APRIL 2008

THE SPANISH ECONOMY

Monthly Report

NUMBER 312

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2007				2008	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	2.9	2.2	1.2	1.5	1.9	2.8	2.5	2.3	1.2
Japan	2.4	2.0	1.6	2.9	1.7	1.9	1.7	1.3	1.8
United Kingdom	2.9	3.0	2.1	3.0	3.2	3.1	2.8	2.5	2.1
Euro area	2.9	2.6	1.7	3.1	2.4	2.6	2.2	1.8	1.7
Germany	*3.1*	*2.6*	*1.7*	*3.7*	*2.6*	*2.5*	*1.8*	*1.5*	*1.6*
France	*2.2*	*1.9*	*1.7*	*1.9*	*1.4*	*2.2*	*2.1*	*1.6*	*1.6*
Consumer prices									
United States	3.3	2.8	3.3	2.5	2.5	2.4	4.0	4.1	3.4
Japan	0.2	0.1	0.5	–0.1	–0.1	–0.1	0.5	0.8	0.3
United Kingdom	2.3	2.3	2.5	2.9	2.6	1.8	2.1	2.4	2.4
Euro area	2.2	2.1	2.9	1.9	1.9	1.9	2.9	3.3	3.2
Germany	*1.6*	*2.3*	*2.4*	*1.8*	*2.1*	*2.3*	*3.1*	*2.9*	*2.6*
France	*1.7*	*1.5*	*2.5*	*1.2*	*1.2*	*1.3*	*2.3*	*2.9*	*2.6*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	3.7	3.1	2.2	3.5	3.4	3.1	2.7	2.4	2.3
Government consumption	4.8	5.1	4.4	6.1	5.0	5.1	4.4	3.5	4.0
Gross fixed capital formation	6.8	5.9	2.4	6.3	6.7	5.8	4.8	3.6	2.5
Capital goods	*10.4*	*11.6*	*5.1*	*13.1*	*13.1*	*11.6*	*8.6*	*7.5*	*6.0*
Construction	*6.0*	*4.0*	*0.9*	*4.9*	*4.6*	*3.8*	*2.9*	*1.4*	*0.4*
Domestic demand (contribution to GDP growth)	5.1	4.6	2.8	5.1	4.9	4.5	3.9	3.1	2.8
Exports of goods and services	5.1	5.3	4.8	3.6	4.7	7.7	5.1	5.1	4.9
Imports of goods and services	8.3	6.6	4.8	6.0	6.7	8.4	5.4	4.9	4.6
Gross domestic product	**3.9**	**3.8**	**2.5**	**4.1**	**4.0**	**3.8**	**3.5**	**2.8**	**2.6**
Other variables									
Employment	3.2	3.0	1.5	3.3	3.1	3.0	2.5	2.0	1.6
Unemployment (% labour force)	8.5	8.3	9.6	8.5	8.0	8.0	8.6	8.9	9.3
Consumer price index	3.5	2.8	3.9	2.4	2.4	2.4	4.0	4.4	4.1
Unit labour costs	2.3	2.7	3.1	2.6	2.6	2.7	2.9		
Current account balance (% GDP)	–8.8	–10.0	–9.7	–10.1	–9.0	–10.2	–10.7		
Net lending or net borrowing rest of the world (% GDP)	–8.1	–9.5	–9.1	–9.5	–8.7	–10.1	–9.8		
Government balance (% GDP)	1.8	2.2	0.9						
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	5.0	5.0	2.0	5.3	5.3	5.1	4.5	2.8	1.9
ECB repo	2.8	3.9	3.9	3.6	3.8	4.0	4.0	4.0	4.0
10-year US bonds	4.8	4.6	3.2	4.7	4.8	4.6	4.1	3.5	3.1
10-year German bonds	3.8	4.2	4.0	4.0	4.4	4.3	4.2	3.9	3.7
Exchange rate									
$/Euro	1.26	1.38	1.51	1.32	1.35	1.39	1.46	1.53	1.53

Contents

Home, sweet home

Spain now has more than 16 million households. It is here that the decisions on consumption, savings and investment that drive the economy are made. For example, household consumption in Spain comes close to 60% of gross domestic product and its growth runs parallel to that of the economy as a whole. As pointed out in one of the key boxes in this Monthly Report, this is not a matter of chance. The capacity of consumption to grow is determined by the increase in gross domestic product which, in turn, largely depends on such variables as the increase in employment and improvements in productivity.

Household consumption has changed a great deal over the years. The increase in living standards, the appearance of new products, changes in preference and relative price changes have turned around the make-up of household budgets. The most notable change in the pattern of consumption has been the reduction in the relative weight of essential goods. When people are better off they tend to spend a higher proportion of income on leisure, culture, hotels, restaurants, cured ham, and name-brand clothing, for example. They also spend money on cell phones, something that only a few years back had not even been invented.

Apart from consumption, other household decisions largely determine the course of the general economic cycle. This may be buying a house or a flat, the main non-financial investment most families make in a lifetime. Spanish statistics show that housing demand is closely allied to the establishment of households. Many other factors are involved in real estate trends but, as noted in another box in this Monthly Report, the most recent growth cycle in this sector may largely be explained by the big increase in the number of households – four million in the past 10 years. The answer lies mainly in the fact that those generations born in the Sixties and the beginning of the Seventies (who made up Spain's «baby boom») were leaving home. Another factor operating in the same direction was heavy immigration as of the Nineties, an unexpected development with major socio-economic impact.

The strong level of home buying gave rise to an increase in household indebtedness. In the past ten years, debt of households has doubled in terms of disposable income, going from 60% to 120%. This trend has caused some concern because it has been so sharp and so fast. Nevertheless, the financial situation of households remains strong. The rise in real estate prices and the increase in value of financial assets has meant a boost in household wealth higher than that increased indebtedness. People are more heavily in debt but also wealthier.

It may be argued that these are averages that, when it comes to the crunch, do not take into account all those households that can barely pay their way each month or have problems meeting their mortgage payments. Coming down to details, the financial survey of households carried out by the Bank of Spain indicates that a high percentage of households with a head of family aged 35-44 years are in debt. As may be expected, the highest debt levels are to be found among younger people, those self-employed and those households with two family members working. However, in terms of the total number of Spanish households, the percentage of those in debt comes to merely half, so that we may expect that households will continue to be a key factor in growth of the economy.

EXECUTIVE SUMMARY

From financial crisis to real crisis?

Subprime mortgage crisis starting in summer 2007 continues to create headaches for monetary authorities.

It all began in the heat of summer 2007. Few people had ever heard of subprime mortgages, a segment of the US mortgage market aimed at customers with low credit rating. Even before this, in February, there had been some danger signals but this was quickly dismissed. How could that trifle affect the brilliant state of the United States economy? Some six months later it became clear that the problem had done nothing but increase and spread and that it had become a crisis of liquidity and solvency that threatened to drag the US economy into a recession, if it had not already done so.

Fed has cut interest rates, put into effect various measures to inject liquidity and even rescued an investment bank.

It must be recognized that the US economic and monetary authorities have made every effort to deal with the problem with speed and firmness. Since August 2007, the Federal Reserve has cut the reference rate by three percentage points to 2.25% in order to ease the lack of liquidity in the monetary system. With the same end in view, it has injected major funds in cash through the various instruments it has available. Furthermore, it has created new instruments to provide liquidity to financial entities. So far the results have not been all that brilliant. The problems of liquidity in the interbank market still exist and investors prefer to channel their funds into safe assets, such as government bonds, even though the yield may by lower than that on private bonds.

US economy may have entered recession.

All of these moves have scarcely eased the nervousness existing in the markets with the stock markets showing downward trends, the dollar in free-fall and a clamping down of bank credit. The worst of all this has fallen to financial entities which have had to make heavy provision in their balance sheets for losses, a fact that has meant major cuts in profits and stock market capitalization. The Federal Reserve even had to come to the rescue of Bear Stearns, one of the leading investment banks on Wall Street. Only a short time back, such a move was unthinkable and it points to the real risks to the system presented by the present financial situation in the United States.

Meantime, what is happening in the real economy? Available economic indicators, still far from current, do not make it possible to categorically state that we are seeing a recession. A good number of analysts, however, take it for granted. The real estate crisis has been going on now for two years and at this point is not easing. Private consumption, the bulwark of growth in recent years, is beginning to falter so far as can be seen from retail business and car sales showrooms. The Conference Board confidence index has dropped to lows not seen for many years. This is not surprising given that employment was down in February for the first time since the terrorist attacks on the Twin Towers in 2001 and wages are not rising. The only optimistic note comes from exports helped by a weakening dollar which is giving some support to capital goods investment.

Beyond the debate on whether the recession in the United States has already begun, the key question is how it is going to come out of this rut. The monetary policy measures, along with the White House plan to foster consumption, may

somewhat ease the drop, which could mean we are seeing a moderate recession along the lines of those in 1990-1991 or the last in 2001. However, the imbalances being carried by the US economy (foreign deficit, household debt) are too high to think that the good times will come back once the storm is over, without more ado. Nor is it likely that the ease in monetary policy which followed the 2001 recession (brought about by the dot-com bubble) is going to be repeated in view of the present inflationary situation. Adjustment of these imbalances and stabilization of the real estate situation would suggest a gradual recovery over the mid-term.

Outside the United States, the world economy continues on its way with the emerging countries going strong and the other developed countries showing discreet prospects. High commodity prices are allowing the exporting countries to maintain income flow and thus promote growth. At the same time, this suggests that, in spite of the dip in the United States, the world slowdown is still gradual. Oil has climbed to new all-time highs going well over the psychological level of 100 dollars a barrel at mid-March (up to 106 dollars for Brent and 109 for West Texas). In any case, we should point out the financial component affecting commodity prices, given that fundamental factors do not explain certain price changes and it is likely that prices will return to levels more in keeping with the world economic situation.

In this context, China remains the only strong engine driving the world economy. Latest growth figures (for the last quarter of 2007) show a rate still higher than 11% in real terms. Some indicators suggest something of a slowdown but the progress of the Asian giant is still overwhelming. The problem lies in prices. In recent months, the increase in the consumer price index has doubled going to 8.7% in February. Even more relevant is the trend in the food component which is growing at a rate of 23%, something having a specially negative effect. China is a net importer of food and price increases in world markets present a risk that goes beyond the purely economic framework. The Chinese authorities have opted for raising interest rates and bank cash reserves with the aim of somewhat cooling off the economy while taking care not to push up an exchange rate that is very beneficial to its exporters.

Commodity exporting economies benefit from high prices while oil goes over threshold of 100 dollars a barrel.

In Europe, the concerns are quite different. In the Euro Area, indicators confirm that the slowdown is continuing but its degree is still limited. The state of private consumption is weak and consumer feeling, expressed in the confidence index, is rather discreet. For the moment, jobs are being created and the unemployment rate is even decreasing. Capital goods investment is pointing to stability and even to some growth. Foreign demand is being affected by the appreciation of the euro which is reducing the trade surplus. However, German exports, a real engine driving the European economy, are showing some resistance to the exchange rate effect, thanks to their highly competitive level.

China grows by 11% but showing major rise in inflation.

The biggest concern now lies in the rise in consumer prices in the Euro Area. The early figure for March moved up to a rate of 3.5%, the highest since the creation of the single currency in 1999. This course has strengthened the anti-inflationary position the European Central Bank has been insisting on. It is felt that this rise has been caused by a combination of pressures in markets for energy commodities and foods. The sharpness of these increases, however, makes it unlikely that the CPI will come close to 2% before the end of the year, in line with the threshold aimed at by the central bank in Frankfurt. In spite of the

Inflation also concern for ECB in context of moderate economic slowdown.

Following prolonged expansionist stage, Spain's economy moving into more moderate growth...

pressures in money and credit markets, which also exist in the Euro Area, the ECB has maintained its interest rates unchanged.

Spain's economy: confidence down

Spain's economy, which at the beginning of 2007 began to show signs of slowing down following more than 10 years of continuous growth, has now sharpened that trend. Inevitably, the toughening of the situation in world financial markets directly affects an economy whose growth has been linked to the entry of foreign financing, which in 2007 amounted to 10% of GDP.

...that is getting sharper due to effect of international financial upsets.

Specifically, the construction sector and, more exactly, the real estate sector has been especially affected by this situation. All through the past year the signs of a slowdown were evident, following a growth stage that began in the mid-Nineties and, along with consumption, has been a major source of growth up to this moment. The real estate slowdown has been heightened in recent months by the upsets in financial markets and the toughening of terms for granting loans. Demand has slackened off in view of prospects of a general worsening of the economic situation and problems of liquidity that have raised the cost of borrowing.

Inflation climbs to 4.4% in just a few months.

Growth of household consumption has also eased. In the first two months of the year retail sales and car sales have shown negative results. The consumer confidence index for February reported the lowest level since 1994, under the effect of a worsening of the labour market, tighter financial terms and the drop in purchasing power arising from the sudden increase in inflationary pressures.

In fact, on the one hand, employment continues to grow although at a progressively lower rate. At the end of February, the number of persons registered as working under Social Security amounted to somewhat more than 19 million, 65,179 persons more than the month before. Nevertheless, the annual change rate continued to drop going to 1.6% as against an increase of 3.0% in 2007, which indicates the slowdown trend in job creation in recent months.

On the other hand, over the past few months consumer prices have doubled in year-on-year growth going as high as 4.4% in February. The rise in oil prices mentioned earlier and the rise in prices of certain foods were the cause of this result. The inflation differential with Spain's neighbours in the Euro Area remains high but has not increased given that basically it is imported inflation. Nevertheless, these high inflation levels cause concern because of their possible indirect or pass-through effects, that is to say, their effects on wages, transportation costs and other farm and industrial products.

Economic activity therefore is headed toward a scenario of lower growth and less job creation. Forecasts by many analysts converge in foreseeable growth of around 2.5% in 2008, a rate that, in any case, is still well above the average for the Euro Area. In the face of this adjustment, Spain's economy has a number of assets, such as a sizeable surplus in the public accounts and a solid financial sector. In any case, the government resulting from the March elections will likely have to face the most complicated task of the past decade.

March 31, 2008

CHRONOLOGY

2007

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.
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.

2008

January	**1**	Further enlargement of **Euro Area** with entry of Cyprus and Malta, making 15 member states.
	22	**Federal Reserve** reduces reference rate to 3.50%.
	30	**Federal Reserve** reduces reference rate to 3.00%.
March	**9**	Spanish Socialist Workers Party wins **general elections**.
	14	One-month forward price of Brent quality **oil** hits all-time high of 106.54 dollars a barrel.
	18	**Federal Reserve** cuts reference rate to 2.25%.
	31	**Euro** exchange rate goes to 1.581 dollars, highest value since launch of European Single Currency at beginning of 1999.

AGENDA

April

- **2** Registrations with Social Security and registered unemployment (March).
- **4** Industrial production index (February).
- **9** EU GDP (4th Quarter).
- **10** Governing Council of European Central Bank.
- **11** CPI (March).
- **15** Balance of payments (January).
- **16** Harmonized CPI for EU (March).
- **24** Producer prices (March). Foreign trade (February).
- **25** Labour force survey (1st quarter).
- **29** Central government revenues and spending (March).
- **30** US GDP (1st Quarter). Fed Open Market Committee. Balance of payments (February).

May

- **6** Industrial production index (March). Registrations with Social Security and unemployment (April).
- **8** Governing Council of European Central Bank.
- **13** CPI (April).
- **14** Early GDP (1st Quarter). Harmonized CPI for EU (April).
- **21** Quarterly National Accounts (1st Quarter). Foreign trade (March).
- **26** Producer prices (April).
- **27** Central government revenue and spending (April).
- **30** Balance of payments (March).

INTERNATIONAL REVIEW

US economy has one foot in recession but biggest risks lie in slow recovery.

United States: confidence disappears

The word «credit» comes from the Latin «credere», meaning «to believe». Believing is similar to having confidence and confidence has been the first victim of the credit crisis brought about by subprime mortgages. In the current situation in the United States we see the coexistence of greatly depressed indicators for confidence and expectations along with indicators for economic activity which, while weak, are showing a much less extreme picture over the short term.

The US gross domestic product (GDP) slowed in the fourth quarter of 2007 growing at 2.5% year-on-year, 0.6% annualized compared with the previous quarter. We cannot rule out that in the first quarter of 2008 we are seeing negative growth but latest economic activity indicators do not give a clear verdict in that direction. Nevertheless, the key question is not so much in the possibility of seeing negative growth in the first half of 2008 but rather in how long this period of economic weakness is going to last. In this respect, the indicators are showing a clearly downward trend that suggests that this period will not be brief. In any case, private consumption will mark out the level of economic activity and the recovery of lost confidence will be the

UNITED STATES: MAIN ECONOMIC INDICATORS

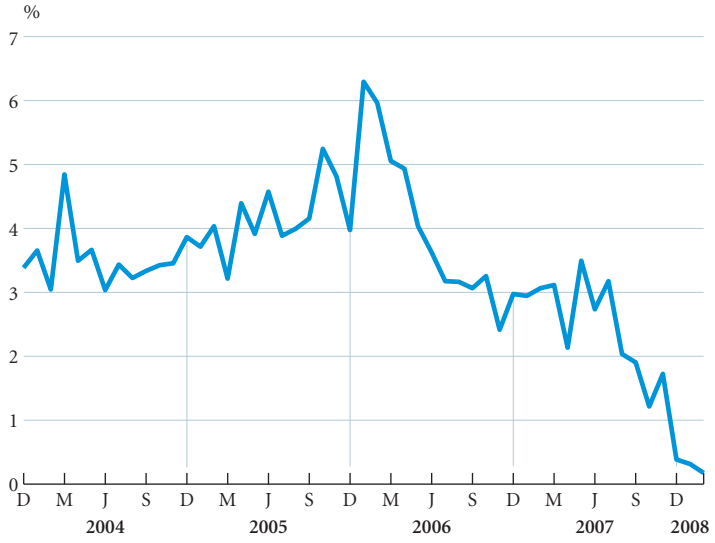
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	2.9	2.2	1.5	1.9	2.8	2.5	–	...	–
Retail sales	6.2	4.0	3.6	4.0	4.1	4.6	4.0	2.6	...
Consumer confidence (1)	105.9	103.4	109.9	106.7	105.7	91.2	87.3	76.4	64.5
Industrial production	4.0	1.9	2.5	1.7	1.6	1.8	2.3	1.0	...
Industrial activity index (ISM) (1)	53.1	51.1	50.5	53.0	51.3	49.6	50.7	48.3	...
Sales of single-family homes	–18.0	–26.3	–24.6	–21.2	–26.6	–33.5	–32.5	–29.8	...
Unemployment rate (2)	4.6	4.6	4.5	4.5	4.7	4.8	4.9	4.8	...
Consumer prices	3.2	2.9	2.4	2.6	2.4	4.0	4.4	4.1	...
Trade balance (3)	–758.5	–708.5	–747.4	–734.3	–707.6	–708.5	–709.4	...	...
3-month interbank interest rate (1)	5.2	5.3	5.4	5.4	5.4	4.9	3.1	3.1	...
Nominal effective exchange rate (4)	82.5	77.9	81.9	79.3	77.0	73.3	73.1	72.6	...

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: CONSUMERS STOP SPENDING

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



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

key element for coming out of the tunnel.

In this respect, the consumer confidence index supplied by the Conference Board continued to drop in March going from 76.4 points to 64.5 points, the lowest level since 1993, apart from the hiatus prior to the war on Iraq. Among the components of this index, the component of the current situation, while it clearly dropped, has not gone to dramatic levels. Things change radically in the expectations component which dropped to levels not known since late 1973 when the sudden end to Richard Nixon's presidency coincided with the start of the oil crisis at the outbreak of the Yom Kippur war. By comparison, the slowdown in retail sales in February seems moderate. These sales, excluding car sales and petrol consumption, were up 2.0% year-on-year, which, if we discount price changes, suggests a practical stagnation with a clear downward trend.

The picture on the business side is following a very similar pattern, without sharp drops but also with a marked trend downward. The economic activity index of the Institute for Supply Management (ISM) for February was down to 48.3 points, a level below 50 indicating some predominance of pessimistic responses. In the case of the services ISM, there was a recovery to 50.8 points following the drastic drop the month before. In both cases there was notable upward pressure of the prices component.

Consumer confidence at low levels but retail sales and ISM index showing gradual slowdown.

Consumers have objective reasons to be pessimistic both regarding the work situation which affects their incomes and the real estate front on which a good part of their wealth depends. Some 63,000 jobs were lost in February. While the labour market is easing off relatively slowly in terms of job creation, in wage terms the process has been faster. Purchasing power of total wages ended 2006 with definite gains but in 2007 the drop was much faster than in the 1999-

Labour market slowing down and wages lose purchasing power.

Housing still not hitting bottom with real estate prices down 11%.

2002 period when the last slowdown took place. This was due to changes in kinds of jobs and the effect of energy prices. In the US case, the clearest effects of the rise in oil comes not in the pass-through to prices in other segments of the economy but in the dip in household budgets.

On the second front, the real estate crisis, the decrease in construction spending is taking nearly one percentage point off economic growth and there are no signs that this has hit bottom. Housing starts in February were down 28.4% from the same period the year before. Pointing in the same direction, building permits, which are an indicator pointing to the level of housing starts, were down a similar 36.1%. Nevertheless, the price of real estate is a key factor in knowing how long the crisis will go on. The value of assets is at once a demonstration and a reason for confidence among consumers and investors and, in view of the Case-Shiller index for housing prices, things are still on a poor track. In January, the general index dropped by 11.4% year-on-year which comes close to a 15% loss if we add the increase in the consumer price index (CPI). Areas such as Las Vegas and Miami showed drops of close to 20%. Sales of existing houses were down 23.8% year-on-year in December while new houses, in view of the greater volatility, dropped by 29.8%.

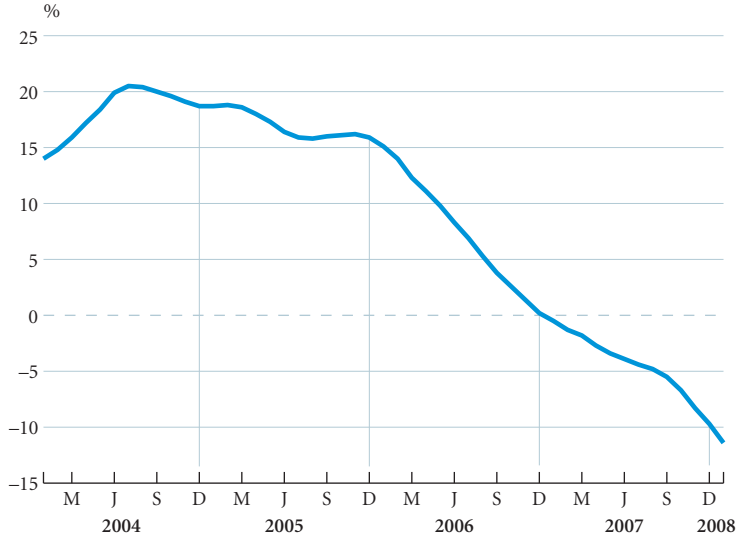
A wave of foreclosures is expected and, with this in mind, the Administration and the Federal Reserve are considering whether to modify loan contracts by offering a grace period to borrowers in default or to use public funds. Both solutions have serious long-term dangers but lack of action also presents major risks. In any case, the use of public funds, a course favoured by the Federal Reserve, seems less drastic that changing loan contracts.

Inflation moderates but still above 4% despite slowdown.

In February the CPI moderated the rise in the previous month and rose by 4.1%

UNITED STATES: REAL ESTATE PRICES KEEP DROPPING

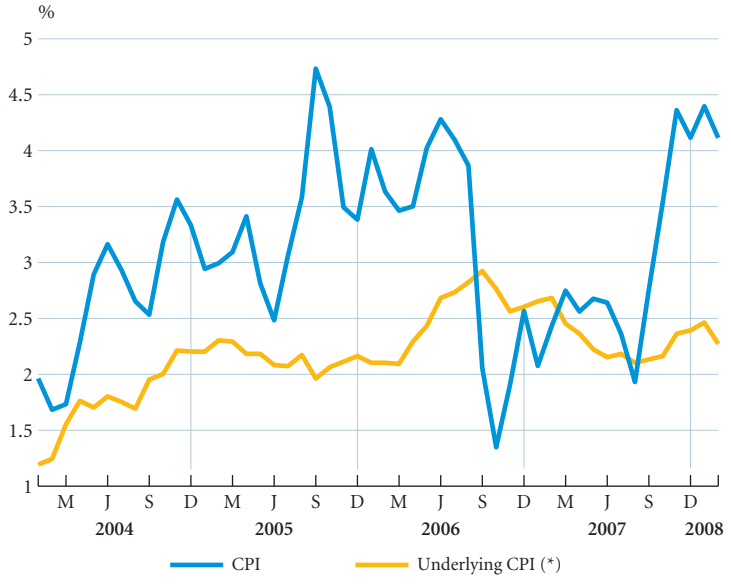
Year-on-year change in Case-Shiller index of housing prices



SOURCE: Standard & Poor's and own calculations.

UNITED STATES: INFLATION SHOWING ITS TEETH

Year-on-year change in consumer price indices



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

year-on-year. The underlying component (the general rate less food and energy) was also down slightly going from growth of 2.5% to 2.2% year-on-year, more in keeping with the expectations of the Federal Reserve which were close to 2.0%. The risk of lower growth is thus greater than the inflation risk but we should not forget that the relation growth-inflation has become less favourable than in the past so that we should not expect that this period of weakness will bring any major modification of prices.

In turn, the trade balance for goods and services in January showed a deficit of 58.2 billion dollars, somewhat lower than in December. Exports continue to grow. In January they grew by 16.6% year-on-year whereas imports were up 11.9%. This improvement is important because the deficit (excluding oil products) stood 47% below the high in October 2005. Nevertheless, the correction of the deficit cannot compensate the weakness in domestic demand and the biggest risk in the foreign sector lies in one of the causes of the current improvement, the loss of value of the dollar, which again takes us to the matter of confidence, that is, confidence in assets expressed in dollars. While the value of real estate assets is in doubt, one positive element is that US government bonds continue to enjoy the favour of international investors.

Trade deficit adjustment continues but dollar presents biggest risk.

Japan: the weakness of a long growth period

The GDP of Japan's economy grew by 1.7% year-on-year in the fourth quarter of 2007, thanks to the strength of investment in capital goods, public consumption and a rise in inventories. Excessive dependence on the foreign sector continues, along with the weakness of private consumption. This leaves the economy in a state of weakness

Japan continues gradual growth but consumers form no part of it.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
Real GDP	2.4	2.0	2.9	1.7	1.9	1.7	–	...
Industrial production	4.5	2.9	3.6	2.3	3.3	2.4	2.2	...
Tankan company Index (1)	22.5	22.0	23.0	23.0	23.0	19.0	–	...
Housing construction	4.5	–17.2	–1.9	–2.8	–36.9	–27.1	–5.7	...
Unemployment rate (2)	4.1	3.9	4.0	3.8	3.8	3.8	3.8	...
Consumer prices	0.2	0.1	–0.1	–0.1	–0.1	0.5	0.7	...
Trade balance (3)	9.4	12.5	10.3	11.1	12.3	12.5	12.5	...
3-month interbank interest rate (1)	0.3	0.7	0.6	0.7	0.8	0.9	0.9	0.9
Nominal effective exchange rate (4)	81.1	77.1	77.6	75.7	76.9	78.4	82.0	82.3

NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion yen.
(4) Change weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.
SOURCE: OECD, national statistical bodies and own calculations.

Dependence on foreign sector and heavy public sector debt present risks.

that is worsening if we take into account that Japan does not have any shock-absorbers in monetary or fiscal policy seeing that the public debt is nearly 160% of GDP and interest rates are at a low 0.5%, which offers practically no possibilities for rate cuts.

Corporate profits concentrated in large companies.

Japan's recovery has been going on for 6 years but it has two clear weaknesses. First, the level of growth has been extremely low. According to the latest revision issued by the International Monetary Fund on the weight of various countries in the whole world economy, Japan continues to lose importance. This should not be serious if we consider the enormous progress of economies like China and India. The problem comes when we compare it with other rich areas. Between 1997 and 2007 the Japanese economy went from being 46% to 41% of the total economy of the Euro Area and from 37% to 31% of the US economy. If this calculation is made in current terms, Japan's deflation means that the decreases are even greater.

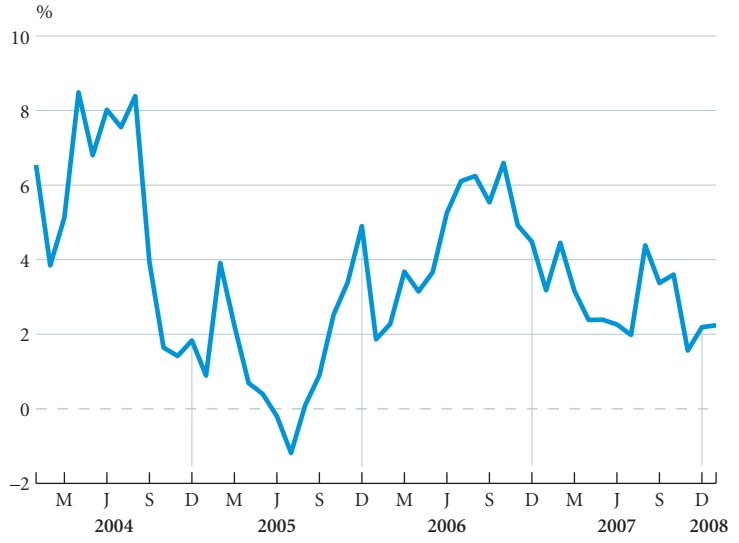
Industrial production and retail sales maintain low profile but investment recovering.

Secondly, the benefits of growth are not turning into wage increases in spite of the fact that the unemployment rate continues at very low levels because of dropping population. In January, the rate was 3.8% of the labour force. The reason could lie in the dual structure of Japanese companies. While the large companies did their homework in the Nineties and are now in good shape, the small and medium companies (which make up 70% of all employment) still have elements of inefficiency. As a result, with wages dropping 0.4% year-on-year in the last quarter of 2007, it is not surprising that private consumption continues weak. Consumer confidence ended the year at the 38.9 points level and, in spite of a slight rise, retail sales were up by a slim 1.3% year-on-year in January. Car sales, while far from the highs in 2005, do not fall into this grim picture but are showing something of a recovery that it is hoped will continue.

On the supply side, industrial production was up 2.2% year-on-year in January, down from the 4.5% in 2006 and 2.9%

JAPAN: INDUSTRIAL PRODUCTION MAINTAINING LOW PROFILE

Year-on-year change in industrial production

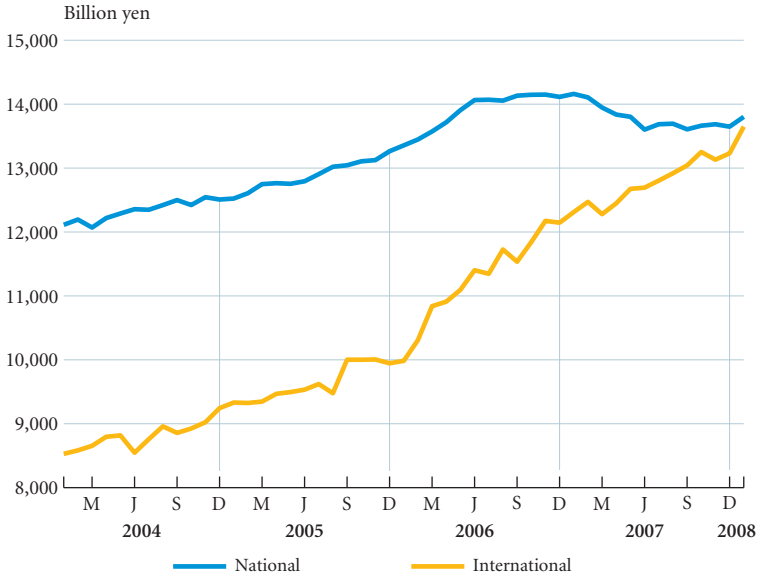


SOURCE: Japanese Ministry of Communications, National Statistics Office and own calculations.

in 2007. That same month, machinery orders, an early indicator of investment demand, rose by 18.9% year-on-year, thanks to a sharp rise in orders by the export industry, which represents 49.7% of the total, as against 40% at the end

JAPAN: INVESTMENT GOING FULL STEAM AHEAD... TO ABROAD

Machinery orders for last 12 months



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

Prices up due to rise in oil but deflation still continues while exports depend on Asian growth.

of 2003, which again shows the dependence on foreign demand.

In the real estate market, housing starts in January showed signs of recovery with a reduction of the drop from 19.0% to 5.7% year-on-year. However, the market is not going along and sales dropped by 44.1% in the Tokyo area in February. Prices are also easing going from an increase of 9.2% to a slight growth of 3.2%. The January CPI rose by 0.7% year-on-year and the traditionally followed index excluding fresh foods rose by 0.8%. Nevertheless, publication of the underlying index (the general index excluding energy and foods) again showed a drop of 0.1% compared with the same period the year before. As a result, all appearance of an end to the period of deflation comes from abroad as import prices continue to rise because of energy and food. The good news was again to be seen in the trade balance which maintained its surplus in January thanks to the fact that exports to Asia compensated for lower demand from the United States.

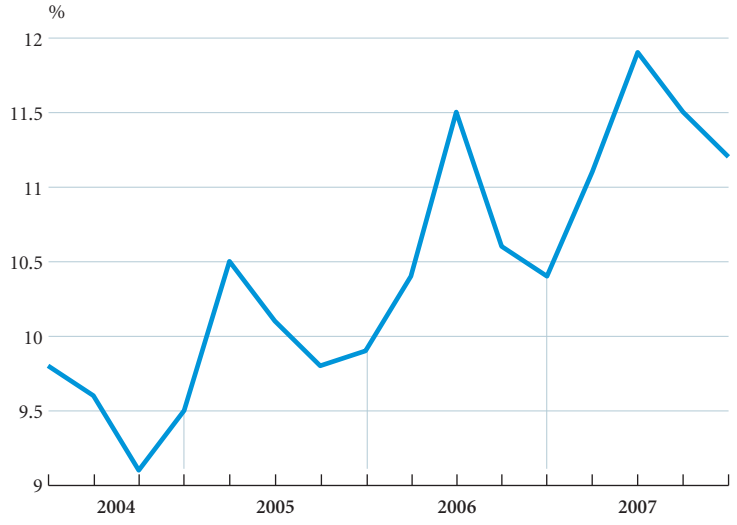
Chinese economy grows by strong 11.4% but showing some signs of slowing down.

China: the search for a slight slowdown

The Chinese economy grew by 11.2% year-on-year in the fourth quarter of 2007 which put the increase for the whole year at 11.4%, the highest rate since 1994. Keeping in mind the high growth rate, the trend in the second half-year marked a slight slowdown, the result of government efforts to control inflation. Economic activity indicators followed a trend similar to the national accounts. Industrial production in February was up 15.4% year-on-year, which also indicates some cooling off if we compare it with the figures of six months earlier. But private consumption continues as the part of the economy that does not grow as it should, especially in rural China. Retail sales in February, discounting price increases, slowed to an

CHINA: IMPRESSIVE GROWTH

Year-on-year change in GDP



SOURCE: Chinese National Statistics Office and own calculations.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
Real GDP	10.7	11.4	11.1	11.9	11.5	11.2	–	...
Industrial production	16.4	17.1	14.6	18.3	18.1	17.5	16.4	15.4
Electrical power production	14.7	15.7	12.4	17.7	16.3	16.1	12.7	18.8
Consumer prices	1.5	4.8	2.7	3.6	6.1	6.6	7.1	8.7
Trade balance (*)	177.5	261.6	200.5	228.9	253.3	261.6	265.2	250.0
3-month interbank interest rate (*)	2.8	3.6	2.8	3.4	3.5	4.7	4.8	4.5
Renminbis to dollar	8.0	7.6	7.7	7.7	7.5	7.4	7.2	7.1

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

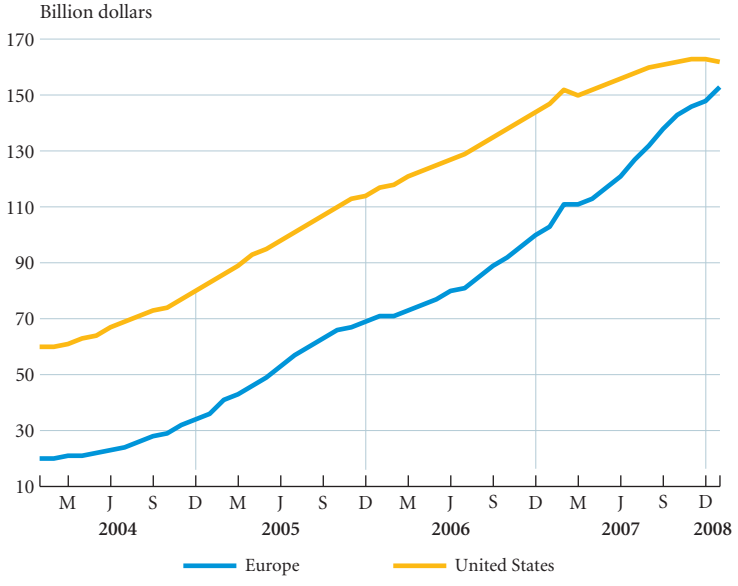
increase of 9.6% while retail sales in the rural areas (assuming a higher share of food in total consumption) could be showing negative growth rates.

The main risk for the economy now is the sharp rise in inflation. The general CPI rose by 8.7% year-on-year in February, twice the rate only eight months back. The situation is even more troubling in the food sector with prices rising 23.3% thus maintaining the trend to sharp increases. The sector represents 14.4% of total retail sales but in the rural areas, where more than 700 million people live, this percentage goes up

Main risk is inflation coming close to 9%, while food prices up 23%.

CHINA: APPRECIATION OF EURO AFFECTING TRADE BALANCES

China's bilateral surplus with United States and Europe



NOTES: Sum of last 12 months.
SOURCE: Chinese National Statistics Office and own calculations.

Bilateral surplus with United States stabilizes but continues to grow with Europe.

considerably. China is an importer of food and price increases in world markets, along with changes in eating habits, mean a risk that goes beyond the purely economic sphere. The government is loath to raise interest rates in order to avoid damaging the mortgage market. The option being followed is to increase the cash ratio which, as of March (after an increase of 0.5%, the fifteenth consecutive rise since mid-2006), was set at 15.5%. With these measures, prime minister Wen Jiabao hopes to end 2008 with a CPI at 4.8%, which seems no easy task.

Even with all its risks, China is the main engine of the world economy. On a continuation of China's growth depend the fortunes of many economies in the Far East, both large and small, given that the Asian giant combines major trade surpluses with Europe and the United States with a sharp deficit with many countries in Asia. Government concern is focused on the loss of value of the US dollar. The appreciation of the Chinese renminbi against the greenback (when this drops) has no effect in terms of other currencies such as the euro.

The foreign surplus for the past 12 months ending in February eased slightly going to 250 billion dollars but, while the positive bilateral balance with the United States was stagnant at 160 billion dollars, the surplus with Europe went to 153 billion dollars, twice that in mid-2006. In contrast, the combined deficit with Taiwan, South Korea and Japan rose to 159 billion dollars.

Mexico: foreign sector is Achilles heel

Industry remains slack but inflation below 4% and labour costs still moderating.

The Mexican economy held to its upward trend with growth of 3.8% year-on-year in the fourth quarter of 2007. This put the increase for the whole year at 3.3%, somewhat below the 4.8% the year before. Private consumption sharpened its rate going to 4.6%. While the figure for the third quarter was revised downward, this component is pointing upward. Private investment also gave signs of life with a rise of 8.9%. But the weaknesses in the Mexican economy continue to be in the public sector that is moving up and in a foreign sector that continues to show problems of competitiveness. The rise in exports, with an increase pf 6.4% in the fourth quarter, lost some of its strength while imports continued to rise with an increase of 10.5%.

Mexico grows by 3.8% with consumption and investment strong but foreign sector dropping.

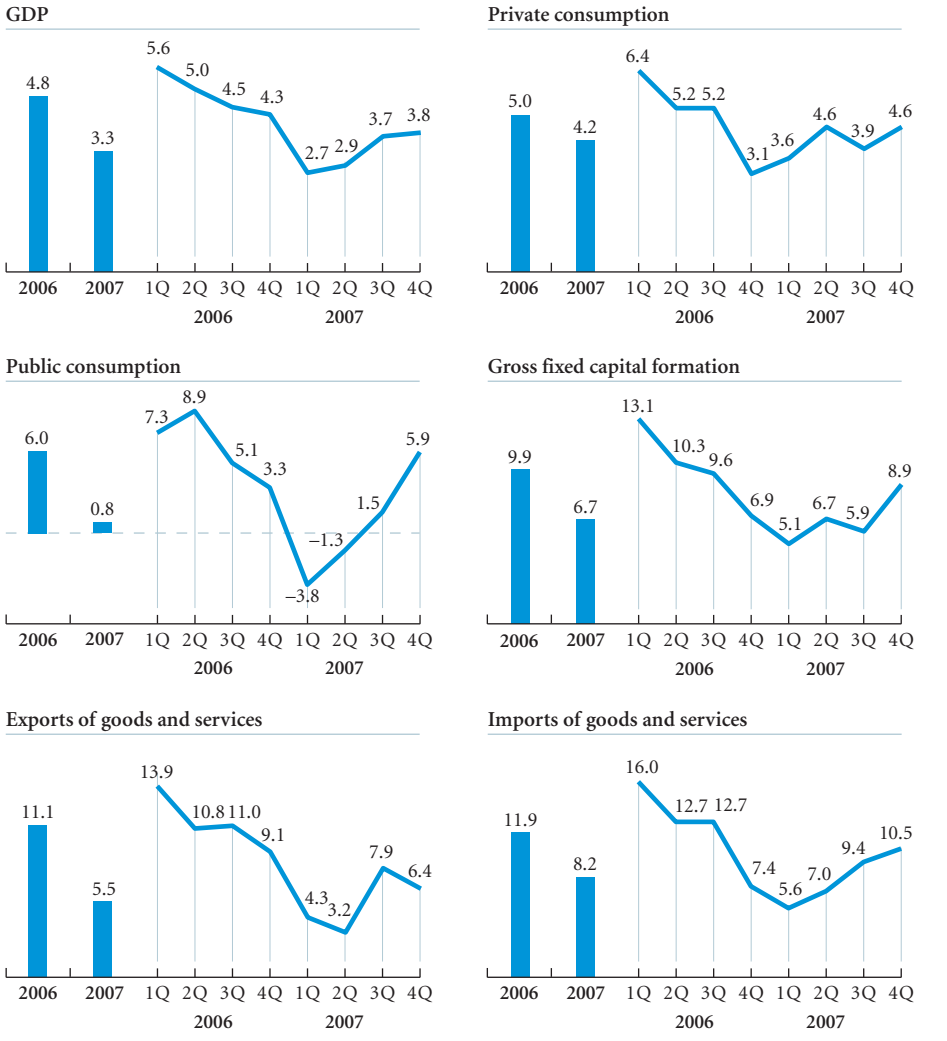
Among the most recent indicators of economic activity things also continue to move up. Industrial production in January rose to growth of 3.1% year-on-year although growth of 1.4% in 2007 pales when compared with the 5.0% the year before. Manufacturing was somewhat better with an increase of 3.7% in January while construction, perhaps reflecting the situation of its US neighbour, rose by a modest 0.8%.

Inflation remains stable. Prices rose by 3.7% year-on-year in February while the underlying index (the general index excluding energy and food) was up 4.0%. Thanks to increases in productivity in December, unit labour costs continued to ease following a substantial rise in May and June 2007. In turn, the official unemployment rate for February cut down the rise in the previous month putting it at a moderate 3.8% of the labour force.

The worsening of the trade balance sharpened with a cumulative trade deficit for the past 12 months ending in January rising to 11.7 billion dollars.

TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Central Bank of Mexico and own calculations.

This meant a worsening which, excluding oil exports, turns out to be more dramatic. Revealing the consequences of the weakness of the US economy, non-oil exports have dropped 10% since October while the drop in imports was not nearly as sharp. The deficit for the past 12 months up to January, excluding oil, was 56.16 billion dollars, a figure close to twice that for the not so far off year 2004.

Commodities: oil hits new highs

Foreign sector sharpens drop.

The figures are staggering. The one-month forward price per barrel Brent was 106.54 dollars on March 14 following in the wake of the West Texas barrel which the day before reported a price of 108.96 dollars. These all-time highs, which have left the psychological barrier of 100 dollars far behind, gave way to several days with sharp swings. At

MEXICO: MAIN ECONOMIC INDICATORS

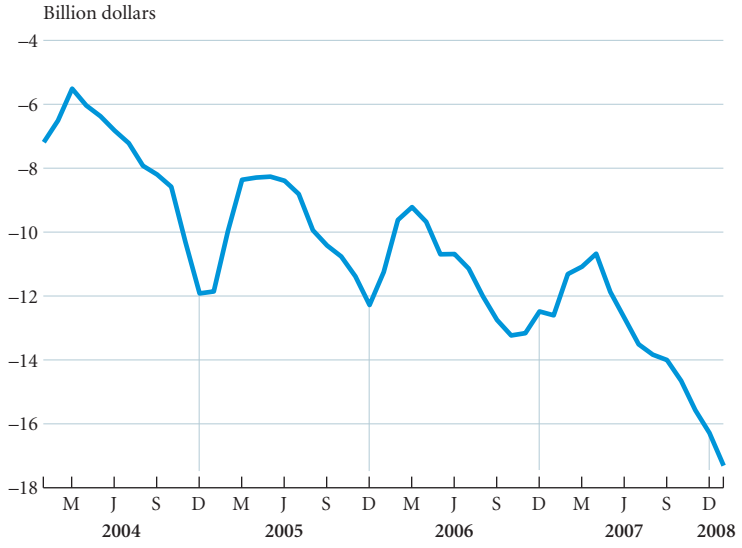
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
Real GDP	4.8	3.3	2.7	2.9	3.7	3.8	–	...
Industrial production	5.0	1.4	0.8	1.1	1.6	1.8	3.1	...
General unemployment rate (*)	3.6	3.7	4.0	3.4	3.9	3.6	4.1	3.8
Consumer prices	3.6	4.0	4.1	4.0	4.0	3.8	3.7	3.7
Trade balance (**)	–6.1	–11.2	–9.4	–11.7	–11.8	–11.2	–11.7	...
3-month interbank interest rate	7.3	7.2	7.2	7.2	7.2	7.2	7.2	7.2
Mexican pesos to dollar	10.9	10.9	11.1	10.8	11.0	10.8	10.8	10.7

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

MEXICO: TRADE DEFICIT WORSENING

Cumulative 3-month figure for trade balance not including oil exports



SOURCE: Central Bank of Mexico and own calculations.

Oil pierces psychological barrier of 100 dollars a barrel...

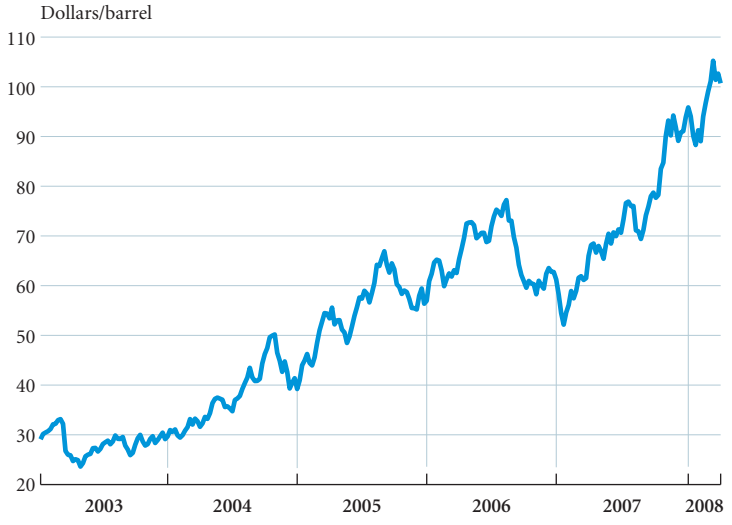
the end of March prices were slightly lower than those record figures. What is happening?

There is no lack of explanations. In a recent note, the US government agency that monitors energy matters listed no less than 12 factors, from the dollar exchange rate to refinery bottlenecks as well as speculative moves in hedge funds. The evident problem is that we cannot isolate these factors and furthermore that our ability to explain them serves in some periods but not in others.

In the first quarter, world supply was 86 million barrels a day whereas demand would have been 87 million barrels. This

OIL STAYS AT ALL-TIME HIGH LEVELS

One-month forward price per barrel Brent as weekly average



SOURCE: Thomson Financial Datastream.

shows the clear trend to a reduction of inventories of oil products which has come to light in recent months. For 2008 as a whole it is expected that supply will marginally exceed demand with the former growing by 1.5% a year while the latter moving up by 3.1%.

On top of this small margin we must add that pumping capacity is very limited and basically centred in Saudi Arabia which helps us to understand that the decision of the Organization of Petroleum Exporting Countries (OPEC) to maintain production quotas until the summer may have created notable pressures in the market.

...due to growth of demand over supply in first quarter.

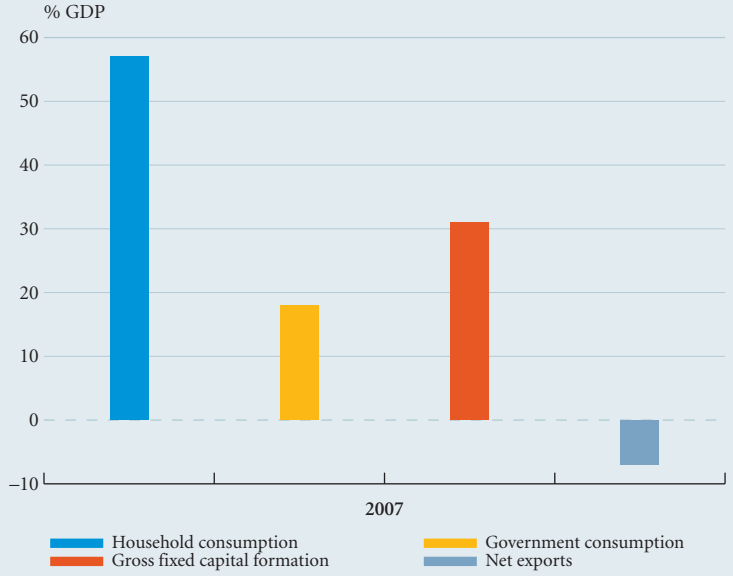
In contrast with other times, other commodities have somewhat moved away from recent trends in oil. After marking up high values for various metals at the beginning of March (whether all-time highs or highs not seen for many years) these have now tended to ease. Some of the most notable monthly decreases were seen in zinc (down 15% monthly), platinum (down 5%) and aluminium (decrease of 3%). Farm commodities have followed a similar route. In this respect, we should mention corrections in soy beans (drop of 12%), coffee (down more than 16% monthly) and cocoa (decrease of 13%).

Commodities drop positions in March.

What makes consumption move?

Household consumption usually accounts for a large fraction of a country's GDP. In the case of Spain, it was 57% in 2007 (see following Graph), in line with that of its neighbouring countries. In the past 10 years, its growth has been 3.9% annual, similar to average GDP growth at 3.8% (see Graph on next page). Over the long term, this similarity is not by chance. Consumption growth is determined by GDP growth which, in turn, basically depends on variables such as the increase in employment and improvements in productivity. Over the short term, however, causality also works in the opposite direction: changes in household consumption affect GDP growth. Let us show how.

HOUSEHOLD CONSUMPTION: LEADING SHAREHOLDER IN GDP



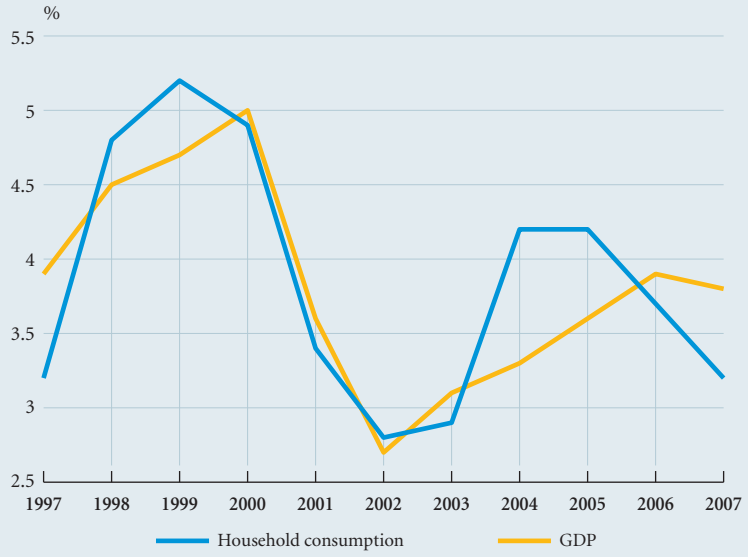
SOURCE: National Institute of Statistics.

The most widely held theory in trying to explain the savings and consumption decisions of households is the Permanent Income Hypothesis developed by US economist Milton Friedman at the end of the Fifties. It argues that private consumption is determined by household wealth –in its broad sense. This concept of wealth includes all household income, both current and future income, and the total asset value net of acquired debt.

The main source of household income is labour income. Therefore, the evolution of labour market is a crucial determinant in private consumption. In recent weeks, the figures for job creation in the United States have caught most attention from analysts of the US economic situation because they may provide clues to consumption and the likelihood the country may be in recession.

The purchasing power of households is also determined by interest rates. In general, a decrease in real interest rates increases the borrowing capacity of households and thus their consumption. Stimulating private

HOUSEHOLD CONSUMPTION AND GDP: GROWING TOGETHER



NOTES: Chain Volume Index (base year 2000).
SOURCE: INE.

consumption along with investment is one of the objectives being pursued by the US Federal Reserve through its recent cuts in official interest rates.

Finally, price fluctuations in household assets influence consumption decisions as they affect the value of their wealth. There is evidence that this «wealth effect» is relatively small in Spain's economy, especially in the case of real estate assets. Olympia Bover, for example, has estimated that an increase of a hundred euros in a dwelling's value would yield an increase in annual household consumption of two euros, a much more modest effect than those estimated for the US or the UK.[1]

On the other hand, expectations on future income, and the capacity of households to «shift» part of that future income to the present, will also have an impact on present consumption. For example, in a downward stage of the economic cycle income expectations tend to drop and households consume less. The ability to use part of future income on current consumption is especially important for young people seeing that it is they who, with the purchase of durable goods, such as a car, have a greater need to spend above current income. Financial institutions, when granting a loan, play a key role in shifting this income from the future to the present. In this respect, changes in criteria for granting loans during the economic cycle have effects on household consumption.

But not only the amount of future income is important. Also key is the uncertainty regarding that amount. In general, a higher level of uncertainty pushes up household savings in order to deal with unexpected situations such as a job loss. Some public policies, however, may reduce that uncertainty through, for example, unemployment benefits.

(1) Bover, O. (2005), «Efectos de la riqueza inmobilaria sobre consumo: resultados a partir de la Encuesta Financiera de las Familias», *Boletín Económico*, Bank of Spain.

Another public policy that may affect consumption and that is currently making headlines is a temporary transfer to households. This policy has recently been put into practice in the United States and its application is also being studied in Spain. If all households were behaving according to the Permanent Income Hypothesis, only a small proportion of this transfer would go into current consumption. However, not all households do behave that way.[2] Thus, if the household receiving the transfer was credit constrained, that household would be able to increase its consumption thanks to that transfer. Hence, the larger the proportion of credit-constrained households, the larger the effect of the transfer on aggregate consumption. In practice, there are also some households that consume all income whether because they like to live well or because they are barely able to cover their basic needs. For them, the transfer would mean an increase in consumption.

On the other hand, we should also keep in mind that part of consumption is imported and the larger this proportion the less will be the effect on growth, because imports are not accounted for in the GDP as they are not produced inside the country. In an economy with full employment it is more likely that increases in consumption will translate into increased imports. Some estimates for the United States show that a transfer valued at 100 dollars increases private consumption by around 50 dollars, ten times more than the Permanent Income Hypothesis would predict.[3] For obvious reasons, this kind of result has spurred on the search for alternative consumption theories.

In a nutshell, private consumption accounts for nearly 60% of Spain's GDP although this does not mean that it is the reason behind long-term economic growth. Nevertheless, over the short term consumption does affect growth. For this reason, consumer confidence, the availability of credit and certain public policies come onto the radar of any economic analyst.

(2) The so-called Ricardian Equivalence Theorem, closely linked to the Permanent Income Hypothesis, even predicts that a transfer would have a nil effect on consumption because households would anticipate an increase in taxes to pay for such a transfer.
(3) Souleles, N.S. (1999), «The Response of Household Consumption to Income Tax Refunds», *American Economic Review*, Vol. 89 (4).

EUROPEAN UNION

Euro Area: orderly economic slowdown

In view of the seriousness of the economic situation in the United States, the Euro Area is showing admirable resistance, for the moment. The problems of the Euro Area rather lean to excessively high inflation. This is the conclusion to be taken from the series of economic reports and forecasts published in recent months by key economic bodies (International Monetary Fund, Organization for Economic Cooperation and Development, and European Commission). All of these bodies coincide in that 2008 will be a year with something of an economic slowdown accompanied by an appreciable rise in prices.

The latest to join this chorus is the European Central Bank (ECB). In its latest half-yearly forecasts, the monetary authority draws a macroeconomic scenario that confirms this consensus view. According to the ECB, we have two difficult years ahead of us. In 2008, according to its main forecast, growth in the Euro Area will be 1.7%, close to one point less than the rate recorded in 2007. The following year (2009) the improvement will be very slight given that gross domestic product (GDP) for the Euro Area will be up by 1.8%.

The fact that in these two years the Euro Area will grow below potential does not mean price pressures will be less than notable. In 2008, according to its main forecast, the ECB is expecting that, on annual average, prices will rise by 2.9% compared with 2007. The bank feels that this rise will be of a temporary nature as it is due to a combination of pressures from energy and food, a trend that is expected to ease as 2008 progresses. In any case, any halt to inflation will be gradual so that in 2009 it will still be above the 2% short-term objective for prices. Compared with what the ECB was

Prices present most pressing problem in Euro Area, not economic slowdown.

ECB MACROECONOMIC FORECASTS FOR EURO AREA

Percentage average year-on-year change (*)

	2007	2008	2009
HCPI	**2.1**	**2.6-3.2**	**1.5-2.7**
Real GDP	**2.6**	**1.3-2.1**	**1.3-2.3**
Private consumption	1.6	1.1-1.7	1.0-2.4
Public consumption	1.9	1.1-2.1	1.0-2.0
Gross fixed capital formation	4.6	0.5-3.1	0.2-3.4
Exports of goods and services	5.7	2.6-5.6	3.1-6.3
Imports of goods and services	4.9	2.0-5.4	2.9-6.3

NOTES: (*) Projections for real GDP and components refer to figures adjusted for working days. Projections for exports and imports include intra-Euro Area trade.
SOURCE: European Central Bank.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
GDP	2.9	2.6	3.1	2.4	2.6	2.2	–	...
Retail sales	1.5	0.9	1.7	1.1	1.4	–0.6	0.2	...
Consumer confidence (*)	–9.1	–4.9	–5.4	–2.6	–3.9	–7.7	–11.5	–12.0
Industrial production	4.0	3.5	4.0	2.9	4.0	3.2	3.6	...
Economic sentiment indicator (*)	106.3	108.4	109.4	111.0	108.7	104.3	101.7	100.1
Unemployment rate (**)	8.3	7.4	7.6	7.5	7.4	7.2	7.1	...
Consumer prices	2.2	2.1	1.9	1.9	1.9	2.9	3.2	3.3
Trade balance (***)	–10.4	20.1	–0.9	15.6	31.4	34.3	25.3	...
3-month Euribor interest rate (*)	3.1	4.3	3.8	4.1	4.5	4.7	4.7	4.4
Nominal effective euro exchange rate (*)	103.6	107.7	105.5	107.1	107.6	110.5	112.1	112.1

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

ECB expects economic slowdown to coincide with period of high inflation in 2008 and 2009.

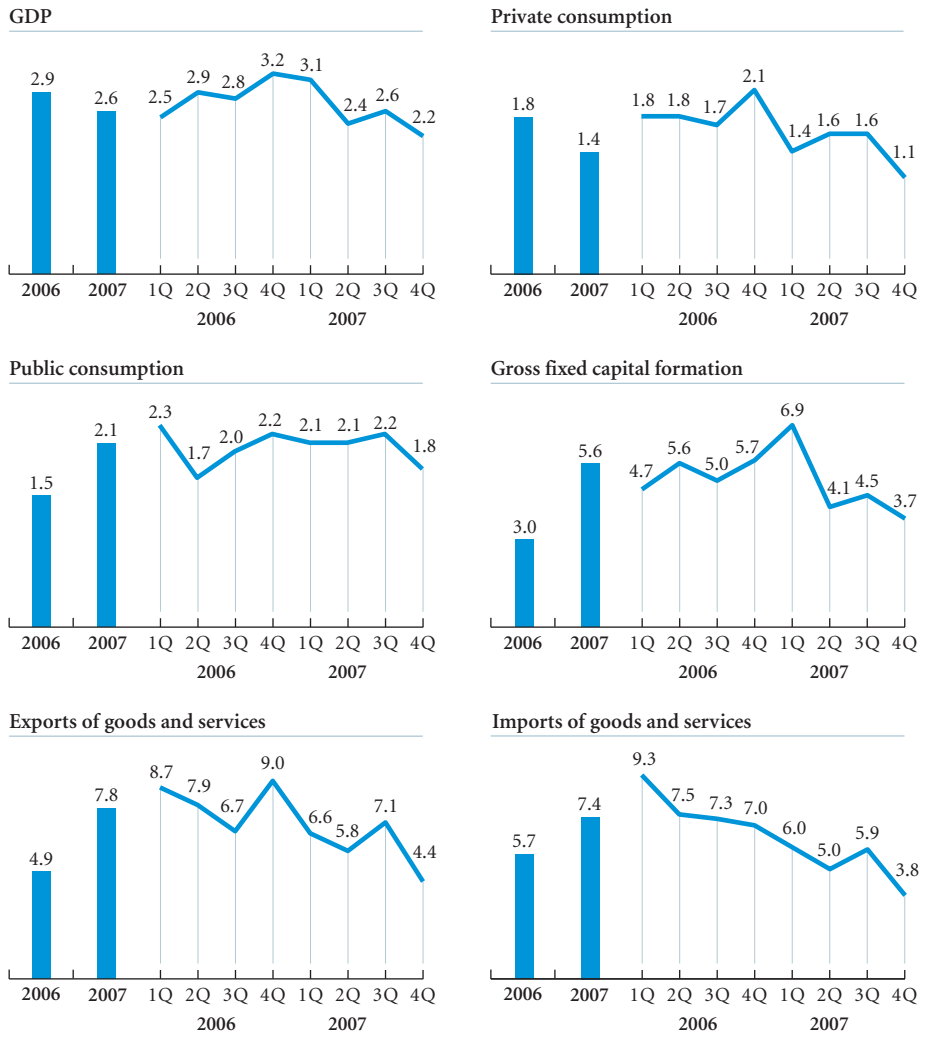
expecting in December 2007, the date of its last forecasts, the new scenario presents lower expected growth with higher inflation, an uncomfortable combination for those responsible for managing monetary policy.

Is this scenario believable? With the figures available up to now, things seem to be going along the lines drawn by the ECB. To begin with, the figures for National Accounting for the fourth quarter make it possible to clearly see the starting point of the process of slowdown in growth. Economic slowdown in that period (GDP went from growth of 2.6% year-on-year in the third quarter to 2.2% in the fourth quarter) was due to a combination of less growth in domestic demand and a substantially lower contribution from the foreign sector. Specifically, the components to show most signs of loss of strength were private consumption and investment, two variables that grew five and eight decimals respectively less than in the previous quarter. With regard to the positive contribution of the foreign sector to the change in GDP, it went from 0.5% in the third quarter to 0.3% in the fourth quarter. As may be seen from the accompanying table, the ECB forecasts suggest it is precisely these that will be the sources of the slowdown: lower consumption and investment and a slowdown in exports.

While this was the situation at the end of 2007, latest indicators confirm that the slowdown is continuing. But they also give a clear indication that strength of this slowdown is still limited. One demand component attracting much attention is consumption. The weakness this showed in the fourth quarter of 2007 was greater than expected so that now it is a matter of properly weighing the state of this variable. Available indicators as a whole suggest weakness, not much different from the fourth quarter.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCE: Eurostat and own calculations.

Retail sales failed to grow in year-on-year terms in January, consumer confidence lost more than three points between January and February and car registrations were down in January but recovered in February. The slight drop in the unemployment rate, one decimal in January to 7.1°%, may help to avoid a collapse of household spending but the background trend is clearly pointing to a cooling off in this area. Slightly more satisfactory was the trend in investment with the main indicators (industrial production of capital goods and level of utilization of production capacity) point either to stability or to something of a recovery.

Supply indicators allow us to somewhat broaden the picture. In general terms, their performance has been better than expected, which may be interpreted as evidence that the rate of adjustment in economic growth is gradual with

Economic slowdown for the moment showing moderate degree.

Exports losing steam.

nothing of a collapse. Some indicators, such as industrial production, even caused surprise with a rise in January, a clear sign that the cyclical downturn is still at an initial stage.

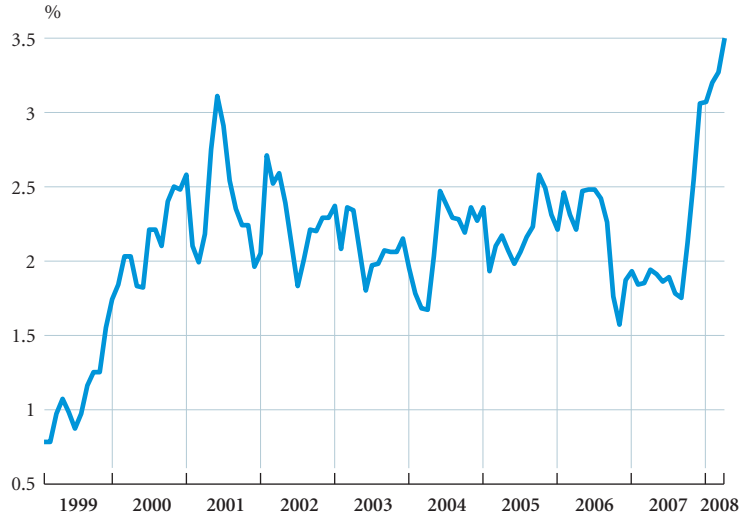
Nevertheless, there is no reason for complacency. Two negative trends that emerged in the Euro Area some time back are now getting sharper. Foreign demand continues to lose strength month after month. In December, exports were up 8.5% year-on-year, in terms of 12-month figures, two percentage points less than reported barely six months earlier. With the nominal effective euro exchange rate 7% higher than one year earlier, the competitiveness of exporters is down and figures for foreign sales may be suffering from this toll. Imports, on the other hand, are holding to more stable growth which led to a trade surplus in December at 28.3 billion euros (cumulative figure for 12 months), as against 35.9 billion euros in November.

Inflation moves up to 3.5% in March.

Still more troubling is the trend in prices. In February, the harmonized consumer price index (HCPI) rose to 3.3% year-on-year, one decimal more than the January figure and 2.4 percentage points higher than that reported one year earlier. The culprits are not new (energy and food) but, even when these volatile components are excluded, the rise is sharp (underlying inflation in February stood at 2.4%). The preliminary figure for March, showing growth of 3.5% year-on-year, confirms this view. Finally, with prices on the rise and economic activity dropping but still showing some strength, the Euro Area is just setting out on the road to a slowdown. Furthermore, it is doing so along the lines drawn by the international economic bodies. Perhaps reality will not be long in showing itself less disciplined.

HIGHEST INFLATION IN HISTORY OF SINGLE CURRENCY

Year-on-year change in harmonized consumer price index



SOURCE: Eurostat and own calculations.

Germany paying price of a too-strong euro

What is the cost of a euro? It is easy to say, for example, that the euro was showing an exchange rate of 1.58 dollars on March 17. On the other hand, it is more complicated to know just what such a strong euro is costing the heavy export oriented German economy. In its latest monthly report, the Bundesbank, Germany's central bank, calculates that in 2007 appreciation of the euro brought about a half-percentage point reduction in growth of GDP, which that year was 2.5%. While the Bundesbank itself recognizes that there are other determinants in exports more important than the exchange rate (such as, for example, growth of destination markets and the attraction of Germany as a supply source), with the euro at all-time highs against the dollar and the international economy weaker and weaker, there is increasing concern about the role of foreign demand in the difficult year ahead.

Bundesbank puts cost of higher value of euro in 2007 at one half-point of growth...

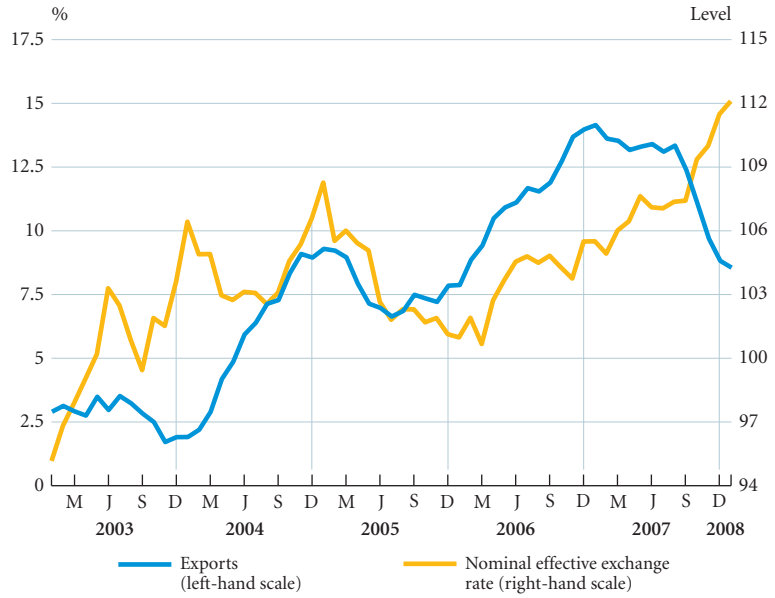
Because of this, the January figures for foreign trade brought some relief. In the first month of the year, German exports grew by 8.8% year-on-year, practically twice the rate for one month earlier. Imports also showed a rise. As a result, the trade surplus as a cumulative figure for 12 months stood at 199.9 billion euros, beating the still good result in December. Nevertheless, taking a longer term view, the rate of export growth in cumulative figure for 12 months, for example, shows that the appreciation of the euro is growing and reaching levels that are penalizing retail sales (see following graph).

The importance of being able to maintain exports becomes clear when we look at other demand indicators. Retail sales grew by a slim 0.6% year-on-year which, on top of the third consecutive

...a toll growing at start of 2008.

STRONG EURO NOW AFFECTING EXPORTS

Year-on-year change in moving average for exports over 12 months and nominal effective exchange rate



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

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
GDP	3.1	2.6	3.7	2.6	2.5	1.8	–	...
Retail sales	6.1	–7.6	–6.5	–7.5	–7.3	–8.8	0.6	...
Industrial production	6.0	5.8	7.5	5.3	5.5	5.2	7.0	...
Industrial activity index (IFO) (*)	105.4	106.2	107.5	108.0	105.4	103.7	103.4	104.1
Unemployment rate (**)	10.7	9.0	9.5	9.2	8.9	8.5	8.1	8.0
Consumer prices	1.6	2.3	1.8	2.1	2.4	3.1	2.9	2.8
Trade balance (***)	151.5	183.5	165.5	178.3	192.0	198.1	199.9	...

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

Start to year better than expected, as shown by good state of industry.

decrease in consumer confidence, shows that it will be difficult for private consumption to act as a bulwark of resistance to the slowdown. This combination of a lower contribution from the foreign sector and weakness in private consumption leaves investment in a lonely position. While investment is certainly holding up (in January industrial production of capital goods grew by 11.4% year-on-year) it would seem to have insufficient drive for the German economy.

In any case, the upward move of the capital goods component in January also showed up in industrial production as a whole (year-on-year rise of 7.0%), which is indicative of the beginning of a reasonably strong year. The IFO index of industrial activity ran along the same lines and, in spite of its recent swings, stood at the 104.8 points level in March, seven decimals above the February figure.

Other key variables have shown fewer changes. Inflation is moving gradually away from the highs reached last November when it went up to 3.4% year-on-year. In February, the CPI grew by 2.8% year-on-year, one decimal less than that seen in January. The unemployment rate is also moving down going to 8% of the labour force. A year ago the figure was 9.5%. This improvement is very opportune as it could contribute to avoiding excessive restraint on household spending.

France begins 2008 in better shape than expected...

France: new attempts at economic reform

In France, the beginning of 2008 was relatively good from an economic point of view. Household consumption recovered with growth of 3.7% year-on-year in February. That same month, consumer confidence rose by four decimals. Industrial production was up 2.7% year-on-year in January, its highest figure since last October. Exports, for which growth had stabilized between September and December, rose slightly in January. Prices have stopped showing an increase in growth rate (the February CPI was again 2.8% year-on-year). Finally, the unemployment rate is dropping going to 7.8% of the labour force, the lowest figure in 12 years.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
GDP	2.2	1.9	1.9	1.4	2.2	2.1	–	...
Domestic consumption	2.7	3.4	3.6	2.8	4.2	3.2	2.3	3.7
Industrial production	1.0	1.5	1.0	0.2	2.2	2.4	2.7	...
Unemployment rate (*)	9.2	8.3	8.6	8.4	8.2	7.9	7.8	...
Consumer prices	1.7	1.5	1.2	1.2	1.3	2.3	2.8	2.8
Trade balance (**)	–27.0	–32.6	–29.0	–30.7	–33.2	–37.6	–40.5	...

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

So, is everything going well? The truth is that, while they refer to the winter, these indicators rather have the appearance of summer flowers. Before many months have passed the economic situation is expected to become less satisfactory. Analysts generally are expecting growth of only 1.6% in 2008, that is to say, below the 1.9% seen in 2007. But even this figure would seem overly optimistic. The French statistics body, INSEE, forecasts growth of only 1.4% in 2008, as a result of the worsening both of domestic demand and the foreign sector. Furthermore, the INSEE scenario holds as a possible risk the fact that it is based on a minimum correction in household spending.

In spite of the fact that the broad economic situation is showing up clubs, French president Nicolas Sarkozy is keeping to his idea of going ahead with economic reform. In this respect, Sarkozy commissioned a group headed by Jacques Attali to prepare a report on measures to improve economic growth. The outcome of this working group was a series of proposals (no less than 316) which run from liberalizing taxi licences to creating 10 key research groups. Following its presentation at the end of January, after the slight political impasse of the municipal elections, it is now expected that the French president will begin to implement a significant part of these measures.

...but rest of year could run less brilliant course.

Italy: slim economic hand-me-down for new government

The Italian economy continues to go through a difficult period. While the good figures at the beginning of 2008 reported by the other large economies of the Euro Area have not be entirely ignored, in the case of Italy things have been at a much lower level. It is true, retail sales rose in January but consumer confidence was down by more than one point in February. Supply indicators have run a similar course. The most significant, industrial production, was down 1.3% year-on-year in January, a figure that was notably better than the figure for December (year-on-year drop of 4.1%). But, with industrial orders down 12% in February and industrial confidence adding up three consecutive months of decreases that same month, it would be surprising if the secondary sector was able to consolidate any improvement made.

New round of structural economic reforms being prepared.

Nor has Italy been able to copy the good figures on the labour market reported by

Italy's economic state weak, well below other large economies of Euro Area.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
GDP	1.9	...	2.4	1.8	1.9	...	–	...
Retail sales	1.2	0.5	1.0	0.1	0.2	0.5	1.0	...
Industrial production	2.6	–0.1	1.2	0.7	0.8	–2.9	–1.3	...
Unemployment rate (*)	6.8	6.1	6.2	6.1	6.0	6.0	–	...
Consumer prices	2.1	1.8	1.7	1.6	1.6	2.4	3.0	2.9
Trade balance (**)	–17.6	–13.7	–19.1	–15.4	–11.3	–8.9	–10.0	...

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

Ministry of Finance growth forecast for 2008 set at 0.6%.

its single currency partners. In the fourth quarter of 2007, in spite of holding in the area of increases, growth of employment was merely 1.1% year-on-year, six decimals less than in the third quarter. In addition, the unemployment rate for the fourth quarter was again 6.0% of the labour force. With regard to prices, the similarities are more apparent. In February the CPI was down one decimal going to 2.9%.

This is the economic situation being handed down to the new government coming out of the legislative elections on April 13-14. There is no reason to be too hopeful about the rest of the year. Forecasts point to low growth. The economic report of the Minister of Finance indicates that 2008 will show slim growth of 0.6%, far from the still moderate 1.5% in 2007. According to Minister Tommaso Padoa-Schioppa, the Italian economy will show a very negative result of its dependence on foreign trade, which will tend to worsen appreciably.

Nevertheless, not all of Italy's problems lie in the foreign sector. According to Confcommercio, the Italian association of companies involved in foreign trade, the situation in domestic demand is also fragile with private consumption close to the level of negative growth. While its main scenario is very similar to that of the government (GDP increase of 0.7% in 2008), its risk scenario suggests growth of 0.2%, that is, one step away from recession.

United Kingdom: consumers still buying but uncertainty growing

The economic situation in the United Kingdom is indeed a paradox. Latest available indicators do not allow us to make out any clear signs of the effect of the international financial crisis. Nevertheless, all analysts coincide in pointing out that the impact of overall restraint on lending will have a specially sharp effect on the British economy. As always, time will tell.

Recent United Kingdom indicators still not reflecting impact of world financial crisis...

Today, however, the British economic situation seems to be comfortably surviving the financial upsets. Households continue to spend somewhat lavishly as shown by the rise in retail sales (growth of close to 6% on average in January and February), a couple of points more than in the fourth quarter. While consumer confidence continues to slide down, for the moment the drop seems fairly orderly. This is not surprising seeing

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
GDP	2.9	3.0	3.0	3.2	3.1	2.8	–	...
Retail sales	3.2	4.4	4.6	4.1	4.9	3.9	5.9	5.5
Industrial production	0.3	0.3	–0.4	0.8	0.1	0.7	0.5	...
Unemployment rate (*)	2.9	2.7	2.8	2.7	2.6	2.5	2.5	2.5
Consumer prices	2.3	2.3	2.9	2.6	1.8	2.1	2.2	2.5
Trade balance (**)	–74.1	–82.2	–78.4	–80.1	–83.2	–87.0	–88.56	...
3-month Libor interest rate (***)	4.6	5.3	5.3	5.6	6.0	6.3	6.0	5.6
Nominal effective pound exchange rate	98.0	103.9	103.9	104.0	104.3	102.2	97.6	95.3

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

that the unemployment rate held at 2.5% between October and February, the lowest figure since 1975, which provides another cushion to household spending.

Other indicators point to a slowdown but without any sudden collapse. Industrial production was up 0.5% year-on-year in January, slightly below the 0.9% figure in December. Somewhat more alarming is the trend in the economic sentiment indicator given that it stood at the 95 points level in February, compared with 104 points in January. Should this trend become consolidated, something that still cannot be said, we should be looking at one of the first tangible indicators of the toothmarks left on the economic situation by the financial crisis.

The most pressing problems therefore remain on the prices front. Here the imbalances have been persistent in recent months, given that since October prices have been above the 2% inflation objective set by the Bank of England. The rise in February to 2.5% year-on-year made it clear that inflation is far from under control. Nevertheless, the British central bank, which lowered its reference rate in December and February, seems to be more concerned about a possible economic slowdown than a rise in inflation that it expects to be temporary. It is probably right and the greater danger may lie in trying to save the economy from a collapse than maintaining inflation prospects stable.

...although this expected to show up in coming months, a situation implicit in Bank of England's easier monetary policy.

FINANCIAL MARKETS

Monetary and capital markets

Crisis gives central banks no respite

Financial crisis beginning in United States in August last year spreading to rest of world.

The so-called subprime mortgage crisis began in August last year. The origin of the problem was the granting of mortgage loans in the United States to customers with low solvency without having carried out suitable risk controls. These mortgages were securitized and in this way passed on to a wide range of financial agents that were scarcely aware of the risks they were taking on. The sudden increase in default of these products set off a crisis of confidence among financial institutions that brought about restriction on the granting of loans, liquidity problems and heavy losses in balance sheets. The financial upsets, which have respected neither markets nor borders, have continued ever since.

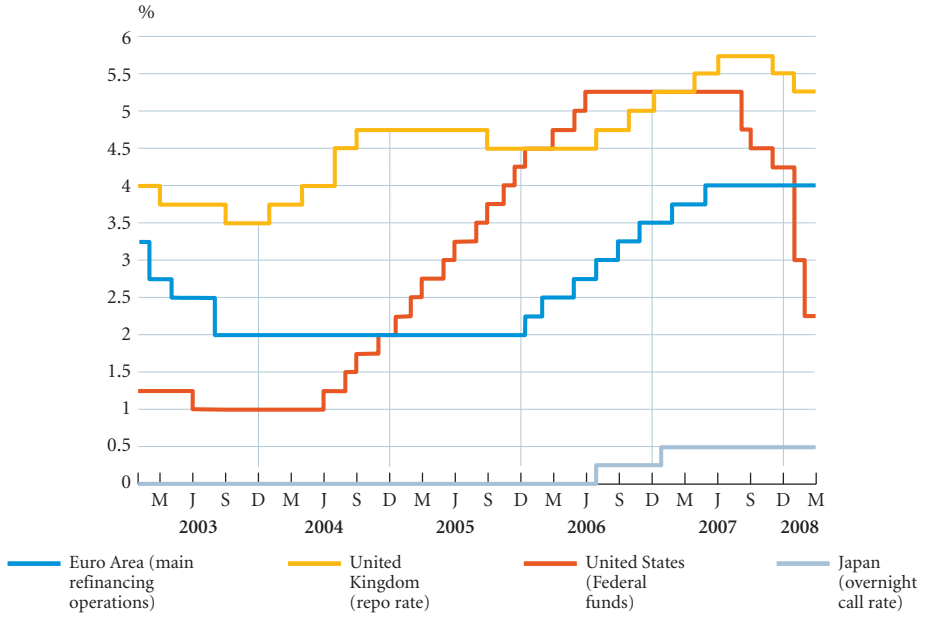
In the United States, the increase in default and the drop in the capital ratios of banks has meant bank credit is harder to get. In interbank markets, where banks lend to each other, the situation has meant an increase in interest rates.

Federal Reserve adopts series of measures to inject liquidity.

In view of the turn taken by the liquidity crisis, which finally had become a banking crisis, the Federal Reserve, the US central bank, at its meeting on monetary policy on March 18, decided to further cut its reference rate, this time by

FEDERAL RESERVE AGAIN CUTS REFERENCE RATE

Central bank reference rates



SOURCE: Central banks.

75 basis points, to 2.25%. In its press release following that meeting, Fed members underlined the sharp decline in economic activity.

Before this cut in the official rate, the Fed adopted a series of measures aimed at easing its effects. The ultimate aim of these measures was to increase liquidity, especially in the interbank market and in the market for assets backed by mortgage securities.

At the beginning of March it created a new «liquidity window» to which US investment banks that had no access to the discount window could apply, as was the case for other deposit-taking banks. Secondly, the Federal Reserve decided to accept as collateral or security for that liquidity not only Treasury bonds but also bonds issued by the federal agencies Freddie Mac and Fannie Mae and even mortgage-backed bonds issued by private companies with high credit rating.

In addition, the Fed announced an increase in swaps with the ECB and the Swiss central bank. A swap of this kind is a financial exchange in which the Fed puts dollars at the disposal of those two central banks so that they may make those dollars available to European commercial banks. In return, the Fed obtains assets in euros.

The liquidity provided under all these measures amounts to 336 billion dollars. Is this enough? It represents nearly 2% of the US gross domestic product and is nearly double the fiscal plan approved by the Administration, which amounts to 170 billion dollars. This is indeed an extraordinary injection of liquidity that reflects the difficulties being experienced by the US financial system.

In any case, all these moves failed to avoid rumours about the lack of liquidity in the fifth largest investment bank in the United States, namely Bear Stearns. A number of its counterparts in the interbank market decided to cut the their lines with this bank. In view of the problem of its financial viability, the Fed arranged the acquisition of Bear Stearns by the JP Morgan commercial bank.

Measures turn out to be insufficient and Fed obliged to rescue a private bank.

In the Euro Area, for the moment there are different concerns. At the meeting of its Governing Council on March 6, the European Central Bank (ECB) kept the official interest rate at 4%. Economic information becoming known since its previous meeting confirmed the existence of strong price pressures over the short term which showed up in the central bank's upward revision of inflation forecasts. It also pointed to an increase in uncertainty about the future course of economic activity.

In Europe, ECB maintains interest rate at 4% and warns about inflation risk.

At the press conference following the meeting of the Governing Council, ECB president Jean-Claude Trichet referred to the risk from the impact of the financial upsets on the granting of loans to companies and households. With regard to non-financial companies, he cited the 14.6% annual increase in credit which, in his words, represented very strong growth. In the case of households, the slowdown in loans granted was consistent with the rise in reference interest rates beginning in December 2005. Finally, he discounted the possibility of there being a sharp drop in credit in coming months.

Furthermore, Trichet confirmed that, in spite of the financial crisis and in contrast to the Fed, the ECB had not modified the list of securities or guarantee assets it would accept in order to provide liquid funds. This had not been changed since the launching of the euro on January 1, 1999. In addition,

Credit granted to companies and households in Euro Area showing notable growth.

China again raises cash ratio for banks in fight against inflation.

he stated that the ECB was very strictly monitoring the credit quality of those guarantees.

The Euro Area central bank again reminded all economic agents of its concern about wage increases that could mean worse prospects on inflation. The ECB announced it was carrying out the monitoring of wage negotiations and was concerned about arrangements under which nominal wages were indexed to the consumer price index.

Elsewhere, concern in China about the increase in inflation has forced the central bank to make a move. The bank has ordained an increase in the cash ratio by a half percentage point, from 15.0% to 15.5%. This move follows the warning by Chinese prime minister Wen, at his annual press conference following the close of the National Popular Assembly in Beijing, when he indicated that the government would make a strong fight against inflation.

In Japan, central bank awaits appointment of new governor.

In this respect, governor Zhou of China's central bank indicated his readiness to raise the reference rate. For the moment, so far this year the central bank has avoided raising the rate following the six increases last year that put the official rate at 7.47%. Inflation, however, has reached 8.7% so that real interest rates in China are negative. Why not quickly raise the interest rate? The reason is the risk of a sharp appreciation of the currency that would make companies lose competitiveness. Furthermore, social stability in China demands the creation of between 2-4 million jobs a year in order to absorb the shift of people from rural areas to the cities.

Interest rates reflect reduction of credit, worse growth prospects and flight to quality.

Finally, in Japan, what seemed like an easy transition at the central bank has become complicated by the absence of a consensus between the government and the opposition about who should succeed to the present governor Fukui who leaves following expiry of his term. The crisis arose with the refusal of the opposition party to accept the second candidate proposed by the government, Tanami, currently president of the Japanese Bank for International Cooperation and former minister of economy. The opposition has stated that Tanami's credentials were similar to those of the first candidate proposed, Muto, vice-chairman of the Bank of Japan but with his 37 years as minister of economy this made him too close to the government thus putting his independence in doubt. This deadlock situation leaves leadership of the Bank of Japan wide open at a critical moment with the risk of damaging the credibility of both the central bank and the government in the midst of sharp upsets in international financial markets.

Interest rates suffer from financial upsets

Interest rates are keenly reflecting the increase in uncertainty. The volatile fluctuations are being brought about with the increase or decrease in the extent of the US subprime mortgage crisis which has become a crisis affecting the solvency and stability of the financial system.

Over the past month, interest rate curves have been subject to the influence of various factors. Short-term interest rates were affected by a further reduction in the availability of credit in interbank markets. As may be seen in the following table, in the Euro Area the one-year Euribor has again gone above 4.6% levels when it seemed that the highs of 4.78% in the final months of last year had been a thing of the past. Following injections

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB reference rate (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2007									
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	4.81	4.69	4.50	5.13	0.99	5.75	6.61	2.62
December	4.00	4.68	4.75	4.25	4.70	0.90	5.50	5.99	2.63
2008									
January	4.00	4.37	4.32	3.00	3.11	0.87	5.50	5.58	2.59
February	4.00	4.38	4.38	3.00	3.06	0.96	5.25	5.74	2.72
March (1)	4.00	4.66	4.65	2.25	2.60	0.97	5.25	5.98	2.80

NOTES: (1) March 19.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 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: 11-12-07(4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%).

(4) Latest dates showing change: 11-1-07 (5.25%), 10-5-07 (5.50%), 5-7-07 (5.75%), 6-12-07 (5.50%), 7-2-08 (5.25%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

of liquidity by the ECB, interest rates were beginning to moderate and in January went to levels that could be said to show some normalization.

February was a month of transition but liquidity was down in March, which again brought pressures in interbank markets. This trend is reflected in the sharp reduction in the availablity of bank credit in view of the need to increase liquidity in bank balance sheets in order to deal with a potential weakening of capitalization ratios. Lending institutions are trying to accumulate liquidity and are less ready to lend money in the interbank market. As a result, the lower availability of credit is raising the price of funds, that is, raising interest rates in the interbank market.

On the other hand, medium and long-term interest rates have been affected by the sharp worsening of growth prospects in the United States and the flight to quality, two factors difficult to separate that both have been operating since the outbreak of the subprime mortgage crisis and that were again showing strong in March. With regard to US growth prospects, if an investor feels that economic activity will slacken, he/she will wait until inflation ends up dropping. In this context, the investor will put confidence in a cut in the central bank reference rate shifting to the

Further rise in one-year Euribor just when downward trend appeared firm.

Interest rates on long-term government bonds still depressed.

interest rate curve of government bonds. With these expectations, the demand for government bonds will rise and thus bond yields will drop, given that price and return move in opposite directions.

Furthermore, in this context there develops a move to buy high quality government bonds, which act as a refuge asset in a crisis situation. In view of the sharp drop in world stock markets, investors prefer to reduce risk in their investment portfolios by selling assets with high risk and giving preference to positions in high quality government bonds.

The following graph shows the downward trend in the price of US 10-year government bonds. Taking into account that inflation in the United States is 4% and that government bonds are offering 3.3% interest, at this time we are seeing negative real long-term interest rates which are discounting an economic situation of recession. Yields have also dropped on long-term government bonds in the Euro Area but these are offering 40 basis points (100 basis points equals 1%) more than US bonds.

Investors differentiating between government bond issuers according to credit rating.

This may be seen in the widespread drop in long-term government bond yields not only in the United States and the Euro Area but also in Japan, United Kingdom and Switzerland. The decreases, however, have not all been of the same size as investors have made distinctions in bond quality. For example, a 10-year government bond issued in Italy is paying interest of 4.32%, that is, 55 basis points more than German bonds. The German bond has a maximum rating of AAA/Aaa whereas the Italian bond has a lower credit rating of Aa2/A+.

It is normal for higher risk to imply a demand for higher yield but the 0.55%

DROP IN ECONOMIC ACTIVITY REFLECTED IN GOVERNMENT BOND PRICES

Interest rate on 10-year government bonds

SOURCE: Bloomberg.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2005	2006	2007		2008	
			September	December	February	19 march
United States	4.39	4.70	4.59	4.02	3.51	3.42
Japan	3.31	1.69	1.69	1.51	1.37	1.28
Euro Area	1.48	3.95	4.33	4.33	3.89	3.77
United Kingdom	4.10	4.74	5.01	4.51	4.47	4.33
Switzerland	1.97	2.52	3.01	3.05	2.96	2.81

SOURCE: Bloomberg.

differential is an all-time high since the launching of the euro. In the middle of last year the differential was only 0.2%. There are two factors that help to explain the rise in this differential. In the first place, there are the unknowns about the new Italian government and its budgetary plans. Secondly, when there is a flight to quality, investors take refuge in German bonds because of the strength and liquidity of that market. Nevertheless, it should be remembered that there is no currency risk as both bonds are expressed in euros and having to pay more than a half-percentage point each year for 10 years implies very strong risk aversion.

Should we halt the drop in the dollar?

The International Monetary Fund (IMF) has advised that it has increased the risk of a drop in growth due to the fact that the volatility in foreign currency markets could provoke a sharper adjustment of trade imbalances. For example, since January 1 the dollar has depreciated by 7.2% against the euro and 12.4% against the Japanese yen.

Along the same lines, following the sharp depreciation of the dollar, the chairman of the IMF and the primeminister of Luxembourg both referred publicly in Brussels to the US policy of a strong dollar. Trichet repeated his message more sharply at a press conference on March 6 and again on March 10. Nevertheless, the result of these comments was nil, seeing that foreign currency markets took no notice of the remarks by the leading figures responsible for monetary policy and the euro.

Trichet and Juncker express concern about dollar exchange rate...

Nevertheless, there are some discordant voices on the matter. The Bundesbank, the German central bank, believes that German exports depend on the growth of its export markets and the attractiveness of a product rather than simply its price. Furthermore, the IMF director general, Strauss-Kahn, while pointing out the risk of the collapse of the dollar to growth, considered that in the present situation there was no need for concerted intervention on the part of the central banks to halt the drop of the dollar.

Perhaps this absence of consensus stopped the ECB chairman from making further comment on the situation of the euro against the dollar. Or perhaps it was the nil result of his comments seeing that finally the dollar dropped further against the euro going to an exchange rate of 1.59 at the session on March 17.

The most interesting comment on the market came from the deputy governor of the Bank of England with the

...but no unanimity on how to halt collapse of dollar.

EXCHANGE RATES OF MAIN CURRENCES

March 19, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2006	Annual
Against US dollar				
Japanese yen	99.4	–8.4	–12.4	–18.2
Pound sterling	0.504	–1.9	0.0	–2.1
Swiss franc	1.001	–9.3	–13.2	–21.1
Canadian dollar	1.004	–1.3	0.6	–17.3
Mexican peso	10.698	–0.6	–2.0	–4.1
Against euro				
US dollar	1.564	6.2	7.2	17.6
Japanese yen	155.4	–2.1	–4.6	–0.6
Swiss franc	1.566	–2.8	–5.3	–2.9
Pound sterling	0.788	4.2	7.2	15.1
Swedish krona	9.402	0.9	–0.4	1.2
Danish krone	7.459	0.1	0.0	0.2
Polish zloty	3.535	–1.2	–1.9	–8.6
Czech crown	25.44	0.4	–4.1	–8.3
Hungarian forint	256.4	–3.2	1.3	4.3

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

DOLLAR COLLAPSES AGAINST EURO

Euro-dollar exchange rate

SOURCE: Bloomberg.

objective observation the dollar had depreciated less against the currencies of those countries with the highest trade surpluses, a fact that posed some risks. For example, there was the risk that a reduction of the US trade deficit might not equal the drop in the trade surplus of countries like China but rather translate into an increase in the trade deficit with other countries. In reality, through control of their currencies, China and the rest of Asia are re-exporting the US trade deficit to the Euro Area.

Another spectacular movement in foreign exchange markets was the exchange rate of the yen against the dollar which broke through the floor of 100 yen to the dollar. This creates a serious problem for Japanese exporters. Central Bank of Japan carries out the most important industrial survey in the country, known as the Tankan index. The latest survey was carried out in November and December last year and more than 10,000 companies took part. The survey asked what was their forecast for the yen-dollar exchange rate in 2008. The average of the responses came to 116.1. The present rate of 99.4 thus represents a level 17% lower than the level expected by Japan's business managers.

Yen exchange rate complicates situation for Japanese exporting companies.

Equity markets go dizzy

The doubts arising about the future of the world economy have shifted to stock market quotations. Whereas in February, following the sharp drop the month before, the stock markets were in a situation of watch and wait, in March investors turned their back on equity assets.

Monthly drops of 9% in the German stock market and 10.9% in Japan do not happen very month and well reflect the lack of enthusiasm among international investors who see how the negative economic news piles up, in spite of the efforts of central banks and governments to control the pernicious effects of the

Stock market stability depends on growth in United States and normalization of interbank markets.

STOCK MARKET HOLDING DOWNWARD TREND

DJ Eurostoxx 50 index for European stock market

SOURCE: Bloomberg.

IBEX performs better than other indices in Europe.

present financial crisis. Since the beginning of the year, some stock markets have dropped more than 20%, a level at which stock market operators feel they have entered a bear market.

We should mention the movement in the IBEX 35, the Spanish stock market reference index, which has shown a relatively better performance than others in Europe. There are two factors behind this difference. In the first place, there was the increase in price of some company shares because of rumours about corporate mergers or acquisitions. Secondly, in the present environment, investors see Spanish banks as among the strongest on the European continent because of their tough risk control, high provisions and good capitalization.

Now, the big question is whether current prices have already discounted the worst possible scenario or whether, while creating a buying opportunity, it has not yet hit bottom. Everything depends on the answer to two questions. First, whether the US economy will be able to recover in the second half of this year and maintain that recovery in 2009. Secondly, what time will be needed to restore normalcy to the interbank markets. The risk of a continuation of the present situation for many more months would lie in further tightening of terms for companies and households to obtain finance.

INDICES OF MAIN WORLD STOCK EXCHANGES

March 19, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,370.4*	*0.3*	*–6.7*	*1.2*
Standard & Poor's	*1,330.8*	*–1.3*	*–9.4*	*–5.1*
Nasdaq	*2,262.3*	*–1.9*	*–14.7*	*–5.5*
Tokyo	12,260.4	–10.9	–19.9	–27.9
London	5,555.9	–6.9	–14.0	–10.2
Euro Area	3,531.9	–7.2	–19.7	–12.9
Frankfurt	*6,373.8*	*–9.0*	*–21.0*	*–4.5*
Paris	*4,566.3*	*–6.5*	*–18.7*	*–16.4*
Amsterdam	*427.4*	*–4.8*	*–17.1*	*–13.2*
Milan	*30,789.0*	*–9.8*	*–20.1*	*–23.9*
Madrid	*12,970.6*	*–2.3*	*–14.6*	*–9.0*
Zurich	7,078.4	–5.2	–16.6	–19.9
Hong Kong	21,866.9	–9.4	–21.4	13.5
Buenos Aires	2,050.2	–0.6	–4.7	1.0
São Paulo	60,462.4	–2.9	–5.4	38.3

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.

SPAIN: OVERALL ANALYSIS

Economic activity

Economic prospects notably worse

At the beginning of 2008, available indicators point to a sharpening of the economic slowdown in recent months. The drop in growth rate is affecting both consumption and investment. On the supply side, there has been a notable loss of drive in construction. Short and long-term prospects suggest these trends will continue.

Retail sales continued to drop in January. The month showed a drop of 2.4% in constant prices compared with the same month last year, one of the biggest year-on-year decreases in the European Union. Nevertheless, the drop slowed somewhat in February. In addition, car sales were down 5.9% in the first two months of the year. This drop was partly due to the elimination of the Prever Plan aimed at replacing passenger cars more than 10 years old and the increase in fuel prices. Nevertheless, it also reflects the decrease in consumer confidence.

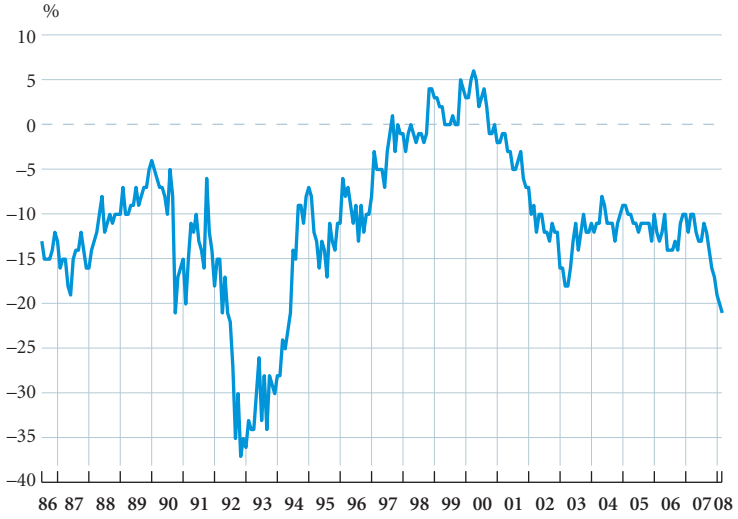
Growth of Spain's economy fast slowing down.

In fact, the consumer confidence index in February reported the lowest level since 1994, under the effect of the worsening of the labour market, less favourable financial terms and relatively high debt levels. Nevertheless, it stood far from the low seen in 1992. In addition, industrial production of consumer goods showed something of a recovery in January with a year-on-year increase of 1.8%.

Retail sales and car sales down at start of year.

CONSUMER CONFIDENCE NOTABLY WORSE

Net balance of consumer confidence indicator



NOTES: Statistical series adjusted for seasonal effects.
SOURCE: European Commission.

DEMAND INDICATORS

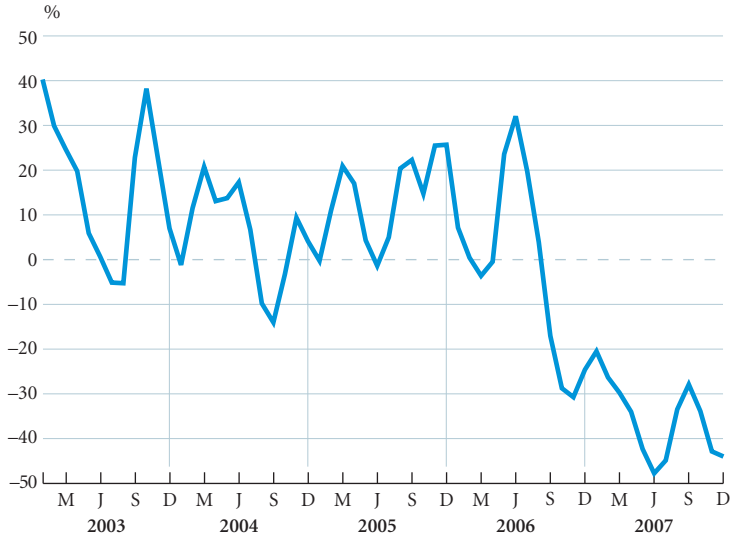
Percentage change over same period year before

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
Consumption								
Production of consumer goods (*)	2.3	1.2	4.8	2.1	0.9	–2.7	1.8	...
Imports of consumer goods (**)	8.9	5.1	–1.1	5.6	8.4	7.7	–2.6	...
Car registrations	–0.9	–1.2	–0.7	–2.4	–2.9	1.3	–12.7	0.7
Credit for consumer durables	14.5	10.0	13.8	9.6	6.9	9.9	–	...
Consumer confidence index (***)	–12.3	–13.3	–10.7	–12.7	–12.3	–17.3	–20.0	–21.0
Investment								
Capital goods production (*)	8.4	5.9	9.0	5.3	6.3	3.3	4.6	...
Imports of capital goods (**)	3.2	9.8	20.1	11.0	–0.6	9.0	–18.3	...
Commercial vehicle registrations	1.5	0.3	1.7	–2.2	–3.0	4.7	–31.0	–13.8
Foreign trade (**)								
Non-energy imports	9.0	7.3	6.4	7.7	7.6	7.5	2.4	...
Exports	5.6	4.2	3.0	2.8	6.7	4.6	3.0	...

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

SHARP DROP IN NEW HOUSING PERMITS

Month-on-month change annualized in trend in new building permits



SOURCE: Ministry of Public Works and own calculations.

The slowdown in domestic consumption and the worsening of international prospects because of the spreading of the crisis in world financial markets is having its effect on investment demand. Commercial vehicles reported sharp drops in the early months of the year. At the beginning of the year, domestic sales of capital goods and software by large companies showed the biggest year-on-year drops since 2002. Capital goods production, however, reported a rise in January, with a year-on-year rise of 4.6%, thus indicating a certain strength.

Construction investment, however, continues at low levels. Cement consumption was down 7.0% in the first two months of the year compared with 12 months earlier. Another early indicator, permits for new housing, was down 24.7% in 2007 compared with the record in 2006, going to 651,427 units, a relatively high figure. The trend in this indicator is pointing to continuation of a substantial drop.

New housing permits down 25% in 2007.

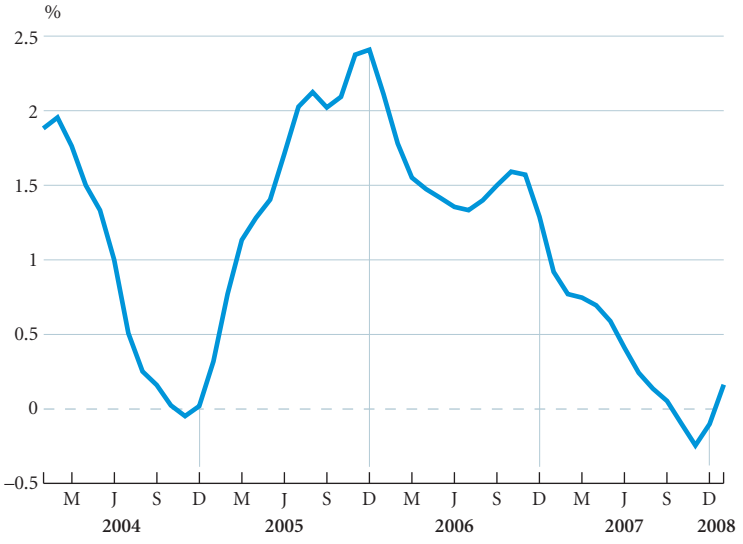
On the supply side, industrial production recovered in January following earlier drops. The general industrial production index rose by 0.7% compared with the same month last year, which means the rate of manufacturing growth was modest. Capital goods, showed a better performance over the past 12 months with a rise of 4.6%, followed by non-durable consumer goods, with an annual increase of 2.3%. The most dynamic branches were electronic equipment manufacturing, the tobacco industry, leather, food, textiles, paper and motor vehicles. The biggest decreases came in office machinery manufacturing, mining of energy products, wood and cork.

With regard to industrial prospects, the confidence index for industry continued to drop in February going to the lowest level since mid-2005, under the negative

Strong drive in manufacturing of electronic equipment, tobacco, leather and food.

SLIGHT RECOVERY IN INDUSTRIAL PRODUCTION

Month-on-month change annualized in trend in general industrial production index



NOTES: Statistical series corrected for calendar differences.
SOURCE: National Institute of Statistics and own calculations.

Housing deals down 14% in 2007.

effect of the increased cost of raw materials. Nevertheless, figures for new orders in January, with a rise of 6.2% compared with the same month in 2006, lead to a moderately optimistic outlook.

With regard to construction, the housing segment is undergoing a process of adjustment due to the slack in the real estate market. Housing deals continued to drop in 2007 with a year-on-year decrease of 13.9%, according to figures from the Spanish Association of Property and Mercantile Registrars. In January 2008 the year-on-year drop sharpened to 27.1%.

With regard to the services sector, foreign tourist arrivals in the first two months of the year showed an increase of 3.9% compared with the same period last year. Overnight hotel stays reported an increase of 2.3% in the past 12 months, a rise slightly higher than that for January 2007. Air passenger traffic showed a considerable year-on-year rise of 8.5% in the first two months of the year although there was a slowdown profile. Road passenger traffic registered a year-on-year increase of 2.8%, slightly lower than in 2007. The retail sector was unfavourably affected by the slowdown in private consumption. In this respect,

SUPPLY INDICATORS

Percentage change over same period year before

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
Industry								
Electricity consumption (1)	3.9	4.1	5.2	4.2	1.9	5.0	3.5	3.3
Industrial production index (2)	3.9	1.9	4.2	2.5	1.1	–0.2	0.7	...
Confidence indicator for industry (3)	–2.7	–0.3	2.3	0.7	–0.7	–3.3	–4.0	–8.0
Utilization of production capacity (4)	80.5	81.3	80.6	81.3	82.1	81.1	–	81.3
Imports of non-energy intermediate goods (5)	10.5	8.0	8.1	8.2	8.7	7.1	9.6	...
Construction								
Cement consumption	8.5	0.3	5.5	–1.3	–1.3	–1.5	–7.9	–6.1
Confidence indicator for construction (3)	14.2	9.3	10.7	15.7	12.0	–1.3	–6.0	–18.0
Housing (new construction approvals)	18.6	–24.7	8.0	–15.0	–50.7	–33.6	...	...
Government tendering	31.3	–15.2	13.3	–2.2	–30.3	–32.7	...	...
Services								
Retail sales	2.0	2.4	4.3	2.9	3.1	–0.3	–2.4	–2.7
Foreign tourists	4.1	1.7	5.2	0.1	1.4	1.6	0.9	6.5
Tourist revenue inflows	5.6	3.5	5.8	2.0	3.2	4.1	...	...
Goods carried by rail (km-tonnes)	–1.2	–4.4	–4.1	–6.5	–1.4	–5.3	–0.8	...
Air passenger traffic	6.8	9.0	9.5	7.1	10.5	8.6	6.9	10.1
Motor vehicle diesel fuel consumption	5.5	4.5	5.8	3.3	4.2	4.7	...	...

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.

the confidence index for the services sector for the early months of the year stood at the lowest levels in recent years.

The slowdown in sale of goods and services by companies has brought an increase in business default, yet another sign of change in the cycle. The number of commercial credit items past-due and unpaid was up 3.9% in January compared with the same month last year, coming to 4.2% of the total figure, while the amount involved rose by 48.7%. In this respect, business activity showed a drop while the establishment of new companies was down 21.3% in January compared with 12 months earlier. In the same period the number of companies going out of business was up by 42.5%.

In this situation, the economic sentiment index dropped to the lowest level in recent years due to the worsening of world economic prospects in the wake of the spread of the crisis in international financial markets. The new government arising from the elections early in March will therefore find itself in the most complicated economic situation seen in the past decade. In order to deal with this some measures have already been indicated, generally of an anti-cyclical nature, such as the lowering of tax holdbacks on wages in order to promote consumption, moves on subsidized housing construction and more spending on public works, fostering of rental housing, aid for relocating unemployed persons and increasing the competitiveness of businesses.

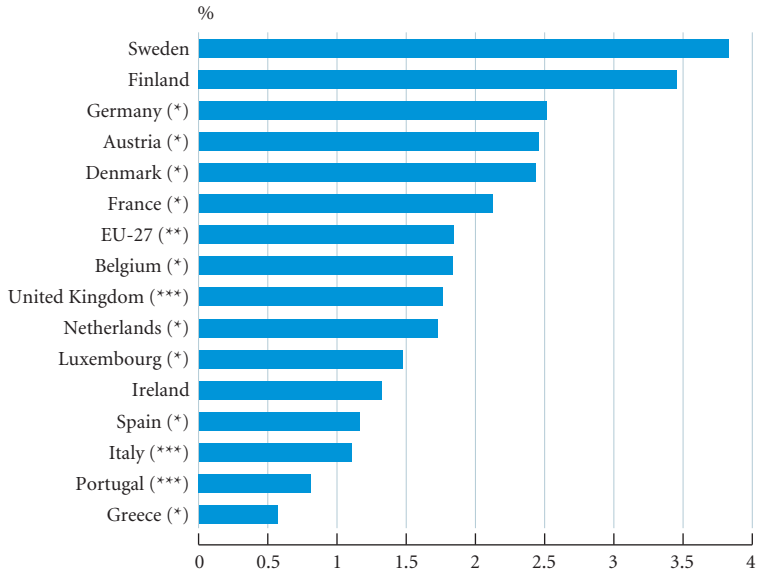
These measures and others that surely will be adopted are indeed needed. However, it should not be forgotten that an increase

Total amount of commercial paper unpaid up 49% in January compared with same month in 2007.

Series of anti-cyclical measures proposed to deal with current economic situation...

SPAIN'S R&D SPENDING STILL WELL BELOW EUROPEAN AVERAGE

R&D spending as percentage of GDP in 2006



NOTES: (*) Provisional.
(**) Estimate.
(***) For 2005.
SOURCE: Eurostat and own calculations.

...but R&D spending must be raised to reach European level.

in productivity is essential in order to ensure a sustained improvement in general welfare in the future. One important aspect is research and development (R&D). In this respect, as may be seen from the above graph, figures recently released by Eurostat indicate that it will be necessary for Spain to redouble its efforts to reach the European average. In fact, Spain's spending on R&D in 2006 was 1.2% of gross domestic product (GDP), substantially below the average for the 27 countries now making up the European Union with a figure of 1.8%, less than one-third of spending by Sweden at 3.8% of GDP.

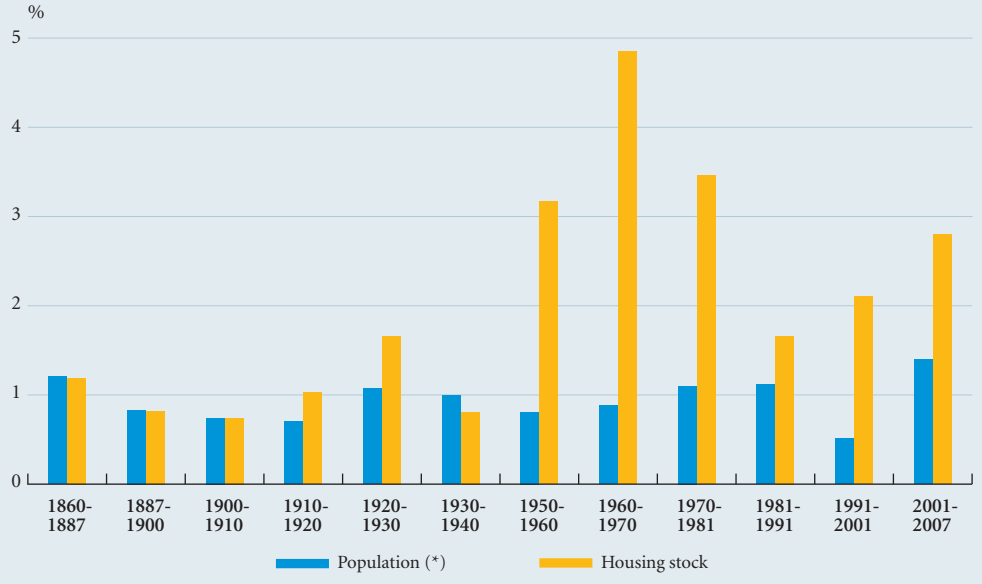
House, home, household, hearth: synonyms that count

Ever since Man gave up nomadic life, one of the main concerns of the human species has been to obtain suitable shelter after long days of work or hunting. In these primitive refuges the key element was fire, a place offering warmth, light and food where humans could live harmoniously with each other. In etymological terms, the word «hearth» comes from «fireplace» as this is the factor that best defines the place where the family group gathers. Often, under early systems of gathering tribute, the tax collector knew where tax could be imposed because of the mere existence of a fireplace or hearth. As a result, hearth, household or home are concepts that are often used as synonyms.

Housing needs have changed over time. In the primitive family house various generations lived together and in classical times the slaves were considered family members. Increasing housing needs have thus changed in step

HOUSING STOCK KEEPS GROWING SUBSTANTIALLY MORE THAN POPULATION

Average annual growth rate of population and housing stock in Spain



NOTES: (*) Urban population (in municipalities of more than 5,000 people) between 1860 and 1900. Total population as of 1900.
SOURCE: J. Leal (2002), INE, Bank of Spain and own calculations.

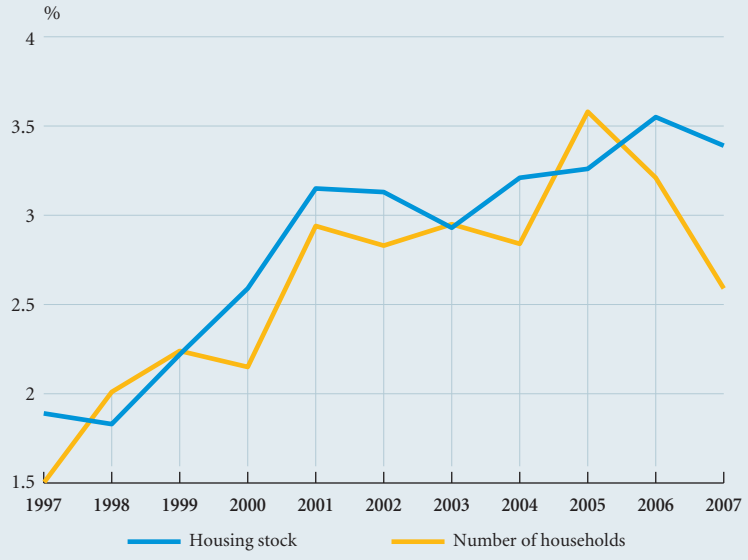
with population growth. In recent times, however, this parity has been broken. The increase in per capita income, the drop in the number of persons per family and the development of holiday homes has meant that the growth of housing stock now exceeds that of the population. The following graph shows that demographic growth and the increase in the number of houses in Spain between 1860 and 1900 occurred at the same rate.[1] Nevertheless, at the turn of the century the housing stock tends to grow somewhat more than the demographic base. As of the middle of the 20th century, however, housing construction begins to grow at rates considerably higher than those for population, a phenomenon that has continued right up to the early years of the present century.

Nevertheless, the main peculiarity of Spanish society with regard to housing is the legal framework it enjoys. In a nutshell, this results in a preference for owning a house or flat. For a number of reasons of a legal nature (regulation of rental contracts), fiscal nature (tax benefits for home ownership) or financial (poor development of markets or a financial culture), buying a house by means of a mortgage in recent decades has become the main means of saving for Spanish families. A good part of the growth of the housing stock in the growth stage of the recent construction cycle may be explained by this socio-economic preference to save by buying a house. This preference, it would seem, has been picked up by the immigrant worker group, a factor that has also added to the market dynamism.

According to latest population censuses, the sharp growth in the number of households in Spain has corresponded with the increase in house numbers as both variables rose by approximately 20% between 1991 and 2001. Estimates for later years point in the same direction. Therefore, formation of households is one of

HOUSING STOCK INCREASING AT SAME RATE AS FORMATION OF HOUSEHOLDS

Percentage year-on-year change

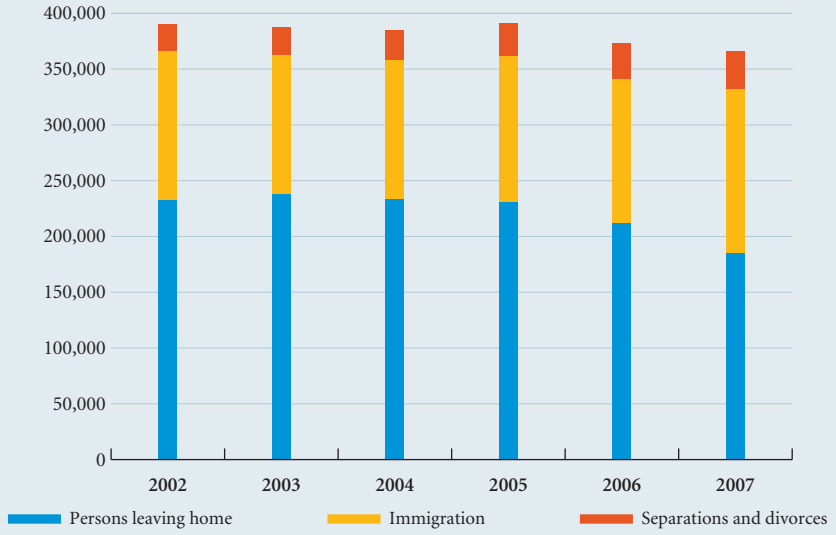


SOURCE: INE, Bank of Spain and own calculations.

(1) Especially see Leal Maldonado, J. (2002): «Cambio familiar y necesidades de vivienda en España». *Revista Mexicana de Sociología*, Vol. 64, No. 4 (Oct.-Dec., 2002), pp. 207-232.

LEAVING HOME MAIN CAUSE OF FORMATION OF NEW HOUSEHOLDS ALTHOUGH THIS NOW ON DECLINE

Number of households formed



SOURCE: INE, Bank of Spain and own calculations.

the variables that best explains housing demand during the latest growth cycle in the sector, although since 2006 we note a divergence between the housing stock and the number of households, as may be seen in the above graph. In any case, the rate of formation of households in Spain is a relevant factor. What does this depend on? The process of forming a household may be based on different reasons. Here, we shall examine three main factors – children leaving home, immigration and divorce or separation.

The formation of households when children leave home depends on various economic factors but also on one that is strictly demographic, namely the size of the population at theoretical home-leaving age (25-34 years). Between 2002 and 2007 this population group continued to increase but, significantly enough, at a progressively lower rate as the years passed. Pressure from the «baby boomers» is thus beginning to ease off. In any case, according to our estimates, this continues to be the main factor in household formation, given that 58% of all households formed in 2002-2007 were due to children leaving home.

The second most important factor is immigration. Figures from the National Institute of Statistics show that net entries of immigrants, while subject to notable swings according to year, tend to grow between 2002-2007. In our estimates of the number of households formed as a result of the arrival of new residents, the results indicate that approximately 34% of households formed were due to this factor. Finally, the rest (at a clearly lower order of magnitude) were households formed as a result of divorce or separation. According to estimates made, approximately 8% households formed in the period 2002-2007 were due to this third factor.

Finally, Spain continues to show something of a population revolution although one tending to lose drive. The past 15 years brought the appearance of the «baby boomers» although, in a process still only in its initial stages, this group has now begun to lose weight. Immigration has also played an important role. From now on there are

going to be more unknowns, especially regarding immigration trends in a context of lower growth of Spain's economy. In the 19th century, the French social philosopher Auguste Comte stated that «demography is destiny». While sometimes this statement may seem to go too far, at least in matters of housing and households over a not so long-term perspective, it remains valid.

Labour market

Job creation continues to lose strength

Services counteract loss of construction jobs.

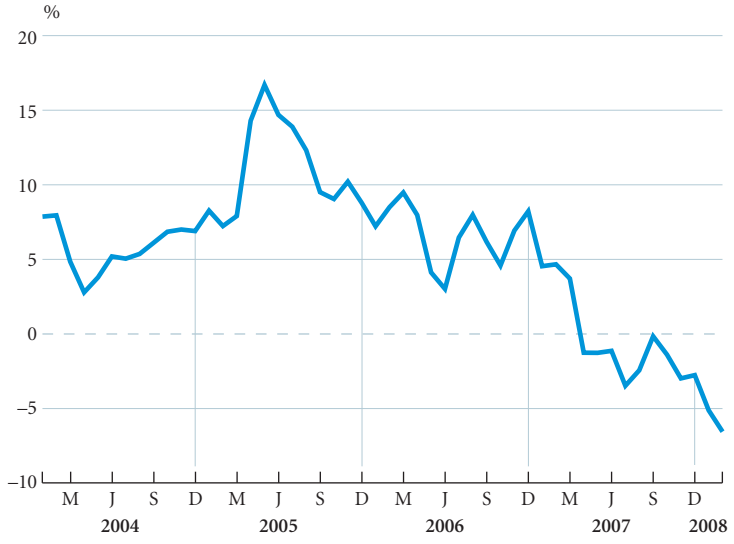
Spain's economy continues to create jobs but at a substantially lower rate than that recorded last year. At the end of February the number of persons registered as working with Social Security was 19,176,237, a figure 65,179 more than the month before. Nevertheless, the annual change rate continued to drop going to 1.6% as against an increase of 3.0% in 2007, which shows the slowdown path in job creation in recent months.

By sector, employment in industry slowed in February to record a year-on-year increase of only 0.1%. The rate of job loss rose in construction with a drop of 2.5% in employment in the past 12 months due to the slack in the residential sector. Fortunately, services counteracted this loss of jobs with an annual increase of 2.9%.

The branches in the services sector creating most jobs in February were the hotel and restaurant business, health services, social services and education. The most dynamic sectors in the past 12 months were health services and social services, education, financial services and domestic services, with growth substantially above the average.

LOSS OF JOBS IN CONSTRUCTION SHARPENING

Month-on-month change annualized in number of workers registered with Social Security under construction sector (*)



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

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	January	February
Persons registered with Social Security								
Sector								
Industry	*0.0*	*2.5*	*2.2*	*2.7*	*2.5*	*2.4*	*1.5*	*0.1*
Construction	*8.7*	*3.3*	*6.1*	*4.4*	*2.3*	*0.5*	*–1.1*	*–2.5*
Services	*5.2*	*3.5*	*4.1*	*3.7*	*3.0*	*3.0*	*2.8*	*2.9*
Job situation								
Wage-earners	*4.7*	*3.0*	*3.9*	*3.5*	*2.6*	*2.2*	*1.7*	*1.5*
Non-wage-earners	*2.2*	*2.8*	*2.5*	*2.7*	*2.9*	*2.9*	*2.5*	*2.3*
Total	**4.3**	**3.0**	**3.6**	**3.3**	**2.7**	**2.4**	**1.9**	**1.6**
Persons employed (*)	**4.1**	**3.1**	**3.4**	**3.4**	**3.1**	**2.4**	**–**	**–**
Jobs (**)	**3.2**	**3.0**	**3.3**	**3.1**	**3.0**	**2.5**	**–**	**–**
Hiring contracts registered (***)								
Permanent	41.1	2.0	25.8	15.6	–1.6	–21.1	–23.0	5.8
Temporary	4.7	0.3	2.6	–1.9	–0.5	1.2	–0.9	0.7
Total	**7.9**	**0.5**	**5.3**	**–0.1**	**–0.7**	**–2.1**	**–4.3**	**1.3**

NOTES: (*) Estimate from Labour Force Survey.
(**) 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.

As is now quite normal, year-on-year growth of self-employed workers since the summer was higher than for the total number of those registered with the Social Security system, which is another indicator of the change in the cyclical stage in the labour market. It is worth noting that, while workers registered under the general system for construction has dropped by 5.4% in the past year, those coming under the self-employed group rose by 8.4%.

The slowdown in job creation is largely affecting males. In the past 12 months ending February the total number of males registered rose by 0.2% while females were up 3.6%. As a result, the proportion of females continued to rise and ended up representing 42.2% of the total.

On the other hand, the slowdown in job creation is not affecting foreign workers as a whole, given that the number of foreign workers registered rose by 8.8% in the past 12 months, two decimals more than in December. The biggest increase came in workers from the European Union, especially from the new member states, with an increase of 19.4%, while those from outside the EU who were registered rose by 3.9%.

In February, the number of hiring contracts registered at public employment service offices showed some recovery with an increase both in the total and in the number of permanent jobs compared with the same month in 2007. Nevertheless, hirings in the first two months of 2008 were below the level reported one year ago.

Slowdown in job creation especially affecting males.

Employment growth rate among foreign workers maintaining high level.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

February 2008

	No. of unemployed	Change over December 2007		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	84,219	15,407	22.4	21,117	33.5	3.6
Industry	290,985	11,004	3.9	10,147	3.6	12.6
Construction	305,263	21,396	7.5	81,007	36.1	13.2
Services	1,406,114	121,864	9.5	126,882	9.9	60.7
First job	228,750	16,113	7.6	903	0.4	9.9
By sex						
Males	964,233	79,094	8.9	170,031	21.4	41.6
Females	1,351,098	106,690	8.6	70,025	5.5	58.4
By age						
Under 25 years	271,323	30,940	12.9	15,986	6.3	11.7
All other ages	2,044,008	154,844	8.2	224,070	12.3	88.3
TOTAL	**2,315,331**	**185,784**	**8.7**	**240,056**	**11.6**	**100.0**

SOURCE: INEM and own calculations.

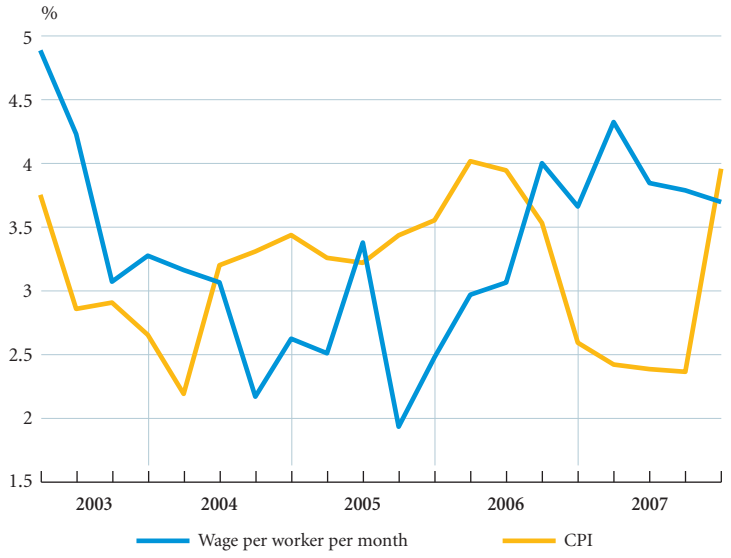
Spain's unemployment rate second highest in European Union following worsening of labour market in recent months.

Sharp rise in registered unemployment in construction

The number of unemployed registered at public employment service offices was 2,315,331 at the end of February. This is the highest figure for the decade and meant a year-on-year increase of 11.6%. As a result of the trend in employment mentioned above, unemployment

INFLATION AGAIN HIGHER THAN RISE IN WAGES IN FOURTH QUARTER OF 2007

Year-on-year change



SOURCE: National Institute of Statistics and own calculations.

WAGE INDICATORS

Percentage change over same period year before

	2006	2007	2007				2008
			1Q	2Q	3Q	4Q	1Q
Increase under general wage agreements (*)	**3.3**	**2.9**	**2.9**	**2.9**	**2.9**	**2.9**	**3.3**
Wage per job equivalent to full-time work (**)	**3.0**	**3.6**	**3.4**	**3.4**	**3.5**	**3.8**	**...**
Quarterly labour cost survey							
Wage costs							
Total	3.4	3.9	4.3	3.8	3.8	3.7	...
Industry	*3.6*	*3.0*	*3.7*	*3.1*	*2.3*	*2.8*	...
Construction	*3.7*	*4.8*	*5.5*	*3.9*	*4.8*	*5.1*	...
Services	*3.7*	*4.2*	*4.5*	*4.3*	*4.2*	*3.8*	...
Average wages per hour worked	4.2	4.4	4.6	4.2	4.6	4.1	...
Other labour costs	3.6	4.4	3.2	4.0	5.2	5.3	...
Work day (***)	–0.6	–0.4	–0.2	–0.3	–0.9	–0.3	...
Farm wages	**2.8**	**3.1**	**3.1**	**2.5**	**3.3**	**3.5**	**...**
Labour cost in construction	**4.4**	**2.4**	**2.5**	**2.4**	**2.3**	**2.5**	**...**

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.

affected males more than females with year-on-year changes of 21.4% and 5.5% respectively.

By age, the number of those unemployed over age 25 rose nearly twice that for young people. By sector, there was a notable rise of 36.1% in unemployment in construction in the past 12 months. On the other hand, among those unemployed with no previous job, unemployment was up by a mere 0.4% over February 2007. On the contrary, the number of registered unemployed foreign workers was up 53.8% in the past 12 months.

In addition, the worsening of the labour market in recent months meant that Spain's unemployment rate in January was the second highest in the European Union, with a rise of one decimal to 8.8%, according to Eurostat figures. The growth trend of unemployment in Spain was in contrast to a continuation of the 7.1% unemployment rate in the Euro Area.

Wages gain in purchasing power in 2007 for first time since 2003

In 2007, total wages rose by 3.9%, substantially above the average increase in inflation (2.8%). As a result, workers recovered purchasing power, given that in the previous three years inflation had risen more than worker wages, according to figures from the quarterly labour cost survey by the National Institute of Statistics. The figures for National Accounting show a similar result with an annual increase in wages per job equivalent to full-time work in 2007 higher than in the year before and higher than inflation.

In all major sectors, wage costs per worker per month rose more than average inflation. The sector reporting

Number of foreign workers registered up 54% since February 2007.

Labour costs continue to grow more in Spain than in Euro Area as a whole.

the highest wage hikes was construction (4.8%) followed by services with an annual increase of 4.2%. In any case, the highest average wages showed up in industry, going to 2,072 euros in the fourth quarter. Average earnings per hour worked rose somewhat more (4.4%) due to a slight drop in effective hours worked.

In the early months of this year we note that the rise in inflation in recent months is having some impact on wages. In February, the wage increase arrived at in collective bargaining agreements was 3.36% (not including wage review clauses) which was higher than the 2.9% figure in the first quarter of last year.

Compared with other European countries, labour costs continued to increase at a higher rate. In the fourth quarter of 2007, nominal labour costs per hour rose by 4.5% in Spain, substantially above the 2.7% rise in the Euro Area as a whole. This bigger increase, along with a mediocre improvement in productivity, presents a drawback for the competitiveness of Spain's economy.

Prices

CPI climb has kept on for six months

February brought a continuation of the rise in the consumer price index (CPI) that began in the last four months of 2007 due to the jump in prices of oil and food commodities. As a result, the annual inflation rate of the CPI rose to 4.4%, marking the highest level since November 1995. In February, however, oil was not the direct culprit for the new rise in the CPI but rather the increase was due to so-called underlying inflation, the more stable core, which went from 3.1% to 3.3% in year-on-year terms.

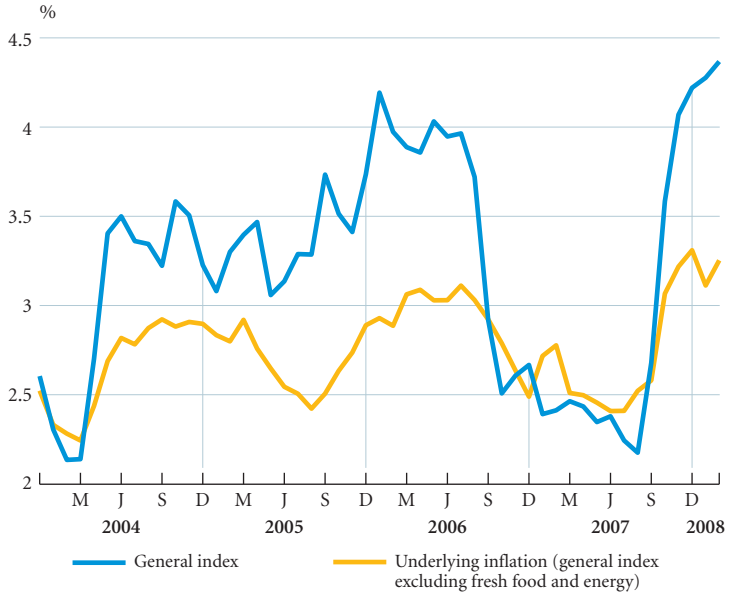
One of the components contributing most to the February increase was processed food which added more than half a decimal, if we include tobacco. There was a notable impact from cooking oil and dairy products, apart from tobacco. On the other hand, the price of milk moved slightly downward in February although it showed a rise of 27.7% compared with the same month last year. The year-on-year change in bread, another basic food, was also down in February although it still stood at a high 11.6%. Fresh foods, in turn, showed a notable drop in February with a year-on-year change rate that went from 5.5% to 5.2%.

Inflation of consumer prices hits highest level since November 1995.

February brings notable upward impact of cooking oil, tobacco and milk products...

RISE IN UNDERLYING INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

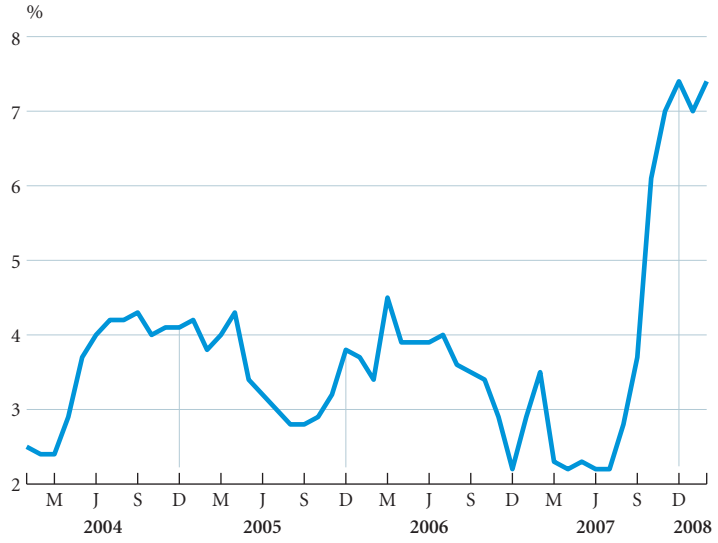
CONSUMER PRICE INDEX

	2007			2008		
	% monthly change	% change over December 2006	% annual change	% monthly change	% change over December 2007	% annual change
January	–0.7	–0.7	2.4	–0.6	–0.6	4.3
February	0.1	–0.6	2.4	0.2	–0.5	4.4
March	0.8	0.1	2.5			
April	1.4	1.5	2.4			
May	0.3	1.8	2.3			
June	0.2	2.0	2.4			
July	–0.7	1.3	2.2			
August	0.1	1.4	2.2			
September	0.3	1.7	2.7			
October	1.3	3.0	3.6			
November	0.7	3.8	4.1			
December	0.4	4.2	4.2			

SOURCE: National Institute of Statistics.

JUMP IN PROCESSED FOOD PRICES IN FEBRUARY

Year-on-year change in processed food prices



SOURCE: National Institute of Statistics.

...as well as insurance.

Another group with a notable upward effect in February was services which, being somewhat sheltered from world competition, continued to show persistent inflation pressures. The year-on-year change rate for services rose to 3.8%. This increase may be explained by insurance, especially car insurance. These, however, showed a rise of only 1.3% in the past 12 months because of sharp competition in this market segment.

CONSUMER PRICE INDEX BY COMPONENT GROUP

February

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2006	2007	2006	2007	2006	2007
By type of spending							
Food and non-alcoholic beverages	108.5	–0.2	–0.1	0.0	0.4	2.5	7.0
Alcoholic beverages and tobacco	110.8	0.2	1.0	5.2	3.1	12.4	3.9
Clothing and footwear	94.2	–1.2	–1.3	–12.7	–13.0	1.0	0.8
Housing	107.6	0.3	0.3	1.5	2.0	3.8	5.3
Furnishings and household equipment	103.8	0.0	0.1	–0.2	–0.1	2.6	2.6
Health	99.3	0.3	0.4	0.5	0.8	1.5	–1.8
Transport	105.8	0.4	0.3	0.3	0.4	–0.1	7.3
Communications	100.2	–0.3	–0.1	0.2	0.3	–1.4	0.9
Recreation and culture	98.3	0.4	0.3	–1.4	–1.1	–0.7	–0.5
Education	107.4	0.1	0.0	0.4	0.2	4.6	3.8
Restaurants and hotels	107.6	0.6	0.6	1.4	1.3	4.6	4.8
Other goods and services	105.7	0.2	0.8	1.6	1.7	3.7	3.1
By group							
Processed food, beverages and tobacco	109.4	0.4	0.7	1.5	1.5	3.5	7.4
Unprocessed food	107.4	–1.3	–1.6	–1.2	–1.0	3.7	5.2
Non-food products	103.7	0.1	0.2	–1.0	–0.8	2.0	3.6
Industrial goods	101.3	–0.2	–0.1	–2.9	–2.6	0.3	3.4
Energy products	*109.1*	*0.2*	*0.0*	*–0.2*	*1.5*	*–1.8*	*13.3*
Fuels and oils	*109.8*	*0.2*	*0.1*	*–1.1*	*0.9*	*–3.5*	*16.7*
Industrial goods excluding energy products	*98.7*	*–0.3*	*-0.2*	*–3.8*	*–3.9*	*1.0*	*0.2*
Services	106.2	0.4	0.5	1.0	1.1	3.8	3.8
Underlying inflation (**)	104.1	0.2	0.3	–0.6	–0.6	2.8	3.3
GENERAL INDEX	**104.9**	**0.1**	**0.2**	**–0.6**	**-0.5**	**2.4**	**4.4**

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

Prices for non-energy industrial goods were up 0.2% in the past 12 months, one decimal more than in January, but they had little effect on the rise of the general CPI. The downward impact of clothing and footwear because of February sales reductions sharper than in the previous year was counteracted by slight increases in prices of other products such as home goods.

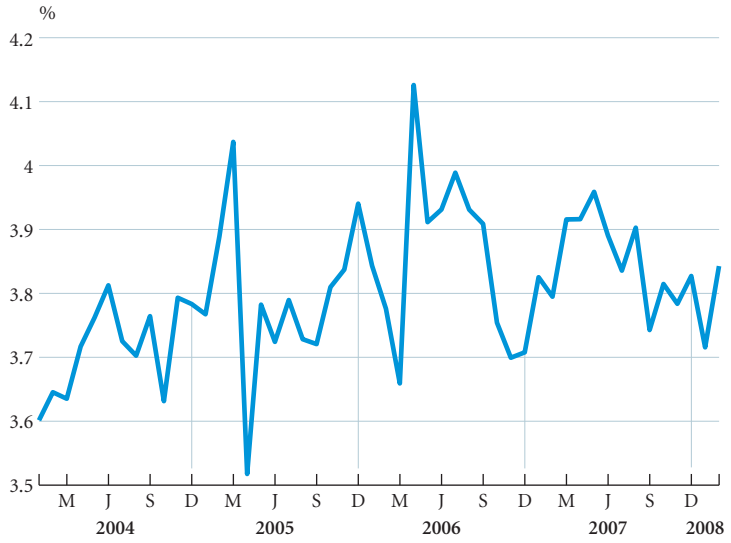
As mentioned above, energy products did not form part of the CPI rise in February seeing that its impact was slightly negative. This included fuel-oils, as well as fuels in general, seeing that the slight rise was lower than that recorded in the same month in 2006.

The inflation rate in terms harmonized with the European Union held at 4.4% in February. As a result, the inflation differential with the Euro Area also held at 1.2%, substantially below the high at the beginning of 2006 but notably above the level in the first half of 2007.

Inflation differential with Euro Area holds at 1.2 percentage points.

INFLATIONARY PRESSURES PERSIST IN SERVICES

Year-on-year change in prices of services



SOURCE: National Institute of Statistics.

Rise in oil and other commodities in March worsens inflation prospects.

The rise in oil prices and other commodities reaching new records in March has worsened prospects for inflation in coming months. Pressures from food commodities will certainly continue over the short term due to growth of world demand higher than supply. Inflation in consumer prices will probably rise a little more in March and possibly will not drop below 4% until the beginning of summer. Nevertheless, the economic slowdown should later bring it down to around 3%.

Commodities put pressure on wholesale prices

The recent rise in oil prices and other commodities in world markets continues to put pressure on wholesale prices. As a result, we note some pass-through of these pressures to prices of end-products.

Prices of food and beverage industry products up 11% over February 2007.

The annual inflation rate for producer prices kept at 6.6% in February, thus holding at the highest level since 1995.

The biggest annual rise came in energy products, with an increase of 13.3% in the past 12 months, one decimal more than in the month before. The year-on-year change rate for intermediate goods also rose by one decimal to 6.0% in February due to the rise in metals and farm commodities. Consumer goods also rose by a considerable 5.4% in the same period largely because of the increase in food raw materials. Producer prices for food products and drinks rose by 11.0% compared with February 2007. On the other hand, annual inflation on capital goods was down by two decimals going to 2.5%, thanks to sharp world competition, the appreciation of the euro and improvements in productivity.

With regard to import prices, in January these underwent a notable increase to 7.1% in spite of the strength of the euro under the effect of the rise in energy prices which rose by 41.4% last year. On the other hand, other components did not go above 2% year-on-year inflation.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2006											
December	–5.8	3.6	2.0	2.6	6.8	2.3	2.4	0.3	–0.2	8.2	–
2007											
January	–6.7	2.7	1.4	2.9	6.3	–1.1	0.4	0.6	–0.2	7.3	–
February	–6.3	2.5	1.4	2.9	6.7	–2.5	0.1	0.5	–0.3	7.4	3.4
March	1.5	2.8	1.7	3.3	6.3	–1.6	0.3	0.4	–0.2	6.8	–
April	6.7	2.7	2.2	3.1	6.5	–2.6	0.2	0.6	0.1	6.1	–
May	0.4	2.4	2.0	3.3	6.0	–2.8	0.8	1.5	0.2	5.6	3.2
June	2.6	2.6	1.8	3.1	5.8	–1.4	1.1	1.0	0.0	5.8	–
July	2.5	2.3	1.9	3.1	5.6	–2.6	0.7	1.0	–0.1	4.1	–
August	5.1	2.3	2.4	3.1	5.4	–2.9	0.7	1.5	0.4	3.9	2.9
September	12.1	3.4	3.2	3.2	5.4	0.8	2.0	1.0	0.3	3.0	–
October	13.8	4.7	4.2	3.2	5.3	6.1	3.1	0.7	0.1	2.0	–
November	15.7	5.4	4.5	3.1	5.1	9.8	4.1	0.9	–0.1	0.9	2.9
December	17.6	5.9	4.8	2.9	5.0	11.6	5.1	1.2	–0.1	1.0	–
2008											
January	...	6.6	5.4	2.7	5.9	13.2	7.1	1.1	0.3	2.0	–
February	...	6.6	5.4	2.5	6.0	13.3	...	...	...	...	...

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

So far as concerns farm prices at origin, prices paid to farmers rose by 17.6% in 2007 in contrast to the drop of 5.8% recorded the year before. Nevertheless, there was notable diversity depending on type of product. Whereas milk was up 39.8%, market livestock was down by 0.7%. However, livestock prices rose by 11% in world markets in February compared with January, a fact that would indicate future increases coming up in the domestic market.

Producer farm prices go up because of price increases in the international markets.

Household spending: from kitchen to restaurant, with cell phones

The make-up of household spending in Spain has undergone a profound change in the past forty years (see Table below). Spain has become an advanced economy and the increase in living standards is reflected in the shopping basket, not only in what Spaniards spend but also how they spend. The appearance of new products, the development of the financial sector, socio-economic changes and differences in relative prices are factors that, together with an increase in incomes, have contributed to completely change household spending.

COMPOSITION OF HOUSEHOLD CONSUMPTION

Percentage of total consumption

	1965	2006
Food, drink and tobacco	43.2	17.4
Clothing and footwear	11.3	5.8
Housing (rent, water, electricity and gas)	16.1	17.5
Furniture and current housing upkeep	9.0	5.5
Health	3.2	3.6
Transportation	6.5	12.5
Communications	0.3	2.7
Leisure and culture	3.6	9.4
Education	1.8	1.5
Hotels and restaurants	3.0	14.1
Other goods and services	2.0	9.7

SOURCE: Own calculations based on figures from Spanish National Accounts, INE.

The most notable change in the pattern of consumption has been the decrease in the relative weight of spending on food and clothing, or essential goods. Whereas more than half of consumption was directed to this type of good in 1965, its weight was 23% in 2006 (the latest year for which figures are available). The weight of another key essential good, housing, has increased but not to a very significant degree. Largely behind the drop in importance of essential goods in consumption lies the increase in household incomes.

In fact, since 1965 per capita income in real terms has tripled and in general an improvement in income does not produce uniform increases in demand for all consumer goods. There are those goods which economists term «superior goods», namely those on which we spend proportionally more to the extent our incomes rise. A typical example is the category of hotels and restaurants which went from 3% of household spending in 1965 to the current 14%. Leisure and culture sectors and transport have greatly benefited from the rise in standard of living. Food and clothing, on the other hand, are not categories of «superior goods». Therefore their relative weight in consumption has dropped notably although there are goods in these categories that have indeed gained weight, as is the case of cured ham and higher quality clothing. While it may be surprising that the proportion of spending on education has not increased, this is due to the fact that, as this is a good largely produced by governments, it is counted as a public investment and not a private one (for the same reason the increase in health spending is not very significant).

Apart from income, sociological and demographic changes have also contributed to change the composition of spending. For example, the progressive move of women into the labour market has reduced spending on fresh foods and, on the other hand, has increased spending in restaurants. The ageing of the population has also driven up spending on health, a trend that will increase in coming years and decades.

Technological progress has also brought new goods onto the market and reduced the price of many others. In some cases, this reduction in price has multiplied demand to such an extent that total spending on that good has grown significantly. The invention of the cell phone largely explains the increased spending on communications. Again, the reduction in relative prices has brought a bigger share going into spending on transportation. A Seat 600 car, for example, in the mid-Sixties cost around 75,000 pesetas which, adjusted for cumulative inflation as of today would be equivalent to more than 10,000 euros, a lot of money for that time. (And this for a car that could reach 120 km an hour only downhill with a tail-wind!) The drop in relative prices of cars, the improvement in quality and the wider range of models available are factors behind the growth of the number of cars on the road and, along with this, the increase in importance of spending on transportation. Another part of the increase is due to the rise in fuel costs.

Finally, it should be noted that the decrease in interest rates on loans along with easier access to consumer loans has also facilitated growth of spending on durable goods. This category includes, for example, motor vehicles, furniture and appliances. It is therefore not surprising that spending on durable goods has grown at an average annual rate of 4.1% (in real terms) since 1965, higher than the growth rate for non-durable goods (3.3%).[1]

To sum up, we are consuming much more than 40 years ago but the make-up of the consumption basket is quite different. The big challenge is to imagine what the make-up of consumption will be in another 40 years. Will medical services for an ageing population take the lead or will it be some new product that today we cannot even imagine?

(1) Figures for growth have been calculated using estimates by Estrada and Buisán (Estudio Económico del Banco de España, Num. 65) for 1965-1996 and INE figures for the more recent period.

Foreign sector

Further rise in trade deficit

Trade deficit keeps growing at still higher rate.

The cumulative figure for the foreign deficit for the 12 months ending January 2008 stood at 100.48 billion euros, a figure 10.8% higher than one year ago. This means that, compared with one month earlier, the increase in the trade imbalance has slightly sharpened so that the process of lower growth in the deficit noted between May and November 2007 seems to have stopped. The export/import ratio for the same period from January 2007 to January 2008 was 64.5%.

Deficit in energy balance lies behind bigger gap.

The culprit for the 1.53 billion euro increase in the trade deficit for the 12 months ending in January was the energy deficit which increased by 1.83 billion euros (as a figure for 12 months) compared with the month before. On the other hand, energy products as a whole showed a reduction in deficit of 305 million euros. The increase in crude oil

FOREIGN TRADE

Cumulative figures for 12 months as of January 2008

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	43,873	7.9	15.5	8,169	9.6	4.5	–35,703	18.6
Consumer goods	76,778	5.8	27.1	65,003	2.3	35.6	–11,775	84.7
Food	*15,937*	*8.5*	*5.6*	*21,086*	*4.9*	*11.6*	*5,150*	*132.3*
Non-foods	*60,841*	*4.8*	*21.5*	*43,917*	*–2.7*	*24.1*	*–16,924*	*72.2*
Capital goods	29,320	3.4	10.4	16,867	0.1	9.2	–12,453	57.5
Non-energy intermediate goods	132,948	10.6	47.0	92,399	11.0	50.6	–40,550	69.5
By geographical area								
European Union	165,940	7.8	58.7	127,713	5.1	70.0	–38,227	77.0
Euro area	*138,880*	*8.6*	*49.1*	*102,466*	*5.4*	*56.2*	*–36,414*	*73.8*
Other countries	116,979	8.4	41.3	54,725	10.4	30.0	–62,253	46.8
Russia	*8,131*	*9.9*	*2.9*	*2,140*	*36.9*	*1.2*	*–5,991*	*26.3*
United States	*10,179*	*18.6*	*3.6*	*7,522*	*–0.1*	*4.1*	*–2,658*	*73.9*
Japan	*6,063*	*2.9*	*2.1*	*1,324*	*–2.0*	*0.7*	*–4,739*	*21.8*
Latin America	*14,874*	*1.3*	*5.3*	*9,983*	*–3.6*	*5.5*	*–4,891*	*67.1*
OPEC	*22,693*	*–0.3*	*8.0*	*5,624*	*18.7*	*3.1*	*–17,069*	*24.8*
Rest	*55,039*	*13.2*	*19.5*	*28,133*	*17.1*	*15.4*	*–26,906*	*51.1*
TOTAL	**282,919**	**8.1**	**100.0**	**182,438**	**6.6**	**100.0**	**–100,481**	**64.5**

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

prices, also coming at a time when a strong euro would be easing the foreign oil bill, is thus showing a pass-through effect on Spain's economy.

In more general terms, we should point out that in the past 12 months both exports and imports have remained very strong. By value, exports were up 6.6% year-on-year while imports rose by 8.1%. This represents a slight slowing down of exports and something of a rise in imports compared with one month earlier.

By product group, those to show the greatest export strength were non-energy intermediate goods, a category that represents more than half of all Spain's exports. In strong contrast, exports of non-food consumer goods were down by 2.7% year-on-year. This trend cannot fail to be troubling given that this group makes up nearly 25% of Spain's sales abroad. With regard to imports, food consumer goods and energy products showed increases around 8% year-on-year, which reflects the sharp increase in cost at origin of oil and food products.

The geographical distribution of foreign trade showed no major changes. The European Union continues to be Spain's key market seeing it is the destination of 70% of the country's exports and the source of 60% of all its imports. With regard to markets outside the EU, there was a notably progressive increase in the importance of Latin America, Russia and members of the Organization of Petroleum Exporting Countries (OPEC). Russia and the OPEC countries also increased their importance as buyers of Spanish goods.

Europe still holding role as key market.

Balance of payments: sharp increase in current account deficit in 2007

The current account balance showed a deficit of 9.30 billion euros in December, three times the level one year ago. The substantial increase in the current account imbalance was basically due to the bigger deficits in the trade balance and the incomes balance. Of less importance was the increase in deficit in the current transfers balance and the reduction of the surplus in services. In this respect, the improvement in the surplus in the transfers balance was not enough to compensate the above situations.

Climb in current account deficit unstoppable.

Looking over the longer term shown by cumulative figures for 12 months, we note that the growth rate in the current account deficit is increasing, thus breaking away from the recent trend to a slowing down. In the last 12 months most of the increase in the current account balance was due to the increase in the incomes deficit, followed some distance away by the higher trade deficit. While the incomes deficit represents approximately 37% of the trade imbalance, its annual increase is 43% higher than that recorded by the trade balance.

Financial inflows freezing up as result of world financial situation.

With regard to financial flows, the highlight was another month of decrease (in cumulative terms for 12 months) in incoming portfolio investment, putting it in year-on-year terms at levels 48% lower than one year ago. Net outflows for direct investment stood at 40.89 billion euros, a figure 26% less than one year earlier. These trends reflect the difficulties of Spain's economy to obtain foreign funding in the current world financial crisis.

BALANCE OF PAYMENTS

2007

	Balance in million euros	Annual change	
		Absolute	%
Current account balance			
Trade balance	–88,459	–8,317	10.4
Services			
Tourism	*27,841*	*396*	*1.4*
Other services	*–5,470*	*–168*	*3.2*
Total	22,371	228	1.0
Income	–32,913	–11,930	56.9
Transfers	–7,200	–1,446	25.1
Total	**–106,201**	**–21,465**	**25.3**
Capital account	**4,812**	**–1,363**	**–22.1**
Financial balance			
Direct investment	–40,894	14,637	–26.4
Portfolio investment	103,094	–95,220	–48.0
Other investment	25,347	60,859	–
Total	**87,547**	**–19,724**	**–18.4**
Errors and omissions	–480	2,429	–83.5
Change in assets of Bank of Spain	14,322	40,122	–

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

Public sector

Central government surplus down in first two months of year

The economic slowdown is beginning to show up in the public accounts. Following a brilliant result in 2007 brought about by a rise in tax revenues, non-financial additions to the public purse rose by only 1.2% in the first two months of 2008 compared with the same period last year, if we include revenues ceded to autonomous governments and local government under the present financial system. In the first two months of the year central government revenues grew at a rate lower than nominal gross domestic product (GDP) and even lower than inflation.

Direct taxes showed a notable increase with a cumulative year-on-year rise of 10.5% as of February, although this was substantially lower than that recorded in 2007. Personal income tax was up 9.5% due to the increase in hold-backs on wages and especially those on capital. Corporate tax was up even more at 25.2%.

Economic slowdown beginning to show up in public accounts...

Where the economic slowdown was most notable, however, was in indirect taxes which were down 6.1% in January-February compared with the same period the year before. Collections for value added tax (VAT) were down 8.2%. This drop may be accounted for by the contraction of economic activity in construction and real estate, the

...especially in indirect tax collections, down 6% in January-February compared with same period year before.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

February 2008

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**18,801**	**–5.3**	**31,634**	**–1.3**
Non-financial revenue adjusted (*)				
Personal income tax	4,968	9.4	16,495	9.5
Corporate tax	6	–	1,252	25.2
VAT	15,768	–7.6	16,924	–8.2
Special taxes	1,788	19.4	3,333	5.6
Other	774	–6.4	2,636	4.7
Total	**23,304**	**–2.6**	**40,640**	**1.2**
Non-financial spending	**9,680**	**–2.0**	**27,803**	**7.7**
Treasury balance	**9,121**	**–8.5**	**3,831**	**–38.5**
Surplus (+) or deficit (–) (**)	***7,947***	***–20.8***	***9,381***	***–27.5***

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

Non-financial payments rising at higher rate than revenues due to current transactions.

weakening in growth rate of consumption and the impact of the introduction as of January 2008 of tax consolidation for corporate groups, under Law 36/2006, dated November 29, incorporating measures to prevent tax fraud.

On the other hand, special taxes were up 5.6%, a figure only slightly lower than that reported in 2007. The biggest year-on-year increase (18.3%) came under the heading for tobacco products. The most important special taxes, those for petroleum products, however, were down by 2.2% due to the negative effect on consumption coming from higher fuel prices. Taxes on alcohol and alcoholic drinks rose by 2.4%, less than inflation.

With regard to other central government revenues, these showed a moderate rise of 4.7% in the early months of the year compared with the same period in 2007. We should point out that the heading for fees was up 49.8%. Nevertheless, interest on the Treasury's current account was down by 5.6% while inflows of capital transfers from the European Union showed a lower rate.

Central government non-financial spending as of February rose at a rate significantly higher than revenues, to show a year-on-year increase of 7.7%. Among this spending, current spending was up 8.7%. Personnel costs rose by 9.9%, spending on goods and services was up 4.0% while financial costs increased by 12.6%.

Capital costs were up only 0.8% in the same two months compared with the same period last year. Nevertheless, civil investment, mainly in roads, rose by 13.9%. On the other hand, military spending was down 17.5% and capital transfers dropped by 2.1%.

Central government surplus drops to 0.8% of GDP in first two months.

The result of the trend in central government revenues and spending was a surplus, which in terms of National Accounting, that is, taking into account amounts due and owing, came to a total of 9.38 billion euros, 27.5% less than in the same period last year. This figure represents 0.84% of GDP, 0.39 percentage points less than in the same period in 2007.

Savings and financing

Demand for credit eases but still growing by 15%

Interest rates on loans and credits granted to companies and households moved slightly down in January following the increases seen over the past two years. On average, interest rates on funding to the private sector stood at 6.0%, some 3 basis points lower than in December. The 1-year Euribor, which is widely used as a reference, dropped in February for the second consecutive month to stand at 4.35% at mid-month only to rise again in March going to the level of 4.7%.

The trend in interbank and loan rates in recent months reflects the pressures in financial markets in the period of upsets that broke out last summer as a result of the subprime mortgage crisis in the United States. This also is affected by expectations of a cut in the European Central Bank official rate although this body has maintained its anti-inflationary position.

1-year Euribor up again in March.

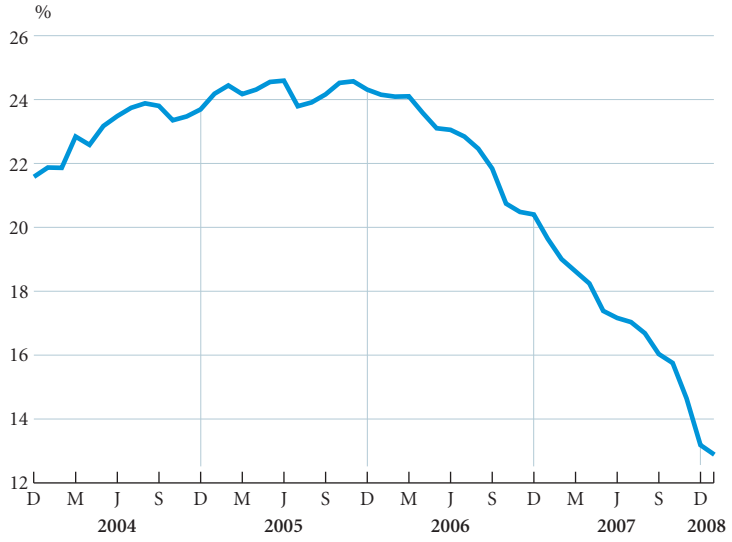
In this framework, the slowdown in financing granted to the private sector lost some strength in January 2008 and the annual change rate stood at 15.1%, one decimal less than last year. Nevertheless, this growth continues to be higher than that in the Euro Area as a whole.

Funding granted to companies eased slightly in growth rate in February going to 16.9%, in line with the economic situation. Leasing, which goes into corporate investment, was up 16.0% for

Companies continue having recourse to bank credit...

SLOWDOWN IN HOUSING LOANS CONTINUES

Year-on-year change in housing finance granted to households



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

January 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	89,281	–1,537	–1.7	6,523	7.9	5.0
Secured loans (*)	1,071,831	3,458	0.3	137,771	14.7	60.6
Other term loans	502,107	4,186	0.8	79,284	18.8	28.4
Demand loans	41,155	580	1.4	7,494	22.3	2.3
Leasing	46,658	365	0.8	6,452	16.0	2.6
Doubtful loans	18,338	2,102	12.9	6,862	59.8	1.0
TOTAL	**1,769,369**	**9,154**	**0.5**	**244,386**	**16.0**	**100.0**

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

...despite sharp drop in funding of real estate activities in 2007.

the 12 months ending in January, some 2.3 points more than in December. Commercial credit, used to provide working capital, showed a much lower growth rate at 7.9%.

It is possible to make an analysis by economic sector using the figures recently published by the Bank of Spain dealing with loans by purpose, although this goes only up to December. In 2007, there was a notable drop in credit for construction with growth going from 33.3% in 2006 to 14.2% in 2007. Services also showed a drop although this was mainly due to funding for real estate activities. This went from an annual increase of more than 50% in 2006 to 24% in December 2007. On the other hand, credit granted to industry was up by 18.5% in 2007, some 4.4 points more than one year earlier.

Slight rise in default rate although this still substantially below European average.

Household debt ended its slowdown in January maintaining a growth rate of 12.7%. This was the result of less of a slowdown in housing loans and some drive in other funding granted to households, which was up 12.0% in the past 12 months. Loans going into consumer durables such as cars, motorcycles, furniture, etc., which make up nearly one-third of this credit, were up 9.9% in 2007, a little less than in the previous year, under the effect of the rise in interest rates.

On the other hand, we note a slight rise in default in keeping with change of stage in the economic cycle. The default rate in January stood at 1.04%, some 0.28 points higher than the level 12 months earlier. Nevertheless, it stands at a very low rate substantially below the European average. Furthermore, Spain's financial institutions have a high level of provisions. In greater detail, although using figures only up to December, we note that the default rate on housing loan mortgages stood at an even lower level, 0.72% at the end of 2007.

Number of mortgage loans down 5% in 2007.

In addition, some 1,768,198 mortgage loans were granted on rural and urban properties in 2007, a drop of 5.1% compared with the year before, according to figures from the National Institute of Statistics. The average amount of each mortgage loan was 149,007 euros, an increase of 6.2% over 2006. The savings banks were the institutions granting the largest number of mortgage loans in 2007 (59.2% of the total), followed by the banks, with 31.7%. The average term

of mortgage loans was 26 years, one year more than the year before. Most mortgages were drawn up with a variable interest rate while 2% were at fixed rate.

With regard to geographical spread of mortgage loans, the autonomous communities with the most mortgages per person in 2007 were Murcia and the Balearic Islands. Nevertheless, the biggest growth took place in Extremadura (18.6%) and Castile-La Mancha (8.2%).

Savers prefer high-return deposits

With regard to financial assets of the private sector, we note that bank deposits in January 2008 showed an annual rise of 15.6 %, equal to that in December 2007. This meant considerable growth, higher than that recorded in the Euro Area. In any case, resources were not enough to finance the volume of loans granted by financial institutions and these had to have recourse to bond issues and to the European Central Bank. Given the problems in capital markets that broke out last summer as a result of the US subprime mortgage crisis, the financial institutions have done their utmost to attract deposits from the private sector, especially with time deposits, which were up 4.5% in January, going above the inflation rate.

As a result, time deposits for up to a two-year term were the type to show the biggest annual increase in January (42.5%). On the other hand, on-sight and savings accounts showed a slight drop because of low returns offered.

With regard to other financial products, participations in mutual funds continued a series of net withdrawals in February, although these were less than in the month before. Observers could note

CREDIT TO PRIVATE SECTOR BY PURPOSE

Fourth 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	25,245	2,231	9.7	2,231	9.7
Industry	141,571	22,083	18.5	22,083	18.5
Construction	153,453	19,136	14.2	19,136	14.2
Services	622,818	117,993	23.4	117,993	23.4
Total	**943,086**	**161,443**	**20.7**	**161,443**	**20.7**
Financing to individuals					
Acquisition and renovation of own home	618,212	73,823	13.6	73,823	13.6
Acquisition of consumer durables	56,576	5,115	9.9	5,115	9.9
Other financing	114,462	10,017	9.6	10,017	9.6
Total	**789,250**	**88,955**	**12.7**	**88,955**	**12.7**
Financing to private non-profit institutions	**6,089**	**384**	**6.7**	**384**	**6.7**
Other unclassified	**21,788**	**805**	**3.8**	**805**	**3.8**
TOTAL	**1,760,213**	**251,587**	**16.7**	**251,587**	**16.7**

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

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

January 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	422,853	–15,204	–3.5	–3,322	–0.8	32.1
Up to 2 years	367,083	14,377	4.1	109,411	42.5	27.8
More than 2-year term	398,421	–3,553	–0.9	59,139	17.4	30.2
Repos	86,369	758	0.9	4,295	5.2	6.6
Total	**1,274,725**	**–3,623**	**–0.3**	**169,522**	**15.3**	**96.7**
Deposits in currencies other than euro	**43,536**	**–308**	**–0.7**	**8,762**	**25.2**	**3.3**
TOTAL	**1,318,261**	**–3,931**	**–0.3**	**178,284**	**15.6**	**100.0**

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

String of net withdrawals from mutual funds continues in February.

aversion to risk among savers, something made clear by net positive subscriptions to guaranteed bond-based funds. Average return on mutual funds was slightly negative in February as a result of capital losses by share-based funds. Nevertheless, share-based funds of emerging markets enjoyed annual gains of 14.2%. On the contrary, Japanese share-based funds showed losses of 26.1%.

In turn, hedge funds continued to increase their assets. During their short experience in the Spanish market, they had accumulated assets for a value of 1.19 billion euros at the end of February, in spite of the instability of international financial markets.

Health insurance shows strong in 2007.

Finally, in the insurance field, life insurance premiums amounted to 22.93 billion euros in 2007, a rise of 2.1% compared with the year before. Premiums for other direct insurance amounted to 31.71 billion euros, an annual increase of 5.3%. The busiest branch was health insurance with an increase of 9.6% in premiums, followed by multi-risk which showed a rise of 7.9%. The most important branch in terms of volume, car insurance, rose by only 2.7% due to the fact that strong competition pushed down premium levels.

Spanish families carrying their debts

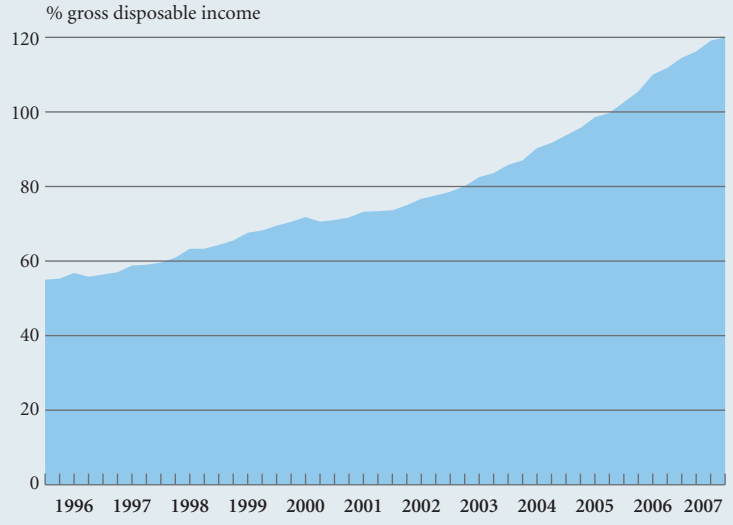
The debt carried by Spanish households has increased significantly over the past ten years, more than doubling in proportion to disposable income (see following Graph). The sharp increase was largely due to the drop in real interest rates, mainly thanks to adoption of the euro, the growth of the housing stock and the increase in housing prices as well as the development of the financial sector in a highly competitive environment. In spite of this trend, the debt/income ratio in Spain, which went to 120% in 2007, was still lower than levels in other advanced countries such as Canada (127%), United States (138%) and the United Kingdom (164%). Furthermore, the financial situation of households in overall terms is stronger that it might seem although it is true that there has been an increase in interest rates in the past two years.

One of the most significant characteristics of borrowing by Spanish families is undoubtedly its main purpose: the purchase of real property, largely main residences. Nearly 80% of household debt goes into acquiring real estate, a higher percentage than in the United States or Canada, where borrowing to finance consumer goods carries more weight. It is curious that in Spain it is more likely that a family will own the house where it lives than own a car. According to the latest Household Financial Survey carried out by the Bank of Spain in 2005, real estate represented around 90% of total household assets.

The fact that borrowing has been directed into the acquisition of real estate, combined with the rise in prices and the increase in value of other assets such as shares, has contributed to the increase in net wealth of households in the past decade. Net wealth is no more than the sum of net financial wealth –the value of financial assets less debt– and real estate wealth. With regard to financial wealth, while debt has increased, the value of financial assets (bank deposits, shares, pension funds, etc.) has also increased and therefore net financial wealth has not fallen as much as debt has risen. On the other hand, real estate wealth has risen very significantly thanks

HOUSEHOLD DEBT UP SHARPLY

Household debt



SOURCE: Bank of Spain.

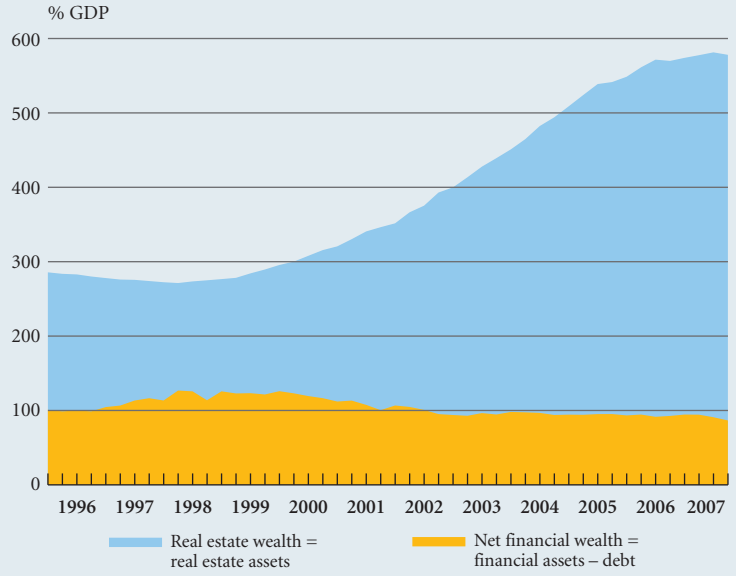
to the increase in housing stock and the rise in housing prices. In fact, real estate wealth has gone up so much that total net wealth has also risen. While it may seem a contradiction, this is not the case. People have borrowed more but they are also wealthier.

The aggregate figures, however, involve quite different situations. In this respect, the Household Financial Survey indicates that half of all households have no debt. Groups less likely to have debts were those with lower incomes and those over 64 years of age. On the other hand, more than 70% of households with a family head aged between 35 and 44 years were in debt. The biggest debt load typically showed up among the youngest persons, those self-employed and households with two members working. Among those households that had debts, this represented 17% of the value of their assets. Only 11% of households had debts amounting to more than 75% of their assets. Generally, it may be said that most households have a relatively solid financial balance.

Moreover in spite of the increase in their liabilities, the financial load of households has not increased to the same extent. According to Bank of Spain estimates, the interest load in 2007 was little more than 6% of gross disposable income of households, compared with slightly more than 4% paid out 10 years ago. Paying off loan principle, in turn, took 11% of income in 2007, four points more than in 1997. In some cases, however, the effort to carry debt is greater, According to the 2005 Household Financial Survey, 12% of households in debt use up more than 40% of their gross income to pay off their debts. Generally, two factors have contained the increase in financial load. On the one hand, the decrease in interest rates from a range of 5.5% and 10% in 1995-1997 to one between 2% and 5% in 2005-2007. In addition, there was the lengthening of typical repayment periods. For example, the average period for repayment of principle applying to a mortgage 10 years ago was 18 years whereas last year this stood at close to 28 years.

Another sign of the relative strength of the financial situation of households is the low default rate. While it is true that this rate has moved up in recent quarters, coinciding with the increase in interest rates, it has done so

DEBT ON RISE BUT WEALTH ALSO UP



SOURCE: Bank of Spain and own calculations.

starting out from extremely low levels. In the case of loans to households to buy homes, the default rate for the Spanish financial system as a whole went from 0.43% in 2006 to 0.73% at the end of 2007. While it may be expected that this ratio will continue to rise somewhat more this year as a result of a lower economic growth rate, the stabilization of interest rates below the levels reached at the end of last year and the possibility of a cut in rates in 2008, should contribute to limit any worsening of this figure.

To sum up, the increase in household debt in recent years has been very sharp but most of this has gone into accumulating wealth in the shape of real estate assets. This has contributed to maintaining the financial balance of households relatively solid. While it is true that the rise in interest rates has increased financial pressure on those households most in debt, interest rates seem to have reached a ceiling at the end of 2007. No doubt, this provides a breathing spell.

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2007

FINANCIAL ACTIVITY	Million euros
Total customer funds	223,850
Receivable from customers	161,789
Profit attributable to Group	2,488

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	26,342
Branches	5,480
Self-service terminals	8,011
Cards	9,809,909

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2008	Million euros
Social	306
Science and environmental	83
Cultural	79
Educational	32
TOTAL BUDGET	**500**

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