EBF Outlook N°25

Mid-Year Economic Outlook on the Euro Area 2008-2009

The euro area: weathering the storm

European Banking Federation

June 2008

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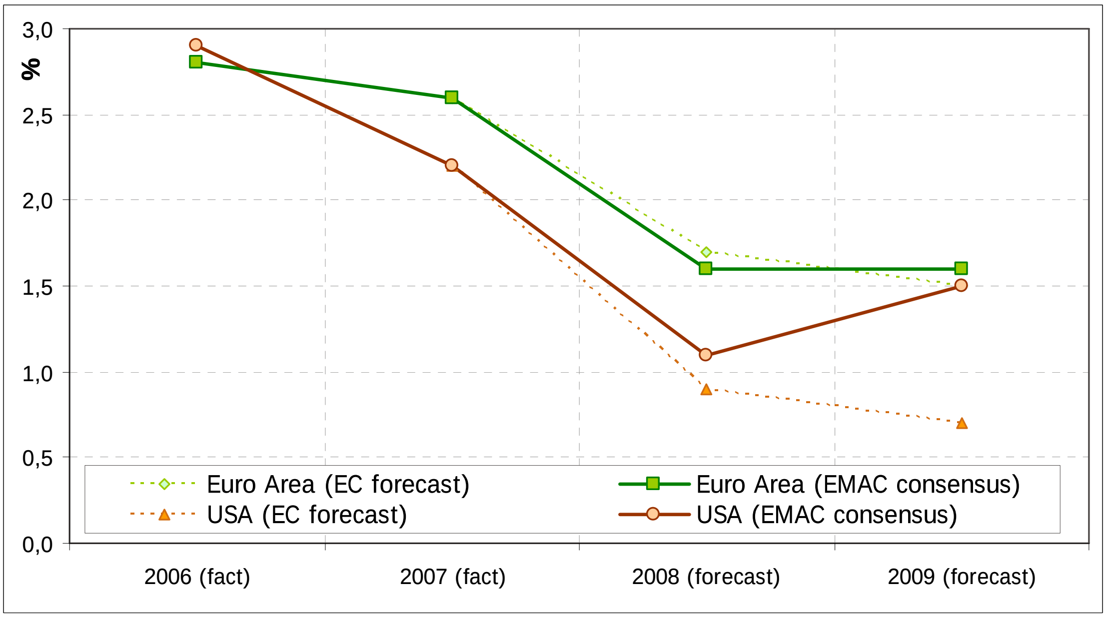
A slowing economy

Since December 2007 when the last Economic Outlook was published, the troubles on world financial markets have become more entrenched and the impact of the financial turmoil, combined with high oil and raw materials prices, slower growth in some advanced economies and the strong euro, has been reflected in another series of downward revisions in euro area growth forecasts.

The banking sector chief economists assembled in the EBF's Economic and Monetary Affairs Committee are observing at first hand the liquidity constraints and the asset write-downs which are contributing to a cooling down of the economy. Overall, slower economic growth is expected in both 2008 and 2009: after a strong 2007 outturn of 2.6%, the average of the forecasts puts GDP growth at 1.6% per annum this year[1] and next, while a relatively high uncertainty about the global economic environment and the longer term evolution of the financial turmoil is reflected in a wide range of 1-2.4% for the 2009 forecasts. A weighted average of the forecasts of individual euro area countries' growth produces a similarly conservative picture of 1.7% growth in 2008 and 1.6% growth in 2009.

Graph 1: **Annual GDP growth projections for the euro area and the USA, %**



The benefits of the euro

In this difficult period, the euro is a source of resilience. If Economic and Monetary Union had not taken place, the member currencies and economies would have been more vulnerable to fluctuations in confidence in the financial markets, with markets keenly assessing each national authority's reaction

[1] This compares with EMAC's expectations in mid-2007 of 2.2% for 2008.

to the crisis. As it is, the infrastructure of economic and financial governance provided by EMU, and in particular the ECB's handling of the crisis, has provided a bulwark against the swirling uncertainty. On the other hand, the euro's appreciation has contributed to a significant de facto tightening of monetary conditions, which has inevitably contributed to a slow-down of economic growth in the euro area and reduced exports. However the balance of euro effects is strongly positive. The European economy went into the credit crunch in a healthier condition than it would have in earlier years partly because economic integration and reforms spurred on by the single currency have begun to bear fruit.

Global conditions

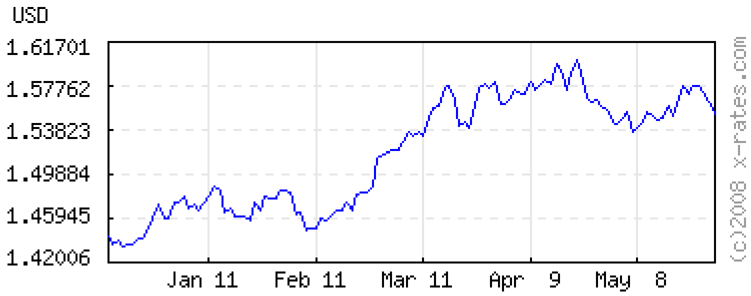
In the past few years, the euro zone has achieved some decoupling from the United States, but Europe depends heavily on global conditions, which are still strongly influenced by the health of the US economy. Slow growth in the US and some other advanced economies will have a dampening effect on the export side of the euro trade balance. But the external sector also brings some upbeat news. The emerging economies in Asia, notably China, in Europe and Latin America, are developing at a fast pace, notwithstanding the condition of the US economy. The Olympic Games in Beijing this summer create a multiplier effect for China's development. The growth of demand in the Asian countries will help maintain export-led euro area countries such as Germany on the high tide. Another increasingly important trading partner for the EU is Russia, whose economy has been expanding at an average rate of 7.3% p.a. over the last four years. Their growth is partly based on exporting fuel (comprising two thirds of exports), significant foreign direct investment inflows and a rise in domestic demand outpacing that of the GDP growth figure. The financial industry in Russia has been expanding at a break-neck speed, with the banking sector thriving on consumer lending and short-to-medium term investments. Nevertheless, Russia is now facing the compelling need for more long-term financing (insurance, re-insurance, pension schemes, mortgage lending, long-term deposits, etc) on the one hand, and the investment into infrastructure on the other, in order to make their growth sustainable and successful.

Compounded with the slower growth in the US and other economies, the strong euro will have a dampening effect on exports. The main scenario of EMAC's chief economists in fact sees the exceptionally strong euro against the dollar as a short-term phenomenon. On balance, a "U-shaped" or "soft" recession is foreseen for the US, with a lengthy recovery period, as a result of climbing oil prices, continuing recession in the housing market, creeping unemployment, and a consequent slowdown in consumer spending. US growth is expected to dip to 1.1% per annum for 2008 (2.2% in 2007), gaining momentum next year with 1.5%. This growth scenario should trigger a re-assessment of the US dollar.

Dollar recovery is widely expected

The world has observed the USD/€ exchange rate peaking to 1.5940 for 1 euro on April 23, but the general expectation is for the euro to gradually weaken against the dollar to 1.51 by the end of 2008 and further down to 1.37 by the end of 2009, as the US economy picks up and euro area inflation stabilises.

Graph 2: **USD / EUR exchange rate**



Source: www.x-rates.com

The current steep USD/€ exchange rate pattern is believed to reflect the high levels of euro inflation, as well as the currently unfolding US recession. As the economic situation stabilises, a foreign exchange market correction should take place, leading to the repricing of the euro and the US dollar.

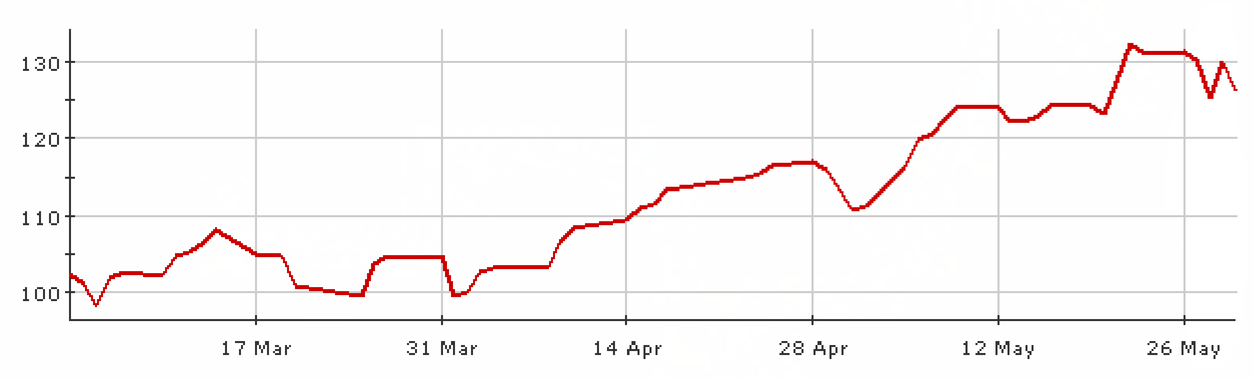
Although most of the chief economists see the current euro strength as likely to be short-lived, a good number of them are forecasting a 1.50 USD/€ rate in mid-2009, and a few of these see this level persisting to December 2009. At the other end of the spectrum, a minority view expects a 1.25 rate by the end of next year.

Inflation and the oil price

After a run of years in which price pressures have been contained, the inflation rate has increased sharply, from an annual headline rate of under 2% at the beginning of 2007 to 3.6% in May 2008. High inflation levels have been caused - to a great extent - by the steadily rising US dollar-denominated price of oil, which peaked at 135.09 USD/bbl for Brent oil on May 22, and other raw materials. This, in combination with the unfolding food crisis has pushed up the global price index. The rising cost of energy is also part of the consequence of the heightened concerns about energy sustainability, the financial demand for oil because of the inverse correlation between oil and other assets, and the impact of energy use on climate change.

The stronger euro is helping to shield member economies from the worst of the commodity price hikes, and inflation should have begun to diminish towards the end of 2008 as the base effects of these price increases fall away. EMAC members on average see the headline rate of inflation averaging 3.1% in 2008 (core HCPI 2.3%), declining to 2.1 (core 2.0 %) in 2009.

Graph 3: **Brent crude oil $/barrel**



Source: http://newsvote.bbc.co.uk/2/shared/fds/hi/business/market_data/commodities/28696/three_month.stm

Growth drivers: corporate strength… and weaker private consumption

Euro area GDP growth in the first quarter of 2008 has been very strong (0.8% quarter on quarter, 2.2% p.a.) and higher than forecasts. But this is in part due to transitory effects and mainly due to the robustness of the growth in Germany (which will be explained later in the text). Growth will be lower in the second quarter and the rest of the year. Those transitory factors will reverse in the second quarter, and the euro area economy will be affected by a less favourable global environment. But the deceleration will not be profound thanks to some sound fundamentals of the euro area economy.

The tightening of credit standards – which appears to be hitting larger corporates more than smaller and medium-sized enterprises – is increasing costs for a part of industry, for which it is likely to have a direct dampening effect on consumption and investment. But the euro area economy is less affected by the financial turmoil than might be expected, because many non-financial companies are now less dependent on bank finance and have strengthened their balance sheets in recent years. Corporate restructuring undertaken in some countries, such as Germany, has helped them to build up their competitiveness and earn higher profits, making them less dependent on external financing. The yearly increase in gross fixed capital formation is expected to decrease from 4.3% in 2007 to 2.5% this year and to 2.2% on average in 2009.

Private consumption appears set to remain weak, and will be unable to compensate for slowing external demand. Continued employment growth (16 million jobs in the past ten years thanks to EMU alone) and the reduction in the level of unemployment have given support to consumer spending, but confidence has been dented by higher food and energy prices and more expensive mortgage loans. Increased demand for employment last year has helped reduce the level of jobless further, and the unemployment rate is expected to remain stable slightly above 7% in 2008/9. However real wage growth is not expected to accelerate significantly, because of the slowing of GDP growth and the perspective for productivity growth. Private consumption is expected to grow by 1.3% on average in 2008 and 1.5% in 2009 (a 1.0% to 2.2% range).

The weak growth outlook for much of the globe is expected to feed through to a small current account deficit. Public finances, meanwhile, will be under greater pressure from higher costs and some measures intended to provide fiscal stimulus - easier to accommodate for some, such as Spain - resulting in a slight increase in the general government deficit (to –1%) but little change in the general government debt level, still around 65% GDP.

Wide regional divergences

The euro area encompasses a wide variety of conditions, based on the different trends of evolution of the national economies.

In Germany, so far, the surprises have been positive. First quarter GDP increased by 1.5%. However, this growth rate had been enhanced by very favourable weather conditions. Further, the main contributor to growth has been an increase in inventories, for which the figures are usually subject to relatively large revisions. Therefore, a lower GDP figure in the second quarter cannot be ruled out. Looking forward, despite the better employment situation, and accelerating wage increases, consumption spending remains weak and seems unlikely to revive in a context of rising inflation. Possible second round effects from higher wage settlements with respect to prices and employment are also a concern. With a lower growth rate in world trade, net exports will no longer be the steam engine of the German economy. Because of these factors and with the current weak political support for economic reform, growth is likely to be moderate and to remain below half-a-percent per quarter for the remainder of 2008 and in 2009.

In France, government initiatives have focussed more on the stimulation of demand than of production. Private consumption, following a half-year of weakness, is expected to grow again. The volume of household debt is greater than before and credit for investment continues to grow. Although lending margins are increasing, overall the effects of a credit crunch are not observed. GDP growth is expected to slow to 1.7% this year after 1.9% in 2007, but pick up to around 2% in 2009.

In Italy, there is a significant redistribution of wealth taking place, with salaries remaining static while corporate profits improve. Households are in difficulty, due to inflation and reduced purchasing power. Future consumption could therefore suffer. It is considered likely that public deficits will increase, and that growth will slow to around 0.5% in 2008, significantly less than in 2007 and lagging its euro area partners. As in Germany, the main challenge is the weakness in domestic demand, which here is seen in both consumption and investment.

The Spanish economy is experiencing a necessary deceleration in economic activity: growth is expected to slow from 3.8% in 2007 to an estimated 2% this year, and lower again in 2009, after which a slow recovery is expected. Unemployment has risen and inflation is running at about 3½%

pa. The weaker aspects of the economy are the current account deficit and inflation. Public sector finances are strong, but scope for fiscal stimulus will be limited as even the operation of automatic stabilisers will be a drain on public finances.

Developments in the financial sector: some banks moving to a new business model

The current turmoil has indeed scarred the financial sector of some European countries, with substantial losses being reported by major banks both in Europe and the US, particularly in the area of mortgage lending. The switch in market conditions from abundant credit to caution has been abrupt. The IMF has estimated (IMF Global Financial Stability Report 2008) financial institutions' aggregate potential write-downs and losses related to the crisis to be approximately USD 945 billion as of March 2008, roughly half of which are considered likely to be shouldered by global banks, the rest being accounted for by insurance companies, pension funds, money market funds, hedge funds, and other institutional investors. It is possible that the scale of write-downs and resulting indirect effects on the economy will be greater than had been generally anticipated; much depends on confidence levels. So far, the non-financial sectors have been developing well and have strong balance sheets, and in the financial sector retrenchment has begun. To prevent further losses, banks have started rearranging their strategies and focussing more on traditional banking businesses, including lending to manufacturing and microfinance, and deposit-generation. The traditional deposit-based universal banking model has shown its worth and helped to sustain bank lending during this period of turmoil in investment banking.

Over the euro area economy as a whole, the chief economists expect credit to become scarcer as well as more expensive, one of the defining reasons for that being greater difficulty accessing wholesale funding. Capital constraints are reducing banks’ ability to lend: with off-balance sheet items being shifted on to balance sheets; providers of capital preferring short term assets; capital less easily obtained than before; and securitisation funding having been significantly reduced, although it will have a role again in the future.

There is so far no clear evidence of a credit crunch in the euro area. ECB statistics for bank lending (up to the last published data, for March 2008) show no weakening in credit growth to non-financial corporations and only a modest decline in credit to households. However on the corporate side these figures cover only part of the financing spectrum. Many larger companies historically will have turned to capital markets for funding, and now the turmoil may be encouraging them to turn to traditional bank lending instead, keeping volumes up. This makes conclusions about current credit conditions difficult. Another factor which may cause credit to become scarcer in the future is the authorities’ reaction to the turmoil, which may result in tighter standards and controls. The potential economic impact of the regulatory response needs to be brought into the equation.

EMAC members' reports on national banking markets generally give a picture of still healthy levels of lending to non-bank customers, albeit with higher base funding costs. A tightening of standards has also been generally observed, not necessarily an overall tightening but possibly the result of a greater differentiation of risks. While higher short term interest rates (due to the financial crisis) are increasing the cost of normal corporate loans, they are also stimulating short term investments. The ***increase in deposit growth*** also reflects a shift in investor preferences in many countries. In the case of Belgium, for example, the declining confidence in structured products (largely sold by banks) due to the financial crisis and the lack of interest in equities has revived interest in classical balance sheet products.

One widespread result of the turmoil has been a ***shift in the composition of bank lending portfolios*** away from retail and residential business. In Germany, the still buoyant economy is keeping bank lending to corporates, particularly in manufacturing, expansive, while mortgage and consumer lending volumes have declined largely owing to a lack of loan demand, which is mainly due to the long period of low income and relative high unemployment and not a result of the subprime crisis. Similarly, in Italy total credit growth is more or less stable around the high levels of 2007, but this is the result of a reshuffling of activity, away from retail to corporate sectors. Signs of deceleration in the mortgage and consumer credit segments are now evident, although these continue to be important areas of activity. In Austria, loan demand has been strong from corporates and in mortgage lending, while demand for consumer loans has stagnated. Current accounts and deposits have risen with double-digit rates. Here again, deposits are expected to continue growing strongly in the months ahead, as the savings rate will remain at a high level (above 10 per cent). In France, the pace of credit growth has remained quite strong in early 2008, at around 9% year-on-year (both for households and for corporates). Flows of new mortgage lending are beginning to decrease slightly - due to lower housing demand however, rather than a credit tightening - and some tightening of credit conditions for corporates is expected. In Spain, bank lending is decelerating, sharply in the case of household lending (as of February, credit growth to the private sector had moderated by seven percentage points to 14%). Tighter financial conditions and a decrease in consumer confidence are the main reasons for this performance. Deposit growth shows a more stable pattern overall in the non-financial sectors. Bank lending is expected to continue its deceleration and to grow at a single digit level by the end of the year. Deposits will perform better, as banks are the main financial intermediary and are focussing their commercial policy on obtaining deposits rather than investment funds. In Greece, growth in mortgage loans is expected to decelerate noticeably from the previous years' trend, and lending activity is expected to slow because interest rates have increased and economic activity is slowing. Similar trends are observable in a new euro member, Slovenia, where credit standards for loans to enterprises and to households are tightening and credit growth rates are expected to slow down significantly in the course of this year, but a significant decline in deposit growth is not expected. Here, banks have implemented the new capital adequacy directive and with the requirement for more rigorous credit standards, some difficulties with the availability of long term funding, and relatively high recent growth rates, further capital will be needed. The profitability of banking operations is expected to suffer this year.

Competition within the euro area banking industry generally has intensified, with aggressive marketing not only for savings and term accounts, but also for products such as consumer loans, stock exchange transactions and payments. In some markets, the pressure on the share of the bigger banks is causing them to review their distribution model for retail banking, putting more focus on internet and self-banking, hoping to take advantage of increased client openness to technological opportunities; in the meantime additional efforts are being made to reduce costs.

Such trends are likely to persist for a certain period because the turbulence is leading banks to reshuffle their strategies. But the expectations are that the worst has probably passed. If short term interest rates decline as expected in the second half of 2008, there may be a shift from term accounts into other types of investment. Overall, however, ***the weakening of the euro area economy will cause aggregate lending growth to slow.***

ECB reluctant to cut rates

The ECB's approach to the markets' short term liquidity problems is judged to have been sensitive and appropriate. Persisting tensions on financial markets may provide an argument for an easing of monetary conditions, but the overriding concern for the ECB will be the control of price pressures, and while the objective of the monetary policy of the ECB is anchoring medium term inflation, it is fighting against the financial turmoil with other measures, such as short term liquidity injections.

While ECB policy will hinge on the inflation numbers, the general state of the economy must be a background element in its decisions. Given that the central focus of ECB policy is the control of price pressures, a high level of inflation constrains its margin of manoeuvre. Yet general economic developments will influence the inflation outlook, making it necessary for the central bank to monitor changes in the growth environment. Above all, it will be looking for headline inflation to fall below 3%, which is not expected to be realised until well into the third quarter of 2008. With such unusually high inflation, the ECB is worried about the risk of second round effects.

The economists expect that the next move in interest rates will be downwards, but that the ECB will be in no hurry to make this move. Over half of the respondents to the EBF survey expect rates to have been cut by 25 to 50 basis points by the end of this year.

Recent inflationary pressures have led the markets to assign some probability to an increase in official refinancing (refi) rates before year-end. But because of the tension in money markets, and the abnormally high spread between refi rates and Euribor rates, monetary conditions are in fact restrictive in spite of the actual level of the refi rate. So the ECB does not need to raise rates to establish restrictive monetary conditions. Beyond the uncertainties of this year, EMAC members mostly agree in projecting that the ECB's main refi rate will have fallen to 3.5% by the end of the first half of

2009, and remain at this level or below for the rest of the year. A minority view sees this rate stable at 4% through to the end of the forecast period.

Risks to EMAC's main scenario

The high level of gloom and anxiety among economic forecasters around the world means that there is room for good surprises. Among these "positive risks" is the possibility that the slowdown in the US is short-lived, and that strengthening of the dollar will help to carry oil and other commodity prices back down to more bearable levels. Growth in world trade may be sturdier than expected, particularly if the faster-growing developing countries are relatively unaffected by US economic weakness and continue to power ahead. Domestic demand in the euro area could surprise on the up-side, buoyed up by the low level of unemployment.

Nevertheless, uncertainty about the impact of the financial turmoil leaves many open questions, in particular about the likely level of US growth and US demand for goods and services from Europe and the developing world. A deep and long US recession, an overshooting of the €/$ exchange rate and/or a deepening of the financial crisis could not fail to hurt euro area growth prospects. Other negative risks include the possibility that China grows slower than expected, and that oil and goods prices stabilise at a high level. A number of emerging economies are being confronted by a growing inflation challenge which could become a serious threat to their economic development.

This edition of the EBF Economic Outlook is written by the Economic and Monetary Affairs Committee of the EBF (EMAC) which has the following members:

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POLL ON THE ECONOMIC OUTLOOK FOR THE EURO AREA 2008-2009

TABLE 1		2006	2007	2008 Forecasts						
				EMAC Consensus			EMAC		COM Forecast	
				2008 mean	2008 range		End-2007	Mid-2007	Spring 2008	Autumn 2007
1. Output and Aggregate demand: (Ann.% change)										
Gross domestic product		2,8	2,6	**1,6**	**1,3**	**1,9**	2,0	2,2	1,7	2,2
Private consumption		1,8	1,5	**1,3**	**0,9**	**2,2**	2,0	2,0	1,4	2,1
Public consumption		2,0	2,3	**1,5**	**1,1**	**2,0**	1,7	1,6	1,9	2,1
Gross investment (GFCF)		5,0	4,3	**2,5**	**1,9**	**3,5**	2,7	3,0	2,0	2,9
Exports		7,9	6,1	**3,8**	**2,7**	**5,0**	4,8	5,5	4,4	5,3
Imports		7,7	5,2	**3,9**	**2,9**	**5,4**	5,2	5,7	4,3	5,5
2. Labour market and prices: (Ann.% change)										
Unemployment rate (%)		8,2	7,4	**7,1**	**7,0**	**7,4**	7,0	7,1	7,2	7,1
Wages (Unit Labour Cost)		1,0	1,5	**2,5**	**2,0**	**3,1**	2,6	2,5	2,4	1,8
Prices (HCPI)		2,2	2,1	**3,1**	**2,7**	**3,5**	2,2	2,0	3,2	2,1
Core HCPI				**2,3**	**1,8**	**2,6**	2,0	2,0		
3. Public Finances: (% GDP)										
General Government Balance		-1,3	-0,6	**-1,0**	**-1,2**	**-0,6**	-1,0	-1,0	-1,0	-0,9
General Government Debt		68,5	66,4	**65,5**	**65,0**	**66,5**	66,6	65,6	65,2	65,0
4. External sector: (% GDP)										
Trade Balance		0,7	0,9	**2,4**	**-0,1**	**20,0**	0,6	1,7	0,8	0,8
Current Account Balance		-0,2	0,0	**0,8**	**-0,5**	**4,0**	0,1	0,7	-0,1	0,0
(p.m.) US growth	**(Ann.% change)**	2,9	2,2	**1,1**	**0,7**	**1,5**	2,2	2,7	0,9	1,7
(p.m.) Oil price (Brent)	**(US$/bl)**	66,2	72,5	**105,6**	**95,0**	**120,0**	80,0	64,6	101,2	78,8
5. Monetary and Financial Indicators:										
Interest rate on ECB's main refinancing operations	Jun-08	3,50	4,00	**3,99**	**3,75**	**4,00**	3,98	4,29		
	Dec-08			**3,81**	**3,50**	**4,00**	3,96	4,31		
3 month interest rate (EURIBOR)	Jun-08	3,08	4,28	**4,56**	**4,30**	**4,80**	4,18	4,43		
	Dec-08			**4,19**	**3,70**	**4,60**	4,20	4,42		
10 year government bond yield (Bund)	Jun-08	3,86	4,33	**4,14**	**3,70**	**4,60**	4,41	4,52		
	Dec-08			**4,20**	**3,90**	**4,60**	4,54	4,52		
M3 growth	Jun-08	9,8	11,5	**9,55**	**8,00**	**12,00**	8,60	8,50		
	Dec-08			**8,64**	**7,00**	**12,00**	8,22	7,47		
Credit to private sector (Ann.% change, M3 definition)	Jun-08	11,5	12,6	**10,40**	**9,00**	**12,00**	8,50	9,00		
	Dec-08			**9,44**	**7,25**	**12,00**	7,33	8,75		
Exchange rate USD/EUR	Jun-08	1,32	1,47	**1,58**	**1,50**	**1,62**	1,45	1,34		
	Dec-08			**1,51**	**1,40**	**1,60**	1,41	1,34		

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Private consumption	1,8	1,5	**1,5**	**1,0**	**2,2**		1,5	1,9
Public consumption	2,0	2,3	**1,6**	**1,1**	**2,0**		1,7	2,0
Gross investment (GFCF)	5,0	4,3	**2,2**	**0,5**	**4,3**		1,2	2,6
Exports	7,9	6,1	**3,9**	**3,2**	**5,1**		4,0	5,4
Imports	7,7	5,2	**4,3**	**3,4**	**5,4**		3,9	5,3
2. Labour market and prices: (Ann.% change)								
Unemployment rate (%)	8,2	7,4	**7,2**	**6,8**	**8,0**		7,3	7,1
Wages (Unit Labour Cost)	1,0	1,5	**2,1**	**1,8**	**2,8**		1,9	1,5
Prices (HCPI)	2,2	2,1	**2,1**	**1,8**	**2,7**		2,2	2,0
Core HCPI			**2,0**	**1,7**	**2,2**			
3. Public Finances: (% GDP)								
General Government Balance	-1,3	-0,6	**-1,0**	**-1,2**	**-0,8**		-1,1	-0,8
General Government Debt	68,5	66,4	**64,8**	**63,5**	**67,0**		64,3	63,4
4. External sector: (% GDP)								
Trade Balance	0,7	0,9	**0,5**	**-0,1**	**0,8**		0,8	0,9
Current Account Balance	-0,2	0,0	**-0,6**	**-0,5**	**0,2**		-0,1	0,1
(p.m.) US growth (Ann.% change)	2,9	2,2	**1,5**	**0,6**	**2,0**		0,7	2,6
(p.m.) Oil price (Brent) (US$/bl)	66,2	72,5	**99,4**	**90,0**	**110,0**		100,0	76,0
5. Monetary and Financial Indicators:								
Interest rate on ECB's main refinancing operations Jun-09	3,50	4,00	**3,49**	**3,25**	**3,75**			
Dec-09			**3,44**	**3,00**	**4,00**			
3 month interest rate (EURIBOR) Jun-09	3,08	4,28	**3,74**	**3,40**	**4,00**			
Dec-09			**3,71**	**3,15**	**4,30**			
10 year government bond yield (Bund) Jun-09	3,86	4,33	**4,14**	**3,80**	**4,60**			
Dec-09			**4,27**	**3,90**	**4,80**			
M3 growth Jun-09	9,8	11,5	**8,41**	**6,80**	**11,00**			
Dec-09			**8,07**	**6,00**	**11,00**			
Credit to private sector (Ann.% change, M3 definition) Jun-09	11,5	12,6	**9,50**	**8,00**	**11,50**			
Dec-09			**8,88**	**7,50**	**11,50**			
Exchange rate USD/EUR Jun-09	1,32	1,47	**1,44**	**1,35**	**1,50**			
Dec-09			**1,37**	**1,25**	**1,50**			