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THE SPANISH ECONOMY

Monthly Report

NUMBER 321

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In one year, surplus of 2.2% of GDP has slipped to deficit of 3.4%. How did this happen?

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	0.7	–1.2	3.0	2.6	1.7	0.3	–1.8
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	3.8	–0.7	4.0	4.1	4.4	5.3	1.6
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	3.9
Euro area	2.1	3.3	1.1	2.9	3.4	3.6	3.8	2.3
Germany	*2.3*	*2.6*	*1.3*	*3.1*	*2.9*	*2.9*	*3.1*	*1.6*
France	*1.5*	*2.8*	*1.7*	*2.3*	*2.9*	*3.3*	*3.3*	*1.8*
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	11.3	15.2	8.6	9.6	10.4	11.3	13.9
Consumer price index	2.8	4.1	1.2	4.0	4.4	4.6	4.9	2.5
Unit labour costs	2.9	2.9	1.0	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	–3.4	–5.8					
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	1.48	1.33	1.45	1.50	1.56	1.51	1.34

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Is Keynesianism coming back?

When the 1929 Depression took place, governments reacted by letting their economies spontaneously find their own balance according to the classical remedies then current. If a bank failed that was good because in this way the market put each one in its place. Nor did the gold standard facilitate the implementation of a national monetary policy. The fact is that the flood of bank failures, companies closing down and the boost in unemployment reached alarming levels while the mechanisms that were supposed to rebalance the situation failed to work. In view of the seriousness of the situation, governments decided to put all their weight on the economy in order to redirect the crisis toward a balance that the market was unable to bring about on its own.

This historical experience brought John M. Keynes to develop a new economic paradigm that broke with the classical tradition, a view that dominated Western economic thinking for decades. Furthermore, it served as justification for strong state intervention in the economy, both directly in certain sectors of economic activity and through extensive regulation in nearly all spheres, particularly in the financial sector. For many years, Keynesian policies were the basis for the big leap in prosperity enjoyed following the end of World War II.

This was so until the Eighties. Persistent inflation, low growth and high unemployment that came after the energy crises in the Seventies could not be solved using traditional Keynesian ideas that merely managed to boost government deficits and thus complicate things even more. With a new swing of the pendulum, the classical ideas of economic liberalism again began to sprout and a current of deregulation was started that at the same time advocated less government involvement in the economy and orthodoxy in the public accounts. As of the mid-Eighties, these new ideas in economic policy made high growth possible and brought inflation and unemployment down to low levels.

The global financial crisis set off as of mid-2007 that brought with it a serious economic recession could mean another swing of the pendulum in the way we understand the economy. The radical measures taken by the US authorities would indicate that the memory of the Great Depression is still current in American society. The rapid intervention of the US authorities in the financial system suggests that no one wants to see a repetition of the 1929 disaster that has been so extensively studied. The amount of funds committed to halting the crisis is enormous. The International Monetary Fund, a body little to be suspected of favouring a planned economy, ended up publishing a special report justifying and advocating that governments should not fail to act with all the resources available to them to compensate the collapse in aggregate demand. In Europe, governments at first considered that the crisis would not affect them and that it was a problem for the United States. Finally, however, the evidence became clear and the governments have decided to break taboos in their measures to sustain the financial system and to find the resources to halt the recession and prevent a depression.

Will these fiscal measures be successful? There certainly are huge risks. But the measures are to deal with an emergency situation, with a crisis that is different from all others and for which the only comparable precedent is the depression in the Thirties of last century. Once normal economic activity is recovered, there will be ample time to reform regulatory rules, the modulation and links between the state and the economy. Perhaps there will also arise a new economic paradigm.

EXECUTIVE SUMMARY

Lean times are here

World economy will scarcely grow in 2009.

The contraction of the world economy is now a fact of life. The International Monetary Fund (IMF) has again revised downward its forecasts and is estimating growth of the world economy in 2009 at 0.5%. In practice, this is equivalent to a global recession given that it is an advance even lower than that of world population. In November, just a few months ago the IMF was still expecting world growth of 2.2%

These downward revisions in growth forecasts have been the rule at all institutions involved in such activities. The extent of the contraction into which the developed economies have moved has not been fully tested and uncertainty remains high. It is clear that this is the biggest recession since the end of World War II and all the references trying to find a precedent lead to the Great Depression in the Thirties of last century.

Aftermath of world financial crisis still being felt.

What makes the current situation so serious is the extent of the financial crisis that was at its origin and this crisis has not yet been straightened out. Experience in all bank crises teaches us that recovery does not come «until all the losses in the financial system have been recognized and the banks have been put in order again», according to Dominique Strauss-Kahn, top executive of the IMF and French ex-Minister of Finance. The drop in the stock markets in January reflects the risk investors still perceive, especially in the financial sphere.

Figures for fourth quarter underline seriousness of drop in real economy.

The big meeting of the G-20 in November established measures that should be adopted in order to re-establish growth, namely, recapitalize those banks in difficulties, get rid of weak assets in the financial system and coordinate fiscal stimulus measures. So far, however, progress has been limited and uneven. Government support for the financial system is clear enough but the persistence of the poor situation leaves some questions still unanswered about how to deal with putting the system in order, with even the nationalization of financial institutions now being mooted. Most countries have announced plans for fiscal stimulus measures but the plans are somewhat discordant and we still do not know the full extent of measures to be adopted in the United States following the change in president.

Meanwhile, available indicators for the past month have accentuated the seriousness of the problems in economic conditions. The drop in industrial production is widespread and in many economies reaches very high levels. A large part of the responsibility for the collapse in industry lies in the decrease in international trade, a joint effect of the sudden worsening of economic prospects and the persistence of the tightening of financial markets. This evaluation would indicate very negative results for growth in the final quarter of 2008, a situation that likely will continue in the first quarter of 2009.

In the United States, the most visible aspect of the recession lies in the real estate sector and the labour market. Housing has still not hit bottom. Real estate prices are reducing the perception of «wealth effect» among many consumers. The Case-Shiller index for November showed a drop of 27%

compared with the high in June 2006. The correction in housing supply is also continuing and in December there were 625,000 housing starts in annual terms, less than one third of the 2006 figure, which makes a new all-time low for this indicator since it began in 1959. That same month, the increase in properties repossessed, auctioned off at low prices, failed to stabilize the drop in sales. All of this indicates that we shall have to wait some months yet before the housing sector stabilizes. In turn, the labour market in the United States remains on a downward course and is dragging down private consumption. Some 2,589,000 jobs were lost in 2008. The unemployment rate in December reached 7.2% of the labour force, the highest since 1991.

Housing and employment in United States showing effects of recession.

One positive factor in the present situation is the rapid improvement in inflation. The December CPI in the United States continued to be very much affected by the swings in oil prices and for the fifth consecutive time dropped in terms of the previous month. The year-on-year change was only 0.1% whereas just three months earlier it was close to 5%. The underlying index, the general index excluding foods and energy, fell for the second consecutive month because of the weakness of aggregate demand and the lower utilization of production capacity, with a year-on-year change of 1.8%. The fear now is whether in coming months the index will show drops in annual rate, which could be the prelude to deflation (a general sustained decrease in price levels), although we believe that the injection of liquidity by the Fed will avoid such a development.

Inflation drops and United States now fearful of deflation.

The Asian economies have also shown radical changes in trend. China's gross domestic product (GDP) grew by 6.8% year-on-year in the fourth quarter, well below the 9% seen in the third quarter and the very high figure of 13% in 2007. The most recent indicators show a tendency that is of concern to the Chinese authorities. In any case, those most hurt by the slowdown in China are the Asian economies as a whole which suffered from sharp contractions in GDP in the fourth quarter, as shown by early estimates for South Korea and Singapore.

In Europe, the picture remains troublesome. In its autumn forecasts report, the European Commission had already announced that the European Union was moving into a serious recession. In January, the Commission again revised its forecasts correcting them substantially downward. Specifically, for the European Union as a whole the EC executive is expecting negative GDP growth at –1.8% in 2009, which represents a reduction of 2 percentage points in growth in terms of its previous forecast. The Commission still maintains that recovery will become a fact next year although this will be weaker than initially forecast, raising GDP growth to 0.5%. Reductions for the Euro Area are similar. Starting out from a growth rate of 0.9% in 2008, the Commission is forecasting a drop of 1.9% in 2009 and a weak recovery going to 0.4% in 2010. These forecasts include the effect of recovery plans announced by the various countries. According to the European executive, these measures will have their maximum effect in 2009 making a contribution to growth of 0.8 percentage points. In 2010, this contribution will be lower (at 0.3 percentage points) but sufficient to bring about a positive growth rate.

In this depressing situation, the Bank of England continued its cuts in reference rate that began in October last year and on January 8 reduced the rate by a half percentage point to 1.5%, the lowest level since the bank was established in 1694. The European Central Bank also cut its reference rate at its meeting on January 15 dropping it from 2.50% to 2.00%, so that the ECB has reduced its official

European Commission makes substantial downward correction in growth forecasts in spite of plans to stimulate economies.

Forecasts also revised downward for Spain: European Commission expecting contraction of 2% in 2009.

interest rate by 2.25 percentage points in little more than three months.

In Spain, forecasts have also been revised downward. In spite of successive packages of fiscal measures to stimulate the economy, which in 2009 will mean an impact equal to around 2.5% of GDP, the government foresees a drop of 1.6%, as compared with the growth projection of 1.0% given in the macroeconomic scenario in the central government budget. The forecasts of the European Commission are more negative and for Spain's economy they predict a long and sharper recession with a drop of 2.0% in GDP in 2009 and 0.2% in 2010. Naturally, the lower economic growth foreseen by the Commission would result in greater loss of jobs and a bigger increase in unemployment. While for 2009 both forecasts put the unemployment rate at around 16%, the divergence is sharper in 2010 seeing that the European Union projection puts the unemployment rate at 18.7% of the labour force, some 3 points more than the government forecast.

Available indicators for fourth quarter suggest sharper decrease in consumption and investment along with drop in jobs and increased unemployment.

With regard to the impact of the recessive situation on the public accounts, these went from a surplus of 2.2% of GDP in 2007 to an estimated deficit of 3.4% in 2008, which would go to close to 6% of GDP in 2009. For the following year, the government foresees a correction of the public deficit to 4.8% of GDP whereas the European Commission puts it at nearly one point higher. In this context of worsening economic prospects, in the fourth week of January Standard & Poor's rating agency lowered the rating for Spanish long-term sovereign bonds by one level to AA+, thus taking away the maximum credit rating obtained in 2004.

Decreases in inflation and interest rates will contribute to arrest drop in household spending and help remodel foreign imbalance.

Available economic indicators suggest a sharpening of economic contraction took place in the fourth quarter of 2008 following a quarter-on-quarter decrease of 0.2% in the third quarter. Both consumption and investment sharpened their decreases in the final stages of the last quarter. On the supply side, as well as construction, industry has also suffered a sharp adjustment while services have not escaped the crisis.

In keeping with the situation of recession, figures for the Labour Force Survey for the fourth quarter confirm that 2008 was marked by the loss of jobs and the increase in the unemployment rate. For the year as a whole, the number of those employed dropped by 620,100, which meant a year-on-year decrease of 3.0%. Employment among immigrant workers was down for the first time. Loss of jobs was heaviest among workers with temporary hiring contracts and to a lesser extent among the self-employed. As a result, during the past year the number of unemployed rose by 1,280,300, or 66.4% year-on-year, affecting a total of 3,207,900 persons. The unemployment rate thus rose by 5.31 percentage points in 2008 reaching 13.9% of the labour force, the highest rate since 2000.

A positive note comes with the containment of inflation with a CPI that ended 2008 at 1.4% after having gone above 5% in mid-year. Thanks to the depressed situation of oil prices and prices of other commodities, the prospects on prices are for moderation which gives something of a breather to household spending capacity. The decrease in interest rates also is a favourable indicator in this respect. Both factors will make possible a substantial decrease in the outside financing needs of Spain's economy, a result of the heavy foreign deficit in recent years. These are factors that will contribute to ease the negative tendencies mentioned above, which should make a better state of the economy possible in the final stages of this year.

January 27, 2009

CHRONOLOGY

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%.
	16	**Federal Reserve** reduces reference rate to band between 0%-0.25%.
	24	Brent quality **oil** price drops to lowest level since July 2004 (37.23 dollars a barrel).

2009

January	**1**	Further extension of **Euro Area** with entry of Slovakia making total of 16 member states.
	15	**European Central Bank** lowers official interest rate to 2.00%.

AGENDA

February

- **3** Registrations with Social Security and registered unemployment (January).
- **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).
- **24** Foreign trade (December). Central government revenue and spending (December 08 and January 09).
- **25** Producer prices (January).
- **27** Balance of payments (December). EU harmonized CPI (January). Early HCPI (February).

March

- **3** Registrations with Social Security and registered unemployment (February).
- **5** Industrial production index (January). Governing Council of European Central Bank.
- **12** CPI (February).
- **13** Labour cost (4th Quarter).
- **16** EU harmonized CPI (February).
- **17** Fed Open Market Committee.
- **24** Central government revenue and spending (February).
- **25** Producer prices (February).
- **26** Foreign trade (January).
- **30** Early HCPI (March).
- **31** Balance of payments (January).

INTERNATIONAL REVIEW

United States: recovering private consumption proves difficult

United States in recession and expecting negative growth in 2009.

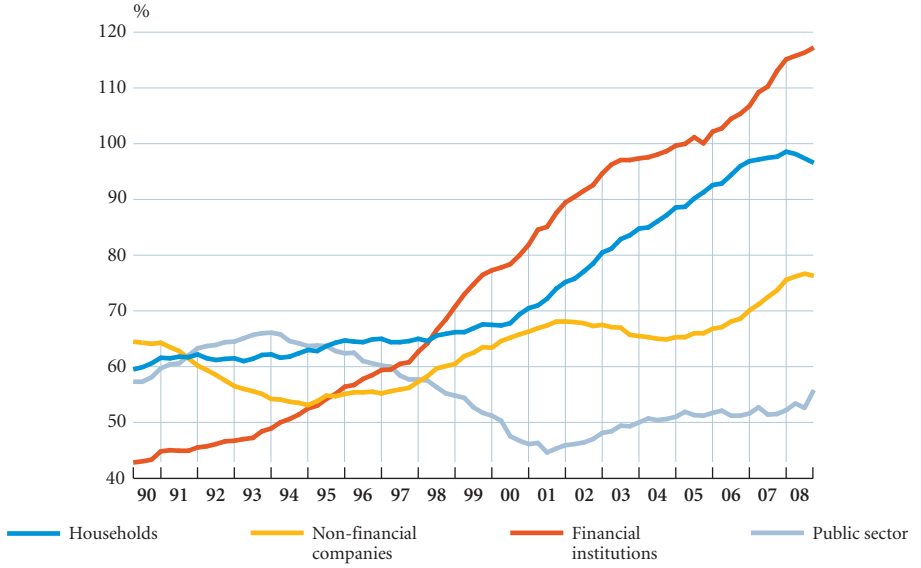
The recently sworn-in President Barack Obama has a difficult task ahead. The economy is in recession and the prospects for 2009 as a whole are for negative growth. Recovery will have to wait until 2010 and it will be slow. Since September 2008 the downturn in the economy has become a sharp collapse. The GDP for the third quarter was down 0.5% quarter-to-quarter annualized while private consumption was down sharper 3.8%. This will be the key variable in 2009 not only because of its 70.5% weight in the GDP but because the worse finances of households represent a weak starting point that will affect the effectiveness of the stimulus measures taken and growth in coming years.

Recovery of savings could make recovery in private consumption difficult.

Since the end of 2000 up until mid-2008 gross borrowing of households went from 70.5% to 97.3% of GDP, only exceeded by the 117.2% figure for the financial sector. The correction in housing prices reduced wealth but not contracted debt so that household borrowing became unsustainable. With the reduction in credit this situation began some correction in the third quarter thus starting a long process of deleveraging of households. The first consequence of this was the end of growth of gross household debt until this has been reduced. A substantial part of

UNITED STATES: HOUSEHOLDS MUST SAVE

Gross debt as percentage of nominal GDP



SOURCE: Federal Reserve and own calculations.

income going to households will be used to reduce contracted debt and not to restore consumption.

To be effective, the fiscal stimulus needed to counteract the worsening of economic activity will have to be exceptionally large. Obama has prepared a package of 825 billion dollars for 2009 and 2010, one third devoted to reducing taxes and two thirds to public investment. The Congressional Budget Office foresees a base deficit of 8.3% of the GDP for 2009 but including the package of the new US president this could go above 12%. If we consider the starting point, this gradual adjustment with increased savings by consumers and major public deficits could last for several years. The increase in savings by Americans will not be sufficient to finance this deficit in an economy already in debt that ended 2008 with a foreign deficit of close to 5% of the GDP. The weakness of the world economy, including the emerging economies, will make foreign financing more difficult. Finally, given the size of the fiscal deficit, over the medium term we could see an inflationary situation with high interest rates that could make private investment difficult and stand in the way of a strong recovery.

The attitude of consumers is a faithful reflection of these difficulties. Following a weak recovery in November, the Conference Board consumer confidence index in December again marked up a new all-time low for the 40 years this index has been in operation, going down from 44.9 points to 38.0, a drastic drop in the perception of the present situation with no improvement in future expectations. In this context, retail sales in December showed a sharp drop compared with November, which, if we exclude the volatile components of cars and petrol, meant a drop of 2.5% year-on-year. Discounting price increases, the drop was 4.2%. By sector, the decreases

Consumer confidence hits all-time lows.

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	December
Real GDP	2.8	2.0	2.3	2.5	2.1	0.7	–	...	–
Retail sales	5.8	4.2	5.4	3.0	2.6	0.6	–5.1	–8.2	–9.8
Consumer confidence (1)	105.9	103.4	91.2	76.5	57.3	57.3	38.8	44.7	38.0
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	32.4
Sales of single-family homes	–18.0	–26.8	–33.7	–33.1	–39.1	–36.4	–42.0	–35.3	...
Unemployment rate (2)	4.6	4.6	4.8	4.9	5.4	6.1	6.6	6.8	7.2
Consumer prices	3.2	2.9	4.0	4.1	4.4	5.3	3.7	1.1	0.1
Trade balance (3)	–753.3	–700.3	–700.3	–697.8	–699.1	–707.5	–707.9	–688.4	...
3-month interbank interest rate (1)	5.2	5.3	4.9	3.0	2.8	3.2	3.0	2.2	1.4
Nominal effective exchange rate (4)	82.5	77.9	73.3	72.0	70.9	73.5	80.4	83	81

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.

Corporate pessimism focussed on employment, new orders and prices.

were widespread although the biggest weaknesses showed up in durable goods, including cars and building materials.

The corporate view, according to the economic activity index of the Institute for Supply Management, continued to confirm this scenario of deep recession. In December, the manufacturing index dropped from 36.2 points to the 32.4 points level, a reading not seen since 1980 that was well below the balance of 50.0 points, considered the threshold that signals the risk of recession. In turn, the services indicator recovered from its all-time low and went from 33.0 points to a level of 39.6. In both cases, we note sharp decreases in the components of employment and especially in new orders and prices that, in manufactures, reached new all-time lows from the start-up of this index which goes back to 1948.

Construction still fails to hit bottom while housing prices show drop of 25%.

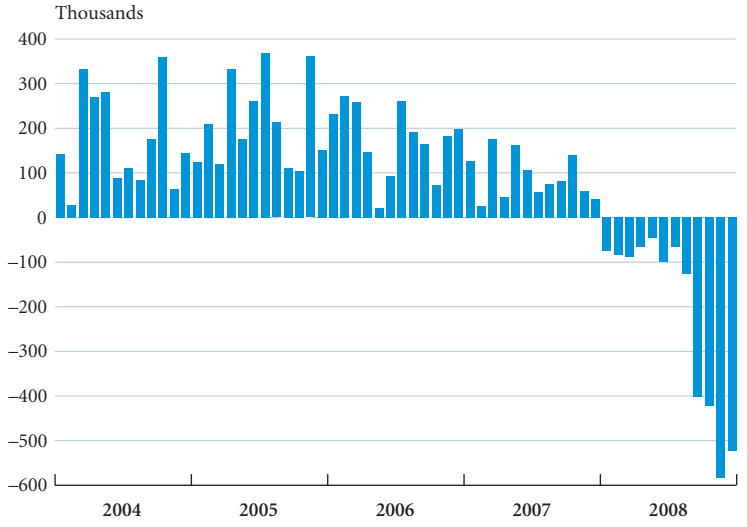
Housing has still not hit bottom. On the demand side, the price of real estate continues to reduce perceived wealth of many consumers. In October, the Case-Shiller index showed a cumulative drop of 25.0% compared with the high in June 2006. Taking into account the increases in CPI, real estate shows a cumulative loss of 30.5% from its maximum level. Correction of the housing supply is also continuing and in December there were 625,000 housing starts in annual terms, less than a third of that recorded in 2006, which constitutes a new all-time low in the indicator since it started up in 1959. That same month, the increase in repossessed homes auctioned off at low prices did not manage to stabilize the drop in sales. All of this indicates that we shall have to wait for several months before the housing sector stabilizes.

Labour market getting worse with 1.9 million jobs lost in four months.

The recent trend in the labour market has gone farther down and has taken private consumption with it. In 2008 some 2,589,000 jobs were lost and of these 1,934,000 came about in the last

UNITED STATES: TWO AND A HALF MILLION JOBS LOST

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



SOURCE: Department of Labour and own calculations.

four months of the year. The December unemployment rate reached 7.2 of the labour force, the highest since 1991. The recession in the motor vehicle industry must be understood in terms of jobs. The Senate granted 14 billion dollars in aid but it will need much more. The three big Detroit companies were asking for funds long before the recession and are still far from a business plan that will ensure their viability over the long term.

On the inflation front, the short-term dangers are disappearing. The general consumer price index (CPI) for December was still very much affected by the swings in oil prices and, for the fifth time in a row, dropped in terms of the month before. The year-on-year change was a slim 0.1% whereas only three months earlier it was close to 5%. The underlying index, the general index less foods and energy, was down for the second consecutive month because of the weakness of aggregate demand and lower utilization of production capacity, showing a year-on-year change of 1.8%.

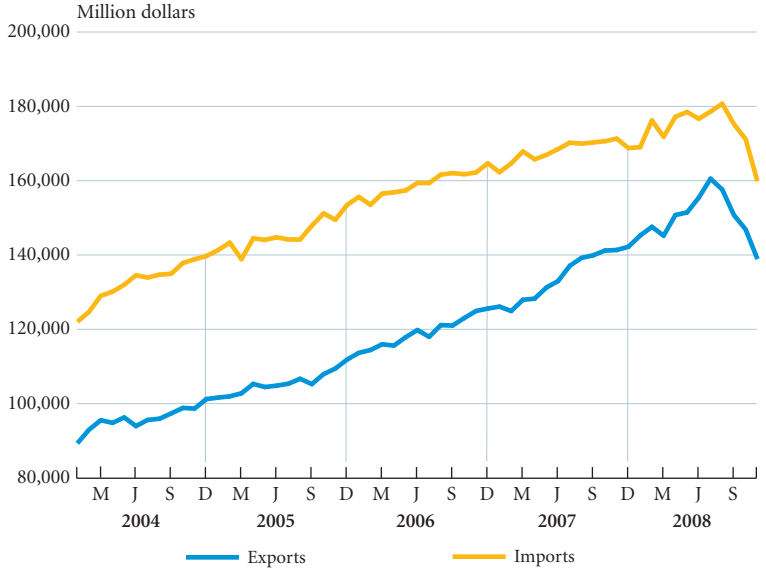
Inflation goes down to 0.1% because of swings in oil.

The foreign sector showed contradictory results in November. The major reduction in the trade deficit that went from 56.69 billion dollars in October to 40.44 billion dollars was not good news. First of all, four-fifths of the improvement was due to cheaper oil. The deficit excluding oil improved but at the cost of a major drop in trade flows. Non-oil imports were down 12.0% compared with the month before because of the weakness in domestic demand. The worst figure, however, was the 5.8% drop in exports brought about by a reduction in the volume of world trade. Weak world demand suggests that the rest of the world is far from compensating the slump in US private consumption. In this context of global weakness the aid the foreign sector can contribute will be limited, which puts a further difficulty in the way of recovery of the US economy.

Trade deficit being corrected at cost of less trade.

UNITED STATES: DROP IN TRADE FLOWS

Monthly figures for exports and imports excluding oil



SOURCE: Department of Trade and own calculations.

Fiscal stimulus hopes

Until very recently fiscal activism did not seem to have a very good image. Among economists there is a fairly wide consensus that the best instrument for overcoming a recession is monetary policy. Orthodoxy lays down that the best option regarding fiscal policy is to let the so-called automatic stabilizers operate. In other words, allow the fiscal balance to get worse as a consequence of lower revenues and higher spending arising from a recession but not go beyond this. This is a valid principle for normal recessions but, in view of the seriousness of the present crisis and the poor operation of the mechanisms through which monetary policy is transmitted, fiscal stimulus policies offer a possible, although imperfect, alternative to counteract the worsening of the economy and contribute to a recovery of confidence.

In general, there are three ways to carry out fiscal stimulus, namely, through more public spending, larger transfers or a reduction in taxes. Keynes was in favour of the first option as the most effective for expanding aggregate demand, arguing that for each euro of spending, GDP increased by more than one euro thanks to the multiplier effect. The GDP rises by one euro because of the direct purchases by the government, so long as these are for goods produced entirely within the country, and somewhat more because of the increase in the consumption of the households that produce those goods and that obtain additional income through their sale. The second option consists of transferring resources from the public sector to the private sector. The risk in this alternative is that those receiving the transfers may devote them to savings or to repaying debts, which would reduce the positive short-term impact on GDP (a risk to be taken into account in the present situation, characterized by high risk aversion in households and companies). This very risk also affects a reduction in taxes although, on the other hand, this alternative may stimulate economic activity if taxes that are especially distortionary are cut or if consumption is given direct incentives, for example, through a temporary substantial tax cut applied in the buying of motor vehicles.

In practice, there is considerable uncertainty about the size of the multiplier in the various policies (the increase in GDP through a stimulus that raises the fiscal deficit by 1% of GDP). The estimates most used put the public spending multiplier between 1 and 1.5 although some analysts have estimated values below 1. For tax cuts, most estimates for multipliers vary between 0.5 and 1 over a time-frame of 1-2 years but reach values of 2-3 over the medium term.[1] In the case of transfers, the short-term effect is similar to that for tax cuts. In any case, tax cuts and transfers may have a considerable effect on GDP over the short term (with a multiplier of more than 1) if beneficiary households or companies spend the greater part of these additional resources. In general, the size of the multipliers, as well as varying under each policy, also depends on the characteristics of the economy receiving the fiscal stimulus. For example, a fiscal stimulus in an economy with a high level of debt may be counterproductive if it puts the solvency of the country in doubt and, as a result, increases the country's risk premium and interest rates.

Historical experience offers us some clues to the factors that have reduced the effectiveness of fiscal stimulus policies. In the first place, public investment programmes, that in principle could have a bigger short-term impact, are slow to materialize and at times are non-productive (the so-called «road to nowhere» problem). On the other hand, tax cuts or an increase in transfers are usually more easily implemented. The fiscal

(1) Cristina Romer, director of the White House Economic Office in the Obama administration, estimates in «The Macroeconomic Effects of Tax Changes: Estimates based on a New Measure of Fiscal Shock», NBER Working Paper No. 13,264 a multiplier of 3 for the United States.

stimulus proposed by President Obama, for example, includes a considerable tax cut because, as his economic team points out, there is a limit to the amount of investment that can be efficiently carried out over a limited period of time. Secondly, in the past, fiscal programme measures have often not been the most suitable to stimulate economic activity but rather their logic seems to have rested more on the power the various pressure groups have exercised over their design. Finally, experience indicates that the correction of the fiscal deficit once the recession is past has tended to take longer than it should, thus increasing the public debt and raising doubts about fiscal sustainability. In this respect, the credibility of the government putting forward a stimulus programme is crucial so that a significant increase in the deficit does not undermine the confidence of consumers and companies.

In a special report published at the end of 2008, the IMF recommended that fiscal stimulus plans being developed ought to be implemented swiftly; be lasting because the recession could be long; diversified, combining spending, transfers and tax cuts; revisable upwards because the recovery of confidence requires a government commitment to do what may be necessary; international in order to join forces in the face of a global crisis; and sustainable in order to avoid a huge increase in government borrowing and an adverse reaction in financial markets. Is this possible? We shall begin to have some answers over coming months.

EFFECT ON GDP OF A FISCAL STIMULUS OF 1% OF GDP DEPENDING ON THE POLICY APPLIED

In percent

Quarter	Public spending	Tax cut
1	1.05	0
2	1.24	0.49
3	1.35	0.58
4	1.44	0.66
5	1.51	0.75
6	1.53	0.84
7	1.54	0.93
8	1.57	0.99

NOTE: The fiscal stimulus supposes that the fiscal deficit increases permanently by 1% of GDP; the figures in the table imply, for example, that eight quarters after the increase in public spending GDP will be 1.57% higher than in a situation without fiscal stimulus.
SOURCE: C. Romer and J. Bernstein. «The Job Impact of the American Recovery and Reinvestment Plan», available on www.change.gov

Japan suffering because of exports

The economy dropped by 1.8% in the third quarter in quarter-to-quarter terms annualized, which confirms that Japan is in recession. The Asian decoupling hypothesis, namely, the capacity of that region to grow despite the weakness of demand from the United States (its main customer) has not worked because of the region's dependence on exports and also because the ills that have affected its US trade partner, such as the scarcity of credit, is of a world nature. With domestic demand limited by a decreasing population and because of cultural factors, Japan's major engine of growth

Japan shows drop because of foreign sector.

Industrial production down 14% reflecting crisis in durable goods.

was exports and capital goods investment by exporting companies. These components, which together make up one third of GDP, lie behind practically the whole of Japan's recession.

Industrial production in November, which was down 13.7% year-on-year, faithfully reflects the drop in exports. The drop in US consumption is sharpest in durable goods which is what Japan exports. If US car consumption n December was down 22.4% year-on-year, the drop in imports of Japanese cars in the same period was close to 40%. As a result, companies are adjusting their production and expectations, as indicated by the Tankan business activity index published by the Bank of Japan for the fourth quarter. For large companies, this stood at the –24 points level, which has not been seen since 2002.

Investment showing worse prospects while real estate market in slump.

Inflation running toward zero and exports down 24%.

On the demand side, the picture is no better. Consumer confidence is at all-time lows, retail sales in November were down 0.9% year-on-year and car sales dropped by 22.8% year-on-year in December. Under investment, prospects for coming months showed a sharper downward trend with machine orders in November dropping by 35.4% year-on-year and the biggest decreases showing up in the export sector. In the housing field, the Tokyo region showed a continuation of the sharp drop in sales along with maintenance of prices while housing starts marked up a fourth month of decreases.

On the inflation front, the November CPI rose by 1.0% year-on-year as against 1.7% the month before, although the underlying index (the general index excluding energy and food) showed a nil increase, thus flirting with a return to the deflationary period that took so long to

JAPAN: MAIN ECONOMIC INDICATORS

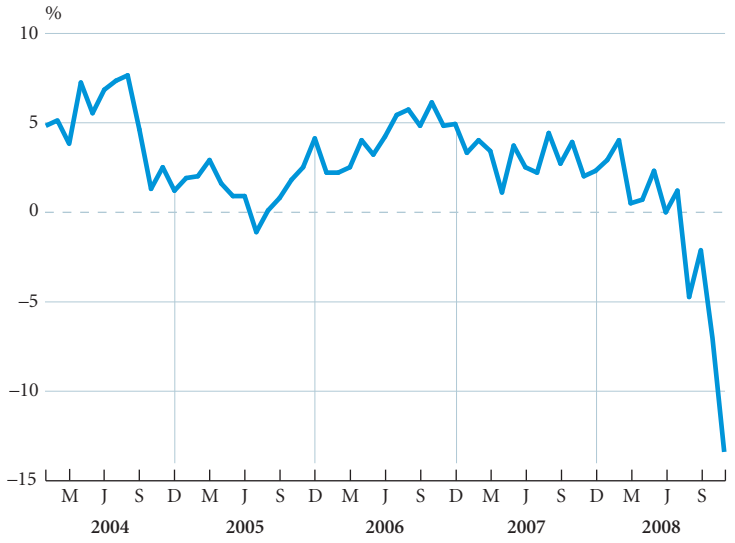
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
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	–13.7	...
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	–0.2	...
Unemployment rate (2)	4.1	3.9	3.8	3.8	4.0	4.0	3.7	3.9	...
Consumer prices	0.2	0.1	0.5	1.0	1.4	2.2	1.7	1.0	...
Trade balance (3)	9.4	12.5	12.5	11.7	10.2	7.3	6.2	4.8	...
3-month interbank interest rate (4)	0.3	0.7	0.9	0.8	0.8	0.9	0.9	0.9	0.7
Nominal effective exchange rate (5)	81.1	77.1	78.4	83.4	82.6	81.9	93.5	98.7	103.2

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 2,000 = 100.
SOURCE: OECD, national statistical bodies and own calculations.

JAPAN: INDUSTRIAL PRODUCTION DROPPING FAST

Month-on-month change in industrial production



SOURCE: Departament of Trade and own calculations.

end. Meanwhile, in the labour market the November unemployment rate was 3.9% of the labour force.

Lower world demand continued to seriously affect the foreign sector which showed a deficit in November for the fourth month in a row. Exports were down more sharply to 23.9% year-on-year while imports dropped by 7.6%. The biggest contribution to this drop came from the drop in sales to the rest of Asia (26.7%), including a decrease of 24.5% in sales to China.

Brazil: from fear of inflation to concern about economic recession

While figures for the fourth-quarter GDP are not available, the latest indicator and forecasts for 2009 show that Brazil will not escape from the world economic slowdown. The Brazilian economy grew by 6.9% year-on-year in the third quarter of 2008 although economic activity indicators indicate a sharp slowdown to 4.0% in the fourth quarter. Domestic demand recorded a marked drop in consumption although investment maintained a good level. Brazil continues to show the biggest trade surplus on the Latin American continent mainly due to the drop in imports. For the fourth quarter, it is estimated that exports will make a positive contribution to GDP growth with an increase in volume of 1.9% year-on-year.

Indicators show Brazil is not escaping from sharp world slowdown.

Among the latest indicators of economic activity, industrial production continued to worsen with a drop of 6.2% year-on-year in November. Industrial production of capital goods, while more volatile, held to the line of a sharp decline in business activity and showed a gain of 3.6% year-on-year in November as against 19.9% on average in the third quarter. This would indicate a break in the upward trend of investment in capital goods in the fourth quarter.

Brazilian industry continues to worsen.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	3.9	5.6	6.1	6.1	6.3	6.9	–	–	–
Industrial production	2.9	5.9	6.5	5.8	6.2	6.9	1.0	–3.5	–
Unemployment rate São Paulo (*)	14.1	14.2	14.2	13.6	14.1	12.8	12.1	11.8	–
Consumer prices	2.8	3.8	4.8	5.4	6.6	7.2	7.3	7.2	6.5
Trade balance (**)	45.8	41.5	41.5	36.4	31.9	29.5	26.5	26.1	24.7
Central bank SELIC rate (***)	13.25	11.25	11.25	11.25	11.75	13.00	13.75	13.75	13.75
Reales to dollar	2.2	1.8	1.8	1.7	1.7	1.6	1.8	2.2	2.3

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
(***) On January 21 the Bank of Brazil reduced SELIC rate to 12.75%.
SOURCE: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

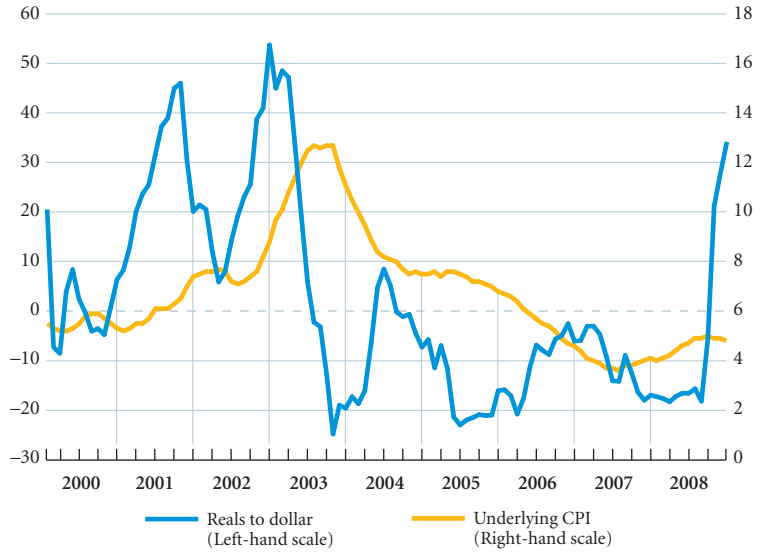
Retail sales accumulate a drop of 1.6% during the past two months.

On the demand side, retail sales in November (as in October) repeated growth of –0.8% month-on-month. Similarly, car sales in November sharpened their drop going down by 13.9% year-on-year.

The slowdown in economic activity will help reduce inflationary pressures which were of concern to the Bank of Brazil. The sharp cut of 100 basis points in the official interest rate in January putting it at 12.75% is a reflection of the new balance of risks where the priority is growth. With a substantial lower growth and, in spite of the fact that December inflation stood at 6.5% year-on-year, the

BRAZIL: DEPRECIATION OF REAL NOT BEING PASSED THROUGH TO PRICES

Percentage change over same period year before



SOURCE: Datastream and own calculations.

central bank has sufficient margin to continue to ease monetary policy, although it will have to watch out for possible pressures on the real. First, the level of inflation may largely be explained by the temporary increase shown in food prices. Secondly, underlying inflation, excluding food and energy prices, in the past three months has dropped to 4.8%. Thirdly, it is important to underline that the depreciation of close to 35% in the Brazilian currency in the final months of 2008, one of the main inflationary risks, has not been passed through to prices. Finally, due to the sharp correction in commodity prices, wholesale prices, also dropped to 9.8% year-on-year as against 12.9% in November.

Mexico: fiscal and monetary armour to deal with recession

The Mexican economy is being much affected by the sharp slowdown in exports, mainly to the United States, its main trading partner. This, together with the loss of confidence, is hurting domestic demand and it is forecast that, in the fourth quarter of 2008, GDP grew by 0.5% year-on-year. Looking at 2009, early business activity indicators point in the same direction and it is expected that in the second and third quarters Mexico will show slightly negative growth.

Mexico suffering impact of US economic recession.

In the third quarter of 2008, total investment still was growing at year-on-year rates of 8% which contributed to maintenance of 2% growth in domestic demand. While private investment was down by 1.1% year-on-year (as a result of the 11.8% collapse in construction investment), public investment and private investment in machinery and capital goods showed very notable strength with growth of 20.6% and 27.2% respectively. Indicators for industrial production suggest that total investment slowed down sharply in the fourth quarter towards zero growth rate.

Private consumption is also showing a downward trend and, after growing at 2.3% year-on-year in the third quarter, figures for retail sales point to growth rates of around 1.7% for the final quarter of 2008.

Domestic demand rate decelerates still more marked by private investment.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	4.9	3.2	4.2	3.2	2.1	1.6	–	–	–
Industrial production	5.8	1.6	2.2	6.0	–1.0	–1.6	–2.4	–3.5	–
General unemployment rate (*)	3.6	3.5	3.5	3.8	3.2	4.2	4.1	4.5	4.3
Consumer prices	3.6	4.0	3.9	3.7	4.9	5.6	5.8	6.2	6.5
Trade balance (**)	–6.2	–10.7	–10.7	–10.8	–8.7	–9.3	–13.3	–15.3	–16.8
Official Banxico rate (%)	7.00	7.50	7.50	7.50	7.50	8.25	8.25	8.25	8.25
Mexican pesos to dollar	10.9	10.9	10.9	10.8	10.4	10.1	10.6	12.7	13.1

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

Fiscal measures and eased monetary policy aimed at limiting the impact on real economy.

To counteract the slowdown the government announced a second fiscal package in January amounting to 1.0% of GDP. These new measures are in addition to those contemplated in the 2009 budget in which a deficit of 1.8% of GDP was foreseen, whereas in 2008 the budgetary balance was even. In the present context of lower economic activity and a sharp correction in the price of oil, it is foreseeable that the fiscal deficit in 2009 will be higher than that estimated by the government. In general, the fiscal measures are aimed at fostering employment, increasing the availability of credit to small and medium companies through development banks, strengthening investment in infrastructures and improving the purchasing power of households through cuts in energy prices.

Chinese growth slows to 6.8% in last quarter of 2008.

With respect to inflation, the government's decision to lower the price of gas and electricity and to freeze the price of petrol will cause substantial moderation in the component of regulated prices in the GDP. Because of this and helped by the collapse noted in commodity prices, inflation of 6.5% year-on-year in December is surely a ceiling down from which we will see a sustained decrease. Banxico, the monetary policy authority, has stated that it expects inflation to drop to 4.0% at the end of 2009 while at the end of 2010 it will move toward the stated objective of 3.0%.

China: slowdown has already begun

Industrial production not recovering and car sales down 8% in December.

The slowdown anticipated by last month's indicators has now arrived. China's GDP grew by 6.8% year-on-year in the fourth quarter of 2008, well below the 9% in the third quarter and the very high figure of 13% in 2007. In spite of leaving behind the days of two-digit growth, most estimates seem to agree that the 2009 growth will be around 7%.

The most recent indicators show a trend that is troubling the Chinese authorities. Industrial production in December grew by 5.7% year-on-year, a figure that, along with 5.4% in November, represents the lowest growth rates since the beginning of 2002. It should be remembered that only six months ago the year-on-year rate was 16%. Car sales also fell by 8.0% year-on-year in December, according to the Chinese Automobile Association. This means that car sales grew by 7.3% in 2008, the worst figure in the past decade.

In addition, the value of exports in December dropped by 2.8% in year-on-year terms. Nevertheless, the sharp drop in imports (21.3%), as result of the drop in oil prices and in domestic and foreign demand, contributed to increasing the surplus in the trade balance which for the year as a whole reached 295.63 billion dollars (approximately 6.7% of GDP). The weakness of the export sector is lowering prospects of an appreciation of the renminbi, hence, causing a flight of speculative capital and a decrease in the rate of accumulating reserves.

Nevertheless, not all the news from this Asian giant is bad. Recent figures on bank credit for December seem to show that the monetary stimulus measures have begun to have an effect. Credit grew by 18.8% year-on-year in December, well above the rates of around 14% shown in the greater part of 2008. We must now wait to see if the other measures introduced by the Chinese government, both fiscal and more structural, are able to boost domestic consumption, a key factor

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	11.6	13.0	11.3	10.6	10.1	9.0	–	6.8	–
Industrial production	16.4	17.5	17.5	16.6	15.9	13.0	8.2	5.4	5.7
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	278.7	295.1
Benchmark interest rate (**)	6.12	7.47	7.47	7.47	7.47	7.20	6.66	5.58	5.31
Renminbi to dollar	8.0	7.6	7.4	7.2	7.0	6.8	6.8	6.8	6.9

NOTES: (*) Cumulative balance for 12 months. Billion dollars.
(**) Percentage at end of period.
Some revisions for 2007 were introduced at the end of the year.
SOURCE: National Statistics Office of China, Thomson Reuters Datastream and own calculations.

in the growth of the country at times of global uncertainty.

Commodities settle into precarious stability

Oil continues to be very volatile in price. Between December 31 and January 27 crude oil started out from 39 dollars a barrel (Brent quality, one month delivery) and, after briefly going close to the 50 dollars line, stood at around 45 dollars. The cumulative rise for the current year is 12.9% although it is too early to see a change in the downward trend that dominated in the second half of 2008.

According to the International Energy Agency, the drop in oil price will continue all through 2009. Contributing to this are improved inventories and lower world demand which, after dropping by 300,000 barrels a day in 2008, will go down another 500,000 barrels sin 2009. Making a special contribution to this situation will be a decrease in Chinese consumption which is expected to grow by 89,000 barrels a day, the lowest increase since 2001.

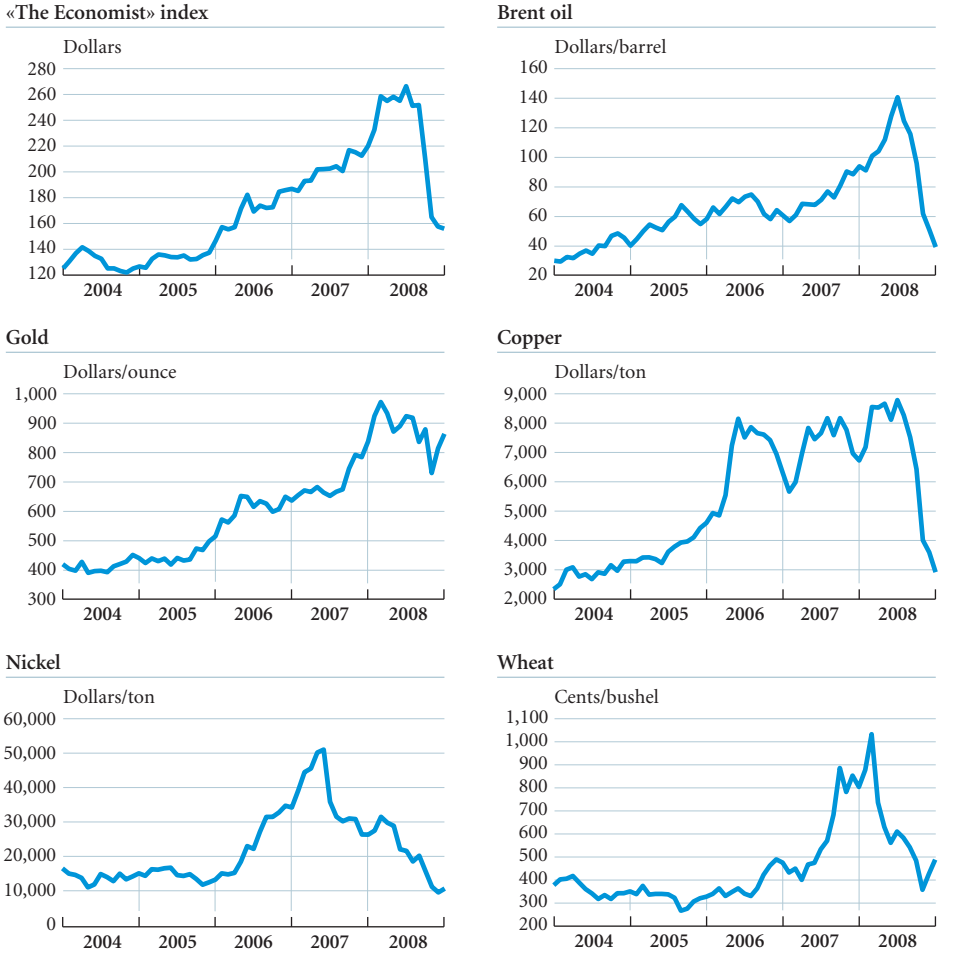
Other commodities as a whole have stabilized their price decreases. *The Economist* commodities index on January 20 was up 10.5% from the low on December 15. In turn, precious metals came to a point of resistance brought about by the drop in gold production in South Africa which in two years has slipped from first to third place in world production. Among those commodities for which prices will drop, copper is expecting lower demand in 2009. Aluminium continued to lose value going to its lowest price in the past five years. In 2009, it is expected there will be over-production of 900,000 tons in spite of a reduction in production.

Credit recovers following various decreases in interest rates.

Oil costing 15% more but drop in demand foreseen in 2009.

Commodities stabilize decreases with exception of aluminium.

TREND IN VARIOUS COMMODITIES



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

EUROPEAN UNION

European Commission forecasts: downward revisions

In its Autumn forecasts, the European Commission had announced that the European Union was entering the first recession in its history. The Commission brought its scenario up to date with substantial revisions to its previous forecasts. This revision states clearly that the financial crisis is passing through to the real economy.

Specifically, for the European Union as a whole the Commission is expecting negative growth of the gross domestic product (GDP) at –1.8% in 2009, which represents a reduction in growth of 2 percentage points compared with its previous forecast. The reduction for 2010 was lower at 0.6 percentage points. With this revision, the Commission is still maintaining that recovery will be a fact next year although it will be weaker than initially forecast with GDP growth at 0.5%. Inflation, which was already expected to show a notable decrease due to the drop in commodity prices, has also been substantially revised downward because of the lower level of economic activity expected. The change rate for the harmonized consumer price index will go down from the 3.7% recorded in 2008 to 1.2% in 2009 and will return to a more moderate rate of 1.9% in 2010 along with the recovery in economic activity.

Commission substantially revises its forecasts downward...

MACROECONOMIC PROJECTIONS FOR EURO AREA (1)

	2005	2006	2007	Current forecasts January 2009 (1)			Difference with Autumn 2008 (2)	
				2008	2009	2010	2009	2010
Gross domestic product	**1.7**	**2.9**	**2.7**	**0.9**	**–1.9**	**0.4**	**–2.0**	**–0.5**
Private consumption	1.8	2.0	1.6	0.5	–0.1	0.3	–0.5	–0.7
Public consumption	1.5	1.9	2.3	2.1	1.6	1.2	0.4	0.2
Investment	3.3	5.5	4.3	0.6	–5.5	–0.7	–2.9	–0.9
Employment	0.7	1.4	1.7	0.7	–1.6	–0.7	–1.2	–0.8
Unemployment rate (3)	9.0	8.3	7.5	7.5	9.3	10.2	0.9	1.5
Inflation (4)	2.2	2.2	2.1	3.3	1.0	1.8	–1.2	–0.3
Government balance (% of GDP)	–2.5	–1.3	–0.6	–1.7	–4.0	–4.4	–2.2	–2.4
Government debt (% of GDP)	70.0	68.3	66.1	68.7	72.7	75.8	5.5	8.2
Current account balance (% of GDP)	0.1	–0.1	0.1	–0.5	–0.7	–0.7	–0.6	–0.6
Growth of GDP in EU	*2.0*	*3.1*	*2.9*	*1.0*	*–1.8*	*0.5*	*–2.0*	*–0.6*

NOTES: (1) Commission revisions are based on figures available up to January 12, 2009.
(2) Plus sign (+) or minus sign (–) indicates a higher (or lower) positive figure or lower (or higher) negative figure compared with Autumn 2008.
(3) Percentage of labour force.
(4) Harmonized consumer price index, nominal change.
SOURCE: European Commission.

MACROECONOMIC FORECASTS FOR EURO AREA COUNTRIES

January 2009

	GDP (*)			Inflation (**)			Unemployment (***)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Belgium	1.3	–1.9	0.3	4.5	1.1	2.0	6.9	8.0	9.2
Germany	1.3	–2.3	0.7	2.8	0.8	1.4	7.1	7.7	8.1
Ireland	–2.0	–5.0	0.0	3.1	0.7	1.8	6.5	9.7	10.7
Greece	2.9	0.2	0.7	4.2	2.5	2.7	8.3	9.0	9.4
Spain	1.2	–2.0	–0.2	4.1	0.6	2.4	11.3	16.1	18.7
France	0.7	–1.8	0.4	3.2	0.8	1.5	7.8	9.8	10.6
Italy	–0.6	–2.0	0.3	3.5	1.2	2.2	6.7	8.2	8.7
Cyprus	3.6	1.1	2.0	4.4	2.0	2.3	3.9	5.1	5.5
Luxembourg	1.0	–0.9	1.4	4.1	0.6	2.5	4.1	4.9	5.8
Malta	2.1	0.7	1.3	4.6	1.9	2.2	6.5	7.4	7.9
Netherlands	1.9	–2.0	0.2	2.2	1.9	1.8	2.9	4.1	5.5
Austria	1.7	–1.2	0.6	3.3	1.2	1.6	4.1	5.1	6.1
Portugal	0.2	–1.6	–0.2	2.7	1.0	2.0	7.8	8.8	9.1
Slovenia	4.0	0.6	2.3	5.5	0.9	2.8	4.5	5.2	5.2
Finland	1.5	–1.2	1.2	3.9	1.8	1.8	6.4	7.8	8.0
Slovakia	7.1	2.7	3.1	4.0	2.9	3.5	9.8	10.6	10.5
Euro area	**0.9**	**–1.9**	**0.4**	**3.3**	**1.0**	**1.8**	**7.5**	**9.3**	**10.2**

NOTES: (*) Percentage real change.
(**) Percentage change in harmonized consumer price index.
(***) Percentage of labour force.
SOURCE: European Commission.

...due to effect of credit crunch on real economy...

The reductions for the Euro Area were similar. Starting out from a growth rate of 0.9% in 2008, the Commission foresees negative growth of –1.9% in 2009 with a slight recovery to 0.4% in 2010. These forecasts now incorporate the effect of recovery plans announced by the various member countries. According to the European executive, these measures will have their maximum effect in 2009 with a contribution to growth of 0.8 percentage points. In 2010 the contribution will be lower at 0.3 percentage points but sufficient to bring a positive growth rate. Inflation in the Euro Area continues to follow a path parallel to that in the European Union as a whole and will therefore show a notable decrease going from 3.3% in 2008 to 1.0% in 2009. The EC states that the downturn will be general in most member countries so that the persistent divergences in inflation differentials will be reduced.

Behind this major worsening in economic prospects largely lies the much-feared effect of the credit crunch on the real economy. A reduced access to credit for households and companies will depress domestic demand in the private sector and economic activity. The current change of prospects in the labour market reflects the sombre tone of the new forecasts. Employment in the Euro Area, which performed relatively well in 2008, will contract by 1.6% in 2009. Given that the performance of the labour market responds somewhat slower than economic conditions it is expected that

MACROECONOMIC FORECASTS FOR EUROPEAN UNION COUNTRIES OUTSIDE EURO AREA

January 2009

	GDP (*)			Inflation (**)			Unemployment (***)		
	2008	2009	2010	2008	2009	2010	2008	2009	2010
Bulgaria	6.4	1.8	2.5	12.0	5.4	4.8	6.0	6.3	6.4
Czech Republic	4.2	1.7	2.3	6.3	2.6	2.3	5.0	5.7	6.6
Denmark	–0.6	–1.0	0.6	3.6	1.6	1.9	3.5	4.5	5.6
Estonia	–2.4	–4.7	1.2	10.6	3.2	2.7	5.1	8.8	9.7
Latvia	–2.3	–6.9	–2.4	15.3	6.8	2.4	6.5	10.4	11.4
Lithuania	3.4	–4.0	–2.6	11.1	5.6	4.8	5.4	8.8	10.2
Hungary	0.9	–1.6	1.0	6.1	2.8	2.2	7.7	8.8	9.1
Poland	5.0	2.0	2.4	4.2	2.9	2.5	7.4	8.4	9.6
Romania	7.8	1.8	2.5	7.9	5.7	4.0	6.2	7.0	6.9
Sweden	0.5	–1.4	1.2	3.3	0.7	1.0	6.2	7.9	8.7
United Kingdom	0.7	–2.8	0.2	3.4	0.1	1.1	5.7	8.2	8.1
European Union	**1.0**	**–1.8**	**0.5**	**3.7**	**1.2**	**1.9**	**7.0**	**8.7**	**9.5**

NOTES: (*) Percentage real change.
(**) Percentage change in harmonized consumer price index.
(***) Percentage of labour force.
SOURCE: European Commission.

in 2010 it will continue to drop by 0.7%. In turn, the unemployment rate will increase by 2.7 percentage points between 2008 and 2010 and will go to 10.2% in the latter year.

Nevertheless, the Commission does not hide the fact that the new macroeconomic scenario is subject to a high level of uncertainty. On the one hand, it points out that it still does not have details of the plans to stimulate the economies announced by the governments of the various member states of the EU. The effect of these plans will depend on their efficacy and the speed with which they are implemented. Another aspect underlined is the medium-term risk arising from the high deficits many countries could reach, as well as the growing levels of government debt. The high cost of servicing that debt could substantially reduce disposable income over the medium term so that economic recovery might be slower.

Euro Area: economic indicators at all-time lows

The slowdown in the European economy came about gradually during 2008 until it became a recession with quarter-on-quarter drops being recorded in the second half of the year. Far from having touched bottom, the impetus of the drop seems to have increased. The clearest analysis comes from the economic sentiment indicator which continues to collapse at a speed unheard of up to now. In November it was already standing at all-time lows.

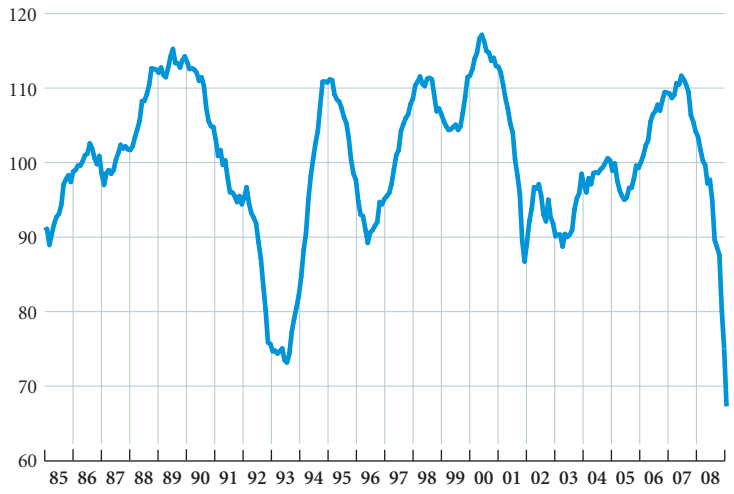
A look over the indicators, both those of demand and supply, reinforces this view. On the demand side, prospects are far from bright. The drop in retail sales (1.5% year-on-year in November) and the collapse of consumer confidence testify to this. Furthermore, the increase in the unemployment rate, which went to 7.8% in November to stand at levels in December 2006, continues to reduce the capacity of household spending.

...but underlines high level of uncertainty surrounding new scenario.

In last quarter of 2008 drop in economic activity in Euro Area seems to have increased in speed.

PESSIMISM SPREADS OVER EURO AREA

Economic sentiment index for Euro Area



SOURCE: European Commission.

Both demand and supply indicators support this view.

The trend in supply indicators also reflects the notable worsening of economic conditions. On the one hand, we should note the sharp drop in industrial activity (down 7.7% year-on-year in November), the biggest since this statistic has been kept. One of the factors responsible for this collapse, apart from the weakness in domestic demand, is the extent and depth of the recession on a world level. This meant that the drop in exports in November was also the biggest since the statistic has been prepared (10.2% year-on-year). In this context, it is not surprising that industrial confidence indicators have dropped to all-time lows.

Inflation is only variable to offer good news.

One of the few economic variables to offer good news is inflation. This fell to 1.6% year-on-year in December, some 2.5 percentage points below that recorded in July. This allowed the European Central Bank to continue on its downward track with interest rates. At its meeting in January it again cut its reference rate by 50 basis points putting it at 2%. If inflation stays at moderate rates, as we forecast it will in 2009, the purchasing power of households will have good support and, furthermore, the European Central Bank will be able to hold interest rates at those levels, or even lower, in coming quarters.

It seems that the financial crisis has passed through to the real economy and is undermining the confidence of economic agents in the Euro Area. In order to work out the possibilities of economic recovery over the short term we must look closely at two fundamental factors. On the one hand, one of the signs of economic recovery may arise from domestic demand if finally it responds to the sharp drop in interest rates. The other focus of attention should be in the details of the economic stimulus measures the governments of the various member states are putting into effect. As underlined by the European Commission report, their effect on growth may be substantial.

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	December
GDP	3.0	2.7	2.2	2.1	1.5	0.7	–	...	–
Retail sales	1.6	0.9	–0.3	–0.2	–1.5	–1.4	–2.0	–1.5	...
Consumer confidence (1)	–9.1	–4.9	–7.7	–11.9	–14.6	–19.3	–23.6	–25.1	–29.7
Industrial production	4.0	3.5	3.1	2.5	1.1	–1.5	–5.7	–7.7	...
Economic sentiment indicator (1)	106.3	108.4	104.3	100.5	96.5	88.5	80.0	74.9	67.1
Unemployment rate (2)	8.3	7.4	7.2	7.2	7.4	7.5	7.7	7.8	...
Consumer prices	2.2	2.1	2.9	3.4	3.6	3.8	3.2	2.1	1.6
Trade balance (3)	–10.4	20.1	34.3	24.4	13.8	–11.1	–25.5	–35.8	...
3-month Euribor interest rate	3.1	4.3	4.7	4.5	4.9	5.0	5.3	4.7	3.8
Nominal effective euro exchange rate (4)	103.6	107.7	110.6	112.8	115.6	113.7	107.6	106.8	112.0

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

Germany: a new plan for 2009

The year 2008 marked the end of a strongly expansionist stage with cumulative growth of 5.9% between 2006 and 2007. This growth mainly rested on two pillars – rising foreign demand and heavy investment. Nevertheless, the weakness of both these factors brought a move into technical recession in the third quarter of 2008 following two consecutive quarters with quarter-on-quarter drops in GDP.

Available figures for the fourth quarter of 2008 show how this trend sharpened. November brought a collapse in demand with year-on-year reductions of 3.2% in retail sales and 9.2% in exports. The contraction in foreign demand ended six years of constant growth in exports and turned it into the worst year since 1993. In December, consumer confidence continued to drop showing the biggest month-on-month decrease since the start of the statistical series in 1979 (7.5 points) mainly due to the future component, a reflection of the pessimistic expectations of consumers.

On the supply side, the picture is no brighter. The year-on-year trend in industrial production dropped in November for the third consecutive month (6.3%) putting it at levels similar to those for 2006. While this was not the biggest drop ever recorded, a similar drop had not been previously seen in such a short time. It was therefore not surprising to see the sharp decrease in the IFO business indicator that stood at the lowest levels since it was set up in 1991. The reduction of inflation to 1% and maintenance of the unemployment rate in December was not enough to improve prospects on the trend in the economy over the short term.

Very sharp drop in Germany's main supply and demand indicators.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
GDP	3.2	2.6	1.7	2.7	1.9	0.8	–	...	–
Retail sales	0.3	–2.3	–3.5	–0.9	–0.1	0.6	0.1	–3.2	...
Industrial production	6.0	5.9	5.0	4.9	3.0	–0.1	–3.6	–6.3	...
Industrial activity index (IFO) (*)	105.5	106.2	103.9	104.0	102.1	94.9	90.1	85.8	82.6
Unemployment rate (**)	10.7	9.0	8.5	8.1	7.9	7.7	7.6	7.6	7.6
Consumer prices	1.6	2.3	3.1	2.9	2.9	3.1	2.4	1.3	1.0
Trade balance (***)	151.3	181.5	195.1	199.1	201.3	194.6	188.3	179.6	...

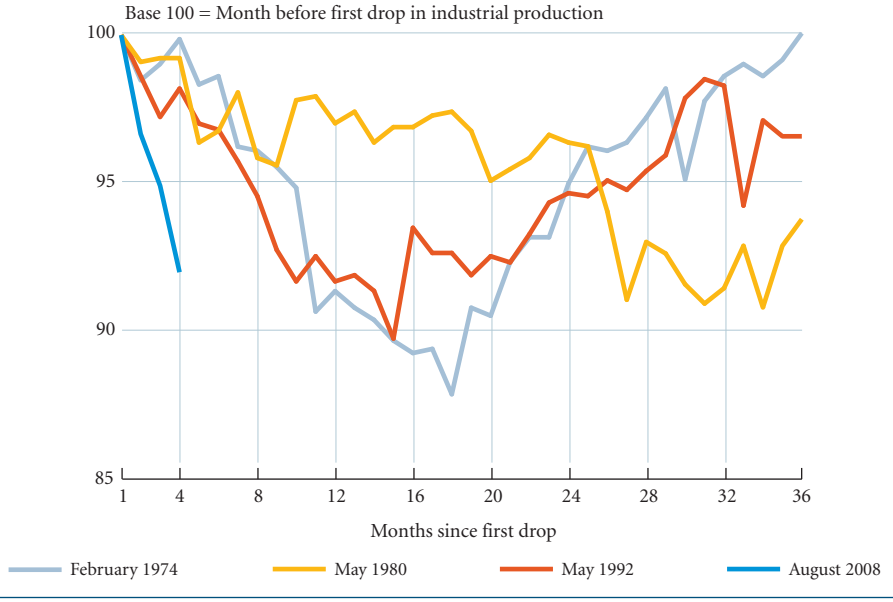
NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion euros.
SOURCE: Eurostat, European Central Bank, European Commission, national statistical bodies and own calculations.

European Commission forecasts biggest drop in GDP since 1960.

The worsening state of the economic scenario brought about a revision of the European Commission's forecasts which are now in line with those published by the IFO Institute the month before. According to the EC, the GDP will drop by 2.3% in 2009 as a whole, making this the biggest decrease since 1960. The main reasons for this will be a reduction in fixed capital investment (5.2%) and in exports (6.1%). The EC forecasts foresee recovery taking place in 2010

INDUSTRIAL PRODUCTION DROPPING MORE RAPIDLY

Cumulative decrease in industrial production in last episodes showing drops



SOURCE: German Institute of Statistics and own calculations.

with growth of 0.7 percentage points. The unemployment rate will go up one percentage point over those two years and will reach 8.1%.

In view of this situation, the German government decided to begin 2009 with the announcement of a new economic stimulus plan amounting to 50 billion euros which, together with the 18 billion euros in the first package approved in November 2008, will be equal to 2.7% of Germany's GDP, to be split between 2009 and 2010.

The main measures in the new package include an increase in public spending on infrastructures and tax cuts to increase the purchasing power of households as well as aids for replacing old cars on the road. The new package also includes the setting up of a fund of 100 billion euros to back new loans to companies, which will be added to the 15 billion euros in the initial plan. As a result of these measures, Germany's government deficit will come close to 3% of GDP in 2009 and will go over that level in 2010.

Germany approves new package of economic stimulus measures amounting to 50 billion euros.

Quantitative easing and fiscal expansion

The financial crisis that began in August 2007 grew severely worse in 2008. This situation forced governments to take unprecedented steps to avoid a financial collapse and thus prevent a sharp drop in the world economy. In the first half of 2008 it was found that the aggressive monetary policy being followed (major cuts in interest rates and quantitative easing) along with direct intervention in the financial and banking system was not enough nor had the effectiveness necessary to reduce the growing risks of world recession and, in the case of some economies, the risk of a deep recession. This led the authorities to change their strategy for dealing with the crisis by designing fiscal policy measures specifically aimed at stimulating economic activity.

Fiscal policy may be a good option to deal with a temporary drop in economic growth. Moreover in a context such as the present one where an easy monetary policy is not sufficient to reduce risk aversion of individuals or to restore confidence in world financial markets. In any case, this strategy also has its risks – a lack of international coordination, an inadequate amount of fiscal stimulus and the possible impact on interest rates (see box «Public deficit and interest rates: sustainability is the key»), and the time it may take to implement the programmes so designed. The optimum course of action would be a simultaneous implementation in all countries in order to maximize the impact and the synergies between economies and to minimize the so-called stowaway effect or, in other words, prevent part of the positive impact resulting in heavier imports instead of stimulating GDP growth.

In the design of a fiscal plan, a number of questions arise. Will the governments increase their infrastructure spending? Will they cut in taxes? Will it be temporary or permanent? Should there be specific measures or those of wider reach? The combination of measures is crucial in determining its effectiveness and efficiency in restoring economic activity in time, smoothing the adjustment of some sectors and creating jobs. The heterogeneity among the various fiscal plans announced depends on the different risk assessments made by governments.

United States was the first country to announce, and bring forward in a resoluted manner, the design of fiscal stimulus plans. An early plan (passed in February 2008) concentrated on fostering household consumption at a moment of definite slowdown in economic activity. The second fiscal stimulus in the United States was

announced by President Obama and, while specific details are still not known, preliminary figures indicates that it will amount to around 825 billion dollars. The plan will involve a group of measures to stimulate economic activity over the short term while undertaking projects of a more structural nature with a long-term effect. Among those measures having an immediate effect are transfers to the states in order to avoid a halt to projects now underway. The plan also involves tax cuts of 250 billion dollars while the rest will be devoted to public spending with an emphasis on infrastructures related to transport, energy and education.

In Europe, fiscal plans largely reflect the economic situation in the different countries of the EU. Looked at by country we can distinguish two large groups. On the one hand, there are those countries with a high level of household indebtedness and where the construction sector has made a strong contribution to economic growth, such as Spain, United Kingdom and Ireland. On the other hand, there are those countries where the construction sector has contributed to growth to a moderate degree and its households show less indebtedness, such as Germany, France and Italy. The first group has registered a deeper negative impact from the spillovers generated by the financial markets over the past year.

This simple breakdown underlines why right from the beginning the governments of Spain and the United Kingdom have designed discretional plans for fiscal stimulus substantially more important than those of their European neighbours. In recent weeks, the German government has decided to raise the size of its fiscal

INTERNATIONAL FISCAL STIMULUS PLANS

	Amount (millions)	% GDP	Main type of measures		Amount (millions)	% GDP	Main type of measures
United States Plan 2008	152,000 $	1.1%	Rebate of $600 to individual taxpayers with income of less than $ 75.000 and $ 1,300 to families with incomes of less than $ 150,000 and a tax credit of $ 300 for a child.	United States Plan 2009	825,000 $	5.5%	Obama Plan: Announcements on investments in roads and bridges, technology, education and health. Details still to come.
France	10,000 €	0.5%	Infrastructures in transport and energy. Advance on tax rebates. Measures to support industry.	Spain	18,000 €	2.4%	Local and national infrastructures. Low-cost housing. Investment to generate jobs and aid (demand) to strategic sectors. Removal of property tax.
Germany	68,000 €	2.7%	Investment in infrastructures, schools and hospitals. Help to small and medium companies, temporary cut in health insurance contributions, incentives to buy new cars.	United Kingdom	30,000 €	1.2%	Government spending. Reduction of VAT from 17.5% o 15% up to end of 2009 to foster demand.
Italy	8,000 €	0.5%	Transfers to households and limit on mortgage interest. Cut in company taxes, toll road charges and public services.	Japan	70,000 $	1.6%	Households and small companies: financial help and tax cuts on mortgages. Spending on investment.
				China	164,000 $	4.9%	Investment in rural areas, bringing forward of investment, reconstruction, economic rentals. Subsidies to farmers and credits to small companies. Reduction of VAT.

SOURCE: National sources and own estimates.

stimulus programme from the 0.6% of GDP initially foreseen to 2.7%. In turn, France and Italy will allocate 0.5% of the GDP in relatively more modest fiscal stimulus measures focused in public investment whose effects will be felt mainly in 2010. The fiscal plans of Spain and the United Kingdom show twice these figures and contain factors that could stimulate economic activity more over the short term.

The uncertainty in the United States is centred on the effectiveness of tax cuts, given the assumption that taxpayers will set aside a major part of the benefits to increase savings and the repayment of debts previously contracted, that is to say, they will not devote the fiscal help to the consumption of goods. Forecasts by President Obama's economic advisory team on the cumulative impact fiscal stimulus will have in 2009-2010 put this at around 3.7% of GDP although uncertainty is very high. In Europe, the differences among the fiscal plans of each country could reduce the synergies of the positive effects on real economic activity and it is likely that the plans of some countries (for example, France and Italy) turn out to be insufficient to counteract the drop in economic activity foreseen.

Finally, fiscal measures have been put into effect. Now all we can do is hope that the results turn out as desired and that they come in time.

France: 2009 to be a lean year

According to the forecasts put out by the European Commission, France grew by 0.7% in 2008, a figure substantially lower than the 2.2% recorded in 2007. Furthermore, the report estimates that the drop in GDP could stand at 1.6% quarter-on-quarter. Both the collapse of the indicators for industrial production and sector confidence and the continuing restriction of credit promise a poor 2009. Nor is help coming from the weakness in the countries that are importers of French products. The slight hope for positive growth that came with GDP growth of 0.1% quarter-on-quarter in the third quarter of 2008 has been left far behind. France is not escaping from the recession.

The sharp drop in the French GDP at the end of 2008 is reflected in the poor performance in industrial production which was down 9.0% year-on-year in November. At the same time, other industrial activity indicators suggest that the downward trend will sharpen in coming months. For example, the rate of utilization of production capacity is well below the long-term average. In addition, both the economic sentiment index and order books were down in December, reaching an all-time low since these figures were first published.

Contraction of French GDP expected in fourth quarter and in first half of 2009.

On the demand side, a number of figures indicate that domestic consumption is notably weak. Household consumption collapsed in December by 1.7% year-on-year, well below the increase of 1.0% the month before. The sharp drop in consumption is a troubling figure, especially if we keep in mind that December is usually a month of high household spending because of the Christmas season. Consumer confidence continued downward in December going to negative levels of the order of –34 points.

The figures show that not only domestic demand is slackening but also foreign demand, given that the trade deficit increased to 56.9 billion euros in November, above the deficit of

Industrial production collapses in France.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
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	0.6	1.1	–1.7
Industrial production	0.9	1.4	2.5	1.7	–0.4	–2.5	–8.0	–9.0	...
Unemployment rate (*)	9.2	8.3	7.8	7.6	7.7	7.7	7.8	7.9	...
Consumer prices	1.7	1.5	2.3	2.9	3.3	3.3	2.7	1.6	1.0
Trade balance (**)	–27.4	–33.3	–38.4	–42.0	–45.8	–50.6	–55.6	–56.9	…

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

Demand slack while inflation moderating.

55.6 billion euros in October. Similarly, it may be expected that the number of unemployed will grow considerably in coming months. As a result, the unemployment rate went up to 7.9% in November, one decimal more that the figure for October. In this situation, the only optimistic note comes from the moderation of inflation which stood at 1.0% in December, lower than the 1.6% recorded the month before.

Drop in French GDP in 2009 estimated at 1.8%.

In such an adverse economic situation as this, the European Commission is forecasting a 1.8% drop in France's GDP in 2009. It also estimates that there should be a very gradual recovery in 2010 with growth of 0.4%. While the government's plan to stimulate the economy will ease the drop in economic activity by 0.4 and 0.2 percentage points in 2009 and 2010, respectively, this will not be enough to avoid a drop in GDP. At the same time, this plan will contribute to raising the fiscal deficit by 0.8 additional percentage points, taking it to 5.4% of the GDP, higher than the 3.2% forecast for 2008.

Italy: a difficult year ahead

European Commission indicates drop of 2.0% in Italy's GDP in 2009.

Italy went into technical recession in the third quarter of 2008 along with most other countries of Europe. Nevertheless, according to the European Commission estimates, the Italian economy has turned out to be one of the few economies with a drop in the GDP for 2008 as a whole. New figures revised by the Commission forecast a slight recovery of the GDP as of 2010 following two consecutive years with decreases (0.6% in 2008 and 2.0% in 2009).

The few indicators available for the final months of 2008 confirm this forecast. On the demand side, retail sales were down 3.0% year-on-year in November while consumer confidence continued on a downward trend going close to the low seen in 1993. The slowdown in exports in recent months, with a year-on-year drop of 1.3% in October 2008 makes the decrease in demand even worse. On the supply side, the industrial production index recorded a drop of 9.0%, the highest since the statistical series began in 1996. Furthermore, industrial confidence continues to drop, going to a new low for the last 25 years in November. The drop in the CPI, with growth of 2.8% in the fourth quarter (2.2% in December) remains the only positive factor.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
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	–0.7	–3.0	...
Industrial production	2.5	–0.1	–2.9	–1.3	–1.6	–4.3	–7.5	–9.0	...
Unemployment rate (*)	6.8	6.1	6.3	6.6	6.7	6.7	–	...	–
Consumer prices	2.1	1.8	2.4	3.1	3.6	4.0	3.5	2.7	2.2
Trade balance (**)	–17.6	–13.7	–8.9	–9.1	–8.6	–10.4	–12.1	–12.9	...

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

Prospects for this year are not very bright. The expected increase in the unemployment rate (1.5 percentage points in 2009, according to the European Commission) will make the drop in demand still worse. This, together with the drop in capital goods investment, will mean a heavy burden for Italy's economy. Only the increase in public spending, coming from the fiscal stimulus plan approved in December 2008 amounting to 8 billion euros, will partially compensate the recession. This is a rather small plan given that the high level of the public debt (more than 100% of GDP) does not allow for making wide use of discretional fiscal policies.

Economic stimulus plan will not be sufficient to compensate drop in activity.

United Kingdom: the worst recession among the large economies of European Union in 2009

In the fourth quarter of 2008 the British economy dropped by 1.5% quarter-on-quarter which, added to the dip of 0.6% in the third quarter, puts it in a state of technical recession. Other available indicators confirm the sharp drop in Britain's economic situation. On the demand side, consumer confidence has continued to drop, going to negative levels of –29 points. We should point out that most of the components of economic sentiment stand at all-time lows since these figures were first published. Furthermore, the sharp drop in car registrations (close to 30% year-on-year in the last 3 months of 2008) confirm the weakness of consumption in the United Kingdom.

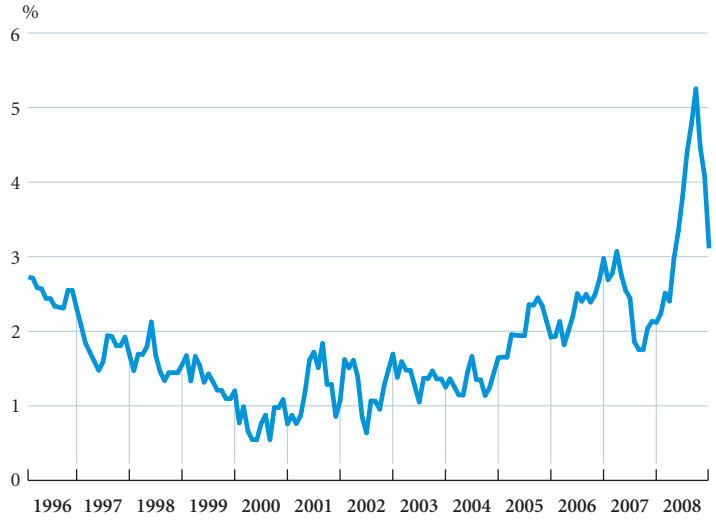
At the same time, the figures show that not only domestic consumption is slackening but also foreign demand. In fact, in spite of the depreciation of the pound sterling, whose nominal effective exchange rate has lost close to 25% of its value in the past year, the trade deficit is not being corrected. The investment component is no better seeing that the level of utilization of production capacity was down in the fourth quarter.

In this context of a general weakness in demand it is not surprising that industrial production has plummeted in recent months. Industrial production in November was down 6.9% year-on-year, the biggest drop since these statistics were first published. In this context, the European Commission has forecast a contraction of 2.8% year-on-year for the British economy in 2009, a drop in GDP substantially higher than

Contraction in British GDP expected for fourth quarter.

BRITISH INFLATION MODERATES

Year-on-year change in consumer price index



SOURCE: ONS.

Drop of 2.8% in GDP estimated for 2009...

that for the other large economies of the European Union.

The labour situation, one of the strong points of the United Kingdom, has also begun to falter. The number of registered unemployed reached 1.16 million in December, the highest figure since January 2000. As a result, the rate for registered unemployed stood at 3.6%, three points above the rate recorded the month before.

...but there's some optimistic news: inflation is moderating and interest rates are going down.

As in the rest of Europe, the only optimistic figures come from the drop in prices and the decrease in interest rates. Both factors should bring about an improvement in the financial situation of households and companies. Inflation eased in December to stand at 3.1% year-on-year, a rate significantly below the 4.1% recorded in November. The moderation in inflation was mainly due to the reduction in VAT but also to the drop in energy prices and heavy discounts in end-of-season sales. At the same time, the Bank of England cut its interest rate by a half percentage point to 1.5% on January 8, its lowest rate since 1694.

In view of such an adverse situation, the United Kingdom last year announced a government fiscal stimulus plan amounting to 1.2% of GDP. It is to be hoped that this package of measures will bring additional growth although to what extent is still uncertain. Nevertheless, it will be clearly insufficient to substantially ease the drop in GDP in 2009. Furthermore, we should point out that one of the troubling factors of the plan lies in the sharp impact this will have on the British deficit. According to European Commission estimates, the fiscal measures in total will contribute to raising the deficit by a half and one percentage points in 2009 and 2010 respectively, putting it at 8.8% of GDP in 2009 and 9.6% in 2010.

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	December
GDP	2.8	3.0	3.0	2.6	1.7	0.3	–	–1.8	–
Retail sales	3.2	4.4	3.9	5.4	4.4	2.3	1.7	1.4	3.9
Industrial production	0.7	0.4	1.0	0.6	–1.2	–2.5	–5.2	–6.9	...
Unemployment rate (*)	2.9	2.7	2.5	2.5	2.6	2.8	3.1	3.3	3.6
Consumer prices	2.3	2.3	2.1	2.4	3.3	4.9	4.5	4.1	3.1
Trade balance (**)	–72.5	–83.2	–88.4	–90.9	–93.2	–94.6	–93.9	–94.2	...
3-month Libor interest rate	4.6	5.3	6.3	6.0	6.0	5.9	6.3	5.8	3.9
Nominal effective pound exchange rate (***)	98.0	103.9	102.2	97.6	92.6	92.8	89.4	85.4	81.2

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.

Emerging Europe: rapid drop in expectations

Europe's emerging economies immersed in stage of economic slowdown.

Whether the emerging countries of Europe would or would not escape unharmed from the combination of the world financial crisis and the slowdown in the world economy has been a leading question for some months. The notable worsening of economic activity indicators in the final stages of 2008 suggests that the situation could be even worse than expected. Largely it is a result of the heavy dependence of these economies on the markets of the industrialized European countries, practically all of which are in recession. In this context, only the easing of inflationary pressures will serve as a partial support in a negative economic situation.

Poland is a specific example of how the worsening of the crisis in taking shape in the region. In November, retail sales dropped by a huge 13.8% year-on-year, which represented a decrease of more than four percentage points in only one month. Figures for industrial production were slightly better with a decrease of 4.4% in December in year-on-year rate. The collapse in manufacturing was largely due to the drop in exports. Growth of exports in cumulative figure for 12 months went from 7.8% year-on-year on average in the third quarter of 2008 to 3.9% in November.

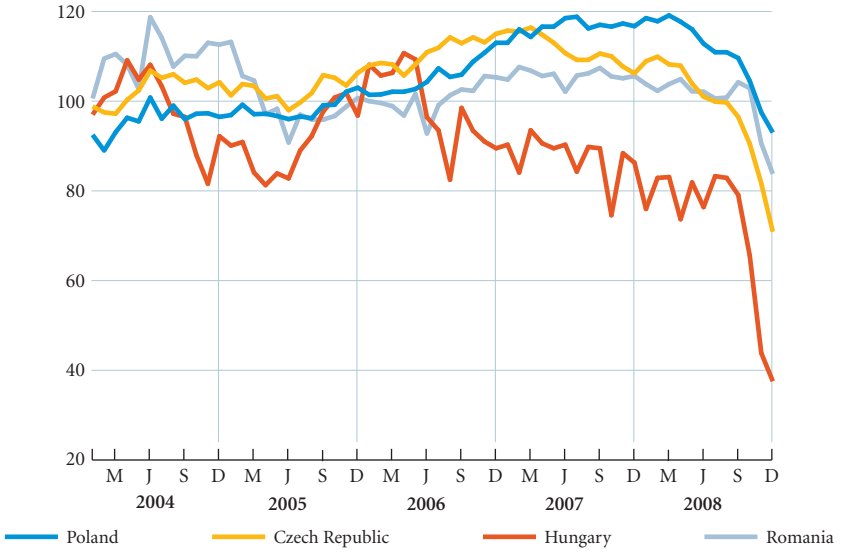
If we combine this trend with the relative strength of imports we understand the increase in the trade deficit to 85.5 billion zlotys in November (in cumulative balance for 12 months) compared with the trade imbalance of 84 billion zlotys in October. In any case, it should be remembered that the trade deficit for 2008 will be around 7% of GDP, a high figure but not one of the worst among the emerging countries of Europe. As mentioned above, inflation has been notably reduced going to 3.4% year-on-year in November, the lowest since December 2007.

Sharp adjustment in demand and supply in Poland.

In view of this situation of cyclical downturn, financial markets have reacted by relatively penalizing some countries in

EMERGING EUROPE LOSING DRIVE

Economic sentiment indicator



SOURCE: European Commission.

Financial markets putting pressure on countries with biggest imbalances.

the region that they see as more problematical. Mostly it involves those countries that have accumulated high macroeconomic imbalances. In these cases, the risk of failure to meet government debt instruments (held in Credit Default Swaps, or CDS), while easing slightly in December, rose again in January. Both the current level and the trend would indicate that the market sees greatest default risks in the case of the three Baltic states (Estonia, Latvia and Lithuania) along with Bulgaria, Romania and Hungary.

POLAND: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
GDP	9.0	8.2	8.7	9.8	9.9	9.3	–	...	–
Retail sales	7.3	4.1	3.2	2.0	0.2	–4.3	–9.6	–13.8	...
Industrial production	12.0	9.6	8.6	8.5	8.2	3.0	–0.1	–9.2	–4.4
Economic sentiment (*)	106.2	117.3	117.7	119.3	116.3	111.3	105.3	98.3	93.8
Unemployment rate (**)	13.9	9.6	8.5	7.8	7.4	6.8	6.5	6.5	...
Consumer prices	1.1	2.4	3.3	4.3	4.4	4.8	4.3	3.8	3.4
Trade balance (***)	–43.9	–44.2	–68.5	–72.8	–76.6	–80.4	–84.0	–85.5	...

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion zlotys.
SOURCE: National statistics offices, national central bank, European Commission and own calculations.

The currencies of the latter two countries have been subject to heavy depreciation pressures so far in 2009. It is no coincidence that Romania and Hungary are among those states showing the sharpest economic slowdown in the region. The scenario being discounted by the markets is also being picked up more and more by economic analysts. To cite a paradigmatic example, the forecast decreases in the GDP of Hungary's economy, which until recently stood at a dip of 1.5%, are now being revised to drops in the range of 3%-4%.

Along similar lines, although probably still overly optimistic, the European Commission recently announced downward growth forecasts for the entire region in 2009. In this context, there is speculation about a sharp easing of monetary policy that would cushion the economic slowdown. For the moment, among the emerging countries, the Hungarian central bank has opted for an initial interest cut of 50 basis points which puts the intervention rate at 9.5%.

Growth forecasts for region being revised downward and substantial cuts expected in reference interest rates.

FINANCIAL MARKETS

Monetary and capital markets

Central banks continue to take strong action

Central banks trying to normalize loan markets.

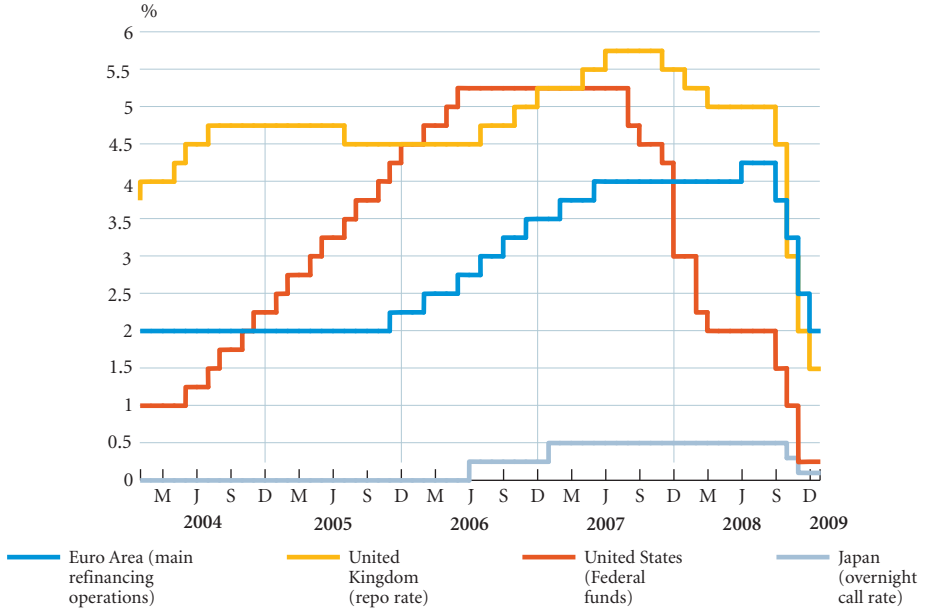
The world's more important central banks continue to act without letup. Some of these institutions, those that still have some margin, have cut the official interest rate but all are carrying out a detailed watch on any change of conditions in financial markets. These reflect the harsh winter in the Northern Hemisphere seeing that, if not completely frozen, they are still at very low temperatures.

At the same time, the central banks are trying to explain their strategies. For example, the governor of the Fed, Ben Bernanke, took advantage of an address to summarize all the measures used to fight the present crisis. He made an interesting distinction between the monetary policy of the Bank of Japan in 2001-2006, known as «quantitative expansion» and what the Fed is implementing, which he called «credit expansion». Quantitative expansion goes from deciding interest rates to establishing an objective for growth of the reserves of the commercial banks at the central bank.

Credit expansion, being used by the Fed, coincides with quantitative expansion in one respect: both have the result of increasing the central bank's balance sheet. In the case of a policy of

UNITED KINGDOM AND EURO AREA CUT OFFICIAL INTEREST RATES

Reference rates of central banks



SOURCE: National central banks.

quantitative expansion, however, this is concentrated on the growth of the reserves of the banks (which form part of the liabilities side of the central bank balance sheet) without taking into account the composition of loans or securities on the assets side. On the other hand, the Fed is concentrating on the composition of the assets in its balance sheet and the effects on conditions in the credit market for households and companies. This is the reason for the multiplicity and variety of programmes to inject liquidity, seeing that each of those programmes is attacking problems in different financial markets.

Fed policy aims at expansion of credit.

In addition, the Bank of England continued with a tendency to make cuts in the reference rate which it began in October last year. On January 8 it cut the official interest rate by 50 basis points (100 basis points is 1%) putting it at 1.5%, the lowest level since the bank was founded in 1694. In the press release justifying its decision, the members of the monetary policy committee of the central bank made reference to corporate surveys which indicated a growing economic contraction in the United Kingdom. Furthermore, they mentioned the need to take steps to fight against reduction in the granting of credit to the economic operators.

At the same time, the European Central Bank (ECB) cut its reference rate at its meeting on January 15 taking it down from 2.50% to 2.00%. Keeping in mind this latest cut, the ECB had reduced its official rate by 225 basis points since October 8 last year. Chairman Jean-Claude Trichet recognized the significant slowdown in the Euro Area economy and declared that the downward risks for growth, already warned about in earlier months, had actually come about. Fortunately, the sharp drop in inflation in the Euro Area, below the ECB 2% reference level, gave him more margin for manoeuvre in order to keep lowering the rate.

While the chairman of the ECB never commits himself to indicating future decisions about interest rates in coming months, in reply to a reporter, he stated that he did not discard a further cut and also mentioned the March meeting as a possible scenario for such action.

Finally, the ECB made clear how important it was for the various countries to adopt fiscal policies that were sustainable over the long term. He recognized that fiscal policies to stimulate the economies, while necessary, should be corrected once the present situation had passed in order to avoid that doubts about their viability over the medium term should undermine the fiscal stimulus.

Bank of England and ECB cut reference rates while not discounting further cuts.

While in recent months the main concern of the central banks has been to avoid the bankruptcy of the financial institutions, now it is to restore the flow of credit in the various financial markets. The central banks are using every means at their disposal to achieve this. In the United Kingdom, for example, the central bank was given new powers enabling it to lend up to 50 billion pounds sterling directly to companies. In fact, if the commercial banks have short-circuited monetary policy, the central bank has begun to assume the functions that under normal conditions those banks would carry out in granting credit.

In this respect, we catch a glimpse of a substantial change in the range of measures designed to combat the crisis. At the beginning of the subprime mortgage crisis, in the United States and the United Kingdom plans were put forward to acquire «toxic» assets from the banks. Later on, the United Kingdom shifted these plans toward recapitalization

Importance of buying «toxic» assets of banks to check crisis again being raised.

of the financial institutions. This idea was copied by former secretary of the Treasury Henry Paulson for the United States. Nevertheless, both Ben Bernanke and British Chancellor of the Exchequer Alistair Darling have recovered that idea defending the importance of buying «toxic» assets in order to reduce the uncertainty still gripping financial markets.

Tendency to normalization of interbank market continuing.

Government bonds discriminate against credit risk

With regard to bond markets, the tendency to an improvement in interbank markets that began in December last year is continuing. In the case of the Euro Area, the 1-year Euribor rate has gone down to 2.57% whereas at the moment of greatest pressure in September it went up to 5.5%. It is maintaining approximately the same differential as the month before (57 basis points with the ECB official rate) but in absolute figures the drop is substantial.

In the United States, the banks are ready to lend money for three months charging an interest rate of only 1.13%. But it is in the United Kingdom where the sharpest change has taken place given that for a 3-month deposit British banks were getting

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)
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	2.50	2.89	3.05	0.25	1.43	0.10	2.00	2.77	0.75
2009									
January (1)	2.00	2.41	2.57	0.25	1.13	0.10	1.50	2.24	0.75

NOTES: (1) January 20.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 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%), 15-01-09 (2,00%).
(3) Latest dates showing change: 11-12-07 (4,25%), 22-01-08 (3,50%), 30-01-08 (3,00%), 18-03-08 (2,25%), 30-04-08 (2,00%), 8-10-08 (1,5%), 29-10-08 (1%), 16-12-08 (0%-0,25%).
(4) Latest dates showing change: 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%), 4-12-08 (2,0%), 8-01-09 (1,50%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

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
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	2.95	3.41	3.81	4.38	2.21	1.17	3.02	2.10
2009								
January (*)	2.98	3.55	4.21	4.56	2.41	1.23	2.98	2.16

NOTES: (*) January 21.
SOURCE: Bloomberg.

6.30% in September whereas this level has slid down to 2.24%.

The reduction in interest rates in the interbank market affects rates on many financial transactions, such as mortgage loans and lines of bank credit for companies. This is an important factor for creating the basis of economic recovery.

In addition, in the government bond market there have been two changes regarding the downward trend in interest rates offered by these instruments. First, we note a halt or stabilization of such movements in the past month. For example, a 10-year US government bond has increased its return by 20 basis points to 2.41%. Both in Japan and Switzerland there has also been a slight increase in return. Long-term British bonds in turn dropped by 4 basis points to stand at 2.98%.

Germany was no exception and its long-term government bonds showed approximately the same return. Nevertheless, it was in the Euro Area where the second significant change took place, given that the S&P rating agency made public a series of modifications with regard to the sovereign ratings of various countries in the Euro Area. For example, it lowered the rating for Greece, Portugal and Spain. In the case of Spain, the reduction was from the highest quality AAA to AA+. According to S&P the reason for this was the structural weakness of the Spanish economy. It was especially concerned about the future trend in the public finances and doubts about the political response needed to deal effectively with economic and fiscal challenges.

These decisions have resulted in a divergence in the trend in return on government bonds in the Euro Area

S&P lowers ratings of Greece, Portugal and Spain while differentials on Euro Area government bonds increase.

Dollar tends to appreciate in January.

countries. As may be seen in the previous table, the differentials in government bonds of France, Italy and Spain have increased in terms of German bonds. This increase in differential reflects the perception of the worsening of credit risk. For example, in January last year a bond issued by the Spanish Treasury was paying interest of 4.13%, some 20 basis points above that offered by a German bond. Now, the Spanish bond must pay 1.23% more than its German counterpart. In the case of a French 10-year bond it must offer a yield 0.56% higher.

It is clear that the likelihood of a failure to pay in all these countries is very low and quite similar. For this reason, it seems that investors have overreacted on this matter. For this reason we should not discount that over coming months the differentials between government bonds the various countries of the Euro Area will narrow a little.

Foreign exchange markets reflect economic uncertainty

In the last quarter of 2008 the foreign exchange market was very volatile. Exchange rates reflected the sharp drop in investor expectations regarding the length and severity of the current recession.

In January the dollar appreciated against all currencies except the Japanese yen. Meanwhile, following the cut in interest rate by the ECB, the euro depreciated against all currencies except those of the East European countries.

It is normal that the euro depreciated in view of the cut in interest rates and the

EXCHANGE RATES OF MAIN CURRENCIES

January 21, 2009

	Exchange rate	% change (*)		
		Monthly	Over December 2008	Annual
Against US dollar				
Japanese yen	89.9	–0.4	–0.8	–17.9
Pound sterling	0.728	8.0	6.3	41.5
Swiss franc	1.143	4.3	6.5	3.0
Canadian dollar	1.264	3.4	3.6	18.1
Mexican peso	13.940	5.4	1.9	21.1
Against euro				
US dollar	1.292	–7.4	–7.6	–10.6
Japanese yen	116.1	–7.7	–8.3	–24.2
Swiss franc	1.476	–3.2	–1.2	–7.9
Pound sterling	0.940	0.0	–1.5	26.4
Swedish krona	10.750	–2.5	–1.8	13.4
Danish krone	7.450	0.0	0.1	0.0
Polish zloty	4.341	5.2	4.6	18.8
Czech crown	27.57	5.2	2.7	4.8
Hungarian forint	284.4	7.7	7.1	9.5

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

POUND AGAIN CLOSE TO PARITY WITH EURO

Pounds sterling to euro

NOTES: January 21 last date.
SOURCE: Bloomberg.

prospect of additional moves in the future. On the other hand, currencies such as the Polish zloty, the Czech crown and the Hungarian forint depreciated against the euro due to structural weaknesses in these economies given the current recession. This especially applies because of the indebtedness of some of those countries in foreign currencies.

East European currencies depreciate against euro.

We should especially refer to two currencies – the pound sterling and the Russian rouble. In the case of the British currency, it may seem that the situation is stable seeing that in the previous table we note that over the past month there has been no change between the pound sterling and the euro. But with a wider perspective, the trend in this exchange rate shows that there has been a sharp depreciation of the pound sterling against the euro (22%) in the period from the end of October to the past year-end. After coming close to parity, profit-taking came into play and the pound recovered to the point where it stood at 0.90 against the euro. But doubts about the solvency of the British financial system and rumours about nationalization of the large UK banks affected the pound exchange rate and it has again depreciated against the euro. In fact, on January 21 a euro could buy 0.94 pounds sterling.

In the case of the rouble the explanation lies in the importance of oil in Russian exports. The collapse in the price of crude oil implied a substantial drop in revenues from this source. Furthermore, the flight of capital which began last year because of the geo-strategic problems between Russia and Georgia obliged the Russian central bank to intervene in the market in order to defend the rouble.

Finally, the Russian authorities took the decision to depreciate the currency in an orderly manner involving various steps. Whereas on December 26 a dollar could buy 29 roubles, one month later the rate was 32.8 roubles, representing a depreciation of 13.3%. We shall have to see the impact on Russian inflation of a

Pound sterling and rouble depreciate sharply.

CONTROLLED DEPRECIATION OF RUSSIAN ROUBLE

Roubles to dollar

NOTES: January 21 last date.
SOURCE: Bloomberg.

New year fails to change downward trend in stock markets...

40% depreciation since August 2008. In public statements, the Russian authorities have shown their satisfaction with the trend in this process and have discounted any sharpening of this programme.

Shares show poor start to year

Last year was one of the worst in the history of the stock markets. Most share indices in the developed countries suffered drops that ran from 34% for the Dow Jones to 50% for the Italian index. Losses of this size stretching over a time-frame of a year allow us to understand the seriousness of the international crisis which is reflected in the sharp drop in the quoted price of shares of listed companies.

...due to disappointment over corporate profits, downward revision of forecast results...

Perhaps more than one investment portfolio manager seeing how the year came to a close had hopes of seeing the end of a very complicated period. However, the start of 2009 has not changed the course. In the first three weeks of January there were drops of another 10%, which represents a real headache for investors. For example, the German stock exchange dropped a further 12.1% while the Madrid stock exchange went down 10.9%. The drops, however, were widespread seeing that S&P in the United States fell by 10.5% and the Eurostoxx 50 went down 8.6%.

There were three factors behind this negative shift. In the first place, there was publication of profits for the fourth quarter of 2008 which were worse than expected. Second, companies have indicated downward revisions in profits forecast for upcoming quarters. Finally, financial analysts have revised downward the objective price of shares of many companies. Quoted prices show the change in the overall environment in which we are now involved. Finally, the

INDICES OF MAIN WORLD STOCK EXCHANGES

January 21, 2009

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*7,949.1*	*–7.3*	*–9.4*	*–34.3*
Standard & Poor's	*805.2*	*–9.3*	*–10.9*	*–39.2*
Nasdaq	*1,440.9*	*–7.9*	*–8.6*	*–38.4*
Tokyo	7,901.6	–8.0	–10.8	–40.7
London	4,031.4	–6.0	–9.1	–27.7
Euro Area	2,174.0	–11.1	–11.2	–41.3
Frankfurt	*4,225.4*	*–10.0*	*–12.2*	*–37.8*
Paris	*2,878.0*	*–10.8*	*–10.6*	*–39.3*
Amsterdam	*235.8*	*–5.5*	*–4.1*	*–44.2*
Milan	*17,661.0*	*–10.3*	*–9.2*	*–47.9*
Madrid	*8,195.3*	*–11.6*	*–10.9*	*–35.1*
Zurich	5,307.5	–2.8	–4.1	–27.2
Hong Kong	12,583.6	–16.8	–12.5	–47.2
Buenos Aires	1,044.6	–4.7	–3.2	–44.3
São Paulo	37,272.1	–4.8	–0.7	–30.6

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.

capacity to generate profits for this year has dropped.

Two conditions are needed to bring about a recovery in corporate operations. First of all, the end of the drop in real estate prices. In this way, we would avoid a decrease in value of assets in bank balance sheets. Furthermore, there needs to be a renewal of the flow of credit in the various financial markets. Nevertheless, these two *sine qua non* conditions for recovery will take time because getting them to happen is no easy matter.

...and downward revision of objective price in many companies.

Public deficit and interest rates: sustainability is the key

The relation between the public deficit and interest rates is a controversial question subject to various theoretical approaches, many empirical studies and frequent political disputes. The overall balance of the debate seems to suggest that the impact of the public deficit on interest rates is modest when it is moderate and seen as controllable. Nevertheless, it can cause havoc in capital markets if the sustainability of the public finances is put in question.

There are two basic channels through which public deficits can affect interest rates. First, a high public deficit may change the balance between aggregate savings and investment, pushing up the real interest rate of the economy (and therefore of financial instruments as a whole). Second, deficits increase the stock of government bonds in absolute terms and in terms relative to other financial assets. The worsening (present and expected) of the financial position of the public sector may raise the risk premium for default incorporated in the interest rate on government bonds.

Public deficit and real interest rate

This relation has been widely examined over the past three decades both on the theoretical and empirical level with mixed results that have kept the controversy open.

The conventional theoretical focus, inspired by Keynesian thinking, postulates that deficits provoke an increase in interest rates. This analysis sets out from the accounting position under which the investment of a country is equal to savings, which includes savings of households, companies and government. When the government increases its deficit (or saves less) it increases competition for available funds, which pushes up interest rates and reduces private investment (so-called «crowding out»).

In the conventional approach, with international mobility of capital the relation between the two variables disappears. An increase in the public deficit reduces domestic savings but its place is taken by international capital flows so that neither interest rates nor investment are affected.

In the neo-classical approach or that of Ricardian equivalence, the relation between deficit and interest rates is more complex and generally quite weak. For example, an increase in the public deficit as the result of a cut in taxes induces a change in the behaviour of households which, anticipating higher future taxes, opt for consuming less and saving more. As a result, total savings is not changed, nor is investment or interest rates.

Since the influential work by Robert Barro and coinciding with the increase in public deficits in the United States in the Eighties and the beginning of the Nineties, many studies tried to demonstrate the carrying out of Ricardian equivalence in that country. More recently, in view of the massive accumulation of reserves by emerging countries, the size of international capital flows has gained much attention in studies of the factors that determine interest rates.

An article by Gale and Orszag in 2004[1] compiles evidence from 66 empirical studies in the United States. Just half (33) found significant effects of deficits on interest rates. In the other half no effects were identified or they were ambiguous. In addition, they simulated an increase in deficit in 1% of GDP with 10 notable macroeconomic models in the United States (including those of the Federal Reserve, the CBO, DRI and Macroeconomic Advisors), obtaining a wide range of results (a rise in interest rate of between 0.10 and 0.99 percentage points at the end of one year).

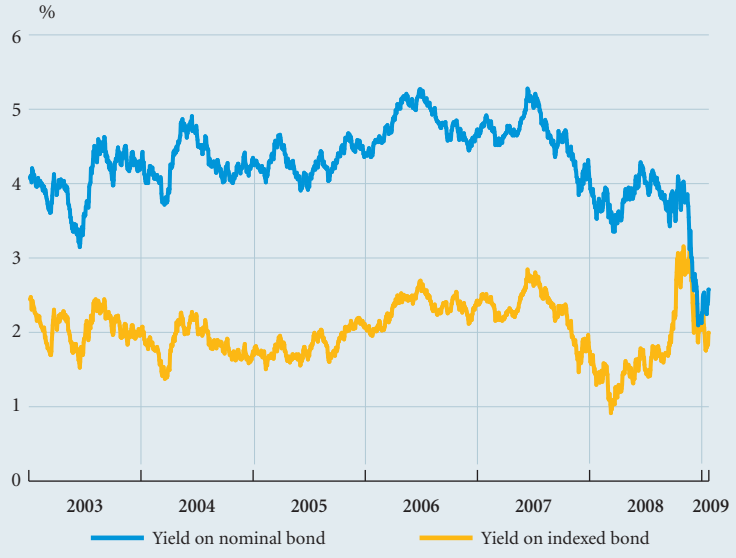
This disparity in results is largely due to notable differences between the studies in factors such as sample period, statistical techniques or the definition of relevant variables. This last question is of special importance given that it makes it possible to incorporate the second channel of influence mentioned earlier.

(1) Gale, W. and Orszag, P., «Budget Deficits, National Saving and Interest Rates», Brookings Papers on Economic Activity, 2004, No. 2.

In fact, Gale and Orszag warn that most of the studies that take into account not only the present deficit but also deficits expected in the future, and that consider long-term interest rates, conclude that the relation between both variables is statistically significant and of large amount. They themselves estimate that an increase of 1% in GDP in projected future deficits raise government bond rates between 0.25 and 0.35 percentage points. These results, however, have not failed to be controversial given that other methodologically similar analyses conclude that the size of the impact is much smaller (Engen and Hubbard, 2004[2] estimate it at only 0.03 percentage points).

RECENT DECREASE IN REAL AND NOMINAL INTEREST RATE ON US GOVERNMENT BONDS

Yields of bond indexed to inflation and nominal US 10-year bond



SOURCE: Thomson Reuters Datastream.

Along the same lines, experience since 2004 has not contributed to remove doubts about this relation with the coexistence of a notable increase in the public deficit with abnormally low levels in long-term rates. Several factors have been put forward to explain this situation. One is emphasized because of the «conventional focus with international mobility of capital», namely the massive buying of US government bonds by foreign investors, particularly governments and central banks in Asia and the Middle East. Warnock and Warnock (2006)[3] estimate that this factor reduces the rate on 10-year government bonds by 0.90 percentage points. But here as well the empirical studies are openly at odds and, for example, Wu (2008)[4] calculates a much lower impact, one nearly imperceptible. In the recent months of financial upsets, two other factors have been added to push down government bond rates. First, their nature as an asset haven and secondly the position of the Federal Reserve which announced its willingness to buy government bonds (and those of other issuers) as part of its strategy to restore the flow of credit and economic activity in the country.

(2) Engen E. and Hubbard G., «Federal Government Debt and Interest Rates», NBER Macroeconomics Annual, 2004.
(3) Warnock F. and Warnock V., «International Capital Flows and U.S. Interest Rates», International Finance Discussion Papers, No. 840, Board Of Governors of the Federal Reserve System, 2005.
(4) Wu T., «Accounting For the Bond-Yield Conundrum», Federal Reserve Of Dallas Economic Letter, February 2008.

Once these last two factors decrease as the crisis situation subsides, the empirical evidence considered suggests that the prospect of larger deficits and bond stocks, along with moderation in buying by foreigners, will lead to a level of balance in long-term interest rates in the United States at levels higher than those at present.

Public deficit and risk premium

As noted, the increase in interest rates could be substantial if at any particular moment economic operators have some doubts about the sustainability of the public accounts over the medium and long term.

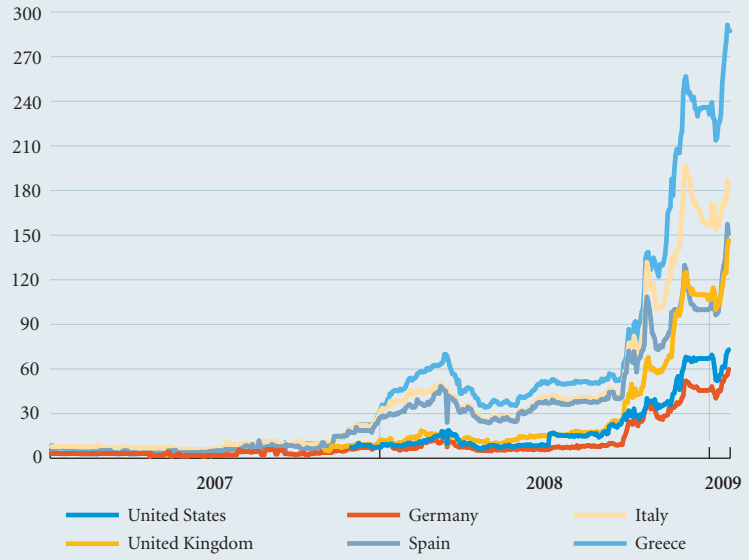
Both in the United States and in Europe demographic trends present major challenges for the public finances (including Social Security) from around 2020 with the retirement of the «baby boom» generation. There is a wide consensus regarding the need to take steps to meet that horizon but the seriousness of the cyclical crisis we are now immersed in is leading toward an increase in deficits that could darken risks over the long term.

In addition, the prospect of a scenario of high deficits and the accumulation of bonds could unleash fears among economic operators that the authorities may have recourse to easy monetary and foreign exchange policies. The subsequent inflation risk would also be reflected in an increase in the interest rate on government bonds demanded by investors.

For the moment, it has been the peripheral countries in the Euro Area (Greece, Ireland, Portugal, Italy and Spain) that have suffered a rapid rise in risk premium, quite noticeable in the differential in their government bonds in terms of German bonds as well as in CDS premiums on their bonds (which may be interpreted as a premium to cover risk of failure to pay).

INCREASE IN RISK PREMIUMS ON GOVERNMENT BONDS

Evaluation of CDS in basis points



SOURCE: Thomson Reuters Datastream.

SPAIN: OVERALL ANALYSIS

Economic activity

Government and European Commission revise growth forecasts downward

With the updating of the 2008-2011 Stability Programme, prepared each year within the EU framework of supervision and coordination of economic policy, the government revised its macroeconomic forecasts for Spain's economy. As a result, in spite of the successive packages of special fiscal measures to stimulate the economy (which in 2009 will have an impact of around 2.5% on the gross domestic product), the government is forecasting negative growth of 1.6% of GDP for the year as compared with a projection of 1.0% in the macroeconomic scenario of the 2009 budget estimates presented at the beginning of the autumn.

The European Commission has also revised downward its growth projections for Spain's economy in its forecasts presented in the fourth week of January. However, the EU scenario is predicting a recession slightly sharper and longer with a drop of 2.0% in GDP in 2009 and 0.25% in 2010, whereas the government predicts that economic recovery will begin in the second quarter of 2009 that will make possible an increase of 1.2% in GDP in 2010. The main discrepancies

European Commission foresees recession lasting to 2010...

MACROECONOMIC FORECASTS FOR SPAIN'S ECONOMY

Percentage real change (unless otherwise stated)

Macroeconomic figures	Estimate for 2008	Forecast for 2009		Forecast for 2010	
		Spanish government	European Commission	Spanish government	European Commission
GDP by demand components					
Private consumption	0.5	–1.5	–2.6	0.7	0.0
Public consumption	5.1	2.1	2.3	1.5	0.2
Gross fixed capital formation	–1.8	–9.3	–6.0	–1.2	–3.7
National demand (*)	0.7	–3.2	–2.8	0.4	–1.0
Exports of goods and services	2.9	0.3	–2.7	3.6	0.6
Imports of goods and services	0.6	–4.6	–4.6	0.4	–2.1
GDP	**1.2**	**–1.6**	**–2.0**	**1.2**	**–0.2**
Labour market					
Employment (**)	–0.4	–3.6	–3.9	0.2	–2.0
Unemployment rate (% of labour force)	11.1	15.9	16.1	15.7	18.7
Other figures					
General government balance (***)	–3.4	–5.8	–6.2	–4.8	–5.7

NOTES: (*) Contribution to growth in percentage points.
(**) Equivalent to full-time in case of Government of Spain forecasts.
(***) As percentage of GDP.
SOURCE: Ministry of Economy and Finance and European Commission.

...and unemployment rate going up to 18.7%.

from a demand point of view show up in private consumption (drop of 1.5% according to the government as against 2.6% in the view of the European Commission) and in exports (rise of 0.3% annual according to the government and a drop of 2.7% as seen by the Commission).

Naturally, the lower economic growth forecast by the European Commission shows up as higher loss of jobs and a bigger increase in unemployment. While for 2009 both forecasts put the unemployment rate at around 16%, the divergence sharpens in 2010 seeing that the European Commission projection puts the unemployment rate at 18.7% of the labour force, 3 points more than that forecast by the government.

Standard & Poor's rating agency lowers rating on Spanish government long-term bonds one step.

With regard to the impact of the recessive scenario on the public accounts, from an estimated deficit of 3.4% of GDP for 2008 this will go to nearly 6% in 2009. For the following year the government sees a correction of the general government public deficit to 4.8% of GDP while the European Commission puts it nearly one point higher. In this context of worsening economic prospects, in the fourth week of January the rating agency Standard & Poor's lowered the rating of Spanish long-term sovereign bonds by one step to AA+. It thus lost the highest AAA credit rating it obtained in 2004. Nevertheless, the present rating stands above that for developed countries such as Japan, Italy and Portugal. On the other hand, the Fitch rating agency maintained the AAA rating for Spanish government bonds.

Economic recession worsens in industry and construction

Available economic indicators suggest there was a sharpening of the economic contraction in the fourth quarter of 2008 following a quarter-on-quarter decrease of 0.2% in the third quarter. Both consumption and investment seem to have dropped more sharply in the final

RETAIL SALES WEAK

Year-on-year change in general retail busines index at constant prices

NOTES: Statistical series adjusted for working days.
SOURCE: National Institute of Statistics and own calculations.

DEMAND INDICATORS

Percentage change over same period year before

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
Consumption									
Production of consumer goods (*)	2.3	1.2	–2.7	–0.8	–5.6	–5.5	–8.4	–9.4	...
Imports of consumer goods (**)	8.9	5.1	7.7	–1.2	–6.9	–4.1	–19.6	–17.9	...
Car registrations	–0.9	–1.2	1.3	–15.3	–19.6	–32.5	–40.0	–49.6	–49.9
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	–46.0
Investment									
Capital goods production (*)	8.4	5.9	3.3	2.0	–3.1	–3.8	–14.0	–16.0	...
Imports of capital goods (**)	3.2	9.8	9.0	–16.0	–16.4	–15.9	–20.9	–39.1	...
Commercial vehicle registrations	1.5	0.3	4.7	–29.5	–34.1	–50.1	–54.3	–63.2	–65.9
Foreign trade (**)									
Non-energy imports	9.0	7.3	7.5	4.3	0.2	–4.1	–15.0	–22.5	...
Exports	5.6	4.2	4.6	2.2	6.6	7.8	–0.3	–16.5	...

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.

stages of last year. On the supply side, as well as construction, industry also seems to have added a sharp adjustment and services apparently did not escape the recession.

The main component of the gross domestic product (GDP) on the demand side, private consumption, continued to worsen in the fourth quarter. The consumer confidence index dropped to an all-time low in December mainly due to the rise in unemployment. Of special note was the collapse in car sales in December (down 49.9%) compared with the same month in 2007, thus setting a record. As a result, car sales in 2008 amounted to 1,161,176 vehicles, the lowest volume in the past 10 years. Both production and imports of consumer goods sharpened their decreases in the early months of the fourth quarter while retail sales remained depressed.

The weakness of demand, both domestic and foreign, along with the drop in corporate profits, had a negative effect on investment. Registrations of commercial vehicles slumped by 65.9% year-on-year in December, marking up an all-time drop. While not going to such extremes, both imports and production of capital goods dropped sharply in the early years of autumn. Domestic sales of large capital goods and software companies showed a decrease of 15.0% in November compared with 12 months earlier. With regard to construction investment, an early indicator such as apparent cement consumption, was down 37.5% in the fourth quarter compared with the same period in 2007, some 11.4 points more than in the third quarter.

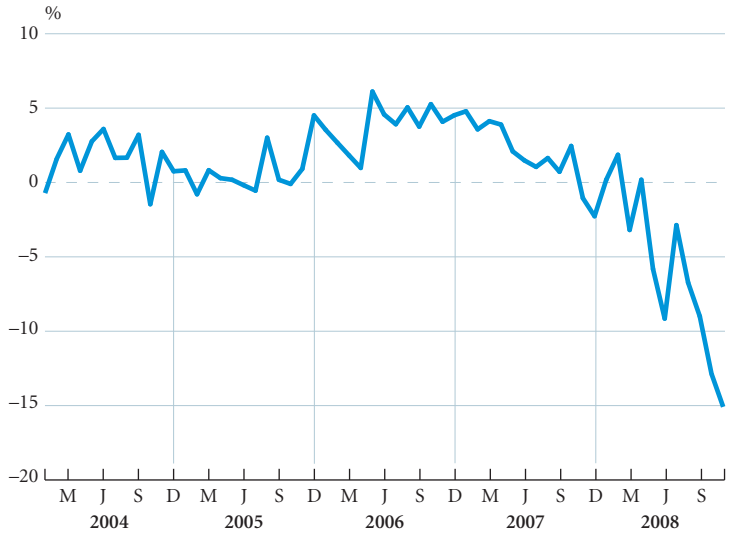
Consumer confidence index drops to all-time low in December and car sales collapse.

On the other hand, available indicators for foreign trade in October and November suggest that a correction of

Sharp contraction in commercial vehicle registrations.

INDUSTRIAL PRODUCTION SUFFERS BIGGEST DROP IN RECENT DECADES

Year-on-year change in industrial production index



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

Industry adjusting to drop in demand.

the foreign deficit is taking place more sharply than expected with a notable drop in imports. In this way, the contribution of the foreign sector to GDP growth seems to be on the rise although it is merely slowing the drop in economic activity.

On the supply side, industry is suffering more than expected and adjusting to the drop in demand. In November, the general industrial production index marked up the biggest year-on-year drop in recent decades going to 15.1% (adjusted for number of working days). Electrical power consumption was down 3.6% in the October-December period compared with the same period the year before after not having recorded any drop since the last recession in 1992-1993. For the moment, prospects are unclear if we are to judge by the drop in the confidence indicator recorded in December and the 28.1% slump in new industrial orders in November compared with 12 months earlier.

Year-on-year drop in housing prices in fourth quarter of 2008.

With regard to construction, the confidence indicator stood at very low levels in the fourth quarter. An early indicator (new residential building permits) was down 64.6% in October compared with the same month in 2007. Government tendering dropped by 12.6% in October compared with 12 months earlier although the start-up of the government's plan to stimulate the economy should bring a recovery in this in coming months.

The correction taking place in construction is a reflection of the crisis in the real estate market. Over-supply of housing is continuing to push prices down. The Ministry of Housing price index showed a year-on-year drop of 3.2% in the fourth quarter of 2008 for the first time since the last recession. Furthermore, the number of housing sales in November came to 36,321, a year-on-year drop of 35.6%.

Nor are services escaping from the recession. The volume of business in the

SUPPLY INDICATORS

Percentage change over same period year before

	2006	2007	2007	2008					
			4Q	1Q	2Q	3Q	October	November	December
Industry									
Electricity consumption (1)	4.0	4.5	4.9	2.7	2.6	1.7	–2.3	–4.9	–3.4
Industrial production index (2)	3.9	1.9	–0.2	–0.5	–5.1	–6.1	–12.9	–15.1	...
Confidence indicator for industry (3)	–2.7	–0.3	–3.3	–7.0	–11.9	–18.7	–27.0	–33.0	–38.0
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	–11.2	–21.6	...
Construction									
Cement consumption	8.5	0.2	–1.9	–13.3	–19.6	–26.1	–34.4	–41.5	–36.2
Confidence indicator for construction (3)	14.2	9.3	–1.3	–14.7	–17.3	–23.7	–38.0	–31.0	–35.0
Housing (new construction approvals)	18.6	–24.7	–33.6	–59.8	–56.0	–62.4	–64.6	...	...
Government tendering	31.3	–15.0	–33.1	27.8	–30.0	6.6	–12.6	...	...
Services									
Retail sales (6)	2.1	2.4	–0.3	–3.6	–5.6	–6.4	–7.9	–8.0	...
Foreign tourists	4.1	1.3	1.4	5.3	0.9	–5.3	–5.4	–11.6	–13.8
Tourist revenue inflows	5.6	3.6	4.5	5.2	1.0	–0.3	–4.2	...	...
Goods carried by rail (ton-km)	–1.2	–3.7	–2.7	–2.7	0.2	–5.2	–13.3	–22.8	...
Air passenger traffic	6.8	9.0	8.5	7.9	–0.7	–4.9	–10.8	–14.3	–13.7
Motor vehicle diesel fuel consumption	5.5	4.8	4.8	–0.9	–2.8	–3.7	–8.0	...	...

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.

services sector dropped by 14.6% in November compared with the same month in 2007. Most industrial branches recorded year-on-year decreases in business volume, the biggest showing up in selection and placement of personnel and in vehicle sales. Tourism recorded an annual drop of 11.0% in keeping with the year-on-year drop of 11.6% in foreign tourist arrivals in November and a 10.6% annual decrease in overnight stays in hotels in the same month. Nevertheless, certain branches such as investigation and security, industrial cleaning services and data-processing showed some strength.

Finally, the effects of the recessive situation also showed up in an increase in default. The number of commercial bills not paid rose by 37.5% in November compared with the same month in 2007. The adverse economic and financial climate also had its effect in fewer companies being set up. In fact, the number of share-issuing limited liability companies established in November was down 38.2% compared with the same month the year before while private limited companies showed a decrease of 37.7%.

Nor are services escaping recession although certain branches showing some strength.

Labour market

Drop in those registered with Social Security

Number of persons registered with Social Security down 4.3% in December 2008 compared with 12 months earlier.

The year 2008 ended with a sharp drop in employment. The rate of job loss continued upward in December, according to figures for those registered with Social Security, with a drop of 4.3% compared with the same month in 2007. The year-on-year drop in employment reported an all-time low since statistics have been kept. In fact, we have to go back to the 1992 recession to find a worsening of the labour market of similar proportions.

Sharp drop in those registered under construction.

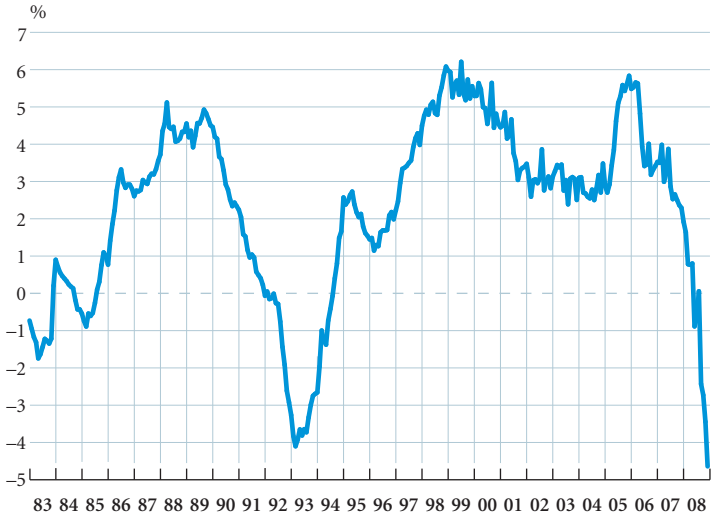
On monthly average, some 190,075 jobs were lost in December while for 2008 as a whole the total figure was 841,465. Of these, 747,061 were Spanish nationals while foreign workers made up 94,404, which meant year-on-year drops of 4.3% and 4.6% respectively.

Considering economic sectors, the worsening of the labour market in 2008 was wide-spread. We should mention that it was construction that reported the biggest drop in registrations, with a year-on-year dip of 22.0%, the worst drop since statistics have been kept. The contraction in industry was 6.9%, while services recorded a negative rate of 1.1%.

The contraction in employment was concentrated in the male group (because of its weight in construction) which reported a year-on-year drop of 6.8%. Nevertheless, female registrations showed a decrease for a second consecutive month putting the year-on-year rate at 1.0%.

TOTAL NUMBER OF THOSE REGISTERED WITH SOCIAL SECURITY DROPS SHARPLY

Year-on-year change in number of those registered with Social Security at month-end



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	December
Persons registered with Social Security (1)									
Sectors of activity									
Industry	*–0.1*	*2.4*	*2.5*	*0.8*	*–1.1*	*–2.6*	*–4.4*	*–5.6*	*–6.9*
Construction	*8.7*	*3.6*	*1.1*	*–2.2*	*–7.0*	*–12.4*	*–17.0*	*–19.8*	*–22.0*
Services	*5.2*	*3.4*	*3.1*	*2.9*	*2.2*	*1.4*	*0.4*	*–0.4*	*–1.1*
Job situation									
Wage-earners	*4.7*	*3.1*	*2.5*	*1.6*	*0.3*	*–1.1*	*–2.6*	*–3.8*	*–4.7*
Non-wage-earners	*2.2*	*2.8*	*3.0*	*2.5*	*1.3*	*–0.1*	*–1.2*	*–1.9*	*–2.5*
Total	**4.3**	**3.0**	**2.6**	**1.7**	**0.5**	**–0.9**	**–2.3**	**–3.5**	**–4.3**
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	–23.4
Temporary	4.7	0.3	1.2	–6.5	–7.4	–9.4	–16.3	–26.3	–10.0
Total	**7.9**	**0.5**	**–2.1**	**–7.2**	**–7.2**	**–9.9**	**–17.1**	**–27.0**	**–11.4**

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.

On the other hand, the loss of jobs was very uneven by ages, having most impact on people under 25 years of age, a group that reported a drop of close to 20.0% annual. The year-on-year drop among persons between 25-54 years was 3.8%. On the other hand, in spite of the fact that those persons above 55 years had shown lower growth in registrations in earlier months, this group still showed a year-on-year rise of 1.3%.

Loss of jobs concentrated in youngest group.

The same unfavourable picture shows up in registered hirings which came to 1,117,577, a drop of 11.4% compared with the same month the year before. Showing the biggest drop were permanent hiring contracts which were down 23.4% to the point where they represented 9.2% of the total, whereas temporary hiring contracts were down 10.0%.

Drop in hirings, especially for permanent jobs.

Registered unemployed goes above three million persons

The increase in the labour force and especially the loss of jobs has meant a sharp rise in unemployment. At the end of December the number of registered unemployed came to 3,128,963 persons, a year-on-year increase of 46.9%. The year 2008 was thus marked by a sharp rise in registered unemployment and this meant a major turnaround from the path followed in recent years.

While the rise in registered unemployment affected all large sectors, it is noteworthy that over the past 12 months the figure for unemployed in construction more than doubled. By sex, the number of unemployed males rose much more than that for females to show 78.1% and 24.8% year-on-year respectively. At the same

Registered unemployment up 47% in one year.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

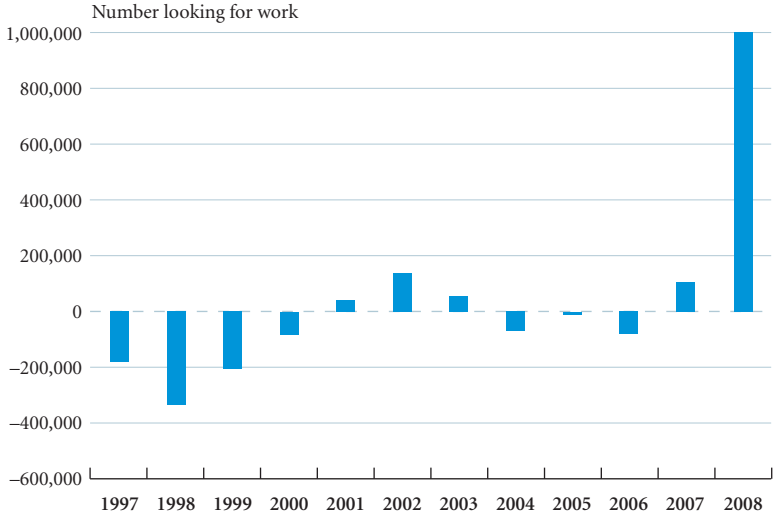
December 2008

	No. of unemployed	Change over December 2007		% share
		Absolute	%	
By sector				
Agriculture	101,338	32,526	47.3	3.2
Industry	399,872	119,891	42.8	12.8
Construction	590,730	306,863	108.1	18.9
Services	1,776,050	491,800	38.3	56.8
First job	260,973	48,336	22.7	8.3
By sex				
Males	1,576,467	691,328	78.1	50.4
Females	1,552,496	308,088	24.8	49.6
By age				
Under 25 years	385,130	144,747	60.2	12.3
All other ages	2,743,833	854,669	45.2	87.7
TOTAL	**3,128,963**	**999,416**	**46.9**	**100.0**

SOURCE: INEM and own calculations.

2008 SEES RISING REGISTERED UNEMPLOYMENT

Year-on-year change in registered unemployment



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

Number of unemployed up in all sectors but especially severe in construction.

time, the increase in registered unemployed was greater among those under 25 years of age, showing an increase of 60.2%, higher than the 45.2% recorded for those above that age.

The rise in registered unemployment was spread over all autonomous communities although the rates were fairly uneven, running from 15.3% year-on-year in Ceuta and Melilla to 76.2% recorded in Murcia.

Prices

Inflation corrected to 1.4%, lowest figure since 1998

December 2008 saw a continuation of the trend to a sharp decrease in inflation measured by the consumer price index (CPI). The year-on-year change rate in the CPI dropped by one point to 1.4%. It thus stood nearly four points below the annual high of 5.3% marked up in July. Since then there was a downward move thanks to the collapse in prices of oil and other commodities that had reached all-time highs. Furthermore, the correction in inflation also reflects the decrease in household consumption.

The stable core of inflation, so-called underlying inflation that excludes the more volatile components (energy products and fresh foods), dropped by 3 decimals in December to end the year at 2.4%, some 9 decimals less than at the end of 2007.

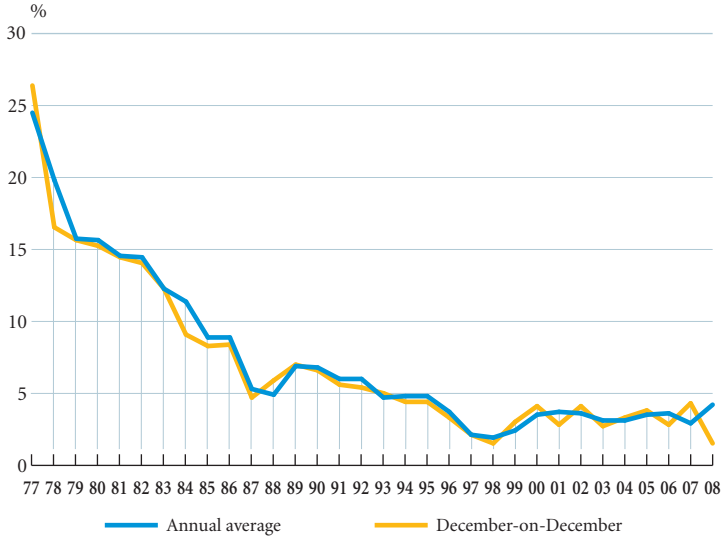
The annual change in the CPI at the end of 2008 was the lowest since 1998. Nevertheless, the average annual inflation rate for the whole year was 4.1% (higher than the 2.8% recorded in 2007) due to the sharp rise in the first half-year as a result of the jump in commodity prices.

By component, the annual change in fuels and fuel-oils was notable as they went from an annual rise of 14.4% in December 2007 to a drop of 12.9% at the end of 2008. Unprocessed foods also showed a sharp drop going from an

December 2008 saw continuation of sharp downturn in inflation thanks to drop in oil and other commodities along with dip in consumption.

INFLATION LOWEST IN PAST 10 YEARS BUT NOT ON ANNUAL AVERAGE

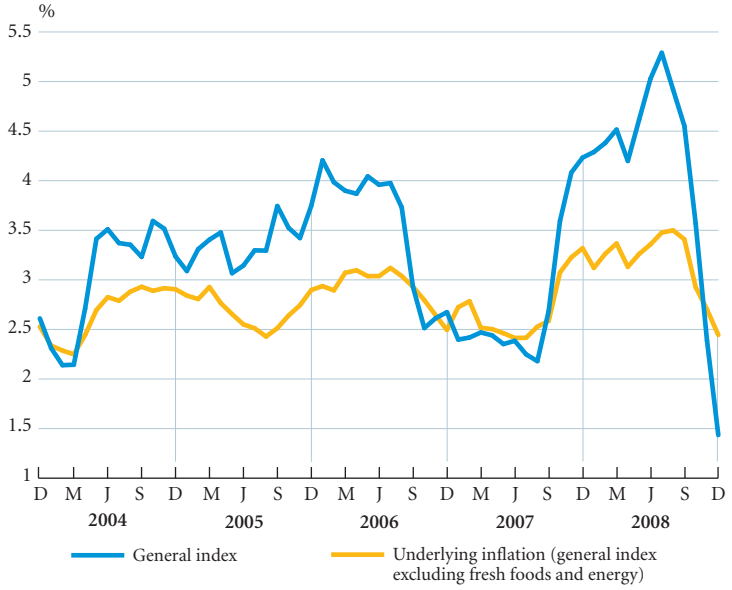
Annual change in general consumer price index



SOURCE: National Institute of Statistics and own calculations.

SHARP DROP IN INFLATION IN FINAL MONTHS OF 2008

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

Services up 3.8% in 2008, the same as in year before.

annual increase of 4.9% to 1.6% in the same period.

Prices of processed foods also eased to a notable degree thus reflecting the normalization of supply in international markets for farm commodities. The annual increase in prices of these foods stood at 3.0% in December 2008, some 4.3 points less than one year earlier.

Non-energy industrial goods continued to be well contained, thanks to strong pressure from international competition. Nevertheless, the annual increase rose slightly from 0.3% in 2007 to 0.4% in 2008 to which the depreciation of the euro in 2008 made its contribution. Nevertheless, prices of clothing and footwear eased from an annual rise of 1.2% in 2007 to 0.5% in 2008.

Services, which are more sheltered from outside competition, continue to show the persistence of inflationary pressures. The annual change rate for prices of services in December 2008 held at 3.8%, the same level as one year earlier. Among the more inflationary services in 2008, air transport rose by 15.7%, higher education was up 6.0% while domestic service moved up 4.8%.

The year 2008 saw a notable spread in annual inflation rates by autonomous community although the range went down to 1.2% for the most inflationary region (Ceuta) with 2.1% and the least inflationary (Castile-La Mancha) with 0.9%, as against a gap of 1.7 points in 2007. In fact, Ceuta had been the autonomous community city with least inflation in 2007. Apart from this case, nine autonomous communities showed inflation rate above the average in 2008, namely, the Basque Country, Melilla, La Rioja, Madrid Community, Catalonia, Canary Islands, Asturias, Aragon and Valencian Community.

The consumer price index harmonized with the European Union showed an

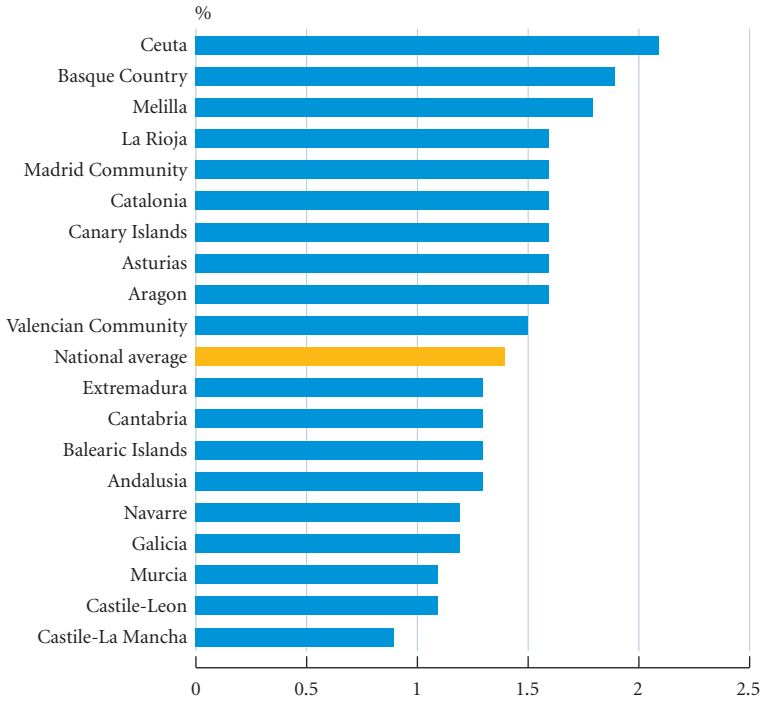
CONSUMER PRICE INDEX

	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	–0.5	1.4	1.4

SOURCE: National Institute of Statistics.

CASTILE-LA MANCHA WAS COMMUNITY WITH LEAST INFLATION IN 2008

Change in CPI between December 2007 and 2008



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

December

	Indices (*)	% monthly change		% annual change	
		2007	2008	2007	2008
By type of spending					
Food and non-alcoholic beverages	110.7	0.9	0.2	6.6	2.4
Alcoholic beverages and tobacco	111.8	0.1	0.0	6.1	3.9
Clothing and footwear	108.9	–1.0	–1.3	1.2	0.5
Housing	111.6	0.1	–0.5	4.8	5.9
Furnishings and household equipment	106.6	0.3	0.2	2.5	2.6
Health	98.8	0.1	–0.1	–2.1	0.3
Transport	99.5	0.8	–3.4	7.1	–5.6
Communications	99.6	–0.2	–0.5	0.8	–0.3
Recreation and culture	99.7	1.4	1.4	–0.8	0.3
Education	111.5	0.1	0.1	4.1	4.0
Restaurants and hotels	110.5	0.4	0.0	4.9	4.0
Other goods and services	107.6	0.2	0.1	3.0	3.5
By group					
Processed food, beverages and tobacco	111.1	0.4	–0.1	7.4	3.0
Unprocessed food	110.2	1.5	0.6	4.9	1.6
Non-food products	105.7	0.3	–0.7	3.4	1.1
Industrial goods	102.5	0.1	–1.7	3.1	–1.5
Energy products	*99.8*	*1.1*	*–5.8*	*11.5*	*–7.2*
Fuels and oils	*94.8*	*1.4*	*–7.9*	*14.4*	*–12.9*
Industrial goods excluding energy products	*103.2*	*–0.3*	*–0.5*	*0.3*	*0.4*
Services	109.0	0.5	0.3	3.8	3.8
Underlying inflation (**)	107.4	0.2	0.0	3.3	2.4
GENERAL INDEX	**106.9**	**0.4**	**–0.5**	**4.2**	**1.4**

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

Inflation differential with Euro Area becomes negative for first time sine 2001.

annual increase of 1.5% in 2008. As a result, the differential with the Euro Area was –0.1%, the lowest since 2001. It should be pointed out that the reduction of this differential was influenced by the heavier weight of fuels and lubricants in the Spanish shopping basket and by a lower participation in certain indirect taxes in Spain, which brings about greater sensitivity in the final sale price to decreases in prices at origin. The price of fuels and lubricants thus dropped 18.1% in 2008 in the Spanish harmonized CPI as against a drop of 15.4% in the Euro Area.

Prospects of further drops in inflation in coming months.

In spite of increases in regulated prices in January, the prospects are for further decreases in inflation in coming months. This tendency will likely continue until the summer when we could briefly see negative annual rate changes due to the effect of oil prices which would be compared with the highs reached in mid-2008.

Foreign sector

Foreign trade: deficit improving

In October 2008, the cumulative trade deficit since January amounted to 81.19 billion euros, thus maintaining the slowdown begun in recent months. Over a longer time-frame, the cumulative balance for 12 months shows a drop in the deficit since the high in June 2008, a month when it came to 104 billion euros. As happened in September, year-on-year growth of cumulative exports between January and October 2008 was higher than that of imports and showed an increase in export/import ratio to 66.4%, some 1.2 percentage points higher than for the same period the year before.

The trade deficit for the first 10 months of 2008 scarcely changed from the same period in 2007. This came about because of the improvement in the non-energy component. The reduction of the capital

Cumulative trade deficit has continued to drop since mid-2008.

FOREIGN TRADE

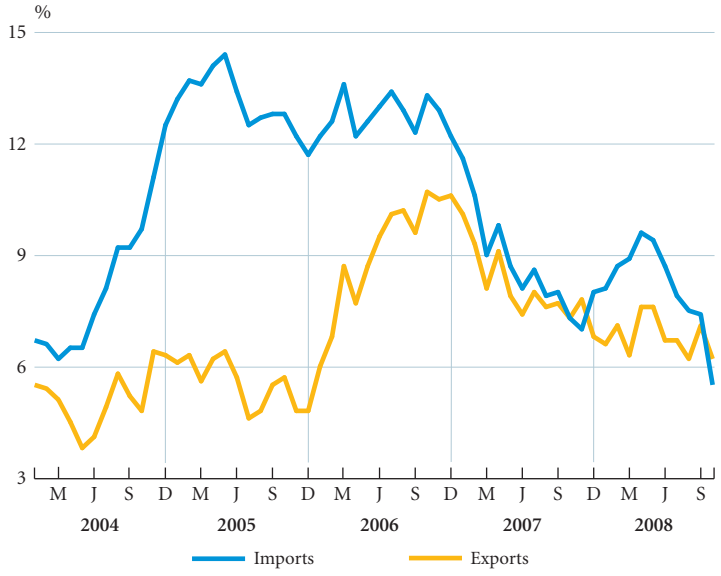
January-October 2008

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	49,717	48.3	20.5	10,068	59.6	6.3	–39,648	20.3
Consumer goods	59,390	–7.3	24.5	57,078	5.6	35.5	–2,312	96.1
Food	*13,299*	*2.4*	*5.5*	*18,294*	*8.0*	*11.4*	*4,995*	*137.6*
Non-foods	*46,091*	*–9.8*	*19.1*	*38,784*	*4.5*	*24.1*	*–7,307*	*84.1*
Capital goods	20,250	–15.2	8.4	13,759	0.6	8.6	–6,492	67.9
Non-energy intermediate goods	112,585	2.7	46.5	79,848	4.2	49.7	–32,738	70.9
By geographical area								
European Union	132,240	–2.9	54.7	111,423	5.2	69.3	–20,816	84.3
Euro area	*109,872*	*–3.7*	*45.4*	*88,918*	*4.2*	*55.3*	*–20,954*	*80.9*
Other countries	109,703	15.5	45.3	49,330	10.2	30.7	–60,373	45.0
Russia	*6,948*	*4.5*	*2.9*	*2,486*	*43.9*	*1.5*	*–4,462*	*35.8*
United States	*9,408*	*14.1*	*3.9*	*6,323*	*–1.1*	*3.9*	*–3,085*	*67.2*
Japan	*4,372*	*–14.6*	*1.8*	*1,227*	*9.4*	*0.8*	*–3,144*	*28.1*
Latin America	*13,477*	*9.3*	*5.6*	*7,796*	*–7.8*	*4.8*	*–5,680*	*57.9*
OPEC	*25,340*	*41.3*	*10.5*	*5,815*	*33.6*	*3.6*	*–19,526*	*22.9*
Rest	*50,158*	*12.1*	*20.7*	*25,682*	*13.0*	*16.0*	*–24,476*	*51.2*
TOTAL	**241,943**	**4.7**	**100.0**	**160,753**	**6.7**	**100.0**	**–81,190**	**66.4**

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

SHARP SLOWDOWN IN IMPORTS

Cumulative balance for last 12 months



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

Growth of imports almost entirely due to increased prices.

goods deficit and the non-food consumer goods deficit compensated the worse energy trade balance whose negative balance in the January-October period of 2008 rose by 12.43 billion euros (45.6% higher than in the same period the year before). Nevertheless, the monthly energy deficit continues with the downward trend begun in July 2008.

A detailed analysis of the cumulative trend in imports and exports in the first 10 months of 2008 shows significant differences in trend. The 4.9% increase in volume of exports was the main reason behind the growth in value of goods exported in this period (6.7%) while the remaining 1.8% was a result of increased prices of goods exported. On the other hand, the 4.2% rise in prices of imports was the main factor behind their increase in value (4.7%). The increase in price was largely due to the energy component which in the first 10 months of 2008 showed a price rise of nearly 30% year-on-year, mainly due to the increase in oil prices in the first half of 2008.

The trend in prices of energy products in the final two months of 2008, along with the course of demand for imported goods in the second half-year, allows us to expect very little growth of imports in nominal terms in 2008, thus allowing that the cumulative trade deficit in 2008 would be lower than that for 2007, thereby breaking away from the trend in the past five years.

Balance of payments: slowdown in current account deficit continuing

The current account deficit in October amounted to 7.86 billion euros, 12.9% lower that the figure for one year earlier, thus making it the fourth consecutive month to show a year-on-year reduction. As a result, the cumulative balance for the past 12 months was reduced from

BALANCE OF PAYMENTS

October

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–73,261	1.0	–90,547	–3,503	4.0
Services					
Tourism	*25,131*	*0.9*	*28,029*	*398*	*1.4*
Other services	*–3,608*	*–17.4*	*–4,899*	*114*	*–2.3*
Total	21,524	4.8	23,130	513	2.3
Income	–28,865	12.3	–34,679	–5,628	19.4
Transfers	–9,147	9.3	–7,514	1,007	–11.8
Total	**–89,750**	**4.3**	**–109,610**	**–7,611**	**7.5**
Capital account	**5,036**	**64.3**	**6,487**	**856**	**15.2**
Financial balance					
Direct investment	–854	–98.0	–6,626	47,085	–87.7
Portfolio investment	9,196	–91.0	11,289	–110,019	–90.7
Other investment	57,634	168.7	65,206	37,890	138.7
Total	**65,975**	**–16.9**	**69,868**	**–25,044**	**–26.4**
Errors and omissions	4,611	–	9,468	9,389	–
Change in assets of Bank of Spain	14,127	203.0	23,786	22,410	–

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.

June to October 2008. The reason for this improvement in the current account imbalance was the reduction of the deficit in the trade balance and transfers balance by 5.4 billion euros, well above the increase in the deficit in the incomes balance.

The increase in the cumulative deficits for 12 months in the current account balance and the capital balance in October 2008 was 6.75 billion euros compared with the same month the year before, the lowest since 2004, and this continues the slowdown that started in April 2008. As a result, the deficit continues to be reduced since the high reached in June 2008, thus generating a slight reduction in the need for foreign financing for Spain's economy.

Funding of the current account deficit is maintaining the pattern followed in recent months, quite different from that existing before the outbreak of the financial upsets in the summer of 2007. As a result, portfolio investments (shares, bonds, notes and mortgage certificates) have stopped being the main source of foreign financing, with a reduction in cumulative balance of 110 billion euros in the past 12 months compared with the same period the year before. This reduction was largely

Deficits in trade balance and transfers balance down 5.4 billion euros since June.

Portfolio investments show change in trend since June 2008.

compensated by lower net direct investment abroad and an increase in funding through short-term financial instruments (loans, deposits and repos) which meant nearly an 85 billion increase in foreign financing. Nevertheless, this process is losing strength given that since June 2008 the cumulative balance of funding through financial instruments dropped by 6.32 billion euros while net portfolio investment rose by 7.63 billion euros. This followed 15 months of constant reduction due to the fact that foreign investment inflows dropped less than Spanish investment abroad.

Public sector

General government deficit goes above 3% of GDP in 2008

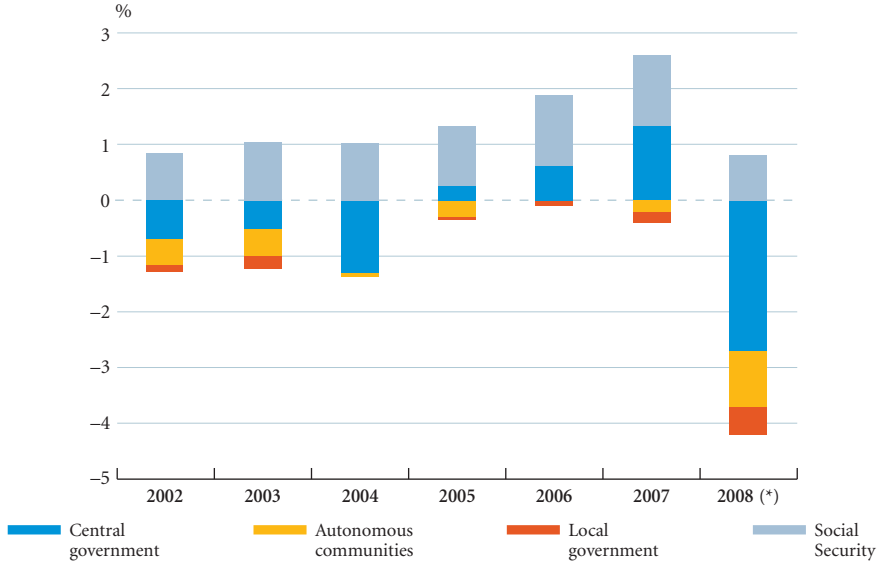
Within the framework of the updated 2008-2011 Stability Plan, the government made known the budget projections for 2008 which show a deficit for general government as a whole of 3.4% of gross domestic product (GDP). This figure goes above the 3% limit set under the Stability and Growth Pact of the European Union for the first time since Spain joined the euro. The sudden worsening of the public accounts, after having obtained a surplus of 2.2% of GDP in 2007, may largely be explained by the effects of the economic cycle on employment, company profits, consumption, investment, imports and increases in property but also by measures and regulatory changes affecting collections of the main taxes. Furthermore, on the spending side there has been an impact from the sharp rise in outlay for unemployment benefits and the progressive improvement in certain public services.

While the worsening of public finances was spread generally in 2008, the situation varies according to the level of government. The biggest change showed up in central government which went from a surplus of 1.3% of GDP in 2007 to a deficit of 2.7% of GDP in 2008.

Recessive situation and series of discretional measures bring sharp turnaround in government accounts.

ONLY SOCIAL SECURITY SHOWS SURPLUS IN 2008

Budgetary balance by level of government as percentage of GDP



NOTES: (*) Budgetary projection.
SOURCE: Ministry of Economy and Finance.

Direct tax collections drop by 2.1 percentage points of GDP in 2008.

The accounts of the autonomous communities were also sharply affected with their deficit going up by 8 decimals of the GDP to 1.0%. The balance of local government, also starting out from a deficit of 0.2% of GDP in 2007, showed less of a worsening by going to 0.5% of GDP. Finally, Social Security maintained a surplus but this was down by a half-point to 0.8% of GDP.

Government revenues were down by around 6% in 2008 mainly due to an annual drop of 12% in tax collections. As a result, the weight of government revenues in the GDP dropped by 4 points to 37%. Direct taxes were down 12% largely because of the discretional measures adopted. In fact, the effect of the reform of personal income tax and company tax dealing with partial payments and tax payable in 2008 is estimated to be of the order of 0.7% of GDP. Early deduction of up to 400 euros of personal income tax came to around 0.5%. The choice of two possible systems for calculating partial payments and the removal of tax effects of the new accounting regulations on calculation of partial payments of company tax meant around 0.3% of GDP. Altogether, these measures would represent around 1.5% of GDP as against an annual decrease of 2.1 points of GDP in direct taxes.

Collections for indirect taxes down 12% because of drop in consumption and decrease in real estate activities.

Indirect taxes also underwent a drop similar to the 12% annual in 2008 mainly because of the sharp drop in private consumption and the crisis in the real estate field which had been a substantial generator of government revenues in previous years. At the same time, the new special system for declaring value added tax which came into effect in January 2008 (under Law 36/2006 dated November 29), which makes it possible to compensate negative and positive balance resulting from balances settled between group entities, had an effect of around 0.3% of GDP. As a result, the participation of indirect taxes in GDP dropped by 1.9 points in 2008.

Another major revenue heading, social insurance contributions, while affected by the drop in employment, grew more than 5%. As a result, these managed to slightly increase their weight in the GDP to 13.1%.

On the other side of the balance sheet, spending in 2008 rose to mark up annual increase of 9%. In this way, its participation in the GDP moved up 1.5 points to 40.4%. There was a notable 13% increase in social transfers because of the increase in unemployment benefits and other matters such as 2,500 euros for the birth or adoption of a child, a factor estimated at 0.1% of GDP.

Spending moves up to 40.4% of GDP because of rise in unemployment benefits and improved public services.

The remuneration of public servants and purchases of goods and services rose by around 8% due to improvements in basic public services. Spending on interest was contained and its weight in the GDP dropped very slightly to 1.5%. Gross capital formation rose by closes to 6%. As a result, its participation in GDP rose by one decimal to 3.9%.

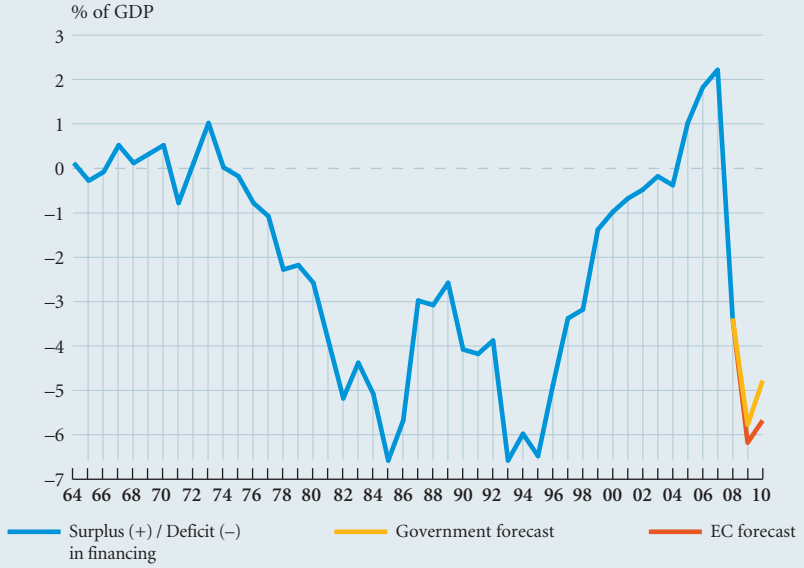
How high can Spain's general government deficit go?

In a very short time, Spain's public accounts have made a radical turnaround going from showing a surplus of 2.2% of gross domestic product (GDP) in 2007 to a deficit of 3.4% in 2008 while the European Commission is forecasting a deficit of 6.2% for Spain in 2009. What happened?

To understand this situation we need to put it into perspective. As of the mid-Seventies and in less than two decades the weight of the public sector in the economy doubled going above 45% of GDP in 1993. Revenues rose at a slightly lower rate so that part of the higher public spending was financed through deficits. Plans to move into the single currency and a favourable economic climate made it possible to correct the persistent deficit in the public accounts as of the middle of the Nineties. The improvement was due not only to the good state of the economy but it had a structural component arising from better control of the budget and efforts to contain and rationalize spending. As of 2005, for the first time since the institution of democracy in Spain, we saw the return of government surpluses. As a result of the good ordering of the public accounts, the weight of the general government debt in the economy was reduced to 36.2% of GDP in 2007, nearly half that in 1995 and substantially below the 60% limit set in the Stability and Growth Pact. This development was in contrast to the much less exemplary performance seen in other Euro Area countries.

SHARP RETURN TO DEFICITS

Budgetary balance of general government



SOURCE: Ministry of Economy and Finance and European Commission.

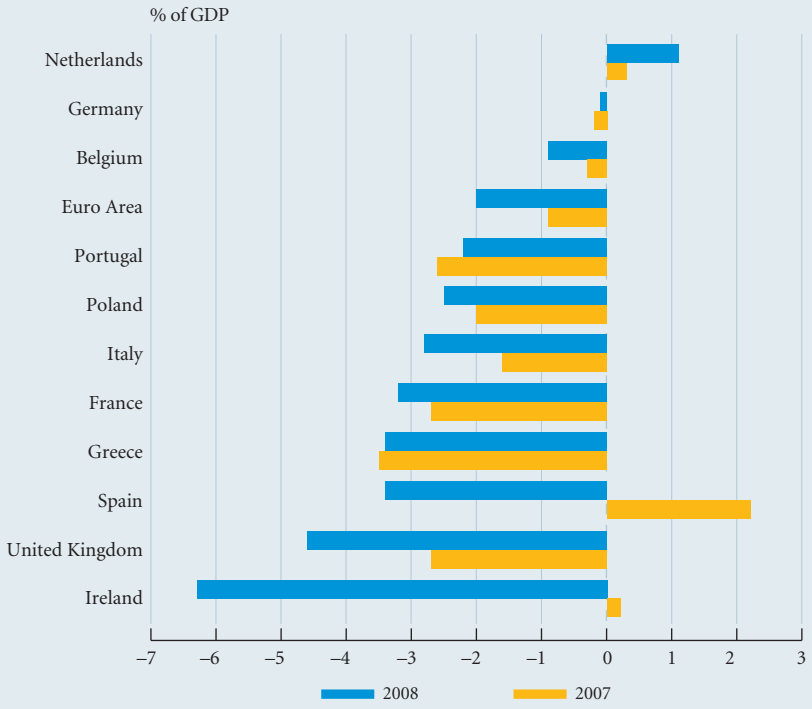
In 2007, there were prospects of a continuation of this trend. The 2007-2010 Stability Plan presented in December 2007 (scarcely more than a year ago) put forward a continuation of the general government surplus based on the supposition that growth of the economy would be in line with its potential. At the same time, the

surpluses brought demands for tax cuts or an increase in social spending. In 2006 a tax reform was thus approved reducing personal income tax and company tax. In 2007, a «baby cheque» of 2,500 euros was introduced along with a Dependency Law. In 2008 a new deduction was instituted amounting to relief of up to 400 euros in personal income tax. In 2009, removal of property tax will come into effect.

Nevertheless, the sharp drop in economic activity in 2008 had an immediate budgetary effect. The so-called «automatic stabilizers» were put into effect and they helped to ease the worsening of the economy but they had a negative impact on the public accounts. In fact, there was a drop in tax collections as a result of the decrease in employment, the dip in company profits, the easing off in consumption and the reduction of investment. At the same time, spending for unemployment benefits increased. As a result, the automatic stabilizers brought about an estimated contraction in the budget balance substantially above 2% of the GDP.

SHARP WORSENING OF GOVERNMENT DEFICITS IN EU

Surplus/deficit of general government in some EU countries



SOURCE: European Commission.

Furthermore, the government has tried to halt the recession through public spending which has involved severe pressure on the budget. The package of measures announced in November 2008 amounted to 11 billion euros, or 1.0% of the GDP. This included a notable figure of 8 billion euros for carrying out public works by local governments. The discretional measures as a whole, which as well as this public spending include the fiscal steps mentioned above, such as the 400 euros deduction on personal income tax, the tax reforms, the «baby cheque» and other moves, involve an estimated impact of approximately 3% of the GDP on the public accounts.

In a situation of recession such as this the prospects for the public finances are quite a problem and point to a rapid worsening of the government deficit. In spite of the fact that it starts out from a sound situation, the general government deficit in 2009 could go above 6% of the GDP. There even exists the risk that the automatic stabilizers and the measures taken to come out of the recession could put the government deficit at all-time high levels, going above those seen in the mid-Nineties. At the same time, in a short period the government debt could go up close to the limit set by the European regulation 60% of the GDP.

In fact, the European Union not only has shown a flexible attitude in view of the gravity of the present situation but has even favoured the adoption of budgetary stimulus measures due to the exceptional situation the European economic is undergoing. In any case, the accumulation of deficits in the form of government bonds means an increase in interest rate risk premium on those bonds (see box «Public deficit and interest rates: sustainability is the key»). In fact, in recent months there has been an increase in the yield differential of Spanish long-term government bonds in terms of German bonds to around one percentage point, the highest since Spain joined the Euro Area, although this has been a general movement in a context of risk aversion and the premium stands well below the levels reached in the mid-Nineties. If the recession is relatively short, these imbalances could be corrected over a reasonable length of time. If the recession lasts more than expected, the imbalance could move up to very high levels and become a heavy load for the Spanish economy as a whole during the recovery stages.

Savings and financing

New bank credit to companies and households in 12 months ending in November amounts to 120 billion euros.

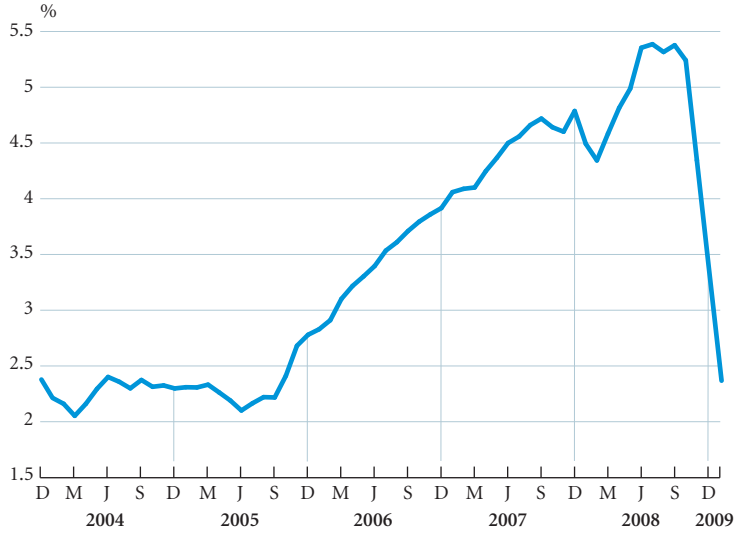
Drop in funding granted to companies gets sharper

The 12-month Euribor, widely used as a reference interest rate, made a sharp turn downward in December starting around mid-October. As a result, on monthly average it ended 2008 at 3.452%, a drop of 90 basis points, the same as the month before. In this way, the increase noted in the early months of that year (taking it to an all-time high of 5.4% in July) was turned around with the change in prospects for the official interest rate of the European Central Bank. As a result, the 1-year Euribor dropped by 134 basis points compared with December 2007. In the early weeks of January the downward move grew sharper and the 12-month Euribor stood at 2.38% at the end of the fourth week in the month due to the recessive situation in the Euro Area which continued to put downward pressure on interest rates.

November saw a sharper decrease in financing granted to the private sector so that the year-on-year change rate dropped to 6.7%, some 8 decimals less than in the previous month. If we look only at credit to companies and households, we note a similar annual increase of 6.9%. New credit granted in the past 12 months amounted to 119.90 billion euros, a drop of 55.7% from one year earlier. This situation may be

NOTABLE DROP IN 1-YEAR EURIBOR

12-month Euribor



NOTES: January 23.
SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

November 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	75,237	–15,605	–17.2	–12,736	–14.5	4.0
Secured loans (*)	1,105,760	37,388	3.5	47,129	4.5	59.2
Other term loans	527,356	29,473	5.9	30,019	6.0	28.2
Demand loans	53,387	12,815	31.6	11,278	26.8	2.9
Leasing	46,271	–22	0.0	660	1.4	2.5
Doubtful loans	59,460	43,209	265.9	43,554	273.8	3.2
TOTAL	**1,867,472**	**107,259**	**6.1**	**119,905**	**6.9**	**100.0**

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

explained by the weakness of demand in the present recessive situation and by some tightening of terms offered.

Funding to companies continued to grow at a higher annual rate than that to households but was rapidly losing strength. The annual change rate for funding granted to non-financial companies stood at 8.0% in November, 7 decimals less than one month earlier. Commercial credit used to finance working capital of companies continued to drop to the point where it showed an annual drop of 14.5%. Leasing, used to finance investments, continued to moderate and showed a year-on-year increase of only 1.4%.

Loans to individuals continued to drop going to an annual growth rate of 5.0%. Total loans for housing purposes rose by 5.1% compared with November 2007 as against an annual increase of 13.2% in December 2007. Demand for mortgage loans has contracted as a result of unemployment and downward prospects for housing prices. Other financing for households slackened off going to an annual increase of 4.5%.

The present economic situation that is weakening company sales and household incomes is also showing up in a rise in default. The default rate of all lending institutions rose to 3.2% in November, some 3 decimals more than in the month before.

Sharp drop in commercial credit to finance working capital of companies.

All-time net withdrawals from mutual funds in 2008

The average interest rate on private sector bank deposits dropped by 3 decimals in November to stand at 3.01%, thus reflecting the easing of monetary policy by the European Central Bank as of October. In any case, the average rate for deposits by companies and households stood at 32 basis points above 12 months earlier thanks to sharp competition to attract deposits existing among financial institutions faced with a complicated situation in wholesale markets.

Rise in unemployment and downward prospects for housing prices bring contraction of demand for mortgage loans.

Bank deposits continued to slow down in the existing recessive situation and showed year-on-year growth of 7.8%, in line with the Euro Area as a whole.

Deposits up to 2 years increase by 41% in past 12 months.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

November 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Overnight deposits (*)	417,040	–21,017	–4.8	–6,867	–1.6	29.7
Up to 2 years	484,745	132,039	37.4	140,008	40.6	34.6
More than 2-year term	390,721	–11,253	–2.8	–15,540	–3.8	27.9
Repos	68,961	–16,631	–19.4	–12,597	–15.4	4.9
Total	**1,361,467**	**83,138**	**6.5**	**105,003**	**8.4**	**97.1**
Deposits in currencies other than euro	**41,105**	**–2,739**	**–6.2**	**–3,656**	**–8.2**	**2.9**
TOTAL	**1,402,572**	**80,399**	**6.1**	**101,347**	**7.8**	**100.0**

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

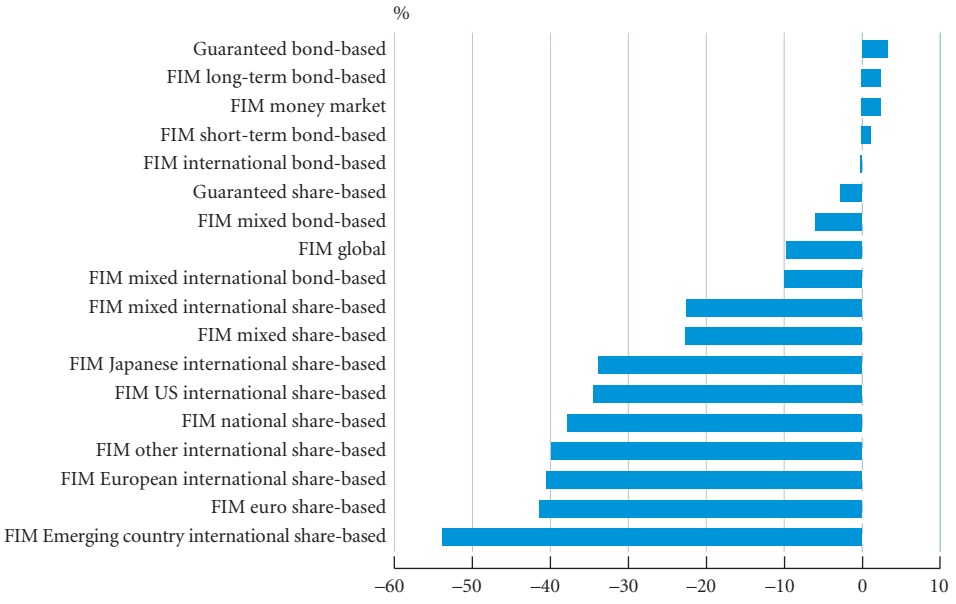
Savings rate of households on way to recovery.

Nevertheless, time deposits up to 2 years showed strong annual growth of 40.6% thanks to the fact that the return on time deposits was higher than that for other types of deposit although it saw a cut of 44 basis points in November when it went to 4.60%. The total of other types of accounts stood at lower levels than one year earlier.

In the third quarter the savings rate of households continued along the path of recovery begun in April-June that was brought about by the drop in

ONLY BOND-BASED AND MONEY-MARKET FUNDS SHOW CAPITAL GAINS IN 2008

Annual yield on mutual funds in 2008



SOURCE: Inverco and own calculations.

consumption and the increase in interest rates in the period. The savings rate of households thus stood at 9.6% of disposable income in the third quarter of 2008, some 5.1 points above the same period in 2007. If we look at the last four quarters, this rate has risen to 11.9% of disposable income, 1.1 points more than in the previous period. In coming quarters, in spite of the drop in nominal interest rates, it is likely that the recovery of household savings will continue, especially for reasons of caution in view of the rise in unemployment.

The increased household savings, however, did not end up in mutual funds which in December continued to record net withdrawals amounting to 2.72 billion euros, due to tough competition from bank deposits and the upsets in financial markets. In 2008 as a whole there were net withdrawals from mutual funds amounting to 57.65 billion euros, an all-time high. As a result, the assets of mutual funds dropped by 29.8% in 2008 going to 167.65 billion euros. Last year, the number of participants dropped by 25.6% to 6,147,542.

The poor performance in shares in 2008 had a negative effect on the yield on mutual funds which on average showed capital losses of 5.6%.

Nevertheless, in the past seventeen years average yield was 3.9% annual, above inflation during that period. Those showing up best were long-term bond-based funds and money-market funds which obtained yields above inflation at year-end. The bottom of the list this time was taken up by emerging country funds whereas in 2007 they had held the lead.

In December 2008, hedge funds continued to show property losses although to a lesser degree than in November. Nevertheless, at the end of the year hedge fund assets amounted to 1.38 billion euros as against 818 million at the beginning of the year which stands in contrast to the drop in this type of fund in international markets. These markets recorded their worst year in recent decades under the effect of the unfavourable trend in international financial markets and funding difficulties.

Finally, in December mutual funds showed a decrease of 1.1% in assets, putting the figure at 7.41 billion euros. In 2008 as a whole, assets dropped by 14.0%, thus reflecting the crisis in the real estate market. Average yield in the past 12 months was 0.7%. Nevertheless, over the past 10 years yield was 6.4% annual.

Hedge funds manage to increase assets in 2008 after two-year presence in Spanish market.

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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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