

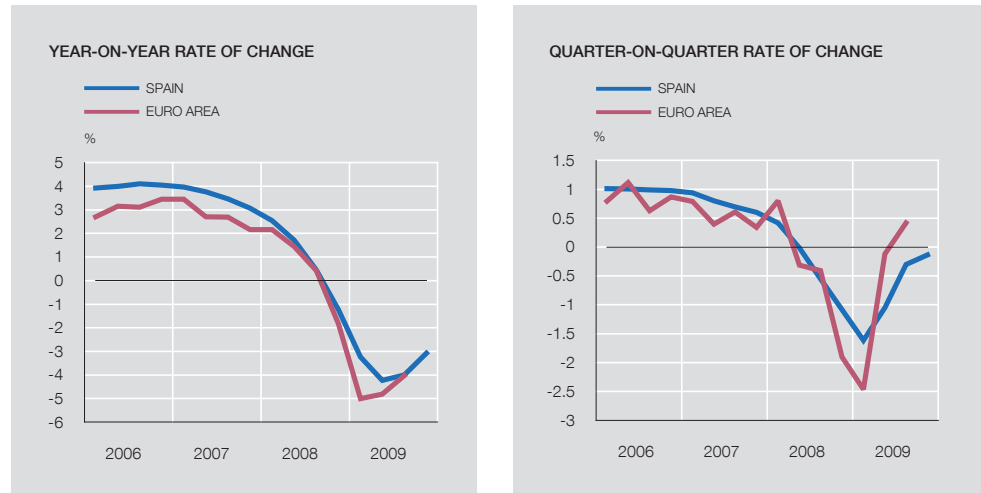
## 1 Overview

In the first three quarters of 2009, the Spanish economy continued on the contractionary course initiated in the second half of 2008. However, the pace of the decline in activity gradually eased from Q1, which marked the height of the contraction. The indicators available suggest that this pattern is expected to have slackened even further in 2009 Q4, and the quarter-on-quarter rate of GDP is estimated to have declined by 0.1% (-0.3% in the previous quarter). That entails a fall in the related year-on-year rate of 3.1%, 0.9 pp down on the previous quarter. On the expenditure side, the pace of decline of national demand eased off to a year-on-year rate of -4.8%, while the contribution of net external demand to GDP, which was positive for the seventh quarter running, fell by 0.5 pp to 2 pp.

As at year-end, GDP is estimated to have declined at a rate of 3.6% over the course of 2009, the biggest fall in activity in recent decades, in step with the severity of the contractionary trends facing the world economy over the past two years. In Spain, however, the imbalances built up during the previous upturn would also have contributed to the decline in activity. The fall-off in output was the result of the marked decline in national demand (6% on average in 2009), which affected all its components, except those linked to general government activity. In the second half of the year there was some smoothing in the quarter-on-quarter path of decline of expenditure, with increases actually being recorded in the case of consumption and investment in equipment, which were influenced by the direct aid for new car purchases, while public investment reflected the execution of projects under the Local Investment Fund. Net external demand softened the impact of the contraction in domestic spending on activity, contributing 2.7 pp to GDP growth. This contribution was also the biggest in recent decades and was underpinned by the decline in imports, which was far greater than that in exports.

On the supply side, the decline in spending affected all the productive branches, but particularly impacted manufacturing industry and construction. That led to a step-up in the process of job destruction, which heightened in the opening months of the year. As a result, in 2009 as a whole employment is expected to have declined by 6.7%, a higher figure than in previous recessions. The deterioration in employment expectations ultimately influenced labour supply, which posted increasingly lower growth and turned down in Q4, in contrast to its buoyancy in previous years. Notwithstanding, the unemployment rate rose to 18% of the labour force (18.8% in Q4) on EPA figures. The contractionary trends in expenditure affected the course of inflation, whose rate of increase lessened, influenced also by the fall in the prices of energy products, which had posted notable increases in 2008. In 2009 as a whole, the CPI fell by 0.3%, compared with an increase of 4.1% in 2008. Annual average inflation had not been negative since 1952.

On the international economic front, financial markets continued to improve – despite some local episodes of tension – and the process of economic recovery initiated in Q3 proceeded once the United States, Japan and the euro area resumed positive growth rates and the rates of expansion picked up in the emerging economies, led by developments in the Asian countries, particularly China. Generally, this improvement in economic activity was based on temporary factors, such as restocking and the exceptional impulses provided by economic policies during the recession. Global inflation began to rise in the closing months of the year, once the base effects prompted by the oil price rises in 2008 were stripped out, although expectations about the future course of prices remain tempered. On the foreign exchange markets the dollar appreciated against the main currencies, and on the commodities markets oil prices resumed a rising course, albeit a notably volatile one.



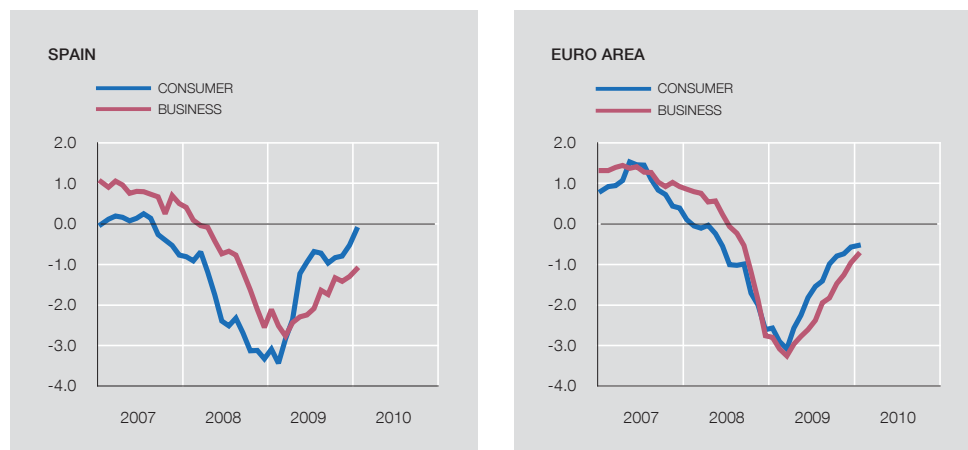
SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

The improvement in the economic and financial situation in recent quarters has prompted a further upward revision in the growth outlook for the world economy, although growing divergence in the strength of the recovery across regions and countries is discernible. In the latest update of its forecasts, the IMF anticipates growth rates of 4% and 4.3% for 2010 and 2011, respectively, although doubts remain over the scale of the recovery, once the monetary and fiscal stimuli in place have been withdrawn. The main factors of uncertainty continue to be the ongoing deleveraging of both the banking sectors and the non-financial private sectors, the labour market adjustment and the deterioration in public finances, which has taken on particular importance in some developed economies in recent months, given the widespread increases in budget deficits and in debt. Of particular significance in this setting are the questions relating to potential exit strategies: the most suitable time to withdraw the exceptional monetary and fiscal measures, and the means of doing this so as to ensure sustained growth without jeopardising the economic recovery and financial stability.

The monetary policy stance remained expansionary in the closing months of 2009, while the central banks of the main developed countries announced – and began to implement, in some cases – plans to withdraw their unconventional liquidity-support measures. In the United States, the official interest rate held in the range of 0% to 0.25%, while the Federal Reserve eliminated or scaled down some of its liquidity and financing facilities, adjusting to banks' lower demand. The Bank of Japan also kept its official interest rates on hold and paved the way for the gradual and orderly withdrawal of the special measures for purchasing private bonds and commercial paper. The Bank of England held its official interest rate unchanged at 0.5% and extended its asset-purchase programme.

The broad trends of recovery have also been shared by the euro area. After posting a positive GDP growth rate in Q3 (following five quarters of marked declines), the latest available indicators point too to growth of an expansionary sign in Q4, although this is still heavily dependent on the measures to stimulate aggregate demand and on temporary factors. Nonetheless, and despite the pick-up in output in the second half of the year, euro area GDP is expected to fall by around 4% in 2009 on the forecasts of the main international agencies, which further anticipate a very gradual recovery in activity for the coming quarters. Inflation turned positive again in the closing months of the year owing to the petering out of the base effects associ-



SOURCE: European Commission.

a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

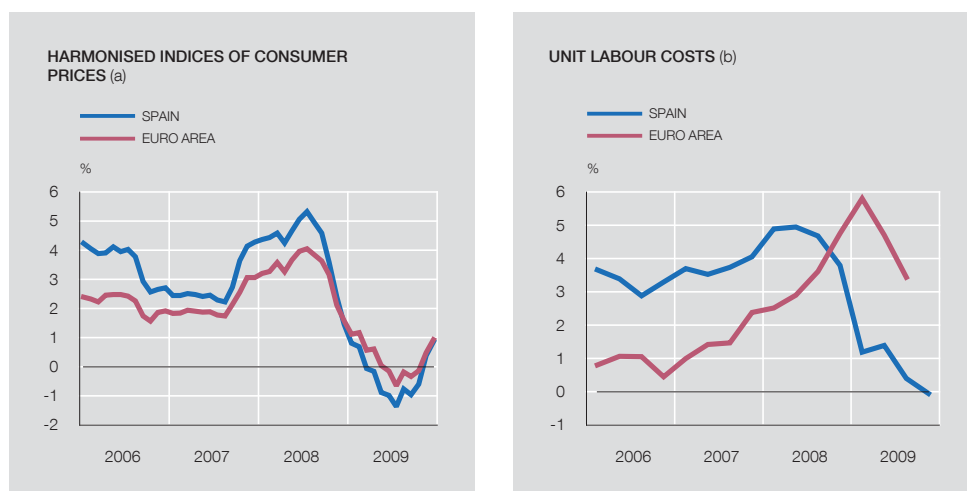
ated with past increases in commodities prices; into the medium term, it is estimated productive slack will contribute to holding inflation at moderate levels.

Turning to economic policies, the deterioration in public finances brought about by the contraction in activity and by the implementation of fiscal stimulus plans has placed 13 euro area countries in an excessive deficit position. Accordingly, they will have to adopt measures to comply with the recommendations made by the Ecofin in November. As regards monetary policy, the absence of risks to price stability in the medium term has led the ECB Governing Council, in its meetings to February, to hold official rates unchanged. The MRO rate has held at 1% since last May, while the marginal lending and deposit facility rates remain at 1.75% and 0.25%, respectively.

The ECB maintained a generous liquidity provision policy and, given the gradual normalisation of conditions on financial markets, it announced in December the start of a gradual withdrawal of some of the extraordinary measures introduced during the financial crisis. Hence the ECB had its last one-year funding operation in December and its six-month tenders will expire in March.

During 2009 Q4, there was a firming in the ongoing normalisation of the financial stress indicators at both the global and euro area levels that have begun in previous months. Interbank market rates were practically unchanged. Volatility and risk premia in the credit derivatives markets continued to lessen and the main stock market indices posted moderate rises, while activity increased on the debt markets. Finally, long-term interest rates moved on a slightly rising course. In 2010 to date, in contrast, there has been a slight rebound in financial instability, with stock market indices dipping, moderate increases in credit risk premia and, amid greater concern over sovereign risk, long-term sovereign bond yield spreads in the euro area have widened against the German benchmark. In early February, the IBEX 35 stood 7.9% below its end-2009 level (after posting gains of 29.3% in 2009), and the Spanish 10-year government bond yield spread over German sovereign debt was 85 bp.

In Spain, household and corporate borrowing costs fell further, which was nonetheless compatible with high premia continuing to be demanded in the higher-risk categories. Meantime, the degree of tightness of lending standards was similar to that in previous quarters, and was



SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.

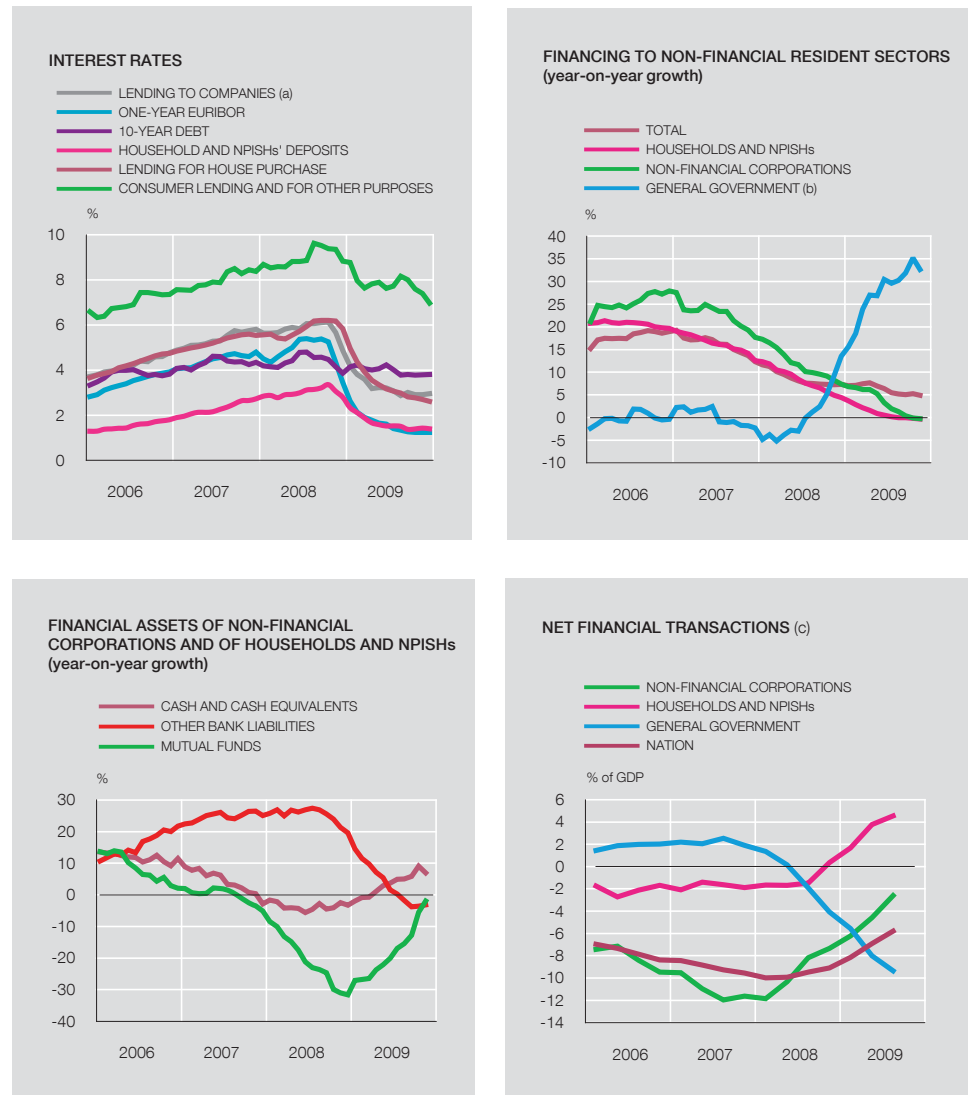
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

in any event stricter than that applied at the start of the financial crisis. In the property market, and according to figures from the Spanish Ministry of Housing, open-market house prices continued to fall during 2009 Q4 but did so at a lesser pace than in the preceding months, declining at a year-on-year rate of 6.3% (0.6% in quarter-on-quarter terms).

Despite this relative improvement in financial conditions and in the international environment, household spending remained sluggish, although there was a slight rise in its consumption component that may be associated chiefly with the effects of the direct aid programme for car purchases (Plan 2000E). The declining course of this variable is therefore estimated to have halted in Q4, following two years of negative quarter-on-quarter rates, ending the year with a 12-month decline of 3.6%. As a result of this process, household consumption on average in 2009 was once again the domestic demand component that most contributed to the decline in GDP.

As indicated on previous occasions, it is difficult to explain the drastic cut in consumption on the basis of developments in its most readily quantifiable determinants (see, for example, Box 4 in the October 2009 *Economic Bulletin*). On one hand, disposable income held at positive albeit moderate growth rates in 2009, underpinned by the sizeable transfers of income by general government, the reduction in interest payments and the fall in consumer prices which all offset the decline in wage income. On the other, the declining course of household wealth slowed in 2009 as a result of the better performance of stock markets and of the lesser decline in property prices. The strong response of consumption should therefore be attributed to factors linked to uncertainty over the current situation, in particular regarding the labour market, which will have boosted precautionary saving, and to households' perception of the need to redress their financial position. Only having regard to these considerations can an explanation be given for the rapid increase in the saving ratio, which stood at 18.7% of disposable income in 2009 Q3, in cumulative four-quarter terms, a figure 8.3 pp up on the low recorded in 2007 Q3 and which marks a new historical high.

Residential investment fell once more in Q4, posting a year-on-year rate of decline of almost 25%, although signs the contractionary trend is slowing are also beginning to be perceptible



SOURCE: Banco de España.

a. Owing to changes in statistical requirements for data compilation, there is a break in the series of bank lending rates in January 2003.

b. Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.

c. Consolidated financing: net of securities and loans that are general government assets.

d. Four-quarter cumulated data.

in this case. While many of the factors depressing the demand for housing remain in place (in particular, worsening income and uncertainty over the labour market), affordability continues to improve. That might boost the demand for housing and contribute to accelerating the absorption of excess capacity that the sector needs for activity to pick up.

Against this background of weak spending and with scarcely no changes in lending standards, which overall remain restrictive, household debt continued to contract. It did so at a year-on-year rate of 0.3% in November, although it is expected to have posted slightly positive increases compared with the previous quarter. Given this development, along with the stagnation of income, the debt ratio will foreseeably steady somewhat in Q4 at levels below the peak reached at end-2008. Other indicators of the household financial position showed signs of improvement, particularly the financial burden, which continued to decrease, and household

saving net of debt servicing, which stood at the highest level since the mid-1990s. As a result of these developments, the worsening of the macroeconomic situation was manifest in fresh increases in the doubtful loans ratio.

There was some recovery in investment project implementation by firms, though it was centred strongly on the components of investment able to benefit from the government's stimulus plans (acquisition of transport equipment and participation in civil engineering projects). This was because the overall conditions for embarking on this kind of expense did not improve appreciably, against a background in which the outlook for the recovery of demand continued to be weak and profits seem to have declined further. A further rise in investment in capital equipment is expected for Q4, trimming the year-on-year fall in this type of investment to -18% (6 pp higher than in Q3).

In this setting, corporate debt continued to decelerate up to November, to the extent that the rate of change was practically zero in terms of its year-on-year behaviour, and negative (around -6%) if calculated taking into account the latest developments. As in the case of households, the signs provided by the financial position indicators of non-financial corporations are mixed. Owing to the weakness of corporate income, fresh falls in the debt ratio are not foreseeable in 2009 Q4, but financial expenses continue to decline, which, unlike in other recessions, is helping to cushion the fall in corporate profits and is drastically reducing borrowing. According to the non-financial accounts of the institutional sectors for Q3, borrowing by non-financial corporations is estimated to have stood at -3.6% of GDP in cumulative four-quarter terms (-7.6% of GDP in 2008).

General government activity continued to be markedly expansionary in the closing months of 2009, as a result of the effect of the aforementioned plans designed to support activity, of the tax cuts and of other measures introduced in 2008 and which continued in 2009. To all these factors should be added the effects of the cyclical weakness which activated the automatic stabilisers and the absence of extraordinary revenue following the collapse in the residential sector, giving rise to a drastic deterioration of public finances, which went from a deficit of 4.1% of GDP in 2008 to one which, according to the latest Stability Programme update (2009-2013) released on 29 January, may amount to 11.4% in 2009. The announcement of the Stability Programme was accompanied by the ratification of the commitment to meet the budgetary stability target within the time horizons set by the EU authorities, so as to conform to the Stability and Growth Pact in the current exceptional circumstances. Essentially, this requires the budget deficit to be reduced to 3% of GDP in 2013. To do this, the government has announced public spending cuts for general government as a whole of €50 billion over the period. Specifically, for 2010 it budgets additional spending cuts of 0.5% of GDP, to which can be added an increase in revenue due to reversal of the temporary effects of some of the expansionary measures taken in recent years and to the planned rises in personal income tax, VAT and tax on saving. Additionally, for the rest of the horizon of the Stability Programme, the Council of Ministers tabled an austerity plan for 2011-2013, which proposes general spending cuts equal to 2.6% of GDP for the period as a whole.

With regard to trade with the rest of the world, the as yet incomplete information available indicates that in the closing months of the year net external demand once again cushioned the impact of the contraction in domestic spending on activity. It made a positive contribution of 2 pp of GDP, a figure down in any event on that of previous quarters, against the background of recovering trade in goods and tourist services. Following this result, and in a year in which trade flows were subject to major turbulence, especially in the opening months of the year, the external sector acted as a buffer as it had in past recessions. As was then the case, the factor

behind this improvement has been the reduction in imports, the outcome of the fall-off in domestic demand; however, in the current situation, the possibility that external demand may act in the immediate future as an underpinning of the recovery would require exports to be stronger. And in the absence of potential exchange rate adjustments, only an improvement in the competitiveness of Spanish firms may bring this about.

In the circumstances described, the nation's net borrowing is estimated to have continued declining in the closing months of the year, after having stood in Q3 at 5.8% of GDP in cumulative four-quarter terms. As a result, it is expected to stand at 4.7% of GDP for the year on average, 50% down on the related 2008 figure. Across the institutional sectors, the correction of the external imbalance was brought about by the increase (of around 12 pp for the year on average) in household and corporate net lending, since the deficit position of the general government sector widened (by somewhat over 7 pp).

On the supply side, there were declines in value added in all the market-economy productive branches in Q4. These were nonetheless lower than the declines in the previous quarter, except in market services, where for the second quarter running a moderate rise was recorded. The completion of some of the projects linked to the State Local Investment Fund slowed the rise in the non-residential construction segment, while residential building is expected to have held on its declining course in a setting in which over-capacity remains at high levels. Following the close of the year, the biggest falls in value added in 2009 were in industry (with an estimated decline of 14%) and in construction (-6%).

The pace of job destruction in the closing months of 2009 also lessened, chiefly as a result of the somewhat less negative behaviour of market services and, to a lesser extent, of industry, while the improvement observed in the two previous quarters in construction slowed for the above-mentioned reasons. For the year as a whole, the rate of job destruction reached unprecedented levels, with an estimated average decline of 6.7%, to which all branches of activity contributed. Against this background, the unemployment rate, according to the EPA, increased notably to 18% of the labour force (against 13.9% in 2008 Q4). This was despite the sharp change in the dynamics of labour supply, which was affected by the significant reduction in net inflows of immigrants and by the reduction in the participation rate owing to worsened labour market conditions. The contraction in employment was far greater than the decline in output, meaning there was a notable increase in apparent labour productivity; however, this recovery has a significant cyclical component, whereby it cannot be extrapolated to the future. Furthermore, the bulk of the adjustment in employment affected temporary contracts and hiring, as a result of which the ratio of temporary to total employees fell over the course of the year, reaching a rate of 25.1% in Q4.

Labour costs eased somewhat, albeit to an insufficient extent from the standpoint of the scale of the adjustment in employment and of the course of final prices. Collective bargaining agreements in 2009, which were entered into in the absence of an Interconfederal Collective Bargaining Agreement, for the first time in many years, incorporated an increase in wage rates of 2.6%. This figure was 1 pp down on the previous year and reflects the containment of inflation in the final months of 2008. The non-application of indexation clauses during 2009 had an effect along these same lines. All told, economy-wide compensation per employee increased at a rate of 4.1% for the year as a whole, marking a most substantial increase in real labour costs and running strongly counter to the serious economic recession and strong rise in unemployment the economy is undergoing. Nonetheless, the exceptional growth of productivity helped temper unit labour costs, which scarcely grew in 2009 (0.7% against 4.6% in 2008).

Inflation responded forcefully to the weakness of demand, adding to which was the disinflationary impact exerted by the decline in energy product prices compared with the levels of the previous year. This latter factor contributed to the CPI posting negative growth rates mid-year. Regarding the behaviour of prices in 2009, the correction of core inflation in particular is worth mentioning. This variable increased by only 0.8% on average during the year and, under this heading, the downward course of services prices, which had traditionally been relatively unresponsive to the cyclical situation, was noteworthy. It should also be highlighted that the easing in prices was greater than that in the euro area, meaning that price differentials were negative for most of the year (the gap stood at zero in December), for the first time since the start of the Monetary Union. With a view to the coming quarters, for which a rebound in consumer prices is expected, it would be very important to maintain inflation differentials favourable to the Spanish economy. That would contribute to securing the gains in competitiveness needed so that the economy may be underpinned by external demand and that the resources surplus to the real estate sector may be reallocated. For this to occur, reforms must be undertaken in the markets for factors, goods and services that allow this pattern of moderation to take root, along the lines laid down by the draft Sustainable Economy Bill, which stresses the importance of implementing supply-side and structural reform policies that enable a sustained long-term growth path to be resumed.

Structural reforms are, along with budgetary consolidation, the main instrument available to the economy to emerge from the crisis and restore growth and employment generation. The government has responded to this need: in addition to its commitment to austerity to ensure that the stability of public finances is redressed, it has outlined proposed reforms which will be specified in the immediate future. Of particular importance among these will be first, those relating to the sustainability of the pension system, where a gradual increase in the retirement age has been announced which may contribute significantly to the financial equilibrium of the public pensions system; and further, those relating to the functioning of the labour market.



## 2 The external environment of the euro area

Financial markets and activity continued to recover during 2009 Q4 and in early 2010, at the same time as there was an ongoing improvement in the economic outlook. However, this recovery process can increasingly be seen to be moving at different rates, both between countries and regions (where the most buoyant areas are emerging Asia, at the global level, and the United States, among the main industrialised economies) and between segments of private-sector financing insofar as the sharp deceleration of bank credit counters the buoyancy of corporate debt issues. This is against a backdrop of a sharp rise in inflation rates due to the base effects which compressed year-on-year rates until summer. Despite the improvement in the economic and financial situation, exiting the crisis is still surrounded by uncertainty since the recovery of activity was boosted by temporary factors, such as the change in the stock-building cycle and fiscal stimulus programmes. Furthermore, the necessary vigour of private-sector demand continues to be weighed down by the weak labour market and sluggish bank lending. In this context, the deterioration in developed economies' public finances has increasingly been perceived in recent months to pose a risk for recovery and financial stability.

The backdrop of a better economic outlook contributed to the favourable performance of financial markets in Q4, although certain events triggered a degree of instability and temporary losses on stock markets, such as the debt restructuring of certain publicly-owned firms in Dubai. More recently, action taken by the Chinese authorities to curb credit growth and moderate the strong recovery in the Chinese economy, announcements about changes in the US financial and regulatory policy framework which, if implemented, could have far-reaching consequences for how its financial system is structured, and the perception of a striking deterioration in Greece's fiscal situation, which has spread to other European countries, were reflected in greater risk aversion. Another factor which has conditioned financial developments has been the incipient process of withdrawing government support measures for the financial sector (which to date has been proceeding in an orderly fashion, as detailed, for the case of the United States in Box 1). More generally, despite the above-mentioned risks concerning the sustainability of public finances, the moderate rise in long-term interest rates in the United States, the United Kingdom and Japan from December would appear to be more closely linked to the improved outlook for activity. Noteworthy on the foreign exchange markets was the dollar, which mid-Q4 began to appreciate against the main currencies of developed economies, in particular against the euro.

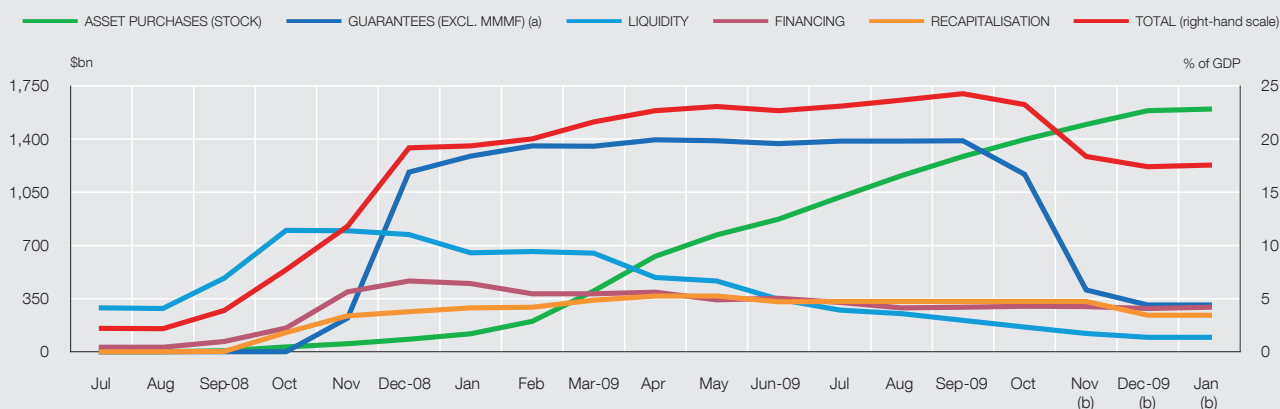
Emerging economies' markets also held on a rising trend for most of the quarter, arising from their improved economic outlook and the low interest rates in developed economies. In general, these two factors coupled with increased appetite for risk and, in some cases, expectations of an appreciation of exchange rates, have stimulated sharp capital inflows (which have led some countries to adopt or reintroduce measures to counter them) at the same time as their sovereign spreads continued to drop until mid-January. As for raw materials, the price of Brent oil fluctuated slightly around \$75 per barrel throughout Q4, whereas the price of gold reached a record high, although it moderated somewhat at the end of the quarter.

In the United States, the initial estimate of GDP in Q4 showed growth of 1.4% in quarter-on-quarter terms (5.7% in annualised terms), which is higher than the 0.6% increase in Q3, arising mainly from the favourable movements in inventories and the effect of the fiscal stimuli on aggregate demand. Thus, in 2009 as a whole the US economy contracted by 2.4% with respect to the previous year. This initial estimate of GDP for Q4 confirms the favourable higher fre-

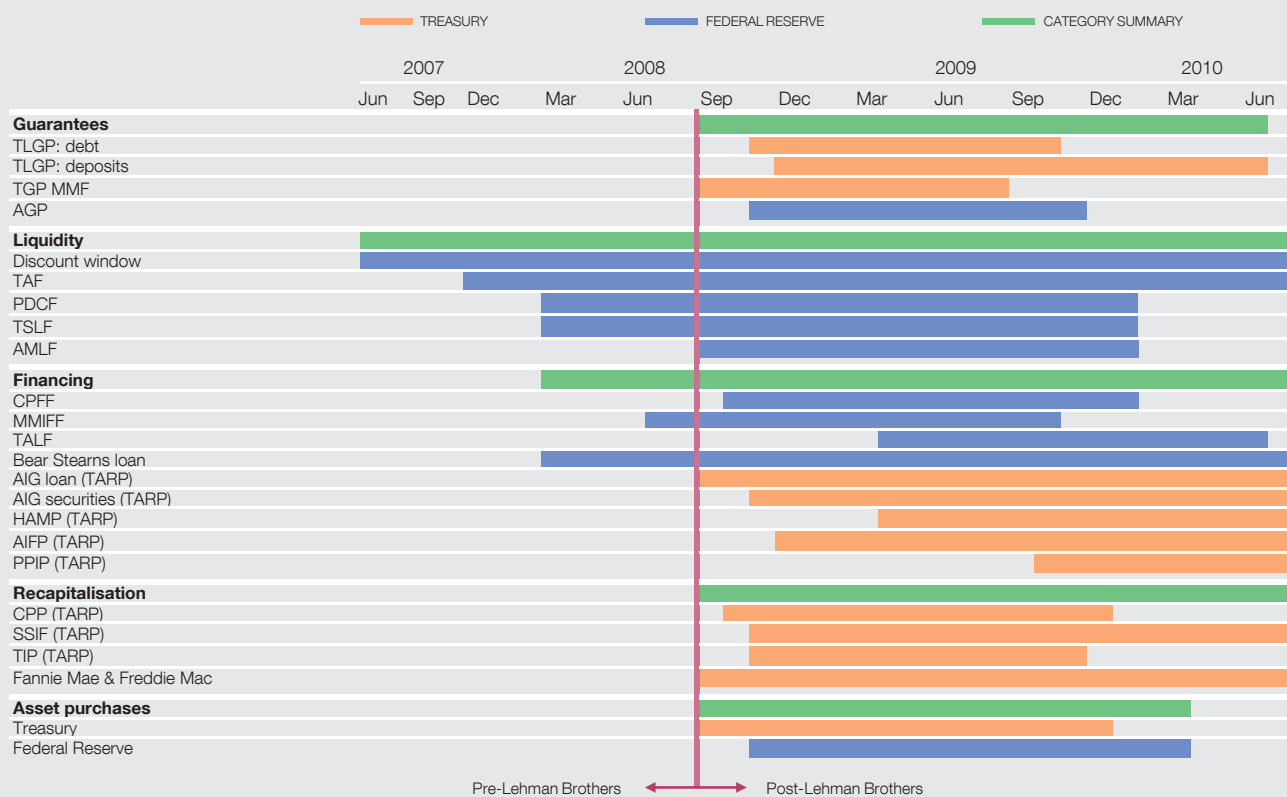
International financial markets have gradually recovered from their slump following the collapse of Lehman Brothers in September 2008. The turning point was seen around March last year and their favourable performance has gained strength (with some fluctuations) following the gradual improvement in the world economic outlook and the better-than-expected results achieved by financial and non-financial institutions from 2009 Q2.

The massive support given by authorities in the early stages of the crisis has played a pivotal role in the process of stabilising markets and improving confidence. This support was in the form of a very broad range of measures whose basic features were: i) the provision of practically limitless liquidity to financial institutions by central banks; ii) abundant financing for the financial and non-financial segments most affected by the crisis; iii) the recapitalisation of beleaguered in-

1 FUNDS COMMITTED BY US AUTHORITIES BETWEEN JULY 2008 AND JANUARY 2010



2 DURATION OF PUBLIC SUPPORT MEASURES IN THE UNITED STATES



SOURCES: Federal Reserve, US Treasury and Banco de España.

a. Guarantees exclude those granted to Money Market Mutual Funds.

b. Due to the delay in the publication of some reports, the November to January data are supported by certain assumptions.

stitutions; iv) the provision of public backing for bank debt issues and, subsequently, for part of certain institutions' asset portfolios, and v) the purchase of impaired assets and government bonds in order to reduce long-term financing costs. The panels in this box group these measures into the five categories identified and show the duration, use and scale of such support in the United States.

Although, even before September 2008, the Federal Reserve's liquidity facilities had been extended and there had been ad hoc cases of financial support (Bear Stearns in March 2008), it was after the collapse of Lehman Brothers that the bulk of the above-mentioned measures were instrumented. As shown in Panel 2,<sup>1</sup> which includes the duration of the measures adopted by the Treasury and the Federal Reserve, between September and October 2008 most of the measures were already in force, although they were implemented gradually and others were added at a much slower pace. Initially, the liquidity facilities represented the most substantial support and led to strong growth of the Federal Reserve's balance sheet; the guarantees were called swiftly following the crisis and the recapitalisation of institutions became very important – although the amount involved was relatively small – with the implementation of TARP (Troubled Asset Relief Program) by the Treasury and other specific support in 2009 Q1, whereas the Federal Reserve's and the Treasury's financing programmes were gradually used throughout that year. Lastly, asset purchases, in which both institutions also participated, have grown in relative and absolute terms from February 2009.

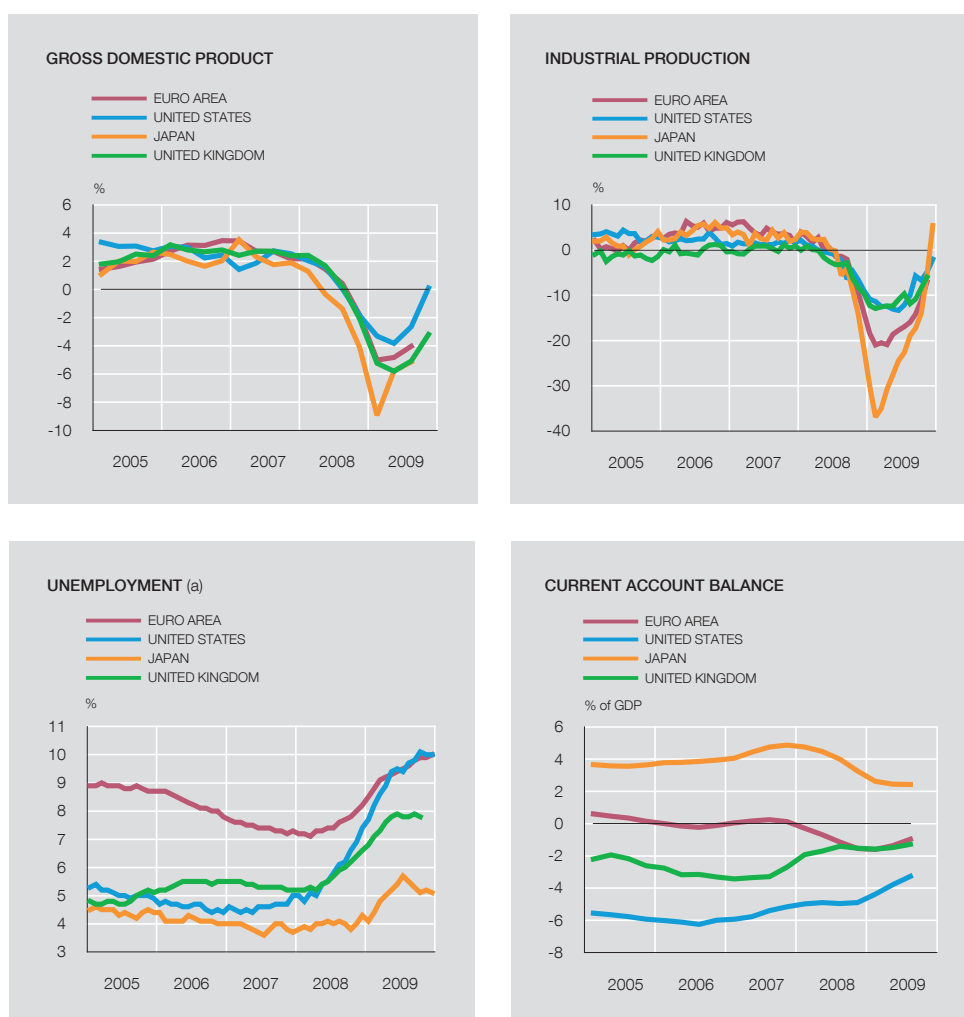
In the context of the recovery of many financial market segments, the use of the support stabilised from April 2009 – when the total funds deployed exceeded \$3.5 bn (approximately 25% of GDP) – and gradually decreased from November. The sequence of the withdrawal of the measures has generally been similar to that of their implementation, although at a much more restrained pace: thus, the stabilisation of the financial situation resulted in less use of short-term liquidity facilities, whose cost began to be higher than that pro-

1. The rows of the table correspond to the programmes instrumented in each area of action. A detailed explanation is beyond the scope of a box. For more detailed information see the US Treasury Department Troubled Asset Relief Program Monthly Congressional Report (January 2010), Federal Reserve System Monthly Report on Credit and Liquidity Programs and the Balance Sheet (January 2010) and the FDIC Quarterly Banking Profile (September 2009).

vided by less tight markets. Thus, although the US authorities have scheduled the expiry of the liquidity measures for February 2010, much of the emergency aid practically ceased to be used during summer 2009. Publicly-guaranteed bank debt issues lost momentum as early as the end of 2008 and were no longer used in October when the programme expired, although other types of guarantees (transaction accounts and asset guarantees) continued to be used intensely until 2009 Q4. At present, most of them have expired, as seen in Panel 2. Demand for some funding facilities (several of which expire in February 2010) has fallen in recent months. The recapitalisation funds have been returned by some financial institutions – in particular the major banks – as they gained access to financing from the market; however, many smaller institutions have held onto them. On the contrary, other funding and recapitalisation facilities remain in force and are important such as the mortgage modification and refinancing programme, the recapitalisation of the mortgage securitisation agencies, Fannie Mae and Freddie Mac, and the capital injection into AIG, the insurance company. Lastly, asset purchases (which are calculated in cumulative terms or as stock in Panel 1) continued apace until the end of last year, although some facilities have already expired and others are about to. For example, in the United States the Treasury has ended its purchase programme of Fannie Mae and Freddie Mac's mortgage backed securities (MBS) and the Federal Reserve plans to end purchases of these assets in March and has already completed purchases of Treasury bonds. However, the assets will foreseeably remain for some time in the public sector, which will mean, among other things, that the Federal Reserve's balance sheet will continue to be considerably oversized compared with before the crisis.

In short, support measures for markets and financial institutions are being wound down in an orderly and selective fashion and at different speeds by market segment at the same time as markets are beginning to function better and as demand for such measures decreases. However, the amount of the funds used still stood at the end of last year at approximately \$2.5 bn, more than 17% of GDP. Although support is being wound down, some of these measures continue to be used quite intensely in specific areas (for example, the US mortgage securitisation segment). And this, given the underlying fragility in the financial system, calls for notable caution and prudence in managing their withdrawal.

quency data published until January. Supply indicators showed significant progress, whereas the performance of demand indicators (personal consumption and consumer confidence) was also positive, albeit weak. Real estate market indicators indicated a slight fragility in the incipient recovery. Turning to the labour market, job destruction was lower than in previous quarters, despite which the unemployment rate increased to 10% in December. As for prices, the CPI went from posting negative year-on-year growth rates in October to a positive year-on-year rate of 2.7% in December, whereas core inflation remained relatively stable. Against this backdrop, at its January meeting the Federal Reserve left official interest rates and its asset purchase target unchanged. With regard to extraordinary financial support measures, as de-

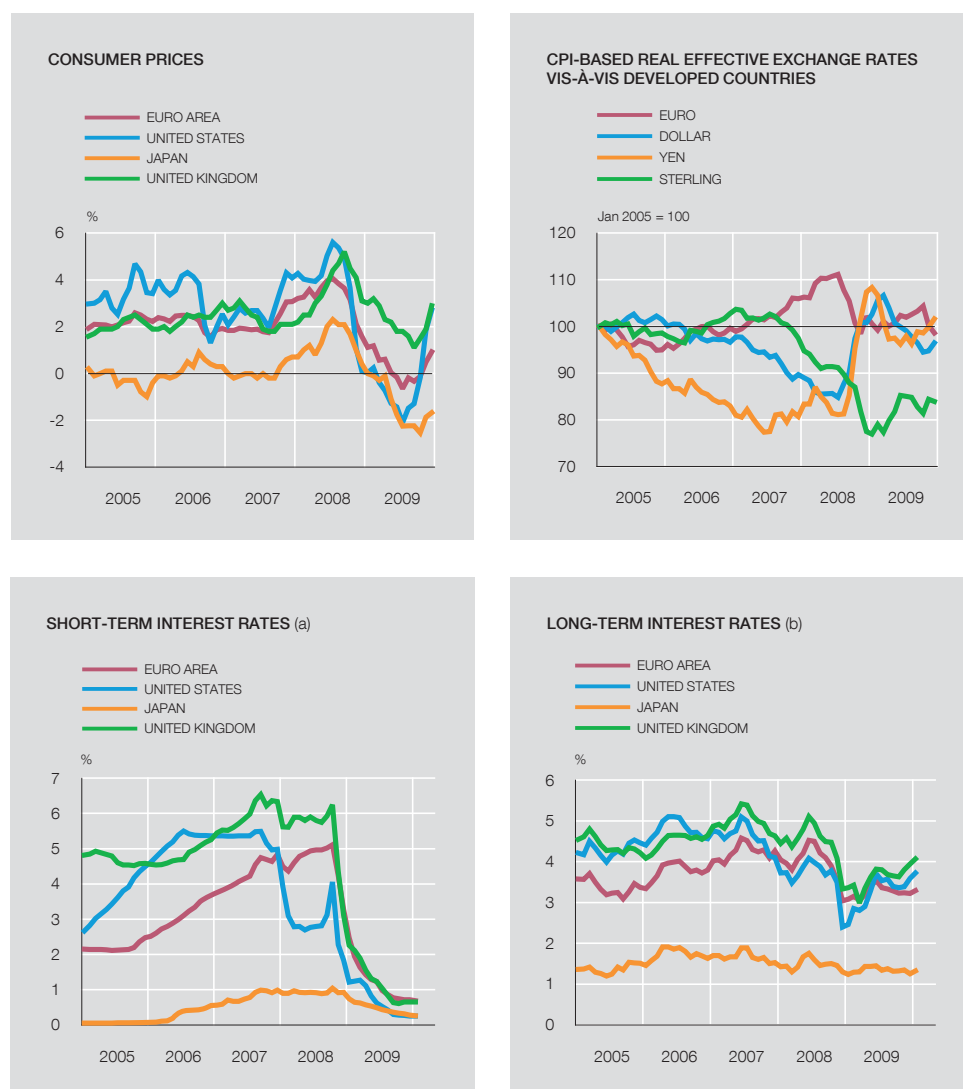


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

scribed in Box 1, most of them remain in place, although demand for them has fallen, some expired and large institutions returned the money used for their recapitalisation.

In Japan GDP for Q3 expanded by 0.3% quarter-on-quarter (-5.1% year-on-year), which is lower than the 0.7% growth posted in the previous quarter, and was essentially underpinned by favourable developments in external demand. In Q4 the lag remained in the economy between buoyant external demand and weak domestic demand, with the result that exports continued to improve, whereas consumption and private investment indicators failed to fully firm up. Furthermore, the process of improvement in supply indicators showed a slight restraint, which was also seen in the deterioration of large firms' expectations. That said, in December unemployment decreased by 0.2 pp with respect to September, to 5.1%. Consumer and wholesale prices continued to fall in year-on-year terms, albeit less sharply. In this setting, the Bank of Japan left interest rates unchanged but decided to create a new collateralised loan facility for the equivalent of 2% of GDP. Additionally, the Government announced new fiscal stimulus measures (with an estimated impact of approximately 1.5% of GDP) aimed, among other purposes, at boosting employment and encouraging the use of greener technologies, although they include the reallocation of funds from previous plans.

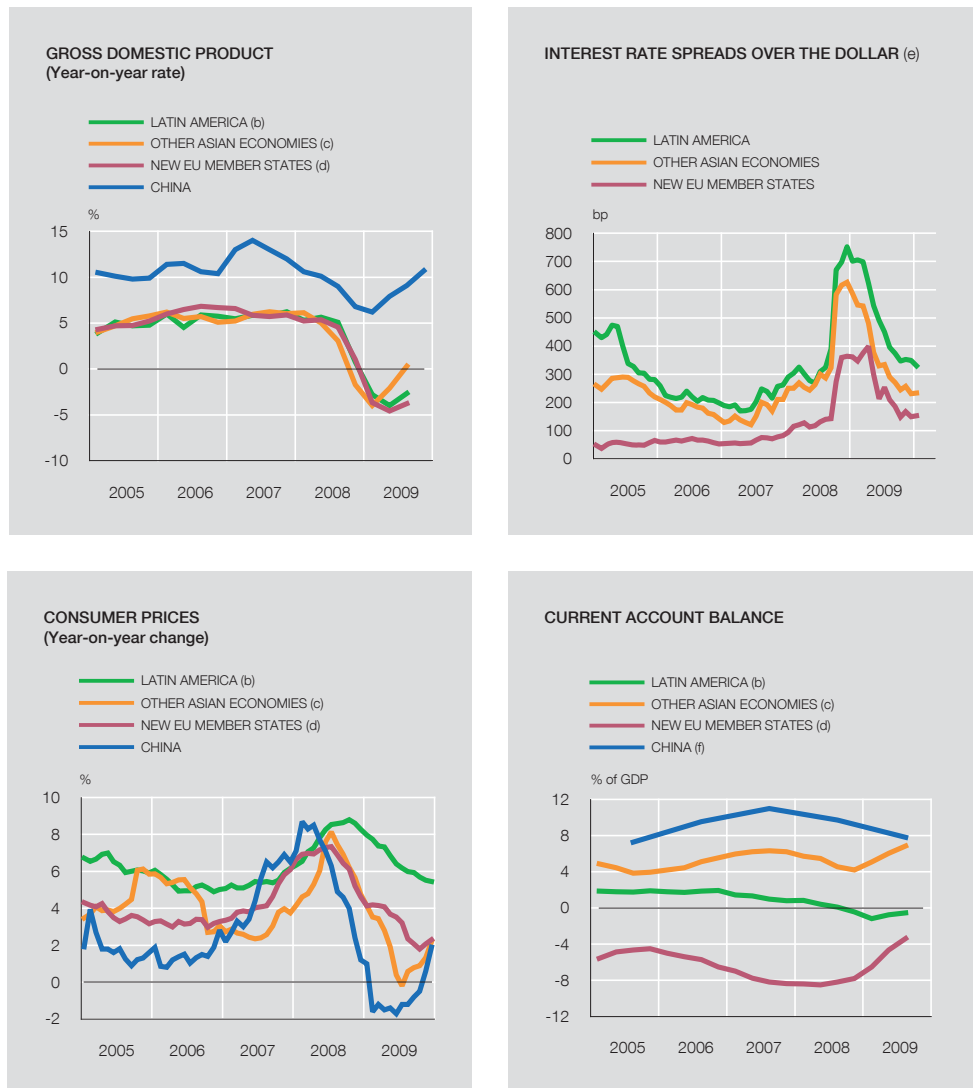


SOURCE: Banco de España.

- a. Three-month interbank market interest rates.
- b. Ten-year government debt yields.

In the United Kingdom, according to the preliminary estimate, GDP for Q4 grew 0.1% quarter-on-quarter (-3.2% year-on-year) in comparison with the 0.2% decline in Q3. Thus, in 2009 as a whole, GDP contracted by 4.8% with respect to 2008. The change in trend in Q4 reflects the slight recovery indicated by the higher frequency indicators published until the end of January. However, the labour market showed a slight weakness and the unemployment rate held at 7.8% in the three months to November. In addition, bank lending was slack, especially to small and medium-sized enterprises and households, except for housing loans which reflect the stabilisation seen in the real estate market. The inflation rate rose by 1.8 pp in Q4 to 2.9% in year-on-year terms in December, which was considerably higher than the official target of 2%, although this increase is considered temporary. Against this backdrop, at its January meeting, the Bank of England kept official interest rates at 0.5% and left its asset purchase programme unchanged.

In the new EU Member States not belonging to the euro area, GDP for Q3 moderated its fall in comparison with the previous quarter from -4.5% to -3.6% year-on-year, on aver-



SOURCES: National statistics and JP Morgan.

a. The aggregate of the different areas has been calculated using the weight of the countries that make up such areas in the world economy, according to IMF information.

b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.

c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.

d. Poland, Hungary, Czech Republic, Estonia, Latvia, Lithuania, Bulgaria and Romania.

e. JP Morgan EMBI spreads. The data on the new EU Member States relate to Hungary and Poland. The Asia aggregate does not include China.

f. Annual data.

age, due to the larger contribution from the external sector, whereas domestic demand remained depressed in most cases, especially in the Baltic states. However, GDP performance continued to differ greatly from country to country, ranging from growth of 1.7% year-on-year in Poland to a decline of -19% in Latvia. Q4 indicators show an export-driven rise in industrial production with the consequent improvement of trade and current account balances. The inflation rate changed trend during Q4 and rose from an average of 2.7% in year-on-year terms in October to 3.1% in December, due in particular to higher fuel prices. Turning to monetary policy, official interest rates continued to fall in those countries where they were still at high levels, such as Romania and Hungary, and, unexpectedly, in the Czech Republic where they were cut by 25 bp in December to 1%, a new all-time low.

In China GDP for Q4 rebounded strongly to 10.7% year-on-year (8.7% for 2009 as a whole) based essentially on economic policy stimuli. Throughout Q4 industrial production quickened considerably and business confidence continued at very high levels, at the same time as demand indicators remained robust, especially investment. The trade surplus widened considerably in the quarter against a background of recovery in international trade. The build-up of international reserves (which amounted to \$2.4 billion at the end of 2009) was vigorous, underpinned by higher inflows of foreign direct investment and short-term capital. Year-on-year CPI inflation increased gradually to 1.9% in December against a setting of loose monetary and credit conditions. Faced with this situation, the central bank increased the bank reserve requirement by 50 bp in January, marking the start of the withdrawal of the monetary impulse. In the rest of emerging Asia, GDP growth in Q3 increased to 3.9% year-on-year, confirming that it is the most buoyant region worldwide. This momentum extended into Q4, as shown by industrial production growth and the striking recovery of exports. Prices increased gradually following some months of negative inflation and monetary policies left interest rates unchanged, although measures were taken to discourage capital inflows.

In Latin America GDP growth quickened in Q3 to 1.3% quarter-on-quarter (-2.7% year-on-year), in comparison with 0.5% in the previous quarter (-4% year-on-year). The recovery was mixed with significant growth in Mexico, Peru and Brazil, stagnation in Argentina and declines in Venezuela. In Q4 the higher frequency indicators seemingly indicated, in general, that the path of recovery would continue. Inflation continued to ease to an average of 5.3% year-on-year in December, the lowest rate in more than two years. In this setting the region's central banks left interest rates unchanged except for Uruguay which cut them. As for public finances, the region's primary balances deteriorated across the board, due to the fall in revenue and the increase in expenditure. Additionally, there was an episode of institutional instability in Argentina as a result of the central bank's opposition to using part of the foreign exchange reserves for debt service. Lastly, Venezuela introduced a dual exchange scheme involving the devaluation of the bolivar against the dollar and setting a preferential rate for food and machinery imports.

### 3 The euro area and the monetary policy of the European Central Bank

In the second half of 2009 the euro area again posted positive GDP growth rates and thus overcame the sharp recession which had begun in 2008 Q2. The gradual stabilisation of the financial markets (not exempt from some bouts of localised turmoil) and a gradual improvement in foreign trade helped to stimulate activity in the area. However, this recovery relied largely on temporary factors, such as changes in inventories and the vigorous pursuit of economic policies.

The available forecasts coincide in pointing to a gradual economic recovery with weak domestic demand and growth rates which, as the influence of the temporary factors driving them progressively dissipates, will initially be more moderate than at end-2009. The high excess capacity will tend to delay the need for new investment, while the required downsizing in some productive sectors may continue to weigh negatively on employment. This unfavourable outlook for the labour market and the cumulative loss of wealth will debilitate private consumption. All this is, moreover, set against a backdrop in which the financial sector is still immersed in a process of deleverage and the public sector has less room for manoeuvre due to budget deterioration and faces, in a large number of countries, the need to take ambitious fiscal consolidation measures.

Euro area inflation also returned to positive values in November and rose to 1% in January, according to the Eurostat preliminary estimate. The rise is largely explained by the base effect associated with the past behaviour of energy prices and all forecasts point to euro area inflation remaining at moderate rates for a prolonged period. Against this background, the ECB's Governing Council has held the official interest rates for main refinancing operations at 1% since May 2009. Furthermore, in December it announced the first steps of a gradual withdrawal of the measures introduced during the crisis, which, given the progressive stabilisation of financial markets, were no longer as necessary as they were before. In any event, the Eurosystem continues to provide the liquidity needed by the system on favourable terms, thus making for the smoother financing of euro area households and firms.

Noteworthy in the fiscal area is the considerable deterioration in public finances. Thirteen euro area countries have an excessive deficit and have to adopt measures to comply with the fiscal adjustment recommendations prepared by the ECOFIN in November. These recommendations are set out in Box 2. The ECOFIN expressed its opinions within the framework of the agreement reached by the ministers to ensure that the exit strategy from the fiscal stimulus and financial sector support plans in the European Union is coordinated and does not hinder the incipient economic recovery. The work to remedy budgetary imbalances will still be compatible with an expansionary fiscal policy in 2010 for the area as a whole, and all countries will have to make considerable consolidation efforts from 2011 at the latest. It will be vital to meet commitments within the EU fiscal framework in order not to weaken agents' confidence and to promote sustained growth of the economy.

Against the background described above, structural reforms have taken on even greater importance, and this should be reflected in the next update of the Lisbon strategy in 2010, known as the EU 2020 strategy. Its implementation will be decisive in counteracting the effects of the crisis on potential output and in generating economic growth which also contributes to fiscal consolidation.



The design of a budgetary consolidation strategy allowing public finances to be put on a sound footing in the medium term, as agreed in the EU summit of finance ministers (ECOFIN) on 20 October 2009, is one of the main challenges facing current economic policy. The Stability and Growth Pact (SGP) is an essential instrument because it provides a means of adequately signalling the commitment to budgetary stability.

In this respect, as prescribed under the Pact, on 2 December 2009, the ECOFIN Council decided to initiate the excessive deficit procedure against eight euro area countries (Belgium, Germany, Italy, the Netherlands, Austria, Portugal, Slovenia and Slovakia) and to review the recommendations and time periods set for those countries with a procedure already open against them since April, namely Greece, France, Spain and Ireland. Consequently, at present 13 of the 16 Member States are subject to this procedure and, on the latest estimates of the Commission, Cyprus will also exceed the threshold of 3% of GDP in 2009.

The excessive deficit procedure is one of the basic pillars on which the SGP rests. The final aim of the Pact is for the euro area Member States to achieve «close-to-balance or in-surplus budgetary positions over the medium term», as this is indispensable for the monetary

union to function properly. To ensure that the various Member States conform to these parameters of budgetary discipline, it was agreed that the Treaty on European Union (the current Lisbon Treaty) should include Article 104 regulating the excessive deficit procedure. This procedure establishes the obligation of euro area Member States to avoid excessive deficits and to set reference values determining when a deficit exists. Thus there is generally considered to be an excessive deficit if the government deficit exceeds 3% of GDP, unless it remains near the reference value and is of an exceptional and temporary nature (caused by a severe crisis). Furthermore, the public debt ratio may not exceed 60% of GDP unless it is on a downward path. In addition, the EDP sets the time periods and supervision procedure applicable to countries incurring an excessive deficit. The process also envisages fines if the measures required to reverse that situation are not taken.

The recommendations made in the EDPs currently open are summarised in Table 1. With regard to time periods, the EDP stipulates that an excessive deficit must be corrected in the year subsequent to that in which it was detected, except in situations of severe economic crisis such as the present one. Therefore the EU finance ministers agreed that consolidation should generally commence in 2011, although, in cases of greater deterioration of public finances, it should

## FISCAL INDICATORS AND EXCESSIVE DEFICIT PROCEDURE IN THE EURO AREA

	BUDGETARY POSITION INDICATORS					EXCESSIVE DEFICIT PROCEDURE		
	2009 budget deficit (a)		2011 budget deficit (a)	Expenditure increase associated with ageing (2010-2060) (b)	Sustainability indicators (c)		Time period for correction	Required structural adjustment (% of GDP)
	Total	Cyclically adjusted			S2 indicator	Risk		
Germany	-3.4	-1.9	79.7	5.1	4.2	medium	2011-2013	0.50
Austria	-4.3	-3.3	77.0	3.3	4.7	medium	2011-2013	0.75
Netherlands	-4.7	-3.2	69.7	9.4	6.9	high	2011-2013	0.75
Italy	-5.3	-3.5	117.8	1.6	1.4	medium	2010-2012	At least 0.5
Belgium	-5.9	-4.6	104.0	6.6	5.3	medium	2010-2012	0.75
Slovenia	-6.3	-4.8	48.2	12.7	12.2	high	2010-2013	At least 0.75
Slovakia	-6.3	-6.0	42.7	5.5	7.4	high	2010-2013	1.00
Portugal	-8.0	-6.6	91.1	2.9	5.5	medium	2010-2013	1.25
France	-8.3	-7.0	87.6	2.2	5.6	medium	2010-2013	> 1
Spain	-11.2	-10.0	74.9	8.3	11.8	high	2010-2013	> 1.5
Ireland	-12.5	-9.6	96.2	8.7	15.0	high	2010-2014	2.00
Malta (d)	-4.5	-4.2	72.5	9.2	7.0	high	2009-2011	0.75
Greece	-12.7	-12.6	135.4	16.0	14.1	high	Not yet defined in 2010	
Euro area	-6.4	-5.0	88.2	5.1	5.8	—	—	—
UK	-12.1	-10.5	88.2	4.8	12.4	high	2010/2011-2014/2015	1.75

SOURCES: European Commission and Banco de España.

a. European Commission autumn 2009 forecasts. Percentage of GDP.

b. European Commission 2009 ageing report. Percentage of GDP.

c. European Commission 2009 sustainability report. The indicator S2 measures the size of the structural or permanent adjustment needed to ensure that the government's intertemporal constraint is met, i.e. that the sum of future revenue ensures repayment of the current debt plus the payment of all future expenditure, including that associated with ageing. Based on this indicator and on other more judgmental items, the European Commission classified the countries into three groups according to whether the risk to sustainability of public finances was low, medium or high (right-hand column).

d. January 2010 recommendation of the European Commission.

commence in 2010. The deadline for most countries to correct their excessive deficits has been set at 2013, except for Ireland (2014) and Belgium and Italy (2012).

As regards the annual structural adjustment which on average must be made by each country in the stipulated correction period, the amount is determined by each country based not only on its level of debt and deficit, but also on its current account balance, the contingent liabilities of the financial system, interest payments, risk premia and expected increases in expenditure associated with population ageing. The EDPs currently open put this adjustment between the 0.5 pp required of Germany and Italy and the 2 pp needed in Ireland.

Greece is an exception, since the Commission concluded that it had not adopted the measures needed to correct its excessive deficit. However, the situation of instability of this economy made it appropriate to introduce budgetary trimming measures in December, and these represent a step in the right direction to avoid the initiation of disciplinary proceedings.

Lastly, the EDPs open also include "invitations" to reform pension and public health systems aimed at ensuring sustainable public finances, especially in those cases in which the Commission considers there is higher risk according to the results of the sustainability report recently prepared by it.

Lastly, the Treaty of Lisbon came into force on 1 December. This treaty endows the European Union with a new legal framework which, among other things, introduces a more efficient decision-making process and will allow the EU to play a greater role in the international sphere.

### 3.1 Economic developments

In 2009 Q3 euro area GDP grew by 0.4% quarter-on-quarter, after five consecutive periods of decline (see Table 1). This improvement was largely driven by the slower rate of decrease of inventories and by the growth of exports and government consumption, while private-sector spending acted to reduce the momentum of activity. Despite the improved confidence, private consumption contracted and investment also declined, albeit less sharply than in previous quarters due to the recovery of capital goods (see Chart 8). All things considered, the contribution of domestic demand to GDP growth (excluding inventories) was slightly negative and, against a background of import strength, that of net external demand was nil. In year-on-year terms, GDP decreased by 4.1%. The breakdown by branch of activity shows a sizeable increase in the value added of industry, which was up by 2.2% with respect to the previous quarter, and, albeit to a lesser extent, increases in those of wholesale and retail trade and of agriculture.

The recovery of activity was apparent in most EU member countries in Q3. The pattern of growth, however, was mixed. Improved exports and investment and, above all, the positive contribution from inventories, allowed the German economy to grow at a quarter-on-quarter rate of 0.7%. In contrast, private consumption slipped significantly, largely reflecting the fewer registrations following the exhaustion of the funds for the German car purchase stimulation plan. The GDP of France again increased at a quarter-on-quarter rate of 0.3%, thanks to the positive contribution of the external sector and government consumption. Lastly, the GDP of Italy grew by 0.6% with respect to Q2 as a result of the recovery of investment in capital goods and of private consumption, linked to government incentives to stimulate car purchases.

Employment contracted further in Q3. The fall of 0.5%, similar to that of the previous quarter, took the year-on-year rate to -2%. The sharpest decreases were again seen in industry and in construction, and amounted to 1.6% and 2% with respect to the previous quarter, respectively. Job losses and the lower rate of contraction of GDP reduced the year-on-year fall of apparent labour productivity, which eased by 0.9% to -2.1%. This behaviour and the wage restraint brought a slowdown in unit labour costs, the year-on-year growth rate of which was 3.5%. At the same time, the fall-off in business margins slackened (see Chart 8).

	2008			2009			2010	
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
NATIONAL ACCOUNTS (quarter-on-quarter growth, unless otherwise indicated)								
GDP	-0.3	-0.4	-1.9	-2.5	-0.1	0.4		
Private consumption	-0.4	0.0	-0.5	-0.4	0.1	-0.1		
Public consumption	0.7	0.5	0.6	0.6	0.6	0.6		
GFCF	-1.4	-1.2	-4.0	-5.4	-1.6	-0.8		
Imports	-1.0	0.0	-4.8	-7.4	-2.8	3.0		
Exports	-0.5	-1.3	-7.2	-8.6	-1.2	3.1		
Contributions to quarter-on-quarter GDP growth (pp)								
<i>Domestic demand (excl. stocks)</i>	<i>-0.4</i>	<i>-0.2</i>	<i>-1.0</i>	<i>-1.2</i>	<i>-0.1</i>	<i>-0.1</i>		
<i>Change in stocks</i>	<i>-0.2</i>	<i>0.3</i>	<i>0.2</i>	<i>-0.8</i>	<i>-0.6</i>	<i>0.5</i>		
<i>Net external demand</i>	<i>0.2</i>	<i>-0.5</i>	<i>-1.1</i>	<i>-0.5</i>	<i>0.5</i>	<i>0.0</i>		
GDP (year-on-year rate of change)	1.4	0.4	-1.8	-5.0	-4.8	-4.0		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working-day adjusted	-1.1	-1.6	-8.2	-8.4	-1.2	2.3	0.9	
Economic sentiment	99.2	92.4	80.0	71.5	75.6	84.1	91.9	95.7
Composite PMI	50.8	47.6	40.2	37.6	43.2	49.5	53.6	53.6
Employment	0.1	-0.2	-0.4	-0.7	-0.5	-0.5		
Unemployment rate	7.4	7.6	8.0	8.8	9.3	9.6	9.9	
PRICE INDICATORS (y-o-y change in end-period data)								
HICP	4.0	3.6	1.6	0.6	-0.1	-0.3	0.9	
PPI	7.9	7.7	1.2	-3.2	-6.5	-7.6	-2.9	
Oil price (USD value)	132.0	98.1	40.5	46.8	68.8	67.7	74.4	72.1
FINANCIAL INDICATORS (end-period data)								
Euro area ten-year bond yield	4.9	4.5	3.8	4.1	4.2	3.8	4.0	4.1
US-euro area ten-year bond spread	-0.88	-0.88	-1.76	-1.31	-0.63	-0.47	-0.17	-0.45
Dollar/euro exchange rate	1.576	1.430	1.392	1.331	1.413	1.464	1.441	1.391
Appreciation/ depreciation of the NEER-21 (b)	2.9	-1.0	2.5	-0.6	-0.9	0.2	-1.0	-2.5
Dow Jones EURO STOXX 50 index (b)	-23.8	-30.9	-44.3	-15.5	-2.0	17.2	21.0	-5.8

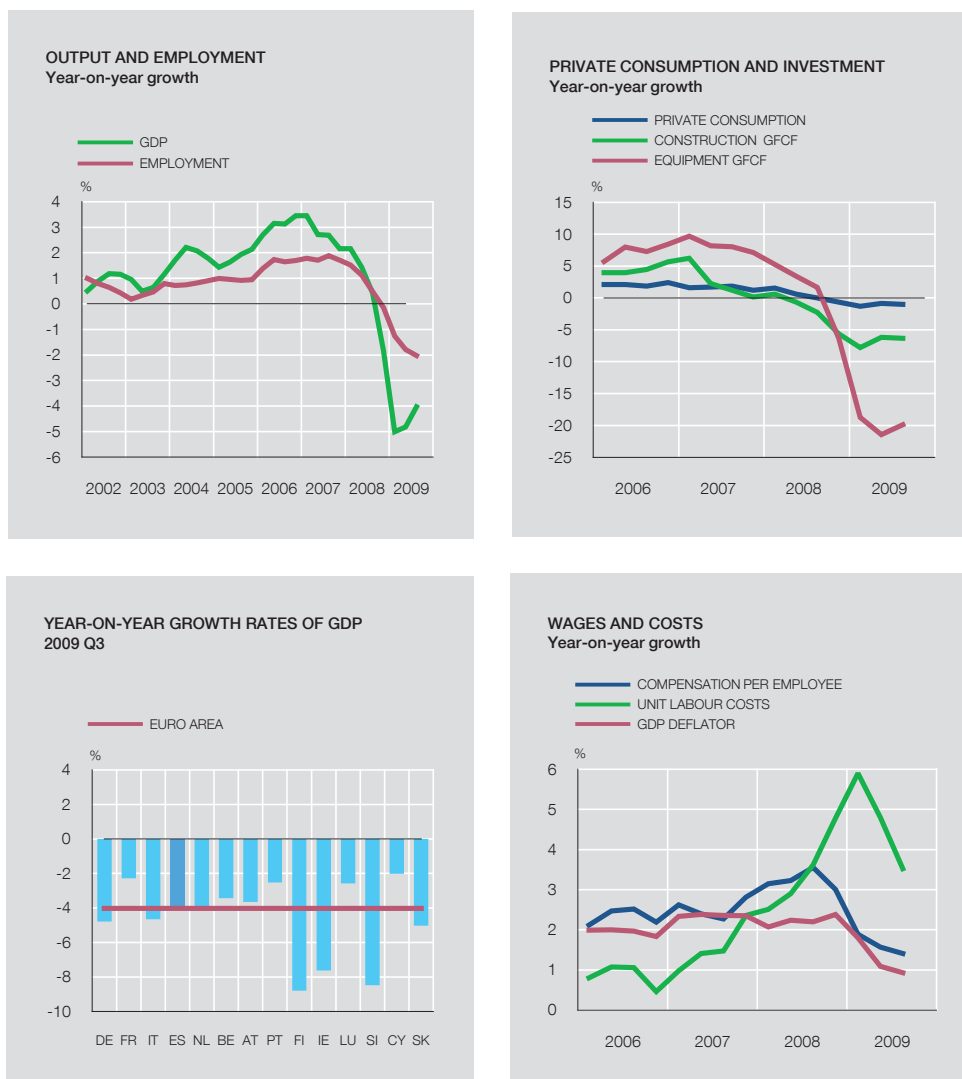
SOURCES: European Commission, Eurostat, Markit Economics, ECB and Banco de España.

a. Information available up to 01 February 2010. Figures in italics are not full quarters.

b. Percentage change over the year.

The latest information suggests that euro area activity recouped a positive rate of growth in the last quarter of the year (see Chart 9). On supply side data to November, industrial production and industrial orders increased with respect to the previous quarter, albeit at a weaker rate than in Q3. Confidence indicators held on their upward path and stood at levels compatible with increased activity, a trend which continued in January. Although the unemployment rate increased to 10% in December, the qualitative labour market indicators reversed their downward trend, holding at levels below their historical averages.

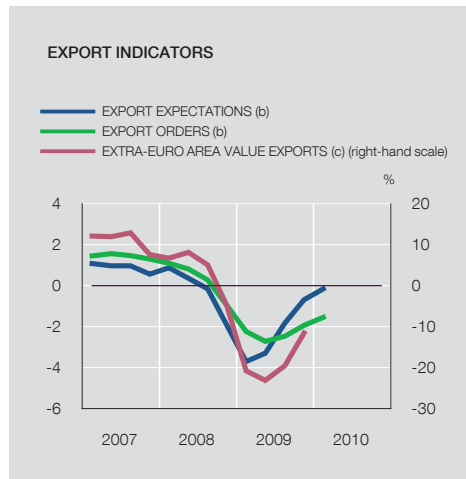
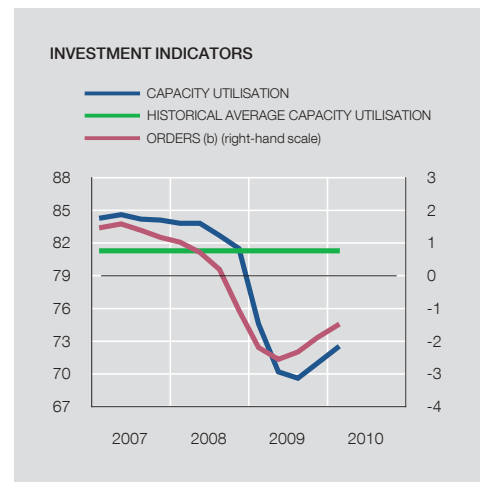
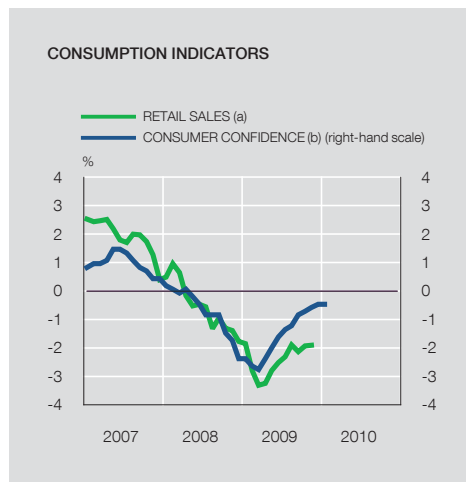
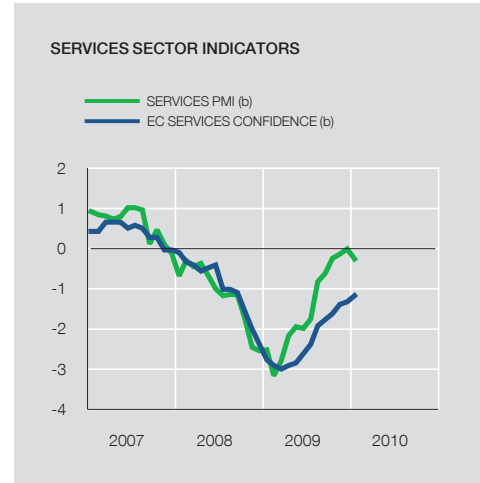
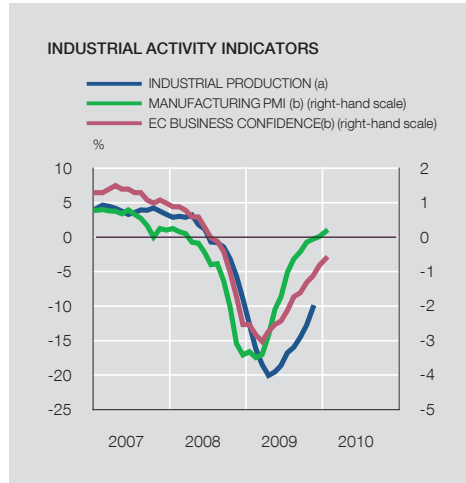
Turning to the demand side, despite the climate of greater confidence, household spending indicators were extremely sluggish. In Q4 the retail sales indicator fell more sharply and the termination of the car purchase incentive plans was reflected in a slowdown in registrations. As to investment in capital goods, the level of capacity utilisation increased slightly in the closing months of the year and in January, although it remained that levels well below its long-term average. The assessment of industrial order books in the European Commission's monthly survey, which can also be interpreted as another indicator of demand pressure, improved notably in Q4 and in January. The information for October and November reflects, on average, a moderate increase in sales abroad, while the outlook for exports and the assessment of foreign orders continue to improve. As explained in Box 3, the trade structure of the euro area



SOURCES: Eurostat and national statistics.

is somewhat biased towards less economically buoyant regions, so euro area exports will foreseeably grow more weakly than world trade. Lastly, the European Commission's stock assessment indicator suggests that, in the second half of the year, inventories will again contribute positively to GDP.

Despite the recovery of output in the second half of 2009, underpinned basically by factors of a temporary nature such as the contribution from fiscal and monetary policies and the moderation in the rate of destocking, the intensity of the crisis will undoubtedly mean that, as predicted by most international agencies, 2009 will close with a fall in GDP of nearly 4%. In the medium term, the latest forecasts of international agencies point to a slow economic recovery, with a growth rate this year which is more feeble than that at end-2009, as a reflection of the fading of the temporary stimuli and the weakness of domestic demand (see Table 2). Indeed, it is likely that the excess plant capacity and the fall in business profits will hold back investment, while private consumption is not expected to become strong, basically due to the high unemployment rate. This scenario of slow growth is also subject to downside risks derived from the scale of the financial system restructuring and from the intensity of the adjustment in employment. In addition, insufficient fiscal consolidation which does not allow countries to



SOURCES: European Commission, Eurostat and Markit Economics.

a. Non-centred year-on-year rates, based on the quarterly moving average of the seasonally adjusted series.

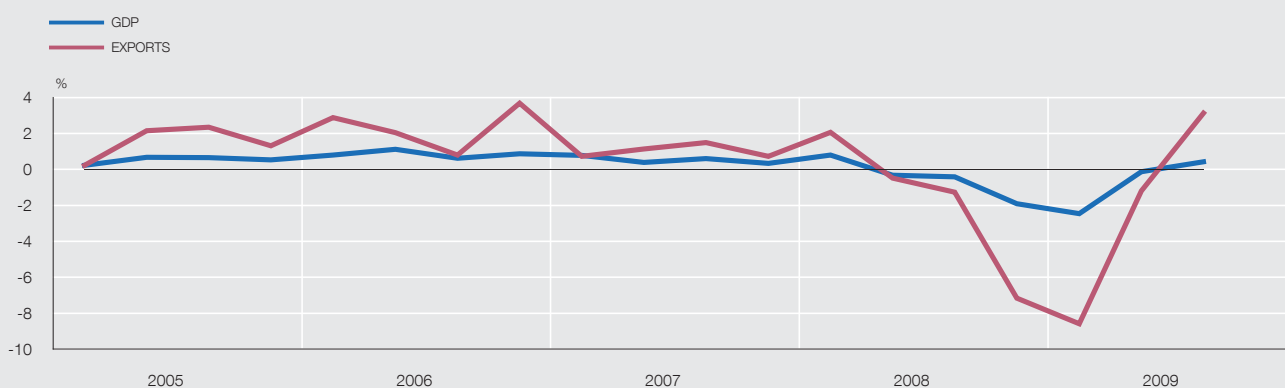
b. Normalised series.

c. Year-on-year rates of the original series. Quarterly average

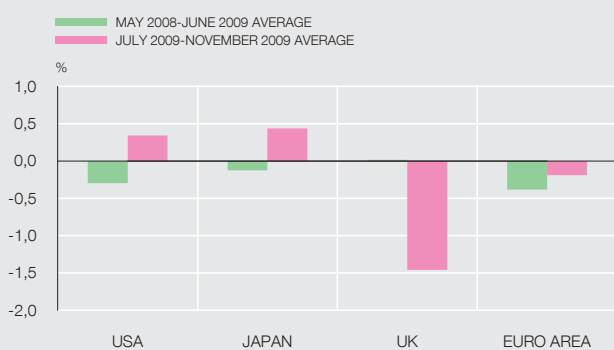
In 2009 Q3 euro area GDP increased for the first time since the beginning of 2008, partly due to the boost from exports (see Chart 1). Given that the growth of domestic demand remains subdued for the time being, the continued recovery of activity in the coming quarters will depend largely on how exports perform. Against a background in which the appreciation of the euro may hinder competitiveness, euro area exports will be strongly determined by world trade developments.

The geographical composition of euro area exports may affect the strength of the recovery of external demand and, ultimately, activity. Indeed, the economic recovery is not uniform in all regions of the world. Therefore, if the export structure of the euro area is biased towards more vigorous areas, the demand from abroad will be greater than if the euro area's export customers are slow in getting over the crisis. To assess the impact of export structure on the buoyancy of exports, a simple indicator of relative export demand for the euro area

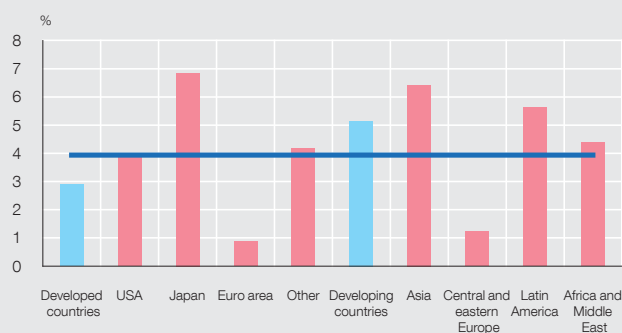
### 1 GDP AND EXPORTS Quarter-on-quarter growth



### 2 EXPORT DEMAND INDICATOR.



### 3 IMPORT GROWTH BY REGION (a) July-November average



### GEOGRAPHICAL COMPOSITION OF NOMINAL EXPORTS. 2008

	WORLD	USA	JAPAN	UNITED KINGDOM	EURO AREA
<b>ADVANCED ECONOMIES</b>	66.2	59.1	57.7	79.5	45.8
USA	12.8	0.0	17.8	13.9	13.1
Japan	4.4	5.1	0.0	1.5	2.6
Euro area	28.5	15.6	10.5	50.8	0.0
Other	20.5	38.4	29.5	13.2	30.1
<b>EMERGING ECONOMIES</b>	33.8	40.9	42.3	20.5	54.2
Asia	12.9	10.3	27.4	5.1	9.3
Central and eastern Europe	9.3	3.0	4.1	6.5	26.7
Latin America	5.5	22.2	5.0	1.9	5.4
Africa and Middle East	6.0	5.5	5.8	7.0	12.7

SOURCES: Eurostat, Banco de España, IMF and CPB.

a. Past 3 months over previous 3 months, percentage change.

was built and compared with those obtained for the United States, Japan and the United Kingdom. The indicator is calculated as the sum of the differences between the total import growth of each region of destination and the world total, weighted by the share of each of these regions within the exports of the country. A positive value of the indicator indicates that the country is exporting to areas in which demand is more buoyant than that of average world trade.<sup>1</sup>

Chart 2 sets out the recent course of this indicator. It shows that in the period of contraction of world trade between May 2008 and June 2009, the demand for euro area exports fell more than world imports and that this difference has persisted during the recovery initiated in July. By contrast, in the United States and Japan external demand has been growing since last summer at slightly higher rates than world trade.

The breakdown of impact by area shows that in the current phase of recovery of world trade, the euro area's geographical bias towards central and eastern Europe, which is growing at rates below the

world average, is resulting in a lower buoyancy of exports (see Chart 3 and the table below it). The negative contribution of this area was not offset by the slight positive effect of the higher relative growth of Asia and Latin America and, to a lesser extent, of Africa and the Middle East, which represent, respectively, 9.3%, 5.4% and 12.7% of its total exports.

By contrast, both the United States and Japan are counterbalancing the negative trade developments with the euro area (the import growth of which is 3.1 pp below that of the world) through exports to other more buoyant areas. Thus the United States has benefited from its strong commercial ties with Latin America and Asia, while Japan has basically taken advantage of its bias towards the Asian market. The high importance of European trade in UK exports explains why they are growing less than would have been determined by the trend of world trade recovery.

In short, the geographical specialisation of euro area exports does not, in principle, seem to be appropriate to fully exploit a world economic recovery with the significant foreseeable differences between countries. This contrasts with a more beneficial trade composition in the United States and Japan, where the greater weight of sales to Latin America and Asia is a key factor in boosting their exports.

1. The world trade data used were taken from the independent research Institute Netherlands Bureau for Economic Policy Analysis and extend up to November.

meet their commitments within the EU could weaken the agents' confidence and hinder the sustained growth of the economy in the medium term.

Euro area inflation turned positive again in the closing months of the year and, on preliminary Eurostat estimates, rose to 1% in January (see Chart 10). This earlier-than-expected pick-up in prices mainly reflects the base effect due to the marked falls in energy prices a year ago. Underlying inflation, as measured by the CPI excluding unprocessed food and energy, held steady at 1% in Q4, after having trended downwards since end-2008. By component, the moderate fall in services and non-energy industrial goods inflation was offset by the rise in processed food prices. Meanwhile, the year-on-year fall in industrial prices slackened to -4.4% in November, basically as a result of movements in the energy component.

The high level of slack in productive capacity, explained by the weak demand, makes it foreseeable that, in the coming months, inflation will continue to be low and positive. According to the Eurosystem December forecast, inflation will average between 0.9% and 1.7% in 2010 and between 0.8% and 2% in 2011. Possible upside risks to this scenario could arise from further commodity price rises and from increases in indirect taxes and administered prices to reduce the high government deficits reached during the crisis. On the other hand, the downward sensitivity of prices to the high degree of slack accumulated in the economy in the last few quarters may possibly be greater than anticipated.

On estimates published by the ECB, the euro area current account deficit amounted to €66 billion (0.8% of GDP) between January and November 2009, nearly half that in the same period of the previous year. Except for the services balance, on which the surplus decreased

	2010		2011	
	GDP	HICP	GDP	HICP
ECB (December 2009)	0.1-1.5	0.9-1.7	0.2-2.2	0.8-2.0
European Commission (November 2009)	0.7	1.1	1.5	1.5
IMF (January 2010)	1.0	—	1.6	—
OECD (November 2009)	0.9	0.9	1.7	0.7
Consensus Forecast (January 2010)	1.3	1.2	1.6	1.5
Eurobarometer (January 2010)	1.3	1.2	1.6	1.5

SOURCES: European Commission, Consensus Forecast, Eurosystem, IMF, MJ Economics and OECD.

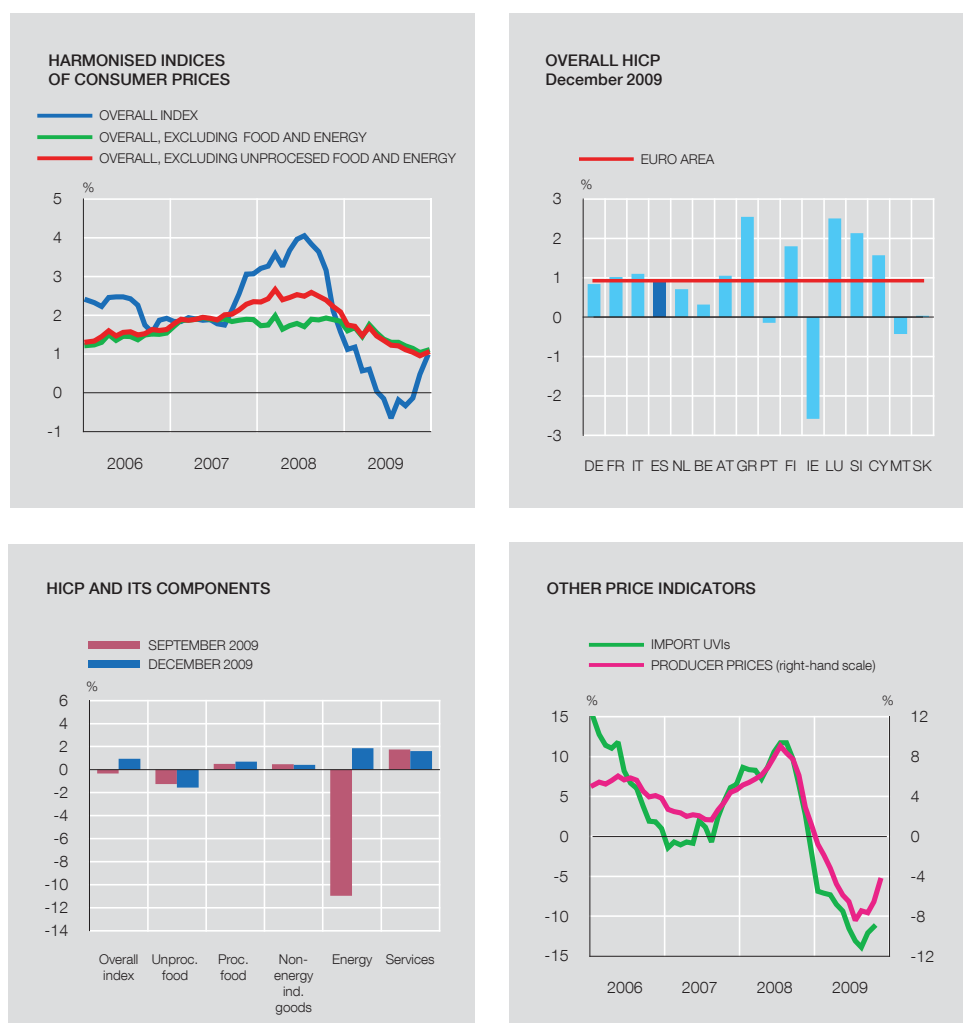
a. Annual rates of change.

slightly, the other components performed more favourably. Thus the negative balance on trade in goods became a surplus as a result of exports falling by less than imports, while the income and current transfers deficit continued to decrease. As regards the financial account, between January and November the net outflows of capital in the form of direct investment amounted to €90 billion, compared with €187 billion in the same period of 2008, while net inflows of portfolio investment amounted to €298 billion, down on the €346 billion in the same period of 2008. Hence, in these eleven months of the year, the basic balance, which is the sum of the current account balance and these two types of investment, showed a surplus of €142 billion, up considerably on the surplus of €27 billion in the same period of 2008 (see Chart 11).

The European Commission's autumn forecasts reconfirmed a significant deterioration in fiscal balances. The euro area's general government deficit will stand at 6.4% of GDP in 2009, against 2% in 2008, and only two countries (Finland and Luxembourg) will comply with the deficit threshold of 3% of GDP (see Table 3). As a result, the December ECOFIN Council meeting initiated the excessive deficit procedure against eight euro area Member States. These events are described in detail in Box 2. For the countries in this situation since April, the Council positively assessed the measures adopted in the cases of Ireland, Spain and France, for whom new recommendations were approved which extend the time horizon for putting their public finances on a sound footing. By contrast, the Council considered that the actions of the Greek government had been insufficient and, furthermore, in January it required action to be taken to remedy the serious deficiencies revealed in its fiscal statistics following the examination by the European Commission. Consequently, Greece submitted a stability programme designed to reduce its budget deficit of 4 pp of GDP in 2010 to 3 pp in the following years, taking it to 2.8% of GDP in 2012. This budgetary programme prescribes a permanent increase in income tax and other extraordinary tax measures which, on the spending side, complement the containment of public-sector wages and the freezing of new recruitment. Meanwhile, Ireland also submitted a highly ambitious stability programme involving substantial cuts in government spending, particularly in government employees' wages.

The expansionary stance of fiscal policy is expected to continue in 2010, although the countries whose public finances have deteriorated most, such as Ireland, Greece and Spain, have begun to take fiscal consolidation measures. Overall, the forecasts of most international agencies indicate that the budget balance will remain practically steady at levels near 7% of GDP in 2010. According to European Commission forecasts, public debt will reach 84% of GDP in 2010, up from the 78.2% estimated for 2009 and the 69.3% in 2008. As





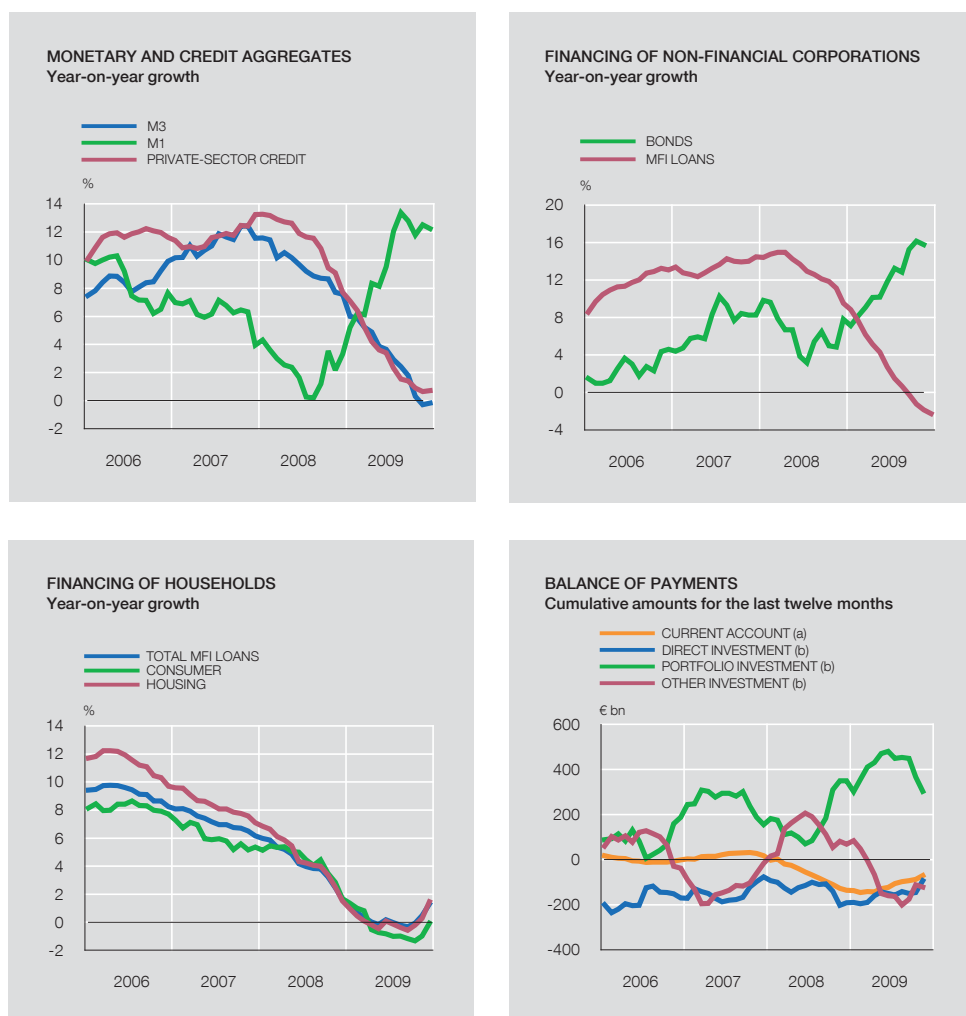
SOURCES: Eurostat and European Central Bank.

revealed by the European Commission's sustainability report in November, bearing on these figures are additional risks posed by population ageing and by the contingent liabilities acquired during the rescue of the banking system. Given this situation, it will not be possible to guarantee financial stability and economic growth if Member States do not adopt credible and ambitious consolidation strategies. They should start to define the details of these strategies in the stability programmes to be submitted in early 2010.

### 3.2 Monetary and financial developments

The stabilisation of the euro area's financial situation continued in 2009 Q4. Volatility and credit risk premia continued to fall (with exceptions in sovereign bonds) and the financial markets became more active, while banks resorted less and less to government guarantees and, in some cases, repaid the aid received in the form of capital.

Despite these improvements, there are still pockets of fragility in the financial situation which give rise to bouts of local instability, as exemplified by the case of World Dubai and the growing concern over the fiscal situation of Greece. According to the latest estimates of the ECB and the IMF, banks are still exposed to high losses on their balance sheets. In addition, the process of deleverage under way in the banking sector may pose an obstacle to the eventual recovery of lending activity once demand rises, although clear signs of this have yet to be observed, according to the latest bank lending survey.



SOURCES: ECB and Banco de España.

- a. A positive (negative) sign denotes a current account surplus (deficit).
- b. Capital inflows less capital outflows. A positive (negative) sign denotes a net capital inflow (outflow).

The ECB pursued a policy of generous liquidity provision and, given the improvement in the funding markets, in December it announced the first steps towards a gradual withdrawal of some of the extraordinary measures introduced during the financial crisis. Thus the last one-year refinancing operation was in December and the six-month tenders will cease following that in March. Further, the ECB, acting in coordination with the central banks involved, announced the discontinuation of operations in Swiss francs and in US dollars from 31 January. In any event, the ECB will continue to provide euro-denominated liquidity on soft terms through the fixed-rate full-allotment procedure, which will continue during at least 2010 Q1. Meanwhile, under the covered bond acquisition programme under way since mid-2009, the Eurosystem has made outright purchases of more than 50% of the €60 billion planned.

The absence of inflationary pressures in the medium term, against a background in which the recovery promises to be timid, meant that, in its meetings up to February, the ECB Governing Council held official interest rates unchanged. Hence the rate on main refinancing operations has stood at 1% since May, while those on lending and deposit facilities were 1.7% and 0.25%, respectively (see Chart 12).

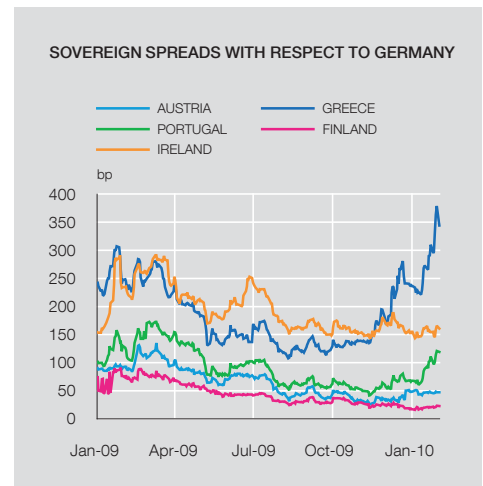
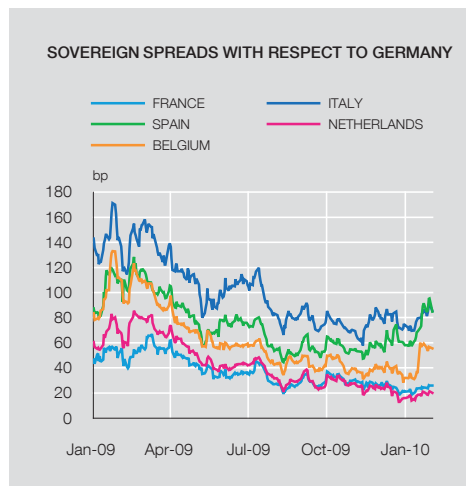
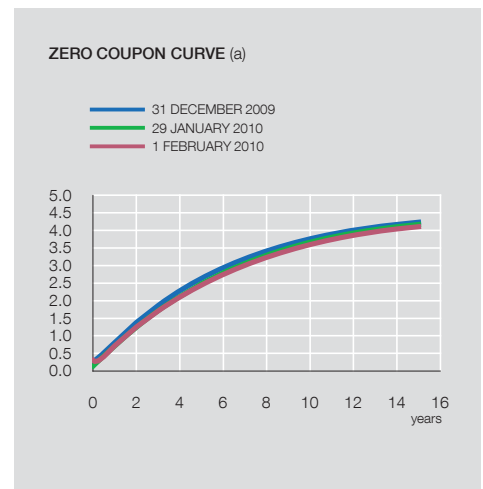
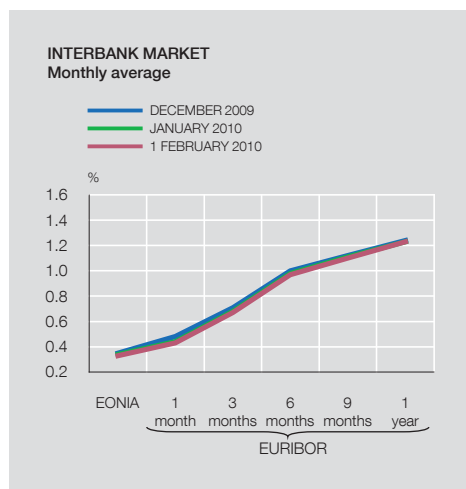
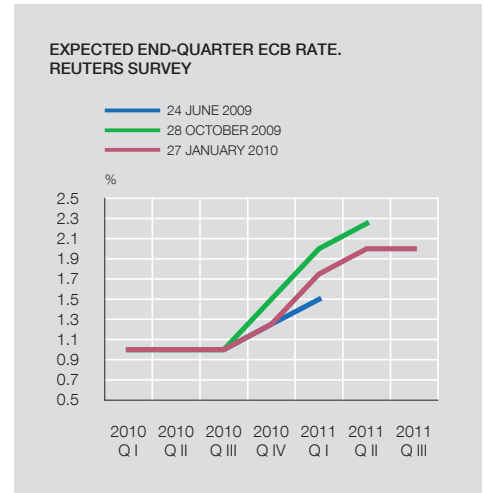
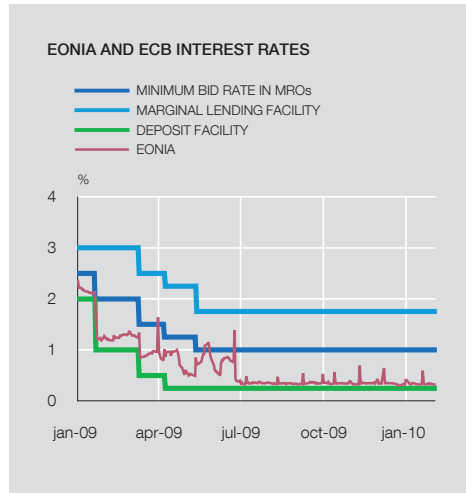
% of GDP	BUDGET BALANCES (a)					
	2007	2008	2009		2010	
			EC (b)	EDP (c)	EC (b)	IMF (d)
	Belgium	-0.2	-1.2	-5.9	-5.9	-5.8
Germany	0.2	0.0	-3.4	-3.7	-5.0	-4.6
Greece	-3.7	-7.7	-12.7	-12.5	-12.2	-7.1
Spain	1.9	-4.1	-11.2	-9.5	-10.1	-12.5
France	-2.7	-3.4	-8.3	-8.2	-8.2	-7.1
Ireland	0.3	-7.2	-12.5	-11.9	-14.7	-13.3
Italy	-1.5	-2.7	-5.3	-5.3	-5.3	-5.6
Luxembourg	3.7	2.5	-2.2	-2.2	-4.2	-4.4
Netherlands	0.2	0.7	-4.7	-4.8	-6.1	-5.7
Austria	-0.6	-0.4	-4.3	-3.9	-5.5	-5.6
Portugal	-2.6	-2.7	-8.0	-5.9	-8.0	-7.3
Finland	5.2	4.5	-2.8	-2.7	-4.5	-4.2
Slovenia	0.0	-1.8	-6.3	-5.9	-7.0	-5.6
Cyprus	3.4	0.9	-3.5	-2.9	-5.7	-6.3
Malta	-2.2	-4.7	-4.5	-3.8	-4.4	-4.4
Slovakia	-1.9	-2.3	-6.3	-6.3	-6.0	-4.4
PRO MEMORIA: Euro area (including Cyprus, Slovakia and Malta )						
Primary balance	2.4	1.0	-3.4		-3.7	
Total balance	-0.6	-2.0	-6.4	-6.0	-6.9	-6.6
Public debt	66.0	69.3	78.2	78.4	84.0	

SOURCES: European Commission, Eurostat and IMF.

- a. Deficit (-)/surplus (+). The deficits that exceed 3% of GDP have been shaded.  
b. European Commission October 2009 forecasts.  
c. Notification of Excessive Deficit Procedure, autumn 2009.  
d. IMF October 2009 forecasts.

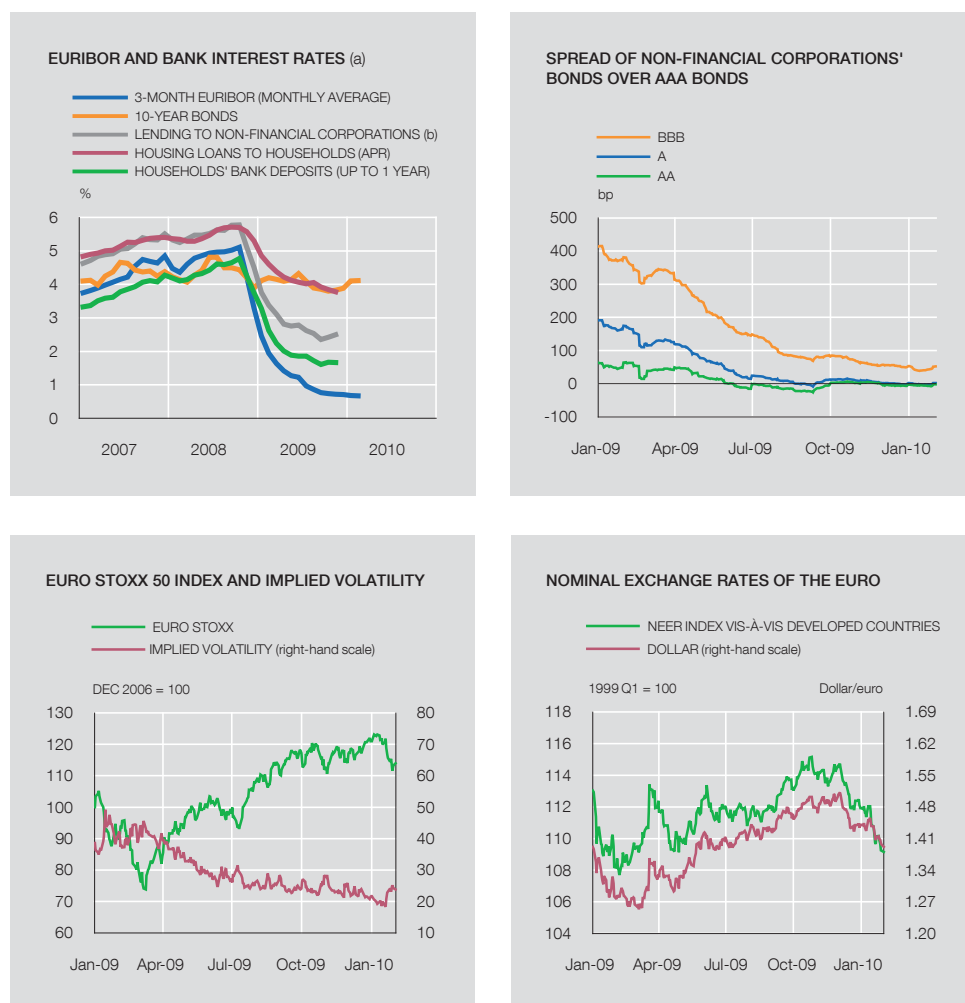
Interbank interest rates held steady at low levels in 2009 Q4. The average levels of three-month and one-year EURIBOR have remained at 0.7% and 1.2%, respectively, since the beginning of the year. In the debt markets, long-term yields saw a slight rise which continued in January, with the euro area 10-year index moving up to average levels of nearly 4.1%. This increase largely reflected the higher risk premia on the sovereign bonds of some Member States and the consequent widening of spreads vis-à-vis the German bund (see Chart 13). The yields on Greek debt increased particularly sharply due to the worrying fiscal situation. This was also reflected in rating downgrades by the three main credit quality rating agencies, in two cases to BBB+. These developments were exacerbated by the revelation of serious deficiencies in Greek fiscal statistics. The warnings about heightened sovereign risk also affected other euro area countries, which saw rises in the cost of their public debt, although to a much lesser extent.

The improvement in confidence again became apparent as the risk premia in a private fixed-income markets narrowed in Q4, most notably in lower credit quality securities. Meanwhile, the cost of bank loans tended to steady around the levels reached at the end of summer, with slight decreases in the case of household credit. According to the January bank lending survey, in Q4 the demand for credit continued to be extremely weak, although a timid increase was observed in house purchase lending. Credit standards underwent no substantial change. In line with these results, lending to households improved in 2009 Q4 and its year-on-year growth, at 1.3% in December, returned to positive territory. The fall in bank lending to firms



SOURCES: ECB and Banco de España.

a. ECB estimate using swap market data.



SOURCES: ECB and Banco de España.

- a. On new operations.  
b. Floating interest rates and up to 1-year initial rate fixation.

sharpened in late 2009, declining by 2.3% in the year as a whole. This decrease masks high negative flows in shorter-term contracts and a notable slowdown in overdrafts, since long-term loans showed growth of nearly 4% in the year. To take advantage of the fall in the cost of market funding, firms, particularly large ones, continued to issue bonds profusely. Although they are not the major source of borrowing by European firms, long-term issues grew year-on-year by more than 25% in November.

Equity market prices held on their upward path in 2009 Q4, although rising more moderately than in the previous months. The EURO STOXX 50 index was up by 21% in the year as a whole, with rises of more than 50% in the metals and banking sectors. This path was interrupted in mid-January when international prices plunged as a result of the announcement of possible regulatory changes in the US banking sector. In January to date, the EURO STOXX 50 index has lost more than 5% against a background of heightened volatility.

In the foreign-exchange markets, the euro exchange rate appreciated until end-November, when it was trading at more than \$1.50 per euro. It then underwent a sharp downward correction against the major currencies which extended into January, and has depreciated in nominal effective terms by nearly 2.5% so far in the year.

Lastly, the broad monetary aggregate M3 continued to lose momentum and for the first time it posted a negative year-on-year growth rate of -0.2% in December. The low interest rates, the slope of the yield curve and the stock market gains continued to drive a shift in investment towards non-monetary assets in search of higher returns. At the same time, the fall in opportunity costs also encouraged the substitution of M3 assets by those of M1 (cash and deposits), which are growing at year-on-year rates above 12%. This partly reflects the base effects of their behaviour as the financial crisis worsened at the end of 2008.

## 4 The Spanish economy

On QNA estimates, the pace at which the Spanish economy had been worsening eased off notably in 2009 Q3, as GDP posted a quarter-on-quarter decline of 0.3% in real terms (compared with -1.1% in Q2). The year-on-year rate of GDP, which is subject to greater inertia, fell by 0.2 pp less than the previous quarter, taking it to -4%. Contributing to this lesser contraction in activity was the behaviour of national demand, which declined by 6.2% year-on-year (0.8 pp less than in the previous quarter). Conversely, the contribution of external demand turned down by 0.7 pp to 2.5 pp, in a setting in which both exports and imports saw their annual rates of decline cut significantly. The pace of job destruction virtually stabilised, with a year-on-year change of -7.2%, meaning that productivity continued to show a high growth rate.

On the conjunctural information available, the decline in GDP continued to slacken in Q4. Specifically, it is estimated that the quarter-on-quarter change in GDP was -0.1% (compared with -0.3% in Q3), while the fall in output in year-on-year terms was 3.1%, 0.9 pp less than in the previous quarter (see Chart 14). This performance would testify to the fact that the fall-off in national demand has become less pronounced, standing at -4.8%, although this would partly be the consequence of the effects of certain public measures with a temporary effect (such as the Plan 2000E, which offers incentives for new car purchases, and the State Local Investment Fund). The positive contribution of the external sector remained high (2 pp), but down on the preceding quarter.

The fall in employment also slowed in Q4 to an estimated rate of decline of 6.1% year-on-year, 1.1 pp down on the previous quarter. The growth of apparent labour productivity is expected to have remained sharp, allowing unit labour costs to fall, despite the fact that compensation per employee continued to post high growth, far outpacing that of inflation. As a result, the labour market adjustment continued to fall heavily on employment, in marked contrast to developments in other European countries. Finally, the CPI rose in Q4, meaning that year-on-year inflation turned positive from November and stood at 0.8% in December. The determining factor here was the energy component while, on the contrary, the growth of the CPI excluding energy and unprocessed food prices remained very modest (averaging 0.2% in Q4), testifying to the notable response of inflation to the weakness of demand.

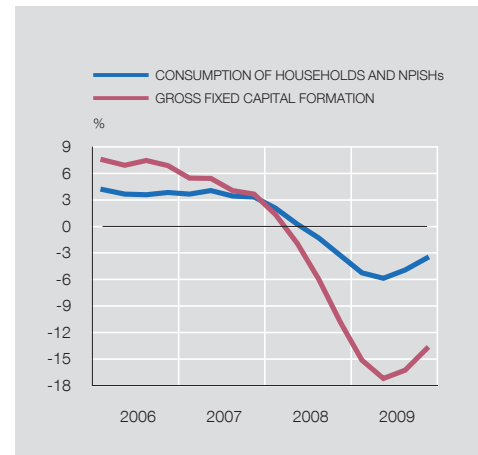
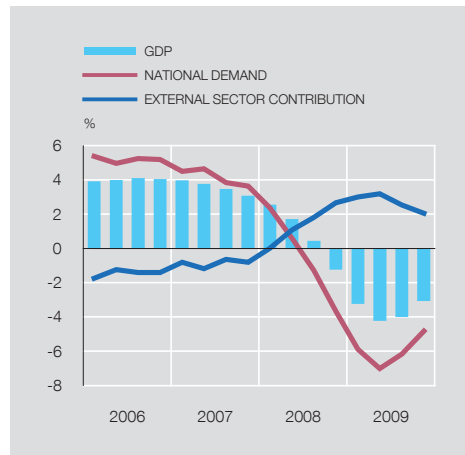
### 4.1 Demand

In 2009 Q4, final consumption spending by households and NPISHs remained on the sluggish course of the previous quarters (see Chart 15), although in quarter-on-quarter terms it may have posted a slightly positive rate, following seven quarters of decline. Among the quantitative indicators, there was sharp growth in new car registrations in the closing months of the year, boosted by the above-mentioned Plan 2000E, although this might have entailed some bringing forward of household spending and, therefore, it might detract from the demand for these durable goods in the future. Among the qualitative indicators, consumer confidence and retail trade confidence held virtually unchanged in Q4, although they rebounded more clearly in January 2010.

As was the case throughout 2009, household consumption spending during Q4 was affected by the uncertainty associated with the labour market deterioration and by the adverse effect of job destruction on wage income. Further unfavourable contributing factors were the maintenance of tight credit standards and the fall in wealth arising from the declining trend in house prices (a trend which nevertheless progressively slowed during the year). These factors tended to depress consumption, despite the fact that other elements had a positive bearing on house-

MAIN DEMAND AGGREGATES (a)

CHART 14

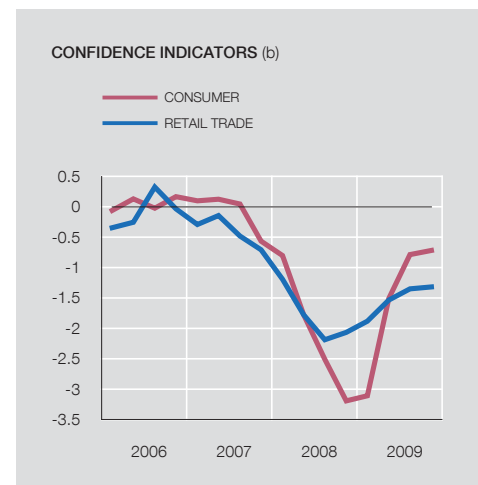
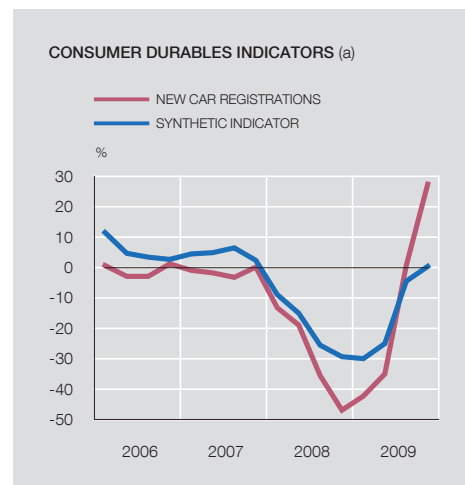
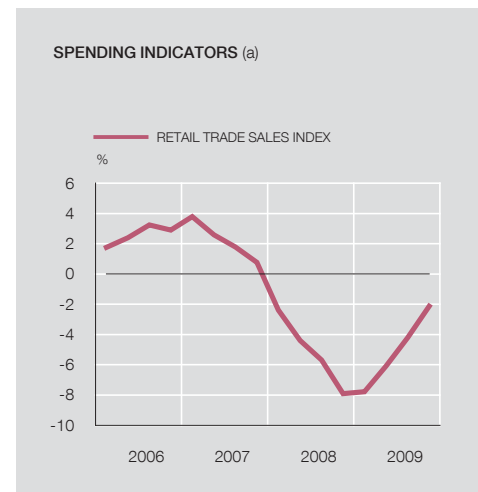
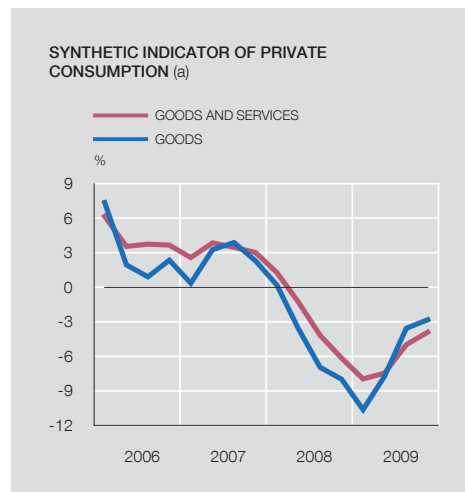


SOURCES: INE and Banco de España.

a. Year-on-year percentage change based on seasonally adjusted series.

PRIVATE CONSUMPTION INDICATORS

CHART 15

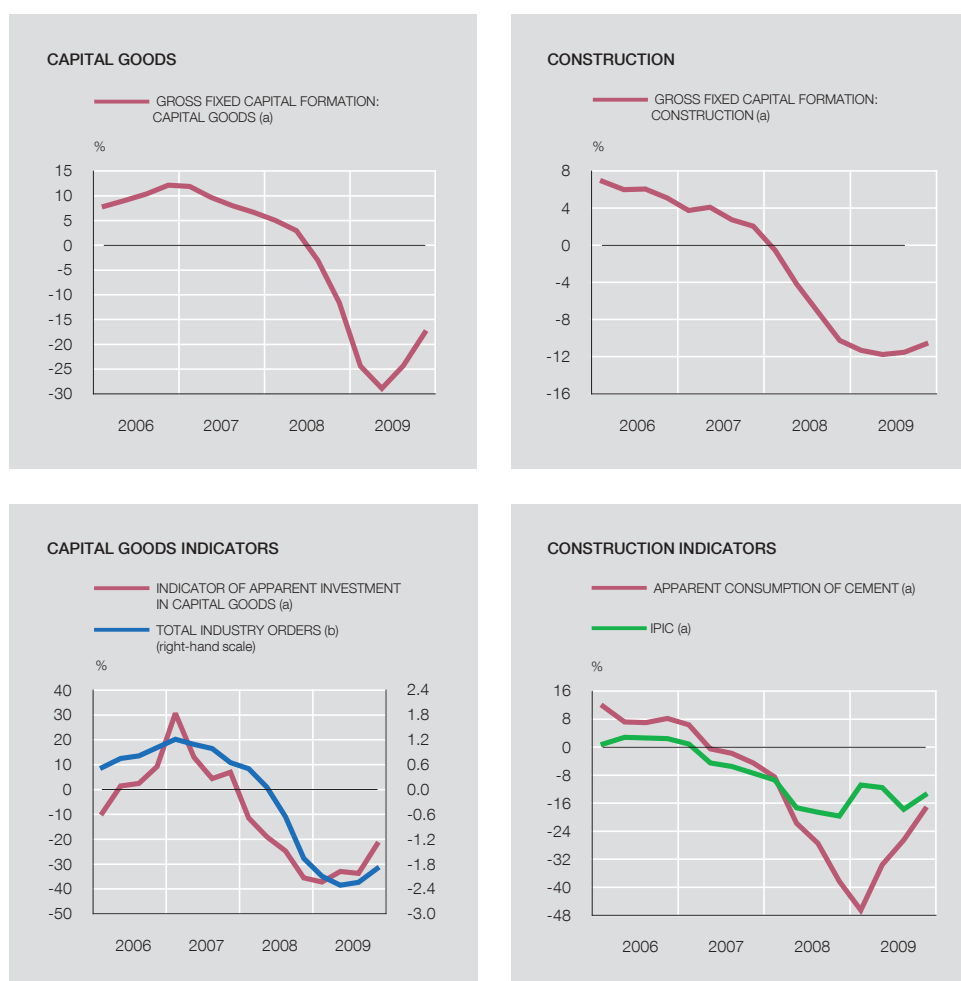


SOURCES: INE, European Commission, ANFAC and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series.

b. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).





SOURCES: INE, European Commission, Eurostat, OFICEMEN and Banco de España.

- a. Year-on-year percentage change based on the seasonally adjusted series.  
 b. Normalised indicator (difference between the indicator and its mean value, divided by the standard deviation).  
 c. Construction Industry Production Index (Eurostat). Year-on-year percentage change based on the seasonally adjusted series.

hold real income, such as low inflation, the moderation of bank interest rates (which mean that net interest payments translate positively into an increase in income) and the impulse provided by general government net transfers. As a result, the sluggishness of consumption was reflected in an increase in the household saving ratio which, on the latest data from the non-financial accounts of the institutional sectors for 2009 Q3, stood at 18.7% of disposable income, an all-time high and 1.1 pp up on the Q2 figure.

It is estimated that final general government consumption grew less, in year-on-year terms, in Q4. This was in line with employment developments in the sector and based on State budget outturn data on expenditure on wages and salaries and net purchases of goods and services.

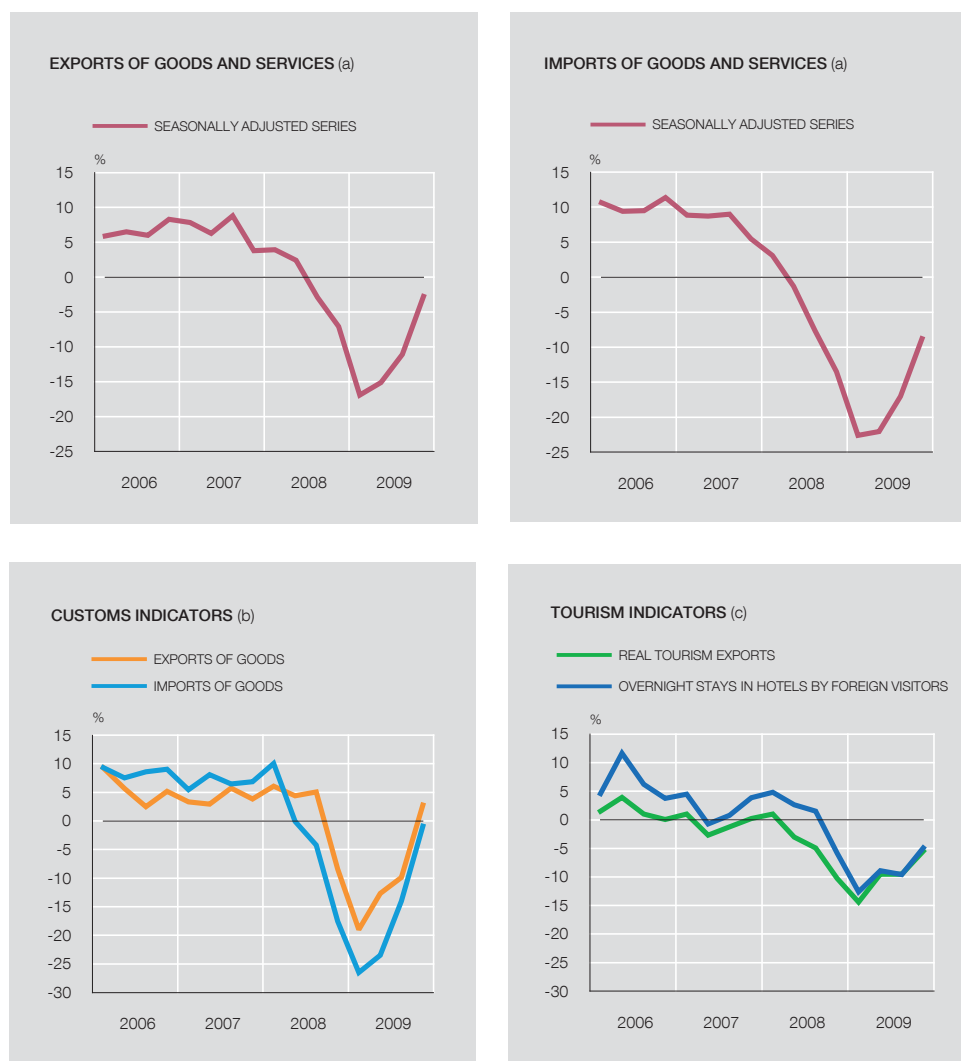
On the information available, investment in equipment trended less negatively in 2009 Q4, furthering the pattern seen in Q3, when there was less of a downturn than one year earlier (see Chart 16). New commercial vehicle registrations (which, for the second quarter running, posted positive quarter-on-quarter growth, assisted by the Plan 2000E terms) and apparent investment in capital goods (where the strong year-on-year contractions recorded since early 2008 slackened) were

both along these lines. Business confidence, both in industry as a whole and in capital-goods-producing branches, was somewhat more favourable in this period, with an improved perception as to order books. Furthermore, capacity utilisation rose slightly at the start of Q4 (the first increase in two years), although it remains far below its historical average. Nonetheless, the year-on-year decline in investment in equipment remained high, against a background of major uncertainty over the force of the recovery in national and external demand, and continuing tight bank credit standards. Further, as in the case of private consumption, some of the rise in recent months in investment in equipment might suggest vehicle-purchase decisions are being brought forward, as a result of the public stimulus plans, which would tend to reduce investment in the future. According to information from the non-financial accounts of the institutional sectors, the slide in business investment was reflected in a fresh decline in the sector's net borrowing in 2009 Q3 to 3.6% of GDP in four-quarter terms (1.5 pp less than in Q2). Also contributing to this was the increase in business saving, driven by the reduction in interest and in tax payments, which offset the decline in the gross operating surplus.

The contractionary behaviour of investment in construction eased in Q4, although this variable held at a very negative rate (see Chart 16). The indicators for the whole of the sector relating to inputs and employment showed a significant slowdown in the pace of the year-on-year downturn, compared with previous quarters. In addition, the indicator of construction business confidence evidenced a clear recovery in 2009 Q4, albeit against a background of some volatility which led it to fall back once more in January this year.

Looking at the different investment components, investment in residential building is expected to have fallen at a slightly lower year-on-year rate than that observed in the previous quarter, although the significant decline in the stock of housing under construction, drawing on the low figures for approvals for new works and for the completion of a still-high volume of projects begun in previous years, means that the prevailing tone continues to be one of sharp contraction in activity in the sector. On the housing demand side, there has been a visible check on the decline in sale transactions in recent months, according to the statistics on the transfer of property rights and to the number of new mortgages taken out. This somewhat less unfavourable picture might be related to the improvement in the affordability indicators which, in turn, is due to the cuts in interest rates and in house prices. However, as in previous quarters, the factors checking the demand for housing – such as the uncertainty over household income generated by the rising unemployment rate and continuing tight credit standards – remain in place. As regards the other components of investment in construction, non-residential building is expected to have severely lost steam in late 2009, according to the figures on approvals for new projects, while the momentum of civil engineering works, linked to the execution of works under the State Local Investment Fund, is estimated to have held up.

Turning to foreign trade, the latest information available suggests that the positive contribution of external demand will have remained high, though down on Q3, in a setting in which both exports and, to a lesser extent, imports continued to post year-on-year declines (see Chart 17). Nonetheless, the pace of the year-on-year decline in both flows was substantially checked. This meant that, in quarter-on-quarter terms, exports and imports posted a positive rate, as in the previous quarter, after their heavy declines in the first half of the year. This pick-up in foreign trade is in line first, with the less unfavourable international setting, as reflected in the emergence from recession of the main advanced economies during 2009 Q3; and further, with the lesser contraction in national demand and in industrial production in Spain. The appreciating trend of the euro in Q4 is expected to have led to a slight worsening in Spain's price-competitiveness indicators against the developed countries, compared with those observed in the same period a year earlier.



SOURCES: INE, Ministerio de Economía, Ministerio de Economía y Hacienda and Banco de España.

- a. QNA data at constant prices.
- b. Deflated seasonally adjusted series.
- c. Seasonally adjusted series.

On Customs data, real goods exports improved notably in Q4, posting an increase of 1.2% on average in October and November, in year-on-year terms, compared with a 9.6% decline in Q3. By type of product, this increase was attributable to sales of non-energy intermediate goods and of non-food consumer goods, which posted positive rates, while the weakness of sales of capital goods became more marked. Car exports performed favourably in the closing months of the year, following the sharp deterioration they showed during the first half of 2009, thanks to the recovery in the European demand for motor vehicles. This was a result of the direct assistance plans targeted on new car purchases that were set in place in some of the main European countries. By region, the downturn in exports to the EU was checked in the final months of 2009, in step with the incipient recovery in the main European economies, while the fall-off in sales to third markets – essentially Asian countries – eased.

As regards exports of tourist services, the Balance of Payments information available to November suggests their rate of decline will slow in the final stretch of 2009, in nominal terms.

Drawing on EGATUR (tourism spending survey) figures, nominal tourist expenditure fell by 3.3% in Q4, compared with the decline of 7.4% the previous quarter. Along these same lines are the real tourism indicators, such as tourists inflows into Spain and the number of overnight hotel stays, the year-on-year decline in which lessened in 2009 Q4. The rate of decline of real exports of non-tourist services is expected to have slackened in 2009 Q4, judging by the Balance of Payments data for October and November, in line with the less unfavourable trend of merchandise trade and of passenger traffic.

Turning to imports, and according to Customs data, goods imports stabilised in year-on-year terms in the October-November period, following the decline of 13.8% in Q3. By product group, consumer goods purchases were firm, increasing by 8.7% in this period, owing to the increases in both food and cars. The sluggishness of imports of intermediate goods and capital goods slackened, although imports of the latter continued to post a very severe contraction in the October-November period (16%, compared with the decline of 23% in Q3).

Finally, on balance of payments figures for October and November, the rate of decline of real services imports is estimated to have eased slightly in 2009 Q4, reflecting the somewhat less unfavourable trend of the travel heading, while purchases of non-tourist services remained weak.

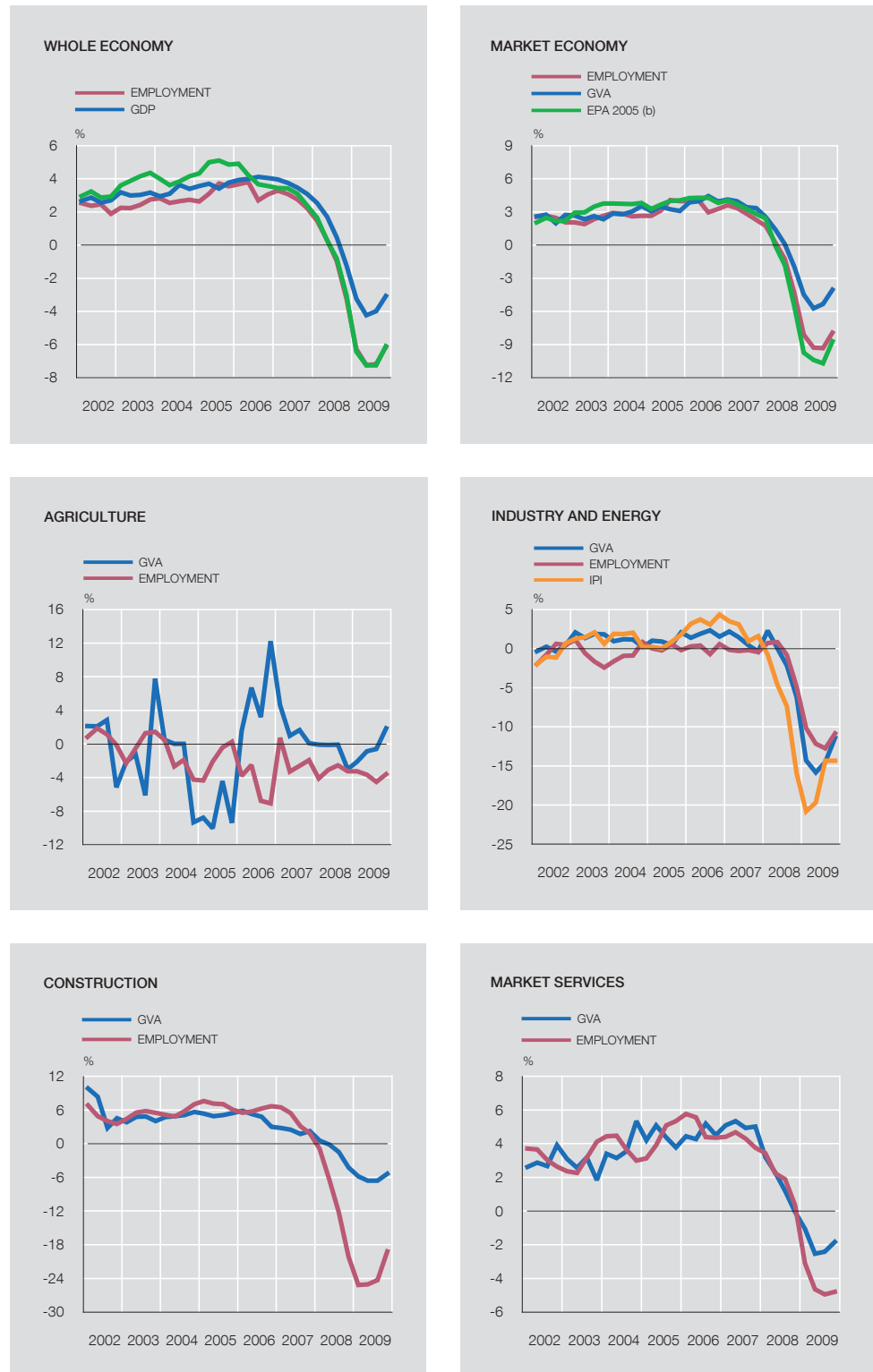
## **4.2 Production and employment**

The information available points to a slowing in the year-on-year decline in market-economy gross value added to around 4% in 2009 Q4 (see Chart 18). In the case of the industrial branches, the industrial production index contracted in October and November to a much more moderate year-on-year rate than in Q3. The improvement was extensive to all types of products, with the exception of the energy branches. The growth rate of the production of food goods even turned positive in the October-November period compared with the same two months a year earlier. Finally, as regards the sector's opinion-based indicators, the confidence indicator continued improving gradually in Q4, and also in January 2010, moving progressively away from the lows of early 2009. Conversely, the PMI-manufacturing index fell slightly in the final quarter of the year.

The latest conjunctural information available on the market services sector likewise points to a year-on-year decline on a lesser scale in 2009 Q4 than in Q3. Among the quantitative indicators of the sector, the year-on-year rate of decline of turnover continued to diminish in November, while large corporations' sales of services posted, in real and calendar-adjusted terms, a reduction of 8% on average in October and November, 2.5 pp less than in Q3. As to the opinion-based indicators, an improvement was seen in Q4 in both services confidence and in the PMI, whose levels still remain in recessionary territory. Into January 2010, services confidence fell back notably.

As to the labour market, the information available suggests a slowing in the rate of deterioration of employment in 2009 Q4. Specifically, the average number of Social Security registrations fell by 4.6% in Q4, compared with the 6% decline in Q3. The year-on-year decline in INEM-registered hires was less marked in Q4 than in Q3, with positive year-on-year growth figures in the last two months of the year.

Finally, EPA figures for Q4 showed a 6.1% decline in employment compared with the same period a year earlier, 1.2 pp down on the previous quarter. This lesser decline in employment is estimated to have affected all the market economy branches, especially construction and industry, while there was a very similar fall in market services to that recorded the preceding quarter.



SOURCES: INE, Ministerio de Fomento and Banco de España.

a. Year-on-year rates based on seasonally adjusted series, except for the EPA which is based on crude series. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.  
 b. Series linked by the Banco de España's DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied up to 2004 Q4.

The slowdown in the rate of decline of employment was centred on wage-earners, whose numbers fell by 5%, compared with 6.5% the previous quarter, since numbers of self-employed fell by 11.1%, somewhat above the rate observed in the summer months. Job destruction was, as in recent quarters, more marked among foreign-nationality employees (-11.8%), while employment in the group of Spanish nationals fell by 5.1% (-6.8% in Q3). With regard to contract duration, the year-on-year rate of decline of temporary workers eased (-14.7%), though labour shedding continued to be far higher in this group than among those with permanent contracts (-1.3%, somewhat below the 1.7% decline in the previous quarter). As a result, the proportion of temporary to total employees stood at 25.1%, 2.8 pp down on a year earlier. Lastly, part-time hires fell slightly (-0.3%), set against the sharp reduction in full-time contracts, with the ratio of part-time to full-time workers rising once again, as in previous quarters, to 13.3%, compared with 12.5% a year earlier.

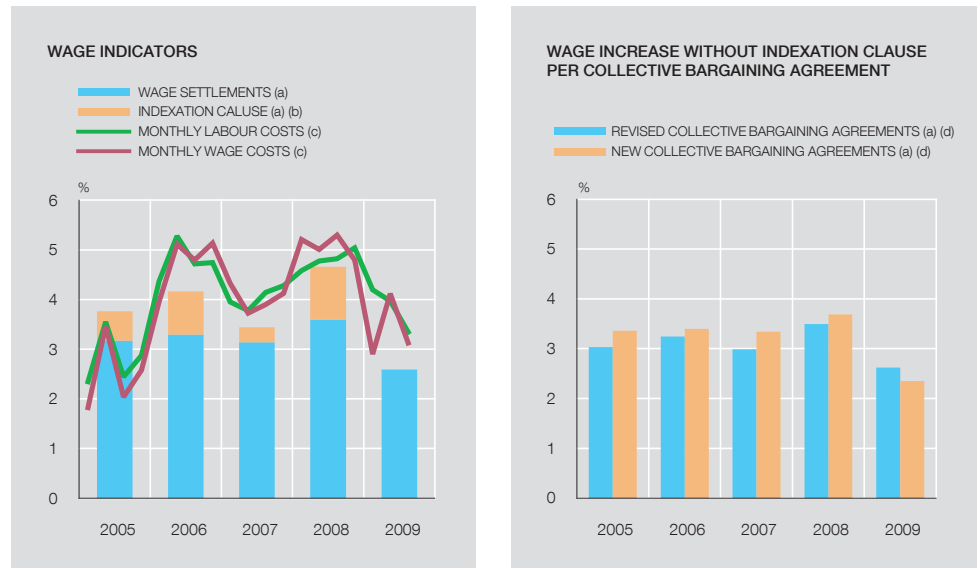
The labour force fell by 0.4% in 2009 Q4 compared with the same period in 2008, holding on the progressively slowing path observed throughout the year. This fall was a result of the slowdown in the population aged over 16, which increased by 0.2% (against 0.4% the previous quarter), and of a further year-on-year decline in the participation rate (-0.3 pp). As regards the breakdown by sex, the growth of the female labour force eased to 1% (2.6% in Q3), while the male labour force held on a similar decline to that recorded three months earlier (-1.5%). In terms of nationality, there was a 1.2% reduction in foreign nationals, for the first time in recent years, as a result both of lower immigrant inflows (0.4%, against 2.1% the previous quarter) and of the fall seen in their participation rate. Spanish nationals continued to show a similar year-on-year decline to that seen the previous quarter (-0.3%).

Finally, numbers unemployed increased by around 203,000 in 2009 Q4, despite the fall in the labour force. However, the year-on-year increase in unemployment eased to around 1.12 million, with the year-on-year rate of change of 34.9%, below the figure of 54.7% in Q3. The unemployment rate rose by almost 1 pp during the quarter to 18.8%, although there was a moderation in its increase in year-on-year terms. Official registered unemployment also showed a slowdown in the increase in numbers unemployed in the closing months of 2009, with a year-on-year increase of close to 30%, following a figure of 43.5% in Q3.

### 4.3 *Costs and prices*

Collective bargaining agreements entered into in 2009 affected more than 8.6 million workers (a very similar figure to 2008). The year concluded with an increase in wage rates of 2.6%, 1 pp below the related 2008 settlement. This slowdown, however, has not been in proportion to the intensity of the deflationary process and the downturn in the labour market witnessed last year. Further, wage settlements under newly signed agreements, which cover only slightly more than one million workers, were very similar (2.3%), which testifies to the scant sensitivity of wage bargaining to the adverse labour market conditions. Finally, the wage indexation clauses, which had a strong impact on wage costs in 2008, ceased to exert an influence in 2009 in view of the reduction in inflation (see Chart 19).

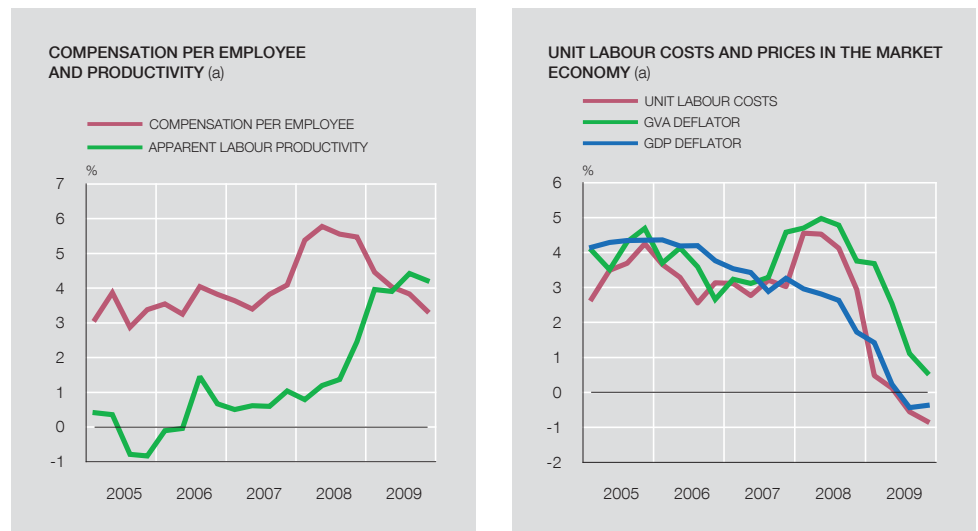
In QNA terms, the economy-wide growth of compensation per employee eased by 0.8 pp in 2009 Q3 to 3.9% (and by 0.2 pp in the market economy, to 3.8%). All told, this growth is notably higher than the wage increases agreed under collective bargaining, which reflects the possible drift associated with the composition effects habitually observed in periods of strong job destruction since, comparatively, more jobs with lower-than-average compensation are destroyed. A further easing in the rate of expansion of compensation per employee is expected for the close of the year, although this is estimated to have continued rising at a substantially higher rate than that of prices (see Chart 20). This somewhat lower National Accounts-terms wage growth, along with the stabilising of the rate of increase of productivity, is



SOURCES: INE and Ministerio de Trabajo e Inmigración.

- a. The last year, with information from collective bargaining agreements to October 2009.
- b. Previous year's indexation clause.
- c. ETCL (quarterly labour costs survey). Year-on-year rates of change.
- d. Revised: collective bargaining agreements with economic effects in the year but which were signed in previous years and are in force for more than one year. New: collective bargaining agreements signed and with economic effects in the year, this being the first or only year they are in force.

PRICES AND LABOUR COSTS IN THE MARKET ECONOMY

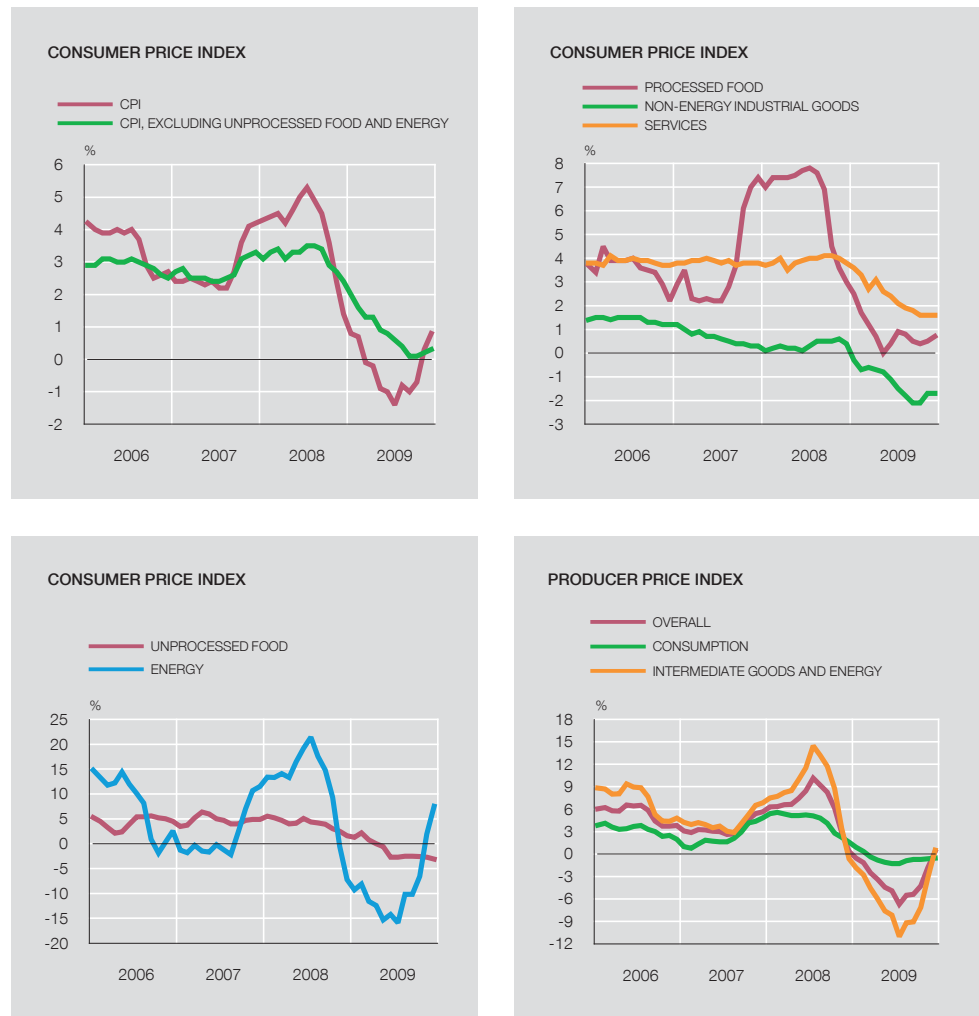


SOURCES: INE and Banco de España.

- a. Year-on-year percentage change based on QNA seasonally adjusted series.

expected to have led in Q4 to a further slowdown in unit labour costs, whose rate of change will have been virtually zero.

For the final quarter of 2009, the domestic component of inflation (measured by the rate of change of the GDP deflator) is estimated to have fallen at a similar rate to that in Q3. At the same time, the fall in import prices will have moderated, as a result of oil price developments, which translated into a less pronounced reduction in the final demand deflator. Among the



SOURCE: INE

a. Year-on-year rate of change based on the original series.

components of this latter variable, it is estimated that the easing of the reductions in the deflators of goods exports and of those of the main national demand components was generalised in Q4.

In particular, the growth rates of the various indicators of consumer prices increased in Q4. The CPI, which had posted a decline of 1% in September, closed Q4 with positive growth of 0.8% (see Chart 21). On average for the quarter, the increase was 0.1%, compared with the decline of 1% in the previous period. The rise in the overall index in Q4 was essentially due to the reversal of the base effects in energy prices, which grew by 0.7%, following a 12.1% decline in Q3. This was the outcome of the rise in transport and heating fuel prices, in parallel with dearer oil on international markets compared with the same period a year earlier, which was offset only partially by the appreciation of the euro against the dollar. Conversely, the remaining CPI components continued to undergo the effects of the sluggishness of demand. Specifically, non-energy industrial goods prices fell at a similar rate to that in Q3 (-1.8%), with sharp falls in car prices as a result of the proliferation of offers and of the plan establishing direct incentives for car purchases. The growth rate of services prices continued declining to 1.6%, in contrast to the rate of close to 4% recorded a year earlier. Processed food prices slowed to



0.5%, 0.2 pp less than in Q3, and the decline in unprocessed food prices intensified, to 2.8%. As a result of the trend of its different components, the CPI excluding unprocessed food and energy remained on the declining course begun in late 2008, posting a year-on-year rate of 0.2% on average in Q4 (0.2 pp less than in Q3). Box 4 examines inflation developments in 2009, paying attention to certain goods and services whose prices eased most significantly.

The rise in HICP inflation in the closing months of the year was somewhat sharper in Spain than in the euro area. This meant that the negative differential, which had stood at 0.7 pp on average in Q3, narrowed to 0.2 pp on average in Q4, and was cancelled out in December (see Chart 22). The lower growth of prices in Spain is fairly extensive to all components, with the exception of energy and processed foods, which showed positive differentials in 2009 Q4. In terms of core inflation, the differential remained negative in Q4, standing at 0.7 pp, unchanged on Q3.

The producer price index rose in December to a year-on-year rate of 0.4%, following 11 months of continuous falls. As in the case of the CPI, this was due to the momentum of energy prices, which grew by 6%. The decline in the prices of intermediate goods also slackened, while the producer prices of both consumer and capital goods remained very moderate. Compared with the euro area, and on information to November, a positive differential remained in place for all the main components. Finally, the decline in the price indices for imports and exports of industrial products slackened, standing in November at respective rates of -3.1% and -1.7%. As with the other price indicators, the acceleration was caused by the rise in energy prices.

#### **4.4 The State budget**

On 29 January the government unveiled its latest Stability Programme Update (SPU), with macroeconomic and fiscal estimates and projections for the period 2009-2013. With regard to the State budget, the SPU kept estimated real GDP growth for the years 2009 and 2010 at -3.6% and -0.3%, respectively. The overall general government balance for 2009 has been revised downwards, and a deficit of 11.4% of GDP is now projected. In the following years, against a background of progressive recovery in the economy, the budget deficit is forecast to fall progressively to 3% in 2013, in compliance with the Stability and Growth Pact. In terms of the sub-sectors, the public finances figures for 2009 will be chiefly determined by the central government balance, for which a deficit of 9.5% of GDP is expected, while the social security system will post a surplus of 0.8% of GDP (see Box 5). It is also anticipated that the regional and local governments will end the year with deficits of 2.2% and of 0.5% of GDP, respectively.

The projected reduction in the budget deficit in the Stability Programme will be centred on central government, and in particular on public spending. In this connection, the government has announced a further cut in budgetary spending initially for this year, equivalent to 0.5% of GDP. In addition, over the rest of the Programme's horizon, the Council of Ministers agreed on an austerity plan spanning the years 2011 to 2013. The plan considers spending cuts equivalent to 2.6% of GDP over the period as a whole, affecting wages and salaries (-0.3% of GDP), operating expenses (-0.2%), investment (-0.5%) and transfers and other expenditure (-1.6%).

Pursuant to National Accounts methodology and on the information available to November 2009, the State budget outturn to November resulted in a deficit of €71.52 billion (6.8% of GDP), far higher than the deficit of €13.97 billion (1.3% of GDP) recorded in the same period in 2008. It should be borne in mind that the State balance presents high seasonality, and December is a month in which the balance achieved up to the previous month traditionally deteriorates, which suggests that the central government deficit recorded to November will be

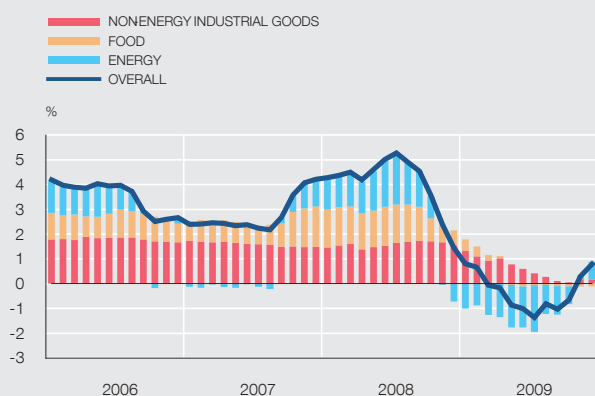
Inflation in Spain, proxied by the growth rate of the consumer price index (CPI), posted a negative rate of change in 2009 for the first time since 1952. Specifically, the rate for last year averaged -0.3%, 4.4 pp down on the related 2008 figure. Furthermore, the inflation differential vis-à-vis the euro area countries [measured using the harmonised index of consumer prices (HICP)] turned negative (-0.5 pp) for the first time since the start of the Monetary Union, in which period it had scarcely moved from its average (0.9 pp). In any event, the strong reduction in inflation in Spain for the year as a whole was compatible with different developments from one half of the year to the next. The marked slowdown in inflation since the summer of 2008 continued during the first half of 2009, to the point where the CPI stood at -1.4% in July. Thereafter, the growth rate of the CPI has been gradually increasing, standing at 0.8% in December 2009. The inflation trajectory in the euro area as a whole has been similar, although the fluctuations in Spain have been much more marked. The inflation differential reached a low of -0.9 pp in July 2009, becoming increasingly less favourable to Spain thereafter until it was cancelled out in December.

The trajectory of the inflation rate described was determined by two very different phenomena: on one hand, by purely statistical

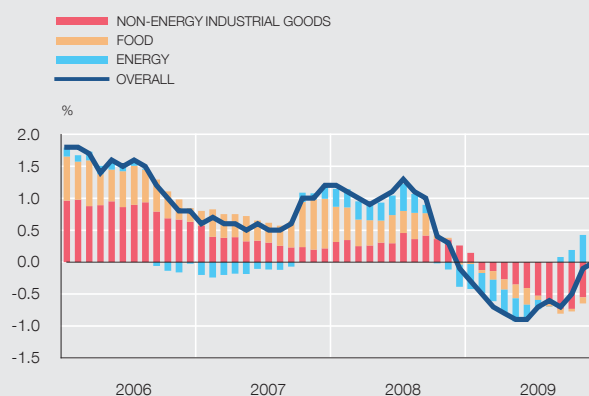
effects, of a temporary nature, which arise on comparing the course of inflation with that observed a year earlier; and on the other, the strongly recessionary background and, in particular, the sharp contraction in household consumption. Both factors contributed to reducing average inflation for the year. Further, the first factor led to the declining path of the first half of the year and the rising path of the second.

Indeed, taking the first of the two factors, the oscillations in aggregate inflation during 2009 were closely linked to the growth rate of energy product prices, whose contributions to the year-on-year growth rate of the CPI are depicted by the blue bars in Panel 1. The marked decline in the rate of change of prices of these goods during the first half of 2009 reflected temporary base effects. The greater relative weight of spending on oil derivatives in overall Spanish household expenditure relative to the euro area, the lesser burden of the excise duties levied on these products in Spain and the greater significance of the indirect and second-round effects in our country explain why the changes in oil prices should have a greater effect on Spanish prices than on those in the euro area. As a result, Spain's inflation differential with the euro area is significantly affected by fluctuations in oil prices (see Panel 2).

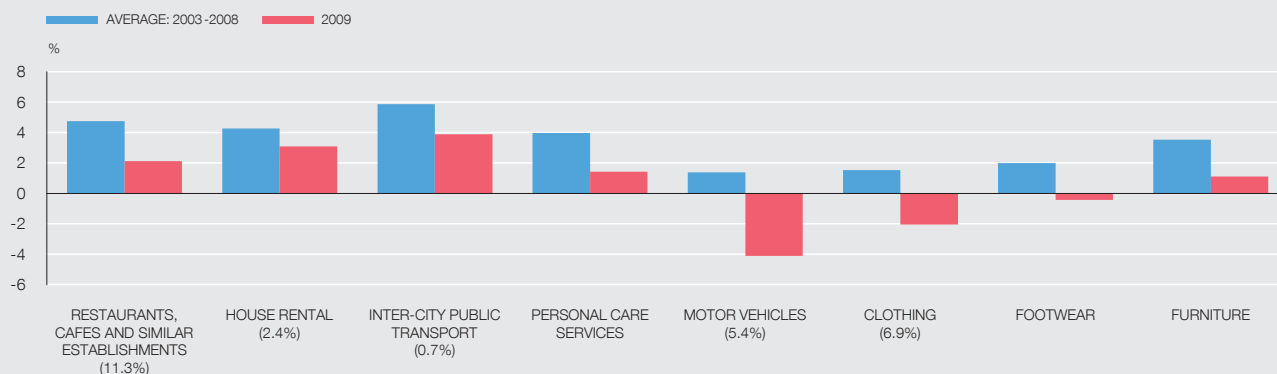
### 1 CONTRIBUTION TO THE CPI GROWTH RATE



### 2 CONTRIBUTIONS TO THE SPAIN-EURO AREA INFLATION DIFFERENTIAL



### 3 SELECTION OF SERVICES AND NONENERGY INDUSTRIAL GOODS SUB-CLASSES. RATES OF CHANGE (WEIGHT OF EACH ITEM IN THE OVERALL INDEX IN 2009 IN BRACKETS)



SOURCES: INE and Banco de España.

Secondly, the marked decline in household spending prompted a far greater easing in Spanish companies' prices than that observed in the past, through the contraction of business margins and the containment of unit labour costs. The latter came about by means of productivity gains being obtained, these in turn stemming from the employment adjustment, in a setting in which wage costs hardly adapted to the cyclical downturn. In terms of groups of goods, these effects were manifest essentially in services and in non-energy industrial goods, whose contribution to inflation during 2009 is depicted by the red bars in Panel 1. Moreover, the contraction in household spending was comparatively much more pronounced in Spain than in the euro area, which explains why the contribution of the inflation differential of these groups of goods to the total differential turned increasingly negative from early 2009 (see the red bars in Panel 2).

The case of services is particularly notable, since services prices, which had historically shown a high degree of stickiness, slowed markedly in 2009 further to the sharp decline in household spending. At the close of the year they stood at a rate of 1.4% in terms of the HICP, 2.4 pp down on the related December 2008 figure. Furthermore, as the decrease is much sharper than in the euro area, the differential narrowed to the extent of becoming favourable to Spain for the first time since the start of the Monetary Union (-0.2 pp in December 2009). The adjustment in non-energy industrial goods consumer prices was likewise notable, in a setting in which the producer prices of these types of goods eased gradually and their import prices moved on a declining trajectory, posting notable falls in the closing months of 2009. The HICP for these types of goods posted a decline of 1.2% in December, 1.6 pp down on the same month a year earlier. The moderation in these prices was sharper than in the euro area, with the negative differential widening to -1.5 pp.

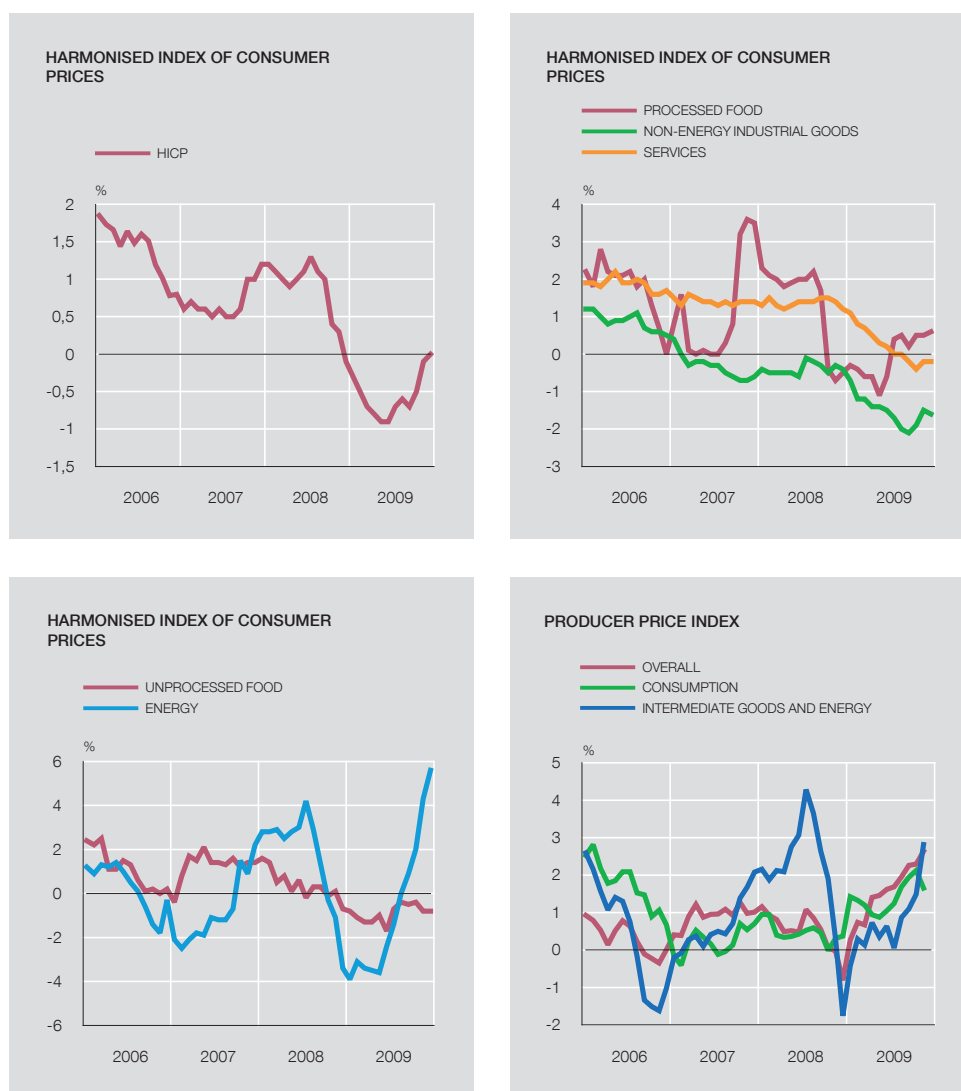
Panel 3 analyses the sub-classes of non-energy industrial goods and services which most contributed to the slowdown in overall inflation last year, comparing the inflation rate observed in 2009 with average rates for the period 2003-2008. Notable under services were prices in the aggregate of restaurants, bars and cafeterias: the end-2009 growth rate in this case was 1.4%, far below the increases of close to 5% recorded in previous years. House rental services, which had traditionally shown very stable increases, slowed notably, no doubt in connection with the fact that the legislation on urban rentals links the updating of rental contract income to the CPI. Finally, there was also a notable reduction in the rate of change of transport services prices which, however, cannot be explained only by the contraction in spending, but also by the changes in the growth rate of fuel prices. Under non-energy industrial goods, some products, such as motor vehicles, saw a significant reduction in demand, which prompted the approval of subsidies for car purchases (Plan 2000 E), which were accompanied by price cuts by vehicle manufacturers and importers. Against this background, car prices in December 2009 were 5% lower than a year earlier. Other goods, such as clothing and footwear, also became cheaper as a result of lower demand, along – probably – with strong competitive pressures due to the growing weight of the new producer countries, particularly China.

The above-mentioned temporary base effects may possibly lead to something of a rising trend in the year-on-year rate of change in the CPI in the first half of 2010. That said, as it is expected that household spending will remain lacklustre, this rising trend of prices will be tempered. Into the second half of the year, increases in the standard and reduced rate of VAT will prompt a further increase in inflation rates, although their impact will depend on the strength shown by demand in that period.

bigger at the close of the year. Along the same lines is the information on the cash-basis State accounts, which posted a deficit of €68.51 billion, compared with the deficit of €11.04 billion in November 2008. The discrepancies between both figures (National Accounts and cash-basis) are chiefly due, as is habitually the case, to adjustments for the different interest-imputation criterion and for the change in outstanding entitlements and obligations.

Likewise under the cash-basis convention, there was a fall in State receipts that seems compatible with that envisaged in the budget outturn projection. This reflects the impact of certain discretionary measures, particularly the residual impact on the closing months of 2009 of the personal income tax credit of up to €400 and the bringing forward of VAT refunds under the new monthly calendar. In particular, both the direct and indirect tax take showed a decline of over 25%.

For the analysis of public receipts, information is also available on total takings from the main taxes, both in the portion assigned to the State and in that relating to the ordinary-regime regional governments. According to this information, the downturn in receipts eased slightly in the closing months across the board. Overall, tax receipts have been affected both by the weak behaviour of tax bases, attributable to the impact of economic crisis, and to the effect of certain discretionary measures. In the case of personal income tax, withholdings on income



SOURCES: Eurostat and Banco de España.

a. Year-on-year rates based on the original series.

from work declined by 3.3%, influenced by the 2 pp reduction in the mortgage expense withholding rate for incomes below €30,000 introduced this year and by the residual impact of the tax credit of up to €400 introduced in the second half of 2008, which will not be fully offset until the end of the year, while the withholdings on investment fund gains decreased by 49.3%. As for corporate income tax, despite declining by 23.2% compared with the same period in 2008, its rate compared with the preceding quarter has improved owing to the second partial payment for the year. In any event, this positive performance is not representative of how business profits are trending, since their comparison is affected by the freedom in choosing how to calculate payment of corporate income tax relating to 2008.

Turning to indirect taxes, VAT continued to post the sharpest falls (29.7% on data to November); however, like other taxes, its rate of decline compared with the previous quarters eased. In addition to the decline in consumption and real estate transactions, VAT developments reflect the adverse effect on takings arising from the bringing forward of refunds and the new monthly refund schedule, owing to the regulations introduced this year. This effect was par-

The National Accounts sub-sector Social Security Funds includes all the public institutional units that provide social benefits. In Spain's case, these units comprise the Social Security System, the National Public Employment Service and the Wage Guarantee Fund. The periodic budget outturn information refers essentially to the first two institutions.

The provisional year-end data for the Social Security System gave a surplus of €8.50 billion in 2009, although the breakdown of all the headings is not yet known. The definitive data, given in the table below, refer to November 2009, when the non-financial surplus amounted to €14.41 billion. Non-financial revenue held at a rate of increase of virtually zero in the second half of the year, compared with declines of close to 5% in the opening months of 2009. This performance was due to the decrease in revenue relating to Social Security contributions during the year (which, however, has been moderating in recent months), in parallel with the trend of Social Security registrations (-3.9% in December, set against a maximum decline of 6.8% in April). Expenditure, in contrast, continued growing at a rate of around 5.6%, as in previous months. Spending on contributory pensions, which is the biggest item, has stabilised at around 6.6%. This heading con-

stantly evidences considerable inertia, owing to the stability in the number of pensions, which rose by 1.7% to November, while the average pension, showing greater volatility, increased by 3.4% in the same month.

As regards the National Public Employment Service (SPEE, by its Spanish abbreviation), the provisional information to December 2009 points likewise to a surplus, slightly higher than €1.4 billion. However, the latest final figure is for September, when the surplus to that month amounted to €246 million. This balance is the outcome of lower receipts relating to contributions (-9.1% year-on-year to 2009 Q3), along with a very high increase in benefits-related spending (63.1% over the same period). The partial information available on some headings to December helps explain how the significant recovery in the balance to the end of the year is underpinned essentially by the strong increase in current transfers from the State and in the slow-down in unemployment-benefit expenditure, which increased by 54.2% in December (after posting highs of 68.5% in May and June). The latter show a similar trend to that relating to the registered unemployed to December, despite the rise in the coverage rate to around 80% in November.

## SOCIAL SECURITY SYSTEM (a)

### Current and capital transactions, in terms of recognised entitlements and obligations

€m and %

	Budget		% change	Outturn in 11 months to November		
	2008	2009		2008	2009	% change
	1	2	3 = 2/1	4	5	6 = 5/4
1 REVENUE	114,113	123,726	8.4	109,084	108,995	-0.1
1.1 Social security contributions	105,107	113,324	7.8	99,546	98,040	-1.5
1.2 Current transfers	6,796	7,439	9.5	6,428	7,608	18.4
Other	2,209	2,963	34.1	3,111	3,347	7.6
2 EXPENDITURE	106,080	114,476	7.9	89,538	94,585	5.6
2.1 Wages and salaries	2,390	2,453	2.7	2,078	2,145	3.2
2.2 Goods and services	1,996	1,995	-0.1	1,620	1,430	-11.8
2.3 Current transfers	101,095	109,465	8.3	85,525	90,479	5.8
Contributory pensions	86,041	93,339	8.5	72,341	77,119	6.6
Sickness benefits	7,716	8,144	5.6	6,558	5,597	-14.7
Other	7,339	7,982	8.8	6,626	7,763	17.2
2.4 Other	599	563	-6.0	314	532	69.3
3 BALANCE	8,033	9,250	15.2	19,546	14,410	-26.3

SOURCES: Ministerio de Hacienda, Ministerio de Trabajo e Inmigración and Banco de España.

a. Only data relating to the system, not to the entire Social Security Funds sector, are given.

The regional (autonomous) governments have reached a very significant weight in general government in regard to revenue and, above all, expenditure. On the latest available figures, for 2008, the regional governments received 35.3% of tax revenues raised and managed 36.5% of total expenditure. Notable regarding this expenditure was that the regional governments were responsible for more than 90% of public spending on health and education. These figures highlight the need to pay attention to the budgetary conduct of the regional governments, in particular in relation to their necessary contribution to budgetary stability.

In this respect, after a deficit of 1.6% of GDP was posted for regional governments as a whole in 2008 (the latest year for which final figures are available), on 7 October 2009 the Fiscal and Financial Policy Council (FFPC) approved, within the framework of the budgetary stability legislation, the budgetary stability targets<sup>1</sup> for the regional governments for 2010-2012. These set limits for the balances of these governments at -2.5% of GDP in 2010, at -1.70% of GDP in 2011 and at -1.30% of GDP in 2012, provided that the corresponding economic and financial rebalancing plans are submitted. Nonetheless, owing to the current economic circumstances, the FFPC agreed that the regional governments which had held their deficit below 0.75% of

GDP in 2008 would be exempt from submitting rebalancing plans.<sup>2</sup> Indeed, Spain's Updated Stability Programme, released in late January, foresees a deficit for the regional governments as a whole of 2.2% of GDP in 2009, which would fall to -1.1% over the horizon to 2013.

Within the framework of these stability targets, the regional governments have submitted their draft budgets for 2010, the main headings of which are in the accompanying table.<sup>3</sup> The budget projections point to a strong deterioration in the balance, to a deficit of 2.3% of GDP, when compared with the initial budget for 2009 (-1% of GDP), albeit in line with the targets agreed by the FFPC for 2010. This outcome arises from a strong decline in revenue (particularly marked in taxes), while there is a small increase in expenditure of 0.3%.

Notable on the revenue side are the strong declines in both direct and indirect taxes, more markedly so in the case of the former than is budgeted for the State, although certain circumstances worthy of mention will be brought to bear in 2010.

2. Galicia, Andalusia, Asturias, Aragon, the Canary Islands, Castile and Leon, and Madrid may avail themselves of this exemption. 3. The table presents the aggregate figures of the initial budget of the regional governments and, in the last column, those of the State. They do not include, however, the budgets for the autonomous city enclaves of Ceuta and Melilla.

1. Note that these targets are set in National Accounts terms.

€m and %

	2008	2009	2010	Rate of change			State
				08/07	09/08	10/09	10/09
1 REVENUE	168,225	164,812	151,175	8.6	-2.0	-8.3	-13.8
— Current revenue	159,416	154,730	142,673	8.6	-2.9	-7.8	-14.5
— Direct taxes	32,202	38,400	30,161	18.3	19.2	-21.5	-13.3
— Indirect taxes	56,114	44,741	36,114	2.7	-20.3	-19.3	-18.9
— Charges, prices and other revenue	4,546	4,737	4,816	5.6	4.2	1.7	-15.7
— Current transfers	65,997	66,261	71,039	9.5	0.4	7.2	-5.4
— Interest and dividends	557	592	543	40.4	6.4	-8.4	8.3
Capital	8,808	10,081	8,503	8.6	14.5	-15.7	73.7
— Disposal of investments	630	633	518	-2.2	0.4	-18.1	-10.5
— Capital transfers	8,178	9,449	7,984	9.6	15.5	-15.5	83.5
2 EXPENDITURE	168,544	175,027	175,525	8.7	3.8	0.3	17.3
Current expenditure	136,373	142,599	145,649	8.7	4.6	2.1	18.1
— Wages and salaries	52,328	55,335	56,485	9.4	5.7	2.1	2.7
— Goods and services	28,033	28,924	29,448	11.0	3.2	1.8	0.4
— Interest payments	2,489	2,741	3,695	4.6	10.1	34.8	33.3
— Current transfers	53,347	55,391	55,810	7.0	3.8	0.8	20.1
— Contingency fund	175	209	212	11.7	19.2	1.4	29.6
Capital	32,171	32,428	29,875	8.7	0.8	-7.9	12.2
— Investment	16,381	15,975	13,254	6.5	-2.5	-17.0	-9.4
— Capital transfers	15,790	16,453	16,621	11.1	4.2	1.0	33.1
BALANCE	-319	-10,215	-24,350	—	—	—	—
% of GDP	0.0	-1.0	-2.3	—	—	—	—

SOURCES: Ministerio de Economía y Hacienda, Regional (Autonomous) Governments and Banco de España.

Firstly, the year 2010 will see the final settlement of the taxes managed by the State in 2008 in which the regional governments have a share: personal income tax, VAT and excise duties. Given that the actual tax-take for that year was below-budget, some regional governments received excessive amounts of prepayments, which they will have to return in 2010. However, regional governments in this situation will be allowed to defer the payments to subsequent years.

Secondly, mention should be made of the distortion arising owing to the approval of the new ordinary-regime regional government financing system in late 2009.<sup>4</sup> As the new system has not been incorporated into the budgeted figures, State transfers to the regional governments and the share of the latter in the above-mentioned assigned taxes have been calculated using the previous system (i.e. neither the new funds approved nor the raising of the tax assignment percentages have been taken into account). To palliate this shortfall to some extent, the State budget has included an item of €9.75 billion of current transfers to regional governments as a prepayment under the new system, which the regional governments have included in their budgets. Net of this payment, the heading of current transfers revenue would post a rate of -7.5%.

As regards expenditure, a slowdown on 2008 has been budgeted for, although as in previous years the rate of change remains above

4. Regulation published in the Official State Gazette of 19 December 2009.

the projection for nominal GDP.<sup>5</sup> Under wages and salaries, the State budget determines wage growth for the entire general government sector. However, the budgeted increases in personnel expenses have traditionally been higher in the regional governments than in the State sector, although there is a departure from this circumstance in the 2010 budget, where the regional governments project an increase in personnel expenses of 2.1%, somewhat below the State projection of 2.7%. Expenditure on purchases and current transfers is very closely linked to the functions of healthcare and education in the case of regional government. In both items a slowdown is budgeted for 2010, although their projected growth rates remain above that of nominal GDP. The interest burden is expected to rise forcefully in 2010 (by 34.8%), similar to that of the State sector, as a result of the increase in regional government debt issues.

Finally, the increase in current expenditure is in contrast to the sharp adjustment of capital expenditure in regional government budgets, which project slowdowns in real investment (to a rate of -17%) and capital transfers (21%), both below the projected increases in the State sector.

5. Both the European Commission's autumn projections and those included in the State budget point to a slight decline in GDP in 2010, in nominal terms. Specifically, the State budget establishes the rate of change of nominal GDP in 2010 at 0.3%.

ticularly sharp in November. Excise duties fell off by -1.5%, compared with -4.9% in the previous six-month period, due in part to the higher rates for taxes on hydrocarbons and tobacco approved mid-year. Finally, the items under the heading of other receipts showed high growth to November, owing partly to the fees earned by the State for guarantees on funds lent under the framework of Royal Decree-Law 7/2008 of 13 October 2008 (on urgent economic and financial measures relating to the Concerted Action Plan of Euro Area Countries), and to the issue premia on public debt issued at a discount (which have proved positive in light of the downtrend in interest rates).

State cash-basis expenditure increased by 24.7% to November, slowing slightly on Q3. The vigorous growth of spending is essentially due to certain transfers from the State to other general government sectors. Thus, current transfers include that made to the National Public Employment Service to finance unemployment benefits, and capital transfers include those to local government by the State Fund for Local Investment. As regards other headings, the growth of wages and salaries quickened to 5.3%, while the increase in interest payments stood at 10.4%. Finally, investment trended somewhat more buoyantly.

#### 4.5 Balance of payments

In the first 11 months of 2009, the combined current and capital account balance was a deficit of €47.3 billion, half that observed in the same period a year earlier (see Table 5). The decrease in this deficit is due essentially to the lower trade deficit and, to a lesser extent, to the correction of the income and current transfers balances, since the balances on services and on capital account worsened.



€m and %

	Outturn 2008	Percentage change 2008/2007	Outturn projection 2009	Percentage change 2009/2008	Outturn JAN-SEP Percentage change 2009/2008	Outturn		
						2008 JAN-NOV	2009 JAN-NOV	Percentage change
						1	2	3
<b>1 REVENUE</b>	129,335	-19.1	100,682	-22.2	-24.4	120,150	95,092	-20.9
Direct taxes	74,096	-23.6	57,979	-21.8	-29.8	70,128	51,955	-25.9
<i>Personal income tax</i>	43,413	-10.7	32,309	-25.6	-32.2	41,155	28,826	-30.0
<i>Corporate income tax</i>	27,301	-39.1	22,300	-18.3	-30.4	25,958	19,947	-23.2
<i>Other (a)</i>	3,382	-4.2	3,370	-0.3	2.4	3,015	3,182	5.5
Indirect taxes	39,229	-19.0	25,471	-35.1	-31.1	37,925	27,900	-26.4
VAT	24,923	-26.2	11,491	-53.9	-41.6	24,676	16,081	-34.8
<i>Excise duties</i>	11,220	-2.2	11,242	0.2	-13.7	10,398	9,297	-10.6
<i>Other (b)</i>	3,086	-4.3	2,738	-11.3	-12.3	2,850	2,522	-11.5
Other net revenue	16,011	11.1	17,232	7.6	22.3	12,097	15,237	26.0
<b>2 EXPENDITURE</b>	148,082	6.0	184,012	24.3	25.3	131,188	163,601	24.7
Wages and salaries	25,231	6.6	26,873	6.5	4.8	21,796	22,952	5.3
Goods and services	4,538	1.9	4,803	5.8	1.7	3,565	4,009	12.4
Interest payments	15,929	9.6	17,434	9.4	10.1	15,708	17,342	10.4
Current transfers	82,797	6.6	106,067	28.1	28.1	74,431	95,657	28.5
Investment	10,648	5.4	11,172	4.9	2.8	8,637	8,902	3.1
Capital transfers	8,940	-3.3	17,663	97.6	155.2	7,051	14,738	109.0
<b>3 CASH-BASIS BALANCE (3 = 1 - 2)</b>	-18,747	—	-83,330	—	—	-11,038	-68,508	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)								
Personal income tax	71,341	-1.8	65,734	-7.9	-10.9	67,109	59,809	-10.9
VAT	48,015	-14.0	29,281	-39.0	-33.9	45,965	32,299	-29.7
Excise duties	19,570	-1.1	20,450	4.5	-2.5	18,020	17,758	-1.5

SOURCE: Ministerio de Economía y Hacienda.

- a. Includes revenue from the tax on the income of non-residents.  
b. Includes taxes on insurance premiums and tariffs.

In the period from January to November 2009, the trade deficit fell by 49% on year-on-year terms to €41.73 billion. This rate of decline is appreciably more pronounced than a year earlier. In the first 11 months of 2009, both exports and, in particular, imports of goods fell off substantially in real terms. The improvement in the terms of trade widened the difference in decline in nominal terms between imports and exports, which were down 27% and 17%, respectively. The energy bill fell substantially, against a background of decline in real terms in net imports of energy products and a marked decline in oil prices on international markets compared with the same period a year earlier. The non-energy trade imbalance decreased significantly, especially during the summer months, falling more sharply than the energy balance.

The services balance showed a surplus of €24.17 billion in the first 11 months of 2009, 5% down on the same period in 2008. This reduction is explained by the fall of 7% in the tourism surplus, to €25.03 billion, while the non-tourism services deficit was corrected to the tune of 41%, to €861 million. Nominal tourism receipts fell by 9% in the first 11 months of 2009, a decline in step with the negative course of the tourism indicators in this period (such as numbers of foreign tourists or their overnight hotel stays) but one which has eased partially in 2009 Q4. Tourism payments fell by 14%, in line with developments in their main determinants and



		January-October		% change 2009/2008 (b)
		2008	2009	
€m				
CREDITS	Current account	311,105	264,389	-15.0
	<i>Goods</i>	165,654	134,403	-18.9
	<i>Services</i>	83,179	75,288	-9.5
	— Tourism	37,287	33,704	-9.6
	— Other services	45,891	41,584	-9.4
	<i>Income</i>	50,417	43,003	-14.7
	<i>Current transfers</i>	11,855	11,695	-1.3
	Capital account	6,147	4,580	-25.5
	Current + capital accounts	317,251	268,969	-15.2
	DEBITS	Current account	400,335	310,314
<i>Goods</i>		241,208	171,731	-28.8
<i>Services</i>		59,444	52,480	-11.7
— Tourism		11,872	10,103	-14.9
— Other services		47,571	42,377	-10.9
<i>Income</i>		78,284	65,318	-16.6
<i>Current transfers</i>		21,399	20,786	-2.9
Capital account		1,101	1,809	64.4
Current + capital accounts		401,436	312,123	-22.2
BALANCES		Current account	-89,231	-45,925
	<i>Goods</i>	-75,554	-37,328	38,226
	<i>Services</i>	23,735	22,808	-927
	— Tourism	25,415	23,601	-1,814
	— Other services	-1,680	-793	887
	<i>Income</i>	-27,867	-22,315	5,552
	<i>Current transfers</i>	-9,545	-9,090	454
	Capital account	5,046	2,771	-2,275
	Current + capital accounts	-84,184	-43,154	41,031

SOURCE: Banco de España.

a. Provisional data.

b. Absolute changes for balances.

the recessionary situation of the Spanish economy. As regards other services, both receipts and payments fell in the first 11 months of 2009 (by 10.3% and 11.2%, respectively).

The deficit on the income balance narrowed by 22% year-on-year on the January-November 2009 period, thanks to the correction witnessed since April, which exceeded the cumulative deterioration in the first quarter of the year. As a result, the income deficit stood at €24.65 billion, against the background of a more marked fall in payments than receipts (18% and 16%, respectively). This development reflects the impact of the reduction in interest rates, which offset the payment of extraordinary dividends in the first four months of 2009.

The current transfers deficit decreased by 22% year-on-year on the first 11 months of 2009 to €8.37 billion. This took place against the background of a moderate decline in payments (1%) and a notable increase in receipts (16%). Finally, in the first 11 months of 2009 the capital account surplus stood at €3.16 billion, 40% down on the same period a year earlier. This decline was fairly generalised across the various capital account headings, reflecting mainly the decrease in general government receipts from the various Community funds.

## 5 Financial developments

### 5.1 Overview

In line with the trends in other world markets, in general there were no major changes in prices in Spanish financial markets in 2009 Q4. Thus, at year-end, the IBEX 35 was up 1.1% on the September close, while in the same period the EURO STOXX 50 index of euro area companies was up 2.5% and the S&P 500 for US companies was up 5.8% (see Chart 23), resulting in cumulative gains in the year of 29.3%, 20.2% and 23.8%, respectively. Volatility diminished in all three indices in the last stretch of the year. On the interbank markets, interest rates showed little movement, with 12-month EURIBOR at end-2009 unchanged on end-September at 1.24%. In turn, Spanish long-term government bond yields rose slightly, in the case of 10-year bonds from 3.72% to 3.96%. This increase was similar to that recorded by the German bund, meaning that the yield spread remained at around 60 bp. By contrast, the credit risk premia of Spanish non-financial corporations traded on derivatives markets declined on average in the period by 20 bp, to 73 bp.

In 2010 to date, the main financial stress indicators have risen, both in the Spanish and the world markets, in contrast to the stability of the previous months. Thus, stock indices have fallen, volatility has increased, credit risk premia have risen moderately and, against a backdrop of growing concern regarding the sustainability of Greece's public finances, long-term sovereign spreads in the euro area have widened with respect to Germany. At the date of this report going to press, the IBEX 35 was down 7.9% on the 2009 close (the EURO STOXX 50 was down 5.8% and the S&P 500 down 2.3%) and the yield spread between Spanish 10-year government bonds and the German bund stood at 85 bp.

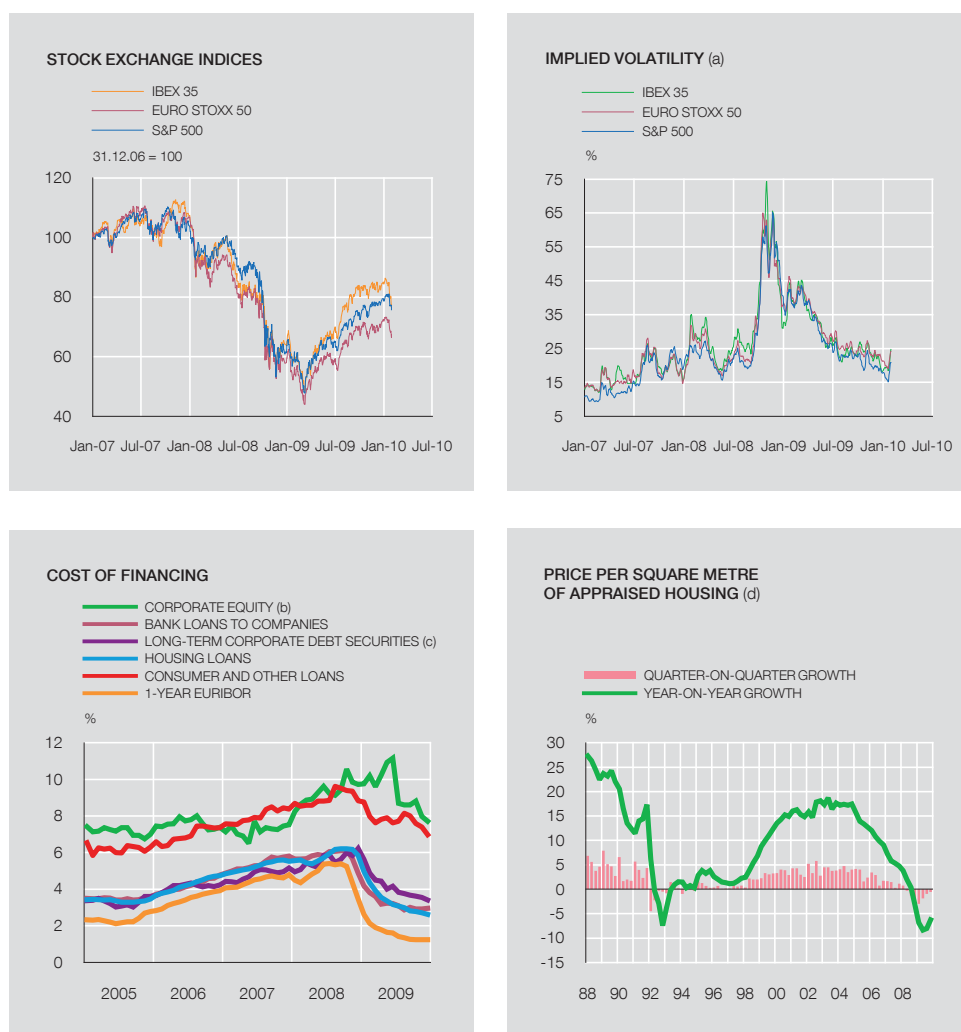
On the real estate market, the price of unsubsidised housing continued to fall in 2009 Q4, according to the latest Ministry of Housing data, although once again at a slower pace than in previous months. Thus, the quarter-on-quarter and year-on-year rates of decline stood at 0.6% and 6.3%, respectively, in December, in comparison with the declines of 0.9% and 8% at-end September.

The cost of borrowing for households and firms continued to decline, in general, throughout 2009 Q4 (see Chart 23). In addition, according to the January Bank Lending Survey (BLS), loan approval criteria were unchanged for the third consecutive quarter.<sup>1</sup> Nevertheless, these criteria are seemingly still tighter than at the onset of the financial crisis, as a result of the tightening accumulated in previous months. Financial institutions foresee no major changes in credit standards, neither for 2010 Q1 nor for 2010 as a whole.

The latest available data on credit to the private sector (relating to November) continue to show further declines – once again somewhat sharper in the case of corporations – in the year-on-year rates of growth, which stood at close to zero both for firms (-0.2%) and households (-0.3%). Annualised seasonally-adjusted quarter-on-quarter rates of growth of household indebtedness at the same date were marginally positive (0.2%); in contrast, corporations recorded negative figures in the order of 2%. In the case of corporate borrowing, different instruments performed differently. Thus, while lending by resident institutions fell once again, posting a more negative rate than in Q3, other sources of financing, used primarily by large corporations, continued to show positive growth, with fixed-income instruments recording particularly

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1. For more details, see the article entitled "Encuesta sobre Préstamos bancarios en España: enero de 2010", by Jorge Martínez Pagés, in the Banco de España's *Boletín Económico*, January 2010.

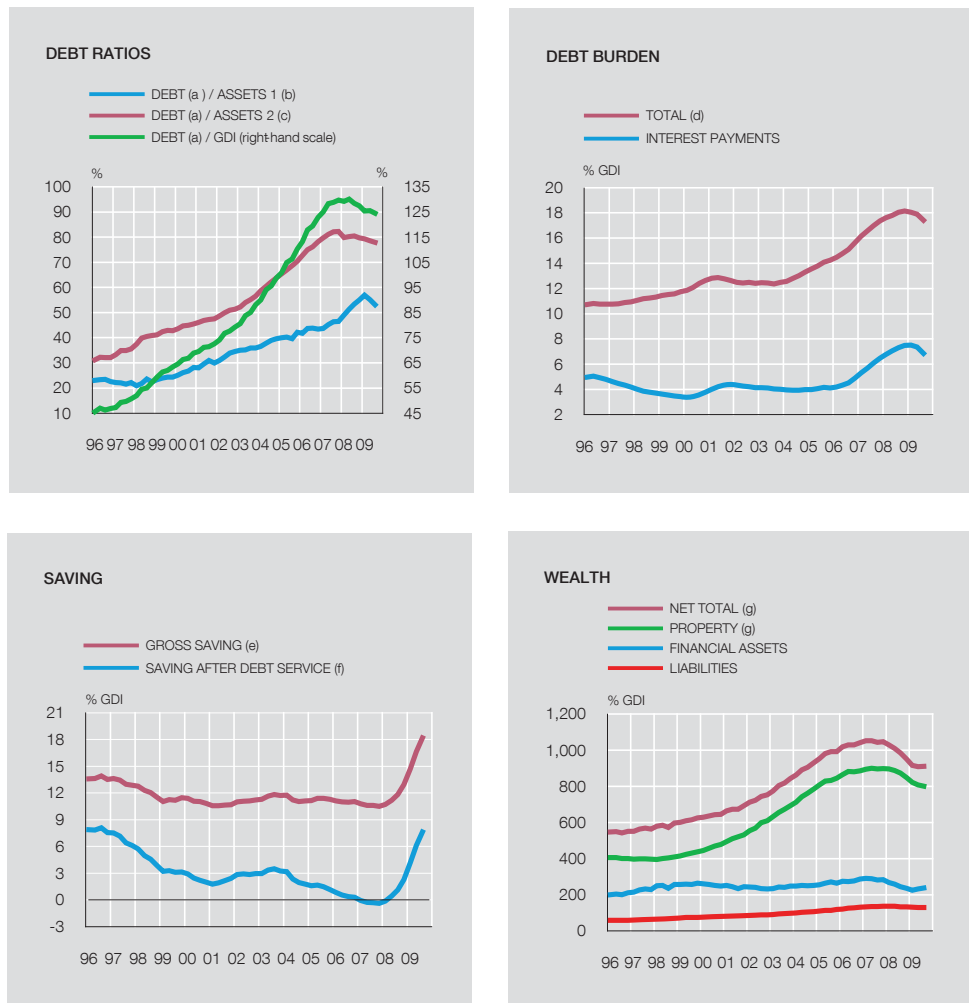


SOURCES: Bloomberg, Credit Trade, Datastream, MSCI Blue Book, Ministerio de Vivienda and Banco de España.

- a. Five-day moving averages.  
 b. The cost of equity is based on a three-stage Gordon dividend discount model.  
 c. The cost of long-term debt is proxied as the sum of the 5-year euro swap rate and a weighted average of the 5-year CDS premia for Spanish non-financial corporations.  
 d. Base 2001 to December 2004; base 2005 thereafter.

strong advances. The provisional data as at December indicate that these trends are likely to continue. The latest data on lending by purpose, relating to September 2009, show that bank credit has decelerated across all sectors, but especially in industry. The minor contraction in household credit in 2009 Q3, combined with household income stability, led to a certain decrease in the ratio of debt to gross disposable income (GDI) (see Chart 24). This, together with the decline in the cost of borrowing, meant that the debt burden continued to fall in the period, while the increase in the gross saving ratio gave a further boost to the ability to save after debt servicing. In line with these developments, the latest Financial Accounts data record an increase in household net lending in the period. In turn, household net wealth was virtually unchanged, as the drop in the value of real estate assets was offset by the increase in the value of financial assets. The provisional data relating to the last months of 2009 point to little change in the household debt ratio and to a further decline in the debt burden ratio.

Turning to firms, the latest National Accounts profit estimates (for 2009 Q3) reflect year-on-year declines, leading to lower corporate returns. This profit performance drove the debt ratio

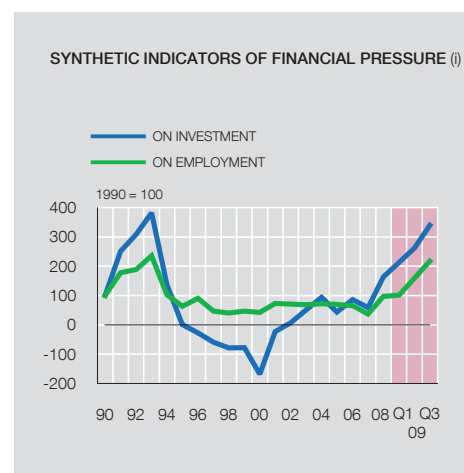
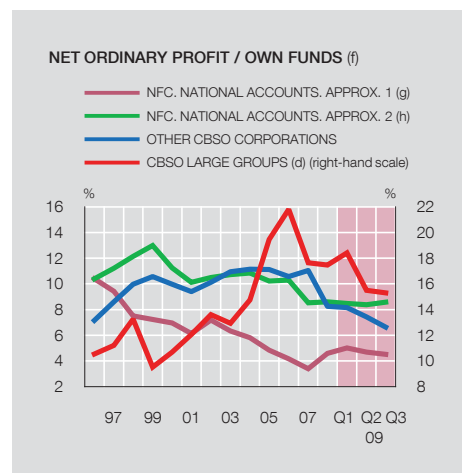
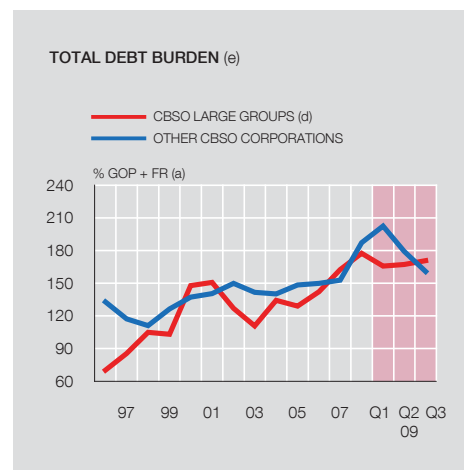
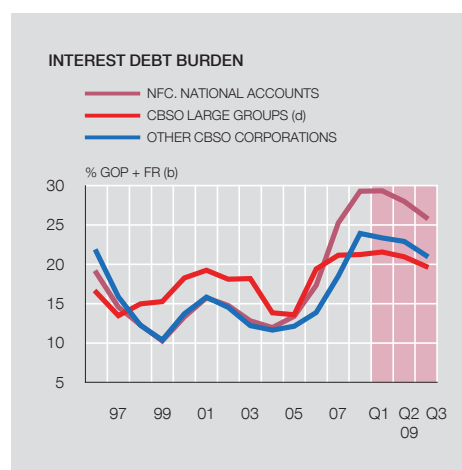
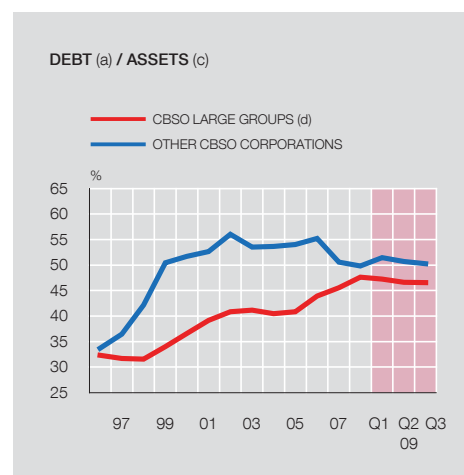
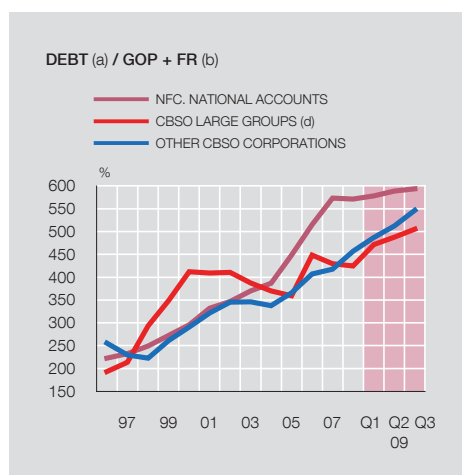


SOURCES: Ministerio de Vivienda, INE and Banco de España.

- a. Includes bank credit and off-balance-sheet securitised loans.  
 b. Assets 1 = Total financial assets less "Other".  
 c. Assets 2 = Assets 1 less shares less holdings in mutual funds.  
 d. Estimated interest payments plus debt repayments.  
 e. Balance of households' use of disposable income account.  
 f. Gross saving less estimated debt repayments.  
 g. Calculated on the basis of the estimated changes in the stock of housing, in the average area per housing unit and in the price per square metre.

up again (see Chart 25), despite the slight dip in borrowing, but the debt burden ratio fell once more, due to lower financing costs. In turn, the contraction in corporate spending led to a further decrease in net borrowing, despite the decline in corporate earnings. The data on firms contributing to the Central Balance Sheet Data Office Quarterly Survey (CBQ), which are predominantly large corporations, also record a contraction in corporate profits in 2009 Q3, albeit higher than that reflected in the National Accounts figures, together with an increase in the debt ratio and a decline in the debt burden ratio. As a result of all the above, the indicators of financial pressure on investment and employment rose, to levels close to those seen in the 1992-1993 recession. The provisional data relating to the final months of 2009 point to a further increase in the debt ratio and to a decline in the debt burden ratio.

The growing level of financial pressure borne by certain segments of the private sector was reflected in further increases in doubtful loans ratios, which for other resident sectors (which



SOURCES: INE and Banco de España.

- a. Interest-bearing borrowed funds.
- b. Gross operating profit plus financial revenue.
- c. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
- d. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefonica groups. Adjusted for intra-group financing to avoid double counting.
- e. Includes interest plus interest-bearing short-term debt.
- f. NOP, using National Accounts data, is defined as GOS plus interest and dividends received less interest paid less fixed capital consumption.
- g. Own funds valued at market price.
- h. Own funds calculated by accumulating flows from the 1996 stock onwards.
- i. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

% GDP	2004	2005	2006	2007	2008		2009		
					Q3	Q4	Q1	Q2	Q3
					National economy	-4.8	-6.5	-8.4	-9.6
Non-financial corporations and households and NPISHs	-5.1	-8.4	-11.1	-13.5	-9.7	-7.0	-4.5	-0.8	1.9
<i>Non-financial corporations</i>	-4.5	-7.1	-9.5	-11.6	-8.2	-7.4	-6.2	-4.6	-2.6
<i>Households and NPISHs</i>	-0.6	-1.3	-1.7	-1.9	-1.5	0.4	1.7	3.8	4.5
Financial institutions	0.6	0.9	0.7	2.1	2.1	2.0	2.0	1.9	1.6
General government	-0.4	1.0	2.0	1.9	-1.9	-4.1	-5.6	-8.0	-9.4
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.7	-11.4	-17.8	-15.9	-14.4	-11.1	-9.2	-6.7	-3.9

SOURCE: Banco de España.

a. Financial resources that cover the gap between expanded gross capital formation (real investment plus permanent financial investment) and gross saving.

include households, firms and financial intermediaries other than credit institutions) as a whole stood at 5.1% in November, 0.2 pp above the September figure.

The latest Financial Accounts data, corresponding to 2009 Q3, reflect a decline in the nation's net borrowing, down to 5.8% of GDP in cumulative 12-month terms (1.1 pp below the June level; see Table 6). This was the result of the increased net lending capacity both of households and non-financial corporations, which was partially offset by the rise in the general government deficit (which stood at close to 9.5% of GDP) and the marginal decline in financial institutions' savings.

The rising government deficit, together with the need to fund general government's growing financial investments, has led to a significant increase in the volume of outstanding debt, which records year-on-year rates of growth in excess of 30%. This, together with the decline in GDP, has been reflected in a rapid rise in the debt-to-GDP ratio, and in an increase in the associated debt burden. Consistent with the extent of general government borrowing, in recent months this sector has accounted for the bulk of the net funds obtained by the Spanish economy abroad (4.7% of GDP in cumulative 12-month terms on data to September 2009).

In short, the lower financing costs of the last few months of the year again helped drive down the debt burden. But the worsening of the macroeconomic situation continued to raise the financial pressure borne by certain segments, especially those with most debt and those most affected by the cyclical position. In addition, despite the deceleration in private sector borrowing in recent quarters, the less favourable profit performance has halted the decline in households' and firms' debt ratios, which remain high, making the possibility of a Spanish economic recovery based on significant credit expansion less likely. The rapid increase in general government debt represents a growing burden that may pose a threat to the sustainability of public finances in the long term.

## 5.2 Households

Interest rates on new loans declined again in 2009 Q4: rates slipped by 20 bp in the case of home loans and by 1.3 pp in the case of consumer and other loans which are more changeable. According to the latest BLS, as the cost of borrowing has declined, credit standards for home loans have remained unchanged, while those for consumer and other loans have eased

slightly. However, respondents to the BLS discern a further decrease in credit demand in 2009 Q4, both for home loans and consumer and other loans.

In this setting, household debt contracted by 0.3% year-on-year in November, in comparison with a decline of 0.1% in September, as the result of a slight dip in the year-on-year rates of growth of home loans and of consumer and other loans (which stood at -0.1% and -1.1%, 0.3 pp and 0.2 pp, respectively, below the Q3 close). By contrast, the annualised quarter-on-quarter rates were marginally positive in both cases, although below the September levels.

According to the latest Financial Accounts data, household investment in financial assets stood at 3.5% of GDP (in cumulative 12-month terms) in September, almost 1 pp above the June level (see Table 7). The breakdown by instrument reflects a recovery in investment fund flows, which recorded their highest level since mid-2007, growing by more than 1 pp in cumulative four-quarter terms to -0.5% of GDP. Among the most liquid assets, there was a restructuring in favour of cash and cash equivalents, to the detriment of time deposits.

The debt ratio as a percentage of GDI fell moderately in 2009 Q3, to just under 125% (see Chart 24), as a result of the modest decline in debt in quarter-on-quarter terms and household income stability. This, combined with the lower financing costs, led to a further decline in the debt burden, while the increase in the household gross saving ratio again boosted the ability to save after debt servicing. Similarly, the Financial Accounts reflect an increase in household net lending capacity in the period, to 4.5% of GDP in comparison with 3.8% in June. In turn, household net wealth was stable in Q3, as the increase in the financial component, driven by stock market appreciation, offset the reduction in housing wealth.

Despite the lower debt burden, in recent months the level of financial pressure borne by households has continued to rise, due to the worsening macroeconomic situation and, in particular, to the mounting unemployment rate. This continued to be reflected in rising doubtful loans ratios, with the sharpest growth continuing to be seen in lending for consumption and other purposes. Thus, in 2009 Q3 this indicator rose by 0.39 pp in the case of consumer and other loans, to 7.13%, but by scarcely 0.04 pp, to 3.05%, in the case of house purchase and refurbishment loans.

### **5.3 Non-financial corporations**

Interest rates on new loans of less than €1 million to corporations fell by 36 bp (to 4.24%) in 2009 Q4, while those on loans of over €1 million, which had fallen more sharply in the previous period, rose by 20 bp to 2.47%. The issuance cost of shares and long-term securities also fell, by 90 bp and 25 bp, respectively, while the cost of issuing short-term securities rose slightly (by 9 bp).

According to the January BLS, financial institutions tightened their loan approval criteria very slightly in Q4. In the same vein, the information provided by the Chambers of Commerce Survey on SME access to financing for the quarter reflects no significant changes in the percentage of these firms that have had difficulties accessing borrowed funds. At the same time, and also according to the BLS, the decline in corporate loan demand would seem to have halted in the last stretch of 2009, for the first time since June 2007.

In this setting, the rate of growth of corporate debt continued to decelerate, to around zero (-0.2%) in year-on-year terms in November, 0.6 pp below the September figure. The annualised quarter-on-quarter rates of growth reflect less momentum (-2%), which would seem to indicate a further decline in year-on-year rates in coming months. This contraction in lending

FINANCIAL TRANSACTIONS OF HOUSEHOLDS, NPISHs AND NON-FINANCIAL CORPORATIONS  
Four-quarter data

TABLE 7

% GDP	2006	2007	2008	2009		
				Q1	Q2	Q3
<b>HOUSEHOLDS AND NPISHs:</b>						
Financial transactions (assets)	10.8	7.1	2.7	1.8	2.6	3.5
Cash and cash equivalents	3.1	-1.0	-0.5	0.3	2.5	3.5
Other deposits and fixed-income securities (a)	5.8	7.5	7.0	4.1	1.5	-0.1
Shares and other equity (b)	-1.3	0.4	-0.6	-0.2	0.0	0.5
Mutual funds	0.2	-1.1	-3.4	-2.7	-1.7	-0.5
Insurance technical reserves	1.8	0.9	0.4	0.5	0.5	0.5
<i>Of which:</i>						
<i>Life assurance</i>	0.6	0.2	-0.1	0.0	0.1	0.1
<i>Retirement</i>	1.0	0.4	0.5	0.4	0.4	0.4
<i>Other</i>	1.1	0.4	-0.2	-0.2	-0.3	-0.4
Financial transactions (liabilities)	12.5	9.0	2.4	0.2	-1.2	-1.1
Credit from resident financial institutions (c)	13.0	9.4	3.4	1.6	0.1	-0.3
<i>Housing purchase credit (c)</i>	10.0	7.1	2.7	1.6	0.7	0.2
<i>Consumer and other credit (c)</i>	3.0	2.1	0.8	0.2	-0.3	-0.3
<i>Other</i>	-0.4	-0.4	-1.0	-1.5	-1.3	-0.7
<b>NON-FINANCIAL CORPORATIONS:</b>						
Financial transactions (assets)	23.4	14.0	4.4	3.0	-3.4	-8.2
Cash and cash equivalents	2.3	-0.4	-1.1	-0.7	-0.9	-0.8
Other deposits and fixed-income securities (a)	1.9	2.0	1.9	1.1	0.6	0.9
Shares and other equity	11.5	8.2	3.1	2.6	1.6	0.9
<i>Of which:</i>						
<i>Vis-à-vis the rest of the world</i>	8.3	6.7	3.4	2.8	1.8	1.4
<i>Trade and intercompany credit</i>	6.6	2.7	-0.2	-0.4	-5.0	-8.6
<i>Other</i>	1.1	1.5	0.7	0.5	0.4	-0.5
Financial transactions (liabilities)	32.9	25.7	11.8	9.2	1.2	-5.6
Credit from resident financial institutions (c)	17.6	13.9	5.5	3.7	1.2	-1.6
Foreign loans	3.3	2.8	2.2	2.4	2.4	1.3
Fixed-income securities (d)	1.8	0.5	0.3	0.7	0.3	0.9
Shares and other equity	2.9	5.3	2.3	1.9	1.4	1.5
Trade and intercompany credit	7.0	3.2	0.0	-0.3	-4.9	-8.6
<i>Other</i>	0.3	0.0	1.3	0.7	0.8	1.0
<b>MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):</b>						
Financing (e)	24.2	15.5	6.1	4.5	2.1	0.2
Households and NPISHs	19.6	12.5	4.4	2.2	0.5	-0.1
Non-financial corporations	27.9	17.7	7.4	6.2	3.3	0.4

SOURCE: Banco de España.

- a. Not including unpaid accrued interest, which is included under "Other".
- b. Excluding mutual funds.
- c. Including off-balance-sheet securitised loans.
- d. Including issues of resident financial subsidiaries.
- e. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation special purpose entities.

volume masks different patterns by instrument and company size. Thus, credit extended by resident institutions fell, in annualised quarter-on-quarter terms, by 6%, while funds obtained from other financing sources, used primarily by large corporations, continued to post positive rates of growth, especially in the case of fixed-income instruments. In turn, disaggregated information on credit extended by resident institutions shows the highest rate of growth among funds granted to companies with most debt, and thus, a priori, larger companies, excluding construction and real estate service firms (for which credit buoyancy is not a function of company size).



The latest information on credit breakdown by productive activity, relating to September 2009, shows a slowdown across all sectors, but most particularly in industry where the growth rate was negative (-1.3%, almost 9 pp below the June figure). Real-estate and non-real-estate services posted a more moderate slowdown, with a year-on-year rate of growth around 3%, while bank credit extended by resident institutions to the construction sector continued to record very negative growth rates (-14.3%, adding 1.1 pp to the decline seen in Q2).

In turn, according to the Financial Accounts, between September 2008 and September 2009 (latest data available), the balance on trade and intercompany credit (both owed by and extended to the sector) fell back significantly, resulting in associated negative flows of funds in the period equivalent to 8.6% of GDP (see Table 7). This was foreseeably a result of the downturn in economic activity and of firms' greater reluctance to grant this type of credit.

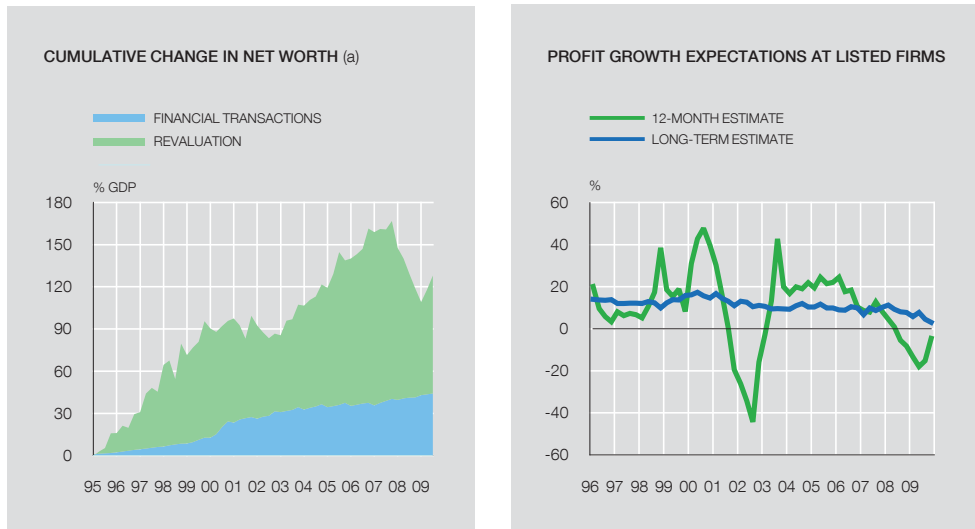
The contraction in corporate spending meant that net borrowing fell again, to 2.6% of GDP, that is, 2 pp below the June figure. The financing gap, an indicator that approximates the funds needed to cover the difference between firms' gross saving and gross capital formation plus foreign investment of a permanent nature, fell rather more sharply (by almost 3 pp), as a result of the lower investment in foreign equity and lower intragroup financing, nearing 4% of GDP.

The latest National Accounts profit estimates (for 2009 Q3) reflect year-on-year declines that would indicate a fall-off in corporate returns. As a result of this profit performance, the debt ratio rose slightly in the period (see Chart 25), despite the minor contraction in borrowing, although the associated debt burden ratio headed down as financing costs also declined. The data on firms contributing to the Central Balance Sheet Data Office Quarterly Survey (CBQ), which are predominantly large corporations, also record a drop in corporate profits. Specifically, both gross operating profit and ordinary net profit at these firms fell by 22% in the first three quarters of 2009 with respect to the same period of 2008, resulting in a sharp decline in returns and in an increase in the debt ratio vis-à-vis the gross operating surplus and financial revenue. Nevertheless, thanks to the lower interest rates, the interest burden related to revenue obtained on ordinary activity decreased, save in the industrial sector; in fact, among the sectors with most representation in the CBQ, industry is the one whose financial position has deteriorated most in recent quarters, and the one that currently has the highest interest burden ratio. The decline in corporate returns and the increase in indebtedness drove the indicators of financial pressure on investment and employment up again, to levels close to those seen in the 1992-1993 recession.

The poor profit performance was also reflected in the non-financial corporations' doubtful loans ratio, which rose again, to stand at 5.7% in September, 0.4 pp above the June level. Construction and real estate service sector companies continued to experience the most difficulties in servicing their debts. The combined doubtful loans ratio for these firms rose from 8.1% to 8.5% in the period, and slightly less (by 0.3 pp to 3.3%) in all other branches of activity.

The latest data on firms' financial statements point to significant differences in their financial performance, depending not only on sector but also on company size. Thus, according to the CBB database (which includes data from companies reporting to the CBA and mercantile register data), ordinary net profit at smaller companies (with fewer than 50 employees) fell by more than 50% in 2008, in comparison with a drop of 21% for their larger peers.

At the end of 2009, analysts continued to expect profits to continue to decline at listed non-financial corporations in coming quarters, although at a slightly lower rate than previously en-

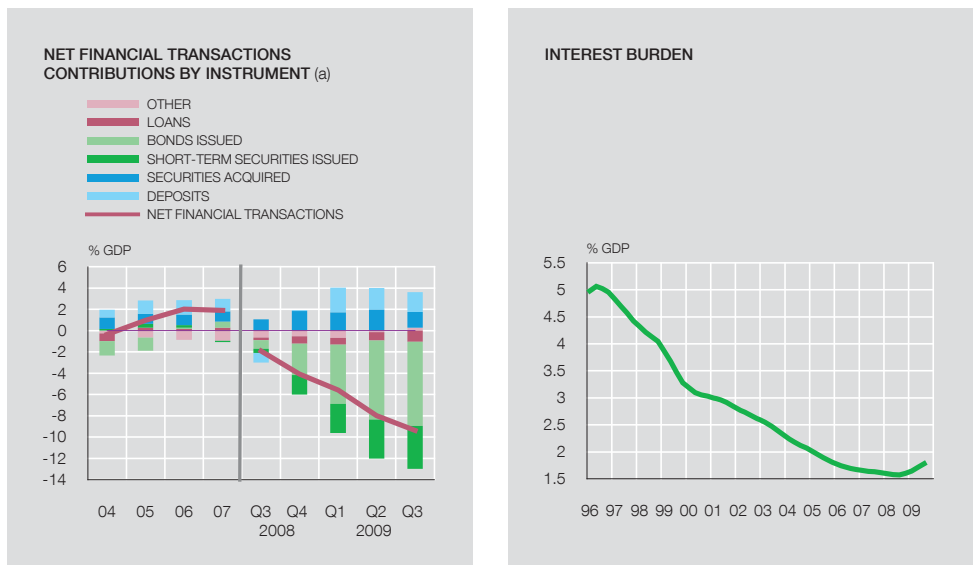


SOURCES: I/B/E/S and Banco de España.

a. Net worth is proxied by the valuation at market price of shares and other equity issued by non-financial corporations.

## GENERAL GOVERNMENT

### Four-quarter data



SOURCE: Banco de España.

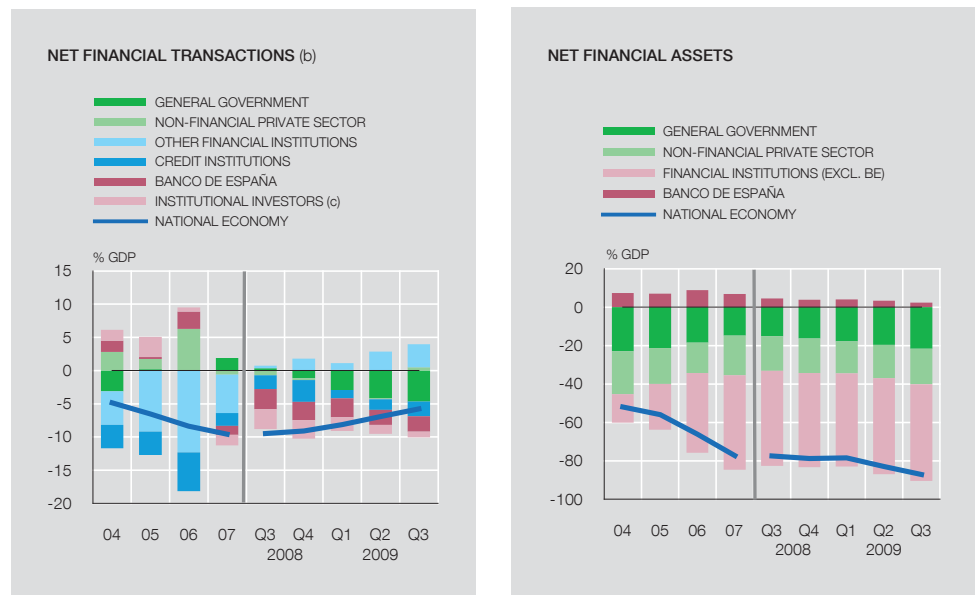
a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.

visaged (see Chart 26). These forecasts were accompanied by some downgrades in profit growth expectations for these same companies for the longer term.

## 5.4 General government

Against a backdrop of rising public spending and declining revenues, general government net borrowing grew again in 2009 Q3, to 9.4% of GDP in cumulative four-quarter terms, 1.4 pp above the June figure (see Table 6).

In 2009 Q3 the issuance of fixed-income securities was once more the main tool used by general government to finance the deficit. However, the funds raised through this channel were



SOURCE: Banco de España.

- a. Four-quarter data for transactions. End-period data for stocks. Unsectorised assets and liabilities not included.  
 b. A negative (positive) sign denotes that the rest of the world grants (receives) financing to (from) the counterpart sector.  
 c. Insurance companies and collective investment institutions.

lower than those thus raised in the previous quarter, as a result of the decline in funds obtained via medium and long-term securities (maturity of more than 12 months), which nevertheless continue to be the main source of general government financing, while those obtained from issuance of short-term securities remained flat. In cumulative four-quarter terms, the funds obtained through fixed-income securities amounted to the equivalent of 12% of GDP, 0.85 pp above the June level (see Chart 27). The funds obtained through loans also increased, representing the equivalent of 1% of GDP in net terms while, between September 2008 and September 2009, acquisitions of financial assets amounted to the equivalent of 3.6% of GDP, somewhat lower than at June 2009.

The surge in general government debt in recent months (year-on-year rate of growth in excess of 30%), together with the decline in GDP, has led to a marked increase in the debt-to-GDP ratio, which neared 50% of GDP in September, 13 pp above the September 2008 figure. As a result of all the above, the associated debt burden rose again in 2009 Q3, to 1.8% of GDP.

## 5.5 The rest of the world

In 2009 Q3, the nation's net borrowing stood at 5.8% of GDP in cumulative 12-month terms, around 1 pp below the June level and 3.3 pp below the figure for 2008 as a whole. By sector, this was due to households' increased net lending capacity and to firms' lower debit balance, which offset the rise in the general government deficit and the decline in financial institutions' savings (see Table 6). The decrease in the nation's net borrowing is lower than that which would be warranted by rationalisation of the private sector, as a result of the sharp increase in general government borrowing.

The breakdown of financial transactions vis-à-vis the rest of the world by sector shows that, in line with the increase in the government deficit, the net funds obtained from abroad via general government issuance rose by 0.5 pp, in cumulative 12-month terms, to 4.7% of GDP (see

The economic crisis has led to higher public spending and lower revenues. As a result, since 2008 Q3 the general government has been running a growing deficit, after running a surplus for the previous three years. The breakdown by subsector (see Panel 1) shows widespread deterioration in public finances, although most particularly at central government level, and also, albeit to a lesser extent, among the regional (autonomous) governments. In fact, the social security system is the only subsector that continues to show a surplus, albeit a smaller one than in previous years. Against this backdrop, this Box explores how the increase in general government net borrowing is being financed, broken down by instrument and by counterpart sector.

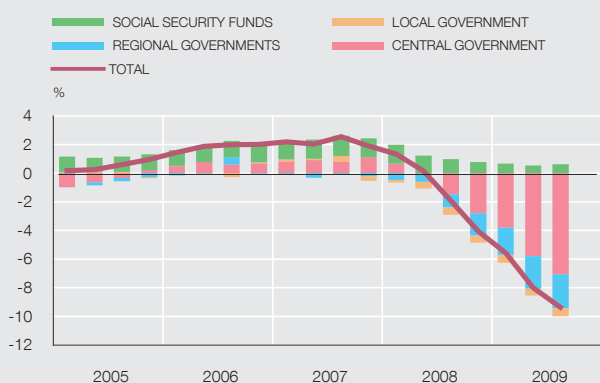
The rapid deterioration in public finances, together with the need to fund the growing investment in financial assets (related, in part, to the financial system support programmes), has resulted in a significant increase in general government debt, which has risen at year-on-year rates of growth in excess of 30% since mid-2009 (see Panel 2). Accordingly, government debt, which represented less than 35% of GDP in March 2008, had risen to almost 50% of GDP by November 2009. The breakdown by instrument shows that general government has primarily relied on the issuance of securities (short-term, and es-

pecially medium and long-term securities); it has also used loans, albeit to a lesser extent. In terms of the balance outstanding, at November 2009 securities accounted for 84% of the total (of which 82% with maturity of more than one year), with loans granted by financial institutions making up the other 16%.

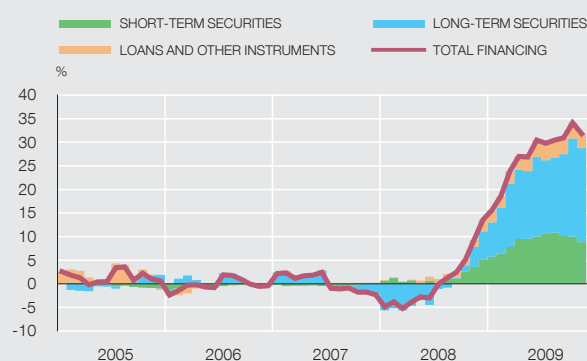
The breakdown by counterpart sector shows that Spanish credit institutions are the agents that have made the most contribution to general government financing since mid-2008. Specifically, between March 2008 and September 2009, these intermediaries provided general government with net funds totalling €74 billion, between loans and asset purchases, equivalent to 48% of all funds raised by general government in that period (see Panel 3). In turn, over the same period, net funds raised abroad amounted to €55 billion (35% of the total), with the remainder coming mainly from Spanish institutional investors. However, in terms of the balance outstanding, at September 2009 (latest data available) non-residents continued to be the main holders of public debt (45%), ahead of credit institutions (34%).

Various factors may have been behind the latest momentum in purchases of government debt (not only of Spanish public debt but also

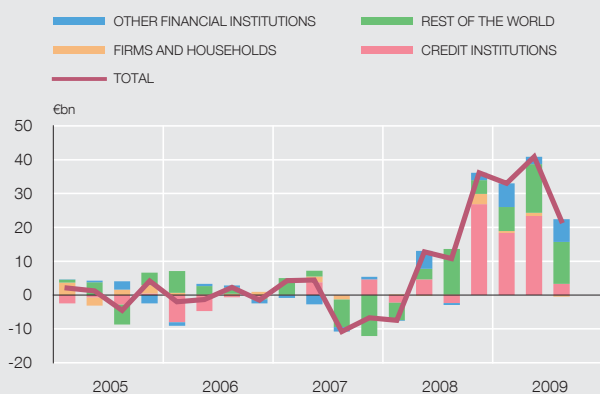
1 GENERAL GOVERNMENT LENDING (+) OR BORROWING (-) AS % OF GDP



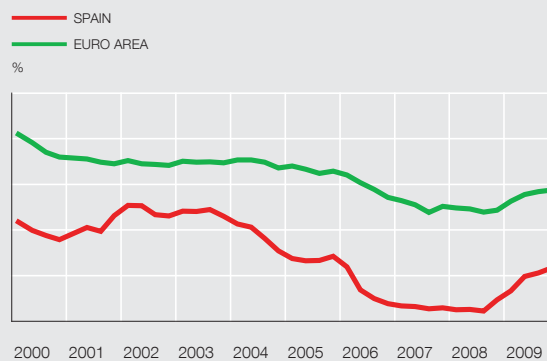
2 YEAR-ON-YEAR GROWTH OF GENERAL GOVERNMENT FINANCING (Contribution by instrument)



3 GENERAL GOVERNMENT NET DEBT ACQUISITIONS



4 MFI EXPOSURE TO GENERAL GOVERNMENT (a)



SOURCES: ECB and Banco de España.

a. As a percentage of non-financial private sector and public sector financing.

of that issued in other parts of the world) by Spanish credit institutions. Moreover, this is a phenomenon that has also been seen in other euro area countries. Higher net borrowing by general government, in Spain and in other countries, has amplified this investment opportunity. In addition, the singular features of government debt make these instruments especially attractive in the present climate: they are highly liquid, as the securities (which represent the bulk of the funds raised) are traded on secondary markets (meaning that the sum invested may be recovered relatively easily and within a short period), and they are low credit risk in comparison with instruments issued by private agents. There was considerable margin for Spanish intermediaries to raise their exposure to the public sector, as in previous years this had fallen to levels that were low, not only historically but also in comparison with the euro area (see Panel 4). Accordingly,

it should be no surprise that, in these circumstances, these instruments have risen as a percentage of the portfolio slightly more in Spain than in the euro area overall.

The 2009 Q3 figures reflect a slowdown in the funds granted by credit institutions to the public sector; on the latest provisional data available, this trend would seem to have continued in subsequent months. Thus, between July and September 2009, net investment by these intermediaries in securities issued by general government totalled €3.3 million, equivalent to 15% of all funds raised by general government, in comparison with a net inflow from non-residents of €12.4 million (56% of the total). Accordingly, government debt securities are becoming the main source of external financing for the Spanish economy.

Chart 28). In fact, in 2009 Q3, resident credit institutions ceased to be the main purchasers of public sector debt, being overtaken by external agents (see Box 7). In turn, in net terms, credit institutions continued to raise more funds from abroad than in the previous quarter, while in comparison with a year earlier institutional investors unwound positions in the rest of the world. The Banco de España's financial assets vis-à-vis the rest of the world also declined, while, in contrast, the capital flows associated with the net liabilities issued by other financial institutions represented a capital outflow equivalent to 3.5% of GDP.

Financial flows of assets and liabilities vis-à-vis the rest of the world were negative or very low between September 2008 and September 2009, against an international backdrop that was quite unfavourable for these transactions (see Table 8). During this period, capital inflows represented the equivalent of 2.9% of GDP, against 4.2% in June. Deposits posted the highest rates of decline, specifically interbank deposits which contracted sharply, bringing the cumulative 12-month flow into negative territory (-0.2% of GDP), together with non-trade credit which was also marginally negative in Q3 (1.6% in cumulative annual terms, 0.9 pp below the mid-2009 figure). Trade credit also fell back significantly, in the case of both asset and especially debt transactions that are booked net under "Other, net" financial transactions and have recorded negative flows since mid-2008. By contrast, investment by non-residents in equity instruments issued by Spanish agents rose, but foreign direct investment in Spain fell slightly, to 2.2% as a percentage of GDP.

Asset-side flows vis-à-vis the rest of the world were negative, in cumulative 12-month terms, at -2.8%, slightly below the June level. Loans, which amounted to 0.3% of GDP, in comparison with 1% in Q2, recorded the sharpest contraction, together with acquisitions of shares and holdings by non-financial corporations, which fell by 0.4 pp as a percentage of GDP to 1.4%. In line with these decreases, Spanish direct investment abroad fell by 0.8 pp to 3.2% of GDP. Net purchases abroad of equity instruments by institutional investors (and total net purchases abroad) were positive, as in the previous quarter, although in cumulative 12-month terms the numbers were once again negative (-0.2% of GDP).

As a result of changes in cross-border financial flows, asset prices and the exchange rate, the Spanish economy's accumulated net debt rose by 4.2 pp to 87.2% of GDP (see Chart 28). By

% GDP	2006	2007	2008	2009		
				Q1	Q2	Q3
NET FINANCIAL TRANSACTIONS	-8.4	-9.6	-9.1	-8.1	-6.9	-5.8
FINANCIAL TRANSACTIONS (ASSETS)	18.0	14.3	3.2	0.6	-2.7	-2.8
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	5.2	2.1	-0.3	-2.1	-5.8	-5.6
<i>Of which:</i>						
<i>Interbank (a)</i>	3.4	4.2	-0.5	-2.3	-5.6	-5.6
Securities other than shares	-1.2	1.6	1.3	-0.2	0.5	0.5
<i>Of which:</i>						
<i>Credit institutions</i>	-2.0	1.8	1.5	0.7	1.5	1.3
<i>Institutional investors (b)</i>	0.6	0.2	-0.9	-1.5	-1.5	-1.7
Shares and other equity	10.8	8.9	2.1	2.7	2.3	2.5
<i>Of which:</i>						
<i>Non-financial corporations</i>	8.3	6.7	3.4	2.8	1.8	1.4
<i>Institutional investors (b)</i>	1.2	-1.1	-1.6	-0.8	-0.5	-0.2
Loans	2.1	1.2	0.7	0.9	1.0	0.3
FINANCIAL TRANSACTIONS (LIABILITIES)	26.4	23.8	12.3	8.8	4.2	2.9
Deposits	0.3	7.3	9.0	4.3	1.9	1.4
<i>Of which:</i>						
<i>Interbank (a)</i>	0.6	6.7	6.2	1.9	0.9	-0.2
Securities other than shares	21.3	8.1	-2.4	0.3	-0.8	-1.1
<i>Of which:</i>						
<i>General government</i>	1.0	-1.4	1.3	2.4	3.4	3.2
<i>Credit institutions</i>	8.0	3.6	-1.9	-1.1	-1.3	-0.8
<i>Other non-monetary financial institutions</i>	12.3	5.8	-1.8	-1.0	-2.9	-3.5
Shares and other equity	0.5	4.8	3.6	2.1	1.5	2.3
<i>Of which:</i>						
<i>Non-financial corporations</i>	0.1	4.9	2.7	1.4	0.7	1.1
Loans	3.5	3.1	2.2	2.5	2.5	1.6
Other, net (c)	-0.4	0.2	0.6	0.1	-0.1	-0.8
MEMORANDUM ITEMS:						
Spanish direct investment abroad	8.4	9.6	5.0	4.9	4.0	3.2
Foreign direct investment in Spain	2.5	4.8	4.4	2.8	2.4	2.2

SOURCE: Banco de España.

a. Correspond only to credit institutions. Include repos.

b. Insurance corporations and collective investment institutions.

c. Includes, in addition to other items, the asset-side caption reflecting insurance technical reserves and the net flow of trade credit.

institutional sector, this rise was essentially due to the increase in general government's and the non-financial private sector's debit positions vis-à-vis non-residents, and to the decrease in the credit balance of the Banco de España. The debit position of financial institutions excluding the Banco de España vis-à-vis the rest of the world remained virtually unchanged.

1.2.2010.