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THE SPANISH ECONOMY

Monthly Report

NUMBER 307

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2006 4Q	2007 1Q	2007 2Q	2007 3Q	2007 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	3.0	2.1	3.2	3.1	3.1	3.3	3.0
Euro area	2.9	2.5	2.1	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	3.2	2.6	2.4	2.0	2.4	2.6	2.4	2.9
Japan	0.2	0.0	0.2	0.3	–0.1	–0.1	–0.1	0.2
United Kingdom	2.3	2.4	2.1	2.7	2.9	2.6	1.8	2.2
Euro area	2.2	2.0	2.2	1.8	1.9	1.9	1.9	2.5
Germany	*1.7*	*2.0*	*2.0*	*1.4*	*1.8*	*1.8*	*2.1*	*2.5*
France	*1.7*	*1.3*	*1.7*	*1.3*	*1.2*	*1.2*	*1.3*	*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	5.3	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	8.1	8.1	8.3	8.5	8.0	8.0	8.0
Consumer price index	3.5	2.6	3.1	2.6	2.4	2.4	2.4	3.4
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		
Net 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	1.5	0.9					
FINANCIAL MARKETS		Forecast						Forecast
Interest rates								
Federal Funds	5.0	5.0	4.3	5.3	5.3	5.3	5.1	4.6
ECB repo	2.8	3.9	4.0	3.3	3.6	3.8	4.0	4.0
10-year US bonds	4.8	4.6	4.5	4.6	4.7	4.8	4.6	4.3
10-year German bonds	3.8	4.3	4.6	3.8	4.0	4.4	4.3	4.3
10-year Spanish bonds	3.8	4.3	4.7	3.8	4.1	4.4	4.4	4.4
Exchange rate								
$/Euro	1.26	1.37	1.42	1.30	1.32	1.35	1.39	1.43

Contents

What's to be done with Government?

As in any other scientific discipline, economics continues to discover the limitations of earlier ideas. It is also learning what conclusions of the past continue to be valid. In any case, it must be recognized that many of the matters of economic policy being debated today were already controversial more than 200 years ago when the science of economics was born. These comings and goings reveal the difficulties that exist in extracting firm conclusions about matters subject to many influences and perceived from many different points of view. One of the most recurring themes thinkers in economic science have dealt with is the role of Government in the economy, a matter central to the organization of society.

The result is not greatly stimulating. Mercantilists believed that the government generally benefited the economy, at least when it supported domestic production intended for export. Adam Smith's doctrine then pointed to the damage the Government's action was capable of inflicting on the free operation of the market. Keynesians considered that the government could contribute to improving economic results and that intervention was a good thing. «Public choice» economists are convinced that the State can often ruin things. Those in favour of «rational expectations» believe that often economic policy is something of an illusion and that it cannot do much to change reality.

It is therefore not surprising that the role of Government in the economy continues to be controversial. There is now scarcely any country where the State administers the economy one hundred percent. China, the star of the emerging economies, bases its brilliant performance on the progressive withdrawal of the State from the management of the economy. In the advanced economies, however, debate continues about the extent of the weight of the public sector, the extension of policies characteristic of the Welfare State (education, health, housing, etc.) and the action of the public sector in the area of economic policy. These are controversial issues that have to do with much-discussed questions such as proposals to reduce taxes, the effects of fiscal policy, protectionist moves in Europe and the United States, what should or should not subsidize the public budget, the degree of freedom parliaments should have when it comes to drawing up budgets, the make-up of spending and the weight of the various taxes, etc.

The size of Government in terms of revenues and spending also continues to be a subject of debate but in general there is agreement in that public deficits are not desirable. Formerly, except in periods of war, states used to balance their accounts. Since the Seventies, however, deficits have become practically a constant, occasionally reaching excessive degrees. Attempts to halt a drop in demand by pushing down on the accelerator of public spending have proven erroneous. It may be that over the short term the fiscal boost would drive economic activity but this stimulus would end up with dire results for inflation, an incorrect allocation of production resources and could even lead to recession. This observation has made it possible to give support to the idea that excessive deficits end up hurting the economy. Today, parliaments understand the problem in spite of the political attractiveness of increasing public spending. In the European Union, at the beginning of the Nineties, the Treaty of Maastricht raised budget stability as a question of common interest. The guidelines of fiscal policy have been extended and it is considered that they are helping to improve the performance of the economy. It is not so much a matter of the size of the Government as of the orthodoxy applied in its accounts.

EXECUTIVE SUMMARY

Toward a dual economy?

Emerging countries growing rapidly, oil and other raw materials going sky-high, while stock markets and corporate profits climb to peaks.

How is the world economy doing? Let us try an *à la carte* analysis. Do we want to be optimistic? Let us take the strong growth of the emerging countries with China in the lead (more than 11%), followed by India (9%) and Russia (8%). This group of countries is now driving the world economy and maintaining it in the strongest and longest growth stage since the Seventies. Let us add in the price of oil and other raw materials, with a barrel that could go to 100 dollars before the end of the year. Are there supply problems? Or others of a geopolitical nature? Yes, but there is also an undoubted rise in demand. We can add the new record level for foreign direct investment in 2006, a year when these flows grew by nearly 40%. Can it be said that the figure is quite old? In that case, let us take the main international stock markets (with the exception of Japan) which stand at all-time highs, with companies gaining more than ever. Do we need to spell out the conclusion?

On the other hand, real estate crisis in United States leading to financial upsets not abating and raises risk of recession.

Are we simply pessimists by nature? That is no problem. Let us go to housing sector in the United States. Lamentations and gritting of teeth. Sales are down, building activity is at a halt and prices are dropping. And there is no sign of the end of the tunnel. Few people expect that the market will stabilize for a number of months. This is a crisis that is now beginning to be a long one and that has brought about a dangerous shock in the financial sector. The financial engineering applied to spreading the risk involved in sub-prime mortgages has collapsed at a moment when default is on the increase. Lack of confidence has hit deep among investors, risk premiums have risen and borrowing conditions have become tougher. Big investment banks in the United States and some elsewhere have acknowledged major losses. The US economy is hanging by a thread because, if the crisis should affect private consumption spending, the result could be close to recession. It is difficult to see this scenario benefiting the rest of the world economy.

In this context, health of world economy uncertain although still room for moderate optimism.

What analysis should we choose? The world economy certainly stands at a delicate cross-roads. Will the emerging countries be able to drive the world economy even with a limping US economy? In its Autumn analysis, the International Monetary Fund (IMF) so believes. The forecast for world growth in 2008 (4.8%) is barely one decimal less that that issued in April, although in July the forecast was corrected upward to 5.2%. This was in spite of the fact that economists in Washington do not expect that the United States, the world's largest economy, will grow more than 1.9%. The risks of this forecast are clearly pointing downward, especially if the real estate problem in the United States is not put in order before the middle of next year.

Finally, it is not crazy to maintain a cautious optimism, even being aware of the dangers that lie in wait. A good part of the confidence being shown in the markets is based on the moves to be expected from the central banks. The Federal Reserve, the US central banking system, demonstrated on September 18 that it was ready to come to the defence of the stability of the financial system when it cut the reference rate by a half-point to 4.75%. And this will not be its last cut. In turn, the European Central Bank interrupted until further notice its increases in the reference rate which now stands at 4%. All the central banks have made an effort to make liquidity available in the interbank market where the financial institutions have been very reluctant to lend to each other and credit restrictions is most noticeable.

In the case of the United States, the price to be paid for the salvage operation carried out by the central bank is the drop in the dollar, especially against the euro and the Canadian dollar. This is good for US exporters which may thus be able to contribute to make the drop in real estate easier to bear. Furthermore, industry also is benefiting from the fact that consumers do not find imported goods so cheap and opt for buying more national products. In fact, in recent months the huge US foreign trade balance has begun to show a clear drop.

For the Euro Area, the problem is that a good part of the adjustment of the dollar falls on its currency. Toward the end of October the exchange rate against the euro was close to 1.44 dollars and this may still have some way down to go. This is in contrast to the relative stability of the currencies benefiting from the big US foreign deficit, such as China. Jean-Claude Juncker, spokesman for the ministers of economy and finance of the Euro Area, considers that Europe does not have to bear the consequences of these global imbalances. Behind him are the manufacturers whose sales abroad are rapidly losing competitiveness. But all is not lost. Germany, the world's biggest exporting power, does not seem to be affected by the strength of the single currency and is maintaining its level of exports. In addition, a strong currency represents an umbrella offering some protection from the rise in raw materials prices. In recent months, the rise in the price of crude oil has run parallel to the climb in the euro-dollar exchange rate.

Finally, the European economy environment is dominated by a course of gradual slowdown in growth although we still note background strength. This is the case, except in varying degrees of growth, for Germany, France and Spain, whereas Italy is proving to be weaker. The United Kingdom, on the other hand, is showing surprising strength. The announcement that the British gross national product grew by 3.3% year-on-year in the third quarter, beating the still strong 3.1% seen in the second quarter, at one stroke swept away all speculation about the extent of the slowdown in economic activity. In spite of the fact that a breakdown by components is not yet available, the indicators make it possible to speculate that household consumption has again been the engine for growth in the British Isles.

Spain's economy: slowdown continues

In the case of Spain's economy, as mentioned earlier, the indicators appearing go in the direction of some loss of drive. There is some agreement that the slowdown will last through the coming year. The disagreements lies in deep this will run. The IMF believes that growth will slow to 2.7% in 2008, as opposed to the forecast in the central government budget for next year at 3.3%. In any case, as a result this forecast range lays out an economy that is growing at a still considerable rate, close to potential.

There are two key elements in such a course – job creation and the strength of companies. Employment, the main

Moves by central banks bring notable drop in dollar thus favouring US economic activity...

...but complicates European economic situation which remains flexible within framework of slight slowdown.

Spain's growth forecasts for 2008 hold within 2.7%-3.3% range.

Job creation maintaining annual growth of 3%, putting total employed at 20.5 million persons, and foreign workers make up growing share.

source of providing household income, may be judged by the labour force survey, which in the third quarter of this year showed a slight drop in rate. In that period, the number of employed persons rose by 143,300, as against an increase of 202,500 in the same quarter last year. In any case, in the past 12 months ending September some 615,000 net jobs were created putting the job total at 20.51 million, an all-time high. This meant a year-on-year increase of 3.1%, three decimals less than in the previous quarter. Most of this job creation showed up in services which raised the number of workers in that area by 544,500 in the past year, with an annual change of 4.2%. Construction raised the level of its employment by 127,400 workers, an annual increase of 4.9%, which nevertheless meant a sharp slowdown. In the past 12 months, industry has cut employment slightly, although at a lower rate than earlier. Finally, the farm sector continued to lose workers.

Foreign workers filled more than half the jobs created in the past 12 months (53.4%) which indicates that the entry of foreign workers into the country is scarcely slowing down. As a result, the number of persons of foreign nationality employed rose to 13.9% of the total in the third quarter. The percentage of foreign workers rose to 24.5% in construction, 18.0% in agriculture, 12.6% in services and 9.1% in industry.

The good situation still to be seen in the labour market continues to attract new people into the labour force, that is to say, those working or actively looking for work. As a result, the number of workers in the labour force has risen by 3.0% in the past 12 months. With the rise of the labour force slightly more than the total number of jobs created in the quarter, the unemployment rate rose slightly to 8.0%, putting it close to the low in the second quarter and one decimal below the third quarter last year. On the other hand, unemployment among the foreign worker population was 11.8%, nearly one percentage point more than one year earlier.

Situation of companies remains excellent with high return on equity.

With regard to the situation of companies, the Bank of Spain's compilation of balance sheet figures for the first half of 2007 show a panorama of excellent health. Companies continue to generate robust profits, the basis for growth of investment and employment. Nevertheless, in a situation of general strength we see signs of a slowdown in some sectors, such as construction, transport and communications and retail trade. On the other hand, industry was showing great strength. Ordinary return on net assets stood at a notable 8.0%, somewhat above the historic average. In terms of equity, ordinary return stood at 11.5%, nearly one percentage point more than in the first half of 2006.

Risks lie in possible effects of US sub-prime mortgage crisis and rise in oil, which could affect economic activity and prices.

This picture of slowdown is now subject to possible indirect effects of the sub-prime mortgage crisis in the United States. Even before this, growth of credit had begun to slowdown because of the loss of drive in the real estate sector. In any case, there is no restriction on credit and the situation of Spain's banking system is one of the most orderly on the Continent. The danger lies more in the effects of a possible slowdown in the European and world economies.

Another risk lies in the course taken by oil prices. The all-time highs in October 2007 will mean a sharp rise in the consumer price index in the final months of the year and will make the situation of certain branches of economic activity complicated where, because of competition, it is not easy to pass the increase in costs on to final prices.

October 29, 2007

CHRONOLOGY

2006

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	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.
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%.
October	9	Dow Jones index for **New York stock exchange** marks up all-time record (14,164.5), a rise of 13.7% compared with end of 2006.
	19	European Council agrees to adopt the **Treaty of Lisbon** in place of the European Constitution.
	29	One-month forward price of *Brent* quality **oil** goes up to all-time level of 89.74 dollars a barrel. **Euro** exchange rate at 1.439 dollars, the highest figure since launching of the single European currency at beginning of 1999. IBEX 35 index for **Spanish stock exchange** reports all-time high (15,738.1) with cumulative capital gains of 11.3% compared with end of December 2006.

AGENDA

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).

December

4 Registrations with Social Security and registered unemployment (November).
5 Industrial production index (October).
6 Governing Council, European Central Bank.
11 Federal Open Market Committee.
14 CPI (November). Balance of payments (September) CPI harmonized with EU (HCPI) (November).
18 Labour cost survey (3rd Quarter). Central government revenues and spending (November).
26 Producer prices (November). Foreign trade (October).

INTERNATIONAL REVIEW

Emerging countries sustaining world growth

IMF reduces world growth forecast to 4.8% in 2008.

In its report on world economic prospects put out in October, the International Monetary Fund (IMF) lowered its growth forecasts for 2008 from 5.2% to 4.8% mainly due to the effects of the real estate and sub-prime mortgage crises in the United States. Nevertheless, world growth remains strong thanks to the emerging countries which are showing greater macroeconomic strength and more political stability than formerly. For the first time, China is noted as the main contributor to world growth.

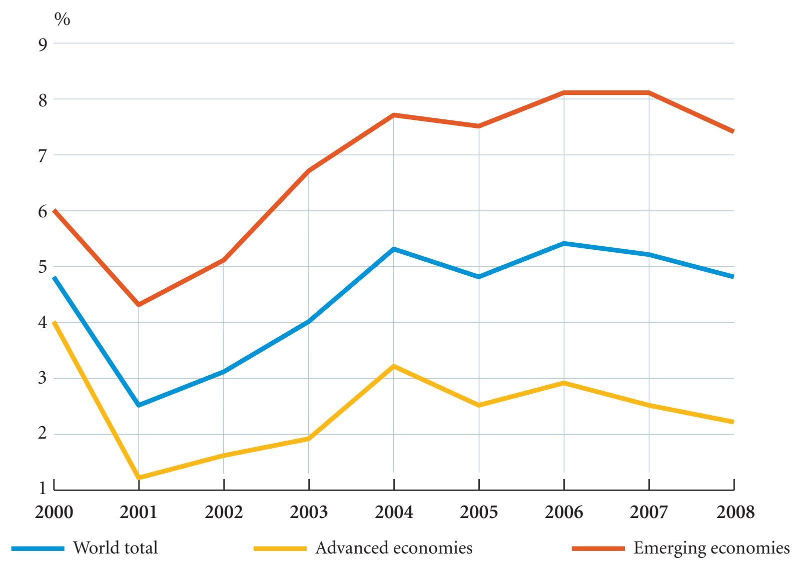
Inflationary tendencies seem to be under control in the advanced economies although there have been some increases in the emerging economies because of food prices while the upward trend in raw materials prices is troubling.

However, downward risks in the main scenario are increasing. A worse situation in borrowing conditions, greater volatility in financial markets, a persistent weakness in the real estate sector affecting various economic sectors and global imbalances (especially the inability to manage the monetary flows these generate) would reduce growth. Nevertheless, the risk from high-cost oil now seems lower than in the past.

By geographical area, it is the United States where forecasts go down most

WORLD GROWTH FIRM BUT RISKS ARE DOWNWARD

Year-on-year change in gross domestic product



NOTES: 2007 and 2008 are forecasts.
SOURCE: International Monetary Fund.

IMF FORECASTS

Annual change as percentage

	2005	2006	2007 (1)	2008 (1)
GDP				
United States	3.1	2.9	1.9	1.9
Japan	1.9	2.2	2.0	1.7
Germany	0.8	2.9	2.4	2.0
France	1.7	2.0	1.9	2.0
Italy	0.1	1.9	1.7	1.3
United Kingdom	1.8	2.8	3.1	2.3
Spain	3.6	3.9	3.7	2.7
Euro Area	**1.5**	**2.8**	**2.5**	**2.1**
Advanced economies	**2.5**	**2.9**	**2.5**	**2.2**
World total	**4.8**	**5.4**	**5.2**	**4.8**
Developing countries	*7.5*	*8.1*	*8.1*	*7.4*
Latin America	*5.6*	*6.3*	*5.8*	*5.2*
Eastern and Central Europe	*4.6*	*5.5*	*5.0*	*4.3*
Russia	*6.4*	*6.7*	*7.0*	*6.5*
China	*10.4*	*11.1*	*11.5*	*10.0*
Consumer prices				
United States	3.4	3.2	2.7	2.3
Japan	–0.3	0.3	0.0	0.5
Germany (2)	1.9	1.8	2.1	1.8
France (2)	1.9	1.9	1.6	1.8
Italy (2)	2.2	2.2	1.9	1.9
United Kingdom (2)	2.0	2.3	2.4	2.0
Spain (2)	3.4	3.6	2.5	2.8
Euro Area (2)	**2.2**	**2.2**	**2.0**	**2.0**
Advanced economies	**2.3**	**2.3**	**2.1**	**2.0**
Developing countries	*5.2*	*5.1*	*5.9*	*5.3*
Unemployment rate (3)				
United States	5.1	4.6	4.7	5.7
Japan	4.4	4.1	4.0	4.0
Germany	9.1	8.1	6.5	6.3
France	9.7	9.5	8.6	8.0
Italy	7.7	6.8	6.5	6.5
United Kingdom	4.8	5.4	5.4	5.4
Spain	9.2	8.5	8.1	8.2
World trade by volume (4)	**7.5**	**9.2**	**6.6**	**6.7**
Oil price ($ per barrel) (5)	**41.3**	**20.5**	**6.6**	**9.5**

NOTES: (1) Forecasts at Octubre 2007.
(2) Harmonized consumer price index.
(3) Percentage of labour force.
(4) Goods and services.
(5) Average spot prices for Brent, Dubai and West Texas Intermediate oil. Average oil price in dollars per barrel forecast at $68.52 in 2007 and $75.00 in 2008.
SOURCE: International Monetary Fund.

US growth forecast for 2008 shows notable reduction to 1.9% but emerging economies compensate.

with a drop in 2008 growth from the 2.8% expected back in July to the present 1.9%. This cut was due to the continued difficulties in the real estate market which are expected to sharpen the decline in construction investment. Higher energy prices, dropping real estate prices and a still strong labour market that is slowing down could weaken consumer spending. The countries gaining most in trade with the United States, namely Canada, Mexico and East Asia, also show downward revisions.

For Japan, the growth projection has also been reduced from 2.6% to 2.0% for 2007 and from 2.0% to 1.7% in 2008 because of the downward forecast for gross domestic product (GDP) in the second quarter because of dependence on dropping world growth and the appreciation of the yen.

IMF says spread of benefits of globalization and technology needed to reduce inequalities.

For Europe, forecasts have been lowered for nearly all countries. Following growth of 2.4% in 2007, expectations for the increase in Germany's GDP in 2008 go down to 2.0%. Growth prospects for France and Italy in 2008 are reduced to 2.0%.

On the inflationary front, increased food prices should be gradually absorbed by adaptation to supply but the process will be long and will set the trend in the indices so that the central banks, which normally watch the underlying components to make their analyses, will have to look more closely at the general indices. Monetary policies were tending to reduce liquidity levels but now have had to adapt to the new growth scenario of credit risk.

In United States, tightening of credit may have long-lasting consequences with investors now more sceptical.

From a longer perspective, the IMF notes that growth of productivity in recent years has rested on a combination of technological progress, a growing opening up of trade, the free circulation of capital between countries and more robust macroeconomic frameworks and financial systems. Having said this, the growth of trade and the introduction of new technology have left behind large segments of the society and inequalities have increased to an undesirable degree, not only between the rich and poor countries but within each country itself. The response, according to the IMF, does not lie in reducing technology or trade but in improving educational systems, making labour markets more efficient and creating social protection measures that ease the impact of economic change without preventing it.

United States: a soft landing that could last a long time

The course of macroeconomic activity always tends to be directed toward a situation that involves growth and brings about price control. At times, we are more concerned about one matter and at other times more about the other and the latest figures suggest that now it seems more important to be concerned about the risk of lower growth than the risk of inflationary pressures. Growth swings around the investment opportunities that are available to business operators, or that they may discover, for the manufacture of goods or the efficient rendering of services and on the capacity of consumers to buy them.

Since 2000, investment opportunities seem to have been slim at a time when a cycle exceptionally good for corporate profits has not managed to boost investment in capital goods as it has on other occasions. In the following graph we see that, whereas in the second half of the Nineties, the period of the «New Economy», growth of investment was

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	3.1	2.9	2.4	2.6	1.5	1.9	–	...	–
Retail sales	6.6	6.2	5.4	5.0	3.4	4.0	3.7	3.8	5.0
Consumer confidence (1)	100.3	105.9	104.4	106.8	109.9	106.7	111.9	105.6	99.8
Industrial production	3.2	4.0	5.1	3.5	2.5	1.7	1.7	1.6	1.9
Industrial activity index (ISM) (1)	55.5	53.9	53.8	50.9	50.8	55.2	53.8	52.9	52.0
Sales of single-family homes	6.5	–18.0	–23.3	–21.9	–24.6	–20.1	–10.5	–21.2	...
Unemployment rate (2)	5.1	4.6	4.7	4.5	4.5	4.5	4.6	4.6	4.7
Consumer prices	3.4	3.2	3.4	1.9	2.4	2.7	2.4	1.9	2.8
Trade balance (3)	–714.4	–758.5	–777.7	–758.5	–746.4	–731.5	–722.9	–712.9	...
3-month interbank interest rate (1)	3.6	5.2	5.4	5.4	5.4	5.4	5.4	5.6	5.2
Nominal effective exchange rate (4)	83.7	82.5	81.6	81.6	81.9	79.3	78	78	76

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.

higher than growth of profits, since 2001 it has always been good corporate profits that have been one step ahead of investment in equipment and software.

Real estate market continues to drop with prices down 4.5%...

The recovery of the real estate sector will also have to wait until later with prices which, according to the Case-Schiller index of Standard & Poor's, dropped by 4.5% year-on-year in July. Housing sales also continued to drop, going down by 12.8% in August and 21.2% year-on-year for existing and new homes, respectively. It is supply, however, that most recently looks blackest with housing starts down in September by 30.8% year-on-year.

The US economy, however, still has its strengths. First, the cycle of profits has meant that companies are relatively little in debt and, second, the labour market continues to show signs of strength, which is giving support to consumption. All of this, along with the cut in interest rates by the Federal Reserve, means that the US economy is moving away from sudden disaster.

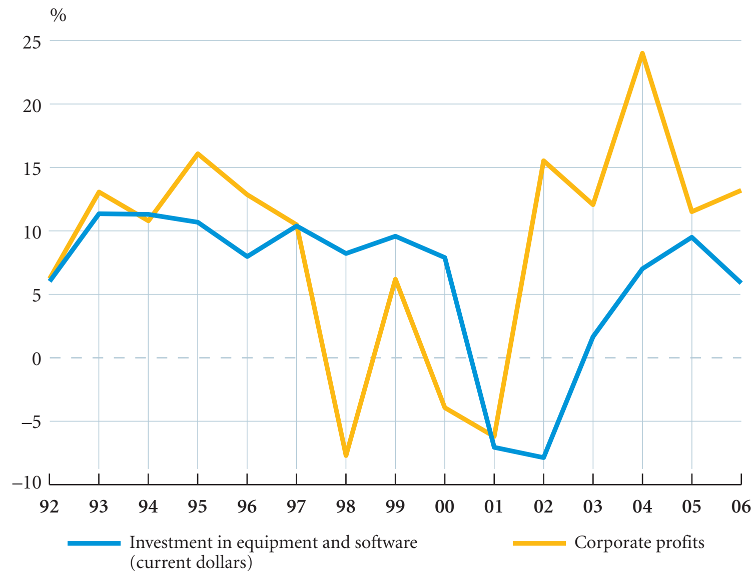
The United States is facing a soft landing but the problem arises in whether it will hit the runway gently, that it does not bounce up again and that recovery in 2008 also is gradual or delayed. Job creation in the past 12 months ending September was 1,629,000 new jobs, which shows a slowdown from the 2,400,000 jobs created in the same period last year. At the same time, despite a slight rise, the unemployment rate remains at a low 4.7% of the labour force. Retail sales are running in the same vein with a rise of 5.0% year-on-year increase in September.

...but labour market and retail sales suffer only moderate drops.

On the supply side, industrial production continued to show a low profile with growth at a poor 1.9% year-on-year in September in keeping with that seen during most of this growth cycle. Business sentiment continues to show a

CORPORATE PROFITS NOT STIMULATING INVESTMENT AS BEFORE

Year-on-year change

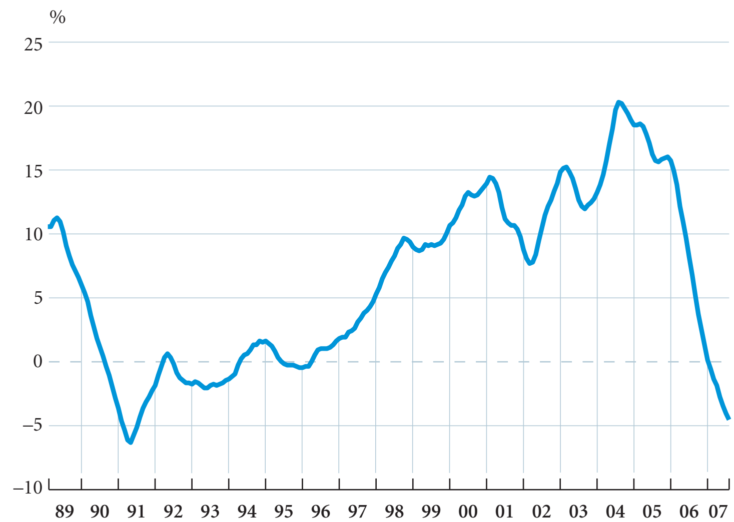


SOURCE: Bureau of Economics and own calculations.

very similar pattern to that of the labour market. The labour force index for the manufacturing sector put out by the Institute for Supply Management was down slightly to the 52.0 points level, whereas the services index was also down, by a figure somewhat more miserable if that were possible, going to

UNITED STATES: DROP IN PRICE OF REAL ESTATE

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



SOURCE: Standard and Poor's and own calculations.

the level of 54.8 points. As both figures stand above the 50 level, where those who see improvement and those who see the opposite are equal, with the components of new orders at somewhat higher levels and jobs going up, the corporate forecast does not show any immediate risk.

Inflationary risks have taken second place compared with the drop in consumption. The consumer price index (CPI) rose by 2.8% year-on-year in September but does not present any immediate risk given that the underlying inflation index (which in the United States excludes food and energy from the general index) repeated the 2.1% increase seen the month before.

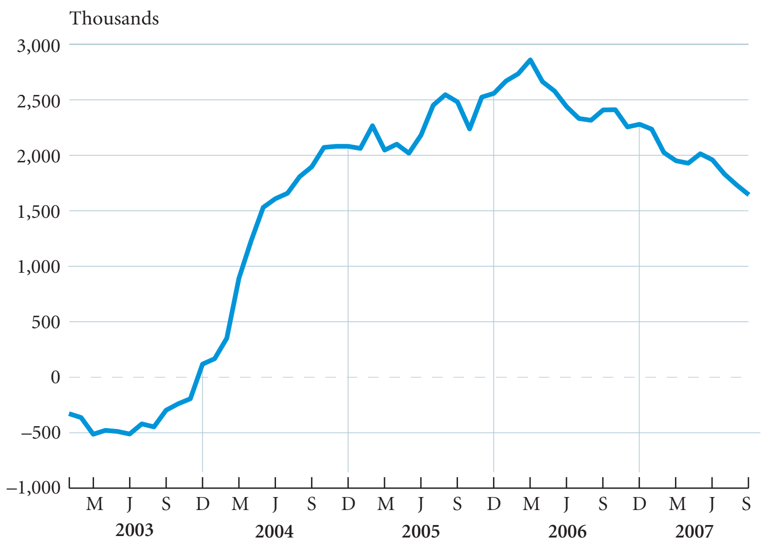
Nevertheless, the inflation picture reveals clouds on the horizon. Some people say that globalization which makes it possible to import low-cost goods has acted as a brake on inflation. In this respect, increases in wage costs in China, the biggest exporter to the United States, and depreciation of the dollar means that this halt is no longer as strong. Other commentators think that the main factor in containment of prices has been the discipline of the central banks, helped by advances in the manufacture of equipment related to the information technologies that have made it possible to do more with less so that the engine of the economy can do more revolutions without overheating.

The problem is that prices for investment in capital goods, which amounts to 9.2% of GDP, rose by 0.7% year-on-year in the second quarter whereas at the beginning of 2000 they were down by more than 2.0%. In the case of consumer durables, which make up 10.7% of the economy, the trend is also clearly upward with prices that are still dropping but much less than before. All of this, at current growth levels, does not so much imply that prices can shoot up as a decrease in the potential growth of the economy. As a result, the ability of the Federal Reserve to manoeuvre in its interest rate policies

Prices not immediate problem but imports and technological products not as cheap as before raise alarm.

UNITED STATES: EMPLOYMENT SLOWS SLIGHTLY

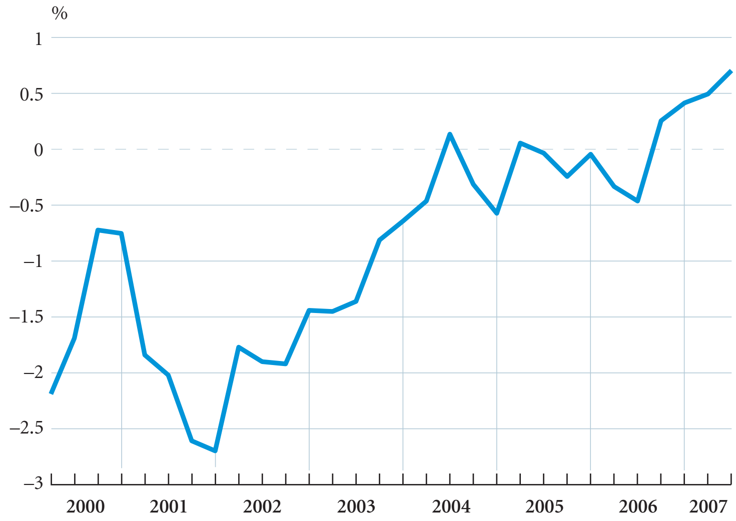
Jobs created in past 12 months



SOURCE: Department of Labour and own calculations.

TECHNOLOGY NOW NOT SO CHEAP

Year-on-year change in prices for investment in equipment and software



SOURCE: Bureau of Economic Analysis and own calculations.

Trade deficit being corrected but dollar stability is key variable.

aimed at helping consumption and investment would not be great.

With the help of a weak dollar and a slowdown in consumption, the trade deficit in goods and services continued to be corrected and in September went down to 57.59 billion dollars, some 15% lower than the high in August 2006. This was a decrease that, excluding oil, amounted to 23%. With exports maintaining their growth rate and imports clearly declining, the biggest risk in this area lies in that a sharp increase in the depreciation of the dollar could make it difficult to finance the current account deficit, something that has been easy up to now.

Japan: where the cautious pay for the spendthrifts

Japan grows by 1.7% thanks to export sector.

Life is often unfair and economic events are not alien to this reality. Proof of this is that Japan, a prudent savings-oriented country (which is now hard to find) stands among those most affected by the excesses of the frantic US economy with its consumers so much in debt and its sub-prime mortgages. It is a paradox that, while by mid-October the US stock market had recovered almost all of the 9% lost in the credit crisis, Japan's Nikkei index for the Tokyo stock exchange had scarcely regained three-quarters of the 16% it had lost.

The Japanese economy continues to enjoy one of the longest periods of growth in its recent history. But, while the modest growth rates are logical in view of the decreasing population, the main problem lies in its heavy dependence on foreign demand. In the second quarter, the export surplus contributed two-thirds of the 1.7% year-on-year growth seen in the GDP. Things do not end there seeing that the increase in capital goods investment, the other major support of economic activity, depends almost exclusively on

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	September
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	4.4	...
Tankan company Index (1)	18.0	22.5	24.0	25.0	23.0	23.0	–	23.0	–
Housing construction	3.9	4.5	–0.8	5.4	–1.9	–2.7	–23.4	–43.3	...
Unemployment rate (2)	4.4	4.1	4.1	4.0	4.0	3.8	3.6	3.8	...
Consumer prices	–0.3	0.2	0.6	0.3	–0.1	–0.1	0.0	–0.2	...
Trade balance (3)	10.2	9.4	8.9	9.4	10.2	11.1	11.1	11.7	...
3-month interbank interest rate (1)	0.1	0.3	0.4	0.5	0.6	0.7	0.8	0.8	0.8
Nominal effective exchange rate (4)	86.2	81.1	80.7	79.2	77.6	75.7	74.5	77.9	78.3

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. Average in 2000 = 100.
SOURCE: OECD, national statistical bodies and own calculations.

those sectors aimed at exports. In this respect, machinery orders in August rose by 5.5% year-on-year, indicating a recovery of investment. While investment arising from domestic demand grew by a slim 0.7%, that aimed at the foreign sector rose by 10.5%.

In recent years, the weight of exports to the United States compared with total sales abroad has dropped notably going from a high of 38% at the end of the Eighties to 23% in 2006. Nevertheless, this decrease has been more than compensated by exports going to China, Hong Kong and South Korea which in turn also sell to the United States. As a result, because of direct or indirect effects on exports and investment, Japan shows a dependence on private US consumption to a greater extent than would at first appear. Any increase in the slowdown of the latter could put an end to the long-lasting but fragile growth of Japan.

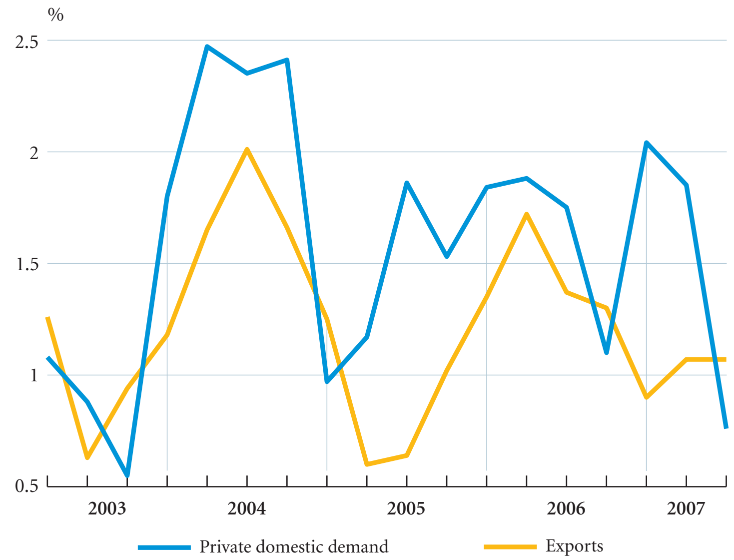
This rather undesirable course is confirmed by the recent trend in Japan's real estate market which, in spite of not having experienced the high prices that have taken place in other advanced countries, at this time also appear to be following the US star. In September, while in the Tokyo area prices showed increases of 7.5% year-on-year, real estate sales dropped by a very sharp 32.3%. The situation on the supply side was also weak with a drop of 43.3% year-on-year in housing starts across the country.

In addition, domestic consumption continued to show signs of strength with a confidence index that dropped from 44.3 to 43.9 points in the third quarter, the lowest level since the beginning of 2004. Retail sales rose in August gaining a modest 0.5% year-on-year but car sales dropped by 4.9% in September. The problem is that, in spite of the latest increases, the unemployment rate stands at a relatively low 3.8% of the labour

Faced with slackening domestic demand, dependence on foreign sector growth high, especially in case of United States.

JAPAN: LITTLE GROWTH APART FROM EXPORTS

Contribution to year-on-year change in GDP



NOTES: Cycle-trend series.
SOURCE: Japanese Institute of Real Estate Economics and own calculations.

Prices continue to drop with end of deflation delayed but exports continue to rise.

force, the labour market is failing to stimulate domestic demand because of the stagnation in wages, one of the first challenges Yasuo Fukuda, the new prime minister, must deal with.

The situation on the prices front remains poor with a CPI that saw the general index drop by 0.2% year-on-year whereas the underlying index (excluding energy but including fresh foods) was down by 0.1%. In turn, the general Tokyo index dropped by another 0.1% year-on-year in September. The oft-announced end of the long deflationary period continues to be awaited while spreading doubts about the strength of the economy.

What is not disappointing is the foreign sector with a trade surplus in August going to 1,400 billion yen, nearly 80% higher than in the same month last year, a result of the rise in exports and the gradual slowdown in imports. In this respect, the recent appreciation of the yen which, since the start of the credit problems in the United States, has gained 5% against the US dollar, is a risk to be taken into account, although the capacity of industry to compensate these currency appreciations through gains in competitiveness has consistently been one of the strong points of Japan's economy.

Brazil moves up a little more

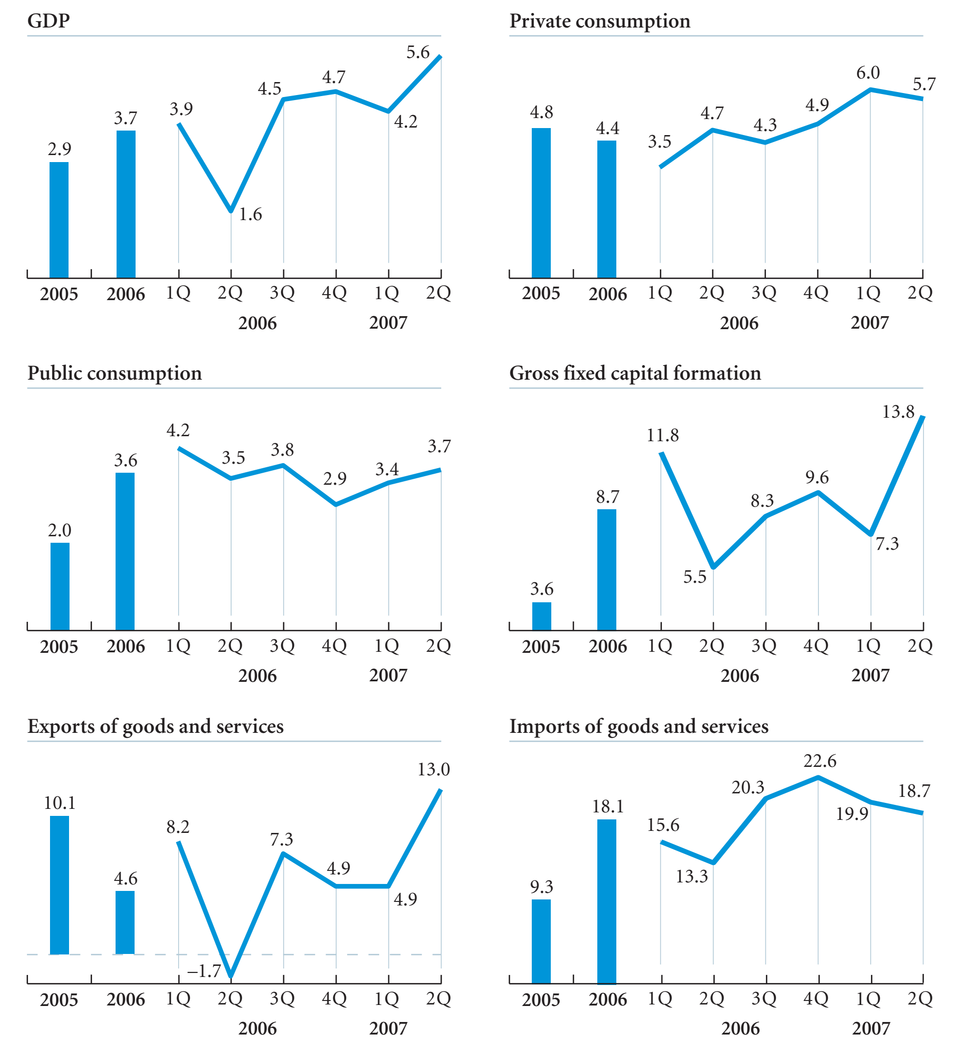
One of the big unknowns of the financial crisis this summer lies in the effects this could have on the emerging economies. While in other periods these economies have been a risk factor, now they are acting as a support of world economic activity with their accounts much more solid and balanced than in previous times. In spite of the weight of the interest on its foreign debt, Brazil is a good example of this with a GDP that grew by 5.6% year-on-year in the second quarter thus raising the level of its growth cycle. Private consumption held up, growing by 5.7%, while investment rose strongly with an increase of 13.8% year-on-year. The foreign sector, in turn, saw a relaunching of exports which, following something of a slowdown, regained strength reporting growth of 13.0% although imports held at growth rates close to 19%. Public consumption was up but always at growth rates lower than those of the private sector.

In the latest indicators of economic activity, industrial production in August held up to show an increase of 6.5% year-on-year but the most significant was that industrial production of capital goods rose by 21.0%, which meant the fourth consecutive quarter of growth in the region of 20% confirming the

Brazil's growth at 5.6% goes above government 5% objective.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-to-year change in real terms



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

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	2.9	3.7	4.5	4.7	4.2	5.6	–	...	–
Industrial production	3.1	2.8	2.8	3.2	3.8	5.7	6.9	6.5	...
Unemployment rate São Paulo (*)	17.0	15.9	16.0	14.3	15.2	15.6	15.0	15.0	...
Consumer prices	6.9	4.2	3.8	3.1	3.0	3.3	3.7	4.2	4.1
Trade balance (**)	40.8	46.3	42.4	46.3	45.8	47.4	45.1	44.1	43.1
Central bank SELIC rate (***)	19.1	15.1	14.4	13.4	12.9	12.3	11.5	11.5	11.3
Reales to dollar	2.4	2.2	2.2	2.1	2.1	2.0	1.9	2.0	1.8

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
(***) Value of central bank rate from the Sistema Especial de Liquidação e Custodia (SELIC).
SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and own calculations.

Inflation goes up to 4.1% while unemployment remains close to 15%.

strength of investment predominating in 2007. Demand followed the strength of supply with retail sales in August growing by 9.9% year-on-year and car sales moving up by 19.8% in September.

Inflation continued its slight rise and prices were up 4.1% year-on-year in September, a figure that, in view of the recent increase in economic activity, seemed rather moderate. While the increase in wholesale prices to 6.9% points to further increases in the general index, values remain well below the norm seen in 2004 when the economy was moving much more slowly. The foreign exchange rate continued to rise but its short-term effects seem to be more control over prices than loss of competitiveness given that the starting point was a cheap currency. The positive figure for the trade balance for the 12 months up to September was down slightly to 43.1 billion dollars.

Argentina grows by 8.7% thanks to private consumption and especially to strength of investment.

In this rather good context, the public sector deficit for the past 12 months ending August was down to 2.1% of GDP, thanks to greater government savings and a relative reduction in interest on the public debt. The unemployment rate in the São Paulo district, however, continued stuck at 15.0% of the labour force in August which meant it was holding at excessively high levels in a country where sharp levels of inequality present a long-term burden.

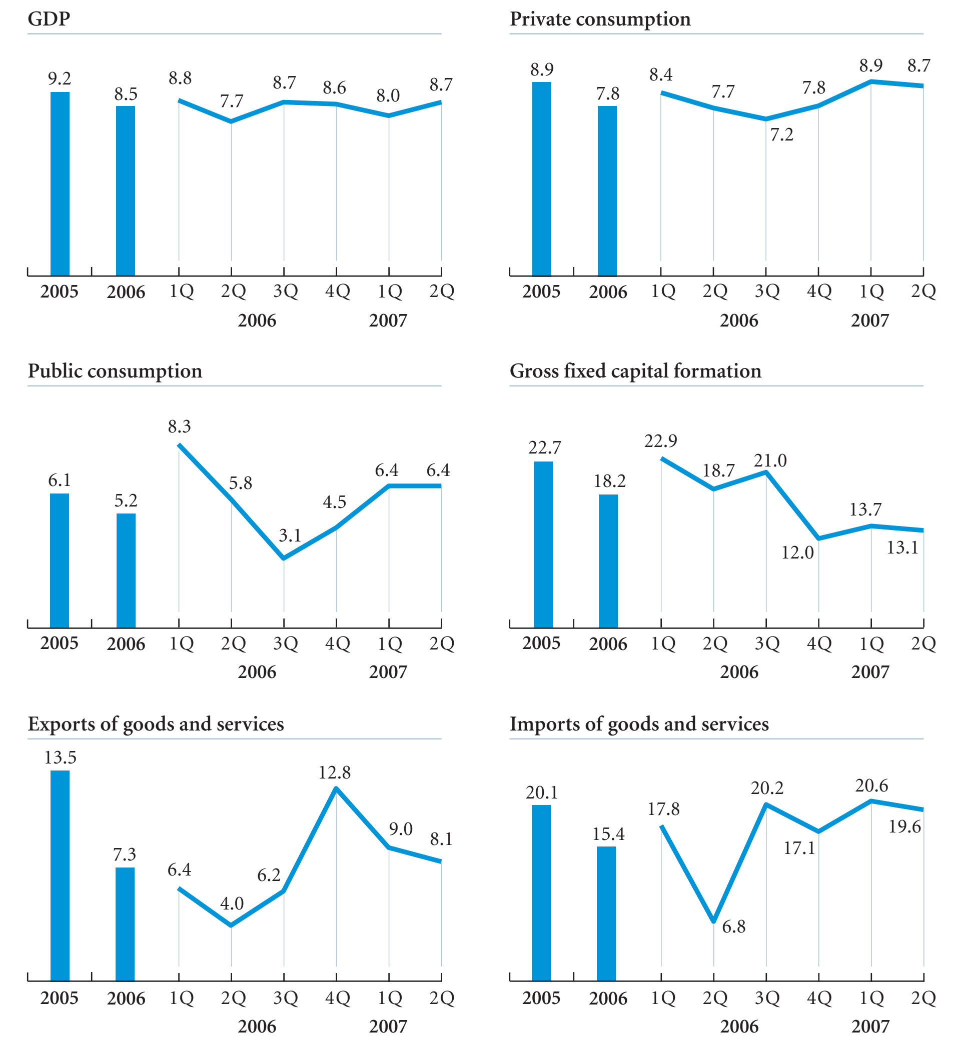
Argentina continues full-speed-ahead

Argentina's growth is maintaining its high profile with a GDP that in the second quarter grew by 8.7% year-on-year. With similar increases in private consumption and especially in investment, which was up by 13.1%, these continued to be the main support of economic activity whereas the public sector stopped rising. The foreign sector, in turn, stabilized its decreases which is not for nothing if we take into account existing strong domestic demand. As a result, exports maintained their growth rate going up by 8.1% although imports continued to rise at rates around 20%.

Most recent demand indicators continued to confirm the strength of the

TREND IN ARGENTINE GDP BY COMPONENT

Percentage year-on-year change in real terms



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

current growth cycle. Retail sales in the Buenos Aires region grew by 26.3% year-on-year in August and department store sales there continued very high with a rise of 36.3%. The persistence of price rises has meant that, in real terms discounting inflation and taking the average for the past 12 months, this indicator now is 5% above the highest levels in 1999 before the 2002 recession. Car sales in the past 12 months ending in September were up 35% year-on-year, going up to 80% of the all-time high.

On the supply side, things are not going quite so fast. Industrial production was stagnant in August with continued weakness in steel output and a chemical sector clearly on a downturn in contrast to the strength in the motor industry and the mining industries. In turn, the Synthetic Indicator of Construction

Demand continues to grow with notable strength and many indicators now above highs before 2002 crisis.

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	9.2	8.5	8.7	8.6	8.0	8.7	–	...	–
Industrial production	7.6	7.3	9.5	6.2	5.7	3.3	–0.6	0.0	...
Unemployment rate (*)	11.6	10.2	10.2	8.7	9.8	8.5	–	...	–
Consumer prices	9.6	10.9	10.6	10.1	9.5	8.8	8.6	8.7	8.6
Trade balance (**)	11.7	12.3	11.6	12.3	11.6	11.2	10.7	10.2	...
3-month interbank interest rate (***)	6.2	9.9	10.2	10.5	9.7	9.4	12.1	12.9	12.8
Pesos to dollar	2.9	3.1	3.1	3.1	3.1	3.1	3.1	3.2	3.1

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
(***) Value.
SOURCE: National Institute of Statistics and Census, Republic of Argentina (INDEC) and own calculations.

Industrial production stagnant because of drop in steel and chemical industry.

Activity for August was up by 5.9% year-on-year while industrial activity rose strongly to reach increases of 9.8% which point to a recovery in industry in coming months.

Inflation still at 8.6% with no help from food and oil while unemployment at 8.5%.

Inflation of 8.6% in September, high compared with the rest of the region, presents a persistent risk that could grow worse in view of world prices for food and oil and could hurt the competitiveness of exports, although the trade surplus remains stable. Food prices in Argentina rose by 12.3% and wholesale prices followed with growth of 13.7%. In turn, the unemployment rate in the second quarter dropped to 8.5% of the labour force, a level that is still high and not very much in keeping with current growth rates.

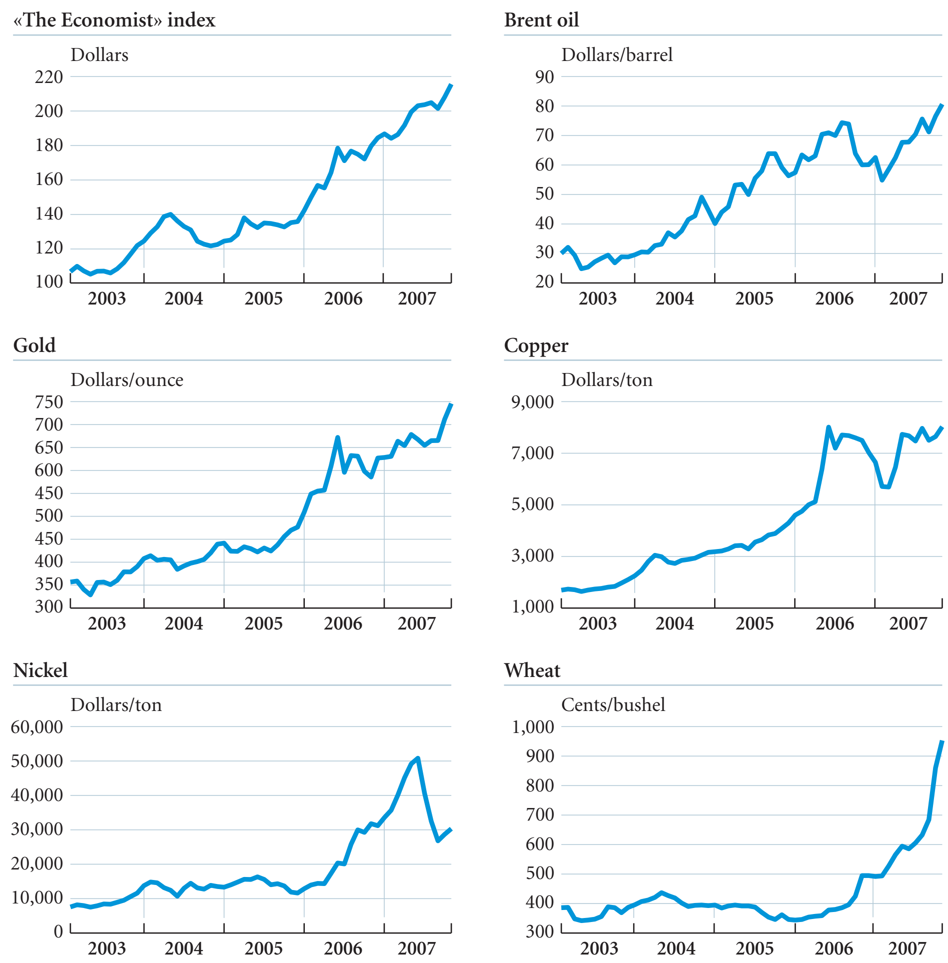
Raw materials: what's the limit?

In recent times, the trend in raw materials has been the subject of many headlines. In spite of the volatility that is a factor of these markets, the background trend has been upward although this move seems to have slowed at certain times in October.

During much of October raw materials markets were dominated by concern that strong demand in 2008 would not be met by a supply with many bottlenecks. This reading of the situation was added to by various episodes of a temporary nature such as, to give a significant example, the geo-strategic uncertainty being brought about by a hypothetical Turkish incursion into Northern Iraq. This upward move reached oil (which reported all-time highs above 89 dollars a barrel of Brent quality and 92 dollars for West Texas quality, both one-month forward) but also metals (with gold close to its highest price in nearly 30 years) and farm raw materials (with wheat at all-time highs and coffee at its highest levels since 1999).

Raw materials continue rally.

TREND IN VARIOUS RAW MATERIALS



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

RAW MATERIALS PRICES

	2005	2006	2006		2007					
			3Q	4Q	1Q	2Q	July	August	September	October
«The Economist» index in dollars (*)										
General	**3.4**	**27.5**	**30.5**	**33.2**	**21.8**	**17.7**	**15.9**	**15.2**	**20.9**	**20.1**
Food	–1.8	10.8	8.4	20.2	16.5	18.9	23.2	29.0	41.4	35.6
Industrials	9.8	46.1	55.5	46.5	26.9	17.0	10.1	4.4	4.7	7.3
Non-food agricultural	*–2.4*	*12.4*	*12.7*	*2.0*	*4.5*	*3.1*	*2.1*	*6.0*	*15.6*	*21.9*
Metals	*16.6*	*62.0*	*76.2*	*66.2*	*36.2*	*21.8*	*12.7*	*4.0*	*1.6*	*3.4*
«The Economist» index in euros (*)	**3.3**	**26.0**	**25.0**	**22.7**	**11.6**	**9.8**	**6.9**	**8.0**	**11.2**	**6.7**
Oil (**)										
Dollars/barrel	55.3	66.4	71.0	61.0	58.7	68.7	75.8	71.3	76.7	82.2
Change rate	45.5	20.1	14.3	5.6	–6.7	–2.6	1.7	–3.6	19.8	36.6
Gold										
Dollars/ounce	445.3	604.4	621.7	614.2	649.6	667.8	665.9	666.1	712.3	754.6
Change rate	8.7	35.7	41.3	26.4	17.2	6.4	5.2	5.4	19.0	28.7

NOTES: (*) Year-on-year change rate.
(**) Brent quality: one-month forward price.
SOURCE: «The Economist», Thomson Financial Datastream and own calculations.

What are the effects of fiscal policy?

One of the classical questions in economics, especially since the Great Depression of 1929, has been what should be the role of fiscal policy in order to stabilize the business cycle. There are two main instruments that the fiscal authorities of a country can use in order to stimulate economic activity, namely, government spending carried out and taxes collected. In this box, we look at which of the two instruments is most effective in increasing the growth rate of a country and stabilizing the business cycle. As we shall see, it is difficult to find a consensus, either at the theoretical or empirical level, on what tool to apply.

Let us imagine an economy that each year grows by a rate of 3%. Suddenly, for whatever reason, the growth rate slows down. What should the government do? Keynes would be quite clear. An increase in government spending stimulates the economy through what is known as the *multiplier effect.* When the government increases public spending, employment grows, either directly by hiring more workers or indirectly by buying or sub-contracting from suppliers. This additional job creation gives an additional boost to demand which in turn creates more employment. The final result is that an additional euro of public spending increases the gross domestic product (GDP) by more than one euro. Nevertheless, an increase in public spending can also have negative effects on growth so it is possible that, in practice, the multiplier is lower or even negative. An increase in spending is often associated with an increase in government debt and long-term interest rates such that private investment contracts. Furthermore, increases in public spending reduce private demand if the government offers public goods and services that replace private consumption. Finally, if public spending is increased, households may anticipate that they will have to pay higher taxes in the future and this may lead them to increase their savings and reduce private consumption in the present.

Because of these negative effects of government spending, things are also quite clear for less Keynesian economists who propose supply-side fiscal policies to stimulate growth. These policies include tax cuts which affect decisions on labour supply and household savings. Thus, they increase the supply of capital and labour in the economy and production increases. Furthermore, a reduction in taxes increases the spending capacity of the private sector by raising after-tax disposable incomes. A third way is to propose that the government acts only through the so-called *automatic stabilizers* of the economy. For example, if a country stands at a trough of the cycle, it is likely that the unemployment rate will increase and thus decrease revenues (through lower social security contributions and personal income tax) and that spending will increase (for example, on unemployment benefits). That is to say, it will incur an automatic deficit that will ease the business cycle.

Both those in favour of supply or demand policies often argue that these pay for themselves. By stimulating growth, these policies will increase tax collections and easily clear off the deficit. The biggest problem with the Keynesian approach seems to be that, in practice, temporary increases in public spending can become permanent. On the other hand, it is usually recognized that supply policies tend to increase income inequality.

In order to find out what is the aggregate effect of fiscal impulses it is important to quantify all these channels which operate in different directions. When we move to the empirical literature, the results vary greatly depending on the methodology used, given that there are various problems related to the measurement of the fiscal impulse. The first is the time sequence of the fiscal impulse. For example, it is not the same to have an increase in public spending that at the same time is accompanied by an increase in taxes than to have an increase in spending that takes place today, is financed through debt creation, and leaves the tax increase for the future. That is to say, it is not the same to have an increase in spending while maintaining the fiscal deficit constant than an increase in spending that raises the deficit and the government debt. The second problem is that it is difficult to distinguish pure increases in public spending from those arising from so-called automatic stabilizers. A third problem is the measurement of the effect of the various types of public spending, given that current spending does not have the same effect as investment or, in the case of the United States, spending going into military purposes and that going into civil purposes, for example.

The following table shows the effects, as estimated by various economists, of increasing public spending or reducing taxes. According to a study by Henry *et al* (2004), the multiplier effect is always higher for an increase in public spending than in the case of a reduction in taxes: an increase in government spending is more effective. A multiplier higher than one means that for each euro invested in public spending, the GDP goes up by more than one euro. In quantitative terms, we may see that in the United States fiscal policy has a stronger effect whereas in the United Kingdom the effect is weaker and in Spain it occupies an intermediate position. On the other hand, a study by Mountford and Uhlig (2005) using US data obtained very different results and suggests that the most powerful tools of fiscal policy are tax cuts, whereas an increase in spending scarcely has any effect and, furthermore, these effects become negative over the long term (not included in the table). This result is in line with the study carried out by David and Christina Romer, professors at the University of California at Berkeley, which suggests that a cut in taxes that reduces revenues by one percentage point of GDP raises the GDP by three percentage points.(1) Through this quick response in the GDP, a tax cut finances itself, given that by raising the GDP tax collections raise in the future.

To sum up, the debate about which fiscal tool to employ in order to increase growth and stabilize the economic cycle is not yet settled. There are various effects to bear in mind when the government increases spending or

(1) See Romer, C. and D. Romer, «The Macroeconomic Effects of Tax Changes: Estimates Based on a New Measure of Fiscal Shocks», NBER Working Paper No. 13264, Cambridge, MA, United States.

reduces taxes, with quite different end results. The differences between countries possibly reflect different initial conditions. For example, it is not the same to increase the deficit when the level of debt is low as when this is excessively high, given that in the latter case the increase in interest rates will be higher, thus depressing private demand. In the same way, it does not have the same effect to increase taxes when these are low as when the average tax rate of the economy is already high and has an important distortion effect. Because of this, the conditions in each country (for example, level of debt over GDP, income distribution and the various elasticities of the economy) must be carefully examined when it comes to deciding which instrument will be the most effective.

EFFECTS OF FISCAL POLICY: NO CLEAR EVIDENCE

		Multiplier			
		Spending		Taxes	
Study	Country	Effect	Horizon	Effect	Horizon
Henry, Hernández de Cos and Momigliano (2004)	Germany	1.2	1 year	0.6	1 year
		1.2	2 years	0.9	2 years
	Euro Area	1.1	1 year	0.3	1 year
		1.6	2 years	0.6	2 years
	United Kingdom	0.8	1 year	0.2	1 year
		0.5	2 years	0.3	2 years
	United States	1.9	1 year	1.0	1 year
		2.2	2 years	1.4	2 years
	Spain	1.2	1 year	0.5	1 year
		1.5	2 years	1.0	2 years
Mountford and Uhlig (2005)	United States	0.4	1 year	0.2	1 year
		0.2	3 years	3.2	3 years
De Castro and Hernández de Cos (2006)	Spain	1.3	1 year	–	–
		1.0	3 years	–	–

NOTES: The effects are normalized to make them comparable. The «Spending» column refers to an increase in public spending of 1 per cent of GDP. The «Taxes» column refers to a reduction in taxes that causes an initial drop in tax revenues equivalent to 1 per cent of GDP.

EUROPEAN UNION

Euro Area: fog on the horizon

Sometimes, analysis of the economic situation is criticized for suffering from the defect of what has popularly been called «driving while looking in the rear-view mirror». That is to say, given that the figures become known with some delay, any analysis suffers from not being up-to-date. This does not present any alarming problem when the road is clear, that is, when we are not close to a downturn in the cycle but it is even more troubling if there is growing uncertainty, as in the current situation. At this time, the main concern arises in knowing whether the effects of the sub-prime mortgage crisis (and, by extension, the adjustment taking place in construction and real estate in the United States) are going to sharply affect the Euro Area economy. For this reason, an effort is made here to combine both views, the current one arising from the latest figures and a more prospective analysis.

Current figures for Euro Area confirm slowdown continuing but moderate in degree.

So, what is «the rear-view mirror» telling us? The figures for the third quarter of 2007 support the analysis that economic activity in this period is recovering from the relative dip in the second quarter but is still not leaving the course of an economic slowdown. Due to a worse than expected performance in investment (especially in construction) and the stagnation in consumption, the slowdown in the second quarter will give way something of a reshuffle of economic activity.

In general terms, consumer indicators are maintaining a weak situation but, on the

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
GDP	1.6	2.9	2.9	3.3	3.2	2.5	–	...	–
Retail sales	1.2	2.1	2.4	2.3	1.7	1.0	1.5	1.0	...
Consumer confidence (*)	–14	–9.0	–8	–7	–5	–2	–2	–4	–5
Industrial production	1.3	4.0	4.1	4.0	3.9	2.7	3.9	4.4	...
Economic sentiment indicator (*)	97.9	106.9	108.2	109.9	110.0	111.6	111.0	109.9	107.1
Unemployment rate (**)	8.6	7.9	7.8	7.6	7.2	7.0	6.9	6.9	...
Consumer prices	2.2	2.2	2.1	1.8	1.9	1.9	1.8	1.7	2.1
Trade balance (***)	42.1	–10.4	–21.6	–13.1	–0.9	15.6	25.9	32.5	...
3-month Euribor interest rate	2.2	3.4	3.1	3.4	3.7	3.9	4.2	4.3	4.7
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.

Consumption remains in somewhat slack stage but investment may be reviving.

other hand, investment has partly taken off again. The figure for retail sale in August (increase of 1.0% year-on-year) is scarcely better than the average for the second quarter. In addition, consumer confidence was down by a couple of points in the third quarter. While maintenance of the unemployment rate at 6.9% in August could help improve the state of household spending, inflation, which went up to 2.1% year-on-year in September (from 1.7% in August) could work against this. Given that the increase in inflation was entirely due to the energy component and that, in view of the situation of oil prices, this heading is going to keep on rising in coming months, the reduction in real purchasing power of the consumer will be maintained.

In view of this complicated situation in consumption, a key indicator of gross fixed capital formation, the capital goods component of industrial production, in July and August jumped up to the growth range of 7% year-on-year, thus beating the average of 4.7% in the second quarter. On the supply side, the most notable factor is that industrial production grew by 4.4% year-on-year in August, adding to a rise of two percentage points compared with June, an unexpected upward move.

The latest focus of attention is the foreign sector. Its importance to date as a support of economic activity has been notable. Because of this the sharp appreciation of the euro was troubling. In terms of nominal effective exchange rate, the euro has been revalued by 2.2% year-on-year as of August. In spite of this loss of international competitiveness, exports to the Euro Area continue to show notable strength. In August, sales abroad were up 13% year-on-year, an excellent figure that consolidates the growth rate in previous months. In turn, the more moderate level of imports is allowing the trade surplus to continue to increase putting it at 32.5 billion euros in August as the cumulative figure for 12 months. One year earlier the situation

FOREIGN SECTOR AIDING GROWTH OF EURO AREA ECONOMY

Trade balance as cumulative figure for 12 months

SOURCE: Eurostat and own calculations.

was a trade deficit amounting to 21.9 billion euros.

This is the present picture but what is waiting ahead for us? To help us go from the current figures to the near future we have several routes. The first is to know what the analysts are thinking, including the international bodies. In this respect, both the latest report on economic prospects put out by the International Monetary Fund (IMF) and the quarterly growth forecast of the European Commission suggest that the second half of 2007 and the beginning of 2008 will show a gradual slowdown. The IMF, for example, predicts that this year the Euro Area will grow by 2.5% with 2.1% in 2008.

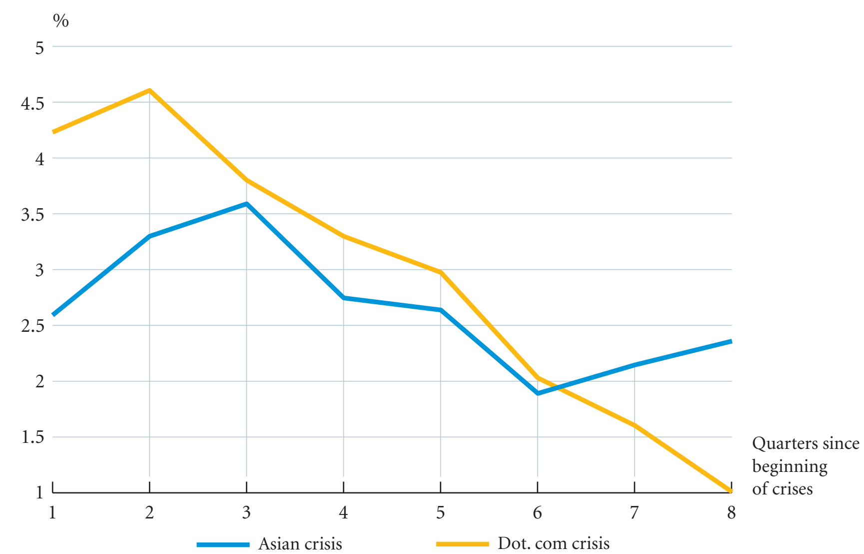
A second exercise offering clues to the future is a comparison of the current period of financial upsets with other similar events. In the IMF report mentioned above an analysis of this type is made. The results suggest that the impact in terms of growth (via an easing off in investment and consumption) may be relatively low. Comparing the four previous crises (the 1987 crack, the Russian bond crisis in 1998, the high-tech crisis in 2000 and the September 11 crisis in 2001) we note that only the bursting of the «dot-com» bubble in 2000 had any serious effect on economic activity in the United States or other industrialized countries. The type of crisis was a rapid slowdown of growth of some dimension followed by a rebound that was also rapid.

Finally, a third common option is to simulate the shock in a macroeconomic model. The European Union recently carried out a simulation of the effect on the Euro Area of a «rough landing» in the United States. The four ways in which a slowdown in the United States could have an impact in Europe are 1) the lower level of exports, 2) the drop in corporate profits of European multinationals operating in the United States, 3) the weakening of the «wealth effect» because of an adjustment on the stock market

Future troubling but experience suggests economic collapse unlikely.

GROWTH OF EURO AREA FOLLOWING TWO FINANCIAL CRISES

Year-on-year GDP growth in Euro Area during two years following outbreak of crises



SOURCE: Eurostat and own calculations.

Germany enjoying positive economic situation.

and 4) the drop in corporate and consumer confidence. Finally, supposing that the United States were to be growing at around one percentage point less in 2008 due to the financial crisis, the Euro Area would grow by approximately a half-point less. It should be pointed out that the European Commission exercise did not specifically analyze the sub-prime mortgage crisis but rather a general slowdown. Significantly, however, the review of prospects in July 2007 made by the IMF shows a decrease of 0.9 percentage points in its forecasts for the United States in 2008 and 0.4 percentage points for Europe. Finally, with the best knowledge available, the future horizon for Europe is an adjustment that, while relatively moderate, would not be insignificant.

Germany: mild Autumn, storm in the Spring?

Improvement in investment in capital goods and industrial activity notable features of third quarter.

Autumn in Germany began gently. With mild temperatures, the climate presented a metaphor for the state of the economy because today Germany is also enjoying benign economic times. While the figures refer to the end of Summer (equally gentle from a meteorological point of view), the only appreciable blemish in the German economic situation shows up in consumption which has still not taken off. The 2.0% year-on-year drop in retail sales followed by a dip of nearly three points in consumer confidence reminds us that household spending has failed to recover.

On the other hand, the upward trend in the capital goods component of industrial production as of August indicates that capital goods investment may be showing some recovery (this is not happening in construction which appears to still be slackening off). With regard to foreign demand, the good situation in exports is continuing. In August, exports grew by 12.5% year-on-year which, combined with the lower level of imports (year-on-year rise of 9.7%) meant that the German trade

INVESTMENT IN CAPITAL GOODS GETS GERMANY MOVING AGAIN

Year-on-year change in 3-month moving average of capital goods component of industrial production

SOURCE: Federal Statistics Office and own calculations.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
GDP	1.0	3.1	3.2	3.9	3.6	2.5	–	...	–
Retail sales	1.4	6.1	5.5	6.5	–1.0	–1.9	–0.9	–2.0	...
Industrial production	2.8	6.0	6.7	6.3	7.6	5.2	4.6	5.2	...
Industrial activity index (IFO) (*)	95.5	105.5	105.3	107.0	107.5	108.0	106.4	105.8	104.2
Unemployment rate (**)	11.7	10.8	10.6	10.1	9.4	9.2	9.0	8.9	8.8
Consumer prices	2.0	1.7	1.6	1.4	1.8	1.8	1.8	2.0	2.4
Trade balance (***)	156.3	153.1	148.3	158.1	168.4	179.8	188.1	191.4	...

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

surplus reached 191.4 billion euros as a cumulative balance for 12 months.

These good figures were repeated on the supply side. Industrial production rose in August going to 5.2% year-on-year, an unexpected upward move. While both the IFO index for industrial activity (down to 103.9 points in October) and industrial orders (slowdown of 2 percentage points in August, putting it at 5.1% year-on-year) suggest that industrial activity will show more moderate figures in coming months, this is undoubtedly a positive result.

With regard to other basic imbalances in the economy, we should point out that inflation in Germany has not escaped the effect of oil at all-time highs. The consumer price index (CPI) stood at 2.4% year-on-year in September (2.0% in August), mainly as a result of the contribution of energy. This upward move was repeated in other significant areas such as producer prices. The unemployment rate, in turn, was down one decimal in September to stand at 8.8% of the labour force.

All of these indicators remind us that the economic boom is continuing. The question is for how much longer? In this respect, the government has lowered its growth forecast for 2008 to 2.0% (until now it has been keeping to 2.4%). From the new macroeconomic table we may conclude that to some extent this revision has been due to the effects of the *sub-prime* mortgage financial storm.

Government lowers growth forecasts for 2008.

France: a «super-Gordian» knot

Unlike Alexander the Great and the Gordian Knot, the French government will have difficulty in opting for a dramatic solution to resolve all its economic problems at one blow. On the structural front, an attempt to partially reform pensions has come up against a broad strike of transport workers. In terms of the economic situation, the European boom is largely passing France by. The French government's solution has been to bet on fiscal expansion in budget estimates that try to guarantee growth of more than 2% in 2008. While it is certain that current spending is contained, the tax cuts approved last

France's 2008 budget generally expansionist giving priority to reviving economy at low ebb.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
GDP	1.7	2.2	2.1	2.1	1.9	1.3	–	...	–
Domestic consumption	3.2	2.7	2.8	2.8	3.5	2.7	4.4	3.6	...
Industrial production	0.2	0.9	0.5	0.6	1.0	0.4	3.3	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	1.5
Trade balance (**)	–1.3	–2.2	–2.3	–2.3	–2.3	–2.5	–2.6	–2.6	...

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

Strength of consumption still not enough to relaunch economic activity.

summer more than compensate for this effort. Because of this, the fiscal adjustment in terms of government deficit is minimal given that it would go from an imbalance of 2.4% of gross domestic product (GDP) in 2007 to one of 2.3% in 2008.

The need to give a boost to economic activity is not without sense if we look at the tottering trend in the second and third quarters. If we limit ourselves to the latest indicators, consumption is lacklustre, industrial production is slowing down and the improvement in the foreign sector is modest. While the first of these trends is not substantially different from that seen in other large economies of the Euro Area, the French economic situation certainly does stand outside the European pattern on two other fronts.

To be specific, the traditional support in recent years, household consumption, combines a temporary recovery up to August and a notable worsening of consumer confidence up to September. Taken together, both indicators clearly suggest that the driving force of this variable may be limited in the near future. In turn, the main supply indicator, industrial production, grew by 2.6% year-on-year in August. While this is not a poor figure, if we take into account the weak results over most of 2007, it represents something of a slowdown compared with the 3.3% in July. Finally, the improvement in exports (these rose by around 6% year-on-year in July and August) was compensated by the strength of imports so that the trade deficit has still failed to drop in recent months.

In this situation, the scarcity of inflationary pressures (the CPI grew by 1.5% year-on-year in September) and the drop in unemployment (with the rate at 8.0% in July) represent some relief in an unexpectedly dark economic picture given the context of growth in the European economy.

Italy: government finances under discussion

Clash between Italian government and Bank of Italy over efforts on fiscal consolidation.

The politicians are at cross purposes on the government deficit. The Minister of Economy, Tommaso Padoa-Schioppa, considers that regarding the budget estimates for 2008 now being debated (putting the government deficit at 2.2%

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
GDP	0.2	1.9	1.6	2.8	2.3	1.8	–	...	–
Retail sales	0.4	1.2	1.6	1.0	1.0	0.1	0.1	...	...
Industrial production	–0.8	2.6	1.6	3.7	1.2	0.6	0.7	1.4	...
Unemployment rate (*)	7.7	6.8	6.6	6.4	6.2	6.0	...	–	...
Consumer prices	1.9	2.1	2.2	1.8	1.7	1.6	1.6	1.6	1.7
Trade balance (**)	8.2	7.0	7.8	10.8	15.7	13.2	–12.7	–11.6	...

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

of GDP) it may be stated that the improvement is appreciable seeing that it is below the 2.4% forecast for 2007. However, Mario Draghi, governor of the Bank of Italy, does not agree.

In his view, the rate of adjustment was not good enough and its make-up erroneous. In its latest Monthly Bulletin, the Bank of Italy stated that failure to contain current spending was the problem in Italy's government finances. Probably, in view of the present situation in Italy, with its slim rate of economic activity and delicate political balances, there is little room for anything more ambitious.

Current figures support this analysis. On the demand side, growth of 0.1% year-on-year for retail sales (no change over the average for the second quarter) and maintenance of consumer confidence at the level of –19 points up to September confirm that household spending remains weak. Scarcely any better is the trend in supply indicators. Industrial production rose to 1.4% year-on-year in August (0.7% in July) thanks to a better state of exports but consolidating this trend is from the point of being considered a reality.

Certainly, inflation is behaving satisfactorily although the rise in September (to 1.7% year-on-year) is moderate compared with that showing up in other European countries. As a positive factor, we should also mention that the unemployment rate stood at 6.0% in the second quarter, the best figure in the 15 years these statistics have been recorded. If we had to highlight a key feature, however, it would be the gradual slowdown of economic activity that is best reflected in the fact that the economic sentiment indicator (which comes close to showing the general state of economic activity) dropped by four points in the third quarter.

Slowdown course to continue in coming months.

United Kingdom: growth gives positive surprise

Speculation about the extent of the economic slowdown in the United Kingdom has been swept away at one stroke. It simply has all gone. In the third quarter, when some slowing down was expected, GDP growth gave everyone a surprise with an increase of 3.3% year-on-year thus beating the already vigorous 3.1% figure in the second quarter. While we have no details of components, the

British growth in third quarter at 3.3% year-on-year shows surprising strength.

Household spending emerges as bastion of economic growth in United Kingdom.

indicators allow us to predict that household consumption was again the engine driving British growth.

The surprising strength of retail sales (these grew by 6.2% year-on-year in September and 5.1% in the third quarter as a whole, thus beating the 3.9% in the second quarter) shows that consumption still has drive. The rise in car registrations in the third quarter shows that the hypothetical tightening of credit is still not showing up in consumer pockets. While the future remains uncertain, some analysts are expecting that the improvement in wages will largely compensate for the tightening of credit.

Other monthly indicators confirm a scenario of notable economic activity. Particularly, the economic sentiment indicator has been moving upward for the past two months (August and September) largely due to the improvement taking place in the services component. Industry stands in a less expansionist stage (growth in August was only 0.7% year-on-year) but even on this front early indicators, such as industrial orders, suggest some improvement.

The trends in prices and the unemployment rate look especially favourable. With an image of annual highs above 3% still fixed in the retina, the CPI showed a moderate 1.7% year-on-year in September, thus consolidating the August figure. The path taken by the unemployment rate is equally positive with repetition of 2.6% of the labour force in September keeping it in the range of all-time lows.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
GDP	1.8	2.8	3.0	3.2	3.1	3.1	–	3.3	–
Retail sales	1.9	3.0	3.5	3.6	4.3	3.9	4.2	4.8	6.2
Industrial production	–2.0	0.0	0.5	0.9	–0.1	0.7	0.9	0.7	...
Unemployment rate (*)	2.7	2.9	3.0	2.9	2.8	2.7	2.7	2.6	2.6
Consumer prices	2.0	2.3	2.4	2.7	2.9	2.6	1.9	1.7	1.7
Trade balance (**)	–64.9	–74.1	–75.3	–77.0	–78.1	–80.0	–81.7	–81.9	–75.4
3-month Libor interest rate	4.6	5.1	4.8	5.1	5.3	5.6	6.0	6.0	6.7
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.

Five lessons from a decade of fiscal consolidation in Europe

In 1995, when the transition toward the Economic and Monetary Union became a fact, concern gripped many German citizens. Were they going to replace their esteemed *Deutschemark*, a bastion of macroeconomic stability, with the unborn euro, a currency to be shared with countries with a doubtful history of budgetary discipline, such as the so-called «Club Med» (Italy, Spain, Portugal and Greece)? In November of that year, Theo Waigel was promoting what was to become the Stability and Growth Pact, that is, a compromise that strengthened the struggle against the public deficit that then figured in the Treaty of Maastricht. The aim of the Pact was to reach a budgetary balance over the long term, incurring those countries failing to meet this in the risk of being sanctioned. Little more than a decade later, have the German fears shown themselves to be founded? Have the «Club Med» countries exhibited a troubling tendency to a lack of fiscal discipline? Are there some conclusions to be taken from all this on how to successfully carry out fiscal consolidation? Reflecting on these questions, we can draw five relevant lessons.

1. Budgetary discipline not exclusive to North

Between 1996 and 2006, the countries showing the best results in terms of budgetary adjustment were either Nordic (Finland, Denmark and Sweden) or Mediterranean (Spain and Greece, although the latter country is still in the red). All of these countries have improved their government balance by the equivalent of five percentage points of gross domestic product (GDP) or more. Germany, on the other hand, is showing budgetary consolidation of only 1.6 percentage points in terms of GDP. Certainly, Italy and Portugal are among the group of five European Union countries with a deficit of more than 3% of GDP in 2006. To make a just evaluation, however, we should point out that Spain's experience largely contradicts Waigel's presumptions. Spain improved its budgetary balance by 6.7 percentage points between 1996-2006, to show a surplus of 1.8% of GDP last year. If we add to this the fact that Germany was just one step away from being considered in a situation of excessive deficit in 2002, the irony becomes clear.

2. The usual suspect (the cycle) is innocent

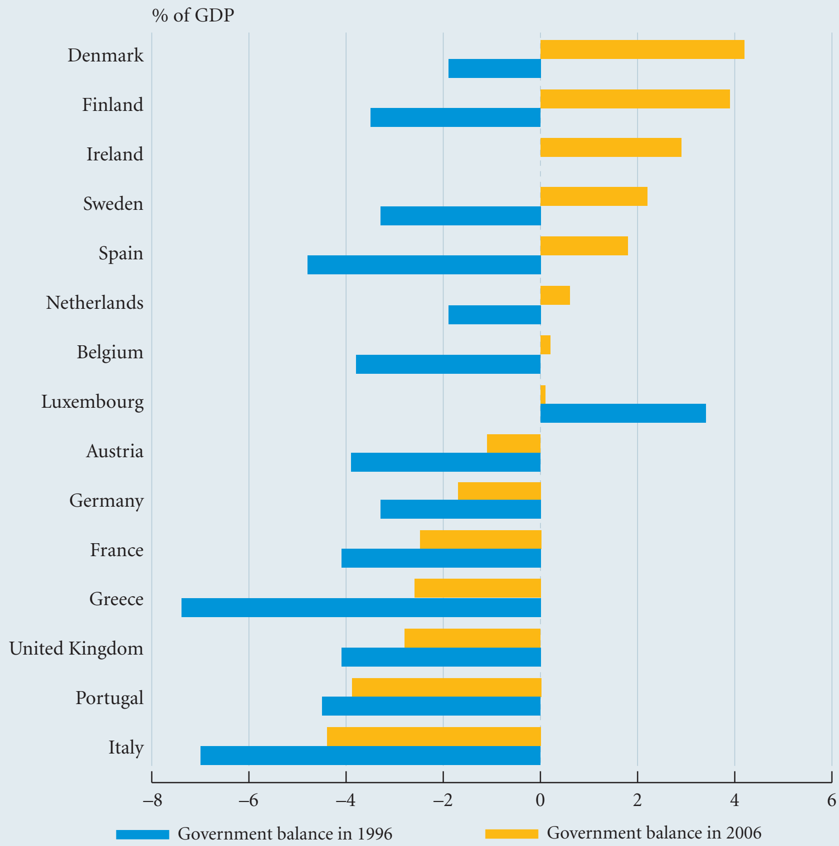
The usual recourse for justifying the slim results of the large economies in terms of budgetary consolidation is to bring up that their economic cycle has gone substantially against adjustment. The figures, however, continue to go against this justification. If we discount the effect of the cycle, an exercise carried out by the European Commission, the resulting government balance (usually called structural) has been sharply reduced in five countries, namely Denmark, Finland, Spain, Sweden and Belgium. That is to say, this practically coincides with those states that have made the biggest effort to bring about consolidation.

3. The worse, the better

The starting position, in terms of public deficits and surpluses carries a lot of weight. Those countries that in 1996 stood in a relatively worse situation in general have tended to record the biggest reductions in their imbalances. This result confirms the intuition, also confirmed in the economic literature, that the budgetary situation has to reach a certain point of seriousness before the political effort that must be made to promote fiscal adjustment can be justified.

FISCAL CONSOLIDATION GOING AHEAD IN EUROPE

Government balance in countries of European Union (EU-15)



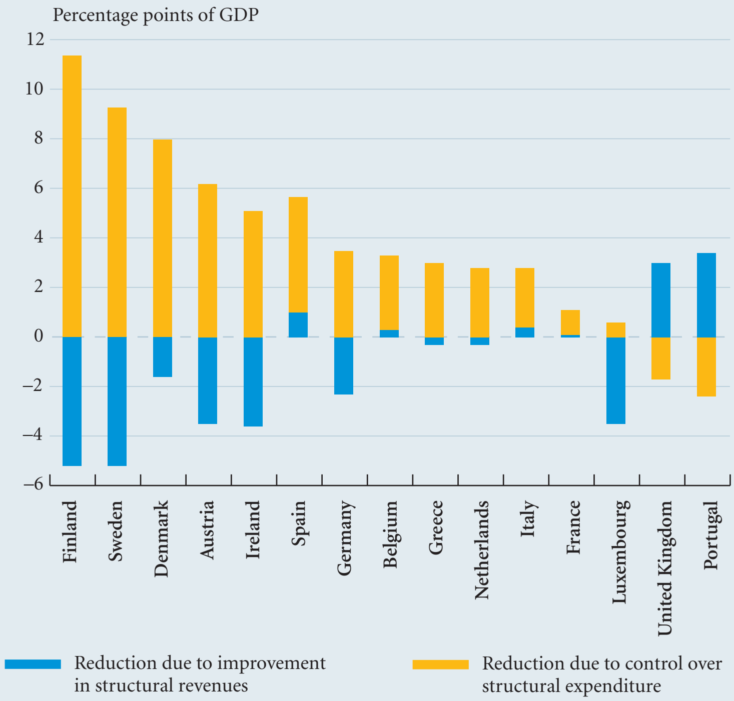
SOURCE: European Commission and own calculations.

4. Recipe for success: control over expenditure

The composition of the budgetary adjustment carried out is a fundamental variable in explaining the best results obtained in the area of budgetary consolidation. In general, we may consider that there are three main alternatives for reducing the government deficit, namely control over expenditure, increasing revenues or a combination of both. If we concentrate on the structural deficit (in order to directly evaluate the variable in the hands of governments) we find that the dominant strategy largely includes control over expenditure (see following graph). Out of the 23 countries in the European Union that have improved their structural balance in the past decade, only four (Malta, Cyprus, Portugal and United Kingdom) have opted for using the course of increasing revenues. Another eight, including Spain, have given priority to containing spending as a means of fiscal consolidation. Finally, the remaining 11 member states have combined both strategies.

CONTROL OVER SPENDING PREDOMINATES IN BIGGEST FISCAL CONSOLIDATION MOVES

Change in structural balance between 1996 and 2006 and contribution of revenues and spending to that change (*)



NOTES: (*) A positive sign indicates that the change in revenues or spending has contributed positively to improving the structural balance. On the other hand, a negative sign indicates a negative contribution to improvement of the structural balance.
SOURCE: European Commission and own calculations.

5. How to do it? See Spain

The case of Spain is illustrative of how to go about a strategy for controlling spending. While the figures available do not make it possible to refer to the improvement in structural deficit, it is worth analyzing the composition of Spain's fiscal adjustment. The improvement in the government balance was 72% due to the reduction of expenditure and 28% due to an increase in revenues. An important part of the reduction of expenditure was due to lower interest paid on the government debt, a result that was aided by the effect of the decrease in interest rates arising from the process of nominal convergence in the transition toward the euro. The second segment of the adjustment was current transfers, especially the reduction of unemployment payments and other social benefits. Significantly, the only spending heading to rise appreciably in the 1996-2006 period was public investment. With regard to tax revenues, the increase in these was carried out almost entirely through an increase in revenues from direct and indirect taxes, whereas social security contributions received during that period remained stable.

FINANCIAL MARKETS

Monetary and capital markets

Central banks faced with a dilemma

Federal Reserve fears lower growth while ECB wary of higher inflation.

On October 9, the Federal Reserve (the Fed) published the minutes of the meeting held on September 18 when it took the decision to lower the reference rate from 5.25% to 4.75%. The minutes reflect that a good part of the meeting was devoted to discussing the effect of the sub-prime mortgage crisis on growth. The members of the Fed reached two important conclusions: 1) inflationary pressures in the United States had moderated and did not represent any problem over the medium term and 2) the risk to the growth scenario had increased and had moved to the central point of the economic monitoring radar of the US central bankers.

Financial crisis stops ECB from raising official rate.

On the other hand, following the meeting on October 4, the governor of the European Central Bank (ECB) read his usual comments putting the accent on inflationary risks. For the ECB this was a major dilemma. On the one hand, due to the crisis of liquidity in the interbank market brought about by the sub-prime mortgage crisis in the United States, it should avoid raising interest rates in order not to make it worse. On the other hand, it had to keep inflation expectations of the economic agents secure. In order to meet this double challenge, the Governing Council took two important decisions. First, not to raise interest rates until it had more economic information giving it a clearer idea of the impact of the financial crisis. The second decision was to warn that inflationary risks had increased over the medium term and to remind people that the main objective of the ECB was price stability. In the end, the ECB is maintaining a delicate balance. It must avoid any increase in the risk premiums for future inflation while at the same time baling out, that is to say, injecting the necessary liquidity to stop the ship from capsizing.

Cracks in anti-inflation front show up among members of ECB in mid-October.

Nevertheless, at mid-month a split could be observed among ECB members on the question of inflation. Jean-Claude Trichet, the governor, Axel Weber, chairman of the Bundesbank and Klaus Liebscher, governor of the Central Bank of Austria emphasized the risk of inflation. In turn, the governors of the central banks of Belgium and the Netherlands, Guy Queden and Nout Wellink, respectively, put the accent on concern about growth in the Euro Area.

For the moment, it would seem that the statements by the ECB had their effect although only partly so. The table shows how the 3-month Euribor rate has dropped from 4.79% to 4.63%. Other short-term interest rates in Japan, Switzerland and United Kingdom also went down. But the decreases in the government bond interest rate in these countries hides a situation of flight to quality. International investors have reduced their positions in high-risk assets and have taken refuge in short-term government bonds with AAA rating, that is to say, free of credit risk. This may be seen clearly in the accompanying graph where it shows the

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages, as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2006									
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	4.27	4.79	4.73	4.75	5.23	1.03	5.75	6.30	2.73
October (1)	4.11	4.63	4.60	4.75	5.09	0.95	5.75	6.27	2.64

NOTES: (1) October 22.
(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.

differential in interest rates for interbank deposits and 3-month Treasury bills in the United States and the Euro Area.

Banks lend money among themselves in the interbank market. Naturally, lending money to another bank involves more risk than lending to the State by buying bonds it issues. It is evident that a country's government bonds with top credit-rating involve a lower risk seeing that states have the power to make collections through taxes, which private companies do not have. For this reason, in order to compensate the higher risk they demand a higher return. Under normal conditions in the Euro Area interbank market on the 3-month interest rate banks require a premium of 8 basis points above the yield offered by a Treasury bill (100 basis points equal 1%). In the United States, the differential is approximately 20 basis points, that is 0.2%. On the other hand, in order to obtain funds in both interbank markets, the other bank requirement is a differential of 0.7% above 3-month Treasury bills.

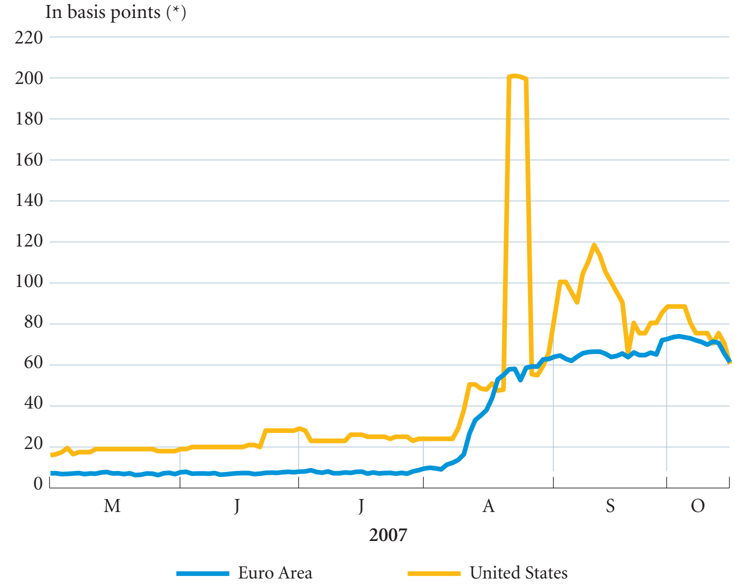
The message is very clear. Banks prefer not to lend money in the market unless the price compensates for the risk

In spite of central bank interventions, some pressures remain in interbank market.

Risk premium remains high in interbank market, reflecting lack of confidence still being felt.

RISK AVERSION STILL CONTINUES

3-month interest rate differential between interbank deposits/Treasury bills



NOTES: (*) 100 basis points = 1 percentage point.
SOURCE: Bloomberg.

created by the uncertainty about the sub-prime mortgage crisis. This situation reflects the lack of confidence currently existing in bank markets. The financial markets have still not normalized their situation although it is true that the interventions by the central banks have so far helped get over what up to now has been the worst moment of this crisis since it broke out at the beginning of summer.

Lower growth and lower long-term interest rates

Long-term interest rates turn downward reflecting lower growth prospects.

Interest rates on long-term government bonds have continued the downturn begun in June when the sub-prime mortgage crisis broke out, which is reflected in the price of financial assets. For example, after reaching 1.88% at the end of June in Japan, the interest rate on 10-year government bonds slid down to 1.59%. The Japanese case may readily be explained by the difficulty that country has in getting rid of deflation.

In the case of the United States, as may be seen in the following graph, the main reason was that investors were convinced that the economic slowdown that began at the beginning of the year was a fact. To the extent that inflation was seen as a problem under control and the capacity of the US economy to continue growing above potential was put in question, the return offered by a US long-term bond was seen as a good buying opportunity. The drop in returns on US long-term bonds was endorsed by the cut in the Federal Reserve reference rate in September.

In the case of Euro Area long-term government bonds, there was also the same downward trend but not as sharp due to the comments by the ECB about

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

10-year government bonds at end of period as annual percentage

	2005	2006	2007			
			March	June	September	October
United States	4.39	4.70	4.64	5.02	4.59	4.43
Japan	3.31	1.69	1.66	1.88	1.69	1.59
Euro Area	1.48	3.95	4.06	4.57	4.33	4.21
United Kingdom	4.10	4.74	4.97	5.46	5.01	4.90
Switzerland	1.97	2.52	2.75	3.23	3.01	2.94

SOURCE: Bloomberg.

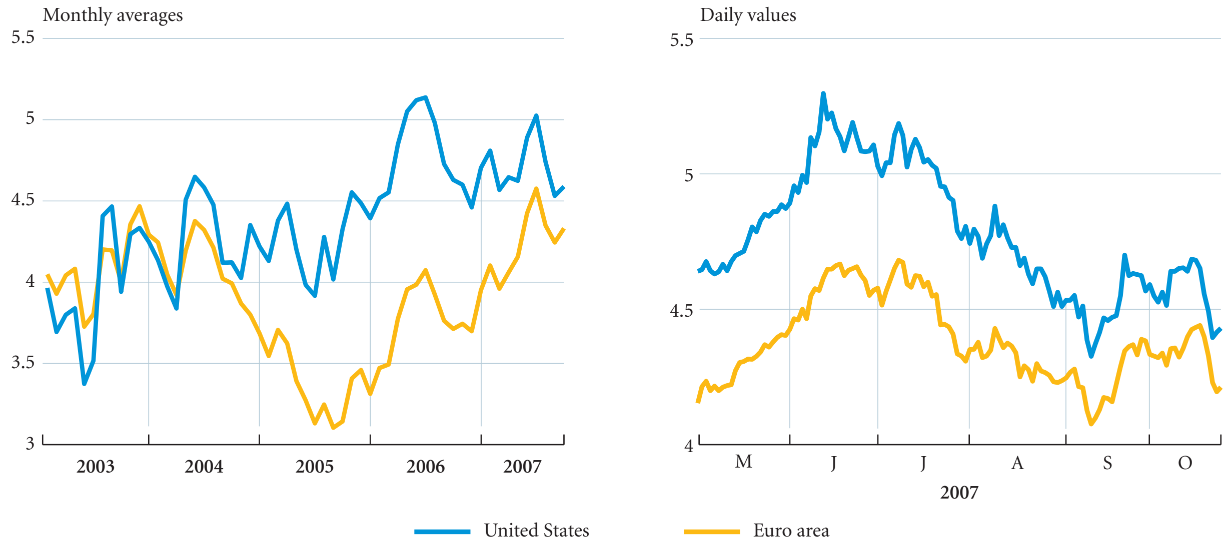
increased inflationary pressures over the medium term. The lower drop was very clear when we look at the differential in long-term interest rates between the United States and the Euro Area. Whereas at the end of June the US bond was showing a yield of more than 0.45%, by October it had gone down to only 0.22% ending up at half the gap between government bonds of both areas.

What are the prospects for the interest rate curves? In the case of the United States, the prospect of further cuts in the official interest rate should allow it to maintain a gradual downward trend over the next two months. Only in the case of a wild drop in the dollar exchange rate would this forecast be put in doubt. In the case of the Euro Area, the uncertainty is still greater. The ECB would probably like to continue raising rates but the financial crisis and the strength of the euro prevent this. In this context, and maintaining the inflation prospects stable, it is reasonable to expect some stability in interest rates from now to the end of the year. In the case of Japan,

Long-term interest rate differentials between United States and Euro Area narrowing.

LONG-TERM INTEREST RATES LEAVE RANGE OF HIGHS BEHIND

Yield on 10-year government bonds as annual percentage



SOURCE: Bloomberg.

Some stability in long-term interest rates expected in coming months.

long-term rates will stay at around the range of 1.6%-1.8% until there is a further rise in interest rates by the Japanese central bank. This is unlikely to happen in coming months and may have to wait until the end of the first quarter of 2008.

Does anyone know the value of the dollar?

Dollar continues downturn depreciating against main currencies.

October brought a continuation of the sharp volatility in foreign exchange markets. As may be seen in the following table, the US dollar has depreciated against the main currencies. What is notable is its depreciation against the Canadian dollar of 3.0% monthly which meant a drop of nearly 20% for the whole of this year. The dollar has also shown a notable drop against the Mexican peso of 1.2%. It should be pointed out that these are two of the most important trading partners of the United States.

The dollar has also dropped sharply against the euro. The European currency reached an all-time high of 1.43 dollars on October 22. At the meeting of the International Monetary Fund (IMF) and the World Bank in mid-October the lack of consensus about what measures to take to gradually correct the imbalances in the balance of payments increases the likelihood of some sharp movements in coming months. Following the meeting, the governor of the Central Bank of Canada, David Dodge, noted that it was at this time that the world needed the competence and ability of the IMF in order to avoid a worsening of the present crisis. Furthermore, he stated that a

EXCHANGE RATES OF MAIN CURRENCES

October 23, 2007

	Exchange rate	% change (*)		
		Monthly	Over December 2006	Annual
Against US dollar				
Japanese yen	114.3	–0.5	–4.2	–4.4
Pound sterling	0.491	–0.7	–3.8	–8.0
Swiss franc	1.175	0.2	–3.8	–7.8
Canadian dollar	0.973	–3.0	–19.8	–16.0
Mexican peso	10.820	–1.2	0.0	–0.3
Against euro				
US dollar	1.420	0.8	7.6	13.1
Japanese yen	162.3	0.3	3.3	8.3
Swiss franc	1.668	1.0	3.7	4.9
Pound sterling	0.698	0.1	3.5	4.1
Swedish krona	9.202	0.3	1.8	0.0
Danish krone	7.455	0.0	0.0	0.0
Polish zloty	3.656	–2.9	–4.6	–5.6
Czech crown	27.18	–1.4	–1.1	–4.1
Hungarian forint	251.8	0.6	0.2	–4.6

NOTES: (*) Plus sign indicates appreciation of dollar (first group) or euro (second group).
SOURCE: Bloomberg and own calculations.

WHERE IS THE LIMIT?

US dollars to euro

SOURCE: Bloomberg and own calculations.

continuation of the macroeconomic imbalances implied a very high risk. The IMF itself, through its head, Rodrigo de Rato, has warned of the risk of a sharp drop of the US dollar that might create doubts about the assets of that country among international investors.

Persistence of imbalances in balance of payments increases risk of sudden currency movements.

Another matter discussed at the annual meeting was the fact that the depreciation of the dollar is being absorbed disproportionately by the euro and the Canadian dollar while the Asian currencies, including the Chinese renminbi, are protected due to the intervention of their governments in defence of an exchange rate that allows them to maintain an excessive competitive advantage for the export of their products. This situation could hurt the growth expectations of both the Euro Area and Canada in 2008. The IMF called upon the various countries to put into place the necessary economic policies to reduce imbalances in the balance of payments and not to base these only on exchange rates to bring about the necessary adjustments.

IMF urges countries to apply economic policies to reduce imbalances.

What is remarkable is the movement of the Japanese yen which is an indicator of risk aversion in financial markets. The yen is one of those currencies used to finance the carry trade (operations involving borrowing in foreign currencies at low interest rates and investing simultaneously in high-yield currencies). When there is an increase in uncertainty about an easy resolution of the present crisis there is usually an appreciation of the Japanese currency and vice versa. The reason is that investors reduce borrowing obtained in yen to finance their buying which implies having to sell other currencies against the yen and this becomes stronger, so that at the moment it is a good barometer to monitor how fear among investors is increasing or diminishing. For the moment, it is holding at the same level as in August and September which would indicate that in October there has not been an increase in risk aversion.

Japanese yen is indicator of risk aversion in financial markets.

Crisis, what crisis?

World stock markets overcome summer dip...

...helped by central banks and absence of investment alternatives.

Following the drops on the stock market in summer, that in some cases went to 10%, there was a notably strong recovery in share markets. This was helped by moves by the central banks which have buoyed up the financial system through low interest rates and injections of funds in the interbank market. Their aim was to avoid a situation where the drop in the price of US sub-prime mortgage assets could spread to other markets. Among the main world stock exchanges, only the Nikkei and the Italian stock exchange show a negative cumulative change since the middle of the year. On the other hand, the other stock markets held at levels showing gains. For example, the Nasdaq hi-tech index has risen by 14% since January 1. Also notable was the German stock market with its most representative index, the DAX30, maintaining latent capital gains of 18.7%.

Furthermore, there are factors which explain the resistance of the stock exchanges during this period – the notable absence of alternatives for investment in other assets. For example, there is general agreement that this is not the moment to go into investments that are over-weighted with real estate assets. Prices of raw materials are at all-time highs and to go into these at this moment would be risky. What's more, high-risk bond assets, as for example assets with sub-prime mortgage security right now are treated like toxic radioactive wastes. This is to say that at this moment there exists the paradox that shares are a kind of haven asset. This somewhat shocking situation is well

INDICES OF MAIN WORLD STOCK EXCHANGES

October 23, 2007

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*13,567.0*	*–1.8*	*8.9*	*12.0*
Standard & Poor's	*1,506.3*	*–1.3*	*6.2*	*9.4*
Nasdaq	*2,753.9*	*3.1*	*14.0*	*16.9*
Tokyo	16,450.6	0.8	–4.5	–2.0
London	6,527.9	1.1	4.9	5.9
Euro Area	4,377.0	0.2	6.2	8.9
Frankfurt	*7,833.1*	*0.5*	*18.7*	*25.5*
Paris	*5,704.7*	*0.1*	*2.9*	*5.4*
Amsterdam	*546.7*	*0.4*	*10.4*	*11.0*
Milan	*39,470.0*	*–1.3*	*–4.7*	*0.2*
Madrid	*15,427.4*	*6.8*	*9.1*	*13.3*
Zurich	8,929.9	0.4	1.6	2.7
Hong Kong	29,376.9	13.7	47.1	62.4
Buenos Aires	2,234.7	5.3	6.9	31.3
São Paulo	61,215.1	5.9	37.6	56.1

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.

HAVE STOCK MARKETS OVERCOME DIP?

National stock market indices with base 1-1-2007=100

SOURCE: Bloomberg and own calculations.

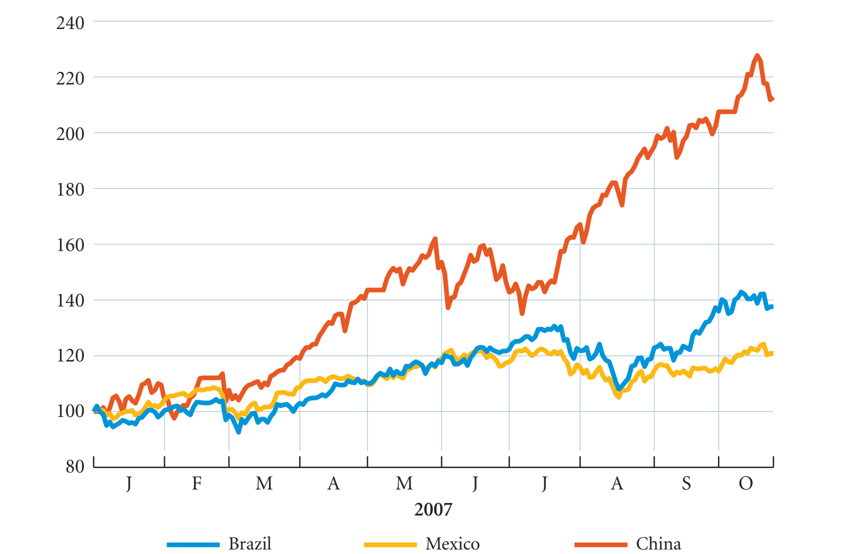
reflected in the performance of the stock markets in emerging countries.

Curiously, the best thing during the crisis is to have invested in emerging stock markets, such as China, Mexico and

Emerging country stock markets act as best asset haven.

WE HAVE NO PROBLEMS, WE'RE EMERGING

National stock market indices in dollars with base 1-1-2007=100



SOURCE: Bloomberg.

Brazil. While the stock markets in Mexico and Brazil rose by 21% and 38% respectively since January 1, the Shanghai stock market jumped by 112%. In the Chinese case, there are a number of reasons for this rise. The absence of a broad system of social welfare and developed loan markets obliges people to maintain a high savings rate in comparison with the developed countries. In addition, the central bank sets the exchange rate of the renminbi according to a basket of currencies, abandoning the autonomy of monetary policy. Precisely in order to avoid a sudden appreciation of its currency, it maintains interest rates low, even below inflation. This means that the Chinese saver has little incentive to invest in bank deposits which offer real interest rates that may be even negative, with the result that part of those savings are channelled into the national stock markets.

Fiscal policy rules: are they useful, implementable and credible?

Today the consensus among macroeconomists is that the application of a simple monetary policy rule, known as the *Taylor Rule*, makes it possible to reduce inflation to low levels and helps to stabilize the economic cycle. This rule proposes that the central bank should increase the policy rate when inflation is above a certain target or when growth of the gross domestic product (GDP) stands above potential. This simple rule of monetary policy has turned out to be enormously successful, and in practice comes reasonably close to the way central banks of the main industrialized economies operate. Is it possible to shift this experience to the management of fiscal policy?

One of the problems associated with fiscal policy is that most governments typically show a deficit bias, given that they have to satisfy pressure groups or lobbies that help ensure their re-election. Nevertheless, excessive spending over revenues leads to an increase in the public debt which sooner or later must be paid by future governments or generations, especially when the increase in public spending is not used to finance public investment which indeed can bring returns in the future. Therefore, imposing legal limits on the spending capacity of a government may be useful for eliminating this deficit bias. In any case, a fiscal policy rule should allow some margin for manoeuvre so that fiscal policy can contribute to stabilize the business cycle over the short term without putting the long-term solvency of the government at risk.

Fiscal rules at the international level vary in specific nature and preciseness. In the United States, to put an example of a rule that is not specific, any additional discretionary spending by the government has to be accompanied by measures to finance it. At the same time, a limit is set on the national debt which only Congress may modify (something that in practice has been done often). Other countries impose controls over some spending items in the budget (wages, for example), but they do not specify limits on the deficit. Experience shows that, in practice, requirements to control spending that are not very specific imply that they end up not being met.

Some other countries have taken control of the deficit somewhat more seriously by adopting formal rules. For example, the Stability and Growth Pact (SGP) of the member countries of the Euro Area stipulates that budget balance should be the goal to be reached under normal conditions. The SGP allows member states to carry out expansionary fiscal policies where necessary and sets the limit of 3% of GDP for the government deficit. The SGP also demands correction measures for those member states where they go over that limit and establishes sanctions if they violate it during the following two years. Spain's Budgetary Stability Law goes further than the Stability and Growth Pact and requires a surplus in the accounts of the General Government when real GDP growth stands above potential and allow slight deficits when the economy is slowing down. Under the current parameters, real potential growth is estimated at 3%. If expected growth stands between 2% and 3%, the accounts must be in balance and a deficit of up to 1% of GDP is permitted when expected growth stands below 2%.

The case of Spain joins the trend that is being followed internationally. In Chile, whose fiscal rules were approved in 2000, the government must present a fiscal surplus of 1% but it has some flexibility depending on the cyclical position of the economy and the price of copper. In the United Kingdom the budget must be in balance from a multi-year perspective covering a whole economic cycle. That is to say, the government may incur slight deficits in the downturn stage of the cycle on condition that these are compensated for in the upturn stage. Furthermore, the United Kingdom has incorporated a new condition, thanks to the previous Chancellor of the Exchequer and present UK prime minister, Gordon Brown, known as the «Golden Rule». This rule stipulates that it is possible to recur to deficit only to finance public investment but not public consumption. This implicitly recognizes that public investment has a future return which means it finances itself, at least in part. Furthermore, like Poland, the United Kingdom puts a limit on the public debt, in this case 40% of GDP. As may be seen in the table, most countries have adopted rules with a multi-year perspective with the aim of stabilizing or reducing the ratio of public debt to GDP.

FISCAL POLICY RULES NOW IN FASHION

Country	Deficit rule	Debt rule
Euro Area	Balanced budget in normal times. Cannot exceed 3% of GDP for 2 consecutive years	–
Chile	Surplus of 1% of GDP in normal times	–
Spain	Fiscal surplus in normal times, deficits up to 1% of GDP	–
New Zealand	Fiscal surplus on average	–
Poland	Cannot exceed 3% of GDP	60% of GDP
United Kingdom	Balanced budget over the business cycle, with «Golden Rule»	40% of GDP
Sweden	2% of GDP over the business cycle	–
Switzerland	Balanced budget over the business cycle	–

SOURCE: C. Wyplosz, 2005, Fiscal Policy: Institutions versus Rules, National Institute Economic Review, No. 191, and own calculations.

The establishment of fiscal stability requirements over the business cycle, rather than obliging a government to meet its fiscal objectives every year, was introduced in order to avoid fiscal policy from becoming excessively procyclical and thus accentuating economic fluctuations instead of smoothing them. Let us suppose that a country adopts a law that obliges it to present a balanced budget each year. If the country is growing above its potential, it is likely that its tax revenues will increase, obliging the country to spend that excess. On the other hand, if the country is going into a downturn of the cycle, it is likely that tax revenues will drop and thus oblige the government to cut public spending, which could worsen the recession. For this reason it is desirable to give flexibility to strict fiscal rules that set a numerical objective for the annual deficit and to make it mandatory to meet that objective from a multi-year perspective.

To sum up, it is necessary to also keep in mind the potential problems of credibility. The adoption of fiscal rules is very recent and comes at a time of an unprecedented economic boom in the past 30 years and these rules have not yet been tested in the face of a recession. Nevertheless, we now have a clear example in the case of France and Germany, which recently infringed the fiscal requirements of the Euro Area but have not been sanctioned. In the case of monetary policy, the government delegates the task of controlling inflation to the central bank, to which it grants independence in order to achieve its objective and also for which it makes it responsible. In the case of fiscal policy, it is not at all clear who should be penalized in the case of failure to meet the objective because the government would be both accuser and accused in the case. Furthermore, should this happen, the government could change the rules of the game allowing the excessive deficit if it considered it opportune.

Because of this potential problem of credibility, the economist Charles Wyplosz has suggested that, just as the central banks have their monetary policy committees independent of political pressure, fiscal policy committees should be set up that would be independent so that a fiscal rule would operate, especially when adherence to it becomes politically difficult. Such committees would decide the size of the pie and parliament would decide how it should be divided up. In this way, excessive spending by government would be avoided and, at the same time, fiscal policy could be used as a factor in stabilizing the cycle.

Economic activity

Economy maintains good state but signs of slowdown appearing

Spain's economy continues its strong growth although this is uneven. In general, consumer spending is up notably although in some segments, such as car sales, it shows a drop. Investment is growing at a good rate but with some signs of a slowdown. On the supply side, growth varies according to branch of production but overall is maintaining a good rhythm.

In any case, the accounts of non-financial companies reflect a good state of affairs, according to the quarterly survey carried out by the Bank of Spain. Companies continue to generate robust profits, forming the basis for growth of investment and employment. In the first half of 2007 gross value added created by non-financial companies, which is obtained by subtracting intermediate consumption from total value of production, rose by 6.8% compared with the same period last year.

In a generally strong situation in companies, however, we note some signs of a slowdown in certain sectors, such as construction, transport and communications and retail trade. These branches seem to have been affected by some drop in private consumption. On the other hand, industry is showing very strong.

Employment among non-financial companies rose substantially. Wages also

Companies continue to create robust profits forming basis for growth of investment and job creation.

PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES

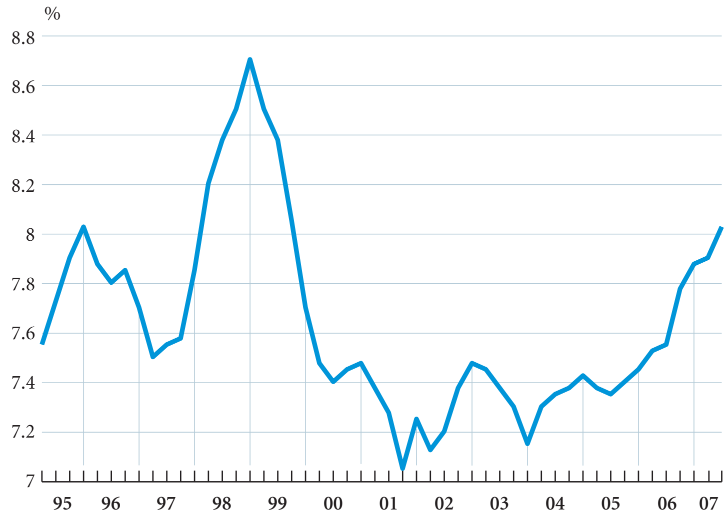
Annual change rates

	2006	First half-year	
		2006	2007
Value of production	10.6	14.1	4.9
Intermediate consumption	12.7	18.2	4.0
Gross value added (GVA)	**6.5**	**6.3**	**6.8**
Wage costs	5.1	5.1	4.8
Gross operating profit	**7.5**	**7.2**	**8.2**
Financial income	46.3	10.2	19.8
Financial costs	38.5	30.6	34.6
Depreciation and provisions	1.6	2.5	–0.8
Net ordinary profit	**16.3**	**4.8**	**8.8**
Capital gains and extraordinary income	52.5	32.4	–35.6
Capital losses and extraordinary costs	–26.8	–21.9	–21.6
Provisions and tax	65.3	141.9	–8.2
Net profit	**33.9**	**–3.2**	**2.7**

SOURCE: Bank of Spain (Central Balance Sheet Data Office Quarterly Survey).

COMPANIES OBTAINING NOTABLE RETURNS

Ordinary returns on net assets as moving average for four quarters



SOURCE: Bank of Spain and own calculations.

Companies creating jobs while wages increasing.

rose quite moderately. As a result, gross operating profit was up by 8.2% compared with the first half of 2006, one point more than one year earlier.

Financial income rose by an excellent 19.8%, largely thanks to dividends received from international investments of Spanish multinationals. Financial costs in turn rose by 34.6%. This sharp increase was due to the rise in interest rates but also to higher corporate borrowing as a result of the acquisition of companies, especially in the second half of last year. Furthermore, given the fact that depreciation and provisions were down by 0.8%, the net ordinary result rose by 8.8%, some 4 points more than in the first half of 2006.

To continue with the flood of corporate results, both capital gains and extraordinary income and capital losses and extraordinary costs were down compared with the first half of 2006 although this showed up to a greater degree in capital gains. As a result, the annual change rate in net profits dropped to 2.7% although this compares favourably with the drop of 3.2% seen in the first half of last year.

Return on equity goes up to 11.5%.

Ordinary return on net assets stood at a notable 8.0%, slightly above the historical average and 6 decimals higher than one year before. In turn, ordinary return on equity stood at 11.5%, some 9 decimals more than in the first half of 2006. Nevertheless, given the fact that financial costs rose in the past 12 months, the difference between ordinary return on net assets and financial costs held at 3.6 percentage points.

Returning to the current situation, early economic indicators appearing in the third quarter suggest the continuation of a gradual economic slowdown. Electrical power consumption in September rose by 2.3% compared with the same month last year, a rate that was lower than the 4.2% reported in the second quarter. The 9.7% year-on-year decrease in the number of businesses set up in August also suggests a loss of economic drive.

DEMAND INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
Consumption									
Production of consumer goods (*)	0.9	2.3	1.9	4.3	4.8	2.1	1.1	0.6	...
Imports of consumer goods (**)	7.9	8.9	2.4	7.6	–1.1	5.6	15.0	5.7	...
Car registrations	2.1	–0.9	–4.1	1.8	–0.7	–2.4	0.0	–2.7	–7.7
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	7.6	2.8	...
Imports of capital goods (**)	20.4	3.2	6.5	3.4	20.1	11.0	0.6	–6.2	...
Commercial vehicle registrations	13.2	1.5	0.5	–1.0	1.7	–2.2	4.2	–4.6	–10.8
Foreign trade (**)									
Non-energy imports	6.0	9.0	8.9	9.3	6.4	7.7	13.8	4.3	...
Exports	0.2	5.6	1.7	4.7	3.0	2.8	10.6	6.0	...

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

Substantial drop in car sales as result of rise in interest rates.

Production of consumer goods also shows a slowdown although the latest figures for imports of consumer goods show a notably strong level. On the other hand, the durable goods segment is also showing weak because of cars, with a drop in sales because of the rise in interest rates. In fact, car registrations were slow in the last months of summer showing a year-on-year drop of 7.7% in September. Certain early indicators present some incongruence. The retail trade confidence index showed a sharp drop in September whereas order books for consumer goods improved in the August-September period. Consumption will therefore likely continue to ease although still remaining quite lively.

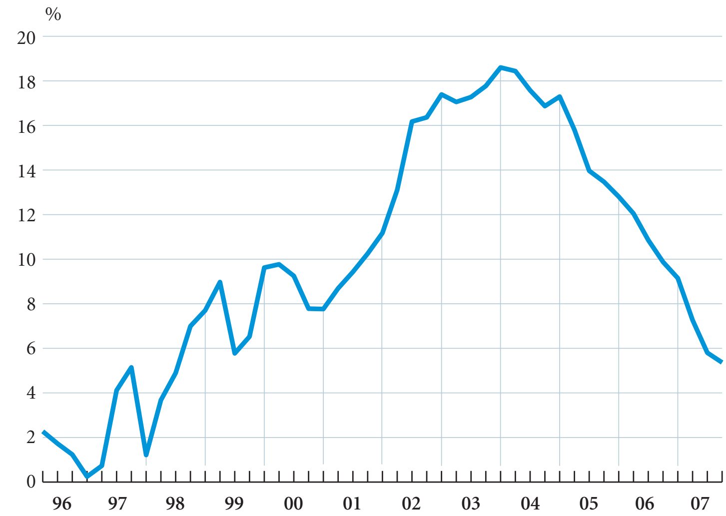
Signs of slowdown in investment, especially in construction.

Investment is also showing signs of running a slowdown course. Cement consumption, an early indicator of construction investment, has continued to drop going to a change rate of 5.6% in September. Production of capital goods rose by 2.8% in August compared with the same month last year, a rate lower than that reported in recent months. At the same time, registrations of commercial vehicles were down by 10.8% in September.

On the supply side, industry showed an increase that was insufficient to compensate for the slowdown in construction. The industrial production index lost strength going to year-on-year growth of 0.6% in August. Figures for business volume in industry rose by 4.5% in August compared with the same month last year, thus showing some moderation. Some recent early indicators for industry are not overly good. New orders in industry rose by only 1% in August while confidence expressed by companies in the sector failed to improve in September, although they held at a level above that reported in 2006.

HOUSING PRICES CONTINUE TO EASE

Year-on-year change in price per square metre for non-subsidized housing



SOURCE: Ministry of Housing and own calculations.

Industry hesitant and construction slowing down although still showing background strength.

The level of construction activity is high, although the real estate market continues to slow down. Proof of this is the easing of housing prices. In any case, the price of non-subsidized housing per square metre rose by 5.3% in the third quarter compared with the same period last year, as against a year-on-year change rate of 9.8% one year earlier. Nevertheless, the confidence index in construction stood at a comfortable level in September.

Tourist season mediocre.

With regard to services, air passenger traffic is showing notable growth although the profile indicates some moderation. On the other hand, the number of passengers coming in low-cost airlines keeps growing, noting annual growth of 41.4% in September. Consumption of motor diesel fuel, another indicator of the transport sector, rose by 7.1% in July compared with the same month last year, the highest rate in recent months.

Latest figures for the tourist sector seem to confirm the modest results this season. Overnight stays in hotels in September grew by only 1.1% over the same month last year. Hotel income was up 3.5% in the same month compared with September last year. The number of foreign tourists showed a year-on-year increase of 1.8% in the final month of the third quarter.

International Monetary Fund reduces 2008 economic growth forecast.

To sum up, the growth rate of the economy is notable but somewhat troubling are the risks arising from the upsets in international financial markets as a result of the sub-prime mortgage crisis in the United States and the slowdown in the real estate market. In this respect, the recent forecasts by the International Monetary Fund have reduced growth foreseen for Spain's economy in 2008 from 3.4% to 2.7%. The loss of drive in Spain's main export markets and the slowdown in domestic demand are behind this reduction.

SUPPLY INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	July	August	September
Industry									
Electricity consumption (1)	3.5	3.8	6.0	3.7	5.0	4.2	1.3	1.5	2.3
Industrial production index (2)	0.7	3.9	4.2	4.6	4.2	2.4	0.9	0.6	...
Confidence indicator for industry (3)	–4.8	–2.7	–2.3	–0.3	2.3	1.2	0.0	–1.0	–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	5.7	...
Construction									
Cement consumption	7.3	8.5	5.7	8.5	5.5	–2.1	3.7	–2.7	–5.6
Confidence indicator for construction (3)	22.4	14.2	14.7	15.0	10.7	15.7	15.0	6.0	15.0
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	1.8
Tourist revenue inflows	6.0	5.6	4.9	3.1	5.8	2.0	2.6	...	...
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	6.8	4.7	7.1	9.5	7.1	11.4	10.4	9.6
Motor vehicle diesel fuel consumption	5.1	5.4	3.9	4.9	5.8	3.3	7.1	...	...

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.

Labour market

Labour market losing drive

Employment growing by more than 3% year-on-year.

The labour market continues to create new jobs at a good rate, although there are signs of some loss of drive. In the third quarter of 2007, employment grew by 3.1% compared with the same period last year, 3 decimals less than in the previous quarter, according to figures from the Labour Force Survey. This figures is in agreement with the moderate slowdown suggested by other indicators for the labour market.

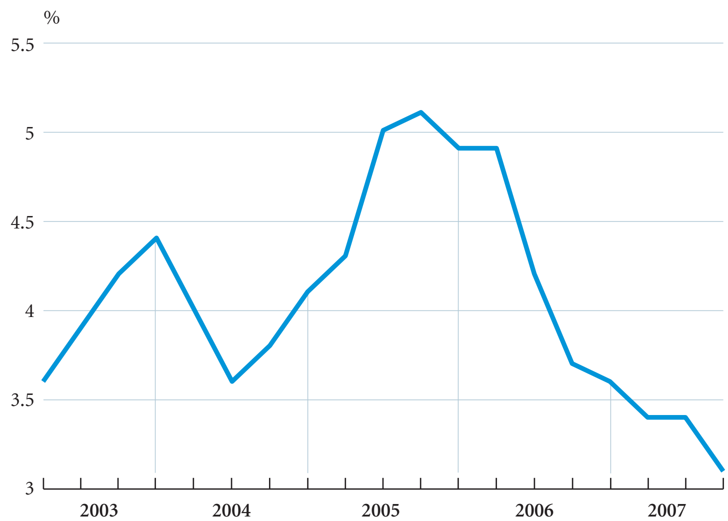
Most job creation concentrated in services.

In the 12 months ending in September some 615,000 net jobs were created putting the total at 20,510,600, a new all-time high, according to the Survey. Most of this job creation was in services which increased that sector's total number of persons employed by 544,500 over the past year, showing an annual change of 4.2%. Construction raised the total number employed by 127,400, an annual increase of 4.9% which, however, meant a sharp easing off. Industry reduced employment slightly over the past 12 months although at a lower rate than previously. Finally, the farm sector continued to lose workers.

The trend in employment in industry reflects the pressure being put on the industrial branches by foreign competition which in many cases results in relocation. Manufacture of office machinery and data-processing equipment has lost 55.8% of its jobs over the past 12 months.

JOB CREATION EASING OFF

Year-on-year change rate in persons employed



SOURCE: National Institute of Statistics.

ESTIMATED EMPLOYMENT

Third quarter 2007

	No. of employees (thousands)	Quarterly change		Cumulative change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	885.3	–35.6	–3.9	–36.5	–4.0	–27.7	–3.0	4.3
Non-farm	19,625.2	179.0	0.9	545.2	2.9	642.6	3.4	95.7
Industry	*3,258.9*	*15.1*	*0.5*	*–60.9*	*–1.8*	*–29.2*	*–0.9*	*15.9*
Construction	*2,717.5*	*3.7*	*0.1*	*94.3*	*3.6*	*127.4*	*4.9*	*13.2*
Services	*13,648.8*	*160.1*	*1.2*	*511.8*	*3.9*	*544.5*	*4.2*	*66.5*
By type of employer								
Private sector	17,578.7	86.1	0.5	484.9	2.8	586.7	3.5	85.7
Public sector	2,931.9	57.2	2.0	23.9	0.8	28.3	1.0	14.3
By work situation								
Wage-earners	16,869.8	90.4	0.5	403.7	2.5	503.9	3.1	82.2
Permanent contract	*11,481.2*	*45.7*	*0.4*	*583.8*	*5.4*	*776.7*	*7.3*	*56.0*
Temporary contract	*5,388.6*	*44.7*	*0.8*	*–180.1*	*–3.2*	*–272.8*	*–4.8*	*26.3*
Non-wage-earners	3,633.1	54.4	1.5	108.9	3.1	116.2	3.3	17.7
Entrepreneurs with employees	*1,141.7*	*32.0*	*2.9*	*53.9*	*5.0*	*47.3*	*4.3*	*5.6*
Entrepreneurs without employees	*2,286.3*	*40.1*	*1.8*	*90.9*	*4.1*	*119.0*	*5.5*	*11.1*
Family help	*205.2*	*–17.6*	*–7.9*	*–35.8*	*–14.9*	*–50.1*	*–19.6*	*1.0*
Other	7.7	–1.6	–16.7	–3.8	–33.0	–5.1	–39.8	0.0
By time worked								
Full-time	18,233.8	306.6	1.7	605.6	3.4	591.4	3.4	88.9
Part-time	2,276.8	–163.4	–6.7	–96.8	–4.1	23.5	1.0	11.1
By sex								
Males	12,089.6	81.9	0.7	258.3	2.2	230.2	1.9	58.9
Females	8,421.0	61.3	0.7	250.5	3.1	384.8	4.8	41.1
TOTAL	**20,510.6**	**143.3**	**0.7**	**508.8**	**2.5**	**615.0**	**3.1**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

Less drastic but still significant were the drops in employment in clothing (18.2%), the textile sector (17.8%), paper (13.9%) and the mining industries (11.4%). Nevertheless, other manufacturing branches, such as the chemical industry (15.6%), manufacture of electronic equipment (11.3%), recycling (7.3%), machine building and mechanical equipment (6.0%) and food (5.2%), substantially increased employment levels.

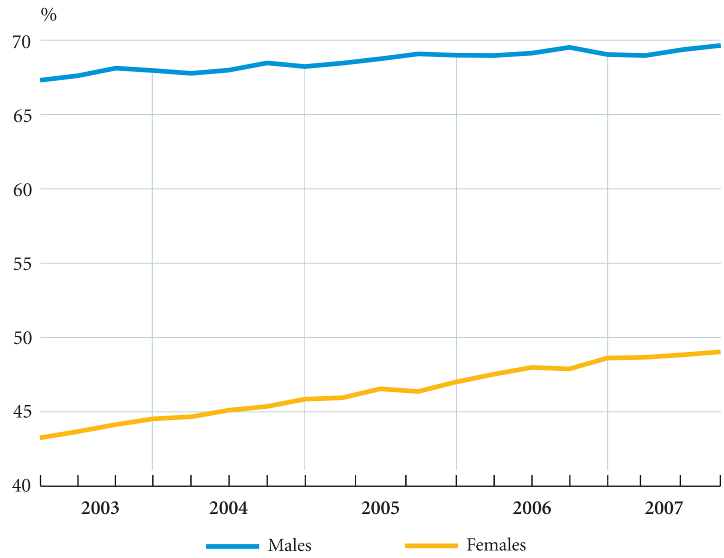
In the services branches, some showed notable drive in job creation as, for example, financial institutions, with a year-on-year increase of 7.9%, and health services, reporting a year-on-year increase of 5.8%. Services to companies showed an increase of 8.2% in employment in the past twelve months although with a downward trend. Within this wide-ranging group the trend was quite uneven. While data-processing activities increased employment by

Sharp slowdown in job creation in construction.

Some industry branches, such as chemicals, showing very strong increase in jobs.

RATE FOR FEMALES IN LABOUR FORCE HITS ALL-TIME HIGH

Percentage of labour force over total populations 16 years or older



SOURCE: National Institute of Statistics.

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Third quarter 2007

	In work force			Employed			Unemployed			Unemployment rate (%)
	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	
Andalusia	3,693	130	3.7	3,228	112	3.6	464	18	4.1	12.6
Aragon	653	37	6.1	621	37	6.4	32	0	0.0	4.9
Asturias	476	6	1.2	442	17	4.1	34	–12	–25.4	7.2
Balearic Islands	562	7	1.2	537	8	1.6	25	–2	–5.4	4.4
Canary Islands	1,021	14	1.3	911	24	2.6	110	–10	–8.4	10.7
Cantabria	277	7	2.7	261	9	3.6	15	–2	–10.4	5.6
Castile-Leon	1,171	21	1.8	1,089	25	2.4	82	–4	–4.6	7.0
Castile-La Mancha	923	40	4.6	858	53	6.6	65	–13	–16.7	7.0
Catalonia	3,781	108	3.0	3,525	82	2.4	256	26	11.5	6.8
Valencian Community	2,444	96	4.1	2,231	77	3.6	213	19	9.6	8.7
Extremadura	477	20	4.4	418	13	3.2	59	7	13.8	12.4
Galicia	1,303	18	1.4	1,215	24	2.0	88	–6	–6.4	6.7
Madrid Community	3,268	104	3.3	3,072	100	3.4	196	4	1.8	6.0
Murcia	689	44	6.8	633	38	6.4	57	6	11.6	8.2
Navarre	303	–1	–0.3	290	0	0.1	13	–1	–838.0	4.4
Basque Country	1,053	–11	–1.0	989	–5	–0.5	64	–5	–7.9	6.1
La Rioja	153	–1	–0.3	144	0	0.2	8	–1	–8.4	5.3
Ceuta and Melilla	58	1	2.1	46	–1	–2.9	11	3	29.5	19.8
TOTAL	**22,303**	**642**	**3.0**	**20,511**	**615**	**3.1**	**1,792**	**27**	**1.5**	**8.0**

SOURCE: National Institute of Statistics and internal figures.

ESTIMATED UNEMPLOYMENT

Third quarter 2007

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	800.9	20.3	2.6	40.7	5.3	44.7	6.2
Females	991.0	11.6	1.2	–13.8	–1.4	55.3	10.5
By age							
Under 25 years	458.0	15.8	3.6	24.8	5.7	25.6	21.3
Other	1,333.9	16.2	1.2	2.0	0.2	74.4	6.6
By personal situation							
Long-term unemployment	461.8	–34.7	–7.0	–59.2	–11.4	25.8	–
Seeking first job	210.1	–1.2	–0.6	–0.6	–0.3	11.7	–
Other	1,120.0	67.9	6.5	86.6	8.4	62.5	–
TOTAL	**1,791.9**	**31.9**	**1.8**	**26.8**	**1.5**	**100.0**	**8.0**

SOURCE: National Institute of Statistics and own calculations.

16.0% over the past year, real estate activities reduced employment by 0.1%. Retail trade and the hotel/restaurant business showed much strength in job creation with annual rates of 5.7% and 3.9% respectively. On the other hand, transport and communications reported a drop of 0.6% in employment.

The number of wage employees was up by 3.1%, in line with the total for those employed. The overall rate for persons on wages was down by one decimal to 82.25%. Employees with permanent hiring contracts rose by 7.3% in the past 12 months thanks to the special tax benefits which ended in December 2006. Those employees with temporary hiring contracts dropped by 4.8% in the past year. Nevertheless, the temporary job status rate rose by one decimal in the last quarter going to 31.9%. Self-employed workers rose slightly more than the total in the last 12 months, namely 3.3%. Among these workers, the number of those employing workers rose by 4.3% while those business operators with no employees rose by 7.0%.

Number of employers up more than 4%.

Foreign workers filled more than half the jobs created in the last 12 months, specifically 53.4%. As a result, the number of those employed having foreign nationality rose to 13.9% of the total in the third quarter. In construction, the share of foreign workers rose to 24.5%. In agriculture it was 18.0% of workers and 12.6% in services. In industry, they represent 9.1% which, nevertheless, is higher than the 7.0% reported in the first quarter of 2005.

The good situation in the labour market continues to attract new workers into the labour force, that is to say, those employed or actively seeking work. The number of workers in the labour force rose by 0.8% compared with the second quarter and 3.0% over the past 12 months. The rate for those in the labour force compared with the total population over 16 years of age rose by 2 decimals going to 59.1%. In the third quarter the male rate of involvement in the labour force rose by 3 decimals to 69.6% while the female rate rose by 2 decimals to 49.0%, thus hitting a new all-time high.

Foreign workers fill more than half of new jobs.

Unemployment rate of foreign workers up 9 decimals in past year.

As the population in the labour force rose slightly more than employment in the quarter, the unemployment rate rose slightly to 8.0%, going close to the low level in the second quarter and just one decimal below the third quarter last year. The number of unemployed estimated by the Labour Force Survey in the third quarter was 1,791,900. In the past 12 months, the number of unemployed rose by 1.5% although the trend by sex was uneven. While unemployed males rose by 5.3%, the number of females unemployed dropped by 1.4%. Nevertheless, the male unemployment rate (6.2%) was substantially below the female rate at 10.5%. On the other hand, unemployment among foreign workers was 11.8%, some 2 decimals less than in the previous quarter but 9 decimals more than one year earlier.

Unemployment rate increases.

From a geographical point of view, the slowdown in job creation was not across the board. Asturias, Castile-La Mancha, Valencian Community and Madrid Community showed higher year-on-year change rates than in the second quarter. Employment growth rates by autonomous community for the past year were also notably different. Whereas in Castile-La Mancha the rate rose by 6.6%, in the Basque Country it dropped by 0.5%.

Registered unemployment slightly worse in September

On the other hand, the number of unemployed registered at public employment offices hit 2,017,363 persons. While a drop of 10,933 persons was reported compared with the end of August, there was an increase of 51,197 compared with September 2006, amounting to 2.6% in relative terms, the highest rate since May 2004. As a result, the figures for registered unemployment have continued to worsen in recent months. It is worth noting that in February the year-on-year change rate was still showing a drop.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

September 2007

	No. of unemployed	Change over December 2006		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	65,158	3,664	6.0	3,638	5.9	3.2
Industry	269,917	–12,231	–4.3	–7,359	–2.7	13.4
Construction	238,892	2,121	0.9	23,247	10.8	11.8
Services	1,221,460	–3,409	–0.3	28,158	2.4	60.5
First job	221,936	4,345	2.0	3,513	1.6	11.0
By sex						
Males	787,351	–16,923	–2.1	34,604	4.6	39.0
Females	1,230,012	11,413	0.9	16,593	1.4	61.0
By age						
Under 25 years	234,419	–7,593	–3.1	–4,291	–1.8	11.6
All other ages	1,782,944	2,083	0.1	55,488	3.2	88.4
TOTAL	**2,017,363**	**–5,510**	**–0.3**	**51,197**	**2.6**	**100.0**

SOURCE: INEM and own calculations.

Prices

Oil and foods put CPI at annual high

As expected, the downward trend in the consumer price index (CPI) that started in mid-2006 was halted in September with a half-point rise putting it at 2.7%. This meant that the low for the past three and a half years reported in August, thanks to the favourable performance in oil prices, was left far behind. In any case, the annual change rate for consumer prices stood two decimals lower than in September last year. Underlying inflation, which shows the trend in inflation by excluding the most volatile factors, was also up but much less so seeing that it went to 2.6%.

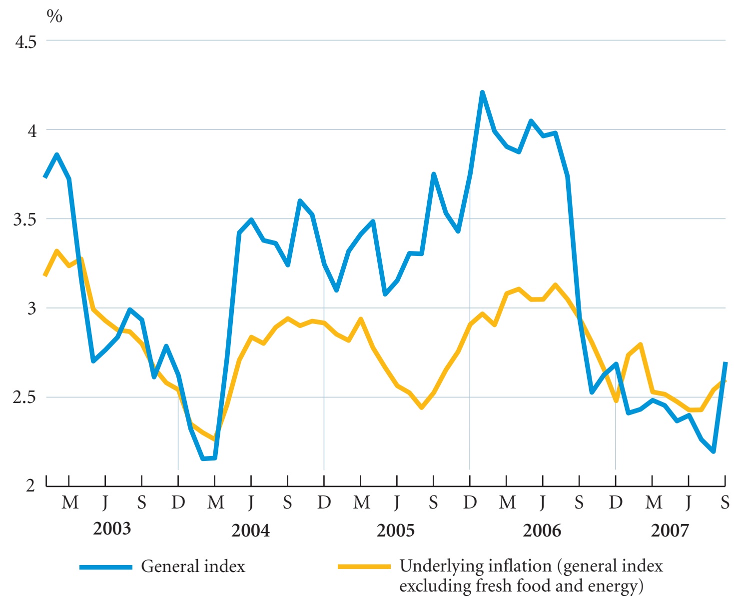
Once more, fuels were the key factor. In fact, as the decrease in the year-on-year change rate for fuels and lubricants went from 4.2% in August to 3.1% in September, it brought about an increase of four decimals in the corresponding general CPI rate, which would explain most of the rise in September. This was due to the trend in crude oil prices which, after showing an all-time high at the beginning of August 2006, tended downwards to again record new all-time highs in September 2007. The appreciation of the euro only partially compensated for this effect on fuel prices.

CPI goes up half-point to 2.7% in September due to fuels and processed foods.

Basic foods (bread, poultry and milk) more expensive but potatoes up only 1.5% in past 12 months.

CPI AGAIN GOES ABOVE UNDERLYING INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

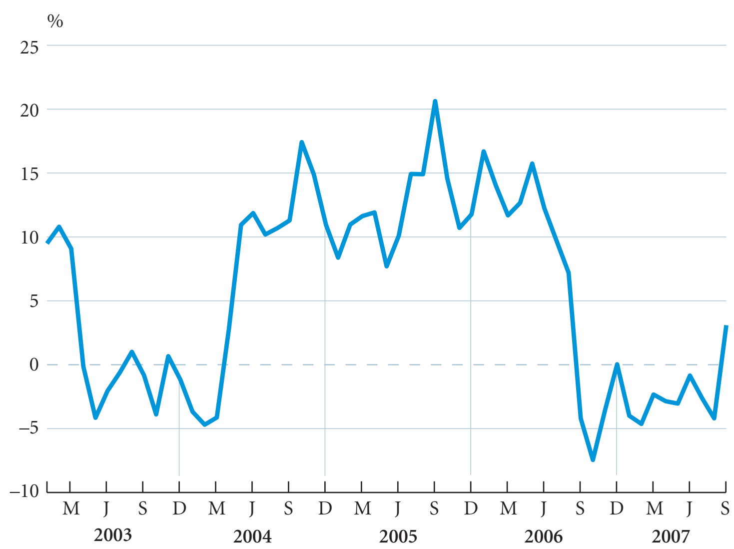
	2006			2007		
	% monthly change	% change over December 2005	% annual change	% monthly change	% change over December 2006	% annual change
January	–0.4	–0.4	4.2	–0.7	–0.7	2.4
February	0.0	–0.4	4.0	0.1	–0.6	2.4
March	0.7	0.3	3.9	0.8	0.1	2.5
April	1.4	1.8	3.9	1.4	1.5	2.4
May	0.4	2.1	4.0	0.3	1.8	2.3
June	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	0.3	1.7	2.7
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.

Processed foods also contributed to the rise of the CPI in September of slightly more than one decimal. Notable in this group was the monthly rise in milk (6.4%) which raised the annual change rate to 11.4%, as may be seen in the accompanying graph. In this way, what has been passed on to the consumer is the increase in prices on international markets because of lower supply brought about adverse weather conditions in the main producer markets, along with

FUELS CAUSE SHARP CPI RISE IN SEPTEMBER

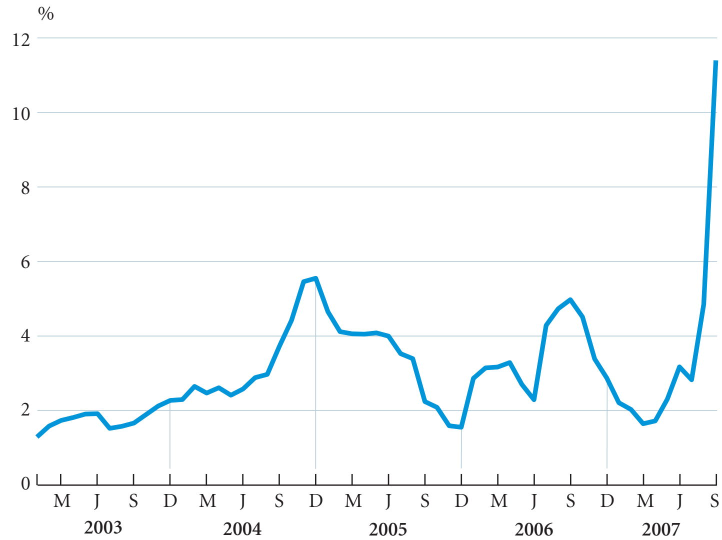
Year-on-year change in prices of fuels and lubricants



SOURCE: National Institute of Statistics.

SHARP RISE IN MILK PRICES

Year-on-year change in milk prices



SOURCE: National Institute of Statistics.

increased demand in emerging markets, among other factors.

Other processed foods, such as bread, and some other unprocessed foods, such as poultry, were also up appreciably in price, reflecting the increase in cereal prices in world raw materials markets. The price of bread continued to rise to the point where it showed a year-on-year change rate of 8.1% and poultry went up 11.3%. As a result, many basic foods have seen notables increases in recent months, although there are exceptions. Potatoes, for example, have risen by only 1.5% in the past year while mutton dropped by 7.6% year-on-year.

Non-energy industrial goods continued to moderate, thanks to sharp pressures from international competition and the appreciation of the euro. On the whole, prices of these products rose by only 0.4% in the past 12 months, reporting the lowest level in recent years.

Low level inflation in non-energy industrial goods.

Services also showed a more moderate price increases. The annual change rate was down by two decimals to 3.7%. The main drive behind this was tourism and the hotel trade with the annual change rate showing a drop of two decimals putting it at 4.3%. Under this heading we should point out that organized tours reported a bigger drop than in September 2006 so that prices of these services were down 0.8% compared with 12 months earlier.

What are the future prospects on inflation? Continuation of the upward course in crude oil prices to new all-time highs in October and pressures on farm raw materials would suggest that the upward course in the CPI will stay for some months yet. The downward trend in consumption and the strength of the single European currency will likely only partially counteract this trend. As a result, the CPI change rate could go above 3% before the end of the year.

Rise in CPI to continue in coming months going above 3%.

CONSUMER PRICE INDEX BY COMPONENT GROUP

September

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2006	2007	2006	2007	2006	2007
By type of spending							
Food and non-alcoholic beverages	104.2	0.3	0.9	2.5	2.8	4.6	3.4
Alcoholic beverages and tobacco	107.1	0.1	0.0	0.7	5.6	1.1	6.4
Clothing and footwear	97.2	3.5	3.5	–8.9	–9.2	1.2	1.0
Housing	104.0	–0.1	0.0	5.1	3.4	5.8	3.2
Furnishings and household equipment	102.8	0.3	0.3	1.6	1.5	2.7	2.5
Health	98.1	0.0	0.0	1.4	–2.5	1.4	–2.2
Transport	102.8	–2.3	0.3	3.7	4.5	0.2	2.6
Communications	100.3	0.0	0.0	–0.8	1.1	–1.1	0.4
Recreation and culture	99.6	–1.6	–1.7	–0.1	–0.6	0.3	–1.0
Education	104.4	0.8	0.7	1.2	1.3	4.0	4.5
Restaurants and hotels	105.9	–0.7	–0.9	4.1	4.6	4.4	4.9
Other goods and services	103.5	0.2	0.1	3.4	2.6	4.0	3.0
By group							
Processed food, beverages and tobacco	104.0	0.1	0.9	2.0	3.5	3.5	3.7
Unprocessed food	105.7	0.6	0.7	2.8	2.3	5.6	4.0
Non-food products	102.3	–0.3	0.2	1.5	1.3	2.5	2.3
Industrial goods	100.2	–0.2	0.9	–0.1	–0.7	1.2	1.0
Energy products	*102.6*	*–3.8*	*0.6*	*6.7*	*6.4*	*0.9*	*2.3*
Fuels and oils	*102.4*	*–5.0*	*0.7*	*7.2*	*7.6*	*–0.4*	*2.1*
Industrial goods excluding energy products	*99.4*	*1.1*	*1.0*	*–2.3*	*–3.0*	*1.3*	*0.4*
Services	104.5	–0.4	–0.6	3.3	3.3	3.9	3.7
Underlying inflation (**)	102.6	0.2	0.3	1.0	1.1	2.9	2.6
GENERAL INDEX	**102.9**	**–0.2**	**0.3**	**1.7**	**1.7**	**2.9**	**2.7**

NOTES: (*) Base 2006 = 100.
(**) General index excluding energy products and unprocessed food.
SOURCE: National Institute of Statistics.

Inflation differential with EMU goes up slightly to 0.6 points.

In addition, the inflation rate in terms harmonized with the European Union also stood at 2.7% in September. As a result, the inflation differential with the Euro Area rose slightly to 0.6 points.

Rise in producer prices in September

Producer prices report highest year-on-year inflation rate in 2007.

As was foreseeable, September saw inflation in producer prices leaving behind the downward trend that had taken it to its lowest level since March 2004. In fact, the general producer price index recorded an annual change of 3.4% in September, some 1.1 points more than the month before. The rise in September was mainly due to increases in energy prices and farm prices, thus reflecting pressures in international raw materials markets.

The year-on-year inflation rate for producer prices stood at an annual high.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2006											
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	9.7	–
November	0.8	3.6	2.4	2.5	6.8	1.0	2.5	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	8.2	–
2007											
January	–6.7	2.7	1.4	2.9	6.3	–1.1	0.4	0.6	–0.2	7.2	–
February	–6.3	2.5	1.4	2.9	6.7	–2.5	0.1	0.4	–0.3	7.4	3.4
March	1.5	2.8	1.7	3.3	6.3	–1.6	0.3	0.4	–0.2	6.7	–
April	6.7	2.7	2.2	3.1	6.5	–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	5.7	3.2
June	2.6	2.6	1.8	3.1	5.8	–1.4	1.2	1.0	0.1	5.9	–
July	2.5	2.3	1.9	3.1	5.6	–2.6	0.7	1.0	0.0	4.1	–
August	...	2.3	2.4	3.1	5.4	–2.9	0.7	1.5	0.3	3.9	...
September	...	3.4	3.2	3.2	5.3	0.8	...	...	...	...	–

NOTES: (*) Figures adjusted for seasonal and calendar effects.
SOURCE: National Institute of Statistics, Ministry of Economy and own calculations.

Livestock prices at origin show rise.

Prices of energy products went from an annual drop of 2.9% in August to a rise of 0.8% in September as a result of the renewed increase in oil. The rise in inflation in consumer goods was concentrated in non-durable products. The food and drink industry was up from 3.7% to 5.9% annual. On the other hand, manufacture of office machinery and data-processing equipment showed a 2.6% drop in prices compared with September 2006, thanks to increased productivity. In turn, intermediate goods continued to ease slightly, reflecting the drop in metal prices although they showed the highest year-on-year inflation rate at 5.3%.

On the other hand, figures for prices paid to farmers as of July were already showing increases under the heading of livestock products. In turn, import prices in August were contained by the strength of the euro and discipline arising from world competition.

Foreign sector

Growth of trade deficit slows largely due to lower contribution from energy balance.

Trade deficit moderating growth rate

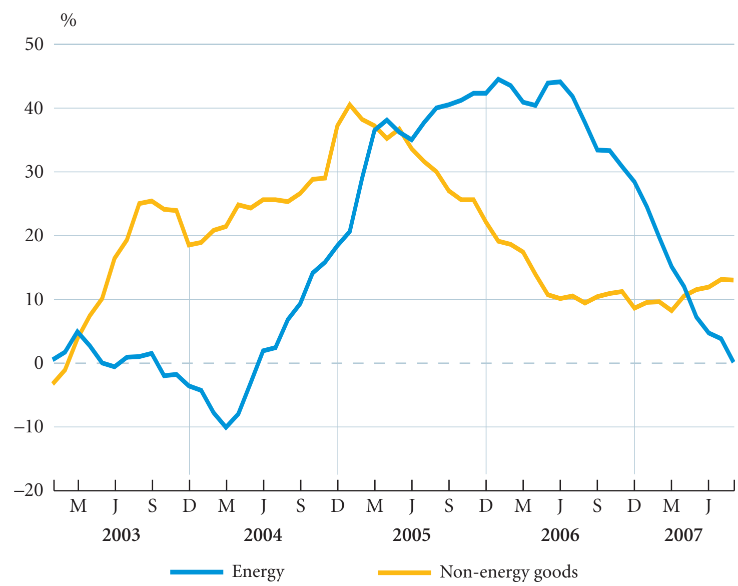
In the first eight months of 2007, both exports and imports of goods have grown by 7.4% in nominal terms. The trade deficit rose to nearly 62.7 billion euros showing growth of 7.2% year-on-year, which confirms the moderate course it has recently followed. Nevertheless, the performance mentioned was entirely due to lower growth of energy products. If these are ignored, we note that growth of the deficit due to all other components rather tended to rise in recent months, as may be noted in the following graph.

In fact, the problem of the imbalance in trade hanging over Spain's economy is far from resolved. The trade balance has not stopped growing in recent years to the point where in August the cumulative negative balance was twice that recorded in the same period in 2003. In 2006, the deficit (as measured by Customs) rose to 9.1% of gross domestic product (GDP), a percentage that could become higher this year.

The increase in Spain's trade deficit in recent years arises for several reasons. The sharp increase in imports due to the strong rise in national demand is certainly one of those reasons. The continuing erosion of the competitiveness of Spain's economy is another factor to take into account. According to the Bank of Spain, in the

GROWTH OF NON-ENERGY TRADE DEFICIT TENDING TO RISE

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



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

FOREIGN TRADE

January-August 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	26,330	–5.3	14.5	4,853	–6.8	4.1	–21,477	18.4
Consumer goods	50,035	6.3	27.5	42,922	5.1	36.0	–7,112	85.8
Food	*10,068*	*9.7*	*5.5*	*13,786*	*5.1*	*11.6*	*3,718*	*136.9*
Non-foods	*39,967*	*5.1*	*22.0*	*29,137*	*0.7*	*24.5*	*–10,830*	*72.9*
Capital goods	18,835	8.1	10.4	10,877	–1.7	9.1	–7,958	57.7
Non-energy intermediate goods	86,603	12.4	47.6	60,453	12.4	50.8	–26,151	69.8
By geographical area								
European Union EU-25	107,288	7.6	59.0	84,017	7.1	70.5	–23,271	78.3
Euro area	*89,649*	*8.1*	*49.3*	*67,318*	*8.1*	*56.5*	*–22,331*	*75.1*
Other countries	74,515	7.0	41.0	35,088	8.1	29.5	–39,427	47.1
Russia	*5,351*	*6.1*	*2.9*	*1,278*	*40.7*	*1.1*	*–4,074*	*23.9*
United States	*6,365*	*12.5*	*3.5*	*5,098*	*2.3*	*4.3*	*–1,267*	*80.1*
Japan	*4,075*	*7.6*	*2.2*	*897*	*4.8*	*0.8*	*–3,178*	*22.0*
Latin America	*9,480*	*1.6*	*5.2*	*6,828*	*0.3*	*5.7*	*–2,653*	*72.0*
OPEC	*13,840*	*–7.2*	*7.6*	*3,319*	*12.8*	*2.8*	*–10,521*	*24.0*
Rest	*35,403*	*14.5*	*19.5*	*17,669*	*10.8*	*14.8*	*–17,735*	*49.9*
TOTAL	**181,803**	**7.4**	**100.0**	**119,105**	**7.4**	**100.0**	**–62,698**	**65.5**

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

past five years (between 2001 and 2006) unit labour costs in Spain have grown by 13.9%, practically twice that for the Euro Area and nearly three times more than for the OECD countries as a whole.

Discounting the effect of price increases, real growth of imports in the first eight months of the year was 6.9% year-on-year, higher than that for exports (4.1%). We should point out the sharp growth in imports of capital goods in that period (11.1% real) although latterly this has been losing drive. Purchases of food consumer goods also recorded sharp growth in those eight months (8.8% by volume), in contrast to more moderate growth in other consumer goods (2.9%).

Growth of imports in real terms still higher than for exports.

With regard to exports, non-energy intermediate goods showed the greatest strength with 7.3% real growth in those eight months compared with the same period last year. On the other hand, there were bigger drops in foreign sales of non-food consumer goods (up 0.6% real in the period under consideration) and of capital goods (down 1.5%).

By geographical area, we should point out that nominal growth of imports from the European Union (7.6% year-on-year from January to August) was higher than for purchases from other countries (7.0%). On the other hand, growth of exports to other countries (8.1%) stood above that reported for sales to the European Union (7.1%).

Exports to third countries growing more than those going to European Union.

Finally, we should underline the strong increase in exports to Russia (40.7%) and the OPEC countries (12.8%).

Rising deficits in incomes and transfers balances

Current account deficit continues to increase...

In the first seven months of 2007, the current account deficit rose to nearly 60.08 billion euros, 20.9% more than in the same period last year. In absolute terms, the deficit keeps getting bigger. In fact, the cumulative negative balance for the last 12 months was above 95 billion euros, twice that at the beginning of 2005, with a growing share of the GDP. This rose from 8.6% in 2006 to come close to 9.5% in 2007.

The trade deficit is the factor with the biggest weight in the current account deficit (nearly 90%) although its contribution to the growth of that imbalance is progressively decreasing. In fact, growth of the cumulative trade deficit in the past 12 months dropped to 10.6% year-on-year in July, practically half that for one year earlier, with the exceptions noted above.

On the other hand, the contributions from the incomes deficit and the transfers deficit keep on growing. In the last 12 months, the incomes deficit rose by nearly 7 billion euros compared with one year earlier while that for transfers rose by 3.17 billion euros. These figures represent around 60% of the total

BALANCE OF PAYMENTS

July 2007

	Cumulative for year		Last 12 months		
				Annual change	
	Million euros	% annual change	Million euros	Absolute	%
Current account balance					
Trade balance	–48,500	8.2	–83,830	–8,034	10.6
Services					
Tourism	*15,366*	*0.7*	*27,546*	*166*	*0.6*
Other services	*–3,375*	*–4.6*	*–5,141*	*366*	*–6.7*
Total	11,991	2.2	22,406	532	2.4
Income	–17,911	44.8	–26,529	–6,996	35.8
Transfers	–5,661	32.9	–7,154	–3,167	79.4
Total	**–60,082**	**20.9**	**–95,107**	**–17,664**	**22.8**
Capital account	**2,309**	**–7.9**	**5,976**	**–404**	**–6.3**
Financial balance					
Direct investment	–26,432	–36.3	–40,458	1,491	–3.6
Portfolio investment	107,643	–27.2	158,139	–7,034	–4.3
Other investment	–2,870	–92.3	–933	21,327	–95.8
Total	**78,341**	**13.8**	**116,748**	**15,785**	**15.6**
Errors and omissions	934	–	1,277	6,956	–
Change in assets of Bank of Spain	–21,502	16.8	–28,895	–4,673	19.3

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

increase shown by the current account deficit in the period under consideration.

At the same time, the surplus in services (which is quite stagnant) now has much less of a compensatory effect than it used to have in past years.

With regard to financial flows, we should point out that, if we exclude the Bank of Spain, these represented a positive balance of 78.34 billion euros in the January-July period. This surplus was created by net inflows for portfolio investments which were much higher than net outflows recorded for other instruments.

...largely due to growth of negative figures in incomes balance and transfers balance.

Public sector

Sharp growth of direct tax collections

Increase in central government non-financial revenues goes 6.7 percentage points above nominal GDP.

The strong growth rate of the economy is having a favourable effect on the public accounts. In the first nine months of the year, central government non-financial revenues were up by 13.8% compared with the same period in 2006, if we include those revenues ceded to autonomous communities and local governments under the current financing system. As a result, inflows to the central government coffers grew at a rate 6.7 percentage points above nominal gross national product (GDP).

Growth of total wages and corporate profits boosts direct tax collections with tax reforms showing little impact.

Collections for direct taxes were up 22.0% compared with the January-September period last year. The main heading was personal income tax with an increase of 16.4%. Playing a part in this sharp increase was a rise of 38.8% in taxable income for 2006. Hold-backs for wages rose by 9.7% which reflects the increase in wages and the limited impact of the personal income tax reforms that came into force in January 2007. Hold-backs on capital earnings, capital gains in investment funds and leasing were up 41.9% due to the increase in capital returns, along with the rise in the hold-back rate from 15% to 18% at the beginning of the year.

Revenues from corporate tax were up by 31.8%. Collections on taxable income for the year 2006 were 34.2% higher than those for the year before. First

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

September 2007

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**11,869**	**9.9**	**111,523**	**11.9**
Non-financial revenue adjusted (*)				
Personal income tax	6,694	13.0	52,608	16.4
Corporate tax	640	17.4	29,372	31.8
VAT	5,366	12.0	41,625	1.9
Special taxes	1,753	6.3	14,764	7.2
Other	1,786	–0.9	14,645	18.4
Total	**16,239**	**10.4**	**153,014**	**13.8**
Non-financial spending	**8,928**	**5.4**	**101,354**	**9.3**
Treasury balance	**2,941**	**26.0**	**10,169**	**47.1**
Surplus (+) or deficit (–) (**)	***515***	***–17.1***	***12,857***	***20.0***

NOTES: (*) Includes tax segments ceded to regional and local governments under current financing system.
(**) In terms of National Accounting.
SOURCE: Ministry of Economy and Finance and own calculations.

partial payments for 2007 were up by 17.6% because of the good state of corporate profits but what also shows up is the modest change in this tax as of January.

Indirect taxes, on the other hand, rose by only 3.4% largely because of the lower level in value added tax (VAT). Cumulative collections for VAT rose by only 1.9% because of the high level of refunds. If this effect is corrected, the increase in VAT in homogeneous terms comes to 4.1% which shows a slowdown in consumption. In turn, special taxes rose to 7.2% thanks to a rise in collections for tobacco products which were up 15.6% following the increase in tax rates. The most important special tax, that on fuels, rose by 2.7% while taxes on alcohol and alcoholic beverages were up 2.0%.

VAT collections reflect slowing down of consumption.

Notable among other non-financial revenues was the rise in government property tax due to profits coming from the Bank of Spain and interest on Treasury accounts. Capital transfers also showed an extraordinary increase as a result of funds received from the EU fund for regional development (FEDER).

On the other hand, non-financial spending by the central government was up 9.3% compared with the first three quarters of 2006. Staff costs showed an annual increase of 6.4% because of higher salaries in some divisions of the public service. Spending on goods and services was up 16.8% as this was a year involving elections. Financial costs was the only heading to drop showing an annual decrease of 7.3% due to the calendar of debt maturities. There was a notably big increase in spending for real investments (15.5%) and in capital transfers (26.8%).

As a result of this performance, with revenues in excess of spending, the central government arrived at a surplus. In terms of National Accounting, that is, using the accounting method that takes into account funds and jobs when they are committed for, the central government showed a cumulative surplus of 12.86 billion euros, a figure that meant an increase of 20.0% compared with the same period in 2006. In terms of GDP, the central government surplus represented 1.22% which compares favourably with the 1.09% obtained the year before.

Central government obtains surplus at 1.22 % of GDP up to September.

Everything, however, is not all roses. The real estate slowdown is having a negative effect on the accounts of autonomous communities which have been ceded the tax on property transfers and on legal documents due to a year-on-year decrease in the number of real estate transactions. In any case, everything seems to indicate that the public accounts as a whole will show a good result for the year 2007.

Slowdown in real estate market has impact on autonomous community accounts.

Budgets for 2050 looking dull

The ageing of the population represents a huge challenge for fiscal policy. The reason: the pressure that will be exerted by the increase in the aged population on public spending in pensions, health and dependence care policies. According to many estimates, this pressure may become asphyxiating. While the demographic situation in Spain is such that we will feel the consequences of this pressure later than in other European countries (the high pressure point will be toward the middle of the century), the predicted increase in spending is greater. Although the first symptoms may hold off for more than a decade in making themselves evident, the time to pose solutions to deactivate this «fiscal time bomb» is already here.

The demographers see it all clearly. The proportion of those 65 years of age and older in the total population will rise spectacularly in coming decades. The latest projections by the National Institute of Statistics (INE) suggest that in 2050 there will be less than two persons between 15 and 64 years for each person over 64 (see table below). Today, this ratio is somewhat above four. Heavy immigration in recent years has delayed the moment when the ratio is to reach its lowest value but it has not changed the fundamental dynamic of the ageing process, a phenomenon that is the result of the drop in the fertility rate and the increase in longevity.

PROJECTIONS OF SPAIN'S POPULATIONS BY AGE GROUP

% of total population

	Scenario of low immigration			Scenario of high immigration		
Age group	2007	2025	2050	2007	2025	2050
Under 16 years of age	14.7	13.7	12.8	14.7	14.1	13.2
From 16 to 64 years	68.4	64.5	53.7	68.4	64.9	55.9
Over 64 years	16.9	21.9	33.5	16.9	21.0	30.8
Total population (millions)	44.2	46.2	43.9	44.2	50.0	53.2

SOURCE: INE.

With no change in current policies, the impact on public spending, while gradual, will be enormous. The biggest increase will come in spending on pensions which at the middle of the century could stand above 15% of GDP, seven points above the current level.[1] To this must be added the foreseeable increase (which could reach 4%-5% of GDP) in spending on health and dependence care programmes. Undoubtedly, these are considerable figures. To finance the increase in spending through higher collections via personal income tax and VAT would require practically doubling present collections for these two taxes as proportion of GDP. The economy would have difficulty carrying this gradual but spectacular increase in tax load without seriously eroding productivity growth, especially if we keep in mind the decrease in the percentage of the population of working age, which is the segment that pays the most taxes.

What can be done with this hot potato? The easiest option is to do nothing and hope that the demographers and the economists are wrong. Not a few suggest this «solution», alleging the poor track record of social

(1) The most recent projections are to be found in Economic Policy Committee (2006), *Impact of ageing populations on public spending*, Brussels; OECD (2007), *OECD Economic Surveys: Spain*, Paris; and Jimeno, J., J. Rojas and S. Fuente (2006), «Modelling the Impact of Aging on Social Security Expenditures», Documentos Occasionales No. 0601, Bank of Spain.

scientists, starting with Malthus, in making long-term projections. This strategy, however, is very risky: if we wait too long and in the end the projections are right, the necessary adjustment will be much more painful. In this respect, the fiscal impact of ageing presents similarities with the phenomenon of climate change as, in both cases, the consequences are subject to much uncertainty, are difficult to quantify and seem to be a long way off. All of these things make it more difficult to assume the costs of adjustment today.

The most sensible thing would be to consider what changes are needed to minimize the impact of ageing on the 2050 budget. In the first place, we could think about reforms in our pension system that would contribute to reduce spending over the long term as, for example, using the entire working life in order to calculate pensions instead of only the last 15 years of contributions, when wages tend to be higher. Another alternative would be to delay the retirement age, which seems feasible in view of increased life expectancy and health condition. Furthermore, this change could be applied gradually to make it politically acceptable. If we were to delay the retirement age by six weeks (up to age 65 and 6 weeks in 2008, 65 and 12 weeks in 2009, etc.), this would reach age 70 in 2050, reducing the population of retirement age by 20%. In the matter of health, it is likely that sooner or later greater use of co-payments by the user will have to be considered as a source of financing as well as an instrument for rationalizing demand. By reducing the generosity of the public systems for pensions and health, these modifications would demand higher individual savings to meet the costs associated with aging. For this purpose, it would be logical to also consider a better tax treatment for savings.

Another way of adapting budget policy to face the future increase in spending is to save now. The way in which general government budgets generate savings is through the accumulation of fiscal surpluses. This makes it possible to reduce the public debt (and corresponding interest payments) and to increase the Social Security reserve fund. Fortunately, with a tax surplus and a relatively low debt level, Spain stands in a much healthier situation than most of its European neighbours, which must make great efforts to adjust the public accounts in view of the ageing of the population. In any case, budget policy over the short and medium term should be set within the long-term strategy of reducing the fiscal cost of ageing (and economic cost in general).

The most important over the short term is to begin the task of making the public aware of this situation. It would be well worthwhile to raise the question of ageing right now. Putting off this discussion will simply increase the costs of adjustment.

Savings and financing

Loan demand moderating

1-year Euribor goes up to 4.725% in September and may have hit ceiling.

The 12-month Euribor, widely used as a reference rate, rose by 6 basis points on monthly average in September going to 4.725%. This was the smallest monthly increase in the past six months and it may now have hit a ceiling with the easing of expectations of official interest rate increases by the European Central Bank. The financial institutions continued to pass through interbank rate increases to interest rates on loans and credits with some slight delay. The average rate on loans and credits to the private sector went up to 5.86% in August, 104 basis points higher than one year earlier.

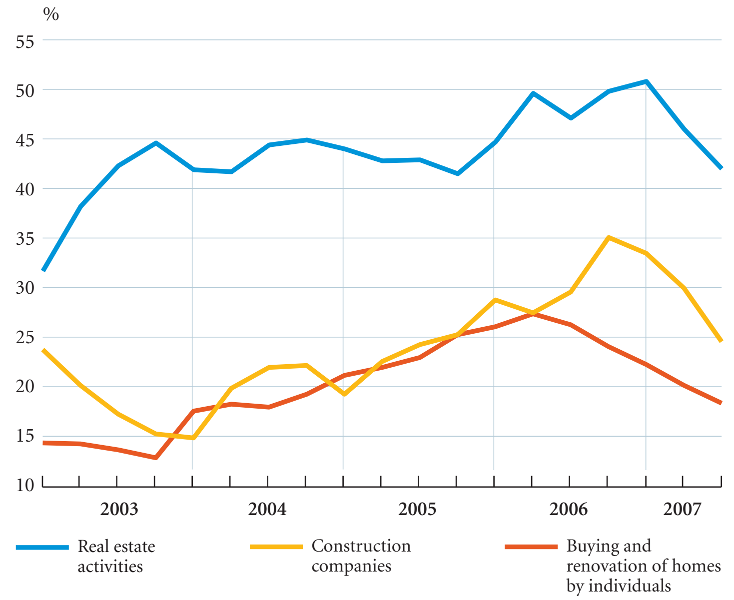
Borrowing conditions at financial institutions for loans and credits to private sector getting tighter.

In this framework, funding to the private sector showed a slight slowdown profile with a year-on-year rise of 20.2% in August, some 4.1 points less than ten months earlier while still maintaining a substantial growth rate. This drive is more notable in the case of companies with a rise of 23.6% in funding in the past 12 months whereas, with regard to households, we note an increasing drop.

By type of credit to businesses, over the past year there was a considerable increase in leasing (funds going into investment) amounting to 15.7%. On the other hand, commercial credit used to finance working capital rose by

CREDIT TO CONSTRUCTION SECTOR ALREADY SLOWING DOWN BEFORE SUB-PRIME MORTGAGE CRISIS

Year-on-year change in credit to private sector



SOURCE: Bank of Spain and own calculations.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

August 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	86,287	911	1.1	8,275	10.6	5.1
Secured loans (*)	1,031,525	108,549	11.8	178,825	21.0	61.2
Other term loans	474,920	60,331	14.6	95,712	25.2	28.2
Demand loans	32,659	–1,454	–4.3	4,638	16.6	1.9
Leasing	44,677	3,964	9.7	6,046	15.7	2.7
Doubtful loans	14,217	3,358	30.9	3,425	31.7	0.8
TOTAL	**1,684,285**	**175,659**	**11.6**	**296,921**	**21.4**	**100.0**

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

10.6% compared with August 2006. The survey of bank loans carried out by the Bank of Spain in July shows somewhat tighter borrowing conditions being applied to loans being sought by companies and suggests that this tightening will continue in the third quarter.

Credit to industry on rise.

By sector, with figures up to June, we note a sharp slowdown in credit going to construction and a slight slowdown in loans channelled into services. On the other hand, credit to industry is showing greater strength although the year-on-year change rate was lower than in other large sectors. Credit granted for real estate activities continued to ease going to an annual change rate of 41.8%, which while very high is 8.8 points less than at the end of 2006.

Household savings rate continues to drop but likely to soon recover.

With regard to households, the savings rate in the second quarter dropped to 10% of disposable income, according to the National Institute of Statistics. The figure includes non-profit organizations. This trend came about as a result of the fact that consumer spending rose more than disposable income. This savings rate stands at an all-time low although this is not out-of-step with a point in the cycle with sharp economic growth. Nevertheless, given the prospects of an economic slowdown it is likely that household savings will recover.

Funding granted to households was up by 15.8% in the past 12 months ending in August, 3.8 points less than in December. This easing off was largely due to a lower growth rate in home-buying. Other loans also eased off sharply going to a year-on-year change rate of 13.8% in August. The slowdown in loans to households was due to a dip in demand as a result of interest rate increases and high housing prices but also to less favourable borrowing conditions which likely will continue along those lines.

Loan default tending upward but still at low levels.

In addition, the rise in interest rates in recent times has brought about an increase in loan default, which may be seen in the fact that doubtful loans rose by 31.7% in the 12 months ending in August. Nevertheless, the default rate of lending institutions as a whole stood at 0.84%, a relatively low level. The rate of doubtful mortgage loans for home-

CREDIT TO PRIVATE SECTOR BY PURPOSE

Second quarter of 2007

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	24,294	1,280	5.6	2,348	10.7
Industry	132,145	12,657	10.6	22,289	20.3
Construction	144,552	10,234	7.6	28,357	24.4
Services	568,184	63,359	12.6	134,872	31.1
Total	**869,174**	**87,530**	**11.2**	**187,866**	**27.6**
Financing to individuals					
Acquisition and renovation of own home	588,694	44,305	8.1	90,446	18.2
Acquisition of consumer durables	53,898	2,437	4.7	4,737	9.6
Other financing	112,135	7,690	7.4	16,846	17.7
Total	**754,726**	**54,432**	**7.8**	**112,029**	**17.4**
Financing to private non-profit institutions	**5,955**	**251**	**4.4**	**846**	**16.6**
Other unclassified	**22,497**	**1,514**	**7.2**	**1,420**	**6.7**
TOTAL	**1,652,351**	**143,726**	**9.5**	**302,161**	**22.4**

NOTES: (*) By credit institutions as a whole: banking system, loan finance establishments and official credit.
SOURCE: Bank of Spain and own calculations.

purchase was even lower at 0.51%, although here we also note an upward trend.

Heavy campaigns by financial institutions to attract deposits

Improvement in returns pushes up time deposits.

The other side of the rise in interest rates is the 21.5% growth of bank deposits in the past 12 months ending in August. This was slightly higher than in the case of loans. This considerable increase was helped by the rise in interest on bank accounts, especially on time deposits. The average interest rate on time deposits of households rose to 3.91% in August, thus showing a rise of 101 basis points in the past year and going well above the inflation rate.

As a result, time deposits for periods up to 2 years show an increase of 38.4% in the past 12 months reaching a 25.0% share. This type of account benefited from the new tax rates on savings which came into effect in January doing away with tax benefits on interest starting out from a 2-year term. In fact, deposits in foreign currency showed a still higher increase due to the differentials in interest rates in their favour, although this is not a product in very wide use. On-demand and savings accounts, in turn, grew by only 4.1% compared with August last year, as they suffered from low returns offered.

The major growth of bank deposits was not sufficient to finance the volume of loans granted (a higher figure) so that financial institutions were forced to have recourse to issuing bonds and securitizations. Given that conditions in financial markets have hardened as a result of the sub-prime mortgage crisis during the summer, which made bond issues more difficult, the financial institutions have stepped up their marketing campaigns to attract deposits from the private sector.

As a result, bank deposits have come fierce competitors of other financial products such as participations in mutual investment funds. The assets of investment funds dropped by 4.14 billion euros in September mainly to the flight of 4.94 billion euros. Participants were also influenced by the capital losses recorded in August as a result of the upsets in financial markets that month. As a result, for the first time in the course of the year the assets of mutual investment funds stood below the level at the beginning of the year because of net money outflows of 7.3 billion euros.

Nevertheless, the average annual return on mutual investment funds stood at 4.54% at the end of the third quarter, with positive returns for nearly all types. The classification was headed by emerging country share-based funds which reported gains of 39.8%, followed by national share-based funds showing an increase of 15.0%.

With regard to hedge funds, which took on a leading role on the international scene during the financial upsets this past summer, their recent course in the Spanish market was scarcely affected. At the end of September their total assets figure amounted to 501 million euros as against 240 million at the end of June.

Investment fund assets drop below level at end of 2006 for first time this year.

Extraordinary gains in emerging country share-based funds.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

August 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	425,816	–22,521	–5.0	16,828	4.1	34.0
Up to 2 years	313,015	66,609	27.0	86,901	38.4	25.0
More than 2-year term	379,634	46,785	14.1	84,548	28.7	30.4
Repos	86,894	3,070	3.7	16,299	23.1	6.9
Total	**1,205,359**	**93,943**	**8.5**	**204,576**	**20.4**	**96.4**
Deposits in currencies other than euro	**45,328**	**12,611**	**38.5**	**16,472**	**57.1**	**3.6**
TOTAL	**1,250,687**	**106,554**	**9.3**	**221,048**	**21.5**	**100.0**

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

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2006

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

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

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

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