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THE SPANISH
ECONOMY

Monthly Report



NUMBER 305

Climate change: certainties and unknowns [Page 13](#)

No doubt human activity affects climate. Up to what point?

To curb or not to curb? That is the question [Page 23](#)

Cost-benefit analysis, key in the debate on climate change

Environmental policy on climate change: where there is a will... is there a way? [Page 33](#)

Quotas or taxes to halt greenhouse-effect gas emissions?

The climate challenge in Spain [Page 49](#)

Spain's efforts to meet Kyoto commitments

RESEARCH DEPARTMENT

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2006			2007		
				2Q	3Q	4Q	1Q	2Q	3Q
INTERNATIONAL ECONOMY	Forecast								
Gross domestic product									
United States	2.9	1.7	2.0	3.2	2.4	2.6	1.5	1.9	1.9
Japan	2.2	2.0	1.9	2.2	1.5	2.4	2.6	2.3	2.2
United Kingdom	2.8	2.7	2.3	2.8	3.0	3.1	3.0	3.0	2.7
Euro area	2.9	2.5	2.3	2.9	2.8	3.3	3.1	2.5	2.4
Germany	3.1	2.3	2.1	3.0	3.2	3.9	3.6	2.5	2.0
France	2.2	1.6	1.6	2.7	2.1	2.1	1.9	1.3	1.6
Consumer prices									
United States	3.2	2.6	2.3	4.0	3.4	2.0	2.4	2.6	2.4
Japan	0.2	0.1	0.2	0.2	0.6	0.3	-0.1	-0.1	0.2
United Kingdom	2.3	2.4	2.1	2.2	2.4	2.7	2.8	2.6	1.9
Euro area	2.2	2.0	2.0	2.5	2.1	1.8	1.9	1.9	1.9
Germany	1.7	1.9	1.8	1.9	1.6	1.3	1.8	1.9	1.9
France	1.7	1.3	1.6	1.9	1.7	1.3	1.2	1.2	1.3
SPANISH ECONOMY	Forecast								
Macroeconomic figures									
Household consumption	3.7	3.2	2.7	3.5	3.7	3.7	3.4	3.3	3.2
Government consumption	4.8	5.3	4.7	4.0	4.8	5.7	5.7	5.5	5.2
Gross fixed capital formation	6.8	6.2	3.7	5.7	6.8	7.0	6.6	6.6	6.1
Capital goods	10.4	12.6	8.9	7.4	11.0	13.0	13.3	13.0	12.5
Construction	6.0	4.3	1.7	5.5	5.9	5.5	5.2	4.6	4.0
Domestic demand (contribution to GDP growth)	5.1	4.7	3.6	4.5	5.1	5.3	5.0	4.9	4.6
Exports of goods and services	5.1	4.5	3.3	4.9	4.2	5.7	3.7	4.8	4.9
Imports of goods and services	8.3	6.6	4.8	6.1	7.5	8.9	5.9	6.7	6.7
Gross domestic product	3.9	3.8	2.9	3.8	3.9	4.0	4.1	4.0	3.8
Other variables									
Employment	3.2	3.0	2.1	3.6	2.7	3.1	3.3	3.2	3.0
Unemployment (% labour force)	8.5	8.0	8.0	8.5	8.1	8.3	8.5	8.0	7.9
Consumer price index	3.5	2.5	2.6	3.9	3.5	2.6	2.4	2.4	2.3
Unit labour costs	2.3	2.2	2.3	2.3	1.9	2.4	2.0	2.1	
Current account balance (% GDP)	-8.8	-9.4	-9.7	-7.7	-9.5	-8.6	-10.2	-9.0	
Not lending or net borrowing rest of the world (% GDP)	-8.1	-8.9	-9.3	-7.3	-8.9	-7.4	-9.6	-8.8	
Government balance (% GDP)	1.8	1.2	0.9						
FINANCIAL MARKETS	Forecast								
Interest rates									
Federal Funds	5.0	4.8	4.5	4.9	5.3	5.3	5.3	5.3	5.0
ECB repo	2.8	4.3	4.3	2.6	2.9	3.3	3.6	4.0	4.0
10-year US bonds	4.8	5.1	5.0	5.1	4.9	4.6	4.7	5.0	4.8
10-year German bonds	3.8	4.8	4.7	4.0	3.9	3.8	4.0	4.6	4.6
10-year Spanish bonds	3.8	4.9	4.8	4.0	3.9	3.8	4.1	4.6	4.6
Exchange rate									
\$/Euro	1.26	1.37	1.32	1.26	1.27	1.29	1.31	1.35	1.36

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The economy and companies in face of climate change

Rio de Janeiro (*a cidade maravilhosa* – the marvellous city) was the scene of the first grand world event dealing with climate change. There in May 1992, at what was dubbed the «World Summit» some 191 countries (nearly all the countries of the world) signed the United Nations Framework Convention on Climate Change. The aim of the Convention was the «stabilization of greenhouse gas concentration in the atmosphere at a level that would prevent dangerous human interference with the climate change system». That is to say, as the climate is worsened because of human activity, it was essential to put in place measures to halt this process. This is one of today's major challenges. At the time of signing the Convention at the beginning of the Nineties, however, the economic actors were scarcely concerned seeing that as they were more concerned about the end of the first Gulf War and the economic recession that the United States had just suffered. It is understandable. The Convention consisted of a declaration of good intentions and fine proposals almost without any practical consequences.

The second event took place in Kyoto, a city that typifies the soul of Japan. There, in December 1997, the so-called Kyoto Protocol was signed. The intent of this instrument was to bring about some of the objectives of the Framework Convention. Specifically, it was agreed to quantify an objective for the reduction of green-house effect gas emissions. Many countries failed to support the agreement. The United States explicitly rejected it. On the other hand, the European Union (EU) adopted it as a guideline and undertook to reduce total emissions by 8% in the period 2008-2012 compared with those in 1990. While much criticized and raising many doubts about its effectiveness, the Protocol today is supported by 36 countries with legal obligations to reduce emissions.

The third and latest event up to now took place at Heiligendamm. This German spa on the Baltic was the scene of a G-8 summit meeting in June 2007 at which, unexpectedly, the leaders of the richest countries committed themselves to reduce carbon dioxide emissions by half by 2050. The larger emerging countries, China, India, Brazil, South Africa and Mexico, joined in this commitment. The United States, the country with the most doubts about Kyoto and responsible for a quarter of all world emissions, agreed to establish quotas. From this point on, the United Nations is to carry on negotiations dealing with how to bring about the reduction of green-house gas emissions under a new global agreement. There are still many questions to be resolved but this time the fight against climate change is being tackled seriously.

What will companies have to do? It is said that at times one must make virtue of necessity. Some companies have the road already mapped out for them. In the EU, the guideline that came out of the Kyoto Protocol established a series of rules of the game for those industries that emit green-house effect gases that already are governing their activities. Other companies may find new opportunities in the area of climate change. Prospects for those who build wind-power plants, distillers of ethanol fuels and those who supply nuclear power generating equipment, to give some examples, have been substantially raised. Many other companies may be or already are being directly affected by climate change, such as those in clothing and agriculture or by measures governments may adopt, such as in transport and motor vehicle manufacturing. Even large financial institutions are showing off their measures favouring the reduction of emissions. Policies taking into account climate change are now having an effect on corporate strategies and more and more they will form an integral part of decisions taken in the world of economics.

OVERALL SUMMARY

Financial crises are a recurring phenomenon in international economic development.

New crisis breaks out in August from fear of effects of collapse of US market for mortgages with low credit rating.

Financial engineering applied to this type of product means effects of crisis are felt far beyond US home territory.

Crisis of confidence in financial markets

«A pin lies on wait for every bubble and when the two eventually meet a new wave of investors learns some very old lessons.» This is the way the well-known investor Warren Buffett describes the end of periods of speculative fury financial markets periodically undergo. Let's remember the latest periods going from the stock market crash in 1987 to that in 2000, not forgetting the crisis of savings institutions in the United States at the beginning of the Nineties, the Mexican crisis in 1994, the Asian crisis in 1997 and the Russian bond crisis or the Long-Term Capital Management hedge fund crisis in 1998. Not to omit the impact generated in 2002 by the collapse of Enron. The bare bones of crises are similar in them all – as a first stage, an excessively bullish market with a progressive disdain for risk; a disagreeable and unexpected surprise that sharply breaks this dynamic; in a final stage, a loss of confidence, a flight to quality, problems of liquidity and restrictions on credit up to the moment when it is considered that there has been a sufficient correction.

A new financial crisis broke out in August. There had been an early warning at the end of February when the markets were jolted by a sudden lack of confidence. But this was a brief episode brought about by fears of an economic recession in the United States which were soon discarded. This time it is serious. The «pin» mentioned by Warren Buffett is the same as that in February: the US mortgage crisis combined with financial engineering with a touch of folly.

The crisis in sub-prime mortgages, a financial heading that includes mortgages of low credit rating, those that are granted to customers with poor solvency, higher risk of default or those about which their ability to meet monthly loan payments is not really known. This is a relatively small market (around 13% of the total mortgage market in the US) but which has shown very sharp growth in recent years. This growth was the result of the boom in housing prices which relaxed requirements when it came time to grant loans and of the actions of a group of mortgage brokers that are not deposit-taking entities like banks and therefore are subject to fewer regulatory requirements.

For the past year and a half, the US real estate market has been immersed in its biggest crisis in the last 15 years. A dip of this size in housing was traditionally capable of unmaking the economy as a whole and sending it into recession. Up until now this has not been the case, thanks to the strength of private consumption and the support of very easy monetary and financial conditions. How, then, do we explain the sudden upsets in all markets? Why is the storm reaching financial institutions in Europe and Asia?

The key lies in the financial engineering applied, a result of which has been the impossibility of knowing where the risk in sub-prime mortgages stands and how it stands. Mortgage brokers do not maintain the mortgages in their balance sheets but transfer them to commercial or investment banks which in turn package them in blocks and issue

securitized bonds that are (or were) placed in investment funds, insurance companies, treasurerships, etc. Risk is thus broadly spread both among types of investor and geographically. Default of sub-prime mortgages not only brings about a collapse in this market but sets off great uncertainty because there is hardly any information about where the bonds may be.

The financial system is based on confidence and this is what is broken down in a crisis like the present one. A number of US mortgage institutions have failed while banks both inside and outside the United States have announced specific failures. Investors are reluctant to take on new risks so that liquidity is reduced, the granting of credit is more selective and interbank interest rates rise. The stock markets drop and non-financial companies encounter more problems in issuing bonds.

What is more, the crisis of confidence comes at a critical moment. The bubble was blown up very high. More than three years of rising stock markets, risk premiums at all-time lows and abnormally low volatility all increased the possibility of seeing one of those periods of correction that end up taking place in the markets. The prolonged stage of international growth, with the rise of the emerging nations, the strength of the US consumer, high corporate profits and still very easy financing terms made up a solid base for five years of economic exuberance.

What will happen now? The immediate consequence has been an increase in risk aversion (risk premiums have risen although not that much), a correction and an increase in volatility in the stock markets and a drop in yields on government bonds. The central banks have already swung into action in order to halt the spiral involving the flight to

quality and to ensure the liquidity of the system. Should the crisis continue, monetary policies will have to be eased. No monetary authority wants to be blamed for failing to act in the face of the possible failure of the system. Once the markets have been sorted out it will be time to introduce the regulatory reforms needed, reforms which could have avoided the crisis, especially in the field of sophisticated loan derivatives, the valuation of risks involved and the protection of consumers.

What will happen in the real economy? The stock market crash in 1987, which created so much concern at the time, passed almost unnoticed by consumers and companies. On the other hand, the bursting of the IT bubble in 2000 brought about a notable slowdown in the world economy. Where do we stand now? In the case of the United States, the real estate crisis up to this point had brought about something similar to a slowdown half-way through the cycle. After recording growth of 3% in 2005 and 2006, gross domestic product (GDP) in the first quarter of 2007 rose by a mere 1.5%. In the second quarter, however, economic activity showed something of an improvement going up to 1.9%.

A number of factors suggest that, if the financial upsets get worse, they could notably worsen the US economic situation. The US consumer, a basic support for the economy, shows a negative savings rate that could bring about a major slowdown in consumer spending if confidence should collapse. After a long stage of profits and financial exuberance, companies could move into a stage of stagnation in investment and job creation. This is a negative scenario which, for the moment, we would discard. On the one hand, in macroeconomic terms, the downward course in real estate would seem close to ending. In addition, the course of

Collapse of confidence in markets provokes problems of liquidity, increase in risk premiums, greater volatility and urgent intervention by central banks.

Consequences for real economy depend on duration and scope of crisis.

Limited impact to be expected in United States in terms of GDP growth although risks appreciable.

Possible drop in US imports could slow international trade thus affecting Asian and European economies.

household and corporate spending does not have to be very greatly affected by the direct effects of what is largely a financial crisis. Finally, monetary and fiscal policies have some margin for action that, no doubt, will be put into operation in case of need.

In Japan and Europe, the effect of the financial upsets should be much slighter and restricted to the financial system. Where do the risks lie? The first is in the possibility of a major slowdown in imports by the United States which would affect the main players in international trade – the Asian and European economies. Secondly, there is the fact that a cooling off in prospects accompanied by increased rigidity in loan markets would not come at an opportune time when the economies of Japan and the Euro Area, while growing above potential, are showing a fairly notable slowdown profile. On the other hand, a slowdown in world growth would immediately produce a downward correction in raw materials prices, which would give support to the sustaining of incomes in the developed economies and allow some easing of financing terms.

In the case of Spain, the direct impact of the sub-prime mortgage crisis will be imperceptible. The economy continues to grow strongly with rates of increase in GDP at 4%. Nevertheless, it is true that the cyclical high in the current growth stage is now behind us. Economic activity has been gradually easing since the first quarter, following a slight rise at the end of 2006. According to the National Institute of Statistics, the easing off in economic activity in the second quarter was due to national demand, given that the foreign sector maintained its negative contribution to GDP at 0.9 percentage points. The performance in the foreign sector was the result of an increase in both exports of goods and services and imports.

The slowdown in national demand was due to most components with construction investment being the most notable. In any case, this sector still grew at a notable rate (4.6% year-on-year in the second quarter). The maturing of the prolonged expansionist stage in the real estate sector was already to be seen in the housing market but public works and industrial construction are showing notable strength. On the other hand, capital goods investment is proving extraordinarily expansionist, with an increase of 13.0% in the past year, palpable evidence of the confidence of companies in future prospects.

Household consumption, in turn, is moderating steadily, a trend in which the rise in interest rates is no doubt having an influence, although we should point out that consumer confidence improved slightly in July and such a relevant indicator as car sales stopped going down in year-on-year terms.

An important support for household consumption is job creation which in the first half-year has continued to show very strong. According to figures from National Accounting, employment grew at the rate of 3.2% year-on-year at the middle of 2007, without any sign of slowing its growth rate. We do see something of a slowdown in the labour market in the latest figures for registrations with Social Security and registered unemployment.

Finally, the prospects for Spain's economy are for a slowdown over coming quarters to rates of around 3%, something that we already were counting on at the beginning of the year. The sub-prime mortgage crisis may have some adverse affect on US growth, perhaps slightly affect the international economy, but it should not significantly change the course of Spain's economy.

August 30, 2007

Direct impact of sub-prime mortgage crisis in Spain seen as imperceptible.

Economy growing by 4%, with job creation staying strong, although some slowdown expected in coming quarters.

CHRONOLOGY

2006

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.
March	8	European Central Bank raises official interest rate to 3.75%.
April	13	Publication of Law 6/2007 in Official Government Bulletin (BOE) modifying the regulations applying to takeover bids which come into force in mid-August.
June	1	IBEX 35 index for Spanish stock market marks up all-time high (15,501.5) with cumulative gains of 9.6% compared with December 2006.
	14	Parliament approves new Law on Safeguarding Competition with creation of National Competition Commission.
	21	EU Council of Ministers approves adoption of euro as national currency for Malta and Cyprus as of January 1, 2008.
	23	European Council agrees on basic lines to be adopted in new treaty that takes place of European Constitution .
July	19	Dow Jones index for New York stock exchange registers all-time high (14,000.4) with rise of 12.3% compared with end of 2006.
August	9	European Central Bank injects extraordinary liquidity into interbank market as early emergency move to ease pressures set off by sub-prime mortgage crisis in United States.
	13	US Federal Reserve reduces discount interest rate from 6.25% to 5.75% in order to relieve effects of sub-prime mortgage crisis .

AGENDA

September

- 4 Registrations with Social Security and registered unemployment (August).
- GDP in EU (2nd Quarter).
- 6 Governing Council of European Central Bank.
- 7 Industrial production index (July).
- 13 CPI (August).
- 14 Balance of payments (June).
- Harmonized CPI (HCPI) for EU (August).
- 18 Fed Open Market Committee.
- 20 Quarterly survey of labour cost (2nd Quarter).
- 25 Producer prices (August).
- Central government revenues and spending (August).
- 26 Foreign trade (July).
- 28 Early HCPI (September).

October

- 2 Registrations with Social Security and registered unemployment (September).
- 4 Governing Council European Central Bank.
- 5 Industrial production index (August).
- 11 CPI (September).
- 15 Balance of payments (July).
- 16 Harmonized CPI (HCPI) for EU (September).
- 23 Central government revenues and spending (September).
- 24 Foreign trade (August).
- 25 Producer prices (September).
- 26 Labour force survey (3rd Quarter).

INTERNATIONAL REVIEW

United States grows at 1.8% with lower consumption and more exports.

Loss of confidence and credit restrictions sharpen consumer slowdown.

United States: sub-prime mortgages work against household consumption

During the 2004 electoral campaign, George W. Bush showed off his economic achievements with satisfaction. He had good reason. His expansionist fiscal policy with its tax cuts had lowered the effects of a major stock market crash. But most of the success was due to easy financing which not even the president's most loyal supporters had expected. The easy money policy of the Federal Reserve, the globalization of commerce and financial engineering worked a miracle of confidence, lowering interest rates and especially bringing down risk premiums.

The low cost of capital this brought about contributed to raising company profits to new highs but caution meant that investment did not follow the same upward track. Nevertheless, help was on the way. Since 2000, low interest rates gave support to a cycle of appreciation in the value of real estate which, because of the wealth effect and mortgage loans at advantageous rates, boosted private consumption, which has been the main player in the current cycle. Private consumption and public spending have raised the current account deficit above 5% of gross domestic product (GDP) but the central banks in Asia and confidence in US securities have facilitated the financing of this deficit.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007		
			3 Q	4 Q	1 Q	2 Q	July
Real GDP	3.1	2.9	2.4	2.6	1.5	1.9	–
Retail sales	6.6	6.2	5.5	5.0	3.4	4.0	3.2
Consumer confidence (1)	100.3	105.9	104.4	106.8	109.9	106.7	112.6
Industrial production	3.2	4.0	5.1	3.5	2.5	1.7	1.4
Industrial activity index (ISM) (1)	55.5	53.9	53.8	50.9	50.8	55.2	53.8
Sales of single-family homes	6.5	–18.0	–23.3	–21.9	–24.6	–18.9	...
Unemployment rate (2)	5.1	4.6	4.7	4.5	4.5	4.5	4.6
Consumer prices	3.4	3.2	3.4	1.9	2.4	2.7	2.4
Trade balance (3)	–714.4	–758.5	–777.7	–758.5	–745.6	–729.0	...
3-month interbank interest rate (1)	3.6	5.2	5.4	5.4	5.4	5.4	5.4
Nominal effective exchange rate (4)	83.7	82.5	81.6	81.6	81.9	79.3	78

NOTES: (1) Value.

(2) Percentage of labour force.

(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.

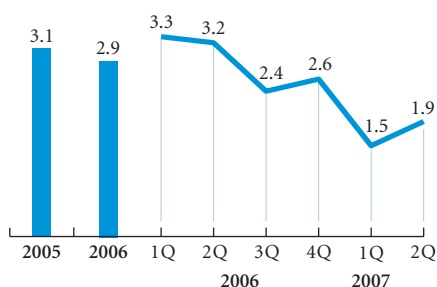
(4) Change weighted for foreign trade movements. Higher values imply currency appreciation.

SOURCE: OECD, national statistical bodies and own calculations.

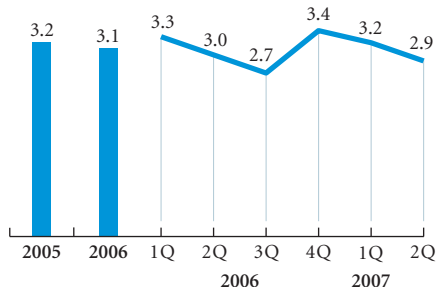
TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms

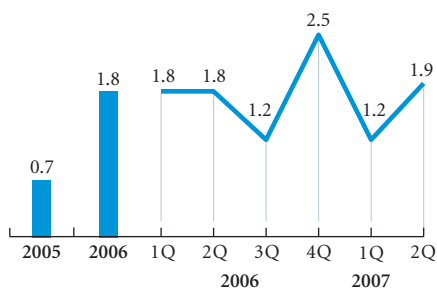
GDP



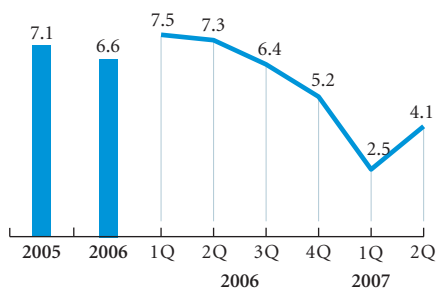
Private consumption



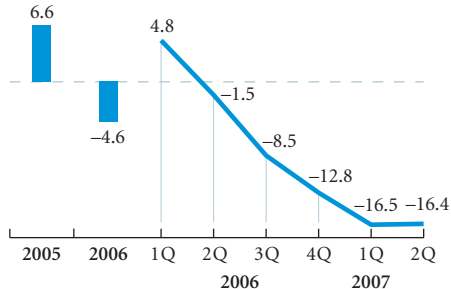
Public consumption



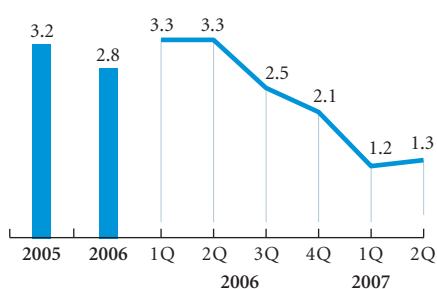
Non-housing investment



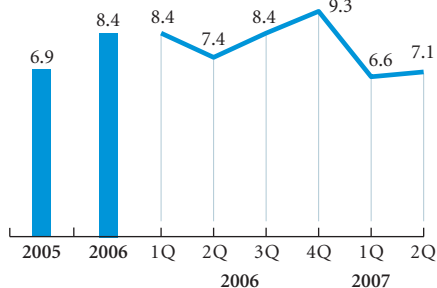
Housing investment



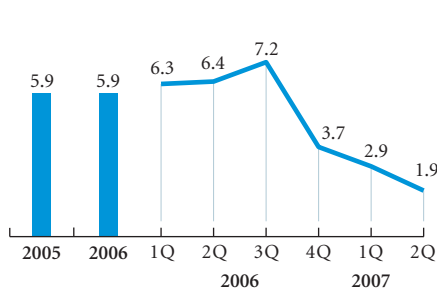
Domestic demand



Exports of goods and services



Imports of goods and services



SOURCE: Bureau of Economic Analysis and own calculations.

It is this confidence that has meant that high oil prices, a dropping dollar and interest rate increases by the Fed failed to

dampen spirits. At the start of the problem of sub-prime mortgages (granted to borrowers with low credit

Investment not taking off.

rating), the housing sector went into recession but economic activity continued to find support in private consumption that continued strong. Figures for GDP in the second quarter show, however, that this could be coming to an end. The economy grew by 1.8% year-on-year with an appreciable rise over the first quarter. But the rise was largely due to July revision of previously published quarters which this time was clearly downward. Furthermore, private consumption ended up dropping with growth at 2.9% year-on-year as against 3.2% in the first quarter, a slowdown that in quarter-on-quarter terms was much more abrupt, going from 3.7% to 1.3%. These decreases were equally shared between durable goods, such as cars and furniture (which were more volatile), and non-durable goods under which food showed major drops. This was not the case with petrol consumption and the fact is consumers are aware that the confidence which allowed them to go heavily into debt is now on a downward track.

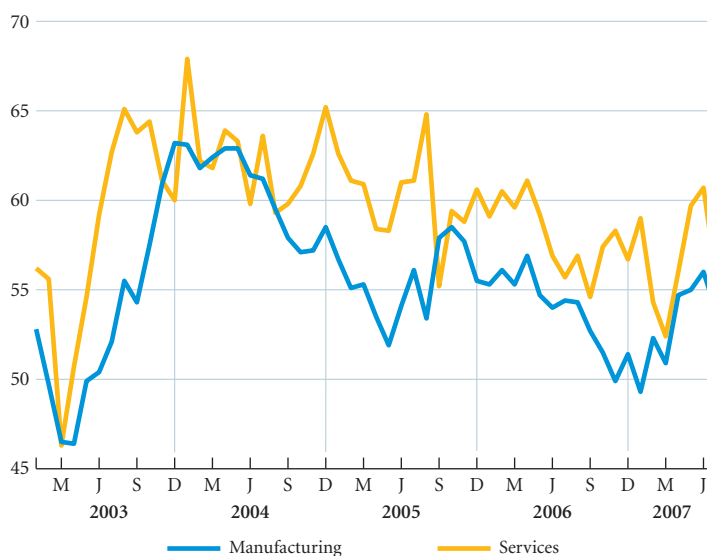
Retail sales slow down but consumers more optimistic than business executives.

Investment in capital goods left behind the unfortunate first quarter without much shine, marking up slim growth of 0.1% year-on-year. The drops in construction were somewhat smaller but the key sector of data-processing and telecommunications did not join the tentative increase in industry. Only industrial construction showed any strength. The expected recovery in the foreign sector was the best figure in GDP, with a quarterly contribution to growth of 1.2% in annual terms, following various quarters taking away strength, although the improvement was due more to an easing in imports because of lower consumption than to confirmation of a recovery in exports. This downward revision of GDP figures means a reduction in growth potential of the economy which stands at the highest possible rate of increase using all its production resources without causing inflation.

In keeping with the slowdown in consumption, retail sales (excluding the

UNITED STATES: BUSINESS EXECUTIVES LESS OPTIMISTIC

Level of ISM indices



SOURCE: Institute for Supply Management and own calculations.

UNITED STATES: NO ONE TAKING RISK ON HOUSING

Housing starts in annual terms



SOURCE: Federal Housing Board, National Association of Realtors and own calculations.

volatile headings of cars and petrol consumption) rose by 4.7% year-on-year in July, 2.5% in real terms discounting price increases, which meant that the growth rate did not reach half that seen in 2006. The consumer confidence index put out by the Conference Board in July rose by from 105.3 to a level of 112.6 points. But in view of other indicators showing drops this gain could be lost in the future. The view of business leaders, which is more in line with the times, is headed in the opposite direction. The economic activity index for July put out by the Institute for Supply Management went from 56.0 to 53.6 points for manufacturing and from 60.7 to 55.8 points in for services. While the level is still above 50 points, which indicates a predominance of optimistic replies, there were significant decreases and the main support comes from exports and prices and not from domestic demand. Also on the supply side, industrial production continued its slow progress with an increase of 1.4% year-on-year.

In turn, housing is going through its particular «witch hunt». The proportion represented by sub-prime mortgages is small but the drop in confidence equally affects individuals and financial institutions and now, as seen in loan markets, any leverage is looked at askance even though the figures are reasonable. The result is a market that has come to a stop with existing housing sales dropping by 11.1% year-on-year in June and new housing down 22.1%. The strong desire to reduce housing inventories meant that housing starts in July were very weak with a further drop of 20.9% year-on-year which put them 40% below the high in January 2006. Only prices maintained the levels of last year with very slight decreases but, in view of the properties for sale, recovery remains some way off.

Up until its recent change in attitude, the position taken by the Federal Reserve had insisted more on inflationary risks than on lower growth. However, the former seems to be losing strength with

Housing sector still failing to recover...

...but inflation holding at moderate levels while trade deficit down.

Japan grows by 2.3% with lower private and public consumption.

the consumer price index (CPI) dropping to a growth rate of 2.4% in July. The underlying component, which in the United States excludes food and energy, repeated the 2.2% seen the month before and, without including home rentals which eased sharply, prices rose by a mere 1.2%. In spite of the recent increases in labour costs, which may be attributed to end-of-cycle delays, and with consumer spirits down, the inflation front seems to be calm.

The labour market continued a moderate downward trend with non-farm labour for the last 12 months growing by 1.4% year-on-year as of July as against 1.7% at the beginning of the year. The unemployment rate rose slightly to 4.6%, a still considerably low level. The trade deficit for July was 58.13 billion dollars which meant a drop of 9.9% year-on-year in which, without ignoring the growth of exports, the key factor was an easing off in imports.

The US economy has clearly strong features in corporate profits, a labour market that is still strong and a foreseeable recovery in the foreign sector but, as president Franklin D. Roosevelt ever said years ago, the only thing we have to fear is fear itself.

Japan: all watching exports and the yen

Being overly liked is normally desirable but at times it may turn into a curse. The recent flight to quality assets in currencies meant a renewed interest in the Japanese yen, a currency with low inflation risk. The problem is that the attraction of the yen, with its subsequent appreciation, makes exports less competitive and these are crucial for an economy where domestic demand is still failing to take off.

In the second quarter of 2007, the GDP grew by 2.3% year-on-year showing a slight

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006			2007		
			2Q	3Q	4Q	1Q	2Q	July
Real GDP	1.9	2.2	2.2	1.5	2.4	2.6	2.3	–
Retail sales	1.4	0.2	–0.2	0.4	–0.1	...	...	...
Industrial production	1.5	4.5	4.0	6.0	5.3	3.6	2.3	...
Tankan company Index (1)	18.0	22.5	21.0	24.0	25.0	23.0	23.0	–
Housing construction	3.9	4.5	8.9	–0.8	5.4	–1.9	–2.7	...
Unemployment rate (2)	4.4	4.1	4.1	4.1	4.0	4.0	3.8	...
Consumer prices	–0.3	0.2	0.2	0.6	0.3	–0.1	–0.1	...
Trade balance (3)	10.2	9.4	9.1	8.9	9.4	10.2	11.1	...
3-month interbank interest rate (1)	0.1	0.3	0.3	0.4	0.5	0.6	0.7	0.8
Nominal effective exchange rate (4)	98.1	91.3	92.9	91.0	89.1	87.1	86.9	...

NOTES: (1) Value.

(2) Percentage of labour force.

(3) Cumulative balance for 12 months. Billion yen.

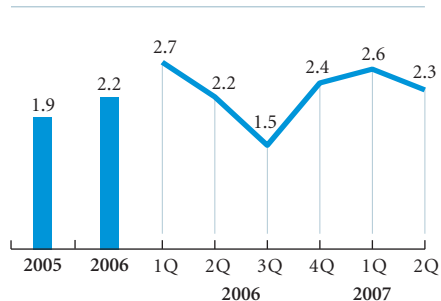
(4) Change weighted for foreign trade movements. Higher values imply currency appreciation.

SOURCE: OECD, national statistical bodies and own calculations.

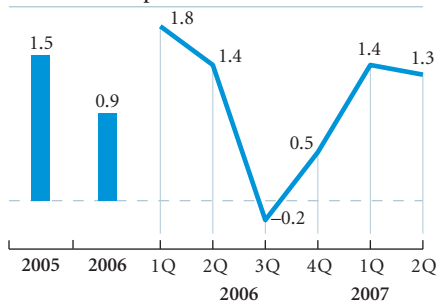
TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms

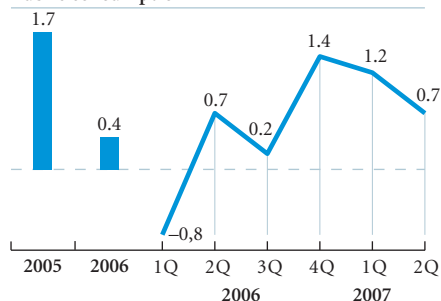
GDP



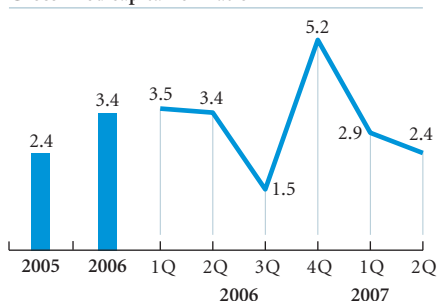
Private consumption



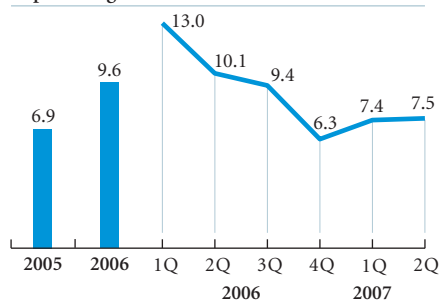
Public consumption



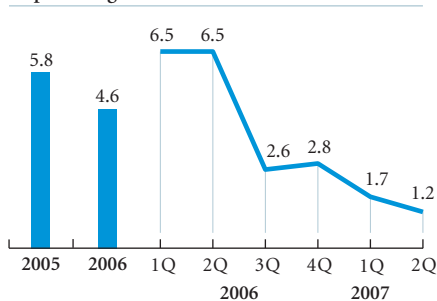
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



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

drop. The slowdown was not so slight in the case of private consumption for which the contribution to growth in quarterly terms annualized was down by half. With public finances taking a slimming cure and investment where the rise in capital goods does not compensate for the drop in construction, the main guarantee of economic activity is the foreign sector with exports growing at a rate well above imports. A

continuation of the present growth cycle, which is low profile but lasting, depends on these exports.

The impression of corporate executives is one of caution. Firstly, the Tankan index of business sentiment among large manufacturing companies put out by the Bank of Japan repeated a level of 23 points in the second quarter. Secondly, machinery orders, with a drop of 4.7%

While domestic demand fails to recover, strong dependence on foreign sector continues.

Industrial production slowing down and consumers more cautious.

year-on-year in June, do not indicate a strong rise in investment. What stands out is that companies are continuing to bet on the foreign sector to the detriment of domestic demand, with orders for export moving up by a modest 1.7% as against a drop of 16.0% in those going to domestic consumption.

The most recent demand indicators also illustrate this dependence on the foreign sector. Retail sales in June were down 0.4% compared with the same period last year. In the case of cars, sales were down in July by 8.6% year-on-year with the total for the past 12 months 15% lower than the level two years ago. The consumer confidence index in the second quarter was down from 46.7 to 44.0 points and savings propensity continued to rise to the detriment of consumption.

In turn, the real estate market showed contradictory signs with sharp drops in sales along with price increases and, following months of slack, a rise in housing starts, which showed growth of 6.0% year-on-year in June. On the supply side, the slowdown in industrial production continued with a rise of 2.3% year-on-year that month as against the 4.5% that kept showing in 2006.

The unemployment rate in June dropped to 3.7% of the labour force but prices remained on negative ground with the general CPI dropping by 0.1% year-to-year with no prospects of any immediate change. The positive counterpart continued to come from the foreign sector with a trade balance that climbed to 11,100 billion yen in the 12 months ending July.

Prices still in negative zone but trade surplus moving up.

JAPAN: INDUSTRIAL PRODUCTION AGAIN HALTING

Year-on-year change in industrial production



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

Climate change: certainties and unknowns

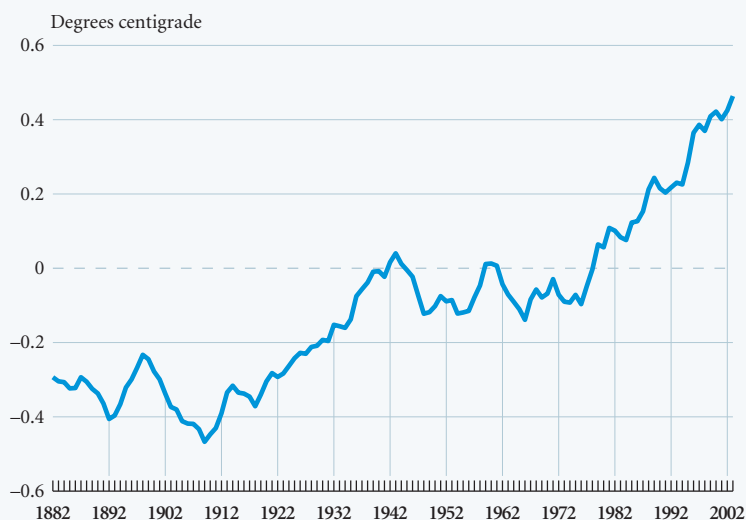
The number and intensity of hurricanes, cyclones or typhoons, floods and heatwaves; vast forest fires that devastate the United States, Portugal, Spain and Australia every summer; winters with no snow and glaciers breaking up at rates not seen before. The list of phenomena being attributed to climate change is endless but,... what are scientists saying on this matter? Is a structural change taking place in world climate? And, if the climate really is changing, should man activity be blamed for it?

The United Nations has been analysing if the Earth's climate is changing and how human activity can affect it for almost two decades. One of the most important steps was taken in 1988 when, together with the World Meteorological Organization, the Intergovernmental Panel on Climate Change (IPCC) was set up. Its main duty consists on summarising and spreading the most recent scientific advances on the topic. Undoubtedly, the job it has been handed is not easy given its complexity and the scarce consensus among the scientific community.

One of the few aspects on which there is general consensus is on the recent evolution of average temperatures on the planet which, as may be seen in the following graph, have risen with practically no interruption over the past 100 years.

UPWARD TREND IN GLOBAL TEMPERATURE

Average annual global temperature less average temperature for 1961-1990 period



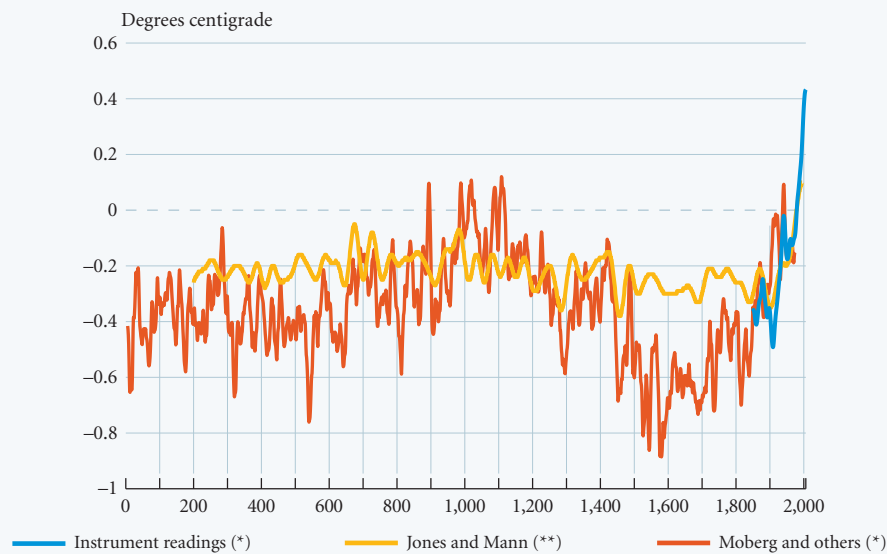
SOURCE: Hadley Centre, United Kingdom.

But, is this rise in temperatures something exceptional or have there been fluctuations of this size before? Unfortunately, the consensus about the historical evolution of temperatures comes to an end when direct temperature (or instrument) measurements are no longer possible and indirect sources of information have to be used. In order to reconstruct the temperatures of the last centuries, scientists have gathered information

from all available sources, such as tree-rings, samples of sub-soils or ice, marine coral, stalagmites in caves or marine sediments, to cite a few examples. This is what P.D. Jones and M.E. Mann did in an article published in the *Review of Geophysics* in 2004 and quoted in the IPCC report for 2007. According to their study, temperatures would have remained almost constant over the past 2,000 years up to the beginning of the 20th century. Since then, there would have begun a totally abnormal climb (see following graph). The same authors conclude that the anomalous behaviour of temperatures in the past 100 years can only be explained by the effect of human activity to the climate.

LONG-TERM ESTIMATES OF TEMPERATURE ARE MORE UNCERTAIN

Average annual global temperatures



NOTES: (*) Average annual global temperature less average temperature for 1961-1990 period.

(**) Average annual global temperature less average temperature for 1856-1980 period.

SOURCE: National Oceanic & Atmospheric Administration, US Department of Commerce, Hadley Centre and own calculations.

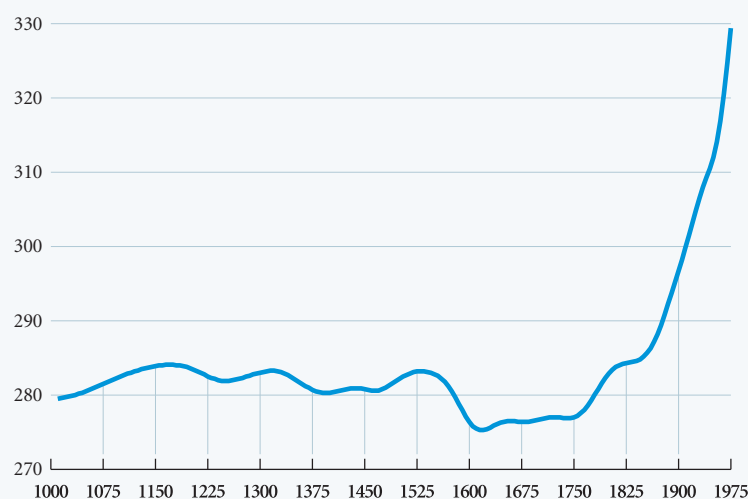
Nevertheless, another study also quoted by the IPCC and published in the prestigious journal *Nature* in 2005 by the scientists A. Moberg, D.M. Sonechkin, K. Holmgren, N.M. Datsenko and W. Karlén questions that temperatures have remained constant over the last two millennia. In this article, which makes use of a larger number of information sources and applies a more sophisticated estimation method, shows that at the beginning of the millennium there was a period with above-average temperatures (see previous graph). One can also distinguish two periods with below-average temperatures: the first was at the middle of the first millennium and the second in the 17th century. The greater variability of temperatures makes the recent rise look less abnormal historically, although it is true, as the authors conclude, that during the past 2,000 years there has not been any period with temperatures as high as those observed since the beginning of the Nineties.

Another point on which there is wide consensus in the scientific community is on the impressive increase of the CO₂ levels in the atmosphere over the past century (see following graph). It is also considered to be proved that a higher presence of these gases increases the greenhouse effect and, therefore, could raise the Earth's temperature. Nevertheless, the consensus also soon comes to an end here. The fact is that, as the

knowledge about how the greenhouse effect functions has increased, we have begun to identify its multiple secondary effects, thus underlining the difficulty in obtaining an estimate of the overall effect of these temperatures. On the one hand, for example, a rise in temperatures could increase water vapour (a greenhouse effect gas) in the atmosphere, thus amplifying the initial impact. It is also probable that this, in turn, would favour an increase in cloud cover, about which we still do not know the effect on temperature. On the other hand, it can be expected that the same increase in temperatures could increase melting at the poles. While it is true that ice reflects solar radiation more than the sea, it is also true that the sea manages to dilute a significant part of CO₂ emissions. At the same time, some studies suggest that an increase in temperatures could acidify the sea and so reduce its capacity to dilute CO₂.

THE LEVEL OF CO₂ IN THE ATMOSPHERE HAS SHARPLY INCREASED IN LAST 100 YEARS

Concentration of CO₂ in parts per million



SOURCE: Law Dome Historical records, the Carbon Dioxide Information Analysis Center, US Department of Energy.

The list of interconnecting links between the various factors involved in the present climatological system is endless, which makes it difficult to quantify the relation between increases in CO₂ and temperature.

In spite of the fact that the scientific community has made great advances in its knowledge of the climatological system, they still do not know the links between the various elements with exactitude nor the speed of adjustment to a new balance in this system. Nevertheless, scientists may simulate the evolution of temperatures with complex mathematical models using all available evidence. In order to determine the influence arising from human activity, they simulate the temperatures taking into account only natural factors and then they add on the variations due to human activity. As set out in the IPCC report, «it is very unlikely that global climate change seen over the past 50 years can be explained without taking human factors into account».

These models can also be used to make projections of the temperatures future trend. According to the studies used by the IPCC, if emissions were to remain constant at levels in 2000, it is estimated that at the end of the

21st century temperatures could rise between 0.3°C and 0.9°C. This increase could be between 1.1°C and 2.9°C in a scenario in which CO₂ emissions continue to increase but population growth is low and more efficient technologies are used, or between 2°C and 5.4°C if population growth is high and technological change is moderate.

There is no doubt that temperatures have been rising over the past century. Furthermore, it is very likely that human activity is partly responsible, although we do not know to what extent. Depending on our behaviour toward the planet, it may be that temperatures will raise more (or maybe a lot more) in the future. What is certain is that, in view of the complexity of the subject and what is at stake, we must continue to work hard to better understand the mechanisms that determine the planetary climate and to evaluate the costs and benefits of the different environmental policy measures. In this respect, the consensus is unanimous.

Brazil maintaining growth level with boost of 4.2%.

Strength of private consumption and increased investment should raise growth to 5% sought.

Brazil takes upward course

The figures for the economy are looking much more solid and balanced than in previous periods. The GDP grew by 4.2% year-on-year in the first quarter thus maintaining the level of the growth cycle. The recovery of private consumption and investment, with growth of 6.0% and 4.0% respectively, constitute some guarantee of this continuing. But the up to now successful foreign sector reduced its contribution to the rise with imports that increased

growth to 5.9% as against exports that slowed to growth of 7.2%, more because of the rise in the services deficit than a drop in the trade surplus.

While public consumption continues its slimming course, industrial production in June rose to a rate of increase at 6.0% year-on-year. Significantly, in line with the strength of investment mentioned above, industrial production of capital goods was up by 17.4% compared with the same period the year before. On the demand side, things continued along the

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007		July
			3Q	4Q	1Q	2Q	
Real GDP	2.9	3.7	4.5	4.7	4.2	...	—
Industrial production	3.1	2.8	2.8	3.2	3.8	5.8	...
Unemployment rate São Paulo (1)	17.0	15.9	16.0	14.3	15.2	15.6	...
Consumer prices	6.9	4.2	3.8	3.1	3.0	3.3	3.7
Trade balance (2)	44.8	46.1	46.1	46.1	45.6	47.3	45.0
Central bank SELIC rate (4)	19.1	15.1	14.4	13.4	12.9	12.3	11.5
Exchange rate (3)	2.4	2.2	2.2	2.1	2.1	2.0	1.9

NOTES: (1) Percentage of labour force.

(2) Cumulative balance for 12 months. Billion dollars.

(3) Value against dollar.

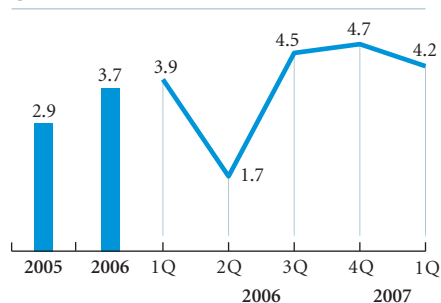
(4) Value of central bank rate from the Sistema Especial de Liquidação e Custódia (SELIC).

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

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms

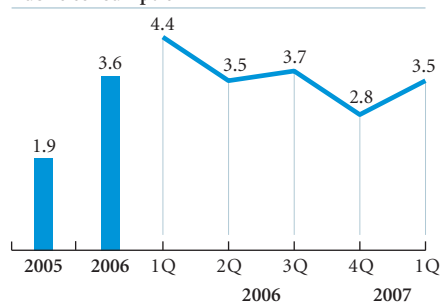
GDP



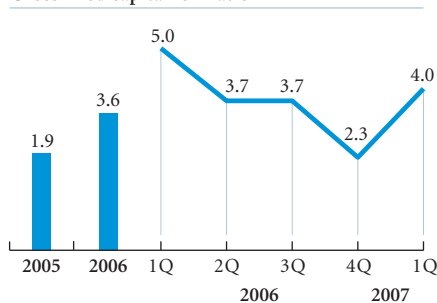
Private consumption



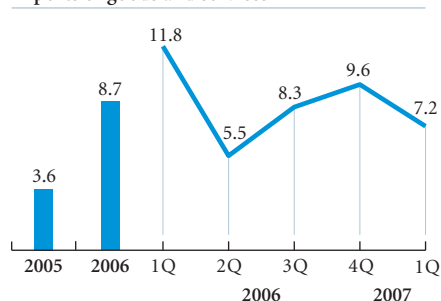
Public consumption



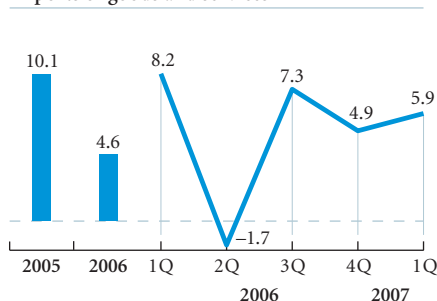
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



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

same lines as supply, a tendency to synchronization that does not seem to be taking place in Argentina. Retail sales in June were up showing an increase of 11.6% year-on-year, with a stronger level in the first half-year than last year.

Inflation remains under control in spite of the rise in July that put it at 3.7% year-on-year with levels close to an all-time low and moderate compared with its

trading partners. The appreciation of the currency should not mean a loss of competitiveness given that the starting point is that of a low-cost currency. In spite of the rise in the deficit in the services balance, the trade balance continued to maintain a positive figure which in the 12 months ending in July came to 45 billion dollars. In this positive context, the unemployment rate in the São Paulo district again dropped slightly

Inflation moves up to still moderate 3.7% but unemployment holds close to 15%.

BRAZIL: INDUSTRIAL INVESTMENT AGAIN MOVING UP

Year-on-year change in industrial production of capital goods



SOURCE: IPEA and own calculations.

Argentina grows by 8.0% thanks to private consumption and investment.

in June going to 14.9% of the labour force, which meant maintaining it at excessively high levels.

Argentina: growth with risk of inflation

Argentine growth is not losing any strength with GDP growing by 8.0% year-on-year in the first quarter. Private consumption and investment continue as the main pillars of economic activity while the foreign sector is still losing strength, hurt by a rise in prices which remains the biggest weakness of the current cycle. While, in contrast to previous times, the economic figures are looking robust, the recent financial upsets present a risk to be taken into account.

Demand continues to grow sharply...

...but industrial production slows because of weakness in steel and chemical industry.

The most recent demand indicators confirm the strength of the growth cycle. Retail sales in the Buenos Aires region grew by an explosive 35.6% year-on-year

in June followed by department store sales which were up 29.8%. In spite of showing a logical slowdown, car sales rose by 11.1% year-on-year in the 12 months ending June, going up to 76.3% of the level before the 2002 recession.

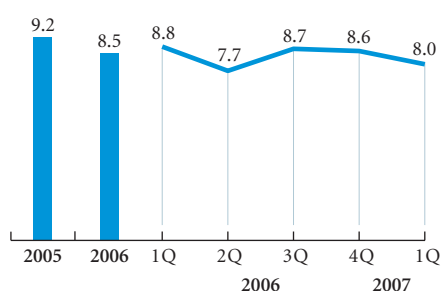
On the supply side, industrial production in June continued to lose steam with slim growth of 1.4% year-on-year, especially taking into account that in the same period last year it grew by more than 10%. The reason for this drop lay in the weakness in steel and the chemical industry, the latter reporting a drop of 14.5% year-on-year. The strength of the mining industries compensated the scene but only in part. In turn, the Synthetic Indicator of Construction Activity showed an increase of 4.3% year-to-year in June thus leaving behind the slack shown in the Spring.

Inflation at 8.6% in June, a figure high compared with the rest of the region,

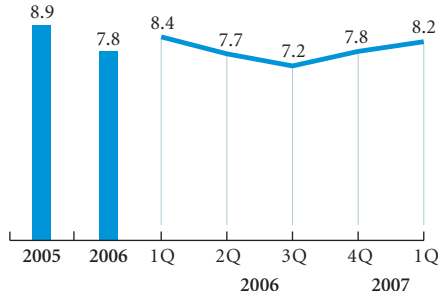
TREND IN ARGENTINE GDP BY COMPONENT

Percentage year-on-year change in real terms

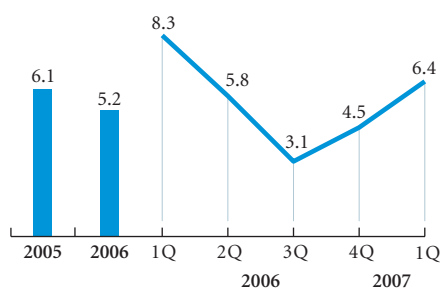
GDP



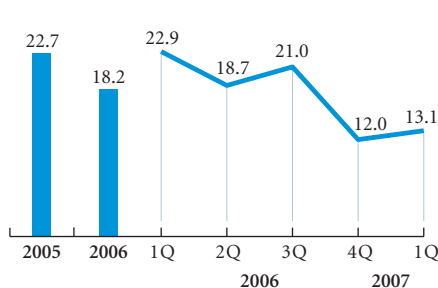
Private consumption



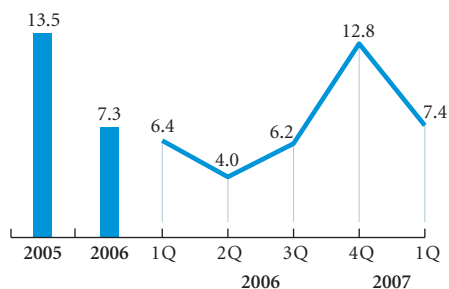
Public consumption



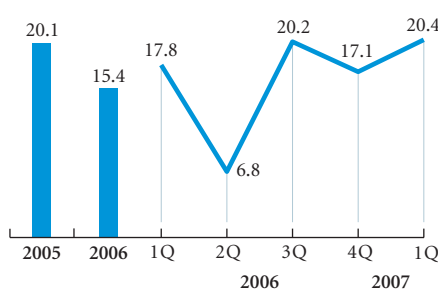
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



SOURCE: National Institute of Statistics and Census, Republic of Argentina (INDEC) and own calculations.

constitutes a risk for macroeconomic stability and the competitiveness of exports, in spite of the fact that the trade surplus is being maintained. Prospects do not indicate any rapid improvement given the recent rise in wholesale prices.

In turn, the unemployment rate in the first quarter rose to 9.8% of the labour force, a high level in view of the strength of domestic demand.

Inflation of 8.6% high for region and hurting foreign sector.

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007		July
			3Q	4Q	1Q	2Q	
Real GDP	9.2	8.5	8.7	8.6	8.0	...	—
Industrial production	7.1	7.8	9.7	6.1	4.6	3.0	...
Unemployment rate (1)	11.6	10.2	10.2	8.7	9.8	...	—
Consumer prices	9.6	10.9	10.6	10.1	9.5	8.8	8.6
Trade balance (2)	11.7	12.3	11.6	12.3	11.6	11.2	...
3-month interbank interest rate (4)	6.2	9.9	10.2	10.5	9.7	9.4	12.1
Exchange rate (3)	2.9	3.1	3.1	3.1	3.1	3.1	3.1

NOTES: (1) Percentage of labour force.

(2) Cumulative balance for 12 months. Billion dollars.

(3) Value against dollar.

(4) Value.

SOURCE: National Institute of Statistics and Census, Republic of Argentina (INDEC) and own calculations.

ARGENTINA: INDUSTRY LOSING GROWTH CYCLE

Year-on-year change in industrial production index



SOURCE: INDEC and own calculations.

Lower demand, now and expected, and exit of more speculative investors brings drop in oil prices.

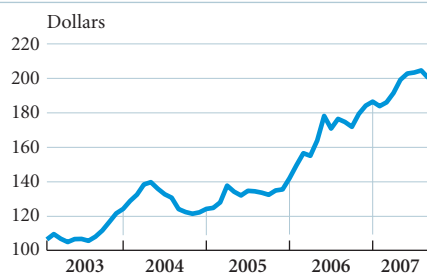
Raw materials: sharp correction in oil prices

After marking up annual highs in July above 77 dollars a barrel for Brent quality for one-month delivery, August brought a substantial drop in oil prices which put quotes in the area of 69-72

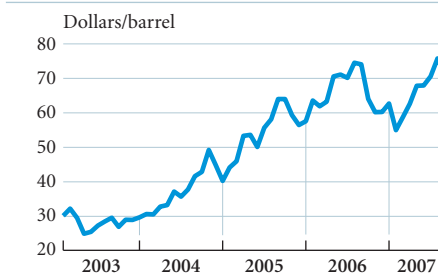
dollars a barrel at the end of the month. This notable downward adjustment was mainly due to three factors. First, the gap between supply and demand of crude has been gradually narrowing. Latest figures indicate that growth of world demand for oil is slowing down (especially in the industrialized

TREND IN VARIOUS RAW MATERIALS

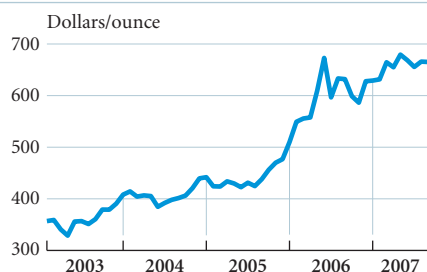
«The Economist» index



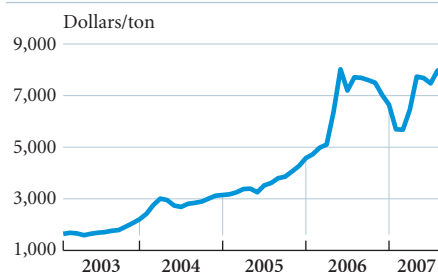
Brent oil



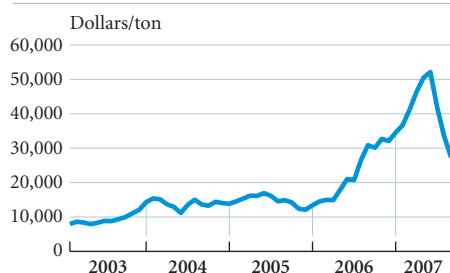
Gold



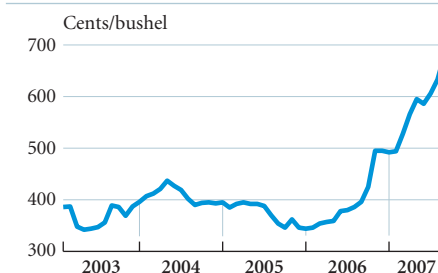
Copper



Nickel



Wheat



SOURCE: «The Economist», Thomson Financial Datastream and own calculations.

countries) while completion of maintenance work in the extraction and refining sectors is making possible a substantial increase in supply, both in the Organization of Petroleum Exporting Countries (OPEC) group and among non-OPEC producers.

A second factor is that it is now felt that future demand will tend to grow less than expected some months ago, to some extent reflecting the effects on the real economy of the recent financial market upsets, particularly the consequences for economic activity of a possible scenario of credit restriction.

Finally, a third factor precisely linked to the financial crisis, has been the withdrawal of the more speculative funds from the oil market.

However, while oil has offered some relief from its climb, other raw materials have shown uneven moves. Metals have tended to be corrected downward since last June. Now, to some extent as a result of the exit of the more speculative investors from the market, this downward sensation has strengthened. On the other hand, farm raw materials, especially wheat, are continuing to show a notable upward trend.

Metal prices show downward corrections over past three months, a trend sharpening as result of financial crisis.

Wheat at all-time highs due to growing food demand and poor harvest prospects this year.

Wheat reached all-time highs in August within a notable upward move (more than 725 cents a bushel). The determining factor for this trend was the growing concern about global demand for food and the difficulties in meeting the increasing demand. This perception was worsened in the case of wheat because major world producers, such as United States, are replacing part of those lands under wheat with crops of maize, a cereal used in producing

ethanol, a «green» fuel now on the increase in these times of dealing with climate change. In addition, poor weather has had a negative effect on harvests in Canada, Europe and Australia. Overall world demand for wheat in the 2007-2008 season will be 614 million tonnes but the harvest will amount to only 607 million tonnes, according to estimates by the International Cereals Council.

RAW MATERIALS PRICES

	2005	2006	2006		2007			
			3 Q	4 Q	1 Q	2 Q	July	August
«The Economist» index in dollars (*)								
General	3.6	27.5	30.5	33.3	21.7	18.1	15.9	14.7
Food	−1.3	11.0	8.5	20.2	16.5	19.0	23.2	28.6
Industrials	9.7	46.1	55.5	46.9	26.9	17.6	10.1	3.8
Non-food agricultural	−1.9	12.5	12.6	2.0	4.5	3.3	2.1	5.9
Metals	16.5	62.0	76.4	66.8	36.2	22.6	12.7	3.2
«The Economist» index in euros (*)								
	4.0	26.3	24.9	22.9	11.6	10.0	6.9	7.8
Oil (**)								
Dollars/barrel	55.1	66.3	70.9	61.0	58.7	68.8	75.8	71.3
Change rate	46.5	21.6	14.7	5.7	−6.5	−2.6	1.7	−3.7
Gold								
Dollars/ounce	445.1	604.1	621.3	614.4	650.3	667.8	665.9	665.9
Change rate	8.6	36.1	41.5	26.6	17.3	6.9	5.2	5.4

NOTES: (*) Year-on-year change rate.

(**) Brent quality: one-month forward price.

SOURCE: «The Economist», Thomson Financial Datastream and own calculations.

To curb or not to curb? That is the question

«Every time I ask you, When, how, and where, You always tell me, Perhaps, perhaps, perhaps...». It is highly likely that when Osvaldo Farrés wrote this famous cha-cha-cha back in the Forties he had in mind a dialogue between two lovers and not global warming. However, listening to it today, the lyrics of his song could well be referring to the dialogue on climate change between government officials and economists or between economists and geophysicists.

The level of complexity and uncertainty that characterizes the study of climate change is so great that giving a precise and rigorous answer to the most basic question (if it exists, its magnitude, or its causes) ends up facing Titanic difficulties (see box on page 13). And, if predicting temperature changes 100 years hence is complicated, making decisions based on those predictions is even more so. As the debate on climate change moves from the strictly scientific arena to the political stage where the matter is whether measures to halt it should or should not be taken, new uncertainties arise and the questions become: When? And how fast should greenhouse gas emissions (GHG) be reduced?

In order to answer such questions, it is necessary to address first two matters: How can we minimize the anthropogenic impact on the climate? And: How costly is that «how» relative to not doing anything about it? The measures of containment within our reach include, for example, using fuels that emit less CO₂ per energy unit, halting deforestation and planting more trees to absorb GHG, or investing in technologies more intensive in renewable energy and in technologies that make it possible to reduce the concentration of GHG in the atmosphere –like, for instance, techniques to capture carbon dioxide from the air and store it in underground sinks. Inevitably, none of these measures to contain climate change is cost-free and each of them must be evaluated relative to a scenario of inaction (business-as-usual). This requires a prior evaluation of the net benefit of either option and it is right there where economists, the experts in cost-benefit analysis, take over.

Based on standard principles of economic rationality, the optimum measure –and, again, «doing nothing» is an option– would be that which presents the most favourable cost-benefit ratio. The cost of each alternative –that is, the sacrifice it requires in terms of GDP– must be compared to its benefits, which are no more than the losses thus avoided. The possible losses associated to climate change include: adverse impact on agricultural productivity, the displacement of people and the loss of capital (factories, housing, infrastructures, etc.) which could result from a possible sea-level rise, the loss of water reserves due to the melting of glaciers, adverse effects on health, human lives, and fauna, or other ecological impacts. The task of evaluation is not a simple one; besides the complexity of assigning a monetary value to non-economic factors, such as the extinction of an animal species, economists must add to their list of complications the fact that many of the effects to be evaluated will take place in the future (more or less far off).

While the use of cost-benefit analysis in evaluating alternative measures to deal with climate change is not new, Sir Nicholas Stern, former Chief Economist of the World Bank and director of the British government's Economic Service, placed the debate on top of the public agenda when, in the Autumn of 2006, he presented his report on the economic consequences of global warming. Referring to climate change as «the greatest market failure the world has ever seen» and, based on the predictions in the Third Report of the Intergovernmental Panel on Climate Change (IPCC), Stern and his collaborators assert that, if we continue with the current trend in greenhouse emissions, the atmospheric concentration of GHG would reach 550 parts

per million in 2035, a figure usually associated with an increase in temperature of at least 2°C. Based on these figures, they estimate that the cost of the avoidable consequences of climate change (equivalent to 5% of GDP per year, considering only economic effects) is far higher than the cost of intervention (1% of GDP per annum) and thus advocate a drastic reduction in emissions of up to 25% of current levels in 2050 and up to 80% over a longer term.

Some people feel that the drastic conclusion of the Stern report is not fully justified. The main arguments used against it are, on the one hand, the great uncertainty still surrounding the estimation of damage associated to climate change and, on the other hand, the fact that this damage would materialize in a far distant future, with all the added valuation difficulties this entails. With regard to uncertainty, the complexity of the system that determines the various possible scenarios is enormous and not only is it necessary to predict climate alterations but also economic, social, and technological changes. We are talking about a century hence and who knows how far world GDP will grow! Who knows what measures will be taken to reduce emissions! Who knows what will be invented!

Moreover, the need to choose today between intervening or not when most of the effects occur tomorrow calls for a comparison of certain losses measured in terms of future consumption with the costs of intervention measured in terms of present consumption. Such a comparison –as any other investment decision that delivers future returns– not only requires the selection of a rate to discount future welfare in order to find its equivalent in present welfare. It also entails ethical judgments when comparing the welfare of different generations and populations with different exposure to climate change. Although the Stern Review has been questioned on several grounds, it is precisely for its particular choice of discount rate that it has received the harshest criticisms.

The Review appeals to ethical arguments to justify a discount rate close to zero (0.1% annual to be specific). This means attributing great importance to the welfare of future generations which, in turn, results in the present value of future effects being magnified, and –in combination with other assumptions in the report– it rationalizes emission cuts as immediate as possible. William Nordhaus, professor of Economics at Yale University and expert in the economics of climate change, argues that such a value is far below the observed rate of return to capital, measure commonly used to discount future effects in cost-benefit analyses. According to Nordhaus, the choice of a more realistic discount rate would lead us to conclude in favour of a not-so-drastic reduction in emissions, what he refers to as a «climate-policy ramp», that is, a gradual reduction in overall emissions that would begin with more modest cuts than those prescribed by the Stern report, and would go on gradually increasing as the century wore on (cuts of 16% in 2015, 25% in 2050 and 42% in 2100).

Aside from the fact that a close-to-zero discount rate can be justified based on ethical criteria of neutrality across generations, the Nobel prize-winner and Stanford University professor, Kenneth Arrow, claims that the case for containment is solid and that it would be difficult to undermine it based on discount rate arguments. Given the consequences of climate change which, in the absence of containment, are uncertain but truly negative, and recognizing that most of us feel some aversion to risk, especially if the risk is very high, Arrow estimates that any discount rate below 8.5% would have led Stern to err in favour of containment and to the detriment of not taking action. Thus, while warning of the need to analyze the robustness of the projections and to carefully evaluate the discount rate, he backs the fundamental conclusion of the Stern Review: better to

take drastic action today than to run the risk of letting the situation get out of hand and not being able to avoid suffering the consequences.

In sum, in spite of some disagreement still persisting over how much and how soon, and in spite of the complexity of the analysis and of the many uncertainties that remain, everything suggests that «containment» is the best option. Hence, when facing the choice between intervening or not, fewer and fewer would still reply «Perhaps, perhaps, perhaps».

EUROPEAN UNION

Euro Area growth slows to 2.5%, a course expected to continue but at more contained rate.

Euro Area: less steam in the engine

The European economy has clearly settled into a slowdown path. After growing at 3.3% year-on-year in the fourth quarter of 2006, economic activity slowed to 3.1% in the first quarter of 2007 and to a rate of 2.5% in the second quarter. Forecasts, however, suggest that the rate of slowdown will be more gradual in the second half of the year.

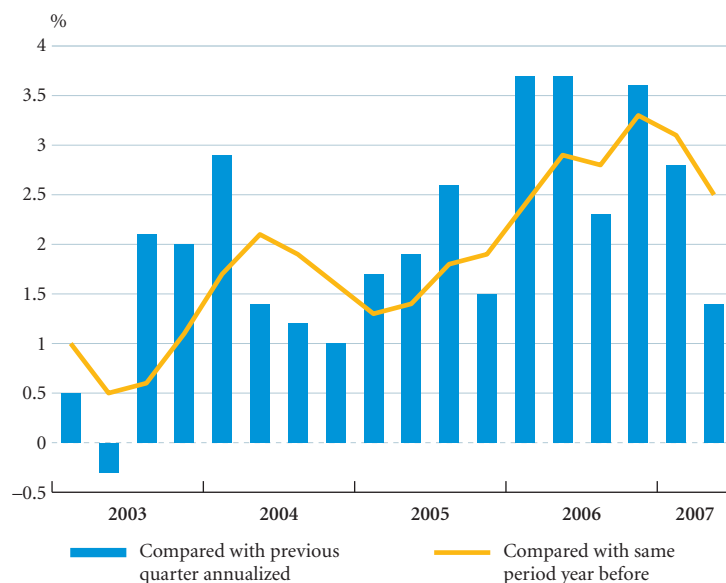
One of the basic reasons explaining why the recovery has not lasted longer and reached a higher level of strength is that private consumption has not taken off.

Although details of the trend by growth component of gross domestic product (GDP) in the second quarter are not yet available, available monthly indicators support this explanation. For example, retail sales grew by 0.9% year-on-year as an average for the April-June period, thus being unable to consolidate the rate of 1.7% for the first quarter which, on the other hand, was not exceptional.

In spite of this, the progressive recovery of consumer confidence suggests some improvement in consumption in coming months. The positive trend in the labour market, with the unemployment rate below 7% in May and June, should contribute to this turnaround. The

EURO AREA RECOVERY MOVES AWAY FROM CYCLICAL HIGHS

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

	2005	2006	2006			2007				
			2 Q	3 Q	4 Q	1 Q	April	May	June	July
GDP	1.6	2.9	2.9	2.8	3.3	3.1	–	2.5	–	–
Retail sales	1.2	2.1	2.3	2.4	2.3	1.7	1.7	0.0	1.0	...
Consumer confidence (*)	–14	–9.0	–10	–8	–7	–5	–4	–1	–2	–2
Industrial production	1.3	4.0	4.3	4.1	4.0	3.9	2.9	2.7	2.4	...
Economic sentiment indicator (*)	97.9	106.9	106.8	108.2	109.9	110.0	111.0	112.1	111.7	111.0
Unemployment rate (**)	8.6	7.9	7.9	7.8	7.6	7.2	7.0	6.9	6.9	...
Consumer prices	2.2	2.2	2.5	2.1	1.8	1.9	1.9	1.9	1.9	1.8
Trade balance (***)	42.1	–10.4	–10.0	–21.6	–13.1	–1.1	9.4	14.9	13.0	...
3-month Euribor interest rate	2.2	3.4	2.8	3.1	3.4	3.7	3.9	4.0	4.1	4.2
Nominal effective euro exchange rate	101.2	104.5	102.6	105.1	104.5	105.5	106.4	107.6	107.0	107.3

NOTES: (*) Value.

(**) Percentage of labour force.

(***) Cumulative balance for 12 months. Billion euros.

SOURCE: Eurostat, European Central Bank, European Commission and own calculations.

strength of household consumption, in any case, will not be sufficient to swing around the recent slowdown path the Euro Area has been following, given that contributions from the foreign sector and investment will not tend to improve in coming months.

Supply indicators coincide with the above view. Industrial activity, a good guide to the moment in the cycle, has been sliding progressively toward a range of lower growth rate. In June, industrial production grew by 2.4% year-on-year, far from the annual highs of above 4% in February and March. A similar path is being followed by services and construction, as may be seen from the trend in their respective confidence indicators.

This easing of economic activity has been accompanied by a relatively stable performance in inflation, although the harmonized consumer price indicator (HCPI) in July stood at growth rates of 1.8% year-on-year. This rate, which was

similar to the 1.9% showing between March and June, was largely due to the fact that the energy component recorded nil year-to-year growth in July, thus breaking the trend in recent months with a drop.

Starting out from this situation, the logical question is about the prospects for coming months. Of special concern is to know what will be the likely extent of the economic slowdown and the trend in inflation that could be part of this process. In spite of the uncertainty surrounding the current episode of financial upsets, the state of economic fundamentals in the Euro Area is positive and allows one to hope that the current momentum, with GDP growth above potential (which may be seen in values slightly above 2%), will continue in coming quarters. At the same time, we may expect some rise in inflation in the final part of the year.

The most immediate risks for meeting this scenario arise from the

A recurring factor (weak consumption) and a new situation (drop in investment) reduce possibilities of economic growth.

Inflation at 1.8% in July thanks to better performance in energy.

Risks in near future arise from international sphere rather than domestic scene.

international sphere. In view of the limited drive being shown by private consumption, the path of moderate slowdown foreseen may take place only in a favourable international context that continues to feed into the export-import binomial, which up until now has been the engine of the present European cycle, given that the recent trend in interest rates and exchange rate are working against it.

With regard to the first of these elements, exports grew by 9% year-on-year in June, approximately three points less than in the average for the first quarter. Foreign sales in recent months have tended to ease, partly due to the negative impact on competitiveness coming from the appreciation of the euro, higher than 3% in the 12 months ending in August. At the same time, the correction now beginning to show up in investment comes partly from tougher financing terms which naturally have come from the tighter money policy of the European Central Bank which has raised the 3-month Euribor to twice the levels seen in 2005.

Germany grows by 2.5% in second quarter as against 3.6% in previous quarter...

Germany: the party lags but isn't over yet

The German economy slowed to 2.5% year-on-year in the second quarter, as against 3.6% in the preceding quarter. This change was due to the fact that the gradual improvement in consumption was not enough to compensate for the slowdown in investment (both in capital goods and construction) and the lower contribution from the foreign sector brought about by the loss of drive in exports.

As of this point, the most recent indicators published suggest that, while the slowdown still has some distance to run, do not suggest that this process will be extremely harsh. In spite of the fact that the course of consumption is disappointing, consolidation of the recovery of consumer confidence in the May-July period suggests a turnaround in the final stages of 2007. The drop in the unemployment rate to 9.0% in July is an additional factor in support of household spending. Households are also being aided by the contained situation in inflation (stable at 1.8% year-on-year in June and July).

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006			2007				
			2Q	3Q	4Q	1Q	April	May	June	July
GDP	1.0	3.1	3.0	3.2	3.9	3.6	—	2.5	—	—
Retail sales	1.4	6.1	5.9	5.5	6.5	−1.2	−0.6	−4.2	−0.8	...
Industrial production	2.8	6.0	6.0	6.7	6.3	7.6	4.6	5.5	4.9	...
Industrial activity index (IFO) (*)	95.5	105.5	106.1	105.2	107.0	107.5	108.6	108.6	107.0	106.4
Unemployment rate (**)	11.7	10.8	11.0	10.6	10.1	9.4	9.2	9.2	9.1	9.0
Consumer prices	2.0	1.7	1.9	1.6	1.3	1.8	1.9	1.9	1.8	1.8
Trade balance (***)	156.3	153.1	151.2	148.3	158.1	168.4	175.4	180.4	183.6	...

NOTES: (*) Value.

(**) Percentage of labour force.

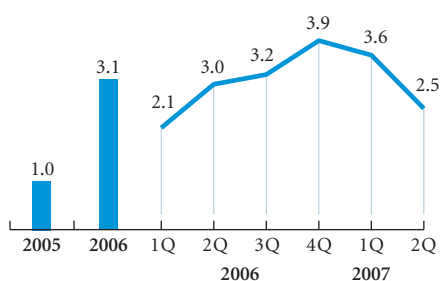
(***) Cumulative balance for 12 months. Billion euros.

SOURCE: OECD, national statistical bodies and own calculations.

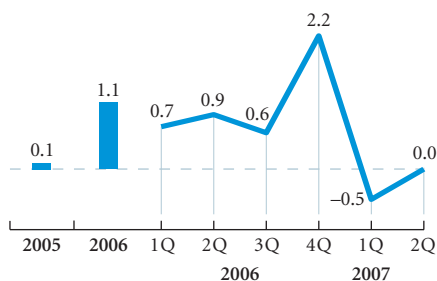
TREND IN GERMAN GDP BY COMPONENT

Percentage year-to-year change

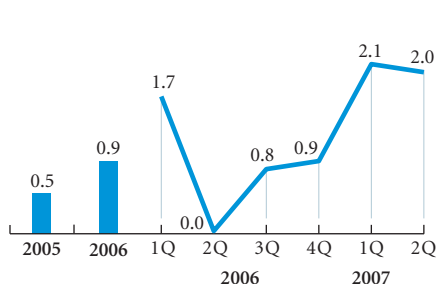
GDP



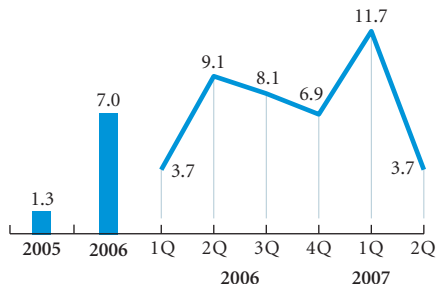
Private consumption



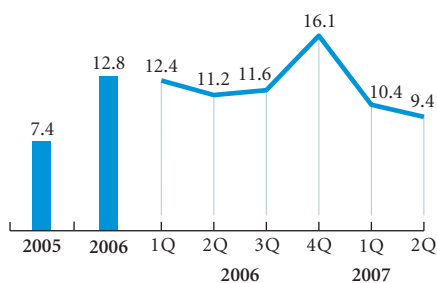
Public consumption



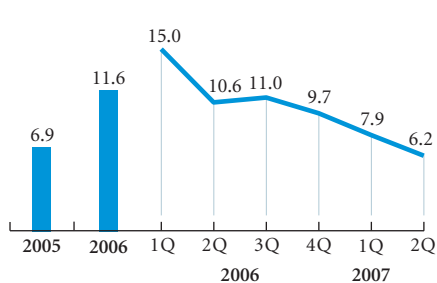
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



SOURCE: Federal Statistics Office and own calculations.

At the same time, industrial activity seems to have reached a ceiling in recent months, given that for three months in a row (from April to June) industrial production has been growing in the range of 5% year-on-year. In any case, the major increase in industrial orders seen in May and June means that prospects in the secondary sector are reasonably positive.

Finally, the current situation and economic prospects in Germany are

reasonably positive. While the peak of the cycle is now past, the road to a level of lower economic activity is very gradual and well anchored in the confidence of the key economic agents. A synthesis of these views is to be seen in the trend in the IFO industrial activity index. After marking up its highest levels since reunification in the early part of this year, in the months of June and July the index showed something of a downward correction. Nevertheless, the gradual nature of the process should

...but downward path will not be as sharp.

Corporate confidence remains high despite some correction.

remind us that Germany continues to run at a good rate. This view is supported by the recent news that in the first half-year the giant of the European economy showed its first government surplus since the time of reunification.

France: major drop in second quarter

France has not yet settled into a recovery path. GDP growth in the second quarter was a mere 1.3% year-on-year, substantially below that expected and the worst figure since the fourth quarter of 2005. This major slowdown, which follows 1.9% year-on-year growth in the first quarter, was mainly due to the notable drop in investment (which went from 5.0% year-on-year in the first quarter to 3.2% in the second) and the drop as a result of the accumulation of inventories, which took a half-point off the change in GDP. On the other hand, both private consumption and public consumption maintained a rate of increase of around 1.8% year-on-year, similar to that seen in the January-March period. In turn, the foreign sector reduced its negative contribution compared with the first quarter by half putting it at minus three decimals.

Latest monthly indicators do not help to remove the unknowns about whether this disappointing stage in the cycle will soon end. On the demand side, the quantitative figures, such as household consumption and car sales, suggest that, between the second and third quarters, the drive in private consumption was maintained. On the other hand, consumer confidence indicators showed a tendency to worsen in June and July, which clouds prospects for any appreciable recovery of household consumption. On the supply side, on the other hand, the situation is different, given that the main indicator, industrial production, dropped sharply in June with a year-on-year decrease of 0.8% whereas sector confidence rose in both June and July.

Interpretation of the trend in prices and unemployment is clearer. In both these areas the French economy is showing a positive trend. In inflation, we should point out that the CPI grew by a mere 1.1% year-on-year in July, slightly less than the 1.2% in June. Furthermore, other relevant prices, such as producer prices, also are tending to move down. With regard to the unemployment rate, in June this stood at 8.0% of the labour

Disappointing growth in France (mere 1.3%) in second quarter.

Third-quarter indicators scarcely remove doubts about economic trends in France.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006			2007				
			2 Q	3 Q	4 Q	1 Q	April	May	June	July
GDP	1.7	2.2	2.7	2.1	2.1	1.9	—	1.3	—	—
Domestic consumption	3.2	2.7	3.0	3.0	2.8	3.5	3.2	1.9	3.1	...
Industrial production	0.2	1.0	1.8	0.7	0.7	0.9	1.3	-0.4	-0.8	...
Unemployment rate (*)	9.8	9.0	9.1	8.8	8.6	8.4	8.2	8.1	8.0	...
Consumer prices	1.7	1.7	1.9	1.7	1.3	1.2	1.3	1.1	1.2	1.1
Trade balance (**)	-1.3	-2.1	-2.1	-2.3	-2.2	-2.2	-2.2	-2.3	-2.4	...

NOTES: (*) Percentage of labour force.

(**) Cumulative balance for 12 months. Billion euros.

SOURCE: OECD, national statistical bodies and own calculations.

force, with a cumulative decrease of one percentage point in one year.

Italy: modest but praiseworthy pension reform

The Italian economy continues along the usual paths followed in recent times. The economic situation is maintaining a discreet level but is not depressed, and the Prodi government is trying to take advantage of its narrow margin for political manoeuvre to push forward some reforms that will not substantially affect national balances.

Looking at the first of these matters, early figures for GDP in the second quarter confirm that Italy is on the course of slowdown that the other large Euro Area economies are also following. After growth of 2.3% year-on-year in the first three months of the year, the rate of economic activity dropped to 1.8% in the second quarter. While details of components are not available, the culprits for this loss of rate, on the demand side, had to be private consumption while, on the supply side, it was industry.

Household consumption indicators (consumer confidence and retail sales)

grew worse in second quarter while starting out from relatively low levels. At the same time, industrial production weakened in the second quarter compared with the preceding quarter. In this context, the only relief came maintenance of the growth rate for inflation at low levels (1.6% year-on-year in July) and from a positive downward trend in unemployment, which put the unemployment rate at 6.2% of the labour force in the first quarter, two decimals less than the figure for the fourth quarter of 2006.

Given this economic situation and taking into account the fragility of Italy's coalition government, the attempts of the government led by Romano Prodi to improve some of the structural deficiencies of the country certainly have merit. In spite of being considered insufficient, a recent agreement between the government and the trade unions opens the door to pension reform. This commitment establishes a gradual increase in the retirement age and the minimum number of years making contributions. If the letter of this agreement is met, the minimum retirement age in 2013 will be 61 years as against the present 57 and the number of contributing years will be 36 (35 at present).

Italy's GDP up 1.8% in second quarter as against earlier 2.3% as result of weak domestic demand.

Modest reform in pensions has more impact on current political scene than any broad effect.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006			2007				
			2 Q	3 Q	4 Q	1 Q	April	May	June	July
GDP	0.2	1.9	1.6	1.6	2.8	2.3	—	1.8	—	—
Retail sales	0.4	1.2	1.8	1.6	1.0	1.0	−0.4	0.2	...	...
Industrial production	−0.8	2.6	1.9	1.8	3.7	1.1	1.0	1.1	0.1	...
Unemployment rate (*)	7.7	6.8	6.9	6.6	6.4	6.2	—	...	—	—
Consumer prices	1.9	2.1	2.2	2.2	1.8	1.7	1.5	1.5	1.7	1.6
Trade balance (**)	8.2	7.0	10.9	7.8	10.8	15.7	−17.3	−16.3	...	...

NOTES: (*) Percentage of labour force.

(**) Cumulative balance for 12 months. Billion euros.

SOURCE: OECD, national statistical bodies and own calculations.

UK inflation at 1.9% in July may indicate some cooling down of economy...

United Kingdom: inflation easing

The picture of an overheated economy on a perilous path partly eased during the summer months. The figure confirming this impression came in inflation which, after looking very menacing in previous months, came up with an excellent result in July, going to 1.9% year-on-year (2.4% in June). In spite of the fact that the latest quarterly report of the Bank of England presents a scenario of prices still above the 2% objective (which in turn has given rise to expectation of some additional upward move in official interest rates), analysts are forecasting that the worst of inflation increases is now a thing of the past.

Even so, the composition of growth in the second quarter, which showed surprising strength in keeping at 3.0% year-on-year, reminds us of the key factors to be kept under watch in the Autumn. The first factor is the persistent

strength of private consumption. In the second quarter, this component rose by 2.6% year-on-year, a rate similar to that shown in the first quarter. In this respect, the figure for retail sales in July, which showed a rise of seven decimals over June putting the figure at 4.4%, confirms this trend. Certainly, so long as the strong labour market does not cool off (a market capable of showing an unemployment rate as low as 2.6% in July), background support from consumption will continue strong.

Another factor to watch is the extent of the slowdown in investment. In the second quarter, gross capital formation dropped to 1.7% year-on-year as against the previous 6.2%. Again, the indicators for the third quarter, still quite few in number, suggest that this trend is not going to be corrected in a hurry, probably reflecting the effects of monetary tightening of corporate borrowing conditions in the UK.

...but this trend will take some time to consolidate.

BRITISH INFLATION MOVES AWAY FROM HIGHS

Year-on-year change in consumer price index



SOURCE: Federal Statistics Office and own calculations.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006			2007				
			2 Q	3 Q	4 Q	1 Q	April	May	June	July
GDP	1.8	2.8	2.8	3.0	3.1	3.0	—	3.0	—	—
Retail sales	1.9	3.2	3.4	3.8	3.8	4.5	4.3	4.0	3.7	4.4
Industrial production	−2.0	0.0	−0.5	0.5	0.9	−0.1	0.3	0.6	0.8	...
Unemployment rate (*)	2.7	2.9	2.9	3.0	2.9	2.8	2.8	2.7	2.7	2.6
Consumer prices	2.0	2.3	2.2	2.4	2.7	2.9	2.8	2.5	2.4	1.9
Trade balance (**)	−64.9	−78.5	−77.5	−81.6	−83.1	−83.5	−83.7	−81.1	−80.6	...
3-month Libor interest rate	4.6	5.1	4.6	4.8	5.1	5.3	5.6	5.7	5.8	6.0
Nominal effective euro exchange rate	99.5	102.7	97.4	100.0	102.7	103.9	104.0	103.9	103.6	104.3

NOTES: (*) Percentage of labour force.

(**) Cumulative balance for 12 months. Billion pounds.

SOURCE: OECD, national statistical bodies and own calculations.

Environmental policy on climate change: where there is a will... is there a way?

Is the attempt to reduce global CO₂ emissions a utopia? The «tragedy of the commons» (as British economist William Forster Lloyd named problems similar to global warming and greenhouse effect gas emissions/GHG) has long been known, just as the conditions for its solution at the lowest possible cost. Nevertheless, ratification of the Kyoto Protocol has turned out to be an arduous process. It has left the United States and Australia by the roadside and important concessions have been made to other reticent countries. Many people feel that an agreement at a world level is unlikely in the near future. What are the causes of such pessimism? If the theory is relatively clear, why the solution seems to be so far?

An initial problem lies in the great uncertainty that exists about the social optimum level of emissions. In fact, if we could determine the most convenient level of emissions with certainty, either a tax on GHG emissions or a system of tradable emission quotas could address the problem. Both instruments would be capable of constraining the behaviour of the polluting agents in order to achieve this optimum level. Moreover, both mechanisms are the least costly as they equalize the cost of reducing emissions by an additional unit across companies to reflect the incremental cost that the society is willing to assume once the benefits arising from such a reduction are taken into account.

But if there is a constant in every study of climate change it is the uncertainty about the benefits and the costs of reducing emissions and, therefore, about their optimal level for the planet. Nevertheless, the different studies carried out to date allow us to be relatively confident on two points. On the one hand, we know that the effects of climate change depend on the stock of emissions accumulated over time and that GHG emitted during a year represent a very small part of this stock. The benefits from reducing emissions, even drastically, over a short period of time would thus be minimal. On the other hand, the cost of cutting emissions by one additional unit increases as we advance in the reduction process (reducing emissions from 100 to 99 costs much less than reducing them from 80 to 79). Hence, the requirement of a sharp reduction in emissions over a short time could turn out to be extremely costly and unsustainable due to its unrealism. On the contrary, more modest requirements, even if they are initially perceived as a lack of ambition, could be sustainable over time.

In this respect, the control of emissions through taxes is preferable to a system of quotas, since it minimizes the risk of incurring heavy costs if our predictions are wrong. A tax effectively sets a maximum for the unit cost of reducing emissions, something that does not happen with a system of quotas. In such a system, once the emission permits are granted, the amount of emissions is fixed whatever the cost this may have for the society.

Nevertheless, efficiency is not the only criterion that a mechanism should meet to be effective. The real challenge consists on implementing this mechanism worldwide, due to all the incentive problems that arise. The initial problem is to ensure the participation of all countries and thus, prevent the efforts of some of them from being wasted as a result of the opportunistic behaviour of others. *A priori*, the developing countries and fossil fuel producers may be the most reticent to participate. The objections of the former can be explained not only because they are not the cause of the problem (although the figures show that they will become responsible for a large part of the future GHG stock) but also because they can hardly afford the effort. Those of the latter are explained by the negative effect that a success in the reduction of emissions would have on their major source of revenues. Transferring large sums of money to them may not be attractive but, nevertheless, it is the only way to induce their participation. To this end, a quota system may be much easier to introduce politically since transfers would be made in an indirect way, by assigning them extra permits that could be sold. In order to increase participation and reduce compensations, some analysts have suggested setting moderate short-term objectives, which would increase notably over time, and a definition of eligibility criteria according to income levels in order to gradually incorporate developing countries to the agreement.

Another problem that arises is that countries have strong incentives to break any agreement that limits their emissions. From their individual point of view, this has insignificant consequences for the global objective if the other countries stick to the agreements. It is not easy to detect (not to mention sanction) the failure of a sovereign country to meet its obligations.

Once stated the main criteria to be satisfied, the question is whether the Kyoto Protocol will meet them. To some extent, the Protocol gathers together all the ideas previously discussed but it does so in a somewhat inadequate way. Setting emissions in 1990 as a base for calculating the necessary reductions is arbitrary and ignores the economic growth of countries since then. Those that have grown notably, such as Spain, face much bigger reductions than expected at the time they signed the Protocol. On the contrary, those countries that have grown less (or even contracted, such as Russia) will have permits in excess, which they will be able to sell without having had to invest anything to reduce their emissions. On the other hand, mechanisms for sanctions in case of fraud lack any real dissuasive strength and the future evolution of commitments to reduce GHG emission has been left up in the air.

In all, in its present form the Protocol does not properly solve the problems of incentives that are created. What is more, the refusal of the United States to join the agreement implies that the permits available to Russia suffice to compensate for the reduction efforts carried out by all the other signatory countries. Nevertheless, the Kyoto Protocol is not so far from the much-desired «ideal» mechanism. Of course, it needs some adjustments. Fortunately, those participating at the Heiligendamm summit seem to have taken note of this.

FINANCIAL MARKETS

Monetary and capital markets

Sub-prime mortgage crisis in United States centre of attention

August 2007 will go down in financial history because of the crisis in the US sub-prime mortgage market. What makes up such an asset? How has the «contamination» process worked? Sub-prime mortgages are mortgages granted to customers of poor solvency and which therefore present greater risk of default than those to «normal» customers. These mortgages are thus qualified when they are granted to persons with a problem credit history or to those unable to provide all the necessary documents (proof of income sources, for example) or in those cases where the amount of the mortgage represents a very high

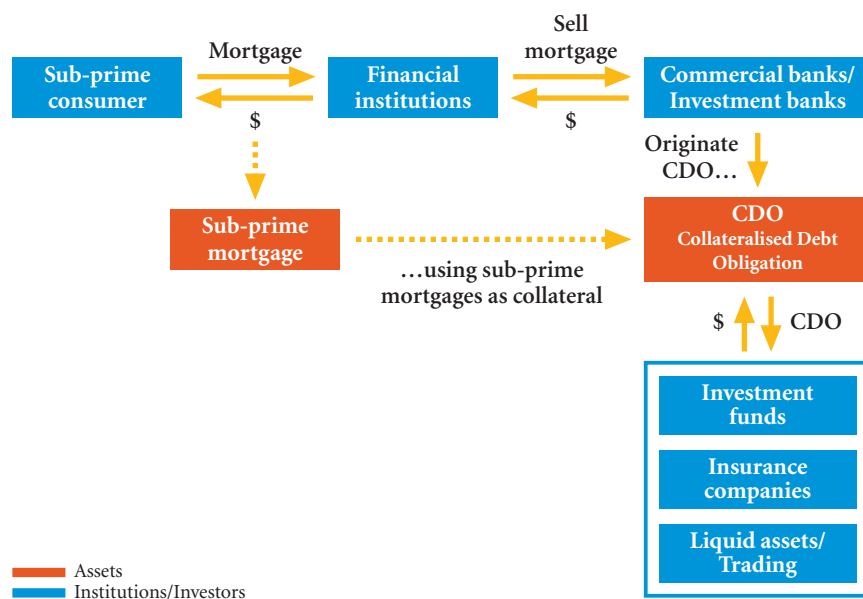
percentage of the price of the home being financed (more than 85%) or the monthly payment represents more than 55% of available earnings, etc. As they are more risky, sub-prime mortgages usually carry a higher interest rate. Normally, customers often pay a differential of between 2% and 3% more than the rate on a standard or prime mortgage.

At this time, the US mortgage market amounts to 10,000 billion dollars, of which sub-prime mortgages represent 13% of the total market and 9% of nominal gross domestic product (GDP) of the United States. *A priori*, it does not seem that its economic importance should place the liquidity of the US

Sub-prime mortgage crisis breaks out in United States.

High-risk mortgages represent 13% of US mortgage market.

TRANSFER OF MORTGAGE RISK



SOURCE: Internal.

Risk on these products transferred to institutional investors through securitizations.

Two key factors in «contamination» process: high liquidity and financial leverage.

Increase in mortgage interest rates, real estate recession and easing of loan financing terms are factors behind rise in mortgage default.

banking system in jeopardy. Nevertheless, two factors have heightened the damaging effects of the increase in default of these assets. Before going into an explanation of this «contamination», however, we should find out who holds these assets in their investment portfolios.

Most of these sub-prime mortgage loans are granted by financial institutions that are not deposit-taking entities and therefore are subject to lower regulatory and supervision requirements compared with those for other banks and deposit institutions. Once the customer uses the loan to buy a house, the debt is noted in the balance sheet of the institution granting the loan. However, in order to boost their business, these institutions relieve themselves of these mortgages and sell them to commercial banks or investment banks.

The new holders, in turn, package the mortgages in blocks and issue securitization bonds (CDO, or Collateralized Debt Obligations) using the sub-prime mortgages as security or collateral. That is to say, based on sub-prime mortgages, they create a new kind of asset that is more easily negotiable in the markets and it is this bond that carries the risk in the operation. To the extent that the holders of the mortgages keep paying off their debt every month, these funds are used to pay those who have bought these bonds. Those buying CDO are usually investment funds, insurance companies, liquid asset holders, traders, etc. who obtain higher yields from these assets than the market average although, naturally, running greater risk. This new product is broken down according to the credit risk assumed and a qualification or credit rating is assigned by the rating agencies. What credit risk does the buyer of these

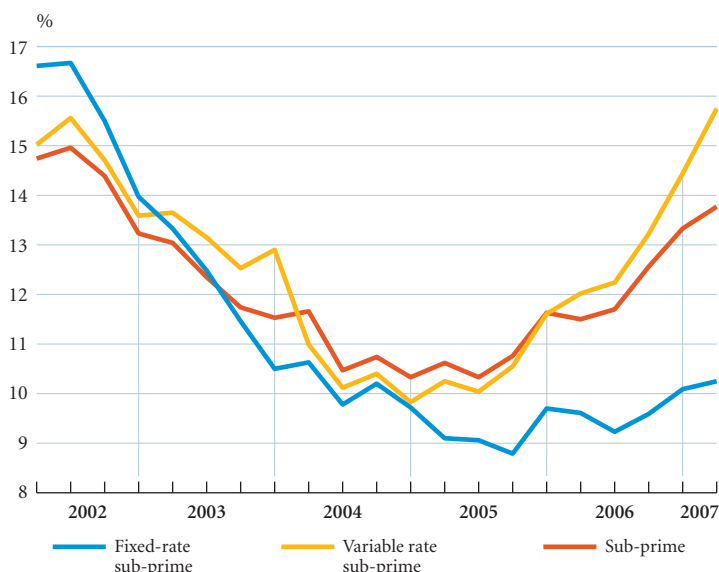
products take on? It is very simple. The security of the product goes back to the sub-prime mortgage. If a customer fails to pay off a mortgage, the losses shift to the holder of the loan or to the bondholder at the end of the risk chain. Finally, through securitization the sub-prime mortgages have been removed from the liabilities column in the balance sheet of the entity granting the original loan, having been transferred to the institutional customers mentioned above (investment funds, treasury departments of banks, insurance companies, etc.).

If the amount of the sub-prime mortgages represents a small percentage and the risk is spread widely, that is to say, finally distributed among markets operators, how do we explain that the crisis ends up «contaminating» other assets? As we suggested earlier, there have been two key factors, namely, high liquidity and financial leverage. For a number of years, the world financial system has been swimming in a sea of liquidity with a range of resulting factors (expansionist monetary policies, low inflation, development of new technology for managing risk, etc.). In order to correct this situation, the central banks in the main economies moved into a stage of interest rate increases in the face of fear of a speculative bubble linked to real estate assets and raw materials.

A number of factors have come together to bring about the sub-prime mortgage financial crisis in the United States. First, the sharp increase in mortgage interest rates (200 basis points in 2 years). What is more, the real estate sector went into recession in January 2006 with a decrease in the number of housing units sold and a drop in prices. In addition, there was a slight economic slowdown and, finally, an easing of conditions for

CONSUMERS CANNOT MEET PAYMENTS ON HIGH-RISK MORTGAGES

Default in terms of total credit granted



SOURCE: Mortgage Bankers Association and own calculations.

granting sub-prime mortgage loans, especially in 2005 and 2006. These elements have brought about an increase in mortgage default.

Institutional customers (especially hedge funds), which invested in this type of product, taking advantage of this opportunity for low-cost funding because of their high liquidity, and the possibility of using the carry trade (transactions involving borrowing in low-interest rate currencies offering high return), combined this with high leverage in order to increase yield. That is to say, funds borrowed money using fund assets as collateral in order to increase their investments in the same assets through complex derivatives. They thus heightened the concentration of risk using money from the fund to buy bonds for which the collateral was high-risk mortgages, borrowing in order to buy more bonds of the same type.

Effects of the crisis in capital markets

Sub-prime mortgage bonds are not listed on organized markets. Due to the absence of real daily quotes, to evaluate them it is common to use sophisticated mathematical models and they are usually evaluated on a monthly basis. Nevertheless, the increase in mortgage default made it necessary to recognize that some of these financial products could not recover the capital invested in them.

The uncertainty about the real value of these assets and about the financial viability of the institutions that granted these mortgages set off a lack of confidence among banks which opted for not lending money to these institutions in the interbank market. This led to an increase in interest rates in the interbank market in certain segments, as is shown in the accompanying table.

Uncertainty about value of these asset sets off all alarm bells.

All institutional investors suffer consequences of drop in credit-worthiness of high-risk mortgages.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2006									
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	3.55	3.82	4.09	5.25	5.36	0.57	5.25	5.57	2.21
March	3.75	3.89	4.11	5.25	5.35	0.67	5.25	5.55	2.26
April	3.81	3.98	4.25	5.25	5.35	0.65	5.25	5.65	2.32
May	3.82	4.07	4.37	5.25	5.36	0.66	5.42	5.77	2.41
June	4.06	4.16	4.50	5.25	5.36	0.70	5.50	5.89	2.54
July	4.05	4.26	4.54	5.25	5.36	0.78	5.75	6.04	2.63
August (1)	4.08	4.73	4.76	5.25	5.51	0.99	5.75	6.61	2.84

NOTES: (1) August 27.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-6-06 (2.75%), 3-8-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%), 8-3-07 (3.75%), 6-6-07 (4.00%).

(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: 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%), 10-5-07 (5.50%).

(5) Interbank rate.

SOURCE : National central banks, Bloomberg and own calculations.

In flight to quality investors reduce high-risk assets and buy government bonds.

The increase in default and the impossibility of obtaining financing led to the failure of many financial entities working in the sub-prime mortgage field. The crisis, however, was not limited to the United States. The spread of this business (the buying of mortgage securitization bonds) went far beyond the US market. Two German banks, the IKB and the Sachsen regional bank, had to be rescued because of losses created by these transactions. In view of the impossibility of calculating the liquid value of their investment funds, a number of institutions temporally closed these savings instruments. BNP-Paribas, for example, closed three investment funds and Goldman Sachs led the rescue of one of its funds by directly investing

3 billion dollars. Another investment bank, Bear Stearns, closed two hedge funds with a loss of 20 billion dollars, advising participants that everything had been lost. And the list continues, although no one knows exactly the range of the problem and until some months go by it will not be possible to get reliable information.

The lack of liquidity in the market also had an impact on the placing of bonds. As a result, the placement of 12 billion dollars in bonds to finance the sale of Chrysler was postponed. Other financing transactions for acquisition of companies were put off or suspended in view of the absence of investors interested in acquiring bonds or loans that were used

FLIGHT TO QUALITY HALTS RISE IN LONG-TERM INTEREST RATES

Trend in yield on 10-year government bonds in 2007



SOURCE: Bloomberg.

to finance acquisition of companies with major leverage.

The effects on prices of assets were soon to appear. Investors hastened to sell those assets that represented higher risk and to take refuge in government bonds. The flight to quality brought about substantial decreases in yield on government bonds. The movements in the interest rate curve were very sharp. US 2-year bonds went down to a quote of 3.99% from 4.80% while the interest rate on a one-month bill collapsed from 5.0% to a quote of 2.1%. The interest rate curves for government bonds shifted downward.

In addition, those companies that had financed themselves in the bond market by issuing bills and other similar instruments were obliged to pay higher risk premiums to the point where many issues were cancelled and companies were opting for using lines of credit opened with their banks. There was a significant increase in risk premiums on low credit rating bonds and on those of

emerging countries, although to a lesser extent. There were sales of currencies which international investors had used to finance themselves, which brought about sharp moves in the New Zealand dollar and the Japanese yen.

On August 9 and 10 the crisis shifted to world stock exchanges which showed sharp drops. The main world stock exchanges suffered decreases that ran between 3.2% and 9.1%, although at month-end they showed a slight recovery. There was also a sharp increase in the volatility of the stock markets. Movements were not only sharp but in a single session swings were very wild, that is to say, the stock market began a session with a sharp drop only to end up with a strong rise or vice versa. In fact, it is interesting to note how this increase in volatility is a reflection of the added cost of risk. It is possible to perfectly check the changes in asset prices taking place in August simply by noting the sharp rise in the volatility of the stock markets.

Companies finding it more difficult to raise funding in secondary bond market.

International stock markets drop between 3% and 9% with sharp increase in volatility.

EXCHANGE RATES OF MAIN CURRENCES

August 27, 2007

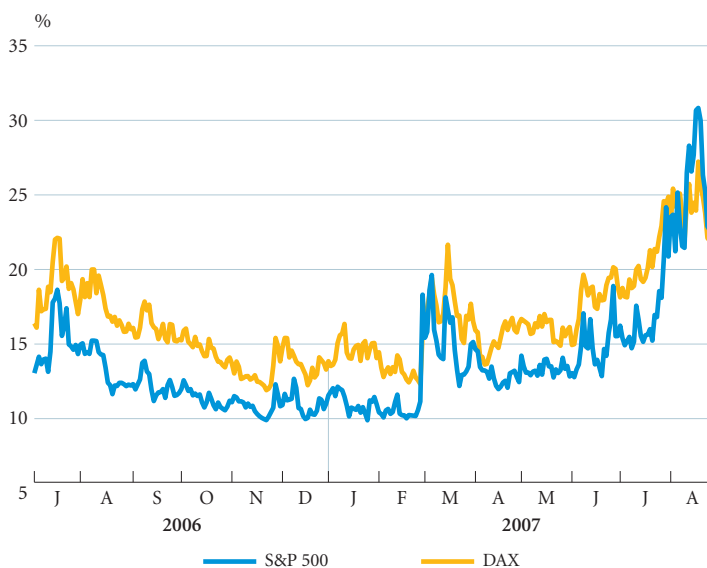
	Exchange rate	% change (*)		
		Monthly	Over December 2006	Annual
Against US dollar				
Japanese yen	116.2	−2.1	−2.4	−0.8
Pound sterling (*)	0.496	0.5	−2.8	−6.1
Swiss franc	1.204	−0.4	−1.3	−2.8
Canadian dollar	1.048	−1.5	−11.2	−6.1
Mexican peso	11.006	−0.1	1.7	1.2
Against euro				
US dollar	1.366	0.2	3.5	6.9
Japanese yen	158.8	−1.8	1.1	6.0
Swiss franc	1.644	−0.2	2.2	4.0
Pound sterling	0.678	0.6	0.6	0.4
Swedish krona	9.364	1.8	3.6	1.1
Danish krone	7.442	0.0	−0.2	−0.2
Polish zloty	3.825	0.5	−0.2	−3.2
Czech crown	27.79	−0.8	1.1	−1.4
Hungarian forint	256.0	1.8	1.9	−7.5

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

SOURCE: Bloomberg.

COST OF RISK GOES SKY-HIGH

Volatility in German and US markets



SOURCE: Bloomberg and own calculations.

INDICES OF MAIN WORLD STOCK EXCHANGES

August 27, 2007

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
<i>Dow Jones</i>	13,378.9	0.9	7.3	18.6
<i>Standard & Poor's</i>	1,479.4	1.4	4.3	14.2
<i>Nasdaq</i>	2,576.7	0.6	6.7	20.4
Tokyo	16,301.4	-5.7	-5.4	2.3
London	6,220.1	0.1	0.0	5.8
Euro area	4,257.3	0.3	3.3	12.6
<i>Frankfurt</i>	7,524.5	1.0	14.1	29.5
<i>Paris</i>	5,613.8	-0.5	1.3	9.8
<i>Amsterdam</i>	520.6	-1.2	5.1	11.9
<i>Milan</i>	40,023.0	1.1	-3.4	6.1
<i>Madrid</i>	14,352.4	-1.6	1.5	19.2
Zurich	8,824.5	1.4	0.4	8.9
Hong Kong	23,577.7	4.5	18.1	39.1
Buenos Aires	2,081.5	-3.2	-0.4	24.1
São Paulo	52,997.6	0.1	19.2	47.4

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

SOURCE : Bloomberg.

The reaction of the central banks

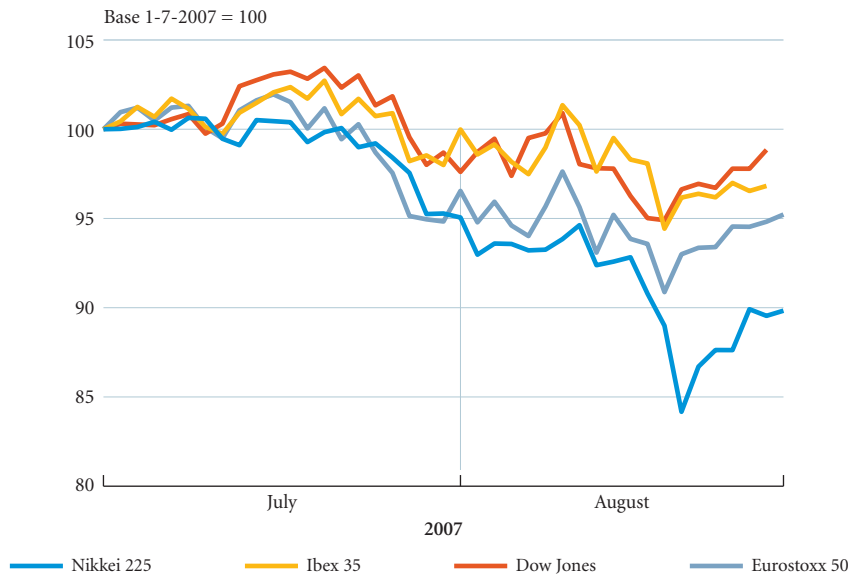
Concerned about risks to the system, the central banks intervened to an extraordinary extent by injecting funds to relieve liquidity problems in monetary markets. On August 9 the European Central Bank (ECB) injected 94.8 billion euros at its 10-day auction but on August 22 saw that there was a real problem of liquidity in the 3-month interest segment so that it injected 40 billion euros at 3 months into the monetary market. In total, central banks in the United States, Europe and Japan injected 350 billion dollars in order to ease pressures in the interbank market.

Following a sharp drop on the Japanese stock market on August 17 (more than 5%), and when European stock markets

were suffering sharp drops, the Federal Reserve lowered its discount rate from 6.25% to 5.75% while maintaining the Federal Funds rate (the official reference rate in the United States), that is, it cut the price of money for banks that use this rate to discount assets at the central bank. As soon as it became known, this move brought about a spectacular recovery in stock markets in Europe and the United States. The Federal Reserve put out two statements. In the first, it announced the cut in the discount rate advising that it was allowing banks to seek liquidity against the delivery of assets for a period of up to 30 days. Furthermore, the Federal Reserve noted that it was willing to accept a wide range of assets as counterpart to this liquidity, including real estate mortgages and related assets in order to help those

Concerned about risk to system, central banks inject liquidity to avoid worse situation in financial markets.

UPSETS IN STOCK MARKETS



SOURCE: Bloomberg and own calculations.

Federal Reserve drops discount rate from 6.25% to 5.75% while, for the moment, maintaining interest rate on Federal Funds.

entities having difficulty in selling these in the interbank market and not finding buyers. In the second statement, it indicated that conditions in financial markets had grown worse and that credit restriction and the increase in uncertainty had the potential to reduce economic growth over coming months. Abandoning its message of concern about inflation, the Federal Reserve left the door open to a reduction in interest rates at its next meeting on September 18 if the economic situation demanded it. The impact of all these measures calmed the markets which consolidated levels reached following the drops.

Three unknowns about coming months

What are the immediate prospects? The first question is the impact on the profit and loss accounts of those financial institutions most exposed to sub-prime mortgage risk. Furthermore, the drop on

the primary capital market means a loss of business because of the suspension of moves for listing on the stock exchange, placement of bonds in the bond market, merger operations and acquisitions that have been suspended or postponed. There will also be an increase in extraordinary provisions and the need for entities to figure assets that cannot be sold in their balance sheets with the subsequent using up of resources and less capacity to grant new loans. It is important to point out that, if the market recovers confidence and is able to reject the feeling of panic that took place in financial markets, this impact will merely mean a small dip in banking business. The problem will be how to maintain the situation over a number of months, given that corporate profits in the financial sector represent 30% of all corporate profits in the United States.

The second unknown is the impact of the tightening of credit terms on the course of the slowing down of US

consumer spending. Finally, the decisions taken by the Federal Reserve and the ECB in coming meetings on official interest rates remain an unknown. In the case of the United States, the possibility of a drop is showing more clearly. For the ECB, there is speculation that there will be a

postponement of the rise that was indicated for the meeting of the Governing Council in September. Finally, the dynamic of the market itself will be decisive for the guarantors of the system to decide to bring all their resources to bear to put out the fire.

Impact of crisis on profit and loss accounts of banks and consumers in United States, as well as doubts about next moves in official interest rates, are unknowns for coming months.

SPAIN: OVERALL ANALYSIS

Economic activity

Economic drive holding much stronger than Euro Area as a whole.

Foreign sector continues to take 0.9 percentage points off GDP growth.

National demand continues to gradually ease

Latest figures for the quarterly National Accounts published by the National Institute of Statistics covering the second quarter of 2007, following a revision of the historical series, confirm that the cyclical high of the current growth stage is now behind us. Nevertheless, Spain is maintaining notable economic strength, much higher than in the Euro Area as a whole.

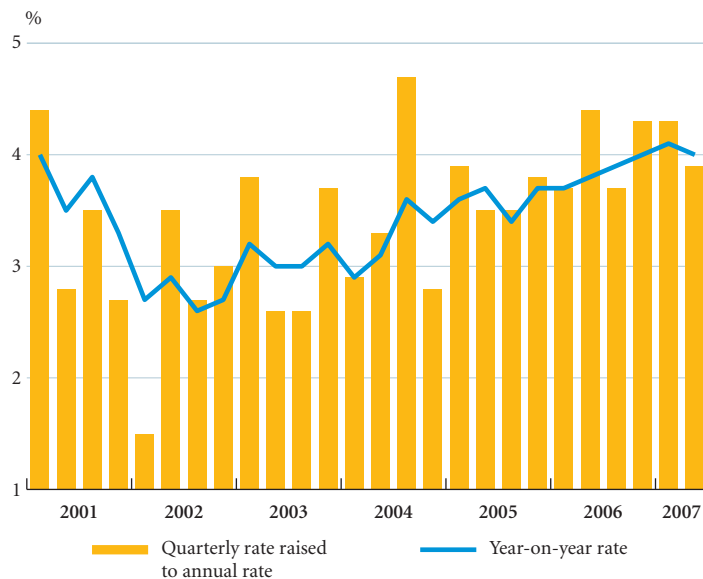
The gross domestic product (GDP) grew by 4.0% in the second quarter compared with the same period the year before. This was barely one decimal less than in

the first quarter when it reached the highest year-on-year rate since 2000. Nevertheless, the quarter-on-quarter growth rate has been slowing down gradually since the first quarter, following a slight rise at the end of 2006. The slowing of economic activity in the second quarter was due to national demand, given that the foreign sector maintained its negative contribution to GDP at 0.9 percentage points. The trend in the foreign sector came as a result of a rise in both exports of goods and services and imports.

The slowdown in national demand came in most components, the sharpest being construction investment. Both

SLIGHT SLOWDOWN IN GROSS DOMESTIC PRODUCT

Change in GDP

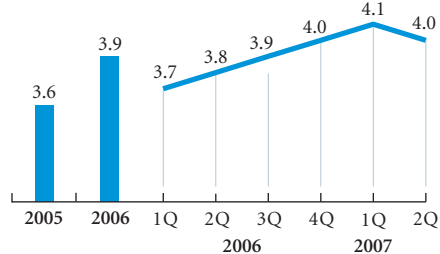


SOURCE: INE and own calculations.

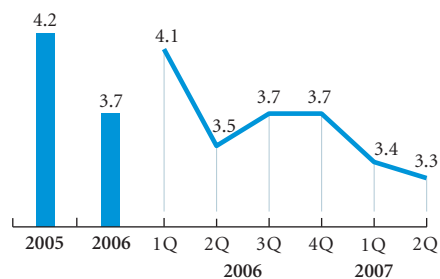
TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)

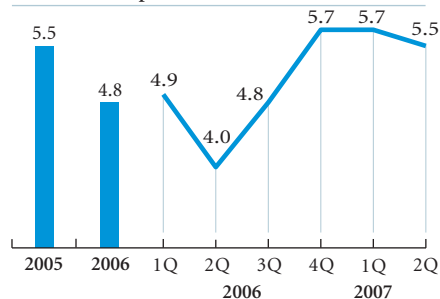
GDP



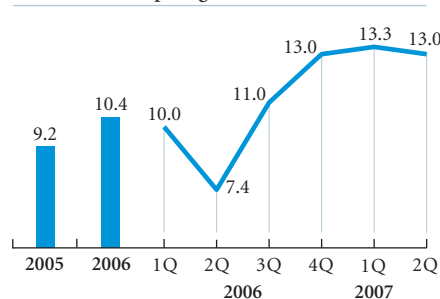
Household consumption



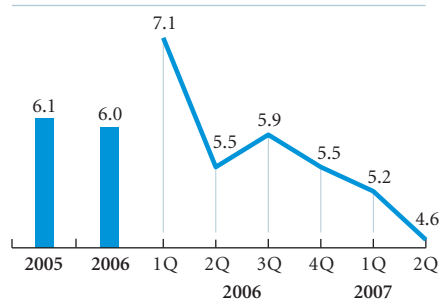
Public consumption



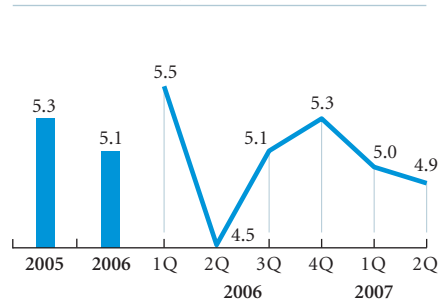
Investment in capital goods



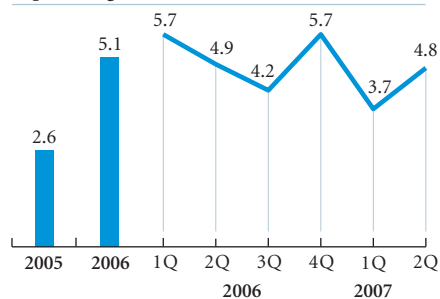
Construction investment



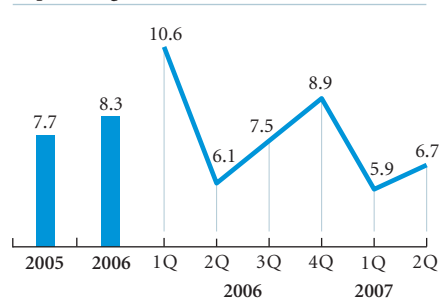
Domestic demand (**)



Exports of goods and services



Imports of goods and services



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

(**) Contribution to GDP growth.

SOURCE: National Institute of Statistics.

household consumption and public consumption eased slightly. The rise in

interest rate in recent times seems to be having its effect on household

Rise in capital goods investment.

Both housing construction and public works easing off.

economies. This trend could continue in the third quarter. Nevertheless, the slowdown will likely be gradual. In fact, consumer confidence improved a little in July and car sales stopped dropping in year-on-year terms.

Investment maintained a sharp year-on-year growth rate of 6.6%. Nevertheless, it showed some slowing down compared with the first quarter due to construction. Investment in capital goods continued to be very strong with an increase of 13.0% compared with the second quarter of 2006. Construction investment was up 4.6%, some 6 decimals less than in the previous quarter. Other investment, related to computer software, prospecting for mines and oil, etc., took on some strength although well below that for capital goods. The rise in investment, based on the strength of demand and

notable corporate profits, looks like continuing in the third quarter. In July, registrations of commercial vehicles recovered with a rise of 4.2% compared with the same month last year.

On the supply side, most sectors showed a decreased growth rate. Only energy and public services reported higher growth rates than in the previous quarter.

The easing off in construction was to be seen in both housing and public works. The performance in the latter was affected by the previous strong drive in public works that was expected to end before the municipal and autonomous community elections in May. The slowdown in the housing sector following the high growth rates in recent years will no doubt be consolidated. Latest figures available for approvals of

DEMAND INDICATORS

Percentage change over same period year before

	2005	2006	2006			2007				
			2Q	3Q	4Q	1Q	April	May	June	July
Consumption										
Production of consumer goods (*)	0.9	2.3	2.2	1.9	4.3	4.8	3.0	2.6	1.8	...
Imports of consumer goods (**)	7.9	8.9	5.9	2.4	7.6	-1.1	10.6	-0.1	7.2	...
Car registrations	2.1	-0.9	-3.6	-4.1	1.8	-0.7	-6.0	-0.2	-1.8	0.0
Credit for consumer durables	15.0	14.5	15.6	13.2	12.0	13.8	-	...	-	-
Consumer confidence index (***)	-10.8	-12.3	-12.7	-13.7	-10.3	-10.7	-12.0	-13.0	-13.0	-11.0
Investment										
Capital goods production (*)	-0.1	8.4	7.6	7.9	11.2	8.9	6.2	4.1	5.7	...
Imports of capital goods (**)	20.4	3.2	-5.0	6.5	3.4	20.1	9.3	17.6	6.2	...
Commercial vehicle registrations	13.2	1.5	-0.2	0.5	-1.0	1.7	1.7	-3.4	-4.2	4.2
Foreign trade (**)										
Non-energy imports	6.0	9.0	4.7	8.9	9.3	6.4	13.3	6.8	3.7	...
Exports	0.2	5.6	3.7	1.7	4.7	3.0	6.7	0.2	2.0	...

NOTES: (*) Adjusted for difference in number of working days.

(**) By volume.

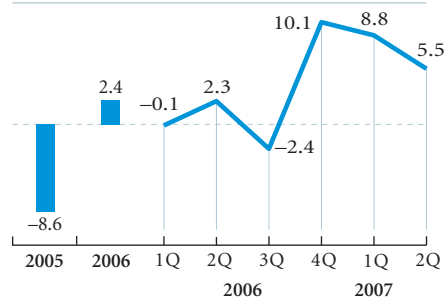
(***) European Commission survey: difference between percentage of positive and negative replies.

SOURCE: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of Economy and Finance, European Commission and own calculations.

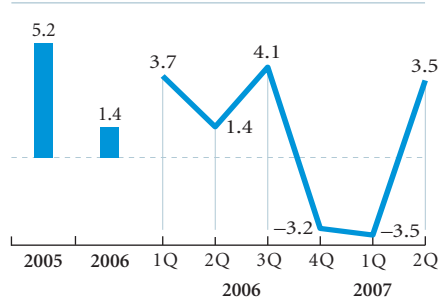
TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-on-year change (*)

Agriculture



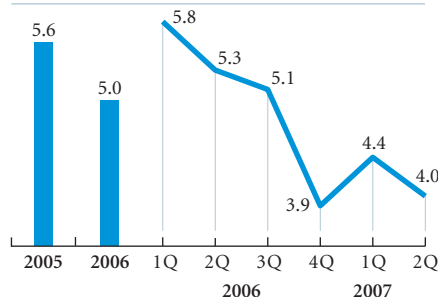
Energy



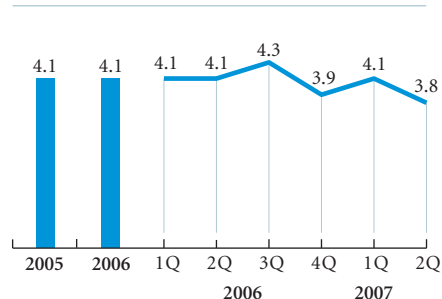
Industry



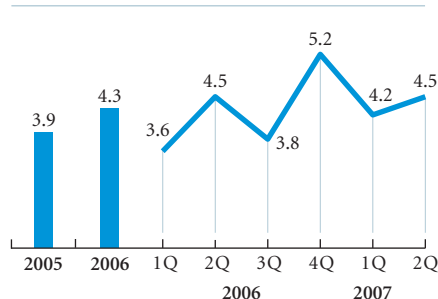
Construction



Market services



Non-market services



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

new housing projects (for May) recorded a year-to-year drop of 20.7%, the biggest drop since May 2001. Nevertheless, the confidence indicator for construction in July stood at a relatively high level.

The primary sector, agriculture and fishing showed a substantial slowdown in the second quarter under the effect of unfavourable weather conditions.

Nevertheless, it reported notable annual growth of 5.5%.

Manufacturing industries also slowed in the April-June period, although they grew more than construction. The year-on-year change rate was down by 7 decimals to 4.8%, which nevertheless does show notable growth. Furthermore, utilization of production capacity in July reached its highest level since 1998.

Manufacturing industry slowing down but grows more than construction.

SUPPLY INDICATORS

Percentage change over same period year before

	2005	2006	2006			2007				
			2Q	3Q	4Q	1Q	April	May	June	July
Industry										
Electricity consumption (1)	3.5	3.8	3.3	6.0	3.7	5.1	8.4	2.6	2.2	1.4
Industrial production index (2)	0.7	3.9	4.0	4.2	4.6	4.2	3.8	2.0	2.0	...
Confidence indicator for industry (3)	−4.8	−2.7	−2.7	−2.3	−0.3	2.3	2.0	0.0	0.0	0.0
Utilization of production capacity (4)	80.2	80.5	80.5	80.3	81.6	80.6	—	81.3	—	82.1
Imports of non-energy intermediate goods (5)	1.6	10.5	6.4	13.8	12.1	8.1	16.4	8.4	1.5	...
Construction										
Cement consumption	7.3	8.5	4.0	5.7	8.5	3.8	0.0	−2.6	−3.3	...
Confidence indicator for construction (3)	22.4	14.2	11.7	14.7	15.0	10.7	16.0	15.0	16.0	15.0
Housing (new construction approvals)	6.2	18.6	6.9	50.5	0.2	8.0	8.2	−20.7	...	...
Government tendering	18.5	31.3	34.8	19.1	55.1	15.1	−12.0	−9.6	...	...
Services										
Retail sales	4.4	5.0	3.8	5.9	5.2	6.2	3.1	4.6	5.9	...
Foreign tourists	6.6	4.3	9.7	3.0	2.5	5.3	−3.5	−1.4	4.8	1.8
Tourist revenue inflows	6.0	5.6	11.0	4.9	3.1	5.8	2.0	0.2	...	...
Goods carried by rail (ton-km)	−3.2	−1.2	−2.7	−3.3	−6.4	−4.1	4.7	−11.1	−10.8	...
Air passenger traffic	9.2	6.7	10.2	4.6	7.1	9.5	6.0	6.7	8.6	11.4
Motor vehicle diesel fuel consumption	5.1	5.4	4.5	3.9	4.9	5.8	4.3	2.4	...	...

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.

Modest increase in productivity.

Market service branches also reported slower growth rates so that the year-on-year change rate was down by 3 decimals to 3.8%. We should also point out that the appreciation of the euro hurt the tourism sector compared with other competing areas.

From an incomes perspective, worker wages rose by 7.0% compared with the second quarter last year, 4 decimals less than GDP at current prices. Given year-on-year growth in the number of wage-earners at 4.0%, wages per worker rose by 2.9% over the second quarter of

2006. Given that productivity rose by only a modest 0.8% over the same quarter last year, it turned out that unit labour cost rose by 2.1% compared with one year earlier. In turn, gross operating surplus rose by 8.1%. The gross domestic product deflator, which allows us to track the trend in prices of products and services in the economy as a whole, showed an annual change of 3.2%, some 2 decimals less than in the previous quarter, but stood considerably higher than that for the Euro Area.

With regard to the second part of the year, we expect that the moderate slowdown in economic growth will

continue. In any case, this means a considerable growth rate, still well above that for the Euro Area.

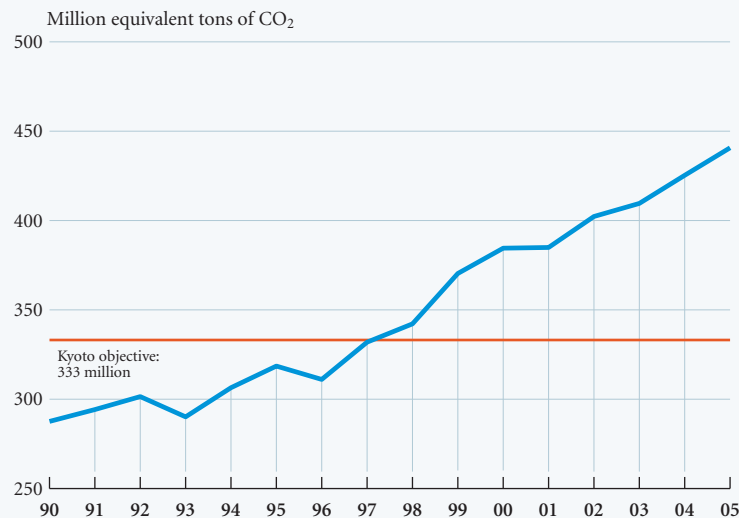
Prospects of gradual easing of economic growth.

The climate challenge in Spain

Question: What country among those making up the European Union (EU) is showing the greatest concern for the effects of climate change. Reply: Spain, according to the European Commission's Eurobarometer. Question: what member state of the EU most fails to meet the main commitment in the fight against climate change, the Kyoto Protocol? Reply: Spain, again. How are we to interpret these contradictions? Are they indeed contradictions? Let's examine each point in turn.

SPAIN'S ECONOMY FARTHER AND FARTHER AWAY FROM KYOTO PROTOCOL

Greenhouse effect gas emissions



SOURCE: Ministry of Environment and own calculations.

It should be remembered that the Kyoto Protocol is an international agreement signed in 1997, which the EU has had to meet as of 2003, aimed at restricting gas emissions that cause a greenhouse effect (GHG). For this purpose it establishes an emission limit by country which must be met on average for the period 2008-2012. In the case of Spain, this objective was negotiated as an increase of 15% over the emissions in the base year (1990 for CO₂, CH₄ and N₂O; 1995 for fluoride gases). The latest figures available (referring to 2005) show growth since then of 53%.

The discrepancy is indeed notable. How can it be explained? In fact, the EU set an overall quota which was later assigned by country. When the Council divided up emissions limits in 1998 the impression then taken of Spain's economy was quite different from that current today, especially in terms of economic growth and demographic strength. Nevertheless, the explanation based on economic growth above that expected is

insufficient. Whereas in other countries carbon intensity (that is to say, the ratio of GHG emissions per person or per unit of gross domestic product) has appreciably dropped, in Spain this has taken place only to a marginal degree in the case of GHG emissions per GDP unit or has even increased, as in the case of GHG emissions per capita, which in 2005 were 38% higher than those in 1990.

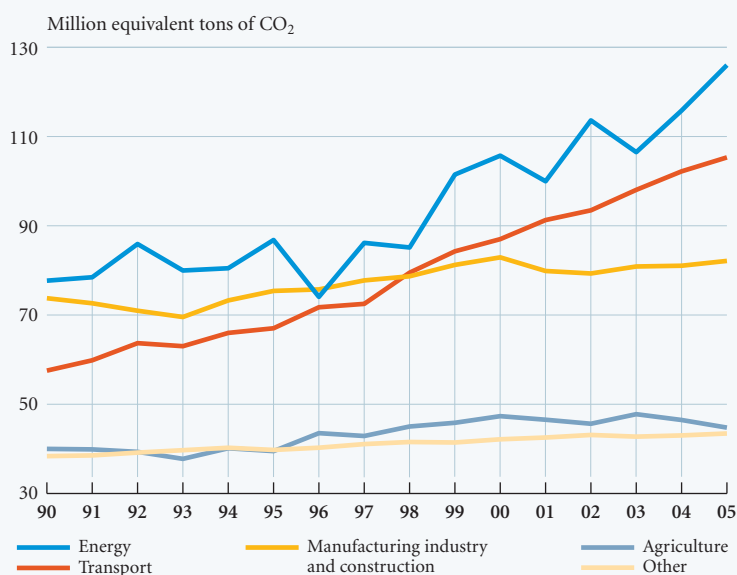
How is it possible that in 15 years of development the economy continues to show such a large appetite for carbon? One explanation arises when we look at those sectors that have most contributed to the increase in emissions, namely energy and transport, the big contributors of emissions in absolute terms. The former is responsible for 31.5% of the increase in GHG emissions between 1990 and 2005, a figure practically identical to 31.2% for transport. Industry (manufacturing and construction) generates some 21.9% of additional emissions compared with those in 1990. All other sectors together barely make up 15.4% of the total.

Therefore, in order to properly understand why Spain is moving away from the Kyoto objectives, we should focus our attention on energy and transport. To start with, it should be pointed out that, in spite of showing similar figures in terms of the additional volumes of GHG emissions, the transport sector shows a more troubling performance seeing that it has increased its emissions by 83% compared with 1990, whereas energy has shown an increase of 62%. While in both cases it is a matter of major discrepancies and, in fact, discrepancies higher than those of the economy as a whole (whose GHG emissions grew by 53% in the 1990-2005 period, as mentioned earlier), the above figures are indicative of two different courses being followed due also to different factors.

In the case of energy, the main reason for the increase was that, in view of the big increase in demand for electricity due to strong economic growth, the response has been more power-stations run by coal, oil and gas.

ENERGY AND TRANSPORT: SECTORS WITH EXCESSIVE EMISSIONS

Greenhouse effect gas emissions by sector



SOURCE: European Environmental Agency and own calculations.

As a result, electrical power generation with no emissions in 2004 was 42% of the total, 10 points less than in 1990. Transport, in turn, has raised its contribution mainly because the sharp increase in demand has largely been met through recourse to road transport as against other modes that are more efficient from a pollution point of view. As a result, the share of road goods transport rose by nearly six points between 1991 and 2005.

In such a situation, what are the prospects of meeting the Kyoto Protocol? The latest «Progress Report» from the Spanish government dated 2006 makes a projection of current trends up to 2020 starting out from emission control policies in force in 2005. This scenario suggests a discrepancy of the order of 50% compared with the objective for 2008-2012, with the industrial and energy sectors showing a 37% deviation and the rest (basically transport) standing at 65%. Later on, at the beginning of 2007, Spanish Strategy on Climate Change establishes the objective of a maximum discrepancy of 37% on average for the reference period. This result would be met by limiting the deviation in the non-industrial and non-energy sectors to 37% (and not the 65% as mentioned earlier) and by maintaining the deviation in industry and energy at 37%.

Although this may not happen immediately, if this tough deviation objective of 37% were to be reached, Spain would be complying with the Protocol. This apparent contradiction (after all the Kyoto objective is 15% and not 37%) is due to the fact that this compromise establishes three instruments whose effects «subtract» from the total figure for a country's emissions. The first instrument is the trading of supplementary GHG emission rights, a mechanism through which Spanish companies needing them may acquire supplementary emission rights or, if they have a surplus, they may sell them. Those companies that may issue or compensate emission rights are the owners of 1,045 large polluting sources in the energy and industrial sectors for which the government establishes annual emission limits through what is known as the National Emissions Assignment Plan. The second instrument is called Clean Development Mechanisms (CDM) which consist of projects financed by Spanish companies or the government aimed at reducing emissions in developing or industrialized countries and generate emission credits in Spain. Finally, a third mechanism that makes it possible to discount total emissions is called «carbon sinks», that is to say, basically, an increase in forested areas.

The government is confident that these new mechanisms will absorb 2% of total emissions. The lion's share of the adjustment will thus fall on the CDM and acquisitions in the carbon credits market, given that they would account for the remaining 20%. According to government estimates, some 58 million tons would have to be acquired annual between 2008 and 2012, with 55% of this by the government through recourse to Clean Development Mechanisms with an estimated cost of 220 million euros annually and 45% by companies in the market, with a cost of 400 million euros annually.

It is obvious that, even in the case where measures of flexibility provide the results forecast and at the estimated cost, the situation remains complicated. Maintaining emissions at 37%, that is to say, below the 400 million equivalent tons of CO₂, will mean having to go from a growth path to one involving reductions, at least in some years. The problem with energy is quite clear. Either we substantially change the mix of electrical power generation or we take a giant step in terms of energy efficiency. If we don't, the deviations will not be reduced.

The basic difficulty, however, is to be found in the transport sector. This sector falls within what is known in Kyoto jargon as a «diffuse sector», that is to say, that, as opposed to what happens with energy or industry, it does not have emission rights assigned to it and does not benefit from the possibility of using the carbon rights market. For this purpose, new instruments are needed that create adequate incentives to reduce the carbon intensity of the sector. The scope of these measures must be manifold, given that the usual problems cast over transport are also multidimensional. In this respect, the most relevant instrument is the Strategic Plan for

Infrastructures and Transport designed to improve transfer between modes and to rationalize Spain's infrastructures network. While well aimed, especially because of its integrated system focus, its effects will be felt only over the long term. Nor will other measures under way, such as modification of taxation on cars by giving preference to less contaminating models, have any immediate impact.

Finally, the government authorities are trying to react to the environmental effects of very high economic and population growth in a situation where public opinion has been made aware of the effects of climate change. The risks lie, first, in that emphasis may be placed on the use of instruments whose effects are more immediate and controllable (that is, the control of non-diffuse sectors) without taking greatly into account the costs these involve. Fortunately, emission rights assigned by the government to industry and energy in its latest National Assignment Plan are what may be described as «ambitiously possible» in the sense that they will not suffocate the production fabric nor at the same time give up trying to balance economic activity and emissions. A second risk is that short-term goals will be given preference in a matter of such a structural nature. It is essential to make it possible that the measures adopted, such as the Strategic Plan for Infrastructures and Transport mentioned above, and ambitious measures such as the Plan for Renewable Energy, setting out ideas that seem quite proper but whose effects will not be noted over the short term, come to fruition at the proper time.

Labour market

Job creation tending to slow down

Employment figures for the second quarter showed a sustained rate of job creation. As a result, the level of employment stood at 20,367,300 persons in the April-June period, according to figures from the Labour Force Survey, with a year-on-year increase of 3.4%, practically identical to that for the first quarter. Figures for National Accounting confirm the survey estimate, showing a sharp higher than expected increase in full-time jobs in the second quarter, with an annual rise of 3.2%. Nevertheless, more recent figures for registrations with Social Security show a tendency to an easing off in job creation.

In the 12 months ended in June, the number of persons employed rose by 674,200, according to the Labour Force Survey. The greater part of this sharp

increase in employment took place in services, with 561,600 new jobs, putting that sector total at 13,488,700. This level was 4.3% higher than one year earlier, as against the figure of 3.5% recorded at the end of March. On the other hand, while showing a higher year-on-year increase of 7.6%, construction was lower than the figure three months earlier (9.4%), which indicates a tendency to a slowdown in job creation in this sector. Both agriculture and industry lost jobs during the past 12 months ending June with year-on-year rates of -3.8% and -1.3% respectively.

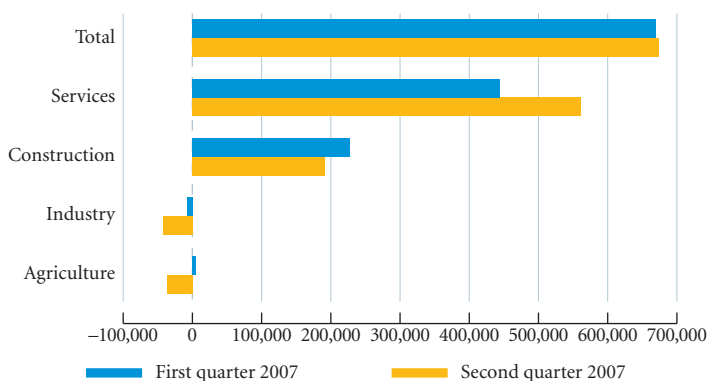
Of the total new jobs created in the past year, some 48.7% were taken up by foreign workers. In the second quarter, the participation of foreign workers in the figure for new jobs dropped to 33.7%. At the end of June, the foreign worker group amounted to 13.5% of the total.

Strong job creation in second quarter but July showing signs of moderation.

Nearly half of new jobs in past 12 months go to foreign workers.

SERVICES SECTOR SUSTAINING JOB CREATION

Change in number of employed over same quarter year before



SOURCE: National Institute of Statistics.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2005	2006	2006				2007					
			1 Q	2 Q	3 Q	4 Q	1 Q	2 Q	April	May	June	July
Persons registered with Social Security												
Wage-earners	4.8	4.7	6.3	5.3	3.9	3.5	3.9	3.5	3.0	3.3	4.1	2.8
<i>Industry</i>	-0.5	0.0	-0.3	0.0	0.0	0.2	2.2	2.7	2.4	2.6	3.0	2.6
<i>Construction</i>	8.6	8.7	11.0	9.5	7.5	6.8	6.1	4.4	4.5	4.3	4.2	3.1
<i>Services</i>	5.7	5.2	6.6	5.8	4.6	4.0	4.1	3.7	3.2	3.5	4.4	3.2
Non-wage-earners	2.6	2.2	2.3	2.2	2.1	2.2	2.5	2.7	2.6	2.7	2.9	2.9
Total	4.4	4.3	5.5	4.8	3.6	3.3	3.6	3.3	3.0	3.2	3.8	2.8
Persons employed (*)	5.6	4.1	4.9	4.2	3.7	3.6	3.4	3.4	-	-	-	-
Jobs (**)	3.2	3.2	3.4	3.6	2.7	3.1	3.3	3.2	-	3.2	-	-
Hiring contracts registered (***)												
Permanent	8.7	41.1	25.6	16.1	46.6	76.8	25.8	15.6	16.0	14.1	16.9	7.5
Temporary	4.6	4.7	13.7	5.5	0.5	0.5	2.6	-1.9	5.0	-2.4	-6.6	4.8
Total	5.0	7.9	15.0	6.4	4.1	7.3	5.3	-0.1	6.3	-0.7	-4.4	5.0

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.

Females fill 55% of new jobs while younger people moving more rapidly into working world.

Some 55% of new jobs created in the past 12 months were taken up by females. In spite of the increase in female employment, this represents only 41.0% of the labour force. By age group, the segment to most increase its employment level in the past 12 months was that made up of young people from 16-19 years of age, with an annual increase of 6.3%. Next came the segment made up of mature workers (from 50-54 years of age) which showed a change rate of 5.9%.

The number of wage-earners rose by 4.1% in the past year, more than average, as is normal in the growth stages of the economy. As a result, the wage-earner rate continued to rise, going to 82.4%. In the past 12 months wage-earners with permanent hiring contract grew by 8.2% as against a drop of 3.6% in the case of those with temporary contracts, largely thanks to the special process of benefits applicable to permanent contracts that

ended in December. In the second quarter, the rate of job creation with permanent hiring contract was higher than that for temporary contracts but the gap between both rates was reduced. At the end of the first half-year the temporary job rate had dropped to 31.8% but it was still relatively high. Self-employed workers rose by 2.6% over the past year while the number of entrepreneurs with employees was up 2.0%.

On the other hand, full-time work grew by 3.7% while part-time work rose by 1.5%. In the second quarter, however, part-time work was down by 2.2% compared with the end of March, both males and females showing decreases. At the end of June, females held 78.9% of jobs in this category.

Employment rose in all autonomous communities in the second quarter.

Level of temporary job status decreasing but less and less.

ESTIMATED EMPLOYMENT

Second quarter 2007

	No. of employees (thousands)	Quarterly change		Cumulative change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	921.0	-69.0	-7.0	-0.8	-0.1	-36.4	-3.8	4.5
Non-farm	19,446.2	366.9	1.9	366.2	1.9	710.5	3.8	95.5
Industry	3,243.8	-21.5	-0.7	-76.0	-2.3	-43.0	-1.3	15.9
Construction	2,713.7	49.1	1.8	90.5	3.4	192.1	7.6	13.3
Services	13,488.7	339.5	2.6	351.7	2.7	561.6	4.3	66.2
By type of employer								
Private sector	17,492.6	355.6	2.1	398.8	2.3	653.3	3.9	85.9
Public sector	2,874.7	-57.5	-2.0	-33.3	-1.1	20.9	0.7	14.1
By work situation								
Wage-earners	16,779.4	264.8	1.6	313.3	1.9	667.8	4.1	82.4
Permanent contract	11,435.5	197.8	1.8	538.1	4.9	864.8	8.2	56.1
Temporary contract	5,343.9	67.0	1.3	-224.8	-4.0	197.0	-3.6	26.2
Non-wage-earners	3,578.7	37.1	1.0	54.5	1.5	12.8	0.4	17.6
Entrepreneurs with employees	1,109.7	25.6	2.4	21.9	2.0	21.6	2.0	5.4
Entrepreneurs without employees	2,246.2	45.8	2.1	50.8	2.3	52.1	2.4	11.0
Family help	222.8	-34.5	-13.4	-18.2	-7.6	-61.0	-21.5	1.1
Other	9.2	-3.9	-29.8	-2.3	-20.0	-6.5	-41.4	0.0
By time worked								
Full-time	17,927.2	352.8	2.0	299.0	1.7	638.4	3.7	88.0
Part-time	2,440.1	-54.7	-2.2	66.5	2.8	35.8	1.5	12.0
By sex								
Males	12,007.7	153.1	1.3	176.4	1.5	303.7	2.6	59.0
Females	8,359.6	144.9	1.8	189.1	2.3	370.5	4.6	41.0
TOTAL	20,367.3	298.1	1.5	365.5	1.8	674.2	3.4	100.0

SOURCE: National Institute of Statistics and own calculations.

Nevertheless, in the past 12 months decreases were reported in the number of those employed in Asturias. On the other hand, Aragon, Murcia and Castile-La Mancha recorded growth rates above 5%.

In addition, figures for registration with Social Security also showed strong job creation in the second quarter, with an annual change rate of 3.8% in the total number registered at the end of June. Nevertheless, as opposed to 2006, this year the total number of those registered

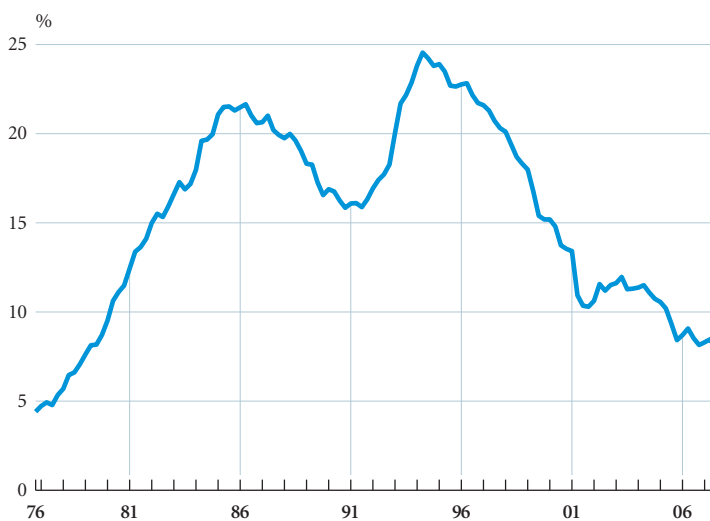
dropped in July so that the year-on-year change rate went down to 2.8%, which would indicate less strength in the labour market. In this respect, construction continued to show decreased growth going to 3.1% year-on-year. Nevertheless, industry increased its year-on-year growth to 2.6%.

The substantial increase in employment since June 2006 involved an increase in the labour force rate given that the labour market began to attract those who were discouraged and had left the labour

July figures for Social Security registrations indicate slowdown in job creation.

UNEMPLOYMENT RATE DROPS TO LOWEST LEVEL SINCE 1978

Unemployment rate over labour force



SOURCE: National Institute of Statistics.

Unemployment rate drops to 8%, lowest level since end of Seventies.

force. The labour activity rate among the 16-64 year-old group rose by 0.73 points, going to 72.6%. The increase in the labour activity rate was largely due to the larger number of females moving into the labour force. In any case, the male rate of labour activity (82.8%) stood substantially above the female rate at 62.1%.

The favourable performance in the labour market brought the unemployment rate down to 8.0% of the labour force. As a result, it was down to its lowest level since 1978 in line with the scenario foreseen by the central government. The number of unemployed thus stood at 1,760,000 persons.

Female unemployment dropped more than that for males, both with regard to last quarter and the last 12 months. Nevertheless, the female unemployment rate (10.5%) was considerably higher than that for males (6.1%).

Long-term unemployment down.

By age group, the trend in unemployment over the past year was

uneven depending on sex. For males, the segment to show the biggest drop in the number of persons unemployed was the 20-24 years of age group, with a decrease of 4.9%, whereas the group between 16-19 years increased by 8.1% in number. On the other hand, for females the younger segment of unemployed was down by 12.6%, whereas females of more than 55 years of age raised the number of persons unemployed by 11.8%.

The segment made up of those who lost their job more than one year ago was down by 9.9% in the second quarter and by 5.5% in the last 12 months ending in June. The figure for those unemployed in industry and agriculture was down even more over the past year. On the other hand, the number of unemployed in construction rose by 2.5%. Young people seeking their first job increased by 0.35% over the past year with the total going to 211,300. It should be pointed out that the unemployment rate for those under 25 years of age (18.2%) is nearly three times that for all others.

ESTIMATED UNEMPLOYMENT

Second quarter 2007

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	780.6	−19.4	−2.4	−14.9	−1.9	44.4	6.1
Females	979.3	−76.7	−7.3	−62.1	−6.0	55.6	10.5
By age							
Under 25 years	442.2	19.1	4.5	−9.7	−2.1	25.1	18.2
Other	1,317.8	−115.2	−8.0	−67.3	−4.9	74.9	6.7
By personal situation							
Long-term unemployment	496.5	−54.3	−9.9	−28.9	−5.5	28.2	−
Seeking first job	211.3	25.9	14.0	0.7	0.4	12.0	−
Other	1,052.2	−67.7	−6.0	−48.9	−4.4	59.8	−
TOTAL	1,760.0	−96.1	−5.2	−77.0	−4.2	100.0	8.0

SOURCE: National Institute of Statistics and own calculations.

Households where all persons were unemployed dropped by 8.3% over the past year. In the same period, family units where all were employed rose by 3.7%. On the other hand, the likelihood of remaining unemployed was estimated at 42.3%, somewhat higher than in the previous quarter.

The drop in the number of unemployed was spread well over the various autonomous communities. In the second quarter, increases were noted only in Valencian Community, Castile-La Mancha and Navarre, whereas in the past year only Valencian Community and Asturias recorded an increase in the number of unemployed. It should be mentioned that La Rioja showed an unemployment rate of less than 5%. At the other extreme, those autonomous communities with an increased unemployment rate were Extremadura (with 12.2%) and Andalusia (with 12.0%).

Drop in registered unemployment in July

The number of unemployed registered at public employment service offices in July showed an increase of 4,469 persons compared with the end of the previous month, as against a drop of 4,770 persons in July 2006. In fact, this was the second time this decade that registered unemployment recorded a rise in July. The biggest monthly boost in unemployment took place in construction with an increase of 11,900 persons, which indicates loss of strength in this sector. We should point out that the increase in unemployment was most devastating among males whereas female unemployment dropped by only 0.6% in the first month of the summer holidays.

On a positive note, the number of hiring contracts of a permanent nature showed a high in the statistics for this month with a year-on-year increase of 7.4%. This type of work contract represented 10.3% of all those signed.

For second time in decade, registered unemployment up in July due to loss of drive in construction.

Number of permanent hiring contracts reaches all-time high in July.

Prices

CPI drops to 2.2% in July as against 4.0% recorded one year ago.

CPI performs well at beginning of summer

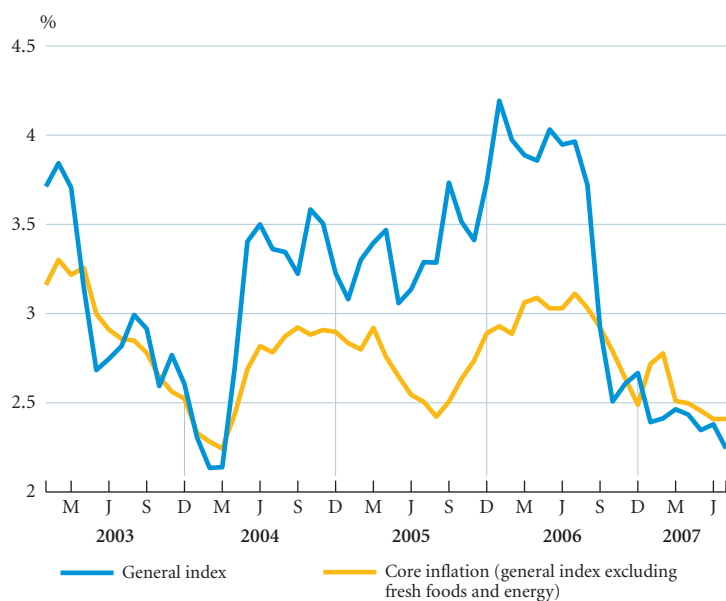
With some ups and downs, at the beginning of summer the CPI continued the gradual downward trend seen in recent months. The general consumer price index thus showed a 2.2% change over the past 12 months ending in July whereas one year ago it stood at 4.0%. This performance was largely brought about by oil prices that reached an all-time high in August 2006. In recent months, however, it was fresh food, services and non-energy industrial products which made possible a slight drop in the year-on-year inflation rate to its lowest level since March 2004.

In fact, the rise in fuel and lubricants in June, as against the drop in the same month in 2006, brought about the one decimal increase in the annual CPI change rate, putting it at 2.4% at the end of the first half-year. Nevertheless, thanks to the strength of the euro in July, the rise in fuels and lubricants was lower than that recorded in the same month last year and this heading contributed much to the drop in general inflation in July.

In addition, another volatile component of the CPI, fresh foods, pushed the CPI down in the past two months so that it went from year-on-year inflation of 6.0% to 4.7%. Potatoes, which in May still showed an annual price rise of more

CPI AT LOWEST LEVEL SINCE MARCH 2004

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

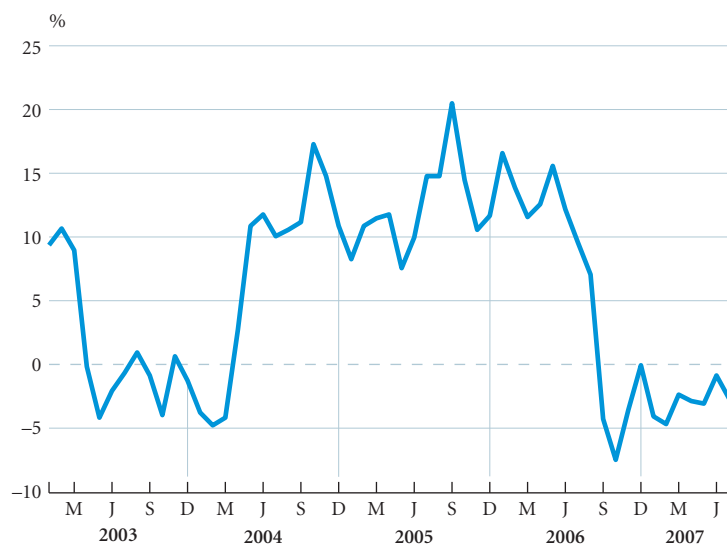
CONSUMER PRICE INDEX

	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	0.1	-0.6	2.4
March	0.7	0.3	3.9	0.8	0.1	2.5
April	1.4	1.8	3.9	1.4	1.5	2.4
May	0.4	2.1	4.0	0.3	1.8	2.3
June	0.2	2.3	3.9	0.2	2.0	2.4
July	-0.6	1.7	4.0	-0.7	1.3	2.2
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.

FUELS PUSH CPI DOWN IN JULY

Year-on-year change in fuels and lubricants



SOURCE: National Institute of Statistics.

than 11% because of the poor harvest of this tubercle in the previous harvest in Central Europe, brought this rate down to 0.1%. Chicken, which had reported an annual rise of 16.4% in May, went down to an increase of 6.0% in July, a much

lower figure although still high because of limited supply as a result of the avian flu crisis.

In any case, inflation in unprocessed foods is more than twice the figure for

Potatoes and chicken show sharp drop.

UNPROCESSED FOODS MOVE DOWN

Year-on-year change in unprocessed food prices



SOURCE: National Institute of Statistics.

Downward trend in inflation not easily sustainable as of August because of prospects in international raw materials markets.

general inflation. This reflects the recent increases seen in international markets as a result of the sharp increase in demand from countries like China and India, along with circumstantial supply problems. Also having an influence in recent times has been demand for farm products for production of ethanol fuels. In addition, we should mention a background upward trend bringing unprocessed food prices in Spain into line with the rest of Europe.

With regard to the more stable core of inflation, so-called underlying inflation, this showed a very slight drop (one decimal) in June putting it at 2.4%, a level it maintained in July. The drop in June may be explained by the slight easing in services from 4.0% to 3.9%. Tourism and the hotel trade dropped from 4.6% to 4.5% because of a less marked rise in prices of organized tours than in June last year, although the rate still held at a high level. Non-energy processed goods also contributed to the

easing of underlying inflation with a drop in annual inflation rate from 0.7% in May to only 0.6% in July.

Is the downward trend in inflation sustainable? In fact, it is possible that the CPI will stand at the same level in August due to the fact that in that month last year crude oil climbed to an all-time high. Nevertheless, what is most likely is that as of then it will rise to around 3% at the end of the year. Why is this? On the one hand, the sharp drop in oil prices in the second half of 2006 will work against it, although the recent easing in fuels could help contain the rise. On the other hand, the poor international cereal harvest this year and a deficient supply of milk products in world markets will push up food prices. What is more, there are persistent inflationary trends in services. All of this is taking place within a framework of notable economic growth and abundant liquidity on the part of consumers.

Inflation differential with European Monetary Union at lowest level since March 2004.

CONSUMER PRICE INDEX BY COMPONENT GROUP

July

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2006	2007	2006	2007	2006	2007
By type of spending							
Food and non-alcoholic beverages	103.0	0.4	0.3	2.1	1.5	4.8	2.6
Alcoholic beverages and tobacco	107.1	0.0	0.1	1.0	5.7	2.1	6.1
Clothing and footwear	94.5	−11.0	−11.1	−11.5	−11.7	1.1	1.0
Housing	103.9	0.3	0.3	5.1	3.3	6.8	3.1
Furnishings and household equipment	102.6	−0.6	−0.6	1.2	1.2	2.7	2.7
Health	98.0	0.2	0.2	1.3	−2.5	1.5	−2.2
Transport	103.0	0.8	0.2	6.0	4.7	5.8	0.6
Communications	100.4	−0.2	−0.2	−0.9	1.3	−1.4	0.7
Recreation and culture	100.0	1.2	0.8	0.2	−0.2	0.5	−1.0
Education	103.6	0.1	0.1	0.4	0.6	3.9	4.6
Restaurants and hotels	105.9	0.9	0.9	4.0	4.7	4.5	5.0
Other goods and services	103.3	0.0	−0.1	3.2	2.4	3.9	3.1
By group							
Processed food, beverages and tobacco	102.8	0.1	0.1	2.3	2.3	4.0	2.2
Unprocessed food	104.8	0.9	0.5	1.3	1.4	5.4	4.7
Non-food products	102.1	−0.9	−1.0	1.6	1.0	3.8	2.0
Industrial goods	99.7	−2.4	−2.7	0.1	−1.2	3.6	0.2
Energy products	102.9	1.5	0.5	10.7	6.6	10.1	−1.2
Fuels and oils	102.7	1.7	0.6	12.6	7.9	11.8	−2.5
Industrial goods excluding energy products	98.6	−3.7	−3.8	−3.2	−3.7	1.5	0.6
Services	104.5	0.7	0.6	3.2	3.3	4.0	3.8
Underlying inflation (**)	102.1	−1.0	−1.0	0.7	0.6	3.1	2.4
GENERAL INDEX	102.4	−0.6	−0.7	1.7	1.3	4.0	2.2

NOTES: (*) Base 2006 = 100.

(**) General index excluding energy products and unprocessed food.

SOURCE: National Institute of Statistics.

In addition, the annual inflation rate for harmonized consumer prices has followed a pattern similar to the general CPI in recent months with a figure of 2.3% in July. As a result, the inflation differential with Spain's associates in the euro area stood at 0.5 percentage points, the lowest level since March 2004.

Inflation in industrial prices drops to lowest level in last three years

The trend in wholesale prices shows a complex inflationary picture. Both industrial prices and import prices stand at relatively low levels, especially the latter. Nevertheless, inflation on intermediate goods is still holding above 5% and pressures can be noted in farm prices.

Annual inflation in intermediate industrial goods still stands above 5%.

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	
2006											
June	6.0	6.3	3.5	2.3	6.8	14.6	6.2	0.8	−0.6	7.5	−
July	0.7	6.4	3.6	2.4	7.0	13.9	5.9	0.4	−0.3	9.6	−
August	0.4	5.7	3.2	2.5	7.2	10.2	5.1	0.6	−0.4	9.2	3.9
September	1.1	4.2	2.7	2.5	6.7	4.1	3.2	0.9	−0.3	9.4	−
October	2.3	3.4	2.3	2.4	6.9	0.5	2.9	0.9	−0.1	9.5	−
November	0.8	3.6	2.4	2.5	6.8	1.0	2.4	0.1	−0.4	8.8	3.7
December	−5.8	3.6	2.0	2.6	6.8	2.3	2.4	0.3	−0.2	8.2	−
2007											
January	−6.7	2.7	1.4	2.9	6.3	−1.1	0.5	0.5	−0.2	7.3	−
February	−6.3	2.5	1.4	2.9	6.7	−2.5	0.1	0.4	−0.2	7.4	3.4
March	1.5	2.8	1.7	3.3	6.2	−1.6	0.2	0.4	−0.1	6.8	−
April	6.7	2.7	2.2	3.1	6.4	−2.6	0.2	0.7	0.0	6.3	−
May	0.4	2.4	2.0	3.3	6.0	−2.8	0.8	1.6	0.1	5.7	3.2
June	2.7	2.6	1.8	3.1	5.8	−1.4	1.3	1.1	−0.1	6.3	−
July	...	2.3	1.8	3.0	5.5	−2.5	...	...	...	...	...

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

SOURCE: Ministry of Agriculture, Fishing and Food, National Institute of Statistics and own calculations.

Import prices up in June because of lower annual appreciation of euro.

The general industrial price index, which has followed a similar profile to that of consumer prices, eased its annual increase to 2.3% in July. As a result, the year-on-year inflation rate for factory-gate prices showed its lowest level since March 2004. It should be remembered that in July 2006 the inflation rate for industrial prices stood at 6.4%.

The decrease since then is mainly attributable to energy prices for which the inflation rate went from a rise of 13.9% to a drop of 2.5% over the past 12 months.

Nevertheless, in the past two months the improvement in inflation was due to the other components. Very much under pressure from foreign competition, consumer goods showed a price increase of only 1.8% in the past year. On the other hand, office machines and

computer equipment dropped by 3.4% compared with July 2006, partly thanks to gains in productivity.

With regard to import prices of industrial products, these rose slightly in June to show an annual change rate of 1.3%, according to figures from the survey by the National Institute of Statistics. This was partly due to the lower annual appreciation of the euro that month. Also contributing to the rise was a lower annual decrease in energy prices.

In turn, farm prices at origin moved up to 2.7% in June compared with the same month the year before. In spite of the volatility of these prices, we clearly note a rise in livestock prices in recent times, going to an annual inflation rate of 10.2% at the end of the first half-year.

Livestock product prices at origin show increase of 10.2% annual at end of first quarter.

Foreign sector

Trade deficit moderating growth

In the first half of 2007 the trade deficit was 46.22 billion euros. While compared with one year ago the trade deficit is 7% higher, the growth rate of the trade imbalance is tending to moderate.

In terms of cumulative balance for 12 months, the trade deficit has gone from year-on-year growth of 20.6% in June 2006 to 9.4% in June this year. Increases of more than 35% in the expansionist year 2005 have therefore been left behind. In addition, the export/import ratio stood at 66.5% in the first half of 2007, one decimal less than in the first half of 2006.

The continuing increase in the trade deficit is due to the fact that exports,

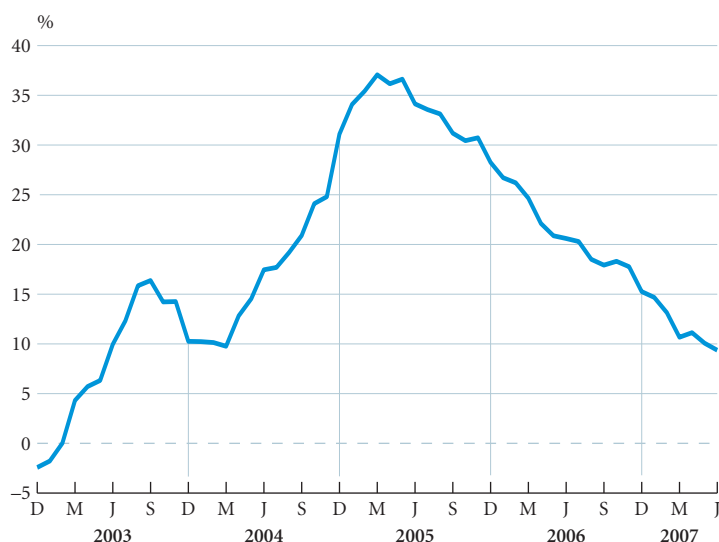
in spite of a good growth rate (6.6% year-on-year in value terms in the first half-year) are growing less sharply than imports (6.7% year-on-year). In real terms, growth of exports has been affected by the increase in export prices (3.6% year-on-year), putting the growth figure at 2.9% year-on-year. On the other hand, with growth of a mere 0.3% year-on-year in import prices, the real increase in imports went to 6.4% year-on-year.

This strength shows up in nearly all sectors. Capital goods and motor vehicles, two of the flagships in Spain's exports (together they make up approximately 40% of total exports), grew by more than 5% year-on-year in the first quarter.

Trade deficit continues to ease.

TRADE IMBALANCE CONTINUES TO BE CORRECTED

Year-on-year change in cumulative trade deficit for 12 months



SOURCE: Ministry of Industry, Tourism and Trade and own calculations.

FOREIGN TRADE

January-June 2007

	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	19,186	−6.6	13.9	3,262	−16.0	3.6	−15,925	17.0
Consumer goods	37,548	4.1	27.2	33,582	4.7	36.6	−3,966	89.4
Food	7,377	8.7	5.4	10,883	5.6	11.9	3,506	147.5
Non-foods	30,171	2.7	21.9	22,698	0.0	24.8	−7,472	75.2
Capital goods	14,789	11.4	10.7	8,470	−0.2	9.2	−6,318	57.3
Non-energy intermediate goods	66,351	11.8	48.1	46,344	11.5	50.6	−20,007	69.8
By geographical area								
European Union EU-25	82,536	7.0	59.9	65,454	6.5	71.4	−17,083	79.3
Euro area	68,967	7.5	50.0	52,516	7.4	57.3	−16,450	76.1
Other countries	55,338	6.2	40.1	26,204	6.7	28.6	−29,134	47.4
Russia	4,105	12.2	3.0	905	37.6	1.0	−3,199	22.1
United States	4,722	10.7	3.4	3,835	1.0	4.2	−887	81.2
Japan	3,150	7.0	2.3	691	2.3	0.8	−2,459	21.9
Latin America	6,898	−3.5	5.0	5,343	7.4	5.8	−1,555	77.5
OPEC	10,127	−7.6	7.3	2,418	9.8	2.6	−7,709	23.9
Rest	26,336	13.7	19.1	13,011	6.2	14.2	−13,325	49.4
TOTAL	137,874	6.7	100.0	91,658	6.6	100.0	−46,216	66.5

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

Exports on good track largely due to European growth.

Another significant sector, chemical products, was even more dynamic with an increase of 9% year-on-year in exports. The most notable exception to this upward trend showed up in energy products for which exports were down by 13.2% year-on-year. With regard to imports, the current trend reflects the strong appetite of Spain's domestic demand, especially in investment. Imports by the capital goods sector, which alone generates a quarter of all Spain's imports, were 9% higher than those one year ago. There were also major increases in raw materials and consumer durables.

From a geographical perspective, we note that Spanish exporters continue to benefit from European recovery. Exports to the Euro Area were up 7.4% year-on-year in the January-June period, the result of the good situation returns offered by markets in France (up 7.4%) and Germany (7.0%). Outside the European Union, we should mention the sharp increase in sales to Russia, which grew by 38% year-on-year. With regard to imports, in a situation similar to that shown by exports, the strength of purchases from the EU (7.0% year-on-year) moved above imports from outside that area, which rose by only 6.2% year-on-year.

Balance of payments: drop in incomes balance compensated by gains in trade balance

In May, the current account deficit stood at 8.18 billion euros, as against an imbalance of 5.68 billion euros in April. This rise was largely due to the increase in the deficit in the incomes balance, followed some distance away by the increase in the deficits in the trade balance and current transfers.

When we compare the monthly figures with cumulative figures for 12 months, we note that the worsening of the incomes balance is the biggest culprit in the increasingly poor situation in the current account balance. In the past

12 months, in spite of the fact that in amount it is scarcely a third of the negative figure for the trade balance, the negative contributions of the incomes balance and the trade balance have tended to come close to each other, going to 7.72 and 7.93 billion euros respectively.

With regard to the financial sphere, referring always to cumulative figures for the last 12 months ending May, we should point out that direct investment outflows (42.21 billion euros) were 7% higher than those reported one year earlier. In complete contrast, portfolio investment inflows stood at 179.33 billion euros, a level 51% higher than in the same period in 2006.

Current account deficit increases by 25% year-on-year in past 12 months.

Worsening of incomes balance coming close to that of trade balance.

BALANCE OF PAYMENTS

May 2007

	Cumulative for year		Last 12 months		
	Million euros	% annual change	Million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	-33,236	5.3	-81,820	-7,926	10.7
Services					
<i>Tourism</i>	8,978	1.1	27,543	585	2.2
<i>Other services</i>	-2,786	16.4	-5,695	-723	14.6
Total	6,191	-4.5	21,848	-138	-0.6
Income	-10,928	68.5	-25,424	-7,717	43.6
Transfers	-4,546	25.4	-6,675	-2,736	69.5
Total	-42,519	20.8	-92,072	-18,518	25.2
Capital account	2,054	18.4	6,494	-993	-13.3
Financial balance					
Direct investment	-21,364	-38.4	-42,207	-2,688	6.8
Portfolio investment	80,569	-19.1	179,329	60,771	51.3
Other investment	-2,275	-86.1	-21,444	-33,615	-
Total	56,929	17.3	115,679	24,468	26.8
Errors and omissions	1,279	-	1,749	7,625	-
Change in assets of Bank of Spain	-17,743	51.7	-31,850	-12,581	65.3

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

SOURCE: Bank of Spain and own calculations.

Public sector

Economic boom continues to favour public accounts.

Changes to personal income tax and company tax have little initial impact on revenue.

Public accounts running strong

The economic boom continues to push up the course of the public accounts. We should mention the good performance of revenues in the first half of the year. In fact, central government non-financial revenues rose to 69.13 billion euros, 12.7% more than in the same period in 2006. If we include revenues ceded to autonomous communities and local government according to the current financing system, central government receipts were up to 93.52 billion euros, an increase of 11.9% compared with the first half of the year before, four points more than nominal gross national product (GDP).

Direct taxes were up 15.7% in the first six months of the year and amounted to 42.07 billion euros. The main contribution came from personal income tax amounting to 31.51 billion euros. This tax heading was up 13.3% as a result of the increase in employment and average wages. The impact of the personal income tax changes showed up as a reduction in the growth rate of wage hold-backs. The positive trend in dividend and interest earnings also contributed to sharp increases in hold-backs on capital earnings and on capital gains in investment funds although the effect of the increase in hold-backs from 15% to 18% showed up as well.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

June 2007

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	3,603	12.3	69,126	12.7
Non-financial revenue adjusted (*)				
Personal income tax	1,974	28.9	31,515	13.3
Corporate tax	525	29.0	8,937	22.5
VAT	1,801	-9.8	33,794	8.4
Special taxes	1,699	2.8	9,485	6.9
Other	1,671	25.8	9,791	16.7
Total	7,670	10.9	93,522	11.9
Non-financial spending	10,655	10.3	64,958	8.0
Treasury balance	-7,052	9.4	4,168	261.5
Surplus (+) or deficit (-) (**)	-8,284	6.4	6,075	136.5

NOTES: (*) Includes tax segments ceded to regional and local governments under current financing system.

(**) In terms of National Accounting.

SOURCE: Ministry of Economy and Finance and own calculations.

In addition, the Tax Agency announced that at the end of July 80% of refunds for the 2006 income tax year had already been made. Refunds amounted to 7.66 billion euros involving 10,659,501 taxpayers, which meant an average refund of 718 euros.

Collections for company tax amounted to 8.94 billion euros, a sharp increase of 22.5%. This increase was due to the good level of company profits and hold-backs for returns on capital. The negative impact of the tax changes thus turned out to be quite limited.

The main revenue heading was again indirect taxes which amounted to 44.84 billion euros in the January-June period, although the annual rate of increase (7.9%) was lower than that for direct taxes. Value added tax (VAT), the star of this tax heading, brought in 33.79 billion euros, an increase of 8.4% compared with the same period last year, in line with the growth of consumption. Under special taxes, fuel taxes (the most important) grew by only 1.8%, as a result of compensation paid to farmers, livestock raisers and transport companies because of the rise in diesel-oil prices in 2006, in spite of the rise in the tax rate on motor-vehicle diesel fuels in 2007. On the other hand, taxes on tobacco were up 16.2% following the increase in tax rates.

Notable among other non-financial revenues were increases in investment support from European Union budgets. Income from profits of the Bank of Spain

and interest earned on Treasury accounts also showed a spectacular rise.

On the other side of the balance sheet, central government cumulative non-financial spending as of June amounted to 64.96 billion euros, which represented growth of 8.0% over the same period the year before. Personnel costs rose by 6.6% due to an improvement in wages in certain government departments. Spending for current goods and services was up by 19.3%, affected by the elections which took place this year. Investments, both civil and military, continued to show high rates of increase, as was the case with capital transfers.

As a result, with revenues higher than spending the central government obtained a surplus in the first half-year. In terms of National Accounting, that is to say, using the accounting methodology that takes into account funds and jobs as they are committed, the central government obtained a surplus of 6.07 billion euros, a figure that was easily more than twice that recorded in the same period in 2006. In terms of the GDP, the central government surplus came to 0.58% as against 0.26% the year before.

It was this favourable situation that made it possible for the prime minister to announce payment of a child endowment cheque of 2,500 euros for every child born or adopted as of July, thus raising family benefits, which in Spain are substantially lower compared with those paid out by the more developed countries in the European Union.

Strength in wages, profits and interest earnings push up direct taxes.

Central government obtains surplus at 0.58% of GDP in first half-year.

Prime minister announces new 2,500 euros endowment benefit for each newborn child as of now.

Savings and financing

Considerable rise in loan interest rates in real terms.

Increase in credit continuing

The 1-year Euribor, commonly used as a reference for many types of loan, especially mortgage loans, continued to rise in July, going to 4.56% on monthly average, thus reflecting the progressive hardening of European Central Bank monetary policy and prospects of this continuing. This level meant an increase of 103 basis points over the same month last year and the highest point since February 2001. In August, the rate continued to rise, going to close to the range of 4.75%.

Growth rate of corporate funding sharpens in second quarter...

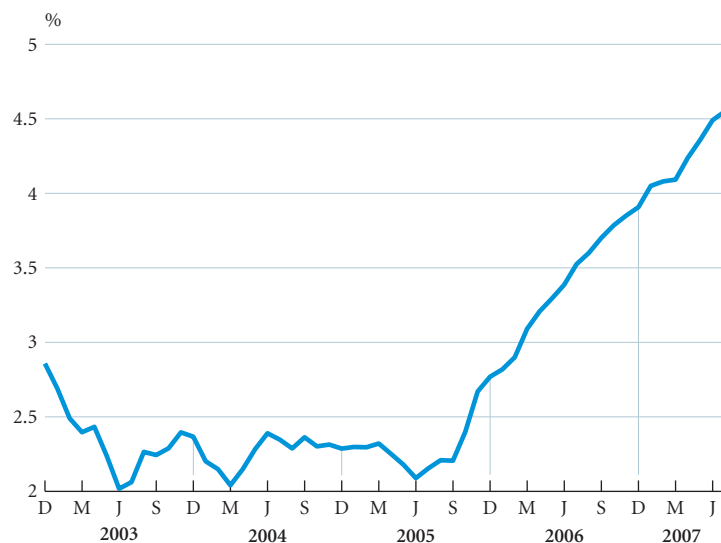
Loan interest rates have also risen in recent months. The average interest rate on loans and credits to the private sector stood at 5.60% in June, 108 basis points

above one year earlier. Overall, interest rates on loans to companies rose slightly more than on loans to households although the level for the latter was higher. Furthermore, in the past 12 months ending June the annual inflation rate went down 1.6 points, so that the real interest rate (which discounts inflation at nominal rate) rose considerably more although it held below the European average.

In this framework, it is not surprising that funding granted to the private sector has lowered its annual growth rate over the past 12 months. Nevertheless, latest available figures up to June show that there was scarcely any easing of financing obtained by companies and households in the second quarter.

ONE-YEAR EURIBOR GOES UP TO HIGHEST LEVEL SINCE 2001

12-month Euribor rate



SOURCE: Bank of Spain.

LOAN FINANCING TO HOUSEHOLDS CONTINUES TO DROP

Year-on-year change in funding granted to households and non-profit organizations



SOURCE: Bank of Spain.

Funding to the private sector thus grew by 20.9% in June compared with the same month the year before, a rate barely 2 decimals lower than that reported at the end of the first quarter, although substantially lower than the figure at the end of 2006. It is possible that in the second half of the year loan terms will be slightly harder thus confirming the slowdown in funding granted to the private sector.

In fact, the change in the level of funding in the second quarter was due to companies, given that loans to households continued to ease. Funding granted to non-financial companies grew by 24.5% in the period June 2006-June 2007, whereas in March 2007 it was rising at an annual rate of 23.3%.

By sector, latest available figures go up to the end of the first quarter. All large sectors show lower annual growth rates than at the end of 2006 with the exception of industry, which reported a

slight rise. The biggest drop came in construction. Nevertheless, total credit granted to construction and real estate services still showed a spectacular annual change rate of 39.8%, although this was 4.1 points lower than the rate recorded in December.

The slowdown in credit granted to households may largely be attributed to housing loans which went from growth of more than 24% annual in 2005 to 17.2% at the end of the first half of 2007. Interest rate increases and higher home prices have worked against the writing of new mortgage loans. According to figures from the National Institute of Statistics, mortgage loans for home purchase were 6% lower in May 2007 than in the same month in 2006. Nevertheless, the average loan amount was 7.6% higher, putting that figure at 150,810 euros. The average term for loans was 26 years, one year more than in 2006, while most continued to employ a variable interest rate. In addition, the default rate on loans with

...while loan financing to households weakens.

Credit to real estate sector slows in first quarter but still shows very high annual growth rate.

CREDIT TO PRIVATE SECTOR BY PURPOSE

First quarter of 2007

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	23,435	421	1.8	2,222	10.5
Industry	121,153	1,664	1.4	15,466	14.6
Construction	137,627	3,310	2.5	31,445	29.6
Services	533,929	29,104	5.8	129,734	32.1
Total	816,144	34,500	4.4	178,867	28.1
Financing to individuals					
Acquisition and renovation of own home	566,341	21,952	4.0	94,375	20.0
Acquisition of consumer durables	52,713	1,252	2.4	6,393	13.8
Other financing	107,073	2,628	2.5	20,480	23.7
Total	726,126	25,832	3.7	121,249	20.0
Financing to private non-profit institutions	5,743	39	0.7	955	20.0
Other unclassified	21,156	173	0.8	2,343	12.5
TOTAL	1,569,169	60,544	4.0	303,414	24.0

NOTES: (*) By credit institutions as a whole: banking system, loan finance establishments and official credit.

SOURCE: Bank of Spain and own calculations.

Bank deposits for terms up to two years grow by 42% in past year.

mortgage security stood at a modest 0.46% at the end of the first quarter although this showed a slight upward trend.

Showing somewhat more detail, loans for consumer durables rose at an annual rate of 13.8% in March 2007, some 1.8 points more than at the end of 2006. Financial institutions are trying to compensate for the drop in mortgage loan business by promoting consumer credit, making it more readily available to the average consumer through marketing campaigns for immediate credit while broadening channels for making loan applications, such as by means of automatic teller machines and Internet.

Slight easing in bank deposits

Bank deposits have continued to grow at a strong rate in recent months, rising

at twice the rate in the Euro Area. Nevertheless, in the second quarter the annual change rate dropped slightly, going to 22.9% at the end of June.

The bank deposits to show most growth in the past 12 months ending June were accounts in foreign currency, which had an interest differential in their favour, although they showed a notable slowdown. Next came term deposits up to two years with an annual increase of 41.7%. This year these deposits have moved into a position ahead of those for longer terms as a result of the disappearance under new tax regulations as of January 1, 2007 of previous tax benefits on interest that favoured the latter.

Private sector bank deposits growing faster than those at savings banks.

At the end of the first half of the year private sector deposits at banks rose by an annual rate of 26.5%, as against 21.0% at savings banks. As a result, the

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

June 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	450,115	1,778	0.4	30,235	7.2	36.0
Up to 2 years	300,522	54,116	22.0	88,499	41.7	24.1
More than 2-year term	373,230	40,381	12.1	83,803	29.0	29.9
Repos	83,622	-202	-0.2	14,316	20.7	6.7
Total	1,207,489	96,073	8.6	216,853	21.9	96.7
Deposits in currencies other than euro	41,182	8,465	25.9	16,001	63.5	3.3
TOTAL	1,248,671	104,538	9.1	232,854	22.9	100.0

NOTES: (*) Includes deposits redeemable at notice, according to ECB definition.

SOURCE: Bank of Spain and own calculations.

banks continued to increase their quota in this market segment.

This financial instrument is becoming a major competitor of other products such as mutual funds. In the first seven months of the year net withdrawals of participations in these funds amounted to 2.4 billion euros, according to Inverco, the professional association of fund managers. Nevertheless, in the same period total assets of funds rose by 3.27 billion euros, 1.3% above December, going to 257.60 billion euros, thanks to cumulative capital gains. As a result, national share-based funds showed a profitability of 25.7% in the past 12 months while euro share-based funds presented 18.6%. Of course, other more conservative types of funds did not reach such extraordinary returns. Gains by short-term bond-based funds were thus 2.9% while long-term bond-based funds showed 1.8%. On the other hand, the

number of participants was up by 1.4% compared with the end of 2006.

In addition, assets of pension funds, intended to meet the financial needs of long-term savers, rose by 13.7% in the past 12 months ending June, going to a figure of 83.65 billion euros. The number of participant accounts was up by 5.2% in the past 12 months going to more than 10 million, covering seven and a half million participants. The biggest increase in assets in the past year showed up in the individual pension system (with a rise of 16.9%), followed by the group system (promoted by organizations such as professional associations, trade unions, etc.) which reported an increase of 15.3%. Average yield in the past twelve months was 8.0%. Average return obtained by pension plans as a whole over the past 17 years was 6.5%, well above inflation.

First seven months of year show net withdrawals from mutual funds.

Pension funds obtain notable returns.

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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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