

Monthly Report



THE EMERGING WORLD: THE BRICs AND BEYOND

The emerging power [Page 12](#)

Emerging economies are the stars of growth but their capacity to boost demand in the rest of the world

Foreign exchange reserves: the mountain keeps on growing [Page 17](#)

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Emerging economies face up to the challenge of achieving efficient financial systems

Spain - Asia: five hundred years on, the journey continues [Page 62](#)

Spain must look again to Asia to revive its exports

Forecast

% change over same period year before unless otherwise noted

	2008	2009	2010	2009				2010	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY	Forecast			Forecast					
Gross domestic product									
United States	0.4	-2.4	2.8	-3.3	-3.8	-2.6	0.1	2.5	3.3
Japan	-1.2	-5.2	1.6	-8.4	-6.0	-4.9	-1.4	2.6	1.3
United Kingdom	0.5	-5.0	1.1	-5.4	-5.9	-5.3	-3.3	-0.6	0.9
Euro area	0.5	-4.0	1.0	-5.0	-4.8	-4.0	-2.1	0.5	1.0
Germany	1.0	-4.9	1.3	-6.7	-5.8	-4.8	-2.4	1.5	1.4
France	0.3	-2.2	1.3	-3.5	-2.7	-2.3	-0.3	1.3	1.3
Consumer prices									
United States	3.8	-0.3	2.1	-0.2	-1.0	-1.6	1.5	2.4	2.2
Japan	1.4	-1.4	-0.7	-0.1	-1.0	-2.2	-2.0	-1.5	-1.2
United Kingdom	3.6	2.2	2.5	3.0	2.1	1.5	2.1	3.2	2.8
Euro area	3.3	0.3	1.2	1.0	0.2	-0.4	0.4	1.0	1.2
Germany	2.6	0.3	0.9	0.8	0.3	-0.2	0.4	0.7	0.8
France	2.8	0.1	1.3	0.7	-0.2	-0.4	0.4	1.2	1.3
SPANISH ECONOMY	Forecast			Forecast					
Macroeconomic figures									
Household consumption	-0.6	-5.0	-0.1	-5.5	-6.0	-5.0	-3.5	-0.8	0.8
Government consumption	5.5	3.8	-0.2	6.0	4.7	4.1	0.8	-0.4	-0.4
Gross fixed capital formation	-4.4	-15.3	-5.7	-14.9	-17.0	-16.0	-12.9	-8.0	-6.3
Capital goods	-1.8	-23.1	-0.7	-24.0	-28.3	-23.8	-15.3	-2.0	-1.0
Construction	-5.5	-11.2	-7.6	-11.3	-11.6	-11.4	-10.2	-9.6	-7.9
Domestic demand (contribution to GDP growth)	-0.5	-6.4	-1.5	-6.3	-7.4	-6.6	-5.3	-2.5	-1.2
Exports of goods and services	-1.0	-11.5	2.2	-16.6	-14.7	-10.8	-2.9	-0.7	1.1
Imports of goods and services	-4.9	-17.9	-2.3	-22.3	-21.7	-17.0	-9.6	-5.1	-2.3
Gross domestic product	0.9	-3.6	-0.4	-3.3	-4.2	-4.0	-3.1	-1.4	-0.4
Other variables									
Employment	-0.6	-6.7	-2.3	-6.3	-7.2	-7.2	-6.1	-3.9	-2.4
Unemployment (% labour force)	11.3	18.0	19.5	17.4	17.9	17.9	18.8	19.9	19.4
Consumer price index	4.1	-0.3	1.3	0.5	-0.7	-1.1	0.1	1.0	1.0
Unit labour costs	4.6	0.2	-0.9	0.9	0.9	-0.1	-0.1		
Current account balance (% GDP)	-9.5	-5.1	-2.8	-7.9	-4.5	-3.8	-4.2		
Net lending or net borrowing rest of the world (% GDP)	-9.1	-4.7	-2.4	-7.6	-4.0	-3.6	-3.7		
General government financial balance (% GDP)	-4.1	-11.2	-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	0.3	0.3
ECB repo	3.9	1.2	1.0	1.8	1.1	1.0	1.0	1.0	1.0
10-year US bonds	3.6	3.2	3.8	2.7	3.3	3.5	3.4	3.7	3.7
10-year German bonds	4.0	3.3	3.3	3.1	3.4	3.3	3.2	3.2	3.2
Exchange rate									
\$/Euro	1.48	1.39	1.37	1.30	1.36	1.43	1.48	1.39	1.39

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The emerging world: the BRICs and beyond

Goldman Sachs coined the term BRIC in 2001 to refer to the group made up of Brazil, Russia, India and China, countries that were growing at a pace that suggested they would become economic giants in the future. According to the investment bank's study, in ten years their weight in world GDP would increase by 50% and, by the middle of the century, this group would match the group of developed economies. Their level of per capita income would still be considerably below that corresponding to rich economies but it would go on rising, and we mustn't forget that the BRICs go to make up 40% of the world's population.

The term became famous and today's reality more than confirms these predictions. Since the study was published, China has become the third economy on the planet, ahead of Germany and behind the United States and Japan, and has recently achieved the distinction of leading world exporter. Brazil and India have also come up to expectations and only Russia has a more uncertain situation. If we look at China, India and Brazil, in 2009 their contribution to the world GDP reached 20% in terms of purchasing power parity, equalling the weight of the United States and that of the European Union. Specifically, 12% of the world GDP originated in China, while India and Brazil produced the remaining 8%. Moreover, the outlook is good: the latest forecasts by the International Monetary Fund predict that China will return to the 10% annual growth rates we'd got used to in the past. For their part, in the coming years India and Brazil are likely to exceed growth averages of 7.2% and 3.5%, respectively, achieved in the decade prior to the crisis. In 2010-11, Brazil, India and China will contribute 1.7 annual percentage points to global growth, contributing 40% of the total (measured in purchasing power parity). China alone will add 1.2 percentage points or 30% to global progress, more than double the United States' contribution.

The BRIC acronym was right to direct attention towards what are known today as the emerging economies. Their increasing economic weight, together with their maintenance of high growth rates, explains their rising contribution to the progress of the world economy. But this phenomenon isn't limited to the four big guns: it extends to a diverse group of countries located in Asia, Eastern Europe, Latin America and Africa. Economies with medium or low incomes according to the World Bank classification, but that have more or less successfully opened themselves up to globalisation in their economic and commercial relations, have adopted a free market economy and have made an effort to provide themselves with the mechanisms required to guarantee institutional stability.

The emerging economies are already the stars of the global economic stage. They are a relevant engine for growth, are large consumers of energy, hold three quarters of the foreign exchange reserves and provide 80% of the world's population. Acknowledgement of this phenomenon has also become evident in the area of international cooperation. The G-7 meetings between the richest countries in the world that, until very recently, called all the shots for the planet, have given way to G-20 meetings that include a large number of emerging countries, since action could not be taken without their approval. The emerging countries are increasingly the future, something those of us in the old west must bear very much in mind.

EXECUTIVE SUMMARY

The scenario of recovery is confirmed but with notable geographical differences.

The United States appears stronger than expected while Japan relies on exports.

The emerging economies, with China and Brazil at the vanguard, do not disappoint.

A disparate recovery

The economic data being published confirm the gradual consolidation of the scenario of recovery, albeit with notable geographical differences. Emerging economies, with China and Brazil as their leading exponents, remain very dynamic and, at a certain distance, the United States and Japan are also making up lost ground, whereas in Europe the recovery seems to have slackened off in this first quarter of the year, although climate-related factors may be partly to blame.

The United States seems to be stronger than expected. Private consumption has kept up after the end of stimulus, industry and capital goods investment are gaining ground and prices are looking stable. But as the abyss of the start of 2009 fades further into the past, this recovery, which is gradually becoming established, is still highly dependent on three factors whose solution does not seem to be close at hand. Firstly, the real estate market, afflicted by an excess supply that's holding it back from coming out of the tunnel. Secondly, households' high level of debt, as well as a public sector that is forced to use expansionary fiscal policies to boost demand. Lastly, the decline in the labour market has been so great that it will take a long time to get back to normal again.

The Japanese economy grew almost 4% annualized quarter-on-quarter in the fourth quarter. Two thirds of this growth came from the foreign sector, boosted by

exports that are growing strongly. The rest of the advance can be put down to a private consumption that, encouraged by government stimulus, resulted in domestic demand making its first positive contribution to growth after six months of decline. Looking at investment, the recovery in capital goods investment was offset by the reduction in stock, a process that must continue given the huge accumulation that took place in 2009, when exports plummeted.

The third world economy, China, will grow by 9.5% in 2010 according to the World Bank, after an advance of 8.7% last year. The outlook has improved thanks to the crisis having been overcome without too many complications and to production and global trade recovering in the second half of 2009. However, more worrying is the formation of a speculative bubble in the real estate market, whose prices are still rising, as well as the potential financial difficulties of local governments after the massive investment made in infrastructure. The Chinese government continues to juggle with cooling measures given the risk of inflation.

It's also worth noting Brazil's evolution, another large emerging economy that, after the recession, has gone back to growth, leaving 2009 with a minimal overall decline of 0.2%. Moreover, in the fourth quarter, and after four negative postings, it already recorded its first year-on-year advance of 4.3%, a less brilliant figure than that of China or India but nonetheless confirming the solidity of its

recovery and promising a 2010 at cruising speed.

The euro area presents much more restrained overtones. The worst of the recession now lies behind it but the path back to completely normal economic activity will be long and this won't be fully achieved until 2011. Growth for the fourth quarter of 2009 remained at a muted rise of 0.1% quarter-on-quarter and indicators for the first quarter are along the same lines. Both consumption and investment appear very weak and continue to limit the euro area's capacity to recover, which is surviving thanks to the foreign sector, the inventory cycle and the fiscal stimulus in operation. Germany, its main economy, is looking at zero growth in the first three months of 2010.

The fragility of Europe's recovery is causing concern. Consumers have not quite got back the level of confidence required to relaunch consumption in an environment where unemployment is still growing. The large amount of idle production capacity does not suggest that investment will soon get back on its feet either. The good results for exports might not be enough to regain rates of growth that can generate employment. Moreover, the need to sort out public accounts means that either costs have to be cut or taxes raised, depressing domestic demand.

Greece is the main exponent of the requirement to slow up the deterioration in government budgets. The markets' reaction to an unruly deficit and spiralling debt have forced the country to present a drastic adjustment plan that includes raising value added tax (VAT), freezing pensions and cutting public administration wages. In return, Greece is asking for help from the rest of its partners in the euro area, something that

has led to complex debate among EU institutions and member states given the lack of mechanisms to rescue national economies within the single currency. Meanwhile, the dollar has appreciated notably against the euro, going from a maximum of 1.51 dollars per euro in November last year to 1.33 at the end of March, a trend that might aid recovery in the euro area.

But while Greece is the most outstanding case of fiscal imbalance, very few member states have escaped the problem of public accounts. This has been highlighted by the European Commission in its assessment of the stability or convergence programmes for fourteen countries in the Union presented mid-March. In addition to Greece, which can't be compared to any other country, Ireland, the United Kingdom and Portugal are in the most delicate situation, without room for manoeuvre. Spain, France, Italy and Belgium are next in terms of seriousness. In all cases, however, the Commission has expressed its concern because it considers the growth forecasts to be optimistic and, if these are not achieved, they might disrupt the path towards stabilization set out in the plans.

In the case of Spain, the European Commission, in addition to asking for more details on its fiscal adjustment measures, particularly as from 2010, highlights the need to adopt reforms that boost productivity, competitiveness and sustainable employment. The Spanish economy will recover from the current recession but, in order to achieve high growth rates, it's vital to implement structural reforms in areas such as education, competition in services and electricity and efficiency in R&D and the labour market.

The expansion of the euro area will not be consolidated until 2011.

Greece is a case apart but fiscal imbalances are a widespread problem.

The European Commission is urging reforms to boost productivity, competitiveness and sustainable employment.

The government is attempting to reduce the public deficit, strengthen the financial system and implement reforms.

The government has tackled this problem from three angles. Firstly, budget consolidation, whose aim is to return the public deficit to around 3% by 2013. Secondly, strengthening and restructuring the financial system. Thirdly, pushing forward with reforms that lay the foundations for solid growth.

The most recent initiative has been a new battery of proposals, presented to the political parties at the beginning of March in order to reach an agreement to tackle the crisis. Of note in this package of measures are the subsidies for reconditioning homes, the direct loans from the Instituto de Crédito Oficial for SMEs and the self-employed, improved aid for the internationalization of firms, more investment in R&D and innovation, a reduction in public and private bad debt and the rationalization of public corporations. Moreover, the government has also sent its Sustainable Economy bill to parliament, containing a wide range of reforms and horizontal actions that aim to consolidate economic growth in the medium term.

But until these reforms start to have an effect, all eyes are still on the short-term indicators. Household consumption appears to be recovering very gently, within a generally weak context and with disparate signs by product. Consequently, while retail sales in general lost energy in January, consumer durables such as domestic appliances and especially vehicles continued to pick up. However, the core component of the consumer price index remaining stable at close to 0% highlights the weakness in household expenditure. In fact, the household confidence index has started the year by halting its improvement,

possibly influenced by the decline in employment in the first two months, by the withdrawal of tax stimulus and by limited wage rises.

With regard to business investment, the slight drop in industrial capacity utilization in the first quarter does not point towards a sustained recovery in capital goods investment. However, some specific indicators look relatively positive. These contradictions can probably be explained by the combined effect of rising exports, after the historic fall in the first part of last year, and a domestic demand that is still very weak.

From the point of view of production, the unusual weather in the first few months of 2010 might have affected activity in sectors such as construction and tourism, although indicators are still incomplete. With regard to the real estate sector, some signs of stabilization can be seen, both in terms of the fall in prices and also in sales, up 2.1% year-on-year in January thanks to the sales of used homes.

In summary, the data available for the first quarter of 2010 still point towards a slight decline in business, of a similar size to the -0.1% quarter-on-quarter recorded in the fourth quarter of 2009. In the second quarter, the getting back to normal of some activities affected by the weather and the bringing forward of some expenses due to the rise in VAT might reinforce the recovery in business and achieve a positive rate of growth in product. In any case, any exit from the recession will occur subtly, with modest rates of growth, awaiting the effects of the reforms implemented.

25 March 2010

Meanwhile, business is developing within a context of weakness, both in consumption and investment.

The exit to the recession is getting closer but growth prospects are still very slight.

CHRONOLOGY

2009

- 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.
- March** **1** The government presents a **new battery of economic policy measures** that aim to achieve agreement among all political forces.

AGENDA

April

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

May

- 4** Registration with Social Security and registered unemployment (April).
EU industrial production index (March).
- 5** Industrial production index (March).
- 6** Governing Council of the Central European Bank.
- 12** GDP flash estimate (first quarter).
EU GDP flash estimate (first quarter).
- 14** CPI (April).
- 18** Foreign trade (March).
EU inflation (April).
- 19** Quarterly national accounts (first quarter).
- 20** Governing Council of the Central European Bank.
- 25** Producer prices (April).
Government revenue and expenditure (April).
- 27** Retail sales (April).
- 28** HCPI flash estimate (May).

INTERNATIONAL REVIEW

The United States bases its recovery on consumption and investment.

Retail sales continue to consolidate their recovery but there's no progress in consumer confidence.

The United States: recovery gains support

The US economy has embarked on the road to recovery much more firmly than expected. Private consumption has kept up after the end of stimuli, industry and capital goods investment are gaining ground and prices are still showing signs of stability. But as the abyss of the start of 2009 fades further into the past, this recovery, which is gradually becoming established, is still highly dependent on three factors whose solution does not seem to be close at hand. Firstly, the real estate market is afflicted by an excess supply that's holding it back from

coming out of the tunnel Secondly, households' high level of debt, as well as a public sector that is forced to use expansionary fiscal policies to boost demand. Thirdly, the labour market will take a long time to recover and it's no surprise that, unlike the conflict generated by the health reform, Democrat and Republican senators have both supported a law for aid to promote employment and extend the unemployment benefit provided by 150 billion dollars.

The latest demand indicators confirm this recovery in private consumption. In February, retail sales without cars

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	4.1	3.9
Consumer confidence (1)	58.0	45.2	29.9	48.3	51.8	51.0	56.5	46.0
Industrial production	-2.2	-9.7	-11.6	-12.9	-9.4	-4.7	0.8	1.7
Manufacturing (ISM) (1)	45.5	46.2	35.9	43.0	51.4	54.6	58.4	56.5
Sales of single-family homes	-37.4	-22.8	-40.0	-27.1	-11.7	-5.4	-6.1	...
Unemployment rate (2)	5.8	9.3	8.2	9.3	9.6	10.0	9.7	9.7
Consumer prices	3.8	-0.4	0.0	-1.2	-1.6	1.4	2.6	2.1
Trade balance (3)	-695.9	-378.6	-605.5	-503.7	-414.2	-378.6	-379.0	...
3-month interbank interest rate (1)	2.8	0.7	1.2	0.8	0.4	0.3	0.2	0.3
Nominal effective exchange rate (4)	83.4	86.5	91.4	88.8	84.5	81.5	82.5	84.4

NOTES: (1) Value.

(2) Percentage of labour force.

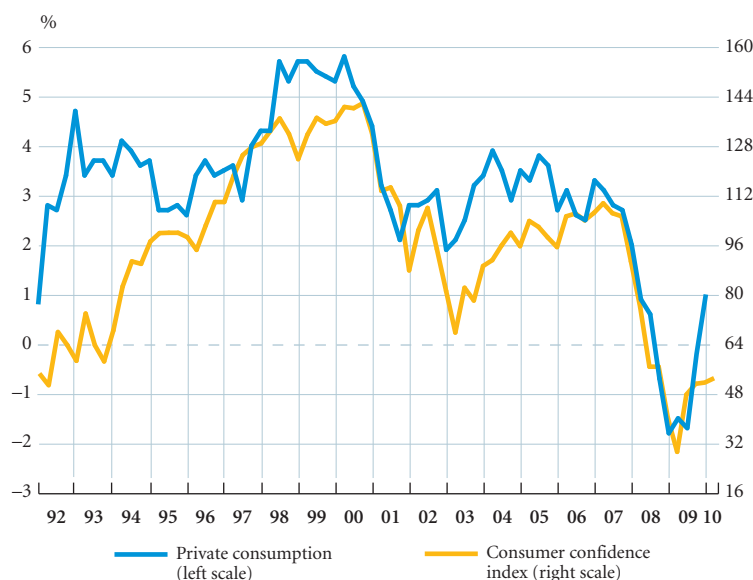
(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.

(4) Exchange rate index weighted for foreign trade movements. Higher values imply currency appreciation.

SOURCES: OECD, national statistical bodies and own calculations.

THE UNITED STATES: CONSUMERS BUY BEFORE REGAINING CONFIDENCE

Year-on-year change in real private consumption and consumer confidence



SOURCES: Bureau of Economic Analysis, Conference Board and own calculations.

or petrol continued their positive trend with a rise of 2.5% year-on-year in real terms. Consequently, retail consumption is 3.0% below the rate of December 2007, representative of the pre-crisis level, after having lost 6.1% in July 2009, its lowest point. On a more pessimistic note, the Conference Board consumer confidence index lost nine points in February and continues at very low levels, with expectations that it will reach a new record low. Although consumers have reasons for despondency founded on high debt and weak employment, recent history shows that this indicator has tended to lag behind recovery in private consumption spending. This might partly explain the discrepancy between the sentiment of consumers and the effective consumption of households.

On the side of producers, business sentiment is still more optimistic than consumer, with a non-financial sector

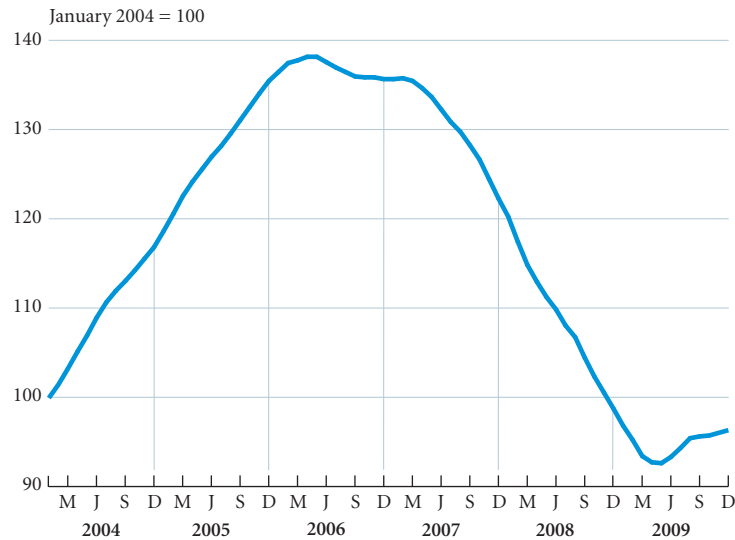
that started the crisis in less debt than banks and families. Consequently, the business sentiment index of the Institute for Supply Management for manufacturers continued at levels befitting strong expansionary stages, in spite of a slight fall to 56.5 points. The services index rose to 54.8 points, thereby coming close to the positive perspectives of manufacturers. For its part, industrial production held on to its recovery in February but continued 10% below its level at the end of 2007. Industrial capacity utilization followed a similar trend, advancing to 72.7%, 3.4 percentage points above the minimum of July 2009 but 10.2 points below the level of December 2007.

The real estate market is still in the doldrums. The recovery in prices has stagnated, with a Case-Shiller price index for second-hand housing between August and December 2009 rising a

The business sector and industrial production continue their upward trend.

THE UNITED STATES: HOUSING IS NOT RECOVERING

Value of the Case-Shiller index for house prices



SOURCES: Standard and Poor's and own calculations.

Excess supply hinders the recovery in house prices and construction.

meagre 0.9%. With the disappearance of state aid for first-home buyers, the volume of sales once again reflects the weakness of a sector that continues to be dominated by excess supply. The number of homes started eased off in February but, beyond the monthly or quarterly variations, the most significant figure is the level of activity, which has spent fifteen months anchored at a quarter of its pre-adjustment level. Building permits, its leading indicator, also declined and ended up painting a sluggish picture in which no notable improvement is expected during the first half of 2010.

The labour market hits bottom but recovery will have to wait.

The labour market, the other obstacle to recovery, doesn't look like recovering significantly in the next few months. 36,000 jobs were lost in February and the unemployment rate remained static at 9.7%. Given its nature, the labour market is usually a delayed indicator and starts to recover when the economy has

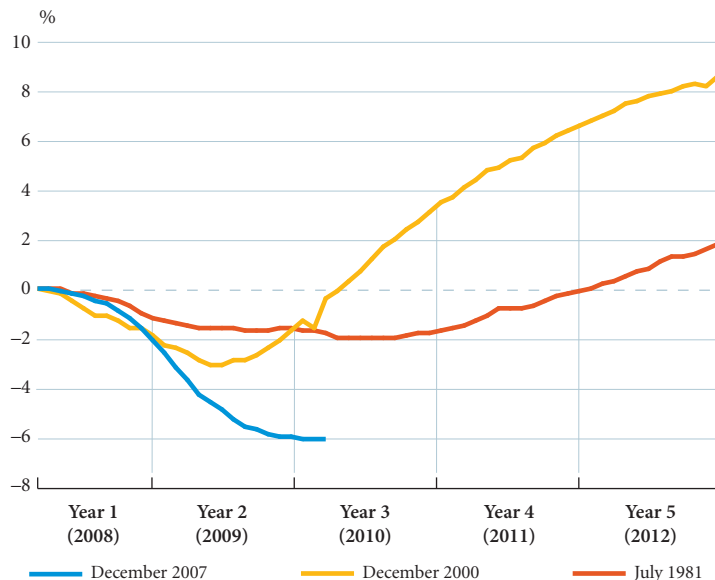
already enjoyed several months of growth. The problem is that the weakness in employment has been more prolonged with each new recession. Moreover, this time job losses have been the largest since 1945. Between January 2008 and February 2010, 8.4 million jobs have been lost, 6.1% of the total corresponding to December 2007. This deterioration has stopped but no rapid recovery can be perceived.

Price stability provides a positive counterweight to these obstacles. The central banks' difficulty in draining liquidity from the system and high public deficits, which would point to an inflationary upswing, are offset by the effects of the low utilization of production capacity. Consequently, the general consumer price index (CPI) rose 2.2% year-on-year in February, leaving behind the base effects of oil prices. More indicative of the current situation, the underlying CPI, which is the general

The CPI rises 2.2% but the core CPI a moderate 1.3%.

THE UNITED STATES: A GREATER DECLINE THAN IN PREVIOUS RECESSIONS

Job losses as percentage of total employed at the start of the slumps (*)



NOTE: (*) The dates between recessions correspond to the last recession (December 2007).

SOURCES: Department of Labor and own calculations.

index without food or energy, moderated its progress to 1.3% year-on-year. Without rent attributed to home owners, core inflation increased 2.6% year-on-year, also easing its rate of growth.

Lastly, the trade deficit for goods and services in January was 37,288 million dollars, 2,614 million below the previous month due to the fall in imports. A similar pattern could be seen in the deficit excluding oil and derivatives, accounting for almost all the improvement. Exports stagnated in January, interrupting their upward swing of the last few months.

Japan: the importance of the foreign sector

The Japanese economy grew 3.8% annualized quarter-on-quarter in the

fourth quarter after the initial estimates were downgraded. The fall in GDP for the whole of 2009 is therefore 5.2%. Two thirds of this quarter-on-quarter growth came from the foreign sector, boosted by strong exports. The rest of the advance can be put down to private consumption that, encouraged by government stimuli, resulted in domestic demand making its first positive contribution to growth after six months of decline. Looking at investment, the recovery in capital goods investment was offset by a reduction in stock, a process that must continue given the huge accumulation throughout 2009, when exports plummeted.

Although the latest revisions have been distinctly downwards, the strength of the upswing is greater than expected thanks to foreign demand. But caution rules the day for domestic demand as, in a deflationary economy, continuing

The trade deficit is down due to the fall in imports.

Japan grows 3.8% thanks to exports and state aid.

JAPAN: 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	-1.2	-5.2	-8.4	-6.0	-4.9	-1.4	-	...
Retail sales	0.3	-2.3	-3.9	-2.8	-1.9	-0.7	2.3	...
Industrial production	-3.4	-22.3	-34.0	-27.6	-19.7	-5.3	20.1	...
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	-8.2	...
Unemployment rate (2)	4.0	5.1	4.5	5.1	5.4	5.2	4.9	...
Consumer prices	1.4	-1.4	-0.1	-1.0	-2.2	-2.0	-1.3	...
Trade balance (3)	4.1	4.0	1.2	0.9	1.7	4.0	5.3	...
3-month interbank interest rate (4)	0.8	0.6	0.7	0.6	0.5	0.5	0.5	0.4
Nominal effective exchange rate (5)	86.6	98.6	102.1	95.7	97.0	99.6	99.3	102.1

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.

High debt will continue to limit the expansion in domestic demand.

growth in private consumption seems unlikely without state aid, while the high level of debt in all sectors will continue to hinder the recovery. The fact that public sector creditors are mainly Japanese might avoid financial turmoil in the short term but it does not alter the fact that there is a limit to public debt and that fiscal policy is less effective with high levels of debt.

Industry and investment confirm their recovery thanks to the export sector.

The latest supply indicators continue to confirm that the improvement is limited to the industrial sector and exports. Industrial production, which in Japan has a close correlation with GDP, maintained its intensity of the previous three months. The general index for January was up 2.7% compared with December, seasonally adjusted, and, since February 2009, has recovered more than half the 36.4% lost during the crisis. Investment perspectives improved in January although they continued to

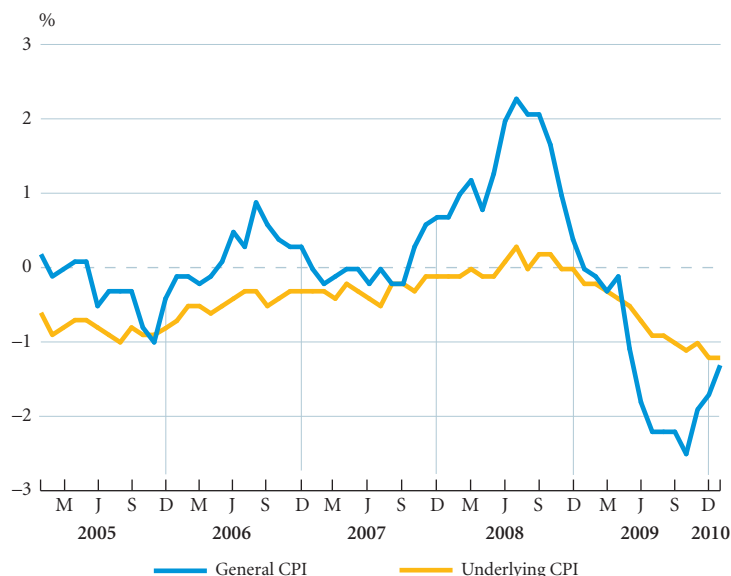
Housing is still weak but unemployment falls to 4.9%.

underline the prime importance of exporters. Consequently, machinery orders aimed at foreign demand picked up, although they are still about 30% below the average for 2008, while the other half, orders aimed at domestic demand, remained stagnant.

Retail sales gained ground in January but, with levels close to those of 2003, continued to be immersed in lethargy, although automobile sales in February seem to be coming out of their slump thanks to state aid. For its part, the housing market saw an upswing in sales in the area of Tokyo offsetting the sharp drop of the previous month but not showing any convincing signs of recovery. In January, new houses started added their fifth month of rises but were still 30% below the average for the last decade, which was not expansionary, indicating that the problems in

JAPAN: DEFLATION, AN UNDERLYING PROBLEM

Year-on-year change in the consumer price index



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

construction date back some time. On a more positive note, the labour market continued to improve with an unemployment rate that fell to 4.9%.

In prices, the underlying weaknesses in domestic demand will prolong the deflationary trends during 2010. Although January's CPI moderated its decline with a fall of 1.3% year-on-year, it is underlying inflation, the general index without energy or food, that sets

the tone, repeating the 1.2% year-on-year drop of the previous month, the highest since the indicator started. A positive counterweight was provided by the foreign sector, with January's trade surplus up 50% compared with December's figures, thanks to the upswing in exports. In spite of the latest rises, exports are still 20% below pre-crisis levels, so we expect exports to continue upholding the economy over the coming months.

The underlying CPI is down 1.2%, and the foreign sector picks up thanks to exports.

The emerging power

The emerging countries' rapid recovery has provided an unusual counterpoint to the decline of the advanced economies during the great recession of 2009. Few would have bet on a 2.1% growth rate for the emerging countries during a year in which the economic activity of the most developed ones plummeted by 3.2%. But this is what happened in 2009. It's no surprise that, given this evidence, a debate has now been started regarding a change in the world's growth engines. In other words, will the emerging world be able to offset the impact on global growth of a slowdown in domestic demand in the United States and other advanced economies?

Without doubt, due to their dynamism and demographic weight, China, India and Brazil are the emerging countries with the greatest economic potential. Their contribution to global GDP in terms of purchasing power parity reached 20% in 2009, equalling the weight of the United States and of the European Union. In particular, 12% of global GDP came from China, while India and Brazil produced the remaining 8%. Moreover, the outlook is good: the latest IMF forecasts predict that China will regain the 10% annual growth rates it had reached in the past and that have turned the country into the third largest economy in the world, after the United States and Japan. For their part, in the coming years India and Brazil are likely to exceed their average growth rates of 7.2% and 3.5% respectively, achieved in the decade prior to the crisis. The possibilities of recovery offered by Russia, often put together in the same basket as the three other countries under the acronym BRIC, are slightly worse, given that its weak industrial base and, in general, its still relatively unattractive business environment continue to hinder its potential growth.

In some respects, the big emerging economies are already the main engines of the world economy. In 2010-11, for example, the BIC (Brazil, India and China) will contribute 1.7 annual percentage points to global growth, accounting for 40% of the total (measured in purchasing power parity). China alone will add 1.2 percentage points or 30% of global progress, more than double the United States' contribution. The growing economic weight of the emerging countries, together with the maintenance of high growth rates, explains the rise in their contribution to growth in the world economy (see the graph below).

However, in spite of the BIC's importance to global growth and especially that of China, their capacity to boost demand in the rest of the world is still limited. An example will help to explain this. Let us suppose that China's domestic demand grows to such an extent that its (net) imports increase by 200 billion dollars in one year. This figure would eliminate the trade surplus recorded in 2009, equivalent to 4% of Chinese GDP; no mean feat. Nevertheless, this would add, directly, a modest 0.4% to the rest of the world's GDP. To this calculation we should also add an estimate of the possible multiplier effect of Chinese purchases as a result of the rise in employment and salaries in the rest of the world, which would also expand world demand. There are few estimates of this multiplier effect but they generally place it between 1 and 2. So, in total, the overall effect might be twice the direct effect: hence, a rise in net imports equivalent to 4% of Chinese GDP would increase GDP in the rest of the world by at most 0.8%, or around 400 billion dollars. By way of comparison, this is approximately equivalent to 1% of the domestic demand of advanced economies.

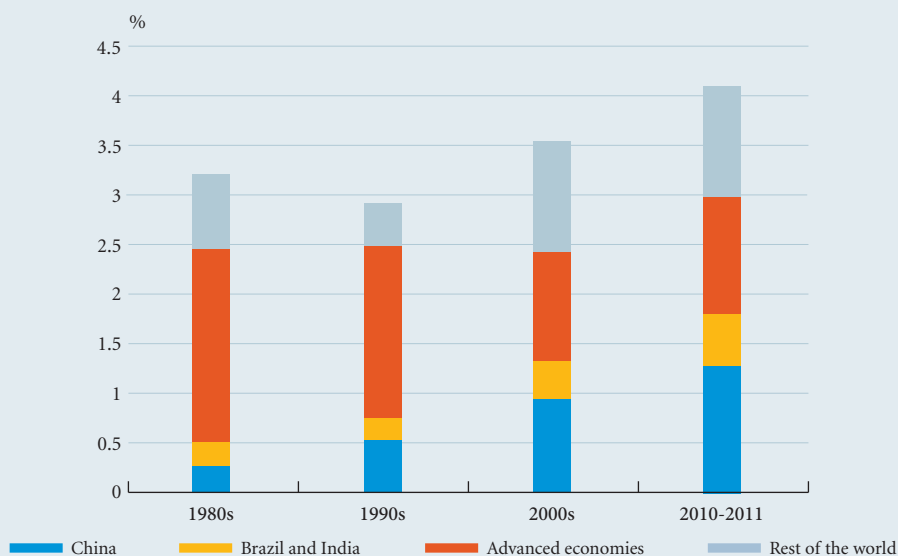
Although this effect is significant, we must admit that such a drastic reduction in the Chinese trade balance over a short period of time is highly unlikely. If such an adjustment occurred over four years, the rise in demand over the rest of the world would only reach 0.2% per year. In the case of India and Brazil, whose

aggregate economic weight is less than that of China, the impact would be even less, especially so given that these countries' aggregate trade deficit limits the margin for increasing net imports.

In the longer term, emerging consumers will have a lot more clout in the global economy. With 40% of the world's population and extraordinary economic growth rates, it is estimated that, in the next twenty years, more than 500 million people will join the rising middle class, which will triple its size in these economies. This segment of the population constitutes those people capable of acquiring goods and services that may be imported from other countries. The introduction of economic reforms aimed at reducing the high savings rate in China, where household consumption only accounts for 35% of GDP, much lower than the 50% average in the rest of Asia and the more than 60% in advanced economies, will also help to increase the influence of consumers from the Asian economic giant on the global market, in addition to being needed to ensure its sustained growth.⁽¹⁾

THE BIG EMERGING ECONOMIES, ESPECIALLY CHINA, KEY TO GLOBAL GROWTH

Contribution to global growth, percentage points
(weight in purchasing power parity)



SOURCE: IMF (WEO October 2009 and Update January 2010).

In short, in spite of the importance of the big emerging countries for global growth, it is still premature to consider them as engines behind demand in the rest of the economies. However, no-one doubts their driving capacity in an increasingly nearer future.

(1) With this aim in mind, the Chinese authorities have already announced the gradual extension of public health cover and the pension system, among other measures.

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China's growth forecasts are above 9%.

China: really cruising

According to the World Bank, China will grow by 9.5% in 2010, after an advance of 8.7% last year. The new report upgrades the forecasts due to its economy's good performance during the crisis and the recovery in production and world trade in the second half of 2009. In addition to dealing with the recurring themes required by any analysis of the Asian giant, the study also highlights two macroeconomic risks: the formation of a speculative bubble in the real estate market, whose prices are still rising; as well as the potential financial difficulties of local governments after the massive investment made in infrastructure.

This strong investment has contributed significantly to Chinese economic growth in 2009. However, lower revenues than expected in infrastructure projects, together with the leading role played by bank credit in its funding, might weaken both the banking sector (with a resurgence in non-performing loans) and also local government, the main suppliers of health, education, and social security.

The CPI soars in February due to food prices.

Concerned about the possible increase in non-performing loans and the risk of

the economy overheating, the monetary authority continues to introduce measures of control. After several increases in the cash ratio, and still refusing to raise the interest rate, the central bank has set the bank lending target at RMB 7.5 trillion per year (\$ 1.1 trillion) compared with the RMB 9.6 trillion in loans granted in 2009. For now, overheating is more a risk than a reality. In particular, February's rise in inflation to 2.7% is basically due to higher food prices, a consequence of the cold of the last few months, and to the seasonal effects in the calendar shift of the Chinese New Year from January in 2009 to February in 2010.

Business indicators continue to show the country's vitality. To start with, industrial production for January and February combined grew 20.7% year-on-year, compared with a 17.9% average in the fourth quarter. The purchasing managers' index (PMI) is still above 50 points - the boundary between recession and expansion, although somewhat lower than in previous months. For its part, domestic demand continued to rise and revealed a certain slowdown in investment growth compared with the acceleration in consumption.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2009				2010	
			1Q	2Q	3Q	4Q	January	February
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	20.7	20.7
Electrical power generation	15.7	6.7	-4.3	-0.4	8.0	24.3	24.7	24.7
Consumer prices (*)	4.8	5.9	-0.6	-1.5	-1.3	0.7	1.5	2.7
Trade balance (**)	262	298	319	296	252	198	173	176
Reference rate (***)	7.47	5.31	5.31	5.31	5.31	5.31	5.31	5.31
Renminbi to dollar (*)	7.6	6.9	6.8	6.8	6.8	6.8	6.8	6.8

NOTES: (*) Average.

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

(***) Percentage at end of period.

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

In particular, investment rose 26.6% year-on-year in February, clearly below the average of 32% in the last quarter. Joint retail sales for January and February also rose 17.9% year-on-year in real terms.

Lastly, in terms of the foreign sector, the trade balance surplus fell again due to the rise in imports, in January-February 55% below the same period a year ago (by 21.8 billion dollars). Combined imports grew by 64% year-on-year and exports by 31%. This adjustment in the trade surplus reduces the possibility of an appreciation in the renminbi in the short term. However, it seems unavoidable that, during the second half of the year, China will reintroduce greater flexibility in the exchange rate as a further instrument to avoid the aforementioned risk of overheating.

Brazil: full steam ahead

The recession in Brazil was short-lived and left no big scars on the economy. After already getting back to growth in the second quarter of the year, the

Brazilian economy has left 2009 with a minimal overall decline of 0.2%. Moreover, in the fourth quarter, and after four negative postings, it already recorded its first year-on-year advance. No less than 4.3%! Not a brilliant figure if we compare it with that of China or India but certainly sparkling with respect to most of the others. And a figure that not only confirms the solidity of its recovery but also promises a 2010 at cruising speed.

Once again, domestic demand has reaffirmed its role as the main engine of recovery. With a 7.7% rise year-on-year, consumption has proven its resistance and, at the same time, the effectiveness of the fiscal and monetary support. For its part, investment continues to pick up and has posted its first year-on-year growth, of 3.3%, after three quarters in negative figures. Public expenditure is also back in the black, and significantly so: 5.5% compared with the same period in 2008. Consequently, the only items that still have negative year-on-year figures are those of the foreign sector: 13% for exports and 12% for imports. Nonetheless, these are slowing up their

Once again, the rest of the indicators continue to show the Chinese economy's vigour.

Brazil's economy has left 2009 with a minimal decline and embraces a 2010 of spirited recovery.

Again, domestic demand is fuelling growth and exports are getting back on track.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2009				2010	
			1Q	2Q	3Q	4Q	January	February
Real GDP	6.1	5.1	-1.9	-1.7	-1.4	4.3	—	...
Industrial production	5.9	2.9	-13.8	-11.3	-8.6	5.9	16.3	...
Consumer confidence (*)	132.3	140.4	128.5	128.4	141.9	154.2	158.7	159.0
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	4.8
Trade balance (***)	40.0	24.8	25.1	27.5	26.4	25.3	25.7	24.3
Interest rate SELIC (%)	12.75	11.25	11.25	9.25	8.75	8.75	8.75	8.75
Reales to dollar (*)	2.1	1.8	2.3	2.0	1.8	1.7	1.9	1.8

NOTES: (*) Value.

(**) Percentage of labour force.

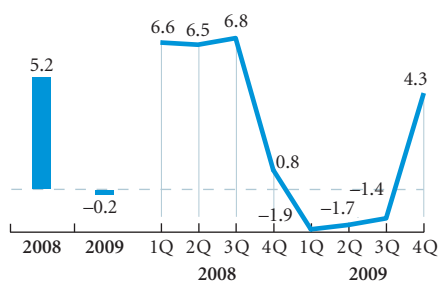
(***) Cumulative balance for 12 months. Billion dollars.

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

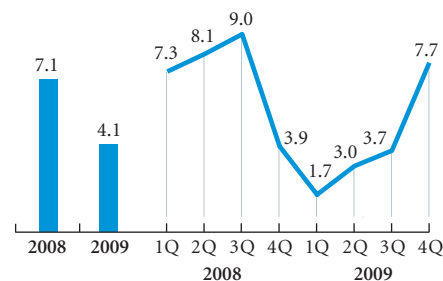
TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms

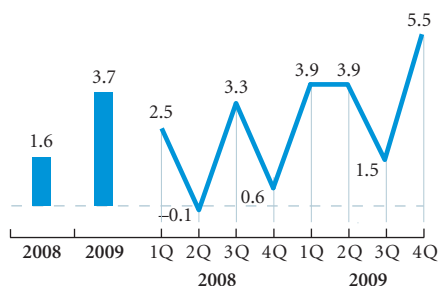
GDP



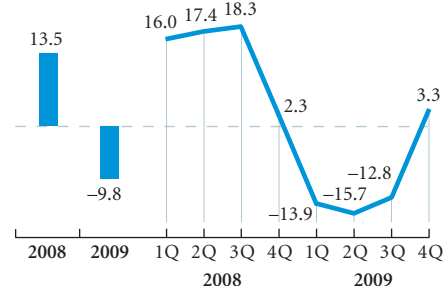
Private consumption



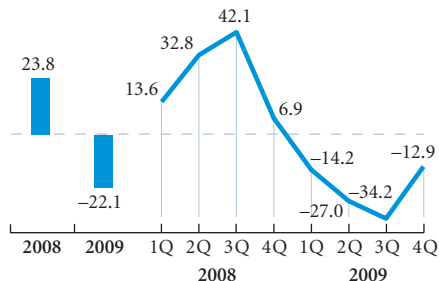
Public consumption



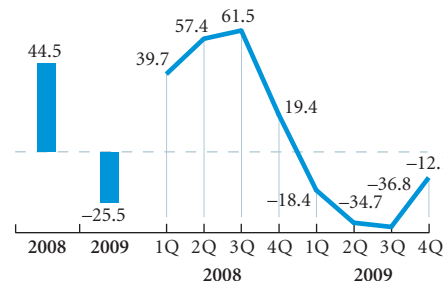
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



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

The real and inflation continue to advance and the central bank is holding interest rates steady... in March.

decline and, compared with the previous quarter, have even ostensibly advanced: 14% and 20%, respectively. For the whole of the year, the final balance was positive for consumption, both private and public, and negative for the rest (see graph above).

Given these results, Brazil's macroeconomic situation continues to invite optimism: an optimism that is both the cause and effect of domestic

confidence at historically high levels and a growth that is expected to be around 5% in 2010. The Brazilian Finance Minister himself agrees with this prediction and links it both to the continued pattern of consumption and also to the upswing in investment, this being driven by the need for new infrastructures because of the Olympic Games in 2016 and offshore oil drilling. For 2011, once the base effect of the crisis has disappeared, the impact

of last year's expansionary policies has dissipated and the stimuli have been withdrawn, growth will return to levels more in line with its potential, around 4%.

In this respect, an opening salvo of monetary adjustment is imminent, very likely in April itself, and fiscal consolidation will have to come sooner

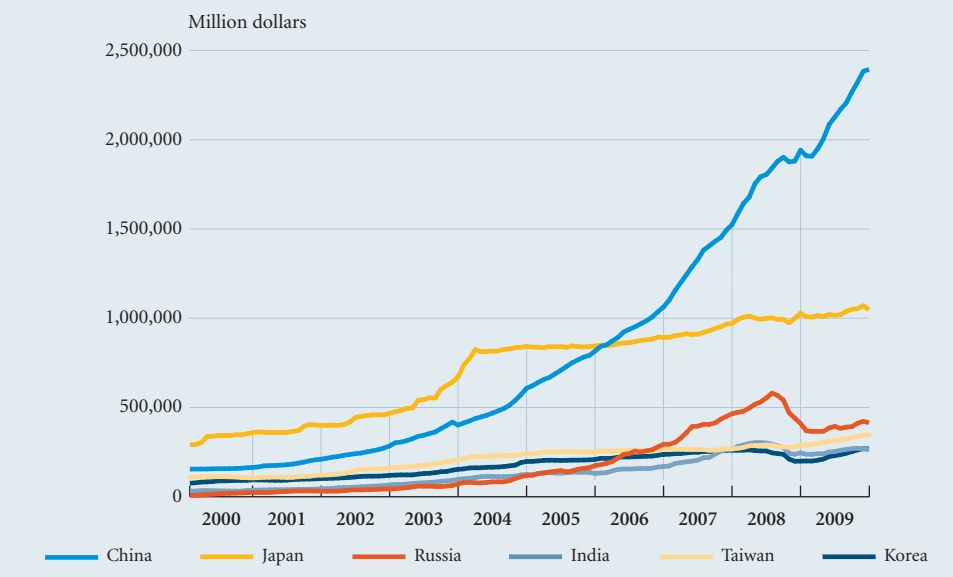
or later, although no-one expects this before October. Sooner rather than later if Brazil wishes to keep its commitment to macroeconomic stability that stood it in such good stead when the crisis started. Ultimately, although the wind may now be blowing in its favour, this always ends up turning and, when this happens, it's best to have the sails under control.

Foreign exchange reserves: the mountain keeps on growing

In his memoirs, Hank Paulson, Treasury Secretary of the United States, recounts a surprising episode at the toughest moment in the global financial crisis. Early in August 2008, coinciding with the start of the Beijing Olympics and the Russian invasion of Georgia, Dimitri Medvedev's Russian government suggested to Beijing a strategic mass sale of Fannie Mae and Freddie Mac bonds. The aim was to force the US government to bail out these government-sponsored enterprises and stop the bonds from losing all their value. China refused but finally both companies (privately owned but with the government's implicit guarantee) were seized by the White House. Russia ended up selling all its bonds, valued at more than 65 billion at the start of the year.

CHINA IS STOCKPILING RESERVES

Official currency reserves of the main holders



SOURCES: International Monetary Fund and Thomson Reuters Datastream.

How can a country that is considered as emerging influence the financial policy of the world's leading economy, hastening the crisis of two bastions of its financial system? The explanation lies in the huge accumulation of foreign reserves by emerging countries. These funds, managed by central banks, are held in secure, liquid assets (the yield is not what matters most), such as the public debt of developed countries and, more specifically, US Treasury bonds or agency or corporate debt backed by the US government. Two thirds of the around 7.5 trillion dollars that go to make up the worldwide official foreign exchange reserves are held in dollars. The advent of the euro has scarcely altered the US currency's predominance.

Since the Asian and Russian crises in 1997 and 1998, emerging countries' foreign reserves have grown to unprecedented levels. The monetary crises of the 1990s, with their corresponding indiscriminate contagion and subsequent requirements for adjustments, highlighted the financial fragility of these countries. The reaction was to hoard foreign assets to create a protective shield against possible further crises. In spite of the fact that, in general, many emerging economies have adopted reforms to liberalise their financial systems and have joined the world economy, their monetary and financial authorities' hunger for reserves has not been

FOREIGN RESERVES (1)

Value at year-end

	In billions of US dollars			By percentage of:						
	1996	2008	2009	GDP 2008	Short-term external debt (2)			Imports		
					1996	2008	2009	1996	2008	2009
Asia (3)	477	3,320	3,355	45	170	589	595	49	74	83
China	105	1,946	1,954	44	376	1,865	1,873	76	172	186
India	20	247	242	20	260	333	324	55	85	88
Korea	33	200	212	21	45	173	177	22	46	55
Others Asia (4)	319	927	948	52	145	502	511	48	62	72
Latin America (5)	142	440	410	13	145	369	300	89	71	69
Brazil	58	193	186	12	111	342	329	109	111	115
Chile	16	23	24	14	201	113	114	89	40	47
Mexico	19	94	84	9	60	241	218	21	30	29
CEE (6)	53	233	211	17	504	107	92	36	43	...
Middle East (7)	17	54	47	9	111	112	90	34	41	...
Russia	11	413	368	25	42	509	446	16	141	143
<i>Pro memoria:</i>										
<i>Net oil exporters (8)</i>	93	885	...	21	200	1.862	...	42	87	...

NOTES: (1) Regional aggregates are the sum of the listed economies; the percentages are simple averages. For 2009, data from the beginning of the year.

(2) Consolidated cross-border claims of all BIS reporting banks outside the reporting area with maturities of up to one year plus international debt securities outstanding with residual maturities of up to one year.

(3) Listed countries.

(4) Philippines, Hong Kong, Indonesia, Malaysia, Singapore, Taipei China and Thailand.

(5) Countries specified plus Argentina, Colombia, Peru and Venezuela.

(6) Central and Eastern Europe: Bulgaria, Croatia, Slovakia, Slovenia, Estonia, Hungary, Latvia, Lithuania, Poland, the Czech Republic and Romania.

(7) Saudi Arabia, Kuwait and Qatar. For Saudi Arabia, excluding investment in foreign securities.

(8) Angola, Algeria, Kazakhstan, Mexico, Nigeria, Norway, Russia, Venezuela and the Middle East.

SOURCE: Bank for International Settlements (BIS).

checked. This accumulation reflects the need to avoid speculative attacks and to have the ability to rescue their banking systems, to carry out exchange rate interventions and, in short, not to have to rely on foreign organisations in the case of a lending crisis.

But the relentless accumulation of international reserves exceeds the levels considered as reasonable for these needs. As reflected in the table, in Asia's emerging economies foreign reserves are six times the short-term external debt (it is considered enough to cover 100%) and account for more than 80% of annual imports (the normal level would be 25%-50%). The case of China is particularly noteworthy, where foreign reserves are eighteen times its short-term external debt and almost double the annual volume of imports. Brazil and Russia also seem to be very well covered in the case of a hypothetical international monetary crisis. In fact, in general emerging economies have not been seriously affected by the global financial crisis and have managed to come out of it much better than on previous occasions.

The key to understanding these huge levels of official foreign reserves is the international imbalance in balance of payments. The data gathered by the International Monetary Fund show a high correlation between the current surpluses of emerging economies and the increase in their foreign reserve holdings. Since the beginning of the century and up to the middle of 2008, most emerging economies experienced high growth, very much oriented towards exports and associated with rising national savings rates and strong inflows of foreign capital. The combination of large current account surpluses and high capital inflows has led to strong appreciation pressures on the currencies of many emerging countries. The refusal to allow a currency to appreciate forces exchange rate interventions and swells the foreign reserves in central banks. China is the leading exponent of this policy, having become the main holder of reserves. This circuit comes to a close in the high, persistent current deficit of the United States which, thanks to the privileged position of the dollar in the international monetary system, can easily finance a voluminous foreign imbalance.

This situation is worrying due to its potentially destabilising effect. Firstly, it's not realistic to assume an unlimited foreign debt capacity, not even for the United States. Secondly, imbalances in currency markets may continue for a good while yet but, at some point, they may lead to a sudden crisis if the confidence they rely on disappears. And, thirdly and most importantly, this situation has an expansionary effect on global liquidity (forcing interest rates down), something that has been present in the genesis of the current global financial crisis.

How can this tendency to accumulate foreign reserves be corrected? The United States and emerging countries are trapped in a kind of prisoner's dilemma where they can't make up their minds whether to cooperate or not. Consequently, a significant part of US public debt is in the hands of foreign central banks that could therefore affect its markets. This could result in a worrying dependency between countries that are perhaps not on very friendly terms. From the other point of view, the dollar's pre-eminence creates unease among those in charge of the currency portfolio of emerging countries. On more than one occasion, China has stated its intention to diversify beyond the dollar, but selling assets in dollars means taking on the risk of depressing these markets, automatically depreciating the value of its foreign reserves: a bad business. For its part, the United States accuses China of artificially keeping its currency devalued. If the Chinese authorities allowed the renminbi to appreciate, the Asian giant's trade imbalance would reduce and China's accumulation of foreign reserves might stabilise. But the Chinese authorities don't seem to be interested.

Adjusting the current volumes of currency reserves towards more reasonable levels and neutralising their destabilising potential would entail reducing the imbalances of the United States economy, as well as the emerging countries accepting more realistic exchange rates and diversifying their foreign reserve holdings in terms of currency and instruments. Until this happens, we will be subject to surprises such as Hank Paulson's in the summer of 2008.

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Mexico is still working to strengthen recovery and economic stability.

Mexico: lessons can also be learned from the crisis

Mexico faced the crisis with relative macroeconomic stability but its economy nonetheless suffered the ravages of recession like few others in Latin America. The size of the fall in GDP in 2009, namely 6.5%, highlighted, on the one hand, its great exposure to fluctuations in manufacturing in the United States and, on the other, the insufficient capacity of fiscal and monetary support to mitigate the combination of a fall in foreign demand and the plummeting of

domestic expenditure. Although this time Mexico was able to resort to counter-cyclical economic policies to tackle its economic adversity, its room for manoeuvre was limited. A limitation that both Calderón's government and the central bank of Mexico are trying to amend, at least in part, with their latest initiatives.

The need for greater international reserves was one of the lessons learned by the Mexican authorities from the crisis. That's why, in the last week of February, the Exchange Commission, made up of members of Banxico and

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2009				2010	
			1 Q	2 Q	3 Q	4 Q	January	February
Real GDP	3.3	1.5	-9.1	-8.5	-6.1	-2.4	—	...
Industrial production	1.9	-0.9	-9.6	-9.6	-6.5	-2.0	4.8	...
Consumer confidence (*)	104.9	92.2	80.1	80.5	83.0	78.4	82.1	80.6
Leading business index	116.5	118.0	108.9	108.3	111.1	113.1	...	...
General unemployment rate (**)	3.7	4.0	5.0	5.2	6.3	5.3	5.9	5.4
Consumer prices	-22.7	-11.8	6.2	6.0	5.1	4.0	4.5	4.8
Trade balance (***)	-10.1	-17.3	-17.6	-15.9	-12.6	-4.7	-3.5	-2.7
Official Banxico rate (%)	7.00	7.50	6.75	4.75	4.50	4.50	4.50	4.50
Mexican pesos to dollar (*)	11.0	10.6	14.2	13.2	13.5	13.1	13.0	12.8

NOTES: (*) Value.

(**) Percentage of labour force.

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

SOURCES: Banco de México and own calculations.

the Tax Office, established a new procedure to swell its coffers of reserves. At the same time, this Commission also requested the renewal, for one year, of the line of credit taken out in April 2009 with the International Monetary Fund. Although this line of credit was never used, it did help to increase investor confidence in the stability of the Mexican economy, so the idea behind extending this is to deal with the risks that still hover over the Aztec economy's recovery. In any case, as reserves are topped up, Mexico plans to gradually reduce its dependence on this line of credit and a progressive recovery in the current account balance will speed up this process.

Another flank to be reinforced, clearly revealed by the crisis, is its room for manoeuvre in fiscal terms. Given Mexico's extraordinary exposure to the recession in the United States, the size of the public push was completely insufficient, although the government couldn't really do much more. Expanding this capacity requires far-reaching reforms in public accounts and President Calderón's government is aware of this. Its new austerity plan predicts savings of more than 3 billion dollars in three years and, although this is merely a first step, it does add its own grain of sand. The key lies in fiscal reform that, according to the government's plans, should be approved before the autumn. Overall, it's not clear whether this reform will manage to correct the historic vulnerabilities of Mexico's public revenues: its over-dependence on oil revenues and widespread tax evasion. In this respect, it is to be expected that, sooner or later, although perhaps not by September, the necessary consensus will be reached to achieve such a reform.

In any case, leaving to one side the gaps uncovered by the last slump, the improved economic situation in Mexico is more than evident and leading indicators for business point towards this continuing. Nonetheless, domestic demand is still convalescing so that, in the short term, the Mexican authorities are bound to maintain their stimuli in order to avoid any risk of relapse. A lesson we already learned from previous crises.

Oil and metal prices on the up

Oil prices went above 80 dollars in spite of the dollar holding on to its gains. Between 18 February 2010 and 18 March 2010, crude rose 5.2%, reaching 81.39 dollars per barrel (Brent quality, for one-month deliveries). This means that crude has gained 4.6% this year while the dollar has gained 5.4% compared with the euro.

The expected recovery is pushing petrol prices up in the short term. However, higher rises are limited by the excess capacity of the OPEC countries. This organization decided to keep its quotas in spite of the latest appreciations and expects that the price of crude will continue within a range of 75-85 dollars per barrel.

As far as the rest of commodities are concerned, the rise in metal prices was offset by falls in food prices. Consequently, the Economist index remained almost unaltered, losing 0.3% between 18 February and 18 March. Of note in metals were the rises in iron, nickel and aluminium. Chile, the world's largest producer of copper, closed several mines because of the earthquakes, but the larger ports of Antofagasta and

Foreign demand continues to drive the Mexican recovery while domestic demand remains timid.

Crude goes over 80 dollars per barrel in spite of the strong dollar.

The recovery is boosting oil prices.

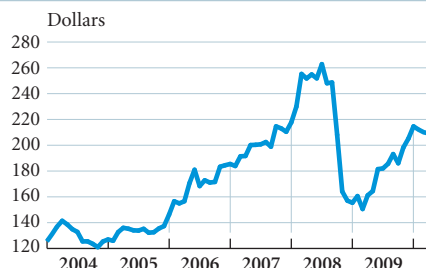
Metals continue to rise while food falls, led by sugar.

Mejillones were unaffected. Consequently, the increase in copper was relatively more moderate after its steep appreciation at the beginning of the year. Precious metals such as platinum and

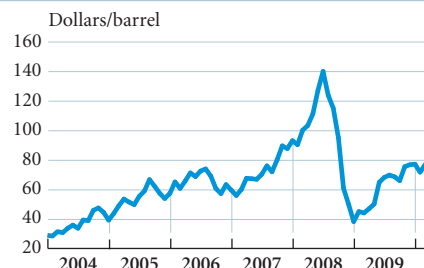
palladium also rose, while gold held steady above the level of 1,100 dollars per ounce. In foods, of note was the slump in sugar, losing 30% after harvests that turned out to be better than expected.

TREND IN VARIOUS COMMODITIES (*)

«The Economist» index



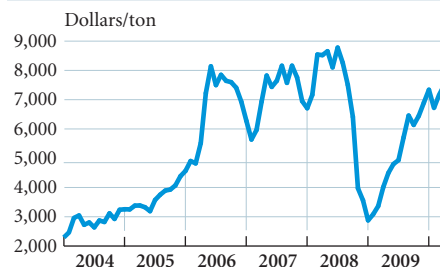
Brent oil



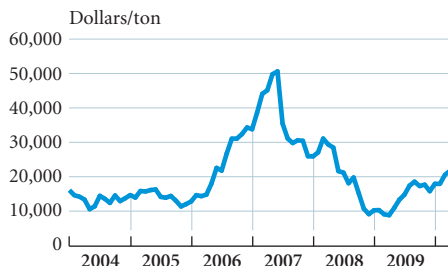
Gold



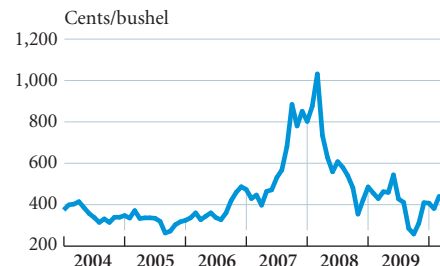
Copper



Nickel



Wheat



NOTE: (*) Figures for last day of month (last date March 18).

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

EUROPEAN UNION

The Euro area: a recovery, but a weak one

Without realising it, we have already left behind the first quarter of 2010 and, for the moment, the only good news in the

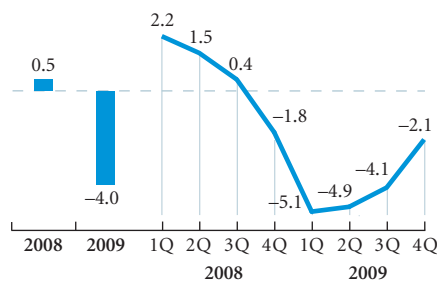
euro area is the arrival of spring and the good weather, as the economic situation still leaves much to be desired. Before entering into detail in our analysis of the latest economic indicators and their future trends, it's worth going back in

The euro area is coming out of recession but at a very slow pace.

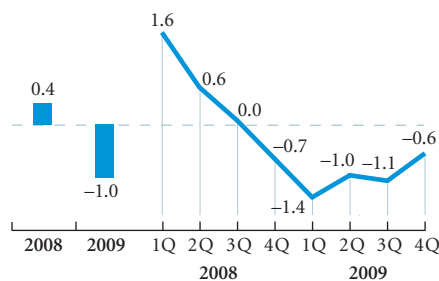
TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change

GDP



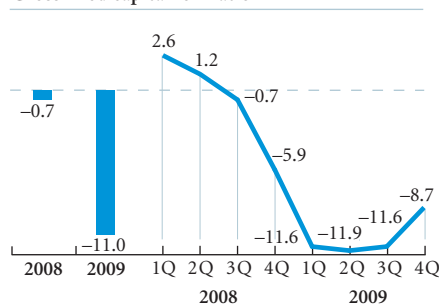
Private consumption



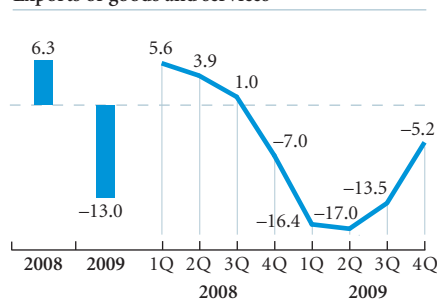
Public consumption



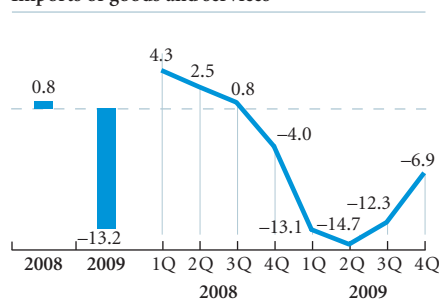
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



SOURCES: Eurostat and own calculations.

Consumption and investment are decelerating recovery...

time a bit. Last month saw the publication of the growth rate for the euro area for the fourth quarter, a miserable rise of 0.1% quarter-on-quarter. Now Eurostat has published the trends in the different components of gross domestic product (GDP). We must look at these to gain insight into the drivers behind the recovery process and the elements that are decelerating it.

Both consumption and investment remained very weak and are still limiting the euro area's capacity to recover. Investment in particular fell 0.8% compared with the previous quarter and deducted 0.2 percentage points from GDP growth. Although it's true that the speed of decline has slowed up considerably, reaching -5.4% in the first quarter of 2009, the recovery is still going at a somewhat slower pace than initially predicted. And nothing suggests things have changed much in the first quarter

of this year. The recovery in the industrial production index continues at a good pace and, in the month of January, reached positive year-on-year growth. Under normal conditions, this would indicate an imminent recovery in investment but the low utilization of production capacity, still at a record low, does not promise a very encouraging future. The business confidence indices don't point towards a very buoyant exit from the recession either. Although most are on the road to recovery, the exit they outline is quite flat.

The profile of recovery for private consumption is not so negative but neither does it predict a fast return to growth rates similar to those enjoyed before the recession. In the last quarter of 2009, these were completely flat, so that the year-on-year rate of change stood at -0.6%. As in the case of investment, the different indicators of

...and the short-term outlook is not too encouraging.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
GDP	0.5	-4.0	-5.1	-4.9	-4.1	-2.1	-	...
Retail sales	-0.7	-2.2	-3.3	-2.5	-2.1	-1.1	-1.3	...
Consumer confidence (1)	-18.1	-24.7	-32.5	-27.9	-21.4	-17.0	-15.8	-17.4
Industrial production	-1.7	...	-18.5	-18.7	-14.5	-7.5	1.9	...
Economic sentiment indicator (1)	93.5	80.8	71.5	75.6	84.1	91.9	96.0	95.9
Unemployment rate (2)	7.5	9.4	8.8	9.3	9.6	9.9	9.9	...
Consumer prices	3.3	0.3	1.0	0.2	-0.4	0.4	1.0	0.9
Trade balance (3)	-1.2	-14.4	-36.3	-31.2	-5.2	15.2	...	...
3-month Euribor interest rate	4.6	1.2	2.0	1.3	0.9	0.7	0.7	0.7
Nominal effective euro exchange rate (4)	110.6	111.7	109.9	111.0	112.1	113.8	110.8	108.0

NOTES: (1) Value.

(2) Percentage of labour force.

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

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

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

the mood of consumption in the first quarter of 2010 did not paint a very encouraging picture. Retail sales, the high frequency reference indicator, continues its slow, erratic recovery. After improving moderately in December, placing the year-on-year rate of change at -0.5%, in the month of January it slid back a little to -1.3%.

Weak demand is patent in other indicators. Inflation, for example, remains far below the average for the last 15 years, namely 1.9%. In the month of February, the year-on-year change in the harmonized consumer price index fell back one tenth of a percentage point to 0.9% and core inflation fell to 0.8%. Although the debate concerning the risk of deflation may gain some ground over the coming months, we do not expect inflation to fall much further. In fact, it should gain strength in the second half of the year, when consumption starts to pick up with a little more conviction. The fundamental keys to this happening

are the future developments in the labour market and the speed and extent of deleveraging.

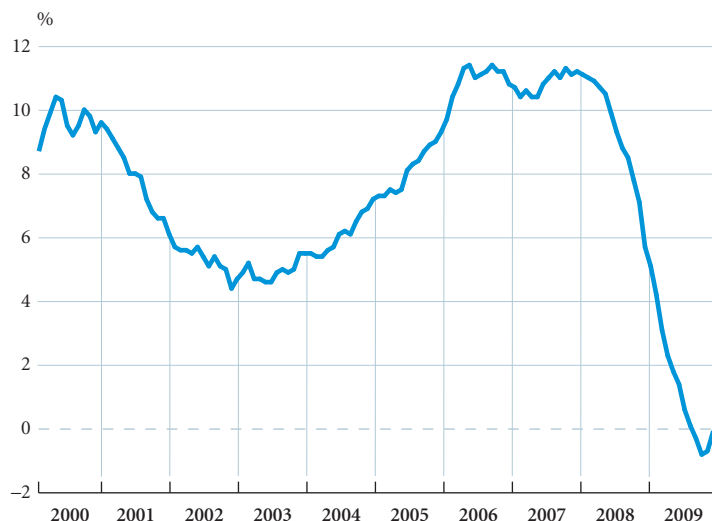
In terms of the labour market, unemployment seems to have hit a ceiling over the last few months. In the month of January, it held steady at 9.9% so that, in the last six months, it has only risen three tenths of a percentage point. We can't rule out an increase over the coming months and, in fact, it might even reach values close to 10.5%, but it's more than likely that, by the end of the year, unemployment will start to fall again. This would undoubtedly be of great help to the recovery in consumption as, in addition to the rise in disposable income for households, it would also considerably reduce the uncertainty that, today, has forced families to increase savings as a precaution.

The deleveraging process will take a bit longer to complete and, in part, this will be one of the factors that will stop

Consumption will remain weak due to high unemployment...

THE DELEVERAGING PROCESS SLOWS UP ITS RECOVERY

Year-on-year change in credit in the euro area



SOURCES: European Central Bank and own calculations.

...and the deleveraging process.

consumption from growing again at cruising speed in the medium term. The year-on-year rate of change in credit is still down in the dumps, with its decline reaching 0.6% in the month of January. It has now been in negative terrain for the last five months and all evidence suggests that this situation will continue over the coming months.

To end our review of the trends in the different GDP components for the fourth quarter, we have yet to mention the performance of the foreign sector. As expected, this continued to sustain the recovery process. The very flexibility that led to the slump in this sector at the end of 2008 is now helping it to exit the recession quite quickly. Exports were up 1.7% compared with the previous quarter and still show no signs of weakness. The rise in imports was also notable, specifically 0.9%, but as a whole the foreign sector added 0.3 percentage points to the euro area's growth. This performance should at least continue for the first half of the year and, in fact, the weak euro predicted for the coming months might extend its contribution into the second half.

So the euro area's road to recovery is not looking very encouraging. The worst of the recession is now behind us, that's true, but economic activity will take a very long time to get back to normal. At present, our forecasts place GDP growth for 2010 as a whole at around 1 but there are clear risks of this being lower. Moreover, it remains to be seen how well the different member states can coordinate the withdrawal of expansionary fiscal policies and how this, in turn, fits with the start of interest rates hikes by the European Central Bank (ECB). At present, its ability to react and coordinate when faced with the crisis sparked by Greece's public debt has

managed to calm the markets but the case has not been closed. We must monitor all this very closely over the coming months.

The German economy is affected by low temperatures

The stagnation of the German economy over the last three months of last year decelerated the recovery started in the second quarter of 2009. A breakdown of GDP shows that the foreign sector was the only one to drive the German economy, with a contribution to growth of 2.2 percentage points in this period. This significant contribution by foreign demand, the largest since the start of the crisis, was offset by a weakening in the rest of the components, particularly stocks. Data available for the first few months of 2010 do not show any signs of improvement in the first quarter.

In January, the trend in the foreign market was less positive, with the trade balance falling back 47.6% compared with the previous month. This was due to higher imports and lower exports, a result of the lower demand for German goods by countries in the European Union. Although the monthly data for international trade are usually quite volatile, this figure highlights the need for domestic demand to recover so that Germany can get back on a sustainable track of growth over the coming months.

On the supply side, monthly indicators showed a certain upswing in January. Consequently, in spite of being at levels similar to 2004, industrial production increased compared with the same month in 2009, recording the first year-on-year rise for the last year and a half. Industrial orders, which are usually

The foreign sector continues to support recovery.

The German foreign sector is the only one to grow in the fourth quarter de 2009.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
GDP	1.0	-4.9	-6.7	-5.8	-4.8	-2.4	-	...
Retail sales	0.0	-2.1	-2.9	-1.8	-2.3	-1.7	-4.0	...
Industrial production	-0.1	-16.0	-19.9	-19.2	-15.5	-8.7	2.1	...
Industrial activity index (IFO) (*)	96.8	87.7	82.6	84.8	89.9	93.5	95.8	95.2
Unemployment rate (**)	7.8	8.1	8.0	8.2	8.2	8.1	8.1	8.2
Consumer prices	2.6	0.4	0.9	0.3	-0.3	0.4	0.8	0.6
Trade balance (***)	195.0	140.2	160.2	140.3	131.0	129.5	136.6	...

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.

ahead of production trends, grew by 4.7% month-on-month in January, pointing towards activity livening up in the coming months.

However, as shown by the IFO business sentiment index, the upswing in business did not arrive till March, due largely to the adverse weather conditions in February. Moreover, as can be seen in the graph below, in spite of the increased industrial capacity utilization in the first quarter, this has only recovered a third of its drop since the start of the recession. This suggests that investment won't show any significant signs of improvement until the second half of 2010.

Private consumption is unlikely to boost the economy over the coming months either. Retail sales were down once again in January, with a fall of 4.0% year-on-year, and the withdrawal of state aid for vehicle purchases led to another fall in registrations in February, 29.8% year-on-year. This weak demand resulted in another drop in inflation, which stood at 0.6% the same month, two tenths of a percentage point below the figure for January.

Weak consumption can largely be explained by the uncertainty hovering over the labour market. On the one hand, the unemployment rate increased after remaining stable for four months, standing at 8.2% in February. As already mentioned on other occasions, the reason for such a moderate decline in unemployment was, to a large extent, due to the short-time working scheme (*kurzarbeit*). In spite of this, the application of this measure and lower overtime resulted, in 2009, to an average drop in employees' wages of 0.4%, the first since 1949.

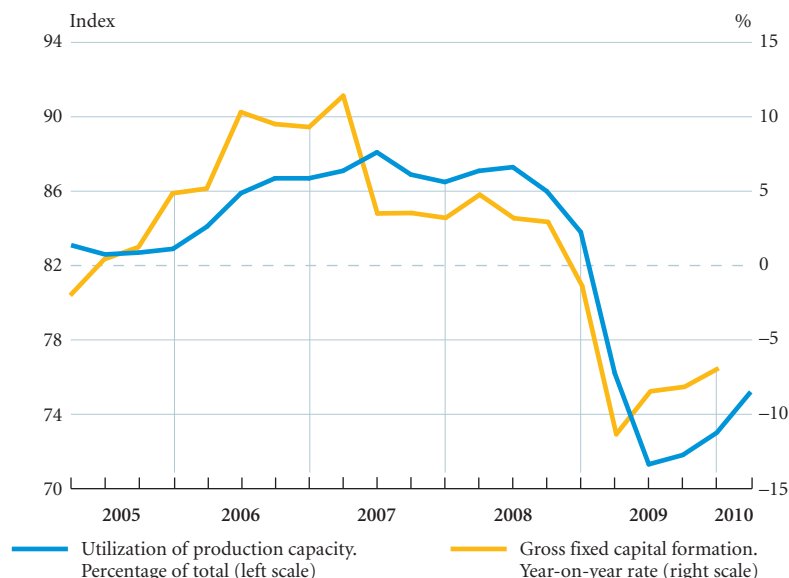
Within this context, public expenditure is not expected to be one of the main sources of growth for the economy. Consequently, given the forecasts for the German deficit, above 5.0% this year (3.3% in 2009), the German government decided to reduce spending in 2010 by close to 5.6 billion euros. The lower decline expected in the job market will permit a large part of this cut by reducing the spending on unemployment benefit. This gesture has undoubtedly not gone unnoticed in the European Union, at a time when fiscal

Industrial activity shows signs of improvement in January.

Private consumption will remain weak during the first few months of the year.

THE LOW UTILIZATION OF PRODUCTION CAPACITY KEEPS INVESTMENT ANCHORED

Utilization of production capacity and investment



SOURCES: Deutsche Bundesbank and own calculations.

The German government cuts its spending budget for 2010.

imbalances are hurting more than one member state.

In short, supply and demand indicators do not predict that the German economy will take off in the first quarter of the year, with growth close to zero. Consequently, our growth prediction for 2010 has been downgraded by 0.2 percentage points (from 1.6% to 1.4%), as no strong upswing in the economy is expected until the second half of the year.

Unemployment and debt mar the French recovery

Available indicators show that the French economy has maintained the recovery started in the second quarter of 2009. Consequently, industrial production grew 3.5% year-on-year in January, after almost two years of

negative figures. Other indicators of industrial activity, such as registrations or the index of industrial orders, also point towards an improvement in the overall French economic situation for the first quarter of 2010. The favourable trend in the number of firms created should also be noted, up month-on-month by 11.3% in February. Along these lines, the report on the overall economic situation published by the Bank of France on 8 March announced slightly positive growth in activity in the first quarter of 2010, with a 0.4% rise in GDP quarter-on-quarter.

Looking at demand, it's important to note the trend in private consumption, as this variable has played a key role in the French economy's recovery. In fact, household consumption increased 1% in 2009 in spite of such an adverse economic situation. This was possible because the French government's social

French business indicators show improvement...

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
GDP	0.3	-2.2	-3.5	-2.7	-2.3	-0.3	-	...
Domestic consumption	-0.6	1.0	-0.8	0.5	-0.1	4.4	1.5	1.6
Industrial production	-2.4	-11.8	-15.7	-15.2	-11.2	-4.5	3.5	...
Unemployment rate (*)	7.9	9.4	8.9	9.3	9.6	10.0	10.1	...
Consumer prices	2.8	0.1	0.6	-0.2	-0.4	0.4	1.1	1.3
Trade balance (**)	-50.3	-48.8	-55.8	-52.9	-45.2	-41.4	-42.4	...

NOTES: (*) Percentage of labour force.

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

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

protection helped to maintain the level of household expenditure. On the other hand, French families are among the least in debt in Europe, partly due to the restrictive conditions of French banks when granting real estate loans. Moreover, French consumption was strongly stimulated by the economic reactivation plan that, among other measures, gave a subsidy of 1,000 euros for purchasing a vehicle in 2009.

However, there is the risk of stagnation in private consumption, to date the bastion of its recovery. On the one hand, the weak performance of the labour market might put off domestic expenditure, with the unemployment rate increasing in January and reaching 10.1%, according to figures from the French Statistics Institute, INSEE. The number of salaried workers also continued to fall, although at a slower rate than in the last quarter of 2009, with an annual loss of 357,600 jobs. The Minister for the Economy, Christine Lagarde, estimates that unemployment will rise throughout 2010 but at an increasingly slower rate. It will only start to fall when economic growth is sustained and sufficiently high.

On the other hand, France's huge debt and public deficit, 77.4% and 7.9% of GDP in 2009 respectively, highlight the need for the government to cut back on its stimulus programme and social cushion. For example, throughout 2010 the aid for buying vehicles will be withdrawn, albeit gradually to stop registrations from plummeting downwards. Consequently, 750 euros have been given as from January 2010 and this will go down to 500 euros as from July.

Similarly, France's Stability Programme 2009-2013, presented to the European Commission, announces measures to cut back public spending to ensure that the excess deficit is corrected by 2013 and does not exceed the stipulated 3% of GDP. For example, this includes the possibility of carrying out a reform of the pension system to delay the retirement age, currently at 60.

With regard to investment, this tends to grow when the index of production capacity utilization exceeds its average over the long term (around 80 points). According to the overall report by the Bank of France, this variable increased in February, totalling 74.4 points,

...but rising unemployment and cutbacks in public expenditure might upset the economic recovery.

The under-utilization of production capacity is falling.

The Italian economy shrank by 5.1% in 2009.

continuing the upward trend started eleven months ago. The turning point at which investment will start to contribute positively to the economy therefore seems to be closer. Lastly, both the improvement in the economic situation of companies buying French products as well as the euro's depreciation will help foreign demand to pick up very gradually over the coming months.

Italian growth will remain moderate in 2010

After signs of recovery in the Italian economy in the third quarter of 2009, GDP fell in the subsequent quarter, with a drop of 0.3% quarter-on-quarter. That places the decline in the Italian economy for 2009 as a whole at 5.1%, the largest among the main European economies. Forecasts point towards a weak recovery in 2010, with growth under 1.0%.

A breakdown of GDP for the fourth quarter shows that this decline was widespread in all its components, with stocks being the only one to contribute positively, by 0.7 percentage points. This effect was totally offset by the negative contribution of the foreign

sector of 0.8 points. Short-term forecasts point towards moderate growth in the economy in the coming quarters, with foreign demand and investment being the main engines of the economy. However, no significant upswing is expected in investment until industrial capacity utilization improves.

The most frequent supply indicators point towards recovery in production. Industrial production was up 2.6% in January 2010 compared with the previous month, this being a much higher figure than expected, and the rise in industrial orders in February, 0.7% month-on-month, suggests that this trend will continue. Consequently, industrial confidence improved again, reaching levels close to those of 2008.

In terms of demand, the worsening job market, with unemployment at 8.2% in the fourth quarter, once again led to a drop in consumer confidence. Given the uncertainty hovering over household income, and the government's need to reduce public spending, domestic demand may continue to fall during the first half of the year. This will be partly replaced by foreign demand, as Italy's main trading partners, particularly in

Industrial production grows 2.6% month-on-month in January.

High debt rules out a bigger plan to stimulate consumption.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
GDP	-1.3	-5.1	-6.2	-6.1	-4.8	-3.0	—	...
Retail sales	-0.3	-1.6	-3.1	-1.2	-2.3	0.0	...	...
Industrial production	-3.4	-17.5	-21.4	-23.0	-15.7	-8.9	-0.2	...
Unemployment rate (*)	6.7	...	7.3	7.6	7.9	8.2	—	—
Consumer prices	3.3	0.8	1.5	0.8	0.1	0.7	1.3	1.2
Trade balance (**)	-10.0	-9.1	-12.8	-11.2	-7.4	-4.9	-3.9	...

NOTES: (*) Percentage of labour force.

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

SOURCES: OECD, national statistical bodies and own calculations.

the euro area, start to exit the recession, suggesting that the foreign sector will become the key to growth in the Italian economy in 2010.

Because of weak private consumption, the Italian government will propose a new plan to stimulate demand, which is expected to total around 300 million euros. This figure is small due to the little room for manoeuvre in the budget for the Italian economy which has, after the United States and Japan, the third largest debt in the world.

Elections hover over the fragile British economy

The lack of clear support by the most important GDP components leads to doubts concerning the solidity of the United Kingdom's recovery. In the fourth quarter of 2009, consumption saw its second consecutive quarter-on-quarter rise (0.4%) after downright drops for more than a year. Nonetheless, this tone of stabilization is threatened by the withdrawal of large fiscal stimulus

schemes, such as the hike in value added tax (VAT) in January and the end of aid for the automobile industry in April.

After a January affected by heavy snowfalls, the outlook for employment improved thanks to a notable reduction in registered unemployment in February.

Investment by companies (immersed in a deleveraging process) fell 3.1% quarter-on-quarter in the fourth quarter, a drop of 14.6% for 2009 as a whole and a heavy burden for the level of economic activity. Without the exceptional contribution of public expenditure and stock adjustments, the British economy would still be in recession.

General elections are going to be held within this difficult context. The Labour Party, currently in government, seems reluctant to abruptly reduce public expenditure so as not to deteriorate the economy further. The main opposing party, the Conservatives, appears more willing to take corrective measures for the public deficit (12.6% of forecast GDP for the 2009-2010 tax year) and

A relapse in the British economy cannot be ruled out.

The public deficit and the recovery, outstanding issues in the electoral debate.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
GDP	0.5	-5.0	-5.4	-5.9	-5.3	-3.3	—	...
Retail sales	2.2	1.4	-0.4	0.4	2.5	3.1	-0.8	3.4
Industrial production	-3.1	-10.2	-12.4	-11.7	-10.7	-5.9	-1.6	...
Unemployment rate (1)	2.8	4.7	4.2	4.7	4.9	5.0	5.0	4.9
Consumer prices	3.6	2.2	3.0	2.1	1.5	2.1	3.5	3.0
Trade balance (2)	-93.7	-86.7	-91.9	-88.7	-84.0	-82.2	-82.3	...
3-month Libor interest rate (3)	5.5	1.2	2.1	1.4	0.8	0.6	0.6	0.6
Nominal effective pound exchange rate (4)	97.6	73.9	73.9	77.0	83.7	79.0	80.4	80.5

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.

**The pound is falling,
dragged down by
post-election doubts.**

thereby avoid undermining the quality of the country's sovereign debt. The latest surveys predict a Conservative victory but by such a slender margin that they would not win an absolute majority. Simple majorities are not usual in the British parliament and historically lead to political instability.

The currency market seems to have discounted this possible electoral result, as the pound sterling has again depreciated noticeably in the last few weeks. Taking January 2007 as a reference, the British currency has depreciated 25% compared with a basket of significant currencies. This weak pound has boosted foreign demand but has also increased inflationary pressures.

Inflation was 3.0% in February, a rate still affected by the rise in VAT at the beginning of the year. In spite of being above the target established by the government, the Bank of England

considers this to be a relatively controlled risk and believes there are macroeconomic factors that will slow up this acceleration in terms of prices, such as the low utilization of installed production capacity and credit restrictions. However, the Bank has also noted that inflation expectations may have changed after this notable upswing which, together with the already mentioned depreciation in the pound, reduces its margin to inject fresh doses of liquidity.

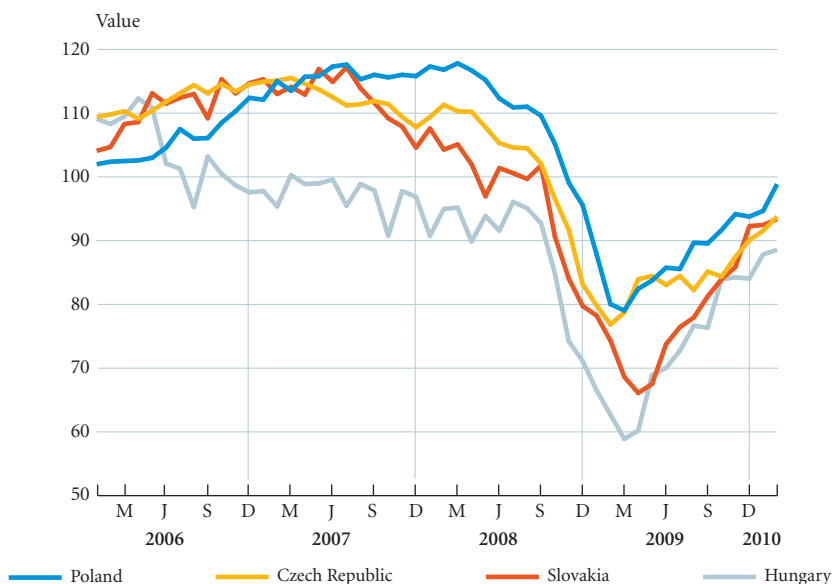
Emerging Europe: a suspect recovery?

The predominant view of the economic situation in emerging Europe and its immediate outlook can be summed up as follows: after a far-reaching recession in 2009, from which only Poland managed to save itself, this year the countries will enjoy an appreciable recovery. However, their notably divergent starting points mean that

**In emerging Europe,
2010 should be a year
of recovery...**

THE RECOVERY PROGRESSES IN EMERGING EUROPE

Index of economic sentiment



SOURCE: European Commission.

growth in 2010 will also be divergent, with four countries recording growth (Poland, Slovakia, the Czech Republic and Romania) and other countries with their GDP still in decline (Hungary, Estonia, Lithuania and Latvia). These differences in growth will close up in 2011, all achieving GDP growth rates clearly above 2%. We also share this view which, as we have already mentioned, is the dominant one among analysts. And the data, as can be seen in the graph above, seem to back this up. Might we all be wrong, however?

Questioning this commonly-held view makes sense if we consider that two significant questions have been hovering over the European economies recently. The first is related to the possibility that the euro area's recovery will be slightly less vigorous than that expected months ago. The most recent business data in the main economies of the Union have been disappointing, reinforcing the idea that, after a worse than expected fourth quarter, the first quarter of 2010 was not excessively dynamic either.

As a reflection of this more sombre tone, in its early forecasts for spring the European Commission predicted a growth of 0.7% for the euro area in 2010. Just a couple of months before, in December, analysts were talking of a predicted growth of 1.3% for the year. This is therefore a significant downgrade in just a short period of time. Along the same lines, the euro's depreciation in the initial tranche of 2010 has been interpreted as a reflection of this worsening outlook. It seems certain that emerging Europe, with its strong trade and financial links with the large economies of the euro area, won't be able to escape the repercussions of a truncated recovery in the European Union.

A second risk that has become endorsed in the last few months is the issue of how sustainable the public finances are in the European Union. The rise in public deficit and the reliance on public debt in various EU countries have led to concerns regarding their impact on the euro area as a whole and, in specific cases such as Greece, even regarding their ability to meet their obligations in coming years. Although Greece's political commitment to avoid not repaying its debt has lessened tension, there is still the belief that redirecting swollen public deficits might make it difficult to sustain activity at a time when the economic reactivation is still fragile.

This debate is not limited to the Mediterranean flank of the euro area, as in some countries of emerging Europe a weakening of their fiscal position has also raised concerns. The clearest case is Poland. In spite of having come through the toughest part of the crisis quite comfortably, its fiscal revenue has been affected, at the same time as its government, attempting to mitigate some of the negative effects of the crisis, has sped up public expenditure. This has highlighted the need to carry out fiscal consolidation that might affect the growth perspectives over the next few years.

So can these risks affect the scenario presented previously? In our opinion, and without underestimating their specific importance, we believe there are significant distinctions that limit their impact on the expected path of recovery for emerging Europe. With regard to worsening forecasts for the euro area, at present the extent of these forecasts does not seem to be enough to derail the improvement in activity in emerging Europe.

...but the worsening outlook in the euro area is causing concern...

...and the need for fiscal consolidation is affecting a still fragile reactivation.

Overall, only if the European recovery openly weakens will this affect emerging Europe.

Moreover, the region has time on its side because, as the year advances, the weight of the foreign sector in its recovery will progressively shift towards a higher contribution from domestic demand, providing the economy with a certain room to manoeuvre. This is not merely plausible speculation, since this progressive replacement of the foreign drive with domestic contribution is starting to appear in Poland, an economy that is further along the cycle than the rest of the countries in Central Europe.

Some points need to be made regarding the need to adjust public imbalances. Firstly, the public deficit figures are not alarming, not even for Poland. Consequently, if forecasts are correct, only Lithuania and Latvia will appreciably exceed the euro area's average in 2010. For their part, Poland, Romania and Slovakia will have deficits in the order of 7% of GDP, similar to those of the euro area as a whole. Neither is the volume of public debt outstanding in relative terms. In 2009, the year in which the average for the euro area was 80% of GDP, only Hungary was at these levels, the

remaining economies being below 60% of GDP.

Given the relatively contained size of the debt, the need for issues is also moderate. Here we should cite the example of Poland, one of the countries with the greater requirements. Consequently, in 2010, this country will have to handle debt maturities equivalent to 8% of GDP and public debt financing of 7%. Even in this context, the revenue expected from privatization, in the order of 2% of GDP, will provide a financial cushion requiring gross issues amounting to 13% of GDP, high but achievable. All this explains why the Polish government, in line with others in the region, predicts that a significant part of the redirection of its public deficit will result from cyclic improvements in revenue, without having to force excessive cuts in spending. If we also bear in mind the fact that other governments, such as Romania and Hungary, already significantly redirected their public spending in 2009, it seems that public accounts will not harm emerging Europe's expected path to recovery.

Even Poland, the country with the most demanding budget position, must not carry out a severe fiscal adjustment in 2010.

FINANCIAL MARKETS

Monetary and capital markets

The ECB advances calmly while the Fed starts the meter

«What we are doing is accompanying the markets' return to normal functioning. And, as I have said, this does not affect the (ECB's) monetary policy stance itself» These words of Jean-Claude Trichet, President of the ECB, perfectly sum up the institution's path and pace in its strategy to withdraw the extraordinary measures introduced as a result of the 2008-2009 crisis.

In terms of standard monetary policy, the ECB kept its official interest rate at 1.0%. It believes that the economic recovery will be slow, eventful and will differ from country to country. In the area of inflation, it doesn't believe there are any upward pressures and sees expectations anchored at 2%. Asked about the difficult fiscal situation for some EMU countries, Trichet stated that these problems do not alter the ECB's monetary stance at all.

In terms of non-standard monetary policy, the details announced by the ECB came as no surprise. Firstly, it confirmed that the last six-month auction would take place on 31 March, taking another step in the passive withdrawal of stimuli. This operation had full allotment and the interest rate was indexed to the average of the minimum rate offered in weekly auctions (MRO). Secondly, it also announced that, as from 28 April, the three-month auctions would be variable rate tender procedures again and that, although there will be no full allotment,

allotment amounts will be set with the aim of avoiding any significant spreads between bid rates and the prevailing MRO rate. Lastly, it also noted that the MROs will continue as fixed rate tender procedures with full allotment, at least until 12 October 2010.

Jean-Claude Trichet also announced the continuation of the policy of eligible assets as collateral for credit operations, so that a minimum credit rating of BBB- is currently required. This measure allows the Greek financial institutions to access credit, avoiding an additional increase in risk premia and in the yields required from the Greek government.

On the other side of the Atlantic, the Federal Reserve (Fed) of the United States decided to keep its interest rate at 0.25%. The central bank again repeated that the weak economy, low inflation and contained expectations for inflation make it certain that these exceptionally low interest rates will remain for a prolonged period.

Although the decision taken is based on low growth, the Fed's macro view is slightly more positive than in preceding months. Consequently, although it says that consumption is limited by the high unemployment, it also points out that the labour market is stabilizing. In January, the Fed associated the weak consumption with job losses and not with the level of unemployment. This change is important because representatives of the central bank stated that one prerequisite for considering a

The fiscal problems of some EMU countries will not alter the ECB's monetary policy.

The ECB continues to withdraw monetary stimuli and confirms its policy of eligible assets as collateral.

The Fed upgrades its view of the economy at the same time as adjusting details in the instruments it will use in its exit strategy.

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									
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	0.70	1.25	0.25	0.25	0.28	0.50	0.61	0.35
2010									
January	1.00	0.67	1.23	0.25	0.25	0.26	0.50	0.62	0.34
February	1.00	0.66	1.22	0.25	0.25	0.25	0.50	0.64	0.36
March (1)	1.00	0.64	1.21	0.25	0.28	0.24	0.50	0.65	0.30

NOTES : (1) March 22.

(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.

Japan increases monetary stimuli while China plays a waiting game.

hike in interest rates is the solid creation of jobs.

Non-standard monetary policy once again caught the attention of the financial markets, with the Fed announcing that its asset purchase programme would end in March. This decision not to extend the programme could be interpreted as a passive advance as, since the assets that mature will not be replaced, the reserve bank's balance will tend to shrink.

Before the monetary policy meeting, Brian Sack, Vice-President of the New York Fed, provided details of the tools they would use to drain a significant portion of the surplus reserves. On the

one hand, he confirmed that the ability to pay interest on reserves is the Fed's primary vehicle. He also referred to reverse repurchase agreements (reverse repos) and term deposits. Concerning the former, he said that only some small-scale operations remain to be carried out. Concerning deposits, he stated that, in spring 2010, test transactions will be conducted to adjust how they function.

The Asian region is in a different phase in the monetary cycle. On the one hand, Japan is one percentage point behind the United States and Europe. Consequently, on 17 March, the Bank of Japan decided to keep its interest rate at 0.1% and not to increase its bond purchase programme, created in December 2009, beyond the

current 1.8 trillion yen per month. Moreover, bearing in mind that special operations matured in March, it wished to minimize any problem with supply and doubled the amount of operations to provide liquidity up to 20 trillion yen. On the other hand, China, which is in a more advanced phase, has not made any other move after increasing by 50 basis points the ratio required from commercial bank reserves, agreed on 12 February.

As in the last few months, interbank markets in the main countries have not seen any significant variations. Interest rates at different terms continue to be anchored at the previous month's levels due to the actions of central banks, which maintain high liquidity to support the global economic recovery.

Public debt is waiting for economic news

The US fiscal deficit reached 10.2% of GDP at the end of last year. In December,

the outstanding balance of the total central administration's debt was 7.8 billion dollars, a rise of 23% compared with the previous year. Official estimates from the Congressional Budget Office point towards a slow reduction of this swollen deficit, starting in 2011 and establishing a fiscal deficit of around 4% of GDP up to 2020.

This outlook has led to statements by international rating agencies on the United States' AAA rating, which would be under pressure. But the notable economic diversification of the world's leading economic power and its outstanding ability to restore its balance after a shock mean that the United States continues to enjoy the confidence of investors. This is highlighted by the increasing purchases of bonds by foreign investors who, in the last twelve months, have invested around 590 billion dollars in this kind of asset.

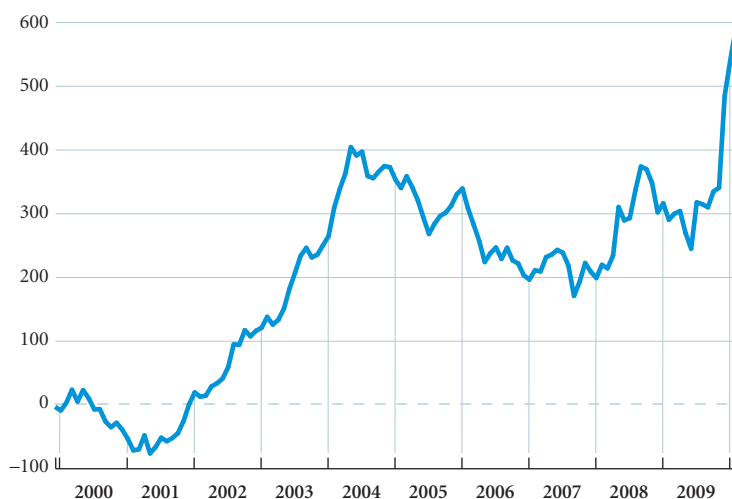
In the euro area, of note is the stability of yield from German and French bonds.

Stability in interbank markets with hardly any significant movement.

In spite of the United States' high debt, international investors continue to buy its public debt.

NET TREASURY PURCHASES BY FOREIGN INVESTORS

Accumulated figure over the last 12 months in billions of dollars



SOURCE: United States Treasury.

Less growth and low inflation in the euro area stabilize the yield on German and French public debt.

There are two reasons behind this absence of volatility. On the one hand, the latest economic data seem to confirm the weakness of the euro area's economic recovery. This will be gentle in intensity and slow in terms of time. Moreover, inflation expectations are firmly anchored.

The second large focus of attention is on countries on the periphery of the region. Portugal has presented a fiscal austerity plan that it hopes will reduce its public deficit to 2.8% of GDP by 2013. The European Commission has announced that the Spanish fiscal consolidation plan is viable in 2010. And Greece has received strong support with the S&P rating agency's decision to eliminate the downgrade that Greece's credit rating was subject to. These elements have helped to correct sovereign differentials.

But although uncertainty has decreased, not all the doubts concerning the Greek situation have disappeared. Firstly, a debate has started on the appropriateness of creating a European Monetary Fund to carry out financial rescues in the euro area. Secondly, although the European finance cabinet has announced the existence of a financial aid plan, they have not provided any details. Moreover, while several European countries have ruled out intervention by the International Monetary Fund, Germany is now considering this alternative.

In the medium and long term, trends in the yield of public debt of the United States and euro area are on the up. The consolidation of the economic recovery on both sides of the Atlantic and the normalization of monetary policy are

The countries on the periphery of the euro area improve their differential but the uncertainty about Greece has still not disappeared entirely.

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								
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	3.10	3.40	4.00	4.10	3.61	1.31	4.03	1.90
March (*)	3.11	3.41	3.87	3.94	3.64	1.38	3.99	1.91

NOTE: (*) March 18.

SOURCE: Bloomberg.

factors that will push yields to higher levels than present. Moreover, various elements, such as the evolution of the fiscal situation in Greece and actions to drain off liquidity by central banks will lead to erratic movements in public debt yields.

The dollar is taking a break from its appreciation

The value of the euro against the dollar peaked at 1.51 in November last year. Since then, the dollar has started a rapid rise that took this rate to 1.35 at the end of February. After this revaluation of approximately 10%, two elements have decelerated the dollar's appreciation. On the one hand, after such intense movement, simple profit-taking by investors produces such pauses in asset

prices. But, moreover, the improved outlook for fiscal consolidation in the countries on the periphery of the euro area has reduced the perception of risk for assets issued in Europe.

On the other hand, pessimism has started to weigh heavy on the pound sterling, which has depreciated again against the rest of the currencies. High fiscal deficit, political uncertainty and the expectations of low economic growth and higher inflation than in Europe or the United States, together with the need for the Bank of England to inject more liquidity into the economy, are not the most solid foundations to stabilize the United Kingdom's currency.

Another focus of tension is the situation of the Chinese currency. The Chinese Prime Minister, Wen Jiabao, has stated

The trend in public debt yields will be slightly upward throughout this year.

The dollar takes a short break on its way up.

EXCHANGE RATES OF MAIN CURRENCIES

March 18, 2010

	Exchange rate	% change (*)		
		Monthly	Over December 2009	Annual
Against US dollar				
Japanese yen	90.1	−1.9	−3.2	−6.8
Pound sterling	0.653	1.4	5.3	−7.2
Swiss franc	1.057	−2.5	2.1	−7.9
Canadian dollar	1.010	−3.6	−4.2	−23.4
Mexican peso	12.455	−3.4	−5.1	−11.9
Against euro				
US dollar	1.369	1.2	−4.6	1.6
Japanese yen	123.4	−0.7	−8.0	−5.1
Swiss franc	1.447	−1.3	−2.5	−6.3
Pound sterling	0.894	2.6	0.8	−5.6
Swedish krona	9.714	−0.8	−5.6	−12.0
Danish krone	7.441	0.0	0.0	−0.1
Polish zloty	3.870	−3.5	−5.9	−16.2
Czech crown	25.36	−1.6	−4.3	−5.6
Hungarian forint	261.6	−3.9	−3.4	−13.9

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

SOURCE: Bloomberg.

Fiscal deficit, low growth, inflation and political uncertainty in the United Kingdom are depreciating the pound sterling.

China is studying the impact of the potential revaluation of its currency.

Private bonds pass the financial uncertainties with flying colours.

Private investors take advantage of the chance to augment their private bond portfolios.

Issuers of high-risk bonds increase their activity in the market.

that the renminbi is not undervalued. After repeated requests by the United States for the Chinese authorities to revalue their currency, the market is awaiting the publication, in April, of the Treasury Department's report, which should decide whether to brand China a currency manipulator. But it has also come to light that several Chinese ministers have carried out stress tests on the economic effect on the country of the renminbi appreciating. This would suggest that the Chinese authorities, in spite of their official statements, are studying this possibility.

Private bonds return to their positive trend of months ago

The turmoil generated by the sovereign debt crisis has provided the chance to confirm the existence of a basically positive trend in private bond markets, based on the maturity of the economic recovery and on the rearrangement of private financial portfolios.

One piece of data that confirms this argument is the fast recovery in the prices of bonds of small and medium-sized companies, or High Yield bonds. In fact, the mere containment of sovereign risk over the last few weeks has led to this market segment quickly becoming dynamic again, both in terms of prices and new issues.

At the same time, the risks that still hover over sovereign debt continue to affect other segments in the corporate bond market that are more closely related to this. In particular, an unstable tone has remained in financial sector bonds, explained by the high interdependence between governments and banks. The credit spreads of large companies with a

high level of debt are also suffering. On the whole, the recovery in prices and volume in these sectors is slowing up.

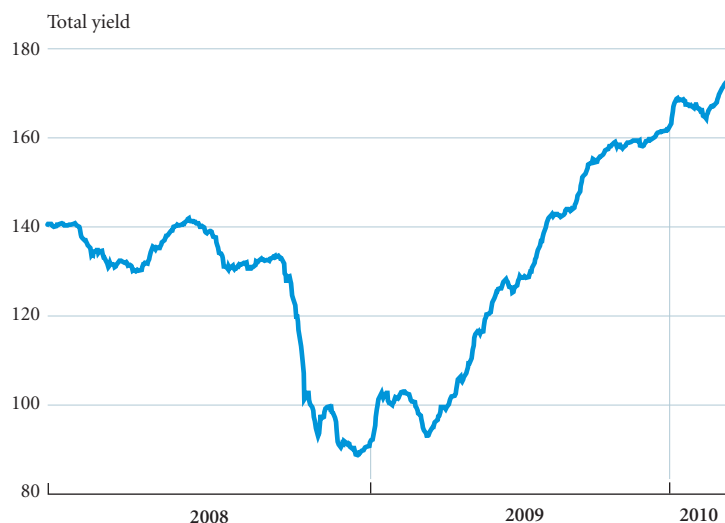
Another source of instability for private bonds comes from the change in orientation of the central banks' monetary policy. However, this variable is having a limited effect on the market. A good example of this has been observed in the United States, with the satisfactory evolution of prices for mortgage-backed bonds after the Federal Reserve finalized the purchase programme for these assets.

Investors have taken advantage of these cheaper periods in corporate bonds to purchase paper at a good price, although opportunities have been few because the volume of transactions fell in the tense period as companies opted to delay issues. In any case, it seems that investors, especially private investors, still want to diversify their portfolios from funds of risk-free assets to others with higher potential returns. In fact, it is very likely that the trend in the flows of savings will continue to be positive towards corporate bonds and particularly for High Yield bonds, because these instruments offer a more attractive return-risk ratio than other financial assets.

Additionally, companies issuing bonds are currently consolidating the structure of their balances. In countries such as the United States, companies, especially large corporations, have lengthened the average duration of their debt by issuing long-term bonds, at the same time as retaining a lot of liquidity, the cash to debt ratio reaching a record high level. Moreover, the private bond market is consolidating its role as a vehicle to finance an increasing number of small and medium-sized enterprises.

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

High yield bond index. Merrill Lynch. Europe



SOURCE: EcoWin.

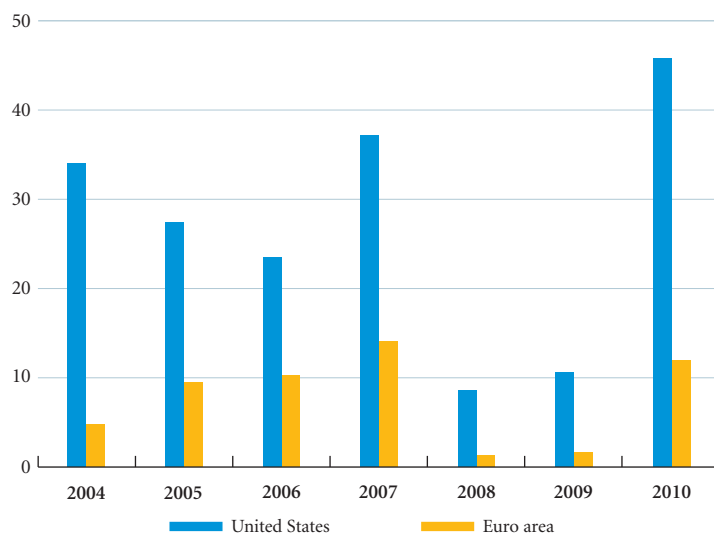
The positive expectations for the private bond market are also endorsed by the highly favourable upgrades by credit rating agencies. In its report on high risk

bonds, Moody's reduced its forecasts for bad debt in the United States from 14.5% in November 2009 to 3.3% for the end of 2010.

Substantial improvement in the expected trend in non-performing loans.

ISSUANCE OF HIGH RISK BONDS (SINCE START OF YEAR)

Billion dollars



SOURCE: Bloomberg.

The stock market indices recover slowly, although attention is still focused on Greek sovereign risk.

In spite of the risks in the short term, there are reasons supporting a favourable scenario in the medium term.

Slow recovery in the stock markets, although all eyes are on Greece

In March, equity markets managed to get back part of the gains lost as a result of the sovereign debt crisis in countries on the periphery of the euro area, although these rises have not been to the same extent. For example, while the S&P 500 exceeded January's figures and reached levels not seen since September 2008, the Eurostoxx50 performed less aggressively. For their part, the rises in emerging economies' markets were hindered by the toughening up of monetary policy in countries such as China and India. In the case of the selective Spanish index, Ibex 35, this continued to be affected by the concerns resulting from the fiscal situation and its impact on the profits of listed firms.

Although the instability generated by the Greek case seems to be in a period of greater control, in the short term it's wise to remember that the risks have still not dissipated and might lead to further corrections in the stock markets. But in the medium term, the trend in certain aspects such as capital flows, the macroeconomic scenario and the performance of business margins, among others, endorse a positive environment for equity markets.

For example, the progressive improvement in global economic data is reducing the differential that existed with regard to surveys of expectations carried out on business people and investors. This trend is gradually restoring confidence in economic players. Moreover, strong inflows

STOCK MARKETS PICK UP SLIGHTLY DUE TO GREATER CONTROL OF GREEK SOVEREIGN RISK

Stock market indices



SOURCE: Bloomberg.

continue in mutual funds that invest in equity, both in developed and emerging economies.

On the other hand, it's worth noting the greater activity in mergers and acquisitions at a global level. To date, the total cash for March reached 200 billion dollars, compared with the average of 140 billion dollars in January and February.

Another fundamental aspect confirming the upward trend in the stock markets in the medium term is the evolution in

corporate profits. On the one hand, the analyst consensus is that these business estimates will continue rising, based on the progressive change in the growth model, driven by the improvement in sales and not by cost-cutting, as in previous quarters. On the other hand, in the United States the results from the S&P 500 campaign for the fourth quarter far outweighed the expected recovery. In Europe, the news has been that, for the first time since the crisis started, the companies on the Stoxx Europe 600 index recorded a rise in sales, close to 1% year-on-year.

Mutual fund capital flows increase their preference for risky assets.

Business margins continue to show signs of recovery in the United States and Europe.

INDICES OF MAIN WORLD STOCK EXCHANGES

March 24, 2010

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
<i>Dow Jones</i>	10,742.0	3.5	3.0	47.6
<i>Standard & Poor's</i>	1,159.9	4.7	4.0	50.9
<i>Nasdaq</i>	2,374.4	5.9	4.6	62.9
Tokyo	10,824.7	4.1	2.6	36.2
London	5,623.6	5.1	3.9	46.3
Euro area	2,882.2	3.7	-2.8	40.5
<i>Frankfurt</i>	5,960.3	4.8	0.0	46.5
<i>Paris</i>	3,905.7	4.0	-0.8	39.9
<i>Amsterdam</i>	336.8	3.6	0.4	58.3
<i>Milan</i>	22,625.0	4.2	-2.7	51.4
<i>Madrid</i>	10,880.1	2.9	-8.9	41.1
Zurich	6,853.1	2.5	4.7	43.2
Hong Kong	20,933.3	2.7	-4.3	63.1
Buenos Aires	2,381.1	1.5	2.6	122.6
São Paulo	68,829.0	2.4	0.4	71.7

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.

BRICs: capital markets and economic growth

Capital markets (specifically the markets for corporate bonds and shares) play an important role both in long-term economic development and also in the cyclic fluctuations and financial stability of countries. Emerging economies, and particularly the quartet known by the term BRIC (Brazil, Russia, India and China), are currently facing the challenge of moulding their financial systems in order to achieve the best on both fronts. The experiences of developed countries, including negative ones such as the 2008-2009 crisis, might be of some help to them.

In the area of economic development there's widespread consensus that an appropriate structure and functioning of bond and stock markets help firms to access financing, encouraging investment and growth in business and therefore improving the welfare of individuals in the medium and long term. Regarding financial stability, a recent study by the Bank of International Settlements⁽¹⁾ points out that encouraging domestic bond markets in local currency strengthens the stability of emerging countries' financial systems. The effect occurs by lowering exchange rate risk and reducing the mismatching between the maturities of foreign currency liabilities (short-term) and assets in the local currency (long-term).

If we accept the advantage of having developed capital markets, two important questions immediately arise. The first relates to the configuration of the legal basis and formal structure. Various studies⁽²⁾ argue that the legal context (Anglo-Saxon, French or Scandinavian) is of vital importance for a country's financial development. The second is whether it's preferable for bank financing to predominate (most emerging countries) or financing through capital markets (United States). In principle, a mixed balanced financial system where banking and capital markets are complementary seems to be the most appropriate. Achieving a balanced structure is almost a requirement in most emerging countries, given that the currently small size of their capital markets means any collapse in the banking system would have huge consequences at a social and economic level, widely affecting the supply of credit, the payment chain and the value of savings.

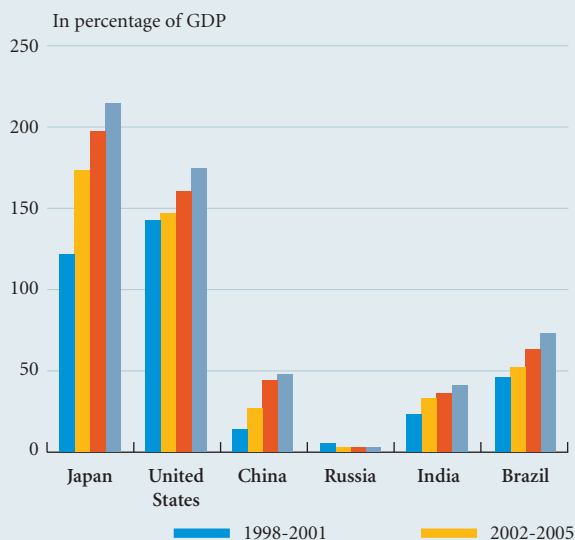
The BRICs have the scale and possibilities to contest, in economic terms, the top positions of influence and global hegemony. However, they will need to improve their domestic financial markets to realize this great potential. But before pointing out the main challenges facing the BRICs in the area of financial development, it is useful to look at how the markets in these countries have developed in the last few years, particularly those of debt and their stock markets.

As a whole, growth in the domestic markets of the BRICs has been significant. If we look at the average rate of stock market capitalization with regard to GDP for the BRICs, the figure is around 35%, while at the end of the 1990s this was hardly more than 20%. In the period from 2004 to 2008, i.e. before the corrections carried out in 2009, the markets operated under exceptional conditions: huge liquidity and a great appetite for risk. Such a buoyant period was taken advantage of by many governments from emerging countries to restructure the profile and currency of their domestic and international bonds. Firms didn't waste this opportunity either, issuing debt in local currency at low interest rates and thereby diversifying their sources of financing. In short, the domestic bond markets in the BRICs have seen significant growth but, as with their stock markets, their size is still far from the levels recorded in more advanced countries.

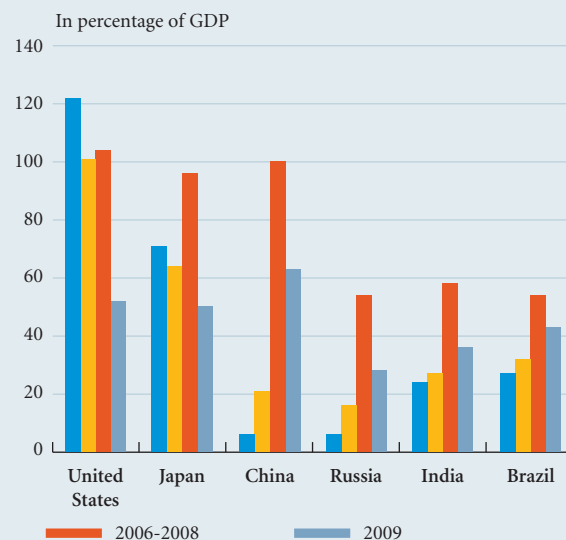
(1) New financing trends in Latin America: a bumpy road towards stability, BIS Papers No. 36, 2008.

(2) See for example, R. La Porta, F. López-de-Silanes, A. Shleifer and R. Vishny: «Legal Determinants of External Finance», Journal of Finance, Vol. LII (3), 1997.

OUTSTANDING BALANCE OF BONDS IN DOMESTIC MARKETS



STOCK MARKET CAPITALIZATION



SOURCES: Bank for International Settlements and Datastream.

As documented in detail in a recent study by the ECB⁽³⁾, for this group of countries to come close to the imaginary border set by developed countries (and thereby increase their weight in the global economy), they need to improve in two key dimensions: institutional and market access. The first relates to the regulatory and judicial framework and the quality of their institutions. The second entails pushing forward with those factors that help individuals and firms to participate in the markets, both buying and selling.

Pushing forward with the institutional aspects in the BRICs will not be easy as this requires far-reaching political actions. Moreover, and simply due to their history, each country's needs are very heterogeneous. A positive note is that the BRICs have already taken significant steps to boost the development of their domestic financial markets. The most visible changes can be seen in the greater degree of legal protection for investors and in the public availability of information, aspects which, as they are less controversial politically, are easier to tackle. At the same time, change quickly translates into new foreign investment. However, advances regarding the strengthening of the legal systems and judicial system (related to the area of medium and long-term structural reforms) have been substantially fewer in number.

The institutional factor also includes aspects related to the «quality» of institutions, such as bureaucratic quality or the extent of corruption. When this dimension is compared among countries, and over time, we can see that the evolution of the BRICs shows a negative trend that is not narrowing their gap with the United States and Japan.

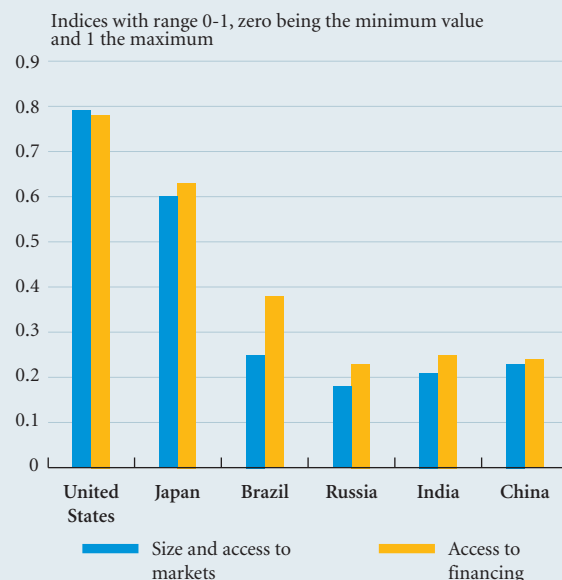
Brazil has acceptable financial access but must work to reduce those aspects related to corruption and bureaucracy, which undermine its institutions. India, on the other hand, has remarkable institutional quality

(3) E. Dorrucchi, A. Meyer-Cirkel and D. Santabárbara: «Domestic Financial Development in Emerging Economies. Evidence and Implications». European Central Bank, Occasional Paper Series No. 102, 2009.

INSTITUTIONAL DIMENSION OF THE DOMESTIC FINANCIAL SYSTEM



MARKET DIMENSION OF THE FINANCIAL SYSTEM



SOURCE: European Central Bank.

but, like Brazil, China and Russia, needs a larger and more accessible market. India could encourage growth in its domestic financial market by relaxing the limits imposed on investment made by banks, pension funds and insurance companies.

In the case of China, there's a complex series of administrative rules (for example, four government agencies share responsibility for approving an issue) that dissuade corporate financing through the markets. The Chinese authorities should reformulate these rules in such a way as to eliminate approval via industry quotas so that consent is based on objective information. Another important aspect related to the bond market is the fact that The People's Bank of China fixes the interest rate to be paid by a bond. This completely distorts the market's risk premia and explains why China has such an underdeveloped debt market.

In summary, the BRICs, together with other emerging countries, have made significant advances in the area of reforms, central to any strategy that aims to reduce the gap between them and industrialized countries in terms of the potential of their domestic financial markets. The path that needs to be followed is long but the final destination, which implies a better and more efficient allocation of resources, based on prices and not on arbitrary decisions, is well worth the effort.

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SPAIN: OVERALL ANALYSIS

Economic activity

Sluggish economic activity at the start of 2010

Indicators available for the first few months of 2010 point towards an exit to the recession but feeble economic activity. Neither consumption nor investment is uniform in tone, although they do seem to have a firm base. Sluggish activity in the euro area, the main trading partner, lower fiscal impulse with the removal, to a large extent, of the 400-euro deduction in personal income tax, the raising of taxes on savings and the partial withdrawal of some fiscal stimulus must have had a modest influence on the vitality of business.

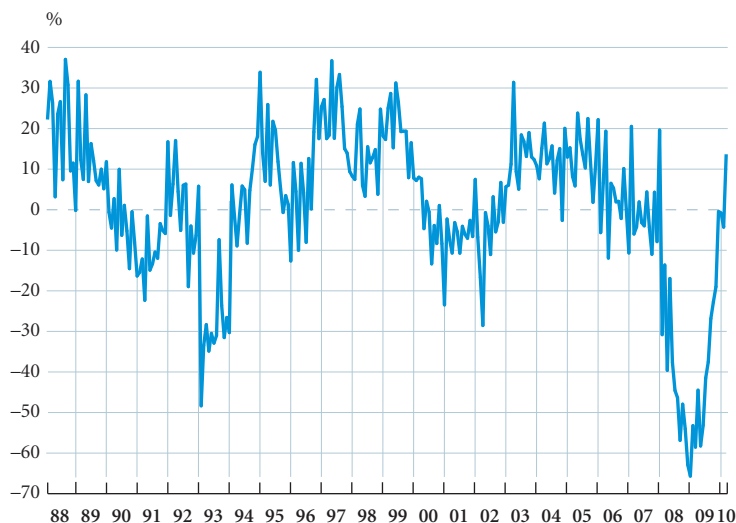
The data on consumption for the start of the year are quite disparate. On the one hand, some indicators show dynamic consumption, such as in automobile sales, 32.9% up in the first two months compared with the same period the previous year, thanks to the direct subsidies of the 2000E plan. Accumulated sales of white domestic goods in the first two months of the year also rose 4.8% year-on-year according to figures from the employers' organisation, ANFEL. But, on the other hand, the general index for retail sales weakened slightly in January, recording a 1.5% year-on-year decrease in terms of constant prices, adjusted for the calendar effect. Moreover, the consumer

The modest pace of growth in the euro area and the partial withdrawal of fiscal stimulus are not helping its relaunch.

Slight relapse in consumer confidence in February.

SALES OF INDUSTRIAL VEHICLES PICK UP

Year-on-year change in the number of load-bearing vehicle registrations



SOURCES: Spanish Traffic Department and own calculations.

Load-bearing vehicle sales post a rise for the first time in two years.

confidence index, which had come close to its historical average in January, suffered a relapse in February.

A slight drop in industrial capacity utilization in the first quarter does not point towards a sustained relaunch of capital goods investment. The production of capital goods continued to pick up in January, although still showing a year-on-year drop of 3.5%. Load-bearing vehicle sales looked better, in February posting an annual rise of 13.5%, the first positive figure in two years. For their part, the domestic sales of equipment and software in large firms recorded a 1.6% annual increase in January after a 13.3% fall in December.

With regard to construction, one leading indicator such as apparent cement consumption fell by 20.2% in the first two months, a little more than in the fourth quarter. This was affected by the

lower volume of extraordinary municipal works plans in execution and the lower number of homes under construction.

From the perspective of supply, the gentle upward trend continued in the secondary sector although the general index for industrial production, adjusted for calendar affects, fell 2.5% year-on-year in January. However, this index posted a year-on-year rise in six autonomous communities. In January, new industrial orders slackened off, with a year-on-year increase of just 0.9%, although confidence in industry continued to improve slightly in February.

With regard to construction, some signs of stabilisation can be noted in the real estate market. The housing price index produced by the National Institute of Statistics fell 4.3% in the fourth quarter

DEMAND INDICATORS

Percentage change over same period year before

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
Consumption								
Production of consumer goods (*)	-4.7	-8.2	-12.6	-9.4	-8.6	-1.7	-2.2	...
Imports of consumer goods (**)	-7.7	-6.1	-9.4	-14.9	-3.4	3.7	...	...
Car registrations	-28.1	-17.9	-43.1	-33.7	-0.6	29.3	18.1	47.0
Credit for consumer durables	3.6	-11.5	-11.9	-14.1	-10.8	-9.1	-	...
Consumer confidence index (***)	-33.8	-28.3	-44.7	-28.0	-20.7	-20.0	-14.0	-18.8
Investment								
Capital goods production (*)	-8.8	-22.1	-30.5	-24.7	-20.2	-10.3	-3.5	...
Imports of capital goods (**)	-19.6	-27.0	-31.3	-35.1	-23.4	-16.9	...	...
Commercial vehicle registrations	-43.6	-40.0	-52.5	-51.9	-30.8	-7.8	-4.6	13.5
Foreign trade (**)								
Non-energy imports	-4.9	-17.5	-26.0	-26.8	-13.4	-0.7	...	...
Exports	1.9	-9.8	-17.9	-14.7	-9.6	4.3	...	...

NOTES: (*) Adjusted for public holidays.

(**) By volume.

(***) European Commission survey: difference between percentage of positive and negative replies.

SOURCES: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of Economy and Finance, European Commission and own calculations.

of 2009, a rate almost three points higher than that posted in the third quarter. The annual change in the price of new housing rose half a point to -5.1%, its first upswing since the first quarter of 2007. This reflects less deterioration in the real estate market, also evidenced by a 2.1% annual rise in the sales of homes in January, the first in many months. However, this increase is due to sales of used homes, which were up 10.7%, while those of new homes fell by 5.1%.

One positive influence on the real estate market is the reduction in the theoretical effort required to purchase a home as a consequence of the cut in interest rates. This might also be affected by anticipated demand given the expected hike in value added tax in July 2010 and the limitation of the discount for housing in personal income tax as from 2011.

The first month of the year was not very propitious for services either. Turnover

for the tertiary sector, adjusted for calendar effects, fell 3.0% compared with January 2009, a higher fall than the previous month. Although all branches recorded drops, the biggest were to be seen in professional, scientific and technical activities, down 6.8%, and administrative activities and auxiliary services, down 5.1%. The lowest drop was in retail, namely 2.2%.

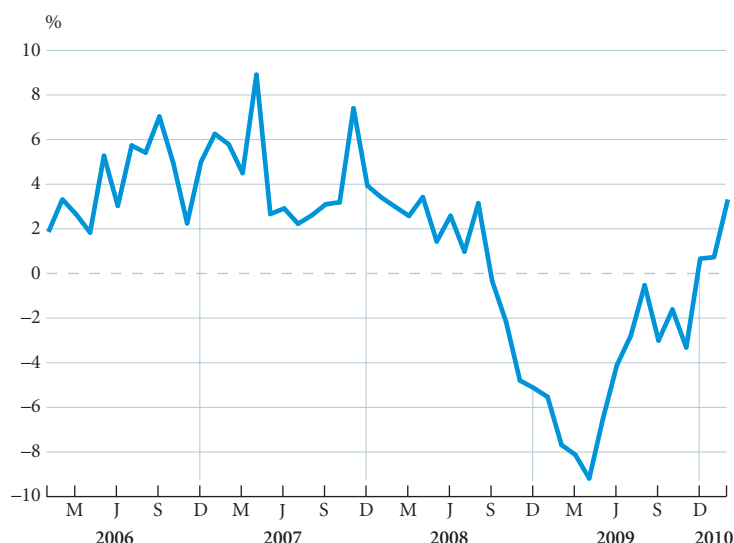
The effects of the recession are also showing up in the rates of bad debt. A stricter control of risk managed to reduce the number of unpaid negotiable instruments in January by 37.3% compared with the same month last year. However, the percentage of unpaid negotiable instruments out of matured instruments has tended to rise slightly in the last few months, standing at 4.8% in January, 4 tenths of a percentage point more than in November.

The unfavourable economic situation makes it difficult for new firms to be set

Little entrepreneurial dynamism but the trend is improving.

ELECTRICITY CONSUMPTION CONSOLIDATES ITS RELAUNCH

Year-on-year change in electricity consumption



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

SOURCE: Red Eléctrica Española.

The government presents a new proposal of economic policy measures.

up. Consequently, in January, although 6,266 new companies were created, this figure was 3.6% lower than that recorded in the same month a year ago. Nonetheless, overall this rate compares favourably with an annual drop of 24.5% in 2009. The number of companies wound up also rose by 5.7% in January compared with twelve months before, slowing up compared with the 7.2% annual rise the year before.

Given this scenario, and as part of its search for political agreement to get back

to economic growth and create jobs, at the start of March the government presented a new proposal of economic policy measures. Earmarked for immediate action were subsidies to recondition housing and direct loans from the Instituto de Crédito Oficial for SMEs and the self-employed. Another proposal was to encourage internationalisation and investment in R&D and innovation, to reduce public and private bad debt and review industrial and energy policy.

SUPPLY INDICATORS

Percentage change over same period year before

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
Industry								
Electricity consumption (1)	0.6	-4.3	-7.0	-6.6	-2.1	-1.4	0.7	3.3
Industrial production index (2)	-7.3	-15.8	-22.6	-18.6	-14.6	-5.6	-2.5	...
Confidence indicator for industry (3)	-18.0	-31.2	-36.7	-35.0	-29.0	-24.1	-21.4	-21.2
Utilization of production capacity (4)	79.5	69.2	68.8	69.5	68.5	69.9	-	69.0
Imports of non-energy intermediate goods (5)	-0.7	-21.6	-32.9	-31.1	-17.1	0.1	...	...
Construction								
Cement consumption	-23.8	-32.9	-46.1	-36.0	-26.4	-16.7	-15.6	-24.0
Confidence indicator for construction (3)	-22.6	-30.6	-36.7	-35.0	-26.3	-24.5	-28.1	-33.2
Housing (new construction approvals)	-59.4	-58.1	-64.3	-62.8	-52.4	-45.5	...	...
Government tendering	3.0	-7.9	-5.3	-8.3	-1.3	-16.0	...	...
Services								
Retail sales (6)	-6.0	-5.4	-8.2	-6.4	-4.5	-2.7	-1.5	...
Foreign tourists	-2.5	-8.8	-16.9	-8.2	-7.8	-3.5	1.1	-3.8
Tourist revenue inflows	-0.4	-9.1	-14.3	-8.0	-9.0	-5.5	...	...
Goods carried by rail (ton-km)	-7.7	-28.4	-34.1	-34.9	-32.4	-7.7	8.4	...
Air passenger traffic	-3.0	-8.1	-18.2	-8.7	-5.2	-0.8	3.3	1.4
Motor vehicle diesel fuel consumption	-3.8	-5.1	-10.3	-5.1	-3.0	-2.0	...	...

NOTES: (1) Adjusted for number of working days and temperature.

(2) Adjusted for public holidays.

(3) European Commission survey: difference between percentage of positive and negative replies.

(4) Business survey: percentage of utilization inferred from replies.

(5) By volume.

(6) Index (without petrol stations) deflated and corrected for calendar effects.

SOURCES: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of Economy and Finances and own calculations.

Labour market

Women weather the storm better

New employment registrations with the Social Security rose by 26,340 in February, although this figure becomes negative in seasonally adjusted terms, resulting in a drop of a little more than 30,000 people. Overall, in the last twelve months the number of registered workers fell by 3.0%, a rate that is lower than the 5.9% recorded in the same month of 2009. We should also note that the weather may have negatively affected the numbers for February.

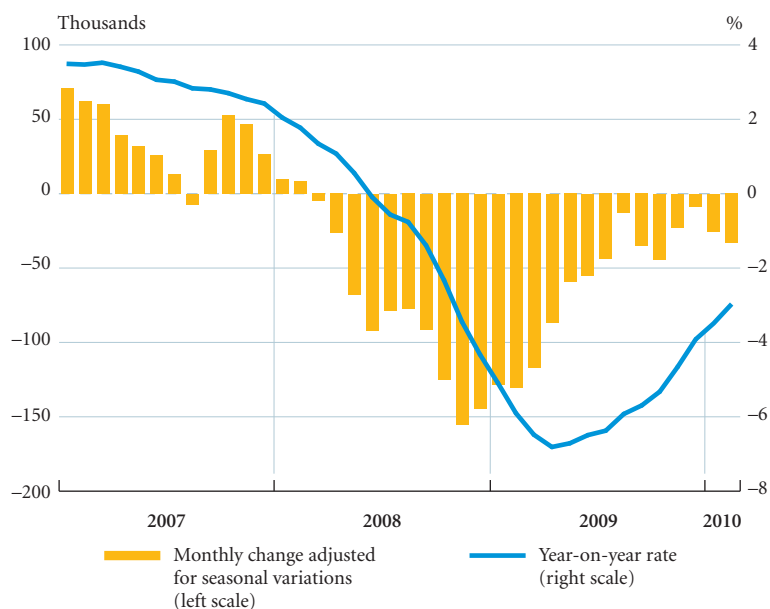
By gender, registration increased in the month for both men and women, leading to a moderation in the decline

of both rates year-on-year, standing at 4.5% and 1.1%, respectively. Women have been affected less than men by the crisis in the economy and employment because of the sectors and jobs where they are mostly employed. According to the Report «Mujer y Mercado de Trabajo 2009» (Women and the Labour Market 2009), produced by the Employment Department of the Ministry of Labour and Immigration, female employment is concentrated in the service sector, precisely the least affected by job losses, with more than 87% of all employed women. According to this report, however, the pace of women joining the job market has slowed up.

Job losses slow up but don't stop.

THE HALT IN JOB LOSSES DOESN'T QUITE MATERIALIZE

New employment registrations with Social Security



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

EMPLOYMENT INDICATORS

Percentage rate of change over same period year before

	2008	2009	2009				2010	
			1Q	2Q	3Q	4Q	January	February
Persons registered with Social Security (1)								
Sectors of activity								
Industry	-2.1	-10.6	-9.3	-11.5	-11.5	-10.0	-8.2	-7.2
Construction	-10.3	-23.1	-25.2	-25.4	-22.0	-18.9	-17.6	-16.2
Services	1.7	-2.6	-2.1	-3.1	-3.0	-2.1	-1.2	-0.8
Job situation								
Wage-earners	-0.7	-6.0	-6.3	-7.0	-6.2	-4.6	-3.3	-2.8
Non-wage-earners	0.4	-4.8	-3.9	-5.0	-5.3	-4.9	-4.3	-4.0
Total	-0.5	-5.8	-5.9	-6.7	-6.0	-4.6	-3.5	-3.0
Persons employed (2)	-0.5	-6.8	-6.4	-7.2	-7.3	-6.1	-	-
Jobs (3)	-0.6	-6.7	-6.3	-7.2	-7.2	-6.1	-	-
Hiring contracts registered (4)								
Permanent	-14.3	-31.0	-35.4	-35.3	-28.6	-22.5	-20.6	-12.5
Temporary	-10.4	-13.5	-23.9	-17.8	-9.4	-2.1	-5.1	2.9
Total	-10.9	-15.5	-25.4	-19.9	-11.4	-4.3	-6.7	1.1

NOTES: (1) Average monthly figures.

(2) Estimate by Labour Force Survey.

(3) Equivalent to full-time work. National Accounting estimate; data adjusted for seasons and public holidays.

(4) At the Spanish Employment Institute (INEM).

SOURCES: National Institute of Statistics, Ministry of Labour and Social Services, Public State Employment Service and own calculations.

The crisis has hit the self-employed hard.

In year-on-year terms, job losses eased off in all production sectors in February, with industry posting a negative rate of 7.2% in the last twelve months, construction 16.2% and services 0.8%.

It should be noted that, in February, the employment trend differed between types, as while salaried employment increased by 39,780, self-employment fell by 12,440. This indicates that the crisis is also hitting the self-employed hard.

The easing of the recession led to a slight year-on-year rise in the number of contracts recorded in February, namely 1.1%. This therefore continued the upward trend in employment contracts started in the month of November but interrupted in January. However, this increase was due exclusively to

temporary contracts, with an annual rise of 2.9%, as permanent contracts decreased by 12.5%.

The rise in registered unemployment is tending to slow up

The number of unemployed registered with the state employment service totalled 4,130,625 people at the end of February. This represents a year-on-year increase of 18.6%, a considerably lower rate than that of last year, with a year-on-year rise of 50.3%. By economic sector, unemployment increased in all segments although to a greater extent in agriculture, with a growth rate of 32% year-on-year. However, this sector accounts for a relatively small percentage of all unemployed.

The number of contracts is growing but only temporary ones.

In February, unemployment rose equally for men and women in absolute figures. By age, the ranks of the registered unemployed grew most among those aged under 25, 4.0% compared with the previous month, than among those over 25 (1.7%). Except in the Balearic Islands, unemployment also increased in all autonomous communities, with Andalusia and the Community of Valencia heading the list.

meaning that the Spanish economy has become relatively less competitive in terms of labour costs.

The main reason for the rise in the total cost is its wage component, up 2.7% year-on-year, which includes the basic wage, wage supplements, overtime and delayed payments. If we exclude the variable factor of wages (extraordinary and delayed payments), we get the ordinary wage cost, which rose by 2.2%.

Registered unemployment up by 19% in one year.

Timid drop in labour costs

According to the quarterly survey of labour costs produced by the National Institute of Statistics, the labour cost per worker and month for firms increased by 2.5% in the fourth quarter of 2009 compared with the same period a year ago. This rate is the lowest since the third quarter of 2005. However, although labour costs slowed up, they still grew more than the average for the euro area, namely 2.1% year-on-year,

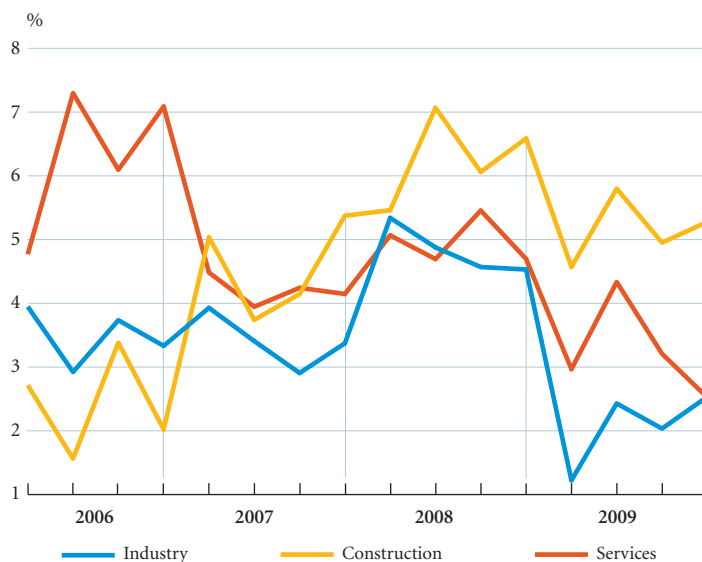
By economic sector, construction has the highest rise in overall labour costs, particularly due to growth in ordinary wages. Growth in the overall cost was similar in industry and services.

It should be noted that the 2.7% rise in average earnings per worker and month in the last quarter of 2009 was much higher than the inflation recorded in the same period, namely 0.1%. The purchasing power of salaried workers therefore increased substantially during

Labour costs slow up but rise more than those of the euro area.

MODEST SLOWDOWN IN WAGE COSTS

Year-on-year change in ordinary wage cost per worker



SOURCES: National Institute of Statistics and own calculations.

Wages gain purchasing power in 2009.

this period and the same thing happened in 2009 as a whole. The slowdown in labour costs was therefore modest, if we take into account the deflation in prices and rising unemployment.

Along these lines, in his speech on 23 February 2010, the governor of the Bank of Spain insisted on the pressing need to reform the labour market in order to achieve greater competitiveness within a monetary union where devaluation is no longer an option. Specifically, his speech pushed for certain changes to be made to the collective bargaining system. According to the governor, flexibility in agreeing wages and other aspects

of the internal organization of firms is essential to improving competitiveness.

In this respect, it's worth noting the signing of the «Agreement for employment and collective bargaining 2010, 2011 and 2012» by business organizations and trade unions, indicating the intention to carry out a policy of moderate wage increases that allows employment to recover and the economy to revive. This establishes criteria to determine wage increases: up to 1% for 2010, between 1% and 2% for 2011, and between 1.5% and 2.5% for 2012, with a wage revision clause linked to the inflation rate recorded throughout the period.

The governor of the Bank of Spain proposes the need to reform collective bargaining.

WAGE INDICATORS

Percentage rate of change over same period year before

	2008	2009	2008		2009			
			3Q	4Q	1Q	2Q	3Q	4Q
Increase under general wage agreements (*)	3.6	2.5	3.5	3.6	2.7	2.7	2.6	2.5
Wage per job equivalent to full-time work (**)	6.1	3.8	6.2	6.0	4.6	4.2	3.3	3.1
Quarterly labour cost survey								
Wage costs								
Total	5.1	3.2	5.3	4.8	2.9	4.1	3.1	2.7
Industry	4.8	2.1	4.6	4.5	1.2	2.4	2.0	2.5
Construction	6.3	5.2	6.1	6.6	4.6	5.8	4.9	5.3
Services	5.0	3.2	5.4	4.7	3.0	4.3	3.2	2.5
Average wages per hour worked	4.9	5.3	6.0	2.7	2.4	9.8	3.9	5.3
Other labour costs	4.1	4.3	3.5	5.8	7.8	3.5	3.9	1.9
Work day (***)	0.2	-2.1	-0.6	2.1	0.4	-5.1	-0.9	-2.4
Farm wages	5.1	1.3	6.1	4.5	3.2	4.0	0.3	2.8
Labour cost in construction	5.7	2.4	7.6	7.9	7.5	4.3	3.7	3.6

NOTES: (*) Does not include wage revision clauses. Cumulative figures.

(**) Quarterly National Accounts: data adjusted for seasons and public holidays.

(***) Effective hours worked per worker per month.

SOURCES: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fisheries and Food, Ministry of Public Works and own calculations.

Prices

In February, inflation falls back two tenths of a percentage point to 0.8%

Consumer price inflation stood at 0.8% year-on-year in February, 2 tenths of a percentage point below the previous month. As expected, inflation has therefore remained at a low level with the largest downward push coming from fuel and oils.

Fuel and oils actually recorded an annual rise of 11.9% in February, 2.0 points less than in the previous month and contributing more than one tenth of a percentage point to the year-on-year drop in inflation. This happened because, in February 2010, their prices stabilised compared with a rise a year earlier.

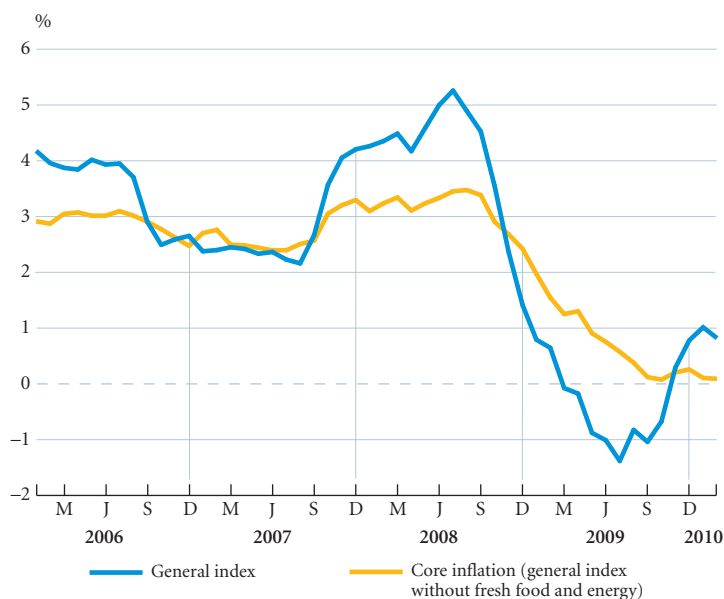
Meanwhile, unprocessed food, also a volatile component, intensified its fall and the year-on-year rate of change in its prices fell to -3.8%, 6 tenths of a percentage point less than in January. It therefore contributed around a fifth of a percentage point to the annual decrease in the general consumer price index (CPI). Of note in this group was the intensification in the drop in pulses and fresh vegetables and fresh fish, to 2.9% and 1.6% year-on-year, respectively.

On the other hand, underlying inflation, which reflects the most stable core of prices, remained at 0.1%, close to the record minimum posted in October 2009. This therefore continued to reveal the weakness in consumer demand,

The main downward push for inflation in February comes from fuel and oils.

CORE INFLATION REMAINS AT A VERY LOW LEVEL

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	-0.2	-1.2	0.8
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.

The weakness of consumption can be seen in the very low level of core inflation...

driving many companies to cut back or contain their prices in order to boost sales.

Processed foods kept the year-on-year rate of change in their prices at 0.5%, with the fall in some products, such

as mineral water, soft drinks and juices and some dairy products offsetting the rise in others, such as tobacco.

However, non-energy industrial products moderated their year-on-year drop to

FUEL AND OIL PRICES SLOW DOWN IN FEBRUARY

Year-on-year change in the price index for fuel and oils



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

February

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2009	2010	2009	2010	2009	2010
By type of spending							
Food and non-alcoholic beverages	107.2	−0.5	−0.8	−0.4	−0.8	1.5	−2.7
Alcoholic beverages and tobacco	129.7	1.2	1.6	3.3	3.0	4.2	12.3
Clothing and footwear	91.4	−1.4	−1.5	−15.0	−15.4	−1.8	−1.2
Housing	113.6	0.4	0.1	0.9	0.9	4.7	0.8
Furnishings and household equipment	106.5	0.1	0.0	−0.5	−0.9	2.2	0.5
Health	97.8	0.2	0.1	0.4	0.2	−0.1	−1.4
Transport	105.0	0.3	−0.1	−0.2	1.6	−6.2	5.8
Communications	99.2	0.0	0.0	0.1	−0.1	−0.5	−0.5
Recreation and culture	96.5	0.2	−0.3	−1.2	−2.2	0.2	−2.1
Education	114.5	0.0	0.0	0.1	0.1	3.9	2.6
Restaurants and hotels	112.1	0.2	0.1	0.4	0.2	3.1	1.0
Other goods and services	110.8	0.3	0.3	1.2	0.9	3.0	1.8
By group							
Processed food, beverages and tobacco	111.9	0.0	0.0	0.2	0.0	1.7	0.5
Unprocessed food	105.5	−0.7	−1.4	−0.4	−1.2	2.2	−3.8
Non-food products	105.4	0.1	−0.1	−1.5	−1.4	0.3	1.3
Industrial goods	100.2	−0.1	−0.3	−3.6	−2.9	−2.5	1.4
Energy products	110.2	1.3	0.0	0.5	2.8	−8.1	9.9
Fuels and oils	105.6	1.8	0.0	−0.5	3.2	−14.1	11.9
Industrial goods excluding energy products	96.5	−0.6	−0.4	−5.0	−4.8	−0.7	−1.5
Services	110.8	0.2	0.1	0.6	0.0	3.3	1.1
Underlying inflation (**)	105.9	−0.1	−0.1	−1.5	−1.7	1.6	0.1
GENERAL INDEX	106.5	0.0	−0.2	−1.2	−1.2	0.7	0.8

NOTES: (*) Base 2006 = 100.

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

SOURCE: National Institute of Statistics.

1.5%. This is mostly due to the almost one point rise in the annual rate for vehicles, as discounts were more pronounced in February 2009 because demand for cars had risen thanks to the 2000E subsidy plan. For clothing and footwear, although the February sales were a little more intense than twelve months ago, their effect on the CPI was much less.

Meanwhile, service prices continued to slow up, recording a year-on-year change

rate of 1.1%, the lowest in the last few decades. Also of note is the fall in package holiday prices compared to an increase in February 2009. On the other hand, restaurants, bars and cafeterias recorded an annual rise of 1.1%, the lowest since August 1986.

According to the EU harmonised price index, annual inflation stood at 0.9%, 2 tenths of a percentage point lower than the previous month. Consequently, the

...and in the new historic low for the last few decades for services, at 1.1%.

The euro's depreciation is helping to push up import prices.

differential with the euro area, which had returned to positive ground in January, was wiped out in February, reflecting the greater weight of fuels and their associated taxes in the Spanish case. However, the differential for the underlying component continued to be favourable for Spain.

Although inflation will tend to rise over the coming months, and even more so in summer due to the increase in the value added tax rate, we predict that inflation will remain contained, pressurised by the weak consumption. Consequently, at year-end it will probably be around 1.5%.

Wholesale prices speed up at the start of 2010

Industrial prices confirmed their upward shift in January with a year-on-year rate of change at 0.9%, half a point more than the previous month. This boost came from intermediate goods, which slowed up their descent to 0.9%, while energy prices held steady at 6.3% and equipment and consumer prices tended to fall. For their part, import prices speeded up to 3.4% year-on-year in January, helped by the slight depreciation of the euro. On the other hand, farm prices at source continued to moderate their drop in December to 5.5% year-on-year, due to arable and animal 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											
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	-9.3	-1.8	-0.6	0.2	-4.6	-0.7	-3.1	-3.1	0.5	-5.4	-0.2
December	-5.5	0.4	-0.5	0.1	-2.7	6.3	1.9	-1.2	0.8	-1.9	-
2010											
January	...	0.9	-0.6	-0.4	-0.9	6.3	3.4	-1.0	0.2	0.2	-

NOTES: (*) Data adjusted for seasons and public holidays.

(**) Except energy.

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

Foreign sector

Exports drive the correction in the trade deficit

The trade deficit posted its largest drop of the last few decades in 2009, with a fall of 46.7% compared with the previous year. This occurred within a context of falling trade flows, with imports down 26.2% in the same period, much higher than the 15.9% recorded by exports. The accumulated deficit last year reached a value of 50.183 billion euros, equivalent to 4.8% of the country's gross domestic product (GDP). This differs significantly from the 9.7% recorded in June 2008 and is at a similar level to that reached ten years ago.

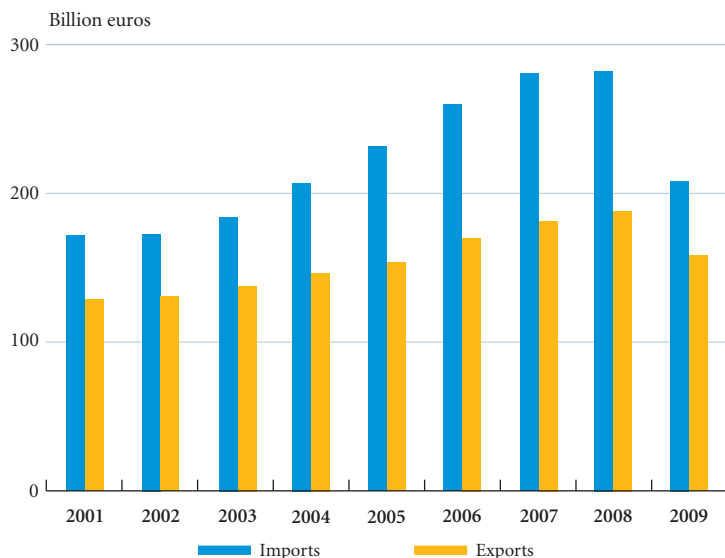
The monthly data reveal a year-on-year reduction in the trade deficit of 41.2% in December, much bigger than that of the previous month, namely 18.4%. It's significant that, unlike what was happening in the previous months, this greater correction in the deficit was due to the reactivation of exports in the month of December, growing 4.0% compared with the same month in 2008. This increase, the first after fourteen months of consecutive falls, contrasts with the drop in imports of 11.6% year-on-year, higher than the figure for November.

The breakdown in exports by economic sector shows the car industry as

Trade deficit falls by 47% in 2009 and equals 4.8% of GDP.

Exports pick up in December.

IMPORTS FALL FURTHER THAN EXPORTS IN 2009



SOURCES: Ministry of the Economy and own calculations.

FOREIGN TRADE

Year 2009

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	34,218	-39.9	16.4	6,806	-42.0	4.3	-27,413	19.9
Consumer goods	64,634	-9.0	31.0	62,974	-6.9	39.8	-1,660	97.4
Food	14,595	-8.7	7.0	21,359	-5.1	13.5	6,764	146.3
Non-foods	50,039	-9.1	24.0	41,615	-7.8	26.3	-8,424	83.2
Capital goods	16,812	-30.7	8.1	13,428	-18.8	8.5	-3,384	79.9
Non-energy intermediate goods	92,773	-28.6	44.5	75,047	-18.7	47.4	-17,726	80.9
By geographical area								
European Union	121,568	-21.5	58.3	109,004	-15.9	68.9	-12,564	89.7
Euro area	99,955	-22.6	48.0	89,741	-13.7	56.7	-10,214	89.8
Other countries	86,869	-31.8	41.7	49,251	-16.0	31.1	-37,619	56.7
Russia	4,587	-39.1	2.2	1,477	-47.9	0.9	-3,110	32.2
United States	8,508	-23.9	4.1	5,803	-24.6	3.7	-2,704	68.2
Japan	3,120	-39.0	1.5	1,217	-18.1	0.8	-1,903	39.0
Latin America	10,846	-30.7	5.2	7,858	-15.9	5.0	-2,987	72.5
OPEC	17,087	-38.2	8.2	6,275	-10.4	4.0	-10,812	36.7
Rest	42,722	-29.1	20.5	26,620	-12.0	16.8	-16,102	62.3
TOTAL	208,437	-26.2	100.0	158,254	-15.9	100.0	-50,183	75.9

SOURCES: Ministry of the Economy and own calculations.

Current deficit falls to 5.1% of GDP.

primarily responsible for this upswing, with a 35.6% year-on-year change in the last month of 2009. This growth can be largely explained by government aid for buying vehicles. It's therefore no surprise that exports to France and Italy rose considerably in this month (with a year-on-year increase of 11.5% and 12.1% respectively).

However, the end of aid for the automobile industry and the weak recovery in Spain's main trading partners in 2010 suggest that the trend in exports will ease off this year. Consequently, we expect the trade deficit to continue shrinking throughout the year, albeit at a slower pace.

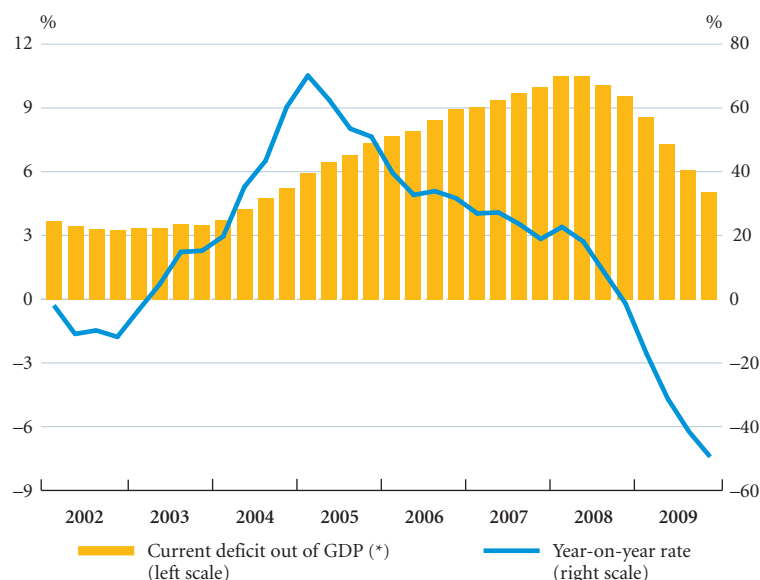
The current deficit keeps up its pace of adjustment

This adjustment in the trade balance largely helped to reduce the current deficit for 2009 as a whole which, with a 49.0% drop compared with the previous year, reached 5.1% of GDP. This improvement in the trade component was accompanied by a reduction in the deficit of the income and current transfer balances. Only the 2.1% reduction in the service balance surplus, the result of a weaker tourism industry, stopped the current adjustment from being greater.

As shown in the graph, the current imbalance in 2009 was at a similar level

THE CURRENT DEFICIT FALLS BACK TO 2004 LEVELS

Deficit of the current account balance



NOTE: (*) Accumulated last four quarters.

SOURCES: Bank of Spain and own calculations.

to that of 2004. Consequently, Spanish financing needs, equivalent to the sum of the current balance and the capital balance, fell by 50.2%, reaching 4.7% of GDP. This figure is 4.4 percentage points less than the one recorded in 2008.

An analysis of December's data does not show any signs of this trend weakening. The current deficit posted its second largest drop since the start of the squeeze, 60.2% year-on-year, driven by improvements in the balance of trade and services, in particular the component not related to tourism.

However, the expected easing off of the adjustment in the balance of goods over the coming months suggests that this correction will be less as from 2010.

With regard to financial flows, portfolio investment established itself as the main source of foreign funds in 2009. In contrast, short-term financing fell almost totally, returning to a level similar to the one before the financial turmoil started due to the subprime crisis. On the other hand, direct foreign investment resulted in net outflows of funds for the sixth consecutive year.

The pace of deficit adjustment slows up in 2010.

Portfolio investment is the main source of financing in 2009.

BALANCE OF PAYMENTS

Year 2009

	Balance in million euros	Annual change	
		Absolute	%
Current account balance			
Trade balance	-45,419	42,241	-48.2
Services			
<i>Tourism</i>	26,207	-1,859	-6.6
<i>Other services</i>	-485	1,317	-73.1
Total	25,723	-543	-2.1
Income	-25,539	8,243	-24.4
Transfers	-7,992	1,243	-13.5
Total	-53,228	51,184	-49.0
Capital account	3,940	-1,566	-28.4
Financial balance			
Direct investment	-6,047	-258	4.5
Portfolio investment	46,351	46,762	-
Other investment	158	-63,592	-99.8
Total	40,462	-17,088	-29.7
Errors and omissions	-1,189	-3,636	-
Change in assets of Bank of Spain	10,015	-29,627	-74.7

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.

Spain - Asia: five hundred years on, the journey continues

In August 1492, Christopher Columbus embarked upon a journey to discover a new route to the Far East. This would give the Castile monarchy access to the products most in demand at that time without having to use the trade routes monopolized by the Portuguese and Genoese. This intrepid enterprise led to the discovery of a new continent and, in the 16th century, meant the largest period of economic growth in Spanish history. Now, five centuries later, Spain's future prosperity requires starting the journey again in order to find trading partners in Asia, a market where the extent of Spanish penetration might still have a long way to go.

Since the start of the new millennium, the emerging countries in Asia have been growing fast. China and India stand out and, according to data from the International Monetary Fund (IMF), they contributed 30% to world growth between 2000 and 2008 (measured in purchasing power parity), much higher than the 1.8% contribution of the four main countries from Latin America (Argentina, Brazil, Chile and Mexico). Taking into account the extraordinary growth predicted for both countries up to 2014, 9.6% in China and 7.5% in India, the bulk of the evidence suggests that their contribution to global economic development will rise over the coming years (see the box «The emerging power»).

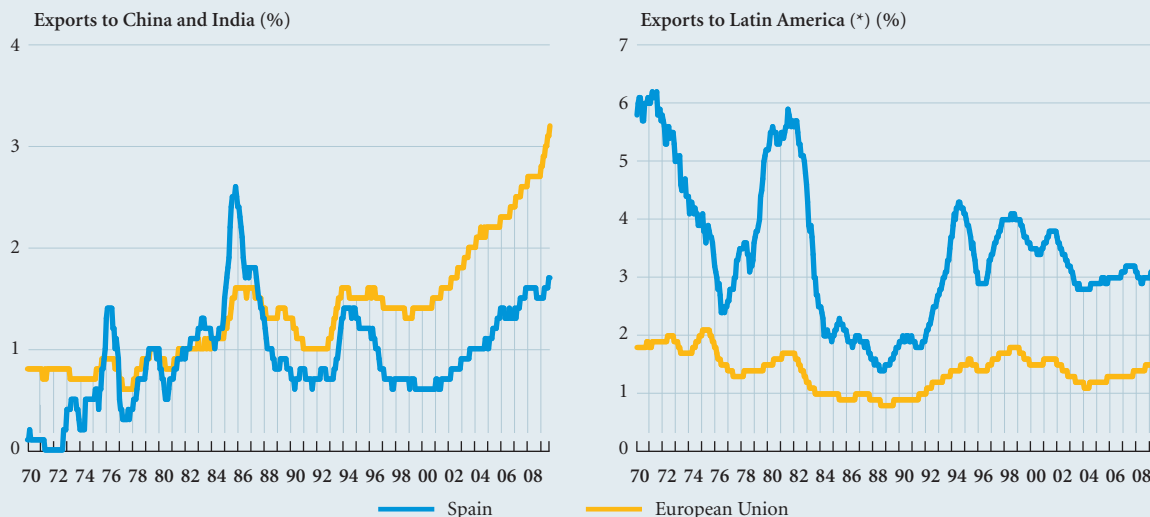
Given that trade and development go hand in hand, the marked growth of Asian countries will be accompanied by a significant increase in their trade. Their large size, made up of more than a third of the world's population, will boost the economies of their trading partners. In fact, it can be seen that those countries with the highest growth predicted for 2010 (according to the IMF) are also the main trading partners of China.⁽¹⁾ Although not necessarily a cause-effect relationship, it seems important for Spain to take advantage of the commercial opportunities detected in the Asian market.

An analysis of the data reveals a clear contrast between the economic relations of Spain with Latin America and those it has with Asia. In terms of its foreign direct investment, Spain allocated 15.3% of the total to Latin America between 2001 and 2009, while only 0.5% went to India or China in the same period. As shown in the graph, this bias can also be seen in trade flows. Since 1995, China and India's share of Spanish exports (calculated as the ratio between exports to these countries and all Spanish exports) has been lower than that for the whole of the European Union, indicating little Spanish presence in the Asian market.⁽²⁾ By contrast, over the last few years the share of Latin America in Spanish exports has doubled that of European countries as a whole.

Spanish trade's bias towards Latin American countries is partly due to geographical, cultural and historical reasons. Cultural or religious similarities, a common language, colonial links or different transport alternatives can make trade easier (or more difficult) between two territories. Consequently, to determine whether Spain

LITTLE SPANISH PRESENCE IN THE ASIAN MARKET, CONTRARY TO THE LATIN AMERICAN CASE

Share of exports (ratio between exports to certain countries out of all exports of Spain and the European Union)



NOTE: (*) Argentina, Brazil, Chile and Mexico.

SOURCE: International Monetary Fund (Direction of Trade Statistics).

(1) Bank of Spain (2009), *China en la economía internacional. Impacto e implicaciones de la crisis*. Boletín Económico, December 2009.

(2) Between 1992 and 1995, approval by the Development Aid Fund (FAD in Spanish) temporarily increased China's share of Spanish exports, placing them at a similar level to the share of European exports.

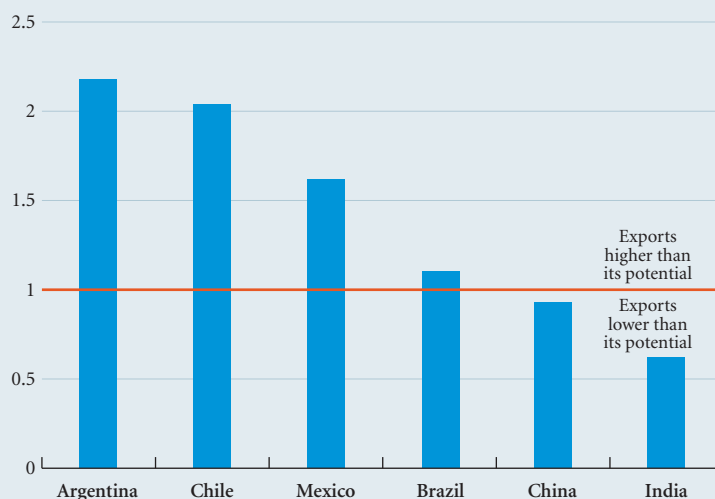
under-exploits its possibilities to export to China and India, we must consider those factors that measure the obstacles to trade between two countries.

A considerable number of studies employ the «gravity model of bilateral trade» to establish a way of measuring the «export potential» of one country to another (i.e. the value of exports given the characteristics of both countries), taking these factors into account. According to this method, trade between two countries increases with their economic size and the closeness (both physical and cultural) between them, while it decreases with obstacles to trade. Based on Noguer's estimates (2006), it's possible to calculate the ratio between Spanish exports to a country and the export potential established by the model. This measure indicates the degree of Spanish penetration in a given market, the ratio being lower than one in the case of the underuse of Spanish export capacity to this country.⁽³⁾

The graph below presents the results from carrying out this exercise with 2007 data from various countries. Here we can see that exports to the sample countries of Latin America were much higher than the level of potential exports (by 54.3%). This figure would be even higher if we only took into account the three Spanish-speaking countries (Argentina, Chile and Mexico). On the other hand, Spain under-exploited its export potential to China and India by 17.9%, confirming the low Spanish penetration in emerging Asian markets.

SPANISH EXPORTS IN CHINA AND INDIA IN 2007 WERE BELOW ITS POTENTIAL

Ratio of Spanish exports to its export potential



NOTE: The export potential has been calculated using coefficients of the model between 2002 and 2004 and data updated to 2007.
SOURCES: International Monetary Fund, Penn World Tables and own calculations.

(3) Noguer, M. (2006), *China: ¿Cuál es el potencial de comercio con España?* Documento de Economía No. 4 "la Caixa".

This lower Spanish penetration in the markets of China and India means that Spanish exports to these two countries are around 800 million euros below its potential. This is less than 0.1% of the annual Spanish gross domestic product (GDP). However, the expectations for economic growth in Asia suggest that the potential for commercial exports to this region will increase. Keeping the low degree of penetration of Spanish exports would therefore mean missing out on an important source of growth. The Instituto Español de Comercio Exterior (Spanish Institute of International trade or ICEX) points to sectors such as industrial technology, one of the leaders of Spanish industry that enjoys growing prestige in China, and also consumer goods (such as wine, olive oil and clothing) as those with the greatest scope.

In short, Asia is looking like one of the main economic engines of the future and, as happened five centuries ago, Spain is lagging behind in its trade relations with this market. A delay that must be overcome in the coming years by taking advantage of the current commercial and investment opportunities in these countries and by strengthening those sectors with the greatest potential. In this respect, the extraordinary interaction between Spain and Latin America can offer additional bridges to access the Asian market and the possibility of creating a trade triangle between Spain, Latin America and Asia. In this way, five hundred years on, the journey started by Columbus might actually reach its destination.

*This box was prepared by Joan Daniel Pina
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Public sector

The slump in taxable bases and the measures taken to relieve the economic crisis have a strong impact on public accounts in 2009.

Plans to reduce the public deficit

The worst recession in the last few decades had a strong impact on central government accounts in 2009. The slump in consumption, investment, wages and corporate profits led to a reduction in the taxable bases of the different taxes. Moreover, the measures to stimulate the economy taken to relieve the crisis also affected public accounts to a large extent.

Non-financial income for the central government totalled 162.46 billion euros in 2009 (before payments to autonomous communities and local governments), 13.9% down on the previous year, while tax income fell 17.1% compared with 2008. Fiscal

pressure therefore reduced, as the nominal gross domestic product fell less sharply, by 3.4%.

Direct taxation totalled 87.521 billion euros, 14.2% less than a year before. Personal income tax (IRPF in Spanish) fell 10.5%. However, the drop in personal income tax is 6.4% when adjusted for the 2008 differential effect because of the 400 euro deduction, as in 2008 this was only applied as from the middle of the year, as well as adjusting for the advance payment of the deduction for housing and the deduction on rental of habitual accommodation, as well as longer deferments.

Revenue from corporate tax decreased 26.1%, largely due to the slump in

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

December 2009

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	6,946	-24.4	102,038	-21.1
Non-financial revenue adjusted (*)				
Personal income tax	4,048	-4.3	63,857	-10.5
Corporate tax	241	-82.1	20,188	-26.1
VAT	1,274	-37.9	33,573	-30.1
Special taxes	1,591	2.6	19,349	-1.1
Other	4,552	0.8	25,493	13.4
Total	11,706	-14.5	162,460	-13.9
Non-financial spending	25,719	55.0	189,319	27.8
Treasury balance	-18,773	153.4	-87,281	365.6
Surplus (+) or deficit (-) (**)	-28,261	70.2	-99,785	226.4

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

(**) In terms of National Accounting.

SOURCES: Ministry of Economy and Finance and own calculations.

operating profits of real estate firms, as well as a reduction in the extraordinary profits of the other firms. The cut in tax rates and the off-balance sheet and consolidation adjustments due to adaptation to the new Accounting System also had an effect.

For their part, indirect taxes totalled 55.661 billion euros, a year-on-year fall of 21.2%. Value added tax (VAT) was down 30.1%, affected by weak consumption and investment, this drop also being affected by the extension, as from January, of the entitlement to monthly refunds. Special taxes dropped 1.1%.

Non-financial payments by central government totalled 189.319 billion euros in 2009, 27.8% more than a year ago. Staff costs rose 5.3%, while those of goods and services were up 7.2% and financial costs 10.8%. But the item with the highest increase in current spending was transfers, soaring 35.7%. Of particular significance under this heading are the 19.255 billion euros to the State Employment Service for unemployment benefit and the advance of 6.59 billion euros to the autonomous communities for resources planned in the new financing system.

On the other hand, real estate investment was down 1.6%, although civil investment rose 5.5%. However, capital transfers were up 94.1% to 17.36 billion euros, of which 6 billion corresponded to the State Local Investment Fund.

These trends in revenue and payments led to a non-financial cash deficit for the central government of 87.281 billion euros, more than four times the figure recorded last year. On a national accounts basis, i.e. according to the rights and obligations recognised, the central government deficit totalled 99.785 billion euros, 9.5% of gross domestic product compared with 2.8% in 2008. This deficit is the highest of the last few decades.

In January 2010, non-financial income for the central government was down 2.9% compared with the same month last year, falling slightly less than the whole of the previous year. Non-financial payments slowed up, rising by 12.4%. Overall, net borrowing totalled 706 million euros, compared with a net lending of 719 million in the same month of 2009. However, it should be noted that January's figures are not indicative of the trends throughout the year.

Within this context, at the beginning of March the government specified some measures in its fiscal consolidation plan to reduce the public deficit to 3% of GDP by 2013, in its proposals to reach a «Political agreement to regain growth and create employment». Consequently, senior positions will be reduced in the rationalisation programme for the general state administration and staff costs will be cut by 4% in general. A rationalisation programme was also approved for the public business sector, reducing the number of public corporations via mergers and concentrations.

The central government's net borrowing stands at 9.5% of the gross domestic product in 2009.

Slowdown in central government payments in January 2010.

The government specifies some measures from its fiscal consolidation plan.

Savings and financing

Sluggish business and more restrictive financing terms than in the economic boom explain the slight fall in private sector financing.

The deleveraging of firms and families continues

The market's expectations that the European Central Bank will keep its official interest rate at 1.0% for a long time, longer than predicted, have driven the one-year Euribor downwards. Its monthly average therefore stood at 1.225% in February, a new record low, albeit only 1 base point below the previous record set in November. In the first few weeks of March, the one-year Euribor continued to slide, setting a new record of 1.213% on the 23rd.

Within this context, the average interest rate for private sector loans by financial institutions held steady at 3.32% in the month of January, with this level

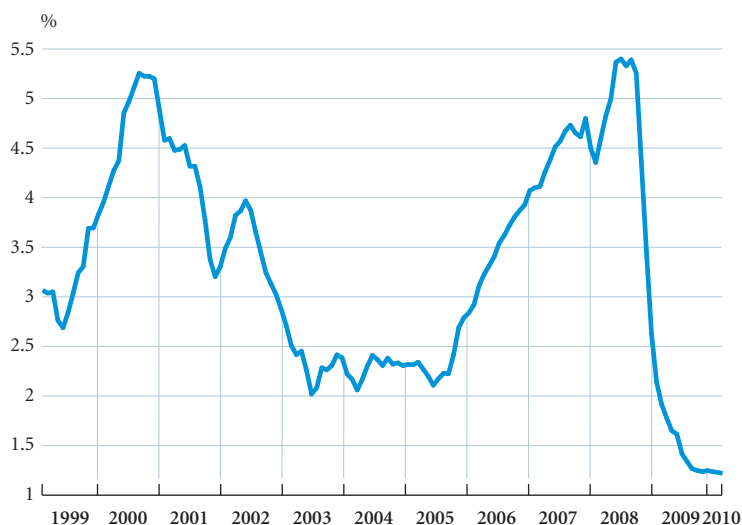
representing an annual drop of 170 basis points.

In spite of the low interest rates, private sector financing continued to decline, with a 1.2% year-on-year reduction in the month of January. On the one hand, this is due to the weak pace of demand within a scenario of economic listlessness and the correction of the high levels of debt reached previously. On the other hand, the conditions offered for financing also have an effect, as these are more restrictive than during the economic boom.

Financing for firms continued to fall slightly, recording a 1.9% year-on-year decrease in January, with the 4.3% drop in domestic credit being partly offset by

NEW RECORD LOW FOR THE ONE-YEAR EURIBOR

12-month Euribor rate



NOTE: At 23 March 2010.
SOURCE: Bank of Spain.

FINANCING OF NON-FINANCIAL SECTORS (1)

January 2010

	Balance	Change this year	Change over 12 months		% share
	Million euros	Million euros	Million euros	% (2)	
Private sector	2,198,922	-6,670	-20,111	-1.2	79.9
Non-financial corporations	1,297,077	-5,434	-14,142	-1.9	47.1
<i>Resident credit institution loans (3)</i>	909,619	-6,762	-44,929	-4.3	33.0
<i>Securities other than shares</i>	57,568	1,326	14,316	33.1	2.1
<i>External loans</i>	329,890	3	16,472	0.3	12.0
Households (4)	901,846	-1,237	-5,969	-0.1	32.8
<i>Housing loans (3)</i>	678,782	875	447	0.3	24.7
<i>Other (3)</i>	220,343	-2,137	-6,637	-1.3	8.0
<i>External loans</i>	2,721	25	221	8.8	0.1
General government (5)	554,674	-4,976	121,410	28.0	20.1
TOTAL	2,753,597	-11,646	101,299	3.6	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 among public administrations are deducted.

SOURCES: Bank of Spain and own calculations.

a 33.1% rise in bond issues and a 0.3% rise in foreign loans. In any case, new operations by resident financial institutions totalled 53,327 million euros for the month.

The only large sector to post a rise in credit in 2009 was services, up 0.4% for the year. However, without loans to real estate developers, the tertiary sector fell by 0.7%. In fact, credit for real estate activities slowed down to 1.7%, 3.1 points less than twelve months earlier but less than the rest of the services. The biggest drop was in construction, with 14.1%, followed by agriculture with 11.9%. Falling to a much smaller extent, industry recorded a reduction of 2.5%.

Loans to households were still sluggish as many families are adjusting their accounts. Their year-on-year rate of change was up 2 tenths of a percentage

point in January, reducing the drop to 0.1%. Housing loans continued to improve slightly on the year, by 0.1%, while the rest cut their annual drop by 6 tenths of a percentage point, to 1.0%. Among these, financing for the purchase of consumer durables fell the most, 9.1% in the last twelve months to December 2009, due to less demand and relatively high interest rates as the risk premium had risen because of bad debt.

The data from the National Institute of Statistics on new mortgages confirm the real estate market crisis in 2009. Last year, 1,088,717 mortgages were taken out on rural and urban properties, down 15.2% compared with the year before. Savings banks gave the largest number of mortgage loans, namely 52.7% of the total, followed by banks, with 36.7% and other financial institutions with 10.5%.

By sector, the biggest drop in credit was for construction.

CREDIT TO PRIVATE SECTOR BY PURPOSE

Fourth quarter of 2009

	Balance (*)	Change over 12 months	
	Million euros	Million euros	%
Financing of production activities			
Agriculture, livestock raising and fishing	23,123	-3,121	-11.9
Industry	152,199	-3,942	-2.5
Construction	130,435	-21,413	-14.1
Services	685,570	2,854	0.4
Total	991,326	-25,621	-2.5
Financing to individuals			
Acquisition and renovation of own home	653,902	-1,242	-0.2
Acquisition of consumer durables	49,228	-4,948	-9.1
Other financing	110,800	708	0.6
Total	813,930	-5,482	-0.7
Financing to private non-profit institutions	5,523	-568	-9.3
Other unclassified	26,255	-1,176	-4.3
TOTAL	1,837,034	-32,848	-1.8

NOTE: (*) By credit institutions as a whole: banking system, loan finance establishments and official credit.

SOURCES: Bank of Spain and own calculations.

Slight reduction in the bad debt rate for mortgage-backed house purchases in the fourth quarter.

The average length of mortgages fell to 21 years, three years less than the length recorded in 2008. The vast majority of mortgages, 95.9%, used a variable interest rate, this being the Euribor in 87.7% of the new agreements. On the other hand, the average value of housing mortgages continued to fall to 117,688 euros, 15.7% less than the previous year.

The effects of the recession can be seen in the intensification of bad debt, with the bad debt rate for all loan institutions as a whole standing at 5.3% at the end of January 2010, 2 tenths of a percentage point more than the previous month and 1.4 points more than a year earlier, returning to the levels of 1996.

In fact, bad debt varies substantially depending on the type of asset. Consequently, based on data available

as from the end of 2009, the bad debt rate for real estate operations stood at 10.1% and for construction at 8.5%. For its part, the rate for consumer durables was 7.6%, one tenth of a percentage point lower than in the third quarter, while the rate for mortgage-backed house purchases was slightly lower, namely 2.8%, 2 tenths of a percentage point less than in the third quarter.

Slowdown in bank deposits

Returns on bank deposits fell slightly at the beginning of 2010. These tended to fall slightly for both families and firms and generally for all timescales, reaching 1.24% on average. However, returns were above both the official European Central Bank interest rate, at 1.0%, and annual inflation.

Within this context, deposits slowed their rate of growth to 2.1% while loans retracted, so that the gap between both got smaller. Savers' greater preference for liquidity, given the uncertain economic situation, meant that on demand and savings deposits rose 9.1% and 14.6%, respectively, in the last twelve months. On the other hand, term deposits fell 2.3%, affected by falling returns.

The competition to bank deposits and stock market volatility led to further outflows of mutual funds in the second month of 2010. Net withdrawals totalled 1,810 million euros in February, concentrated in short-term euro bonds

and in the money market, these being the two areas with the lowest annual yields. The highest net subscriptions were recorded by global funds, with 191 million euros.

In the last twelve months, the average yield for mutual funds was 5.2% but with a large spread. International equity funds from emerging markets boasted spectacular annual gains of 71.9% and Spanish equity of 35.6%. All categories achieved gains, although the yield from the money market was slightly below 1.0%. In the last nineteen years, the average yield for mutual funds was 4.2%, above inflation for the period.

The gap between loans and deposits is narrowing.

The average yield for mutual funds in the last twelve months up to February stands at 5.2%.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

January 2010

	Balance	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	260,883	-1,852	-0.7	21,659	9.1	18.6
Savings deposits	205,492	-2,299	-1.1	26,195	14.6	14.6
Term deposits	711,767	-8,245	-1.1	-16,446	-2.3	50.7
Deposits in foreign currency	24,048	2,033	9.2	-7,174	-23.0	1.7
Total deposits	1,202,191	-10,362	-0.9	24,234	2.1	85.7
Other liabilities (*)	200,541	-12,588	-5.9	-35,354	-15.0	14.3
TOTAL	1,402,731	-22,951	-1.6	-11,121	-0.8	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.

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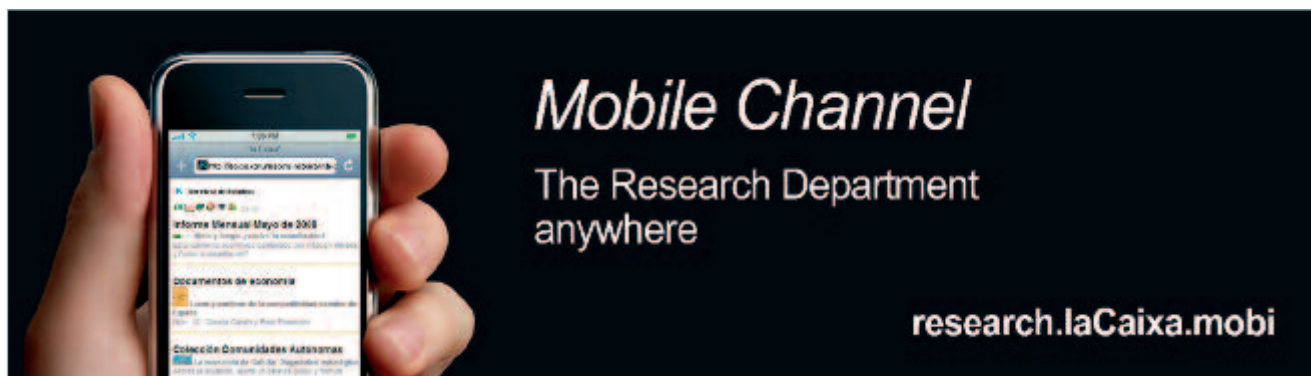
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As of December 31, 2009

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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