DECEMBER 2007

THE SPANISH ECONOMY

Monthly Report

NUMBER 308

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2006	2007			
				4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast						Forecast
Gross domestic product								
United States	2.9	2.1	2.0	2.6	1.5	1.9	2.6	2.5
Japan	2.2	1.9	1.7	2.4	2.5	1.5	2.2	1.5
United Kingdom	2.8	3.0	2.1	3.2	3.1	3.1	3.2	3.0
Euro area	2.9	2.6	2.1	3.3	3.2	2.5	2.6	2.2
Germany	*3.1*	*2.5*	*2.0*	*3.9*	*3.6*	*2.5*	*2.5*	*1.5*
France	*2.2*	*1.8*	*1.8*	*2.1*	*1.9*	*1.4*	*2.1*	*1.8*
Consumer prices								
United States	3.2	2.7	2.7	2.0	2.4	2.6	2.4	3.5
Japan	0.2	0.0	0.2	0.3	–0.1	–0.1	–0.1	0.2
United Kingdom	2.3	2.4	2.1	2.7	2.9	2.6	1.8	2.2
Euro area	2.2	2.1	2.3	1.8	1.9	1.9	1.9	2.8
Germany	*1.7*	*2.1*	*2.0*	*1.4*	*1.8*	*1.8*	*2.1*	*2.7*
France	*1.7*	*1.3*	*1.7*	*1.3*	*1.2*	*1.2*	*1.3*	*1.8*
SPANISH ECONOMY		Forecast						Forecast
Macroeconomic figures								
Household consumption	3.7	3.1	2.4	3.7	3.4	3.3	2.9	2.7
Government consumption	4.8	5.5	5.2	4.9	5.7	5.0	5.8	5.6
Gross fixed capital formation	6.8	5.9	3.2	6.4	6.6	6.6	5.6	4.9
Capital goods	*10.4*	*11.7*	*6.8*	*11.4*	*13.3*	*13.1*	*11.2*	*9.6*
Construction	*6.0*	*4.2*	*1.7*	*5.7*	*5.2*	*4.6*	*3.8*	*3.4*
Domestic demand (contribution to GDP growth)	5.1	4.6	3.3	5.3	5.1	4.9	4.4	4.1
Exports of goods and services	5.1	6.0	5.6	7.3	3.6	4.8	8.0	7.7
Imports of goods and services	8.3	7.2	6.0	8.8	5.9	6.6	8.3	8.0
Gross domestic product	**3.9**	**3.8**	**2.9**	**4.0**	**4.1**	**4.0**	**3.8**	**3.5**
Other variables								
Employment	3.2	3.0	2.0	3.1	3.3	3.2	3.0	2.7
Unemployment (% labour force)	8.5	8.1	8.2	8.3	8.5	8.0	8.0	8.1
Consumer price index	3.5	2.8	3.1	2.6	2.4	2.4	2.4	3.8
Unit labour costs	2.3	3.0	3.1	2.4	2.8	2.9	3.0	3.2
Current account balance (% GDP)	–8.8	–9.5	–9.6	–8.6	–10.4	–9.0	–10.1	
Net lending or net borrowing rest of the world (% GDP)	–8.1	–8.9	–9.0	–7.4	–9.8	–8.8	–9.9	
Government balance (% GDP)	1.8	1.5	0.9					
FINANCIAL MARKETS		Forecast						Forecast
Interest rates								
Federal Funds	5.0	5.0	4.0	5.3	5.3	5.3	5.1	4.5
ECB repo	2.8	3.9	4.0	3.3	3.6	3.8	4.0	4.0
10-year US bonds	4.8	4.6	4.5	4.6	4.7	4.8	4.6	4.4
10-year German bonds	3.8	4.3	4.6	3.8	4.0	4.4	4.3	4.3
10-year Spanish bonds	3.8	4.3	4.7	3.8	4.1	4.4	4.4	4.4
Exchange rate								
$/Euro	1.26	1.38	1.47	1.30	1.32	1.35	1.39	1.46

Contents

Financial innovation, derivatives and other common suspects

How is it possible to imagine 500 trillion dollars? This is a figure equivalent to the gross domestic product of the United States for 35 years. Enough to make one giddy. This, however, is the figure for open positions in over-the-counter derivatives markets world-wide, measured by underlying assets at the end of June 2007, according to the Bank for International Settlements in Basle. And this segment of derivatives is only part of the galaxy of products fitting into the category of financial innovation. This is innovation that, nearly every time there is a crisis in the financial sector, becomes a prime suspect for the calamities taking place. The upsets taking place in the markets since August as a result of the US mortgage crisis have once more focused attention on innovation in the financial markets.

The easiest to blame would be those aggressive Wall Street executives. But the fact is that financial innovation is as old as money itself, if not older. Otherwise, how shall we define the idea that arose in some tiny kingdom in the Middle East to mint metal coins many centuries before our era? Or the idea of using paper money as happened in the Chinese Song dynasty 1000 years ago? These were revolutionary innovations beside which FRAs, swaps and warrants would seem minor reforms.

What we now understand by financial innovation began to develop toward the end of the Seventies when the world economy began to take on a global dimension and the financial markets stopped being national feuds. Financial innovations seek one or more objectives at the same time. The most common is to transfer risks, that is, to protect oneself against unexpected changes in interest rates, exchange rates, share movements, etc. They are also used to increase liquidity by facilitating the transferability of assets. At the same time, they try to open up new areas of financing or investment for investors or savers who normally do not have access to those areas. Finally, they may serve to increase the equity of an issuer, thus improving his solvency. The growing sophistication of these innovations gave rise to a new category, financial derivatives, whose main characteristic is that their value is based on another asset, a so-called underlying asset. This structure can be complex given that it may be made up of various basic components such as a forward which is usually the most frequent and a combination of assets. Their usefulness has greatly spread their employment, as may be seen from the figures given above. Their complexity, however, does not make them easy to understand and for this reason, at times of market upsets, they are often blamed for their supposed destructive potential in financial markets.

The current subprime mortgage crisis, with CDOs (collateralized debt obligations) playing a leading part, should serve to refine certain aspects related to the issue, negotiation and regulation of this type of derivative. It would be desirable to have greater transparency in the calculation, distribution and concentration of the risks of this type of product on the international financial scene. Any regulation of these instruments must be coordinated globally and must avoid those legal loopholes that could give rise to abusive practices which always end up having to be paid for. However, it is important not to remove the flexibility that has made it possible for derivatives, with their ability to divide up the financial risks in smaller parts and components that can be negotiated according to specific management objectives, to change the dimension of the financial system, broadening its capacity and improving the efficiency of the markets.

EXECUTIVE SUMMARY

Subprime mortgage crisis: tough times

Subprime mortgage crisis threatens stability of some large international financial institutions.

What began a couple of years ago as a crisis in the US real estate sector just last August turned into a crisis in the mortgage market that brought about a collapse of liquidity in financial markets with a flight to quality and a boost in risk aversion. Now it threatens to develop into a problem of solvency for some of the world's leading financial institutions which could result in a possible freeze on credit. Far from being solved, the picture has grown worse in recent weeks.

In order to trace the course of the crisis, it should be remembered that in September and October the stock markets went up, apparently having nothing to do with interbank liquidity problems, the extraordinary provisions made by the large investment banks and maintenance of risk premiums at high levels. What is more, the macroeconomic figures were surprisingly good. In the United States, the third-quarter gross domestic product (GDP) was up by 2.6% compared with the same period last year as against growth of 1.5% and 1.9% in the first two quarters respectively. The same happened in Japan whose GDP rose by 2.2% in July-September (1.5% in the second quarter) and in the Euro Area which maintained its economic drive with growth of 2.6%, one decimal more than in the previous period. Results in the emerging countries in the third quarter were not disappointing with increases of 11.5% in China, 9.2% in India, 7.8% in Russia and 5.6% in Brazil.

Third quarter macroeconomic results still show some economies with high growth...

November, however, was a bad month. Hopes of a more or less rapid solution of the crisis have quite disappeared and there has been a considerable worsening of expectations. It is feared that more bad news is still to come now that we are getting close to year-end. Alarm bells have again begun to go off signalling pressures in money markets, high spreads, more provision for insolvencies and restrictions on credit. Finally, the stock markets showed a sharp drop in November largely dragged down by the decline in financial shares. US 10-year Treasury bonds have dropped to 4%, a clear sign of the pessimism with which the market is facing the immediate future. The effect of the subprime mortgage crisis on US financial entities is now starting to be compared with the last big crisis in the sector, the Savings and Loan crisis toward the end of the Eighties.

...but outlook less optimistic for coming months.

As a result, the good macroeconomic figures for the third quarter have been put aside and many people are now talking of an imminent recession. It surely will not go that far but the figures expected for the final stages of the year are hardly favourable. The US real estate recession is not easing off. Spending on construction in the third quarter was down 20.1% compared with the previous period in annual terms. In spite of a slight rise in October, housing starts were 16.4% below the same period last year. Pointing in the same direction, building permits, which are an early indicator of housing starts, were down 24.5%, while prices keep dropping. The consumer, who generates three-quarters of the GDP, is not giving up and continues to be an indomitable bastion in the face of the forces of recession. But some figures start to be troubling, such as the drop in

confidence to the levels seen at the time of the *Katrina* hurricane two years ago.

Nor are the figures from Japan and the euro area as good as they may look. The Japanese economy is suffering from a sharp real estate crisis and growth is still largely dependent on exports, with the factor of fragility this implies. The sudden appreciation of the yen in November brought an immediate drop on the stock market which, to some extent, shows the sensitiveness of the economy to the situation in the foreign sector. In the Euro Area, the good growth figures are not changing the trend to a slowdown so that we cannot be confident that continental Europe will take the place of the United States. Furthermore, the strength of the euro against the currencies of its main trading partners (dollar, pound sterling, renmimbi, and yen) does not suggest a gentle course for foreign sales in coming months.

Faced with the increased risk of stagnation in the United States and further slowing down in Japan and Europe, the solution should be easier money. The US Federal Reserve has cut its reference rate for Federal Funds twice since the outbreak of the crisis. The European Central Bank and the Bank of Japan have not made any move. Should the Federal Reserve make a further cut? This is what financial circles are calling for.

But Ben Bernanke, chairman of the US central bank system, has his doubts. Why so? The reply lies in the per-barrel price of oil which has come close to 100 dollars while the dollar exchange rate is at all-time lows. There is a risk of a slowdown, even a recession, but also of inflation and this is creating a very complicated dilemma for monetary policy. Cutting interest rates further could boost inflation without managing to revive the economy. This already has a bad name, stagflation, or stagnation along with inflation. This is a scenario that takes us back to the Seventies and the beginning of the Eighties, the most complicated for economic policy since World War II. Furthermore, cutting US interest rates could give a heavy blow to a dollar that is already very weak. This also brings back bad memories of the Seventies when the dollar suffered the consequences of the imbalance in the US balance of payments starting a long decline that undermined the international monetary system established at Bretton Woods.

Japan and Europe not likely to take place of United States as engines of world economy.

Neither the Bank of Japan nor the ECB have things much easier. The governor of the Bank of Japan makes no secret of his wanting to raise the present reference rate that now stands at a very low 0.50%. But with economic growth still unsettled and deflation still a factor it will be difficult to make such a move. Jean-Claude Trichet, chairman of the ECB, also has his hands tied. The consumer price index rose to 2.6% in October and has still not reached a ceiling. The risk ofinflation is clear and perhaps because of this he will have to renew the increases in interest rates interrupted by the subprime mortgage crisis. The rise in the euro putting it close to an exchange rate of 1.50 dollars would caution against adding fuel to the fire with the risk of setting off a slowdown in economic activity.

Monetary policy has very narrow margin for manoeuvre because of inflation risks and moves in exchange rates.

Spain's economy: facing a slowdown

The overall economic situation is also complicated in the case of Spain. The good times are being left behind to the extent that figures for National Accounting show a return of growth rates to more sustainable levels. In any case, figures for the third quarter show a firm advance putting growth at 3.8% compared with the same quarter in 2006. Growth of Spain's economy continues to be substantially higher than that of the Euro Area, although the differential has narrowed.

Spain's economy grows 3.8% in third quarter.

Household consumption losing strength and construction spending easing off although capital goods investment still showing high rates.

Growth is moderating but at the same time it is taking place in a more balanced way. The slowdown is showing up in household consumption and construction investment. On the other hand, the foreign sector has improved its contribution to the GDP by taking off less from growth.

Household consumption continued to lose strength in the summer months thus presenting a year-on-year increase of 2.9%, some four decimals less than in the second quarter. On the other hand, general government consumption rose in the third quarter to show a year-on-year increase of 5.8%. With regard to investment, all components showed a more moderate growth rate. The year-on-year change rate in construction was down to 3.8%, far from the 7.1% in the first quarter of 2006, thus showing the lower strength in residential building and public works. The annual increase in investment in residential building was down to 2.9% and probably the slowdown in housing construction will continue in coming months, if we are to go by the drop in new building approvals. With regard to construction of infrastructures, comparison of the latest annual rate with the previous period is affected by the latest autonomous community and municipal elections so that an early recovery is likely, in view of projects now under way. Investment in capital goods showed substantially lower growth with quarter-on-quarter growth going to 0.8%, although the year-on-year rate stood at a high 11.2%.

Foreign sector improving, partly compensating drop in domestic demand.

With regard to the foreign sector, both exports of goods and services were up thanks to the boost in foreign demand. Imports of goods and services also strengthened, although to a lesser extent, so that this put a brake on the worsening of the foreign sector.

Employment growing by 3% but productivity scarcely any better while inflation suffering impact of rise in oil.

On the supply side, the slowdown in construction and the primary sector can be compensated only partially by the gradual rise in market services and industry. Gross value added of construction showed a notable loss of strength with the annual change rate going to 3.6%. Industry improved slightly although the change rate in annual terms was down to 2.4%. Market services branches to show improved strength included transport, company services and retail trade. Public services, on the other hand, showed slower progress. As a whole, services branches maintained a notable growth rate with the year-on-year change rate going up by two decimals to 4.4%.

According to figures for the Quarterly Accounts, the third quarter showed a continuing trend to a gradual slowdown in employment although it still reported sizeable year-on-year growth of 3.0%. Employment in industry did not improve over the previous quarter and continued to be slightly lower than the same month last year. Construction continued to lose drive although it showed the biggest rise in employment compared with one year ago. In turn, market services were weaker but maintained a year-on-year growth rate of 3.2%.

The weak point remains the trend in productivity which scarcely showed any improvement. Nor is inflation going through a good period given that the effect of the rise in oil has brought about a notable rise in the consumer price index, as has happened in other economies. In a complicated international economic situation, Spain's economy faces the year-end with notable momentum which will allow it to reach total growth of 3.8% for the year, one of the highest in the Euro Area, and with prospects of continuing to grow above the EU average in 2008.

November 27, 2007

CHRONOLOGY

2006

November	**29**	Publication in BOE Official Bulletin of Law 35/2006 on reforms to **Personal Income Tax** and partial modification of laws on Corporate Tax, Non-resident tax and Property Tax.
December	**7**	**European Central Bank** raises official interest rate to 3.50%.

2007

January	**1**	**European Union** enlarged to 27 member states following inclusion of Romania and Bulgaria; and **euro area** numbers 13 members following adoption of European single currency by Slovenia. Reforms to **Personal Income Tax** and **Corporate Tax go** into force.
March	**8**	**European Central Bank** raises official interest rate to 3.75%.
April	**13**	Publication of Law 6/2007 in Official Government Bulletin (BOE) modifying the regulations applying to **takeover bids** which come into force in mid-August.
June	**6**	**European Central Bank** raises official interest rate to 4.00%.
	14	Parliament approves new **Law on Safeguarding Competition** with creation of National Competition Commission.
	21	EU Council of Ministers approves **adoption of euro as national currency for Malta and Cyprus** as of January 1, 2008.
August	**9**	European Central Bank injects extraordinary liquidity into interbank market as early emergency move to ease pressures set off by **subprime mortgage crisis** in United States.
	13	US Federal Reserve reduces discount interest rate from 6.25% to 5.75% in order to relieve effects of **subprime mortgage crisis**.
September	**18**	**Federal Reserve** reduces reference rate to 4.75%.
October	**9**	Dow Jones index for **New York stock exchange** marks up all-time record (14,164.5), a rise of 13.7% compared with end of 2006.
	19	European Council agrees to adopt the **Treaty of Lisbon** in place of the European Constitution.
	31	**Federal Reserve** cuts reference rate to 4.50%.
November	**8**	IBEX 35 index for **Spanish stock market** marks up all-time high (15,945.7) with cumulative gains of 12.7% compared with end of December 2006.
	23	One-month forward price of Brent quality **oil** goes up to all-time high level of 95.45 dollars a barrel.
	27	**Euro** exchange rate at 1.487 dollars, highest figure since launching of European single currency at beginning of 1999.

AGENDA

December

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

January

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

INTERNATIONAL REVIEW

US GDP grows 2.6% in third quarter thanks to domestic demand and exports...

United States: slowdown gradual but continuing

The recent trend in the US economy may be described by that popular old Spanish saying «Not so bad and not so good!» Following a very poor start to the year that set off alarm bells and gave ammunition to ominous prophecies, there came the robust figures for the gross domestic product (GDP) in the third quarter which have made all the problems seem to evaporate. The saying «not so bad and not so good» applies. The economy continues its gradual but constant slowdown.

The GDP showed a slight rise and grew by 2.6% year-on-year in the third quarter, 3.9% compared with the second quarter in annual terms. The recovery profile of economic activity is reinforced by its make-up. Domestic demand increased its contribution to quarter-on-quarter growth from 2.4% to 2.9%, thanks to recovery of private consumption. In addition, while the contribution of the foreign sector went from 1.3% to 1.0%, the forecast remained upward, given that exports continued strong and with the only drop coming from the natural increase in imports due to the strength of domestic consumption.

...but weakness in construction continues and real estate prices down 5%.

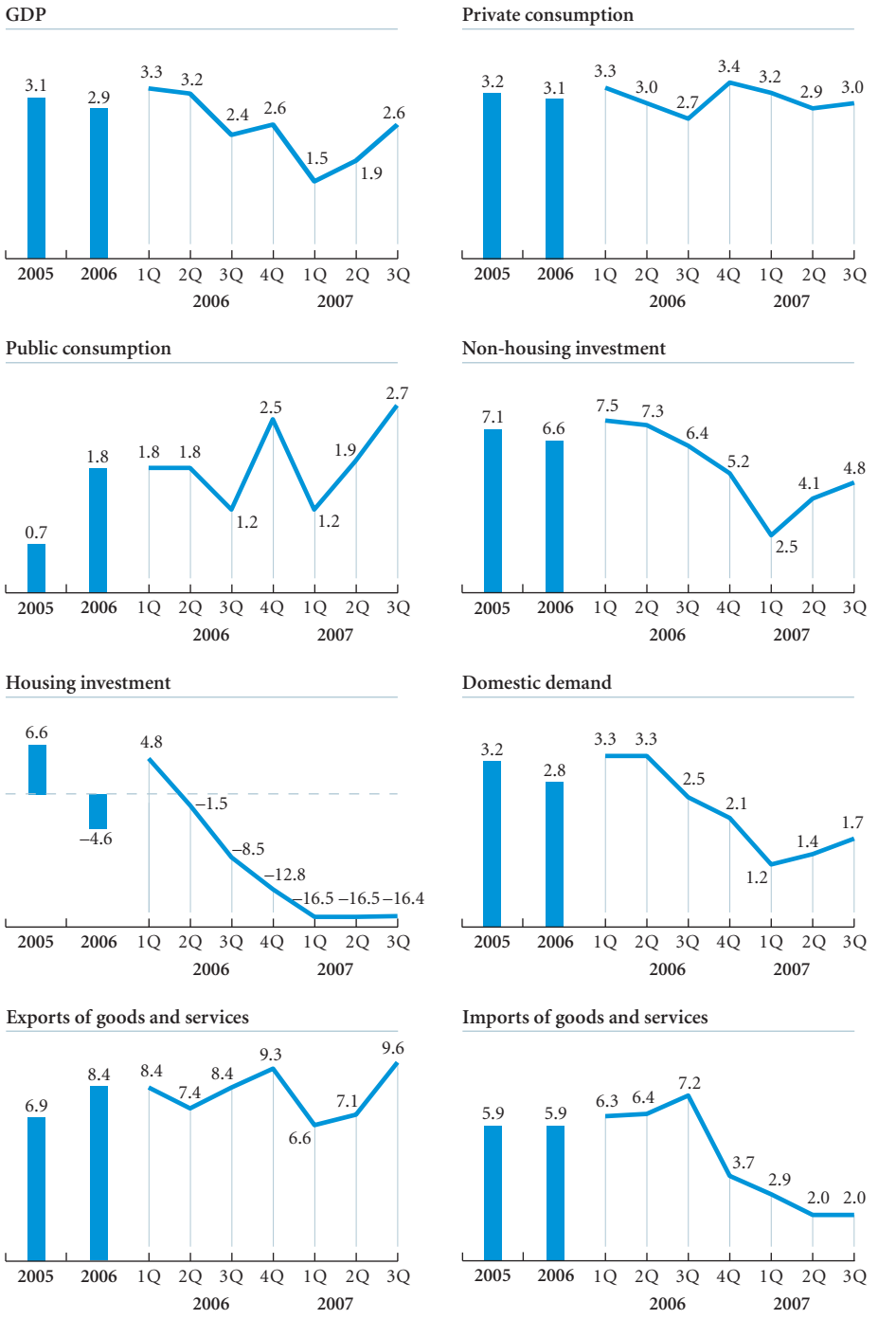
In spite of this, growth prospects continue to be somewhat down across the Atlantic. Firstly, recovery of capital goods investment is not shining too brightly and construction is still not near the end of the tunnel. Secondly, the background trend in private consumption remains as a gradual slowdown. The effects the weakness in the housing sector may have on this slowdown characteristically last a certain length of time and the biggest part is still to come. Thirdly, the labour market, the other big support of indebted consumers, is still holding its own but also tending downward.

The housing market affects economic activity through two mechanisms. On the one hand, in supply, construction spending in the third quarter was down 20.1% in annual terms compared with the previous period and, as it is a component of the GDP, took away 0.9% from this (over a total of 3.9%). Prospects are still not bright as, in spite of a slight rise in October, housing starts were 16.4% below the same period last year, showing a sharp slump in the crucial single-family segment. Pointing in the same direction, building permits, which are an early indicator of housing starts, were down by 24.5%.

A second mechanism by which the housing sector acts on aggregate demand is the wealth effect. Falling prices make consumers feel poorer and their buying ends up dropping. The Case-Schiller index for housing prices showed sharper drops in August with a loss of 5.0% year-on-year. Areas such as Las Vegas, Florida, Detroit and San Diego suffered substantially bigger drops. Sales of existing housing were down 19.8% year-on-year in September. New housing sales were no better and the ratio between houses sold or rented compared with vacant properties

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



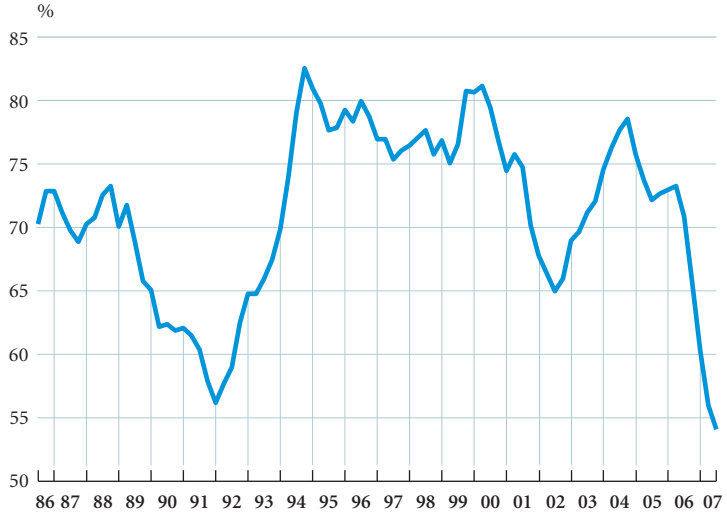
SOURCE: Bureau of Economic Analysis and own calculations.

dropped to 54.1% in the second quarter, a level below the lows in 1991 when the previous housing crisis took place.

With banks seeing so many mortgage loans going into default, and disposing of assets considered to involve risk and

UNITED STATES: REAL ESTATE MARKET AT LOW LEVEL

Housing sales and rentals compared with available housing inventories



SOURCE: Federal Housing Board and own calculations.

Private consumption and prospects down slightly while labour market showing strong.

restricting credit, the spending prospects of consumers already in debt are not good. Retail sales continue along this course although without big collapses. Excluding cars and petrol, which are highly volatile, retail consumption in October was up by 3.6% year-on-year, which marks out a course of gradual but well defined slowdown. In line with this trend, the Conference Board confidence index continued to drop, going from 99.5 to the level of 95.6 points.

The labour market continues to show a very similar trend. Figures for October, with 160,000 new jobs, were better than expected but, even so, over the past 12 months only 1,676,000 jobs were created whereas in the same period last year the figure was 2,394,000. The unemployment rate in October remained unchanged at 4.7% of the labour force.

Business executives see maintenance of economic activity and employment...

This trend to slowdown, however, is softened by the non-financial companies that continue to present profits and, in contrast to consumers, are showing reasonable debt levels. The slowdown in the economy is thus finding an element of resistance that may be noted in the trend in the management activity index put out by the Institute for Supply Management. In the manufacturing sector it was down slightly from 52.0 points to 50.9 points, a level that, because it stands above 50, indicates that optimistic replies are still winning, although not by a lot, over pessimistic views. In services, the index even went slightly upward from 54.8 points to 55.8 points. It is also of note that, apart from the upward pressure on price components, new orders (especially for export) are among the highest while employment remains above 50.

In turn, inflation continues under control. The consumer price index (CPI) for October showed an increase going from growth of 2.8% to 3.5% year-on-year because of the specific performance in the energy sector. Prices in October 2007 were not substantially higher than in September but comparison with the

UNITED STATES: SLOWDOWN IN CONSUMPTION CONTINUES

Year-on-year change in retail sales excluding cars and petrol

SOURCE: Department of Commerce and own calculations.

level of prices in October 2006 (which at that time reported a substantial drop) shows a sharp increase that does not fit into the current situation. This shows up better in the underlying component (the general rate less food and energy) which continued to show a rate of 2.1% year-on-year.

...so long as prices hold steady, oil permitting.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007			
			4Q	1Q	2Q	3Q	October
Real GDP	3.1	2.9	2.6	1.5	1.9	2.6	–
Retail sales	6.6	6.1	5.0	3.4	4.0	4.0	5.2
Consumer confidence (1)	100.3	105.9	106.8	109.9	106.7	105.7	95.6
Industrial production	3.2	4.0	3.5	2.5	1.7	1.8	1.8
Industrial activity index (ISM) (1)	55.5	53.9	50.9	50.8	55.2	52.9	50.9
Sales of single-family homes	6.5	–18.0	–21.9	–24.6	–21.2	–22.8	...
Unemployment rate (2)	5.1	4.6	4.5	4.5	4.5	4.6	4.7
Consumer prices	3.4	3.2	1.9	2.4	2.7	2.4	3.5
Trade balance (3)	–714.4	–758.5	–758.5	–746.4	–731.5	–704.4	...
3-month interbank interest rate (1)	3.6	5.2	5.4	5.4	5.4	5.4	4.9
Nominal effective exchange rate (4)	83.7	82.5	81.6	81.9	79.3	77.0	73.9

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

Economy less able to grow without inflation.

Nevertheless, the highest rate at which the economy can advance without creating inflationary pressures has been reduced, as noted by the Federal Reserve. In the present situation, this translates into lower growth rates without there being significant changes in the growth rate of prices, or that the risks are more on the side of lower growth than on inflationary pressures. All of this is weakening the dollar and facilitating the growth of exports which in recent times are acting as one of the strengths of the economy. The trade deficit was 55 billion dollars in September, some 23% below the high reached in 2006. Nevertheless, aid to a weak dollar should not go to undesirable lengths seeing that it is in confidence in the greenback where the capacity to finance the US economy lies.

Japan's GDP moves up with growth of 2.2% thanks to capital goods investment and foreign sector...

Japan: a fragile recovery

Japan's economy recovered from a poor second quarter to show salutary growth of 2.2% year-on-year in the third quarter. The keys to this growth, in order of importance in quantitative terms, were a recovery of capital goods investment, a continuation of the increase in exports, a rise in inventories and some recovery in private consumption that seems higher that it is seeing that it is compared with the especially weak third quarter in 2006. Nevertheless, things are less buoyant than they seem. First of all, the rise seems bigger because growth in the previous three quarters was revised downward. Secondly, construction is showing a sharp drop that could continue for some time and, thirdly, the recovery in investment could be short-lived.

Construction investment in the third quarter was down by 10.9% year-on-year, largely because of changes in regulations aimed at safer buildings in case of earthquakes. While this is not due to the normal operation of the real estate market, in some aspects its effects have been greater than the housing crisis

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007			
			4Q	1Q	2Q	3Q	October
Real GDP	1.9	2.2	2.4	2.5	1.5	2.2	–
Industrial production	1.5	4.5	5.3	3.6	2.3	3.3	...
Tankan company Index (1)	18.0	22.5	25.0	23.0	23.0	23.0	–
Housing construction	3.9	4.5	5.4	–1.9	–2.7	–37.1	...
Unemployment rate (2)	4.4	4.1	4.0	4.0	3.8	3.8	...
Consumer prices	–0.3	0.2	0.3	–0.1	–0.1	–0.1	...
Trade balance (3)	10.2	9.4	9.4	10.2	11.1	12.3	...
3-month interbank interest rate (1)	0.1	0.3	0.5	0.6	0.7	0.8	0.9
Nominal effective exchange rate (4)	86.2	81.1	79.2	77.6	75.7	76.9	76.9

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

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.

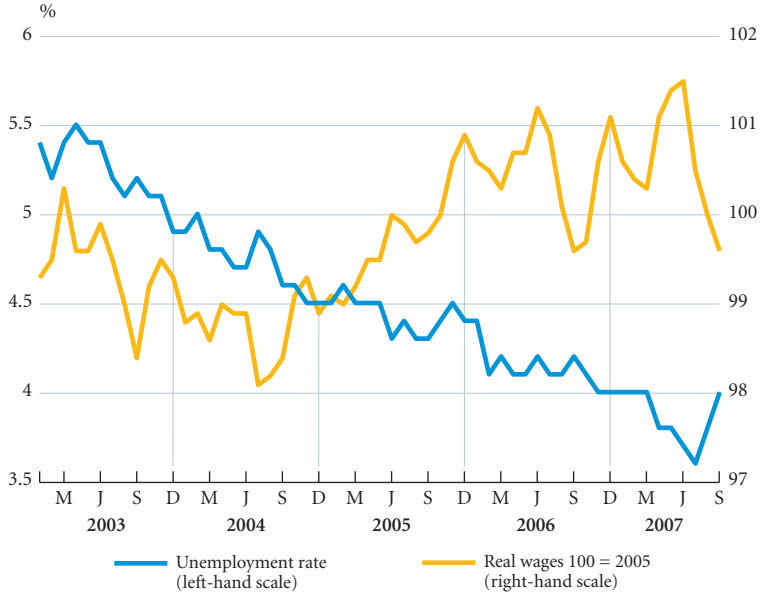
in the United States. Housing starts in September were down 44.0% year-on-year. Furthermore, if we leave aside legislation changes, the Japanese housing market is not overly strong with sales in the Tokyo region down by 25.8% in October. Not having participated in the increases taking place in other countries, prices held firm showing increases of 8.0%.

Capital goods investment in the third quarter seem to have recovered slightly from a weak period going up to rates of increase of 1.6% year-on-year. This was a slim recovery that did not compensate for the decreases in construction and which, furthermore, seems to have its days counted, seeing that in October the early indicator (machinery orders) showed a reduction in growth rate from 5.5% to 1.6% year-on-year and combined growth in investment going into the export industry with sharp drops in those aimed at domestic demand.

...but construction down 11% and consumption going nowhere.

JAPAN: UNEMPLOYMENT LOW BUT WAGES NOT MOVING

Unemployment rate and quarterly average of real wages level (*)



NOTES: (*) Discounting price increases.
SOURCE: Ministry of Communications, Japan, National Statistics Office and own calculations.

Wages not moving in spite of low unemployment.

The Tankan index showing activity of large manufacturing companies published by the Central Bank of Japan continued at the 23 points level, which indicates that the sector continues to enjoy good health, with corporate profits remaining high. This is not the case with wages. In spite of having a decreasing labour force from demographic causes and an unemployment rate of only 4.0% of the labour force, making the labour force more flexible has led salaries to grow by a mere 0.6% in real terms (discounting price increases) compared with the 2005 average. While in the past two months there has been a modest increase in this respect, we shall have to see if this continues. All of these factors, along with those of culture, do no help stimulate private consumption for which the confidence index in the third quarter dropped for the third consecutive time, on this occasion going to the 43.9 points level.

End of deflation seems close but prices still dropping.

On the prices front, deflation keeps announcing its end, now through surveys that show a rise in the cost of living. Nevertheless, the September CPI dropped by 0.2% year-to-year while the underlying index (which excludes fresh foods from the general index) was down 0.1%. The good news is that prices in Tokyo grew by 0.1% in October, so that this time things seem to be going seriously.

While industrial production in September showed a clear slowdown with a reduction in growth to 3.4% year-on-year, the trade balance continued full-steam-ahead. In the 12 months ending September it moved up to 12,300 billion yen thanks to the continuing strength of exports.

China: growing through industry and liquidity

Last month, at a supermarket of the Tesco company they put up a poster announcing that they would be selling 3,000 bottles of cooking oil at half-price. On the appointed day the crush of buyers ended up with 19 people in hospital. This event describes the inflation situation in China more graphically than the official statistics.

The Chinese economy grew by 11.5% year-on-year in the third quarter, a somewhat slower rate than in the previous quarter but coming within the spectacular progress made this year. Exports, which now amount to 33.8% of the economy, and investment were again the leaders of this advance. By sector, growth was almost exclusively concentrated in the industrial sector.

Economic activity indicators followed the same pattern, with industrial production moving up 17.4% year-on-year in October thus leaving behind any idea of cooling off. Nevertheless, the private consumer continues to be the segment that is not growing as it should. In this respect, retail sales in October were up 18.1% year-on-year, an increase that should be welcomed. The problem is that this was entirely due to price increases. If we discount these, the increases are running far behind the rest of the economy.

Inflation continues to rise with the general CPI in October showing an increase of 6.5% year-on-year. The problem is that food rose by 17.6%. This sector represents 14.1% of total retail sales although in the rural areas (with 70% of the population) this percentage goes up considerably, which contributes to worsening the rural-city differences which have been an endemic problem in China's development.

The major influence of a possible slowdown in the United States on the Chinese economy should not be seen so much in the hypothetical reduction of its imports from China as the effects this is having on monetary policy. Exports to the United States directly contribute 0.4% to China's nominal growth, which stands at 19.7%. What is more crucial is the contribution of growth from exports to Europe (1.6%) and those that go to Asia, which contribute 2.1%. Even considering the indirect effects,

Chinese economy grows by 11.5% led by exports and investment.

Industry continues to show strength but consumption still behind.

CHINA: MAIN ECONOMIC INDICATORS

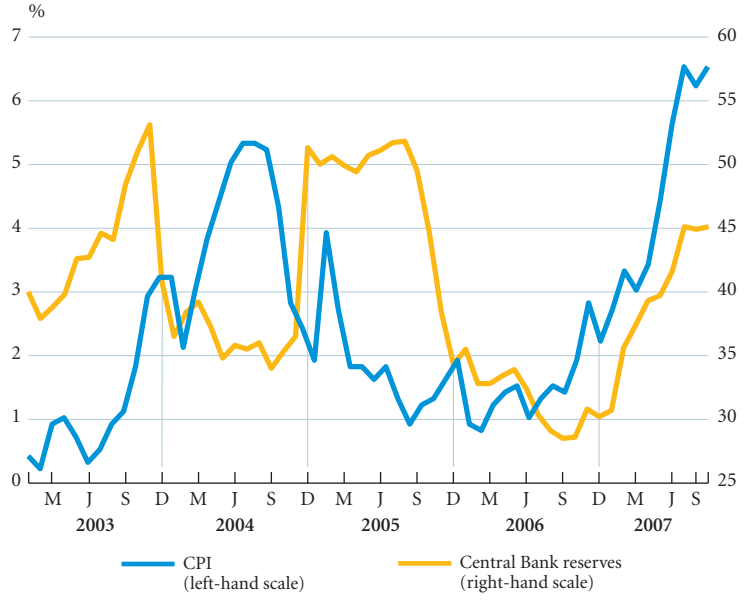
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007			
			4Q	1Q	2Q	3Q	October
Real GDP	10.1	10.7	10.4	11.1	11.9	11.5	–
Industrial production	15.9	16.4	14.8	...	...	...	...
Electrical power production	13.4	14.7	15.3	12.4	17.7	16.3	17.4
Consumer prices	1.8	1.5	2.0	2.7	3.6	6.1	6.5
Trade balance (*)	102.0	177.5	177.5	200.5	228.8	253.3	256.5
3-month interbank interest rate (*)	2.4	2.8	3.1	2.8	3.4	3.5	4.3
Renminbi to dollar	8.2	8.0	7.8	7.7	7.7	7.5	7.5

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

CHINA: IS ACCUMULATION OF RESERVES BOOSTING INFLATION?

Year-on-year change in CPI and Central Bank reserves



SOURCE: Chinese National Statistics Office and own calculations.

Inflation goes to 6.5% boosted by accumulation of reserves while stock market hitting records.

according to the Asian Development Bank, a slowdown in the US economy would have difficulty in reducing China's growth by more than 1.0%.

Nevertheless, the so-called «Asian decoupling» is by no means complete. The cuts in interest rate by the Federal Reserve have weakened the dollar. In order to lessen the appreciation of their currencies against the dollar, the Asian central banks have acquired vast reserves in dollars. As the sale of government bonds does not function efficiently, this translates into increases in the money supply that neutralizes the very small rate increases and cash reserves in order to somewhat cool off the economic machinery, thus increasing the inflationary flames in a country that, according to the International Energy Agency, could be the world's biggest consumer of energy in 2010.

This liquidity will also go into the stock market which in October had a total capitalization of 109.3% of nominal GDP, or 177.7% if we add the Hong Kong and Taiwan markets, whereas only a year ago it was 31.7%. In this respect, we should point out that the listing on the stock exchange (and subsequent appreciation) of a small part of the capital of the State energy enterprise Petrochina turned it into the world's leading company with a market value of more than 1,000 billion dollars.

Mexico: growth with no inflation but with foreign deficit

Mexico's GDP grows by 3.7% without creating inflationary pressures with help of private consumption and investment.

The Mexican economy grew by 3.7% year-on-year in the third quarter, which meant a notable increase over the 2.8% in the previous period. Consumption and private investment are the main engines of growth while the foreign sector lags behind. Among the most recent indicators of economic activity, industrial production in September slowed down to a growth figure of a mere 0.4% year-on-

MEXICAN INDUSTRY LOSING DRIVE

Year-on-year change in industrial production (*)

NOTES: (*) Trend series.
SOURCE: Central Bank of Mexico and own calculations.

year. While construction followed a low profile although still improving, it was manufacturing where the economy ran out of steam with a year-on-year drop of 0.3% compared with an increase of 3.2% the month before.

In spite of the latest problems in industry, unit labour costs seem to have gradually returned to the fold. Following a sharp rise in May and June, they moved up a slight 0.3% year-on-year in August, thanks to increases in productivity. Along the same lines, in spite of the strength of domestic demand, the rate of GDP increase again dropped from 4% to stand at a moderate 3.7% year-on-year in October. In turn, the underlying index

Industry falling behind but labour costs moderating following rise in second quarter.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007			
			4Q	1Q	2Q	3Q	October
Real GDP	2.8	4.8	4.3	2.6	2.8	3.7	–
Industrial production	1.8	5.0	3.6	0.5	0.7	1.8	...
General unemployment rate (*)	3.6	3.6	3.7	4.0	3.4	3.9	...
Consumer prices	4.0	3.6	4.1	4.1	4.0	4.0	3.7
Trade balance (**)	–7.6	–6.1	–6.1	–9.4	–11.7	–11.8	...
3-month interbank interest rate	9.5	7.3	7.2	7.2	7.2	7.2	7.2
Mexican pesos to dollar	10.9	10.9	10.9	11.1	10.8	11.0	10.7

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

MEXICO: TRADE DEFICIT CONTINUES WITHOUT HITTING BOTTOM

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

SOURCE: Central Bank of Mexico and own calculations.

Inflation moderate but trade deficit still worsening.

(excluding energy and food) also eased slightly going to 3.9%.

The unemployment rate stood at 3.9% of the labour force in September, a very low level that, nevertheless, could hide important pockets of unemployment. In the foreign sector, the trade balance for the past 12 months up to September showed a growing deficit of 11.8 billion dollars. Not counting oil exports the deficit reached 50.27 billion dollars, 11.8% above the same last year.

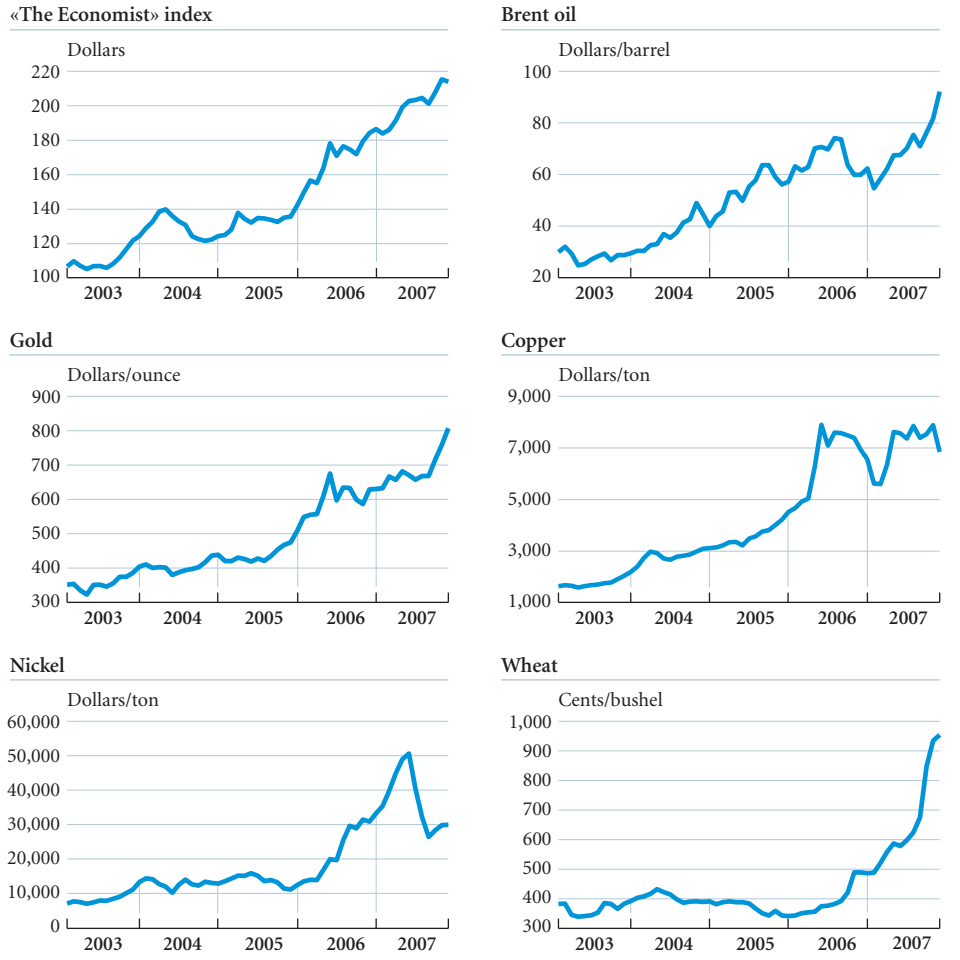
Raw materials: oil reaches giddy price levels

Oil holding at high levels with psychological level of 100 dollars a barrel close at hand.

In spite of the important fluctuations recorded during the month, oil is not leaving the band of high prices. After standing above 94 dollars a barrel (one-month forward Brent quality) at the beginning of November, the pressures on prices seemed to ease. Nevertheless, on November 23 it again recorded an all-time high of 95.45 dollars a barrel. Three days earlier the per barrel price of West Texas oil had close at 98.48 dollars. The psychological level of 100 dollars a barrel (reached during some daily sessions) is therefore seen as close at hand.

What is causing these giddy prices? There are three factors pushing up the price of oil. First, of a fundamental nature, lies in the difficulties of supply to meet a fast growing demand. This argument is supported by the fact that the highs for oil have coincided with moments when poor indicators of the supply/demand ratio have become known and especially figures for inventories of oil products in the United States. Nevertheless, this explanation, that could well justify the growing trend in recent years, does not satisfactorily account for the latest upward move, a rise that has been practically vertical in little less than a month and a half (a rise of 21% since October 10). Here we see

TREND IN VARIOUS RAW MATERIALS



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

the intervention of two other factors. First, the entry of highly speculative funds; second, the geo-strategic risk premium linked basically to the situation in the Middle East.

Over the medium term, the prospects are uncertain. In its November monthly report, the International Energy Agency revised downward expected demand for the final quarter of 2007 and for 2008. The basic cause for this expected lower demand are the high prices for oil which, in the view of this international body, is combined with slightly worse growth prospects. In addition, the Third Summit of heads of state and government of the Organization of Petroleum Exporting Countries (OPEC) repeated the oil cartel's thesis that the rise in prices was not due to a problem of insufficient supply, which could put in doubt existing forecasts of an increase in production by OPEC.

With regard to other raw materials, November brought something of a truce in the rally shown in recent times. «The Economist» index of raw materials, measured in dollars, dropped by 1.1% in

International Energy Agency feels these prices will cut back demand for crude oil.

RAW MATERIALS PRICES

	2005	2006	2007					
			1Q	2Q	3Q	4Q	October	November
«The Economist» index in dollars (*)								
General	**3.4**	**27.5**	**21.8**	**17.7**	**17.2**	**16.8**	**20.1**	**15.6**
Food	–1.8	10.8	16.5	18.9	30.9	30.1	35.6	30.1
Industrials	9.8	46.1	26.9	17.0	6.4	5.6	7.3	3.5
Non-food agricultural	*–2.4*	*12.4*	*4.5*	*3.1*	*7.6*	*25.8*	*21.9*	*29.2*
Metals	*16.6*	*62.0*	*36.2*	*21.8*	*6.2*	*0.2*	*3.4*	*–3.3*
«The Economist» index in euros (*)	**3.3**	**26.0**	**11.6**	**9.8**	**8.6**	**4.3**	**6.7**	**1.7**
Oil (**)								
Dollars/barrel	55.3	66.4	58.7	68.7	74.5	89.5	82.2	92.4
Change rate	45.5	20.1	–6.7	–2.6	5.0	46.8	36.6	53.4
Gold								
Dollars/ounce	445.3	604.4	649.6	667.8	680.2	782.7	754.6	806.6
Change rate	8.7	35.7	17.2	6.4	9.4	27.4	28.7	28.5

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

Metals show downward correction in November.

November, slowing its growth rate by more than four points compared with one month earlier. This result was due to the drop in metals, which in one month have dropped by 5.8% to stand at levels 3.5% below those one year ago. Of special note were the drops in copper, lead and zinc which have recorded decreases of more than 15% in the past month. Food raw materials and non-food farm raw materials, on the other hand, continued to grow in November.

Financial crises and how to escape from the wheel of fortune

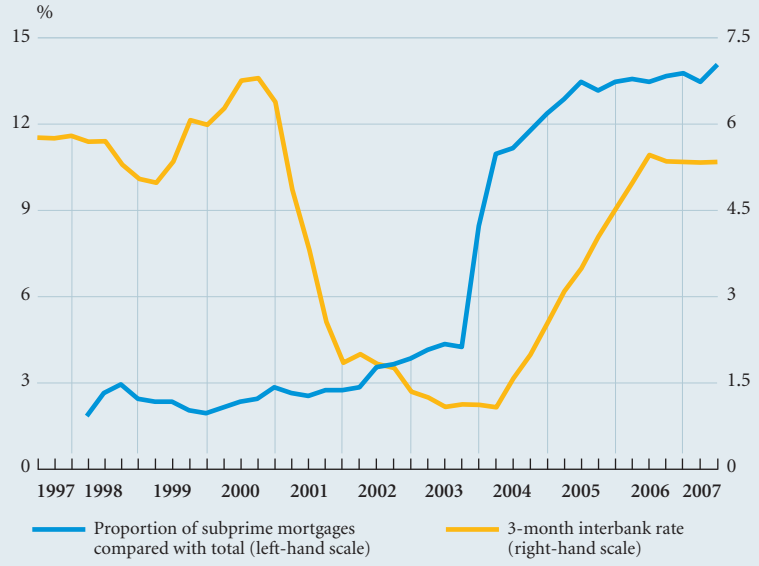
Often, when prices of assets show very sharp increases, there is a widespread conviction that we are at a stage that is new and different from any that has gone before. When the bubble bursts, there come the lamentations for not having known how to take advantage of experience gained from earlier crises. Ortega y Gasset used to say that you had to know your history to be able to escape from it. What light can previous crises throw to help explain the current upsets in the markets?

After some earlier warnings, the storm hitting the financial systems, known as the «subprime mortgage crisis», with all its repercussions, broke out half way through this past summer. An explanation of the current crisis in the markets includes elementary sins in risk management and excessive technical sophistication. The first started in the United States with the concession of mortgage loans to persons of

doubtful solvency. These subprime mortgages, of low credit rating, went from making up 2.5% of the total in 2001 to the present 14.0%. There were few incentives for caution. The rights to receive monthly payments for subprime mortgages were distributed in packages known as collateralized debt obligations (CDOs), obligations with subsidiary collateral (see box «Subprime mortgage crisis: are credit derivatives to blame?» on page 35). CDOs were sold to other other entities which included them in their portfolios of financial assets and the initial error was blameless given that the dangers were far away from those who created them and were considered minimal in a situation of low interest rates and low risk premiums. But, when rates went up low-income families began to fail to meet their mortgage payments and the CDOs fell under suspicion.

MORTGAGE LOANS FREELY GRANTED AND BANKS CUT OFF CREDIT

Proportion of subprime mortgage loans compared with total and 3-month interbank rate (figures at end of quarter)



SOURCE: Federal Reserve, Moody's and own calculations.

In addition, CDO portfolios were made up of complex mathematical instruments at times using biased evaluation criteria. With the first defaults, the lack of a market valuation price gave rise to a witch-hunt and almost all credit risk assets fell under suspicion world-wide. Financial entities fled toward liquid money thus adding to the weakness of the real estate sector with a restriction of liquidity that showed up in interbank rates.

The first episode comparable with the present situation is now 20 years back. On October 19, 1987, the Dow Jones index for the New York stock exchange dropped 22%, the biggest dip in a single day in all its long history. The causes were automatic programmes of portfolio insurance which, in view of the drops in prices, gave prior sell orders all at once. The US economy was relatively strong, the Federal Reserve cut interest rates and the scare did not get worse. All of this brings optimism to the present crossroads, given that at the worst moments this summer the Dow Jones stock market index scarcely lost 10%. Furthermore, corporate profits are robust, the Fed is helping and the rest of the world continues to grow. Nevertheless, the 1987 crack is not too comparable

with the current one. At that time, the problems were in non-financial companies whereas the subprime mortgage episode has mainly affected banks and investment funds.

But crises are not always unrelated. The present story could be an epilogue to something that began in 1998. The episode most similar to the present situation took place in the summer of 1998 when, in view of the collapse of the Russian stock market, the sophisticated investment fund Long Term Capital Management (LTCM), counselled by the most prestigious academics in the financial arts, found itself with a shortage of nearly 3 billion dollars. Then, as now, the assets affected were of great sophistication and it was difficult to evaluate possible losses. There was uncertainty, which is a synonym for risk. In view of the gravity of the situation, the Federal Reserve acted as a shining knight and cut the intervention rate by 0.25 percentage points three consecutive times. An easy monetary policy, together with the fantasy of a «new economy» generated by the new information and communications technology, set off a giddy upward race on the stock exchange. The race came to a sudden halt in 2000 with the bursting of the bubble of the Internet companies. From the highs in March 2000 to the lows in October 2002, the S&P 500 index lost 45%, the technology-oriented Nasdaq index lost 78% and economic growth suffered.

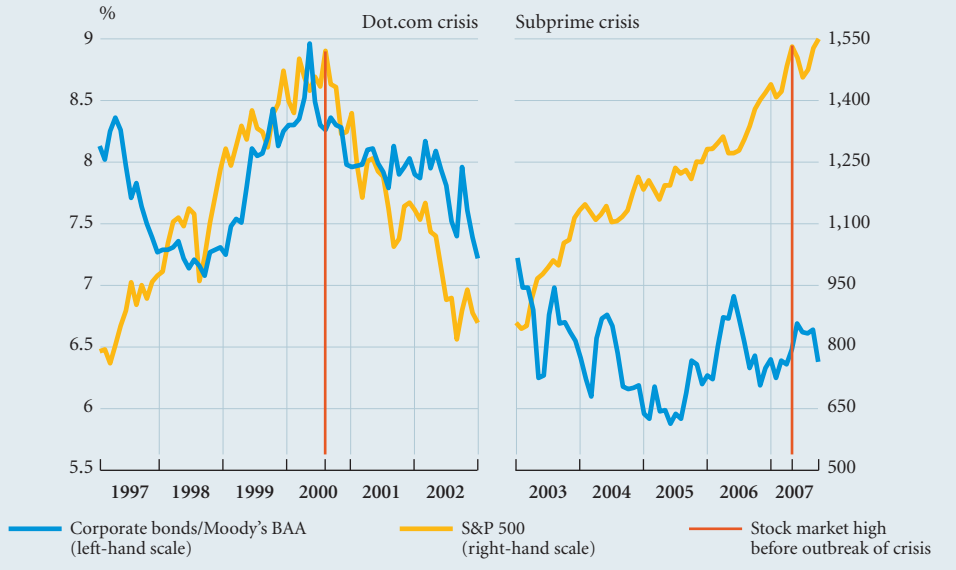
The nature of the Internet bubble is farther away from the present situation, if this were possible. In the «new economy», rising share prices coincided with poor corporate results while it was believed that the coming of the new era would bring big future profits. Once more, the problems were concentrated in the non-financial sector, especially in the new information technology companies. These optimistic fancies brought a heavy demand for credit which drove up interest rates and risk premiums. With the collapse of the expectations of the new economy, the stock market and demand for credit fell simultaneously sending down interest rates and, with some delay, risk premiums.

In 2007, just the opposite took place. The non-financial sector, especially the information technology sector, is riding out the storm with high profits and low borrowing whereas the problems lie on the financial side. But one thing leads to another. In 2001, the Fed again lowered its rates and the market understood that, if things went badly, the central bank was there to fix things up. The success of the central banks in the fight against inflation and the effects of globalization has reduced inflationary risks. The prudence of cautious companies did the rest to take us to a stage of cheap money where no one cared about how much the debtor had borrowed.

Whether or not it repeats itself, history continues and can bring new surprises. In the first place, the losses in bank balance sheets may reach 200 billion dollars, seventy times that of the LTCM. Secondly, the problem is more widespread than it was then and includes weaknesses in real estate which normally have more profound and enduring effects on the real economy than stock market crises. Thirdly, the optimism in the stock market about a repetition of the price rises seen in 1999 is based on the fact that the Federal Reserve will guarantee liquidity, corporate profits remain high and a weak dollar, combined with robust demand from the emerging countries, will give strength to the export sector. The problem is that the Federal Reserve has a memory and will be more ready than it was then to raise interest rates if inflationary pressures increase. Another matter is that when corporate profits are high it is easier to cut rates than to raise them. Finally, demand from the emerging countries has largely been based on exports to a United States that in the future may buy less.

DOT.COM AND SUBPRIME: TWO VERY DIFFERENT CRISES

Interest rate and stock market index in USA (figures for month-end)



SOURCE: Federal Reserve, Moody's and own calculations.

The current episode means a toughening of credit terms by the financial entities. Companies do not have great leverage but with many consumers highly indebted, the effects on the economy, which now are relatively gentle, could become more widespread and lasting than the 1998 crisis.

EUROPEAN UNION

European Commission expecting moderate slowdown in 2008 and 2009.

European Commission forecasts: European Union riding out the storm

The subprime mortgage crisis, the real estate recession in the United States, oil prices at all-time highs. The European Union (EU) is facing a series of factors that could possibly have a negative effect on the future course of the economy. Nevertheless, in the judgment of the European Commission, the EU will be able to overcome all these obstacles without any great problems. For every risk there exists a factor that could soften the blow. Inflationary pressure from raw materials is being eased by appreciation of the euro. The toll a strong euro inflicts on the contribution from the foreign sector is partly compensated by solid domestic fundamentals. And the slowdown in the United States does not present the same risks as in previous episodes, given that to a large extent the strength of the emerging economies, with powerful China in a notable position, is taking its place.

In broad figures, while the sharp growth rate in 2007 (2.9% for the EU as a whole) is not going to be repeated in the immediate future, the rate of economic activity will drop only moderately to stand at 2.4% both in 2008 and 2009. The Euro Area will run a similar course going from 2.6% this year to 2.2% in 2008 and 2.1% in 2009. Nor do prices suggest a negative trend. While the EU executive expects an increase in inflation in coming months, it foresees that the later slowdown will mean that growth of this variable in 2008 will be 2.4% in the EU, only marginally higher than the

MACROECONOMIC PROJECTIONS FOR EURO AREA (1)

	2005	2006	Current forecasts Autumn 2007			Difference with Spring 2007 (2)	
			2007	2008	2009	2007	2008
Gross domestic product	**1.5**	**2.8**	**2.6**	**2.2**	**2.1**	**0.0**	**0.3**
Consumption	1.5	1.8	1.7	2.1	1.9	–0.4	–0.3
Investment	1.4	1.9	2.0	2.1	2.0	0.2	0.2
Employment	0.5	1.3	1.5	1.0	0.8	0.1	–0.2
Unemployment rate (3)	8.9	8.3	7.3	7.1	7.1	0.1	0.3
Inflation (4)	2.2	2.2	2.0	2.1	2.0	0.1	0.2
Government balance (% of GDP)	–2.5	–1.5	–0.8	–0.9	–0.8	0.2	–0.1
Government debt (% of GDP)	70.3	68.6	65.0	66.5	63.4	–0.3	0.0
Current account balance (% of GDP)	0.2	–0.1	0.0	0.0	0.1	–0.2	–0.1
Growth of GDP in EU-27	*1.8*	*3.0*	*2.9*	*2.4*	*2.4*	*0.0*	*–0.3*

NOTES: (1) Annual change as percentage unless otherwise indicated.
(2) Plus sign (+) or minus sign (–) indicates a higher (or lower) positive figure or lower (or higher) negative figure compared with Spring 2007.
(3) Percentage of labour force.
(4) Harmonized consumer price index.
SOURCE: European Commission.

MACROECONOMIC FORECASTS OF EURO AREA COUNTRIES

Autumn 2007

	GDP (*)			Inflation (**)			Unemployment (***)		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Belgium	2.7	2.1	2.2	1.7	2.1	1.8	7.5	7.2	6.9
Germany	2.5	2.1	2.2	2.2	2.0	1.8	8.1	7.7	7.6
Greece	4.1	3.8	3.7	2.8	3.1	3.1	8.4	7.9	7.5
Spain	3.8	3.0	2.3	2.6	2.9	2.7	8.1	8.5	9.1
France	1.9	2.0	1.8	1.5	1.7	1.6	8.6	8.2	8.1
Ireland	4.9	3.5	3.8	2.8	2.2	2.0	4.5	5.3	5.5
Italy	1.9	1.4	1.6	1.9	2.0	1.9	5.9	5.7	5.5
Luxembourg	5.2	4.7	4.5	2.5	2.8	2.3	4.7	4.5	4.2
Netherlands	2.7	2.6	2.5	1.6	2.3	2.7	3.1	2.7	2.4
Austria	3.3	2.7	2.4	1.9	1.9	1.8	4.3	4.2	4.2
Portugal	1.8	2.0	2.1	2.4	2.4	2.3	8.0	8.0	7.7
Slovenia	6.0	4.6	4.0	3.5	3.7	2.9	4.9	4.7	4.6
Finland	4.3	3.4	2.8	1.5	2.4	2.1	6.7	6.4	6.3
Euro area	**2.6**	**2.2**	**2.1**	**2.0**	**2.1**	**2.0**	**7.3**	**7.1**	**7.1**

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

2.3% seen in 2007. Furthermore, the course will be there and back given that in 2009 it is expected that inflation will be only 2.2%. The Euro Area is showing still tighter figures going from 2.0% in 2007 to 2.1% in 2008 and again 2.0% in 2009.

What are the essential features of the European economy at this moment? Three different perspectives allow us to examine this question. From the point of view of the composition of growth, with reference to the Euro Area, the slowdown may be explained by a lower contribution from the foreign sector and by the investment cycle which is moving away from the peak period seen in recent quarters. This leaves consumption as the only component on the rise although it is unable to fully compensate for the slowdown in foreign demand and investment.

A look at the cyclical position by country shows another notable aspect. The pattern that had dominated in the upward stage of the cycle has been partly broken in this downward stage. The drive in Germany and the countries of its traditional area of influence (especially Austria, the Netherlands and Belgium) is giving way to growth of this group of much smaller countries. On top of the fact that the German economic engine is easing its foot off the accelerator comes the poor economic drive in the other two large Euro Area countries, France and Italy. We should also mention that, in the opinion of the European Commission, Spain will lose drive compared with the other two economies recently enjoying high growth (Ireland and Greece). Outside the single currency area, in spite of some slowing down, the situation of explosive growth in the Central and Eastern European countries is

Euro Area to grow slightly above 2% in each of next two years.

Germany could begin to lose steam in 2008 in contrast to persistent drive in Eastern Europe.

MACROECONOMIC FORECASTS FOR EUROPEAN UNION COUNTRIES OUTSIDE EURO AREA

Autumn 2007

	GDP (*)			Inflation (**)			Unemployment (***)		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Bulgaria	6.3	6.0	6.2	7.1	7.3	5.8	7.5	6.8	6.0
Czech Republic	5.8	5.0	4.9	3.0	3.8	3.2	5.9	5.4	5.5
Denmark	1.9	1.3	1.4	1.7	2.4	2.4	3.0	2.7	2.7
Estonia	7.8	6.4	6.2	6.3	7.3	4.8	4.9	4.8	4.9
Cyprus	3.8	3.9	3.9	2.0	2.3	2.1	4.3	4.1	3.9
Latvia	10.5	7.2	6.2	9.6	9.8	6.0	5.8	5.5	5.6
Lithuania	8.5	7.5	6.3	5.6	6.5	5.2	4.2	4.2	4.4
Hungary	2.0	2.6	3.4	7.7	4.9	2.8	7.3	7.0	6.9
Malta	3.1	2.8	2.9	0.8	2.5	2.2	6.8	6.6	6.5
Poland	6.5	5.6	5.2	2.5	2.8	2.9	9.4	7.3	6.4
Romania	6.0	5.9	5.8	4.7	5.6	4.6	7.1	7.0	6.9
Slovakia	8.7	7.0	7.2	1.7	2.5	3.0	11.2	9.7	9.0
Sweden	3.4	3.1	2.4	1.6	2.0	2.0	6.1	5.8	5.7
United Kingdom	3.1	2.2	2.5	2.4	2.2	2.0	5.3	5.4	5.3
EU-27	**2.9**	**2.4**	**2.4**	**2.3**	**2.4**	**2.2**	**7.1**	**6.8**	**6.6**
United States	*2.1*	*1.7*	*2.6*	*2.7*	*1.9*	*1.5*	*4.6*	*5.3*	*5.4*
Japan	*1.9*	*1.9*	*2.3*	*0.0*	*0.2*	*0.5*	*3.9*	*4.0*	*4.0*

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.

Surprise jump: Euro Area economy moves up in third quarter contrary to expectations.

Investment and foreign sector are candidates for role as engines of growth.

continuing. Finally, we may mention that, following a period of many successive years of dynamic growth, the United Kingdom faces two years with weaker prospects.

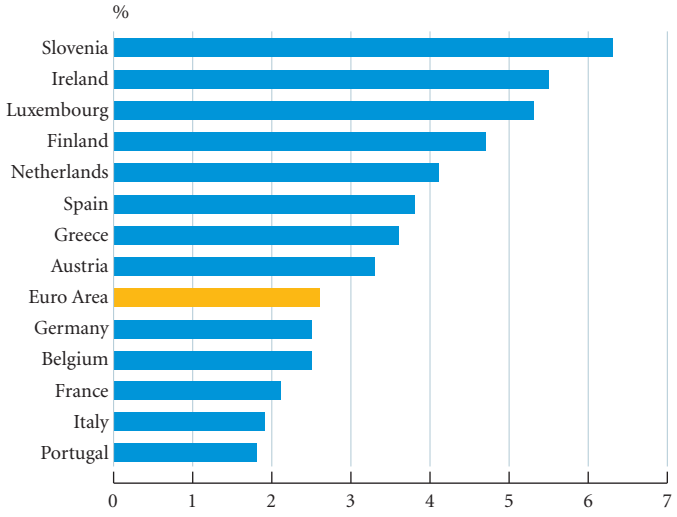
The third prospects, those which in general terms may be called economic fundamentals, complete the picture. Specifically, the EU executive points out the high profit margins of European companies, maintenance of confidence indicators (business and consumer) at levels above the long-term trend, continuing growth of employment and, in certain countries, the additional support coming from fiscal policy. All these factors give the European economy a fund of resistance which helps to reduce the risks it may face from a sharp slowdown in economic activity.

Euro area: positive surprise in third quarter

Figures for growth in the third quarter were awaited with some expectation given that they would make it possible to clarify the extent of the economic slowdown and the real state of the three big countries, namely Germany, France and Italy. The figures brought quite a surprise. To start off, when it was expected that economic growth in the Euro Area would slow down in the third quarter compared with the previous 2.5%, the increase published by Eurostat

SMALL ECONOMIES GROWING MOST

Real year-on-year change in gross domestic product in Euro Area



NOTES: Figures for third quarter of 2007, except in cases of Finland, Luxembourg, Ireland and Slovenia for which figures are for second quarter.
SOURCE: Eurostat.

showed that it had grown by 2.6% year-to-year. This higher than expected rate was mainly due to the fact that Germany and France were much higher than anticipated with growth of 2.5% and 2.1% respectively.

Where could this extra economic activity have come from? In general, the monthly indicators were pointing to a lower level of activity (for example, economic sentiment had fallen by two points in the third quarter). In spite of this broad erroneous sign, the indicators did show some clues regarding the main aids to growth. On the demand side, private consumption seems to have acted as a positive although contained element, but recovery of key indicators, such as retail sales, over the second quarter is moderate. On the other hand, investment in capital goods may have played a more decisive role. In this respect, we note the growth of the capital goods component in industrial production in the third quarter.

Along with the likely change in the investment cycle, other support may have come from the foreign sector. According to figures for the trade balance in goods to hand, growth of the trade surplus to September has been appreciable. Specifically, on average for the third quarter, the trade surplus doubled (as a cumulative figure for 12 months) thanks to growth of exports above 10% year-on-year which beat the year-on-year increase of 6% for imports. This result is especially notable if we take into account that the effective nominal exchange rate for the euro appreciated 4% between January and October. In addition, we should point out that the reduced drive in exports to the United States was compensated by the greater weight of emerging markets. To be precise, the four countries to which exports have grown most in cumulative figures for January-August compared with one year ago were Russia, India, Brazil and China, that is, the so-called BRIC countries.

European exports swinging to BRIC countries (Brazil, Russia, India and China).

Inflation rising due to poor performance of oil and food.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	1.6	2.9	2.9	3.3	3.2	2.5	–	2.6	–	–
Retail sales	1.2	2.1	2.4	2.3	1.7	1.0	1.4	1.0	1.6	...
Consumer confidence (*)	–14	–9.0	–8	–7	–5	–2	–2	–4	–6	–6
Industrial production	1.3	4.0	4.1	4.0	4.0	2.7	4.0	4.6	3.4	...
Economic sentiment indicator (*)	97.9	106.9	108.2	109.9	110.0	111.6	111.0	110.0	106.9	105.9
Unemployment rate (**)	8.9	8.3	8.2	8.0	7.7	7.5	7.4	7.4	7.3	...
Consumer prices	2.2	2.2	2.1	1.8	1.9	1.9	1.8	1.7	2.1	2.6
Trade balance (***)	42.1	–10.4	–21.6	–13.1	–0.9	15.6	26.1	33.4	34.1	...
3-month Euribor interest rate	2.2	3.1	3.2	3.6	3.8	4.1	4.2	4.3	4.7	4.8
Nominal effective euro exchange rate	103.3	103.6	104.5	104.6	105.5	107.1	107.3	107.2	107.0	109.6

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

Germany enjoying positive economic stage.

The good state of exports largely explains why European industry is going through a strong period. In the third quarter, industrial production grew by 3.9% year-on-year, as against 2.7% in the second quarter. In any case, we should mention that immediate prospects are leaving this high point behind (both industrial confidence and industrial orders are down as of October).

With regard to inflation, consumer prices grew by 2.6% year-on-year in October, a notable increase over the 2.1% in September. This rise was due to the rise in the energy component but also to food, both fresh and processed. As a result, underlying inflation (discounting energy and unprocessed foods) rose by one decimal to 2.1% year-on-year. The course shown by the unemployment rate is more positive with a drop of one decimal in September putting it at 7.3%.

Germany: a brilliant present with uncertain future

Germany continues to show two sides. First, the positive side, refers to the current economic situation. The figure most representative of this situation is growth of the economy in the third quarter which brought a positive surprise on showing year-on-year growth of 2.5%, the same figure as in the second quarter. It should be remembered that the analysts as a whole were expecting figures of the order of a half-point less.

The breakdown by component shows that domestic demand has increased thanks to the improved state of private consumption and investment in capital goods. This increase in domestic demand made it possible that the drop in the foreign sector (more a result of the strength of imports than a loss of drive in exports, which continue to be strong) was more than compensated.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	1.0	3.1	3.2	3.9	3.6	2.5	–	2.5	–	–
Retail sales	1.4	6.1	5.5	6.5	–1.0	–1.9	–0.7	–1.9	–1.9	...
Industrial production	2.8	6.0	6.7	6.3	7.6	5.2	4.6	5.4	6.1	...
Industrial activity index (IFO) (*)	95.5	105.5	105.3	107.0	107.5	108.0	106.4	105.8	104.2	103.9
Unemployment rate (**)	11.7	10.8	10.6	10.1	9.4	9.2	9.0	8.9	8.8	8.7
Consumer prices	2.0	1.7	1.6	1.4	1.8	1.8	1.8	2.0	2.4	2.4
Trade balance (***)	156.3	151.6	146.0	155.3	165.1	177.4	187.2	190.5	193.9	...

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

On the supply side, the industrial sector benefited most from the good export situation. Breaking with the forecasts, industrial production in September grew by 6.1% year-on-year, which meant two consecutive months of increase compared with levels that in themselves were strong.

This rate of economic activity largely explains why the labour situation remains favourable. The unemployment rate was down one decimal in October to stand at 8.7% of the labour force. This figure is 1.6 percentage points better than one year ago. Furthermore, we should point out that in October Germany managed to reach the objective it was set by the Lisbon Strategy (the medium-term EU economic programme) by putting the employment rate at more than 70% of the labour force (specifically at 70.7%, equivalent to more than 40 million persons). This was an historic goal which was reached much before the limit established at 2010. This positive reading of the present situation also encompasses inflation. In spite of standing at 2.4% year-on-year in October, in contrast to other economies, the German CPI has not worsened over September, which somewhat puts things in proper perspective.

So, what about the other side, the less satisfactory aspect? In the future and not too far off. Various factors are coming together to make 2008 a year less full of hope. First, wage negotiations have started off badly as the railway unions have demanded a wage rise of more than 30% and, in view of the negative stance of the railways, have responded with a wide-spread strike with it effects even touching industrial activity.

In turn, the government itself is not in a very strong situation. While the «Grand Coalition» remains beyond doubt, the resignation of vice-chancellor Franz Münterfering, champion of the more pro-liberalization line of Germany's Social Democratic Party, seems to confirm that we are unlikely to see any great desire for reforms during the rest of the legislature. To this social and political squeeze we should add the more truly economic front. The experts are putting out growth forecasts for 2008 that are only moderate. The macroeconomic

Germany's labour situation satisfactory with more than 40 million people working.

Lower growth forecasts, weakening of government and tough strike in railways may signal move into less of an economic boom.

pictures from the government and the European Commission show the most optimistic figures (2.1%). The International Monetary Fund drops this by one decimal to 2.0% and finally the government's committee of independent experts (the so-called «Five wise men») points to growth of only 1.9%. It should be remembered that the year-end is expected to show an increase in GDP of the order of 2.6%.

Is this too pessimistic? For the moment, the more anticipatory indicators have now begun to suggest that these scenarios could become a reality. The IFO index of industrial activity dropped to 103.9 points in October which meant six consecutive months showing a decrease. While current levels are still historically high, the trend to moderation does not leave too much leeway. Relevant confidence indicators, such as consumer confidence and the figure for services, suggest a similar situation.

France: a breather in third quarter

France grows more than expected in third quarter.

Following disappointing GDP growth of 1.4% year-on-year in the second quarter, the rise to 2.1% in the third quarter was received in France with great satisfaction. Private consumption, the traditional support of the French growth pattern, again rose in the third quarter which, together with maintenance of investment and the bigger contribution from inventories helped to bring about a rise of seven decimals in domestic demand compared with the second quarter. In addition, the downward pull from the foreign sector was reduced by half.

Starting out from these trends, the latest indicators are more contained. Consumer confidence has dropped by nearly five points in the last two months (September and October) which, together with the drop in household consumption in October, points to a lower level of household spending in coming months. In general terms, the economic sentiment index stabilized at the 110 points level in September and October, which is far from the indicator showing high levels last summer. All this makes to possible to guess that the next figure for GDP growth will point more to an economic slowdown than to growth.

Nevertheless, these weaker prospects do not imply that the general tone of the

FRANCE: MAIN ECONOMIC INDICATORS

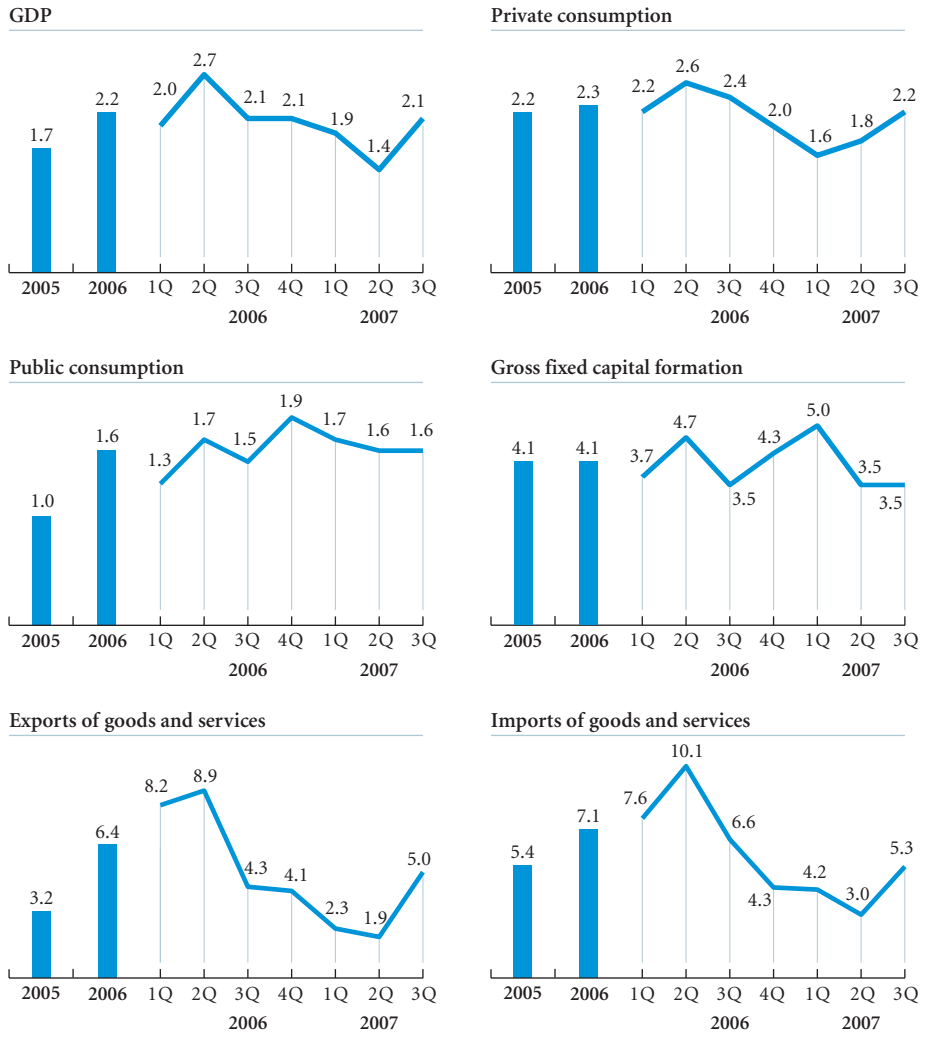
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	1.7	2.2	2.1	2.1	1.9	1.4	–	2.1	–	–
Domestic consumption	3.2	2.7	2.8	2.8	3.6	2.8	4.5	3.0	5.1	2.7
Industrial production	0.2	0.9	0.7	0.5	1.0	0.2	3.0	2.1	1.1	...
Unemployment rate (*)	9.7	9.5	9.5	9.3	9.0	8.8	8.7	8.6	8.6	...
Consumer prices	1.7	1.7	1.7	1.3	1.2	1.2	1.1	1.2	1.5	2.0
Trade balance (**)	–1.3	–2.2	–2.3	–2.3	–2.4	–2.5	–2.6	–2.6	–2.8	...

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

TREND IN FRANCE'S GDP BY COMPONENT

Percentage year-on-year change



SOURCE: INSEE and own calculations.

French economy is clouded. In spite of the rise in inflation due mainly to oil, the CPI show a rise of only 2.0% year-on-year in October and, if we discount the more volatile headings, the resulting index grew by only 1.6% year-on-year, with no change over September. At the same time, the unemployment rate continued to show a continuing downward trend. On average for the third quarter, the rate stood at 8.6% year-on-year, two decimals below the level in the second quarter.

Italy: a slight improvement in the economy

In line with what has been happening in the other large European economies, growth in Italy in the third quarter was positive. According to preliminary

Consumption acts as support to recovery but immediate prospects are more contained.

Italy grows by 1.9% in third quarter improving on figure for previous quarter.

figures, the economy grew by 1.9% in that period, up by one decimal from the figure in the second quarter. Available indicators suggest that to a large extent this slight increase would have come from some recovery in domestic demand (for example and, with reference to consumption, retail sales were up 1.4% year-on-year in August as against 0.1% in the second quarter) and from a bigger contribution from the foreign sector.

In this respect, we should point out the good state of exports which in the third quarter grew by 11.3% year-on-year, better than the 10.4% recorded in the second quarter. This trend, combined with the reduced level of imports (foreign purchases were up by 5.9% in the third quarter), meant that the foreign deficit (as cumulative figure for twelve months) was reduced by 28% in the third quarter. The main beneficiary of the recovery in exports is industry although the growth rate of secondary activity remains low (industrial production moved up 0.8% year-on-year in the third quarter, a modest figure but better than the 0.6% seen in the previous quarter).

Foreign sector showing notable improvement.

The trend in prices and unemployment is similar to that recorded in other countries of the Euro Area. Inflation is going up mainly due to the higher cost of energy (the September CPI grew by 2.1% year-on-year as against the previous 1.7%) while the unemployment rate stood at 6.0% of the labour force in the second quarter, two decimals less than in the first three months of 2007.

Starting out from this situation, immediate prospects in Italy are for some worsening. Strictly on the current economic situation, the synthetic index of early indicators was down by 3% year-on-year in September suggesting a first half-year with a slowdown. The drop in the economic sentiment index to 102.2 points in October reinforces this view. With regard to the area of economic policy, the government just managed to obtain approval of the budget in a close vote in the Senate thus managing to save the coalition government from another pitfall. Nevertheless, in view of the delicate balancing trick the government has to go through when an economic issue is at stake, it is unlikely that we shall see any ambitious attempts at reform.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	0.2	1.9	1.6	2.8	2.4	1.8	–	1.9	–	–
Retail sales	0.4	1.2	1.6	1.0	1.0	0.1	0.1	1.4	...	...
Industrial production	–0.8	2.6	1.8	3.8	1.2	0.6	0.6	1.1	0.8	...
Unemployment rate (*)	7.7	6.8	6.6	6.4	6.2	6.0	–	...	–	...
Consumer prices	1.9	2.1	2.2	1.8	1.7	1.6	1.6	1.6	1.7	2.1
Trade balance (**)	–9.8	–21.4	–22.0	–21.4	–18.4	–14.5	–12.7	–11.7	–10.4	...

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

United Kingdom: the golden age is over

On October 19 it became known that the British economy had grown by 3.3% year-on-year in the third quarter, thus going well above the most optimistic forecasts. Less than one month later, the report on inflation issued by the Bank of England sketched out a scenario of low growth (less than 2% in some quarters of 2008, the most moderate since the end of 2005), thus anticipating that the effect of the contraction of credit on corporate activity and consumer buying would be significant. The degree of the slowdown led the governor of the Bank of England, Mervyn King, to declare that this «definitely would be sharp compared with the gradual movement seen over the past ten years».

Available indicators scarcely allow us to glimpse this course of correction. The figure attracting most interest is retail sales in October. The month-on-month drop of 0.1%, the first in nine months, has been underlined in economic circles. Nevertheless, in year-on-year terms, growth of this sector continues at 4.4%. While this is certainly a slowdown compared with the 5.9% year-on-year figure for September, this figure alone does not mean we should discard the idea that the British year-end could still be showing a good part of the recent strong drive. This could be so, especially if we keep in mind that just this October there was a rise in consumer confidence.

Other indicators also support the idea of a continuation of the tendency to a notable rate of economic activity. The unemployment rate held at 2.6% of the labour force in October, still at all-time lows. In spite of rising to 2.0% year-on-year in October, consumer prices still stand at the objective level set by the Bank of England. The poor state of industry (industrial production was down by 0.3% year-on-year in September) goes a long way back and therefore seeing this drop in terms of a cyclical slowdown could be erroneous. To sum up, while forecasts for 2008 are certainly not very optimistic, the steps leading to such a low growth stage are still at their very beginning.

Bank of England recognizes that 2008 will be poor growth year...

...but road to slowdown has scarcely begun.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006		2007					
			3Q	4Q	1Q	2Q	July	August	September	October
GDP	1.8	2.8	3.0	3.2	3.1	3.1	–	3.3	–	–
Retail sales	1.9	3.0	3.5	3.6	4.3	3.9	4.2	4.8	5.9	4.4
Industrial production	–2.0	0.0	0.5	0.9	–0.1	0.7	0.9	0.7	–0.3	...
Unemployment rate (*)	2.7	2.9	3.0	2.9	2.8	2.7	2.7	2.6	2.6	2.6
Consumer prices	2.0	2.3	2.4	2.7	2.9	2.6	1.9	1.7	1.7	2.0
Trade balance (**)	–64.9	–74.1	–75.3	–77.0	–78.1	–80.0	–81.8	–82.1	–83.4	...
3-month Libor interest rate	4.8	4.8	4.9	5.2	5.5	5.8	6.0	6.0	6.7	6.3
Nominal effective pound sterling exchange rate	100.3	101.0	102.0	103.3	104.2	103.7	104.3	104.6	104.4	102.2

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

FINANCIAL MARKETS

Monetary and capital markets

Central banks concerned about subprime mortgage crisis

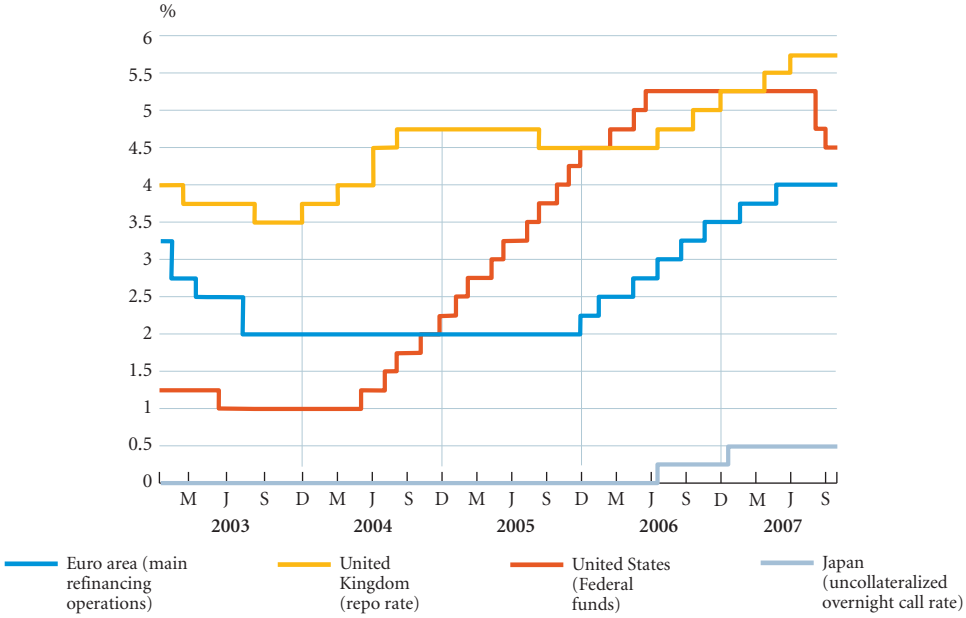
In view of seriousness of subprime mortgage crisis, Federal Reserve governor appears before US Congress.

In view of the extent of the subprime mortgage crisis, on November 8 the governor of the Federal Reserve (the Fed, the US central bank system) appeared before the Economic Committee of the US Congress. After thanking Ben Bernanke for accepting the invitation, Congress members and Senators were very incisive as they felt that the Fed should strengthen its battery of measures in order to stop the problem from getting worse. Charles E. Schumer, committee chairman, stated that the subprime mortgage crisis not only had not been contained but had permeated the rest of the economy. He also told the governor that, if he felt that due to the office he held he was unable to state publicly all the things he wanted to say, at least he should say them to members of the administration in private, working «behind the scenes», as his predecessor Alan Greenspan had done, a man who had never hesitated but risked his personal prestige in order to resolve the crises he had had to face.

Bernanke explained the policies the Fed had put into operation. The first measure was to again lower the reference rate by 25 basis points from 4.75% to 4.50% at the meeting held on October 31. Secondly, the Fed advised the credit

FEDERAL RESERVE APPLIES SALVE TO WOUNDS

Central bank reference rates



SOURCE: National central banks.

institutions to work together with owners who could not meet their recent mortgage payments in order to reach a repayment plan that would make it possible to deal with the situation and in some cases avoid foreclosure. The mortgage industry is following this advice and increasing its efforts to find solutions case by case. While foreclosure is not always possible to avoid, these techniques to ease the losses to preserve the property of the home, may turn out to be less costly. Thirdly, the Fed has set up work teams made up of all the economic operators involved in order to find community solutions in some of those areas sharply hit by the crisis.

Finally, using the authority invested in it by Congress, before the end of the year the Fed will publish regulations to reduce fraudulent practices and abuses in the granting of subprime mortgage loans.

Bernanke explains measures taken by Fed related to crisis.

The central bank took advantage of November to announce that as of now it would publish its estimates for the economy four times a year, adding summaries of discussion on its projections on inflation and growth. On November 20, the Fed published the minutes of its last official meeting in which it incorporated these estimates for the first time. These point out the

Economic forecasts reflect growing uncertainty.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2006									
October	3.25	3.56	3.86	5.25	5.37	0.44	4.75	5.19	1.84
November	3.25	3.64	3.86	5.25	5.37	0.51	5.00	5.25	1.94
December	3.50	3.73	4.03	5.25	5.36	0.57	5.00	5.32	2.09
2007									
January	3.50	3.78	4.10	5.25	5.36	0.53	5.25	5.59	2.18
February	3.50	3.85	4.06	5.25	5.35	0.71	5.25	5.53	2.19
March	3.75	3.92	4.18	5.25	5.35	0.67	5.25	5.62	2.27
April	3.75	4.02	4.30	5.25	5.36	0.67	5.25	5.73	2.32
May	3.75	4.12	4.46	5.25	5.36	0.69	5.50	5.81	2.42
June	4.00	4.18	4.53	5.25	5.36	0.76	5.50	6.00	2.67
July	4.00	4.26	4.54	5.25	5.36	0.78	5.75	6.04	2.63
August	4.00	4.74	4.78	5.25	5.62	0.97	5.75	6.69	2.86
September	4.00	4.79	4.73	4.75	5.23	1.03	5.75	6.30	2.82
October	4.00	4.60	4.60	4.50	4.89	0.90	5.75	6.28	2.68
November (1)	4.00	4.64	4.60	4.50	5.00	0.92	5.75	6.49	2.63

NOTES: (1) November 20.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-6-06 (2,75%), 3-8-06 (3,00%), 5-10-06 (3,25%), 7-12-06 (3,50%), 8-3-07 (3,75%), 6-6-07 (4,00%).

(3) Latest dates showing change: 13-12-05 (4,25%), 31-1-06 (4,50%), 28-3-06 (4,75%), 10-5-06 (5,00%), 29-6-06 (5,25%), 18-09-07 (4,75%), 31-10-07 (4,50%).

(4) Latest dates showing change: 6-5-04 (4,25%), 10-6-04 (4,50%), 5-8-04 (4,75%), 4-8-05 (4,50%), 3-8-06 (4,75%), 9-11-06 (5,00%), 11-1-07 (5,25%), 10-5-07 (5,50%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

ECB continues wait-and-see strategy.

worsening of growth estimates for 2008 by members of the Federal Open Market Committee. Furthermore, they greatly broaden the range of estimates of those taking part in the meeting, which reflects the increased uncertainty among central bank executives about future economic trends.

The European Central Bank (ECB) was not free of the reverberations of the subprime mortgage crisis as it recognized following its official meeting on November 8 and the central bank continues to follow development of pressures in the interbank market with great attention. According to the ECB, both an economic analysis and a monetary analysis would advise waiting for further information before taking a decision on the reference rate. In fact, the ECB has not noted any reduction in the level of uncertainty in financial markets since its previous meeting in October.

Bank of England indicates possible interest rate cuts next year.

Governor Jean-Claude Trichet announced that it is very important that inflation prospects in financial markets remain stable. The increase in inflation due to energy and food prices is not being passed through to other components forming part of the goods and services basket. While he considers that inflation will hold above 2% for some months, he feels that it will moderate during 2008. Furthermore, for the moment, he believes that the shock of increased prices for energy and food is transitory rather than permanent.

On the other hand, in its November report on inflation, the Bank of England, the central bank, pointed out that there was a possibility it would lower the reference rate in the first quarter of 2008 in order to prevent an economic slowdown without pushing up inflation. It pointed out that its forecast is that inflation will go back to its objective of 2% in 2009 with the hypothesis that it would lower the reference rate from 5.75% to 5.5%. At its last meeting on November 8, two members of the Monetary Policy Committee voted in favour of a cut in the reference rate.

The subprime mortgage crisis also weighed heavily on executives of Japan's central bank, which in its recently published minutes stated the need to adopt a wait-and-see attitude on the development of events in financial markets. While the discussions of members of the Executive Committee of the central bank put the emphasis on the need to raise interest rates in order to avoid the creation of financial bubbles, current uncertainty prevented them from raising the reference rate from the current 0.5%.

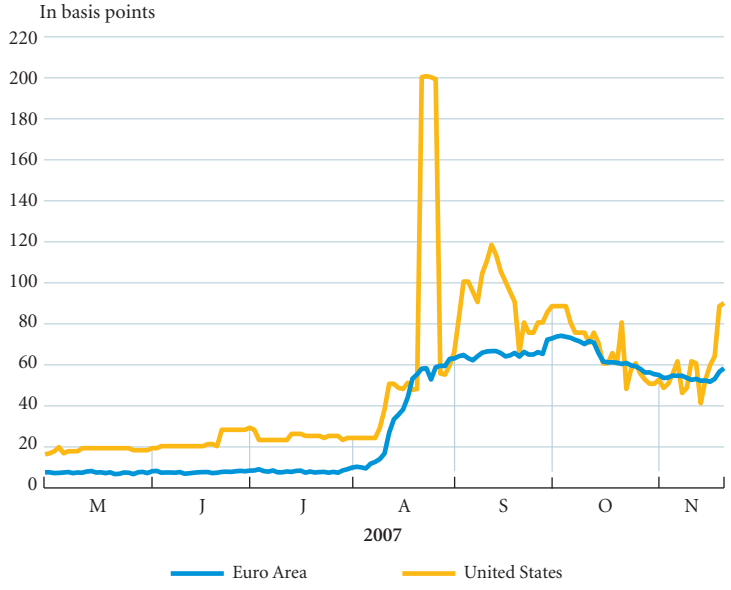
Interbank markets continue to tighten.

The various statements and strategies of the more important central banks have led to varied performances in short-term interest rates. While the 3-month rate in the Euro Area is running at 4.64% with no big changes over the previous month, the 3-month rate in the United States rose to 5.00% with the reference rate standing at 4.50%. The problems in the interbank market also shifted to the United Kingdom as it would seem contradictory that, while the central bank is talking about the possibility of reducing the reference rate in 2008, the 3-month interbank rate should hit 6.49%, an increase of 0.21% since October.

The following graph shows how risk aversion in the US interbank market has sharpened, thus widening the interest-rate differential with government bonds in this market, putting it at the level of 0.90%. That is to say, while the return on a 3-month US Treasury bill is 4.15%, if a bank seeks a 3-month loan from another

PLEASE BRING THE FIRST-AID KIT

3-month differential in interest on interbank deposits/notes



SOURCE: Bloomberg and own calculations.

bank it is asked for 5.05%. In spite of all the injections of liquidity and rate cuts by the Fed, the announcement of allocations for extraordinary losses by credit institutions in the United States is causing an increase in uncertainty and in the cost of risk in the form of higher interest rates.

Subprime mortgage crisis: are credit derivatives to blame?

Warren Buffet, the world's best-known investor, once called financial derivatives «time bombs». On the other hand, Alan Greenspan, former governor of the Federal Reserve, believes they are «indispensable tools for managing risk». Surely, however, both would be in agreement that financial derivatives constitute one of the key factors in the subprime mortgage crisis. But, what are financial derivatives? A derivative is a financial instrument whose value is based on the price of another asset, called an underlying asset. An example is an option to buy 1,000 General Electric shares within one year at a fixed price of 40 dollars. The option buyer has a benefit if within one year the price goes above 40 dollars since he will be able to buy an asset which perhaps is worth 60 dollars although it cost only 40. In this case, the possibility, but not the obligation, to buy is what we understand by a financial derivative and the General Electric shares constitute the underlying asset, that is, the pre-existing asset and what gives us the price of the derivative.

The four main characteristics of a derivative asset are: 1) its valuation depends on the price of the underlying asset, 2) it requires an initial investment that often is quite low in comparison with direct purchase of the

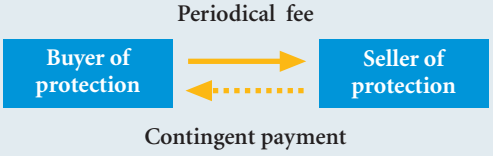
underlying asset, 3) the contract expires at a future date and 4) it may be traded in organized markets (on a stock exchange, for example) or in non-organized markets.

What assets can be used to create derivatives? Broadly speaking, we may classify underlying financial assets used to create derivatives in four large groups: 1) foreign currencies, 2) equity shares, 3) raw materials and 4) fixed-income. Under the latter, bonds are the best-known assets. The simplest bond is a financial instrument that pays a fixed interest rate. In reality, however, we may break a bond down into a series of complex attributes – its liquidity, its interest rate risk and its credit or default risk. The latter risk is what the bond buyer incurs if the issuer cannot return the money and goes bankrupt.

It is from this credit risk that we obtain credit derivatives. The risk of non-payment is the underlying asset in this type of derivative. In fact, credit derivatives are instruments whose price is based on the solvency of the issuer. The characteristic feature of credit derivatives is that they divide and isolate the credit risk, facilitating negotiation of the risk of non-payment with the aim of contesting, transferring or covering this risk. Most of these assets can take on a multitude of forms and reach a very high degree of complexity.

The simplest credit derivative is a bilateral contract under which the seller offers protection against credit risk over a company which is called the reference entity, while the buyer acquires protection against the possibility of default. The most basic is a product called a credit default swap (CDS). This is an exchange of credit risk. If an investor buys bonds or credits issued by a private entity and wants to protect his investment, he may buy a CDS. Should the issuer or the asset go bankrupt, the seller covers the losses. It is similar to fire insurance in which payment depends on whether the damage intended to be covered takes place. If coverage is paid up for the next three years, the buyer will pay a periodical commission, annual, for example. If the contingency takes place, the seller will have to cover the losses resulting from the fire.

CREDIT DEFAULT SWAP



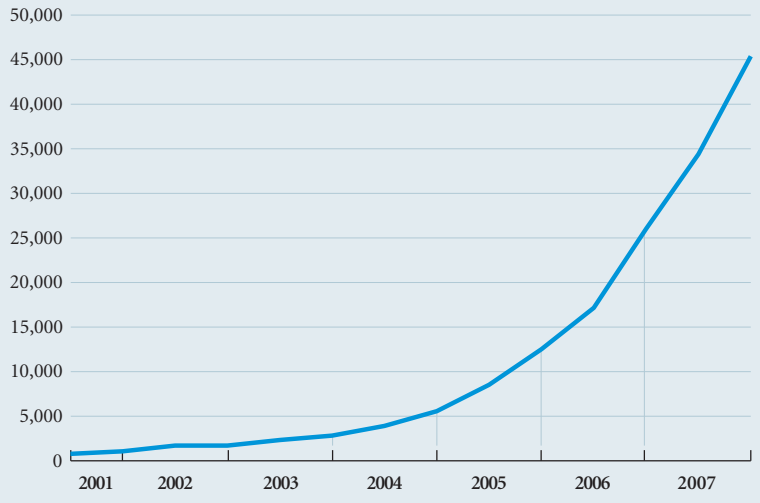
One of the most used credit derivatives, and one most talked about since the outbreak of the subprime mortgage crisis, is the collateralized debt obligation (CDO). This is a bond whose underlying asset is a household or company debt. In the case of a company, the debt takes the form of bank loans or bonds issued in the bond market. In households, they are normally loans with mortgage security. These are the loans underlying a CDO. If one of the companies forming the underlying asset declares bankruptcy or the mortgage payments are not met, the loss is carried by the CDO holder, given that this instrument stops paying part of the financial flow that was backed by those companies or households. As a last resort, through the CDO, the investor bears the risk of non-payment of the underlying assets. The value of the CDO depends on the credit risk of the companies or assets forming the underlying asset and for this reason it is a credit derivative.

It is through CDOs that the investor is exposed to credit risk for a large number of different types of credit through a single asset. This exposure to default risk can be sold in tranches of degrees of credit risk. For example, a CDO may be made up of three segments, the lower of which is the first to suffer losses in case of an increase in default produced in the underlying asset, which in this case are the corporate bonds used to create the CDO.

How big is this market? In June 2007, the volume of credit derivatives issued reached 45,000 billion dollars, measured by underlying assets. As a reference for comparison, the gross domestic product of the United States is 13,800 billion dollars. In the following graph we see the spectacular increase in credit derivatives in recent years bringing it to its present volume. This is a much more important market than even the market for equity derivatives that are quoted outside the stock exchanges and which reached an outstanding volume of 10,000 billion dollars.

RISE OF CREDIT DERIVATIVES

Trend in outstanding volume of credit derivatives in billion dollars



SOURCE: International Swaps and Derivatives Association.

What relation does the subprime mortgage crisis in the United States have to credit derivatives? In the United States, the increase in default of low credit rating mortgage loans, known as subprime mortgages, has brought substantial losses to investors who hold assets (among these, credit derivatives) backed by subprime mortgage collateral. This has also brought about increases in interest rate premiums demanded for these assets. But one of the characteristics of credit derivatives mentioned above is that they require a very small investment compared with the value of the underlying asset. That is to say, if a unit of underlying asset (which could be a mortgage loan) costs 200,000 euros, the derivative might cost only 2 euros. Therefore, with a small investment it is possible to obtain a relatively high return. At the same time, the exposure to risk is high (an essential characteristic of a financial derivative) because it increases the capacity to multiply the losses and gains of these instruments. If the buying off these derivatives is carried out or guaranteed using credit, the multiplier

effect is thus enormous. Finally, in the current subprime mortgage crisis, credit derivatives have functioned as multipliers of the losses produced in the underlying assets.

In reality, both Warren Buffet and Alan Greenspan are right. Poor use of these derivatives can bring about enormous losses because of the leverage obtained with these financial structures. Nevertheless, credit derivatives make it possible to broaden financial markets and thus spread risks more efficiently among market agents. Credit derivatives are like cell phones and other modern inventions. They are useful and almost indispensable when we recognize their virtues but troublesome and even dangerous if improperly used.

Downward trend in long-term interest rates continues.

Long-term interest rates reflect worsening prospects

Long-term interest rates on government bonds have sharpened the downturn that began in June. The increased losses by US banks have driven up buying of bonds and the subsequent drop in the return they offer. The interest rate on US 10-year Treasury bonds is now quoted at 4%, whereas the central bank reference rate holds at 4.50%.

In the Euro Area, the yield on long-term government bonds has dropped by 21 basis points (100 basis points is 1%) to also stand at 4.0%. This movement has ended the differential between US and Euro Area government bond rates.

In 2007, on average, US long-term bonds were offering a yield of more than 0.45%. The drop in long-term rates has been general around the world. In the case of Japan, the 10-year interest rate, which had gone to nearly 2%, fell to 1.43% in the middle of the year. Nevertheless, while decreases in long-term rates on government bonds have been sharp, they have not been greater than the drops in the short-term segments of interest rate curves. The result has been that the curves have turned positive, that is to say, they have increased the slope.

It is interesting to note the trend in the interest rate curve in the Euro Area in the past month as this well reflects the

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

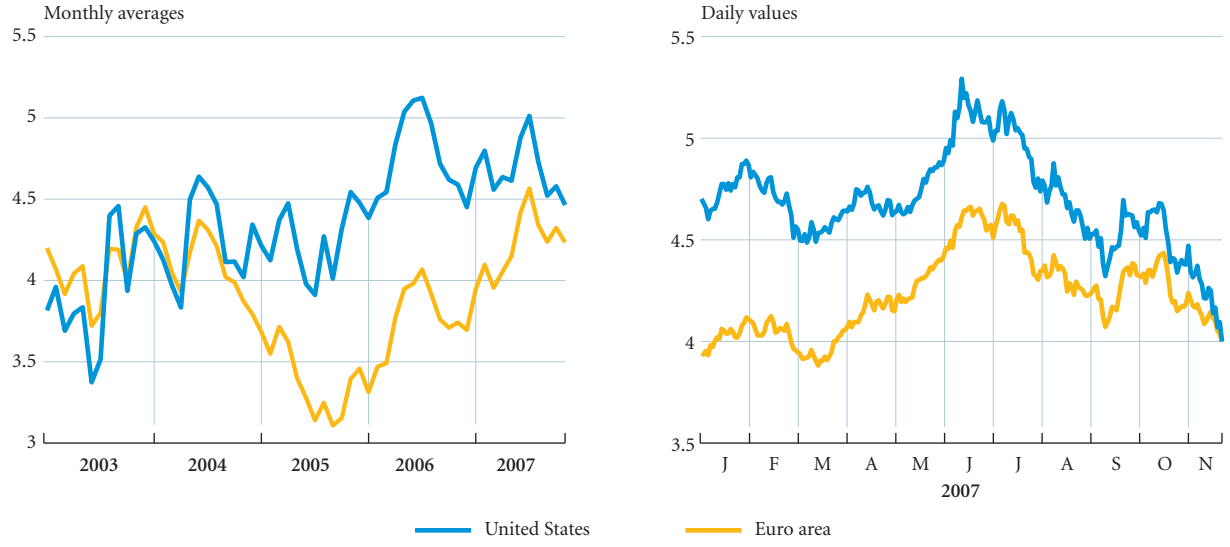
10-year government bonds at end of period as annual percentage

	2005	2006	2007			
			June	September	October	November (*)
United States	4.39	4.70	5.02	4.59	4.43	4.00
Japan	3.31	1.69	1.88	1.69	1.59	1.43
Euro Area	1.48	3.95	4.57	4.33	4.21	4.00
United Kingdom	4.10	4.74	5.46	5.01	4.90	4.59
Switzerland	1.97	2.52	3.23	3.01	2.94	2.85

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

LONG-TERM INTEREST RATES LEAVE BEHIND HIGH LEVELS

Yield on 10-year government bonds as annual percentage



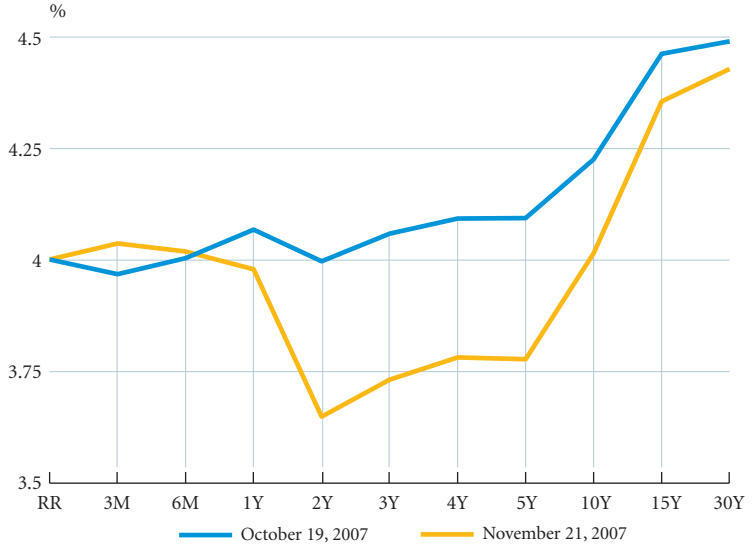
SOURCE: Bloomberg.

expectations of market operators. In the shortest segment (up to one year), the rates stay very close to 4%, which is the ECB reference rate and which indirectly sets the price of money at which banks may obtain funding by recourse to the ECB. The intermediate segment, from 1 year to 5 years, is the part of the curve that best shows the expectations of the economic cycle with regard to growth

10-year government bonds in EU and USA now showing same return.

LOWER GROWTH WITHOUT INFLATION RISK

Interest rate curve for Euro Area government bonds



NOTES: RR = Reference rate of European Central Bank, M = Months, Y = years.
SOURCE: Bloomberg and own calculations.

Euro Area interest rate curve shows lower growth without inflation problems.

and that reflects increased uncertainty about growth in 2008. On the other hand, the long segment of the interest rate curve, which includes from 10 years to 30 years, reflects inflation prospects more sharply.

The movement in the past month indicates that investors believe that the current increase in inflation because of the rise in energy prices and farm raw materials prices is not a permanent increase and that as the year 2008 wears on inflation will come close to the 2% figure of the ECB objective.

Value of dollar remains an unknown quantity

Increased depreciation of dollar sounds alarm bells.

In foreign currency markets it is necessary to point out two fundamental facts. The first is the continuing depreciation of the dollar. The sharpness of the move of the dollar against the euro has been such that the very governor of the ECB, Jean-Claude Trichet, has again dragged out of the trunk of old remarks the phrase: «sharp movements (in a currency) are not welcome». Other key managers of economic policy have shown their agreement. For example, Henry Paulson, US Secretary of the Treasury, stated that his country still maintained a policy of a strong dollar.

In addition, at the latest meeting of OPEC the situation of the value of the dollar was discussed. Some countries supported the need to change the system of fixing the price of oil in dollars due to the weakness of that currency and wanted to include a comment to this effect in the final statement. On the other hand, other ministers considered that to

EXCHANGE RATES OF MAIN CURRENCES

November 21, 2007

	Exchange rate	% change (*)		
		Monthly	Over December 2006	Annual
Against US dollar				
Japanese yen	108.4	–5.7	–9.8	–8.8
Pound sterling	0.487	–1.1	–4.7	–7.6
Swiss franc	1.104	–6.7	–10.4	–12.4
Canadian dollar	0.989	1.1	–17.8	–15.9
Mexican peso	11.016	1.8	1.8	0.6
Against euro				
US dollar	1.482	4.5	12.3	15.4
Japanese yen	160.7	–1.1	2.3	6.1
Swiss franc	1.637	–2.0	1.7	2.7
Pound sterling	0.721	3.4	7.0	6.6
Swedish krona	9.338	1.5	3.3	2.5
Danish krone	7.454	0.0	0.0	0.0
Polish zloty	3.689	1.0	–3.7	–2.9
Czech crown	26.80	–1.6	–2.5	–4.1
Hungarian forint	256.6	1.8	2.2	–0.1

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

do this would mean adding volatility to the market and increasing the risk of a bigger drop in the dollar. The OPEC ministers made these statements believing they were doing so behind closed doors but by mistake these comments were sent out by the press, thus increasing the volatility of the markets.

The European currency reached an all-time high of 1.482 dollars on November 21 so that the dollar has depreciated by 12.3% against the single currency since the beginning of the year. The US currency, however, did not fall against all currencies given that over the past month it has recovered slightly against the Canadian dollar although it showed a cumulative drop of 17.8% this year.

Due to the fact that the euro was introduced in January 1999 there has been only a relatively short period of euro-dollar exchange rates. To obtain more of a sense of this move, it is interesting to do a small exercise in archaeological reconstruction. This involves creating a synthetic index since 1971 which reconstructs the euro-dollar statistical series using the exchange rate for the deutschemark translated to the euro using a *fixing* in which the German currency was set at 1 euro being the equivalent of 1.l95 deutschemarks. This exercise allows us to observe the movement of the dollar and to see if the level reached had come about at any moment in recent decades and to more clearly understand the concern of the central banks executives, ministers of economy and other economic agents.

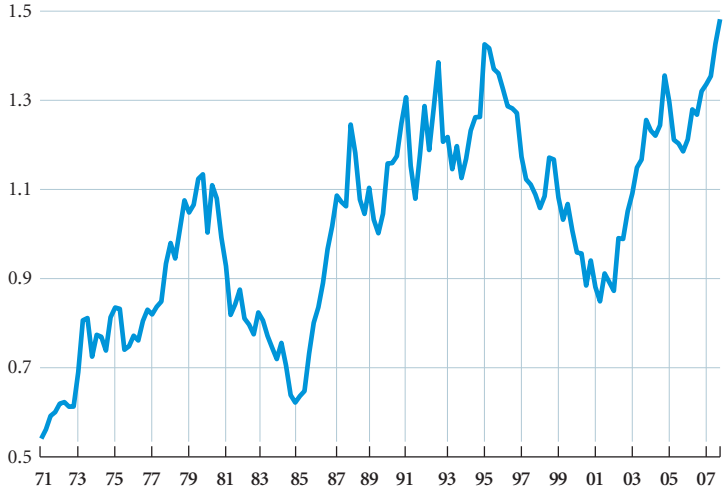
The following graph shows that the previous high in this synthetic index for the euro-dollar rate came about in March 1995 when it was running at 1.4255, a very high rate but lower than the 1.482 reached at the end of November. Sharp changes in currencies have negative effects for business executives because of the increased uncertainty about final receipts in local currency and the cost of imports. The increase in volatility implies that obtaining cover through exchange-rate

Present exchange rate of euro (1.482 dollars) never before reached.

To find similar value we must go back to 1995.

AT THAT PRICE I'LL BUY TWO

Synthetic index of dollar against euro



SOURCE: Bloomberg own calculations.

Yen strengthened by increased risk aversion.

insurance turns out to be more expensive. Undoubtedly, this exchange rate level means more difficulties for European exporters.

The second basic fact in foreign currency markets has been the appreciation of the Japanese yen. Increased risk aversion has meant a reduction in positions financed through borrowing in yen. Last month, a dollar would buy 114 yen. Today, it buys only 108.4 yen, that is to say, in the past month the yen has appreciated by 5.7%. For this reason, the Japanese authorities have publicly come out against the speed of this process which they consider will have negative repercussions for the Japanese economy. A country like Japan, still in a situation of deflation, may buy more cheaply abroad through the appreciation of its currency but this could worsen the problem of falling prices. In addition, Japanese exporters will have more problems as their products become less attractive for the rest of the world because of the relative increased cost of their products.

Oil, growth prospects and corporate profits weighing on stock markets.

Situation in equity share markets grows more complicated

Three factors have added to the pessimism of investors who have thus reduced their exposure in the stock markets. First, there are high energy prices which reduce disposable income of households and increase production costs in a context where companies do not have much power to set prices due to globalization. Secondly, the worsening of estimates by the various bodies about growth which means a more

INDICES OF MAIN WORLD STOCK EXCHANGES

November 20, 2007

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,958.4*	*–4.2*	*4.0*	*5.2*
Standard & Poor's	*1,433.3*	*–4.5*	*1.1*	*2.3*
Nasdaq	*2,593.4*	*–4.8*	*7.4*	*5.7*
Tokyo	15,211.5	–9.5	–11.7	–3.3
London	6,169.1	–5.5	–0.8	–0.6
Euro Area	4,257.8	–3.5	3.3	4.0
Frankfurt	*7,578.4*	*–3.9*	*14.9*	*17.5*
Paris	*5,472.2*	*–4.7*	*–1.3*	*0.3*
Amsterdam	*493.7*	*–10.4*	*–0.3*	*0.4*
Milan	*37,932.0*	*–4.9*	*–8.5*	*–6.8*
Madrid	*15,624.9*	*0.6*	*10.5*	*9.6*
Zurich	8,317.7	–6.9	–5.3	–5.1
Hong Kong	27,771.2	–5.7	39.1	46.5
Buenos Aires	2,243.5	0.3	7.3	18.3
São Paulo	62,336.0	2.4	40.2	51.9

NOTES: (*) New York: Dow Jones Industrials, Standard & Poor's Composite, Nasdaq Composite; Tokyo: Nikkei 225; Euro area: DJ Eurostoxx 50; London: Financial Times 100; Frankfurt: DAX; Paris: CAC 40; Amsterdam: AEX; Milan: MIBTEL; Madrid: IBEX 35 for Spanish stock exchanges; Zurich: Swiss Market Index; Hong Kong: Hang Seng; Buenos Aires: Merval; São Paulo: Bovespa.
SOURCE: Bloomberg.

complicated environment for increasing corporate profits. Finally, the poor company results in the third quarter. These were concentrated in the financial sector which is making massive provision to cover losses in those products related to the subprime mortgage crisis. In other sectors as well there have been downward revisions of profit forecasts for coming quarters as, for example, in the real estate and transport sectors, and in technological sectors, all of which note a slowdown in levels of order books.

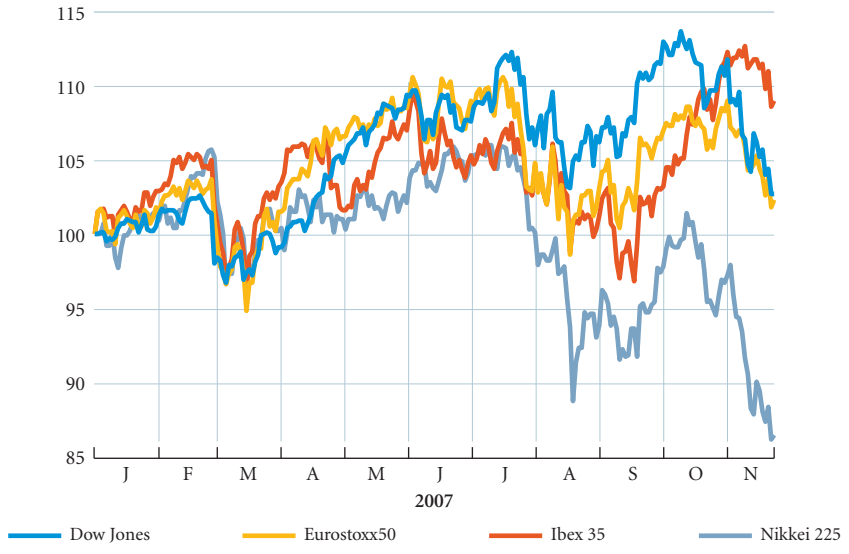
The different share indices in the United States have dropped by around 4.5% in the past month. For example, the S&P 500 shows a cumulative change of only 1.1% since January 1. But other exchanges have suffered more in the last four weeks. Among these, the index for the Netherlands, with a drop of 10.4%, and the Nikkei 225 index in Japan, which shows a cumulative change of –11.7%.

The increased uncertainty about the course of the world economy and its impact on corporate profit and loss accounts has shown up as increased volatility in the stock markets. This rise in volatility may be interpreted as an increase in the cost of risk represented by investing in equity shares. A greater variation in profits means that investors demand a higher premium. Translated to stock market prices, these prices drop as a reflection of the uncertainty about coming quarters. The main problem is that the two alternative scenarios are a long way off. One possible scenario is a correction of the crisis which would avoid the risk of a recession in the United States. The other scenario is precisely negative growth of the US GDP. Today, the first scenario is the most likely and this is reflected in the expectations of economic agents. The problem, however, is that the consequences of one or other scenario are diametrically opposed and this in itself is bringing about increased nervousness among investors.

Increased volatility of stock markets reflects growing uncertainty.

WE HAVE NOT LEFT CURVES BEHIND

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



SOURCE: Bloomberg and own calculations.

SPAIN: OVERALL ANALYSIS

Economic activity

National demand moderating

GDP increases 3.8% in third quarter compared with same period last year in line with forecasts.

The gross domestic product (GDP) of Spain's economy continued to slow down in the third quarter, according to the early estimate of the National Institute of Statistics (INE). The economy grew by 3.8% in year-on-year terms, two decimals less than in the previous quarter, in line with forecasts. This confirms the slowdown course in economic growth, as may be more clearly noted in the quarter-on-quarter change rates in the accompanying graph. Nevertheless, the year-on-year growth of Spain's economy continues to be substantially higher than that of the Euro Area, although the differential has narrowed.

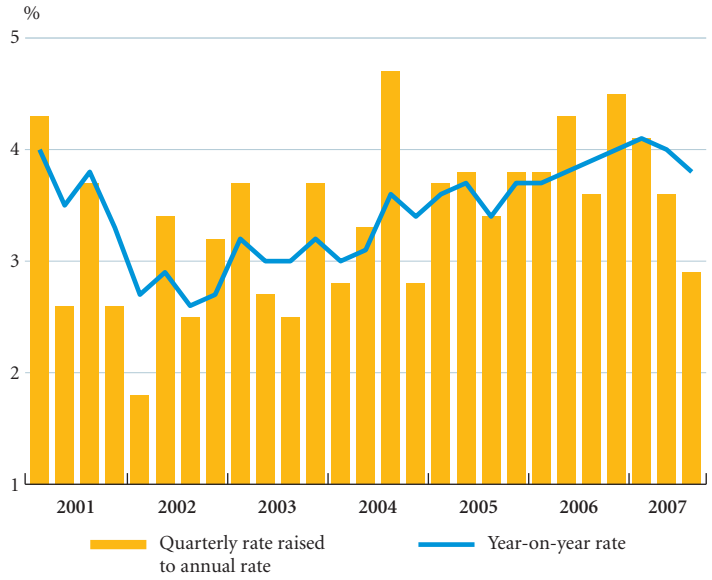
Spain's economy continues to grow more than Euro Area but differential dropping.

The easing of economic growth was due to most demand components, especially household consumption and investment in construction. On the other hand, the foreign sector improved its negative contribution to the change in GDP by 3 decimals putting it at 6 decimals. On a positive note, there was more of a balance in economic growth, which until now has been very much concentrated in construction along with a big foreign imbalance.

In fact, the contribution of national demand to year-on-year GDP growth was down 5 decimals to 4.4 percentage points, a long way from the 5.8 points recorded in the second quarter of 2005. The main component, household

TOP OF CYCLE NOW BEHIND US

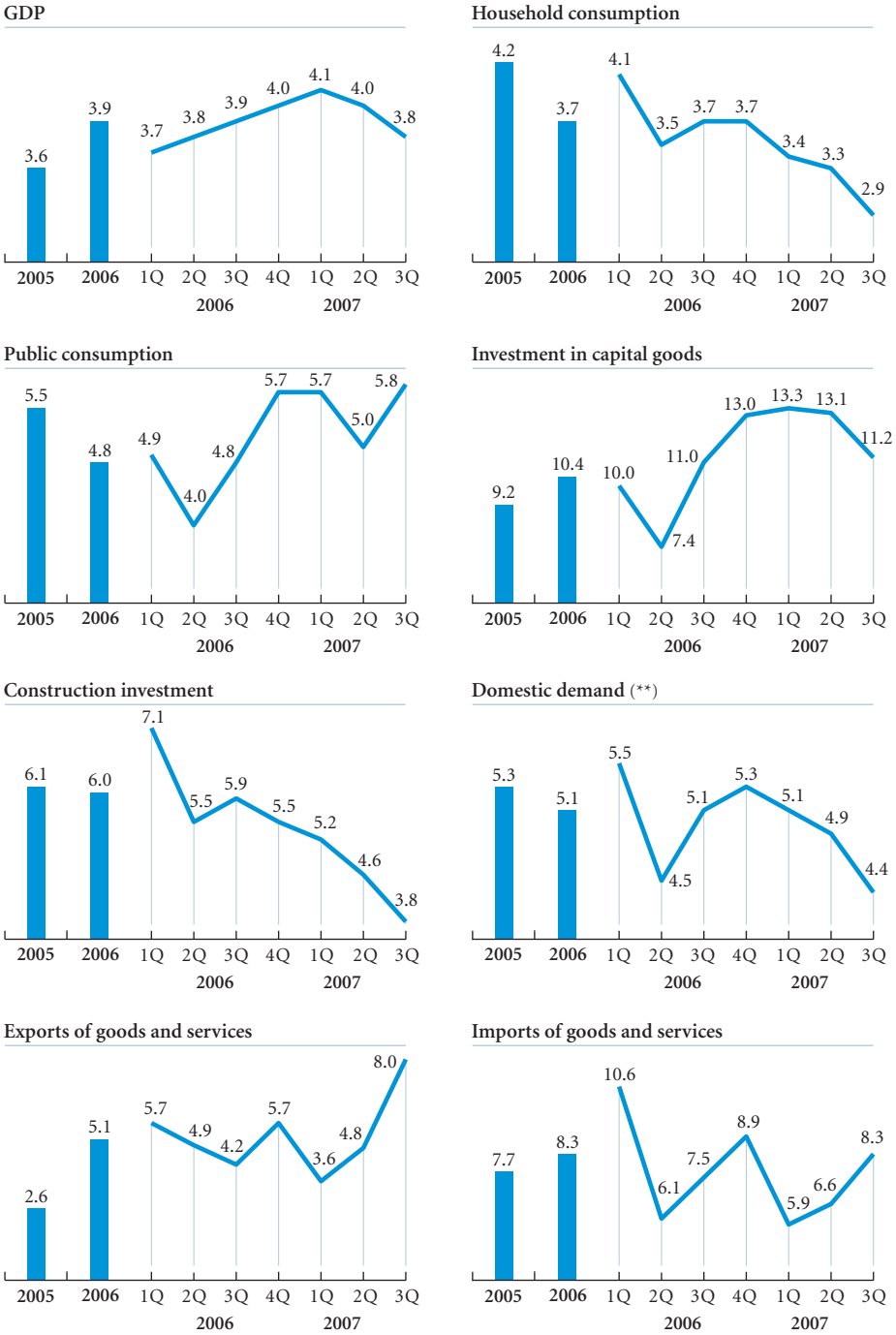
Change in GDP



SOURCE: INE and own calculations.

TREND IN SPAIN'S GDP BY COMPONENT

Percentatge year-on-year change (*)



Moderation mainly due to household consumption and construction.

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

Foreign sector improving although contribution remains negative.

consumption, continued to lose strength to the point where it showed a year-on-year increase of 2.9%, some 4 decimals less than in the second quarter. According to INE figures, the slowdown in household consumption is taking place more in goods than in services. Especially notable under goods is the drop in motor vehicle buying. It is likely that the drop in growth of household consumption will continue in coming months although rather gently seeing that job creation continues to give it support. In fact, car sales in October showed some recovery although these were boosted by special deals offered by various car-makers.

On the other hand, general government consumption rose in the third quarter to show a year-on-year rise of 5.8%. Both wages and the acquisition of goods and services contributed to this increase.

All investment components showed an easing in growth rate. The year-on-year change rate for construction dropped to 3.8%, a long way from the 7.1% in the first quarter of 2006. This reflects the lower drive in residential building and public works. The annual increase in investment in residential building was down 2.9% as a result of the loss of drive in the real estate market. The slowdown in housing construction will likely continue in coming months if we are to go by the drop in approvals for new building. With regard to construction of infrastructures, the latest annual rate is affected by comparison with the period prior to the last autonomous community and municipal elections so that early recovery is likely, given the projects now underway. With regard to capital goods investment, this showed a substantial drop putting the figure for quarter-on-quarter growth at 0.8% although the year-on-year rate stood

DEMAND INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007					
			3Q	4Q	1Q	2Q	July	August	September	October
Consumption										
Production of consumer goods (*)	0.9	2.3	1.9	4.3	4.8	2.1	1.3	1.9	–0.4	...
Imports of consumer goods (**)	7.9	8.9	2.4	7.6	–1.1	5.6	15.0	5.7	4.6	...
Car registrations	2.1	–0.9	–4.1	1.8	–0.7	–2.4	0.0	–2.7	–7.7	3.4
Credit for consumer durables	15.0	14.5	13.2	12.0	13.8	9.6	–	...	–	–
Consumer confidence index (***)	–10.8	–12.3	–13.7	–10.3	–10.7	–12.7	–11.0	–12.0	–14.0	–16.0
Investment										
Capital goods production (*)	–0.1	8.4	7.9	11.2	8.9	5.3	7.8	5.3	4.8	...
Imports of capital goods (**)	20.4	3.2	6.5	3.4	20.1	11.0	0.6	–6.2	3.0	...
Commercial vehicle registrations	13.2	1.5	0.5	–1.0	1.7	–2.2	4.2	–4.6	–11.2	4.4
Foreign trade (**)										
Non-energy imports	6.0	9.0	8.9	9.3	6.4	7.7	13.8	4.3	4.5	...
Exports	0.2	5.6	1.7	4.7	3.0	2.8	10.6	6.0	3.4	...

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

at a high 11.2%. Other investment, that includes spending on data-processing software, mining and oil prospecting, etc., was down compared with the second quarter.

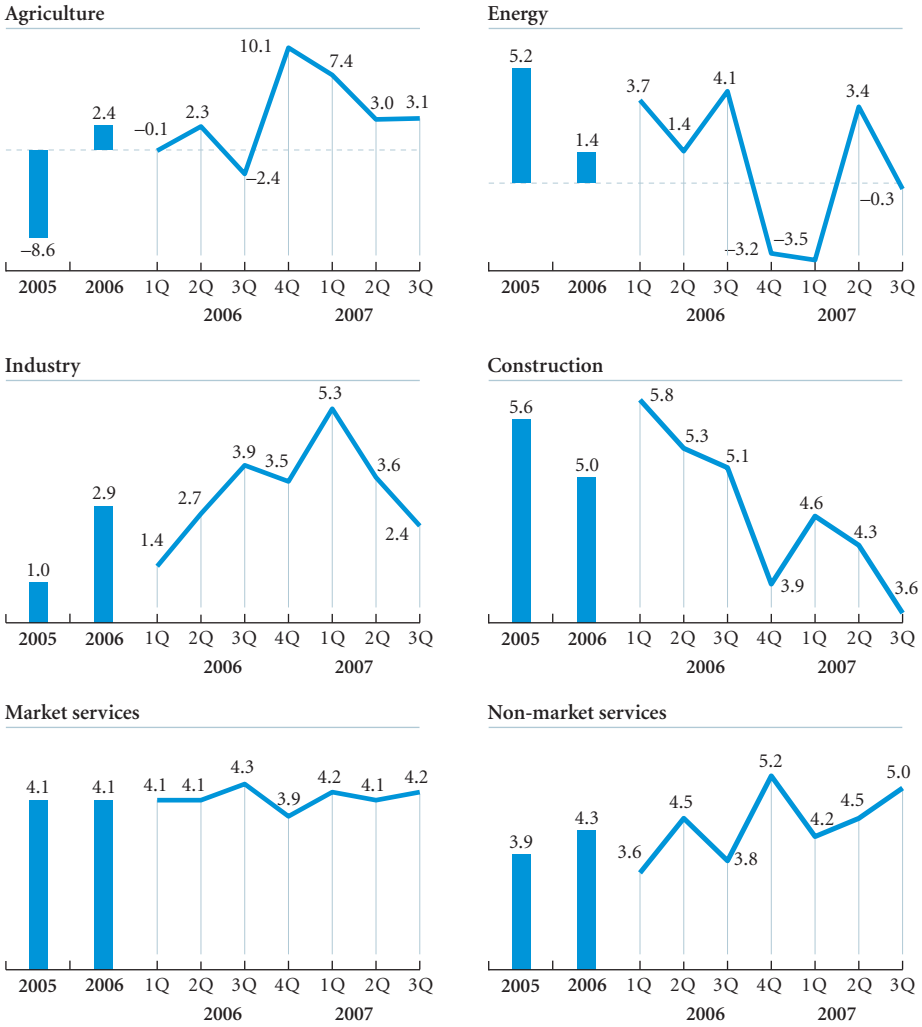
With regard to the foreign sector, both exports of goods and services were up, thanks to the rise in foreign demand. Imports of goods and services also revived, although to a lesser degree, so that the worsening of the foreign sector was slowed down.

On the supply side, the slowdown in construction and the primary sector was only partly compensated by the gradual increase in market services and industry. Value added in construction showed a notable loss of strength with its annual change rate going to 3.6%. The energy sector suffered a year-on-year drop. Industry was up slightly although the annual dropped by 1.2 points to 2.4%. Over coming months, it would seem difficult for the industrial sectors to counteract the foreseeable slowdown in

Strength in services and industry not enough to compensate slowdown in construction.

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentatge year-on-year change (*)



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

Economic growth faces downward risks and difficulties seen for reaching 3% in 2008.

construction, if we take into account the latest figures for new orders in industry.

The branches of market services to show the strongest drive were transport, company services and retail trade. Non-market services, on the other hand, moved ahead more slowly. Services branches as a whole maintained a notable growth rate with the year-on-year change rate rising two decimals to 4.4%.

Gross value added in the primary sector continued to drop compared with the previous quarter. Nevertheless, the year-on-year change rate was up one decimal to 3.1% thanks to the relatively good result in agriculture.

Is this trend to economic slowdown going to continue? Very likely. Discussion ranges more over how sharp the slowdown will be. A greater degree of credit restriction, the strengthening of the euro and the increased price of raw materials have all increased downward risks. In this situation, the European Commission recently lowered its economic growth forecasts for 2008 to 3% going to 2.3% in 2009. In fact, while growth for this year seems to be assured at around 3.8%, in the next two years it will have difficulty in going to 3% annual.

SUPPLY INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007					
			3Q	4Q	1Q	2Q	July	August	September	October
Industry										
Electricity consumption (1)	3.5	3.8	6.0	3.8	5.2	4.4	1.4	1.5	2.3	3.4
Industrial production index (2)	0.7	3.9	4.2	4.6	4.2	2.4	1.1	1.6	0.6	...
Confidence indicator for industry (3)	–4.8	–2.7	–2.3	–0.3	2.3	1.2	0.0	–1.0	–1.0	–6.0
Utilization of production capacity (4)	80.2	80.5	80.3	81.6	80.6	81.3	–	82.1	–	–
Imports of non-energy intermediate goods (5)	1.6	10.5	13.8	12.1	8.1	8.2	15.8	5.7	4.7	...
Construction										
Cement consumption	7.3	8.5	5.7	8.5	5.5	–1.3	3.7	–2.7	–5.6	5.2
Confidence indicator for construction (3)	22.4	14.2	14.7	15.0	10.7	15.7	15.0	6.0	15.0	8.0
Housing (new construction approvals)	6.2	18.6	50.5	0.2	8.0	–15.0	–37.1	–39.0	...	...
Government tendering	18.5	31.3	19.1	55.0	14.9	–2.1	21.5	–55.8	...	...
Services										
Retail sales	4.4	5.0	5.9	5.2	6.2	4.5	4.8	5.4	2.4	...
Foreign tourists	6.6	3.8	1.8	2.3	5.3	0.1	1.8	3.0	1.8	0.0
Tourist revenue inflows	6.0	5.6	4.9	3.1	5.8	2.0	2.6	4.0	...	...
Goods carried by rail (ton-km)	–3.2	–1.2	–3.3	–6.4	–4.1	–6.5	7.2	–4.0	–6.7	...
Air passenger traffic	9.2	6.8	4.7	7.1	9.5	7.1	11.4	10.4	9.6	...
Motor vehicle diesel fuel consumption	5.1	5.4	3.9	4.9	5.8	3.3	7.1	6.1	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for difference in number of working days.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
SOURCE: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of Economy and Finances and own calculations.

Labour market

Job creation slowing down

In line with the situation of slight economic slowdown, latest figures for registrations with Social Security indicate that job creation is growing at a slower rate. The period of extraordinary labour regularization begun in 2005, which resulted in a spectacular rise in registrations, is now far behind us, as may be seen in the accompanying graph. In October, the number of workers registered with Social Security was down by 75,719 persons due mainly to a seasonal effect arising from the end of the summer season. The total number of those registered stood at 19,232,271 which meant a rise of 2.5% compared with the same month last year.

In the past 12 months the total number registered with Social Security was up 464,520. Of these, 308,105 were Spaniards while 156,415 were foreign workers. The latter rose by 8.4% over the past year to 2,021,166 which now represents 10.5% of all registrations.

Number registered with Social Security growing at 2.5% annual rate.

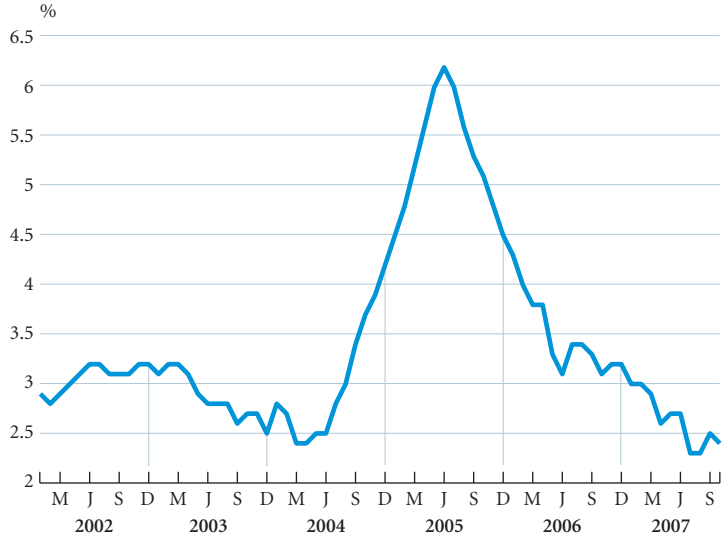
By sex, females continue to join the labour market at an increasing rate. As a result, those females registered with Social Security rose by 3.8% in the past 12 months while males were up 1.5%. At the end of October, females registered (8,043,185) represented 41.8% of the total.

Foreign workers registered with Social Security up 8.4% in past year to now represent 10.5% of total.

The sector showing the greatest strength in job creation was services with a year-

EMPLOYMENT GROWING LESS

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



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

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2005	2006	2006		2007			
			3Q	4Q	1Q	2Q	3Q	October
Persons registered with Social Security								
Sector								
Industry	*–0.5*	*0.0*	*0.0*	*0.2*	*2.2*	*2.7*	*2.5*	*2.6*
Construction	*8.6*	*8.7*	*7.5*	*6.8*	*6.1*	*4.4*	*2.3*	*1.4*
Services	*5.7*	*5.2*	*4.6*	*4.0*	*4.1*	*3.7*	*3.0*	*2.9*
Job situation								
Wage-earners	*4.8*	*4.7*	*3.9*	*3.5*	*3.9*	*3.5*	*2.6*	*2.4*
Non-wage-earners	*2.6*	*2.2*	*2.1*	*2.2*	*2.5*	*2.7*	*2.9*	*3.0*
Total	**4.4**	**4.3**	**3.6**	**3.3**	**3.6**	**3.3**	**2.7**	**2.5**
Persons employed (*)	**5.6**	**4.1**	**3.7**	**3.6**	**3.4**	**3.4**	**3.1**	**–**
Jobs (**)	**3.2**	**3.2**	**2.7**	**3.1**	**3.3**	**3.2**	**3.0**	**–**
Hiring contracts registered (***)								
Permanent	8.7	41.1	46.6	76.8	25.8	15.6	–1.6	–2.7
Temporary	4.6	4.7	0.5	0.5	2.6	–1.9	–0.5	6.3
Total	**5.0**	**7.9**	**4.1**	**7.3**	**5.3**	**–0.1**	**-0.7**	**5.1**

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

Self-employed workers in construction up 10.1% in past 12 months while rest down 0.9%.

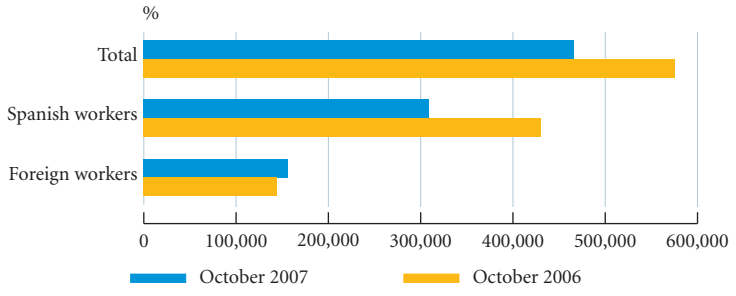
on-year increase of 2.9%. Construction seems to be showing some improvement in employment but this is due to self-employed persons which were up 10.1% compared with October 2006, seeing that those registered under the general scheme dropped by 0.9% over the past 12 months. With regard to industry, this showed a tendency toward more moderate job creation with a year-on-year change of 2.6%.

On the other hand, figures for jobs equivalent to full-time work show a similar picture, according to National Accounting. The third quarter saw a continuation of the trend toward a gradual slowdown in total employment with year-on-year growth of 3.0%, two decimals less than in the previous quarter. Employment in industry showed no improvement over the previous quarter and continued to be slightly lower than in the same period the year before. With regard to construction, this continued to lose strength although it showed the highest increase in employment compared with one year earlier. In turn, market services weakened although it maintained year-on-year growth of 3.2%.

As a result of the trend in the quarterly gross domestic product and full-time employment, the year-on-year change in apparent labour productivity stood at 0.8%, the same level as in the second quarter. Total wages maintained an annual increase of 7.3% in the third quarter given that average wages rose slightly thus compensating for the downturn in the number of those working for wages. In this way, unit labour cost rose by one decimal to 3.0%,

FOREIGN WORKER REGISTRATIONS WITH SOCIAL SECURITY HOLD STRONG

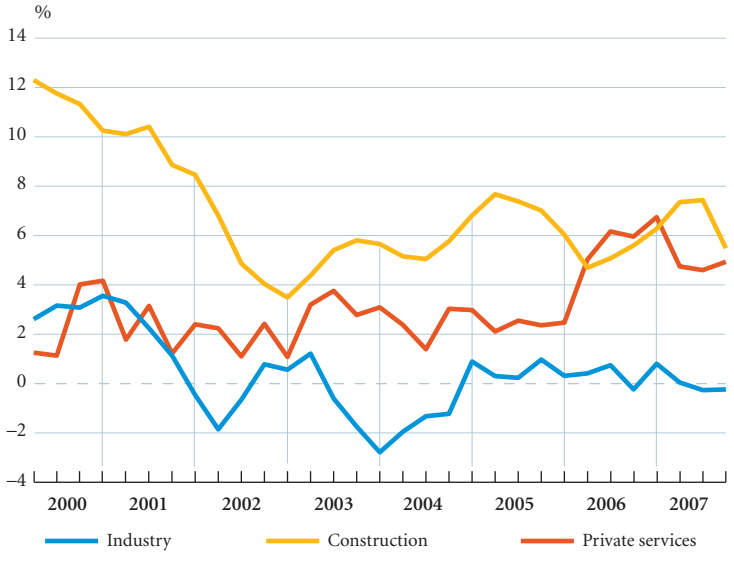
Change in number of those registered with Social Security in past 12 months



SOURCE: Ministry of Labour and Social Affairs and own calculations.

CONSTRUCTION LOSING STEAM WHILE SERVICES ON MOVE

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



SOURCE: National Institute of Statistics and own calculations.

thus going higher than the implicit deflator for the economy.

In addition, we note background strength in the labour market, if we are to go by the good level of hiring. Some 1,911,389 hiring contracts were registered in October, 5.1% more than in the same month last year. The number of permanent hiring contracts signed that month was down 2.7% compared with October 2006, following the end of incentives for converting other types of hiring contracts into permanent jobs at the close of 2006. Nevertheless, in October stable hiring contracts represented 12.2% of the total, a notable share.

Hiring strong in October.

Worsening of registered unemployment eases up in October

The number of unemployed registered at public employment service offices in

Number of male foreign workers registered as unemployed up 31% in past 12 months.

Sustained increase in beneficiaries of cash unemployment benefits in recent years.

October rose to 2,048,577, some 2.8% more than 12 months earlier. Nevertheless, the greater part of the monthly increase (31,214 persons) was due to seasonal effect with the end of the tourist season. Overall, we note some moderation in the trend to worsening of registered unemployment. The construction sector showed the biggest increase in unemployment over the past year at 12.6%. It is thus not surprising that unemployment rose more among males than females over the past 12 months. In addition, the number of male foreign workers registered as unemployed rose by 31.0% compared with October 2006.

On the other hand, the number of those receiving cash unemployment benefits has risen in a sustained manner in recent years reaching 1,409,580 in September. This figure means an increase of 34.0% since 1999. In the case of contribution level, the increase was higher at 75.6%. As a result, the net rate of cover rose from 63.5% in 1999 to 95.3% in September.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

October 2007

	No. of unemployed	Change over December 2006		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	66,765	5,271	8.6	3,828	6.1	3.3
Industry	270,556	–11,592	–4.1	–5,997	–2.2	13.2
Construction	240,385	3,614	1.5	26,980	12.6	11.7
Services	1,253,805	28,936	2.4	38,209	3.1	61.2
First job	217,066	–525	–0.2	–7,279	–3.2	10.6
By sex						
Males	802,831	–1,443	–0.2	40,340	5.3	39.2
Females	1,245,746	27,147	2.2	15,401	1.3	60.8
By age						
Under 25 years	235,125	–6,887	–2.8	–15,159	–6.1	11.5
All other ages	1,813,452	32,591	1.8	70,900	4.1	88.5
TOTAL	**2,048,577**	**25,704**	**1.3**	**55,741**	**2.8**	**100.0**

SOURCE: INEM and own calculations.

Prices

Foods and oil push up CPI

The sharp increase in prices of food and fuels and fuel-oils brought about a sudden rise in the consumer price index (CPI) in October with the result that the year-on-year change rate went to 3.6%, going back to the level in August 2006. The all-time highs recorded for oil prices in October were not fully compensated by the appreciation of the euro so that its effect was felt at service stations and thus in the CPI. The rise in farm raw materials prices in world markets is also being passed through to the shopping basket. In this case, the more stable core inflation figure, so-called underlying inflation, was also affected and rose to 3.1%.

CPI again at August 2006 level.

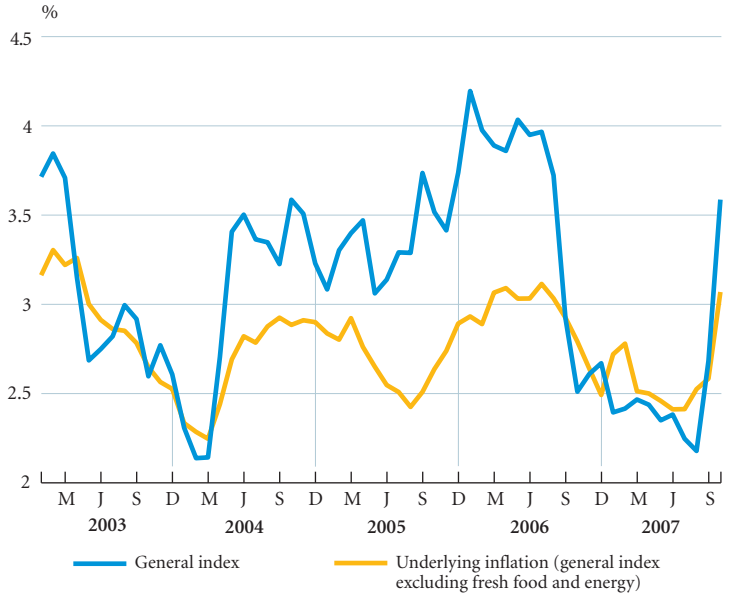
In effect, out of the nine decimals of increase in the year-on-year inflation rate in October, slightly more than half came from foods, mainly processed foods. The current weight of food and drink in the CPI is 22.1% while the year-on-year inflation rate for these items showed a rise from 3.4% in September to 5.5% in October.

The component to rise most in the past 12 months was milk with an increase of 24.2%. As mentioned above, this increase was due to the fact milk

Underlying inflation up to 3.1% due to processed foods.

SHARP RISE IN INFLATION TO 3.6%

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

producers had added on the rise in raw materials to the price to the consumer. The root cause was the performance in world markets. Here, prices have gone up spectacularly in recent times due both to demand shocks and supply shocks. On the one hand, world demand had shown an increase due to bigger demand coming from the so-called emerging countries. On the other hand, there have been limitations in world supply because of adverse weather

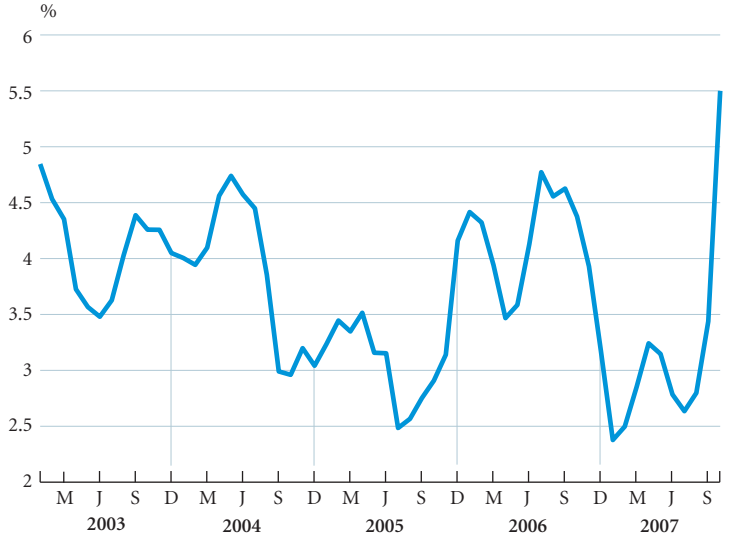
CONSUMER PRICE INDEX

	2006			2007		
	% monthly change	% change over December 2005	% annual change	% monthly change	% change over December 2006	% annual change
January	–0.4	–0.4	4.2	–0.7	–0.7	2.4
February	0.0	–0.4	4.0	0.1	–0.6	2.4
March	0.7	0.3	3.9	0.8	0.1	2.5
April	1.4	1.8	3.9	1.4	1.5	2.4
May	0.4	2.1	4.0	0.3	1.8	2.3
June	0.2	2.3	3.9	0.2	2.0	2.4
July	–0.6	1.7	4.0	–0.7	1.3	2.2
August	0.2	1.9	3.7	0.1	1.4	2.2
September	–0.2	1.7	2.9	0.3	1.7	2.7
October	0.4	2.1	2.5	1.3	3.0	3.6
November	0.2	2.4	2.6			
December	0.3	2.7	2.7			

SOURCE: National Institute of Statistics.

SHARP RISE IN FOOD PRICES

Year-on-year change in food and non-alcoholic beverages component of CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

October

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2006	2007	2006	2007	2006	2007
By type of spending							
Food and non-alcoholic beverages	106.2	–0.1	1.9	2.5	4.7	4.4	5.5
Alcoholic beverages and tobacco	107.3	0.0	0.2	0.8	5.9	0.9	6.6
Clothing and footwear	105.9	9.1	9.0	–0.6	–1.0	1.3	0.9
Housing	104.7	–0.3	0.7	4.8	4.1	4.9	4.2
Furnishings and household equipment	103.2	0.4	0.4	2.0	1.9	2.6	2.5
Health	98.3	0.1	0.2	1.5	–2.3	1.5	–2.1
Transport	103.1	–1.9	0.3	1.7	4.8	–1.0	4.9
Communications	100.2	–0.2	–0.1	–1.0	1.1	–1.2	0.6
Recreation and culture	98.8	–1.1	–0.8	–1.2	–1.4	–0.3	–0.7
Education	106.9	2.4	2.4	3.7	3.8	4.0	4.5
Restaurants and hotels	105.8	0.0	0.0	4.1	4.5	4.4	4.8
Other goods and services	103.6	0.2	0.1	3.6	2.7	4.0	3.0
By group							
Processed food, beverages and tobacco	106.4	0.0	2.3	2.1	5.9	3.4	6.1
Unprocessed food	106.2	–0.2	0.5	2.6	2.8	5.2	4.7
Non-food products	103.5	0.6	1.1	2.1	2.4	2.0	2.9
Industrial goods	102.5	1.1	2.2	1.0	1.5	0.4	2.0
Energy products	*103.6*	*–3.5*	*1.0*	*2.9*	*7.4*	*–1.9*	*7.0*
Fuels and oils	*103.7*	*–4.7*	*1.3*	*2.2*	*8.9*	*–4.1*	*8.4*
Industrial goods excluding energy products	*102.0*	*2.7*	*2.7*	*0.4*	*–0.4*	*1.3*	*0.4*
Services	104.6	0.0	0.1	3.3	3.4	3.8	3.8
Underlying inflation (**)	104.1	0.9	1.4	2.0	2.6	2.8	3.1
GENERAL INDEX	**104.2**	**0.4**	**1.3**	**2.1**	**3.0**	**2.5**	**3.6**

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

conditions in the main producing countries. This relative scarcity has been passed through to Spanish market prices due to the rigidity of the Common Agricultural Policy which has limited and restricted milk production for many years.

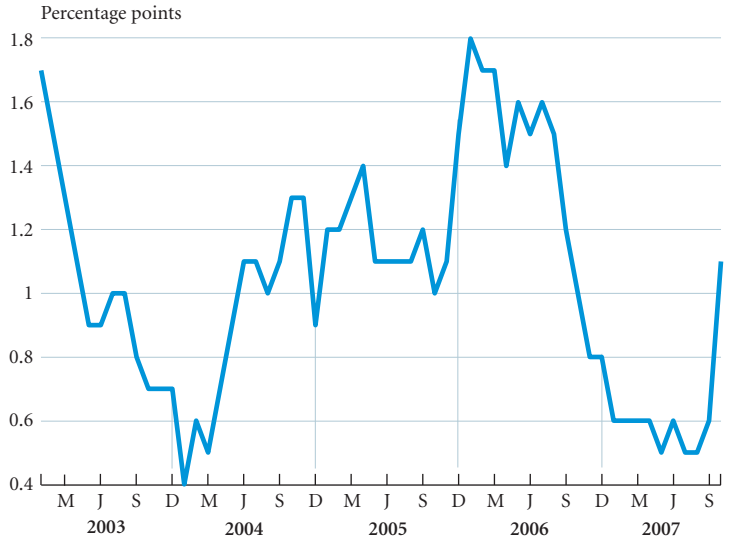
Prices of cereals have also risen greatly in recent months. This has raised the cost of livestock production. At the moment, these pressures are concentrated in poultry which has risen by 14% over the past year while mutton and pork are depressed. On the other hand, the effect of the rise in grains has certainly been noted in cereals and by-products, especially bread, the price of which has risen 13.4% since October 2006. In the case of cereals, the price rise is the result of heavier world demand along with poor world harvests.

Not all the news is bad. Some basic foods show prices lower than one year ago. Cooking oils were down 14% over the

Sharp rise in milk reflecting spectacular increase on international markets.

INFLATION DIFFERENTIAL WITH EURO AREA AGAIN GOES ABOVE ONE POINT

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



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

Prices of cooking oil and potatoes show drop in past 12 months.

past 12 months following increases last year. Similarly, the price of potatoes has fallen slightly over the past year following the last sharp rise.

What also helps is the practical stability of non-energy industrial goods whose year-on-year rate held stable at 0.4% annual in October, contained by sharp competition in world markets. On the other hand, the inflation rate for services, which are more sheltered from competition arising from globalization, rose by one decimal to 3.8%.

With regard to the inflation picture for coming months, pressures in oil markets and food markets do not look good. As a result, the CPI could end the year close to 4%. Nevertheless, next year inflation should be corrected with the help of a slowdown in consumption, so long as there are no unexpected increases in the price of crude oil.

Year-on-year inflation rate could go close to 4% at year-end but should move down in 2008.

The year-on-year inflation rate harmonized with the European Union stood at 3.6%. As a result, the inflation differential with the Euro Area rose by a half-point to 1.1 percentage points. The higher weighting of fuels and foods in the Spanish CPI, along with the lower level of taxes in fuel prices, accounts for this trend.

Wholesale prices move up

The rise in energy prices and farm raw materials prices in international markets in recent months has been passed through to wholesale prices in recent months. As a result, the low levels of inflation shown by most prices at origin have now been left behind for some months.

The year-on-year inflation rate of industrial prices rose to 4.7% in October, more than twice the level of the low recorded in August. This sharp rise was mainly due to energy products for which the inflation rate rose to 6.1% from 0.8% shown in September. Non-durable

consumer goods also reported a sharp rise to 4.4%, some 1.2 points more than in the month before, thus reflecting the rise in farm prices. In fact, factory gate prices for food and drink products rose by 8.3% over the past 12 months.

Import prices could not escape the rise in inflation after standing at very low levels up until the summer. In fact, in September the general price index for import prices rose by 2.3% over the past year in spite of the appreciation of the euro. Prices of capital goods also tended to rise but, thanks to world competition and gains in productivity, they rose by only 0.3% in the past 12 months. With regard to intermediate goods, these continued to ease as a result of the pass through of the drop in metal prices.

Year-on-year inflation of industrial prices up to 4.7% in October, more than twice level two months earlier.

Prices paid to farmers showed a sharp rise in August, the latest month available. Both agricultural products (with a rise of 10.9% year-on-year) and especially livestock products (milk, eggs, etc,) with a rise of 21.9% were up considerably.

Livestock products at origin rise 22% in last 12 months ending August.

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											
August	0.4	5.7	3.2	2.5	7.2	10.2	5.1	0.5	–0.4	9.2	3.9
September	1.1	4.2	2.7	2.5	6.7	4.1	3.2	0.9	–0.2	9.4	–
October	2.3	3.4	2.3	2.4	6.9	0.5	3.0	0.8	–0.1	9.5	–
November	0.8	3.6	2.4	2.5	6.8	1.0	2.5	–0.1	–0.3	8.8	3.7
December	–5.8	3.6	2.0	2.6	6.8	2.3	2.4	0.2	–0.2	8.2	–
2007											
January	–6.7	2.7	1.4	2.9	6.3	–1.1	0.4	0.6	–0.2	7.2	–
February	–6.3	2.5	1.4	2.9	6.7	–2.5	0.1	0.4	–0.2	7.4	3.4
March	1.5	2.8	1.7	3.3	6.3	–1.6	0.3	0.4	–0.2	6.7	–
April	6.7	2.7	2.2	3.1	6.5	–2.6	0.2	0.7	0.0	6.1	–
May	0.4	2.4	2.0	3.3	6.0	–2.8	0.7	1.5	0.1	5.6	3.2
June	2.6	2.6	1.8	3.1	5.8	–1.4	1.2	1.0	0.0	5.9	–
July	2.5	2.3	1.9	3.1	5.6	–2.6	0.7	0.9	–0.1	4.1	–
August	5.1	2.3	2.4	3.1	5.4	–2.9	0.7	1.6	0.2	3.8	2.9
September	...	3.4	3.2	3.2	5.4	0.8	2.3	1.2	0.3	3.1	–
October	...	4.7	4.2	3.2	5.3	6.1	...	...	...	...	–

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

Foreign sector

Trade deficit again worsening

Trade deficit breaks with downward trend.

In the period between January and September 2007, the trade deficit was 71.11 billion euros. This indicates that, after a number of months showing a slowdown trend, the trade deficit in cumulative terms from January to September grew by 7.6% year-on-year as against 7.2% year-on-year reported for January-August. The export/import ratio stood at 65.3%, down one decimal from the same period in 2006 for the first nine months of the year.

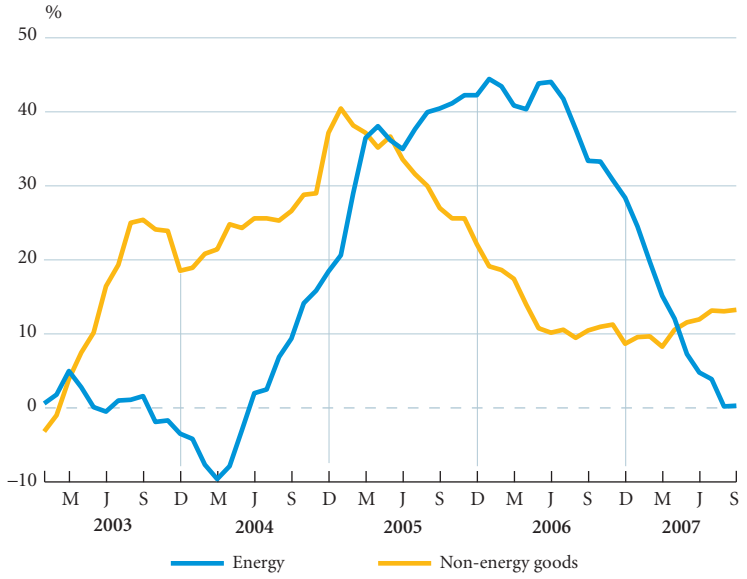
Worsening of energy balance makes easing of trade imbalance impossible.

This poor result is not surprising. Since the beginning of the year the slowdown in the increase in the deficit was basically due to the slowdown in the trade balance of the energy balance. On the other hand, non-energy goods were tending to increase some months earlier. From the moment when the trade imbalance in energy products worsened the trade deficit again began to increase. The immediate prospects are equally negative. Given the trend in oil prices in the Autumn, it is most likely that the imbalance in the energy balance will increase.

In more general terms, we should point out that in the January-September period both exports and imports grew by somewhat more than 7% year-on-year in value. In real terms, the difference

ENERGY NO LONGER EASING PROBLEMS OF TRADE BALANCE

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



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

FOREIGN TRADE

January-September 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	29,624	–4.3	14.4	5,555	–4.0	4.1	–24,069	18.8
Consumer goods	56,571	6.1	27.6	48,095	4.5	35.9	–8,475	85.0
Food	*11,476*	*9.8*	*5.6*	*15,213*	*5.0*	*11.4*	*3,737*	*132.6*
Non-foods	*45,094*	*4.9*	*22.0*	*32,882*	*0.2*	*24.5*	*–12,212*	*72.9*
Capital goods	21,189	7.9	10.3	12,196	–1.4	9.1	–8,993	57.6
Non-energy intermediate goods	97,733	12.1	47.6	68,163	12.1	50.9	–29,570	69.7
By geographical area								
European Union EU-25	120,853	7.5	58.9	94,423	6.3	70.5	–26,430	78.1
Euro area	*100,937*	*7.9*	*49.2*	*75,616*	*7.1*	*56.4*	*–25,322*	*74.9*
Other countries	84,264	7.2	41.1	39,585	9.6	29.5	–44,678	47.0
Russia	*6,041*	*7.2*	*2.9*	*1,490*	*42.4*	*1.1*	*–4,551*	*24.7*
United States	*7,203*	*15.7*	*3.5*	*5,693*	*3.4*	*4.2*	*–1,509*	*79.0*
Japan	*4,535*	*6.4*	*2.2*	*1,016*	*5.7*	*0.8*	*–3,519*	*22.4*
Latin America	*10,821*	*2.7*	*5.3*	*7,526*	*0.4*	*5.6*	*–3,294*	*69.6*
OPEC	*15,638*	*–6.6*	*7.6*	*3,720*	*14.2*	*2.8*	*–11,918*	*23.8*
Rest	*40,026*	*13.6*	*19.5*	*20,140*	*12.8*	*15.0*	*–19,886*	*50.3*
TOTAL	**205,117**	**7.3**	**100.0**	**134,008**	**7.2**	**100.0**	**–71,108**	**65.3**

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

between exports and imports was greater, given that, whereas the former were up by 4.0% year-on-year, foreign purchases rose by 6.6%.

The most dynamic product groups were non-energy intermediate goods which showed growth of more than 12% year-on-year both for exports and imports. It should be remembered that this segment alone represented approximately half of Spain's foreign trade. Some distance behind, foreign trade in food consumer goods was also vigorous. Imports of these products moved up by 10% year-on-year while exports rose by 5%.

Finally, the recent trend in foreign markets continues to be marked by recent developments. The European Union (EU) continues to be the reference trading partner of Spain's economy. In spite of the strength in the case of China (imports with a growth rate of 34% year-on-year) and Russia (Spain's exports showing growth of 42% year-on-year), the EU is still the destination of 71% of Spain's exports and the origin of 60% of its purchases abroad.

Lively trade with emerging countries.

Balance of payments: incomes deficit reaches high levels

In the past 12 months ending in August, the current account balance recorded 20.4% year-on-year growth in the current account balance, approximately

Current account deficit still growing but more slowly.

Troubling performance in incomes balance.

two points less than the cumulative figure for the 12 months ending in July. This drop is largely due to the slowdown in growth of the trade deficit and, to a lesser extent, of the transfers balance.

The counterweight to this trend comes from the incomes balance which continues to increase in growth rate. In absolute values, the contribution of the incomes balance is now one billion euros above the trade balance, a result the importance of which becomes clearer if we consider that the incomes balance does not come to a third of the trade balance.

With regard to the area of financial flows, the most notable fact is that for another month there has been a decrease (in cumulative terms for 12 months) of inflows for portfolio investment, putting these at levels of 14% less than one year ago in year-on-year terms. Outflows for direct investment showed practically the same year-on-year rate of decrease.

BALANCE OF PAYMENTS

August 2007

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–55,481	6.2	–83,370	–6,447	8.4
Services					
Tourism	*19,055*	*1.2*	*27,674*	*335*	*1.2*
Other services	*–3,586*	*–3.4*	*–5,176*	*284*	*–5.2*
Total	15,470	2.4	22,498	618	2.8
Income	–20,284	44.6	–27,236	–7,343	36.9
Transfers	–6,521	31.0	–7,295	–2,991	69.5
Total	**–66,817**	**19.0**	**–95,403**	**–16,163**	**20.4**
Capital account	**2,418**	**–25.3**	**5,355**	**–1,030**	**–16.1**
Financial balance					
Direct investment	–27,623	–37.8	–38,775	6,304	–14.0
Portfolio investment	107,808	–28.1	156,113	–24,706	–13.7
Other investment	–8,509	–78.0	–5,282	32,063	–85.9
Total	**71,676**	**7.2**	**112,056**	**13,661**	**13.9**
Errors and omissions	–1,496	–67.4	188	7,025	–
Change in assets of Bank of Spain	–5,782	–38.4	–22,196	–3,494	18.7

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.

Savings and financing

Slowdown in funding to private sector sharpens

The 1-year Euribor reference rate showed an average monthly decrease in October for the first time in the past two years. This was a modest drop of 8 hundredths but the decrease looks like continuing as the pressures in the interbank market as a result of the subprime mortgage crisis in the United States gradually abate. Nevertheless, in the past 12 months the 1-year Euribor showed a total increase of 0.85 points putting it at 4.647%.

1-year Euribor down slightly in October, a trend that could continue.

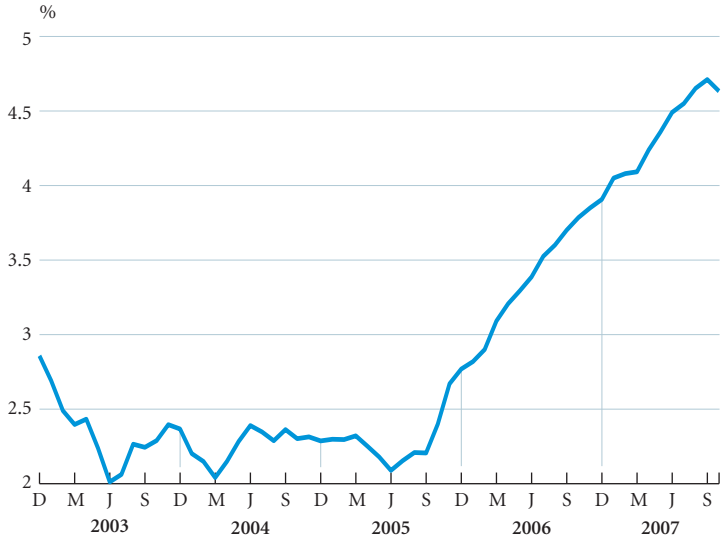
On the other hand, the financial institutions tightened lending conditions in the third quarter, according to the survey on bank loans carried out by the Bank of Spain, and this trend will continue in the final months of the year. This tightening of supply was due to the effect of the upsets in international financial markets in the summer and the change in the perception of the economic situation in general. These tighter conditions especially affected long-term financing of large companies and mortgages for home purchase by families. Furthermore, financial institutions surveyed noted less demand for credit.

Financial entities toughen loan conditions in third quarter and maintain trend in fourth quarter.

In this environment, funding to the private sector continued to rise due to the strength of the economy but at a substantially lower rate. Total funding

ONE-YEAR EURIBOR HITS CEILING

12-month Euribor rate



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

September 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	87,875	2,499	2.9	8,429	10.6	5.2
Secured loans (*)	1,038,617	115,641	12.5	171,161	19.7	60.9
Other term loans	484,681	70,092	16.9	91,421	23.2	28.4
Demand loans	35,586	1,473	4.3	5,894	19.9	2.1
Leasing	44,877	4,164	10.2	5,653	14.4	2.6
Doubtful loans	14,328	3,469	31.9	3,432	31.5	0.8
TOTAL	**1,705,963**	**197,337**	**13.1**	**285,990**	**20.1**	**100.0**

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

Total funding to private sector up 19% in last 12 months, 5 points less than one year ago.

to companies and households rose by 18.9% in September compared with the same month last year, a rate 5.4 points lower that that recorded 12 months earlier. Funding going to companies in this recent period rose at a higher rate than that channelled to households but also showed a definite easing. Total funding going to companies rose by 21.8% compared with September 2006, some 6.1 points less than in December.

Loans by savings banks up slightly more that those of banks compared with September 2006.

Credit for investment recently showed a significant slowdown putting the annual change rate for leasing at 14.4%. In turn, commercial credit, used to provide working capital of companies, rose by 10.6% over the past year.

Default rate at lending institutions down 3 hundredths in September.

With regard to households, funding continued to show a decrease in growth rate going to an annual change level of 15.2% in September, some 4.4 points less than in December. This slowdown was mainly due to the loss of drive in housing loans which cooled off to growth of 16.0%. Loans for consumer credit and other purposes also eased to 13.0% compared with September 2006.

Over the past year, private sector loans by both savings banks and banks have slowed down. Nevertheless, loans by savings banks showed growth slightly above that of banks over the past 12 months.

In addition, the higher level of interest rates and the slowing down of the economy meant that doubtful loans rose by 31.5% in the past 12 months. Nevertheless, the default rate, measured as the ratio between doubtful loans and the total amount of credit granted to companies and households by financial institutions as a whole, was down by 3 hundredths in September compared with the previous month going to 0.84%, a relatively low rate.

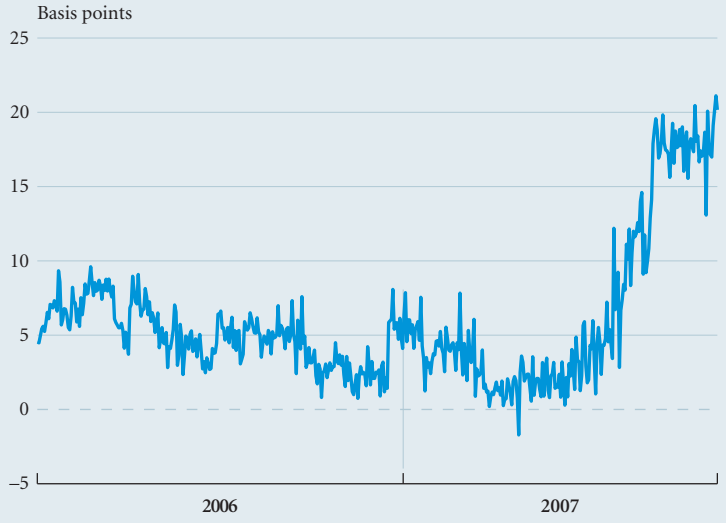
From traditional mortgages to mortgage covered bonds

In Spain in recent years investment has far exceeded domestic savings. This would not have been possible without access to foreign savings, especially that of our European neighbours. A good part of this savings has come into Spain through the financial system by selling covered bonds known as *cédulas hipotecarias*. Financial inflows through this instrument last year were equivalent to approximately one quarter of Spain's current account deficit.[1] The sharp growth and notable importance of this funding in Spain is the matter we deal with here. Let us begin at the beginning. What is a covered bond?

We all know what a mortgage is. We have either taken one out to buy a house or we know several others who have done so. To oversimplify, we also know that the financial institution that gave us a mortgage loan did so thanks to those persons who decided to deposit their savings in that institution. Nevertheless, the financial institutions have other ways of financing. One of these is to issue bonds with mortgage collateral, known as mortgage covered bonds or simply covered bonds, with its Spanish designation being *cédula hipotecaria*. A covered bond is no more than a bond issued by a financial institution that is characterized by a double degree of protection or collateral. They are guaranteed by the financial institution issuing them as well as by the mortgage loans of the issuing entity that also meet certain conditions. Among those conditions, Spanish legislation establishes, for example, a maximum of 80% loan to value (LTV) for residential mortgages and a maximum of 70% LTV for commercial mortgages. The law also limits the issue of covered bonds to a maximum of 90% of the value of the mortgage portfolio that may be used as backing. Nevertheless, in

INTEREST RATES ON «CÉDULAS HIPOTECARIAS» HAVE INCREASED FROM VERY LOW LEVELS AS RESULT OF RECENT FINANCIAL TURBULENCES

Differential over interest rate in interbank market



SOURCE: Bloomberg and own calculations.

(1) This estimate is the result of applying the percentage of the stock of securitization instruments in foreign hands at the end of 2006 by the volume of «cédulas hipotecarias» issued that year.

practice Spanish entities are a long way from that limit, which reinforces the credit quality of covered bonds in circulation.

It is precisely this double guarantee that distinguishes covered bonds from those bonds backed by mortgages commonly used in the North American market (mortgage-backed securities - MBS). In the case of the latter, both defaults and early repayments of the pool of mortgages guaranteeing the bond in question directly apply to payments received by the MBS holder. On issuing an MBS, the financial entity to a large extent divests itself of a part of its mortgage portfolio, which in fact is removed from its balance sheet. While that entity usually continues to manage the collection of mortgage loan payments, it does so as if it were doing so on behalf of the MBS holder. If the mortgage loan falls into default, the bank does not back it with its balance sheet. The only guarantee is the house.

Thanks to the low risk profile, covered bonds have tended to offer an interest rate very close to the rate in the interbank market (where financial entities lend to each other). In recent years, as shown in the graph, the differential in interest rates in favour of 10-year covered bonds has fluctuated around 5 basis points (that is, 0.05%). Recently, this difference has increased to 15-20 basis points as a result of the financial market turbulences brought about by the subprime mortgage crisis in the United States, an impact some feel is exaggerated given the very low risk profile of such bonds.

The issue of *cédulas hipotecarias*, and in general of European covered bonds has shown spectacular growth over the past decade. In the mid-Nineties, issues in Europe as a whole failed to amount to 100 billion euros whereas last year they were above 350 billion euros.[2] In this period, Spain has become the second largest issuer in Europe after Germany. What lies behind this sharp increase? Undoubtedly, the introduction of the euro has had a lot to do with this with the elimination of currency risk. Other factors we may mention are the context of low interest rates which makes it more difficult for financial entities to attract new deposits and the increase in institutional investors, such as pension funds and insurance companies, who want low-risk assets offering interest rates somewhat higher than government bonds. Furthermore, the secondary market in covered bonds is very liquid which also increases their attractiveness.

In a nutshell, covered bonds are a good example of relatively simple financial innovation that has facilitated international financial flows. In this way, savings has been able to go from where there is an excess to where it is most needed. The financial system has played a key role in this process.

(2) Packer, F., Stever, R., Upper, C. «The covered bond market», BIS, Quarterly Review 2007.

Upsets in wholesale capital markets force financial institutions to step up campaigns to attract deposits and make short-term note issues.

Sharp growth of time deposits

The tightening of borrowing conditions in wholesale capital markets and the interbank market has led a good number of financial institutions to step up their campaigns to attract deposits in order to meet the high volume of loans granted. The average interest rate on time deposits thus rose substantially to 4.15% in September.

As a result, time deposits for terms up to two years showed an extraordinary rise

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

September 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	438,299	–10,038	–2.2	10,578	2.5	34.7
Up to 2 years	318,549	72,143	29.3	89,028	38.8	25.2
More than 2-year term	375,998	43,149	13.0	77,548	26.0	29.8
Repos	85,960	2,136	2.5	15,739	22.4	6.8
Total	**1,218,805**	**107,389**	**9.7**	**192,892**	**18.8**	**96.5**
Deposits in currencies other than euro	**43,864**	**11,147**	**34.1**	**14,814**	**51.0**	**3.5**
TOTAL	**1,262,670**	**118,537**	**10.4**	**207,707**	**19.7**	**100.0**

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

of 38.8% in the last 12 months, once the discrimination shown toward those of longer term had been removed under the new tax regulations on savings that came into force in January. In fact, deposits in foreign currency, favoured by certain higher interest rate differentials, showed an annual rise of 51.0% although their share of the total is only 3.5%. On the other hand, on demand and savings deposits rose by only 2.5%, under the effect of low returns. Overall, deposits were up by 19.7% in the past year, slightly less than loans to the private sector, so that the financial institutions also had to have recourse to short-term note issues.

Tough competition to attract deposits has had a negative effect on net sales of mutual fund shares in recent months. In October alone withdrawals came to a total 5.28 billion euros, with net sales in the first ten months of the year amounting to 12.51 billion euros. The drop in mutual fund assets in this period was lower (4.64 billion euros) equivalent to 1.8% thanks to cumulative capital gains putting the total at 249.69 billion euros, according to figures from Inverco, the fund management association.

In fact, the average annual return reported by mutual funds was 4.5% although there was a considerable spread according to type. Share-based funds in emerging markets headed the classification with spectacular gains of 44.1% annual, while Japanese share-based funds closed with losses of 7.8%.

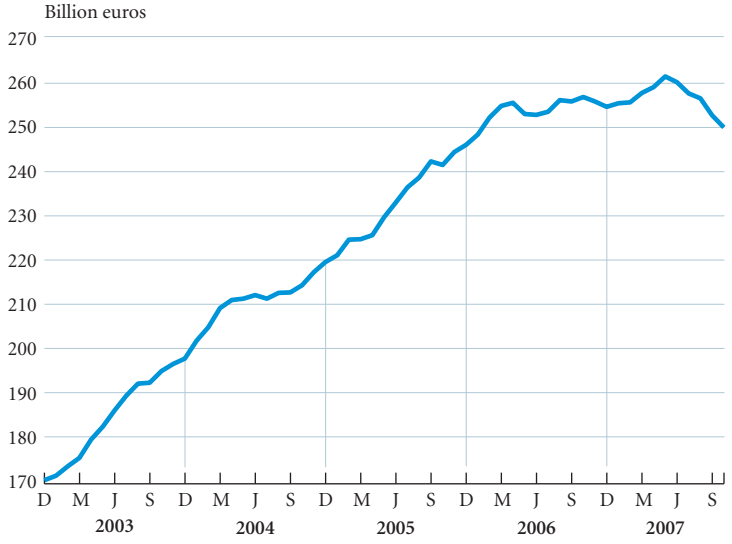
With regard to hedge funds, these continue to take their first steps in the Spanish market. As a result, total assets amounted to 538 million euros at the end of October as against 240 million at the end of the first half-year.

The volume of pension fund assets, which are intended to meet the financial needs of long-term savers, rose by 10.2% in the 12 months ending in September going to a figure of 83.86 billion euros. Over the past year, the number of participants has risen by 5.0%. The estimated number of participants stood at around seven and a half million. The biggest increase in assets over the past 12 months was in the individual system

Average annual return on mutual funds stands at 4.5%.

DROP IN MUTUAL FUND ASSETS BECAUSE OF COMPETITION FROM OTHER FINANCIAL PRODUCTS

Total mutual fund assets



SOURCE: Inverco.

Total pension fund assets up 10.2% in past 12 months ending September.

with a rise of 12.9%, followed by the associate system (promoted by associations such as professional groups, trade unions, etc.) with a rise of 8.5%.

Average return on pension funds in the past 17 years has been 6.35%, well over inflation during the period.

Hedge funds: licence to invest

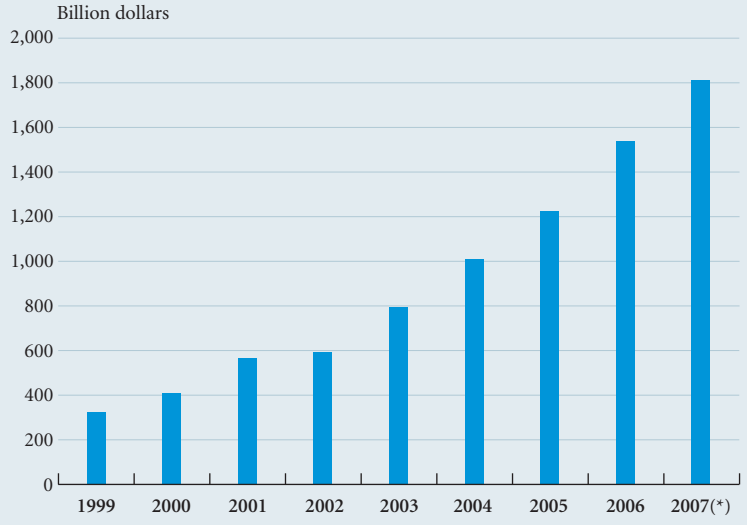
The double zero in «007» distinguishes James Bond as one of the few agents in his department with a «licence to kill». In the investment world, hedge funds also have certain privileges. The term «libre» in «fondos de inversión libre» –the Spanish official designation for hedge funds– emphasizes the freedom of this type of fund to invest in a wide range of strategies, as they are exempt from most of the rules that put limits on their conventional equivalents. Curiously, the list of parallels between the most celebrated British spy in films and hedge funds (HF) does not end there. Both are seductive while at the same time disturbing; they have a long history of success but then the odd reverse; and they try to win no matter what the circumstances. Nevertheless, there is one aspect in which they clearly differ. Whereas 007 is extremely well known, HF continue to be a mystery for most people. For this reason, it is not gratuitous to begin at the beginning in order to better understand what they do and what their role is in the world financial system.

HF have just completed their first year in Spain but their origins date back to the middle of last century. The first fund was set up in 1949 by Alfred W. Jones combining 40,000 dollars from his own pocket and 60,000

dollars from others and since then the HF industry has not stopped growing. In the past 20 years it has gone from counting a few funds in a few well-known hands –such as George Soros or Julian Robertson– to thousands of them, working out complex mathematical models day by day, and operating in a vast universe of investment styles, assets, and markets. In 2007, there were more than 9,000 funds world-wide managing assets worth 1,800 billion dollars, equivalent to 13% of US GDP (see graph below). In relative terms, though, their weight is still modest –mutual funds in the United States were managing at the end of September a capital six times greater.

ASSETS MANAGED BY HEDGE FUNDS INCREASE

Assets managed by hedge funds



NOTES: (*) Figures at the end of September 2007.
SOURCES: Moore Capital Management, Bloomberg according to HFR Inc. data and own calculations.

Although the HF industry is nowadays quite heterogeneous, we will focus on its typical characteristics. Above all, a HF is a mutual investment entity set up as a private company. As such, investor partners entrust their money to the fund manager with the peculiarity that the manager is, at the same time, an investment partner. As opposed to conventional mutual funds, HF are not open to the broad public but are directed exclusively to accredited investors (individuals with high net worth or institutions).[1] It is precisely this limitation what allows them to be exempt from most regulations designed to protect the small investor and to enjoy that way enormous flexibility in their investment policy.

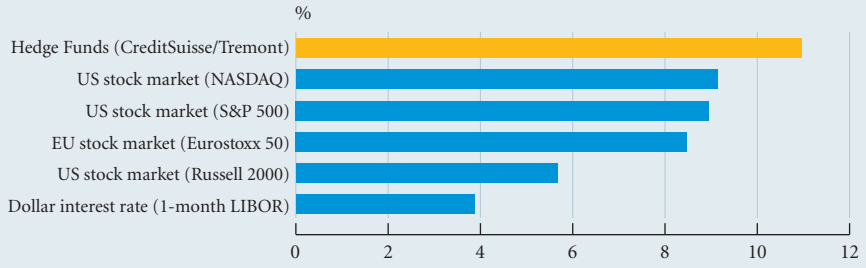
This flexibility has allowed HF to obtain high returns (see accompanying graph). On the other hand, these funds usually require investors to lock up their investment for a minimum of two or three years and they normally collect fees higher than those of conventional funds, although these fees are more linked to the fund's returns (for example, it is not unusual to observe a management fee of 2% of capital under management and a performance fee that may swing between 15% and 25% of the partner's cumulative returns).

(1) The proliferation of «funds of hedge funds», mutual investment funds that do not invest directly in securities but largely in other pure hedge funds, has opened up access to the returns of the HF sector to the small investor.

In practice, this increased flexibility makes it possible for HF investment strategies to be quite different from those of conventional investment funds. The latter normally put together their portfolios from long positions (buying) in various securities with prospects of showing a rise in value. The overriding objective of a HF, on the other hand, is to exploit arbitrage opportunities (taking advantage of asset price differentials that do not seem sustainable). For this purpose, they rely on short selling (borrowing a security they believe overvalued to then sell it and later buy it back at a lower price) and the extensive use of derivatives (see box «Subprime mortgage crisis: are lending derivatives to blame?»).

HIGH YIELD ON HEDGE FUNDS

Annualized return, 1994-2006



SOURCE: Bloomberg and own calculations.

To take an example, let us suppose that both manager 1 of a conventional mutual fund and manager 2 of a HF come to the conclusion that security A, very similar to security B, is undervalued in terms of B. In the simplest scenario, manager 1 would buy more A and less B. On the other hand, manager 2 would buy A and sell B short. In a bull market, security A would tend to appreciate more than B and both managers would obtain positive returns. But, if the market drops, A would tend to fall less than B and the conventional fund would show losses. The HF, however, would come out winning seeing that the return depends on the relative performance of the two securities (its long position in A would lose value but this would be compensated by its short position in B, given that it would be able to repurchase the security at a lower price and thus obtain a benefit).

We should emphasize that we are talking about exploiting small –sometimes infinitely small– price differentials, in which case recourse to leverage (borrowing in order to invest) is key so that HF can broaden their positions and thus multiply the return on arbitrage operations. If investing capital of 100 million euros makes it possible to gain 5 million euros in one month, the return on capital is 5% for that period. If we borrow another 100 million euros at 2% interest and invest in the same strategy, the return will be 8% on the original capital of 100 million euros (gains of 10 millions and costs of 2 million on an investment of 100 million). With this process of leverage, which not only increases yield but also risk, the role of prime broker (mainly investment banks) is essential as these act as key intermediaries for carrying out these operations and providing the financing needed.

The growing complexity of the network of exposure between HF and their financial intermediaries has raised some fears about the systematic risk that could arise from a crisis in an HF. Many people still remember what happened in 1998 when one of the giants, Long Term Capital Fund, went from obtaining an average annual yield of more than 40% to losing more than 1.8 billion dollars in one month. Its situation close to collapse led

the Federal Reserve to intervene in order to prevent the crisis from spreading to the whole financial system. That crisis made quite clear how vulnerable the financial system was to risks linked to hedge funds. While everything suggests that investment banks have substantially improved risk management in their exposure to HF operations since the 1998 crisis, so that the vulnerability of the system to isolated episodes of collapse of a HF has been reduced, there continue to be world-wide pressures to tighten the supervision of HF and promote greater transparency in their operations.

In the debate about HF needing stronger regulation or not, some feel that the former would take away from their privacy, agility, and flexibility and, therefore, that it could reduce the benefits HF bring to the financial system. These benefits, although difficult to quantify, may be considerable. Through arbitrage operations they contribute to the correct valuation of assets while their strategic flexibility allows them to offer innovative opportunities for diversification and to take risks that other institutions prefer to avoid. All of these factors may yield more efficient and comprehensive markets and a better allocation of risk, although the ability of HF to continue carrying out this role greatly depends on the privacy and flexibility permitted by the small degree of regulation to which they are subject.

In the film «Licence to kill», M decides to give Bond back his licence after having temporarily revoked it. We shall see how the future unfolds for HF but it is clear that any measure to limit their current strategic licence should properly weigh its costs and its benefits, unless the regulatory institutions are able to administer licences with the same ease as M.

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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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