MARCH 2007

THE SPANISH ECONOMY

Monthly Report

NUMBER 300

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2005	2006	2007	2006				2007	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast					Forecast	
Gross domestic product									
United States	3.2	3.3	2.7	3.7	3.5	3.0	3.1	2.7	2.7
Japan	1.9	2.2	1.9	2.7	2.2	1.5	2.3	2.3	2.0
United Kingdom	1.9	2.7	2.4	2.4	2.7	2.9	3.0	2.4	2.6
Euro area	1.5	2.8	2.4	2.2	2.9	2.7	3.3	2.8	2.3
Germany	*1.1*	*2.9*	*1.8*	*1.9*	*2.8*	*3.1*	*3.7*	*2.9*	*1.9*
France	*1.2*	*2.0*	*2.0*	*1.3*	*2.6*	*1.9*	*2.2*	*2.3*	*1.6*
Consumer prices									
United States	3.4	3.2	1.9	3.7	4.0	3.4	2.0	2.1	1.5
Japan	–0.3	0.2	0.4	–0.1	0.2	0.6	0.3	0.4	0.4
United Kingdom	2.0	2.3	2.2	2.0	2.2	2.4	2.7	2.4	2.1
Euro area	2.2	2.2	1.8	2.3	2.5	2.1	1.8	1.8	1.6
Germany	*2.0*	*1.7*	*1.7*	*2.0*	*1.9*	*1.6*	*1.3*	*1.8*	*1.6*
France	*1.7*	*1.7*	*1.5*	*1.8*	*1.9*	*1.7*	*1.3*	*1.2*	*1.2*
SPANISH ECONOMY			Forecast					Forecast	
Macroeconomic figures									
Household consumption	4.2	3.7	3.5	3.7	3.6	3.6	3.7	3.7	3.6
Government consumption	4.8	4.4	4.4	4.3	4.4	4.2	4.9	4.2	4.3
Gross fixed capital formation	7.0	6.3	4.8	6.3	6.2	6.4	6.4	5.9	5.4
Capital goods	*9.0*	*9.7*	*5.6*	*8.6*	*9.1*	*9.6*	*11.4*	*9.5*	*8.0*
Construction	*6.0*	*5.9*	*4.8*	*5.8*	*5.8*	*6.2*	*5.7*	*5.4*	*4.8*
Domestic demand (contribution to GDP growth)	5.2	4.9	4.3	4.8	4.8	4.8	4.9	4.6	4.4
Exports of goods and services	1.5	6.2	4.2	9.5	4.9	3.4	7.3	2.6	4.8
Imports of goods and services	7.0	8.4	5.4	11.6	7.3	6.0	8.8	4.5	6.4
Gross domestic product	**3.5**	**3.9**	**3.6**	**3.7**	**3.8**	**3.8**	**4.0**	**3.9**	**3.8**
Other variables									
Employment	3.1	3.1	2.8	3.2	3.1	3.0	3.0	2.9	2.8
Unemployment (% labour force)	9.2	8.5	8.0	9.1	8.5	8.1	8.3	8.2	8.0
Consumer price index	3.4	3.5	2.5	4.0	3.9	3.5	2.6	2.5	2.3
Unit labour costs	2.2	2.6	2.2	2.3	2.7	2.7	2.8		
Current account balance (% GDP)	–7.5	–8.5	–9.3	–10.0	–7.8	–8.4	–7.9		
Not lending or net borrowing rest of the world (% GDP)	–6.5	–7.8	–8.8	–9.7	–7.4	–7.8	–6.7		
Government balance (% GDP)	1.1	1.8	1.2						
FINANCIAL MARKETS			Forecast					Forecast	
Interest rates									
Federal Funds	3.2	5.0	5.2	4.4	4.9	5.3	5.3	5.3	5.3
ECB repo	2.0	2.8	3.8	2.3	2.6	2.9	3.3	3.6	3.8
10-year US bonds	4.3	4.8	5.0	4.6	5.1	4.9	4.6	4.8	5.0
10-year German bonds	3.4	3.8	4.3	3.5	4.0	3.9	3.8	4.1	4.3
10-year Spanish bonds	3.4	3.8	4.3	3.5	4.0	3.9	3.8	4.1	4.3
Exchange rate									
$/Euro	1.25	1.26	1.34	1.20	1.26	1.27	1.29	1.31	1.35

THE SPANISH ECONOMY
MONTHLY REPORT
March 2007

CAJA DE AHORROS
Y PENSIONES
DE BARCELONA

Research Department

Av. Diagonal, 629,
planta 6, torre I
08028 BARCELONA
Tel. 34 93 404 76 82
Telefax 34 93 404 68 92
www.research.lacaixa.com
e-mail:
informemensual@lacaixa.com

"la Caixa" GROUP: KEY FIGURES

As of December 31, 2006

FINANCIAL ACTIVITY	Million euros
Total customer funds	197,495
Receivable from customers	139,765
Profit attributable to Group	3,025

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	25,241
Branches	5,186
Self-service terminals	7,493
Cards	9,007,335

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2007	Million euros
Social	256
Science and environmental	64
Cultural	54
Educational	26
TOTAL BUDGET	**400**

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Contents

Growing international mobility of savings

When Robinson Crusoe was shipwrecked on an unknown and apparently deserted island, only his courage and boldness would reveal his ability to survive in such a hostile environment. Constantly fishing and gathering, he soon found out how little free time he had and how scarce was the technology at his disposal. But, once his basic needs were met, he was able to perfect his techniques, make better tools and put his shelter in order. That is, in economic terms, at the moment his production capacity was higher than his consumption needs, he could devote his excess time to activities that allowed him to substantially improve his future production capacity. «Saving» time and putting it into investment are key factors in the development and economic progress of any society.

The adventures of the man on the desert isle are useful to illustrate elementary economic concepts and for this reason they are often used in teaching economics. When a much greater population complicates the model, the complexity of economic phenomena increases but the essence remains. Savings/investment analysis is precisely a matter that has taken up most effort in the history of economic thinking. What is beyond doubt is its importance in the real world when it comes to explaining economic dynamics, both in simple economies and in the existing diversity in the world today.

In the era of globalization, one of the most notable developments has been the relocation of processes of savings and investment. The progressive removal of economic borders is freeing savings from its national ties. What a Robinson Crusoe saves on one continent is used by another Robinson Crusoe on another continent. Investment is not now constrained by the capacity of personal savings or those of business or on a national scale. When it comes to channelling those savings, the efficiency of the international financial system largely explains why in recent times the international economy has grown at the highest rates in decades and that, nevertheless, long-term interest rates remain at all-time low levels. Especially at a time of increasing prices of raw materials, notably oil, which has done less harm than might be expected to those countries dependent on those products, thanks to the fact that the exporting countries have moved their savings toward international financial markets thus facilitating the adjustment of world economies.

This ability to adjust savings and investment at a global level undoubtedly constitutes the optimization of the international economic pattern. Those countries or regions that are more dynamic, with greater growth potential, are able to absorb the savings of more mature economies or regions with less ability to generate attractive financial assets in a balance that is more fruitful than that of economies closed off by national restrictions. The paradox lies in that now the main world source of savings is the Chinese economy whose growth potential is very high whereas the main recipient of this savings is the US economy whose growth depends precisely on the excess spending which shows up in the huge deficit in the current account balance, as it has done for a number of years. This is a paradox that may largely be explained by the strength of US financial markets, their capacity for innovation and the development of new instruments. But it also raises the unknown factor of how long it is possible to keep stretching the rope of financial leverage.

OVERALL SUMMARY

Better growth prospects

Latest macroeconomic figures draw profile of improvement in activity in main economies...

While the debate about global warming continues, another «heating up» is more and more beyond doubt, namely that of the world economy. At least this is what is suggested by the results of growth for the final quarter of 2006. In that period, both the European Union and the United States and Japan have shown higher than expected results, confirming the belief that the present growth cycle is in excellent health.

...without losing sight of imbalances still to be resolved and risks hanging over international financial system.

The risks of the present situation remain but they do not seem to be immediate threats. The price of oil has settled between 50 and 60 dollars a barrel of Brent and only at the end of February, as a result of fears about an attack on Iran, has it dared to move out of that range. Monetary interest rates have risen in many countries but long-term rates have scarcely moved up, leaving financial conditions still very easy. Trade imbalances between countries and regions have hardly improved but nor have they grown appreciably worse whereas exchange rates have gradually been correcting some imbalances. In any case, we should mention the warning put out at the last meeting of the G-7, the group of richest countries on the planet, about the massive growth of hedge funds and other speculative instruments which are more and more seen as a risk to the stability of international finances.

US economy seems to be moving toward a «soft landing» but will have to make sure landing strip in good condition.

In the United States, publication of growth of 3.4% year-to-year in the fourth quarter came as a surprise (although this was later revised downward) in a period when housing is going through the blackest moment of the year. In fact, while the construction component in the gross domestic product (GDP) dipped more than 12% compared with the same period last year, households continued their usual consumption spending rate, apparently untouched by the halt in the real estate sector. Some indicators suggest that the drop in sales and prices of housing units has hit bottom but the figure for housing starts in January threw cold water on the more optimistic prospects for the sector.

It may be that all this fits in with the idea of the «soft landing» so much desired by the head of the Federal Reserve, Ben Bernanke. Not so much because the slowdown is slower than was feared but because growth of productivity, still high, makes it possible to control unit labour costs and inflationary pressures while also creating jobs. What more could we ask for?

Nevertheless, a closer look at the GDP figures for the fourth quarter reveals two disquieting risks. The first, that growth of consumer spending is based on negative saving. That is to say, household consumption is higher than incomes, which may be explained by the wealth effect (the rise in the stock and price of housing gives greater economic security that turns into heavier consumption) or, simply, by the sale of assets in order not to reduce the rate of spending. Keeping in mind that stock market and real estate capital gains may rapidly disappear in a moment of recession, we should cross our fingers to prevent this happening. The second element for concern about the figures for the last quarter is the halt to corporate investment in machinery and equipment. In fact, the index of manufacturing activity stands in a risk area, which is not surprising given the rash of firings in the country's most emblematic industry, namely the automotive industry.

In this context, the Federal Reserve continues to hesitate over interest rates. Bernanke has launched messages about excessive inflation but Wall Street believes that interest rates will remain stable over coming months. On the other hand, the Bank of Japan finally decided to act in February by raising its reference rate by a quarter-point to 0.50%. This was a move expected by the market back in January but political pressure seems to have obliged the monetary authorities to wait for clearer figures. These came in the middle of the month with announcement of GDP growth of 4.8% at quarter-to-quarter rate raised to annual rate, the highest for three years. With the figures at hand, the Japanese central bank considered itself justified in tightening monetary policy to the level mentioned above, an interest rate still low but the highest in ten years.

Following the rise in Japan, foreign exchange markets were expecting some improvement in the yen which, in the past two years, had hit lows against the dollar and the euro. But the weak future plans stated by the governor of the Bank of Japan did not set off speculative operations based on exchange rate differences between currencies (the carry trade) but just the opposite. These speculative transactions consist of borrowing in yen and other currencies with low interest rates and investing in funds expressed in high-yield currencies. The result was another drop in the yen.

While Fed leaves monetary interest rates unchanged, Bank of Japan decides to raise them but fails to discourage carry trade.

The ECB did not look kindly on the subsequent appreciation of the euro but this did not dissuade it from again raising its reference rates. The members of the ECB governing council believe that monetary policy remains accommodative, that is to say, too easy for an economy that has shown plenty of proof that it is growing at its potential or more.

Of course, following release of figures for the third quarter by Eurostat, no one is now disputing the good economic situation in the EU and the euro area in particular. And the European Commission even less. Joaquín Almunia, commissioner for Economic and Monetary Affairs, drew a brilliant economic picture in the early forecasts of the European Commission presented at mid-month. Growth of the euro area in the fourth quarter put the increase in the 2006 GDP at 2.8%, a figure much higher than expected at the beginning of the year, and Brussels is betting on a gradual slowdown during 2007, forecasting a rate of 2.4%. In addition, the Commission is not expecting any problems on the inflation front and foresees a continuation of the drop in the unemployment rate (the lowest in the past decade) along with a reduction in the government deficits.

ECB also in stage of increasing rates, its reasons based on brilliant results and growth prospects in euro area.

Growth with higher quality

One of the main players in the recovery in the euro area was Spain's economy which reported the highest growth rate among the large and medium-sized countries. Growth in the fourth quarter went above forecasts and put annual growth at one decimal below 4%, the highest rate since 2000. But more than the new burst of activity, perhaps the

Spain continues in lead with 2006 growth close to 4%.

Consumption driving demand but somewhat less than one year ago while growth of housing construction seems to have hit ceiling.

most important factor was that growth was of higher quality. Domestic demand is showing lower drive while foreign demand is less negative, inflation is tending to moderate and productivity is improving.

Undoubtedly, the main role is still falling to consumption spending and investment. Final household consumption slowed its growth rate to 3.7% (five decimals less than in 2005) mainly due to lower consumption of consumer durable goods (car sales, for example, were down by 2.0%). Nevertheless, we note an uneven performance over the year. In the first half, growth tended to drop slightly but toward the end became stronger. At the beginning of 2007 we note a similar situation. The few figures available are of an expansionist tone in spite of the fact that consumer confidence has worsened to some extent.

Notable growth in industry with uneven situation in services.

In turn, public consumption grew by 4.4% as against 4.8% in 2005, showing a more irregular performance over the year. We should point out the substantial increase in spending in the final quarter with a rise of 4.9% year-to-year.

Gross capital formation showed a more moderate rate of increase in 2006 going to 6.3% (seven decimals less than in 2005). Capital goods investment gradually increased in growth rate during 2006, marking up a notable high in the fourth quarter (11.4%). In construction, housing and infrastructure works (mainly road and rail related to the high-speed train) continued to be the driving force of activity. Housing construction rose by 6.4% (six decimals more than in 2005) but showed a downward trend over the course of the year and ended up reducing its year-to-year rate of increase to 5.0% in the fourth quarter.

On the supply side, the most notable point in 2006 was the progress in industry which grew by 3.3% as against a poor 0.3% in 2005. The growth rate in the sector gained strength throughout the year taking it to 4.4% year-to-year in the fourth quarter. On the other hand, the trend in services in 2006 was quite uneven. Public services raised growth to 4.0% (a half-point more than in 2005) in line with the trend in earnings of public servants. On the other hand, market services showed a significant drop in growth rate (rise of 3.4% as against 4.6% in 2005). Those branches related to finance, information technology, communications and company services were the most dynamic for the year as a whole. Retail trade and tourism also recorded significant growth but less than in the activities mentioned above.

Productivity growth begins to emerge from stagnation while inflation differential with euro area down to half-point.

The strong growth of the economy made it possible to continue creating jobs while at the same time improving the productivity of the labour factor. As a result, the ratio between value added and jobs equivalent to full-time work was up by 0.8%, twice that for the previous year. This increase was entirely due to the trend in industry which showed a sharp increase in activity without substantially changing its average employment level. In other groups of economic activity, gains in productivity were non-existent. In any case, we see here a positive sign which comes together with the rapid cut in the inflation differential with the euro area to a half percentage point (nearly two points one year ago). A harmonized consumer price index of 2.4% has not been recorded since 2004. The gain in inflation, at a moment of growth in economic activity, along with an improvement in productivity, offer two rays of hope for the capacity and potential of Spain's economy.

February 26, 2007

CHRONOLOGY

2006

March	**2**	**European Central Bank** raises official interest rate to 2.50%.
	28	**Federal Reserve** raises reference interest rates to 4.75%.
	31	Government approves **economic policy package** including budgetary measures and others on mortgage market, energy sector and rail transport.
May	**4**	Agreement between government, business organizations and trade unions on **labour reform** aimed at reducing extent of temporary work.
	10	**Federal Reserve** raises reference rate to 5%.
June	**8**	**European Central Bank** raises official interest rate to 2.75%.
	29	**Federal Reserve Board** increases reference rate to 5.25%.
July	**11**	European Council authorizes **Slovenia** to adopt euro as currency as of January 1, 2007.
	24	Multilateral negotiations in **Doha Round** of World Trade Organization, aimed at greater liberalization of international trade, indefinitely suspended.
August	**3**	**European Central Bank** raises official interest rate to 3.00%.
	8	One-month forward price of Brent quality **oil** goes up to all-time high of 78.49 dollars a barrel.
	12	UN Security Council approves resolution for **cease-fire in Lebanon** in conflict between Israel and Hezbollah.
September	**26**	European Commission gives go-ahead to entry of **Romania and Bulgaria** into European Union on January 1, 2007.
October	**5**	**European Central Bank** raises official interest rate to 3.25%.
November	**29**	Publication in BOE Official Bulletin of Law 35/2006 on reforms to **Personal Income Tax** and partial modification of laws on Corporate Tax, Non-resident tax and Property Tax.
December	**7**	**European Central Bank** raises official interest rate to 3.50%.

2007

January	**1**	**European Union** enlarged to 27 member states following inclusion of Romania and Bulgaria; and **euro area** numbers 13 members following adoption of European single currency by Slovenia. Reforms to **Personal Income Tax** and **Corporate Tax go** into force.
February	**19**	IBEX 35 index for **Spanish stock market** marks up all-time high (14,915.8) with cumulative gains of 5.4% compared with end of December 2006.
	20	Dow Jones index for **New York stock exchange** reports all-time record (12,786.6), an increase of 2.6% over end of 2006.

AGENDA

March

2 Registrations with Social Security and registered unemployment (February).
6 Industrial production index (January).
8 Meeting of Governing Council of European Central Bank.
13 CPI (February).
15 Balance of payments (December).
Labour costs (4th Quarter).
Harmonized CPI for EU (February).
20 Central government revenue and spending (February).
21 Meeting of Fed Open Market Committee.
26 Producer prices (February). Foreign trade (January).
29 Preliminary HCPI (March).

April

3 Registrations with Social Security and registered unemployment (March).
4 Industrial production index (February).
12 Meeting of Governing Council of European Central Bank.
13 CPI (March).
GDP for EU (4th Quarter).
16 Balance of payments (January).
Harmonized CPI for EU (March).
24 Central government revenue and spending (March).
25 Producer prices (March). Foreign trade (February).
27 Labour Force Survey (1st quarter).
Preliminary HCPI (April).
US GDP.

INTERNATIONAL REVIEW

United States grows 3.4% in final quarter of 2006, led more by consumers than investors.

United States: consumption in spite of everything

When growth continues more than expected, someone has to make prudent warnings about a possible sudden drop. Certainly, 2006 was not the year for the expected moderation in the economy nor for the hoped-for correction of the trade deficit. Following second and third quarters with weak economic activity, the figures for the gross domestic product (GDP) in the fourth quarter (with growth of 3.4% year-to-year) showed a notable recovery of the economy although not as high as levels in the first quarter.

The difference compared with the beginning of the year is that private consumption was confirmed as the main support for growth, with a rise of 3.7%. On the other side of the coin, there continued to be sharp drops in housing investment which this time around was followed by a major drop in capital goods although this did not mean an excessive reduction of growth. The foreign sector combined increased strength in exports with lower imports and temporarily compensated for the weakness in investment. The problem lies in seeing if this correction in the trade imbalance will continue since exports are being helped by extraordinary orders in the aircraft sector.

As a result, the slowdown is gentle enough to be hardly perceptible but, in view of the strength of consumption, the drop in investment, the foreign imbalance and the negative household savings in terms of disposable income, what is now the big unanswered question is the sustainability of the current situation.

UNITED STATES: MAIN ECONOMIC INDICATORS

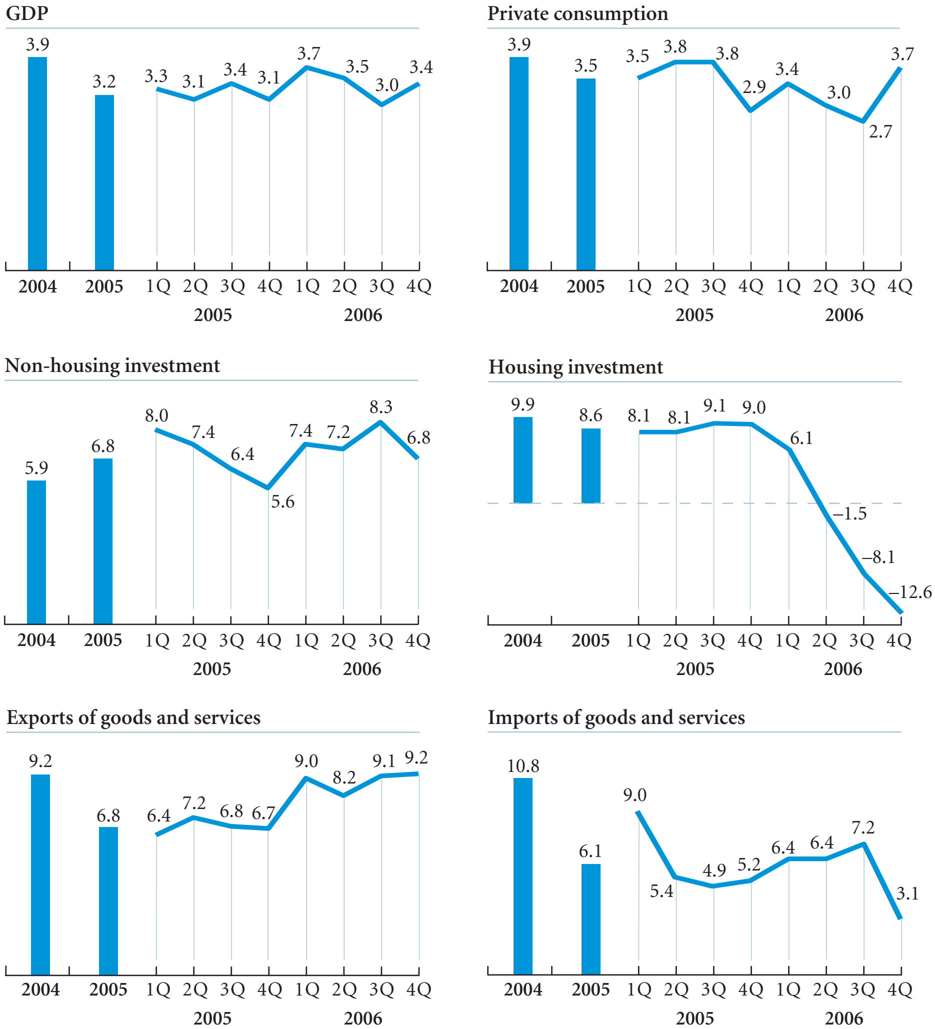
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007
			1Q	2Q	3Q	4Q	January
Real GDP	3.2	3.4	3.7	3.5	3.0	3.4	–
Retail sales	7.2	6.3	8.3	6.6	5.5	5.0	2.3
Consumer confidence (*)	100.3	105.9	105.7	106.6	104.4	106.8	110.3
Industrial production	3.2	4.1	3.3	4.2	5.1	3.7	2.6
Industrial activity index (ISM) (*)	55.5	53.9	55.6	55.2	53.8	50.9	49.3
Sales of single-family homes	6.6	–16.4	–11.6	–14.4	–22.3	–17.1	...
Unemployment rate (**)	5.1	4.6	4.7	4.6	4.7	4.5	4.6
Consumer prices	3.4	3.2	3.7	4.0	3.4	1.9	2.1
Trade balance (***)	–717	–764	–740	–761	–780	–764	...

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

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-to-year change in real terms



SOURCE: Bureau of Economic Analysis and ows calculations.

Most recent demand indicators confirm the strength of consumption with retail sales that seems to have put to rest the hesitation seen in the autumn. Apart from some slowdown compared with figures of one year ago, the component excluding cars and petrol (which because it has fewer swings more clearly sets the trend), discounting price increases, grew in annual terms by more than 5% since October, the weakest month in the real estate sector so far.

In keeping with the above, the consumer confidence index of the Conference Board rose slightly to 110.3 points in January, a level not reached all through 2006. But the question of sustainability remains in the wings given that this confidence is concentrated on the present situation whereas the expectations component shows a much lower picture, with people waiting for an end to the party that never seems to come.

Retail sales recover while confidence in present situation growing.

Housing stabilizing its losses but recovery something still to be seen.

The real estate market may have hit bottom. Recent months show some improvement in sales and prices, which are not dropping, although housing starts were again down in January indicating that this is not the moment to set all the bells chiming. But, beyond the level of economic activity, prices are the factor that will decide the sustainability of current levels of consumption and therefore of economic activity in general. Household savings in the United States is negative in terms of disposable income and the fact is that Americans are spending more than they earn.

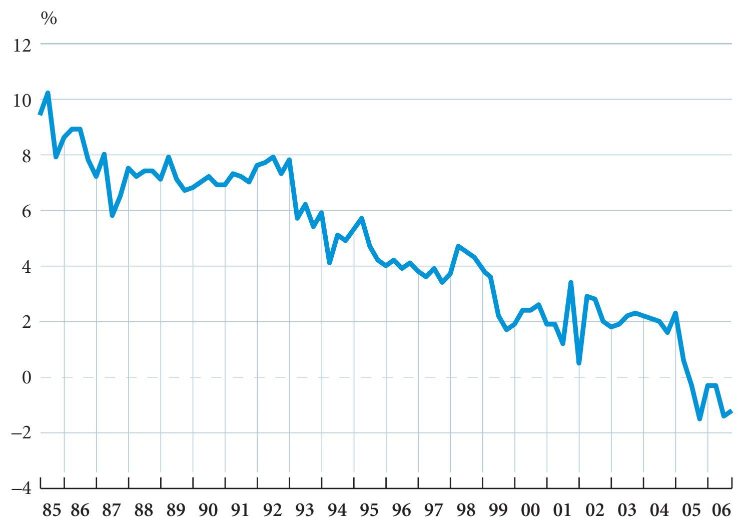
In this respect, the wealth effect and the turning of assets into liquid funds are playing a significant role. Capital gains on selling assets do not form part of disposable income but on the other hand these create fiscal amounts that do. At times such as these, when there is a sharp appreciation of assets, it is natural that there be some profit-taking, which reduces savings. This lack of savings could affect the sustainability of economic activity in the case of sudden drops in the value of assets. In this sense, the slowdown of activity in the housing market could be seen as a positive factor seeing that, if in view of lower demand supply drops swiftly, housing prices could obtain some support. The uncertainty still lies in the relative speed of these adjustments.

Corporate confidence holding up.

On the corporate side, positive views continue to dominate. In the manufacturing sector, the January index of the Institute for Supply Management fell to the 49.3 points level, close to the 50 level where those who see a weakening of economic activity and those who expect an improvement come out equal. The perception, however, is better than would appear from the index seeing that the weakest component is the level of inventories which, together with the strength of new orders, points to the soundness of demand. In services, the index rose to 59.0 points which provides a more upward picture than anticipated.

UNITED STATES: SAVINGS DISAPPEARING

Household savings in terms of disposable income



SOURCE: Bureau of Economic Analysis and own calculations.

Prices are moving up more moderately than the big numbers would indicate. The January consumer price index (CPI) rose by 2.1% year-to-year, lower than the 2.6% in December. Nevertheless, base effects brought about by oil price changes have made recent readings less valid. The underlying component which, because it excludes the volatile prices of energy and food, gives a clearer picture of price pressures, went up 2.7%, a slight rise. This is higher than the figure unofficially considered optimum by the Fed but the inflation picture should become clearer in coming months. In the first place, the non-energy private consumption deflator for the GDP in the fourth quarter was up a more acceptable 2.1% over the previous quarter in annual terms. Secondly, rentals are pushing prices up because of the difficulty in buying a house and with a heavy weighting in the index as it includes rentals for those living in their own homes (not actually paid in cash). Excluding rentals, the CPI rose less than 1.5% year-to-year, a value to keep in mind if the ravages of the housing and oil markets allow.

Core inflation, now at 2.7%, should tend to ease.

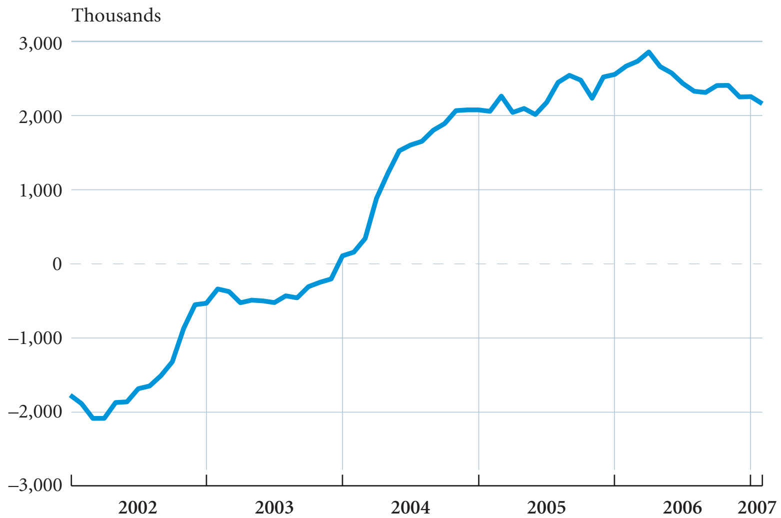
Another point that should help an appreciation of the direction in inflationary trends is the labour market. Up until January job creation over the past 12 months was stabilized at around 2.1 million new jobs although with a slight downward trend. The manufacturing sector lost 110,000 jobs in the same period. These figures are far from causing exuberance although population trends mean that the unemployment rate stands at 4.6% of the labour force, a relatively low figure. For five months wages have been gaining purchasing power in year-to-year terms but inflation trends that may arise from this are contained.

Stability dominating labour market.

The trade deficit in December was 61.18 billion dollars, an increase of 3 billion dollars, of which 2 billion may be

UNITED STATES: JOB CREATION STABILIZING

Job creation in past 12 months



SOURCE: Department of Labour and own calculations.

Trade deficit should consolidate incipient correction.

attributed to the oil balance. Even taking into consideration that cheaper oil should have beneficial effects on the trade balance, the effective correction of the deficit will come when the non-energy segment reacts and shows the improvements now appearing in national accounting.

Finally, we should refer to the budget estimates for the next financial year which comes on top of the perception that the present situation is better than the future. The ambitious goals in foreign policy mean incurring in the highest military and security spending in history (more than 600 billion dollars), partly because more explicit accounting of the costs of the wars in Afghanistan and Iraq is included. If these estimates are approved, something unlikely that in view of the strength of the Democrats, health costs would suffer substantial cuts through which the government expects to reduce the fiscal deficit to 1.8% of the GDP in 2007 and 1.6% in 2008. The problem is that the current figures seem optimistic and population trends could greatly worsen the situation in coming years.

Japanese train starts moving again

Japan renews growth moving up to 2.3%...

It seems that the fears of prime minister Shimzo Abe and his Minister of Economy, Hiroko Ota, were somewhat exaggerated seeing that Japan's growth is not as fragile as was thought. After all, the fourth-quarter GDP turned around the downward trend of previous months going up to 2.3% year-to-year, a striking 4.8% compared with the previous quarter in annual terms. To add to all this good news, growth in this case was led by domestic demand, which (especially in Japan's case) is a sign of firmness. Private consumption was up 0.6% year-to-year going back to positive ground while investment in capital goods continued to show strength, gaining 10% over the same period the year before. In fact, the Japanese economy has passed the bend of slump where it had settled down in the autumn. Looking at this upward reaction more carefully, however, one feels far from that unmistaken picture of robust recovery seen at the beginning of 2006. Four factors would recommend caution.

...but starting level low and private consumer deflator drops.

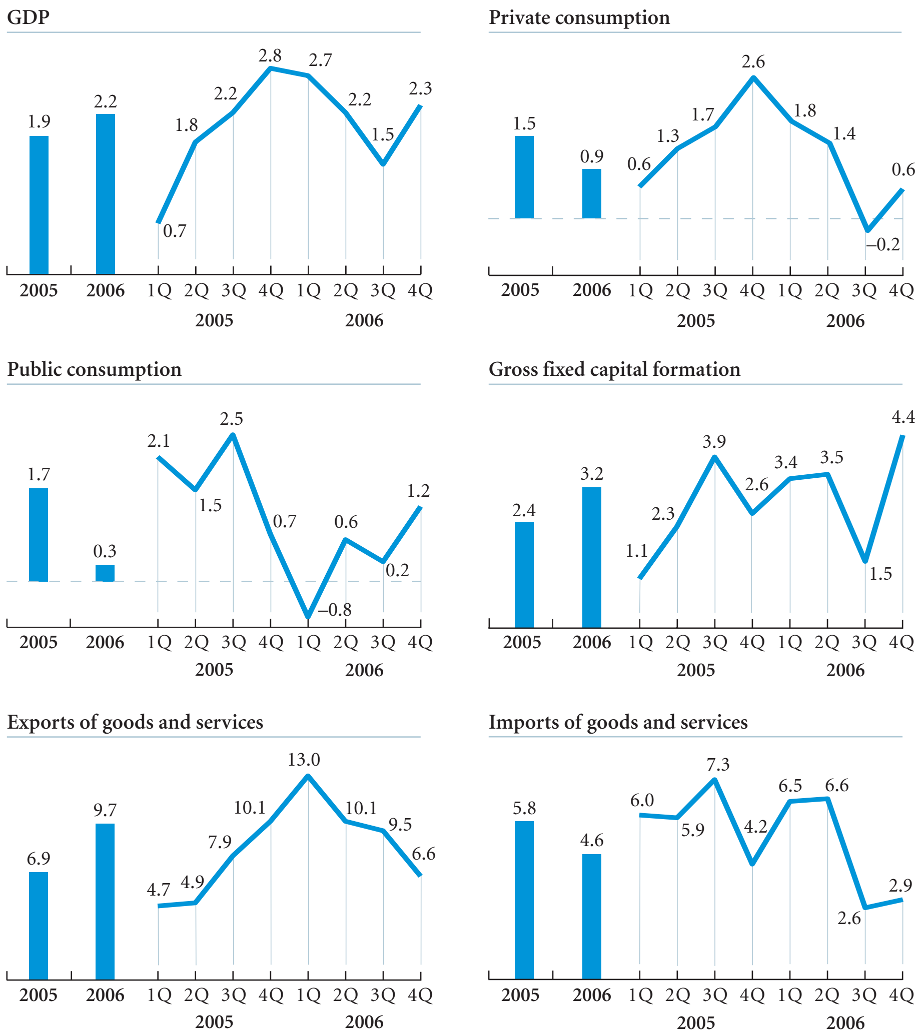
To begin with, the quite weak figures for third quarter were revised even lower, which magnifies the increases in the fourth quarter. As a result, in spite of the increase in economic activity, the level of recovery continues to be much closer to the weak situation in the third quarter than to the picture it showed only four months ago. The second qualification is that, in absolute terms, one fifth of the reaction was brought about by the recovery of public investment, necessarily temporary because of the situation of the government treasury, which went from dropping by 19% to a gain of 11%. A third reason for doubt lies in the ambiguous performance of the foreign sector which notably reduced its contribution to growth because of the weakness of exports. The fourth reason, but not that of least weight, was the drop in the private consumption deflator which, after a brief moment of stability, again returned to negative ground and left all weapons raised on the end-of-deflation front.

Retail sales remain slack.

The most recent indicators of economic activity continue to show a picture of modest recovery. Retail sales in December were down 0.6% year-to-year and in January 10.2% fewer cars were sold than in the same period the year before, thus continuing the downturn begun in mid-2005. As a positive

TREND IN JAPAN'S GPD BY COMPONENT

Percentage year-to-year change in real terms



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

counterpoint, the Tokyo real estate market is showing prices on the rise although with sales more and more stagnant. Consumer confidence in the fourth quarter moved up to 47.3 points, a relatively high level that is not coherent with weak consumer interest. Industrial production in December was up by 4.6% year-to-year and continues to show the more robust picture of the present moment. Machinery orders in December showed a slight year-to-year drop following the sharp increases in previous months due to special large orders.

Industrial sector remains strong.

The December consumer price index rose by 0.3% year-to-year, an increase that, we exclude volatile fresh foods, was even slimmer and would stand at 0.1%. The situation of energy in these indices could introduce considerable bias but the trend in Tokyo prices in January and the drop in the private consumption deflation mentioned above rather point

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2005	2006					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	1.9	2.2	2.8	2.7	2.2	1.5	–	2.3	–
Retail sales	1.4	0.2	0.7	0.6	–0.2	0.4	0.3	–0.1	–0.6
Industrial production	1.5	4.2	3.6	2.8	3.7	5.3	6.1	4.9	4.6
Tankan company index (*)	18.0	22.5	21.0	20.0	21.0	24.0	–	25.0	–
Housing construction	3.9	4.5	6.7	4.9	8.9	–0.8	2.3	3.9	10.3
Unemployment rate (**)	4.4	4.1	4.5	4.2	4.1	4.1	4.1	4.0	4.1
Consumer prices	–0.3	0.2	–0.7	–0.1	0.2	0.6	0.4	0.3	0.3
Trade balance (***)	10.2	9.4	10.2	9.5	9.1	8.9	9.0	9.4	9.4

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

Low unemployment rate not helping to raise wages.

downward. The December unemployment rate stood at 4.1% of the labour force, a low figure that reflects a population on the decline but one which does not fail to bring about wage increases. The trade balance continued on positive ground always expecting heavy purchases from the United States and China. Japan showed a good year-end which nevertheless must continue in order to be able to show consistent growth close to its modest potential.

China: the strange case of growth without consumption

China grows 10.7% in 2006 without inflationary pressures.

The recovery of some religious beliefs from the past in China, especially those of a more popular nature, is now a fact and furthermore enjoys the half-hearted blessing of the government that not long ago would have considered them heretical. At the same time, the interest of the large multinationals in retail sales in the Chinese market continues to rise although their successes have been uneven. Today, these two very different realities have a lot to do with the economic progress of the country. China continues to run full steam ahead, even more than expected by analysts, which was not small. The GDP rose by 10.4% year-to-year putting growth for the whole of 2006 at 10.7%. Inflation remains moderate with an increase of 2.2% year-to-year in January. Nevertheless, in spite of the headlines, the economy has weaknesses that darken this bright picture.

In the first place, growth is excessively dominated by heavy industry. The industrial sector, with growth of 12.5% year-to-year in the fourth quarter, continues to lead the increases and now represents 48% of the economy as a whole whereas services grew somewhat less (10%) and saw its participation drop to a level slightly below 40%.

In second place, economic activity is dominated by investment (industrial, of course) and exports while consumption scarcely represents 39% of the GDP whereas in most countries it goes above 50% at least.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2005	2006						2007
			4Q	1Q	2Q	3Q	October	November	December	January
Real GDP	9.9	10.7	9.9	10.4	11.5	10.6	–	10.4	–	–
Industrial production	15.9	16.4	16.4	16.8	18.0	16.2	14.7	14.9	14.7	...
Electrical power production	13.4	14.7	11.8	13.4	13.2	16.5	15.6	15.7	14.5	...
Consumer prices	1.8	1.5	1.4	1.2	1.4	1.3	1.4	1.9	2.8	2.2
Trade balance (*)	102.0	177.2	102.0	108.8	123.4	143.3	155.2	167.6	177.2	183.5

NOTES: (*) Cumulative balance for 12 months. Billion dollars.
SOURCE: National Statistics Office of China, Thomson Financial Datastream and own calculations.

Growth increase out of balance with excessive weight of industry and weak consumption.

Things may now be moving in the right direction and, while due caution should be taken, four factors would support this view. Among economic activity indicators for December, industrial production continued to grow by 14.7% year-to-year, a high rate but one which means substantial moderation over the usual levels in recent years. Heavy industry still remains the dominant sector. This supremacy, however, could be giving off signs of wearing out. The inefficient state conglomerates continue to lose weight in industry and in November came to represent 34% of the total whereas two years ago they held 40%.

A third factor that suggests that China is on the move lies in retail sales. In December, these grew by 14.6% year-to-year combining some growth, notably in the rural areas, with the slight slowdown in industry. Beyond the figures, however, the relative weakness of Chinese consumption shows the institutional deficits the country suffers from with the big differences between city and rural areas as one of it main problems. It is here that religious resurgence and the fortunes of Wal-Mart and Carrefour take on special significance. Improved social protection and more secure property rights would stimulate consumption but, in the absence of effective measures in this regard, the temples dedicated to black dragons or Confucius could be contributing to all this.

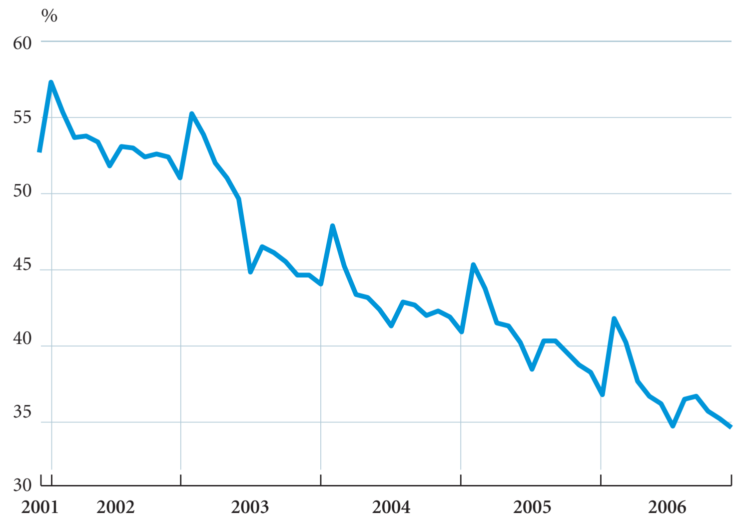
A Chinese temple, a place where one makes predictions about the future and tends to relate this to good fortune, is capable of holding together a lot of small stores and can have an influence on a relatively large area turning it into a modern version of what used to be an ancient fair. With more than 100 million persons who claim they are believers in some way or another, religion may be a factor for social stability and a force behind consumption, given that a person for whom good prophesies strengthen confidence may consume more, and this may be a force for giving cohesion to a market that is now very fragmented. Imitating to some extent the incipient popularity of the local temples, Carrefour, with a decentralized strategy that seeks out local partners and keeps in mind local idiosyncrasies, seems to be a jump ahead of Wal-Mart which adopts a more centralized approach of technological sophistication. Where both coincide is in betting on a 440 billion dollar market which in 2010 could be close to 600 billion.

Institutional factors and fostering of traditional beliefs may help bond disperse market.

The fourth positive factor is to be found in the foreign sector. The increase in the

CHINA: WANING INHERITANCE FROM PAST

Share of state conglomerates in industrial production



SOURCE: Chinese National Statistics Office, London Market and own calculations.

Local Chinese companies take on bigger role alongside foreign corporations.

trade surplus is well known and this is largely concentrated in trade with the United States and Europe while it presents a deficit with many Asian countries. Nevertheless, apart from the figures, there is the growing leadership of Chinese companies. Up to 2005 it had been the foreign companies established in China that had led the huge growth in the surplus but since the Spring of 2006 the proportion of the figure applicable to Chinese companies has been strongly recovering ground. China's economic numbers are convincing but, beyond the simple figures, the factors mentioned that affect the entrepreneurial spirit and the behaviour of consumers are those that are setting the direction for the economic march of the Asian giant.

China, a savings colossus

China consumes little more than half of what it produces and, with a savings rate of 47% of GDP in 2005, has become one of the world's big savers[1] (see accompanying graph). This pattern of savings is fairly common in developing Asian countries which on average (including China) save 40% of their GDP. Nevertheless, this does not happen in the more advanced economies where saving rates are close to 20% of GDP.[2] To what can we attribute this big difference in behaviour?

(1) Figures for China: Chinese National Bureau of Statistics 2005 and International Monetary Fund Country Report No. 06/394.
(2) International Monetary Fund: «World Economic Outlook – 2006».

It is worth examining the reasons for such a high level in China's savings rate in detail. Given that in every economy there are three institutional sectors (households, corporations and the government) this analysis requires a look at each of these separately.

After a significant rise in the Nineties, the savings rate of Chinese households has remained fairly stable at around 20% of GDP. The reason for such a high rate is mainly precautionary. The gradual reduction of the existing low rates of health coverage and unemployment benefits provided by government and companies induced families to increase their savings rate in order to meet unexpected situations of illness or loss of a job. Furthermore, government spending on education and pensions is also very low so that families must save in order to educate their children and be able to retire in decency. One figure that illustrates this need for saving is a comparison of government social spending in China, which amounted to 3.5% of the GDP in 2005, with that of Spain, which in education alone invested 4.5% of the GDP back in 2003.(3)

Another factor contributing to the high rate of household savings is the underdevelopment of Chinese financial markets. Access to credit to acquire durable goods is difficult and it is not easy to obtain insurance to cover specific risks so that households have only the resource of savings to buy such goods or meet eventualities.

Nevertheless, in spite of the fact that households save a lot, the constant increase of total savings in China in recent years may largely explained by the rise in savings by the government and by firms, the other two economic agents.

The government went from savings of close to 5% of GDP in 1992 to 10% in 2005. As in the case of households, the main reason can be seen as precautionary, given that it is the fragile situation in the financial sector that has forced the Chinese government to increase its savings rate in order to recapitalize the banks.

Nevertheless, the role of the government in shaping savings behaviour does not stop here because it is also a key influence behind the strong rise in corporate savings. To be specific, Chinese companies have gone from savings of around 10% of GDP in 1992 to 20% in 2005. In recent years, corporate profits have been growing in terms of GDP, partly due to certain corporate reforms but especially thanks to support for exports from the government, which has maintained the exchange rate undervalued. As a result, retained earnings by companies, that is their savings, has become a key factor in explaining total Chinese savings.

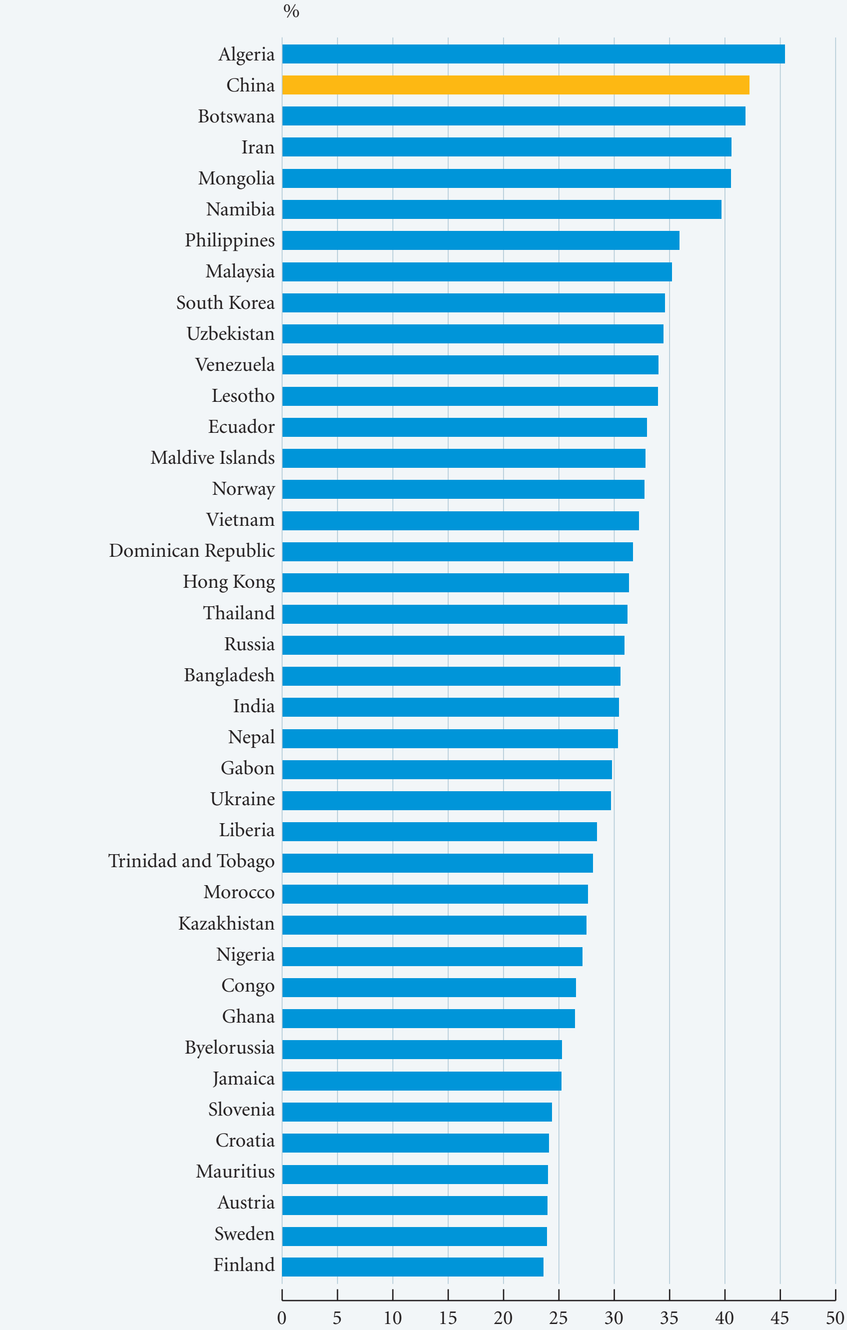
It is especially the state-owned companies, which have a 50% share in total corporate profits, which are saving disproportionately. As they are not obliged to distribute dividends to their owner (the government), these companies generate large savings (or retained earnings), part of which they reinvest in the company itself, a fact that often gives rise to poor allocation of resources in certain assets and/or sectors. If these earnings were distributed to the government, it could increase its spending on health services, education, unemployment benefits and pensions, among other programmes, without the need for increasing taxes for this purpose. In this way, households could reduce their savings rate or, what is the same, increase consumption which would help generate a growth model based on private consumption instead of the current one based on investment and exports.

Implicitly admitting that their savings rate is too high, China has proposed to increase its consumption. With this in mind, the government hopes to increase its spending on social benefits, increase the minimum wage and reform policies related to the exchange rate, providing these with more flexibility. Nevertheless, it seems

(3) Figures for Spain: National Institute of Statistics.

BIGGEST SAVERS: THE 40 LEADING COUNTRIES

National savings in terms of GDP



SOURCE: World Bank.

that the proposals put forward by the Chinese government are not being carried out. The government is even acting to prevent the appreciation of the renminbi. Spending on social programmes is still small. And attempts to increase the minimum wage are running into problems. First, there is the wide freedom given by the central government to local government to set the minimum wage in their area. Second, the little effect this policy has on workers given that only a very small proportion stands below the minimum wage.[4]

In any case, we should not overlook the fact that it is the position of net savings (savings less investment) of countries like China (see accompanying table) that makes it possible for economies like those of the United States or Spain to invest more than they save, thus financing part of domestic investment and their current account deficits. If China changes its attitude on savings and reduces them significantly, it could mean that neighbouring countries would follow suit and this could imply an increase in world interest rates as we speculated in the January issue of this Monthly Report.

SAVINGS AND INVESTMENT IN CHINA

	2002		2005	
	% of GDP	Billion $	% of GDP	Billion $
Savings	38	554	47	1,051
Investment	35	510	40	894

SOURCE: International Monetary Fund.

(4) Lardy, Nicholas R., October 2006, «China: Toward a Consumption-Driven Growth Path», *Policy Briefs in Internacional Economics, Institute for Internacional Economics.*

Mexico: good growth, prices permitting

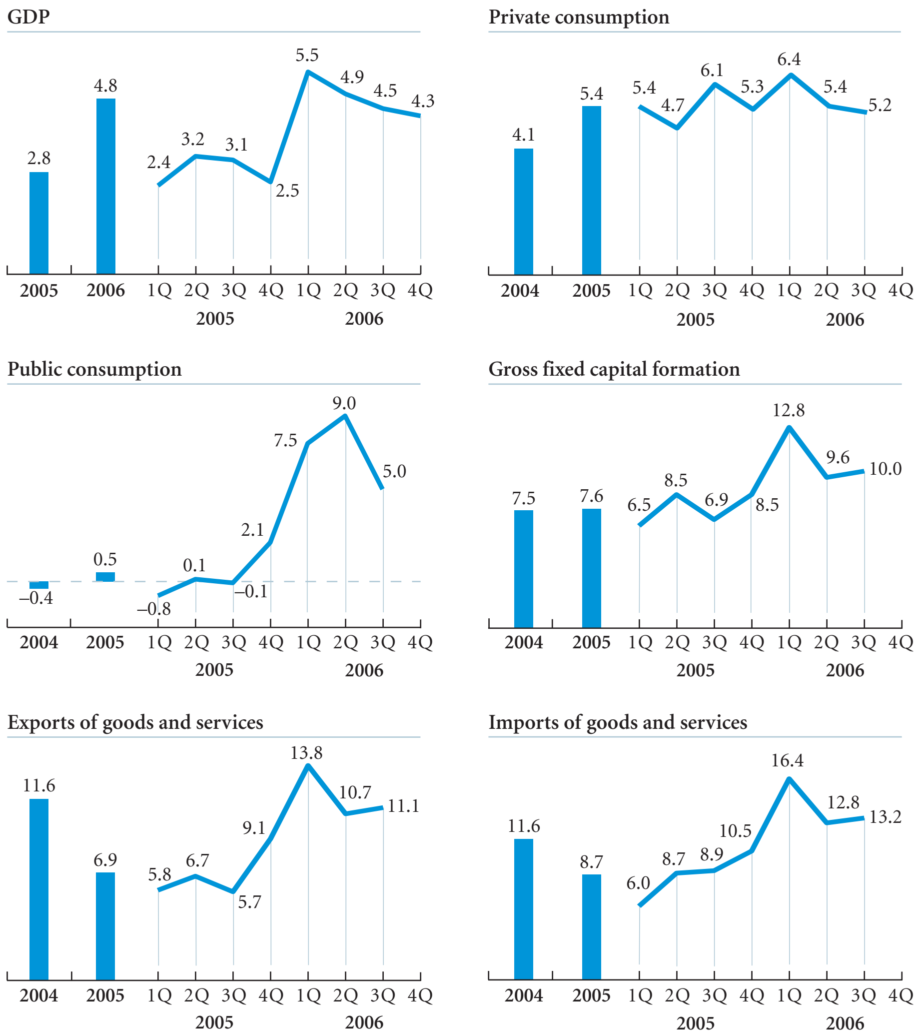
The Mexican economy ended the year strongly with growth of 4.3% year-to-year in the second quarter. Growth continues to be backed by private consumption which, with an increase of 5.2% increased its lead to the detriment of public consumption which, after rising to 9.0% at mid-year, in the third quarter lost a good part of its proud appearance. The predominance of the private sector was reinforced by the strength of investment which in the third quarter moved up to growth of 10% year-to-year. This drive was dominated by private fixed capital formation which rose to 13.3% while that of state origin dropped by 6.6%, thus losing the strength shown at the beginning of the year. The gradual slowdown of the economy must be seen entirely within the process of containing government spending. While domestic demand is looking good, the foreign sector is showing a more ambiguous picture with the rise in exports compensated by a recovery in imports which continue to grow at a higher rate.

Mexico grows by 4.3% with private sectors in lead.

Among the most recent economic activity indicators, industrial production in December slowed to a slim growth of 1.6% year-to-year. The slowdown was concentrated more in manufactures than in construction, which confirms the incipient lead it was showing at the end of last summer. In the first group, there were notable decreases in industrial production of *maquiladoras*, which dropped by 1.3% compared with

TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-to-year change in real terms



SOURCE: Central Bank of Mexico and internal figures.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2005	2006						2007
			4Q	1Q	2Q	3Q	October	November	December	January
Real GDP	2.8	4.8	2.5	5.5	4.9	4.5	–	4.3	–	–
Industrial production	1.8	5.0	2.9	7.1	3.9	5.4	4.4	4.6	1.6	...
General unemployment rate (*)	3.6	3.6	3.1	3.5	3.2	4.0	4.0	3.6	3.5	...
Consumer prices	4.0	3.6	3.1	3.7	3.1	3.5	4.3	4.1	4.1	4.0
Trade balance (**)	–7.6	–5.8	–7.6	–5.0	–4.5	–5.3	–5.8	–5.9	–5.8	...

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
SOURCE: Central Bank of Mexico.

the same period the year before. In this respect, the pressure of Chinese competition can be seen although, in view of the trend in domestic demand, it is a positive sign that economic activity remains strong in the face of this process which, to some extent, means a reduction of the Mexican economy's foreign dependence.

The question of price stability seems on the way to being resolved, with inflation in January up by 4.0% year-to-year. The GDP deflator, that had set off alarm bells in the second quarter with a rise of 8.5%, by autumn seemed to get back in the fold with growth of 4.9% year-to-year, helped by the moderation in public consumption mentioned above.
Also on the credit side, the official unemployment rate dropped slightly to 3.5% of the labour force in December.

Drop in maquiladoras weakens manufacturing activity...

The deficit in the foreign sector showed some stabilization of the downturn process with a trade balance (excluding oil exports) that, in the three months ending in December, showed a deficit of 12.34 billion dollars, some 300 million dollars less than that reported in the third quarter, in spite of the weakness of the *maquiladoras*. This is a positive sign for the correction of one of the trouble spots in an economy that continues to appear in relatively good health.

...but prices ease and foreign sector able to stabilize drop.

EUROPEAN UNION

European Commission expecting good 2007

Euro area to grow by 2.4% in 2007 with European Union at 2.7%.

The European Union grew by 2.9% in 2006 while the euro area reached 2.7%. Will 2007 be able to maintain this economic result? According to its preliminary Spring forecast, the European Commission is expecting that this year will show a rate only moderately lower at 2.7% for the EU and 2.4% for the euro area.

In any case, both figures are positive. First of all, because the expected composition of growth, with a bigger contribution coming from domestic demand, will help the sustainability of growth in future years. Secondly, because growth, even going above potential, will not generate excessive pressure on prices. Thanks to the lower than expected impact of the increase in Germany's value added tax in effect since January, and the drop in energy price pressures, the harmonized consumer price index (HCPI) will go down two decimals in 2007 to stand at 1.8%. In addition, the EC executive is confident that the improvement in productivity recently recorded will continue which, together with the beneficial effect of growing international price competition, will make a contained trend in inflation possible.

Year will be noted for increased role of domestic demand compatible with lower inflation.

Finally, another two notable facets of the European Commission's forecasts are the relatively better starting point in labour market matters at the beginning 2007 (the unemployment rate is at its lowest point in more than a decade) and the better balancing of the public finances. Both trends should be maintained during the current year.

EUROPEAN COMMISSION MACROECONOMIC FORECASTS

Country	Growth				Inflation (*)			
	2006	Current forecast for 2007	Previous forecast for 2007 (**)	Difference	2006	Current forecast for 2007	Previous forecast for 2007 (**)	Difference
Germany	2.7	1.8	1.2	0.6	1.8	1.7	2.2	–0.5
Spain	3.8	3.7	3.4	0.3	3.6	2.5	2.8	–0.3
France	1.9	2.2	2.3	–0.1	1.9	1.5	1.8	–0.3
Italy	1.9	2.0	1.4	0.6	2.2	1.9	2.0	–0.1
Euro area	**2.7**	**2.4**	**2.1**	**0.3**	**2.2**	**1.8**	**2.1**	**–0.3**
United Kingdom	2.7	2.7	2.6	0.1	2.3	2.2	2.2	0.0
EU-27	**2.9**	**2.7**	**2.4**	**0.3**	**2.2**	**2.0**	**2.3**	**–0.3**

NOTES: (*) Harmonized consumer price index.
(**) Date of forecast: November 2006.
SOURCE: European Commission.

Euro area: year-end goes full steam ahead

The figure for growth in the fourth quarter was awaited with great interest. Monthly indicators available pointed to a year-end on the rise. The final figures, however, went well above even the most optimistic forecasts with growth at 3.3% year-to-year, the highest figure since the third quarter of 2000. In the third quarter it had gone up to 2.7% year-to-year. After this rise came the upward move in Germany, France and Italy, the three large economies in the euro area. Specifically the German economy grew by 3.7% year-to-year, the French economy was up 2.2% and the Italian economy rose by 2.9%.

We still do not have a breakdown by component but monthly data published indicates that the big news likely will be a clearer recovery of private consumption. At least, the increase in retail sales as of December (with growth of 2.2% year-to-year as against 1.8% in the third quarter) and the continued growth of consumer confidence would so indicate.

Another two factors that would have played a positive role are investment and foreign demand. In the first case, relevant indicators such as industrial production of capital goods ended the year 2006 on the rise. With regard to the foreign sector, the good performance in exports has made possible a notable turnaround in the trade deficit. To be specific, the cumulative deficit for 12 months ending in December was only 8.2 billion euros, a definite correction over the figures recorded just a few months earlier. The average negative balance in the third quarter, for example, was 21.2 billion euros.

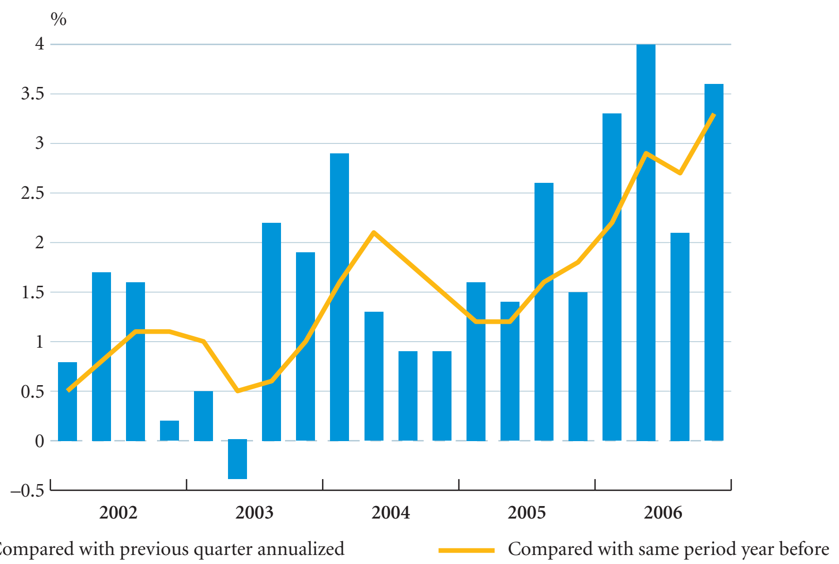
On the supply side, we should point out that industry continues to take advantage of this growth. Following a slight correction in November, industrial production rose by 1.3 percentage points in December, going to 4.0% year-to-year.

In final stages of 2006, euro area growth beat all expectations going to 3.3%.

Likely behind this rise was increase in consumption added to boost in investment and exports.

EURO AREA PUTS FOOT ON ACCELERATOR

Change in gross domestic product in real terms



SOURCE: Eurostat and own calculations.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006						2007
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	1.7	1.5	1.8	2.2	2.9	2.7	–	3.3	–	–
Retail sales	1.5	1.3	1.3	0.8	1.6	1.8	0.8	1.6	2.2	...
Consumer confidence (*)	–14	–14	–13	–11	–10	–8	–8	–7	–6	–7
Industrial production	2.0	1.3	2.2	3.4	4.2	4.1	3.8	2.7	4.0	...
Economic sentiment indicator (*)	99.2	97.9	100.1	102.6	106.8	108.2	110.0	109.9	109.8	109.2
Unemployment rate (**)	8.8	8.6	8.4	8.2	7.8	7.7	7.6	7.6	7.5	7.4
Consumer prices	2.1	2.2	2.3	2.3	2.5	2.1	1.6	1.9	1.9	1.8
Trade balance (***)	80.4	42.1	22.1	3.1	–9.8	–21.2	–18.9	–11.7	–8.2	...

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion euros.
SOURCE: Eurostat, European Central Bank, European Commission and internal figures.

2007 begins with gradual slowdown as logical result of starting out from strong rate of economic activity.

This trend had been anticipated by the strength shown by industrial orders in recent months. This good trend makes it possible to hope that with the start of 2007 industry will really take off.

Now the main question is to see how the slowdown expected in 2007 will begin to take shape. It was especially troubling that confidence of the main economic players could worsen so abruptly, as has happened in other similar situations in the euro area, and that the impact of the rise in Germany's value added tax on inflation could be heavy. Both hypotheses have been discarded. Economic sentiment, a qualitative indicator that reflects the expectations of the economic players, dropped only moderately in January, going down six decimals to the 109.2 points level. It should be remembered that the levels from which these figures started out at the end of the fourth quarter were high.

With reform of sickness insurance, Merkel government carries out four structural reforms which has not stopped consolidation of economic recovery.

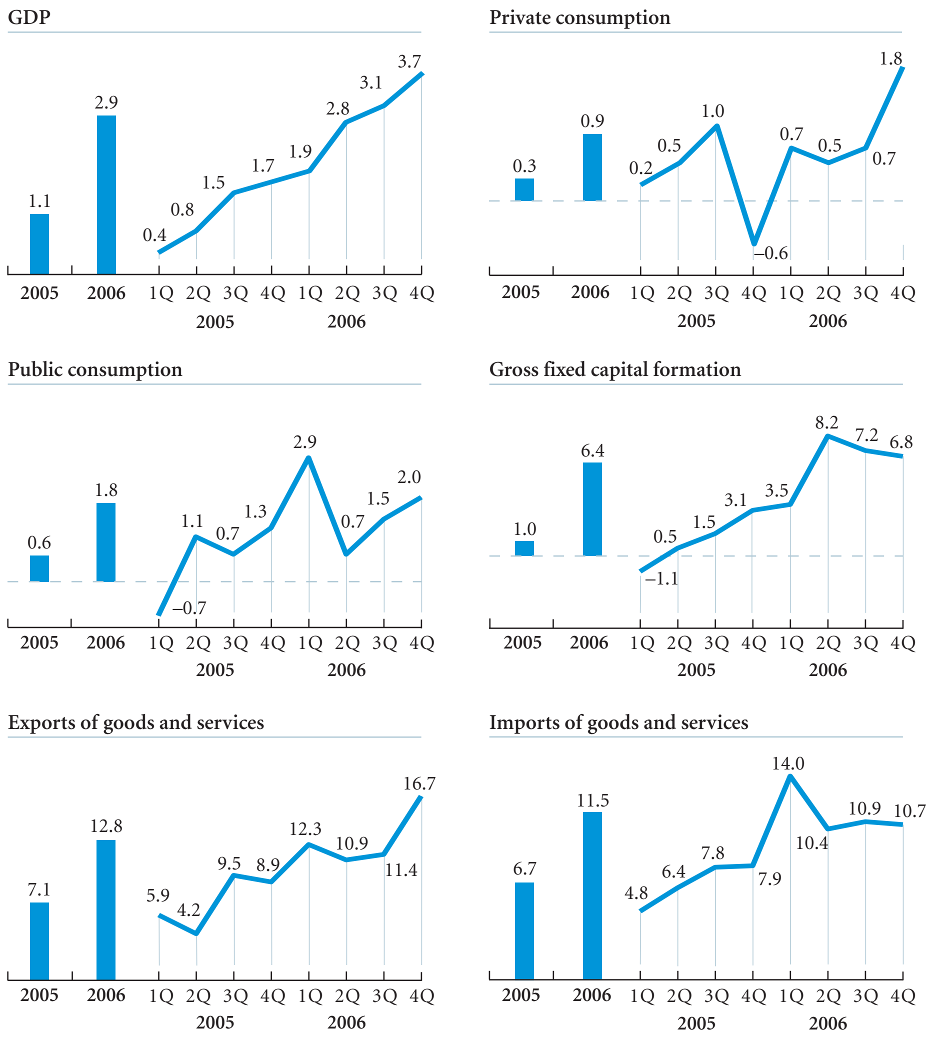
With regard to inflation, growth of the CPI in January was 1.8% year-to-year. That is to say, the growth rate of consumer prices dropped slightly compared with the figure for December. The forecasts put out for January were substantially higher, of the order of 2.1%. In fact, another concern has been put to rest.

Germany: Merkel, the reformer

A year and a half ago, when the Grand Coalition led by Angela Merkel began its course, we wrote in this Monthly Report that the challenge facing the new government was a double one, that it was necessary to both carry out major reforms that had been put off for a long time and make this modernizing effort without wrecking the incipient economic recovery. Now it may be said that the Merkel government is managing to do this. Within days of each other has come news that the reform of the health insurance system had been approved (the fourth reform, following fiscal reform, the redistribution of jurisdiction between the *lander* and the federal government and the reform dealing with retirement benefits) and that the gross domestic product (GDP) grew by 3.7% year-to-year in the fourth quarter of 2006, a rate at a surprisingly high level.

TREND IN GERMANY'S GDP BY COMPONENT

Percentage year-to-year change



SOURCE: Federal Statistics Office and own calculations.

Germany is certainly not going to turn into an Asian Tiger as it could even soon face a moderate economic slowdown. It should also be stated clearly that the reforms carried out may be termed modest. But, in any case, to launch four reforms dealing with sensitive matters in a year and a half in a country where consensus has been built over decades, and at the same time put economic growth back on the tracks are decided merits of the Grand Coalition.

Looking at details, the main thrust of the reform in health approved in the *Bundestag* on February 3 was the rationalization of the health insurance system. Now, those insured under the system are registered at 250 public offices with different benefits in many cases. Furthermore, under the current system some 300,000 persons are not insured. The reform, which goes into force on April 1, involves an increase in contributions paid half by employers

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006						2007
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	0.8	1.1	1.7	1.9	2.8	3.1	–	3.7	–	–
Retail sales	2.1	1.3	0.4	0.6	0.2	0.0	0.0	–0.4	–0.2	...
Industrial production	2.5	2.7	4.7	4.5	6.0	6.6	3.5	6.3	5.5	...
Industrial activity index (IFO) (*)	95.4	95.5	98.6	103.6	106.1	105.2	105.4	106.9	108.7	107.9
Unemployment rate (**)	10.6	11.7	11.4	11.4	11.1	10.6	10.3	10.1	9.8	9.5
Consumer prices	1.6	2.0	2.2	2.0	1.9	1.6	1.1	1.5	1.3	1.7
Trade balance (***)	149	156.3	158.4	154.8	151.3	148.2	153.1	158.7	161.8	...

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

Germany grows 3.7% in fourth quarter and 2.9% in 2006 as a whole.

and half by wage-earners and an increase in federal government funding. On the other hand, it is expected that all German residents will be covered by the system in 2009. This reform also modifies the catalogue of benefits and involves an effort to reduce costs through measures such as the increase pharmaceutical companies must apply to medicines sold to public bodies.

The second big news of the month was the explosive growth in the fourth quarter (3.7% year-to-year as against 3.1% in the previous quarter). This may briefly be explained by the fact that those components that had not yet significantly contributed to growth (mainly private consumption and construction investment) have now increased their growth rate while at the same time the foreign sector has raised its strong contribution to growth. All of this has made it possible to counteract the drop in capital goods investment.

Impact of increase in VAT on inflation less than expected.

We said earlier that the immediate prospects were not for consolidation of this growth rate. Forecasts point to a first quarter with a slight slowdown and this is supported by the few indicators now available. The IFO index of industrial activity stood at the 107.0 points level in February, a correction of nine decimals compared with the January figure. While this is a logical adjustment given that the IFO index is at all-time high levels (in fact, the highest levels since reunification), this trend will likely continue in coming months.

Another factor for concern, the inflationary impact of the three-point rise in the value added tax rate, has diminished with news that the CPI grew by only 1.7% year-to-year in January, four decimals less than expected. Other year-end indicators mainly serve to establish a starting point for 2007. In December, industrial production showed a slight correction, retail sales moved up and the foreign surplus rose. Taken together, these indicators suggest a start for the year with economic activity showing a very slight drop and no excessive pressure on prices.

France: third-quarter slump over

Following nil quarter-to-quarter growth in July-September in 2006, the trend in the GDP over the last three months of that year seemed to be key in limiting the extent of the slump in the French economy. Judging by national accounting figures available, it may now be stated that France is again moving ahead and doing so through public consumption and exports. As a whole, the French economy grew by 2.0% in 2006, equal to the rate recorded in 2004 and above the 1.2% seen in 2005.

To be specific, year-to-year growth of the GDP stood at 2.2% in the fourth quarter as against 1.8% in the previous quarter, thanks to a rise in public consumption which reported an equally strong rise as in the GDP as a whole (from 1.9% to 2.2%). Thanks also to the contribution from the foreign sector (nil contribution to change in GDP as against a take-away of 1.1 points in the third quarter). With regard to other demand components, private consumption and investment slowed slightly. In turn, the change in inventories took four decimals off GDP growth whereas in the third quarter this had contributed three decimals.

Starting out from these trends, all the monthly indicators point to some loss of strength at the start of 2007. While household consumption has begun on a clear note of growth (up 7.1% year-to-year in December), consumer confidence began the year at the 10 points level, thus consolidating the drop recorded in December. This trend presents a paradox seeing that the labour market is showing a clear improvement. To cite just one indicator, the unemployment rate in December (8.6% of the labour force) was the best since June 2001.

On the supply side, a similar situation shows up in industrial activity. Industrial production improved in December but the industrial confidence indicator was down for that month and in January. In this case, however, the poorer situation in order books is consistent with the worsening industrial prospects in France. In line with the drop in confidence in the tertiary sector in December and January, services are also losing some of their previous strength. With regard to prices, the situation remains contained. The CPI stood at 1.2% year-to-year in January as against 1.5% the month before. Overall, the economic situation in France began

France grows by 2.2% in fourth quarter ending slump in third quarter.

2007 begins with some downward slide noticeable in loss of confidence among consumers and business executives.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006						2007
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	2.0	1.2	1.0	1.3	2.5	1.8	–	2.2	–	–
Domestic consumption	3.8	2.9	2.2	2.9	4.8	4.3	4.1	4.2	6.4	7.1
Industrial production	2.0	0.2	–0.6	0.5	1.7	0.6	2.4	–1.4	0.7	...
Unemployment rate (*)	10.0	9.9	9.7	9.6	9.1	8.9	8.8	8.7	8.6	...
Consumer prices	2.1	1.7	1.6	1.8	1.9	1.7	1.1	1.4	1.5	1.2
Trade balance (**)	0.1	–1.3	–1.8	–2.1	–2.1	–2.4	–2.4	–2.4	–2.4	...

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

the year with some moderation but the trend in its fundamental imbalances (prices and unemployment) is favourable.

Italy: liberalization drop by drop

Italy adopts package of liberalization measures, certainly less ambitious than its economy needs.

The difficult arrangements Romano Prodi's centre-left government had to make to obtain a working majority following the 2006 elections suggested that the reforms undertaken would be of little substance. The reality went even beyond those limited expectations but the government ended up falling. On the credit side of the nine months of the Prodi government there stand two economic reform measures.

The first attempt, aimed at liberalizing various sectors, brought a noisy protest by taxi-drivers in July 2006. In spite of the fact that the reform stayed in place, its application is being excessively slow as pointed out by the Organization for Economic Cooperation and Development (OECD) in a recent report.

Rise in economic activity in final stages of 2006, higher than expected, should foster reform process.

At the end of January, the Prodi government approved a new batch of liberalizing measures. Although these covered a wide range of matters, we should mention those making it easier to set up a new business, the reduction of costs in changing a mortgage from one entity to another, the liberalization of international passenger transport and more flexibility in criteria for opening petrol stations, hair-dressing establishments, newspaper stands and cinemas. Are these the measures Italy really needs? Some members of parliament on the coalition government's own side have termed them insufficient but, in any case, they do reflect some small progress in the right direction. Unfortunately, the political uncertainty now opening up does not help sticking to this reform road.

The fact is that the unexpected strength of the renewed growth in the fourth quarter may have been a key factor in this situation. After growing in the first three quarters of 2006 at the rate of 1.7% annual, there was an increase of 2.9% in the GDP in the final quarter. Other indicators also point to a better economic situation. Retail sales rose in November, industrial production was up in December, the trade deficit dropped

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006						2007
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	0.9	0.1	0.5	1.7	1.7	1.7	–	2.9	–	–
Retail sales	–0.4	0.4	1.9	0.5	1.8	1.6	0.4	1.7	0.9	...
Industrial production	–0.5	–0.9	0.3	2.7	1.7	1.4	3.6	3.4	4.4	...
Unemployment rate (*)	8.0	7.7	7.5	7.2	6.9	6.8	–	...	–	–
Consumer prices	2.2	1.9	2.2	2.1	2.2	2.2	1.8	1.8	1.9	1.7
Trade balance (**)	–1.2	–9.4	–8.5	–12.9	–16.5	–21.3	–22.6	–21.9	–21.1	...

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

slightly in December and inflation, in itself moderate, was down again in January. Indeed, this presents an opportunity to take advantage of the economic situation in order to step up the pace of reform seeing that the costs of any adjustment are less onerous in a boom situation.

United Kingdom: more fuel to the flames, and not much left!

Growth in the United Kingdom in the fourth quarter was 3.0% year-to-year (2.9% in the third quarter). When the preliminary estimate was known, this strong growth seemed out of place (it was expected that a slowdown would begin in this period) and now that a breakdown by component has been made public it has brought some surprises. On the domestic demand side, some increase was expected in private consumption, which indeed has been confirmed, but it was not thought that investment would join in this increased growth. The other news, this time negative, came from exports which collapsed in the fourth quarter so that the take-away from GDP growth from that sector has increased. Will there be more surprises from the United Kingdom in the first quarter? Probably not. Retail sales in January slowed by eight decimals to 3.2% while consumer confidence dropped by close to two points. It therefore seems that consumption is beginning to halt its drive in spite of the fact that the unemployment rate is still low (2.9% in January). Industrial orders in January were down two points which would suggest that the slowdown in industrial production in December will continue at the start of 2007. Economic sentiment, a broad indicator of the general state of the economy, stood at the 104 points level in January, seven points less than in the previous month.

If this slowdown is confirmed, we may expect the pressure on prices to progressively ease. Up to now, however, inflation continues to stand far from the Bank of England objective at 2%. The British CPI stood at 2.7% year-to-year in January. While this represents some improvement over the 3% in December, it remains a troubling rate.

British economy grows 3.0% in fourth quarter, more than expected.

While signs of slowdown apparent, prices continue to show pressures.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006						2007
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	3.3	1.9	2.0	2.4	2.7	2.9	–	3.0	–	–
Retail sales	6.1	1.9	2.6	1.7	3.4	3.8	4.0	3.2	4.0	3.2
Industrial production	0.8	–1.9	–2.6	–1.0	–0.6	0.4	1.1	0.9	0.5	...
Unemployment rate (*)	2.7	2.7	2.8	2.9	3.0	3.0	3.0	3.0	3.0	2.9
Consumer prices	1.3	2.0	2.1	1.9	2.2	2.4	2.5	2.7	3.0	2.7
Trade balance (**)	–56.1	–64.6	–67.4	–72.0	–78.1	–82.2	–83.6	–83.9	–84.3	...

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion pounds.
SOURCE: OECD, national statistical bodies and internal figures.

FINANCIAL MARKETS

Monetary and capital markets

Bank of Japan indicates gradual increase in reference rate.

Federal Reserve likely to maintain objective level of Federal Funds at 5.25% for some months.

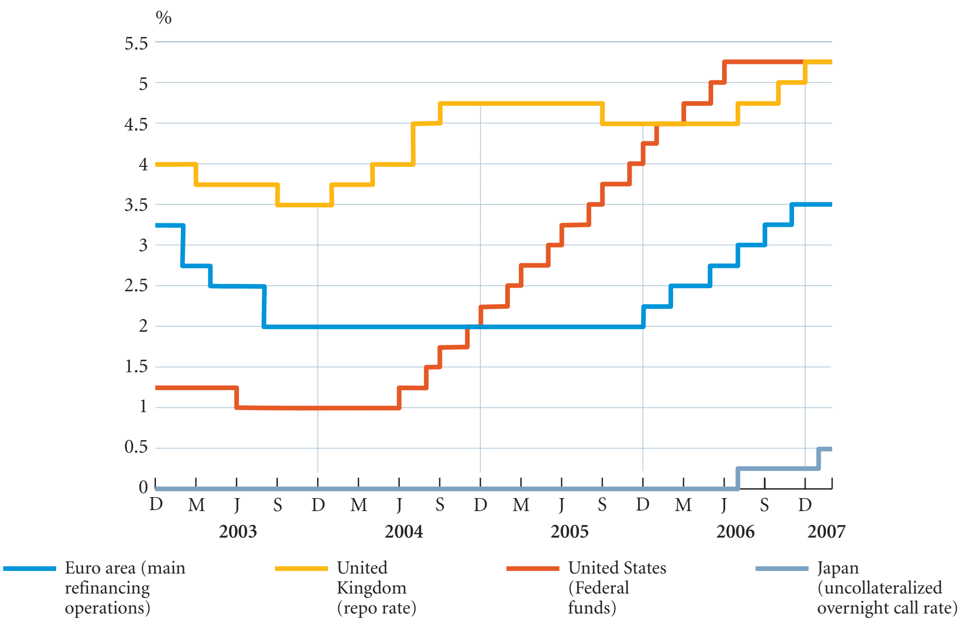
Bank of Japan raises reference rate

The Bank of Japan finally decided to raise its interest rates in the third week of February. After confusing the markets in January when nearly all operators were expecting a rise, this time the Japanese monetary authority stopped vacillating and declared an increase of 25 basis points in its reference rate putting it at 0.50%. This was the second upward move since it began its restrictive turn in July 2006. The argument given by the Japanese central bank was the good macroeconomic results in the fourth quarter published a few days beforehand. While it is true that inflation scarcely exists, the monetary authority believes that the economy will continue to grow at a moderate rate. The central bank chose a gradual path for raising its interest rates so that the official rate will probably stay at 0.50% for some months.

The same thing will likely happen in the United States where no changes are expected in coming months. The message given out by the US monetary authority is to maintain the objective of the overnight interbank rate at 5.25%, a level resulting from the balance between the improvement in the economic situation and the problems affecting the real estate market. In his appearance before a Congress committee in mid-

CENTRAL BANKS RAISE THEIR RATES

Monetary policy reference rates



SOURCE: National central banks.

February, Ben Bernanke, chairman of the Federal Reserve, stated that inflation was tending to drop but indicated that the Fed would maintain an upward bias in monetary policy, that is, over the long term they could end up raising the interest rate.

British rates also point to a rise. On February 8, the Monetary Policy Committee of the Bank of England decided to maintain the official interest rate at 5.25%. In contrast to its meeting in January, when the increase in the interest rate caught the markets unprepared, this was no surprise and later on prospects of further increases somewhat cooled off. Nevertheless, as expected by the market, some rise is likely in coming months in order to contain inflationary pressures.

At its meeting in the second week of February, the European Central Bank (ECB) did not modify its reference rate level but left it at 3.50%. Chairman Trichet, however, repeated that the level of interest rates was still low and that monetary policy was easy and pointed to a further rise in reference rates in March. While the rise in crude oil prices in recent years has not had significant pass-

Expected increase in Eurosystem interest rate in March certainly will not be last.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euríbor (5) 3-month	Euríbor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2006									
January	2.30	2.51	2.83	4.26	4.60	0.10	4.50	4.60	1.01
February	2.31	2.60	2.91	4.50	4.76	0.11	4.50	4.58	1.09
March	2.56	2.72	3.11	4.54	4.92	0.12	4.50	4.59	1.21
April	2.58	2.79	3.22	4.75	5.07	0.13	4.50	4.63	1.28
May	2.58	2.89	3.31	5.00	5.18	0.19	4.50	4.70	1.40
June	2.76	2.99	3.40	5.03	5.38	0.31	4.50	4.73	1.48
July	2.80	3.10	3.54	5.25	5.50	0.40	4.50	4.73	1.53
August	2.98	3.23	3.62	5.25	5.42	0.44	4.73	4.94	1.61
September	3.03	3.34	3.72	5.25	5.38	0.44	4.75	5.03	1.74
October	3.23	3.50	3.80	5.25	5.37	0.44	4.75	5.13	1.85
November	3.31	3.60	3.86	5.25	5.37	0.48	4.93	5.23	1.90
December	3.50	3.68	3.92	5.25	5.36	0.53	5.00	5.29	2.02
2007									
January (*)	3.56	3.75	4.06	5.25	5.36	0.55	5.16	5.49	2.15
February (1)	3.55	3.85	4.12	5.25	5.36	0.66	5.25	5.54	2.22

NOTES: (*) Provisional figures.
(1) February 23.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 1-12-05 (2.25%), 2-3-06 (2.50%), 8-6-06 (2.75%), 3-8-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%).
(3) Latest dates showing change: 9-8-05 (3.50%), 20-9-05 (3.75%), 1-11-05 (4.00%), 13-12-05 (4.25%), 31-1-06 (4.50%), 28-3-06 (4.75%), 10-5-06 (5.00%), 29-6-06 (5.25%).
(4) Latest dates showing change: 5-2-04 (4.00%), 6-5-04 (4.25%), 10-6-04 (4.50%), 5-8-04 (4.75%), 4-8-05 (4.50%), 3-8-06 (4.75%), 9-11-06 (5.00%), 11-1-07 (5.25%).
(5) Interbank offer rate.
SOURCE: National central banks, Thomson Financial Datastream and own calculations.

Central banks of India and Sweden tighten monetary policy.

through effects, the ECB expressed its concern about the outcome of wage negotiations underway. Given that the European economy seems to keep growing more than expected, it is possible that the rise in March will not be the last in this round. With this rise the reference rate could go to 4%, a point closer to the neutral level.

The institution that did decide to act once more was the central bank of India, that was alarmed by signs of overheating of the economy. At the end of January, among other restraints on monetary policy, it decided to raise the repo rate by 25 basis points to 7.5%. The Indian economy is growing more than expected and the central bank raised its own growth projections for the year ending March 2007 to 8.5%-9%, which increases inflation risks. In addition, in mid-February the Bank of Sweden again raised its reference rate by 25 basis points to 3.25% bringing it close to the euro area level.

G-7 meeting puts no obstacles in way of bigger drop in yen...

Main Asian currencies remain undervalued

...and this continues under pressure from broad interest rate differential working against it.

There were expectations that the summit of finance ministers from the group of most industrialized countries (G-7) in Essen, Germany, at the end of the second week of February might deal with exchange rates. Beforehand, a number of European leaders had voiced concern about the weakness of the yen. The Japanese currency had marked up an all-time low against the euro in the fourth week of January when it was running at 158.1 yen. Nevertheless, it was not expected that the G-7 would adopt any measures in this matter seeing that differing positions were being taken. Leaders from the United States seemed more troubled about the trend in the Chinese yuan while Japanese figures stated that they would not intervene in foreign exchange markets. While this is true, indeed pressure was put on the Bank of Japan not to raise interest rates and it is the unfavourable differential in this respect that constitutes the main cause of the low exchange rate of the yen at this time.

In fact, in January the yen recorded the lowest level in real effective terms (taking inflation into account) since September 1985, which is indicative of the undervaluation of the Japanese currency. Nevertheless, the statement issued by the G-7 did not mention the yen directly although it expressed its confidence that the market would finally reflect the recovery of Japan's economy. At the same time, the G-7 repeated its call on China to make its exchange rate more flexible. The moderate position taken by the G-7 did not have much effect on foreign exchange markets. On February 14, the yen recorded a further low against the euro (158.6 units) while at the end of the fourth week in January it was running at more than 159 to the euro.

With regard to the dollar, the Monday following the G-7 meeting the yen marked up its lowest level since December 2002 with a rate of 121.9 to the dollar although it later somewhat recovered due to the weakness of the dollar and publication of higher than expected economic growth in the fourth quarter of 2006. It went to a rate of 119 yen to the dollar at mid-month. The increase in the Bank of Japan reference rate mentioned above will probably not be enough to avoid downward pressure on the yen.

Increase in trade deficit has negative effect on dollar.

In turn, in recent weeks the dollar has lost the gains made in the early stages of the year. One reason for this was the easing of

EXCHANGE RATES OF MAIN CURRENCIES

January 2007

	Final session of month		Monthly figures				*Exchange rate February 23, 2007*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2) Monthly	Over December 2005	Annual	
Against US dollar							
Japanese yen	120.9	1.6	120.4	2.5	2.5	4.1	121.1
Pound sterling (1)	1.964	0.3	1.959	–0.2	–0.2	10.9	1.963
Swiss franc	1.245	2.1	1.243	2.7	2.7	–2.8	1.232
Canadian dollar	1.177	1.0	1.176	1.9	1.9	1.6	1.160
Mexican peso	11.04	2.2	10.95	0.9	0.9	3.8	11.03
Nominal effective index (4)	*107.7*	*0.8*	*107.6*	*0.8*	*0.8*	*–2.4*	*106.9*
Against euro							
US dollar	1.295	–1.6	1.301	–1.5	–1.5	7.5	1.313
Japanese yen	157.3	0.2	156.6	1.0	1.0	12.0	159.4
Swiss franc	1.621	0.9	1.615	1.1	1.1	4.2	1.626
Pound sterling	0.663	–1.2	0.664	–1.3	–1.3	–3.2	0.669
Swedish krona	9.052	0.1	9.078	0.5	0.5	–2.5	9.306
Danish krone (3)	7.455	0.0	7.454	0.0	0.0	–0.1	7.455
Polish zloty	3.927	2.5	3.877	1.7	1.7	1.5	3.882
Czech crown	28.16	2.5	27.82	0.2	0.2	–3.1	28.33
Hungarian forint	257.2	2.2	253.8	0.0	0.0	1.2	252.3
Nominal effective index (5)	*104.9*	*–0.6*	*104.9*	*–0.6*	*–0.6*	*3.5*	*105.8*

NOTES: (1) Units to pound sterling.
(2) Percentages of change refer to rates as shown in table.
(3) Danish krone has central parity of 7.46038 against euro with fluctuation band of ±2.25%.
(4) Broad nominal effective index of US Federal Reserve Board. Calculated as a weighted average of the foreign exchange value of the US dollar against the 26 currencies of those countries with greatest volume of trade with the United States. Base: 1-1997 = 100.
(5) European Central Bank nominal effective exchange rate index for the euro. Calculated as a weighted average of the bilateral value of the euro against the currencies of the 23 main trading partners of the euro area. Base: I-1999 = 100.
SOURCE: Thomson Financial Datastream and own calculations.

prospects on interest rates as a result of publication of moderate economic indicators and the Congress appearance of Ben Bernanke, chairman of the Federal Reserve, which was interpreted by the market in calming terms with regard to inflation. At the same time, the increase in the trade deficit in December also had a negative effect on the dollar.

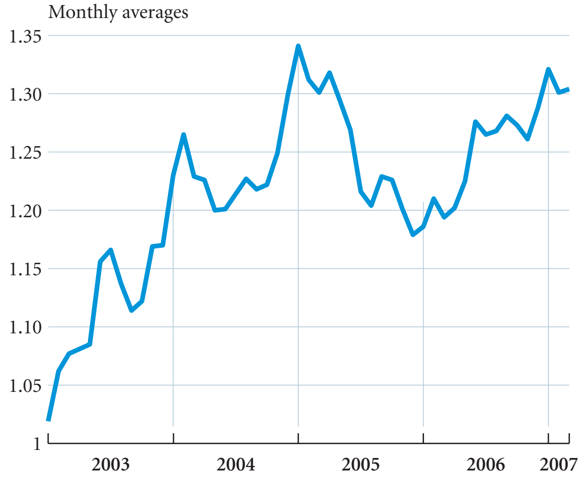
On the other hand, the euro has recovered strength in recent weeks helped by improved economic prospects and consolidation of an upward trend in interest rates. As a result, in relation to the basket of currencies of its main trading partners, the single currency recovered the level held at the beginning of the year. Against the greenback, the euro went back to the level of 1.31 dollars.

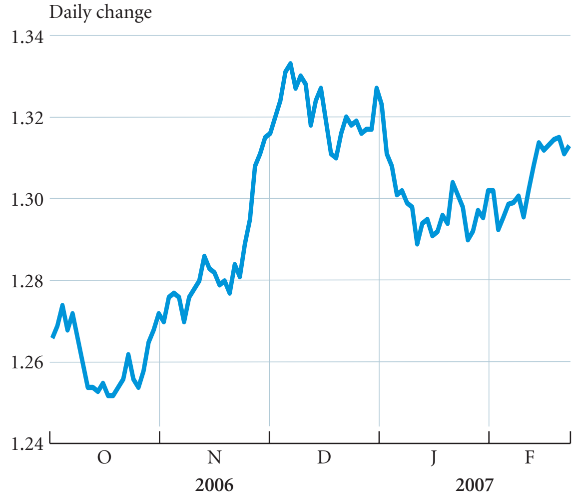
Pound sterling losses shine with drop in upward expectations on interest rates.

On the other hand, in recent weeks the pound sterling has lost some of its shine. This was mainly due to the cooling off of upward expectations on the Bank of England's official interest rate as a result of more moderate forecasts for economic activity and inflation.

EURO REACTS AGAINST DOLLAR

US dollars to euro

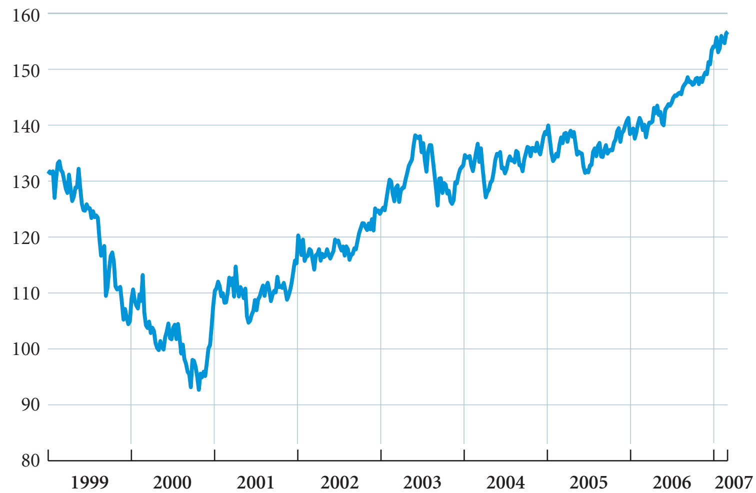




NOTES: Figures go up to February 23.
SOURCE: OCDE, Thomson Financial Datastream and own calculations.

SINGLE CURRENCY MARKS UP NEW RECORD AGAINST YEN

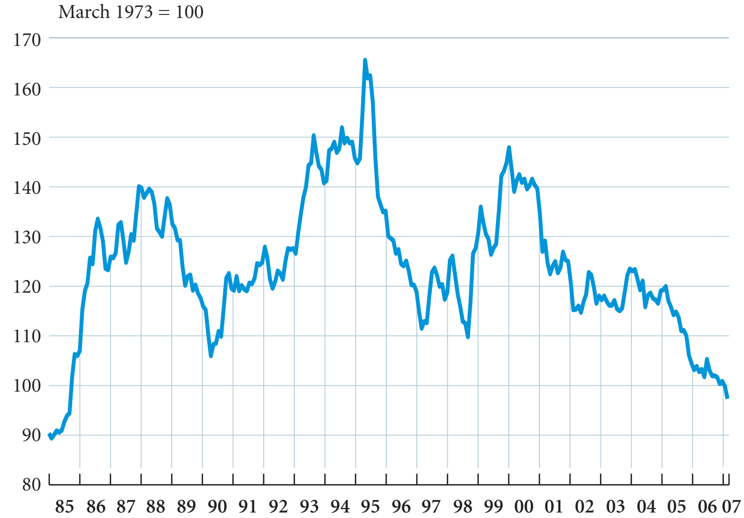
Yen to euro



NOTES: Figures go up to February 21.
SOURCE: Thomson Financial Datastream.

YEN DROPS TO LOWEST LEVEL IN LAST 21 YEARS IN REAL TERMS

Index of effective real exchange rate of yen at Bank of Japan



NOTES: Figures go up to January.
SOURCE: Thomson Financial Datastream.

Slight drop in yield on US Treasury bonds

The yield on US 10-year Treasury bonds moved up to 4.89% toward the end of January with the holding off of an expected cut in interest rates by the Fed. Nevertheless, just a few days later, lower than expected job creation in January took away optimism about the economy and the yield on long-term Treasury bonds tended to drop. A more contained prospect for inflation also contributed to a slight drop in long-term bond interest rates to around 4.7% in the fourth week of the month.

In the euro area, bonds followed the trend in similar instruments on the other side of the Atlantic. Nevertheless, in recent weeks downward pressure has not been as strong as a result of the favourable macroeconomic figures and the more aggressive tone of statements by the European Central Bank. As a result, the long-term interest rate differential between the dollar and the euro tended to narrow going to less than 70 basis points.

Situation of contained inflation brings about downward slide in yield on US Treasury bonds.

In addition, with the raising of the credit rating on Indian bonds to the BBB level by Standard & Poor's rating agency the Asian giant moved into the category of average quality credit rating, according to all the main rating agencies. This reflects the improvement in the economic situation of the sub-continent which, as indicated earlier, is now undergoing sharp growth.

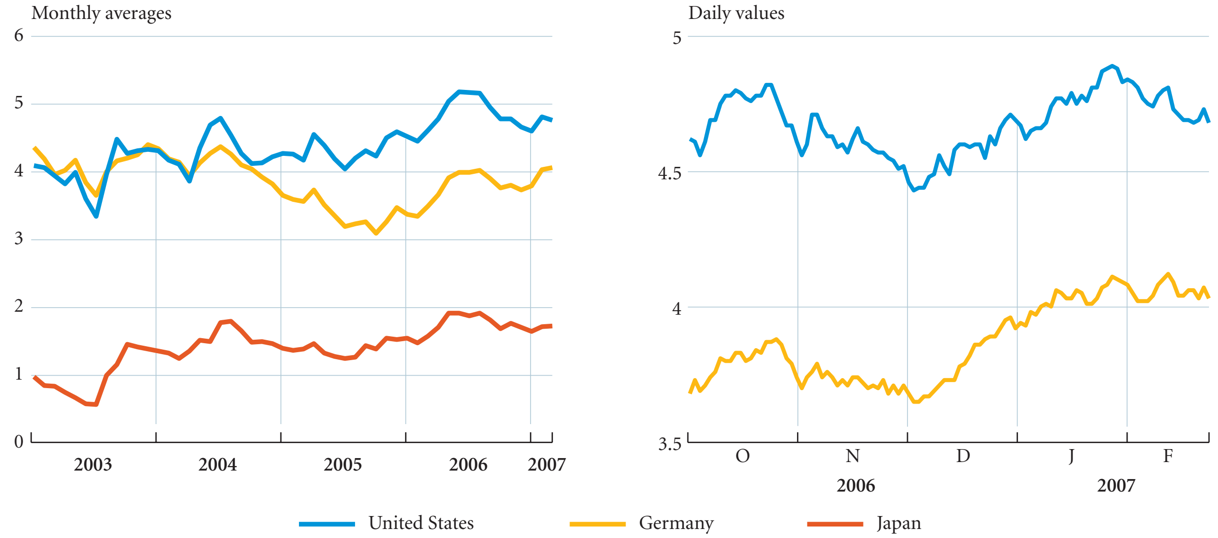
Indian bonds move up to average quality credit rating.

On the other hand, aversion to risk is holding at very low levels. In the second-last week in February, the risk premium on sovereign bonds of emerging countries marked up a new all-time low level at 164 basis points. In turn, the risk premium on corporate bonds also stood at low levels.

Aversion to risk holds at very low levels.

NARROWING OF LONG-TERM INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO

Yield on 10-year government bonds as annual percentage



NOTES: Interest rates go up to February 23.
SOURCE: Bank of Spain and Thomson Financial Datastream.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

10-year government bonds: average for period as annual percentage

	2004	2005	2006				2007	
			1Q	2Q	3Q	4Q	January	February 23
United States	4.31	4.33	4.61	5.13	4.96	4.68	4.81	4.68
Japan	1.50	1.39	1.58	1.90	1.80	1.70	1.71	1.67
Germany	4.07	3.38	3.50	3.96	3.89	3.77	4.03	4.03
France	4.10	3.41	3.51	3.99	3.90	3.78	4.06	4.09
Italy	4.24	3.56	3.71	4.27	4.18	4.03	4.24	4.25
Spain	4.10	3.39	3.49	3.97	3.89	3.79	4.07	4.09
United Kingdom	4.93	4.47	4.23	4.65	4.67	4.65	4.93	4.89
Switzerland	2.57	2.04	2.18	2.67	2.61	2.38	2.55	2.58

SOURCE: Bank of Spain, Thomson Financial Datastream and own calculations.

Growth of profits, lower long-term interest rates and drive in corporate mergers and take-overs enliven stock markets.

Stock exchanges inspire optimism

In the early months of the year, international stock exchanges have shown a favourable trend marking up new all-time highs in many cases. The prospect of a continuation of growth in the world economy and in corporate profits, the easing of long-term interest rates, some containment of oil prices and the drive in corporate mergers and take-overs has enlivened the stock markets.

In the United States, with the possibility of a «soft landing» for the economy growing stronger thus side-stepping the

INDICES OF MAIN WORLD STOCK EXCHANGES

January 31, 2007

	Index (*)	% monthly change	% cumulative change	% annual change	Quote on February 23, 2007: % cumulative change	Quote on February 23, 2007: *% change over same date in 2004*
New York						
Dow Jones	*12,621.7*	*1.3*	*1.3*	*16.2*	*1.5*	*19.2*
Standard & Poor's	*1,438.2*	*1.4*	*1.4*	*12.4*	*2.3*	*27.2*
Nasdaq	*2,463.9*	*2.0*	*2.0*	*6.9*	*4.1*	*25.3*
Tokyo	17,383.4	0.9	0.9	4.4	5.6	67.3
London	6,203.1	–0.3	–0.3	7.7	2.9	41.5
Euro area	4,178.5	1.4	1.4	13.2	3.1	46.0
Frankfurt	*6,789.1*	*2.9*	*2.9*	*19.6*	*6.0*	*71.9*
Paris	*5,608.3*	*1.2*	*1.2*	*13.3*	*3.2*	*53.2*
Amsterdam	*499.8*	*0.9*	*0.9*	*10.9*	*3.1*	*41.9*
Milan	*32,483.0*	*1.9*	*1.9*	*16.8*	*3.4*	*59.1*
Madrid	*14,553.2*	*2.9*	*2.9*	*31.1*	*4.4*	*79.1*
Zurich	9,135.1	4.0	4.0	17.0	5.4	57.4
Hong Kong	20,106.4	0.7	0.7	27.6	3.7	50.5
Buenos Aires	2,070.6	–0.9	–0.9	15.4	5.4	83.6
São Paulo	44,641.0	0.4	0.4	16.3	3.5	115.7

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

real estate recession, the stock markets recovered strength. The Dow Jones index continue to climb to new all-time high levels. The broader Standard & Poor's 500 index came closer and closer to the high in 2000. The Nasdaq index made a notable advance in the early weeks of 2007 thanks to the positive performance of high-tech shares, although it stands far from the levels in 2000. In any case, the sectors showing a better result so far this year were those for materials and public utilities. At the other end of the scale, energy companies showed a drop compared with the end of 2006, because of the drop in the price of crude oil.

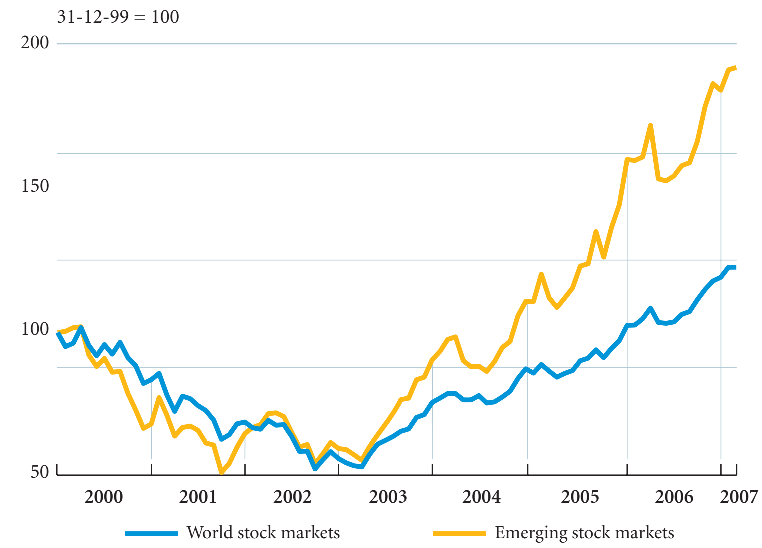
In the euro area, the improved economic growth forecasts naturally have pushed the markets up. Moves to consolidate the European market, as in the case of the electrical power sector, has continued to boost the markets. The DJ Eurostoxx 50 index, which includes the largest companies in the euro area, rose by more than 3% at the end of the fourth week in February. Among the main markets, the biggest increase over December showed up in the German stock market.

Spanish stock market stands among leading group in Europe.

The Spanish stock market also stood among the leading group of European markets to show a notable rise along with new all-time highs. The new taxation situation on savings gave a boost to stock market trading, including shares of many smaller companies, which are more speculative.

INTERNATIONAL STOCK MARKETS CONTINUE TO MARK UP ALL-TIME HIGHS

Indices in dollars



NOTES: Rates go up to February 23.
SOURCE: Thomson Financial Datastream, Morgan Stanley Capital International and own calculations.

Emerging market stock exchanges again active following drop in January.

The Swiss stock market also recorded new all-time highs in a situation of very low interest rates. Once the rise in the Bank of England official interest rate had been assimilated, the British market regrouped positions in January going to the highest level since 2000, a reflection of the good state of the United Kingdom economy.

In Asia, the Nikkei 225 index for the Tokyo stock exchange continued to gain strength helped along by gains among exporting companies who had the benefit of an extraordinarily weak yen. The rise in the Bank of Japan reference rate in the third week of February brought only a slight transitory dip. We should mention that, in spite of the rise in recent years, the Nikkei 225 index has still not reached half of the high recorded at the end of 1989.

After showing decreases in January as a result of the drop in raw materials prices, stock exchanges in emerging markets recovered in February, going to new high levels in general terms. Toward the end of January, the Chinese stock market suffered a sharp drop as a result of rumours about whether the authorities would act to cool off stock market fever and this meant it lost par for the year. Nevertheless, it later managed to gain momentum and marked up new all-time highs.

SPAIN: OVERALL ANALYSIS

Economic activity

Balance for 2006: more growth and lower imbalances

In the fourth quarter of 2006, the gross domestic product (GDP) generated by Spain's economy grew by 4.0% year-to-year, two decimals more than in the previous quarter, thus keeping up the growth path begun three years ago. In 2006 as a whole, total growth of the GDP rose to 3.9% year-to-year, four decimals higher than in 2005. This growth rate is much higher than that reported in neighbouring countries (more than one percentage higher than the euro area as a whole). The most positive feature, however, is that this major increase in economic activity was accompanied by increased containment of the Spanish economy's chronic imbalances. Prices were down and productivity improved and the foreign deficit tended to moderate.

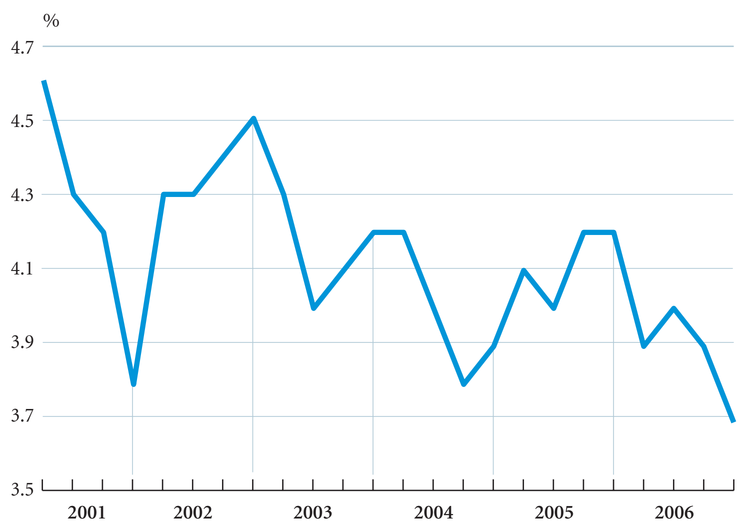
GDP grows 3.9% in 2006, going more than one point above increase in euro area.

This is still a clearly insufficient correction but it goes in the right direction. National demand moderated, with a contribution to GDP growth of 4.9 points (three decimals less than in 2005) while, at the same time, the negative contribution of the foreign sector dropped to one point (seven decimals less) as a result of increased growth of exports higher than in the case of imports. Nevertheless, this improvement failed to stop a further increase in the foreign deficit (above 82.9 billion euros, around 8.5% of the GDP), but did so at a more moderate rate (growth of 23% as against 37% in 2005).

Growth of national demand eases along with drop in negative contribution from foreign sector.

RISE IN PRICES SLOWING DOWN

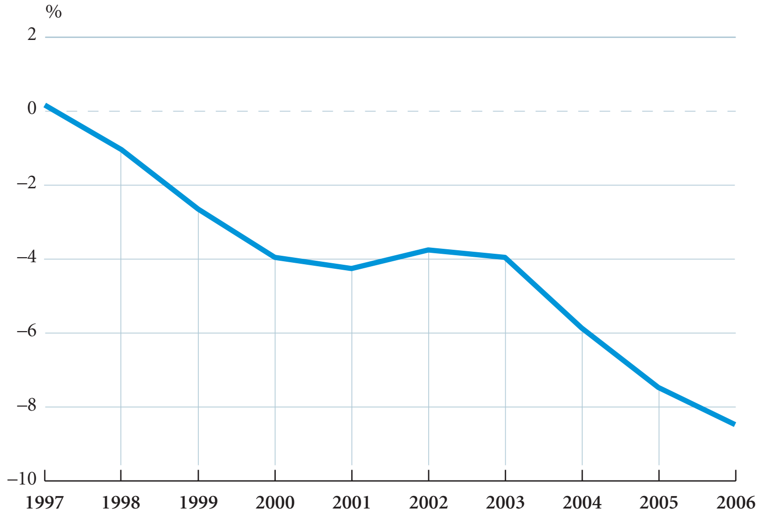
Year-to-year change in GDP deflator



SOURCE: INE and own calculations.

FOREIGN DEFICIT CONTINUES TO RISE BUT MORE MODERATELY

Current account deficit over GDP



SOURCE: INE and own calculations.

Rise in private consumption moderates but recovers greater strength toward year-end.

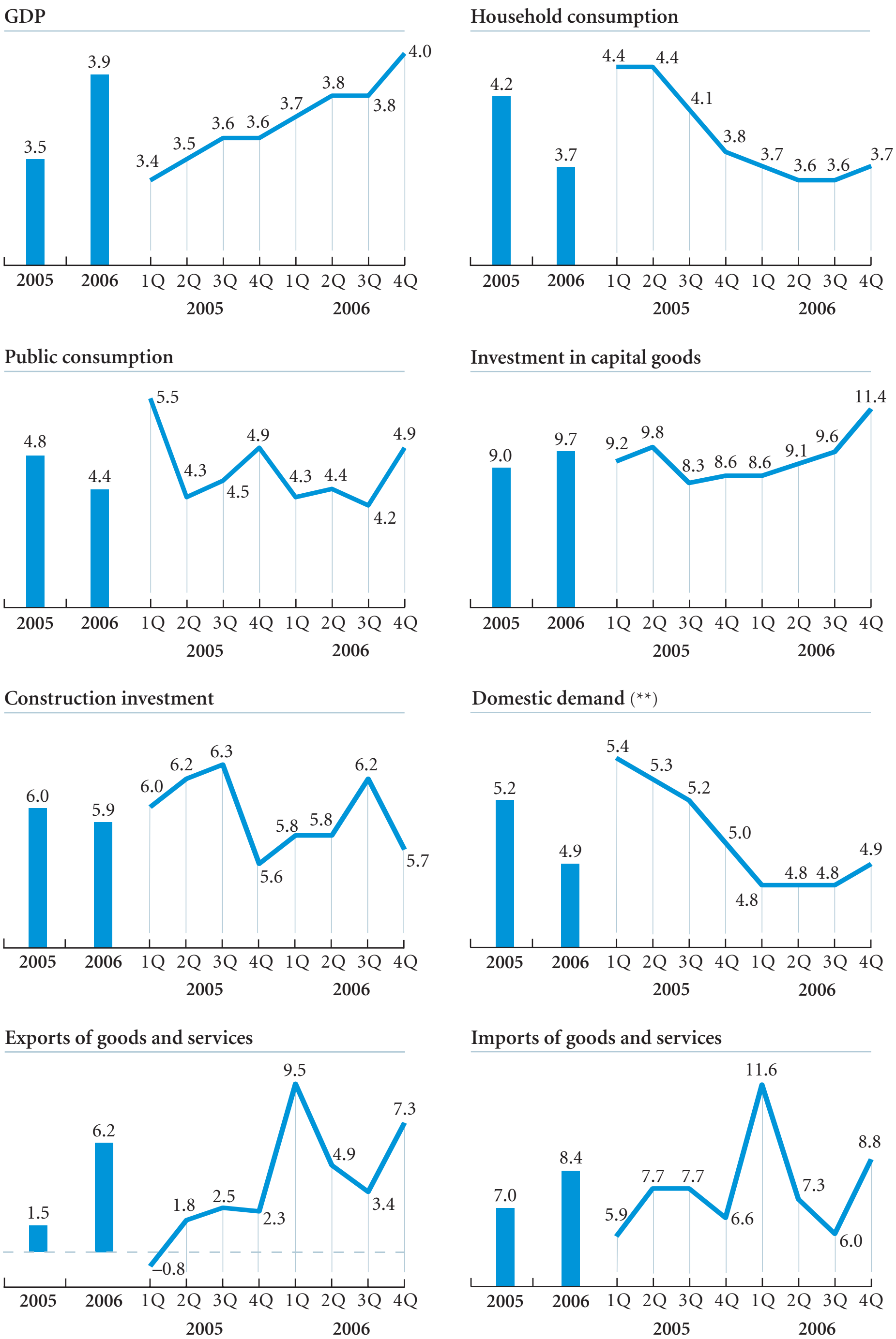
In the year as a whole, final household consumption decreased its growth rate to 3.7% (five decimals less than in 2005) due mainly to lower consumption of consumer durables (passenger car sales were down 2.0%). Nevertheless, there was an uneven performance during the course of the year. In the first half-year growth tended to ease slightly but toward year-end it took on greater strength. At the beginning of 2007 we are seeing a similar pattern. The few figures available show a growth sign (in January passenger car and four-wheel-drive vehicle registrations were up 2.7% year-to-year) in spite of the fact that consumer confidence has somewhat worsened (a drop to –12 points).

Public consumption grew by 4.4% (as against 4.8% in 2005) showing a very uneven performance in the course of the year. We should point out the big rise in spending in the final quarter (with an increase of 4.9% year-to-year) mainly due to a rise in wages of public servants.

In overall terms, the growth rate of gross capital formation also slowed in 2006 going to 6.3% (seven decimals less than in 2005) although two of its components, investment in capital goods and construction, enjoyed a fairly expansionist performance. The former increased growth to 9.7% (as against 9.0% the year before) while the latter showed lower growth (5.9%), only one decimal less than in 2005. On the other hand, investment in other products was down significantly (3.2% as against 7.5% in 2005).

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-to-year change (*)



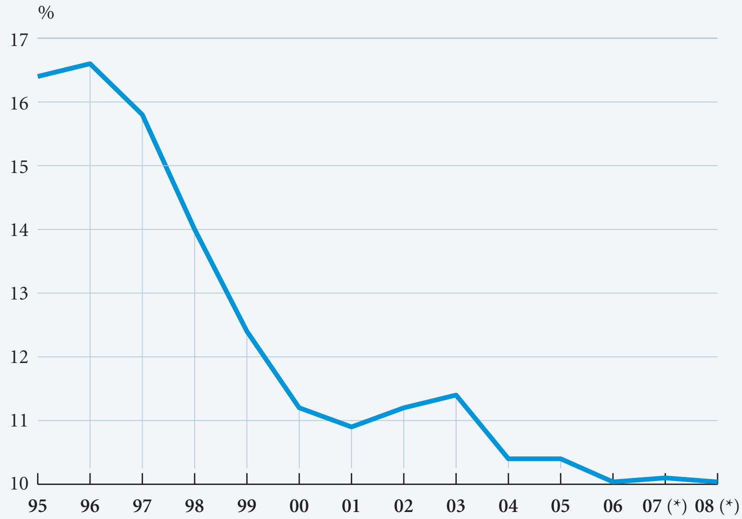
NOTES: (*) Figures adjusted for seasonal and calendar effects.
(**) Contribution to GDP growth.
SOURCE: National Institute of Statistics.

The roaring 2000s: consumption and wealth grow fast

There is no doubt the last 10 years have brought an economic boom to Spain. As part of that boom, household consumption has been growing at an annual average rate of 7% in nominal terms. Nevertheless, the savings rate has been dropping year after year (as shown in the following graph) and now represents only 10% of disposable income.

HOUSEHOLD SAVINGS AT VERY LOW LEVELS

Household savings in terms of gross disposable income



NOTES: (*) Forecasts.
SOURCE: Organization for Economic Cooperation and Development.

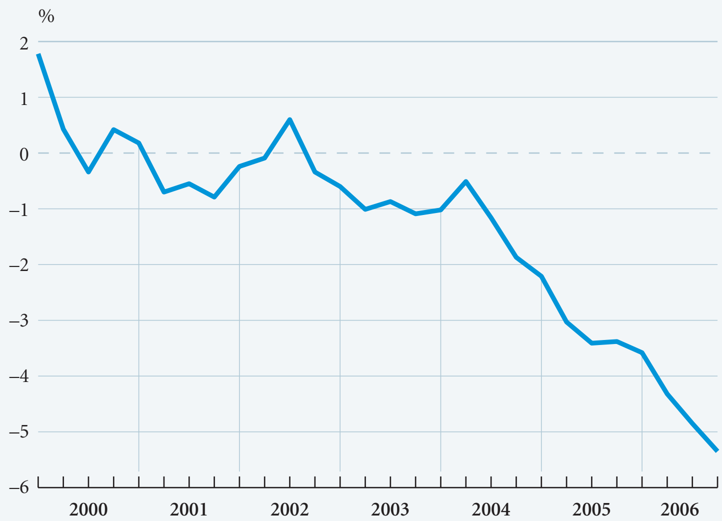
Furthermore, over the past decade credit has been growing at an average annual rate of 17% partly due to the rise in consumer credit but especially thanks to the sharp increase in mortgage loans, meaning that the little being saved in Spain is going into investment in housing (see following graph).

The economic situation in Spain has been characterized by sharp growth in consumption and credit as well as by low household savings, with figures that remind us of those of the 1920's. The problem is that the roaring twenties did not have a happy ending. It is therefore worth analysing the reasons that brought us here as well as the sustainability of this situation.

Historically, economists have considered the study of saving and consumption decisions as one of the priorities on their agendas. The main theories held today are still inspired by the *Life-Cycle Theory*, set out in 1954 by the Nobel prize-winner Franco Modigliani, and the *Permanent Income Hypothesis* put forward three years later by Milton Friedman, also a Nobel prize-winner. Both pointed out that consumption is largely determined by income and the capital gains each individual hopes to obtain during a lifetime, thus emphasising the time factor as part of the nature of the decision. In this context, households pace the course of their consumption adjusting savings from one period to the next. One of the immediate consequences is that consumption

SAVINGS DOES NOT COVER HOUSING LOAN PAYMENTS

Household savings after mortgage loan payments in relation to gross disposable income (cumulative figure for last four quarters)



SOURCE: Bank of Spain and own calculations.

becomes independent of current income and its transitory changes and is determined only by permanent and unexpected changes.

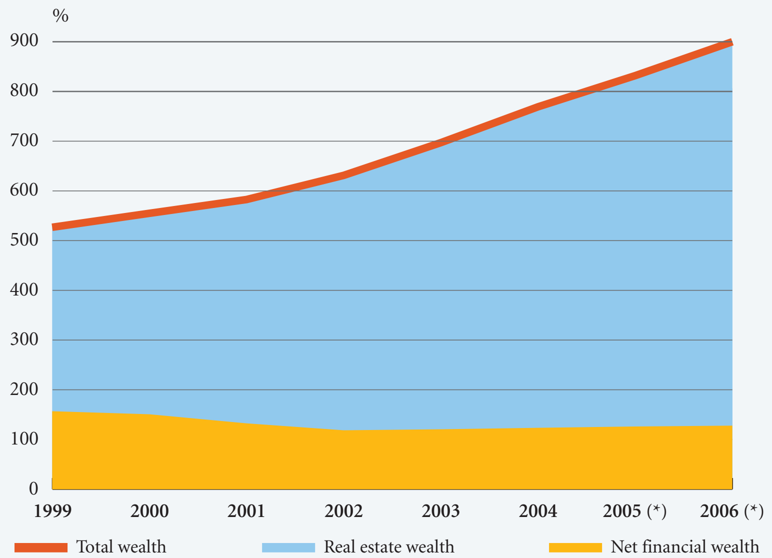
In Spain, an important structural change that has increased expected income, and that has thus boosted consumption, has been the sharp increase in the rate of activity of the labour force and the almost uninterrupted decrease in unemployment, which today stands at 8%, less than half that of 10 years ago. But the positive effects of the drop in unemployment are double in nature given that not only has it increased expected income but it has also reduced uncertainty in income thus making it possible for households to save less in order to meet possible negative eventualities. The reduction in uncertainty about future income also has been aided by less volatility in macroeconomic conditions, mainly thanks to a low stable inflation rate and a credible, and independent, monetary policy. These are factors which, helped by Spain's joining the European Union, are fundamental for understanding the other big structural change in Spain's economy that is also key in explaining the increase in consumption. This is the sharp drop in real interest rates, which has been a disincentive to savings and has fostered demand for credit.

Furthermore, the *Life-Cycle Theory* tells us that the average propensity to consume changes during a lifetime, being higher in youth and old age when incomes are lower. In this respect, the entry of the «Baby Boom» generation in the labour market also contributes to a drop in savings at the aggregate level. This effect is reinforced by the heavy inflow of immigrants given that the average age of those workers is 31 years.

At the end of the Seventies both theories were strongly criticized by the Neo-Keynesian school led by the Nobel prize-winner Joseph Stiglitz. The reason for this disagreement lies in that, by postulating that individuals can decide on consumption according to their lifetime earnings, it is assumed that everyone has access to the financial markets, an idea very hotly discussed at that time. The significance of that criticism lies in that, if there is no access to credit, not all households wishing to apply for a loan at this moment (because they are expecting higher income in the future) can do so and are therefore unable to spread out their consumption in an optimum way. Nonetheless, we should underline the enormous development that has taken place in Spain's financial system which in the past decade has increased its assets at an average annual rate of 12%, with an efficient management that has been able to reduce the default rate to all-time lows. This has facilitated the access of households to various credit instruments at low real interest rates and hence, it has amplified the effect of the «Baby Boom» and the immigration wave.

WEALTH OF SPANIARDS CONTINUES TO RISE

Household wealth in relation to corrected gross disposable income



NOTES: (*) Own estimates.
SOURCE: Bank of Spain and own calculations.

As mentioned at the beginning, another important aspect affecting the savings decision is capital gains. This is a key factor to understand the recent consumption decisions of households, given that, as may be seen in the above graph, the wealth of Spanish households has increased by 50% in the past 5 years. This increase has been possible thanks to the strength of financial wealth, which has remained stable, but especially due to the sharp rise in housing prices which has pushed up real estate wealth. The result is the solid housing portfolio of Spanish families, which has allowed consumption to increase, especially through credit, using real estate as collateral.

Spanish households have had enough reasons to increase consumption, both at the aggregate and individual level, but they should not forget that none of the factors mentioned earlier can be maintained indefinitely. Clearly, the «Baby Boom» is temporary, the major inflows of immigration can be expected to ease off, the financial system is now at a more mature level and the growth of housing prices is beginning to cool down, with its subsequent effects on wealth. Having reached this point, and so long as Spain does not manage to increase its productivity in a structural way, the Nobel-prize-winners Modigliani, Friedman and Stiglitz, with their theories at hand, would tell us that households will progressively adjust their savings rate, thus putting off any worsening, in order to adapt to the new economic situation in the same way they adapted to the new economic environment brought about by the adoption of the euro and the growth of employment.

Investment in capital goods gradually increased in growth during 2006, marking up a notable high in the fourth quarter (11.4%). In construction, housing construction and infrastructure works (mainly highways and rail works linked to the high-speed train) continued as driving forces of economic activity. Housing construction specifically rose by 6.4% (six decimals more than in 2005) but showed a downward trend over the year and ended up with a year-to-year increase dropping to 5.0% in the fourth quarter.

As indicated earlier, the improvement in the foreign sector was due to the strength of exports, especially in goods, which in 2006 showed an increase in growth (5.6% as against nil growth in 2005). This was proportionally higher than in services, which were up 7.5% as against 4.5% the year before. In the year as a whole, imports grew by 8.4%, some 1.4 points more than the year before.

On the supply side, the most notable factor in 2006 was the rise in gross value added in industry which was up 3.3% as against 0.3% in 2005. The growth rate in the sector increased during the year going to 4.4% year-to-year in the fourth quarter. Machine-building and manufacture of electrical equipment, electronic and optical equipment and, to a lesser extent, the automotive industry were the most dynamic branches in 2006. The textile, leather and clothing industries also showed some signs of recovery following the sharp drops recorded in previous years. Prospects for 2007 continue to be very favourable, if we are to go by the trend in the sector confidence indicator which moved up to three points in December 2006 repeating the same figure in

In 2006 as a whole, gross capital formation eases off...

...but investment in capital goods shows higher growth while construction investment down only one decimal.

DEMAND INDICATORS

Percentage change over same period year before

	2005	2006	2006						2007
			1Q	2Q	3Q	October	November	December	January
Consumption									
Production of consumer goods (*)	0.9	2.3	0.6	2.1	1.9	4.9	3.9	4.1	...
Imports of consumer goods (**)	7.9	8.9	20.5	5.9	2.4	13.6	8.9	0.3	...
Car registrations	0.8	–2.0	2.4	–4.3	–5.3	5.8	0.1	–5.5	1.1
Credit for consumer durables	15.0	15.4	17.6	15.6	13.2	–	...	–	–
Consumer confidence index (***)	–10.8	–12.3	–12.3	–12.7	–13.7	–11.0	–10.0	–10.0	–12.0
Investment									
Capital goods production (*)	–0.1	8.2	6.7	7.6	8.0	10.2	12.6	8.1	...
Imports of capital goods (**)	20.4	3.2	10.0	–5.0	6.5	31.5	–4.6	–8.1	...
Commercial vehicle registrations	13.2	1.5	7.4	–0.2	0.5	9.9	–0.2	–10.9	20.3
Foreign trade (**)									
Non-energy imports	6.0	9.0	13.7	4.7	8.9	17.5	9.7	0.9	...
Exports	0.2	5.6	12.7	3.7	1.7	9.3	0.1	5.2	...

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

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)

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

Industry consolidating recovery...

January, the first positive sign in many months.

Another notable point is the recovery of the positive growth path in the agricultural and fishing branches (mainly thanks to the sharp increase in the fourth quarter) following three consecutive years of negative figures.

...and primary sector branches recover positive growth path.

The trend in services in 2006 was very uneven. Non-market services increased growth to 4.0% (a half-point more than in 2005), in line with the increase in wages of public servants. On the other hand, market services showed a significant slowdown (3.4% as against 4.6% in 2005). Those branches related to financial operations, information technology, communications and company services were the most dynamic during the year as a whole. Retail trade and tourism also recorded significant growth although not as sharp

SUPPLY INDICATORS

Percentage change over same period year before

	2005	2006	2006						2007
			1Q	2Q	3Q	October	November	December	January
Industry									
Electricity consumption (1)	3.4	3.5	2.0	3.1	5.8	4.3	1.9	4.4	6.6
Industrial production index (2)	0.7	3.8	2.6	4.0	4.2	5.3	4.0	3.8	...
Confidence indicator for industry (3)	–4.8	–2.7	–5.3	–2.7	–2.3	–2.0	–2.0	3.0	3.0
Utilization of production capacity (4)	80.2	80.5	79.7	80.5	80.3	–	81.6	–	–
Imports of non-energy intermediate goods (5)	1.6	10.5	10.3	6.4	13.8	16.9	15.2	4.1	...
Construction									
Cement consumption	7.3	8.2	17.1	4.0	4.5	12.0	6.8	6.4	13.4
Confidence indicator for construction (3)	22.4	14.2	15.3	11.7	14.7	13.0	16.0	16.0	10.0
Housing (new construction approvals)	6.2	21.6	18.5	6.3	50.5	21.6	–4.1	...	...
Government tendering	18.5	28.3	15.1	34.8	19.3	58.3	43.7	...	...
Services									
Retail sales	4.4	5.0	5.2	3.8	5.9	4.2	5.9	5.3	...
Foreign tourists	6.6	4.5	1.1	9.6	3.7	3.6	1.4	1.8	4.0
Tourist revenue inflows	5.8	0.1	–7.6	3.0	3.9	–3.9	–3.6	...	...
Goods carried by rail (km-tonnes)	–3.2	–0.3	8.1	–2.7	–3.3	–4.4	–4.1	...	...
Air passenger traffic	9.2	6.7	5.2	10.1	4.5	6.1	6.4	9.2	6.7
Motor vehicle diesel fuel consumption	5.1	5.8	8.7	4.5	3.9	8.5	4.4	...	...

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

as in those economic activities mentioned above.

Uneven performance in services. Non-market services slow growth rate.

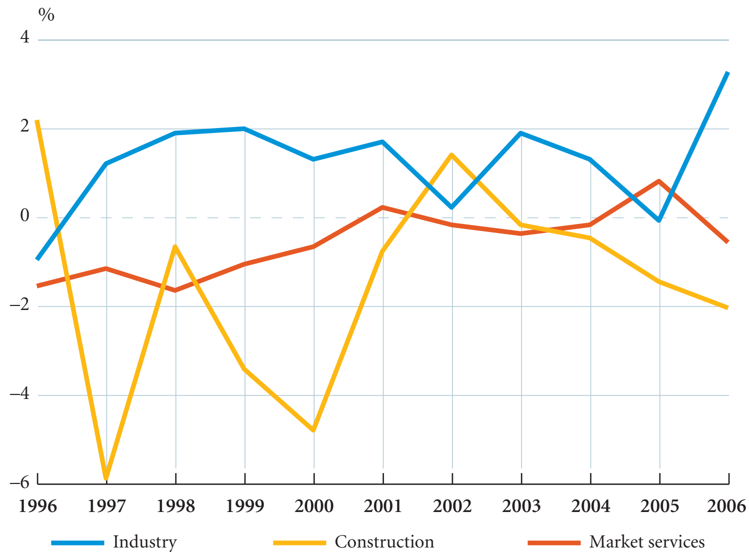
The rate of increase in employment showed a decreasing profile during the year although annual growth, in terms of jobs equivalent to full-time work, repeated the 3.1% reported in 2005, thus being lower than real growth of the GDP. As a result, apparent productivity of the labour factor improved somewhat, showing an increase of 0.8%, twice that for the year before. This increase, however, was entirely due to the trend in industry, which showed a sharp increase in activity without any substantial change in average employment. In other groups of economic activity, gains in productivity were non-existent.

Apparent improvement in labour productivity due only to performance in industry.

Finally, we should point out that wages showed an increase in growth rate to 6.8%, seven decimals more than in 2005, mainly due to the increase in average wages per worker. Along the same lines, labour cost per product unit showed an increase in growth going to 2.7%, five decimals more than in 2005.

SUBSTANTIAL IMPROVEMENT IN PRODUCTIVITY IN INDUSTRY

Change in GDP per job equivalent to full-time work



SOURCE: INE and own calculations.

Labour market

Employment growing, unemployment dropping

Figures from the Labour Force Survey for the fourth quarter of 2006 fall within the present excellent state of the labour market. In the quarter, figures went above the all-time high of 20 million persons employed, nearly 3.6% more than in the same period in 2005. Growth of employment made it possible to absorb the substantial increase in the labour force (3.1%) and to reduce estimated unemployment by 1.7%. Due to this improvement, the unemployment rate fell to 8.3%, the lowest rate at any year-end since 1979. In spite of this excellent result, the year-to-year growth rate of employment gradually slowed during 2006, keeping in mind that we are starting out from high rates in 2005. Nevertheless, this trend ended up moderating in the final quarter, a period when the annual growth rate fell by only one decimal compared with that for the previous quarter.

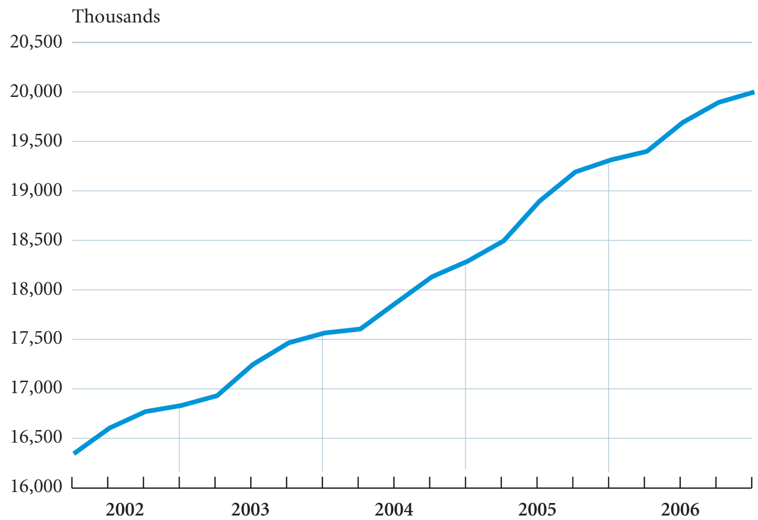
Employment records strong increase in 2006 while unemployment rate down to 8.3% at year-end.

The total number of persons registered with Social Security in 2006 showed a similar trend and there was even a slight increase in growth of registrations in the final months of the year, something that continued into January 2007. The total number of persons registered that month grew by 3.5% year-to-year, one decimal more than in December and two decimals above the average for the fourth quarter. From a sector point of view, the most notable aspect was the sharp rise in registrations in industry.

Slight increase in growth of total registrations with Social Security in recent months.

NUMBER OF EMPLOYED NOW ABOVE 20 MILLION

Labour Force Survey estimate of number of persons employed



SOURCE: National Institute of Statistics.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2004	2005	2006	2006 1Q	2006 2Q	2006 3Q	2006 4Q	2007 January
Persons registered with Social Security								
Wage-earners	2.7	4.8	4.7	6.3	5.3	3.9	3.5	3.7
Industry	*–0.5*	*–0.5*	*0.0*	*–0.3*	*0.0*	*0.0*	*0.2*	*1.3*
Construction	*5.6*	*8.6*	*8.7*	*11.0*	*9.5*	*7.5*	*6.8*	*6.5*
Services	*3.9*	*5.7*	*5.2*	*6.6*	*5.8*	*4.6*	*4.0*	*4.0*
Non-wage-earners	3.2	2.6	2.2	2.3	2.2	2.1	2.2	2.3
Total	**2.8**	**4.4**	**4.3**	**5.5**	**4.8**	**3.6**	**3.3**	**3.5**
Persons employed (*)	**3.9**	**5.6**	**4.1**	**4.9**	**4.2**	**3.7**	**3.6**	–
Jobs (**)	**2.6**	**3.1**	**3.1**	**3.2**	**3.1**	**3.0**	**3.0**	–
Hiring contracts registered (***)								
Permanent	11.8	8.7	41.1	25.6	16.1	46.6	76.8	59.9
Temporary	11.4	4.6	4.7	13.7	5.5	0.5	0.5	6.5
Total	**11.5**	**5.0**	**7.9**	**15.0**	**6.4**	**4.1**	**7.3**	**12.3**

NOTES: (*) Estimate from Labour Force Survey (changes for 2005 adjusted for impact of methodological changes).
(**) Equivalent to full-time work. National Accounting estimate; figures adjusted for seasonal effects and number of working days.
(***) At INEM.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, Employment Institute and own calculations.

546,000 net jobs created in 2006 and more than 5 million in past 10 years.

The total number of those registered in that sector grew by 1.3% year-to-year in January leaving behind the stagnation seen all through 2006. Construction and services, in turn, maintained a strong growth rate (6.5% and 4.0% respectively).

Over the whole year (from the 4th quarter in 2005 to 4th quarter in 2006) nearly 546,000 net jobs were created in terms of jobs equivalent to full-time work, according to the Quarterly National Accounts. With a different approach, the Labour Force Survey puts the increase in employed persons at 687,600, with participation of the foreign worker population close to 60%.

Total employment rate goes above 66% at end of 2006 but female rate still below 55%.

In the last ten years, Spain's economy has generated more than 5.3 million net jobs (in terms of National Accounting) with an annual growth rate of 3.4%, only 0.4 decimals less than average growth of the GDP. Nearly 26% of employment generated in that decade was taken up by the construction sector (which more than doubled in number of jobs), close to 67% went into services and around 7% were employed in industry, in spite of the drop in the latter sector in recent times.

At the end of 2006, the employment rate (the percentage of those employed over the total population between 16 and 64 years) reached 66.2%, even going above the objective set out in the Spanish National Reform Plan for 2010. Nevertheless, the female employment rate still stood at 54.8% (4.3 points more than one year earlier) holding well below the figure for the male group (77.4%, two points more than in 2005). Those autonomous communities with the highest employment levels are Madrid Community, Navarre and Catalonia,

ESTIMATED EMPLOYMENT

Fourth quarter of 2006

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	921.8	8.7	1.0	–85.0	–8.4	4.6
Non-farm	19,080.0	97.4	0.5	772.6	4.2	95.4
Industry	*3,319.8*	*31.7*	*1.0*	*31.3*	*1.0*	*16.6*
Construction	*2,623.2*	*33.1*	*1.3*	*200.4*	*8.3*	*13.1*
Services	*13,137.0*	*32.6*	*0.2*	*540.9*	*4.3*	*65.7*
By type of employer						
Private sector	17,093.8	101.8	0.6	647.5	3.9	85.5
Public sector	2,908.0	4.4	0.2	40.0	1.4	14.5
By work situation						
Wage-earners	16,466.1	100.2	0.6	624.4	3.9	82.3
Permanent contract	*10,897.4*	*192.9*	*1.8*	*406.1*	*3.9*	*54.5*
Temporary contract	*5,568.7*	*–92.7*	*–1.6*	*218.3*	*4.1*	*27.8*
Non-wage-earners	3,524.2	7.3	0.2	78.0	2.3	17.6
Entrepreneurs with employees	*1,087.8*	*–6.6*	*–0.6*	*58.3*	*5.7*	*5.4*
Entrepreneurs without employees	*2,195.4*	*28.1*	*1.3*	*43.8*	*2.0*	*11.0*
Family help	*241.0*	*–14.2*	*–5.6*	*–24.1*	*–9.1*	*1.2*
Other	11.4	–1.4	–10.9	–15.0	–56.8	0.1
By time worked						
Full-time	17,628.2	–14.2	–0.1	629.2	3.7	88.1
Part-time	2,373.6	120.4	5.3	58.3	2.5	11.9
By sex						
Males	11,831.3	–28.1	–0.2	281.7	2.4	59.2
Females	8,170.5	134.3	1.7	405.8	5.2	40.8
TOTAL	**20,001.8**	**106.1**	**0.5**	**687.6**	**3.6**	**100.0**

SOURCE: National Institute of Statistics and internal figures.

with employment rates close to 72% while at the other extreme stand Extremadura, Andalusia and Asturias, with rates below 60%.

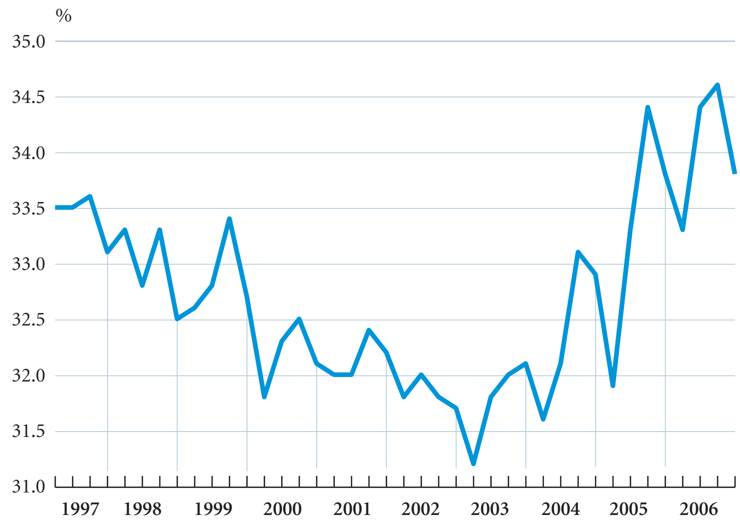
There is no doubt that the high rate of temporary work constitutes a major problem for the development of Spain's labour market. Has there been any significant improvement in this anomaly? In principle, following the measures taken last year to stimulate full-time work, there was an increase in the growth of the total number of wage-earners with permanent contract in the final quarter of 2006. In spite of this, however, the ratio of temporary work to all jobs dropped by only eight decimals compared with the previous quarter. It thus stood at 33.8%, the same level as at the end of 2005, as may be seen in the following graph.

One third of all jobs still temporary.

The segmentation of Spain's labour market (the precariousness of employment for a third of those working stands in contrast to the higher level of security for the rest) was again the centre of criticism by the

PROPORTION OF TEMPORARY JOBS REMAINS VERY HIGH

Workers with temporary hiring contract over total wages-earners



SOURCE: INE and own calculations.

Organization for Economic Cooperation and Development (OECD) which, in its latest report «Going for Growth 2007», among other things, advocated greater flexibility in conditions for permanent hiring contracts.

In any case, at the beginning of 2007, there was still an upward trend in permanent hiring contracts. In January, more than 255,400 of these contracts were signed, the highest figure in all the statistical history, with an increase of nearly 60% over the same month the year before. Nearly 77% of these contracts were for full-time work, with annual growth for this type of contract fairly similar to that for part-time work.

The drop in unemployment mentioned earlier was mainly in favour of the labour force of Spanish nationality which in the fourth quarter saw a drop in unemployment rate to 7.7% (0.8 points less than one year earlier). On the other hand, the unemployment rate among the foreign worker group rose to 12.0%, some 1.8 points more than in the fourth quarter of 2005. Unemployment continued to increase in greater proportion among those of low educational level. In the illiterate population, unemployment affected 16.4% of the labour force and dropped progressively as the level of education rose, going to 3.2% in the case of those with doctorates.

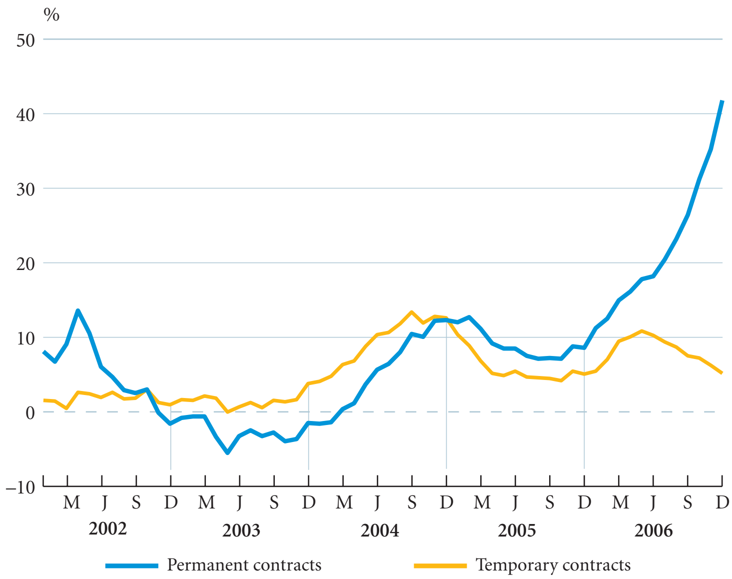
Female unemployment rate nearly twice male rate.

In addition, unemployment dropped in fairly similar proportions among males and females although the female unemployment rate (11.4%) was still nearly twice that for males (6.1%). If we look at distribution by age, we note a greater concentration of unemployment among the younger segments. Between 16 and 19 years it involved 31.1% of the population, a percentage that dropped substantially among older groups (below 6% as of 45 years of age).

From a geographical point of view, Extremadura, Andalusia and Canary Islands head the ranking for those autonomous communities with the highest unemployment rates (12.9%,

PERMANENT HIRING CONTRACTS CONTINUE TO INCREASE

Contracts registered at INEM: cumulative change in last 12 months compared with previous 12 months



SOURCE: Instituto de Empleo and own calculations.

ESTIMATED UNEMPLOYMENT

Fourth quarter of 2006

	No. of unem-ployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	763.8	3.5	0.5	–57.4	–7.0	42.2	6.1
Females	1,046.9	42.1	4.2	26.8	2.6	57.8	11.4
By age							
Under 25 years	434.1	0.9	0.2	–22.2	–4.9	24.0	17.8
Other	1,376.5	44.6	3.3	–8.5	–0.6	76.0	7.1
By personal situation							
Long-term unemployment	523.1	2.1	0.4	–34.1	–6.1	28.9	–
Seeking first job	201.8	–8.9	–4.2	–18.5	–8.4	11.1	–
Other	1,085.8	52.4	5.1	22.0	2.1	60.0	–
TOTAL	**1,810.7**	**45.6**	**2.6**	**–30.6**	**–1.7**	**100.0**	**8.3**

SOURCE: National Institute of Statistics and internal figures.

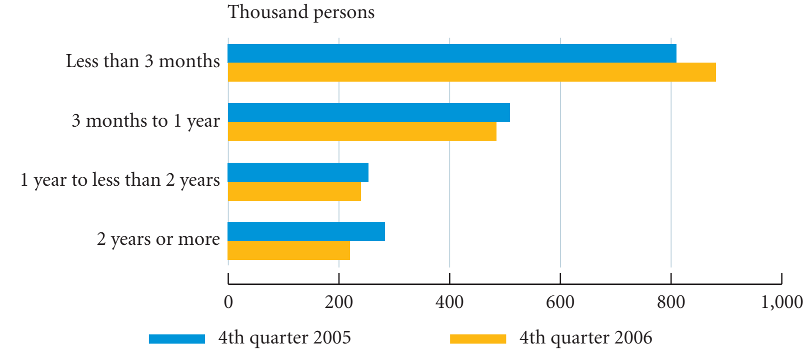
12.2% and 11.5% respectively) all much higher than the national average. Madrid Community and Catalonia, with 6.5% and 6.7% respectively, stood below the average. Cantabria, Aragon and Navarre round out the list with rates equal to or less than 6%.

Average time spent unemployed shows drop.

Finally, on a favourable note, it should be pointed out that unemployment was

LONG-TERM UNEMPLOYMENT DOWN

Unemployed according to time spent looking for work



SOURCE: National Institute of Statistics.

down most among those with the longest time spent actively seeking work, as may be seen in the previous graph. Also down significantly was the number of households where all persons were without work.

Registered unemployment tending downward

Downward trend in registered unemployment increasing.

Registered unemployment rose by 59,635 persons in January compared with the month before. This was, however, a purely seasonal increase, lower than in other years. In fact, in year-to-year terms, the decrease continued for the tenth consecutive month. Since January 2006, unemployment has dropped by 89,000 persons with the downward trend gradually sharpening.

In the past 12 months, unemployment has dropped more sharply in the male group (6.4%) than for females (2.6%) and for those under 25 years of age (12.0%) in comparison with all other ages (2.9%). In the same period, unemployment was down significantly in all production sectors although this was especially sharp in industry (7.0%) in line with the recovery taking place in that sector.

Prices

CPI gets face-lift

With the New Year comes a new life, or at least a face-lift. This is what happened to the consumer price index (CPI) at the beginning of 2007. The index has been remodelled in order to obtain greater accuracy in measuring price levels and more representative coverage. The CPI is thus adapting to market changes and consumer habits. For this reason, as was foreseen, the former CPI with base 2001 has given place to the new index with base 2006. This takes into account changes in the make-up of the shopping basket and more up-to-date weighting. Some articles have thus disappeared from the sample such as sewing fabrics, the consumption of which is now insignificant, while others, such as physiotherapy services and operations for aesthetic surgery and myopia, have been added. Furthermore, the number of municipalities in the sample has been increased to 177 (as against 141 for base 2001), with emphasis on small localities.

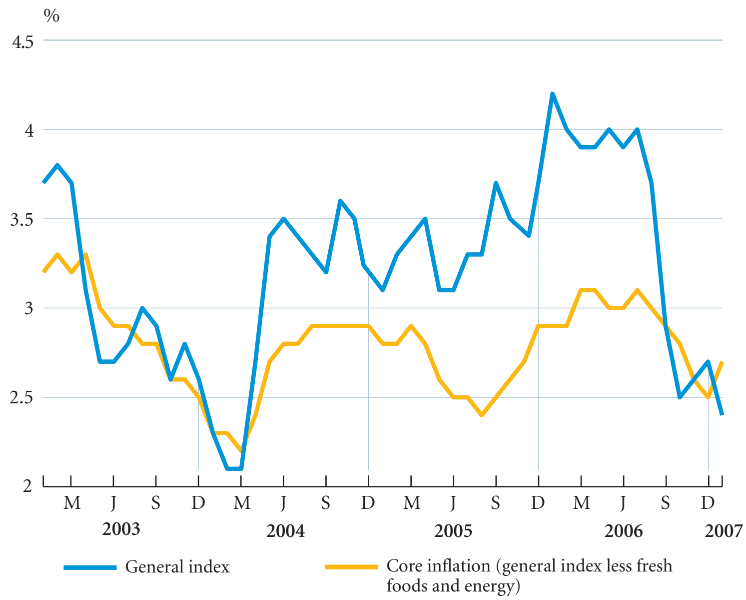
CPI adapting to market changes and consumer habits.

As if it were itself the result of an aesthetic surgery operation, the January CPI was much slimmer. To be specific, it was 3 decimals lower than in December in year-to-year terms, that is, 2.4%. This was the lowest rate since March 2004. Nevertheless, this positive trend was not due to the change in its

Inflation drops 3 decimals to lowest rate since March 2004.

DROP IN CPI IN SPITE OF RISE IN CORE INFLATION

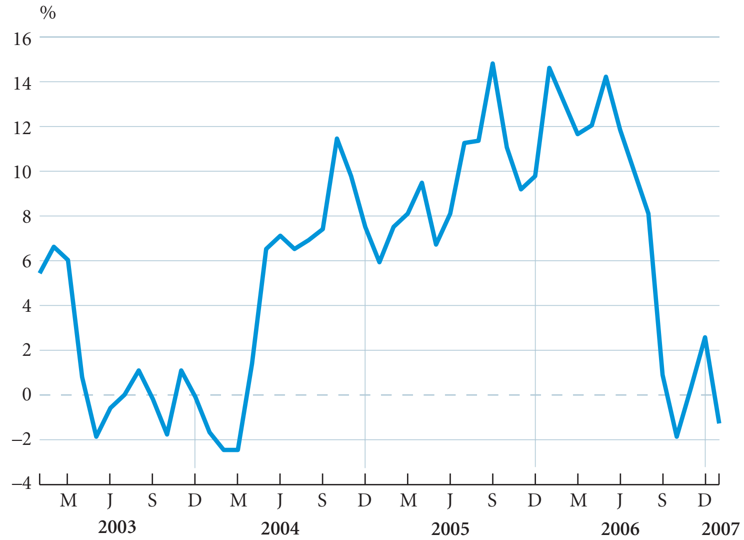
Year-to-year change in CPI



SOURCE: National Institute of Statistics.

LOWER ENERGY PRODUCT PRICES EASE CPI

Year-to-year change in energy products group of CPI



SOURCE: National Institute of Statistics.

make-up but to some other well-known factors such as energy products and food. In fact, if the latter products and fresh foods are excluded, the year-to-year change in the price index goes up to 2.7% (2 decimals more than in December).

Thanks to the drop in oil prices in the early weeks of the year and to rises in gas

CONSUMER PRICE INDEX

	2006			2007		
	% monthly change	% change over December 2005	% annual change	% monthly change	% change over December 2006	% annual change
January	–0.4	–0.4	4.2	–0.7	–0.7	2.4
February	0.0	–0.4	4.0			
March	0.7	0.3	3.9			
April	1.4	1.8	3.9			
May	0.4	2.1	4.0			
June	0.2	2.3	3.9			
July	–0.6	1.7	4.0			
August	0.2	1.9	3.7			
September	–0.2	1.7	2.9			
October	0.4	2.1	2.5			
November	0.2	2.4	2.6			
December	0.3	2.7	2.7			

SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

January

	Indices (*)	% monthly change		% annual change	
		2006	2007	2006	2007
By type of spending					
Food and non-alcoholic beverages	101.6	0.9	0.2	4.4	2.4
Alcoholic beverages and tobacco	106.4	–2.2	5.0	2.7	8.9
Clothing and footwear	94.6	–11.7	–11.7	1.1	1.3
Housing	101.8	2.2	1.2	7.8	3.9
Furnishings and household equipment	101.1	–0.4	–0.2	2.2	2.9
Health	100.8	0.3	0.2	0.7	1.6
Transport	98.3	1.5	–0.1	7.9	0.2
Communications	99.7	0.3	0.5	–1.5	–1.3
Recreation and culture	98.4	–1.6	–1.8	0.2	–0.8
Education	103.4	0.2	0.3	3.8	4.6
Restaurants and hotels	102.0	0.6	0.8	4.5	4.6
Other goods and services	102.3	1.5	1.4	3.4	3.8
By group					
Processed food, beverages and tobacco	101.5	0.3	1.0	3.7	2.9
Unprocessed food	103.4	1.0	0.0	5.3	3.5
Non-food products	99.9	–0.7	–1.1	4.2	2.2
Industrial goods	98.1	–1.9	–2.8	4.5	0.6
Energy products	*96.2*	*3.5*	*–0.3*	*14.8*	*–1.3*
Fuels and oils	*93.9*	*3.3*	*–1.3*	*18.7*	*–2.9*
Industrial goods excluding energy products	*98.7*	*–3.6*	*–3.6*	*1.4*	*1.2*
Services	101.8	0.5	0.6	3.8	3.8
Underlying inflation (**)	100.7	–1.0	–0.8	2.9	2.7
GENERAL INDEX	**100.5**	**–0.4**	**–0.7**	**4.2**	**2.4**

NOTES: (*) Base 2001 = 100.
(**) General index excluding energy products and unprocessed food.
SOURCE: National Institute of Statistics.

and electricity lower than those in January 2006, energy had a moderating effect on the general CPI in January. Fuels were down 4.0% in January compared with 12 months earlier, considerably less than the drop in oil prices. In any case, energy products as a whole went from an annual increase of 2.6% in December to a drop of 1.3% in January.

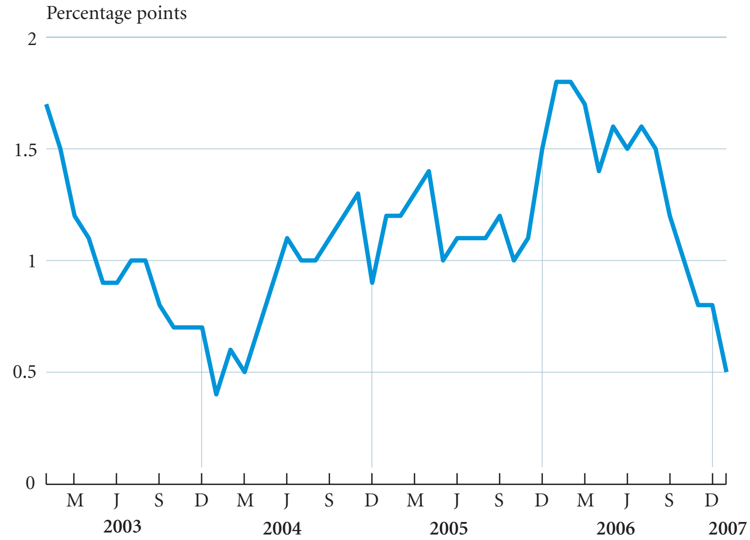
Unprocessed foods also eased in price to a 3.5% annual rise, one point less than in December. The drop in mutton and poultry in January was notable. Potatoes, however, continued to show an annual rise of more than 20%. At the same time, processed foods were down thanks to the drop in cooking oil although the price of bread was up 5.2% over the past 12 months. In addition, there was a notable rise of 6.6% in tobacco in January that put the year-to-year rate at 11.4%, which was in contrast to an increase of only 1.1% in 2006.

Inflation in non-energy industrial goods, subject to heavy pressure from

Fresh food prices ease although potatoes show more than 20% annual rise.

INFLATION DIFFERENTIAL WITH EURO AREA DROPS TO HALF-POINT

Difference in year-to-year change in harmonized CPI between Spain and Euro Area



SOURCE: Eurostat, National Institute of Statistics and own calculations.

Notable cut in inflation differential with euro area.

international competition, remained stuck at 1.2%. On the other hand, there was some persistence in the area of services which are generally more protected from foreign market pressure. As a result, annual inflation in services was up slightly to 3.8%.

Nevertheless, prospects for the CPI over coming months continue to favour a gradual easing mainly due to the effect of high crude oil prices in the first half of 2006. Later on, however, it is likely that inflation will rise to a level similar to that at the end of 2006.

The favourable trend in prices in January now makes it possible to see a more acceptable comparison with Spain's neighbours in the European Union. In harmonized terms, inflation also stood at 2.4% annual in the first month of the year so that the inflation differential with the euro area in January narrowed to 0.6 points with the rise in EU prices holding at 1.8%. Such a favourable result has not been seen since March 2004. Undoubtedly, for Spain's CPI this was a good start to the year.

Drop in wholesale prices

Inflationary pressures continued to moderate in the economy as a whole in the final months of 2006, as shown by the gross domestic product deflator which rose by 3.6% in the final quarter of last year compared with the same period the year before, as against 4% in the second quarter. In any case, the average inflation level is still too high which could adversely affect competitiveness of the economy over the medium term.

Drop in oil and metal products eases producer prices in January.

In January, producer prices showed notable moderation with a drop of 2.7% in year-to-year change rate. Nevertheless, this decrease was largely due to the decrease in oil prices which put the overall level of energy prices at 1.1% below January 2006. Prices of consumer goods also eased thanks to

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2005											
December	2.1	5.2	3.2	2.0	3.2	15.6	7.1	0.9	10.2	8.9	–
2006											
January	4.0	6.3	3.5	2.1	3.6	20.6	5.6	–6.5	–5.1	15.2	–
February	0.8	6.3	3.6	2.1	3.9	20.1	6.6	2.5	3.2	9.2	3.9
March	–10.2	5.8	3.3	2.0	4.6	16.4	6.0	2.7	7.5	7.2	–
April	–8.1	5.7	2.9	2.2	5.1	15.4	7.4	3.2	–4.2	11.7	–
May	–3.6	6.6	3.2	2.3	6.1	17.8	6.1	4.2	–0.6	8.2	4.0
June	6.0	6.3	3.5	2.3	6.8	14.6	1.7	–1.5	–3.2	4.2	–
July	0.7	6.4	3.6	2.4	7.0	13.9	1.1	0.5	–7.3	3.1	–
August	0.4	5.7	3.2	2.5	7.2	10.2	2.3	–0.6	–0.5	4.0	3.8
September	1.1	4.2	2.7	2.5	6.7	4.1	0.8	2.4	–5.0	1.0	–
October	2.3	3.4	2.3	2.4	6.9	0.5	1.7	0.1	–8.2	4.5	–
November	0.7	3.6	2.4	2.5	6.8	1.0	0.2	–5.4	–0.7	2.8	3.6
December	–5.8	3.6	2.0	2.6	6.8	2.3	1.2	–2.2	4.1	2.1	–
2007											
January	...	2.7	1.4	2.9	6.3	–1.1	...	...	...	...	...

NOTES : (*) Figures adjusted for seasonal and calendar effects.

SOURCE: National Institute of Statistics, Ministry of Economy and own calculations.

moderation in non-durable goods. On the other hand, capital goods showed a rise to 2.9% which would suggest some pass-through of rises in intermediate goods prices in previous months. Nevertheless, intermediate goods prices have eased their rate of increase in recent months. Prices of metal products thus went from a rise of 17.2% in December to 12.6% for the 12 months ending in January.

Prices of imported goods also showed signs of easing in December, the latest figure available. According to the survey by the National Institute of Statistics, the import prices index was up by 2.2% in December 2006 compared with the same month the year before, as against 7.5% in May. Prices of consumer goods and capital goods, subject to heavy pressure from international markets, scarcely rose during 2006 and even went down. Prices of intermediate goods indicated that the rise in raw materials prices was losing strength.

Finally, farm wholesale prices were down 5.8% in December. As mentioned earlier, this drop had some effect on the January consumer price index.

Sharp drop in farm prices in December.

Foreign sector

Trade deficit reaches 9.2% of GDP in 2006 despite substantial improvement in exports.

Trade deficit in 2006: new all-time high

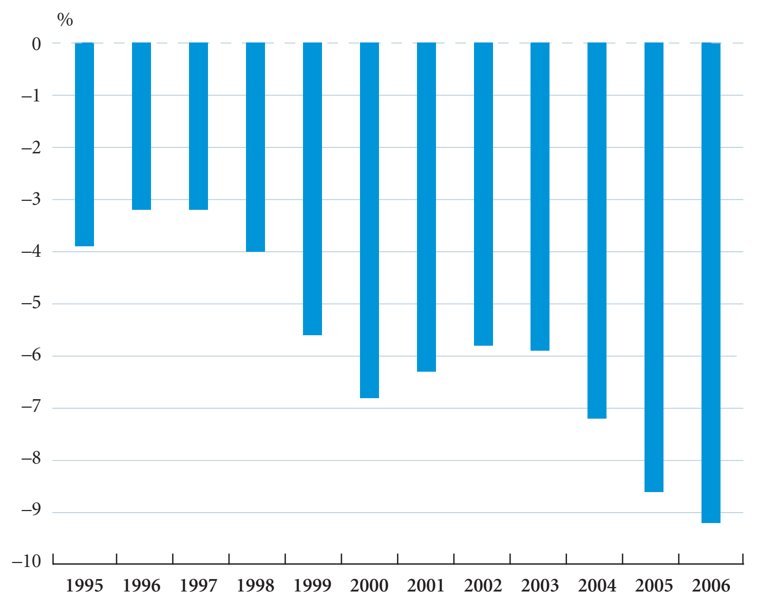
In 2006, Spain's trade deficit hit 89.7 billion euros, a figure equal to 9.2% of the gross domestic product (GDP), 15.3% higher than the figure recorded one year earlier. While the foreign imbalance remains very high (in fact, this is a new all-time high), it should be pointed out that this is the third consecutive year to show a drop in the foreign imbalance. Furthermore, marking a significant change, exports showed a substantial recovery with an increase twice that for one year earlier: from 4.8% in 2005 to 10.6% in 2006.

It is true, the strength of domestic demand is still driving up imports but here also we can see a partly positive sign although the growth rate is tending to stabilize (12.2% nominal in 2006; 11.7% in 2005). Nevertheless, the strength of imports meant that the export/import ratio dropped to 65.4%, one point less than in 2005.

By product, the most notable features in 2006 were the major growth in imports of energy products, capital goods and intermediate energy products, three groups which added more than two-digit increases. This good result is especially relevant in the last of the above groups given that it represents approximately half of Spain's exports. In imports, energy products continue as the most dynamic group showing annual growth

TRADE DEFICIT GOES ABOVE 9% OF GDP

Trade balance as percentage of gross domestic product



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

FOREIGN TRADE

Cumulative figure for 12 months ended December 2006

	Imports			Exports			Balance	Export/ Import ratio (%)
	Million euros	% annual change in value	% share	Million euros	% annual change in value	% share	Million euros	
By product group								
Energy products	40,719	26.8	15.7	7,548	19.8	4.4	–33,170	18.5
Consumer goods	72,563	8.6	28.0	63,005	7.5	37.1	–9,557	86.8
Food	*14,562*	*3.8*	*5.6*	*19,893*	*6.5*	*11.7*	*5,330*	*136.6*
Non-foods	*58,000*	*9.8*	*22.3*	*43,112*	*8.0*	*25.4*	*–14,888*	*74.3*
Capital goods	27,740	1.6	10.7	17,057	14.8	10.0	–10,683	61.5
Non-energy intermediate goods	118,538	12.8	45.7	82,261	11.5	48.4	–36,276	69.4
By geographical area								
Euro area	126,681	7.5	48.8	95,465	7.8	56.2	–31,216	75.4
Rest of European Union EU 25	25,007	9.5	9.6	24,037	8.6	14.1	–970	96.1
Russia	7,343	42.6	2.8	1,510	37.6	0.9	–5,833	20.6
United States	8,476	8.3	3.3	7,498	22.9	4.4	–978	88.5
China	14,302	22.9	5.5	815	137.0	0.5	–13,486	5.7
Japan	5,841	–0.5	2.3	1,347	16.6	0.8	–4,494	23.1
Rest of Asia	23,559	25.9	9.1	6,743	13.6	4.0	–16,817	28.6
Latin America	22,058	27.0	8.5	4,300	3.8	2.5	–17,759	19.5
OPEC	14,569	28.1	5.6	10,436	29.7	6.1	–4,134	71.6
Rest	11,723	–7.7	4.5	17,722	10.5	10.4	5,999	151.2
TOTAL	**259,559**	**12.2**	**100.0**	**169,872**	**10.6**	**100.0**	**–89,687**	**65.4**

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

of more than 26%, followed by non-energy intermediate goods.

By geographical area, Spain's trade continues to be concentrated in the European Union. Specifically, 70% of exports go to the EU, approximately two percentage points less than in 2005. In other export markets, the most significant changes in share were an increase in exports to OPEC countries and a loss of weight in exports to Latin America. In imports, the most notable change was the gradual increase in imports from China.

What are the prospects for the foreign sector in 2007? Two factors underlying the major increase in the trade imbalance will not drop off substantially this year. Forecasts suggest that the slowdown in Spain's economy will be limited although indeed the drive in domestic demand will partly ease off. It would seem that the cumulative loss of foreign competitiveness adversely affecting export results is not going to be appreciably corrected. This could make it more difficult for the recovery of exports in 2006, largely because of growth in Europe, to be repeated at the same level in 2007. We shall probably continue to see new all-time highs in the trade deficit in the future.

Energy products show biggest increases both in exports and imports.

Prospects for redressing balance in 2007 no more than slight.

Balance of payments: growing still worse

Current account balance up nearly 40% year-to-year in first eleven months of 2006 due to worsening of trade balance.

In the first eleven months of 2006, the cumulative deficit in the balance of payments stood at 82.05 billion euros. This is 37.7% higher than the figure one year earlier and represents growth of nearly six percentage points compared with the cumulative figure for January-October. Similar to what has taken place in previous months, the main cause of this imbalance was the increase in the trade deficit. Of less importance was the increase in the deficits in the incomes balance and the transfers balance and the reduction of the surplus in the services balance.

In the services balance, the drop in the positive figure under the tourism heading, which now stands at levels 4.5% lower than in the same period in 2005, came together with a further increase in the cumulative deficit in other services.

In financial account, net inflows for January-November 2006 amounted to 103.31 billion euros, nearly twice that for the same period in 2005.

BALANCE OF PAYMENTS

November 2006

	Cumulative for year		Last 12 months		
	Balance	% annual change	Balance	Annual change: Absolute	Annual change: %
Current account balance					
Trade balance	–74,875	19.8	–81,329	–13,310	19.6
Services					
Tourism	*24,451*	*–4.5*	*25,210*	*–1,657*	*–6.2*
Other services	*–4,978*	*49.2*	*–5,377*	*–1,702*	*46.3*
Total	19,473	–12.6	19,833	–3,359	–14.5
Income	–19,918	25.9	–21,303	–3,931	22.6
Transfers	–6,730	91.9	–6,307	–4,212	201.1
Total	**–82,050**	**37.7**	**–89,106**	**–24,812**	**38.6**
Capital account	**4,104**	**–32.7**	**5,975**	**–1,771**	**–22.9**
Financial balance					
Direct investment	–43,094	–	–50,266	–42,514	–
Portfolio investment	183,738	282.3	193,563	137,174	243.3
Other investment	–37,332	–	–35,327	–42,434	–
Total	**103,312**	**80.8**	**107,969**	**52,225**	**93.7**
Errors and omissions	–3,452	61.8	–2,215	–780	54.3
Change in assets of Bank of Spain	–21,914	–	–22,624	–24,863	–

NOTES: The figure resulting from the sum of current account balance, capital account balance and financial balance is compensated by the change in assets of Bank of Spain plus errors and omissions.
SOURCE: Bank of Spain and own calculations.

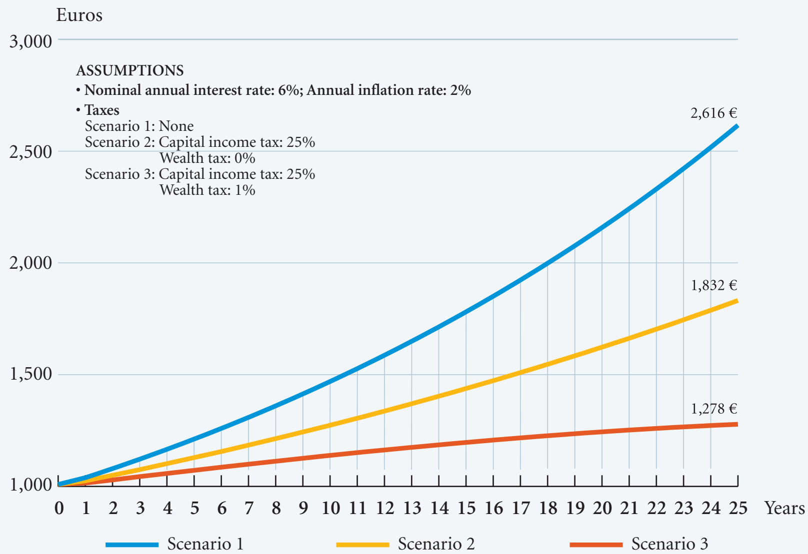
Bad news on tax on savings

Savings are subject to a wide range of taxes. The most obvious are those levied on property and its returns, namely interest, dividends or capital gains. But there are other taxes, such as those on corporate profits, which are nothing more than yields on savings, or on inheritances, which were the savings of the deceased. All of these cause important distortions in consumption and savings as well as in investment decisions regarding various kinds of assets. These are examined below.

In the first place, taxes on savings change the level of future consumption that we can expect when we abstain from present consumption. Put another way, they reduce the relative price between present and future consumption. The example of a person who decides to save 1,000 euros serves to illustrate the importance of this effect. Let us suppose that this person has access to an investment with an annual return of 6% in nominal terms. With annual inflation at 2% and no taxes on savings, the savings will grow to 1,470 euros at the end of 10 years (at constant prices of today). If, on the other hand, the saver had to pay a tax of 25% on annual returns, the savings will only grow to 1,275 euros or 13% less. This distortion increases to the extent that we

TAXES ON SAVINGS SIGNIFICANTLY CHANGE LONG-TERM YIELDS

Trend in purchasing power of savings of 1,000 euros over 25 years (at constant prices)



SOURCE: Own calculations.

lengthen the period of savings (it becomes 30% at the end of 25 years, for example) as a result of the effect of compound interest, especially if to the tax on returns we add a wealth tax (see accompanying graph). For this reason, taxes on earnings from capital especially penalizes long-term savings.

A wide range of theoretical and empirical studies underline that this intertemporal distortion has considerable negative consequences. By discouraging the accumulation of capital, taxes on savings reduce significantly the stock of capital per worker over the long term, which reduces productivity and wage levels. Empirical studies have tended to confirm that a decrease in the after-tax rate of return reduces the level of savings. Some theories go further and suggest that this type of distortion could be the main reason for differences between countries in per capita income levels.

The lack of neutrality in taxes on savings (with different taxation levels depending on the type of asset) also distorts the allocation of resources to various kinds of capital. Investment in a company that is subject to corporate tax is especially penalized. In this case, returns are taxed first by the corporate income tax (with the general rate in Spain at 32.5%) and, if the company decides to distribute dividends, they are subject to the personal income tax (at a rate of 18% in Spain). If the company does not declare dividends, this increases the value of its shares and, when they are sold, the saver will have to pay a tax on the corresponding capital gains (18% in Spain). While tax laws generally introduce measures to ease this double taxation (as is the case in Spain), in most cases it is not totally eliminated.

Some investments, on the other hand, enjoy quite advantageous tax treatment. A notable case in Spain is investment in a home. First, because the services they provide the homeowner (which are like a cash income equivalent to the interest paid on an investment) are not subject to tax. Second, because mortgage payments are deductible from personal income tax. Third, because capital gains at the time of selling the home are subject to very favourable treatment (including, in many cases, exemption, for instance for those over 65 years of age). As a result of these measures, there tends to be over-investment in housing compared with other assets.

Over the past decade there has been a global trend to lower taxation on savings (and to increase taxes on consumption). Some observers have pointed out that this has been the result of competition to lower taxes in order to attract international investment and to avoid the flight of capital. Undoubtedly, this may have been a factor. But this trend could also be interpreted as a process through which those responsible for economic policy apply the conclusions of economists to the real world. In any case, taxes on labour have also been reduced in many countries following warnings by economists about the adverse effects these may have on labour supply and the accumulation of human capital.

In Spain, recent tax reforms have introduced some improvements to the taxation on savings but have not meant any substantial lowering of the tax burden on savings. One aspect that has showed progress is the neutrality of taxes with the introduction of a single 18% rate on personal income tax for savings income, independent of the period over which this is generated. Nevertheless, in a broad sense, the tax system is still far from being neutral, as the distortions mentioned above continue to be in place. Furthermore, the tax rate of 18% means an increase in the tax on long-term capital gains which previously were taxed at 15%. The reforms introduced a minimum level of earnings from savings that are exempt from taxes, but while this has positive effects on equity it is of little importance in terms of efficiency because of the impact on those taxpayers providing the largest volume of savings is insignificant. The reduction of corporate income tax rate is also good news for savings although the elimination of deductions means that the tax burden has not been significantly reduced.

While all taxes (at least those imposed in practice) introduce distortions, some are more costly than others in terms of efficiency. The intertemporal distortions associated with taxes on savings are especially pernicious, reducing productivity and wages over the long term. While these taxes are attractive from the point of view of equity (because the rich pay more), they also make us all a little poorer.

Savings and financing

Financing of private sector steps up in 2006

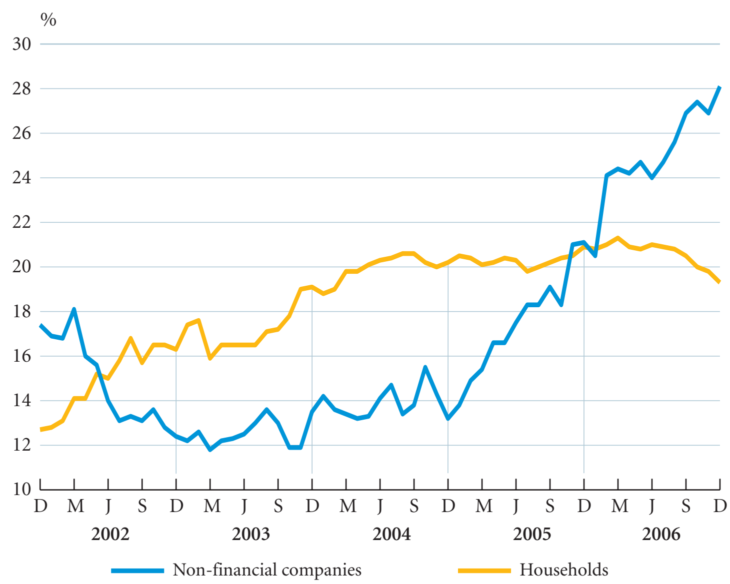
Notable increase in bank interest rates in recent months.

Interest rates on loans showed a notable rise in 2006, with the pass-through of the upturn begun by the European Central Bank in December 2005. The average interest rate on loans and credits granted to the private sector stood at 5.10% in December 2006, some 117 basis points more than in the same month the year before. The 1-year Euribor, the main reference index for the mortgage market, reached 3.92% in December, an annual increase of 114 basis points. In January, it kept moving up and went to 4.06%, the highest level since August 2001.

In spite of the rise in interest rates, funding granted to the private sector rose in 2006, going to 24.1%, the highest annual growth rate since at least the mid-Nineties. The favourable economic situation and relatively low interest rates in real terms (discounting inflation) contributed to the growth of financing. Nevertheless, we should note the difference between the behaviour of companies and that of households. While the funding of non-financial companies showed the highest annual change rate in the past decade (28.1%), credit going to households eased slightly to show annual growth of 19.3%.

FINANCING GRANTED TO COMPANIES IN 2006 GROWS AT HIGHEST RATE IN LAST DECADE

Year-to-year changing in financing



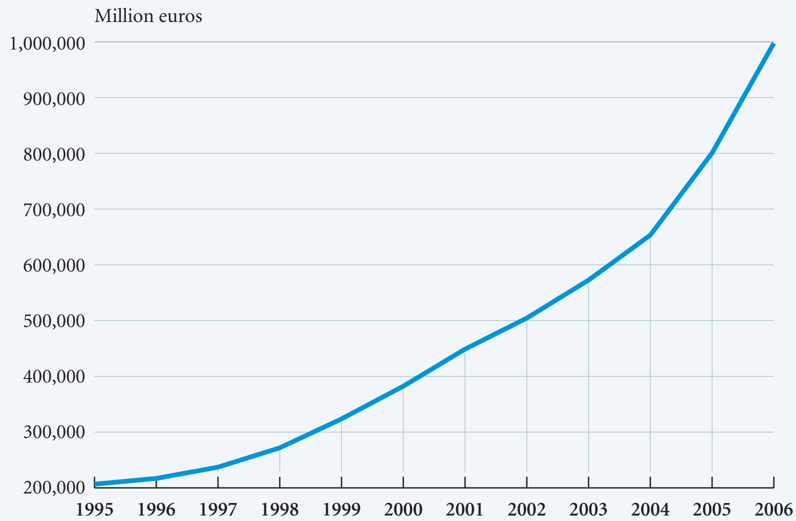
SOURCE: Bank of Spain.

Is the Spanish companies' leverage too high?

Spanish companies have taken advantage of the recent period of strong growth and low interest rates to push forward strategic objectives, namely, to obtain greater «critical mass», increase their ability to gain access to new markets, to develop new products, etc. This has been carried out through corporate operations involving the acquisition of other companies or through internal growth. In both cases, it has meant an increase in their borrowing levels.

CORPORATE DEBT SHOOTS UP

Outstanding balance of borrowing by non-financial companies



SOURCE: Bank of Spain.

This spectacular increase in corporate funding opens up a series of questions:

- Has borrowing by Spanish companies reached an excessive level?
- Does the beginning of interest rate increases mean a difficult increase in financial load?
- Finally, following this heavy investment, has the capacity for new corporate investment become exhausted?

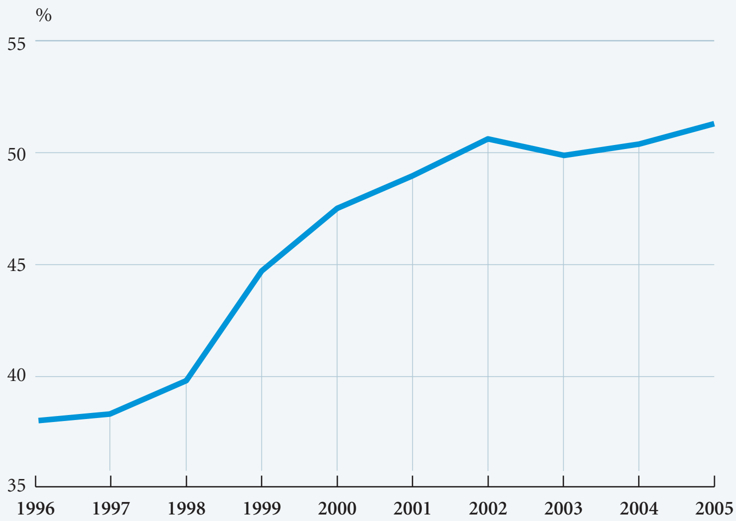
In Spain, we have a number of other sources to help us form an opinion about these questions. First, the Bank of Spain's Composite Company Balance Sheets are designed largely to gather and maintain economic-financial information about Spain's non-financial corporations. This sampling gathers together the corporate results of resident individual companies, both those listed and non-listed.

According to the Composite Company Balance Sheets, the outstanding balance of loans granted to non-financial companies has multiplied by nearly five since 1995 to reach a figure of 1,000 billion euros, which represents 104.2% of Spain's GDP. What is more, this figure does not include bond issues made by those companies. This figure confirms the feeling that corporate growth has involved an increase in borrowing.

Nevertheless, to get an idea of the borrowing ratio it is more useful to divide outside resources by liabilities involving remuneration. This ratio has moved up from levels below 40% to above 50%.

COMPANIES ADAPTING TO ECONOMIC STABILITY

Borrowing ratio: outside resources involving cost over liabilities (*)



NOTES: (*) Equity, long-term liabilities and short-term financing involving cost.
SOURCE: Bank of Spain.

Companies have adapted to the new financing conditions offered in the euro area, namely, macroeconomic stability and low interest rates. They have adjusted their capital structure in order to benefit from more liquid and broader loan markets. For this reason, it is important to check out their capacity to handle this borrowing through returns being generated. Maintenance of ordinary profitability of net assets at high levels of 8% and the lowering of financial costs in the Nineties because of the convergence of interest rates has meant a 5% increase in the differential between profitability and financial cost. These conditions are favourable for new investment projects.

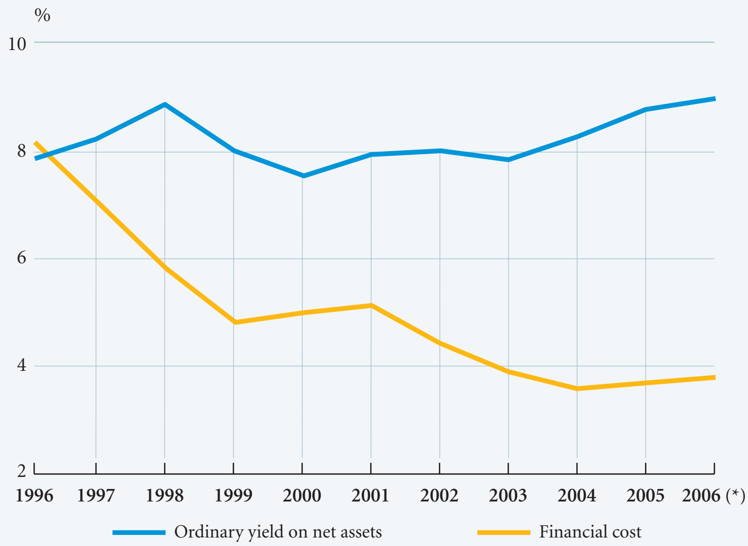
In any case, the Composite Company Balance Sheets have their limitations when it comes to determining the trend in corporate activity. The sample covers between 25% and 30% of the gross value added of this economic sector. This implies that a large financial transaction by a multinational group, for example, could carry excessive weight in the overall picture.

In spite of this, the Composite Company Balance Sheets figures are very useful for analyzing the results of Spanish companies, above all income and financial costs, the profitability obtained by companies and extraordinary accounting figures. All these factors affect the dividends they are going to distribute and they thus constitute essential information.

It is also interesting to contrast earlier information with the trend in companies listed among the IBEX 35. Two ratios may be useful for calibrating the level and quality of corporate borrowing.

GROWING YIELD DIFFERENTIAL

Yield on assets and financial cost



NOTES: (*) Figure taken from Quarterly Composite Corporate Balance Sheets.
SOURCE: Bank of Spain.

The first is the Debt / EBITDA ratio, EBITDA being the acronym for «Earnings before interest, tax, depreciation and amortization», the gross operating profit before deducting those items. This is a relation that indicates how many years it may take to repay debt using the gross operating profit. The second ratio is EBITDA / Interest charges, which tells us if the gross operating profit makes it possible to meet interest payments on corporate debt.

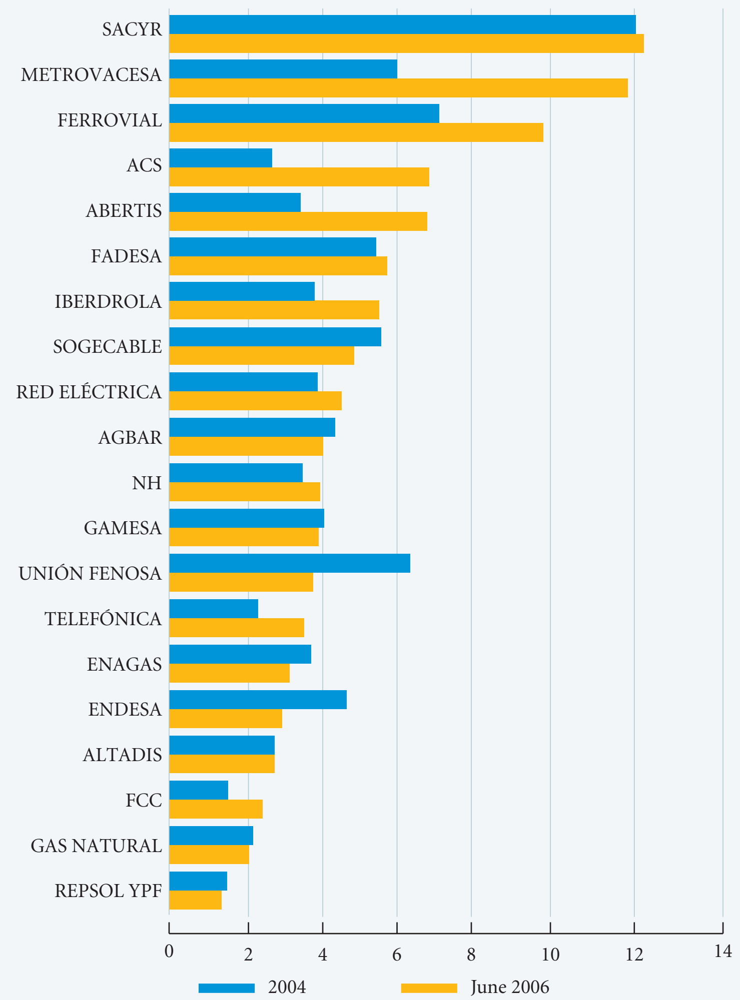
The Debt / EBITDA ratio has especially increased in the construction and real estate sector. In recent years, this sector has diversified its activities through acquisitions. Generally, the rating agencies consider that this ratio should be below 3 for industrial companies and below 5.2 for companies in the electrical, construction and real estate sectors in order to obtain an «investment grade» credit rating, that is to say, a high credit rating.

With regard to the EBITDA / Interest charges ratio, the rating agencies usually consider that a level above 4 for industrial companies and 2.7 for electrical power companies is sufficient for them to be described as having a high solvency credit profile. In this case, the IBEX 35 companies show a high ratio which means a good safety cushion against interest rate increases that might make their debt more costly.

In terms of both ratios, we may state that Spanish companies are not maintaining excessive levels of financial leverage. In addition, companies included in the IBEX 35 continue to benefit from very low cost funding. To go by figures shown in the Composite Company Balance Sheets, a substantial differential is being maintained between the level of financing cost and profitability obtained from investments. As a result, it may be stated that, after studying all available information on Spanish companies, this coincides in supporting the following conclusions:

LEVEL OF FINANCIAL LEVERAGE REFLECTS GOOD CREDIT PROFILE

Trend in Debt / EBITDA ratio (*)



NOTES: (*) Non-financial companies in IBEX 35 with significant ratios.
SOURCE: Company financial accounts.

1) In general, companies are maintaining a prudent level of financial leverage.

2) Spanish companies are ready to meet a gradual increase in interest rates, which would make the financing of their debt more costly. The interest rate increases being discounted by consensus in the European market do not present any problem and do not have to involve any major impact on corporate margins.

3) Growth of profits and satisfactory management of financial costs create favourable conditions for new investment plans.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

December 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	85,366	10,005	13.3	10,005	13.3	5.7
Secured loans (*)	922,980	193,693	26.6	193,693	26.6	61.2
Other term loans	414,601	89,305	27.5	89,305	27.5	27.5
Demand loans	34,122	6,064	21.6	6,064	21.6	2.3
Leasing	40,714	5,720	16.3	5,720	16.3	2.7
Doubtful loans	10,834	1,203	12.5	1,203	12.5	0.7
TOTAL	**1,508,616**	**305,988**	**25.4**	**305,988**	**25.4**	**100.0**

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

Under credit granted to companies, commercial credit going to finance working capital rose by a notable 13.3% in 2006. The increase in leasing, used for funding investment, was even higher at 16.3%.

The downturn in loans to individuals was due to the drop in housing loans which went from 24.3% in 2005 to 19.9% in 2006. Increased housing prices and the increase in interest rates, counteracted only partly by longer mortgage repayment periods, was behind this drop. It is foreseeable that this trend will continue in 2007. On the other hand, other credit to households showed a higher rate of increase partly due to the policy of financial institutions to compensate for lower growth in mortgage loans. Nevertheless, new household consumer credit transactions for buying cars, motorcycles, furniture, appliance, travel, etc. amounted to 53.1 billion euros, an annual increase of 10.1%, down from the figure reported the year before (22.9%).

Doubtful loans in the private sector were up 12.5% in 2006 amounting to 10.8 billion euros. Nevertheless, due to the higher volume of credit, the default rate continued to drop going to 0.72% in December, thus marking up a new all-time low in spite of the rise in interest rates.

On the other hand, the savings banks continued to gain market share in this segment in 2006 and reached 47.0% of the total at the end of the year (9 decimals more than in 2006). Banks took a 43.6% market share, four decimals less than in 2005, the same as was the case with loan institutions, whereas credit cooperatives lost two decimals.

Strong growth of bank deposits in 2006

In order to finance future growth of credit, financial institutions heavily promoted the attraction of bank deposits in 2006 by means of marketing campaigns and diversification of products offered. The increased yield on deposits also contributed to making them more attractive. In this way, deposits of companies and households at

Drop in home mortgages in 2006 following three strong growth years.

Household consumer credit up in 2006 but less than year before.

Default rate drops to all-time low at end of 2006.

Savings banks gain share in loans but lose share in deposits, opposite to case with banks.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

December 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	447,484	51,294	12.9	51,294	12.9	39.4
Up to 2 years	246,220	55,700	29.2	55,700	29.2	21.7
More than 2-year term	332,776	93,294	39.0	93,294	39.0	29.3
Repos	75,721	2,675	3.7	2,675	3.7	6.7
Total	**1,102,201**	**202,963**	**22.6**	**202,963**	**22.6**	**97.1**
Deposits in currencies other than euro	**32,717**	**17,078**	**109.2**	**17,078**	**109.2**	**2.9**
TOTAL	**1,134,918**	**220,041**	**24.1**	**220,041**	**24.1**	**100.0**

NOTES: (*) Includes deposits redeemable at notice, according to ECB definition.
SOURCE: Bank of Spain and own calculations.

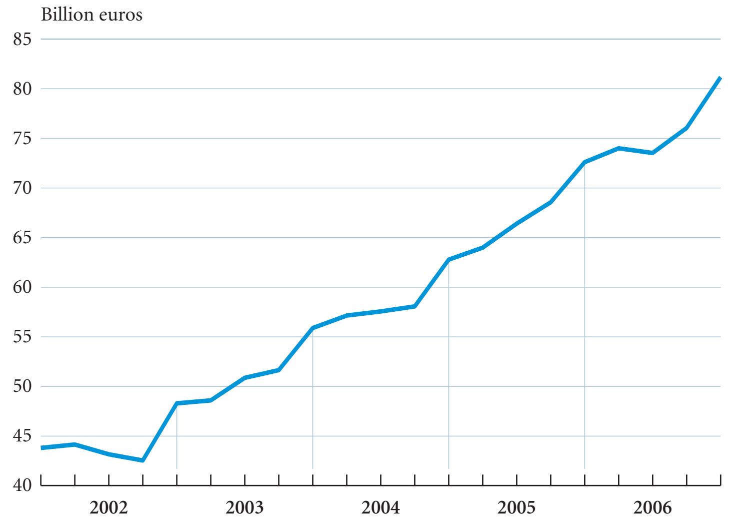
Deposits of private sector more than double those of euro area.

banks grew by 24.1% last year, more than twice the growth reported in the euro area. In any case, the increase in deposits was lower than the rise in loans so that banks largely had to have recourse to bond issues.

The biggest annual increase in 2006 was in foreign currency deposits with the existing favourable interest rate differential. Nevertheless, the share of this in the total came to only 2.9%. More than half of all bank deposits are time deposits. Those for terms of more than two years, which up to the end of the year enjoyed a tax deduction of 40% of interest, showed a sharp rise of 39.0%. On-demand and savings accounts, in turn, rose by only

PENSION FUND ASSETS SHOW NOTABLE GROWTH IN 2006

Total assets of pension funds



SOURCE: Inverco.

12.9%, close to half average growth, because of their low returns.

By type of institution, the banks' share of this market rose by 1.1 points in 2006 going to 41.4%, thus recovering ground, while the savings banks lost nine decimals and credit cooperatives two decimals. Nevertheless, the savings banks continued to show the highest share at 51.8%.

In January, with the new tax regulations related to savings now in force (which generally apply the same tax rates to all the various financial instruments), participations in securities mutual funds continued to follow the trend in previous months with net withdrawals of money. In January, negative net subscriptions amounted to 974 million euros. Nevertheless, disinvestment was concentrated in short-term bond-based funds while European and Spanish share-based funds and guaranteed bond-based funds reported notable demand. In any case, the number of participants was down slightly during the month (0.6%). Mutual funds had to face strong competition from the new types of bank deposits being offered.

The yield on securities mutual funds stood at 4.9% on average in January, twice the inflation rate. Nevertheless, yields were quite varied depending on type. National share-based funds again headed the classification with gains of 31.5% while euro area share-based funds showed 17.2%. On the other hand, Japanese share-based funds showed capital losses of 7.0%.

Withdrawal of money from securities mutual funds continues in January.

Another savings instrument with an important place in portfolios of individuals are pension funds. The volume of assets in pension funds rose to 81.2 billion euros at the end of 2006. This figure represents an increase of 11.4% in the past 12 months. By type, the individual pensin fund system showed the biggest annual increase (14.2%) putting the total at 49.91 billion euros. The number of accounts under this system rose by 6.1%. The work-related system, which includes company pension schemes, rose by 7.0% to a figure of 30.16 billion euros. Finally, the group system, which includes professional associations, trade unions and other groups, rose by 11.6% to 1.1 billion euros. The average yield obtained by pension funds in 2006 was 5.2%. If we look at the past 16 years, the average yield on pension funds was 6.7%, substantially higher than the inflation rate in this period.

Average yield on pension funds in past 16 years was 6.7%, substantially higher than inflation rate in that period.

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