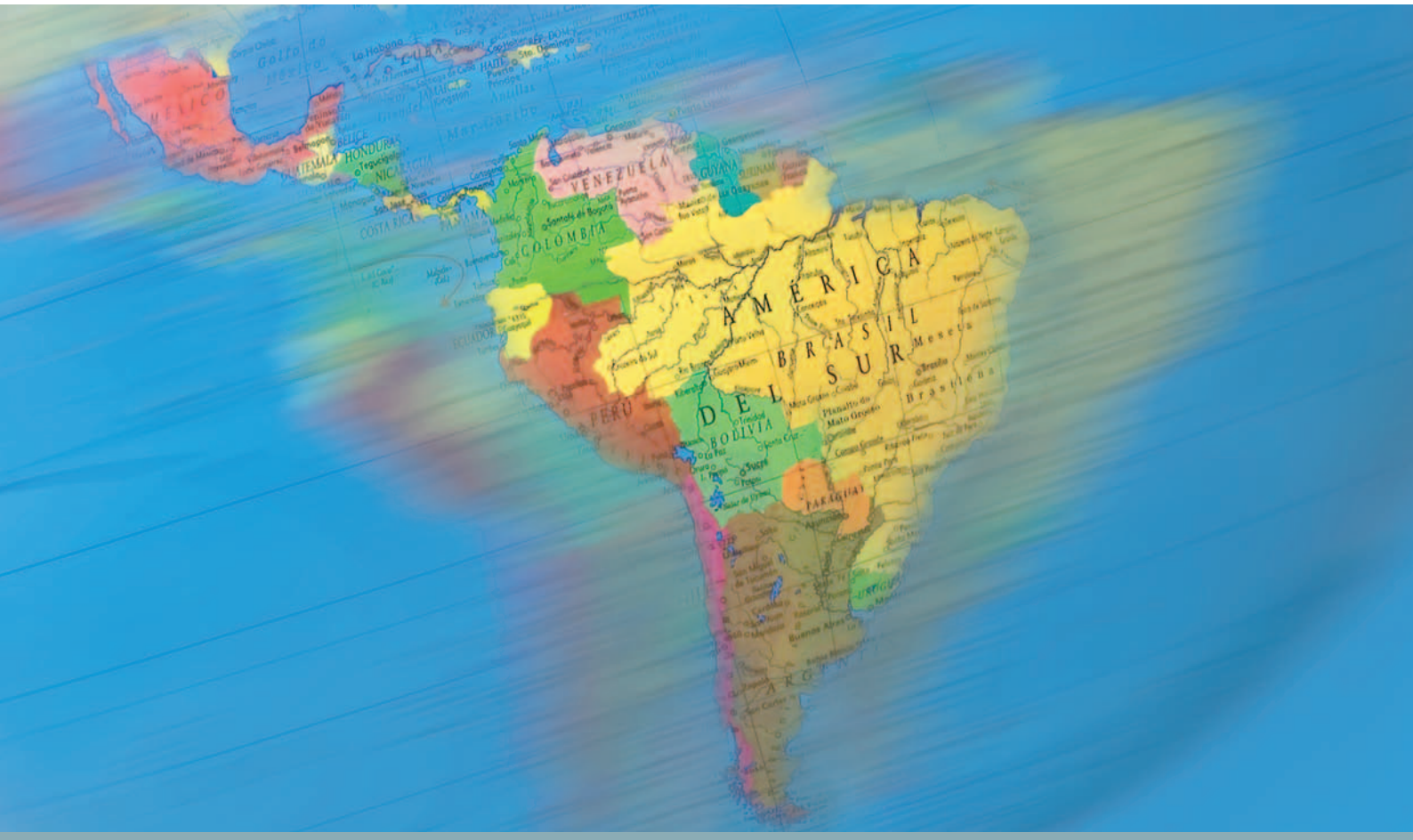
JUNE 2007

THE SPANISH ECONOMY

Monthly Report



NUMBER 303

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2006				2007	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY		Forecast							Forecast
Gross domestic product									
United States	3.3	2.3	2.5	3.7	3.5	3.0	3.1	2.1	2.2
Japan	2.2	2.0	1.9	2.7	2.1	1.5	2.4	2.2	2.2
United Kingdom	2.8	2.5	2.3	2.4	2.7	2.9	3.0	2.8	2.6
Euro area	2.8	2.5	2.3	2.2	2.8	2.8	3.3	3.1	2.8
Germany	*2.9*	*2.3*	*2.2*	*1.9*	*2.9*	*3.2*	*3.9*	*3.6*	*2.7*
France	*2.0*	*2.1*	*2.1*	*1.9*	*2.7*	*2.1*	*2.2*	*2.0*	*1.9*
Consumer prices									
United States	3.2	2.2	2.3	3.7	4.0	3.4	2.0	2.4	2.3
Japan	0.2	0.2	0.4	–0.1	0.2	0.6	0.3	–0.1	0.3
United Kingdom	2.3	2.4	2.1	2.0	2.2	2.4	2.7	2.8	2.5
Euro area	2.2	1.9	2.0	2.3	2.5	2.1	1.8	1.9	1.7
Germany	*1.7*	*1.8*	*1.8*	*2.0*	*1.9*	*1.6*	*1.3*	*1.8*	*1.7*
France	*1.7*	*1.4*	*1.6*	*1.8*	*1.9*	*1.7*	*1.3*	*1.2*	*1.2*
SPANISH ECONOMY		Forecast							Forecast
Macroeconomic figures									
Household consumption	3.7	3.4	2.9	3.7	3.6	3.6	3.7	3.5	3.4
Government consumption	4.4	4.5	4.3	4.3	4.4	4.2	4.9	5.2	4.6
Gross fixed capital formation	6.3	5.8	4.1	6.3	6.2	6.4	6.4	6.6	6.3
Capital goods	*9.7*	*9.6*	*5.0*	*8.6*	*9.1*	*9.6*	*11.4*	*12.1*	*11.2*
Construction	*5.9*	*5.1*	*3.8*	*5.8*	*5.8*	*6.2*	*5.7*	*5.6*	*5.3*
Domestic demand (contribution to GDP growth)	4.9	4.5	3.8	4.8	4.8	4.8	4.9	4.8	4.7
Exports of goods and services	6.2	4.3	3.6	9.5	4.9	3.4	7.3	4.2	4.4
Imports of goods and services	8.4	5.5	4.8	11.6	7.3	6.0	8.8	5.6	5.7
Gross domestic product	**3.9**	**3.8**	**3.1**	**3.7**	**3.8**	**3.8**	**4.0**	**4.1**	**4.0**
Other variables									
Employment	3.1	2.9	2.3	3.2	3.1	2.9	3.1	3.0	2.9
Unemployment (% labour force)	8.5	8.0	7.8	9.1	8.5	8.1	8.3	8.5	8.0
Consumer price index	3.5	2.5	2.6	4.0	3.9	3.5	2.6	2.4	2.3
Unit labour costs	2.7	2.2	2.3	2.3	2.7	2.7	2.8	2.4	
Current account balance (% GDP)	–8.5	–9.4	–9.8	–10.0	–7.8	–8.4	–7.9	–10.3	
Not lending or net borrowing rest of the world (% GDP)	–7.8	–8.9	–9.4	–9.7	–7.4	–7.8	–6.7	–9.8	
Government balance (% GDP)	1.8	1.2	0.9						
FINANCIAL MARKETS		Forecast							Forecast
Interest rates									
Federal Funds	5.0	5.2	5.0	4.4	4.9	5.3	5.3	5.3	5.3
ECB repo	2.8	3.9	4.3	2.3	2.6	2.9	3.3	3.6	3.8
10-year US bonds	4.8	4.9	5.3	4.6	5.1	4.9	4.6	4.7	4.8
10-year German bonds	3.8	4.3	4.7	3.5	4.0	3.9	3.8	4.0	4.3
10-year Spanish bonds	3.8	4.4	4.8	3.5	4.0	3.9	3.8	4.1	4.3
Exchange rate									
$/Euro	1.26	1.35	1.31	1.20	1.26	1.27	1.29	1.31	1.35

Contents

Latin America: facing a promising future

Latin America entered the 21st century showing the strongest growth since the Seventies with clearly favourable future prospects. According to a recent report by the International Monetary Fund, these good results were due to a combination of generally sound economic policies and a good world economic situation, as well as high prices for raw materials which have made it possible to increase public spending and reduce deficits in many countries. Because of these results, unemployment and poverty have been reduced and, for the first time in decades, inequalities in income within the region have been reduced although these still remain very high.

It must also be recognized that for more than a decade many Latin American politicians and economic policy makers have come to understand the damaging impact of inflation on economic growth, income distribution and poverty. The steps taken by many countries to establish the fight against inflation as a central point of economic and monetary policy has meant a major advance toward macroeconomic stability, an indispensable factor when it comes to dealing with the economic and social challenges the region faces. We need only recall how hyperinflation in the Eighties and Nineties ravaged the normal functioning of markets and transactions, with inflation reaching 1,700% annual in Bolivia, 900% annual in Peru and 600% and 700% in Argentina and Brazil.

In spite of the good news, there are three basic questions we cannot escape. The first, that the good economic situation has scarcely changed the parameters of inequality and backwardness that plague the region. The second is that, compared with the take-off in Asia, the results in Latin America are clearly not good enough. The third and most important matter is that there are few guarantees that some countries in the region will not revert to their old ways and again slip into a state of confusion and disorder. It would therefore be worth going deeply into the present situation and prospects for the region in order to work out if there is going to be a continuation of this growth cycle which could contribute to ease the well-known deficits.

In this edition of the Monthly Report we note the commitment of many Latin American countries to stability. This commitment shows up in monetary policies aimed at reaching inflation objectives, with central banks being expressly forbidden to finance the public sector. In parallel, government debt in the region has dropped significantly although it remains high. The foreign position has improved considerably, largely thanks to China's hunger for the raw materials produced in the region. In any case, macroeconomic stability will not be seen as having sufficient value if not accompanied by economic growth that reduces poverty and inequality. In this respect, Latin America's limited growth potential may be attributed to poor levels of investment (both in physical and human capital) and the slow improvement in productivity. In the background, lies the unsatisfactory development of institutions, understood as the rules of the game, both formal and informal, that provide a framework within which interactions of a social, political and economic kind can take place. To shift to a stage of stronger institutions will mean increased capacity for growth and development. In a favourable international economic situation and with the reforms many countries have begun to carry out it may be possible to leave behind past times of difficulty and face the promising future the region deserves.

OVERALL SUMMARY

World economy: a time for the central banks

US GDP slows down considerably with 2.1% growth in first quarter of 2007.

Growth of the world economy is continuing its course in the first half of 2007. In the United States, attention remains centred on the vicissitudes of the real estate sector which showed a drop of 17% in real terms in the first quarter, according to macroeconomic figures put out by the Bureau of Economic Analysis. As a result, growth of gross domestic product (GDP) in the leading world economy dropped to 2.1% in year-on-year rate down from 3.1% at the end of 2006. The end of the housing crisis does not seem close, if we are to go by current indicators on sales, prices and construction. What seems to be clearer is that this is not going to affect other spending headings. At least this must be the thinking on Wall Street where the stock market keeps on marking up new highs with the Dow Jones above 13,000 points, corporate profits still considerable and a fever of acquisitions, mergers and buying back of shares.

The US consumer continues in a lead role. Petrol is again expensive but jobs are still being created and wages of skilled workers keep rising so that spending capacity is holding up. Another support should come from the foreign sector. The extraordinary growth of the world economy, along with depreciation of the dollar, should bolster growth of US exports. This, however, is not what happened in the first quarter. On the contrary, foreign sales of goods and services slowed thus bringing about the mediocre results in total GDP growth.

Inflation still moderate but Federal Reserve has reasons to stay alert.

The slowdown in demand did not impress the Federal Reserve, the US central banking system. At the beginning of May, the Monetary Policy Committee again showed its concern about inflation risks. This is a risk not being ignored by financial markets nor by most analysts, who are not anticipating any increases in interest rates in the second half-year. In fact, the April consumer price index (CPI) was down two decimals to 2.6% while core inflation stood at 2.4%. Why then is the Fed troubled? One explanation comes from the labour market which, depending on how one looks at it, may be seen as overheated. Job creation is continuing at a good rate, the unemployment rate still stands very low and labour costs are tending to rise. Another reason is productivity with growth of this factor clearly losing drive. Furthermore, energy prices are rising and the dollar is dropping in value. There certainly are reasons to stay on the alert even if the slowdown gets no worse.

China raises interest rates to cool off overheated economy.

While the Fed is maintaining its rates frozen, other main central banks are tending to increases. In May, the most notable case was China. The star of the show was the stock market with a revaluation of more than 50% in Shanghai so far this year following a rise of 131% in 2006. Concerned about the possibility of a speculative bubble, the Chinese authorities have taken a number of measures, notable among which is the

increase in reference rates and widening of the daily fluctuation band for the renmimbi. The latter move, was a somewhat symbolic step intended as a response to US demands that China revalue its currency, now subject to closely controlled flotation.

The Bank of England also decided to raise its reference rate to 5.50% in May. The British inflation rate rose to 3.1% in March, a long way from the 2% objective, in a situation of growth in economic activity, a rise in private consumption and an unemployment rate at low levels. This scenario explains the hardening of monetary policy which likely will continue in coming months.

We may also expect some upward move by the Bank of Japan. It is not that the macroeconomic figures are all that bright. In the first quarter, the GDP rose by 2.2% compared with the same period last year showing a profile of moderate slowdown. In a country where the population leans toward a decline, however, this is a considerable rate, above theoretical growth potential. Furthermore, as indicated by the Organization for Economic Cooperation and Development (OECD) in its latest report, the country is going through its longest growth period since World War II. The problem lies in that the deflation stage cannot be considered quite over. The increase in the April CPI was 0.0% while the private consumer deflator in the first quarter still showed a drop of 0.2% in year-on-year rate. The Bank of Japan will not find it easy to raise its reference rate (now at 0.5%) until deflation is fully a thing of the past.

Jean-Claude Trichet, chairman of the European Central Bank (ECB), has things clearer. Investors and analysts see it for certain that he will raise the Eurosystem reference rate to 4% in June.

Recent growth figures and future prospects fully justify another turn of the screw in monetary policy even if there are no relevant inflation risks or the euro has hit all-time highs against the dollar, yen and Swiss franc. The perfect alibi was provided this month by Joaquín Almunia, commissioner for economic and monetary affairs. In its Spring forecasts, the European Commission raised growth in the euro area to 2.6% in 2007 and 2.5% in 2008. The two pillars of growth will be investment and private consumption, helped by foreign demand and job creation with no problems foreseen in the area of inflation. So far, the year has begun well. Eurostat estimates that the first quarter GDP in the euro area was up 3.1%, although this figure represents a slight drop from 3.3% in the final quarter of 2006.

Bank of Japan may raise interest rates but persistence of deflation makes decision difficult.

Spain's economy: the question is 2008

Recovery of economic activity in euro area seems well consolidated and further ECB rise now a given.

Growth of Spain's economy was also satisfactory in the first quarter. It even had its surprises. Both the Bank of Spain and the National Institute of Statistics (INE) predicted a year-on-year growth rate of 4.0% but the final INE estimate was 4.1%, one decimal higher than that at the end of last year. The upward trend in GDP goes above all expectations and may be largely explained by the rise in capital goods investment and the good results in the foreign sector.

Capital goods investment increased year-on-year growth rate by no less than 12.1%, the highest rate since 1999. Behind this estimate lay the positive trend in industrial production, imports of this type of goods, order books and sales by companies in this field.

Growth of Spain's economy continues to show surprising strength going above 4% in first quarter...

The foreign sector in turn took only 0.7 percentage points off GDP growth in the

...spurred on by drive in capital goods investment and improved export markets...

first quarter, a figure much lower than usual up to now. The reason lay in the loss of strength both in exports and imports, although this was sharper in the case of the latter.

The other two most important components of domestic demand show a profile of gradual slowdown. This was the case in household consumption which grew by 3.5% in the reference quarter, the lowest figure in the past three years. Construction spending was also up, with an increase of 5.6% year-on-year, one decimal less than in the preceding quarter. In this case, the containment of the rate of advance in housing construction was largely compensated by a renewed drive in civil works.

...while consumption and real estate spending show lower growth.

Everything suggests that the rate of housing construction will continue to gradually ease off in coming months following a long growth stage. At the moment, the volume under construction is still high although some early indicators point to more of a containment. Sales contracts for existing housing have particularly undergone a contraction in recent months while prices have slowed down their climb.

The change of scene in housing construction, one of the big supports of growth in recent years, is causing some concern. The slowdown in the sector could bring about a notable drop in growth, not in 2007 (given that current growth at around 3.7% seems assured) but in 2008. In its recent Spring forecasts, the OECD foresaw growth of 2.7% in 2008, nearly one point less than the forecast for 2007. This figure is well below that forecast by the European Commission (3.4%), by the International Monetary Fund (also 3.4%) or the Bank of Spain (3.1%).

Slowdown in housing to be gradual and largely compensated by other demand components.

The boom in housing in Spain is not an isolated case. In the OECD report mentioned we find a surprising figure. In half of the 30 member countries of OECD, the year 2006 showed a high in the housing investment ratio over GDP for the past 10 years. Experience in recent decades indicates that following a boom in housing there usually comes a sharp reversal that often creates a wide downturn in activity. The report recognizes, however, that on this occasion things are different. The correction mentioned was often a result of a rapid rise in interest rates following a substantial and unexpected increase in inflation. This is not so in the current conjuncture.

Our conclusion is that, at least so far as Spain is concerned, the slowdown in the sector will be gradual and moderate. It does not have to be otherwise in an environment defined by increases in interest rates close to reaching a ceiling, with no prospect of a worsening in inflationary trends and with still strong demographic and economic factors lying behind the real estate boom. This does not mean that the loss of overall growth rate is not going to be appreciable. However, it comes at an opportune moment. The good economic situation being experienced by the European Union, which makes up the main export market for Spanish goods and services, could partly compensate for a hypothetical real estate slowdown. Precisely for this reason, the scenario of a gradual containment of growth being put forward for coming years has the virtue of presenting more balanced growth with an increase in corporate investment and sales to foreign markets.

May 28, 2007

CHRONOLOGY

2006

May	**4**	Agreement between government, business organizations and trade unions on **labour reform** aimed at reducing extent of temporary work.
	10	**Federal Reserve** raises reference rate to 5%.
June	**8**	**European Central Bank** raises official interest rate to 2.75%.
	29	**Federal Reserve Board** increases reference rate to 5.25%.
July	**11**	European Council authorizes **Slovenia** to adopt euro as currency as of January 1, 2007.
	24	Multilateral negotiations in **Doha Round** of World Trade Organization, aimed at greater liberalization of international trade, indefinitely suspended.
August	**3**	**European Central Bank** raises official interest rate to 3.00%.
	8	One-month forward price of Brent quality **oil** goes up to all-time high of 78.49 dollars a barrel.
	12	UN Security Council approves resolution for **cease-fire in Lebanon** in conflict between Israel and Hezbollah.
September	**26**	European Commission gives go-ahead to entry of **Romania and Bulgaria** into European Union on January 1, 2007.
October	**5**	**European Central Bank** raises official interest rate to 3.25%.
November	**29**	Publication in BOE Official Bulletin of Law 35/2006 on reforms to **Personal Income Tax** and partial modification of laws on Corporate Tax, Non-resident tax and Property Tax.
December	**7**	**European Central Bank** raises official interest rate to 3.50%.

2007

January	**1**	**European Union** enlarged to 27 member states following inclusion of Romania and Bulgaria; and **euro area** numbers 13 members following adoption of European single currency by Slovenia. Reforms to **Personal Income Tax** and **Corporate Tax go** into force.
March	**8**	**European Central Bank** raises official interest rate to 3.75%.
April	**13**	Publication of Law 6/2007 in Official Government Bulletin (BOE) modifying the regulations applying to **takeover bids** which come into force in mid-August.
May	**21**	Dow Jones index for **New York stock exchange** marks up all-time record (13,542.9), an increase of 8.7% compared with the end of 2006.
	23	IBEX 35 index for **Spanish stock market** records all-time high (15,223.9) with cumulative gains of 7.6% compared with end of December 2006.

AGENDA

June

1 Euro area GDP (1st Quarter).
4 Registrations with Social Security and registered unemployment (May).
5 Industrial production index (April).
6 Governing Council, European Central Bank.
13 CPI (May).
14 Harmonized CPI (HCPI) for EU (May).
15 Balance of payments (March).
Quarterly labour cost survey (1st Quarter).
25 Producer prices (May). Foreign trade (April).
26 Central government revenue and spending (May).
28 Preliminary HCPI (June).
Open Market Committee, Federal Reserve.

July

3 Registrations with Social Security and registered unemployment (June).
5 Industrial production index (May).
Governing Council, European Central Bank.
13 CPI (June).
16 Balance of payments (April).
Harmonized CPI (HCPI) for EU (June).
24 Central government revenues and spending (June).
25 Producer prices (June). Foreign trade (May).
27 Labour Force Survey (2nd Quarter).
US GDP (2nd Quarter).
30 Preliminary HCPI (July).

INTERNATIONAL REVIEW

OECD forecasts: search for lost balances

OECD raises growth forecasts for 2007 to 2.7%.

The Organization for Economic Cooperation and Development (OECD) has raised its growth forecast for 2007 from 2.5% to 2.7%, a rate it hopes to see repeated in 2008. Within a favourable basic scenario, the OECD foresees a rebalancing of world growth with the United States facing a «soft landing» while recovery in Europe gains in strength, Japan maintains a sound course and China and India continue their vigorous growth. The effect of the US slowdown on the world economy will not be like back in 2001 but with world demand strong and higher levels of employment there are risks of overheating, especially in 2008. The fiscal and foreign imbalances also continue to be a centre of attention although it is expected these will start to be corrected in 2007.

United States slows to 2.1% while euro area strengthens growth to 2.7%.

In the United States, apart from the continuing weakness of the housing sector which could slow down economic recovery, there is the risk of a more general slowdown with lower growth of productivity that may put difficulties in the way of moderating inflation. The growth forecast for 2007 and 2008 has been dropped to 2.1% and 2.5% respectively.

The OECD notes that the recovery in the euro area is gaining strength and it expects that growth of gross domestic product (GDP) in 2007 will reach 2.7%, only to ease to 2.3% in 2008. Germany and Italy are the countries for which prospects are most strengthened, with increases of 2.9% and 2.0% expected in 2007. Forecasts for Spain were confirmed with expected growth at 3.6% although these are revised downward for 2008 with a projected increase of 2.7%. Japan expects to grow by 2.1% this year. The deflationary period has not yet been fully left behind which likely means that the monetary authorities will act with caution without raising interest rates prematurely. Nevertheless, banking activity is recovering and property prices seem to have stabilized so that the growth forecast for 2008 has been raised to 2.4%.

Inflation risks still present and monetary policies will act accordingly.

In this favourable basic scenario, the OECD also notes risks. The low levels of unemployment in member countries, along with the increased strength of world demand, involve inflationary pressures. Intermediate products, shipping costs and food have seen substantial price increases which will be watched by the central banks. In the United States, the smaller increase in economic activity and the weakness of the real estate market should help moderate inflation and give the Fed some small margin for manoeuvre. For Europe, it is expected that the ECB will end the year with its intervention rate at 4.25%.

With regard to fiscal imbalances, it is a priority to take advantage of the present economic situation to improve the sustainability of the public accounts over the long term. In this respect, experience shows that the correction of fiscal balances through control of spending

OECD: ECONOMIC OUTLOOK (1)

	2004	2005	2006	2007	2008
GDP (2)					
United States	3.9	3.2	3.3	2.1	2.5
Japan	2.3	2.7	2.2	2.4	2.1
Germany	0.8	1.1	3.0	2.9	2.2
France	2.0	1.2	2.1	2.2	2.2
Italy	1.0	0.2	1.9	2.0	1.7
United Kingdom	3.3	1.9	2.8	2.7	2.5
Spain	3.2	3.5	3.9	3.6	2.7
Euro area	**1.7**	**1.5**	**2.8**	**2.7**	**2.3**
OECD	**3.2**	**2.7**	**3.2**	**2.7**	**2.7**
Inflation (3)					
United States	2.7	3.4	3.2	2.6	2.6
Japan	0.0	–0.6	0.2	–0.3	0.3
Germany	1.9	1.9	1.8	1.8	1.7
France	2.3	1.9	1.9	1.3	1.7
Italy	2.3	2.2	2.2	2.0	2.1
United Kingdom	1.3	2.0	2.3	2.4	2.0
Spain	3.1	3.4	3.6	2.5	2.7
Euro area	**2.2**	**2.2**	**2.2**	**1.8**	**2.0**
OECD	**2.3**	**2.0**	**2.2**	**2.1**	**2.0**
Unemployment (4)					
United States	5.5	5.1	4.6	4.6	4.8
Japan	4.7	4.4	4.1	3.8	3.6
Germany	9.2	9.1	8.1	7.7	7.2
France	9.2	9.1	8.1	6.9	6.3
Italy	8.1	7.8	6.9	6.3	6.0
United Kingdom	4.7	4.8	5.5	5.5	5.5
Spain	10.5	9.2	8.5	8.2	8.1
Euro area	**9.2**	**8.5**	**7.8**	**7.1**	**6.7**
OECD	**6.7**	**6.5**	**5.9**	**5.6**	**5.5**
Current account balance (5)					
United States	–5.7	–6.4	–6.5	–6.1	–6.2
Japan	3.7	3.7	3.9	4.8	5.4
Germany	4.3	4.6	5.1	6.7	7.0
France	0.1	–1.2	–1.2	–1.0	–1.0
Italy	–0.9	–1.6	–2.4	–2.5	–2.6
United Kingdom	–1.6	–2.4	–3.4	–3.2	–2.7
Spain	–5.3	–7.4	–8.7	–10.1	–10.5
Euro area	**1.1**	**0.3**	**0.1**	**0.4**	**0.4**
OECD	**–1.1**	**–1.6**	**–1.9**	**–1.5**	**–1.5**
World trade (6)	**10.3**	**7.5**	**9.6**	**7.5**	**8.3**

NOTES: (1) Starting hypothesis: a) Fiscal policies in force or announced will not change. b) Exchange rates will not change from level on May 9, 2007 (1 dollar = 119.72 yen = 0.740 euros). c) Closing date of publication and for including figures was May 16, 2007.
(2) All percentage change rates in real tems.
(3) Percentage change rates in GDP deflator.
(4) As percentage of labour force.
(5) As percentage of GDP.
(6) Arithmetical average of percentage annual growth rates of world imports and exports by volume.
SOURCE: Organization for Economic Cooperation and Development.

Fiscal and foreign deficits need correction.

brings the best results, although it is necessary to restrict tax cuts over the short term. With regard to the foreign sector, prospects are slightly better for a correction of the trade deficit in the United States whereas for Germany and Japan current trade surpluses have been revised upward for 2007 and 2008.

OECD: FINANCIAL OUTLOOK (1)

	2004	2005	2006	2007	2008
Government deficit (–) or surplus (+) (2)					
United States	–4.6	–3.7	–2.3	–2.7	–2.9
Japan	–6.2	–6.4	–2.4	–2.7	–3.0
Germany	–3.7	–3.2	–1.7	–0.7	–0.4
France	–3.6	–3.0	–2.6	–2.3	–1.7
Italy	–3.5	–4.3	–4.5	–2.5	–2.5
United Kingdom	–3.3	–3.3	–2.9	–2.7	–2.6
Spain	–0.2	1.1	1.8	1.5	1.5
Euro area	**–2.8**	**–2.4**	**–1.6**	**–1.0**	**–0.7**
OECD	**–3.5**	**–2.9**	**–1.6**	**–1.6**	**–1.6**
Short-term interest rates (3)					
United States	1.6	3.5	5.2	5.3	5.0
Japan	0.0	0.0	0.2	0.5	0.6
United Kingdom	4.6	4.7	4.8	5.5	5.4
Euro area	**2.1**	**2.2**	**3.1**	**4.1**	**4.3**
Long-term interest rates (4)					
United States	4.3	4.3	4.8	4.7	4.8
Japan	1.5	1.4	1.8	1.9	2.4
Germany	4.0	3.4	3.8	4.1	4.2
France	4.1	3.4	3.8	4.1	4.2
Italy	4.3	3.6	4.1	4.4	4.5
United Kingdom	4.9	4.4	4.5	5.0	5.0
Spain	4.1	3.4	3.8	4.1	4.2
Euro area	**4.1**	**3.4**	**3.8**	**4.2**	**4.3**

NOTES: (1) Starting hypothesis: a) Fiscal policies in force or announced will not change. b) Exchange rates will not change from level on May 9, 2007 (1 dollar = 119.72 yen = 0.740 euros). c) Closing date of publication and for including figures was May 16, 2007.
(2) As percentage of GDP.
(3) 3-month interest rates on national money markets.
(4) Government bond interest rates on most representative issues in each country.
SOURCE: Organization for Economic Cooperation and Development.

United States: waiting for more favourable trade winds

United States slows growth to 2.1% because of weak exports...

The ship of the US economy has been weathering the storms with surprising success. Neither the price of oil nor fears of inflation, nor the weakness of the real estate market have managed to shake a ship that painstakingly continues along a slowdown path with the Fed, without hesitation, saying it is more concerned about inflation than a lack of growth.

Nevertheless, in view of the latest figures on the gross domestic product (GDP), it is the trade deficit, an old travelling

companion, that is sowing deep seeds of doubt. The economy grew by 2.1% year-on-year in the first quarter of 2007. This slowdown turned out greater than expected although the biggest surprise was that the origin of this drop was not in domestic demand, where the effects of the weakness in housing were most feared, but in the foreign sector.

Far from hauling in sails, domestic demand, helped by a still strong labour market and the good state of companies, recovered lost vigour and grew by 1.7% in annualized term compared with the previous quarter when the growth rate had dropped to 0.8%. This renewed vitality was supported by the continued strength of private consumption and the recovery of non-residential development concentrated in data-processing equipment and software which, because of base effects, did not show up in year-on-year growth figures. Consumption was up 3.8% quarter-to-quarter annualized while non-residential investment rose by 2.1% after having lost 3.1% in the previous quarter. In turn, housing investment continued to give no clear signs of a recovery and dropped by 17.0% compared with the previous quarter in annualized terms.

In the foreign sector, the blame for the drop this time cannot be laid on the appetite of the US public but rather on the poor performance of sales abroad. While imports held a low profile, exports slowed down considerably with a poor growth figure of 5.5% year-on-year as against 9.4% in the previous quarter.

According to the Federal Reserve, the two factors most contributing to the US current account deficit in recent years have been labour productivity higher than its main trading partners and weak world demand. Productivity, which is the capacity to do more with constant production factors, created higher profit prospects that led to the appreciation of corporate assets. This attracted foreign investors who wanted to buy US assets, which strengthened the dollar and reduced competitiveness of exports. At the same time, the appreciation of assets through the wealth effect, encouraged US consumers to foster more imports. The relative weakness of demand from trading partners did the rest, fostering exports to the United States.

...but consumption holding up, investment in data-processing and software recovering...

But now there is no excuse, given that these two factors have changed from positive to negative. The upward course of productivity has slowed down and world demand is more robust than that of the United States. As a result, the dollar has weakened. All this should make products made in the United States more competitive and push exports up. Most observers see things this way but this is yet to happen.

...but foreign sector sagging.

The index for economic activity and corporate sentiment put out by the Institute for Supply Management supports this upward hypothesis. In manufacturing, the index went from a level of 50.9 to 54.7 points in April, keeping above the 50 level which indicates that there are more optimists than pessimists. Services continued along a similar pattern gaining 4 points and going to the 56.0 level. In both cases, the components showing strongest were new orders, prices and, to a significant extent, export orders.

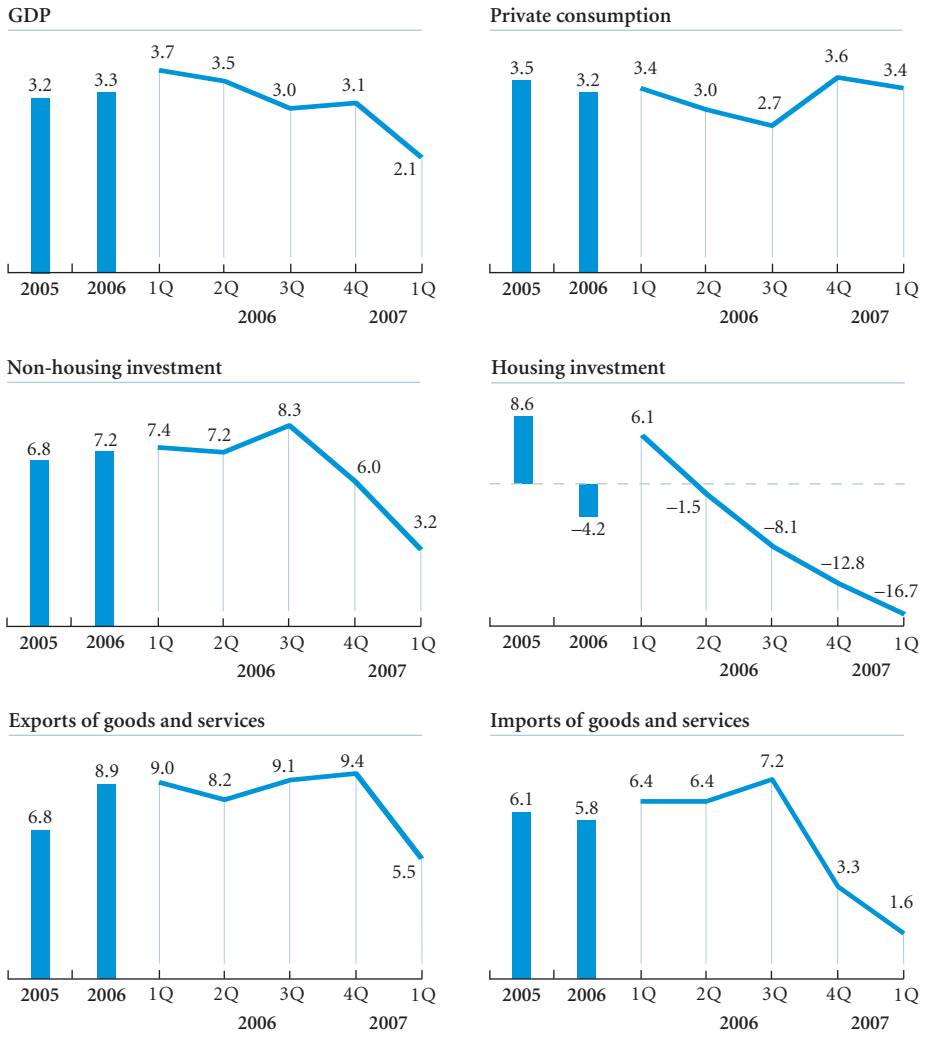
Factors causing foreign deficit lose strength.

The negative counterpart was in industrial production which slowed its growth rate to a slim 1.9% year-on-year. Furthermore, recovery of investment in first quarter GDP did not come through the industrial sector, where transportation equipment continued to perform clearly downward.

Weakness in industry continues.

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Bureau of Economic Analysis and own calculations.

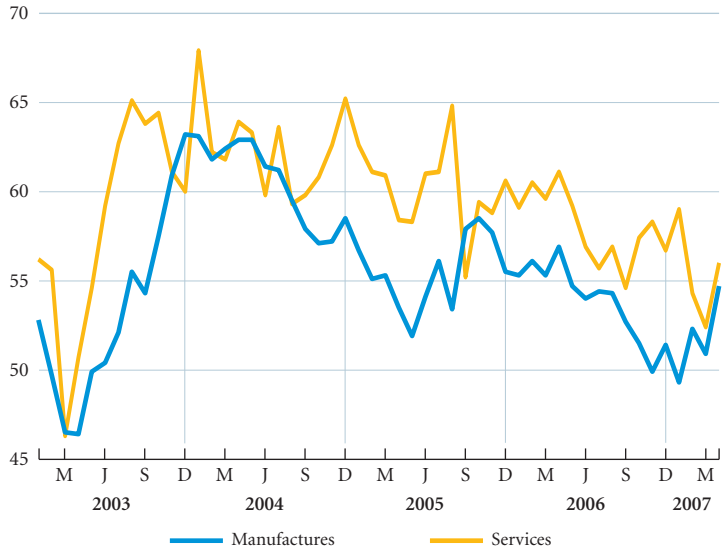
Housing sector fails to recover...

On the demand side, retail consumption in April had already shown clearer signs of a drop with growth going to 3.8% year-on-year, well below the 4.5% in March. In spite of this, consumption still was fairly strong given that this slowdown was largely brought about by an upward revision of previous months and base effects. In the same way, the consumer confidence index published by the Conference Board dropped to the 104.0 points level in April but the perception of the present situation remains above the average for the second half of 2006.

As a result, for now domestic demand seems to be more than reasonably well riding the housing recession. Nevertheless, the real estate sector is a long way from seeing the light at the end of the tunnel. Housing starts in April rose compared with previous months, partly thanks to the fact that those very months were revised downward, but new

UNITED STATES: BUSINESS EXECUTIVES MODERATELY OPTIMISTIC

Level of ISM indices



SOURCE: Institute for Supply Management and own calculations.

construction go-aheads were down 8.9% compared with March. As this was a preliminary indicator, the recovery also seems slightly premature.

If supply was short, so was demand. The number of sales has still not recovered with housing sales dropping by 11.9% year-on-year in April in the case of existing houses and 23.5% for new homes. Along the same lines, the proportion of houses for sale over the total has increased rapidly and this is now 50% above typical levels for the past decade.

Nevertheless, in spite of this picture of weakness, prices have held up significantly. In existing housing, prices have dropped by a mere 0.9% year-on-year and new housing prices are up 6.4% so that there is no reduction of the wealth effect which is giving support to private consumption.

This consumption continues to rest on the labour market which, in spite of the downward trend, was still able to create 1,881,000 new jobs in the past 12 months ending in April combined with an unemployment rate of only 4.5% of the labour force.

...but house prices holding up.

The inflation front brought good news in April in spite of the moderate concern expressed by the Fed. The general consumer price indicator (CPI) went from growth of 2.8% to 2.6% year-on-year while the underlying component (the general rate less energy and foods) eased from 2.5% to 2.4%. This improvement is better than it appears. If we eliminate the important effect of housing rentals, which still grew nearly 4%, the rest of the underlying component (50% of general GDP) slowed down to growth of 1.2%.

Finally, we should point out that the trade deficit in goods and services in March again showed further worsening to reach 63.89 billion dollars, 10.4% above the February figure. The fact is

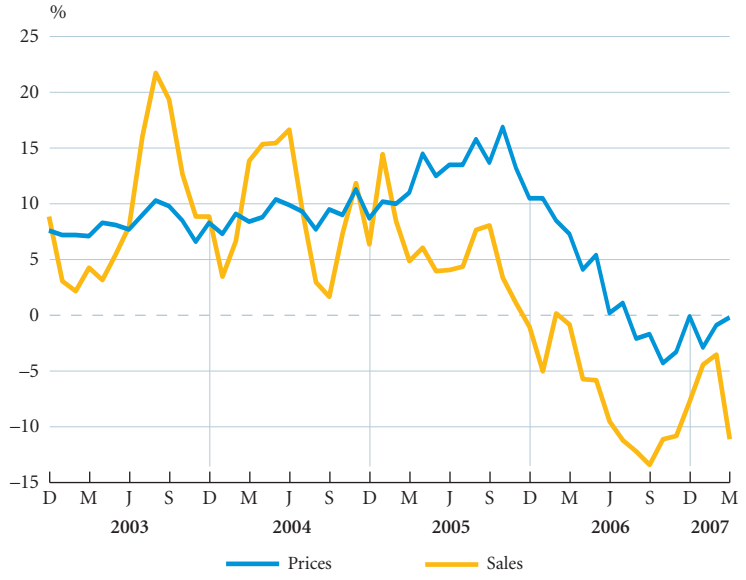
Inflation moderating with growth of core component at 2.4%.

Trade deficit again worsening because of slowdown in exports.

that neither oil nor China was to blame. The deficit, excluding oil, rose by 6.1% to 41 billion dollars while the deficit in bilateral balance with the Asian giant was 17.25 billion dollars, well below the figure for February and the average for 2006. The weakness of exports was the main cause of this worsening which leaves us hoping for the better times promised by the forecasts.

UNITED STATES: HOUSING PRICES HOLDING UP

Year-on-year change in prices and sales of existing housing



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

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	3.2	3.3	3.7	3.5	3.0	3.1	–	2.1	–	–
Retail sales	6.6	6.1	7.9	6.4	5.4	5.0	2.2	3.6	4.4	3.2
Consumer confidence (*)	100.3	105.9	105.7	106.6	104.4	106.8	110.2	111.2	108.2	104.0
Industrial production	3.2	4.0	3.3	4.2	5.1	3.5	2.4	2.9	2.1	1.9
Industrial activity index (ISM) (*)	55.5	53.9	55.6	55.2	53.8	50.9	49.3	52.3	50.9	54.7
Sales of single-family homes	6.6	–17.7	–11.6	–14.4	–22.3	–22.5	–25.6	–19.5	–23.5	...
Unemployment rate (**)	5.1	4.6	4.7	4.6	4.7	4.5	4.6	4.5	4.4	4.5
Consumer prices	3.4	3.2	3.7	4.0	3.4	1.9	2.1	2.4	2.8	2.6
Trade balance (***)	–717	–765	–740	–762	–781	–765	–758	–753	–754	...

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative figure for 12 months in goods and services balance. Billion dollars.
SOURCE: OECD, national statistical bodies and internal figures.

Japan: consumption recovers but investment weak

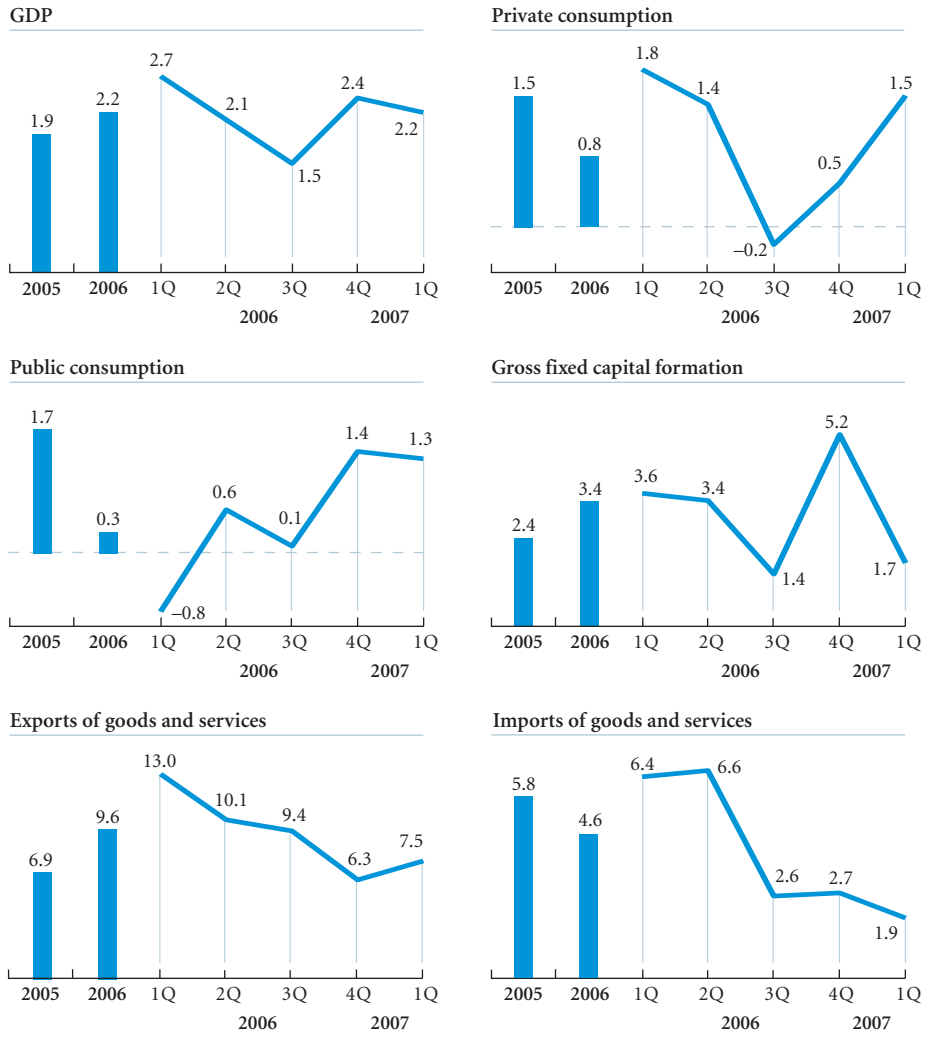
The Tokyo Mitsubishi UFJ, the world's biggest bank in terms of assets, is expecting a notable drop in profits in 2007. It competitors, the Sumitomo Mitsui Financial Group and the Mizuho Financial Group predict similar results. Their problem is that, on the one hand, companies are asking for fewer loans and are not accepting the latest interest rate increases and, on the other hand, consumers feel that they pay the banks too much for their loans. This situation underlines the various sharp ridges that currently characterize the present situation in the Japanese economy.

In the first quarter of 2007, GDP grew by 2.2% year-on-year, somewhat less than in the previous period and continuing with the low-profile growth in keeping with the demographic possibilities of the country. Despite the moderate slowdown, there are two quite positive factors. In the

Japan grows by 2.2% with more consumption and less investment.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

Continuation of higher private consumption should increase yield on investment...

first place, there was a notable increase in private consumption which grew by 1.5% year-on-year as against the previous 0.5% at year-end. In second place, exports of goods and services rose sharply after some hesitation and went up to 7.5% which, along with a moderation in imports, raised the contribution of domestic demand to growth. The depressing factor this time was capital goods investment which, after showing very strong in 2006, went through a sharp slowdown going from increases of 10.9% to gains of 4.9% year-on-year.

This result can be interpreted in two ways. On the one hand, it indicates a weaker business sentiment that can also be observed in the drop in the Tankan index for large manufacturing companies put out by the Bank of Japan for which the level in the first quarter went from 25 to 23 points. Nor do machinery orders suggest any early recovery of investment. Apart from the constant increase in the proportion represented by export orders, both these orders and those meeting domestic demand showed drops of more than 15% year-on-year in March, which does not go in favour of the business volume of Tokyo Mitsubishi. On the other hand, consumption has traditionally been lacking in Japan and at times there has been excessive investment which generally yields less than in other countries. With these low yields we can understand the problems the banks have when it comes to a pass-through of latest interest rate increases. Because of this, the combination of more private consumption and higher sales abroad with more moderate capital goods investment, if it continues, should be seen as a positive correction factor which could result in higher yields from production capital.

...but consumer indicators not strong...

This continuation is still far from being confirmed in the case of private consumption, if we are to go by the poor retail sales in March. In the case of cars, April was the month with lowest sales since January 1998 which meant that the total for the last 12 months was down 9.1% year-on-year. The consumer confidence index for the first quarter of 2007 was

JAPAN: MAIN ECONOMIC INDICATORS

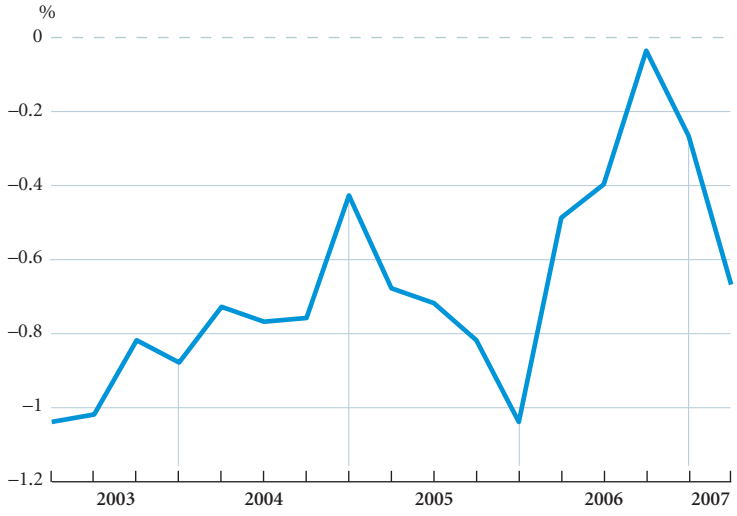
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	1.9	2.2	2.7	2.1	1.5	2.4	–	2.2	–
Retail sales	1.4	0.2	0.6	–0.2	0.4	–0.1	–0.8	–0.3	...
Industrial production	1.5	4.5	2.6	4.0	6.0	5.3	3.2	4.5	3.2
Tankan company index (*)	18.0	22.5	20.0	21.0	24.0	25.0	–	23.0	–
Housing construction	3.9	4.5	4.9	8.9	–0.8	5.4	–0.8	–9.9	5.5
Unemployment rate (**)	4.4	4.1	4.2	4.1	4.1	4.0	4.0	4.0	4.0
Consumer prices	–0.3	0.2	–0.1	0.2	0.6	0.3	0.0	–0.2	–0.1
Trade balance (***)	10.2	9.4	9.5	9.1	8.9	9.4	9.9	9.8	10.3

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

JAPAN: DEFLATION FAILS TO GO AWAY

Year-on-year change in GDP consumption deflator



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

down slightly from 47.0 to 46.7 points while the propensity to save in March continued to increase over the same period last year, in spite of the fact that the unemployment rate in March remained at a low 4.0% of the labour force. In turn, the real estate market continued to show signs of weakness in April with sharp decreases in the number of houses sold and at prices that were stagnating. Despite this, housing starts in March showed some increase. Supply fell in with the low profile and industrial production that month slowed down, going from growth of 4.5% to 3.2% year-on-year.

...and prices keep dropping.

On the prices front, negative figures predominated. The March CPI lost 0.1% year-on-year which, excluding fresh foods, showed a drop of 0.3%. In turn, the private consumption deflator for the first quarter was down 0.2% compared with the previous period although the background trend continues to be upward, suggesting an end to the deflationary period at the end of the year. Coherent with the GDP figures, the trade balance for the past 12 months ending in March rose to 10,300 billion yen, 8% above the same period last year.

Latin America: stability recovered

Times of economic prosperity seem to have arrived in Latin America. After some turbulent years in the Eighties and Nineties, when the region was rocked by a series of financial crises of both internal and external origin, the fact is that the past decade has brought a certain stability. After the Brazilian financial crisis in 1998, the famous collapse in Argentina in 2001 was the exception rather than the rule in the region.

In order to examine the return to macroeconomic stability in Latin America we shall focus on a key indicator – inflation. In the Eighties and Nineties, Latin American countries were incapable of containing government spending while tax collection was insufficient. Because of this, they periodically had to have recourse to monetizing public spending, that is, they had to print money to cover a significant part of the budget and pay existing debt. This brought about annual inflation rates of three, four and even five digits (Bolivia had an inflation rate of 11,750% in 1985, in Brazil and Argentina inflation went above 1,000% on three occasions in each country). These crises kept recurring.

Nevertheless, since the mid-Nineties, inflation stability has been taking root in the region. In the following table we have divided the evolution of inflation since 1980 in a «Before» period and an «After» period. The cut-off year is chosen at the moment when annual inflation crossed the 20% threshold and did not go back beyond that point. That is to say, the «Before» column shows annual average inflation in the period between 1980 and the year of change whereas the «After» column shows the period between the year of change and 2006. As may be observed, all the countries were able to lower their inflation rates below 10% on average. The only exception is Venezuela, where inflation was relatively low until 1986 and has not consistently decreased below 20% since then. Because of this, as opposed to the situation in other countries, in Venezuela the cut-off year is the year when inflation went above 20% and did not drop.

AVERAGE ANNUAL INFLATION

	Before (%)	After (%)	Cut-off year
Argentina	628.3	6.3	1993
Bolivia	1,724.7	8.5	1987
Brazil	740.0	7.8	1996
Chile	21.3	5.3	1992
Colombia	22.8	6.5	1999
Ecuador	39.3	5.7	2002
Mexico	44.7	5.4	2000
Peru	916.1	6.3	1995
Uruguay	55.7	8.6	1998
Venezuela	12.6	37.5	1986

NOTES: Cut-off year described in text.
SOURCE: IMF and own calculations.

Why has inflation been successfully reduced in the past decade? In the unsuccessful stabilization plans of the Eighties and early Nineties, the countries adopted a fixed exchange rate (usually pegging their currencies to the US dollar) in order to control inflation. The idea was to limit money supply growth by linking the amount of money a country could issue to the accumulation of international reserves in the central bank. Nevertheless, these exchange rate arrangements were not credible because the fiscal problem was not tackled. Ultimately, the country's authorities returned to their old ways, spent in excess, printed money and the system collapsed. Argentina's convertibility plan with an exchange rate pegged to the US dollar worked between 1993 and 2001 but the lack of fiscal discipline (exemplified by the existence of «patacones», which were bonds issued by the provincial governments that could be used as currency), meant that the situation became unsustainable.

One major reason behind the recent stability in the region has been institutional reform, including the adoption of inflation targeting monetary policy regimes over the past decade, following the trend in the industrialized countries. Under this monetary policy regime, formally adopted by Brazil, Chile, Colombia, Mexico and Peru, the central bank devotes itself exclusively to obtaining a numerical inflation target and has sufficient independence to do so. As a result, one of the cornerstones of inflation targeting regimes is the outright prohibition that the central bank provides financing to the government. One could think that a fixed exchange rate with a prohibition on financing the government could also be successful in providing macroeconomic stability. Nevertheless, when a country adopts a fixed exchange rate it must accept the monetary policy of the country to whose currency its exchange rate is pegged to and it may well be that what is suitable for one country is not so for another. This was one of the problems for Argentina in the 2001 crisis. The main problem was a lack of fiscal discipline but the strength of the US currency at that time, to which the peso was pegged, meant a loss of competitiveness for Argentine exports in relation to its neighbouring countries which had flexible exchange rates, thus aggravating the recession. The additional advantage of an inflation targeting regime over an exchange rate peg is that the exchange rate is flexible, which allows the country to better absorb external shocks and set monetary policy according to domestic conditions.

Nevertheless, it should be recognized that the world economic situation has been very good and that it is easier to do one's homework when winds are favourable than when they are adverse. The interest rate spread between emerging markets and industrial economies stands at all-time lows (less than 200 basis points); the world economy has been growing at a record rate in the past 30 years (5.4% in 2006, according to the IMF); and inflation has dropped world-wide and not only in those countries that have adopted inflation targeting. Furthermore, the external position of Latin American economies has improved, given that the terms of trade are very favourable due to China's appetite for raw materials produced in the region. As a result, we may wonder what will happen if the economic situation becomes less favourable. Will the region go back to its old ways with recurring financial crises, fiscal problems and hyperinflation or has Latin America moved into the honour guard in terms of macroeconomic management to stay?

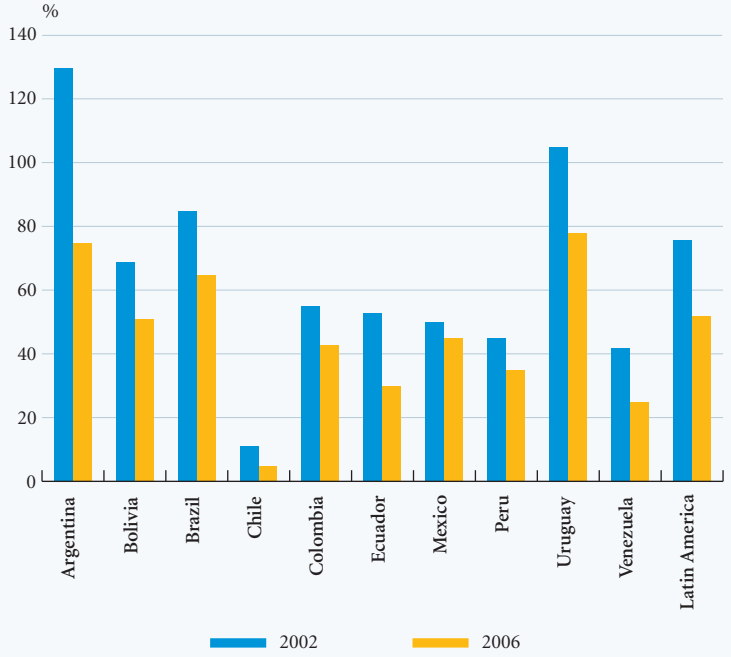
Some recent figures suggest a moderate optimism about the future. According to an IMF study, fiscal policy in the region in the recent growth surge has become less pro-cyclical when compared with the economic expansions of the Nineties.[1] Between 2002 and 2006, the public sector finances improved instead of worsening as in previous expansions. Furthermore, fiscal constraints imposed by an inflation targeting regime, the renegotiation of Argentina's debt and additional revenues arising from the increase in commodities prices have significantly brought down public debt levels in the region. The level of debt in 2002 was 76% of GDP and slightly above 54% in 2006. In spite of this decrease, the debt level in Latin America is higher than in 1996, so vulnerabilities in the event of less favourable economic conditions still exist.

To sum up, the most important question to answer is how has the region benefited from its recently-won macroeconomic stability? The following table sets out average annual real growth rates for each country, dividing the sample period into a «Before» period and an «After» period using the same criteria that we adopted for inflation. The result is somewhat disappointing. In spite of the fact that growth rates in the region have increased in most countries with macroeconomic stability, these rates have not yet reached the levels of the emerging countries of South East Asia or Eastern Europe. It therefore would seem that macroeconomic stability is a necessary ingredient but not sufficient to obtain economic growth levels that make it possible to significantly reduce poverty and inequality. This clearly adds a political risk to macroeconomic stability. If

(1) See *Regional Economic Outlook*, Western Hemisphere, International Monetary Fund, Washington, DC, November 2006.

SIGNIFICANT DECREASE IN PUBLIC DEBT OF LATIN AMERICAN COUNTRIES

Public debt in percent of GDP



SOURCE: IMF.

people generally do not perceive an increase in their well-being, it is then more likely that we shall see the election of populist governments whose macroeconomic policies, including for instance the reversal of some institutional reforms, could take the region back to the problems that formerly ravaged the region. Now that Latin America has managed to stabilize the upsets that once affected its economy, it is time to raise the sights and go full-steam-ahead.

AVERAGE REAL GDP GROWTH

	Before (%)	After (%)	Cut-off year
Argentina	0.8	3.1	1993
Bolivia	1.4	3.4	1987
Brazil	2.6	2.5	1996
Chile	4.6	5.0	1992
Colombia	3.2	3.9	1999
Ecuador	2.5	4.9	2002
Mexico	2.9	2.9	2000
Peru	0.6	4.8	1995
Uruguay	2.7	1.1	1998
Venezuela	0.1	2.7	1986

NOTES: Cut-off year described in text.
SOURCE: IMF and own calculations.

Brazil: gaining outside what it loses inside

In the first quarter of 2007 it is expected that Brazil's economy will maintain the growth rate at the end of last year with a slight upward trend. Because of the good state of inflation, the trade surplus and continuing growth, it is expected that the unemployment rate will be reduced, this being a matter still to be resolved in this buoyant economic situation.

Monthly demand indicators show good prospects for growth in the first quarter with retail sales in March that maintained the drive seen at the beginning of the year and moved up to growth of 11.5% year-on-year. Car sales followed a similar pattern with an increase of 14.4%. On the supply side, increases were somewhat more restrained. Industrial production showed an increase of 3.9% in March, still relatively modest, but the background trend is upward. Industrial production of capital goods was up a robust 12.7% year-on-year which, while lower than the 17.7% in January, continued the upward course.

Brazil hoping to maintain high growth in first quarter.

Moderate inflation continues to be one of the strong points of Brazil's economy with the April CPI continuing very stable with a rise of 3.0% year-on-year, in spite of the increase in consumption. The negative counterpoint continues to come from unemployment. The unemployment rate for São Paulo region, after showing a gradual downward trend that took it to 14.3% at the end of 2006, rose again in March to 15.9% of the labour force. This means a headache for a government trying to find a balance between preserving social peace and ensuring macroeconomic stability.

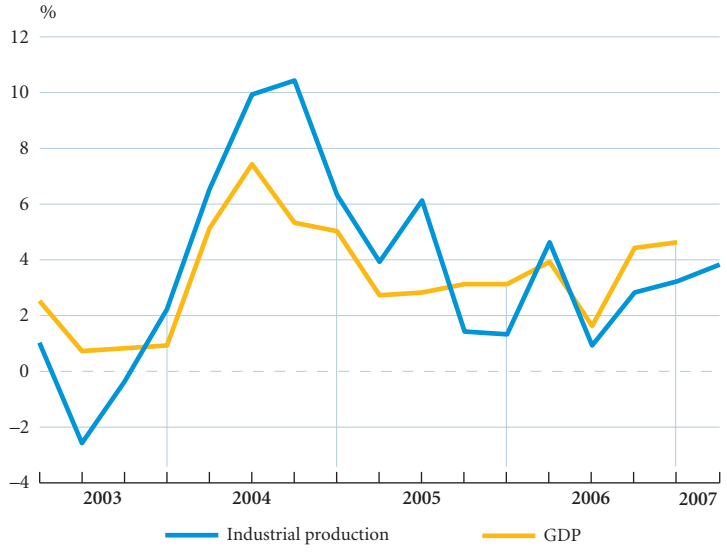
Demand and industry keep gaining strength...

It is the foreign sector where Brazil's economy shows its most favourable face, consolidating a trade deficit that in the past 12 months ending in April continued to grow reaching 46.7 billion

...and prices rise only 3%, but unemployment high.

BRAZIL: INDUSTRY POINTING TO CONTINUED GROWTH

Year-on-year change in industrial production and GDP in real terms



SOURCE: IPEA and own calculations.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	2.9	3.6	3.9	1.6	4.4	4.6	–	...	–	–
Industrial production	3.1	2.8	4.6	0.9	2.8	3.2	4.5	3.0	3.9	...
Unemployment rate São Paulo (*)	17.0	15.9	16.3	16.9	16.0	14.3	14.4	15.3	15.9	...
Consumer prices	6.9	4.2	5.5	4.3	3.8	3.1	3.0	3.0	3.0	3.0
Trade balance (**)	44.8	46.1	45.7	44.5	46.1	46.1	45.8	45.9	45.6	46.7

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and own calculations.

Argentina expecting continued growth.

dollars. This was an improvement that took place in spite of the strong level of imports, thanks to the strength of exports which were up 26.6% year-on-year.

Argentina expects continuing growth

Argentina's economy is expected to continue strong growth in the first quarter through a combination of solid domestic demand and foreign surplus although inflation and unemployment are improving far too slowly.

Demand indicators up sharply but construction weakening.

Retail sales continued to increase their impressive stride in March with a rise of 28.9% year-on-year in the Buenos Aires region. Department store sales also were up 30.6% in the same period. An indicator of the continuing recovery is car sales which, in the past 12 months up to March, stood at 73.9% of the all-time high in March 1998 whereas one year ago they were at only 54.4%.

On the supply side, things are somewhat more calmly with industrial production in March showing growth of 4.4% year-on-year with maintenance of the increase in the industrial activity index. Nevertheless, construction dropped in March with the Synthetic Indicator of Construction Activity (ISAC) down 2.6% year-on-year following two months showing increases.

ARGENTINA: MAIN ECONOMIC INDICATORS

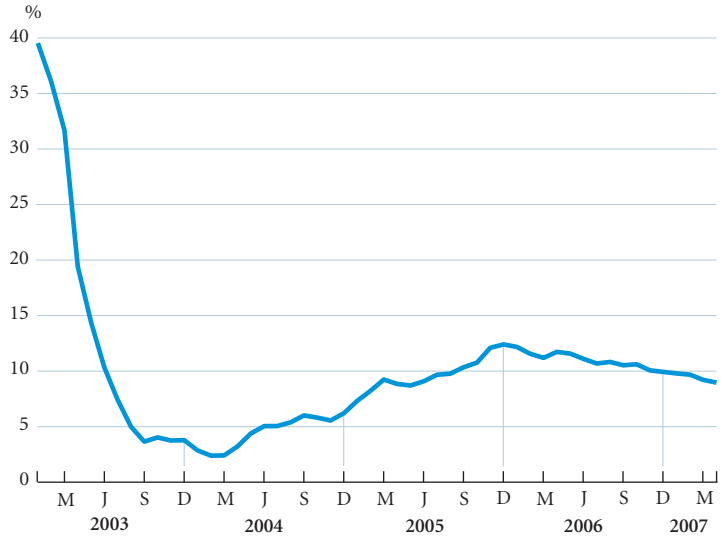
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	9.2	8.5	8.8	7.7	8.7	8.6	–	...	–	–
Industrial production	7.6	7.6	6.7	8.7	9.2	6.1	5.2	2.6	4.4	...
Unemployment rate (*)	11.6	10.2	11.4	10.4	10.2	8.7	–	9.8	–	–
Consumer prices	9.6	10.9	11.6	11.4	10.6	10.1	9.7	9.6	9.1	8.9
Trade balance (**)	11.7	12.3	11.7	12.3	11.6	12.3	11.9	11.9	11.6	11.4

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

ARGENTINA: INFLATION RISK REMAINS

Year-on-year change in CPI



SOURCE: INDEC and own calculations.

Inflation continues as the big unknown in the current growth phase. The CPI continues to moderate but the process is slow and the country's main neighbours in the region are ahead. In April, prices rose by 8.9% year-on-year which was a slight improvement over the 9.8% at the end of 2006. The unemployment rate continues to be another matter still to be improved. Following a downward trend up to the end of last year, in spite of growth of demand, the drop in construction activity meant that in the first quarter of 2007 there was an increase in unemployment from 8.7% to 9.8% of the labour force. The trade surplus held stable and for the past 12 months ending in March it stood at 11.7 billion dollars.

Inflation remains risk on top of continued unemployment.

Four years of growth: 100 years of prosperity?

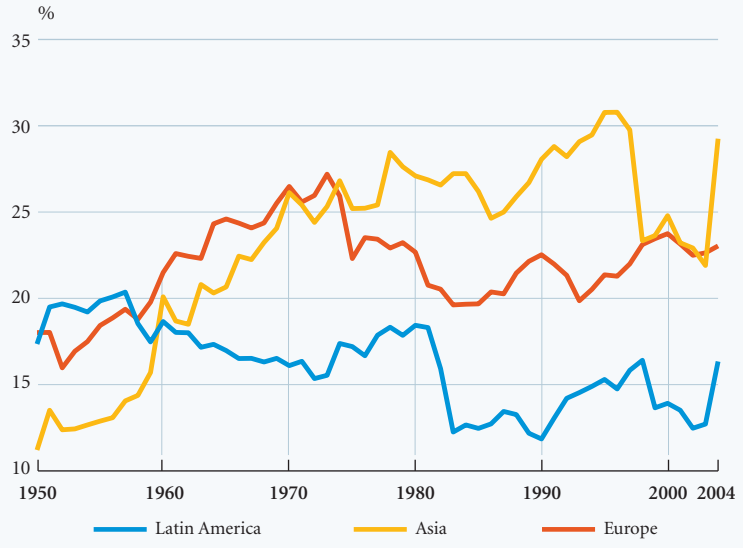
After completing four consecutive years of economic growth, there is an air of optimism in Latin America. Since the last crisis in 2002, the GDP in the region has grown at an average rate exceeding 4% and forecasts for 2007 point to a growth rate of 5%. Nevertheless, the modern history of Latin America is that of a continent that has not been able to move forward without retrocede again. Since 1970, any stage of economic boom has ended in a sharp recession that has dragged down with it economic, political and social capital that took so many years to build. Is there any reason to believe that something has changed? Has Latin America found the way to the path of stable long run growth?

The recent good performance of the Latin American economies may be partly explained by the renewed strength of foreign demand (especially from Asia), the recovery of domestic demand stimulated by low interest rates, and the consolidation of macroeconomic stability (see Box «*Latin America: stability recovered*»

on page 15). With the exception of the latter, these factors are an interim solution and, even though they may explain recent increases in the growth rate, they do not ensure that it will last in the medium-long term. The economic growth of a country can be attributed to factor accumulation (labour, physical and human capital) and productivity improvements. In this respect, the Latin American countries do not seem to have done their homework.

LATIN AMERICA: AT THE TAIL-END OF INVESTMENT SINCE THE SIXTIES

Investment in terms of GDP



SOURCE: *Penn World Tables 6.2* and own calculations.

Since the Sixties, the average level of investment in physical capital (as percentage of GDP) has been far behind the average of the EU-12 countries and even more so with regard to the Asian countries (see Graph above). In terms of human capital, neither does it seem that education policies in Latin America are producing the desired result. While the region has an average percentage of population with primary schooling fairly similar to that of Asia, United States, and Europe, the deficit in secondary education is remarkable. As shown in the table below, the quality of education must also be improved. The Latin American averages in the quality of math and science teaching, the standards of the educational system, and schools' access to new technologies are all lower than in other regions.

In sum, both low investment and poor education of the labour force would have contributed to the weak growth in Latin America over the last third of the 20th century. Still, the figures indicate that the main factor behind the growth slowdown in the region was the poor productivity gains since the Seventies, always lower than the world average (even negative some times).

Realizing that the modest growth in Latin America may be attributed to low levels of investment and to weak productivity growth is only the first step towards understanding the fundamentals of growth. Other questions immediately arise. Why does Latin America invest so little? Why is productivity not improving? The answer lies in those attributes of a country that promote (or slow down) both the accumulation of factors and their

productivity. Among the various theories put forward in economic research as possible «deep determinants», three stand out, namely geography, institutions and economic integration.

THE LOW QUALITY OF THE EDUCATION SYSTEM ALSO SLOWS GROWTH

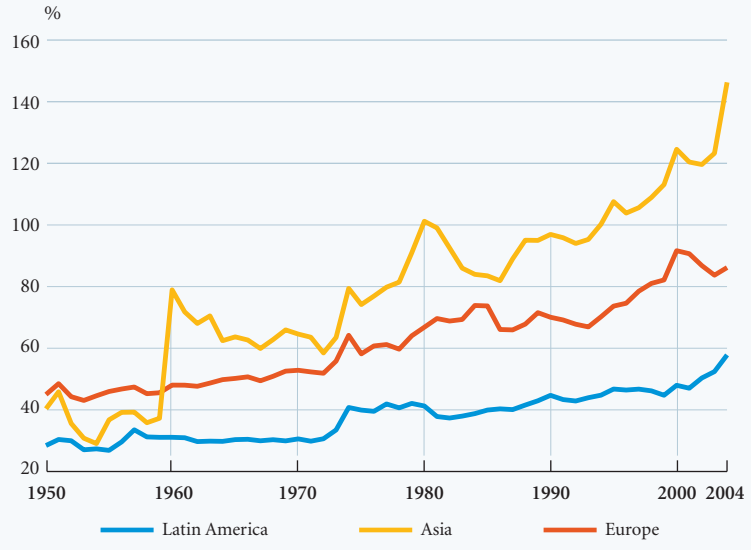
	Primary school enrollment (%)	Secondary school enrollment (%)	Mathematics and science skills (Index from 0 to 10)	Quality of education (Index from 0 to 10)	Quality of public schools (Index from 0 to 10)	Access to Internet in schools (Index from 0 to 10)
Latin America	94.9	66.6	4.4	3.8	3.5	4.5
Asia (*)	93.4	80.2	7.1	6.1	6.2	6.6
Europe	98.9	94.0	6.8	6.5	7.5	7.3
United States	92.4	89.3	6.5	6.9	7.1	8.5

NOTES: Enrollment figures are for 2004. Quality indicators are for 2005-2006.
(*) Rates for secondary enrollment in Asia for 2000.
SOURCE: *World Development Indicators* (World Bank), *The Global Information Technology Report* (World Economic Forum) and own calculations.

The geography hypothesis argues that climate, ecology, and geography of a country largely condition its degree of economic development. According to Professor Jeffrey Sachs (Columbia Univerity), some countries enjoy an advantage in the growth race because they have better access to raw materials and navigation routes, proximity to rich countries, and favourable climate. Nevertheless, while a rough geography may explain, for example, the poor growth of Bolivia we cannot apply that same logic to the majority of Latin American countries and, even less, claim that the diverging trends observed between Asia and Latin America are due to differences in access to navigation routes or climate.

TRADE OPENNESS: LATIN AMERICA STILL LAGGING BEHIND

Exports and imports in terms of GDP



NOTES: Trade openness measured by exports plus imports over GDP.
SOURCE: *Penn World Tables 6.2* and own calculations.

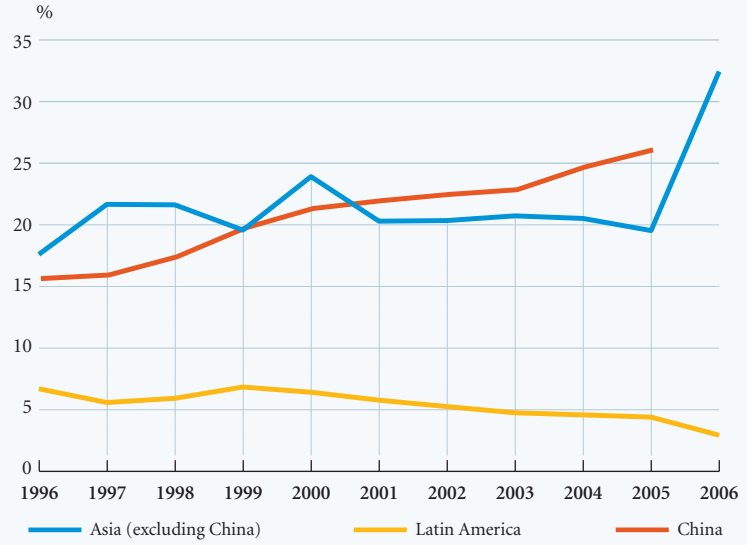
A second theory argues that the quality of institutions is the key determinant of economic growth. In a recent paper, Jeromin Zettelmeyer, an economist at the International Monetary Fund, argues that the quality of institutions in Latin America has, in general, improved since the Seventies despite the recent worsening of corruption and protection of property rights in some countries. In any case, he generally agrees that there is still a long way to go, as shown in the Box starting on page 34.

Finally, the importance of trade openness for a country's growth is a central hypothesis in economics and some argue it was key in the success of the Asian «miracles». The boost to growth from trade works through its ability to improve the resource allocation, promote competition, and spread technology and know-how. In spite of a clear commitment to the liberalization of trade since the end of the Eighties and the breath of fresh air coming from the explosion of Chinese demand over the past five years, the fact is that Latin America still has work to do in the area of foreign trade. Their trade openness has only slightly improved and they remain very much closed relative to other areas of the world, especially Asia, as shown in the previous graph.

At the same time, Latin American exports continue to be concentrated in primary products and in manufactures of low technological content, in clear contrast to the Asian countries. This type of specialization not only exposes the Latin American economies to the volatility characterizing markets for these products but also restricts the benefits of trade.

MORE HIGH-TECH EXPORTS FROM ASIA THAN FROM LATIN AMERICA

Exports of products with high technological content in relation to total products



NOTES: Products with high technological content include products of aeronautical, pharmaceutical, electronic, optical, photographic, technical or medical nature and electrical equipment (Classification 85, 88, 90 and 30 of HS2002).
SOURCE: UN Comtrade and own calculations.

In a nutshell, there is still a way to go. Latin America needs to take advantage of the opportunity offered by the present favourable environment to invest in the pillars of growth, namely, institutions, human capital and trade openness. These are keys for being able to write its own one hundred-year history of prosperity (or even longer).

Raw materials: price increases in May

The price of Brent quality oil hit 71.21 dollars a barrel on May 25, the highest price since August 2006. The price of crude dropped 15% in the first 15 days of January but since then it has followed an upward course. Geopolitical tension over Iran and instability in Nigeria in May pushed up prices.

The increase in oil prices have been joined by a rise in prices of agricultural raw materials. In May, cocoa rose by 9.8%, soy by 9.4%, coffee by 8.0%, maize by 4.3% and cotton by 1.8%. In most cases, the reason was bad news about growth of supply. For example, it is expected that coffee consumption will go 5.4% above production in the 2007-2008 season. In the case of wheat, we find the paradox that whereas Ukraine, the eighth biggest exporter of wheat, has officially announced the loss of 400,000 hectares of crop due to drought in that country, in the United States heavy rains and floods in Kansas and Oklahoma have put crops in danger in two of the biggest wheat-producing states.

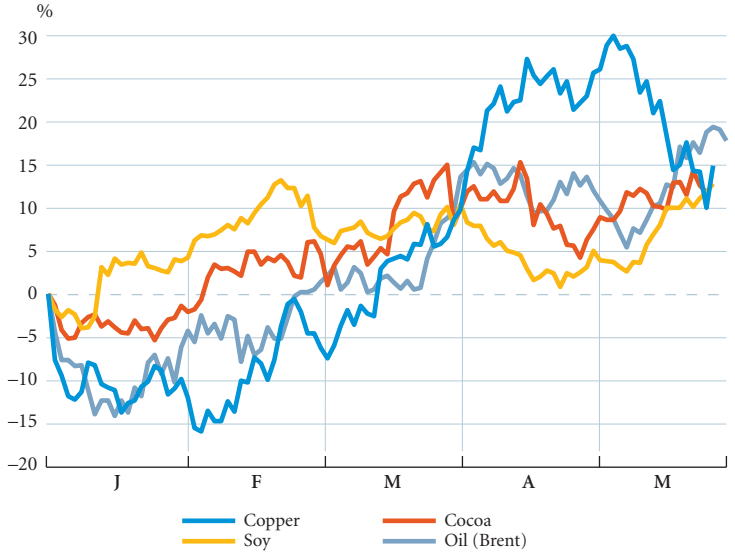
With regard to metals, lead was up 4.6% but the rest (gold, silver, aluminium and zinc) fell by around 4.5% in May in a move to consolidate the new highs reached in recent months. The only exception was copper which fell by around 12.4% because of over-supply of this metal in spite of world economic growth. In all cases, high prices continue to reflect the high level of world industrial production and the need to increase inventory levels.

Oil keeps to upward trend in May because of instability over Iran and Nigeria.

Prices for agricultural raw materials up because of forecast drop in supply while metals consolidate price levels.

NEW RALLY IN RAW MATERIALS

Price changes in raw materials since January 1, 2007



SOURCE: Bloomberg.

EUROPEAN UNION

European Union predicting more expansionist 2007 and forecasts euro area growth of 2.6%...

...thanks to better performance in investment and increase in private consumption.

European Commission forecasts: revised upward, more optimistic

In its Spring forecasts just published, the European Commission revises economic growth forecasts upward with no modification of its estimate of controlled inflation compared with its previous forecasts put out in the Autumn of last year. According to the EU body, the European Union (27-EU) will grow by 2.9% year-on-year this year (3.0% in 2006) while it is expected to ease this growth rate with an increase of 2.7% in gross domestic product (GDP) in 2008. The euro area will follow this cycle with growth of 2.6% in 2007 and 2.5% in 2008. In 2006, growth recorded in the euro area was 2.7%.

The big supports for growth will be investment and an increase in private consumption. Capital goods investment will be aided by improved demand prospects, good financial conditions, corporate profits and high utilization of production capacity, as well as the need to invest in new technology.

Strong job creation and the increase in total wages, combined with moderate inflation, will improve growth of net disposable income of consumers. Furthermore, job creation has pushed up consumer confidence. The European Union foresees the creation of 5.5 million jobs in the 2007-2008 period.

One of the risks in this scenario would come with any significant increase in oil prices. It its scenario, the European Commission employs a forecast of 66.2 dollars a barrel (Brent quality) in 2007 and 70.3 dollars a barrel in 2008.

MACROECONOMIC FORECASTS FOR EURO AREA (1)

	2004	2005	Current forecasts Spring 2007			Difference with Autumn 2006 (2)	
			2006	2007	2008	2007	2008
Gross domestic product	**2.0**	**1.4**	**2.7**	**2.6**	**2.5**	**0.5**	**0.3**
Consumption	1.5	1.4	1.8	2.1	2.4	0.5	0.3
Investment	2.2	2.5	4.7	4.4	3.6	1.4	0.6
Employment	0.8	0.8	1.4	1.4	1.2	0.2	0.1
Unemployment rate (3)	8.8	8.6	7.9	7.3	6.9	–0.4	–0.5
Inflation (4)	2.1	2.2	2.2	1.9	1.9	–0.2	0.0
Government balance (% of GDP)	–2.8	–2.5	–1.6	–1.0	–0.8	0.5	0.5
Government debt (% of GDP)	69.7	70.5	69.0	66.9	65.0	–1.1	–1.9
Current account balance (% of GDP)	0.8	0.0	0.0	0.2	0.1	0.1	0.0
Growth of GDP in EU-27	*2.5*	*1.7*	*3.0*	*2.9*	*2.7*	*0.5*	*0.3*

NOTES: (1) Annual change as percentage unless otherwise stated.
(2) Plus sign «+» («–») indicates a higher (or lower) positive figure or lower (or higher) negative figure compared with Autumn 2006.
(3) Percentage of labour force.
(4) Harmonized consumer price index.
SOURCE: European Commission.

MACROECONOMIC FORECASTS FOR EURO AREA COUNTRIES

Spring 2007

	GDP (*)			Inflation (**)			Unemployment (***)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Germany	2.7	2.5	2.4	1.8	1.9	1.7	8.4	7.3	6.5
Austria	3.1	2.9	2.5	1.7	1.8	1.7	4.8	4.4	4.3
Belgium	3.1	2.3	2.2	2.3	1.8	1.8	8.2	7.8	7.6
Slovenia	5.2	4.3	4.0	2.5	2.6	2.7	6.0	5.8	5.6
Spain	3.9	3.7	3.4	3.6	2.4	2.6	8.6	8.1	7.8
Finland	5.5	3.1	2.7	1.3	1.5	1.7	7.7	7.2	6.8
France	2.0	2.4	2.3	1.9	1.5	1.7	9.4	8.9	8.5
Greece	4.3	3.7	3.7	3.3	3.2	3.1	8.9	8.5	8.1
Ireland	6.0	5.0	4.0	2.7	2.6	2.2	4.4	4.5	4.6
Italy	1.9	1.9	1.7	2.2	1.9	2.0	6.8	6.6	6.4
Luxembourg	6.2	5.0	4.7	3.0	2.4	2.7	4.7	4.6	4.4
Netherlands	2.9	2.8	2.6	1.7	1.5	2.1	3.9	3.2	2.7
Portugal	1.3	1.8	2.0	3.0	2.3	2.3	7.7	7.7	7.5
Euro area	**2.7**	**2.6**	**2.5**	**2.2**	**1.9**	**1.9**	**7.9**	**7.3**	**6.9**

NOTES: (*) Percentage real change.
(**) Percentage change in harmonized consumer price index.
(***) Percentage of labour force.
SOURCE: European Commission.

Nevertheless, in spite of the growth forecast above potential, the European Commission estimates a negligible inflation effect. Harmonized inflation for the euro area will hold at 1.9% on annual average in 2007 and 2008. Two factors lie behind this absence of price pressures. The first is the favorable base effect due to big increases in oil prices last year. Secondly, we note the minor impact of the increase in value added tax (VAT) in Germany.

A second risk factor in this scenario would be a sharp slowdown in the US economy which would imply a major correction of world macroeconomic imbalances. Another risk factor would be a big correction in the real estate market in the euro area. The European Commission believes that the most likely scenario is that of a «soft landing» in this sector. It indicates that the increase in interest rates is moderating housing price increases in all member countries.

While the spread of growth in the member countries of the European Union was lower in 2005 and 2006, it still maintains a broad range of forecasts for growth in 2007 which run from 1.8% in Portugal to 10% in Latvia. This may partly be explained by the process of convergence in those countries recently joining the European Union. Nevertheless, in the euro area there is something of a spread. In the case of the three big countries, both Germany and France are expected to grow by around 2.5% while Italy will repeat growth shown last year, that is, 1.9%. While an improvement is expected in domestic demand in Italy, net exports will contribute less to growth in 2007.

Foreign risks, such as oil prices and slowdown in USA and internal risks, like real estate correction, are substantial.

MACROECONOMIC FORECASTS FOR EU COUNTRIES OUTSIDE EURO AREA

Spring 2007

	GDP (*)			Inflation (**)			Unemployment (***)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Bulgary	6.1	6.1	6.2	7.4	4.2	4.3	9	8.2	7.4
Cyprus	3.8	3.8	3.9	2.2	1.3	2.0	4.7	4.8	4.8
Denmark	3.1	2.3	2.0	1.9	1.9	2.2	3.9	3.3	3.3
Slovakia	8.3	8.5	6.5	4.3	1.7	2.4	13.4	12.2	11.7
Estonia	11.4	8.7	8.2	4.4	5.1	5.3	5.9	6.6	6.2
Hungary	3.9	2.4	2.6	4.0	7.5	3.8	7.5	7.8	7.8
Lethonia	11.9	9.6	7.9	6.6	7.2	6.2	6.8	6.3	6.0
Lithuania	7.5	7.3	7.3	3.8	4.7	4.4	5.6	4.8	4.3
Malta	2.9	3.0	2.8	2.6	1.4	2.1	7.4	7.4	7.3
Poland	6.1	6.1	5.5	1.3	2.0	2.5	13.8	11.0	9.0
United Kingdom	2.8	2.8	2.5	2.3	2.3	2.0	5.3	5.0	4.9
Czech Republic	6.1	4.9	4.9	2.1	2.4	2.9	7.1	6.4	6.1
Rumania	7.7	6.7	6.3	5.1	4.3	3.8	7.4	7.2	7.1
Sweden	4.4	3.8	3.3	1.5	1.2	1.9	7.0	6.4	5.9
EU-27	**3.0**	**2.9**	**2.7**	**2.3**	**2.2**	**2.1**	**7.9**	**7.2**	**6.7**
United States	*3.3*	*2.2*	*2.7*	*3.2*	*2.3*	*1.9*	*4.6*	*4.7*	*5.0*
Japan	*2.3*	*2.3*	*2.1*	*0.2*	*0.0*	*0.4*	*4.1*	*4.1*	*4.2*

NOTES: (*) Percentage real change.
(**) Percentage change in harmonized consumer price index, except United States and Japan, in which cases it is national consumer price index.
(***) Percentage of labour force.
SOURCE: European Commission.

Euro area: private consumption joins investment

Euro area grows 3.1% in first quarter.

The estimate put out by Eurostat on growth in the euro area in the first quarter of 2007 was 3.1%. The level of growth has been reduced two decimals compared with the previous quarter. The reason for this slight slowdown lies in lower growth of private consumption which qualified the sharp increase in the fourth quarter. Nevertheless, in the euro area as a whole retail sales have increased to 1.7% year-on-year. Consumption will aid growth of the economic cycle for the rest of the year.

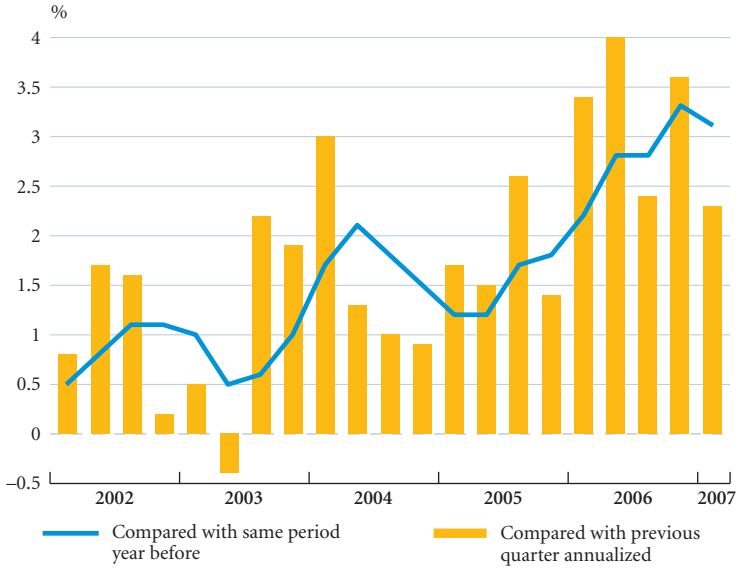
Investment still one of main supports of growth.

This improvement in private consumption is fundamental for two reasons. The main reason is that it represents 60% of GDP in the euro area and, secondly, it provides a sharp line of defence against the slowdown taking place in the United States. Finally, growth based on domestic demand is often of better quality and less sensitive to the risk of a drop in growth in other economic areas. Industrial investment is holding at very high levels, both in consumer durables and in capital goods, the latter being boosted by the increase in exports. It may therefore be stated that investment is also continuing to be one of the basic supports of growth in the euro area.

The key factor in the boost in consumption has been job creation which has strengthened consumer confidence in the future. While at the

EURO AREA MAINTAINING FULL-SPEED-AHEAD

Change in gross domestic product in real terms



SOURCE: Eurostat and own calculations.

end of 2006 the unemployment rate was 7.9%, at this time the latest figure for March shows a rate of only 7.2%, an all-time low in the euro area. The improvement in the labour market is spread broadly to include all economic sectors and member countries. This symmetry is a positive factor as it reflects the strength of job creation.

With regard to imbalances, inflation is holding below 2% in spite of the high

Europe's capacity to further increase growth helped by high job creation.

EURO AREA: MAIN ECONOMIC INDICATORS

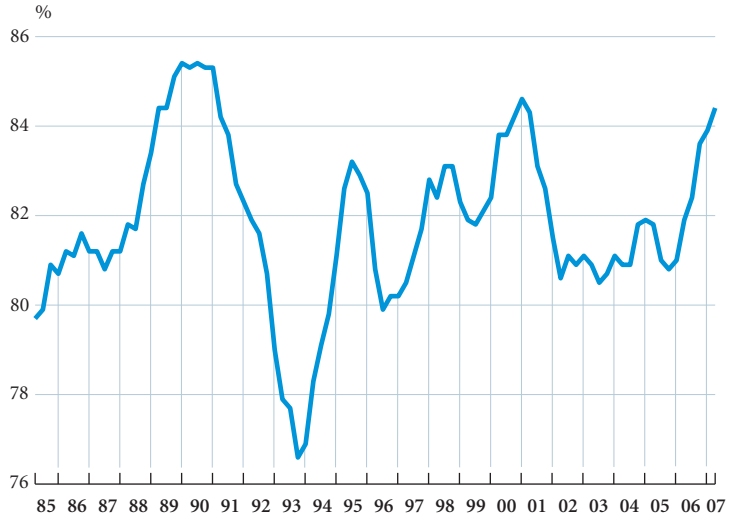
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007	
			1Q	2Q	3Q	4Q	1Q	April
GDP	1.5	2.8	2.2	2.8	2.8	3.3	3.1	–
Retail sales	1.2	2.0	1.2	2.2	2.3	2.3	1.7	...
Consumer confidence (*)	–14	–9	–11	–10	–8	–7	–5	–4
Industrial production	1.3	4.0	3.5	4.3	4.1	3.9	3.8	...
Economic sentiment indicator (*)	97.9	106.9	102.6	106.8	108.2	109.9	110.0	111.0
Unemployment rate (**)	8.6	7.9	8.2	7.9	7.8	7.6	7.3	...
Consumer prices	2.2	2.2	2.3	2.5	2.1	1.8	1.9	1.9
Trade balance (***)	42.1	–10.4	3.0	–10.0	–21.6	–13.1	–4.1	...

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

INDUSTRY STEPS ON THE GAS

Utilization of industrial production capacity



SOURCE: Eurostat and own calculations.

Inflation stays below 2% in spite of high level of utilization of production capacity, thanks to rise in productivity.

level of utilization of industrial capacity, helped by a sharp increase in cyclical productivity in the euro area and the appreciation of the euro which is making it possible to keep down import prices.

Nevertheless, the appreciation of the euro meant that the euro area's trade deficit with China rose by 30% in the first two months of the year going to 19.7 billion euros. The trade deficit with Japan also rose by 15% to reach 3.8 billion euros in the January-February period.

Germany: economic engine increasing speed

German growth stands at 3.6% in first quarter, higher than expected, in spite of increase in VAT.

The GDP rose by 3.6% in the first quarter, slightly less than in the last quarter of 2006. The reason was the expected drop in private consumption following the rise in VAT. Growth was especially based on capital formation which maintained its already strong trend. Net exports also made a positive contribution to growth of Germany's economy. Furthermore, the disappearance of the VAT effect in the second quarter will boost growth of consumption which will likely show its true strength.

On the supply side, two factors continue to be very positive. Firstly, industrial production, which showed growth of 7.7% annual in March. Not only order books but also domestic demand continue to drive German industry. The second positive factor is job creation and the reduction of unemployment. In the first quarter some 174,000 jobs were created and the unemployment rate dropped to 9.2% from the 9.8% at the end of last year.

These very positive factors have pushed up indices for business sentiment. The IFO industrial activity index hit 108.6 points in May putting it within range of

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007	
			1Q	2Q	3Q	4Q	1Q	April
GDP	1.1	3.0	1.9	2.9	3.2	3.9	3.6	–
Retail sales	1.4	6.6	7.5	6.8	6.6	7.4	–3.8	...
Industrial production	2.8	5.6	4.6	6.0	6.6	6.1	1.51	...
Industrial activity index (IFO) (*)	95.5	105.5	103.6	106.1	105.2	107.0	107.5	108.6
Unemployment rate (**)	11.7	10.8	11.4	11.0	10.6	10.1	9.3	9.2
Consumer prices	2.0	1.7	2.0	1.9	1.6	1.3	1.8	1.9
Trade balance (***)	156.3	153.1	154.6	151.2	148.3	158.1	168.4	...

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

all-time highs since reunification. German business executives have good reason to be optimistic. Company profits are rising, exports are holding firm in spite of a strong euro and, finally, consumption should behave well in coming quarters. Not even the increase in oil prices has managed to erode the optimism of German business executives. The factors set out above have pushed up consumer confidence that has gone to its highest levels since 1985.

In addition, in spite of the high growth, inflation is still below 2%. Since March of this year it has held at 1.9%. While the latest wage agreements have included better conditions than in recent years, the sharp increase in productivity will prevent unit labour costs from rising. In addition, the much-feared repercussions on GDP from the increase in VAT were lower than expected. This is partly because business executives brought forward those repercussions on prices last year and partly because of lower increases in energy prices.

France: going full-steam-ahead

Inflation stays below 2%.

The French GDP grew at an annual rate of 2.0% in the first quarter. All headings continue to show strong although increased imports (with an increase of 3.4%) and lower private consumption (showing an rise of 1.6%) reduced growth by two decimals. Private consumption was slightly weaker in services (heading for transport, health and restaurants). Inventories also made a negative contribution in the first quarter.

Strength of French economy holding up.

Two factors make it possible to be optimistic regarding consumption in coming quarters, specifically, the high level of consumer confidence and the expected announcement of tax cuts in July.

On the supply side, corporate confidence stands at its highest point since March 2001. This increase in company expectations is based on an increase in foreign orders and the need to rebuild inventories that have dropped to very low levels. This would indicate

Despite slack consumption in first quarter, this likely will be compensated by bigger growth in second quarter.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007	
			1Q	2Q	3Q	4Q	1Q	April
GDP	1.7	2.2	1.9	2.7	2.1	2.2	2.0	–
Domestic consumption	2.9	4.2	2.8	4.8	4.3	4.9	6.0	...
Industrial production	0.2	1.0	0.6	1.8	0.7	0.8	1.9	...
Unemployment rate (*)	9.8	9.0	9.5	9.1	8.8	8.6	8.4	...
Consumer prices	1.7	1.7	1.8	1.9	1.7	1.3	1.2	1.3
Trade balance (**)	–1.3	–2.1	–2.0	–2.0	–2.3	–2.2	–2.2	...

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

Labour market confirms strength along with continued absence of price rises.

that industrial production will likely increase in coming months. At this moment, industrial production is growing at an annual rate of 1.1%. The strength of the labour market is demonstrated by an unemployment rate of 8.3% in April, the lowest level in the past 24 years. The number of unemployed dropped by 71,000 persons in the first quarter of this year. Employment, excluding the agricultural sector and the public sector, grew at an annual rate of 1.4%. This is another factor that should help private consumption in coming quarters.

Initial measures of new government will be key for bracing up economic growth.

The new French president, Nicolas Sarkozy, began his mandate by announcing his new government. There are several aspects on this worth noting. Firstly, the opening to the centre and the left in order to ensure a broad parliamentary majority in the legislative elections to be held in June. Secondly, the powerful Ministry of Economy and Finance has been divided in two with the Ministry of Finance remaining along with a new Ministry of Economic Strategy, a clear indication that the president wants to weaken the traditional influence of the technocrats on the Budget and the Treasury. Finally, it is worth noting that the new president has named persons of great experience and negotiating skills who have had good relations with the trade unions putting them in key posts involved in negotiations aimed at domestic reforms. The initial measures the new government carries out will be of great importance for maintaining growth and letting the economic agents know the new road to be followed.

Italy also exists

Italy grows by 2.3% in first quarter, more than expected, thanks to private consumption and investment.

The GDP grew by 2.3% in the first quarter. While a breakdown of components is not yet available, the trend in monthly indicators points to a substantial contribution from private consumption and investment. Following the stagnation in retail sales in the first month of the year (0.0%), these picked up in February. The increase in net disposable income and tax incentives for buying cars and other durable goods should give support to consumption this year.

Industrial production grew at the rate of 1.3% in March. Following the sharp growth in the last quarter of 2006 (3.8%), we can expect a slight slowdown greater than that seen in Italy in the first

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007			
			1Q	2Q	3Q	4Q	January	February	March	April
GDP	0.2	1.9	1.7	1.6	1.6	2.8	–	2.3	–	–
Retail sales	0.4	1.2	0.5	1.8	1.6	1.0	0.0	0.4	...	...
Industrial production	–0.8	2.6	3.2	1.9	1.6	3.8	1.6	0.7	1.3	...
Unemployment rate (*)	7.7	6.8	7.2	6.9	6.7	6.5	–	...	–	–
Consumer prices	1.9	2.1	2.1	2.2	2.2	1.8	1.7	1.8	1.7	1.5

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

quarter. Nevertheless, growth of export orders improved prospects along with a slight reduction in inventories which pushed up industrial production, especially in consumer goods production.

Business confidence is at its highest in the past six years. High utilization of industrial production capacity and the expected recovery in public spending is giving business executives good cheer. Finally, we should end this review with a reminder that inflation showed moderate growth in April (1.5% year-on-year compared with 1.7% in March). Since October last year, Italy has held inflation below 2%, which makes it possible to state that it is showing enviable price stability.

United Kingdom: focus on consumption

Now that the preliminary estimate for growth in the first quarter is known (2.9% year-on-year), the main doubt about the drive in the British economy remains the future trend in private consumption. Available indicators, especially those for retail sales, suggest that a decline is in progress. While these were growing at a rate of 5.0% in March, they showed a drop in April to a rate of 4.2% year-on-year. It would seem that, following the latest rise in official interest rates, the increase in the cost of mortgage borrowing combined with the rise in taxes is reducing net disposable income of households. It is still too soon, however, to state that consumption has begun to follow a slowdown path. Furthermore, the labour market is holding strong given that the unemployment rate continues at a surprising 2.8%, while consumer confidence remains high, which should help consumption.

On the export side, industrial production is suffering from the strength of the pound sterling which is being supported by the latest interest rate increases. Whereas in the last quarter of 2006 industrial production grew at a rate pf 1.0% year-on-year, the latest figure for March indicates a drop of 0.2%.

With regard to other matters of interest, we should mention that, in spite of the fact that inflation in April was down to 2.8% from 3.1% the month before, the trend in prices is still troubling to Bank of England governor Mervyn King. The central bank indicated the need to again raise the official interest rate bring inflation back to around 2%. The trade

United Kingdom grows by 2.8% marking up record with 59 consecutive quarters of growth.

Consumption defies latest interest rate increases and labour market fails to take note.

Inflation remains troublesome matter for Bank of England.

deficit is maintaining a slightly worse course due to the higher relative growth of imports compared with exports, which is a reflection of the appreciation of the pound sterling.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006				2007	
			1Q	2Q	3Q	4Q	1Q	April
GDP	1.9	2.8	2.4	2.7	2.9	3.0	2.9	–
Retail sales	1.9	3.2	1.7	3.4	3.8	3.8	4.6	4.2
Industrial production	–1.9	0.1	–0.7	–0.4	0.6	1.0	–0.5	...
Unemployment rate (*)	2.7	3.0	2.9	3.0	3.0	3.0	2.9	2.8
Consumer prices	2.0	2.3	1.9	2.2	2.4	2.7	2.9	2.8
Trade balance (**)	–64.9	–78.5	–72.0	–77.5	–81.4	–83.2	–83.2	...

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

Sound institutions, the missing link in Latin America's progress

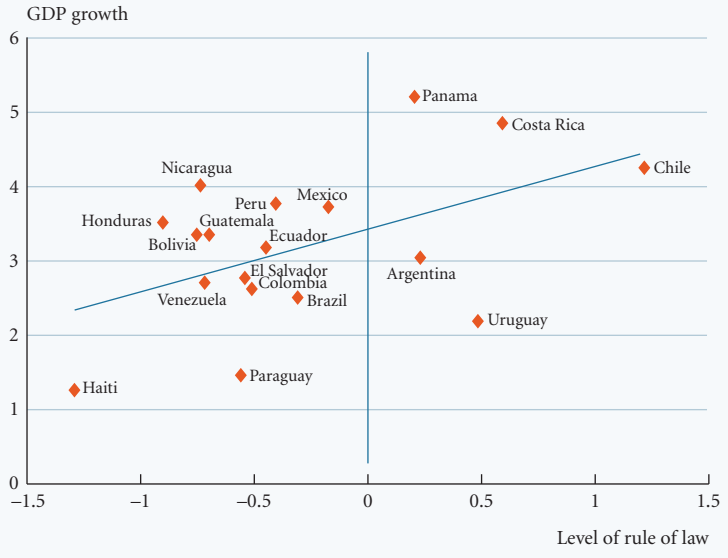
In 1941, the illustrious writer Stefan Zweig prophesied that Brazil was undoubtedly the land of the future. This was a view that could easily have been broadened to Latin America as a whole, given that it was a time when people were speculating about the precise moment when Argentina would become one of the world's richest countries. Nearly seven decades later, the view of the writer second most read in his time and of his contemporaries may seem that of a dreamer. The economic history of Latin America is marked by periods that exemplify wrong approaches to economic development, such as the policy of substituting imports begun at the end of the Forties or the «lost decade» of the Eighties. The question that constantly arises when one studies the region is why some countries that possess vast natural resources, that are geographically close to the United States and culturally close to Europe and have benefited at various moment in history from notable waves of immigration have not ended up taking off economically.

No doubt, factors such as the degree of accumulation of production factors (capital and labour) and the management of macroeconomic policies are relevant, as set out in the previous box. Here, we examine in more detail the role of institutions, a factor the importance of which was intuited by Adam Smith and which two centuries later has been «rediscovered» by economists. As seen in the following graph, the question is relevant in Latin America. Economic prosperity and institutions are closely linked together, given that those countries in the region with the strongest institutions in 1996 are those that on average have grown most in the period 1996-2006.

As opposed to the prevailing view two decades ago, today it is not believed that countries would develop stronger institutions starting out from a certain level of economic prosperity. As put forward by economist Douglass North, the causation may rather be the opposite. Institutions (understood as rules of the game, formal and informal, that establish the framework within which interactions of a social, political or economic

SOUNDNESS OF INSTITUTIONS AFFECTS GROWTH

Relation between average GDP growth in 1996-2006 and level of rule of law in 1996



SOURCE: World Bank, International Monetary Fund and own calculations.

nature take place) are determinants of economic development. «Good» institutions are those that create a system of incentives for the economic agents which helps to reduce uncertainty and promote efficiency. While simple enough, the idea is quite powerful. It is not surprising that in 1993 North obtained the Nobel Prize for Economics for his forward vision.

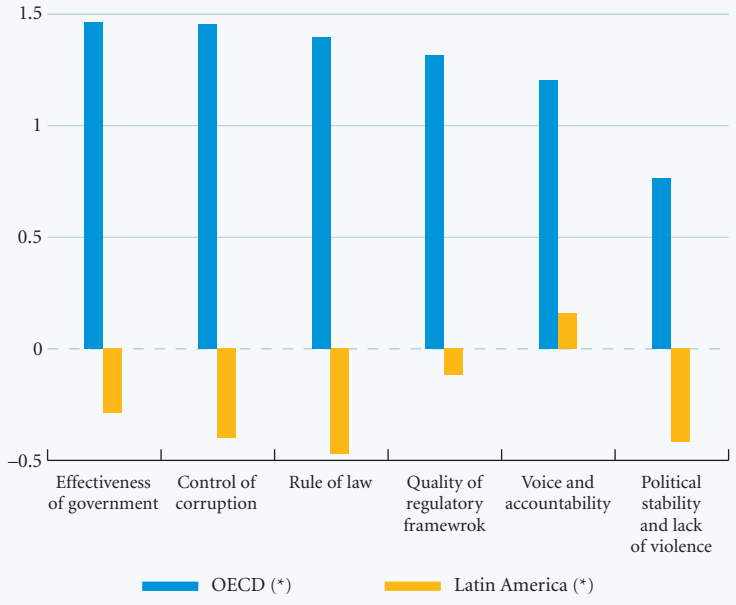
What is the situation in Latin America? The reply does not come rapidly given that «measuring the soundness of institutions» is an exercise with its evident difficulties. Nevertheless, in view of its importance in economic terms, for a number of years the World Bank has carried out the key work of clarifying the concept and empirical measurement of the soundness of institutions.[1] As a key concept, it employs the idea of governance, that is to say, the processes and institutions through which political power is exercised in a country. Governance is broken down into three different segments: 1) the process through which the government is elected, accounts for its actions and is replaced, measured by two indicators – voice and accountability and political stability: 2) the capacity of government to manage resources efficiently and to formulate and institute regulations and policies and ensure that they are implemented. In this case, the indicators are the quality of regulatory framewrok and the effectiveness of the government; and 3) the respect for institutions governing social and economic interactions which is approached by means of an indicator of control of corruption and another on the rule of law.

Using these indicators from the World Bank it is possible to obtain an X-ray of Latin America in terms of the soundness of its institutions. If we take the group of most developed countries as a reference (those in the Organization for Economic Cooperation and Development, OECD, excluding Mexico), we may extract certain conclusions about the situation in the region. As may be seen in the following graph, to start with, Latin

(1) For a summary of this approach and database, refer to Kaufmann, D., Kraay, A. and Mastruzzi, M., «Governance Matters V: Aggregate and Individual Governance Indicators for 1996-2005» (2006). World Bank Policy Research Working Paper No. 4012.

MAJOR CHALLENGES REMAIN FOR LATIN AMERICA IN INSTITUTIONAL MATTERS

Indicator of soundness in areas of governance (2005)



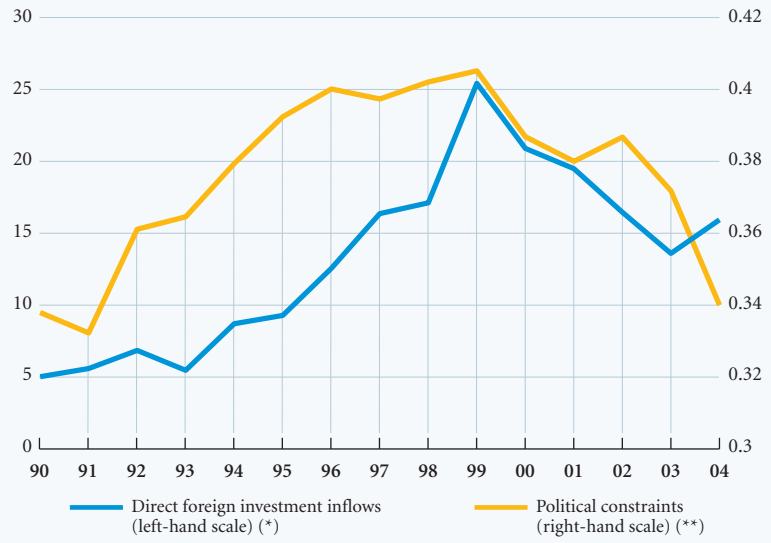
NOTES: (*) Mexico has been eliminated from OECD group and has been included in total Latin America.
SOURCE: World Bank and own calculations.

America has a level of governance substantially lower in soundness than that of the OECD countries. Furthermore, the breakdown by areas of governance also varies. In the more developed countries the areas showing the highest degree of soundness are the effectiveness of government, control of corruption and rule of law. On the contrary, the best situation in Latin America is held in areas of voice and accountability and the quality of regulatory framewrok, while the third aspect is the effectiveness of government. Indeed, Latin America still has some way to go in improving governance before it comes level with the more advanced countries around the globe. Furthermore, its starting point in not only lower but quite different.

In this regional evaluation we should not overlook the fact that the situation is notably uneven. On looking at the previous six indicators, it is possible to identify three large groups of countries. A few have a situation on a similar level to the advanced economies. This is the case of Chile and Costa Rica and, somewhat less well defined, Uruguay. A second group is made up of states that show a lower level of institutions but with some strengths in one or more areas. This is the situation found, for example, in two large regional economies (Brazil and Mexico) and in other countries such as Argentina and Colombia. Finally, the situation in some states is clearly more complicated. Among these countries, we should not fail to mention the case of Haiti.

The challenge, therefore, is how to shift a country toward a situation with a higher level of institutions. The course followed in the past decade shows that, while demanding, the challenge is not impossible. If we take an overall indicator of the institutional framework (that known as «The Index of Economic Freedom» published by the Heritage Foundation), we gather that, with some major swings, the overall institutional framework of Latin America in 2007 is more favourable in terms of business and trade freedom, more secure in the defence of property rights and more open to foreign direct investment than it was ten years ago.

LOW POLITICAL CONSTRAINTS, A POOR OPTION FOR ATTRACTING FOREIGN INVESTMENT



NOTES: (*) Inflows of direct foreign investment as percentage of total gross capital formation.
(**) Witold Henisz indicator of political constrainsts; the higher the value, the lower the margin of arbitrary power of political players.
SOURCE: Witold Henisz, Naciones Unidas and own calculations.

The process, however, is loaded with difficulties. One of the most troubling is certainly that concerning legal protection. While other aspects of institutional soundness may be improved, one of the fundamental decisions along the road to economic development, deciding to invest in the region, is critically dependent on the existence of a legal framework governed by rules that are not only clear but also stable. This matter has turned out to be essential in the key discussion about determinants of direct foreign investment. In a series of influential recent papers, Witold Henisz shows that the degree political constrainsts is closely related to investment decisions and that, in turn, political constrainsts is linked to the institutional framework.[2] In this matter, especially in recent years, the results have not been satisfactory.

Finally, for Brazil (and Argentina and Mexico and the whole region) to really become the land of the future as glimpsed by Zweig and his contemporaries, a lot will depend on the decisions taken in a field (institutional reform) that will yield its fruit over a long period of time. However, without this investment in institutional capital, other «lost decades» could likely hang over a region that deserves a better future.

(2) Because of its general nature, we recommend Henisz, W.J. (2004) «Political Institutions and Policy Volatility». Economics and Politics 16 (1): 1-27.

FINANCIAL MARKETS

Monetary and capital markets

Monetary policies continue watch over inflation

Central banks hardening monetary policies but money supply still high.

In general, the central banks continue to feel that inflationary risks still exist, especially after the recent boost in oil prices. All through May, some of the main central banks continued to raise official interest rates thus helping to reduce world money supply which, in any case, remains abundant.

Further increases in Bank of England official rate to contain inflation still lie ahead.

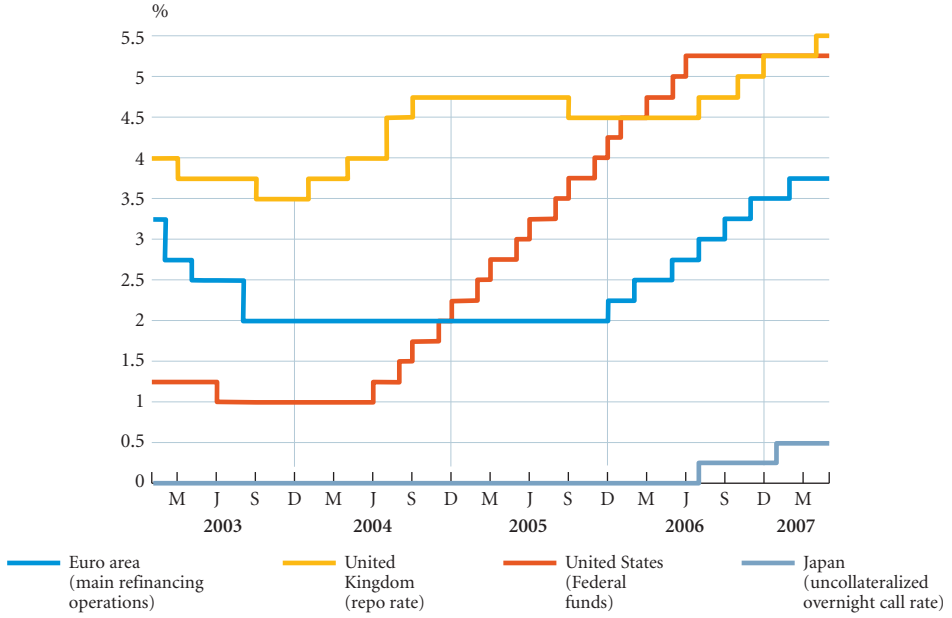
This is the case with the Bank of England which raised its reference rate by 25 basis points to 5.50% at the meeting of its Monetary Policy Committee on May 10. With this move it put the rate at the highest level in the past six years.

The British central bank justified the move in order to contain inflation which had reached 3.1% in March, well above the objective of 2% in an environment of strong economic growth. Later on, at the presentation of the central bank's report on inflation, governor Mervyn King suggested that the restrictive cycle had not ended, thus confirming current expectations.

In Asia, the Bank of China again raised its reference rates in a new attempt to cool down the run-away economy. It raised the interest rate on 1-year loans by 18 basis points to 6.57% and on 12-month deposits by 27 basis points to 3.06%. Furthermore, cash ratio for banks was raised a half-point to 11.5%.

BANK OF ENGLAND RAISES OFFICIAL INTEREST RATE

Monetary policy reference interest rates



SOURCE: National central banks.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euríbor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2006									
April	2.58	2.79	3.22	4.75	5.07	0.13	4.50	4.63	1.28
May	2.58	2.89	3.31	5.00	5.18	0.19	4.50	4.70	1.40
June	2.76	2.99	3.40	5.03	5.38	0.31	4.50	4.73	1.48
July	2.80	3.10	3.54	5.25	5.50	0.40	4.50	4.73	1.53
August	2.98	3.23	3.62	5.25	5.42	0.44	4.73	4.94	1.61
September	3.03	3.34	3.72	5.25	5.38	0.44	4.75	5.03	1.74
October	3.23	3.50	3.80	5.25	5.37	0.44	4.75	5.13	1.85
November	3.31	3.60	3.86	5.25	5.37	0.48	4.93	5.23	1.90
December	3.50	3.68	3.92	5.25	5.36	0.53	5.00	5.29	2.02
2007									
January	3.56	3.75	4.06	5.25	5.36	0.55	5.16	5.49	2.15
February	3.55	3.82	4.09	5.25	5.36	0.57	5.25	5.57	2.21
March	3.75	3.89	4.11	5.25	5.35	0.67	5.25	5.55	2.26
April (*)	3.82	3.98	4.25	5.25	5.35	0.65	5.25	5.65	2.32
May (1)	3.82	4.10	4.42	5.25	5.36	0.66	5.50	5.80	2.46

NOTES: (*) Provisional figures.
(1) May 25.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 2-3-06 (2.50%), 8-6-06 (2.75%), 3-8-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%), 8-3-07 (3.75%).
(3) Latest dates showing change: 9-8-05 (3.50%), 20-9-05 (3.75%), 1-11-05 (4.00%), 13-12-05 (4.25%), 31-1-06 (4.50%), 28-3-06 (4.75%), 10-5-06 (5.00%), 29-6-06 (5.25%).
(4) Latest dates showing change: 6-5-04 (4.25%), 10-6-04 (4.50%), 5-8-04 (4.75%), 4-8-05 (4.50%), 3-8-06 (4.75%), 9-11-06 (5.00%), 11-1-07 (5.25%), 10-5-07 (5.50%).
(5) Interbank offer rate.
SOURCE: National central banks, Thomson Financial Datastream and own calculations.

On the other hand, the Bank of Japan made no change in its position on monetary policy at its meeting on May 17. In its report on the economy, the Japanese monetary authority considered that growth would continue at a moderate rate. While it foresaw inflation remaining close to 0% over the short term, it forecast that over the long term it would be positive, in keeping with greater utilization of production capacity. In this environment, it is likely that the Japanese central bank will continue to gradually normalize its official interest rate (now at 0.50%). Its next move could take place in the summer.

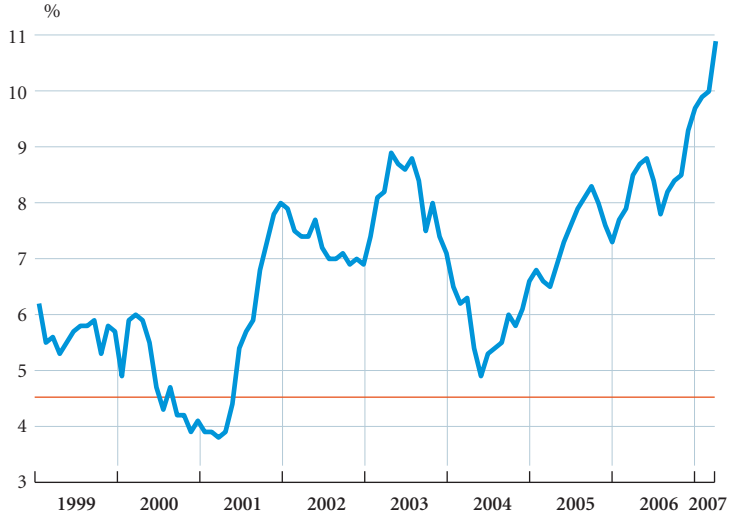
On the other side of the Pacific, the US Federal Reserve also made no move to modify its position at its meeting on May 9. The Fed repeated that the main risk was that inflation would not moderate as expected. Nevertheless, financial markets continue to bet that the next move will be downward, given the slowdown in the economy and the delicate state of the real estate market.

In Europe, up to that point the European Central Bank had also made no change in its interest rates. Nevertheless, chairman Jean-Claude Trichet issued a clear signal that these

Bank of China again raises reference rates slightly in attempt to halt overheating of economy.

NEW ALL-TIME HIGH IN GLOWTH OF BROAD MONEY SUPPLY FIGURE FOR EURO AREA

Year-on-year change rate in M3 for euro area



NOTE: Red line represents reference growth of 4.5%.
SOURCE: European Central Bank.

Eurosystem interest rate very unlikely to stay at 4% forecast for June.

would rise at its meeting on June 6, mentioning that «strong vigilance» was necessary. Trichet insisted that inflationary risks were increasing. Given that he recognized that monetary policy remained easy and that growth of the broad M3 money supply figure in the euro area in March had reached 10.9% in year-on-year terms (marking up a new all-time high and standing at more than twice the reference figure of 4.5%), it is likely that the rise in the Eurosystem interest rate will not stay at the 4% as expected for June.

Yen and dollar weaken

Dollar falls to lowest level against broad basket of currencies in last 10 years.

The slowdown in economic activity in the United States and subsequent expectations of cuts in the Federal Reserve interest rate have slightly weakened the dollar in recent weeks. In the fourth week of May, the effective exchange rate of the US currency recorded its lowest level since July 1997. The dollar showed a drop of 20.1% compared with the high at the beginning of 2002. Nevertheless, this depreciation does not seem sufficient to balance the massive US foreign deficit so that downward pressure on the greenback will likely continue.

The depreciation of the dollar in recent weeks has especially shown up against emerging country currencies as, for example, the Brazilian real and the Philippine peso which showed their highest exchange rate against the dollar in recent years. On the other hand, the dollar held up against the euro after the European currency had marked up an all-time high of 1.365 dollars on April 25, 2007.

The weakness of the dollar did not especially show up against the Japanese yen in a situation of renewed appetite for risk boosted by the carry trade, that is, by transactions involving borrowing in currencies with low interest rates, such as

EXCHANGE RATES OF MAIN CURRENCIES

April 2007

	Final session of month		Monthly figures				*Exchange rate May 25, 2007*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2)			
				Monthly	Over December 2006	Annual	
Against US dollar							
Japanese yen	119.4	1.5	118.9	1.4	1.3	1.7	*121.8*
Pound sterling (1)	2.000	1.6	1.988	2.1	1.3	12.4	*1.984*
Swiss franc	1.207	–0.5	1.213	–0.4	0.2	–5.4	*1.228*
Canadian dollar	1.110	–3.8	1.135	–2.9	–1.6	–0.8	*1.080*
Mexican peso	10.93	–1.0	10.98	–1.2	1.2	–0.6	*10.78*
Nominal effective index (4)	*104.5*	*–1.4*	*105.3*	*–1.3*	*–1.3*	*–4.1*	*104.2*
Against euro							
US dollar	1.361	2.2	1.350	2.0	2.2	10.2	*1.344*
Japanese yen	162.8	3.5	160.5	3.4	3.6	11.8	*163.5*
Swiss franc	1.646	1.3	1.637	1.5	2.5	4.0	*1.650*
Pound sterling	0.683	0.4	0.679	–0.1	1.0	–2.1	*0.678*
Swedish krona	9.152	–2.1	9.240	–0.6	2.3	–1.0	*9.191*
Danish krone (3)	7.451	0.0	7.453	0.0	0.0	–0.1	*7.452*
Polish zloty	3.781	–2.2	3.817	–1.8	0.1	–2.7	*3.811*
Czech crown	28.12	0.4	28.01	–0.2	0.9	–1.8	*28.31*
Hungarian forint	247.2	–0.3	246.0	–1.6	–3.1	–7.4	*249.8*
Nominal effective index (5)	*107.6*	*1.1*	*107.1*	*0.9*	*1.4*	*4.0*	*107.0*

NOTES: (1) Units to pound sterling.
(2) Percentages of change refer to rates as shown in table.
(3) Danish krone has central parity of 7.46038 against euro with fluctuation band of ±2.25%.
(4) Broad nominal effective index of US Federal Reserve Board. Calculated as a weighted average of the foreign exchange value of the US dollar against the 26 currencies of those countries with greatest volume of trade with the United States. Base: 1-1997 = 100.
(5) European Central Bank nominal effective exchange rate index for the euro. Calculated as a weighted average of the bilateral value of the euro against the currencies of the 23 main trading partners of the euro area. Base: I-1999 = 100.
SOURCE: Thomson Financial Datastream and own calculations.

the yen, while at the same time investing in high-yield currencies. In fact, the yen again dropped in overall terms going to its lowest level since October 1998. In terms of the euro, the Japanese currency marked up an all-time low of 163.9 units in the fourth week of May.

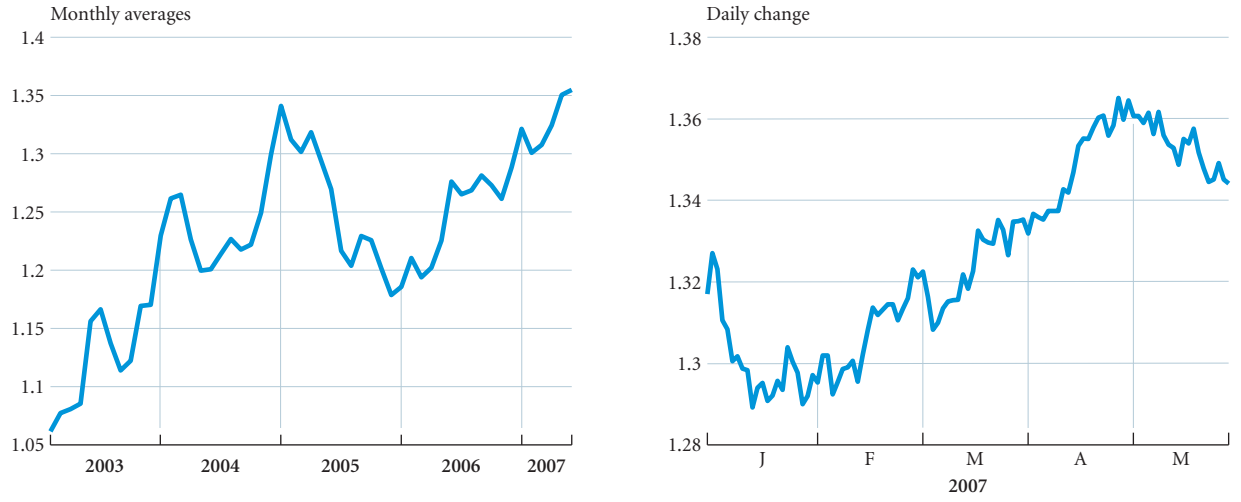
In this context, the euro also recorded a record against the Swiss franc in the fourth week of May when it went to 1.656 Swiss francs. The substantial interest rate differential in favour of the European currency and the prospect of further rate increases by the European Central Bank boosted the euro in another carry trade situation.

In addition, at the end of the third week of May the Bank of China announced the widening of the daily fluctuation band for the renmimbi in place since July 2005 from 0.3% to 0.5%. This decision came just a few days before the visit of a Chinese ministerial delegation to meet with US Secretary of the Treasury Henry Paulson. In fact, this move was largely of a symbolic nature given that the day-to-day change in the yuan practically never comes near the maximum limit of 0.3%.

Euro marks up record against Swiss franc bolstered by substantial differential in interest rates in its favour.

EURO EASES AFTER MARKING UP ALL-TIME HIGH AGAINST DOLLAR

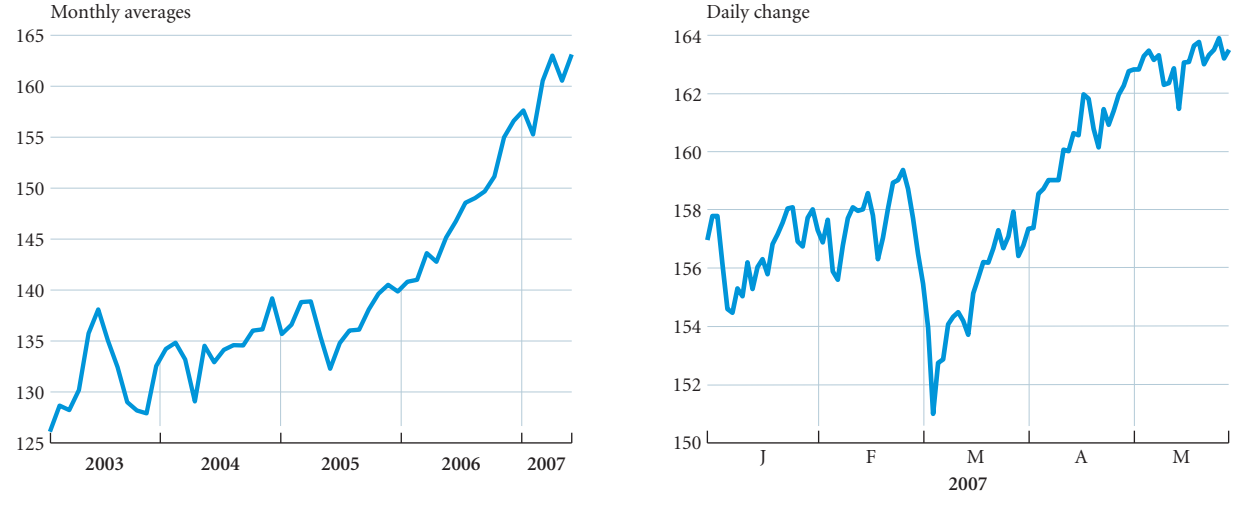
US dollars to euro



NOTES: Figures go up to May 25.
SOURCE: Thomson Financial Datastream and own calculations.

EURO RECORDS NEW HIGH AGAINST YEN WITH BOOST IN CARRY TRADE

Yen to euro



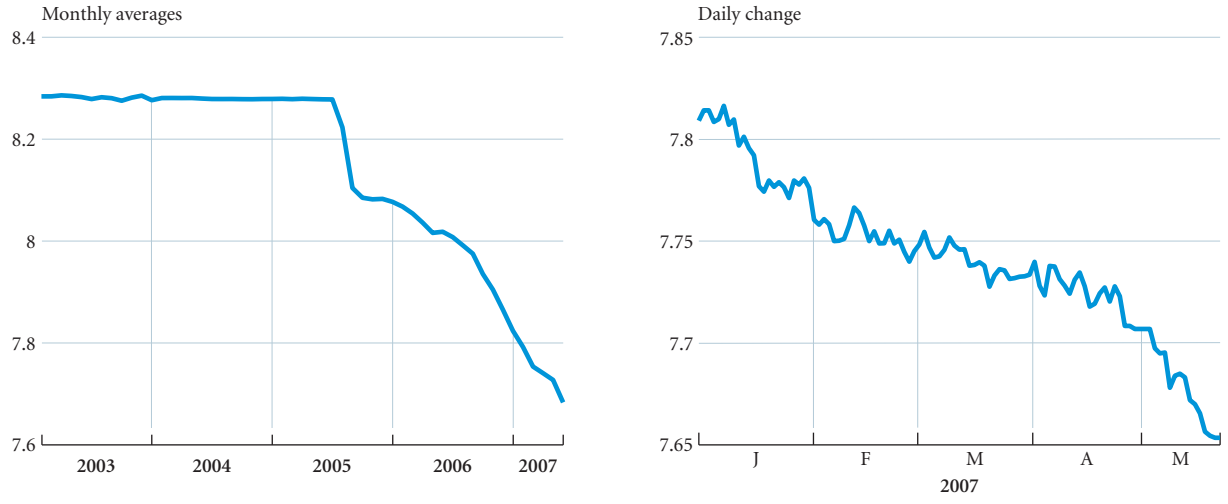
NOTES: Figures go up to May 25.
SOURCE: Thomson Financial Datastream and own calculations.

Bank of China announces widening of daily fluctuation band for yuan with little practical effect.

Following the announcement, however, the Japanese yen moved up briefly against the dollar only to mark up a new overall low a few days later. Nevertheless, as may be seen in the following graph, the Chinese currency continues on a gradual path of appreciation against the dollar. It has risen by about 2% since the beginning of the year and 8% since July 20, 2005 before controlled flotation was begun. The Chinese authorities do not like brusque changes.

CHINESE YUAN APPRECIATING VERY GRADUALLY AGAINST DOLLAR

Chinese yuan to US dollar



NOTES: Figures go up to May 25.
SOURCE: Thomson Financial Datastream and own calculations.

Gradual rise in government bond yields

The repeated concern about inflation expressed by the US Federal Reserve and the low levels of risk aversion now current, that took away the safe-haven role of government bonds, tended to push yields on US government bonds upward. In any case, the interest rate on US 10-year Treasury bonds did not go above the level at the end of January.

On this side of the Atlantic, the yield on German government bonds rose in recent weeks pushed up by statements by various executives of the European Central Bank. As a result, the yield on German 10-year government bonds marked up a high since June 2004 in the

Yield on German long-term government bonds moves up to highest level since June 2004.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

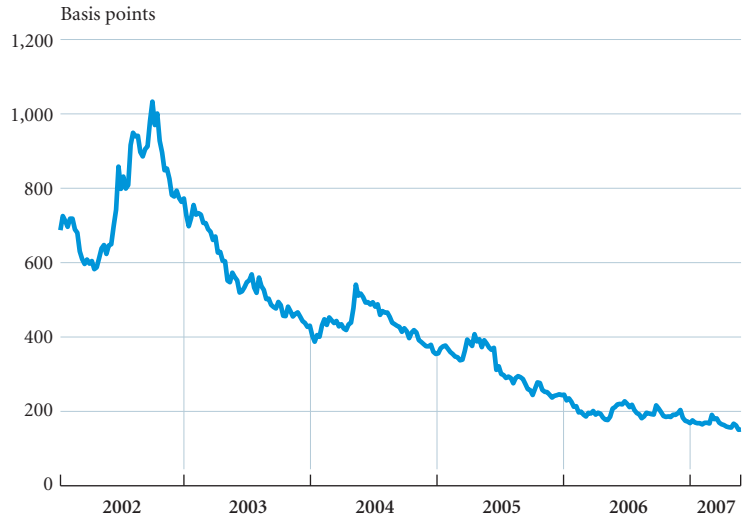
10-year government bonds: average for period as annual percentage

	2005	2006	2006			2007		
			2Q	3Q	4Q	1Q	April	May 25
United States	4.33	4.85	5.13	4.96	4.68	4.74	4.75	4.86
Japan	1.39	1.75	1.90	1.80	1.70	1.68	1.68	1.72
Germany	3.38	3.78	3.96	3.89	3.77	4.01	4.16	4.37
France	3.41	3.80	3.99	3.90	3.78	4.05	4.21	4.42
Italy	3.56	4.05	4.27	4.18	4.03	4.23	4.38	4.56
Spain	3.39	3.79	3.97	3.89	3.79	4.06	4.21	4.43
United Kingdom	4.47	4.55	4.65	4.67	4.65	4.92	5.10	5.23
Switzerland	2.04	2.46	2.67	2.61	2.38	2.57	2.74	2.95

SOURCE: Bank of Spain, Thomson Financial Datastream and own calculations.

RISK PREMIUM ON EMERGING COUNTRY SOVEREIGN BONDS RECORDS NEW ALL-TIME LOW

Differential in sovereign bonds of emerging countries compared with US Treasury bonds measured with JP Morgan EMBI+ index



NOTES: Figures go up to May 25.
SOURCE: JP Morgan and Thomson Financial Datastream.

Increase expected in default of low-credit-rating bonds starting out from very low levels.

fourth week of May. The differential in long-term interest rates between the dollar and the euro stood at 49 basis points.

In addition, the risk premium on sovereign bonds of emerging countries dropped to an all-time low in the fourth week of May. In recent weeks the risk premium on corporate bonds has also continued to drop going to low levels. This trend is helped by low default levels as a result of the favourable economic situation and ample liquidity in financial markets. In any case, April brought a very slight rise in the default rate for global low-credit-rating bonds, according to Moody's rating agency. It rose to 1.5% in the last 12 months from the 1.4% recorded in March.

Growth of company profits, lively activity in corporate mergers and ample liquidity help boost stock markets.

This slight rise is in line with the forecast of an increase in this rate in 2007 and 2008.

Stock markets mark up new all-time highs

After recovering from the sharp correction at the end of February, international stock markets again moved into an upward stage and in recent weeks they have generally marked up new all-time highs. Notable growth in company profits, the flurry of corporate moves in acquisitions and mergers and high liquidity in international financial markets came as a counter to higher oil prices. While the good state of the world economy is helping the boost in the stock markets, we should not discount the possibility of further shocks.

The US stock markets have continued to advance in recent weeks betting on a «soft landing» for the economy to the point where the broad Standard & Poor's 500 index stood very close to the record set back in 2000. On the other hand, the

INDICES OF MAIN WORLD STOCK EXCHANGES

April 30, 2007

	Index (*)	% monthly change	% cumulative change	% annual change	*Quotation on May 25, 2007*	
					% cumulative change	*% change over same date in 2004*
New York						
Dow Jones	*13,062.9*	*5.7*	*4.8*	*14.9*	*8.4*	*33.5*
Standard & Poor's	*1,482.4*	*4.3*	*4.5*	*13.1*	*6.9*	*36.2*
Nasdaq	*2,525.1*	*4.3*	*4.5*	*8.7*	*5.9*	*30.2*
Tokyo	17,400.4	0.7	1.0	2.9	1.5	*59.5*
London	6,449.2	2.2	3.7	7.1	5.6	*48.7*
Euro area	4,392.3	5.1	6.6	14.4	8.3	*65.4*
Frankfurt	*7,408.9*	*7.1*	*12.3*	*23.3*	*17.3*	*102.2*
Paris	*5,960.0*	*5.8*	*7.5*	*14.9*	*9.3*	*67.8*
Amsterdam	*530.8*	*4.0*	*7.2*	*13.1*	*8.1*	*61.5*
Milan	*33,979.0*	*4.4*	*6.5*	*15.5*	*5.4*	*65.6*
Madrid	*14,374.6*	*–1.8*	*1.6*	*20.9*	*6.4*	*92.0*
Zurich	9,428.3	5.0	7.3	17.2	6.8	*66.1*
Hong Kong	20,319.0	2.6	1.8	22.0	2.8	*75.5*
Buenos Aires	2,154.6	2.5	3.1	12.9	3.9	*130.4*
São Paulo	48,956.0	6.9	10.1	21.3	16.1	*173.7*

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: Thomson Financial Datastream and own calculations.

Nasdaq index, which is representative of high-tech shares, in spite of marking up an annual high, still stood more than 40% of the record set before the bursting of the high-tech bubble. In fact, so far this year the information technology sector has shown a rather discreet rise.

Standard & Poor's index stands close to high in 2000 but Nasdaq still far behind.

In Europe, euphoria has predominated in the stock markets, thus reflecting the improvement in economic prospects. Of special note was the result in the German stock market which showed the biggest gains among the main European exchanges. On the other side of the English Channel, the London stock exchange also reported increases in keeping with the strength of the economy.

The Spanish stock market, in turn, recovered from the jolt suffered by real estate companies and moved into the range of market highs. The selective IBEX 35 index again went above the 15,000 points level marking up a record in the fourth week in May. The processes of restructuring now underway in various sectors is driving up market quotes.

Euphoria in European stock markets.

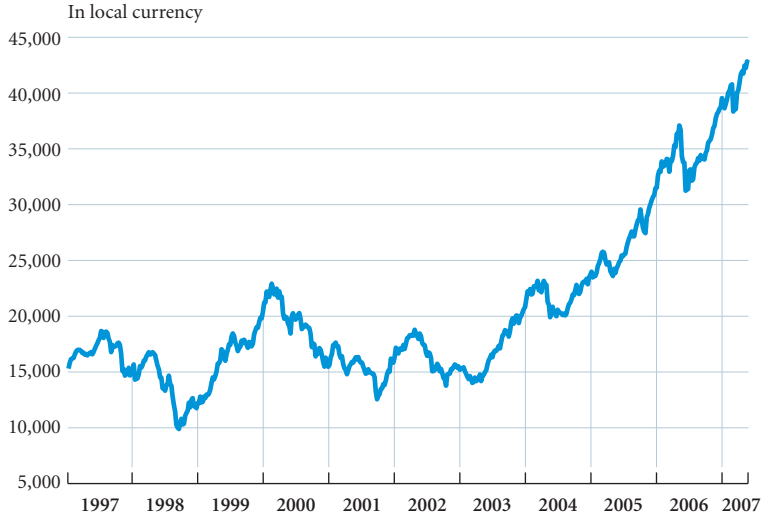
The recovery in recent weeks was especially notable in the case of emerging country stock markets. Many of these marked up new all-time highs, as in the case of Brazil, Mexico, South Korea, Indonesia, Philippines, Singapore, Hong Kong and China.

IBEX 35 again goes above 15,000 points level to mark up record.

The Chinese stock market is another matter. The index for the Shanghai stock

EMERGING COUNTRY STOCK MARKETS UP

Morgan Stanley Capital international index of emerging stock markets



NOTES: Figures go up to May 25.
SOURCE: Morgan Stanley Capital and Thomson Financial Datastream.

Chinese authorities vainly try to halt wild rise on stock markets.

exchange has risen more than 50% since the beginning of the year after a rise of 131% last year. The Chinese authorities have vainly tried to slow down the rise on the stock exchange in view of obvious signs of a speculative bubble, such as «per» ratios above 50. With this in mind, they recently liberalized investments by banks in foreign markets in order to take pressure off the domestic stock market.

Nevertheless, individual investors continue to bet on equities in view of the very low yield on bank deposits. The stock market fever showed up in the fact that daily turnover on Chinese stock markets went above the total volume of transactions on all other Asian markets, including Japan. We should point out that the phenomenon of the sky-high rise in Chinese indices is one more sign of the surplus liquidity accumulated in the economy, largely as a result of an excessively undervalued exchange rate which is bringing about a spectacular increase in foreign currency reserves.

SPAIN: OVERALL ANALYSIS

Economic activity

GDP grows more than expected

In the first quarter of 2007, gross domestic product (GDP) generated by Spain's economy was up 4.1% year-on-year, above the figure predicted by most analysts and previous estimates both by the Bank of Spain and the National Institute of Statistics itself. In any case, if we look at the quarterly change rate which more accurately reflects the most recent trend, we see that the rate of increase in GDP has eased slightly. This could indicate that the strong GDP growth rate has now come close to the top of the cycle.

What are the keys to the surprising drive in Spain's economy in recent months? Mainly, the progressive improvement in the foreign sector. In the first quarter of 2007 this took only 0.7 points away from GDP growth, much less than in the preceding period. (Its negative contribution in 2005 and 2006 was only 1.7 points and one point respectively.) Thanks to this current improvement, Spain's foreign deficit, the real Achilles' heel of the present model of Spanish growth, has tended to halt its sharply worsening situation.

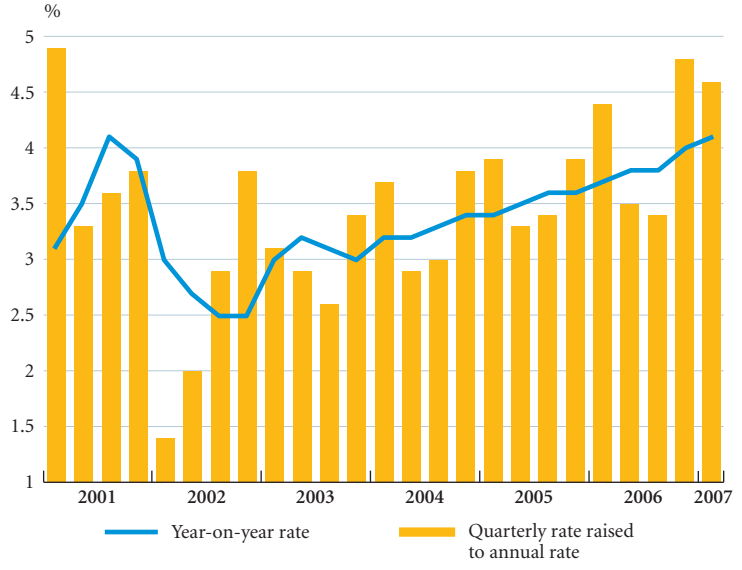
At the same time, national demand tended to moderate slightly

GDP bumps growth to 4.1% in first quarter of 2007, highest rate since 2001...

...partly thanks to negative contribution of foreign sector.

RISE IN GDP RATE MAY HAVE HIT CEILING

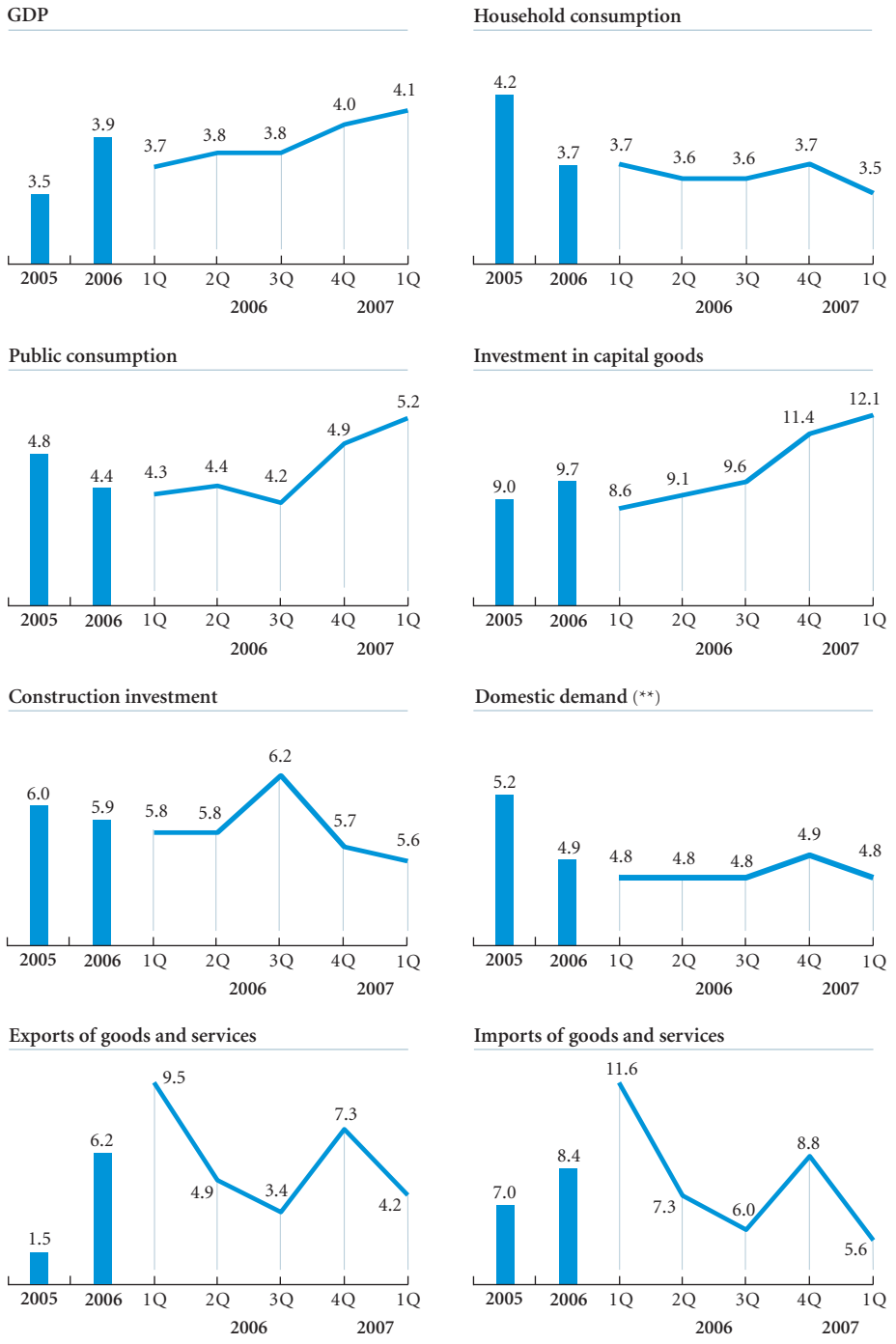
Change in GDP



SOURCE: INE and own calculations.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-on-year change (*)



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

(it contributed 4.8 points to GDP growth, one decimal less than in the preceding period). This was largely due to the lower growth rate of household consumption which was down to 3.5% year-on-year, the lowest in the past three years. It seems that little by little the recent increases in interest rates, which reduce consumer buying capacity, are having their effect. In keeping with this situation, consumer confidence is tending to drop slightly (it fell to –12 points in April). In any case, the increase in employment, one of the main supports of consumption, continues quite strong.

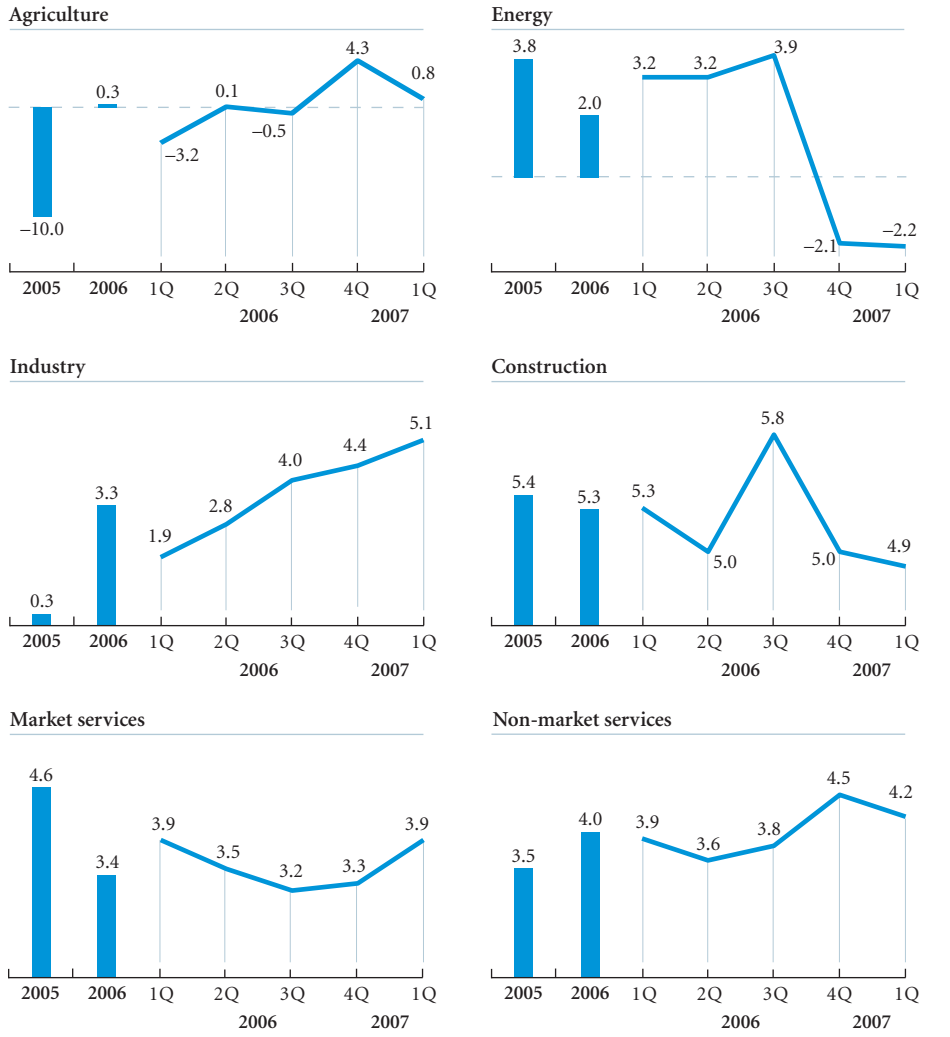
Consumption tending to ease...

On the other hand, in the period under consideration, investment showed very expansionist growth. Specifically, capital

...but capital goods investment recording strong drive...

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-on-year change (*)



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

...and construction maintaining sustained growth thanks to boost in public works.

goods investment increased in growth rate no less than 12.1%, the highest rate since 1999. In addition, construction, which in recent years has become a fundamental support of Spain's economic growth, continued to show considerable strength with a year-on-year growth rate of 5.6%, only one decimal less that in the previous quarter. In this case, the slowdown in growth rate in housing construction was compensated by renewed drive in public works.

Gradual slowdown expected in housing construction rate in coming months.

Everything points to a continuation of gradual easing in the housing construction rate in coming months. At the moment, the volume of housing under construction is still very high but some early indicators, such as new building approvals, show clear signs of a slowdown. Signs from the real estate market also suggest increased containment.

Industry takes on strong drive...

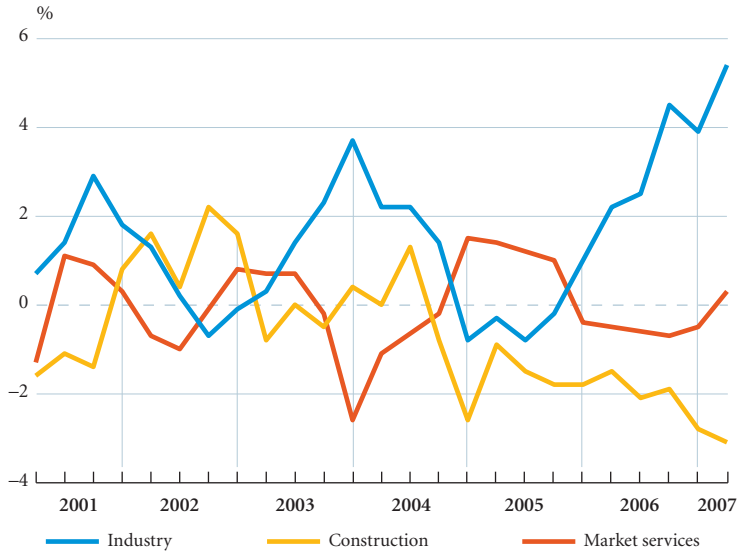
Particularly sales of existing housing have undergone substantial contraction in recent months. The easing of prices seems to be heading in the same direction. (The increase in prices of non-subsidized housing per m^2 was only 7.2% year-on-year in the first quarter of 2007.)

Spain's economic growth, however, continues to depend on consumption and construction. Together they contributed three points to growth of GDP in the first quarter of 2007. Increased investment in capital goods, the sustaining of exports and moderation in imports are all contributing to give a better balance to Spain's economic growth.

One notable fact is the consolidation of recovery in industry which in the period mentioned increased its year-on-year growth rate to 5.1%. In terms of value added, its contribution to GDP growth (0.7 percentage points) is now higher than that from construction (0.5 points). Another very positive aspect is the sharp

SHARP RISE IN PRODUCTIVITY IN INDUSTRY

Year-on-year change in GDP per job equivalent to full-time work



SOURCE: INE and own calculations.

increase in productivity shown by that sector in recent months, as may be noted in the above graph. This is good news, given that the increased competitiveness of industry is a key factor for competing in the world market and ensures a more gradual shift toward a growth model less dependent on the construction cycle.

Services branches also stepped up aggregate growth (from 3.5% to 4.0%) largely thanks to the drive in market sectors. Those activities to show greatest strength were those linked to company services, transport and, to a lesser extent, retail trade.

From the point of view of incomes, the containment of wages was notable with growth at 7.0%, one decimal less than in the preceding period. The decrease of three decimals in the growth rate of average wages compensated for the rise of two decimals in the growth the total number of wage-earners. Thanks to this and the improvement in productivity, labour cost per product unit was down by four decimals to 2.4%, nine decimals below the implicit deflator for the economy. Overall prices measured by this deflator grew by 3.3%, three decimals less than in the previous quarter.

...along with certain service-related activities.

The little information yet available on the second quarter shows something of a continuation of the trends indicated earlier. Consumer spending is still moderating, something very notable in certain consumer durables, as in the case of passenger cars which showed a drop of 6.0% in sales in April. Nevertheless, this refers to an atypical month because it includes the Easter Week holidays.

Wage moderation brings about drop in unit labour cost growth.

Second quarter begins with no big changes in trend.

Forecasts point to a gradual slowdown in economic activity in the second half-year brought about by the loss of drive in construction which will sharpen in 2008. The Organization for Economic Cooperation and Development, for example, foresees still sharp growth in 2007 (3.6%) but drops this to 2.7% for next year.

OECD foresees gradual slowdown in growth during this year and next.

Labour market

Firm progress in employment

Employment still rising...

Employment held to a high growth rate in the first quarter of 2007 at around 3.4% year-on-year, according to figures from the Labour Force Survey. The total number of persons employed went above the level of 20 million, the highest in history. Coming as a surprise was the sharp rise in job creation in construction (9.4% year-on-year), nearly one point more than in the fourth quarter. Also notable was the drop of 0.3% year-on-year recorded in industry.

...with sharp rise in construction and sustained growth in services.

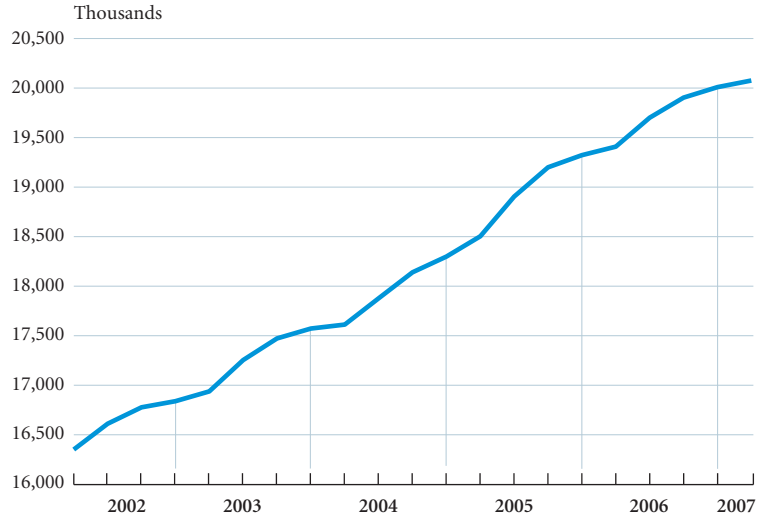
Both trends (the boost in construction and the drop in industry) are corroborated by figures from National Accounting which show that, in the case of industry, the stagnation in employment was accompanied by a substantial improvement in labour productivity. On the other hand, figures from Social Security show a somewhat different picture with a gradual slowdown in the rate of registrations for construction and a substantial increase for industry.

With regard to services, the Labour Force Survey indicates a moderate drop in the rate of increase in employment (down to 3.5% year-on-year, some eight decimals less than in the previous quarter) whereas the figures from National Accounting and Social Security point to greater stability.

In the past 12 months around 669,000 net jobs were created, according to the Labour Force Survey, with a proportion of 53% made up of foreign workers.

RECORD EMPLOYMENT FIGURE

Labour Force Survey estimate of number employed



SOURCE: National Institute of Statistics.

EMPLOYMENT INDICATORS

Percentage change over same period year before

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

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

In the first quarter of 2007, some 13.2% of the total number of employed persons had foreign nationality, nearly one and a half points more than one year ago. Among the foreign worker group, the rate of entry into the labour force is higher (76.3%) than among Spaniards (56.5%) while the unemployment rate is also higher (12.6% as against 7.8%).

The construction sector accounted for nearly one third of new jobs and the remaining two-thirds ended up in services, mainly private services. In terms of jobs equivalent to full-time work, National Accounting puts new jobs created in the past year at around 554,000, with a distribution by sector similar to that given by the Labour Force Survey.

According to that survey, female employment grew more sharply (5.0% year-on-year) than male employment (2.4%) and the rate of increase was also much higher among the adult population (above 5.5% in the age brackets between 40 and 55 years) than among those younger.

From the point of view of job creation, the most dynamic autonomous communities were Aragon, Canary Islands, Castile-La Mancha, Extremadura and Murcia with year-on-year increases of more than 5.5%. On the other hand, Asturias, Cantabria, Catalonia, Galicia, Madrid Community, Basque Country and La Rioja reported growth figures below the national average.

One positive aspect worth mentioning among all the figures given by the Labour Force Survey was the relative improvement in the temporary job status rate. In the first quarter of 2007, temporary job contracts represented 32% of the total, 1.8 points less than one

669,000 jobs created in past year.

Temporary job ratio down by nearly two points compared with one year ago.

ESTIMATED EMPLOYMENT

First quarter 2007

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	990.0	68.2	7.4	5.2	0.5	4.9
Non-farm	19,079.3	–0.7	0.0	664.0	3.6	95.1
Industry	*3,265.3*	*–54.5*	*–1.6*	*–8.3*	*–0.3*	*16.3*
Construction	*2,664.7*	*41.5*	*1.6*	*228.0*	*9.4*	*13.3*
Services	*13,149.3*	*12.3*	*0.1*	*444.3*	*3.5*	*65.5*
By type of employer						
Private sector	17,137.0	43.2	0.3	600.2	3.6	85.4
Public sector	2,932.2	24.2	0.8	68.9	2.4	14.6
By work situation						
Wage-earners	16,514.5	48.4	0.3	625.6	3.9	82.3
Permanent contract	*11,237.7*	*340.3*	*3.1*	*644.7*	*6.1*	*56.0*
Temporary contract	*5,276.8*	*–291.9*	*–5.2*	*–19.1*	*–0.4*	*26.3*
Non-wage-earners	3,541.6	17.4	0.5	60.1	1.7	17.6
Entrepreneurs with employees	*1,084.0*	*–3.8*	*–0.3*	*31.2*	*3.0*	*5.4*
Entrepreneurs without employees	*2,200.4*	*5.0*	*0.2*	*49.8*	*2.3*	*11.0*
Family help	*257.2*	*16.2*	*6.7*	*–20.9*	*–7.5*	*1.3*
Other	13.1	1.6	13.9	–16.6	–55.9	0.1
By time worked						
Full-time	17,574.4	–53.8	–0.3	588.1	3.5	87.6
Part-time	2,494.8	121.2	5.1	80.9	3.4	12.4
By sex						
Males	11,854.6	23.3	0.2	279.0	2.4	59.1
Females	8,214.7	44.2	0.5	390.2	5.0	40.9
TOTAL	**20,069.2**	**67.4**	**0.3**	**669.1**	**3.4**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

Unemployment down by 80,000 persons in last 12 months.

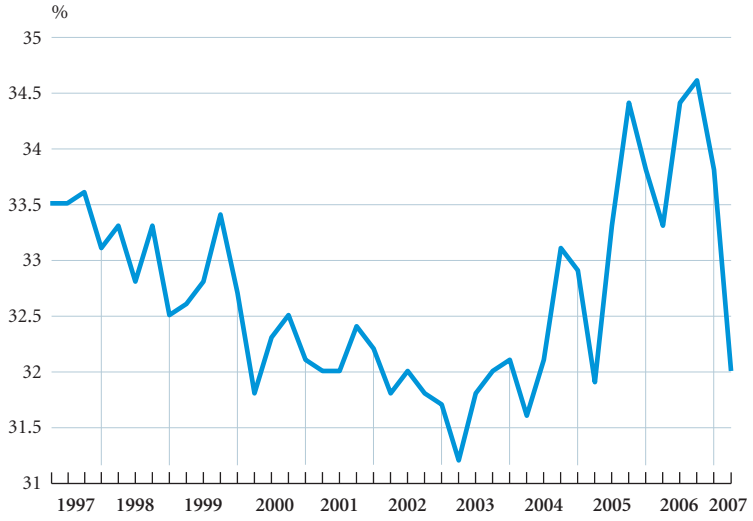
year earlier. This improvement was largely possible thanks to permanent job incentives which came into force in July 2006 as an outcome of the Agreement on Improving Growth and Employment. This is a still insufficient improvement if we take into account the distance from the European Union average which shows a rate of temporary job employment below 14%.

The labour force rose by nearly 589,000 persons, less than employment, so that estimated unemployment was down by nearly 80,000, thus ending the quarter with 1,856,100 unemployed. The unemployment rate stood at 8.5% of the labour force, six decimals less than one year ago but slightly higher than in the previous quarter. In addition, the rate of activity of the population over 16 years of age held at 58.6%, the same as in the fourth quarter and six decimals above the corresponding figure for one year earlier.

Unemployment shows up in greater proportion among the female population

DROP IN PROPORTION OF TEMPORARY JOBS

Workers with temporary hiring contract over total persons employed



SOURCE: INE and own calculations.

ESTIMATED UNEMPLOYMENT

First quarter 2007

	No. of unem-ployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	800.1	36.3	4.8	–46.3	–5.5	43.1	6.3
Females	1,056.0	9.1	0.9	–33.4	–3.1	56.9	11.4
By age							
Under 25 years	423.1	–11.0	–2.5	–31.1	–6.8	22.8	17.8
Other	1,433.0	56.4	4.1	–48.6	–3.3	77.2	7.3
By personal situation							
Long-term unemployment	550.8	27.7	5.3	20.0	3.8	29.7	–
Seeking first job	185.4	–16.4	–8.1	–18.3	–9.0	10.0	–
Other	1,119.9	34.1	3.1	–81.4	–6.8	60.3	–
TOTAL	**1,856.1**	**45.4**	**2.5**	**–79.7**	**–4.1**	**100.0**	**8.5**

SOURCE: National Institute of Statistics and own calculations.

(11.4% of the labour force) than among males (6.3%) and among those under 25 years of age (17.8%) compared with all other ages (7.3%). From a geographical point of view, the listing for unemployment is headed by Extremadura and Andalusia with unemployment rates of 13.0% and 12.5% respectively. At the bottom come Catalonia, Basque Country and La Rioja (all three with 6.7%), Madrid Community (6.6%), Aragon (5.7%) and Navarre (5.1%).

Extremadura and Andalusia head unemployment list.

Prices

Energy products make possible slight drop in April CPI

Year-on-year CPI change rate down slightly to 2.4% in April.

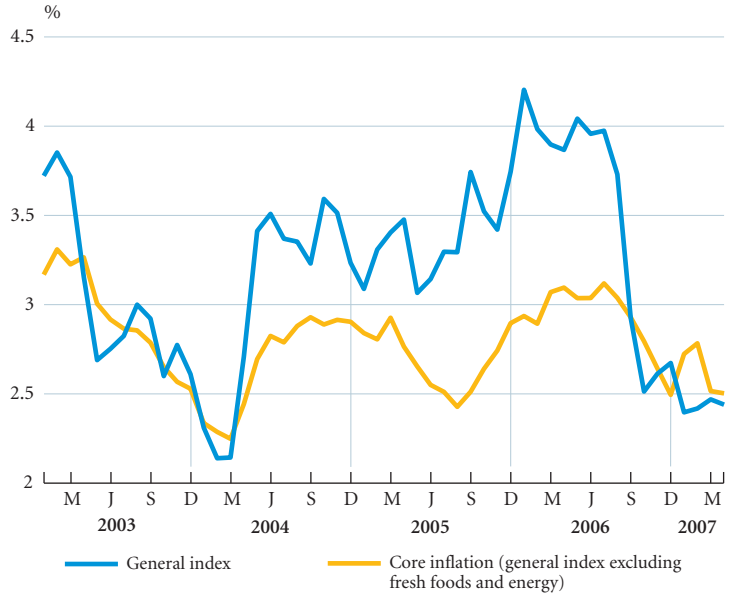
A higher than expected rise in fresh food prices stood in the way of a bigger drop in the consumer price index (CPI) in April. Unprocessed foods increased in price nearly doubling the year-on-year change rate from the 3.5% recorded in January to 6.4% in April. Perhaps the clearest case showed up in poultry. In April 2006, the price of poultry reported a drop of 9.6% compared with 12 months earlier. The avian flu crisis brought a sharp drop in demand because of fear of catching the virus. Once these fears receded and given the limited supply, the recovery of demand brought increases of up to 19.0%. In April 2007 prices at local wholesale markets reached all-time highs meaning that the upward trend could continue in the immediate future.

With passing of fears about avian flu, recovery of demand for poultry causes big 19% rise over April 2006.

Luckily, the effect from fuels and lubricants was favourable and made possible a very slight easing in the consumer price index. In fact, fuels and oils contributed somewhat more than one decimal to the drop in the April CPI, after having had an effect of similar size but in the opposite direction in March. There was a notable decrease in the price of gas which went from an increase of 24% one year ago to a 3% year-on-year drop in April.

CORE INFLATION CONTINUES STEADY

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

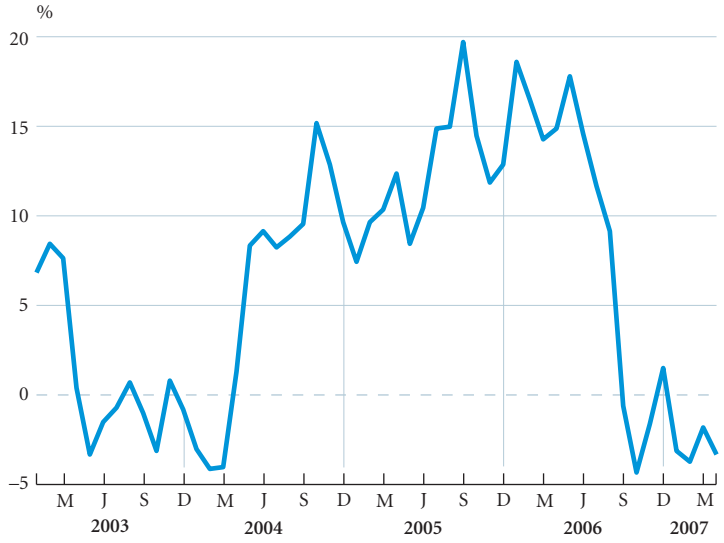
CONSUMER PRICE INDEX

	2006			2007		
	% monthly change	% change over December 2005	% annual change	% monthly change	% change over December 2006	% annual change
January	–0.4	–0.4	4.2	–0.7	–0.7	2.4
February	0.0	–0.4	4.0	0.1	–0.6	2.4
March	0.7	0.3	3.9	0.8	0.1	2.5
April	1.4	1.8	3.9	1.4	1.5	2.4
May	0.4	2.1	4.0			
June	0.2	2.3	3.9			
July	–0.6	1.7	4.0			
August	0.2	1.9	3.7			
September	–0.2	1.7	2.9			
October	0.4	2.1	2.5			
November	0.2	2.4	2.6			
December	0.3	2.7	2.7			

SOURCE: National Institute of Statistics.

DROP IN PRICES OF FUELS AND OILS

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



SOURCE: National Institute of Statistics.

Core inflation not dropping.

Following the decrease in the CPI in January this year, when it went from 2.7% to 2.4%, inflation measured by consumer prices has held around this level. The more stable segment, so-called core inflation, which excludes energy products and unprocessed foods, stayed at 2.5% in April thus showing resistance to the drop in inflation.

The persistence of this situation is largely centred on services which are generally

CONSUMER PRICE INDEX BY COMPONENT GROUP

April

	Índices (*)	% monthly change		% change over previous December		% annual change	
		2006	2007	2006	2007	2006	2007
By type of spending							
Food and non-alcoholic beverages	102.4	0.2	0.6	0.9	1.0	3.5	3.2
Alcoholic beverages and tobacco	106.9	0.3	0.1	0.6	5.4	2.2	6.3
Clothing and footwear	105.6	9.3	9.3	–1.1	–1.3	1.3	1.0
Housing	103.1	1.1	0.3	4.3	2.5	7.2	3.2
Furnishings and household equipment	102.5	0.7	0.8	1.1	1.1	2.7	2.6
Health	97.6	0.4	0.4	0.7	–3.0	1.3	–2.1
Transport	101.4	1.5	1.4	4.3	3.1	6.7	0.7
Communications	100.5	–0.2	–0.2	–0.4	1.4	–1.2	0.3
Recreation and culture	99.9	1.0	0.6	–0.6	–0.4	1.1	–0.4
Education	103.5	0.1	0.0	0.3	0.5	3.9	4.5
Restaurants and hotels	104.5	0.9	1.2	2.6	3.2	4.8	5.0
Other goods and services	103.2	0.3	0.3	2.7	2.3	3.4	3.5
By group							
Processed food, beverages and tobacco	102.4	0.3	0.2	2.0	2.0	3.9	2.2
Unprocessed food	103.8	–0.1	1.1	–1.4	0.4	2.1	6.4
Non-food products	102.6	1.8	1.7	2.1	1.6	4.0	2.0
Industrial goods	101.7	2.9	2.6	2.0	0.8	4.0	0.3
Energy products	*100.2*	*3.1*	*1.9*	*8.0*	*3.8*	*12.2*	*–1.5*
Fuels and oils	*99.1*	*4.1*	*2.5*	*9.3*	*4.1*	*15.0*	*–3.1*
Industrial goods excluding energy products	*102.2*	*2.8*	*2.9*	*0.1*	*–0.2*	*1.4*	*0.9*
Services	103.6	0.7	0.7	2.2	2.4	4.1	3.9
Underlying inflation (**)	102.9	1.4	1.3	1.4	1.4	3.1	2.5
GENERAL INDEX	**102.7**	**1.4**	**1.4**	**1.8**	**1.5**	**3.9**	**2.4**

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

Boosted by tourist demand, hotel, restaurant and café prices up 5% in one year, twice general CPI.

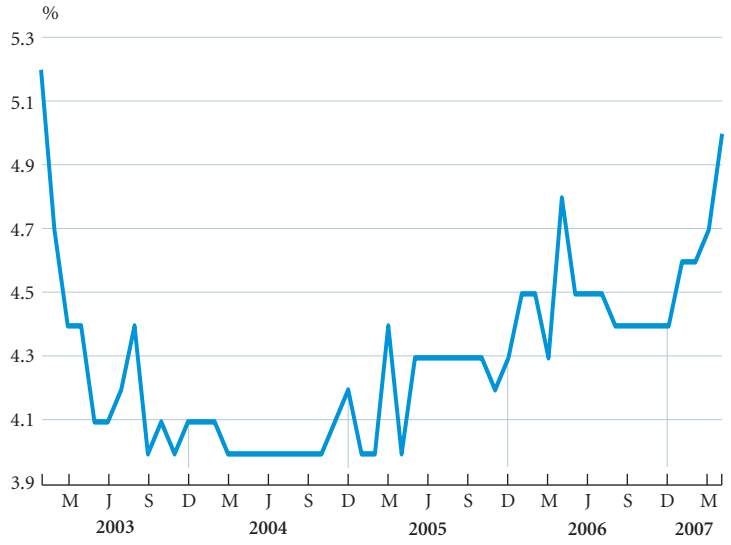
shielded from foreign competition. As a whole, services held at 3.9% in April. Nevertheless, some branches, such as hotels, restaurants and cafés, showed certain increases boosted by tourist demand. The index for these sub-sectors rose by 5.0% in the past 12 months, above the average and more than twice the general CPI. On the other hand, organized tours were down to 0.3%.

It is just as well that world market discipline is keeping the price of non-energy industrial goods below 1%. Nevertheless, the year-on-year change rate for these goods showed a slight increase in April going to 0.9%. This increase was counteracted by the slight drop in processed food prices to 2.2% compared with April 2006. Under this heading we should mention that cooking oil continued on a downward trend and showed a year-on-year drop of 21.9%.

In this context, we may ask if the drop in the year-on-year CPI will continue. The

INFLATIONARY PRESSURES PERSIST IN SOME SERVICES

Year-on-year change in hotel, café and restaurant prices



SOURCE: National Institute of Statistics.

tendency in components shows that it may still be possible to squeeze off the odd decimal. Nevertheless, in the second half-year inflation will probably rise due to the base effect of fuels because of the drop in prices of these items in the second half of 2006. Possibly a slowdown in consumption, brought about by the rise in European Central Bank interest rates begun in December 2005, will not be enough to avoid a rise in the CPI in the second half-year so that it could end 2007 at a level similar to that last year.

The inflation rate for consumer prices in terms harmonized with the European Union remained at 2.5% in April. As a result, the inflation differential with the euro area remained unchanged at 0.6 points.

Wholesale prices ease slightly

Wholesale price have generally tended to ease slightly. Nevertheless, relatively high inflation in intermediate goods, which reflects the increased cost of raw materials in world markets, and some increases in farm markets at origin could mean some difficulties for containing inflation.

CPI could still scrape off a few decimals but certainly will bounce back in second half-year.

In April, the general producer price index showed a year-on-year change of 2.7%, one decimal less than the month before. This drop was largely due to the bigger drop in energy products, down to 2.6% compared with April 2006. The reduction in the year-on-year change rate in the production and distribution of electrical power and gas from 5.2% to 3.8% came as a favourable contribution.

The year-on-year change rate for capital goods slowed very slightly going to 3.2%. On the other hand, consumer goods rose by 2.2% in the last 12 months ending in April, 5 decimals more than in the previous month, due to a rise in non-durable goods. In turn, intermediate goods continued to show strong inflation with a year-on-year rise of 6.4%.

Year-on-year inflation rate for producer prices drops one decimal to 2.7% in April.

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											
March	–10.2	5.8	3.3	2.0	4.6	16.4	7.2	3.5	–0.1	5.2	–
April	–8.1	5.7	2.9	2.2	5.1	15.4	7.4	2.6	–0.1	6.2	–
May	–3.6	6.6	3.2	2.3	6.1	17.8	7.7	1.5	–0.6	7.7	4.0
June	6.0	6.3	3.5	2.3	6.8	14.6	6.1	1.0	–0.6	7.3	–
July	0.7	6.4	3.6	2.4	7.0	13.9	5.9	0.6	–0.3	9.3	–
August	0.4	5.7	3.2	2.5	7.2	10.2	5.1	0.7	–0.4	8.8	3.8
September	1.1	4.2	2.7	2.5	6.7	4.1	3.2	0.8	–0.2	9.0	–
October	2.3	3.4	2.3	2.4	6.9	0.5	3.0	0.7	–0.1	9.3	–
November	0.8	3.6	2.4	2.5	6.8	1.0	2.4	–0.1	–0.3	8.5	3.6
December	–5.8	3.6	2.0	2.6	6.8	2.3	2.3	0.2	–0.3	7.9	–
2007											
January	–6.7	2.7	1.4	2.9	6.3	–1.2	0.7	0.4	–0.3	7.6	–
February	–6.3	2.5	1.4	2.9	6.7	–2.5	0.0	0.1	–0.2	7.0	3.3
March	1.4	2.8	1.7	3.3	6.3	–1.6	–0.1	0.3	–0.3	6.1	–
April	...	2.7	2.2	3.2	6.4	–2.6	...	...	...	...	...

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

Imported goods help contain inflation, thanks to strengthening of euro.

On the other hand, thanks to the strengthening of the euro, imported products contributed to containing inflation. According to figures supplied by the National Institute of Statistics survey of importing companies, the import price index showed a slight drop of 0.1% in the past 12 months up to March, in line with the tendency to a decrease.

By component, however, the situation is varied. Both consumer goods and capital goods showed very low change rates in prices but, while prices of capital goods were down 0.3% in the past year, prices of consumer goods rose by this amount. This, in turn, is the result of a rise in non-durable consumer goods of 0.9% and a drop of 1.7% in durable goods. Prices of imported energy products were down by 10.6% compared with March 2006, while other intermediate goods rose by 6.1% in the same period due to the sharp rise in raw materials prices.

With regard to farm products at origin, there was a rise in prices in March which turned around the year-on-year drop in previous months. Prices obtained by farmers rose by 1.4% in March compared with the same month last year. While all main components tended to rise, we should mention the year-on-year increase in livestock products of 5.1%.

Foreign sector

Trade deficit: exports responding

The trade deficit in March was 7.8 billion euros, somewhat higher than the February figure. Nevertheless, in the monthly total exports were up 3.9% year-on-year, well above imports which showed an increase of 2.7%. In real terms, not taking price changes into account, the differences were greater given that exports moved up 1.9% year-on-year as against stagnation in imports.

In the 12 months ending in March the deficit was 90.88 billion euros, slightly below the February figure although helped by lower energy imports. The non-energy deficit for the period was 58.27 billion euros, 8.3% more than in the same period last year but with an increasing slowdown given that up to

Trade deficit stabilizes thanks to exports.

FOREIGN TRADE

Cumulative total for past 12 months ending March 2007

	Imports			Exports			Balance	Export/ Import ratio (%)
	Million euros	% annual change in value	% share	Million euros	% annual change in value	% share	Million euros	
By product group								
Energy products	39,767	12.3	15.1	7,151	0.9	4.1	–32,616	18.0
Consumer goods	73,088	4.7	27.7	63,981	6.0	37.0	–9,107	87.5
Food	*14,902*	*4.1*	*5.7*	*20,344*	*7.7*	*11.8*	*5,441*	*136.5*
Non-foods	*58,185*	*4.8*	*22.1*	*43,637*	*5.2*	*25.3*	*–14,548*	*75.0*
Capital goods	28,823	2.9	10.9	16,875	4.1	9.8	–11,949	58.5
Non-energy intermediate goods	122,017	12.3	46.3	84,800	11.3	49.1	–37,216	69.5
By geographical area								
Euro area	128,789	6.0	48.8	98,008	7.9	56.7	–30,781	76.1
Rest of European Union EU-25	26,299	7.0	10.0	24,761	6.0	14.3	–1,538	94.2
Russia	7,567	35.9	2.9	1,647	37.8	1.0	–5,920	21.8
United States	8,601	4.2	3.3	7,617	14.5	4.4	–983	88.6
China	15,526	27.1	5.9	1,688	3.8	1.0	–13,839	10.9
Japan	5,970	3.2	2.3	1,332	8.5	0.8	–4,637	22.3
Rest of Asia	14,432	16.5	5.5	4,387	6.8	2.5	–10,044	30.4
OPEC	21,958	11.5	8.3	4,567	2.1	2.6	–17,391	20.8
Latin America	14,716	15.3	5.6	10,518	18.7	6.1	–4,197	71.5
Rest	19,838	3.2	7.5	18,281	4.7	10.6	–1,557	92.2
TOTAL	**263,695**	**9.0**	**100.0**	**172,807**	**8.1**	**100.0**	**–90,888**	**65.5**

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

In real terms, growth of exports higher than for imports.

November 2006 the norm had been two-digit increases. Non-energy exports in the period grew by 8.5% year-on-year, going above the increase in imports (8.4%) for the first time since the beginning of 2003. In real terms, the latest tendency in exports is clearly to show increases, while imports are maintaining rises, although export growth is slightly faster.

Looked at by sector, the take-off in exports came specifically in chemical products, consumer durables, semi-manufactured non-chemical and food goods, which were up by more than two digits in year-on-year terms. The surprise came in capital goods and cars which, in spite of representing close to 40% of total sales abroad in March, gained only 2.4% and 0.1% year-on-year respectively. In imports, the biggest increases showed up in raw materials and non-chemical manufactures while the largest import heading, capital goods, rose by 7.8% year-on-year.

Deficit moderating with euro area but still worsening with Asia.

By geographical area, in the past 12 months ending in March, the deficit with the euro area reached 30.78 billion euros, somewhat less than the February figure. This drop in the deficit, partly as a result of increased demand in the area, also showed up in the first three months of the year which reported a deficit of 2.35 billion euros as against 2.42 billion euros in the same period last year. The bilateral deficit with the United States was also down slightly to stand at 983 million euros whereas the deficit with Latin America was 4.20 billion euros, in line with levels reached in 2006. Where the worsening shows up is with the Far East with the exception of Japan where the deficit is holding stable. The deficit with China for the past 12 months ending in March reached 13.84 billion euros, 27% above figures for last year while the deficit with the rest of Asia (excluding Japan, China and OPEC countries) reached 10.04 billion euros, an increase of 16.5% year-on-year.

Current account balance deficit reaches 88 billion euros.

Balance of payments: slight improvement in trade deficit fails to compensate transfer outflows

In February, the current account balance deficit was 8.99 million euros, slightly above the figure for the previous month (8.62 billion). Nevertheless, the trade deficit for the same period was 6.02 billion euros, some 430 million euros lower than in January and 10% below the 2006 average. The current account deficit rose because of the continuing drop in the services surplus and, especially, because of the sharper drop in the current transfers balance. This was not helped by the incomes balance with a negative figure of 1.94 billion euros, nearly 11% above the typical figures in 2006.

In financial account, direct investment inflows went above outflows for the first time since November 2005, although more by a drop in the latter than by an increase in the former.

From the point of view of trends, in the last 12 months ending in February 2007, the cumulative deficit in the current account balance increased to 88.18 billion euros, some 19.27 billion more than in the same period one year earlier. This worsening, however, seems to be stabilizing given that it practically repeated the January figures. Growth of the trade deficit represented 53.1% of the increase in the current account deficit. This share shows a downward trend while the increase in net outflows for current transfers is now up to 20.1%, whereas one year ago its

contribution was practically nil. The incomes balance, which has been putting in the rest, doubled its negative contribution over the same period last year.

With regard to financial account, in the 12 months ending February net outflows for direct investment were down by 30.31 billion euros, a substantial drop from 56.61 billion euros, largely brought about by base effects and some slowing down in Spanish investment abroad. In turn, inflows continued stable at a level still below what was normal in 2005 and the first half of 2006.

Improvement in trade deficit exceeded by increase in net outflows for current transfers.

BALANCE OF PAYMENTS

February 2007

	Cumulative for year		Last 12 months		
	Balance	% annual change	Balance	Annual change	
				Absolute	%
Current account balance					
Trade balance	–12,473	7.5	–81,013	–10,229	14.5
Services					
Tourism	*2,940*	*1.4*	*27,486*	*1,070*	*4.0*
Other services	*–1,169*	*–11.8*	*–5,145*	*–199*	*4.0*
Total	1,771	12.6	22,341	871	4.1
Income	–3,889	84.4	–22,763	–6,030	36.0
Transfers	–3,011	48.9	–6,743	–3,880	135.5
Total	**–17,602**	**24.3**	**–88,177**	**–19,267**	**28.0**
Capital account	**1,432**	**107.7**	**6,917**	**–1,381**	**–16.6**
Financial balance					
Direct investment	–702	–97.3	–30,313	8,147	–21.2
Portfolio investment	34,424	–9.1	194,873	117,968	153.4
Other investment	–10,114	–174.9	–59,130	–91,063	–285.2
Total	**23,608**	**–7.2**	**105,431**	**34,768**	**49.2**
Errors and omissions	–855	–65.9	–1,257	2,662	–67.9
Change in assets of Bank of Spain	–6,582	–	–22,913	–16,781	–

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.

Remittances to Latin America: is it manna from heaven?

Latin America receives more remittances than any other part of the world. According to the World Bank, these remittances amounted to 48 billion dollars in 2005, a figure equal to 2% of region GDP and 70% of direct foreign investment it receives and eight times higher than official development aid (see Table below). This is a figure that, in real terms, has grown by ten times in the last 20 years. In absolute terms, Mexico is the leading recipient of remittances in the region as well as in the world. In relative terms, however, it is bettered by other Central American countries, such as Honduras, El Salvador and Nicaragua, where a much greater proportion of the population has emigrated (see Graph below). In view of these figures, it is not surprising that remittances have attracted the interest of academics, international financial institutions, governments and banks. One of the aspects most studied has been its impact on the economic development of the recipient countries.

LATIN AMERICA: INFLOWS OF REMITTANCES, DIRECT INVESTMENT AND OFFICIAL AID

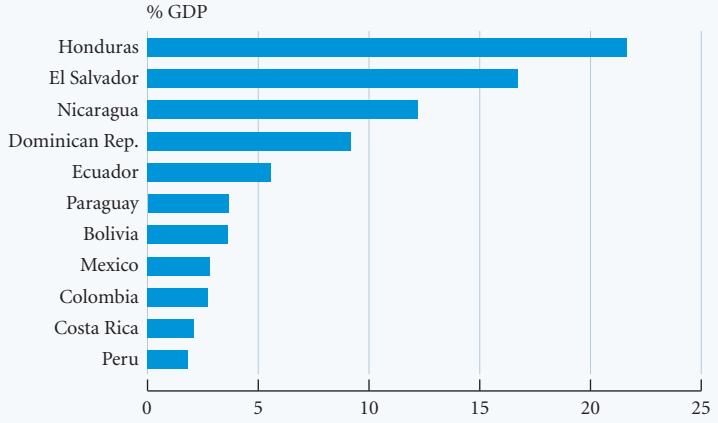
2005
Million US dollars

	Remittances	Direct foreign investment	Official development aid
Latin America and Caribbean Area	48,201	70,017	6,308
East Asia and Pacific Area	45,053	96,898	9,496
South Asia	35,558	9,869	9,260
Europe and Central Asia	31,363	73,687	5,731
North Africa and Middle East	24,001	13,765	26,946
Sub-Saharan Africa	8,728	16,559	32,620

SOURCE: World Bank.

NOTABLE WEIGHT OF REMITTANCES IN CENTRAL AMERICAN ECONOMIES

2005
Remittances received



NOTES: Graph includes those countries where remittances exceeds 1% GDP in 2005.
SOURCE: World Bank.

It would seem logical to expect that remittances reduce overall poverty, measured for instance as the proportion of the population with income below two dollars a day (thus measured, the poverty ratio is about 22% in Latin America). In any case, remittances are direct income transfers that do especially benefit those who most need them. The figures seem to confirm this intuition. Studies using surveys of households to calculate poverty ratios including and excluding income from remittances indicate that in most cases the ratio is sharply reduced by remittances (by 3 to 5 percentage points), especially in those countries where emigrants come from the poorest segments of the society as in Mexico and El Salvador. It is curious that in some countries it is not those who are in greatest need that receive the most remittances. In Peru and Nicaragua, for example, between 35% and 40% of those receiving remittances belong to the 20% of the population with the highest incomes. Logically, in these countries the impact of remittances on poverty is much lower.

These calculations, however, do not take into account that remittances at least partly replace the income that the emigrants would have been able to obtain in their country of origin. A more complete analysis would require an estimate of the income of those households in a «non-emigration» scenario, calculating the ratio of poverty associated with that situation and comparing it with the ratio obtained with emigration and remittances. The results of this exercise, carried out by the World Bank,[1] confirm that emigration and remittances tend to reduce poverty but the size of the effect, in contrast to other studies, is relatively modest: an increase in remittances of 1% of GDP reduces the poverty ratio by 0.3 percentage points.

It is also the case that households that receive remittances tend to spend more on housing, education and health. This is good news as this is the kind of spending that may increase labour productivity of workers and therefore their wages. This effect seems to be more noticeable in middle-class and upper-middle-class households.

It is well-known that GDP growth in developing countries is much more volatile than in the industrialized countries. In other words, business cycles are more pronounced. In this context, remittances could play an important stabilization role. Most studies conclude that remittances in fact tend to be counter-cyclical and therefore reduce GDP volatility.[2] In any case, because of the lack of robustness of this result, we may deduce that not all remittances are purely altruistic. Some remittances seem to be a result of the existence of investment opportunities in the recipient economies and, as in the case of normal private capital flows, they are pro-cyclical.

Not everything related to remittances, however, turns out to be benefits. Members of those households receiving remittances tend to participate less in the labour market (see Graph below). In Mexico, the effect is considerable: Whereas 90% of adult males of working age who receive no remittances participate in the labour force, only 60% of those who do receive remittances partipate. It would seem that remittances increase reserve wages – the minimum needed so that these adults are willing to work. In addition, there are also signs that a significant volume of remittances brings about a loss of competitiveness in the export sector.[3] It happens in this way: part of the remittances is spent on non-tradable goods, such as certain services, and part on goods that are tradable. This tends to increase the price of the former more than of the latter, given that these may be imported. The increase in the relative price of non-tradable goods in turn improves the profits of this sector and creates the incentive for its expansion, which tends to increase wages and causes a loss of competitiveness in the export sector.

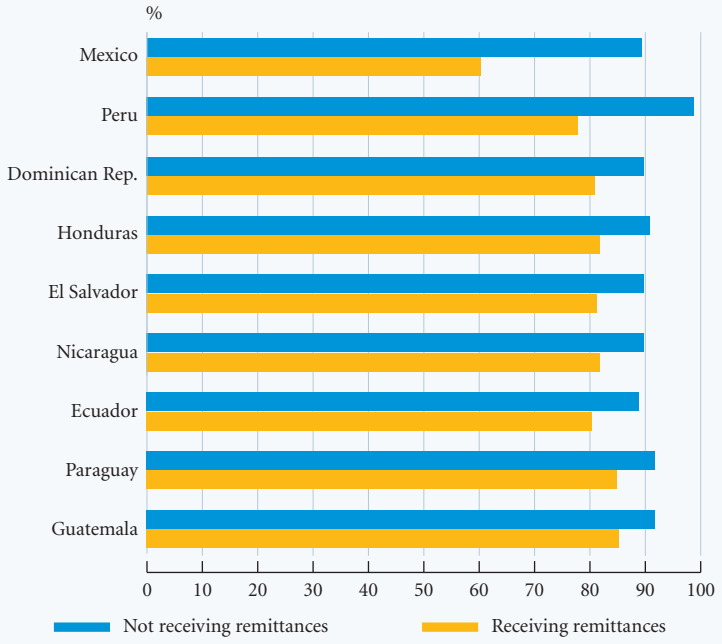
(1) World Bank (2007). *Close to Home: The Development Impact of Remittances in Latin America*, Washington DC.
(2) For example, Sayan, S. (2006). «*Business Cycles and Worker's Remittances: How Do Migrant Workers Respond to Cyclical Movements of GDP at Home?*», IMF Working Paper No. 06/52.
(3) Acosta, P., Lartey, E. and Mandelman, F. (2007). «*Remittances and Dutch Disease*», Federal Reserve Bank of Atlanta, Working Paper 2007-8.

The net impact of these different effects on economic growth of economies receiving remittances seems uncertain. Paola Giuliano and Marta Ruiz-Arranz, for example, do not find any significant effect of remittances on growth.[4] The World Bank study mentioned above, on the other hand, concludes that the impact is indeed statistically significant although not so much in economic terms. An increase of 1% GDP in remittances tends to increase the GDP growth rate by 0.1-0.2 percentage points.

To sum up, available empirical studies suggest that the impact of remittances on the reduction of poverty and the increase in economic growth, while possibly positive, is very modest. Emigration and remittances cannot replace good economic policies and strong institutions as engines of sustained growth.

LOW INVOLVEMENT IN LABOUR FORCE AMONG MALES RECEIVING REMITTANCES

2004
Rate of male labour force participation



NOTE: Includes males between 25 and 59 years of age.
SOURCE: World Bank.

(4) Giuliano, P. and Ruiz-Arranz, M. (2005). «*Remittances, Financial Development and Growth*», IMF Working Paper 05/234.

Savings and financing

Credit granted to companies and households continues to slacken

The rise in European Central Bank interest rates has continued to pass through to bank rates. In April the one-year Euribor, widely used as a reference rate for many loan transactions in the private sector, rose to 4.25% as a result of the expectation of further increases in the Eurosystem reference rate. The one-year Euribor thus stood 103 basis points above the level 12 months earlier.

The increase in loan interest rates has contributed to moderation of the growth of funding granted to companies and households. Financial resources obtained by the private sector rose by 21.2% in March compared with the same month last year. This meant a slowdown of 24.3% in the year-on-year rate marked up in September 2006. Nevertheless, growth of financing continues high, twice the figure in the euro area as a whole, under the stimulus of the good state of the economy.

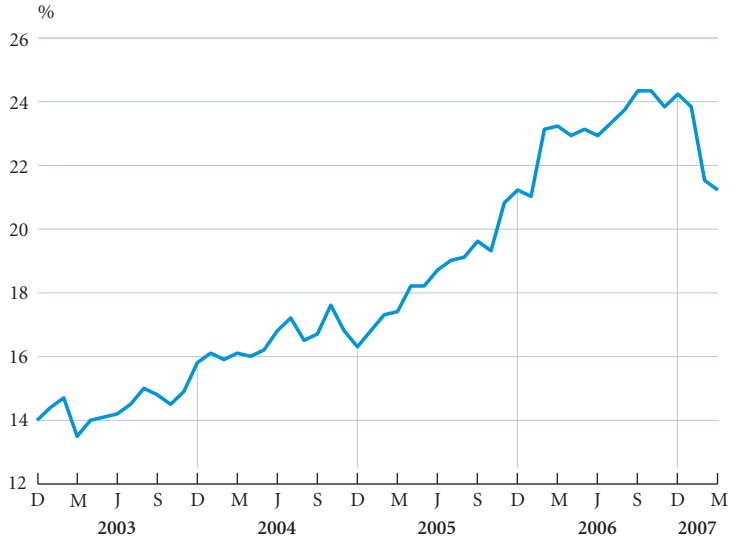
Rise in loan interest rates helps slow down financing to private sector.

Credit going to individuals rose at an annual rate of 18.4% at the end of the first quarter, 2.9 points less than the rate in March 2006. This easing off came largely in funding for housing which went down to 18.7% in March this year as against 24.1% one year ago. On the other hand, other loans to households have scarcely eased off, although they grew at a lower rate of 17.6% in the past

Slowdown in loans to households concentrated in housing.

SLOWDOWN IN FINANCING TO PRIVATE SECTOR IN FIRST QUARTER

Year-on-year change in financing to private sector



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

March 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	81,424	–3,942	–4.6	9,582	13.3	5.2
Secured loans (*)	967,512	44,521	4.8	190,932	24.6	61.7
Other term loans	434,695	20,106	4.8	91,749	26.8	27.7
Demand loans	31,648	–2,474	–7.3	3,720	13.3	2.0
Leasing	42,103	1,390	3.4	5,580	15.3	2.7
Doubtful loans	11,786	951	8.8	1,850	18.6	0.8
TOTAL	**1,569,169**	**60,553**	**4.0**	**303,414**	**24.0**	**100.0**

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

Loan default rate stands close to all-time low.

12 months as of March. This trend was partly due to the policy of financial institutions to promote this type of loan in order to counteract the drop in mortgage loans.

On the other hand, doubtful loans at lending institutions rose by 18.6% in the period March 2006-March 2007. Nevertheless, given that growth of total assets was higher, the doubtful loan rate stood at only 0.75%, just 3 hundredths above the all-time low in December 2006.

Growth of bank deposits higher than rise in loans

Bank deposits show no signs of slowdown.

As opposed to credit granted to the private sector, bank deposits do not appear to have slowed down. In the last 12 months up to March 2007, deposits of companies and households in lending

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

March 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	437,071	–10,876	–2.4	39,829	10.0	36.6
Up to 2 years	277,671	31,422	12.8	78,422	39.4	23.3
More than 2-year term	356,428	23,579	7.1	90,666	34.1	29.9
Repos	81,571	1,116	1.4	10,862	15.4	6.8
Total	**1,152,741**	**45,242**	**4.1**	**219,778**	**23.6**	**96.6**
Deposits in currencies other than euro	**40,689**	**7,972**	**24.4**	**21,026**	**106.9**	**3.4**
TOTAL	**1,193,430**	**53,214**	**4.7**	**240,805**	**25.3**	**100.0**

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

institutions rose by 25.3%, a rate 0.6 percentage points higher than the figure for December 2006. In any case, in spite of the fact that growth of deposits has exceeded that of loans for the first time since December 2001, the increase in deposits in absolute terms continues to be insufficient to finance loans. This situation continued to lead financial institutions to issue bonds in order to cover this gap in funding.

With regard to other assets in favour with savers, the assets of securities mutual funds rose by 2.2% in the first four months of the year going to a figure of 259.8 billion euros, according to figures from Inverco, an association of fund managers. Those funds showing the biggest increases were share-based funds and mixed bond-based funds (with increases of 6%) followed by international funds which were up 5%. Average yield on securities mutual funds for the past 12 months ended in April was 4.95%, more than twice the inflation rate in that period.

In addition, total pension fund assets at the end of the first quarter amounted to 81.94 billion euros. This figure represents an increase of 10.7% in the past 12 months. Average annual weighted yield was 4.4%, well above inflation.

Assets of pension funds up 11% in last 12 months ending March.

Increase in net financial wealth of households in 2006

Following decreases in the previous three years, deposits regained ground in household portfolios in 2006. Their weight in household financial assets went up to 33.4%, thus making up one third of the total. This trend will probably continue in 2007 following the change in taxation on financial products which has given all of these equal tax treatment.

Deposits recover ground in household portfolios in 2006 after three years of decreases.

NET HOUSEHOLD FINANCIAL WEALTH

	2006			Annual change		Change over 5 years	
	Million euros	Structure as %	% of GDP	Million euros	%	Million euros	%
Financial assets							
Cash	88,207	5.0	9.0	8,068	10.1	47,532	116.9
Deposits	584,974	33.4	59.9	73,659	14.4	179,803	44.4
Securities other than shares	43,047	2.5	4.4	7,816	22.2	17,994	71.8
Shares and participations in investment funds	729,306	41.7	74.7	92,854	14.6	289,830	65.9
Insurance technical reserves	247,765	14.2	25.4	18,317	8.0	87,294	54.4
Other	57,317	3.3	5.9	10,496	22.4	22,742	65.8
Total	**1,750,614**	**100.0**	**179.3**	**211,210**	**13.7**	**645,194**	**58.4**
Financial liabilities							
Loans	778,695	93.6	79.8	125,171	19.2	451,136	137.7
Other	53,593	6.4	5.5	4,963	10.2	2,011	3.9
Total	**832,289**	**100.0**	**85.3**	**130,135**	**18.5**	**453,147**	**119.5**
Net financial worth	**918,326**	**–**	**94.1**	**81,075**	**9.7**	**192,047**	**26.4**

NOTES: (*) Includes non-profit institutions serving households.
SOURCE: Bank of Spain and internal figures.

Equities held directly by households increase share of total due to revaluations.

The share portfolio, including participations in mutual funds, continued to gain weight in the total going to 41.7%. Equities directly held by households increased their share of the total by 1.8 points putting the figure at 26.1%. Nevertheless, this was due to revaluations, given that net sales were recorded both in listed and unlisted shares. Net acquisitions of participations in mutual funds did indeed show up as positive although they were well below the three previous years.

Loans rise to 125% of disposable household income, above euro area average.

Financial products linked to insurance rose by a notable 8.0% which, however, was below the 13.7% growth of total assets. In this way, their share of the total dropped slightly for the fourth year in a row. By type, the most dynamic were pension funds which, however, also grew less than the average.

With regard to cash, in 2006 this rose by only 10.1% while its share in the total dropped to 5.0%. Nevertheless, since the end of 2001 it has increased by 116.0%, the biggest increase in the main headings. This extraordinary change in five years may partly be explained by the fact that with the coming into circulation of banknotes in euros at the beginning of 2002, there was a drop in circulation of banknotes in pesetas.

Net household financial wealth up to 94% of GDP in 2006 following drop in previous year.

Nevertheless, since then there has been a sharp increase in bank notes in circulation which could be linked to a boost in the «black» economy.

On the other side of the financial balance sheet of households, financial liabilities rose by 18.5% in 2006 and continued to increase more than assets. In large part, they are made up of loans which rose by 19.2%. Some 95% of these are long-term loans, mainly mortgage loans. With regard to gross disposable household income, loans rose by 124.6%, a figure below that for the United Kingdom and the United States but higher than the average for the euro area. We should point out the sharp growth seen in loans to households in the past five years (137.7%) partly as a result of the major drop in interest rates that came about following the launching of the single European currency. Loans rose to 17,670 euros per person in 2006.

As a result, the financial wealth of households, defined as financial assets less financial liabilities, rose by 9.7% to 918.33 billion euros in 2006. In terms of gross domestic product, the financial wealth of households rose to 94.1% following a decrease the year before. Per capita, net financial wealth amounted to 20.839 euros, 8.0% more than in 2005.

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2006

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

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

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

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