

Monthly Report



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Modernization of financial systems contributing to region's economic growth

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2006	2007			
				4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY								
	Forecast			Forecast				
Gross domestic product								
United States	2.9	1.7	2.0	2.6	1.5	1.9	1.8	1.7
Japan	2.2	2.0	1.7	2.5	2.6	1.7	2.0	1.7
United Kingdom	2.8	2.7	2.1	3.2	3.1	3.1	2.6	2.1
Euro area	2.9	2.5	2.3	3.3	3.2	2.5	2.4	2.1
Germany	3.1	2.3	2.1	3.9	3.6	2.5	2.0	1.2
France	2.2	1.6	1.6	2.1	1.9	1.3	1.6	1.6
Consumer prices								
United States	3.3	2.6	2.1	2.0	2.4	2.6	2.4	2.8
Japan	0.2	0.0	0.2	0.3	−0.1	−0.1	0.0	0.2
United Kingdom	2.3	2.4	2.0	2.7	2.9	2.6	1.9	2.2
Euro area	2.2	2.0	2.0	1.8	1.9	1.9	1.9	2.3
Germany	1.7	1.9	1.8	1.4	1.8	1.8	2.1	2.0
France	1.7	1.3	1.6	1.3	1.2	1.2	1.2	1.8
SPANISH ECONOMY								
	Forecast			Forecast				
Macroeconomic figures								
Household consumption	3.7	3.2	2.7	3.7	3.4	3.3	3.2	3.1
Government consumption	4.8	5.3	4.7	4.9	5.7	5.5	5.2	4.9
Gross fixed capital formation	6.8	6.2	3.7	6.4	6.6	6.6	6.1	5.5
Capital goods	10.4	12.6	8.9	11.4	13.3	13.0	12.5	11.7
Construction	6.0	4.3	1.7	5.7	5.2	4.6	4.0	3.4
Domestic demand (contribution to GDP growth)	5.1	4.7	3.6	4.9	5.0	4.9	4.6	4.4
Exports of goods and services	5.1	4.5	3.3	7.3	3.7	4.8	4.9	4.6
Imports of goods and services	8.3	6.6	4.8	8.8	5.9	6.7	6.7	6.9
Gross domestic product	3.9	3.8	2.9	4.0	4.1	4.0	3.8	3.4
Other variables								
Employment	3.2	3.0	2.1	3.1	3.3	3.2	3.0	2.7
Unemployment (% labour force)	8.5	8.0	8.0	8.3	8.5	8.0	7.9	7.8
Consumer price index	3.5	2.6	2.7	2.6	2.4	2.4	2.4	3.1
Unit labour costs	2.3	2.2	2.3	2.4	2.0	2.1		
Current account balance (% GDP)	−8.8	−9.4	−9.7	−8.6	−10.2	−9.0		
Not lending or net borrowing rest of the world (% GDP)	−8.1	−8.9	−9.3	−7.4	−9.6	−8.8		
Government balance (% GDP)	1.8	1.2	0.9					
FINANCIAL MARKETS								
	Forecast			Forecast				
Interest rates								
Federal Funds	5.3	5.0	4.5	5.3	5.3	5.3	5.1	4.6
ECB repo	3.5	3.9	4.3	3.5	3.6	3.8	4.0	4.2
10-year US bonds	4.7	4.7	4.7	4.7	4.7	4.8	4.6	4.6
10-year German bonds	3.9	4.3	4.5	3.9	4.0	4.4	4.3	4.5
10-year Spanish bonds	4.0	4.4	4.7	4.0	4.1	4.4	4.4	4.6
Exchange rate								
\$/Euro	1.32	1.37	1.39	1.32	1.32	1.35	1.39	1.42

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Eastern Europe: Brussels offers way to modernization

«We have seen the need of the Union, as a bulwark against foreign danger, as the conservator of peace among ourselves, as the guardian of our commerce and other common interests, as the only substitute for those military establishments which have subverted the liberties of the Old World». At the beginning of the Nineties the countries of Central and Eastern Europe that wanted to move on to a new page in their history and find their way to political, economic and social modernity could have written these words which concisely state the promise they saw in their much desired accession to the European Union (EU). The fact that they were written by James Madison in 1787, when another continent saw the union of peoples as the only way to the future, reminds us that, although history never repeats itself, it sometimes seems to do so.

Little more than three years after the enlargement of the EU to the East, it is worthwhile to see if those new member states are taking advantage of the opportunities offered. The response to be taken from this issue of Monthly Report, which has been devoted to this matter, is affirmative. The countries of Central and Eastern Europe have grown substantially more than the EU-15 in the past decade, reducing the enormous per capita income differential separating them from Western Europe. Furthermore, this real convergence has come about thanks to the improvement in productivity and capital investment, which shows a transition toward economic modernization. At the same time they have benefitted from major inflows of foreign direct investment and have taken great advantage of the possibilities provided by agreements on customs tariff removal begun in 1995 in order to move ahead on trade integration. Even in the critical financial sector the process of updating has been unquestionable.

Economic progress has thus been notable if we are to go by the precarious conditions on starting out. However, the goal is still not yet in sight. To paraphrase Winston Churchill, this may not be the end but perhaps the beginning of the end. The countries themselves, in their National Reform Programmes, set out the challenges still to be met, such as budgetary consolidation, investment in infrastructures and creation of human capital. Furthermore, the opinion of their citizens, gathered in the Eurobarometer opinion survey, is notable for its common sense. People are concerned about the economic situation, inflation and the welfare state. It is the ordinary human concerns that strike home. They have major structural challenges still to meet and the fear is sometimes mentioned that, when the incentive coming from the EU extension has worn out, the drive for reform could lose its popular and political support.

The fact is we are still a long way apart. According to the Eurobarometer survey, citizens of the EU-15 say they are concerned about immigration, crime, terrorism, the climate and the environment. The gap between the agendas of the various countries reminds us that the new member states have only one foot in the stirrup of economic development. But don't let us be fooled. This may be a strong point hiding behind their state of weakness. They have the whole world to win and their weapon lies in the European Union. In general, their citizens are more confident in the future of the EU than those countries with a longer status in the new Europe. They are betting on further enlargements even though other views are quite against that possibility. And they have greater confidence in the EU institutions, far from the disdain expressed by some citizens of the old EU-15. Finally, they are betting on Europe. How like this is to the situation of Spain in 1986!

EXECUTIVE SUMMARY

Federal Reserve helps put out sub-prime mortgage fire by half-point cut in reference rate...

...although liquidity problems continue in interbank market and loan markets.

Crisis has no quick solution and does not help straighten out background problem of recession in US real estate market.

Financial turmoils, true fears

When the US Federal Reserve announced a cut in the interest rate on Federal Funds on September 18 putting it at 4.75%, a feeling of relief spread across financial markets. Up until then, the steady stream of bad news did nothing but complicate the feeling of crisis since the beginning of summer when the problem of sub-prime mortgages (with low credit rating) began to come to the surface. Critics questioned the propriety of the central bank's move in coming to the rescue of financial institutions that had run excessive risks, given that this stimulated and supported irresponsible action (so-called *moral hazard*). The truth is that no central bank can ignore a liquidity crisis or one of solvency that affects the financial system. The markets applauded the Fed's decision with sharp increases on the stock exchanges and some easing of interbank interest rates.

The Fed's action, however, has not resolved all the difficulties by any means. The interbank market has dried up and problems of liquidity for certain terms still persist. This is so even in Europe, where the European Central Bank (ECB) has not managed to normalize ordinary interbank transactions in spite of a number of extraordinary injections of funds. Outside the Euro Area, the case of Northern Rock bank, with customers lining up because of fear of losing their savings in the face of a possible bankruptcy, takes us back to periods we believed to be left behind and this shows the reverberations that can come from a crisis starting a great distance away.

Short-term bond issues are down considerably. The loan market, which until recently was in full swing because of corporate transactions of buying, selling or merger has lost its allure.

The financial crisis is far from being beaten. Henry Paulson, US Secretary of the Treasury, has stated that this was going to be a long crisis, given that cleaning up the lack of prudence in a certain segment of the financial market would not be simple. And, the background problem, the real estate recession, makes the continuation of uncertainty justified. Three are the reasons that justify the upholding of the uncertainty.

First of all, the crises brought about by an increase in default require more time to be resolved. For example, in the case of the United States, some 450,000 customers with sub-prime mortgages involving variable monthly payments will receive revised figures in the next three months. Monthly payments will be revised upward and, in view of the impossibility of meeting the increase, some of these mortgages will be added to those in default. Secondly, it is still too early to make a reliable estimate of the course of slowdown in the US consumer spending. Finally, the depreciation of the dollar has been very sharp and surely must have its effect on demand for goods and services of exporters in Asia and Europe.

Finally, the US real estate crisis has ended up reaching their financial system and then, through financial innovation procedures, has spread to institutions

and investors world wide, that in many cases have been the first to learn that they were involved. The collapse of confidence created by this type of financial upset and the halt in loan investment does not exactly help to resolve the basic problem, the real estate recession. Could this drag down the rest of the economy? Are we facing a soft landing, a rough landing or are we heading into a recession? Alan Greenspan, former Fed chairman, puts a 50% chance of recession over the short-medium term. The next question is: Could a possible state of stagnation or a recession in the United States spread to the rest of the world, thus ending the long-lasting strong growth stage in the world economy in recent years?

The traditional reply to the above question is that indeed when the United States sneezes the rest of the world catches cold. But now things are not so clear. Today the world economy is a «flying machine» with two engines – US private consumption and the strength of the emerging countries. Specifically, the Asian economies are showing their own very strong drive which for the moment does not seem to be affected by the mortgage loan upsets. Evidence of this is the course taken by raw materials prices. The per barrel price of oil has gone above 80 dollars, an all-time high, both with reference to Europe and the United States. Other raw materials of an industrial or agricultural type show price rises. Part of these increases may be attributed to speculative money leaving the dollar and seeking havens with less risk. Other indicators, such as ship chartering, confirm the strength of economic activity and international trade.

China is the central hub of the emerging countries. For the moment it is showing no signs of slowing down. Industrial production is growing by 17% and in

recent months private consumption has risen to similar rates. The Chinese stock market continues to rise, indifferent to the ups and downs of western markets. The authorities keep raising interest rates little by little and are allowing a very gradual appreciation of the currency, concerned as they are about rising inflation and the risk of overheating. Exports to the United States represent 20% of the total. A slowdown in those exports due to a cooling down of the US economy dropping them by 10% would directly take 0.7% off nominal gross domestic product (GDP). In view of China's growth this would be far from dramatic.

Could the world economy «flying machine» keep aloft with one motor damaged? This is one of the most debated questions at this moment and no doubt one raised by the European Commission when it drew up the revisions of its Spring forecasts in mid-September. The Commission recognizes that it is not in a position to fully evaluate the effects of the mortgage loan crisis on future growth. It points out a possible worsening of economic activity in 2008 due to the hypothetical contraction of credit and it has limited itself to a marginal revision of the trend expected for the remainder of 2007. In fact, the main factor behind that trend is the worse than expected performance in the second quarter. It does recognize, however, that the uncertainty surrounding the forecasts for these years is higher than normal.

In the Euro Area, all eyes are on the ECB. With a mature economic cycle (growth above potential but with a tendency to slow down) a sudden worsening of prospects along with appreciation of the euro could bring about the end of the growth stage that was presumed to last longer. The ECB has interrupted the interest rate increases it has been

Could crisis affect international growth? Not if emerging countries hold strong.

China showing no signs of slowdown and problem of government authorities is to cool down growth.

European economic cycle seems mature and, with strong euro, could be affected by possible slowdown in world growth.

Industry and services maintain economic activity while construction suffering from slowdown in housing market.

applying in steps since the end of 2005 but must face the criticism of being less flexible than the Fed without losing sight of inflation figures less favourable than desirable.

Spain's economy: gradual slowdown

In Spain's economy, the characteristic note is a slight slowdown of economic activity. Industrial production showed a profile of slight slowdown at the beginning of the third quarter, with corporate confidence down, but with order books still in a healthy state. Services, in turn, continue to grow at a stable rate. Business volume for the sector rose by 8.8% in July compared with the same month last year, although the tourist season is turning out to be quite ordinary.

Labour market indicates lower job creation.

On the other hand, the picture in construction has clouded over with a sharp drop in corporate confidence in August and a yearly drop in cement consumption that month. A number of signs reveal the progressive cooling off of the housing market, as in approvals for new building which were down 37% in July compared with 12 months before. In addition, mortgage loans continue to ease off under the effect of interest rate increases although they are still showing very high annual growth rates. The other side of the picture comes in government tendering which showed an annual rise of 20% in July, indicating an improvement in public works.

Central government budget for 2008 forecasts another surplus with public accounts in balance.

On the demand side, early figures for the third quarter suggest that private consumption still remains strong. Retail sales show a robust growth rate and imports of consumer goods recorded a sharp increase in July. Nevertheless, car sales were poor in the warmer months of the year with a year-on-year drop in August.

With regard to capital goods investment, indicators show high growth figures.

The labour market also coincides with this showing a slowdown in job creation. Those registered with Social Security rose by 2.5% year-on-year in August as against 3.6% in the first quarter. By sector, we note that the slowdown shows up sharper in construction having gone to an annual rate of 2.1% from 6.1% in the first quarter. As a result, both services and industry are now showing higher annual change rates than construction. The decreased strength in the labour market also shows up in a drop of 2.7% in registered hiring contracts at public employment offices in August compared with the same month last year.

With regard to the foreign sector, figures available for trade in goods in July indicate high annual growth rates although rates for imports were greater. As a result, the foreign sector will continue to make a negative contribution to GDP growth but probably less and less if the easing in national demand becomes consolidated.

Prospects of a slowdown will hold for the rest of the year and for 2008 and the extent of this slowdown could be influenced by the possible effect of the mortgage loan crisis on the world economy. In presenting the budget for next year, the government put GDP growth at 3.3%, as against 3.8% for 2007, a higher figure than that for most forecasts. What has not been touched upon is the financial situation of the public sector which has reported high surpluses since 2005. This constitutes a factor of calm in view of a less tranquil economic picture than that in previous years.

September 28, 2007

CHRONOLOGY

2006

- 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.
- 6** **European Central Bank** raises official interest rate to 4.00%.
- 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**.
- September 18** **Federal Reserve** reduces reference rate to 4.75%.
- 27** **Euro** exchange rate hits 1.418 dollars, highest value since launching of single European currency at beginning of 1999.
- 28** One-month forward price for Brent quality **oil** goes to all-time high of 80.74 dollars a barrel.

AGENDA

October

- 2** Registrations with Social Security and registered unemployment (September).
- 4** Governing Council of 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).
- 30** Early HCPI (October).
- 31** US GDP (3rd Quarter). Fed. Open Market Committee.

November

- 5** Registrations with Social Security and registered unemployment (October).
- 6** Industrial production index (September).
- 8** Governing Council of European Central Bank.
- 13** EU GDP (3rd Quarter).
- 14** Early GDP (3rd Quarter). CPI (October).
- 15** Balance of payments (August). HCPI for EU (October).
- 20** Foreign trade (September).
- 21** Quarterly national accounts (3rd quarter).
- 26** Producer prices (October).
- 27** Central government revenues and spending (October).
- 29** Early HCPI (November).

INTERNATIONAL REVIEW

United States grows by 1.9%.

Bigger slowdown in private consumption is greatest present risk.

United States: a little less wealth and much more caution

A famous poem by Rudyard Kipling goes like this: «If you can make one heap of all your winnings And risk it on one turn of pitch-and-toss, And lose, and start again at your beginnings And never breathe a word about your loss (...) Yours is the Earth and everything that's in it, And – which is more – you'll be a Man, my son». From this we may deduct that getting over a sudden loss of accumulated wealth must be rather difficult. In his own way, Kipling was describing the importance of the wealth effect in consumption, which implies that there is a direct relation between accumulated wealth and current

consumption. Although it may not be as dramatic, US consumers find themselves in a similar situation and it should be remembered that their annual spending is equivalent to 72% of gross domestic product (GDP). After seeing how household wealth rose month after month thanks to the appreciation of their homes, the question now is to see how these levels of consumption develop if the price of real estate should sharpen its incipient correction.

The economy rose in the second quarter going from growth of 1.5% to 1.9% year-on-year. Nevertheless, private consumption, the main bulwark of growth in recent years, had a flat. The upward reaction showed up in

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	August
Real GDP	3.1	2.9	2.4	2.6	1.5	1.9	–	...
Retail sales	6.6	6.1	5.4	5.0	3.4	4.0	3.6	3.7
Consumer confidence (1)	100.3	105.9	104.4	106.8	109.9	106.7	111.9	105.0
Industrial production	3.2	4.0	5.1	3.5	2.5	1.8	1.7	1.7
Industrial activity index (ISM) (1)	55.5	53.9	53.8	50.9	50.8	55.2	53.8	52.9
Sales of single-family homes	6.5	–18.0	–23.3	–21.9	–24.6	–19.1	–10.2	...
Unemployment rate (2)	5.1	4.6	4.7	4.5	4.5	4.5	4.6	4.6
Consumer prices	3.4	3.2	3.4	1.9	2.4	2.7	2.4	1.9
Trade balance (3)	–714.4	–758.5	–777.7	–758.5	–764.4	–731.5	–723.2	...
3-month interbank interest rate (1)	3.6	5.2	5.4	5.4	5.4	5.4	5.4	5.6
Nominal effective exchange rate (4)	83.7	82.5	81.6	81.6	81.9	79.3	77.5	77.5

NOTES: (1) Value.

(2) Percentage of labour force.

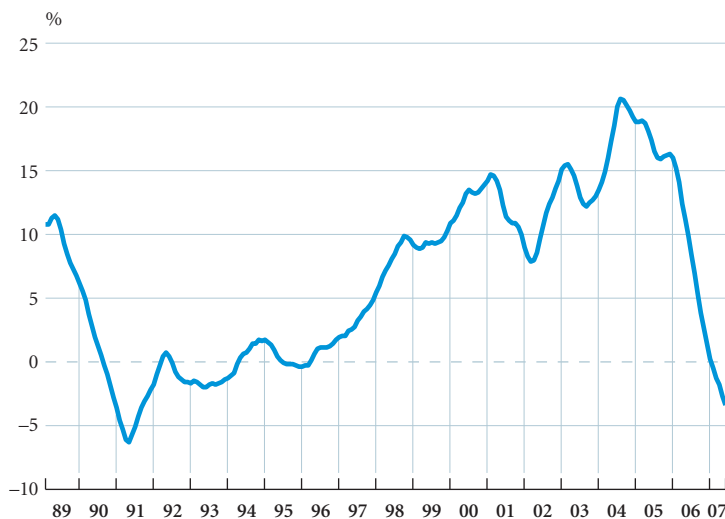
(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.

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

SOURCE: OECD, national statistical bodies and own calculations.

UNITED STATES: REAL ESTATE SHOWS CHANGE OF TREND

Year-on-year change in Case-Schiller index of housing prices



SOURCE: Standard & Poor's and own calculations.

the foreign sector, public consumption and the accumulation of inventories. Investment in production activities, while not dropping maintained a low profile and construction continued stagnant. Even so, retail sales in August, not including the always variable sales of cars and petrol, grew by 4.7% year-on-year or 2.7% if we discount price increases, which shows that consumption still has some strength.

The problem is that the trend is toward a slowdown. In this respect, an early indicator such as the situation of Wal-Mart, by far the biggest retail chain in the country, is not offering very bright prospects. Its results in the third quarter were surprisingly low and, furthermore, the company reduced its expected profit forecast for 2007 as a whole because of lower activity in the US market and the fact is that the words of Kipling, or the wealth effect, are carrying weight. According to Martin Feldstein, in his conclusions at the Annual Symposium of the Kansas City Federal Reserve at

Jackson Hole, the real estate wealth of US households is 21,000 billion dollars, approximately 1.5 times GDP. A hypothetical loss of 20% in real estate prices (equivalent to 30% of GDP) would turn into a reduction of 1.5% of GDP through lower private consumption, which potentially could bring on a recession.

This has not yet happened but in May the statistically robust Case-Schiller index for housing prices dropped by 3.4% year-on-year, showing a sharp slowdown. The trend in the number of houses for sale since May and forecasts of increased loan default in coming months, because of the end of grace periods with low interest in many mortgage loan agreements, means it is likely the trend will continue downward for some time. Activity in the market continued to slacken in August with decreases in sales close to 10% compared with the same period last year. The contraction in this sector has some momentum and supply seems to be

Retail consumption holding up...

...but housing prices drop while labour market loses drive.

reflecting this with further drops in housing starts going to 19.1% year-on-year in August.

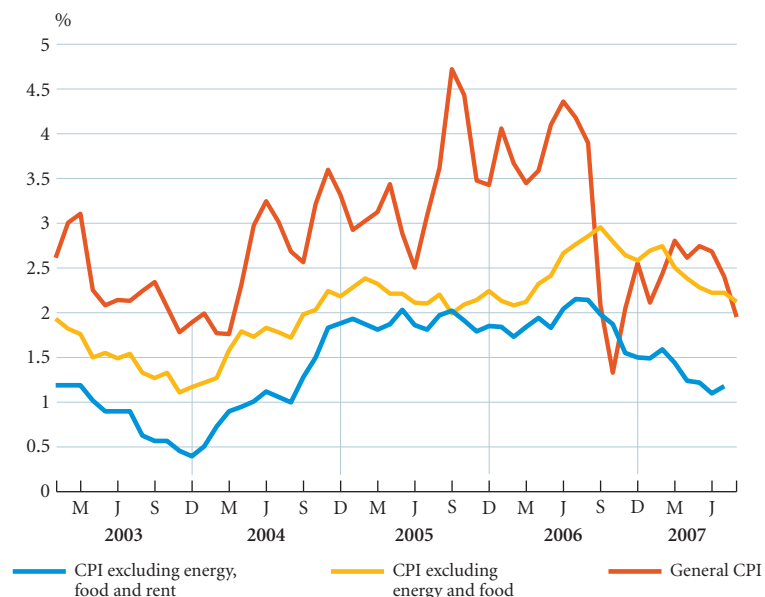
Up to this time, the labour market has been acting as a major source of support to the level of economic activity. The unemployment rate in August held at a low 4.6% of the labour force but some 4,000 jobs were lost when it was hoped to create 110,000. While the margin for error in this figure is high and the drop is very low, it is significant because this is the first such drop in the last four years with the subsequent psychological effect at a moment when fear and changes in perception of risk are important. A sign of this state of affairs is that the consumer confidence index put out by the Conference Board in August was down from 111.9 points to 105.0 points.

While at this time the main risk is a sharpening of the slowdown in

consumption because of the recession in the housing sector and loan markets, we should not forget the strength of the economy in the area of prices and the improvement in the foreign sector which gives the Federal Reserve some margin for manoeuvre as shown by the half-point cut in the reference rate in September. The consumer price index in August was down from growth of 2.4% to 1.9% year-on-year. Pessimists may say that a large part of the improvement was due to base effects in oil prices, something that in view of latest figures should not last very long. Although this is partly true, it should not be forgotten that the underlying component (the general index excluding energy and foods) also showed a positive trend going from increases of 2.2% to 2.1% and that in recent years housing rentals, with prices dropping, have had a much greater effect on the CPI than oil.

UNITED STATES: INFLATIONARY PRESSURES CONTINUE TO EASE

Year-on-year change in US CPI



SOURCE: Department of Labour and own calculations.

Producer prices were also down in August going from increases of 3.9% to 2.1% year-on-year. An additional inflation risk is that the depreciation of the dollar makes it more difficult for the foreign sector to continue to be the source of low costs to the extent it has been up until now. Nevertheless, the weakening of consumption should more than compensate for this effect, as seems to be indicated by the private consumption deflator of GDP in the second quarter, without taking into consideration energy consumption that rose by 1.9% over the previous quarter in annual terms, well below the 2.8% in the first quarter. In any case, we must accept that in the future the inflation-growth mix will be less favourable than it has been up until now.

The trade deficit in August was already showing a tendency to correction based not only on lower imports as a result of the weakness in private consumption but also on a revival of exports, boosted by strong world demand. As a result, the trade deficit in goods and services (excluding oil) stood 19% lower than the high reported in October 2005.

The business sentiment and activity index put out by the Institute for Supply Management showed slight decreases but held slightly above the 50 level so that those seeing rises equalled those expecting drops. Nevertheless, new orders, especially export orders, showed a strong performance which should help some recovery in industrial production which in August rose by 1.7% year-on-year. Now we need only hope that a continuation of price moderation and correction of the foreign imbalance will be sufficient to help the economy through this difficult situation with the aid of the Fed, but without have to recur to the heroism Kipling described in his poem.

Japan: rather grey domestic demand

Yasuo Fukuda, 71, a leader of the Liberal-Democratic Party which has governed Japan over the past 50 years (except for a period of 9 months), son of a former prime minister in the Seventies, only a year ago was considered a dreary dull option from the past. The fact is that, after the reforms carried out by Junichiro Koizumi, his successor Shinzo Abe, a younger man born after the end of World War II, seemed like an attractive alternative.

But Abe lasted only a short time quitting in mid-September in the midst of corruption scandals, an increase in social inequalities and with an economy with less drive. While quite grey at first sight, the new prime minister, Yasuo Fukuda, is now a credible government leader for the future. His intention is to deal with those things that have grown worse and at the same time maintain the changes begun by Koizumi. In spite of such reforms, Japan continues to be the same as ever, with a heavy dependence on the foreign sector, with poor return on capital invested and a system that favours producers over consumers. There are therefore few things this new mature prime minister will be able to put behind him even if he should want to.

Following the customary revision of national accounts for the second quarter by the Ministry of Communications, economic growth in that quarter was 1.7% year-on-year, substantially below the 2.3% previously published. It is significant that that GDP contracted by 1.2% in annual terms compared with the first quarter. Private consumption continues to maintain a low profile with the good level it reached in 2004 left far behind and a contribution to growth at only a slim 0.7%. With public

Lower inflation gives Federal Reserve some margin...

...and trade deficit starting to be corrected.

Business executives watching cautiously.

Japan grows by 1.7% thanks to export sector.

Consumers still not seeing things clearly but investment should rise.

JAPAN: 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	August
Real GDP	1.9	2.2	1.4	2.5	2.6	1.7	–	...
Industrial production	1.5	4.5	6.0	5.3	3.6	2.3	2.0	...
Tankan company Index (1)	18.0	22.5	24.0	25.0	23.0	23.0	–	...
Housing construction	3.9	4.5	–0.8	5.4	–1.9	–2.7	–23.4	...
Unemployment rate (2)	4.4	4.1	4.1	4.0	4.0	3.8	3.6	...
Consumer prices	–0.3	0.2	0.6	0.3	–0.1	–0.1	0.0	...
Trade balance (3)	10.2	9.4	8.9	9.4	10.2	11.1	11.1	...
3-month interbank interest rate (1)	0.1	0.3	0.4	0.5	0.6	0.7	0.8	0.8
Nominal effective exchange rate (4)	98.1	91.3	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.

Real estate market remains weak...

consumption on a slimming programme and capital goods investment down, only the foreign sector held its head up. Somewhat lower imports and exports that remained strong raised the foreign sector's contribution to growth to 1.0%.

Among latest indicators, industrial production in July slowed slightly with modest growth of 2.0% year-on-year. Machinery orders that same month recovered from the dip in June and, excluding ship projects (which because of their unusual nature create distortions) moved up by 9.7% year-on-year. This recovery, which finally included industries aimed at domestic consumption, would indicate a rise in investment coming in the third quarter, also in keeping with the latest surveys on business confidence.

Nevertheless, although the poor figures for the second quarter may be revised upward, while private consumption shows no signs of improving, domestic demand likely will continue to be as

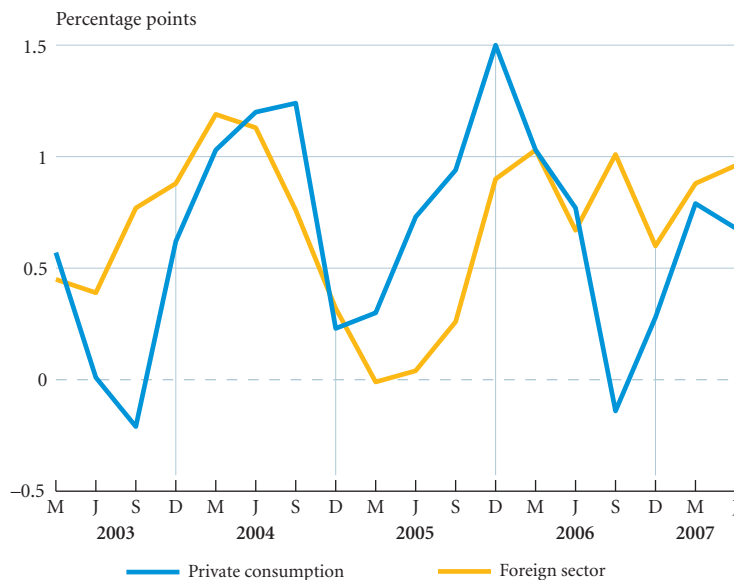
sluggish as the political situation. Latest indicators show no signs of improvement in this respect. Retail sales in July were down 2.3% year-on-year and, although car sales in August rose by a weak 0.8%, they are still a long way from levels in previous years. Nor is the housing market showing much strength. While prices were up moderately in August, the number of properties sold in Tokyo continued to fall sharply and the stock of those for sale moved up. In keeping with this situation, housing starts were down by 23.4% year-on-year in July.

Prices are not getting out of the shades of deflation. Whereas the general CPI in July repeated the figures for the same period last year, the more reliable underlying index, which in Japan is the general index less fresh foods, was down by 0.1%. In Tokyo the August CPI was down 0.2% year-on-year. On the other hand, the unemployment rate continued to drop and in July was only 3.6% of the labour force. This is a good figure which

...and deflation persists but with little unemployment.

JAPAN: EXPORTS GROWING MORE THAN CONSUMPTION

Contribution to year-on-year change in GDP



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

cannot fail to strengthen demand as it is partly due to a decreasing population and the general perception of a lowering of social protection. The trade surplus for the past 12 months ending in July rose to 11,100 billion yen but the threat of lower purchases by the United States and the strength of the yen are still an element of risk for the main bastion of economic activity.

China: economy growing and prices as well

The truth is as it is, even if we look at it backwards. This phrase of Machado fits China perfectly in double measure. Quarter after quarter people expect to see a slowdown and the reality ends up being just the opposite, as shown by the second- quarter increase in the GDP which went up to 11.9% year-on-year. But, whereas up to now sharp growth went along with prices under control, the

situation has now changed. Although the authorities are trying to control prices, the reality is as it is and inflation reached 6.5% year-on-year in August. If this official figure may seem moderate, inflation in foods is certainly not going as it did to 18.2% year-on-year. In a country where nearly 50% of labour is devoted to agriculture many observers feel this is more relevant than the general index. Price increases, along with excessive dependence on the foreign sector, make up the two Achilles' heels of this main engine of world growth.

This is an engine where demand is beginning to take off and stand alongside continuing growth in supply. Industrial production in August reported a very small drop but even so it grew by 17.5% year-on-year. The important news, however, was the rise in retail consumption which was up 17.1% year-on-year whereas in January it was growing by 12.7%. This rise in

China grows by 11.9% backed by industry and foreign sector.

Inflation goes up to 6.5% while food prices rise 18.2%.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006			2007			
			2Q	3Q	4Q	1Q	2Q	July	August
Real GDP	10.1	10.7	11.5	10.6	10.4	11.1	11.9	—	...
Industrial production	15.9	16.4	18.0	16.2	14.8	14.4	18.3	18.0	17.5
Electrical power production	13.4	14.7	13.2	16.5	15.3	12.4	17.7	15.8	16.3
Consumer prices	1.8	1.5	1.4	1.3	2.0	2.7	3.6	5.6	6.5
Trade balance (*)	102.0	177.5	123.4	143.3	177.5	200.6	228.9	238.7	244.9
3-month interbank interest rate (*)	2.4	2.8	2.9	3.0	3.1	2.8	3.4	3.6	3.3
Exchange rate (**)	8.2	8.0	8.0	7.9	7.8	7.7	7.7	7.6	7.5

NOTES: (*) Cumulative balance for 12 months. Billion dollars.

(**) In terms of dollar.

SOURCE: National Statistics Office of China, Thomson Financial Datastream and own calculations.

Consumption taking off but still has some way to go.

consumption must be welcomed and even more so if, as in this case, it includes the rural regions which are still behind the urban areas. Nevertheless, the bottlenecks due to inefficiency (a result of the rapid economic transformation and certain factors inherited from the communist past) mean that there are scarcities at various points in the production chain and as a result prices rise. An example of this is the change in diet, a result of development, with more meat being eaten, which among other factors has brought a rise in the prices of those cereals fed to livestock.

Given the inequalities in income and the vital importance of the food sector, should this inflation continue it could erode the apparent state of social peace, something that remains a constant in China in spite of all the economic swings. In view of this, the monetary authorities again raised interest rates in August (by 18 basis points) putting the reference rate for loans of less than six months at 6.21%, a high rate compared with the 5.22% at the end of 2005. But the effects of this are still to be seen. The appreciation of the renminbi against the

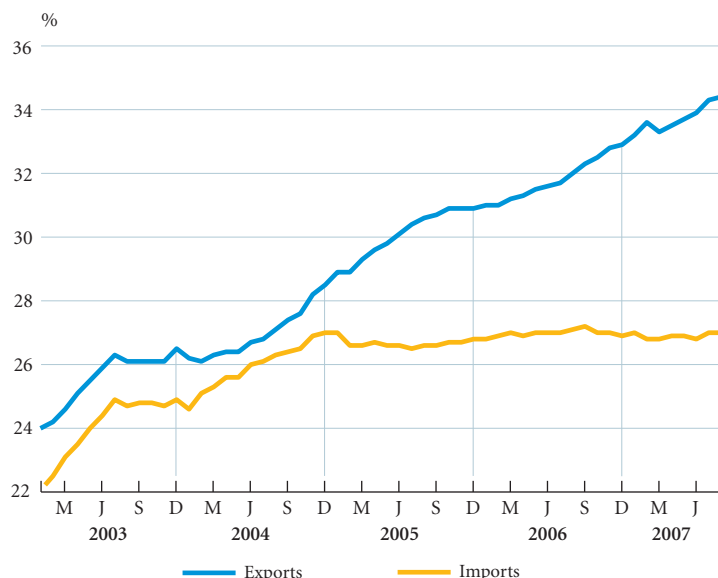
dollar is still relatively small and given the depreciation of the greenback and the strength of the foreign sector, with purchases very much centred on raw materials for industry, any effect in moderating prices through cheap imports does not seem as if it will be particularly great.

With regard to the second aspect, dependence on growth of exports and the excessive weight of the bilateral surplus with the United States, things do not seem likely to be adjusted. The trade surplus for the past 12 months ending August reached 244.9 billion dollars, 80% above the same period the year before. The bilateral surplus with the United States and Europe reached 148.4 billion dollars and 127.4 billion dollars respectively. In turn, exports contributed nearly half of all growth and represented 34.4% of GDP while those going to the United States reached 6.9%. A slowdown in the latter due to a cooling off of the US economy reducing them by 10% would take 0.7% off nominal GDP, something that, in view of China's growth, would not be dramatic.

Foreign surplus continues to grow but dependence on increased exports is now a risk.

CHINA: WEIGHTING OF EXPORTS EXCESSIVE

Weight of exports and imports in terms of GDP for past 12 months



SOURCE: Chinese National Statistics Office, Economist Intelligence Unit and own calculations.

Nevertheless, the problem would also reside in indirect effects. Lower US imports from China would also imply lower imports from other Asian countries that depend on those to a greater extent. Those countries, with lower growth in turn, would reduce their imports from China which make up 16.1% of its economy. Probably, investment by foreign companies going into export industries would also suffer a drop. This shows the growing importance of continuing to raise domestic consumption without creating inflationary pressures.

Mexico: economic activity takes off again

The Mexican economy showed a slight rise in the second quarter with 2.8% year-on-year growth which put an end to the slowdown seen in recent quarters. Private consumption confirmed its

recovery showing increases of 4.6%.

Private investment also moved up with growth of 6.9% year-on-year, which gives a stronger picture than the 4.9% in the previous quarter. The public sector partly recovered from the halt at the beginning of the year but is still in a slimming-down stage.

In turn, the foreign sector is still the one presenting more doubts. While imports rose following the trail of consumption, exports continued to be slack, going up by a mere 3.6%, partly the victim of an overvalued exchange rate. In spite of the fact that this is linked to the now dropping dollar, Mexican productivity has not benefited from this situation and its products have not become cheaper in terms of those of its trading partners as a group.

Among most recent activity indicators things have also improved in recent months. Industrial production in July

Mexico grows by 2.8% while consumption and investment recover...

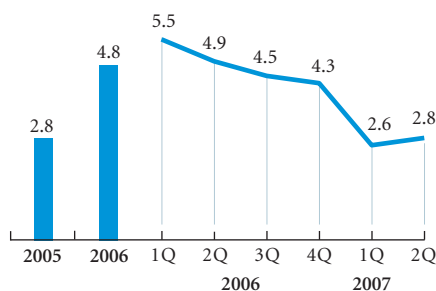
...but this not the case with exports.

Industrial sector recovery tentative.

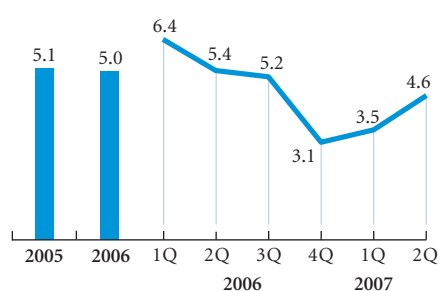
TREND IN MEXICAN GDP BY COMPONENT

Percentage year-on-year change in real terms

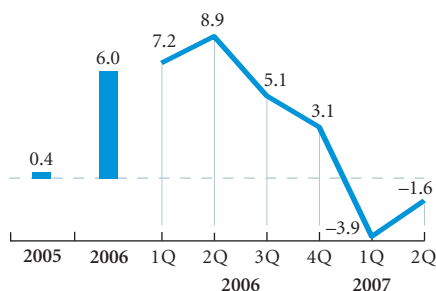
GDP



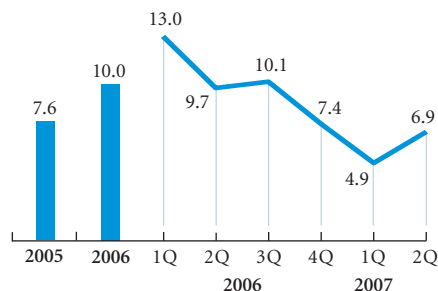
Private consumption



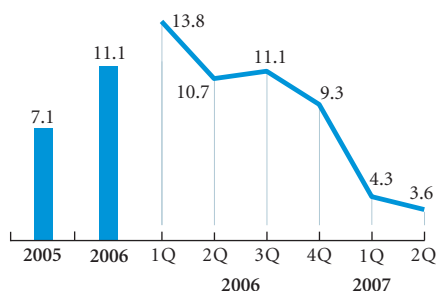
Public consumption



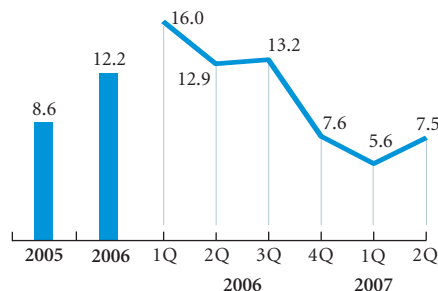
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



SOURCE: Central Bank of Mexico and own calculations.

showed a slight rise with growth of 2.5% year-on-year after having been in hibernation all Winter and Spring. Manufactures moved ahead with an advance of 2.8%, while construction (also reflecting the predominant climate in its neighbour to the North) showed a little more momentum with growth at a modest 1.2%.

Inflation remains stable but higher than that of its neighbours. Prices were up

4.0% year-on-year in August while the underlying index (the general index less energy and foods) rose by 3.9%. Most troubling was the rise in unit labour costs which in the second quarter rose sharply with growth at 6.6% year-on-year. All of this contributes to the loss of competitiveness lying behind the stagnation in exports mentioned earlier. In turn, the official unemployment rate in August stood at a mild 3.9% of the labour force.

Inflation at 4.0% but labour costs rise.

MEXICO: 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	2 Q	July	August
Real GDP	2.8	4.8	4.9	4.5	4.3	2.6	2.8	—	...
Industrial production	1.8	5.0	3.9	5.4	3.6	0.5	0.7	2.5	...
General unemployment rate (*)	3.6	3.6	3.2	4.0	3.7	4.0	3.4	4.0	3.9
Consumer prices	4.0	3.6	3.1	3.5	4.1	4.1	4.0	4.1	4.0
Trade balance (**)	-7.6	-6.1	-4.5	-5.4	-6.1	-9.5	-11.7	-12.1	...
3-month interbank interest rate	9.5	7.3	7.2	7.2	7.2	7.2	7.2	7.2	7.2
Exchange rate (***)	10.9	10.9	11.2	10.9	10.9	11.1	10.8	10.9	11.0

NOTES: (*) Percentage of labour force.

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

(***) In terms of dollar.

SOURCE: Central Bank of Mexico.

MEXICO: TRADE DEFICIT FAILS TO HIT BOTTOM

Cumulative figure for 3-monthly trade balance excluding oil exports



SOURCE: Central Bank of Mexico and own calculations.

The trade balance continued to worsen following some weak signs of correction. The cumulative balance for the past 12 months ended July went down to 12.1 billion dollars. Without the support of oil exports, which at this time provide a precarious cushion, the trade deficit in the same period came close to 50 billion dollars, an increase of 16.4% year-to-year.

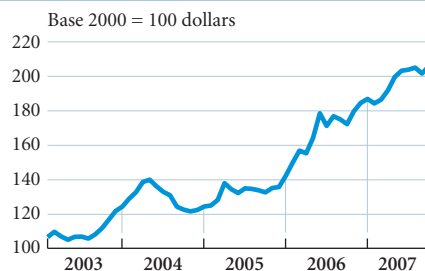
Raw materials: oil goes to all-time highs

On September 28 the per barrel one-month forward price of Brent quality oil closed at 80.7 dollars, a new all-time high that demolished by more than two dollars the price reached in August 2006 during the Israeli move into Lebanon.

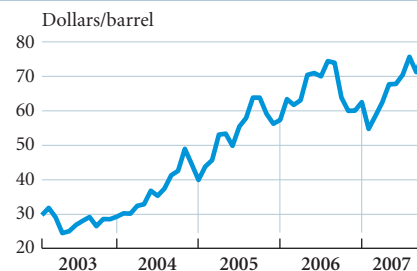
Foreign sector continues to worsen.

TREND IN VARIOUS RAW MATERIALS

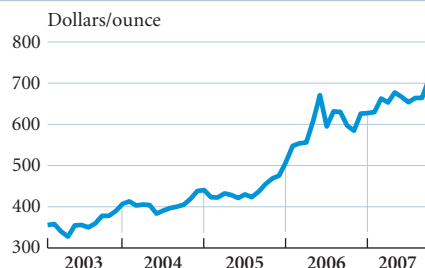
«The Economist» index



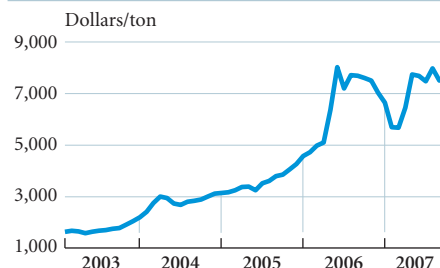
Brent oil



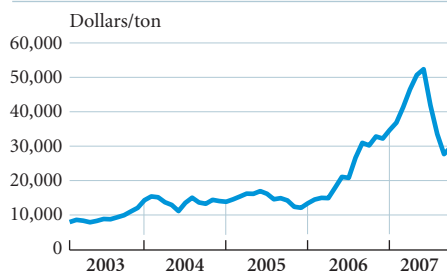
Gold



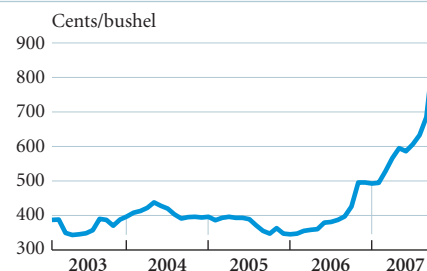
Copper



Nickel



Wheat



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

Oil price goes to 80-dollars-a-barrel range which means market expecting strong demand in 2008...

Now it is not war, nor weather problems in the Gulf of Mexico in the hurricane season that have put oil at levels 32% higher than one year ago.

The trend in oil points to a scenario of expected upward demand in coming months that only fits into equally strong world growth. Available figures on demand suggest that the slowdown in demand for crude taking place in the industrialized countries is being more than compensated by the increase in emerging economies. It is based on this view that oil futures indicate that in mid-

2008 a barrel will stand at around 76 dollars, only slightly less than current levels.

Other raw materials drive this home. In spite of the fact that the various products are following different courses, in general terms the trend in the two major groups of raw materials (agricultural materials and metals) confirm that the world appetite is holding firm and that no sudden adjustment in demand is expected. In recent times, wheat has been in the headlines following a clearly upward trend taking it to all-time highs.

RAW MATERIALS PRICES

	2005	2006	2006				2007		
			3 Q	4 Q	1 Q	2 Q	July	August	September
«The Economist» index in dollars (*)									
General	3.6	27.5	30.5	33.3	21.7	18.1	15.9	15.2	19.5
Food	−1.3	11.0	8.5	20.2	16.5	19.0	23.2	29.0	39.5
Industrials	9.7	46.1	55.5	46.9	26.9	17.6	10.1	4.4	3.7
Non-food agricultural	−1.9	12.5	12.6	2.0	4.5	3.3	2.1	6.0	14.9
Metals	16.5	62.0	76.4	66.8	36.2	22.6	12.7	4.0	0.5
«The Economist» index in euros (*)									
	4.0	26.3	24.9	22.9	11.6	10.0	6.9	8.0	10.4
Oil (**)									
Dollars/barrel	55.1	66.3	70.9	61.0	58.7	68.8	75.8	71.3	76.8
Change rate	46.5	21.6	14.7	5.7	−6.5	−2.6	1.7	−3.6	19.9
Gold									
Dollars/ounce	445.1	604.1	621.3	614.4	650.3	667.8	665.9	666.1	711.7
Change rate	8.6	36.1	41.5	26.6	17.3	6.9	5.2	5.4	18.8

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

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

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

Nevertheless, other significant products, such as gold, platinum and lead, among the metals, and rubber, coffee and cotton, among agricultural raw materials, also showed notable growth rates in

September. Finally, if raw materials are any guide to next year, 2008 should not show any collapse in world economic activity.

...a scenario also underlying notable growth of other raw materials, especially of agricultural type.

EUROPEAN UNION

European Union slightly revises growth forecasts for 2007, implicitly acknowledging impact of financial crisis.

Euro Area slows to 2.5% in second quarter due to loss of drive in domestic demand.

2007 forecasts: lower growth, more inflation

In its early figures for September, the European Commission slightly revised its 2007 growth forecasts for the Euro Area. It predicts that growth will be 2.5%, one decimal less than what was expected in its Spring forecasts. At the same time, the EU executive modified upwards its inflation forecasts which go to 2.0% in 2007 as against the 1.9% previously seen. Growth forecasts for the European Union as a whole have also been revised downward by one decimal, while consumer prices have been kept unchanged.

These forecasts were *a priori* of great interest because they had been drawn up following the sub-prime mortgage financial crisis that began in August. Nevertheless, the European Commission recognizes that it is not in a position to

fully evaluate the effects of that crisis on future growth. It indicates a possible worsening of economic activity in 2008 due to a hypothetical contraction of credit and it limited itself to marginally revising the trend foreseen for the rest of 2007. In fact, the main factor behind this trend is the worse than expected performance in the second quarter. It does recognize, however, that the uncertainty surrounding the forecasts for these years is higher than normal.

Euro Area: clouds on the horizon

The dominant view is that the Euro Area economy stands in a good position to overcome any possible negative effects brought about by the sub-prime mortgage financial crisis in the United States. Joaquín Almunia, European Commissioner for Economic Affairs, underlined this on September 5 during

EUROPEAN COMMISSION MACROECONOMIC FORECASTS

Percentage annual change

Country	Growth			Inflation (*)		
	2006	Current forecast for 2007	Difference over previous forecast (**)	2006	Current forecast for 2007	Difference over previous forecast (**)
Germany	2.9	2.4	-0.1	1.8	2.1	0.2
Spain	3.9	3.7	0.0	3.6	2.5	0.1
France	2.0	1.9	-0.5	1.9	1.4	-0.1
Italy	1.9	1.9	0.0	2.2	1.9	0.0
Euro area	2.8	2.5	-0.1	2.2	2.0	0.1
United Kingdom	2.8	2.9	0.1	2.3	2.4	0.1
EU-27	3.0	2.8	-0.1	2.3	2.2	0.0

NOTES: (*) Harmonized consumer price index.

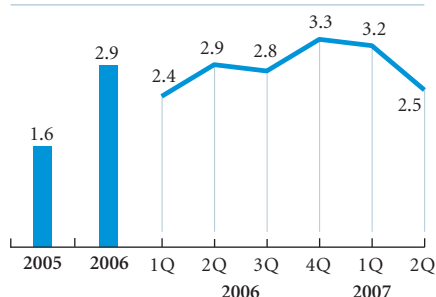
(**) May, 2007

SOURCE: European Commission.

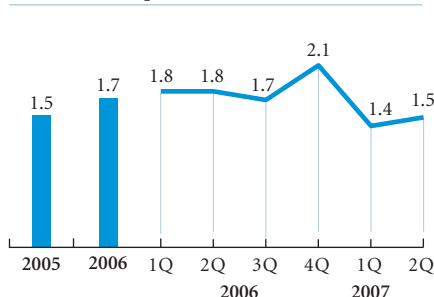
TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change

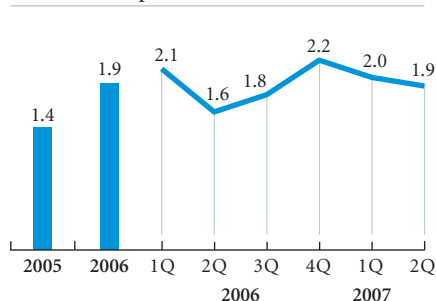
GDP



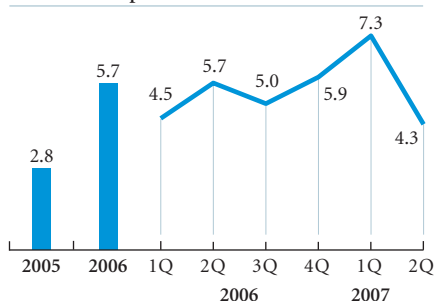
Private consumption



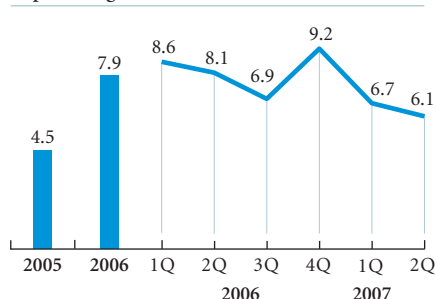
Public consumption



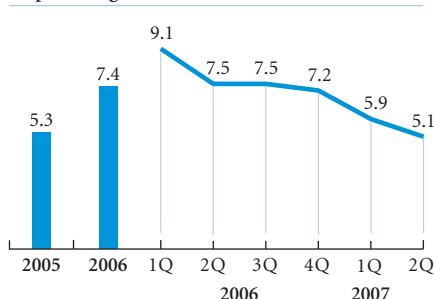
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



SOURCE: Eurostat and own calculations.

his appearance before the European Parliament. According to the Commissioner, the world economy, especially that of the emerging economies, would be able to compensate for a hypothetical loss of growth rate in the United States. Furthermore, key domestic variables, such as investment and consumption, should be able to weather the storm. Almunia concluded: «we have good reason to remain

confident about the economic fundamentals of Europe and the capacity to overcome the current turbulences.»

This is certainly true. But undoubtedly there are other reasons, of equal importance, that throw some cold water on the European commissioner's optimism. To begin with, the growth figures for the second quarter show the odd blemish. During that period, the

Slowdown course to continue in coming months, although quite contained.

EURO AREA: 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	August
GDP	1.6	2.9	2.8	3.3	3.2	2.5	–	...
Retail sales	1.2	2.1	2.4	2.3	1.7	1.0	0.7	...
Consumer confidence (*)	–14	–9.0	–8	–7	–5	–2	–2	–3
Industrial production	1.3	4.0	4.1	4.0	3.9	2.7	3.7	...
Economic sentiment indicator (*)	97.9	106.9	108.2	109.9	110.0	111.6	111.0	110.0
Unemployment rate (**)	8.6	7.9	7.8	7.6	7.2	7.0	6.9	...
Consumer prices	2.2	2.2	2.1	1.8	1.9	1.9	1.8	1.7
Trade balance (***)	42.1	–10.4	–21.6	–13.1	–0.9	15.3	24.3	...
3-month Euribor interest rate	2.2	3.4	3.1	3.4	3.7	3.9	4.2	4.3
Nominal effective euro exchange rate	101.2	104.5	105.1	104.5	105.5	106.4	107.3	107.2

NOTES: (*) Value.

(**) Percentage of labour force.

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

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

Concern that financial crisis may substantially affect foreign demand or consumer and corporate confidence.

Euro Area economy grew by 2.5% year-on-year compared with 3.2% in the first quarter. What is troubling is not so much the sharpness of the slowdown (which likely will moderate in the second half-year) as the composition of growth.

The first notable feature is that private consumption showed only a marginal increase in growth rate. It should be remembered that the forecasts of most analysts indicated a substantially higher increase in growth. A second factor on the debit side is that investment suffered from a big drop in the second quarter. Without the support of domestic demand, everything again depends on the foreign sector. On this front, the situation comes out a draw. The slowdown in exports has been balanced by a drop in imports so that the positive contribution of the foreign sector to the change in gross domestic product (GDP) has been unchanged in terms of the first quarter.

If we shift our attention to the third quarter, we note that the previous trends are persisting. The indicators for private consumption are losing a little more drive. Retail sales grew by a mere 0.7% year-on-year in July and consumer confidence lost one point in August. Nor does investment offer great hopes. Although the capital goods component of industrial production rose in July, utilization of production capacity was down to six decimals in August. Once more, the foreign sector seemed to save the game given that not in vain the foreign surplus continued to rise as of July.

Finally, the danger comes from the impact of a crisis that could affect some of the essential links in the current European cycle. If the world economic situation gets worse than expected, the likelihood of a drop in European exports is quite high, a troubling possibility due to the fact that this is the main channel for growth. Nor does the investment front point to a growth trend, given that

we cannot expect any big improvement in its final determinants (expected demand and, especially, financial conditions) in coming months. And, while consumption will benefit from the combined effect of contained inflation (a mere 1.7% year-on-year in August) and a gradually dropping unemployment rate (at 6.9% in July and August) it is difficult to see any significant upturn ahead. Furthermore, all these trends could become sharper if consumer and corporate confidence should deteriorate, a danger that Joaquín Almunia mentioned as the most important but also the most unpredictable factor of all.

To recapitulate: at the start of the third quarter the Euro Area is keeping to a reasonably active drive (and the rise in industrial production in July helps confirm this) but the longer term prospects are less positive. Even if the financial crisis is contained, the trends in consumption and investment (already to be noted in the second quarter) suggest that we are moving into a stage of lower growth.

Germany: A time for reform?

Just when there was concern that in the second part of the legislature, the «Grand Coalition» might go into something of a political block, the response has come from Meseberg. At a two-day meeting in this small town in the north-east of Germany, government ministers presented their economic policy programme for the 2007-2009 period. This involved a package of many measures reaching into various sectors. While the two main objectives are clear enough (consolidating the growth stage of the cycle and improving the distribution of wealth, which also showed up in the title *Aufschwung – Teilhabe – Wohlstand*), one of the criticisms of the package is the lack of better defined areas of action.

It is noted that the most significant measures deal with matters of education and research and development but, in fact, is not at all clear which are the priority programmes, that is to say the grand projects that show where they want to go. In addition, what is

Germany presents economic policy for 2007-2009 somewhat lacking in grand projects.

Overall positive economic situation would allow more ambitious reforms.

GERMANY: 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	August
GDP	1.0	3.1	3.2	3.9	3.6	2.5	–	...
Retail sales	1.4	6.1	5.5	6.5	–1.2	–2.2	–1.6	...
Industrial production	2.8	6.0	6.7	6.3	7.6	5.1	4.4	...
Industrial activity index (IFO) (*)	95.5	105.5	105.2	107.0	107.5	108.1	106.4	105.8
Unemployment rate (**)	11.7	10.8	10.6	10.1	9.4	9.2	9.0	9.0
Consumer prices	2.0	1.7	1.6	1.4	1.8	1.8	1.8	2.0
Trade balance (***)	156.3	153.1	148.3	158.1	168.4	179.8	188.1	...

NOTES: (*) Value.

(**) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

GERMANY'S FOREIGN SECTOR, KEY GROWTH FACTOR

Trade balance, cumulative figure for 12 months



SOURCE: Federal Statistics Office and own calculations.

Third quarter begins with some slight slowdown of economy.

troubling is whether the measures of the federal government will find their echo among the *länder*, which are essential partners in many of these projects. Furthermore, some of the measures proposed, such as higher coverage in minimum wages rates, go against the reform measures followed some years back. Finally, some analysts have pointed out some lack of ambition. For example, given the good state of tax collections, maintaining the objective of reaching a zero public deficit in 2010 would not seem very demanding.

Certainly, it would be logical to take advantage of the current boom period to drive home pending reform, given that as quarters move on the growth rate will lose some of its shine. For the moment, the third quarter has begun with some loss of level in consumer indicators (retail sales were down by 1.6% year-on-year in July and consumer confidence dropped by nearly three points in July and August), no doubt

compensated by some stabilization of the drop in investment and the continuing advance in the foreign sector. In July, the German trade surplus, expressed as a cumulative figure for 12 months, stood at levels 26% higher than one year earlier.

On the supply side, the picture emerging is that of an economy gradually slowing down. The IFO industrial activity index stood at the 104 points level in September, which represents the fourth consecutive month of decreases. In any case, it should be remembered that this starts out from the highest levels in more than 15 years. A similar path is being taken by industrial production which dropped to 4.4% year-on-year in July (5.2% in June).

With regard to prices, the general trend for the moment is positive. The consumer price index (CPI) grew by 2.0% year-on-year in August, slightly

above the 1.8% seen in July. In any case, as of September the rise in the energy component will tend to substantially boost inflation. We may be less sceptical about the trend in the unemployment rate which stood at 9.0% of the labour force in August (it was 1.6 points higher one year ago).

France: a critical third quarter

Following the unexpected economic slowdown in the second quarter, attention is centred on evaluating the exact drive in the final part of the year 2007. The broadest indicator of economic activity, economic sentiment, for July shows that the French economy has begun the third quarter slightly better than it ended the previous quarter. This improvement was due to the increase in confidence in the service sector and industry. On the other hand, consumer confidence is down slightly.

Non-qualitative indicators confirm the above trends. Car registrations collapsed in August while industrial production of consumer goods rose slightly in July. Overall, consumer indicators suggest a practically flat trend which in itself

is an improvement over the previous slowdown.

Any appreciable improvement in household spending, however, will depend on the favourable performance of fundamental variables, such as unemployment (in July the unemployment rate stood at 8.0%, with no change over June) and inflation (rise of one decimal in August to 1.2%). In this respect, the prospects are not negative given that the foreseeable rise in inflation starts out from very low levels whereas the forecasts indicate further reductions in the unemployment rate.

With regard to supply indicators, the most notable is the rise in industrial activity in July, a month when industrial production grew by 2.6% year-on-year, far from the year-on-year drop of 0.6% in June. Nevertheless, the poor growth of industrial orders in June and July suggests that this level could be short-lived.

Following poor second-quarter growth, present quarter key in deciding if French economy taking off.

Consumption seems to be holding to practically flat trend.

Italy: forecasts point downward

The present situation: an economy that is showing a growth rate among the poorest in the Euro Area (in the second

Recovery in industry may be ephemeral as industrial orders fail to provide back-up.

FRANCE: 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	August
GDP	1.7	2.2	2.1	2.1	1.9	1.3	—	...
Domestic consumption	3.2	2.7	3.0	2.8	3.5	2.7	4.4	3.6
Industrial production	0.2	0.9	0.6	0.7	1.0	0.2	2.6	...
Unemployment rate (*)	9.8	9.0	8.8	8.6	8.4	8.1	8.0	...
Consumer prices	1.7	1.7	1.7	1.3	1.2	1.2	1.1	1.2
Trade balance (**)	-1.3	-2.2	-2.3	-2.3	-2.3	-2.4	-2.5	...

NOTES: (*) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007			
			1 Q	2 Q	3 Q	4 Q	1 Q	2 Q	July	August
GDP	0.2	1.9	1.7	1.7	1.6	2.8	2.3	1.8	–	...
Retail sales	0.4	1.2	0.5	1.8	1.6	1.0	1.0	0.1	0.1	...
Industrial production	–0.8	2.6	3.0	1.9	1.6	3.7	1.1	0.7	–0.3	...
Unemployment rate (*)	7.7	6.8	7.2	6.9	6.6	6.4	6.2	6.0	0.0	0.0
Consumer prices	1.9	2.1	2.1	2.2	2.2	1.8	1.7	1.6	1.6	1.6
Trade balance (**)	8.2	7.0	6.2	10.9	7.8	10.8	15.7	13.2	...	...

NOTES: (*) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

Worsening prospects bring downward revision of growth forecasts for 2008...

quarter the GDP grew by only 1.8% year-on-year, only better among those published than in the case of France). Immediate prospects: official growth forecasts (2.0% for 2007) could be short-lived. Mario Draghi, governor of the Bank of Italy, recently revealed that even disregarding the possible effects of the financial crisis, it would be difficult to reach a figure of 1.7% in 2008. Off the record, it has been recognized that the new official forecasts could be 1.6% for the coming year. Direct effect: given the poor growth expected, the budget for 2008 does not make any modification in the tax load. In fact, the idea of a possible increase in the tax load in order to ease the government deficit has been postponed to the indefinite future.

Certainly, latest available indicators do not allow a more optimistic view. Consumer confidence in August stood at the lowest level since September 2005. Industrial production was down 0.3% year-on-year in July bringing two consecutive months in the range of year-on-year decreases. The guideline made up of early indicators sharpened its rate of decrease in August, thus pointing to lean prospects for coming quarters.

In the same way, the economic sentiment indicator lost more than four points in July and August. The only strong trump card for the Italian economy, that related to containing inflation (1.6% year-on-year in July and August) could also be short-lived, although the forecasts suggest an upward year-end. Overall, this battery of figures confirms the perception that, on the economic front, Italy will be slow to take off.

United Kingdom: from an overheated economy to one that is lukewarm?

In little less than two months the main concern has shifted from deciding whether the British economy was controlling excessive growth (the hypothesis of overheating) to fear about the effects of the financial crisis. Available figures still reflect an economy with strong growth and therefore support the idea that the tensions brought about by that growth have not disappeared. Consumption remains strong, as shown by the fact that retail sales in August showed a rise of 5.0% year-on-year, equal to the highs for the year. Industrial production stabilized in July at levels of increase of the order of

...opinion confirmed by slack in current indicators.

Possible overheating of UK economy not as troubling as impact of financial crisis.

UNITED KINGDOM: 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	August
GDP	1.8	2.8	3.0	3.1	3.0	3.0	—	...
Retail sales	1.9	3.1	3.7	3.7	4.5	4.0	4.4	5.0
Industrial production	-2.0	0.0	0.5	0.9	-0.1	0.7	0.9	...
Unemployment rate (*)	2.7	2.9	3.0	2.9	2.8	2.7	2.7	2.6
Consumer prices	2.0	2.3	2.4	2.7	2.9	2.6	1.9	1.7
Trade balance (**)	-64.9	-74.1	-75.3	-77.0	-78.1	-80.0	-81.3	...
3-month Libor interest rate	4.6	5.1	4.8	5.1	5.3	5.6	6.0	6.0
Nominal effective pound exchange rate	99.5	102.7	100.0	102.7	103.9	104.0	104.3	104.6

NOTES: (*) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

1% year-on-year, slim enough figures but higher than those recorded in the second quarter. Finally, as shown by the trend in economic sentiment (an overall indicator of economic drive), up until August the economy has maintained a state of notable growth.

What about the fundamental imbalances? The trend in consumer prices, which had been troubling in the first half of the year, has been contained as shown by CPI growth of only 1.7% year-on-year in August. Certainly, a rise in the final stages of 2007 is expected but it would seem that the worst inflation rises are now over. In any case, the possible bottleneck represented by a labour market with unemployment at low levels (the unemployment rate in August was 2.6%), reminds us that there still may exist restraints on production factors.

But future concerns go well beyond current indicators. The active role of the Bank of England (shown in the extent of its intervention in the case of Northern

Rock mortgage bank) has indicated that the extent of the crisis may be greater in the United Kingdom than in other countries of the EU. In the British case, two specific factors come into play and interact. These are the overall importance of financial activity, which is highly globalized (and therefore sensitive to a world-wide crisis such as that we have just seen happening) and a real-estate sector that, following two years of noting some recovery, now again seems to be going back to losing step.

This has meant that the influential business association, the *Confederation of British Industry*, has revised its growth forecasts for 2008 downward to 2.2%, two decimals less than was expected before the crisis. Furthermore, the analysts as a whole are expecting an even more complicated year, given that their forecasts point to growth of 2.1% for the coming year. Complicated times indeed lie ahead, with current drive vigorous to the point where it is still creating pressures but with prospects that are much more luke-warm.

Downward revision of 2008 growth forecasts starting.

Investing east of Eden

The fall of the Berlin wall at the end of 1989 raised the hopes of many people in Eastern Europe that they might come to form part of modern democratic Europe. These dreams were soon clouded over by the long slump most of the Central and Eastern European countries (CEEC) went through at the beginning of the Nineties. Nevertheless, their spectacular growth over the past decade, when they grew far above the European Union (EU-15) average and even above that for the emerging countries, has brought back those hopes even among the most sceptical.

AVERAGE ANNUAL GDP GROWTH RATE IN REAL TERMS

As percentage

	2001-2003	2004-2006
Bulgaria	4.5	6.3
Czech Republic	2.7	5.7
Estonia	7.6	10.0
Latvia	7.2	10.4
Lithuania	7.9	7.5
Hungary	4.2	4.3
Poland	2.2	5.0
Romania	5.3	6.8
Slovenia	3.0	4.5
Slovakia	3.8	6.6
CEEC average	4.9	6.7
EU-15	1.4	2.2

SOURCE: Eurostat and own calculations.

The effect of this real growth differential is that the CEEC have begun to reduce the gap in per capita income separating them from the EU-15. The change in the Baltics has been the most spectacular. As may be seen in the following table, the purchasing power of the average citizen in those countries in 1997 stood somewhat above 30% of the level of the average citizen in the EU-15 whereas in 2006 this figure had reached 50% in Latvia and even 60% in Estonia. While progress in other countries has not been as strong, the tendency to converge is seen to be general. What are the factors behind this convergence?

Most studies indicate the higher level of investment in physical capital and the increase in total factor productivity (TFP) as the main elements responsible for the high rates of growth and convergence seen in those countries. The improvements in TFP are increases in production not brought about by a change in the use of the classic production factors, namely capital and labour. In the Baltic countries, TFP accounts for two-thirds of growth while the rest may be explained by investment in physical capital.⁽¹⁾ In the Central European countries, TFP and investment contribute equally to the growth rate. The key role of TFP is good news since, by fostering technological innovation, it is the source of growth that is most long-lasting.

(1) IMF Occasional Papers (2006), «Growth in the Central and Eastern European Countries of the European Union».

PER CAPITA GDP IN TERMS OF PURCHASING POWER

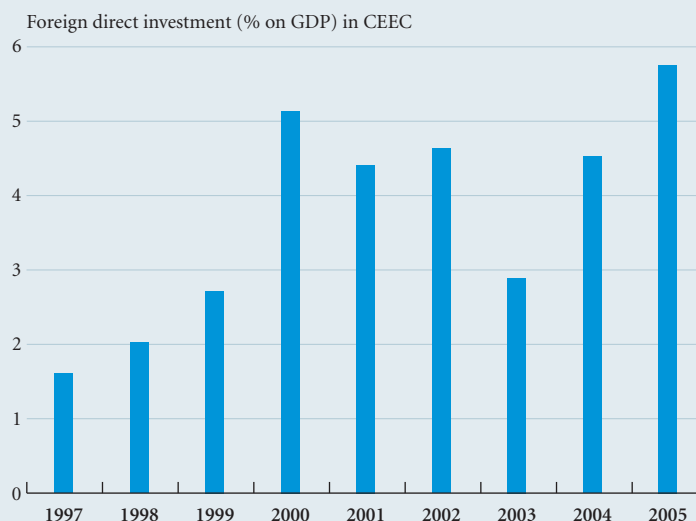
EU-15 = 100

	1997	2006
Bulgaria	23	33
Czech Republic	63	71
Estonia	36	60
Latvia	30	50
Lithuania	33	52
Hungary	45	58
Poland	41	47
Romania	28	34
Slovenia	66	78
Slovakia	45	56
CEEC average	42	54
EU-15	100	100

SOURCE: Eurostat, IMF and own calculations.

In this context, capital inflows in the form of foreign direct investment (FDI) have had special importance. According to Lane and Milesi-Ferretti, the high level of this type of inflow into the CEEC has helped increase not only physical capital but also productivity.⁽²⁾ There are two ways in which FDI fosters growth. First, it makes possible the use of foreign savings to finance capital accumulation which steps up this process. Second, it is a vehicle for the transfer of technology and know-how, which turns into increases in productivity.

FOREIGN DIRECT INVESTMENT AS A PERCENTAGE OF GDP HOLDING UP AND EVEN INCREASING IN CEEC



SOURCE: Eurostat and own calculations.

(2) Lane, P. R, Milesi-Ferretti, G. M. (2006), «Capital Flows to Central and Eastern Europe», IMF Working Paper 188.

Given the fundamental role carried out by FDI in capital accumulation and productivity improvement in the CEEC, it is natural to inquire about the sustainability of these flows over the medium and long term. In this respect, geographical and cultural proximity, the quality and cost of labour, tax treatment and institutions (all strong reasons behind the decision where to locate FDI) favour the CEEC as a preferred destination for FDI, especially from the EU countries. As shown in the following table, wage costs of an employee in terms of productivity continue to give the CEEC an important advantage over EU-15 countries. To be specific, whereas wages are six times lower, workers are only four times less productive.

WAGES AND PRODUCTIVITY OF AVERAGE WORKER

2004

	Wages per hour (euros)	Wages per hour (EU-15 = 100)	Productivity per worker (GDP/worker) (EU-15 = 100)
Bulgaria	1.5	6	11
Czech Republic	5.9	24	31
Estonia	4.2	18	26
Latvia	2.5	11	18
Lithuania	3.2	13	21
Hungary	5.5	23	35
Poland	4.7	20	25
Romania	1.8	7	11
Slovenia	10.4	43	46
Slovakia	4.4	18	26
CEEC average (*)	4.0	17	23
EU-15	24.0	100	100

NOTES: (*) Weighted by population.

SOURCE: Eurostat and own calculations.

On the other hand, the process of integration in the EU has been key in speeding up the process of modernization of their institutions. Finally, regarding taxation, corporate taxes and direct incentives to investment are much more favourable than in most EU countries, as may be seen in the final table.

The sustainability of FDI flows is closely related to foreign current account deficits. All of the CEEC have high such deficits, something that has troubled some observers. Nevertheless, it is comforting that most of these are being financed precisely by FDI which limits the financial borrowing of these economies, is a more stable source of funding than, for example, portfolio flows into the stock exchange (which are easily reversed) and reveals confidence in the evolution of competitiveness in these countries. In any case, we should keep an eye on the gap between the deficits and FDI.

In a nutshell, the CEEC still have considerable potential to attract foreign investment. This should help them to continue their rapid process of convergence. The road still to cover is long but what is important is that they have now begun the journey.

EFFECTIVE RATE OF CORPORATE TAX

2006, as percentage

Bulgaria	7.4
Estonia	9.6
Hungary	7.8
Latvia	9.1
Lithuania	5.9
Poland	11.5
Romania	9.3
Slovenia	7.7
Slovakia	15.6
EU-13 (*)	18.9

NOTES: (*) Excluding Belgium and Luxembourg.

SOURCE: World Bank and own calculations.

FINANCIAL MARKETS

Monetary and capital markets

Reverberations of sub-prime mortgage crisis continues in financial markets through September.

Sub-prime mortgage crisis holds market attention

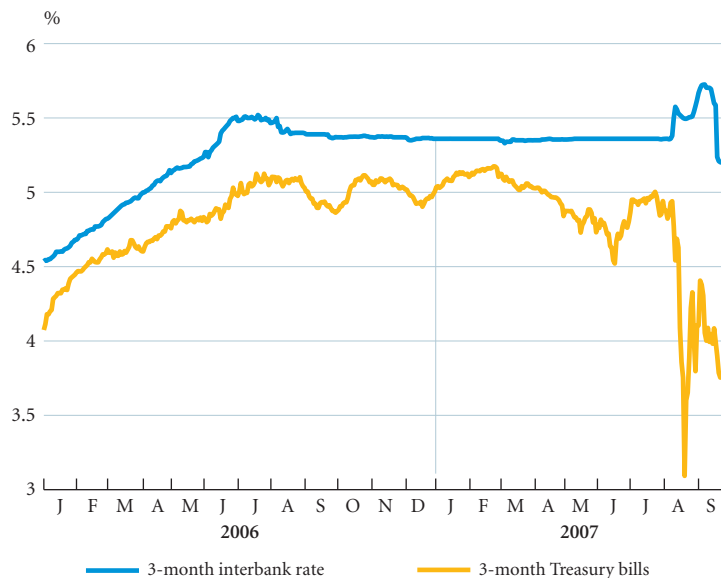
September brought a continuation of the sub-prime mortgage crisis in the United States and its impact on the rest of the world through the financial markets. Secretary of the Treasury Henry Paulson declared that the crisis would be a long one. The European Commissioner for Economic and Financial Affairs, Joaquín Almunia joined in this view when stating that the volatility of the markets was behind the decision to lower the forecasts for economic growth. That is to say, he recognized that the spread of the damage in the financial markets to the real economy was indeed a fact. The interbank market in the United States

continued to rise, as may be seen in the following graph, while the state of liquidity was being maintained.

While investors took refuge in government securities, buying US Treasury bills, the banks reduced their positions in the interbank market and had difficulty in issuing bonds. In the United States, for example, the outstanding balance of notes with real security in the private fixed-income market dropped by 251.3 billion dollars in just a few weeks. On June 25 there was an outstanding balance of 1,180 billion dollars, whereas by September 19 this had been reduced to 930 billion dollars. That is to say, this was paper issued by various companies that fell due and

LIQUIDITY IN US INTERBANK MARKET HOLDS FIRM

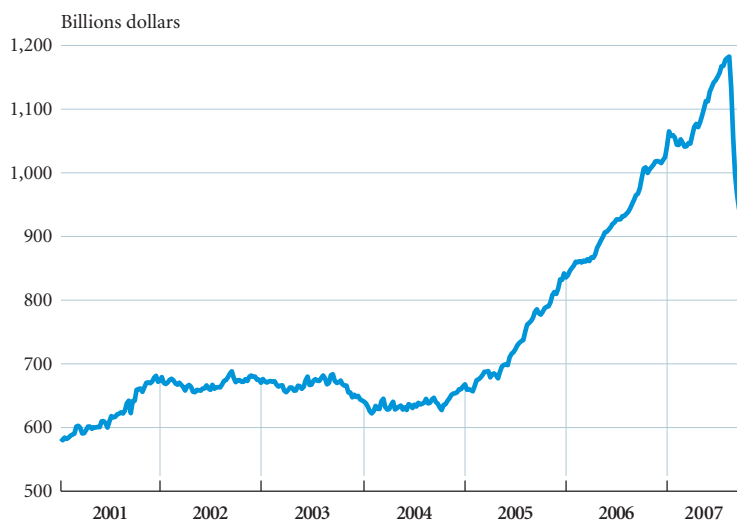
Interest rates in interbank market and on 3-month Treasury bills in United States



SOURCE: Bloomberg and own calculations.

INVESTORS NOT BUYING US COMMERCIAL PAPER

Outstanding balance of asset-backed commercial paper (*)



NOTES: (*) Asset-backed securities.

SOURCE: Bloomberg and own calculations.

could not be refinanced in the markets because they were excessively expensive because of widening of loan differentials.

Another example of the problems brought about by the mortgage crisis was the pattern followed by the British bank Northern Rock. On September 13 it announced that it had asked for emergency funds from the Bank of England as lender of last resort with the agreement of the UK Chancellor of the Exchequer for an amount of 3 billion pounds sterling (4.38 billion euros). The reason for the move was the difficulty in obtaining funds in the interbank market given that the bank was financing more than 75% of its loan operations through that market instead of through deposits. After making this announcement, the bank's shares collapsed by 32%. In 2000, Northern Rock became part of the FTSE 100 stock exchange index which includes the 100 companies with highest capitalization listed on the London stock exchange. In spite of having few branches, the notable impact of its

liquidity crisis in the financial system was due to its strong development of financial innovation which allowed it to shift risk very rapidly. On September 14, the day after the announcement, there were long line-ups of customers wanting to withdraw all their savings. In two days the bank had lost 2 billion pounds sterling. On September 17, the share price again plummeted by 35% going from 438 pennies to 283 pennies. That day, the Chancellor of the Exchequer announced that the British government and the Bank of England would guarantee all the deposits of Northern Rock without any limit.

Central banks and their recipe for dealing with the crisis

From the beginning of the crisis two methods were debated for dealing with it. On the one hand, the central banks in the United States and the European Central Bank injected liquidity into the interbank system in an attempt to

British Northern Rock bank needs to ask Bank of England for emergency funds.

While Federal Reserve and European Central Bank inject liquidity into system, Bank of England initially adopts more passive position.

Panic from loss of customer confidence in Northern Rock brings change of attitude in Bank of England which puts more proactive strategy in motion to resolve crisis.

normalize a high-risk situation in which banks were afraid to lend money, for risk of non-payment, as they did not know the real situation about who had sub-prime risk included in their balance sheets. As a result of their moves, the central banks were able to grease the financial machinery, which is vital in the present-day economy because all business begins and ends in a financial institution that drives credit.

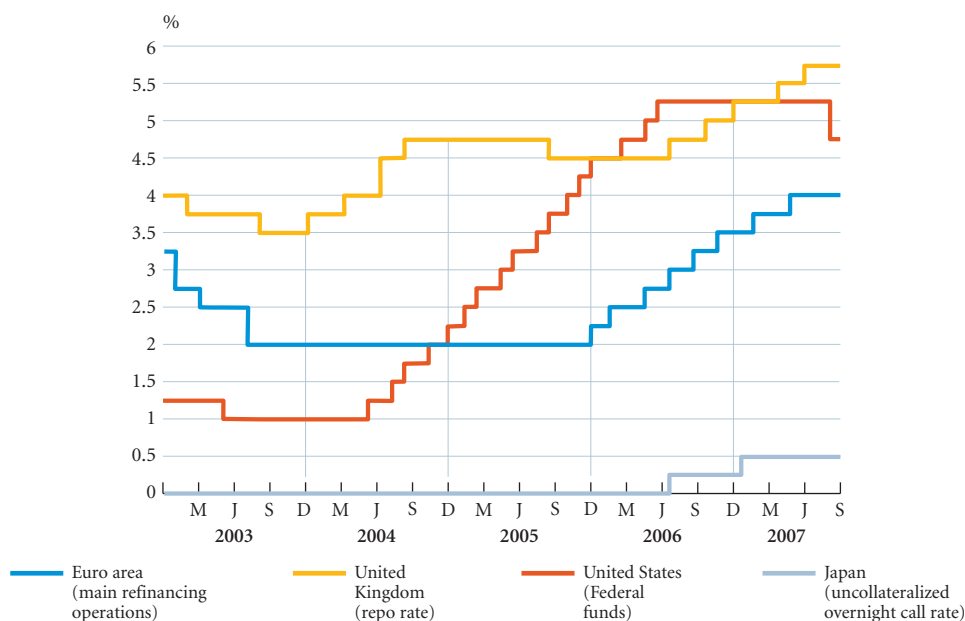
Nevertheless, at first the Bank of England adopted what is known in banking jargon as a hawkish position, that is being reluctant to inject funds. As governor Mervyn King noted in his letter to the Treasury on September 12, the injection of liquidity was inefficient as it invited an increase in so-called moral hazard. Moral hazard is an economic concept expressing the possibility that a person or institution may change conduct because of the fact of being insured. In the case under consideration, facilitating liquidity to banking

institutions, thus easing the problem of the crisis, could bring about even more risky behaviour in the future, given that in case of crisis they would count on the central banks to bail them out. The end result is a poor assignment of risk that sows the seeds of future financial crises.

The line-ups of customers to take their deposits out of Northern Rock because of panic about the risk of losing their savings, however, made the Bank of England change its position. On September 19, the central bank decided to use the strategy of injecting liquidity used by the Federal Reserve and the ECB. In spite of the fact that British law now provides for a 100% guarantee of a first segment of 2,000 pounds sterling (2,868 euros) deposited in an account at a financial institution and 90% of a second segment of 31,000 pounds sterling (44,463 euros), this guarantee was insufficient to control the panic that came over customers who did not trust the situation. When the line-ups were

FEDERAL RESERVE MAKES A MOVE

Reference rates set by central banks



SOURCE: National central banks and own calculations.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
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	4.08	4.73	4.76	5.25	5.51	0.99	5.75	6.61	2.84
September (1)	4.15	4.72	4.69	4.75	5.21	1.00	5.75	6.37	2.76

NOTES: (1) September 21.

(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: 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%), 18-09-07 (4.75%).

(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.

shown on television and in view of the rumours that, if something were not done, it could also affect other smaller institutions, the Bank of England stated that, due to the worsening of the situation, it was going to change its strategy making this an example of decisive action of the right kind at this moment.

Meanwhile, at its meeting on September 18, the Federal Reserve (the Fed) decided to lower its official reference rate by 50 basis points from 5.25% to 4.75% and the discount rate (the interest rate used by banks to discount assets with the central bank) from 5.75% to 5.25%. In its press release, the Federal Open Market

Committee pointed out four aspects:

1) While growth of the economy was holding moderate, the restriction of credit could potentially worsen the recession in the housing market and affect growth of the economy as a whole; 2) The present action of the Fed must be seen in the context of preventing some of the adverse effects of disruptions in the financial markets; 3) It confirmed the existence of inflationary risks; 4) the central bank stated that its subsequent moves on interest rates would be subject to the various economic figures as they became known.

Other US institutions intervened in order to halt the crisis, among these

US Federal Reserve cuts official interest rate from 5.25% to 4.75% at meeting on September 18.

Other US agencies move in attempt to stabilize sub-prime mortgage market.

Spectacular impact of cut in Fed interest rates brings major stock market increases.

being the regulators of the Federal National Mortgage Association, popularly known as Fannie Mae and Freddie Mac. These are two quasi-governmental agencies whose objective is to finance the buying and selling of conventional housing mortgages as well as mortgages insured by the Federal Housing Administration, which is a division of the US Department of Housing and Urban Development. Set up by the US Congress, they have the mission of aiding families by facilitating access to home ownership.

These companies, which are listed on the stock exchange, regulated by the Federal authorities and government-sponsored, buy mortgages from lenders right across the country. Subsequently, they securitize them in order to sell them to investors in various ways. Securitization

consists of converting certain assets, generally loans, into securities that are negotiable on the market. Freddie Mac is not backed by the US government but the company has special authorization to ask the Treasury for loans. The Bush administration has authorized them to buy some 20 billion dollars in sub-prime mortgages in order to stabilize the market. The two agencies hold or guarantee 40% of all housing loans in the United States.

Impact of measures on capital markets

Following the cut in interest rates in the United States, there was a spectacular rise on the stock markets. The S&P 500 rose by 2.9% and the Nasdaq by 2.7%. The news came at 8:15 in the evening when

Dollar collapses against euro reaching all-time low.

INDICES OF MAIN WORLD STOCK EXCHANGES

September 21, 2007

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
<i>Dow Jones</i>	13,860	5.9	11.2	20.2
<i>Standard & Poor's</i>	1,529	5.7	7.8	16.0
<i>Nasdaq</i>	2,678	6.2	10.9	19.7
Tokyo	16,313	2.6	-5.3	3.0
London	6,454	6.0	3.7	9.4
Euro area	4,376	4.8	6.2	13.5
<i>Frankfurt</i>	7,794	5.0	18.2	30.7
<i>Paris</i>	5,701	5.2	2.9	9.5
<i>Amsterdam</i>	545	7.7	10.0	13.9
<i>Milan</i>	39,970	2.6	-3.5	4.5
<i>Madrid</i>	14,451	1.5	2.2	15.8
Zurich	8,897	3.4	1.3	6.3
Hong Kong	25,844	18.9	29.4	46.7
Buenos Aires	2,113	7.7	1.1	28.2
São Paulo	57,810	16.0	30.0	66.0

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 and own calculations.

EXCHANGE RATES OF MAIN CURRENCES

September 19, 2007

	Exchange rate	% change (*)		
		Monthly	Over December 2006	Annual
Against US dollar				
Japanese yen	115.6	1.0	−3.0	−0.7
Pound sterling (*)	0.495	−1.9	−3.1	−6.0
Swiss franc	1.173	−2.8	−3.9	−5.9
Canadian dollar	1.001	−6.2	−16.5	−11.9
Mexican peso	10.947	−1.8	1.2	−1.3
Against euro				
US dollar	1.408	4.5	6.6	10.1
Japanese yen	162.8	5.6	3.6	9.4
Swiss franc	1.652	1.7	2.6	4.0
Pound sterling	0.697	2.5	3.4	3.7
Swedish krona	9.191	−2.1	1.6	−0.4
Danish krone	7.454	0.1	0.0	−0.1
Polish zloty	3.756	−2.4	−2.0	−5.5
Czech crown	27.50	−0.6	0.0	−3.3
Hungarian forint	249.9	−4.5	−0.5	−9.6

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

SOURCE: Bloomberg.

the European markets were already closed but the next day the Eurostoxx 50 rose by 2.9% pointing to a wave of optimism in the share markets.

Interest rates diverged. Whereas the interest rate on 2-year government bonds, which is most sensitive to changes in reference rates, fell by 11 basis points to 3.95%, long-term bonds with 30-year maturity term rose from 4.74% to 4.80%. The biggest impact, however, came in the foreign exchange market with the euro/dollar rate showing an all-time high of 1.418 on September 27. The reason was expectation in the market that the Fed would continue to lower the official interest rate and the interest rate differential between the two currencies would narrow. The euro appreciated 4.5% against the dollar in just one month. The dollar depreciated against all other currencies except the yen. For

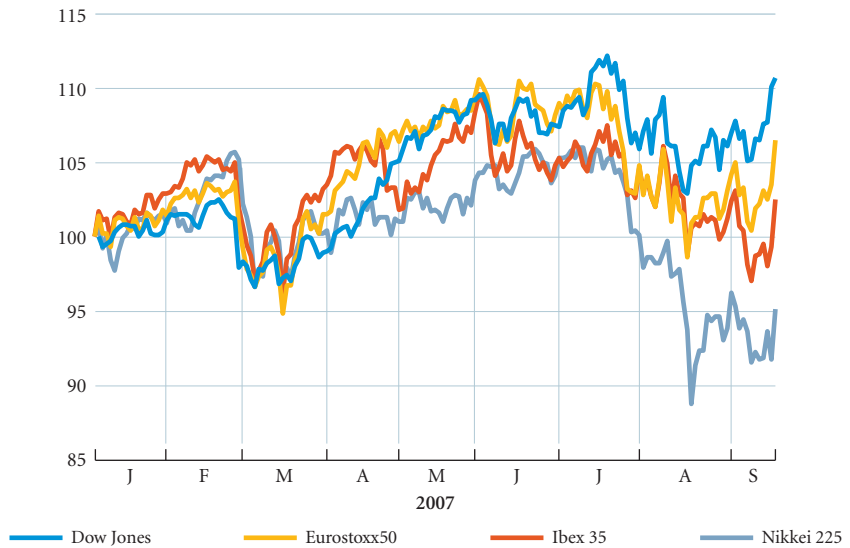
example, the Canadian dollar reached parity with the US dollar, something that had not happened since 1977, some 31 years ago.

The rises on the stock exchange that too place in the 48 hours following the cut in Federal Reserve rates became consolidated. At the end of September only the Japanese stock market was 5% below the starting point on January 1. With regard to short-term interest rates in the United States, these dropped 30 basis points for a 3-month term compared with August. Since the beginning of the crisis we see how the interest rate curve for government bonds has become positive. On July 20, the interest rate curve had less of a dip than the current curve. We see how the drop in official interest rate by the Fed had a bigger impact on the short-term segment (3 months to 2 years), which is normal

Moves by central banks manage to stabilize financial markets.

STOCK MARKETS RECOVER THANKS TO FEDERAL RESERVE OXYGEN TENT

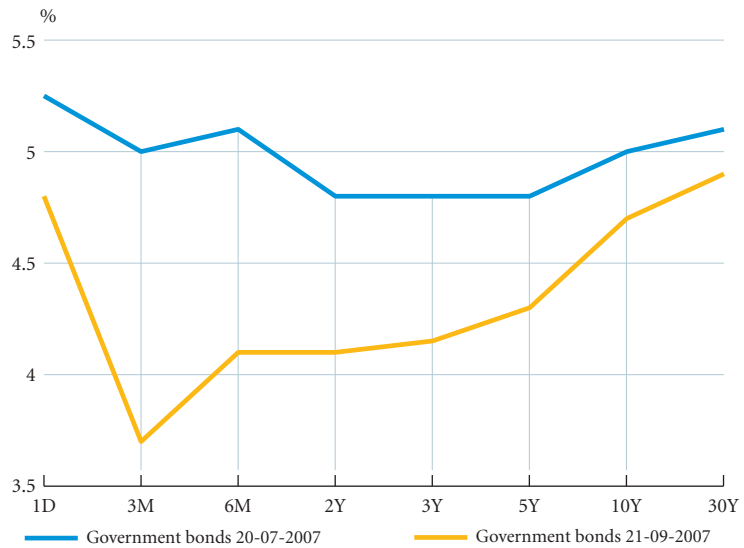
Trend on stock markets with base 1-1-2007 = 100



SOURCE: Bloomberg and own calculations.

INTEREST RATE CURVE FOR US TREASURY BONDS TURNS POSITIVE

Interest rate curve for US Treasury bonds



NOTES: D = Day, M = Month, A = Year.

1D is central bank official rate.

SOURCE: Bloomberg and own calculations.

seeing that the markets are also discounting a further cut by the Fed. On the other hand, government bonds with longer maturities cannot lower their yield very much because investors must cover the potential risk of higher inflation in the future. In fact, a drop

in the official interest rate, that is to say, an easier monetary policy, has the objective of reactivating or supporting consumption and investment in an economy. In addition, the Fed's press release confirmed the existence of inflation risk.

EURO HITS ALL-TIME HIGHS AGAINST DOLLAR

US dollars to euro



SOURCE: Bloomberg and own calculations.

The euro in Central and Eastern Europe: can we expect new members?

With the enlargement of the European Union (EU) towards the East, a number of countries have become candidates to join the Economic and Monetary Union (EMU) and use the euro as their currency. Officially, all the new member states of the EU are committed to adopt the single currency, given that none of them has been able to adopt opt-out clauses, like the United Kingdom and Denmark had negotiated earlier.⁽¹⁾ In this box, we examine what are the criteria for joining the EMU, what is the position of the new member states of Central and Eastern Europe with respect to these criteria, and how likely it is that other countries will join in the foreseeable future.

Since the launching of the euro in 1999 with eleven countries taking part, two new members have joined the club. Greece joined in 2001 and Slovenia did the same in 2007 as the «bright boy» of the ex-communist

(1) It should also be remembered that in a referendum Swedish citizens decided to delay their country's entry in the Euro Area.

countries. Furthermore, the European Commission has already given the green light to the entry of Malta and Cyprus starting in 2008. Just like Spain had to do its homework to get into the euro, the new candidates must fulfil the macroeconomic requirements of the Maastricht Treaty.

To join the Euro Area it is necessary to meet the following criteria, laid out in the Maastricht Treaty: 1) the inflation rate should not exceed by more than 1.5 percentage points the average of the three countries with lowest inflation rates; 2) the government deficit should be below 3% of GDP and the level of government debt should be lower than 60% of GDP; 3) long-term interest rates should not exceed by more than 2% the average of the three countries with lowest inflation rates; and 4) the currency of the country candidate should take part in the exchange rate mechanism with the euro (which consists of maintaining a fixed exchange rate with a fluctuation band of 15%, known as the ERM-II) for at least two years. Furthermore, these criteria must be satisfied in a sustainable way in the view of the European Commission in order to ensure that the new member of the EMU has converged in a solid way and not just temporarily and that, therefore, the loss of monetary policy autonomy will not result in excessive costs and will not counteract the benefits of joining the EMU.

In the following table we examine up to what point the countries of Central and Eastern Europe fulfil the Maastricht criteria, according to the evaluation made by the European Commission every two years or at the request of a member state (as in the case of Lithuania in May 2006 when its application for joining was denied). These evaluations remain in force as of July 2007. Interestingly, the failed criteria that do not allow any of the countries under consideration to join the euro at this time seem to follow a regional pattern.

MEETING THE CONVERGENCE CRITERIA

Country	Criteria not met	Date of evaluation
Lithuania	I	May 2006
Estonia	I	December 2006
Latvia	I, ER	December 2006
Hungary	All	December 2006
Poland	DD, ER	December 2006
Slovakia	I, DD, ER	December 2006
Czech Republic	DD, ER	December 2006

NOTES: I = Inflation, ER = Exchange rate, Int. = Interest rates, DD = deficits and debt.

SOURCE: European Commission, Directorate-General of Economic and Financial Affairs.

In the three Baltic countries the main problem is inflation. The reference value in July 2007 stands at 2.3% whereas inflation in Lithuania is 4.3%, in Estonia 4.9% and in Latvia 7.5%. These countries have a fixed exchange rate with the euro, so in fact they already follow the monetary policy of the ECB. Their economies are suffering clear signs of overheating (for several years the «Baltic Tigers» have been growing above 7%) and they appear to need a more restrictive monetary policy to be able to lower inflation to acceptable levels and meet the Maastricht criteria. Nevertheless, by keeping the fixed exchange rate regime, their only option is to continue on the path of deepening structural reforms. The three Baltic countries have straightened out their public finances so they also meet the deficits and debt and long-term interest rates criteria by a large margin.

On the other hand, the countries of Central Europe (Czech Republic, Slovakia, Poland and Hungary) suffer from various major problems in meeting the targets set at Maastricht, which suggests that they are still far

from adopting the euro. The main problem is fiscal. Weak governments and unstable coalitions in all four countries in recent years have had the result that it has not been possible to contain spending. Therefore, all these countries have deficits above 3% of GDP and all fail to pass the fiscal criterium. On the other hand, only the Czech Republic and Poland have inflation under control and meet the Maastricht criteria, thanks to the adoption of inflation targeting monetary policy regimes. Furthermore, none of the four countries in this group met the exchange rate criteria. All of these countries, with the exception of Slovakia, have a flexible exchange rate and do not participate in the ERM-II. Within this group, Hungary receives special mention because it does not meet any criteria, the fiscal deficit stood at 9.5% of GDP in 2006 and inflation was above 8% in mid-2007.

Finally, we should mention that the two countries who joined the EU most recently, Romania and Bulgaria, are also very far from adopting the euro. Neither of the two countries has been evaluated by the European Commission yet. As of today, Romania would only meet the fiscal criterium and, while it has been able to reduce its inflation rate from 10% to 4% in two years, it remains to be seen if this decrease can be maintained and is sustainable. Bulgaria would also meet the criteria on long-term interest rates and has a fixed exchange rate with the euro although it does not take part in the ERM-II. Nevertheless, inflation has been above 5% in recent years. For these two countries the process of convergence with Europe has only just begun.

As a result, it is quite unlikely that we shall see new members in the EMU in the near future. After all, for each country the crucial decision is the optimal speed of adopting the euro and how to spread the costs and benefits of that adoption over time. The long-term benefits of belonging in the EMU include more stable and credible macroeconomic policies (especially in monetary policy), the increase in trade with the other EMU countries and, finally, a drop in interest rates which makes possible an increase in investment, employment and per capita income. On the other hand, the loss of autonomy in monetary and exchange rate policies may be critical when a country is going through a process of transformation and structural reform, although in some countries the adoption of a fixed exchange rate with the euro has worked well. The political cost of carrying out fiscal consolidation, which initially may reduce growth in a few percentage points, requires governments that are well equipped for the task and enjoy strong support. According to the International Monetary Fund, the best way for the Central European countries to go would be: fiscal consolidation and strengthening of reforms, reduction of inflation and entry in the ERM-II.⁽²⁾ This is a road that, in the best of cases, could lead to entry into the Euro Area within a period of five years.

Finally, it should be noted that the European Commission has been inflexible when it comes to evaluating new applicants, pointing out that new candidates must apply with their homework well done or not even bother asking for admission. In the case of Lithuania, the official reason for not authorizing its entry in the euro in May 2006 was that inflation stood at 0.1 percentage points above the reference value. To justify that decision, the European Commission considered that the position of the Lithuanian economy was not sustainable and that the inflation projections indicated an acceleration of prices in the immediate future, which in fact ended up taking place. As a result, the «No» handed to Lithuania suggests that, from the point of view of Brussels, there is no hurry to expand the Euro Area. The single currency is a project with profound implications for the economic and political life of the countries involved and experience shows that we should go forward without being in a hurry but, on the other hand, without pause.

(2) See Schadler, S. et al, Adopting the euro in Central Europe: Challenges of the next step in European integration, Occasional Paper 234, International Monetary Fund, Washington DC, 2005.

SPAIN: OVERALL ANALYSIS

Economic activity

Economy maintaining gradual slowdown path.

Construction slowing down but industry and services remain strong

Following a strong rate of progress in the economy in the second quarter, although somewhat lower than in the first quarter, initial figures for the summer months suggest a continuation of the same levels. In any case, the slowdown in economic activity seems to be gradual, in spite of the upsets in international financial markets as a result of sub-prime mortgages in the United States.

Industry prospects relatively favourable despite appreciation of euro.

Industrial production showed a profile of some slight slowdown at the beginning of the third quarter. Industry confidence continued to move downward being hurt by the stronger euro. Nevertheless, the

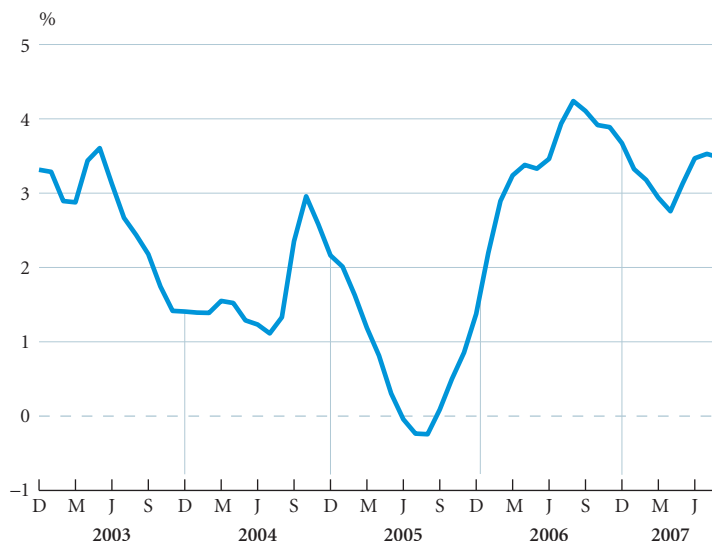
level of economic activity was high.

The energy product industries, electronic equipment manufacturing, machine building, mechanical equipment and motor vehicle production showed great strength. On the other hand, manufacturing of office and data-processing equipment, the tobacco industry, coke production, oil refining and generation and transmission of electrical energy and gas showed a drop in level of activity in July compared with the same month last year.

Industry prospects were relatively favourable, if we are to go by the annual increase of 8.5% in new orders in July. Intermediate goods branches, durable consumer goods branches and

GOOD LEVEL OF RETAIL SALES IN SUMMER

Month-on-month change annualized for retail sales index (*)



NOTES: (*) Cycle-trend series corrected for calendar differences at constant prices.
SOURCE: INE and own calculations.

SUPPLY INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007			
			3Q	4Q	1Q	2Q	July	August
Industry								
Electricity consumption (1)	3.5	3.8	6.0	3.7	5.1	4.3	1.4	1.6
Industrial production index (2)	0.7	3.9	4.2	4.6	4.2	2.5	1.3	...
Confidence indicator for industry (3)	−4.8	−2.7	−2.3	−0.3	2.3	1.2	0.0	−1.0
Utilization of production capacity (4)	80.2	80.5	80.3	81.6	80.6	81.3	—	82.1
Imports of non-energy intermediate goods (5)	1.6	10.5	13.8	12.1	8.1	8.2	15.8	...
Construction								
Cement consumption	7.3	8.5	5.7	8.5	4.8	−2.1	3.7	−2.7
Confidence indicator for construction (3)	22.4	14.2	14.7	15.0	10.7	15.7	15.0	6.0
Housing (new construction approvals)	6.2	18.6	50.5	0.2	8.0	−15.0	−37.1	...
Government tendering	18.5	31.3	19.1	55.1	15.2	−2.1	20.0	...
Services								
Retail sales	4.4	5.0	5.9	5.2	6.2	4.5	4.7	5.5
Foreign tourists	6.6	4.0	2.3	2.5	5.3	0.1	1.8	3.0
Tourist revenue inflows	6.0	5.6	4.9	3.1	5.8	2.0	...	...
Goods carried by rail (ton-km)	−3.2	−1.2	−3.3	−6.4	−4.1	−6.5	7.2	−4.0
Air passenger traffic	9.2	6.7	4.6	7.1	9.5	7.1	11.4	10.4
Motor vehicle diesel fuel consumption	5.1	5.4	3.9	4.9	5.8	3.3	...	...

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.

equipment showed growth rates of more than 10% for new orders compared with July 2006.

On the other hand, the picture has darkened for construction or at least this is suggested by the trend in early indicators, such as the sharp drop in company confidence in August and an annual reduction in cement consumption that month. Various signs show a progressive cooling off in the housing market. Another early indicator, new project approvals, fell by 37.1% in July compared with 12 months earlier. In any case, this represents 448,991 approvals in the first seven months of the

year, which is still a high level. In addition, mortgage loans continue to ease, as a result of the increase in interest rates, but they are still showing very high annual growth rates. A different note comes in government tendering, which showed an annual rise of 20.0% in July, suggesting an improvement in public works.

Fortunately, services generally are continuing to show notable growth. The volume of business for companies in that sector rose by 8.8% in July compared with the same month the year before. The most active branches were company services, retail trade, transport, information technology and tourism.

Sharp drop in confidence in construction sector in August.

Tourist season rather ordinary.

The tourist season is turning out rather average. In July-August, overnight stays at hotels rose by 1.2% compared with the same period in 2006, with a rise of 0.4% in the case of residents and 1.8% for non-residents. On the other hand, confidence in the services sector in August recovered the level seen in the February-March period.

On the demand side, the main figures for the third quarter point to somewhat lower growth of private consumption. Retail sales are showing a robust growth rate and imports of consumer goods recorded a sharp increase in July. Nevertheless, car sales were weak in the hot months of the year, with a year-on-year drop in August. Furthermore, consumer confidence is failing to take off.

With regard to capital goods investment, it would seem to be growing at high levels. Production of capital goods rose by 7.0% in July compared with the same month last year, although registrations of commercial vehicles continued to show ups and downs.

With regard to the foreign sector, available figures for trade in goods for July indicate high growth rates, although these were higher in the case of imports. As a result, the foreign sector will continue to make a negative contribution to growth of gross domestic product but this will likely be lower and lower if moderation in national demand is consolidated.

Consumer confidence fails to take off.

DEMAND INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007			
			3Q	4Q	1Q	2Q	July	August
Consumption								
Production of consumer goods (*)	0.9	2.3	1.9	4.3	4.8	2.5	2.8	...
Imports of consumer goods (**)	7.9	8.9	2.4	7.6	−1.1	5.6	15.0	...
Car registrations	2.1	−0.9	−4.1	1.8	−0.7	−2.4	0.0	−2.7
Credit for consumer durables	15.0	14.5	13.2	12.0	13.8	9.6	—	...
Consumer confidence index (***)	−10.8	−12.3	−13.7	−10.3	−10.7	−12.7	−11.0	−12.0
Investment								
Capital goods production (*)	−0.1	8.4	7.9	11.2	8.9	5.3	7.0	...
Imports of capital goods (**)	20.4	3.2	6.5	3.4	20.1	11.0	0.6	...
Commercial vehicle registrations	13.2	1.5	0.5	−1.0	1.7	−2.2	4.2	−4.6
Foreign trade (**)								
Non-energy imports	6.0	9.0	8.9	9.3	6.4	7.7	13.8	...
Exports	0.2	5.6	1.7	4.7	3.0	2.8	10.6	...

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.

Labour market

Drop in job creation rate

In August it is normal to see a drop in the number of workers registered with Social Security. Nevertheless, this year the sharpness of the drop that month came as a surprise and indicated a loss of drive in the labour market following a period of extraordinary strength.

The year-on-year growth rate of the total number of workers registered with Social Security was 2.5% in August, as against 3.6% in the first quarter. This slowdown in the job creation rate applied to wage-earners, given that non-wage-earners

rose by 2.9% in August as against an annual rate of 2.5% in the first three months of the year. By sector, we note that the slowdown is sharper in construction having gone down to an annual rate of 2.1% from 6.1% in the first quarter. As a result, both services and industry are now showing annual change rates higher than those for construction.

In spite of the drop in job creation in recent months, the labour market is maintaining notably firm. In the past 12 months the number of those registered with Social Security rose by 464,416

Normal drop in registrations with Social Security in August sharpens.

Both services and industry now showing higher year-on-year growth rates than construction.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007			
			3 Q	4 Q	1 Q	2 Q	July	August
Persons registered with Social Security								
Wage-earners	4.8	4.7	3.9	3.5	3.9	3.5	2.8	2.4
<i>Industry</i>	-0.5	0.0	0.0	0.2	2.2	2.7	2.6	2.4
<i>Construction</i>	8.6	8.7	7.5	6.8	6.1	4.4	3.1	2.1
<i>Services</i>	5.7	5.2	4.6	4.0	4.1	3.7	3.2	2.9
Non-wage-earners	2.6	2.2	2.1	2.2	2.5	2.7	2.9	2.9
Total	4.4	4.3	3.6	3.3	3.6	3.3	2.8	2.5
Persons employed (*)	5.6	4.1	3.7	3.6	3.4	3.4	-	-
Jobs (**)	3.2	3.2	2.7	3.1	3.3	3.2	-	-
Hiring contracts registered (***)								
Permanent	8.7	41.1	46.6	76.8	25.8	15.6	7.5	-8.9
Temporary	4.6	4.7	0.5	0.5	2.6	-1.9	4.8	-2.0
Total	5.0	7.9	4.1	7.3	5.3	-0.1	5.0	2.7

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.

First year-on-year drop in number of permanent hiring contracts since start-up of last labour reforms.

persons. Of this increase, 29.7% applied to foreign workers. In addition, the rate of increase in females registered in the past 12 months (3.9%) was more than twice that for males (1.6%), which is in keeping with the drop in construction, which largely employs males.

The drop in strength of the labour market is also shown by the 2.7% decrease in the number of contracts registered at the public employment service in August compared with the same month the year before. Still more notable was the drop of 8.9% in permanent hiring contracts compared with August 2006, given that there has not been a year-on-year decrease since the start-up of the last labour reforms. Nevertheless, initial permanent labour contracts were up by 26.7% compared with August last year. On the other hand, there was a reduction in conversions to permanent contract from other types seeing that this type has not enjoyed any kind of incentive since the end of 2006. In turn, temporary hiring contracts were

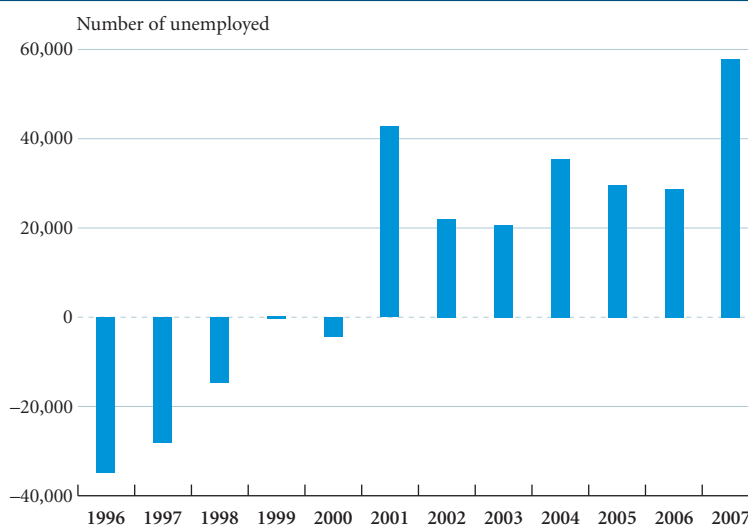
down by 2.0% compared with the same month last year. Altogether stable work contracts made up 9.9% of all hiring, an appreciable share.

Sharp rise in registered unemployment in summer

Registered unemployment reported by public employment offices rose by 57,958 in August going to 2,028,296 persons. This monthly increase was twice that recorded in the same month in 2006 and, in fact, was an all-time high brought about by unfavourable weather. The increase in registered unemployment in August affected all large economic sectors and dropped only in those without any previous job. It was construction that reported the biggest relative increase in registered unemployment (9.6%) followed by industry and services. The rise in unemployment was seen in most autonomous communities except Castile-Leon and Cantabria.

RECORD RISE IN REGISTERED UNEMPLOYMENT IN AUGUST

Monthly change in registered unemployment in August each year



SOURCE: Employment Institute and own calculations.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

August 2007

	No. of unemployed	Change over December 2006		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	65,341	3,847	6.3	3,728	6.1	3.2
Industry	276,997	−5,151	−1.8	−8,015	−2.8	13.7
Construction	250,883	14,112	6.0	22,296	9.8	12.4
Services	1,218,721	−6,148	−0.5	21,978	1.8	60.1
First job	216,354	−1,237	−0.6	4,632	2.2	10.7
By sex						
Males	799,785	−4,489	−0.6	31,415	4.1	39.4
Females	1,228,511	9,912	0.8	13,204	1.1	60.6
By age						
Under 25 years	226,321	−15,691	−6.5	−3,234	−1.4	11.2
All other ages	1,801,975	21,114	1.2	47,853	2.7	88.8
TOTAL	2,028,296	5,423	0.3	44,619	2.2	100.0

SOURCE: INEM and own calculations.

In the past 12 months registered unemployment rose by 2.2%. Nevertheless, the trend was quite varied by sector. In construction, unemployment rose by 9.8%, while in industry it was down by 2.8%. In agriculture, registered unemployed rose notably and to a lesser extent in services. With an increase of 4.1%, the increase in unemployment affected males more than females who reported a rise of 1.1%. Nevertheless, the female group made up 60.6% of the total. On the other hand, we should mention that the figure for young people unemployed was down 1.4% as against an increase of 2.7% for those over 25 years of age.

Gradual drop in labour costs

Labour costs showed something of a slowdown in the second quarter of 2007. Average labour cost per worker per month stood at 2,283 euros, a year-on-

year rise of 3.9%, one decimal less than in the previous quarter, according to the quarterly labour cost survey by the National Institute of Statistics.

On the other hand, labour cost per effective hour worked rose by 4.2% in the second quarter in relation to the same period in 2006. This increased growth was due to a drop of 0.3% in the number of hours worked. According to this measure, the annual increase in labour costs was down in industry whereas it held steady in construction and rose in services.

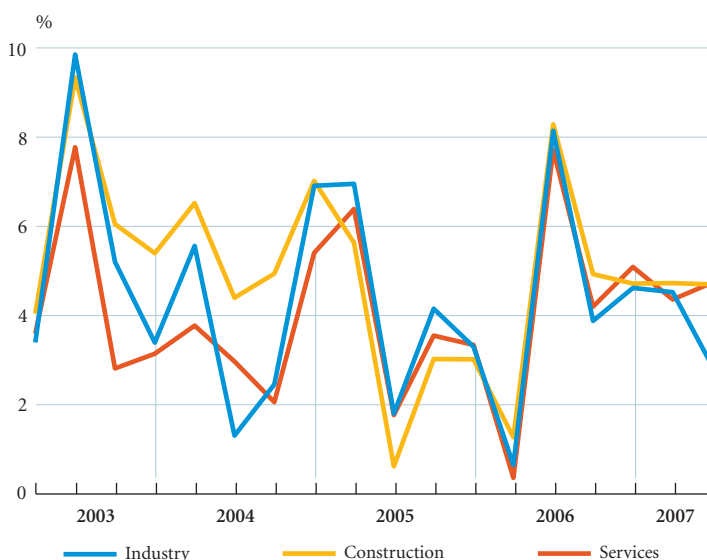
Average earnings per worker per month eased to a year-on-year rate of 3.8%. Given that the annual inflation rate held at 2.4% in the second quarter, purchasing power of workers rose by 1.4%, four decimals less than in the first quarter, but this was compared with the 2004-2006 period which showed a loss of purchasing power.

Young registered unemployed down in past 12 months.

Workers gaining purchasing power but less than in first quarter.

LABOUR COSTS IN INDUSTRY EASING

Year-on-year change in labour cost per effective hour worked



SOURCE: Quarterly survey of labour cost and own calculations.

WAGE INDICATORS

Percentage change over same period year before

	2005	2006	2006				2007	
			1 Q	2 Q	3 Q	4 Q	1 Q	2 Q
Increase under general wage agreements (*)	3.2	3.3	3.1	3.2	3.2	3.3	2.9	2.9
Wage per job equivalent to full-time work (**)	2.8	3.0	2.5	2.5	3.1	3.4	2.8	2.9
Quarterly labour cost survey								
Wage costs								
Total	2.6	3.4	3.0	3.1	4.0	3.7	4.3	3.8
Industry	2.7	3.6	3.8	3.1	4.1	3.6	3.7	3.1
Construction	2.3	3.7	3.8	3.1	4.2	3.9	5.5	3.9
Services	2.9	3.7	3.0	3.4	4.3	4.0	4.5	4.3
Average wages per hour worked	3.2	4.2	0.0	7.1	4.4	5.0	4.6	4.2
Other labour costs	3.6	3.6	4.4	4.9	2.6	2.6	3.2	4.0
Work day (***)	-0.6	-0.6	3.0	-3.8	-0.3	-1.3	-0.2	-0.3
Farm wages	3.1	2.8	2.9	2.6	3.2	2.4	3.1	2.5
Labour cost in construction	4.3	4.4	4.2	4.5	4.5	4.5	1.5	1.4

NOTES: (*) Does not include wage revision clauses.

(**) Quarterly National Accounts: figures adjusted for seasonal and calendar differences.

(***) Effective hours worked per worker per month.

SOURCE: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fishing and Food, Ministry of Public Works and own calculations.

Prices

CPI holds at lowest level since March 2004

Once more, thanks to the favourable performance of fuels and lubricants, the year-on-year change rate in the consumer price index (CPI) held at 2.2% in August, the lowest level since March 2004. Unprocessed foods also contributed to the easing of inflation in August. On the other hand, the more stable core of inflation, so-called underlying inflation, which excludes energy products and fresh foods, rose slightly to 2.5% in August.

The price of fuels showed a bigger year-on-year drop in August compared

with the all-time high reported in the same month of 2006 when the price of oil reached a record. As a result, fuels and lubricants dropped by 4.2% compared with August last year and made a negative contribution of nearly one decimal to the year-on-year change in the general CPI.

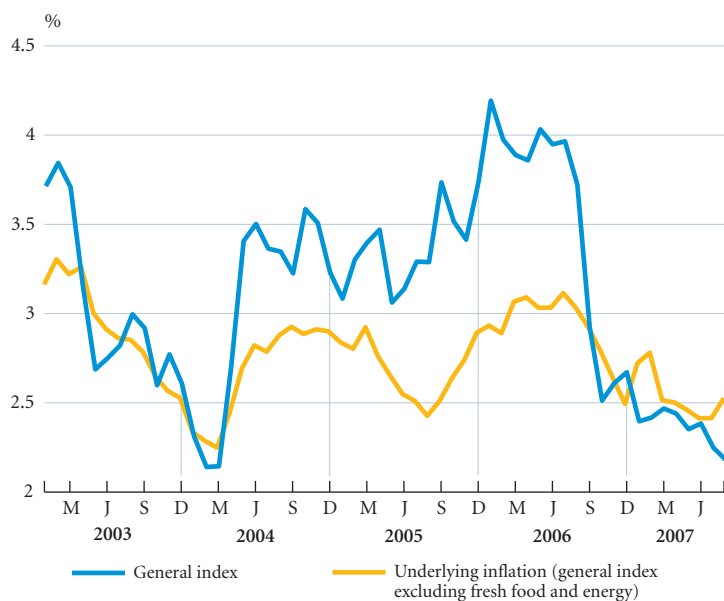
At the same time, unprocessed foods continued to push the CPI down with the drop in year-on-year change rate to 4.0% from 4.7% in July, although this was less than in the case of fuels. The drop in fresh foods was mainly due to the trend in prices of meat and fish. On the other hand, potatoes and eggs showed increases.

Unprocessed foods also contribute to easing inflation in August...

...although potatoes and eggs show increases.

UNDERLYING INFLATION TENDING SLIGHTLY UPWARD

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	0.1	1.4	2.2
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			

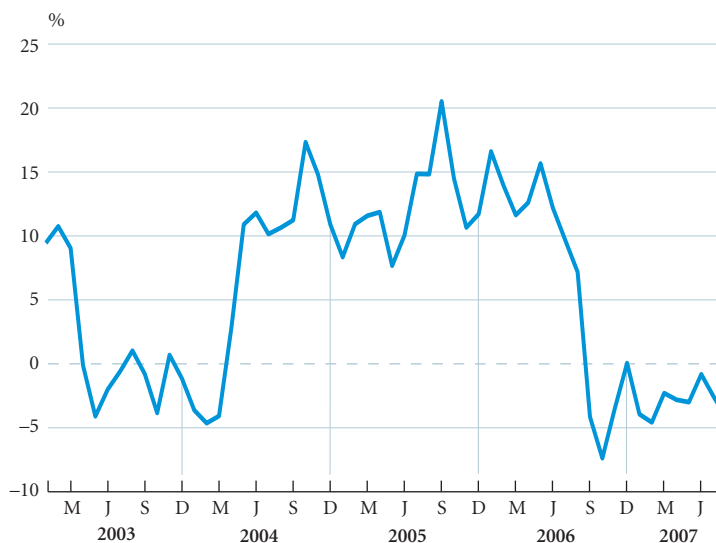
SOURCE: National Institute of Statistics.

On the other hand, processed foods took on an upward course in August with a rise of 2.8% in the past 12 months, 6 decimals more than in July. The main explanation for this unfavourable performance may be found in cooking

oils which slowed their drop. At the same time, milk contributed to the rise by increasing to 4.7% from the 2.7% reported in July. This rise was a result of the limitation of supply by the main producers because of poor weather

FUELS PUSH DOWN CPI IN AUGUST

Year-on-year change in prices of fuels and lubricants



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

August

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2006	2007	2006	2007	2006	2007
By type of spending							
Food and non-alcoholic beverages	103.3	0.2	0.3	2.2	1.9	4.6	2.8
Alcoholic beverages and tobacco	107.1	−0.4	0.0	0.6	5.7	1.7	6.5
Clothing and footwear	93.9	−0.6	−0.7	−12.0	−12.3	1.1	1.0
Housing	104.0	0.1	0.1	5.2	3.4	6.4	3.1
Furnishings and household equipment	102.5	0.1	0.0	1.3	1.2	2.7	2.6
Health	98.1	0.0	0.0	1.3	−2.5	1.5	−2.2
Transport	102.5	0.2	−0.5	6.1	4.2	4.8	−0.1
Communications	100.3	0.1	−0.1	−0.9	1.1	−1.2	0.5
Recreation and culture	101.3	1.2	1.3	1.5	1.1	0.5	−0.9
Education	103.6	0.0	0.0	0.4	0.6	3.9	4.5
Restaurants and hotels	106.8	0.8	0.8	4.9	5.5	4.4	5.0
Other goods and services	103.4	0.1	0.0	3.2	2.5	3.9	3.1
By group							
Processed food, beverages and tobacco	103.1	−0.3	0.3	2.0	2.6	3.6	2.8
Unprocessed food	105.0	0.9	0.2	2.2	1.6	5.4	4.0
Non-food products	102.2	0.2	0.1	1.8	1.1	3.6	1.8
Industrial goods	99.3	0.0	−0.4	0.1	−1.6	3.2	−0.2
Energy products	102.1	0.2	−0.8	10.9	5.8	8.2	−2.2
Fuels and oils	101.6	0.3	−1.0	12.9	6.8	9.3	−3.8
Industrial goods excluding energy products	98.3	−0.1	−0.3	−3.3	−4.0	1.5	0.5
Services	105.1	0.5	0.6	3.7	3.9	3.9	3.9
Underlying inflation (**)	102.3	0.1	0.2	0.8	0.9	3.0	2.5
GENERAL INDEX	102.5	0.2	0.1	1.9	1.4	3.7	2.2

NOTES: (*) Base 2006 = 100.

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

SOURCE: National Institute of Statistics.

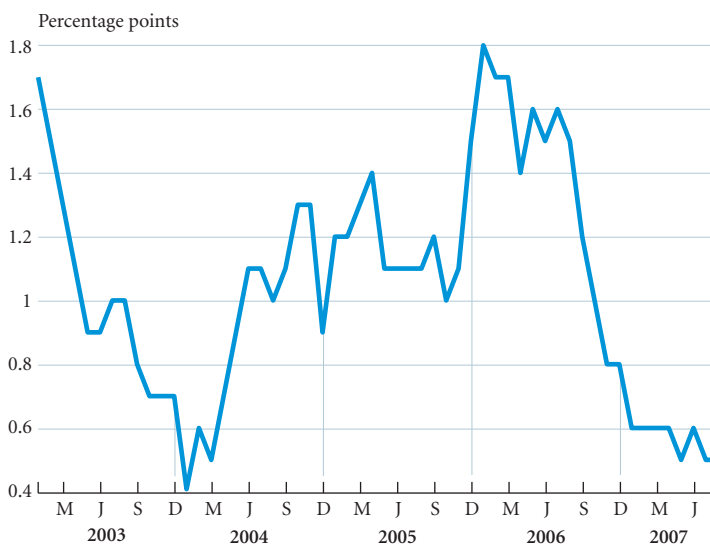
conditions, among other factors. Bread also boosted its increase to 6.4% year-on-year.

At the same time, services were up slightly to show a year-on-year rise of 3.9%, which indicates the persistence of background inflationary pressures. In this respect, tourism and the hotel and restaurant trade moved up to 4.5% compared with August 2006, one decimal more than in July.

On the other hand, industrial goods excluding energy products, which are subject to sharp international competition, showed a price rise of only 0.5% in the past year, one decimal less than in July, marking up the lowest inflation since April 2004. We should point out that computer equipment have dropped by 20.2% in price in the past 12 months. Clothing and footwear prices were down in August because of the usual sales. Nevertheless, the sharpness

INFLATION DIFFERENTIAL WITH EURO AREA HITS LOWEST LEVEL SINCE JANUARY 2004

Year-on-year change difference in harmonized CPI between Spain and Euro Area



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

Prospect of rise in CPI as of September going to around 3% at year-end...

...due to base effect of oil and increases in agricultural raw materials.

Producer prices mark up lowest year-on-year inflation rate since March 2004.

of these decreases was similar to the year before so that the year-on-year change rate held at the same level as in July (1.0%).

Has the steam run out of the decreases in the CPI? This is highly likely. As of September the contributions from fuels will stop being negative, given the recent trend in crude oil prices compared on the other hand with the period of drops in 2006. Furthermore, increases in world prices for agricultural raw materials, particularly cereals, as a result both of restricted supply and strong demand by the emerging countries, will be carried through to food prices. As a result, in the last four months of the year the CPI will tend to rise to around 3% toward the end of the year.

On the other hand, the inflation rate harmonized with the European Union dropped by one decimal to 2.2% in August, the same level as the general CPI. In this way, the inflation differential with

the Euro Area stood at 0.5%, the lowest level since January 2004.

Wholesale prices ease in summer

During the summer months wholesale producer prices were contained. Both factory-gate prices and imported producer prices showed relatively low inflation rates, much lower than those recorded one year earlier. The decrease in inflation in that period was largely due to the drop in oil prices since August last year. Nevertheless, intermediate goods prices still held to a notable inflation rate. This, along with recent all-time highs in crude oil prices, indicate inflationary pressures in coming months.

The general producer price index marked up a year-on-year inflation rate of 2.3% in August, the lowest since March 2004. Most components showed moderate change with the exception of non-durable consumer goods. Among

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	7.6	−
July	0.7	6.4	3.6	2.4	7.0	13.9	6.0	0.4	−0.3	9.7	−
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	−0.2	9.4	−
October	2.3	3.4	2.3	2.4	6.9	0.5	3.0	0.9	−0.1	9.6	−
November	0.8	3.6	2.4	2.5	6.8	1.0	2.4	0.1	−0.3	8.8	3.7
December	−5.8	3.6	2.0	2.6	6.8	2.3	2.4	0.3	−0.2	8.3	−
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	−0.3	7.5	3.4
March	1.5	2.8	1.7	3.3	6.2	−1.6	0.3	0.4	−0.2	6.8	−
April	6.7	2.7	2.2	3.1	6.4	−2.6	0.1	0.7	0.1	6.1	−
May	0.4	2.4	2.0	3.3	6.0	−2.8	0.8	1.6	0.2	5.6	3.2
June	2.7	2.6	1.8	3.1	5.8	−1.4	1.2	1.0	0.1	6.0	−
July	...	2.3	1.9	3.1	5.6	−2.5	0.8	1.0	0.0	4.2	−
August	...	2.3	2.3	3.1	5.4	−2.8	...	...	...	...	...

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

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

these goods, there was a notable rise in prices of food and drink products which were up from 2.5% in July to 3.7% in August as a result of companies making a carry-through of higher priced agricultural raw materials.

Consumer durables and capital goods, under pressure from international market competition, showed no change in annual inflation rates. Energy prices, in turn, increased their year-on-year drop compared with August 2006 when oil prices marked up an all-time high.

With regard to prices of imported industrial products, the year-on-year change rate dropped to 0.8% in July as a result of the stronger euro, according to figures from the survey of importing companies supplied by the National Institute of Statistics. Both capital goods and consumer goods held to very low inflation rates whereas that for intermediate goods eased to 4.2%. The recent appreciation of the euro is a factor that will partly counteract the expected increase in prices in coming months.

Stronger euro favours drop in annual inflation on imported industrial goods.

Foreign sector

After various months of slowing down, trade imbalance shows surprising rise.

Trade deficit gives nasty surprise

For the first seven months of 2007, the trade deficit amounted to 54.88 billion euros, a figure 9% higher than that for the same period in 2006. By comparison, the increase in the trade imbalance was only 7% higher in the first half-year, which indicates that the trend to a slowdown in the trade deficit may have halted. Figures for the cumulative balance for the past 12 months, which

come closer to the background trend, support this view, seeing that the growth rate rose by four decimals to stand at 9.8% in July. The export/import ratio in turn was three decimals worse in the January-July period in 2007 compared with one year ago, showing a figure of 66.1%.

Behind this worsening in trade we find greatly increased strength in imports which goes well ahead of the quite

FOREIGN TRADE

January-July 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	22,775	−4.8	14.1	3,927	−13.5	3.7	−18,848	17.2
Consumer goods	44,192	5.6	27.3	39,047	5.9	36.5	−5,145	88.4
Food	8,715	9.5	5.4	12,402	5.3	11.6	3,687	142.3
Non-foods	35,477	4.4	21.9	26,645	1.8	24.9	−8,832	75.1
Capital goods	16,998	10.3	10.5	9,903	−1.0	9.3	−7,095	58.3
Non-energy intermediate goods	77,893	13.1	48.1	54,103	12.2	50.6	−23,790	69.5
By geographical area								
European Union EU-25	96,465	8.0	59.6	76,188	7.3	71.2	−20,277	79.0
Euro area	80,793	8.5	49.9	61,130	8.2	57.1	−19,663	75.7
Other countries	65,392	7.8	40.4	30,791	7.5	28.8	−34,601	47.1
Russia	4,814	11.1	3.0	1,113	41.9	1.0	−3,702	23.1
United States	5,599	9.6	3.5	4,527	2.2	4.2	−1,071	80.9
Japan	3,651	8.2	2.3	824	7.0	0.8	−2,827	22.6
Latin America	8,202	0.0	5.1	6,128	4.1	5.7	−2,074	74.7
OPEC	11,983	−6.6	7.4	2,847	11.8	2.7	−9,136	23.8
Rest	31,143	16.1	19.2	15,352	8.0	14.4	−15,791	49.3
TOTAL	161,857	7.9	100.0	106,979	7.4	100.0	−54,878	66.1

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

positive rate in exports. Purchases abroad, in value terms, were up by 8% year-on-year in the January-July period while exports rose by a notable but lower figure of 7.4%. In real terms, the gap between imports and exports is sharper, given that the former grew by 7% year-on-year while the latter stood at a growth rate of 4%, always expressed in terms of the January-July period.

The trend in trade flows by sector show a strength that, with practically no exception, affects all economic sectors. With regard to sales abroad, the three main exporter sectors (capital goods, motor vehicles and foods that together make up more than half of Spain's exports), have grown more than 5% year-on-year in the first seven months of 2007. From the point of view of imports, the situation is similar. The two leading import sectors, capital goods and the motor vehicle sector, are showing notable strength with year-on-year growth figures of 10% and 8% respectively. The other side of things, both from the perspective of exports and imports, comes from the energy product sector. As opposed to the general trend, this shows flows with abroad falling in year-on-year terms in the January-July period of this year.

With regard to the trend in the main foreign markets, the most significant factor remains the good state of the European Union (EU), especially the countries of the Euro Area. Both Spain's exports to and imports from the Euro Area showed greater strength than trade overall. This was particularly noticeable in the case of France and Germany, two markets that represent approximately one third of all Spanish exports and imports. Outside the European Union, we should mention the good export performance to emerging economies,

notably Russia, Brazil, Argentina, India and China. With regard to purchases from abroad, Spain's most dynamic non-EU supplier is still China, followed at some distance by Turkey and Morocco. Nevertheless, it should be remembered that, in spite of this strength in trade, the emerging economies still hold little importance compared with European markets.

Balance of payments: notable increase in incomes deficit

In June, there was a current account deficit of 7.68 billion euros, 26% higher than that reported one year earlier. The two main culprits for the widening of this imbalance were the increases in the trade balance deficit and the deficit in the incomes balance. The current transfers account also made its contribution given that one year ago it was in surplus whereas in June it stood in deficit. The increase in the services surplus was not enough to compensate for the change mentioned.

In cumulative terms for 12 months, which provide more of a trend perspective, the negative picture given by the latest figures is partly amended. The cumulative deficit in the current account balance for the 12 months ended June is practically identical to that recorded last month. Furthermore, the figure shows a tendency toward something of a slowdown (in June it grew by 25%, two points less than in May). The most significant news, however, is that the negative contribution of the incomes balance is now greater than that of the trade balance. The importance of this figure is underlined if we recall that the trade deficit is approximately three times the imbalance in the incomes account.

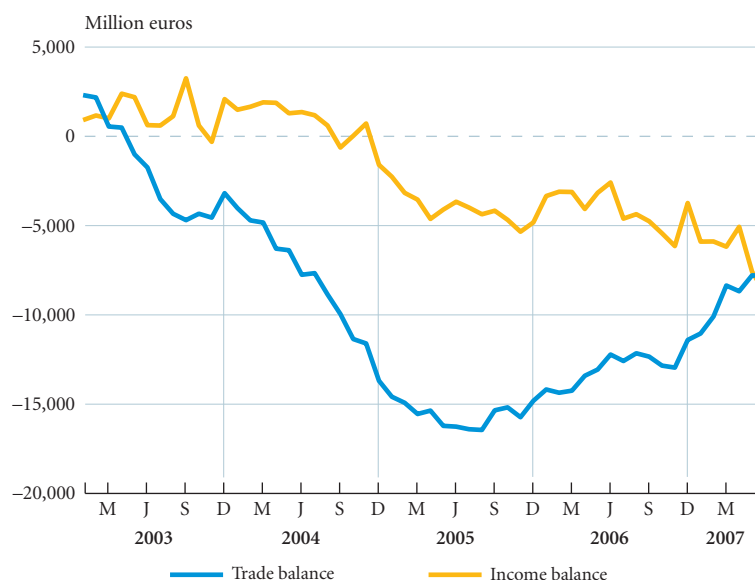
Driving forces behind exports (consumer goods, cars and food) take advantage of good world scene.

Exports to emerging countries move ahead at good rate.

Widening of current account deficit stabilizes in past 12 months.

IMBALANCE IN INCOMES BALANCE NOW BIGGER THAN THAT FOR FOREIGN TRADE

Absolute year-on-year change in cumulative balance for 12 months



SOURCE: Bank of Spain and own calculations.

BALANCE OF PAYMENTS

June 2007

	Cumulative for year		Last 12 months		
	Million euros	% annual change	Million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	-40,687	6.1	-82,470	-7,959	10.7
Services					
<i>Tourism</i>	11,849	1.6	27,632	362	1.3
<i>Other services</i>	-3,229	5.9	-5,481	13	-0.2
Total	8,620	0.1	22,151	375	1.7
Income	-13,412	64.2	-26,229	-8,922	51.6
Transfers	-4,724	40.9	-7,124	-3,677	106.7
Total	-50,203	21.7	-93,672	-20,183	27.5
Capital account	2,156	11.4	6,396	90	1.4
Financial balance					
Direct investment	-22,249	-44.6	-37,624	3,096	-7.6
Portfolio investment	92,963	-26.6	164,636	33,318	25.4
Other investment	-3,093	-89.0	-10,514	-10,798	-
Total	67,621	15.8	116,498	25,616	28.2
Errors and omissions	-182	-94.1	-6	6,507	-99.9
Change in assets of Bank of Spain	-19,393	21.4	-29,216	-12,030	70.0

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.

In the financial sphere, the most notable factor in the recent picture is that inflows of portfolio investment, while not completely losing their drive, have slowed down in growth rate to half the figure one month earlier (always in

terms of cumulative figure for 12 months). The level of direct investment outflows, which fell by 8% year-on-year as of June, is also dropping (it rose to 7% year-on-year for the 12 months ending in May).

Increase in imbalance in incomes balance now higher than for trade balance.

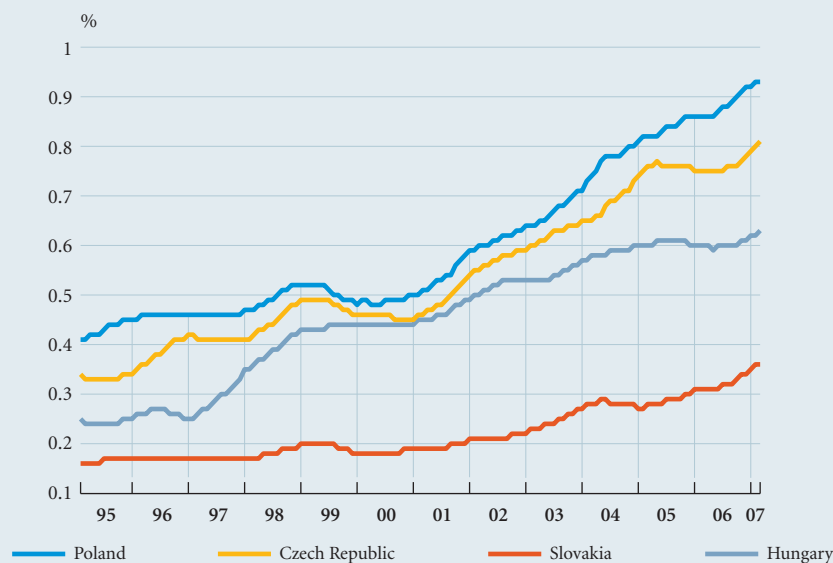
Poland closer than it would seem

The extension of the European Union (EU) toward the East is an irreversible fact which should broaden our horizons. Among other things, because an unstoppable process has begun that will have important effects on Spain's trade and investment. As often happens, this represents both opportunity and risk. It offers opportunity because more trade makes it possible to show the best of Spain and enjoy the best of the others, as the Athenians and Venetians discovered, and the classical economists somewhat later. But there is also a risk, given that the new member states are competitors vying with Spain both for customers and direct investment.

Four countries of Central Europe stand as most significant when speaking of trade (see accompanying graph), all of them members of the EU since 2004, namely Hungary, gripped by domestic rigidities, the former Czechoslovakia and, especially Poland, whose trade with Spain is equal to that of all the other new members.

WINDS OF TRADE BLOWING STRONG FROM EAST

Share of total world exports in past 12 months



SOURCE: International Monetary Fund and own calculations.

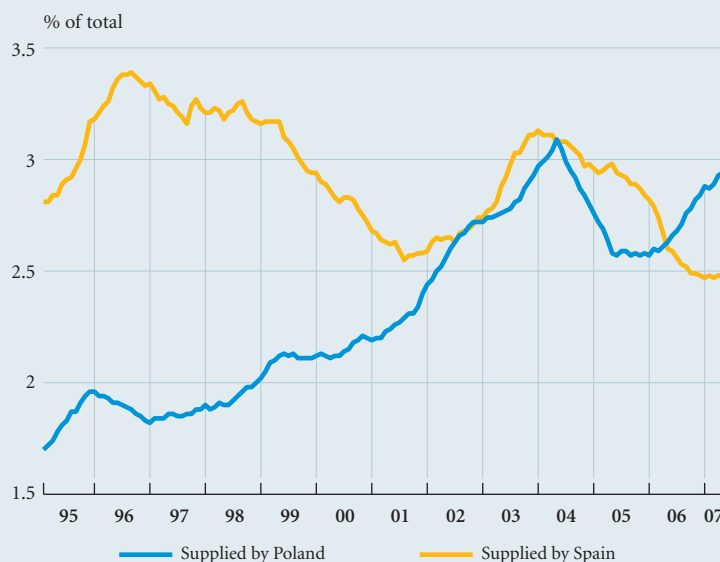
The first aspect to be noted is that, following their move into the EU, there has been an opening up of trade in all these countries with exports and imports gaining weight in terms of their GDP which, in turn, each shows a strong growth rate. Simultaneously, their competitiveness has benefited from the increase in foreign direct investment. In terms of foreign capital accumulated by these investments, the total amount of the new member states in Central and Eastern Europe in 1991 amounted to 7% of cumulative foreign capital in Spain. In 1995, this was close to 30% and in 2005, after joining the EU it came to 71%. Partly because of this investment, the share of exports of these countries in the world total has increased, in contrast to what has happened in the countries of the Euro Area as a whole.

Another notable feature is that the impact of the new member states of Central and Eastern Europe on European trade has been most uneven. We live in the era of Internet and information highways. Nevertheless, in matters of trade matters as prosaic as geography and history have their importance and Poland and the countries of former Czechoslovakia are reaping the benefit. In the competitive German market, the penetration of products from those countries is moving ahead, partly to the detriment of countries of the Euro Area, although it is worthwhile pointing out that Spain's exports have maintained their level, as may be seen in the following graph. It would appear that, while geographical distance continues to have its effect, it also acts as a cushion, leaving the challenges and opportunities for later. Nothing could be farther from the reality because the process of trade integration is moving ahead rapidly. Trade by Poland, Czech Republic and Slovakia with Spain in terms of total foreign trade growth went from 9% in 2000 to 12.5% in 2006 whereas the weight of trade with Germany, although at a higher starting point, dropped from 32% to 27%.

A third aspect is related to Spain's competitiveness, that is, the country's ability to hold onto its customers and win new ones. In the theory of world trade, each partner is specialized in what it knows how to do relatively better. In this respect, Spain and Poland are very similar while being different from Germany. The Germans are

UNEVEN FORTUNES OF SPAIN AND POLAND

Goods imports by Germany (*)



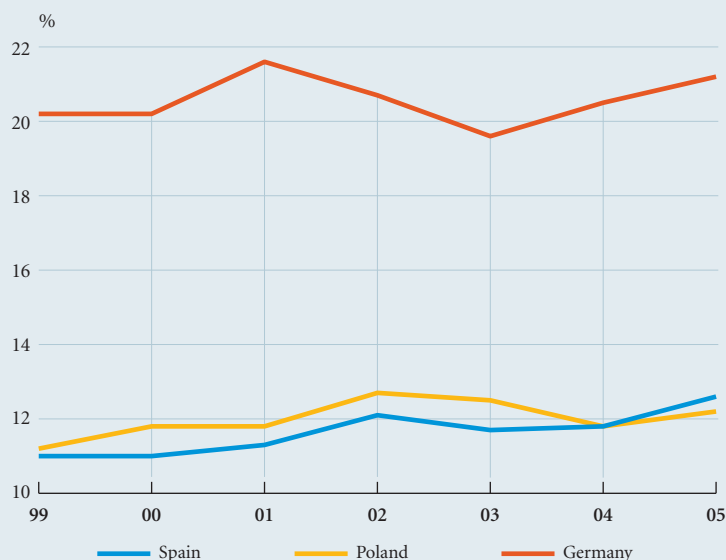
NOTES: (*) Moving averages for 12 months.

SOURCE: International Monetary Fund and own calculations.

complementary to the Poles and see them as efficient providers of products they do not make. Spaniards, on the other hand, are competitors of Poland and these days the battle is not easy. As shown in the previous graph, whereas Poland's exports have advanced significantly in the German market, Spain's exports there have shown something of a drop in market share.

SPAIN MORE LIKE POLAND THAN GERMANY

Weight of high-technology content exports in total



SOURCE: UN ComTrade and own calculations.

In order to keep up levels in world markets it is fundamental to improve competitiveness. This is difficult to measure and it is always necessary to qualify the results of the various measures applied. One easy way to do this is to look at how those products that best show competitive advantages become established in the world market. In general, these are products that incorporate higher technology content, such as machinery and electronic equipment, precision instruments, pharmaceutical products and aircraft. Germany, whose products of high technology content in 2005 made up 21% of all its exports, stands well above Spain and Poland, which in the crucial technology sector show similar figures at somewhat above 12% of exports.

While it is not necessary to beat one's breast, given that between 2002 and 2005 Spain's exports with high technology content grew by 60%, a rate similar to that of Germany, there is no room for complacency. Germany's starting point is much higher whereas Poland, with whom Spain's is competing more directly, saw its technology exports grow by 113% in the same period, which reminds us that Spain should take the challenge of competitiveness in technology very seriously.

Public sector

Central government budget for 2008 aims at boosting productivity and improving social well-being...

...and is based on scenario of slight economic slowdown.

Consolidated spending up 8.0%, more than economy as a whole.

Capital spending growing less than nominal GDP.

Central government budget for 2008

The central government budget for 2008 confirms the priority being given to a model of economy policy made up of balanced, sustainable and competitive growth. For this purpose it maintains budgetary stability while boosting productivity and developing measures for improving social well-being and social cohesion.

The budget takes into consideration a scenario of some slight economic slowdown, as may be seen in the accompanying table. In 2008, growth of gross domestic product (GDP) in real terms was down by 5 decimals to 3.3%, a level that in any case was higher than the consensus figure for forecasts by analysts. Final national consumption is slowing in similar fashion, putting annual growth at 3.4%. Gross capital formation is also easing although it shows higher growth at 4.6%. Capital goods are up by 7.9% while construction increases by 3.8%. The foreign sector will reduce its negative contribution to GDP growth to 6 decimals. Naturally, job creation is also down to 2.2%, whereas the unemployment rate is reduced slightly to 7.9% of the labour force.

In order to meet its objectives, the 2008 budget shows consolidated spending by the central government, Social Security, autonomous bodies and public corporations, excluding financial liabilities, of 314.52 billion euros. This figure means an increase of 8.0% over the year before, so that it has a rather

expansionist approach if we compare it with expected nominal GDP growth of 6.7%. This consolidated spending does not include spending by other levels of government (autonomous communities and municipalities) nor measures taken by public sector corporations and foundations or other public bodies, such as Spanish Radio and Television Corporation.

Current consolidated spending is up by 7.3%, higher than the economy as a whole. The heading to increase most is current transfers which are up 7.7%. Next come staff costs which are to rise by 6.9%. The heading to rise least is financial costs with an increase of 4.3%, below nominal GDP growth. In any case, this takes up 16.68 billion euros, 1.5% of GDP.

Consolidated capital spending, amounting to 23.8 billion euros, is also to grow below nominal GDP with an increase of 5.2%. Both real investment and capital transfers show a similar increase.

On the other hand, financial assets are up by 18.0% to 24.77 billion euros. This heading includes allocation of an amount of 6.81 billion euros to the Pension Reserve Fund. Other major headings in this segment include allocation of 2.45 billion euros for the State Ground Transport Infrastructures Corporation, credits to the Development Aid Fund amounting to 2.34 billion euros and an allocation to the Ministry of Industry, Tourism and Trade for civil

MACROECONOMIC SCENARIO 2006-2008

	2006	2007	2008
GDP and components (% real change)			
Spending on national final consumption	4.0	3.9	3.4
<i>Spending on private national final consumption (*)</i>	3.8	3.4	3.1
<i>Spending on final consumption (General government)</i>	4.8	4.8	4.4
Gross capital formation	7.0	5.8	4.6
Gross fixed capital formation	6.8	5.8	4.6
<i>Capital goods</i>	10.4	9.9	7.9
<i>Other products</i>	4.6	2.7	2.6
<i>Construction</i>	6.0	5.1	3.8
Change in inventories (contribution to GDP growth)	0.1	0.0	0.0
National demand	4.8	4.3	3.7
Exports of goods and services	5.1	5.3	5.0
Imports of goods and services	8.3	6.8	6.0
Foreign balance (contribution to GDP growth)	-1.2	-0.8	-0.6
Gross domestic product	3.9	3.8	3.3
GDP at current prices (billion euros)	981.0	1,051.1	1,121.5
GDP at current prices (% change)	8.0	7.1	6.7
Prices and costs (% change)			
GDP deflator	4.0	3.2	3.3
Wages (labour cost) per wage-earner	3.0	3.1	3.1
Labour market			
Total employment (% change) (**)	3.2	2.8	2.2
Employment (change in thousands) (**)	571.8	509.9	419.1
Unemployment rate (% of labour force)	8.5	8.1	7.9
Productivity per employed person (% change) (**)	0.7	1.0	1.1
Surplus (+) / Deficit (-) (General government, % of GDP)	1.83	1.30	1.15

NOTES: (*) Includes households and non-profit organizations serving households.

(**) Employment equivalent to full-time work, according to National Accounting.

SOURCE: INE and Ministry of Economy and Finance.

research projects for an amount of 2.25 billion euros. It would appear that these transactions are closer to being of a spending nature rather than financial investment.

From another point of view, if we go by spending policy, the biggest heading is still social spending, which makes up 50.5% of the total. Under this heading, the main section is pensions which represent 31.2% of budget spending with growth of 7.2%. We should

mention the improvement of minimum pensions. Contributory pensions show a rise of 6.5% where the pensioner has a dependent spouse and 5.0% in other cases, except pensions for widows with dependent families which go up by 22.3%.

Among other social spending headings, the one to show the biggest increase is social services and social support which is up by 24.8% to 2.29 billion euros. Included under this heading is attention

CONSOLIDATED 2008 BUDGET FOR CENTRAL GOVERNMENT, AUTONOMOUS BODIES, SOCIAL SECURITY AND OTHER BODIES

Million euros

	Spending	% change (*)		Revenue	% change (*)
Current operations			Current operations		
Staff costs	31,290	6.9	Direct taxes and Social Security contributions	220,046	8.1
Current goods and services	8,376	6.3	Indirect taxes	53,363	5.2
Financial costs	16,679	4.3	Fees and other revenue	5,083	6.6
Current transfers	206,094	7.7	Current transfers	12,653	0.9
Total	262,440	7.3	Government property earnings	5,826	33.5
Capital operations			Total	296,972	7.6
Contingency fund	3,508	15.8	Capital operations		
Real investment	14,040	5.3	Disposal of real investments	571	3.3
Capital transfers	9,761	5.1	Capital transfers	4,071	35.4
Total	23,802	5.2	Total	4,642	30.4
Total non-financial operations	289,749	7.2	Total financial operations	301,614	7.9
Financial assets	24,773	18.0			
Financial liabilities	34,893	3.3			
Total financial operations	59,666	8.9			
TOTAL BUDGET	349,415	7.5			

NOTES: (*) Change over initial 2007 budget.

SOURCE: Ministry of Economy and Finance.

Sharp rise in allocations for attention to dependent persons.

to dependent persons with allocations amounting to 871 million euros, more than twice that for the year before. Also of note are allocations for the welcoming and integration of immigrants. In addition, within the framework of family protection, the government establishes a new benefit of 2,500 euros for the birth or adoption of a child applicable as a personal income tax benefit, except in the case of those who do not qualify for that deduction, in which case it will be handled as a Social Security benefit.

New benefits for birth of a child and for rental housing.

Another new aspect comes under housing policy. The allocation for access to housing is up by 9.7%. Public housing is given increased emphasis. At the same time, rental is to be fostered and, as a new feature, 210 euros a month will be granted toward paying the rent for employed young people who earn a maximum of 22,000 euros a year gross,

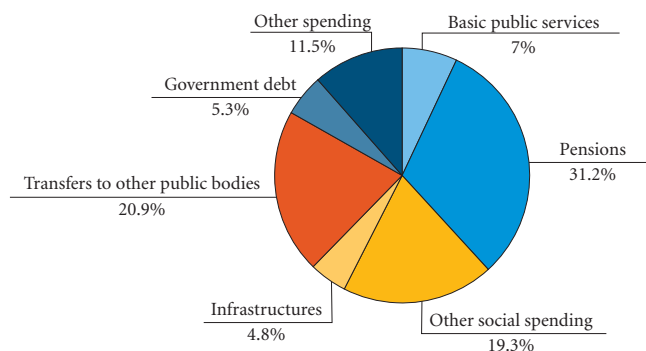
among other support and tax deductions.

An important heading is that of unemployment, to which 15.78 billion euros are allocated, 5.0% of the budget. This heading obtains a rise of 9.0% as a result of higher benefits and an increase in the number of beneficiaries, partly due to the high level of job turnaround.

Under spending of an economic nature, the most important heading is infrastructures. The budget allocation here is up 5.9% going to 15.08 billion euros. The increase goes up to 9.4% if we add allocations to the corporate public sector. Investment in infrastructures come in application of the Strategic Plan for Infrastructures and Transport and the National Hydrological Plan, which are plans for measures of a medium or long-term nature. Some 2.55 billion euros is

SOCIAL SPENDING TAKES UP MORE THAN HALF OF BUDGET

Breakdown of spending in consolidated central government budget for 2008 by policy (non-financial transactions plus financial assets as percentage of total)



SOURCE: Ministry of Economy and Finance and own calculations.

set aside for new road infrastructures. Furthermore, the State Corporation for Ground Transportation Infrastructures is to make investments of 1.20 billion euros in roads. The government will invest 1.65 billion euros in the railway network while public corporations will invest a further 5.13 billion euros, especially in the high speed train network. In turn, waterworks investment will amount to 2.01 billion euros coming from the central government and another 2.47 billion euros from the Water Corporations.

The boost to R&D&I is defined as a political priority. According to the 2008 budget, the funds going to research, development and civil innovation are up by 17.4% to 7.68 billion euros, although this accounts for only 2.4% of the total budget. Along with military R&D&I, it represents 0.83% of GDP, which puts it substantially below the level of investment in the more developed countries.

In addition, basic public services show an increase of 12.6% going up to 22.04

billion euros, 7.0% of the total budget. The heading to go up most is foreign policy with an increase of 51.3%. The overall figure for Official Development Aid comes to 0.5% of GDP. Policing and penal institutions are up by 9.0%, justice by 7.8% and defence 5.9%.

On the other side of the budget balance sheet, the forecast puts revenue up by 8.7%, with non-financial revenue rising by 7.9%. In this way, consolidated revenue is to grow slightly more than spending and the economy as a whole, although this will naturally undergo a slowdown compared with the previous year.

The tax load (direct taxes, indirect taxes and social security contributions) in terms of the initial budget comes to 24.4% of GDP in 2008. This means one decimal less than in the initial budget for 2007, but 4 decimals above 2006.

With regard to tax collections, the main increase over the initial budget is due to direct taxes and social security contributions which are up 8.1%.

Notable boost in R&D&I spending although still below that for most advanced countries.

Expected tax load stands at level similar to 2007 but above that of a few years ago.

Surplus of general government in 2008 at 1.15% of GDP, slightly below that seen for 2007.

In terms of increase in tax paid in 2007, personal income tax is up 5.2%. In 2008, we strongly note the effects of tax reforms that came into effect in January 2007. Apart from the updating of the tax rate by 2%, on this occasion the amounts of personal and family minimums and deductions for work earnings have been deflated. Corporation tax is up by 6.2% compared with the progress in liquidation once the new gradual reduction in tax rate comes into effect. Social security contributions are up 7.5% as a result of an increase in the number of contributors and contribution bases. Indirect taxes are up 5.2%, less than the nominal GDP, reflecting the slowdown in consumer spending.

Formally, the 2008 budget shows a consolidated surplus in terms of National Accounting equivalent to 1.15% of GDP. This result comes from surpluses in Social Security amounting to 0.60% of GDP, 0.30% in central government and 0.25% in the autonomous communities. The surplus foreseen in general government will therefore be lower than that expected for 2007, which is estimated at 1.3% of GDP. The ratio of debt in terms of GDP of general government will thus continue to drop going to 34.3% of GDP, the lowest level in the past 20 years.

Savings and financing

Growth of credit slows

The 12-month Euribor, the reference rate used for many types of loan, especially mortgage loans, continued to rise in August going to 4.67% thus showing the highest level since December 2000. Over the past year the 12-month Euribor rose by 105 basis points with a carry-through of a similar rise in the European Central Bank official interest rate. Given that this rate is expected to rise to 4.25% in coming months and, especially as a consequence of increases in the interbank rate arising from the US sub-prime mortgage crisis, the 12-month Euribor is still likely to go up a little on monthly average in September.

Nevertheless, it may already have hit a ceiling.

As usual, lending institutions have carried through increases in the interbank rate to customer transactions with some slight delay. As a result, the average interest rate on loans and credits granted to the private sector stood at 5.63% in July, an increase of 102 basis points compared with the same month last year. Given that the inflation rate dropped by 1.8 percentage points in the same period, the increase was still more significant in real terms.

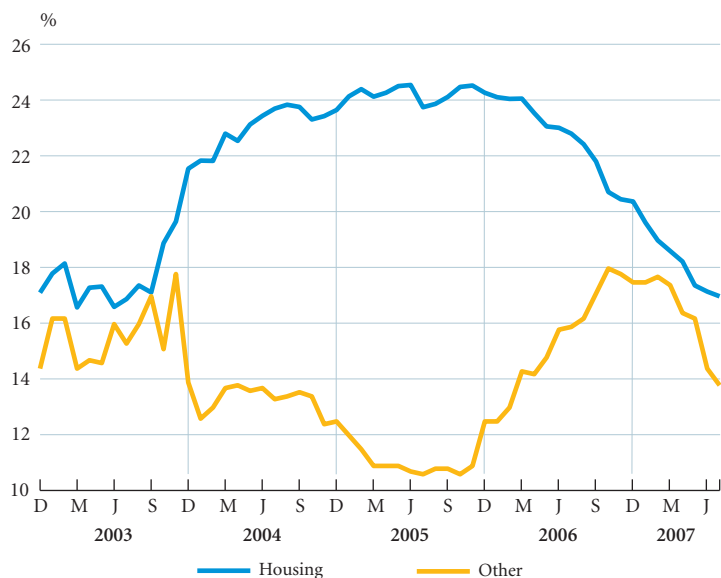
In this context, funding granted to the private sector continued to decrease in July and showed a year-on-year change

12-month Euribor likely to hit ceiling in September.

Growth of funding granted to private sector much higher than in Euro Area as a whole.

SUBSTANTIAL DROP IN FUNDING GRANTED TO HOUSEHOLDS

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



SOURCE: Bank of Spain.

Impact of sub-prime mortgage crisis likely to sharpen drop in funding granted to companies.

rate of 19.8%, some 4.4 points less than in December 2006. Nevertheless, this is still a high growth rate well above that in the Euro Area as a whole and reflects notable economic strength.

So far this year, the increasing slowdown in funding has shown up among companies which have gone from annual growth of 27.9% in December to 22.7% in July. Nevertheless, they continue to show a higher year-on-year increase than households. The impact of the international financial market crisis set off by sub-prime mortgages in the United States is making it harder for companies to get financing in capital markets which had reached spectacular growth levels so that it is likely that the drop in corporate financing will continue.

The volume of loans and credits obtained by households rose by 16.1% in the last 12 months ending in July, some 3.5 percentage points less than in December. This drop was largely due to a slowing down in home-purchase loans. Loans for this purpose went down to growth of 17.0% in July compared with 20.4% at the end of last year. As well as the rise in interest rates, the high prices

being reached for housing and tougher terms for borrowing against mortgage security are slowing down mortgage loans.

In June, according to figures from the National Institute of Statistics, the number of mortgage loans granted dropped 5.2% compared with the same month last year. In the first half-year as a whole the number of mortgage loans registered was down 1.7%. Nevertheless, funds lent in the first half of the year rose by 9.1% compared with the same period in 2006 with the average figure per mortgage loan going up by 11.1%.

Not only loans for home acquisition were down. In spite of marketing campaigns to foster consumer credit, other loans showed a similar drop in recent months, as may be noted in the above graph, in keeping with the easing off in consumption.

On the other hand, the recent rise in interest rates has brought about a slight increase in default. The doubtful loans rate, that is to say, the quotient between the figure for doubtful loans and total loans to the private sector by all lending institutions stood at 0.79%. Nevertheless, this is a low level that stands close to the

Number of mortgage loans granted in first half-year down 1.7% compared with same period last year.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

July 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	87,080	1,704	2.0	8,680	11.1	5.2
Secured loans (*)	1,023,880	100,904	10.9	178,182	21.1	61.0
Other term loans	473,447	58,858	14.2	94,953	25.1	28.2
Demand loans	35,223	1,110	3.3	4,747	15.6	2.1
Leasing	44,760	4,047	9.9	5,680	14.5	2.7
Doubtful loans	13,184	2,325	21.4	2,654	25.2	0.8
TOTAL	1,677,573	168,947	11.2	294,895	21.3	100.0

NOTES : (*) Greater part made up of loans with mortgage security.

SOURCE: Bank of Spain and own calculations.

all-time low of 0.72% recorded at the end of 2006.

Slowdown in growth of bank deposits

Bank deposits of companies and households have also shown a slowdown in recent months. At the end of July they reported an increase of 20.8% compared with the same month last year, some 4.5 points less than at the end of the first quarter. The sharp increase in deposits in recent months has been fostered by a considerable increase in returns. The interest rate on time deposits for a one-year term was above the annual inflation rate in September 2006 and since then has substantially increased in real terms.

The type of deposit to show the biggest increase in relative terms was those in foreign currency fostered by favourable interest rate differentials. Nevertheless, these made up only 3.7% of the total.

Time deposits for up to a 2-year term also showed sharp growth, due to the new tax rate on savings that removed any discrimination in matters of term. On the other hand, on demand and savings accounts rose by only 4.1% in the past 12 months because of lower returns.

In spite of the sharp increase in deposits in recent months, this was not sufficient to finance the growth of loans so that financial institutions had to have recourse mainly to bond issues and securitizations. The crisis set off by US sub-prime mortgages posed difficulties for this type of financing so that deposits have regained importance.

Bank deposits are representing fierce competition for other financial products in household portfolios, such as investment funds. The assets of investment funds underwent a drop of 1.26 billion euros in August, according to figures supplied by Inverco, the association of

Sharp increase in deposits for terms up to 2 years following coming into effect of new tax rates on savings.

CONSIDERABLE INCREASE IN RETURN ON TIME DEPOSITS

Effective interest rate on time deposits for terms up to 1 year by households (new transactions)



SOURCE: Bank of Spain.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

July 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	435,986	-12,351	-2.8	17,186	4.1	35.0
Up to 2 years	303,818	57,412	23.3	84,702	38.7	24.4
More than 2-year term	381,258	48,409	14.5	84,883	28.6	30.6
Repos	80,052	-3,772	-4.5	10,283	14.7	6.4
Total	1,201,113	89,697	8.1	197,053	19.6	96.3
Deposits in currencies other than euro	45,559	12,842	39.3	17,230	60.8	3.7
TOTAL	1,246,672	102,539	9.0	214,283	20.8	100.0

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

SOURCE: Bank of Spain and own calculations.

Average annual return on investment funds in August well over twice inflation.

investment managers. This drop was due to capital losses arising from the upsets in financial markets although there were also net sales of participations amounting to 400 million euros. The main outflows from funds in August took place in global funds and in European share-based funds, while short-term bond-based funds, which are more conservative, were on the rise. Since January, the assets of investment funds have increased by 0.7% going up to 256.08 billion euros, thanks to capital gains obtained, seeing that in the first eight months of the year there were negative net flows in participations for an amount of 2.39 billion euros.

As a result of the upsets in financial markets, the average yield on investment funds dropped somewhat in August. In any case, the average annual yield stood at 5.0%, more than twice the inflation rate. Emerging country funds headed the ranking with 30.3% followed by national share-based funds at 21.8%. Only Japanese share-based fund showed losses amounting to 5.4%.

With regard to hedge funds, which were in the eye of the storm on the international scene during the summer crisis, this crisis does not seem to have affected their recent showing in the Spanish market. At the end of August their assets stood at 481 million euros as against 240 million at the close of the first half-year.

In addition, another financial instrument now enjoying the favour of savers is insurance. In the first half of 2007, premiums billed for direct insurance rose by 11.1% compared with the same period the year before to show a total of 28.7 billion euros, according to figures supplied by ICEA. Life insurance premiums were the most dynamic with an increase of 18.9%, as against a rise of 5.8% for the rest. Among this group, the most growth-oriented were health and multi-risk insurance which reported an increase of 9% in total premiums. The most important branch in terms of volume, car insurance, was up by only 3.6% due to sharper competition, which showed up in premium price levels.

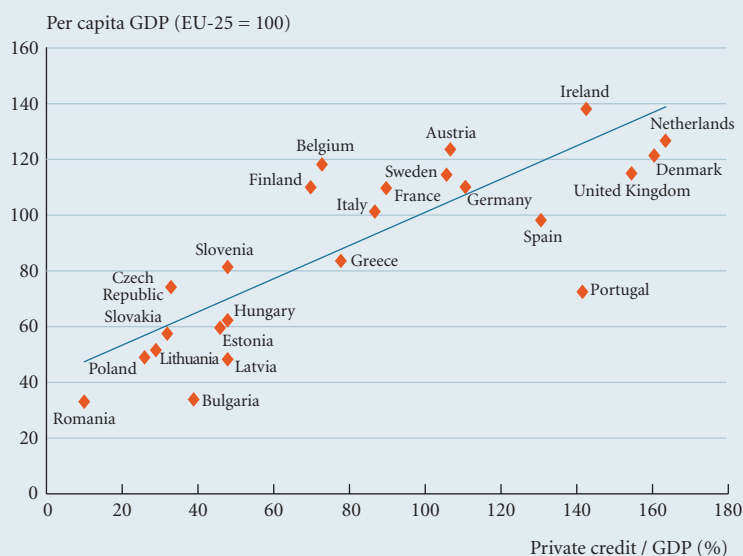
Sub-prime mortgage crisis fails to halt growth of Spanish hedge funds.

Vigorous growth of direct life insurance in first half-year.

Financial development in Central and Eastern Europe: Key to strengthening growth

The good functioning of the financial system is key to economic growth given that it strengthens the savings capacity of a country and enables companies to invest in new technology or carry out expansion projects. At the beginning of the Nineties, in the period of transition from a planned economy to a market economy, the countries of Central and Eastern Europe (CEEC) tended to privatize and liberalize their financial systems, while at the same time began to modernize their regulatory systems in order to make them more competitive. Hereunder, we look at the level of maturity and development reached by the financial systems in these economies, pointing out their contribution to growth and in what aspects they may improve their efficiency and reduce their risks.

MOST DEVELOPED FINANCIAL SYSTEMS ARE LOCATED IN RICHER COUNTRIES



SOURCE: World Bank and Eurostat (figures for 2005).

The contribution of the financial sector to economic growth has been the subject of debate among economists for decades. While in 1988, Nobel prize winner Robert Lucas stated that «the role of the financial sector has been exaggerated»⁽¹⁾ that same year another Nobel prize winner Merton Miller declared that the proposition that the financial markets contribute to growth was too obvious to merit serious discussion.⁽²⁾ While it is clear that the more developed financial systems are to be found in the richer countries (see accompanying graph), the causal relationship is not so clear. On the one hand, the development of these systems may be the result of an increase in demand for credit created by an increase in economic activity. On the other hand, however, it may be that a greater capacity of the financial sector to grant credit creates stronger economic activity and, as a result, higher growth.

(1) Lucas, R. (1988). *On the mechanics of Economic Development*, Journal of Monetary Economics, page 6.

(2) Miller, M. (1988). *Financial Markets and Economic Growth*, Journal of Applied Corporate Finance, page 14.

Today, many empirical studies confirm the importance of the financial sector in economic growth. A recent study by Bena and Jurajda for the countries of the European Union (EU-15) shows how the introduction of the single market in 1992 especially benefited those manufacturing companies located in countries with more advanced financial sectors. Specifically, the study estimates that value added of companies located in the country with the most highly developed financial system, namely the United Kingdom, grew by nearly 3 percentage points more per year in the ten-year period 1993-2003 than it would have grown if it had had a financial system among the least developed in the EU, such as Greece. Other estimates, such as those of Levine and Zervos, imply that the annual growth rate of the gross domestic product of the CEEC could be one percentage point higher if the level of development of their financial systems were comparable with the countries of the EU-15.⁽³⁾ These figures give an idea of the potential for aiding growth that the development of their financial systems can offer the CEEC.

Some characteristics of these countries mean that the development of the financial system is especially important. On the one hand, their productivity levels will tend to converge with the rest of the European Union. For this process to be carried out successfully, companies will need to adopt new technologies, which will require a financial system capable of providing the necessary financing. On the other hand, joining the European common market also means a major increase in trade, as has been happening in recent years. A financial system that can aid those companies that need to internationalize their business is fundamental for maximizing growth and that of the economy in general.

INDICATORS OF MODERNIZATION OF THE FINANCIAL SYSTEM

2005

	% loans granted by private banks	% loans granted by foreign banks	Application of Basle regulations	Planning to apply Basle II regulations	Level of capitalization of banking sector (*)
Bulgaria	99.6	78.0	✓	✓	15.3
Czech Republic	96.8	83.9	✓	✓	11.9
Estonia	100.0	99.3	✓	✓	11.7
Hungary	100.0	97.3	✓	✓	10.8
Latvia	94.5	62.8	✓	✓	10.1
Lithuania	100.0	90.5	✓	✓	10.3
Poland	79.5	69.2	✓	✓	14.5
Romania	96.4	60.5	✓	✓	21.0
Slovakia	99.0	94.0	✓	✓	14.8
Slovenia	...	31.9	✓	✓	10.5
Central and Eastern European average	96.2	81.7	100.0	100.0	13.1
EU-15 average	93.0	18.0	100.0	100.0	13.0

NOTES: (*) Capital ratio (% assets) adjusted for risk employing definitions in 1988 Basle Agreement.

SOURCE: World Bank, central banks and own calculations.

(3) Bena, J., and Jurajda, S. (2007). *Financial Development and Growth in Direct Firm-Level Comparisons*. Centre for Economic Policy Research, Discussion Papers No. 6395; and Levine, R. and Zervos, S. (1998). *Stock Markets, Banks, and Economic Growth*, American Economic Review, vol. 88.

In order to facilitate the development of the financial system, the CEEC have carried out substantial modernization of their regulatory systems. To date, they have successfully pursued processes of privatization and liberalization of the sector. As shown in the previous table, nearly all loans are granted by private banks which, in most cases, are foreign owned. Furthermore, all the countries now follow the guidelines set out in the 1988 Basle Agreement, which guarantees that the banking system is sufficiently capitalized. At the same time, all of them also have plans to implement the new Basle Agreement which has the objective of making the financial system more transparent and safe by making capital requirements conditional to the risk taken by each entity.

INDICATORS OF BANKING AND INSTITUTIONAL EFFICIENCY

2005

	Financial development	Banking efficiency			Institutional efficiency	
	Private credit (% GDP)	Operating margin (**)	Operating costs (**)	Doubtful loans (% total)	Efficiency of legal system (***)	Days for carrying out contractual guarantee
Bulgaria	38.8	5.1	3.9	1.2	2.5	440
Czech Republic	33.1	3.0	1.8	4.3	3.5	820
Estonia	45.9	3.0	1.6	0.1	5.1	275
Hungary	48.0	3.4	2.9	2.8	4.2	335
Lithuania	28.6	2.2	2.0	0.4	3.6	166
Latvia	48.3	3.0	2.2	0.4	3.8	240
Poland	26.3	2.0	3.0	5.7	3.6	980
Romania	10.1	4.0	4.8	8.3	3.1	335
Slovakia	31.7	2.5	2.0	2.1	3.6	565
Slovenia	48.3	2.8	2.5	4.8	4.2	1,350
Eastern European average	35.9	3.1	2.7	3.0	3.7	551
EU-15 average (*)	116.0	2.0	1.0	1.0	5.3	416

NOTES: (*) Excluding Luxembourg.

(**) As percentage of assets generating interest.

(***) Index from 1 (most inefficient) to 7 (most efficient, neutral and transparent).

SOURCE: World Bank, World Economic Forum, central banks and own calculations.

Although their financial systems have substantially reduced their operating margins and operating costs to the point where they have reached levels similar to the rest of the European Union, there are still two areas that could be improved. First, banking efficiency, which may improve if loan default levels continue to drop at the rate seen in recent years. Second, institutional efficiency, which also could be substantially improved, particularly in legal protection and governmental costs, which are fundamental requirements for companies and institutions to have easier access to credit.

Undoubtedly, the modernization of the financial system of the Eastern European countries has not only contributed to their economic growth in recent years but will continue to do so in coming decades. However, to take the fullest advantage of the process of integration in the EU, the improvement of banking and institutional efficiency will be key.

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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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