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THE SPANISH ECONOMY

Monthly Report

NUMBER 319

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2007	2008	2009	2007	2008			
				4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast						Forecast
Gross domestic product								
United States	2.0	1.4	–0.5	2.3	2.5	2.1	0.7	0.4
Japan	2.1	0.4	–0.1	1.6	1.3	0.7	0.0	–0.6
United Kingdom	3.0	1.0	–0.5	2.9	2.3	1.5	0.3	0.0
Euro area	2.6	1.1	–0.3	2.1	2.1	1.4	0.6	0.2
Germany	*2.6*	*1.3*	*–0.4*	*1.7*	*2.7*	*1.9*	*0.8*	*0.3*
France	*2.1*	*0.8*	*–0.2*	*2.2*	*2.0*	*1.2*	*0.6*	*–0.2*
Consumer prices								
United States	2.9	3.9	0.2	4.0	4.1	4.4	5.3	2.0
Japan	0.1	1.1	0.0	0.5	1.0	1.4	2.2	0.0
United Kingdom	2.3	3.7	2.6	2.1	2.4	3.3	4.9	4.4
Euro area	2.1	3.3	1.6	2.9	3.4	3.6	3.8	2.5
Germany	*2.3*	*2.7*	*1.3*	*3.1*	*2.9*	*2.9*	*3.2*	*1.8*
France	*1.5*	*2.9*	*1.7*	*2.3*	*2.9*	*3.3*	*3.3*	*2.0*
SPANISH ECONOMY		Forecast						Forecast
Macroeconomic figures								
Household consumption	3.4	0.8	–0.8	2.9	2.1	1.1	0.1	–0.3
Government consumption	4.9	5.0	3.8	4.4	3.6	4.9	5.9	5.5
Gross fixed capital formation	5.3	–1.6	–7.7	4.5	2.8	–0.2	–3.2	–5.9
Capital goods	*10.0*	*0.9*	*–11.6*	*7.1*	*5.7*	*2.2*	*–0.6*	*–3.7*
Construction	*3.8*	*–4.3*	*–8.5*	*2.9*	*0.4*	*–2.3*	*–6.4*	*–8.9*
Domestic demand (contribution to GDP growth)	4.4	0.8	–2.2	3.8	2.8	1.5	0.1	–1.0
Exports of goods and services	4.9	2.8	0.8	4.0	4.4	4.2	1.5	1.0
Imports of goods and services	6.2	0.9	–3.0	4.9	4.0	2.4	–1.1	–1.6
Gross domestic product	**3.7**	**1.3**	**–0.8**	**3.3**	**2.6**	**1.8**	**0.9**	**–0.1**
Other variables								
Employment	2.9	–0.2	–2.4	2.2	1.4	0.4	–0.8	–1.7
Unemployment (% labour force)	8.3	11.0	14.5	8.6	9.6	10.4	11.3	12.5
Consumer price index	2.8	4.2	2.1	4.0	4.4	4.6	4.9	2.8
Unit labour costs	2.9	3.6	2.7	3.0	3.9	4.0	3.6	
Current account balance (% GDP)	–10.1	–10.0	–8.4	–10.5	–12.1	–9.4	–8.7	
Net lending or net borrowing rest of the world (% GDP)	–9.7	–9.5	–7.9	–9.6	–11.3	–8.9	–8.5	
Government balance (% GDP)	2.2	–3.0	–4.6					
FINANCIAL MARKETS		Forecast						Forecast
Interest rates								
Federal Funds	5.0	2.1	0.5	4.5	3.2	2.1	2.0	1.1
ECB repo	3.8	3.9	2.1	4.0	4.0	4.0	4.2	3.3
10-year US bonds	4.6	3.7	3.4	4.3	3.6	3.9	3.8	3.6
10-year German bonds	4.2	4.0	3.2	4.2	3.9	4.3	4.3	3.7
Exchange rate								
$/Euro	1.37	1.46	1.29	1.45	1.50	1.56	1.51	1.29

Contents

The Euro ten years later

On January 1, 1999 the euro became the currency of eleven member states of the European Union. Notes and coin in euros would still take three years to appear but 300 million citizens became aware that one of the basic references of daily life, the cash carried in their pockets, had changed. Ten year later, the single currency has consolidated its role in all aspects and has become one of the main symbols of European integration although one relevant group of countries is still opposed to its adoption.

The euro is somewhat bold, arising as it did at a time of optimism and rapid change at the end of the Eighties that sought to solidify the process of integration of European countries that began in the Fifties. Substituting the national currencies with another common and shared currency was a step without precedent in the modern economic history of Europe seeing that there did not exist a shared political sovereignty. This was a step that would greatly have pleased Jean Monnet, one of the persons who inspired the European Communities, the forerunner of the European Union, who promoted this kind of advance in order to reach the longed dreamed of political integration of the peoples of Europe.

Ten years later it would be difficult to argue that political integration had advanced but few would doubt the success of the euro. From the initial eleven countries it goes up to 16 on January 1, 2009 (Slovakia becomes the latest new member) and in this decade no country has made plans to leave. The single currency has become the world's second most important currency after the dollar. The euro has stimulated economic integration, increasing trade flow between EU member states, and financial integration, especially in the wholesale segments of the market. The euro decade has coincided with the creation of 16 million jobs. The euro and its mentor, the European Central Bank, have consolidated their prestige as references of an area of macroeconomic stability, supporting expectations for downward inflation in spite of not strictly meeting its self-imposed objectives.

However, the Economic and Monetary Union also has its detractors. For most citizens, changing over to the euro complicated the calculation of prices and the common currency was blamed for an increase in prices when notes and coins were put into circulation in 2002. The Euro Area has been accused of suffering something of a sclerosis given that its growth potential stands very low, its productivity is running below other regions and per capita income has run aground at a level barely 70% of that of the United States. Furthermore, the euro has deprived member states of their autonomy in setting interest rates and foreign exchange rates thus making necessary adjustments at the national level more difficult.

At this time of world economic and financial crisis the euro has undergone its first big test. One immediate merit point acknowledged is its role as an umbrella or protection against the international financial upsets. This is so up to the point where some countries that up until now have been reluctant to join have reconsidered their positions and are planning to join over the short or medium term. As a result, in view of a recession such as the current one, without precedent in the 10-year life of the common currency, wisdom in national policies, the adoption of necessary structural reforms and close coordination between all member states offer the only way to get through a very complicated period.

EXECUTIVE SUMMARY

The recession is already here

2008 ending with some economies in recession...

At the beginning of 2008 we were troubled by the financial crisis, the rise in commodity prices and the easing off in economic activity. Nevertheless, we generally were confident that the financial upsets would settle down,that inflation would be kept under control and that the emerging economies would at least partly compensate for the slowdown in the advanced countries. Now, as we come close to 2009, we find ourselves on the threshold of a sharp slowdown in world growth and few people would bet on the financial front being finally stabilized. In any case, things could have been worse. The exceptional orchestrated interventions by governments to support financial institutions since September have blocked the possibility of a general wave of bank insolvencies. Now it is the turn of government support to deal with weakness on the strictly macroeconomic level. Commodity prices, which in summer were breaking all-time records, have now collapsed.

...and others about to go into recession.

In any case, the prevailing feeling is that economic prospects for 2009 and beyond are indeed sombre. Is this pessimism justified? It probably is, given that the signs from the economic indicators, sentiment in the financial markets and the analyses made by the international bodies all coincide. Between the end of 2008 and the beginning of 2009 the large economies will be fully in recession while the emerging countries will undergo a notable slowdown. Economic indicators suggest that indeed most of the advanced countries are now in recession or soon will be. Gross domestic product (GDP) showed drops in the United States, Japan and the Euro Area. In the latter two cases this was the second consecutive quarter to show a quarter-on-quarter decrease. That is to say, they have moved into what is conventionally known as a technical recession. Furthermore, the few available indicators for the fourth quarter (the ISM manufacturing activity index and the German IFO index) confirm that the sharpness of the crisis increases as we come closer to year-end.

Spain's GDP drops for first time since 1993.

Spain does not escape the destiny of its reference partners and its GDP also dropped in the third quarter, a situation that has not taken place since 1993. Not only is the quarter-on-quarter decrease negative in itself. Its make-up brings up other doubts. In this respect, the Spanish case is representative of fairly general trends. The GDP dropped by 0.2% compared with the second quarter largely due to the contraction of private consumption and a recession in consumption is never a positive sign. With consumer confidence at a low level and purchases of durable goods down for several months, the cooling down in economic activity is growing sharper in the fourth quarter. Fortunately, some imbalances are being put in order. This is so in inflation, which stood at 2.4% in November (5.3% in July), and the foreign deficit that is dropping appreciably. This good news, however, does not take away the bad taste brought about by the loss of jobs in the third quarter or the drop in those registered with Social Security at a rate of 3%.

Trends at the end of 2008 thus leave little doubt about the downward path

of the main variables. The question lies in the sharpness of the contraction of growth and how long this will last. Both the stock markets and government bonds are discounting a recessive scenario along with a sharp improvement in inflationary pressures. The drop in stock market quotes for most of November, on top of that in previous months, would likely be in anticipation of a sharp contraction of corporate profits as a direct result of decreases in GDP in the main advanced economies. At the same time, the drop in returns on long-term government bonds may be attributed to the increase in the attraction of these assets at times of uncertainty. The markets also allow us to evaluate how the financial aspect of the crisis is moving. In this, we note some easing of interbank interest rates with the 1-year Euribor below 4% in the final days of November, more than one percentage point less than the high in September. But we also note that, following some difficulties, the corporate bond market has not been able to find the road back to normal.

Financial markets anticipating recessive scenario with low inflation in advanced economies.

The international bodies have just driven home their verdict on a recession scenario. Specifically, the forecasts published by the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD) coincide in stating that the advanced economies will show a drop in 2009. While the specific figures vary, most of these countries will stand within a range of decrease from 0.5% to 1%. For Spain, the IMF is expecting a drop of 0.7% in GDP whereas the OECD is forecasting a worse result as its forecast is for a drop of 0.9%. At the same time, both the IMF and the OECD foresee a major drop in inflation putting it in the area of 1.5% in 2009, approximately half the figure for 2008.

IMF and OECD forecasting drops in GDP in Western countries in 2009.

In fact, available figures confirm that the advanced economies are going into recession, if they have not already done so. Underlying the trend in financial markets is a scenario of a sharp reduction of economic activity along with low inflationary pressures. Both the OECD and the IMF are giving out similar forecasts of a sharp contraction of growth in Europe and United States. In view of this situation, governments have opted for recovering the prescription of fiscal stimulus in order to ease a cyclical drop of great magnitude. The rapid worsening of the economy has made it necessary to take urgent steps and to work out some kind of international coordination.

The G-20 meeting in Washington on November 15 established minimum bases for a consensus on the economic policy to be implemented in coming months, namely easing of monetary policy and fiscal expansion, along with increased activity of the international bodies in order to help those economies in difficulties and maintenance of measures to bail out the banks. At the same time, it confirmed a commitment to avoid the temptation to apply trade protection measures and the need to foster the reform of the international financial system on principles of transparency, international coordination and financial responsibility.

Along these lines, the European Commission has tried to orient the efforts of its member states. On November 26, the EC executive announced a series of measures that should serve to provide increased growth over the next two years. The package, which amounts to 200 billion euros, involves a number of measures financed from the EC budget (for an amount of 30 billion euros) and other funds from member states to come under national budgets for the remaining 170 billion euros. The EU contribution is to be divided in practically equal parts of 15.6 billion euros in the form of credits for

International coordination efforts aimed at joint measures for needed fiscal incentives and financial bailouts.

Governments trying to ensure solvency and liquidity of banks...

small and medium businesses from the European Investment Bank and 14.4 billion euros from the EU budget, largely in advances from the Cohesion Fund and the trans-European energy and telecommunications networks. With regard to the part involving national budgets, the European Commission merely indicated a series of possible measures such as, for example, an increase in public spending, the issue of guarantees for loans or reductions in value added tax (VAT) and social security contributions.

Undoubtedly, it is a matter of confirming what the various member states are already implementing. While at this moment the details of many national plans to stimulate the economy are unknown, the general measures taken are clear. The most developed because they are the most urgent are those measures aimed at resolving problems of solvency and liquidity of financial institutions. According to some estimates, the total figure committed, including guarantees, may have gone above 7% of world GDP.

...while trying to restore demand through tax cuts and public investment.

A second front, which is now in motion, involves public measures that have a direct impact on households and companies (subsidies and tax reductions) and those that imply increased public spending and investment. With regard to tax reductions, these may be of a general nature (such as the proposal to reduce VAT in the United Kingdom) or more specific (such as tax deductions for production investment as introduced in the United States, Germany and France as well as income tax deductions, as applied in Spain and Germany, for example). New infrastructure programmes have also been launched or brought forward in such countries as China and Germany.

Spanish government announces series of measures to deal with critical aspects of economy –consumption, investment and credit.

These are largely make up of relatively small tax stimulus packages given that in most cases they come to 1.2%-1.3% of national GDP with the exception of the United States and China which are committing very significant amounts in terms of GDP. Furthermore, fiscal policy does not act alone given that the easing of monetary policy has still continued in recent weeks. In November, the European Central Bank cut its intervention rate to 3.25% and a further cut is expected in December. The Bank of England also cut its reference rate to 3% and other central banks have followed this move.

In the case of Spain, available figures on measures aimed at fostering household and corporate spending now amount to approximately 1.1% of GDP, a figure that the final cabinet meeting in November increased by 11 billion euros, 1% of GDP, which will go into financing municipal public works and also supporting the motor vehicle sector, among others.

Finally, we should mention the area of public intervention involving the overall amount of guarantees and credits for households and non-financial companies the aim of which is to activate credit channels. Spain's measures in this field amount to approximately 3.8% of GDP in 2008 and 2009 and involve such aspects as corporate investments and the financing of motor vehicles and housing.

Is this public intervention process going to avoid an undesirably sharp contraction of growth? Over the short term, its effects should at least soften part of the downward impact. Its effects over the long term are less certain. For the moment, however, it is a matter of keeping the patient alive. Later on, if all has worked well, there will be time to discuss how to return to a balanced pattern of growth.

November 28, 2008

CHRONOLOGY

2007

November	**8**	IBEX 35 index for **Spanish stock market** marks up all-time high (15,945.7) with cumulative gains of 12.7% compared with end of December 2006.
December	**11**	**Federal Reserve** cuts reference rate to 4.25%.
	13	Central banks in United States, Euro Area, United Kingdom, Switzerland and Canada announce plan for **coordinated measures to relieve difficulties in monetary markets** brought about by financial upsets.

2008

January	**1**	Further enlargement of **Euro Area** with entry of Cyprus and Malta, making 15 member states.
	22	**Federal Reserve** reduces reference rate to 3.50%.
	30	**Federal Reserve** reduces reference rate to 3.00%.
March	**9**	Spanish Socialist Workers Party wins **general elections**.
	18	**Federal Reserve** cuts reference rate to 2.25%.
April	**18**	Government approves a **Plan for measures to stimulate the economy**.
	30	**Federal Reserve** reduces reference rate to 2.00%.
July	**3**	**European Central Bank** raises official rate to 4.25%.
	11	One-month forward price of *Brent* quality **oil** goes up to all-time high of 146.6 dollars a barrel.
	15	**Euro** exchange rate hits 1.599 dollars, highest value since launching of European Single Currency at beginning of 1999.
August	**14**	Government puts into effect its **programme of 24 economic measures** for 2008 and 2009.
September	**19**	US government presents **bailout plan for country's banking system** amounting to 700 billion dollars.
October	**7**	Spanish government announces creation of **fund for purchase of financial assets** of financial institutions up to maximum of 50 billion euros and raises guarantee on deposits and investments to 100,000 euros.
	8	**European Central Bank**, **Federal Reserve** and **Bank of England** cut official interest rates by 50 basis points in joint move with other central banks.
	12	Euro Area countries agree on **joint action** to strengthen financial system up to end of 2009.
	13	Government authorizes granting of **government guarantees** up to 100 billion euros in 2008 on new financial transactions of financial institutions with possible extension to 2009.
	28	IBEX 35 index for **Spanish stock exchange** marks up lowest level (7,905.4) since 2004.
	29	**Federal Reserve** cuts reference rate to 1.00%.
November	**6**	**European Central Bank** lowers official interest rate to 3.25%.
	15	Meeting of G-20 in Washington to **reform international financial system**.
	20	Dow Jones index for **New York stock exchange** records lowest level since 2003 (7,552.3).
	21	Price of *Brent* quality **oil** drops to lowest level since February 2005 (47.96 dollars a barrel).

AGENDA

December

- **2** Registrations with Social Security and registered unemployment (November).
- **4** Governing Council of European Central Bank.
- **5** Industrial production index (October).
- **12** CPI (November).
- **16** Fed Open Market Committee.
- **17** Harmonized CPI for EU (November).
- **18** Labour cost survey (3rd Quarter).
- **23** Central government revenue and spending (November). Foreign trade (October).
- **29** Producer prices (November).
- **30** Balance of payments (October).

January

- **5** Early HCPI (December).
- **9** Industrial production index (November).
- **15** CPI (December). Governing Council of European Central Bank. Harmonized CPI for EU (December).
- **23** Labour Force Survey (4th Quarter).
- **26** Producer prices (December).
- **28** Fed Open Market Committee.
- **30** Balance of payments (November).

INTERNATIONAL REVIEW

OECD expecting economies of United States, the Euro Area and Japan to drop in 2009.

Forecasts point to lower growth

The Organization for Economic Cooperation and Development (OECD) and the International Monetary Fund (IMF) have announced downward revisions in growth prospects. The OECD is expecting the US economy to drop by 0.9% in 2009 with moderate growth of 1.6% in 2010. The Euro Area will also be down 0.5% in 2009 with growth of 1.2% in 2010. Japan, in turn, will drop by a less severe 0.1% to later move up by a slim 0.6%. The key OECD scenario is based on three premises. It sees a short period of extremes in the financial sector followed by intermitant upsets that will gradually diminish toward the end of 2009, an adjustment in the real estate sector that will still last for some time and the partial compensatory effect of more reasonable commodity prices that will increase purchasing power of households.

OECD FORECASTS (1)

	2005	2006	2007	2008	2009	2010
GDP (2)						
United States	3.1	2.9	2.2	1.4	–0.9	1.6
Japan	1.9	2.4	2.1	0.5	–0.1	0.6
Euro Area	**1.7**	**2.9**	**2.6**	**1.1**	**–0.5**	**1.2**
OECD	**2.7**	**3.1**	**2.7**	**1.4**	**–0.3**	**1.5**
Inflation (3)						
United States	3.4	3.2	2.9	3.6	1.2	1.3
Japan	–0.6	0.2	0.1	1.4	0.3	–0.1
Euro Area	**2.2**	**2.2**	**2.1**	**3.4**	**1.4**	**1.3**
OECD	**2.0**	**2.2**	**2.2**	**3.3**	**1.7**	**1.5**
Unemployment (4)						
United States	5.1	4.6	4.6	5.7	7.3	7.5
Japan	4.4	4.1	3.9	4.1	4.4	4.4
Euro Area	**8.8**	**8.2**	**7.4**	**7.4**	**8.6**	**9.0**
OECD	**6.5**	**6.0**	**5.6**	**5.9**	**6.9**	**7.2**
Current account balance (5)						
United States	–6.1	–6.2	–5.3	–4.9	–3.9	–3.6
Japan	3.7	3.9	4.8	3.8	4.3	3.9
Euro Area	**0.4**	**0.2**	**0.2**	**–0.3**	**0.2**	**0.2**
OECD	**–1.5**	**–1.7**	**–1.4**	**–1.5**	**–1.0**	**–1.0**

NOTES: (1) Starting hypothesis: a) Fiscal policies in force or announced will not change; b) Exchange rates will not change from level on October 28, 2008 (1 dollar = 95.69 yen = 0.80 euros); c) Closing date of publication and for including figures was October 31, 2008.
(2) All percentage change rates in real tems.
(3) Percentage change rates in GDP deflator.
(4) As percentage of labour force.
(5) As percentage of GDP.
SOURCE: Organization for Economic Cooperation and Development.

For its part, the IMF has appreciably reduced the growth forecasts it put out barely a month ago in its report on world economic prospects which shows the degree of uncertainty regarding the world economic situation. According to the IMF, the world economy will grow by 2.2% in 2009 instead of the 3.0% previously forecast. In the United States it expects a drop of 0.7% in 2009 while for Japan it is forecasting a decrease of 0.2%. Similarly, in Europe can expect drops in nearly all countries. The Euro Area economy will decrease by 0.5% in 2009 while in Germany it is expecting growth of –0.8% because of the effect of lower world demand for its exports. France will drop by 0.5% and Spain 0.7%. The sharpest drop will be in the United Kingdom for which the IMF expects a contraction of 1.3%.

The IMF also believes that there will be a significant slowdown in the main emerging economies although their overall growth rate at 5.1% in 2009 will still be higher tha the group of advanced countries.

IMF forecasts are very similar in revisions made just a month ago.

IMF FORECASTS

Annual change as percentage

	2006	2007	2008 (*)	2009 (*)	Difference from October forecast	
					2008	2009
GDP						
United States	**2.8**	**2.0**	**1.4**	**–0.7**	**–0.2**	**–0.8**
Japan	2.4	2.1	0.5	–0.2	–0.2	–0.7
Germany	3.0	2.5	1.7	–0.8	–0.1	–0.8
France	2.2	2.2	0.8	–0.5	–0.1	–0.7
Italy	1.8	1.5	–0.2	–0.6	–0.1	–0.4
United Kingdom	2.8	3.0	0.8	–1.3	–0.2	–1.2
Spain	3.9	3.7	1.4	–0.7	–	–0.5
Euro Area	**2.8**	**2.6**	**1.2**	**–0.5**	**–0.1**	**–0.7**
Advanced economies	**3.0**	**2.6**	**1.4**	**–0.3**	**–0.1**	**–0.8**
World total	**5.1**	**5.0**	**3.7**	**2.2**	**–0.2**	**–0.8**
Developing countries	*7.9*	*8.0*	*6.6*	*5.1*	*–0.3*	*–1.0*
Latin America	*5.5*	*5.6*	*4.5*	*2.5*	*–0.1*	*–0.7*
Eastern and Central Europe	*6.7*	*5.7*	*4.2*	*2.5*	*–0.3*	*–0.9*
Russia	*7.4*	*8.1*	*6.8*	*3.5*	*–0.2*	*–2.0*
China	*11.6*	*11.9*	*9.7*	*8.5*	–	*–0.8*
Consumer prices						
Advanced economies	**2.4**	**2.2**	**3.6**	**1.4**	**–**	**–0.6**
Developing countries	*5.4*	*6.4*	*9.2*	*7.1*	*–0.2*	*–0.7*
World trade by volume (**)	**9.3**	**7.2**	**4.6**	**2.1**	**–0.3**	**–2.0**
Oil price ($ per barrel) (***)	**20.5**	**10.7**	**40.2**	**–31.6**	**–10.6**	**–25.3**

NOTES: (1) Forecasts at November 2008.
(**) Goods and services.
(***) Average spot prices for Brent, Dubai and West Texas Intermediate oil. Average oil price in dollars per barrel forecast at $71,13 in 2008 and $68,00 in 2009.
SOURCE: International Monetary Fund.

United States: moving toward recession

United States moving close to recession with crisis of confidence and consumers much in debt...

The US economy is rapidly getting worse with no convincing signs of recovery. The supports and guarantees given the financial sector have still not been passed through to other areas of economic activity, as shown by the rise in risk premiums on corporate bonds. Consumers find themselves right in the middle of this downturn. With reduced purchasing power and high debt they see the threat of further bankruptcies and the constant drop in value of their assets undermining their confidence. The one positive factor is the moderation of inflation.

...although reduction of commodity prices comes as relief.

The drop in commodity prices offers relief for household purchasing power given that with the same dollars they can now buy more gallons of petrol. If oil prices hold at present levelss, close to 50 dollars a barrel, by mid-2009 we may be seeing negative movements in the CPI.

Gross domestic product (GDP) in the United States in the third quarter was down 0.5% in month-on-month terms annualized and it is expected to continued downwards in the fourth quarter. The weakest point now and the one holding greatest risk is private consumption which was down 3.7%. Also taking away from the strength of growth are capital goods investment and construction which has still not hit bottom. In this situation of weak domestic demand, the foreign sector has begun to make positive contributions but it is getting weaker and weaker with exports losing half the drive they showed in the previous quarter, a result of the slowdown in world demand. With these heavy burdens, the United States is at the doors of a recession with prospects for

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	3Q	October
Real GDP	2.8	2.0	2.3	2.3	2.5	2.1	0.7	–
Retail sales	5.8	4.1	4.1	4.9	3.0	2.6	0.7	–4.1
Consumer confidence (1)	105.9	103.4	105.7	91.2	76.5	57.3	57.3	38.0
Industrial production	2.2	1.7	1.8	2.1	1.9	0.2	–2.6	–4.1
Manufacturing (ISM) (1)	53.1	51.1	51.3	49.6	49.2	49.5	47.8	38.9
Sales of single-family homes	–18.0	–26.8	–27.3	–33.7	–33.1	–39.1	–34.6	...
Unemployment rate (2)	4.6	4.6	4.7	4.8	4.9	5.3	6.0	6.5
Consumer prices	3.2	2.9	2.4	4.0	4.1	4.4	5.3	3.7
Trade balance (3)	–753.3	–700.3	–701.4	–700.3	–697.8	–699.6	–708.3	...
3-month interbank interest rate (1)	5.2	5.3	5.4	4.9	3.0	2.8	3.2	3.0
Nominal effective exchange rate (4)	82.5	77.9	77.0	73.3	72.0	70.9	73.5	80.4

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

2009 pointing to nil growth at best, that is to say, taking into consideration the major supports from the public sector.

This sombre picture is reflected in state of mind of consumers as shown in the Conference Board consumer confidence index which in October was down from 61.4 points to 38.0 points, the lowest figure in the nearly 40 years the index has been available. In this context, retail sales in October added up their third consecutive month of decreases. This meant that, excluding cars and petrol (the mosts volatile components), retail consumption grew by a poor 0.5% which, if we discount price changes, turns into a drop of 1.6%. In addition, car sales in the same period showed a cumulative drop of 23.4% year-on-year. With these factors operating, tradespeople are predicting a bad season for Christmas shopping.

The corporate view, reflected in the index published by the Institute for Supply Management, gave up all past ambiguity and in October sharpened its downward trend to show a clear recession scenario with levels similar to those in 1991. The manufacturing index dropped from a level of 43.5 points to 38.9 points, well below the balance level of 50.0 points considered the threshold pointing to a risk of recession. In turn, the services index dropped sharply from 52.1 points to a level of 44.2 points. In both cases, we see that in just a few months we have passed from inflationary pressures to drastic price drops. Of special note is the weakness in employment and the sharp drop in new orders, especially in manufactures.

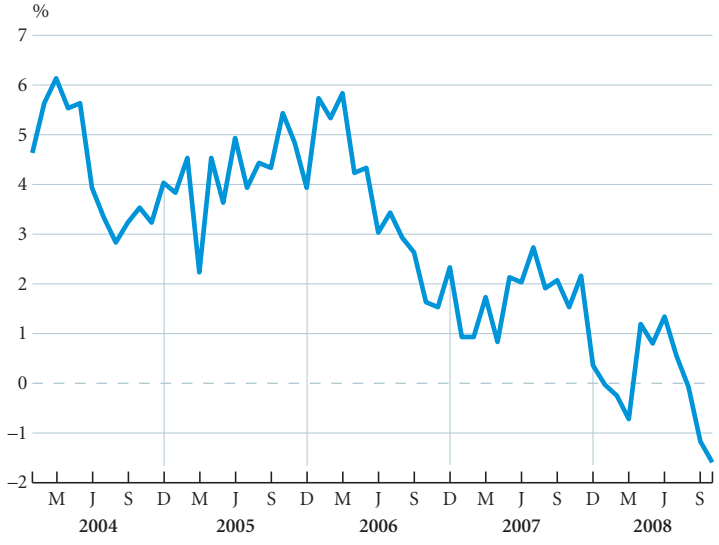
Consumer pessimism passing through to retail consumption.

The housing sector continues without touching bottom. On the demand side, real estate prices continue to reduce the perceived wealth of many consumers.

Business executives give out worse forecasts and see no rise in prices.

UNITED STATES: SLOWDOWN IN CONSUMPTION GROWS WORSE

Real retail sales excluding cars and petrol in year-on-year change (*)



NOTES: (*) Figures deflated by consumer price index excluding energy and foods.
SOURCE: Department of Commerce and own calculations.

Construction still not hitting bottom due to excessive supply.

The Case-Shiller index accumulated a drop of 22.0% compared with the high in June 2006 which, on top of the rise in the CPI, meant a loss in value of 28%. As a result of the constant drop in prices, the decrease in the number of sales seems to have hit bottom but there is still substantial oversupply in the housing market, made worse by the delay in income related to real estate prices. This stops supply from hitting bottom, as shown by the drop of construction in the GDP in the third quarter and in housing starts that in October was down by 38.0% year-on-year. Pointing in the same direction, building permits (an early indicator of starts) were down by 40.1%. The most palpable evidence of the sharpness of the adjustment is not in the decreases but rather in the levels reached seeing that in annual terms the 791,000 housing starts in October represent an all-time los since the index was started in 1959.

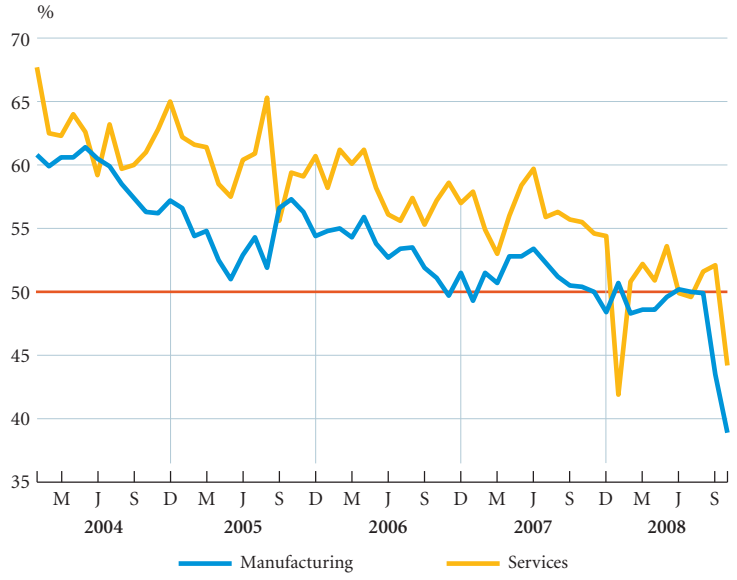
Labour market shows increasing drop with nearly 1.2 million jobs lost.

The weakness in private consumption has had its origin in the drop in household purchasing power mentioned above and in this the fragile situation in the labour market plays a crucial role. Some 240,000 jobs were lost in October and it turned out that the loss of jobs in previous months had been well above the initial estimate. This raised the total number of jobs lost in the January-October period of this year to 1,179,000. The unemployment rate reached 6.5% of the labour force and the trend is upward. In turn, wages maintained their purchasing power compared with the same period last year largely thanks to the drop in the price of oil.

On the prices front, the consumer price index (CPI) rose by 3.7% year-on-year in October which means a sharp slowdown compared with the rise of 4.9% in September. In view of the volatility in the general index, the key variable is still

UNITED STATES: BUSINESS EXECUTIVES SEE BAD TIMES AHEAD

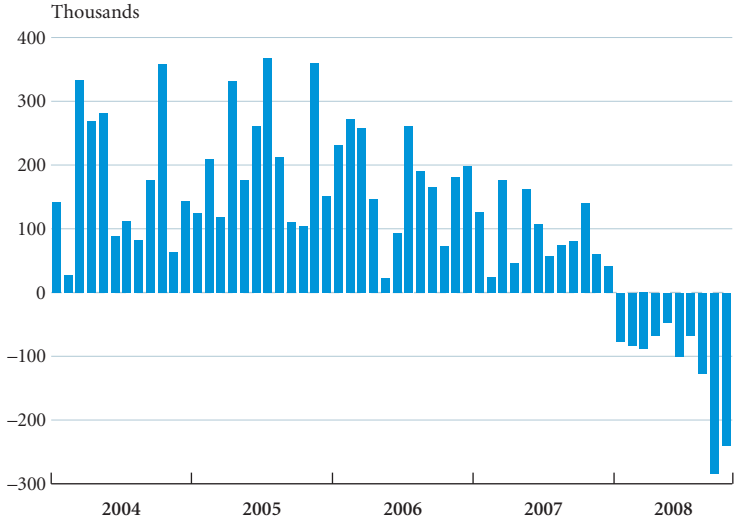
Level of ISM indices (*)



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

UNITED STATES: DROP IN EMPLOYMENT GROWING WORSE

Job creation (+) or job loss (–) in net monthly non-farm employment



SOURCE: Department of Labour and own calculations.

the underlying component (the general index less food and energy) which also moderated its climb with a rise of 2.2% year-on-year as against the earlier 2.5%. In the same period, producer prices rose by 5.1% year-on-year, which meant a sharp slowdown compared with the 8.7% in September because of the low utilization of production capacity, which in October stood at 76.3%, and the drop in oil prices.

In the foreign sector, which is now becoming a support for growth, the trade balance in goods and services showed a deficit of 56.47 billion dollars in September, a figure which, in spite of the weakness in consumer demand, stands 1.8% above the same period last year. In this respect, the hoped-for improvement in the trade balance (excluding oil and oil derivatives) has been stagnant for four months, if not decreasing. The reason lies in the slowdown in exports which seem to have hit a ceiling. Exports grew by 8.8% year-on-year as against an increase of 16.3% the month before, a sharper drop than that in imports which went from growth of 13.6% to an increase of 6.9% year-on-year.

Inflation rapidly moderating and drops below 4% but trade deficit resisting correction.

Japan already in recession

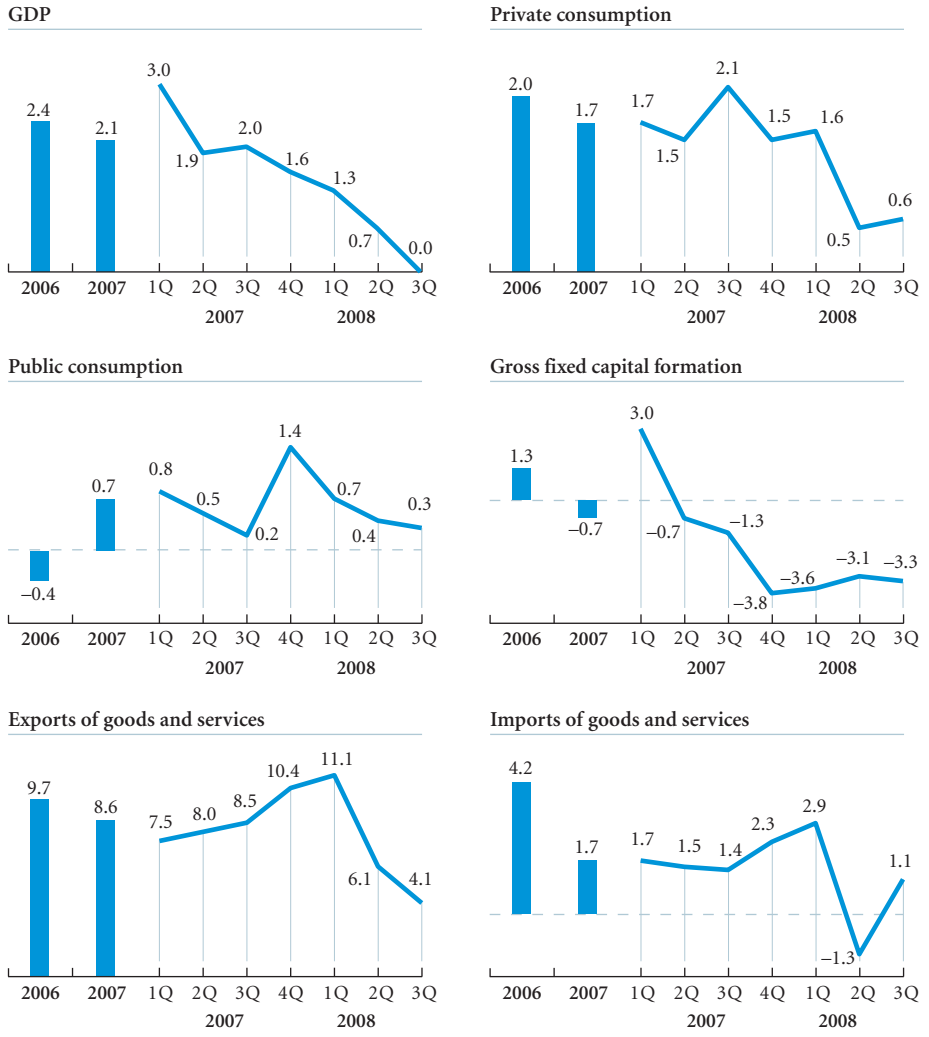
The GDP for Japan's economy in the third quarter was down by 0.6% in quarter-on-quarter terms annualized, which put year-on-year growth at 0.0%. Growth in the three previous quarters was also revised downward, especially that for the second quarter which now shows a drop of 3.7% quarter-on-quarter annualized. These two successive periods of negative growth put the economy in recession.

The breakdown by component largely shows dark spots although it also provides some light. The worsening in the foreign sector is continuing, the result of weakness in world demand, although exports were not as bad as in

Japan's GDP drops for second consecutive month and economy moves into recession.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Institut of Economic and Social Investigation and own calcualtions.

Investment in capital goods and exports are weakest components.

the previous quarter. Nevertheless, it was the increase in imports that ended up dragging the foreign sector down. The weakness of Japan's economy lies in its dependence on foreign sales which, this time, was especially evident in the drop of 6.7% quarter-on-quarter annualized in capital goods investment, which is largely carried out by exporting companies. This decrease in itself explains the drop in the economy in the third quarter. On the positive side, we should underline the slight recovery in private consumption and the sharp rise in construction which went from decreases of 11.9% to growth of 17.0% in quarter-on-quarter terms.

Doubts about this good news lie in whether it will continue. First of all, private consumption may have shown some increase because of the Olympic

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	2.4	2.1	2.0	1.6	1.3	0.7	–	0.0	–
Industrial production	4.2	2.9	3.1	2.7	2.5	1.0	1.2	–4.7	–2.1
Tankan company Index (1)	22.5	22.0	23.0	19.0	11.0	5.0	–	–3.0	–
Housing construction	4.5	–17.2	–36.9	–27.1	–8.9	–10.9	19.2	53.5	54.4
Unemployment rate (2)	4.1	3.9	3.8	3.8	3.8	4.0	4.0	4.1	4.0
Consumer prices	0.2	0.1	–0.1	0.5	1.0	1.4	2.3	2.1	2.1
Trade balance (3)	9.4	12.5	12.3	12.5	11.7	10.2	9.7	8.2	7.0
3-month interbank interest rate (4)	0.3	0.7	0.8	0.9	0.8	0.8	0.9	0.9	0.9
Nominal effective exchange rate (5)	81.1	77.1	76.9	78.4	83.4	82.6	80.6	80.7	84.4

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

Games in Beijing. Secondly, indicators for the housing market do not support the sharp upturn that appear in the national accounts. This has resulted in the two tax support plans put in motion by the Taro Aso government. Involving 6,800 billion yen (1.3% of GDP), the principal beneficiaries will be housholds. These benefits will include 60,000 yen (500 euros) for an average family of four people with exemptions for those paying off mortgages. Small and medium companies, as well as banks, would also receive aid. The problem with these tax measures is that the gross debt of the government Treasury is more than 170% of GDP although its creditors are mainly Japanese as opposed to the situation in the United States.

Among the more recent demand indicators there is not much light. Consumer confidence in the third quarter went to all-time lows and retail sales were again down in September. Car sales, an early indicator of demand, dropped again in October following slight signs of recovery in the first half of 2008. On the supply side, there doesn't seem to be any relief either. Industrial production did not recover from the severe correction in August and in September dropped by 2.1% year-on-year. Industrial production of consumer goods in the same period was down by a moderate 0.6%. Under capital formation, prospects for coming months remain dark with machinery orders down by 9.3% year-on-year and where the weakness was largely divided equally between the export sector and that related to domestic demand.

On the housing front, latest indicators do not confirm a continuation of the sharp increase in construction noted in the GDP in the third quarter. In spite of the rise in October, the volume of sales in the Tokyo area held to a sharp downward trend whereas prices have

Fiscal measures amounting to 6,800 billion yen aimed at boosting domestic demand.

Construction recovering but real estate sales still slack and industry keeps dropping.

been relatively stagnant since May. On the supply side, housing starts in the January-September period moved up by a moderate 2.3% year-on-year that indicates a rather modest recovery compared with the low level reached in the third quarter of 2007.

Inflation holding above 2% but likely will drop in coming months.

On the inflation front, the advances in the general index continue to be caused more by the after effects of the high cost of oil than for the strength of domestic demand. In September, the CPI rose by 2.1% year-on-year, wyile the index, excluding fresh foods, held just below the all-time high to show an increase of 2.3% year-on-year. Nevertheless, prices should rapidly moderate given that the underlying index (the general inflation index less energy and foods) showed an increase of 0.2% year-on-year. The Tokyo CPI for October with an increase of 1.2% year-on-year, and the continuation of decreases in commodity prices help support the hypothesis of a rapid return to inflation in Japan at values closer to 0, without discarding possible incursions onto negative ground, with a decrease in prices. In turn, the September unemployment rate was down slightly to stand at 4.0% of the labour force.

Exports still stagnant because of lower world demand.

In the foreign sector, the trade surplus continues to drop rapidly. In the 12 months ending in September, the positive balance dropped to 7,000 billion yen, 42.3% below the level for the same period the year before. It is significant that September was the second consecutive month to show a trade deficit. This is something unusual in Japan and the cause lies in stagnation in exports to the United States, and especially those to China. Japanese manufactures continue to be competitive but the appreciation of the yen and the weakness of world demand are making it difficult for a return to good winds in this Far East country.

Brazil: growing alone

With a lack of figures for the GDP in the third quarter, latest indicators and forecasts for 2009 paint Brazil as one of the economies least affected by the credit crisis. The Brazilian economy grew by 6.2% year-on-year in the second quarter, well above the average for recent years. The leading factor in economic activity remains domestic demand, although with less consumption and much more investment. While Brazil continues to

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
Real GDP	3.7	5.4	5.6	6.1	5.9	6.2	–	...	–	–
Unemployment rate São Paulo (*)	15.9	15.0	15.0	14.0	13.8	13.7	12.7	12.8	...	...
Consumer prices	4.2	3.6	4.0	4.3	4.6	5.6	6.4	6.2	6.3	6.4
Trade balance (**)	46.5	40.0	43.2	40.0	34.1	30.8	30.7	29.5	28.7	26.5
Central bank SELIC rate (***)	15.1	12.0	11.4	11.3	11.3	11.9	13.0	13.0	13.8	13.8
Reales to dollar	2.2	1.9	1.9	1.8	1.7	1.6	1.6	1.6	1.9	2.1

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
(***) Value of central bank rate from the Sistema Especial de Liquidação e Custodia (SELIC).
SOURCE: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

have the biggest trade surplus on the Latin American continent, the foreign sector continues to show an erratic profile with exports growing well below imports.

Among the latest indicators of economic activity, industrial production continued to sharpen increases and September showed growth of 9.4% year-on-year. With its more volatile nature but still maintaining its strength, industrial production of capital goods continued to show two-digit growth recording a gain of 25.8% year-on-year, which would indicate a continuation of the upward cycle in investment in the third quarter GDP. Logically, utilization of production capacity continued with the increase prevalent since the beginning of the year with a figure reaching 84.4% which is equal to the all-time high in 2007.

On the demand side, retail sales continued to show robust growth. Retail consumption in Brazil was something still to be dealt with. The macroeconomic accounts were satisfactory but, nevertheless, they did not reflect consumption by households, many of which stand at the poverty level. Nevertheless, as of 2004 and especially as a continuation, retail sales in 2007 and 2008 are going through an upward cycle that shows no signs of easing off, as is shown by the increase of 9.4% year-on-year in September. In a similar way, car sales in the January-October period were up by 22.2% year-on-year. The continuation of these rates of increase meant that in October 47% more units were sold than on average in 2006, which gives some idea of the drive in domestic demand.

The strength of domestic demand is bringing about relatively moderate inflationary pressures with the CPI in October rising by 6.4% year-on-year although staying with a profile of relative stability. Pressure on wholesale prices are

Brazil continues to skirt around effects of credit crisis.

Industry continues strong growth led by capital goods.

BRAZIL: COMING CLOSE TO FISCAL BALANCE

Government deficit in past 12 months in terms of GDP

SOURCE: Instituto da Pesquisa Economica Aplicada and own calculations.

Retail sales holding at strong level and CPI goes up 6.4%.

gradually easing as shown by the increase of 14.7% in October, a high level but below 15% for the second consecutive month. Given all these elements, the central bank is remaining vigilant and is holding its SELIC reference rate at 13.8%, a level it reached following gradual increases up to September.

Government finances improve but trade surplus down.

In the labour market, improvements are slower given that the unemployment rate in the São Paulo district ended its gradual decreases to stand at 12.8% of the labour force in August. In turn, the public sector continues to improve. In the first place, this is because of revenues coming into the Treasury. Thanks to strong economic activity, the fiscal surplus before paying interest on debt was 4.6% of GDP in the last twelve months ending in September. There were also continuing effects from the improvement in bond quality ratings so that interest paid amounted to 5.9% of GDP, below 6% for the first time since 1998. All of these factors helped to reduce the total government deficit to 1.3% of GDP, less than half the level in 2006. In the foreign sector, the relative loss of value by the real did not manage to right the drop in the trade surplus which, in the past twelve months ending in October, was 26.51 billion dollars, 16.16 billion less than in the same period the year before. This was a decrease that, in spite of the fragility of world demand, was due more to the increase in imports than to a sudden slowdown in exports.

Argentina grows by 7.5% but indicators point to slowdown.

Argentina: growth losing strength

The Argentine economy grew by 7.5% year-on-year in the second quarter and maintained its now long expansionist cycle based on domestic demand although with a clear easing off of private consumption and a sharper drop in investment.

Inflationary pressures, which in Argentina have been worse than in other emerging economies, seem to be easing somewhat. In October, the increase in CPI was 8.4% year-on-year, thus returning to rates at the beginning of the year. In the same way, wholesale prices of national goods rose by 10.9%, which also meant lower increases whereas energy products did maintain a notable increase of 20.9%. The downward trend in oil prices in this respect should mean

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
Real GDP	8.5	8.7	8.8	9.1	8.3	7.5	–	...	–	–
Industrial production	7.7	5.9	3.6	6.2	5.1	3.7	3.6	4.1	2.3	...
Unemployment rate (*)	10.2	8.5	8.1	7.5	8.4	8.0	–	...	–	–
Consumer prices	10.9	8.8	8.6	8.5	8.5	9.1	9.1	9.0	8.7	8.4
Trade balance (**)	12.3	11.1	10.4	11.1	12.3	10.9	11.4	13.4	14.2	...
3-month interbank interest rate (***)	9.9	11.3	12.6	13.7	10.7	14.2	14.1	13.9	13.7	19.3
Pesos to dollar	3.1	3.1	3.1	3.1	3.2	3.1	3.0	3.0	3.1	3.4

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
(***) Value.
SOURCE: National Institute of Statistics and Census, Republic of Argentina (INDEC) and own calculations.

notable relief for the Argentine economy, which should become visible in coming months.

Most recent demand indicators, while strong, show a process of sharp slowdown. Retail sales in the Buenos Aires region in September, grew by 16.0% year-on-year while the total for department stores was up 28.6%. In spite of the fact that these figures are high and include price increases, in both cases there was a notable easing compared with rates in August when the rates of increase were 27.3% and 37.0% respectively. Car sales in the last twelve months ending in October continued to confirm these signs of an easing-off of demand with growth of 9.7% year-on-year, whereas only three months earlier the increases were around 15%.

The downward track is also dominant on the supply side. Industrial production continues a trend to slow down with a poor advance of 2.3% year-on year. By sector, the motor vehicle industry maintained its recovery but the metal and chemical industries showed major drops. These decreases spread into the construction sector, given that in August the Synthetic Indicator of Construction Activity was down by 21.1% year-on-year, the second decrease in three months, something that had not happened since the recession in 2002. The Indicator of Industrial Activity showed a better performance in September with an increase of 5.7% year-on-year.

As against the loss of strength in domestic demand, the foreign sector corrected its flat position with a trade surplus for the twelve months ending in September that rose to 14.18 billion dollars, thanks to the notable strength in exports which, in the same period, rose by 38.4% year-on-year.

Commodities: a time of slashed prices

Inflation still above 8% but prospects are for prices to moderate.

November again brought further decreases in commodity prices. Between the first of the month and the 24th of November, the «The Economist» commodities index was down by 2.5%. Apart from the drop in November, what is impressive is the fact that since the annual highs at the beginning of June, this index has collapsed by more than 40%. Oil, which is not included in the index compiled by this economic weekly, fell by 15% between November 1-24 and more than 60% since the beginning of July when it marked up all-time highs. On November 24, the level was 52.5 dollars a barrel (1-month forward price for *Brent* quality oil), compared with 62 dollars at the beginning of the month.

Weakness in construction added to drop in retail consumption and industrial production.

Since the beginning of July, the segment showing the biggest adjustment has been metals which as a group fell by more than 50%. In this category it should be noted that products such as nickle, copper and platinum have even beaten this rate of decrease. Other components have shown lower rates of decrease with drops of less than 40% since the record prices in July. Specifically, non-food farm commodities have dropped by 38% while food commodities are down 37%. These figures suggest a pattern. Commodities for industrial use (most metals and some farm commodities) are those that have shown the biggest adjustments. These are products for which demand is of a more cyclical nature than that for foods and other commodities.

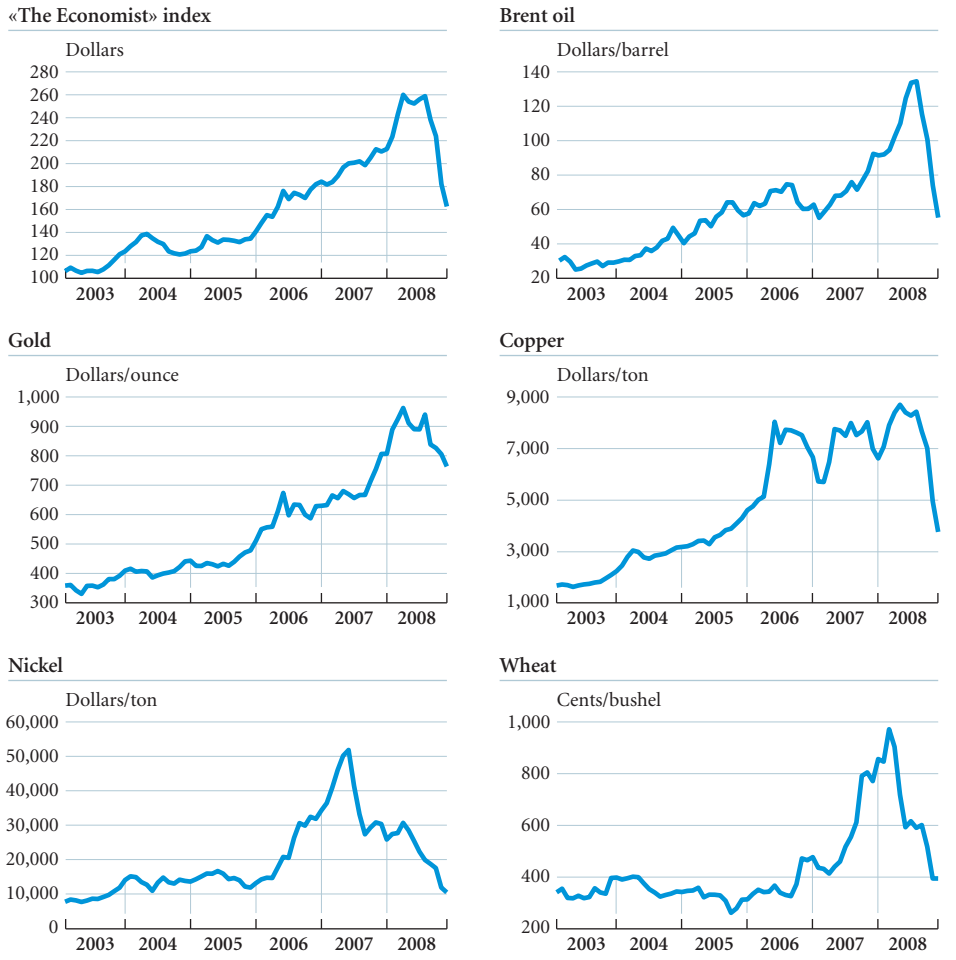
November brings another month of falling commodity prices.

If the economic cycle is the main culprit, a decrease in prices must be linked to changes in prospects for world growth. In the case of oil, the International Energy Agency has revised downward expected demand for 2009 so that it has gone from forecasting demand of 87.7 million barrels a day last August

Prospects of decreasing world demand depressing prices.

to propose 86.5 million barrels a day in November. If the Agency's forecasts are met, world oil demand in 2009 will be only 0.3% higher than that in 2008. Such a low figure for growth of demand has not been seen since 1985.

TREND IN VARIOUS RAW MATERIALS



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

EUROPEAN UNION

European Union forecasts: first recession in euro era

The European Commission recognizes that the European Union (EU) is going to suffer badly from the effects of the global crisis. The triple impact of the financial crisis, the adjustment in real estate in various countries and the delayed effect of various years with high-cost commodities are going to cause a slowdown in world growth that, in turn, will hit the EU badly. To be specific, the EU executive is expecting growth of gross domestic product (GDP) of 0.2% for the EU as a whole in 2009 (for 2008 it estimates growth of 1.4%) and 1.1% in 2010. The scenario for inflation is more favourable given that the lower growth of economic activity and the adjustment in commodity prices will help inflation drop from 3.9% in 2008 to 2.4% in 2009 and 2.2% in 2010. Compared with previous forecasts, these figures represent a notable downward correction for growth in 2008 and 2009 along with an upward revision for inflation in 2008 (but not for inflation in 2009).

The Euro Area will run along similar lines. Starting out from a growth rate of 1.2% in 2008, the Commission forecasts minimum growth of 0.1% in 2009 with recovery up to 0.9% in 2010. Inflation will also show a parallel path to that of the EU as a whole going from an increase of 3.5% in 2008 to slip downward to 2.2% in 2010. Apart from these annual

European Commission declares that Euro Area is entering first recession in its history.

MACROECONOMIC PROJECTIONS FOR EURO AREA (1)

	2005	2006	2007	Current forecasts Autumn 2008 (1)			Difference with Spring 2008 (2)	
				2008	2009	2010	2008	2009
Gross domestic product	**1.7**	**2.9**	**2.7**	**1.2**	**0.1**	**0.9**	**–0.6**	**–1.5**
Private consumption	1.8	2.0	1.6	0.5	0.4	1.0	–0.9	–1.1
Public consumption	1.5	1.9	2.3	1.8	1.2	1.0	–0.1	–0.5
Investment	3.3	5.5	4.3	1.2	–2.6	0.2	–0.9	–3.8
Employment	0.7	1.4	1.7	0.9	–0.4	0.1	0.0	–0.9
Unemployment rate (3)	9.0	8.3	7.5	7.6	8.4	8.7	0.4	1.1
Inflation (4)	2.2	2.2	2.1	3.5	2.2	2.2	0.4	0.0
Government balance (% of GDP) (5)	–2.5	–1.3	–0.6	–1.3	–1.8	–2.0	–0.3	–0.7
Government debt (% of GDP)	70.0	68.3	66.1	66.6	67.2	67.6	1.7	3.1
Current account balance (% of GDP)	0.1	–0.1	0.1	–0.4	–0.1	–0.1	–0.4	–0.1
Growth of GDP in EU	*2.0*	*3.1*	*2.9*	*1.4*	*0.2*	*1.1*	*–0.6*	*–1.6*

NOTES: (1) Commission revisions are based on figures available up to October 23, 2008.
(2) Plus sign (+) or minus sign (–) indicates a higher (or lower) positive figure or lower (or higher) negative figure compared with Spring 2008.
(3) Percentage of labour force.
(4) Harmonized consumer price index, nominal change.
(5) Processes related to UMTS licences included.
SOURCE: European Commission.

MACROECONOMIC FORECASTS OF EURO AREA COUNTRIES

Autumn 2008

	GDP (1)				Inflation (2)				Unemployment (3)			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Belgium	2.8	1.4	0.1	0.9	1.8	4.7	2.5	2.0	7.5	7.1	8.0	8.7
Germany	2.5	1.7	0.0	1.0	2.3	3.0	2.1	1.9	8.4	7.3	7.5	7.4
Ireland	6.0	–1.6	–0.9	2.4	2.9	3.3	2.1	1.8	4.6	6.1	7.6	7.4
Greece	4.0	3.1	2.5	2.6	3.0	4.4	3.5	3.3	8.3	9.0	9.2	9.3
Spain	3.7	1.3	–0.2	0.5	2.8	4.2	2.1	2.8	8.3	10.8	13.8	15.5
France	2.2	0.9	0.0	0.8	1.6	3.3	1.8	1.7	8.3	8.0	9.0	9.3
Italy	1.5	0.0	0.0	0.6	2.0	3.6	2.0	2.1	6.1	6.8	7.1	7.3
Cyprus	4.4	3.7	2.9	3.2	2.2	4.5	2.9	3.2	4.0	3.9	3.8	3.7
Luxembourg	5.2	2.5	1.2	2.3	2.7	4.4	2.2	2.7	4.1	4.0	4.3	4.7
Malta	3.7	2.4	2.0	2.2	0.7	4.4	3.0	2.2	6.4	5.9	6.2	6.4
Netherlands	3.5	2.3	0.4	0.9	1.6	2.5	3.0	2.3	3.2	3.0	3.4	3.7
Austria	3.1	1.9	0.6	1.3	2.2	3.4	2.1	1.9	4.4	3.9	4.2	4.5
Portugal	1.9	0.5	0.1	0.7	2.4	2.9	2.3	2.1	8.1	7.7	7.9	7.9
Slovenia	6.8	4.4	2.9	3.7	3.8	6.2	3.7	3.1	4.9	4.5	4.8	4.7
Finland	4.5	2.4	1.3	2.0	1.6	4.2	2.6	1.8	6.9	6.3	6.5	6.4
Slovakia (4)	10.4	7.0	4.9	5.5	1.9	4.0	3.5	3.3	11.1	9.9	9.8	9.6
Euro area	**2.7**	**1.2**	**0.1**	**0.9**	**2.1**	**3.5**	**2.2**	**2.1**	**7.5**	**7.6**	**8.4**	**8.7**

NOTES: (1) Percentage real change.
(2) Percentage change in harmonized consumer price index.
(3) Percentage of labour force.
(4) In spite of the fact that official incorporation of Slovakia in Euro Area begins January 1, 2009, the European Commission includes it in the Euro Area calculations in order to ensure homogeneity of all figures.
SOURCE: European Commission.

Global crisis depressing investment and exports thus making Euro Area without growth capacity.

figures, we should point out that the European Commission expects that 2008 will have shown three consecutive quarters with a quarter-on-quarter drop in GDP which means the first technical recession in the nearly 10-year of the history of the single currency. This is certainly an event to be celebrated sadly.

The impact of the economic crisis owes much to the particular starting-out situation of the Euro Area. During the period of growth, the two key elements in effect were investment and foreign demand while private consumption exercised a lesser role. Because of this, when world growth is showing its effect on the European foreign sector and investment is being affected by the financial crisis, the Euro Area is engulfed in the rapid worsening of its growth rate. According to the EU executive, investment in 2009 will drop by close to 2% while the rate of exports will be reduced to half that recorded in 2008. While in the case of foreign demand, the slowdown in imports will make it possible to largely compensate for the lower showing in exports, this is not the case with investment.

With regard to other significant factors, it may be mentioned that as a result of the worsening of economic activity, the labour market is going to appreciably worsen. In 2009, employment will

MACROECONOMIC FORECASTS FOR EUROPEAN UNION COUNTRIES OUTSIDE EURO AREA

Autumn 2008

	GDP (*)				Inflation (**)				Unemployment (***)			
	2007	2008	2009	2010	2007	2008	2009	2010	2007	2008	2009	2010
Bulgaria	6.2	5.8	5.6	4.7	7.6	12.4	7.9	6.8	6.9	6.0	5.8	5.7
Czech Republic	6.5	4.7	5.0	3.9	3.0	6.6	3.1	2.7	5.3	5.0	5.0	5.2
Denmark	1.8	1.3	1.1	0.9	1.7	3.8	2.3	2.0	3.8	3.1	3.5	4.3
Estonia	7.1	2.7	4.3	2.0	6.7	10.6	4.9	3.3	4.7	5.0	6.7	7.7
Latvia	10.3	3.8	2.5	1.0	10.1	15.7	8.2	4.7	6.0	6.5	9.2	9.6
Lithuania	8.8	6.1	3.7	–1.1	5.8	11.9	7.1	7.5	4.3	4.9	7.1	8.4
Hungary	1.3	1.9	3.2	1.8	7.9	3.6	3.9	2.9	7.4	8.1	8.6	8.5
Poland	6.5	5.3	5.0	4.2	2.6	4.3	3.5	2.6	9.6	7.3	7.3	7.8
Romania	6.0	6.2	5.1	5.0	4.9	7.8	5.7	4.0	6.4	6.1	6.4	6.1
Sweden	2.6	2.2	1.8	1.8	1.7	3.0	1.7	1.9	6.1	6.0	6.8	7.3
United Kingdom	3.0	1.7	1.6	0.4	2.3	3.7	1.9	1.2	5.3	5.7	7.1	6.9
European Union	**2.8**	**2.0**	**1.8**	**1.1**	**2.4**	**3.9**	**2.4**	**2.2**	**7.1**	**7.0**	**7.8**	**8.1**
United States	2.2	0.9	0.7	1.0	2.8	4.4	1.5	0.8	4.6	5.7	7.5	8.1
Japan	2.0	1.2	1.1	0.6	0.0	1.6	0.8	0.7	3.9	4.1	4.7	4.6

NOTES: (*) Percentage real change.
(**) Percentage change in harmonized consumer price index except for United States and Japan, which is the index of national prices.
(***) Percentage of labour force.
SOURCE: European Commission.

contract by 0.4% and will recover only marginally in 2010. In turn, the unemployment rate will go up one percentage point between 2008 and 2010 to reach close to 9% of the labour force. At the end of the forecast period, the figure for unemployed in the Euro Area will be close to 14 million persons. Another area in which the economic drop will be appreciated is in public finances. Compared with a public imbalance of 1.3% of GDP in 2008, two years later the deficit will go up to 2.0%. This worse situation will be due more to the increase in spending then to lower revenues.

In spite of its sombre tone, this macroeconomic scenario may end up being even somewhat too positive. Just a few days following its publication, the International Monetary Fund and the Organization for Economic Cooperation and Development both published forecasts in which they foresaw a drop in GDP in the Euro Area of the order of 0.5% in 2009. While the European Commission certainly considers that the risks for its scenario (particularly that the financial crisis could last more than expected and that it could be sharper than estimated) tend to generate lower growth, it is likely that the reality will be more severe than that assumed by that body.

European Commission scenario likely too optimistic.

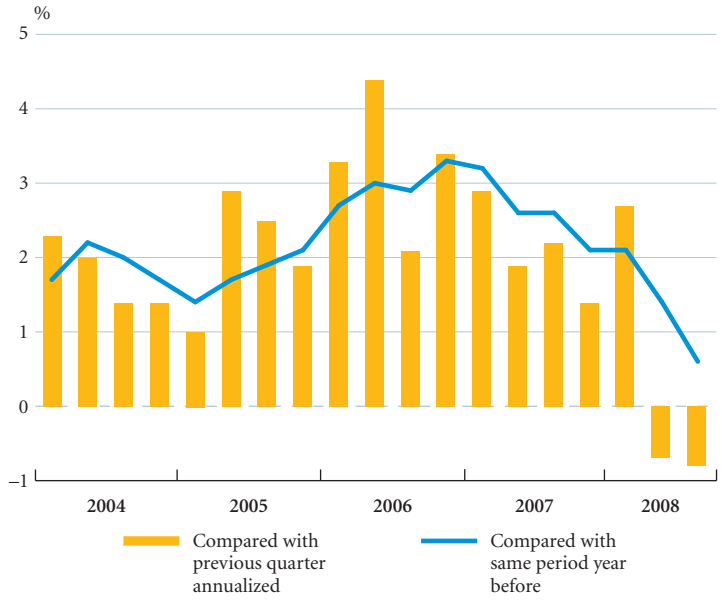
Euro Area in recession: And now what?

Growth figures for the third quarter have confirmed that the Euro Area has definitely moved into recession. The Euro Area GDP in that period fell by 0.2% compared with the third quarter.

Euro Area entering its first recession hand-in-hand with poor situation in Germany and Italy.

EURO AREA MOVES INTO RECESSION

Change in gross domestic product in real terms



SOURCE: Eurostat and own calculations.

Consumption especially of consumer durables heavily affected by recession.

The same drop showed up in the second quarter. As mentioned earlier, this is the first recession in the history of the euro. At year-on-year rate, growth slipped to 0.7%, a rate equal to half that reported in the second quarter. With available figures we see that three economies in the Euro Area already are in recession, namely Germany and Italy (that went into recession in the third quarter) and Ireland (that suffered the same fate in the second quarter). Low growth in France and Austria (early estimated quarter-on-quarter growth of 0.1%) and the nil quarter-on-quarter growth in the Netherlands and Portugal round out a situation of practically halted economic growth.

Investment and exports reflect financial difficulties and drop in international demand.

What are some of the ways the economic adjustment is taking place? Despite a lack of breakdown figures for demand components in the third quarter, the monthly indicators allow us to come close to the situation. One big factor to collapse was private consumption as shown but the drop in retail sales in the third quarter. The decrease in household spending is taking place more in consumer durables than in non-durable goods. Industrial production of consumer durables dropped by 6.7% year-on-year in September whereas industrial production of non-durable goods showed a lower year-on-year decrease of 2.2%.

Another support for domestic demand, investment, is also showing a drop. Both the adjustment in the level of utilization of industrial production capacity (with a drop of one percentage point in the third quarter) and the trend in industrial production of capital goods (year-on-year drop of 0.9% in September) underline that capital goods investment is rapidly fitting itself to the worse situation in credit and the worsening of expected demand.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	3.0	2.6	2.6	2.1	2.1	1.4	–	0.7	–	–
Retail sales	1.5	0.9	1.2	–0.3	–0.2	–1.5	–1.5	–1.5	–1.3	...
Consumer confidence (1)	–9.1	–4.9	–3.9	–7.7	–11.9	–14.6	–19.7	–19.2	–18.9	–23.6
Industrial production	4.0	3.5	4.0	3.1	2.5	1.1	–1.1	–0.7	–2.4	...
Economic sentiment indicator (1)	106.3	108.4	108.7	104.3	100.5	96.5	89.5	88.5	87.5	80.4
Unemployment rate (2)	8.3	7.4	7.4	7.3	7.2	7.4	7.4	7.5	7.5	...
Consumer prices	2.2	2.1	1.9	2.9	3.4	3.6	4.0	3.8	3.6	3.2
Trade balance (3)	–10.4	20.1	31.4	34.3	23.5	11.5	–3.7	–14.9	–24.3	...
3-month Euribor interest rate	3.1	4.3	4.5	4.7	4.5	4.9	5.0	5.0	5.0	5.3
Nominal effective euro exchange rate (4)	103.6	107.7	107.7	110.6	112.8	115.6	115.8	113.5	111.6	107.6

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

With the weakness in domestic demand, growth in the Euro Area is dependent on the foreign sector. But news on this front is far from bright. The trade balance, which up until the second quarter was positive, in September recorded a deficit of 24.3 billion euros as cumulative figure for 12 months. The stabilization of the rate of increase in exports from the Euro Area in the 12 months ending in September at 6% year-on-year implies that it is growing at a rate approximately half that recorded one year ago. Imports, on the other hand, continue to move up at substantially higher rates of the order of 10% year-on-year.

The impact of this situation in demand, both domestic and international, on the drop in supply is a clear worsening of the latter. In September, industrial production decreased by 2.4% year-on-year while confidence in services and construction in October dropped to negative levels not seen for more than a decade. The crisis has thus reached a wide range of economic sectors. The lack of drive in demand is also beginning to have an impact on the unemployment rate which, after standing in the area of 7.2% in the first quarter, followed a stepped series of increases to reach 7.5% in September.

The favourable counterpart of the adjustment in demand is the lower pressure on prices. In October, the consumer price index (CPI) stood at 3.2% year-on-year, four decimals below the September figure. The drop in inflation largely came as a result of the slowdown in the energy component and, to a lesser degree, to lower growth in the group of unprocessed foods.

Starting out from this situation, what can we expect over the short term? Qualitative indicators available for the fourth quarter (economic sentiment and purchasing manager indices, for example) suggest that in the last three months of 2008 the recession will grow

Inflation drops to 3.2% thanks to cheaper energy.

European Commission trying to coordinate ambitious package of fiscal measures.

sharper so that any sign of recovery will have to wait until well into 2009. This is in line with the scenario drawn by the international bodies such as the IMF and OECD that suggest a drop in GDP in 2009 of some size (–0.5% on annual average). In this context, we can expect a further gradual worsening of the labour market although also a rapid easing of inflationary pressures.

German economy in recession.

To deal with these negative prospects, the European Commission has presented a series of coordinated tax measures to stimulate the economy. The package, which will amount to some 200 billion euros (approximately 1.5% of the European Union GDP), will largely be financed from national budgets which will bear some 170 billion euros. The remaining 30 billion euros will be distributed practically equally among credits to small and medium companies from the European Investment Bank and amounts from European programmes aimed at financing infrastructures in transport, energy and telecommunications. For the national segment, the Commission merely indicated a series of possible measures (reductions in VAT and social security contributions, increased spending, government cover for credit, etc.). The proposal must be ratified by the European Council for it to go into effect.

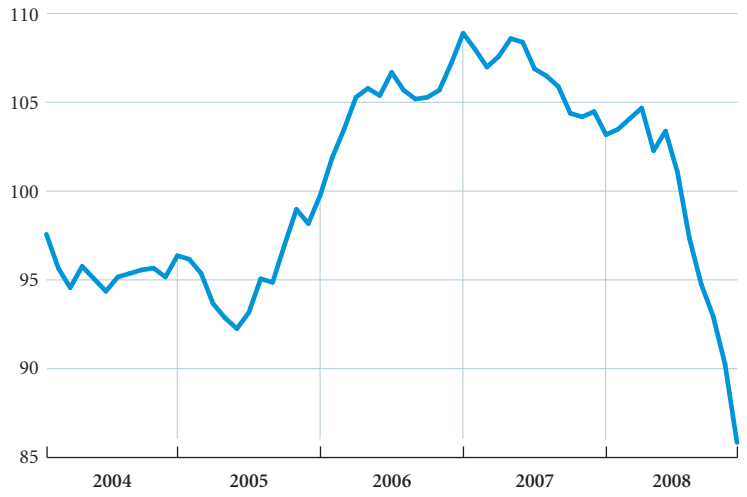
Sharp economic drop at end of third quarter and beginning of fourth quarter.

Germany: at door of a complicated 2009

Germany faces 2009 plagued by uncertainty. The present situation is one of weakness. In the third quarter the GDP fell by 0.5% quarter-on-quarter, thus showing a worse drop than the 0.4% in the second quarter due to the poor state of investment and exports. At year-on-year rate, a figure close to the medium-term trend, growth in the third quarter was 0.8%, compared with 1.7% in the second quarter.

ECONOMIC ACTIVITY COLLAPSES IN GERMANY

Figure for IFO industrial activity index



SOURCE: IFO Institute.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	3.2	2.6	2.4	1.7	2.7	1.9	–	0.8	–	–
Retail sales	0.3	–2.2	–2.2	–3.3	–0.9	–0.2	1.4	–3.3	1.2	...
Industrial production	6.0	5.9	5.7	5.0	5.0	3.0	0.1	1.5	–2.3	...
Industrial activity index (IFO) (*)	105.4	106.2	105.5	103.9	104.0	102.2	97.3	94.7	92.9	90.2
Unemployment rate (**)	10.7	9.0	8.9	8.5	8.1	7.9	7.8	7.7	7.6	7.5
Consumer prices	1.6	2.3	2.3	3.1	2.9	2.9	3.3	3.1	3.0	2.4
Trade balance (***)	151.3	181.5	189.4	195.1	199.1	201.3	197.6	195.5	190.7	...

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

The few indicators available for the fourth quarter, along with those for the end of the third quarter, suggest that economic drive is weakening even more in the final stages of 2008. Motor vehicle registrations dropped by 8.2% year-on-year in October, industrial production was down 2.3% year-on-year in September and the trade surplus dropped that month to 190.7 billion euros (in cumulative balance for 12 months). In fact, consumption is down sharply, industry is losing its drive and the foreign sector is bringing less and less growth. This explains why the IFO industrial activity index collapsed in November going to the area of 85 points, the lowest since the crisis in 1992-1993. The fact that in October the labour market was able to reduce the unemployment rate to 7.5% and that in November inflation could drop to 1.4% year-on-year is hardly sufficient relief against the rather bleak economic scenario.

In view of this situation, the German government decided to adopt a series of tax relief measures amounting to 32 billion euros, that is to say, equivalent to 1.3% of GDP. This is a series of measures including, among others, an increase in company tax deductions for investment in machinery and the elimination of car registration taxes. The induced impact of the package estimated by the government amounts to 50 billion euros in terms of investment and additional consumption.

Government approves series of measures involving tax cuts and increased investment.

The Advisory Economic Council, involving representatives of the main economic research institutes, has roundly denounced the programme calling it «a mixture of quite insufficient measures». At the same time, this council considers that it should be more clearly aimed at infrastructures and education. Others have demanded much bigger tax cuts. Nevertheless, the prospects of going much further, especially with regard to tax deductions, are limited and it is worth recalling that the German government faces federal elections in 2009 and the lack of consensus on economic policy within the «Grand Coalition» has been evident for more than a year.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	2.4	2.1	2.4	2.2	2.0	1.2	–	0.6	–	–
Domestic consumption	3.3	4.4	4.8	3.8	2.4	1.5	1.4	0.1	1.4	0.7
Industrial production	1.0	1.4	2.1	2.3	1.7	–0.2	–1.9	–2.6	–1.9	…
Unemployment rate (*)	9.2	8.3	8.2	7.9	7.7	7.7	7.8	8.0	7.9	…
Consumer prices	1.7	1.5	1.3	2.3	2.9	3.3	3.6	3.2	3.0	2.7
Trade balance (**)	–27.4	–33.2	–33.9	–38.3	–41.6	–45.9	–49.1	–51.5	–53.6	…

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

France: third quarter only just saved

France grows more than expected in third quarter...

Whereas it was accepted as certain that France would go into recession in the third quarter, everyone was surprised when it grew by 0.1% quarter-on-quarter. When we look at the small size of the increase in GDP, this was more of a psychological relief than a real one but it has had some impact in a European context full of mainly negative news. What now seems less likely is that the French economy can avoid a drop in growth in the fourth quarter. The Bank of France has come out in favour of this opinion and it expects a quarter-on-quarter drop of 0.5% in GDP in the fourth quarter.

...but weakness in current activity puts end of 2008 in doubt.

Available indicators are quite negative. Consumer confidence plummeted in October going to –32 points, the worse figure since 1996. The drop in industrial production of consumer goods (year-on-year decrease of 0.4% in September) and the collapse in motor vehicle registrations confirm that private consumption is making substantial adjustments. And, if domestic demand is getting weak, foreign demand offers little relief. In September, the trade deficit (as cumulative figure for 12 months) stood at 53.6 billion euros, two million euros more than in August.

On the supply side, the situation is similar. Industrial production in September dropped by 1.9% year-on-year, a path that, in view of the worsening of industrial confidence in October, it will likely continue in coming months. Nor are services in great shape as shown by the fact that confidence in the services sector dropped by more than five points in October. Finally, construction continues caught in a very complicated stage. In a context in itself negative, the figures for housing starts and building permits have shown surprisingly worse. In fact, there is no sector of the economy that shows up as being able to work as an engine of economic activity.

Inflation drops but unemployment rate worsening.

As is also happening in other Euro Area economies, the result of this weak situation shows up in the impact on the labour market and on the prices front. The unemployment rate, after standing in the area of 7.7% in the first quarter, began to rise in the third quarter, a period when it reached 7.9% of the labour force. With regard to inflation, the CPI dropped to 2.7% year-on-year

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	1.9	1.4	1.6	0.1	0.4	–0.2	–	–0.9	–	–
Retail sales	1.2	0.5	0.2	0.5	0.9	–1.7	2.1	–1.3	0.5	...
Industrial production	2.4	0.0	0.8	–2.9	–1.4	–1.7	–3.2	–3.7	–4.8	...
Unemployment rate (*)	6.8	6.2	6.2	6.3	6.6	6.8	–	...	–	–
Consumer prices	2.1	1.8	1.6	2.4	3.1	3.6	4.1	4.1	3.8	3.5
Trade balance (**)	–17.6	–13.7	–11.3	–8.9	–9.1	–8.6	–9.1	–10.5	–11.6	...

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

in October as compared with 3.0% year-on-year in September. The slowdown was entirely due to the volatile components of the index given that, if these are excluded, inflation held at 2.1% in September and October.

Italy: mired in the recession

In January Italy will hold the presidency in turn of the G-8. The last time the country held this notable international role was in 2001. In eight years the world has greatly changed and, at least in the economic sphere, Italy has changed less than what might be desired. This has been a period during which the third largest economy in the Euro Area has marked up 11 quarterly drops in GDP out of a total of 32 quarters as well as four recessions. Average annual growth in these eight years has been less than 1%. This is a disappointing history for a country that is traditionally industrious and competitive.

The situation does not look any more brilliant from a strictly immediate economic situation. In the third quarter the GDP was down by 0.5% quarter-on-quarter. As in other countries, this is the second consecutive quarter to show a drop. In year-on-year terms, the GDP was down 0.9%. Growth is being hampered by the combined effect of a weakness in consumption, investment and exports.

Italy marks up fourth recession since 2001.

A few indicators point out the seriousness of the situation in each of these areas. Retail sales were down 1.3% year-on-year in August, the capital goods component of industrial production dropped by 8.2% year-on-year in September and exports went from growth of close to 8% year-on-year in the second quarter (in cumulative figure for 12 months) to grow by three percentage points less in the third quarter. Inflation, on the other hand, has provided a breather going to 3.5% year-on-year in October as against 3.8% in September.

Domestic demand suffers from impact of crisis.

United Kingdom: stagflation in British Isles

The British economic situation is running in a different track from that of its EU associates. Up until now the growth situation has been only slightly unfavourable for the British economy.

Forecasts suggest British economy to suffer major drop in activity and higher level of inflation than in the Euro Area.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	2.8	3.0	3.3	2.9	2.3	1.5	–	0.3	–	–
Retail sales	3.2	4.4	5.0	3.8	5.4	4.4	2.0	3.0	1.7	2.0
Industrial production	0.7	0.4	0.3	1.0	0.6	–1.1	–1.7	–2.3	–2.2	...
Unemployment rate (*)	2.9	2.7	2.6	2.5	2.5	2.6	2.7	2.8	2.9	3.0
Consumer prices	2.3	2.3	1.8	2.1	2.4	3.3	4.4	4.8	5.2	4.5
Trade balance (**)	–72.5	–83.2	–84.7	–88.4	–90.9	–92.9	–94.2	–94.8	–94.1	...
3-month Libor interest rate	4.6	5.3	6.0	6.3	6.0	6.0	5.9	5.8	5.7	6.3
Nominal effective pound exchange rate (***)	98.0	103.9	104.3	102.2	97.6	92.6	92.8	92.5	88.2	89.4

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

Impact of dropping consumption too heavy a burden for British economy.

In the third quarter, year-on-year growth was 0.3%, four decimals less than the Euro Area as a whole. This was not especially alarming because the British adjustment had begun earlier. What is now troubling indeed is that 2009 seems as if it will be a grim year. The IMF forecasts, for example, indicate that the economy will drop by more than 1% next year, that is to say, more than twice the decrease in the euro economies. This is certainly a devastating prognosis that puts in doubt any possibility of a rapid recovery.

The course being taken by the recession in Britain has its own peculiarities. The main problem, which is shown by such indicators as retail sales in September and the drop in consumer confidence in October, is that consumption is going to collapse in coming quarters. Given that strength has been a distinctive feature of the British economic drive, the lack of this strength is going to be felt. Another specific problem is the sharp adjustment in investment, both in capital goods and in housing. This entire scenario of weakness is already showing up in embryonic form in available indicators.

In September, industrial production was down 2.2% year-on-year, in October unemployment rose for the fourth consecutive month and in the same month economic sentiment collapsed to the 70 points level.

As well as low growth, at present and especially in the future, one factor that makes the British situation unique is that inflationary trends are more entrenched than in the case of its associates on the Continent. In spite of the fact that inflation eased to 4.5% in October, this rate compares unfavourably with 3.2% in the Euro Area. This is an old problem, as shown by the fact that the medium-term inflation objective of the Bank of England (2% year-on-year) has not been met since the beginning of 2005. The worst is that in its November report the Old Lady of Threadneedle Street foresees that, following several months of clear decreases, from mid-2009 on inflation will remain stuck at a relatively high level for an economy in recession.

The complicated economic situation has forced the British government to launch

a tax incentive plan amounting to 20 billion pounds sterling. The key measure under this plan is the temporary reduction of VAT which goes from 17.5% to 15% up to December 31, 2009. To compensate for the drop in tax revenues certain special taxes will be raised along with income tax for higher income levels.

Government lowers VAT in attempt to foster consumption.

Seeking protection in turbulent times

Following ten years under the single currency, the euro project may be considered a success to the extent that it has been able to provide macroeconomic stability to the economies participating in the Economic and Monetary Union (EMU). Nevertheless, if we are to judge the attraction of the euro in terms of its ability to draw in new members, the verdict here is not favourable. Apart from those countries which we may consider as traditionally against joining the euro (United Kingdom, Denmark and Sweden), a large majority of the new member states coming into the EU in 2004 and 2007 have shown little enthusiasm for joining the euro club.

Of the twelve new members states, only three (Malta, Cyprus and Slovenia) have bet on the EMU. The lack of interest in the euro is also to be seen in public opinion. A recent Eurobarometer opinion survey (July 2008), the official survey of the European Commission, showed that out of the nine Central and Eastern European member states, forming part of the EU but not of the euro, in six of those states (Slovakia, Lithuania, Latvia, Czech Republic, Estonia and Poland) 45% of people were against moving into the single currency. Of the other three states, in two countries (Hungary and Bulgaria) more than a third of the population was against the euro project and only in Romania was the figure relatively low at around 20%. Paradoxically, Slovakia, which will join the euro in 2009, was the country showing the highest percentage of people reticent about that change. While these figures present only a partial view of reality, given that a survey always contains its biases, the fact is that in this case the government position is in line with that of the citizenry and, except for Slovakia, only Romania has officially declared its desire to join in… 2014.

Behind the public perception and the political position lies an undoubted economic reality. Joining the EMU and adopting the single currency involves meeting the so-called convergence criteria. The five convergence criteria a country must meet are: 1) that the inflation rate is not more than 1.5 percentage points above the average of the three countries with lowest inflation; 2) that the public deficit is lower than 3% of GDP and the level of government debt stands below 60% of GDP; 3) that long-term interest rates are not more than 2% above the average of the three countries with lowest inflation; 4) that the currency of the candidate country take part in the euro Exchange Rate Mechanism (maintaining a fixed central rate with a fluctuation band of 15%, known as the ERM II) for a period of at least two years; and 5) that national legislation is in accord with the Treaty of Maastricht in those aspects referring to the European System of Central Banks and the European Central Bank (and its statutes).

What does meeting those criteria mean for the new EU member states? These are countries with relatively low prosperity and therefore higher growth potential but with a tendency to record higher inflation. For this reason, the convergence criteria involve a stage of fiscal consolidation and monetary rigor. All of this leads to lower short-term growth although this may be more sustainable over the long-term. This involves a complicated political cost which helps us to understand their reluctance to join the EMU.

This was more or less the situation last summer. Since then, however, there have been significant statements which have been rather unexpected. At the beginning of September, the Polish prime minister Donald Tusk made a surprise announcement about his country's intention to join the euro in 2012. This will be a complicated process that, as well as the need for the country's fiscal consolidation mentioned above (in April 2008 the European Commission considered that Poland was in an excessively deficit situation), this will involve legal changes full of uncertainty including complex constitutional reform.

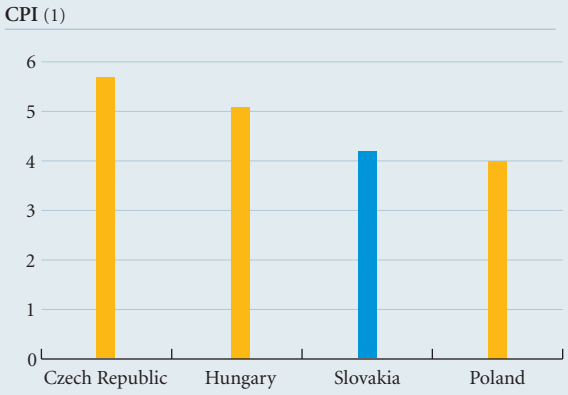
In this Copernican turn toward the euro Poland is not alone. Other newcomers have made similar statements. Czech Republic is now looking at a scenario for joining in 2012, a date that other countries have mentioned as desirable, as in the case of Bulgaria, Latvia and Estonia. Hungary feels that it will be able to meet the convergence criteria in 2009. Furthermore, new candidates for the single currency, totally unexpected some months ago, have now appeared on the scene. Members of the government in Sweden and Denmark, which had rejected joining the euro in referendums, have stated that it would be desirable to plan to join the single currency. In the case of Denmark, they are now talking of 2011 as the date for a new referendum on the question. Even the United Kingdom, the intellectual and political champion of opposition to the single currency for many years, may be reopening the debate. Finally, Iceland, which not only is outside the euro but is not even a member of the EU, is thinking of becoming a candidate for the single currency. What has happened so that a project which up until now had so little appeal has now become so desirable?

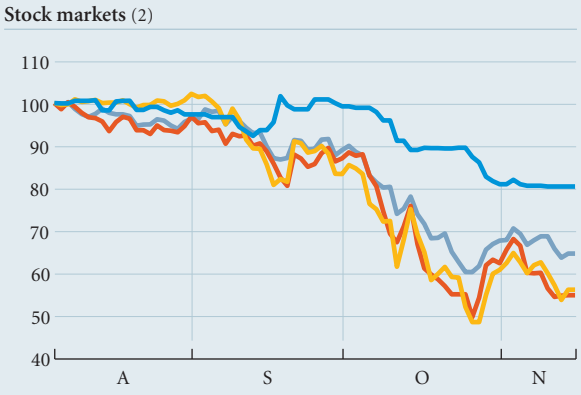
The financial crisis, as in many other areas of economic reality, has radically changed public opinion about the desirability of the single currency. While the benefits and costs of sharing a currency, specifically the euro, have been a cause for academic, political and public debate for many years, in a context of deep financial crisis one of the benefits of the euro (protection against undesirable changes in exchange rate) seems above discussion. This is not a theoretical debate far from the interest of ordinary people. In the Eurobarometer survey mentioned earlier we noted that nearly half the population of Slovakia, Lithuania, Latvia, Czech Republic, Estonia, Poland, Hungary, Bulgaria and Romania stated that the benefits of the single currency for their country would be to protect it from the effects of international crises.

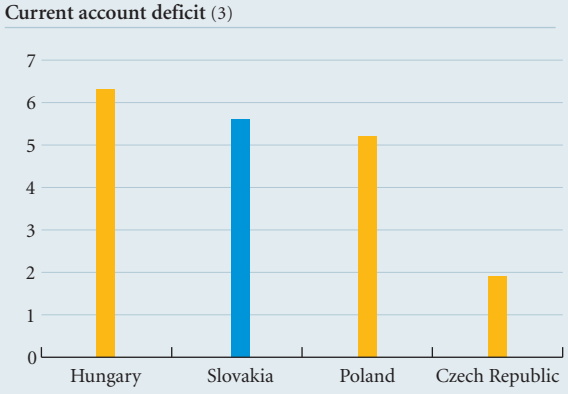
This shielding effect against recession offered by the euro is becoming quite noticeable. While it would seem that such a strong evaluation is difficult to demonstrate, the fact that one of the new member states, namely Slovakia, is to join the euro in January 2009 makes it possible to see up to what point the single currency protects an economy from the financial crisis. If the macroeconomic conditions, that is to say, the macro fundamentals, are similar in Slovakia and other EU states outside the euro, but on the other hand the pressure on currencies, interest rates and stock markets is lower, it may be inferred that Slovakia is benefiting from the effect of protection from the euro (even before its official adoption).

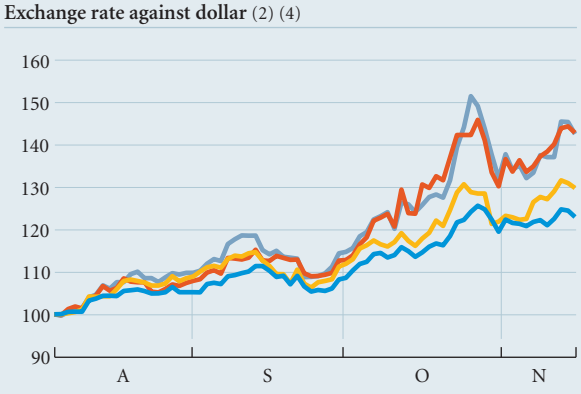
The figures indicate that this is so. The macroeconomic imbalances in Slovakia are not substantially different from those in the other countries of Central and Eastern Europe. Available figures (see graphs on the following page) indicate that, in terms of current deficit, inflationary pressures and government imbalances, its situation is similar to that of countries such as Czech Republic, Hungary and Poland. In spite of these macroeconomic similarities, the financial variables show that the crisis is affecting Slovakia to a relatively low degree. While since last August when the financial upsets worsened and the Slovak stock market dropped by approximately 20%, most of the stock markets in the region had fallen by twice that amount. At the same time, pressure on the exchange rate of the Slovak crown has been low. In terms of the dollar, and again since the beginning of August, the Slovak currency has depreciated by approximately 25%, a long way from the 45% loss in value of the Hungarian forint and the Polish zloty. In this context, there has been little need to support the currency

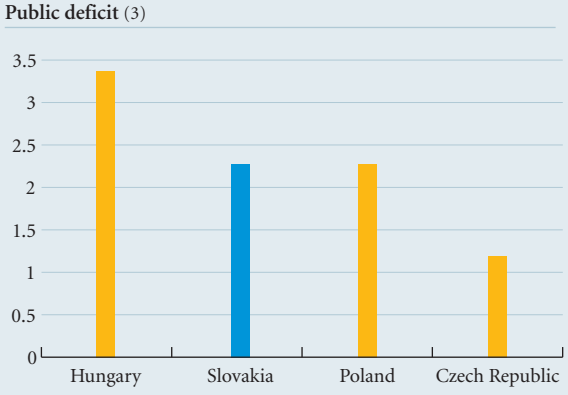
THE SHIELD OF THE EURO IN SLOVAKIA: SIMILAR MACROECONOMIC IMBALANCES BUT LOWER FINANCIAL PRESSURES

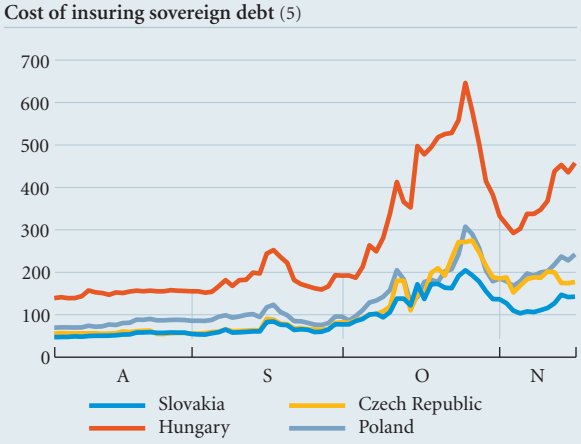












NOTES: (1) Year-on-year change in percentage (October 2008) at annualized rate.
(2) August 1, 2008 = 100.
(3) Percentage of GDP forecast for 2008.
(4) Higher values imply depreciation of the currency.
(5) 10-year bond Credit Default Swap in basis points.
SOURCE: European Commission and Thomson Reuters Datastream.

MEETING OF CONVERGENCE CRITERIA

Country	Inflation	Exchange rate	Interest rate	Deficit and debt	Legal compatibility
Bulgaria	•	•	✓	✓	•
Czech Republic	•	•	✓	✓	•
Estonia	•	✓	•	✓	✓
Latvia	•	✓	✓	✓	•
Lithuania	•	✓	✓	✓	✓
Hungary	•	•	•	•	•
Poland	•	•	✓	•	•
Romania	•	•	•	✓	•
Slovakia	✓	✓	✓	✓	•
Sweden	✓	•	✓	✓	•

✓ Meets criteria • Fails to meet criteria

SOURCE: European Commission, Convergence Report May 2008.

through aggressive monetary tightening. Whereas short-term interest rates tended to rise in all economies in the area (of the order of 150 basis points since last August), in Slovakia not only has there not been an increase but the 3-month interest rate has dropped by nearly 75 basis points.

Recent experience thus confirms the protection role of the single currency against the crisis. The situation for possible candidates is now a long way from being simple. The lack of political interest up to now has meant that in all cases they failed to meet the convergence criteria (see table). While progress in this area may take place, in the present economic situation it is going to be costly in terms of growth as well as politically complicated. On the other hand, the economic situation may have made it possible to more easily deal with the course of convergence than in previous years. In economics, as in life, we remember the euro only when times are hard. This is also the case now.

FINANCIAL MARKETS

Monetary and capital markets

Heavy activity of central banks and governments in view of recession

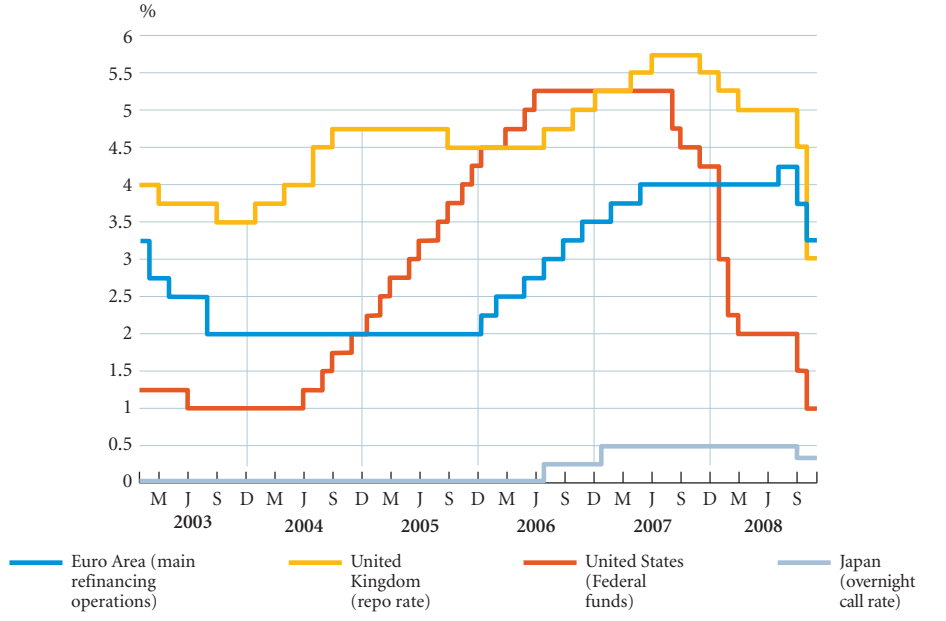
Demands for better coordination of economic policies and reform of the international financial structure received a positive response at the meeting of the G-20 in Washington. The G-20 is a block made up of the eight main advanced economies, the eleven main emerging economies along with representation of the European Union. This forum for cooperation and consultation met in Washington on November 15 at the proposal of Europe with the United States acting as host.

This initial meeting meant the beginning of reforms proposed for some time. While this is a first step to be followed by further meetings, the process is now underway and probably cannot be stopped because of the need to avoid a new crisis in the future and because a lack of agreement could worsen the present crisis. For this reason, the incentive to reach an agreement was very strong and therefore a series of measures to stabilize the markets and economic growth was unanimously adopted. In order to achieve these objectives it was decided to unconditionally support the financial system, to coordinate expansionist

G-20 meets in Washington and agrees on reforms to international financial structure.

PRICE OF MONEY CONTINUES TO DROP

Reference rates of central banks



SOURCE: National central banks.

Main features of agreement are to strengthen transparency, improve regulation, increase international cooperation and commitment to open economy.

fiscal policies and aid to emerging countries.

On top of the above measures came a series of basic principles for reform of financial markets. These included strengthening transparency in those markets and in financial products, improving the regulation and supervision of the rating agencies, protecting the investor and consumers, increasing international cooperation in regulatory matters and finally, reforming the International Monetary Fund and the Financial Stability Forum (FSF). The FSF is an international body set up in 1999 with the aim of promoting international financial stability. Its members are international financial institutions, central banks as well as national regulatory and supervisory bodies. Both institutions will have to identify the vulnerable points in the world economy and in this way anticipate potential dangers in order to take more preventive action. Finally, the G-20 leaders announced their commitment to an open, global economy in order not only to avoid an increase in trade barriers but also to further agreement in the current round of negotiations within the World Trade Organisation.

Bank of England and ECB cut official rates in face of poor growth in both areas.

The G-20 meeting did not stop other official bodies from maintaining their activity in the fight against the crisis. The central banks are maintaining their tendency to inject liquidity and cut the price of money. In the case of the Bank of England, in view of the seriousness of the situation in the UK the monetary policy committee cut the official interest rate by 150 basis points (100 basis points is 1%) on November 6, putting it at 3%. The main reason for the move was the forecast of a deep recession for the UK economy. This reduction was the sharpest since 1992 and put the official interest rate at levels not seen since 1955. The members of the monetary policy committee saw the possibility of even cutting 250 basis points from the official interest rate, according to the minutes of their meeting.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS DOWN

Trend in credit granted to Euro Area residents

SOURCE: ECB.

Also on November 6, the European Central Bank (ECB) took a decision to lower its reference rate by 50 basis points putting it at 3.25%. The central bank chairman, Jean-Claude Trichet stated that prospects for price stability in the Euro Area had substantially improved because of the drop in commodity prices, especially in oil.

On the other hand, the members of the ECB governing council are concerned about the impact of financial instability on the real economy given that the latest economic figures indicate that the Euro Area has gone into recession and the prospects are for a worsening of the situation. This is the second factor given by the ECB for controlling inflation over the medium term. The weakening of demand reduces the ability of European companies to set prices given that, in a situation of dropping sales, it is more difficult to raise prices of goods and services without losing market share.

In its analysis, the ECB usually uses another key element to make decisions on monetary policy, namely an analysis of the trend in the monetary aggregates. In this case, the ECB took note of the continuing slowdown in those aggregates and added that the economic agents had chosen to take money out of investment funds and shift it to bank deposits because of the guarantees afforded by governments. With regard to money supply, the central bank of the Euro Area was cognizant of a slowdown in the granting of loans to residents of the Euro Area.

ECB concerned about future economic course in Euro Area and feels inflation risk now less important.

However, the list of countries whose central banks lowered interest rates in November was much longer and included Denmark, Czech Republic, Slovakia, South Korea and Australia. Furthermore, on November 20, Switzerland's central bank cut its official interest rate by 100 basis points putting it at 1%. In fact, it may be stated that in view of the synchronization of the economic crisis there has been a coordinated response in official interest rate cuts almost world-wide.

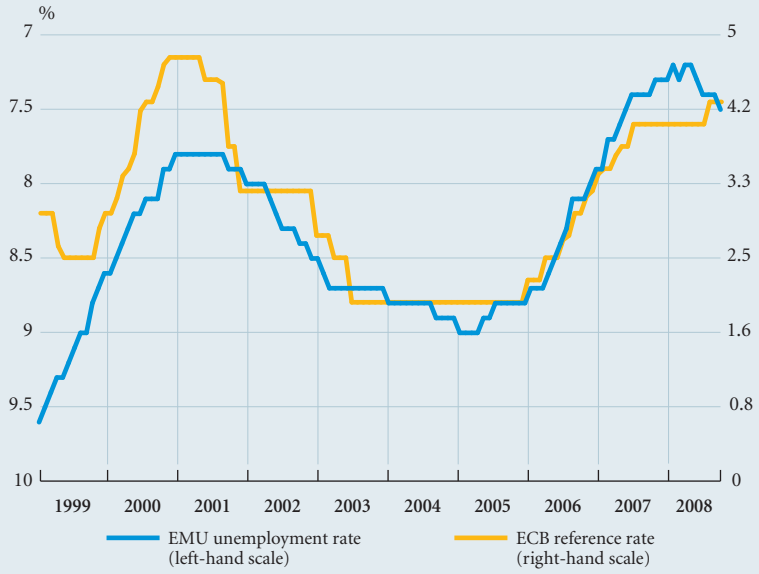
Various central banks cut reference rates.

Does the ECB take into account the unemployment rate when it sets the interest rate?

At times of economic slowdown it is quite common to hear people urging interest rate cuts. A few months ago, the strength of the euro also brought demands in political and business circles for a cut in interest rates to counteract the appreciation of the currency and revive the economy. Nevertheless, the ECB resisted lowering rates for most of the year alleging that inflation stood at very high levels. Those critical of the central bank suggested that it should include among its objectives maximizing the level of employment as this would allow the ECB to lower rates even when inflation stands at values above the 2% objective. Such criticism is not out of place. The US Federal Reserve, for example, has the double mandate of price stability along with maximum sustainable employment. It is therefore reasonable to ask if the ECB should have a similar mandate instead of dealing exclusively with inflation as required by the overriding objective of price stability.

As noted in another box in this Monthly Report, the ECB has managed to maintain inflation in a band of «below, but close to, 2%» only less than 40% of the time in the last 10 years. It would therefore seem that the ECB has followed a monetary policy less strict than established under its statutes. It does not seem that the ECB has sacrificed economic growth to achieve its inflation objectives but rather quite the contrary. As a picture is

CLEAR RELATION BETWEEN ECB REFERENCE RATE AND UNEMPLOYMENT RATE IN EUROPE



SOURCE: BCE and Eurostat.

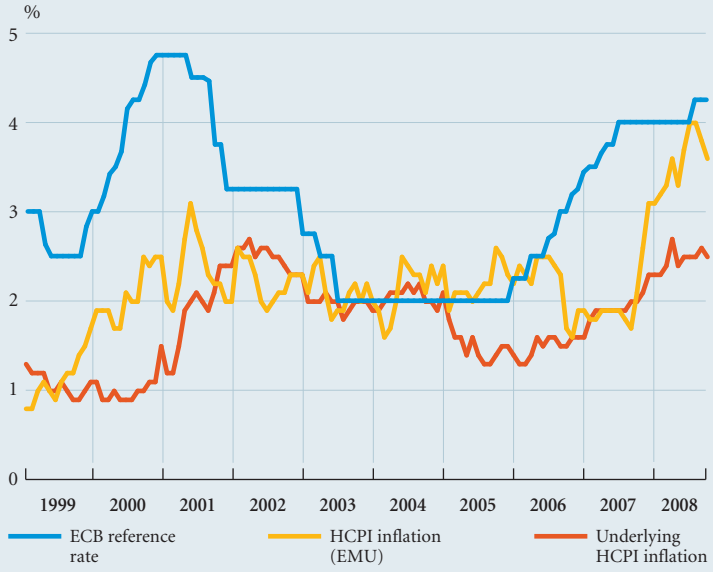
worth more than a thousand words, the above graph shows the rate of unemployment in the Euro Area (with inverted scale) and the ECB reference rate. As may be seen, the two statistical series have run close together over the past 10 years. When unemployment increases, the ECB tends to cut interest rates. This relation shows up more clearly since 2001 when the reference rate starts reacting with some delay to fluctuations in the unemployment rate. Because of this, criticism suggesting that the ECB does not pay attention to the unemployment rate in the euro area would appear to be exaggerated.

And how does the ECB react to changes in the inflation rate? In the following graph, we show the trend in the ECB reference rate along with inflation in the Harmonized Consumer Price Index and the underlying component (excluding energy and fresh foods). As opposed to the case of the unemployment rate, it is more difficult to readily find a relationship between the ECB reference rate and inflation. During some periods the reference rate has been well above the inflation rate, whereas between 2003-2005 inflation stood above the reference rate, which implies negative real interest rates.

The implication of this simple graphic analysis is confirmed in a recent study by the Economic Research Department of ”la Caixa”.[1] Using econometric methods, this study shows that since 1999 the ECB has responded much more to fluctuations in the unemployment rates than those in inflation. By contrast, in the 90's the central banks in the Euro Area reacted in a similar way to fluctuations in both variables. This result may also be seen when other variables of real activity are used in place of the unemployment rate, such as the output gap (that is, the difference between current GDP and potential). One explanation of this result is that during the 90’s the central banks in Europe were trying to lower inflation to the levels set at Maastricht and

(1) See Rabanal, P., 2008, *Should the ECB Target Employment?*, ”la Caixa” Economic Paper, No. 6.

RELATION BETWEEN REFERENCE RATES AND INFLATION RATES IN EUROPE FAR FROM CLEAR



SOURCE: BCE and Eurostat.

therefore were aggressively responding to the increase in inflation. Since the creation of the EMU, on the other hand, the credibility of the ECB has made it possible to maintain well-anchored inflation expectations and, in view of the moderate swings in inflation, the ECB has not needed to vary its rates for this to return to values close to 2%. The risk in this strategy is that if inflation persists at levels above the objective, the ECB may lose credibility, which would increase expectations for inflation and interest rates over the long term.

To sum up, in spite of the fact that the ECB's mandate is to maintain price stability, the ECB is not insensitive to the labour market situation in the Euro Area. As we have shown, the ECB reference rate is sensitive to changes in the unemployment rate. Furthermore, the ECB has allowed deviations from its inflation objective of «below, but close to, 2%», instead of maintaining a more restrictive monetary policy that would have hurt growth and job creation in the Euro Area. Given the rhetoric of the ECB and what its critics say, this result may seem surprising.

Drop in government bond yield in view of world recession

The measures taken up till now are helping to normalize interbank markets. The following table shows how the 1-year Euribor rate has dropped to 4%, a level not seen since March last year. There is still some way for it to go seeing that, whereas at the beginning of the year the differential between the official ECB rate and the 1-year Euribor was 0.32 percentage points, on November 26 the differential was 0.75 percentage points. Nevertheless, it may be stated that since the highs seen in September there has been a downward trend that has taken the 1-year Euribor from 5.5% to the current 4%.

1-year Euribor drops to 4%.

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						
2007									
October	4.00	4.60	4.60	4.50	4.89	0.90	5.75	6.28	2.68
November	4.00	4.81	4.69	4.50	5.13	0.99	5.75	6.61	2.62
December	4.00	4.68	4.75	4.25	4.70	0.90	5.50	5.99	2.63
2008									
January	4.00	4.37	4.32	3.00	3.11	0.87	5.50	5.58	2.59
February	4.00	4.38	4.38	3.00	3.06	0.96	5.25	5.74	2.72
March	4.00	4.73	4.73	2.25	2.69	0.91	5.25	6.00	2.78
April	4.00	4.86	4.96	2.00	2.85	0.92	5.00	5.84	2.86
May	4.00	4.86	5.10	2.00	2.68	0.92	5.00	5.87	2.78
June	4.00	4.95	5.39	2.00	2.78	0.93	5.00	5.95	2.73
July	4.25	4.97	5.37	2.00	2.79	0.90	5.00	5.78	2.78
August	4.25	4.96	5.34	2.00	2.81	0.88	5.00	5.75	2.70
September	4.25	5.27	5.50	2.00	4.05	1.02	5.00	6.30	3.00
October	3.75	4.76	4.87	1.00	3.03	0.94	4.50	5.84	2.43
November (1)	3.25	3.90	4.00	1.00	2.20	0.93	3.00	3.96	1.85

NOTES: (1) November 26.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 7-12-06 (3.50%), 8-03-07 (3.75%), 6-06-07 (4.00%), 3-07-08 (4.25%), 8-10-08 (3.75%), 6-11-08 (3.25%).

(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%).

(4) Latest dates showing change: 10-05-07 (5.50%), 5-07-07 (5.75%), 6-12-07 (5.50%), 7-02-08 (5.25%), 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

Lower inflation and recession go in favour of government bonds.

The same phenomenon has taken place in the United States where the 3-month rate in the interbank market has dropped to 2.20% whereas in September only two months ago it reported a figure of 4.05%. In this case, the reduction has been 1.8 percentage points in the past two months. In Japan, in spite of the rise taking place in September, the 3-month interbank rate has again gone well below 1% marking up 0.93% on November 26. That is to say, Japanese banks are willing to lend money to each other for 3 months earning interest at a rate of 0.93%. This is a low level by it must be borne in mind that Japan's official rate has dropped from 0.5% to 0.3% nor can we discount further reductions because Japan's economy has moved into recession.

The most spectacular move came about in the British interbank market where the 3-month rate fell by 2.34 percentage points in two months from the 6.30% quoted in September to a 3.96% return asked on November 26.

In the case of long-term government bonds, the trend to a reduction in yields continues. Whereas until recently the aim was a flight to quality, that is, investors preferred to get out of riskier financial assets and buy government bonds in

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

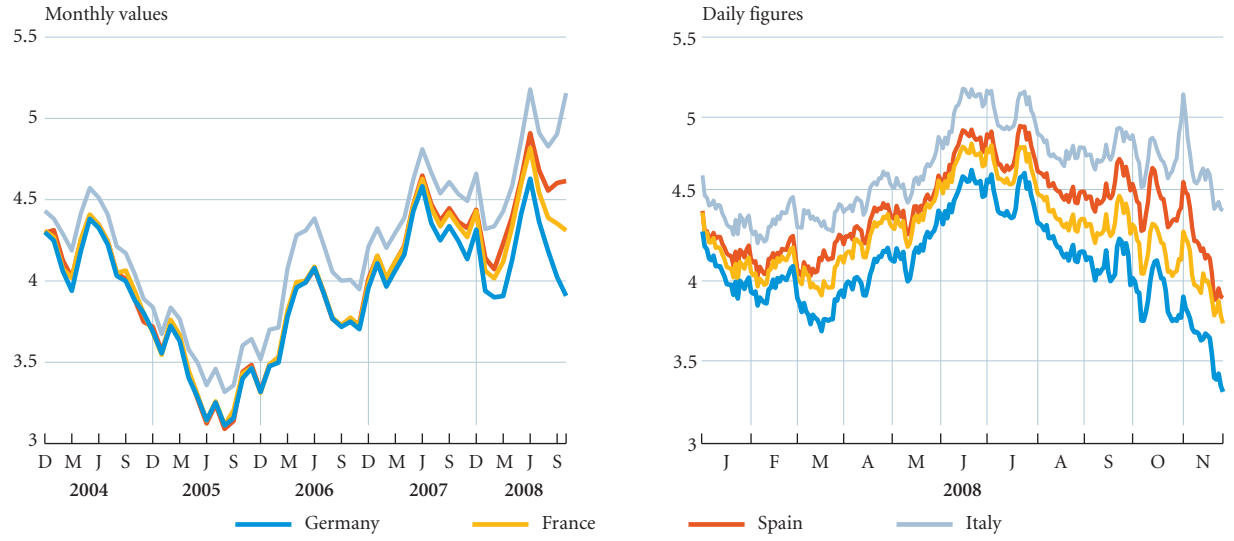
10-year government bonds at end of period as annual percentage

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2007								
October	4.24	4.33	4.36	4.53	4.47	1.61	4.93	2.98
November	4.13	4.26	4.32	4.48	3.94	1.48	4.64	2.88
December	4.31	4.42	4.43	4.65	4.02	1.51	4.51	3.05
2008								
January	3.93	4.05	4.13	4.31	3.59	1.44	4.48	2.81
February	3.89	4.01	4.06	4.33	3.51	1.37	4.47	2.96
March	3.90	4.11	4.22	4.42	3.41	1.28	4.35	2.92
April	4.12	4.33	4.39	4.58	3.73	1.59	4.67	3.12
May	4.41	4.59	4.62	4.86	4.06	1.76	4.99	3.19
June	4.62	4.81	4.90	5.17	3.97	1.60	5.13	3.29
July	4.36	4.53	4.67	4.90	3.95	1.54	4.81	3.05
August	4.18	4.38	4.55	4.82	3.81	1.42	4.48	2.89
September	4.02	4.35	4.60	4.90	3.82	1.47	4.45	2.61
October	3.90	4.30	4.61	5.15	3.95	1.48	4.52	2.84
November (*)	3.31	3.73	3.89	4.43	3.01	1.39	3.80	2.23

NOTES: (*) November 26.
SOURCE: Bloomberg.

PREFERENCE FOR GERMAN GOVERNMENT BONDS

Yield on 10-year government bonds as annual percentage



NOTES: Latest figure November 26.
SOURCE: Bloomberg.

Prospects of further government bond issues with no change in yield for the moment.

order to protect their capital, at this time increased pessimism about the duration and extent of a recession taking place world-wide has led to the buying of an asset of great value at times of recession. In addition, the expectation of sharp drops in inflation in all countries makes this financial product more attractive seeing that the purchasing power of money is decreasing and therefore bonds again become more interesting.

For the moment, the belief that governments will have to increase their bond issues to finance expected increases in government deficits because of the drop in economic activity and to be able to finance fiscal aid plans, is not having a negative effect on government bonds. Under normal conditions, a sharp increase in bond issues by any government should bring down prices and thus raise their yield. But at this time the risk of a deep recession is overriding all other factors.

Most foreign currencies take a breather except for pound sterling and Mexican peso which still show sharp volatility.

For example, a US 10-year Treasury bond has shown a drop in yield from 3.95% at the end of October to 3% on November 26. In the Euro Area as well German government bonds have reduced their yield by 59 basis points putting it at 3.31% at the end of November. Looking at the Euro Area countries, Spanish bonds have converged with Germany more rapidly than the rest. From the beginning of the crisis investors have preferred to take refuge in German bonds because of their range and greater liquidity compared with the other Euro Area countries. But now the differential between German bonds and those of other countries is narrowing, as may be seen from the above graph. This narrowing has gone in favour of Spanish bonds.

Pound sterling suffering from prospect of deep recession.

Pound sterling and Mexican peso fail to achieve stability

Following the sharp volatility in foreign exchange markets in October, these markets took something of a breather in November as they consolidated the new levels reached, with a couple of exceptions. First, the currency to follow a sharp tendency to depreciate was the pound sterling. In the period from October 24 to November 24, the British currency depreciated by 5.8%. At this time, a dollar buys 0.67 pounds sterling whereas at the end of July it could buy only 0.50 pounds. That is to say, in this period the dollar appreciated by 32.6%. But the British currency has also depreciated sharply against the euro. On November 24 a euro could buy 0.851 pounds sterling whereas at the end of October the exchange rate was 0.792.

The main reason for this swing in the pound sterling was the adjustment of investment portfolios. World investment portfolio managers must follow the principle of diversification to avoid massive losses due to excessive concentration. The United Kingdom is one of the world's largest economies and therefore the weight of British assets must be in keeping with its importance. Nevertheless, when there is a consensus among economists that this will be a country to suffer one of the worst recessions in its history in 2009 compared with other countries, all interest in buying pounds sterling soon disappears.

The other exception is the Mexican peso which has given more than one headache to Mexico's central bank. The Mexican peso collapsed against the dollar going to a figure of 13.90 pesos to the dollar on November 20.

EXCHANGE RATES OF MAIN CURRENCIES

November 24, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2007	Annual
Against US dollar				
Japanese yen	96.0	1.7	–16.5	–11.9
Pound sterling	0.665	5.8	32.1	37.8
Swiss franc	1.206	3.2	6.0	9.0
Canadian dollar	1.256	–1.7	20.5	21.2
Mexican peso	13.467	0.6	19.1	18.2
Against euro				
US dollar	1.280	1.4	–12.2	–13.9
Japanese yen	122.9	3.3	–24.6	–23.1
Swiss franc	1.544	4.8	–6.7	–5.4
Pound sterling	0.851	7.4	15.8	18.6
Swedish krona	10.428	4.1	10.5	12.5
Danish krone	7.455	0.0	0.0	0.0
Polish zloty	3.851	1.0	7.1	4.6
Czech crown	25.36	1.4	–4.5	–5.2
Hungarian forint	261.5	–4.9	3.4	1.4

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

As opposed to the above two cases, the euro-dollar exchange rate showed greater stability in November. Since July the change in the quotation of the Euro Area currency against the dollar has gone through two stages. First came a sharp depreciation of the euro which began in July this year when a euro could buy nearly 1.60 dollars and then it changed by mid-October when a euro was worth only 1.30 dollars. The second stage began on October 21 when the quote for the euro stood within in a range of 1.25 and 1.30, approximately. This is where it now stands. The sharp depreciation of the euro may be explained by the narrow differentials in interest rates between the two regions seeing that the ECB is cutting the official rate from higher level whereas as the Fed already holds the reference rate at 1%. Furthermore, we must add the prospect that the United States (which had moved into recession earlier) would come out of the recession before the Euro Area. Having included this information in the quoted price, for the moment, while awaiting further news or a significant change in trend, the markets seem to sit comfortably in the range mentioned above.

Euro-dollar exchange rate on hold awaiting further economic information to decide future trend.

Stock markets unable to find firm bottom

In fact, November has been disastrous for the stock markets which are still struggling to find a firm bottom. Only on November 24, after learning about a new bailout plan by the US federal government for the Citigroup bank, did share indices in the developed countries move up strongly with increases in the range of 4% to 9%. But this rise was not

Stock markets fail to halt drop in November.

sufficient to recover levels that would make it possible to state that the downswing was over. If they should manage to consolidate these gains, it will be a first step in leaving behind a year that in any case will find it difficult not to go down in the history of finance bearing the adjective «disastrous».

Two elements have been a burden on shares in November. The first was economic figures that indicate a simultaneous recession world-wide whose duration and depth has created doubts about the solidness of some financial systems, as in the case of the United States. The bailout of Citigroup shows that US banks still need public recapitalization to avoid situations of high default risk.

Doubts about health of financial sector join worse situation in US motor vehicle sector all of which brings about further investor pessimism.

The second negative factor for investors has been the difficulty being seen in the US motor vehicle sector. While today the weight of this industry in the economy is much less than it was 30 or 40 years ago, it remains relevant, as shown by a broad overview.

In the United States, this sector employs 240,000 persons directly but indirectly provides jobs for some millions of other workers, if we include those working in sales offices, parts suppliers for the industry, etc. Its contribution to the country's gross domestic product is 4%, it spends 12 billion dollars on research and development and provides 2 million people with medical insurance if we take into account persons retired from the sector who have this right due to their

INDICES OF MAIN WORLD STOCK EXCHANGES

November 24, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*8,216.0*	*–1.9*	*–38.1*	*–36.7*
Standard & Poor's	*820.2*	*–6.5*	*–44.1*	*–43.1*
Nasdaq	*1,416.4*	*–8.7*	*–46.6*	*–45.5*
Tokyo	7,910.8	3.4	–48.3	–46.9
London	3,976.9	2.4	–38.4	–36.5
Euro Area	2,250.6	–3.5	–48.8	–47.3
Frankfurt	*4,298.0*	*0.1*	*–46.7*	*–43.5*
Paris	*3,006.5*	*–5.9*	*–46.4*	*–45.5*
Amsterdam	*232.8*	*–5.4*	*–54.9*	*–52.7*
Milan	*19,064.0*	*–4.1*	*–50.6*	*–49.8*
Madrid	*8,305.4*	*–0.6*	*–45.3*	*–46.0*
Zurich	5,303.2	–6.6	–37.5	–36.7
Hong Kong	12,457.9	–1.3	–55.2	–53.1
Buenos Aires	886.6	–0.4	–58.8	–59.9
São Paulo	33,473.0	6.3	–47.6	–45.1

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

being former employees, along with other family members.

In this context, investors held to a tendency to reducing risk in their investment portfolios and preferred to reduce their holdings in shares.

Over the past month, the Spanish stock market represented by the selective IBEX 35 did relatively better than most European stock markets with the exception of Germany. A comparison with the Spanish stock market is also favourable if we take into account yield since the beginning of the year. Whereas the Spanish stock market showed a drop of 45.3%, the other stock markets were down more. This is bitter comfort, however, when the whole group fails to pass the examination. Indeed, just one month off the end of the year investment in shares presents a rather disappointing picture.

While index for Spanish stock market has done better than Euro Area competitors, 2008 has not been a good year for shares.

SPAIN: OVERALL ANALYSIS

Economic activity

Long economic growth stage comes to an end

GDP up 0.9% in third quarter compared with same period last year, 9 decimals less than in second quarter.

After a year and a half of economic slowdown, gross domestic product (GDP) showed a quarterly drop in the third quarter of 2008, the first decrease since the beginning of 1993, according to the National Institute of Statistics. The worsening of the economic slowdown was due to the impact of the financial crisis and the effect of certain commodity prices at still high levels in the July-September period. Nevertheless, the main downward drive comes from the change in cycle stage in the real estate sector.

Drastic reduction in contribution of national demand to GDP growth while foreign sector makes better showing.

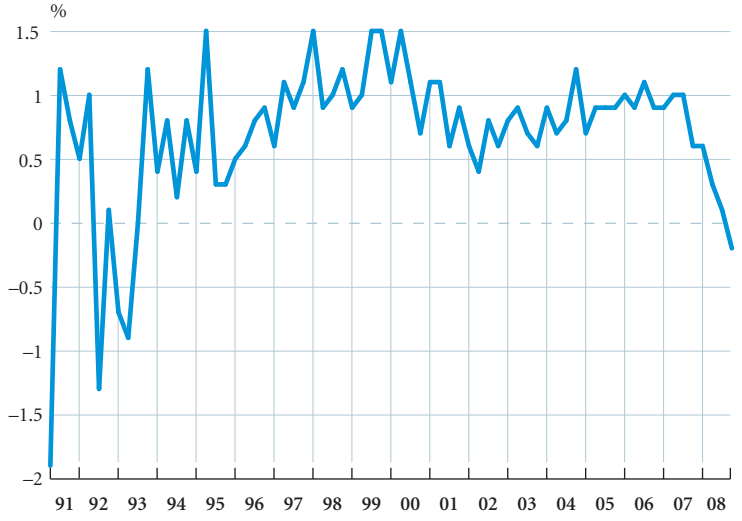
At year-on-year rate, however, the GDP still grew by 0.9%, nine decimals less than in the previous quarter. This rate was slightly above that for the European Union as a whole which also showed a dip in economic growth rate.

The trend in GDP in the third quarter was evident in the collapse of the contribution of national demand to year-on-year growth, going from 1.5% in the second quarter to only 0.1%. On the other hand, the contribution from the foreign sector showed an improvement of 5 decimals putting it at 0.8%. Adjustment of the imbalance in the foreign sector was also evident in a reduction of the current account deficit to 8.7% of the GDP, seven decimals less than in the previous quarter but still at too high a level.

The drop in growth rate of national demand came both from investment

FIRST QUARTERLY DROP IN GDP SINCE BEGINNING OF 1993

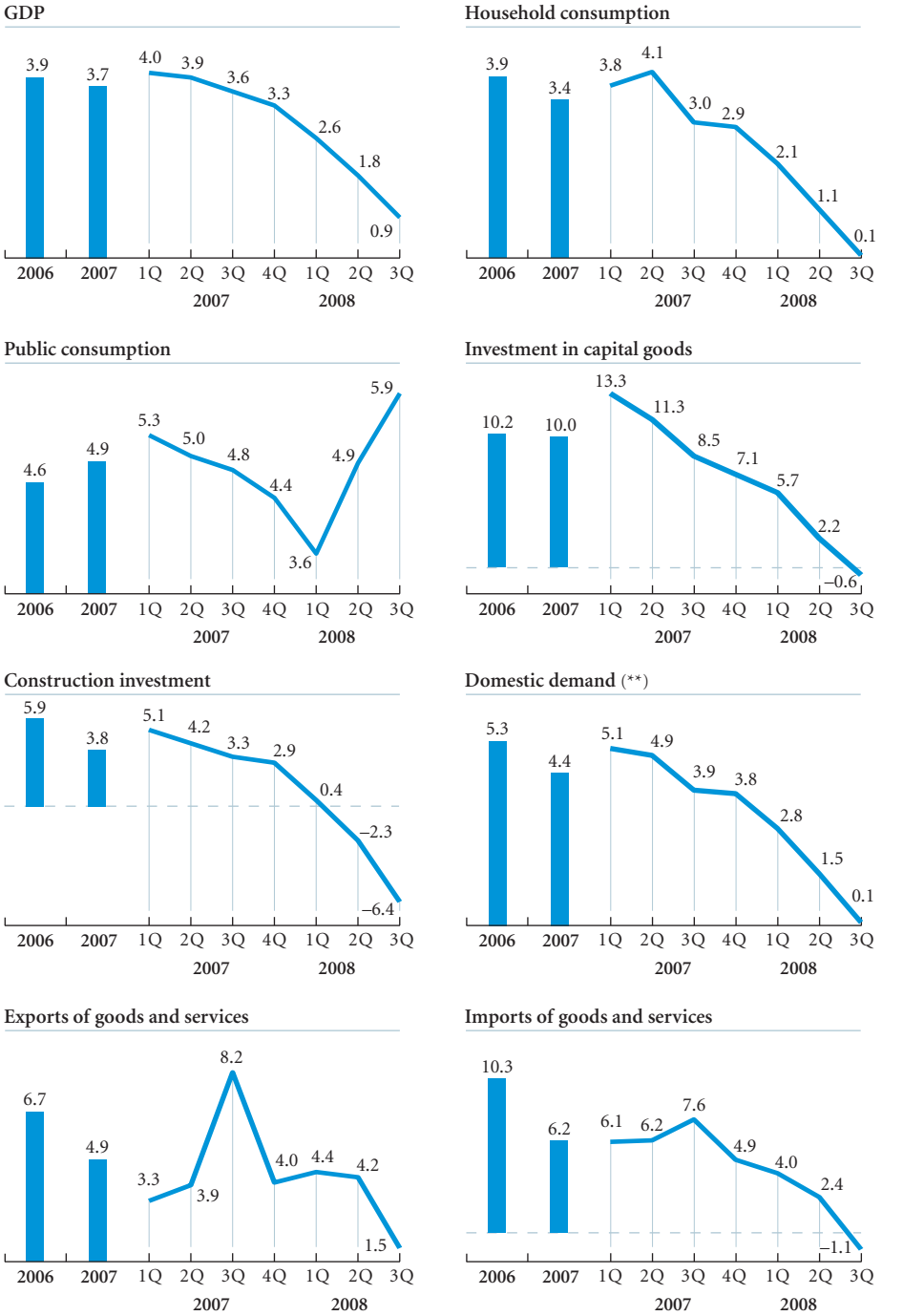
Quarterly change in GDP



SOURCE: National Institute of Statistics.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



NOTES: (*) Figures adjusted for seasonal and working days effects.
(**) Contribution to GDP growth.
SOURCE: National Institute of Statistics.

Households put brake on consumption...

and consumption. Under consumption, household consumption was down 1.0% compared with the previous quarter with a contraction especially in consumer durables. This trend seems likely to continue in the fourth quarter if we are to go by the 40% year-on-year drop in car sales in October. The weakness in household consumption came along with the drop in employment in the quarter and the increasing weakness in consumer confidence because of the collapse of the stock markets and the drop in housing prices, which prompted an increase in savings levels.

On the other hand, public consumption took on an anti-cyclical tone and went up 5.9% compared with the third quarter of 2007. This big increase in current public spending was due both to personnel costs in that sector and to purchases of goods and services.

...and companies reconsidering investment plans.

Investment continued to drop in response to the weakness in demand, both domestic and foreign, to the decrease in corporate profits and the tightening of financing terms. As a result, gross fixed capital formation showed a quarterly drop of 1.9% in the third quarter, the same as in the second quarter. Construction investment continued to drop even further, especially in housing, which showed a quarterly drop of 6.9%. Investment in capital goods was also down, especially due to transportation equipment which dropped by 4.6% in the quarter. Investment in other products, such as data-processing software, mining and oil exploration, etc. provided only partial compensation with a rise of 2.6% in the quarter.

The improvement in the foreign sector mentioned earlier was largely due to the

DEMAND INDICATORS

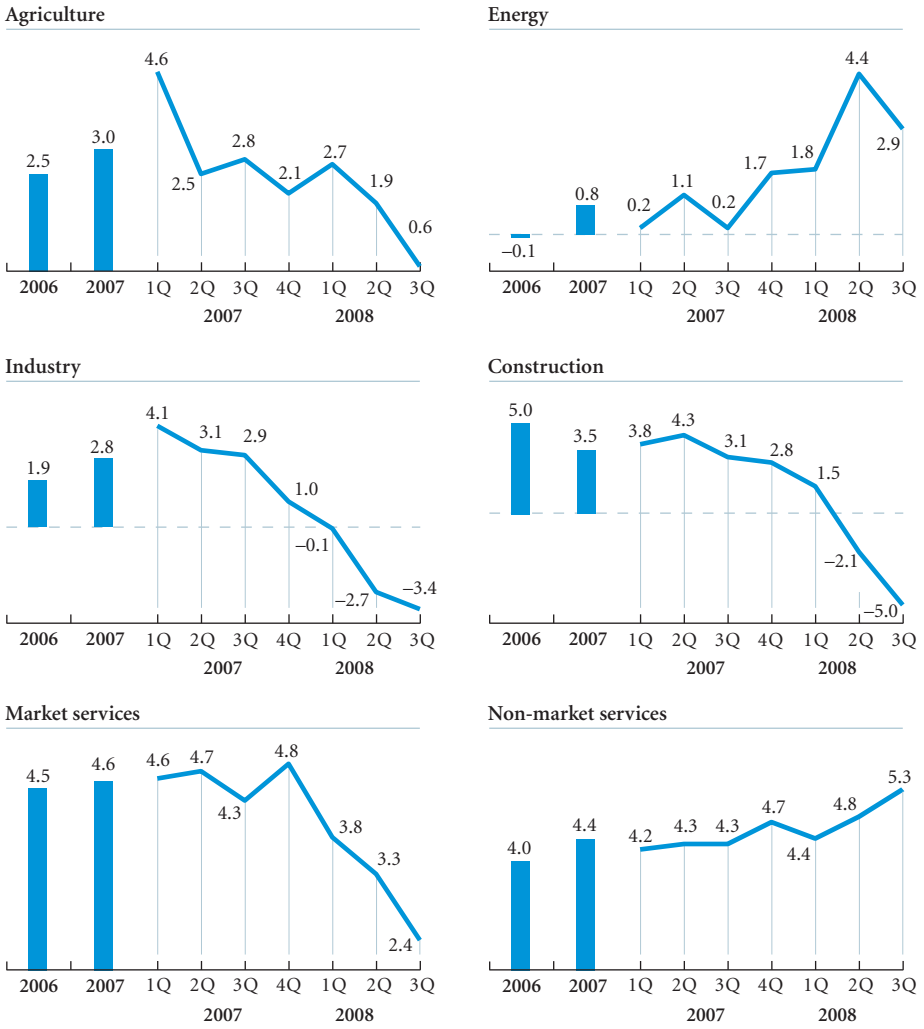
Percentage change over same period year before

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
Consumption										
Production of consumer goods (*)	2.3	1.2	0.9	–2.7	–0.8	–5.6	–2.1	–6.1	–8.6	...
Imports of consumer goods (**)	8.9	5.1	8.4	7.7	–1.2	–6.9	–4.0	–12.6	...	...
Car registrations	–0.9	–1.2	–2.9	1.3	–15.3	–19.6	–27.4	–41.3	–32.2	–40.0
Credit for consumer durables	14.5	10.0	6.9	9.9	8.8	7.1	–	…	–	–
Consumer confidence index (***)	–12.3	–13.3	–12.3	–17.3	–20.0	–31.3	–39.0	–37.0	–39.0	–44.0
Investment										
Capital goods production (*)	8.4	5.9	6.3	3.3	2.0	–3.1	1.8	–10.9	–5.0	...
Imports of capital goods (**)	3.2	9.8	–0.6	9.0	–16.0	–16.4	–7.8	–28.1	...	...
Commercial vehicle registrations	1.5	0.3	–3.0	4.7	–29.5	–34.0	–46.6	–57.0	–48.1	–54.3
Foreign trade (**)										
Non-energy imports	9.0	7.3	7.6	7.5	4.3	0.2	–2.7	–10.2	...	...
Exports	5.6	4.2	6.7	4.6	2.2	6.6	9.5	–2.7	...	...

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

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-on-year change (*)



NOTES: (*) Figures adjusted for seasonal and working days effects.
SOURCE: National Institute of Statistics.

year-on-year drop of 1.1% in imports of goods and services after having shown a rise of 2.4% in the second quarter. Exports were also slower but to a lesser extent with growth of 1.5% compared with the same quarter last year.

On the supply side, growth was down in all major sectors. The adjustment in construction was still sharper and value added of this sector dropped by 5.0% compared with the third quarter of 2007. The energy and industrial sectors also showed a steeper drop going to 2.5% in year-on-year change rate.

Growth in services branches slowed to a year-on-year increase of 3.0%, some 6 decimals less than in the previous quarter, due to market services which showed a dip in change rate to 2.4% compared with the same quarter last

Adjustment in construction gets more acute.

International bodies foresee a recession.

year. Certain company services and information technology were the most dynamic branches. At the opposite end were motor vehicle sales. Non-market services showed a year-on-year increase of 5.3%, a half-point more than in the second quarter.

Agriculture, livestock raising and fishing showed a quarterly contraction of 1.7%. As a result, year-on-year growth in gross value added of these sectors was down to 0.6%.

Forecasts for Spain's economy made by international bodies that have been appearing in recent weeks are notable for their continuing downward revisions for economic growth in 2009. The autumn forecasts of the European Commission put this at a decrease of 0.2%. The latest forecasts by the International Monetary Fund raised the annual drop in GDP to 0.9%, some 7 decimals less than forecasts made one month earlier. The Organization for Economic Cooperation and

SUPPLY INDICATORS

Percentage change over same period year before

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	July	August	September	October
Industry										
Electricity consumption (1)	4.0	4.4	2.5	4.9	2.5	2.6	1.6	2.9	0.7	–1.7
Industrial production index (2)	3.9	1.9	1.1	–0.2	–0.5	–5.1	–2.9	–6.7	–8.8	...
Confidence indicator for industry (3)	–2.7	–0.3	–0.7	–3.3	–7.0	–11.9	–16.0	–18.0	–22.0	–27.0
Utilization of production capacity (4)	80.5	81.3	82.1	81.1	81.3	80.3	–	79.3	–	76.8
Imports of non-energy intermediate goods (5)	10.5	8.0	8.7	7.1	11.4	6.9	–1.2	–5.8	...	...
Construction										
Cement consumption	8.5	0.2	–1.1	–1.9	–13.3	–18.9	–23.8	–30.2	–24.8	–34.4
Confidence indicator for construction (3)	14.2	9.3	12.0	–1.3	–14.7	–17.3	–30.0	–15.0	–26.0	–38.0
Housing (new construction approvals)	18.6	–24.7	–50.7	–33.6	–59.8	–56.0	–58.0	–67.9	...	...
Government tendering	31.3	–14.9	–30.0	–33.1	27.8	–32.1	–9.3	12.2	...	...
Services										
Retail sales (6)	2.1	2.4	3.1	–0.3	–3.6	–5.6	–6.1	–6.1	–7.2	–8.0
Foreign tourists	4.1	1.4	1.2	1.6	5.3	0.9	–8.0	–1.8	–5.9	...
Tourist revenue inflows	5.6	3.6	3.3	4.5	5.2	1.0	1.1	0.3	...	...
Goods carried by rail (ton-km)	–1.2	–4.4	–1.4	–5.3	–2.7	–0.7	–0.7	–17.8	4.1	...
Air passenger traffic	6.8	9.0	10.6	8.5	7.9	–0.7	–3.7	–2.4	–8.8	–10.8
Motor vehicle diesel fuel consumption	5.5	4.8	4.3	4.7	–0.9	–2.8	–0.9	–8.3	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for difference in number of working days.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
(6) Index deflated and corrected for calendar effects.
SOURCE: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of Economy and Finances and own calculations.

Development (OECD) also indicated an annual drop of 0.9% in GDP in 2009 along with a later gradual end to the economic recession.

In this environment, the central government has approved a financial aid plan for small and medium businesses based on a new line of credit through the Official Credit Institute (ICO) amounting to 10 billion euros, as well as extension of other existing lines amounting to more than 3 billion euros, which will also provide for funding of working capital. In addition, the government announced the preparation of measures to stimulate the economy to be coordinated with the European Union. These measures will concentrate on investment in infrastructures. Up to now, the main measure with an impact on the budget has been a further tax credit of up to 400 euros on personal income tax.

Government launches new measures to stimulate economy.

Labour market

October brings substantial drop in number registered with Social Security.

Labour market cooling off

The economic crisis is having a substantial effect on the labour market. In October, the average number of persons registered with Social Security stood at 18,918,473, a monthly drop of 101,886, a figure in sharp contrast to the increase of 80,699 in the same month in 2007. As a result, the worsening of the labour market in recent times becomes clear to the point where the trend in loss of jobs comes close to 3% annual.

In the past 12 months the monthly average number of those registered with Social Security has dropped by 453,211 persons (2.3%). The year-on-year decreases mainly involved those coming under the general scheme although the number of self-employed persons under the normal scheme was down 0.9%. On the other hand, those under the domestic employees scheme saw an increase of 6.4%. By main sector, the level of registration was down in construction and industry while services and agriculture reported an increase.

EMPLOYMENT INDICATORS

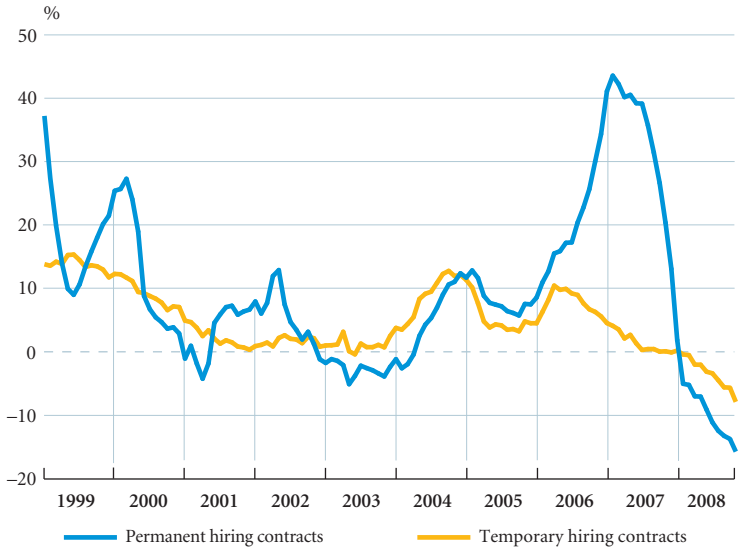
Percentage change over same period year before

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	3Q	October
Persons registered with Social Security								
Sector								
Industry	*0.0*	*2.5*	*2.5*	*2.4*	*0.3*	*–1.4*	*–2.8*	*–4.7*
Construction	*8.7*	*3.3*	*2.3*	*0.5*	*–2.8*	*–7.8*	*–13.0*	*–18.2*
Services	*5.2*	*3.5*	*3.0*	*3.0*	*2.6*	*2.0*	*1.4*	*0.2*
Job situation								
Wage-earners	*4.7*	*3.0*	*2.6*	*2.2*	*1.2*	*0.0*	*–1.2*	*–3.0*
Non-wage-earners	*2.2*	*2.8*	*2.9*	*2.9*	*2.3*	*1.1*	*–0.3*	*–1.5*
Total	**4.3**	**3.0**	**2.7**	**2.4**	**1.4**	**0.2**	**–1.0**	**–2.7**
Persons employed (*)	**4.1**	**3.1**	**3.1**	**2.4**	**1.7**	**0.3**	**–0.8**	**–**
Jobs (**)	**3.2**	**2.9**	**2.8**	**2.2**	**1.4**	**0.4**	**–0.8**	**–**
Hiring contracts registered (***)								
Permanent	41.1	2.0	–1.6	–21.1	–11.8	–5.6	–13.8	–22.7
Temporary	4.7	0.3	–0.5	1.2	–6.5	–7.4	–9.4	–16.3
Total	**7.9**	**0.5**	**–0.7**	**–2.1**	**–7.2**	**–7.2**	**–9.9**	**–17.1**

NOTES: (*) Estimate from Labour Force Survey (changes for 2005 corrected for impact of methodological changes).
(**) Equivalent to full-time work. National Accounting estimate; figures adjusted for seasonal effects and number of working days.
(***) At INEM.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, Employment Institute and own calculations.

LOSS OF STRENGTH IN HIRING

Hiring contracts registered with INEM: cumulative change in last 12 months compared with the same period the year before



SOURCE: National Employment Institute (INEM) and own calculations.

The figures for jobs equivalent to full-time work given by National Accounting support the trend to loss of jobs. In the third quarter these jobs were down 0.8% compared with the same period last year, as against a year-on-year increase of 0.4% in the second quarter. Decreases in employment were across the board, especially in construction, with an annual reduction of 12.8%. In the industry and energy branches the level of employment was down 1.2% while in the primary sector the drop was 4.1%. The increase of 2.1% in services was offset by decreases in other sectors.

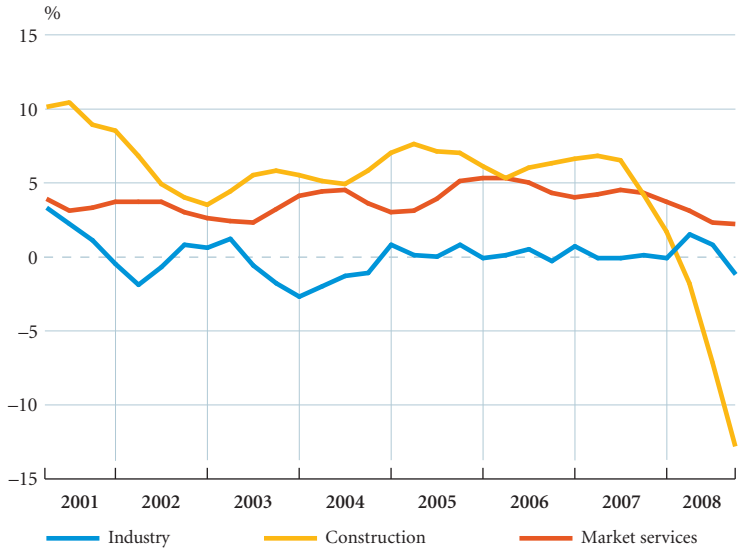
On the other hand, the third quarter saw a recovery in apparent labour productivity which rose by 1.7% compared with the same period in 2007, some 4 decimals more than in the previous quarter due to the trend in the quarterly gross domestic product and in full-time employment. Wages moderated to show annual growth of 4.5% but this was mainly due to the drop in employment given that the average wage per worker scarcely eased to 5.3%. As a result, the annual increase in labour cost went down to 3.6%, some two decimals above the implicit deflator for the economy.

The decreasing strength of the labour market also shows up in hirings. In October, the number of hiring contracts registered at public employment offices was down by 17.1% compared with the same month last year going to 1,584,811, as against a year-on-year decrease of 9.2% in the cumulative figure for the first ten months of the year. In October 2008, some 180,229 permanent job contracts were recorded, which represents a drop of 22.7% compared with the same month last year. In spite of this decrease, stable job contracts made up 11.4% of the total. On the other hand, permanent full-time contracts were down more than part-time hirings. In turn, temporary hiring contracts showed a decrease of

Number of permanent full-time hiring contracts registered down more than part-time contracts.

JOB CREATION IN SERVICES ONLY PARTLY OFFSETS DROPS IN CONSTRUCTION AND INDUSTRY

Year-on-year change in jobs equivalent to full-time work



SOURCE: National Employment Institute (INEM) and own calculations.

Government reveals various proposals to foster employment.

16.3% compared with October 2007 going down to 1,404,582.

In view of this situation, within the framework of the process of social dialogue, the government put forward a proposal for a new type of deduction in Social Security contributions of companies for an amount of 1,500 euros a year for two years aimed at fostering permanent hiring contracts for those unemployed with family responsibilities. Furthermore, there is a proposal to increase the capitalization from 40% to 60% of unemployment benefits in order to foster self-employment.

Increase in unemployment spread across all sectors, especially in construction.

Seventh consecutive month of increase in registered unemployment

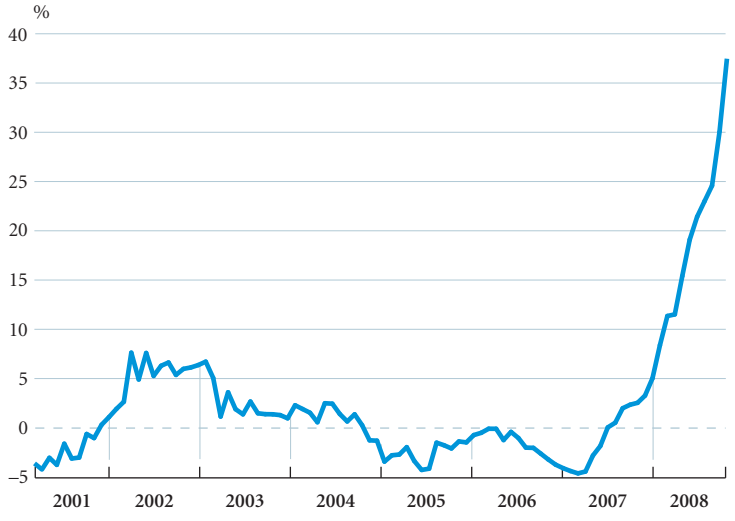
The net drop in the level of employment is causing a sharp increase in unemployment. The number of unemployed registered at public employment offices in October rose by 192,658. While part of the increase in unemployment in October was due to seasonal factors arising from the end of the tourist season, its size (six times higher than the rise recorded in the same month in 2007) leaves no doubt about the worsening of the labour market. At the end of October the number of registered unemployed came to 2,818,026, representing a year-on-year increase of 37.6%.

Unemployment benefits show year-on-year increase of 42% in September 2008.

The sharp increase in registered unemployment has meant a significant rise in unemployment benefit costs which rose by 41.8% in September 2008 compared with the same month in 2007. At the end of September, the total number of those on unemployment benefits came to 1,851,308, some 31.3% more than 12 months earlier. In addition, the number of foreign workers on benefits in September 2008 was up 78.5% compared with the same month last year going up to 209,101, some 11.3% of the total.

SHARP RISE IN REGISTERED UNEMPLOYMENT

Year-on-year change rate for registered unemployment (*)



NOTES: (*) May 2005 saw a break in the statistical series due to the start-up of the new SISPE management model.
SOURCE: Ministry of Labour and Social Affairs and own calculations.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

October 2008

	No. of unemployed	Change over December 2007		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	94,630	25,818	37.5	27,865	41.7	3.4
Industry	349,430	69,449	24.8	78,874	29.2	12.4
Construction	479,576	195,709	68.9	239,191	99.5	17.0
Services	1,631,882	347,632	27.1	378,077	30.2	57.9
First job	262,508	49,871	23.5	45,442	20.9	9.3
By sex						
Males	1,335,865	450,726	50.9	533,034	66.4	47.4
Females	1,482,161	237,753	19.1	236,415	19.0	52.6
By age						
Under 25 years	358,755	118,372	49.2	123,630	52.6	12.7
All other ages	2,459,271	570,107	30.2	645,819	35.6	87.3
TOTAL	**2,818,026**	**688,479**	**32.3**	**769,449**	**37.6**	**100.0**

SOURCE: INEM and own calculations.

Prices

Drop in inflation sharpens

Year-on-year inflation rate down one point to 3.6% in October...

The drop in inflation that started in August sharpened in October. As a result, the year-on-year change rate in the consumer price index (CPI) went down one point to 3.6%, a long way from the high of 5.3% in July. This decrease largely reflects the collapse in oil prices in international markets but also that in other commodity prices. Underlying inflation, taken as the more stable core of inflation that excludes more volatile elements such as energy products and fresh foods, was down 5 decimals to 2.9%.

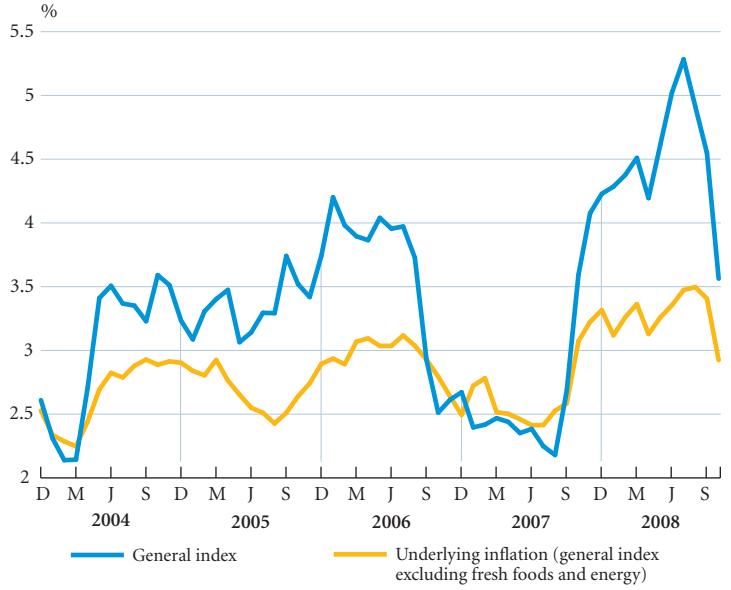
...thanks to downward move in fuels and fuel-oils...

The main downward push in inflation in October came from fuels and fuel-oils which cut more than a half-point from the year-on-year CPI seeing that it went from a year-on-year increase of 16.2% in September to 8.9% in October. The other erratic factor in the shopping basket, unprocessed foods, eased from an annual increase of 3.9% to 3.0% and thus contributed nearly one decimal to the reduction of year-on-year inflation.

With regard to the components of underlying inflation, the one leading the drop in October was processed foods, for which prices held practically stable compared with sharp increases in the same month last year. There were notable negative effects on inflation from milk products and bread which

SHARP DROP IN UNDERLYING INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2007			2008		
	% monthly change	% change over December 2006	% annual change	% monthly change	% change over December 2007	% annual change
January	–0.7	–0.7	2.4	–0.6	–0.6	4.3
February	0.1	–0.6	2.4	0.2	–0.5	4.4
March	0.8	0.1	2.5	0.9	0.4	4.5
April	1.4	1.5	2.4	1.1	1.5	4.2
May	0.3	1.8	2.3	0.7	2.2	4.6
June	0.2	2.0	2.4	0.6	2.8	5.0
July	–0.7	1.3	2.2	–0.5	2.3	5.3
August	0.1	1.4	2.2	–0.2	2.1	4.9
September	0.3	1.7	2.7	0.0	2.0	4.5
October	1.3	3.0	3.6	0.3	2.4	3.6
November	0.7	3.8	4.1			
December	0.4	4.2	4.2			

SOURCE: National Institute of Statistics.

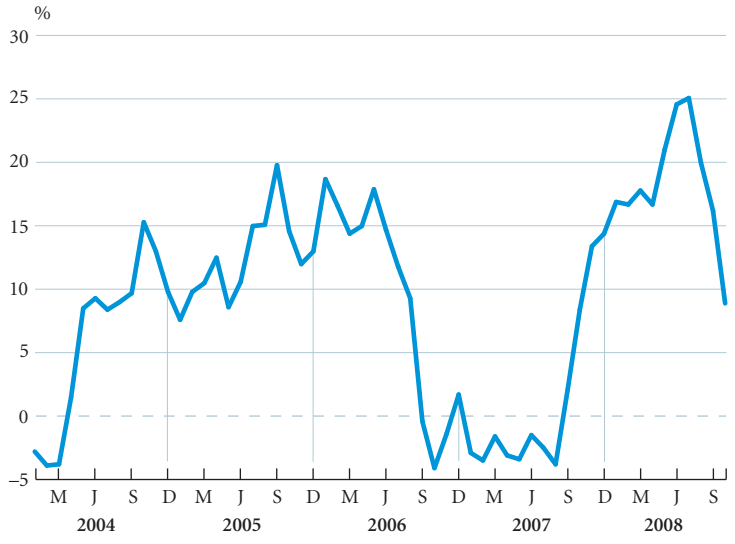
reflect the downward trend in farm commodities in world markets in recent months with the normalizing of supply.

The year-on-year change rate for prices of non-energy industrial goods held at 0.5%. Containment in this case was brought about by sharp competition in

...and processed foods.

BRAKE ON FUEL AND FUEL-OIL PRICES

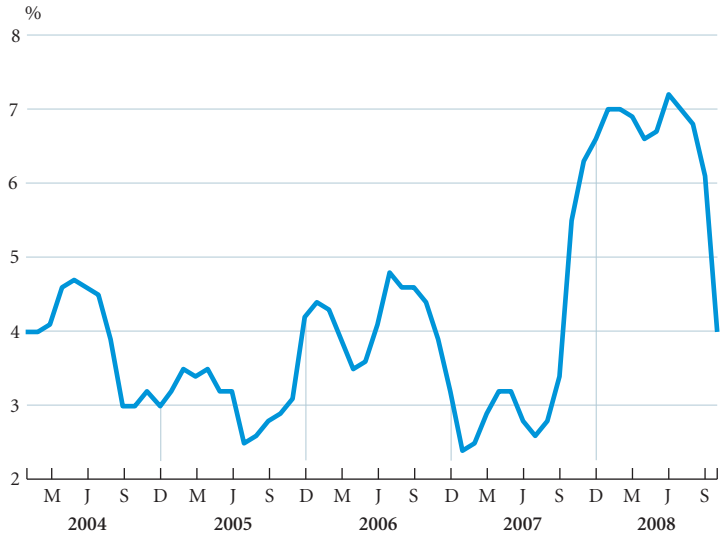
Year-on-year change in prices of fuels and fuel-oils



SOURCE: National Institute of Statistics.

FOOD PRICES MODERATING

Year-on-year change in prices of food and non-alcoholic beverages



SOURCE: National Institute of Statistics.

Inflation differential with Euro Area narrows to 0.4 points, lowest level since beginning of 2002.

world markets. The downward pressure on prices due to weak demand was counteracted by depreciation of the euro.

The year-on-year change rate for prices of services also showed no change in October but stood at a much higher level (4.1%) which was partly a reflection of a lower level of competition. Year-on-year rates for domestic service (4.8%), medical visits (4.8%) and hotels, cafés and restaurants (4.7%) stood more than one point above general inflation.

Inflation could end year well below 2.5%.

The index for prices harmonized with the European Union also reported a year-on-year increase of 3.6%. As a result, the inflation differential with the Euro Area narrowed by a half-point to 0.4 points, the lowest level since the beginning of 2002. We should point out that this reduction was very much influenced by the drop in fuel prices which carry more weight in the Spanish CPI.

Just two months from year-end, prospects for inflation are quite optimistic. The year-on-year CPI change rate will likely end the year well below 2.5% unless there is a turnaround in price trends for commodities.

CONSUMER PRICE INDEX BY COMPONENT GROUP

October

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2007	2008	2007	2008	2007	2008
By type of spending							
Food and non-alcoholic beverages	110.5	1.9	–0.1	4.8	2.2	5.5	4.0
Alcoholic beverages and tobacco	111.6	0.2	0.1	5.8	3.8	6.6	4.0
Clothing and footwear	106.7	9.0	9.2	–1.0	–1.5	0.9	0.7
Housing	112.4	0.7	0.1	4.1	6.6	4.2	7.4
Furnishings and household equipment	106.0	0.4	0.5	1.9	2.1	2.5	2.7
Health	98.8	0.2	0.2	–2.3	0.3	–2.1	0.5
Transport	107.3	0.3	–2.5	4.8	1.9	4.9	4.2
Communications	100.2	–0.1	0.0	1.0	0.3	0.6	0.0
Recreation and culture	99.3	–0.8	–0.5	–1.4	–0.2	–0.7	0.4
Education	111.9	2.4	2.7	3.8	4.3	4.5	4.6
Restaurants and hotels	110.7	0.0	–0.2	4.5	4.3	4.8	4.7
Other goods and services	107.4	0.1	0.2	2.7	3.4	3.0	3.7
By group							
Processed food, beverages and tobacco	111.2	2.3	0.1	5.9	3.1	6.1	4.5
Unprocessed food	109.4	0.5	–0.4	2.8	0.9	4.7	3.0
Non-food products	107.0	1.1	0.5	2.4	2.4	2.9	3.4
Industrial goods	105.3	2.2	0.9	1.5	1.2	2.0	2.7
Energy products	*113.3*	*1.0*	*–3.9*	*7.4*	*5.3*	*7.0*	*9.3*
Fuels and oils	*112.9*	*1.3*	*–5.1*	*8.9*	*3.7*	*8.4*	*8.9*
Industrial goods excluding energy products	*102.6*	*2.7*	*2.7*	*–0.4*	*–0.2*	*0.4*	*0.5*
Services	108.9	0.1	0.0	3.4	3.6	3.8	4.1
Underlying inflation (**)	107.1	1.4	0.9	2.6	2.2	3.1	2.9
GENERAL INDEX	**107.9**	**1.3**	**0.3**	**3.0**	**2.4**	**3.6**	**3.6**

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

Wholesale prices confirm a downward trend

The drop in commodity prices in recent months and particularly the collapse in oil prices since July continues to be passed through to wholesale prices for which inflation had marked up highs for recent years. A number of causes, both on the demand and supply side, contributed to the turnaround in the upward move in commodities, one of the most significant being the weakness in demand brought about by the world financial crisis.

In this context, industrial prices continued to ease. The annual change rate in October stood at 5.9%, some 2.2 points less than in the previous month and 4.4. points below the highest level since 1984 recorded in July 2008. The main factor in this downturn was energy for which the annual change rate

Annual change rate in industrial prices drops to 5.9% in October.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2007											
September	12.1	3.4	3.2	3.2	5.4	0.8	2.0	1.0	0.3	3.1	–
October	13.8	4.7	4.2	3.2	5.3	6.1	3.1	0.6	0.0	2.0	–
November	15.7	5.4	4.5	3.1	5.1	9.8	4.1	0.7	0.0	0.7	3.0
December	17.6	5.9	4.8	2.9	5.0	11.6	4.9	1.1	–0.1	0.7	–
2008											
January	11.1	6.6	5.4	2.7	5.9	13.3	6.7	1.1	0.4	1.8	–
February	7.3	6.6	5.4	2.5	6.0	13.3	6.8	1.4	0.3	1.8	3.2
March	10.5	6.9	5.5	2.3	6.3	14.6	6.7	0.7	–0.2	2.1	–
April	8.5	7.2	5.3	2.3	6.0	16.5	6.8	0.6	–0.2	2.2	–
May	15.2	7.9	5.3	2.0	5.9	21.2	9.1	0.7	–0.1	3.0	3.3
June	8.6	9.0	5.4	2.1	6.3	25.5	10.3	1.1	–0.3	3.4	–
July	14.1	10.3	5.2	2.3	7.4	30.3	10.6	0.5	–0.1	4.7	–
August	6.9	9.2	4.9	2.3	7.5	25.3	9.6	1.3	0.3	5.8	3.4
September	–2.3	8.1	4.2	2.1	7.1	21.6	8.6	1.7	0.6	6.6	–
October	...	5.9	2.9	2.1	5.0	15.2	...	...	...	...	–

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

Year-on-year decrease in farm prices in spite of rise in market livestock prices.

dropped by 6.4 points to 15.2%, a level that was still quite high and with some margin for further decreases. The year-on-year rate for intermediate goods was down 2.1 points to 5.0%. At the same time, prices of consumer goods slowed their rate of increase to 2.9% compared with October 2007.

By branch, those showing the biggest price increases in the past 12 months were energy, metallurgy and chemicals which still reflected past pressures in commodity prices. On the other hand, the manufacture of office machinery and data-processing equipment showed an annul drop of 2.0% thanks to marked competition in international markets and increases in productivity.

Import prices in September confirmed a downturn with the annual inflation rate standing at 8.6% in September, one point less than in the month before. The downturn came as a result of energy which showed a year-on-year rate down by 9.9 points to 35.1%. On the other hand, annual change rates for consumer prices and prices for equipment and intermediate goods rose slightly under pressure from depreciation of the euro.

With regard to farm prices, these fell to 2.3% in September, a level below the same months last year. Farm prices had not shown a negative year-on-year rate since February 2007. This drop may be explained by drops in livestock products (9.7%) and agricultural products (5.0%). Market livestock prices, on the other hand, which had stayed relatively low, rose sharply to 8.4% year-on-year.

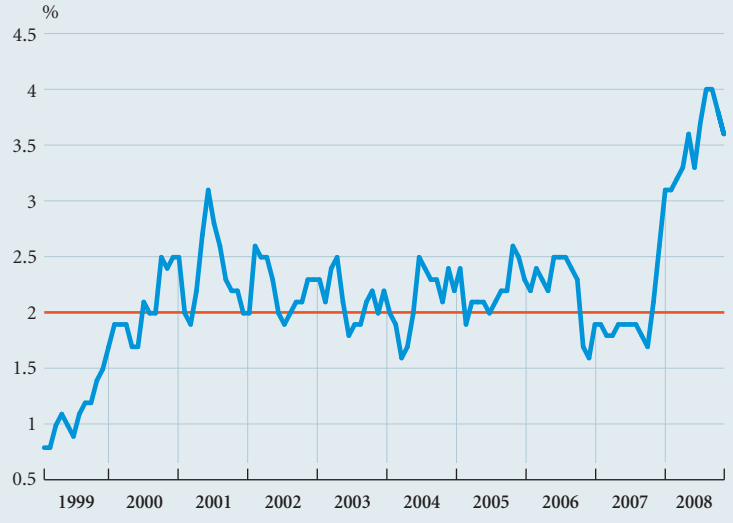
The euro and inflation: evaluating its first ten years

In January 1999, the euro, Europe's new common currency, went into circulation. At the same time, the European Central Bank took charge of the monetary policy in the European Monetary Union (EMU) or Euro Area, the group of countries that had adopted the euro. Following the tradition of the German central bank, the Bundesbank, the architects of the EMU were very clear from the beginning that the main function of a central bank should be to maintain inflation at very low levels. Because of this, the Treaty of the European Union made price stability the primary objective of ECB policy. In the middle of 1998, the ECB defined price stability as an inflation rate for the Harmonized Index of Consumer Prices (HICP) below 2% over the medium term.[1] Ten years later seems to be a good time to evaluate how well the ECB has handled this task.

The following graph shows the inflation rate in the EMU since January 1999, with the horizontal line representing the 2% target. If the reader thinks that the inflation rate has been above target for most of the time, that is correct. The inflation rate has been within the target range only in 42 of the last 118 months. From this point of view, the ECB has met its inflation target only 36% of the time.

Nevertheless, on average, inflation has not been very much above 2%. To be specific, since the creation of the euro, average inflation in the EMU has been 2.18%, a value certainly above the medium-term objective but one that is fairly low in absolute and historical terms. As may be seen in the following table, average inflation in the Euro Area stands in the intermediate range compared with other industrialized economies. In the Euro Area, inflation has been lower than that recorded in the United States, Canada or Australia, but higher than that in Japan. It should be pointed out that the United Kingdom and Sweden, two of the countries in the EU-15 that decided not to adopt the euro, have recorded average inflation rates below 2% over the past decade.

INFLATION RATE OFTEN STANDS ABOVE 2%



SOURCE: Eurostat.

(1) Later, with the revision of its strategy carried out in 2004, the ECB clarified that its target was an inflation rate «below, but close, to 2%».

Another country that chose to stay out, Denmark, has recorded an average inflation rate one decimal less that in the Euro Area.

AVERAGE INFLATION 1999-2008	
Euro Area	2.18
United Kingdom	1.71
Sweden	1.69
Denmark	2.09
United States	2.86
Australia	3.12
Canada	2.27
Japan	–0.20

SOURCE: Thomson Reuters Datastream.

Furthermore, we should keep in mind that in the past five years the price of energy has gone up fivefold and there has been a sustained increase in commodity prices, including those of food. The ECB has been able to do little or nothing to avoid the direct impact of a world increase in prices of oil and other commodities on inflation. On average, since 1999 core inflation (excluding energy and fresh foods) has been 1.8%.

Given the circumstances, it may be argued that the ECB has done a good job. Without a doubt, this has not been an easy decade. Apart from the increases in commodity prices, the ECB has had to deal with the effects of the bursting of the *dot-com* bubble, the uncertainties associated with the change of the millennium, the terrorist attacks in the United States on September 11, 2001 and, more recently, with the world financial crisis. It is also true that the ECB set very high standards for itself that it has not been able to meet. To make use of a simile from soccer, it is as if a team had set itself to win the Champions League, the League and Cup of its own country all in one year. Does it mean a failure if it wins *only* the two first tournaments? It all depends on how the objectives are set.

If we use the criterion that inflation must be below 2% over the medium term, we may conclude that the ECB has failed to achieve its target. But it should be remembered that other advanced countries have more flexible objectives. The Federal Reserve in the United States, for example, does not have a specific numerical target. Other central banks with specific inflation targets, such as Canada, United Kingdom, New Zealand and Sweden, have a central inflation target of 2% with a fluctuation band of 1%, while Australia has an inflation target between 2% and 3%. This allows some flexibility when it comes to managing monetary policy, especially when the economy suffers inflationary *shocks*. If we evaluate the ECB assuming that it had adopted an inflation target of 2% with a 1% band, its success rate would have been 85%.

In fact, some years ago an evaluation report prepared by a group of monetary policy experts suggested that in practice the ECB acted as if it had an inflation target between 1% and 3% and suggested that it should adopt that objective.[2] The ECB opted for an inflation target «below 2%» in order to establish its anti-inflation

(2) See Galí, J., Gerlach, S., Rotemberg, J., Uhlig, H. and Woodford, M., 2004, «The Monetary Policy Strategy of the ECB Reconsidered», Monitoring the European Central Bank 5, CEPR.

credentials and to assure the member states of Northern Europe that the Bundesbank's policy would have continuity. Nevertheless, it may be counterproductive to set objectives that later on are consistently not met because over the long term this could cause a problem of credibility. That is to say, it is worse to have a strict objective that is seldom met that to have a more realistic or less ambitious objective that is often achieved.

An inflation target of 2% with a 1% band around it would give the ECB greater margin to manoeuvre. What is more, the monetary authority could very well meet the objective most of the time. On the other hand, it would not involve any significant cost given that inflation already fluctuates between 1% and 3% most of the time. And there is no empirical evidence to suggest that having an inflation target between 1% and 3% would be worse for economic activity than having a target below, but close, to 2%.[3]

(3) See Khan, M. and Senhadji, A., 2001, «Threshold Effects in the Relationship between Inflation and Growth», IMF Staff Papers, Vol. 48, pp 1-21.

Foreign sector

Improvement in non-energy balance continues

Trade deficit up 4.8% because of worse energy balance.

Between January and September 2008 the trade deficit was 74.54 billion euros, an increase of 4.8% year-on-year which confirms that the deficit continues to lose strength and indicates further decreases in the deficit in coming months. With regard to the export/import ratio, this stood at 65.9%, slightly above the 65.3% in the same period last year.

The reason for the slight increase in the trade imbalance was again the worsening of the energy trade balance for which the negative balance in the January-September period increased by 50.5% year-on-year going to 36.22 billion euros. Nevertheless, trends in recent months show that these increases are now losing strength given that the energy deficit in September (3.62 billion euros) was 20.1% lower than the high in July and continues on a downward course. In turn, the non-energy deficit for January-

FOREIGN TRADE

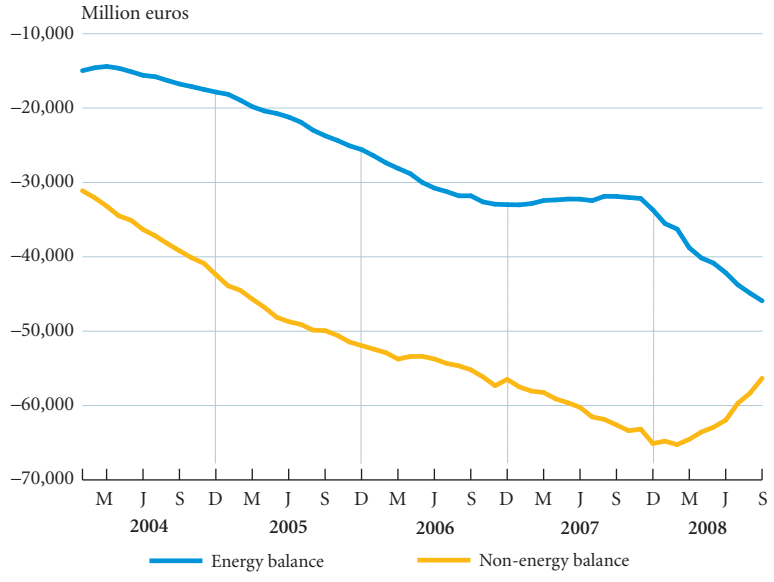
January-September 2008

	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	45,287	52.9	20.7	9,063	63.2	6.3	–36,224	20.0
Consumer goods	53,212	–5.9	24.3	51,141	6.3	35.5	–2,071	96.1
Food	*11,880*	*3.5*	*5.4*	*16,423*	*7.9*	*11.4*	*4,542*	*138.2*
Non-foods	*41,332*	*–8.9*	*18.9*	*34,718*	*2.0*	*24.1*	*–6,614*	*84.0*
Capital goods	18,135	–14.4	8.3	12,387	1.6	8.6	–5,748	68.3
Non-energy intermediate goods	101,992	4.4	46.7	71,491	4.9	49.6	–30,501	70.1
By geographical area								
European Union	119,274	–1.3	54.6	100,238	6.2	69.6	–19,036	84.0
Euro area	*99,180*	*–2.1*	*45.4*	*79,908*	*5.1*	*55.5*	*–19,271*	*80.6*
Other countries	99,352	17.9	45.4	43,843	10.8	30.4	–55,508	44.1
Russia	*6,410*	*6.1*	*2.9*	*2,186*	*46.7*	*1.5*	*–4,224*	*34.1*
United States	*8,553*	*18.8*	*3.9*	*5,653*	*–0.7*	*3.9*	*–2,900*	*66.1*
Japan	*3,982*	*–12.2*	*1.8*	*1,080*	*6.3*	*0.7*	*–2,902*	*27.1*
Latin America	*12,147*	*12.3*	*5.6*	*6,902*	*–8.3*	*4.8*	*–5,245*	*56.8*
OPEC	*22,643*	*42.8*	*10.4*	*5,028*	*31.0*	*3.5*	*–17,615*	*22.2*
Rest	*45,616*	*14.6*	*20.9*	*22,995*	*14.8*	*16.0*	*–22,621*	*50.4*
TOTAL	**218,626**	**6.6**	**100.0**	**144,082**	**7.5**	**100.0**	**–74,544**	**65.9**

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

NON-ENERGY DEFICIT MAKES SHARP CORRECTION

Trade balance by type of product (*)



NOTES: (*) Total for 12 months.
SOURCE: Department of Customs and Special Taxes and own calculations.

September was 38.32 billion euros, some 18.5% below the same period last year, which meant the seventh consecutive months of decreases that keep getting sharper. The improvement in the non-energy trade balance was largely due to the improvement in the non-food consumer goods balance followed by the capital goods balance.

Balance of payments: drop in current account deficit

The current account deficit recorded a deficit of 6.93 billion euros, a level 7.8% lower than in the same period last year.

Over a longer time-frame, the trend in the cumulative figure for 12 months shows a clear easing of recent trends. Since March, 2008 the current deficit has been going through a process of slowdown that keeps on getting sharper. In the 12 months ending in August it grew by 10.9% year-on-year, a rate much below the 21.5% in March. This easing is the result of a lower increase in the negative figure for the income balance and, to a lesser extent, in current transfers.

With regard to financial flows, there has been a continuation of the process of substitution of the portfolio investment balance with an increase in the other investments balance although not as strongly as in previous months. The other investments balance, excluding derivatives, is mainly made up of loans, deposits and repos of other resident sectors, public administrations and financial institutions. These amounts are the result of the change in instruments related to cover for the liquidity needs of Spain's economy.

As a result, inflows for portfolio investment in the past 12 months ending

Non-energy deficit sharpens its decrease while exports improve more than imports.

Deficits in income balance and current transfers balance growing less than at beginning of 2008.

BALANCE OF PAYMENTS

August 2008

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–60,938	7.9	–94,284	–8,443	9.8
Services					
Tourism	*19,569*	*2.8*	*28,340*	*719*	*2.6*
Other services	*–2,477*	*–31.6*	*–4,515*	*627*	*–12.2*
Total	17,092	10.8	23,825	1,345	6.0
Income	–21,980	2.8	–32,100	–3,348	11.6
Transfers	–7,132	16.6	–7,750	–365	4.9
Total	**–72,957**	**6.4**	**–110,309**	**–10,811**	**10.9**
Capital account	**4,422**	**112.7**	**6,859**	**1,844**	**36.8**
Financial balance					
Direct investment	6,869	–	–9,767	35,078	–78.2
Portfolio investment	9,257	–91.6	3,432	–156,255	–97.9
Other investment	25,237	–	59,892	60,696	–
Total	**41,363**	**–41.8**	**53,557**	**–60,481**	**–53.0**
Errors and omissions	2,876	154.9	5,492	2,851	108.0
Change in assets of Bank of Spain	24,297	–	44,401	66,597	–

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

Net inflows for portfolio investment down notably.

in August were 3.43 billion euros whereas in the same period last year they were 159.69 billion euros. This drop continues to be largely compensated by an increase in other investments account which in the same period went from a negative balance of 150 million euros to a positive figure of 77.16 billions. Nevertheless, this process is losing some of its drive given that the balance of other investments has been dropping from the high of 107.99 billion euros in March 2008.

Direct foreign investment reaches 66 billion euros.

In turn, the improvement in the direct investments balance has been getting stronger and in the 12 months ending in August showed a net balance of outflows at 9.77 billion euros, a fifth of the amount recorded at year-end. This improvement was largely due to the increase in inflows (foreign investment in Spain), which at 66.21 billion euros was more than three times the low figure in September 2007.

Trading in the euro era

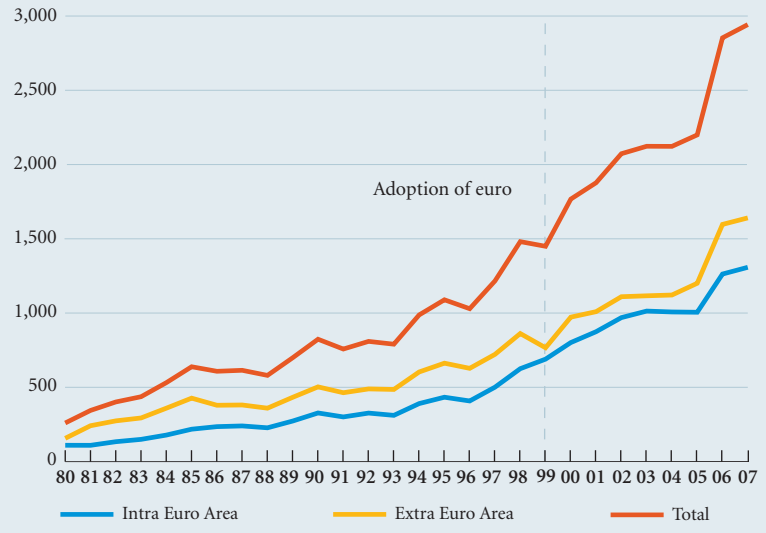
The introduction of the euro ten years ago, besides being an event of major political significance, was a milestone along the road to economic integration of the European Union. A lot has been said about the costs arising from giving up autonomy in monetary policy when adopting the euro. Sharing a currency, however, also has its advantages which include facilitating trade relationships. While imports of countries in the Euro Area grew both in the decade prior to adoption of the euro as well as in the following decade (see accompanying graph), in order to compute the impact of the euro on trade it is necessary to isolate this effect from those arising from other factors such as, for example, import prices, economic integration measures in the EU and changes in customs policy.

For many years, economists have considered that the use of different currencies by countries had a depressing effect on trade and therefore on economic growth. The classic idea, which began with Jacob Viner, and on which the theory of «optimum currency areas» stated by Nobel prize-winner Robert Mundell is based, depends on the risks and costs involved in changes in the exchange rate. Within this perspective the exchange rate is a transaction cost inherent in trade which disappears when a country joins a monetary union although, of course, only between the economies of the union. In this respect, adopting a common currency is equivalent to a preferential trade liberalization, where the advantage of a reduction in cost, and therefore of price, is not general in all countries of the world but only in the group of countries that share the same currency.

Preferential measures generally have a double-sided effect on trade: trade creation and trade diversion. There is a situation of trade creation between preferential areas when domestic production is replaced by imports from other member states which now can be carried out at lower cost (this increase in volume of trade is known as

IMPORTS FOLLOWING ADOPTION OF EURO

Billion euros



SOURCE: Thomson Reuters Datastream and own calculations.

the *intensive margin*). Nevertheless, this preferential liberalization may also generate trade diversion when imports that used to come from outside the monetary union are replaced by imports from member states which, even if less efficient, are favoured by the reduction in transaction costs.

Empirical evidence suggests that trade creation effect of the euro was fairly small (around 5%) and, what is even more surprising, no trade diversion was observed.[1] On the other hand, the founding countries of the EU that did not adopt the euro (United Kingdom, Denmark and Sweden) did not show major differences in trade creation or trade diversion when compared with the other 11 founding countries. Therefore it seems that the Viner-Mundell theory is not the main mechanism behind the increase in trade among the Eurozone countries.

A second channel affecting trade is through a change in market structure. In particular, the adoption of a single currency makes it easier for buyers to compare prices in the various countries of the union thus increasing sensitivity to price differences. In other words, demand becomes more elastic forcing firms to lower their margins and therefore their prices (pro-competitive effect). The lower the prices, the more trade there will be between countries (trade creation). This theory, as opposed to the classic theory, does not involve trade diversion, since the change in demand elasticity is true for all those countries that wish to sell in the new market and not only for those belonging to the Euro Area. The predictions under this theory are more in agreement with empirical evidence. Trade is created and prices fall, although both effects are quantitatively small.

Recently, the newest branch of trade economics has switched from the study of trade between countries to the study of factors that lead the various firms in each country to export and to send foreign direct investment. Marc Meltiz was the economist who opened the season on this new way of focusing on the study of trade in 2003. Later on, Baldwin and Taglioni (2004) applied it to the study of the Euro Area, producing an alternative analysis to that of Mundell which, furthermore, is corroborated empirically. In this new theory, firms of one country and sector differ from one another by their level of productivity and only the most productive ones are able to incur the fixed cost involved in exporting. Moreover, within any one sector it is considered that each firm produces a good or a service slightly different from its competitor (a unique variety) which allows it some price difference. When various countries decide to form a monetary union, the fixed cost involved in exporting to the group of countries is lower. Hence, this lower fixed cost allows less productive firms, along with their new goods and services, to enter the export market thus increasing the variety of products (an increase known as the *extensive margin* of trade).

To sum up, according to latest studies, the euro increases trade in the Euro Area and this brings higher levels of welfare. Nevertheless, the main mechanism affects the *extensive margin* of trade rather than the *intensive margin*. That is to say, countries both inside and outside the monetary union increase the varieties of goods and services they sell in the Eurozone. And, contrary to the classic view, the increase in the volume of those types of goods that already were being exported is quite residual.

(1) Micco, Alejandro, Ernesto Stein, Guillermo Ordonez (2003), «The Currency Union Effect on Trade: Early Evidence From EMU», Economic Policy, 316-356.

Public sector

Central government deficit tends to worsen

The downward stage of the economic cycle is having a heavy impact on the public accounts. In the first 10 months of the year, central government revenues in Treasury terms (that is, according to monetary flows recorded) amounted to 162.95 billion euros before amounts ceded to autonomous communities and local governments under the current financing system. This figure means a drop of 11.6% compared with the same period last year.

Collections for direct taxes in the January-October period showed a year-on-year drop of 14.2%. The main tax heading, personal income tax, brought in 60.39 billion euros, 1.5% less than in the same period in 2007. This decrease was largely due to the new advance deduction of up to 400 euros in tax payable and the impact of the forward deduction for birth or adoption of children. Of greater importance was the drop in collections for company tax (34.6%) especially because of the drop in corporate profits.

Central government revenues down 12% in first 10 months of year as result of worsening economic situation.

Indirect taxes amounted to 10.3% less than in the first 10 months of 2007. The noteworthy tax in this group, value added tax (VAT), dropped by 14.0% due to the sharp slowdown in consumption and the new rule on tax consolidation for company groups established in January

Sharp drop in collections for company tax and VAT.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

October 2008

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**19,074**	**–28.8**	**112,640**	**–18.6**
Non-financial revenue adjusted (*)				
Personal income tax	7,825	–10.2	60,394	–1.5
Corporate tax	5,706	–48.1	26,409	–34.6
VAT	7,182	–16.7	43,226	–14.0
Special taxes	1,653	3.0	16,332	–0.2
Other	1,212	–8.3	16,593	3.9
Total	**23,578**	**–24.6**	**162,954**	**–11.6**
Non-financial spending	**12,883**	**8.3**	**119,458**	**5.5**
Treasury balance	**6,191**	**–58.5**	**–6,818**	**–**
Surplus (+) or deficit (–) (**)	***4,991***	***–67.9***	***–8,585***	**–**

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

Last year's budget surplus turns into deficit in current year.

2008. Special taxes were down by 0.2% seeing that the decrease of 4.3% in the most important special tax (that on fuels) was almost totally counterbalanced by the increase of 4.8% in taxes on tobacco.

On the other side of the balance sheet, cumulative spending up to October was up 5.5%. This increase may be attributed to current payments which rose by 6.3% whereas capital spending was down 0.7%.

Under current spending, personnel costs were up 6.7%. Financial costs rose by 9.7% while purchase of goods and services showed an increase of 3.1%.

In capital transactions, real investments rose by 9.7% pushed up by the 14.9% rise in civil investments of the Ministry of Public Works. On the other hand, capital transfers were down 12.0%.

As a result of revenues and spending, the central government accounts showed a public deficit of 6.82 billion euros in the January-October period. In terms of National Accounting, that is to say, taking into account rights and obligations generated, the deficit came to 8.59 billion euros. This deficit represents 0.78% of gross domestic product (GDP) which stands in contrast to a surplus of 2.64% in the same period in 2007, which is illustrative of the effects of the economic recession on the public accounts.

First auction held by Financial Assets Acquisition Fund fails to meet expectations.

In addition, the first auction of the Financial Assets Acquisition Fund was held on November 20. As is well-known, this fund is aimed at providing liquidity to financial institutions so that they in turn will stimulate the flow of liquidity to companies and households. The fund is authorized to buy assets up to a maximum of 50 billion euros up to the end of 2009.

The first auction, held in late November, did not live up to expectations. In fact, the effective maximum amount at the auction was set at 5 billion euros but the total amount asked for in 70 bids by 28 entities came to only 4.56 billion euros. The amount granted against 2-year mortgage certificate repos, bonds secured by mortgage certificates, bonds secured by assets and mortgage bonds backed by loans granted to the private sector with credit ratings of at least AA was 2.12 billion euros, that is 42.3% of the top limit. The minimum interest rate accepted at the auction was 3.15%, lower than the 3.25% rate of the European Central Bank which, furthermore, is for a much shorter term, but the average weighted rate was 3.34%. The next auction has been set for December 11, also with a maximum limit of 5 billion euros but this time with outright purchase.

Savings and financing

Interest rates dropping

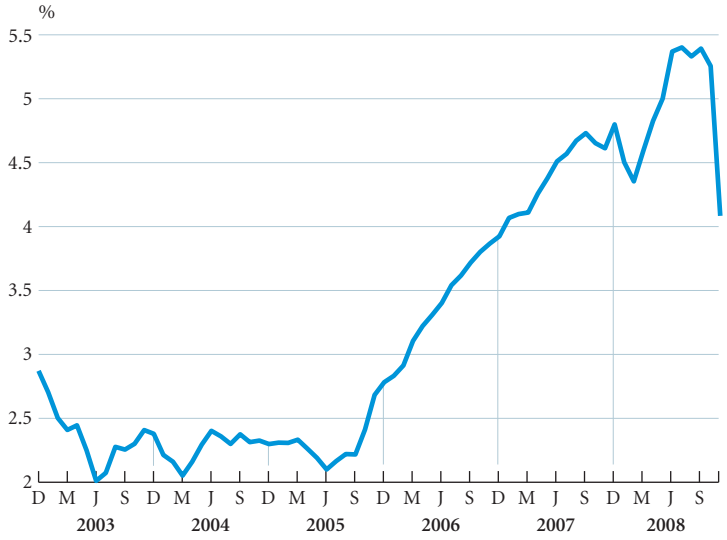
The 1-year Euribor, widely used as a reference rate on loan transactions, dropped by 6 basis points on monthly average in October going to 5.25%. The cut in the official rate by the European Central Bank (ECB) at the beginning of the month and prospects of further cuts brought about this decrease. Nevertheless, it still stood only 15 basis points below the all-time high recorded in July and 60 basis points higher than one year ago. Nevertheless, the downward trend sharpened in the early weeks of November to a level close to 4% at the beginning of the fourth week in the month. This level meant a difference of nearly 0.8 percentage points above the ECB reference rate, which is still high, thus reflecting the persistent lack of confidence in the interbank market.

One-year Euribor drops to near 4% in November due to ECB rate cuts...

In this environment, loan interest rates at financial institutions eased their rise in September. Average interest rate stood at 6.75%, two basis points above the previous month and marked a maximum for the past two years, but it should be pointed out that the monthly increase in deposits was higher. This small monthly rise was due to the increase noted in loan interest rates for companies, with the average rate going up 5 basis points to 6.11%, while the rate on loans to households held at 7.07%.

EURIBOR MOVING DOWN

12-month Euribor



NOTES: November 24.
SOURCE: Bank of Spain.

FINANCING OF COMPANIES AND HOUSEHOLDS CONTINUES TO SLOW DOWN

Year-on-year change in funding granted to non-financial companies and households (*)

NOTES: (*) Includes non-profit bodies serving households.
SOURCE: Bank of Spain.

...and weak demand for credit from companies and households.

The downturn in interest rates also reflects the weakness in demand due to the worse state of the economy which, combined with still restrictive liquidity, meant that funding granted to the private sector has continued to drop sharply. As a result, at the end of the third quarter the year-on-year change rate stood at 8.0%, a growth rate similar to the Euro Area as a whole.

Commercial credit down 13% since September 2007.

Under funding granted to the private sector, total loans to companies and households rose by 8.6% in the past 12 months. In September there was a monthly increase of 0.6%, half that recorded in September 2007.

Funding granted to non-financial companies continued to drop substantially going to an annual increase of 9.1%, less than half that 12 months earlier. Commercial credit, used to finance working capital, dropped by 13.4% compared with the same month the year before. At the same time, financing for investment projects eased a great deal if we are to go by the modest annual increase of 4.5% in leasing.

Sharp drop in housing mortgage loans.

There was also a sharp drop in funding granted to households with the annual change rate going to 6.6% as against a rate of 15.3% in September 2007. Housing loans showed a sharp drop going to an annual change rate of 6.3%. Housing demand is weak because of the worsening of household confidence with the increase in unemployment and downward prospects for real estate prices. Other loans to households, including consumption of goods and services, were also down although to a lesser degree and showed an annual increase of 6.8%.

With the current picture of a contraction in economic activity, default continued to show a tendency to increase and, for

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

September 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	76,076	–14,766	–16.3	–11,799	–13.4	4.1
Secured loans (*)	1,107,513	39,141	3.7	68,892	6.6	59.8
Other term loans	527,585	29,702	6.0	42,877	8.8	28.5
Demand loans	45,564	4,992	12.3	9,978	28.0	2.5
Leasing	47,036	743	1.6	2,030	4.5	2.5
Doubtful loans	48,707	32,456	199.7	34,377	239.9	2.6
TOTAL	**1,852,481**	**92,268**	**5.2**	**146,355**	**8.6**	**100.0**

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

credit institutions as a whole, the ratio in terms of total credit granted to the private sector in September stood at 2.6%. In spite of the increase in recent months, default stands at relatively low levels and it should be pointed out that Spain's financial institutions hold ample provisions to cover possible failure to pay.

In order to ease the financial difficulties of households, the government has announced a series of temporary measures. It has provided the possibility that unemployed persons with mortgage loans up to an initial amount of 170,000 euros may partially postpone their monthly payments. At the same time, it has broadened the period set for terminating housing savings accounts due to the sluggishness of the real estate market. It has also extended the period for selling a present home by two years in the case of those who have bought another home, while maintaining tax exemption on capital gains. Furthermore, workers with income below 33,000 euros a year, to whom the deduction in personal income tax for purchase of a current home with outside financing applies, may ask for a 2-point reduction of withholding amounts for the same tax.

Government announces measures to ease financial difficulties of households.

Record withdrawals from mutual funds in October

The difficulties in obtaining funding in wholesale markets continued to force credit institutions to increase their efforts to obtain such financing through deposits by households and companies. As a result, yields on bank deposits continued to rise in September. Of special note was the increase in return on time deposits of individuals which rose by 6 basis points during the month going to 4.84%.

In this context, total bank deposits of the private sector maintained a growth rate close to 10% in September. The biggest annual growth came in deposits for a 2-year term which were up by 47.2%. On the other hand, on-demand and savings accounts were down 3.7% as a result of the low returns. Annual growth of deposits in foreign currency was a slim 0.5% seeing that interest rates were generally unfavourable in view of expectations on exchange rates.

Total bank deposits going full-steam-ahead at 10% annual thanks to time deposits.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

September 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Overnight deposits (*)	422,217	–15,840	–3.6	–16,082	–3.7	30.2
Up to 2 years	468,947	116,241	33.0	150,398	47.2	33.6
More than 2-year term	393,000	–8,974	–2.2	4,855	1.3	28.1
Repos	68,398	–17,194	–20.1	–17,562	–20.4	4.9
Total	**1,352,562**	**74,233**	**5.8**	**121,610**	**9.9**	**96.8**
Deposits in currencies other than euro	**44,087**	**243**	**0.6**	**223**	**0.5**	**3.2**
TOTAL	**1,396,648**	**74,475**	**5.6**	**121,831**	**9.6**	**100.0**

NOTES: (*) Includes deposits redeemable at notice, according to ECB definition.
SOURCE: Bank of Spain and own calculations.

Mutual funds showing negative yields and assets continue to drop.

The poor trend in financial markets in October and the fierce competition for deposits had its effects on mutual funds. Assets of these funds dropped by 11.13 billion euros during the month mainly due to net withdrawals of participations reaching an all-time high of 8.12 billion euros. In fact, since the outbreak of the crisis in international financial markets in the summer of 2007, due to high-risk mortgages in the United States, the trend in investment fund assets has been downward. At month-end investment fund showed a year-on-year drop of 30.1% in assets putting the figure at 174.49 billion euros. Risk aversion among savers showed up strongly in October and, apart from the shift to deposits, refuge was taken in guaranteed bond-based funds and those based on long-term bonds.

Due to the adverse situation in financial markets average yield during the month was –1.5%, which put average annual return at –6.5%. Nevertheless, there was a very wide range among funds running from 2.9% for guaranteed bond-based funds to capital losses of 51.3% on share-based funds of emerging countries. Over the past 17 years, however, average annual return stands above 4%.

In spite of the difficulties most hedge funds are having in international markets, which are more mature, these funds continued to increase their assets in the Spanish market going to a figure of 1.50 billion euros, as against 818 million euros in December 2007. Finally, the assets of investment funds rose to 8.18 billion euros while their average weighted yield over the past 12 months was 3.5%.

INDEX 2008

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As of December 31, 2007

FINANCIAL ACTIVITY	Million euros
Total customer funds	223,850
Receivable from customers	161,789
Profit attributable to Group	2,488

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	26,342
Branches	5,480
Self-service terminals	8,011
Cards	9,809,909

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2008	Million euros
Social	306
Science and environmental	83
Cultural	79
Educational	32
TOTAL BUDGET	**500**

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