NUMBER 329 • NOVEMBER 2009

THE SPANISH ECONOMY

Monthly Report

REFORMING THE SERVICE SECTOR

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	–2.5	2.0	–3.3	–3.8	–2.3	–0.3
Japan	–0.7	–5.7	1.7	–8.4	–7.2	–5.3	–1.6
United Kingdom	0.6	–4.6	0.8	–5.0	–5.5	–5.2	–3.0
Euro area	0.7	–4.0	0.8	–4.9	–4.8	–4.2	–2.2
Germany	*1.0*	*–5.1*	*0.8*	*–6.7*	*–5.9*	*–5.2*	*–2.6*
France	*0.7*	*–2.2*	*0.8*	*–3.4*	*–2.6*	*–2.2*	*–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	2.0	3.0	2.1	1.5	1.0
Euro area	3.3	0.3	1.2	1.0	0.2	–0.4	0.4
Germany	*2.6*	*0.3*	*1.0*	*0.8*	*0.3*	*–0.3*	*0.2*
France	*2.8*	*0.1*	*1.2*	*0.7*	*–0.2*	*–0.3*	*0.4*
SPANISH ECONOMY		Forecast				Forecast	
Macroeconomic figures							
Household consumption	–0.6	–5.0	–0.5	–5.1	–5.9	–5.3	–3.8
Government consumption	5.5	4.3	1.5	6.4	5.1	3.0	2.7
Gross fixed capital formation	–4.4	–17.0	–5.7	–15.2	–17.0	–18.2	–17.4
Capital goods	*–1.8*	*–29.5*	*–9.6*	*–24.2*	*–28.9*	*–33.0*	*–32.2*
Construction	*–5.5*	*–12.5*	*–6.1*	*–11.5*	*–12.0*	*–13.6*	*–12.8*
Domestic demand (contribution to GDP growth)	–0.5	–6.8	–1.4	–6.1	–7.3	–7.3	–6.0
Exports of goods and services	–1.0	–14.4	2.3	–17.6	–15.7	–13.3	–11.2
Imports of goods and services	–4.9	–21.5	–1.7	–22.9	–22.3	–21.7	–19.0
Gross domestic product	**0.9**	**–3.7**	**–0.4**	**–3.2**	**–4.2**	**–4.2**	**–3.3**
Other variables							
Employment	–0.6	–6.4	–2.1	–6.3	–7.1	–7.2	–6.2
Unemployment (% labour force)	11.3	18.1	20.3	17.4	17.9	17.9	19.3
Consumer price index	4.1	–0.3	1.4	0.5	–0.7	–1.1	0.1
Unit labour costs	4.6	0.8	–0.8	1.0	1.4		
Current account balance (% GDP)	–9.5	–5.8	–4.3	–8.1	–4.5		
Net lending or net borrowing rest of the world (% GDP)	–9.1	–5.3	–3.8	–7.8	–3.9		
Government balance (% GDP)	–4.1	–10.9	–9.8				
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	1.1	1.8	1.1	1.0	1.0
10-year US bonds	3.6	3.2	3.7	2.7	3.3	3.5	3.3
10-year German bonds	4.0	3.2	3.5	3.1	3.4	3.3	3.2
Exchange rate							
$/Euro	1.48	1.38	1.38	1.30	1.36	1.43	1.49

Contents

Services: the great reform

The hullaballoo caused by indicators and news on the economic crisis prevents us from hearing a murmur that is faint but will nonetheless play a vital role in how the economy evolves over the next few years. This murmur is caused by the reform of services, a sector that contains around two thirds of the value added of developed economies. At the end of 2006, and after a long, complex negotiation, the European Parliament and the Council passed the Services or Bolkestein Directive, named after the EU commissioner who promoted it, which establishes a general legal framework to facilitate the exercise of the freedom of establishment for service providers and the free movement of services, while maintaining a high quality of services.

However, transposing this Directive into Spanish law is turning out to be a complicated task. In March this year, the Spanish government passed a bill on general concepts, known as the «Umbrella Act»; in June, it passed a package of reforms of a specific nature, known as the «Omnibus Act». In July, it also passed a specific bill on the regulation of retail trade.

Why so complicated? Firstly, the aim was to comply with one of the precepts established when founding the European community at the end of the 1950s: the free movement of services. In some EU countries there are numerous barriers to the free establishment of non-national professionals, and it is a similar situation with firms, in spite of the progress made. But the latest reason for launching the great reform proposed by the Services Directive is the patent delay of most EU countries in developing the tertiary sector.

In fact, in the last fifteen years an evident gap has opened up in growth in sector productivity between countries with a more liberalized legislation, such as the United States, United Kingdom and some small European countries, and those with greater regulation, such as most of continental Europe. Empirical evidence reveals that different sector regulations are the cause of this divergence. It is not a question of more or less regulation but of having rules that allow and promote free competition, innovation, quality and access for new firms. It is not a question of eliminating regulations justified from an environmental or social perspective but to get rid of restrictions that go beyond the intended purpose. It is also a question of placing public administration at the service of economic activity, promoting «points of single contact» and e-government.

It is estimated that the scope of the Services Directive will affect more than 40% of the added value of the Spanish economy. It does not apply to those sectors for which there is already a specific EU regulation, such as telecommunications, transport and financial services (although the regulations for these sectors are naturally also being revised), as well as certain activities, such as health or social services. But the nature of the tertiary sector means that improvements in its productivity spread throughout the economy, both towards the industrial sector, a great consumer of services, as well as among the different activities of the services sector itself. Improving services means a more efficient and productive and, therefore, more prosperous economy with higher living standards. This is precisely the reward we should expect from the great reform.

EXECUTIVE SUMMARY

The end of the tunnel

The United States and Euro Area leave negative growth figures behind them.

After several long quarters of recession, the two key players in the world economy, the United States and the Euro Area, recorded growth in activity in the third quarter (although the first official estimates for the Euro Area will not be known until mid-November). Now the question is how fast this recovery can be and on its more than likely ups and downs. The favorable data from the third quarter do not mean that the biggest economic and financial crisis in the world in the last 60 years is over.

Action taken by the public sector and the foreign sector's contribution are key to this improvement...

What are the main strengths and weaknesses of the current recovery? How far does it spread? One of the factors driving advanced economies is without doubt the public sector. This was already the case in the second quarter, particularly in the Euro Area, and it is expected to gain in strength in the third quarter, especially in the United States. The foreign sector is also becoming one of the pillars in the recovery, particularly for countries in the Euro Area, where exports are relatively more important. For the US economy it is estimated that returning to normal stock levels, currently very low, will have a positive effect.

...while waiting for consumption and investment to join the recovery.

Consumption and investment are taking a back seat for the moment. In the United States, retail sales fell in September after the incentive scheme for buying new cars ended, which had boosted sales in July and August. In the Euro Area, the recovery in retail sales is quite modest. The year-on-year change is above the minimum reached in February this year but continues at the same values observed since then. Neither will investment give us much to smile about in the short term but the recovery in industrial production is being somewhat more convincing. Both in the United States and in the Euro Area, industrial production continued to grow in the month of September. Moreover, early indicators suggest that this trend will continue over the coming months.

So the two motors of the world economy can now see light at the end of the tunnel. In the Euro Area, the weakness that will more than likely appear both in private consumption and investment will mean that growth will change only slightly in the coming quarters. In the United States, however, the end of the real estate recession and huge economic stimulus measures may lead to greater dynamism in the next few months.

Nevertheless, although recovery seems to have taken root, private domestic demand needs to react for it to become consolidated in the medium term, namely consumption and investment. Something that will not happen very quickly. Household consumption is hampered by high uncertainty due to growing unemployment. In the Euro Area, this rose one more percentage point in August and stood at 9.6%, the highest in practically 11 years. The months of intense job destruction are also a thing of the past in the United States but the adjustment still has to run

its course. Unemployment stood at 9.8%, which means that the net figure of jobs destroyed since the end of 2007 totals 7.2 million. Everything suggests that the unemployment rate will remain close to two digits until at least the second half of next year.

Neither will investment make a fast recovery, as production capacity utilization is at record low levels in most developed economies. In short, the factors that are currently driving growth will gradually be replaced throughout 2010 and 2011. That's why, although recovery is a given, we don't expect it to be strong in the main advanced economies.

And the emerging economies? Here the outlook is significantly better. In its forecasts of October, the International Monetary Fund noted that, while growth in advanced economies will be around 1.3% in 2010, emerging economies will more quickly return to similar rates to those enjoyed in the years prior to the crisis. China will continue to lead growth in Asia, with a figure of 9.0%, and Brazil will go from 0.7% growth in 2009 to 3.5% in 2010. The recovery in countries of Eastern Europe will also be notable. After suffering a significant fallback in 2009, with a forecast negative growth of 5.0%, in 2010 this will be 1.8%.

This scenario of sustained recovery is reflected in the evolution of the financial markets and in the tone of messages from the main central banks. Both the Federal Reserve of the United States and the European Central Bank have stressed the greater stability that is finally holding sway in the markets. A situation that reinforces the approach of monetary authorities of focusing all their efforts on studying how to systematically withdraw the extraordinary injections of cash they have made.

It is also worth noting, once again, the improvement in wholesale credit markets, particularly in high risk segments and in those with central bank intervention. Large companies are taking advantage of the low cost of financing and high market liquidity to issue record volumes of corporate debt, in a process that reaches a wide spectrum of issuers in terms of country, sector and rating. On the other hand, credit aimed at small and medium-sized enterprises has not yet taken off.

In October, bond markets also returned to positive trends, although some fatigue can be observed after the spectacular rise in the last few months. Apart from lower risk aversion, the improvement in potential returns on shares has been encouraged by good corporate results in the third quarter, with largely positive surprises and the recovery of investment in hedge funds.

The outlook for the Spanish economy is similar to that of the rest of developed countries. However, positive quarter-on-quarter growth figures will take a little longer and won't arrive till next year. The different profile of the recovery means that if, in 2009, gross domestic product has fallen less than in other developed economies, in 2010 the Spanish economy will still be in recession, in contrast with the advances made by most of the rest. Within this context, the foreign sector is making a significant contribution, waiting for domestic demand of the private sector to complete its adjustment. The impulse from the public sector will diminish next year, in line with the provisions of the General State Budget for 2010, which prioritizes putting a brake on the

The outlook for emerging economies is better.

Financial markets reflect the new scenario of sustained recovery.

The Spanish economy will not achieve positive growth figures until 2010.

Job losses continue at a high rate, over 7%, and unemployment has reached more than 4 million.

deterioration in public accounts to the detriment of measures taken to relieve the seriousness of the recession.

Meanwhile, the negative note continues to be provided by the labor market. In the third quarter, employment was 1.5 million lower than the same period last year, a year-on-year decrease of 7.3%, a similar pace to that of the second quarter. Until the second quarter of 2009, job losses mainly affected employees with temporary contracts and, to a lesser extent, the self-employed. In the third quarter, however, losses also started to significantly affect employees with permanent contracts. Construction, industry and trade took the lion share in terms of job losses, while public administration, health and social services continue to create jobs in year-on-year terms.

Household savings have climbed up to 17% and prices are falling.

The worsening labor market demotivates those looking for employment, making them give up on the task, so that the population that is jobless and actively seeking employment has suddenly dropped. This means that unemployment has risen less than job losses, reaching 4.1 million, so that the unemployment rate for the third quarter of 2009 remained at the same level as the previous quarter, 17.9% of the labor force. What should be noted, however, are the notable differences between autonomous communities, with rates of 25% in the Canary Islands and Andalusia while Cantabria and Navarre remain at 10%-11%.

Hopeful signs from activity indicators.

The most recent data do not suggest improvement. In September, Social Security employment registrations put an end to the slowdown in deterioration that had been seen over the last few months. This situation was partly due to the end of municipal works financed by the State Local Investment Fund and the number of unemployed registered with the public employment offices was once again on the up.

The uncertainty resulting from the delicate labor market situation affects expectations regarding household income, which partly explains the quick rise in household savings. In the second quarter, the portion of income allocated for savings was 17.5% in accumulated terms over four quarters, a big difference from the 11% of a year before. Consequently, consumption spending is very depressed, forcing prices to fall. The consumption price index recorded a year-on-year decrease of 1.0% in September, with core inflation recording 0.1% year-on-year growth. It is predicted that, over the coming months, prices will return to the zone of inflation due to the base effect of oil, but the weakness in the rest of the components will probably remain in the coming months.

In spite of these disappointing data, it should be noted that the consumer and industrial confidence indices have now left behind their record low levels and are clearly on the up. It's a similar picture for activity indicators, such as retail sales, cement consumption, diesel consumption, etc. given that, within their negative trend, there has been a general upward turn. It's a slow and difficult road to recovery but we trust that it will become more consolidated over the coming months.

October 28, 2009

CHRONOLOGY

2008

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	**26**	The Spanish government passes the **2010 State General Budget**, which eliminates the deduction of 400 euros from income tax, raises the duty on capital income and also the general and low VAT rates as from July 2010.
	28	Ibex 35 for the **Spanish stock exchange** records its highest annual level (11,891.2) with accumulated gains of 29.3% compared with the end of December 2008.
October	**19**	Dow Jones index for the **New York stock exchange** records its highest annual level (10,092.2), up 15.0% compared with the end of 2008.

AGENDA

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).

December

- **2** Registrations with Social Security and registered unemployment (November).
- **3** Governing Council Central European Bank.
- **4** Industrial production index (October).
- **15** CPI (November). Fed Open Market Committee.
- **16** EU HCPI (November). Labor cost survey (3rd Quarter).
- **22** International trade (November). Central government revenue and spending (November).
- **23** Producer prices (November).
- **30** Balance of payments (November).

INTERNATIONAL REVIEW

IMF forecasts: caution but a better outlook

The IMF forecasts worldwide growth of 3.1% for 2010, led by emerging Asia.

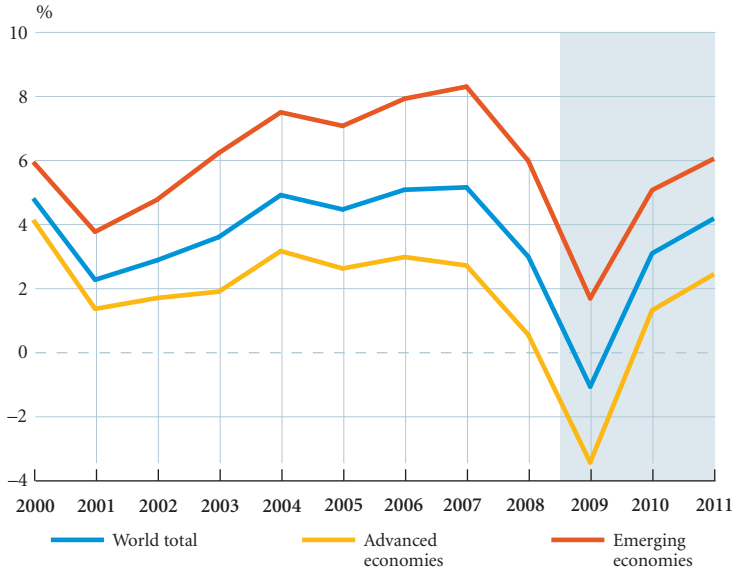
In its World Economic Outlook for October, the International Monetary Fund (IMF) upped its forecasts for 2010 and predicts that the world economy will grow again, led by emerging Asia. Consumption and real estate markets are stabilizing, while the stock cycle is picking up. But the Fund believes that the fiscal and monetary stimuli that enabled this slow recovery should be maintained, as the factors now supporting demand, such as the restocking of inventories, will diminish over the coming months, while weaknesses will continue.

Fiscal and monetary stimuli will still be necessary to sustain the recovery.

Although the financial turmoil has died down, many economic sectors will continue to have difficulty getting credit, while the financial system might not completely recover before the end of 2010. Consumption will be particularly weak in advanced economies, especially those that experienced housing bubbles and large current account deficits. The loss of jobs and the drop in household income have been intense and will need stimuli to boost consumption. By geographical area, recovery will be

COMING OUT OF RECESSION

Year-on-year change in gross domestic product



NOTES: 2009, 2010 and 2011 are forecasts.
SOURCE: International Monetary Fund.

modest in advanced economies, which are projected to grow 1.3% in 2010, while emerging economies should see more decisive growth of 5.1%, causing the world economy to grow by 3.1%.

By country, the prospects are worse for the United States although, with a forecast contraction of 2.7% for 2009, it improves its outlook for 2010 with expected growth of 1.5%. In the Euro Area, with more persistent unemployment rates, recovery will be weaker with a drop of 4.2% in 2009 followed by a modest rise of 0.3% in 2010. Japan and Germany, hit harder by the world trade crisis due to their specialization in capital goods, will recover gradually given the apathy of investment at a global level, with growth rates of 1.7% for Japan and 0.3% for Germany. China will continue to lead growth in Asia, with an economy that will expand by 8.5% in 2009 and 9.0% in 2010.

Forecasts have generally been raised for the rest of European countries. During 2010, France is expected to grow by 0.9%, Italy by 0.2% and the United Kingdom by 0.9%, while Spain, whose recession in 2009 was somewhat less severe than in the Euro Area as a whole, will continue with negative figures in 2010, with a drop of 0.7%. According to the Fund, financial crises have long lasting effects in terms of growth, which tends to worsen the relationship with inflation. However, given the large amount of excess capacity, the Fund does not see any immediate risk of prices rising in advanced economies, leaving certain margin for demand stimuli to continue.

Advanced economies will grow by 1.3% in 2010 and emerging economies by 5.1%.

Inflation will give room for stimuli to continue.

IMF FORECASTS

Annual change as percentage (*)

	GDP		Consumer prices		Unemployment rate (**)	
	2009	2010	2009	2010	2009	2010
United States	–2.7	1.5	–0.4	1.7	9.3	10.1
Japan	–5.4	1.7	–1.1	–0.8	5.4	6.1
Germany	–5.3	0.3	0.1	0.2	8.0	10.7
France	–2.4	0.9	0.3	1.1	9.5	10.3
Italy	–5.1	0.2	0.8	0.9	9.1	10.5
United Kingdom	–4.4	0.9	1.9	1.5	7.6	9.3
Spain	–3.8	–0.7	–0.3	0.9	18.2	20.2
Euro Area	**–4.2**	**0.3**	**0.3**	**0.8**	**9.9**	**11.7**
Advanced economies	**–3.4**	**1.3**	**0.1**	**1.1**	**8.2**	**9.3**
Developing countries	**1.7**	**5.1**	**5.5**	**4.9**	**...**	**...**
Latin America	*–2.5*	*2.9*	*6.1*	*5.2*	...	...
Eastern and Central Europe	*–5.0*	*1.8*	*4.8*	*4.2*	...	...
Emerging Asia	*6.2*	*7.3*	*3.0*	*3.4*	...	...
World Total	**–1.1**	**3.1**	**2.5**	**2.9**	**...**	**...**
World trade by volume (***)	**–11.9**	**2.5**				

NOTES: (*) Forecasts at October 2009.
(**) Percentage of labour force.
(***) Goods and services.
SOURCE: International Monetary Fund.

The greatest risk lies in the weak demand in advanced economies.

Risks for the baseline scenario are largely diminishing. The main danger is that private demand in advanced economies will continue to be sluggish, which would create a tough dilemma between being able to sustain public debt and maintain stimuli. Rising oil prices could also hinder many countries on their road to recovery. From a more optimistic point of view, it should be remembered that, with a return to the frightful thirties less likely, there may be a positive turnabout in financial market sentiment that could drive larger growth rates.

United States: recovery without V for Victory

United States: recovery is firm but expansive policies are still needed.

As this report went to press, the Bureau of Economic Analysis announced that the annualized quarter-on-quarter growth rate was 3.5% in the third quarter, leaving behind the deepest recession since 1945.

This recovery is founded on the gradual dissipation of financial turmoil, the change in inventory cycles and the stabilizing of private consumption and real estate prices, as well as on some fiscal and monetary stimuli unprecedented since the end of the Second World War. In fact, the Congressional Budget Office announced that, in the fiscal year of 2009, the Federal Budget would have a deficit of 1.4 billion dollars, 9.9% of GDP, much higher than the 3.2% of 2008. However, in spite of the high cost of these measures, including stimuli to buy vehicles and housing and the bailout plan for toxic assets in the financial system (245,000 million dollars), demand will continue to need support until the second half of 2010.

Three factors are hampering the recovery in demand. Firstly, consumers are continuing with their long deleveraging process, with the consequent reduction in budgets for purchases. Aware of this,

UNITED STATES: MAIN ECONOMIC INDICATORS

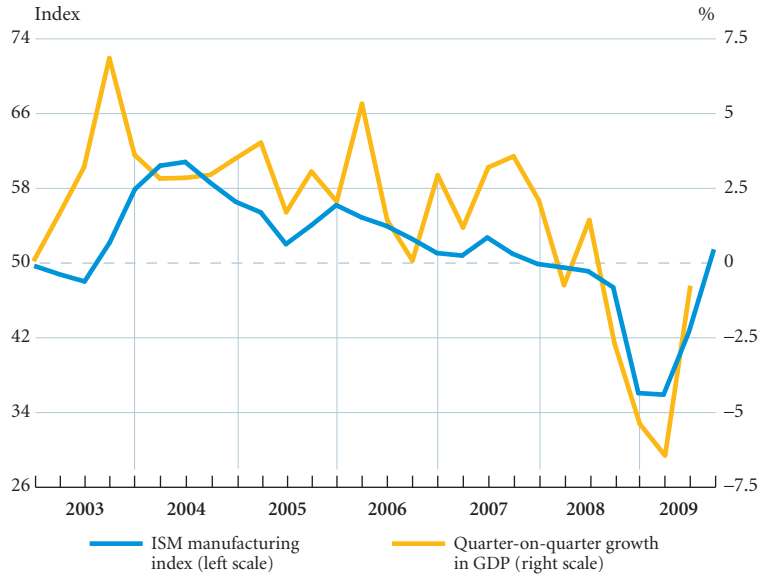
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	2.1	0.4	0.0	–1.9	–3.3	–3.8	–	–2.3	–
Retail sales	3.3	–0.7	0.3	–8.0	–8.9	–9.5	–8.5	–5.8	–5.7
Consumer confidence (1)	103.4	58.0	57.3	40.7	29.9	48.3	47.4	54.5	53.1
Industrial production	1.5	–2.2	–3.2	–6.7	–11.6	–12.9	–12.5	–10.4	–6.1
Manufacturing (ISM) (1)	51.1	45.5	47.4	36.1	35.9	42.6	48.9	52.9	52.6
Sales of single-family homes	–26.7	–37.4	–36.2	–41.0	–40.0	–27.1	–14.8	–3.4	...
Unemployment rate (2)	4.6	5.8	6.1	6.9	8.1	9.3	9.4	9.7	9.8
Consumer prices	2.9	3.8	5.3	1.6	0.0	–1.2	–2.1	–1.5	–1.3
Trade balance (3)	–701.4	–695.9	–725.8	–695.9	–605.7	–505.9	–472.8	–442.6	...
3-month interbank interest rate (1)	5.3	2.8	3.2	2.2	1.2	0.8	0.5	0.3	0.3
Nominal effective exchange rate (4)	77.9	74.4	73.5	81.3	82.7	79.4	76.5	75.2	74.6

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: ENTREPRENEURS SEE A CLEARER PATH

ISM manufacturing index and annualized quarter-on-quarter growth in GDP



SOURCE: Bureau of Economic Analysis, Labor Department and own calculations.

traders expect that, this Christmas, households will spend 1.0% less than in the 2008 campaign. The second factor is the weakness in the job market, as employment is lagging behind in the recovery. Lastly, in spite of the significant injection of liquidity in the system, bank credit is hardly reaching small firms and consumers. On a positive note, the excess capacity in the economy will help keep inflationist tensions at bay over the coming months, providing room to maneuver so that expansive policies can be maintained until the recovery has really taken hold.

The latest indicators for demand suggest this slow recovery. Retail sales fell at the end of the «Cash for Clunkers» program to stimulate car sales in July and August. However, the indicator without automobiles or oil once again improved on the figure for the previous month, by 0.4%, confirming that consumption has a relatively solid base. But the Conference Board Consumer Confidence index for September lost its impulse of the previous two months, going from 54.5 to 53.1 points, with the biggest failings centered on how consumers perceive the current situation.

The recovery will be held back by household debt, the job market and the need for credit.

On the supply side, business confidence is optimistic for the second consecutive month although industry indicators have only slightly improved. The manufacturing index took a slight break from its long run of rises, remaining at 52.6 points, while the services index reached 55.1 points. For its part, industrial production in September recorded its third month of progress but its recovery continues to be weak compared with its previous fall, while the figure for production capacity utilization of 70.4% remained close to its record low.

Consumer confidence continues low but retail sales have come alive again after the stimuli.

The housing market is also showing the same pattern of slow improvement.

Businessmen become optimistic but industrial activity is slow to recover.

UNITED STATES: STABILIZATION RATHER THAN RECOVERY

Houses started in annual terms

SOURCE: Department of Commerce and own calculations.

Housing hits rock bottom. Prices confirm the end of the downward trend but there is still too much supply.

The Case-Shiller price index had its second month of increases in July, growing by 1.3% compared with June, seasonally adjusted, after three years of downward slides totaling a drop of 33.1%. Areas such as San Francisco and Cleveland have accumulated a recovery of 6.7% and 7.9% since their minimum levels, while Las Vegas and Detroit have yet to bottom out. But the sector's recovery will be hindered by mortgage foreclosures due to default which, according to the National Association of Realtors, rose in August by 23% year-on-year, making it difficult to reduce the number of homes available for sale, currently 2.4 million. The 590,000 homes started in September, 11,000 more than the record low of April, are a modest increase which is far from the millions typical of 2006.

The labor market is still weak, with unemployment at 9.8%.

The job market will continue to be one of the US economy's weak points in the coming months. The months of intensive job destruction are over but adjustment has yet to be completed. 263,000 jobs were lost in September, taking the net figure of jobs lost since the end of 2007 to 7.2 million. The unemployment rate, which rose to 9.8%, continues its upward trend and won't substantially improve until well into 2010.

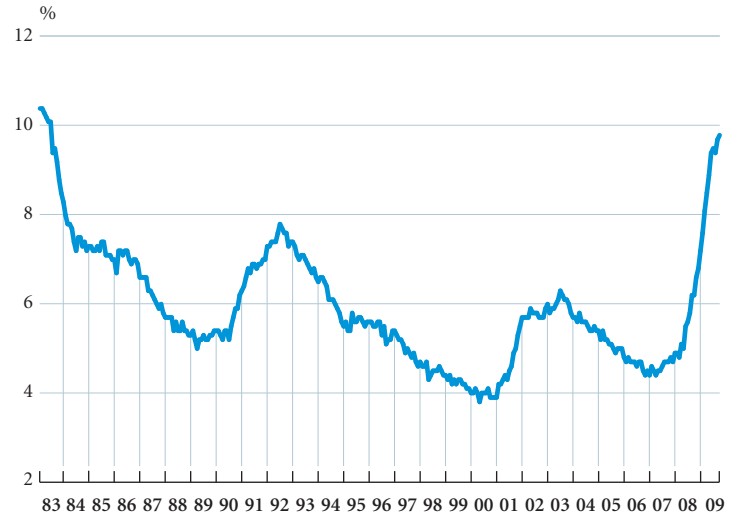
The CPI is down 1.5% while underlying inflation is up 1.4% and looking stable.

Weak demand and leisure resources ensure that prices remain stable. The general consumption price index (CPI), which in September fell 1.3% year-on-year, should rebound in the coming months due to oil prices. For its part, underlying inflation, which is the general index excluding fresh foods and energy, picked up slightly and rose 1.5% year-on-year although, without the help of the drop in house rental prices, it would have risen 2.1%.

In the area of the foreign sector, the trade deficit for goods and services in August totaled 30,710 million dollars, 1,140 million below the figure for July and a little more than half the value at the start

UNITED STATES: UNEMPLOYMENT FIGURES UNHEARD OF SINCE 1983

Unemployment rate compared with active population



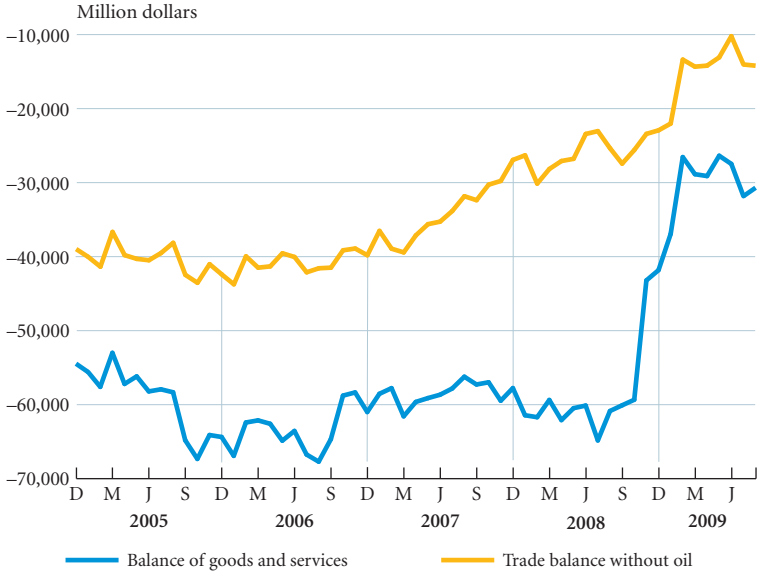
SOURCE: Department of Labor and own calculations.

of 2008. However, the recovery in exports and imports is running out of steam. Lower domestic demand and the global reduction in trade flows had initially resulted in a correction in foreign deficit that nonetheless has continued for the last five months. The balance without oil and its derivates, more in line with fundamental trends, showed a deficit in September of 14,204 million dollars,

The trade deficit is slowing up the correction started with the worldwide crisis in trade.

UNITED STATES: A PERSISTENT TRADE DEFICIT IN SPITE OF EVERYTHING

Monthly figures for the balance of goods and services, seasonally adjusted



SOURCE: Department of Commerce and own calculations.

Japan grows 2.3% thanks to exports and government subsidies.

higher than the figure for March when the trade crisis had reached its peak. Long term there is an underlying positive trend but the expected recovery in domestic demand and trade flows will hinder any strong contribution to growth from the foreign sector over the coming months.

Japan: waiting for relief from exports

In the second quarter, annualized growth in the Japanese economy was up 2.3% quarter-on-quarter, due to improvement in the foreign sector and government stimuli to private consumption. Exports, a pillar for growth in the last few years, were strongly affected by the fall in worldwide demand and by restrictions on credit for exports. The loss of jobs and consequent reduction in income in the world economy, as well as the readjustment in investment, have all greatly reduced demand for consumer durables and capital, traditionally strong points for Japanese exports.

The growth in Asia should boost the Japanese economy but public debt doubles GDP.

In this second half of 2009 and in 2010, business will continue to be boosted via fiscal aid and the foreign sector. For the first area, stimuli are predicted close to 5% of GDP for 2009 and 2010. But Japan is, in this respect, the opposite case to China. Its public funds started the crisis in a precarious state due to the fiscal expansions of the deflationist period in the 1990s. Public debt, now close to 200% of GDP, might compromise the effectiveness of the stimuli being implemented. Prospects are better, however, in the foreign sector. Half Japanese sales abroad are to China and the emerging economies of eastern Asia, which are leading worldwide recovery with higher growth rates than previously expected. This should mean that the foreign sector improves, although this has not been the case to date.

JAPAN: MAIN ECONOMIC INDICATORS

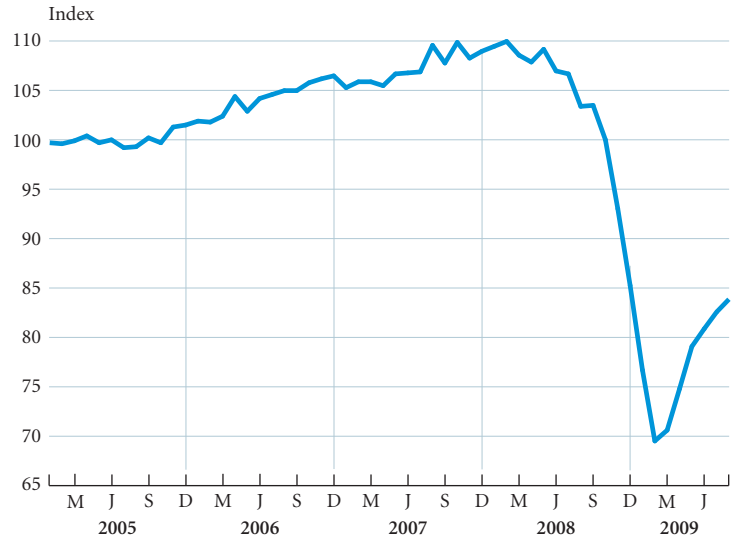
Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	2.3	–0.7	–0.3	–4.5	–8.4	–7.2	–	...	–
Retail sales	–0.1	0.3	0.8	–1.5	–3.9	–2.8	–2.4	–1.8	...
Industrial production	2.9	–3.4	–3.3	–15.0	–34.0	–27.6	–22.7	–18.9	...
Tankan company Index (1)	22.0	–2.8	–3.0	–24.0	–58.0	–48.0	–	–33.0	–
Housing construction	–17.2	2.4	40.3	3.9	–21.4	–32.0	–32.0	–38.4	...
Unemployment rate (2)	3.9	4.0	4.0	4.0	4.4	5.2	5.7	5.5	...
Consumer prices	0.1	1.4	2.2	1.0	–0.1	–1.0	–2.2	–2.2	...
Trade balance (3)	12.6	4.0	7.5	4.0	1.4	1.0	1.0	1.6	...
3-month interbank interest rate (4)	0.7	0.8	0.9	0.8	0.7	0.6	0.6	0.5	0.5
Nominal effective exchange rate (5)	77.1	86.6	81.9	98.5	102.1	95.7	96.9	95.5	98.5

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 RECOVERY IS LOSING STEAM

Seasonally adjusted industrial production index



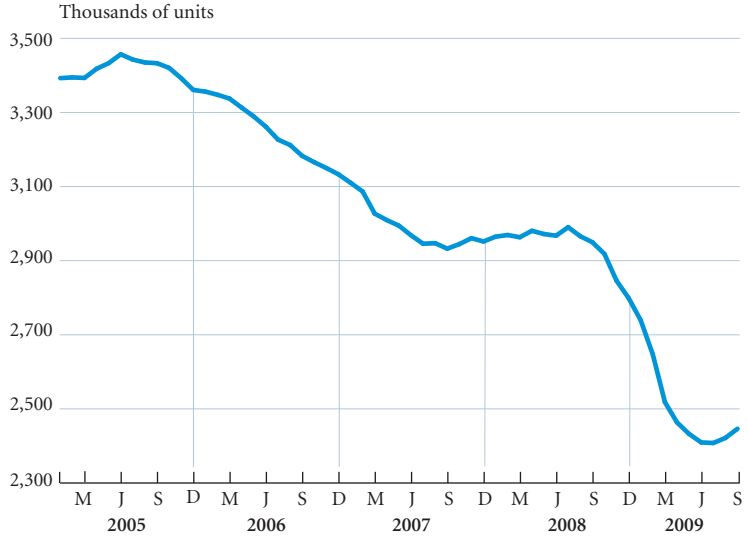
SOURCE: Japanese Ministry of Communications, National Statistics Office and own calculations.

Moreover, the latest indicators for supply don't quite back up this improved outlook. Industry's recovery has noticeably slowed up over the last three months, although it is still far from the levels of May 2008. Along the same lines, for the second quarter the Tankan business sentiment index for large manufacturers was less bad but nonetheless indicated that entrepreneurs

Industry's recovery is slowing up and the rebound in investment has yet to arrive.

JAPAN: THE HARD TASK OF INCENTIVIZING CAR PURCHASES

Automobile sales. Total from the last twelve months



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

Exports are down and unemployment at 5.5%.

are unwilling to reactivate their investment plans. The same caution can also be seen in machinery orders, an early indicator of investment, which in August fell because of the export sector. Similarly, the balance of trade for September (according to the balance of payments) was still positive but with a downward trend. Exports, down 0.8% compared with August, suffered their third consecutive drop, while imports continued to rise slightly, so the desired boost from foreign trade has been called into question.

On the demand side, retail sales in August fell 1.8% year-on-year, while government subsidies helped automobile sales in August and September to rebound strongly, growing by 8.2% and 9.2% year-on-year, respectively. For its part, the housing market picked up in September in the area of Tokyo, both in terms of sales and prices, but the continual low levels of housing started to raise doubts as to whether these increases will continue. A similar picture can be seen in the labor market, still one of the Japanese economy's weak points, where there was also a slight improvement. The unemployment rate for August, which had hit record levels in July, fell to 5.5%, while the recovery in employment this time included the battered sector of manufacturing.

The new deflationist period will go on until 2010, with the CPI falling by 2.2%.

This weak demand means that deflationist trends will continue throughout 2010. The CPI for August fell by 2.2% year-on-year, at maximum levels since the index started in 1971, while underlying inflation, the general index without energy or food products, once again fell by 0.9% year-on-year, accumulating its eight consecutive month of reductions.

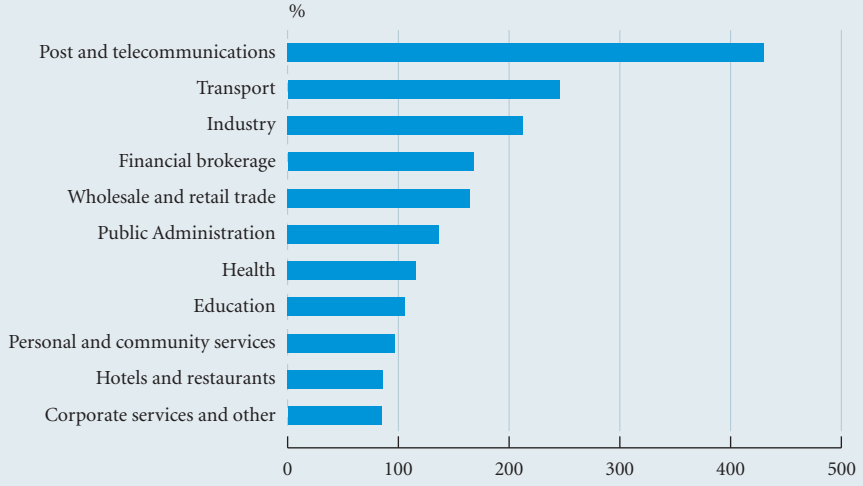
Services, efficiency and productivity

Car manufacturers can increase their production every year without needing to increase their workforce. A theater company, however, can only satisfy the maximum number of spectators the theater can hold; if they want to entertain more people, they have to increase the number of performances, with the consequent rise in number of hours worked. In industry, economies of scale mean that production costs can be cut and profit per hour worked increased, i.e. greater productivity. This hardly seems possible in most of the services sector. This insight was used by the American William Baumol to theorize on the lower growth in productivity in services compared with manufacturing, which meant that, for many years, the services sector was seen as a hindrance to economic growth. Such low productivity would also entail relatively higher growth in prices for services than industry. Bad propaganda for services, which in the last few decades has actually become the dominant sector, accounting for around two thirds of what the economy produces.

It's evident that industry performs better in terms of productivity, although there are cases where productivity in the tertiary sector exceeds that of the manufacturing industry, this being the case of telecommunications and transport. Overall, the high number of personnel involved in most tertiary activities makes it difficult to improve productivity, whereas industrial production needs increasingly less contribution from labor thanks to investment in capital goods and improved processes.

SERVICE PRODUCTIVITY IS NOT ALWAYS LOWER THAN THAT OF INDUSTRY

Growth in real gross value added by hour worked in the Euro Area, 1980-2005



SOURCE: EUKLEMS database and own calculations.

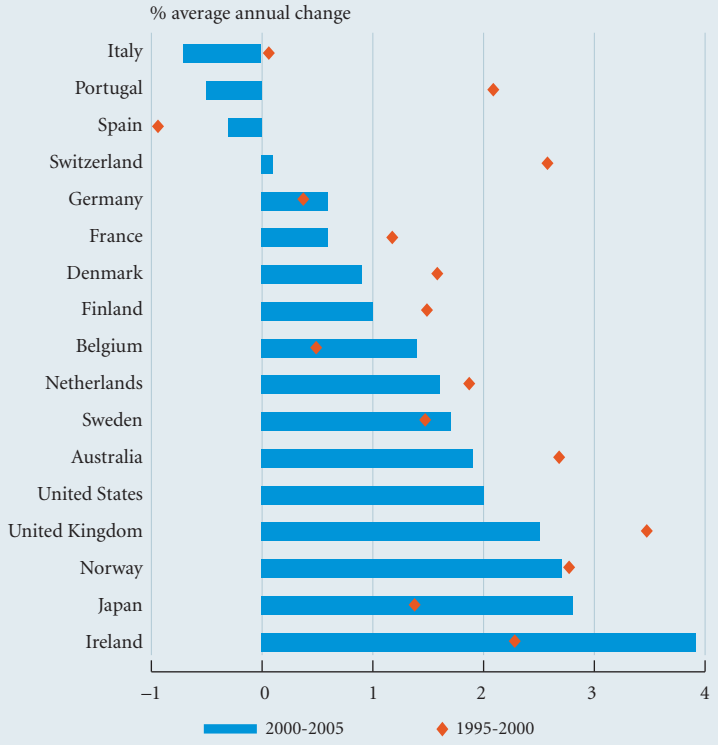
One true criticism regarding the supposed inferiority of services in terms of productivity concerns the difficulty of appropriately measuring product quality. This problem also occurs in the manufacturing industry, especially in products related to new technologies, but in general a product's attributes, such as computer, can be quantified: processing speed, memory capacity, image resolution, etc. But how can improvements in service quality be objectively evaluated in the restaurant sector, a lawyer's practice or the branches of a bank, for example? There are reasons to believe that there have been significant advances in quality in many of the tertiary sector's activities but, when measuring what is produced, this crucial point is ignored by the National Accounts system.

In spite of these finer distinctions, what is true is that Baumol's disease, namely slower growth in productivity in the services sector, means that, as the tertiary sector increases its relative importance for the economy, gains in overall productivity will fall. However, in the last fifteen years, this trend has altered in a group of countries such as the United States, Australia and some small European countries, which have seen significant improvements in advances in productivity in the economy as a whole. However, other countries, in fact most of the economies in continental Europe, have practically stagnated in terms of advances in productivity. And the area where this productivity gap can best be seen is, precisely, in the services component.

Initially it was believed that the cause lay in the early incorporation of new information and communication technologies in production processes in certain countries. However, when these differences continued, it was clear that this was not the case. A huge number of empirical studies now agree on the cause of this dichotomy: different approaches in regulating the services sector. The constraint on those countries that lag behind can be explained principally by three causes: firstly, the barriers preventing entry to some tertiary

NOTABLE DISPARITIES IN PRODUCTIVITY GROWTH IN SERVICES

Gross value added by employed person



SOURCE: OECD.

activities; secondly, low competitive pressure and, lastly, the low quality or high cost of activities.[1] These factors hinder the necessary renovation and dynamism of service companies and undermine incentives to adopt new technologies. The impact of anti-competitive regulation on cost structures is greater in those industrial sectors that use information and communication technologies more extensively, given that these largely use inputs from the tertiary sector, thereby spreading the effects of inappropriate regulation for services throughout the economy.

Regulation that is excessive, inappropriate or unrelated to how the market works for activities in the tertiary sector hinders the effective allocation of resources, damaging more efficient and dynamic firms. These anti-competitive regulations affect service efficiency and negatively impact those companies that are more open to advances in new technologies. Studies show that the more services are regulated, the less productivity tends to grow in the economy as a whole. Countries with less restrictive regulations, such as the United States, United Kingdom, Canada and Australia, enjoy greater growth in productivity than countries with more restrictive regulations, such as Italy, Portugal, Spain and France.

(1) Jens Arnold, Giuseppe Nicoletti and Stefano Scarpetta, «Regulation, Allocative Efficiency and Productivity in OECD Countries: Industry and Firm-Level Evidence» Economics Department Working Paper No. 616, OECD 2008.

Growth in productivity is a decisive factor in rising levels of income and wealth, both in relative and absolute terms. There's no point thinking about continual increases in income per capita unless there's progress in productivity, and today the services sector, given its weight and nature, is key to advances in productivity throughout the economy. That's why reforms that help and stimulate the tertiary sector to operate better and more efficiently are crucial to improving the standard of living.

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

China: leading the recovery

The IMF's upward revision of the forecast for China was the first bit of good news. We did not have to wait much for the second bit. With year-on-year growth of 8.9% in the third quarter, the figure of 7.9% from the second quarter now seems modest. In line with the good news from China, and after four quarters of negative growth, Singapore, a manufacturing base and one of the large financial centers for emerging Asia, advanced 0.8% year-on-year in the third quarter.

China grows 8.9% in the third quarter

Following the trend of the last few months, most indicators in September improved on the previous month's figures and the biggest surprise coming from the foreign sector, which had so far resisted showing clear signs of recovery. Although the data from August already prompted us to write that trade had started to get its breath back, any lingering doubts concerning the strength of trade have disappeared with September's figures. In particular, exports fell in September by 15% year-on-year, much lower than the average between January and August of 22%. During this period, exports have benefited from the lack of movement in exchange rates of the renminbi against the dollar and, given the changes in the

Trade shows clear signs of recovery.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before, unless otherwise indicated

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	13.0	9.0	9.0	6.8	6.1	7.9	–	8.9	–
Industrial production	17.5	12.6	13.0	6.4	9.7	9.0	10.8	12.3	13.9
Electrical power generation	15.7	6.7	6.7	–6.0	–4.3	–0.4	4.7	8.9	10.7
Consumer prices (*)	4.8	5.9	5.3	2.5	–0.6	–1.5	–1.8	–1.2	–0.8
Trade balance (**)	262	297	259	297	318	295	281	267	251
Reference rate (***)	7.47	5.31	7.20	5.31	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	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.

Industrial production is already within the 15% range of past years.

latter, from the depreciation of the renminbi against major currencies. On the other hand, the big slow-down in the fall in imports, which went from 17% in August to 3.8% in September, explains the reduction in trade surplus for September to 12,932 million dollars.

Given improved exports, the likelihood of the renminbi once again appreciating against the dollar has increased. A more flexible exchange rate will also help to adjust monetary policies to the conditions of China's economy. Without doubt, China requires more restrictive monetary policies than the American economy, where recovery is expected to be more gradual. Lastly, a stronger renminbi is absolutely necessary to help rebalance Chinese growth towards domestic consumption.

The Shanghai stock market continues on the up.

Other recent indicators suggest that growth will become even stronger during the latter part of the year. The purchasing managers' index (PMI) for September rose for the fourth consecutive month, standing at 54.3, in line with the vitality of the economy. Industrial production grew in September by 13.9% year-on-year, higher than the 12.3% for August and already within the range of 15%-16% of previous years. Bank credit continues its upward trend, a consequence of the expansive monetary policies implemented by the country's authorities. With a year-on-year growth of 34.1% in September, the average for the first nine months stands at 30%, doubling 2008's figure. Finally, retail sales rose in September by 11.5% year-on-year, below the figure of 15.4% for August due to the shift in the calendar, from September to October, of the Mid-Autumn Moon Festival.

Given this new momentum in China, the fall in prices observed in the last few months has slowed up dramatically. Specifically, the CPI fell in September by 0.8% year-on-year, much less than the 1.2% for August and 1.8% for July, and we expect the rise in commodity and housing prices will push inflation into positive figures over the coming months.

Lastly, the Shanghai stock market continues its upward trend. In the first three weeks of October, the Composite index had risen 8%, close to the values seen at the beginning of July, just before the big change in August. Given this scenario, voices have been heard warning of the risk of a speculative bubble. However, the stock market index is still 50% below the peaks reached in 2007.

Brazil: the games and Tobin, all going to Rio

Lula da Silva and the Brazilian representatives got very good news in Copenhagen, when IOC chairman, Jacques Rogge, announced the name of the city chosen to host the 2016 Olympics. Their joyous reaction revealed not only the satisfaction of becoming the first Latin American country to host an Olympic event but also their belief that the Rio effect would bring to the country much more than games: infrastructures, prestige, a global platform and, of course, wealth.

The IOC and IMF add to Brazil's optimism.

The latest IMF forecasts also invite optimism and bestow on Brazil the role of leader in Latin America's recovery. For 2009, and after raising its previous estimate by 0.6 percentage points, it has fixed the drop in Brazilian GDP at a modest 0.7%. At the same time it also predicts a more vigorous recovery in

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	5.6	5.1	6.7	1.2	–1.6	–1.2	–	...	–
Industrial production	5.9	2.9	6.2	–6.9	–13.7	–11.3	–10.5	–8.1	...
Consumer confidence (*)	132.3	140.4	136.3	132.9	128.5	128.4	139.9	139.8	146.1
Unemployment rate São Paulo (**)	15.0	13.0	12.7	11.6	12.6	13.9	13.4	13.1	...
Consumer prices	3.6	5.7	6.3	6.2	5.8	5.2	4.5	4.4	4.3
Trade balance (***)	40.0	24.8	28.7	24.8	25.0	27.4	27.0	27.8	26.4
Interest rate SELIC (%)	12.75	11.25	13.75	13.75	11.25	9.25	8.75	8.75	8.75
Reales to dollar (*)	2.1	1.8	1.9	2.3	2.3	2.0	1.9	1.9	1.8

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.

2010, adding 1 percentage point to the forecast from July and placing it at 3.5%. This revision can be explained by the turn-around in commodity prices, the recovery in external demand in key markets and the improved confidence of firms and consumers in Brazil.

Everything suggests that this confidence will continue to strengthen and early indicators from the third quarter reveal a welcome scenario: vigorous activity and benign inflation. The consumer economic sentiment index recovered strongly in September and has now surpassed the levels prior to the crisis. In August, and for the fourth month in a row, retail sales continued to advance, with a year-on-year growth of 4.6% and, the following month, vehicle sales broke records with a year-on-year rise of 14.9%, boosted by credit and tax incentives. The impetus provided by domestic demand can also be partly explained by the progress made in the job market, whose formal sector has now made up for the 800,000 jobs lost between September 2008 and January 2009. On the supply side, in September the purchasing managers' index (PMI) once again passed the threshold of 50 that indicates recovery, while industrial production has now grown for the last seven months and has reduced its year-on-year decline, which is now 8.1%.

Domestic confidence making strong progress.

October 2009 will therefore be remembered in Brazil as a good month. But not so much by its international investors, surprised by a new tax on foreign capital inflows. This duty, in the purest style of Tobin, the Nobel Laureate for economics who, in 1971, suggested a duty on capital flows to placate speculation, levies 2% on the purchase both of equity and bonds, although it excludes direct foreign investment. With this tax, Lula's government aims to slow up the rise in value of the real (more than 30% against the dollar since its minimum level in March), which might complicate the recovery in 2010. So far attempts have been made to offset this rise by trading in the foreign exchange market, thereby annulling this intervention, which is more costly

Brazil surprises with a new tax on capital inflows.

Mexico glimpses signs of recovery and prepares for full growth in 2010.

for public funds than the Tobin duty, whose annual revenue might amount to 0.3% of GDP.

In any case, the IMF has already warned of the doubtful effectiveness of this kind of measure. Moreover, with the Brazilian economy on the up and global investors looking for returns in emerging markets, it's unlikely that the measure will manage to slow up the upward trend in the real for very long.

Mexico: pending fiscal reform... and its rating

At this stage, no-one doubts that Mexico is one of the countries that has suffered most from the turbulence of the crisis and this has been confirmed by the latest IMF forecasts, which have not altered their predictions for growth for the Mexican economy in 2009, although most of its neighbors in Latin America have seen a rise in their figures. In spite of this, the Aztec country is now starting to show signs of incipient recovery.

Fiscal reform and its consequences are monopolizing political and economic attention in Mexico.

The most revealing figure regarding a possible change in trend comes from the foreign sector, with exports reaching, in August, their highest level since November 2008. Domestic expenditure also shows signs of improvement. Retail sales continued to curb their trend in August, although still falling 5.5% year-on-year, and the consumer confidence index, after a disappointing drop the previous month, picked up slightly in September, although it's still below its 2008 value. But we have to wait and see whether the disadvantaged labor market, with an unemployment rate that has moderated its rise but hasn't fallen, will hinder progress in this confidence.

With regard to supply, industrial production continues with negative figures, losing 0.2% compared with July and 7.8% year-on-year. However, the IMEF manufacturing index continued its progress, reaching 51.6 points and surpassing, for the third consecutive month, the threshold of 50 that indicates recovery. All this suggests that, although the road to recovery seems to be an

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	3.3	1.4	1.5	–1.7	–8.4	–9.7	–	...	–
Industrial production	2.4	–0.9	–1.5	–4.3	–9.9	–10.0	–7.0	–7.8	...
Consumer confidence (*)	104.9	92.2	88.9	83.3	80.1	80.5	85.4	81.6	81.9
General unemployment rate (**)	3.7	4.0	4.2	4.3	5.0	5.2	6.1	6.3	6.4
Consumer prices	–22.7	–11.8	5.5	6.2	6.2	6.0	5.4	5.1	4.9
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	4.50
Mexican pesos to dollar (*)	11.0	10.6	11.0	13.9	14.2	13.2	13.2	13.3	13.5

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

arduous one for industry, its worst days are over.

So, if there are no surprises, the expected panorama for 2010 changes significantly: we expect a notable pick-up in the Aztec economy, with growth around 4%, boosted by the gradual recovery both in exports, especially to the United States, and also by domestic consumption; a trend most analysts agree with. However, Mexico still needs to resolve a series of structural hurdles that might hinder the country's growth in the medium and long term, a need that some rating agencies also insist on, as they are particularly concerned about the sustainability of a Mexican fiscal pattern that is overly dependent on oil.

In this respect, on October 20, the Mexican congress passed a subset of measures proposed by the government's fiscal reform project, although it rejected the introduction of a new generalized tax on goods and services. Among these provisions, it was agreed to increase, in 2010, value added tax (VAT) by one percentage point to 16%, and income tax (IT) for the highest income brackets by two points, to 30%. The new plan reduces the 2010 fiscal deficit to 0.75% of GDP, higher than the 0.25% initially budgeted by the government but much lower than the 3.2% which would have resulted had the status quo been maintained. In any case, we shall have to wait and see whether the senate approves what has been agreed in the lower chamber and if this will be enough to protect the country's sovereign debt rating against a possible downgrading, as well as to boost long-term growth for the second power in Latin America.

Oil puts its foot on the gas

Oil prices have intensified their climb. Between September 20 and October 21, crude was up 14.1% and reached 78.38 dollars per barrel (Brent crude, one-month delivery). This rise was concentrated in the last two weeks and accumulated an increase of 100.5% in the current year and year-on-year rise of 14.5%.

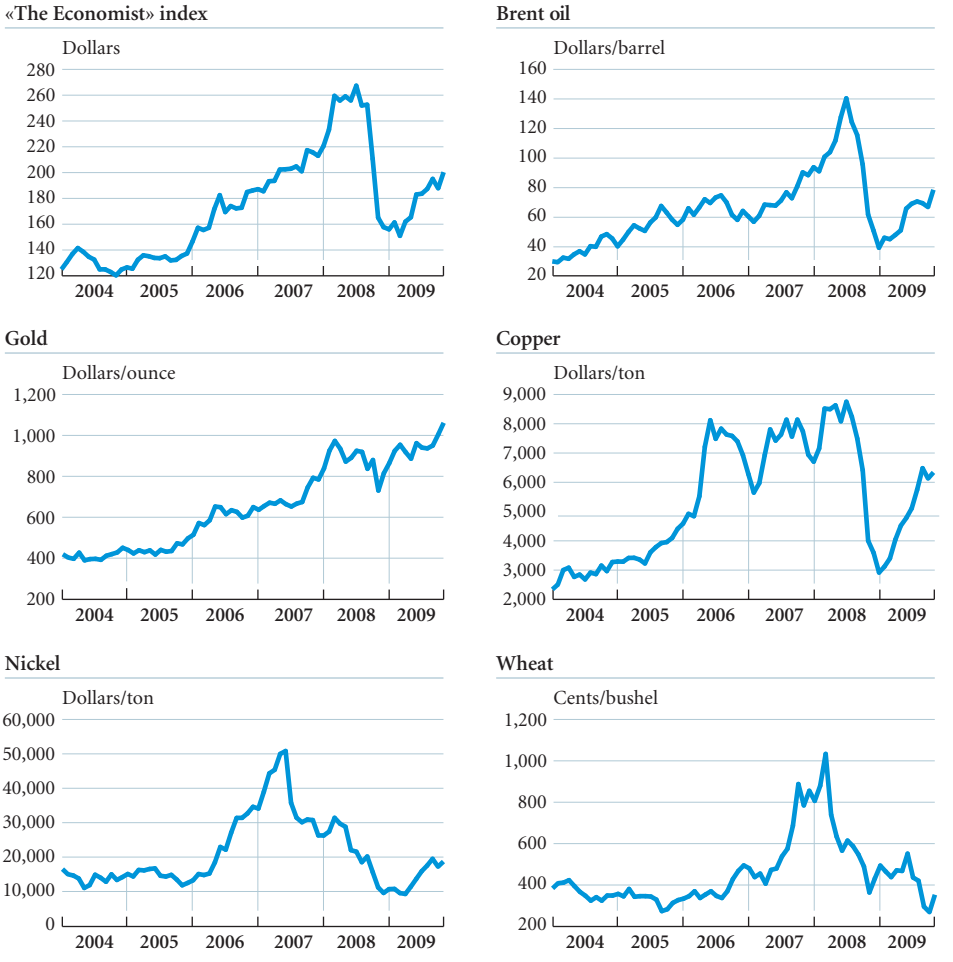
The increase in oil prices, and to a lesser degree other commodities, is the result of financial factors such as the weak dollar and the reduction in risk aversion, as well as to fundamental factors that have become increasingly important throughout 2009. These factors are the improved expectations for world recovery and particularly the importance of emerging economies, which use oil more intensively. In this respect, the IEA has revised its figure for the world demand of oil for the third time since May. Also significant is the lack of investment in extraction capacity during the last few months on the part of countries from the Organization of the Petroleum Exporting Countries (OPEC).

Commodity prices have followed the trend in oil but much more modestly. *The Economist* commodity price index was up 3.4% between September 21 and October 12, with a current year increase of 26.5%. Gold and base metals rose moderately, while foods increased more sharply.

The price of crude reaches 78 dollars, double its price at the start of the year.

Expectations of greater worldwide growth pull oil prices up.

TREND IN VARIOUS COMMODITIES (*)



NOTES: (*) Figures for last day of month (last date October 21).
SOURCE: «The Economist», Thomson Reuters Datastream and own calculations.

EUROPEAN UNION

Euro Area: imminent recovery

Practically all analysts now assume that the quarter-on-quarter growth rate of the Euro Area, which will be known by mid-November, will be positive in the third quarter. But the big question is how fast the recovery will be. If quarter-on-quarter growth is positive but around 0.1% or 0.2% in the third quarter, the theory that would gain ground would be that the recovery will be slow in the Euro Area, particularly compared with the United States, where everything suggests growth will be quite a lot stronger. If, on the other hand, the quarter-on-quarter growth rate reaches values of 0.6% or higher, the medium-term prospects will be more encouraging.

To estimate what has happened throughout the third quarter, as yet without the national accounting data, we can briefly review the main strengths and weaknesses of the Euro Area's economy by using the most frequent series. This will provide us with some idea of how fast the recovery process might be.

The measures to stimulate the economy taken by different governments were already being noticed in the second quarter and everything suggests that this trend will continue in the third. The

Positive quarter-on-quarter growth in the third quarter.

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	September
GDP	2.7	0.6	0.4	–1.8	–4.9	–4.8	–	...	–
Retail sales	1.4	–0.7	–1.0	–1.9	–3.2	–2.4	–1.8	–2.7	...
Consumer confidence (1)	–4.9	–18.0	–19.1	–27.1	–32.5	–27.9	–23.0	–22.0	–19.0
Industrial production	3.5	–1.7	–1.5	–9.0	–18.5	–18.6	–15.9	–15.3	...
Economic sentiment indicator (1)	108.9	91.1	89.9	75.6	65.7	70.2	76.0	80.8	82.8
Unemployment rate (2)	7.4	7.5	7.6	8.0	8.8	9.3	9.5	9.6	...
Consumer prices	2.1	3.3	3.8	2.3	1.0	0.2	–0.6	–0.2	–0.3
Trade balance (3)	20.1	–1.2	–11.4	–31.7	–36.4	–31.8	–11.9	–6.6	...
3-month Euribor interest rate	4.3	4.6	5.0	4.2	2.0	1.3	1.1	0.9	0.8
Nominal effective euro exchange rate (4)	107.9	113.0	114.0	109.1	111.9	113.2	113.8	113.9	115.2

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.

The measures to stimulate the economy and the foreign sector are the driving forces behind the recovery.

foreign sector, which also contributed positively to growth in the second quarter, is expected to continue being the driving force behind recovery. Imports once again fell in the first two months of the third quarter, something that clearly shows the growing weakness in household consumption. After the big increases recorded in the month of July, exports took a step backwards in the month of August. However, the purchasing managers' export orders index continued to rise in September and October. This suggests that the foreign sector's contribution to growth will be of a similar size to that recorded in the second quarter.

Consumption will continue to be weak in the short term...

Private consumption, which provided a pleasant surprise last quarter with a positive contribution to growth of 0.1 percentage points, will probably continue along the same lines, as there is nothing to suggest that this factor will make a great recovery. It's true that consumer confidence has continued to rise significantly throughout the quarter and is now at the levels of September last year, just before the Lehman Brothers investment bank went bankrupt, but the recovery in retail sales is still quite modest. In the month of August, the year-on-year change was 2.7%, significantly above the minimum achieved in February this year but in line with data observed since then.

...and neither will investment give us much to shout about.

Neither has investment given us much to shout about in the short term. Production capacity utilization in the month of August was at the lowest level ever. The positive note is being offered by the recovery in industrial production which, unlike retail sales, is somewhat more convincing. The year-on-year change in the month of August recorded a drop of 15.3%, six percentage points higher than the minimum reached in

INDUSTRY IS STARTING TO RECOVER

Indicators of industrial activity

SOURCE: Eurostat, Bloomberg and own calculations.

April this year. The purchasing managers' index (PMI) for September and October also shows that this trend continues at the end of the third quarter and beginning of the fourth.

So there are reasons to believe that the economy of the Euro Area will have finally pulled out of technical recession in the third quarter, although given the weakness that will probably still be seen in private consumption and investment, quarter-on-quarter growth will be around 0.3% or 0.4%. A relatively modest growth rate but one which allows us to hope for quite a solid recovery.

For this to actually take place, the main factors driving growth, namely the foreign and the public sector, will have to be replaced by private consumption and investment.

As already noted on other occasions, private consumption is hampered by the high uncertainty caused by growing unemployment. In the month of August, this rose one percentage point further, reaching 9.6%, the highest in practically 11 years. Although the latest data clearly reflect a slowdown in the rise in this figure, historical evidence shows that the unemployment rate does not start to fall until around 4 quarters after economic activity picks up. So the unemployment rate will remain close to two digits until at least the second half of next year.

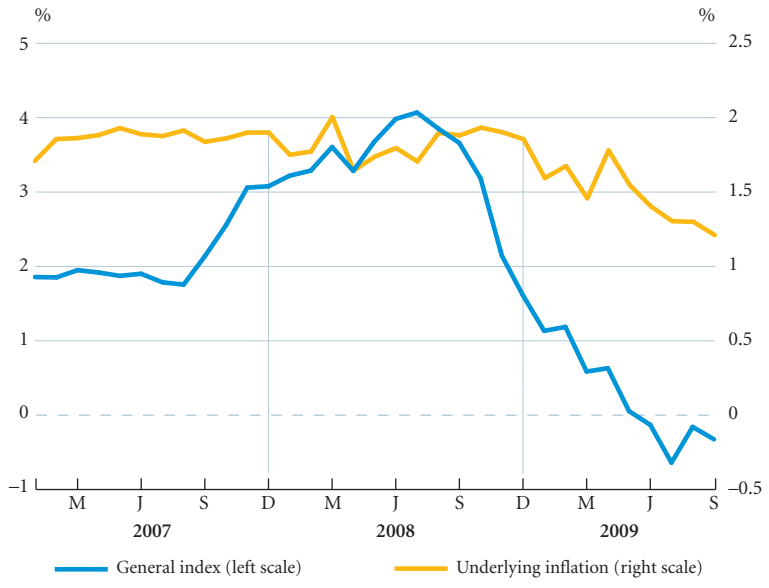
Neither does a strong recovery in investment seem very likely in the medium term. As we have mentioned before, production capacity utilization is at record low levels and any adjustment will be gradual.

Recovery in the financial sector also appears to be quite slow, making it

These two factors will continue to gain ground gradually over the next year.

CORE INFLATION IS SLOWING UP

Year-on-year change in the Euro Area's harmonized consumer price index



SOURCE: Eurostat and own calculations.

Recovery will be sustained but not too vigorous.

unlikely that credit will flow again at levels prior to the crisis. However, many firms are resorting to direct financing by issuing debt, taking advantage of the low interest rates due to the large injections of liquidity carried out by the European Central Bank.

Interest rates will probably continue at 1% until at least the third quarter next year, as the change in prices continues in negative figures. The year-on-year percentage change in consumer prices fell 0.3% in the month of September and, although it will recover over the coming months as the effect of the fall in commodity prices disappears, inflationist pressure will continue to be low. An example of this is that core inflation fell again in the month of September and is now at 1.3%.

Given this setting, we expect the factors currently driving growth to be replaced gradually throughout 2010 and 2011. That's why, although recovery will be sustained, we don't expect it to be very vigorous.

The parties in the new German government are committed to cutting taxes...

The new German government decides to lower taxes

The general elections last September led to a change in the composition of the German government, with the FDP liberal party being the new partner for Angela Merkel's CDU. These results have placed in government those parties whose electoral programs contained tax cuts, with the aim of stimulating economic activity and relieving families' tax burden, given the current situation.

These proposed tax cuts contrast with the new government's limited room for maneuver in fiscal terms, due to the progressive deterioration in German public accounts in 2009. Particularly if we take into account the fact that revenue from the first nine months of the year only covered 65% of public expenditure, placing the estimated deficit-to-GDP ratio above 4.0% in 2009 and at a higher level in 2010, exceeding the 3.0% limit set by the Maastricht treaty. Consequently, the European

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
GDP	2.6	1.0	0.8	–1.8	–6.7	–5.9	–	...	–
Retail sales	–3.0	–0.5	0.2	–0.4	–2.8	–1.6	–0.1	–2.9	...
Industrial production	5.9	–0.1	–0.1	–7.5	–20.0	–19.3	–17.0	–17.4	...
Industrial activity index (IFO) (*)	106.2	96.8	94.7	86.2	82.6	84.7	87.4	90.5	91.3
Unemployment rate (**)	9.0	7.8	7.6	7.6	8.0	8.2	8.3	8.3	8.2
Consumer prices	2.3	2.6	3.1	1.7	0.9	0.3	–0.5	0.0	–0.3
Trade balance (***)	181.5	195.3	196.3	183.0	159.6	138.9	132.7	129.4	...

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.

Commission launched an excessive deficit procedure in October.

In spite of this, negotiations between both parties suggest a cut in taxes close to 24,000 million euros, which might already start to be implemented in 2010. According to the government, this cut is justified by the improved forecasts for the German economy in 2009 and 2010. The recovery in the second quarter of the year, driven both by rebounds in the foreign sector and investment as well as by growth in public and private consumption, allowed the government to lower to 5.0% the expected fall in German GDP in 2009, one percentage point less than before, and to predict 1.2% growth in 2010. These figures are in line with those of leading German economic institutes.

An analysis of the most frequent indicators shows that these continue to move away from the minimums reached in the first quarter, albeit slowly. On the supply side, new growth was recorded in industrial confidence in September. Moreover, both production and industrial orders in August rose 1.8% month-on-month, although not enough to improve the change in these series compared with the same month last year. This fact, together with the low utilization of production capacity, at 71.8% in the third quarter of the year, suggests there will be weak growth in investment during this period.

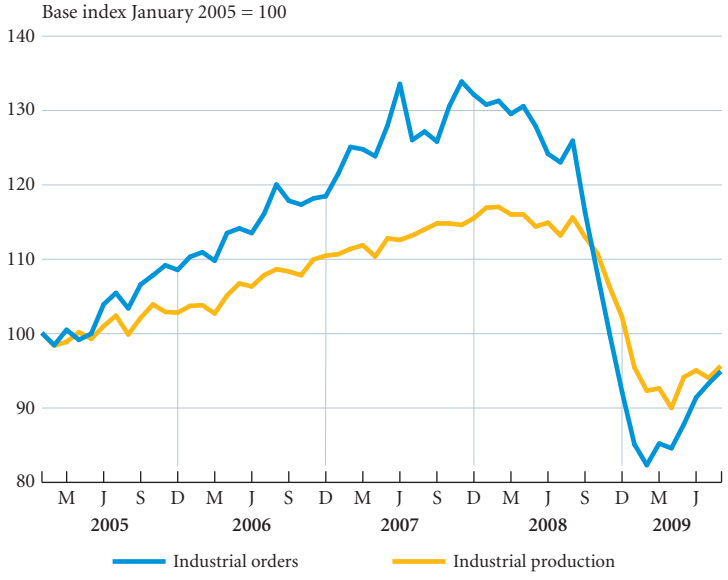
On the demand side, no clear trend has been observed. The real gross disposable income of German households was up in the third quarter due to a 0.3% fall in prices compared with the same period in 2008, the lowest inflation rate in the last twenty years. Given this scenario, consumer confidence continued to improve in the month of September.

...supported by the improved economic forecasts for 2009 and 2010.

German retail sales fall 2.9% year-on-year in August.

INDUSTRIAL ACTIVITY IS RECOVERING, ALBEIT SLOWLY

Indicators of industrial activity



SOURCE: Deutsche Bundesbank and own calculations.

German trade balance also fell in August.

However, retail sales recorded in August a fall of 6.4% month-on-month (2.9% year-on-year). It should be noted that automobile sales are not included in this series, so their increase during the first nine months of the year (up 26.1% compared with the same period in 2008), boosted by fiscal stimuli, very possibly reduced the consumption of other goods.

There are certain risks that might result in a slower recovery in 2010.

However, other causes can be found for this weakening in demand. The financial turmoil of the last year has reduced growth in bank credit given to households, in July 2009 this being at 1.1% compared with the same month in 2008. Moreover, in spite of the further fall in the unemployment rate in September which, at 8.2%, is below the levels of 2007, there is some uncertainty about how the labor market will evolve, largely due to the sharp drop in the number of hours worked by employees. This contraction is the result of temporary workday reduction plans (Kurzarbeit) which, according to the German employment office, affect close to 1.4 million workers.

The French economy is one of the least affected by the economic situation.

Neither were August's data very positive with regard to the foreign sector, one of the main engines of the Germany economy, with a fall in the trade balance after growth for six consecutive months. This drop can be explained by the 2.0% decrease in exports in August compared with the previous month, while imports rose 0.9% in the same period.

The greater deterioration expected in the labor market in 2010 and the end of fiscal stimuli for its main trading partners might lead to a reduction in demand for German goods in the coming year. This fact, together with greater constraint in public consumption, may mean that the recovery in 2010 is slower than the government predicts.

The French economy continues on the path to recovery

France stands out as being one of the developed countries that has suffered the least during the current recessive cycle. According to the latest report by the International Monetary Fund (IMF), French GDP is expected to fall 2.4% in 2009, one percentage point less than the fall forecast for the rest of the advanced

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
GDP	2.3	0.3	0.1	–1.7	–3.5	–2.8	...	...	...
Domestic consumption	4.9	–0.6	–0.9	–2.5	–1.0	0.2	–0.5	–1.3	...
Industrial production	1.2	–2.5	–2.4	–9.0	–15.6	–14.5	–12.4	–10.8	...
Unemployment rate (*)	8.3	7.8	7.9	8.3	8.9	9.4	9.7	9.9	...
Consumer prices	1.5	2.8	3.3	1.8	0.6	–0.2	–0.7	–0.2	–0.4
Trade balance (**)	–33.7	–48.6	–50.9	–55.4	–55.2	–53.7	–48.2	–46.0	...

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

economies. This lesser impact is because of the idiosyncratic nature of the French economy, which is notably less dependent on the foreign sector and where the public sector plays a key role.

It was precisely the good performance of public consumption, together with private consumption picking up in the second quarter, which led to growth in the French economy in this period, becoming one of the first to show signs of recovery. For the second half of the year, indicators show that the economy will continue to grow, albeit moderately.

On the supply side, industrial activity continued to rise during the third quarter. This was the case of industrial production, which in August recorded, for the fourth consecutive month, growth of 1.8% compared with the previous month. This increase exceeded analysts' forecasts and was due to the large growth in activity in the car industry, up 18.2% month-on-month, in order to meet the demand created by stimuli to buy passenger cars. Both industrial confidence and orders suggest that this trend will continue. However, the under-utilization of production capacity and the end of subsidies for the car industry mean that a growth in investment is not expected in the short term.

In the case of demand, it was the foreign sector that recorded the biggest recovery with a 39.6% fall in trade deficit in August compared with the same month in 2008, due to exports falling less than imports. On the other hand, during the same month the consumption of French households fell for the second consecutive month, at the same time as consumer confidence deteriorated.

These data are due to the progressive decline in the labor market, which in August recorded an unemployment rate of 9.9%, far from the 7.6% reached a year and a half ago. Moreover, the lag between the unemployment rate and growth in GDP suggests that the number of unemployed will continue to rise in 2009 and the beginning of 2010, having an effect on households' private consumption. This fact, together with the end of some stimuli for consumption, suggest that private consumption will fall off, particularly in the fourth quarter of the year, and this might not be offset by the improvement in purchasing power resulting from the fall in prices.

That's why, given this risk of stagnation in demand in the coming quarters, the French Minister for Finance is not planning a mass withdrawal of the measures aimed at stimulating the economy as, in her opinion, there would be the risk of falling back into recession.

Industrial production is above forecasts, driven by the car industry.

Foreign and domestic demand show different trends.

The rise in unemployment may lead to private consumption stagnating at the end of 2009 in France.

Uncertainty concerning Italian recovery

The main economic analysts predict that the Italian economy will be one of the most affected by the current recessive cycle, with a contraction in GDP of around 5% in 2009. These forecasts implicitly include recovery in activity already in the third quarter this year. However, Italy's weak economic structure raises doubts concerning the intensity and speed of this recovery, particularly with regard to 2010. To date, cyclic indicators do not show any evident signs of the new direction of growth.

There are doubts concerning the intensity of Italian economic recovery.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
GDP	1.5	–1.0	–1.3	–2.9	–6.0	–6.0	–	...	–
Retail sales	1.3	–0.3	0.1	–1.7	–2.9	–1.2	–2.5	–2.9	...
Industrial production	2.2	–3.4	–4.1	–10.7	–21.2	–22.9	–19.0	–11.7	...
Unemployment rate (*)	6.2	6.7	6.8	7.0	7.3	7.4	–	...	–
Consumer prices	1.8	3.3	4.0	2.8	1.5	0.8	0.0	0.1	0.2
Trade balance (**)	–12.8	–10.0	–10.8	–12.3	–11.1	–9.1	–6.4	–5.6	...

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

In spite of growth in industrial production, investment is not expected to pick up.

From the point of view of supply, undoubtedly the growth in industrial production in August stands out, 7.0% up on the previous month and revived by intermediate goods and consumer durables. This greater activity was partly motivated by the increase in stock, previously at excessively low levels. That's why this trend is not expected to continue over the coming months, especially with the fall in industrial orders and the reduction in industrial confidence in September due to growing pessimism compared with the evolution in demand. This outlook for demand, together with the lower utilization of production capacity, confirms that investment in the third quarter will see practically zero growth.

Demand has weakened, affected by the deterioration in the labor market.

Neither do the most frequent indicators suggest that demand will drive recovery. Trends in retail sales, with a year-on-year drop of 2.9% in August, show that not even low inflation has been enough to stimulate consumption among Italian households. This weakness has been caused by the progressive deterioration in the labor market, which has led to rising unemployment and a fall in the hours worked. With regard to foreign demand, the value of exports fell 25.0% in August compared with the same month in 2008. However, a greater contraction in imports led to an improvement, albeit slight, in the trade deficit.

It therefore seems unlikely that the Italian economy will be on a clear path to recovery in the coming quarters. Given this situation, the government is planning new measures to reactivate private consumption and investment, such as temporarily extending subsidies for buying vehicles or removing regional duties on companies. However, both measures would continue to weaken the already battered Italian public accounts.

United Kingdom: recovery is taking time

UK GDP has fallen unexpectedly by 0.4% quarter-on-quarter in the third quarter.

UK GDP fell by 0.4% quarter-on-quarter in the third quarter of 2009, a decrease of 5.2% compared with the same period in 2008. Although this drop is less than the last quarter, the figure has been a nasty surprise for analysts as a whole, who predicted that the British

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	September
GDP	2.6	0.6	0.3	–2.0	–5.0	–5.5	–	–5.2	–
Retail sales	4.2	2.6	1.3	1.8	0.4	0.9	2.8	2.2	2.4
Industrial production	0.3	–3.1	–3.2	–8.1	–12.5	–11.7	–9.3	–11.2	...
Unemployment rate (*)	2.7	2.8	2.8	3.4	4.2	4.7	4.9	4.9	5.0
Consumer prices	2.3	3.6	4.9	3.9	3.0	2.1	1.7	1.5	1.1
Trade balance (**)	–83.4	–93.7	–95.4	–94.1	–91.8	–88.4	–85.1	–83.3	...
3-month Libor interest rate	5.3	6.0	5.9	6.3	2.8	1.6	1.2	0.9	0.7
Nominal effective pound exchange rate (***)	103.9	97.6	92.8	89.4	73.9	77.0	83.7	84.4	81.4

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

economy would grow and leave the recession behind.

Given these disappointing results, it's worth noting the positive trend shown by consumption. In September, wholesale sales recorded their fourth consecutive month with year-on-year increases, 2.4%, and the consumer confidence indicator has recovered its level of March 2008. This positive tone contrasts with the slowdown in wages, which reflect the downward trend in the labor market, only growing 1.9% year-on-year in August.

On the supply side, industrial production has accentuated its downward trend, returning to negative year-on-year values of two digits (an unexpected 11.2% in August). Moreover, the slight improvement in the construction industry seems unsustainable due to the expected changes in price levels.

The threat of the British fiscal deficit, 11.6% of GDP forecast by the IMF for 2009 compared with an average of 5.3% for advanced countries, means that containment measures must be implemented, either increasing taxes or reducing spending, which might further impinge upon the already meager prospects for recovery. For the moment, the closeness of elections, expected in spring 2010, has prevented any specific plan being established for the medium term. However, the temporary fiscal stimuli which expire at the end of the year are not expected to be renewed, as is the case of the provisional reduction of 2.5 percentage points in Value Added Tax, which in January will go back to its previous level of 17.5%.

Fiscal deficit means that fiscal stimuli are living on borrowed time.

This rise in VAT and the base effect due to low oil prices at the start of 2009 will result in inflation picking up in the first few months of 2010. However, the Bank of England is not expected to moderate its expansionist policy due to the

Inflation expected to pick up early in 2010.

In emerging Europe, recovery will continue to be fragile, of moderate intensity and unequal in geographical terms.

fragility of the recovery. The unexpected absence of growth this quarter might even lead to an intensification of monetary stimuli.

Emerging Europe: goodbye recession, hello expansion?

Two decades after the fall of the Berlin Wall, emerging Europe is celebrating this important event, which has left a sweet and sour aftertaste. The events following November 9 1989 would give rise, in the long term, to true European reunification and a far-reaching structural change that has allowed these states to approach the living standards of Western Europe. However, this undeniable fact has been obscured by the tough crisis of 2009. In some cases, such as Hungary, it has been the worst recession since the fall of the Wall. Now that it seems to have done its worst and GDP might start to grow in the second half of 2009, it's a good time to reflect on the possible economic scenario for the coming year.

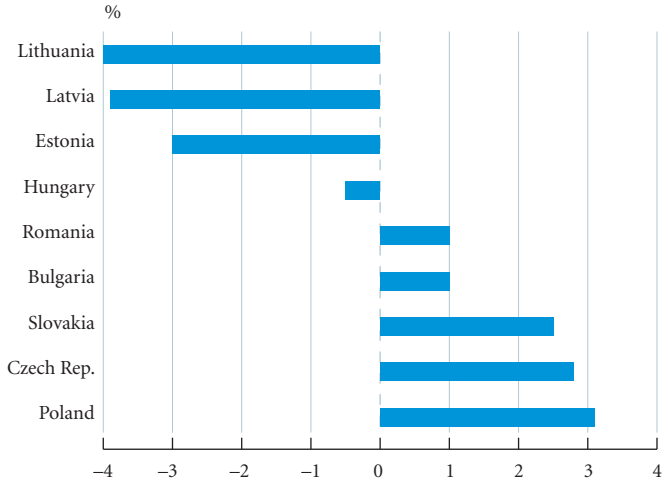
Although there are still many unknowns, three fundamental questions can be asked whose answer may provide the tone for the immediate future. The first question refers to the intensity of the recovery. Available indicators suggest clear improvement for 2010 but with some still fragile bases. We should remember that the greatest activity is fundamentally due to the recovery of the global industrial cycle, which largely results from the need to replace stocks that had fallen too low and also from the support received by certain key sectors (in particular, automobiles) in the central markets of the Euro Area.

Domestic demand still sluggish.

However, domestic demand still looks weak. We expect that, in the second half of 2010, the rise in exports will start to have a clearer effect on investment and the conditions will then be in place for a recovery in consumption. All this leads us to predict modest growth in 2010, below potential in all economies in the region. If everything goes as expected, it will be in 2011 when emerging Europe will grow again with certain dynamism,

OUTLOOK FOR 2010: RECOVERY DEPENDS ON WHERE YOU ARE

Real change in gross domestic product forecast for 2010



SOURCE: Own calculations.

relying in particular on expansion in the Euro Area being sufficiently intense and long lasting.

A second question hovering over the scenario is the evolution in international financing. Is it going to be enough to finance the impending expansion? The forecasts being given for 2010 are, with all due caution, reassuring. Assuming that there will be no new episodes of a global increase in risk aversion, the different aspects of international financing seem to be on the right track. According to forecasts from the Institute of International Finance, an association of large international banks, 2010 should see significant recovery in private capital flows. Moreover, the foreign debt to be attended to in 2010 (interest rates and capital amortization) is at a level that should not involve any difficulties. Also significant is the fact that international multilateral institutions are maintaining their financial commitments.

International financing should not be a serious problem in 2010.

The cyclic improvement and restructuring of international financial flows are reflected in the trends in country risk indicators, which have ostensibly moved away from the levels reached at the most critical moments of 2009, indicating that the market thinks a hypothetical non-payment of sovereign debt is not likely. Overall, the differences shown between countries remind us that the region is far from being homogeneous. In fact, a clear distinction should be made between three groups of countries: Poland, Czech Republic and Slovakia, in a better relative position; Hungary, Romania and Bulgaria, in an intermediate position; and finally, the Baltic countries.

Country risk indicators have ostensibly improved.

This segmentation leads us to a third question, namely what we will inherit from the recession. This question actually affects two different issues, so we should first ask whether the imbalances accumulated throughout the expansion phase cut short in 2008 have been corrected. But we must also ask about the delayed effects of the crisis.

In general terms, the recession has allowed the partial correction of the most inflated excesses in the previous expansion phase. Current deficit has fallen (fundamentally thanks to trade balance improvements), the strong preponderance of debt in foreign currency has dropped, growth in private credit has slowed up appreciably and inflationist tensions have become more moderate. On the other hand, the situation of public accounts has got significantly worse in 2009 although, with certain exceptions, this imbalance has been widened by the fall in public income and in spite of efforts to contain public spending. In fact, all these trends are largely due to developments in the cycle and we will therefore have to keep an eye on how they might regenerate in a more dynamic economic environment.

Neither should we ignore the delayed effects of the crisis, i.e. all the consequences of the current weakness in the economy that will progressively appear in the near future. One of them, bank debt, will be at record high levels throughout the first half of 2010. Although the data are not fully comparable, we can note that the Baltic countries, together with Romania and Bulgaria, are probably going to have default levels approximately three times those expected for Poland, the Czech Republic and Slovakia. That's why these countries will probably need new bank recapitalization in order to maintain their current levels of solvency.

Certain macroeconomic imbalances have lessened due to the crisis.

There will be an increase in bad debt, while improvements in employment are still a long way off.

Other variables that are going to get worse due to their delayed nature compared with the cycle are those concerning the labor market (in particular, the unemployment rate will rise in 2010), whose trends will ultimately condition the recovery in private consumption. Similarly, and although the links are not direct here, it is likely that political instability will increase, as has already been seen on occasion throughout 2009. In general terms, the three countries that began the crisis with fewer macroeconomic imbalances, the already mentioned Poland, Czech Republic and Slovakia, are going to be in a better position in the recovery, as they will tend to suffer less dramatic delayed effects from the crisis in 2010.

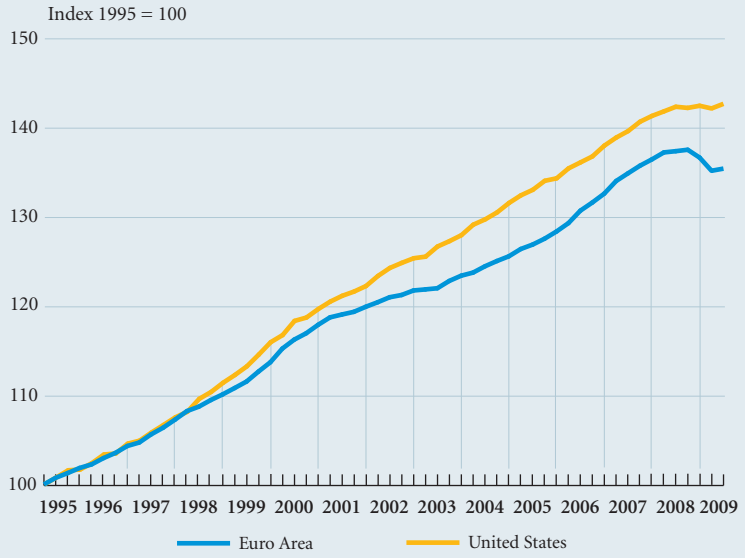
Good service serves a purpose

Growth in the Euro Area has clearly lagged behind that of the United States over the last few decades. For example, since 1995 the Euro Area's average growth rate has remained at 1.9%, while in the North American economy the figure has reached 2.7%. There are various explanations for this disparity in growth, but how the services sector has evolved is certainly one of the factors to be taken into account.

In both economies, the services sector is the most important of all. Throughout the European Union, more than two thirds of workers are in this sector and its contribution to growth has been around 75% over the last decade. It is also vital for this sector to perform well so that other sectors can maximize their production capacity. A good example of this is the financial sector, as well as communications and transport. A developed financial system or good communication and transport networks are essential for industry to develop.

SERVICES IN EUROPE ARE NOT GROWING LIKE IN THE UNITED STATES

Trends in real gross value added of the services sector



SOURCE: Eurostat and Bureau of Economic Analysis.

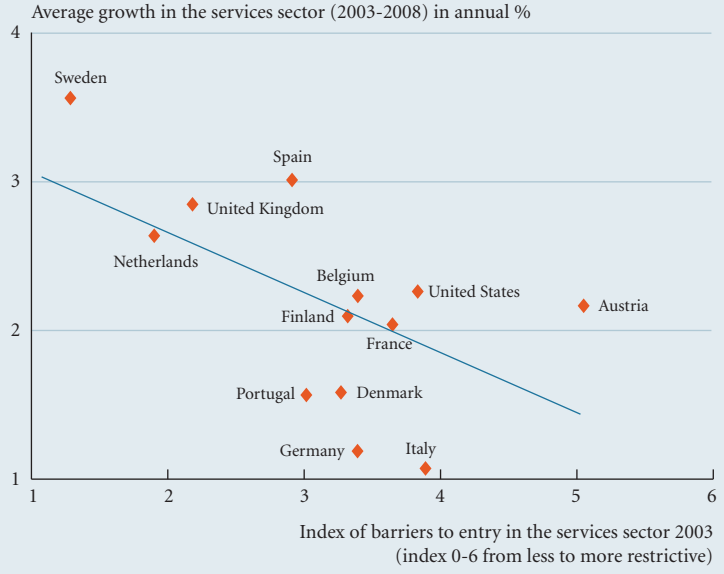
As can be seen in the graph above, the growth rate for services as a whole in the United States has continually remained above the European rate. The result: the gross value added of services has grown 43% in the United States. Growth has also been substantial in the Euro Area but it has remained eight percentage points below the American figure.

The European Commission believes that higher levels of regulatory intervention, and differences in regulation at a national level, do not allow the European services sector to achieve its potential growth. The free circulation of capital and people between different countries in the EU was a first and decisive step to boost the single market. However, trade in services has remained very limited, particularly if we take into account the sector's importance for the economy as a whole. That's why, in December 2006, the European Parliament passed the Services Directive and this will be transposed by the different member states to their own legal systems before the end of the year.

The Directive has three main objectives: to reduce barriers to the entrance of new competitors, promote trade in services between countries and harmonize regulation at a European level. And the Directive will apply to all companies in the sector except those subject to specific regulations at a sector level, such as the financial sector, social services and health.

Substantial positive effects are expected from the Directive coming into force. A company or professional that currently wishes to export services or wishes to set up shop in other countries of the European Union must first get information on and then adapt to the specific regulations of each country. This provides the different national companies or professionals in the sector with a certain degree of protection against competition. Reducing barriers to entry and to trade in general will increase the competitive pressure on companies and will therefore also improve the sector's efficiency and growth. This is precisely what the following graph

BARRIERS TO ENTRY REDUCE THE SECTOR'S GROWTH



SOURCE: OECD and Eurostat.

shows. In countries where barriers to entry were higher in 2003, the average growth of the services sector in subsequent years has been lower.

Of course, there are some studies that provide a somewhat more sophisticated analysis of the expected effect of the change in the degree of regulation on economic growth. The study commissioned by the European Commission,[1] for example, uses an extensive database of firms to analyze the Directive's effect on the sector's gross value added, productivity, employment, wages and prices. The results are certainly positive. According to this study, increased competition will make prices fall and this will help total consumption rise by 0.6%. Improved productivity will also help generate 600,000 net jobs. Neither is the estimated effect on the sector's gross value added at all insignificant, a rise of 0.8%.

However, a later study points out the importance of one of the points in the Directive that was ultimately not approved: the so-called country of origin principle.[2] According to this, any firm that complies with the regulations of an EU country should be able to do business in any other country. This principle, fundamental for sector integration at a European level, provoked distrust in some countries, fearful of losing control over certain key services. The debate engendered was intense. One of the sources of tension was that labor-intensive service companies would hire their workers in those countries where labor was cheaper and, moreover, under the labor conditions of the country of origin. This puts great pressure on the degree of labor protection. So the effects on growth, although significant, will be less than those initially forecasted. The effect on trade in services will be substantially reduced and, instead of rising by around 45%, it will now grow 30%. This will also have a direct effect on GDP, which will increase 0.3% instead of the initial forecast of 0.5%.

The approval of the Services Directive still arouses some fears, such as lower quality in the provision of services. It's very difficult to quantify this effect and it has therefore not been taken into account in the studies carried out. Now that the Directive has been approved, its effects will have to be closely monitored so that the maximum benefits can be reaped without reducing service quality.

(1) Copenhagen Economics, *Economic Assessment of the Barriers for the Internal Market for Services*, 2004.
(2) De Bruijin, Kox, Lejour, *The Trade-Induced Effects of the Services Directive and the Country of Origin Principle*, CPB Document 108, 2006.

This box was prepared by Oriol Aspachs-Bracons
European Unit, "la Caixa" Research Department

FINANCIAL MARKETS

Monetary and capital markets

Getting back to normal in monetary terms: the importance of choosing the right moment

As the worst of the financial crisis lies behind us, the world's two leading central banks, the Federal Reserve of the United States (Fed) and the European Central Bank (ECB), claim to have detected greater stability in financial markets. This diagnosis explains why the Fed has decided to modify some of the facilities created to tackle the crisis. For example, since the start of the summer, the Fed has reduced the TAF (Term Auction Facility) from 250,000 million dollars down to 150,000. In Europe, the greater liquidity enjoyed by institutions is reflected in the sharp drop in funds requested in weekly refinancing transactions. Demand recorded in the last few weeks has been below 100,000 million euros, three times less than the record levels at the end of 2008. This situation reinforces the monetary authorities' belief of the need to focus all efforts on planning an exit strategy, with the aim of systematically withdrawing the extraordinary injection of cash carried out.

These exit strategies have two lines of action: one passive and one active. The passive line simply requires facilities to be allowed to expire and these are then not renewed, such as auctions of loans in dollars or the loan facility to buy commercial paper. In fact, the amount of some of these facilities has already significantly fallen from the high levels reached at the end of 2008 due to the lower demand for liquidity on the part of financial institutions. The second line of action, specific measures to reduce the supply of liquidity and/or higher interest rates, presents significant challenges due to the possible impact on markets operations and on the expectation created among agents regarding inflation. The right time to act must be chosen for this active strategy to be successful, as well as applying caution in using the available instruments.

The greater stability of financial markets...

In a recent press release, the Fed has acknowledged that, in collaboration with market agents, it is trying out operational aspects related to the draining of liquidity (specifically through reverse repo agreements). It's evident that the Fed is planning ahead so that, once the right moment comes, everything will go like clockwork. The Fed is also considering the possibility of extending the number and type of counterparties to operate with it beyond the 19 officially appointed primary dealers. The monetary authority is also evaluating the use of other instruments such as buying back banks' surplus reserves or the direct sale of assets.

...reinforces the Fed and ECB's view regarding the need to push forward with strategies to withdraw monetary expansion.

The ECB's position for reversing the huge expansion in its balances is less complex than that faced by the Fed. However, a note of great caution lies over the institution. This explains why, after the famous monetary policy meeting held on October 8, Jean-Claude Trichet once again stressed the need to outline, very much in advance, the road map to be followed in order to withdraw

The Fed tries out operational aspects related to the draining of liquidity.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro Area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2008									
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	1.00	0.75	1.24	0.25	0.29	0.35	0.50	0.54	0.31
October (1)	1.00	0.74	1.25	0.25	0.28	0.33	0.50	0.59	0.24

NOTES: (1) October 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.

Interbank interest rates in the Euro Area and the United States remain stable.

monetary and fiscal stimuli. Europe's main line of action has been to relax conditions for short-term refinancing operations and to create special one-year loans (LTRO). This will allow the ECB to follow an essentially passive strategy or, should inflationist risks arise, to implement, for example, reverse repo agreements in the style of those being prepared by the Fed. Due to its modest size, the bond purchase program started up by the ECB does not represent a significant obstacle for the exit strategy. In the current economic climate, changes in conventional monetary policy (interest rate modifications) are not likely until 2010 is well underway. Weak growth and probably stable inflation are helping central banks to maintain additional interest rates at low levels for a period of time, so as not to interrupt the incipient economic recovery and the normal functioning of markets.

In this respect, the stability (and also the low levels) recorded by interbank interest rates in Europe and the United States show that the markets do not think official interest rates will remain low for a prolonged period. It is likely that, in the spring of 2010, the Fed and the ECB will modify the tone of their communication policy and begin to signal the time when they might start

to raise interest rates. A slight upward trend will be observed in the interbank interest rates at this point.

Stability in government bond markets

The table below shows how the government bond markets remained stable during October. In fact, rates started to settle firmly at low levels during the month of June. So, for example, the 10-year German bund offered an annual interest rate of 3.29% at the end of October, very close to the level recorded for June. But not only German debt, because the other bonds issued by central governments in the Euro Area have also shown the same lack of movement.

What is the reason for such a dearth of significant change in this financial market? There are two key factors that can explain this situation. Firstly, investors and analysts have not substantially changed their expectations regarding inflation over the last few months, so most institutions publishing forecasts of the economic situation agree that the price recovery will be modest and tension-free. In other words, at present most people continue to observe an absence of inflationist problems, substantiated by the high degree of leisure capacity in economies and in spite of the huge liquidity being issued by central banks.

There are no significant changes in the government bond markets...

Secondly, the amount of debt issued by members of the Euro Area has fallen in the third quarter compared with the two previous quarters. In fact, most governments have already issued 90% of their targets for the year, as each of them has attempted to bring forward their schedule of issues so that, by this last

...due to the firmness of inflation expectations and the low volume of issues.

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								
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	3.22	3.54	3.81	4.02	3.31	1.30	3.59	1.99
October (*)	3.29	3.60	3.85	4.14	3.36	1.36	3.64	2.12

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

Firm inflation forecasts and fewer government bond issues are factors that contribute to stability.

stage of the year, there are relatively few bonds being offered.

However, for these two elements, and particularly the second, there is a risk of change in the coming months and in 2010 and this might lead to the reappearance of tension in government bond markets.

Exchange rates: the dollar has depreciated

The table below shows how, during the last month, the dollar has fallen by 1.8% against the euro. One euro is currently worth 1.49 dollars, 12.6% more than one year ago. It should also be noted that the dollar has not only fallen against the euro but has depreciated against most currencies.

Low interest rates in the United States have helped to weaken the dollar.

Low interest rates in the United States have led to this fall in the dollar. International investors take out debt in dollars, taking advantage of the currency's low interest rates, and also buy assets issued in currencies that provide a higher return. This kind of financial deal is known as carry trade, referring to the difference between the exchange rate financing the transaction and the interest rate offered for the assets bought.

The cheaper dollar has sparked a response in many countries and not just verbally. Some central banks in Asia have jointly intervened in currency markets to put a stop to their currencies appreciating against the dollar. These countries are worried about their exports becoming less competitive compared with China, which has

EXCHANGE RATES OF MAIN CURRENCIES

October 21, 2009

	Exchange rate	% change (*)		
		Monthly	Over December 2008	Annual
Against US dollar				
Japanese yen	90.9	–1.1	0.3	–10.2
Pound sterling	0.603	–2.2	–13.5	0.8
Swiss franc	1.010	–2.2	–5.8	–13.9
Canadian dollar	1.054	–2.4	–15.6	–15.2
Mexican peso	12.995	–3.0	–5.2	–1.9
Against euro				
US dollar	1.494	1.8	6.5	12.6
Japanese yen	135.9	0.7	6.7	3.7
Swiss franc	1.510	–0.3	1.1	0.4
Pound sterling	0.902	–0.4	–5.9	13.3
Swedish krona	10.354	2.1	–5.7	1.9
Danish krone	7.444	0.0	0.0	–0.1
Polish zloty	4.160	–0.3	0.3	11.4
Czech crown	25.83	2.7	–4.0	1.0
Hungarian forint	264.6	–2.4	–0.4	–5.2

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

actually kept a fixed exchange rate against the dollar since July last year. For its part, Brazil decided to impose a tax on short-term foreign capital inflows, also with the aim of dissuading flows that make the Brazilian real more expensive against the dollar.

Even European finance ministers and the President of the ECB, Jean-Claude Trichet, have announced that they are against the excessive appreciation of the euro. In short, this might hinder or delay the recovery of the Euro Area because exports are an essential element in boosting the EU's business cycle. In order to consolidate global recovery, it would certainly be desirable to avoid excessive volatility in currency markets. However, the likelihood of rises in the US reference interest rate throughout 2010 should help to slow up or even reverse the current downward trend in the dollar.

Asia and Europe are concerned about the dollar's depreciation and its impact on their exports.

Consolidation in advances of corporate bonds

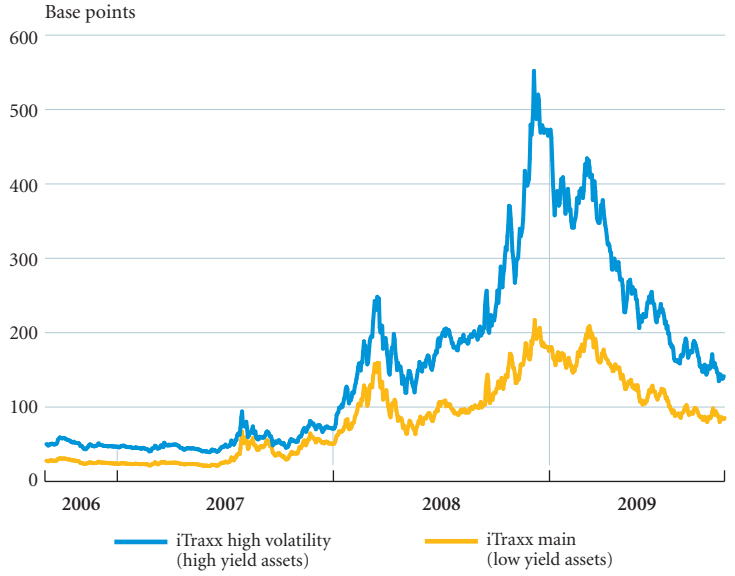
In October, the bond markets have consolidated their upturn thanks to the gradual improvement in expectations for economic recovery, to lower risk in financial markets (supported by actions by governments and central banks) and to investors' increased appetite for risk given the meager returns from other financial assets.

This improvement has resulted in a widespread fall in yields and a reduction in spread. The resolve of central banks to keep interest rates at low levels for a period of time has reduced the cost of debt in some sectors, such as mortgages, to minimum levels. This is the case of the United States, where the cost of 15-year mortgages has fallen to below 4.5%, record levels. The drop in financing costs

Widespread reduction in yields and credit spreads in corporate bond markets.

WIDESPREAD DROPS IN RISK PREMIA

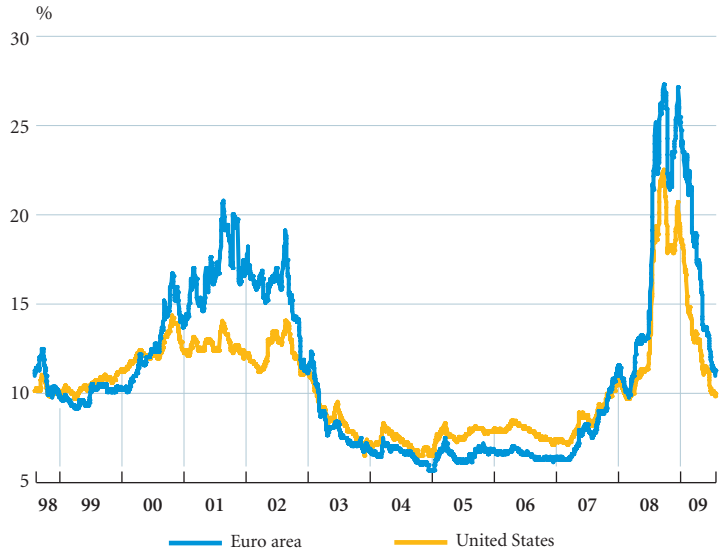
Credit spread in the Euro area



SOURCE: EcoWin.

SHARP DROP IN RETURNS FROM HIGH YIELD MARKETS

Returns from high yield bonds in the Euro area and United States



SOURCE: EcoWin.

Companies continue to issue at top speed, taking advantage of highly favorable market conditions.

and in credit spreads is closely linked to the lenient approach maintained by central banks.

Improvements in the wholesale market over the last few weeks have been greater in high yield segments and those with central bank intervention. In the United States, the start-up of the toxic asset purchase program (PPIP) has been vital in improving this sector, while in the Euro Area the ECB's purchase of covered bonds has had a very positive effect on these assets.

Companies are taking advantage of low financing costs and high liquidity in markets to issue record amounts of corporate debt. Both in the United States and in Europe, the amounts of bonds issued by companies continue to smash records in a process that is affecting a wide range of issuers with regard to country, sector and rating.

For their part, private investors are still attracted by the yield-risk dichotomy. Since last April, the amount of capital flows towards the private bond market has increased non-stop. Everything suggests that this process will continue during the coming months because cash funds are still recording high levels of assets and their yield is practically zero.

The gradual improvement in the macroeconomic situation and the sharp fall in financial risk, spurred on by central bank intervention, are encouraging rating agencies to up the ratings of firms. The fall in expected default rates in various sectors of the United States, as well as in other countries, is notable, particularly in the high yield segment. This situation reflects the effectiveness of central bank action, as well as the economic recovery.

In the medium term, and notwithstanding temporary adjustments, the outlook for bond markets continues to be positive, based on the consolidation of economic recovery and a gradual improvement in

corporate profits. Within this context, the flow of investment towards this market is expected to remain firm. At the same time the issuing of corporate bonds will slow up, principally because most large firms have already issued medium and long-term debt and their financing needs have been met for the next few months.

Stock markets moderate their pace of growth

Equity markets once again performed well in October, although the overall tone has been one of moderation in the speed of revaluation. We must remember that, since the record lows in March, the main stock market indices have accumulated an average revaluation rate of 60%.

In a context where liquidity levels are still very high, investors are increasingly attracted by the possible returns provided by high yield assets, such as shares. In fact, a lower aversion to risk has played a key role in stock market appreciation, at a time when institutional funds' initial levels of participation in equity were low.

Other factors boosting the stock markets, related to the business sphere, are the success of corporate results in the third quarter, as well as investment picking up in hedge funds.

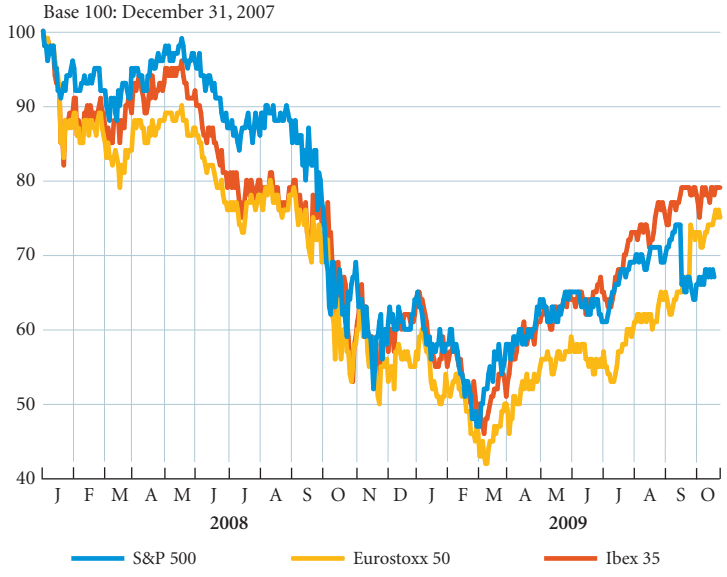
In fact, one of the most eagerly awaited events by investors and portfolio managers is the periodic publication of the profits of listed firms. The campaign started in October to publish the third quarter results in the United States and Europe, with positive surprises predominating. After the drastic slump in forecasts during the first few months of the year, analysts have steadily improved their estimates since April.

The future for the sector continues to look good, especially due to the low yields provided by alternative investments.

The rise in stock markets is supported by economic recovery and reduced risk.

STOCK MARKETS CONTINUE THEIR UPWARD TREND

Key stock markets



SOURCE: Bloomberg.

Corporate profits have recovered in the second half of the year.

In addition to the good results being published, the recovery in the global economy, fall in risk premia and greater market volatility have all contributed to the change in estimates by financial analysts.

The fact that the percentage of firms publishing better results than expected is substantially higher than those with negative surprises is one of the main driving forces behind the indices. In addition to confirming that corporate recovery is underway, this also supposes a rise in yield per share and attracts flows of investment. To date, out of the 40% of the S&P 500 companies that have published their results, 80% have presented favorable surprises. The fundamental reason for this increase has been the aggressive cost cutting carried out by firms, particularly in terms of workforce.

Hedge funds return to risk asset markets.

Another aspect that contributes positively is the return of hedge funds to equity markets. At the start of the crisis, these specialized funds almost totally abandoned risk assets as a whole, dragging down share prices. Now, when the deficiencies in the global financial system seem to have been resolved, and given a more stable medium-term economic outlook, once again hedge funds have started to position themselves in corporate bond and equity assets with a marked preference for those of emerging economies.

INDICES OF MAIN WORLD STOCK EXCHANGES

October 27, 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.

In the medium term, the upward trend in stock markets should continue, although the pace of increase may slacken; but it is in the short term where indices are more likely to be adjusted. In effect, after eight consecutive months of stock market revaluation, and within a context where normality in the financial system seems to have almost been restored, the main risk consists of investors reacting negatively to disappointment in the pace of global economic recovery.

The main risk is deterioration in expectations regarding the economic recovery.

The post-crisis financial system: smaller and simpler?

The financial sector has undergone a rampant crisis of international scope over the last two years. At its crucial point at the end of 2008, various organizations succumbed to difficulties, some financial markets became blocked and, in fact, the system as a whole was close to collapse. Catastrophe was largely avoided thanks to the decisive intervention of governments and central banks in most countries.

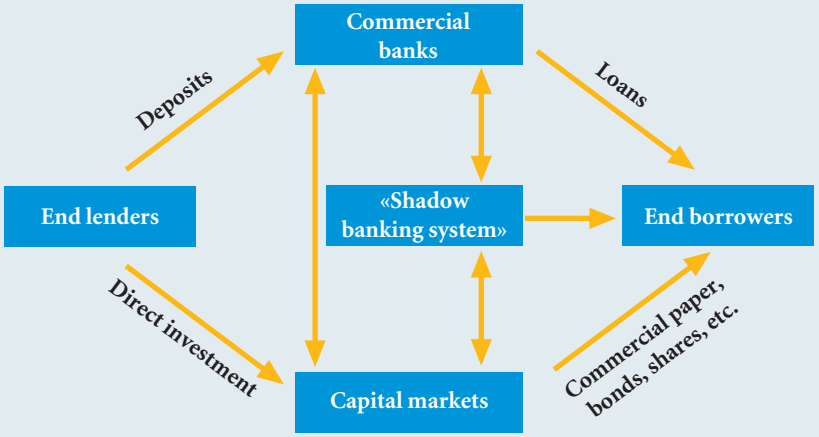
As on other occasions throughout history, a crisis of this magnitude is triggering major transformations in the system's physiognomy. On the one hand, supra-national and national authorities are implementing a program of both wide-ranging and far-reaching regulatory reforms, while lenders, borrowers and brokers are modifying their patterns of behavior based on the lessons learned during this traumatic experience, as well as on the new prevailing circumstances.

It's still far too early to get a precise picture of how the financial system will look within, let's say, four or five years. But it is possible to identify some forces in motion that will more than likely be decisive.

But first, it might be useful to briefly go over some basic features of how this system evolved during the years before the crisis. Two aspects stand out: the financial sector increased its presence in the economy as a whole and did so oriented towards an increasingly more disintermediated and more complex model. The points of departure, details and circumstances were naturally different in different countries, but this was certainly the general pattern.

Disintermediation refers to the fact that, in addition to traditional banks (which take deposits from savers and give out short and long-term loans), a large number of other channels developed to transfer resources from those with a surplus to those with a deficit. Firstly, the classic capital markets, such as those allowing governments to issue bonds or companies commercial paper, bonds and shares, which are then acquired by savers (either directly or, for example, through mutual or pension funds). Secondly, a variety of organizations and instruments that, with the support of capital markets, step in and redirect resources towards end borrowers. This complex structure, which some call the «shadow banking system», includes institutions such as investment banks, money market funds, SIVs (Structured Investment Vehicles), hedge and private equity funds, as well as (in its broadest sense) instruments such as securitization or credit derivatives. It was precisely these institutions that led to the greater presence of financial activities in the economy as a whole, especially in the United States (it is estimated that, in 2007, the volume of assets managed by these institutions exceeded that of traditional commercial banks).

DIAGRAM OF THE FINANCIAL SECTOR



SOURCE: Own calculations.

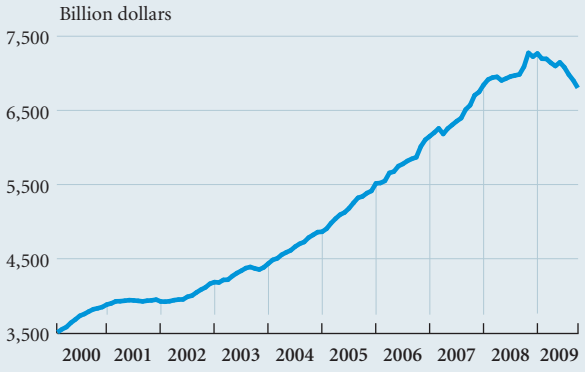
The crisis and its repercussions have altered how these three types of channel work, but not all in the same way. The shadow system has been its greatest victim. In fact, the turmoil was created and spread largely through the dysfunctions and weaknesses of institutions such as investment banks and complex structured financing instruments (SIVs, CDOs). Most of these elements have disappeared or have been transformed into simpler versions. Other areas, such as hedge and private equity funds, have seen a huge drop in volume. The problems of securitization markets are particularly of note, considering just how large they had become in the years before the crisis and their links with some banks (those adopting the originate-and-distribute model). Over the last few months, securitization issuance has relied almost exclusively on the participation of governments (as guarantors) or central banks (as purchasers or financers), while issuance on the open market has been very low.

The work of the traditional banking sector, although weak, has not suffered so greatly. In fact, during the toughest stage in the crisis, part of the activity of the «shadow system» was rechanneled towards the balances of commercial banks. Subsequently, and due to the severity of the deterioration in the real economy and to a logical deleveraging process on the part of banks and families, loans have slumped. However, the extent of this decrease, both in the United States and in Europe, has not deviated substantially from the empirical regularities observed in business cycles of the past. On the other hand, the evolution of deposits over the last two years of crisis has been almost tension-free, albeit with the help of extended government guarantees.

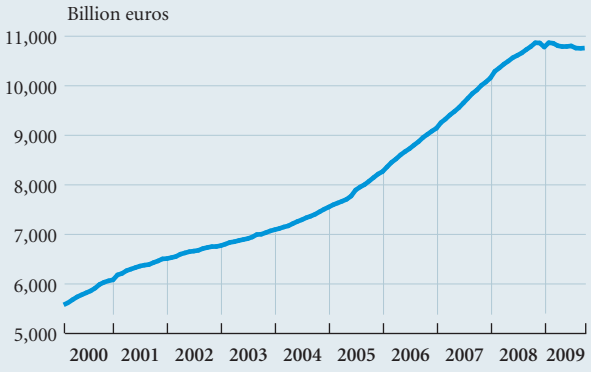
Lastly, the dynamics of the classic capital markets provide a certain counterpoint to this situation. Some of these markets also stopped during the critical weeks after Lehman Brothers went bust, but they soon recovered and are really booming this year. In the case of government bond markets, this was entirely to be expected. More remarkable are the records being set in corporate bond issuance, first from high rating firms and, more recently, from low quality enterprises. Without doubt, these markets have indirectly benefited from the measures adopted by governments and central banks, but also in their favor is a higher degree of transparency than in the case of securitization, together with limitations on the loan capacity of banks depending on their capital status.

FINANCIAL MARKET ACTIVITY

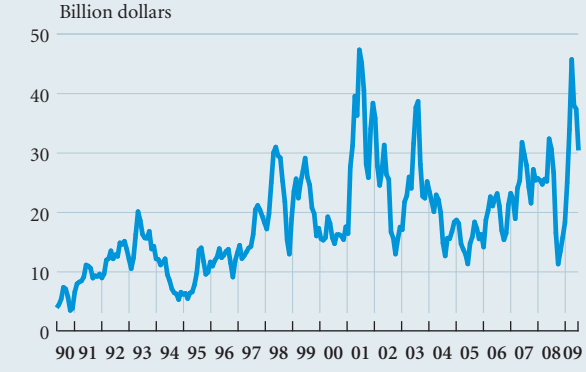
Bank loans in the United States



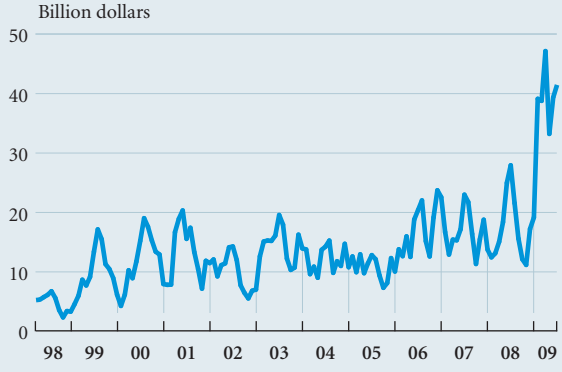
Bank loans in the Euro area



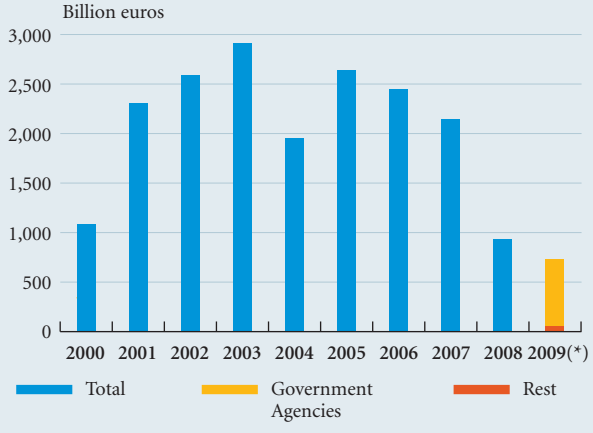
Corporate bond issuance in the United States (**)



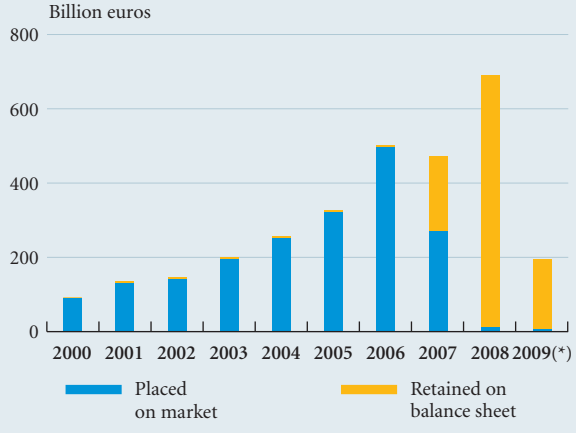
Corporate bond issuance in Europe (**)



Securitization issuance in the United States



Securitization issuance in Europe



NOTES: (*) Up to June.
(**) Quarter moving average.
SOURCE: Fed, ECB, IMF, SIFMA and ESF.

In short, the initial reaction to the crisis has been a reduction in the size of the financial sector and a reorientation towards simpler markets and instruments. As we move on from the crisis, whether these patterns continue in the medium and long-term will depend on how some fundamental factors evolve (technological, macroeconomic and regulatory), which in previous years were pushing towards a large, complex system.

Changes in the regulatory framework will be particularly important. The overriding opinion is that far-reaching reforms are required to mitigate systemic risk, i.e. the risk that problems initially localized in one area, market or institution will spread to the system as a whole. From this perspective, the «shadow system», scarcely regulated or supervised in the past, is now being subjected to thorough scrutiny (new rules for hedge funds, for CDS, for securitization, etc.). This will probably delimit its development and interdependence with other areas. With regard to the traditional banking sector, the key proposals focus on increasing the capital and liquidity requirements of individualized institutions, at the same time as establishing mechanisms to avoid problems being passed on from one to the other. These requirements will be proportionally greater for large institutions and for those carrying out complex, high risk activities (securitization, trading, etc.) In this case, the likely outcome will be simpler activities but also less availability and more expensive credit. On the other hand, reforms put forward for the classic capital markets do not seem to be as significant and basically aim to improve transparency (e.g. through rating agencies).

On the whole, given the nature of these initial proposals for reform, we might hope that the new trend towards a simpler, more delimited system will indeed become firmly established. However, the regulatory process has only just begun and the push for reform may slow up or even change direction due to various reasons, such as insufficient coordination between the different regulatory levels, especially internationally.

This box was prepared by Avelino Hernández
Financial Markets Unit, "la Caixa" Research Department

SPAIN: OVERALL ANALYSIS

Economic activity

The recession is easing up

The decline in activity has slowed up thanks largely to the monetary and fiscal stimuli implemented by the European Central Bank and the Spanish government, and also to the improved international situation. Confidence is therefore returning gradually, as can be seen in the graph below. However, economic progress is fragile and requires the boost provided by stimuli. Confidence indicators were therefore still below past averages.

Within this context, of particular interest is the economic situation of companies, a fundamental factor in recovering from recession. According to data from the Quarterly Composite Balance Sheet, published by the Bank of Spain, in the first six months of 2009 the value added of firms in the sample (calculated by subtracting intermediate consumption goods from the value of production) fell by 15.7% year-on-year compared with a rise of 2.1% during the first half of 2008.

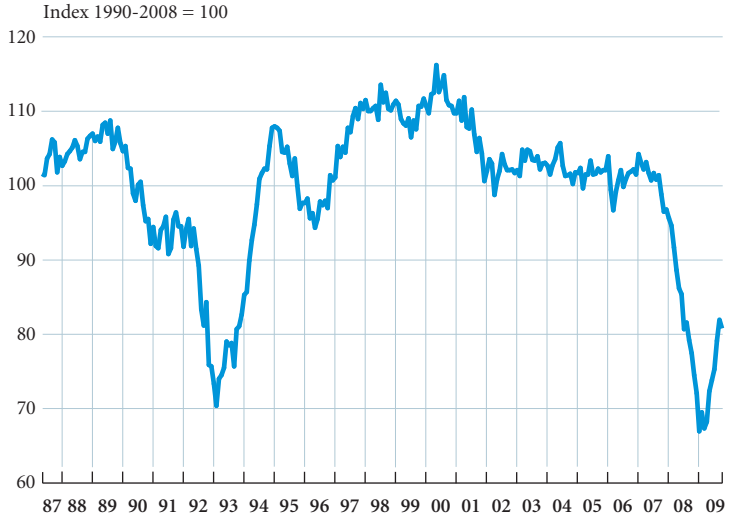
Economic stimuli help to slow up the decline in activity.

Staff costs fell by 0.7%. Similarly, gross operating profit was down 27.0% compared with a year ago and the net ordinary result suffered a similar year-on-year decrease of 28.0%. Lower profits than usual intensified the slump in results for the year, these being 37.4% compared with a high of 43.6% in the first six months of 2008. However, this surplus continues to be notably positive, accounting for 34.2% of gross value added. On the other hand, both the

Business profits slump.

CONFIDENCE SHOWING SOME IMPROVEMENT

Economic sentiment indicator (*)



NOTES: (*) Made up of confidence indicators for industry, services, consumers, construction and retail. Seasonally adjusted.
SOURCE: European Commission.

PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES

Annual change rates

	2008	First half-year semester	
		2008	2009
Value of production	3.1	8.8	–25.2
Intermediate consumption	6.1	12.2	–30.0
Gross value added (GVA)	**–3.3**	**2.1**	**–15.7**
Wage costs	3.5	4.6	–0.7
Gross operating profit	**–8.3**	**0.3**	**–27.0**
Financial income	2.2	17.5	–4.4
Financial costs	15.8	21.2	–20.6
Depreciation and provisions	–0.1	–2.7	–4.5
Net ordinary profit	**–17.3**	**0.5**	**–28.0**
Profit/loss due to disposal and deterioration	–	–	–51.0
Variations in fair value and rest of profit/loss	57.4	84.7	–76.9
Corporate income tax	–68.5	2.2	–30.0
Net profit	**–29.1**	**43.6**	**–37.4**

SOURCE: Bank of Spain (Quarterly Composite Balance Sheet).

Automobile sales are up thanks to direct subsidies.

ordinary return on net assets as well as on equity continued their downward slide, standing at 5.6% and 7.4%, respectively.

Going back to the economic situation overall, available data show less deterioration in consumption but with some good and bad points. The best results come from automobile sales, which in September recorded a year-on-year rise of 18.0% thanks to the direct subsidies of the Plan 2000-E implemented by the central government and most autonomous communities. However, the worsening of unemployment in September, once the effects of the municipal works plan financed by the central government had come to an end, was bound to have a negative effect on consumer confidence, whose index has fallen slightly.

Sharp contraction in investment.

With regard to investment, some indicators, such as the production of capital goods and registration of industrial vehicles, suggest that the downward trend is being contained. Nevertheless, domestic sales of equipment and software in large firms continue their sharp year-on-year drop, falling by 25.0% in the first two months of the third quarter.

Investment in construction, an early indicator based on the apparent consumption of cement over the last few months, is falling more slowly but still saw a year-on-year decrease of 23.7% in September. In fact, the residential subsector is continuing the readjustment forced on it by ever-increasing stocks of housing, as the number of finished homes exceed the number of houses being sold, although house purchases have been helped to a certain extent by the fall in interest rates and real estate prices over the last few months.

From the point of view of supply, data for industrial production in August showed the odd hint of improvement.

DEMAND INDICATORS

Percentage change over same period year before

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
Consumption									
Production of consumer goods (*)	1.7	–4.7	–4.5	–10.3	–12.6	–9.4	–11.9	–9.3	...
Imports of consumer goods (**)	5.1	–7.7	–4.1	–17.2	–9.4	–14.9	–9.1	2.2	...
Car registrations	–1.2	–28.1	–32.5	–46.6	–43.1	–33.7	–10.9	0.0	18.0
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	–22.0
Investment									
Capital goods production (*)	4.6	–8.8	–8.0	–20.8	–30.5	–24.7	–26.3	–13.0	...
Imports of capital goods (**)	9.8	–19.6	–15.9	–28.8	–31.3	–35.1	–37.2	–15.9	...
Commercial vehicle registrations	0.3	–43.6	–50.1	–61.3	–52.4	–51.9	–37.8	–27.0	–22.9
Foreign trade (**)									
Non-energy imports	7.3	–4.9	–4.1	–19.0	–26.0	–26.8	–18.9	–11.0	...
Exports	4.2	1.9	7.8	–8.4	–17.9	–14.7	–9.3	–6.4	...

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

This is offset, however, by the higher year-on-year fall in electricity consumption in September, 2.8% compared with 0.5% the previous month, and the slight setback in the confidence index of the secondary sector at the end of the third quarter.

Turnover for services fell by 14.4% year-on-year, adjusted for the number of working days in August, a decrease that is practically no lower than the one recorded for the previous month, although slightly lower than the figure for the first four months. The subsectors with the highest year-on-year drops were trade, transport and company services. Neither are the trends favorable in tourism, also affected by the international crisis. The summer season was a little better than the first half of the year but it ended with a year-on-year fall of 7.8% in visits by foreign tourists in the third quarter, a mere 0.4 percentage points less than the previous quarter.

The difficult economic situation has led to fewer companies being set up. Accordingly, 4,663 commercial companies were registered in August, 18.3% fewer than in the same month in 2008. Overall, this drop is less than the accumulated figure for the first eight months of the year, namely 29.2%. However, more companies are being wound up. In August, 974 firms were dissolved, 33.8% more than twelve months before.

More companies being wound up.

In terms of the outlook, the economic situation continues to recover but in no way can we say that the huge imbalances accumulated by the Spanish economy have been completely amended. Consequently, and with the help of higher foreign demand, the Spanish economy is likely to continue moving out of recession, but this will happen very gradually.

A gradual recovery in the economy is expected.

SUPPLY INDICATORS

Percentage change over same period year before

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
Industry									
Electricity consumption (1)	4.4	0.6	1.2	–4.1	–7.0	–6.6	–2.8	–0.5	–2.8
Industrial production index (2)	2.0	–7.3	–6.3	–16.6	–22.6	–18.6	–18.0	–13.1	...
Confidence indicator for industry (3)	–0.3	–18.0	–18.7	–32.7	–36.7	–35.5	–32.0	–27.0	–28.0
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	–17.2	...
Construction									
Cement consumption	0.2	–23.8	–25.2	–38.1	–46.1	–36.0	–32.3	–21.2	–23.7
Confidence indicator for construction (3)	9.3	–22.6	–23.7	–34.7	–36.7	–35.0	–32.0	–24.0	–23.0
Housing (new construction approvals)	–24.7	–59.4	–62.4	–60.2	–64.1	–62.8	–50.7	...	...
Government tendering	–15.0	3.0	6.4	12.4	–5.3	–8.2	3.2	...	...
Services									
Retail sales (6)	2.3	–6.3	–7.1	–7.7	–6.3	–4.2	–2.8	–3.0	...
Foreign tourists	1.1	–2.5	–5.4	–9.0	–16.2	–8.2	–6.1	–8.1	–9.5
Tourist revenue inflows	3.3	–0.4	0.2	–8.0	–14.3	–8.0	–8.3	...	...
Goods carried by rail (ton-km)	–3.7	–7.7	–1.7	–23.0	–34.1	–34.9	–43.9	–27.3	...
Air passenger traffic	9.0	–3.0	–4.8	–12.7	–18.2	–8.7	–4.8	–5.5	–5.2
Motor vehicle diesel fuel consumption	5.1	–3.8	–3.7	–7.7	–10.3	–5.1	–3.7	...	...

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

Shopping mall or main street shopping?

The 15th century Grand Bazaar in Istanbul holds 55,000 square meters of stores and covers more than 58 streets. For some people it is the first large shopping mall in history. However, the image evoked by today's notion of a shopping mall is not that of a legendary marketplace in the heart of the city but of a modern commercial area on its outskirts. Now that the deadline for transposing the European Services Directive is approaching, the debate in Spain has intensified on the costs and benefits of liberalizing retail trade, a debate that tends to oppose this new generation of commercial areas to more urban and traditional small-format stores.

In a market economy, the aim of regulation, not only that on retail trade but on any sector, is either to correct a market failure yielding a sub-optimum allocation of available resources, or to achieve non-economic goals,

generally of a social or political nature. When this regulation manages to resolve a market failure, resources are allocated more efficiently. However, when regulatory intervention has non-economic aims, a certain loss of efficiency is justified by defending other priorities of general interest, such as preserving the environment or a more evenly balanced urban development. In both scenarios, regulation can improve welfare in its broadest and not exclusively economic sense.

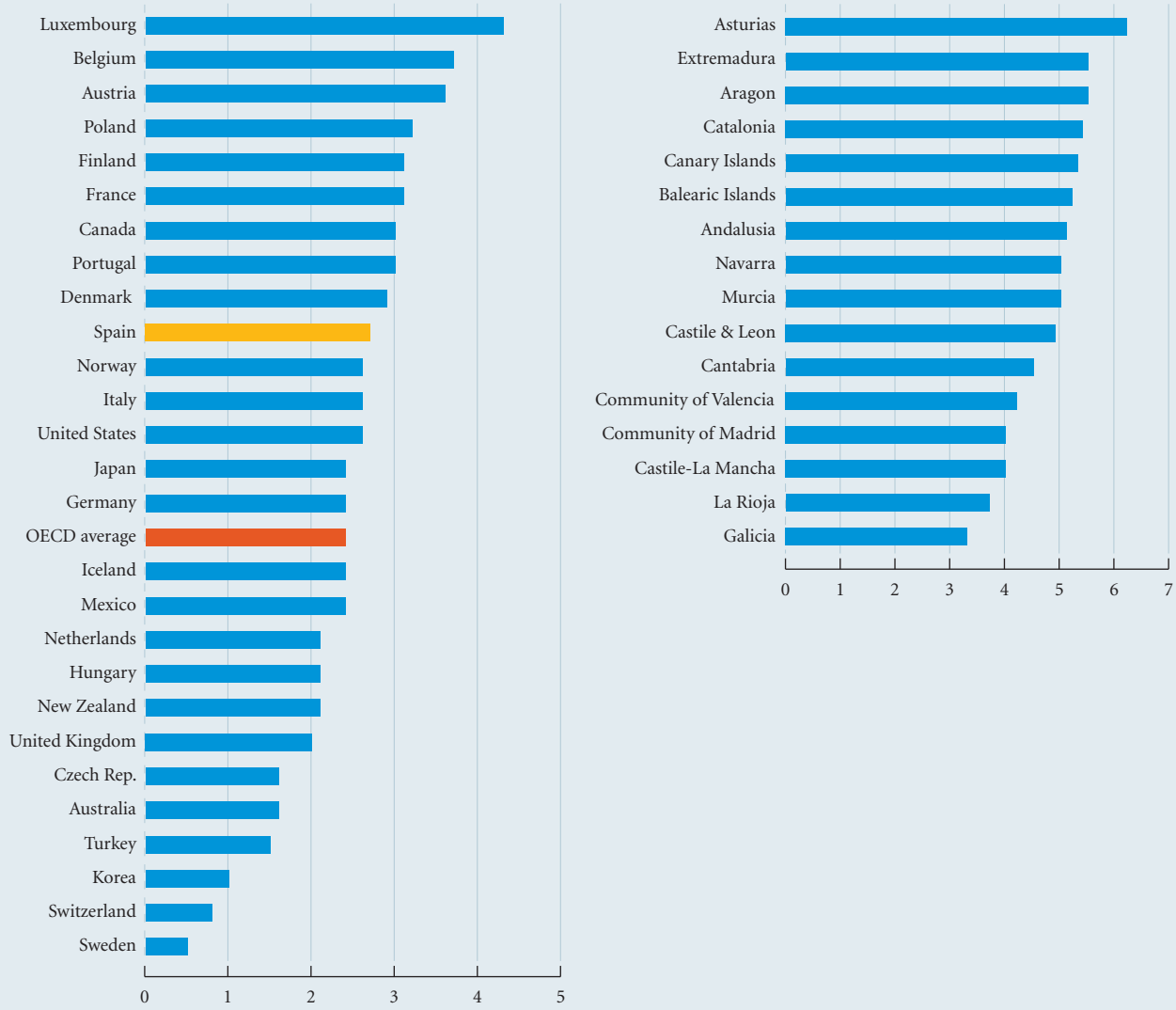
In retailing, regulation usually takes the form of technical or administrative barriers, either to new companies entering the market, by means of prior licensing to start up a business or moratoria on start-ups, or by limiting how established firms operate through regulation of business hours or sales periods. In the case of Spain, an additional hurdle comes from the complexity of the legal framework, the result of the particular organization of the territory and the distribution of powers among the central government, autonomous communities, and local authorities. Although it's true that trade restrictions in Spain have been gradually relaxed since the Retail Trade Act (*Ley de Ordenación del Comercio Minorista*) came into force in 1996, they still exceed the OECD average (see the diagram below). In this respect, those defending liberalization hope that the new Services Directive will encourage greater progress and lead the way to a more open and flexible commercial network in Spain.

The Services Directive, otherwise known as the Bolkestein Directive, aims to eliminate barriers to the freedom of establishment, provision, and movement of services within the European Union, as well as to harmonize regulation of the tertiary sector across member states. Among the measures stipulated by the Directive regarding retail trade, it is worth noting the homogenization of regulations across territories and the elimination of any kind of establishment license, except when pursuing non-economic goals of general interest and providing such limitations are not discriminatory or disproportionate with regard to those objectives. In any case, the transposition of the Directive to the legal framework of each country lies in the hands of the member states and, in Spain, this will take the form of two new laws: the act on free access to service activities and on exercising this right, otherwise known as the «Ley Paraguas» (or «Umbrella Act»), which establishes the general framework of reference, and the Omnibus Act, which adapts several earlier laws to the former. The specific regulations for each sector will also be amended, including those governing retail trade.

The bill to revise the Retail Trade Act was approved by the Council of Ministers in August but, despite following the Directive's general criteria, it has not avoided controversy. The roots of this controversy lie in the relative flexibility of the new bill and in the margin for interpretation given to the governments of autonomous communities which have, according to the 1996 Act, the last word in terms of retail trade taking place within their territory. Some bodies, including the Spanish Competition Authority and the Bank of Spain, have expressed certain unease, fearing that the new legislation does not open the door to competition as per the European Commission's aim, wasting a unique opportunity to move forward in an area where, in the opinion both of these bodies and of the Commission itself, there is still a lot to be done.

The defense of retail liberalization is based on different arguments, but the cost incurred by inadequate legislation for economic agents in terms of efficiency and welfare is, in all certainty, a key factor. In regard to retail, it is estimated that the inefficient allocation of available resources, resulting from excessive or incorrect regulation, reduces the degree of competition, impedes efficiencies associated with economies of scale and dissuades innovation. This leads to lower productivity and higher margins for incumbent firms that, in turn, lead to higher prices, a loss in purchasing power for real wages and, ultimately, less consumer welfare and lower revenue for

REGULATORY BARRIERS TO RETAIL TRADE IN SPAIN EXCEED THE OECD AVERAGE AND DIFFER NOTABLY ACROSS AUTONOMOUS COMMUNITIES



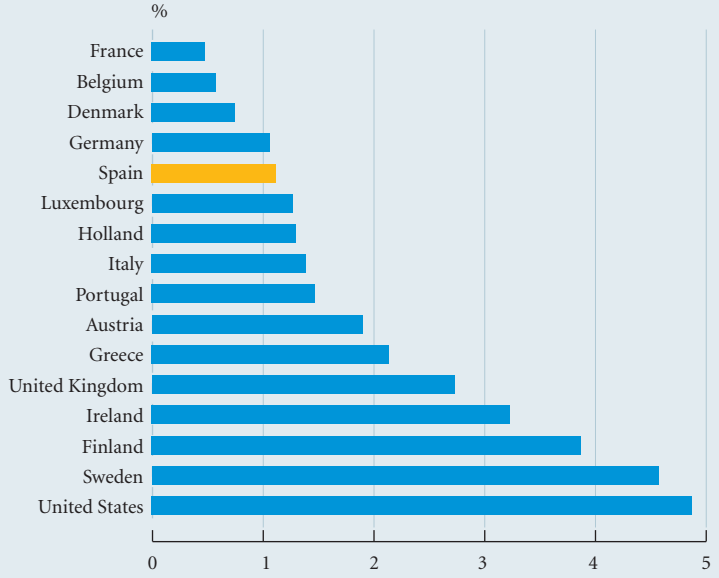
SOURCE: PMR database (OECD), Bank of Spain and own calculations.

firms deterred from entering the market in question. Some people believe that this reasoning essentially explains the low growth in retail productivity in countries such as France and Spain (see the diagram below).

On the other side of the debate, those who advocate retail trade regulation generally prioritize economic dimensions other than pure efficiency. The most usual arguments are: urban development criteria that defend a city model incorporating a dynamic commercial town center; protecting consumers with little mobility and the work-life balance of those employed in the sector. This kind of regulation tends to favor more urban, small-format retail stores rather than large-scale malls on city outskirts. The 1996 Act, for example, explicitly

RETAIL TRADE PRODUCTIVITY IN SPAIN, AMONG THE MOST SLUGGISH IN THE EUROPEAN UNION

Growth in productivity per hour worked (annual average 1995-2005)



SOURCE: EU-KLEMS March (2008) and own calculations.

aims to protect small local retailers. On the other hand, certain restrictions to free trade are based on the existence of market failures, such as negative externalities of an environmental nature associated with certain commercial formats that require private transportation.

Efficiency aside, those in favor of a more flexible retail sector also mention women in paid employment when they advocate the liberalization of store opening hours, another usual and controversial barrier to free commercial activity. This structural change in the modern Spanish labor market means that many families can only shop on their days off or outside working hours that, in many cases, do not coincide with store opening hours. However, this argument comes head to head against one of the reasons used to defend store opening hours restrictions: the negative impact of extending these hours on the work-life balance of those employed in retailing.

In short, the discussion originated by the proposal to revise the Retail Act shows that the historical controversy concerning the liberalization of such a key sector for the economy has not abated. It is to be hoped that the definitive act and the final judgment by the European Commission regarding this legislation will help the different parties to find some common ground and to improve the status quo of society in general. Ultimately, retail trade is a service and, as such, its *raison d'être* is none other than service for the benefit of all those involved, be it in a legendary town marketplace, in a modern shopping mall on the city outskirts or in a small store in a classic town or modern city center.

This box was prepared by Marta Noguer
International Unit, "la Caixa" Research Department

Labour market

Deterioration in the labor market becomes more marked

The effects on employment of the State Local Investment Fund's municipal works plan are coming to an end.

The slump in economic activity continues to damage the labor market. In September, on average 17,935,095 people were registered as employed with Social Security, 66,216 fewer than the previous month. The slowdown in the downward trend that had been seen over the last few months has therefore been cut short. One fact contributing to this decline is that many municipal works financed by the State Local Investment Fund have ended.

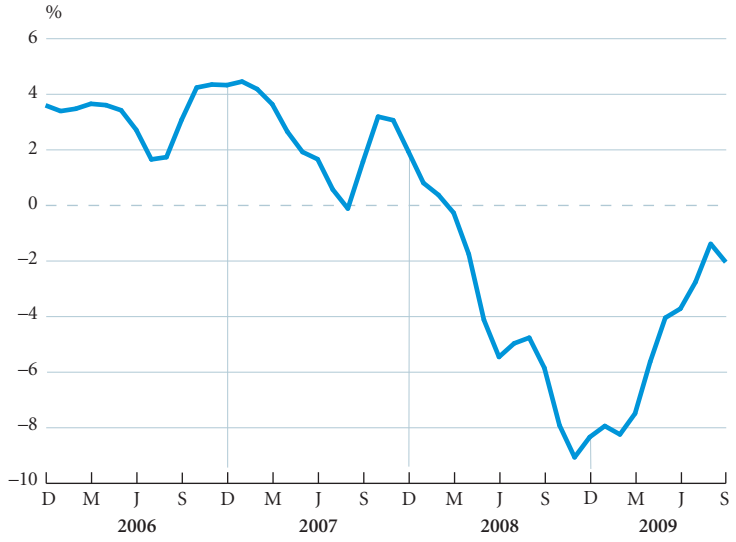
Construction has recorded the biggest year-on-year drop in Social Security registrations of 21.2%.

In the last twelve months, the number of people registered as employed with Social Security has fallen by 1,085,265, a percentage of 5.7%, although this year-on-year decrease is less than in preceding months. Most sectors lost workers in this period except for agriculture, which rose 10.2%, and domestic workers, increasing by 1.4%. Overall, the number of registered wage-earners fell by 5.8%, while non-wage-earners fell by 5.2%.

By sector, the biggest drop in the last year was in construction, down 21.2%, resulting primarily from the tough changes occurring in the residential segment. The number of registered workers in the industrial sector also fell sharply by 11.2%, because of the crisis in the sector. Service registrations were also down but to a lesser degree, by 2.9%, while agriculture was up 5.6%.

THE FALL IN SOCIAL SECURITY REGISTRATIONS IS ACCELERATING

Annualized month-on-month change in the total number of workers registered with Social Security (*)



NOTES: (*) Cycle-trend series of average monthly values.
SOURCE: Ministry of Labor and Social Affairs and own calculations.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2007	2008	2008		2009				
			3Q	4Q	1Q	2Q	July	August	September
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*	*–11.2*
Construction	*3.6*	*–10.3*	*–12.4*	*–19.5*	*–25.2*	*–25.4*	*–23.0*	*–21.7*	*–21.2*
Services	*3.5*	*1.7*	*1.6*	*–0.2*	*–2.1*	*–3.1*	*–3.2*	*–2.9*	*–2.9*
Job situation									
Wage-earners	*3.1*	*–0.7*	*–1.1*	*–3.7*	*–6.3*	*–7.0*	*–6.6*	*–6.1*	*–5.8*
Non-wage-earners	*2.8*	*0.4*	*–0.1*	*–1.9*	*–3.9*	*–5.0*	*–5.3*	*–5.3*	*–5.2*
Total	**3.0**	**–0.5**	**–0.9**	**–3.4**	**–5.8**	**–6.7**	**–6.4**	**–5.9**	**–5.7**
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	–26.0
Temporary	0.3	–10.4	–9.4	–17.9	–23.9	–17.8	–11.9	–8.0	–7.7
Total	**0.5**	**–10.9**	**–9.9**	**–18.9**	**–25.4**	**–19.9**	**–13.7**	**–10.0**	**–9.8**

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 the Government Employment Service.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, Government Employment Service and own calculations.

By sex, the drop in registrations was higher among men than women, who tend to predominate in services, the large sector that has seen the smallest fall in registrations. While male registrations fell by 7.7%, female registrations were down 3.1%. The proportion of female registrations therefore stood at 44.1%, almost equaling the record level achieved last May.

By nationality, the slump in registration since September 2008 was greater among foreigners, who are overly concentrated in construction, this figure falling by 8.6%. For their part, Spanish registrations were down 5.3%.

The labor market's loss of dynamism is also reflected in the smaller number of employment contracts. In fact, 1,354,836 contracts were recorded in September, a year-on-year decrease of 9.8%. The greatest decline was for permanent contracts, standing at 128,374, an annual decrease of 26.0%, while temporary contracts totaled 1,226,462, down 7.7%. Overall, these year-on-year reductions were a little less severe than in previous months.

Notable drop in permanent employment contracts.

Registered unemployment confirms its upward trend

Understandably, the increasing destruction of jobs has led to a rise in unemployment. At the end of the third quarter, there were 3,709,447 unemployed people registered at the public employment offices, 80,367 more than in August, the second consecutive

Registered unemployment up 41% in one year.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

September 2009

	No. of unemployed	Change over December 2008		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	95,378	19,367	25.5	31,038	48.2	2.6
Industry	488,280	74,855	18.1	147,622	43.3	13.2
Construction	708,078	50,642	7.7	208,807	41.8	19.1
Services	2,140,158	349,883	19.5	610,060	39.9	57.7
First job	277,553	85,737	44.7	86,552	45.3	7.5
By sex						
Males	1,851,361	274,894	17.4	632,629	51.9	49.9
Females	1,858,086	305,590	19.7	451,450	32.1	50.1
By age						
Under 25 years	444,606	59,476	15.4	124,963	39.1	12.0
All other ages	3,264,841	521,008	19.0	959,116	41.6	88.0
TOTAL	**3,709,447**	**580,484**	**18.6**	**1,084,079**	**41.3**	**100.0**

SOURCE: Government Employment Service and own calculations.

Sharp rise in unemployment benefits.

monthly increase. This figure represents a year-on-year rise of 41.3%, a little lower than the rate of previous months.

More than 80% of the monthly increase in registered unemployed was concentrated in the services sector, partly related to the end of the tourist season. There was also a significant increase of 17,448 people looking for their first job. A rise in the labor force is typical after the holiday period and at the end of the academic year. However, in seasonally-adjusted terms unemployment has clearly speeded up over the last few months.

The sharp rise in unemployment figures with the advent of the economic crisis, which has supposed an increase of almost 1.7 million people in the last two years, has led to huge increases in unemployment benefit. The total number of people receiving benefit at the end of August was 2,708,204, a growth of 46.1% compared with the same month last year. Total expenditure in August was 2,608 million euros, 45.5% higher than twelve months before.

More than 50,000 applications to join the unemployment and job-seeking protection scheme.

The rate of coverage, defined as the ratio between the total number of people receiving benefits and the total registered unemployed with work experience, plus those receiving temporary agricultural aid, was 76.65% in August. On the other hand, at the end of September 52,252 people had already applied to join the unemployment and job-seeking protection scheme so as to receive a benefit of 422 euros per month.

The outlook for unemployment over the coming months is not encouraging. Employment is not expected to rise until the economy enjoys significant growth once again, so that any drop in the unemployment figures will take a few quarters yet.

Prices

Relapse in prices

The consumer price index (CPI) recorded a year-on-year drop of 1.0% in September, 0.2 percentage points more than in the previous month. However, this fall was 0.3 percentage points less than that recorded in July, the biggest drop in recent decades.

The accelerating downward trend in September's prices can be attributed to the most stable core of prices, known as underlying inflation. This fell more than expected with a year-on-year drop of 0.3 percentage points to 0.1%, the lowest level in decades, reflecting the strong deflationary pressure on prices. In fact, although this is also a result of the latest fall in commodity prices, many companies have also cut prices to boost sales and stimulate weakened consumption.

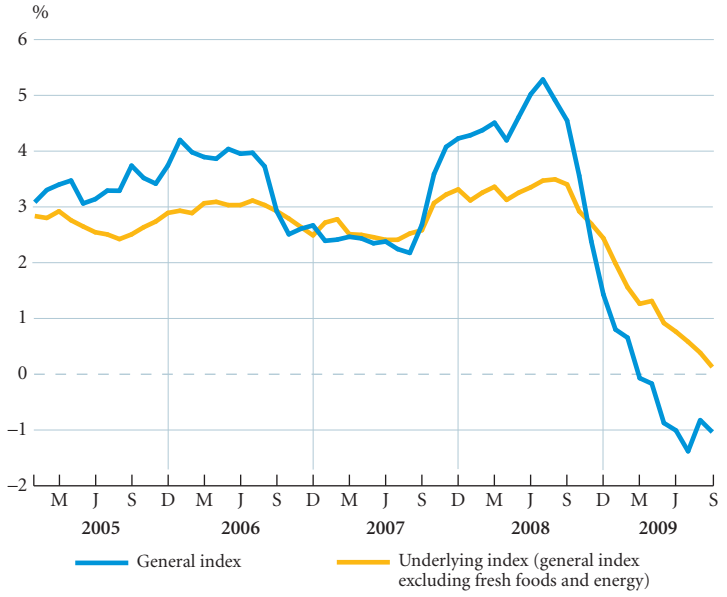
This deflationary pressure on prices in September comes principally from non-energy industrial goods, contributing almost 0.1 percentage point to the decrease in the CPI year-on-year rate, with these prices falling 2.1% over the twelve months up to September, 0.3 percentage points more than the preceding month and also representing the largest fall in recent decades. Both the weak demand and pressure from international markets have

The CPI has fallen 1.0% over the last twelve months.

Core inflation is down 0.3 percentage points to 0.1% due to the underlying slump.

UNDERLYING INFLATION APPROACHES 0%

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

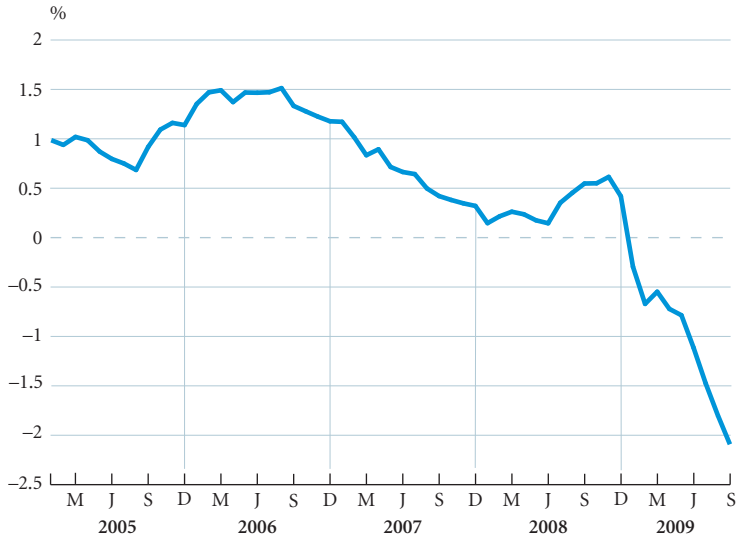
CONSUMER PRICE INDEX

	2008			2009		
	% monthly change	% change over December 2007	% annual change	% monthly change	% change over December 2008	% annual change
January	–0.6	–0.6	4.3	–1.2	–1.2	0.8
February	0.2	–0.5	4.4	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	–0.2	–0.4	–1.0
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.

THE PRICES OF INDUSTRIAL GOODS HAVE FALLEN MORE THAN 2% IN THE LAST TWELVE MONTHS

Year-on-year change in CPI of industrial goods without energy products



SOURCE: National Institute of Statistics.

Prices for goods of industrial origin are falling...

contributed to this trend. Particularly of note in September was the year-on-year drop in the price of automobiles to 7.0%.

Shrinking consumption is also having an effect on services, although these are less affected by foreign competition. Service prices therefore continued to slow up,

recording a year-on-year change of 1.8%, 0.2 percentage points less than in August. Almost half this drop can be explained by the slowdown in prices for hotels, cafeterias and restaurants, to 1.3%.

Processed foods contributed a decrease of 0.05 percentage points to the CPI year-on-year change. Both mineral water and soft drinks, as well as some dairy products, also contributed to this decrease, although processed food as a whole saw a year-on-year increase of 0.5%.

On the other hand, unprocessed food had practically no effect at all on the change in the CPI year-on-year rate in September, as the year-on-year fall in its prices remained at 2.5%. The other highly volatile component of prices, energy products, had a very slight positive effect on the CPI change rate as its year-on-year drop leveled out slightly.

The year-on-year CPI harmonized with the European Union also fell 1.0% in

...while service prices are slowing down.

CONSUMER PRICE INDEX BY COMPONENT GROUP

September

	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	0.2	0.0	2.3	–2.5	6.1	–2.4
Alcoholic beverages and tobacco	126.0	0.1	0.0	3.7	12.7	4.2	13.0
Clothing and footwear	95.5	3.6	3.6	–9.8	–12.3	0.5	–2.2
Housing	111.9	0.0	–0.1	6.5	0.2	7.9	–0.3
Furnishings and household equipment	106.7	0.4	0.2	1.6	0.1	2.6	1.2
Health	97.4	0.1	0.1	0.1	–1.4	0.6	–1.2
Transport	102.7	–1.1	–1.5	4.5	3.2	7.2	–6.8
Communications	99.4	0.0	0.0	0.2	–0.3	–0.1	–0.8
Recreation and culture	98.6	–1.7	–1.8	0.4	–1.1	0.2	–1.2
Education	112.5	1.2	0.7	1.6	0.9	4.4	3.2
Restaurants and hotels	112.4	–0.9	–1.2	4.5	1.7	4.8	1.3
Other goods and services	109.5	0.3	0.1	3.2	1.8	3.6	2.1
By group							
Processed food, beverages and tobacco	111.6	0.2	–0.2	3.0	0.5	6.9	0.5
Unprocessed food	107.1	0.4	0.3	1.3	–2.8	3.9	–2.5
Non-food products	105.3	–0.1	–0.3	1.9	–0.4	4.1	–1.2
Industrial goods	100.1	0.3	0.1	0.3	–2.3	4.1	–4.0
Energy products	*105.8*	*–1.8*	*–1.7*	*9.5*	*6.1*	*14.8*	*–10.2*
Fuels and oils	*100.6*	*–2.4*	*–2.3*	*9.3*	*6.0*	*16.2*	*–15.5*
Industrial goods excluding energy products	*97.8*	*1.1*	*0.8*	*–2.8*	*–5.2*	*0.5*	*–2.1*
Services	110.8	–0.5	–0.7	3.6	1.6	4.1	1.8
Underlying index (**)	106.2	0.2	–0.1	1.2	–1.1	3.4	0.1
GENERAL INDEX	**106.4**	**0.0**	**–0.2**	**2.0**	**–0.4**	**4.5**	**–1.0**

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

Inflation in general will return to positive figures by the end of the year.

the last year. As a result, the inflation differential with the Euro Area remained at 0.6 points, 0.3 percentage points lower than the record figure in May.

The continuing deflationary pressure on prices suggests that the fall in core inflation will continue and might even reach negative figures. However, given the expected development in crude prices, the most likely situation is for prices to pick up again over the next few months, getting back to a positive year-on-year inflation rate by the end of the year.

The fall in producer prices is easing

The fall in farm prices at source accelerated in July.

Producer prices recorded a year-on-year decrease of 5.5% in August. This constitutes a turning point after the minimum of recent decades of 6.7%, recorded in July 2009. This trend is mostly explained by trends in commodity prices and particularly oil, which reached record levels in July 2008. The decrease in most of the components of producer prices eased off slightly, except in capital goods which continued to slide, reaching a year-on-year change rate of 0.3%.

Import prices also picked up in August and their year-on-year decrease fell by 1.5 points to 9.8%. Farm prices at source fell more quickly in July, up to a year-on-year decrease of 17.9%. This was mostly due to farm products, which fell by 26.9%, while market livestock prices picked up and recorded a year-on-year rate of 1.1%.

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											
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	–3.7	–
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	–17.9	–6.7	–1.2	0.5	–7.7	–16.0	–11.3	2.0	2.3	–7.0	–
August	...	–5.5	–0.9	0.3	–7.7	–11.6	–9.8	0.9	2.0	–7.4	...

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

Foreign sector

The trade deficit continues to fall

The Spanish trade deficit for the month of August fell by 40.5% compared with August 2008, totaling 4,523 million euros. This drop was slightly more moderate than those recorded in previous months but, including this month, reductions have been accumulating for the last fourteen months in a row. Consequently, the accumulated deficit in the first eight months of the year fell by 52.4% compared with the same period last year.

As in previous months, this drop in deficit occurred within a context of falling trade flows. However, the accumulated fall in imports for the first eight months of 2009 of 31.1%, compared with the same period in 2008, was higher than that of exports (19.8% in the same period). This has improved the trade balance and has increased the export-import ratio to 76.1% for this period, more than ten percentage points higher than last year.

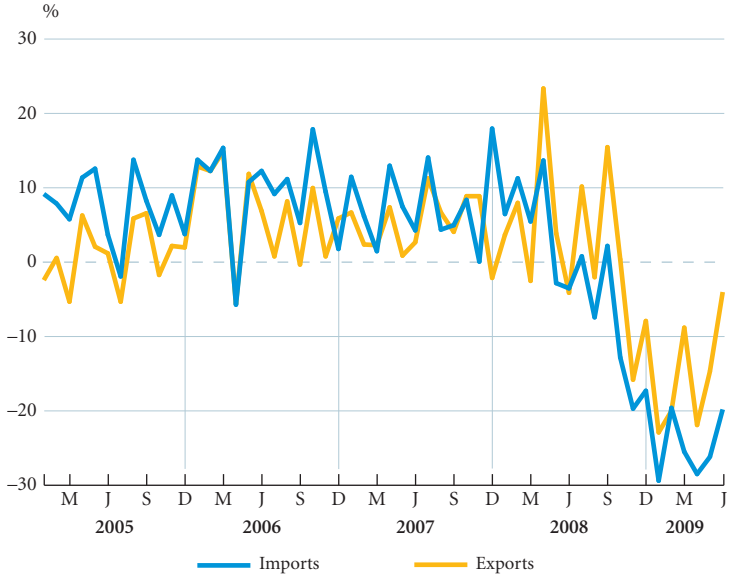
The trade deficit for the first eight months of the year falls by 52.4% year-on-year.

A more detailed analysis of these figures shows that, in August, the drop in the value of trade flows can largely be explained by a fall in prices, particularly in energy and food products. For this reason, in the last few months the real data show a rapid deceleration of the drop in the volume of exports and imports. Consequently, as can be seen in the graph, the real fall in exports in August was 6.4%

The volume of trade flows has started to stabilize.

THE VOLUME OF INTERNATIONAL TRADE IS STARTING TO STABILIZE

Year-on-year change in actual monthly data



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

FOREIGN TRADE

January-August 2009

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	22,318	–44.8	16.7	4,388	–44.0	4.3	–17,930	19.7
Consumer goods	41,963	–10.2	31.4	40,982	–8.1	40.3	–981	97.7
Food	*9,440*	*–9.0*	*7.1*	*14,190*	*–4.0*	*13.9*	*4,749*	*150.3*
Non-foods	*32,523*	*–10.6*	*24.3*	*26,792*	*–10.1*	*26.3*	*–5,731*	*82.4*
Capital goods	10,634	–34.3	8.0	8,506	–22.9	8.4	–2,128	80.0
Non-energy intermediate goods	58,735	–35.1	43.9	47,860	–24.5	47.0	–10,875	81.5
By geographical area								
European Union	77,623	–26.5	58.1	70,131	–20.2	68.9	–7,491	90.3
Euro Area	*64,562*	*–27.2*	*48.3*	*57,725*	*–18.0*	*56.7*	*–6,837*	*89.4*
Other countries	56,027	–36.5	41.9	31,604	–18.8	31.1	–24,423	56.4
Russia	*2,870*	*–51.7*	*2.1*	*946*	*–50.2*	*0.9*	*–1,924*	*33.0*
United States	*5,711*	*–25.8*	*4.3*	*3,986*	*–21.2*	*3.9*	*–1,725*	*69.8*
Japan	*1,948*	*–46.2*	*1.5*	*762*	*–21.4*	*0.7*	*–1,186*	*39.1*
Latin America	*6,914*	*–35.3*	*5.2*	*5,037*	*–17.8*	*5.0*	*–1,878*	*72.8*
OPEC	*11,024*	*–41.8*	*8.2*	*4,311*	*0.3*	*4.2*	*–6,713*	*39.1*
Rest	*27,560*	*–33.4*	*20.6*	*16,563*	*–19.4*	*16.3*	*–10,997*	*60.1*
TOTAL	**133,650**	**–31.1**	**100.0**	**101,736**	**–19.8**	**100.0**	**–31,914**	**76.1**

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

The fall in deficit is expected to slow up over the coming months.

year-on-year, 10.5 percentage points less than the nominal change. Similarly, the year-on-year drop in actual imports for the same month was 11.4%.

In spite of the fact that falls in trade flows have been widespread, both in terms of sector and also geographically, it can be seen that, in August, vehicle exports rose 18.8% compared with the same month last year. This figure was undoubtedly the result of the different subsidy plans for vehicle purchase in the main European countries. Similarly, imports of automobile components also picked up in the same period, growing by 6.1%.

Current account deficit goes on falling in July...

Furthermore, the economic recovery in France and Germany has also led to an increase in foreign demand by these countries. This trend is expected to continue in the short term. However, the end of fiscal stimuli by governments and the trend shown by real imports leads to the conclusion that the rate of decrease in the deficit will slow up over the coming months.

Balance of payments: financing needs continue reducing

Improvements in the trade and incomes balances in the month of July led to the current account deficit for this month recording a fall of 73.6% compared with the same month in 2008, totaling 2,046 million euros. Only the services balance has bucked this trend, as it recorded a

drop in its surplus for the third consecutive month, the result of less revenue coming from tourism.

This latest reduction in July's current balance followed the trend of the accumulated balance in the last twelve months, down 34.6% compared with the same period last year. The lower current deficit greatly offset the reduction in surplus of the capital account and meant that the accumulated deficit for the last twelve months stood at 69,076 million euros, similar levels to those of June 2006. New data from international trade for the month of August also suggest that this trend will continue, with an adjustment in the Spanish foreign imbalance, although increasingly less marked.

...reducing financing needs to 2006 levels.

With regard to financial flows, the fall in deficit has led to a reduction in foreign capital inflows for the year. The heading most affected was short-term investment, which saw portfolio investments become the main net capital inflow in July, although short-term investment continued to be the main source of funds in this period.

Short-term financing continues to lose importance.

BALANCE OF PAYMENTS

July 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	–24,622	–55.7	–56,754	39,870	–41.3
Services					
Tourism	*14,534*	*–7.8*	*26,832*	*–1,441*	*–5.1*
Other services	*–406*	*–63.4*	*–1,100*	*1,640*	*–59.8*
Total	14,129	–3.6	25,732	199	0.8
Income	–18,670	0.1	–33,796	–1,893	5.9
Transfers	–5,631	–17.2	–8,066	368	–4.4
Total	**–34,795**	**–47.5**	**–72,884**	**38,543**	**–34.6**
Capital account	**2,343**	**–42.0**	**3,808**	**–2,795**	**–42.3**
Financial balance					
Direct investment	–3,439	–	–17,504	–5,225	42.6
Portfolio investment	9,455	35.0	6,212	5,626	–
Other investment	16,833	–43.6	55,445	–6,845	–11.0
Total	**22,849**	**–48.1**	**44,153**	**–6,445**	**–12.7**
Errors and omissions	756	–	4,754	5,167	–
Change in assets of Bank of Spain	8,847	–53.0	20,169	–34,471	–63.1

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

The central government budget for 2010

The main aim of the 2010 budget is to rebalance public accounts and ease the effects of the economic crisis.

The central government presented its 2010 General Budget (PGE-2010 in Spanish) for debate and approval in the midst of the worst economic recession in recent decades. This budget has been prepared with the aim of rebalancing public accounts due to commitments assumed under the Stability and Growth Pact of the European Union, as well as easing the effects of the economic crisis and also realigning the model of growth. After an expected general government deficit of 9.5% of gross domestic product (GDP) in 2009, the public deficit forecast for 2010 is 8.1% of GDP.

The 2010 General Budget was drawn up based on a macroeconomic situation that predicted a fall in GDP of 3.6% in 2009 and of 0.3% in 2010, although it's worth mentioning that the latter is slightly less than that forecast by analysts in general.

The consolidated expenditure forecast is slightly higher than the initial budget for 2009.

The consolidated expenditure forecast by the PGE-2010 for the central government public sector (excluding public enterprises) is 350,657 million euros, including financial assets. This figure accounts for 33.4% of forecast GDP, one decimal more than in 2009. This is 0.1%

CONSOLIDATED 2010 BUDGET FOR CENTRAL GOVERNMENT, AUTONOMOUS BODIES, SOCIAL SECURITY AND OTHER BODIES

Million euros

EXPENDITURES	Central government	Autonomous bodies	Social Security	Other bodies	Total consolidated	% change over initial budget
Current transactions						
Staff costs	27,572	2,088	2,483	1,675	33,817	2.3
Current goods and services	3,515	2,308	2,033	687	8,543	0.1
Financial costs	23,224	24	19	0	23,267	33.2
Current transfers	103,025	48,161	111,556	767	233,377	7.4
Total	**157,336**	**52,581**	**116,090**	**3,129**	**299,005**	**8.2**
Capital transactions						
Contingency fund	4,215				4,215	29.6
Real investments	9,429	1,863	513	478	12,283	–10.2
Capital transfers	14,268	2,433	3	108	14,968	35.2
Total	**23,697**	**4,296**	**516**	**586**	**27,251**	**10.1**
Total non-financial transactions	**185,249**	**56,877**	**116,607**	**3,715**	**330,471**	**8.6**
Financial assets	15,746	456	3,980	3	20,186	–55.9
Financial liabilities	35,409	294	0	0	35,704	4.1
Total financial transactions	**51,155**	**751**	**3,981**	**3**	**55,890**	**–30.2**
TOTAL	**236,404**	**57,627**	**120,587**	**3,718**	**386,361**	**0.5**

SOURCE: Ministry of Economy and Finance and own calculations.

higher than the initial forecast for 2009 and 0.4 points more than the estimated nominal growth for the economy. This consolidated growth excludes the change in financial liabilities and does not include growth by territorial governments (autonomous communities and local government) or the activities of the public enterprise sector or other public entities or foundations.

Consolidated current non-financial expenditure is up 8.2% compared with the initial 2009 forecast but the heading with the biggest increase is financial costs, rising 33.2% to 23,267 million euros, 2.2% of GDP, in spite of very low interest rates, due to the huge expansion in public debt. The largest item, current transfers, has increased 7.4%. Staff costs are up 2.3%. This rise can be explained particularly by the increase in workforce and improved resources in the Justice and Citizen Security Administration, as the pay rise has been fixed at 0.3%. However, the salaries of top government officials and those from other central government institutions have been frozen for the second year running.

For their part, consolidated capital costs are up 10.1%. Real investment is down 10.2%, although capital transfers have risen by 35.2%.

In terms of expenditure policy, it's clear that the government has prioritized social expenditure. In fact, social expenditure as a whole is up 3.8%, not only above nominal GDP but also above consolidated expenditure as a whole. It has therefore increased its relative weight by 1.8 points, up to 51.6%.

The main heading within social expenditure is pensions, which go

Financial expenditure is up by 33% to 2.2% of gross domestic product.

Social spending accounts for 51.6% of total consolidated expenditure.

CONSOLIDATED 2010 BUDGET FOR CENTRAL GOVERNMENT, AUTONOMOUS BODIES AND SOCIAL SECURITY AND OTHER BODIES

Million euros

RECEIPTS	Central government	Autonomous bodies	Social Security	Other bodies	Total consolidated	% change over initial budget
Current transactions						
Direct taxes and social insurance contributions	66,813	24,255	107,377		198,445	–8.2
Indirect taxes	40,736				40,736	–18.9
Fees and other revenue	3,147	1,548	1,237	237	6,169	–6.1
Current transfers	5,492	25,597	8,356	2,708	12,020	–1.5
Property earnings	3,445	785	2,464	33	6,726	0.1
Total	**119,634**	**52,185**	**119,433**	**2,977**	**264,097**	**–9.5**
Capital transactions						
Disposal of real investments	107	221	7	0	335	–8.8
Capital transfers	1,886	3,224	46	421	3,733	38.9
Total	**1,993**	**3,445**	**54**	**421**	**4,068**	**33.2**
Total non-financial transactions	**121,627**	**55,630**	**119,486**	**3,398**	**268,165**	**–9.1**
Financial assets	3,192	1,653	1,095	319	6,259	–3.7
Total financial transactions	**3,192**	**1,653**	**1,095**	**319**	**6,259**	**–3.7**
TOTAL	**124,819**	**57,283**	**120,581**	**3,717**	**274,424**	**–9.0**
Gross borrowing requirement	*–111,585*	*–344*	*–6*	*–1*	*–111,937*	*78.3*

SOURCE: Ministry of Economy and Finance and own calculations.

Spending on pensions is up while spending on unemployment growth almost reaches 60%.

to make up 30.9% of the consolidated budget, an increase of 2.1%. Expenditure on pensions represents 10.3% of GDP. The increase in this heading comes from the 1.0% rise in pensions, as well as the 1.8% increase in the number of contributory pensioners and improved minimum pensions, among other factors. The other large heading for social expenditure, namely unemployment, is up 57.9% due to the escalation in the number of unemployed. This heading includes extraordinary aid for the unemployed of 420 euros a month for workers who have used up all their prior benefits and subsidies.

Spending is up on infrastructures but there are cuts in R&D&I.

Government spending on infrastructures is considered to be of prime importance in boosting the economy, increasing productivity and ensuring the market of goods and services works effectively, as well as encouraging development of the most disadvantaged areas. Expenditure on infrastructures totals 14,070 million euros in the consolidated budget, up 6.8%. This figure accounts for 4.0% of the total and represents 1.3% of GDP. 2010 will continue with the development and implementation of medium and long-term action plans, basically the Strategic Plan for Infrastructures and Transport and the National Hydrological Plan.

Both civil and military research, development and innovation have been cut, although the latter to a greater degree. Overall, R&D&I is down 5.5% to 9,129 million euros, 2.6% of the total. This amount represents 0.87% of GDP, not only slightly below the level of investment for the most developed countries but even half a decimal lower than the 2009 figure.

Change in tax orientation: the 400 euro deduction in income tax is withdrawn while rates on savings and VAT are increased.

On the other side of the budgetary balance sheet, it is expected that consolidated receipts will fall by 9.0% compared with the initial budget, down to 274,424 million euros, 26.1% of GDP. However, the main heading in tax collection, namely personal income tax, is expected to rise by 7.2% compared with the early figures for collections in 2009 because of several legislative measures. This increase is mostly due to the removal the deduction of 400 euros, although a proposal has been made in parliament for only part of this deduction to be withdrawn. Such a removal would lead to an estimated rise in taxes collected of 4,100 million euros, as well as to the rise in the savings tax rate, from 18% to 19% for the first 6,000 euros and the rest at 21%, and also to the effect on the total tax due of bringing forward to 2009 the tax credits for investment in the main residence.

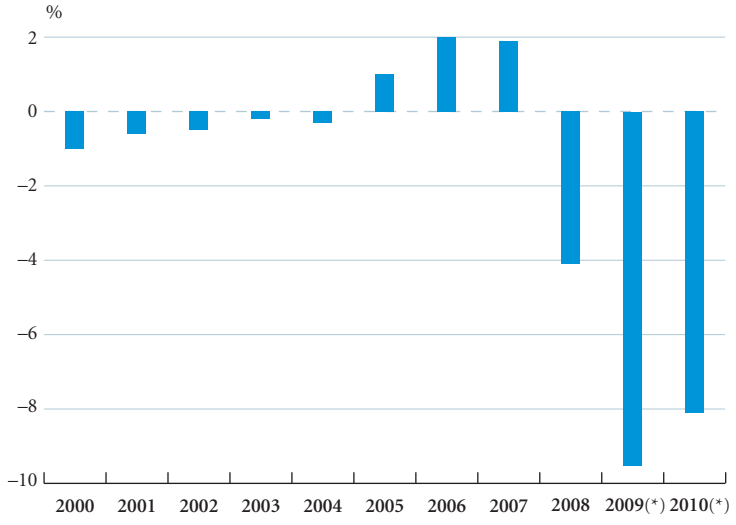
Company tax is down 9.5% in terms of early figures for collections in 2009 because of the downward trend in corporate profits. This is also affected by a reduction of 5 points in the tax rate (25% to 20%) for SMEs with fewer than 25 workers and revenue below 5 million euros that maintain or create jobs.

Receipts from indirect taxation are expected to rise by 16.3% compared with the early figures for collections in 2009. Revenue from value added tax (VAT) is up 26.1% because the effect of introducing the new monthly rebate system in 2009 has now disappeared, as well as due to the tax increase that will come into effect as from 1 July 2010. The general tax rate will rise by 2 points, up to 18%, while the low tax rate goes up to 8% and the extra low rate stays the same at 4%. On the other hand, receipts from special taxes will rise 4.8%, due particularly to the increase, in June 2009, in rates levied on tobacco products and hydrocarbons.

The 2010 General Budget shows a consolidated deficit (national accounts

PUBLIC DEFICIT HAS DOUBLED IN 2009 AS THE ECONOMIC SITUATION DETERIORATES

Capacity (+) / need (–) for funding in general government, as % of GDP



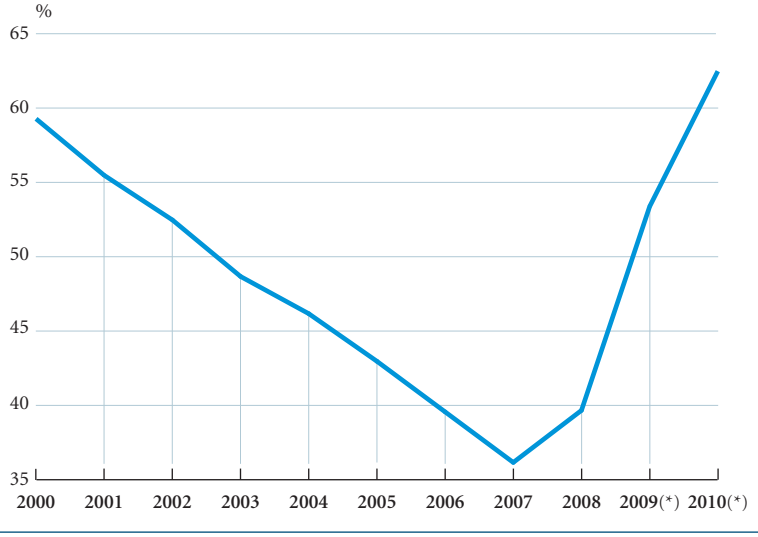
NOTES: (*) Official forecasts.
SOURCE: Ministry of Economy and Finance.

basis) equivalent to 8.1% of GDP, 1.4 points lower than the 2009 forecast. This is the result of a central government deficit of 5.4% of GDP, a Social Security surplus of 0.2%, deficits of 2.5% from the autonomous communities and of 0.4% from local entities. Overall, the debt ratio of general government in GDP terms will increase to 62.5% of GDP, 9.1 points higher than in 2009.

Public debt will rise to 62.5% of GDP.

PUBLIC DEBT IS ON THE RISE

General government debt as percentage of GDP



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

Savings and financing

Private sector financing has grown by 1% in the last twelve months.

Bond issues become a larger part of company funding.

The private sector continues to deleverage

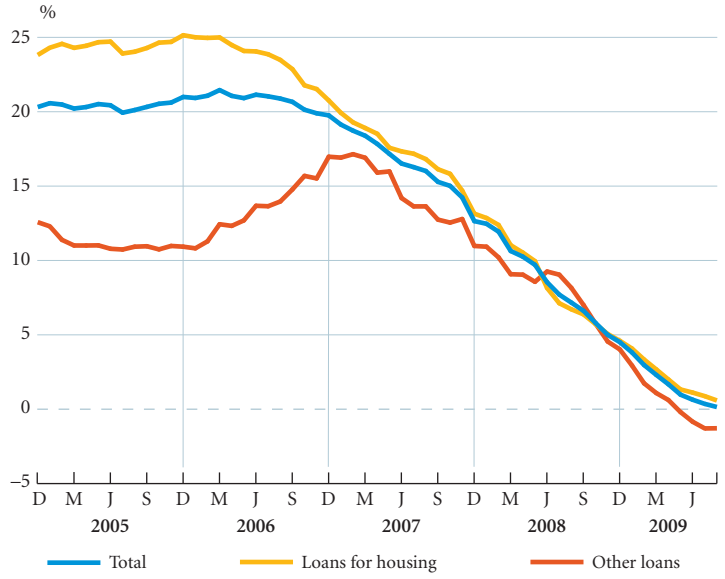
In August, the financing received by firms and households continued to slow down. This process of adjustment after the high levels of debt reached before the start of the economic crisis is being driven by weak demand and more cautious risk management on the part of financial institutions. Funding for the resident private sector therefore only rose 1.1% in the last twelve months, 7.6 points less than in August 2008.

The funding of non-financial companies continued the slowdown of the last period and recorded a year-on-year growth of 1.8%, slightly under the 9.9% recorded one year before. In fact, loans from resident financial institutions have fallen by 1.1% since August 2008. However, bond issues have risen 24.2% over the last twelve months thanks to improved conditions in the financial markets. For their part, foreign loans were up 7.9% compared with August last year.

On the other hand, commercial loans, used to finance companies' working capital, are still suffering, falling 36.4% in the last twelve months up to August. Investment funding continues to be very weak, judging by the year-on-year decrease of 16.6% in financial leasing.

HOUSEHOLD FINANCING IS AT THE SAME LEVEL AS AUGUST 2008

Year-on-year change in financing granted to resident households (*)



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

FINANCING OF NON-FINANCIAL SECTORS (1)

August 2009

	Balance	Change this year	Change over 12 months		% participation
	Million euros	Million euros	Million euros	% (2)	
Private sector	2,212,082	–5,087	26,922	1.1	84.7
Non-financial corporations	1,308,725	2,093	30,428	1.8	50.1
Resident credit institution loans (3)	*926,399*	*–27,736*	*–12,988*	*–1.1*	*35.5*
Securities other than shares	*49,055*	*7,978*	*9,568*	*24.2*	*1.9*
External loans	*333,272*	*21,851*	*33,848*	*7.9*	*12.8*
Households (4)	903,356	–7,180	–3,506	0.0	34.6
Housing loans (3)	*676,324*	*–2,125*	*2,128*	*0.5*	*25.9*
Other (3)	*224,394*	*–5,319*	*–5,965*	*–1.4*	*8.6*
External loans	*2,639*	*264*	*330*	*14.3*	*0.1*
General government	403,103	72,957	102,406	34.1	15.4
TOTAL	**2,611,603**	**64,288**	**125,746**	**4.9**	**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 securitized loans.
(4) Include those non-profit institutions serving households.
SOURCE: Bank of Spain and own calculations.

Financing to households was at the same level as twelve months previously, continuing the slowdown of the last few years. Loans for housing continued to decelerate and rose by 0.5% compared with August 2008, 6.1 points less than one year ago. However, there have been fewer drops in the number of mortgaged homes in the last few months. According to data from the National Institute of Statistics, 58,995 mortgages were taken out on homes in July, 19.1% less than twelve months before but comparing favorably with an accumulated year-on-year drop of 29.7% in the first seven months of the year.

This relative improvement is partly due to the fall in the 12-month Euribor rate, widely used as an index in the mortgage market, whose monthly average hit another record low in September of 1.26%, 412 basis points less than a year earlier. This decrease reflects the cuts made in the official European Central Bank interest rate in the last period, as well as the reduction in risk premium in the interbank market. It even dropped below this level during the first few weeks of October. The fall in real estate prices also contributed, so that the theoretical effort to buy a home is now slightly less than last year.

The 12-month Euribor rate hit a new record low of 1.26% in September and continued falling in October.

However, default has continued to rise due to the economic recession. The default rate for financial institutions as a whole rose two decimals in August, up to 4.9%, 2.4 points more than twelve months before.

With regard to public sector financing, this is showing an upward trend. August saw a year-on-year growth of 34.1%, although 2.6 points lower than that recorded for July. The overall financing of resident sectors therefore continued to slow up, with a year-on-year increase

The default rate has risen to 4.9%.

Families are saving more.

of 4.9%, 0.5 percentage points less than in July and 3.5 points less than in August the previous year.

Growth in bank deposits slows up

Household savings continue to recover after having hit rock bottom during the boom years. These savings have largely been stimulated by caution in view of the uncertainty created by the sharp rise in unemployment. According to data from the National Institute of Statistics for the second quarter, the disposable income of households rose 4.3% year-on-year. Given that consumption costs fell by 8.6% and that investment was down 27.0% compared with the second quarter of 2009, net lending stood at 29,087 million euros in the second quarter. This is equivalent to 10.9% of the quarterly gross domestic product (GDP), compared with 0.5% a year ago.

For the first time in the last five years, on demand and savings deposits have grown more than term deposits.

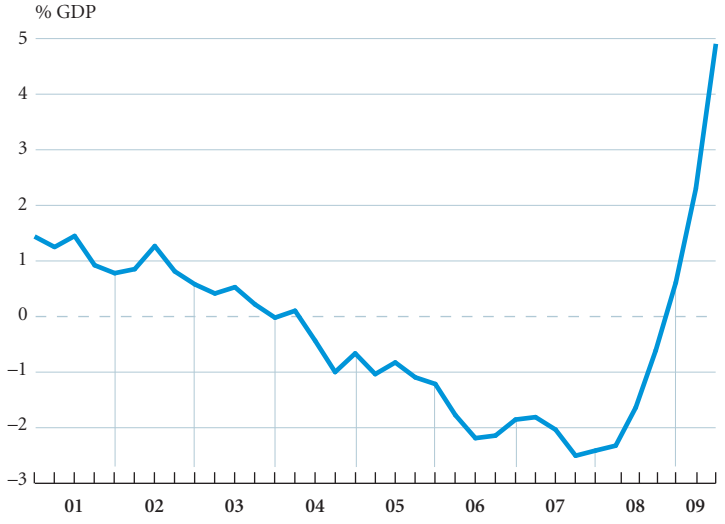
This net financial saving was placed particularly in bank deposits. However, in the first few months of the third quarter, private sector deposits as a whole tended to slow up, contributing to a slight drop in yield.

Consequently, bank deposits overall had a year-on-year change rate of 5.2% in August, 10.7 points less than one year ago. For the first time in five years, year-on-year growth in on-demand and savings deposits was higher than that of term deposits, at 5.6%. This was due, on the one hand, to the smaller gap between short and medium-term interest rates and also to investors opting for liquidity.

Competition between bank deposits and some share issues led to mutual funds recording net withdrawals once again in September, after having recorded net subscriptions in August. In September, sales of shares in mutual funds exceeded purchases by 1,560 million euros, so that

RECOVERY IN HOUSEHOLD NET LENDING

Net lending of households and non-profit institutions providing services to households as percentage of GDP (*)



NOTES: (*) Latest four-quarter moving average.
SOURCE: National Institute of Statistics and own calculations.

BANK LIABILITIES DUE TO COMPANIES AND HOUSEHOLDS

August 2009

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On demand deposits	254,860	10,048	4.1	14,701	6.1	17.9
Savings deposits	197,451	17,674	9.8	19,177	10.8	13.9
Term deposits	735,253	5,981	0.8	39,038	5.6	51.8
Deposits in foreign currency	24,500	–4,818	–16.4	–12,533	–33.8	1.7
Total deposits	**1,212,065**	**28,886**	**2.4**	**60,384**	**5.2**	**85.3**
Other liabilities (*)	**208,599**	**–40,031**	**–16.1**	**–38,516**	**–15.6**	**14.7**
TOTAL	**1,420,664**	**–11,144**	**–0.8**	**21,867**	**1.6**	**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.

the net accumulated withdrawals in the first nine months of 2009 totaled 10,668 million euros. However, most mutual fund categories recorded net subscriptions, such as long-term Euro bonds, international mixed equity, mixed Euro bonds and global funds. Free investment funds, the so-called hedge funds, also recorded net gains due to the improved situation in international financial markets, although to a much lesser degree.

Accumulated yield up to the end of the third quarter was positive for all types of mutual fund, being higher than 4% on average. The average yield over the last twelve months was 2.6%, with a wide spread. The greatest gains came from international equity from emerging markets, with 10.6%, and from national equity, with 9.0%, while the biggest drop was in US international equity, of 11.3%.

Mutual funds went back to net withdrawals in September.

All mutual fund categories achieved positive yields compared with December, with an average of 4%.

"la Caixa" RESEARCH DEPARTMENT

Publications

All publications are available on Internet:
www.laCaixa.es/research
E-mail: publicacionesestudios@lacaixa.es

THE SPANISH ECONOMY MONTHLY REPORT
Report on the economic situation (available also in Spanish version)

ANUARIO ECONÓMICO DE ESPAÑA 2009
Selección de indicadores
Complete edition available on Internet

COLECCIÓN COMUNIDADES AUTÓNOMAS
1. La economía de Galicia: diagnóstico estratégico

2. La economía de Illes Balears: diagnóstico estratégico

3. La economía de Andalucía: diagnóstico estratégico

CÁTEDRA "la Caixa" ECONOMÍA Y SOCIEDAD
1. El tiempo que llega. Once miradas desde España José Luis García Delgado (editor)

DOCUMENTOS DE ECONOMÍA "la Caixa"
3. *Offshoring* y deslocalización: nuevas tendencias de la economía internacional Claudia Canals

4. China: ¿Cuál es el potencial de comercio con España? Marta Noguer

5. La sostenibilidad del déficit exterior de Estados Unidos Enric Fernández

6. El tiempo con los hijos y la actividad laboral de los padres Maria Gutiérrez-Domènech

7. La inversión extranjera directa en España: ¿qué podemos aprender del tigre celta? Claudia Canals y Marta Noguer

8. Telecomunicaciones: ¿ante una nueva etapa de fusiones? Jordi Gual y Sandra Jódar-Rosell

9. El enigmático mundo de los *hedge funds*: beneficios y riesgos Marta Noguer

10. Luces y sombras de la competitividad exterior de España Claudia Canals y Enric Fernández

11. ¿Cuánto cuesta ir al trabajo? El coste en tiempo y en dinero Maria Gutiérrez-Domènech

12. Consecuencias económicas de los ciclos del precio de la vivienda Oriol Aspachs-Bracons

13. Ayudas públicas en el sector bancario: ¿rescate de unos, perjuicio de otros? Sandra Jódar-Rosell y Jordi Gual

14. El carácter procíclico del sistema financiero Jordi Gual

15. Factores determinantes del rendimiento educativo: el caso de Cataluña Maria Gutiérrez-Domènech

"la Caixa" ECONOMIC PAPERS
1. Vertical industrial policy in the EU: An empirical analysis of the effectiveness of state aid Jordi Gual and Sandra Jódar-Rosell

2. Explaining Inflation Differentials between Spain and the Euro Area Pau Rabanal

3. A Value Chain Analysis of Foreign Direct Investment Claudia Canals and Marta Noguer

4. Time to Rethink Merger Policy? Jordi Gual

5. Integrating regulated network markets in Europe Jordi Gual

6. Should the ECB target employment? Pau Rabanal

"la Caixa" WORKING PAPERS
Only available in electronic format at: www.laCaixa.es/research

01/2008. Offshoring and wage inequality in the UK, 1992-2004 Claudia Canals

02/2008. The Effects of Housing Prices and Monetary Policy in a Currency Union Oriol Aspachs and Pau Rabanal

03/2008. Cointegrated TFP Processes and International Business Cycles P. Rabanal, J. F. Rubio-Ramírez and V. Tuesta

01/2009. What Matters for Education? Evidence for Catalonia Maria Gutiérrez-Domènech and Alícia Adserà

02/2009. The Drivers of Housing Cycles in Spain Oriol Aspachs-Bracons and Pau Rabanal

ECONOMIC STUDIES
35. La generación de la transición: entre el trabajo y la jubilación Víctor Pérez-Díaz y Juan Carlos Rodríguez

36. El cambio climático: análisis y política económica. Una introducción Josep M. Vegara (director), Isabel Busom, Montserrat Colldeforns, Ana Isabel Guerra y Ferran Sancho

Academic Advisory Council

The Academic Advisory Council guides the Research Department in its work of analyzing economic and social policy that may be most effective for the progress of Spanish and European society. The Council is made up as follows:

- Manuel Castells
  Universitat Oberta de Catalunya and University of Southern California
- Antonio Ciccone
  ICREA-Universitat Pompeu Fabra
- Luis Garicano
  London School of Economics
- Josefina Gómez Mendoza
  Universidad Autónoma de Madrid
- Mauro F. Guillén
  Wharton School, University of Pennsylvania
- Inés Macho-Stadler
  Universitat Autònoma de Barcelona
- Massimo Motta
  Barcelona GSE - Universitat Pompeu Fabra
- Ginés de Rus
  Universidad de Las Palmas de Gran Canaria
- Robert Tornabell
  ESADE Business School
- Jaume Ventura
  CREI-Universitat Pompeu Fabra

Research Department

- Jordi Gual
  Chief Economist of "la Caixa"
- Joan Elias
  Director, European Unit
- Enric Fernández
  Director, International Unit
- Avelino Hernández
  Director, Financial Markets Unit

THE SPANISH ECONOMY
MONTHLY REPORT
November 2009

CAJA DE AHORROS Y PENSIONES DE BARCELONA

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

For subscriptions (new, cancellations, etc.):
publicacionesestudios@lacaixa.es

"la Caixa" GROUP: KEY FIGURES

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**

Design, page make-up and printing: www.cege.es - Ciutat d'Asunción, 42 - 08030 Barcelona D. L.: B. 21063-1980 ISSN: 1134-1920