

The inflation differential with the euro area is positive again but not its core component.

CONSUMER PRICE INDEX BY COMPONENT GROUP

January

	Indices (*)	% monthly change		% annual change	
		2009	2010	2009	2010
By type of spending					
Food and non-alcoholic beverages	108.0	0.0	–0.1	1.9	–2.4
Alcoholic beverages and tobacco	127.7	2.1	1.3	4.0	11.8
Clothing and footwear	92.8	–13.8	–14.1	–1.7	–1.1
Housing	113.5	0.5	0.8	4.6	1.2
Furnishings and household equipment	106.5	–0.7	–0.9	2.1	0.6
Health	97.7	0.2	0.2	0.1	–1.3
Transport	105.1	–0.6	1.7	–6.2	6.3
Communications	99.3	0.1	0.0	–0.5	–0.5
Recreation and culture	96.7	–1.4	–1.9	0.3	–1.6
Education	114.5	0.1	0.0	3.9	2.6
Restaurants and hotels	111.9	0.2	0.1	3.5	1.1
Other goods and services	110.5	0.9	0.6	3.5	1.8
By group					
Processed food, beverages and tobacco	111.9	0.2	0.1	2.5	0.5
Unprocessed food	107.0	0.3	0.2	1.3	–3.2
Non-food products	105.5	–1.6	–1.3	0.5	1.5
Industrial goods	100.5	–3.5	–2.6	–2.5	1.6
Energy products	*110.2*	*–0.8*	*2.8*	*–9.3*	*11.4*
Fuels and oils	*105.6*	*–2.3*	*3.2*	*–15.6*	*13.9*
Industrial goods excluding energy products	*96.9*	*–4.4*	*–4.4*	*–0.3*	*–1.7*
Services	110.7	0.3	–0.1	3.6	1.2
Underlying inflation (**)	106.0	–1.4	–1.6	2.0	0.1
GENERAL INDEX	**106.7**	**–1.2**	**–1.0**	**0.8**	**1.0**

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

Wholesale prices again post positive year-on-year changes

Slowdown in falling farm prices at source.

Industrial prices closed 2009 with a 0.4% year-on-year change, similar to the figure for a year ago. They therefore recovered after having recorded their greatest fall in the last few decades in the month of July. Import prices also returned to positive figures in December 2009 after twelve months of negative year-on-year change. These upswings were boosted particularly by energy prices and those of intermediate goods. On the other hand, farm prices at source continued to slow up their decline in autumn due to the arable component and meat products.

INFLATION INDICATORS

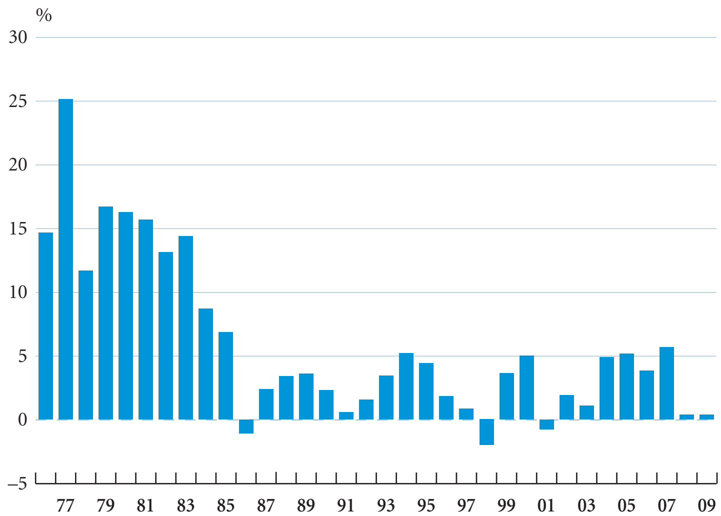
Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2008											
October	–7.6	6.1	2.8	2.4	5.3	14.9	5.2	3.2	1.3	5.1	–
November	–10.5	2.9	2.2	2.3	2.9	4.3	0.9	4.3	1.9	5.0	1.7
December	–10.3	0.4	1.6	2.3	1.0	–3.4	–3.9	2.6	1.6	2.0	–
2009											
January	–7.2	–0.5	0.9	1.9	–1.6	–2.2	–4.9	2.8	2.0	0.4	–
February	–5.4	–1.1	0.4	1.6	–3.2	–1.9	–5.6	3.0	2.6	–1.2	1.5
March	–7.1	–2.5	–0.4	1.3	–4.3	–5.0	–6.9	2.6	3.1	–2.7	–
April	–7.7	–3.4	–0.8	1.2	–5.5	–6.8	–7.4	2.5	3.1	–3.7	–
May	–15.1	–4.4	–1.1	1.1	–6.3	–9.8	–9.9	1.8	2.5	–5.5	0.2
June	–17.2	–4.9	–1.3	0.9	–6.9	–10.1	–10.8	1.3	2.4	–6.0	–
July	–17.9	–6.7	–1.3	0.5	–7.8	–16.0	–11.4	2.0	2.3	–7.1	–
August	–14.8	–5.5	–0.9	0.3	–7.7	–11.5	–9.8	0.6	2.1	–7.4	–0.6
September	–14.0	–5.4	–0.7	0.4	–7.6	–11.5	–9.2	–0.5	1.7	–7.6	–
October	–12.2	–4.3	–0.7	0.2	–6.3	–8.4	–7.2	–2.1	1.0	–6.7	–
November	...	–1.8	–0.6	0.2	–4.6	–0.7	–3.1	–3.1	0.5	–5.3	–0.2
December	...	0.4	–0.5	0.1	–2.7	6.3	1.8	–1.3	0.8	–1.9	–

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

PRODUCER PRICES: TWO CONSECUTIVE YEARS OF MODERATION

% annual change in December for each year for the general producer price index



SOURCES: National Institute of Statistics and own calculations.

Foreign sector

Sharp fall in foreign imbalance in 2009

Current account deficit falls by 48% in 2009.

According to National Accounts data from the National Institute of Statistics (INE), the current deficit reached 53,556 million euros in 2009, 48.4% less than a year ago. According to these figures, the greatest adjustment in the imbalance occurred in the balances of services and trade, with a 66.3% reduction year-on-year. The economy's current deficit therefore accounted for 5.1% of gross domestic product (GDP) in 2009, significantly below the figure of 9.6% for 2008.

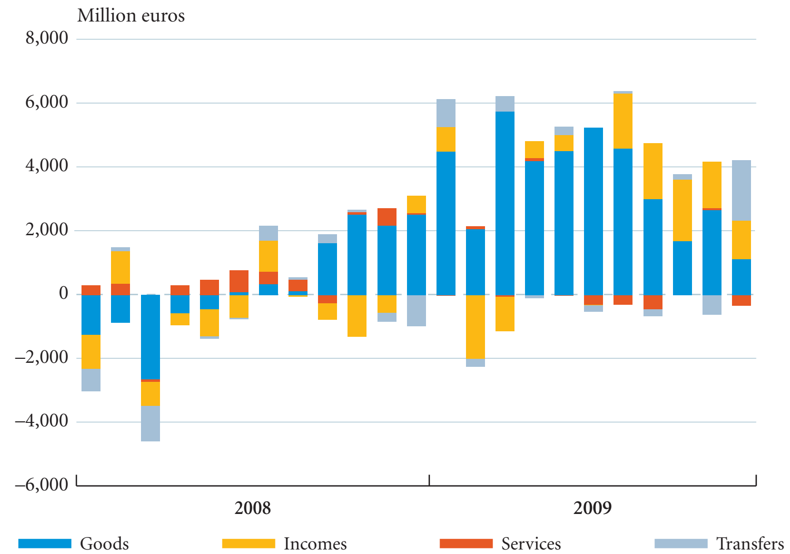
Incomes and current transfers lead the reduction.

These figures are in line with the balance of payments data, showing a 45.4% reduction in the current account balance deficit for November 2009 compared with the same month last year. Thanks to this improvement, the seventeenth since June 2008, the accumulated deficit shrank by 48.3% in the first eleven months of the year.

However, details of the different balance of payments accounts show that, unlike in previous months, the correction in the trade imbalance was not the main reason behind the improved current deficit. Consequently, and as already suggested by the international trade figures published last month, the slow up in the contraction of trade flows meant that the reduction in the balance of goods deficit

A SMALLER TRADE DEFICIT IS NO LONGER THE MAIN REASON FOR THE IMPROVED CURRENT BALANCE

Change in balance compared with the same month last year



SOURCES: Bank of Spain and own calculations.

was 20.2% compared with the same month in 2008. As can be seen in the graph above, this was offset by improvements in the income and current transfer balances, contributing almost 80% to this month's reduction in the current deficit.

This graph also shows that November was the fifth consecutive month with a significant improvement in the income balance deficit. This is due to the fall in investment income paid abroad, especially by the private sector, which includes financial institutions and other resident sectors. On the other hand, the surplus in the services balance continued its gradual decline, although this time due to its non-tourist component performing badly.

Moreover, the surplus in the capital account increased in November, after posting gradual reductions for the last six months. This led to further shrinkage year-on-year in financing needs of 48.5%. For the year as a whole, INE's figures place this reduction at 50.2%, totalling 49,297 million euros and accounting for 4.7% of GDP, a similar level to that recorded in 2004.

Financing needs account for 4.7% of GDP in 2009.

BALANCE OF PAYMENTS

November 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	–41,733	–48.5	–48,316	41,869	–46.4
Services					
Tourism	*25,026*	*–6.9*	*26,204*	*–2,011*	*–7.1*
Other services	*–861*	*–41.3*	*–1,196*	*788*	*–39.7*
Total	24,166	–4.9	25,008	–1,223	–4.7
Income	–24,652	–21.5	–27,020	7,317	–21.3
Transfers	–8,374	–21.9	–6,892	1,361	–16.5
Total	**–50,593**	**–48.3**	**–57,219**	**49,324**	**–46.3**
Capital account	**3,159**	**–40.4**	**3,368**	**–3,089**	**–47.8**
Financial balance					
Direct investment	–4,833	5.2	–7,150	1,231	–14.7
Portfolio investment	47,031	–	44,730	45,714	–
Other investment	6,873	–90.1	6,039	–67,756	–91.8
Total	**49,071**	**–30.7**	**43,620**	**–20,810**	**–32.3**
Errors and omissions	–940	–	2,563	–87	–3.3
Change in assets of Bank of Spain	–697	–	7,669	–26,071	–77.3

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.

Public sector

Due to the economic crisis, the public deficit rises to a record 11.4% of GDP in 2009.

Public investment increases its share in GDP by one percentage point to 4.8%.

The public deficit soars in 2009

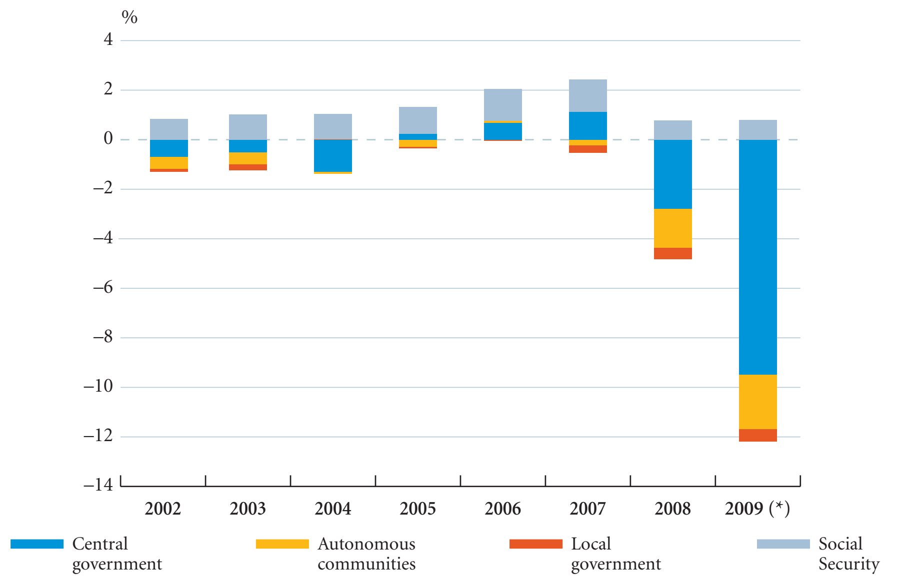
As part of its update for the Stability Programme 2009-2013, the government brought forward its budget forecasts for 2009, showing a deficit for public administration as a whole of 11.4% of gross domestic product (GDP), 7.3 points more than the previous year and a record figure. This notable deterioration in public accounts is due particularly to the direct effects of the worst economic recession in the last few decades on the different items under revenue and expenditure, but is also due to the temporary measures implemented by the government in order to contain the drop in demand, reinforce the confidence of economic agents and mitigate the effects of the crisis.

Most of 2009's public deficit was produced by the central government, this accounting for 9.5% of GDP, while the autonomous communities extended their deficits by 0.6 points of GDP, up to 2.2%. However local government deficit held steady at 0.5% of GDP. Social Security was the only administration that posted a surplus which, although it was lower, remained at 0.8% of nominal GDP as this also fell.

The weight of public revenue in GDP fell 2.4 points to 34.6%. For its part, taxation was down 2.9 points of GDP to 18.2%.

ONLY SOCIAL SECURITY ACHIEVES A SURPLUS IN 2009

Budget balance by administration type as percentage of GDP



NOTA: (*) Budget forecast.

SOURCES: Ministry of Economy, National Institute of Statistics and own calculations.

A little more than a third of this fall can be attributed to the economic cycle, while the drop in revenue from some taxes related to movable assets and real estate explains around another half point of GDP of the drop in revenue.

Among the discretional measures having an impact on the budget were those aimed at improving company liquidity (modifications in how value added tax or VAT is handled) and household liquidity (bringing forward rebates in personal income tax), leading to a cost of 0.7% of GDP in 2009. Moreover, longer deferments for VAT and corporate tax payments accounted for 0.5% of GDP.

With regard to expenditure, this grew by 5 percentage points of GDP, now accounting for 46.1%. Almost half this rise can be put down to benefit payments, with those related to unemployment rising by more than 12,000 million euros. Wages and the purchase of current goods and services also entailed a considerable rise of 1.7 points of GDP, up to 18.0%, and higher public debt led to a 0.3% increase in interest payments, up to 1.9% of GDP, while public investment increased its share in GDP by one percentage point to 4.8%.

According to estimates by the Ministry of Economy and Finance, the cyclical component of GDP was 1.4% in 2009. The primary structural deficit, after discounting interest, was estimated at 8.1% of GDP. If we eliminate the temporary measures to stimulate the economy from this figure, the primary structural deficit becomes 5.7% of GDP.

Along these lines, the Stability Programme 2009-2013 contains a strategy to consolidate the budget, adjusting within this period the aforementioned 5.7 points of GDP and aiming to reduce public deficit to 3% of GDP by 2013, thereby complying with the limit set in the Stability and Growth Pact of the European Union. This strategy is based on the central government budget for 2010 and on a further package of measures approved on 29 January 2010 by the Spanish cabinet. The containment of costs will affect all policies except for unemployment benefits, pensions, subsidies for dependency, scholarships and aid for study, R&D&i and official development aid. Expenditure on staff, operations, investment and the rest of costs will therefore be cut back.

On the other hand, public debt rose by 15.5 points of GDP in 2009 up to 55.2%. In spite of this sharp increase, the level is considerably below the average for the euro area, namely 78.2% of GDP. The rise in debt can be broken down into more than 11 points for public deficit, 1.4 points due to the fall in nominal GDP and the rest due particularly to central government contributions to the Financial Asset Acquisition Fund and the Fund for Orderly Bank Restructuring.

The government adopts a strategy to consolidate the budget and redirect public deficit to 3% of GDP by 2013.

Public debt rises to 55.2% of GDP but is still significantly lower than the average for the euro area.

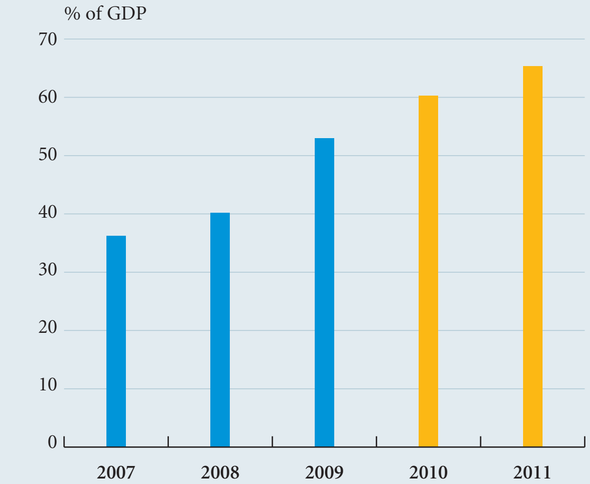
Fiscal and monetary policy: an increasingly complicated relationship

During part of 2009, the global economy flirted with the prospect of a depression that could only be compared with the one in the nineteen thirties. To avoid such a scenario, the central banks and governments of the main economies set up exceptional measures of fiscal and monetary expansion with massive injections of liquidity and high public deficits. Data for the fourth quarter of 2009 and most of the forecasts for 2010 suggest that the worst is now behind us: the possibility of a depression has faded and the global economy seems to be on the road to recovery.

But 2010 won't be a quiet year. The process of reducing debt affecting most rich economies, as well as the problems remaining in the financial sector, will hinder growth. Moreover, the ordered withdrawal of fiscal and monetary expansion measures doesn't promise to be at all straightforward. Specifically, the interaction between the monetary and fiscal authorities has been relatively easy while both backed expansive policies; but conflict could arise in 2010.

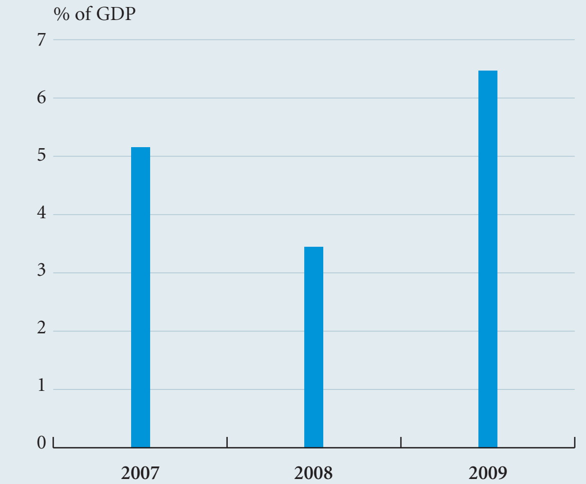
US PUBLIC DEBT WILL CONTINUE TO GROW...

Public debt (*)



...BUT THERE'S NO ROOM FOR IT ON THE FED'S BALANCE SHEET

Treasury bonds and state collateralized agency debt on the Fed balance sheet



NOTE: (*) Debt in the hands of the public. Data after 2009 are CBO forecasts.
SOURCES: Bureau of Economic Analysis, Federal Reserve, CBO, Thomson Reuters Datastream and own calculations.

On the one hand, the fiscal authority would rather the monetary authority held onto a lax monetary policy such as the one to date. Low interest rates are a considerable aid to public funds given their impact on the cost of debt as central bank purchases of public debt help to finance the government, and an expansive monetary policy, if it encourages economic growth, helps to reduce the fiscal deficit as it increases public revenue and reduces spending on unemployment. However, making the fiscal authority's life easier is not the priority of the central bank; rather it's to avoid the appearance of inflationary pressures. That's why its present concern is focused on getting monetary policy back to normal.

Another point of friction is the central bank's preference for fiscal adjustment to be carried out as soon as possible. Balanced public budgets help to control inflation and reduce upward pressure on long term interest rates, giving monetary policy more room to manoeuvre. However, the road to fiscal consolidation is not a smooth one: in the short term, private demand continues fragile and there's still a need for expansionary fiscal policies. Moreover, recovery in the labour market will be slow, making it difficult for central government revenue to increase and for expenditure on unemployment benefits to fall. And, lastly, we cannot ignore the tremendous political cost of withdrawing stimuli and other adjustments required to balance the public accounts. That's why fiscal consolidation is unlikely to be as fast as the monetary authority would wish.

The outcome of this difficult interaction between the fiscal and monetary authorities will be determined by and, in turn, will test the independence of the central banks. Within this context, it's worth being quite clear about the benefits provided by an independent monetary authority. Firstly, there's evidence that independence frees up the monetary authority to pursue price stability more consistently, with a clear commitment. This makes it easier to anchor expectations regarding inflation. For example, in the last five years, commodities have been extremely volatile but the underlying price indices (excluding energy and food) have remained stable thanks partly to the belief that, if prices rose, the monetary authority would take decisive action. There's also evidence that extreme levels of inflation reduce growth, while moderate price rises encourage it.

With regard to the independence of monetary authorities, the situation of the ECB and Fed is very different, with the former having the edge. The ECB's mandate is exclusively to control inflation while the Fed's also includes growth targets. A more diffuse mandate like that of the US central bank can arouse more criticism from outside observers concerning monetary policy decisions. But perhaps the greatest risk for the Fed lies in the process of regulatory change in which it is immersed. For example, leading members of Congress have proposed regulatory changes that would open the door to audits of the central bank's actions, including decisions on monetary policy, a step that would seriously compromise the Fed's independence.

The paths to recovery will be many and varied but all will involve striking a compromise between the return to monetary normality and the rate of progress in fiscal consolidation. Inflationary tensions have not appeared but this might change over the coming months. If the expectations for inflation, at present well anchored, start to move upwards, the best remedy is an independent monetary authority and central bankers aware of just how much is at stake in 2010.

This box was prepared by the International Unit
"la Caixa" Research Department

Savings and financing

Private sector coming out of debt

Bank loan interest rate falls 238 basis points in 2009.

The one-year Euribor interest rate, widely used as a reference, stood at 1.232% as a monthly average in January 2010, very slightly above the historic minimum recorded in the month of November 2009 but 139 basis points less than twelve months before. Subsequently, the interest rate fluctuated around this minimum and on 26 February the one-year Euribor posted another historic minimum when it fell to 1.215%, as no change is expected over the coming months in the official European Central Bank interest rate, standing at 1.00% since May 2009.

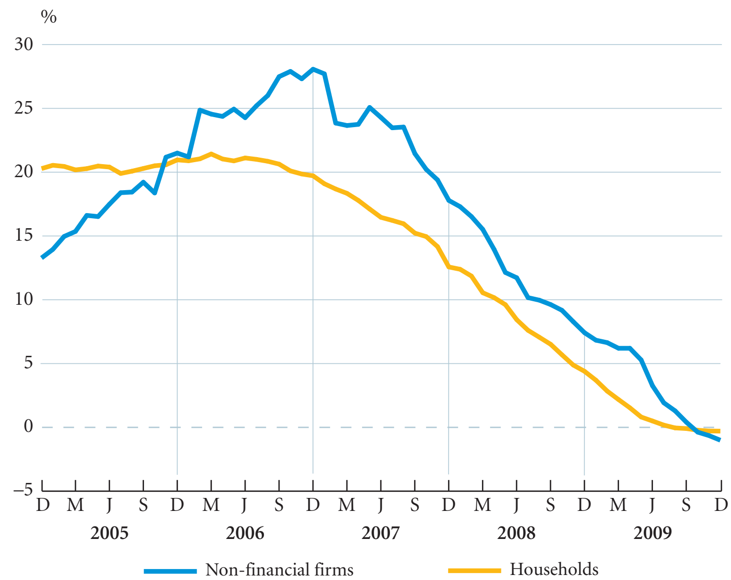
Within this context, in the month of December 2009 the synthetic interest rate for loans and credit from credit institutions to firms and households continued to fall, down to 3.32%. It therefore stood at 238 basis points below the level of a year ago.

Private sector financing in 2009 declines less than nominal gross domestic product.

In spite of the drop in nominal interest rates, demand weakened for private sector financing in 2009 due to the unfavourable economic situation. Moreover, financing terms also got tougher in terms of supply compared with last year. Consequently, private sector financing fell slightly, 0.7% year-on-year, continuing the slowdown

SLIGHT SHRINKAGE IN FINANCING FOR FIRMS AND HOUSEHOLDS IN 2009

Year-on-year change in financing



SOURCE: Bank of Spain.

FINANCING OF NON-FINANCIAL SECTORS (1)

December 2009

	Balance	Change over 12 months		% share
	Million euros	Million euros	% (2)	
Private sector	2,211,869	–5,133	–0.7	79.8
Non-financial corporations	1,308,306	1,841	–1.0	47.2
Resident credit institution loans (3)	*916,579*	*–37,556*	*–3.5*	*33.1*
Securities other than shares	*56,243*	*15,180*	*37.0*	*2.0*
External loans	*335,484*	*24,216*	*1.8*	*12.1*
Households (4)	903,563	–6,974	–0.3	32.6
Housing loans (3)	*677,955*	*–493*	*0.1*	*24.4*
Other (3)	*222,912*	*–6,800*	*–1.5*	*8.0*
External loans	*2,696*	*320*	*13.5*	*0.1*
General government (5)	561,099	129,076	29.9	20.2
TOTAL	**2,772,968**	**123,943**	**4.3**	**100.0**

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

started in 2006. Deleveraging therefore continued in firms and households, which had reached high levels of debt. Overall, the reduction in private sector financing was less than the fall in nominal gross domestic product in 2009, which was 3.4%.

Financing for non-financial firms fell 1.0% in 2009, after having grown 7.4% the previous year. Loans granted by resident financial institutions were down 3.5%. Trade credit, aimed at financing firms' working capital, fell by 25.5%. Financial leases, used to fund investment, decreased 16.4%. This decline in credit was partly offset by a rise of 37.0% in bond issuance as the capital markets got back to normal, as well as by a 1.8% increase in foreign loans.

Credit to households also continued to slow up, posting a year-on-year decrease of 0.3% in 2009 after having grown 4.4% the previous year. Credit aimed at housing rose slightly by 0.1% as the theoretical effort required to buy a home had fallen due to lower house prices and interest rates. However, credit for consumption and other purposes shrank by 1.5%, affected by higher interest rates, 7.0% in December, because of a higher risk premium resulting from increased bad debt.

Housing loans up slightly.

The effects of the slump in economic activity and escalating unemployment continue to have harsh repercussions in terms of increased bad debt. The bad debt rate for all credit institutions rose to 5.1% in 2009, 1.7 points higher than a year earlier and returning to the level of the middle of 1996. However, we should also note a reduction in the growth of this rate, rising 2.4 points in 2008, this being due to more demanding risk management policy. The bad debt rate for banking was 5.0%, for savings banks

Bad debt for financial institutions ends 2009 at 5.1%.

The European Commission authorizes the recapitalization of financial institutions.

5.1%, for cooperatives 3.8% and for financing institutions 10.2%.

Savings banks continued to claw back market share in the private sector credit segment, reaching 48.4%, half a point more than in 2008 and setting a record high at the end of the year, far above the 21.3% of 1979, before the liberalization of the financial area. For their part, banks improved their share by one tenth of a percentage point, up to 43.8%, and credit cooperatives also by one tenth of a percentage point, up to 5.3%. Meanwhile, the relative weight of financial credit establishments and electronic money institutions fell by 8 tenths of a percentage point to 2.4%.

For its part, public debt, measured according to the Protocol on the excessive deficit procedure, via consolidated gross debt at nominal value, rose 29.9% in 2009, slightly more than the 13.5% growth of a year ago. This expansion offset the drop in private sector financing. Overall, total financing to resident sectors continued to slow up its growth to 4.3% in 2009, 3 points less than a year earlier.

Meanwhile, at the end of January the European Commission passed the Spanish scheme to recapitalize credit institutions through its Fund for Orderly Bank Restructuring (FROB in Spanish) up to 30 June 2010, although this period may be extended. The remuneration applicable to the shares to be subscribed by the FROB, in order to support integration, is set at a minimum of 7.75%.

Moderate growth in bank deposits

In 2009, returns from bank deposits tended to fall in line with the official European Central Bank interest rate, standing at 1.0% since May. In December, the average bank deposit interest rate stood at 1.28%, 1.44 points lower than twelve months before but above inflation.

In 2009, sight and savings deposits were up while term deposits were down.

Given the reduction in the nominal return on deposits, the growth in their balance slowed down to 2.5%, although this was still higher than the growth in credit. Of note in 2009 was the 7.3% rise in sight deposits and especially the

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

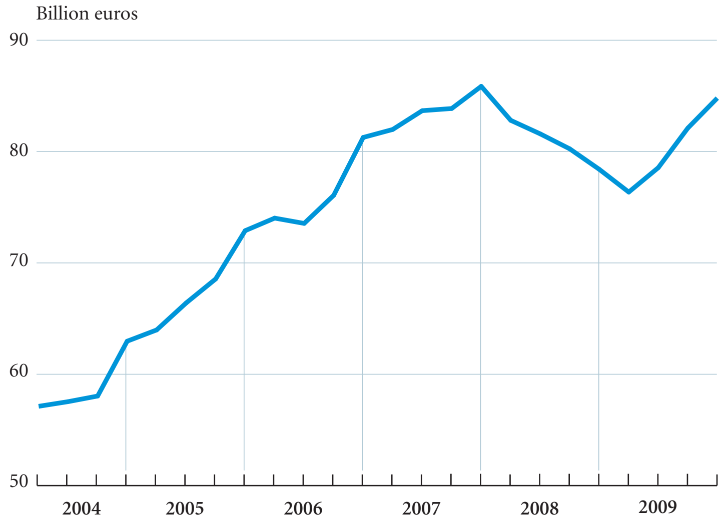
December 2009

	Total	Change over 12 months		% share
	Million euros	Million euros	%	
On demand deposits	262,735	17,923	7.3	18.4
Savings deposits	207,791	28,014	15.6	14.6
Term deposits	720,012	–9,261	–1.3	50.5
Deposits in foreign currency	22,015	–7,303	–24.9	1.5
Total deposits	**1,212,553**	**29,374**	**2.5**	**85.1**
Other liabilities (*)	**213,129**	**–35,500**	**–14.3**	**14.9**
TOTAL	**1,425,682**	**–6,126**	**–0.4**	**100.0**

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

PENSION FUNDS PICK UP IN 2009

Total assets in pension funds



SOURCE: Inverco.

15.6% rise in savings deposits, due to savers' greater preference for liquidity in a more uncertain economic situation. However, the balance of term deposits fell by 1.3% and deposits in foreign currency, generally affected by unfavourable interest rate differentials, were down 24.9%.

Hardly any variations were recorded in 2009 in this market segment in terms of the different types of organisations. Credit cooperatives increased their share by 0.3 tenths of a percentage point at the cost of banks, while savings banks held onto their share of 55.5%.

Mutual funds provide an alternative to deposits. Their assets fell by 1,370 million euros in January 2010 to 161,184 million because of drops in value due to the month's unfavourable stock market trends in general, as well as to net withdrawals of 485 million euros. However, the annual net yield was 4.5%.

Another favourite product for savers, pension funds, managed to total 84,789 million euros at the end of 2009, an annual rise of 8.1%, while the number of participants rose by 1.2% and yield reached 7.7% on average. In the last nineteen years, the average yield has been 5.6%, higher than inflation for the period.

Lastly, another destination for savings, namely insurance, posted a premium volume of 59,884 million euros in direct insurance, an annual rise of 1.2%. This growth was due to the life category, up 5.8%, while the rest fell by 2.6%.

Pension funds achieve a yield of 7.7% in 2009.

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As of December 31, 2009

FINANCIAL ACTIVITY	Million euros
Total customer funds	237,799
Receivable from customers	178,026
Profit attributable to Group	1,510

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	27,505
Branches	5,326
Self-service terminals	7,951
Cards (million)	10.3

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2010	Million euros
Social	356
Science and environmental	62
Cultural	55
Educational and research	27
TOTAL BUDGET	**500**

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