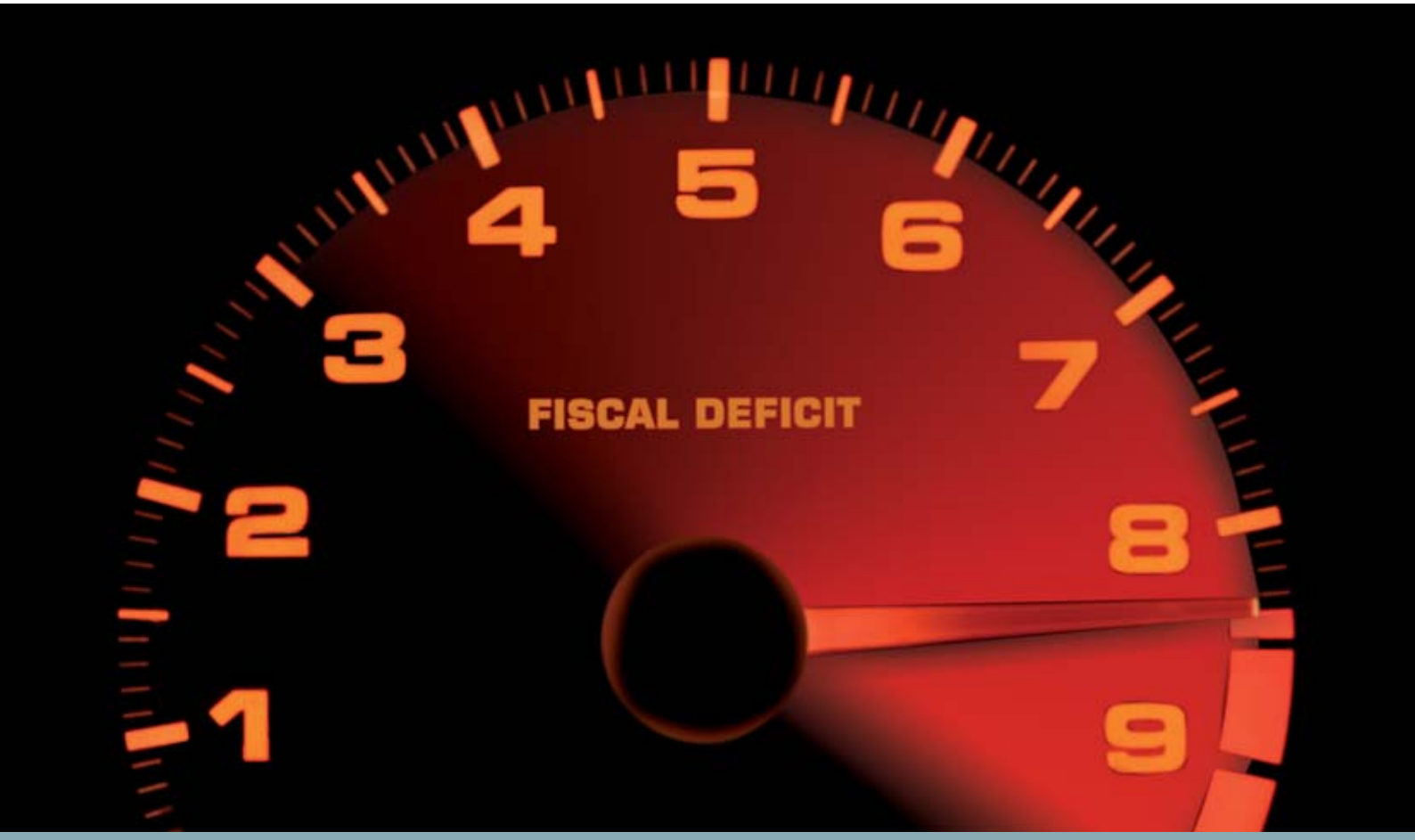
OCTOBER 2009

THE SPANISH ECONOMY

Monthly Report



NUMBER 328

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2008	2009	2010	2009 1Q	2009 2Q	2009 3Q	2009 4Q
INTERNATIONAL ECONOMY		Forecast				Forecast	
Gross domestic product							
United States	0.4	–2.6	1.9	–3.3	–3.9	–2.5	–0.6
Japan	–0.7	–5.7	1.7	–8.4	–7.2	–5.3	–1.6
United Kingdom	0.6	–4.4	1.0	–5.0	–5.5	–4.6	–2.5
Euro area	0.7	–4.0	0.8	–4.8	–4.7	–4.2	–2.3
Germany	*1.0*	*–5.2*	*0.8*	*–6.7*	*–5.9*	*–5.3*	*–2.7*
France	*0.7*	*–2.3*	*0.9*	*–3.4*	*–2.6*	*–2.3*	*–0.7*
Consumer prices							
United States	3.8	–0.4	1.9	–0.2	–0.9	–1.6	1.0
Japan	1.4	–1.2	–0.1	–0.1	–1.0	–2.2	–1.6
United Kingdom	3.6	1.9	1.8	3.0	2.1	1.2	1.4
Euro area	3.3	0.4	1.3	1.0	0.2	–0.2	0.7
Germany	*2.6*	*0.4*	*1.1*	*0.8*	*0.3*	*–0.1*	*0.5*
France	*2.8*	*0.3*	*0.3*	*0.6*	*–0.2*	*–0.2*	*0.9*
SPANISH ECONOMY		Forecast				Forecast	
Macroeconomic figures							
Household consumption	–0.6	–4.9	–0.1	–5.1	–5.9	–4.9	–3.8
Government consumption	5.5	4.3	1.5	6.4	5.1	5.0	4.1
Gross fixed capital formation	–4.4	–17.0	–4.9	–15.2	–17.0	–15.1	–12.5
Capital goods	*–1.8*	*–29.5*	*–7.3*	*–24.2*	*–28.9*	*–24.0*	*–15.0*
Construction	*–5.5*	*–12.5*	*–6.1*	*–11.5*	*–12.0*	*–12.4*	*–12.0*
Domestic demand (contribution to GDP growth)	–0.5	–6.8	–0.9	–6.1	–7.3	–5.8	–4.5
Exports of goods and services	–1.0	–14.4	2.8	–17.6	–15.7	–12.0	–7.6
Imports of goods and services	–4.9	–21.5	–1.0	–22.9	–22.3	–15.5	–11.1
Gross domestic product	**0.9**	**–3.7**	**0.0**	**–3.2**	**–4.2**	**–4.2**	**–3.1**
Other variables							
Employment	–0.6	–6.4	–1.8	–6.3	–7.1	–6.9	–5.5
Unemployment (% labour force)	11.3	18.1	20.1	17.4	17.9	17.9	19.1
Consumer price index	4.1	–0.3	1.6	0.5	–0.7	–1.1	0.2
Unit labour costs	4.6	0.2	–0.8	1.0	1.4		
Current account balance (% GDP)	–9.5	–5.8	–4.8	–8.1	–4.5		
Net lending or net borrowing rest of the world (% GDP)	–9.1	–5.3	–4.2	–7.8	–3.9		
Government balance (% GDP)	–3.8	–10.9	–11.4				
FINANCIAL MARKETS		Forecast					Forecast
Interest rates							
Federal Funds	2.1	0.3	0.6	0.3	0.3	0.3	0.3
ECB repo	3.9	1.2	1.3	1.8	1.1	1.0	1.0
10-year US bonds	3.6	3.2	3.7	2.7	3.3	3.5	3.4
10-year German bonds	4.0	3.2	3.6	3.1	3.4	3.1	3.2
Exchange rate							
$/Euro	1.48	1.38	1.38	1.30	1.36	1.43	1.42

Contents

What's to be done about the fiscal deficit?

Before the crisis there was a broad consensus that the utilization of discretional fiscal policies of a counter-cyclical nature was undesirable as they did not contribute to the stability of the economy and could even have adverse effects. It was better to allow the «automatic stabilizers» to operate. If economic activity was falling, the drop in tax collections and the increase in transfers to individuals (unemployment benefits) would automatically ease the decrease. On the other hand, if the economy heated up again, this mechanism acted in the other direction partly counteracting the cyclical movement. Furthemore, it was considered that monetary policy was indeed adequate to deal with episodes of recession or overheating.

This was followed in the early stages of the financial crisis that broke out in 2007. When the instruments of conventional monetary policy were used up (scarcely with any results), the central banks then applied measures of an exceptional nature in an attempt to expand liquidity by all possible means. Governments went on the alert in order to avoid a collapse of the financial system and to support those entities in difficulties. What was feared actually came to pass. The bankruptcy of Lehman Brothers on September 15, 2008 set off the alarms, turned the crisis into a global one and put many financial entities at grave risk.

With credit channels blocked, real economic activity suffered a sharp slowdown, all happening at the same time at the international level, that suddenly ended a long stage of prosperity, excesses and imbalances. In view of the severe and unexpected financial crisis, that inexorably was passed on to real economic activity, any initial hesitation to put extraordinary fiscal policies into practice was set aside. The automatic stabilizers were not working. Governments and international bodies called a clearing of the decks for action with fiscal measures. The disaster had to be faced, cost what it may.

And it has cost a lot. At this moment, the worst of the crisis seems to be behind us but this year many countries will reach government deficits at two digits of gross domestic product, something unheard of in times of peace. The mountain of government debt keeps on growing without stopping. Now the international bodies are hurrying to warn governments that they may not be able to manage the imbalance. What is to be done? We should distinguish between the four factors that put the deficits off the rails – the automatic stabilizers, financial system support, discretional fiscal stimulus and, in some cases, other nondiscretionary effects corresponding to extraordinary income arising from a real estate or financial boom that is not going to be repeated. In an optimum scenario in which the present incipient recovery is consolidated, the automatic stabilizers would stop generating deficits on their own, the reshaping of financial markets would minimize the losses arising from aids to entities and the fiscal stimulus packages would be retired as the economy recovered strength. The fourth factor in generating deficits would make it necessary to adjust government revenues and spending in those countries where these have developed. In any case, in this context, the balancing of government finances would be possible within a reasonable period of time.

The problem lies in whether we must wait for recovery to take place, if it is weaker than expected or should there be any repetition. In all these cases, we shall have to decide which is worse, whether we should let the deficit and the government debt keep growing (with increasingly dangerous deficits) or cut off the flow with the subsequent risk of jeopardizing recovery. This is a delicate dilemma the solution of which for the moment is floating in the air and for which there are no general recipes given that the situation is different in each country.

EXECUTIVE SUMMARY

Third and final stage: recovering lost jobs

Worst of recession now behind us but improvement not yet felt by ordinary citizen or companies but rather the opposite.

The recovery of the international economy is continuing. The worst of the financial crisis is now behind us. These are two statements now being repeated in specialized circles which were also heard at the summit of leaders of the main world economies in the G-20 at the end of September. Nevertheless, for most ordinary citizens and business executives the recession stands at its peak and signs of recovery are not evident. What is really happening?

Main stock market indices paint recovery scenario.

A brief review of the various stages in the recovery process could help us to understand the dynamic at play. The first stage began with normalization of international financial markets. One year after the failure of Lehman Brothers investment bank the situation has improved noticeably. Most indicators of financial pressures have now recovered levels prior to the crisis. The clearest example is the trend in the main international stock market indices which now stand at levels close to those of September last year and now suggest a world economic scenario for a recovery of the cycle and a reduction of risk. Private bond markets also keep improving. Credit risk premiums on corporate bonds have gone down to levels before the Lehman Brothers crisis. Large companies are making record bond issues and lengthening bond maturities.

The segment finding it hardest to recover is bank credit. Bank loans to small companies and households are stagnant or still falling, both in the United States and the Euro Area. This is the result of a major process of deleveraging that the banks themselves and households must carry out in coming quarters. If we are to be guided by the experience of earlier episodes, credit will take time to straighten out but as a result of the measures taken by the European Central Bank and the Federal Reserve (the Fed) and various governments it is to be hoped that the correction will not be overly long in coming.

Germany, France and Japan leading recovery in economic activity in developed countries...

The second stage of the recovery process was led, or is being led, by the revival of economic activity. Three of the main world economic powers, Germany, France and Japan, reached this stage in the second quarter on marking up a positive quarter-on-quarter growth rate. The United States and the Euro Area as a whole considerably reduced their rates of contraction and everything suggests that in the third quarter both economies will return to positive ground.

In the United States it is noteworthy that the housing market has now hit bottom. Both the Case-Shiller price index and the number of housing starts point in this direction and it seems likely that this sector will go back to making positive contributions to economic growth. In any case, it is important to underline that the recovery process begun in the main developed economies is partly linked to the economic stimulus programmes carried out by the various governments. It is because of this that we are not expecting a very rapid process

in either of these two cases. In the United States we foresee that in 2010 the economy will mark up a growth rate of close to 2% while in the Euro Area, with its lower growth potential, it will be difficult for it to go above 1%.

Over the medium term, the challenge lies in a recovery of consumer and corporate confidence and the normalization of international trade. This is critical because the current hesitant recovery is resting on stimulus programmes that are coming from public deficits that will be difficult to sustain. In addition, the foreign sector that is being a determinant in the recovery of the developed economies, especially for the Japanese and German economies, depends on an economy such as China which is also supported by a massive package of economic growth measures which thus has a limited life. It is also true that for other developing countries such as Mexico, Poland or Czech Republic growth prospects have notably improved but this is the result of the recovery of its main trading partners, the United States and the countries of the Euro Area. These delicate balances show the fragile nature of the current recovery.

In this context, a factor that largely explains why the incipient improvement in economic activity is not perceptible in the case of households and companies is that the labour market is still getting seriously worse. This fully justifies the fact that consumers are putting off spending and is a factor in the lack of confidence of companies in the immediate future. Normally, the stabilization of the labour market is the third and last stage in the process of economic recovery.

In the Euro Area, the unemployment rate arrived at in July was 9.5% and the current recessive period has left close to 4 million persons without work, a figure that is relatively low compared with the historical decrease in economic activity. In the United States, the months with major drops in employment are now a thing of the past but the correction has still not hit bottom. Some 216,000 jobs were lost in August, the biggest drop in one year but applications for unemployment benefits in the same period moved up, as did the unemployment rate, which again went up to 9.7%. We do not foresee that the labour market will show convincing signs of recovery until mid-2010. The apparent dichotomy between the recovery in economic activity and the perception one may have of the state of the economy will still continue for some months.

...but weak factors in recovery do not guarantee its continuing over medium or long term.

The situation in which Spain's economy stands remains very close to these features. Spain's financial markets have recovered fairly quickly. Without looking farther, the IBEX 35 has now shown an increase of nearly 30% so far this year and bond issues have been given a strong boost with the improvement in the condition of financial markets with a year-on-year increase of 26.2%. As in other developed countries, bank credit is taking time to come out of the hole. In July, funding granted to the private sector showed a year-on-year increase of only 1.5% as against 9.1% twelve months earlier. It should be kept in mind, however, that domestic demand in the first half of 2009 took off nearly 8 percentage points from the gross domestic product (GDP) for the period in current terms, so that in these circumstances it is difficult to expect a relaunching of credit.

Worsening of labour market lies behind drop in consumer and corporate confidence.

With regard to the second stage of the process of economic recovery, the revival of economic activity, Spain's economy stands behind most of the economies in

Spain's economic activity showing lower drop but end of recession will be slower in spite of optimism arising from stock market index.

Labour market halting downturn but unemployment continues to climb.

its orbit. In any case, it is also true that the contraction of the GDP up until now has been less than in many of those countries. Growth figures for the second quarter indicate a moderation in the rate of economic contraction, a process that continued in the third quarter. On the supply side, all sectors recorded higher year-on-year decreases than in the first quarter although in coming months these sharp decreases will likely ease. This is suggested by the improvement in industrial confidence in July and August and the easing of the reduction in electrical power consumption.

In view of this reality, the third stage of the recovery process, the improvement in the labour market, will have to wait more than desirable. The trend to loss of jobs has eased substantially in recent months but it still continues. The unemployment rate has risen to the highest in the European Union and twice the average. The slight improvement in the economic situation does not indicate any correction of this until the end of 2010. In this respect, the Organization for Economic Cooperation and Development (OECD) recently predicted that the unemployment rate in Spain could come close to 20% next year.

Exports move ahead favourably.

The problem for the medium-term growth of Spain's economy is also similar to that of the rest of the developed countries. In any case, we should underline the dynamic state of the foreign sector which is helping to drastically reduce the current account deficit, one of the major imbalances of Spain's economy.

Central government's 2010 budget raises taxes to contain high public deficit in still recessive context.

The biggest concern at this time lies in the effects of the generous stimulus programmes put into motion to halt the drop in economic activity. In this respect, the central government budget estimates for 2010 approved by Cabinet at the end of September include a broad range of measures to keep the public accounts afloat. Specifically, these include removal of the 400-euro deduction on personal income tax, a rise in value added tax from 16% to 18% in the general category and from 7% to 8% in the reduced category as of July 1, and an increase in taxation on capital earnings up to a maximum of 21%. On the other hand, the budget reduces the tax rate from 25% to 20% in the case of small and medium companies and self-employed workers who maintain or increase employment. In central government spending, the budget provides for a cut of 3.9%. As a result, it is planned to reduce the government deficit from 9.5% of GDP in 2009 to 8.1% in 2010 while maintaining the objective of returning to a deficit of 3% in 2012. In turn, the public debt would go from 53.4% in 2009 to 62.5% in 2010, still well below the average for the Euro Area.

The economic authorities recognize that the budget year will occur in a situation still marked by the recession given that a drop of 0.3% in GDP is expected with decreases in consumption and investment and with flat price indices. Employment will continue to drop and unemployment will reach all-time highs. Only the foreign sector will save the year given that its contribution to growth is estimated at 0.7 percentage points. In any case, this course represents a considerable improvement over the results for 2009 which are showing a decrease of 3.6% in GDP and a drop in employment of 6%. It therefore involves a scenario of slow recovery, very much conditioned by the weakness of domestic demand and the revival of the world economy.

September 28, 2009

CHRONOLOGY

2008

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**.
March	**5**	**European Central Bank** lowers official interest rate to 1.50%.
	6	Central government announces measures to **facilitate financing of working capital for medium-sized companies** and to **revive employment** and ease effects of **unemployment**.
	27	Government approves series of **measures to boost economic activity**: reform of law on meetings of creditors, revival of credit insurance and introduction of EU directive on services.
April	**2**	**European Central Bank** lowers official interest rate to 1.25%. G-20 meeting in London aimed at **reform of international financial system**.
May	**7**	**European Central Bank** lowers official interest rate to 1.00% and announces measures to facilitate liquidity in banking system.
	12	Government announces **new economic policy measures**: partial removal of tax deduction for buying normal residence as of 2011, aids for buying cars, reduced taxes for some small and medium-size businesses and self-employed persons, etc.
June	**12**	Government **increases taxes** on tobacco, petrol and diesel fuel for motor vehicles.
	26	Government establishes **Fund for Orderly Restructuring of Banks**.
September	**22**	Dow Jones index for **New York stock exchange** records annual high (9,829.9), a rise of 12.0% compared with end of 2008.
	23	IBEX 35 index for **Spanish stock market** marks up annual high (11,853.3) with cumulative gain of 28.9% compared with end of December 2008.

AGENDA

October

- **2** Registration with Social Security and registered unemployment (September).
- **5** Industrial production index (August).
- **8** Governing Council European Central Bank.
- **14** CPI (September).
- **15** EU HCPI (September).
- **22** Foreign trade (August).
- **23** Labour force survey (3rd Quarter).
- **26** Producer prices (September).
- **27** Central government revenue and spending (September).
- **29** Flash HCPI (October). US GDP (3rd Quarter).
- **30** Balance of payments (August).

November

- **3** Registrations with Social Security and registered unemployment (October). Fed Open Market Committee.
- **5** Industrial production index (September). Governing Council European Central Bank.
- **12** Flash GDP (3rd Quarter).
- **13** CPI (October). EU GDP (3rd Quarter).
- **17** Harmonized CPI for EU (October).
- **18** Quarterly National Accounts (3rd Quarter).
- **24** Producer prices (October). Central government revenue and spending (October). Foreign trade (October).
- **27** HCPI (November).
- **30** Balance of payments (September).

INTERNATIONAL REVIEW

United States: a hard recovery begins

United States: growth of economy expected in third quarter.

Available indicators suggest that the world's largest economy has now left behind the deepest and longest recession since World War II. The third quarter will again show growth of the gross domestic product (GDP) in quarter-on-quarter terms following a year of consecutive drops. The improvement in risk premiums, the bottoming-out that seems to have taken place in the real estate market and price stability show a better picture that only three months ago.

Recovery will be hindered by household debt and labour market.

The road back to recovery, however, will not be easy. With the sharp drops that have taken place it is possible that in coming months there will be increases of some importance. Nevertheless, a consistent and vigorous upward trend is far from certain. The economy remains dependent on expansionist policies. Household finances have benefited from recent recoveries in financial asset prices but the process of reducing debt still has a long way to go. This means that a significant part of income is going into savings rather than consumption. Loans granted to households, which form the greater part of their debt, were down by

UNITED STATES: MAIN ECONOMIC INDICATORS

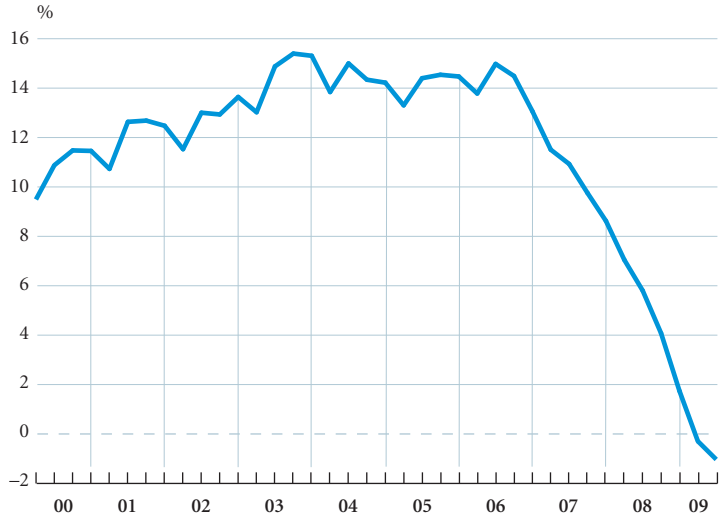
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
Real GDP	2.1	0.4	0.0	–1.9	–3.3	–3.9	–	...
Retail sales	3.3	–0.7	0.3	–8.0	–8.9	–9.5	–8.5	–5.3
Consumer confidence (1)	103.4	58.0	57.3	40.7	29.9	48.3	47.4	54.1
Industrial production	1.5	–2.2	–3.2	–6.7	–11.6	–13.0	–12.4	–10.7
Manufacturing (ISM) (1)	51.1	45.5	47.4	36.1	35.9	42.6	48.9	52.9
Sales of single-family homes	–26.7	–37.4	–36.2	–41.0	–40.0	–28.0	–13.4	...
Unemployment rate (2)	4.6	5.8	6.1	6.9	8.1	9.3	9.4	9.7
Consumer prices	2.9	3.8	5.3	1.6	0.0	–1.2	–2.1	–1.5
Trade balance (3)	–701.4	–695.9	–725.8	–695.9	–605.7	–505.9	–472.9	...
3-month interbank interest rate (1)	5.3	2.8	3.2	2.2	1.2	0.8	0.5	0.3
Nominal effective exchange rate (4)	77.9	74.4	73.5	81.3	82.7	79.4	76.5	75.2

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

UNITED STATES: COURSE OF DELEVERAGE NOW BEGINNING

Year-on-year change in household debt



SOURCE: Federal Reserve and own calculations.

1.1% year-on-year in the second quarter whereas in the four years before the recession increases of 14% were predominant. The labour market will also continue to be a burden in coming months which will limit consumer incomes.

Latest demand indicators confirm this incipient trend to recovery. Retail sales in August were up 2.7% over July. While government incentives to buy cars had considerable significance in this advance, the indicator excluding cars and petrol showed its best figure since February rising by 0.6% over the month before. This confirms the background strength of consumption in recent months. The question now is if this increase will continue when government incentives are reduced. Along the same lines of improvement, the consumer confidence index published by the Conference Board in August showed an upward move following two months in row of decreases going from 47.4 points to the level of 54.1.

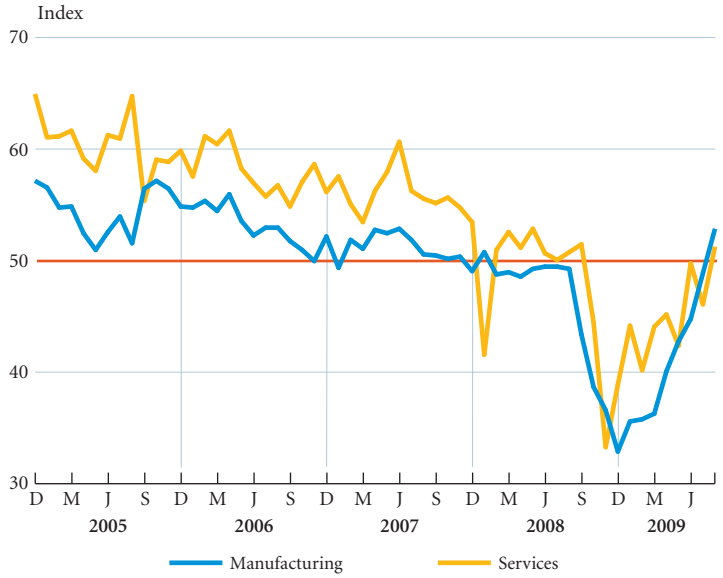
Consumer confidence improving and retail sales on rise.

On the supply side, the signs of recovery are more and more established although they are mainly confined to confidence indicators rather than real economic activity figures. The business sentiment index put out by the Institute for Supply Management in August went above the threshold of 50 points which is considered the point marking the beginning of an expansionist stage. The manufacturing index showed its eighth month with consecutive increases going to the 52.9 points level while services compensated for the drop the previous month by moving up to 51.3 points. Industrial production in August recorded its second month to show a rise but continued to show signs of slowing down and was still far from levels seen in the same period last year. In the same way, utilization of production capacity left behind its very low levels but did so rather weakly.

Business executives now optimistic but industrial production remains weak.

UNITED STATES: BUSINESS EXECUTIVES AGAIN SEEING POSITIVE SIGNS

Level of ISM indices (*)



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

Housing hits bottom. Prices rise for first time in three years.

The housing market is now showing a pattern similar to that in the rest of the economy. It has now hit bottom but is beginning a recovery that is held back by past excesses. In the case of real estate, these excesses are the mortgage loan defaults that, following repossessions, increase the stock of properties on the market. Following three years of uninterrupted drops, the Case-Shiller price index showed an increase of 0.7% over the previous month, in seasonally adjusted terms. On top of the stabilization of sales came additions to supply. August saw 598,000 housing starts in annual terms. This confirms the gradual trend to recovery since the all-time low in April and it is likely that the sector will soon again be making positive contributions to economic growth.

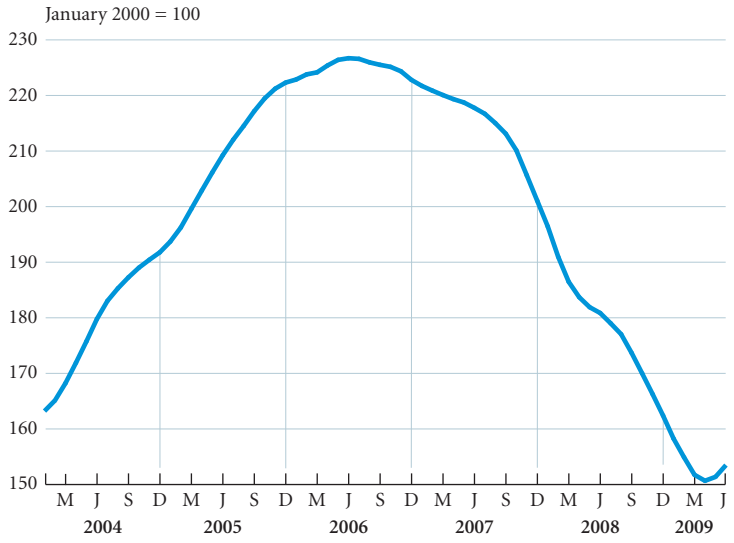
Labour market remains weak with unemployment rate at 9.7% along with more long-term unemployment.

The labour market remains weak. Big drops in employment are a thing of the past but the adjustment has not yet hit bottom. Some 216,000 jobs were lost in August, the highest figure for one year but requests for unemployment benefits in that period showed a rise as did the unemployment rate which again went to 9.7% and it is likely that this upward trend will still continue for some months. The proportion of long-term unemployed remained close to highs and, in view of the significant number of involuntary part-time workers, hours worked and wages are still in the low range.

Poor demand and idle resources mean that inflation trends are still not being seen in spite of the price rise in oil and the high budgetary deficit. The general consumer price index (CPI) was down by 1.5% year-on-year in August while the underlying CPI (the general index less food and energy) eased its increase with a rise of 1.4% year-on-year. This easing

UNITED STATES: REAL ESTATE PRICES BRING LONG-AWAITED GOOD NEWS

Case-Shiller housing price index



SOURCE: Standard and Poor's and own calculations.

was partly helped by the stagnation in housing rentals.

Under the heading of the foreign sector, the trade deficit in goods and services in July was 31.91 billion dollars, some 4.4 billion higher than the figure for the month before, which, to the extent of 90%, was due to the worsening of the balance excluding oil and oil derivatives. In the past month, exports have held the limelight. First of all, following the low in April, exports of goods (excluding oil) showed a rise of 4.7% but imports, which in previous months had been weaker, were up in July to show a cumulative increase of 4.1%. Furthermore, trade flows are still at very low levels with exports and imports some 22.4% and 30.4% lower than in the same month last year respectively. This would indicate that, with the recovery of domestic demand and trade, imports seem to be showing more upward potential. Over the long term, the weakness of the dollar should help correct the trade imbalance which, however, is showing to be more persistent than earlier anticipated.

CPI drops by 1.5% while underlying inflation stabilizing with move up to 1.4%.

High-price oil prevents bigger correction of trade deficit.

Fiscal consolidation: when, how and how much?

The worsening of the public deficit in periods of crisis involves an increase in government debt that runs the risk of reaching unsustainable levels. Early signs of economic stabilization underscore the need to begin planning for fiscal adjustment. When to implement this, to what levels and what are the alternatives for reducing the deficit are three key questions in any adjustment plan.

Part of the adjustment will be automatic but, generally, this is not enough to sufficiently reduce the deficit. The deficit has shot up mainly as a result of the automatic stabilizers, discretional fiscal stimuli and, in some cases, the decline in activity in the real estate sector. As their name would indicate, the stabilizers react automatically in the face of an economic slowdown, whether through a decrease in revenues or an increase in government spending, for example, on unemployment benefits. Hence, the part of the increase in the deficit caused by the automatic stabilizers decreases by itself with the return to the economy's potential growth and, somewhat later, to full employment. Nevertheless, this adjustment may be affected if the crisis harms the country's potential growth or if unemployment stays high for a long time. The loss of revenues as a result of lower economic activity in the real estate sector may also be quite lasting. With regard to discretional fiscal stimuli, some have a temporary nature, such as extraordinary spending on infrastructures, but others may be permanent, such as new social benefits for vulnerable groups or tax cuts. While the former will stop having an impact on the deficit when the projects in question are completed (although we cannot ignore maintenance costs), this does not apply to the latter.

The start of fiscal adjustment should be determined by the circumstances of each country. For example, those economies that start out with a low level of debt will have greater margin for delaying fiscal correction. Fiscal consolidation must also be linked to the economy getting back to «normal», given that beginning the adjustment too early –as Japan did in the Nineties– could bring about a relapse. If we accept the generally agreed on forecasts for the advanced economies, we should expect the beginning of gradual fiscal consolidation in 2010. This would largely be thanks to the ability of the automatic stabilizers to reduce the deficit. Furthermore, in the second half of 2010, those economies that are further advanced in the cycle could begin to reduce or not renew the discretional policies so long as the recovery is showing a certain strength.

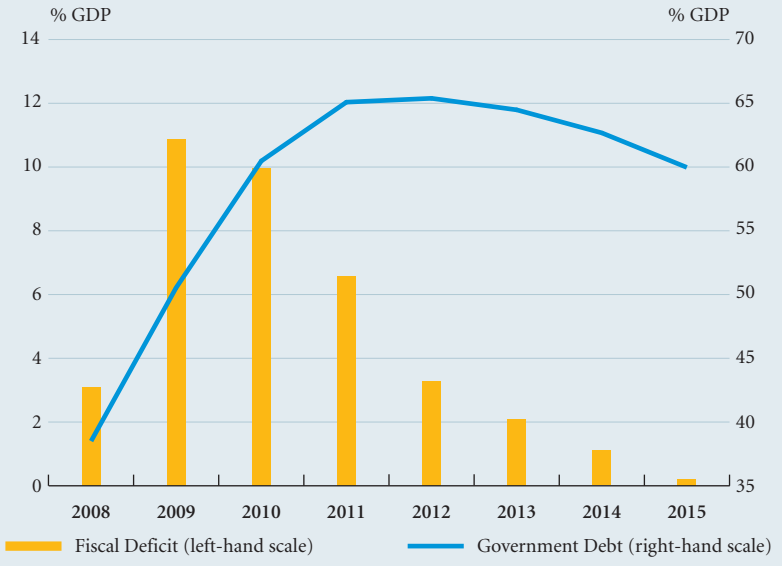
In any case, and despite the large bulk of the adjustment should be postponed until recovery from recession, governments should begin to make quite clear their medium and long-term adjustment plans in order to strengthen their credibility. Germany has been one of the pioneers in imposing a constitutional ceiling on its medium-term fiscal deficit.

A key part of this plan should involve the size of the adjustment, which depends on the desired level of public debt. The growth capacity of each country and forecasts for its population ageing, among other particular factors, will determine the supportable level of debt. An economy with high growth potential, at rates above the interest rate payable on its bonds, may allow itself to maintain higher debt levels and therefore will not need such a sharp adjustment. In the same way, the prospects for population ageing require a bigger fiscal correction seeing that government spending will increase in the future. In the countries of the Euro Area, the fiscal adjustment will also be guided by the terms of the Stability and Growth Pact which sets a limit on debt of 60% of GDP. By way of example, in the case of Spain, stabilizing the debt at this level in 2015 would require a gradual adjustment of the deficit until it reaches a fiscal balance of 0% in 2015 which would imply going from

a primary deficit (excluding interest payments) somewhat above 9% in 2009 to a primary surplus of 3% in 2015 (see following graph for more details of hypotheses).

SCENARIO ILLUSTRATING FISCAL ADJUSTMENT IN SPAIN

Fiscal Deficit and Government Debt



NOTES: Supposes average growth of 2% in real GDP between 2010 and 2015 and an average real interest rate of 2.4%.
SOURCE: IMF and own calculations.

Once the objective debt level is established, as well as the time horizon for the fiscal correction, it remains to be worked out how to carry out such a fiscal adjustment. There are essentially two ways: an increase in government revenues or a reduction in spending. Not all measures, however, have the same impact on economic growth. For example, higher taxes on labour or savings or a reduction in spending on education or infrastructures could bring about a worsening of potential growth through disincentives on savings and work and a decrease in a country's human and physical capital. On the revenue side, a more neutral alternative from the potential growth standpoint, while often politically more costly, is to raise indirect taxes. Stronger measures to combat tax fraud is another option worth exploring both for reasons of efficiency and equity. With regard to spending, the adjustment should be carried out in non-priority areas. Some countries, such as Ireland, have also suggested a revision of the universal nature of certain social benefits in order to concentrate on those persons most vulnerable.

To sum up, the inevitable fiscal adjustment should begin gradually with the economic recovery, which in many cases should take place at the end of 2010. The size and form of the adjustment will depend on the economic characteristics of each country and, as almost always happens in economics, on the political situation of the moment.

This box was prepared by Clàudia Canals
International Unit, "la Caixa" Research Department

Japan: again relying on foreign sector

Japan grows by 2.3% thanks to recovery of exports but investment remains weak.

Japan's economy came out of the recession in the second quarter but saw it growth revised downward putting it at a rise of 2.3% quarter-on-quarter annualized as against the 3.7% previously given out. The improvement in exports, which grew by 28.1% in the same period, was unable to compensate for the worse figure for capital goods investment and public investment. The latter underlines the limits of expansionist policy in Japan which represents a situation opposite that of China. As opposed to that Asia giant, the public finances began the crisis in a precarious state because of stimuli introduced in the deflationary period in the Nineties. With the recent fiscal stimuli in 2009 the public debt comes close to 200% of the GDP.

China's recovery boosts exports but government funds running out.

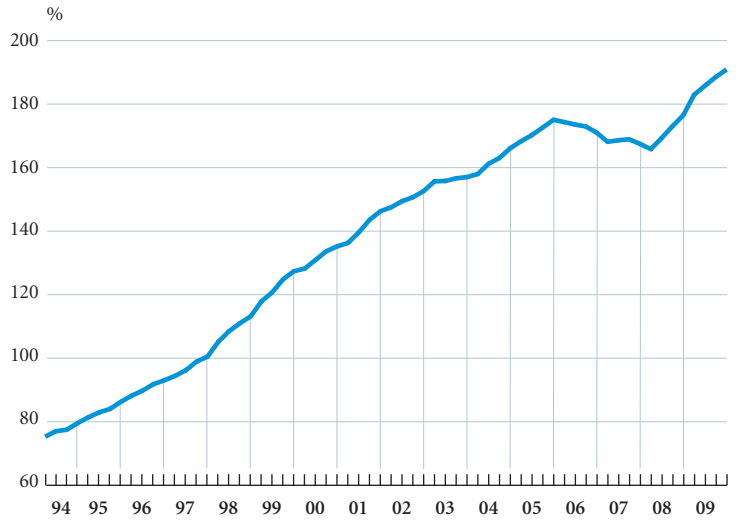
Industrial production continues to recover and investment spending improving prospects.

The good news came from the foreign sector. China's recovery is becoming stronger and US retail sales had a smoothing effect on price quotations for Japanese companies involved in exports. Weaknesses remain in the area of domestic demand. Latest indicators do not suggest a continuation of the increase in consumption and retail sales in July showed a drop of 2.4% year-on-year whereas car sales in August indicate that government incentives have managed to slow the worsening but have not been able to foster an upward move in demand.

On the supply side, the improvement in the world picture continued to aid recovery although figures are still a long way from May-June 2008 levels. In this context, industrial production in July continued to rise and stood 18.8% higher than the low in February. This is a recovery that, in absolute terms, only compensates for 30% of the drop since June 2008. Also along the same lines, investment spending showed signs of recovery but always with an eye to exports. An early indicator of this, machinery orders, showed a second month of increases with spending aimed

JAPAN: CRISIS WORSENING POOR SITUATION INHERITED FROM THE PAST

Government debt in terms of GDP



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

JAPAN: MAIN ECONOMIC INDICATORS

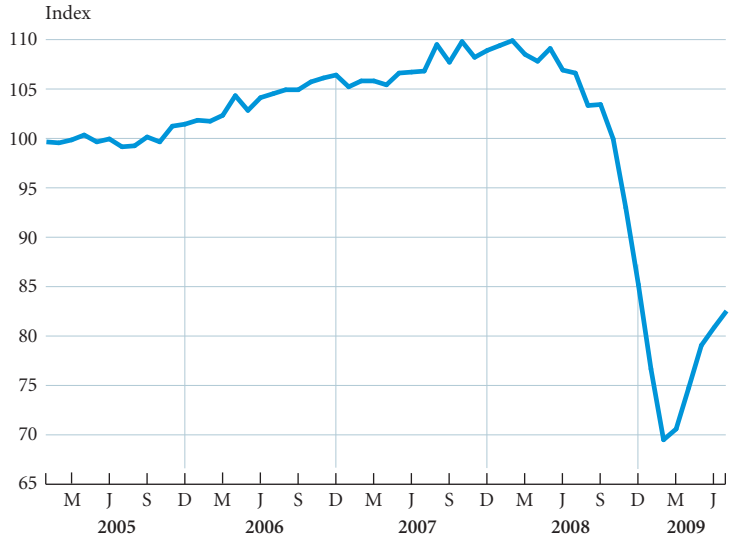
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009		
			2Q	3Q	4Q	1Q	2Q	July
Real GDP	2.3	–0.7	0.7	–0.3	–4.5	–8.4	–7.2	–
Retail sales	–0.1	0.3	0.2	0.8	–1.5	–3.9	–2.8	–2.4
Industrial production	2.9	–3.4	1.6	–3.3	–15.0	–34.0	–27.6	–22.7
Tankan company Index (1)	22.0	–2.8	5.0	–3.0	–24.0	–58.0	–48.0	–
Housing construction	–17.2	2.4	–11.1	40.3	3.9	–21.4	–32.0	–32.0
Unemployment rate (2)	3.9	4.0	4.0	4.0	4.0	4.4	5.2	5.7
Consumer prices	0.1	1.4	1.4	2.2	1.0	–0.1	–1.0	–2.2
Trade balance (3)	12.6	4.0	10.3	7.5	4.0	1.4	1.0	1.0
3-month interbank interest rate (4)	0.7	0.8	0.8	0.9	0.8	0.7	0.6	0.6
Nominal effective exchange rate (5)	77.1	86.6	82.6	81.9	98.5	102.1	95.7	96.9

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

JAPAN: INDUSTRIAL PRODUCTION CONTINUES TO RECOVER

Industrial production index



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

Unemployment hits all-time high of 5.7% while wages remain at low levels.

at meeting domestic demand which showed a boost of 21.8% year-on-year in July while those to meet foreign demand were down 4.2%.

In turn, the housing market continued on its downward course. Sales in the Tokyo area in August wiped out their modest recovery with a drop of 8.2% year-on-year while prices continued to go down. In a situation of increasing weakness, supply continued to show a worse picture with housing starts in July down by 32.0% year-on-year. Clearly showing the weakness of demand, the labour market today is one of the most fragile components of Japan's economy. The unemployment rate in July rose to 5.7%, an all-time high since the start of this indicator in 1953. Some 400,000 jobs were lost in July, of which 120,000 were in manufacturing. This is a sector that, in spite of the recovery in industrial production, continued to reduce its total number of employees. Wages showed a slight improvement in July but remained 6.5% below the same period last year.

CPI drops by 2.2% while underlying inflation down 0.9% because of weak domestic demand.

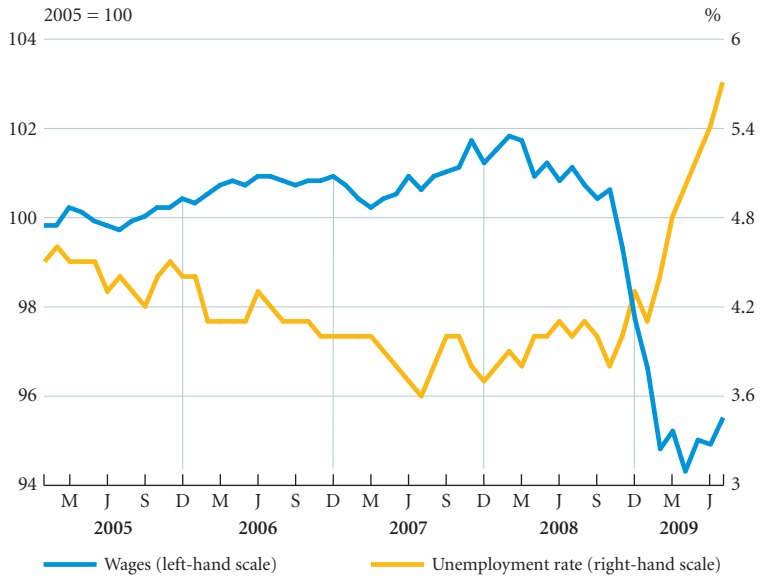
The weaknesses in employment and domestic demand helped increase deflationary tendencies. The July CPI showed a drop of 2.2% year-on-year, the biggest decrease since the start of this index in 1971. As opposed to other large economies, the underlying CPI (the general index less energy and food) in Japan is also dropping and in the same period lost 0.9% year-on-year adding up seven months of decreases in a row. The weakness of domestic demand will make it difficult for prices to go back to positive terrain in coming months.

Exports showing slower recovery but trade surplus holding.

The foreign sector continues to recover from the sharp drops in the first quarter although trade continued well below levels for last year. Japan's exports which, with a high level of capital goods of high value added, are half-way between a return to levels before the crisis.

JAPAN: UNEMPLOYMENT RISING WHILE WAGES HIT BOTTOM

Manufacturing wages index and unemployment over labour force



SOURCE: Japanese Ministry of Labour and own calculations.

Nevertheless, the figures for June indicate that the recovery in exports is slowing down whereas the increase in imports is gaining strength thus limiting the upward move of the contribution of the export sector to economic growth.

China: stable recovery

While last month China amazed us with grawth of 7.9% year-on-year grouth rate in the second quarter, this month the most recent indicators do nothing but confirm its recovery. At the same time, India surprises with a growth rate of 6.0% year-on-year in the second quarter, above the 4.1% in the first quarter.

China's retail sales in August were up 15.4% year-on-year, slightly above July and in line with the strength of other indicators. The purchasing managers index (PMI) for August stood at 54 points as against 53.3 in July and at levels above 50 since March. Finally, automobiles sales were up by 81% year-on-year in August which puts China on the way to surpass the US as world's top auto market in 2009.

China on recovery path closely followed by India.

On the supply side, industrial production in August was up by 12.3% year-on-year, higher than the 10.8% in July and coming close to the rates of 15%-16% in past years. Bank lending continues to grow and, with an increase of 34.1% year-on-year in August, put the average so far this year at around 30%, double the 2008 figure. This growth in credit and the major fiscal stimulus introduced by the government are behind the recovery. In any case, changes of a more structural kind, such as the boosting of domestic consumption, will be keys to future growth.

Industrial production grows by 12% with bank lending still on rise.

The foreign sector is also beginning to recover strength although not as fast as domestic demand. In particular, exports were down by 23.4% year-on-year in August, similar to the 22.9% figure in July and imports dropped by 17% year-on-year in August, higher than the 14.9% in July.

Trade still somewhat lagging.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
Real GDP	13.0	9.0	9.0	6.8	6.1	7.9	–	...
Industrial production	17.5	12.6	13.0	6.4	9.7	9.0	10.8	12.3
Electrical power generation	15.7	6.7	6.7	–6.0	–4.3	–0.4	4.7	8.9
Consumer prices (*)	4.8	5.9	5.3	2.5	–0.6	–1.5	–1.8	–1.2
Trade balance (**)	262	297	259	297	318	295	281	267
Reference rate (***)	7.47	5.31	7.20	5.31	5.31	5.31	5.31	5.31
Renminbi to dollar (*)	7.6	6.9	6.8	6.8	6.8	6.8	6.8	6.8

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

Shanghai stock market up again.

Nevertheless, an early seasonally-adjusted estimate of quarter-on-quarter growth of exports indicates values of around 3% in the third quarter.

In a context of recovery, the drop in prices has been slowing down. In August, the CPI went down by 1.2% year-on-year as against 1.8% in July and 1.7% in June. The drop in the price of housing along with the big rise in commodity prices in 2008 meant that price indices are now still in negative terrain.

Brazil leaving recession behind.

Finally, the Shanghai stock market returned to the growth path started at the beginning of the year and leaving behind the correction occurred in August. In the first half of September the Composite index was revalued by 13% although it did not recover the values seen in July.

Brazil: GDP and oil again doing the samba

Consumption takes the reins while investment and exports still hurting.

Brazil stands between gains and losses. Since the beginning of September the Brazilian economy is all good news and not only because of a return to growth but also because of new oil discoveries in the Pre-sal marine area.

After half the year in negative terrain, the GDP grew by 1.9% quarter-on-quarter in the second quarter of 2009 which makes Brazil one of the first countries in the G-20 to come out of the recession. Private consumption, boosted by credit and fiscal stimuli, rose by 2.1% between March and June thus confirming its role as the main engine behind the incipient recovery. Investment and public spending held stable. On the other hand, foreign demand was able to add its grain of sand thanks to renewed demand by China for Brazil's raw materials. On the supply side, industry was the most dynamic sector with growth of 2.1% in seasonally-adjusted quarter-on-quarter rate as against 1.2% for the services sector.

In year-on-year terms, growth stopped dropping but was unable to avoid ending up down by 1.2%. On the one hand, responsibility for this was weak investment which continues to drop by double digits compared with 2008, at 17% year-on-year. On the other hand,

BRAZIL: MAIN ECONOMIC INDICATORS

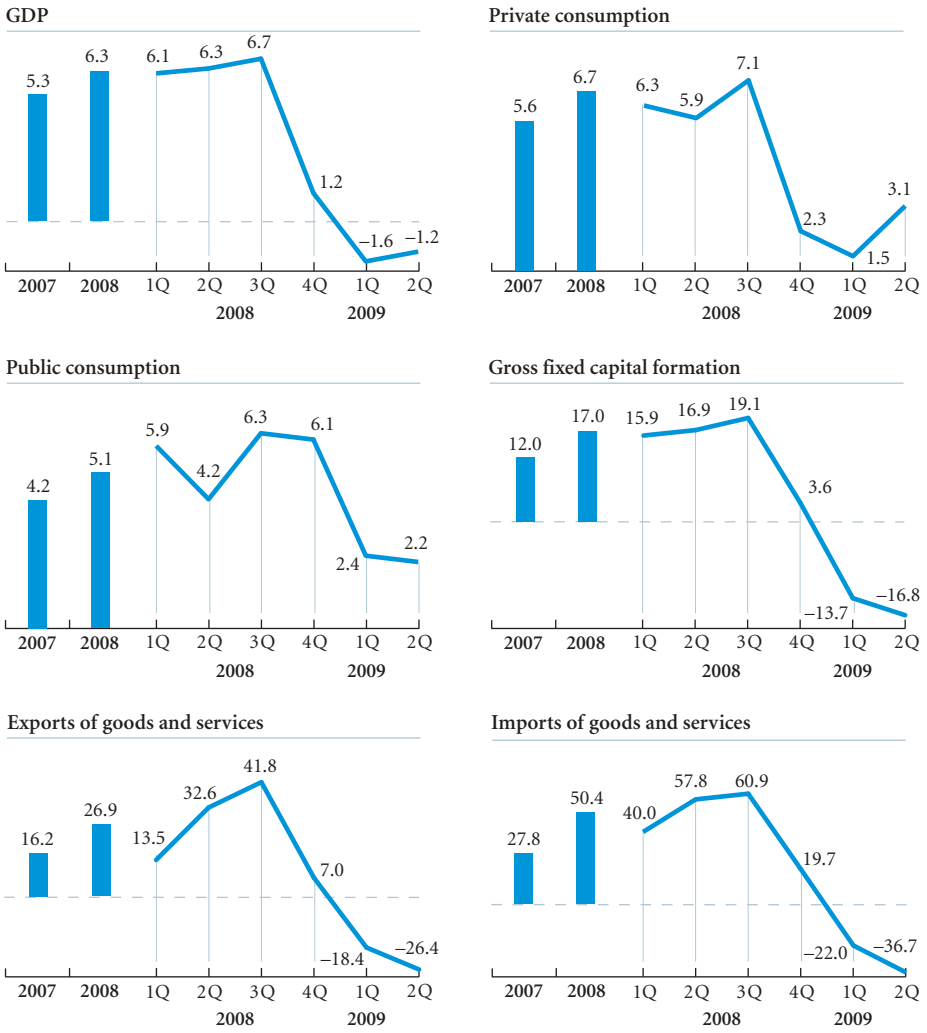
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
Real GDP	5.6	5.1	6.7	1.2	–1.6	–1.2	–	–1.2
Industrial production	5.9	2.9	5.9	–6.7	–13.6	–11.3	–10.4	...
Consumer confidence (*)	132.3	140.4	136.3	132.9	128.5	128.4	139.9	139.8
Unemployment rate São Paulo (**)	15.0	13.0	12.7	11.6	12.6	13.9	13.4	...
Consumer prices	3.6	5.7	6.3	6.2	5.8	5.2	4.5	4.4
Trade balance (***)	40.0	24.8	28.7	24.8	25.0	27.4	27.0	27.8
Interest rate SELIC (%)	12.75	11.25	13.75	13.75	11.25	9.25	8.75	8.75
Reales to dollar (*)	2.1	1.8	1.9	2.3	2.3	2.0	1.9	1.9

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion dollars.
SOURCE: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and own calculations.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and own calculations.

the cause was foreign demand pulled down by exports which dropped by 26.4% compared with the same period last year. Public consumption in turn gradually reduced its contribution to growth in contrast to private consumption which confirmed its strength with an advance of 3.1% year-on-year.

In any case, Brazil is leaving behind a technical recession notable for its brevity and latest figures only add reasons for believing that the year 2009 will end up much better than it began. Consumer confidence is now coming close to levels before the recession and retail sales continued advancing in July with year-on-year growth of 5.7%. These were supported by some relief in the labour market and credit which saw an increase of 20.8% compared with July 2008 thus setting new all-time records as a percentage of GDP (45%). Vehicle

Industry showing signs of advance.

Mexican economy awaiting US recovery.

exports again dropped but the impact of tax exemptions showed up as an increase in domestic registrations of 5.5% year-on-year.

On the supply side industry is gradually slowing its drop and leading indicators point toward a progressive improvement in the second half-year. In August, after a year of falling behind, the purchasing managers index (PMI) went above the 50 points threshold that indicates recovery. Industrial production grew for the sixth consecutive month in July although it was down by 10.4% at year-on-year rate.

In fact, Brazil is looking toward 2010 optimistically. Everything indicates that the recovery will gain strength in the third and fourth quarters of 2009 to the extent that the reconstruction of inventories will take investment out of the hole and the gradual improvement of the foreign sector comes from exports. At the same time, it is expected that a situation with an expansionist monetary policy, a labour market improving and contained inflation will continue to spur on private spending which will have to deal with the progressive removal of fiscal stimuli between September and the end of the year. If this scenario is confirmed, the governing party will face the presidential elections in October 2010 in a much more comfortable position. Even so, it is to be expected that an increase in public spending, in keeping with the electoral process, will also contribute to the increase in growth in 2010.

Fiscal reform in Mexico causing much debate.

Mexico: light at the end of the tunnel

The world economic recession and especially its effect on the US manufacturing industry dragged the Mexican economy into a recession that, if forecasts are not mistaken, from which it will soon emerge. The main reason for optimism also comes from the other side of the border. It is expected that a return to growth in the United States and the renewal of a restructured motor vehicle sector will boost Mexico's exports and therefore its GDP toward the end of 2009.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
Real GDP	3.3	1.4	1.5	–1.7	–8.4	–9.7	–	–
Industrial production	2.4	–1.0	–1.5	–4.4	–9.9	–10.0	–7.0	...
Consumer confidence (*)	104.9	92.2	88.9	83.3	80.1	80.5	85.4	81.6
General unemployment rate (**)	3.7	4.0	4.2	4.3	5.0	5.2	6.1	6.3
Consumer prices	–22.7	–11.8	5.5	6.2	6.2	6.0	5.4	5.1
Trade balance (***)	–10.1	–17.3	–11.9	–17.3	–17.5	–16.0	–16.0	–14.6
Official Banxico rate (%)	7.00	7.50	8.25	8.25	6.75	4.75	4.50	4.50
Mexican pesos to dollar (*)	11.0	10.6	11.0	13.9	14.2	13.2	13.2	13.3

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

Latest figures point in this direction. Industrial production in July moved ahead compared with the previous month recording its lowest year-on-year drop so far this year (7%). In turn, IMEF manufacturing index in August reached its highest point in thirteen months (51.5) going for the second consecutive month above the 50 points threshold that indicates recovery. All of this suggests that the contractile stage of manufacturing activity either ended with the first half-year or is about to be ended. If this is so, it would be well received by a labour market that suffered again in August with an unemployment rate of 6.3%.

With regard to demand, there is a long way still to go. Domestic spending showed signs of improvement with retail sales beginning to moderate its correction, while still dropping by 5.1% year-on-year in June but the consumer confidence index dropped again in August by 9.1% year-on-year and 4.5% compared with July. Investment also was down by 12.7% year-on-year in June. In spite of all, restrictions on credit seem to be easing and inflation, while above the official objective, continues on a downward path so that it is not expected that the Bank of Mexico will make any move at least until it has crossed the line of 2010, when it is expected growth will be resumed and inflationary pressures may appear.

Furthermore, it should be kept in mind that, although economic prospects for 2010 are favourable, Mexico must face up to a series of structural reforms long overdue in order to improve the trend to long-term growth. Notable among these reforms is a fiscal system that, above all, should reduce its dependence on the performance in oil. The government's proposal is already on the table and everything points toward a fiscal correction in 2010, in spite of the fact that some people feel this to be rash in a situation of a potentially fragile recovery. In any case, the July elections somewhat reduced president Calderon's margin for manoeuvre, so that what is most likely is a further delay in measures of a more structural nature, at least until after the presidential elections in 2012. If this is so, it could generate some doubt about the sustainability of the fiscal deficit over the medium term and end up reducing the rating on the country's sovereign bonds.

Oil and gold resume increases

Crude oil price depending on weak dollar and recovery of emerging economies.

Following a slight respite, oil prices again took on an upward path. Between August 20 and September 18 crude oil dropped by 2.8% although in the second half of that period the tendency shifted upward taking the price to 71.92 dollars a barrel (1-month delivery, Brent quality), thus accumulating a rise of 84.0% in the current year. This level was still below the 95.9 dollars in September 2008 but as of October it should begin to show year-on-year increases compared with drops in the final quarter of 2008.

The Fed's expansionist policy, Treasury borrowing and the persistence of the US foreign imbalance will continue to push the dollar down which will benefit commodities. The settling down of Chinese recovery and that of the main emerging economies, as well as the perception that the worst of the recession is over will have an effect in the same direction. With supply being able to meet increased demand, oil should remain at current levels with slight increases in 2010.

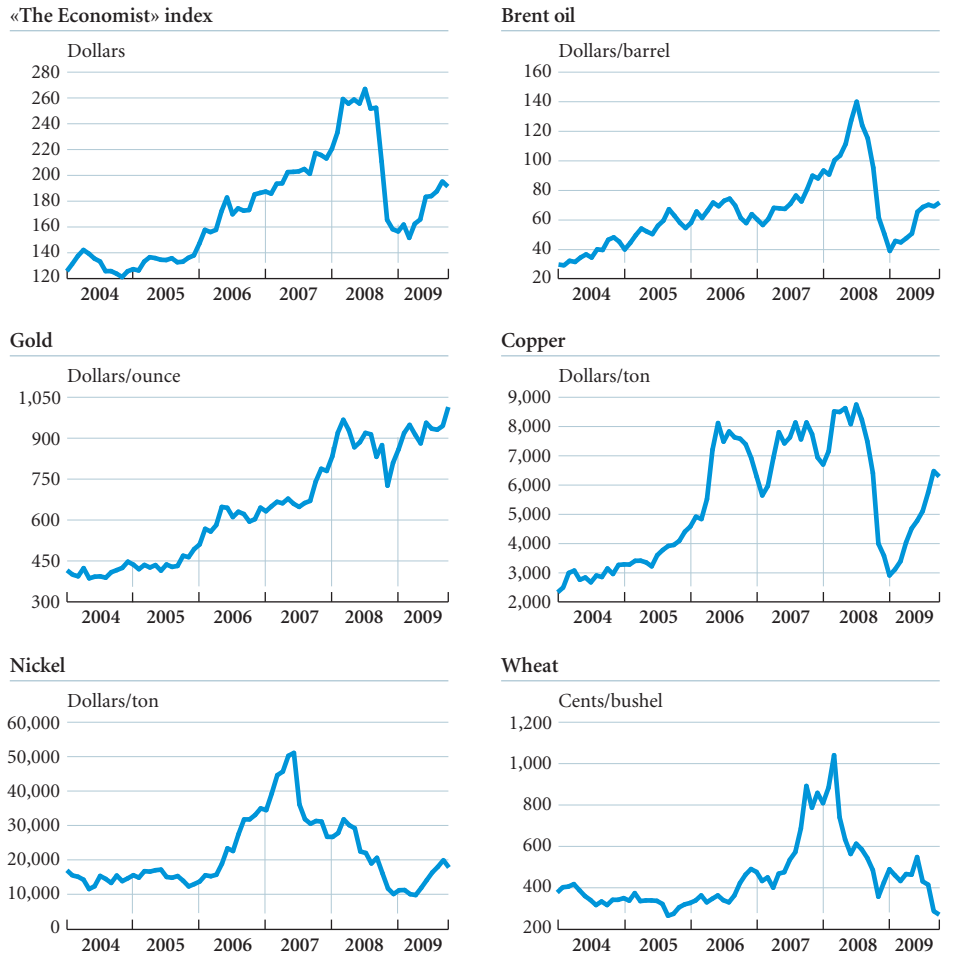
Commodity prices have taken a break. *The Economist* index for commodities rose by a low 0.3% between July 20 and September 18 putting the increase for the current year at 22.4%. Gold and precious

Commodities ease price increases because of drop in base metals.

metals increased their advances because of the weakness of the dollar whereas base metals showed drops.

In this respect, the recovery of world industrial activity should increase scrap production which forms an important supply of base metals. This would continue to moderate the Chinese boom in imports seen in the first half of the year although without breaking its basic strength in coming months.

TREND IN VARIOUS COMMODITIES (*)



NOTES: (*) Figures for last day of month (last date September 18).
SOURCE: «The Economist», Thomson Reuters Datastream and own calculations.

EUROPEAN UNION

Euro Area: a recovery with risks

Following the fact that the Euro Area growth rate in the second quarter was above the most optimistic forecasts, while still in negative terrain, the question lies in the strength of this period of recovery. With regard to the second half of 2009, the consensus among analysts is fairly general seeing that most suggest that in the next two quarters we shall see quarter-on-quarter growth rates slightly above zero. Everything indicates that the process of recovery will continue but at a very slow rate. Nevertheless, for next year there is much greater uncertainty.

This is reflected in the wide range of forecasts by the various analysis centres. While some analysts suggest growth in the Euro Area of close to 3%, the European Commission puts it at 0.5% and the European Central Bank (ECB) does not discount that the growth rate could stay in negative terrain for the whole year.

Quarter-on-quarter growth rates expected to be positive in next two quarters.

Let's look at the various positions. Now that we know the factors that are driving recovery, the course of the economy in coming quarters seems fairly clear. To be specific, the key factors for a recovery of the European economy in the second quarter were consumption and the foreign sector. The contribution to growth

Foreign sector and consumption driving recovery...

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
GDP	2.7	0.6	0.5	–1.7	–4.9	–4.7	–	...
Retail sales	1.4	–0.7	–1.0	–1.9	–3.2	–2.3	–1.7	...
Consumer confidence (1)	–4.9	–18.0	–19.1	–27.1	–32.5	–27.9	–23.0	–22.0
Industrial production	3.5	–1.7	–1.4	–9.0	–18.4	–18.5	–16.0	...
Economic sentiment indicator (1)	108.9	91.1	89.9	75.6	65.7	70.2	76.0	80.6
Unemployment rate (2)	7.4	7.5	7.6	8.0	8.8	9.3	9.5	...
Consumer prices	2.1	3.3	3.8	2.3	1.0	0.2	–0.6	–0.2
Trade balance (3)	20.1	–1.2	–11.4	–31.7	–36.6	–32.0	–12.0	...
3-month Euribor interest rate	4.3	4.6	5.0	4.2	2.0	1.3	1.1	0.9
Nominal effective euro exchange rate (4)	107.9	113.0	114.0	109.1	111.9	113.2	113.8	113.9

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.

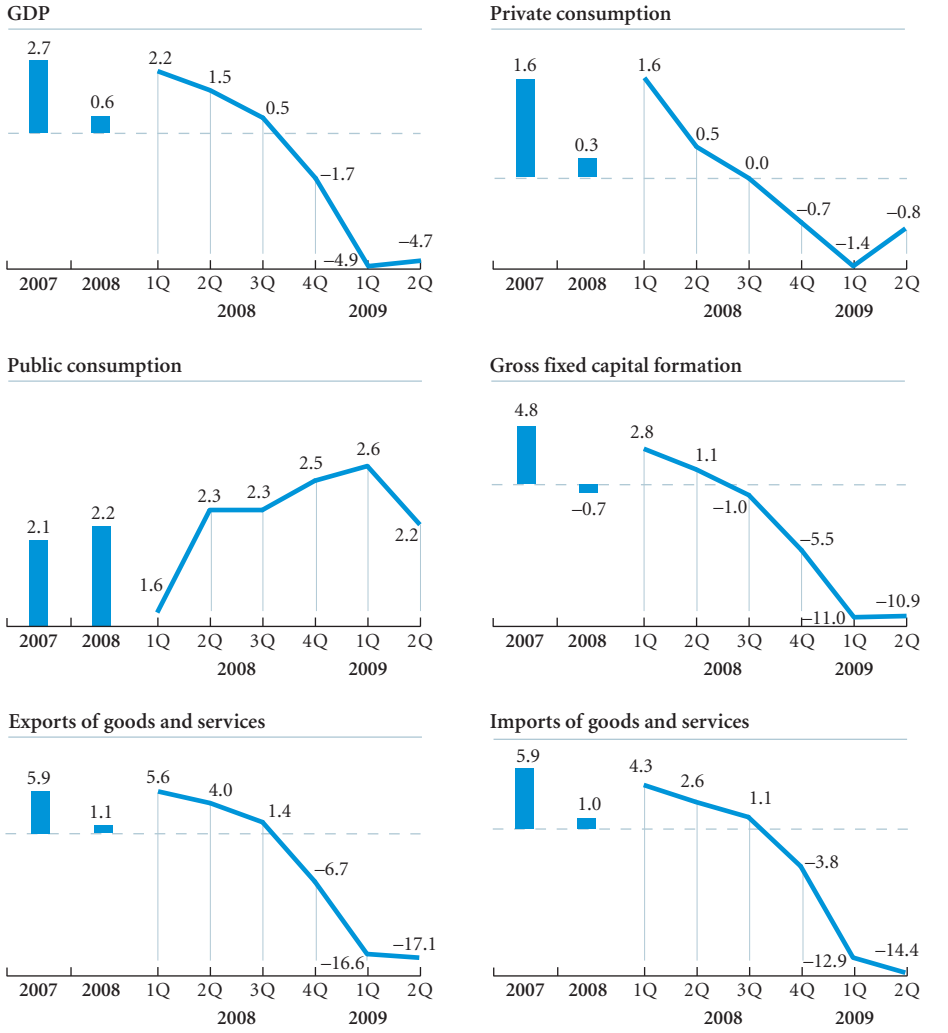
...thanks to growth in Asia and economic stimulus programmes.

coming from the foreign sector was 0.7 percentage points. This was the result of a substantial easing of the drop in exports which, after going down 8.8% quarter-on-quarter in the first quarter, slipped down by only 1.1% in the second quarter. Imports also eased their decrease rate although to a lesser extent. With regard to domestic demand, its strength rested on both private consumption and public consumption. With quarter-on-quarter growth of 0.2% and 0.4% respectively, they each added one decimal to growth of the economy.

The improvement in foreign trade was the result of the sharp growth being enjoyed by the Asian economies and normalization of the financial sector. On the other hand, the drive in consumer demand is coming from the effect of economic stimulus programmes being carried out by the various governments. The more frequent figures indicate that both these factors will

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCE: Eurostat and own calculations.

continue to be the growth reference over the short term. In July, exports were up 4.1% compared with the month before while imports dropped by 0.3%. This is consolidating the surplus in the trade balance. The improvement in consumer confidence and retail sales show that private consumption continued to recover in the third quarter. Specifically, retail sales in July marked up a year-on-year drop of 1.7%, far from the decrease of 4.5% recorded in February.

The level of investment continues to be a disappointing factor. Gross capital formation was down 10.9% year-on-year in the second quarter, a figure practically the same as that recorded in the first quarter of this year. Furthermore, industrial production slowed its recent rate of recovery and remains depressed at an all-time low rate. In July, it recorded a drop of 16% year-on-year, only 6 decimals above the figure reported in June.

With regard to medium-term forecasts, one fact becomes clear. None of the factors driving current growth in the Euro Area is sustainable over the medium term. On the one hand, the various governments will have to substantially reduce the economic stimulus programmes carried out in 2009 if they want to maintain their public accounts in good shape. This warning comes from the European Commission in its report on forecasts issued in September. This will weaken the recovery of domestic demand.

Nor will aid from the foreign sector last much longer. While China is showing growth rates close to two digits, this is the result of putting into force a major package of economic growth measures by the government and these, therefore, have a limited life.

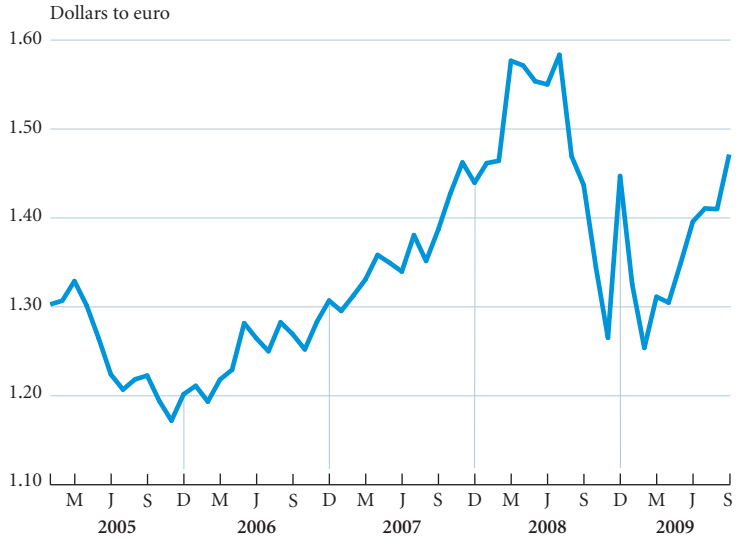
Nor is the strong appreciation of the euro going to help the foreign sector.

Investment still disappointing factor.

None of the factors behind current growth are sustainable over medium term.

APPRECIATION OF EURO WILL REDUCE BOOST FROM FOREIGN SECTOR

Euro/dollar exchange rate (*)



NOTES: (*) A rise indicates appreciation of euro.
SOURCE: Datastream.

Spread in forecasts for next year reflects high level of uncertainty.

Against the US dollar, the euro has appreciated 17.5% since the low reached in February this year. This trend is not sustainable over the medium term and will probably continue being corrected as of next year. One of the factors that will bring about this turnaround will be the tempo of the monetary policy followed by the European Central Bank and the Federal Reserve. Given that both economies have prices under control (the year-on-year change in August showed a decrease of 0.2% in the Euro Area and 1.5% in the United States), the upward cycle in exchange rates will be set by the consolidation of recovery in the two economies. In this respect, everything suggests that the Fed will move before the ECB seeing that the greater flexibility of the US economy will allow it to recover faster. The Fed could begin to raise interest rates between Spring and Summer next year whereas the ECB will find it difficult to do so before the Autumn.

What makes the medium-term forecasts of the analysts so different, however, is the interpretation each makes of the main risks affecting the European economy, such as the future worsening of the labour market, the capacity of the financial sector to recover and the effectiveness and duration of economic stimulus programmes. With regard to the labour market, the unemployment rate in July went to 9.5%. While the current recessive process has left close to 4 million persons without work, the figure is relatively low if we compare it with the all-time drop in economic activity. In this sense, keeping in mind the trend recorded in previous recessive periods, the unemployment rate should go up to levels close to 11% in the middle of next year. In any case, some more optimistic views suggest that the moderate worsening of the labour market is the result of the programmes put into effect by some European Union countries which may mean that unemployment could stop rising earlier than expected.

The ability of the financial sector to recover is another major unknown. While bond markets have recovered surprisingly fast, credit to the private sector and households show no signs of recovery. If we are to be guided by the experience of previous recessions, credit will still take time to come good. If finally the measures taken by the ECB and various countries are effective, however, the recovery of credit could aid the recovery of investment and private consumption.

Nor are future measures to be taken by governments very clear. On the one hand, they must reduce their economic stimulus programmes in order to avoid a huge increase in government debt while being aware that, if the removal of these programmes is too fast, this could send the economy back into recession. In our forecast, we assume that all the imbalances will gradually be adjusted. This brings us to the conclusion that next year growth will stand close to 1% although it will be difficult for it to go higher.

Germany hoping for recovery to consolidate

Private consumption and foreign sector become main engines driving German economy in second quarter.

Germany faced its general elections last month in the knowledge that it was one of the first European economies to come out of the recession with GDP growth of 0.3% in the second quarter compared with the previous quarter. This unexpected recovery was the result of the positive contribution of all components of the gross domestic product (GDP) except the change in inventories. Of special note were private

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
GDP	2.6	1.0	0.8	–1.8	–6.7	–5.9	–	...
Retail sales	–3.0	–0.5	0.1	–0.4	–2.7	–1.5	–0.8	...
Industrial production	5.8	0.0	0.0	–7.5	–20.0	–19.3	–16.9	...
Industrial activity index (IFO) (*)	106.2	96.8	94.7	86.2	82.6	84.7	87.4	90.5
Unemployment rate (**)	9.0	7.8	7.7	7.6	8.0	8.3	8.3	8.3
Consumer prices	2.3	2.6	3.1	1.7	0.9	0.3	–0.5	0.0
Trade balance (***)	181.5	195.3	196.3	183.0	159.6	138.9	132.7	...

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

consumption and the foreign sector with contributions of 0.4% and 1.7% respectively. In view of this improvement, the main economic institutes have revised their forecasts by close to one percentage point, putting the year-on-year drop in the German economy between 5.0% and 5.5% in 2009. This figure means that the economy will maintain its gradual growth rate over coming quarters.

Economic growth forecasts revised upward.

The most frequent indicators available for the third quarter of 2009, both for supply and demand, confirm this trend. There was notable growth of retail sales at 5.8% month-on-month in July. The main reasons for the recovery in consumption were the low inflation rate and the fiscal stimulus measures applied by the government aimed at increasing disposable income of households. Furthermore, foreign demand continues to recover with growth of exports in July at 2.3% compared with the month before thus making this the third consecutive increase and reducing the year-on-year drop in exports in July to 18.8%.

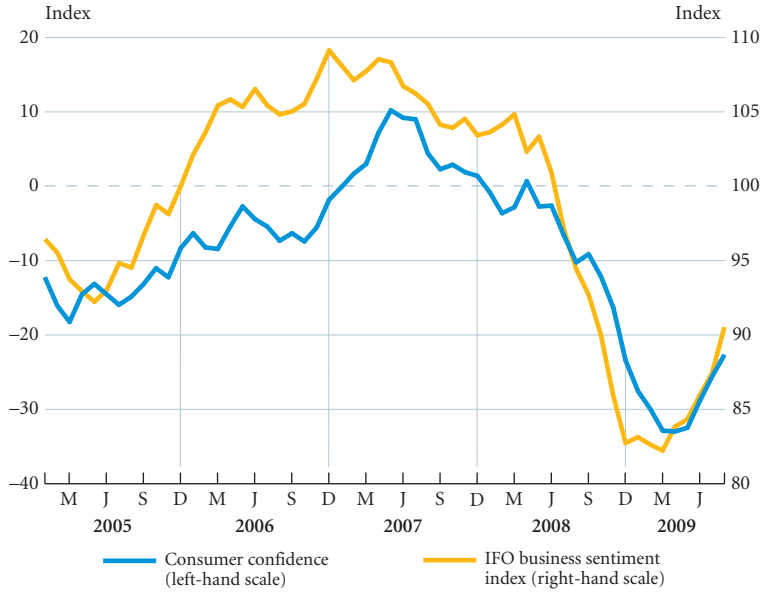
As a result of this increase in demand, both domestic and foreign, industrial orders again rose in July ending up far from the lows seen in February. Industrial production that month was down 0.9% compared with the month before thus reflecting the process of adapting inventories to the new economic situation. Nevertheless, the rise in orders and the low level of current inventories makes it possible to foresee an increase in industrial production in coming months with a subsequent increase in utilization of production capacity after going to very low levels in the second quarter of 2009.

The trend in confidence indices, both for consumers and business executives, reflects this recovery. As may be seen in the graph, these indicators have not stopped rising since the low reached between February and March 2009. What is more, in both cases the future components of these statistical series anticipate further increases that will keep leaving behind the all-time lows they are still showing. In spite of the clear signs of improvement in the German economy, there are certain risks that could interrupt the return to a growth path, especially in 2010.

Supply and demand indicators point to continued GDP growth in third quarter...

CONFIDENCE CONTINUES TO RISE

German confidence indices



SOURCE: Deutsche Bundesbank and own calculations.

...which could be interrupted by uncertainty in labour market and exports.

First of all, the end of the financial stimuli in some of its main trading partners could have a negative effect on German exports. On the other hand, while the economic recession has only slightly affected the unemployment rate which is holding at close to the lows reached in 2008, the hours worked per employee have been drastically reduced thus pointing to a sharply worse situation in the labour market. The stagnation in this market and the ending of programmes for temporary reduction of work suggest there could be an increase in the unemployment rate in 2010 putting it above 10%. This would have a negative effect on private household consumption, one of the components currently driving the German economy.

New government must face delicate economic situation.

Furthermore, the automatic stabilizers and fiscal stimulus programmes have affected the state of the public finances in 2009 and it is expected this will continue in 2010. According to the government's Fiscal Reconciliation Programme, the government deficit will then stand above 6%, raising the public debt to 80%, both being figures well above the limits established under the Treaty of Maastricht.

The new German government will therefore face a difficult task during its mandate. It will have to stimulate the economy, particularly private consumption, in order to avoid stagnation and its dependence on the foreign sector. Furthermore, good management of the public accounts will be needed, especially through containment of spending, once the economy begins to show signs of consolidating. The latter task will be made more difficult if electoral promises of higher spending on education and social improvements are kept.

France: rise in unemployment muddies recovery

«The crisis has not ended. It will end on the day we see the beginning of a drop in unemployment.» This was the line used by the French prime minister François Fillon when declaring that the way out of the recession would be long. He made this statement on announcing the government's latest economic forecasts which put the drop in the 2009 GDP at 2.25% thus improving on previous forecasts by three-quarters of a point. The reason for this major correction was the recovery in the French economy in the second quarter after four quarters in a row showing decreases in economic activity.

The prime minister's concern arises from the rapid increase in unemployment between January and July 2009, a month when the unemployment rate reached 9.8%, more than one percentage point above the figure at the beginning of the year. In spite of the drop in prices in the first two months of the third quarter, the worsening of the labour market meant that household consumption was down in this period. Furthermore, consumer confidence showed practically no increase in July thus confirming the worsening of perceptions about the present situation.

French government revises economic growth upward.

In a similar way, both the confidence index and industrial production were down in July following several months in a row showing improvements. However, not only news was bad during the third quarter. Industrial orders in July were up sharply showing growth of 4.6% compared with the month before. This increase was the result of a sharp increase in orders from Euro Area countries which showed growth of 18.6%. On the other hand, the Purchasing Managers Index (PMI), a synthetic index reflecting economic sentiment of business executives, also shows a very substantial increase in August. Furthermore, the foreign sector reported a recovery in exports in July that brought about a further reduction in the deficit in the trade balance.

Increase in unemployment rate slows household consumption.

Nevertheless, in view of the lack of signs confirming consolidation of the French economy, the government has no immediate plans to remove the economic stimulus measures taken, most of these being aimed at strengthening consumption, seeing that if it were to do this, it would run the risk of the economy going back into recession.

French government will not remove aids until recovery firm.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
GDP	2.3	0.3	0.1	–1.6	–3.4	–2.6	...	...
Domestic consumption	4.9	–0.6	–0.9	–2.5	–1.0	0.2	–0.5	–1.3
Industrial production	1.2	–2.5	–2.2	–9.0	–15.9	–15.0	–13.0	...
Unemployment rate (*)	8.3	7.8	7.8	8.3	8.8	9.4	9.8	...
Consumer prices	1.5	2.8	3.3	1.8	0.6	–0.2	–0.7	–0.2
Trade balance (**)	–33.8	–49.3	–51.4	–55.8	–55.2	–53.5	–48.4	...

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

In Italy, public and private consumption recover in second quarter of 2009.

Italy moving toward recovery in third quarter

Italy's GDP dropped by 0.5% in the second quarter compared with the previous quarter. This contraction was significantly lower than that reported in the first quarter (2.7%) and is a breakaway from four quarters in a row showing an increasing drop. A breakdown of the figures shows that this slowdown was largely brought about by the improvement in consumption, both private and public. The lower drop in investment and the foreign sector also played a notable role.

Everything pointing to rise in production in third quarter.

The few figures available for following months confirm this trend. On the demand side we note a gradual improvement in consumer confidence in July and August which stood at levels similar to those at the beginning of 2007. What is more, the increase in purchasing power of households because of the stagnation in prices during these two months make it possible to foresee greater strength in retail sales in this period. While we do not yet have figures for the foreign sector for July, the recovery of economies such as those of Germany and France suggest a gradual recovery of exports over coming months.

On the supply side, while the year-on-year drops recorded both in industrial production and orders are still high, the month-on-month figures are showing some recovery. Industrial production in July rose by 1.0% compared with the month before, led by the motor vehicle industry, pharmaceuticals and chemicals. The rise in industrial orders in August, along with the sharp decrease in inventories in the second quarter, makes it possible to anticipate a significant recovery in industrial production in the third quarter of 2009.

Government raises forecasts although major downward risks remain.

In view of these prospects, the Italian government has reduced its forecast of a drop in GDP in 2009 to 5%, putting the start of recovery already in the third quarter of this year. At the same time, it considers that the economy will show growth of 0.5% in 2010. This figure, however, holds major downward risks. The structural weakness of the public accounts, with an expected deficit of 5.0% in 2009, in spite of the rather slight fiscal stimuli introduced, and the increase in the unemployment rate in coming quarters (the OECD foresees that this will go to 10.5% in 2010) could mean that recovery will be slower in coming years.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008			2009			
			2Q	3Q	4Q	1Q	2Q	July	August
GDP	1.5	–1.0	–0.3	–1.3	–2.9	–6.0	–6.0	–	...
Retail sales	1.3	–0.3	–0.7	0.1	–1.7	–2.9	–1.2	...	...
Industrial production	2.1	–3.4	0.1	–4.0	–10.6	–21.1	–22.9	–20.4	...
Unemployment rate (*)	6.2	6.7	6.7	6.8	7.0	7.3	7.4	–	...
Consumer prices	1.8	3.3	3.6	4.0	2.8	1.5	0.8	0.0	0.1
Trade balance (**)	–12.8	–10.0	–8.6	–10.8	–12.3	–11.1	–9.1	...	...

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

United Kingdom: first signs of a long recovery?

Britain's GDP dropped by 5.5% year-on-year in the second quarter. The quarter-on-quarter drop was 0.6% in contrast to the decrease of 2.5% in the quarter before but still a long way from the positive figures in France and Germany. By component, private consumption was down 3.6% year-on-year while the level of investment was 17.2% lower than one year earlier. As was foreseeable, public spending moderated its decrease with a year-on-year increase of 2.2%. On the other hand, exports and imports were down 13% and 15.1% year-on-year respectively, which meant a positive contribution to GDP growth from the foreign sector of one percentage point.

In view of these disappointing results in the second quarter, the notable improvement in economic sentiment and business confidence in recent months, particularly in the services sector, could mean the consolidation of a change in trend in keeping with the world upturn. Industrial production has substantially reduced its decline to show 9.3% year-on-year in July compared with 12% in the second quarter while building permits in July marked up the smallest year-on-year decrease since the same month one year ago.

The consumer confidence indicator is also pointing in the same direction. Retail sales have reported the third consecutive month with positive year-on-year growth at 2.1% in August. Nevertheless, the moderation in wages, unemployment at 5% in August and high debt levels are slowing recovery of household spending, even with interest rates at all-time lows.

In spite of these early signs of an incipient recovery, which could translate into positive quarter-on-quarter growth in the third quarter, the Bank of England has shown caution maintaining its expansionist policy with a reference rate at 0.5%. In this respect, bank governor Mervyn King has warned that recovery could be slow and uncertain and has shown little willingness to moderate monetary policy while there are no

British GDP down 5.5% year-on-year in second quarter of 2009.

Indices suggest slight recovery could take place in third quarter.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
GDP	2.6	0.6	0.3	–2.0	–5.0	–5.5	_	...
Retail sales	4.2	2.6	1.2	1.8	0.5	1.1	2.9	2.1
Industrial production	0.3	–3.1	–3.2	–8.1	–12.5	–11.7	–9.3	...
Unemployment rate (*)	2.7	2.8	2.8	3.4	4.2	4.7	4.9	5.0
Consumer prices	2.3	3.6	4.9	3.9	3.0	2.1	1.7	1.5
Trade balance (**)	–83.4	–93.7	–95.4	–94.1	–91.8	–88.4	–85.2	...
3-month Libor interest rate	5.3	6.0	5.9	6.3	2.8	1.6	1.2	0.9
Nominal effective pound exchange rate (***)	103.9	97.6	92.8	89.4	73.9	77.0	83.7	84.4

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

Inflation continues downward trend going to 1.5% in August.

pressures on price levels. For now, inflation has continued its downward course going to 1.5% year-on-year in August but continuing on positive ground mainly because of the depreciation of the pound sterling.

Emerging Europe: taking flight (with lead on its wings)

The region is undergoing a clear improvement in economic prospects. Following an alarming start to 2009 when it seemed that some countries in the area were about to suspend their international payments and practically all the economies ready to go into severe recession, three factors made it possible to turn the situation around. These were the world decrease in risk aversion, international financial support and, more recently, recovery of key export markets.

Prospects for Emerging Europe improving as shown by recovery in Poland...

The recent economic development in Poland perfectly exemplifies this situation. On the financial front, the improvement may especially be seen in the positive trend in country risk indicators, in the stock market and in the currency. After going close to the level of 400 basis points in March, the cost of insuring sovereign bonds dropped blow the threshold of 100 basis points at the beginning of September. The stock market and the zloty followed similar paths going to lows in February with sustained recovery since then. Fundamental to this correction was that Poland had benefited from the so-called Flexible Credit Line of the International Monetary Fund, financing that widened its margin for manoeuvre in dealing with short-term capital movements and, at a deeper level, that has allowed the country to benefit from the world reduction in risk aversion.

As of the second quarter, recovery in the Euro Area, especially in the motor vehicle industry, has rapidly turned into an increase in the rate of economic activity, as shown by indicators such as economic sentiment, industrial production and exports. In this respect, the improved situation in exports took place in a context of a collapse in imports which facilitated a rapid improvement in the current account balance which became positive in the first half-year.

POLAND: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
GDP	6.8	4.8	4.9	2.6	1.7	1.4	–	...
Retail sales	4.1	–2.5	–3.8	–9.1	–17.5	–12.9	–7.8	...
Industrial production	...	2.7	2.1	–6.1	–10.6	–7.4	–4.5	–0.2
Economic sentiment indicator (*)	114.8	109.2	108.9	97.4	77.7	79.8	81.7	86.2
Unemployment rate (**)	9.6	7.2	6.9	6.9	7.7	8.2	8.2	...
Consumer prices	2.4	4.3	4.8	3.9	3.6	4.1	4.1	4.1
Trade balance (***)	–61.3	–81.9	–84.6	–90.0	–85.7	–71.2	–62.5	...

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

As a result, in the second quarter the GDP grew by 0.5% quarter-on-quarter (1.4% year-on-year), which was higher than expected, thanks to the clearly positive contribution from the foreign sector which in fact runs parallel with domestic demand that is still dropping. This trend in financial situation and economic activity, which is better than expected some months ago, has brought about an upward revision in the country's growth forecasts. To give a significant example, in its advance Autumn forecasts the European Commission expects positive growth of 1.0% this year as against a drop of 1.4% predicted in its Spring forecasts.

As a result, is everything going well? Yes, but not as well as may be gleaned from earlier figures. To begin with, it should be remembered that it is a matter of a recovery from unusually sharp levels of decrease. Quite apart from any rebound effect there are still other doubts. Continuing with the case of Poland, we can see persistent risks in the matter of the sustainability of recovery, the banking system and the fiscal situation. With regard to the first of these risks, the consolidation of recovery will critically depend on two factors, 1) that the Euro Area continues on a recovery path and 2) that domestic demand, which is still weak, will again show appreciable growth.

This domestic recovery in turn depends on the credit channel returning to a normal situation. While the worst predictions about the banking system have not come to pass (for example, the West European banks have maintained their subsidiaries adequately capitalized), in a context of increasing default in coming months, there will still be considerable pressure on bank profits. The rise in default will partly come from the burden still being carried by a high percentage of private debt expressed in foreign currencies. Other factors that would raise default are loss of jobs and the erosion of corporate profits being reported.

Finally, fiscal risk must be taken into account. The sharp drop in tax collections has pushed up the public deficit so that for 2009 this is expected to go above 6% of GDP, it being very unlikely that this will go down rapidly in 2010. All of this has caused concern about the impact this imbalance could have on interest rates.

The fact that presidential elections are to be held in 2010 could act as an incentive to increase discretional public spending or, at the very least, to defer the inevitable budgetary adjustments. Fortunately, as a disciplinary factor over the medium term, the levels forecast for the public debt (more than 50% of GDP in 2009) require the government under the constitution to adopt measures aimed at avoiding increases in the public debt.

While this is the situation that faces the country in the best economic situation and with the most solid macroeconomic fundamentals in the region, an evaluation of the risks for its neighbours is indeed darker. In Romania and Hungary, improvement in economic activity through exports is limited by a notable adjustment in public spending, necessary to correct previously built-up imbalances (and in order to continue benefiting from IMF financing).
In the Baltic states, and to a lesser extent in Bulgaria, this situation is repeated although to a worse extent given that the imbalances they must face up to are bigger. Furthermore, the political balances and the electoral calendar in some countries are more complex.

...a country benefiting from lower risk aversion, international financial support and return of growth in Euro Area.

Attention needed on sustainability of recovery, increase in default and public finances.

The sensation we are left with following a review of the region is certainly that a «match point» has been avoided thanks to a fortunate combination of international moves and an improvement in the foreign sector but indeed the game continues. And the game may be lost if these countries do not manage to adjust pending imbalances, restore their lost competitiveness and channel more costly and less abundant international financing toward economic activities with higher value added. In fact, there is little room for complacency in view of a recovery that has largely come as the result of outside events.

Fiscal stimulus plans and their impact on the economy

The reaction of the economic authorities when faced with the biggest recession since World War II was to launch major fiscal stimulus packages in order to halt the drop in economic activity. The recession now seems to have abated and it is even possible to see the end of the tunnel. The fiscal accounts, however, are showing up with a menacing colour of red. Should the fiscal stimuli now be withdrawn with the subsequent risk of setting back the incipient recovery? Or should they be maintained in spite of the danger of a spiralling worse situation in fiscal balances?

Until quite recently there was something of a consensus that the use of discretionary measures did not contribute to economic stability and could even have prejudicial effects. Nevertheless, the alarm caused by the world recession and the depletion of monetary policies seemed to justify a change in focus. At the end of 2008, the International Monetary Fund (IMF) launched a strong recommendation for all countries to adopt fiscal stimulus plans timely large, diversified and coordinated internationally. They should also be sustainable, that is, they should not involve a huge boost in government debt.

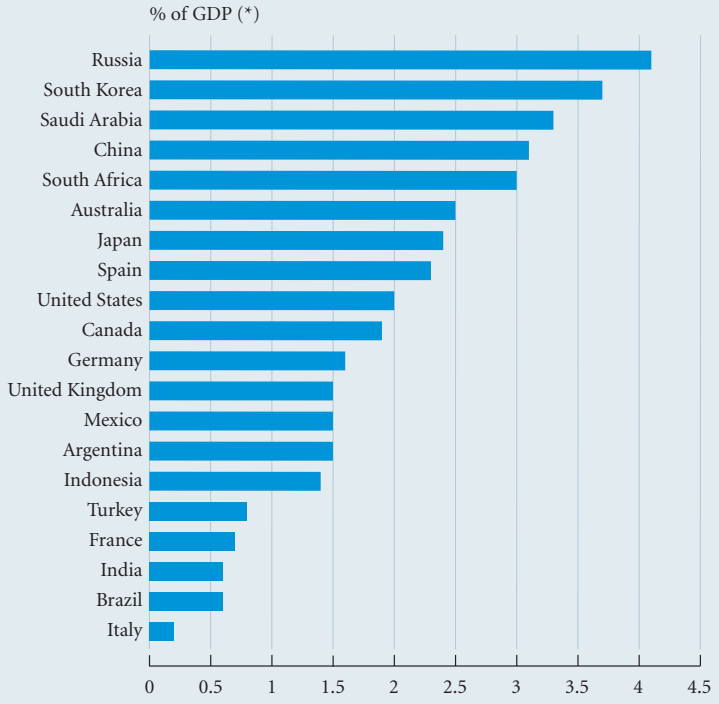
The response was not long in coming. Most of the developed and emerging economies launched major fiscal stimulus packages. Outstanding because of their size were those adopted by the United States and China but in relative terms the measures taken by Russia, South Korea and Saudi Arabia were remarkable. The European Union (EU) took on this idea and at the end of 2008 the European Council also recommended that each member state put into effect discretionary fiscal stimulus packages of at least 1.5% of GDP. Within the EU, Spain is the country to adopt the biggest package of discretionary measures. In July, the IMF estimated that the discretionary measures for the G-20 as a whole would amount to 2% of GDP in 2009 while in 2010 they would come to 1.6% of GDP.

The measures launched and their aims have been quite varied and included helping the spending capacity of consumers, the reduction of taxes, government investment and other measures aimed at improving the state of the labour market and business activity. The biggest volume of funds, especially in the emerging economies, is going into spending on infrastructures while also having significant weight in the developed economies are aids to sectors of the population most affected by the recession and cuts on personal and corporate income taxes.

What have been the effects of these discretional fiscal moves? To begin with, it is clear that they have contributed to increase public deficits that were already in poor shape because of the effect of the automatic stabilizers and measures aimed at stabilizing the financial system. But have they helped ease the recession? What has been their effect in terms of growth of the various economies? Unfortunately, it is not possible to

EVERYONE FIGHTING THE RECESSION

Cost of fiscal stimulus measures in 2009



NOTES: (*) Estimates based on measures announced up until May 2009. Does not include acquisitions of financial assets or recapitalization of financial entities or measures planned before outbreak of the crisis.
SOURCE: IMF.

answer these questions because of the short time since they were implemented and the subsequent lack of empirical data. As an analysis, we may cite the simulation of the impact carried out by the European Commission using an econometric model the result of which, in the case of the EU, shows a total effect on GDP of 0.75 percentage points in 2009 and 0.33 points in 2010. Theoretical estimates for the G-20 made by the IMF run within the range of 1.2-4.7 percentage points for 2009 and 0.1-1.0 points in 2010. In any case, these are results that must be taken with care seeing that is not the same to simulate an *ex ante* impact than measuring it *ex post*. The hypotheses used for models greatly affect the result of an *ex ante* analysis.

The debate also involves the actual nature of stimulus measures. The logic of these measures is that government spending (or lower revenues) provides a multiplier effect in private spending. For example, a reduction in taxes raises household incomes and turns into consumer spending which, in turn, generates an increase in economic activity, new incomes, and so on. The final result is that a fiscal impulse of 1 brings about an increase of more than 1 in GDP. This view, however, is not shared by all economists by any means. In the matter before us, a cut in taxes in a situation of severe recession will more likely be converted into savings, or the reduction of debt, and even more so at the tail-end of a real estate recession and a drop in financial markets. This could be so in the case of measures such as the «household cheque» provided by the US government in 2008 or the tax deduction of 400 euros on personal incomes in Spain. In these cases, the multiplier may be lower than one or even zero, although the improvement in household balance sheets would

show a positive result. In the case of an increase in government spending, in consumption or investment, the multiplier effects may be clearer given that they mean an increase in aggregate demand. However, they are still open to discussion. For example, one of the measures most applied, aids for buying new cars, present uncertainty about whether their effects are those of substitution (the purchase of a car instead of other consumer goods), a change in season (taking advantage of the subsidy to bring forward an outlay that would be made in any case), or benefiting foreign producers, given that they bring about an increase in imports. With regard to government investment, discussion is centred on the difficulty of implementing this quickly enough and on the economic and social returns that come from chosen projects.

In view of the worsening of government deficits, the question arises whether to remove fiscal stimuli in order to contain the negative figures in public finances. The message put out by the G-20 is to maintain these stimuli until recovery is strong, which would mean to continue them in 2010. Certainly, a rash withdrawal of these stimuli could put the incipient international recovery in jeopardy. Nevertheless, in a situation such as the present, which is much less dramatic than that in the Autumn of 2008, it is worth calmly looking at the measures adopted or planned in the light of current experience. This means discriminating according to their contribution in cost-benefit terms both over the short and long term and, at the same time, thinking about the possibility, in those cases where it may be opportune, to replace them with measures that may be better suited to a scenario following the economic crisis, such as incentives to private investment, for the creation of businesses, innovation and the adaptation and flexibility of companies and markets. And, naturally, taking into account that there are no universal answers and that measures in each country must meet their own particular conditions.

This box was prepared by Joan Elias
European Unit, "la Caixa" Research Department

FINANCIAL MARKETS

Monetary and capital markets

Central banks maintain direction for the moment

As widely expected, the Federal Reserve (Fed) at its meeting on September 23 decided to maintain the official interest rate within the range of 0%-0.25%. In spite of the fact that this decision was taken unanimously in the responsible committee (Federal Reserve Open Market Committee – FOMC), public statements by notable members of the Fed let it be known that, with regard to unconventional measures, there were varied opinions on when it should begin withdrawing the stimuli. The chairmen of the Richmond and Philadelphia Feds (J. Lacker and C. Plosser) were in favour of beginning their withdrawal «even before vigorous growth had time to become established». Nevertheless, the chairman of the San Francisco Fed (J. Yellen) would prefer to delay monetary adjustment so as not to run the risk of interrupting recovery and incur deflation. Even so, in a clear message to the markets, Yellen pointed out that all members of the FOMC will maintain their independence and a firm determination to restrict monetary policy when the moment arrives.

With reference to the strategy for putting aside the huge monetary expansion, two points in the FOMC press release stand out. Firstly, the Fed will continue with its plans to buy mortgage-based securities (MBS) and Treasuries indicating that there was still concern for the liquidity of the mortgage loan market. Secondly, it was noted that operations will gradually be reduced in order to allow a gentle transition. This means that within the FOMC what dominates is the feeling that it is premature to withdraw the stimuli at this moment but that we could see a beginning of this in coming months.

Federal Reserve maintains rates and announces it will continue facilities.

In the economic sphere it is important to point out that the evaluation of growth has improved in relation to the press release in August. Now the Fed experts are stating that «following the severe contraction, economic activity has risen», whereas before they were maintaining that «economic activity is stabilizing». Furthermore, the Fed expects that inflation will remain low for some time which justifies maintaining low interest rates.

Fed sees withdrawing unconventional stimuli premature.

At the beginning of September, the European Central Bank (ECB) announced that it was going to maintain its 1% interest rate for its main weekly refinancing transactions, a decision that caused no surprise. At the same time, the special long-term refinancing operations, with one-year maturity and a fixed rate of 1% referred to in its press release, ended up with a demand for 75.2 billion euros divided up among 589 institutions, as against 442 billion euros at the previous special transacion which took place in June.

With regard to the strategy to turn around the extraordinary monetary expansion carried out in recent months, ECB chairman Jean-Claude Trichet said only that the moment for retiring these

Result of the ECB auction indicates liquidity being normalized.

ECB president's monthly report announces global recession has hit bottom.

stimuli had not yet arrived. These statements seem to reflect some uncertainty and caution among members of the ECB Council in view of the risks to growth (depressed domestic demand) and downward pressures on inflation (idle capacity). In its press release the ECB recognized that the evidence of an improvement shown in economic activity had brought about slight positive changes in the expected trend of foreign demand and the labour market. Even so, the ECB underlined the message that recovery would be weak and slow.

Interbank rates in Euro Area and United States still at low levels.

For its part, the Monetary Policy Committee (MPC) of the Bank of England, as in the case of the Fed and the ECB, voted to maintain the official interest rate stable, in this case at 0.5%. Furthermore, this institution has set in motion the purchase of assets (for 50 billion pounds) agreed upon in August.

Undoubtedly, the historic low reached in interbank rates in the Euro Area and in the United States may be explained by the decisions taken by the central banks. A clear example of this is the EONIA interest rate which is holding at levels of around 0.25% or the case of the 1-month and 3-month Euribor rates running between 0.47% and 0.80% respectively since August 24. In the case of the United States, the low levels reached reflect the normalization now being noted in the financial sector.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro Area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2008									
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	0.86	2.00	2.77	0.75
2009									
January	2.00	2.09	2.27	0.25	1.18	0.67	1.50	2.17	0.70
February	2.00	1.83	2.03	0.25	1.26	0.63	1.00	2.05	0.75
March	1.50	1.52	1.81	0.25	1.19	0.60	0.50	1.65	0.63
April	1.25	1.37	1.73	0.25	1.02	0.55	0.50	1.45	0.66
May	1.00	1.27	1.63	0.25	0.66	0.52	0.50	1.28	0.60
June	1.00	1.10	1.50	0.25	0.60	0.46	0.50	1.19	0.33
July	1.00	0.89	1.36	0.25	0.48	0.41	0.50	0.89	0.41
August	1.00	0.82	1.30	0.25	0.35	0.39	0.50	0.69	0.30
September (1)	1.00	0.76	1.25	0.25	0.29	0.35	0.50	0.57	0.23

NOTES: (1) September 22.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-10-08 (3.75%), 6-11-08 (3.25%), 4-12-08 (2.50%), 5-03-09 (1.50%), 2-04-09 (1.25%), 7-05-09 (1.00%).

(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%), 8-10-08 (1.5%), 29-10-08 (1%), 16-12-08 (0%-0.25%).

(4) Latest dates showing change: 10-04-08 (5.00%), 8-10-08 (4.5%), 6-11-08 (3.0%), 4-12-08 (2.0%), 7-01-09 (1.5%), 5-02-09 (1.0%), 5-03-09 (0.50%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	Germany	France	Spain	Italy	United States	Japan	United Kingdom	Switzerland
2008								
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	3.11	3.66	4.28	4.68	3.01	1.28	3.62	2.24
March	3.00	3.55	4.05	4.39	2.66	1.35	3.17	2.10
April	3.18	3.59	3.92	4.28	3.12	1.43	3.50	2.14
May	3.59	3.95	4.29	4.48	3.46	1.49	3.75	2.41
June	3.39	3.73	4.13	4.43	3.53	1.36	3.69	2.32
July	3.30	3.57	3.85	4.16	3.48	1.42	3.80	1.97
August	3.26	3.54	3.78	4.08	3.40	1.31	3.56	2.03
September (*)	3.39	3.65	3.91	4.09	3.43	1.35	3.74	2.11

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

Impasse in government bond markets

In the last three months the performance of government bonds may be defined in one word – stability. In fact, the previous table shows how since the end of June interest rates offered on government bonds with 10-year maturity have moved within a very narrow range. For example, in the case of French bonds these are being quoted at a yield of around 3.5%. In the meantime, German bonds have gone back to 3.39% as of the end of June. Nor have Spanish government bonds shown violent moves seeing that over the past quarter they have presented a yield of slightly below 4%.

There are two elements that stand out in government bond markets. The first is the sudden increase in interest rate differentials between countries in the Euro Area has left behind the highs reached in February although it is showing some difficulty in returning to the prior situation. It is possible that new levels of balance may be reached in differentials between Germany and other countries, at least in coming months, and that they will not immediately go back to the pre-crisis period, but it also seems to be confirmed that they have left the worst behind.

Stability in government bond markets continues.

In second place, the stability on the surface of bond markets obscures the accumulation of powerful forces (public deficits, inflation, unconventional measures of the central banks, etc.) which for now are in balance but whose evolution is quite unknown. Certainly, as recovery becomes consolidated government bonds will tend to offer a higher yield rate. It is foreseeable that by the end of the year they will show levels slightly above those at present. This movement should not be very sharp because two key factors will still be in

Strong liquidity and absence of inflationary pressures will prevent sharp rise in yield on government bonds over short term.

Dollar now being used as carry-trade currency.

force. The first is indirect support through liquidity or directly through the purchase of bonds that the central banks are providing. A second factor is the absence of imminent inflationary pressures at the present moment in the cycle. Nevertheless, with 2010 in mind risks for bond markets will be higher with a high possibility of upsets.

Exchange rates: financing cheaper in dollars

Finally, the calm in foreign exchange markets that existed for several months has now been broken. The following table shows how the dollar has depreciated notably over the past month. For example, the quotation of the euro against the dollar that in mid-August stood at 1.43 has now gone to 1.48, while a month ago the dollar could buy 97 yen now it will only be exchanged for 91.4 yen.

One basic reason for this depreciation of the dollar lies in the low interest rates existing in the United States as a result of the aggressive monetary policy of quantitative expansion put into effect by the Federal Reserve. This puts the dollar in a situation similar to the yen some years ago in its now being used as the currency for financing carry-trade operations. This term covers a variety of operations made up of borrowing in currencies with a low interest rate and then investing in assets expressed in currencies showing a high yield.

EXCHANGE RATES OF MAIN CURRENCIES

September 22, 2009

	Exchange rate	% change (*)		
		Monthly	Over December 2008	Annual
Against US dollar				
Japanese yen	91.4	–3.5	0.8	–15.5
Pound sterling	0.614	0.9	–11.5	12.2
Swiss franc	1.025	–3.5	–4.3	–4.8
Canadian dollar	1.070	–0.5	–13.9	3.2
Mexican peso	13.340	3.0	–2.5	20.3
Against euro				
US dollar	1.478	3.2	5.4	0.0
Japanese yen	135.0	–0.2	6.1	–15.5
Swiss franc	1.515	–0.2	1.4	–4.8
Pound sterling	0.908	4.0	–5.2	12.2
Swedish krona	10.109	0.2	–8.3	5.1
Danish krone	7.441	0.0	0.0	–0.3
Polish zloty	4.163	1.3	0.3	20.6
Czech crown	25.15	–1.1	–6.8	4.9
Hungarian forint	271.3	1.3	2.1	11.3

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

Shares raise positions

The stock markets ended September on the rise for the sixth month in a row contributing to a calm first anniversary of the failure of Lehman Brothers. The main stock market indices came to stand at levels close to those recorded on that date betting on an overall economic-financial scenario of a recovery of the cycle and a reduction of risks of recession. The S&P 500 and the Eurostoxx 50 have piled up revaluations close to 60% since March, a month considered as a point of change in the course of share markets.

The continuing improvement in risk premium indicators, the moderation of volatility as well as the narrowing of differentials on corporate bonds, helped investors become more attracted to buying shares. This shift, for example, was observed all through the month in US investment funds in which the portfolios of individuals have been reoriented toward shares to the detriment of money market assets having lower revaluation potential.

S&P 500 and Eurostoxx 50 reach highest revaluations so far this year in September.

The continuation of the upward stock market rally was due both to the improvement in macroeconomic figures and more recently to the growing number of positive news items in the corporate sphere. On the first front, as the year advances recovery of economic activity figures seems to be consolidating thus confirming what confidence indices suggested in the Spring and that gave backing to the buying thrust in the stock market.

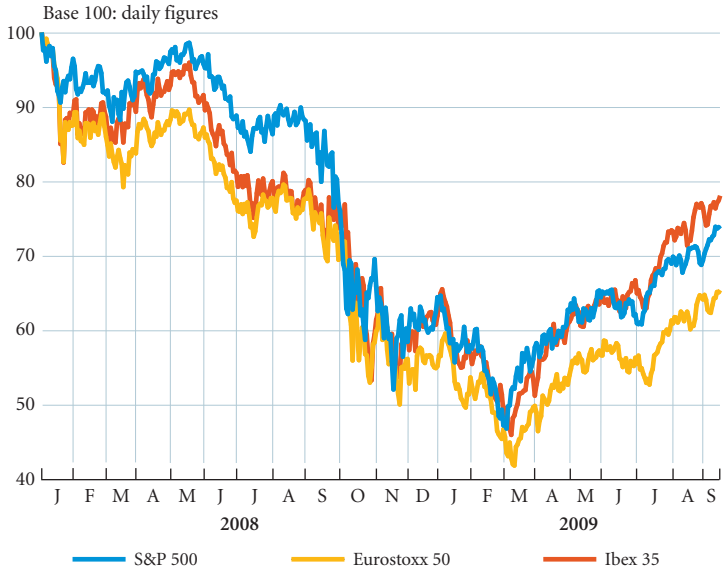
Individual investors show higher preference for shares.

In the broad range of information two facts stand out. The first was the proposal by the G-20 forum to modify the regulatory framework of the world financial sector. In spite of measures carried out to resolve the difficult situation of credit institutions, what

Economic figures give part support to revaluation of stock markets.

STOCK MARKETS RECOVER LEVELS OF ONE YEAR AGO

Main stock market indices



SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

September 22, 2009

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*9,778.9*	*2.9*	*11.4*	*–11.2*
Standard & Poor's	*1,064.7*	*3.8*	*17.9*	*–11.8*
Nasdaq	*2,138.0*	*5.8*	*35.6*	*–1.9*
Tokyo	10,370.5	1.3	17.1	–13.0
London	5,187.0	6.9	17.0	–0.9
Euro Area	2,904.7	5.8	18.7	–8.7
Frankfurt	*5,738.0*	*5.0*	*19.3*	*–6.1*
Paris	*3,853.5*	*6.6*	*19.7*	*–8.8*
Amsterdam	*314.6*	*6.8*	*27.9*	*–16.1*
Milan	*23,340.1*	*6.6*	*19.9*	*–14.9*
Madrid	*11,878.3*	*6.4*	*29.2*	*4.9*
Zurich	6,360.0	3.6	14.9	–7.7
Hong Kong	21,685.4	7.4	50.7	10.5
Buenos Aires	1,986.3	10.5	84.0	17.5
São Paulo	60,928.0	5.5	62.3	18.2

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.

Proposals for regulation of financial system and announcement of corporate mergers have positive effect.

remains clear is the willingness of the political and monetary authorities to toughen regulations in order to avoid any new financial crisis. The changes will focus on introducing a model that ensures the solvency of the banks through the allocation of anti-cyclical provisions and greater control of leverage.

A second notable fact in the corporate sphere is the increasing flood of news about mergers and acquisitions at the world level. Since Spring, the increase in the number of transactions of this type has done nothing but return confidence to capital markets given that as well as offering an alternative to the restrictions on financing for the real economy, it supports the context of stock market revaluation.

Private bonds improve as economic prospects recover.

Improvement in credit markets continuing

The private bond markets are also continuing to improve in this situation of prospects for economic recovery that are increasingly positive. Credit risk premiums on corporate bonds have been reduced to levels before the Lehman Brothers crisis. In addition, with official interest rates close to zero, domestic yield rates on bonds of these companies stand at all-time lows in many market sectors. The lower cost of financing companies has meant that these are carrying out issues in record volume and are extending the maturity dates of their bonds.

The conjunction of expansionist monetary policies and programmes

SHARP DROP IN RISK PREMIUMS ON INVESTMENT GRADE BONDS

Credit rating differentials on investment grade corporate bonds (United States)

SOURCE: EcoWin and Merrill Lynch.

of governments to guarantee financial assets of banks has meant the rapid recovery of corporate bond markets. The proposal by governments to increase solvency margins for financial institutions is not having any significant effect on bonds issued by these entities.

The improvement in corporate bond markets has also reached companies of low solvency bringing about a unique situation in that the recovery of prices for high yield bonds has developed while default ratios in the sector continue to rise.

While this boom is going on in corporate bond markets, bank loans to small companies and households are stagnant or falling both in the United States and in the Euro Area. It is very likely that both phenomena are related in a common and complementary dynamic. In the trend in bank credit, factors of supply and demand have an influence. On the one hand, the commercial banks are involved in a process of deleveraging so that they are inclined to control credit in order to improve their solvency and liquidity ratios. On the other hand, households and small and medium companies are increasing their savings while reducing their debt from fear of the crisis.

The inclination of investors for credit risk in this market has been fostered by the change in cycle in the process of qualification by the rating agencies. After several downward revisions in ratings on bonds of many companies, the agencies are changing the bias toward upward revisions. This means important support for the sector, given that it shows a green light on the purchase of bonds by institutional investors that demand a certain minimum level of credit rating on bonds in order to include them in their portfolios.

Risk premiums adjusting both on investment grade bonds and high yield bonds.

Corporate bonds show binomial of yield-risk attractive to private investors.

RISK PREMIUMS ON HIGH-YIELD BONDS ALSO UNDERGO DECREASES

Differentials in credit rating of high yield bonds (United States)

SOURCE: EcoWin and Merrill Lynch.

Fiscal deficits, ratings and sovereign differentials

Financial failure or bankruptcy is a situation where an individual or a legally-constituted body cannot meet the payments that must be made. Among those bodies are companies, foundations, associations and even states. As in the case of companies, states have the capacity to borrow in capital markets in order to finance the spending programmes they carry out.

Nevertheless, there is a fundamental difference between states and other entities. States have the coercive capacity to collect taxes. That is to say, they can impose or raise taxes if their financial situation so requires so that theoretically their credit profile should be among the highest. In spite of this, we could draw up a long list of states that have not met payment of commitments taken on. We have simply to recall the bankruptcies of Latin American countries in the period 1982-1986 or the case of Russia in 1998.

The reasons behind bankruptcy are quite varied. For example, at times a state may imprudently borrow above its possibilities. In other cases, an unexpected negative shock in its economy may bring about a severe depreciation of its currency and, having its bonds issued in a foreign currency may have suddenly increased the debt load and this takes it into bankruptcy. Another fairly typical case takes place when most of a country's debt is held by foreign investors and a situation of financial panic beginning in another country spreads over to it, thus preventing a refinancing operation and taking the state to a failure to pay.

It is obvious that those states that go to capital markets to obtain financing have different credit profiles. Not only the larger credit rating agencies, such as Standard & Poor's, Moody's and Fitch, but all those investors who acquire government bonds of states study this credit profile and assign it a rating.

CREDIT RATINGS

Ratings	Characteristics	Examples
AAA	Strong political institutions. Economic policy adaptable to context. Prosperous economy. Low fiscal deficit. Integration in international financial system. Low inflation. Independent central bank. Low foreign debt.	United States, Germany, France
AA	Strong political institutions. Economic policy adaptable to context. Economy slightly more vulnerable than AAA. Low fiscal deficit. Integration in international financial system. Low inflation. Independent central bank. Modest foreign debt.	Belgium, Spain, Ireland
A	Stable political institutions but with possible risks. Generally flexible economic policy. Moderate fiscal deficit. Integration in financial system. Moderate inflation. Central bank with more limited flexibility. Moderate foreign debt.	Italy, Greece, Israel, China, Malta
BBB	Political institutions with possible risks and less transparent. Economic policy generally flexible. Less prosperous economy. Moderate fiscal deficit. Growing integration in international financial system. Moderate inflation. Central bank with flexibility.	Hungary, Mexico, Iceland, India, Brazil
BB	Significant political risks. Economic policy with little flexibility. Economy not very prosperous and vulnerable to outside influences with impediments to growth. Growing integration in international financial system. Inflation variable. Flexibility of central bank limited.	Mongolia, Venezuela, Uruguay, Egypt
B	Weak political institutions with uncertain political context. Limited economic policy. Economy vulnerable to outside influences with impediments to growth. Poor integration in international financial system. High inflation. Central bank with problems.	Dominican Republic, Pakistan, Sri Lanka
CCC	Weak political institutions and uncertain political context. Clear present risk of bankruptcy. Economy vulnerable to outside influences with impediments to growth. Inflation high with possibility of hyperinflation. Financial sector weak with liquidity problems.	Jamaica, Ecuador, Ukraine

NOTES: Ratings are those assigned by Standard & Poor's rating agency and in force in September 2009.

An AAA rating is assigned to those countries with the highest credit quality. The rating scale runs from AAA to CCC. The latter is the worst a country can obtain before being assigned a D rating which signifies that the country is in a situation of bankruptcy. Generally, a country comes out of this following intense negotiations to restructure debt and negotiate waivers. That is to say, by obtaining a remission or exemption of part of the debt made by the creditor in favour of the debtor.

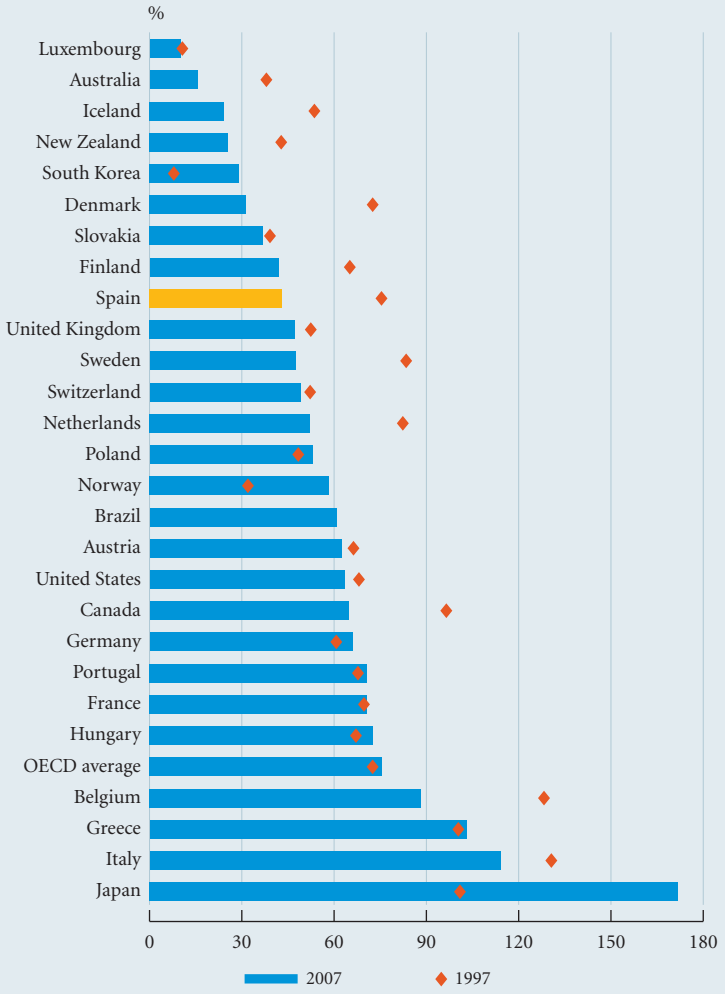
What are the most important criteria for deciding on the credit strength of a country? While an analysis may involve an exhaustive study of many kinds, most fit into the following broad areas: political risk, economic structure, growth prospects, the flexibility of monetary and fiscal policies, the stock of existing debt, liquidity and foreign debt of the country.

The above table gives a résumé of the main characteristics countries must demonstrate to those awarding any specific rating. Furthermore, some examples are added of countries currently standing at each of these levels, according to Standard & Poor's rating agency.

When possible, these attributes are expressed quantitatively through various ratios and measurements in order to establish the country's credit profile. One of the ratios commonly published is the government debt of a country in relation to its GDP. The following graph sets out in order the countries that belong to the OECD in relation to this ratio. At the end of 2007, Japan's government debt reached 170% of GDP while Spain's was under 45%.

SOME HEAVILY INDEBTED COUNTRIES

Government debt as percentage of GDP



SOURCE: OECD.

Most countries took advantage of the economic boom at the end of the Nineties to reduce their stock of debt although not all were able to do so. The question is when is a country very much in debt and must be considered to be showing a high credit risk. There is no final answer. One guide may be the convergence criteria of the EMU (European Monetary Union) which lays down that this ratio must not go over 60% although we know that if a country does exceed this level it may be allowed to do this so long as the course of the ratio is downward and close to the limit.

High fiscal deficits that continue over a period of time impose a course of government borrowing that may be unsustainable. For this reason, supranational bodies, such as the IMF, the European Commission and the

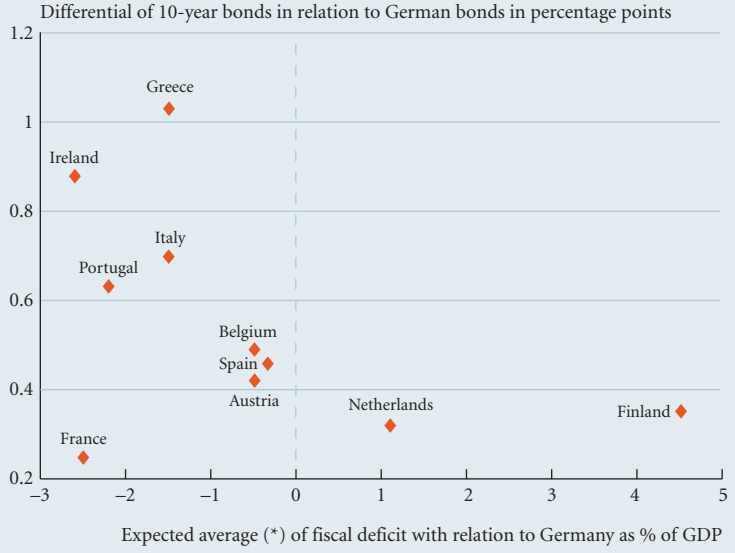
European Central Bank (ECB), insist on their concern about current fiscal deficits. While these deficits may be explained by the sharp world recession, the various countries are being asked to bear in mind the sustainability of their government finances seeing that over the medium term there is the risk of a serious worsening of credit profiles.

But do the financial markets take into account a country's credit risk? Of course. Investors demand a higher return on government bonds that show a higher risk, that is, a higher sovereign differential. The following graph shows that investors act coherently, demanding a higher return for carrying higher risk.

It may be shown that, for bonds of those countries with a higher relative fiscal deficit than Germany, investors want a higher interest rate differential compared with German bonds of the same maturity.

This graph, however, serves to underline that the expected course of the public finances of each country is more important than the current deficit. For example, if we compare the case of France with that of Italy, we find that a higher differential is demanded from Italian bonds in spite of the fact that France currently has relatively higher fiscal deficit. The explanation for this lies in the worse prospects for Italy's public accounts as is also shown in the ratings assigned in the above table.

FISCAL DEFICITS AND DIFFERENTIALS IN GOVERNMENT BONDS



NOTES: (*) For 2007, 2008 and 2009.
SOURCE: European Central Bank.

In addition it is very important to keep in mind that the differential in interest rates demanded for a government bond does not only reflect credit risk but also the bond's liquidity risk. Those national bond markets that show greater liquidity, that is to say, those markets with a huge turnover and those where the volume of bond issues is large attract investors more and therefore have lower differentials.

To be precise, the ECB[1] recently published the results of a survey according to which the most relative variable for explaining sovereign differentials within the EMU in the most recent months of the financial crisis is the different liquidity levels of national markets and not so much the differences in credit risk premiums between countries.

In conclusion, large and persistent fiscal deficits bring about drops in ratings that reflect the credit profile of a country and increase sovereign differentials that the country must offer in capital markets in order to obtain financing. In some cases, the severity of these deficits may even lead to failure to pay on its bonds.

(1) *ECB Monthly Bulletin,* July 2009, «The Determinants of Long-Term Sovereign Bond Yield Spreads in the Euro Area», pages 71 and 72.

This box was prepared by Alejandro Gisbert Mir
Financial Markets Unit, "la Caixa" Research Department

SPAIN: OVERALL ANALYSIS

Economic activity

Economic slump easing

National Accounting figures for the second quarter prepared by the National Institute for Statistics confirm a quarter-on-quarter drop in economic activity for the fifth quarter in a row although with some moderation in the last period. In fact, in the second quarter of 2009 the gross domestic product (GDP) was down 1.1% compared with the first quarter but 5 decimals less than in the previous period. This easing of the recession came as a result of the improvement of the world economic situation, the expansionist effect of monetary and fiscal stimuli and the gradual return to normalcy in financial markets. This brake being applied to the contraction seems to be continuing in the third quarter, if we are to go by available economic figures.

Nevertheless, in the second quarter the GDP dropped by 4.2% compared with the same period in 2008, the biggest decrease in recent decades, although this was lower than that recorded for the European Union (4.8%) and the Euro Area (4.6%). The drop in GDP was due to national demand which was took off 7.3 points, while the foreign sector brought 3.1 points to growth, 2 decimals more than in the previous quarter.

Improvement in world economic situation and expansionist effect of monetary and fiscal stimuli easing recession.

DEMAND INDICATORS

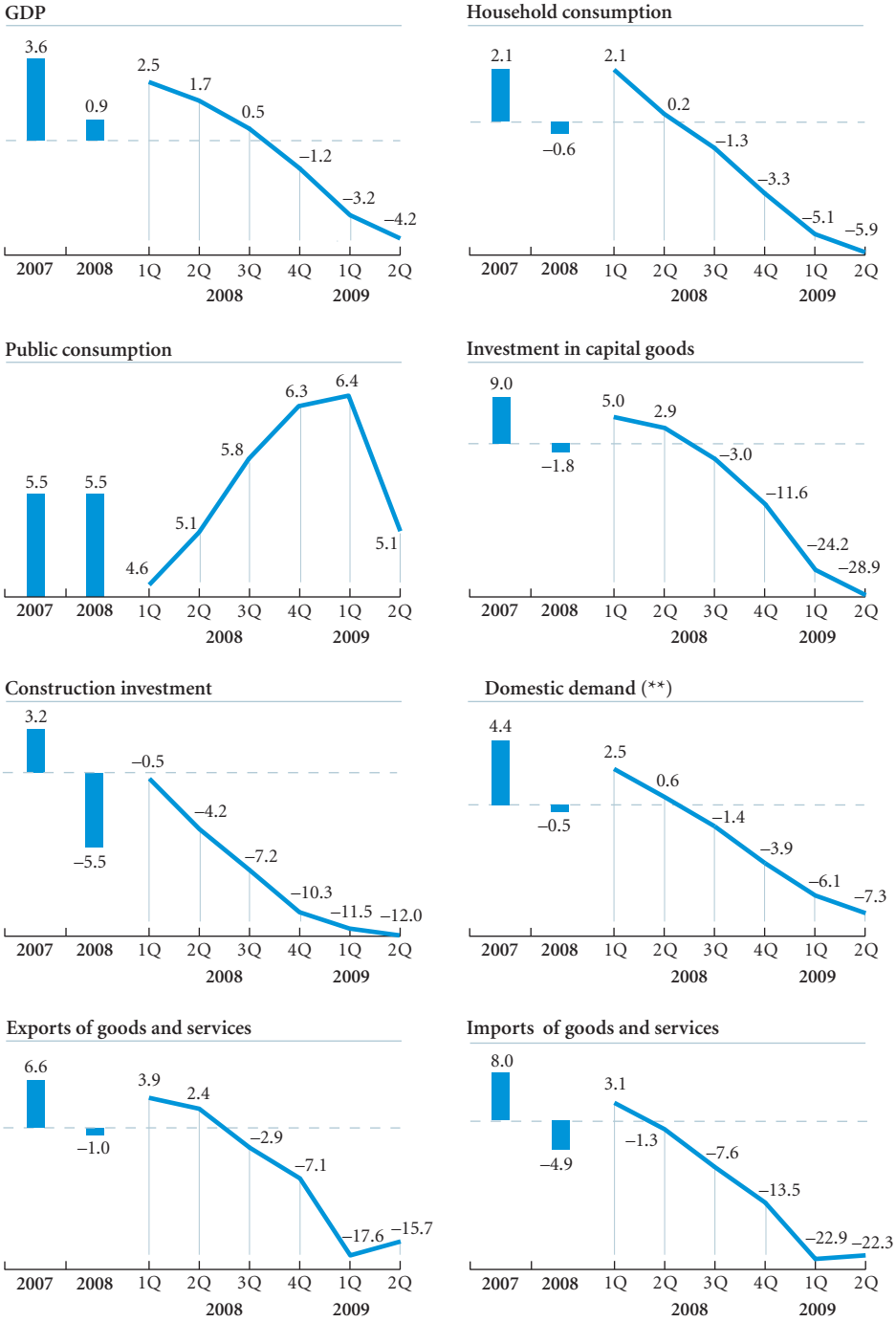
Percentage change over same period year before

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
Consumption								
Production of consumer goods (*)	1.7	–4.7	–4.5	–10.3	–12.6	–9.4	–10.7	...
Imports of consumer goods (**)	5.1	–7.7	–4.1	–17.2	–9.4	–14.9	–9.1	...
Car registrations	–1.2	–28.1	–32.5	–46.6	–43.1	–33.7	–10.9	0.0
Credit for consumer durables	10.0	3.6	3.4	–4.2	–11.9	–14.1	–	...
Consumer confidence index (***)	–13.3	–33.8	–38.0	–45.3	–44.7	–28.0	–20.0	–20.0
Investment								
Capital goods production (*)	4.6	–8.8	–8.0	–20.8	–30.5	–24.6	–26.7	...
Imports of capital goods (**)	9.8	–19.6	–15.9	–28.8	–31.3	–35.1	–37.2	...
Commercial vehicle registrations	0.3	–43.6	–50.1	–61.3	–52.4	–51.9	–37.8	–27.0
Foreign trade (**)								
Non-energy imports	7.3	–4.9	–4.1	–19.0	–26.0	–26.8	–18.9	...
Exports	4.2	1.9	7.8	–8.4	–17.9	–14.7	–9.3	...

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

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



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

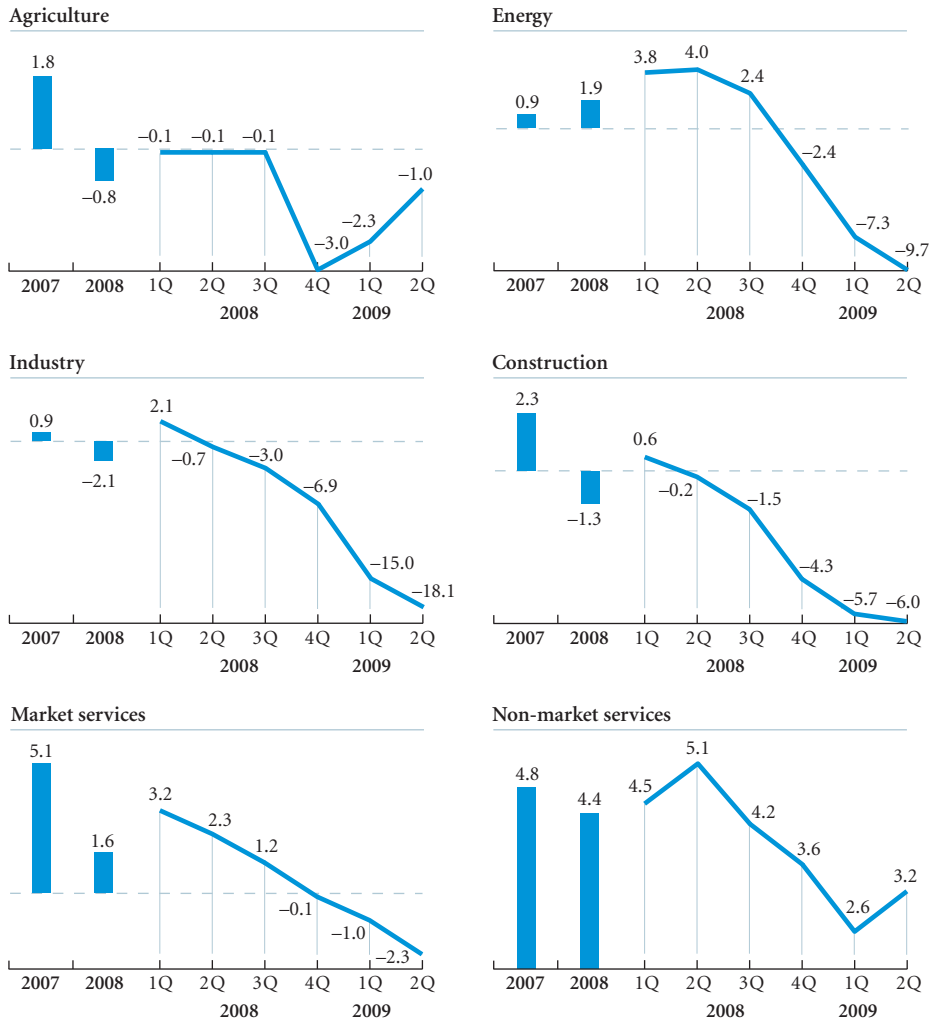
Household consumption continued to contract in the second quarter going down by 5.9% compared with one year earlier because of lower wage incomes due to less employment as well as because of the effect of price drops in real estate assets, the tightening of lending terms and an increased propensity to save because of greater uncertainty in view of the rise in unemployment. Nevertheless, in quarter-on-quarter terms, we note some moderation in the drop in household consumption that appears to be happening in the third quarter.

In August, the year-on-year drop in car sales came to a halt following 15 months of decreases while purchases by individuals rose by 19.3%, boosted by the 2000-E Plan of the central government and most Autonomous Communities. Retail sales are also showing a trend to less contraction marking up a year-on-

Contraction in consumption moderating.

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.

Commercial vehicle registrations softening drop.

year decrease of 3.1% in July. At the same time, in the early months of the third quarter consumer confidence improved although it still stood at a relatively low level.

Correction in residential construction continuing while infrastructure works on increase.

Investment was also down sharply in the second quarter with a year-on-year drop of 17.0%, some 1.8 points more than in the first quarter. The biggest drop was in capital goods which were down 28.9% in the past 12 months under the effect of very weak demand, lower corporate profits, uncertainty about economic prospects and a drop in utilization of production capacity. Nevertheless, the rate of decrease is easing. Registrations of commercial vehicles decreased by 27.0% year-on-year in August as against a drop of 51.9% in the second quarter.

Gross capital formation also reported a notable drop of 12.0% compared with the second quarter of 2008. This decrease was due to a continuation of the correction in the residential sector given the high unsold housing stock. On the other hand, infrastructure works were up 1.2% compared with the same quarter last year, thanks to the municipal

SUPPLY INDICATORS

Percentage change over same period year before

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
Industry								
Electricity consumption (1)	4.5	0.6	0.9	–3.6	–7.0	–6.5	–2.6	–0.4
Industrial production index (2)	2.0	–7.3	–6.3	–16.6	–22.6	–18.6	–17.4	...
Confidence indicator for industry (3)	–0.3	–18.0	–18.7	–32.7	–36.7	–35.5	–32.0	–27.0
Utilization of production capacity (4)	81.3	79.5	79.3	76.9	68.8	69.5	...	68.5
Imports of non-energy intermediate goods (5)	8.0	–0.7	–2.1	–18.2	–32.9	–31.1	–21.2	...
Construction								
Cement consumption	0.2	–23.8	–25.2	–38.1	–46.5	–36.0	–32.3	–21.2
Confidence indicator for construction (3)	9.3	–22.6	–23.7	–34.7	–36.7	–35.0	–32.0	–24.0
Housing (new construction approvals)	–24.7	–59.4	–62.4	–60.2	–64.1	–69.5	...	...
Government tendering	–15.0	3.0	6.4	12.4	–5.1	–28.2	...	...
Services								
Retail sales (6)	2.3	–6.3	–7.1	–7.7	–6.3	–4.2	–3.1	...
Foreign tourists	1.1	–2.4	–5.2	–9.0	–16.3	–8.2	–6.1	...
Tourist revenue inflows	3.3	–0.4	0.2	–8.0	–14.3	–8.0	...	...
Goods carried by rail (ton-km)	–3.7	–7.7	–1.7	–23.0	–34.1	–34.9	–43.9	...
Air passenger traffic	9.0	–3.1	–4.9	–12.7	–18.2	–8.7	–4.8	–5.5
Motor vehicle diesel fuel consumption	5.1	–3.8	–3.7	–7.7	–10.3	–5.1	...	...

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.

works plan put into action by the central government and projects linked to the high-speed train network.

With regard to the foreign sector, exports of goods and services reduced their year-on-year drop by 1.8 points to 15.7%, thanks to the improvement in demand, especially from the European Union. Imports of goods and services also slowed in the second quarter but less sharply than exports to show a year-on-year decrease of 22.3%.

On the supply side, all large sectors recorded year-on-year decreases in the first quarter except the primary branches. Under the effect of demand problems and a lack of competitiveness, industry showed a year-on-year decrease in value added of 16.8% some 3 points more than in the previous quarter. The biggest decreases came in consumer durables and capital goods. In coming months these big drops will likely ease, as indicated by the improvement in industrial confidence in July and August and an easing of the reduction in electrical power consumption. Nevertheless, the coming in of new orders remains very weak so that the weakness in the secondary sector will continue.

The value added of services was down 1.1% compared with the second quarter of 2008, some 9 decimals more than in the previous quarter, because of bigger contraction in market services. Nevertheless, the year-on-year drop in the business volume of the services sector was contained at 14.3% in July with transport, retail trade and company services recording the biggest drops. Tourism also reported a negative trend in the summer but not as bad as in the first part of the year, thanks to price reductions.

With regard to incomes, wage earnings were down by 2.6% compared with the second quarter of 2008, some 4 decimals more than in the first quarter largely as a result of the drop in employment given that average earnings per worker rose by 4.6%, some 3 decimals more than in the previous quarter. On the other hand, gross operating profit and gross mixed income were down sharply to show a negative annual change rate of 1.6% for the first time in this economic cycle.

Tourism shows negative trend in summer but less than in first part of year.

Apparent productivity of labour factor showed a year-on-year increase of 3.2%, one decimal less than that in the previous quarter. The biggest year-on-year increase in productivity showed up in construction (25.8%) although this was lower than in the first quarter. This was followed by the primary sectors with 2.6%. On the other hand, the energy and industrial sectors showed annual decreases of 10.7% and 6.1% respectively. As a result, unit labour cost rose to 1.4% to stand 1.3 points above the GDP deflator.

Productivity halts improvement in second quarter while unit labour cost moves up.

The unfavourable economic situation is also reflected in the creation of fewer businesses which in turn affects the worsening of the labour market. In July, some 6,119 companies were established, 24.3% less than in the same month in 2008. Nevertheless, this decrease was lower than that for the total in the first seven months of the year.

With regard to prospects, we expect a progressive improvement in economic activity in coming quarters with help from the international recovery. In any case, given the size of the cumulative imbalances it is likely that coming out of the recession will be very gradual.

We expect progressive improvement in economic activity.

Labour market

Number of those registered with Social Security as working drops by 1.5 million since high in July 2007.

Stimulus programme helps sustain labour market

The total number of persons registered with Social Security as working stood at 18,001,310 on monthly average in August. This figure meant a year-on-year decrease of 5.9%. This drop, however, was lower than in previous months and nearly one point less than in April. In fact, the trend to loss of jobs measured by registrations with Social Security has substantially eased in recent months as may be seen in the following graph.

This has been made possible by the relative easing of the economic recession to which the State Fund for Local Investment has contributed. This economic stimulus programme set in motion by the central government is estimated to have generated more than 400,000 jobs up to the second week in September although these have been temporary jobs. Nevertheless, since July 2007, the high point in employment in Spain, the average number of those registered with Social Security as working dropped by 1,492,740 persons.

The easing off in the decrease in registrations was noted in all economic sectors but especially in construction which has directly benefited from the government economic stimulus programme for municipal works. Nevertheless, the number of those

DROP IN THOSE REGISTERED WITH SOCIAL SECURITY SLOWS NOTABLY

Month-on-month change annualized in total number registered with Social Security as working (*)

NOTES: (*) Cycle-trend statistical series for monthly averages.
SOURCE: Ministry of Labour and Social Affairs and own calculations.

registered in this sector showed the biggest year-on-year drop (21.7% in August) which reflects the sharp correction in the residential sector.

By type of company, we note that all size categories lost persons registered in the last 12 months up to the end of August. Nevertheless, the biggest drops came in small companies. In fact, those companies between 6 and 49 workers in non-farm sectors show decreases in registrations of more than 10% whereas those among companies with more than 1,000 workers did not reach 5%. In any case, the group that showed the lowest year-on-year decrease was very small companies with 1-2 workers which reported a drop of 4.8%.

By sex, we note that the relative improvement in recent months has involved males more than females, given that construction works employ more males. Nevertheless, in the past year the drop in male registrations (8.0%) was more than twice that for females (3.2%). As a result, the share for females stood at 43.9% of the total, 2 decimals below the all-time high reached in May 2009.

By nationality, the number of Spanish workers registered was down by 5.5% in the period August 2008-August 2009. In this period, foreign workers registered dropped by 9.3%.

Hiring contracts registered at the Public Employment Service in August amounted to 944,823, a drop of 10.0% compared with the same month last year. Of this total, some 7.3% (68,735) were of a permanent nature. This meant a year-on-year decrease of 29.6%.

Biggest drops in registration take place in small companies.

Relative halt to worsening of employment in recent months involves males more than females.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2007	2008	2008		2009			
			3Q	4Q	1Q	2Q	July	August
Persons registered with Social Security (1)								
Sectors of activity								
Industry	*2.4*	*–2.1*	*–2.4*	*–5.6*	*–9.3*	*–11.5*	*–11.8*	*–11.5*
Construction	*3.6*	*–10.3*	*–12.4*	*–19.5*	*–25.2*	*–25.4*	*–23.0*	*–21.7*
Services	*3.5*	*1.7*	*1.6*	*–0.2*	*–2.1*	*–3.1*	*–3.2*	*–2.9*
Job situation								
Wage-earners	*3.1*	*–0.7*	*–1.1*	*–3.7*	*–6.3*	*–7.0*	*–6.6*	*–6.1*
Non-wage-earners	*2.8*	*0.4*	*–0.1*	*–1.9*	*–3.9*	*–5.0*	*–5.3*	*–5.3*
Total	**3.0**	**–0.5**	**–0.9**	**–3.4**	**–5.8**	**–6.7**	**–6.4**	**–5.9**
Persons employed (2)	**3.1**	**–0.5**	**–0.8**	**–3.0**	**–6.4**	**–7.2**	**–**	**–**
Jobs (3)	**2.8**	**–0.6**	**–1.0**	**–3.2**	**–6.3**	**–7.1**	**–**	**–**
Hiring contracts registered (4)								
Permanent	2.0	–14.3	–13.8	–26.0	–35.4	–35.3	–30.7	–29.6
Temporary	0.3	–10.4	–9.4	–17.9	–23.9	–17.8	–11.9	–8.0
Total	**0.5**	**–10.9**	**–9.9**	**–18.9**	**–25.4**	**–19.9**	**–13.7**	**–10.0**

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

Biggest drop in past 12 months seen in registrations by foreign workers.

In any case, these rates show an improvement over the first eight months of the year.

Registered unemployment up in August

Following three months of decreases, the number of unemployed registered at the Public Employment Service rose again in August. The monthly increase of 84,985 persons put the total at 3,629,080. This increase was partly due to seasonal effects such as the end of temporary hiring contracts and new persons moving into the labour force but also having an influence was the lower level of hiring, especially because of the drop in activity in the tourism sector. As a result, the seasonally-adjusted figures show something of an increase in registered unemployment in August although the year-on-year change rate (43.4%) was lower than that reported in previous months. In the past two years the number of registered unemployed has risen by 1,600,784 persons.

Unemployment rate twice that of European Union in July and showing upward trend.

The increase in unemployment in Spain meant that the seasonally-adjusted unemployment rate in July stood at 18.5%, according to calculations by Eurostat. This rate meant the highest level in the European Union and double the average. The small improvement in the economic situation does not allow us to see any correction in unemployment for quite a few quarters. In this respect, the Organization for Economic Cooperation and Development (OECD) recently predicted that the unemployment rate could come close to 20% in 2010. Given this situation, the central government announced that it would extend the benefit of 422 euros to

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

August 2009

	No. of unemployed	Change over December 2008		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	95,018	19,007	25.0	31,973	50.7	2.6
Industry	488,917	75,492	18.3	155,674	46.7	13.5
Construction	709,362	51,926	7.9	226,365	46.9	19.5
Services	2,075,678	285,403	15.9	602,911	40.9	57.2
First job	260,105	68,289	35.6	82,156	46.2	7.2
By sex						
Males	1,817,405	240,938	15.3	655,214	56.4	50.1
Females	1,811,675	259,179	16.7	443,865	32.5	49.9
By age						
Under 25 years	413,798	28,668	7.4	124,266	42.9	11.4
All other ages	3,215,282	471,449	17.2	974,813	43.5	88.6
TOTAL	**3,629,080**	**500,117**	**16.0**	**1,099,079**	**43.4**	**100.0**

SOURCE: INEM and own calculations.

those unemployed who had used up their benefits since January 2009 where these were initially approved only from August.

Little easing in labour costs for companies

The wage increase settled on in labour agreements up to August not including wage revision clauses was 2.7%. This rate was less than the 3.6% reported in 2008 but much less than the drop in inflation in recent times and puts it at a level substantially higher than the inflation objective of the European Central Bank at 2%.

On the other hand, labour cost for companies rose by 3.9% in the second quarter compared with the same period last year, according to the quarterly survey of labour costs carried out by the National Institute of Statistics. This rate is only very slightly less than that reported in the first quarter. Total wage costs rose by 4.1% compared with the second quarter of 2008, some 1.2 points more than in the previous quarter. Nevertheless, ordinary wage costs, excluding overtime and back pay, moved up by 3.4% year-on-year to 1,607 euros per worker per month.

Ordinary wages eased in all sectors although at uneven levels. The biggest drop came in industry, which is subject to the biggest competitive pressures, where ordinary labour costs rose by 1.7% compared with the second quarter of 2008, under the effect of an increase in legal applications for adjustments in the number employed.

Ordinary wage costs move up 3.4% year-on-year to 1,607 euros per worker per month.

WAGE INDICATORS

Percentage change over same period year before

	2007	2008	2008				2009	
			1Q	2Q	3Q	4Q	1Q	2Q
Increase under general wage agreements (*)	**3.1**	**3.6**	**3.4**	**3.5**	**3.5**	**3.6**	**2.7**	**2.7**
Wage per job equivalent to full-time work (**)	**4.5**	**6.1**	**6.0**	**6.4**	**6.2**	**6.0**	**4.3**	**4.6**
Quarterly labour cost survey								
Wage costs								
Total	4.0	5.4	5.6	5.4	5.8	5.1	2.9	4.1
Industry	*3.4*	*5.6*	*6.1*	*5.6*	*5.3*	*5.3*	*1.1*	*2.3*
Construction	*4.5*	*6.5*	*5.8*	*7.2*	*6.3*	*6.7*	*4.5*	*5.5*
Services	*4.2*	*5.1*	*5.2*	*4.9*	*5.7*	*4.7*	*3.0*	*4.3*
Average wages per hour worked	*4.6*	*5.1*	*9.6*	*2.3*	*6.3*	*3.0*	*2.4*	*9.7*
Other labour costs	4.1	4.4	3.3	4.4	4.0	6.0	7.1	3.5
Work day (***)	–0.5	0.2	–3.6	3.0	–0.6	2.1	0.4	–5.2
Farm wages	**3.1**	**5.1**	**4.6**	**5.2**	**6.1**	**4.5**	**3.2**	**4.0**
Labour cost in construction	**2.4**	**5.7**	**0.8**	**6.4**	**7.6**	**7.9**	**7.5**	**4.3**

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

Prices

Consumer price index still in negative terrain.

Drop in prices easing

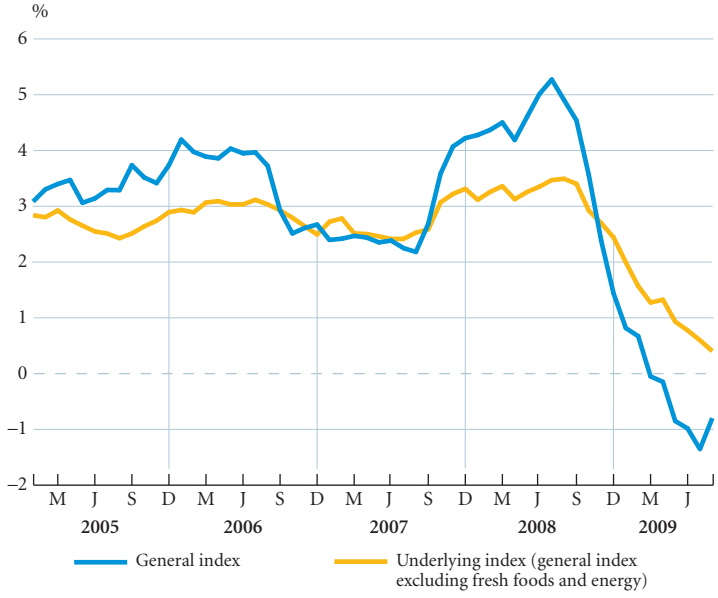
As expected, August brought a break in the downward trend in the annual change rate of the consumer price index (CPI) that began 12 months earlier. In fact, this rate rose in August after the CPI had marked up the biggest year-on-year drop in recent decades in July. The CPI rate continued negative in August (0.8%) although this was 6 decimals less than in the month before.

This turnaround may largely be explained by the swings in prices of oil and other commodities in recent times. Fuels and fuel-oils thus contributed 7 decimals to the increase in the year-on-year CPI rate in August going from an annual drop of 22.5% in July to 15.6%.

Nevertheless, the more stable core in price changes, so-called underlying inflation that excludes unprocessed foods and energy products, continued to go down dropping by 2 decimals in August to reach 0.4%. This course partly reflects the pass-through of the earlier drop in commodity prices but also the downward pressures arising from the contraction in consumption with the subsequent lowering or easing of prices by companies in order to stimulate sales. This is also reflected in the gross domestic product deflator which in the second quarter rose by only 0.1% year-on-year.

UNDERLYING INFLATION DROPS TO NEW LOW OF 0.4%

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

Returning to underlying inflation, all its main components were down in August although only non-energy industrial goods showed a minus sign. These goods sharpened their drop in prices to 1.8% annual thus contributing minus one decimal to the year-on-year change in the CPI. As well as a result of the weakness of consumption, this drop was due to strong competition in international markets. Sales campaigns thus ended with reductions somewhat greater than 12 months ago and clothing and footwear showed a year-on-year

Downward base pressures persist as result of contraction of consumption taking underlying inflation to 0.4%.

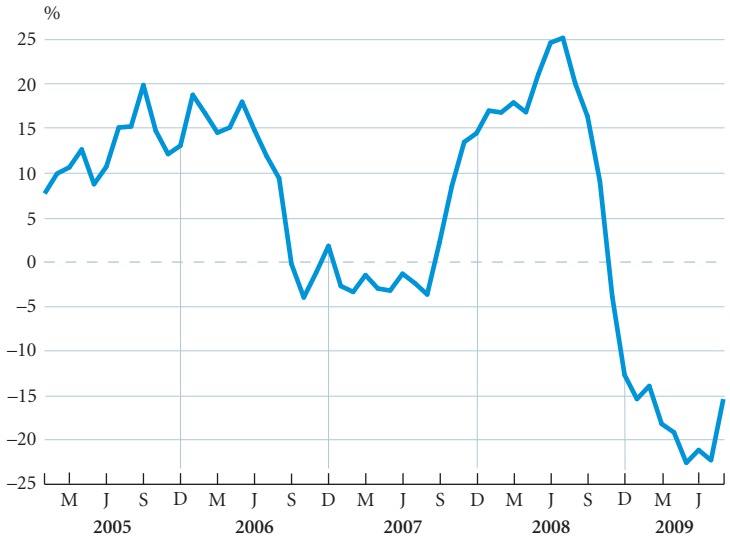
CONSUMER PRICE INDEX

	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	0.0	–1.2	0.7
March	0.9	0.4	4.5	0.2	–1.1	–0.1
April	1.1	1.5	4.2	1.0	–0.1	–0.2
May	0.7	2.2	4.6	0.0	–0.1	–0.9
June	0.6	2.8	5.0	0.4	0.3	–1.0
July	–0.5	2.3	5.3	–0.9	–0.5	–1.4
August	–0.2	2.1	4.9	0.3	–0.2	–0.8
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.

PRICES OF FUELS AND FUEL-OILS RISING

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



SOURCE: National Institute of Statistics.

Inflation in services also easing.

decrease of 2.2%. In turn, car prices showed a year-on-year drop of 5.8%, some 1.6 points more than in July.

While more sheltered from competition, services were unable to escape the effects of lower demand and prices continued to drop going down to 1.9% annual in August, the lowest rate in recent decades. Organized travel rose less than in August 2008 dropping by 2.7% compared with the same month last year.

The European Union harmonized consumer price index ran along the same lines as the CPI and also marked up a year-on-year drop of 0.8% in August. As a result, the negative differential with the Euro Area continued to narrow going to 0.6 percentage points, three decimals less than that record in May, as a result of the greater weight of fuels in the Spanish shopping basket and lower taxes on fuels which increase the impact of price increases in these products.

CONSUMER PRICE INDEX BY COMPONENT GROUP

August

	Indices (*)	% monthly change		% change over previous December		% monthly change	
		2008	2009	2008	2009	2008	2009
By type of spending							
Food and non-alcoholic beverages	108.0	0.1	0.2	2.1	–2.4	6.8	–2.1
Alcoholic beverages and tobacco	125.9	0.0	0.1	3.6	12.7	4.0	13.0
Clothing and footwear	92.2	–0.7	–0.8	–12.9	–15.3	0.4	–2.2
Housing	112.0	–0.3	0.2	6.5	0.4	7.9	–0.2
Furnishings and household equipment	106.5	0.0	0.1	1.2	–0.1	2.5	1.3
Health	97.3	0.0	0.0	0.1	–1.5	0.5	–1.3
Transport	104.2	–2.3	1.1	5.7	4.8	8.6	–6.4
Communications	99.4	–0.1	0.0	0.2	–0.3	–0.1	–0.8
Recreation and culture	100.4	1.4	0.6	2.1	0.7	0.2	–1.1
Education	111.7	0.0	0.0	0.4	0.2	3.9	3.8
Restaurants and hotels	113.7	0.8	0.9	5.5	2.9	4.9	1.5
Other goods and services	109.3	0.0	0.1	3.0	1.6	3.5	2.2
By group							
Processed food, beverages and tobacco	111.8	0.2	0.1	2.9	0.7	7.6	0.8
Unprocessed food	106.7	0.0	0.2	0.9	–3.1	4.2	–2.5
Non-food products	105.6	–0.3	0.4	2.0	–0.1	4.4	–1.0
Industrial goods	100.0	–1.2	0.4	0.0	–2.4	4.7	–3.8
Energy products	*107.7*	*–3.9*	*2.5*	*11.6*	*8.0*	*17.6*	*–10.2*
Fuels and oils	*102.9*	*–5.1*	*3.3*	*12.0*	*8.5*	*20.0*	*–15.6*
Industrial goods excluding energy products	*97.0*	*–0.2*	*–0.5*	*–3.9*	*–6.0*	*0.5*	*–1.8*
Services	111.5	0.6	0.5	4.1	2.3	4.0	1.9
Underlying index (**)	106.3	0.3	0.1	1.0	–1.0	3.5	0.4
GENERAL INDEX	**106.7**	**–0.2**	**0.3**	**2.1**	**–0.2**	**4.9**	**–0.8**

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

With regard to prospects for the trend in prices, while the downward trend in underlying inflation could continue, in coming months it is likely that the effect of the rise in fuels will show up to a greater extent. As a result, it is foreseeable that the annual change will be less and less negative and that toward the end of the year it will go back to positive terrain.

Inflation to again go into positive terrain toward end of year.

Wholesale prices show record drops

Producer prices sharpened their downward trend in July marking up the biggest year-on-year drop in recent decades (6.7%). This trend reflected the course of commodity prices, especially for oil, which in July 2008 had shown a record.

The decrease in import prices was even greater as it marked up a year-on-year decrease of 11.2%, a factor contributing to this being the appreciation of the euro in the past 12 months. In turn, farm prices at origin collapsed recording a year-on-year drop of 17.2% in June. All main components showed year-on-year decreases although the biggest drop came in agricultural products (24.7%).

Farm prices at origin collapsing.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods (**)	
2008											
June	9.2	8.4	5.2	2.3	6.2	21.1	10.4	1.1	–0.2	2.6	–
July	12.6	10.2	5.1	2.5	7.3	27.4	10.4	0.5	–0.2	3.7	–
August	6.0	9.2	4.8	2.5	7.6	23.2	9.6	1.3	0.3	5.0	2.6
September	–0.8	8.3	4.1	2.4	7.1	19.9	8.5	1.9	0.6	5.9	–
October	–7.6	6.1	2.8	2.4	5.3	14.9	5.2	3.2	1.3	5.1	–
November	–10.5	2.9	2.2	2.3	2.9	4.3	0.9	4.3	1.9	5.0	1.7
December	–10.3	0.4	1.6	2.3	1.0	–3.4	–3.9	2.6	1.6	2.0	–
2009											
January	–7.2	–0.5	0.9	1.9	–1.6	–2.2	–4.9	2.8	2.0	0.4	–
February	–5.4	–1.1	0.4	1.6	–3.2	–1.9	–5.6	3.0	2.6	–1.2	1.3
March	–7.1	–2.5	–0.4	1.3	–4.3	–5.0	–6.9	2.6	3.1	–2.7	–
April	–7.7	–3.4	–0.8	1.2	–5.5	–6.8	–7.4	2.5	3.1	–3.6	–
May	–14.3	–4.4	–1.1	1.1	–6.3	–9.8	–9.9	1.8	2.5	–5.4	0.1
June	–17.2	–4.9	–1.3	0.9	–6.8	–10.1	–10.8	1.3	2.4	–6.0	–
July	...	–6.7	–1.2	0.5	–7.8	–16.0	–11.2	2.1	2.3	–7.0	–

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

Foreign sector

Deficit in current account balance down 42% in first half of 2009 from rise in goods balance.

Net borrowing down to 6.0% of GDP in first half-year.

Trade balance continues to reduce current account deficit

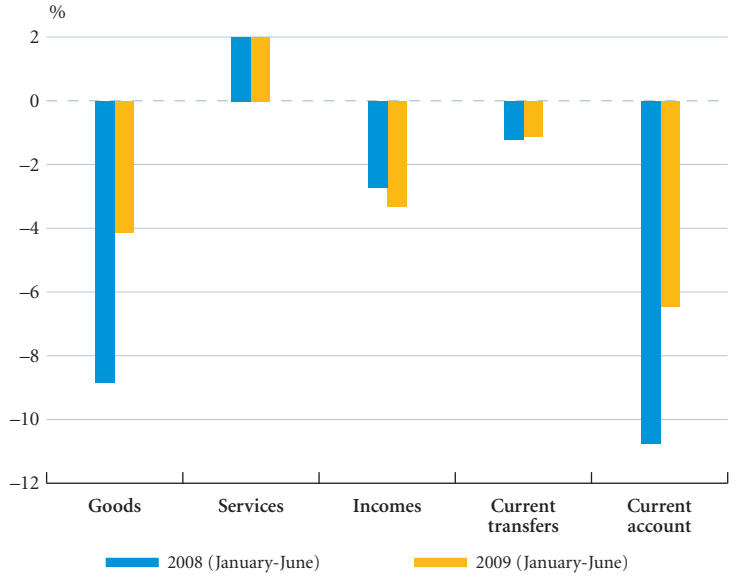
The drop in Spain's domestic demand in June was one of the main reasons for the sharp reduction in imports that month. As a result, the deficit in the goods balance dropped by 64.8% year-on-year compared with June 2008, thus increasing the contraction of the cumulative balance in the first half-year to 54.6% compared with the first half of last year.

This significant improvement in the trade balance, along with that recorded for the current transfers account, more than offset the worsening of the deficit in the incomes balance which was brought about by interest payments on the economy's growing foreign debt. Furthermore, the balance of services recorded a drop of 0.5% in the surplus in the first half-year due to the reduction in inflows for tourism and travel which were down by 10.8%. The result was that the current account imbalance in the period went to 34.1 billion euros, some 41.8% below the figure recorded in the first half of 2008.

The graph shows the contraction in the current account deficit which in the first half of 2009 represented 6.4% of Spain's gross domestic product (GDP), a level similar to that in the first half of 2004 and more than four percentage points below the high reached one year earlier.

CURRENT ACCOUNT DEFICIT CONTRACTS SHARPLY IN FIRST HALF OF 2009

Cumulative balances for first half-year in proportion to GDP for same period



SOURCE: Balance of payments and own calculations.

The improvement in the current account deficit more than compensated for the reduction in the surplus in capital account, which includes capital transfers from the European Union. As a result, the foreign deficit of Spain's economy in the first half-year was down 41.9% year-on-year in the first half-year to stand at 6.0% of GDP. Forecasts for the deficit indicate maintenance of this trend over coming months although at a lower rate.

The decrease in the deficit brought a drop in foreign capital inflows in the first half of 2009 amounting to 18.80 billion euros. The heading to suffer most was short-term investment which made up two-thirds of such contracts in this period although this continued as the main source for attracting funds. Nevertheless, in recent months we have begun to see something of a change in the make-up of funding. In June, as a result, direct investment became the main source for net capital inflows to the detriment of portfolio investment and short-term financing.

On the other hand, cover for the deficit through an increase in deposits at the Bank of Spain is losing weight. We thus note a 47.6% reduction of this resource in the first half of the year. This reduction comes from lower use of the Eurosystem liquidity auctions, thanks to the easing of conditions related to liquidity in the financial system.

Short-term financing losing weight.

BALANCE OF PAYMENTS

June 2009

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–21,820	–54.6	–61,371	35,586	–36.7
Services					
Tourism	*11,000*	*–7.9*	*27,120*	*–1,009*	*–3.6*
Other services	*–330*	*–73.1*	*–905*	*2,084*	*–69.7*
Total	10,670	–0.5	26,215	1,075	4.3
Income	–17,337	16.6	–36,246	–3,377	10.3
Transfers	–5,585	–11.5	–8,512	399	–4.5
Total	**–34,072**	**–41.8**	**–79,913**	**33,683**	**–29.7**
Capital account	**2,179**	**–41.5**	**3,962**	**–2,584**	**–39.5**
Financial balance					
Direct investment	–798	–	–15,511	–58	0.4
Portfolio investment	1,227	–	6,530	12	0.2
Other investment	25,126	–34.0	55,513	–16,446	–22.9
Total	**25,555**	**–42.4**	**46,533**	**–16,492**	**–26.2**
Errors and omissions	598	–	4,507	5,160	–
Change in assets of Bank of Spain	5,740	–47.6	24,912	–19,768	–44.2

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.

Public sector

Economic recession and stimulus measures to ease crisis have negative effect on public accounts.

Increase in taxes announced to halt rise in public deficit

The state of recession continues to have an adverse impact on central government accounts as a result of the reduction of taxable bases. Also having an effect on this are the economic stimulus measures applied by the government to ease the recession. Because of this, total central government non-financial revenues up to July were down 16.9% compared with the same period last year. This drop goes down to 12.7% in homogenous terms, that is, after adjustments are made for timing differences between revenues and rebates.

Total tax collections showed a year-on-year drop of 20.2% in the first seven months of the year. When corrected for earlier rebates, larger deferments and various regulatory changes, this stands at 12.3%.

Revenues from direct taxes showed a year-on-year decrease of 14.0%. The main heading, personal income tax, was down 12.9%. In adjusted terms, this reduction stands at 8.2%. Wage hold-backs dropped by 4.6%, reflecting the drop in wage mass, while hold-backs on capital earnings were down 2.3% because of lower dividends and bank interest. Hold-backs for leasing and gains on mutual funds dropped by 2.9% and 46.5% respectively. In turn, company tax was down 25.2% largely as a result of the drop in corporate profits.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

July 2009

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**11,405**	**2.4**	**57,757**	**–24.8**
Non-financial revenue adjusted (*)				
Personal income tax	10,486	11.2	39,762	–12.9
Corporate tax	1,376	–26.9	6,924	–25.2
VAT	3,800	–37.7	22,432	–36.1
Special taxes	1,713	8.5	10,851	–3.0
Other	2,088	8.6	14,409	16.5
Total	**19,463**	**–6.9**	**94,378**	**–16.9**
Non-financial spending	**25,532**	**30.1**	**108,703**	**24.5**
Treasury balance	**–14,127**	**66.4**	**–50,946**	**382.8**
Surplus (+) or deficit (–) (**)	***–11,080***	***108.6***	***–49,687***	***401.3***

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

Total indirect taxes fell by 27.5%. The biggest contributor, value added tax (VAT), was down 36.1%. Nevertheless, if we discount the effect of making earlier rebates, the broadening of the system for making monthly rebates and larger deferments, this reduction eases to 16.9%. Special taxes eased their decrease to 3.0%, thanks to the increase on tax rates on tobacco and petroleum products approved in June, as well as the recovery of consumption of fuels and electricity.

In turn, spending continued to rise going to 108.70 billion euros in the January-July period, an increase of 24.5% year-on-year. Spending as a result of current transactions was up 18.2% while capital transactions rose by 77.3%.

With regard to current spending, personnel costs were up 4.8%, current costs rose by 2.7% while financial costs increased by 12.4%. Nevertheless, the heading to increase most was current transfers with a year-on-year increase of 24.5%. Contributing to this increase was 9.51 billion euros channelled into the Government Employment Service mainly to cover unemployment benefits.

Under capital transactions, real investments rose slightly (0.6%) thanks to payments to the Ministry of Public Works. Capital transfers almost tripled largely due to an allocation of 5.5 billion euros to the State Fund for Local Investment for carrying out municipal public works.

As a result of the fact that spending was also twice the amount of revenues, there was a cumulative Treasury deficit of 50.95 billion euros, nearly five times that for the same period in 2008. In addition, net operations on financial assets increased by 10.58 billion euros largely because of a payment of 9.5 billion euros to the Fund for Acquisition of Financial Assets and another payment of 2.25 billion euros to the Fund for Orderly Restructuring of Banks. As a result, borrowing requirement rose to 61.53 billion euros, nine times more than in the same period last year. In National Accounting terms, that is following criteria of rights and obligations generated, there was a deficit equal to 4.7% of gross domestic product as against a deficit of 0.9% in the first seven months of last year.

Given the growth tendency of the public deficit and the government's commitment to gradually correct it, the central government has announced that under the 2010 budget it plans to introduce various tax increases and cuts in spending. The increases in taxes, which could mean somewhat over 10 billion euros more in revenues, involve the removal of the 400-euro deduction on personal income tax, an increase in indirect taxes and a rise in tax on capital earnings.

Reduced wages mass, lower dividends and corporate profits cutting direct tax collections.

Special taxes reduce drop as result of increased rates in June.

In 2010, income tax deduction of 400 euros to be removed and indirect taxes and tax on capital earnings raised.

Savings and financing

Funding of companies and households down because of weak demand and tightening of borrowing terms.

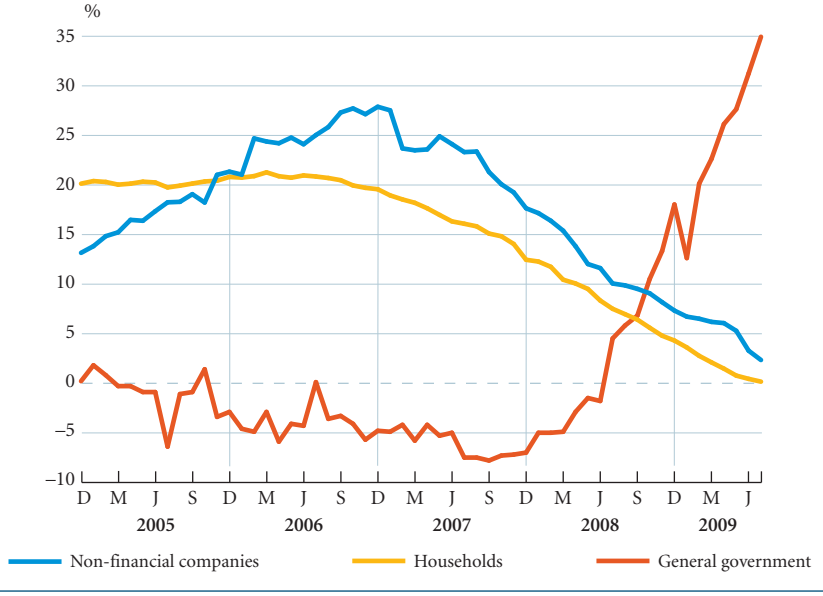
Downturn in private sector funding continues

The weakness in demand for credit due to the economic recession along with tightening of borrowing terms following adoption more prudent risk management policies now means that funding to the private sector is continuing to drop. According to the Bank of Spain, July showed year-on-year growth of only 1.5% as against 9.1% some 12 months earlier. As a result, we have seen a continuation of the process of adjusting corporate and household balance sheets which had shown excessively high debt levels during the upward stage of the economic cycle.

The funding of non-financial companies continued to drop in July going to year-on-year growth of 2.4%, some 5 points less than in December 2008. It should be pointed out that, for the first time in this cycle, total loans of resident lending institutions (including off-balance sheet titularized loans) stood below the level one year earlier. On the other hand, bond issues obtained a strong boost following the substantially better conditions in financial markets, with a year-on-year increase of 26.2%. Loans from abroad continued to slow down showing a year-on-year increase of 7.6% although their contribution to total change (1.8%) was higher than that of the other components.

FUNDING OF HOUSEHOLDS STAGNANT WHILE PUBLIC SECTOR FINANCING STEPS UP

Year-on-year change rate in funding granted to resident non-financial sectors



SOURCE: Bank of Spain.

FINANCING OF NON-FINANCIAL SECTORS (1)

July 2009

	Balance	Change this year	Change over 12 months		% participation
	Million euros	Million euros	Million euros	% (2)	
Private sector	2,215,681	2,039	31,039	1.5	85.2
Non-financial companies	1,309,820	6,723	32,386	2.4	50.4
Loans to resident entities (3)	*936,146*	*–17,989*	*–4,949*	*–0.2*	*36.0*
Different share values	*49,881*	*8,804*	*10,345*	*26.2*	*1.9*
Loans from abroad	*323,793*	*15,907*	*26,991*	*7.6*	*12.5*
Households (4)	905,861	–4,684	–1,347	0.2	34.8
Housing loans (3)	671,692	–1,462	3,924	0.7	25.8
Other (3)	231,502	–3,505	–5,630	–1.3	8.9
Loans from abroad	2,667	283	358	15.5	0.1
General government	384,552	54,185	99,701	35.0	14.8
TOTAL	**2,600,233**	**56,224**	**130,741**	**5.4**	**100.0**

NOTES: (1) Resident in Spain.
(2) Year-on-year change rates calculated as effective flow/balance at beginning of period.
(3) Include bank off-balance-sheet titularized loans.
(4) Include those non-profit institutions serving households.
SOURCE: Bank of Spain and own calculations.

The slowdown in credit is taking place in all production sectors. From figures going up to June, however, we note that the sharpness of this slowdown has been uneven over the past 12 months. There has been a drop in credit in construction of 13.4% along with a 7.8% decrease in the primary sector. In industry, total loans showed a year-on-year increase of 7.1% while in services the increase was 4.3%. With regard to real estate activities, the year-on-year change rate went from 50.6% at the end of 2006 to 3.7% in June 2008.

The process of reducing the level of household debt continued in July to the point where total funding was practically stagnant, showing merely a slight annual increase of 0.2% over the same month last year. Home-purchase loans continued to drop to the point where they showed a slim annual increase of 0.7%. Nevertheless, the number of housing mortgages showed an annual decrease of 10.8% as against a drop of 31.4% in the first half-year, according to figures from the National Institute of Statistics. This was brought about by the drop in housing prices and interest rates. The average amount of mortgage loans was 117,843 euros, 17.0% less than one year earlier.

Drop in credit shows up in all production sectors, especially in construction.

Other funding granted to individuals showed a sharper drop going to 1.3% year-on-year in July. This was mainly due to the decrease in credit for buying consumer durables, such as cars, motorbikes, appliances, furniture, etc., which showed a year-on-year decrease of 14.1% in the past 12 months ending in June.

With regard to default, the doubtful loans rate at lending institutions in July again took on an upward path going to 4.7%. The doubtful loans rate differs

Collapse in credit for purchase of consumer durables.

CREDIT TO PRIVATE SECTOR BY PURPOSE

Second quarter of 2009

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	23,732	–2,512	–9.6	–1,995	–7.8
Industry	158,800	2,659	1.7	10,583	7.1
Construction	134,690	–17,158	–11.3	–20,910	–13.4
Services	690,271	7,555	1.1	28,509	4.3
Total	**1,007,492**	**–9,456**	**–0.9**	**16,185**	**1.6**
Financing to individuals					
Acquisition and renovation of own home	651,564	–3,581	–0.5	11,317	1.8
Acquisition of consumer durables	49,583	–4,593	–8.5	–8,143	–14.1
Other financing	113,922	3,830	3.5	–5,179	–4.3
Total	**815,068**	**–4,344**	**–0.5**	**–2,006**	**–0.2**
Financing to private non-profit institutions	**5,382**	**–709**	**–11.6**	**–570**	**–9.6**
Other unclassified	**33,063**	**5,632**	**20.5**	**9,223**	**38.7**
TOTAL	**1,861,005**	**–8,877**	**–0.5**	**22,831**	**1.2**

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

Default rate of real estate developers and construction companies moves up to 8%.

considerably according to the various borrowers and products. Using figures up to June, we note that the doubtful loans rate for home-purchase mortgages for individuals stood at 3.0% while loans for buying consumer durables was 7.6%. The rate for construction firms stood at 7.8% while that for real estate developers rose to 8.2%. We should point out that doubtful loans for real estate activities made up 31.0% of the total.

With regard to funding granted to general government, this continued to increase with a year-on-year rise of 35.0% in July involving major growth of both short-term and medium and long-term bonds. Nevertheless, this only partly compensated for the adjustment in the private sector so that total funding granted to resident non-financial sectors continued to show a decrease in growth rate going to 5.4% in July, some 3.1 points less than one year earlier.

Bank interest rates continue to drop.

Concerning interest rates, the 1-year Euribor, widely used as a reference, marked up a new all-time low of 1.33% on monthly average in August to stand at 399 basis points below 12 months earlier. This reflected the cuts by the European Central Bank in this period and a drop in risk premium in the interbank market. In the early weeks of September the 12-month Euribor continued its gradual downward trend to the range of 1.25%.

Interest on bank loans and credits continued to drop showing an average of 3.66% in July, some 271 basis points below the same month last year. The lower drop in the 12-month Euribor may be explained by the increase in risk premium as a result of the sharp rise in default.

Mutual funds again showing net inflows

Returns on private sector deposits were down very slightly on average in July to stand at 1.40%. In fact, interest rates on time deposits by individuals rose by a small fraction (3 cents of a euro) going to 2.37% although they showed a year-on-year decrease of 242 basis points, less than the drop in loan rates.

In this situation, private sector deposits at lending institutions continued to show a lower growth rate going to 7.1% year-on-year in July. Nevertheless, on-demand accounts were up with annual growth of 6.2% as a result of the increased preference for liquidity among savers in view of growing uncertainty about the economic recession and for the drop in the interest rate differential with time deposits.

The decreased attractiveness of bank deposits following the drop in yields and the improvement in financial markets brought about a recovery of saver interest in mutual funds. As a result, net subscriptions for a value of 282 million euros were recorded in August, the first positive figures since April 2007. The biggest flow of funds was toward short-term bonds in euros for an amount of 331 million euros which would suggest a continuation of risk aversion.

Practically all fund categories showed positive monthly returns in August. In terms of December, average yield stood at 3.56% with spectacular gains of 46.0% in international share-based funds of emerging countries and 24.3% for national share-based funds. Average annual yield stood at 0.6%. Average yield over the past 18 years stood at 4.1%, higher than inflation during this period.

Spectacular gains of some share-based mutual funds compared with December.

In addition, the total amount of direct insurance premiums rose by 1.6% in the first half of 2009 compared with the same period last year. The life branch was up 7.6% while all others dropped by 3.1%. The biggest decrease came in car insurance premiums which were down 7.0% under the impact of a drop in sales. On the other hand, health care premiums were up 5.2% while those for multi-risk rose by 2.7%.

Notable increase in volume of direct life insurance premiums in first half-year.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

July 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	255,382	10,570	4.3	14,982	6.2	18.0
Savings deposits	198,214	18,437	10.3	18,018	10.0	13.9
Term deposits	734,255	4,983	0.7	56,240	8.3	51.6
Deposits in foreign currency	25,016	–4,302	–14.7	–8,876	–26.2	1.8
Total deposits	**1,212,868**	**29,689**	**2.5**	**80,364**	**7.1**	**85.3**
Other liabilities (*)	**209,493**	**–39,137**	**–15.7**	**–42,365**	**–16.8**	**14.7**
TOTAL	**1,422,360**	**–9,448**	**–0.7**	**37,998**	**2.7**	**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.

Trapped amid financial bail-outs?

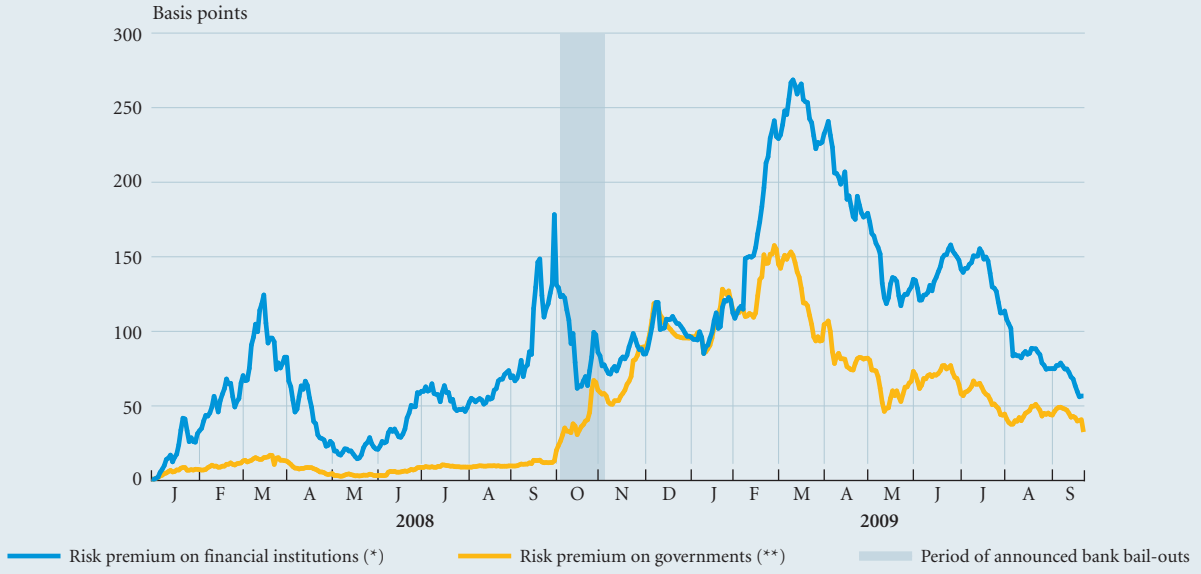
The failure of Lehman Brothers investment bank in September 2008 and the banking turmoil that followed showed up the fragility of the global financial system. In view of this situation and the threat of a deep transmission to the real economy, governments of the main economies announced various bail-out plans to safeguard their banking systems. These measures followed schemes that were agreed on internationally and were aimed at re-establishing confidence in the financial system and stimulating the granting of credit.

One year later, there is no doubt about the important role which these plans have played, along with the provision of liquidity by the central banks, in order to avoid a bank collapse and gradually bring things back to a situation which, while still delicate, is now showing major signs of improvement. Nevertheless, we may ask about for the effects of these bail-outs, especially with regard to government budgets.

The first consequence was the partial shift of risk from the financial sector to the public sector. This phenomenon may be seen in the trend in premiums on credit default swaps (CDS), which are financial instruments that implicitly reflect the bankruptcy risk of lending institutions.[1] Thus, the higher the premium the greater the risk of bankruptcy that investors apply to a specific asset.

ANNOUNCEMENT OF BANK BAIL-OUTS RAISES GOVERNMENT RISK

Cumulative change of risk premiums over level on 01-01-2008



NOTES: (*) CDS financial itraxx Europe.
(**) Average of sovereign CDS (sample of 15 European countries).
SOURCE: Datastream and own calculations.

(1) For more information, see box *How have governments' bank rescue packages affected investors' perceptions of credit risk? (ECB Monthly Bulletin*, March 2009).

The above graph shows the increase in risk of bankruptcy of the main European governments as a result of the announcement of their bank bail-out plans. At the same time, the solvency of the European financial system improved and, as opposed to the public sector, recovered levels prior to the failure of Lehman Brothers while reflecting the shift of risk between the two sectors.

It is government budgets, however, that have been most affected by the high figure for measures to bail out the banking system. These measures are mainly of three types: capital injections, plans to clean up assets and government guarantees to cover debt. Furthermore, we should keep in mind bank deposit guarantees although they are not included in this analysis because of their nature.

While the implementation of these measures has been wide-spread, the specific characteristics of each country (such as relative size of the banking sector, its exposure to «toxic» assets and its capacity to manoeuvre its budget) lie behind the differences in bail-out plans. As an example, whereas Spain and Italy have injected capital into their financial sectors, other countries such as Belgium, Luxembourg and the Netherlands have put in major amounts, especially with the recapitalization of Dexia and Fortis. In a similar way, the buying of bank assets has been considerable in countries like the United Kingdom and United States. In the area of government guarantees, Ireland stands out with guarantees of the financial sector that account for more than twice its GDP.

In addition, the measures taken do not have the same effect on the public accounts. Guarantees of bank bond issues are a contingent liability that only affects government budgets in the case of execution of the guarantee so that their announcement does not represent any short-term payout and even provides income in the form of commissions collected. On the other hand, both capital injections and the buying of assets involves an immediate payout by the government which will increase its public debt if there is recourse to bond issues for this purpose. In these cases, in most countries, the deficit is affected only if the acquisitions of capital and assets are carried out at higher than market price, given that there is an implicit transfer of resources that has to be taken into account as spending.

As a result of the above factors, the heterogeneous nature of the bail-out packages of the countries involved has meant that the immediate impact of these on government balances varies considerably.[2] According to the International Monetary Fund (IMF), the immediate layout made by the advanced economies of the G-20 under bank bail-out plans is equivalent to 5.3% of their GDP. This figure goes up to 6.7% if we only take into account only the member states of the European Union, the United Kingdom outstands among, with costs of 20.2% of GDP due to the major acquisition of assets carried out. On the other hand, Ireland, with government guarantees of bank debt equivalent to 257% of GDP, showed a layout equivalent to only 5.3% of GDP as a result of recapitalization of the financial system. In the case of Spain, measures taken stand below the average for the advanced countries with a 4.6% immediate impact.

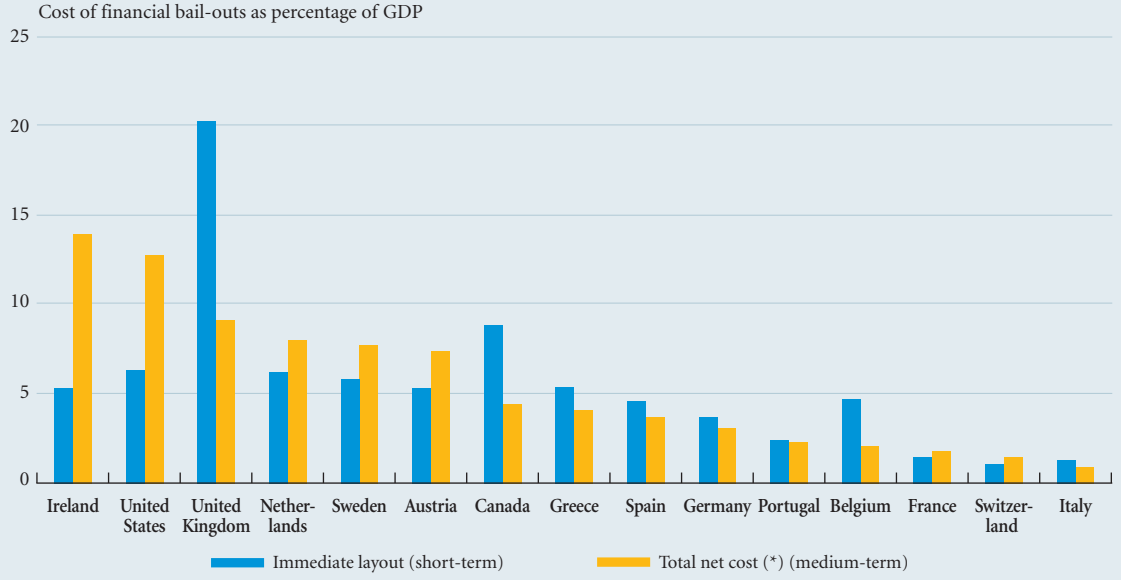
There is no doubt that a cost analysis of bank bail-outs should take into account other factors apart from immediate spending. At least, these should include the trend in value of assets acquired by government, the profitability of capital invested in the banks and the losses or profits arising from the guarantees. Therefore, the final net cost may be considerably lower than the layout made over the short term depending on the trend

(2) See *The impact of government support to the banking sector on euro area public finances* (*ECB Monthly Bulletin,* July 2009), *The State of Public Finances: Outlook and Medium-Term Policies after the 2008* Crisis (IMF) and *Update on Fiscal Stimulus and Financial Sector Measures.*

in the financial sector following these interventions. In the case of Sweden following the 2001 crisis, the increase in value of assets and the yield on investment made it possible, at the moment of sale, to cover 94.4% of the layout made (recovery rate). A quite different case was that of Finland in the same period where the recovery rate was under 20%.

Following the same reasoning, we cannot rule out obtaining a profit over the medium term through revaluation of the assets and capital acquired by governments. A clear example is the profit obtained by the Swiss government with the sale of its participation in UBS. In similar fashion, shares of Citi-group have increased in value going to more than 40% above the acquisition price paid by the US Treasury.

HETEROGENEOUS NATURE OF COUNTRIES WITH REGARD TO COSTS OF FINANCIAL BAIL-OUT



NOTES: (*) Includes estimated costs of guarantees and provisions by central banks.
SOURCE: International Monetary Fund, according to april 2009 data. There have not been major changes since then.

In the above graph we see estimates by the IMF regarding the total costs arising from bank bail-out plans. The four countries with the greatest cost over the medium term (Ireland, United States, United Kingdom and the Netherlands) show a financial model based on «originate to distribute» (a model which distinguishes between the entities that generate the operation of financing from those that assume the risk of that financing) and the sharp growth in value of assets in the period prior to the crisis.

We note that some countries show a medium-term cost considerably higher than their immediate indebtedness. This is the result of a low rate of recovery of the value of bank assets acquired or the cost of execution of government guarantees (as happened in Ireland). In the case of Spain, the recovery rate estimated by the IMF is 49.9%, slightly lower than the 55% recorded in the advanced economies throughout their history although sufficient to compensate the costs arising from their guarantees and to put the

medium-term cost nearly one point below that generated over the short term. Nevertheless, these are estimates based on past experience. The evidence from past financial crises also shows that efficient and transparent management of bail-out measures and the design of adequate strategies to end them once the situation has stabilized can drastically reduce the impact of a financial bail-out on public finances.

This box was prepared by Joan Daniel Pina
European Unit, "la Caixa" Research Department

"la Caixa" RESEARCH DEPARTMENT

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Research Department

Av. Diagonal, 629,
torre I, planta 6
08028 BARCELONA
Tel. 34 93 404 76 82
Telefax 34 93 404 68 92
www.laCaixa.es/research

e-mail:
For enquiries regarding The Spanish Economy Monthly Report:
informemensual@lacaixa.com

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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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