JANUARY 2009

THE SPANISH ECONOMY

Monthly Report

NUMBER 320

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	–0.6	2.3	2.5	2.1	0.7	0.3
Japan	2.4	0.1	–0.2	2.0	1.4	0.6	–0.3	–1.1
United Kingdom	3.0	1.0	–1.2	3.0	2.6	1.7	0.3	–0.1
Euro area	2.6	1.0	–0.7	2.1	2.1	1.4	0.6	–0.2
Germany	*2.6*	*1.3*	*–0.9*	*1.7*	*2.7*	*1.9*	*0.8*	*0.1*
France	*2.1*	*0.8*	*–0.6*	*2.2*	*2.0*	*1.2*	*0.6*	*–0.2*
Consumer prices								
United States	2.9	3.9	–0.1	4.0	4.1	4.4	5.3	1.8
Japan	0.1	1.1	0.0	0.5	1.0	1.4	2.2	0.0
United Kingdom	2.3	3.6	1.2	2.1	2.4	3.3	4.9	3.8
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	0.5	–1.8	2.9	2.1	1.1	0.1	–1.3
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	–8.0	4.5	2.8	–0.2	–3.2	–5.6
Capital goods	*10.0*	*1.1*	*–8.9*	*7.1*	*5.7*	*2.2*	*–0.6*	*–3.0*
Construction	*3.8*	*–4.3*	*–10.3*	*2.9*	*0.4*	*–2.3*	*–6.4*	*–8.9*
Domestic demand (contribution to GDP growth)	4.4	0.7	–2.7	3.8	2.8	1.5	0.1	–1.5
Exports of goods and services	4.9	2.7	0.6	4.0	4.4	4.2	1.5	0.7
Imports of goods and services	6.2	0.6	–3.5	4.9	4.0	2.4	–1.1	–2.8
Gross domestic product	**3.7**	**1.2**	**–1.3**	**3.3**	**2.6**	**1.8**	**0.9**	**–0.3**
Other variables								
Employment	2.9	–0.4	–3.0	2.2	1.4	0.4	–0.8	–2.7
Unemployment (% labour force)	8.3	11.2	15.2	8.6	9.6	10.4	11.3	13.4
Consumer price index	2.8	4.1	1.4	4.0	4.4	4.6	4.9	2.6
Unit labour costs	2.9	3.6	2.7	3.0	3.9	4.0	3.6	
Current account balance (% GDP)	–10.1	–9.8	–8.0	–10.5	–12.1	–9.4	–8.7	
Net lending or net borrowing rest of the world (% GDP)	–9.7	–9.4	–7.7	–9.6	–11.3	–8.9	–8.5	
Government balance (% GDP)	2.2	–3.0	–5.5					
FINANCIAL MARKETS		Forecast						Forecast
Interest rates								
Federal Funds	5.0	2.1	0.3	4.5	3.2	2.1	2.0	0.9
ECB repo	3.8	3.9	1.7	4.0	4.0	4.0	4.2	3.3
10-year US bonds	4.6	3.6	2.2	4.3	3.6	3.9	3.8	3.2
10-year German bonds	4.2	4.0	3.0	4.2	3.9	4.3	4.3	3.5
Exchange rate								
$/Euro	1.37	1.46	1.29	1.45	1.50	1.56	1.51	1.29

Contents

The economy in 2009: out of The Twilight Zone

In the years of black and white television around the Fifties and Sixties, a television series captured big audiences. It was called *The Twilight Zone*. During the nearly five years it was being shown the mix of science-fiction, fantasy and terror attracted a huge public thrilled by its imaginative scripts. The secret of the series' success was probably the disturbing sensation that took hold of the viewer from beginning to end of every episode that always had a surprise ending. It is worth remembering this famous television series because the year just approaching is beginning to show many disturbing factors some of which are quite strange. Undoubtedly, we are at a unique moment in the evolution of the world economy. This is so, both because of growth and prices and because of the situation in the financial sector and the type of response coming in economic policy. Let's look at each of these factors.

We have to go back a long way to find a synchronized episode of economic contraction in nearly all the developed economies. In the United States, the recession that began in January 2008 looks like being the longest since the 1929 Depression. Many economic activity indicators have dropped to all-time lows and even to levels never reached in the period statistics have been maintained. Furthermore, the collapse of oil prices could take consumer price indices into negative figures in coming months, which has raised fears of moving into deflation. The Japanese experience reminds us that deflation is very dangerous territory. And what about Europe? Just one figure is noteworthy. The German IFO business activity index in December stood at the 82.6 points level, the lowest since this statistic has been published and pointing toward a deep recession in the leading economy on the Continent.

With regard to the global financial crisis, it would be difficult for pressures seen in 2008 to get any worse. The financial system at one stage was on the edge of catastrophe. The astronomical losses, problems of liquidity and widespread lack of confidence meant the disappearance of the big investment banks. Many of the international financial entities that have survived are now capitalized at a fraction of their value before the crisis and are now within the reach of more modest investors. These are investors who, if they prefer, can buy up nearly bankrupt industrial giants, like General Motors or Ford, at a very good price.

If we look at the response of governments and central banks, it must be recognized that they have acted rapidly and strongly. The United States has beaten them all with reference rates nearly at zero and major growth of the central bank balance sheet. The Fed has pulled out all stops in its fight against recession and deflation. More restrained, the European Central Bank has drastically cut its reference rate and also expanded its balance sheet. In general, governments have set in motion unrestricted aid to financial systems and, spurred on by the main international bodies, have announced major spending plans for emergency measures.

The end result of these measures is uncertain, given that recession has already begun in the main economies but we are confident that these will ease a situation that could become very critical. In any case, until the economic and financial scene becomes clearer it will be difficult to avoid a sensation of unease, much like the scriptwriters of the series *The Twilight Zone* wanted to pass on to television audiences.

EXECUTIVE SUMMARY

High level of uncertainty

Widespread pessimism at start of 2009...

The year 2009 is beginning in an environment of widespread uncertainty which matured during 2008 when, in line with Murphy's Law, everything that could get worse got worse. Is it just bad luck? There will be plenty of time to debate why the world economy has reached this point. The most relevant fact at this time is that the world has gone through much worse crises and that the lessons learned from those provide valuable resources to deal with the present situation. An addendum to Murphy's Law states that, if things are left to themselves, the problems will go from bad to worse. This does not apply in this case, given that all governments affected have pulled out all their heavy monetary and budgetary artillery so that by the end of 2009 we may be able to see the current wave of pessimism as a broad exaggeration.

...because of flood of bad news in final stages of 2008.

For the moment, much to our sorrow, we stand in a season of bad news. The United States, the world's leading economy, has been in recession since January 2008 although up to the first half of the year the main indicator, gross national product (GDP), had recorded advances. Nevertheless, since September the levels of economic activity have shown a sharp drop that means that forecasts for the fourth quarter are for a sharp drop in GDP, which will likely be repeated in the first quarter of 2009. What is going wrong? No doubt it is private consumption, which up to now has sustained precarious growth, heavily affected by a real estate sector that is going through a long deep recession.

The withdrawal of the US consumer was not hard to foresee if we keep in mind that in the first 11 months of 2008 more than 1.9 million jobs were lost and the unemployment rate rose to 6.7% from the low of 4.6%. Furthermore, the recession has hit households with gross borrowing equivalent to close to 100% of GDP and with financial and real estate assets that have lost a good part of their value, in a context of tighter credit terms. The positive side was the collapse of oil prices which has returned some of the lost purchasing power but has been unable to re-establish confidence indicators and these are now running at levels close to all-time lows.

Drop in oil prices returns some lost purchasing power but raises fear of deflation.

The collapse in oil and other commodities had an unexpected negative effect. It raised fears of deflation. The US consumer price index (CPI) for November stood at 1.1% at annual rate after having reached levels of 5.6% last July. If oil prices do not jump in coming months, the CPI could go into negative rates before many months are over. In fact, we could not speak of deflation if the underlying segment of the index (that excluding volatile prices such as those of energy and foods) does not move onto negative ground. But the risk is there and recent experience with deflation (merely that of Japan) obliges us to pay full attention to this matter.

The combination of recession with the risk of deflation has forced the Federal Reserve, the US central bank system, to strong rapid action. In fact, at the meeting of its monetary committee on December 16, it was decided to leave the reference rate within a band between 0% and 0.25%, a low never before set since

the founding of the US central bank in 1913. Furthermore, the Fed took advantage of its press release to give out three important messages about the direction of its monetary policy. The first was that it would use all the methods available to it so that the US economy would return to a path of stable growth. The second point was that the present exceptional conditions would require maintenance of the present very low official interest rate for a long period of time. The third message was that over coming quarters the central bank would acquire large amounts of agency debt and bonds for which collateral was mortgage assets with the aim of supporting the mortgage market and the construction sector.

The immediate effect of this policy has been a drop in interest rates for all terms. In the US interbank market where 3-month transactions were closing at 4.8% in October they are now doing so at 1.5%. Investors are ready to buy 10-year government bonds that are offering a yield of only 2.1% annual, far from the annual high of 4.3% reached in June. The cut in the Federal Reserve interest rate and the injection of massive amounts of liquidity have brought about a sharp depreciation of the dollar in the past month, namely 12% against the euro and 7.2% against the Japanese yen.

In the Euro Area, for the moment the recessive situation seems to be not as sharp although available figures for the fourth quarter indicate that, far from easing, the recession is getting worse. In July-September 2008, the GDP contracted for the second consecutive quarter, putting the economy in a situation of technical recession. With regard to domestic demand, the component most affected is gross fixed capital formation which, after growing by 2.6% year-on-year in the second quarter, scarcely reached a rise of 0.9% in July-September. In turn, private consumption, while showing nil growth in the third quarter, started out from moderate growth of 0.4% year-on-year. The foreign sector also slowed appreciably. In fact, the worse performance in exports and investment largely lies behind the move into recession, because of the less dynamic foreign and domestic situation and the added burden of an exchange rate showing effective appreciation.

Federal Reserve lowers reference rate to practically zero and plans to buy private sector bonds.

In view of this scenario, the European Central Bank (ECB) has also taken firm action. The reference rate went from 4.25% in July to 2.50% in December while, although to a lesser extent that the Fed, the ECB also injected massive amounts of liquidity, reflected in an increase in liabilities in its balance sheet. In any case, the ECB is maintaining a more orthodox position than its US equivalent seeing that, while the ECB is supporting the spending plans aimed at countering the severity of the economic slowdown, it reminds the member countries of the European Union of the need to maintain fiscal discipline over the medium and long term.

Recession seems less severe in Euro Area but indicators keep getting worse.

On the same day in December that the ECB cut its reference rate, the Bank of England lowered its rate by 100 basis points to 2%, the lowest level since 1951, because of the sharp worsening of the British economy. The Bank of Japan did somewhat the same thing maintaining its reference rate at 0.30% but on December 19 it decided to lower it to 0.10% and announced that it would broaden the buying of government bonds in order to inject liquidity into the Japanese economy.

All these measures are an indication of the progressive worsening of the economic situation in the advanced economies. What is happening in the emerging economies? The slight prospects of a decoupling of those economies from the advanced

ECB and other central banks cut reference rates.

Emerging economies will not act as counterweight to recession in advanced economies.

economies, that might allow the emerging economies to drive the world economy, have almost completely vanished. The Chinese economy, the main contributor to world growth in 2008, is showing more and more signs of slowing down. Although the third-quarter GDP grew by 9.0% year-on-year latest supply and demand indicators show a much more depressed situation. In general, the brake on inflows of foreign direct investment and the dip in world trade will have their effect while the drop in commodity prices could substantially hurt the growth potential of producer countries.

Spain's economy also suffering recessive situation with direct impact on labour market.

In Spain, following a GDP drop in the third quarter of 2008, the first quarter-on-quarter dip since the beginning of 1993, available indicators for the fourth quarter point to a sharpening of the contraction in economic activity. Household consumption continues to weaken especially in the case of consumer durables due to more restrictive financial terms, the increase in unemployment and especially because of fears about future prospects which comes out in a consumer confidence index at an all-time low level.

Nor is investment showing a good moment due to the weakness of both domestic and foreign demand and the drop in corporate profits. On the supply side, the industrial sector is suffering a severe blow due to the drop in demand and an accumulation of problems of competitiveness. The epicentre of sector adjustment, however, is no doubt to be found in construction and especially in the real estate sector which showed a drop of 27.1% in housing sales in September compared with the same month the year before and a year-on-year decrease of 63.5% in approvals for new housing construction.

The recessive situation in the economy shows up worst in the labour markets. Figures for those registered with Social Security in November show a sharpening in loss of jobs. On monthly average, the number registered as working stood at 18.72 million, a year-on-year decrease of 3.5% compared with a drop of 2.3% in October. In November, on monthly average, some 197,087 jobs were lost with a total of 671,772 in the past 12 months. As a result, unemployment showed a rise affecting nearly 3 million persons, according to figures for registered unemployed at employment offices in November, a rise of 43% year-on-year.

Improvements in inflation and foreign imbalance while economic authorities launch new plan to stimulate economy.

On the positive side of the balance sheet we find the decrease in inflation and the foreign imbalance. November saw a continuation of the slowdown in growth of the consumer price index, which went from 5.3% in July to 2.4% in November and it is expected that in coming months it will stand below 2%. With regard to the current account deficit, we should point out the tendency to improvement thanks to the fact that the trade balance and the incomes balance are increasing their imbalances at a substantially lower rate while the deficit in the transfers balance has dropped and the surplus in services has shown a moderate increase.

Following the guidelines worked out by the European Union, on top of the measures already adopted to aid the financial sector, the government has announced a new plan for measures to stimulate the economy amounting to 8 billion euros for investment at the municipal level as well as 3 billion euros to carry out immediate measures to go into R&D, the motor vehicle industry, the environment, construction of public buildings and renovation of housing, minor transport infrastructures and measures linked to the delivery of social services.

December 23, 2008

CHRONOLOGY

2007

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).
	28	Government announces 8 billion-euro **public works plan** for municipalities and 3 billion-euro plan for investment in various sectors and economic spheres.
December	**4**	**European Central Bank** lowers official interest rate to 2.50%.
	5	Price of Brent quality **oil** drops to lowest level since January 2005 (41.86 dollars a barrel).
	16	**Federal Reserve** reduces reference rate to band between 0%-0.25%.

AGENDA

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).

February

- **5** Industrial production index (December). Governing Council of European Central Bank.
- **12** Early GDP (4th Quarter).
- **13** CPI (January). EU GDP (4th Quarter).
- **18** Quarterly National Accounts (4th Quarter).
- **25** Producer prices (January).
- **26** Balance of payments (December). EU Harmonized CPI (January).

INTERNATIONAL REVIEW

United States: looking for the bottom

United States in recession with extreme weakness in private consumption.

The US economy is in recession, anticipating a very weak 2009 where drops dominate the scene and recovery still lies down the road. Since September the levels of economic activity have shown a sharp worsening that has been added to the slowdown beginning in the fourth quarter of 2007. While the gross domestic product in the third quarter was down 0.4% year-on-year, the forecasts for the fourth quarter are for more decreases, if this were possible. The downward risks are centred on private consumption, which represents 70% of gross domestic product (GDP), that dropped by 3.7% quarter-on-quarter annualized in the third quarter. The figures for October relating to the fourth quarter also point to similar decreases.

Debt of households and financial institutions hit 97% and 117% of GDP respectively.

Along with this situation of weak aggregate demand, inflationary trends have rapidly dissipated. On top of the drop in oil prices in other sectors has come significant stagnation in other sector prices because of the lower use of production capacity. For its part, after cutting its reference rate to a band between 0%-0.25%, the Federal Reserve has run the gamut of its conventional monetary policy. Fiscal policy will also

UNITED STATES: MAIN ECONOMIC INDICATORS

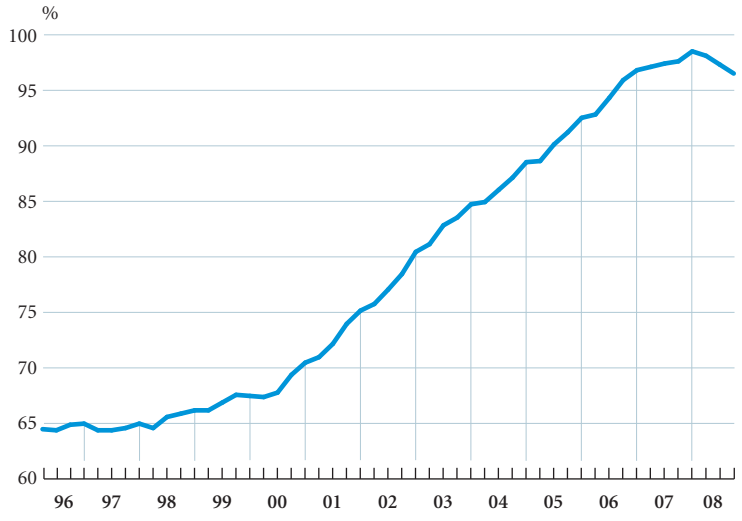
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
Real GDP	2.8	2.0	2.3	2.5	2.1	0.7	–	...
Retail sales	5.8	4.2	5.2	3.0	2.6	0.6	–4.6	–7.4
Consumer confidence (1)	105.9	103.4	91.2	76.5	57.3	57.3	38.8	44.9
Industrial production	2.2	1.7	2.1	1.9	0.2	–3.0	–4.5	–5.5
Manufacturing (ISM) (1)	53.1	51.1	49.6	49.2	49.5	47.8	38.9	36.2
Sales of single-family homes	–18.0	–26.8	–33.7	–33.1	–39.1	–35.4	–40.1	...
Unemployment rate (2)	4.6	4.6	4.8	4.9	5.3	6.0	6.5	6.7
Consumer prices	3.2	2.9	4.0	4.1	4.4	5.3	3.7	1.1
Trade balance (3)	–753.3	–700.3	–700.3	–697.8	–699.1	–707.5	–708.4	...
3-month interbank interest rate (1)	5.2	5.3	4.9	3.0	2.8	3.2	3.0	2.2
Nominal effective exchange rate (4)	82.5	77.9	73.3	72.0	70.9	73.5	80.4	82.7

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.

UNITED STATES: DEBT REMAINS HIGH

Gross debt of households as percentage of nominal GDP



SOURCE: Federal Reserve and own calculations.

play its part through tax cuts and government policies. With current private consumption indicators dropping sharply without finding a bottom and aid given to banks still not reaching other sectors, there are fears of deflation, understood as a continuing and general drop in prices brought about by the weakness in demand, that has still not shown up in forecasts of price indices.

The incentive to avoid the ghost of deflation is high in much-indebted economy. The crisis has surprised households and financial institutions with gross debt of 96.5% and 117.2% of GDP in current dollars, respectively, while at the same time the United States is a net debtor nation in terms of abroad. A debtor is fearful of a general drop in prices because it reduces the price of everything except the amount of the debt contracted. A creditor fears a rise in prices where everything is higher in amount except what has to be repaid.

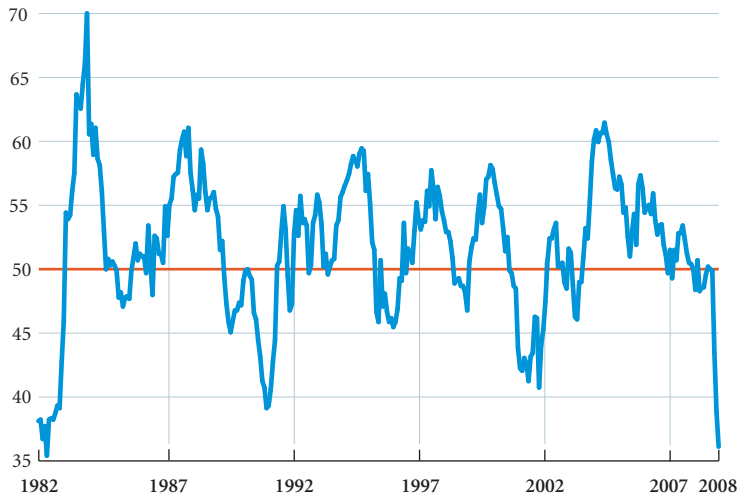
With such incentives, what may take place over the long term is an over-correction from corrective measures which can generate serious inflationary pressures.

This dismal scenario is reflected in the spirits of consumers, as seen in the Conference Board consumer confidence index. Following an all-time low in October, the index recovered only slightly in November going to 44.9 points, thanks to improved expectations which did not show up in the perception of the present situation. In this context of weak demand, retail sales in November reported an unexpected rise following three consecutive months of decreases, although, if we exclude cars and petrol, retail sales held at 0.3% below the level seen in the same period last year, which, discounting price changes, works out at a decrease of 2.2%. Notable among the weakest sectors was the drop of 25.2% year-on-year in car sales and the 10.9% drop in furniture and home goods,

Consumers still locked into pessimism and retail sales move down.

UNITED STATES: CORPORATE VIEW KEEPS DROPPING

Level of ISM business activity index for manufacturing sector



SOURCE: Institute for Supply Management.

Business executives give dramatically worse forecasts dropping to all-time lows.

which illustrates the precarious situation in sales of durable goods.

The view of business executives, as reflected in the business activity index published by the Institute for Supply Management, continues to show a scenario of deep recession which comes on top of the downward trend predominating all through 2008. The manufacturing index dropped from the 38.9 level to 36.2 points, very much below the balance level of 50.0 points considered the threshold indicating risks of a recession. The services index showed a second month with sharp decreases, going from 44.2 points to the 33.0 level, the absolute low shown by the index since it began in 1997. In both cases, there were sharp decreases in the components of employment and new orders, especially export orders. With regard to prices, in four months the index has gone from a situation of inflationary pressures to all-time lows since the index was first established, which in manufactures goes back to 1948.

Construction still not hitting bottom due to over-supply.

The housing sector has still not hit bottom. On the demand side, the price of real estate continues to reduce perceived wealth of many consumers. The Case-Shiller index shows a drop of 23.4% compared with the high in June 2006. Keeping in mind the cumulative rise in consumer prices (CPI) since then, real estate represents a loss of 29.0%, a correction that goes well above the drop of 21.9% taking place between August 1989 and March 1994, corresponding to the earlier downward cycle in housing. The increase in homes being auctioned off has contributed to stabilize the number of real estate deals which since October 2007 seems to have hit bottom. Nevertheless, over-supply and decreased household incomes in terms of the real estate prices continue to keep the over construction sector from hitting bottom.

Housing starts in November were down 18.9% compared with October, a year-on-year drop of 47.0% white the 625,000 housing starts in annual terms made an all-time low since introduction of this indicator in January 1959. Pointing in the same direction, building permits (an early indicator) were down 48.1%.

Private consumption and real estate purchases depend on household disposable income and, for the large majority of households, this depends on the state of the labour market which at this time is in a state of «free fall». In November, some 533,000 jobs were lost and revision of data added another 199,000 to the losses in the two previous months. As a result, in the January-November period some 1,911,000 jobs were lost, of which two-thirds were concentrated in the past three months. The unemployment rate hit 6.7% of the labour force in November and the trend is up. In this context, the precarious situation of the US auto industry takes on special significance. Last month the industry was unable to present a credible restructuring plan that would allow the Senate to give the green light to economic aid, needed to meet its pressing liquidity needs. If we include indirect jobs lost and pensioners, bankruptcy of the three large Detroit companies would affect between one and three million families with implications for demand that go far beyond the strictly stock market sphere.

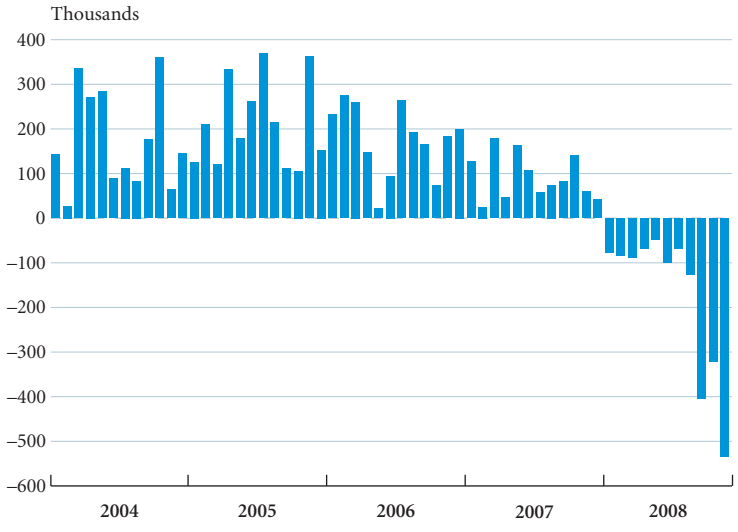
Labour market sharpens drop with 1.9 million jobs lost.

With regard to prices, day by day inflationary pressures are disappearing although deflation still seems far off. The November CPI was down 1.7% compared with October while the underlying index (the general index not including food or energy) reported a second consecutive month practically stagnant, the cause of which lies more in the weakness of overall demand than in swings in oil prices. Year-on-year changes

Inflation rapidly moderating and drops to 1.1% but trade deficit still resists correction.

UNITED STATES: EMPLOYMENT DROPS SHARPLY

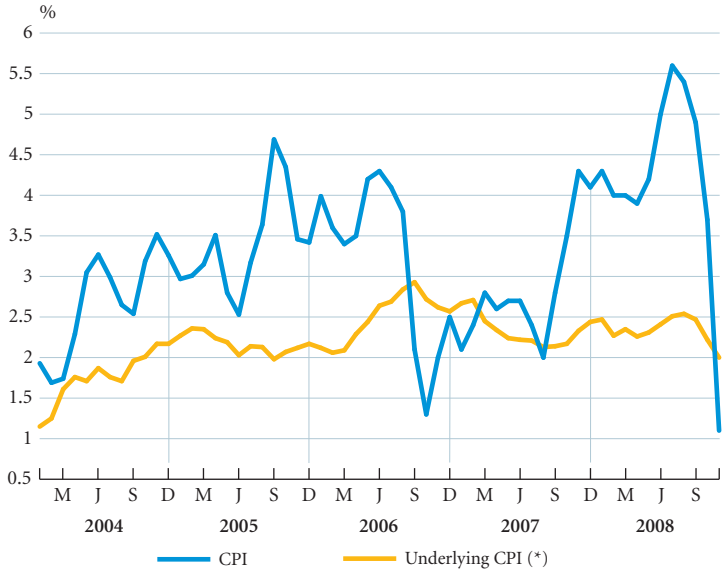
Net monthly creation (+) or loss (–) of non-farm jobs



SOURCE: Department of Labour and own calculations.

UNITED STATES: INFLATION TAKES A BREATHER THANKS TO OIL

Year-on-year change in consumer prices



NOTES: (*) Underlying index excludes food and energy.
SOURCE: Department of Labour and own calculations.

Japan undergoes recession that is growing worse.

moderated increases to stand at 1.1% and 2.0%, respectively.

The foreign sector is not acting as a stimulus for the economy and continues to lose strength due to lower world growth. In spite of the weakness of domestic demand, the trade balance for goods and services showed a deficit of 57.19 billion dollars in October, 1.5% above the same period last year. Exports intensified a process of slowdown with 5.3% year-on-year growth, a rate barely half of that three months earlier. In spite of the drop in imports, the trade deficit excluding oil remains stagnant with little change from the October level of 24.50 billion dollars.

Japan already in recession

Investment in capital goods and exports are weakest components.

The review of the third quarter GDP showed a weaker situation than that reflected in the previous flash figure. The economy was down 1.8% in quarter-on-quarter terms annualized which left the year-on-year drop at 0.3% and confirmed that the recession is deeper than previously anticipated.

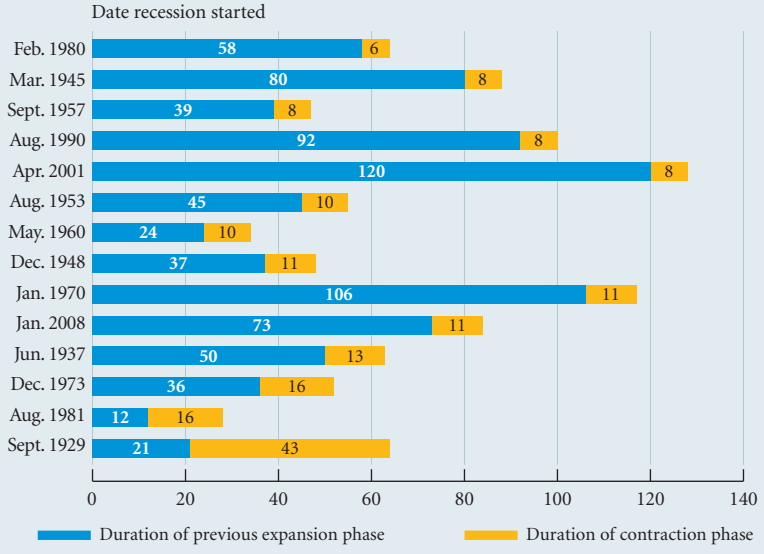
In a world with major trade imbalances where there coexist lender countries (with trade surplus) and borrower countries (with deficit), Japan belongs to the former group. The six years of growth that ended in March 2008 were possible thanks to the drive in foreign demand which drove up capital goods investment, given that practically half of the component was made up of investment spending by export compaies. With the slowdown in world demand, exports and investment eased off rapidly so that the drops in these two components (which together make up a third of GDP) almost entirely explain the recession in Japan.

Recession but not depression: a look at 1929 and Japan in the Nineties

The National Bureau of Economic Research (NBER) has declared it official: the United States has been in recession, surprisingly, since January 2008. While there has not been a drop in GDP in two consecutive quarters (the usual definition of a technical recession), the NBER considers that the significant deterioration of activity and employment indicators observed during the past year warrant calling it a recession. There is a consensus that the recession will extend at least until mid-2009, which would make it the longest since the 1929 Great Depression (see following graph). Is it likely that we stand at the threshold of a depression like that one or at the beginning of a decade of close to nil growth, as in Japan in the Nineties? There are several reasons to be relatively optimistic: The most likely outcome is that the United States will suffer a longer than usual recession but one far from the 1929 event or that taking place in Japan.

UNITED STATES: ON TRACK FOR THE LONGEST RECESSION SINCE 1929

Duration of economic cycles in months



SOURCE: NBER and own calculations.

No doubt about it, there are similarities between the 1929 Great Depression and that in Japan with the present financial crisis. In all three cases, the overvaluation of assets (shares in 1929, real estate in Japan and United States) brought about banking crises which spread to the real economy through the interruption of the normal flow of credit. Nevertheless, the differences between these three episodes, especially in the reaction of the economic authorities, are also quite notable.

The four main factors that turned the 1929 crisis into a depression were: *i)* the failure of the Federal Reserve to deal with the massive bankruptcies that took place in the financial system; *ii)* the sheer size of the following contraction of credit; *iii)* the deflationary spiral brought about by the drop in money supply and economic

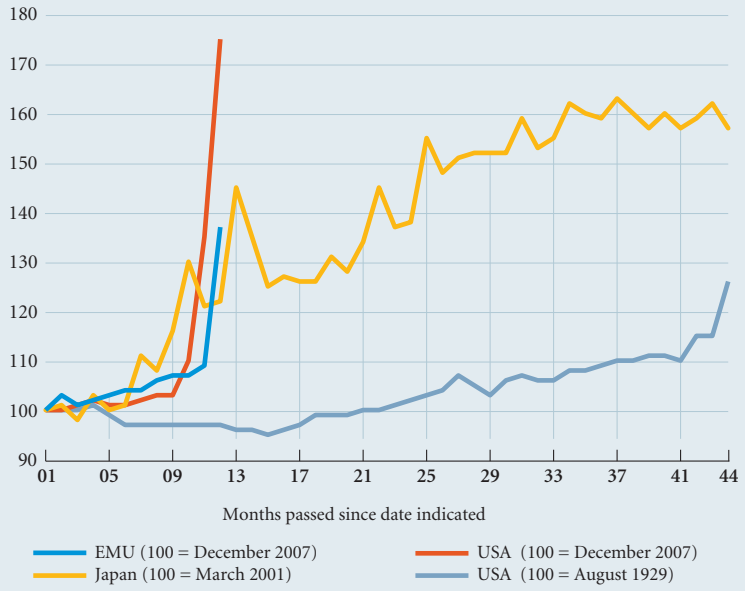
activity, which increased the value of debts in real terms and real interest rates; *iv)* the implementation of protectionist measures which significantly reduced international trade.

The current crisis, while it is turning out to be sharper than initially expected, occurs in a different context and, therefore, the likelihood of its turning into a depression is low. On the one hand, especially following the collapse of Lehman Brothers, the economic and monetary authorities world over seem to be more aware of the importance of avoiding the bankruptcy of systemically important entities. The increase in deposit guarantees has boosted depositor confidence and avoided the panics that were so common during the 1929 crisis. On the other hand, the actions of the fiscal and monetary authorities to avoid a sharp contraction of credit, a drop in price levels and a long recession are being very different from the experiences of 1929 and even of Japan.

The differences are obvious in terms of speed and determination. In the first place, recognition of the problems in the financial system has been relatively quick. Institutions world over have acknowledged major losses linked to the drop in value of assets by making write-downs and have begun a process of recapitalization through private and public capital. During the Japanese crisis, on the other hand, the financial institutions (supported by the supervisory authorities) took years to recognize the fragility of their balance sheets. Secondly, the monetary authorities have reacted aggressively making historic cuts in interest rates, both individually and in concert. On December 16, for example, the Federal Reserve lowered its reference rate to a band between 0%-0.25%, the lowest level in its 94-year history. Furthermore, programmes have been designed for injecting liquidity aimed at easing financial pressures. Between March 2001 and the beginning of 2006, the Bank of Japan expanded the money supply by 76%. This stands in contrast to the determination

CENTRAL BANKS ACT WITH MORE DETERMINATION THAN IN 1929 OR IN THE CASE OF JAPAN

Indices of base money during various crises



NOTES: Base money is the sum of cash in circulation plus deposits of financial institutions at central bank.
SOURCE: Federal Reserve Bank, European Central Bank and Bank of Japan.

of the Federal Reserve, which took less than three months to reach a comparble expansion of the money supply (see graphic on previous page). The European Central Bank has also been active in solving the financing problems of financial institutions, organizing extraordinary liquidity auctions and broadening the qualification of instruments eligible for use as collateral.

In terms of fiscal policy, both in Europe and the United States plans are being discussed and worked out aimed at minimizing the economic effects of the current crisis. In the United States, President-elect Barack Obama has announced a package of investments in infrastructures and tax cuts of around 800 billion dollars, equivalent to nearly 5% of GDP, the biggest plan of this kind since 1956. The plan ranges from traditional infrastructures to the creation of «green jobs» to reduce energy use. The EMU member states have also reached an agreement on carrying out fiscal stimuli equal to 1.5% of GDP of each country, although implementation details are still not fully known.

When we look at the various measures being taken to check the current crisis, it becomes clear that the lessons from the episodes of the 1929 Great Depression and Japan in the Nineties have not been ignored. In general, the authorities are showing much more determination and daring than they did during those to previous episodes, which makes the risk of a depression more distant. Having said this, it is necessary to keep alert. The road to recovery is not without its risks.

Industry suffering another correction while expectations of business executives and consumers grow worse.

Most recent demand indicators show rather dismal picture. Consumer confidence in the fourth quarter hit another all-time low going from 33.2 points to the 31.2 points level. Retail sales were down 0.7% year-on-year in October while car sales (an early indicator of demand) sharpened their drop in November with a reduction of 27.9% year-on-year. On the supply side, the situation is getting even worse, if this were possible. Industrial production, still not recovered from the severe correction in August, suffered another drastic drop in October and accumulated a drop of 7.0% year-on-year, a path also followed by industrial production of consumer goods that were down 4.5%. On top of this weakness comes publication of the Tankan index of business activity prepared by the Bank of Japan for the fourth quarter. The index for large manufacturing companies was down from –3 points to the –24 points level, exactly where we find the general index for large companies, although with less severe drops. For the first quarter of the year the figures suggest a lack-lustre –38 points for manufacturing companies. Under the heading of capital formation, prospects for coming months have shown a clearly downward turn with machinery orders dropping by 29.6% year-on-year and where, on top of the weakness in orders aimed at domestic demand, we must add a sharp drop in those going to the export sector.

Construction recovers very slowly but prices remain stable.

In the housing sector, the volume of sales in the Tokyo area maintained its downward tendency while prices have held within an ill-defined area since May. Land prices dropped slightly in the third quarter. On the supply side, housing starts from January-October were up by a moderate 3.7% year-on-year which continues to show that the recovery from the low level reached in the third quarter of 2007 has been rather modest.

JAPAN: MAIN ECONOMIC INDICATORS

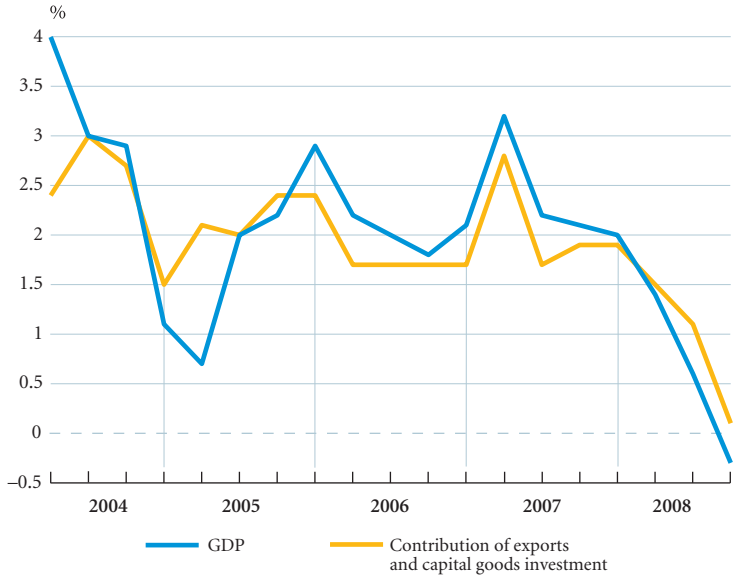
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
Real GDP	2.0	2.4	2.0	1.4	0.6	–0.3	–	...
Industrial production	4.2	2.9	2.7	2.5	1.0	–1.9	–7.0	...
Tankan company Index (1)	22.5	22.0	19.0	11.0	5.0	–3.0	–	–24.0
Housing construction	4.5	–17.2	–27.1	–8.9	–10.9	40.2	19.8	...
Unemployment rate (2)	4.1	3.9	3.8	3.8	4.0	4.1	3.7	...
Consumer prices	0.2	0.1	0.5	1.0	1.4	2.2	1.7	...
Trade balance (3)	9.4	12.5	12.5	11.7	10.2	7.0	5.9	...
3-month interbank interest rate (4)	0.3	0.7	0.9	0.8	0.8	0.9	0.9	0.9
Nominal effective exchange rate (5)	81.1	77.1	78.4	83.4	82.6	81.9	93.5	98.7

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.

JAPAN: NEARLY EVERYTHING DEPENDS ON FOREIGN SECTOR

Contribution to year-on-year GDP growth

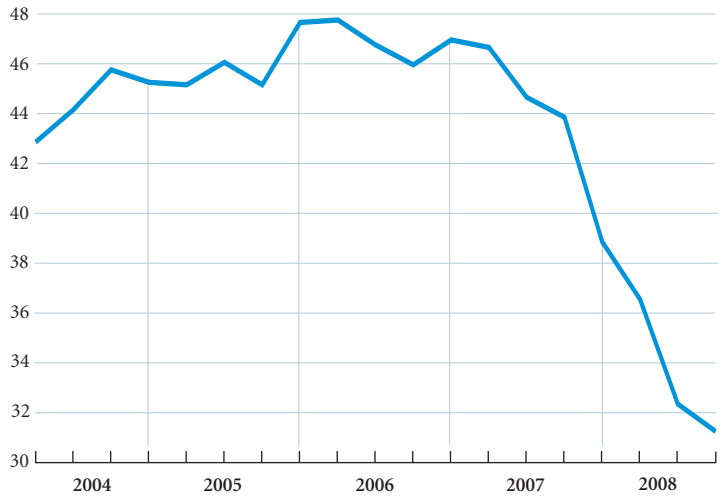


SOURCE: Japanese Ministry of Communications, National Statistics Office and own calculations.

On the inflation front, the increases in the general index began to show the effects of cheaper oil and the October CPI rose 1.7% year-on-year as against 2.1% the month before. The price index not including fresh foods followed a

JAPAN: CONSUMER FEARS INCREASE

Consumer confidence index



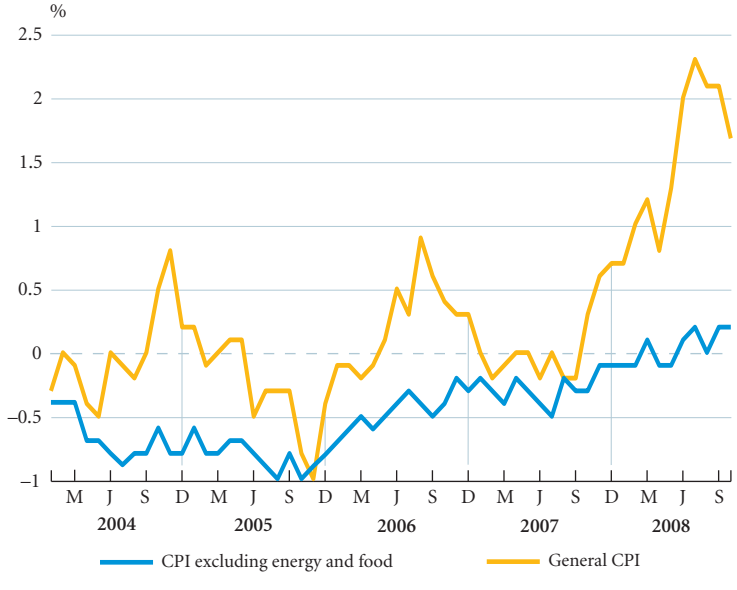
SOURCE: Japanese Ministry of Economy, Trade and Industry and own calculations.

similar course with an increase of 1.9%. In turn, the general index excluding energy and foods showed an increase of 0.2% year-on-year. Following a downward course, the Tokyo CPI for November (with a rise of 1.1% year-on-year) and a continuation of cheap oil point to a rapid return to Japanese

Inflation stands below 2% and tendency is down.

JAPAN: MODERATE INFLATION THAT WILL RISE

Year-on-year change in consumer price index



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

Exports remain stagnant because of lower world demand.

inflation at values very close to zero. In the labour market, the October unemployment rate continued downward, going to 3.7% of the labour force although the purchasing power of wages dropped to 1992 levels.

Lower world demand continues to have serious effects on the Japanese economy. The trade surplus for the past 12 months up to October dropped to 5,900 billion yen, little more than one third of the highs in October 2004. Exports continued to drop sharply with a notable decrease of 9.2% year-on-year in the heading for October while imports for the same month rose by 8.6%. Exports to the United States were down 19.0% while those going to the rest of Asia (50% of the total) were down 4.0% which includes a drop of 0.9% in sales to China.

China grows by 9% but latest indicators point to slowdown.

China showing definite slowdown

China's economy, the main contributor to world growth in 2008, is showing more and more signs of a slowdown. While the third-quarter GDP grew by 9.0% year-on-year, latest supply and demand indicators are showing a much more depressed picture.

On the supply side, industrial production grew by 5.4% year-on-year in November which, if we exclude the distortion effects of the lunar calendar for the Chinese New Year, is the lowest growth since the beginnings of 2002. Motor vehicle production in November was down by 17.5% year-on-year, a weakness with a most recent precedent going back to 1993, which was followed by a drop of 14.3% in output of television receivers. To complete this

CHINA: INDUSTRIAL SLOWDOWN NOW A FACT

Year-on-year change in industrial production (*)

NOTES: (*) Figures corrected for calendar effects of Chinese Lunar New Year.
SOURCE: Chinese National Statistics Office and own calculations.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
Real GDP	11.0	11.8	11.3	10.6	10.1	9.0	–	...
Industrial production	16.4	17.1	17.5	16.5	15.9	13.0	8.2	5.4
Electrical power production	14.7	15.7	16.1	16.0	11.9	6.7	–3.0	–7.8
Consumer prices	1.5	4.8	6.6	8.0	7.8	5.3	4.0	2.4
Trade balance (*)	177.5	262.4	262.4	256.5	247.2	256.9	265.0	278.8
3-month interbank interest rate (**)	2.8	3.6	4.7	4.6	4.6	4.4	4.1	3.7
Renminbis to dollar	8.0	7.6	7.4	7.1	6.9	6.8	6.8	6.8

NOTES: (*) Cumulative balance for 12 months. Billion dollars.
(**) Percentage.
SOURCE: National Statistics Office of China, Thomson Reuters Datastream and own calculations.

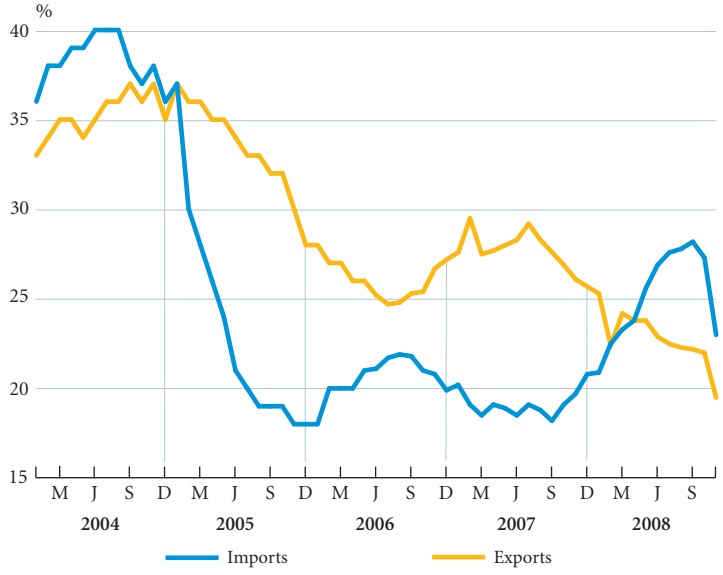
check-list, cement production and primary energy production, while not showing decreases are also undergoing a definite slowdown.

On the demand side, the cooling off of activity is not so clear. Retail sales in November, if we discount price increases, continued to move up going to 18.0%,

Industrial production up 5.4%, lowest rise since 1990.

CHINA: EXPORTS AND IMPORTS SLOWING DOWN

Year-on-year change (*)



NOTES: (*) The sum of last 12 months.
SOURCE: Chinese National Statistics Office and own calculations.

Inflation eases to 2.4% while foods rise by 5.9%.

followed by a gradual improvement the rural areas which are benefiting from a reduction in price pressures in foods. The real estate sector continues to confirm that it is cooling off. In the first three quarters of 2008, housing prices in Beijing dropped by 5.5% and 3.7% in Shanghai while commercial property prices were down 5.5%.

Imports slowing down more sharply than exports.

The positive note in this slowdown is that inflationary problems are diminishing. The general CPI rose by 2.4% year-on-year in November whereas in February it went to 8.7%. The food component, which in China holds special importance as a cost of living index, was also down with an increase of 5.9% year-on-year, well below the 23.3% nine months back.

Commodity imports still dropping sharply.

We also note signs of cooling down in the foreign sector. The trade surplus for 12 months ending November continued to increase going to 278.77 billion dollars but this was due to a slowdown in imports which was sharper than that in exports. Looking more at the short term, exports were down by 2.2% year-on-year in November while imports dropped by a sharp 17.9%. By geographical area, exports to United States and Europe (42.3% of the total) slowed more sharply than those going to Asia (46.7% of the total) where exports to the Pacific Area showed an increase in growth rate to 27.7%.

By heading, the cooling down of commodity imports is still confirming a decrease in growth rate. In terms of volume, oil imports dropped by 1.8% year-on-year in November while aluminium was down 38.5% whereas in October China imported 25.5% less steel than the average for 2006 although copper imports stabilized followed a period of sharp decreases.

The BRICs are also suffering, some more than others

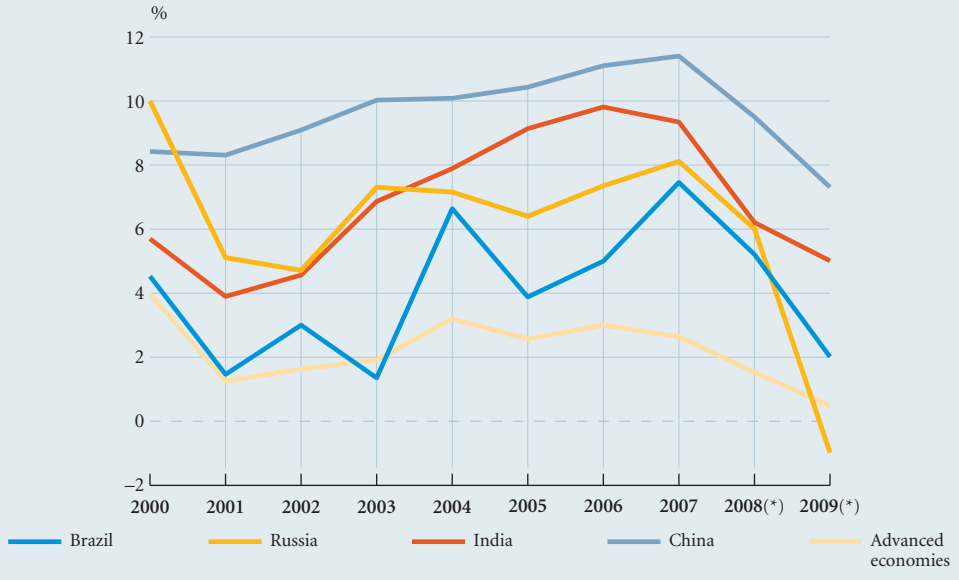
Ever since 2001 when Jim O'Neill, an economist at Goldman Sachs, coined the acronym BRIC to designate the group of emerging countries made up of Brazil, Russia, India and China, the way of looking at the world economy and its interconnections has substantially changed. What does not seem to have changed is the key role these countries play in global growth.

Their high growth rates in recent years and the fact that they account for 42% of world population are the main features that define the BRIC as a group. In particular, their average annual growth rate was close to 8% during the 2000-2007 period. Furthermore, they contributed to around 36% of world growth and it is expected that China's contribution alone will be close to 40% by 2009. Finally, the BRICs as a whole have accumulated large foreign reserves (2,800 billion dollars) which means nearly 40% of world reserves.

At the beginning of the new millennium, the vitality of these emerging countries brought up several theories prophesizing a process of decoupling between the cycle of the BRICs and that of the advanced economies. A lot has happened since then and in recent months it has become clear that the emerging countries are also going to suffer the consequences of the world financial crisis. This will happen but not to all equally. China

THE BRICs SLOW DOWN, SOME MORE THAN OTHERS

Annual growth rates



NOTES: (*) Forecasts for 2008 and 2009.
SOURCE: Thomson Reuters Datastream, IMF, IIF and own calculations.

will continue as the strongest economy among the BRICs, with growth rates of 7%-8%. India's growth could hold above 5% while the slowdown in Brazil will be more notable with growth dropping to values around 2%. Russia, on the other hand, is likely to show negative growth (see above graph).

In China, the growth potential of domestic demand is the main strength at a moment of weakness in foreign demand. Private consumption still represents a small part of GDP (less than 50%) and the Chinese government is taking a series of measures, both fiscal and of a more structural nature, to boost consumption. The starting point of China's fiscal balance (a surplus in 2007) has made it possible to put forward a package of fiscal measures equivalent to 5% of GDP. The increase in spending on education, health and pensions should contribute to reducing the high savings rate of Chinese households (to a large extent of a precautionary nature). The reduction in the price of oil will also provide a breather for China's economy, a net oil importer. For the moment, the drop in inflation, partly the result of lower fuel prices, has made it possible for the central bank to sharply lower interest rates and the reserve requirement ratio, which could contribute to growth in the upcoming year.

Nevertheless, the slowdown in China's exports with the drop in world demand, especially from United States and Western Europe (areas that make up 40% of all Chinese exports), involve a downward risk. November exports were down compared with the year before for the first time in more than seven years (2.2%). However, as a large proportion of inputs used by the export sector are imported (in other words, the value added of China's exports is not very high), the negative impact of a drop in exports on GDP growth, which measures value added domestically, while it cannot be ignored is not as high as might be feared.

India's economy is less dependent on foreign trade than China's (the weight of exports in GDP is much lower) and, for this reason, it will not suffer so much from the impact of a global slowdown in trade. On the other hand, the drop in oil prices means a major breather for consumers, companies and for the government which was partly subsidizing fuel prices. The world financial crisis will be felt through a drop in the investment inflows which were providing a considerable amount of liquidity to the financial system and driving the growth of credit. Nonetheless, the drop in inflation (as in China) has provided the central bank with a precious margin for manoeuvre in reducing the interest rate and the reserve requirement ratio. The reduction of the subsidy on fuel and efforts at fiscal consolidation in recent years has also created room for fiscal expansion that the authorities have taken advantage of in order to announce a fiscal stimuli plan equivalent to more than 1% of GDP.

Brazil, and especially Russia, both major exporters of commodities, will suffer from the fall in world demand and the sharp drop in commodity prices. In the case of Russia, the drop in oil prices has a very significant impact on fiscal revenues thus, reducing the margin for carrying out expansionary fiscal policies. In both countries, the worsening of their foreign position has brought about depreciation of local currencies which is tending to push inflation up and to limit the margin for monetary policy. In fact, Russia's central bank was forced to raise interest rates in December (100 basis points) in order to defend the rouble and halt the flight of capital whereas Brazil has not changed its interest rates. The flight of capital from Russia, as well as being a major loss of international reserves, will reduce liquidity of the financial system and considerably tighten terms for access to credit. Brazil's more solid fiscal situation and the credibility of its central bank means that the situation is somewhat more manageable.

In fact, the BRICs will also suffer from the world crisis, although not all to the same degree. Whereas the Asian giants will be glad of the collapse of oil prices and the strength of economic policies, Brazil and Russia will pay for their high dependence on commodity exports. For all four countries, the short-term risks have a downward bias. Over the medium term, however, the BRICs have a broad upward path ahead and, no doubt, they will again surprise us with their growth rates.

Mexico grows by 1.6% with slowdown in investment and consumption.

Mexico: slowdown along with inflation

The slowing down of the economy was again sharper in the third quarter, with a GDP showing growth of 1.6% year-on-year, well below the 2.7% in the previous period. Latest economic activity indicators confirm the slowdown in the economy, reflecting the influence of the weakness of Mexico's neighbour to the north. On the supply side, general industrial production was down 1.9% year-on-year in September, thus running up the fifth consecutive month to show decreases. Manufacturing production was down by a slighter 0.3%. Demand also slid downward with retail sales in September dropping by 1.3%, a higher rate than the month before.

In spite of the increased weakness in aggregate demand, the inflation front saw further price increases. The general CPI rose by 6.2% year-on-year in November, well above the 5.8% in October. This rise was followed, although with less strength, by the underlying CPI (the general rate excluding energy and foods) which showed a rise of 5.5% year-on-year. One reason for this slight inflationary move could be unit labour

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
Real GDP	4.9	3.2	4.2	2.6	2.7	1.6	–	...
Industrial production	5.4	1.9	3.1	1.1	1.3	–1.3	...	...
General unemployment rate (*)	3.6	3.7	3.6	3.9	3.5	4.2	4.1	...
Consumer prices	3.6	4.0	3.8	3.9	4.9	5.5	5.8	6.2
Trade balance (**)	–6.1	–10.1	–10.1	–9.1	–7.6	–11.3	–12.5	...
3-month interbank interest rate (***)	7.3	7.2	7.2	7.2	7.2	7.2	7.2	7.2
Mexican pesos to dollar	10.9	10.9	10.8	10.7	10.4	10.4	12.7	13.2

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
(***) Percentage.
SOURCE: Central Bank of Mexico and own calculations.

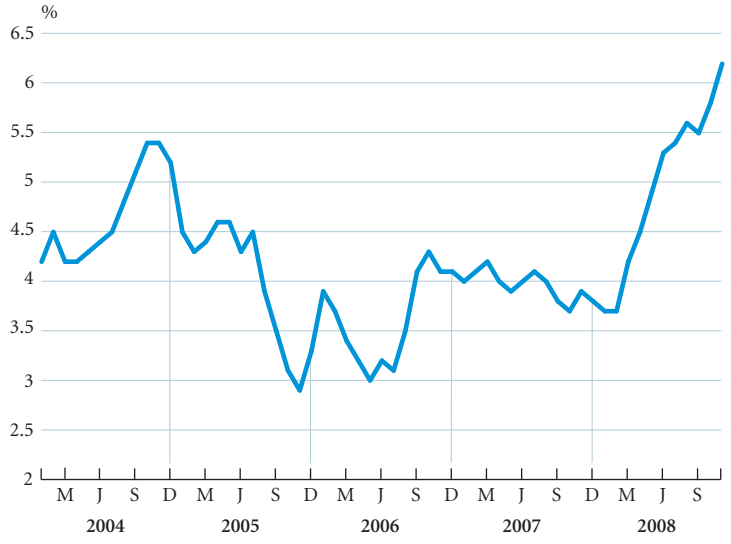
costs which, after a period of some easing off, in August showed a sharp rise that was only partly corrected in September with an increase of 7.1% year-on-year. The general unemployment rate dropped slightly in October to 4.1% of the labour force, within a tendency of stability in official statistics.

In the foreign sector, the weak point of growth in recent years, the trade deficit conditioned to worsen in spite of the weaker drive in private consumption. With the Mexican economy's dependence on oil, in a situation of easing prices, the road in coming months continues downward. The trade deficit in the past

Inflation reaches 6.2% in spite of slowdown while unemployment holds close to 4%.

MEXICO: INFLATION IS THREATENING

Year-on-year change in CPI



SOURCE: Central Bank of Mexico and own calculations.

Oil in stage of sharp volatility keeps dropping.

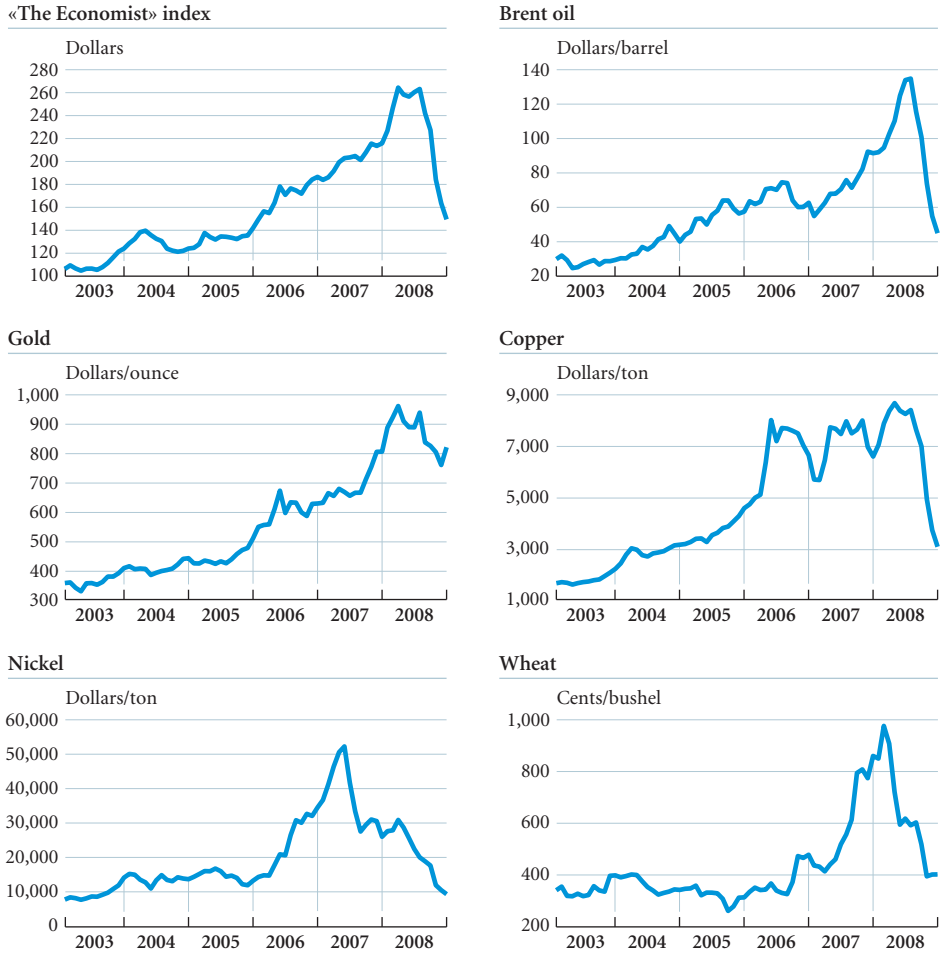
12 months ending in October was up again rising to 12.49 billion dollars. If we exclude oil, exports have been stable for while imports continued to grow at a good rate, putting the deficit at 68.54 billion dollars, some 34.41% higher than in the same period the year before.

Commodities continue to drop

Oil has undergone some weeks of sharp volatility. Between December 1 and December 23, oil was commanding 50 dollars a barrel (one-month delivery for *Brent* quality), tried to get back to the 50-dollar level and ended up at 40 dollars. Beyond the swings, the predominating background trend remains downward, as in previous months, so that in this period the price dropped 23%.

This performance does not fail to be surprising seeing that on December 18 the Organization for Oil Exporting Countries (OPEC) announced the biggest production cut in its history. As of January 1, 2009, the oil cartel will

TREND IN VARIOUS RAW MATERIALS



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

offer 2.2 million barrels a day less, a figure equivalent to approximately 8% of its total production. From this, we may assume that the expected demand factor has weighed more heavily in the thinking of market agents. In this respect, we should underline that the International Energy Agency announced that it foresaw the first contraction in oil demand recorded in 25 years.

Other commodities as a whole also followed a downward course, although not a sharp. *The Economist* commodities index dropped by 4% between December 1-18. The biggest decreases in the various products showed up in certain metals, such as copper, which dropped 20% and lead which was down 16%.

Notable correction of some metal prices.

EUROPEAN UNION

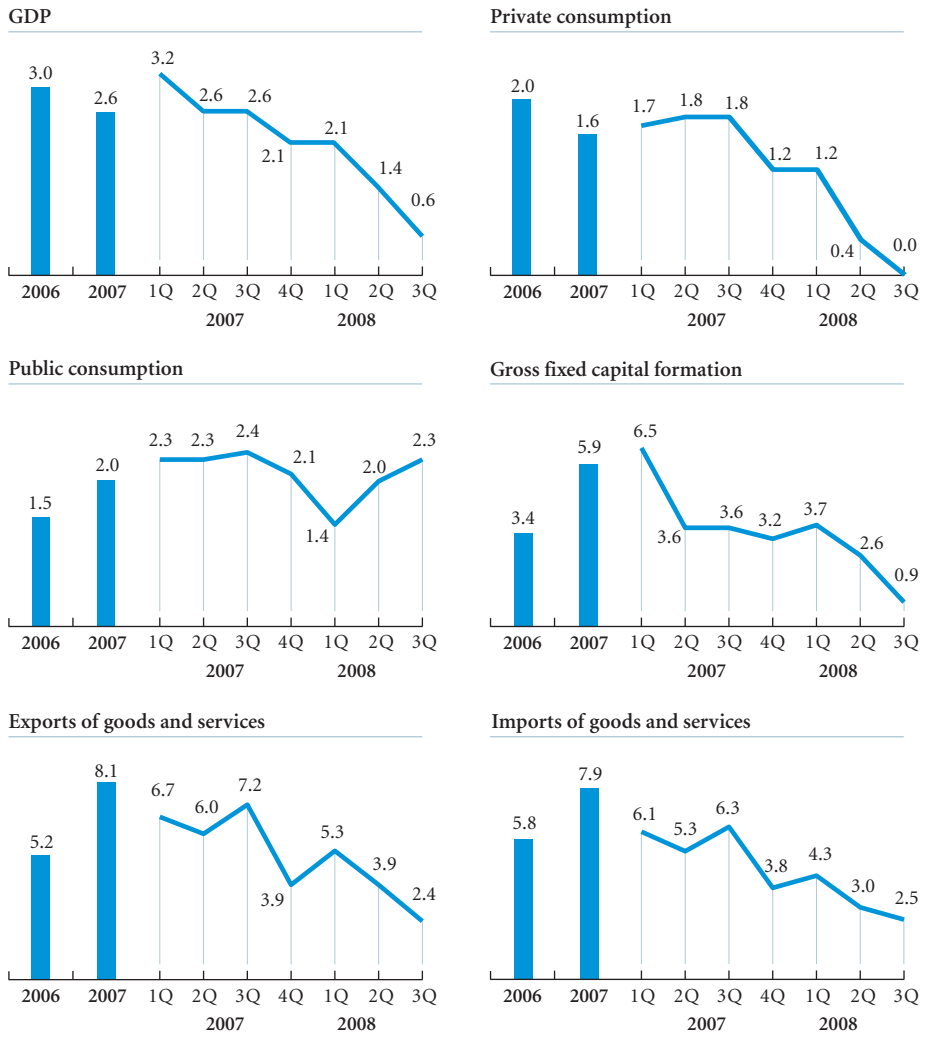
Euro Area moves into recession in fourth quarter...

Euro Area: recession becomes serious

In the third quarter of 2008, gross domestic product (GDP) of the Euro Area contracted for the second consecutive quarter. It therefore moved into a situation of technical recession. Figures available for the fourth quarter tend to confirm that, far from easing, the recession is growing worse. All this

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCE: Eurostat and own calculations.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
GDP	3.0	2.6	2.1	2.1	1.4	0.6	–	...
Retail sales	1.5	0.9	–0.3	–0.2	–1.5	–1.5	–2.1	...
Consumer confidence (1)	–9.1	–4.9	–7.7	–11.9	–14.6	–19.3	–23.6	–25.1
Industrial production	4.0	3.5	3.1	2.5	1.1	–1.6	–5.3	...
Economic sentiment indicator (1)	106.3	108.4	104.3	100.5	96.5	88.5	80.0	74.9
Unemployment rate (2)	8.3	7.4	7.3	7.2	7.4	7.5	7.7	...
Consumer prices	2.2	2.1	2.9	3.4	3.6	3.8	3.2	2.1
Trade balance (3)	–10.4	20.1	34.3	23.5	11.5	–14.3	...	...
3-month Euribor interest rate	3.1	4.3	4.7	4.5	4.9	5.0	5.3	4.7
Nominal effective euro exchange rate (4)	103.6	107.7	110.6	112.8	115.6	113.7	107.6	106.8

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

indicates that the turnaround is still a long way off especially if we look at the paths along which the single currency economy is moving.

Information supplied by National Accounting for the third quarter is helpful for really understanding where the loss of economic activity is taking place. In this period, the Euro Area GDP dropped by 0.2% compared with the second quarter. At year-on-year rate, a figure that comes closer to the medium-term trend, growth dropped to 0.6%, compared with 1.4% year-on-year in the previous quarter. This notable drop in economic activity in the past 12 months was due to the fact that both domestic and foreign demand are rapidly growing worse.

With regard to domestic demand, the component that has shown the biggest adjustment is gross fixed capital formation which, after growing by 2.6% year-on-year in the second quarter barely moved ahead by 0.9% in July-September. Private consumption, while recording nil growth in the third quarter, started out from a moderate increase of 0.4% year-on-year. In contrast to this trend was the increase in public consumption that reached 2.3% year-on-year thus going above the 2.0% seen in the previous quarter. The contribution of inventories to the change in GDP was nil. Domestic demand overall grew by 0.6% year-on-year, half that noted in the previous quarter. The foreign sector also slowed appreciably given that its contribution to growth was zero due to the fact that, while both exports and imports moderated, foreign sales eased even more.

...due to worse overall situation in domestic and foreign demand.

In fact, the worse performance in exports and investment largely explains in what components the economic crisis is hurting most. The main component arises from a less dynamic foreign

Slowdown in credit to companies affecting investment.

Inflation continues to drop.

situation and many months with the effective nominal exchange rate in appreciation. While this second factor was corrected in September and October, foreign demand continues to drop so that we cannot expect any big improvements in terms of the contribution from the foreign sector in the fourth quarter and beyond.

In investment, one way to understand what is happening is to remember that this largely responds to expected demand and financial conditions. Given that neither domestic demand nor the foreign sector is pointing to a change toward increased economic activity, the only relief in gross fixed capital formation could come from a clear improvement in financial conditions.

Economic sentiment at lowest level since 1995.

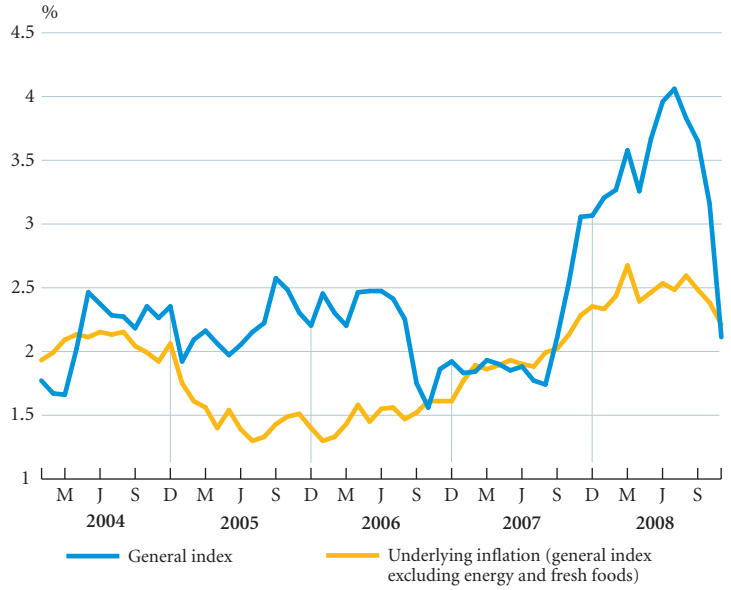
In spite of the sharp drop in the reference rate by the European Central Bank, credit effectively granted to companies has dropped substantially since the highs reached at the beginning of 2008. As against an increase in credit granted to non-financial companies in the first quarter of 2008 at 15.0% year-on-year, in the third quarter this had dropped to 12.2%. As is happening with expected demand, immediate prospects are also downward in terms of growth of credit granted to companies.

Furthermore, so far as the fourth quarter can be judged and according to available indicators, the situation in private consumption has worsened. In October, retail sales dropped by 2.1% year-on-year while consumer confidence collapsed to the –25 points level. Both the present situation and that immediately coming up is indeed slim in terms of household spending.

Supply indicators complete the picture for the fourth quarter. The broadest indicator, that for economic sentiment, fell to the 75 points level in November, its

ENERGY AND FOOD EASE INFLATIONARY PRESSURES

Year-on-year change in CPI



SOURCE: Eurostat.

worst figure since 1995 when this statistic was first compiled. The industrial sector, traditionally the most cyclical, is severely suffering the move into recession. In October, industrial production stood at levels 5.3% lower than one year earlier. The collapse in industrial orders as of November would indicate that the trend in coming months will continue downward. This poor state of economic activity is repeated in the construction sector and in services, as far as can be seen from their respective confidence indicators.

The rapid worsening of the economy is having its impact on the labour market. Since March, the unemployment rate has begun to halt the downward trend followed in the false peak of the cycle going to 7.7% of the labour force last October. There has thus been a half-point increase in little more than six months. In this overall negative situation, inflation comes as a relief. In November, the harmonized consumer price index (HCPI) stood at 2.1% year-on-year, far from the annual high of 4.0% last July. The drop in pressures from energy and food components has brought a notable easing of inflation. If these volatile components are discounted, the resulting rate stood at 2.1% year-on-year.

The easing off in inflation makes growth the main objective of economic policy in the Euro Area. In this respect, it should be remembered that on December 12 last the European Council decided to adopt the package of fiscal stimulus measures put forward earlier by the European Commission. This involved a series of measures totalling 200 billion euros, most of which (170 billion euros) would come out of national budgets while the remaining 30 billion euros would be a charge to the EU budget. The EU part of the package would concentrate on extending the financing of the European Investment Bank aimed at small and medium companies and aid to various projects in transport infrastructures, energy and telecommunications. With regard to national measures, specific choices are left to each member state although types of aid are to be coordinated (specific aid to sectors such as motor vehicles and construction, a combination of increased government spending and tax reductions, as well as various structural reforms pending).

Dark forecasts for Germany's growth in 2009.

Germany: 2009 could be worst year in decades

The economy of the Federal Republic of Germany could be about to move into one of the worst years in its recent history. While uncertainty about the trend in the GDP in 2009 is very high, the forecasts of the large economic analysis institutes (known as the «wise ones») recently made public suggest very negative scenarios. For example, the IFO Institute puts forward a drop of 2.2% in GDP for 2009 followed by a further decrease of 0.2% in 2010. It should be remembered that in no recession since 1960 has there been a drop of more than 1% annual.

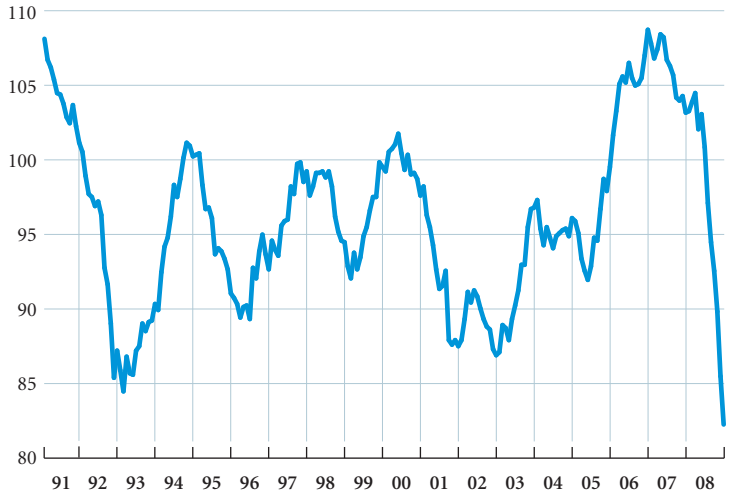
IFO indicator at lowest levels since 1991.

In spite of the fact that when this macroeconomic scenario was made known it seemed somewhat extreme, just a few days later it was leaked that the German Minister of Economy had been dealing with internal forecasts of a drop in GDP of around 3%. In view of this meagre picture it is understandable that, in spite of some reluctance on the part of Peer Steinbrück, Minister of Economy, it is speculated that the federal government will announce a new package of economic stimuli amounting to

New package designed to stimulate economy.

GERMANY AT ITS WORST MOMENT SINCE REUNIFICATION

IFO indicator of business activity



SOURCE: IFO Institute.

Consumption, investment and exports moving down.

30 billion euros, approximately 1.2% of GDP. This programme comes on top of those agreed on in October and November amounting to 32 billion euros.

Do the latest available indicators lend support to this negative scenario? While the present situation is far from the collapse of economic activity underlying those forecasts, the trends are clearly negative. The IFO indicator for business activity, that is often taken as reflecting Germany's general economic pulse, dropped to the 82.6 points level in December, the worst figure since 1991 when this indicator was first published. This is a sign of the poor situation hitting industry (industrial production dropped by 3.9% year-on-year in October), services and construction.

The poor state of supply has its counterpart on the demand side. The state of consumption tended to be depressed as the fourth quarter advanced as shown by the fact that retail sales fell by 0.8% year-on-year in October. If we also take into consideration that consumer confidence in November stood at its lowest level since July 2005, we can also infer that the immediate future is not promising. All of this was so in spite of the fact that the unemployment rate was still holding at a relatively low level (7.5% in November) along with the easing of inflationary pressures (inflation in November stood at 1.4% year-on-year).

Inflation tending to moderate.

The collapse of investment, noted in the year-on-year drop in industrial production of capital goods of close to 5% in October, aggravated the domestic situation. What is more, Germany's economic problems do not end with domestic demand. In October, as cumulative figure for 12 months, the trade surplus stood at 188.2 million euros compared with 190.7 million euros the month before. This drop in the trade balance was due to the combined result of a rise in imports along with a slowdown in exports.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
GDP	3.2	2.6	1.7	2.7	1.9	0.8	–	...
Retail sales	0.3	–2.3	–3.5	–0.9	–0.2	0.5	–0.8	...
Industrial production	6.0	5.9	5.0	5.0	3.0	–0.1	–3.9	...
Industrial activity index (IFO) (*)	105.4	106.2	103.9	104.0	102.2	95.0	90.2	85.8
Unemployment rate (**)	10.7	9.0	8.5	8.1	7.9	7.7	7.5	7.5
Consumer prices	1.6	2.3	3.1	2.9	2.9	3.2	2.4	1.4
Trade balance (***)	151.3	181.5	195.1	199.1	201.3	194.6	188.2	...

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.

France: collapse in fourth quarter

Just as France surprised everyone in the third quarter with growth of 0.1% quarter-on-quarter, in the fourth quarter available indicators suggest that the economy has contracted. To what extent? According to forecasts put out by the Bank of France, the drop in GDP in the final three months of 2008 could stand at 0.7%. This sharp drop, according to the French central bank, comes from the poor state of industry and, although to a lesser extent, from the worsening of tertiary sector activity. Causing more alarm, both the figures from the survey of business managers and order books suggest that the downward trend will get stronger as 2009 advances. For the moment, industrial production in October beat downward forecasts with a drop of 7.2% year-on-year.

On the demand side, most of the economic adjustment is taking place in the cooling off of household consumption. Various indicators suggest that the start of the fourth quarter was downward. Household consumption grew by a minimum of 0.7% year-on-year in November while consumer confidence held at levels around –30 points in October and November. A similar trend was seen in industrial production of capital goods (with a nil year-on-year growth in October hurting the increase of 0.3% in the third quarter), an indicator that comes close to the strength of investment.

Contraction in France's GDP expected in fourth quarter.

In this context of domestic weakness we cannot expect to find any relief from foreign demand given that in the 12 months ending in October the trade deficit rose to 55.6 billion euros compared with the deficit of 52.3 billion euros in September. The other key imbalances in the economy (prices and unemployment) showed contrasting results given that, while inflation slowed to 1.6% year-on-year in November (2.7% in October), the unemployment rate rose to 8.2% in October, two decimals above the figure for September.

In this very adverse situation, the government's fiscal support plan

Both domestic and foreign demand slackening.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
GDP	2.4	2.1	2.2	2.0	1.2	0.6	–	...
Domestic consumption	3.3	4.4	3.8	2.4	1.5	0.9	0.7	...
Industrial production	0.9	1.4	2.5	1.6	–0.4	–2.4	–7.2	...
Unemployment rate (*)	9.2	8.3	7.9	7.7	7.7	8.0	8.2	...
Consumer prices	1.7	1.5	2.3	2.9	3.3	3.3	2.7	1.6
Trade balance (**)	–27.4	–33.0	–38.1	–41.3	–45.1	–50.3	–55.6	...

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

Plans to stimulate economy will only partially ease drop in economic activity.

adopted at the beginning of December, which amounts to the equivalent of 1.3% of GDP, will scarcely have a palliative effect. According to some estimates, the effect of this body of measures (concentrated mainly on stimulating investment) in terms of new growth will be around 0.6%, insufficient to avoid a drop in GDP in 2009.

Italy: moving into recession

Italy's GDP down 0.5% in third quarter.

In the third quarter of 2008 the Italian economy dropped by 0.5% quarter-on-quarter which, added to the drop of 0.4% in the second quarter, puts it into a state of technical recession. At year-on-year rate, the GDP dropped by 0.9% thus showing worse than the dip of 0.2% in the previous quarter. In a way similar to that seen in the Euro Area as a whole, investment and exports are the components where the year-on-year drop has most hurt Italy's growth.

Specifically, in the third quarter gross fixed capital formation was down 1.9% year-on-year (a contraction of 0.1% year-on-year in the second quarter), while private consumption was down 0.6% (with no change over the previous

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
GDP	1.9	1.4	0.1	0.4	–0.2	–0.9	–	...
Retail sales	1.2	0.5	0.5	0.9	–1.7	0.5	...	...
Industrial production	2.5	–0.1	–2.9	–1.4	–1.6	–4.2	–6.1	...
Unemployment rate (*)	6.8	6.2	6.3	6.6	6.8	...	–	...
Consumer prices	2.1	1.8	2.4	3.1	3.6	4.0	3.5	2.7
Trade balance (**)	–17.6	–13.7	–8.9	–9.1	–8.6	–10.4	–12.1	...

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

quarter) and public consumption marked up an increase of 1.1% year-on-year (in line with the increase of 1.3% in the three months previous). In turn, exports were down 3.1% year-on-year, far from the increase of 1.1% in the second quarter, and imports dropped by 3.4% (compared with the drop of 1.7% in the second quarter).

The few indicators available for the fourth quarter point to a continuation of these downward trends although even sharper. From the size of demand we can point out the drop in consumer confidence which in October and November went down 3.5 points to stand at rates of –26 points. We should mention that the present situation component stands in the area of –70 points, an extraordinary result that suggests an extremely pessimistic perception of the situation by Italian consumers. On the supply side, to mention only one significant indicator, the collapse of industrial production (6.1% year-on-year) reveals the worsening cyclical situation of the economy. The drop in CPI to 2.7% year-on-year in November, as against the previous 3.5%, goes almost unnoticed in a sea of poor macroeconomic figures.

Weakness expected to sharpen in final stages of 2008.

United Kingdom: consumption slack

The economic situation in the fourth quarter has been rapidly worsening thus consolidating expectations that the United Kingdom will undergo the worst recession among the large European Union economies. The drop in consumer confidence of more than four points in October and November, the deep contraction in car registrations (close to 40% year-on-year in November) and the slowdown in retail sales (growth of 2% year-on-year in October) confirm that consumption, the lungs of the economy, is having difficulty breathing. This is a troubling situation although one of its fundamentals, the labour situation, is still holding up relatively well. Jobs were still being created in the second quarter while the unemployment rate (3% in October) is low.

United Kingdom shows notable worsening in final months of 2008.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
GDP	2.8	3.0	2.9	2.3	1.5	0.3	–	…
Retail sales	3.2	4.4	3.8	5.4	4.4	2.3	2.0	…
Industrial production	0.7	0.4	1.0	0.6	–1.2	–2.5	–5.2	…
Unemployment rate (*)	2.9	2.7	2.5	2.5	2.6	2.8	3.1	3.3
Consumer prices	2.3	2.3	2.1	2.4	3.3	4.9	4.5	4.1
Trade balance (**)	–72.5	–83.2	–88.4	–90.9	–93.2	–94.6	–94.0	…
3-month Libor interest rate	4.6	5.3	6.3	6.0	6.0	5.9	6.3	5.8
Nominal effective pound exchange rate (***)	98.0	103.9	102.2	97.6	92.6	92.8	89.4	85.4

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.

Inflation begins to leave behind high levels seen in previous months.

The state of investment is not better. The level of utilization of production capacity dropped below 80% in the fourth quarter, a situation not seen since the fourth quarter of 2005. Also alarming is the trend in foreign demand. In spite of the depreciation of the pound sterling, a currency whose effective nominal exchange rate has lost more than 15% of its value in the past year, the trade deficit is scarcely being corrected. These foreign difficulties partly account for the poor state of industry. In October, industrial production fell by more than 5% year-on-year, worse than the year-on-year drop of 2.9% in September.

The only optimistic note of the month comes in inflation. After reaching troubling levels in September (more than 5.2% year-on-year) the CPI moderated in November to 4.1% year-on-year, notably easing concern that a situation of stagflation (recession with inflation) might be developing. While current levels still are twice the 2% inflation objective of the Bank of England, forecasts suggest that this situation could be corrected in just a few months.

FINANCIAL MARKETS

Monetary and capital markets

Central banks face new challenges

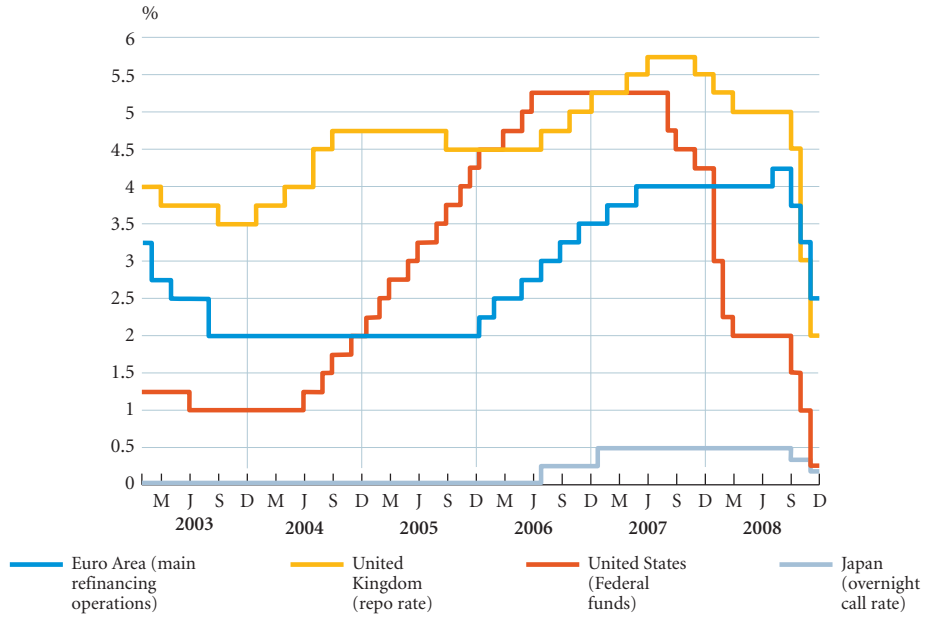
In recent weeks, with few exceptions the central banks have followed a trend to cut reference rates. This includes the Federal Reserve to the point where it has gone close to the 0% limit in view of the picture of recession and prospects of deflation. We may ask when a central bank cuts its interest rate to 0% does it any longer have arms to deal with the situation? The answer is that it may still continue to apply measures to stimulate the economy, as shown by the episode in Japan in the Nineties, the only experience of this kind in current times. For this reason, the central banks are urgently searching through their old manuals for measures to increase the money supply, to continue injecting liquidity, in what has now become known as «quantitative easing». That is to say, to go from setting interest rates to establishing an objective for growth of the reserves of the banks within the central bank.

We may thus consider that there are three stages in the conduct of monetary policy by the central banks when they must inject liquidity into the system. First and most common is to lower the official interest rate. When this has reached 0% and the central bank

Central banks have instruments to continue injecting money into economy even if interest rate goes to 0%...

REACHING THE LOWER LIMIT

Reference rates of central banks



SOURCE: National central banks.

...by establishing quantitative easing objectives for bank reserves.

is obliged to so maintain it for a long period of time, it moves on to a second stage. It now begins to apply a policy of quantitative easing that consists of the central bank buying government bonds with the aim of injecting liquidity into the financial system. The final stage would be to broaden the assets accepted by the central bank to inject liquidity as, for example, private bonds and other types of asset in order to continue boosting expectations of economic recovery and facilitating more rapid adjustments in the financial system. In this case, the central bank changes the risk profile of assets in its balance sheet.

Federal Reserve lowers official interest rate to range between 0%-0.25%.

The Federal Reserve has already carried out the first stage. At its meeting on December 16, it cut its official interest rate by 75 basis points (100 basis points equals 1%) putting it at 0.25%, the lowest level since the founding of the central bank in the United States in 1914. In its announcement, the central bank strictly specified that the official interest rate would move within a range between 0%-0.25%.

In its press release, the members of the Fed's Open Market Committee considered troubling the sharp worsening of the labour market and the slowdown in industrial production, consumption and investment. Furthermore, they recognized the seriousness of the recession because of the added factor of restriction of credit in capital markets. In addition, the Fed admitted that inflationary pressures, which had been one of its concerns all year, had eased appreciably and it was hoped that this trend would continue due to the sharp drop in commodity prices.

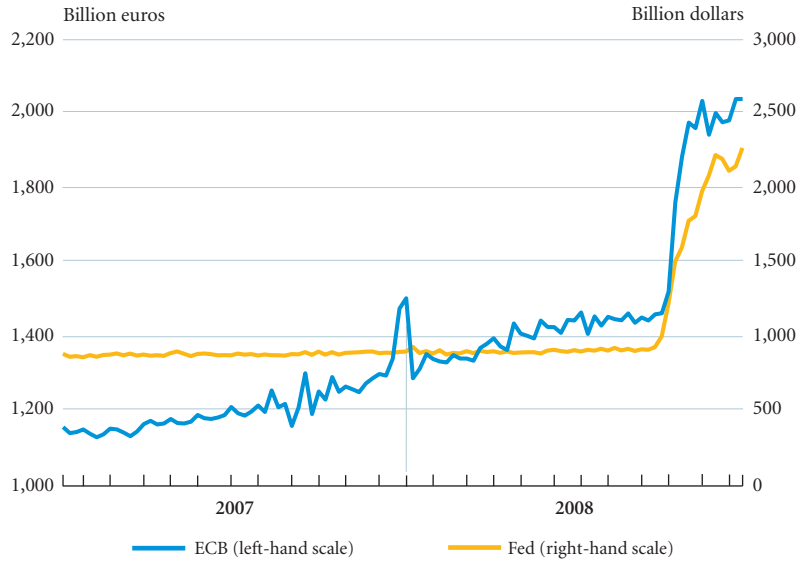
Fed decides to continue buying mortgage-backed bonds and opens up possibility of acquiring government bonds.

Furthermore, in its press release the Fed added three important messages about the future direction of monetary policy. The first was that it would use all its available resources to bring the US economy back on to a path of stable growth. Secondly, that the present exceptional conditions would demand maintenance of the official interest rate as low as the current rate for a long period of time. Finally, that in coming quarters the central bank would acquire large amounts of agency bonds and mortgage-backed bonds to support the mortgage market and the construction sector.

In addition, it added that the committee was studying the benefits of beginning a policy of buying government long-term bonds. It also left open the possibility of following new ways to use its balance sheet with the twin objective of supporting capital markets and economic activity. In terms of the three stages mentioned above regarding the carrying out of monetary policy in order to inject liquidity, there arises the paradox that the Fed has gone directly to the third stage, that is to say, accepting non-conventional assets in order to provide liquidity and is studying the second stage, that is, the acquisition of long-term government bonds. Finally, the US central bank has publicly recognized that several months ago it began to make massive injections of liquidity using its balance sheet.

In the following graph, we see this sharp growth that increased the assets side of the Fed's balance sheet by 1,000 billion dollars in September 2008 putting it at 2,200 billion dollars at the end of December. This was a massive increase that in less than one quarter doubled the balance sheet of the US central bank. In the same graph we note that the European Central Bank (ECB) also injected massive amounts of liquidity,

TOTAL ASSETS IN BALANCE SHEETS OF EUROPEAN CENTRAL BANK AND FEDERAL RESERVE



SOURCE: Central banks.

as reflected in the increase in the assets side of its balance sheet.

To be precise, at its meeting on December 4 the ECB decided to cut its reference rate by 75 basis points putting it at 2.50%. Governor Jean-Claude Trichet made public the central banks growth estimates for the Euro Area in 2009, expecting growth to be negative for the first time since 1993. However, the central bank's downward forecasts for inflation for the Euro Area allow it to have fewer restraints for lowering the official interest rate.

The ECB is concerned about the impact of the financial crisis on the real economy which is showing up in the slowdown in granting loans to Euro Area residents. Whereas in January 2008 this variable grew at a year-on-year rate of 11.1%, the latest figure for October shows growth of 7.8%. And, while the ECB supports fiscal spending plans to counteract the severity of the economic slowdown, it reminds member states of the European Union of the need to maintain fiscal discipline over the medium and long term. It thus considers the Stability and Growth Pact an essential tool. Finally, the ECB emphasizes the need to carry out structural changes to strengthen the flexibility of the economy with the aim of being able to more easily absorb negative shocks such as we are now experiencing.

On the same day that the ECB cut its interest rates, the Bank of England reduced its official rate by 100 basis points putting it at the 2% level, its lowest since 1951. The reason was the sharp worsening of the British economy which came as a surprise to members of Monetary Policy Committee of the UK central bank. The same downward move was followed by the central banks of Sweden and Denmark.

Another surprise in the moves by the central banks was the cut applied to its

Central banks in Euro Area and United States use balance sheets to inject liquidity.

official rate by the Bank of Japan. In fact, Japan had an official interest rate of 0.30% but on December 19 the central bank decided to lower this to 0.10% and announced that it would increase the purchase of government bonds to inject liquidity in Japan's economy.

Cuts in official interest rates, fuller information on bank losses and bank recapitalization moves have brought improvement in interbank market.

Drop in yield on government bonds sharpening

The downward trend in official rates of central banks is affecting interbank markets by helping to open them up. In fact, the sharp increase in liquidity is lowering the price of funds banks lend to each other. But is it not only the increase in liquidity but all the measures being taken by the central banks and governments, including the most heterodoxical, that have reduced the strong risk aversion being displayed by the interbank market around September. What is more, increased transparency regarding bank losses, recapitalization of banks (both public and private), and the action taken by governments have been

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro Area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2007									
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	3.25	3.85	3.95	1.00	2.22	0.93	3.00	3.91	1.23
December (1)	2.50	3.08	3.26	0.25	1.50	0.10	2.00	2.98	0.75

NOTES: (1) December 19.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 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%), 4-12-08 (2.50%).
(3) Latest dates showing change: 11-12-07(4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).
(4) Latest dates showing change: 10-05-07 (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%), 04-12-08 (2.0%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

additional factors in maintaining the trend to a reduction in interbank interest rates that began in October. This process makes it possible to state that there have been several months of continuing improvement.

For example, in the Euro Area the 3-month Euribor was 3.08% on December 19, a drop of 77 basis points compared with the end of November. Perhaps the most significant change has been the sharp drop in the 12-month Euribor rate which, after hitting the psychological level of 4%, in mid-December stood at 3.26%. In the United States, the levels reached were spectacular as well as historic. Even though the situation has not normalized in the interbank market in any sphere, US banks are ready to lend each other money over 3 months asking for a return of only 1.5%. Japan is not standing aside seeing it has gone back to levels of 0.10% in the 3-month interbank market. The cut in the British market has also been substantial. While in September UK banks were lending money for a 3-month term asking a yield of 6.3%, now it is possible to borrow the same amount for the same term paying a return of only 2.98%, that is to say, less than half the interest rate they had to pay only three months back. These figures show that the central banks have been successful in achieving their aim of lowering the cost for financial institutions to obtain capital in the interbank market.

In the case of long-term government bonds, the cut in official interest rates has pushed up the price of bonds and brought about the sharp drop in return

Yield on long-term government bonds drops to very low levels.

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								
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	3.26	3.68	3.89	4.46	2.92	1.40	3.77	2.28
December (*)	2.99	3.46	3.83	4.33	2.07	1.24	3.19	2.15

NOTES: (*) December 19.
SOURCE: Bloomberg.

Spanish government bonds yielding less than 4%.

these now offer. In addition, in the United States the announcement of a study by the Fed regarding the acquisition of long-term bonds has collapsed the return offered by US bonds. Investors are willing to buy 10-year government bonds offering a return of only 2.07% annual. This level is not very far from that offered by German long-term government bonds which, while allowing a higher return, in fact, offers only 2.99%.

In the rest of the Euro Area there have also been sharp cuts in interest rates on government bonds. In the case of Spain, a 10-year bond now shows a return of 3.83%. The yield of nearly 5% offered by Spanish bonds in June has dropped because of the exceptional worsening of the economic situation. Nevertheless, all factors suggest that this situation of low interest rates on government bonds will continue over coming months.

Sharp increase in volatility of foreign exchange markets

The cut in the Federal Reserve reference rate has caused a sharp depreciation of the dollar. In general, a deep drop in interest rates in a country usually brings with it the risk of depreciation of its currency. Such a sharp cut in the official interest rate as taking it to 0% makes it less attractive to buy bonds of the country that offer a very low return. For this reason, international investors are

EXCHANGE RATES OF MAIN CURRENCIES

December 19, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2007	Annual
Against US dollar				
Japanese yen	89.3	–7.2	–25.1	–27.0
Pound sterling	0.669	–0.1	32.7	33.6
Swiss franc	1.103	–10.1	–2.8	–4.8
Canadian dollar	1.228	–2.2	18.7	18.3
Mexican peso	13.162	–2.7	17.2	17.6
Against euro				
US dollar	1.398	11.9	–4.2	–2.8
Japanese yen	124.8	4.4	–23.5	–23.5
Swiss franc	1.541	1.6	–6.8	–7.3
Pound sterling	0.934	11.8	27.1	29.7
Swedish krona	10.950	6.9	16.0	15.8
Danish krone	7.451	0.0	–0.1	–0.2
Polish zloty	4.082	7.2	13.5	12.9
Czech crown	26.34	2.4	–0.8	0.2
Hungarian forint	264.5	–2.7	4.6	4.0

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

less interested in buying those assets and there is thus less demand for the currency in which they are issued. In addition, 0% interest rates indicate a very serious situation. In this environment, foreign investors will not buy dollars to acquire shares as it is likely there will be a drop in profits shown by companies in coming quarters.

Finally, the massive injection of dollars by the central bank removes the scarcity of the currency experienced by other world banks. All these reasons lie behind the drop in the dollar which has depreciated 11.9% against the euro in the past month whereas in the same period it has depreciated 7.2% against the Japanese yen, as may be seen in the above table. As a result, there has been a break in the range within which the euro-dollar was being quoted between 1.25 and 1.30 that was operative from the end of October. The US currency has also depreciated against the Canadian dollar and the Mexican peso (in both cases around 2.5% in the same period, while, on the other hand, it has held up against the pound sterling.

Nevertheless, the pound sterling sharply depreciated against other currencies when investors reduced their holdings of assets issued in pounds sterling. Specifically, pound has depreciated 11.8% against the euro in just one month. On December 19 a euro could buy 0.934 pounds sterling, an all-time high never before reached since the start-up of the single currency. The deep drop in the British economy and prospects of even sharper and more rapid cuts by the Bank of England in comparison with the action of the ECB lie behind this process.

Dollar and pound sterling depreciate sharply against other currencies.

Breather in stock markets in December

Following the sharp drops on world stock markets in October and November, December brought a pleasant breather. In keeping with the improvements in the interbank markets and fewer negative news items compared with the previous two months, shares in most stock markets of the industrialized countries reported increases that in some cases were considerable.

One example was the US Nasdaq high-tech market which showed a monthly change of 12% as of December 19. The Tokyo stock exchange, following news that the country had gone into recession and that the government's official growth forecast for the new year was negative, even managed to hold up with a moderate rise of 3.8% in monthly change. With a monthly increase of 11.3%, Spain's selective IBEX 35 has been one of the most notable with investors indicating that perhaps they had over-reacted by selling shares in Spanish companies.

Not only has there been the slight improvement seen in other financial markets but also the halt to the panic seen in previous months. It is evident that 2008 has been very complicated for investors in shares. Cumulative drops since the beginning of the year of up to 50%, as seen in indices in stock markets in Amsterdam and Milan, indicate the sharp adjustment in valuation that has taken place in shares.

Following two consecutive months of sharp drops, share market shows a slight rise in December.

It is important to underline the massive «evaporation» of wealth that has taken place in world stock markets. For this purpose, it is useful to note the concept

INDICES OF MAIN WORLD STOCK EXCHANGES

December 19, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*8,605.0*	*7.6*	*–35.1*	*–34.8*
Standard & Poor's	*885.3*	*9.8*	*–39.7*	*–39.1*
Nasdaq	*1,552.4*	*12.0*	*–41.5*	*–40.3*
Tokyo	8,588.5	3.8	–43.9	–42.9
London	4,214.7	5.2	–34.7	–32.9
Euro Area	2,422.7	5.5	–44.9	–43.7
Frankfurt	*4,703.3*	*8.0*	*–41.7*	*–40.0*
Paris	*3,177.8*	*2.9*	*–43.4*	*–42.2*
Amsterdam	*246.8*	*3.6*	*–52.2*	*–50.9*
Milan	*19,221.0*	*–1.6*	*–50.1*	*–49.4*
Madrid	*9,136.4*	*11.3*	*–39.8*	*–39.8*
Zurich	5,443.2	–1.5	–35.8	–35.2
Hong Kong	15,127.5	18.0	–45.6	–44.0
Buenos Aires	1,116.4	20.6	–48.1	–47.6
São Paulo	39,536.3	18.4	–38.1	–35.9

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.

2008 sees valuation of companies listed world wide diminish by 29,000 billion dollars.

of stock market capitalization, that is to say, the value of companies on the stock market, obtained by multiplying the number of shares of each company by its price to thus arrive at the value attributed by the market. If we make this calculation on January 1, 2008 for all world companies listed on official stock markets we obtain a figure of 60,800 billion dollars. On the other hand, if the calculation is made on December 19, the value of all companies was only 31,800 billion dollars. Put another way, the value of all listed companies world-wide dropped by nearly 50% in 2008. The disappearance of 29,000 billion dollars is as if all the wealth generated in the United States, the Euro Area and Japan in one year had gone.

A world in debt: How will deleveraging play out?

Following years of sharp growth of debt levels in most of the advanced economies a correction of this trend has now begun. Nowhere is this more evident than in the United States. Household debt there fell in nominal terms in the third quarter of 2008 for the first time since at least 1952, the first year for which there are figures. The financial sector was the first to begin this process of deleveraging, made necessary by losses that have reduced their level of capitalization and the freeze of international financial markets. Later on, households and non-financial companies were caught up in this dynamic, some forced by the difficulty in getting access to credit, while others, because of the uncertainty regarding economic prospects, prefer to save.

Since the beginning of the subprime mortgage crisis, the international financial sector has recognized losses of more than 1,000 billion dollars. In order to counteract the impact on solvency ratios (in other words, the level of capitalization) the entities that did not go into bankruptcy have followed two strategies. On the one hand, they have attracted new capital (starting with private investors and later, in many cases, public capital). Simultaneously, they have begun to limit growth and even reduce the amount of assets in their balance sheets, especially those carrying higher risk, in order to reduce possible future losses (or to reduce capital required under regulations). This has contributed to limit the supply of credit to companies and households.

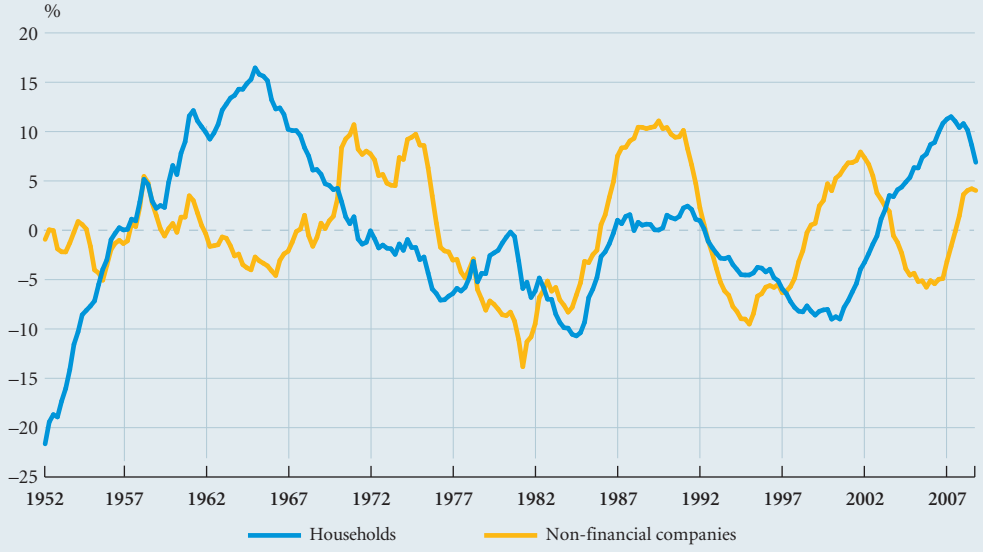
Financial institutions have also been forced to reduce their debt levels for a very simple reason – uncertainty regarding their solvency and the sharpening of risk aversion has dried up the capital markets that used to finance them. This effect has been especially pronounced for those entities that were using off-balance sheet vehicles that were highly indebted (the famous Special Investment Vehicles) to invest in high risk assets or for institutions little or not regulated, such as hedge funds which used leverage to amplify their returns.

A disorganized or sudden debt reduction could prove very dangerous and this justifies the plans for injecting liquidity and recapitalization orchestrated by governments and central banks. Fire sales of assets push prices down, which harms the balance sheets in the financial system as a whole and generates a downward spiral of capital losses, forced sale of assets and further decreases in asset prices. If it is not stopped in time such a spiral can result in a credit crunch, a general limitation in the credit supply. Precisely the difficulty of access to credit in the case of households and companies, along with a general increase in uncertainty, had become catalysts in the process of debt reduction outside the financial sector in the final months of 2008.

Households, on the one hand, have speeded up the reduction of their debt levels because of the increased uncertainty, partly created by the increase in the unemployment rate. The reduction in wealth, especially as a result of the drop in home real estate prices, has also fostered a higher preference for saving. On the other hand, greater uncertainty has also affected non-financial companies, which have reduced investment and increased liquidity in their balance sheets. Furthermore, some companies had borrowed in order to acquire other companies using the acquired asset as collateral for the loan. The drop in value of such acquisitions has precipitated debt reduction when the borrower companies have not been able to provide additional collateral for their loans or to meet repayments.

DEBT OF COMPANIES AND HOUSEHOLDS STANDS WELL ABOVE LONG-TERM TREND IN UNITED STATES

Deviation in debt ratio over % GDP in terms of trend



SOURCE: Thomson Reuters Datastream and own calculations.

The process of debt reduction in households and companies will mean that both consumption and investment in 2009 will show negative growth rates in most of the advanced economies, including the United States and the larger economies in the Euro Area. The extent of this effect, however, will depend on the effectiveness of the fiscal stimulus plans announced in recent weeks aimed at reactivating economic activity, maintaining jobs and in this way ease the process of debt reduction by the all economic agents. The effectiveness of the measures taken by the various central banks is also fundamental. On those measures depends the reactivation of lending activity and especially that a process of deflation does not begin. Deflation could be especially dangerous given that it would increase the level of debt in real terms, which would bring about increased contraction of consumption and investment. In any case, the monetary expansion that have started to engineer the Fed and the ECB (see box «Recession but not depression») should be sufficient to bring an increase in inflation in the second half of 2009.

The year just beginning will be marked by deleveraging in the private sector. Its impact on economic activity will depend on the speed of this readjustment, which will be influenced by action taken on monetary policy and the capacity of fiscal expansion plans to ease the situation. We should not lose sight, however, of the fact that these plans involve major borrowing by the public sector, a process that is probably needed now but will have to be corrected over the medium term.

SPAIN: OVERALL ANALYSIS

Economic activity

Economic contraction growing sharper

While in the third quarter of 2008, gross domestic product (GDP) recorded its first quarter-on-quarter drop since the beginning of 1993, available indicators for the fourth quarters suggest a sharpening of the contraction in economic activity. Both consumption and investment continue to lose drive. From a supply point of view, construction is still going through a difficult adjustment but industry and services are also losing strength.

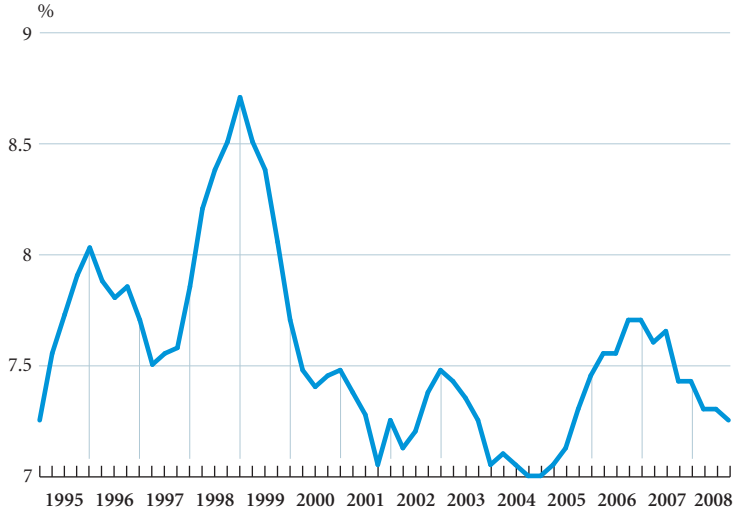
Within this framework, the Quarterly Composite Balance Sheets compiled by the Bank of Spain provide a sharp look at the state of companies. According to results for the third quarter of 2008, the general health of companies is good although there are signs of worsening. Up to September, gross value added generated by non-financial companies (which is obtained by subtracting intermediate consumption goods from the value of production) rose by only 1.0% compared with the same period the year before, 3.6 points less than one year earlier.

In spite of the sharp economic slowdown, company personnel costs rose by 5.0% compared with the same period in 2007, some 6 decimals more than one year earlier because of the general rise in average wages, no doubt due to the application of wage revision clauses. The gross economic operating result thus dropped by 1.8% compared with the same period one year earlier.

Economic health of companies is good but clear signs of worsening now showing up.

CORPORATE PROFITABILITY SLOWING SLIGHTLY

Ordinary yield on net assets, moving average of four quarters



SOURCE: Bank of Spain and own calculations.

PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES

Annual change rates

	2007	Quarters: 1-3	
		2007	2008
Value of production	7.3	4.2	9.7
Intermediate consumption	8.3	4.0	14.3
Gross value added (GVA)	**5.1**	**4.6**	**1.0**
Wage costs	6.1	4.4	5.0
Gross operating profit	**4.2**	**4.7**	**–1.8**
Financial income	31.5	13.6	26.9
Financial costs	38.7	37.4	28.7
Depreciation and provisions	–1.0	–0.4	–1.4
Net ordinary profit	**5.9**	**0.2**	**–3.6**
Extraordinary income and costs	75.9	–24.5	107.1
Provisions and tax	43.8	–11.4	–11.9
Net profit	**9.8**	**–2.8**	**25.7**

SOURCE: Bank of Spain (Central Balance Sheet Data Office Quarterly Survey).

Up to September 2008, net ordinary profit of companies shows year-on-year drop of 3.6%.

Continuing with the flow of results, financial income grew a little less than financial costs. As a result, while depreciation and operating provisions were down 1.4%, net ordinary profit showed a drop of 3.6%.

Nevertheless, operations of an extraordinary nature had a favourable impact on final results of companies. They compensated for the negative trend in ordinary economic activity and made it possible for net profit to increase by 25.7% annual. It should be noted that, if it were not for some very exceptional operations by large Spanish multinational groups, net result for the period January-September 2008 would have tended toward stagnation.

Nevertheless, return on net assets showed a notable level of 7.6%, although 2 decimals below the same period in 2007. Ordinary return on equity stood at 9.7% due to the fact that financial cost stood 2.5 points below ordinary return on net assets. Nevertheless, return on equity was down 1.3 points compared with one year earlier. The levels of corporate returns sustain investment and employment but the trend is downward.

November car sales record collapse of nearly 50% year-on-year.

Going back to the general economic situation, household consumption continued to weaken, especially in consumer durables. In November, car sales suffered a collapse of 49.6% compared with the same month in 2007. This was due to tougher financing terms but also to a sharp drop in consumer confidence in view of the sharp rise in unemployment. In fact, in November the consumer confidence indicator held at the all-time low level noted in October.

Nor is investment going through a good moment due to the weakness in both domestic and foreign demand and profits moderation. What is more, the utilization of production capacity continued downward in the fourth quarter. As a result, industrial production

DEMAND INDICATORS

Percentage change over same period year before

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
Consumption								
Production of consumer goods (*)	2.3	1.2	–2.7	–0.8	–5.6	–5.5	–8.3	...
Imports of consumer goods (**)	8.9	5.1	7.7	–1.2	–6.9	–4.1	...	...
Car registrations	–0.9	–1.2	1.3	–15.3	–19.6	–32.5	–40.0	–49.6
Credit for consumer durables	14.5	10.0	9.9	8.8	7.1	3.4	–	…
Consumer confidence index (***)	–12.3	–13.3	–17.3	–20.0	–31.3	–38.3	–44.0	–44.0
Investment								
Capital goods production (*)	8.4	5.9	3.3	2.0	–3.1	–3.8	–13.8	...
Imports of capital goods (**)	3.2	9.8	9.0	–16.0	–16.4	–15.9	...	...
Commercial vehicle registrations	1.5	0.3	4.7	–29.5	–34.1	–50.1	–54.3	–63.2
Foreign trade (**)								
Non-energy imports	9.0	7.3	7.5	4.3	0.2	–4.1	...	...
Exports	5.6	4.2	4.6	2.2	6.6	7.8	...	...

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.

of capital goods was down 13.8% in October compared with the same month the year before. Domestic sales of equipment and software in large companies reported a year-on-year drop of 9.2% in October. Apparent cement consumption, an early indicator of construction investment, continued to collapse showing an annual drop of 41.5% in November.

On the supply side, the industrial sector is suffering deeply from the drop in demand and an accumulation of problems of competitiveness. The general industrial production index marked up a sharp drop of 12.8% in October compared with the same month in 2007. Incoming industrial orders were down 14.6% in October compared with the same month the year before. In this context, the industrial confidence indicator dropped again in November going to the lowest level seen in this economic cycle.

The epicentre of the sector adjustment, however, is certainly to be found in construction after its having enjoyed a long period of strong growth. Nevertheless, the confidence indicator in construction saw something of an improvement in November. The real estate sector continued depressed with a 27.1% drop in housing sales in September compared with the same month the year before. In the same month, permits for new housing units recorded a year-on-year drop of 63.5%, somewhat below that noted in August.

Apparent cement consumption down more than 40% in November compared with same month in 2007.

The services sector is also losing strength. The recession in the tourist sector continued into October, if we are to

Industrial orders down 15% in October compared with 12 months earlier.

SUPPLY INDICATORS

Percentage change over same period year before

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
Industry								
Electricity consumption (1)	4.0	4.4	4.9	2.5	2.6	1.8	–1.7	–4.9
Industrial production index (2)	3.9	1.9	–0.2	–0.5	–5.1	–6.1	–12.8	...
Confidence indicator for industry (3)	–2.7	–0.3	–3.3	–7.0	–11.9	–18.7	–27.0	–33.0
Utilization of production capacity (4)	80.5	81.3	81.1	81.3	80.3	79.3	–	76.8
Imports of non-energy intermediate goods (5)	10.5	8.0	7.1	11.4	6.9	–2.1	...	...
Construction								
Cement consumption	8.5	0.2	–1.9	–13.3	–19.7	–26.1	–34.4	–41.5
Confidence indicator for construction (3)	14.2	9.3	–1.3	–14.7	–17.3	–23.7	–38.0	–31.0
Housing (new construction approvals)	18.6	–24.7	–33.6	–59.8	–56.0	–62.4	...	...
Government tendering	31.3	–14.9	–33.1	27.8	–30.5	7.6	...	...
Services								
Retail sales (6)	2.1	2.4	–0.3	–3.6	–5.6	–6.4	–8.0	...
Foreign tourists	4.1	1.3	1.5	5.3	0.9	–5.2	–5.4	...
Tourist revenue inflows	5.6	3.6	4.5	5.2	1.0	–0.3	...	...
Goods carried by rail (ton-km)	–1.2	–3.7	–2.7	–2.7	0.2	–5.2	–13.3	...
Air passenger traffic	6.8	9.0	8.5	7.9	–0.7	–4.9	–10.8	–14.3
Motor vehicle diesel fuel consumption	5.5	4.8	4.7	–0.9	–2.8	–3.7	...	...

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.

International Monetary Fund again makes downward revision to growth forecast for Spain's economy to drop of at least 1% in 2009.

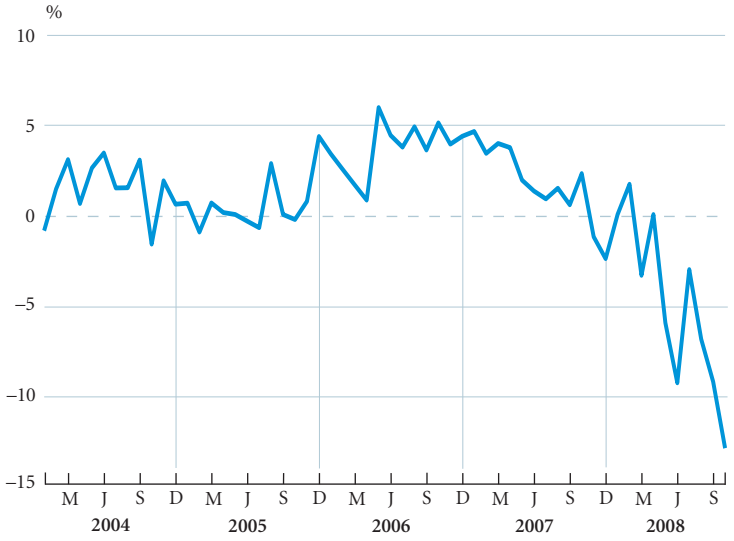
judge by the 5.1% drop the number of hotels stays compared with the same month the year before. The decrease was most pronounced among national residents than among foreign visitors.

In this situation, the International Monetary Fund again revised its growth forecasts for Spain's economy in 2009 prophesizing a drop in gross domestic product of at least 1%. This international body considers that, in spite of the drive coming from measures adopted by the government and the recent drop in commodity prices, the economy will undergo considerable contraction. To prevent this from being too long drawn out, it suggested a series of reforms in the labour market and in goods and services markets.

In turn, the government set out details of a new programme of measures to stimulate the economy which comes within the European Economic Recovery Plan. It approved 8 billion euros for the State Fund for Local Investment making it possible for municipalities to carry out urgent measures in their areas involving

SHARP DROP IN INDUSTRIAL PRODUCTION

Year-on-year change in industrial production index



NOTES: Statistical series adjusted for calendar differences.
SOURCE: National Institute of Statistics.

investment. Furthermore, 3 billion euros were applied to the carrying out of immediate projects, aimed at R&D, the motor vehicle industry, the environment, construction of public buildings and renovation of housing, small transportation infrastructures and measures related to social services.

Government settles on plan for measures to stimulate economy in coordination with European Union.

Spanish economy facing recession

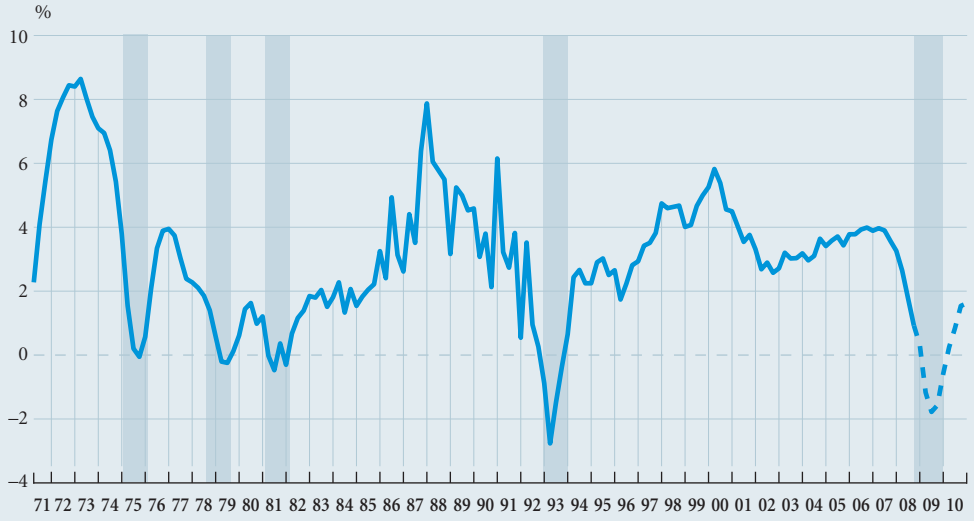
Spain's economy has moved into a recession the duration and severity of which is hard to know, although it is expected to be substantial, given the rapid worsening of indicators available at this time. This break in growth ends a prolonged expansionist cycle lasting more than 14 years during which the economy has grown on average by more than 3% annual in real terms, while at the same time undergoing notable changes in many areas.

Since the beginning of the Seventies (quarter-to-quarter figures for National Accounting are not available for previous years), Spain's economy has gone through four recessions. A common factor of all these recessions is that they were relatively brief (between 9-12 months) so that, compared with the other OECD economies, Spain's economy is one that has been least time in a state of recession in the past 40 years.[1]

(1) Claessens, Stijn, M. Ayhan Kose and Marco E. Terrones «What Happens During Recessions, Crunches and Busts?» IMF Working Paper 08/274.

RECESSIONS IN SPAIN'S ECONOMY: FEW AND BRIEF

Annual change in GDP



NOTES: The blocks correspond to recessions.
SOURCE: OECD and own estimates and forecasts.

Can previous recessions serve as lessons or guidance? Up to a certain point, given that no two recessions are alike because of the distinct circumstances that set them off, that intervene in the way they develop and that contribute to their resolution. The first three recessions, taking place between the mid-Seventies and the beginning of the Eighties, took place in a specific economic and political context (oil shocks, transition to parliamentary democracy in Spain) very different from that of the 1992-1993 crisis or the current recession.

The two recessions in the Seventies were relatively mild in terms of a drop in production and were followed by recoveries that were also short-lived. The recovery that came after the recession at the beginning of the Eighties (which opened up a 10-year growth period) suffered from an early start and continued with a period of high volatility in the behaviour of the macroeconomic aggregates.

The first recession, which ran from the beginning of 1975 to the Autumn of that year, followed a model of supply shock. The sudden rise in oil prices as of the end of 1973 caught by surprise economies with a high growth rate and whose level of investment was thus high. In many countries, the belief that the recession would be short set in motion policies for sustaining demand which, when the rise in the price of energy became permanent, made the adjustment much more difficult. It was from this time on that average OECD growth fell notably compared with that recorded in the Sixties, that unemployment rates shot up, inflationary expectations settled down and the public finances moved into the red.

In Spain, the first oil crisis took on greater dimension because of the specific nature of the production model and the specific political circumstances of the years of transition to democracy. The considerable rigidities of the economy, notably in the area of wages, and the insufficient measures of adjustment in the energy and

labour fields came together with a monetary policy that began very easy but progressively hardened, so that the further increase in oil prices in 1980 ended hopes of a continuing recovery.

In contrast to the crises during the Seventies and Eighties, the recession that hit in mid-1992 broke out for various reasons. Underlying this recession was oil shock as a result of the first Gulf War in 1990 which caused a halt to world economic growth that led many countries into recession. In the domestic scene, monetary policy of previous years was clearly aimed at halting inflationary pressures, part of which arose from the heavy inflow of capital attracted by Spain's joining the European Communities and growth of the public deficit. In parallel, the sharp appreciation of the peseta reduced Spain's competitive capacity in terms of abroad while growth of the real estate sector meant heavy borrowing by households.

COMPARISON OF VARIOUS RECESSIONS IN SPAIN'S ECONOMY

	1975-1 to 1975-3	1978-3 to 1979-2	1981-1 to 1981-4	1992-4 to 1993-3
Duration (1)	3	4	4	4
% GDP change/total (3)	–0.2	–0.3	–0.3	–0.4
% GDP change/worst quarter (2)	–2.0	–0.6	–2.2	–3.7
% change in private consumption/worst quarter (2)	–0.5	–0.3	–1.5	–4.0
% change FBCF/worst quarter (2)	–8.1	–6.7	–8.1	–21.5
Contribution of foreign sector to GDP growth as % (3)	0.3	–0.5	0.2	0.3
Increase in number of unemployed (3) (5)	–	170	284	625
Maximum unemployment rate (4)	–	9.1	13.6	19.3
% change in industrial production (3)	–	0.9	–1.7	–4.0
% change in car registrations (3)	8.9	–8.9	–16.9	–14.1

NOTES: (1) Number of quarters.
(2) Quarterly change annualized.
(3) From previous period to final period of recession.
(4) From previous period to maximum reached (even one year following recession).
(5) Thousands.
SOURCE: OECD, INE, Bank of Spain and own calculations.

As a prologue to the current recession we can find certain elements of previous crises. In 2008 we went through an episode of energy shock, given that the price of oil reached record levels in the summer both in absolute value and in real terms but later on, in just a few months, the price of oil plummeted. We were also at the end of a housing construction cycle which this time was very long-lasting and left households with historically high debt loads. At the same time, in the management of the recession we find a tightening of financial terms both because of the rise in short-term interest rates and the rise in the effective real exchange rate, a result of the revaluation of the euro and a domestic increase in prices and wages higher than Spain's competitors.

No doubt, the most distinctive aspect of the current crisis is the world financial crisis turning into a synchronized recession in the advanced economies which, for the first time since statistics have been gathered, has meant that the overall OECD area has undergone a drop in GDP. This is an exceptional

situation which indicates a complicated stage ahead although the response from economic policies has also been exceptional. In any case, we should bear in mind the circumstances of the crisis at the start of the Nineties where we can also note a dip in world growth and a major crisis in the European Monetary System as of the second half of 1992, something that created great instability.

Spain is especially sensitive to the closing of world financial markets given that it has a very high current account deficit that is financed through foreign savings. Another factor distinct from earlier recessions, so far as concerns Spain's economy, is the impossibility of recourse to currency devaluation in order to recover competitiveness abroad and give the economy a boost by this route. In the last recession, particularly, the three devaluations of the peseta between 1992 and 1993 undoubtedly helped to compensate the drop in domestic demand and managed to introduce new growth to a stagnant economy. Nevertheless, it is important to remember that the devaluations involving the peseta in its recent history were often quickly counteracted either by the simultaneous devaluation of other currencies or by a rise in domestic costs greater than that taking place among Spain's competitors.

In any case, it should be kept in mind that the need already existing before the recession to halt the loss of competitiveness with abroad has now become even clearer. If this is not done, there is the risk of coming out of the recession badly, which could result in potential growth rates well below those seen during the vast growth period experienced over the past 14 years.

Labour market

Marked drop in employment

The recessive situation in the economy shows up worst of all in the labour market. Figures for registration with Social Security in November show increased loss of jobs. On monthly average, the number of those registered stood at 18,721,387, a year-on-year drop of 3.5% as against a decrease of 2.3% in October.

On monthly average, some 197,087 jobs were lost in November and 671,772 in the past 12 months. Of these workers, 616,449 were Spanish nationals while 55,323 were foreign workers, which meant year-on-year decreases of 3.6% and 2.7% respectively. The worsening of the labour market generally affected all sectors. Nevertheless, in the 12 months registrations were down most in construction with a year-on-year decrease of 19.8%. In industry, contraction in employment was 5.6% while in services the rate was negative at –0.4% for the first time in this economic cycle. Nevertheless, health services and social services were up 7.5%, domestic servants rose by 5.8%, education was up 4.0% and the public service was up 1.6%.

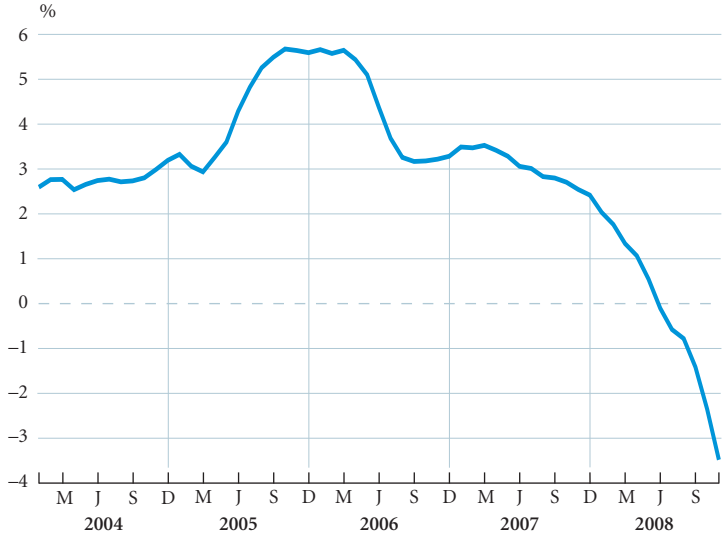
By sex, the contraction in employment was concentrated among males, who

Number of those registered with Social Security down 3.5% in November 2008 compared with 12 months earlier.

Registrations in services sector record drop for first time in this economic cycle.

LOSS OF JOBS ON INCREASE

Year-on-year change in monthly average number of workers registered with Social Security



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

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2006	2007	2007	2008				
			4Q	1Q	2Q	3Q	October	November
Persons registered with Social Security (1)								
Sector								
Industry	*–0.1*	*2.4*	*2.5*	*0.8*	*–1.1*	*–2.6*	*–4.4*	*–5.6*
Construction	*8.7*	*3.6*	*1.1*	*–2.2*	*–7.0*	*–12.4*	*–17.0*	*–19.8*
Services	*5.2*	*3.4*	*3.1*	*2.9*	*2.2*	*1.4*	*0.4*	*–0.4*
Job situation								
Wage-earners	*4.7*	*3.1*	*2.5*	*1.6*	*0.3*	*–1.1*	*–2.6*	*–3.8*
Non-wage-earners	*2.2*	*2.8*	*3.0*	*2.5*	*1.3*	*–0.1*	*–1.2*	*–1.9*
Total	**4.3**	**3.0**	**2.6**	**1.7**	**0.5**	**–0.9**	**–2.3**	**–3.5**
Persons employed (2)	**4.1**	**3.1**	**2.4**	**1.7**	**0.3**	**–0.8**	**–**	**–**
Jobs (3)	**3.2**	**2.9**	**2.2**	**1.4**	**0.4**	**–0.8**	**–**	**–**
Hiring contracts registered (4)								
Permanent	41.1	2.0	–21.1	–11.8	–5.6	–13.8	–22.7	–32.0
Temporary	4.7	0.3	1.2	–6.5	–7.4	–9.4	–16.3	–26.3
Total	**7.9**	**0.5**	**–2.1**	**–7.2**	**–7.2**	**–9.9**	**–17.1**	**–27.0**

NOTES: (1) Average monthly figures.
(2) Estimate by Labour Force Survey.
(3) Equivalent to full-time work. National Accounting estimate; figures adjusted for seasonal effects and number of working days.
(4) At INEM.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, Employment Institute and own calculations.

Drop in hiring.

hold the greatest weight in construction, with a year-on-year decrease of 5.9%. Nevertheless, for the first time in recent years the number of females registered showed a year-on-year drop in average level of 0.15%. Nevertheless, their participation in the total continued to rise going to 43.4%, a new record.

Naturally, the progressive drop in the number of persons registered has affected revenues from contributions to the Social Security system. In January-October there was a year-on-year change of 5.5% as against an increase of 7.0% in the same period of 2007. As a result, there has been a consolidation of the trend to lower growth of revenues than of spending, which means a reduction in the surplus of Social Security.

By type of workplace, employment shows rise only in large plants.

In addition, the cooling off in the labour market has also been noted in the level of hiring contracts.The number of hiring contracts registered in November amounted to 1,162,614 with a drop of 27.0% compared with the same month the year before. Those contracts to show the biggest drop were those for permanent jobs which were down 32.0% to the point where they represented 11.1% of the total, while temporary job contracts were down by 26.3%.

On the other hand, according to the quarterly survey carried out by the Ministry of Labour and Social Affairs which as opposed to the Labour Force Survey is aimed at companies instead of households and covers the non-farm area while excluding the public service,

showed a year-on-year drop of 3.9% in the July-September period. Workers with temporary contracts were down 11.8%. Those workers with permanent contracts showed a much smaller drop of 0.2%. The larger plants were the only ones to increase employment although only slightly at 0.2%. The biggest drop in employment took place in plants of medium size (51-250 workers), with a decrease of 7.3%.

Registered unemployed total close to three million

Job losses and the increase in the labour force have meant a sharp increase in unemployment. At the end of November the number of registered unemployed totalled 2,989,269 persons, an annual increase of 42.7%. The low of 1,835,740 noted in mid-2001 has been left far behind and in recent months registered unemployment has been increasing. In November alone, 171,243 persons were added to the unemployment rolls, more than triple that the year before.

The rise in registered unemployment affected all large sectors. What is notable is that the number of unemployed in the construction field was more than double over the past 12 months. Among those seeking their first job unemployment rose to 22.3%.

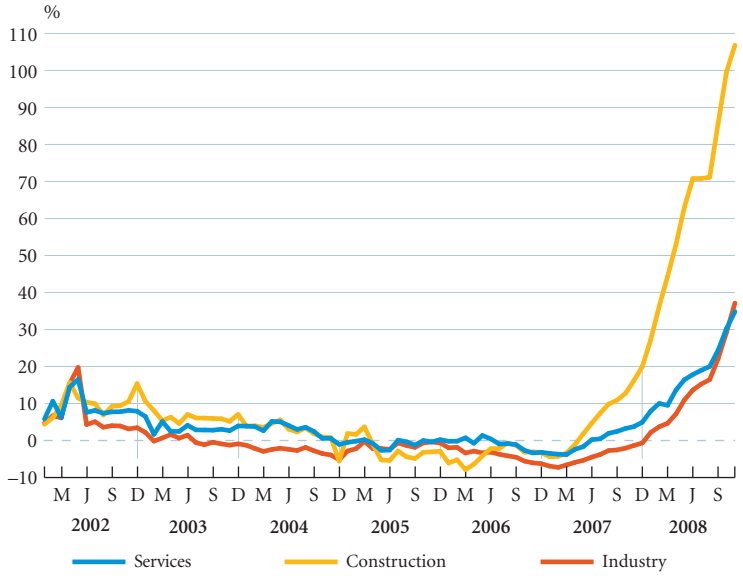
According to Eurostat figures, Spain's unemployment rate corrected for seasonal effects amounted to 12.8% of the labour force in October with an increase of 4.3 points in the past year. This rate stands well above the 7.1% average for the European Union and is the highest in the 27 member states.

Registered unemployment rises 43% in one year.

Unemployment benefits now cover more than 90% of unemployed.

RISE IN REGISTERED UNEMPLOYED ESPECIALLY IN CONSTRUCTION

Year-on-year change rate (*)



NOTES: (*) In May 2005 there was a break in the statistical series due to the coming into force of a new SISPE management model.
SOURCE: Ministry of Labour and Social Affairs and own calculations.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

November 2008

	No. of unemployed	Change over December 2007		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	100,422	31,610	45.9	31,212	45.1	3.4
Industry	372,147	92,166	32.9	100,609	37.1	12.4
Construction	520,029	236,162	83.2	268,464	106.7	17.4
Services	1,729,579	445,329	34.7	445,895	34.7	57.9
First job	267,092	54,455	25.6	48,616	22.3	8.9
By sex						
Males	1,447,780	562,641	63.6	613,733	73.6	48.4
Females	1,541,489	297,081	23.9	281,063	22.3	51.6
By age						
Under 25 years	385,192	144,809	60.2	141,498	58.1	12.9
All other ages	2,604,077	714,913	37.8	753,298	40.7	87.1
TOTAL	**2,989,269**	**859,722**	**40.4**	**894,796**	**42.7**	**100.0**

SOURCE: INEM and own calculations.

Total wages up 5.3% in third quarter.

Nevertheless, coverage of unemployment benefits, that is, the percentage of those receiving benefits out of the total has been progressively increasing in recent years to stand at 90.2% in August whereas in 2002 it did not go above 60.0%.

Labour costs grow more than inflation

In spite of the reduction in employment and the sharp rise in unemployment, labour costs continued to rise in the third quarter. According to the Quarterly Survey of Labour Costs prepared by the National Institute of Statistics, labour costs of companies rose by 5.1% in the third quarter compared with the same period the year before, going to 2,313.9 euros per worker per month, thus reflecting the increase in inflation in the recent period reaching its maximum in July. Nevertheless, the annual increase in labour costs in the third quarter was slightly lower than that noted in the second quarter (5.3%) when it reached its biggest increase since the first quarter of 2003.

Purchasing power of workers up 0.3% annual, slightly less than in previous quarter.

The main component of labour costs, wage costs, rose by 5.3% in the past 12 months, 2 decimals more than in the second quarter, reaching 1,692.6 euros per worker per month. Wage increases show up in all sectors with regard to ordinary wage costs made up of base wages, add-ons and over-time pay which rose by 5.4% compared with the third quarter of 2007 in the economy as a whole. Non-wage costs were up by 4.9%. Its main component, obligatory payments to Social Security, rose by 3.9% annual.

Labour cost per effective hour worked rose by 6.3% compared with the same quarter the year before, going to 18.46 euros. This big increase was due to the fact that effective hours worked were down 1.2%, given that in the third

quarter of 2008 there were more feast-days and holidays than in the same period the year before.

Average earning per worker per month, which rose by 5.3% at year-on-year rate, was higher than inflation recorded during the period. As a result, purchasing power of workers rose by 0.3% in annual and real terms, slightly below the previous quarter.

WAGE INDICATORS

Percentage change over same period year before

	2006	2007	2007		2008		
			3Q	4Q	1Q	2Q	3Q
Increase under general wage agreements (*)	**3.3**	**3.1**	**2.9**	**3.1**	**3.4**	**3.5**	**3.5**
Wage per job equivalent to full-time work (**)	**3.9**	**3.7**	**3.8**	**4.1**	**5.1**	**5.4**	**5.3**
Quarterly labour cost survey							
Wage costs							
Total	3.4	3.9	3.8	3.7	5.3	5.1	5.3
Industry	*3.6*	*3.0*	*2.3*	*2.8*	*5.8*	*5.1*	*4.8*
Construction	*3.7*	*4.8*	*4.8*	*5.1*	*4.8*	*6.5*	*5.8*
Services	*3.7*	*4.2*	*4.2*	*3.8*	*5.1*	*4.8*	*5.3*
Average wages per hour worked	4.2	4.4	4.6	4.1	9.0	1.9	6.5
Other labour costs	3.6	4.4	5.2	5.3	4.5	5.7	4.9
Work day (***)	–0.6	–0.4	–0.9	–0.3	–3.5	3.1	–1.2
Farm wages	**2.8**	**3.1**	**3.3**	**3.5**	**4.6**	**5.2**	**6.1**
Labour cost in construction	**4.4**	**2.4**	**2.3**	**2.3**	**0.8**	**6.4**	**7.6**

NOTES: (*) Does not include wage revision clauses. Cumulative figures.
(**) Quarterly National Accounts: figures adjusted for seasonal and calendar differences.
(***) Effective hours worked per worker per month.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fishing and Food, Ministry of Public Works and own calculations.

Prices

Sharp drop in inflation

Year-on-year CPI change rate down 1.2 points in November, biggest drop since January 1987 putting figure at 2.4%...

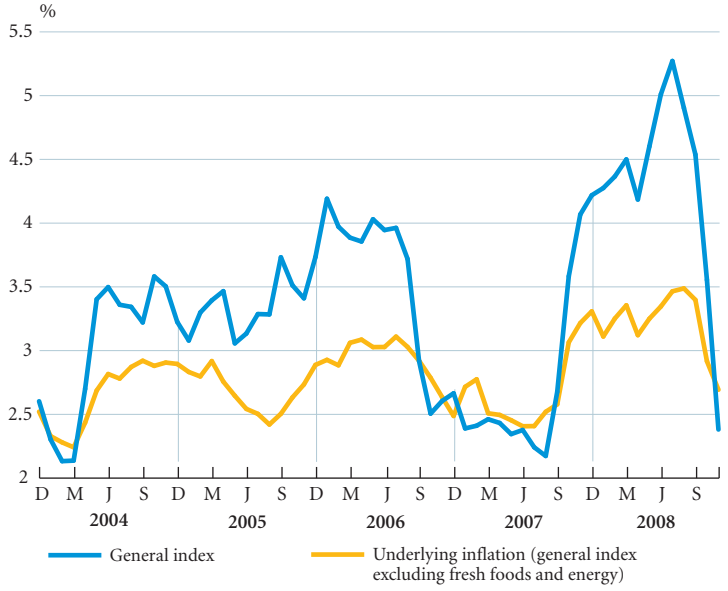
The increasing drop in inflation in the consumer price index (CPI) begun back in August continued in November. As a result, the year-on-year CPI rate was down 1.2 points to 2.4%, less than half the high of 5.3% recorded in July. The drop in the year-on-year change rate in November was the biggest since January 1987. This downturn was largely due to the collapse in the price of oil and other commodities in recent months reflecting the world economic slowdown. The more stable core of inflation, so-called underlying inflation that excludes the more volatile factors such as energy products and unprocessed foods, went down by 2 decimals to 2.7%. As a result, general inflation was below underlying inflation, something that has not happened since August 2007.

...due to downward drag from fuels and fuel-oils...

Out of the 1.2 points decrease in the year-on-year CPI rate in November, one whole point was due to the sharp drop in prices of fuels and fuel-oils, compared with a rise in November 2007. As a result, prices of these products dropped by 4.0% compared with the same month last year. Unprocessed foods also contributed slightly to the moderation in inflation with a drop of a half-point in the year-on-year rate putting it at 2.5%. Of note was the drop in fresh vegetables and produce to a year-on-year change rate of only 0.1%.

GENERAL INFLATION AGAIN STANDS BELOW 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	–0.4	2.0	2.4
December	0.4	4.2	4.2			

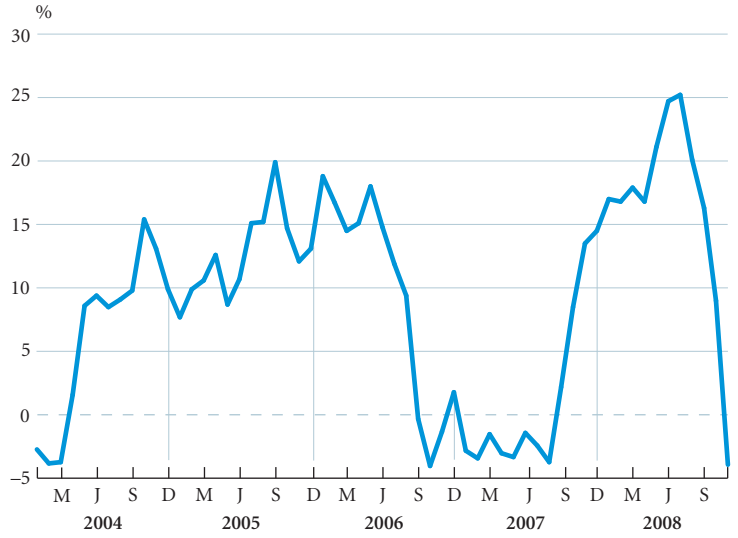
SOURCE: National Institute of Statistics.

With regard to underlying inflation, the 2-decimal drop in November may largely be attributed to processed foods, such as milk and other milk products, cheese, bread and cooking oil. In this way, food prices keep reflecting the drop in commodity prices in world markets with the normalization of supply. The price of milk was down by 4.8% year-on-year while bread slowed its increase to 2.9%.

...and processed foods.

FUELS AND FUEL-OILS PUSH DOWN CPI

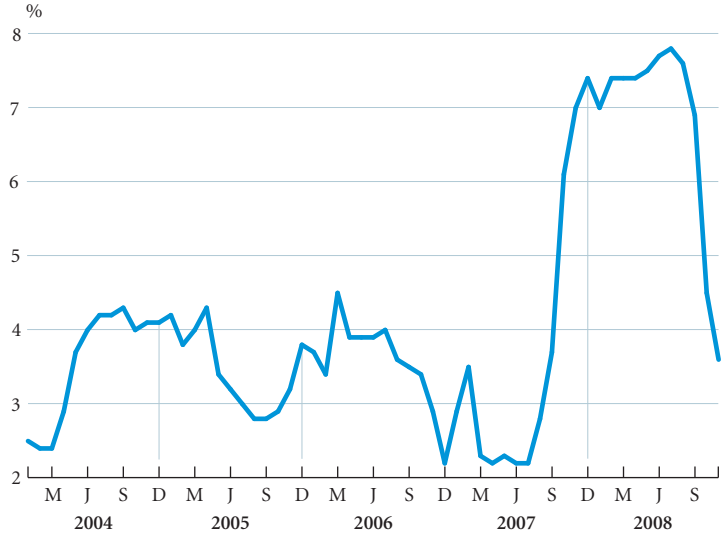
Year-on-year change in prices of fuels and fuel-oils



SOURCE: National Institute of Statistics.

PROCESSED FOOD PRICES ALSO MOVE DOWN

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



SOURCE: National Institute of Statistics.

Inflation differential with Euro Area contracts to 0.3 points, lowest level since 2001.

With regard to non-energy industrial goods, the annual change rate rose slightly to 0.6%. Especially contributing to this rise were clothing and footwear which showed an increase in annual change rate of one decimal to 0.8%, thus reflecting the depreciation of the euro in recent months.

Prices of services slowed slightly in November with the year-on-year change rate standing at 4.0%, thanks to the moderation in hotels and other lodging. In any case, this rate is relatively high and indicates its being partly sheltered from international competition.

CPI rate likely to drop more in coming months.

The price index harmonized with the European Union also recorded a year-on-year rise of 2.4% in November. As a result, the inflation differential with the Euro Area dropped by one decimal to 0.3 points, its lowest level since 2001. The narrowing of the differential was largely due to the drop in fuel prices which hold a higher count in Spain's CPI.

The trend to containment of inflation is sure to continue in December. As a result, it is likely that the annual change in CPI in December will stand well below 2% with the downward trend possibly continuing to mid-2009 when it could temporarily show negative annual change rates due to the base oil effect, that is to say, because of the all-time highs in crude oil prices marked up in the summer of 2007.

CONSUMER PRICE INDEX BY COMPONENT GROUP

November

	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	0.9	0.0	5.7	2.2	6.3	3.1
Alcoholic beverages and tobacco	111.7	0.1	0.1	6.0	3.9	6.6	4.0
Clothing and footwear	110.2	3.2	3.4	2.2	1.8	1.2	0.8
Housing	112.2	0.5	–0.2	4.6	6.4	4.7	6.6
Furnishings and household equipment	106.4	0.3	0.4	2.2	2.5	2.4	2.8
Health	98.9	0.1	0.1	–2.2	0.4	–2.1	0.5
Transport	102.9	1.4	–4.1	6.2	–2.3	6.6	–1.5
Communications	100.1	–0.1	–0.1	0.9	0.2	0.7	0.0
Recreation and culture	98.3	–0.8	–0.9	–2.2	–1.1	–0.7	0.3
Education	111.4	0.2	–0.4	4.0	3.9	4.1	4.0
Restaurants and hotels	110.5	–0.1	–0.3	4.5	4.0	4.8	4.5
Other goods and services	107.5	0.1	0.0	2.8	3.4	3.0	3.6
By group							
Processed food, beverages and tobacco	111.2	0.9	0.0	6.9	3.1	7.0	3.6
Unprocessed food	109.5	0.6	0.1	3.4	1.0	4.9	2.5
Non-food products	106.4	0.7	–0.6	3.1	1.8	3.3	2.1
Industrial goods	104.3	1.4	–0.9	3.0	0.3	2.9	0.4
Energy products	*105.8*	*2.7*	*–6.6*	*10.3*	*–1.6*	*10.7*	*–0.5*
Fuels and oils	*103.0*	*3.5*	*–8.8*	*12.8*	*–5.4*	*13.4*	*–4.0*
Industrial goods excluding energy products	*103.6*	*1.0*	*1.0*	*0.6*	*0.9*	*0.3*	*0.6*
Services	108.7	–0.1	–0.2	3.3	3.4	3.8	4.0
Underlying inflation (**)	107.4	0.5	0.3	3.1	2.5	3.2	2.7
GENERAL INDEX	**107.5**	**0.7**	**–0.4**	**3.8**	**2.0**	**4.1**	**2.4**

NOTES: (*) Base 2006 = 100.

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

SOURCE: National Institute of Statistics.

Foreign sector

Balance of payments: current account deficit still growing but less

Current account deficit tending to more contained growth thanks to relative improvement in trade balance and incomes balance and reduction of transfers deficit.

In September, the current account deficit reached 8.49 billion euros, practically the same figure recorded one year ago (8.47 billion euros). The lack of any improvement in the current account imbalance was due to the fact that the reduction in the deficits in the trade balance and the transfers balance were compensated by the worsening of the incomes balance and the services balance.

This monthly result, however, obscures the background tendency of an improvement in the balance of payments. If we turn our attention to the cumulative figures for 12 months, a figure that is closer to those followed over the mid-term, we note that the current account deficit amounted to 110.33 billion euros in September,

BALANCE OF PAYMENTS

September 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	–67,416	5.2	–93,147	–6,765	7.8
Services					
Tourism	*22,541*	*1.3*	*28,109*	*465*	*1.7*
Other services	*–3,279*	*–18.3*	*–4,923*	*–57*	*1.2*
Total	19,262	5.7	23,186	408	1.8
Income	–25,336	5.9	–32,917	–3,754	12.9
Transfers	–7,960	10.0	–7,455	216	–2.8
Total	**–81,449**	**5.8**	**–110,333**	**–9,894**	**9.9**
Capital account	**4,797**	**115.4**	**7,086**	**1,926**	**37.3**
Financial balance					
Direct investment	4,730	–	–3,980	45,728	–92.0
Portfolio investment	13,846	–88.1	982	–151,114	–99.4
Other investment	32,761	–	66,062	64,341	–
Total	**51,337**	**–28.3**	**63,064**	**–41,046**	**–39.4**
Errors and omissions	3,130	–	6,891	5,536	408.6
Change in assets of Bank of Spain	22,184	–	33,292	43,478	–

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.

CURRENT ACCOUNT DEFICIT RAPIDLY BEING CORRECTED

Year-on-year growth of current account deficit in cumulative figure for 12 months

SOURCE: Bank of Spain.

a figure only 9.9% higher than that one year earlier. This growth rate is a long way from those above 23.6% recorded in September 2007. What has taken place in these 12 months?

Most changes have been largely due to the fact that the trade balance and the incomes balance have increased their imbalances at a rate substantially less while the deficit in the transfers balance has even decreased. The surplus in services, on the other hand, has grown merely marginally and its importance in correcting the current account deficit has been minimal.

With regard to financial flows, the most notable factor is that net portfolio investment, after being positive during the 12 months ending in August, held in the area of positive balance in September. Direct investment has also held in a similar direction with a reduction of its negative position to 3.98 billion euros, clearly in contrast to the negative figure of 9.77 billion euros in August.

Inflows of portfolio investment remain positive yet another month.

Savings and financing

Growing drop in credit to households

Sharp drop in 12-month Euribor.

In November, the 12-month Euribor, an interest rate widely used as a reference in loan transactions, continued the downturn begun in mid-October because of expectations of official rate cuts by the European Central Bank. As a result, it stood at 4.35% on monthly average in November, 104 basis points below the all-time high in July. The early weeks of December saw a continuation of the downward trend in the 1-year Euribor which went to 3.26% at the end of the third week in December. In any case, it was 75 basis points above the reference rate of the European monetary authority, which meant a relatively high risk premium, something indicative of the persistence of pressures in the interbank market.

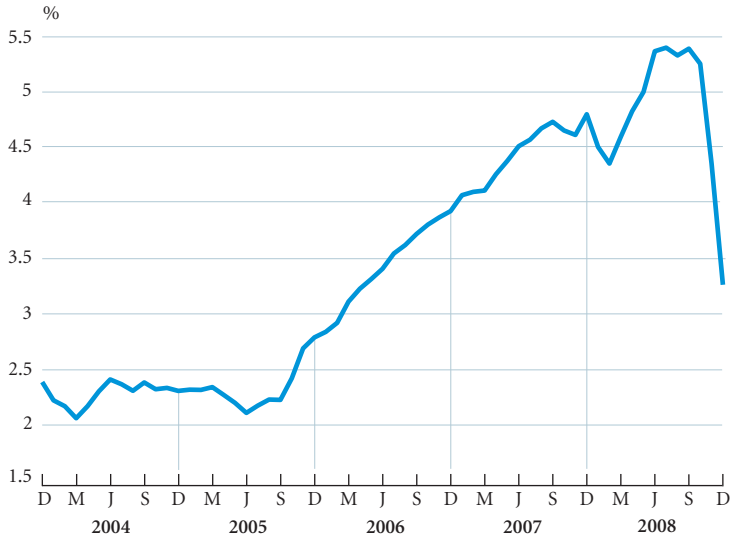
Weakness in private sector demand for credit while borrowing terms tighten.

In this environment, the average interest rate for loans at credit institutions in October held at the same level as in September following a period of increases which began toward the end of 2005. The interest rate on home mortgages held at 6.21% while consumer credit and loans for other purposes dropped very slightly to 9.35%.

Apart from the rise in interest rates in the third quarter, there was a general tightening of terms on loans and credits to the private sector, according to the survey of bank loans carried out by the Bank of Spain. At the same time, this

SHARP DROP IN 1-YEAR EURIBOR

12-month Euribor



NOTES: December 19.
SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

October 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	75,007	–15,835	–17.4	–11,220	–13.0	4.0
Secured loans (*)	1,106,938	38,566	3.6	57,905	5.5	59.5
Other term loans	531,308	33,425	6.7	38,136	7.7	28.6
Demand loans	46,598	6,026	14.9	10,241	28.2	2.5
Leasing	46,642	349	0.8	1,336	2.9	2.5
Doubtful loans	54,177	37,926	233.4	38,777	251.8	2.9
TOTAL	**1,860,669**	**100,456**	**5.7**	**135,175**	**7.8**	**100.0**

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

survey discovered a weakness in demand by companies and households. These trends are expected to continue showing up in the fourth quarter of 2008.

In October there was a continuation of the trend to a slowdown in funding granted to the private sector. The year-on-year change rate dropped to 7.6%, a half-point less than in September and 10.2 points below one year earlier. While the drop in funding affected both companies and households, the annual growth of credit to the former (8.9%)

Especially sharp halt to funding of real estate sector.

CREDIT TO PRIVATE SECTOR BY PURPOSE

Third quarter of 2008

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	26,593	1,348	5.3	1,508	6.0
Industry	155,481	13,910	9.8	15,149	10.8
Construction	156,363	2,910	1.9	6,022	4.0
Services	667,233	44,415	7.1	72,990	12.3
Total	**1,005,670**	**62,584**	**6.6**	**95,669**	**10.5**
Financing to individuals					
Acquisition and renovation of own home	646,761	28,549	4.6	42,138	7.0
Acquisition of consumer durables	55,859	–717	–1.3	1,824	3.4
Other financing	114,132	–330	–0.3	4,593	4.2
Total	**816,752**	**27,502**	**3.5**	**48,555**	**6.3**
Financing to private non-profit institutions	**6,063**	**–26**	**–0.4**	**–43**	**–0.7**
Other unclassified	**24,075**	**2,287**	**10.5**	**2,253**	**10.3**
TOTAL	**1,852,560**	**92,347**	**5.2**	**146,434**	**8.6**

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

Credit for buying consumer durables grows less than inflation in past 12 months.

was higher than that going to households (5.8%).

At more of breakdown although with figures going only to September, we note that the slowdown in funding affected all large production sectors except the primary sector in the third quarter. The slowdown was especially marked in the real estate sector. Funding granted to developers went from growth of 35.1% annual in September 2007 to 7.8% in the third quarter of 2008. Overall financing to construction and real estate activities rose by 6.5% in recent months ending in September 2008 as against a year-on-year change rate of 28.7% twelve months earlier, which illustrates the halt in credit to the real estate sector. In any case, in the third quarter funding rose by 0.6% compared with the second quarter.

Default ratio for mortgage-backed home-purchase loans stands at 1.3%.

With regard to households, not only did the slowdown in credit for buying or renovating a home continue but that going into acquisition of consumer durables also suffered a sharp contraction so that it came to show annual growth of 3.4% (below inflation) as against a rate of 7.1% at the end of the previous quarter. Other funding granted to households (for travel, studies, bonds and shares, lands, etc.) also eased to show an annual increase of 4.2%.

The recessive situation which, as mentioned earlier, is bringing about a slowdown in the growth rate of credit, fosters an increase in loans in default with the drop in business sales, increased unemployment and restraint on liquidity to some extent. In this way, the default ratio continued to rise in October to stand at 2.9% for lending institutions as a whole. The default ratio for home acquisition with mortgage rose to 1.8%. These levels may still be considered moderate. Furthermore, we should point out that Spain's financial institutions hold broad provision to meet any eventual case of default.

Deposit institutions raise return on term deposits.

Bank deposits also showing lower growth rate

In spite of the drop in the Euribor and maintenance of loan interest rates (as mentioned above), difficulties in obtaining finance in wholesale markets meant that return on bank deposits continued to rise in October due to sharper competition between financial institutions to attract customer deposits. Average interest rate on deposits at financial institutions thus rose to 3.35%, some 13 basis points more than in September and 67 more than in October 2007.

While returns on bank deposits rose, they continued to ease in October going to year-on-year growth of 8.6%, in any case, slightly above growth of loan rates. The drop in deposits showed up in all types to the point where balances of on-demand and savings accounts, deposits for more than two years, repos, and deposits in foreign currency stood below the level one year earlier. In any case, deposits of up to two years showed a year-on-year rise of 42.4% thanks to the rise in interest rates. The return on term accounts for individuals rose to 5.04% in October, the highest level in recent years, an increase of 73 basis points compared with 12 months earlier.

Sharp competition for bank deposits and the unfavourable state of financial markets continue to have a negative affect on participations in mutual funds. The assets of these funds stood at 170.22 billion euros at the end of November, a drop of 4.23 billion euros over the month before and 30.1% in the

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

October 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Overnight deposits (*)	407,012	–31,045	–7.1	–14,043	–3.3	29.2
Up to 2 years	477,481	124,775	35.4	142,127	42.4	34.2
More than 2-year term	391,742	–10,232	–2.5	–8,209	–2.1	28.1
Repos	74,330	–11,262	–13.2	–7,675	–9.4	5.3
Total	**1,350,565**	**72,236**	**5.7**	**112,201**	**9.1**	**96.9**
Deposits in currencies other than euro	**43,608**	**–236**	**–0.5**	**–1,942**	**–4.3**	**3.1**
TOTAL	**1,394,172**	**71,999**	**5.4**	**110,258**	**8.6**	**100.0**

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

past 12 months. The greater part of this monthly drop may be explained by net withdrawals of participations amounting to 3.78 billion euros, concentrated in guaranteed share-based funds, short-term bond-based funds, money market funds and global funds. On the other hand, long-term bond-based funds recorded net subscriptions of 156 million euros, showing a monthly return of 1.19% (not annualized) with the drop in implicit long-term returns and allowing for capital gains.

The adverse scenario to be faced by mutual funds in Spain also applies internationally. From December 2007 to September 2008 harmonized assets of mutual funds in Europe fell by nearly 1,000 billion euros (16%). In a similar way, assets of mutual funds in the United States were down 12% in the same period.

With regard to hedge funds, according to Inverco (the association of mutual fund organizations and pension funds), November saw the biggest drop in assets in the nearly two years since they came on the scene in the Spanish market (6%) putting the figure at 1.41 billion euros. In general, international hedge funds have gone through a very difficult period in recent months due to the contraction of liquidity. On the other hand, the assets of mutual funds showed a drop of 8.4% in November alone to show a total of 7.49 billion euros.

Adverse environment brings drop in assets of international mutual funds.

Finally, total premiums for direct insurance in the first nine months of the year was 44.04 billion euros, a year-on-year increase of 6.3%, according to figures supplied by ICEA, the insurance association. Life insurance premiums were up 10.9% while non-life premiums rose by 2.9%. Among the latter, health insurance premiums made a strong rise of 8.6% while multi-risk premiums were up 8.0%. On the other hand, car insurance premiums were down by 0.9% with the collapse in car sales.

Hedge funds also show major dip.

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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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