FEBRUARY 2008

THE SPANISH ECONOMY

Monthly Report

NUMBER 310

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Massive demand by China and other emerging countries driving up commodity prices

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Boost in biofuels putting pressure on food prices

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2007				2008	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast					Forecast	
Gross domestic product									
United States	2.9	2.2	1.8	1.5	1.9	2.8	2.5	2.4	1.7
Japan	2.4	1.9	1.5	2.8	1.6	2.0	1.3	1.1	1.9
United Kingdom	2.9	3.1	2.1	3.1	3.2	3.3	2.9	2.5	2.1
Euro area	2.9	2.6	1.7	3.2	2.5	2.7	2.2	1.8	1.9
Germany	*3.1*	*2.5*	*1.7*	*3.6*	*2.5*	*2.5*	*1.5*	*1.5*	*1.6*
France	*2.2*	*1.8*	*1.7*	*2.0*	*1.4*	*2.2*	*1.8*	*1.6*	*1.6*
Consumer prices									
United States	3.2	2.8	3.2	2.4	2.6	2.4	4.0	3.9	3.0
Japan	0.2	0.1	0.4	–0.1	–0.1	–0.1	0.5	0.5	0.4
United Kingdom	2.3	2.3	1.9	2.9	2.6	1.8	2.1	2.1	1.8
Euro area	2.2	2.1	2.3	1.9	1.9	1.9	2.9	2.7	2.2
Germany	*1.7*	*2.2*	*2.1*	*1.8*	*1.8*	*2.1*	*2.8*	*2.6*	*2.2*
France	*1.7*	*1.5*	*1.8*	*1.2*	*1.2*	*1.3*	*2.3*	*2.4*	*1.9*
SPANISH ECONOMY			Forecast					Forecast	
Macroeconomic figures									
Household consumption	3.7	3.1	2.2	3.4	3.3	2.9	2.7	2.4	2.3
Government consumption	4.8	5.5	5.2	5.7	5.0	5.8	5.6	5.4	5.2
Gross fixed capital formation	6.8	5.9	2.2	6.6	6.6	5.6	4.9	3.0	2.1
Capital goods	*10.4*	*11.7*	*5.3*	*13.3*	*13.1*	*11.2*	*9.6*	*8.0*	*6.0*
Construction	*6.0*	*4.2*	*0.9*	*5.2*	*4.6*	*3.8*	*3.4*	*1.0*	*0.4*
Domestic demand (contribution to GDP growth)	5.1	4.6	2.9	5.1	4.9	4.4	4.1	3.3	2.9
Exports of goods and services	5.1	6.0	5.1	3.6	4.8	8.0	7.7	6.0	5.0
Imports of goods and services	8.3	7.2	5.4	5.9	6.6	8.3	8.0	6.0	6.0
Gross domestic product	**3.9**	**3.8**	**2.5**	**4.1**	**4.0**	**3.8**	**3.5**	**2.9**	**2.3**
Other variables									
Employment	3.2	3.0	1.5	3.3	3.2	3.0	2.7	2.0	1.6
Unemployment (% labour force)	8.5	8.3	8.7	8.5	8.0	8.0	8.6	8.9	8.5
Consumer price index	3.5	2.8	3.8	2.4	2.4	2.4	4.0	4.4	4.1
Unit labour costs	2.3	3.0	3.1	2.8	2.9	3.0	3.2		
Current account balance (% GDP)	–8.8	–9.5	–9.6	–10.4	–9.0	–10.1			
Net lending or net borrowing rest of the world (% GDP)	–8.1	–8.9	–9.0	–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	2.7	5.3	5.3	5.1	4.5	3.3	2.9
ECB repo	2.8	3.9	3.8	3.6	3.8	4.0	4.0	4.0	3.9
10-year US bonds	4.8	4.6	3.5	4.7	4.8	4.6	4.1	3.6	3.5
10-year German bonds	3.8	4.2	4.0	4.0	4.4	4.3	4.2	3.8	4.0
Exchange rate									
$/Euro	1.26	1.38	1.47	1.32	1.35	1.39	1.46	1.50	1.48

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Commodities: Entering a new era?

It has always been believed that a generous supply of commodities is not necessarily good for a country's economy. People even talk of the «curse of oil wealth», as it is sometimes called, to explain that oil-rich countries are often at the tail-end of development (with notable exceptions, of course). In fact, a good number of the more advanced economies on the planet are not in that category because they are rich in natural resources but because of their efficiency when it comes to combining production factors and developing new technology and products.

From a more empirical point of view, the earlier intuition turns out to be true, given that in the past century commodity prices have tended to drop in relative terms against prices of manufactured goods. This trend is due to various factors. First, demand for commodities is tending to grow less than the world economy. In other words, economies are now less dependent on commodities than 100 years ago. In addition, improvements in efficiency and productivity constantly being introduced in the manufacturing sector and services, that make it possible to raise wages and benefits, are not taking place at the same pace in agriculture or the extraction of commodities. Furthermore, the latter tend to be homogeneous products with little margin for differentiation.

Nevertheless, for some years now all these ideas seem open to question in view of the sharp rise in commodity prices. This rise went far beyond the usual volatility of these products and forces us to ask if this is a fundamental change or are we facing a more or less ephemeral parenthesis before they go back to historical trends.

Some observers feel that we are facing a new paradigm of long-term trends and that the «culprits» are the emerging countries, with China in the lead. If these low-income, high-population countries are able to maintain the economic success they have enjoyed recently and advance rapidly to the level of well-being of the more developed countries, their needs for consumption of commodities (both agricultural and industrial) are going to be enormous. That is to say, demand has suddenly risen and the problem now is supply. In recent years, China has absorbed practically the entire increase in world consumption of industrial commodities. What is more, it is forecast that shortly after 2010 China will be the world's biggest energy consumer and that, along with India, will be responsible for 45% of the increase in energy demand up to 2030. Development will also mean changed consumer patterns. The rice diet will lose importance while meat, eggs and milk products will rise. What will be the result? Growing demand pressure for these products will also mean an increase in prices for commodities such as cereals and milk products. If we add to this the boom in biofuels, we can better understand the wave of price increases in commodities.

Whether these price increases are lasting or not, they still need to be explained. In any case, as a reaction to high prices, the search has sharpened for alternative materials and new technology that will allow supply to meet these new needs. An undoubted fact is the financial power the rise in commodity prices has given producers in recent years. The examples of Russia, which in a short time has become the third leading country in terms of foreign currency holdings, and the so-called sovereign funds of the oil-rich countries coming to the rescue of large financial institutions, clearly show the change that has taken place in the world of commodities.

EXECUTIVE SUMMARY

Financial upsets grow worse at start of 2008

Gradual easing of monetary interest rates but financial instability persists.

International financial instability broke out back in the summer of 2007 with the subprime mortgage crisis, still a long way from being contained, and remains virulent at the beginning of 2008. While increases in short-term interest rates have eased thanks to monetary policy moves (the Federal Reserve drastically cut its reference rates and all the central banks have worked to provide the necessary liquidity), in other segments of the market the upsets continue. Credit differentials have increased in an environment of dropping government bond yields. The stock exchanges have suffered a notable increase in volatility and seem to have moved into a bear market, anticipating a situation of great weakness or recession in the economy of the United States.

Fourth week of January sees further episode of sharp fluctuations on stock exchanges...

From the beginning of December of last year, the most important world stock exchanges have dropped between 14% and 20%. The vicissitudes of shares, however, sharpened in January. On Monday, January 21, when US markets were closed for a holiday, Asian and European markets suffered major drops. One of the factors that set off the crisis of confidence among investors was the announcement on Friday January 18 of a cut in the credit classification of some major US credit insurance companies, the so-called monoline insurance companies. The effects of this move involved lowering the classification of bonds issued for an amount of 2,400 billion dollars with the subsequent impact on bond prices, reorganizing of portfolios and the taking up of bank capital for those issues included in financial institution balance sheets.

...with Federal Reserve applying drastic cut in reference rates.

The recovery at the end of the week, Thursday and Friday, was mainly due to the decision to adopt a rescue plan through which to recapitalize the monoline insurance companies in order to guarantee the stability of the financial system. Beforehand, however, the Federal Reserve decided to apply an exceptional cut in its reference rate, given that this decision was made before the monetary policy meeting set for January 30. In fact, on Tuesday, January 22, the US monetary authority reduced the Federal Funds rate by 0.75 points putting it at 3.50%. This was the biggest cut in the past 23 years. The speed and size of the move are significant and indicate the risk perception of the central bank.

In contrast to this move, the governor of the European Central Bank (ECB), Jean-Claude Trichet, made it clear that he was not thinking of following the course taken by the Fed and that his main concern was to maintain inflation prospects steady. The position of the euro monetary authority is that, while economic slowdown in the United States will certainly affect the rest of the world, the effects in the Euro Area will not be noted until much later and will be milder than in the case of previous episodes. In fact, the indications from the ECB are to maintain its policy and wait and see.

Within this complicated financial picture, we should point out the improvement in short-term interest rates. The injections of liquidity and rate cuts by some central banks has managed to reduce pressures in monetary markets.

Normalization has been most complete in those monetary areas where there was greater pressure at the end of last year, that is, United States and United Kingdom. In the Euro Area as well the 3-month Euribor, which had reached 4.8% at the end of November, has dropped to 4.4%. For example, the 1-year Euribor, to which most mortgages in Spain are referred, has halted its upward move and, whereas a few months ago it seemed to be heading toward 5%, has now gone back toward 4.4%.

On the other hand, the tightening of credit terms has increased compared with the easy situation operating up until six months ago. The latest survey of loans granted carried out by the ECB, covering the fourth quarter of last year and prospects for the first quarter of this year, shows that banks are maintaining a firm position in granting credit to companies and this is expected to sharpen for large companies in the first quarter. Factors contributing to this situation in order of importance are the worsening of prospects in the economic sector, increased cost of capital for banks and, to a lesser extent, less competition among banks to attract new customers in the business sector.

What happens now in these financial upsets will very much depend on the trend followed by the US economy. There is no doubt the year began badly with the likelihood of recession included and the key lies in the performance of private consumption. The low level of savings, the drop in housing prices, the hardening of credit terms and the increased cost of energy may leave very weak those factors that up until now have been the main support of economic activity in the United States and the world in general. As mentioned earlier, monetary policy is still adequate to the task but in view of all these pressures it was necessary to provide a rapid specific fiscal stimulus so that everything would not fall on low interest rates. This is the objective of the plan announced by president Bush that is currently being negotiated between the White House and the Senate, the main point of which is the issuing of cheques to taxpayers in order to increase spending.

With regard to the European economy, the situation remains one of slowdown. On the demand side, the drop in retail sales in November (1.3% year-on-year) and the collapse of consumer confidence suggest weakness in private consumption. In any case, the fact that the unemployment rate in November stood at 7.2% year-on-year, that is to say, a figure seven decimals less than one year earlier, represents a support for household spending. Can the foreign sector counteract this lower domestic drive? It would seem less and less. Following 14 months with a trade balance tending to recover, this profile was broken in November. This was only a relative surprise, given that the gradual drop in exports from September to November, combined with maintenance of growth in imports, indicated this result was coming. In this process, the appreciation of the euro may be having a major role given that, measured by the nominal effective exchange rate, the single currency was revalued some 4% only in the fourth quarter.

Nevertheless, as pointed out earlier, the figure that most troubles the ECB monetary authorities is inflation seeing that this is well above the threshold of 2%. In December, the harmonized consumer price index (HCPI) was again 3.1% year-on-year with no change over November. In any case, from this point on it is to be expected that the rise in prices will not go much beyond this. Forecasts of a slowdown in the industrialized economies would indicate a drop in oil prices in coming quarters because of lower demand, which would ease pressure on the energy component in the harmonized CPI.

Bank lending terms harden in Europe because of worse forecasts and higher cost of capital.

Resolving financial upsets will depend on course of US economy over coming quarters.

Europe moving into a slow-down but for now rise in inflation seems more troubling.

Spain's economy: less job creation

Figures for Spain's labour market beginning to reflect slowdown in economic activity.

With regard to Spain's economy, this does not lie outside the situation of a general slowdown. In 2007, it again showed an increase in gross domestic product of close to 4% but in recent months the loss of drive in economic activity has become more noticeable. Figures from the labour force survey for the fourth quarter provide a serious warning in this respect. The figures show a slowdown in job creation to an annual rate of 2.4%, seven decimals less than in the previous quarter. For the first time since 1995 jobs were lost in a fourth quarter, while the unemployment rate rose to 8.6%, six decimals more than in the previous period. In 2007 as a whole, unemployment rose by 117,000 persons, the first annual increase since 2003.

Nor is 2007 inflation balance favourable with CPI rising to 4.2%.

In spite of everything, the tendency to create jobs is being maintained. At the end of 2007, those registered at Social Security with jobs amounted to somewhat more than 19 million persons, an all-time high for a year-end. This figure meant a year-on-year increase of somewhat more than 2%, a rate practically identical with that of the labour force survey. In absolute figures, the increase in registrations with Social Security during the year was 425,496 persons, a considerable number but which accounts for the lower increase in absolute terms since 2003. Of this figure, 268,364 were Spanish workers, making up 63.1% of the total. Registered foreign workers rose by 8.6% as against 8.0% recorded at the end of 2006. As a result, the participation of foreign workers in the total continued to increase going to 10.3% in December.

Decrease in demand for credit both by companies and households.

Nor was there a favourable balance for inflation in 2007 due to the sharp rise in prices as of the summer. The annual CPI change rate rose to 4.2% in December, 1.6 points more than in 2006, recording the biggest year-end increase since 1995. The cause lay largely in higher-cost oil and food in international commodities markets. Nevertheless, the average annual change in CPI was 2.8%, the lowest rate in the past eight years. This difference was due to the peculiar profile of the year-on-year CPI rate over the year which, up until August, was running between 2% and 2.5% only to rise to the rate mentioned in the final months of the year. What are the prospects for inflation in 2008? Lower demand pressure should help a gradual decrease in background pressures. In coming months, however, there will still be some increases arising from inflationary pressures on food and energy.

The financial upsets, along with the hardening of credit terms and prospects of lower growth, lie behind the drop in growth rate of funding granted to companies, something that has sharpened in recent months. Year-on-year growth thus went from 23.4% in August to 19.3% in November. Commercial credit, used to finance working capital of companies, showed a reduction in annual change rate to less than 10%. Nevertheless, funding of investment, in an approximate estimate based on leasing operations, continued to show a good level. With regard to funds granted to households, these also continued to gradually ease. In any case, for the past 12 months ended November they showed an annual increase of 14.2%.

In this context defined by stock market upsets and the worsening of prospects, the economic authorities have tried to put out messages urging calm, reminding one and all of the strong aspects of Spain's economy, notable among which is the sizeable surplus in the public accounts.

January 29, 2008

CHRONOLOGY

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.
December	11	**Federal Reserve** cuts reference rate to 4.25%.
	13	Central banks in United States, Euro Area, United Kingdom, Switzerland and Canada announce plan for **coordinated measures to relieve difficulties in monetary markets** brought about by financial upsets.

2008

January	1	Further enlargement of **Euro Area** with entry of Cyprus and Malta, making 15 member states.
	3	One-month forward price of Brent **oil** moves up to all-time high level of 98.25 dollars a barrel.
	14	**Euro** exchange rate at 1.4895 dollars, highest value since launch of single European currency at beginning of 1999.
	22	**Federal Reserve** reduces reference rate to 3.50%.
	30	**Federal Reserve** reduces reference rate to 3.00%.

AGENDA

February

- **5** Industrial production index (December).
- **7** Governing Council of European Central Bank.
- **14** Preliminary GDP for Spain (4th Quarter).
  GDP for EU (4th Quarter).
- **15** CPI (January). Balance of payments (November).
- **20** Quarterly national accounts (4th Quarter).
  Foreign trade (December).
- **21** Central government revenues and spending (January).
- **25** Producer prices (January).
- **29** Preliminary HCPI (February).
  Harmonized CPI for EU (January).

March

- **5** Industrial production index (January).
- **6** Governing Council of European Central Bank.
- **13** CPI (January).
- **14** Balance of payments (November).
  Labour cost (4th Quarter).
  Harmonized CPI for EU (February).
- **18** Fed Open Market Committee.
- **19** Foreign trade (January).
- **25** Producer prices (February).
  Central government revenues and spending (February).
- **31** Preliminary HCPI (March).

INTERNATIONAL REVIEW

United States grows by 2.5% in fourth quarter which means a substantial slowdown in economic activity.

United States: fear of recession

A month ago the economy was going through a narrow defile between fear of lower growth and rising inflation. The strength of domestic demand in the third quarter raised doubts about the former. But, when president Bush declared that the economy needed a shot of vitamins in the arm when announcing a package of fiscal measures totalling 145 billion dollars and the Fed drastically reduced its intervention rate, this all suggested that the doubts had decreased and that the risk lay in the sharpness of the slowdown or even the recession.

The United States is expecting a poor start to the year, with the likelihood of recession included, and the key lies in the performance of private consumption. The low level of savings, the drop in housing prices, the tightening of credit terms and the higher cost of energy could leave in a weak state the factor that has been acting as the main support of economy in the United States and the world, given that, through its imports (that is, its trade deficit) has absorbed the excess savings of the emerging economies, of Japan and, to a lesser extent, of Europe. Monetary policy was ready to act but in view of such pressures it was necessary to provide rapid specific

UNITED STATES: MAIN ECONOMIC INDICATORS

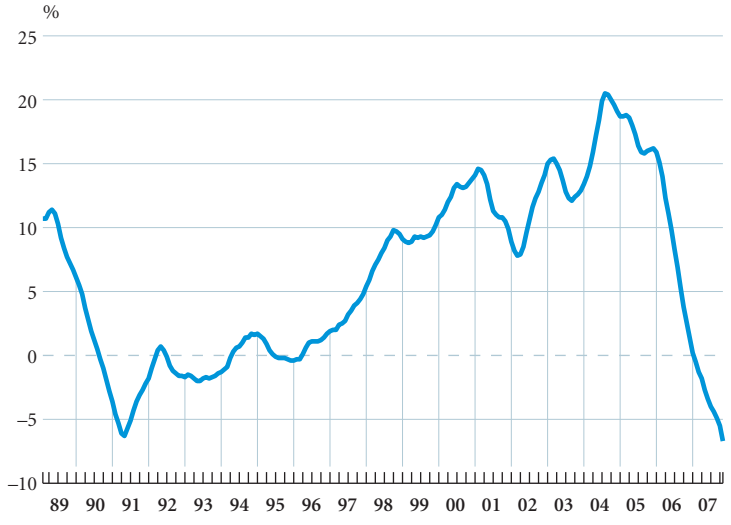
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	3.1	2.9	2.6	1.5	1.9	2.8	–	2.5	–
Retail sales	6.6	6.2	5.1	3.4	4.0	4.1	4.8	5.9	4.1
Consumer confidence (1)	100.3	105.9	106.8	109.9	106.7	105.7	95.2	87.8	88.6
Industrial production	3.2	4.0	3.5	2.5	1.7	1.6	1.5	2.2	1.5
Industrial activity index (ISM) (1)	55.5	53.9	50.9	50.8	55.2	52.9	50.9	50.8	47.7
Sales of single-family homes	6.5	–18.0	–21.9	–24.6	–21.2	–26.4	–25.3	–34.4	...
Unemployment rate (2)	5.1	4.6	4.4	4.5	4.5	4.7	4.8	4.7	5.0
Consumer prices	3.4	3.2	1.9	2.4	2.7	2.4	3.5	4.3	4.1
Trade balance (3)	–714.4	–758.5	–758.5	–746.4	–732.2	–706.1	–705.7	–710.4	...
3-month interbank interest rate (1)	3.6	5.2	5.4	5.4	5.4	5.4	4.9	5.1	4.7
Nominal effective exchange rate (4)	83.7	82.5	81.6	81.9	79.3	77.0	73.9	72	74

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

UNITED STATES: HOUSING PRICES CONTINUE TO DROP

Year-on-year change in Case-Shiller housing price index



SOURCE: Standard & Poor's and own calculations.

fiscal stimulus so that not everything would fall on low interest rates because, among other things, this could add upsets in the dollar exchange rate.

The gross domestic product (GDP) moved up 2.5% year-on-year in the fourth quarter. There were notable drops in retail sales. Excluding cars and petrol, which are highly volatile, retail consumption in December grew by 3.7% year-on-year, 1.3% discounting price increases. Also running along these lines was the consumer confidence index from the Conference Board given that the slight rise shown (to the level of 88.6 points) was due to a slight correction of the drastic drop in prospects the month before. A significant point is that this weakness has been turning into the perception of the present situation which went from 115.7 points to 108.3, a level similar to the low in October 2005 following hurricane *Katrina*.

Some dark clouds are also appearing in what seemed like strength at the beginning of the year, namely the firm state of non-financial companies. Latest results published suggest a drastic drop in profits and this logical change of attitude is reflected in the index of business activity put out by the Institute for Supply Management. In the manufacturing sector the index dropped from 50.8 to the 47.7 points level, below 50 which indicates that pessimistic responses were in the lead with a clarity not seen since the start of the war on Iraq. In services, things look somewhat better although the index dropped from 54.1 points to 53.1. By component, prices generally are close to the 70 points level while in manufacturing we note weakness in employment and a sharp drop in new orders. In services, prices are holding, although just barely, in the optimistic range.

Retail sales slowing down and perception of current situation grows worse.

The housing market continues well on the downward track. On the supply side, the storm is growing worse with a much deeper drop than during other cycles. Housing starts dropped more sharply in

Manufacturing executives more pessimistic while those in services see things more calmly.

UNITED STATES: CONSTRUCTION COMPANIES HAVE NEGATIVE OUTLOOK

Housing starts in legal terms

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

Construction undergoing sharp slowdown with home prices down 6.7%.

December losing 14% compared with November with a total drop of 38.2% year-on-year which reduces this activity to less than half that operating in 2005. The sharpness of the drop in supply is having its effect on growth but, with housing investment representing 4.5% of total GDP in current dollars, the most troubling aspect is what it implies regarding the scenario construction companies have for the real estate market and therefore for private consumption, that equals a decisive 70.0% of GDP. Sales of existing housing were down 20.0% year-on-year in November while new housing dropped by 34.4%. The slowdown in the Case-Shiller index for housing prices was also sharper with a loss of 6.7% year-on-year in October.

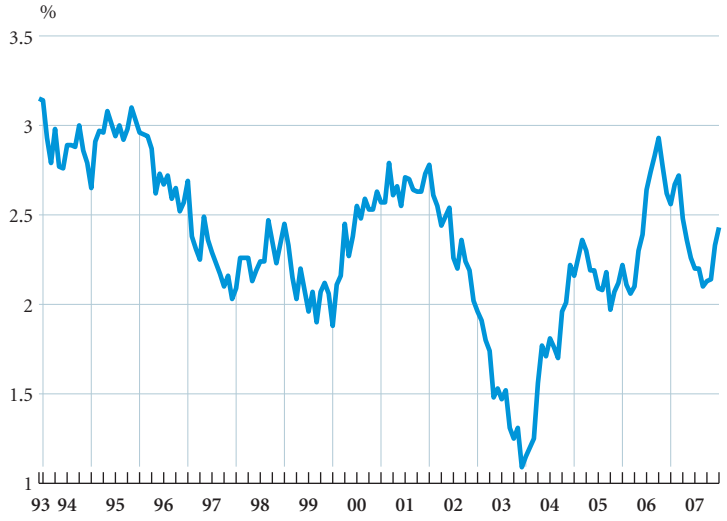
The pass-through of the weakness in the housing market and the tightening of private consumer credit terms is taking place through three channels, to which a fourth may be added. First, there is the wealth effect for the fact that, as consumers feel they are not as wealthy as a result of the drop in the prices of their assets, the restrict their spending. There is also the lower capacity to find finance using equity of diminishing value as collateral. Thirdly, the tightening of borrowing terms not only affects those who have a low credit rating but all other households seeing that those who hope to buy a house are obliged to save more in order to make the down-payment. Finally, the higher price of oil, while it may not affect the non-energy components of the CPI, through increased spending on petrol, does reduce the funds available for other goods and services.

Employment slowing down while unemployment rate rises to 5%.

The labour market had a poor month in December with only 18,000 new jobs added to the economy and an unemployment rate that went from 4.7% to 5.0% of the labour force. The most notable, however, continues to be the persistence of a more moderate downward trend than in previous

UNITED STATES: NOT SUCH A BAD LONG-TERM TREND

Year-on-year change in underlying consumer price index (*)



NOTES: (*) The underlying index excluded food and energy.
SOURCE: Department of Labour and own calculations.

slowdown cycles of the economy. This is adding some fuel to consumption but increasingly less given that in the past 12 months an average of 111,000 jobs have been created each month, half what was normal at the beginning of 2006.

The December consumer price index (CPI) maintained a rise going to 4.1% year-on-year. The core component (the general index less food and energy) rose slightly with the increase going from 2.3% to 2.4% year-on-year. The increase in inflation must be seen as a bad spoke in the wheel in the implementation of expansionist monetary policies than as the start of an upward spiral in prices. The speed with which the economy can advance without creating inflationary pressures has been reduced and the Federal Reserve must preserve its anti-inflation reputation in order to keep being effective. Both producer prices and the underlying index (excluding the inflationary and volatile home rentals) are showing a scenario that is less removed from price stability.

Inflation holds above 4% while correction of deficit must wait.

On the foreign front, things are taking longer than expected. The trade balance in goods and services in November showed a deficit of 63.12 billion dollars, an increase of 8.0% year-on-year which cannot continue. Exports rose by a robust 13.0% but it was the boost in imports (with a rise from 9.1% to 11.4%) that caused the growth of the deficit.

Japan: consumers still lagging

The Japanese economy grew by 2.0% year-on-year in the third quarter and the fourth quarter is expected to be weak. Forecasts for 2008 are for a slowdown with growth for the whole year at around 1.5% because of slack domestic consumption, lower investment drive, the persistence of weaknesses in the housing sector and heavy

Japan grows by 2% but domestic demand still remains a challenge.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	1.9	2.4	2.5	2.8	1.6	2.0	–	...	–
Industrial production	1.5	4.5	5.3	3.6	2.3	3.3	3.6	1.6	...
Tankan company Index (1)	18.0	22.5	25.0	23.0	23.0	23.0	–	19.0	–
Housing construction	3.9	4.5	5.4	–1.9	–2.7	–37.1	–35.0	–27.0	...
Unemployment rate (2)	4.4	4.1	4.0	4.0	3.8	3.8	4.0	3.8	...
Consumer prices	–0.3	0.2	0.3	–0.1	–0.1	–0.1	0.3	0.6	...
Trade balance (3)	10.2	9.4	9.4	10.2	11.1	12.3	12.7	12.8	...
3-month interbank interest rate (1)	0.1	0.3	0.5	0.6	0.7	0.8	0.9	0.9	0.9
Nominal effective exchange rate (4)	86.2	81.1	79.2	77.6	75.7	76.9	76.9	79.4	78.8

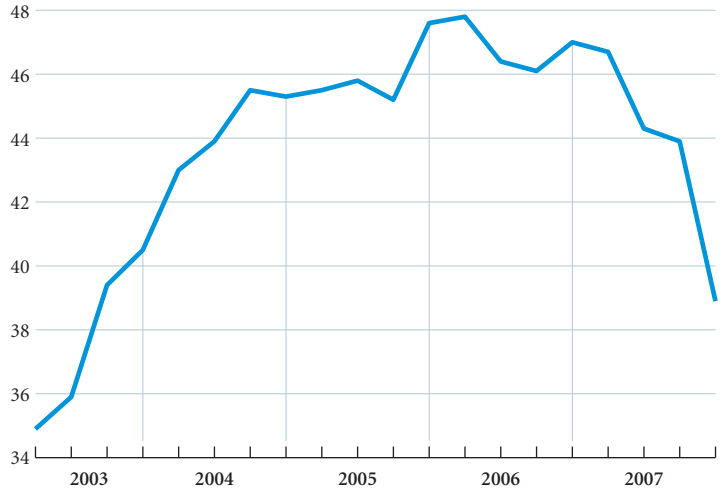
NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative balance for 12 months. Billion yen.
(4) Change weighted for foreign trade movements. Higher values imply currency appreciation. Average in 2000 = 100.
SOURCE: OECD, national statistical bodies and own calculations.

dependence on foreign exports in a context of a world slowdown.

Domestic consumption continues to suffer from the structural changes taking place in the labour market. In line with the Japanese mentality, an increase in temporary work and less paternalism in labour relations continue to drag down consumer confidence, which in the last

JAPAN: CONSUMERS FEARFUL

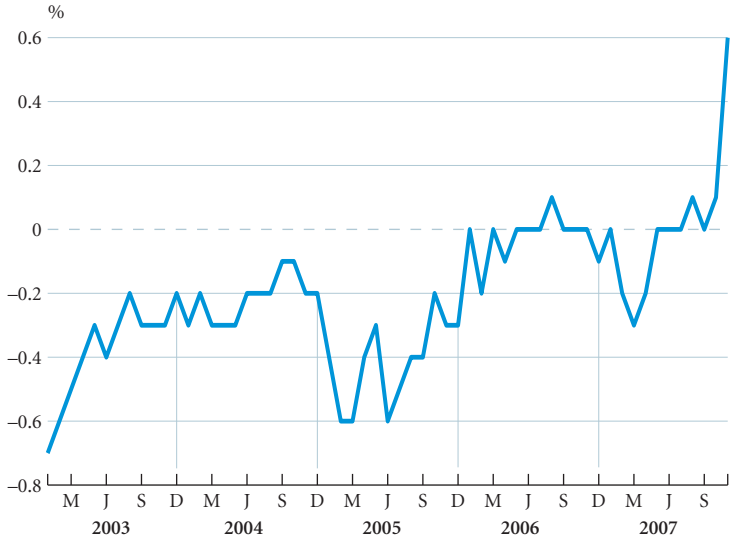
Consumer confidence index



SOURCE: Japanese Ministry of Economy, Trade and Industry and own calculations.

JAPAN: DEFLATION MORE AND MORE THING OF PAST

Year-on-year change in consumer price index, excluding fresh foods



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

quarter of 2007 dropped from 43.9 points to the 38.9 points level, in keeping with what had been the case in 2002 when the economy was stagnant. Machinery orders in November, which indicate investment trends, dropped because of worse prospects in the export sector, thus confirming the decrease in the Tankan economic activity and business sentiment index of large manufacturing companies to 19 points in the fourth quarter. Industrial production again dropped in November thus reducing the year-on-year increase to a slim 1.6% so that traditionally strong Japanese industry is continuing to show a low profile.

Business executives see things getting blacker and reduce investment.

The housing sector is attempting to come out of its slack. The effects of the change in regulations aimed at building safety are gradually fading on the supply side but the market remains weak. Housing starts in November rose for the second consecutive month although they have added up a total drop of 27.0% year-on-year. The number of housing units sold in the Tokyo area also rose in December although it is too soon to speak of any change in trend with a drop of 35.5% compared with the same period the year before especially when prices, with a drop of 5.1% in December, do not join in.

Housing recovers slightly but sharp losses raise doubts.

The unemployment rate in November dropped from 4.0% to 3.8% of the labour force which coincided with a slight rise in wages, both in manufacturing and services. On the prices front, Japan has been leaving its deflationary ghosts behind it. The November CPI rose by 0.6% year-on-year. Core inflation, excluding fresh foods from the general index but not energy, this time also came onto positive ground with an increase of 0.4%. While we may see positive changes in prices, the absence of inflation is quite obvious and this clarifies things for the Bank of Japan whose most pressing task is to buttress growth.

Prices up 0.6% while unemployment drops to 3.8%.

Chinese economy grows by 11.5% led by exports and investment while industry unstoppable.

In the foreign sector, the cumulative surplus in the trade balance for the 12 months ending November continued at 12,800 billion yen. Exports were down but they maintained level with growth of 8.6% year-on-year while imports came out of their stagnation with an increase of 10.5%.

China: Is growth excessive?

The Chinese economy grew by 11.2% year-on-year in the fourth quarter, a rate somewhat lower than that in the previous quarter but which puts the total for the year at a robust 11.4%. Economic activity indicators followed the same pattern. Industrial production moved up 17.4% year-on-year in December putting behind any prospect of cooling off. Private consumption continued to be the area that failed to grow as it might. In this respect, retail sales moved up 20.2% year-on-year in December which, not counting prices increases stood at 12.9%, a clear slowdown from 2005 and 2006, indicating that private consumption continues to be a challenge for China's growth. The fact is that Chinese growth has a bias toward heavy industry, big differences between country and city and a further bias toward investment and exports at the expense of private consumption.

Effect of US slowdown on exports will be limited.

The foreign surplus in 2007 reached 261.5 billion dollars, another all-time high. Exports, which make up 33.5% of the economy, are directed toward the United States and Europe. Any drastic slowdown in US purchases of Chinese goods, however, should have only limited effects on the economy. Exports to the United States make up 6.4% of China's nominal GDP but in 2007 this showed an easing off so that the contribution of these exports to growth is much lower. Even considering indirect effects, according to the Asian Development Bank, a slowdown in the US economy would hardly reduce growth directly by more than 1,0%. Nevertheless, investment (which makes up 40% of GDP) could be affected in this respect. Close to 60% of Chinese exports are carried out by foreign companies located in China. Any decrease in prospects of these companies could also mean a reduction in foreign direct investment with a greater impact on growth although, in this respect, we should also take into account the incipient growth of local companies.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

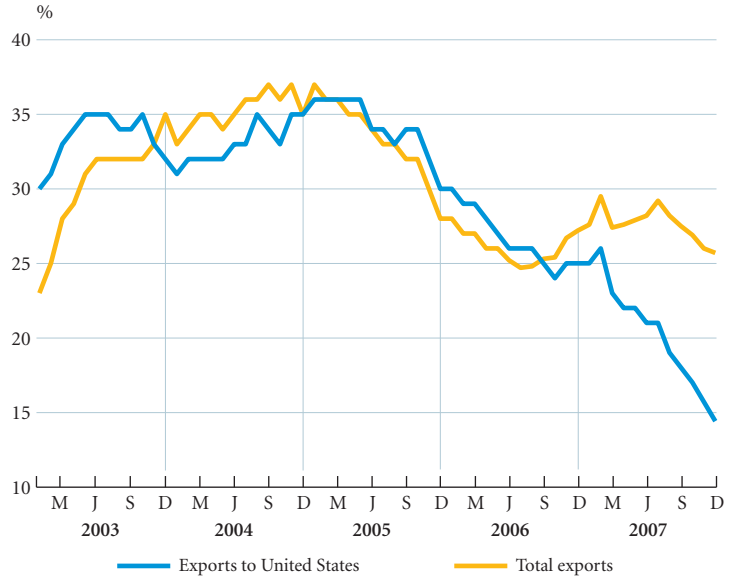
	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	10.1	10.7	10.4	11.1	11.9	11.5	–	11.2	–
Industrial production	15.9	16.4	14.8	14.4	18.3	18.1	17.9	17.3	17.4
Electrical power production	13.4	14.7	15.3	12.4	17.7	16.3	17.4	16.6	14.5
Consumer prices	1.8	1.5	2.0	2.7	3.6	6.1	6.5	6.9	6.5
Trade balance (*)	102.0	177.5	177.5	200.5	228.9	253.2	256.5	259.9	261.5
3-month interbank interest rate (*)	2.4	2.8	3.1	2.8	3.4	3.5	4.3	5.1	4.7
Renminbi to dollar	8.2	8.0	7.8	7.7	7.7	7.5	7.5	7.4	7.3

NOTES: (*) Cumulative balance for 12 months. Billion dollars.

SOURCE: National Statistics Office of China, Thomson Financial Datastream and own calculations.

CHINA: EXPORTS TO UNITED STATES NOW SLOWING DOWN

Year-on-year change in exports (*)

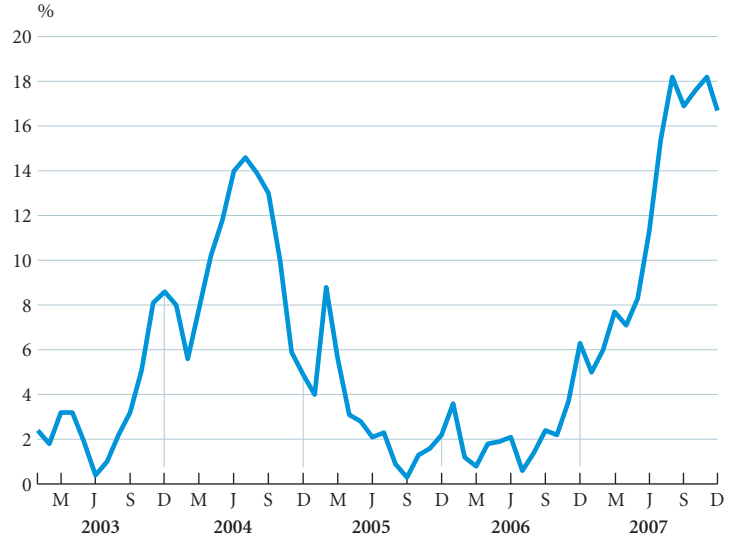


NOTES: (*) Sum of last 12 months.
SOURCE: Chinese National Statistics Office and own calculations.

One pressing problem of China's economy is growing inflation and the need to maintain monetary stability. The general CPI rose by 6.5% year-on-year in December thus maintaining its upward trend. Food prices rose by a quite

CHINA: FOOD PRICES SHOOTING UP

Year-on-year change in food consumer price index



SOURCE: Chinese National Sstatistics Office, London Market and own calculations.

Inflation hits 6.5% and new law on labour contracts could help boost level.

troubling 16.7%. This component represents 14.1% of total retail sales but in the rural areas the percentage jumps considerably. The new law on labour hiring contracts, which now makes easy firing practices more difficult, will increase costs in 2008, adding further pressure on prices.

Measures for cooling off economy.

The Chinese authorities are beginning to show their concern about overheating of the economy which is to be seen mainly in inflation. Control of the exchange rate of the national currency remains very firm but we note increasing appreciation. Nevertheless, there was a notable decision to increase the cash reserves of banks to 15%. In any case, China's growth is strong and quantification of the effects any slowdown in the leading economies may have remains an unknown and the fact is that any *decoupling* of China and the United States is by no means certain.

China is eating up the world

A documentary recently aired by the US television network CNN compared China with a giant vacuum-cleaner sucking up the natural wealth of the planet. While the intention of the report was to denounce the illegal traffic in protected animal species, population growth and economic take-off in China have not only fed its appetite for exotic turtles but its demand for all types of commodities too.

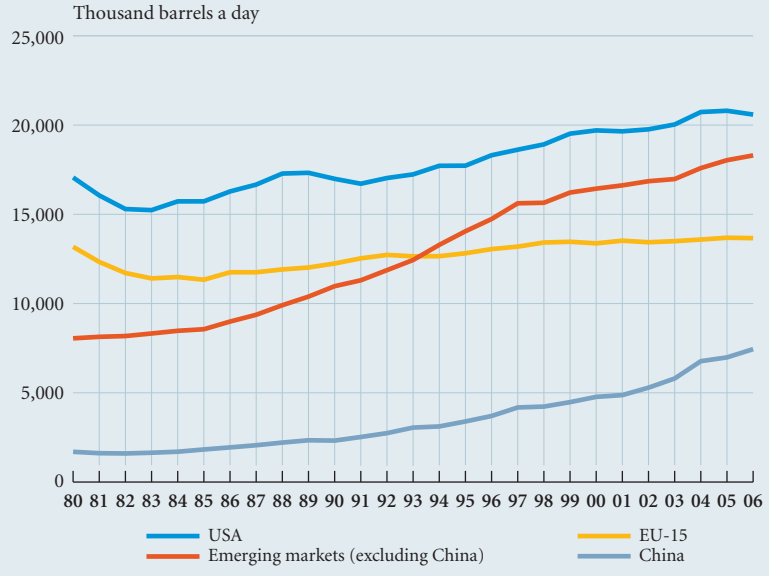
Since its reform process started in the early Eighties, China has grown at a spectacular rate until becoming one of the main engines of world growth. With an average annual growth close to 10% and a model of development based on industry, it is not surprising that its demand for oil and other fuels and for basic industrial inputs, such as metals, has not stopped growing.

The case of oil is illustrative. China has been responsible for more than 35% of the increase in world crude consumption since 2000. Nowadays, it is the second largest world consumer after the United States while 15 years ago it was the fifth and was even a net exporter of crude oil. Changes in this pattern are not expected over the long term. The International Energy Agency forecasts that shortly after 2010 China will become the world's biggest consumer of energy and that, together with India, these two countries will be responsible for 45% of the increase in energy demand up to 2030. Part of this increase in demand will be the result of sharp growth in the use of motor vehicles, which is still at very low levels in both China and India while experience suggests that it grows sharply when per capita income comes close to 10,000 dollars, a figure that both countries should reach over the medium term.

Economic growth is also changing consumption patterns in Chinese society. Millions of Chinese have emerged from poverty and, everyday, more and more of them acquire middle-class purchasing power, especially in the cities. This growing urban middle class is gradually changing its habits. With regard to diet, for example, rice consumption is losing weight to foods richer in protein, such as meat, eggs and milk products. Average meat consumption rose from 20 kilos per person per year in 1985 to more than 50 kilos in the 2000s. Even so, this figure is far from average consumption in economically advanced countries such as Spain where people consume more than 110 kilos per person per year. In turn, increased consumption of meat yields greater demand for cereals, thus putting upward pressure on crop prices. For example, to produce a kilo of pork, the most commonly eaten in China, requires 6 kilos of cereals.

GROWING WEIGHT OF EMERGING COUNTRIES AS OIL CONSUMERS

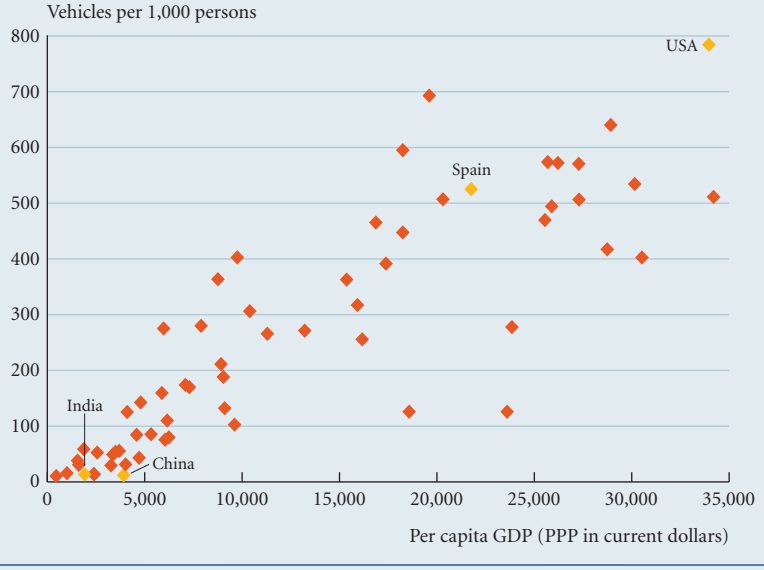
Oil consumption



SOURCE: British Petroleum and own calculations.

The idea that the insatiable demand of China –and to a lesser degree that of India and other emerging countries– is the main driver of the enormous surge in global commodity prices in recent years is gaining ground day by day (see following Graphs). Nevertheless, while being a determining factor, not all the price

LEVEL OF MOTOR VEHICLE USE STILL LOW IN CHINA AND INDIA



NOTES: Figures for 2000.
SOURCE: World Bank and own calculations.

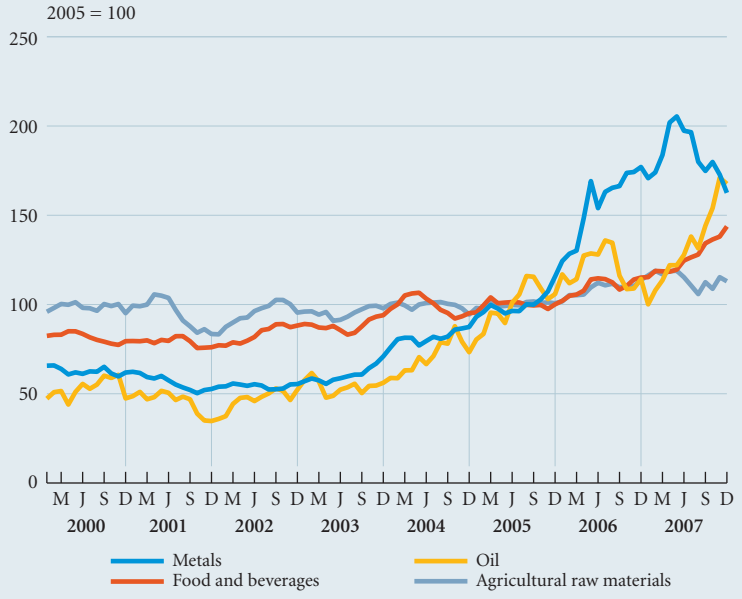
increases (and the spectacular rises in recent months less so) can be attributed to the take-off of emerging countries.

On the demand side, besides those countries' growing appetite, there has been in recent years a sharp increase in the use of cereals by the biofuels industry and this also contributed to the rise in prices (see Box «Biofuels: at what price?»). With regard to supply, various factors had a greater or lesser impact on the prices of various commodities, although, most likely, they were not as important as demand factors. These supply side factors refer mainly to the effect of instability in the Middle East on oil prices and droughts in major crop producer countries, such as Australia. Many have pointed to climate change as being responsible for the more extreme and unusual weather conditions affecting farm production.

There are those who believe that the changes in demand and supply observed in recent years (related to food habits in emerging countries, climate change and the boom of biofuels) are of a more permanent nature than other factors that may have brought about price increases in previous cycles. For this reason, they suggest that the upward trend in commodity prices may continue. Nevertheless, other analysts expect that, as in the past, supply will end up reacting to high prices and that this may satisfy the rise in demand, exerting downward pressure on prices. Finally, we cannot ignore the possibility that a speculative bubble lies behind the price rise of some commodities.

Whatever happens to prices we will learn it tomorrow but, as of today, it is quite clear that China is eating up the world, figuratively and literally.

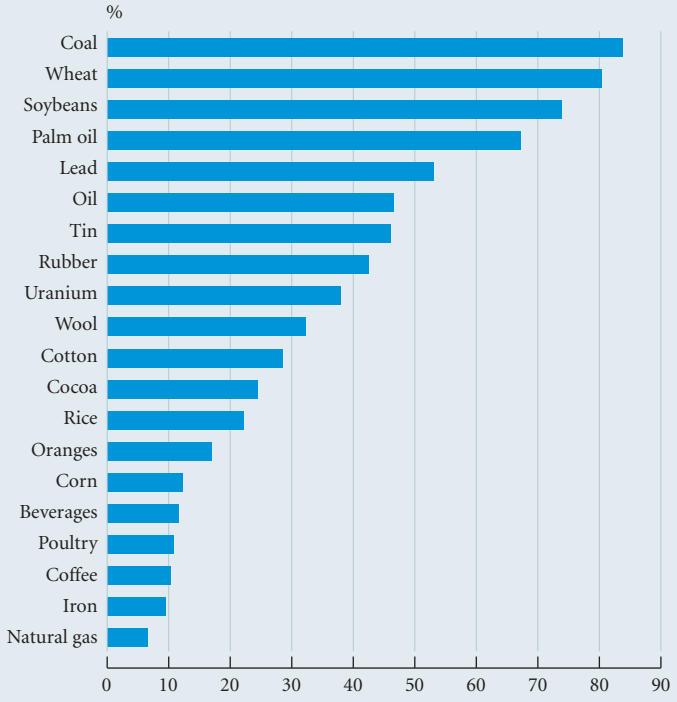
COMMODITY PRICE INDICES



NOTES: Monthly figures.
SOURCE: IMF and own calculations.

WORLD COMMODITY PRICES SURGE IN 2007

Price change in dollars between December 2006 and December 2007



SOURCE: IMF and own calculations.

Mexico: recovery continues with less inflation

Mexico's economy continued to move ahead with growth of 3.7% year-on-year in the third quarter. Private consumption confirmed its recovery with increases of 5.0% while private investment lost some drive but managed to maintain level with a rise of 6.0% year-on-year. The public sector continued to recover from the stagnation at the beginning of the year with a very small advance. Nevertheless, it is in the foreign sector where the main doubts lie given that, while exports sharpened their drive with a rise of 7.4%, these again went lower than imports which were up 9.8%.

Among the more recent indicators of economic activity, things also have improved in recent months. Industrial production slowed in November with weak growth of 0.8% year-on-year and looks like ending a year in which sluggishness has been the dominant note. Manufacturing was somewhat better with an increase of 2.2% while construction (reflecting the dominant situation of its neighbour to the North) rose by a modest 0.3%.

Inflation remains stable. Prices rose by 3.8% year-on-year in December and the core index (the general index less energy and food) rose by 4.0%. The increase in unit labour costs in the second quarter

Mexico grows by 3.7% while consumption and investment remain strong but foreign sector dropping.

TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-on-year change in real terms

SOURCE: Central Bank of Mexico and own calculations.

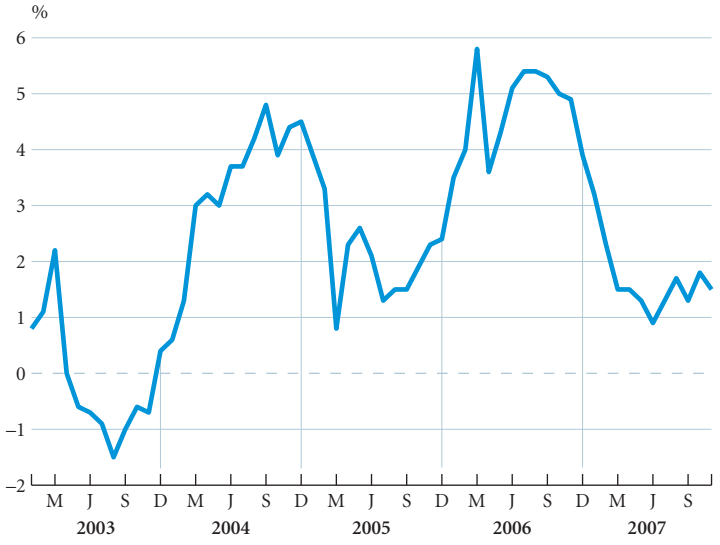
Industry remains weak but inflation goes below 4% and labour costs moderate.

was less than in the third quarter with an increase which dropped from 6.7% to 2.4% year-on-year which eases losses in competitiveness. In turn, the official unemployment rate dropped to a harmless 3.4% of the labour force.

The worsening of the trade balance took a breather but prospects continued to be downward. The cumulative trade deficit for the last 12 months ending in November was down slightly to 11.2 billion dollars. This was an improvement due to oil exports given that, without this precarious cushion, the trade deficit for that period hit 52.6 billion dollars, an increase of 15.6% year-on-year.

MEXICO: 2007 PROVES POOR YEAR FOR INDUSTRY

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



NOTES: (*) Series trend.
SOURCE: Central Bank of Mexico and own calculations.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	2.8	4.8	4.3	2.6	2.8	3.7	–	...	–
Industrial production	1.8	5.0	3.5	0.5	0.7	1.7	3.2	0.8	...
General unemployment rate (*)	3.6	3.6	3.7	4.0	3.4	3.9	3.9	3.5	3.4
Consumer prices	4.0	3.6	4.1	4.1	4.0	4.0	3.7	3.9	3.8
Trade balance (**)	–7.6	–6.1	–6.1	–9.4	–11.7	–11.8	–12.1	–11.2	...
3-month interbank interest rate	9.5	7.3	7.2	7.2	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	10.9	10.9

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

Gold takes off

Commodities underwent a major rise in the early weeks of the year. The Economist index, which synthesizes the world trend in commodities rose by 4.7% in January (in dollars). This upward background, however, hides an uneven trend in the various raw materials. The food group grew by 5.8% in the first month and metals were only slightly lower (increase of 3.5% year-on-year). The non-food farm products group were up less at 3.0%.

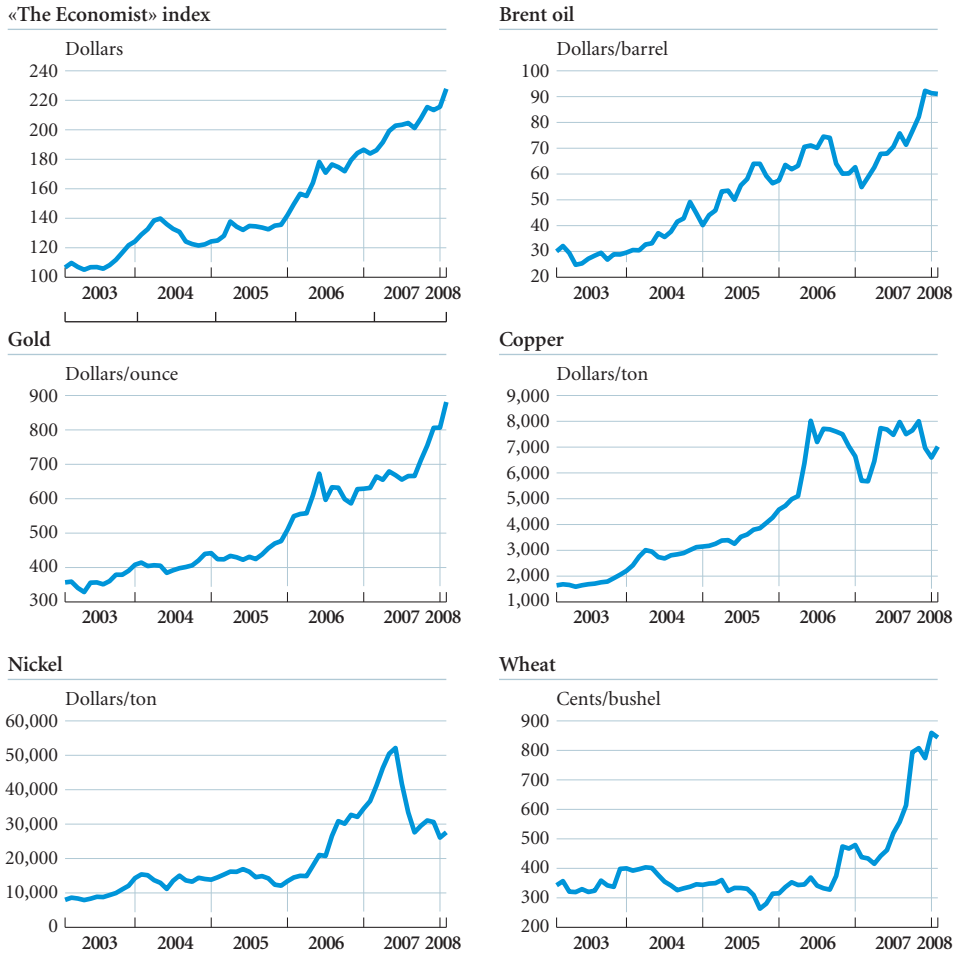
Foreign sector continues to worsen.

Upward trend in commodities, especially farm products and metals.

The reason for this upward movement involves various forces. The most fundamental in nature did not vary greatly. Heavy demand, both in the industrialized countries and the emerging economies, are face to face with a supply finding limited ability to sufficiently increase. On the other hand, the beginning of year was marked by sharp financial upsets which brought about major flows of funds into commodities. In this respect, we should distinguish between the early days of January, when there were notable increases in commodities, and something of a downward move in the final days of January.

In this respect, the trend in gold is of special significance because it synthesizes many of the above questions. The gold price in January was 41% higher than one year earlier. At different times during the month it seemed it would come close to the psychological level of 1,000 dollars an ounce, although the downward move in the second half of January moved away from that level.

TREND IN VARIOUS RAW MATERIALS



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

Behind this sharp increase lie factors of supply and demand. Among the former, the most helpful in explaining the rise in the gold price was that mining production is growing less than the world gross domestic product (GDP) which, together with lower than expected sales by the central banks and the drop in South Africa's reserves, suggest some restriction in supply.

But probably it is the trend in demand that provides the best explanation of the upward trend in gold. Sharp economic growth in the emerging countries (especially in India which represents 20% of world demand) comes on top of the role of gold as a refuge asset in situations of financial upsets or in the face of a weak dollar, two situations that have come about in recent weeks and which help explain the recent sharp upward swing in this key precious metal.

Gold maintains refuge role at time of financial upsets.

Finally, we should point out that oil has somewhat escaped from earlier trends. Following a rise at the beginning of January, that was not very different from that recorded for all commodities (a move that hit an all-time high of 98.25 dollars a barrel for Brent quality, one-month forward price) oil has settled into a downward path that put prices in the area of 90 dollars at month-end. The drop of more than 10 dollars in just a few sessions has been interpreted as the market's response to clearly downward demand forecasts, arising in turn from the perception that world economic growth could turn out to be lower that was forecast just a few weeks earlier.

Oil marks up all-time high and then drops sharply.

RAW MATERIALS PRICES

	2005	2006	2006	2007						2008
			4Q	1Q	2Q	3Q	October	November	December	January
«The Economist» index in dollars (*)										
General	**3.4**	**27.5**	**33.2**	**21.8**	**17.7**	**17.2**	**20.1**	**15.9**	**15.6**	**22.8**
Food	–1.8	10.8	20.2	16.5	18.9	30.9	35.6	30.6	37.9	44.6
Industrials	9.8	46.1	46.5	26.9	17.0	6.4	7.3	3.5	–3.8	2.9
Non-food agricultural	*–2.4*	*12.4*	*2.0*	*4.5*	*3.1*	*7.6*	*21.9*	*29.5*	*26.4*	*20.7*
Metals	*16.6*	*62.0*	*66.2*	*36.2*	*21.8*	*6.2*	*3.4*	*–3.4*	*–12.1*	*–2.7*
«The Economist» index in euros (*)	**3.3**	**26.0**	**22.7**	**11.6**	**9.8**	**8.6**	**6.7**	**1.7**	**4.8**	**9.1**
Oil (**)										
Dollars/barrel	55.3	66.4	61.0	58.7	68.7	74.5	82.2	92.3	91.3	91.8
Change rate	45.5	20.1	5.6	–6.7	–2.6	5.0	36.6	53.2	45.8	67.1
Gold										
Dollars/ounce	445.3	604.4	614.2	649.6	667.8	680.2	754.6	806.0	806.5	888.9
Change rate	8.7	35.7	26.4	17.2	6.4	9.4	28.7	28.4	28.2	40.8

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

EUROPEAN UNION

Euro Area economy loses drive in fourth quarter.

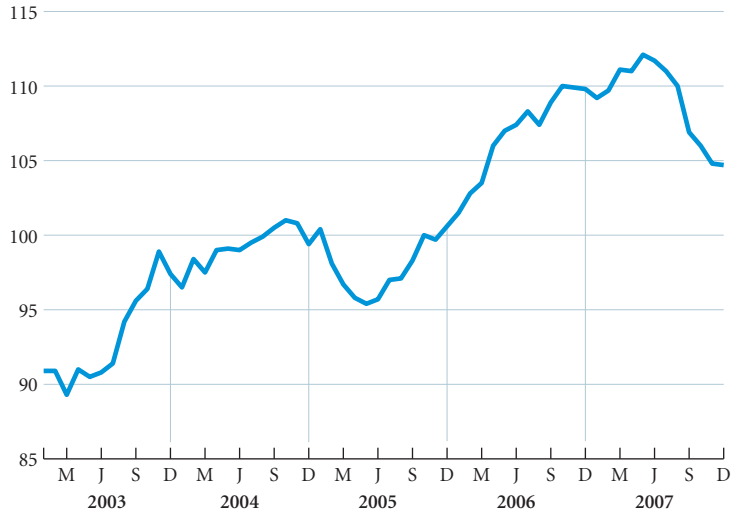
Euro Area: orderly correction

Is the change of year bringing with it a change of cycle? The upsets in the financial markets demand an even shaper analysis, if this were possible, of the so-called real economy. We shall look at three ideas. First, the Euro Area moved into a stage of lower growth in the fourth quarter, very likely far from the 2.7% year-on-year seen in the third quarter. Second, the high figures for inflation, far from the price control objective of the European Central Bank (ECB), will last for some time but will gradually ease. Third, the momentum of growth and the fundamentals of the European economy allow us to hope that, for the moment, the international financial and economic upsets may have a moderate impact in terms of economic activity. In any case, let us go over the factors underlying these suppositions case by case.

With regard to world economic performance in the fourth quarter, the sharpest analysis is to be found in the economic sentiment indicator. The trend in the final stages of 2007 supplies us with two conclusions. First, that economic activity did indeed drop during the final quarter, definitively leaving behind the high cycles that began at the end of last Spring. Second, that the rate of decrease, far from sharpening, was lower in November and December. In spite of this, there is nothing that would lead us to expect that the trend will not remain downward in coming months.

EURO AREA FACING SLOWDOWN

Level of economic sentiment index



SOURCE: European Union.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
GDP	1.6	2.9	3.2	3.2	2.5	2.7	–	...	–
Retail sales	1.2	2.1	2.3	1.7	1.1	1.3	0.5	–1.3	...
Consumer confidence (*)	–13.8	–9.0	–7.1	–5.2	–2.4	–3.7	–6.1	–8.0	–8.6
Industrial production	1.3	4.0	4.0	4.0	2.7	4.0	4.1	2.8	...
Economic sentiment indicator (*)	97.9	106.9	109.9	110.0	111.6	109.3	106.0	104.8	104.7
Unemployment rate (**)	8.8	8.3	7.9	7.6	7.5	7.3	7.2	7.2	...
Consumer prices	2.2	2.2	1.8	1.9	1.9	1.9	2.6	3.1	3.1
Trade balance (***)	42.1	–10.4	–13.1	–0.9	15.6	31.3	37.4	34.9	...
3-month Euribor interest rate (*)	2.2	3.1	3.6	3.8	4.1	4.5	4.8	4.6	4.8
Nominal effective euro exchange rate (*)	103.3	103.6	104.6	105.5	107.1	107.6	109.6	109.8	111.0

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

A review of the indicators, both of supply and demand, will complete this examination. On the supply side, we should point out that industrial activity, a good indicator given its sensitivity to cyclical swings, has shown less positive figures than those common in recent times, with industrial production growing at 2.8% year-on-year in November (1.3 percentage points less than in October) and industrial orders at their worst level since May 2006.

On the demand side, the drop in retail sales in November (1.3% year-on-year) and the collapse of consumer confidence suggest weakness in private consumption. In any case, the fact that the unemployment rate in November stood at 7.2% year-on-year, that is to say, a figure seven decimals lower than one year earlier, represents support for household spending.

Investment also appears to be moving into a lower growth stage. In the fourth quarter the level of utilization of industrial production capacity was down by two decimals compared with the previous quarter going to 84.2%. In addition, industrial production of capital goods in November was up 3.9% year-on-year, the worst figure since April 2006.

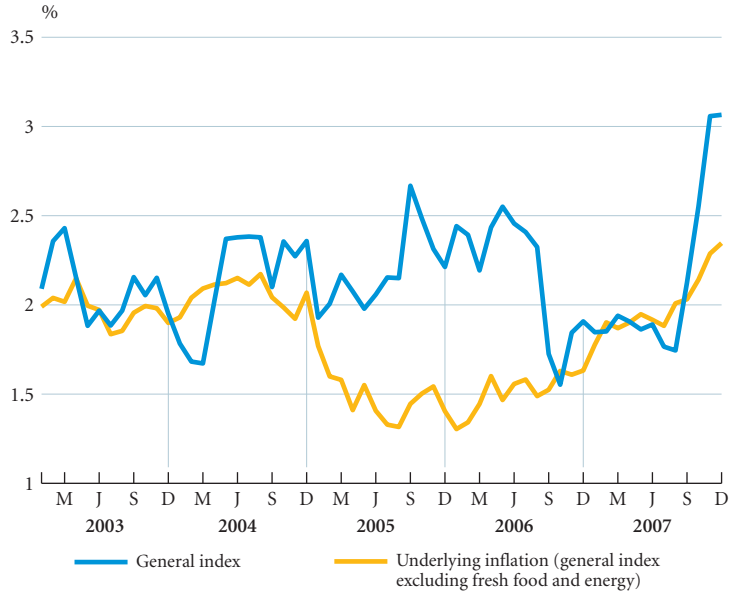
Private consumption remains weak and investment seems to be moving down.

Will the foreign sector be able to counteract this lower domestic drive? Less and less, it would seem. Following 14 months with the trade deficit tending to recover, this profile was broken in November. This was only a relative surprise seeing that the gradual slowdown in exports from September to November, combined with maintenance of the growth of imports, suggested such a result. In this process, it would seem quite clear that the cost of the appreciation of the euro, in terms of loss of competitiveness, played an leading role. It should be remembered that, measured by the effective nominal exchange rate, the value of the euro went up 4% in the fourth quarter.

Foreign sector driving economic activity but less so.

SHARP RISE IN INFLATION IN EURO AREA

Year-on-year change in CPI



SOURCE: Eurostat and own calculations.

Troubling growth of consumer prices, more than 3% in December, could open way to progressive slowdown.

The second question: what is happening to prices? In December, the harmonized consumer price index (HCPI) was again 3.1%, the same as in November. As well as being alarming in itself that this figure is significantly far from the 2% set as the ECB inflation objective, the make-up of the figure is disquieting given that, not only the more volatile segments are responsible for the increase. Underlying inflation, which excludes energy and unprocessed foods, has stuck at 2.3% year-on-year whereas only three months ago it was 2.0%. In any case, from this point on it is to be hoped that the process of price increases does not go much beyond this point. Forecasts of a slowdown in the industrialized economies open up the possibility of a drop in crude oil prices in coming quarters because of lower demand, which could alleviate pressure on the energy component of the harmonized CPI.

If international crisis gets no worse and does not affect Asia, Euro Area should continue moderately expansionist.

The final question: will the Euro Area be able to resist the worsening of the international economic situation? At this time, two different macroeconomic scenarios are shaping up. If the crisis ends up with an brief but sharp economic adjustment in the United States while Asia continues to exercise its role as world engine, the current momentum of the Euro Area could continue. That is to say, even though domestic demand may grow less and the contribution of the sector may drop, the economy will maintain sufficient strength to grow within the area of potential, that is to say, not far from 2%. On the other hand, if the crisis should weaken the Asian growth engine thus complicating an exit from the crisis for a couple of quarters, the Euro Area would have difficulty in escaping from a further stage of low growth.

Germany: 2007 was a good year and now what?

Germany continues to benefit from its best economic stage since the end of the Nineties. According to early figures from the Federal Statistics Office, in 2007 the German economy grew by 2.5%, slightly below the 2.9% in 2006. When adjusted for effective days worked, these figures turn into an increase in gross domestic product (GDP) of 2.6% in 2007 and 3.1% in 2006. In order to find various consecutive years with growth of 2% or more we have to go back to 1998-2000.

It should be remembered that one year ago there was real concern about the impact of an increase in value added tax and that the forecasts most analysts were putting out suggested growth would be a mere 1.5% in 2007. In the end, private consumption scarcely dropped in 2007 and this movement was more than compensated by the bigger drive from public consumption and the contribution of the foreign sector. Furthermore, the year end up with a budgetary balance and an increase of 1.7% in the number of jobs (net job creation was 650,000).

Recent indicators confirm that Germany's economic drive has remained strong until very recently. But they raise a qualification: there has been a downturn in recent months. Consumption indicators show a lack of drive in this domain. For example, retail sales were down by 3.1% in November and consumer confidence dropped in November and December. Penalized by the euro exchange rate, exports have begun to grow at a lower rate. Whereas six months ago in May foreign sales (as movable 12-month average) were growing by 13.3% year-on-year, in November they had slowed to 9.7% year-on-year.

Industrial production, following various months of strong growth, dropped by nearly three percentage points in November. After a surprising rise in November, the IFO industrial activity index dropped by 1.2 percentage points

In 2007, Germany grows much more than expected one year ago, balances its public accounts and creates employment.

Latest trends suggest gradual cooling down of economy in final stages of 2007.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
GDP	1.0	3.1	3.9	3.6	2.5	2.5	–	...	–
Retail sales	1.4	6.1	6.5	–1.0	–1.9	–1.8	0.2	–3.1	...
Industrial production	2.8	6.0	6.3	7.6	5.4	5.5	6.4	3.5	...
Industrial activity index (IFO) (*)	95.5	105.5	107.0	107.5	108.0	105.4	103.9	104.2	103.0
Unemployment rate (**)	11.7	10.8	10.1	9.4	9.2	8.9	8.7	8.6	8.4
Consumer prices	2.0	1.7	1.3	1.8	1.8	2.1	2.4	3.1	2.7
Trade balance (***)	156.3	151.6	155.3	165.1	177.4	190.5	195.0	196.0	...

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

Germany still benefitting from support of strong labour market.

in December picking up the course of decreases that began last June. We do not feel that the rise in January (0.4 points) will exclude further drops over the short term. Overall, this group of indicators confirms a recent trend to lower growth.

Nevertheless, to avoid an overly dramatic point of view, it should be remembered that some essential fundamentals of Germany's economy remain strong. The labour market particularly is showing a good situation so that this is becoming an important pillar of support. The unemployment rate dropped by two decimals in December going to 8.4%, a level 1.4 points lower than that recorded one year earlier. Employment figures for November confirm that for the third consecutive month the total number of those employed stood above 40 million.

In France, consumer confidence drops due to concern about sharp bite from inflation.

The prices front, which is a concern in Europe, also shows a less alarming aspect in the case of Germany. The German CPI grew by 2.7% year-on-year in December down four decimals from November. Only three of the twelve states using the single currency last year showed an easing of inflation in December. Furthermore, in spite of the fact that the German press has made much of the fact that the railway company has accepted an 11% wage revision for its drivers, Germany's containment on the wages front remains notable. Unit labour costs grew by a mere 0.2% year-on-year in the third quarter while hourly wages grew by a modest 1.3% year-on-year in October. It would thus seem unlikely that there is wage pressure enough to easily pass through to final prices.

Other indicators point only to gradual slowdown.

France: consumer confidence weakens but economy keeps going

Reform efforts in France have come up against an enemy that, because unexpected, may not be so tough after all. In the face of an attempt to give priority to moves of a structural nature, the immediate worsening of the situation has turned out to be the ordinary citizen's real concern. In the fourth quarter consumer confidence dropped by 5 points, largely because French consumers have taken a negative view of the current situation. Not so much of the future situation, on the other hand, which is showing less worse. This result cannot fail to be paradoxical given the fact that generally the future is expected to be worse than the current situation.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
GDP	1.7	2.2	2.1	2.0	1.4	2.2	–	...	–
Domestic consumption	3.2	2.7	2.8	3.6	2.8	4.2	3.0	2.4	4.0
Industrial production	0.3	0.9	0.6	1.0	0.3	2.3	4.2	2.5	...
Unemployment rate (*)	9.3	9.2	8.9	8.7	8.5	8.2	8.0	7.9	...
Consumer prices	1.7	1.7	1.3	1.2	1.2	1.3	2.0	2.4	2.6
Trade balance (**)	–15.7	–26.7	–28.3	–28.6	–30.4	–32.6	–35.2	–37.8	...

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

The press has reflected this concern paying special attention to the worse inflation and the loss of purchasing power this involves. This is not merely a rhethorical question. Households really are tightening their belts as shown by the fact that household consumption grew at a rate of 3.2% year-on-year in the fourth quarter, far from the 4.2% in the third quarter. This was a logical reaction given that inflation in December moved up to 2.6% year-on-year, whereas one year earlier in December 2006 the growth rate was only 1.5%.

But these bad figures, while relevant, are not the whole story. Some indicators are showing substantially better than expected results. Industrial production, to look no further, grew by 3.4% year-on-year as the average for October and November compared with 2.3% in the third quarter. Given that exports up to November continued to slow down, this rise in industry suggests that the domestic market is not in such bad shape as it might appear.

The economic sentiment indicator is pointing in the same direction and while it dropped in the fourth quarter this was a moderate downward shift of scarcely one point. This makes it possible to foresee that in the fourth quarter French growth will not be very far from the previous quarter when the economy moved ahead by 2.2% year-on-year. Furthermore, the drop in the unemployment rate will continue to ease the rigours of the slowdown for some time.

Later on, things may get worse but, at least in the matter of economic growth, the French economy seems ready to be able to avoid any great loss of strength and could drop only moderately below 2% in 2008. To do this, the road of pragmatic reform, international agreements and letting the balancing systems of the French welfare-state model operate (that is to say, continuing what seems to be the direction of the government up to now) may remain a well-devised combination in spite of the worsening of the immediate economic situation.

Forecasts suggest 2008 will be far from disastrous.

Italy: a crisis of confidence

The news that Italy's per capital GDP now stood below that of Spain in 2006, according to Eurostat figures, to paraphrase a recent European best-seller novel, has caused «astonishment and shudders» in Italian public opinion. While the figure by itself is a mere anecdote, the reaction it caused signifies the ill-feeling the economic situation is arousing in Italy. The country's economy reported its last strong growth in 2000 when it reached 3.8% while since then showing an erratic path not going above 2% annual in any year. The loss of international competitiveness reported since its entry in the euro has affected the traditionally strong industrial sector which in turn has led to a situation where the foreign sector has been in deficit since 2004. At the end of 2006 and beginnings of 2007 an incipient improvement was noted when growth for the average of the fourth and first quarters stood at 2.6%.

Italy's economic difficulties reduce confidence.

From then on, however, there has been a new change. Growth has dropped (in the second quarter it was 1.8% year-on-year and 1.9% in the third quarter). And inflation has risen (2.6% year-on-year in December, far from the 1.9% twelve months earlier). Private consumption has had difficulty in consolidating recovery and industrial production slipped back to the range of year-on-year

Recovery at end of 2006 and start of 2007 weakens in course of year.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
GDP	0.2	1.9	2.8	2.4	1.8	1.9	–	...	–
Retail sales	0.4	1.2	1.0	1.0	0.1	0.2	2.3	0.3	...
Industrial production	–0.8	2.6	3.7	1.2	0.7	0.7	–1.4	–2.8	...
Unemployment rate (*)	7.7	6.8	6.4	6.2	6.0	5.9	–	...	–
Consumer prices	1.9	2.1	1.8	1.7	1.6	1.6	2.1	2.4	2.6
Trade balance (**)	–5.1	–18.2	–22.0	–19.6	–16.0	–11.6	–9.0	–8.2	...

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

Bank of Italy puts out low growth scenario for 2008 and 2009.

drops in October and November. Exports too, which seemed to have found a stable growth path, again dropped in the 12 months ending in November. Taking all these indicators together, there is little doubt that the slowdown in the fourth quarter would have been substantial.

Nevertheless, the worse may still be to come. In its latest economic bulletin, the Bank of Italy presented its macroeconomic scenario for 2008 and 2009. From estimated growth of 1.7% in 2007, according to the central bank's forecasts, it will go rates of increase of the order of 1% in the next two years, as a result of an adverse international environment and also domestic difficulties. Specifically, the Bank of Italy expects that domestic demand will slow down in 2008 and 2009 due to low growth of consumption and investment and that the negative contribution of the foreign sector will not be corrected until 2009. Inflation, in turn, will show no let-up in 2008 given that on annual average it will maintain its current growth rate. In 2009, on the other hand, it is expected to return to levels of 2%. All this means little relief for the dejected Italian citizen who must now also deal with the fall of the Prodi government.

Sudden weakening of private consumption in United Kingdom troubling.

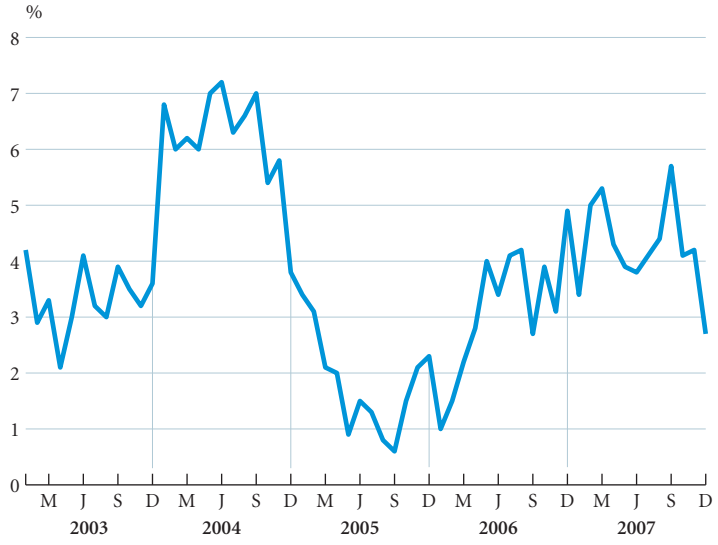
United Kingdom: consumers feeling hurt or even depressed?

Will the United Kingdom escape from major slowdown in growth? This will largely depend on whether consumption manages to avoid a collapse and resist the tightening of loan terms and a more negative general economic situation than has existed in recent years. For the moment, there is no sign of any rapid end to the process of adjustment in household spending. An example of this is to be found in one specific indicator and a statement. The indicator, retail sales, grew by a weak 2.7% year-on-year in December, its worst level since September 2006 and less than half the rate seen a mere three months before in September 2007. The statement, by Stuart Rose, executive director of Marks & Spencer, pointed out that balance for the past Christmas season was «...the worst I've seen in a decade».

Indicators pointing to the future, such as the prospects component of the consumer confidence index, clearly suggest that the process of containment of private consumption is not ended. Along the same lines come forecasts by various analysts that household consumption may not rise before the end

BRITISH CONSUMER SPENDING TIGHTENS

Year-on-year change in retail sales



SOURCE: Office for National Statistics.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
GDP	1.8	2.9	3.3	3.1	3.2	3.3	–	...	–
Retail sales	1.8	3.2	3.9	4.6	4.0	4.8	4.1	4.2	2.7
Industrial production	–2.0	0.1	0.9	–0.3	0.6	0.3	1.0	0.3	...
Unemployment rate (*)	2.7	2.9	2.9	2.8	2.7	2.6	2.5	2.5	2.5
Consumer prices	2.0	2.3	2.7	2.9	2.6	1.8	2.0	2.1	2.1
Trade balance (**)	–64.9	–74.0	–76.9	–77.8	–79.0	–81.6	–83.5	–84.2	...
3-month Libor interest rate (***)	4.9	4.6	5.1	5.3	5.6	6.0	6.3	6.3	6.6
Nominal effective pound exchange rate	99.6	98.0	102.7	103.9	104.0	104.3	102.2	102.9	101.2

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

of 2008. Other indicators, such as industrial production, which grew by a modest 0.3% year-to-year in November, and economic sentiment, support the idea that the economy's drive is on the wane. Practically the only relief comes in the positive situation in the labour market, with an unemployment rate stationary at 2.5% between October and December.

In this situation, will the Bank of England come to the rescue? There is no lack of urging. As well as the comments by Stuart Rose, Alistair Darling, Chancellor of the Exchequer,

Other indicators also support analysis of an economy fast losing strength.

Bank of England likely to cut interest rates but whether this will fully revive economy remains unclear.

has declared that in his view the central bank had sufficient margin for manoeuvre in monetary policy to lower its intervention rates. The problem faced by the Bank of England, however, is that it must hold inflation prospects firm. (While inflation stood at 2.1% year-on-year in December, forecasts suggest an upward thrust from these levels.) The central bank must also avoid weaking the pound sterling even more and try to salvage growth. According to most views, the balance of risks lies more in the latter factor but even so the United Kingdom may not be able to prevent an economic standstill. For the moment, according to early estimates, growth in the fourth quarter was 2.9% year-on-year as against 3.3% in the preceding quarter. The adjustment has thus already begun.

FINANCIAL MARKETS

Monetary and capital markets

Federal Reserve applies anti-crisis potion

In a drastic move on January 22 the Federal Reserve, the US central banking system, cut the reference rate by 0.75 points putting it at 3.50%. This decision was taken before the meeting of the monetary policy committee set for January 30 in a situation of fear of a sudden collapse of the stock markets. The amount of the cut was the highest in the past 23 years. The rapidity and sharpness of the move are significant and indicate the degree of perception of risk held by the central bank authorities.

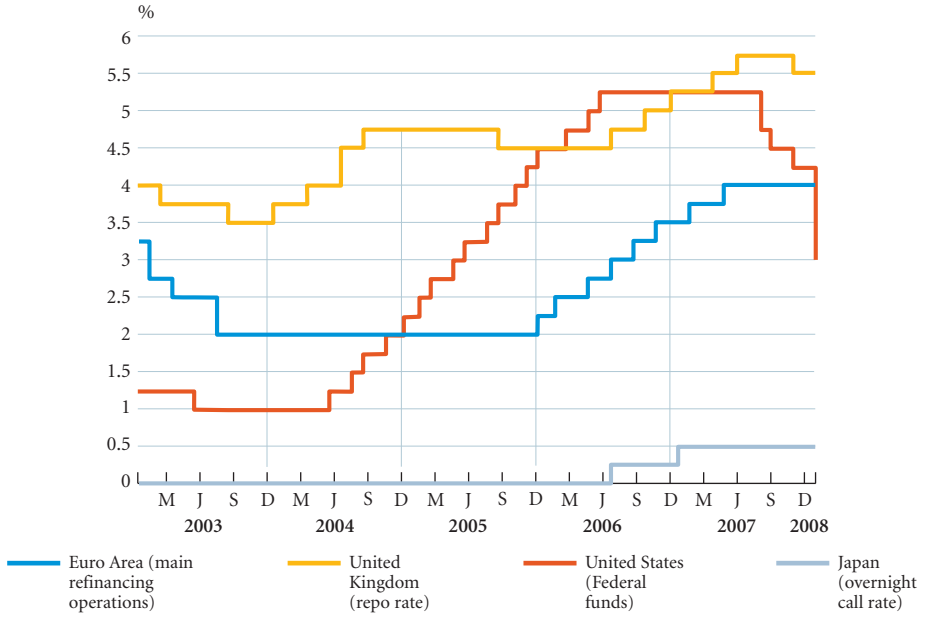
In a situation of economic slowdown and in view of the increase of downward risks in economic activity in the United States, the central bank authorities preferred to sharply surprise the markets in order to try to stabilize the situation. Furthermore, in the statement issued the Fed openly stated that it would continue to act decidedly in order to contain risks. In fact, on January 30, the monetary committee of the Federal Reserve decided to apply a further cut of 50 basis points in the reference rate.

In contrast, in an appearance before the European Parliament the day after

Federal Reserve continues to cut reference rate because of risk of recession in United States and drop on stock markets.

FEDERAL RESERVE CUTS REFERENCE RATE TO 3%

Central bank reference rates



SOURCE: Central banks.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB reference rate (2)	Euribor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2006									
December	3.50	3.73	4.03	5.25	5.36	0.57	5.00	5.32	2.09
2007									
January	3.50	3.78	4.10	5.25	5.36	0.53	5.25	5.59	2.18
February	3.50	3.85	4.06	5.25	5.35	0.71	5.25	5.53	2.19
March	3.75	3.92	4.18	5.25	5.35	0.67	5.25	5.62	2.27
April	3.75	4.02	4.30	5.25	5.36	0.67	5.25	5.73	2.32
May	3.75	4.12	4.46	5.25	5.36	0.69	5.50	5.81	2.42
June	4.00	4.18	4.53	5.25	5.36	0.76	5.50	6.00	2.67
July	4.00	4.26	4.54	5.25	5.36	0.78	5.75	6.04	2.63
August	4.00	4.74	4.78	5.25	5.62	0.97	5.75	6.69	2.86
September	4.00	4.79	4.73	4.75	5.23	1.03	5.75	6.30	2.82
October	4.00	4.60	4.60	4.50	4.89	0.90	5.75	6.28	2.68
November	4.00	4.81	4.69	4.50	5.13	0.99	5.75	6.61	2.62
December	4.00	4.68	4.75	4.25	4.70	0.90	5.50	5.99	2.63
2008									
January (1)	4.00	4.39	4.42	3.50	3.85	0.90	5.50	5.57	2.59

NOTES: (1) January 22.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 8-6-06 (2.75%), 3-8-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%), 8-3-07 (3.75%), 6-6-07 (4.00%).

(3) Latest dates showing change: 13-12-05 (4.25%), 31-1-06 (4.50%), 28-3-06 (4.75%), 10-5-06 (5.00%), 29-6-06 (5.25%), 18-09-07 (4.75%), 31-10-07 (4.50%), 11-12-07 (4.25%), 22-01-2008 (3.50%).

(4) Latest dates showing change: 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%), 6-12-07 (5.25%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

On other hand, European Central Bank maintains anti-inflation stand.

the first Fed cut in January, the governor of the European Central Bank (ECB), Jean-Claude Trichet, stated that at times of sharp upsets it was the responsibility of the central bank to maintain inflation prospects firmly under control in order to avoid increased volatility. He was joined in these statements by Axel Weber, member of the ECB governing council and chairman of the Bundesbank, who stated that, while the economic slowdown in the United States would certainly affect the rest of the world, its effects on the Euro Area could come later and that this time they could be gentler than in previous episodes. In all, the word from the ECB is it would maintain its policy of wait-and-see before making any decision on monetary policy.

The ECB statement is consistent with its monetary policy decision January 10 when it maintained the Euro Area official rate at 4%. While the monetary authority recognizes that expectations of economic growth have worsened and that risks for the economy are downward, it continues to maintain its central scenario in which growth this year will be close to

potential. While it recognizes that consumer prices will hold above 2% because of the thrust of energy and food prices in coming months, it believes that the dynamic of prices itself will remedy the situation by the end of the year so long as there is no pass-through from price increases to wages.

In the above table we note how finally the sum-total of injections of liquidity and interest rate cuts by some central banks has managed to reduce pressures in monetary markets. Normalization has been sharpest in those monetary areas where the biggest problems arose at the end of last year, that is to say, in United States and United Kingdom. Also in the Euro Area, the 3-month Euribor, which had reached 4.81% at the end of November, has dropped to 4.39%. For example, the 1-year Euribor, to which most mortgages in Spain are linked, broke with it upward course and while just a few months ago it seemed headed to 5%, now is running at 4.42%.

Nor are things good in Asia seeing that, at its meeting on January 22, the Bank of Japan maintained its reference rate at 0.5% and recognized that growth in the Japanese fiscal year ending on March 31 would be lower than potential growth of 1.5%-2.0% due to the drop in real estate investment. Governor Toshihiko Fukui stated that he was maintaining the basic policy of normalizing the official rate as the Japanese economy grew. Nevertheless, the central bank governor had to admit that the body's governing council faced a difficult situation due to uncertainty about the impact of the slowdown in the United States. The governor feels that the reason for raising the official rate gradually is to avoid any risk of over-investment that would make future growth over a long period unsustainable because of the creation of bubbles in all kinds of economic activity.

In turn, in its struggle against inflation, the Chinese central bank again raised the cash reserves of trading banks to 15% effective from January 25. This is the eleventh increase in the past 13 months. This measure, was joined by the regulator of China's financial system which announced it would make the terms for granting credits more restrictive in 2008 in order to counteract overheating of the economy.

Interbank market interest rates slowly becoming normal.

Long-term interest rates drop but credit restricted in Euro Area

Long-term interest rates on government bonds have dropped notably in the context of financial upsets. In spite of the fact that the ECB is maintaining its reference rate at 4%, the interest rate on 10-year government bonds in the Euro Area has fallen to 3.91%, that is to say, the interest rate curve is inverted. The most notable movement came in the United States where the 10-year bond has hit a price of 3.63%.

China decides to raise bank cash reserve to cool off economy.

There are two factors behind the drop in the government bond rate curves. First, the worsening prospects for growth in the United States and doubts about the impact of this slowdown on the rest of the world. This factor has led the market to discount rate cuts by central banks which has dragged the whole interest rate curve with it. The second factor is the flight to quality, that is, the selling of high-risk assets and the buying as refuge of risk-free assets, such as bonds issued by Euro Area governments and the United States. As the movement of bond prices and their return is inverse, massive buying has raised the price of government bonds thus pushing down the return offered by these assets.

Long-term interest rates on government bonds drop because of economic slowdown prospects.

The following graph shows the sharp shift of government bond curves in the

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2005	2006	2007			2008
			June	September	November	January 23
United States	4.39	4.70	5.02	4.59	4.02	3.63
Japan	3.31	1.69	1.88	1.69	1.51	1.36
Euro Area	1.48	3.95	4.57	4.33	4.33	3.91
United Kingdom	4.10	4.74	5.46	5.01	4.51	4.37
Switzerland	1.97	2.52	3.23	3.01	3.05	2.75

SOURCE: Bloomberg.

Flight to quality pushes interest rate curves down.

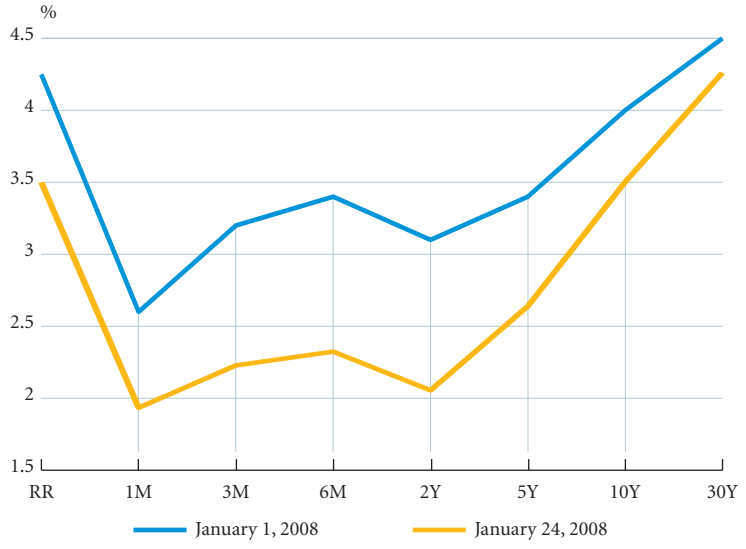
Euro Area and the United States since the beginning of this year. Whereas on January 1 an investor could acquire a 2-year bond issued by a Euro Area government offering a 4% return, on the other hand, buying the same bond now would offer only an annual return of 3.4%.

The drops have been sharpest in the short segments of the curves. In the case of the Euro Area, yields have been cut by around 60 basis points (100 basis points is 1%) while in the United States, in the 3-month to 2-year segments, the drops have been around 100 basis points. These movements came about in the first 24 days of the year, that is to say, movement has been rapid and very sharp.

It is always important to know the situation for granting loans, information

DROP IN INTEREST RATES

Interest rate curve for US government bonds



NOTES: RR = Central bank reference rate. M = Months, Y = Years.
SOURCE: Bloomberg and own calculations.

that takes on increased importance in a situation of financial upsets. From this point of view, it is useful to follow the survey carried out four times a year by the ECB about the situation on the granting of loans in the Euro Area. The ECB normally surveys 85 financial institutions and to make the inquiry significant it chooses the more important entities. The aim of the survey is to learn about financial terms and to complement statistics on the state of supply and demand for loans to companies and households in the Euro Area. Due to the financial upsets, the ECB decided to bring this survey forward and the results were made public on January 18.

The survey on the granting of loans reviews the fourth quarter of last year and prospects for the first quarter of this year. From the survey we may draw four conclusions. The first is that the tightening of granting loans to companies is being maintained and it is expected that this will intensify for large companies in the first quarter. Factors contributing to this tightening in order of importance are the worsening of prospects for the economic sector, increased cost of capital for banks and, to a lesser extent, reduced competition between banks to attract new customers in the business sector.

The second point to be drawn from the survey is that the banks also foresee a bigger drop in demand for credit by the big companies compared with small and medium-sized companies in the first quarter of 2008. The main reason is the expected reduction of moves involving mergers and acquisitions and due to the increase in uncertainty and the postponing of some plans for investment in fixed assets.

The third important factor is that expectations for the real estate sector have made financial institutions more careful in granting loans to households to finance home-buying. This hardening has been implemented through increasing differentials and other commissions in the process of granting a mortgage loan as well as demanding more collateral in order to authorize the transaction. Finally, there continues to be a sharp slowdown in demand for loans by households to finance home-purchase. While consumer credit for households is also slowing down, for the moment it is doing so less sharply than in the case of housing loans.

European banks confirm hardening of credit terms.

Widening differentials and demand for increased collateral are ways of tightening mortgage loans.

CONDITIONS FOR GRANTING LOANS AND DEMAND FOR BANK CREDIT IN EURO AREA

	SUPPLY				DEMAND			
	Companies		Households		Companies		Households	
	Large	Medium/small	Housing	Consumer	Large	Medium/small	Housing	Consumer
4th Qtr. 2007	Hardening	Hardening	Sharp hardening	Sharp hardening	Decrease	Decrease	Sharp decrease	Decrease
1st Qtr. 2008	Sharp hardening	Hardening	Hardening	Hardening	Sharp decrease	Decrease	Sharp decrease	Decrease

SOURCE: BCE and own calculations.

Foreign exchange markets reflect lower desire to take on risks

Sharp volatility in foreign exchange markets.

The widespread volatility in financial asset markets has also affected foreign currency markets. In the first week of the year the euro was priced at 1.472 dollars and went to an all-time high of 1.487 on January 14 only to weaken later on in a situation of high volatility. The accompanying table shows that the change in the euro against the dollar since the end of December last year was nil. This figure, however, hides sharp movements up and down.

Investors reduce portfolios in yen and dollars and take refuge in Swiss franc.

In general, it may be said that in January the dollar depreciated somewhat more than 5% against the Japanese yen and 3.5% against the Swiss franc.

Factors affecting these movements are the different positions held by economic agents with the Federal Reserve cutting interest rates, the ECB maintaining its anti-inflationary stance and investors nervous about the prospects for corporate profits and doubts about the US economy. In the face of this situation, investment portfolio managers decided to reduce risk, which resulted in an appreciation of the yen causing them to cut borrowing positions in yen. Furthermore, the weight of the dollar was reduced and refuge was taken in the Swiss franc which often acts as a reserve currency when financial upsets are on the increase. Nor was the British currency left out seeing that investors abandoned the pound sterling in view of the prospects of bigger interest rate cuts in the United Kingdom.

EXCHANGE RATES OF MAIN CURRENCES

January 23, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2006	Annual
Against US dollar				
Japanese yen	106.1	–7.7	–5.3	–14.6
Pound sterling	0.511	1.0	1.4	1.2
Swiss franc	1.095	–5.7	–3.5	–13.5
Canadian dollar	1.027	4.2	2.8	–14.9
Mexican peso	10.942	1.2	0.3	–0.1
Against euro				
US dollar	1.459	1.3	0.0	12.0
Japanese yen	154.8	–5.9	–5.0	–2.3
Swiss franc	1.597	–4.1	–3.4	–1.3
Pound sterling	0.745	2.4	1.4	13.4
Swedish krona	9.501	0.2	0.7	4.6
Danish krone	7.451	–0.1	–0.1	0.0
Polish zloty	3.628	0.5	0.7	–6.5
Czech crown	26.04	–1.8	–1.8	–7.3
Hungarian forint	258.0	1.6	1.9	1.4

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

Year begins with more drops in share values

Since the beginning of December last year the largest world stock exchanges have dropped between 14% and 20%. The only exception was the Nikkei index for the Japanese stock market which began its drop in mid-October last year and since then has accumulated a drop of 22%. But events in shares sharpened in January. On Monday, January 21, when markets in the United States were closed for the Martin Luther King holiday, the Asian and European stock markets reported major drops.

One of the factors setting off the crisis of confidence among investors on Monday, January 21 was the announcement on Friday, January 18 of cuts in the credit ratings of some major US credit insurance companies, the so-called monoline insurers. These companies insure bond issues carried out by other issuers that hold a rating lower than the AAA maximum. In case of default, the monoline insurer promises that the investor will receive all the money. In return, the issuer pays a premium.

The strategic importance of these companies lies in that they have insured issues for a value of billions of dollars. The losses that could take place in the US financial system could be of such an order of magnitude that they could cause a risk to the system. The cuts in the ratings of these insurers would have meant lowering the classification of bonds issued by an amount of 2,400 billion dollars, with the subsequent impact on prices, reorganization of portfolios and using up of bank capital for those issues that are included in the financial balance sheets of financial institutions.

Another factor weighing on the spirits of investors was doubt about the speed and efficiency of the start-up of the US

Fatal week in stock markets...

SHARP DROP ON STOCK EXCHANGES

Trend in stock exchanges with base 1-1-2007 = 100

SOURCE: Bloomberg and own calculations.

INDICES OF MAIN WORLD STOCK EXCHANGES

January 25, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,207.2*	*–9.9*	*–8.0*	*–2.3*
Standard & Poor's	*1,330.6*	*–11.1*	*–9.4*	*–6.6*
Nasdaq	*2,326.2*	*–14.3*	*–12.3*	*–4.4*
Tokyo	13,629.2	–12.4	–11.0	–21.9
London	5,869.0	–9.4	–9.1	–6.4
Euro Area	3,777.1	–13.9	–14.2	–9.5
Frankfurt	*6,816.7*	*–14.8*	*–15.5*	*1.5*
Paris	*4,878.1*	*–13.1*	*–13.1*	*–13.0*
Amsterdam	*438.7*	*–15.0*	*–14.9*	*–12.8*
Milan	*25,898.0*	*–11.0*	*–11.9*	*–20.6*
Madrid	*13,141.1*	*–14.1*	*–13.4*	*–9.6*
Zurich	7,686.9	–9.2	–9.4	–15.8
Hong Kong	25,122.4	–10.7	–9.7	21.5
Buenos Aires	1,982.7	–7.6	–7.9	–3.0
São Paulo	57,463.0	–8.9	–10.1	28.6

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.

...set off by drop in credit rating of monoline insurers, among other factors.

Treasury's fiscal plan because of the technical difficulty of having the key measures of a fiscal shock plan ready before the middle of the year. In addition, the drop on Monday, January 21 could be made worse by the transactions of Société Générale on ridding itself of fraudulent positions created by an operator in the futures market.

Action by Fed calms down markets but volatility on increase.

In any case, in view of the danger that the collapse could be repeated the next day in the US market, the Federal Reserve took the extraordinary decision to cut the official interest rate before the markets opened. The drop in the Fed's rates made a strong recovery possible on Tuesday but Wednesday saw significant drops of approximately 5% when the ECB stated it was not ready to lower its rates. Nevertheless, the stock markets recovered on Thursday and Friday going up around 8%.

The recovery seen at the end of the week (January 24 and 25) was largely due to the meeting held by insurance regulators in New York State with the main banks in order to draw up a rescue plan involving recapitalization of the monoline insurers in order to guarantee the stability of the financial system. Nevertheless, the market has still not established stable levels and volatility remains high.

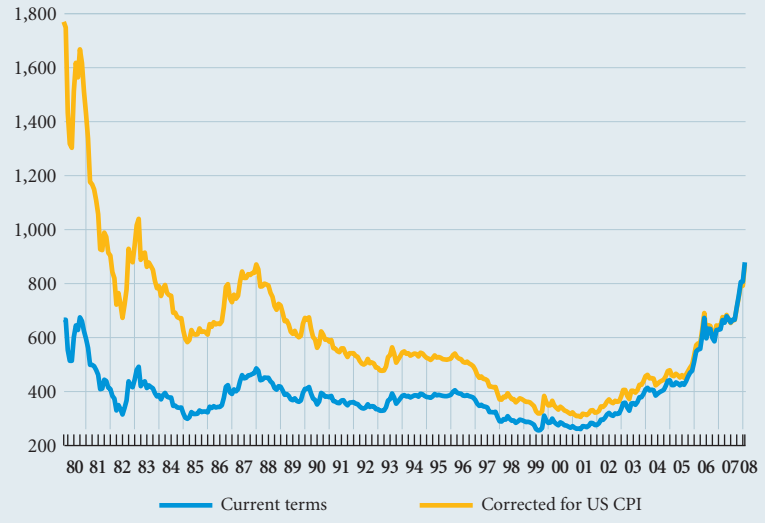
Gold hits 900 dollars: What's the reason?

The fascination for gold comes down from far-off times. In *The Metamorphosis*, Ovid tells how king Midas gained the favour of Dionysius, the god of wine, by giving Silenus refuge in his palace after one of his celebrated alcoholic excesses. Delighted, Dionysius granted him a wish and Midas chose the gift of being able to turn everything he touched into gold. Nevertheless, a banquet where he turned all the food into precious stones was enough for him to be sorry for his greed. In order to free himself of the gift, he had to wash his hands in the river Pactolus, an act that turned the river bottom into a great deposit of the precious metal.

The reserves of this river ran out some centuries ago but not interest in the golden metal. The alchemists, including Isaac Newton, consistently sought after the philosopher's stone that would allow them to convert base metal into gold but they failed in their attempt. If they had been successful, it is unlikely that gold would now be running close to 900 dollars an ounce troy (approximately 31 grams). In today's climate of economic uncertainty, this precious metal has again begun to shine and its price has risen by 40% compared with its value at the beginning of 2007, a return very few assets can boast about over this period.

PRICE OF GOLD AT HIGHS IN NOMINAL TERMS, BUT NOT IN REAL TERMS

Dollars per ounce troy as monthly averages



SOURCE: Datastream and own calculations.

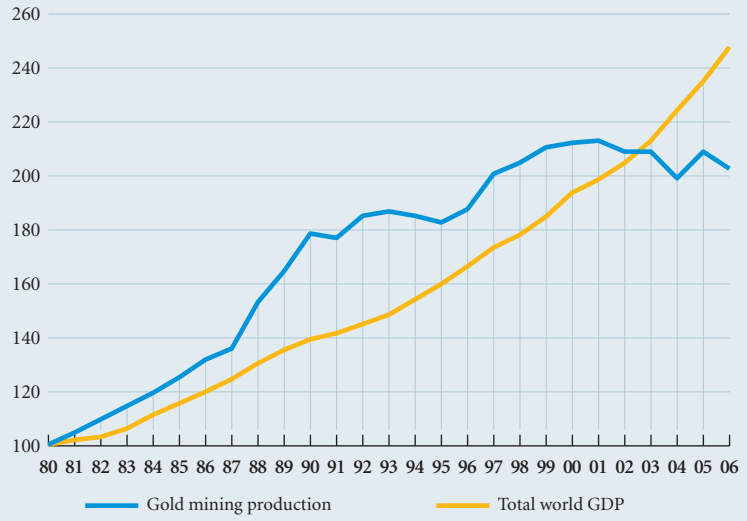
Over the very long term, however, gold has not been a good investment. In fact, it has taken more than 25 years for its price to go above the highs reached in 1980. Discounting the effect of inflation, the current level of prices still stands 50% below the maximum. This pattern of return is common to other commodities whose prices, in real terms, followed a downward course between 1980 and the end of the Nineties and increased only since then. Indeed the rise has been sharp, with gold prices going up 250% between 2000 and 2008.

The rise of gold in recent years has coincided with stagnation in supply. As shown in the following graph, world mining production has lost steam since around 2000. The main reason is the drop in production in South Africa due to the increase in mining costs and the fall in reserves. In 2007, for the first time in more than 100 years, this African country lost its position to China as the world's leading producer. Another factor on the supply side that seems to have affected prices is the lower than expected level of sales by central banks around the world. A few years ago the central banks had plans to reduce their gold holdings and replace them with government bonds, which are easier to store and furthermore pay an annual interest. In spite of these plans, some 30,000 tons of gold ingots continue to form part of central bank official reserves, only 3,400 tons less than in 2000 (see following Table). This volume of official sales was approximately equivalent to 15% of world demand, below the level of maximum sales the central banks agreed upon in 2004 in order to avoid a collapse in the price of gold.

The rise in demand has also contributed to the increase in prices. Three main factors have been behind this. In the first place, we have seen sharp economic growth in India and oil-producing countries of the Middle East, all countries with a strong tradition of buying jewels. Curiously, India is responsible for 20% of world demand for gold although its GDP, corrected for purchasing power, represents little more than 4% of world GDP,

GOLD SUPPLY STAGNANT

Indices 1980 = 100



SOURCE: World Gold Council and IMF.

according to latest estimates by the World Bank. Nevertheless, the latest news from India is that demand there has fallen sharply in recent months, which puts in doubt the sustainability of current price levels.[1] The second factor with a sharp impact on demand has been the creation as of 2003 of various listed funds (also known as

(1) *«India's families tap their gold reserves»*, Financial Times, January 17, 2008.

Exchange Traded Funds or ETF) which invest in gold. In 2006, ETF contributed more than 7% to world gold demand. Thirdly, gold has benefited in recent years, and especially in recent months, from its traditional role as a refuge asset during periods of weakness of the dollar and financial upsets. Historically, the price of gold tends to rise when the dollar depreciates and it is immune to drops on the stock market.

To sum up, the rise in the price of gold in recent years has largely been due to the lack of growth in supply and the sharp rise in demand for jewelry in the emerging countries. In recent months, however, gold has clearly benefited from the perception it holds as a refuge asset at a time of uncertainty. But what will happen when the storm abates? In that case, we cannot discard a considerable drop in the gold price. If this should happen, perhaps it would be good to remember that the best refuge asset, in fact, is a government bond indexed for inflation, the least risky asset we know of.

OFFICIAL GOLD HOLDINGS AND ETF HOLDINGS (*)

In tons

	2000	2007
United States	8,138	8,133
Germany	3,468	3,417
IMF	3,217	3,217
France	3,025	2,643
Italy	2,452	2,452
Switzerland	2,590	1,177
Japan	754	765
Netherlands	912	641
ECB	747	605
China	395	600
World official holdings	33,375	29,955
Holdings in ETF	0	866

NOTES: (*) Exchange Traded Funds.
SOURCE: World Gold Council.

SPAIN: OVERALL ANALYSIS

Economic activity

Spain stands in leading group of world economies

Spain holds ninth world place in size of economy measured at current exchange rates and eleventh place in purchasing power parity...

Recent years of economic globalization have been characterized by the rise of the emerging economies, some of which have moved into top spots in the world economy classified by size. What is Spain's position in this situation? The World Bank, in collaboration with other international bodies recently updated its classification which makes possible a homogeneous analysis. Using figures for 2005, Spain occupied ninth place in gross domestic product (GDP) at current exchange rates, only slightly behind Canada.

The best way to compare the size of different economies is by parity of purchasing power, that is to say, adjusting the GDP according to relative price levels. In fact, comparison of GDP using exchange rates normally undervalues the size of developing economies whose price levels tend to be much lower than those of the advanced countries.

From this point of view, Spain's economy held eleventh place in GDP by parity of

WORLD GDP (2005)

Billion US dollars

	In purchasing power parity (*)		At current exchange rates	
	Total	% world GDP	Total	% world GDP
1 United States	12,376	22.5	12,376	27.9
2 China	5,333	9.7	2,244	5.1
3 Japan	3,870	7.0	4,549	10.3
4 Germany	2,515	4.6	2,791	6.3
5 India	2,341	4.3	779	1.8
6 United Kingdom	1,902	3.5	2,244	5.1
7 France	1,862	3.4	2,136	4.8
8 Russia	1,698	3.1	763	1.7
9 Italy	1,627	3.0	1,770	4.0
10 Brazil	1,585	2.9	883	2.0
11 Spain	**1,184**	**2.2**	**1,130**	**2.6**
12 Mexico	1,175	2.1	768	1.7
13 Canada	1,133	2.1	1,135	2.6
14 South Korea	1,027	1.9	791	1.8
15 Australia	672	1.2	712	1.6

NOTES: (*) GDP adjussted for relative price levels.
SOURCE: World Bank and own calculations.

purchasing power in 2005. Three emerging giants, India, Russia and Brazil, with a much greater population moved ahead. On the other hand, using this measurement, Spain was ahead of Canada.

But how does this work out in terms of per capita GDP, a measurement that comes closer to the well-being of the citizen. In this case, Spain's position is not as favourable seeing that it occupies 25th place measured by parity of purchasing power. The top spots are held by relatively small countries such as Luxembourg, Qatar, Norway, Brunei and Kuwait and, as may be noted, most of these are oil-rich. Nevertheless, United States holds sixth place while Ireland comes in eighth spot.

Nevertheless, using latest Eurostat figures for 2006, Spain was ahead of Italy in per capita GDP by parity of purchasing power. According to World Bank figures for 2005, Spain had come closer to Italy thanks to the drive in its economy, reaching 27,270 dollars as against Italy's 27,750. As a result, in 2006 Spain held 12th place in GDP in parity of purchasing power in the European Union, being 5% above the average for the 27 member states.

...although it drops to number 25 in per capita GDP in purchasing power parity.

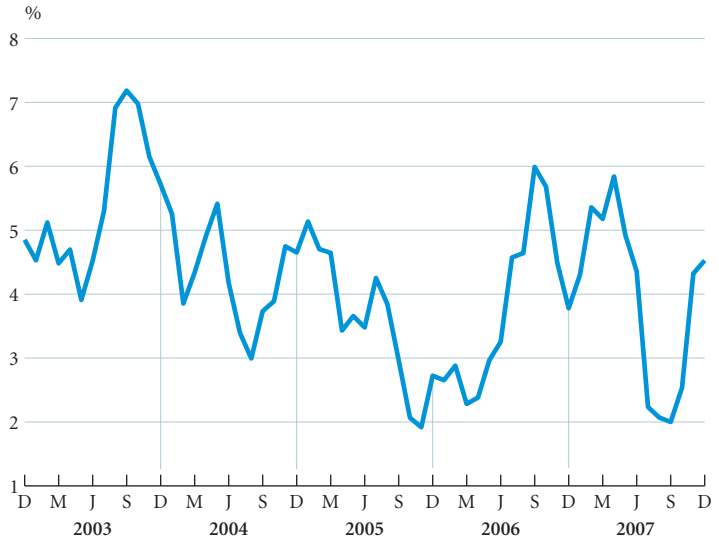
2007: a good balance but showing signs of a slowdown

At the end of 2007, the economy was showing a notably good level. Electricity consumption, for example, adjusted for number of working days and temperature, was up 4.5% in the fourth quarter compared with the same period the year before, as against a year-on-year rate of 3.8% in the final quarter of 2006. Nevertheless, we note trends to reduced economic drive. The main drops in this respect show up in construction, which has enjoyed a number of years of extraordinary expansion due to housing,

Construction and spending on consumer durables losing drive.

NOTABLE ECONOMIC DRIVE

Year-on-year change in electric power consumption (*)



NOTES: (*) Adjusted for effects of working days and temperature as 3-month moving average.
SOURCE: Red Eléctrica Española and own calculations.

Car sales down and drop in consumer confidence...

as well as in buying of consumer durables.

On the demand side, consumption is showing signs of a slowdown. For example, car sales are weak. In the fourth quarter of 2007 they were up 1.3% compared with the same period the year before, a half-point less than one year earlier. Furthermore, in December figures were affected by higher registrations of top-level models due to the fact that taxes on such vehicles were to be raised as of January. In any case, car sales in 2007 were down 1.2% compared with the year before, a little more than in 2006. On the other hand, helped by the appreciation of the euro, imports of consumer goods were strong with a year-on-year increase of 9.2% in October.

...but level of investment in capital goods holding high.

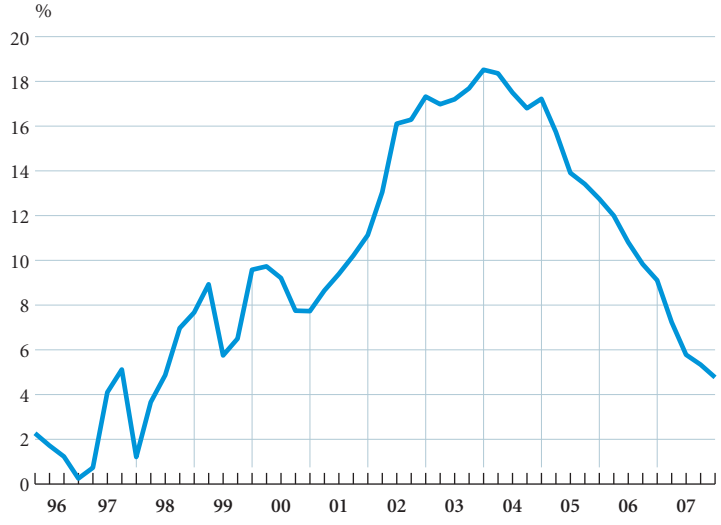
On the other hand, we note a progressive worsening of consumer confidence. The index published by the European Commission in December dropped to its lowest level since 1994, although it is still far from the record in 1992. No doubt, the rise in prices of fuels, food and the increase in interest rates in recent months has had an unfavourable impact. The crisis in the financial markets must also have had a negative effect.

On the other hand, investment in capital goods is holding at a high level. Registration of commercial vehicles in the fourth quarter, for example, rose by 5.2% compared with the same period in 2006 as against a drop in the fourth quarter of 2006. Construction investment continued to advance but at a substantially lower rate. Activity in public works was notably strong as a result of tenders accepted. Nevertheless, judging by an early indicator of construction investment, cement consumption, is it possible there will be a sharper slowdown in coming months.

Industrial growth has weakened to some extent, adversely affected by the strength of the single European currency and cost increases, both in labour and raw materials. In any case, car production

RISE IN HOUSING PRICES COMES CLOSE TO CPI

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



SOURCE: Ministry of Housing and own calculations.

in 2007 was up 5.6% thanks to exports, which compares favourably with the slight drop the year before. With regard to short-term prospects, the confidence indicator for the sector has worsened slightly in recent months but still is holding at a level above the historical average. Another early indicator, industrial orders received in October and November increased above the average for the first 11 months of the year, which provides some cause for optimism regarding this sector.

Passenger car production up 5.6% in 2007 thanks to exports.

Residential construction is undergoing a process of adjustment as a result of lower demand for housing. This shows up in a drop in the number of home sales compared with 2006. Housing prices have also reflected lower demand and have continued to ease to the point where they showed an annual increase of 4.8% in the final quarter of 2007, the lowest increase in the past 10 years and only a half-point above the inflation rate. This process of adjustment to lower demand is reflected in the sharp drop in the number of approvals for new housing construction although this was partly due to the effect of anticipating the coming into force of a new building code. In this context, the government has approved measures to foster home rental and aid the real estate sector.

In turn, services are showing more sustained growth. In the January-November period, the volume of business in the sector rose by 6.9% compared with the same months in 2006. The branches to show most strength were company services, such as research and security services, legal and economic advice, personnel selection and job placement and advertising. Information technology also was very dynamic, especially computer services. Distribution,

Sustained growth in services.

DEMAND INDICATORS

Percentage change over same period year before

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Consumption									
Production of consumer goods (*)	0.9	2.3	4.3	4.8	2.1	0.8	–0.1	–2.5	...
Imports of consumer goods (**)	7.9	8.9	7.6	–1.1	5.6	8.4	9.2	–1.3	...
Car registrations	2.1	–0.9	1.8	–0.7	–2.4	–2.9	3.4	–5.9	6.3
Credit for consumer durables	15.0	14.5	12.0	13.8	9.6	6.9	–	...	–
Consumer confidence index (***)	–10.8	–12.3	–10.3	–10.7	–12.7	–12.3	–16.0	–17.0	–19.0
Investment									
Capital goods production (*)	–0.1	8.4	11.2	8.9	5.3	6.3	8.5	–0.2	...
Imports of capital goods (**)	20.4	3.2	3.4	20.1	11.0	–0.6	6.8	–1.8	...
Commercial vehicle registrations	13.2	1.5	–1.0	1.7	–2.2	–3.0	4.1	–8.1	20.9
Foreign trade (**)									
Non-energy imports	6.0	9.0	9.3	6.4	7.7	7.6	8.3	–0.2	...
Exports	0.2	5.6	4.7	3.0	2.8	6.7	8.2	8.2	...

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.

2007 ends with signs of a slowdown.

especially wholesale trade, also showed a good level. Transportation also moved ahead notably, especially by air.

On the other hand, tourism showed lower drive. The balance for the season ended with a new record in the number of foreign tourists although growth was modest at 1.7% as against 4.1% the year before. Overnight hotel-stays were up 2.1% in 2007, substantially below the increase of 8.7% the year before. Foreign tourists were up more than Spanish tourists at 2.5% as against 1.6%.

To sum up, from the point of view of economic activity, the year-end will show a good growth figure, close to 3.8%, substantially above that for the Euro Area as a whole. Nevertheless, the more unfavourable foreign environment beginning to show up for 2008 will likely sharpen the present tendency to a slowdown.

SUPPLY INDICATORS

Percentage change over same period year before

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Industry									
Electricity consumption (1)	3.5	3.8	3.8	5.2	4.4	2.0	3.5	7.2	2.9
Industrial production index (2)	0.7	3.9	4.6	4.2	2.4	1.1	2.6	–0.6	...
Confidence indicator for industry (3)	–4.8	–2.7	–0.3	2.3	1.2	–0.7	–6.0	–1.0	–3.0
Utilization of production capacity (4)	80.2	80.5	81.6	80.6	81.3	82.1	–	81.1	–
Imports of non-energy intermediate goods (5)	1.6	10.5	12.1	8.1	8.2	8.7	8.3	0.9	...
Construction									
Cement consumption	7.3	8.5	8.6	5.5	–1.3	–1.4	5.2	–1.8	–9.4
Confidence indicator for construction (3)	22.4	14.2	15.0	10.7	15.7	12.0	8.0	–6.0	–6.0
Housing (new construction approvals)	6.2	18.6	0.2	8.0	–15.0	–50.7	–32.4	...	...
Government tendering	18.5	31.3	55.0	13.3	–2.2	–29.8	–33.5	...	...
Services									
Retail sales	4.4	5.2	5.2	6.2	4.5	3.7	6.6	4.4	...
Foreign tourists	6.6	4.1	1.9	5.3	0.1	1.4	0.0	5.0	0.7
Tourist revenue inflows	6.0	5.6	3.1	5.8	2.0	3.2	2.7	...	...
Goods carried by rail (ton-km)	–3.2	–1.2	–6.4	–4.1	–6.5	–1.4	–0.6	–9.3	...
Air passenger traffic	9.2	6.8	7.3	9.5	7.1	10.5	8.3	10.2	7.2
Motor vehicle diesel fuel consumption	5.1	5.4	4.9	5.8	3.3	4.2	9.4	...	...

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.

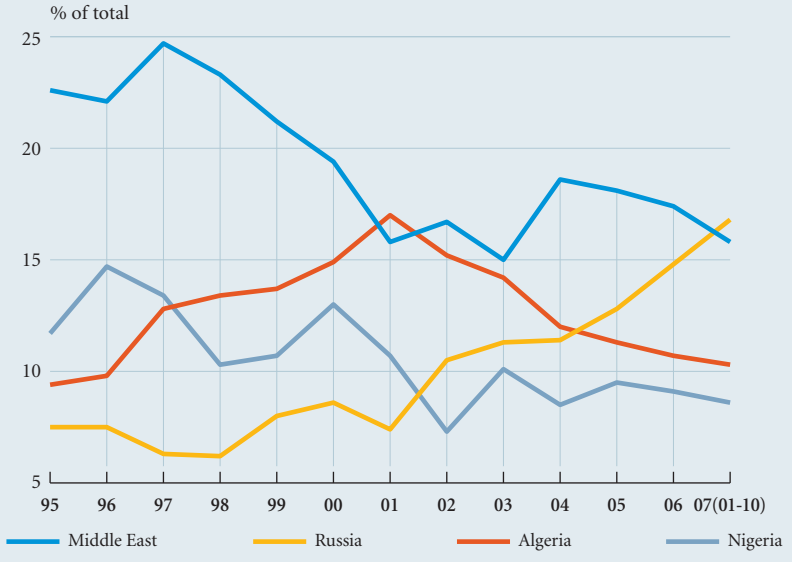
Spain's energy dependence

One of the factors behind the development of the Western economies in recent decades has been the easy and relatively cheap access to energy. The increase in consumption is an outward sign of this prosperity and one of its clearest exponents is the number of cars on the road. In 1980, there were somewhat less than 7 million cars whereas today this figure has more than tripled. But energy keeps becoming more expensive, environmental concerns arising from the use of certain fuels are growing and suppliers are often located in politically unsettled geographical areas, all of which brings about instability and uncertainty. Growing sensitivity about the effects of energy use has prompted many people to ask if energy will be able to keep exercising the same role in future decades as it has up to now. This box does not pretend to answer such a complex question but simply to show that in the case of Spain's economy, as is happening generally in the developed economies, the negative effects of energy use seem to be somewhat less important and that it is possible to improve energy efficiency.

Spain is a country that depends on imported energy. Most of what is consumed must be imported from far-off countries. In 2006, the degree of energy self-sufficiency failed to reach 20%, whereas in 1986 it came to 37%, according to figures supplied by the Ministry of Industry, Trade and Tourism. Logically, the importation of energy raw materials harms Spain's foreign trade balance that already is showing a deficit. The energy imbalance makes up a third of the total trade deficit that in the third quarter of 2007 was more than 9.4% of gross domestic product (GDP). If we look for the main culprits, the leading role is reserved for oil which, whether because of consumer demand or price increases, alone represents a quarter of the total trade deficit.

INCREASING GEOGRAPHICAL DIVERSIFICATION

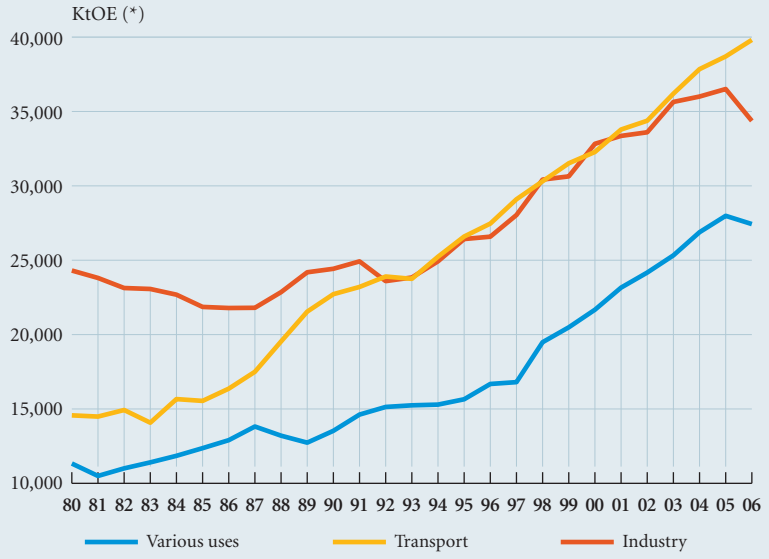
Origin of Spain's energy imports



SOURCE: Bank of Spain, INE and own calculations.

INDUSTRY HELPING TO MODERATE ENERGY CONSUMPTION

Final energy consumption by sector



NOTES: (*) KtOE = thousand tonne oil equivalent.
SOURCE: Ministry of Industry, Trade and Tourism.

Spain starts out clearly at a disadvantage but this could improve somewhat or even considerably. To begin with, the supposed geo-strategic weakness brought about by dependence on abroad is not really so great given that the diversity of supplier countries has increased. In 1995, according to the Ministry of Industry, Trade and Tourism, imported oil coming from Saudi Arabia, Iran, Libya and Nigeria was more than half the monetary value of total oil imports, whereas in the first ten months of 2007 it barely went above a quarter. In the same period, that part of energy imports coming from the Middle East dropped from 22.6% to 15.8% of the total. In addition, the share represented by gas from Algeria in 2001 reached a relative high of 17.0% of total energy imports only to drop to 10.3% in 2007. The increase in the segment involving Russian oil (from 7.5% to 16.8%), in terms of diversification, avoided more risks than it provided.

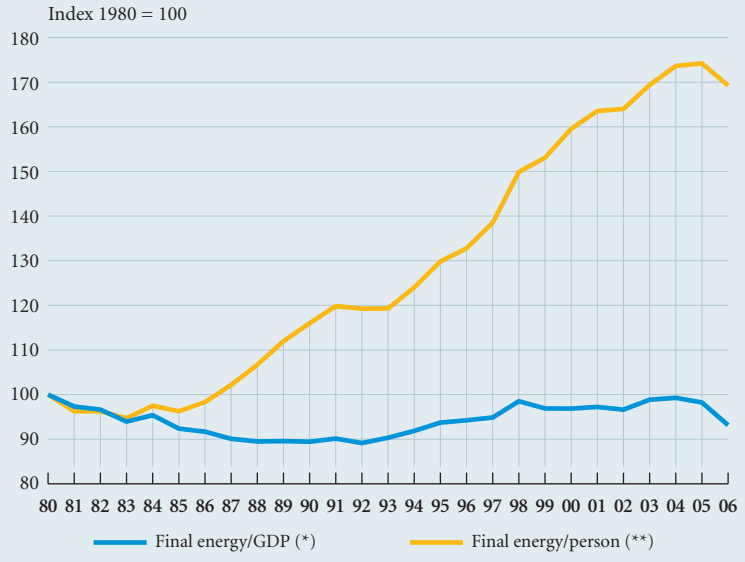
Another problem area is the rise in prices of hydrocarbons which has a direct effect on inflation. In five years, «black gold» has increased its price in dollars by four. Its effect on inflation is evident. Nevertheless, the beast is somewhat less fierce than it may seem. The effect of energy prices on consumer price indices that exclude energy is less than in previous periods. According to Blanchard and Galí,[1] the causes lie in the lower weight of oil consumption in the economy, in less rigidity in wages and in the monetary policies of those central banks that are more committed to controlling inflation.

Under the heading of the trade balance things do not look so good but we should not exaggerate. In spite of the drastic increase in energy prices in the past five years, the energy deficit has scarcely increased its share

(1) Blanchard, O. and J. Galí (2007) «The Macroeconomic Effects of Oil Price Shocks: Why are the 2000s so different from the 1970s?» Working Paper n. 07-21, MIT Department of Economics.

IS SPAIN BECOMING MORE EFFICIENT IN ENERGY USE?

Final energy intensity



NOTES: (*) Tonne oil equivalent per million constant euros of gross domestic product.
(**) Tonne oil equivalent per person.
SOURCE: Ministry of Industry, Trade and Tourism.

of the total deficit. In spite of the increased number of drivers and cars, the fact is that the last rise in oil prices was borne better than that in 1999-2000. Between the end of 2003 and the end of 2006, black gold rose by 105%. In spite of this, whereas at the end of 2000 total energy imports represented 3.8% of GDP, in 2007 their relative importance had barely increased to 4.0%.

Finally, we may ask if Spain is making proper use of the energy it consumes. The starting point is regular with an economy that, for every euro of GDP, it spends along the same lines as its European partners but with the difference that up until 2005 this figure was moving upward. There is also the matter of fuel consumption for transport to be dealt with. In this sphere, according to figures from the International Energy Agency, consumption per unit of GDP in 2005 was 28.7% higher than the average for the European countries in the Organization for Economic Cooperation and Development, a difference that was moving up. On the other hand, industry, that often seems like the main culprit of energy waste, has substantially moderated its contribution to total final energy consumption.

Since 2005, we note some moderation in energy intensity, that is to say, in final energy consumption per unit of GDP. There is still no conclusive evidence that there has been a structural change in this direction of if this is a shift in the economy toward sectors that are less energy intensive. A continuation of this process will depend on being able to consolidate the savings in oil and on whether there is a continuation of the downward trend in other energy sources that began in 2005. The hunger for energy is high and growing, especially when we look at the growth of consumption per person. Some progress has been made in saving energy but there still remains a long road ahead.

Labour market

Job creation down in 2007

Year-end record in total number of persons registered with Social Security.

Foreign workers now make up more than 10% of all registrations.

Registration of females hits high share of 42%.

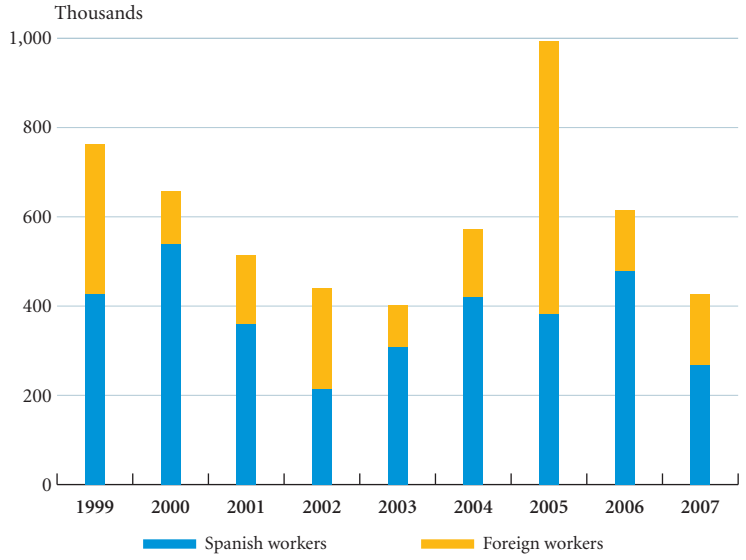
Those persons registered with Social Security at the end of 2007 came to a total of 19,195,755, the highest figure ever recorded at any year-end. This figure meant a year-on-year increase of 2.3%, a rate 1.1 points lower than that reported in 2006. This drop in job creation is in line with the change in the economic cycle that took place in 2007. If we examine the trend in the total number of those registered with Social Security we note that in the first half of 2007 there was a continuation of the drop in the employment growth rate while in the second half-year this stabilized at a rate slightly above 2%.

The increase in registrations during the year amounted to 425,496 persons, the lowest in absolute terms since 2003. Of this number, 268,364 were Spaniards, some 63.1% of the total. Foreign worker registrations were up 8.6% as against 8.0% reported at the end of 2006. As a result, the share of the total held by foreign workers continued to increase going to 10.3% in December.

Women continued to move ahead in the labour market. Females registered were up 3.9%, three times the increase rate for males (1.1%). Their share thus marked up a new record of 42.35% as against 36.1% some 10 years ago.

MORE THAN 400,000 NEW REGISTRATIONS WITH SOCIAL SECURITY IN 2007

Annual increase in number of persons registered as working



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

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Persons registered with Social Security									
Sector									
Industry	*–0.5*	*0.0*	*0.2*	*2.2*	*2.7*	*2.5*	*2.6*	*2.4*	*2.3*
Construction	*8.6*	*8.7*	*6.8*	*6.1*	*4.4*	*2.3*	*1.4*	*0.5*	*–0.6*
Services	*5.7*	*5.2*	*4.0*	*4.1*	*3.7*	*3.0*	*2.9*	*3.0*	*3.1*
Job situation									
Wage-earners	*4.8*	*4.7*	*3.5*	*3.9*	*3.5*	*2.6*	*2.4*	*2.2*	*2.1*
Non-wage-earners	*2.6*	*2.2*	*2.2*	*2.5*	*2.7*	*2.9*	*3.0*	*3.0*	*2.9*
Total	**4.4**	**4.3**	**3.3**	**3.6**	**3.3**	**2.7**	**2.5**	**2.3**	**2.3**
Persons employed (*)	**5.6**	**4.1**	**3.6**	**3.4**	**3.4**	**3.1**	**–**	**–**	**–**
Jobs (**)	**3.2**	**3.2**	**3.1**	**3.3**	**3.2**	**3.0**	**–**	**–**	**–**
Hiring contracts registered (***)									
Permanent	8.7	41.1	76.8	25.8	15.6	–1.6	–2.7	–18.1	–42.8
Temporary	4.6	4.7	0.5	2.6	–1.9	–0.5	6.3	–1.9	–2.1
Total	**5.0**	**7.9**	**7.3**	**5.3**	**–0.1**	**–0.7**	**5.1**	**–4.1**	**–9.0**

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.

The sector creating most employment was services which made up 92.7% of net new registrations. The total number of those registered in services moved up by 3.1%. Nearly half of all new registrations involved social services (203,364 persons), an increase of 19.3%. Other branches to show notable increases were education, hotel and restaurant trade, transport and company services (which include temporary employment companies).

Industry also showed a considerable increase in employment at 2.3%. The most dynamic manufacturing branches in this respect were food, machinery and equipment, motor vehicles, transportation equipment and medical/surgery goods. The private sector continued to drop in number of those registered with Social Security going down 1.3%, although this was less than in 2006 when it was down by 2.8%.

Construction was another matter and, after reporting sharp growth in employment all decade, showed a drop in registrations with Social Security of 0.6% in 2007. In fact, the drop in the general scheme was 3.5% but this was partly compensated by a rise of 7.0% in self-employed persons in the sector. This also reflects the slowdown in construction.

The sustained increase in registrations with Social Security made it possible to boost revenues from contributions by 6.9% in the first 11 months of the year compared with the same period the year before. Up to November, cumulative revenues rose by 8.4% compared with a rise of 7.1% in spending. As a result, at

Services account for 93% of new jobs and nearly half represented by social services.

Loss of registrations in construction following years of sharp growth.

the end of that month Social Security showed a cumulative surplus of 18.60 billion euros. Nevertheless, this positive balance was down in December because of the payment resulting from the inflation adjustment in pensions and the extra pay going to public servants.

On the other hand, growth of employment in 2007 was very uneven in the autonomous communities, ranging from 5.6% annual in Castile-La Mancha to 0.9% in the Canary Islands. Well above the average came Aragon, Extremadura and Navarre. Right at the end of the line were Valencian Community, Murcia and Andalusia.

Increase in registered unemployment

Decrease in registered unemployment among young women.

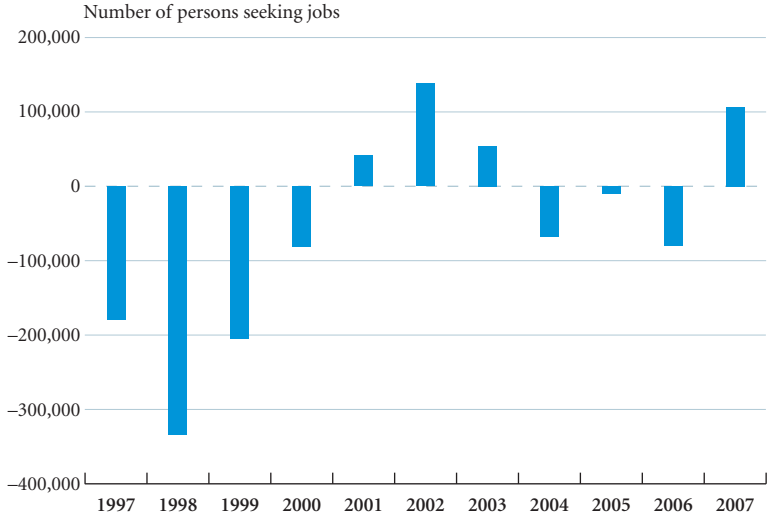
The number of unemployed registered at government employment services was up by 106,674 in 2007 so that last year ended with a figure of 2,129,547. This figure meant an annual increase of 5.3%, the highest in the past five years. As a result, the past year saw a break in the downward trend in registered unemployment enjoyed in recent years. In fact, if we look at the trend, we note an increase in registered unemployment over the last months.

The increase in registered unemployment in 2007 was largely attributable to the slowdown in job creation in services and the loss of employment in construction. As a result, the number of registered unemployed in services rose by 59,381 with 47,096 in construction. Nevertheless, in relative terms, the increase in unemployment was higher in construction at 19.9% as against 4.9% in services. Unemployment was also up notably in agriculture at 11.9%. In industry, on the other hand, there was a modest drop of 0.8% in unemployment. The reduction in unemployment of those seeking their first job was greater at 2.3%.

In line with the current trend in employment, the number of males

REGISTERED UNEMPLOYMENT MOVES UP AGAIN

Annual change in registered unemployment



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

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

December 2007

	No. of unemployed	Change over December 2006		% share
		Absolute	%	
By sector				
Agriculture	68,812	7,318	11.9	3.2
Industry	279,981	–2,167	–0.8	13.1
Construction	283,867	47,096	19.9	13.3
Services	1,284,250	59,381	4.8	60.3
First job	212,637	–4,954	–2.3	10.0
By sex				
Males	885,139	80,865	10.1	41.6
Females	1,244,408	25,809	2.1	58.4
By age				
Under 25 years	240,383	–1,629	–0.7	11.3
All other ages	1,889,164	108,303	6.1	88.7
TOTAL	**2,129,547**	**106,674**	**5.3**	**100.0**

SOURCE: INEM and own calculations.

registered as unemployed was up much more than that for females, showing 10.1% as against 2.1%. By age, unemployment was up by 6.1% among those over 25 while it was down for younger people. Young women unemployed showed a drop of 6.3%.

By nationality, we note that foreign workers showed a higher number of registered unemployed at 24.6%. Notable among this group was the increase of 53.5% in unemployment in construction. On the other hand, those in this situation but seeking their first job showed a drop of 1.4%.

In the autonomous communities, the trend in unemployment was very uneven. In Murcia, Canary Islands and Valencian Community there were two-digit annual increases. At the other end of the scale stood Galicia, Asturias and the Basque Country. These northern communities reported decreases in the number of registered unemployed.

In addition, the government employment service estimates how employable are those persons registered. According to these estimates, at the end of 2007 some 36.1% of registered unemployed had an average employability level, those with low employability level made up 30.6%, some 17.2% held a high level while 16.1% stood at a very low level. This degree of employability tends to drop with age. Among those over 45, only 9.4% had a high level of employability.

Slight increase in hiring contracts in 2007.

In addition, total hiring contracts in 2007 rose to 18,622,108, an all-time record. This figure represents an increase of 0.5% compared with the year before. Of the total, 2,220,384 were hired under permanent contracts, this also being an all-time record, with a rise of 1.9% compared with 2006.

Prices

Inflation goes above 4%

2007 CPI goes up 1.6 points more than in 2006.

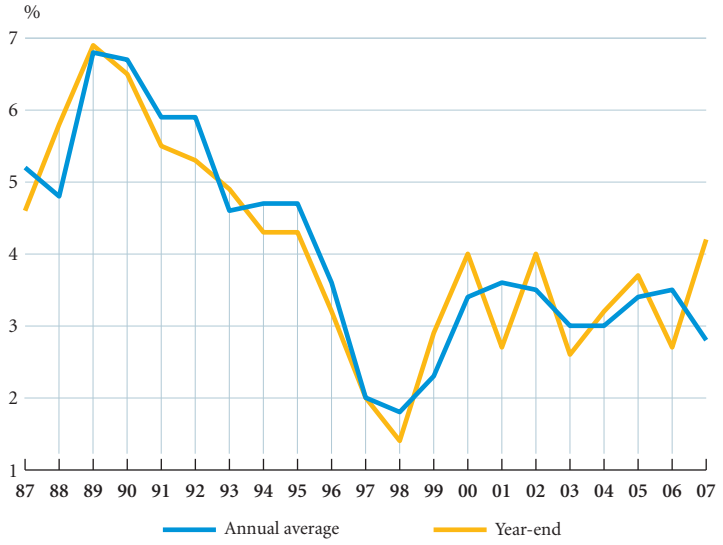
The balance for inflation in 2007 was not favourable due to the sharp rise in prices as of the summer. The annual change rate in the consumer price index (CPI) rose to 4.2% in December, 1.6 points more than in 2006 marking up the highest year-end figure since 1995. The cause mainly lay in the increase in prices for oil and food in international raw materials markets. Nevertheless, the average annual change in the CPI turned out to be 2.8%, the lowest rate in the past eight years. This difference was due to the peculiar profile of the year-on-year CPI rate over the course of the year which up to August was running between 2% and 2.5% only to climb to the rate mentioned above in the final months of the year.

Figure for December strikes much more inflationary note than 2007 as whole turned out.

The discrepancy between the annual average and the December rate is of some importance. The December rate is used for indexing economic figures as significant as Social Security pensions (in this case the November rate is used), wages, rentals and other private contracts so that it has a direct effect on public spending, labour costs for companies and payments for many individuals. On the other hand, the annual average rate more accurately shows inflation for the whole period of the year, although despite this it is not used as the reference figure. As a result, in this case the December figure would give a much more inflationary note than 2007 was in reality. The difference between one and the other rate came to 1.4 percentage points, the biggest

MONTHLY CPI FOR DECEMBER MOVES AWAY FROM ANNUAL AVERAGE

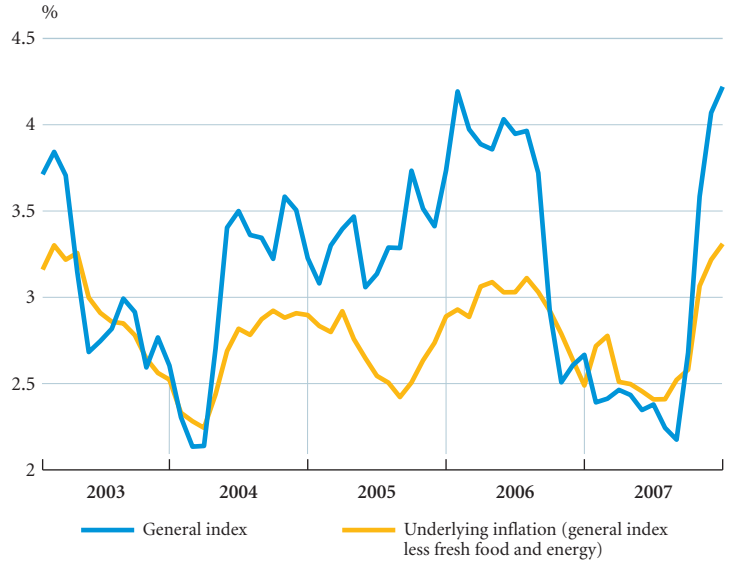
Annual change in CPI



SOURCE: National Institute of Statistics and own calculations.

SHARP RISE IN INFLATION IN FINAL MONTHS OF 2007

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

divergence since 1984 when the annual average was 11.3% and the December rate stood at 9.0%. In any case, we should point out that the difference between one rate and the other tends to be compensated over time.

Fuels played a decisive role in the December result contributing nearly half of the monthly increase. The price of petrol and diesel-fuel continued to rise at service stations reflecting the rise in oil prices in world markets which again

Sharp increases in milk, bread and chicken while oil and potatoes down.

CONSUMER PRICE INDEX

	2006			2007		
	% monthly change	% change over December 2005	% annual change	% monthly change	% change over December 2006	% annual change
January	–0.4	–0.4	4.2	–0.7	–0.7	2.4
February	0.0	–0.4	4.0	0.1	–0.6	2.4
March	0.7	0.3	3.9	0.8	0.1	2.5
April	1.4	1.8	3.9	1.4	1.5	2.4
May	0.4	2.1	4.0	0.3	1.8	2.3
June	0.2	2.3	3.9	0.2	2.0	2.4
July	–0.6	1.7	4.0	–0.7	1.3	2.2
August	0.2	1.9	3.7	0.1	1.4	2.2
September	–0.2	1.7	2.9	0.3	1.7	2.7
October	0.4	2.1	2.5	1.3	3.0	3.6
November	0.2	2.4	2.6	0.7	3.8	4.1
December	0.3	2.7	2.7	0.4	4.2	4.2

SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

December

	Indices (*)	% monthly change		% annual change	
		2006	2007	2006	2007
By type of spending					
Food and non-alcoholic beverages	108.1	0.5	0.9	3.2	6.6
Alcoholic beverages and tobacco	107.5	0.6	0.1	1.4	6.1
Clothing and footwear	108.3	–1.0	–1.0	1.3	1.2
Housing	105.4	0.1	0.1	4.9	4.8
Furnishings and household equipment	103.9	0.2	0.3	2.6	2.5
Health	98.5	0.1	0.1	1.7	–2.1
Transport	105.3	0.4	0.8	1.8	7.1
Communications	99.9	–0.3	–0.2	–1.5	0.8
Recreation and culture	99.4	1.5	1.4	–0.6	–0.8
Education	107.2	0.1	0.1	4.4	4.1
Restaurants and hotels	106.2	0.3	0.4	4.4	4.9
Other goods and services	103.9	0.2	0.2	3.9	3.0
By group					
Processed food, beverages and tobacco	107.8	0.1	0.4	2.2	7.4
Unprocessed food	108.4	1.4	1.5	4.5	4.9
Non-food products	104.5	0.2	0.3	2.6	3.4
Industrial goods	104.0	–0.1	0.1	1.5	3.1
Energy products	*107.5*	*0.4*	*1.1*	*2.6*	*11.5*
Fuels and oils	*108.9*	*0.5*	*1.4*	*1.7*	*14.4*
Industrial goods excluding energy products	*102.7*	*–0.2*	*–0.3*	*1.2*	*0.3*
Services	105.1	0.5	0.5	3.7	3.8
Underlying inflation (**)	104.8	0.1	0.2	2.5	3.3
GENERAL INDEX	**105.4**	**0.3**	**0.4**	**2.7**	**4.2**

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

Annual inflation on non-energy industrial goods drops to only 0.3% partly thanks to appreciation of euro.

marked up a new record in December. Fuels and oils where thus one of the components of the CPI to show a higher increase in 2007 with an annual rise of 16.2%.

Still higher was the annual change in milk (up 31.7%) although its inflationary impact is less due to its lower weighting in the shopping basket. Nevertheless, the contribution of processed foods as a whole was important going from inflation of 2.2% at the end of 2006 to 7.4% in December 2007. Another notable rise came in bread which rose by 14.4% in the course of last year. But not all the news for consumers is bad. The price of cooking oil was down by 10.4% in 2007 and potatoes dropped by 4.8%.

Other good news was that annual inflation on industrial goods was down from 1.2% in December 2006 to a mere 0.3% one year later. Sharp competition in these goods in

international markets and appreciation of the euro contributed to this good result. The trend in services prices was not as favourable with annual inflation moving up one decimal to 3.8%. The fact that services are more sheltered from competition contributes to a continuation of inflation at a higher level in this activity. Notable in this sphere was the annual increase of 4.9% in hotels, cafés and restaurants.

The spread in annual inflation rates by autonomous community was similar to the year before, with a swing running between 3.0% recorded in Ceuta and 4.7% in Murcia. Apart from this, another seven autonomous communities showed inflation rates higher than the average, namely Castile-La Mancha, Castile-Leon, Cantabria, Aragon, Valencian Community, Catalonia and Canary Islands.

The year-on-year inflation rate harmonized with the European Union ended 2007 at 4.3%, 1.6 points more than at the end of 2006. The inflation differential with the Euro Area stood at 1.2 points, 0.4 points more than 12 months earlier. This increase may partly be explained by the higher weighting of fuels and food in Spain's CPI and because the lower weighting of certain indirect taxes in Spain causes greater sensitivity of final sale price to increases in prices at origin.

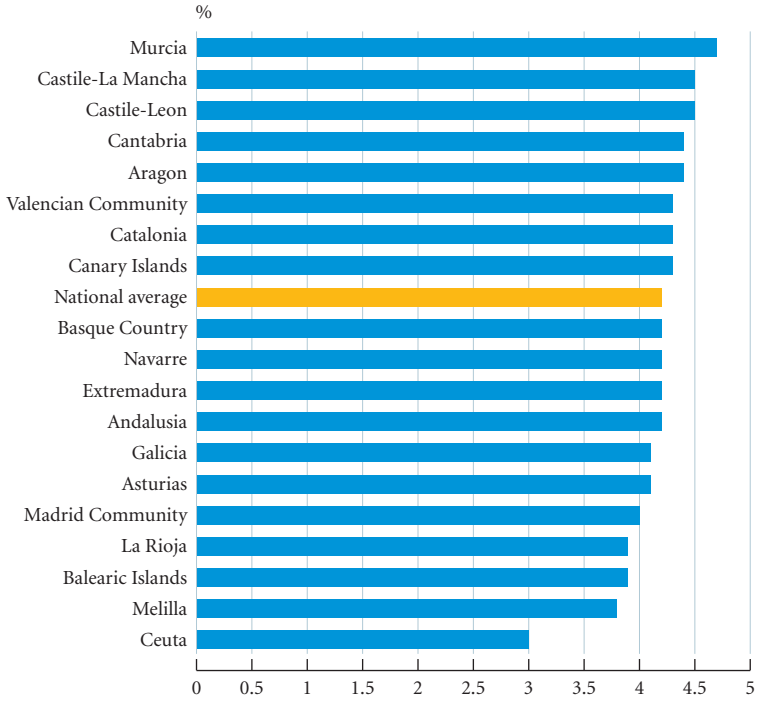
Inflation persists in services, a sector more sheltered from competition.

What are the prospects on inflation opening up for 2008? Lower demand pressure should produce a gradual drop in background pressures. Over coming months, however, there will likely be some increases arising from inflationary pressures on food. Nor is the increase in regulated prices in January likely to decrease inflation.

Inflation likely to drop in 2008 but not in next few months.

MURCIA IS MOST INFLATIONARY AUTONOMOUS COMMUNITY IN 2007

Change in CPI between December 2006-2007



SOURCE: National Institute of Statistics.

Biofuels: at what price?

In the past year, food prices have soared all over the world. According to figures from the National Institute of Statistics, in 2007 they rose by 6.6% in Spain, well above the 3.2% increase in 2006. The food products to rise the most were milk (31.0%), bread (14.4%), poultry (10.2%), mutton (9.9%) and eggs (9.6%). It is not surprising that, in this context, the increase in food prices is widely discussed. This is so much so that a new term has been coined to define inflation of food products: «agflation». What lies behind this phenomenon? The two main causes are the growth of the emerging countries, mainly China (see box «China eating up the world») and the increased production of biofuels.

No doubt, the production of biofuels has grown spectacularly in recent years. In the case of biogasoline, mainly bioethanol, production has doubled in the past two years. A good part of this production is taking place in the United States and Brazil. World production of biodiesel, concentrated in the European Union, has grown even more although from a much lower level. The boost in biofuels is due to two factors – the high price of oil and the fight against climate change. The increase in oil prices from less than 30 dollars a barrel in 2000 to an average of 70 dollars in 2007 and more than 90 dollars in recent weeks has made production of fuel from biomass an economically paying proposition, or almost so. Estimates based on average prices in 2006 and the first half of 2007, when oil was around 65 dollars a barrel, indicated that production of a litre of ethanol based on corn cost 40 cents whereas production of a litre of gasoline from oil cost only 6 cents less (see above Table).

COSTS AND BENEFITS OF BIOFUELS

Fuel	Production costs per litre ($)(*)	Reduction in gas emissions compared with traditional fuels (%)(**)
Ethanol		
Produced from:		
Sugar cane (Brazil)	0.23-0.29	–91
Corn (United States)	0.40	–18
Wheat (Europe)	0.59	–47
Sugar beet (Europe)	0.76	–35
Cellulose	0.71	–88
Gasoline	**0.34**	**0**
Biodiesel		
Produced from:		
Palm oil (Malaysia)	0.54	de –70 a –110
Soybean oil (United States)	0.66	–70
Rapeseed-seed oil (Europe)	0.87	de –21 a –38
Jatropha (India)	0.40-0.65	de –100 a –120
Diesel	**0.41**	**0**

NOTES: (*) Cost calculations based on average prices in 2006 and first half of 2007 (the corresponding price of oil was 65 dollars a barrel). Production costs for gasoline and diesel fuel have been adjusted downward to compensate for their higher energy efficiency compared with the use of biofuels in conventional motor vehicles.
(**) In some cases, the reduction is more than 100% because crops absorb CO_2.
SOURCE: International Monetary Fund.

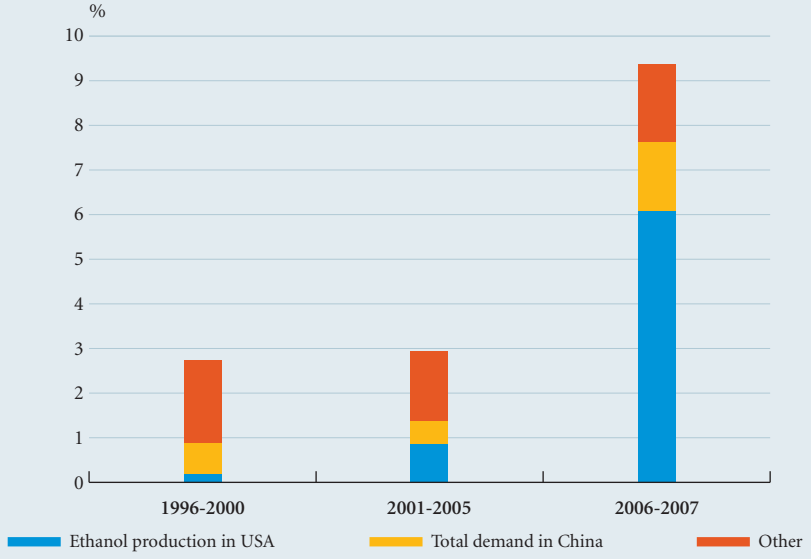
In addition, as part of the fight against climate change, there are many more public subsidies favouring the production of «green fuels» and this has helped reduce effective production cost.

The basic ingredients of the two most common biofuels (ethanol and biodiesel) are raw materials from the food sector. In the case of ethanol, it is corn and sugars while, for biodiesel it is colza-seed, soya and sunflower-seed. Because of this, the production of biofuels has added to the heavy demand pressure on these raw materials and has directly affected their prices (see Graphs below). Indirectly, the prices of other crops have also been under pressure. On the one hand, this is because producers have increased the area of crops for growing raw materials for fuel production at the expense of other crops thus reducing their supply. On the demand side, consumers have responded to price increases by replacing some foods with others (rice instead of corn, for example) which tends to shift price rises from one product to another. A third means of passing through price increases is in the cost of prepared animal foods and other staples for livestock and farm animals. This increases the price of meat and eggs, for example, although no one has dared to work out the exact size of this effect because of its complexity.

Nevertheless, is it logical to attribute all «agflation» to the production of biofuels? Probably not. Other factors, such as the sharp growth in demand for agricultural products in the large emerging economies, must be taken into account. It should not be forgotten that the contraction of the emerging economies in the second half of the Nineties following the Asian crisis was the main culprit in the drop in prices of raw materials during that period. To some extent it is logical that in recent years, due to their increased growth, they have exercised upward pressure on raw materials prices, both agricultural and non-agricultural. In fact, what we have seen is a general increase in the prices of raw materials, even higher in non-agricultural products such as metals, which are not used in producing biofuels.

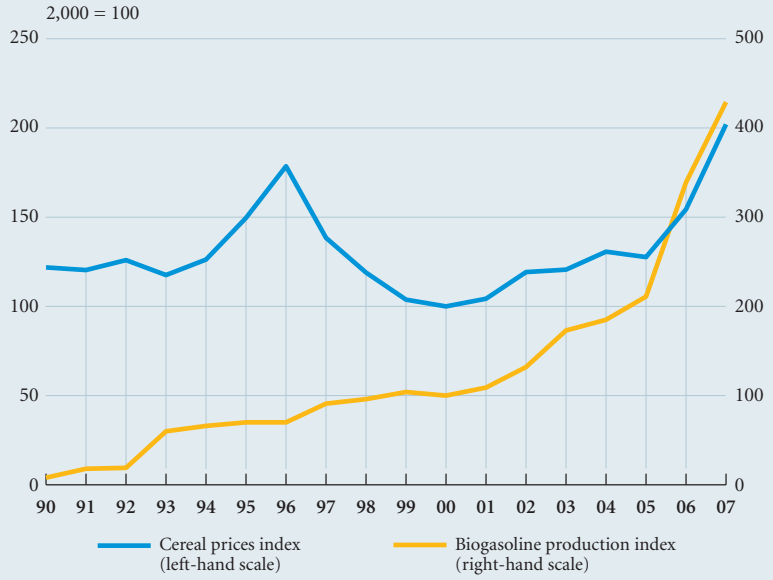
ETHANOL PRODUCTION IN UNITED STATES BOOSTS DEMAND FOR CORN

Contribution to increse in global consumption of corn (1996-2007)



SOURCE: International Monetary Fund.

PRODUCTION OF BIOGASOLINE AND PRICES OF CEREALS ON INCREASE



SOURCE: International Energy Agency and International Monetary Fund.

Looking forward, we may expect that supply will react to high prices although this response could take time. On the one hand, it is likely that land under cultivation will increase, especially if the restraints on agricultural exports from developing countries to more advanced economies are lessened. The reduction of customs duties would also help to move agricultural production for biofuels to those areas where it is less costly. For example, it is much cheaper to produce ethanol from Brazilian sugar cane than from US corn but the United States imposes high customs duties on cane imports. In addition, the development of technology that does not use food raw materials for producing biofuels and uses instead cellulose or jatropha (a type of non-edible oily pine-nut) also raises the possibility of putting a halt to «agflation».

To sum up, it would seem that it is not entirely by chance that a litre of milk and a litre of gasoline both cost more than a euro. Let us hope that technological innovation lends a hand and helps put an end to «agflation». This would be a blessing, especially for the poorer countries where families spend more than 60% of their household budget on food.

Year-on-year inflation in industrial prices marks up highest level since 1985 in December 2007.

Rise in wholesale prices

The year-on-year inflation rate for industrial prices ended 2007 at 5.9%, the highest level since 1985. Nevertheless, the average annual inflation rate was 3.3%, some 2 points below the figure for the year before. This difference may be explained by the profile of the year-on-year rate during the year. It dropped from 3.6% in December 2006 to 2.3% in July due to the performance in oil prices. Later on, the increase in those prices, along with the rise in other raw materials brought about a bump in industrial prices so that the change rate

ended up 2.3 points above the end of 2006.

In spite of the strengthening of the euro, import prices also showed a rise, although this was somewhat lower. This was caused mainly by energy products for which prices rose by 22.9% in November compared with 12 months earlier. On the other hand, year-on-year inflation on intermediate goods had been reduced to 0.8% from the 8.8% shown one year earlier.

Farm prices obtained by producers also showed a sharp rise. Those to rise most were livestock prices (milk, etc.), with a year-on-year increase of 34.5% in October. On the other hand, market livestock prices dropped by 2.5% although the drop tended to be set back.

Sharp rise in livestock prices.

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											
October	2.3	3.4	2.3	2.4	6.9	0.5	3.0	0.8	–0.1	9.6	–
November	0.8	3.6	2.4	2.5	6.8	1.0	2.5	0.0	–0.3	8.8	3.7
December	–5.8	3.6	2.0	2.6	6.8	2.3	2.4	0.3	–0.2	8.2	–
2007											
January	–6.7	2.7	1.4	2.9	6.3	–1.1	0.4	0.6	–0.2	7.2	–
February	–6.3	2.5	1.4	2.9	6.7	–2.5	0.1	0.4	–0.3	7.4	3.4
March	1.5	2.8	1.7	3.3	6.3	–1.6	0.3	0.4	–0.2	6.7	–
April	6.7	2.7	2.2	3.1	6.5	–2.6	0.2	0.6	0.0	6.1	–
May	0.4	2.4	2.0	3.3	6.0	–2.8	0.8	1.5	0.1	5.6	3.2
June	2.6	2.6	1.8	3.1	5.8	–1.4	1.1	1.0	0.0	5.9	–
July	2.5	2.3	1.9	3.1	5.6	–2.6	0.7	1.0	–0.1	4.1	–
August	5.1	2.3	2.4	3.1	5.4	–2.9	0.7	1.5	0.3	3.8	2.9
September	12.1	3.4	3.2	3.2	5.4	0.8	2.0	1.0	0.2	3.0	–
October	13.8	4.7	4.2	3.2	5.3	6.1	3.1	0.7	0.0	1.9	–
November	...	5.4	4.4	3.1	5.1	9.8	4.0	0.8	–0.2	0.8	...
December	...	5.9	4.9	2.9	4.9	11.6	...	...	...	...	–

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

Foreign sector

Trade deficit increasing at slower rate

Trade deficit growing at rate of 7% due to energy balance.

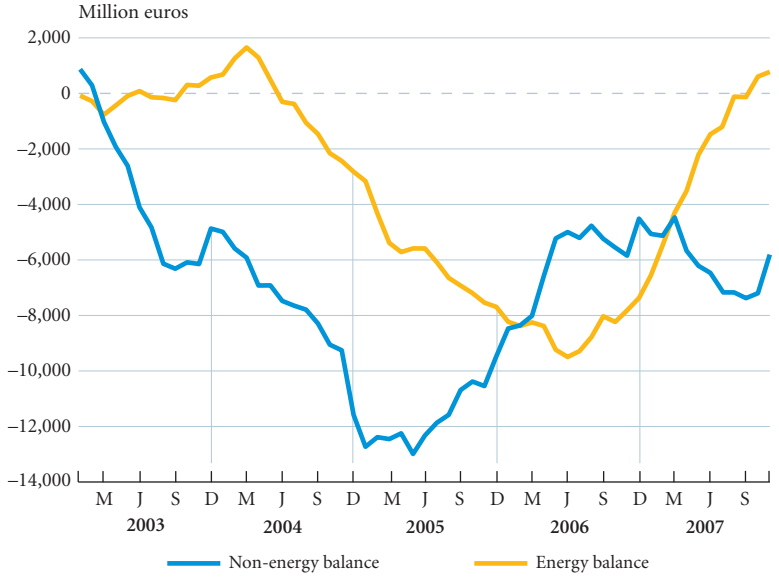
In the period January-November 2007, the trade deficit was 89.12 billion euros. This means that, following the rise in August, in cumulative terms for January-November, the trade deficit grew by 7.0% year-on-year as against 7.9% year-on-year reported between January and October and would support a tendency to slowdown. The export-import rate stood at 65.2 in the first eleven months of the year, one decimal above the same period in 2006.

From the beginning of the year the slowing down of the increase in the deficit was mainly due to the easing of the energy balance in the trade balance. In recent months the improvement in the energy balance has lost some strength while the non-energy balance showed a rise that was interrupted in November. Immediate prospects are not overly bright as it is possible that the imbalance in the energy balance may again increase.

In more general terms, it should be pointed out that in the period January-November exports grew by 7.7% year-on-year while imports were up 7.4%. The trade deficit thus rose by 7.0%, the lowest growth since 2003. In real terms, the gap between exports and imports continues, given that, while the former

ENERGY BALANCE STAGNANT

Year-on-year increases in energy and non-energy trade balance (*)



NOTES: (*) Sum of last 12 months.
SOURCE: Department of Customs and Special Taxes and own calculations.

FOREIGN TRADE

January-November 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	37,267	–1.1	14.5	7,151	5.9	4.3	–30,116	19.2
Consumer goods	70,874	6.3	27.6	59,892	3.7	35.8	–10,982	84.5
Food	*14,484*	*9.2*	*5.6*	*19,079*	*5.6*	*11.4*	*4.595*	*131.7*
Non-foods	*56,390*	*5.3*	*22.0*	*40,813*	*–0.8*	*24.4*	*–15,577*	*72.4*
Capital goods	26,885	7.1	10.5	15,315	0.7	9.2	–11,570	57.0
Non-energy intermediate goods	121,374	11.2	47.3	84,925	12.3	50.8	–36,449	70.0
By geographical area								
European Union EU-25	151,174	7.6	59.0	117,391	5.6	70.2	–33,783	77.7
Euro area	*126,193*	*8.1*	*49.2*	*93,855*	*6.1*	*56.1*	*–32,338*	*74.4*
Other countries	105,227	7.2	41.0	49,892	13.0	29.8	–55,334	47.4
Russia	*7,359*	*6.9*	*2.9*	*1,946*	*43.0*	*1.2*	*–5,413*	*26.4*
United States	*9,138*	*19.2*	*3.6*	*6,970*	*4.8*	*4.2*	*–2,168*	*76.3*
Japan	*5,626*	*4.6*	*2.2*	*1,234*	*–0.7*	*0.7*	*–4,391*	*21.9*
Latin America	*13,636*	*1.9*	*5.3*	*9,274*	*1.4*	*5.5*	*–4,362*	*68.0*
OPEC	*19,364*	*–5.7*	*7.6*	*4,983*	*24.3*	*3.0*	*–14,382*	*25.7*
Rest	*50,105*	*13.1*	*19.5*	*25,485*	*17.2*	*15.2*	*–24,619*	*50.9*
TOTAL	**256,400**	**7.4**	**100.0**	**167,283**	**7.7**	**100.0**	**–89,117**	**65.2**

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

grew by 4.8% year-on-year, purchases abroad were up 7.4%.

In November, the most dynamic groups of products exported were energy goods which, in spite of representing 5.2% of exports, doubled their figure compared with the same period the year before. Sectors of greater weight such as food and capital goods reported advances of 15% while the chemicals sector improved by 13.0%. Energy imports also showed strong with an increase of 18.2% because of the increase in the price of oil. Consumer goods and food also reported important increases.

Finally, the performance in foreign markets continues to follow recent trends. The European Union (EU) remains the reference trading partner for Spain's economy, representing as it does the destination of 69% of the country's exports and the origin of 60% of Spain's purchases abroad. Nevertheless, exports to Asia showed great drive with growth of 35.2% while those to Africa were up 26.5%. Also showing strong growth were exports to Turkey (47.5%), Russia (40.9%) and Norway (29.9%). Imports from North America and Asia rose by 8.8% and 8.7% respectively.

Trade with countries outside European Union shows strongest growth.

BALANCE OF PAYMENTS

October 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	–71,346	7.1	–84,885	–5,625	7.1
Services					
Tourism	*25,027*	*1.3*	*27,756*	*315*	*1.1*
Other services	*–4,188*	*–8.0*	*–4,939*	*314*	*–6.0*
Total	20,839	3.3	22,817	629	2.8
Income	–25,935	39.5	–28,328	–6,639	30.6
Transfers	–8,818	44.2	–8,457	–4,068	92.7
Total	**–85,259**	**19.8**	**–98,853**	**–15,704**	**18.9**
Capital account	**3,348**	**–7.1**	**5,920**	**–60**	**–1.0**
Financial balance					
Direct investment	–38,134	–17.6	–47,397	–495	1.1
Portfolio investment	100,399	–44.5	117,712	–64,796	–35.5
Other investment	18,460	–	23,243	58,128	–
Total	**80,725**	**–14.5**	**93,559**	**–7,163**	**–7.1**
Errors and omissions	–3,477	–20.7	–2,002	2,167	–52,0
Change in assets of Bank of Spain	4,663	–	1,376	20,760	–

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.

Balance of payments: incomes deficit reaches high levels

Trade deficit eases and worsening of current account deficit slows down.

The current account balance recorded a deficit of 9.77 billion euros in October, a figure 29.6% higher than one year earlier. The widening of the current account imbalance was due, in practically equal measure, to the increased deficits in the transfers balance and the trade balance which again contributed to the negative balance following the turn-around in August. The increase in the deficit in the incomes balance was also substantial but less than in previous months.

Deficit in transfers balance growing while incomes balance fails to improve.

In order to evaluate these results over a longer time-frame it would be useful to show the trend in cumulative figures for 12 months which provide a better view of trends. To start off, we should point out that the current account imbalance is tending to show slower growth, a course that began in 2005. In the 12 months ending in October, the current account deficit grew by 18.4% year-on-year, one percentage point less than the cumulative figure for 12 months ending September. The main contribution to this slowdown came from the drop in the growth of the trade deficit.

Nevertheless, whereas the services balance is still following a stationary trend, the incomes balance and the transfers balance are growing increasingly worse so that in the

12 months end in October both contributed two-thirds to the worsening (by 15.70 billion euros) of the current account balance compared with the same period the year before.

With regard to financial flows, the outstanding note is that, in terms of the cumulative figure of 12 months, the decrease in the balance of portfolio investment is getting sharper with net entries of 117.71 billion euros, 64.80 billion less than one year earlier. In turn, net outflows for direct investment showed a small advance after several months of decreases.

Savings and financing

Funding to private sector losing steam

12-month Euribor moves down in January.

In December, the 12-month Euribor came to the peak of a series of increases. Widely used as a reference in many contracts, this rate rose to 4.79% on monthly average going to its highest level since December 2000. As a result, it recorded an increase of 0.87 percentage points compared with one year earlier. Nevertheless, this increase was lower than that marked up in 2006. In fact, the increase in December was largely due to liquidity problems in the interbank market with the approach of the year-end. In the early weeks of January, the 12-month Euribor moved down with the expectation of a less aggressive position by the European Central Bank and went back to the level in May 2007.

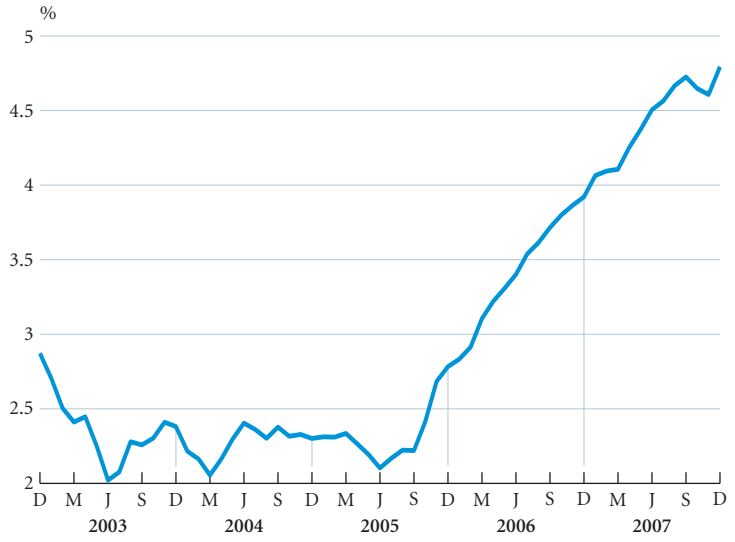
Drop in financing to private sector because of lower demand and more stringent lending terms.

The trend to an increase in interest rates explains the fact that funding to the private sector has shown a slowdown, to which less brilliant economic prospects have contributed. The annual change rate of this variable was 17.1% in November, some 7.1 percentage points less than at the end of 2006. This slowdown in funding was due to lower demand but also to more stringent lending terms. Nevertheless, the annual change rate continues to be substantially above that for the Euro Area.

The lower growth rate for funding of companies has sharpened in recent

1-YEAR EURIBOR ENDS 2007 AT HIGHEST LEVEL IN PAST SEVEN YEARS

12-month Euribor



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

November 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	86,498	1,122	1.3	7,045	8.9	5.0
Secured loans (*)	1,058,717	135,741	14.7	158,662	17.6	60.6
Other term loans	497,631	83,042	20.0	85,546	20.8	28.5
Demand loans	42,144	8,031	23.5	6,815	19.3	2.4
Leasing	45,741	5,028	12.3	6,858	17.6	2.6
Doubtful loans	15,895	5,036	46.4	5,036	46.4	0.9
TOTAL	**1,746,626**	**238,000**	**15.8**	**269,962**	**18.3**	**100.0**

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

months. Year-to-year growth went from 23.4% in August to 19.3% in November. Commercial credit, used to finance working capital of companies, showed a drop in annual change rate to less than 10%. Nevertheless, funding for investment, as seen from leasing operations, continued to show a good level.

Funding company investments continues to show good level.

Funds going to households also continue to ease gradually. In the past 12 months ending in November these showed an annual increase of 14.2%. Finance for housing showed a similar annual increase at 14.6%. This rate was 5.8 percentage points lower than in December 2006. The drop in this funding was the result of lower demand in view of higher interest rates and increased housing prices.

Increased interest rates and housing prices dampen demand for mortgage loans.

December also saw approval of Law 41/2007 dealing with reform of the mortgage market aimed at making it more flexible. The law establishes the bases for development of the mortgage market in coming years. It regulates transparency in loan and mortgage contracts and modifies refinancing mechanisms with regard to bonds and «cédulas hipotecarias» (covered mortgage bonds).

Mortgage market reform law passed.

The default rate continued to rise slightly in November going to 0.91%. This rate means an increase of less than two decimals over the level at the end of 2006 and is relatively low. Furthermore, Spain's financial institutions have substantial provisions to meet any foreseeable increase in default.

Major withdrawals from mutual funds in 2007

Funding difficulties of financial institutions in capital markets following the outbreak of the subprime mortgage crisis in the United States led to a broadening of other means of financing loans granted. Apart from the issue of notes, which are short-term instruments, there was greater competition for attracting bank deposits. As a result, the interest rate on time-deposits by individuals moved up to 4.3% in November, more than one point higher than the level in December 2006.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

November 2007

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	423,946	–24,391	–5.4	3,880	0.9	32.9
Up to 2 years	344,655	98,249	39.9	99,756	40.7	26.7
More than 2-year term	395,160	62,311	18.7	74,103	23.1	30.6
Repos	81,585	–2,239	–2.7	8,529	11.7	6.3
Total	**1,245,346**	**133,930**	**12.1**	**186,268**	**17.6**	**96.5**
Deposits in currencies other than euro	**44,761**	**12,044**	**36.8**	**14,876**	**49.8**	**3.5**
TOTAL	**1,290,106**	**145,973**	**12.8**	**201,143**	**18.5**	**100.0**

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

Sharper competition to attract bank deposits...

The improved return on bank accounts has boosted the growth of deposits by the private sector which went up 18.5% in the past 12 months ending in November. The biggest increase showed up in accounts in foreign currency boosted by interest rate differentials in their favour, although these accounted for only 3.5% of total deposits. The bulk of deposits showed up in time-deposits for terms up to two years which reported a sharp annual increase of 40.7%. On the other hand, on-demand and savings accounts grew by only 0.9% over the past year as a result of low returns, substantially below inflation.

In spite of the attractiveness of these products, the household savings rate does not seem to be reacting. According to figures supplied by the National Institute of Statistics, the household savings rate in the third quarter of 2007 stood at 4.8% of disposable income, one point less than a year earlier. This result was due to the relatively modest year-on-year growth of disposable income (3.8%) under the effect of a 21.4% increase in income and property taxes and an increase in consumer spending of 5.1%. If we take the last four months into consideration, the household savings rate stood at 9.9% of disposable income, three decimals less than in the preceding period.

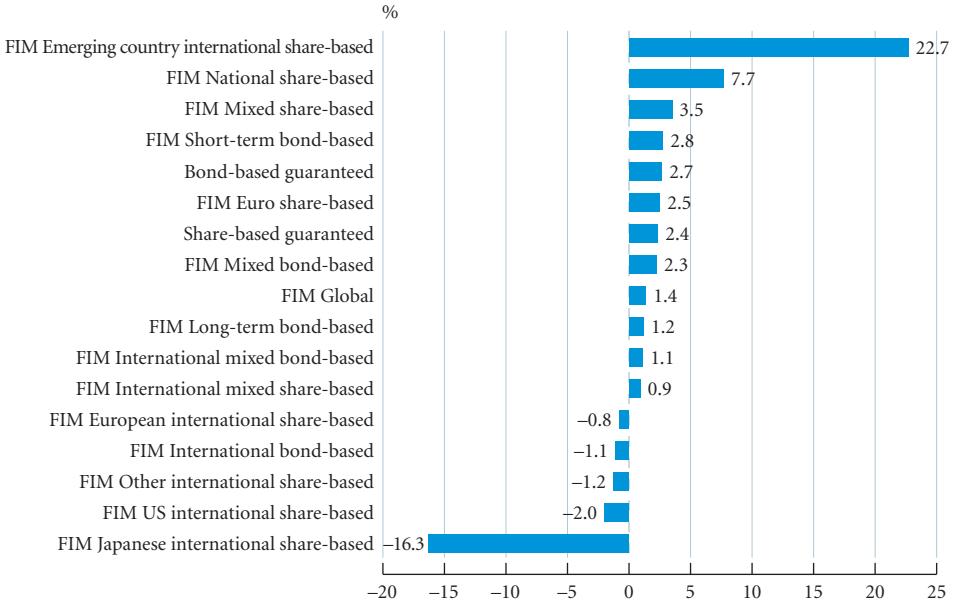
...has negative effect on mutual funds.

As well as deposits, other instruments used for saving are securities mutual funds shares. Nevertheless, in 2007 there were net withdrawals of securities mutual funds shares for a value of 20.19 billion euros with the result that assets of these funds dropped by 6.1% to 238.70 billion euros.

This negative trend may be explained by a number of factors. On the one hand, as explained above, the marketing policies financial institutions have been concentrating on attracting deposits to the detriment of other products such as mutual funds. In addition, savers began to compare past returns on funds with future returns offered by deposits without always taking into account that we were in a period of increasing interest rates. Furthermore, in the latter part of the year, the upsets in international financial markets increased risk aversion of participants. As a result, in the course of 2007 the number of participants in mutual funds dropped by 6.3% to 8,264,240.

EMERGING COUNTRY FUNDS LEAD IN 2007

Annual yield on securities mutual funds in 2007



SOURCE: Inverco and own calculations.

The average annual yield obtained on securities mutual funds was 2.4% although for the last 16 years as a whole yield rose to 4.5%, which was above average inflation for the period. On the other hand, yields were widely varied depending on type of fund. Share-based funds of emerging markets headed the classification with capital gains of 22.7%, followed some distance behind by national share-based funds with gains of 7.7%. The most conservative funds reported the most modest increases, as was the case with short-term bond-based funds with gains of 2.8%. The appreciation of the euro contributed to increase losses in Japanese share-based funds which recorded the biggest losses at 16.3%.

Another type of fund, so-called hedge funds, raised their assets to 818 million euros at the end of 2007, practically still at the beginning of their development in the Spanish market. In spite of their growth, the total for these funds represents only 0.25% of the total volume of mutual fund institutions. The number of participants is also small with a figure of 2,716 at year-end.

The number of participants in real estate mutual funds rose by 165,781. Assets of this type of fund were up 2.1% in 2007 going to 8.61 billion euros. Average yield on these funds was 5.4% while in the past 10 years it showed 7.0%.

Yield on securities mutual funds stands at 2.4% in 2007 with wide range depending on type.

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2007

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

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

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

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