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THE SPANISH ECONOMY

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RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2006	2007			
				4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast						Forecast
Gross domestic product								
United States	2.9	2.2	2.0	2.6	1.5	1.9	2.8	2.7
Japan	2.4	1.9	1.5	2.5	2.8	1.6	2.0	1.3
United Kingdom	2.8	3.0	2.1	3.2	3.1	3.1	3.2	3.0
Euro area	2.9	2.6	2.1	3.3	3.2	2.5	2.7	2.2
Germany	*3.1*	*2.5*	*2.0*	*3.9*	*3.6*	*2.5*	*2.5*	*1.5*
France	*2.2*	*1.8*	*1.8*	*2.1*	*1.9*	*1.4*	*2.1*	*1.8*
Consumer prices								
United States	3.2	2.7	2.7	2.0	2.4	2.6	2.4	3.5
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	2.1	2.3	1.8	1.9	1.9	1.9	2.8
Germany	*1.7*	*2.1*	*2.0*	*1.4*	*1.8*	*1.8*	*2.1*	*2.7*
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	3.1	2.4	3.7	3.4	3.3	2.9	2.7
Government consumption	4.8	5.5	5.2	4.9	5.7	5.0	5.8	5.6
Gross fixed capital formation	6.8	5.9	3.2	6.4	6.6	6.6	5.6	4.9
Capital goods	*10.4*	*11.7*	*6.8*	*11.4*	*13.3*	*13.1*	*11.2*	*9.6*
Construction	*6.0*	*4.2*	*1.7*	*5.7*	*5.2*	*4.6*	*3.8*	*3.4*
Domestic demand (contribution to GDP growth)	5.1	4.6	3.3	5.3	5.1	4.9	4.4	4.1
Exports of goods and services	5.1	6.0	5.6	7.3	3.6	4.8	8.0	7.7
Imports of goods and services	8.3	7.2	6.0	8.8	5.9	6.6	8.3	8.0
Gross domestic product	**3.9**	**3.8**	**2.9**	**4.0**	**4.1**	**4.0**	**3.8**	**3.5**
Other variables								
Employment	3.2	3.0	2.0	3.1	3.3	3.2	3.0	2.7
Unemployment (% labour force)	8.5	8.1	8.2	8.3	8.5	8.0	8.0	8.1
Consumer price index	3.5	2.8	3.7	2.6	2.4	2.4	2.4	4.0
Unit labour costs	2.3	3.0	3.1	2.4	2.8	2.9	3.0	3.2
Current account balance (% GDP)	–8.8	–9.5	–9.6	–8.6	–10.4	–9.0	–10.1	
Net lending or net borrowing rest of the world (% GDP)	–8.1	–8.9	–9.0	–7.4	–9.8	–8.8	–9.9	
Government balance (% GDP)	1.8	1.5	0.9					
FINANCIAL MARKETS		Forecast						Forecast
Interest rates								
Federal Funds	5.0	5.0	3.8	5.3	5.3	5.3	5.1	4.5
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	4.0	4.6	4.7	4.8	4.6	4.1
10-year German bonds	3.8	4.2	4.3	3.8	4.0	4.4	4.3	4.1
10-year Spanish bonds	3.8	4.3	4.4	3.8	4.1	4.4	4.4	4.3
Exchange rate								
$/Euro	1.26	1.38	1.47	1.30	1.32	1.35	1.39	1.47

Contents

Challenges and threats in 2008

A year ago, the analysts were all racking their brains in an attempt to divine what unexpected event might bring an end to the long sharp growth stage of the world economy. As the Bank for International Settlements stated in its 2006 report, the continued excellent performance of the world economy produced a mixture of satisfaction and surprise. Satisfaction, because vigorous growth with low inflation was bringing about a general increase in the standard of living in most countries and a reduction of poverty. Surprise, because many imbalances threatened this good performance although none of them seemed likely to put that in question. The unstoppable rise in prices of raw materials, the ill-matching of current accounts, the record level of household indebtedness, the accumulation of reserves in some Asian countries... nothing seemed capable of stopping a world economy more and more strongly driven by the emerging countries. In July 2007, the International Monetary Fund was still correcting upward its growth forecast for the world economy for the year as a whole.

Now, almost without our noticing it, with a swing of the pendulum, our perception of future economic prospects has grown worse at unusual speed. The cause is to be found in a segment of the US mortgage market which very few people had even heard about before 2007, namely subprime mortgages. Default arising with these mortgage loans amounts to relatively high losses for the financial system. But the real problem lies in the mistrust generated by the method of evaluating and spreading the risks in that market. These risks were kept out of bank balance sheets although they have ended up going back there, thus increasing the need for liquidity. Distrust about which entities had potential problems of liquidity and solvency spread to an extraordinary extent, upsetting the normal operation of the markets, setting off volatility and raising premiums in an indiscriminate manner, even in those segments of high credit quality. The reverberations of the crisis have been felt on the five continents and right at this moment no one can predict with any certainty its extent and duration.

The subprime crisis has pushed away the optimism that existed in the economic forecasts because it may act as a catalyst for the imbalances and latent problems in the world economy for some years yet. If, as a result, the economy of the United States should run aground, the first to be hurt could be the Asian countries exporting manufactured goods and, on the rebound, the emerging economies as a whole. A development of this kind would slow down world trade so that European growth, which still very much depends on the foreign sector, could be seriously affected. If we add to this the inflationary pressures now showing up, in a situation of tightening credit, this could all create a very difficult scenario for the year just beginning.

But the world economy is not going to collapse like so many dominoes. The long growth stage will moderate, especially in the United States, but we should not underrate the capacity of the emerging countries to keep growing even without the help of US consumers. The stage of high liquidity and low perception of risk in the financial markets must be considered at an end but this is good for securing more balanced growth. Inflation is a risk that should not be underrated but among economic operators there does not exist the perception of a complicated horizon on the prices front. In any case, the robust world growth that began the 21st century will be subjected to its first big test in 2008.

EXECUTIVE SUMMARY

2008 begins under sign of subprime mortgage crisis

Subprime mortgage crisis affecting some of biggest companies on Wall Street.

The world economy continues under the effects of the uncertainty unleashed by the upsets in financial markets. The gradual flow of news about entities affected has not stopped and some of the main companies on Wall Street have been hit. Investment banks of the size of Citigroup, UBS and Morgan Stanley have been obliged to have recourse to investors from Asian economies and the Middle East in order to obtain funds to shore up their capital positions. Liquidity in monetary markets remains insufficient, borrowing terms are hardening and all of this ends up substantially hurting consumer and corporate confidence.

OECD underlines risks in 2008 forecasts but goes for relatively optimistic scenario.

In its recent Autumn report, the Organization for Economic Cooperation and Development (OECD) reduced its forecast for growth of the gross domestic product (GDP) for the group of member countries in 2008 to 2.3%, down from 2.7% forecast last Spring. What were the reasons? Naturally, the financial upsets but also the cooling down of housing markets which have gone through a long growth cycle in recent years in most of the member countries. Also because of the rise in energy prices and prices of other raw materials. Nevertheless, the OECD estimates that factors, such as the high level of employment, robust corporate profits and the strength the emerging economies have given to international trade, mean that the central scenario is relatively good over the medium term.

In the United States, this basic scenario is characterized by a sharpening of the correction of the real estate market which, nevertheless, will not bring with it big increases in unemployment. In the next two years inflation will go down from 2.8% to more comfortable levels and the correction of the trade deficit will continue. This is expected to close at 2.2% in 2007 but growth prospects for 2008 are down to 2.0%, going back to 2.2% in 2009. In the Euro Area in general all forecasts have been revised downward but the trend over the mid-term will be to recover usual growth rates. The GDP for the monetary union as a whole in 2007 will have moved up by 2.6%, while slowing down to 1.9% in 2008 and recovering slightly to 2.0% in 2009. By country, Germany and Italy which in May had seen their prospects improved, will go back to their previous situation with estimated growth of 1.8% and 1.3% respectively in 2008, well below the increases in 2007 while there are no signs of any significant recovery in 2009. Forecasts for France are also down with growth remaining relatively stable, while in 2009 it will move up slightly to 2.0%.

Tightening of monetary interest rates makes it necessary to find new formulas to deal with paralysis in markets.

The forecast scenario is conditioned by whether the upsets in the financial markets diminish and do not give rise to a contraction of credit which could put the expected growth in danger. At this time, there are scarcely any signs in that direction. The tightening of the interbank market continues in spite of the efforts of the central banks to contain interest rates and provide all the liquidity requested. In December, the US Federal Reserve and the Bank of

England cut their reference rates and, more important, the main central banks (United States, Euro Area, United Kingdom, Canada and Switzerland) launched a coordinated effort to provide liquidity to the markets. But risk aversion continues, something that becomes clear when we compare interest rates in the interbank market, where operators borrow funds to adjust their cash needs, and equivalent rates on government bonds, assets considered safe. The differential between both has continued to be abnormally wide since the outbreak of the subprime mortgage crisis last summer. In the United States, the 3-month interbank deposit rate is 4.8% while the yield on a US Treasury bill for the same term is running at 3.5%. In Spain, equivalent rates are 4.8% and 3.9% respectively. In other segments of monetary and financial markets similar abnormal situations take place.

These problems of liquidity and credit left the stock markets relatively calm in 2007, given that we cannot term their results as negative. Not for the extraordinary performance of stock markets in the emerging countries which have just ended a brilliant year of increases (in some cases with all-time highs) but also of those in the developed countries. In the United States, source of the subprime mortgage crisis, the Standard & Poor's index ended the year slightly positive whereas the Nasdaq, representative of high-tech shares, recorded gains of more than 10%. The worst result came in the Japanese stock market with sharply negative returns.

The relatively favourable performance of share markets may suggest that investors believe in a scenario of moderate optimism for the world economy. Could this be so? Certainly, the financial state of companies is good, expectations for profits are still favourable and the world economy continues to benefit from the drive and dynamism of the emerging economies. The latest revised figure for the US GDP in the third quarter is promising in this respect with a rise of 2.8% year-on-year, 4.9% compared with the second quarter in annual terms. Consumer demand and private investment retain their momentum while exports are really feeling the weakness of the dollar. But one should not be over confident. Initial forecasts for the fourth quarter of last year are much weaker, consumer confidence is at a low level and expectations generally come hand-in-hand with great uncertainty.

Stock markets relatively unscathed by upsets in 2007, with some exceptions.

In the European Union, the panorama is similar: relative strength of domestic demand and maintenance of exports but low consumer confidence and signs of anxiety in companies. Especially troubling in the Euro Area is the sharp rise in inflation in recent months with a consumer price index (CPI) going up to 3.1% year-on-year in November (the highest since May 2001). This increase, largely due to rises in oil and foods, is unlikely to be turned around over the short term, which presents the risk that inflationary pressures will spread among the various economic agents thus creating a more complicated situation for economic policy.

Economic activity indicators maintaining growth scenario but expectations of consumers and business executives quite depressed.

Lower growth and higher inflation in 2008

The OECD has also revised downward its forecasts for Spain anticipating an appreciable slowdown from the robust 3.8% in 2007 to 2.5% in 2008 while in 2009, with forecast growth of 2.4%, there will scarcely be any recovery. Nevertheless, in a situation marked by the uncertainties mentioned, the only thing that remains clear is that the growth profile recorded in 2007 has been downward and we may expect this

OECD also cuts growth forecasts for Spain's economy.

Housing construction largely responsible for slowdown in growth.

trend to continue in 2008. A good part of this loss of drive lies with construction with the wearing out of the long growth cycle the sector has enjoyed in recent years. We note a stagnant situation in go-aheads for new construction, which are an early indicator of residential building activity, although the volume of housing units currently under construction ensures the level of activity in the sector for 2008. Nevertheless, the company confidence index in the sector has continued to show a drop. This may be attributed to the cooling off of the real estate market. According to figures from the Property Registrars Association, housing transactions were down 16.0% in the third quarter of 2007 compared with the same period the year before.

Rise in CPI toward end of 2007 due to state of international prices for raw materials.

In the labour market as well we note the same state of slowdown although job creation is still maintaining a notable rate. The number of workers registered with Social Security was up 2.3% in November compared with the same month the year before, a rate only one decimal lower than that for October. Labour costs tended to rise in the third quarter. Average labour cost per worker per month stood at 2,201 euros, a figure that meant a year-on-year rise of 4.2%, three decimals more than in the previous quarter, according to the quarterly survey of labour costs carried out by the National Institute of Statistics.

This performance coincides with a sharp rise in the main inflation reference, the consumer price index. Once more, fuels were the leading agents in the worsening of the index in the latter part of 2007. Prices of processed foods were also up considerably reflecting the increases in international prices for farm raw materials. As a result, the CPI rate rose to 4.1% in November, a half-point more than in the month before, thus going back to the level at the beginning of 2006. In turn, underlying inflation (which excludes the more volatile products such as energy and unprocessed foods) continued to rise going to 3.2% annual. The latent increases in food prices will likely continue to push up inflation in the early months of 2008. Nevertheless, in the second half of the year inflationary pressures should decrease so that inflation could drop substantially in the second half of 2008 to stand below 3%.

Foreign deficit shows no sign of improvement in coming months in spite of trade imbalance not getting worse.

Another sensitive point of the Spanish economy is the foreign sector deficit. In terms of the balance of payments, the current imbalance is tending to increase at an annual rate of 20%. The trade balance is tending to contain its position in the red thanks to a slowdown in import demand and maintenance of foreign demand. On the other hand, we note a rapid worsening of the current transfers balance, which includes substantial immigrant remittances abroad, and a considerable increase in the incomes balance. In these circumstances and in view of the importance of these headings in Spain's accounts with abroad, we cannot expect appreciable improvements in 2008.

The best news about the state of the economy continues to come from the public accounts. Just one month before the end of 2007, central government non-financial revenue was up 11.7% and inflows into the public purse rose at a rate of 4.5 percentage points above the nominal gross domestic product so that in terms of the GDP the government surplus was 2.5%, a half-point more than that recorded in the same period in 2006.

December 27, 2007

CHRONOLOGY

2006

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 **subprime 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 **subprime 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.
	31	**Federal Reserve** cuts reference rate to 4.50%.
November	8	IBEX 35 index for **Spanish stock market** marks up all-time high (15,945.7) with cumulative gains of 12.7% compared with end of December 2006.
	23	One-month forward price of Brent quality **oil** goes up to all-time high level of 95.45 dollars a barrel.
	27	**Euro** exchange rate at 1.487 dollars, highest figure since launching of European single currency at beginning of 1999.
December	11	**Federal Reserve** cuts reference rate to 4.25%.
	13	Central banks in United States, Euro Area, United Kingdom, Switzerland and Canada announce plan for **coordinated measures to relieve difficulties in monetary markets** brought about by financial upsets.

AGENDA

January

- 3 Flash estimate HCPI (December).
- 10 Industrial production index (November).
  Governing Council of European Central Bank.
- 15 CPI (December). Balance of payments (October).
- 16 Harmonized CPI for EU (December).
- 24 Producer prices (December).
- 25 Labour Force Survey (4th Quarter).
- 30 Fed Open Market Committee.

February

- 5 Industrial production index (December).
- 7 Governing Council of European Central Bank.
- 14 Flash estimate GDP for Spain (4th Quarter).
  GDP for EU (4th Quarter).
- 15 CPI (January). Balance of payments (November).
- 20 Quarterly National Accounts (4th Quarter).
- 25 Producer prices (January).
- 29 Harmonized CPI for EU (January).

INTERNATIONAL REVIEW

OECD forecasting lower growth but no crises

OECD lowers growth forecast for 2008 to 2.3%.

For its members as a whole, the Organization for Economic Cooperation and Development (OECD) has maintained its Spring forecast of growth of gross domestic product (GDP) at 2.7% in 2007. Its expectations for 2008, however, are down from 2.7% to 2.3% with a slight rise in 2009 to 2.4%.
The main economies have recently gone through a series of crises in the form of financial upsets, the cooling down of housing markets and the rise in energy products and other raw materials which will reduce economic activity over the short term. The biggest downward revisions show up in the United States, United Kingdom, and Japan.

Financial crisis could reduce growth over short term but scenario holds good.

Nevertheless, according to the OECD, factors such as the high employment level, good corporate profits and the strength the emerging economies have given to international trade mean that the basic scenario over the medium terms remains relatively good.

United States will slowdown in 2008 with 2.0% growth while Euro Area will go up 1.9%.

In the United States this basic scenario is characterized by a sharper adjustment in the real estate market which, however, will not result in major increases in unemployment. In the next two years inflation will go back from 2.8% to more comfortable levels, slightly below 2.0% and the correction of the trade deficit will continue. For 2007 the US is expected to show 2.2% growth but the forecast for 2008 has been reduced to 2.0% with the growth figure going back to 2.2% in 2009.

In the Euro Area, in general, all forecasts have been revised downward but the tendency over the medium term will be to recover regular growth rates. The GDP for the monetary union as a whole will show a rise of 2.6% in 2007 with a slowdown to 1.9% in 2008 and a slight recovery to 2.0% in 2009. By country, Germany and Italy, which in May saw their prospects improved, go back to their previous situation with estimated growth rates of 1.8% and 1.3% respectively in 2008, well below the increases in 2007 and without any major signs of recovery in 2009. Forecasts for France are also lowered although growth will hold relatively stable with a slight rise to 2.0% in 2009.

In the case of Spain, the downward revision is less but an appreciable slowdown is seen from the robust 3.8% in 2007 to 2.5% in 2008 with no sign of recovery coming in 2009 when forecast growth is 2.4%. In turn, the Japanese economy will continue to depend on the foreign sector. Growth forecasts have been revised sharply downward with the GDP moving up by 1.9% in 2007 only to slowdown to an increase of 1.6% in 2008. The end of deflation, however, must open up more compensated growth patterns which should bring a slight recovery in 2009 to growth rates of 1.8%.

The problem with this main scenario is that the risks are all biased to the negative side with lower growth and with no relief from inflationary pressures. In this sense, expectations

OECD: ECONOMIC OUTLOOK (1)

	2005	2006	2007	2008	2009
GDP (2)					
United States	3.1	2.9	2.2	2.0	2.2
Japan	1.9	2.2	1.9	1.6	1.8
Germany	1.0	3.1	2.6	1.8	1.6
France	1.7	2.2	1.9	1.8	2.0
Italy	0.2	1.9	1.8	1.3	1.3
United Kingdom	1.8	2.8	3.1	2.0	2.4
Spain	3.6	3.9	3.8	2.5	2.4
Euro area	**1.6**	**2.9**	**2.6**	**1.9**	**2.0**
OECD	**2.7**	**3.1**	**2.7**	**2.3**	**2.4**
Inflation (3)					
United States	3.4	3.2	2.8	2.7	1.9
Japan	–0.6	0.2	0.0	0.3	0.4
Germany	1.9	1.8	2.2	2.3	1.8
France	1.9	1.9	1.5	2.2	1.9
Italy	2.2	2.2	2.0	2.4	1.9
United Kingdom	2.0	2.3	2.3	2.2	2.0
Spain	3.4	3.6	2.8	3.6	2.5
Euro area	**2.2**	**2.2**	**2.1**	**2.5**	**2.0**
OECD	**2.0**	**2.2**	**2.3**	**2.1**	**2.1**
Unemployment (4)					
United States	5.1	4.6	4.6	5.0	5.0
Japan	4.4	4.1	3.8	3.7	3.6
Germany	9.1	8.1	6.4	5.7	5.6
France	8.8	8.8	8.0	7.5	7.4
Italy	7.8	6.8	5.9	5.8	5.8
United Kingdom	4.8	5.5	5.5	5.7	5.5
Spain	9.2	8.5	8.1	8.1	8.3
Euro area	**8.4**	**7.7**	**6.8**	**6.4**	**6.4**
OECD	**6.4**	**5.9**	**5.4**	**5.4**	**5.3**
Current account balance (5)					
United States	–6.4	–6.5	–5.6	–5.4	–5.3
Japan	3.7	3.9	4.7	4.8	5.2
Germany	4.6	5.1	6.7	7.0	7.0
France	–1.2	–1.2	–1.0	–1.0	–1.0
Italy	–1.6	–2.4	–2.5	–2.6	–2.6
United Kingdom	–2.4	–3.4	–3.2	–2.7	–2.7
Spain	–7.4	–8.7	–10.1	–10.5	–10.5
Euro area	**0.3**	**0.1**	**0.2**	**–0.1**	**–0.2**
OECD	**–1.6**	**–1.9**	**–1.4**	**–1.4**	**–1.4**
World trade (6)	**7.5**	**9.6**	**7.0**	**8.1**	**8.1**

NOTES: (1) Starting hypothesis: a) Fiscal policies in force or announced will not change; b) Exchange rates will not change from level on November 12, 2007 (1 dollar = 109.38 yen = 0.690 euros); c) Closing date of publication and for including figures was November 20, 2007.
(2) All percentage change rates in real tems.
(3) Percentage change rates in GDP deflator.
(4) As percentage of labour force.
(5) As percentage of GDP.
(6) Arithmetical average of percentage annual growth rates of world imports and exports by volume.
SOURCE: Organization for Economic Cooperation and Development.

OECD: FINANCIAL OUTLOOK (1)

	2005	2006	2007	2008	2009
Government deficit (–) or surplus (+) (2)					
United States	–3.6	–2.6	–2.8	–3.4	–3.5
Japan	–6.4	–2.9	–3.4	–3.8	–3.4
Germany	–3.4	–1.6	0.0	0.1	0.3
France	–3.0	–2.6	–2.5	–2.6	–2.6
Italy	–4.3	–4.5	–2.2	–2.3	–2.0
United Kingdom	–3.5	–2.8	–2.9	–3.4	–2.7
Spain	1.0	1.8	1.9	1.5	1.3
Euro area	**–2.5**	**–1.6**	**–0.7**	**–0.7**	**–0.6**
OECD	**–2.9**	**–1.8**	**–1.6**	**–2.0**	**–1.9**
Short-term interest rates (3)					
United States	3.5	5.2	5.3	4.6	4.7
Japan	0.0	0.2	0.7	0.6	0.9
United Kingdom	4.7	4.8	5.9	5.2	5.1
Euro area	**2.2**	**3.1**	**4.3**	**4.2**	**4.1**
Long-term interest rates (4)					
United States	4.3	4.8	4.7	4.5	4.8
Japan	1.4	1.7	1.7	1.9	2.4
Germany	3.4	3.8	4.2	4.2	4.4
France	3.4	3.8	4.3	4.3	4.4
Italy	3.6	4.0	4.5	4.5	4.7
United Kingdom	4.4	4.5	5.0	4.9	5.1
Spain	3.4	3.8	4.3	4.2	4.4
Euro area	**3.4**	**3.8**	**4.3**	**4.3**	**4.5**

NOTES: (1) Starting hypothesis: a) Fiscal policies in force or announced will not change; b) Exchange rates will not change from level on November 12, 2007 (1 dollar = 109.38 yen = 0.690 euros); c) Closing date of publication and for including figures was November 20, 2007.
(2) As percentage of GDP.
(3) 3-month interest rates on national money markets.
(4) Government bond interest rates on most representative issues in each country.
SOURCE: Organization for Economic Cooperation and Development.

Risks for main scenario are inflationary pressures, spread of weakness in real estate and persistence of problems in financial sector.

on inflation are static, that is to say that the economic agents have faith in the capacity of the central banks to control price rises. This is an important advantage which gives flexibility to monetary policy to ease the effects of the spreading weakness of the housing sector and, in addition, help soften the shock of possible increases in the price of oil and other raw materials. Nevertheless, this cannot be taken for granted given that the deflationary effects of imports from China are easing off while energy and foods are likely to show price increases for some time yet.

In the area of public finances, the situation in Germany and its prospects are showing notable improvement. In Spain as well the fiscal balance expected for 2007 is slightly better confirming prospects for surpluses in 2008 and 2009. But the good news ends there. Forecasts are generally worse in spite of coming at a moment when it has been relatively easy to balance the public accounts.

Another important risk is the appearance of further financial upsets due to the current situation of the banking system. Its deficiencies have shown up with the

Will the world economy decouple from a slowdown in the United States?

The United States is facing a difficult end to 2007 and start to 2008. Most analysts foresee average GDP growth in these two quarters at around 1%, well below the 3% where they put its growth potential. Nor do they discount the possibility of the US economy moving into a recession. Alan Greenspan, among others, puts that possibility at around 50%. In this context, it is not surprising that there has been much debate about the possible repercussions of a slowdown or recession in the United States on the rest of the world.

There are two sides in this debate. First, there are those who feel that, at this moment, global growth depends more on the strength of the emerging countries and that, for this reason, world growth would not greatly suffer. They believe in the decoupling hypothesis. There are also those who believe that «when the United States sneezes, the rest of the world catches a cold». The latter group recall that US GDP still represents nearly one third of the world GDP.[1] Both arguments are to some extent right.

A glance at history suggests that, in fact, weakness of the US economy tends to coincide with a slowdown in the rest of the world. The following table shows the changes in GDP growth rate in the United States and other regions during the five recessions and two episodes of sharp slowdown the US economy has undergone since 1970.[2] On average, the GDP growth rate in the United States fell by nearly four points during those recessions. During those episodes, the growth of other industrialized countries dropped by two percentage points while Latin America and the Asian countries also showed significant drops although these were not as big. In contrast to the periods of recession, the economic slowdowns do not seem to coincide quite as clearly with a drop in the rate of economic activity in other countries.

WHEN THE UNITED STATES SNEEZES, DOES THE REST OF THE WORLD CATCH A COLD?

Changes in growth rate of various regions during recessions and slowdowns in United States.
(Percentage points compared with potential growth rate)

	Recessions					Slowdowns		All recessions	All slowdowns
	1974-75	1980	1982	1991	2001	1986	1995		
United States	–6.1	–3.4	–4.5	–2.1	–2.9	–0.7	–1.5	–3.8	–1.1
Other industrial economies	–5.4	–1.5	0.4	–1.3	–2.0	–0.1	–0.3	–2.0	–0.1
Latin America	–3.2	–0.8	–3.9	1.1	–1.8	1.9	–	–1.7	0.9
Emerging Asian countries	–3.5	–0.3	–1.5	–0.1	–1.1	0.9	0.3	–1.3	0.6

SOURCE: World Economic Outlook, April 2007, International Monetary Fund.

To some extent, the economic weakness of other regions has coincided with that of the United States because the main cause has been global, as was the case in the 1974-75 oil crisis or the bursting of the high-technology bubble in 2001. But even when such a common factor does not exist, a slowdown or recession in the United States spreads to the rest of the world. This occurs in two ways, namely through trade and financial channels. It

(1) This figure is the average for last five years at current exchange rates. The proportion is reduced to 22% if the GDP is measured in terms of purchasing power parity.
(2) The change in growth rate is expressed in terms of the potential growth rate of the respective economies.

is not for nothing that the United States is the destination of 20% of world exports and its stock markets represent 40% of total world capitalization.

US imports are sharply cyclical and their growth drops notably during periods of slowdown and especially in times of recession. This happens because nearly 50% of imports are capital goods or consumer durables and these are precisely the two types of goods most sensitive to the economic cycle. Obviously, those countries exporting most to the United States are those to most suffer the consequences of that drop in demand for imports. In fact, the countries most affected would be their neighbours to the north and the south. Exports to the United States from Canada and Mexico represent nearly 25% of the GDP of each of those countries. Many Asian countries also depend significantly on exports to the US economy, including China and Taiwan (in both cases close to 10% of GDP). While European countries are less exposed to trade with the United States (exports represent less than 2% of the region's GDP), Europe's exports could indirectly suffer from a loss of competitiveness in the world market if the US slowdown goes hand-in-hand with a weak dollar.

The growing integration of financial markets has increased the importance of the financial channel as a transmission belt for an economic slowdown or a recession. A recession in the United States would very likely be accompanied by a correction on the stock market which, in the light of experience, could shift to other markets. After all, a global investor tends to respond to losses in one of the main markets by reducing positions in other markets, a result of increased risk aversion. In addition, in the current context, the subprime mortgage crisis provides a new channel for adversely affecting the economy through problems in interbank markets, capital losses by major world financial entities and the possible concurrent restriction of credit (see box «Subprime mortgage crisis: the risks of risk»).

Will the rest of the world be able to survive a slowdown in the United States? The answer depends on how steep that slowdown is and the existence of global factors behind that weakness. In the face of a recession, trade and financial connections would affect the rest of the world. On the other hand, a gradual slowdown could be easier to ride out. With regard to global factors, the extent of the subprime mortgage crisis will be of key importance in coming months, in addition to the usual geopolitical risks.

Fiscal consolidation still awaited while exchange rate instability could provoke protectionist moves.

coming of the subprime mortgage crisis and, so long as there is no end to the process of losses showing up in profit and loss accounts, risk and uncertainty will remain.

The exchange rate of the dollar and its stability present another danger that could bring calls for protectionism, which could hurt world trade, one of the supports of the world economy at this time. The other side of the coin is the need for appreciation of the renminbi which could help to level off the drive in China's economy and halt the rise of inflation.

United States: are the Seventies coming back?

A young shepherd named Peter used to ask his friends for help by crying «wolf» although no wolf ever turned up. Then one day when a real wolf turned up the other shepherds failed to come to his aid. In the current situation in the United States there is not just one sluggish wolf

but two. The first is the fact that the financial crisis is still spreading and has ended up affecting the real economy and causing a recession or period of low growth. The other «wolf» is an old friend that has been lying low for some time, namely inflation. With both making their appearance at the same time and, if policies followed are not correct, the situation becomes reminiscent of the Seventies when there was a coexistence of low growth and inflation.

Things do not have to happen as sharply as they did at that time. Our growth forecast for 2007 is 2.2% and 2.0% in 2008, which, taking into consideration the fact that the US gross domestic product (GDP) has been growing by an average close to 3% in recent decades, now means two years of growth below normal. To some extent, the first danger has already made its appearance but only to some extent. The challenge is to stop things from getting worse because there are major risks. The correction in the real estate sector is getting worse and employment, while always increasing, is following a gradual slowdown. All of this affects the trend in private consumption which, while representing 71% of the GDP, at this time is contributing only 40% to growth and therefore will be the key variable.

For the moment, revised figures for the GDP in the third quarter are promising in this respect with an increase of 2.8% year-on-year, 4.9% compared with the second quarter in annual terms. Domestic demand remains strong and exports are holding in the high band. Retail sales are following this course without any major drops. Excluding cars and petrol, which are highly volatile, retail consumption in November was up by 5.2% year-on-year, a good figure which, nevertheless, does not break the trend to gradual slowdown. Along these lines, the consumer confidence index

GDP in United States grows 2.8% in third quarter thanks to domestic demand and exports.

UNITED STATES: MAIN ECONOMIC INDICATORS

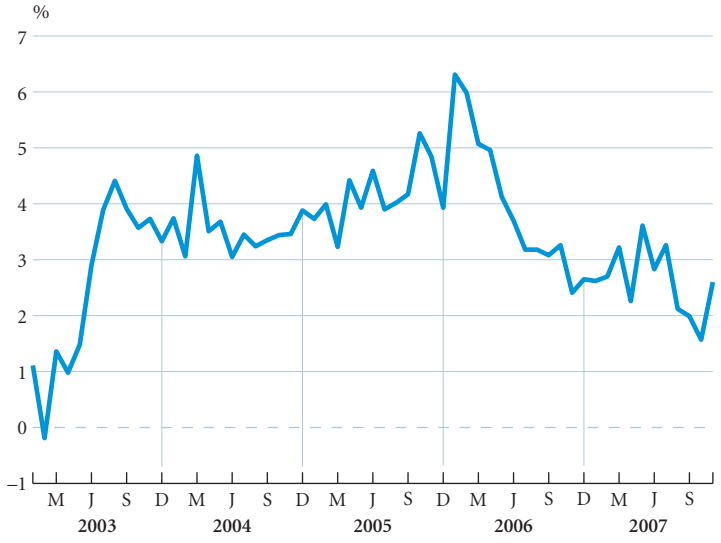
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
Real GDP	3.1	2.9	2.6	1.5	1.9	2.8	–	...
Retail sales	6.6	6.2	5.1	3.4	4.0	4.1	5.0	6.3
Consumer confidence (1)	100.3	105.9	106.8	109.9	106.7	105.7	95.2	87.3
Industrial production	3.2	4.0	3.5	2.5	1.7	1.7	1.4	2.1
Industrial activity index (ISM) (1)	55.5	53.9	50.9	50.8	55.2	52.9	50.9	50.8
Sales of single-family homes	6.5	–18.0	–21.9	–24.6	–21.2	–25.3	–23.5	...
Unemployment rate (2)	5.1	4.6	4.5	4.5	4.5	4.6	4.7	4.7
Consumer prices	3.4	3.2	1.9	2.4	2.7	2.4	3.5	4.3
Trade balance (3)	–714.4	–758.5	–758.5	–746.4	–732.2	–706.1	–705.7	...
3-month interbank interest rate (1)	3.6	5.2	5.4	5.4	5.4	5.4	4.9	5.1
Nominal effective exchange rate (4)	83.7	82.5	81.6	81.9	79.3	77.0	73.9	72

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.
(4) Change weighted for foreign trade movements. Higher values imply currency appreciation.
SOURCE: OECD, national statistical bodies and own calculations.

UNITED STATES: CONSUMER SPENDING SLOWING DOWN

Real retail sales, excluding cars and petrol, month-on-month change annualized (*)



NOTES: (*) Series trend in figures deflated by price index excluding energy and food.
SOURCE: Departament of Commerce and own calculations.

Private consumption remains strong but expectations down, while business executives kept busy but foresee price increases.

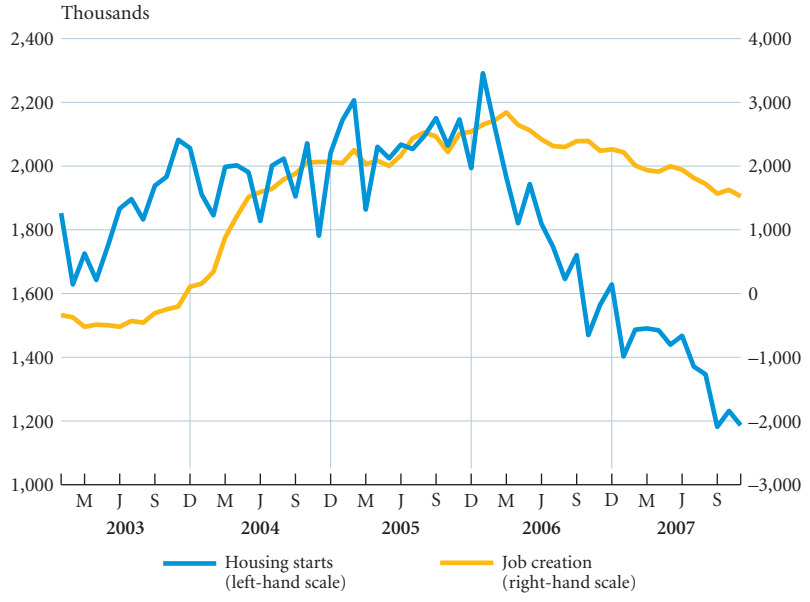
of the Conference Board remained low, going from 95.2 to the 87.3 points level. What is significant is that there is a growing difference between the perception of the present situation and expectations. The latter went from 80.0 to 68.7 points, a level below the low in October 2001 following the September 11 terrorist attacks on the World Trade Center, which had not been reached since 1993. We are fearful of the «wolf» of slowdown although some may say that, for the moment, this wolf is showing up weaker.

With the sound situation in profit and loss accounts of non-financial companies, with borrowing at more reasonable levels, the slowdown in the economy is finding a supporting factor that may be confirmed by the business activity index of the Institute for Supply Management in November. In the manufacturing sector, the index was practically unchanged at 50.8 points, a level that being above 50 indicates that optimistic responses are still ahead, even though only just, of pessimistic replies. In services, the index dropped from 55.8 points to 54.1 thus maintaining a stable line. Nevertheless, if we look at components we see a shadow of lack of confidence with employment in the manufacturing sector dropping below the 50 level and prices sharpening their rise significantly.

The housing market still continues on a downturn. On the supply side, rather than easing off the storm is worsening with a much more abrupt drop than in other downward cycles in the sector. Housing starts showed a worse drop in November with a figure of 24.2% below the same period the year before, making a cumulative decrease of 48.2% compared with the not so far off all-time high in January 2006. Existing property sales were down 20.7% year-on-year in October while new housing sales dropped 23.5%. The drop in prices has also been sharp with the Case-Schiller index for

UNITED STATES: EMPLOYMENT HOLDS UP BETTER THAN CONSTRUCTION

Housing starts in annual terms and job creation over past 12 months



SOURCE: Department of Labor, Bureau of the Census and own calculations.

housing prices showing sharper decreases in September with a loss of 5.5% year-on-year. Generally, the areas showing the biggest decreases are those where prices had risen most but in both cases it has been lower-priced housing that has dropped most in value. In the matter of subprime mortgages (those of low credit rating), some 600,000 households are now in a state of seizure and 600,000 more could go into a critical stage when interest rates are revised upward in coming months. Because of this, the government plan to freeze debts is correct although it may be arbitrary and could be a reward for lack of prudence.

The labour market continues a more gradual trend but is also on a downward path. New jobs are still being created, as shown by the 94,000 jobs in November and this is the best news for the consumer. Nevertheless, in the last 12 months an average of 127,000 jobs have been created per month whereas the average in the preceding 12 months was 187,000. In turn, the November unemployment rate held unchanged at 4.7% of the labour force, so that, for the moment, the first «wolf» has been tamed.

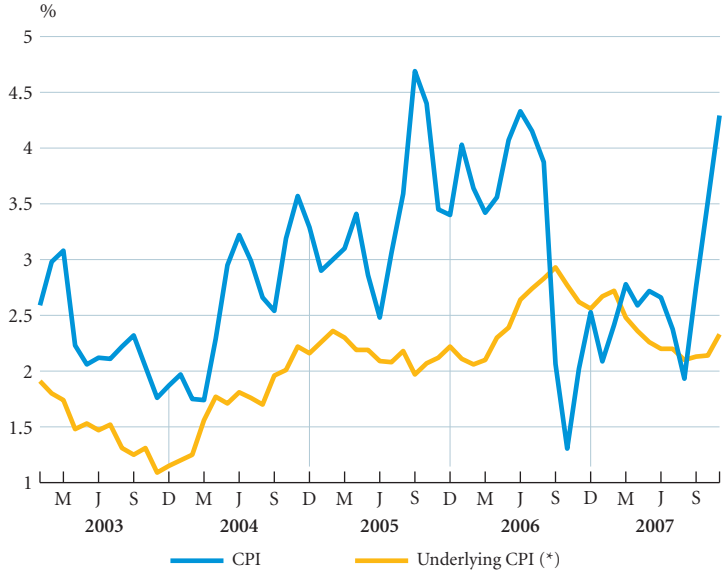
Housing still not seeing light with prices down 5.5% and housing starts showing total drop of 48%.

In the case of inflation, the lilies have begun to sprout thorns. The November consumer price index (CPI) was up going from growth of 3.5% to 4.3% year-on-year. Apart from upward pressure from oil, the price rise is widespread as shown by the underlying component (the general index less food and energy) which raised its growth rate from 2.1% to 2.3% year-on-year. Producer prices, with a rise of 7.7% year-on-year also help define a more sombre picture than that just a few months ago. The problem is that the speed at which the economy may progress without creating inflationary pressures has now dropped. For this reason, it is essential that expectations for inflation hold at moderate rates given that, on the contrary, the ability of

Employment slowing down but unemployment rate at low 4.7%.

UNITED STATES: INFLATION SHOWING ITS TEETH

Year-on-year change in consumer price indices



NOTES: (*) Underlying index excludes food and energy.
SOURCE: Department of Labor and own calculations.

Inflation goes above 4%, a warning it could make things difficult for Federal Reserve, but trade deficit still being corrected.

monetary policy to shore up the deficit in growth will be greatly reduced.

Upward pressures on raw materials prices from the emerging economies do not help as is the case with their accumulation of foreign currency and inefficient monetary policies. This reduces their capacity to export to the large economies at low prices. In the foreign sector, things continue to evolve favourably. The trade balance in goods and services in October showed a deficit of 57.82 billion dollars, a drop of 0.6% year-on-year. Exports were up by a robust 13.7% but imports rose by 9.2%. If we exclude oil, the deficit is now 28% below the all-time high.

Japan's GDP up 2% thanks to capital goods investment and foreign sector but construction on downturn and private consumption still weak.

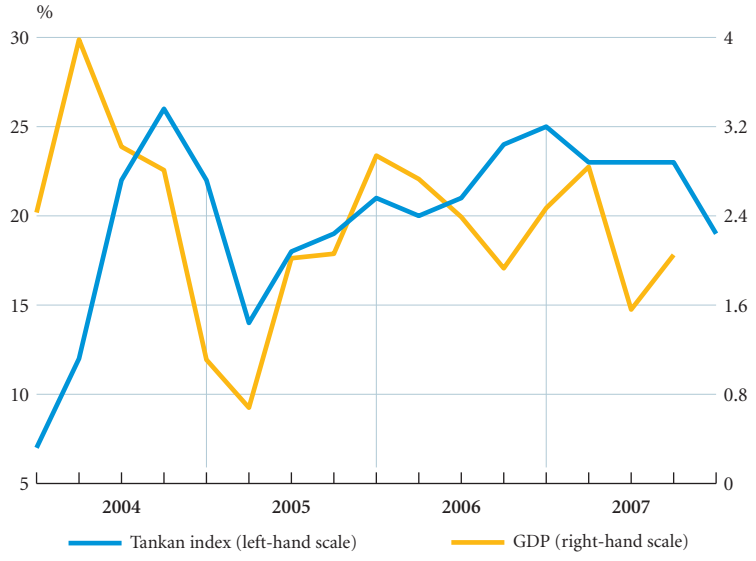
Japan: dusk over the rising sun

Tokyo has become a rough sketch of current-day Japan. It is a refined city where the best dishes are served raw and discretion is the norm. In the same way, the economic figures, with their swings and revisions, hide a long period of low growth that is getting still lower. Proof of this is that the GDP for the third quarter of 2007 was revised downward putting growth at 2.0% year-on-year, along with lower inventories and less capital goods investment. Following a final quarter in 2007 that is expected to be weak, forecasts for 2008 are for a slowdown with growth for the whole year at around 1.5% because of four factors that weaken the progress of the economy. These factors are weak domestic consumption, a lower level of investment, changes in regulations that have weakened the housing sector and heavy dependence on exports. In 2009 there should be some slight recovery if the international environment evolves positively.

With regard to the first two factors, investment by large companies always with an eye on exports has been one of the pillars of growth. The profits of these

JAPAN: TAKAN INDEX NOT PROMISING ABUNDANCE

Tankan index for large manufacturing companies and year-on-year change in GDP



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

corporations have risen sharply but, as the small companies which make up 70% of employment have not participated in this boom, the good times have not filtered down to wages and as a result private consumption continues to languish. Machinery orders, which indicate the trend in investment, rose in October thanks to the export sector, but nevertheless in the third quarter the Tankan index of business activity and sentiment for the large manufacturing companies put out by the Bank of Japan was down from 23 points to the 19 points level, the lowest since 2005. The component of expectations was also down to 15 points. Industrial production in October also kept to a relatively low profile with an increase of 3.6% year-on-year. All this means that one of the strong points of Japan's economy is no longer quite as strong.

With regard to the third factor, construction investment in the third quarter was down 11.1% year-on-year, largely due to changes in regulations seeking to make buildings safer in case of earthquake. While this was not due to the normal operation of the market, its effects have been greater than those of the current real estate crisis in the United States and could stretch out into the greater part of 2008. As a result, housing starts in October were down 35.0% year-on-year. The housing market seems to be increasing the upsets given that sales in November were down 51.7% in the Tokyo area compared with the same period the year before. Not having been part of the rise taking place in other countries, prices continued to move up with increases of 11.7%. In view of the general situation, these increases seem difficult to maintain but they have been holding up since mid-2006.

Manufacturers see things worse than before.

The unemployment rate in October continued at 4.0% of the labour force. In spite of this, wages rose very little except in the manufacturing sector where there was a small increase. On the prices front, deflation was at an end,

Housing sales plummet but prices moving up.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
Real GDP	1.9	2.4	2.5	2.8	1.6	2.0	–	...
Industrial production	1.5	4.5	5.3	3.6	2.3	3.3	3.6	...
Tankan company Index (1)	18.0	22.5	25.0	23.0	23.0	23.0	–	19.0
Housing construction	3.9	4.5	5.4	–1.9	–2.7	–37.1	–35.0	...
Unemployment rate (2)	4.4	4.1	4.0	4.0	3.8	3.8	4.0	...
Consumer prices	–0.3	0.2	0.3	–0.1	–0.1	–0.1	0.3	...
Trade balance (3)	10.2	9.4	9.4	10.2	11.1	12.3	12.8	...
3-month interbank interest rate (1)	0.1	0.3	0.5	0.6	0.7	0.8	0.9	0.9
Nominal effective exchange rate (4)	86.2	81.1	79.2	77.6	75.7	76.9	76.9	79.4

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.

Exports maintaining trade surplus.

at least for the moment, with the CPI going up to 0.3% year-on-year in October. Nevertheless, in this victory lies a trap. Oil and food have played an important role in the rise in prices and proof of this is that the underlying CPI, which excludes fresh foods but not energy from the general rate, held where it was, thus repeating the figure for the same period the year before. The Bank of Japan is thus the only central bank among the rich economies that has no

JAPAN: DEFLATION COMES TO AN END.... FOR THE MOMENT

Year-on-year change in consumer price index

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

inflation problems and can simply concern itself with looking after the lack of growth.

The city of Osaka, which in ancient times was an important commercial centre, today is thriving, breathes a sense of business activity and here, in contrast to Tokyo and the rest of the country, the pedestrians walk on the right as in the rest of the world. Perhaps there should be more than one Osaka in Japan because, so far as concerns dependence on the outside world, the Japanese export sector fills its role well in the hope that world demand does not slacken. The cumulative surplus in the trade balance for the 12 months ending in October rose to 12,800 billion yen thanks to the fact that exports continued to rise whereas imports were stagnant.

Brazil stays in high band

Brazil's GDP moved up by a strong 5.6% year-on-year in the third quarter, a sign of the new role the emerging countries have taken on as a support for world growth in the context of slowdown in the developed economies. Private consumption maintained a relatively strong advance moving up 6.1% while investment held its strength with an increase of 14.4%. Nevertheless, it was the foreign sector that showed more of a feeling of crisis with exports down sharply given that the growth rate there went from 13.3% to a modest 1.8%. In turn, imports were up 20.4% year-on-year as a result of strong domestic demand. Public consumption showed a modest rise but with a lower rate of increase than the rest of the economy.

Brazil grows by 5.6% aided by private consumption and investment but exports feeling squeeze.

Among the latest economic activity indicators, industrial production sharpened going up 10.3% year-on-year. Industrial production of capital goods, very important for the continued growth of Brazil, also gained momentum with growth of 26.8%. As a result of this boost in industry, the utilization of production capacity that month stood at all-time levels. On the demand side, retail sales grew by 8.5% year-on-year while in November car sales rose by 23.8%. With this level of economic activity, the good news is that the increase in inflation is almost non-existent with the CPI going up by a modest 4.2% year-to-year in November.

Industry continues full-steam-ahead but inflation holds close to 4%.

BRAZIL: MAIN ECONOMIC INDICATORS

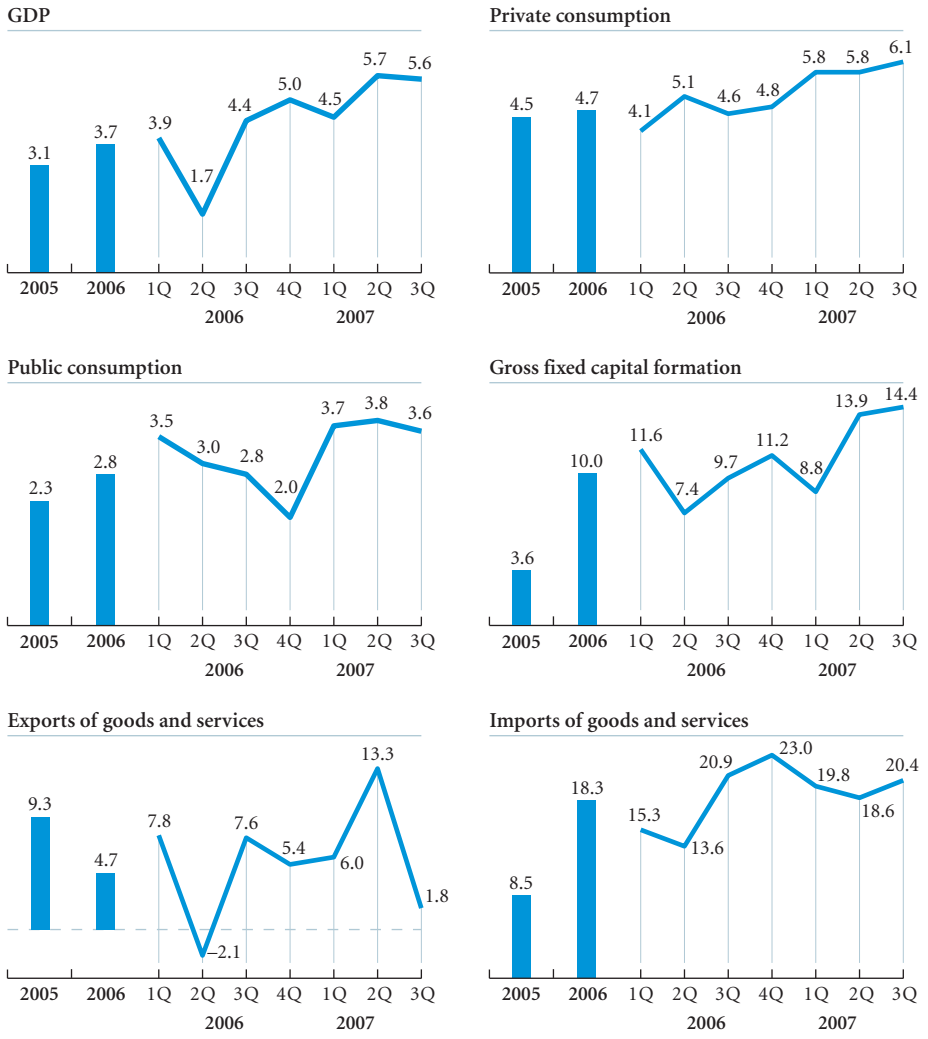
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
Real GDP	3.1	3.7	5.0	4.5	5.7	5.6	–	...
Industrial production	3.1	2.8	3.2	3.8	5.8	6.3	10.3	...
Unemployment rate São Paulo (*)	17.0	15.9	14.3	15.2	15.6	15.0	14.4	...
Consumer prices	6.9	4.2	3.1	3.0	3.3	4.0	4.1	4.2
Trade balance (**)	40.8	46.3	46.3	45.8	47.4	43.1	42.6	41.4
Central bank SELIC rate (***)	19.1	15.1	13.4	12.9	12.3	11.4	11.3	11.3
Reales to dollar	2.4	2.2	2.1	2.1	2.0	1.9	1.7	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.

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.

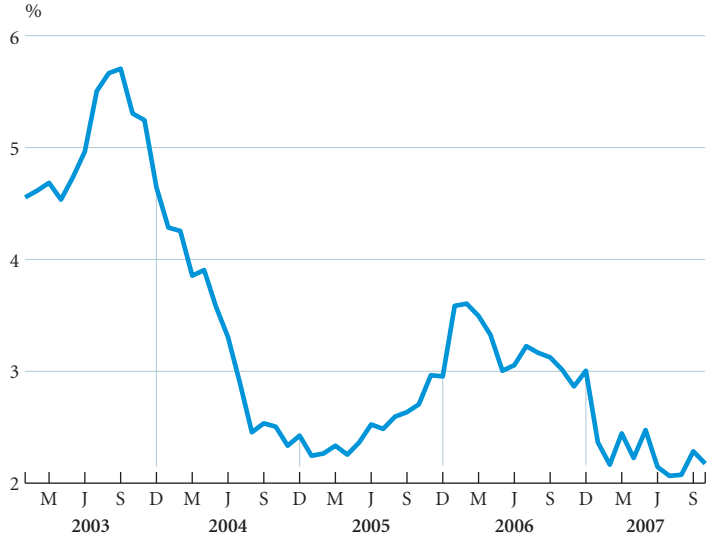
Public finances continue on austerity path but unemployment runs above 14% and trade surplus dropping.

The most notable increases came in wholesale prices which rose by 7.5%, a rate that continues a tendency to increase in recent months while wages rose by 11.9% year-on-year in October, a high rate but one that means a notable drop compared with that operating in 2006 and the beginning of 2007.

The unemployment rate in the São Paulo district in October dropped slightly to 14.4% of the labour force, a relatively high figure given the strength of growth at this time. In October savings by the public sector compensated the increase in interest on the foreign debt, putting the deficit for the past 12 months at 2.2% of the GDP, in line with values for recent months. In turn, the real seems to have momentarily halted its upward move while, partly as a result of the world economic situation, the trade surplus dropped by 37%

BRAZIL: REDUCTION OF PUBLIC DEFICIT SUCCESSFUL

Public deficit in past 12 months in terms of GDP



SOURCE: Institute of Applied Economic Research (IPEA) and own calculations.

in November compared with the same period the year before, thus sharpening the decrease that began to show up last summer.

Argentina has new president but economy going non-stop

In taking over from her husband Nestor Kirchner, Cristina Fernández, the new president-elect, will inherit an economy in much better shape that he found but with challenges still to be met such as control of inflation and improvement of the public sector. Growth is maintaining a high profile and furthermore is lasting with a GDP that grew by 8.7% year-on-year in the third quarter of 2007. Private consumption with similar increases and especially investment, that was up by 12.8%, continue to be the main sources providing the strength of growth. In turn, public consumption continued to rise and gain strength while the foreign sector kept decreasing moderately with exports up 8.6% as against growth of imports at 19.0%, the result of a rise in domestic demand.

Argentina grows by 8.7% thanks to domestic demand but foreign sector weaker.

Latest demand indicators keep pointing to a continuation of the growth cycle. Retail sales in the Buenos Aires region in October were up 24.1% year-on-year with a robust 35.7% in the total for department stores. Levels in 1999 before the 2003 crisis have now been passed. Car sales in the past 12 months were up 33.3% year-on-year, a figure slightly less than 15% under the all-time high. On the supply side, things are going rather more calmly with industrial production in October maintaining the low profile seen in recent months with increases of 2.9% year-on-year.

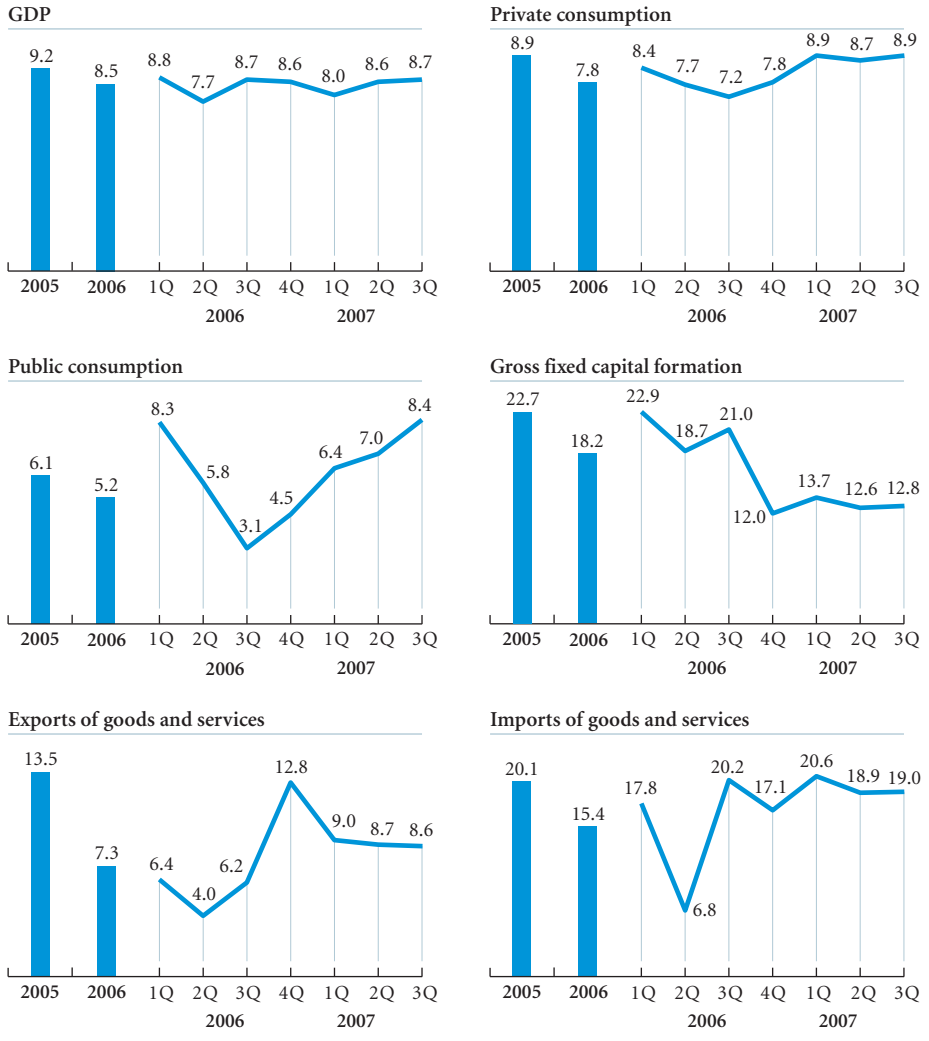
Retail consumption remains strong and stands close to all-time highs.

The strongest sectors were motor vehicles, non-metallic minerals and energy while the steel and chemical industries stabilized their decreases and the «other metals» sector had still not hit bottom. The Synthetic Indicator of Construction Activity rose in October showing growth of 11.1% whereas the

Industry seems to have hit bottom and should step out of low profile.

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.

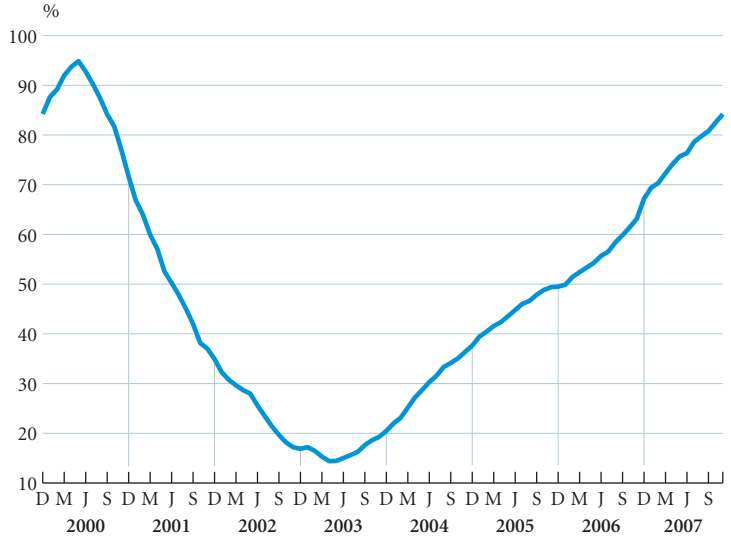
Inflation at 8.5% remains a risk while unemployment drops to 8.1%.

industrial activity indicator also rose by 9.6%, which suggests that the problems in industry are perhaps being left behind.

Inflation continues firm and refuses to go down. The November CPI rose 8.5% year-on-year pushed up by energy and raw materials. In the labour market, with help from the strength of demand, the unemployment rate in the third quarter was down to 8.1% of the labour force, a level that now seems somewhat more comfortable compared with the rise at the beginning of 2007. The trade surplus continued to slide down, a result of the increase in imports.

ARGENTINA: RECOVERY SEEN THROUGH A CAR WINDOW

Car sales in past 12 months compared with 1998 high



SOURCE: INDEC and own calculations.

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
Real GDP	9.2	8.5	8.6	8.0	8.6	8.7	–	...
Industrial production	7.3	7.5	6.4	6.2	4.5	1.9	2.9	...
Unemployment rate (*)	11.6	10.2	8.7	9.8	8.5	8.1	–	...
Consumer prices	9.6	10.9	10.1	9.5	8.8	8.6	8.4	8.5
Trade balance (**)	11.7	12.3	12.3	11.8	11.5	10.5	10.7	...
3-month interbank interest rate (***)	6.2	9.9	10.5	9.7	9.4	12.6	12.9	14.1
Pesos to dollar	2.9	3.1	3.1	3.1	3.1	3.1	3.1	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.

EUROPEAN UNION

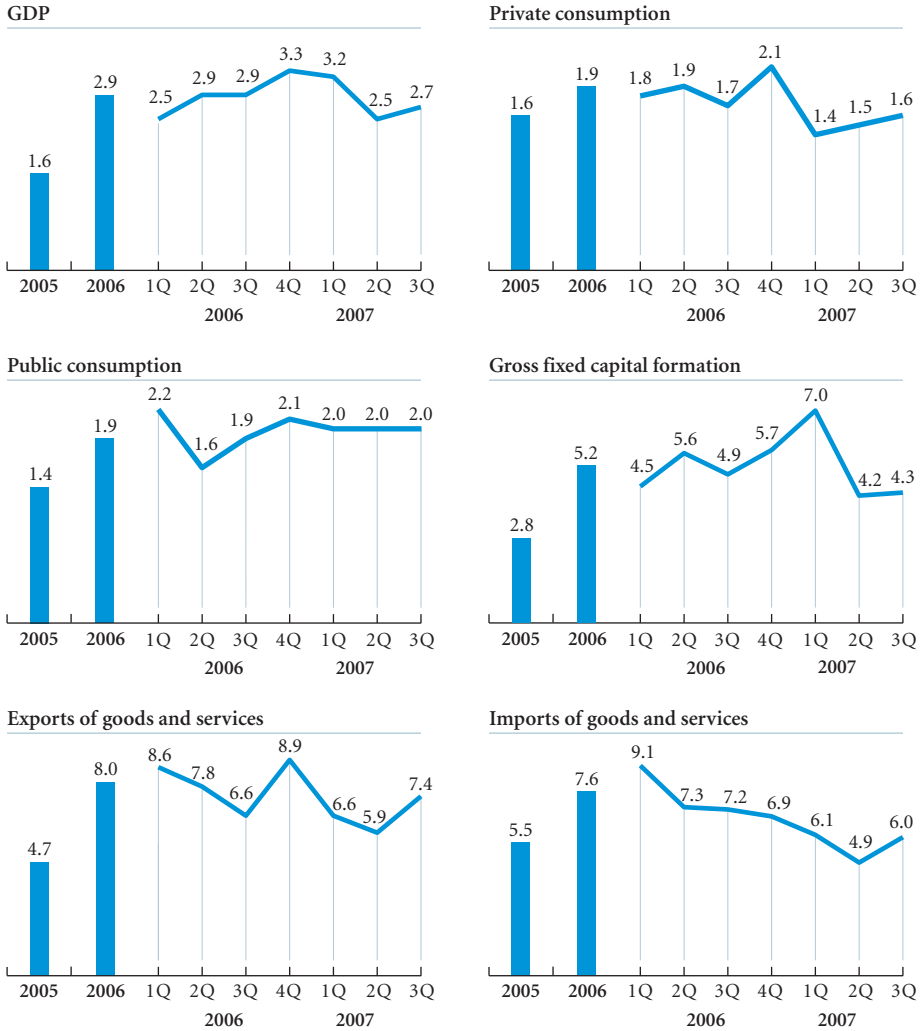
Euro Area moving into lower growth stage while inflation still notable.

Euro Area: leaving the comfort zone

The excellent figure for economic growth in the third quarter may be the last clearly positive result for the Euro Area for some time. This was well stated by Lucas Papademos, vice-chairman of the European Central Bank when he declared that «the present economic situation in the Euro Area seems to indicate that in coming months there will be an uncomfortable, although

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCE: Eurostat and own calculations.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
GDP	1.6	2.9	3.3	3.2	2.5	2.7	–	...
Retail sales	1.2	2.1	2.3	1.7	1.0	1.3	0.3	...
Consumer confidence (*)	–13.8	–9.0	–7.1	–5.2	–2.4	–3.7	–6.1	–8.0
Industrial production	1.3	4.0	4.0	4.0	2.7	3.9	3.8	...
Economic sentiment indicator (*)	97.9	106.9	109.9	110.0	111.6	109.3	106.0	104.8
Unemployment rate (**)	8.8	8.3	7.9	7.6	7.5	7.4	7.2	...
Consumer prices	2.2	2.2	1.8	1.9	1.9	1.9	2.6	3.1
Trade balance (***)	42.1	–10.4	–13.1	–0.8	16.0	31.9	38.7	...
3-month Euribor interest rate (*)	2.2	3.1	3.6	3.8	4.1	4.5	4.8	4.6
Nominal effective euro exchange rate (*)	103.3	103.6	104.6	105.5	107.1	107.6	109.6	109.8

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

temporary, combination of high inflation and economic growth on a slowdown».

Certainly, the contrast between present indicators and those indicators of a more anticipatory nature is becoming sharper. In order to establish the starting point, the third quarter showed an excellent growth rate of 2.7% year-on-year, which represents a rise over the 2.5% the previous quarter. This increased rate of progress in economic activity was largely due to a rise in private consumption and investment, on the part of domestic demand, and the bigger contribution from the foreign sector.

Starting out from these trends, figures available for the fourth quarter suggest a slowdown in growth still far from any sign of collapse. To judge by available indicators, the process is gradual. This is suggested, for example, by the economic sentiment indicator, which well reflects economic activity as a whole, that showed a drop of two points in October and November. This course of lower economic growth is reflected in the areas of demand and supply.

With regard to the first, the lower level of retail sales (these grew by only 0.3% year-on-year in October) and the drop in consumer confidence (for which the -8 points figure in November was the worst since September 2006) confirm the irregular state of household consumption. In any case, the gradual decrease in the unemployment rate (this fell to 7.2% in October, one decimal less than in September) may give some support to this erratic state of consumption. On the other hand, the course of investment seems stronger.

The trend in foreign demand seems even stronger at least up to the end of the third quarter. In October, the cumulative trade surplus for 12 months stood at 38.7 billion euros, a figure in contrast to the deficit of 19.3 billion euros one year ago.

With exports for 12 months up to October growing by 10% year-on-year

Economic activity down in fourth quarter but not to dramatic extent.

Industry at good levels although future more uncertain.

Forecasts indicate coming quarters with growth around 2%.

(while imports reached only 5% year-on-year), the drive in the foreign sector for the moment is holding up against the loss of competitiveness brought about by the appreciation of the euro. In this respect, it should be remembered that in November the single currency had appreciated by 5% in nominal effective exchange rate compared with one year earlier.

Nevertheless, when we focus our attention on supply prospects, the signs of economic weakness become clearer. The unexpected improvement in industrial production in October, which moved up to 3.8% year-on-year as against 3.3% the month before, must be put alongside the poor trend in industrial orders and the erratic course of industrial confidence, both of which are early indicators. In any case, the trend in the services sectors and construction is worse, with respective confidence indicators hitting a downward path since the middle of the third quarter.

Germany enjoying acceptable rate of economic activity...

Prices present another cause for concern. The current rise in inflation to 3.1% year-on-year in November (the highest since May 2001) becomes significant if we take into account not only the present level but also that immediate prospects do not allow us to expect a rapid slowdown of the harmonized consumer price index (HCPI). Both the composition of the increase (largely due to rises in oil and food) and the expectations of inflation by economic agents suggest that there will be little let-up in inflationary pressures in coming months.

...especially notable in strength of secondary sector.

In this context, it is not surprising that the composite indicator made up of early indicators has sharpened its decline since last August, thus pointing to a definite slowdown. Coinciding with these signs, most economic analysts, including the international bodies, suggest that growth of the Euro Area in 2008 will tend to stand at values of the order of 2%. The cycle highs thus have definitely been left behind.

Germany: a troubled giant

Germany exemplifies the economic crises affecting Europe. Most of the latest indicators suggest that the German economy stands in an acceptable situation although a cloud of uncertainty is floating over economic agents. On the demand side, the trend in retail sales shows a recovery up to October which, together with some stabilization of the consumer confidence indicator, suggests a livelier drive in consumption. The sharp growth of the capital goods component of industrial production (more than 10% year-on-year in October) confirms that investment remains strong.

Furthermore, this reasonably positive situation may also be seen on the supply side. Industrial production was up by 5.9% year-on-year in September and October thus defying forecasts of a progressive slowdown. As a result of this good situation, the drop in unemployment has continued putting the unemployment rate at 8.6% of the labour force in November, one and a half points below the figure for one year earlier.

In spite of these calming figures, Europe's leading economy is showing some signs that are a cause for concern. First, also in common with its other Euro Area partners, is the rise in prices. In November, the CPI grew by 3.1% year-on-year. While this rise was largely due to the increases in energy and food,

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
GDP	1.0	3.1	3.9	3.6	2.5	2.5	–	...
Retail sales	1.4	6.1	6.5	–1.0	–1.9	–1.7	–0.4	...
Industrial production	2.8	6.0	6.3	7.6	5.2	5.3	5.9	...
Industrial activity index (IFO) (*)	95.5	105.5	107.0	107.5	108.0	105.4	103.9	104.2
Unemployment rate (**)	11.7	10.8	10.1	9.4	9.2	8.9	8.7	8.6
Consumer prices	2.0	1.7	1.3	1.8	1.8	2.1	2.4	3.1
Trade balance (***)	156.3	151.6	155.3	165.1	177.4	190.5	194.9	...

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

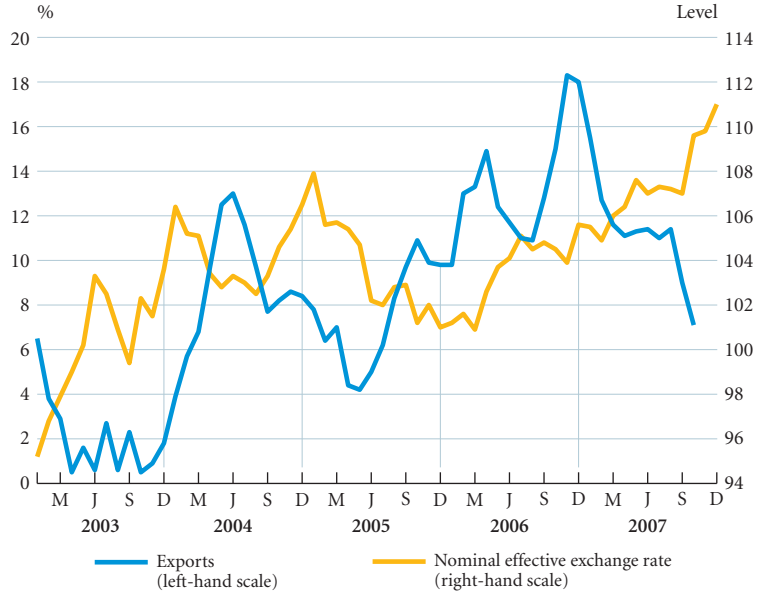
this came along with a general increase in prices, as shown by indicators such as production prices and the GDP deflator.

Given the existing dependence on foreign demand, an excessive rise in prices could lead to a troubling squeeze on competitiveness. Furthermore, this comes on top of the appreciation of the euro which in itself brings about a loss of foreign competitiveness. For the moment, exports have lost little ground (growth of 11% year-on-year in cumulative figure for 12 months ending

In spite of this, concern about future increasing.

GERMAN FOREIGN SECTOR BEGINNING TO NOTE APPRECIATION OF EURO

Year-on-year change in 3-month moving average of exports and nominal effective euro exchange rate



SOURCE: Federal Statistics Office, European Central Bank and own calculations.

Reform in France still complicated but Sarkozy now proposing broad deregulation package.

in October, two points less than in third quarter on average), and and are clearly above imports, which were up by only 7%, which made possible a further rise in the trade surplus. But concern at the corporate level remains.

In this respect, the trend in the IFO industrial activity index is significant. Following an unexpected rise to 104 points in November, this indicator dropped back to 103 points in December. This trend has been interpreted by German analysts as a reflection of concern about the trend in the currency and, quite recently, of uncertainty about future financial terms.

Reform programme not accompanied by strong economic growth...

Other points of dissatisfaction which are less tangible are beginning to show up. The changes in the make-up of the «Grand Coalition» have left out one of the personalities most representative of the liberal line within the Social-Democratic Party, Franz Müntefering, thus probably leaving some gaps in the ambitious reforms of Chancellor Merkel. For example, this has led to some groups responding to the announcement that the public deficit in 2008 will be lower than in 1990 with the accusation that the performance of tax revenues would make it possible to achieve a balanced budget beforehand. In fact, Germany is moving toward a stage of lower growth and is doing so with confidence in its strength somewhat weakened, perhaps more than an objective evaluation of the situation would justify.

...given that demand keeps losing steam.

France: is reform a ¿Mission Impossible?

Up to this point, dealing with major structural reforms in France looks like an impossible task. For this reason, Nicolas Sarkozy's reform programme, in spite of receiving broad support in the elections, was seen as difficult to carry out. Now the perception has begun to change. The first indication came from the lack of popular support for the public transport strike called in response to changes in the so-called special government pension schemes. Those calling the strike decided to end the protest after only nine days and return to the negotiating table. Without waiting, President Sarkozy launched a programme of 100 measures to simplify the over-regulation of economic activities and to rationalize some of the government's administrative machinery. According to some estimates, the reduction in regulations will

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
GDP	1.7	2.2	2.1	1.9	1.4	2.1	–	...
Domestic consumption	3.2	2.7	2.8	3.6	2.8	4.2	3.0	2.4
Industrial production	0.2	0.9	0.6	1.1	0.2	2.1	4.0	...
Unemployment rate (*)	9.2	9.2	8.9	8.7	8.5	8.3	8.1	...
Consumer prices	1.7	1.7	1.3	1.2	1.2	1.3	2.0	2.4
Trade balance (**)	–15.7	–26.8	–28.5	–28.7	–30.5	–32.5	–35.1	...

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion euros.
SOURCE: OECD, Eurostat, INSEE, European Commission and own calculations.

represent a savings of 15 billion euros a year for companies.

While the objective is reform, the French government cannot wait for better economic times. Following an unexpected improvement in the third quarter, the year-end clearly points a less expansionist period ahead. The main demand indicators, with household consumption as a notable variable, began to move down in the final quarter of 2007. After average growth of 4.2% year-on-year in the third quarter, in November this barely reached a growth rate of 2.4%.

Nor is foreign demand pointing in the opposite direction. Up to October, the cumulative figure for 12 months in exports slowed to 3.6% year-on-year which, together with maintenance of imports at rates of 5% year-on-year, has raised the trade deficit to 2.9 billion euros. In this situation of a slowdown in exports, the recovery of industrial production in October probably rests on a weak foundation. The weakness of industrial orders between September and November would confirm this view.

A modest drop in the unemployment rate (8.1% in October, one decimal less than in September) and the rise in inflation to 2.4% year-on-year in November (2.0% the month before) complete the range of available indicators. From this point on, prospects are not greatly positive. Prime minister François Fillon has recognized that he is concerned about 2008. It is highly likely that growth in 2008 will stand within the low range of the government's forecast (which shows a spread between 2.0% and 2.5%). In view of this, we cannot expect an economic context that will greatly ease the effects of the adjustment. Therefore time for reforms is right now.

Italian consumer noting effects of higher inflation, downturn in economic activity and adjustment in public spending.

Italy: the consumer gets hurt

The Italian consumer feels ill-treated. In spite of the fact that Romano Prodi is correct in stating that Italy's inflation is not a bigger problem than in other European countries (the prime minister is correct in saying that inflation at 2.4% year-on-year in November is below the Euro Area average), the ordinary citizen's perception runs in the opposite direction.

Confindustria expecting poor growth in 2008 at only 1%...

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
GDP	0.2	1.9	2.8	2.4	1.8	1.9	–	...
Retail sales	0.4	1.2	1.0	1.0	0.1	0.2	...	...
Industrial production	–0.9	2.7	3.7	1.2	0.6	0.8	–0.9	...
Unemployment rate (*)	7.7	6.8	6.4	6.2	6.0	...	–	...
Consumer prices	1.9	2.1	1.8	1.7	1.6	1.6	2.1	2.4
Trade balance (**)	–5.1	–18.2	–22.0	–19.6	–16.0	–11.6	–9.1	...

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

...largely as result of drop in consumer spending.

Following the «pasta strike» some months ago in protest against the rise in the price of a key item of Italian diet, December was full of strikes. While the most notable was the international transport workers' strike demanding compensation for the rise in fuels, the strike of transport workers was no less significant and the worst in the sector in more than 25 years. Underlying all these expressions of discontent is a combination of high price increases, poor growth and some adjustment in public spending.

In United Kingdom, concern about slow growth with high inflation, now being dubbed «slowflation».

In this respect, the Finance Law (equivalent to Spain's Budget Law) approved on December 16 fully reflects these tensions. The growth forecast for 2008 (1.5%) is modest (but higher than that proposed by the business organization Confindustria at a mere 1%, largely arising from forecasts for private consumption at minimum growth levels). In spite of the official position that there is no inflation problem, the law establishes a new body (Mister Prezzi) devoted to controlling situations involving exorbitant price fixing. Finally, some relatively minor adjustments in funds allocated and certain supports to the Mezziogiorno region have caused considerable controversy.

Figures confirm move in this direction: economic activity beginning to slowdown...

The latest indicators published do not ease this perception. No doubt, consumption is slack. Retail sales, for example, fell by 0.6% year-on-year in September while consumer confidence was down in October and November, even though the unemployment rate fell to 6.0% in the second quarter. Industrial production in October, in spite of maintenance of the rate of exports, stood at a levels 0.9% lower than those one year earlier.

United Kingdom: «slowflation», a new danger

As English is a language that lends itself to neologisms, the British economic situation justifies the arrival on the scene of the term «slowflation», that is to say, moderate growth combined with inflationary pressures. This is far from the dramatic «stagflation» of the Seventies (recession plus inflation) but also from the good growth rates in recent years. In fact, it is still dealing with prospects rather than tangible reality but the danger seems to have some base.

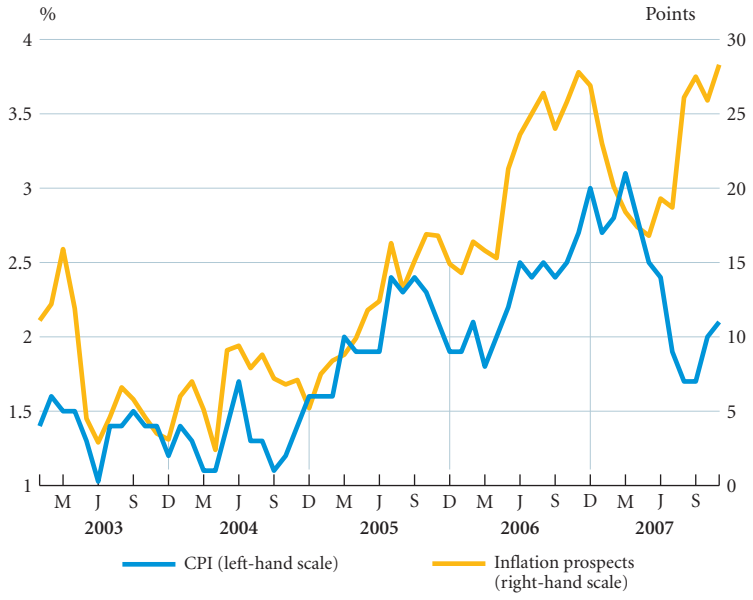
To begin with, what has been a fundamental support of growth, private consumption, seems to be easing off its drive. This is suggested, for example, by the slowdown in retail sales (growth of 4.4% year-on-year in November, four decimals less than in the third quarter). The cooling off in the situation has also shown up in early consumer indicators. It is true that the unemployment rate is holding at very low levels (2.5% in November) but this is not sufficient support to maintain household spending.

Nor is foreign demand going to relieve the situation although the trade deficit in October, as cumulative figure for 12 months, stood at 83.5 billion pounds sterling (7 billion more than one year ago). The situation on the supply side is no better. While industrial production rose to 1.0% year-on-year in October, this figure is overshadowed by the drop in confidence in the services sector (in November this stood at its lowest level since October 2006) and by the poor indicators for construction.

Given that the level of economic activity is on a downward slide, it is worth reviewing inflationary concerns, the second half of

INFLATION UP IN UNITED KINGDOM AND WILL GO STILL HIGHER

Year-on-year change in CPI and inflation prospects



SOURCE: National Statistics Office, European Commission and own calculations.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
GDP	1.8	2.8	3.2	3.1	3.1	3.2	–	...
Retail sales	1.9	3.0	3.6	4.3	3.9	4.8	4.2	4.4
Industrial production	–2.0	0.1	0.9	–0.3	0.6	0.3	1.0	...
Unemployment rate (*)	2.7	2.9	2.9	2.8	2.7	2.6	2.5	2.5
Consumer prices	2.0	2.3	2.7	2.9	2.6	1.8	2.0	2.1
Trade balance (**)	–64.9	–74.0	–76.9	–77.8	–79.0	–81.6	–83.5	...
3-month Libor interest rate (***)	4.9	4.6	5.1	5.3	5.6	6.0	6.3	6.3
Nominal effective pound exchange rate	99.6	98.0	102.7	103.9	104.0	104.3	102.2	102.9

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion pounds.
(***) Value.
SOURCE: OECD, Bank of England, ONS, European Commission and own calculations.

«slowflation». More than the current figures (inflation in November stood at 2.1% year-on-year, one decimal above the Bank of England objective) of concern are inflation forecasts. According to the latest quarterly survey carried out by the Bank of England, inflation prospects stand at their highest levels since 1999. Forecasts put out by analysts point in a similar direction. In fact, some rather more complicated months lie ahead with economic activity locking into a slower pace and prices resisting any slackening off.

...and inflation prospects worsen.

FINANCIAL MARKETS

Monetary and capital markets

Fundamental changes made in effort to contain financial instability.

Central banks deal with subprime mortgage crisis

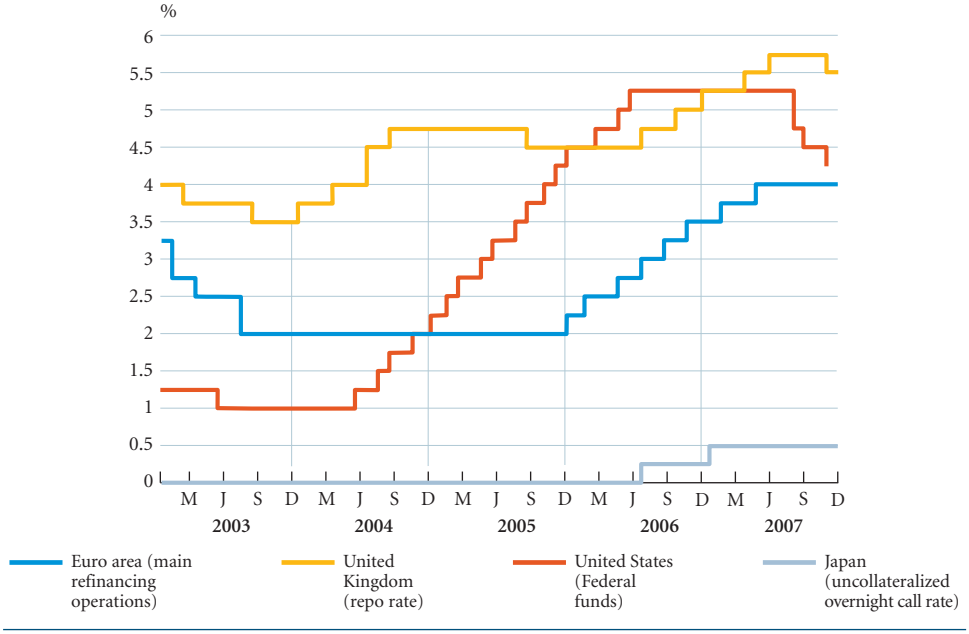
The subprime mortgage crisis continues to involve the agendas, statements and moves of the central banks. We should especially mention the decision of the main central banks to take concerted action to guarantee the fluid operation of monetary markets. Also significant were the changes in financial regulations and the strengthening of instruments for injecting liquidity into the market made by the Federal Reserve.

Due to the worsening of the upsets, at its meeting on December 11, the Fed took the decision to lower the reference rate from 4.50% to 4.25%. The Bank of England did the same, cutting its reference rate by 25 basis points in a unanimous decision by all nine members on December 6. These were cuts aimed at strengthening other means of injecting liquidity but which up to now have had modest results.

Furthermore, in order to ease the tightening up of the interbank market, the Fed created a new mechanism for injecting liquidity, namely the Term Auction Facility which complements its open market operations and the discount window. With this new facility, the Fed offers banks 1-month loans and in the future loans for terms even up to

FORGET THE FIRST-AID KIT, WE'RE GOING TO OPERATE

Reference rates set by central banks



SOURCE: National central banks.

3 months. Any bank can apply to this system although no bank can obtain more than 10% of the total amount auctioned and no distinction will be made between banks in terms of financial strength and collateral required to obtain liquidity.

In addition, the governor of the Fed fulfilled his promise before members of Congress in his appearance in November to publish regulations before the end of the year aimed at reducing fraudulent practices and abuses in the granting of mortgage loans in the United States. The legal changes, a consequence of the subprime mortgage crisis, will serve to avoid repeating the same errors in the next crisis but on the other hand it cannot resolve the current one.

In spite of all the efforts to normalize the markets, the injections of liquidity made by the central banks in November have not achieved the objective of reducing problems in the interbank market, as may be seen in the following table. For example, whereas the Fed cut its reference rate by 25 basis points on October 31, the 3-month interbank rate moved up from 4.89% to 5.0%. In the United Kingdom we see that the 3-month interbank rate rose from 6.28% to 6.49%. The Euro Area was no

Injections of liquidity in November fail to calm down markets.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB reference rate (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									
November	3.25	3.64	3.86	5.25	5.37	0.51	5.00	5.25	1.94
December	3.50	3.73	4.03	5.25	5.36	0.57	5.00	5.32	2.09
2007									
January	3.50	3.78	4.10	5.25	5.36	0.53	5.25	5.59	2.18
February	3.50	3.85	4.06	5.25	5.35	0.71	5.25	5.53	2.19
March	3.75	3.92	4.18	5.25	5.35	0.67	5.25	5.62	2.27
April	3.75	4.02	4.30	5.25	5.36	0.67	5.25	5.73	2.32
May	3.75	4.12	4.46	5.25	5.36	0.69	5.50	5.81	2.42
June	4.00	4.18	4.53	5.25	5.36	0.76	5.50	6.00	2.67
July	4.00	4.26	4.54	5.25	5.36	0.78	5.75	6.04	2.63
August	4.00	4.74	4.78	5.25	5.62	0.97	5.75	6.69	2.86
September	4.00	4.79	4.73	4.75	5.23	1.03	5.75	6.30	2.82
October	4.00	4.60	4.60	4.50	4.89	0.90	5.75	6.28	2.68
November	4.00	4.64	4.60	4.50	5.00	0.92	5.75	6.49	2.63
December (1)	4.00	4.79	4.79	4.25	4.88	0.96	5.50	6.14	2.64

NOTES: (1) December 21.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-6-06 (2.75%), 3-8-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%), 8-3-07 (3.75%), 6-6-07 (4.00%).
(3) Latest dates showing change: 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%), 31-10-07 (4.50%), 11-12-07 (4.25%).
(4) Latest dates showing change: 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%), 5-7-07 (5.75%), 6-12-07 (5.50%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

Central banks decide to intervene in concerted move to end upsets in monetary markets.

exception. The differences between the European Central Bank reference rate and the 3-month Euribor and 1-year Euribor held at levels well above the historical average.

The rise in interest rates in the interbank market is due to the lack of confidence brought about by the subprime mortgage crisis. Banks are cautious about lending money for two reasons. The main reason is the loss of confidence brought about by the multi-million dollar losses because of the increase in default. The second most important reason is temporary but reinforces the other. Generally at year-end there is greater pressure in the interbank market due to the increase banks make in their liquidity to adjust it to desired levels for the presentation of their equity situation at the end of the year.

ECB still concerned about price rises in Euro Area.

In view of this situation, on December 12 the central banks of United States, the Euro Area, United Kingdom, Canada and Switzerland launched a concerted operation to inject liquidity. Those responsible for monetary policy felt that a major rescue operation was necessary in order to normalize the markets, one which required close coordination.

The concerted operation began with the announcement that the ECB and the Swiss central bank would join the Fed in a currency swap in order to auction 24 billion dollars. The central banks of the United Kingdom and Canada carried out substantial changes in the types of asset they would accept as collateral in order to grant liquidity to banks in their respective countries. In addition, the Bank of England decided to carry out a profound revision of its open market operations in order to strengthen the operative capacity of its monetary policy.

Japan fails to raise interest rates but China should raise rates because of increased inflation.

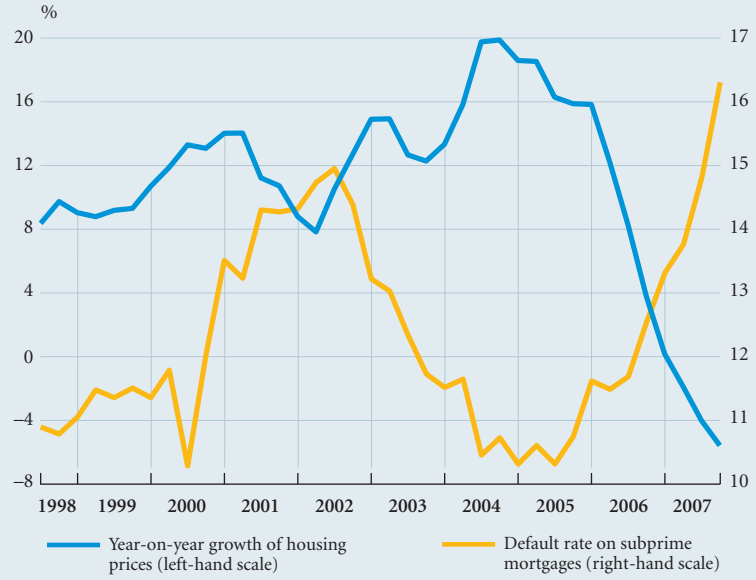
While the ECB was one of the central banks taking part in the operation to inject liquidity, it is still following the development of price increases in the Euro Area on its radar. In his statement following the official ECB meeting on December 6, governor Jean-Claude Trichet noted that a number of members of the Governing Council had supported the need for a rise in the reference rate in order to counteract underlying pressures in prices brought about by the increase in oil prices and food raw materials. Later on, the governor himself confirmed the ECB's awareness of possible repercussions of these price increases on other components of the consumer price index. Furthermore, he added, that there was no contradiction between this possibility and the reductions in interest rates carried out in other countries, seeing that «our colleagues are in a different situation».

In Asia as well, the central banks have had to make some difficult decisions. The nine members of the Executive Board of the Bank of Japan voted in favour of maintaining the interest rate and warned of the risks of a drop in the country's growth. On the other hand, China raised its official interest due to the sharp rise in prices as reflected in the CPI. The main problem of the Chinese authorities is that, while they must raise interest rates more in order to avoid inflationary pressures, at the same time they do not want to accept the subsequent appreciation of the currency.

Subprime mortgage crisis: the risks of risk

For some years now the economy of the United States has surprised everyone with the strength of its growth, resisting the rise in oil prices and its all-time high current account deficit. Also to the surprise of many, its weakness has come hand-in-hand with a sharp rise in default rates of subprime mortgages, those granted to high credit-risk borrowers. As shown in the following graph, the increase of the default rate has gone above the levels reached in 2002. Furthermore, it has been accompanied by a drop in nominal prices for housing (6% since the high in June 2006), which reduces the value of the collateral given for mortgage loans.

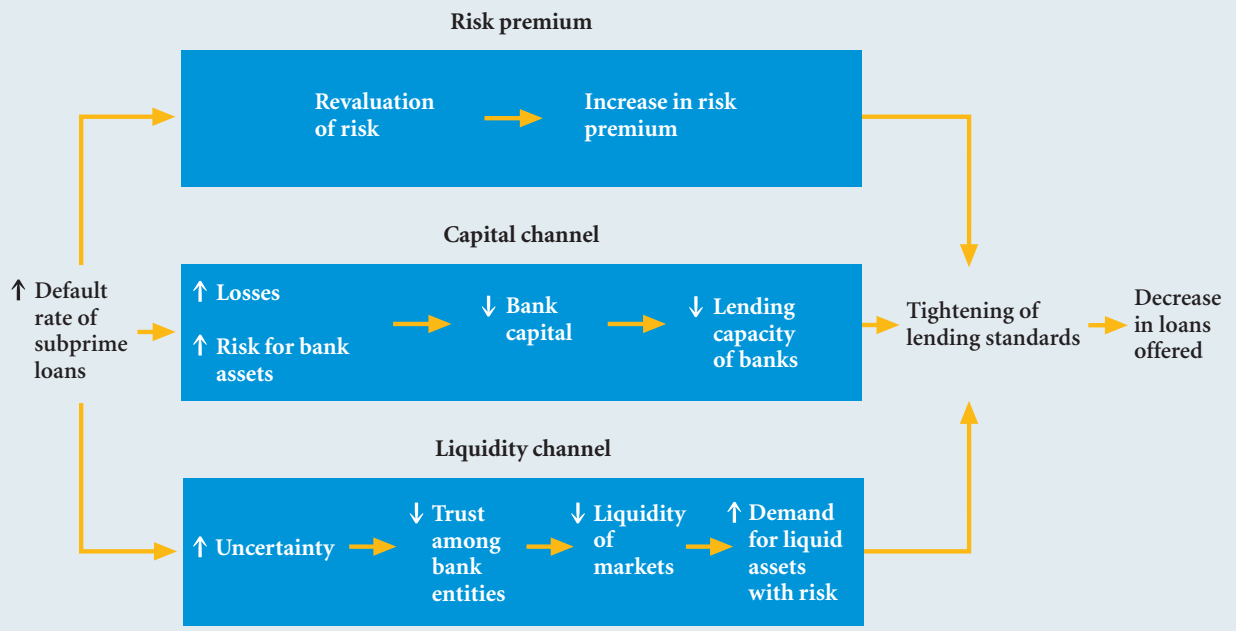
THE DEFAULT RATE INCREASES AND THE VALUE OF COLLATERAL OF MORTGAGES FALLS IN UNITED STATES



SOURCE: Datastream, Standard & Poor's and own calculations.

To date, the estimated losses from the increase in the default rate of subprime mortgages stands at around 70 billion dollars. Nevertheless, the real fear lies in the impact these losses may have on the functioning of financial markets and the lending capacity of banks. This is the fear of a credit crunch, a contraction in the supply of credit that could affect corporate investment and household consumption. This box analyses the mechanisms that could transform the crisis in the subprime mortgage market (which represents only 13% of total mortgage market) into a credit crunch, as well as the risk that this could take place and the various steps taken to avoid this happening.

As shown in the following table, there are various channels through which the increase in the default rate of subprime mortgages may have effects on the real economy. In the first place, the rise in default has set off a revaluation of the price of risky assets, such as subprime mortgage securitizations. This has brought about an increase in risk premiums and, therefore, a tightening of the terms for granting credit. In addition, there are two transmission channels that are somewhat more complex – the capital channel and the liquidity channel. With regard to the first, the increase in default rates has forced financial intermediaries to increase the



provisions for expected losses, thus limiting their capacity to accumulate equity. How does this affect the supply of credit? The lending capacity of banks depends directly on the ratio of capital over total assets for two reasons. Under the Basle rules, banks are obliged to maintain a minimum level of capital. Furthermore, good capitalization makes a bank safer, given than it can absorb a higher level of unexpected losses, and this improves the capacity of banks to raise deposits and other resources that may be used for granting loans. Therefore, the fall of the capital ratios may compel financial intermediaries to tighten the credit standards to approve loan applications and to reduce the supply of credit. To the extent that these problems increase, banks may be forced to stop funding some solvent companies and households, thus affecting the good progress of the economy.

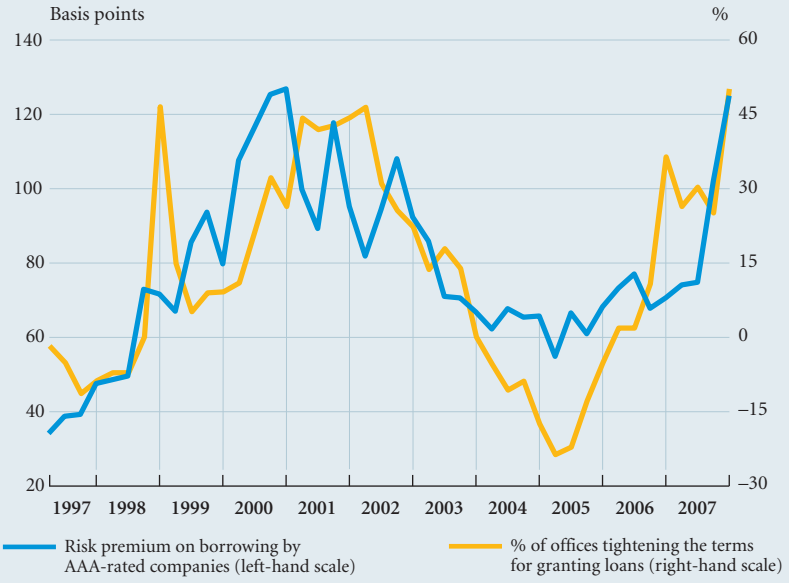
What is more, the capital channel may be amplified by the crisis being felt by monoline insurance companies. These companies emerged as insurers of low-risk debt so that if the issuer declared bankruptcy they took over payment of the debt. Nevertheless, over the past decade they have begun to insure assets of greater risk associated with subprime loans. With the recent increase of default rates, the capacity of these companies to meet all payments is not clear. If at the end they could not do so, the assets of banks that are qualified as safe for the monoline insurance backup should be restated as risky assets, with the subsequent effects mentioned above.

The liquidity channel, on the other hand, has its origin in the complex distribution of subprime loans through sophisticated financial assets, which makes it difficult to identify those financial intermediaries who hold the risk in the final instance. To be specific, the business model followed by many US mortgage entities (known as «originate and distribute») consisted in packaging (with the help of investment banks) various types of loans in a complex financial asset known as ABS (asset-backed security). Later on they sold this in the market, thus managing to rid themselves of a large part of the risk of default which was distributed among the various

investors that bought them. From what we now know, in many cases the rating agencies underestimated the default risk so that buyers were not aware of the risk they were taking on. Now, financial intermediaries know the real risk of these financial assets but, given that they do not know for certain who holds them or in what amount, they prefer to invest in safer assets. The interbank market, where banks borrow among themselves over the short term to meet specific liquidity needs, is one of the markets to suffer most. This has meant that banks now prefer to increase the liquidity in their balance sheets in order to reassure themselves in the face of possible future liquidity needs. Because of this, they are tending to reduce the loans they are willing to provide as also has happened in the capital channel.

At this stage, various measures have been taken to minimise the impact of the amplification channels. On the one hand, with the backing of the government, the main US banks have agreed to study case by case each subprime mortgage in risk of failure to see if it would be more profitable and viable to avoid failure by freezing the interest rate for a period of 5 years. According to the Department of the Treasury, this measure could affect more than half a million loans that had a very low interest rate in the early years but later moved into higher rates. On the other hand, both the US Federal Reserve and various central banks in the developed countries have injected liquidity into the interbank market. While they have not been able to reduce the risk premium to levels before last summer, their intervention has shown the existence of a source of liquidity of last resort, which has brought a breath of fresh air to the markets. With regard to the capital channel, the savings of emerging countries and the petroleum producing countries seems to be available to recapitalize those banks in need. For the moment, a number of large banks, including UBS, Citigroup and Morgan Stanley, have already obtained major injections of capital from investment funds in Singapore, the Arab Emirates and China.[1]

IT IS INCREASINGLY DIFFICULT TO OBTAIN FUNDING IN UNITED STATES



SOURCE: Datastream, US Federal Reserve and own calculations.

(1) Assets of most important sovereign investment funds of emerging countries and petroleum producing countries represent somewhat more than twice market capitalization of 20 largest US banks.

For the moment, US banks have begun to tighten the terms for granting loans and the risk premium of companies with a AAA credit rating (the safest in the market) has risen sharply to levels seen in 2000. Nevertheless, the good state of consumption and non-residential investment, which grew by 2.7% and 9.4% respectively in the third quarter, suggests that the real economy has still not reacted to the hardening of financial terms although it would be expected to do this with some delay.

The final impact on the economy will largely depend on how long the uncertainty in the market lasts as well as on how effective are the measures taken. While it may be expected that uncertainty will be reduced when the banks make their results public, it is also true that, as we still do not have details of the various measures taken, it is too early to judge their real extent. Furthermore, it is necessary to closely watch both the trend in inflation (which, should it hold at present levels, could limit the ability of the Federal Reserve to stimulate the economy) and the drop in housing prices which, by reducing real estate wealth, could significantly cut consumption.

Interest rates incorporate increased cost of risk

Interest rate curves show that situation still not normalized.

Long-term government bond interest rates have moved up a few basis points due to the increase in inflationary pressures as a result of the sharp increases in prices of en energy and raw materials in recent months. To some extent, however, this movement also represents a correction of the drop in rates as a result of the «flight to quality» that came about in November. At that time, investors divested themselves of positions in assets high- risk assets and took refuge in government bonds of the developed countries with the subsequent drop in yield these offered.

Nevertheless, movements have been gradual. For example, the interest rate on Euro Area government bonds rose from 4.13% to 4.28% and in the United States 10-year bonds again went above 4% after having reached 3.94% the month before.

How do we measure these increases and the risk aversion that exists in bond markets? There are two ways that are very useful. The first involves comparing the interest rate curves for government

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2005	2006	2007			
			June	September	November	December (*)
United States	4.39	4.70	5.02	4.59	3.94	4.07
Japan	3.31	1.69	1.88	1.69	1.48	1.56
Euro Area	1.48	3.95	4.57	4.33	4.13	4.28
United Kingdom	4.10	4.74	5.46	5.01	4.64	4.63
Switzerland	1.97	2.52	3.23	3.01	2.88	2.99

NOTES: (*) December 21.
SOURCE: Bloomberg.

bonds and the interbank market. The second is to study the trend in the credit differentials demanded of bonds issued by private companies.

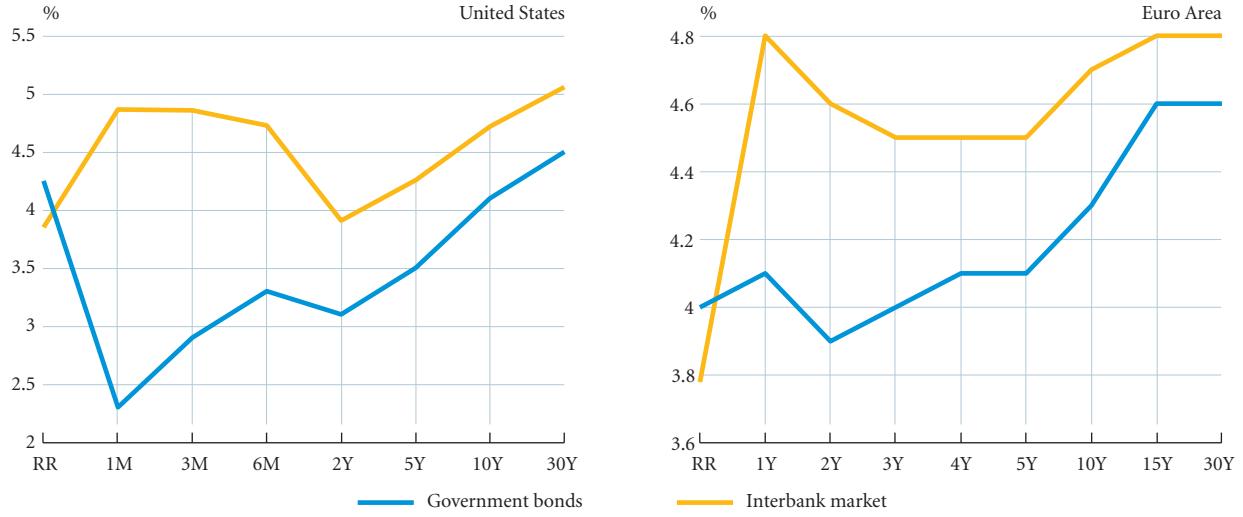
The following graph shows the interest rate curves for government bond markets and the interbank market in the United States and the Euro Area. The interest rate curve for government bonds is formed by means of the yields offered by bond issues with different maturities. The curves for the interbank market are the quotations offered by banks for lending for various terms. The interbank curve is always higher than that for government bonds because, although the likelihood of a bank going bankrupt is very low, it does exist and therefore a higher risk must be compensated with a higher interest rate.

For example, the interest rate on a one-month term bill in the United States may run at 2.3% whereas in the 1-month interbank market interest is quoted at 4.9%. The same thing happens in the Euro Area although certainly not as sharply. The yield on a 1-year bond is 4.1% while in the interbank market a 1-year term is quoted at 4.8%.

The graphs show a situation in which there is a big difference between the quotation for government bonds and the interbank market, especially in the short segments of the curves. This reflects a lower desire on the part of banks to borrow money from each other. Raising the price of money at 1-month or 1-year means reducing demand for interbank loans for those terms seeing that now they are more expensive. The objective of the injections of liquidity in the interbank market by the central banks is basically to reduce these differentials in rates between the two curves. Injecting liquidity implies covering demand for funds by the banks, thus easing the price of money for those terms between banks.

I'M SORRY BUT I CANT LEND YOU ANY MONEY

Interest rate curve for government bonds and interbank market in United States and Euro Area



NOTES: RR = Central bank reference rate. In the interbank market curve this is the 1-day quotation, M = months, Y = years.
Figures on December 21, 2007.
SOURCE: Bloomberg and own calculations.

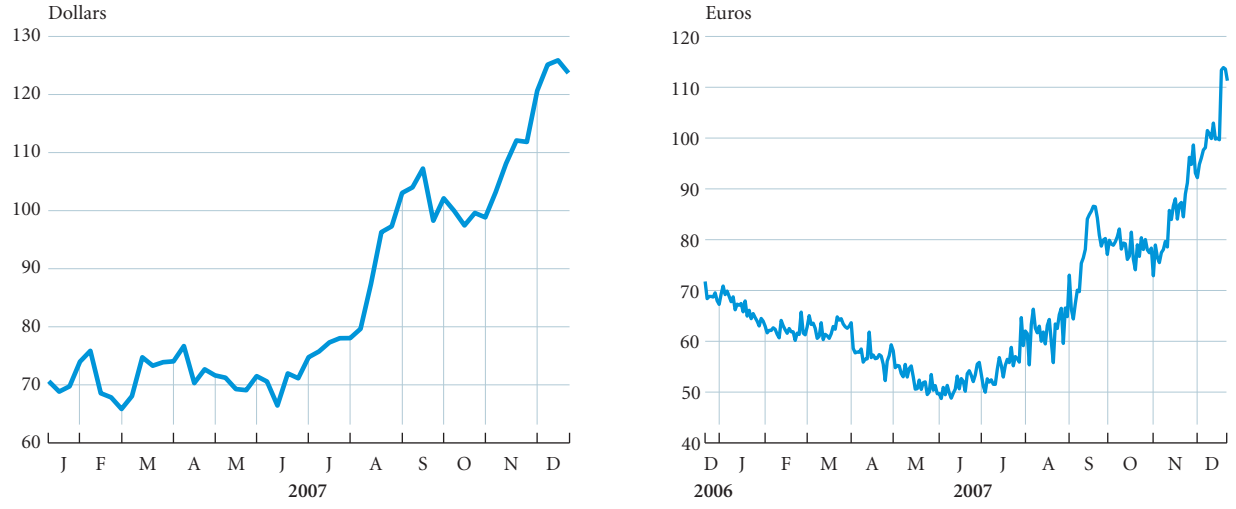
WHAT'S THEIR CREDIT RATING?

Ratings according to Standard & Poor's

Investment Grade	Junk Bond
AAA	BB+
AA+	BB
AA	BB–
AA–	B+
A+	B
A	B–
A–	
BBB+	
BBB	
BBB–	

WHAT CREDIT RATING DO YOU HAVE?

Differentials in credit quality or private 10-year bonds issued in dollars with AAA rating and private bonds issued in euros with BBB rating, in basis points



SOURCE: Bloomberg and own calculations.

The second way to study the increased level of uncertainty is through differentials in credit. What do private companies pay when issuing bonds to obtain funding in the bond market?

Companies have to pay more if their credit rating is low, that is to say, if their likelihood of bankruptcy is higher. The ratings assigned to companies run from the best classification AAA to the D classification, which indicates that the company has defaulted. The above table shows the classification and distinction between bonds that are classed as «investment grade» or very safe and those denominated «junk bonds» which mean a more speculative investment where the risk of default is much higher.

In the above graph we see the trend in credit differentials. For example, a bond

issued by a company in dollars with a maturity of 10 years and an AAA rating must pay 123 basis points (100 basis points is 1%) more than the same term costs in the interbank market. This is to say, as the 10-year rate in the US interbank market is 4.71%, a private bond in dollars is able to get funding but must offer a return of 5.94% (4.71% + 1.23%).

On the other hand, a bond issued by a company in euros with 10-year maturity and a BBB rating must pay 111 basis points more than for the same term in the Euro Area interbank market, that is to say, 5.81%. But what is important is the trend in the differential demanded from the private sector for finance which, as may be observed, has risen considerably thus indicating a higher price for risk, that is to say, greater risk aversion on the part of investors.

Increase in volatility of foreign currency markets

Dollar halts tendency to depreciate against euro.

In the foreign currency market, the tendency of the dollar to depreciate against the euro has been halted. Whereas on November 26 the euro reached an all-time high of 1.4873 against the *greenback*, the dollar managed to regain ground and over the past month has been revalued by 3.3% against the euro going to 1.437. News about inflation, somewhat worse than expected in the United States, together with the good news about the rate of US consumer spending over the Christmas season implies that investors see it less likely that the Fed will lower interest rates in coming months.

In addition, there are two other factors that have helped the recovery of the

EXCHANGE RATES OF MAIN CURRENCES

December 21, 2007

	Exchange rate	% change (*)		
		Monthly	Over December 2006	Annual
Against US dollar				
Japanese yen	113.5	4.5	–4.9	–4.3
Pound sterling	0.504	4.0	–1.3	–1.2
Swiss franc	1.155	4.6	–5.5	–5.3
Canadian dollar	0.997	1.0	–17.0	–15.9
Mexican peso	10.820	–1.6	0.0	–0.4
Against euro				
US dollar	1.437	–3.3	8.9	9.1
Japanese yen	163.1	1.2	3.8	4.6
Swiss franc	1.661	1.5	3.2	3.6
Pound sterling	0.724	0.6	7.4	7.8
Swedish krona	9.448	1.4	4.5	5.4
Danish krone	7.462	0.1	0.1	0.1
Polish zloty	3.619	–1.9	–5.6	–5.2
Czech crown	26.45	–1.3	–3.8	–4.2
Hungarian forint	254.0	–1.2	1.1	0.7

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

dollar. The first, the currency swap between the Fed and the ECB mentioned earlier which has provided dollars to certain European banks anxious to get currency from the other side of the Atlantic. In addition, various Asian sovereign investment funds along with Middle East investors have bought shares of various US banks which had to recapitalize in view of their losses arising from the subprime mortgage crisis.

The Japanese yen has also weakened against the dollar following news of the worsening of economic prospects for the Japanese economy and after the sharp cut in growth estimates for Japan made by the government and the Bank of Japan.

Foreign exchange markets: what goes up must come down?

The year just ending will be remembered for the collapse of the US currency, which has hit all-time lows. The dollar has lost 60% of its value against the euro since 2001 and, after breaking a number of low records, came close to 1.50 dollars per euro at the end of November. In terms of the former Spanish currency, the dollar has traded at an exchange rate equivalent to 112 pesetas per dollar, a figure not seen since the beginning of 1993. Against the pound sterling, the dollar has been running at levels of «two for one» unheard of since the beginning of the Eighties. On the other hand, the Japanese yen has also remained weak but, as we shall explain below, for different reasons than in the case of the dollar.

In this box, we look at the prospects for the foreign exchange market in 2008. Given the relative strength of some currencies in historical terms (or weakness, where this applies), we may ask if the maxim «what goes up must come down» applies in the case of the euro and the pound sterling and if, on the other hand, «what comes down, must go up» in the case of the US dollar and the yen. We shall look at the prospects for the main currencies from the perspective of the goods markets (the trade balance) and of asset markets (that is, interest rates) and we shall also comment on the role played by the exchange rates of some emerging markets, especially China, in the adjustment mechanism.

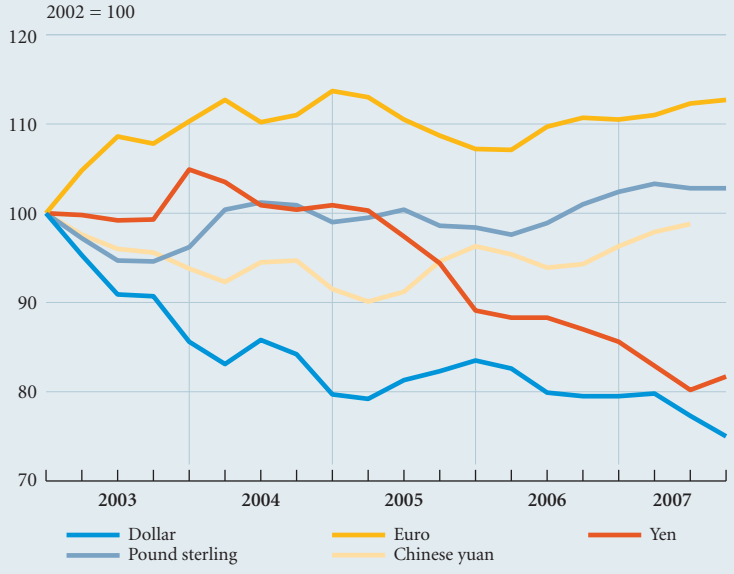
In order to get a better perspective on trends in the main currencies, the following graph shows the real effective exchange rate of those currencies. This indicator shows a weighted average of bilateral exchange rates of a currency vis-a-vis its main trading partners and takes into account the inflation differential between countries.[1] As may be seen, the yen and the dollar have lost value, the euro has gained and the yuan and pound sterling have a value similar to what they had in 2003.

The weakness of the dollar may be attributed to two main factors, one of a structural nature and the other of a more temporary type. Let us begin with the structural factor, the well-known trade deficit of the United States. This deficit reached 6.2% of GDP at the end of 2005 and by then many economists predicted that part of the adjustment mechanism had to come from a depreciation of the dollar. By increasing the cost of imports and making exports cheaper, a loss in value of the greenback would give a positive boost to the trade balance. It is for this reason that now the US trade deficit has been reduced to 5% of GDP. In fact, if during this period the

(1) An increase in the real exchange rate, that is, a real appreciation, may result from an increase in the nominal exchange rate or from higher inflation in terms of other countries.

WINNERS AND LOSERS IN THE CURRENCY RACE

Effective real exchange rate



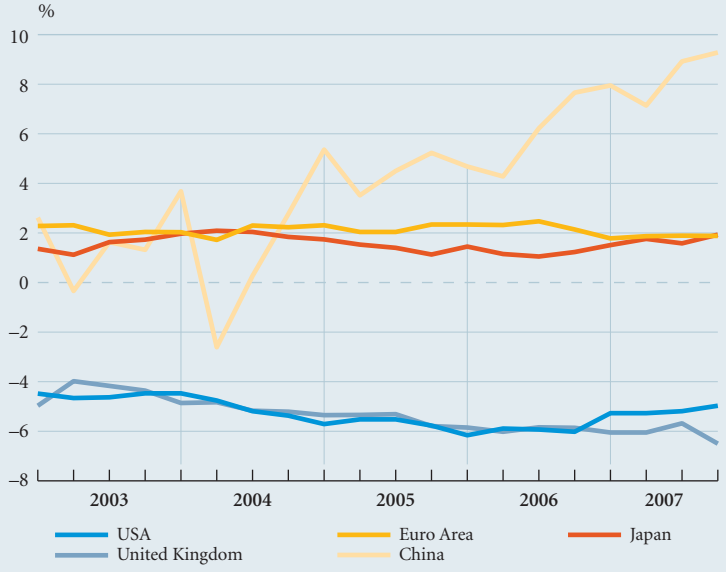
NOTES: A rise in effective real exchange rate signifies appreciation.
SOURCE: Thomson Financial Datastream, OECD and national authorities.

price of oil (a commodity of which the US is a big importer) had not risen, the reduction of the trade deficit would have been around 0.5% of GDP larger. The second factor explaining the weakness of the dollar is of a more temporary nature and depends on the present economic cycle. If the Federal Reserve cuts interest rates more than other central banks (such as the ECB) in 2008 to counteract the effects of the housing and subprime mortgage crises, as financial markets anticipate, it is likely that the dollar will remain weak over the short term. Another factor that could work against the dollar is the growing presence of the euro as a reserve currency for central banks of emerging countries. The dollar is clearly the leading reserve currency. It represents 65% of total foreign currency reserves against 25% for the euro. Nevertheless, it is to be expected that the emerging countries will further diversify their currency portfolios and even more so if the weakness of the dollar is seen as long lasting. In fact, the mere announcement of the intention to diversify currency portfolios by some central banks of petroleum exporting countries has already caused slight depreciations of the dollar.

If the dollar must depreciate, against what currencies should it do so and what are the implications for the euro exchange rate? As shown in the following graph, China is one of the keys. The growing trade surplus of the emerging Asian giant, which now is hitting 9% of GDP, is symptomatic of the fact that the yuan is sharply undervalued. In spite of the fact that the Chinese authorities abandoned the system of a fixed exchange rate to the US dollar, so far the bilateral exchange rate has risen only slightly, namely 11% in two years (from 8.28 yuan to the dollar in 2005 to 7.37 yuan to the dollar at the end of 2007). Signs of overheating shown by the Chinese economy, with inflation at 6% and rising, and real growth above 10% would suggest that China cannot continue to import US monetary policy (through an excessively rigid exchange rate) and must let its currency appreciate much more than it has done up to now. Undoubtedly, this would ease pressure on other bilateral exchange rates such as that for the euro/dollar.

PERSISTENT TRADE IMBALANCES

Trade balance as percentage of GDP



SOURCE: Thomson Financial Datastream and national authorities.

As may be seen in the above graph, Japan and the Euro Area have trade balances that fluctuate around a surplus of 1% of GDP. Why has the yen weakened against the euro if the foreign position of both economic regions is similar? The yen has been a victim of Japan's low interest rates which have brought about the phenomenon known as the «carry trade». When the interest rate differential between two countries is high, investors borrow in the currency with a low interest rate (the yen) and invest in assets expressed in currencies with higher interest rates in a situation of low volatility and little perception of risk. Initially, therefore, the yen depreciates when investors sell the Japanese currency and buy other currencies to make their investments. When investments mature, in theory the opposite transactions would occur in foreign currency markets and there would be a return to the initial exchange rate. But, if interest rate differences persist, investors again carry out the same massive transactions selling yen against other currencies thus depressing the value of the yen even more. Obviously, the transaction carries an exchange rate risk but this is compensated if the yield differential is high as has recently been the case. The yen has thus depreciated in the past two years due to this phenomenon but, as interest rates in Japan rise and rates drop or remain steady in other countries, we should expect that the incentives for the carry trade will not compensate for the possible risk and that as a result the yen will appreciate in the absence of massive sales.

Finally, with regard to predicting foreign exchange rates, the maxim of «what goes up must come down» is often true over the long term and for this reason we could say that the dollar and the yen may be undervalued, whereas the Chinese yuan is the currency that seems most clearly undervalued. The euro seems slightly overvalued and its recent appreciation against the dollar arises largely from the downturn of the economic cycle in the United States and the lack of flexibility in the yuan/dollar exchange rate. If these factors disappear over time, it is possible to expect a slight depreciation of the euro over the long term. Nevertheless, the inherent volatility of the financial markets, the cyclical position of each economy and the presence of major players whose exchange rates are not entirely flexible may mean that a return to long-term values may not be without its surprises.

Modest year in stock markets of developed countries

With the arrival of year-end we should look at the returns obtained by investors in equity shares. The stock exchanges of the developed countries have shown a generally modest performance with the odd exception, such as the index for the German stock market which recorded a cumulative change of around 20%. The US stock markets generally obtained returns of less than 10%.

The IBEX 35, in turn, came up to year-end with cumulative latent capital gains of 8%. Bearing in mind the current upsets and their effect on the quotations of companies linked to the construction, real estate and banking sectors, this result meant a good performance for the Spanish stock market index.

The worst result among the more important stock markets showed up in Japan. The Nikkei index has suffered much more from the impact of financial instability and showed a cumulative return of –11.4%. On the other hand, stock markets in the emerging countries have generally benefited from a cycle with increasing prices for raw materials in those countries that are prominently exporters of those goods and from strong world growth in those logistical centres of world industrial production, such as India and China.

Stock markets in developed countries, except Japan, end year with positive results but generally modest.

INDICES OF MAIN WORLD STOCK EXCHANGES

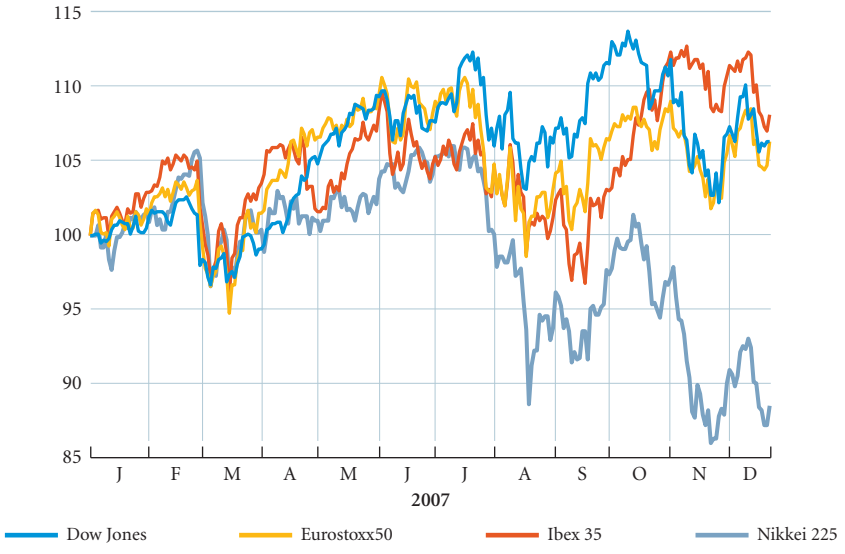
December 21, 2007

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*13,245.6*	*3.5*	*6.3*	*6.6*
Standard & Poor's	*1,460.1*	*3.1*	*2.9*	*2.9*
Nasdaq	*2,640.9*	*3.1*	*9.3*	*9.3*
Tokyo	15,257.0	2.8	–11.4	–10.5
London	6,433.1	6.0	3.4	4.0
Euro Area	4,379.7	4.4	6.3	6.5
Frankfurt	*7,980.0*	*6.1*	*21.0*	*21.4*
Paris	*5,586.1*	*3.8*	*0.8*	*1.4*
Amsterdam	*512.5*	*6.0*	*3.5*	*3.6*
Milan	*38,231.0*	*2.3*	*–7.7*	*–7.4*
Madrid	*15,292.9*	*–0.5*	*8.1*	*8.1*
Zurich	8,458.5	4.1	–3.7	–3.6
Hong Kong	27,626.9	3.8	38.4	43.7
Buenos Aires	2,140.3	–3.4	2.4	4.2
São Paulo	62,846.0	3.7	41.3	44.9

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.

MARKET MAKES ADEQUATE PROGRESS BUT SHOULD IMPROVE

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



SOURCE: Bloomberg and own calculations.

2008 presents various challenges for equity shares.

In the annual trend in stock markets in the developed countries we see a «before and after» set by the outbreak of the subprime mortgage crisis in the United States. Challenge will come with 2008 when we must evaluate the impact of credit restrictions on the real economy and if it brings about lower growth in some regions of the world. The upsets have affected the corporate profit and loss accounts in the financial and real estate sectors but without spilling over to other economic sectors to such a great extent. Is this situation sustainable? The key lies in an early resolution of current imbalances.

SPAIN: OVERALL ANALYSIS

Economic activity

Gradual economic slowdown

In the final stages of 2007, the economy continues at a strong beat although there are signs of a slight slowdown. Consumption is generally maintaining considerable drive although investment is losing strength. The various economic sectors are showing strong although this is less marked in construction.

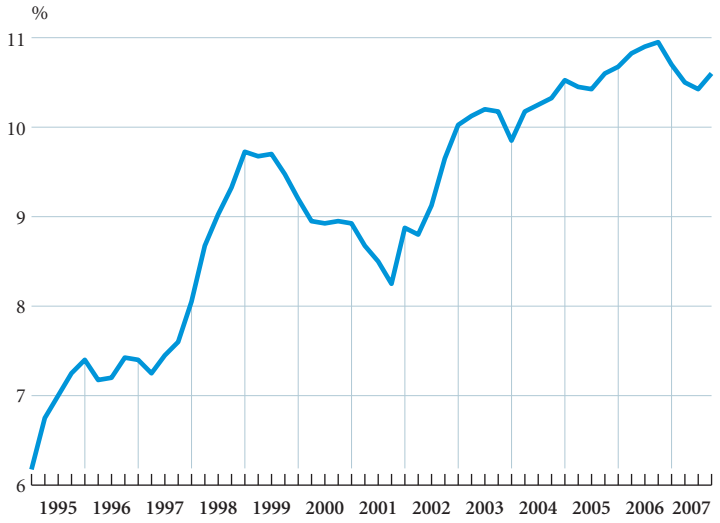
Figures for the Quarterly Company Balance Sheet Figures compiled by the Bank of Spain are a good thermometer to measure the temperature of economic activity. According to results for the third quarter of 2007 the state of companies is good although we note some signs of moderation. In the January-September period of 2007, gross value added by non-financial companies, which is obtained by deducting intermediate consumption from the value of production, rose by 5.4% compared with the same period the year before, 2.1 points less than one year earlier. The economic slowdown was more marked in some branches, such as retail trade, as a result of some loss of drive in consumption.

Wage costs of companies in the sample were up 4.3% compared with the same period in 2006, some 1.2 points less than one year earlier. This performance was due to slightly less job creation than in the months of 2007, given that wages grew at a similar rate. As a result, the gross operating result rose by 6.2% compared with the same period one year earlier, a notable growth figure even though 2.9 percentage points lower than the year before.

Economic state of companies remains good.

CORPORATE RETURNS STAND AT HIGH LEVEL

Ordinary return on equity (moving average for four quarters)



SOURCE: Bank of Spain and own calculations.

PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES

Annual change rates

	2006	Quarters: 1-3	
		2006	2007
Value of production	10.0	12.5	4.3
Intermediate consumption	11.1	15.2	3.8
Gross value added (GVA)	**7.4**	**7.5**	**5.4**
Wage costs	6.6	5.5	4.3
Gross operating profit	**8.3**	**9.1**	**6.2**
Financial income	27.6	21.0	18.6
Financial costs	35.8	34.1	35.8
Depreciation and provisions	7.3	1.9	–0.2
Net ordinary profit	**7.9**	**10.0**	**4.5**
Capital gains and extraordinary income	70.8	31.4	–13.3
Capital losses and extraordinary costs	–28.0	–39.8	7.4
Provisions and tax	76.0	130.9	–15.0
Net profit	**39.8**	**11.5**	**3.0**

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

High corporate returns sustaining growth of investment and employment.

Financial income of companies rose by 18.6% as a result of higher interest obtained. Nevertheless, the increase in financial costs was still higher due to greater borrowing by companies to carry out expansion plans and to the rise in interest rates. The net ordinary result, after subtracting the financial balance and depreciation and operating provisions, amounted to 4.5% compared with 12 months earlier, which also indicates a slowdown.

In the early quarters of 2007 capital gains and extraordinary income were down compared with the year before. This explains why the net result showed only annual growth of 3.0%.

In fact, the profitability of companies shows notable high levels. Ordinary return on net assets stood at 7.9%, the same level as in the same period in 2006. Ordinary return on equity was higher at a robust 11.3%, given that financial costs were 3.5 points lower than net ordinary return on assets. High corporate returns are sustaining growth of investment and employment.

Returning to the present economic situation, early indicators for the fourth quarter are still showing economic drive, with a few exceptions. Electricity consumption, adjusted for working days and temperature, was up 7.2% in November compared with the same month the year before.

Consumer durables slowing down.

Consumption seems to keep going reasonably well, especially in services. In consumer durables, on the other hand, we note a slowdown to the point where car sales in November were down 5.9% compared with the same month the year before under the effect of the rise in interest rates. Nor is consumer confidence very buoyant having dropped in November to the lowest point in recent years.

In turn, investment is tending to ease off, mainly in capital goods. Production in

DEMAND INDICATORS

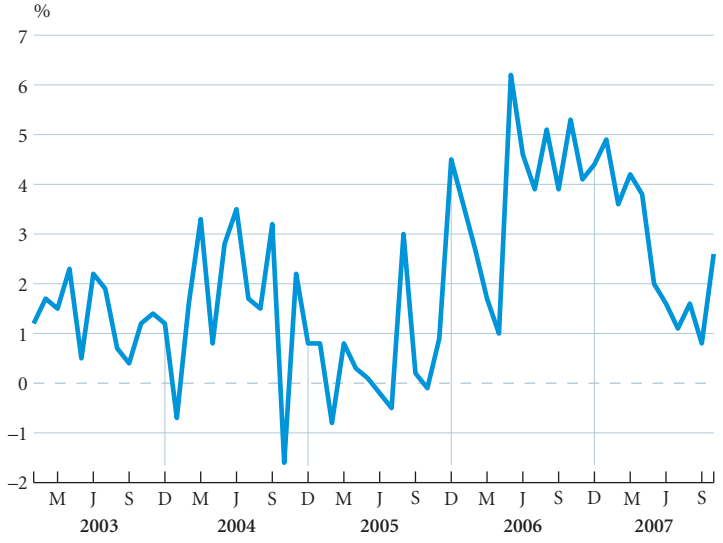
Percentage change over same period year before

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	3Q	October	November
Consumption									
Production of consumer goods (*)	0.9	2.3	1.9	4.3	4.8	2.1	1.0	0.6	...
Imports of consumer goods (**)	7.9	8.9	2.4	7.6	–1.1	5.6	8.4	...	...
Car registrations	2.1	–0.9	–4.1	1.8	–0.7	–2.4	–2.9	3.4	–5.9
Credit for consumer durables	15.0	14.5	13.2	12.0	13.8	9.6	6.9	–	…
Consumer confidence index (***)	–10.8	–12.3	–13.7	–10.3	–10.7	–12.7	–12.3	–16.0	–17.0
Investment									
Capital goods production (*)	–0.1	8.4	7.9	11.2	8.9	5.3	6.2	7.4	...
Imports of capital goods (**)	20.4	3.2	6.5	3.4	20.1	11.0	–0.6	...	...
Commercial vehicle registrations	13.2	1.5	0.5	–1.0	1.7	–2.2	–3.0	4.1	–7.8
Foreign trade (**)									
Non-energy imports	6.0	9.0	8.9	9.3	6.4	7.7	7.6	...	...
Exports	0.2	5.6	1.7	4.7	3.0	2.8	6.7	...	...

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.

INDUSTRIAL PRODUCTION GIVES POSITIVE SURPRISE IN OCTOBER

Year-on-year change in industrial production index



NOTES: Statistical series adjusted for calendar differences.
SOURCE: National Institute of Statistics.

Sharp rise in capital goods production.

this component was up by 7.4% in October compared with the same month in 2006. Sales of commercial vehicles and equipment imports, on the other hand, reported a slowdown course. Cement consumption, an early indicator of construction investment, marked up a year-on-year increase of 5.2% in October, although the figure for November showed a slight drop.

On the supply side, the industrial production index brought a positive surprise in October with growth of 2.6% compared with the same month in 2006, more than was expected, although less than 12 months earlier. Corporate confidence showed some improvement in November compared with the low level recorded in October. On the other hand, utilization of production capacity was down slightly but still held at high levels. Industry prospects are reasonably good, if we are to judge by the rise of 10.5% in the general index for new orders in industry in October. This was higher than the average of 5.4% for the first 10 months of the year.

Industry prospects improving.

With regard to construction, this is maintaining a notable rate of economic activity within a framework of

SUPPLY INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007				
			3Q	4Q	1Q	2Q	3Q	October	November
Industry									
Electricity consumption (1)	3.5	3.8	6.0	3.8	5.2	4.4	2.0	3.5	7.2
Industrial production index (2)	0.7	3.9	4.2	4.6	4.2	2.4	1.1	2.6	...
Confidence indicator for industry (3)	–4.8	–2.7	–2.3	–0.3	2.3	1.2	–0.7	–6.0	–1.0
Utilization of production capacity (4)	80.2	80.5	80.3	81.6	80.6	81.3	82.1	–	81.1
Imports of non-energy intermediate goods (5)	1.6	10.5	13.8	12.1	8.1	8.2	8.7	...	...
Construction									
Cement consumption	7.3	8.5	5.7	8.5	5.5	–1.0	–1.4	5.2	–1.8
Confidence indicator for construction (3)	22.4	14.2	14.7	15.0	10.7	15.7	12.0	8.0	–6.0
Housing (new construction approvals)	6.2	18.6	50.5	0.2	8.0	–15.0	–50.7	...	...
Government tendering	18.5	31.3	19.1	55.0	13.3	–2.1	–29.6	...	...
Services									
Retail sales	4.4	5.0	5.9	5.2	6.2	4.5	4.2	6.6	...
Foreign tourists	6.6	3.8	1.8	2.3	5.3	0.1	2.3	0.0	...
Tourist revenue inflows	6.0	5.6	4.9	3.1	5.8	2.0	3.2	...	...
Goods carried by rail (ton-km)	–3.2	–1.2	–3.3	–6.4	–4.1	–6.5	–1.4	–0.6	...
Air passenger traffic	9.2	6.8	4.7	7.2	9.5	7.1	10.5	8.3	10.2
Motor vehicle diesel fuel consumption	5.1	5.4	3.9	4.9	5.8	3.3	6.6	...	...

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.

slowdown. This state will tend to sharpen in the residential sub-sector, if we are to judge by the drop in the early indicator for approvals for new housing construction, although this has been affected by the building code which, at one stage, brought about many early applications in expectation of higher future costs as a result of stricter regulations. In this framework, the confidence indicator in construction continued to worsen. A contributing factor was the cooling off in the real estate market. According to figures supplied by the Property Registrars Association, housing transactions were down 16.0% in the third quarter compared with the same period the year before.

Services are making appreciable progress. Business volume was up 9.3% in October compared with the same month in 2006. Retail sales showed a continuation of moderate growth at the beginning of the fourth quarter. Air passenger traffic indicated a strong annual growth rate in the early months of the final quarter. With regard to tourism, hotel overnight stays in October were up 0.7% compared with the same month in 2006, in keeping with a mediocre season.

Services make appreciable progress.

To sum up, economic activity maintained notable drive so that annual growth for 2007 will stand close to 3.8%. Nevertheless, it is showing signs of a slowdown and there are downward risks arising from the upsets in financial markets, which suggest less favourable financing terms. In this situation, the Organization for Economic Cooperation and Development has reduced its growth forecasts for Spain's economy for 2008 to 2.5% and to 2.4% in 2009.

OECD lowers economic growth forecast for 2008 to 2.5%.

Housing cooling off

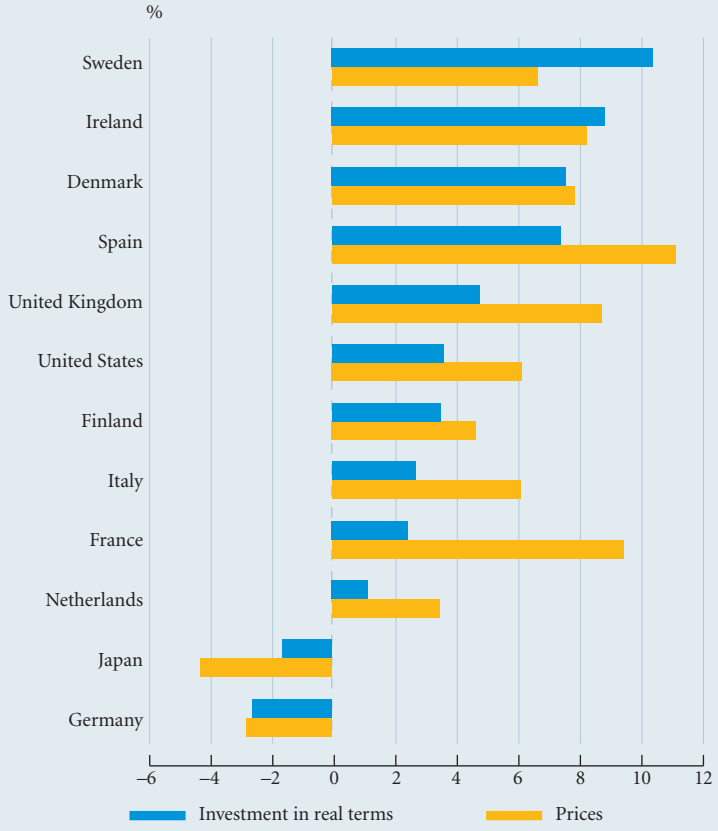
The real estate sector is cooling off in most of the developed countries and not as a result of climate change. In nearly all member countries of the Organization for Economic Cooperation and Development (OECD) investment is slowing down and prices are stagnant. This involves a change of cycle that arrived before the upsets in financial markets set off last summer made their presence felt in loan markets. These upsets did nothing to ease the drop in expectations within the sector. While the slowdown in the sector is being felt in many countries, only the United States and Ireland showed a decrease in housing investment and a drop in real prices in 2007. In Japan and Germany the sector also shows a recessive situation although in these two cases the difference lies in that these countries have not gone through a long growth stage.

This change of cycle has taken place following an extended period during which real estate activity went through notable growth at the same time in many countries. For this reason the main cause of the slowdown in housing is the wearing out of the upward cycle in an economic activity that is precisely characterized by undergoing notably high swings. At the same time, prices have shown notable increases going to all-time highs both in absolute terms and in relation to household incomes.

Where the slump in housing has been most notable is in the United States given that contraction in the sector, which began at the beginning of 2006, has done nothing but grow worse since then and prospects are rather pessimistic. The US real estate crisis worsened as of last August with the rise of the phenomenon of subprime

LONG EXPANSIONIST STAGE IN RESIDENTIAL INVESTMENT

Years 2000-2006 (average annual change)



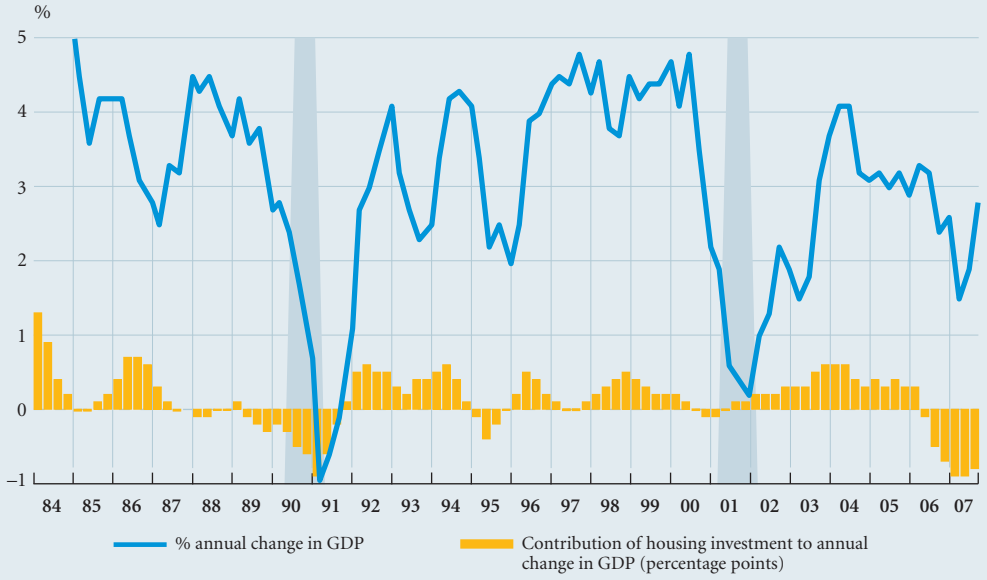
SOURCE: AMECO, OECD and own calculations.

mortgages and it is on the way to becoming one of the most serious in recent history. In contrast to what has been common in real estate crises in the United States, on this occasion the loss of real estate wealth for the moment has not had a significant impact on private consumption and for this reason has not brought about a more pronounced slowdown of the economy.

In Ireland, housing construction has also gone into a recessive stage. Following more than 10 years of growth, a rebound from the extraordinary growth of the economy and heavy immigration, residential construction went to more than 10% of gross national product, the highest level in the OECD. Nevertheless, as of mid-2006 the slowdown in economic activity and in transactions became evident, while at the same time prices began to drop, trends which likely will continue in coming quarters.

Other economies, including that of Spain, are beginning to feel the effects of the wearing out of the construction cycle. Up to what point is this drop significant? First of all, this will depend on the strength of the last growth cycle in each country, given that it may be expected that where growth has been very high the slowdown may be sharper. The most important question, however, whether the rise, whatever its size, has been

GDP HOLDING UP IN UNITED STATES



NOTES: Shaded areas represent recessions.
SOURCE: Bureau of Economic Analysis, National Bureau of Economic Research and own calculations.

the result of economic fundamentals or whether factors of a more speculative nature have been involved. Indeed, if growth has been the result of changes in economic fundamentals, the slowdown stage will depend on whether these continue to be present or not.

These fundamentals may be of three kinds. First, there are those arising from financial conditions – the level and volatility of interest rates, the development of mortgage loan products, innovation and competition in the bank market, etc. Second, the economic situation largely determines the demand for investment in housing, which is the most important investment made by households, so that the growth of household incomes, the unemployment rate and expectations of wage increases or employment will be determining factors in this respect. Third, demography is a basic element in housing demand both with regard to natural growth of the population and immigration and to social changes such as the divorce rate or the extent young people leave home.

Due to this range of factors, the trend in residential investment in 2008 could be quite varied depending on country. A common factor, however, will be a contraction of credit arising from the US subprime mortgage crisis. The anxiety caused by the spreading of risk for these assets has generated something of an upset in certain sectors of the loan market and what at first looked like a problem that would be resolved in a short space of time has turned into a financial storm affecting many countries, reducing liquidity of financial markets and affecting the normal carrying out of operations in these markets. Furthermore, the US mortgage crisis has worsened confidence indices not only in the United States but in many other developed countries. The decreased drive in credit thus becomes a factor that is not going to foster real estate activity, given that this largely depends on the ease of obtaining loans.

A LONG CYCLE WEARS OUT

Annual change

SOURCE: AMECO and own calculations.

In the case of Spain, over the past 13 years housing construction has gone through an exceptional growth stage, both in volume of building and in prices. As may be seen in the above graph, the duration of this stage was longer than that recorded between the middle of the Eighties and the early Nineties. The conjunction of a series of factors lies behind this unique period. From a financial point of view, the drop in interest rates from the moment when the early integration of Spain's monetary system in the euro was anticipated became a determining factor in the willingness of households to borrow in order to buy a home, an asset that was given tax relief and one that has been a traditional way of saving in this country. The excellent state of the economy, showing up in an historic rise in figures for employment, meant a significant rise in the incomes of Spanish households thus increasing their ability to take on a higher level of debt. As if this was not enough, increased immigration in recent years added a significant level of demand for housing, both in the cities (by immigrants finding jobs) and in holiday home areas (by Europeans deciding to spend their retirement years on the Iberian peninsula).

As noted earlier, prospects for the real estate sector are generally for a slowdown, partly due to some wearing out of those factors favouring its earlier growth and the financial upsets set off by the subprime mortgage crisis. The consequences for general growth of the economy will be felt, given that, apart from its direct effects, real estate activity has important drag effects on other factors of the economy. Estimates by the OECD indicate that those countries most affected could be Ireland and Denmark while others, including Spain, will see the weight of residential investment on their GDP slightly reduced. With regard to prices, recent experience in countries like the United Kingdom, Australia, Finland and even the United States shows that the corrections do not have to be great, especially if there is not a substantial increase in interest rates.

Labour market

Job creation sustained but at lower rate than in 2006

The labour market is continuing a trend to slowdown although job creation is holding at a notable rate. The number of workers registered with Social Security rose by 2.3% in November compared with the same month last year, a rate one decimal below that recorded in October and substantially lower than in 2006. Nevertheless, if we look at the trend we note that in recent months the labour market has maintained a job creation rate slightly higher than 2% in annualized terms.

The number of persons registered with Social Security dropped by 93,426 in November going to 19,325,697 at month-end although this was due to seasonal effects. In the past 12 months the total number of persons registered rose by 441,582, of which 284,159 were Spanish workers and 157,423 foreign workers. In the past year, the number of Spaniards registered rose by 1.7% while foreign workers were up by 8.4%.

Annual job creation rate holding above 2%, according to Social Security registrations.

By sex, females continued to increase their share of total registrations putting them at 42.0% at the end of November whereas in 1997 they represented only

Foreign workers show biggest increase in Social Security registrations and in unemployment.

EMPLOYMENT INDICATORS

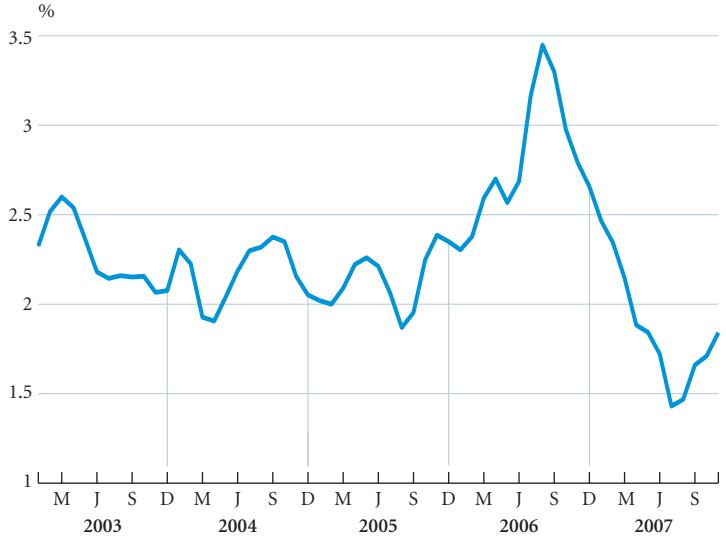
Percentage change over same period year before

	2005	2006	2006	2007				
			4Q	1Q	2Q	3Q	October	November
Persons registered with Social Security								
Sector	–0.5	0.0	0.2	2.2	2.7	2.5	2.6	2.4
Industry	*8.6*	*8.7*	*6.8*	*6.1*	*4.4*	*2.3*	*1.4*	*0.5*
Construction	*5.7*	*5.2*	*4.0*	*4.1*	*3.7*	*3.0*	*2.9*	*3.0*
Services								
Job situation								
Wage-earners	*4.8*	*4.7*	*3.5*	*3.9*	*3.5*	*2.6*	*2.4*	*2.2*
Non-wage-earners	*2.6*	*2.2*	*2.2*	*2.5*	*2.7*	*2.9*	*3.0*	*3.0*
Total	**4.4**	**4.3**	**3.3**	**3.6**	**3.3**	**2.7**	**2.5**	**2.3**
Persons employed (*)	**5.6**	**4.1**	**3.6**	**3.4**	**3.4**	**3.1**	–	–
Jobs (**)	**3.2**	**3.2**	**3.1**	**3.3**	**3.2**	**3.0**	–	–
Hiring contracts registered (***)								
Permanent	8.7	41.1	76.8	25.8	15.6	–1.6	–2.7	–18.1
Temporary	4.6	4.7	0.5	2.6	–1.9	–0.5	6.3	–1.9
Total	**5.0**	**7.9**	**7.3**	**5.3**	**–0.1**	**–0.7**	**5.1**	**–4.1**

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

SPANISH WORKERS REGISTERED WITH SOCIAL SECURITY SHOWS MODEST GROWTH

Year-on-year change in total number registered with Social Security (*)



NOTES: (*) Cycle-trend series.
SOURCE: Ministry of Labour and Social Affairs and own calculations.

Poor growth of employment in industry.

36.1%. This trend naturally was due to the higher rate of female registrations (3.9% in the past 12 months), a rate three times that for males.

By sector, the most dynamic was services with a level of Social Security registrations going up 3.0% in the past 12 months and with even a higher increase in the most recent period. Those services branches to show the highest growth in employment in the past 12 months were health services, education and domestic service. Industry reported an increase of 2.4% in registrations over the past year, although the growth rate has dropped below 1% in the past two months.

With regard to construction, the year-to-year change rate dropped to 0.5% in November and, in fact, in the past two months it has been showing a loss of jobs. The change of cycle in this sector has had another qualitative effect. The downturn in the sector has meant that many workers have decided to become self-employed. As a result, the number of self-employed workers in construction has risen by 10.2% in the past 12 months whereas the number of those coming under the general scheme was down 2.0% in the same period.

The increase in the level of registrations has meant that the accounts of Social Security now show a substantial surplus. In the first 10 months of 2007 receipts for contributions rose by 7.0% compared with the same period the year before.

Job creation concentrated in large and medium-sized companies.

On the other hand, the total number of hiring contracts signed in November was 1,592,018, a decrease of 4.1% compared with the same month the year before. In the first 11 months of the year, cumulative hiring went up to 17,360,789, an increase of 1.2% compared with the same period in 2006. In November, both permanent hiring contracts and

temporary contracts were down compared with the same month the year before.

In addition, according to figures from the quarterly survey of the labour situation carried out by the Ministry of Labour and Social Affairs (which, as opposed to the labour force survey, is done through companies instead of households), in the third quarter of 2007 the rate of temporary hiring in the private sector went down to 31.9%. This rate was an all-time low for the statistical series and reflects the effect of labour reforms carried out. This survey makes it possible to break down the annual increase in workers by size of workplace. In the past 12 months ending in September, wage-earners rose by 9.8% in those workplaces with more than 250 workers, 4.5% in those from 51-250, while in those from 1-10 the increase was 1.5% and in those from 11-50 it was 0.9%. In other words, employment was greater in the large and medium-sized companies.

Registered unemployment slightly worse in November

The number of persons registered at public employment offices rose by 45,896 in November to stand at 2,094,473. This figure meant a year-on-year increase of 3.5%, some 7 decimals more than the month before. This was the biggest monthly increase for this month since 2003. In fact, in recent months the number of registered unemployed has been increasing at an annual rate of 4%.

Compared with one year earlier, in November construction and agriculture showed the biggest relative increase in registered unemployment. Unemployment was again up sharply in

Registered unemployment up 3.5% in November compared with same month last year.

Number of unemployed up in all autonomous communities in November.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

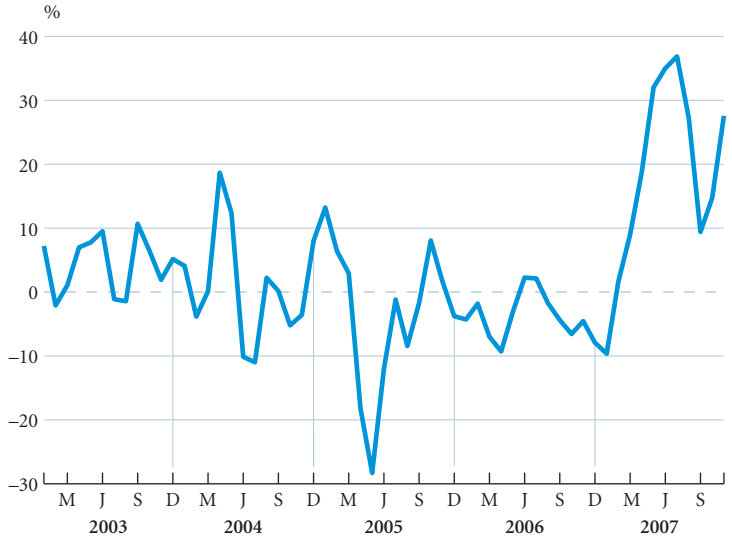
November 2007

	No. of unemployed	Change over December 2006		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	69,210	7,716	12.5	5,322	8.3	3.3
Industry	271,538	–10,610	–3.8	–3,979	–1.4	13.0
Construction	251,565	14,794	6.2	34,819	16.1	12.0
Services	1,283,684	58,815	4.8	45,228	3.7	61.3
First job	218,476	885	0.4	–10,081	–4.4	10.4
By sex						
Males	834,047	29,773	3.7	56,985	7.3	39.8
Females	1,260,426	41,827	3.4	14,324	1.1	60.2
By age						
Under 25 years	243,694	1,682	0.7	–11,886	–4.7	11.6
All other ages	1,850,779	69,918	3.9	83,195	4.7	88.4
TOTAL	**2,094,473**	**71,600**	**3.5**	**71,309**	**3.5**	**100.0**

SOURCE: INEM and own calculations.

UNEMPLOYMENT IN CONSTRUCTION AGAIN UP SHARPLY

Month-on-month change annualized in number of registered unemployed in construction (*)



NOTES: (*) Cycle-trend series.
SOURCE: Ministry of Labour and Social Affairs and own calculations.

Workers increase purchasing power by 1.4% year-on-year in third quarter.

construction in the past month whereas in industry and to a lesser extent in services it tended to drop. By sex, registered unemployment rose in both sectors in the past 12 months although more sharply in the case of males who are in the majority in construction.

From a geographical point of view, we should mention that the number of registered unemployed rose in all autonomous communities in November. In addition, foreign workers registered as unemployed rose by 22.9% compared with November 2006.

Rise in labour costs

Labour costs tended to rise in the third quarter. Average labour cost per worker per month stood at 2,201 euros, a figure that meant a year-on-year increase of 4.2%, some 3 decimals more than in the previous quarter, according to the quarterly labour cost survey carried out by the National Institute of Statistics.

In fact, wage cost per worker per month, which includes ordinary wages, overtime and back-pay, rose to a lesser degree at 3.8% compared with the same quarter the year before. In addition, other labour costs rose by 5.2% largely due to indemnities for dismissal and end of contract, especially in construction.

On the other hand, labour cost per effective hour worked rose by 5.1% in the third quarter compared with the same period in 2006. This higher increase was the result of a 0.9% decrease in the number of hours worked.

In real terms, average increase per worker per month was 1.4% in year-on-year rate due to the fact that average inflation in the quarter was 2.4%. In this way, the annual gain in purchasing

WAGE INDICATORS

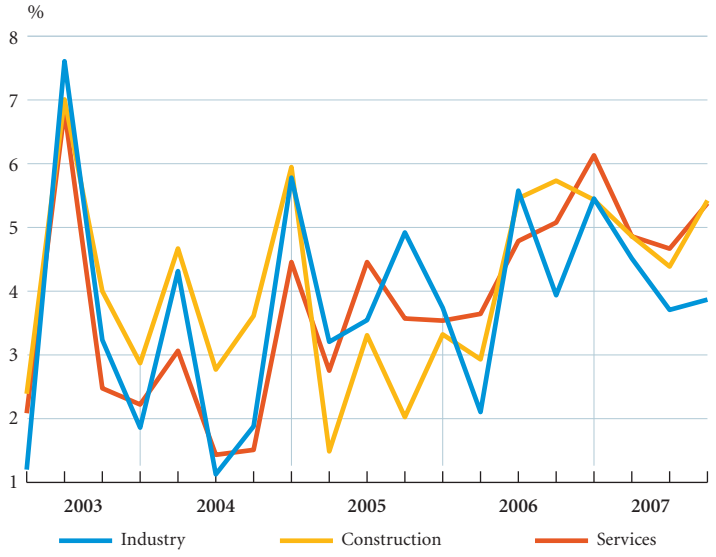
Percentage change over same period year before

	2005	2006	2006		2007		
			3 Q	4 Q	1 Q	2 Q	3 Q
Increase under general wage agreements (*)	**3.2**	**3.3**	**3.2**	**3.3**	**2.9**	**2.9**	**2.9**
Wage per job equivalent to full-time work (**)	**2.8**	**3.0**	**3.1**	**3.4**	**3.6**	**3.7**	**3.7**
Quarterly labour cost survey							
Wage costs							
Total	2.6	3.4	4.0	3.7	4.3	3.8	3.8
Industry	*2.7*	*3.6*	*4.1*	*3.6*	*3.7*	*3.1*	*2.3*
Construction	*2.3*	*3.7*	*4.2*	*3.9*	*5.5*	*3.9*	*4.8*
Services	*2.9*	*3.7*	*4.3*	*4.0*	*4.5*	*4.3*	*4.2*
Average wages per hour worked	3.2	4.2	4.4	5.0	4.6	4.2	4.6
Other labour costs	3.6	3.6	2.6	2.6	3.2	4.0	5.2
Work day (***)	–0.6	–0.6	–0.3	–1.3	–0.2	–0.3	–0.9
Farm wages	**3.1**	**2.8**	**3.2**	**2.4**	**3.1**	**2.5**	**3.3**
Labour cost in construction	**4.3**	**4.4**	**4.5**	**4.5**	**2.5**	**2.4**	**2.3**

NOTES: (*) Does not include wage revision clauses. Cumulative figures.
(**) Quarterly National Accounts: figures adjusted for seasonal and calendar differences.
(***) Effective hours worked per worker per month.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fishing and Food, Ministry of Public Works and own calculations.

WAGE COSTS NOT EASING

Year-on-year change in jobs equivalent to full-time work



SOURCE: Quarterly Labour Force Survey and own calculations.

power stood at the same level as in the previous quarter.

By autonomous community, we see a notable range in labour costs per worker per month. The highest costs were recorded in the Basque Country (2,262 euros), followed by Madrid Community and Navarre, whereas the lowest showed up in Extremadura (1,834 euros), Murcia and Canary Islands.

For 2008, procedures for collective bargaining on wages under the Inter-Union Agreement on Collective Bargaining are to be maintained. As a result, the main business organizations and leading trade unions have stated that wages under agreements will be increased in terms of forecast inflation of 2%. However, revision clauses will be maintained in order to guarantee purchasing power.

Prices

Fuels and foods ruin CPI at year-end

Once more, fuels have played a lead role in the consumer price index (CPI). The highs reached by oil prices in November were not fully compensated by the appreciation of the euro and these were quickly passed through to fuel prices at the pumps. Priced of processed foods were also up considerably thus continuing the pass through of international prices for farm raw materials. As a result, the CPI rate rose to 4.1% in November, a half-point more than in the month before, thus going back to the level at the beginning of 2006. Underlying inflation, which makes up core inflation by excluding energy products and unprocessed foods, items that are very volatile, continued to rise although only by 0.15 decimals putting it at 3.2% annual.

Underlying inflation goes up to 3.2% because of processed foods.

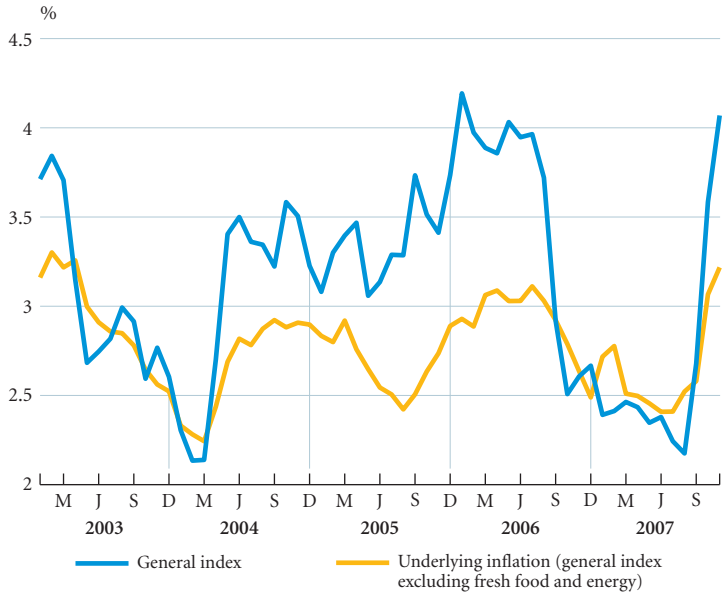
In fact, of the five decimal increase in the year-on-year inflation rate in November, slightly more than half came from fuels and lubricants for which prices rose by 15.1% over the past 12 months. Apart from this, other fuels, such as fuel-oil, were up 20.4% compared with the same month last year.

Sharp rise in some basic foods such as milk, bread and eggs...

In turn, processed foods contributed 0.15 points to the rise in annual inflation

INFLATION RETRACES ITS STEPS

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

...although potatoes and cooking oil down in price.

in November and the annual change rate rose by 9 decimals to 7.0%. Among these items, we should mention the annual rise of 30.5% in milk. Other milk products, such as yoghurt, rose by 10.6% and cheese was up by 8.6%. These increases reflect the rise in milk prices in world markets as a result of shorter supply due to weather conditions in the main producer countries and to European Union quotas on the one hand and, on the other hand, to increased demand by populous emerging countries. Bread also continued to rise

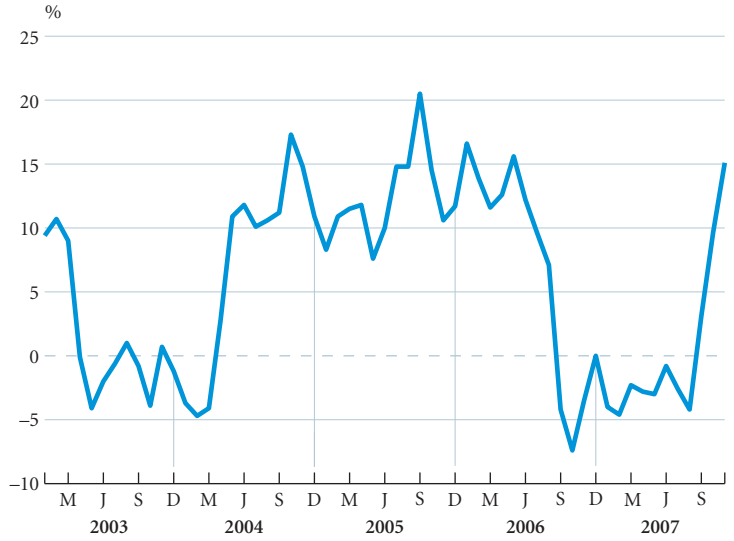
CONSUMER PRICE INDEX

	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	1.3	3.0	3.6
November	0.2	2.4	2.6	0.7	3.8	4.1
December	0.3	2.7	2.7			

SOURCE: National Institute of Statistics.

SHARP RISE IN FUELS

Year-on-year change in fuel and fuel-oil component of CPI



SOURCE: National Institute of Statistics.

in price (up to 14.1% annual) as a result of increased cereal prices. On the other hand, cooking oils showed an annual drop of 12.7% following the big rise in earlier periods.

The inflation rate for unprocessed foods rose less (two decimals) taking it to 4.9% annual. A series of supply and demand factors raised eggs by 9.7% and fresh fruit by 7.1%. On the other hand, potatoes were down 3.4%. Beef held to an annual change rate of 4.4% while pork rose by only 0.5%.

Along with the good news we should also mention that non-energy industrial prices continued to ease. The annual inflation rate thus stood at a tiny 0.3% in November thanks to the strength of the euro and sharp competition in world markets.

Prices of services, which are more sheltered from foreign competition, held to a price increase of 3.8% annual. Among those items rising below average were secondary education (3.5%) while those going above were university education (4.8%) and tourism and hotel trade (4.4%).

Prices of non-energy industrial goods continue to drop.

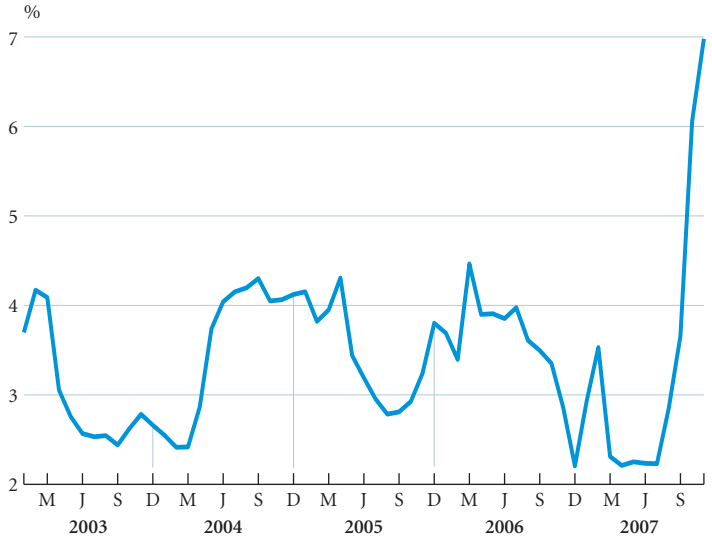
Looking at year-end, the CPI will stand at around 4%. Latent price increases in food likely will continue to push up inflation in the early months of 2008. Nevertheless, in the second half of the year inflationary pressures will likely ease so that inflation should drop substantially next year to stand below 3%.

The year-on-year inflation rate harmonized with the European Union also reported 4.1%. As a result, the inflation differential with the Euro Area continued at 1.1 percentage points. The heavier weighting of fuels and foods in the Spanish CPI, along with a lower level of taxes in fuel prices, partly explain this differential.

CPI likely to continue moving up early in 2008 but should later show substantial drop.

SHARP RISE IN PROCESSED FOOD PRICES

Year-on-year change in processed foods group of CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

November

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2006	2007	2006	2007	2006	2007
By type of spending							
Food and non-alcoholic beverages	107.2	0.2	0.9	2.6	5.7	3.9	6.3
Alcoholic beverages and tobacco	107.4	0.1	0.1	0.9	6.0	1.0	6.6
Clothing and footwear	109.4	2.9	3.2	2.3	2.2	1.3	1.2
Housing	105.3	0.0	0.5	4.8	4.6	4.7	4.7
Furnishings and household equipment	103.6	0.4	0.3	2.4	2.2	2.7	2.4
Health	98.4	0.1	0.1	1.6	–2.2	1.6	–2.1
Transport	104.5	–0.3	1.4	1.4	6.2	0.5	6.6
Communications	100.1	–0.2	–0.1	–1.2	0.9	–1.4	0.7
Recreation and culture	98.1	–0.8	–0.8	–2.0	–2.2	–0.7	–0.7
Education	107.1	0.6	0.2	4.3	4.0	4.3	4.1
Restaurants and hotels	105.7	0.0	–0.1	4.1	4.5	4.4	4.8
Other goods and services	103.7	0.1	0.1	3.6	2.8	3.9	3.0
By group							
Processed food, beverages and tobacco	107.4	0.0	0.9	2.1	6.9	2.9	7.0
Unprocessed food	106.8	0.4	0.6	3.0	3.4	5.0	4.9
Non-food products	104.2	0.3	0.7	2.4	3.1	2.3	3.3
Industrial goods	103.9	0.6	1.4	1.6	3.0	1.0	2.9
Energy products	*106.4*	*–0.7*	*2.7*	*2.2*	*10.3*	*0.3*	*10.7*
Fuels and oils	*107.3*	*–1.0*	*3.5*	*1.1*	*12.8*	*–1.4*	*13.4*
Industrial goods excluding energy products	*103.0*	*1.0*	*1.0*	*1.4*	*0.6*	*1.2*	*0.3*
Services	104.5	0.0	–0.1	3.2	3.3	3.7	3.8
Underlying inflation (**)	104.6	0.3	0.5	2.3	3.1	2.6	3.2
GENERAL INDEX	**105.0**	**0.2**	**0.7**	**2.4**	**3.8**	**2.6**	**4.1**

NOTES: (*) Base 2006 = 100.

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

SOURCE: National Institute of Statistics.

Foreign sector

Balance of payments: increase in current account imbalance stabilizing

The deficit in the current account balance in September amounted to 8.67 billion euros, an increase of 16% compared with the same month in 2006. The increase was due to the fact that the improvement in the services surplus did not compensate for the increase in the deficits in the trade balance, the incomes balance and the current transfers balance.

In terms of cumulative balance for the 12 months ending in September (a figure closer to the trend), we note that the current imbalance has tended to stabilize at a year-on-year increase of around 20% for the second consecutive month. In September (always using the cumulative figure for 12 months), the increased growth of the surplus in the services balance and the movement of the deficit in the incomes balance in the opposite direction compensated for the higher

Current account deficit grows at 20% year-on-year rate over past 12 months ending September.

BALANCE OF PAYMENTS

September 2007

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–63,004	6.7	–84,103	–6,510	8.4
Services					
Tourism	*22,278*	*1.3*	*27,739*	*355*	*1.3*
Other services	*–3,962*	*–9.5*	*–4,888*	*540*	*–10.0*
Total	18,316	4.0	22,852	895	4.1
Income	–23,147	41.6	–27,789	–7,237	35.2
Transfers	–7,650	31.4	–7,580	–3,215	73.7
Total	**–75,486**	**18.7**	**–96,620**	**–16,067**	**19.9**
Capital account	**2,523**	**–22.1**	**5,457**	**–439**	**–7.4**
Financial balance					
Direct investment	–35,267	–25.9	–43,172	4,469	–9.4
Portfolio investment	115,212	–30.3	148,201	–22,072	–13.0
Other investment	–7,188	–82.3	–2,031	30,958	–93.8
Total	**72,756**	**–5.5**	**102,998**	**13,355**	**14.9**
Errors and omissions	–3,009	–29.5	–1,649	2,887	–63.6
Change in assets of Bank of Spain	3,215	–	–10,186	264	–2.5

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.

Financial flows beginning to reflect financial crisis.

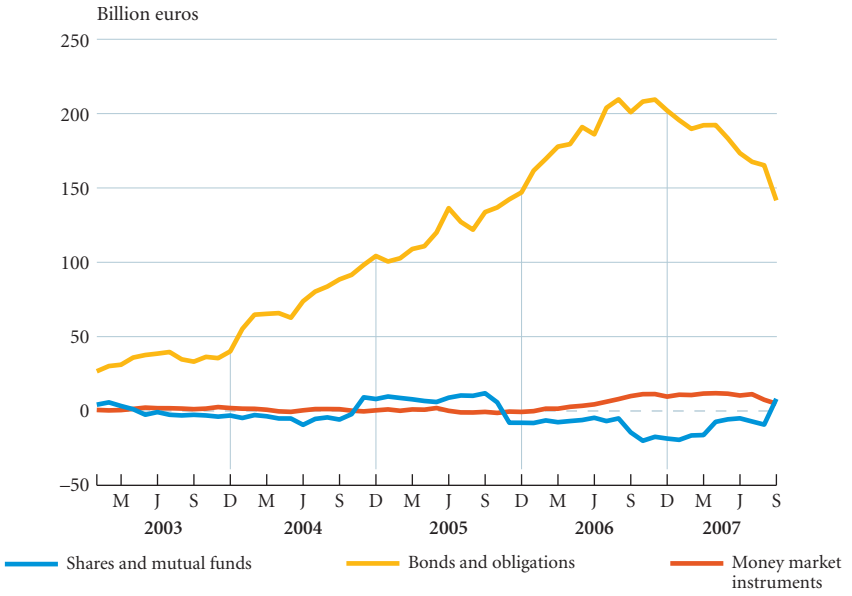
rate of increase in the deficit in the transfers balance.

With regard to financial flows, it should be noted that net outflows of direct investment stood at 43.17 billion euros (as cumulative balance for 12 months), a figure 9.4% lower than one year earlier, whereas net inflows for portfolio investment (amounting to 148.20 billion euros) were down to a greater extent going to 13.0% year-on-year.

The latter heading, that for portfolio investment, is the centre of attention due to the financial upsets arising from the subprime mortgage crisis. Specifically, inflows of foreign portfolio investment into Spain were up for the 12 months ending in September. Nevertheless, there was a significant change in the main headings. Since August, inflows of investment involving bonds and obligations have shown a substantial sharpening of their downward trend, thus reflecting the progressive hardening of the global financial situation.
A similar movement, although much less sharp, was followed by inflows for investment in monetary instruments. Finally, by reporting a rise since August, investment in shares and mutual funds broke with recent trends.

INFLOWS OF PORTFOLIO INVESTMENT SLOWING DOWN

Cumulative balance for 12 months



SOURCE: Bank of Spain and own calculations.

Public sector

Surplus in central government accounts shows sharp rise

The good state of the economy is reflected in the public accounts. In the January-November period central government non-financial revenues were up 11.7% compared with the same period in 2006, taking into account revenues ceded to the autonomous regions and local government under the current financial system. Central government revenues thus rose at a rate above 4.5 percentage points above nominal gross domestic product (GDP).

Direct taxes were up 18.2% compared with the first eleven months of last year. The biggst heading, personal income tax, rose by 16.4%. This sizeable rise was due to an extraordinary increase in taxable income in 2006. Also having an effect was the limited impact of the tax reforms applicable in 2007 and the increase in total wages and income on capital. Revenue from corporate tax was up 20.3% compared with last year. In this tax heading we also note the small effect of the new tax regulations on collections.

Revenues increase at rate 4.5 points higher than nominal GDP.

Indirect tax collections were up to a much lesser degree (only 2.7%), even lower than inflation which partly reflects the slowdown in household consumption. Collections for value added tax (VAT) showed a modest rise of 3.8% in homogeneous terms adjusted for the rate

Taxation reforms have little impact on direct tax collections.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

November 2007

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**10,080**	**18.4**	**148,408**	**12.1**
Non-financial revenue adjusted (*)				
Personal income tax	7,187	23.8	68,513	16.4
Corporate tax	180	–	40,540	20.3
VAT	3,023	2.9	53,271	1.2
Special taxes	1,766	8.9	18,135	6.7
Other	2,223	21.4	18,189	17.0
Total	**14,379**	**17.9**	**198,648**	**11.7**
Non-financial spending	**11,055**	**10.2**	**124,304**	**7.8**
Treasury balance	**–975**	**–35.7**	**24,104**	**41.2**
Surplus (+) or deficit (–) (**)	***–2,383***	***–9.2***	***25,835***	***31.3***

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.

Indirect taxes growing less than inflation as result of drop in consumer spending.

of tax rebates. Collections for special taxes were up slightly more at 6.7%. The most important special tax, that on fuels, rose by only 2.8% in spite of the recovery of fuel consumption last month. On the other hand, the next biggest special tax, that on tobacco, was up 13.9% due to the rise in tax rates and the price per pack.

Under non-tax revenues, profits of the Bank of Spain were up 41.5% while interest on the Treasury current account rose by 86.6%. In addition, capital transfers grew by 41.0% thanks to higher receipts from the FEDER regional development fund of the European Union.

Current spending up less than nominal GDP.

In addition, cumulative central government spending was up 7.8% compared with the January-November period in 2006, a rate substantially below that for revenues. Among those amounts, current spending rose by 6.2%, less than the nominal GDP. Public service salaries were up b 6.0%. Current spending on goods and services rose by 15.3% under the effect of elections held during the year. Financial costs was the only large heading to show a drop due to the debt repayment calendar.

Central government surplus amounts to 2.5% of GDP.

On the other hand, capital spending showed a significant rise above the economy as a whole with a growth rate of 20.7%. Real investment was up 9.8% while capital transfers rose by 35.0%. We should mention the sharp increase in spending for interest subsidies on government aided loans for home acquisition.

As a result of the outcome of revenues and spending, the central government ended up with a notable surplus. In terms of National Accounting, that is, using the accounting method that brings into account revenues and spending at the time these are committed, the central government marked up a cumulative surplus of 25.83 billion euros, a figure that represents an increase of 31.3% compared with the same period in 2006. In terms of GDP, the central government surplus amounted to 2.46%, which was higher than the 2.01% recorded in 2006.

Savings and financing

Funding of companies and households continues gradual drop

The 1-year Euribor reference rate continued to drop on monthly average in November going to 4.61%. As a result, it was down 4 basis points compared with the month before and 12 basis points in terms of the high for this decade noted in September. Nevertheless, the 12-month Euribor stood at 74 basis points above the level one year earlier. In addition, in the early weeks of December the 1-year Euribor showed a rise following the increased pressures in the interbank market in view of the year-end and increasing possibilities of a further rise in the official interest rate of the European Central Bank faced with inflationary pressures.

1-year Euribor again drops slightly in November but moves up in December.

In an environment of some hardening of credit terms and a slowdown in economic activity, funding to the private sector continued to slacken growth in October. According to latest available figures, funding to the private sector rose by 17.7% in October compared with the same month last year, some 6.5 points less than in December, which illustrates the degree of slowdown taking place. In any case, the rate of annual increase in funding granted to companies and households is substantially above that in the Euro Area.

Funding obtained by non-financial companies rose by 19.8% in the last 12 months ending in October. While this is a high growth rate, it is 8.1 points lower than that recorded at the end of 2006. The growth of 17.1% in leasing in the period October 2006-October 2007 reflects the strength of demand for funding intended for investment.

Annual rate of increase in funding to companies and households substantially higher than in Euro Area.

On the other hand, the recent publication of figures for credit by

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

October 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	85,446	70	0.1	8,495	11.0	5.0
Secured loans (*)	1,049,018	126,042	13.7	165,978	18.8	60.8
Other term loans	493,207	78,618	19.0	88,349	21.8	28.6
Demand loans	36,351	2,238	6.6	5,629	18.3	2.1
Leasing	45,284	4,571	11.2	6,618	17.1	2.6
Doubtful loans	15,333	4,474	41.2	4,376	39.9	0.9
TOTAL	**1,724,639**	**216,013**	**14.3**	**279,445**	**19.3**	**100.0**

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

CREDIT TO PRIVATE SECTOR BY PURPOSE

Third 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	25,023	2,009	8.7	2,563	11.4
Industry	140,365	20,877	17.5	25,099	21.8
Construction	150,368	16,051	11.9	22,948	18.0
Services	594,235	89,410	17.7	131,324	28.4
Total	**909,991**	**128,347**	**16.4**	**181,933**	**25.0**
Financing to individuals					
Acquisition and renovation of own home	604,623	60,234	11.1	85,493	16.5
Acquisition of consumer durables	54,035	2,574	5.0	3,483	6.9
Other financing	109,539	5,094	4.9	12,248	12.6
Total	**768,197**	**67,903**	**9.7**	**101,225**	**15.2**
Financing to private non-profit institutions	**6,106**	**402**	**7.0**	**747**	**13.9**
Other unclassified	**21,822**	**839**	**4.0**	**2,238**	**11.4**
TOTAL	**1,706,116**	**197,491**	**13.1**	**286,143**	**20.2**

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

Slight rise in credit to industry and agriculture with slowdown in financing for construction.

purpose makes possible more detailed analysis, although the figures go up only to September. We note some increase in credit for agriculture and industry, with the latter recording annual growth of 21.8%. On the other hand, credit going into construction showed a sharp slowdown as did services to a lesser extent. In any case, services continued to show the highest annual change rate at 28.4 %. Under this heading, there was a notable slowdown in credit for real estate activities which went from annual growth of 41.8% in the second quarter to 35.1% at the end of the third quarter. Compared with the second quarter, this credit was up by a notable 3.7% but well below the figure recorded some months back. In fact, if we exclude the real-estate sub-sector, credit granted to services was up slightly.

Loans for real estate activities continue to rise but to much lower degree.

With regard to households, financing continued to show a drop in growth rate putting it at 15.0% in the past 12 months ending in October. While high, this rate represents a drop of 4.6 points compared with December 2006. This slowdown may be largely attributed to loans for home-purchase which, nevertheless, rose by 15.8% compared with October 2006. In addition, statistics on loans broken down by purpose published by the Bank of Spain reveal that in the third quarter both credit for buying durable goods and for other purposes showed a lower annual growth rate.

Extraordinary growth of time deposits

The current difficulties for borrowing in wholesale financial markets in recent

months because of the subprime mortgage crisis in the United States has sharpened the desire of financial entities to attract deposits by the private sector. As a result, competition for deposits has continued to drive up return on bank accounts. The average interest rate on deposits thus continued to rise in October going to 4.31%, some 1.27 points above 12 months earlier.

As a result, the growth of deposits has scarcely eased in spite of the course of slowdown followed by the economy. Two-year term deposits have risen by 41.7% in the past 12 months ending in October, following elimination of tax discrimination according to term under the new regulations starting in 2007. The growth of deposits in foreign currency was even greater (54.3% annual). These took advantage of favourable differentials in interest rates, although their share of the total was only 3.6%.

The stiff competition for deposits has hurt mutual funds in recent months. The situation was repeated in November with net sales of participations in mutual funds amounting to 3.73 billion euros. As a result, in the first eleven months of the year there were net withdrawals for an amount of 16.33 billion euros and assets fell by 4.3% compared with December 2006. Also contributing to this drop was the volatility in financial markets in recent times and risk aversion among savers. Average annual return stood at 3.5% but there was a wide spread depending on the various categories.

Insurance premiums are another important financial instrument for savers. In the January-September 2007 period, premiums for direct insurance amounted to 41.16 billion euros, an increase of 9.4% compared with the same period last year, according to ICEA figures. Life insurance premiums showed a substantial rise with annual growth of 14.5% while non-life insurance rose by 5.9%.

Overall, savers changed their preferences according to the financial and fiscal situation. However, this did not fundamentally change the particularities of the average Spanish saver. To learn about these particularities, it is useful to refer to the household financial survey recently published by the Bank of Spain

Competition for bank deposits pushes interest rates up...

...to detriment of mutual funds.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

October 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	421,123	–27,214	–6.1	5,933	1.4	33.1
Up to 2 years	334,994	88,588	36.0	98,593	41.7	26.3
More than 2-year term	388,123	55,274	16.6	76,229	24.4	30.5
Repos	82,005	–1,819	–2.2	9,846	13.6	6.4
Total	**1,226,244**	**114,828**	**10.3**	**190,600**	**18.4**	**96.4**
Deposits in currencies other than euro	**45,550**	**12,833**	**39.2**	**16,024**	**54.3**	**3.6**
TOTAL	**1,271,794**	**127,661**	**11.2**	**206,625**	**19.4**	**100.0**

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

Survey of household finances reveals situation in incomes, wealth and debts of family units.

showing the results for 2005. In fact, the central bank began this survey back in 2002 and it is the only statistical source in Spain making it possible to relate income, assets, debts and spending of each family unit. As a result, it has been possible to calculate ratios of individual indebtedness for various households which often show up as very different from aggregate ratios, given that the breakdowns of wealth and debt are not symmetrical. With these results it is possible to study the response of household consumption to changes in real estate wealth or to deduce some questions regarding the effect of certain economic policy measures such as what type of household may be most affected by increases in interest rates. Because of its interest, a summary of this survey is given below.

HOUSEHOLD FINANCIAL SURVEY (2005)
Main results
Wealth
Real estate property represents 80% of all assets
81.3% of households own main residence, with average value of 180,300 euros
21% of households own a house apart from main residence, with average value of 103,100 euros
92.3% of households have bank accounts for making debt payments
Percentage of households owning:
Listed shares: 11.4%
Mutual funds: 8.7%
Bonds: 1.5%
Pension plans: 29.3%
Indebtedness
Household debt represents 9.3% of all assets
49.6% of households have some kind of debt still owing:
26% of households for payments on main residence
Average amount of debt still owing is 31,400 euros. Highest amounts noted among young people (average 60,100 euros)
Average amount of debt still owing for purchase of main residence is 42,100 euros
Ratios (averages for households in debt)
Debt repayment/income ratio: 17.0%
Debt/income ratio: 99.3%
Debt/gross wealth ratio: 17.2%
Increase in percentage of households with heavy financial load:
Percentage of households with debt repayments of more than 40% of income: 5.8%
Percentage of households with total debt more than three times their income: 9.5%
Percentage of households with debt still owing of more than 75% of gross wealth: 5.5%

SOURCE: Bank of Spain and own calculations.

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THE SPANISH ECONOMY MONTHLY REPORT

Report on the economic situation (available also in Spanish version)

ANUARIO ECONÓMICO DE ESPAÑA 2007

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As of December 31, 2006

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

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

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

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