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THE SPANISH ECONOMY

Monthly Report

NUMBER 322

Deflation: a risk to keep in mind Page 10
The spectre of inflation appears in world's largest economies

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The two big central banks take different strategies to reactivate the economy

Is there a risk of deflation in 21st century Spain? Page 62
The possibility is far off although low inflation could help restore competitiveness

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2007	2008	2009	2008				2009	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	2.0	1.1	–1.7	2.5	2.1	0.7	–0.8	–1.4	–2.4
Japan	2.4	–0.7	–3.2	1.4	0.6	–0.2	–4.6	–5.2	–4.3
United Kingdom	3.0	0.7	–2.5	2.6	1.7	0.3	–1.9	–2.9	–3.2
Euro area	2.6	0.9	–2.0	2.1	1.4	0.6	–0.5	–1.7	–2.4
Germany	*2.6*	*1.0*	*–2.3*	*2.8*	*2.0*	*0.8*	*–1.7*	*–2.1*	*–2.8*
France	*2.1*	*0.6*	*–1.7*	*2.0*	*1.2*	*0.6*	*–1.0*	*–1.9*	*–1.9*
Consumer prices									
United States	2.9	3.8	–1.2	4.1	4.4	5.3	1.6	–0.6	–2.2
Japan	0.1	1.4	–0.8	1.0	1.4	2.2	1.0	0.6	–0.3
United Kingdom	2.3	3.6	1.4	2.4	3.3	4.9	3.9	1.7	1.3
Euro area	2.1	3.3	1.0	3.4	3.6	3.8	2.3	1.2	0.8
Germany	*2.3*	*2.6*	*0.8*	*2.9*	*2.9*	*3.1*	*1.6*	*0.8*	*0.6*
France	*1.5*	*2.8*	*0.9*	*2.9*	*3.3*	*3.3*	*1.8*	*0.9*	*0.5*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	3.4	0.1	–2.6	2.0	0.8	–0.2	–2.3	–4.3	–2.8
Government consumption	4.9	5.3	4.3	3.7	5.0	6.1	6.3	5.2	4.8
Gross fixed capital formation	5.3	–3.0	–12.3	2.4	–0.8	–4.1	–9.3	–12.4	–15.5
Capital goods	*10.0*	*–1.1*	*–13.0*	*5.2*	*1.8*	*–1.3*	*–9.7*	*–13.0*	*–13.0*
Construction	*3.8*	*–5.3*	*–14.5*	*0.2*	*–3.1*	*–7.3*	*–10.9*	*–14.1*	*–19.6*
Domestic demand (contribution to GDP growth)	4.4	0.1	–4.2	2.6	1.2	–0.2	–3.0	–5.2	–5.2
Exports of goods and services	4.9	0.7	–6.2	4.8	4.4	1.5	–7.9	–11.6	–6.9
Imports of goods and services	6.2	–2.5	–11.2	3.6	1.8	–2.0	–13.2	–18.4	–13.2
Gross domestic product	**3.7**	**1.2**	**–2.3**	**2.7**	**1.8**	**0.9**	**–0.7**	**–2.2**	**–2.8**
Other variables									
Employment	2.9	–0.6	–5.0	1.6	0.1	–0.9	–3.1	–5.1	–5.6
Unemployment (% labour force)	8.3	11.3	17.6	9.6	10.4	11.3	13.9	16.6	17.4
Consumer price index	2.8	4.1	0.5	4.4	4.6	4.9	2.5	0.6	0.1
Unit labour costs	2.9	3.4	–0.3	4.2	3.6	3.4	2.6		
Current account balance (% GDP)	–10.1	–9.5	–8.0	–12.1	–9.5	–8.7	–7.9		
Net lending or net borrowing rest of the world (% GDP)	–9.7	–9.1	–6.5	–11.2	–9.0	–8.4	–7.6		
Government balance (% GDP)	2.2	–3.8	–7.8						
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	5.0	2.0	0.3	3.2	2.1	2.0	0.9	0.3	0.3
ECB repo	3.8	3.9	1.4	4.0	4.0	4.2	3.4	1.9	1.3
10-year US bonds	4.6	3.6	3.0	3.6	3.9	3.8	3.2	2.8	3.1
10-year German bonds	4.2	4.0	2.9	3.9	4.3	4.3	3.5	3.2	2.9
Exchange rate									
$/Euro	1.37	1.48	1.28	1.50	1.56	1.51	1.34	1.31	1.28

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Fear of deflation

Inflation rates in most advanced countries have dropped to lows that have not been recorded for many years. This is a development in keeping with the recession now affecting the world economy. In fact, in periods of cyclical contraction we can expect a decrease in inflation. Up this point then there is nothing to report. However, the forecast that inflation rates are going to move into negative ground in coming months, along with concerns that the recession could be deeper and last longer than expected has set off a fear of deflation. Specifically, the fear is that there could be a spiral with a general decrease in prices of goods and services combined with a prolonged period of stagnation or recession. Last century left behind very few historical records of a phenomenon of this kind in what are currently considered the developed economies. But those that occurred were significant – the United States in the Thirties and Japan in the Nineties.

To speak of deflation we have to dig deep into the past. Since the middle of last century the big concern of economic policy has been inflation. And even before then, many historians attribute the rise of Nazism and subsequently the cause of World War II to Germany's hyperinflation in the Twenties. Both phenomena, inflation and deflation, finally have the same monetary origin. Up until the early decades of the 20th century, money in circulation was controlled by the precious metal standard, either gold or silver. With the progressive substitution of the precious metal standard by the fiduciary issue backed by a national central bank, the volume of money in circulation lost its link with precious metal reserves. Discretionary power in monetary management often resulted in an excess of money supply which until very recently brought about firm inflationary prospects.

But, if inflation was so bad, why is deflation likewise so bad? For a number of reasons. It tends to delay consumption and investment decisions. If such and such a product will have a lower price tomorrow, why buy it today? It increases the real value of debts which brings about pressure on those in debt that may result in an increase in losses and bankruptcies. In a deflationary situation, the price of assets tends to decrease which reduces the value of loan guarantees and therefore increases the losses of financial institutions through default. This means lower availability of credit and less economic activity. Furthermore, as wages show downward rigidity, company margins grow narrower which brings about less investment and less employment. One more evil is the «liquidity trap» into which one can fall when the central bank cuts its rates to the maximum (as low as 0%) so that the best asset to invest in is cash, which carries no risk and has positive real profitability. Finally, persistent deflation is closely linked to a prolonged economic depression, something that Japan well knows.

In any case, we should say that at this moment the risk of a deflationary spiral is a long way off. Firstly, because foreseeable negative rates for consumer price indices in coming months are only the result of the effect of the collapse in oil prices since last summer whereas underlying inflation (the more stable core of inflation) is showing positive rates. In this respect, it is hardly worth talking about deflation. Secondly, because, in the face of the recession in the advanced economies, monetary and fiscal policies have been firmly set in motion, having very much in mind the lessons learned from the Great Depression and from Japan. With this baggage, we may be confident that deflation will continue to be a chapter in the history books.

EXECUTIVE SUMMARY

A different recession

Nature of current recession hard to compare with previous episodes because it began with a world financial crisis.

In recent decades the economy has been characterized by a tendency to increase the volume of the gross domestic product (GDP), that is, of the total goods and services produced in a specific period. But this growth constitutes a trend over the medium or long term. Over the short or medium term economies suffer from fluctuations for various reasons. Economists use the term «business cycle» to describe these swings. If the economy stops growing for two consecutive quarters, we talk of recession, according to the most accepted conventional definition. There is no doubt that at this moment most of the main world economies must be termed «in recession».

Fourth quarter of 2008 results show troublesome panorama in terms of growth, international trade and industrial production.

But we are not faced with any old recession. It was set off largely by a financial crisis which, according to historical experience, makes the matter more serious. But it was not a financial crisis of a local or regional type as has normally been the case. We are faced with a financial crisis of world dimensions. With the exception of the Great Depression in the Thirties of last century there is no comparable historic experience. Certainly, the strong response by the economic authorities has no precedent and this brings in a different factor, this time a positive one.

Barack Obama launches three initiatives to deal with crisis...

In the meantime, the economic figures churn out their round of misfortunes. GDP growth figures for the fourth quarter of last year, which became known in February, have caused considerable alarm. In quarter-on-quarter rate, the figure in the United States dropped by 1.6%, while in the Euro Area it was down 1.5% and in the United Kingdom the drop was 1.8% with 3.3% in Japan. A number of Asian economies, especially Thailand, South Korea, Taiwan and Singapore lost around 5%, the same as Brazil. In the developed economies, the collapse of confidence and darkening expectations battered domestic demand. In those economies more oriented toward international trade, the sudden slump in trade in the fourth quarter meant a substantial reverse. Exporters of commodities saw their profits evaporate because of the collapse in prices. Those countries that depended on international financing are suffering from a sudden interruption of investment flows. In all countries, production and order books of industrial companies are showing unheard of slumps or situations not seen for many years.

In the United States, the much awaited swearing-in of the new president Barrack Obama has not managed to clear up the economic picture. This is not for any lack of action by the new Administration. In just a few weeks in office, he has adopted three transcendental initiatives. The first, the fiscal stimulus plan (787.8 billion dollars), was aimed at reducing taxes, or for transfers and direct spending for investment in alternative energy, water, education and health.

The second initiative was a plan for aid to families to help pay mortgages, which includes additional funds for the

mortgage insurers Fannie Mae and Freddy Mac and economic incentives for banks that ease conditions on existing mortgages. Finally, the third move was the plan for financial stability, a new attempt to shore up the faltering US financial system.

This extensive array of moves did not impress the markets. The lack of details on the financial plan in such aspects as the evaluation of «toxic assets», questions about the plan's start-up and the possibility that the government might end up opting for nationalization of one or more banks could be the reason for the harsh punishment meted out to the financial sector in the stock markets in February. But practically all shares were dragged down with drops on the US stock market that were of the order of 15% so far this year.

While the recession continues to spread its shadow over the economy it will be difficult for the markets to recover their calm. In the United States, the origin of the recession, the bursting of the real estate boom, shows little sign of touching bottom. The drop in home prices has now reached 28% in terms of the high in June 2006. Housing developer confidence is at a low level and the supply of houses is still dropping. In December there were 466,000 housing starts in annual terms, a new all-time low that represents barely one-fifth of those built in 2006.

In Japan, the poor figure for the GDP mentioned earlier has much to do with the drop in exports (down 13% year-on-year in the fourth quarter) and the sharp decrease in capital goods investment (11.1% year-on-year). The drop in industrial production of 22.5% year-on-year in December has no equal since World War II. On the demand side, the picture is not much better given that consumer confidence in the fourth quarter again marked up a new all-time low and car sales continue to drop with a decrease of 28.0% year-on-year in January.

...but stock markets report new drops because of financial situation.

In the Euro Area, the indicators leave no doubt that the slowdown in the economy is widespread. On the demand side, retail sales, for example, were down in December for the seventh month in a row. Industrial production seems to be in free-fall state reaching 12% in December. The utilization of industrial capacity, which usually runs between 80% and 85%, in just one quarter fell from 81.5% to 75%. Our forecasts indicate a drop of 2% in GDP in 2009.

In the fourth quarter of 2008, the German economy, the main engine on the Continent, suffered from the biggest blow since reunification with a 2.1% quarter-to-quarter drop in GDP, thus heading the decreases among the main Euro Area economies. Why was the drop in Germany's GDP higher than the rest of the European countries? In large measure, the German economy depends on foreign trade. Some 75% of Germany's exports in 2008 went to other European countries and, of these, a fifth went to economies of Eastern Europe. The sharp downturn in the economies of the European Union (EU), including those of Eastern Europe, in the final quarter of 2008 lay behind the trend in German exports.

Japan suffering direct consequences of slump in world trade.

Some of the Eastern European economies of the EU (the Baltic countries, Romania, Bulgaria and Hungary) stand in a very difficult situation due to their dependence on demand from the EU, now in recession, and especially for having based their high growth in recent years on foreign funding that now has suddenly dried up because of the world financial crisis. In some countries, this reality is made worse by the fact that a considerable part

Europe undergoes contraction of growth in fourth quarter while difficult situation in some East European countries adds new concerns.

Spain moves into recession for first time since 1993.

of household and company debt is expressed in foreign currency which, due to sharp devaluation of national currencies, raises growing default risks and has a negative effect on the spending capacity of economic agents.

Spain's economy is not escaping from the recessive international scene. In 2008, the GDP grew by 1.2% (against an increase of 3.7% in 2007). The slowdown in economic activity, however, became sharper as the year wore on and in the final quarters we came to see increasingly negative growth rates (at 1.0% in the fourth quarter). According to the conventional definition mentioned above, in the second half of the year the economy moved into recession thus putting an end to a long period of growth that began after the 1993 recession. In any case, both for the year as a whole and for the final quarter, GDP growth in Spain was higher than that in the Euro Area and that in the European Union as a whole.

Domestic demand contracting because of drop in spending by households and companies.

The sharp slowdown in demand meant that its contribution to GDP growth dropped from 4.3 points to a miserable 0.1%. This drop was partly due to household consumption (its main component) which marked up annual increase of 0.1% (growth of 3.4% in 2007). In the final quarter, household consumption reported a year-on-year drop of 2.3%, the biggest decrease since the second quarter of 1993, the result of a sharp rise in unemployment and the cooling down of household confidence in the immediate economic future. We should point out that Spain's unemployment rate is the highest in the 30 economies forming the Organization for Economic Cooperation and Development (OECD).

GDP to contract more than 2% in real terms in 2009 but downturn will ease as of second half-year if financial conditions normalize.

Domestic demand was also halted by investment. This dropped by 3.0% in 2008 (after having risen by 5.3% the year before) under the effect of weak domestic and foreign demand and the drop in corporate profits. Still greater was the drop in construction investment of 5.3% for the year and 10.9% in the last quarter, marking up the biggest drop in recent decades and beating the biggest year-on-year drop of 8.2% in the previous recession that took place in the second quarter of 1993. This was mainly due to the drop in housing investment that reached 19.6% in the last quarter of 2008 which came with the real estate market crisis that reported price drops and a slump of 28.6% in housing sales.

On the other hand, the foreign sector contributed one point to GDP growth in 2008 as against subtracting 8 decimals in 2007. This was due to the fact that imports of goods and services slowed much more than exports to the point where they were down 2.5%. As a result, the deficit, that had shown a high of 9.7% of GDP in 2007, went down by 6 decimals in 2008.

Prospects point to a drop of more than 2% in Spain's real GDP in 2009. This trend is the result of an analysis of those tendencies related to the sharp slowdown in national demand, with major decreases in investment, both in construction and capital goods. Household consumption will also keep contracting although to a much lesser extent than investment. On the other hand, the contribution to GDP growth from the foreign sector will increase to two percentage points. While the recession is still sharp in the first quarter of the year, we foresee a brake being put on the downturn as of the second half when the adjustments in the industrial and real estate sectors have reached their peak, with the expansionist effect of fiscal policy coming into play in a context of price moderation, as well as counting on the progressive normalization of financial conditions.

February 26, 2009

CHRONOLOGY

2008

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 enlargement of **Euro Area** with entry of Slovakia making total of 16 member states.
	15	**European Central Bank** lowers official interest rate to 2.00%.
	20	Barack Obama sworn in as **President of the United States**.

AGENDA

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** HCPI flash estimate (March).
- **31** Balance of payments (January).

April

- **2** Registrations with Social Security and registered unemployment (March).
  Governing Council of European Central Bank.
- **3** Industrial production index (February).
- **15** CPI (March).
- **16** Harmonized CPI for EU (March).
- **22** Foreign trade (February).
- **23** Producer prices (March).
- **24** Labour Force Survey (1st Quarter).
- **28** Central government revenue and spending (March).
  Fed Open Market Committee.
- **29** Retail sales (March).
- **30** HCPI flash estimate (April).

INTERNATIONAL REVIEW

United States: how much aid will be needed?

Fiscal stimulus of 788 billion dollars to be spread over next three years.

President Obama's fiscal stimulus plan is now taking shape. Agreement between Congress and Senate put the total figure at 787.8 billion dollars. Of this total, 211.8 billion dollars will go into tax cuts. Added to these are 267 billion dollars in transfers, among which are tax rebates amounting to 73.8 billion dollars. The biggest heading is 309 billion dollars in direct spending which includes 51 billion dollars for alternative energy and water and 71 billion dollars for education and health. The effects of these measures will begin to be felt in 2009 but the biggest effect will be in 2010 and, to a lesser extent, in 2011.

On top of the fiscal stimulus plan, the White House approved an aid plan for households to pay their mortgages. The plan includes additional funds to the mortgage loan insurers Fannie Mae and Freddy Mac, at 100 billion dollars each. It also includes economic incentives (up to 1,000 dollars) for banks that ease existing mortgage terms. In addition, if the change brings about punctual meeting of payments, banks may receive up to 1,000 dollars annually for three

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008						2009	
			1Q	2Q	3Q	October	November	December	January	February
Real GDP	2.0	1.3	2.5	2.1	0.7	–	–0.2	–	–	...
Retail sales	4.2	–0.5	3.1	2.6	0.6	–5.1	–8.4	–10.5	–9.7	...
Consumer confidence (1)	103.4	58.0	76.5	57.3	57.3	38.8	44.7	38.6	37.7	25.0
Industrial production	1.7	–1.8	1.9	0.2	–3.0	–4.3	–5.9	–8.2	–10.0	...
Manufacturing (ISM) (1)	51.1	45.5	49.5	49.1	47.4	38.7	36.6	32.9	35.6	...
Sales of single-family homes	–26.8	–37.6	–33.1	–39.1	–36.7	–43.8	–38.3	–44.8	...	...
Unemployment rate (2)	4.6	5.8	4.9	5.4	6.1	6.6	6.8	7.2	7.6	...
Consumer prices	2.9	3.8	4.1	4.4	5.3	3.7	1.1	0.1	0.0	...
Trade balance (3)	–700	–677	–699	–702	–712	–713	–695	–677	...	...
3-month interbank interest rate (1)	5.3	2.8	3.0	2.8	3.2	3.0	2.2	1.4	1.2	1.2
Nominal effective exchange rate (4)	77.9	74.4	72.0	70.9	73.5	80.4	82.7	80.7	81.0	82.4

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

years. In addition, those households that meet their mortgage payments may be rewarded with a reduction of up to 1,000 dollars a year on their outstanding debt for a period of five years.

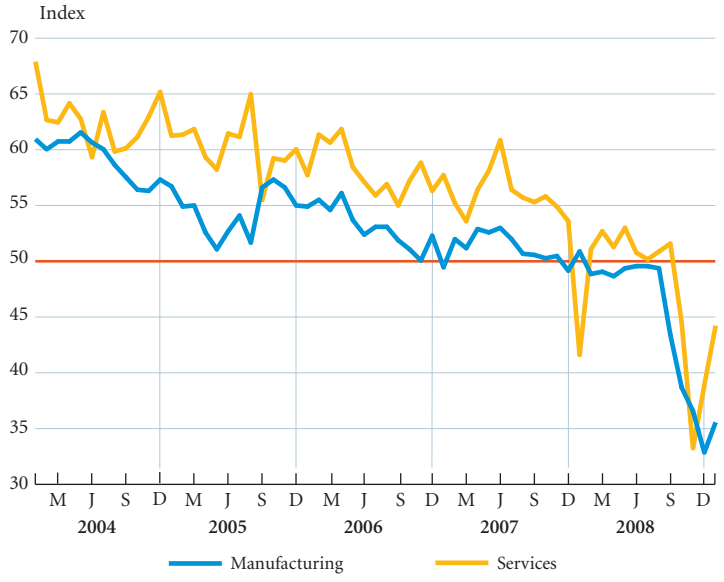
The biggest doubt, however, is not about the value of these measures but whether they are sufficient. The year 2009 will inevitably be a year of downturns and there are doubts about recovery in 2010. On top of an economy in recession, with the gross domestic product (GDP) for the fourth quarter showing a drop of 3.8% quarter-on-quarter annualized, there has come a drastic reduction in world trade flows. The biggest problem will be to reactivate private consumption that began the recession with a high level of debt. The necessary recovery of savings will mean that many of these aids will go into savings and not into reviving consumer buying. In addition, there is the question of financing these aids in an economy that is already showing a foreign deficit and finds itself in a situation of world recession.

Consumer feeling is a good reflection of these difficulties. In January, the consumer confidence index of the Conference Board again showed a new all-time low for the 40 years this indicator has existed with a drop from 38.0 points to 37.3 points, while there was also a continuation of the worsening perception of the present situation. Retail sales in January, however, showed a better than expected performance with the first month to report month-on-month increases, although modest, after five months of decreases in a row. The recovery took place in food and consumer electronics while construction materials continued to drop. Even so, excluding the volatile figures for cars and petrol, retail consumption was down 2.7% compared with the year before.

Aid will also help reduce mortgage loan default.

UNITED STATES: CORPORATE VIEW MOVES ABOVE MINUMUM LEVELS

Level of ISM indices (*)



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

Business executives remain pessimistic especially on employment.

Exhibiting even greater weakness, the combined sale of passenger cars and four-wheel-drive vehicles was 655,000 units, the lowest in the last 30 years.

According to the business activity index of the Institute for Supply Management, corporate opinion held to this scenario of deep recession although it recovered from all-time lows. The manufacturing index rose from 32.9 points to 35.6 points although this was still well below the balance level of 50.0 points considered the threshold indicating risks of a recession. In turn, the services index reported a second consecutive month with increases going from 38.9 points to the level of 44.2 points. In both cases, the weakness in employment persisted and in manufacturing new orders were weak.

Construction fails to hit bottom while prices add up decrease of 27%.

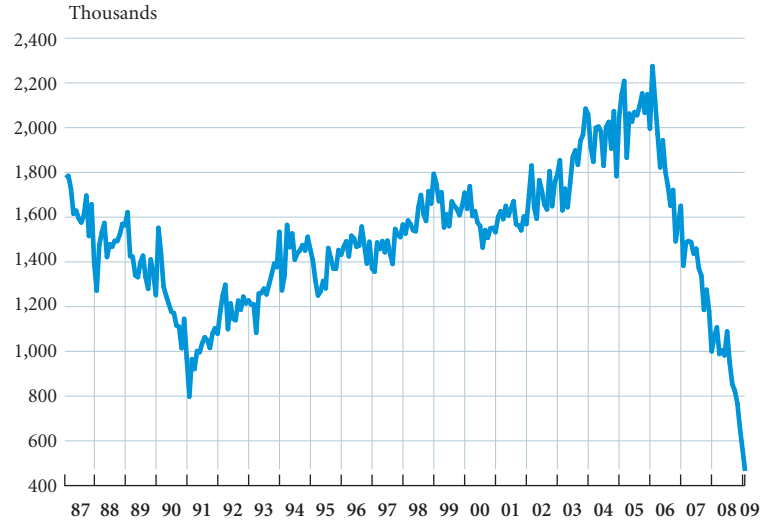
Housing has still not hit bottom. On the demand side, the price of real estate continues to worsen the property situation of households. The Case-Shiller index for December showed sharper decreases and reported a drop of 28.3% compared with the high in June 2006 which, if we consider the increases in CPI, stood at 31.6%. On the demand side, confidence among developers stands at a low ebb and the correction in housing supply seems to have no bottom seeing that, in annual terms, there were 466,000 housing starts in December, a new all-time low that is barely a fifth of those built in 2006. The only positive note was that in December sales recovered the background of stability seen in previous months although this was at the expense of a decrease in prices and an increase in repossessions.

Labour market gloom gets worse with 3.6 million jobs lost since January 2008.

If it is housing property that determines the wealth of households, the labour market determines a large part of their income and it is here that the situation also keeps getting worse. Some 598,000 non-farm jobs were lost

UNITED STATES: WORST HOUSING RECESSION IN MANY YEARS

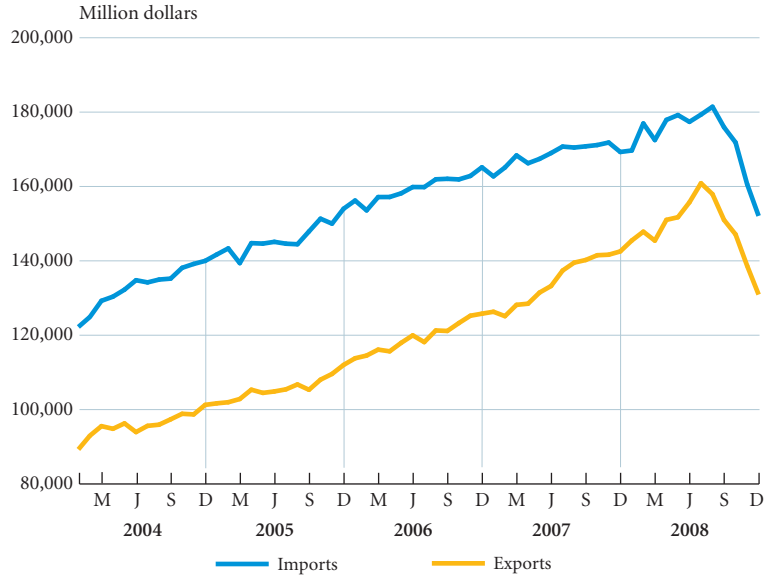
Housing starts in annual terms



SOURCE: Federal Housing Board, National Association of Realtors and own calculations.

UNITED STATES: SHARP REDUCTION IN TRADE FLOWS

Monthly value of exports and imports excluding oil



SOURCE: Department of Commerce and own calculations.

in January. As a result, since January 2008, when the decreases began, 3,572,000 jobs have been lost, a record drop in absolute terms. The unemployment rate in January also reflected this situation in going up to 7.6% of the labour force, the highest in the past 15 years.

On the prices front, the general consumer price index (CPI) in January remained unchanged from the same period last year. The dangers of inflation some months ago have thus changed into the risk of deflation. Nevertheless, the situation in this respect would be set by the underlying index (the general index excluding food and energy) which slowed to 1.7% in year-on-year terms. In 2009, the CPI will have some months with year-on-year decreases but real deflation will show up in the underlying index, discounting swings in oil. In this respect, deflation seems somewhat far off if we take into consideration short-term figures month by month, seeing that the January CPI rose in terms of December thus breaking with five months of consecutive decreases.

Inflation hits zero because of swings in oil.

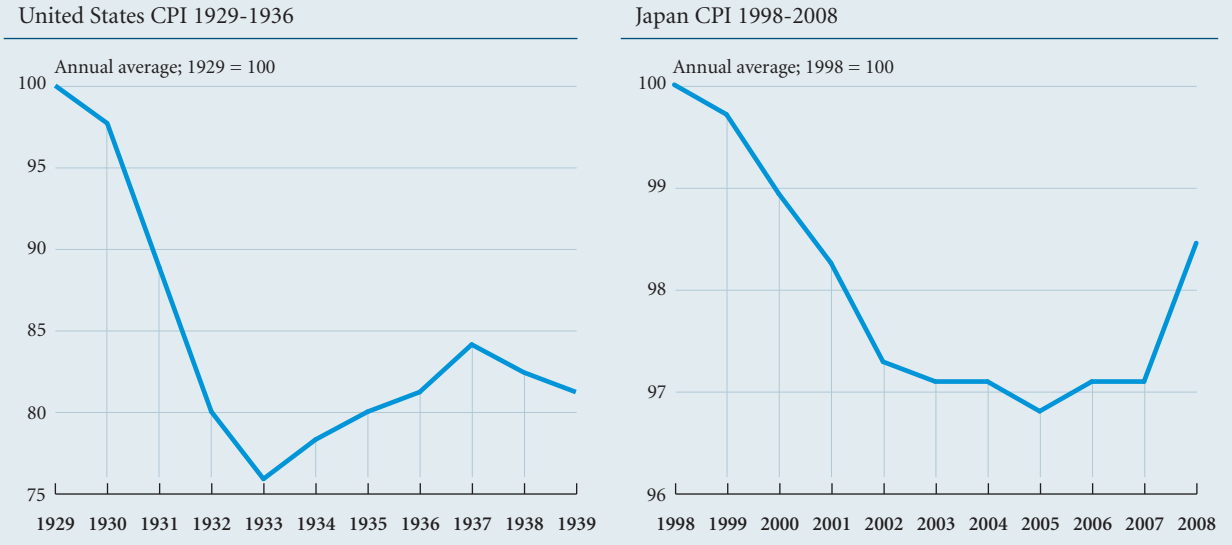
The foreign sector continues to be a concern, not for the continuing deficit but rather because of the reduction in trade mentioned above, partly because of the crisis in loan markets and resulting caution, which leaves suppliers unprotected against customer failure to pay. The trade deficit in goods and services continued to decrease in December going to 39.93 billion dollars, well below the 56.69 billion dollars in October. The problem is that exports stood 11.7% below the level two months earlier and were compensated by a bigger reduction in imports, where the lower oil bill made the difference.

Trade deficit corrected at expense of drop in trade.

Deflation: a risk to keep in mind

The inflation rate in the largest world economies –United States, Japan and the Euro Area– will move into negative territory in 2009. While the main reason for this drop will be the collapse in the price of oil and, therefore, it is expected that inflation will turn positive toward the end of the year, there is the risk that in a situation of weak demand the general level of prices could begin a longer process of decreases. The experience of the United States in the Thirties, when the CPI fell by 24% between 1930 and 1933, is no doubt unrepeatable (the errors of those days have been well noted) but even gentler deflation along the lines of Japan in the Nineties would make the recession longer and deeper.

DEFLATION EPISODES (MORE SERIOUS AND LESS SERIOUS)



SOURCE: United States Department of Labour and Datastream.

In general, the most usual cause of a deflation process is a major drop in aggregate demand brought about, for example, by the bursting of an asset bubble, a financial crisis or an increase in uncertainty for geopolitical reasons. The drop in economic activity behind this contraction in demand tends to reduce the inflation rate, which may become negative, especially if it starts out from levels not far from zero. In fact, the inflation rate objectives of the central banks are not so low precisely to reduce the probability of moving too easily into negative inflation rates.

Faced with weakness in demand and the risk of deflation, monetary policy responds by cutting interest rates but there is a limit to this: Nominal interest rates cannot drop below zero. Who is going to lend money at a negative interest rate if the alternative, keeping that money in cash, pays a nominal return of zero? The problem is that although the nominal interest rate is zero, the real interest rate is positive if the prospects are for deflation and this could stand in the way of a recovery of aggregate demand. Often, overcoming a recession requires negative real interest rates in order to sufficiently stimulate consumption and investment.

Zero rates and deflation may give rise to a so-called «liquidity trap», a situation in which the best asset to invest in is cash, an asset with no risk and high real profitability.

Deflation has a harmful impact on economic activity in a number of ways. First, it raises the real value of debts, which causes an increase in default and bankruptcies. Furthermore, in a deflationary context, the price of assets also tends to drop, which reduces the value of loan guarantees and therefore increases the losses of financial institutions related to nonperforming loans. Faced with this situation, banks increase the risk premium they collect for their loans and reduce the availability of credit, which makes the recession worse. A deflationary situation also pushes up real wages if these are sticky in nominal terms, which brings about heavier jobs losses and prolongs the recession. Worsening of the recession increases deflation and may bring about a deflationary spiral that is difficult to stop.

To escape from the liquidity trap and end a situation of deflation is not easy. Once the nominal interest rate has gone down to zero the only way to reduce the real interest rate is to increase expectations of inflation. If the monetary authority is able to convince the economic agents that inflation will return to a positive level, even higher than the central bank objective in normal times, the subsequent drop in the real interest rate would contribute to revive demand, come out of the recession and end deflation. Of course, the economic agents do not have much confidence in a central bank that promises more inflation when its usual message has been the opposite. In the words of Paul Krugman, the challenge for the central bank is «to credibly promise to be irresponsible»[1] The recent publication by the Fed for the first time in its history of a sort of long-term inflation objective (2%) can be interpreted as proof of the importance of a central bank's communications policy at a time of deflation risk.

The central bank can reinforce its promises of a return to inflation through specific measures. One possibility, even with interest rates at zero, is to generate sharp growth of the money supply (see box «The Fed and the ECB: two strategies and one problem – deflation») which sooner or later will increase price levels (after all, as Milton Friedman said «inflation is always and everywhere a monetary phenomenon»). One of the risks with this strategy is that the central bank actions may get out of hand and generate too much inflation. Another possibility for the central bank is to intervene to reduce long-term interest rates, for example, by buying government bonds. A third way, related to the other two, would be to contribute to financing an expansionary fiscal policy. In fact, the Fed is now using these three alternatives to fight the recession and avoid deflation. Another possible way to create inflation is to depreciate or devalue the currency although this alternative is not viable if, as is now happening, the risk of deflation affects the world's three biggest economies (naturally, not all can depreciate).

To sum up, deflation is like a lot of other things. Preventing it is better and easier than curing it. It is therefore crucial not to ignore the risks of deflation and to take the necessary measures, orthodox and less so, to prevent it from happening. Today it is not part of our central scenario of projections but the risk is there.

(1) Krugman, Paul (1998), «It's Baaack! Japan's slump and the Return of the Liquidity Trap», *Brookings Papers on Economic Activity*, 1998:2.

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

Japan: drop in exports collapses economic activity

Japan's GDP down 4.6% because of foreign sector.

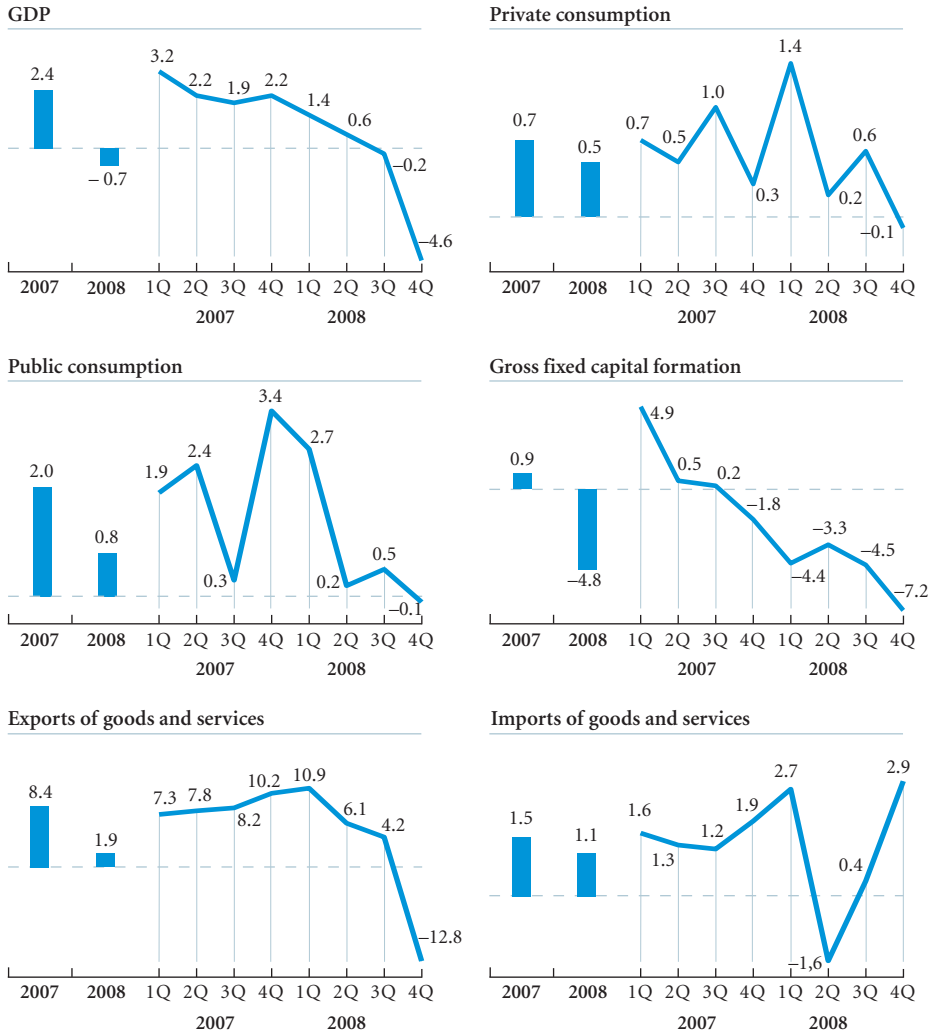
Industrial production drops 22% reflecting recession in durable goods.

Economic activity fell sharply at the end of 2008. The fourth-quarter GDP was down 4.6% year-on-year, 12.7% in quarter-on-quarter terms annualized. The 12.8% year-on-year drop in exports contributed three-quarters of this sharp reduction in economic activity. First of all, this gives some idea of Japan's dependence on foreign demand and, secondly, shows the size of the drop in trade. The other component that dropped sharply was investment in capital goods, the 11.1% year-on-year decrease of which contributed to nearly a quarter of the decrease in the GDP.

Japan is a major exporting country whose direct dependence on demand from the rest of Asia is greater than its equally high dependence on purchases by the United States. The rapid worsening of Japan's economic prospects has been an indication of the fast

TREND IN JAPAN'S GDP BY COMPONENT

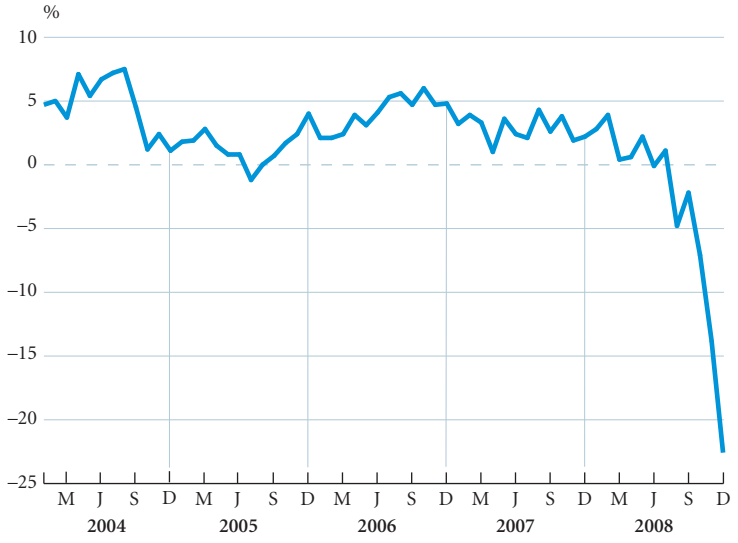
Percentage year-on-year change in real terms



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

JAPAN: INDUSTRIAL PRODUCTION SHOWS ALL-TIME DROP

Year-on-year change in industrial production



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

disappearance of the hypothesis of Asia's decoupling (the ability of that region to grow in spite of weak demand from the United States).

Industrial production in December, which was down 22.5% year-on-year, also reflects the drop in exports. Most of this decrease, without equal since World War II, showed up in the past two months, coinciding with the drop in trade. In a country where the weight of industry is considerable when compared with other rich economies, the companies are taking note of this and are adjusting their production and expectations accordingly, as indicated by the Tankan index of business activity covering the fourth quarter put out by the Bank of Japan.

On the demand side as well, the bottom has not yet been reached. Consumer confidence in the fourth quarter again marked up an all-time low, dropping from the 31.2 points level to 26.7. In the same context, retail sales in December showed a poor Christmas season with a drop of 2.7% year-on-year while car sales continued their collapse with a January drop of 28.0% year-on-year. This situation was repeated under investment which showed worse prospects for coming months. An early indicator, machinery orders, maintained a marked downward bias in December with a year-on-year decrease of 24.5%, the sharpest drops showing up in the export sector.

Investment prospects worsen and real estate market remains weak.

With regard to prices, the Japanese economy is again playing with an old problem – the spectre of deflation. The December CPI was up by a mere 0.4% year-on-year whereas three months ago it was close to 2.1%. It is the underlying index (the general index less energy and food), however, with a nil increase over the same period last year, that clearly shows how close the country is to deflation territory. In the labour market, the unemployment rate in December rose to 4.4% of the labour force, the highest figure since 2004.

Inflation close to zero while exports down 36%.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008						2009
			1Q	2Q	3Q	October	November	December	January
Real GDP	2.4	–0.7	1.4	0.6	–0.2	–	–4.6	–	–
Industrial production	2.9	–3.3	2.5	1.0	–1.9	–7.0	–13.7	–22.6	...
Tankan company Index (1)	22.0	–2.8	11.0	5.0	–3.0	–	–24.0	–	–
Housing construction	–17.2	2.4	–8.8	–11.1	40.3	20.1	0.0	–5.8	...
Unemployment rate (2)	3.9	4.0	3.8	4.0	4.1	3.7	3.9	4.4	...
Consumer prices	0.1	1.4	1.0	1.4	2.2	1.7	1.0	0.4	...
Trade balance (3)	12.5	3.9	11.7	10.2	7.3	6.2	4.8	3.9	...
3-month interbank interest rate (4)	0.7	0.8	0.8	0.8	0.9	0.9	0.9	0.7	0.7
Nominal effective exchange rate (5)	77.1	86.6	83.4	82.6	81.9	93.5	98.7	103.2	105.1

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

Lower demand and especially the credit crisis, along with greater difficulty in ensuring payment of invoices, continued to adversely affect the foreign sector which showed a deficit in December for the fifth month in a row. There were sharper decreases in exports with a drop of 36.2% year-on-year while imports were down 26.7% in December. Exports to the United States dropped by 36.9% year-on-year, those going to the rest of Asia were down 36.5% while those to China fell by 35.5%, which gives some idea of the fragile state of growth in the region.

Lessons from deflation in Japan

Japan is the only large economy to have recently gone through a period of deflation, that being understood as a prolonged and general decrease in prices. Because of this, an analysis of Japan's deflation process may shed some light on and aid an understanding of the present situation. Inflation in Japan came as a result of a loss in the value of assets, both financial and non-financial, and particularly because non-financial companies expected that those decreases would endure. As a result, non-financial companies hurried to put their balance sheets in order by reducing their leverage and thus limiting new investments. According to Richard C. Koo,[1] chief economist at Nomura Research Institute, this approach was of greater importance in bringing about deflation that the problems of solvency existing in the financial sector. Let us see why.

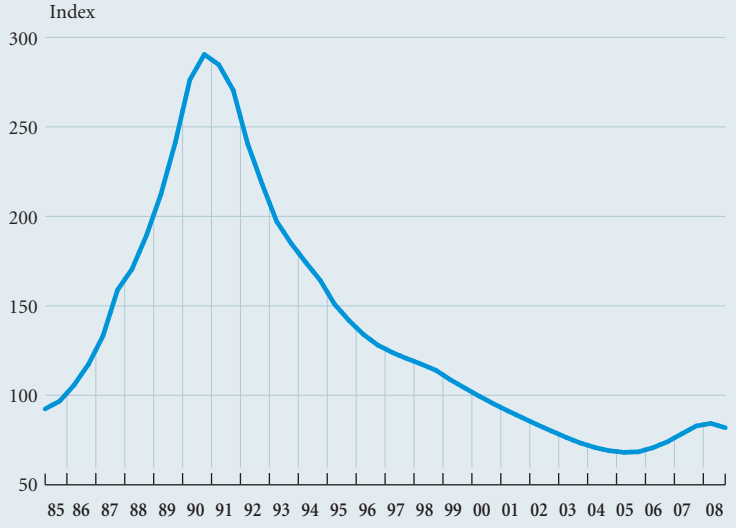
(1) Richard C. Koo, *Balance sheet Recession*, John Wiley & Sons 2003.

Up until the Eighties, Japan's economy rested on two basic pillars. First, strong household savings gave support to the second pillar, heavy investment by non-financial exporting companies which were and still are competitive. Thanks to a high level of savings, major investment efforts were financed at very low borrowing rates. As a result, these companies had a high debt level with net equity of less than 20% of the value of their assets.

Then came the stock market correction of 1989, followed by a still more drastic decrease in real estate prices. Between the end of 1989 and August 1998 stock market capitalization lost 49.5%. In turn, the price of land in the six main cities dropped by 59.9% of the high reached in 1990. Between 1989 and 1997 the combined loss in value of various assets rose to 2.7 times the nominal GDP of the then second largest world economy. Rather more than half of this decrease was concentrated in the non-financial business sector.

COLLAPSE OF LAND PRICES IN JAPAN

Land price index in six largest cities



SOURCE: Japan Real Estate Institute, Thomson Datastream and own calculations.

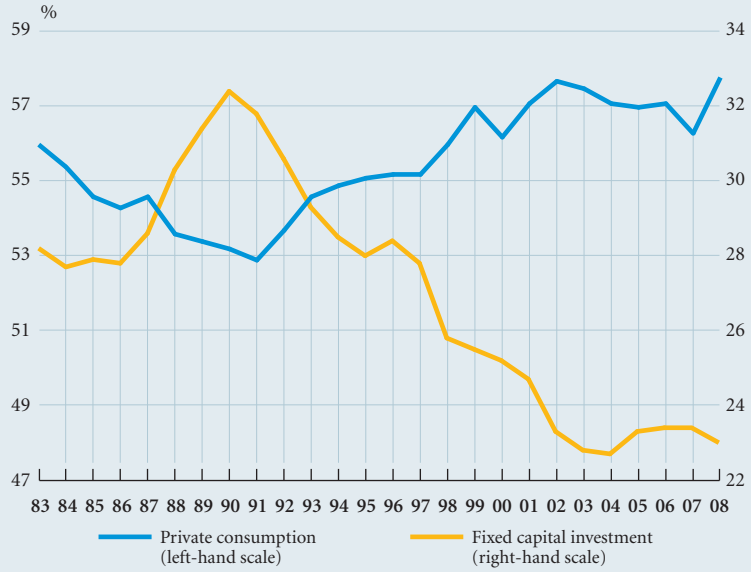
The heavily indebted companies saw the value of their assets drop while their leverage did not decrease. This meant that many companies found themselves in situation with a severe lack of balance in their equity. In commercial terms, not taking the financial situation into account, these companies remained viable seeing that many were involved in exports and the world economy continued to demand Japanese products. As a result, the priority of companies changed to putting their balance sheets in order. Income was then no longer reinvested as before but rather used to reduce debts while investment opportunities, as advantageous as they might be, were left for the future.

The variable that contributed most to reducing aggregate demand in the deflation process was corporate investment and, as a result, lower demand for loan funds. It is well known that Japanese consumers have a propensity to save but this remained unchanged. On the other hand, non-residential investment by

companies played a much more active role going from 19.8% to 13.8% of nominal GDP, a loss of 6.0 percentage points. The lower demand for investment contributed to the weakening of the mechanisms for monetary supply movement. The increase in money supply was held as cash at the banks and not as loans so that this did not help to reactivate the economy. Fiscal policy helped the drops in GDP to be relatively moderate. Even so, this was at the expense of raising public sector debt to 187.7% of GDP in 2007. In any case, between April 1998 and March 2006 prices dropped by 3.7% whereas gross domestic product was stagnant between the end of 1996 to the end of 2001 in what has become known as the lost decade. Discounting that the population level is practically stagnant, what remains is very weak recovery with growth depending on exports to the rest of the world.

INVESTORS MAKE MOVES BUT NOT CONSUMERS

Contribution to GDP



SOURCE: Japan Ministry of Communications, Thomson Datastream and own calculations.

Having reached this point, we may ask: is Japan's deflation an example of what the world economy may expect in coming years? A first approach would be to compare and examine the differences between a deflationary Japan and the world's largest economy, that of the United States. The first difference makes things worse. Japan went through its deflationary process with buoyant world demand importing its products. In 2009, however, with a widespread contraction, growth through exports is difficult. Following this approach, the simultaneousness of fiscal stimuli will make financing from abroad more difficult. It should be remembered that up until now this funding has come largely from Eastern Asia, with China and Japan representing more than 40% of US Treasury bonds held. However, these countries are suffering from a much deeper recession than they expected and their future appetite for US bonds could be lower than in the past.

The second difference is that in the United States the leveraged sector is not made up of the non-financial companies but rather the consumers and the banks. The main change therefore will not be less investment but

less consumption. Income received is used to reduce debt and not spent on consumption. Replacing US consumption (70% of its economy and 17% of the world economy) as a source of growth is by no means easy.

Are there reasons for some optimism? The answer is yes. The most notable is the smaller figure for loss of wealth. As mentioned earlier, in Japan this was 2.7 times GDP. The ravages in the United States, while enormous, have been a lot less up to this moment. In all of 2007 and the first three quarters of 2008, total financial wealth lost was 51% of GDP whereas total wealth of households (financial and tangible) dropped by the equivalent of 71% of GDP. Approximately half of this loss was concentrated in real estate. The flow of information also works in its favour. In Japan it was several years before losses were made public whereas in the United States this took only a matter of months although in Japan there is still some way to go. The Fed has acted more decisively than the Japanese authorities with a policy of quantitative easing (see box «Recession but not depression: a look at 1929 and Japan in the Nineties» in Monthly Report for January, 2009). The US demographic situation is also more favourable and allows for greater potential growth of domestic demand than in Japan. Even so, care should be taken. Japan's deflation chapter has not yet been closed even after 10 years and the present international crisis in the real economy has only just begun.

This box was prepared by Jordi Singla
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Latin America: economic improvements partly chase away fears of the past

Latin America faces a recessive 2009.

The economic and financial situation in Latin America has notably worsened as a result of the world recession. In 2009, Latin America will undergo a recessive stage that will bring about a contraction of 1.2% in GDP. In fact, some countries in the region already showed sharp negative growth figures in the fourth quarter of 2008.

Forecasts for 2009 indicate that Argentina's GDP will drop by 1.5% due to the drop in commodity prices, lack of investment and the huge flight of capital. Chile will show nil growth because of the drop in the price of copper, its main export. Peru, which has prepared a fiscal stimulus plan, will see more moderate growth with a drop to 4.0% (as against 9.1% in 2008).

Brazil has been in technical recession since the end of 2008. While this has not been confirmed, it is expected that in the fourth quarter of 2008 the GDP contracted by around 5% in quarter-to-quarter rate. Production in the motor vehicle sector, which collapsed at the end of last year, showed a strong rebound in January 2009 helped by the 6% reduction in the direct tax on car production and special credits granted by state banks for car purchase. Nevertheless, the generally weak situation continues to affect other sectors. In 2009, negative growth of 2.1% is expected because of the slowdown in domestic consumption, the sharp moderation in gross capital formation and restrictions on credit.

Brazil and Mexico are now in technical recession.

Recession arrives after a period of substantial reduction of foreign exposure.

In 2009, Mexico will suffer from the recession in its neighbour to the North and the drop in oil prices. The services sector and manufacturing are directly affected by the slowdown in the United States because of extensive trade connections. Household demand will be greatly affected by the drop in remittances (equal to 2.2% of GDP). In January, the INEGI PMI indicator for manufacturing was down 3.2% to 40.6 points, which indicates that the correction begun in the third quarter of 2008 has sharpened. The consumer confidence indicator dropped to 83.3 points, 4.8 points less than in December while household plans to buy durable goods collapsed by 9.1 points to 71.3. Restrictions on credit are also contributing to the contraction of private consumption.

Drop in inflation provides margin to relax monetary policy but cautiously.

In general terms, the region is facing the present recession from a stronger financial and fiscal position than in the past. For example, international reserves in 2008 rose up to 450 billion dollars, three times the level in 1999, which provides a considerable margin to ease pressures on foreign exchange rates. In the past five years, the region has shown a fiscal deficit of around 0.6% of GDP, a substantial improvement over the 3% average in the 1994-2003 decade. Even so, countries such as Argentina, Ecuador and Venezuela, which finance a major segment of public spending from revenue linked to commodity exports, will face substantial difficulties in 2009.

A number of countries have responded to the recession with measures to support economic activity. In Mexico, according to IMF estimates, the fiscal stimulus implicit in the 2009 budget will be 1% of GDP. The stimulus plan goes hand in hand with a bigger increase in credit granted by state banks, a measure that will give added support to economic activity. In the case of Brazil, the government has not yet announced a fiscal plan of any significance, mainly because its margin for manoeuvre is

MACROECONOMIC PICTURE FOR LATIN AMERICA

	Real GDP growth (%)			Inflation rate (year-end)			Current account (% of GDP)			Fiscal balance (% of GDP)		
	2007	2008(*)	2009(**)	2007	2008	2009(**)	2007	2008(*)	2009(**)	2007	2008(*)	2009(**)
Argentina	8.7	6.9	–1.5	8.5	10.0	15.0	2.7	2.0	–0.3	1.4	1.2	–0.5
Brazil	5.4	5.7	–2.1	4.5	6.5	5.0	0.6	–1.8	–1.5	–2.3	–1.8	–2.5
Chile	5.0	4.3	0.0	7.8	5.8	3.5	4.5	–2.7	–2.6	8.9	4.5	–3.0
Colombia	6.3	4.1	0.5	5.0	4.0	3.8	–3.4	–2.0	–1.9	–1.0	–1.4	–3.0
Mexico	3.3	1.8	–2.0	3.8	6.5	4.0	–1.0	–1.5	–3.5	0.0	–0.1	–2.5
Peru	8.9	9.1	4.0	3.2	2.8	2.5	1.4	–2.1	–3.0	2.9	1.4	–0.1
Venezuela	8.2	4.9	0.0	15.3	19.0	19.0	10.5	14.2	4.3	1.5	–1.1	–5.2
Latam 7 (*)	**5.6**	**4.7**	**–1.2**	**5.7**	**7.3**	**6.6**	**0.7**	**–0.5**	**–1.3**	**–0.3**	**–0.6**	**–2.5**
Latam 7 excluding Arg and Ven (*)	**5.0**	**4.4**	**–1.3**	**3.7**	**4.8**	**3.5**	**0.0**	**–1.7**	**–2.5**	**0.3**	**0.1**	**–0.7**

NOTES: (*) Estimate.
(**) Forecast.
(***) Weighted for GDP PPA.
SOURCE: National Statistics Bodies and own calculations.

quite limited. Measures already taken are specific such as the support given to the motor vehicle sector mentioned above, an increase in funds for infrastructures and a plan for low-cost housing that the government is shortly to announce in detail.

The improvement seen in the area of inflation also gives the monetary authorities greater margin for action. In 2008, the inflation rate in Latin America was 7.3% or 4.8% if we exclude Argentina and Venezuela. In this context, the central banks of Peru, Mexico, Brazil and Chile have cut interest rates by 25, 50, 100 and 250 basis points respectively in 2009. The economic authorities recognize the importance of continuing to ease monetary policy to give added support to growth but they are also aware of the need to avoid a heavy flight of capital and to step up depreciation of currencies.

What are the risks ahead? In 2009, the main risk for Latin America is of a bigger world contraction which could even more affect the price of raw materials and thus bring about bigger losses in terms of trade. No doubt, one of the region's big challenges will continue to be how to reduce its excessive dependence on commodity exports. With a scenario of greater than expected contraction, the margin for fiscal policy to stimulate domestic demand will be very limited. An increase in foreign deficits would also mean increased risks for the countries of the region which will see their access to international financing becoming more expensive.

2009 will be a year of risks in growth, financing of current account and in monetary and fiscal stability.

Emerging Asia: downward revisions

The theories predicting a process of decoupling between the developed economies and those still emerging have long been discarded. Even so, the size of the recent drop in economic activity in many Asian countries has come as a surprise to many people. This has forced the IMF, among other bodies, to revise Asian growth in 2009 downward from

Downward revision of growth in emerging Asia.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2008				2009
			1Q	2Q	3Q	4Q	January
Real GDP	13.0	9.0	10.6	10.1	9.0	6.8	–
Industrial production	17.5	12.6	–	15.9	13.0	6.4	...
Electrical power generation	15.7	6.7	16.0	11.9	6.7	–6.0	...
Consumer prices (*)	4.8	5.9	8.0	7.8	5.3	2.5	1.0
Trade balance (**)	262.4	295.1	256.5	247.2	256.9	295.1	314.8
Benchmark interest rate (***)	7.47	5.31	7.47	7.47	7.20	5.31	5.31
Renminbi to dollar (*)	7.6	6.9	7.2	7.0	6.8	6.8	6.8

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

CHINESE STOCK MARKET TURNS AROUND IN 2009

Shanghai 180 index

SOURCE: Thomson Reuters Datastream.

In spite of big drop in exports, China's trade surplus again swells because of collapse in imports.

4.9% to 2.7%. The forecast of a 4% contraction in South Korea is an extreme case in this new context. In the case of China, the IMF puts growth at 6.7% and 8% for 2009 and 2010 respectively. These figures are somewhat more optimistic than our forecasts of 6% and 7.5%, although all of these figures are below the two-digit growth we are accustomed to see from this Asian giant.

Demand indicators still failing to show any clear take-off in domestic consumption.

The slowdown has made itself felt in figures for international trade. The value of China's contracted by 17.5 % in January in year-on-year terms, the biggest drop in 13 years and the third consecutive month to show negative rates. Specifically, exports to the United States and the European Union were down 10% and 17% respectively (these markets make up 40% of all China's exports). In any case, the big drop in imports which came to 43.1% lay behind the increase in the trade surplus in January to 39.11 billion dollars.

Shanghai stock market showing signs of optimism.

The latest figure for the purchasing managers index (PMI) confirms this state of weakness. In spite of a slight rise from 41.2 in December to 45.3 in January, the value for the index (below 50) is consistent with a continuation of the downward trend in industrial production that began last autumn.

On the other hand, figures available on retail sales in the fourth quarter of 2008 are more cheerful seeing that the 20.6% year-on-year growth puts growth for 2008 at 21.6% annual, nearly 5 points above last year. Nevertheless, the big drop in the value of imports in January may be revealing some weakness in consumption. Along similar lines, the 20 million immigrants from rural areas who have lost their jobs will be cause for a slowdown in domestic demand. We shall have to wait a little to see if the fiscal stimulus measures adopted by the Chinese government will contribute to a take-off in domestic consumption.

In spite of the relative worsening of the economic indicators, the Shanghai stock market has shown a revaluation of 28% so far this year, which some analysts see as an optimistic opinion of investors about the programmes introduced to stimulate the economy.

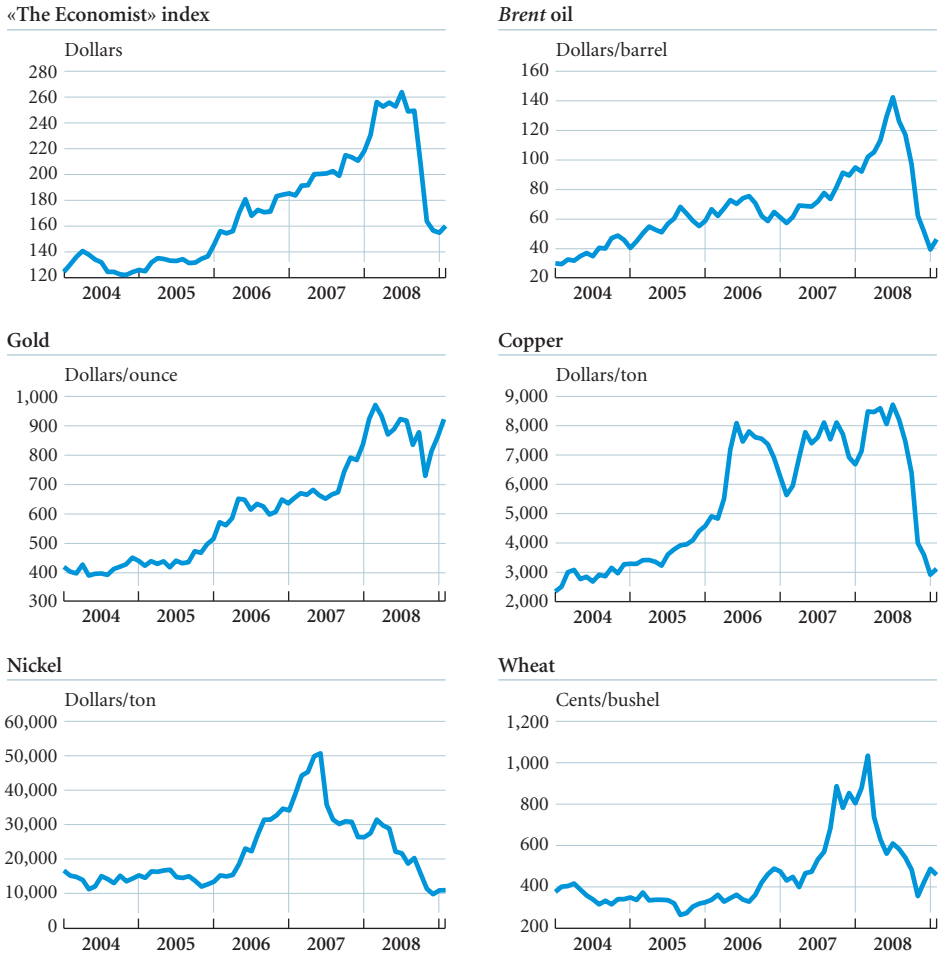
Oil drops while gold rises

The price of oil has reduced its volatility but has dropped again. Between January 20 and February 23 it started out as 45.3 dollars a barrel (Brent quality, one-month delivery) and went down to 42.1 dollars. The cumulative increase for the year thus dropped to 7.8%, after having come close to a gain of 20% at the end of January.

The International Energy Agency again revised slightly downward world demand for oil in 2009 putting it at 84.7 million barrels a day, some 570,000 barrels a day less. World demand would thus drop by 1.1% which would mean a second consecutive year of decreases. This figure

Oil price again moving down.

TREND IN VARIOUS COMMODITIES



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

Metals drop but foods and precious metals keep rising.

for demand carried more weight in setting oil prices than the reduction in supply of 520,000 barrels a day begun in January.

In the first 20 days of February other raw materials showed two quite different stories. Whereas metals lost what they had gained the month before, precious metals (headed by gold) and food commodities moved upward.

The Economist commodities index dropped by 2.3% between January 20 and February 23. The biggest decreases came in nickel and aluminium while copper held its recent increase. Precious metals again benefited from risk aversion. As result of this situation, an ounce of gold came close to the 1,000 dollar level. In turn, foods rose in spite of the recent drop in the price of wheat.

EUROPEAN UNION

Euro Area: economy suffers sharp reverse in final quarter of 2008

Sharp drop in GDP in fourth quarter of 2008.

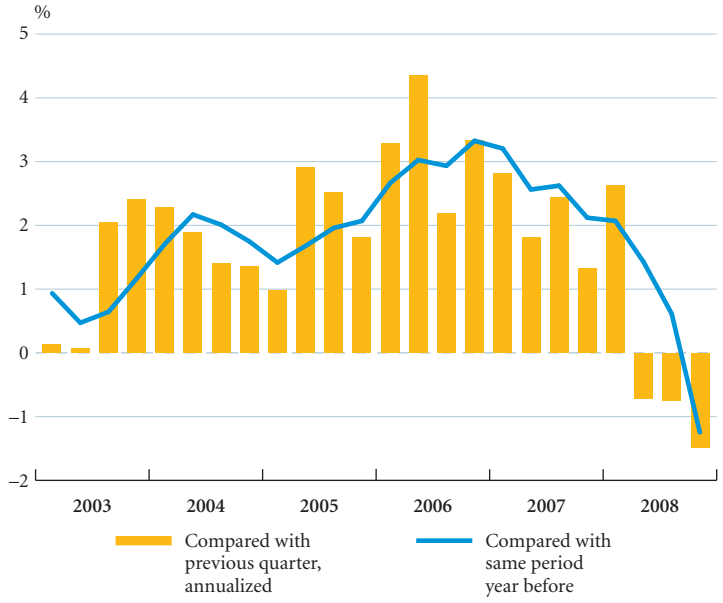
The Euro Area underwent a sharp drop in gross domestic product (GDP) in the final quarter of 2008. To be specific, it reported a drop of 1.2% compared with the same quarter in 2007 so that growth for the year as a whole stood at 0.7%. As suggested in Monthly Report for February, the pass-through of the financial crisis to the real economy made it foreseeable that the drop in GDP would be greater in the fourth quarter. Finally, however, all forecasts turned out falling short. Forecasts by "la Caixa" for 2008, along with those by the International Monetary Fund, were three decimals above the final result whereas those of the European Commission, which were revised substantially downward in January, were one decimal closer. For the European Union as a whole, figures for the fourth quarter were also very disappointing. In annual terms, the economy dropped by 1.1% putting growth in 2008 at only 0.8%.

Slowdown affects all components.

Given that a breakdown of the main components of the 4th quarter GDP has not yet been published, it is not possible to know exactly what factors lay behind this setback. Nevertheless, the monthly indicators leave no doubt that the downturn in the economy is widespread. On the demand side, retail sales in

EURO AREA MOVES WELL INTO RECESSION

Change in gross domestic product in real terms



SOURCE: Eurostat and own calculations.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009
			1Q	2Q	3Q	4Q	January
GDP	2.6	0.7	2.1	1.5	0.7	–1.2	–
Retail sales	0.9	–1.3	–0.1	–1.5	–1.4	–2.0	...
Consumer confidence (1)	–4.9	–18.0	–11.9	–14.6	–19.3	–26.1	–30.5
Industrial production	3.5	–1.7	2.5	1.2	–1.4	–8.6	...
Economic sentiment indicator (1)	108.4	91.1	101.4	97.5	89.9	75.8	67.1
Unemployment rate (2)	7.4	7.5	7.2	7.4	7.5	7.9	8.2
Consumer prices	2.1	3.3	3.4	3.6	3.8	2.3	1.1
Trade balance (3)	20.1	–1.1	24.3	13.8	–11.4	–31.1	...
3-month Euribor interest rate	4.3	4.6	4.5	4.9	5.0	4.2	2.9
Nominal effective euro exchange rate (4)	107.7	113.0	113.0	116.0	114.0	109.1	111.9

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.

Major drop in industrial production.

December dropped for the seventh month in a row. With a decrease of 1.5%, somewhat less than that in November, the drop is the biggest since this statistical series was set up.

The collapse in supply indicators suggests that the production economy is also going through very difficult times. Industrial production, indeed, seems to be dropping fast. Following the historic contraction in November (8.4%), in December this went to 12%. As a result, utilization of production capacity, which usually swings between 80% and 85%, in just one quarter collapsed from 81.5% to 75%.

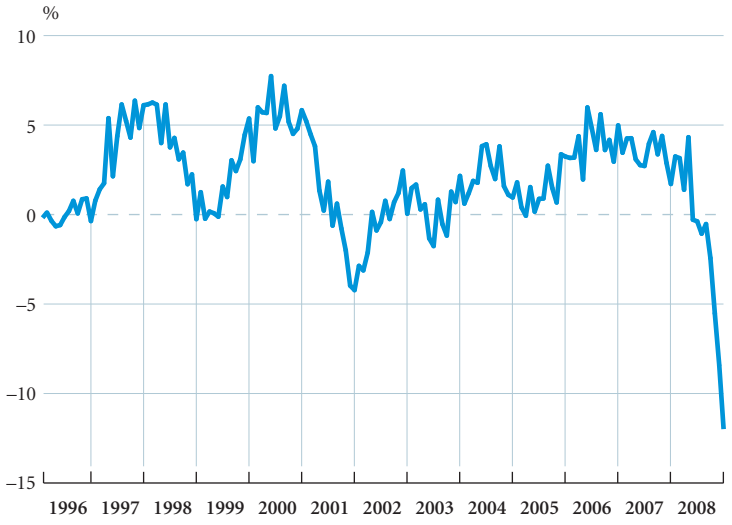
The financial crisis that had its origin in the United States reached world proportions in the final quarter of 2008 greatly affecting both developed and emerging countries. This is making world trade one the main things to suffer. This shows up in foreign trade figures for the monetary union in the final quarter of 2008. Exports, which had been growing without interruption since the first quarter of 2004, dropped by 4.1% compared with the same quarter in 2007. The contraction in imports was somewhat lower (1.2%) but this also put an end to a growth cycle that had lasted for nearly 5 years.

Exports drop.

In view of such negative results, the million-euro question is whether the drop has hit bottom or if, on the other hand, there is still some margin for the contractive spiral to continue. Unfortunately, all indicators suggest that the recession will get worse in the first part of the year and that it will not be until the second half that we shall begin to note some signs of recovery. This is what comes from our scenario of forecasts which has been revised substantially downward. For 2009 as a whole we are expecting a drop of 2.0% while during 2010 the economy should

INDUSTRIAL PRODUCTION COLLAPSES

Year-on-year change in industrial production



SOURCE: Eurostat and own calculations.

gradually recover a growth path showing a modest 0.3%. But there are three key aspects we must keep following closely. First, the performance of the financial sector, second, the details and implementation of the economic stimulus plans in the various EU countries and third, the affect of the crisis on the emerging countries.

A key to recovery of the European economy is the financial system seeing that the investment capacity of small and medium companies and the borrowing possibilities of households depend on this. In this respect, the sharp slowdown taking place in the growth of credit, which went into negative rates in December, is not a very good sign. Nevertheless, the three-monthly survey carried out by the European Central Bank among the main financial entities inquiring about their credit policy gives us a slight breath of fresh air. Specifically, the January survey indicates that the financial institutions have stopped hardening their credit policies. The turnaround in availability of credit, if confirmed, could be a first step toward a recovery of this factor.

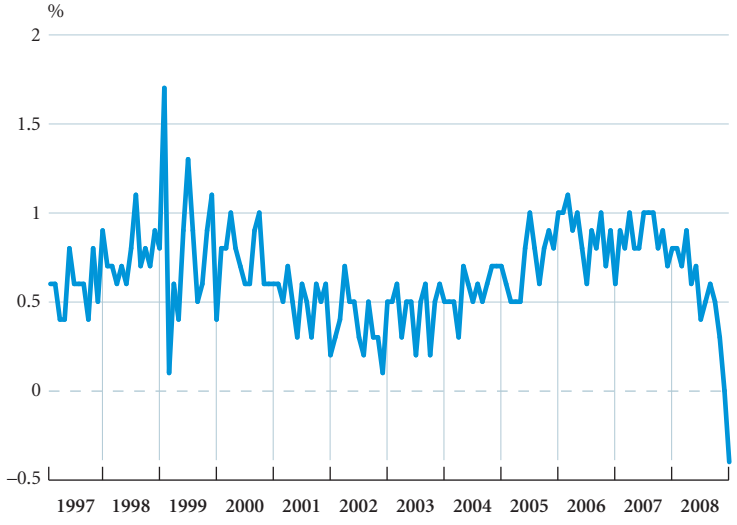
Financial system is key to economic recovery...

Nevertheless, the already damaged European financial system could suffer a second round of upsets due to the worsening of the real economy. In order to help put the sector back on its feet, one of the measures being taken is the creation of a «bad bank», that is, a bank that collects together the low quality assets of the financial entities. The economy ministers of the various countries discussed the general principles of this measure at the Ecofin meeting and agreed that implementation should be coordinated in order to avoid problems of jurisdiction. No doubt, this measure could help to restore confidence but the details of the plan will end up determining its success.

The policy being carried out by the European Central Bank will also be

CREDIT CONTRACTS IN EURO AREA FOR FIRST TIME

Monthly change in credit granted to private sector



SOURCE: European Central Bank.

...along with economic stimulus plans...

a determining factor in the future recovery of credit. While at the February meeting it was decided to leave the reference rate at 2%, it is very difficult to see it being kept at theses levels much longer given that inflation, which dropped to 1.1% year-on-year in January, seems as if it will stay well below 2%, the limit set by the top monetary authority. This is how things look in our new forecast scenario. Furthermore, the European Central Bank is introducing liquidity in the system through policies of quantitative and qualitative easing of its balance sheet. While it is difficult to evaluate the effectiveness of these measures, as we do not know what would have happened if they had not been introduced, it is clear that for the moment they have failed to restore the flow of credit. (For a detailed analysis, see box «The Fed and the ECB: two strategies and one problem – deflation»).

...and extent of recession in emerging countries.

Another key aspect for the recovery of the European economy, especially for the second half of 2009, involves the plans for economic rescue announced by the various countries. Following the announcements being made by the governments of each country, forecasts for government deficits have shot up. Because of the deviations already recorded in 2008, the EU executive began its procedures for dealing with excessive deficits involving Spain, Ireland, Greece, France, Latvia and Malta. In addition, such procedures are already under way relating to Hungary and the United Kingdom. Nevertheless, Joaquín Almunia, European Commissioner for Economic and Monetary Policy, has insisted that no one is thinking of a firm reading of the Stability Pact which, under normal circumstances, would limit the government deficit to 3%. Nevertheless, he did emphasize that fiscal discipline is essential for a return to the path of stable growth over the medium term.

The last key factor is the foreign sector, especially in the East European countries

and China. With regard to the first group of countries, their importance lies in the possible impact the pressures now being seen in their financial systems could have on the European financial system as a whole. The importance of China, on the other hand, comes from its trade ties with the EU and the world economy. If its slowdown is confirmed, European exports could suffer even more.

Germany suffering from stagnation of its main economic engines

In the fourth quarter of 2008, the German economy suffered its worst blow since reunification with a decrease of 2.1% quarter-on-quarter, heading the drops in the main economies of the Euro Area. Due to this further reduction in the GDP, the third consecutive cut in the GDP in 2008, the German economy grew by only 1.0% last year compared with 2007, a figure clearly lower than the forecasts published by the main institutions in January that stood around 1.3%. An analysis by component shows a sharp drop in investments (down 0.5%) and exports (decrease of 5.6%) compared with the fourth quarter of 2007.

In fourth quarter of 2008 German economy suffers biggest plummet since reunification...

Like the other developed European economies, Germany underwent a major contraction of demand, both domestic (with a drop of 0.8% year-on-year in retail sales in the final quarter of 2008) and especially foreign demand. In December, exports showed the biggest drop since 1993 with a reduction of 11.7% compared with the same month in 2007. In the face of this situation, supply indicators are reflecting a reduction in economic activity recording all-time decreases in December 2008. As a result, industrial production dropped by 12% compared with December the year before while industrial orders were down more than 28% in the same period. Confidence indicators, both demand and industrial, have gone to new lows in the early months of 2009.

Why is it that the collapse of Germany's GDP in the fourth quarter of 2008 was more severe than that of other European countries? The German economy largely depends on two sectors that have suffered severe blows in recent months,

...with sharp drop in industrial production...

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008				2009
			1Q	2Q	3Q	4Q	January
GDP	2.6	1.0	2.8	2.0	0.8	–1.7	–
Retail sales	–2.6	–0.2	–0.7	0.1	0.7	–0.8	...
Industrial production	5.9	0.0	4.9	3.0	–0.1	–7.5	...
Industrial activity index (IFO) (*)	106.2	96.8	104.0	102.1	94.8	86.2	83.0
Unemployment rate (**)	9.0	7.8	8.0	7.9	7.7	7.6	7.8
Consumer prices	2.3	2.6	2.9	2.9	3.1	1.6	0.9
Trade balance (***)	181.5	195.2	199.5	202.3	196.3	182.9	...

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

...the result of much worse situation in foreign sector and motor vehicles.

namely, foreign trade and the motor vehicle industry. Some 75% of German exports in 2008 went to other European countries and, out of these, one fifth were for economies in Eastern Europe. The sharp drop in the European economies, including those of the East, during the last quarter of 2008, caused this collapse in exports. On the other hand, the motor vehicle industry suffered a severe contraction in demand, both foreign (with a drop of 12% in exports in the fourth quarter of 2008) and domestic (with a reduction in car registrations close to 11% in the same period and 14% year-on-year in January 2009). This was a blow to an industry that gives employment, directly or indirectly, to close to three million workers, according to the German Institute of Statistics.

Medium-term prospects not bright.

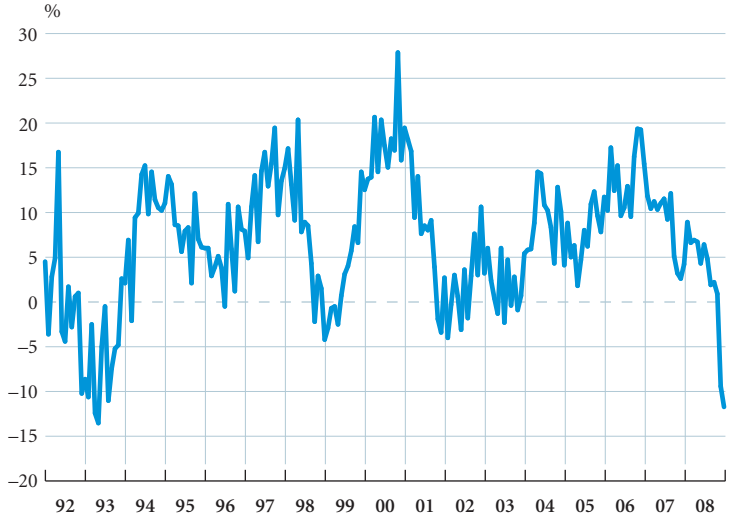
Forecasts for the first half of 2009 show no signs of an improvement in these factors dragging the German economy toward its biggest recession since reunification. As a result, experts are expecting a bigger drop in consumption, investment and exports. The labour market, which up to January 2009 was showing an unemployment rate of 7.8% (close to the low reached in 2008) will feel the effects and likely go above 9%. The increase in public spending under the fiscal stimulus plans approved in recent months and the effect of various measures related to the economic agents could ease the drop in Germany's GDP in 2009. The German government deficit in 2008 was only 0.1% of the GDP, the lowest since reunification. Nevertheless, the economic stimulus plans will involve higher borrowing by the German economy over the next two years thus raising the public debt to 70% of GDP, five percentage points above the figure recorded in 2008.

France: demand collapses in fourth quarter of 2008

The forecasts put out by the European Commission last month on the trend in the French GDP in the final quarter

GERMAN EXPORTS DECLINING

Year-on-year change in goods exports



SOURCE: Bundesbank.

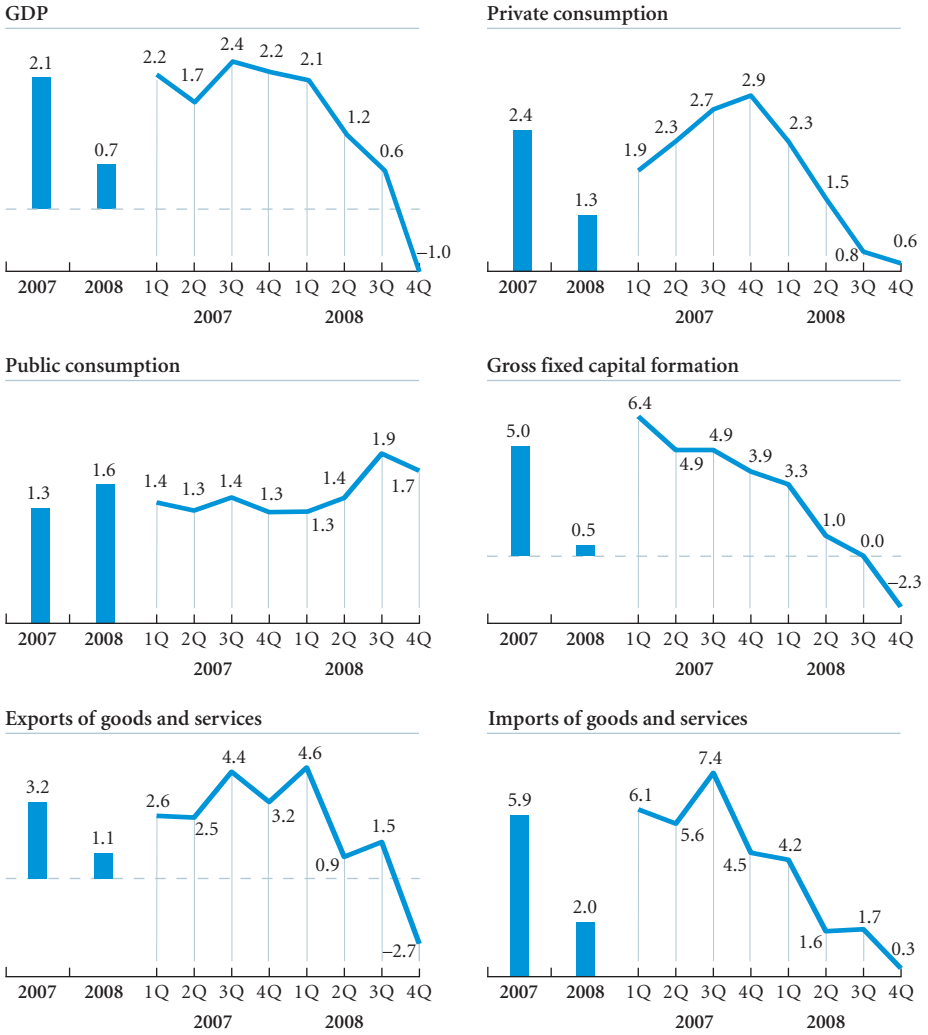
of 2008 have turned out to be correct. National accounting figures have confirmed that France grew by 0.7% in 2008. At the same time, as expected, GDP growth of 0.1% quarter-on-quarter recorded in the third quarter of 2008 created only false hopes. In fact, in the fourth quarter the GDP collapsed by 1.2% quarter-on-quarter.

The indicators, both on the demand side and the supply side, pointed to a notable worsening of the situation and this showed up in a drop of 1.0% year-on-year in the final quarter of 2008. The collapse of France's GDP is reflected in the poor performance in industrial production which was down by 11.1% year-on-year in December. Other industrial activity indicators suggest that the downward trend will continue over coming months. For example, the economic sentiment index again dropped in January. Order books have been more favourable seeing that,

French GDP drops 1.0% year-on-year in final quarter of 2008.

TREND IN FRANCE'S GDP BY COMPONENT

Percentage year-on-year change



SOURCE: INSEE and own calculations.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008						2009
			1Q	2Q	3Q	October	November	December	January
GDP	2.1	0.7	2.1	1.2	0.6	–	–1.0	–	–
Domestic consumption	4.4	1.2	2.4	1.5	0.9	0.6	1.1	–1.7	...
Industrial production	1.4	–2.6	1.6	–0.4	–2.2	–7.7	–9.1	–11.1	...
Unemployment rate (*)	8.3	7.8	7.6	7.7	7.7	7.9	8.0	8.1	...
Consumer prices	1.5	2.8	2.9	3.3	3.3	2.7	1.6	1.0	0.7
Trade balance (**)	–33.5	–48.5	–42.1	–45.9	–50.6	–55.5	–56.5	–54.5	...

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

Investment in France goes into the red.

after an all-time low in December, they showed a very moderate increase in January 2009.

On the demand side, various indicators are showing weak domestic consumption. Household consumption fell drastically in December (by 1.7% year-on-year) and this contributed to the fact that growth of private consumption in 2008 stood at 1.3% year-on-year. This figure is notably below the 2.4% marked up the year before and, furthermore, shows a clearly downward profile. For example, the consumer confidence index in January continued downward going to levels of the order of 35 negative points.

What is of more concern is the pitiful performance of investment and exports in 2008. France's quarterly national accounting figures show that gross capital formation last year rose by barely 0.5% year-on-year, a figure in contrast with the increase of 5.0% recorded in 2007. In the fourth quarter of 2008 the figures were negative with a year-on-year decrease of 2.3%. At the same time, the figures also reflect very weak foreign demand given that, while in 2007 exports grew by 3.2% year-on-year, the increase reached in 2008 was only 1.1%. Again, the collapse took place in the final quarter with a year-on-year decrease of 2.7%. The only breather in demand, while very slight, came from public consumption. This was up in 2008 and may possibly grow still more in 2009 under the effect of the government's fiscal stimulus plan.

Rise in unemployment rate.

On the other hand, in this very adverse economic situation, we may expect that the number of unemployed will increase in coming months. The unemployment rate rose to 8.1% in December, one decimal above the November figure. In this context, the only optimistic news comes from the drop in prices to 0.7% in January, less than the 1.0% recorded the month before and the lowest since September 1999. This factor may bring with it an improvement in the financial situation of households and companies and it could give a push to domestic demand. The moderation of inflation was especially due to sale discounts on clothing and footwear and the drop in prices in the energy sector.

Italy facing biggest recession in recent times

The Italian economy bid farewell to 2008 with the biggest drop in recent decades reaching a drop of 0.9% in GDP compared with the year before. In the final quarter of 2008, it stayed with the trend in the previous two quarters, showing a drop of 2.6% compared with the same period in 2007. The drastic drop in investment and consumption, along with the decrease in foreign demand, were the main causes of this collapse, which was more than one percentage point above the high reached in the 1993 recession. All of this would suggest that this recession will considerably exceed the most recent contractions seen in the Italian economy with new lows being recorded in 2009.

The most recent indicators would suggest such a trend. On the demand side, both retail sale and exports continued to drop in the final month of 2008. Available figures for 2009 do not inspire optimism. Motor vehicle registrations were down in January with a drop of 32% compared with the year before presenting a threat to the car industry, one of the main driving forces in Italy's economy. In spite of these figures, consumer confidence improved slightly in January although it was still at low levels due to an increase in future expectations. On the supply side, the news is no brighter. With the contraction in demand, industrial production was down and in December 2008 recorded its worst drop since 1975 with a decrease of 13% year-on-year. Furthermore, the decrease in industrial orders in January 2009 would indicate a continuation of this trend over coming months. As a result, industrial confidence went to a new low in January.

Italy leaves 2008 behind with biggest GDP drop in decades...

In view of this situation, in February Italy announced an increase in its fiscal stimulus plan estimated at 2 billion euros in order to stimulate car buying. This raises the total figure for the plan to 10 billion euros, equivalent to 0.6% of Italy's GDP, well below the percentages being given out by the main European economies. The total figure for these measures would seem insufficient to deal with the present situation. Nevertheless, Italy's heavy government debt, estimated to be above 105% of GDP in 2008, well above the 60% established by the European Union directives, stands in the way of applying further anti-cyclical

...a trend to continue in 2009.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008						2009
			1Q	2Q	3Q	October	November	December	January
GDP	1.4	–0.9	0.3	–0.4	–1.1	–	–2.6	–	–
Retail sales	0.5	–0.7	0.9	–1.7	0.5	–0.7	–3.0	–1.9	...
Industrial production	–0.2	–4.5	–1.3	–1.6	–4.3	–7.9	–10.6	–13.0	...
Unemployment rate (*)	6.1	...	6.6	6.7	6.7	–	...	–	–
Consumer prices	1.8	3.3	3.1	3.6	4.0	3.5	2.7	2.2	1.6
Trade balance (**)	–13.7	–10.1	–9.1	–8.6	–10.4	–12.1	–13.0	–11.5	...

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

Government debt increases in 2008 going above 105% of GDP.

measures in order to cushion the recession.

United Kingdom: poor economic indicators

National accounting figures for the United Kingdom show a sharp contraction of the GDP in the fourth quarter of 2008 with a drop to 1.9% year-on-year. The British economy has seen private consumption moderate substantially in recent months. The figures suggest that household consumption dropped for the third quarter in a row putting the year-on-year decrease at 0.2% in the fourth quarter of 2008. At the same time, we should mention the role of investment in the slowdown in the British economy given that gross capital formation fell by a sharp 9.7% year-on-year in the fourth quarter of 2008. The only boost in domestic demand came from public consumption which rose by 4.4% year-on-year in the fourth quarter of 2008 partly as a result of the drive coming from the fiscal stimulus plan.

Britain's GDP drops by 1.9% year-on-year in last quarter of 2008.

Figures showing the trend in foreign demand offer no relief. Due to the slowdown in world trade, British exports dropped by 5.3% year-on-year in the fourth quarter of 2008 in spite of the fact that the effective nominal exchange rate for the pound sterling has depreciated by around 20% in the past year.

According to the «Inflation Report» released by the Bank of England in February 2009, Britain's economic slowdown has not yet hit bottom and will continue just as sharply early in 2009. In fact, all available indicators support this view. On the demand side, consumer confidence continued to drop in January going to negative levels of 35 points. While retail sales in the fourth quarter of 2008 were higher than in the previous quarter, there is much uncertainty about these figures because of the difficulty in removing seasonal effects and the variation in prices. Furthermore, a good part of sales in December and January was the result of sharp discounts at sales and it is not expected that buying will continue at the same pace.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008						2009
			1Q	2Q	3Q	October	November	December	January
GDP	3.0	0.7	2.6	1.7	0.2	–	–1.9	–	–
Retail sales	4.4	3.5	5.3	4.4	2.3	1.8	1.4	4.3	3.6
Industrial production	0.4	–3.0	0.4	–1.5	–3.0	–5.9	–7.8	–9.3	...
Unemployment rate (*)	2.7	2.8	2.5	2.6	2.8	3.1	3.3	3.6	3.8
Consumer prices	2.3	3.6	2.4	3.3	4.9	4.5	4.1	3.1	3.0
Trade balance (**)	–83.2	–93.0	–90.9	–93.1	–94.3	–93.7	–93.8	–93.2	...
3-month Libor interest rate	5.3	6.0	6.0	6.0	5.9	6.3	5.8	3.9	2.8
Nominal effective pound exchange rate (***)	103.9	97.6	97.6	92.6	92.8	89.4	85.4	81.2	73.7

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.

Similarly, the drop in the number of car registrations in January (30% year-on-year) shows the same state of weakness in consumption. Most of the components of economic sentiment have reached new all-time lows since these statistics were first compiled.

In this very adverse economic situation it is not surprising that in recent months industrial production has severely dropped. In December it was down 9.3%, the worst drop since this statistic has been gathered. In view of this, the increase of two decimals in the registered unemployment rate in January putting it at 3.8% even seems of little importance. In any case, the increase in the number of unemployed will probably continue in coming months and this will contribute to keeping a clearly downward profile for household consumption.

All of this shows very slim prospects for the British economy. The drop in employment is creating lower income levels for households while the drop in housing prices means a reduction of household wealth. If we add credit restrictions and an increased propensity to reduce debt and increase savings, we may expect that this year household consumption will continue to be weak. Nevertheless, there are two figures that could likely ease this downward trend as they bring about an improvement in the financial situation of households and companies, namely, the drop in prices and the lowering of interest rates. Inflation was down one decimal in January going to 3.0% year-on-year while the Bank of England lowered its interest rate by a half-point on February 5 putting it at 1.0%, a new all-time low.

At the same time, another factor that could help boost economic activity in the United Kingdom is the proposal by the Bank of England to carry out quantitative easing. This measure involves printing money to buy government bonds and private sector assets with the aim of increasing liquidity in the market and thus encouraging financial entities to recover their normal lending levels. Nevertheless, this plan is not without its problems and is rejected by those who feel it could push up inflation and increase the devaluation of the pound.

Industrial production drops by 9.3% in December 2008.

Emerging Europe: on the road to recession

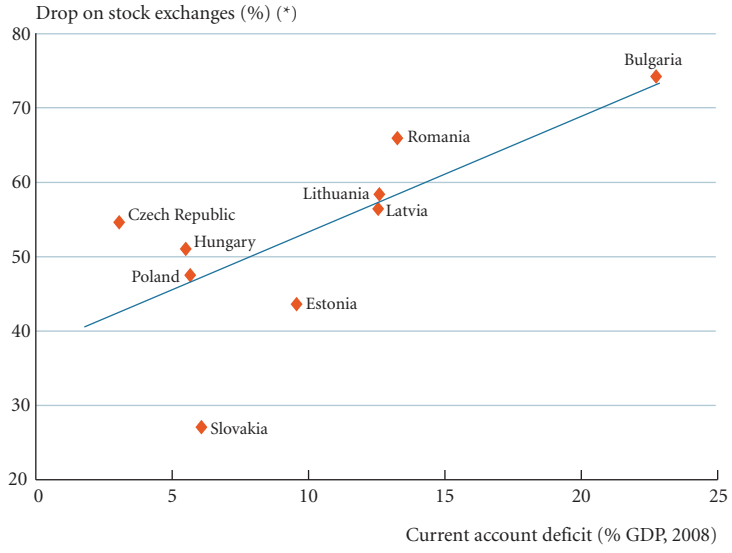
On February 17, Moody's rating agency announced that it would probably revise its evaluation of the credit rating of various financial institutions with a major presence in emerging European countries. This news acted as a signal for substantial moves in financial markets leading to sharp drops in certain key markets in just a few days (the Budapest stock market, for example, went down 12% the following week) and for depreciations of more than 4% in currencies such as the Hungarian forint and the Polish zloty. While in view of this sudden financial correction it would seem that doubts have begun to arise about this region, the fact is that, since the end of the summer of 2008, the trend in stock markets, currencies and country- risk indicators would suggest that this revaluation of regional risk in nothing new.

Despite easing of inflation and drop in interest rates, weak consumption expected in first half of 2009.

Two macroeconomic questions underlie the loss of confidence in these markets. First, as these countries are greatly dependent on the economic cycle of the Euro Area, that area's move into recession implies that its growth forecasts are being sharply revised downward. A second risk comes from the high level

Depreciation of currencies and stock market slump in emerging European countries.

MARKETS CONCERNED ABOUT EXCESSIVE CURRENT ACCOUNT DEFICIT



NOTES: (*) Between August 1, 2008 and February 19, 2009.
SOURCE: Thomson Reuters Datastream, official statistics bodies and own calculations.

Dependence on Euro Area now in recession and difficulty in getting international financing for economic activity represent blocks on growth in 2009.

of activity seen in some countries in previous years at the cost of creating macroeconomic imbalances (foreign imbalances but also those of a fiscal nature and inflation).

What is most troubling today is the heavy dependence on foreign financing, the sustainability of which, in a context of world financial crisis, is put in question. In some countries, this reality is made worse by the fact that a considerable part of borrowing is expressed in foreign currency which, in a situation of sharp depreciation of national currencies, carries with it the risks of growing default and a negative effect on the spending capacity of households and companies.

With regard to macroeconomic imbalances, those seen to be most vulnerable are the Baltic countries. With regard to interrelation with the Euro Area, this affects the key economy of the region, Poland, and the Czech Republic.

Undoubtedly in the worst situation are three countries that are showing major macroeconomic imbalances as well as a cyclical link with the Euro Area, namely Romania, Bulgaria and Hungary.

The latter economy is of special interest because its recent development could be something of a forerunner for other countries in the region. To begin with, Hungary is farther ahead in the cycle than other economies of Central Europe, as shown by the fact that in the fourth quarter of 2008 it recorded a quarter-on-quarter drop of 1% in GDP whereas other countries, such as the Czech Republic, were still holding in the range of positive quarterly growth. Other available indicators, such as industrial production (that dropped by 23% year-on-year in December), confirm the contraction in economic activity.

Hungary undergoes notable cyclical drop with little margin for economic policy.

A second significant risk is that, in spite of the economic downturn and the

HUNGARY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwises indicated

	2006	2007	2008						2009
			1Q	2Q	3Q	October	November	December	January
GDP	4.1	1.1	1.4	1.5	0.5	–	–1.0	–	–
Retail sales	–1.1	–6.9	–3.1	1.7	2.6	2.4	2.4	...	...
Industrial production	10.6	8.6	6.3	3.5	–2.8	–6.6	–9.1	–23.1	...
Economic sentiment index (*)	102.2	92.9	87.2	84.5	88.3	74.8	57.9	52.9	45.5
Unemployment rate (**)	7.5	7.3	8.0	7.7	7.6	7.7	7.8	8.0	...
Consumer prices	2.4	5.4	5.2	5.7	5.5	4.6	4.1	3.8	3.4
Trade balance (***)	–0.7	–0.3	45.8	112.4	49.7	13.6	13.4	23.6	...

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

easing of inflation (standing at 3.4% year-on-year in January), the margin available for economic policy moves is small. On the one hand, while the National Bank of Hungary cut the reference rate by 50 basis points in February (putting it at 9.5%), excessive easing could push down the foreign exchange rate for the forint even more. On the other hand, fiscal policy is circumscribed by the conditions agreed to with the International Monetary Fund last October, a restriction that limits increases in spending and tax reductions.

The aid received from the IMF represents the third factor in Hungary's situation that could be of a general nature. While up to now Hungary has been the only country among the member states of the European Union that has received such aid to avoid the risk of default in its international obligations, it is highly likely that Romania and perhaps Poland will end up benefiting from similar agreements. Finally, events this month remind us that in 2009 the region will likely undergo a notable cyclical downturn but also that these economies will obtain international aid that will avoid any dangerous spreading of regional problems that could seriously affect all of Europe.

If needed, the region can count on international financial aid.

FINANCIAL MARKETS

Monetary and capital markets

New plans to combat recession

Monetary policy heads work out new plans to combat recession.

When a doctor is treating a patient he must make a diagnosis following an exploration of all the symptoms. Finally, the doctor must propose a cure taking into account all possible disadvantages. Nevertheless, at times the complexity of the illness is such that the doctor has to revise the prescription. This is what has happened in the present crisis that began back in August 2007. A more profound knowledge of the origins and effects of the financial crisis and especially experience regarding the effectiveness of the plans put in place to arrest the crisis has allow those responsible for economic policy to work out new and more suitable solutions.

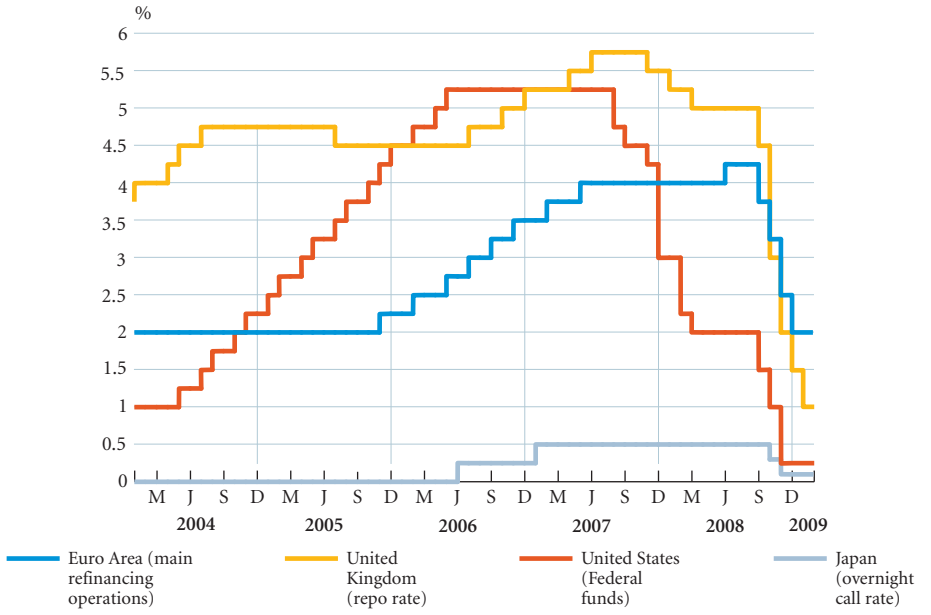
Financial Stability Plan in United States involves public and private sectors.

At the beginning of February, the US Secretary of the Treasury, Timothy F. Geithner, presented a new Financial Stability Plan to Congress. Its strategy is based on combining the strength of the Federal Government with that of the private sector in order to stabilize the financial system. This is an immediate objective in order to reach the final goal which involves reviving the flow of credit to companies and households.

Four pillars of the plan may be underlined. First, a mixed fund is

UNITED KINGDOM CUTS REFERENCE RATE TO 1%

Central bank reference rates



SOURCE: National central banks.

established (involving public and private funds) to acquire assets from banks for an amount of half a billion dollars. Secondly, a solvency test for the banks is carried out and if they pass this test they may be recapitalized with public funds. Furthermore, the TALF Federal Reserve programme is broadened to 1 billion dollars. Under this programme, the Fed provides direct credit for the acquisition of titularizations of loans to consumers and small and medium companies. Finally, a programme would be launched to stop mortgage default with later repossessions through the establishment of a fund of 75 billion dollars to subsidize the rearrangement of loans.

The plan was received with scepticism by the financial markets largely because of the lack of important technical details, for example, how to evaluate «toxic assets». However, it will be put into operation and this will show its ability to reach the objective of stabilizing the financial system in the United States.

The Bank of England, in turn, continues to take strong action with many measures. Following the meeting of its Monetary Policy Committee on February 5 it decided to cut its reference rate by 50 basis points (100 basis points is 1%) putting it at 1%. It justified the move mentioning the complex conditions of the financial markets and the difficulties of companies to obtain funding. It also pointed out the worsening growth prospects world-wide while indicating a further sharp contraction in economic activity and inflation ahead for the United Kingdom.

This meeting of the Bank of England also took an important decision. The members of the committee unanimously agreed that the governor should write to the Chancellor of the Exchequer asking for authorization for the central bank to acquire government bonds and other private sector bonds, financing such acquisitions through a policy of quantitative easing with the aim of increasing liquidity in the financial markets.

Bank of England continues aggressive policy of reference rate cuts.

On the other hand, the European Central Bank decided to maintain the official interest rate in the Euro Area at 2%. This had already been discounted by the financial markets and therefore came as no surprise. At the press conference following the meeting of the Governing Council on February 5, chairman Jean-Claude Trichet stated that the ECB could cut its official interest rate at its meeting in March. The reason for this was the sharp worsening of the economic situation in the Euro Area. Furthermore, he indicated that the cut would very likely be 50 basis points.

While ECB maintains rate at 2% and suggests possible further cut at next meeting.

For the moment, the ECB has been reluctant to lower the reference rate as aggressively as other central banks such as the Fed, the Bank of England and the Bank of Japan or to adopt the unconventional strategies these have followed. The reasons for this approach have been mentioned by various members of the ECB Council in public statements. One point they have stressed is the operational difficulties in implementing a non-conventional quantitative easing policy in the Euro Area.

For example, should the ECB decide to buy government bonds it would have to decide from which country. This could mean applying many criteria. Should it buy them pro rata depending on the amount issued by the various countries or according to the ease of achieving its objective of lowering interest rates on government bonds of some particular

ECB unwilling to lower official rate to 0% because of technical complexity for Euro Area.

Bank of Japan decides to acquire private bonds and presents dark picture ahead for Japanese economy.

term? Or should it do so to lower the interest rate curve of government bonds of those countries that are being most hurt in the financial markets? Indeed, it is not easy to decide on the strategic and tactical aspects of an operation of such complexity in an area made up of 16 sovereign states. That is to say, the specific nature of government bonds in these countries, keeping in mind the various credit and liquidity risks they present among other factors, greatly complicates the implementation of non-conventional measures and explains the cautious position taken so far by members of the ECB Governing Council.

The Bank of Japan also decided to maintain the official interest rate at 0.10% at its meeting on February 19. Due to the sharp worsening of the economy, however, it decided to broaden certain aid already programmed for Japanese financial institutions. In addition, it made an important announcement on its decision to acquire private bonds. The central bank will buy up to 1 billion yen (8,333 million euros) in corporate bonds with A rating or higher. These purchases are to take place in the period starting on March 4 and ending on September 30. According to the governor of the Bank of Japan, Shirakawa, the measure has been adopted in order to facilitate corporate access to credit. Nevertheless, it considers that the Japanese economy will continue to be in a serious situation over the next quarter and that companies will remain in an extremely difficult environment for financing their operations.

Interest rates in interbank market reach or maintain low levels.

Reduction of interest rates in interbank market will increase consumer incomes and lower cost of corporate financing.

Normalization of interbank markets

The massive injection of liquidity made it possible for the interbank markets to reach or maintain low interest rate levels in February. In the Euro Area, for example, the 3-month Euribor rate stands at 1.90%, thus standing below the ECB reference rate. This means that interbank market quotations are now incorporating the news of a very likely cut in the ECB official rate at its next meeting in March.

This means that the banks are willing to lend to each other at an interest rate lower than it costs them to obtain liquidity by going to the ECB due to prospects of further cuts. The 12-month Euribor has also dropped considerably reaching 2.08% on February 20. This is good news for two reasons. First of all, it indicates that we are now a long way away from the pressures operating at the worst moments from the start of the financial crisis. At the same time, all those loans referenced to this index that are to be revised in coming months will benefit from lower interest rates. In the case of households with a mortgage this will increase their disposable income for other purposes while for companies it will mean a decrease in the cost of funding.

The same thing happened in the United Kingdom following the sharp cuts by the Bank of England. In only four months the 12-month Libor rate dropped considerably from 6.30% in September to 2.07% son February 20. On the other hand, both in Switzerland and the United States we can now speak of stability in interbank market rates. In the case of the 3-month Libor rate in dollars, this rose by seven basis points to 1.25%.

In Japan, the 3-month interbank market rate has held at 0.10% for the past three months. With the prospect of the Bank of Japan's quantitative easing policy

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro Area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2008									
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	2.00	2.09	2.27	0.25	1.18	0.10	1.50	2.17	0.70
February (1)	2.00	1.90	2.08	0.25	1.25	0.10	1.00	2.07	0.75

NOTES: (1) February 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%), 15-01-08 (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: 10-05-07 (5.50%), 5-07-07 (5.75%), 6-12-07 (5.50%), 7-02-08 (5.25%), 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 04-12-08 (2.0%), 7-01-09 (1.5%), 05-02-09 (1.0%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

being maintained it is likely that Japan's interbank market rates will stay in a narrow band in coming months holding close to current levels.

In the case of long-term government bonds two key factors should be noted. First, in February there was a resumption of the tendency to lower yields available on government bonds which began around the middle of last year and ended in January. The second key factor was the maintenance and even the increase in the differential created in the Euro Area between Germany and the other member countries.

On February 20, for example, the differential on long-term government bonds between Spain and Germany was 1.21 percentage points whereas at the end of January it was 1.09 points. In the case of France, if we compare the same period, the differential rose by 1 basic point to reach 0.52 points. As a result, in spite of the fact that the absolute level of interest rates on long-term government bonds in the Euro Area countries has dropped, the differentials with German bonds have been maintained or have even increased. It is foreseeable that these will narrow in coming months seeing that current levels include some degree

Long-term government bonds return to lower yields.

of risk aversion that is particularly high in view of the uncertainties in the world economic scenario.

Dollar acting as refuge

Faced with uncertainty, investors take refuge in dollar.

Two key matters in the foreign exchange market deserve to be mentioned. First, in February the dollar recovered against the euro and the Japanese yen. Specifically, ion the past month the dollar has appreciated by 1.3% against the euro and 6.2% against the yen. The euro has suffered because the market is discounting that the ECB will again cut the official interest rate in coming months. In addition, the high degree of uncertainty about the world economic and financial situation, with problems spreading to various regions, has been capitalized on by the dollar which has acted as refuge currency. Both factors should continue supporting the dollar against the euro over coming months.

Nevertheless, we should be warned that one of the biggest risks for the US currency would be a failure of the fiscal stimulus plan to reactivate the world's leading economy. For the moment, however, this is not the key scenario and therefore the tendencies in February will likely be maintained in coming weeks.

The second key point is the situation in the countries of Eastern Europe. Companies and consumers in these countries have borrowed heavily in foreign currencies. When these countries were growing fast, with plenty of liquidity, in a context of low risk aversion, they had no problems in obtaining funding. But the sharp upsets brought about by the current crisis have not left these countries unharmed. The repatriation of financial investments made in these countries, their sharp economic downturn and the difficulties of foreign banks to renew credits has

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

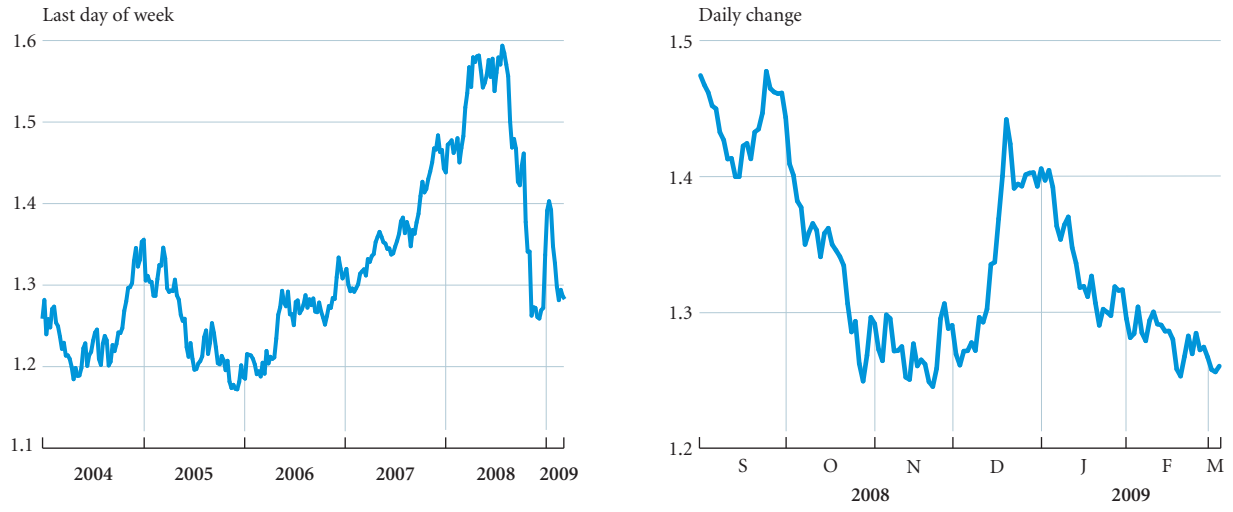
10-year government bonds at end of period as annual percentage

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2008								
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	3.30	3.81	4.39	4.71	2.84	1.30	3.70	2.18
February (*)	3.03	3.55	4.24	4.48	2.80	1.28	3.43	2.07

NOTES: (*) February 20.
SOURCE: Bloomberg.

DOLLAR GETS STRONGER

Euro-dollar exchange rate



SOURCE: Bloomberg.

been a lethal combination that has brought about the depreciation of their currencies.

For this reason, the two most important rating agencies have each published reports in which they point out the possibility that those European banks with heaviest exposure in loans to Eastern Europe may have to face reductions in their credit ratings. This exposure is no trivial matter as pointed out by in a report by the Bank for International Settlements (BIS). In its report for June last year it indicated that the countries most exposed through their banks in Eastern Europe were Austria, Switzerland, Italy, Germany and France while Sweden was notably exposed in the Baltic countries. For this reason, many countries, including Austria, have asked for an international financial aid plan for the region in order to prevent system risks of an increase in default for Europe as a whole.

The BIS report shows that the total exposure of European banks in Poland had reached a figure of 280 billion dollars. We should not forget the loans of more than 200 billion dollars to the Czech Republic and more than 150 billion dollars to Hungary. Another dizzying figure is the 200 billion dollars in credits granted to Russia by European banks.

It was precisely the drop in oil prices that had a negative in Russia. The central bank even went back to defending its currency in order to avoid its going above 36 roubles to the dollar. While it would seem that the central bank has sufficient reserves to defend its currency, the terms have already obliged it to employ very significant amounts. For this reason it also played with the possibility of raising its interest rate to defend the rouble although it did not do this due to the sharp economic slowdown. Another alternative under consideration is imposing administrative controls on flows of foreign capital.

Behaviour of East European currencies causing concern because of exposure of European banks.

EXCHANGE RATES OF MAIN CURRENCIES

February 23, 2009

	Exchange rate	% change (*)		
		Monthly	Over December 2008	Annual
Against US dollar				
Japanese yen	94.6	6.2	4.2	–14.2
Pound sterling	0.686	–5.6	0.2	25.9
Swiss franc	1.163	0.7	8.1	6.3
Canadian dollar	1.252	1.7	2.6	20.4
Mexican peso	14.711	4.6	7.1	26.8
Against euro				
US dollar	1.281	–1.3	–9.1	–15.8
Japanese yen	121.2	5.0	–4.5	–32.2
Swiss franc	1.489	–0.5	–0.3	–8.5
Pound sterling	0.878	–7.0	–8.7	14.2
Swedish krona	11.125	4.6	1.6	16.3
Danish krone	7.450	0.0	0.1	–0.1
Polish zloty	4.613	4.5	10.1	23.4
Czech crown	28.15	0.8	4.6	11.2
Hungarian forint	295.9	2.4	10.2	11.7

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

RUSSIAN CENTRAL BANK DEFENDS ITS CURRENCY

Roubles to dollar

NOTES: Latest figure: February 23.
SOURCE: Bloomberg.

Drop on stock market seems unstoppable

The economic picture and prospects for coming months has not provided a stable framework to prevent shares from dropping. One could feel that, in general terms, taking into account the cumulative drop since the beginning of 2008, that the stock markets were cheap. For example, the Dow Jones index has dropped by 45% since January 1, 2008 while most European indices, such as the DAX or the CAC-40 or the IBEX 35 have reported cuts of more than 50%.

The problem has been the constant downward revisions of corporate profits. This prevented a clear view of the capacity of capital invested in companies to generate profitability. Uncertainty about the impact of anti-crisis plans on the course of the world economy turned into deep insecurity when it came to making forecasts about future profits. Furthermore, in view of cuts in dividends and the need to recapitalize companies, investors had no other choice than to keep reducing the weight given to shares in their investment portfolios.

By sector, those shares to suffer most were still financial. Neither rumours of nationalization of banks in the United States nor the sharp rise in default at a number of entities did anything to stabilize share prices of banks. On the contrary, the sharp increase in volatility came into play with huge movements in quotes for some of the world's largest banks. While no economic sector escaped from the drops on the stock markets, it was noted that the utility companies (electricity, gas and water)

Downward revision of profits, drop in dividends and recapitalization of companies make unfavourable climate for shares.

INDICES OF MAIN WORLD STOCK EXCHANGES

February 23, 2009

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*7,365.7*	*–8.8*	*–16.1*	*–40.5*
Standard & Poor's	*770.1*	*–7.4*	*–14.7*	*–43.1*
Nasdaq	*1,441.2*	*–2.4*	*–8.6*	*–37.4*
Tokyo	7,376.2	–4.8	–16.7	–45.4
London	3,912.4	–3.5	–11.8	–33.6
Euro Area	2,045.7	–4.8	–16.4	–45.3
Frankfurt	*4,066.6*	*–2.7*	*–15.5*	*–40.3*
Paris	*2,788.1*	*–2.1*	*–13.4*	*–42.2*
Amsterdam	*229.1*	*–2.2*	*–6.9*	*–49.3*
Milan	*15,792.0*	*–8.6*	*–18.8*	*–52.8*
Madrid	*7,703.7*	*–5.7*	*–16.2*	*–40.8*
Zurich	4,863.1	–8.4	–12.1	–34.8
Hong Kong	13,175.1	4.7	–8.4	–43.5
Buenos Aires	1,048.6	–1.7	–2.9	–49.8
São Paulo	38,714.6	1.5	3.1	–40.1

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

and telecommunications behaved somewhat better. When all is said and done, investors believe that it is the stability of income and the high dividends in those sectors that offer a defensive factor that becomes very welcome in the midst of the current upsets.

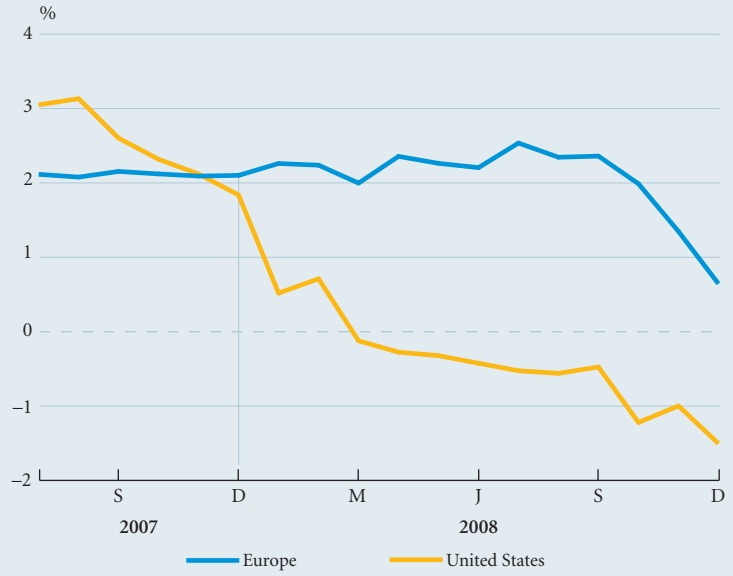
The Fed and the ECB: two strategies and one problem – deflation

The monetary policy carried out by the various central banks has been carefully followed since the outbreak of the subprime mortgage crisis. Up until then policy was limited to setting the interest rate necessary to maintain inflation at low levels. Nevertheless, the financial market turmoil limited the effectiveness of their moves. This obliged them to carry out many reforms, especially in the case of the Fed.[1] Now, furthermore, they face the risk of deflation – the maintenance of inflation at negative rates over a long period of time. In order to avoid such a scenario, the Fed and the ECB have now begun to take a series of extraordinary measures, although these are not risk free.

As shown in the accompanying graph, the response of the two monetary authorities has been different up to this date. The Fed quickly responded right from the start of the crisis and lowered the reference rate from 5.25% where it stood in August 2007 to 0.25% in December 2008. This means that the real interest rate (calculated as the difference between the reference rate and core inflation) has been negative in spite of the fact

ECB REACTING MORE TIMIDLY THAN THE FED

Real interest rates (*)



NOTES: (*) Real interest rates are calculated as reference rates less core inflation.
SOURCE: Thomson Datastream and own calculations.

(1) See box «Ben S. Bernanke: new measures for new problems» published in the Monthly Report, May 2008, for a more detailed explanation.

that core inflation may have eased. The ECB, on the other hand, maintained its interest rate at 4% and even raised it 25 basis points in the third quarter of 2008 letting the real interest rate increase. It was not until October 2008, when lack of confidence became rampant, that it began to lower its rates. The delayed response of the ECB meant that today it still has some margin for manoeuvre in order to stimulate demand through interest rate cuts whereas the Fed seems to have been left without ammunition.

However, the central banks still have a battery of instruments to continue stimulating the economy even when the nominal interest rates are close to zero. The more conventional instruments are policies for injecting liquidity or policies of quantitative easing of their balance sheets – policies that increase their size through an increase in the money supply without raising credit risk. For example, when the central bank injects liquidity by buying government bonds from financial institutions. Under normal conditions, the institutions would use this liquidity to expand credit to companies and households. Nevertheless, in a situation of high risk aversion as now exists they prefer to maintain their liquidity at the central bank.

A further step would be the so-called qualitative easing of the balance sheet. Under this concept we find those policies that affect the risk taken by the central bank. For example, in order to provide the financial institutions with greater liquidity, the central bank may offer them credit with the guarantee of assets of lower quality than government bonds. For example, mortgage backed securities. As in the first case, this would imply an increase in liquidity although the final objective is that this money be used to give credit to companies and households. If none of these measures manages to increase the availability of credit, the central bank may buy commercial paper by printing more money. This would directly increase the amount of money in circulation.

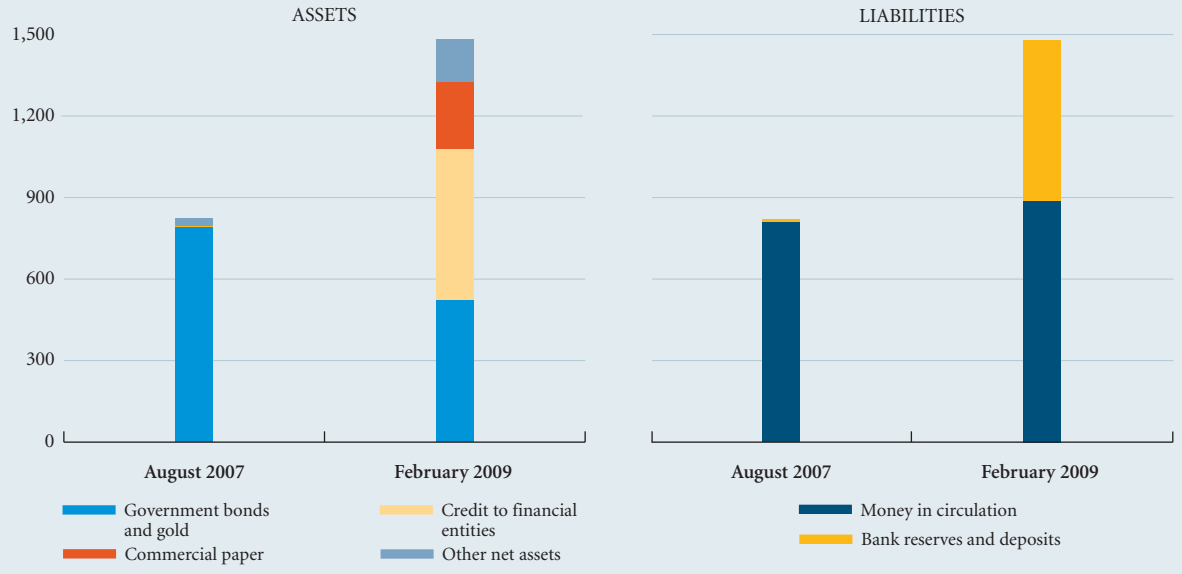
As may be seen in the accompanying graphs, both the Fed and the ECB have carried out a substantial transformation of their balance sheets since August 2007. In the case of the Fed, assets managed have increased by 105%, mainly due to the increase in credit to financial entities. For this purpose, since the beginning of 2008 the Fed has been increasing the range of assets banks could use as collateral. Furthermore, on seeing that the institutions were keeping their money on deposit at the central bank, in October the Fed began to buy commercial paper directly. The Fed is thus carrying out both quantitative and qualitative easing of its balance sheet. The response of the European Central Bank has been less aggressive. Its balance sheet has increased by 65% and, given that it has been accepting a wide range of assets as collateral, it too has carried out both quantitative and qualitative easing of its balance sheet, although it has not yet reached the point where it is buying commercial paper directly.

Evaluating the effectiveness of these measures is difficult as we do not know what would have happened if they had not been taken. However, it is clear that so far we have not managed to revive credit. Furthermore, this policy is not risk free. First of all, because it has increased the credit risk taken by the central banks. In addition, as noted by the Bank of England at the meeting of its monetary policy committee in February, the sharp drop in interest rates will reduce the operating margin of the financial institutions. This could hurt the already limping financial system and it would make the reanimation of credit more difficult. Finally, over the mid-term the huge cushion of liquidity at the disposal of the financial institutions at the central banks could generate inflationary pressures if this is used indiscriminately. In order to avoid this happening, the monetary authorities will have to rapidly reduce the size of their balance sheets when recovery takes place.

Up to now, the two big central banks have followed different strategies to reactivate the economy. The Fed has opted to drastically reduce interest rates and has expanded its balance sheet. For the moment, the ECB is carefully examining the risks it takes but, if the economy does not show signs of recovery, it could be forced to follow in the steps of its US colleagues.

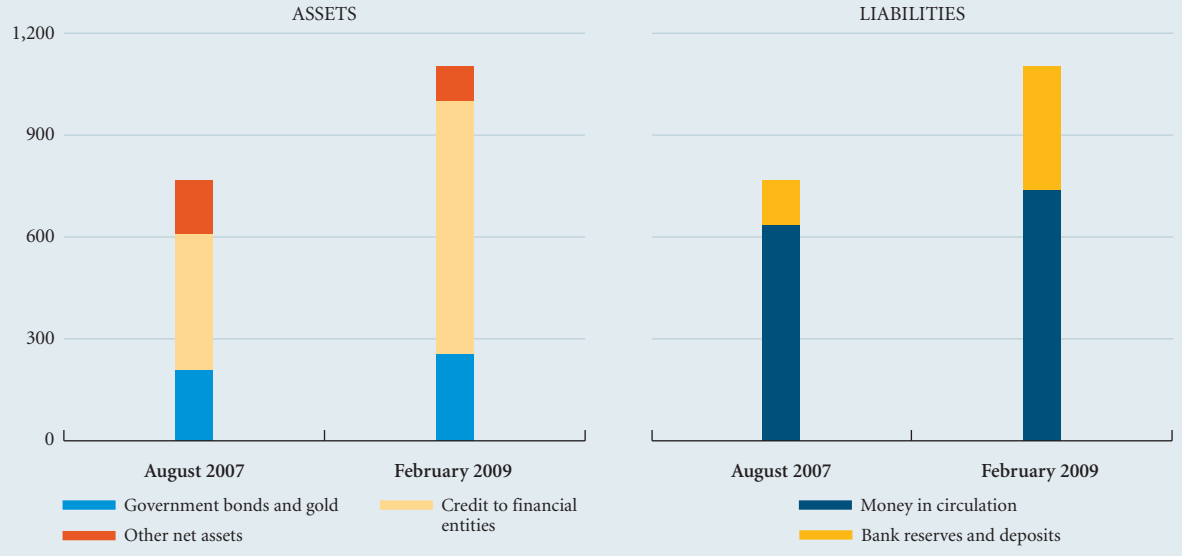
BALANCE SHEET OF THE FED HAS UNDERGONE MAJOR TRANSFORMATION

Billion dollars



REACTION OF ECB HAS BEEN LESS AGGRESSIVE

Billion euros



SOURCE: Federal Reserve, European Central Bank and own calculations.

This box was prepared by Oriol Aspachs
European Economy Department, "la Caixa" Research Department

SPAIN: OVERALL ANALYSIS

Economic activity

Economy moves into recession in 2008

Gross domestic product (GDP) of Spain's economy stood at 1,095.16 billion euros in 2008 and recorded real annual growth of 1.2%, some 2.5 points less than the year before. The slowdown in economic activity, however, sharpened at the year progressed and in the last two quarters it showed negative quarter-on-quarter growth rates, with a rate of 1.0% in the fourth quarter. As a result, in the second half-year the economy moved into recession thus ending a long period of economic growth. In the final quarter of 2008 the year-on-year change rate of the GDP was negative for the first time since the last recession in 1993 showing a drop of 0.7%. Nevertheless, both for the year as a whole and in the final quarter Spain's GDP growth was higher than that of the European Union or the Euro Area.

The unfavourable trend in economic activity may be accounted for by a sharp slowdown in domestic demand which was not fully compensated by the improvement in the foreign sector. A positive factor was that the foreign imbalance began to be corrected even though only moderately. Productivity was up notably but at the expense of job losses.

The sharp slowdown in national demand showed up as a reduction

Gross domestic product of Spain's economy grows 1.2% in 2008...

...but shows negative quarter-on-quarter change rates in final two quarters thus marking end of long period of economic growth.

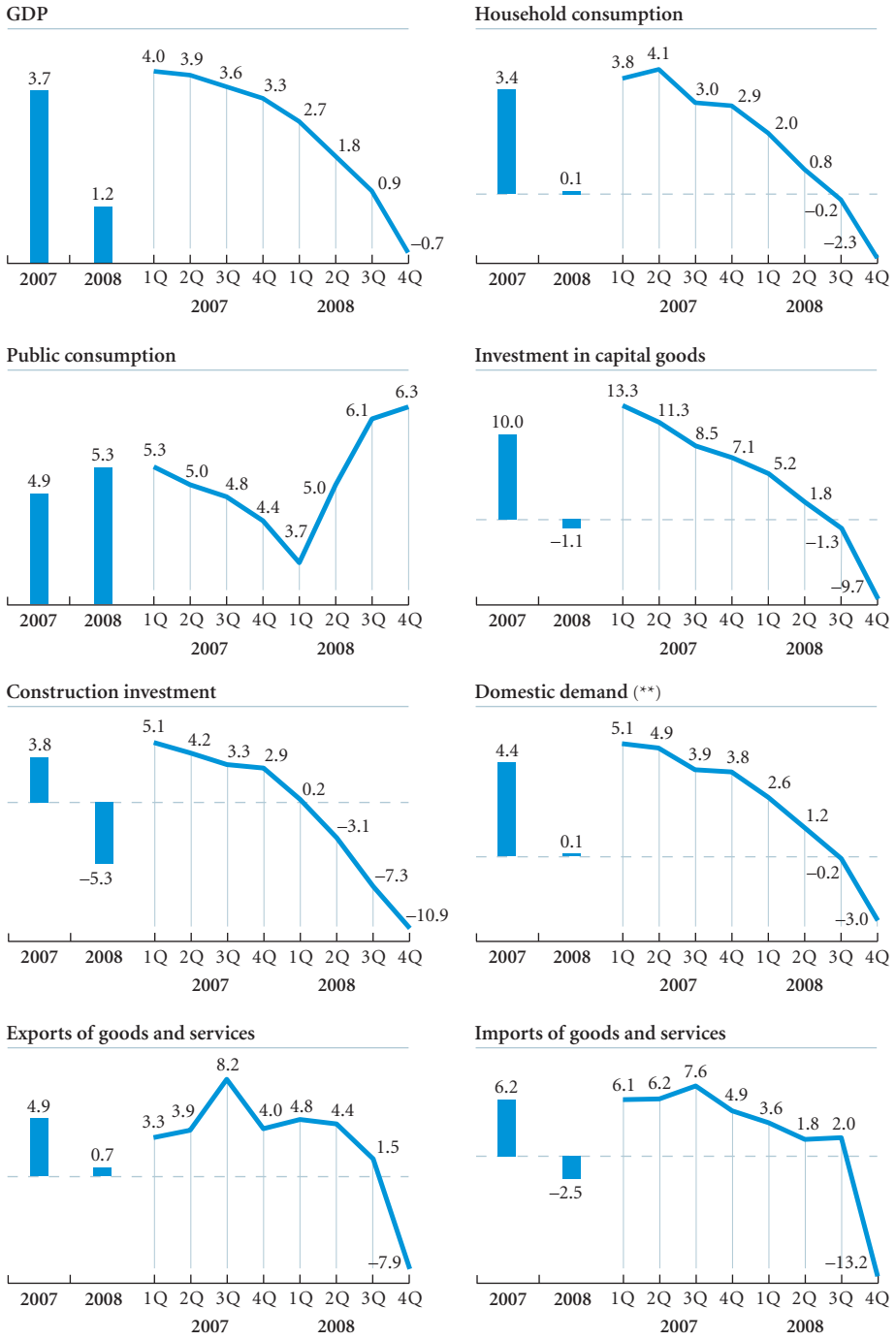
AFTER LONG GROWTH STAGE A RECESSIVE PERIOD HAS BEGUN

Year-on-year change rate of gross domestic product in real terms (Quarters)

NOTES: Figures adjusted for seasonal conditions and calendar differences.
SOURCE: INE and own calculations.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



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

in its contribution to GDP of 4.3 points to a miserable 0.1%. This moderation was partly due to household consumption which showed an annual increase of 0.1%, some 3.4 points less than in 2007 under the effect of the drop in disposable income with the decrease in employment. In the final quarter household consumption reported a year-on-year drop of 2.3%, the lowest rate since the second quarter of 1993.

The dip in spending was greater in goods than in services. There was a notable decrease of 28.1% in car sales which stood at the 1998 level. The drop in sales continued into the first month of 2009. The weakness in the consumer confidence index, which reached an all-time low in December 2008, suggested a continuing contraction of buying in consumer durables. On the other hand, public consumption, playing a counter-cyclical role, was up 5.3% in 2008, some 4 decimals more than in 2007, due to a rise in salaries of public servants.

Sharp slowdown in national demand.

As with investment, domestic demand was at a low ebb. It dropped by 3.0% in 2008, after having risen by 5.3% the year before. It was affected by the slack in domestic and foreign demand and lower corporate profits. Spending on capital goods was down 1.1% for the year as a whole but in the fourth quarter the year-on-year decrease was 9.7%. Utilization of production capacity continued to drop in the first quarter of 2009, marking up the lowest level since 1994, which suggests that the contraction of investment will continue in 2009.

Car sales drop 28% in 2008 and go to 1998 level.

The drop in construction was even greater at 5.3% for the year and 10.9% in the final quarter, marking up the

Investment spending on capital goods down 9.7% in fourth quarter of 2008 compared with one year earlier.

DEMAND INDICATORS

Percentage change over same period year before

	2007	2008	2008				2009	
			1Q	2Q	3Q	4Q	January	February
Consumption								
Production of consumer goods (*)	1.2	–5.3	–0.8	–5.6	–5.5	–9.5	...	...
Imports of consumer goods (**)	5.1	–7.7	–1.2	–6.9	–4.1	–17.2	...	...
Car registrations	–1.2	–28.1	–15.3	–19.6	–32.5	–46.6	–41.6	...
Credit for consumer durables	10.0	6.4	8.8	7.1	3.4	...	–	...
Consumer confidence index (***)	–13.3	–33.6	–20.0	–31.3	–38.3	–44.7	–44.0	–48.0
Investment								
Capital goods production (*)	5.9	–5.6	2.0	–3.1	–3.8	–16.9	...	...
Imports of capital goods (**)	9.8	–19.6	–16.0	–16.4	–15.9	–28.8	...	...
Commercial vehicle registrations	0.3	–43.6	–29.5	–34.1	–50.1	–61.3	–53.5	...
Foreign trade (**)								
Non-energy imports	7.3	–4.9	4.3	0.2	–4.1	–19.0	...	...
Exports	4.2	1.9	2.2	6.6	7.8	–8.4	...	...

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.

Construction investment marks up biggest year-on-year drop in recent decades in fourth quarter of 2008.

biggest drop in recent decades and going above the maximum year-on-year drop of 8.2% seen in the previous recession in the second quarter of 1993. This was mainly due to a sharp drop in investment in housing from 10.9% in 2008 and from 19.6% in the final quarter of 2008, as a result of the real estate market crisis with dropping prices and a 28.6% decrease in housing sales. Other building construction, although down notably, grew by 0.9% for the year as a whole. Other investment (in data-processing software, mineral and oil exploration, etc.) eased its growth rate to 1.9% although in the fourth quarter it showed a year-on-year contraction of 3.7%.

Foreign sector contributes one point to GDP growth as against taking off 0.8 points in 2007.

The foreign sector contributed one point to GDP growth in 2008 as against taking off 8 decimals the year before. This development was due to the fact that imports of goods and services slowed much more than exports to the point where they were down 2.5%. As a result, the foreign deficit, which had recorded a high of 9.7% of GDP in 2007, dropped down to 9.1% in 2008.

Productivity up 1.8% but at expense of lost jobs.

On the supply side, we note that the contraction in construction brought about a progressive slowdown in other sectors, although energy branches and public services marked up higher growth than in 2007. Farming and fishing dropped by 0.6% in 2008 after having shown an increase of 3.0% the year before.

The industrial sector reported an annual drop of 2.7% in value added. Industrial production was down 6.8% in the course of the year with a notable year-on-year drop of 14.6% in consumer durables. In December, industrial orders were down 25.1% compared with the same month the year before, which indicates weak prospects for the sector in coming months.

Growth of private services slowed notably going down to 2.6% although in the fourth quarter its growth rate had dropped to 0.7% annual. The sub-sectors information technology and communications showed greater strength. On the other hand, motor vehicles and fuel and wholesale trade were those to show the biggest drop in business activity. Nor was tourism free of the crisis as it showed a drop of 2.6% in arrivals of foreign tourists and a drop of 1.2% in overnight stays in hotels.

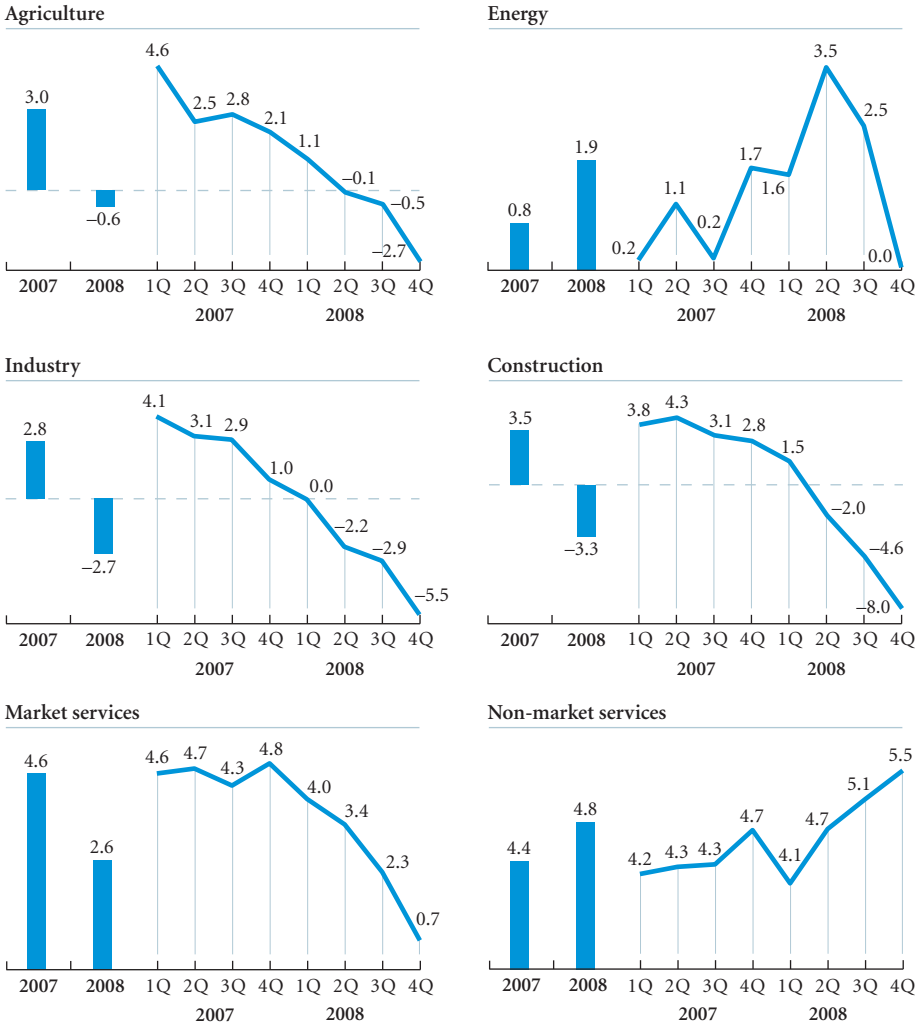
The number of jobs equivalent to full-time work was down 0.6% in 2008, the first annual drop since 1994. As a result, apparent productivity of the labour factor rose by 1.8%, one point more than in the year before. By sector, the biggest increase in productivity showed up in construction where it rose by 8.3% after having recorded drops in previous years. Nevertheless, the increase in productivity came at the cost of a 10.7% decrease in employment. In the primary sector, productivity rose by 4.3%, a half-point less than in 2007. In market services productivity rose by 0.6%, slightly more than the year before. On the other hand, productivity in the industrial branches fell by 1.5%. As a result, given that wages rose by 4.6%, labour costs per production unit increased by 3.4%, some 5 decimals more than in 2007.

Number of insolvency proceedings nearly triples in 2008 compared with year before.

The severity of the recession also showed up in a steep increase in default because of the weak state of sales and tougher financing terms. The number of commercial effects unpaid was up 32.3% in 2008 compared with the year before. The percentage of defaulting effects out of all those due rose by nearly 2 points in the course of the year and stood at 5.7% in December. At the same time, the number of insolvency proceedings nearly tripled in 2008 compared with 2007.

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



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

On the other hand, the number of businesses established was down by 27.8% compared with the year before.

With regard to economic prospects, the worsening world situation as a result of the international financial crisis leads to a forecast of a drop in GDP in 2009 of more than 2%. This is based on a sharp slowdown in national demand, with major decreases in investment, both in construction and capital goods. Household consumption also will keep contracting although to a much lesser extent than investment. On the other hand, the contribution from the foreign sector to GDP growth will go up to two points. Although we foresee a deepening of the recession in coming months, as of the second half-year we expect to see a process of recovery.

Prospects of recession worsening in coming months with improvement starting in second half of 2009.

SUPPLY INDICATORS

Percentage change over same period year before

	2007	2008	2008				2009	
			1Q	2Q	3Q	4Q	January	February
Industry								
Electricity consumption (1)	4.5	0.7	2.9	2.1	1.6	–3.5	–5.6	...
Industrial production index (2)	1.9	–6.8	–0.5	–5.1	–6.1	–15.8	...	...
Confidence indicator for industry (3)	–0.3	–18.0	–7.0	–13.7	–18.7	–32.7	–33.0	–37.0
Utilization of production capacity (4)	81.3	79.5	81.3	80.3	79.3	76.9	–	72.8
Imports of non-energy intermediate goods (5)	8.0	–0.7	11.4	6.9	–2.1	–18.2	...	...
Construction								
Cement consumption	0.2	–23.6	–13.3	–19.6	–25.2	–37.5	–51.9	...
Confidence indicator for construction (3)	9.3	–22.6	–14.7	–17.3	–23.7	–34.7	–38.0	–35.0
Housing (new construction approvals)	–24.7	–59.4	–59.8	–56.0	–62.4	–60.2	...	...
Government tendering	–15.0	4.1	27.7	–29.9	6.4	16.9	...	...
Services								
Retail sales (6)	2.4	–5.8	–3.6	–5.6	–6.4	–7.3	...	...
Foreign tourists	1.3	–2.6	5.3	0.9	–5.3	–9.5	–10.1	...
Tourist revenue inflows	3.6	–0.7	5.2	1.0	–0.3	–8.2	...	...
Goods carried by rail (ton-km)	–3.7	–7.7	–2.7	0.2	–5.2	–23.0	...	...
Air passenger traffic	9.0	–3.1	7.9	–0.7	–4.9	–12.7	–17.1	...
Motor vehicle diesel fuel consumption	4.9	–3.8	–0.9	–2.8	–3.7	–9.6	...	...

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.

Labour market

Sharp drop in employment and big growth in unemployment

Figures from the Labour Force Survey for the fourth quarter of 2008 carried out by the National Institute of Statistics show the dismal situation in the labour market. In 2008 some 620,100 jobs were lost, putting the total figure for those employed at 19,856,700. The drop in employment was especially notable in the fourth quarter with a drop of 489,700 persons compared with the previous quarter. This drop represented an all-time high since statistics have been kept. Furthermore, we may expect that the rate of job loss seen in recent months will continue. The January figure for those registered with Social Security at month-end would so indicate. In fact, in the first month of 2009 this figure was down 349,569, the biggest drop since this data has been kept, putting the figure at 18,182,740, which meant a year-on-year drop of 5.1%. Furthermore, the number of hiring contracts signed through the public employment service in January was down 28.8% compared with the same month the year before. The biggest drop came in permanent hiring contracts which reported a decrease of 39.4%.

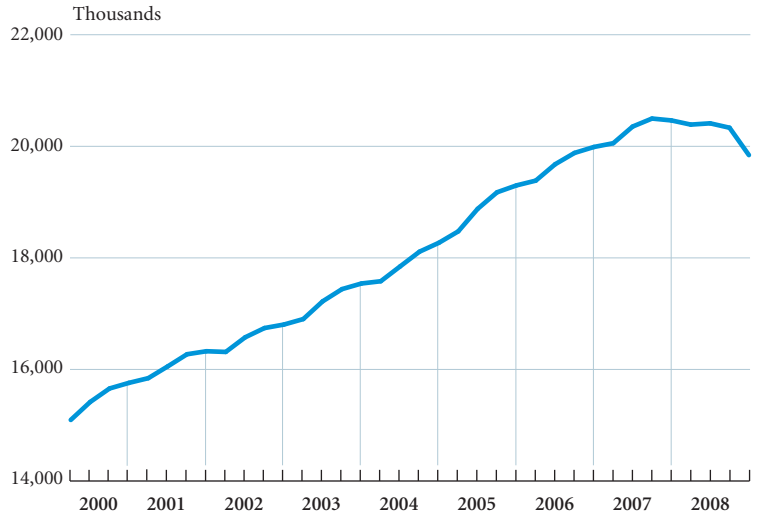
620,100 jobs lost in 2008, according to Labour Force Survey.

National Accounting figures show the same situation for job losses. In 2008, jobs equivalent to full-time work were down 0.6%, a figure in contrast to growth of 2.9% in 2007. At the same time, the figures show that the loss of jobs was sharper in the final quarter with a year-on-year drop of 3.1%. By sector, the figures show that construction reported the biggest drop with a decrease

January employment indicators confirm continuing drop.

SHARP DROP IN NUMBER OF PERSONS EMPLOYED

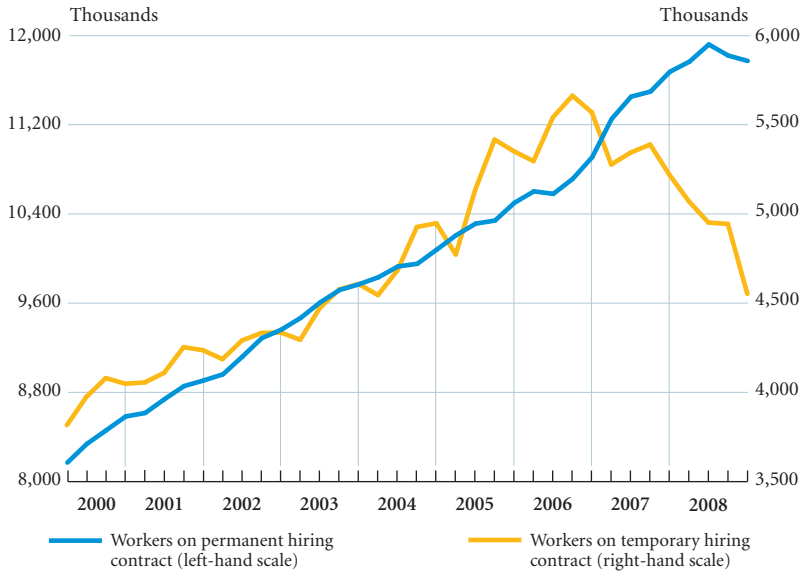
Number of persons employed, according to Labour Force Survey estimate



SOURCE: National Institute of Statistics.

TEMPORARY WORKERS UNDERGO FIRST ADJUSTMENT

Number of temporary workers, according to Labour Force Survey estimate



SOURCE: National Institute of Statistics.

Jobs lost in 2008 concentrated in construction sector and among younger group.

of 21.0%, compared with the fourth quarter the year before.

Returning to the Labour Force Survey, the figures confirm that the loss of jobs in 2008 was worst in construction with a year-on-year drop of 20.7% in the final quarter of 2008. In spite of the fact that employment in the services sector grew in 2008, the figures show that in the final quarter jobs in this sector also began to show losses.

In addition, we should mention that the loss of jobs in Spain is higher than in other Euro Area countries undergoing a similar state of recession or one even sharper. The worse performance in the labour market in Spain is partly due to the heavier weight of the construction sector and the larger volume of temporary hiring contracts. Figures from the Labour Force Survey show that the group to suffer the biggest drop in 2008 was that of those workers on temporary hiring contract which reported a decrease of 12.7% year-on-year. On the other hand, for the year as a whole the total number of workers on permanent hiring contract was up by a modest 0.8%. Nevertheless, job losses are also beginning to show up in those under permanent hiring contract as this group reported a decrease in the fourth quarter of 2008.

By age group, the differences were significant seeing that job losses were concentrated in those under 30 years of age. In fact, job losses were relatively low for adults and there was even growth of jobs in the over-45 age group.

At the same time, we should point out the differences by sex, seeing that, while males showed a year-on-year drop of 5.5% in jobs in the final quarter of 2008, female employment increased, although very modestly at 0.4%. In addition, employment was down more among

Spanish nationals (3.7%) than among foreign workers. For the latter, the number of persons employed stayed slightly below the level reached the year before. At the end of 2008, foreign workers made up 14.5% of total employment. Nevertheless, in the final quarter of 2008 employment among the immigrant group was down for the first time.

All autonomous communities, with the exception of Asturias, showed job losses in 2008. In the fourth quarter, the biggest drops took place in Andalusia, Canary Islands and Catalonia, with year-on-year rate of decrease above 4%. On the other hand, the lowest rates for job-loss were reported from the Balearic Islands, Galicia and the autonomous cities of Ceuta and Melilla.

In spite of the economic slowdown, which often reduces the incentive to actively look for employment among those of working age, the labour force

Employment among immigrant group down for first time in final quarter of 2008.

ESTIMATED EMPLOYMENT

Fourth quarter of 2008

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	863.4	14.4	1.7	–42.4	–4.7	4.3
Non-farm	18,993.3	–504.1	–2.6	–577.8	–3.0	95.7
Industry	*3,059.6*	*–168.1*	*–5.2*	*–219.5*	*–6.7*	*15.4*
Construction	*2,135.0*	*–228.3*	*–9.7*	*–558.5*	*–20.7*	*10.8*
Services	*13,798.7*	*–107.7*	*–0.8*	*200.2*	*1.5*	*69.5*
By type of employer						
Private sector	16,827.2	–529.0	–3.0	–736.4	–4.2	84.7
Public sector	3,029.5	39.4	1.3	116.2	4.0	15.3
By work situation						
Wage-earners	16,308.2	–437.9	–2.6	–568.4	–3.4	82.1
Permanent contract	*11,753.9*	*–47.5*	*–0.4*	*95.7*	*0.8*	*59.2*
Temporary contract	*4,554.3*	*–390.4*	*–7.9*	*–664.1*	*–12.7*	*22.9*
Non-wage-earners	3,535.0	–49.9	–1.4	–58.2	–1.6	17.8
Entrepreneurs with employees	*1,165.3*	*–16.2*	*–1.4*	*29.0*	*2.6*	*5.9*
Entrepreneurs without employees	*2,172.7*	*–10.5*	*–0.5*	*–81.9*	*–3.6*	*10.9*
Family help	*197.0*	*–23.2*	*–10.5*	*–5.3*	*–2.6*	*1.0*
Other	13.6	–1.7	–11.1	6.5	91.5	0.1
By time worked						
Full-time	17,377.8	–644.7	–3.6	–716.0	–4.0	87.5
Part-time	2,479.0	155.1	6.7	95.9	4.0	12.5
By sex						
Males	11,340.6	–418.3	–3.6	–656.5	–5.5	57.1
Females	8,516.2	–71.2	–0.8	36.4	0.4	42.9
TOTAL	**19,856.7**	**–489.7**	**–2.4**	**–620.2**	**–3.0**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Fourth quarter of 2008

	In work force			Employed			Unemployed			Unemployment rate (%)
	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	
Andalusia	3,905	160	4.3	3,054	–167	–5.2	850	326	62.2	21.8
Aragon	665	15	2.3	601	–15	–2.5	64	31	92.1	9.6
Asturias	492	15	3.2	443	5	1.2	49	10	26.4	9.9
Balearic Islands	564	20	3.7	495	0	–0.1	70	21	41.8	12.3
Canary Islands	1,056	31	3.1	832	–80	–8.7	224	111	98.2	21.2
Cantabria	282	5	1.8	256	–7	–2.7	25	12	96.1	8.9
Castile-Leon	1,186	24	2.1	1,053	–28	–2.6	133	52	63.7	11.2
Castile-La Mancha	966	40	4.3	822	–30	–3.5	144	70	95.5	14.9
Catalonia	3,855	56	1.5	3,399	–148	–4.2	456	204	81.0	11.8
Valencian Community	2,570	97	3.9	2,188	–61	–2.7	382	159	71.0	14.9
Extremadura	483	2	0.5	397	–14	–3.4	87	16	23.1	18.0
Galicia	1,324	32	2.4	1,195	–1	–0.1	129	33	33.7	9.7
Madrid Community	3,402	119	3.6	3,057	–17	–0.5	345	136	64.9	10.1
Murcia	725	32	4.6	613	–23	–3.6	113	55	96.5	15.5
Navarre	309	6	1.8	284	–7	–2.3	25	12	93.1	8.1
Basque Country	1,064	5	0.4	975	–23	–2.3	89	28	46.0	8.3
La Rioja	160	2	1.5	145	–4	–2.9	16	7	75.3	9.7
Ceuta and Melilla	58	–1	–2.3	49	0	–0.2	10	–1	–11.9	16.5
TOTAL	**23,065**	**660**	**2.9**	**19,857**	**–620**	**–3.0**	**3,208**	**1,281**	**66.4**	**13.9**

SOURCE: National Institute of Statistics and own calculations.

Labour force continues to grow in 2008...

has continued to grow in recent years although to a more moderate degree. The labour force rose by 2.9% to 23.1 million persons at the end of 2008 putting the labour force rate at 60.1%. By sex, the number of women in the labour force rose in the fourth quarter of 2008 and for the first time went above 10 million, thus reaching a female labour force rate at 51.4%. On the other hand, the number of males in the labour force dropped last quarter putting the male labour force rate down by six decimals to 69.2%. In addition, the foreign worker labour force rate rose by nearly one point in the final quarter of 2008 putting it at 77.3%. The age breakdown of foreign workers largely accounts for the difference in their labour force rate from that of Spanish nationals.

...and unemployment goes up nearly 1.3 million putting unemployment rate at 13.9%.

Because of job losses and the increase in the labour force, in 2008 there was a massive rise in unemployment affecting nearly 1.3 million persons, an increase of 66.4% year-on-year. As a result, the unemployment rate rose by 5.3 percentage points thus going to 13.9% of the labour force, the highest rate since 2000. The unemployment rate for Spanish nationals stood at 12.5% while for foreign workers it was 21.3%.

ESTIMATED UNEMPLOYMENT

Fourth quarter of 2008

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	1,688.8	335.2	24.8	809.6	92.1	52.6	13.0
Females	1,519.0	273.8	22.0	470.7	44.9	47.4	15.1
By age							
Under 25 years	684.9	71.9	11.7	237.2	53.0	21.4	29.2
Other	2,523.0	537.2	27.1	1,043.2	70.5	78.7	12.2
By personal situation							
Long-term unemployment	789.1	179.6	29.5	273.3	53.0	24.6	–
Seeking first job	249.3	–8.0	–3.1	63.7	34.3	7.8	–
Other	2,169.4	437.4	25.3	943.3	76.9	67.6	–
TOTAL	**3,207.8**	**609.0**	**23.4**	**1,280.3**	**66.4**	**100.0**	**13.9**

SOURCE: National Institute of Statistics and own calculations.

Increase in registered unemployment sharpens in January

The number of unemployed registered at public employment offices rose by 198,838 persons in January, the highest increase in a decade putting the figure at 3,327,801. This figure represents an annual rise of 47.1% which means that the rapid growth of registered unemployment is continuing.

Unemployment was up in all sectors in the final quarter of 2008. While the increase in unemployment last year was concentrated in the construction sector, figures for the first month of 2009 show that the upward trend in unemployment is now showing up in industry and services. In addition, the growth rate of female unemployment in January was 6.6% compared with the month before which was higher than the male rate at 6.1%. This figure is a break with the trend in recent months when the increase in male unemployment was above that for females.

Registered unemployment keeps rising in January.

Increase in registered unemployment now reaching services sector.

Prices

CPI records lowest rate in past 40 years

CPI records biggest monthly drop in any month of January with year-on-year change rate of 0.8%.

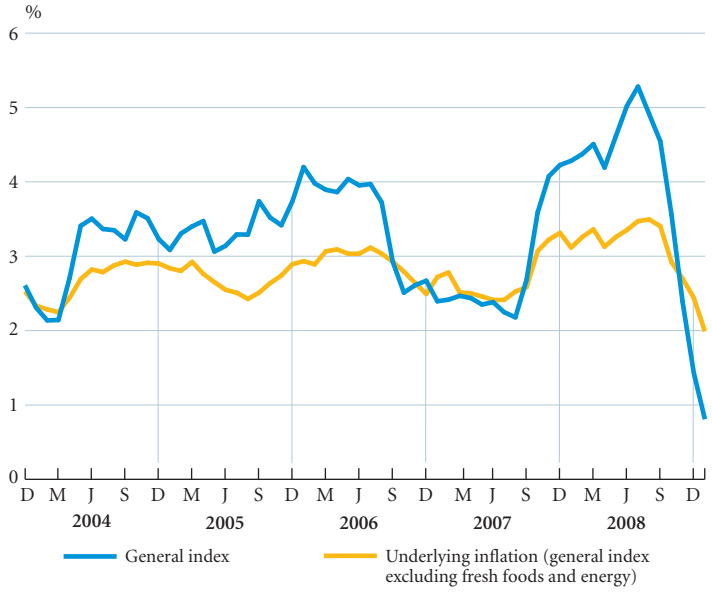
The downward move in inflation continued in January 2009 when the general consumer price index dropped by 1.2 points compared with December, thus recording the biggest monthly decrease in any January in the historical statistical series. As a result, the year-on-year change in CPI went down by 6 decimals to 0.8%, the lowest level since June 1969. Quite remarkable was the sharp drop in inflation in recent months from 5.3% in July 2008 due largely to the collapse of oil prices and food commodities. Nevertheless, in the past two months the moderation of inflation (more than expected) was also due to the effect of the contraction in consumption and possibly to the passing through of the reduction in fuel prices and in prices of other products and services.

Contraction in consumption brings more moderate prices in all special groups.

In January, it is worth noting that all groups forming special components of the CPI reduced their year-on-year change rates without exception, which demonstrates the existing anti-inflationary pressures. If we look at another breakdown, that of consumer groups, only alcohol and tobacco showed an increase in annual change rate due to

SHARP DROP IN INFLATION RATE

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2008			2009		
	% monthly change	% change over December 2007	% annual change	% monthly change	% change over December 2008	% annual change
January	–0.6	–0.6	4.3	–1.2	–1.2	0.8
February	0.2	–0.5	4.4			
March	0.9	0.4	4.5			
April	1.1	1.5	4.2			
May	0.7	2.2	4.6			
June	0.6	2.8	5.0			
July	–0.5	2.3	5.3			
August	–0.2	2.1	4.9			
September	0.0	2.0	4.5			
October	0.3	2.4	3.6			
November	–0.4	2.0	2.4			
December	–0.5	1.4	1.4			

SOURCE: National Institute of Statistics.

tobacco. As a result, the more stable core of inflation, so-called underlying inflation, that excludes non-processed foods and energy products, was down by 4.5 decimals to 2.0%, the lowest level since 1997.

The main contribution to the decrease in the annual change rate in January came from energy products with a figure of more than 2 decimals, thanks mainly to gas and fuels. The negative impact from unprocessed foods was much more modest.

The drop in processed foods was more significant. We should point out the turnaround from the extraordinary rise that had affected cereals and livestock products following the record level in food raw materials in international markets.

Another distinctive feature of the trend in prices in January was the sharper reductions in the winter sale prices as a retail tactic to stimulate consumer buying. Clothing and footwear prices were down 1.7% compared with the same month in 2008, the first year-on-year drop since January 1978.

In turn, some services that were affected by the weakness of demand also showed some easing of prices. Hotels, cafés and restaurants added a half-decimal to the year-on-year drop in inflation while communications did so to a much lower degree.

The consumer price index harmonized with the European Union also showed an annual increase of 0.8%. As a result, the differential with the Euro Area was negative at –0.3 percentage points, the lowest since 2001. We should mention that the narrowing of this differential was influenced by the heavier weight of fuels and lubricants in the Spanish index.

The downward trend in inflation will likely continue until the summer and could even briefly show negative annual change rates because of the all-time high price of oil in July 2008.

Underlying inflation goes down to 2.0%, the lowest level since 1997.

Inflation differential with Euro Area is negative at –0.3 percentage points.

CONSUMER PRICE INDEX BY COMPONENT GROUP

January

	Indices (*)	% monthly change		% annual change	
		2008	2009	2008	2009
By type of spending					
Food and non-alcoholic beverages	110.7	0.5	0.0	7.0	1.9
Alcoholic beverages and tobacco	114.1	2.1	2.1	3.1	4.0
Clothing and footwear	93.8	–11.9	–13.8	0.9	–1.7
Housing	112.2	1.7	0.5	5.3	4.6
Furnishings and household equipment	105.9	–0.2	–0.7	2.5	2.1
Health	99.0	0.4	0.2	–1.9	0.1
Transport	98.9	0.1	–0.6	7.3	–6.2
Communications	99.8	0.4	0.1	0.7	–0.5
Recreation and culture	98.3	–1.4	–1.4	–0.4	0.3
Education	111.6	0.1	0.1	3.9	3.9
Restaurants and hotels	110.7	0.7	0.2	4.8	3.5
Other goods and services	108.6	0.9	0.9	2.4	3.5
By group					
Processed food, beverages and tobacco	111.4	0.7	0.2	7.0	2.5
Unprocessed food	110.5	0.6	0.3	5.5	1.3
Non-food products	104.0	–1.0	–1.6	3.6	0.5
Industrial goods	98.9	–2.5	–3.5	3.4	–2.5
Energy products	*98.9*	*1.4*	*–0.8*	*13.4*	*–9.3*
Fuels and oils	*92.7*	*0.9*	*–2.3*	*16.9*	*–15.6*
Industrial goods excluding energy products	*98.6*	*–3.8*	*–4.4*	*0.1*	*–0.3*
Services	109.4	0.5	0.3	3.7	3.6
Underlying inflation (**)	105.9	–1.0	–1.4	3.1	2.0
GENERAL INDEX	**105.6**	**–0.6**	**–1.2**	**4.3**	**0.8**

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

Sharp drop in farm prices at origin in final months of 2008.

Negative inflation in wholesale prices

All annual change rates in wholesale prices stood on negative ground at the end of 2008 thus reflecting the sharp year-on-year drop in commodity prices, especially in energy products. The general index of industrial prices was down 0.2% compared with December 2007, the biggest drop in the past seven years. Import prices were also down by 3.8% compared with the end of 2007. The drop in prices obtained by farmers (9.7% annual) was greater due to the collapse in livestock products such as milk and agricultural produce.

INFLATION INDICATORS

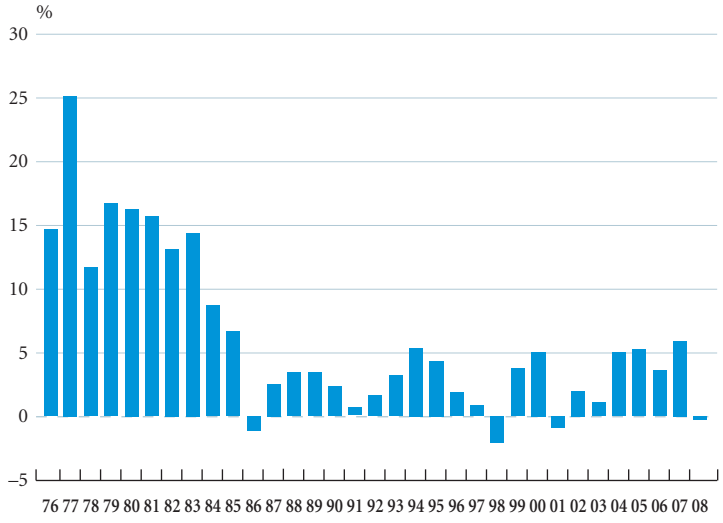
Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2007											
December	17.6	5.9	4.8	2.9	5.0	11.6	4.9	1.1	–0.1	0.7	–
2008											
January	11.1	6.6	5.4	2.7	5.9	13.3	6.7	1.1	0.4	1.8	–
February	7.3	6.6	5.4	2.5	6.0	13.3	6.8	1.4	0.3	1.8	3.2
March	10.5	6.9	5.5	2.3	6.3	14.6	6.8	0.7	–0.2	2.1	–
April	8.5	7.2	5.3	2.3	6.0	16.5	6.8	0.6	–0.2	2.2	–
May	15.2	7.9	5.3	2.0	5.9	21.2	9.1	0.7	–0.1	3.0	3.1
June	8.6	9.0	5.4	2.1	6.3	25.5	10.3	1.1	–0.3	3.4	–
July	14.1	10.3	5.2	2.2	7.3	30.3	10.6	0.5	–0.1	4.7	–
August	6.9	9.2	4.9	2.2	7.4	25.5	9.6	1.3	0.3	5.8	3.4
September	–2.3	8.1	4.2	2.1	7.1	21.6	8.6	1.8	0.6	6.5	–
October	–8.2	5.9	2.9	2.1	5.0	15.2	5.2	3.1	1.4	5.3	–
November	–11.4	2.5	2.1	2.0	2.9	2.9	0.8	4.2	1.9	4.6	2.5
December	–9.7	–0.2	1.6	2.0	1.1	–7.0	–3.8	2.4	1.6	1.7	–

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

PRODUCER PRICES: BIGGEST DROP SINCE 2001

Annual change of general producer price index in December each year



SOURCE: National Institute of Statistics and own calculations.

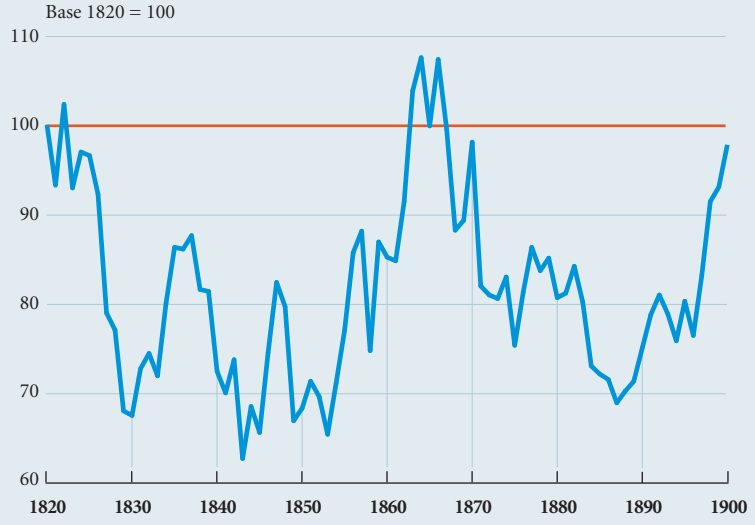
Is there a risk of deflation in 21st century Spain?

In a short space of time we have gone from annual CPI growth of 5.3% in July 2008 to a rate of 0.8% six months later. The producer price index showed a negative annual change of –0.2% in December 2008 whereas five months earlier it reported a maximum level for the past 24 years. These sharp drops in inflation indicators and the prospect that these rates could go down further have raised fears of deflation, that is, a persistent decrease in the general level of prices.

Not many of our readers will remember having lived through a period of deflation in Spain as this is something that has been almost forgotten. On the other hand, the big concern in recent decades has been inflation. Nevertheless, there have been earlier periods with stages of price decreases alternating with times of inflation. In fact, inflation and deflation are phenomena of monetary origin. In the days of the precious metal standard (gold or silver, or both) the abundance or scarcity of money in circulation, relative to the level of production of the economy, largely determined the rise or fall of prices. In the 19th century prices were globally stable, especially if we compare them with the 20th century, but in fact there were drops in prices in a number of years and these were not necessarily linked to decreases in economic activity.

IN 19TH CENTURY PRICES ROSE AND FELL

Price index in Spain



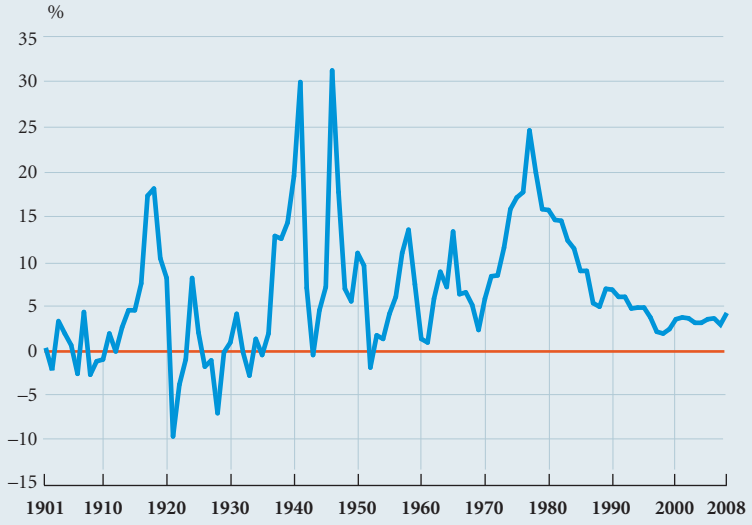
NOTES: Wholesale prices.
SOURCE: J. Sardà wholesale price index up to 1890, the gold standard commissions as of that date and own calculations.

With the progressive substitution of the precious metal standard with the fiduciary issue, backed by the national central bank, the volume of money in circulation was no longer linked to metallic reserves. Discretionary powers in monetary management made it possible to adjust the money supply to swings in farm and industrial production but, at the same time, it provided a strong temptation to states anxious to have funds to spend. The central bank, which ended up as the state banker, often had no other recourse than to

further increase the money supply more than needed. In this way, the phenomenon of inflation kept spreading, inflationary prospects settled into the minds of the economic agents and for a good part of the 20th century price increases were one of the main concerns of economic policy. Since the Spanish Civil War, only during two years (in 1943 and 1952) did the level of consumer prices stand below the year before.

INFLATION DOMINATES 20TH CENTURY

Year-on-year change in price index



NOTES: Wholesale price index of gold standard commission up to 1909 and cost of living and consumer prices index after that date.
SOURCE: De Ojeda, A., «Estudios de Historia Económica», No. 17 Bank of Spain, INE and own calculations.

As of the Nineties of last century, the central banks began to have a more autonomous status in relation to government which made it possible to implement the management of monetary policy oriented toward the fight against inflation. Disinflation, or a reduction in the inflation rate, was general in most advanced countries. In Spain, the most relevant factor was its joining the Economic and Monetary Union in 1999, a step that meant renouncing national monetary and foreign exchange policy and giving up these powers to an independent body, the European Central Bank (ECB).

In view of the possibility of a deflationary period, the states of the Euro Area have no powers of their own in monetary or foreign exchange rate policy to fight against it. We must have confidence that the ECB will act adequately and have the measures at its disposal necessary to avoid falling into a deflationary spiral that could seriously reduce growth prospects of the economy. But we must understand that the ECB watches over inflation in the Euro Area as a whole. Spain's economy forms part of the Eurosystem and, in the same way that since the creation of that system Spanish inflation has run above the Euro Area average, and, of course, above the objective set by the ECB for the area as a whole, in any new period Spanish inflation could just as easily stand below that level or even be negative.

In this context, we may well ask if deflation is possible in Spain. On the one hand, we are now in a recession of the economy as a whole and especially in private consumption. One of things that can set it off is a situation

of drops in prices of stock market and real estate assets which brings about a negative wealth effect tending to depress consumption. Nevertheless, according to empirical estimates made regarding this effect, the contractive impact on consumption seems to be relatively limited. As a result, the marginal propensity to consume is a few cents of increased consumption per euro of increase in real estate wealth.[1] On the other hand, deflationary pressures may come from an excess of installed production capacity, which would contract demand for investment not only in construction. Forecasts for Spain's gross domestic product in coming years stand substantially below potential level, which could tend to moderate prices. On top of this, there is the sharp drop in credit in recent months.

Nevertheless, the traditional rigidities in Spain's economy could make deflation less imminent. Wages are usually indexed to inflation and this year there will likely be increases of more than 2%, which would put pressure on prices. Services, which are strongly sheltered from foreign competition, will probably continue to show some continuation of inflation. In addition, expectations (which are a key factor) do not suggest a deflationary situation. Forecasts by most analysts put average inflation for the year in positive figures with a rise taking place in 2010. The basis for this view is that underlying inflation, considered as the more stable core of inflation, now stands at 2.0%. Furthermore, while the energy component could drag inflation into negative ground in the middle months of this year due to the base effect of oil products (in July 2008 the price of crude oil hit a record), this effect will disappear at the end of 2009, and this could produce an increase in inflation.

Does this mean we do not need to be concerned about deflation? In 2009, the risk of deflation is low. If the recession stretches out more than expected, deflationary pressures could increase with the risk of our slipping into a stage of price decreases. In any case, the best scenario would be one with stable prices so that Spain's lower inflation in terms of the European Union would make it possible to recover competitiveness and thus help the country move out of the recession.

(1) See Bover, O. (2006) «Wealth Effects on Consumption: Microeconometric Estimates from the Spanish Survey of Household Finances», CEPR Discussion Paper 5874.

This box was prepared by the Department of European Economy, Research Department, "la Caixa"

Foreign sector

Foreign trade: economic recession easing trade deficit

The trade deficit for 2008 as a whole was 94.1 billion euros which, after five consecutive years of increases, meant a drop of 4.9% compared with the year before. The cumulative deficit for 12 months reached its maximum in June 2008 going above 104 billion euros, thus reflecting the turnaround in this statistic in the first half of the year. The decrease in the deficit was especially big in the final quarter of 2008 compared with the same period in 2007, with a figure at around 30%, thus showing a reduction of the deficit both in the energy component (8%) and in all other products (42%).

The drop in domestic demand meant that for the first time in the past 5 years the year-on-year increase in exports in 2008 was above that for imports, with growth of 3.7% and 0.6% respectively. The export/import ratio was above that for 2007 by two percentage points at 66.7%. While the growth of exports may be explained equally by the increase in volume (1.9%) and prices (1.8%), real imports were down in 2008 so that it was the increase in prices, especially for energy products, the cause of this growth in 2008.

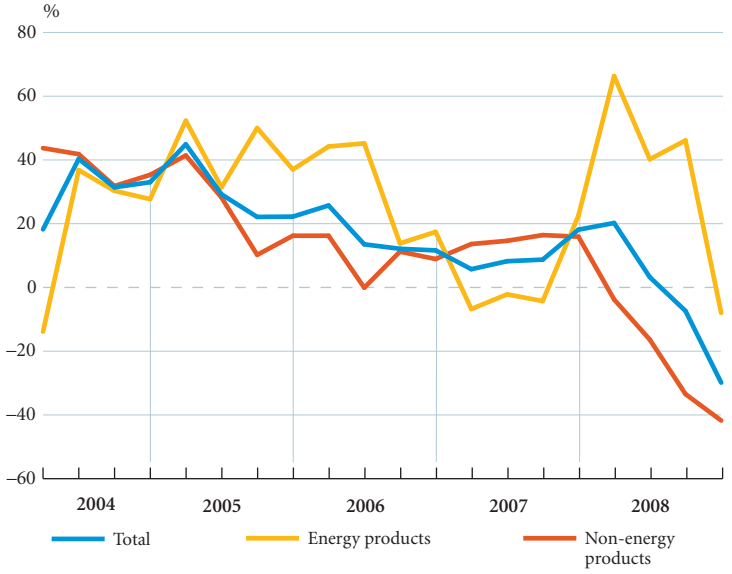
December trade deficit records 30% decrease.

The worsening economic situation at the end of 2008 brought about a contraction in the volume of world trade. Spain was not excluded from this situation and the

Volume of Spain's trade down due to economic situation.

TRADE DEFICIT REDUCED IN FINAL QUARTER OF 2008

Change in trade deficit compared with same quarter year before



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

FOREIGN TRADE

Year 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	56,978	36.3	20.2	11,734	48.2	6.2	–45,244	20.6
Consumer goods	71,031	–7.7	25.2	67,659	4.4	36.0	–3,372	95.3
Food	*15,984*	*1.0*	*5.7*	*22,513*	*6.8*	*12.0*	*6,529*	*140.8*
Non-foods	*55,047*	*–10.0*	*19.5*	*45,147*	*3.2*	*24.0*	*–9,900*	*82.0*
Capital goods	24,274	–18.3	8.6	16,531	–1.3	8.8	–7,743	68.1
Non-energy intermediate goods	129,968	–1.5	46.0	92,260	0.3	49.0	–37,708	71.0
By geographical area								
European Union	154,896	–6.5	54.9	129,582	1.9	68.9	–25,314	83.7
Euro area	*128,232*	*–7.6*	*45.4*	*103,563*	*1.5*	*55.0*	*–24,669*	*80.8*
Other countries	127,355	11.0	45.1	58,602	7.9	31.1	–68,753	46.0
Russia	*7,532*	*–4.6*	*2.7*	*2,836*	*35.9*	*1.5*	*–4,696*	*37.6*
United States	*11,172*	*12.5*	*4.0*	*7,693*	*1.6*	*4.1*	*–3,479*	*68.9*
Japan	*5,112*	*–15.3*	*1.8*	*1,486*	*11.7*	*0.8*	*–3,626*	*29.1*
Latin America	*15,649*	*6.5*	*5.5*	*9,345*	*–7.1*	*5.0*	*–6,305*	*59.7*
OPEC	*29,359*	*34.6*	*10.4*	*7,201*	*28.8*	*3.8*	*–22,158*	*24.5*
Rest	*58,531*	*7.7*	*20.7*	*30,042*	*8.5*	*16.0*	*–28,489*	*51.3*
TOTAL	**282,251**	**0.6**	**100.0**	**188,184**	**3.7**	**100.0**	**–94,067**	**66.7**

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

Deficit expected to keep easing in coming months.

value of its exports and imports showed decreases of 7.4% and 16.5% respectively in December 2008. These reductions were largely brought about by the drop in demand for durable goods and intermediate products for production, which had a notable effect on some sectors such as motor vehicles with exports down 31.5% in December.

The European Union market took up close to 69% of Spain's exports in 2008. With its main trading partners moving into recession in the second half of the year and the subsequent reduction in foreign demand in those countries, both in consumer and intermediate goods, meant a substantial drop in exports to those countries. The year-on-year decrease in December was 13.1%, the biggest since 1995. Only the increase in exports in markets of lesser trade importance, such as those of Africa and Japan, partially compensated for this collapse.

In view of the current situation, it is expected that imports and exports will continue to show the downward trends seen in recent months. On the one hand, the drop in demand from Spain's main European trading partners will affect the volume of exports. The reductions in imports will be even greater in the early months of the year due to the drop in Spanish demand and the difference in oil prices compared with last year, thus bringing about a drop in the trade deficit in this period.

Balance of payments: current account deficit keeps dropping

The current account balance recorded a deficit of 6.37 billion euros in December, 29.6% below the level for the same period the year before. The reduction in the current account imbalance was almost entirely due to the lower deficit in the trade balance. The increased surplus in the services account partly compensated the worse deficit in the current transfers account and the incomes balance.

If we consider this over a longer time span, the cumulative deficit was down 1.2% in 2008 compared with the year before, mainly due to the increase in incomes, the result of the heavier debt load of the economy and the increase in interest rates during most of the year.

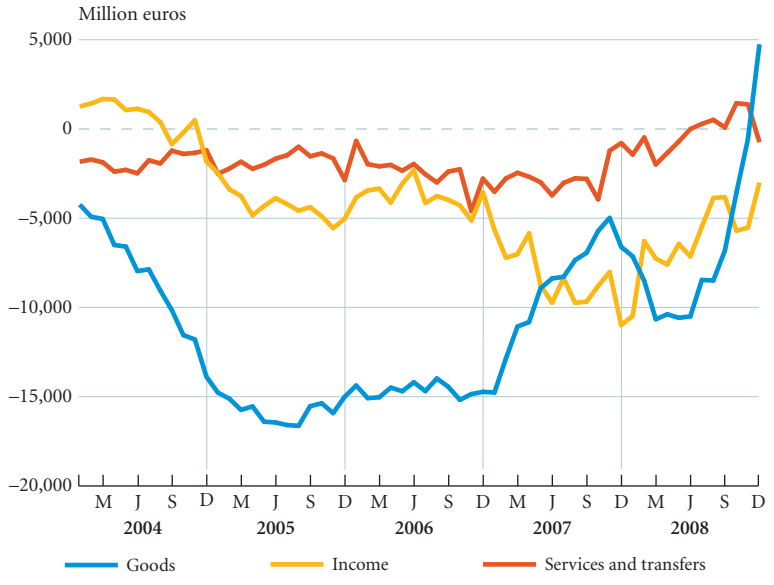
Figures for the trade deficit in December and forecasts for 2009 would indicate that the lower current account deficits will continue over coming months, thus reducing the need for foreign financing of Spain's economy.

With regard to the area of financial flows, the pattern seen in recent months will continue. The reduction in portfolio investment as a cumulative total for the past 12 months (close to 100 billion euros) was partly compensated by lower net foreign direct investment abroad and the increase in funding through short-term financial instruments (loans, deposits and repos). The latter component is taking on much more importance and is a reflection of the change in how the liquidity needs of Spain's financial institutions are being covered.

December records six months in a row with drop in current account deficit.

CONTRIBUTIONS TO CHANGE IN CURRENT ACCOUNT DEFICIT

Cumulative deficit over past 12 months



SOURCE: Bank of Spain balance of payments and own calculations.

BALANCE OF PAYMENTS

December 2008

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–84,980	–5.4	–84,980	4,826	–5.4
Services					
Tourism	*27,780*	*–0.1*	*27,780*	*–31*	*–0.1*
Other services	*–4,017*	*–29.0*	*–4,017*	*1,640*	*–29.0*
Total	23,762	7.3	23,762	1,610	7.3
Income	–34,437	9.3	–34,437	–2,930	9.3
Transfers	–9,010	33.8	–9,010	–2,276	33.8
Total	**–104,664**	**–1.2**	**–104,664**	**1,229**	**–1.2**
Capital account	**5,558**	**23.1**	**5,558**	**1,042**	**23.1**
Financial balance					
Direct investment	–5,082	–89.7	–5,082	44,435	–89.7
Portfolio investment	4,860	–95.3	4,860	–98,944	–95.3
Other investment	60,020	106.8	60,020	30,995	106.8
Total	**59,798**	**–28.2**	**59,798**	**–23,513**	**–28.2**
Errors and omissions	9,172	145.0	9,172	5,428	145.0
Change in assets of Bank of Spain	30,137	110.4	30,137	15,815	110.4

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.

Savings and financing

Funding to companies and households up 6% in 2008

In January, the Euribor (widely used as a reference rate) continued the downward trend begun in mid-October as a result of the drop in prospects for the trend in the official interest rate in the Euro Area. Also contributing to the drop was the notable decrease in the risk premium, which had reached record levels, thanks to the measures taken by governments and central banks to end the blockage in the international market. The monthly average for the 12-month Euribor stood at 2.62% in January 2009, a drop of 188 basis points compared with one year earlier. In the early weeks of February, the 1-year Euribor continued its downward course and went close to the level of the reference rate of the European Central Bank (ECB) to stand at 2.0%.

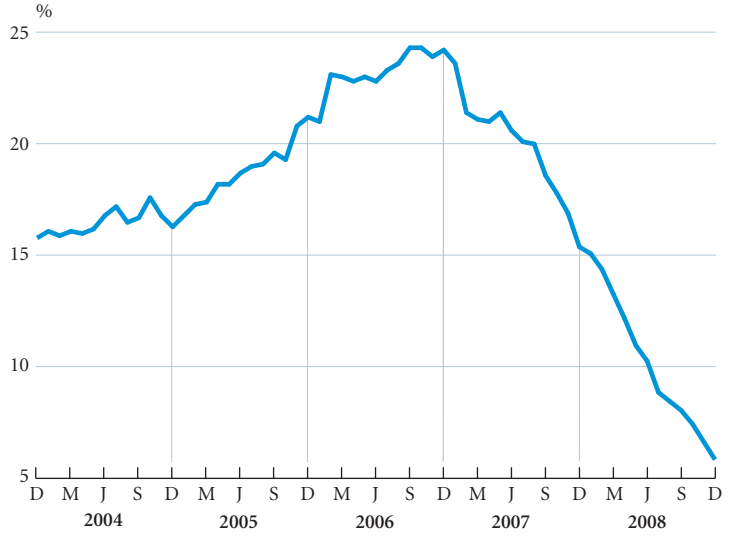
One-year Euribor comes close to ECB reference rate.

In this framework, after having reached the maximum level in recent years at the beginning of Autumn (6.57%), the average interest rate on credits and loans to the private sector began to ease downward going to 5.71% in December 2008. As a result, it marked up a year-on-year decrease of 32 basis points. Nevertheless, we should point out that interest rates rose in real terms given that the decrease in inflation was higher than the drop in nominal rates.

Bank loan interest rates ease downward.

DROP IN FUNDING TO PRIVATE SECTOR SHARPENS IN 2008

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



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

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

December 2008

	Total	Change over 12 months		% share
	Million euros	Million euros	%	
Commercial credit	74,215	–16,627	–18.3	4.0
Secured loans (*)	1,108,816	40,444	3.8	59.3
Other term loans	529,457	31,574	6.3	28.3
Demand loans	49,044	8,472	20.9	2.6
Leasing	45,230	–1,063	–2.3	2.4
Doubtful loans	63,127	46,876	288.5	3.4
TOTAL	**1,869,889**	**109,677**	**6.2**	**100.0**

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

Funding to private sector grows 1.7 points more than nominal gross domestic product.

Along with the weakness in demand for loans because of the recessive situation and tougher loan conditions by offering banks, this explains why in 2008 there was a drop in funding to the private sector. At the end of last year, funding to companies and households grew by 5.9% compared with 12 months before, some 9.5 points less than 12 months earlier and far from the year-on-year rate of 24.3% recorded in September 2006. Nevertheless, it grew 1.7 points more than the nominal gross domestic product.

By type of customer, funding to companies showed a sharp slowdown in 2008 going from year-on-year growth of 17.5% in December 2007 to 7.0% one year later. There was a notable drop of 18.3% in commercial credit (used to finance working capital). Funds aimed at investment were also down considerably if we are to judge by the year-on-year drop in leasing of 2.3%.

Loans and credits granted to households grew less than those going to companies. Housing loans rose by 4.5% in 2008 thus showing a substantial drop from the year-on-year rate of 13.0% in December 2007. While in the final quarter of 2008 the financial effort needed to buy a house was lower because of the drop in prices and interest rates, it was still higher than one year earlier. Other credit to individuals was also down sharply to show an annual increase of 3.8%.

While the slowdown in credit to the private sector showed up in all financial institutions, the savings banks increased their share of this market segment by 2 decimals to 47.5% in 2008 although this level was 3 decimals lower than the high obtained in August 2007. Banks were down in share 2 decimals going to 43.4% while credit cooperatives and other financial institutions maintained their shares at 5.1% and 3.9% respectively.

Default ratio ends 2008 at 3.4%.

The impact of the economic crisis is turning into a sharp increase in default which until recently had stood at all-time lows. In 2008 the default ratio rose from 0.9% in December 2007 to 3.4% 12 months later.

Bank deposits grow more than loans in 2008

The average interest rate on private sector bank deposits continued to drop in December in line with the trend in official interest rates in the Euro Area going to 2.74%, around the same level as one year earlier. Nevertheless, in real terms, that is, taking inflation into account, it stood substantially above the level at that moment.

In this context, given the risk aversion of individuals and the marketing drives by financial institutions to attract deposits and thus increase their liquidity, total private sector deposits in financial institutions grew more than loans rising by 13.1% in year-on-year terms. This increase was concentrated in time deposits which showed an increase of 27.3%.

As opposed to loans, the banks gained market share in the deposit segment (0.9 points) giving them 37.8% although the savings banks had the biggest share at 55.4%. In turn, credit cooperatives lost 5 decimals in share, putting them at 6.5%, whereas loan finance companies had a 0.2% share.

Return on deposits increases in real terms in 2008.

The fierce competition for bank deposits and the generally unfavourable trend in financial markets continued to bring about net withdrawals of participations in mutual funds. In January, however, net withdrawals of 1.81 billion euros were lower than those in previous months and net subscriptions of 156 million euros were recorded in long-term-bond-based funds. Average weighted annual yield for the month was negative at –3.7% but, if we consider the past 18 years, the yield rose to 4.3%, which was better than average inflation in the period.

Nor did real estate investment funds escape the financial upsets. In January, their assets were down 2.1% to 7.25 billion euros. The number of participants dropped by 12.6% to 135,351. Average weighted yield for the past 12 months was negative at –2.0% although for the past 10 years it was 6.1%.

Mutual funds affected by crisis.

Pension funds were also unable to avoid the effects of the financial crisis. While

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

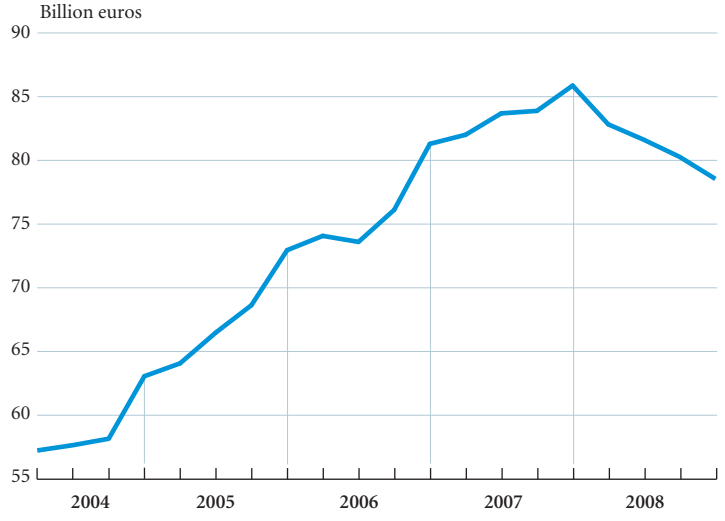
December 2008

	Total	Change over 12 months		% share
	Million euros	Million euros	%	
On demand deposits	244,812	–13,831	–5.3	17.1
Savings deposits	179,777	382	0.2	12.6
Term deposits	729,272	156,483	27.3	50.9
Deposits in foreign currency	29,318	–6,326	–17.7	2.0
Total deposits	**1,183,179**	**136,708**	**13.1**	**82.6**
Other liabilities (*)	248,631	–27,099	–9.8	17.4
TOTAL	**1,431,810**	**109,609**	**8.3**	**100.0**

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

PENSION FUNDS ALSO SUFFER EFFECTS OF FINANCIAL CRISIS IN 2008

Total assets of pension funds



SOURCE: Inverco.

Average annual return on pension funds substantially above inflation in last 18 years.

net contributions totalled 1.87 billion euros in 2008 and participations rose by 2.3%, average annual yield was negative at –8.05%. Nevertheless, if we take a long-term view more appropriate for this product, average annual return was 5.5%, substantially higher than inflation in the period.

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As of December 31, 2008

FINANCIAL ACTIVITY	Million euros
Total customer funds	238,407
Receivable from customers	176,100
Profit attributable to Group	1,802

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	27,818
Branches	5,530
Self-service terminals	8,113
Cards (thousands)	10,344

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2009	Million euros
Social	310
Science and environmental	81
Cultural	79
Educational	30
TOTAL BUDGET	**500**

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