MARCH 2008

THE SPANISH ECONOMY

Monthly Report

NUMBER 311

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	2.1	1.7	2.9	1.7	1.9	1.8	1.3	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	2.7	1.7	3.2	2.5	2.7	2.3	1.8	1.9
Germany	*3.1*	*2.6*	*1.7*	*3.7*	*2.6*	*2.5*	*1.8*	*1.5*	*1.6*
France	*2.2*	*1.9*	*1.7*	*1.9*	*1.3*	*2.2*	*2.1*	*1.6*	*1.6*
Consumer prices									
United States	3.3	2.8	3.2	2.5	2.5	2.4	4.0	4.0	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	2.4	1.9	1.9	1.9	2.9	2.9	2.3
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	3.5	3.4	3.1	2.7	2.4	2.3
Government consumption	4.8	5.1	4.4	6.1	5.0	5.1	4.4	3.5	4.0
Gross fixed capital formation	6.8	5.9	2.4	6.3	6.7	5.8	4.8	3.6	2.5
Capital goods	*10.4*	*11.6*	*5.1*	*13.1*	*13.1*	*11.6*	*8.6*	*7.5*	*6.0*
Construction	*6.0*	*4.0*	*0.9*	*4.9*	*4.6*	*3.8*	*2.9*	*1.4*	*0.4*
Domestic demand (contribution to GDP growth)	5.1	4.6	2.8	5.1	4.9	4.5	3.9	3.1	2.8
Exports of goods and services	5.1	5.3	4.8	3.6	4.7	7.7	5.1	5.1	4.9
Imports of goods and services	8.3	6.6	4.8	6.0	6.7	8.4	5.4	4.9	4.6
Gross domestic product	**3.9**	**3.8**	**2.5**	**4.1**	**4.0**	**3.8**	**3.5**	**2.9**	**2.6**
Other variables									
Employment	3.2	3.0	1.5	3.3	3.1	3.0	2.5	2.0	1.6
Unemployment (% labour force)	8.5	8.3	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	4.3	4.1
Unit labour costs	2.3	2.7	3.1	2.6	2.6	2.7	2.9		
Current account balance (% GDP)	–8.8	–10.0	–9.7	–10.1	–9.0	–10.2	–10.7		
Net lending or net borrowing rest of the world (% GDP)	–8.1	–9.5	–9.1	–9.5	–8.7	–10.1	–9.8		
Government balance (% GDP)	1.8	2.2	0.9						
FINANCIAL MARKETS			Forecast					Forecast	
Interest rates									
Federal Funds	5.0	5.0	2.2	5.3	5.3	5.1	4.5	2.8	2.0
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	3.9	4.0
Exchange rate									
$/Euro	1.26	1.38	1.50	1.32	1.35	1.39	1.46	1.52	1.52

Contents

What's to be done with exchange rates?

According to Kindleberger, in his *Financial History of Europe*, foreign exchange is a bill of exchange that allows payment in foreign currency. At that time, the expression came to signify any means of foreign payment except those in precious metals. Today, the term is generically applied to national monetary units when they are used in transactions with abroad. Exchange rates are therefore nothing more than coefficients that make it possible to express the value of one currency with another. They are prices that synthesize all the strengths and weaknesses of economies. They are therefore precious information, so long as these exchange rates are the result of the free play of supply and demand.

This is not always so. National authorities often intervene in the market in order to affect the exchange rate, something that is often accompanied by the protests of those who feel themselves adversely affected. In the case of the recurring protests in the United States against China because of undervaluation of the renminbi, which gives Chinese manufactures a competitive advantage that contributes to the enormous gap in the US trade balance. In the Box entitled «Is it possible to know who is manipulating the exchange rate?» (Page 67), we set out the efforts of the International Monetary Fund to establish a method for working out what is the exchange rate balance for each country. This is indeed an ambitious task but one theoretically possible within more or less broad margins. The problem lies in that, once we become aware of existing imbalances, what body would become the referee that would oblige decisions and even apply sanctions on offending countries?

So long as we cannot resolve this problem, foreign imbalances will continue to exist. In fact, the international economy seems to have settled into a «stable imbalance» in which the United States is generating an enormous trade deficit due to its imports, especially those from Asian countries. The balance is levelled out by the buying of US financial assets by those countries with surpluses, which in turn creates huge levels of foreign reserves, with China in the lead. This process is explained in more detail in the Box on page 10. The growing importance of «sovereign funds» (state-owned investment funds) in this process has raised some alarm because of its potential control over sectors or companies considered sensitive or strategic to the economic and financial activity of the advanced countries.

Up to this point it would seem that the free fluctuation of exchange rates would be the ideal basis for monetary relations between countries. But the reality is much more complicated. A fixed exchange rate system can be advantageous. It can strengthen trade ties and direct investment and, in the context of a macroeconomic stabilization plan, contribute to halt a problem of high inflation. In fact, in recent years there has been an increase in the number of countries opting for fixed exchange rates, as noted in the Box «A fixed exchange rate: back to the future?» on page 44. Of course, this is the case with the countries of the European Union that have adopted the euro, although technically this is not a matter of setting exchange rates but adopting a single common currency. In any case, the result is a growth of trade and economic integration which, as we know, is always good for the general welfare of the population. Nevertheless, as noted in the Box on page 26, this also has its disadvantages and the road still to go is long. The fact is that, as stated in the beginning, the exchange rate is a price, a valuable bit of information, but on its own it cannot perform miracles.

EXECUTIVE SUMMARY

Story of three economies, or why United States not doing well while Europe and China holding up better

Economic situation in United States, Europe and China shows divergence.

«It was the best of times, it was the worst of times, it was the age of wisdom, it was the age of foolishness, it was the epoch of belief, it was the epoch of incredulity, it was the season of Light it was the season of Darkness, it was the spring of hope, it was the winter of despair...». In his memorable beginning of *A Tale of Two Cities*, Charles Dickens was referring to another time but one that strikes a bell today. Now, however, the spring of hope may be put off until summer or even later. In large measure, it depends on how we position the light because these days the three big world economic regions (United States, Europe and China and the emerging countries) stand in quite different situations.

Latest figures from United States confirm state of extreme weakness...

The US economy is the big unknown. In recent times there has been much speculation about its real state of affairs. Doubts about whether it will or will not go into recession. (To go by conventionally accepted criteria, whether there will be a drop in gross domestic product during two quarters.) Or whether on the other hand it will move into a period of reduced but positive growth, seasoned with inflation holding at levels that are too high. Contrary to what may seem likely, the last scenario, that of stagflation, is not less negative than that of temporary recession followed by a recovery of economic activity.

...although economic policy moves seem to be laying basis for better second half of 2008.

Latest figures fully reflect that the present moment is one of weakness but do not dispel doubts about the future. Growth in the fourth quarter reflected an undoubted slowdown although its make-up did not come out totally negative given that private consumption showed a correction but not a collapse. Other indicators, such as housing sales, business activity and services as seen by the Institute for Supply Management, retail sales and consumer confidence indicate that the adjustment is shown in prospects for both supply and demand. Inflation is not helping given that it settled above 4% between November and January (although it is true that this was due mainly to the rise in energy prices).

The United States then is not good but what about the future? If recent trends continue, not very good. But at least we note that economic policy is playing its role. Ben Bernanke, chairman of the Federal Reserve, has stated that this body would act quickly and to the degree needed to support growth. This was no idle statement given that the Fed has already taken strong action lowering the intervention rate from 4.25% to 3% so far this year. The fiscal plan, a push equal to 1.2% of US gross domestic product, strengthens the involvement of economic policy and improves the possibility that the economy could revive as of the final stages of 2008.

These decisions seem to have calmed down the nerves of the most pessimistic. To be specific, the panorama has seemed sufficiently acceptable for the US stock markets to enjoy a month with some recovery suggesting that in summer the situation may be more encouraging for business activity. In spite of everything, no one is expecting this recovery to be

very strong. In its forecasts for 2008 and 2009, the Federal Reserve was expecting average annual growth of 1.7% and 2.4% respectively, far from the long-term trend which rather suggest 3%.

The Euro Area is travelling a different road. In 2007 it had a year of recovery and for the moment is enjoying a growth momentum that is giving it some protection from the cooling off happening outside. Nevertheless, as were reminded by 4th quarter growth (2.3% year-on-year as against 2.7% in the previous quarter), those in the single currency are not going to be able to escape from the world slowdown. It still remains an economy notably dependent on the foreign sector and it is thus beginning to get negative signals from abroad in the shape of a strong euro that hurts its international competitiveness and less dynamic foreign demand.

While no one is speaking of recession in the Euro Area, the European Commission has revised downward its growth forecasts for 2008 (it suggests a figure of 1.8%) and for a rise in inflation (2.6%). This combination complicates life for the European Central Bank which, while it continues to maintain that its main contribution to economic welfare is to keep down inflation prospects, it has partly eased the firmness of its line, a situation that has been interpreted as a way to gain monetary flexibility at a time when the economy has begun to slow down. The European stock markets, with one eye on one side of the Atlantic and the other at home, ended the month of February practically flat waiting for some signs regarding the future.

And the future, at least for some time, is taking on the shape of an Asian giant. China continues to be seen, in the eyes of many, as the saviour of the world. For Europe it is the leading market for exports and its function as the factory of the world does not seem in jeopardy. The problem, with growth of 11.2% growth in the fourth quarter of 2007 and inflation above 6.5% in the same period, is rather how to contain hypothetical overheating. These are paradoxes of the global economy in which China's attempt to ensure that its powerful engine is not derailed runs side-by-side with the hope that US economy is not going to stop for too long. As always, happiness (in the economic sense) runs by neighbourhood. Or, to follow Dickensian thinking, by city.

Euro Area still benefiting from momentum of acceptable growth...

Spain's economy: neither so good nor so bad

An impartial observer of Spain's economy could have difficulty in working out where we stand. Some indicators suggest an economy at a time of good form, at least in terms of most economies on the Old Continent. Others create certain alarm, given that they seem to involve a sharp decline or an unusually sharp slowdown.

...although European Commission expects less growth and more inflation in 2008, an awkward combination for European Central Bank.

Beginning with the bottle half-full, figures for the fourth quarter from National Accounting allow us to better evaluate how 2007 evolved. Overall, it was a good year given that growth was 3.8%, a mere one decimal less than in 2006, which would imply that the gap with the Euro Area in terms of growth continues to increase. Furthermore, the composition of growth is more in balance given that construction hold less weight and the contribution of the foreign sector to the change in GDP is somewhat less negative.

The results in control of the public finances were also satisfactory (with a government surplus of 2.2% of GDP, this was the best in decades). This was also the case in job creation which was close to a half-million in 2007, so that at the end of the year the economy reached

Spain enjoyed good 2007 in terms of growth and employment...

...although in final stretch of year things began to go wrong with higher inflation, weaker growth and worsening labour market.

a record figure of 20.5 million persons employed.

Nevertheless (and here we switch to the bottle that is half-empty), we must admit that, while 2007 as a whole was a good year, there are two exceptions. First, regarding the foreign sector imbalance. In 2007, the trade deficit reached a figure equivalent to 9.4% of GDP, a figure by all means too high. A second imbalance was in prices given that inflation ended last year with growth of more than 4%.

At the same time, in recent months the rate of economic activity has moved into a slowdown course. The GDP grew by 3.5% year-on-year in the fourth quarter, the smallest growth in two years. During the same period we note the first drop in the number of persons employed since 2002 and furthermore registered unemployment in January brought a surprise with the highest increase in a decade. This was similar to the figure for registrations with Social Security which in January showed its biggest drop since 1994.

European Commission expecting growth of 2.7%, a good figure in relative terms with Europe...

Another reminder of problems was the January figure for inflation that, because of oil and food, stood at 4.3% year-on-year, the highest since 1995. In this context, in the first month of 2008 the moderate drop in core inflation (excluding energy and processed foods) does not offer sufficient consolation. Especially if we consider that industrial and import prices recorded sharp growth, which indicates that pressure on final prices will not be eased in a hurry.

...but also foresees too high inflation in 2008.

What will 2008 bring? Will recent trends toward a worsening of the economy continue? If this is so, how sharp will this be? One informed voice, that of the European Commission, offers an opinion that may be considered fairly reasonable. As the Spring forecasts come in, the European Commission is expecting that Spain's growth in 2008 will be 2.7%, three decimals less than it was forecasting last autumn. This does mean an appreciable slowdown from the 3.8% in 2007 but at the same time it is growth rate substantially better than the 1.8% the Commission is forecasting for the Euro Area as a whole. The EU body is putting out a scenario of growth in 2008 in which the first half of the year will be slightly more dynamic than the second half-year.

However, while the panorama in terms of growth is not overly negative, on the prices front the relief expected is quite slim. Average inflation in 2008, in harmonized terms, will go up by 3.7%, its biggest rise in years. Most inflationary pressures, according to EU forecasts, will be concentrated in the first half of the year (a period when it is unlikely to drop below 4%). Later on, there should be a gradual drop in inflation so that at the end of 2008 it could stand within the range of 3%. The year will thus be a lively one. The European Commission has reminded us that its forecasts are running lower, that is to say, that growth will be less than expected. In all likelihood, Spain will closely follow this trend.

Finally, after nearly a decade and a half of exceptional economic growth, it is not surprising that Spain's economy might take a breather. In any case, we should closely watch progress during a time of increasing upsets.

February 27, 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.
	22	**Federal Reserve** reduces reference rate to 3.50%.
	30	**Federal Reserve** reduces reference rate to 3.00%.
February	26	One-month forward **oil** price (Brent quality) moves up to all-time high level of 98.76 dollars a barrel.
	27	**Euro** exchange value at 1.504 dollars, highest since launching of single European currency at beginning of 1999.

AGENDA

March

- **4** Registrations with Social Security and registered unemployment (Feberuary).
- **5** Industrial production index (January).
- **6** Governing Council of European Central Bank.
- **13** CPI (February).
- **14** Balance of payments (December). Labour costs (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).

April

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

INTERNATIONAL REVIEW

United States: concerned with recession... and recovery

US GDP grows 2.5% in fourth quarter with biggest weakness in inventories and construction.

The US gross domestic product (GDP) slowed more than expected in the fourth quarter with year-on-year growth of 2.5%. In year-on-year terms the slowdown over the third quarter was even sharper going from an increase of 4.9% to a shaky 0.6%. Nevertheless, the make-up of this figure is better than expected given that half of the slowdown was due to weakness in the creation of inventories and a quarter to the slowdown in exports. In turn, private consumption, the component which will be the key to the US economy in 2008, slowed less than expected with growth of 2.5% year-on-year. On the investment front, the crisis in the real estate sector sharpened, if this were possible, and the slack in equipment and software is continuing.

Federal Reserve lowers growth prospects and puts strength of recovery in doubt.

The problem is not going to be so much whether or not it comes to negative growth in the first half of 2008 but rather whether the recovery which should begin at the end of the year is sufficiently robust. If this should not happen, this would mean a lapse of more than two years growing below the long-term trend of 3.0%. In this respect, the Federal Reserve has modified downward its growth forecasts for 2008 and 2009, with an expected average increase of 1.7% and 2.4%, respectively, putting both cases below the long-term trend. The real recovery is thus being left for the far-off year 2010 when the reductions in the Fed's interest rates would be noted more strongly and growth would likely be 2.8%.

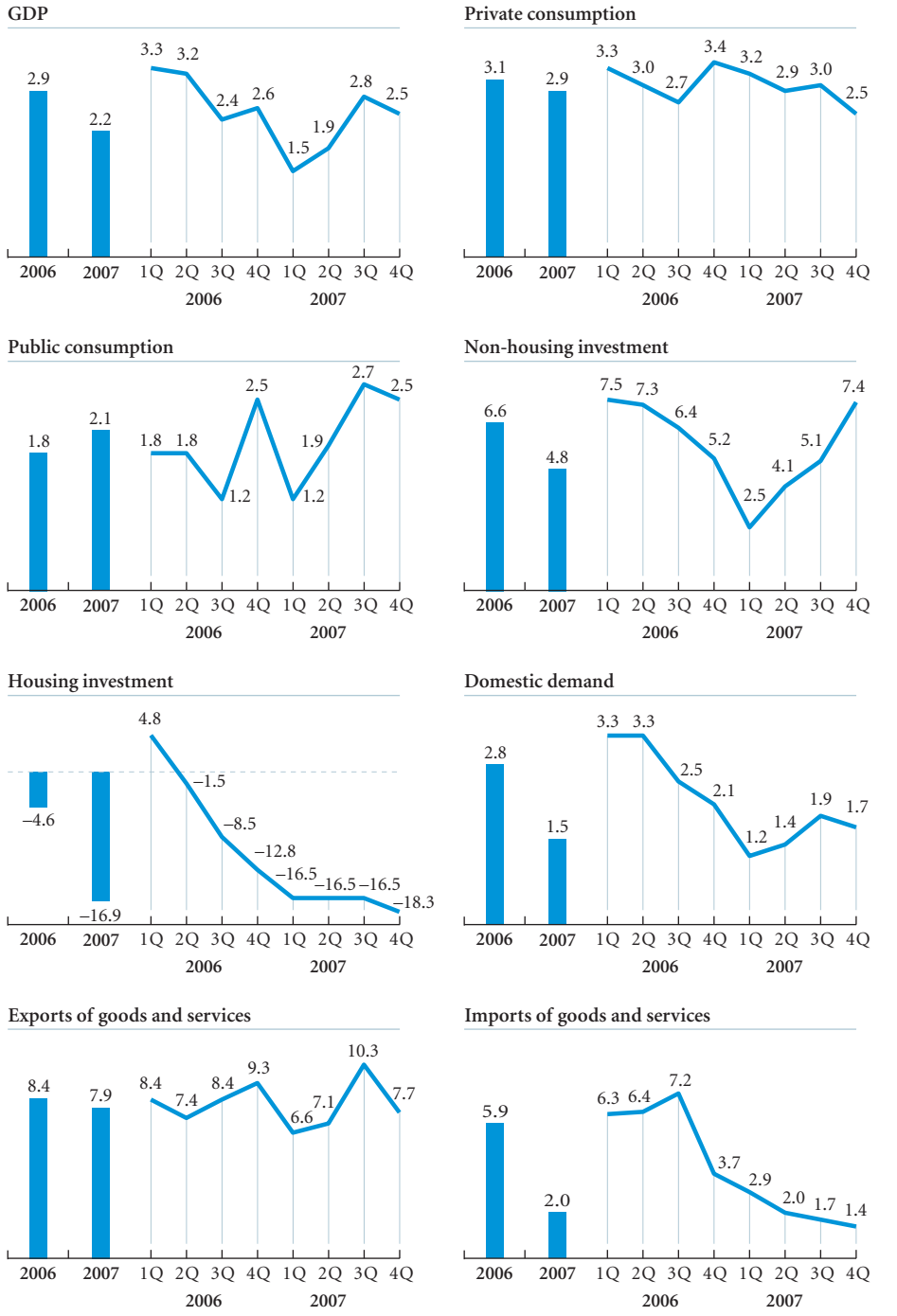
Administration agrees on fiscal stimulus to relieve drop in consumer purchasing power.

Since the high in 2000, US average purchasing power has dropped in real terms, that is to say, if we take into account price increases. This drop in household income has been compensated by the ability to buy using cheap credit with buoyant real estate assets as collateral. While the first remains operative, the second point has been dramatically reduced. The Administration has made an agreement with the Senate and Congress for a fiscal stimulus plan amounting to 170 billion dollars (1.2% of GDP) which will largely go to families with incomes between 3,000 and 15,000 dollars, precisely the American average income that has been having problems for some time. The effects of the plan should begin to be felt as of September. The question to be asked is if this will be sufficient, given that periods of real estate weakness tend to lengthen. A good number of families may see how their mortgage debt goes above the market value of their homes and employment, the biggest support for consumption continues a slow but constant drop.

Construction spending in the third quarter was down 23.9% compared with the previous period in annual terms which indicates that it still has not hit bottom. Housing starts in January were down a sharp 38.4% below the same period the year before. Pointing in the same direction, building permits which have been an early indicator of these dropped a similar 33.1%. With regard to the evaluation of assets, Case-Shiller index for housing prices in November continued to sharpen decreases with a

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



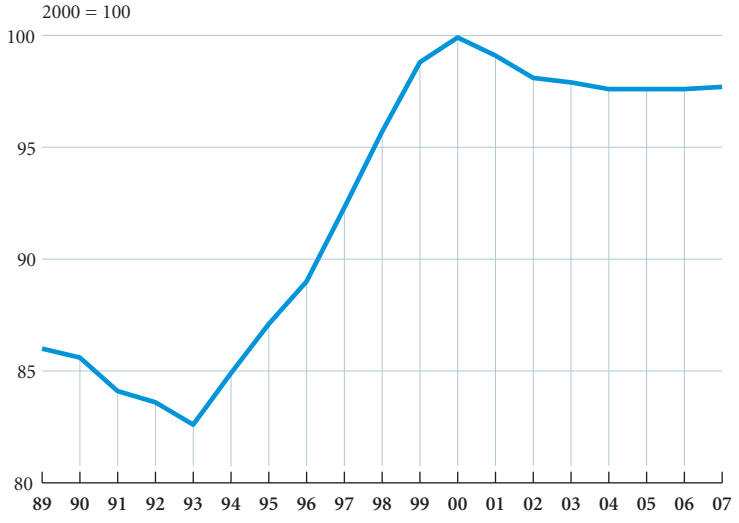
SOURCE: Bureau of Economic Analysis and own calculations.

Housing still not hitting bottom either in construction or prices.

loss of 8.4% year-on-year which, if we add the increase in CPI, means a loss of more than 11%. Sales of existing houses in December fell by 21.6% year-on-year and sales of new houses, taking advantage of greater volatility, were

UNITED STATES: CONSUMERS CAUGHT

Real average household income (*)



NOTE: (*) Income taking into account increases in CPI.
SOURCE: National Association of Realtors and own calculations.

Retail sales and labour market show sustained slowdown.

down by 40.7%. The Secretary of the Treasury, Hank Paulson, has set up a plan called «Lifeline» which, in coordination with the six main banks holding most mortgages, proposes to give an additional 30 days grace period for mortgage contracts that may have been in default for 90 days or more. The idea is to avoid foreclosures but the shareholders of these financial institutions see difficulties in its implementation.

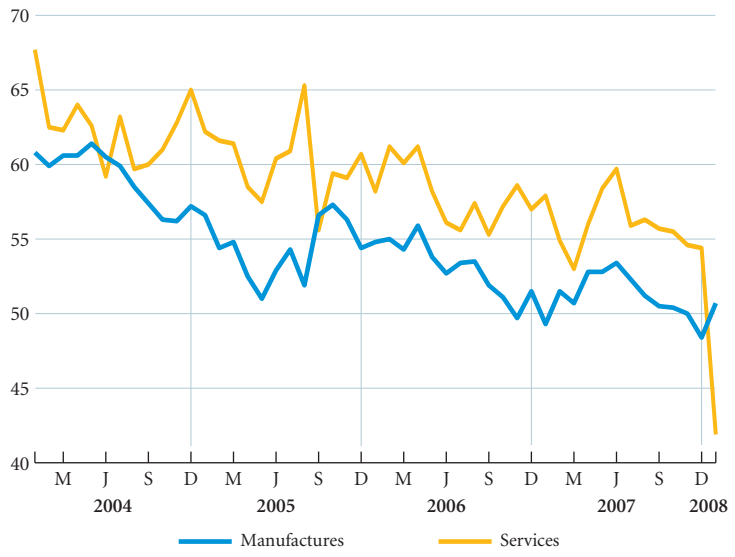
Retail sales continue along the path of GDP figures, a slowdown without major events. In January, retail consumption, excluding cars and petrol which are highly volatile, grew by 2.4% year-on-year. In line with this downward trend, the consumer confidence index put out by the Conference Board continued downward going from 90.6 to the 87.9 points level. The component made up of the current situation showed a slight rise which could not compensate the continuing drop in expectations. The labour market continues to show a very similar trend. Figures for January showed the first drop in employment since September 2002. Nevertheless, the 17,000 jobs lost were at the cost of the public sector and an upward revision of previous months. As in the GDP figures, the tendency is more relevant given that in the last 12 months employment grew by 0.7% whereas two years ago it was growing by 2.0%. The unemployment rate in January dropped slightly to 4.9% of the labour force.

Business executives lowering expectations especially in services with biggest drop in ISM since 1997.

The greatest strength of the economy at this time lies in non-financial companies which continue to present profits and which, in contrast to consumers, are showing reasonable borrowing levels. Nevertheless, things may be beginning to change. The trend in the business activity index of the Institute for Supply Management in the services sector dropped drastically in January from 54.4 to 41.9 points, the biggest monthly drop since it was set up in 1997. If it goes below the 50 level it indicates that pessimist responses won over those that

UNITED STATES: BUSINESS EXECUTIVES SEEING THINGS WORSE AND WORSE

Level of ISM indices (*)



NOTE: (*) A level of 50 implies as many optimistic as negative replies.
SOURCE: Institute for Supply Management and own calculations.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007						2008
			1Q	2Q	3Q	October	November	December	January
Real GDP	2.9	2.2	1.5	1.9	2.8	–	2.5	–	–
Retail sales	6.2	4.1	3.5	4.0	4.1	4.8	5.6	3.7	3.9
Consumer confidence (1)	105.9	103.4	109.9	106.7	105.7	95.2	87.8	90.6	87.9
Industrial production	4.0	1.9	2.5	1.7	1.6	1.4	2.2	1.7	2.3
Industrial activity index (ISM) (1)	53.1	51.1	50.5	53.0	51.3	50.4	50.0	48.4	50.7
Sales of single-family homes	–18.0	–26.3	–24.6	–21.2	–26.6	–23.8	–35.8	–40.7	...
Unemployment rate (2)	4.6	4.6	4.5	4.5	4.7	4.8	4.7	5.0	4.9
Consumer prices	3.2	2.9	2.4	2.6	2.4	3.5	4.4	4.1	4.4
Trade balance (3)	–758.5	–711.6	–747.2	–733.9	–708.6	–708.5	–713.2	–711.6	...
3-month interbank interest rate (1)	5.2	5.3	5.4	5.4	5.4	4.9	5.1	4.7	3.1
Nominal effective exchange rate (4)	82.5	77.9	81.9	79.3	77.0	73.9	72.2	73.7	73.1

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

No squeeze on prices thanks to oil.

were optimistic. In manufactures, the index even showed a slight rise from 48.4 to 50.7 points. With the high level of the prices component and the drop in new orders, the picture is of increased corporate concern given that it is the duration of low growth, with the lower sales figures this involves, that can end up undermining company balance sheets.

The consumer price index (CPI) for January moved up going from growth of 4.1% to 4.4% year-on-year because of the particular performance in the energy sector. The underlying component, the general rate excluding food and energy, was also up going from increases of 2.4% to 2.5% year-on-year. Nevertheless, the underlying deflator of private consumption, watched by the Federal Reserve, grew by a more reasonable 2.2%. In this respect, the Fed, following the rise in 2008 does not see any excessive departure from levels at 2.0% over the long term, so that attention is clearly fixed on low growth, putting inflation risks in second place for the time being.

Trade deficit improves again in December after poor November figure.

The trade balance for goods and services in December showed a deficit of 58.77 billion dollars, a year-on-year decrease of 2.6% which puts things in place following the unexpected rise in the deficit in November. Exports were up by a robust 13.6% while imports slowed to growth of 8.4%, which would indicate that in the first quarter of 2008 the foreign sector could make a more tangible contribution to growth of the economy.

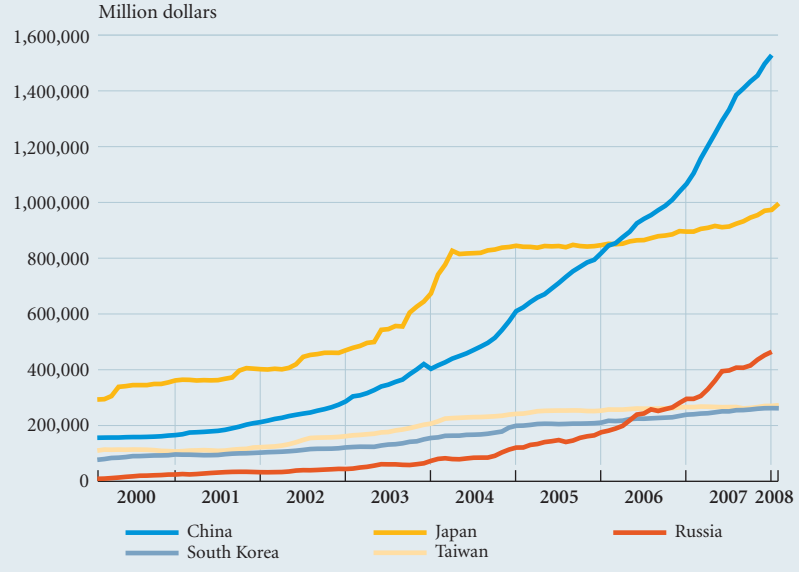
Trade and foreign exchange imbalances: vicious or virtuous circle?

The growth of international trade in recent years has been accompanied by growing imbalances in the balance of payments. In 2007 the United States had accumulated a current account deficit of 700 billion dollars, which stands in contrast to the notable surpluses in economies such as those of Japan, China and other emerging countries. We could expect that these imbalances would be compensated over time by changes in foreign exchange rates but this is not always so as may be seen in the Box «Is it possible to know who is manipulating the exchange rate?» on page 67. The result is an anomalous and rapid accumulation of foreign exchange reserves in a number of economies. The circle is closed when these reserves are invested in assets such as US Treasury Bonds.

It may be expected that the continuing surplus in the current account balance would have the result of an appreciation of the exchange rate, that is the relative increase in prices of goods and services in the country due to the fact that they are more in demand in world markets. This was the case, for example, in the Federal Republic of Germany in the Sixties and Seventies when powerful German exports dragged the deutschemark through periodic revaluations. For the same reason, we may now expect that the exchange rate for the US dollar would depreciate because of the persistent current account deficit. This was so between 2000 and 2007 but only to some extent. While the US dollar has lost value in terms of the euro, the Canadian dollar and the pound sterling, for example, have not done so to the same extent in terms of the currencies of many emerging economies which have major bilateral surpluses with the United States, so that correction of these imbalances has only gone half-way. Among these emerging economies we may distinguish between those whose surplus is based on commodity exports from those that are major exporters of manufactured goods.

INCREDIBLE INCREASE IN RESERVES

Main holders of foreign currency in central banks



SOURCE: International Monetary Fund and own calculations.

US DOLLAR ON DOWNWARD COURSE

Effective real exchange rate of US dollar (*)

NOTES: (*) Real effective exchange rate is calculated in terms of a basket of main trading partners discounting effects of inflation.
SOURCE: Economist Intelligence Unit and own calculations.

With regard to commodity exporters, Saudi Arabia, for example, maintains a fixed exchange rate with regard to the dollar in spite of the fact that between 2000 and 2007 oil prices have quadrupled. Furthermore, as its inflation has been lower than that in the United States, the real exchange rate has dropped. Other major oil exporters, such as Bahrain, Iran, Kuwait and Venezuela, follow a similar pattern with real depreciations of the exchange rate which coexist with current account surpluses. There are notable exceptions in this group, however, such as Russia and Nigeria, whose oil surpluses have been accompanied by major foreign exchange appreciations.

With regard to exporters of manufactured goods, this largely applies to economies in the Far East. The most notable case is China, the country with the biggest surplus in the world with a high positive balance in its bilateral trade with the United States. Its currency, the renminbi, has appreciated slightly against the dollar but, as its domestic prices have risen less than those in the United States and the US currency has lost value, the combination of both these effects is real depreciation of the exchange rate of 0.8% between the end of 2000 and 2007. Other economies exporting manufactured goods, such as Taiwan, Hong Kong and Singapore, with positive figures in current account balance of 9.8%, 7.0% and 21.0% of GDP respectively, have seen depreciations in their real exchange rate. Japan has also been joining this pattern while the exceptions have been South Korea, Thailand and Indonesia, whose currencies have notably appreciated.

The succession of current account surpluses has led to the accumulation of currency reserves in the central banks of all these countries. China's reserves are close to 1,500 billion dollars, those of Japan come close to 1,000 billion, while Russia, Taiwan and South Korea have accumulated another 1,000 billion dollars between them. In view of this major hoard of reserves, the countries of the Middle East and some Asian countries have channelled their surpluses into so-called Sovereign Funds. These are state-owned funds that invest in diversified portfolios of international assets in order to obtain higher returns than through the traditional conservative management of currency reserves. Lately we see greater interest on the part of Asian economies in this means of making balance of payments surpluses profitable. There is therefore great potential for growth of Sovereign Funds. Countries in the Middle East hold two-thirds of the total volume of these funds but in the future the Asian economies will be leading their growth. According to analysts quoted by the Federal Reserve, the delayed entry of the Asian economies in these funds will raise total assets managed from the present 1,500 to 2,500 billion dollars to 15,000 billion dollars over the next ten years, an amount higher than the US nominal GDP in 2007[1].

MAIN SOVEREIGN FUNDS

Country	Name of fund	Year launched	Value (*)	% of GDP (**)
United Emirates	ADIA	1976	625	521
Norway	Government Pension Fund Clobal	1990	322	103
Singapore	GIC	1981	215	169
Kuwait	Kuwait Investment Authority	1953	213	269
China	China Investment Corporation	2007	200	8
Russia	Stabilisation Fund	2004	128	14
Singapore	Temansek	1974	108	85
Qatar	Qatar Investment Authority	2005	60	185

NOTES: (*) Milliard dollars.
(**) 2006.
SOURCE: Standard Chartered and Financial Times.

(1) Joshua Aizenman «Sovereign Wealth Funds: stumbling blocks for stepping stones to financial globalization?» Economic Letter, 2007-38, 14, December 2007, Federal Reserve Bank of San Francisco.

The size of these funds and their state ownership is creating some uncertainty and even rejection in certain circles[2], as happened in the attempt to buy the US Unical oil company in 2005 by the Chinese state-owned oil company CNOOC. Nevertheless, in the financial crisis created by the subprime mortgages, capital provided by some Sovereign Funds to certain banks in trouble have been welcomed and have meant a breather for the markets. The circle of imbalances is being closed to everyone's liking, at least on this occasion.

(2) Lawrence Summers (2007) «Funds that shape capitalist logic», Financial Times, July 29, 2007.

Japan: growth thanks to foreign sector

Japan's GDP grows 1.8% thanks to capital goods investment, public consumption and inventories...

The GDP of Japan's economy grew by 1.8% year-on-year in the fourth quarter, well above expected following a series of figures that pointed to maintenance of a state of weakness. In growth compared with the previous quarter annualized this meant an increase of 3.7%. Support came from the strength of capital goods investment, in public consumption and the increase in inventories. Nevertheless, there was a continuation of the excessive dependence on the foreign sector and weakness in private consumption. Exports, which represented 16.1% of GDP, continued a strong line and, in absolute terms, contributed nearly half of the growth of the whole economy with regard to the third quarter whereas private consumption, which in Japan meant a low 55.2% of GDP, continued to grow by a meagre 1.1% year-on-year.

Construction investment in the third quarter was down 21.4% year-on-year, which may be related to changes in building regulations. Although housing starts are now showing signs of recovery in December they were down 19.0% year-on-year. The reason is that the housing market is not brilliant with sales in December dropping by 42.4% in the Tokyo area. Prices, which in Japan are following a unique situation of strength after sharp drops in the Nineties, held up with increases of 9.2%.

Capital goods investment which improved its recovery this time around compensated for drops in the construction sector. This effect, however, may have reached its limit given that machinery orders, which are an early indicator of investment demand, rose by 3.3% year-on-year in December, well below the figures for September and October. This again underlines the dependence on foreign demand given that orders going to the export industry rose by 11.0% while those for domestic demand were down 3.3%.

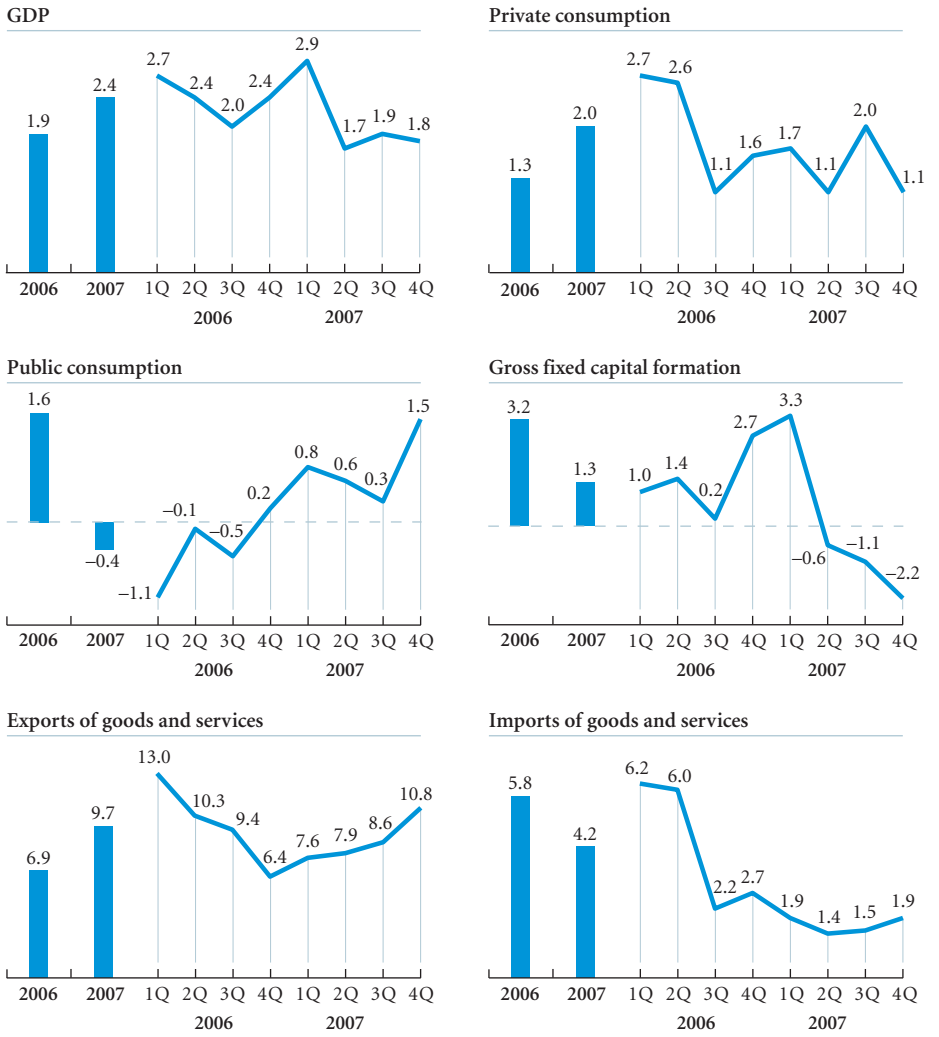
...but dependence on foreign sector increasing with private consumption still weakening.

Toshihiko Fukui, the retiring chairman of the Bank of Japan, could find his recognition as the man who beat deflation somewhat tarnished. With the Tankan index for large manufacturing companies, published by the Bank of Japan, at the 19 points level, with consumer confidence for the same period at the low levelof 38.9 points and with industrial production that grew by a slim 2.2% year-on-year in December, the upward forecasts of the Bank of Japan are in doubt. This comes on top of the fact that the main contributor to the end of deflation has been volatile prices for energy. The CPI was up 0.7% year-on-year in December and the normally

Inflation on positive ground largely due to increase in oil prices.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

Low unemployment and trade surplus remain strong points.

followed index excluding fresh foods was up 0.8%. Nevertheless, publication of the underlying index (the general index excluding energy and food) raised alarm when it showed a drop of 0.1% over the same period the year before and this is inflation that is coming from outside, with import prices that rose by 6.8% in December.

On the credit side, the unemployment rate in December held at a low 3.8% of the labour force while the trade balance continued full steam ahead with a cumulative surplus for the 12 months ending in December of 12,500 billion yen, thanks to the continued good state of exports and the competitiveness of the yen.

Brazil's foreign sector in danger

Brazil's GDP moved up a strong 5.6% year-on-year in the third quarter, an example of the new role acquired by

JAPAN: MAIN ECONOMIC INDICATORS

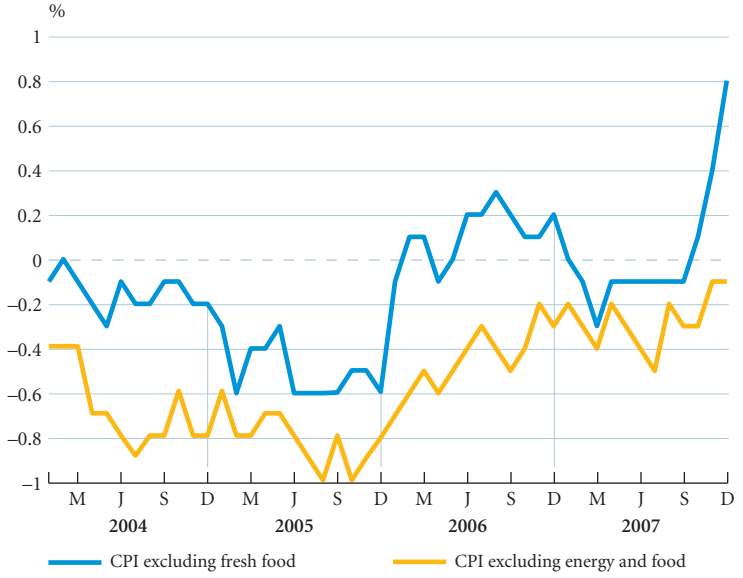
Percentage change over same period year before unless otherwise indicated

	2006	2007	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	2.4	2.1	2.4	2.9	1.7	1.9	–	1.8	–
Industrial production	4.5	2.9	5.3	3.6	2.3	3.3	3.6	1.6	2.2
Tankan company Index (1)	22.5	22.0	25.0	23.0	23.0	23.0	–	19.0	–
Housing construction	4.5	–17.2	5.1	–1.9	–2.8	–36.9	–35.0	–27.3	–19.0
Unemployment rate (2)	4.1	3.9	4.0	4.0	3.8	3.8	4.0	3.8	3.8
Consumer prices	0.2	0.1	0.3	–0.1	–0.1	–0.1	0.3	0.6	0.7
Trade balance (3)	9.4	12.5	9.4	10.2	11.1	12.3	12.7	12.8	12.5
3-month interbank interest rate (1)	0.3	0.7	0.5	0.6	0.7	0.8	0.9	0.9	0.9
Nominal effective exchange rate (4)	81.1	77.1	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.

JAPAN: TWO DIFFERENT STORIES ON CPI

Year-on-year change in price indices



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

emerging countries as a support for world growth in a situation of slowdown in the developed economies. Private consumption moved ahead by 6.1% while investment rose by 14.4%. Nevertheless, the foreign sector showed something of a crisis with exports slowing down sharply leaving growth at a modest 1.8%. The world slowdown may mean that in 2008 the current account balance could be in deficit for the first time since 2002.

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

BRAZIL: MAIN ECONOMIC INDICATORS

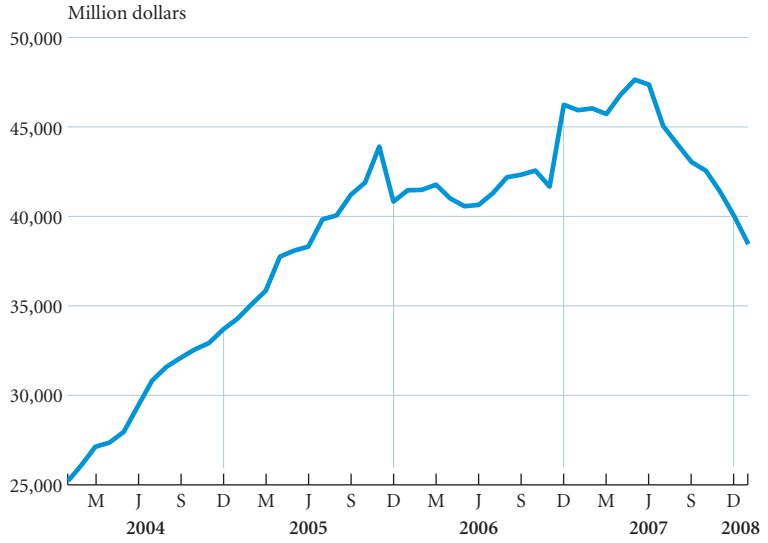
Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	3.1	3.7	5.0	4.5	5.7	5.6	–	...	–
Industrial production	3.1	2.8	3.2	3.8	5.8	6.3	10.5	6.7	6.4
Unemployment rate São Paulo (*)	17.0	15.9	14.3	15.2	15.6	15.0	14.4	14.2	13.5
Consumer prices	6.9	4.2	3.1	3.0	3.3	4.0	4.1	4.2	4.5
Trade balance (**)	40.8	46.3	46.3	45.7	47.4	43.1	42.6	41.4	40.0
Central bank SELIC rate (***)	19.1	15.1	13.4	12.9	12.3	11.4	11.3	11.3	11.3
Reales to dollar	2.4	2.2	2.1	2.1	2.0	1.9	1.7	1.8	1.8

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
(***) Value of central bank rate from the Sistema Especial de Liquidação e Custodia (SELIC).
SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and own calculations.

BRAZIL: TRADE SURPLUS RAPIDLY DROPPING

Cumulative trade balance for last twelve months



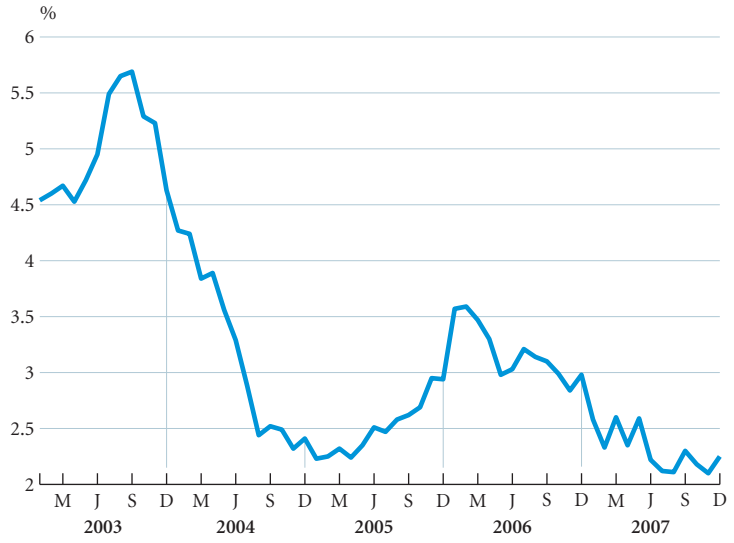
SOURCE: Instituto da Pesquisa Economica Aplicada and own calculations.

Industry continues strong advance but inflation up to 4.6%.

Among latest indicators of economic activity, industrial production in December continued to lose strength from the high in October with growth at 6.4% year-on-year. Industrial production of capital goods, more crucial for a continuation of growth, also dropped somewhat. Even so, the rate of increase held at a more than respectable 19.9%. Along with this slight slowdown in industry, utilization of production capacity dropped from an all-time high to stand at the lowest level since February. On the demand side, retail sales were up 9.9% year-on-year in November and have maintained a strong level in recent months. Also on an uptrend, car sales rose by 35.3%

BRAZIL: SUCCESS IN REDUCTION OF PUBLIC DEFICIT

Public deficit for last 12 months in terms of GDP



SOURCE: Instituto da Pesquisa Economica Aplicada and own calculations.

in January. With this level of economic activity, the CPI is still maintaining moderate levels but a clear upward trend is developing. Prices rose by 4.6% year-on-year in January, a rate clearly above the 3.0% at the beginning of 2007. Following this trend, wholesale prices continued to rise with an increase of 10.3% year-on-year in January.

The unemployment rate in São Paulo district in December continued to drop going to 13.5% of the labour force, a relatively high figure but substantially lower than the 17% which applied in 2005. In December, the savings in the public sector compensated for two-thirds of the interest on the foreign debt putting the deficit for the past 12 months at 2.3% of the GDP, in line with values in 2007 but well below the 3.0% in December 2006. In turn, the real seems to have momentarily stopped its upward trend whereas, partly as a result of the world economic situation, the trade surplus in January was 38.5 billion dollars, some 7.5 billion dollars less than in the same period the year before, thus continuing the downward course begun in June 2007.

Public finances continue on austerity road and unemployment down from 14% but trade surplus continues to drop.

Argentina: a good situation but for inflation

Growth is maintaining a high and stable profile with the GDP growing by 8.7% year-on-year in the third quarter of 2007. Private consumption, with similar increases especially in investment, was up by 12.8% and both continue to be the main supports for growth whereas the foreign sector is still contributing an appreciable surplus. Nevertheless, this certainly positive macro-economic picture has one dark point in the area of control of inflation. Prices in Argentina are rising markedly above what is happening in other countries of the region. On top of this weakness comes the requirement by the International Monetary Fund that the Statistics and Census Institute of

Argentina grows by 8.7% thanks to domestic demand.

ARGENTINA: MAIN ECONOMIC INDICATORS

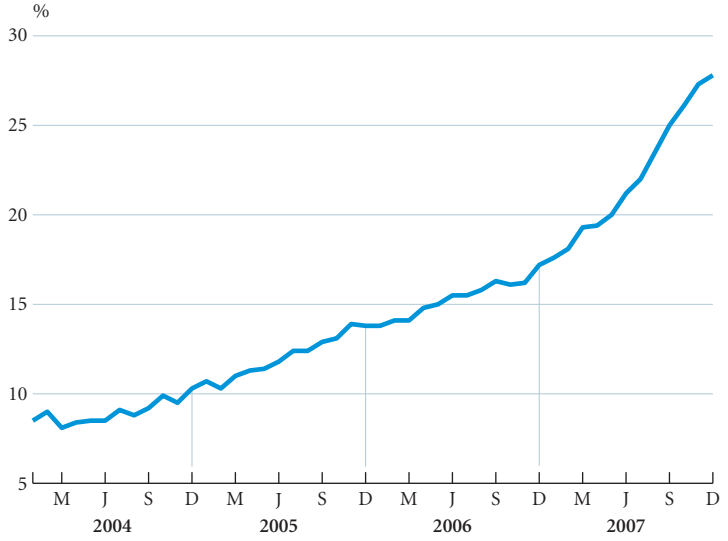
Percentage change over the same period year before unless otherwise indicated

	2005	2006	2006	2007					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	9.2	8.5	8.6	8.0	8.6	8.7	–	...	–
Industrial production	7.3	7.4	6.1	5.6	4.5	2.2	5.3	7.3	...
Unemployment rate (*)	11.6	9.3	8.7	8.2	7.7	7.3	–	...	–
Consumer prices	9.6	10.9	10.1	9.5	8.8	8.6	8.4	8.5	8.5
Trade balance (**)	11.7	12.3	12.3	11.8	11.5	10.5	10.7	10.8	11.2
3-month interbank interest rate (***)	6.2	9.9	10.5	9.7	9.4	12.6	12.9	14.1	14.1
Pesos to dollar	2.9	3.1	3.1	3.1	3.1	3.1	3.1	3.1	3.2

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

ARGENTINA: DEMAND CONTINUES STRONG

Year-on-year change in retail sales at supermarkets (*)



NOTE: (*) Series trend.
SOURCE: INDEC and own calculations.

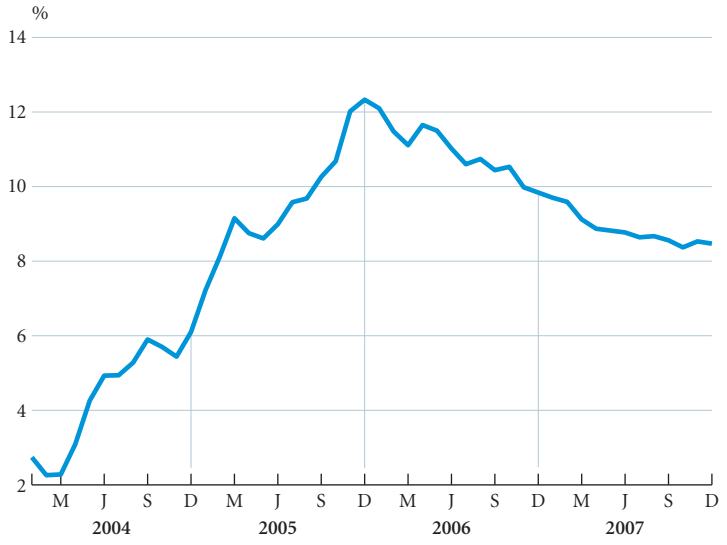
Retail consumption remains strong going close to all-time highs.

the Argentina Republic clarify its figures on inflation and the methodology used for calculating it. The new government of Cristina Fernandez is attempting to apply the US CPI system but, for the moment, retail merchants and especially those holding bonds with interest indexed to the CPI do not appear to be satisfied.

More recent demand indicators continue to point to a continuation of the expansionist cycle. Retail sales in December grew by 26.0% year-on-year in the Buenos Aires region and a strong 30.7% for the total of department stores. Levels back in 1999 before the 2002 crisis now have been exceeded. Car sales in the 12 months ending in

ARGENTINA: INFLATION BOTTLENECK

Year-on-year change in CPI



SOURCE: INDEC and own calculations.

January were up by 26.1% year-on-year, very little below the all-time high. On the supply side things were somewhat calmer but activity in industry was gradually coming close to the level of demand. Industrial production thus sharpened the rise in October with an increase of 7.3% year-on-year.

The strong advance in the automotive sector was added to that in steel and the metal industries which recovered from their slack with growth of 20.5% and 27.1% respectively in November. The paper sector was up and non-metallic mineral industries maintained a notable rate of advance although the chemical sector continued to show signs of weakness. The Synthetic Indicator of Construction Activity maintained the increase shown in the two previous months with a rise of 10.4% in December, while the industrial activity indicator for the same period showed a similar profile with an advance of 9.7%.

Inflation continues to drop very gradually. The CPI rose by 8.2% year-on-year in January, pushed up by energy and commodities. Prospects are still not good given that wholesale prices rose by 15.1% and continued to rise. In the labour market, aided by the strength of demand, the unemployment rate dropped to 7.3% of the labour force in the third quarter, following the statistical series revised downward through the broadening of the sample used by the permanent survey of households. In turn, the trade surplus for December rose to 11.2 billion dollars, the highest figure since June in spite of the rise in domestic demand.

Construction and industry move up with growth around 10%.

Commodities: oil at record prices

Oil recorded new all-time highs in February. On February 26, West Texas Oil closed at 100.7 dollars a barrel (for 1-month delivery). A barrel of Brent for the same delivery hit 98.76 dollars. Although prices later were corrected

Inflation at 8.2% presents risk while unemployment drops to 7.3%.

Oil continues at high levels going above psychological figure of 100 dollars a barrel.

slightly the average figure for February, more than 94 dollars (for Brent) was the highest in history. How can we explain this unexpected break in what seemed to be a solid downward trend which began in the first 10 days of January?

While determining the underlying factors is not an easy exercise, on this occasion it seems that the factor of restrictions in supply has been more important than the trend in oil demand. In keeping with macroeconomic prospects, the latter factor should not have been pushing up prices. In this respect, both the US Department of Energy and the International Energy Agency recently reduced their demand forecasts for 2008.

Problems of supply probable culprits in recent price upturn.

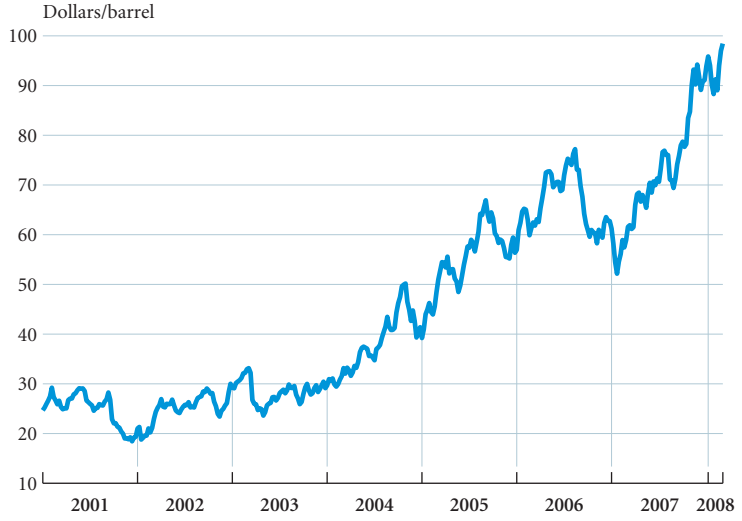
If it is not demand, must it be supply? Available figures indicate that oil extraction capacity is limited, with that existing in Saudi Arabia being the only significant example. This explains that speculation on the possible maintenance (or even a hypothetical cut) in production by the Organization of Petroleum Exporting Countries (OPEC) next March 5 may have acted in setting off the rise.

This factor has also been reinforced by a succession of news items about other problems in the oil production and distribution chain. These include a breakdown in an important Texas refinery, leaks in a Nigerian oil pipeline, suspension of Russian supply to Germany because of disagreement over prices, etc. Finally, the gap between supply and demand continues to be seen as unsatisfactory, as shown by the fact that petroleum reserves in the countries making up the Organization of Petroleum Exporting Countries (OPEC) measured in days of supply are at their lowest level in three years.

The trend in other commodities rounds out a troubling scene. «The Economist» index for commodities in dollars shot up 8% in February. This sharp rise was due to the strength

OIL SETTLES INTO REGION OF ALL-TIME HIGHS

1-month per barrel price of Brent quality oil as weekly averages



SOURCE: Thomson Financial Datastream.

RAW MATERIALS PRICES

	2005	2006	2007				2008	
			1Q	2Q	3Q	4Q	January	February
«The Economist» index in dollars (*)								
General	**3.4**	**27.5**	**21.8**	**17.7**	**17.2**	**17.2**	**23.2**	**31.8**
Food	–1.8	10.8	16.5	18.9	30.9	34.6	44.9	55.6
Industrials	9.8	46.1	26.9	17.0	6.4	2.5	3.4	10.0
Non-food agricultural	*–2.4*	*12.4*	*4.5*	*3.1*	*7.6*	*25.9*	*21.0*	*20.8*
Metals	*13.6*	*62.0*	*36.2*	*21.8*	*6.2*	*–3.8*	*–2.0*	*6.4*
«The Economist» index in euros (*)	**3.3**	**26.0**	**11.6**	**9.8**	**8.6**	**4.5**	**9.4**	**17.1**
Oil (**)								
Dollars/barrel	55.3	66.4	58.7	68.7	74.5	88.4	91.9	94.4
Change rate	45.5	20.1	–6.7	–2.6	5.0	45.0	67.3	60.8
Gold								
Dollars/ounce	445.3	604.4	649.6	667.8	680.2	788.2	888.9	923.1
Change rate	8.7	35.7	17.2	6.4	9.4	28.3	40.8	38.9

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

noted in two components, food and metal commodities, both with increases of close to 9% that month. By specific product, we should mention the substantial increases taking place in February in platinum (rise of 30% recording all-time highs), copper (15%), coffee (14%), aluminium (10%) and cocoa (8%). The sharpness of these movements reminds us that, given the yield on other areas of investment, part of available capital is being directed into certain commodities.

Metals and food commodities show dizzying increase in levels.

EUROPEAN UNION

European Commission forecasts: 2008 to be difficult year

Financial upsets, weakness in USA and energy prices bring downward revision of Euro Area growth in 2008...

Less growth with more inflation. That would be a short summary of how the European Commission sees 2008. In its early Spring forecasts it predicts that economic growth this year will stand at 1.8%, four decimals less than the rate put out in its previous forecasts in Autumn. Growth in the Euro Area in 2007 was 2.7% so that current forecasts point to a substantial economic slowdown. For the European Union as a whole, growth of 2.0% is expected in 2008, also four decimals lower than forecasts published last Autumn.

...and rise in inflation although price pressures will ease during year.

The forces having a negative effect on growth are basically the effects of the current financial crisis, the poor state of affairs in the United States and high commodity prices. The European Commission puts a specially strong role on the first of these causes, noting that the functioning of the various segments of credit continues to be affected by the financial upsets.

With regard to prices, the rise seen in recent months still cannot be considered over. As a result of price increases of energy and food, inflationary pressures will be strong in the first quarter of 2008. For the rest of the year the situation will gradually improve. Annual average in 2008 will be 2.6% in the Euro Area and 2.9% in the EU.

While the European Commission recognizes that the scenario presents risks in the sense that the reality may be worse than foreseen, its forecasts seem fairly optimistic in terms of growth and more in keeping with the consensus of analysts with regard to prices. To make a comparison, some weeks ago the

EUROPEAN COMMISSION MACROECONOMIC FORECASTS

	Growth			Inflation (*)		
Country	Current forecast for 2008	Previous forecast for 2008 (**)	Difference	Current forecast for 2008	Previous forecast for 2008 (**)	Difference
Germany	1.6	2.1	–0.5	2.3	2.0	0.3
Spain	2.7	3.0	–0.3	3.7	2.9	0.8
France	1.7	2.0	–0.3	2.4	1.7	0.7
Italy	0.7	1.4	–0.7	2.7	2.0	0.7
Euro area	**1.8**	**2.2**	**–0.4**	**2.6**	**2.1**	**0.5**
United Kingdom	1.7	2.2	–0.5	2.5	2.2	0.3
EU-27	**2.0**	**2.4**	**–0.4**	**2.9**	**2.4**	**0.5**

NOTES: (*) Harmonized consumer price index.
(**) Date of forecast: November 2007.
SOURCE: European Commission.

International Monetary Fund was predicting that the Euro Area would grow by 1.6% in 2008.

Euro Area: slowdown already here

In his fine novel *The Tartar Steppe*, Dino Buzzati describes a troop detachment that is spending considerable time preparing to face an imminent attack by the Tartars that never takes place. Finally, when the long wait has exhausted the energy of the defenders, the Tartars arrive and crush the fort. Without going to these lengths, the slowdown in the Euro Area, that has been coming for some months, seems like Buzzati's ghost-like enemy. Now it has finally arrived and no doubt will be with us for some time. Fortunately, Europe's defences are better than those in the novel.

It was during the fourth quarter of 2007 that it was notable that the foot was off the growth accelerator. After reaching a rate of increase in gross domestic product (GDP) of 2.7% year-on-year in the third quarter, in the final three months of last year the economy has moved ahead at a more moderate rate of 2.3% year-on-year. In quarter-on-quarter rate raised to annual rate, the sharpness of the slowdown becomes more noticeable given that it drops from 3.1% to 1.7%, that is to say, in the fourth quarter it grew at a rate nearly half that recorded in the previous quarter.

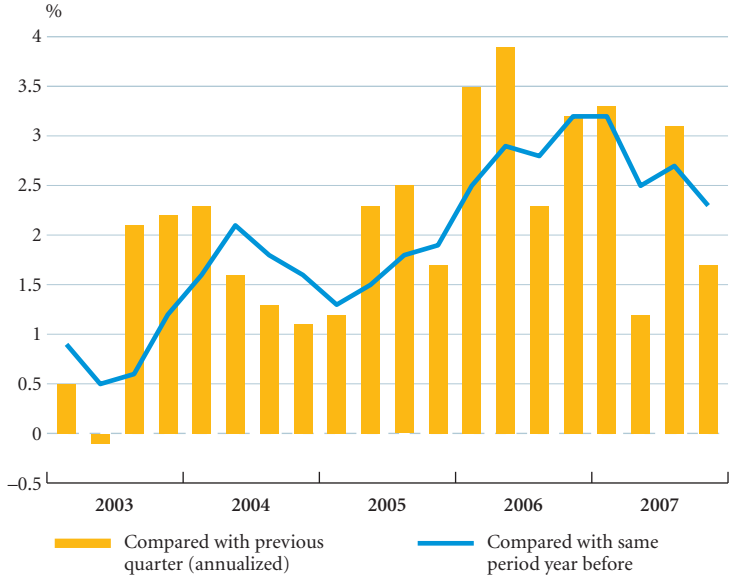
Substantial drop in growth in fourth quarter.

In itself this figure is not alarming. Although the breakdown by component has not yet been published, the performance in the latest monthly indicators provides some clues about the current economic situation in Europe. In general, the economic sentiment indicator suggests how this is producing a link between the fourth quarter of 2007 and the first quarter

Slowdown grows sharper at start of 2008.

EURO AREA STEPS ONTO SLOWDOWN TRACK

Change in gross domestic product in real terms



SOURCE: Eurostat and own calculations.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007						2008
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	1.6	2.9	3.2	3.2	2.5	2.7	–	2.3	–	–
Retail sales	1.2	2.1	2.3	1.7	1.0	1.4	0.9	–1.2	–1.9	...
Consumer confidence (*)	–13.9	–9.1	–7.2	–5.4	–2.6	–3.9	–6.2	–8.1	–8.7	–11.5
Industrial production	1.3	4.0	4.1	4.0	2.8	4.1	4.3	3.1	1.3	...
Economic sentiment indicator (*)	97.4	106.3	109.3	109.4	111.0	108.7	105.4	104.1	103.4	101.7
Unemployment rate (**)	8.8	8.3	7.9	7.6	7.5	7.4	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	15.7	31.7	37.9	35.9	28.3	...
3-month Euribor interest rate (*)	2.2	3.1	3.6	3.8	4.1	4.5	4.8	4.6	4.8	4.7
Nominal effective euro exchange rate (*)	103.3	103.6	104.6	105.5	107.1	107.6	109.4	110.0	111.5	112.1

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

of 2008. After a moderate drop in October and November, in December and especially in January, this indicator dropped more clearly. This suggests that the loss of economic drive took real shape only very close to the end of 2007 and that this is continuing at the start of 2008.

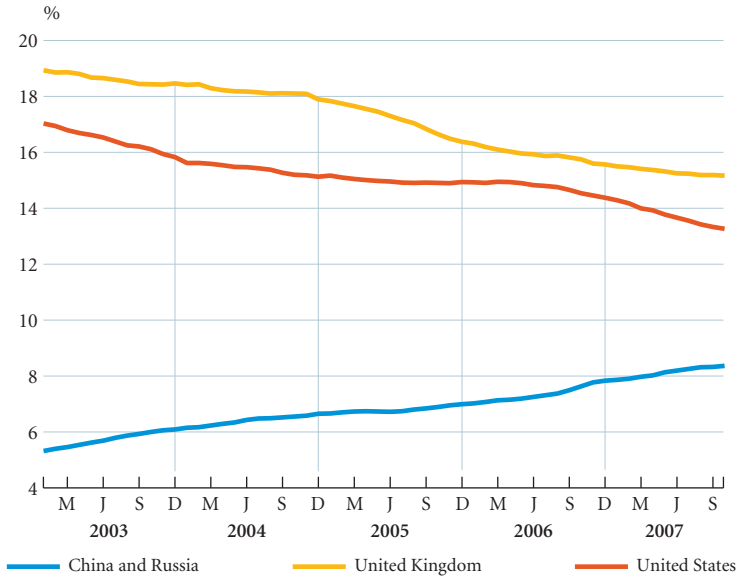
Other supply indicators are also useful in identifying the cyclical drop. The most significant of these, industrial production, grew by a moderate 1.3% year-on-year in December (3.1% in November) and the drop in the industrial climate in January also indicates reduced strength in coming months. While showing stronger growth momentum up until December, services also eased their drive in January.

On the demand side, the story is repeated. Both consumption and investment have shown downward indicators. With regard to household spending, retail sales were down 1.9% year-on-year in December and the future does not look very buoyant, seeing that consumer confidence dropped by more than five points between October and January. Similarly, capital goods production, a good indicator of investment, moved up 2.4% year-on-year in December as compared with 5.2% year-on-year in November.

In turn, foreign demand, which up to now has been playing a fundamental role in sustaining economic activity, showed an initial change of trend in November, a month when the trade surplus, as a cumulative figure for 12 months, dropped to 35.9 billion euros (37.9 billion in October). In December, this trend not only was consolidated but there was a surprising increase in the drop with a surplus going to only 28.3 billion euros.

WILL DECREASED DRIVE IN INDUSTRIALIZED MARKETS BE COMPENSATED BY THOSE OF EMERGING REGIONS?

Percentage total exports of Euro Area by geographical destinations.
Cumulative figure for 12 months



SOURCE: Eurostat and own calculations.

The main reason for this movement was weaker exports which combined with maintenance of the rate of imports. It seems undoubted that the feared effect on export prices of an appreciated euro is now touching foreign sales. What is more, it would seem that efforts to shift European exports toward the emerging economies and reduce dependence on the United States made in 2007 had reached their limit.

Exports beginning to suffer.

The present picture in the Euro Area, which based on the above factors may be reduced to less consumption, investment and exports, also includes a less positive than expected trend in the labour market and a frankly negative appreciation on the prices front. With regard to the first point, the unemployment rate in December stood at 7.2% of the labour force, thus repeating the figure for November. In the final months of 2007 we saw some restraint on the decrease in unemployment, a situation expected to continue in coming months.

Nevertheless, the situation in inflation is worse. Latest available statistics showing a breakdown, those for December, indicate that the harmonized consumer price index (HCPI) grew by 3.1% year-on-year due to the impact of the energy and food components. If these are excluded, the situation is no better seeing that underlying inflation in December stood at 2.3% year-on-year, a definitely high figure. In January, inflation added on one decimal more to reach 3.2% year-on-year, a rate still farther away from the European Central Bank objective (2%).

Inflation at troubling levels.

Here we must go back to earlier remarks in this chapter of the Monthly Report indicating that economic growth in the Euro Area will continue

to lose steam at least until the end of 2008, without discarding that it may reach a bit farther. On the other hand, prices should leave behind current levels as the year goes on. This scenario does not bear signs of being as dramatic as people are predicting for the US economy.

In the European situation there are a number of resources that may ease the slowdown process. The budgetary situation of the Euro Area member states has some margin for fiscal policy to play something of an opposite role. In spite of the fact that the unemployment rate has a limited downward path, job creation, even if it were to slow compared with 2007, is expected to be positive in 2008 and this provides a fund of strength for consumer spending. The good international environment (outside the United States) should mean that the drop in exports could hit bottom in coming months. Finally, the trend in profits of non-financial companies is acceptable while profit margins continue to increase.

Euroland: Together but not an item

For those pro-Europe, the European Economic and Monetary Union (EMU) is like Disneyland for a child –a dream come true. On January 1, 2009 that dream will celebrate its 10th birthday. To commemorate the date, the European Commission is preparing a report with a detailed analysis of the path followed by the EMU. Among other questions, the report intends to evaluate the impact of the single currency on the economies of the Euro Area. The task is not simple: while on paper the costs and benefits of participating in the monetary union seem clear enough, the real impact of the EMU remains to be determined.

From a theoretical perspective, joining a monetary union has its price –the sacrifice of giving up the country's own monetary and exchange rate policies. A country participating in a monetary union has little influence on the fixing of the interest rate –especially if it is a small country– and it cannot take recourse in depreciating its exchange rate in order to resolve a problem of competitiveness. All of this involves a substantial cost for those countries whose national business cycles are very much in disaccord with those of the other member states or for those with serious problems of competitiveness. Nevertheless, for a country with a history of high inflation, the measure may turn out to be beneficial if it brings credibility and seriousness in carrying out monetary policy and thus reduces inflation expectations over the long run.

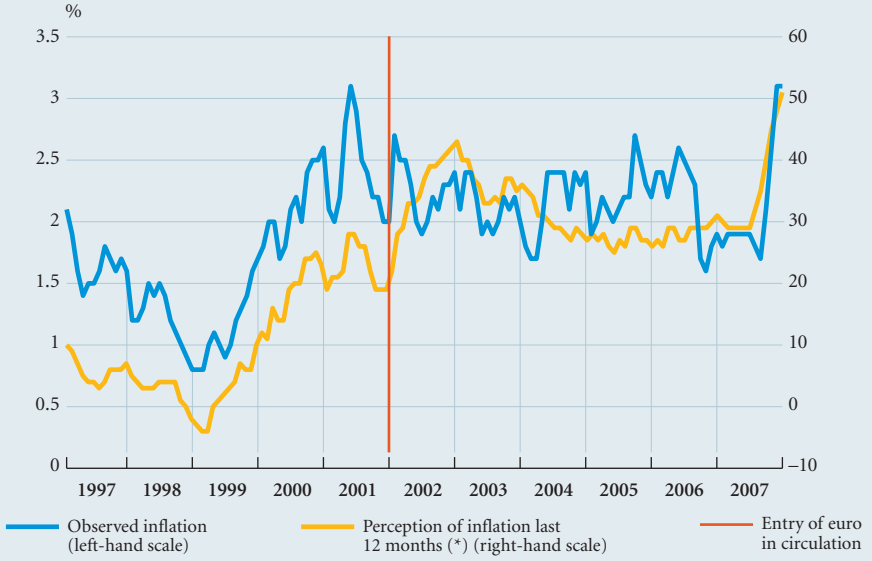
The single currency can also bring other benefits. Most of these benefits arise from a reduction in costs associated with the use of many currencies, basically transaction costs and risks resulting from exchange rates uncertainty. The removal of these barriers drives trade and international investment within the union resulting in greater commercial and financial integration of the participating economies. In turn, we may expect that this greater integration will not only facilitate convergence of national business cycles –and thus the carrying through and effectiveness of a single monetary policy– but also competition and a more efficient allocation of resources, laying down the road to a path of higher growth.

In the reality of the EMU, some studies suggest that from the beginning of the Nineties there has, in fact, been greater synchronization of the business cycles of member states, which reduces the cost of participating in the monetary union. Nevertheless, other experts maintain that, in spite of greater synchronization, the

determinants of national business cycles continue to be quite different so that we cannot speak of a European business cycle or conclude that the costs of participation are insignificant.

With regard to prices, the European Commission believes that, in general, the adoption of the euro has helped controlling inflationary pressures. This goes in contrast with the perception of many citizens that the introduction of the euro imposed an additional cost in terms of inflation at the moment of conversion from local currencies. According to a survey carried out by the European Commission at the end of 2006, 93% of respondents believed that the euro created inflation. Given that conversion exchange rates were fixed sufficiently in advance, it was to be expected that the entry into circulation of the euro on January 1, 2002 would be neutral with regard to the level of prices and therefore there would be no reason to anticipate any significant increase in real inflation or in perceived inflation. Nevertheless, while both studies by the Bank of Spain and the European Commission conclude that the impact of the euro's entry into circulation was moderate (less than 0.3 percentage points), that impact was magnified in the eyes of consumers. As shown in the following graph, citizens perceived a higher increase in inflation than that reflected in the statistics.

PERCEIVED INFLATION NOT ALWAYS COINCIDED WITH REAL INFLATION



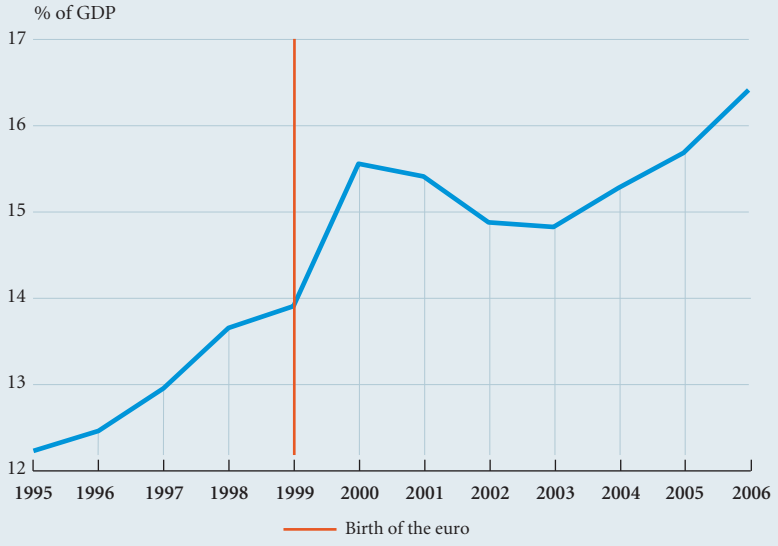
NOTES: (*) Difference between proportion of those surveyed who believed that prices had risen much or moderately and the proportion of those surveyed responding that prices had dropped or had scarcely changed. In percentage terms and seasonally adjusted.
SOURCE: European Commission, Eurostat and own calculations.

Although a number of explanations have been considered, it is not clear what explains this divergence between observed and perceived. One hypothesis states that many citizens continue to value prices in terms of their old currency and, instead of comparing the current price with last year's, they may be comparing it with the price in the year before conversion, ignoring the cumulative inflation since then. Another explanation alludes to the existence of previous expectation of an inflationary effect of the euro that might have driven an upward bias in the perception held by consumers. A third hypothesis, with many supporters, starts out from the idea that consumers base their perception of inflation on the prices of those goods they

normally buy, such as food, fuel, and personal services, and on the fact that, for various reasons not necessarily related to the euro, the prices of those products rose more than the mean around the date of conversion to the euro. Furthermore, the form of payment also affects the perception of inflation because we tend to assign greater weight to those products that are usually paid for in cash (such as morning coffee and newspapers which also belong to all those most frequently-bought consumer products) than those paid through bank orders. In any case, as seen in the above graph, the gap between perceived inflation and real inflation lasted only two years.

In terms of benefits and with regard to trade integration, the disappearance of nominal exchange rate risk and lower transaction costs within the EMU have certainly shown up in a greater volume of trade (see graph below). Between 1998 and 2006 the ratio of exports to GDP within the euro area rose by three percentage points exceeding 16% whereas exports of services rose by nearly 1 percentage point coming close to a –still modest– 3.5% of GDP. Furthermore, everything indicates that this higher volume of trade was not at the expense of trade with third countries.

INTRA-EMU EXPORTS HAVE INCREASED



SOURCE: Eurostat and own calculations.

In spite of everything, the volume of trade within the euro area has increased much less than was predicted by some experts such as Professor Andrew K. Rose (Berkeley University). According to his early predictions, participating in a monetary union would triple the volume of trade between member countries. Although in later studies Rose reduced that figure, Richard Baldwin, economist at the Graduate Institute of International Studies in Geneva, has estimated that the increase in trade attributable to adoption of the euro did not exceed 9%.

On the financial side, a series of European Central Bank indicators suggests that the degree of integration within the EMU has been advancing although that progress was not homogeneous in all markets. For example, while the interbank money market has been fully integrated right from the beginning and the government

bond market has been gradually converging, other markets such as the mortgage market and stock markets seem to be less integrated although they show signs of convergence. Commercial banks, which continue to be quite segmented, turn out to be something largely to be resolved, although this is a market which given its nature is often of a regional or national dimension.

In a nutshell, in spite of the fact that the euro has contributed to greater integration, there still exist barriers to a true single market within the EMU so that many of the benefits attributed to the single currency are still to be achieved. It is therefore desirable to see progress in matters still unresolved which frequently have a non-economic component. Barriers of a cultural or institutional nature require other sort of reforms and probably more time and willingness on everybody's part. In any case, that is not the euro's duty.

Germany: industrial engine down some revolutions but holding up

Germany's very international economy is not escaping the slowdown wave on the world economic scene. In the fourth quarter of 2007, German growth stood at 1.8% year-on-year, a notable drop from the 2.5% in the third quarter. This slowdown was due to a worse performance in practically all GDP components although we should underline the worsening of private consumption and exports.

Starting out from this reality, two basic questions about the current economic situation in Germany are attracting attention. First, the real state of German consumption and its immediate prospects. Normally, the German consumer tends to adjust the rate of spending fairly quickly in times of uncertainty such as now. With available figures, it does not seem that on this occasion this behaviour is greatly different from the norm.

While the latest figure for retail sales (drop of 6.9% year-on-year in December), this has a downward bias because of the fact that December 2006 was atypically strong, and the background trend is toward increasing weakness. In this respect, consumer confidence is more reliable and the drop in January to –1.1 points indicates a loss of strength but not a collapse in consumption.

Germany showing troubling consumption level, variable unlikely to move up in near future.

A similar feeling, with some support for consumption, comes from the point of view of consumption fundamentals. Inflationary pressures (the CPI in January brought two consecutive months at 2.7%), which affect real purchasing power, are going to be counteracted by the continuing improvement of the labour market (the unemployment rate dropped to 8.1% in December and may not yet have exhausted its downward potential). Overall, however, we are expecting a relatively contained level of household spending over coming months.

Industry continues role as engine of growth...

Another point of interest is industry. The year 2007 was largely that of industry, especially export manufacturing industry. Now, with a strong euro and a world slowdown, the figures are being scrutinized with renewed interest. First, the good news. In spite of a drop in strength, industrial production continues to grow at notable rates. In December, this indicator rose to 4.3% year-on-year, beating the figure of 4.1% in November. The rise in industrial orders in the fourth quarter is prolonging the

...but immediate prospects not promising.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007						2008
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	1.0	3.1	3.9	3.7	2.6	2.5	–	1.8	–	–
Retail sales	1.4	6.1	6.6	–1.0	–1.9	–1.8	0.6	–3.3	–6.9	...
Industrial production	2.8	6.0	6.3	7.5	5.3	5.5	6.3	4.1	4.3	...
Industrial activity index (IFO) (*)	95.5	105.5	107.0	107.5	108.0	105.4	103.9	104.2	103.0	103.4
Unemployment rate (**)	11.7	10.7	10.0	9.4	9.2	8.9	8.7	8.5	8.3	8.1
Consumer prices	2.0	1.7	1.3	1.8	1.8	2.1	2.4	3.1	2.7	2.7
Trade balance (***)	156.3	151.6	155.3	165.5	178.3	192.0	196.9	198.1	199.4	...

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

France holds growth in fourth quarter in somewhat unexpected result.

boom in the secondary sector to the early months of 2008.

We now look at those aspects not so positive. Exports, a key variable for industry, continue to lose ground, not all of a rush but without stopping. While in terms of cumulative surplus for 12 months, the foreign sector improved its positive position as of December, exports went from growth rates of 13%-14% year-on-year (always in cumulative terms for 12 months) in the first three quarters of 2007 to growth five points lower in December. This trend no doubt weighs heavily on the spirits of German business executives. The IFO index of industrial activity is recording notable swings with a background downward trend. While January and February rose, the drop in December was not fully compensated by this. An analysis of the situation becomes quite clear. We are seeing a notable loss of drive in business activity.

France: fourth quarter brings relief

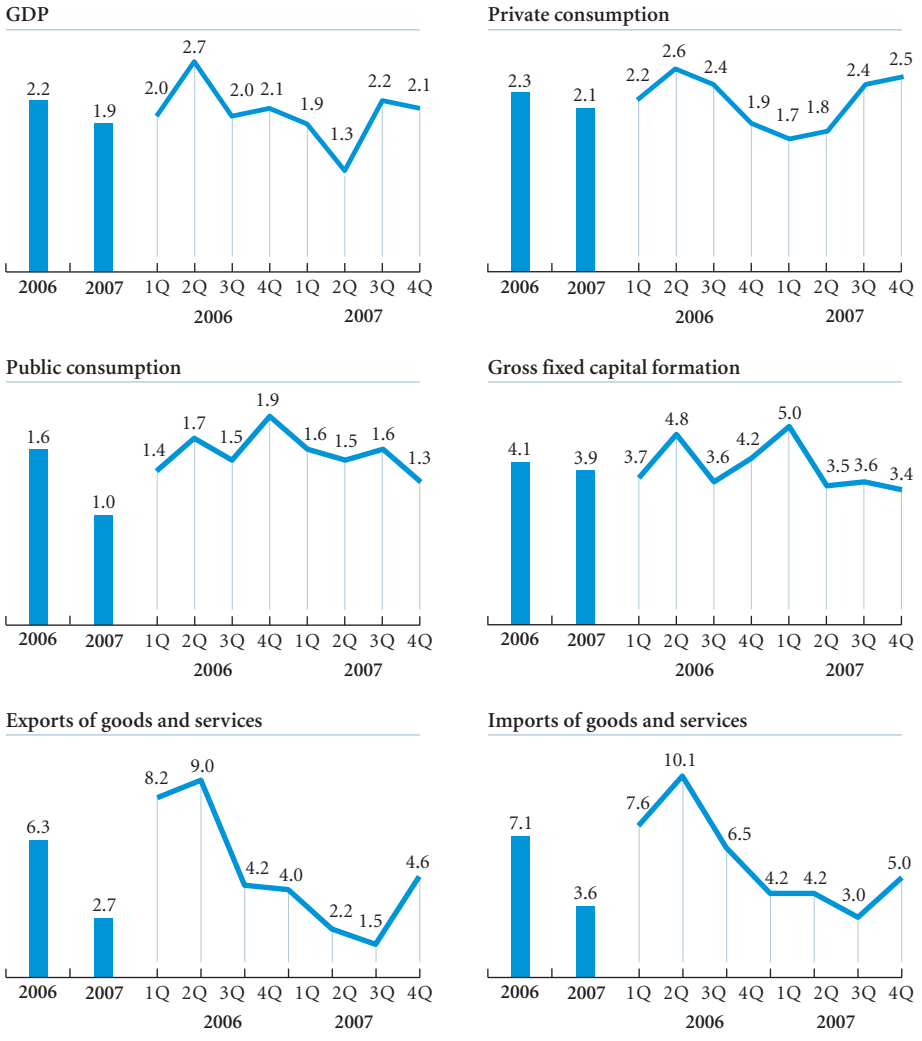
Loss of economic growth rate to progressively take shape.

The performance of the French economy in the final stages of 2007 was troubling. The indicators pointed to a worsening of the economic situation. Finally, national accounting figures for the fourth quarter were better than expected. The GDP moved up 2.1% year-on-year in that period merely one decimal less than the 2.2% in the third quarter. The rise in private consumption compensated for the lower drive in public consumption and investment and the bigger drain coming from the change in inventories. Foreign demand, in turn, made a nil contribution to the change in GDP. This was the first time since the first quarter of 2006 that the contribution from the foreign sector did not take away from growth.

The above figures, which suggest that France is escaping relatively unscathed from the economic slowdown, must be taken with caution. Firstly, the French economy is showing a cyclical profile different from the large European economies given that it had lost strength between 2006 and the first half of 2007. A second factor to keep in mind is that as of the end of 2007 the economy has fallen more in line with the behaviour dominant in the Euro Area, that is, showing a loss of strength.

TREND IN FRANCE'S GDP BY COMPONENT

Percentage year-on-year change



SOURCE: INSEE and own calculations.

More significant recent indicators confirm this trend both on demand side and supply side. While the level of household consumption remains appreciable (increase of 4% year-on-year in December), the collapse of consumer confidence in January suggests that French households will soon move into a stage of greater containment in spending. On the supply side, industrial production has rapidly left behind the annual highs seen in October, moving ahead in December by a mere 1.2% year-on-year. The erratic course of industrial confidence up to January and the low level of industrial orders (also up to January) draw a scenario for industrial activity on the wane.

On the other hand, while France is showing a particular pattern in terms of growth, this is not showing up either in terms of unemployment (in December the unemployment rate was down one decimal to 7.8%) or in prices. On the latter front, the rise in inflation to 2.8%

Ecofin issues sharp reprimand on France's weak objectives for controlling government deficit.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007						2008
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	1.7	2.2	2.1	1.9	1.3	2.2	–	2.1	–	–
Domestic consumption	3.2	2.7	2.8	3.6	2.8	4.2	3.0	2.6	4.0	...
Industrial production	0.3	1.0	0.7	1.1	0.2	2.1	4.1	2.1	1.2	...
Unemployment rate (*)	9.3	9.2	8.9	8.7	8.5	8.2	8.0	7.9	7.8	...
Consumer prices	1.7	1.7	1.3	1.2	1.2	1.3	2.0	2.4	2.6	2.8
Trade balance (**)	–15.7	–26.7	–28.3	–28.7	–30.4	–32.5	–35.0	–37.4	–39.0	...

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

Fall of government complicates already poor economic outlook.

year-on-year in January was caused by shared European problems involving pressures from energy and food.

Nor does the special French case manage to meet EU rules on controlling the government deficit. Although last summer Nicolas Sarcozy was saying that France should postpone the general objective of reaching a budget balance until 2012 (while the other member states of the Euro Area would do so in 2010), the Ministers of Economy and Finance meeting on February 12, spoke out against this lack of effort to control the public finances.

Italy: a complicated year ahead

The fall of the Prodi government and the subsequent calling of elections has torn up the previous script for 2008. Before the legislature ended it seemed that Romano Prodi's team would try to push through some additional economic reforms while carrying out a fiscal policy that tended to avoid increasing the government deficit. Nevertheless, few people were expecting Italy to grow much above 1% in 2008. Now the political picture has lowered the economic prospects even more.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2005	2006	2006	2007						2008
			4Q	1Q	2Q	3Q	October	November	December	January
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	0.6	0.8	–1.4	–3.0	–4.8	...
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	2.9
Trade balance (**)	–5.1	–18.2	–22.0	–19.6	–16.0	–11.6	–9.0	–8.4	–9.5	...

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

The starting point is certainly far from bright. Consumption is not strong with retail sales growing by a low 0.3% year-on-year in November and industrial production of consumer goods dropping by 7% year-on-year in December. If we are to go by the collapse of industrial production (year-on-year drop of 4.8% in December), industry is not finding support either in domestic demand or foreign demand.

The latter point was underlined by figures for foreign trade in December. Exports during that month, in cumulative figures for 12 months, were down two percentage points which, combined with a lower drop in imports, meant that the foreign deficit (in cumulative figures for 12 months) again rose, something that had not happened since October 2006. Nor is inflation easing off as it stood at 2.9% year-on-year in January compared with 2.6% in December. In this context, the drop in the unemployment rate to 5.9% in the third quarter is not sufficient consolation.

As these are the latest figures, little improvement can be seen over the short term. Qualitative indicators, which give some early signals, are showing a major drop of confidence in the economy on the part of companies and consumers. Consumer confidence, services and industry could either stand on negative ground or keep dropping up to January. Along these same lines, the indicator made up of early indicators ended 2007 with an increased rate of drop for recent months, something that suggests that the first half of 2008 will be quite weak.

Poor indicators for industrial activity, exports and prices.

United Kingdom: open on too many fronts

Following many years playing a brilliant role, the British economy is beginning to show an accumulation of problems not foreseeable some months back. The attempt to gradually control growth of consumption came up against the tightening of credit terms which has brought about a rather sharp adjustment. Retail sales in December

Bank crisis, fiscal reform, government deficit, weakness in real estate and drop in consumption present too many obstacles for British economy.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006						2007
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	1.8	2.9	3.3	3.1	3.2	3.3	–	2.9	–	–
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	–0.1	0.6	0.3	1.0	0.3	0.7	...
Unemployment rate (*)	2.7	2.9	2.9	2.8	2.7	2.6	2.5	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	2.2
Trade balance (**)	–64.9	–74.0	–76.9	–78.1	–79.7	–82.8	–85.7	–86.9	–87.4	...
3-month Libor interest rate (***)	4.9	4.6	5.1	5.3	5.6	6.0	6.3	6.3	6.6	6.0
Nominal effective pound exchange rate	99.6	98.0	102.7	103.9	104.0	104.3	102.2	102.9	101.2	97.6

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

Second half of 2008 with poor economic growth expected to lie ahead.

were up 2.7% year-on-year whereas one month earlier they rose at the rate of 4.2%.

The financial solvency problems of the banks brought with it a controversial government option to nationalize the Northern Rock bank, the first such case since the Seventies. The difficulty in controlling the public debt and the government deficit, even after some boom years, has come on top of fiscal reform for taxing capital gains, which has also been very controversial. In 2008, the government deficit will likely go above 3% of GDP and, following nationalization of Northern Rock, the public debt will go up to 44% of GDP. Finally (at least for now), the situation in the real estate sector remains very weak, as shown by the fact that housing starts are at their lowest level in four years.

All of this together shows rather lean prospects for the British economy. In spite of the fact that consumer prices have stabilized at the 2% range (2.2% year-on-year in January) and that the unemployment rate is holding at a low 2.5%, in January as well fundamental economic activity indicators, such as economic sentiment and consumer confidence, are clearly pointing downward. According to forecasts by the Bank of England and those put out by various analysts, the critical moment will be the second half of 2008, a period when the economy will hit bottom. How deep that bottom will be is the question to be solved in coming months.

Monetary and capital markets

US concerned about growth, Europe about inflation

Top US economic authorities explain strategies to Senate.

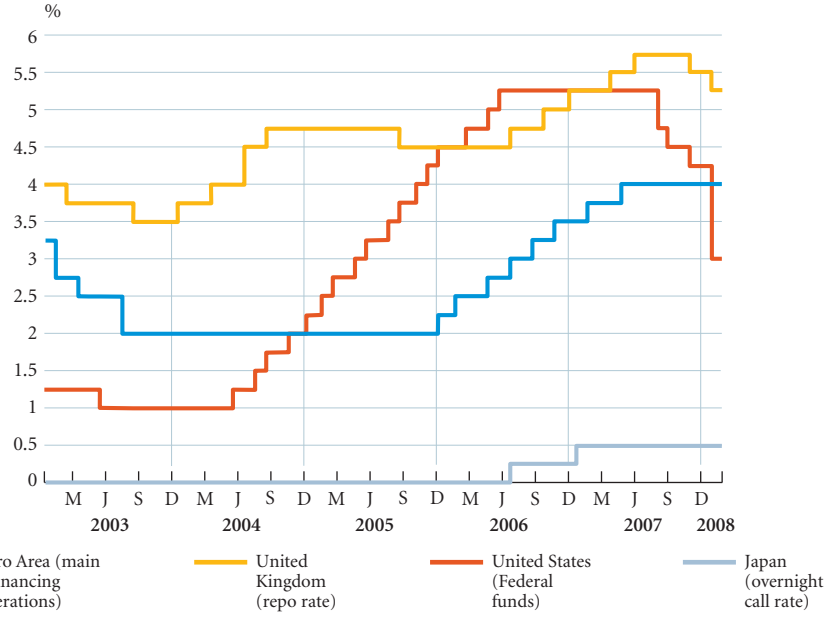
On February 14, there was a sombre atmosphere at the Senate appearance of Ben Bernanke, governor of the Fed, Hank Paulson, Secretary of the Treasury and Christopher Cox, chairman of the Securities and Exchange Commission (SEC).

Bernanke, in his first appearance following the cut of 1.25 percentage points in the Fed's reference rate in January, detailed forecasts for economic activity for the year. The crux of his statements was based on three messages. The first was that he was expecting low growth in the first half of this year with a slight recovery in the second half. The risks in this scenario are for a drop in terms of economic activity. Secondly, he was expecting some easing of inflation, that is to say, this matter has moved into second place in the list of the central banks concerns. Finally, the corrolary of this analysis was his stated willingness to continue reducing interest rates.

Secretary of the Treasury Paulson spoke about the fiscal plan and the speed with which it would be implemented. He also spoke of efforts being made to avoid mortgage foreclosures. For his part, the president of the SEC underlined the need to increase

BANK OF ENGLAND LOWERS REFERENCE RATE TO 5.25%

Central bank reference rates



SOURCE: Central banks.

Inflation causes concern in Europe.

transparency on Wall Street. Both received sharp criticism for not having acted more rapidly in the subprime mortgage crisis in the United States.

To sum up, according to the chairmen of the Fed and the SEC and the US Secretary of the Treasury, an easier fiscal and monetary policy has been implemented to aid the consumer and, in the last instance, to support the financial markets in order to avoid new drops. In any case, cuts in the Fed interest rate are still expected.

On the other hand, the main problem for the European central banks is inflation. The Swedish central bank, for example, raised its reference rate by 25 basis points to 4.25%, basing its move on price increases. The Bank of England published its report on inflation on February 13 in which it foresaw inflation going to a level above 3%. In that case, according to British legislation, the central bank would be obliged to send a letter to the Chancellor of the Exchequer explaining what moves it planned to take in order to bring inflation down below 3%, as it had to do for the first and only time in April last year after gaining its independence.

United Kingdom nationalizes Northern Rock bank.

This concern about the level of prices was not any hindrance to lowering the reference rate by 25 basis points to 5.25% on February 7. According to the statement issued by the Bank of England, the decision was taken due to the worsening of expectations for economic activity. This seems a contradiction, in less than a week, but it stands within the zigzag path taken by the UK central bank since the beginning of the subprime mortgage crisis to which we have become accustomed.

ECB relaxes position on reference rate but maintains anti-inflation course.

The biggest news from the United Kingdom was nationalization of Northern Rock bank on February 17 announced by Chancellor of the Exchequer Darling. Officially, the two proposals for its purchase by private groups were lower than what the Chancellor of the Exchequer considered reasonable, taking into account the public funds of taxpayers committed to the project. The government contributed 55 billion pounds sterling in order to avoid the bank's collapse. The objective when the financial markets stabilize is to proceed to a sale of the bank. This is the first nationalization carried out in the UK since the Seventies.

Concern about inflation is also shared by the European Central Bank (ECB). Following the meeting of the ECB Governing Council held on February 7, at a press conference to explain the decision to maintain the official interest rate at 4%, the chairman opened up the possibility of making a cut in interest rates in the future. He did so indirectly by including in the statement he read confirmation of the downward risk in economic activity in the Euro Area.

When a reporter asked whether this implied a change in the basic economic scenario being followed by the ECB, chairman Trichet replied that in March they would publish new ECB growth and inflation estimates. He also stated that no member of the Governing Council at the meeting had asked for a cut or for an increase in the reference rate. The reading by the market is that perhaps there will be a drop in interest rates toward summer.

In later statements, Trichet continued to discount immediate cuts in the reference rate. Axel Weber, chairman of the Bundesbank, also indicated that the cuts in interest rate discounted by the financial markets did not take into account the inflation risk in coming months. Our interpretation: the ECB

has eased its position so that it can lower the rate if this is considered necessary in coming months but still continues its anti-inflationary statements in order to maintain inflation prospects stable.

With regard to money markets, for the second consecutive month the situation has been more relaxed. Calm has been restored following the sharp increases in interest rates, a reflection of the lack of liquidity in financial markets since the beginning of the outbreak of the crisis in August last year. It is true, however, that absolute normality has still not been restored. In the case of the Euro Area, in the last seven years up to July last year, the average differential between the interbank interest rate and the reference rate was 17 basis points (100 basis points = 1%). Nevertheless, the 3-month Euribor stands at 4.36% whereas the reference rate is holding at 4%.

Under normal conditions, this situation would indicate that the market was expecting an increase in interest rates. But in reality the futures market is discounting two cuts by the ECB of 25 basis points this year. That is to say, the 3-month Euribor continues high because the problem of liquidity in the interbank

Monetary markets remain calm.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB reference rate (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
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	4.00	4.37	4.32	3.00	3.11	0.87	5.50	5.58	2.59
February (1)	4.00	4.36	4.35	3.00	3.07	0.90	5.25	5.65	2.66

NOTES: (1) January 20.

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

(3) Latest dates showing change: 28-3-06 (4.75%), 10-5-06 (5.00%), 29-6-06 (5.25%), 18-9-07 (4.75%), 31-10-07 (4.50%) 11-12-07 (4.25%), 22-1-08 (3.50%), 30-1-08 (3.00%).

(4) Latest dates showing change: 3-8-06 (4.75%), 9-11-06 (5.00%), 11-1-07 (5.25%), 10-5-07 (5.50%), 5-7-7 (5.75%), 6-12-07 (5.50%), 7-2-08 (5.25%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

Bank of China should act in view of inflation figure.

market in the Euro Area has still not been resolved. However, the situation has certainly improved substantially over that recorded between November 2007 and January 2008.

Changes are expected in Asia during the month of March. In the case of China, although the Central Bank of China has not changed its reference rate or increased cash reserves, it seems fairly likely that it will make a move due to the poor inflation figure which reached 7.1% in January. Japan will also see a change on March 19, given that the 5-year mandate of the Japanese Central Bank governor, Fukui, will then expire. He was the governor who brought about the decision of Cabinet to abandon the 0% reference rate and raise it to 0.50%. It was a valient decision seeing that it coincided with a period of deflation in the country and was based on the doctrine that remains current about the need to continue to gradually normalize monetary policy in order to avoid further financial bubbles in other economic sectors. The policy of normalizing interest rates also attempts to avoid poor assignment of resources through over-investment in Japanese industry. In view of the uncertainty of the path ahead for Japan's economy, it will be interesting to see which candidates the government puts forward to replace Fukui because of the challenges to be faced by the new governor.

Long-term interest rates on government bonds make slight correction for trend in previous months.

Rise in long-term interest rates

Interest rates on long-term government bonds have risen world-wide except in Japan where they have moved up a mere four basis points compared with January. Since the beginning of this year Japanese 10-year government bonds have offered a return running in the range between 1.3% and 1.5%. This movement is due to the fact that expectations of further interest rate increases by the Japanese central bank have been cooling off in recent months due to the international financial upsets and the future course of economic activity in Japan that is not expected to show good results in the first quarter of this year.

On the other hand, both in the United States and the United Kingdom interest rates on 10-year government bonds have risen by 0.2%. They have also moved up slightly in the Euro Area going above the psychological level of 4%. Why has this rise, although small, taken place in a situation of drops in reference rates and even with the downward prospects in the Euro Area?

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2005	2006	2007		2008	
			September	December	January	February 21
United States	4.39	4.70	4.59	4.02	3.59	3.79
Japan	3.31	1.69	1.69	1.51	1.45	1.49
Euro Area	1.48	3.95	4.33	4.33	3.93	4.01
United Kingdom	4.10	4.74	5.01	4.51	4.48	4.68
Switzerland	1.97	2.52	3.01	3.05	2.81	2.91

SOURCE: Bloomberg.

There are two reasons. First, this is a move for correction of the sharp drops that came in previous months due to the phenomenon of a flight to quality. In moments of panic investors will often sell assets involving high risk and invest their funds in buying government bonds with higher credit rating in order to preserve capital invested. The price of bonds and the return offered move in opposite directions. With increased demand for bonds the price rises and return drops. Following the upsets in the financial markets there has been something of a calm. The sharp drops on the the stock markets have put some assets into a relatively cheap situation and investors have felt that prices were reasonable for moving in.

Secondly, news about inflation and statements of concern put out by some central banks have also increased the risk premium asked for a bond in order to be protected against loss of purchasing power.

But what about private bond issues? Private bonds are still suffering from the crushing increase in risk aversion. To check on this, the simplest way is to compare how credit risk has evolved. In the following graphs we see how the cost of insuring default risk has increased.

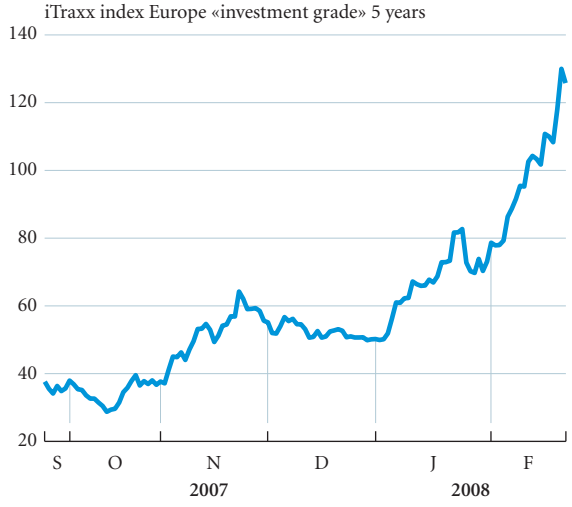
Before the outbreak of the crisis, an investor wanting to cover a portfolio of bonds issued with investment grade rating for 10 million euros in September last year had to pay 40,000 euros for insurance. On the other hand, the investor must now pay 120,000 euros to cover the risk that one of these companies may declare bankruptcy. In barely six months there has been an increase of 200% for buying the same insurance.

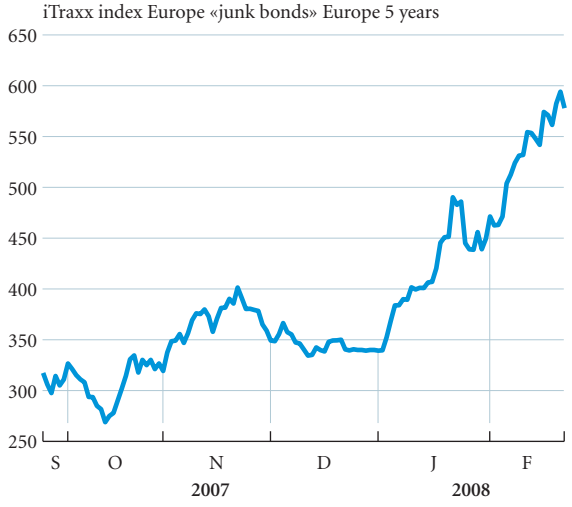
To buy insurance for a bond portfolio of the same characteristics as before but, with the only change being that now the credit rating of those bonds is that of «junk bonds», the investor would have to

Insurance on default risk now more costly.

COVERING DEFAULT RISK MORE EXPENSIVE

iTraxx indices, cost of insuring 10 million euros in bonds, in basis points





SOURCE: Bloomberg and own calculations.

Renminbi continues to appreciate but now somewhat more rapidly.

pay 577,000 euros. The increase is less but now it also turns out more costly to get protection against default credit risk. The reason is clear enough. The drop in economic prospects implies the view that there has to be an increase in default.

Only Chinese renminbi showing a clear trend

In February, the only currency to maintain a clear trend to appreciation was the renminbi against the dollar. In reality, the Chinese central bank abandoned its autonomy in monetary policy to instead control the course of appreciation of the currency and thus avoid a brutal loss of competitiveness by exporters over a short space of time. As a result, economic agents will have more time to adapt to the change. But due to the sharp increase in inflation the authorities have been obliged to speed up the process of appreciation of the renminbi as may be noted in the following graph.

The dollar depreciated against all currencies except the Japanese yen with which it appreciated by 0.7%. Still more curious was the trend in the eurodollar in recent months. Following its sharp depreciation against the euro, as of October the US dollar stabilized at a range between 1.43 and 1.49 at which it has held since then.

Following the poor economic news in January and February it was to be expected there would be a weakening of the dollar and but on the other hand the dollar strengthened going from 1.49 on January 31 to 1.45 on February 11. The currency of an economy in which there is a sharp drop in expectations for growth and more cuts in the reference rate normally would tend to depreciate.Why

APPRECIATION OF RENMINBI GATHERS PACE

Exchange rate of renminbi against dollar

SOURCE: Bloomberg.

DOLLAR MAINTAINS EXCHANGE RATE RANGE OVER 4 MONTHS

Euro-dollar exchange rate

SOURCE: Bloomberg.

has this not been so? One explanation is that the market is discounting that the United States, being the first economy to go into this slowdown, will be the first to come out of it. This is a suspect explanation as uncertainty is so high that economists still have not been able to clearly work out an economic scenario without some reserves about the duration time for the slowdown now being experienced in the United States.

A second explanation appeals to the inexorable economic law of supply and demand. On the one hand, sovereign funds are using dollars to buy shares in various US banks (see Box «Trade and foreign exchange imbalances: a vicious or virtuous circle?» on page 10). In addition, due to the paralysis of the private bond market in the Euro Area, many large European companies are raising funds by issuing bonds in dollars. In both cases, buyers of these assets, whether bonds or shares, have to be bought with dollars.

This second explanation makes more sense if we understand that later on the European companies changed the dollars obtained for euros and therefore the appreciation moves in the dollar must be seen as compensated when the contrary move is carried out. In the above graph we see how the euro recovered at the end of the year. In any case, there are still no figures about these flows in order to reach an idea that would convincingly explain the movement of the greenback in recent weeks. Finally, in view of the prospect of further cuts in the reference rate in the United States, the euro went to 1.52 against the dollar on February 29.

Dollar undecided against euro with range between 1.43 and 1.49.

A floor for the stock market?

Following the scare in January, the stock markets seem to have found a floor, as may be seen in the following graph using the trend in quotes shown by the European DJ Eurostoxx 50 index.

EXCHANGE RATES OF MAIN CURRENCES

February 22, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2006	Annual
Against US dollar				
Japanese yen	107.2	0.7	–4.2	–13.4
Pound sterling	0.509	–0.3	1.0	–0.5
Swiss franc	1.087	–0.7	–4.3	–13.9
Canadian dollar	1.013	–1.6	1.5	–14.7
Mexican peso	10.783	–1.4	–1.2	–2.2
Against euro				
US dollar	1.484	1.4	1.7	13.0
Japanese yen	159.0	2.1	–2.4	–0.4
Swiss franc	1.613	0.7	–2.5	–0.8
Pound sterling	0.754	1.1	2.6	12.4
Swedish krona	9.305	–1.8	–1.4	0.1
Danish krone	7.455	0.1	0.0	0.0
Polish zloty	3.569	–1.5	–1.0	–8.1
Czech crown	25.04	–4.4	–5.6	–11.4
Hungarian forint	264.1	2.7	4.4	4.8

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

Stock markets find floor while waiting to see how fronts now open clear up.

Following the correction of share prices, stock market analysts are changing their estimates, aided by publication of corporate profits for 2007 and forecasts companies have made for this year. The problem is that the high degree of uncertainty makes it difficult to decipher the year in terms of profit per share. There are a number of fronts still open. Among these, there is the future of bond insurance companies, the so-called monoline insurers, the course followed by the United States and the end of the period for announcing losses by financial institutions.

As may be seen in the accompanying table, losses in stock market in the developed countries are being maintained in a range from 7.4% for Dow Jones to 15.2% for the German stock market index. Among the markets doing best was the Japanese stock market which rose by 7.4%, boosted by better than expected economic growth rates. We shall now have to see if this good performance can be maintained over coming months in view of the challenges presented by Japan's economy.

IS THIS THE FLOOR FOR THE DROP?

European DJ Eurostoxx 50 stock market index

SOURCE: Bloomberg.

INDICES OF MAIN WORLD STOCK EXCHANGES

February 22, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,284.3*	*2.6*	*–7.4*	*–3.2*
Standard & Poor's	*1,342.5*	*2.4*	*–8.6*	*–7.8*
Nasdaq	*2,299.8*	*0.3*	*–13.3*	*–8.9*
Tokyo	13,500.5	7.4	–11.8	–25.4
London	5,936.6	3.4	–8.1	–7.0
Euro Area	3,761.0	0.2	–14.5	–11.3
Frankfurt	*6,841.2*	*1.1*	*–15.2*	*–1.9*
Paris	*4,856.2*	*0.3*	*–13.5*	*–14.9*
Amsterdam	*454.9*	*5.0*	*–11.8*	*–10.7*
Milan	*33,775.0*	*–1.5*	*–12.4*	*–20.5*
Madrid	*13,074.0*	*1.8*	*–13.9*	*–11.6*
Zurich	7,562.0	1.0	–10.9	–18.3
Hong Kong	23,305.0	7.1	–16.2	12.0
Buenos Aires	2,083.5	7.2	–3.2	–5.5
São Paulo	63,792.2	13.7	–0.1	37.3

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

A fixed exchange rate: back to the future?

Up until 1972, all the countries in the capitalist world took part in the Bretton Woods system of fixed exchange rates which regulated international financial relations following the end of World War II. In 1996, after nearly 25 years following the collapse of Bretton Woods, more than two-thirds of the world's countries were still operating with fixed exchange rates. Later, the wave of international financial crises between1997-2001 caused many countries to let their currencies float as they did not possess sufficient international reserves to defend a fixed exchange rate. Nevertheless, in the last six years we have seen a slight reversal in this trend and, in fact, there has been an increase in the number of countries with fixed exchange rates. Because of this, we should ask to what we owe this renewed interest and if this recent trend is temporary or reflects a new pattern in the world financial scene.

TREND IN EXCHANGE RATE SYSTEMS

	1996	2001	2007
Fixed exchange rate	**124**	**93**	**105**
Conventional	63	55	70
Intermediate	44	17	12
Currency board	12	13	13
No separate legal tender	5	8	10
Flexible exchange rate	**60**	**93**	**83**
With intervention	37	43	48
No intervention	23	50	35

SOURCE: IMF.

We may distinguish four types of fixed exchange rate regimes. Under the definition of «conventional» fixed exchange rates we find those countries whose currency fluctuates with a margin of 1% daily, while the «intermediate» systems have wider fluctuation bands. Some of the countries hoping to belong to the EMU fall into this latter category and have a fixed exchange rate with the euro within a band of 15%, as is the case of the three Baltic countries. Under a currency board system we find those countries whose exchange rate is set by law and furthermore it is guaranteed that the entire national currency issue is backed by foreign assets in the currency against which the national currency is fixed. An example of this group is Bulgaria. The last case, «no separate legal tender», when a country directly adopts the currency of another country but without the right to participate in monetary policy decisions, is the most extreme version of a fixed exchange rate. This is the case of dollarized countries like El Salvador and Ecuador or «euroized» countries such as Andorra and Montenegro. Neither the Fed nor the ECB consult with these countries when making decisions.

Many countries with a flexible exchange rate follow a monetary policy framework of inflation targeting and by definition have no target for the level of the exchange rate. Within the category of flexible exchange rate countries, we find those countries that do not intervene in the foreign exchange market, as is the case of the main currencies, or those countries that intervene occasionally to reduce the volatility of their exchange rates but have no fixed or pre-announced objective for the level of the exchange rate. The countries of the Euro Area fall into the category of flexible exchange rate with no intervention because the euro exchange rate is freely set

by the market and the countries that belong to the EMU, such as Spain, are members with voting power in the ECB governing council.

There are two main advantages of using a fixed exchange rate system. First, it allows countries with chronic inflation problems to import the monetary policy of a foreign central bank that has more credibility, which may bring about lower inflation so long as fiscal policy is sufficiently balanced. Secondly, fixing the exchange rate with a large economic area also strengthens commercial links, along with foreign direct investment, by eliminating the uncertainty associated with exchange rate volatility. It is not surprising that the European countries outside the EMU fix their exchange rates against the euro, although in the rest of the world the US dollar continues to be the preferred currency.

When it comes to fixing the exchange rate to another currency not everything are benefits. Adopting the monetary policy of another country means that sometimes, what is suitable for one country (the United States, for example) is not suitable for another (Argentina, for example, in 2001 when the peso was at an exchange rate of one-to-one with the dollar), especially if economic cycles are not synchronized. Secondly, it is no longer possible to use the exchange rate as a tool for cushioning external shocks, such as changes in world demand for a country's exports. Finally, fixed exchange rates can encourage speculative attacks and financial crises if doubts arise regarding the sustainability of the exchange rate. Betting against an overvalued currency is an operation with little risk and enormous potential gain, as George Soros well knows, and as the British authorities learned during the crisis which took the pound sterling out of the European Monetary System in 1992.

If fixed exchange rates are not free of problems, why this renewed interest in this system? Firstly, one key reason is that it is a system easy to implement by the central bank and easy for the public to understand. Many countries fix their exchange rate with a major currency simply because their own central banks do not have the technical capacity to implement another system. It is symptomatic that a large majority of countries with fixed exchange rates are to be found in the Middle East, Africa and some regions of Asia. Furthermore, in highly regulated economies it is difficult to liberalize the foreign exchange market without undertaking other reforms in the banking system. Some developing countries have liberalized the foreign exchange market only to find that this created too much volatility in the exchange rate and have since retraced their steps.

Secondly, there are many countries that, in spite of declaring that they operate under a flexible exchange rate, they intervene so much in the foreign exchange market that, *de facto*, they behave like a fixed exchange rate. In this case, the IMF classifies them as if they had a fixed exchange rate. What is the reason for this? The answer is the good economic climate in emerging markets. Both demand for the commodities and manufactured goods that these countries export has increased in recent times, improving their trade balances and creating appreciation pressures for their currencies. Concerned about the possible loss of competitiveness this might bring, many countries have resisted the tendency of their currencies to appreciate by accumulating international reserves through a very simple operation: they print national currency to buy dollars in the market and maintain the parity.

To sum up, the increase in the number of countries following a fixed exchange rate is largely temporary and not without risks. In the first place, many emerging countries are showing signs of overheating and need monetary conditions much more restrictive than those of the United States or Europe. The other side of the coin in resisting appreciation is that it may excessively expand the money supply and generate inflation, as is already happening in China where inflation has gone up from 1% to 7% in the last year and a half. Secondly,

various emerging countries would go back to a situation of deficit in the current account balance if the growth rate of their exports were to be affected by the cyclical downturn in the industrialized world. In this case, the currencies of those countries would face downward pressure. Trying to indefinitely resist a depreciation may be painful given that it is either necessary to sell international reserves to support the national currency or adopt contractive fiscal policies.

Given the fact that monetary policy cannot achieve inflation and exchange rate targets at the same time, what should those countries do in such situations? The solution to be applied would be that countries with a fixed exchange rate should take control of monetary policy and introduce more flexibility. A recent example is the case of Hungary. Faced with the impossibility of maintaining a fixed exchange rate with a fluctuation band against the euro and, at the same time, control inflation, the Hungarian authorities have moved toward directing monetary policy in order to avoid an excessive growth rate of prices and have decided to allow the forint to fluctuate freely in the market.

SPAIN: OVERALL ANALYSIS

Economic activity

Balance sheet for 2007: facing the deceleration

Gross domestic product (GDP) of the Spanish economy exceeded one trillion euros for the first time in 2007 and registered annual growth of 3.8%, only one decimal less than the previous year. Nevertheless, the profile for recent quarters was a slightly more marked reduction of economic expansion, with a year-on-year increase of 3.5% in the fourth quarter. Economic growth in 2007 was notably higher than the European Union as a whole and the differential with the Euro Area even increased.

Spain's GDP exceeds one trillion euros for first time and grows 3.8% in 2007.

In 2007 the tendency towards moderation of domestic demand continued, as did an improvement in the negative contribution of the foreign sector. Growth thus tended to be more balanced, especially as the importance of construction was gradually reduced. Moreover, the increase in productivity was greater, though the foreign deficit continued to grow, reaching 10.0% of GDP.

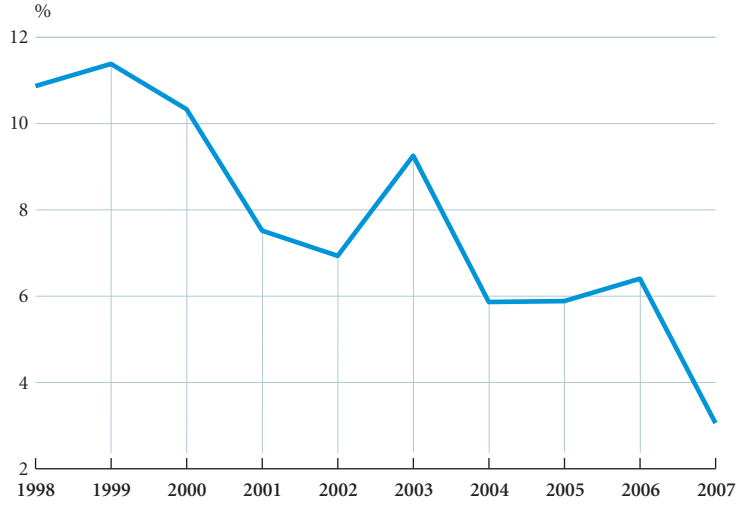
Trend towards moderation of domestic demand continues while negative contribution to foreign sector improves.

The contribution of domestic demand to GDP growth was 4.6 percentage points, half a point less than the previous year. This moderation came largely from household consumption, the main component, which went from an annual increase of 3.7% to 3.1%. That slowdown was greater in spending on goods, mainly durables such as motor vehicles, than on services. Early in 2008 both car sales and

Slowdown in household consumption, especially in goods.

MARKED SLOWDOWN IN HOUSING INVESTMENT

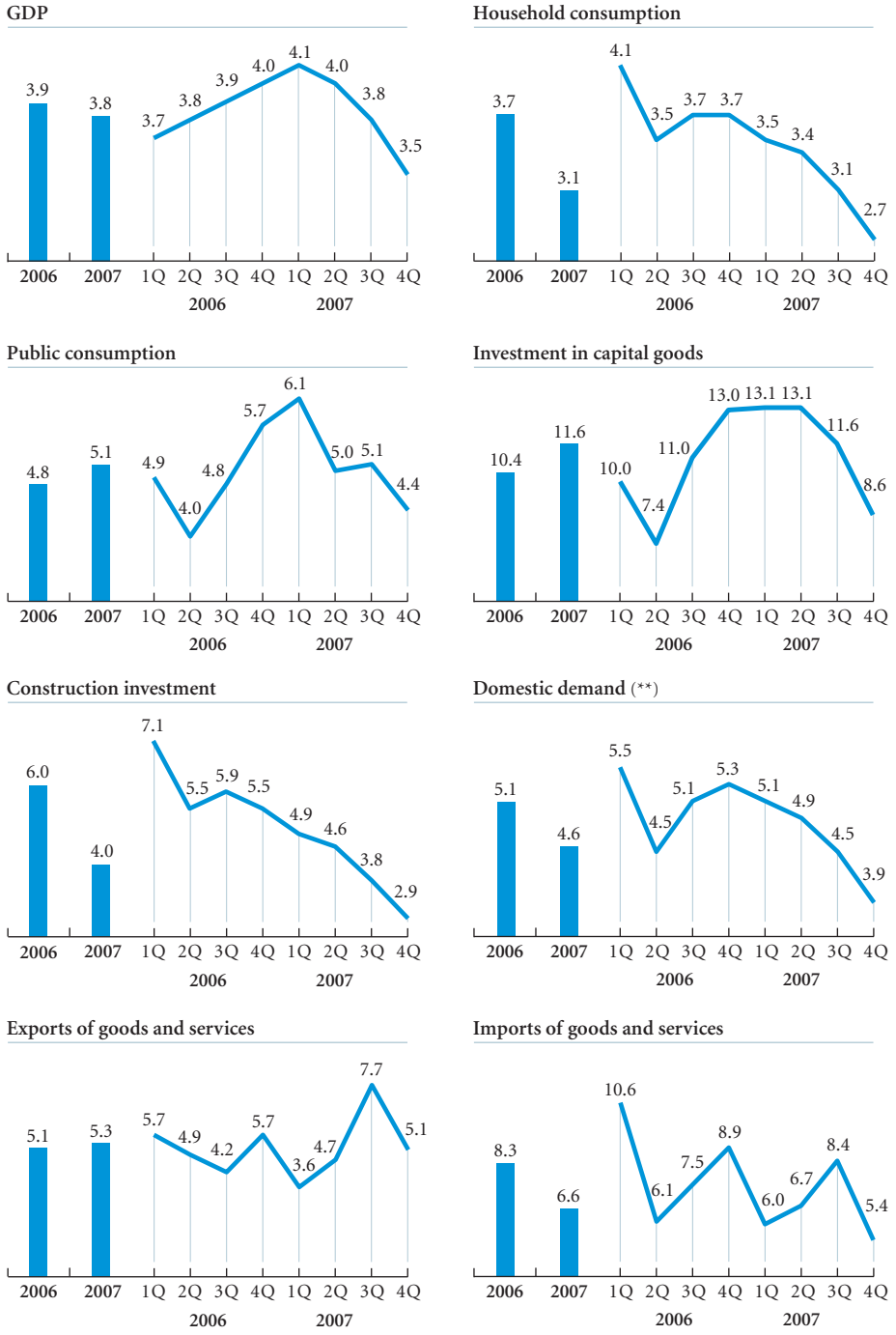
Annual change in housing investment



SOURCES: INE and own calculations.

TREND IN SPAIN'S GDP BY COMPONENT

Percentatge year-on-year change (*)



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

the fall in the consumer confidence index point to a continuation of that trend. On the other hand, general government consumption moved up by three decimals to reach 5.1%.

The other major component of demand, investment, also reduced its growth rate, though not in all its components. Gross capital formation in capital goods increased by 11.6% in 2007, helping to improve productivity, and exceeding the already high rate seen the previous year. Nevertheless, in recent quarters a tendency to slowdown could be noted. This was more marked in construction investment, especially housing, given the sluggishness that has overtaken the property market, with a strong drop in prices of homes and a decrease in the number of transactions. Other investment (spending on computer software, mineral and oil prospecting, etc.) also slowed down in growth rate, but to a lesser extent.

Meanwhile, the negative contribution of the foreign sector to growth fell by five decimals, to seven. That was the result of an acceleration in exports and a slowdown in imports in response to a weaker thrust of domestic demand. Exports of both goods and services revived, though the first to a lesser extent. Imports of both goods and services moderated, the former more so. However, the deficit in the economy worsened, reaching 9.5% of GDP as opposed to the 8.1% recorded in 2006.

On the supply side, in 2007 three sectors showed more expansionist behaviour, namely, the primary sector, industry and non-market services. On the other hand, construction, energy and market services moderated their growth rate.

Major growth in capital goods investment, 12% per annum, helps improve productivity.

DEMAND INDICATORS

Percentage change over same period year before

	2006	2007	2007						2008
			1Q	2Q	3Q	October	November	December	January
Consumption									
Production of consumer goods (*)	2.3	1.2	4.8	2.1	0.8	–0.1	–3.2	–5.1	...
Imports of consumer goods (**)	8.9	5.1	–1.1	5.6	8.4	9.2	–1.3	16.3	...
Car registrations	–0.9	–1.2	–0.7	–2.4	–2.9	3.4	–5.9	6.3	–12.7
Credit for consumer durables	14.5	10.0	13.8	9.6	6.9	–	...	–	–
Consumer confidence index (***)	–12.3	–13.3	–10.7	–12.7	–12.3	–16.0	–17.0	–19.0	–20.0
Investment									
Capital goods production (*)	8.4	5.8	8.9	5.3	6.3	8.4	–0.5	1.1	...
Imports of capital goods (**)	3.2	9.8	20.1	11.0	–0.6	6.8	–1.8	24.9	...
Commercial vehicle registrations	1.5	0.3	1.7	–2.2	–3.0	4.1	–8.1	19.4	–31.0
Foreign trade (**)									
Non-energy imports	9.0	7.3	6.4	7.7	7.6	8.3	–0.2	15.5	...
Exports	5.6	4.2	3.0	2.8	6.7	8.2	8.2	–2.8	...

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.

Strength seen in some industrial branches such as machine building and metal products manufacturing...

Gross value added in industry rose by 3.1% in 2007, two decimals more than in the previous year. However, the profile was clearly on the downturn over the year, so much so that industrial production underwent a year-on-year drop in December. The most dynamic branches were machine building, furniture and miscellaneous manufacturing, machinery and electrical material, precision and optical equipment and metal products manufacturing. On the other hand, office machinery and computer equipment and leather and footwear suffered severe drops in production as they felt sharp world competition. The prospects for 2008 are not very encouraging, given the recent decreases in the confidence index in industry. However, the level of new orders gives hope for moderate growth in industry.

...and services like retail trade, hotels and catering, and transport.

The agriculture and fishery sectors were very dynamic. Their gross value added rose by 3.8% in 2007, 1.4 points more than the previous year.

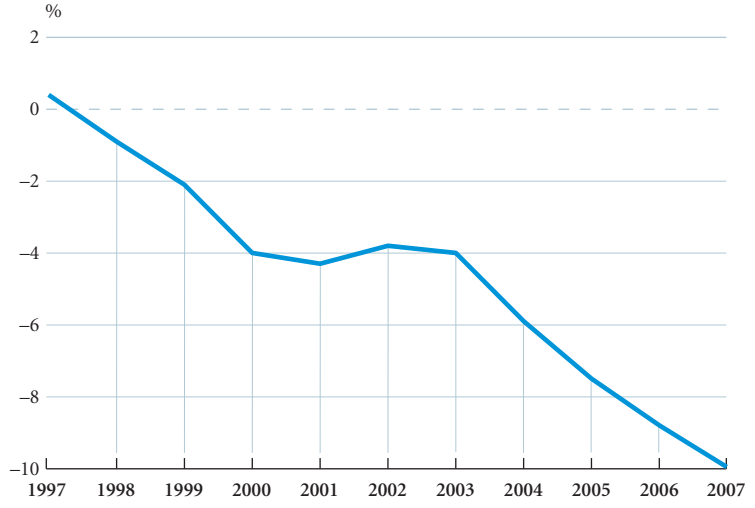
Market services in general slowed down slightly. Nevertheless, they showed high growth of 4.0%. The branches reporting greatest strength were retail trade, the hotel and catering business, and transport. Company services, on the other hand, were weaker. Non-market services increased by 5.0% thanks to the remuneration of salaried workers in the public sector.

Highest annual growth in productivity since 1996 but level still very low.

Given the performance in production and an average growth in employment of 3.0%, the apparent productivity of work rose by 0.8%, one decimal more than in 2006, reaching the highest level since 1996. However, the increase in productivity remains rather low. By sector, the biggest increase in productivity was in agriculture and fishery as a consequence of greater production with less employment, although the rise in productivity was smaller than that recorded in 2006. In industry, on the other hand, the increase in productivity was greater than in the previous year, up to 3.3%. In market

FOREIGN DEFICIT CONTINUES TO GROW

Current account balance over GDP



SOURCE: INE and own calculations.

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentatge year-to-year change (*)

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

services productivity rose by 0.9%, slightly more than in 2006. Lastly, construction productivity not only continued to fall as a result of the low level of average qualification of the workforce but recorded the biggest drop in the past decade.

As a result of the performance in productivity and a 7.1% increase in the remuneration of salaried workers, labour costs per production unit rose by 2.7% in 2007, four decimals more than the previous year. This put the change four decimals below the implicit GDP deflator.

As far as the prospects for 2008 are concerned, early indicators available, combined with the strength of the euro, tighter credit terms, the increased cost of commodities and the weaker thrust of foreign demand point to a continuation of the path of economic slowdown.

Labour costs per product unit rise 2.7%, less than GDP deflator.

SUPPLY INDICATORS

Percentage change over same period year before

	2006	2007	2007						2008
			1Q	2Q	3Q	October	November	December	January
Industry									
Electricity consumption (1)	3.8	4.1	5.2	4.4	2.0	3.5	7.2	3.9	3.6
Industrial production index (2)	3.9	1.9	4.2	2.4	1.1	2.6	–1.0	–2.4	...
Confidence indicator for industry (3)	–2.7	–0.3	2.3	0.7	–0.7	–6.0	–1.0	–3.0	–4.0
Utilization of production capacity (4)	80.5	81.3	80.6	81.3	82.1	–	81.1	–	81.3
Imports of non-energy intermediate goods (5)	10.5	8.0	8.1	8.2	8.7	8.3	0.9	13.0	...
Construction									
Cement consumption	8.5	0.3	5.5	–1.3	–1.3	5.2	–1.8	–9.4	–7.9
Confidence indicator for construction (3)	14.2	9.3	10.7	15.7	12.0	8.0	–6.0	–6.0	–6.0
Housing (new construction approvals)	18.6	–23.7	8.0	–15.0	–50.7	–32.4	–28.8	...	...
Government tendering	31.3	–13.4	13.3	–2.2	–29.7	–33.2	–37.4	...	...
Services									
Retail sales	2.0	2.5	4.3	2.9	3.1	1.3	0.4	–1.9	...
Foreign tourists	4.1	1.7	5.3	0.1	1.4	0.0	5.0	0.7	0.9
Tourist revenue inflows	5.6	3.5	5.8	2.0	3.2	2.7	6.3	...	...
Goods carried by rail (km-tonnes)	–1.2	–4.4	–4.1	–6.5	–1.4	–0.6	–9.3	–6.2	...
Air passenger traffic	6.8	9.0	9.5	7.1	10.5	8.3	10.2	7.2	6.9
Motor vehicle diesel fuel consumption	5.5	4.8	5.8	3.3	4.2	9.4	4.0	...	...

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.

Prospects of economic slowdown in 2008.

The European Commission recently lowered its growth forecast for the Spanish economy for 2008 to 2.7%. Moreover, greater effort to improve competitiveness is considered necessary, which involves higher investment in spending on R&D and infrastructures and improvement of the education system.

Labour market

Job creation insufficient to absorb those entering labour force

In keeping with a situation showing a downward trend in the economy, the number of those employed dropped by 33,700 persons in the fourth quarter of 2007 compared with the previous period, according to the Labour Force Survey carried out by the National Institute of Statistics. This was the first decrease in the number of persons working since 2002. Given that the labour force also increased by 102,000 persons, the unemployment rate rose by six decimals to 8.6%, the same as the level two years earlier, and leaving far behind the lowest level since 1978 recorded in the second quarter of 2007.

The year 2007 saw a continuation of the slowdown trend in job creation already noted in 2006. In any case, last year the number of persons working rose by 2.4% as against an increase of 3.6% recorded in 2006. Overall, some 475,100 new jobs were created in 2007, with a total of 20,476,900 persons employed, an all-time record at year-end.

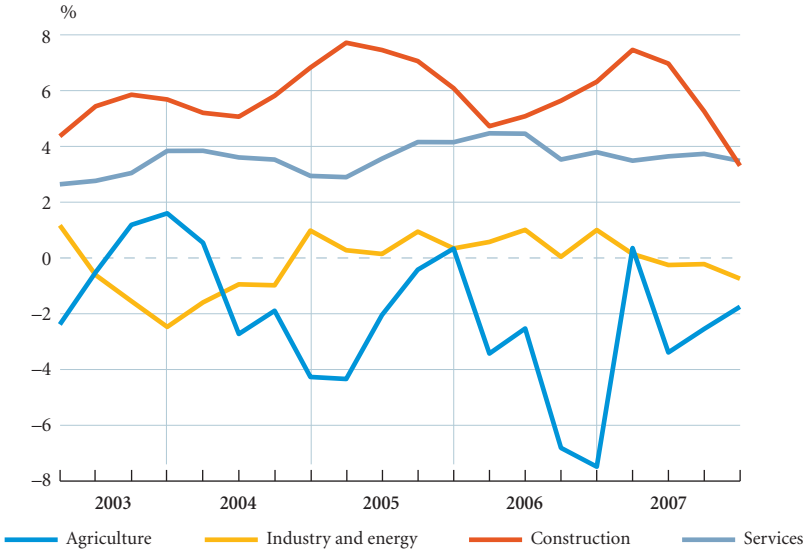
475,000 jobs created in 2007, according to Labour Force Survey, bringing total number of people working to all-time high at year-end.

In the past ten years some 6,942,500 net new jobs have been created, a truly extraordinary figure. Nevertheless, the easing off noted in recent years seems likely to continue. At least the January figure for those registered with Social Security would so indicate. In fact, in the first month of 2008 such workers decreased by 84,697, the biggest drop

2008 likely to see continuing downward trend in job creation.

SLOWDOWN IN JOB CREATION IN RECENT QUARTERS

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



NOTES: (*) Quarterly National Accounts figures adjusted for seasonal and calendar difference.
SOURCE: National Institute of Statistics.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2005	2006	2007	2007				2008
				1Q	2Q	3Q	4Q	January
Persons registered with Social Security								
Sector								
Industry	*–0.5*	*0.0*	*2.5*	*2.2*	*2.7*	*2.5*	*2.4*	*1.5*
Construction	*8.6*	*8.7*	*3.3*	*6.1*	*4.4*	*2.3*	*0.5*	*–1.1*
Services	*5.7*	*5.2*	*3.5*	*4.1*	*3.7*	*3.0*	*3.0*	*2.8*
Job situation								
Wage-earners	*4.8*	*4.7*	*3.0*	*3.9*	*3.5*	*2.6*	*2.2*	*1.7*
Non-wage-earners	*2.6*	*2.2*	*2.8*	*2.5*	*2.7*	*2.9*	*2.9*	*2.5*
Total	**4.4**	**4.3**	**3.0**	**3.6**	**3.3**	**2.7**	**2.4**	**1.9**
Persons employed (*)	**5.6**	**4.1**	**3.1**	**3.4**	**3.4**	**3.1**	**2.4**	**–**
Jobs (**)	**3.2**	**3.2**	**3.0**	**3.3**	**3.1**	**3.0**	**2.5**	**–**
Hiring contracts registered (***)								
Permanent	8.7	41.1	2.0	25.8	15.6	–1.6	–21.1	–23.0
Temporary	4.6	4.7	0.3	2.6	–1.9	–0.5	1.2	–0.9
Total	**5.0**	**7.9**	**0.5**	**5.3**	**–0.1**	**–0.7**	**–2.1**	**–4.3**

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

Construction shows loss of jobs in fourth quarter of 2007 for first time since 1996.

in the first month of the year since 1994, putting the total at 19,111,058, which meant annual growth of 1.9%, four decimals below that recorded in December 2007. Furthermore, in January the number of hiring contracts signed through the public employment service was down 4.3% compared with the same month the year before. The biggest decrease came in permanent contracts (23.0%) while temporary contracts were down slightly (0.9%).

Figures for National Accounting also indicate a slowdown in job creation in the fourth quarter, although this was very gradual. Jobs equivalent to full-time work in non-energy industrial sectors and market services even rose slightly. Jobs continued be lost in the primary sector although at a lower rate. Jobs were also down in construction for the first time since the beginning of 1996 and again following a period of strong job creation. This trend may be explained by the slack in the real estate market in recent months.

In 2007 as a whole, full-time jobs were up 3.0%, two decimals less than in 2006. This meant creation of 550,000 new jobs equivalent to full-time work. Construction recorded a 3.3% increase in the number of jobs equivalent to full-time work compared with the fourth quarter of 2006, well below the growth of 6.3% the year before. The drop recorded in services was much lower so that this was the sector in which the biggest increase in employment took place (3.5%). In the industrial branches, the annual balance was not positive with a 0.6% loss of jobs, while in energy branches the drop was 4.4%.

Going back to the Labour Force Survey, while the slowdown affected all the large economic sectors, there were

ESTIMATED EMPLOYMENT

Fourth quarter of 2007

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	905.8	20.4	2.3	–16.0	–1.7	4.4
Non-farm	19,571.1	–54.1	–0.3	491.1	2.6	95.6
Industry	*3,279.1*	*20.2*	*0.6*	*–40.7*	*–1.2*	*16.0*
Construction	*2,693.5*	*–24.0*	*–0.9*	*70.3*	*2.7*	*13.2*
Services	*13,598.5*	*–50.3*	*–0.4*	*461.5*	*3.5*	*66.4*
By type of employer						
Private sector	17,563.6	–15.1	–0.1	469.8	2.7	85.8
Public sector	2,913.3	–18.6	–0.6	5.3	0.2	14.2
By work situation						
Wage-earners	16,876.5	6.8	0.0	410.4	2.5	82.4
Permanent contract	*11,658.2*	*177.0*	*1.5*	*760.8*	*7.0*	*56.9*
Temporary contract	*5,218.4*	*–170.2*	*–3.2*	*–350.4*	*–6.3*	*25.5*
Non-wage-earners	3,593.2	–40.0	–1.1	69.0	2.0	17.5
Entrepreneurs with employees	*1,136.3*	*–5.4*	*–0.5*	*48.5*	*4.5*	*5.5*
Entrepreneurs without employees	*2,254.6*	*–31.7*	*–1.4*	*59.2*	*2.7*	*11.0*
Family help	*202.3*	*–2.9*	*–1.4*	*–38.7*	*–16.1*	*1.0*
Other	7.1	–0.6	–7.7	–4.3	–37.8	0.0
By time worked						
Full-time	18,093.8	–140.1	–0.8	465.6	2.6	88.4
Part-time	2,383.1	106.4	4.7	9.5	0.4	11.6
By sex						
Males	11,997.1	–92.5	–0.8	165.8	1.4	58.6
Females	8,479.8	58.8	0.7	309.3	3.8	41.4
TOTAL	**20,476.9**	**–33.7**	**–0.2**	**475.1**	**2.4**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

big differences in job creation in 2007 as a whole. Agriculture and industry showed a loss of jobs while construction, and especially services, created jobs. The drop in employment in construction was quite marked going from year-on-year change of 8.3% to 2.7% in the fourth quarter of 2007.

By age groups, there were also substantial differences. During last year as a whole, the number of persons with jobs under 30 years of age dropped slightly while among adults the figure as up considerably.

Of special note was the growth of employment in the 50-54 age group, which reported a 5.9% increase, partly thanks to benefits available on hiring those over 45.

At the same time there were remarkable differences by sex. The rate of increase in employment among females (3.8%) was more than twice that for males (1.4%). In the case of young women 16-19 years of age, employment was up 1.4% while employment of young men of the same age dropped by 3.0%.

Foreign workers now make up 14% of total.

In addition, following the trend in recent years, employment rose more among the immigrant population with a rise of 11.0%. In fact, in the fourth quarter the number of foreign workers employed rose by 40,700 persons to 2,887,000 which meant 14.1% of the all those employed.

The unemployment rate, that is to say, the proportion of those employed with regard to those aged 16-64 years stood at 66.5% in the final quarter of 2007 even going above the objective set for 2010 in Spain's National Reform Plan. There was a notable improvement in the female employment rate which stood at 55.9% although this was still well below the male rate at 76.9%.

Temporary employment ratio down three points in 2007.

Another favourable feature of the trend in the labour market in 2007 was the decrease in the ratio of temporary work. In fact, this ratio dropped to 30.9% in the fourth quarter, more than 2.9 points below the level one year earlier. Nevertheless, the ratio of temporary work was still substantially above the average in the main European countries.

All Autonomous Communities recorded employment increases in 2007. The biggest growth figures came in Murcia, the cities of Ceuta and Melilla, Aragon and Castile-La Mancha, with increases of more than 4%. At the opposite end of the scale, the Basque Country, The Balearic Islands and Extremadura recorded growth of less than 1.0%.

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Fourth quarter of 2007

	In work force			Employed			Unemployed			Unemployment rate (%)
	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	
Andalusia	3,745	155	4.3	3,221	69	2.2	524	86	19.5	14.0
Aragon	650	30	4.9	616	28	4.8	33	2	6.7	5.1
Asturias	476	11	2.3	438	15	3.5	39	–4	–9.4	8.1
Balearic Islands	544	20	3.9	495	4	0.7	49	17	51.7	9.0
Canary Islands	1,024	23	2.2	912	25	2.8	113	–2	–1.9	11.0
Cantabria	276	7	2.5	264	10	4.0	13	–3	–20.8	4.6
Castile-Leon	1,162	16	1.4	1,081	21	1.9	81	–4	–5.0	7.0
Castile-La Mancha	925	37	4.2	852	35	4.3	74	2	3.1	8.0
Catalonia	3,799	100	2.7	3,547	95	2.8	252	5	1.9	6.6
Valencian Community	2,472	77	3.2	2,249	57	2.6	223	20	9.8	9.0
Extremadura	481	14	3.0	410	4	1.0	71	10	16.6	14.7
Galicia	1,293	20	1.5	1,196	26	2.2	97	–6	–5.8	7.5
Madrid Community	3,283	42	1.3	3,074	43	1.4	209	–1	–0.5	6.4
Murcia	693	35	5.4	636	30	4.9	57	5	10.2	8.3
Navarre	304	2	0.7	291	3	1.1	13	–1	–6.2	4.3
Basque Country	1,059	–6	–0.6	999	4	0.4	61	–10	–14.6	5.7
La Rioja	158	3	1.9	149	5	3.5	9	–2	–18.5	5.6
Ceuta and Melilla	60	7	13.1	49	2	4.9	11	5	...	18.3
TOTAL	**22,405**	**592**	**2.7**	**20,477**	**475**	**2.4**	**1,928**	**117**	**6.5**	**8.6**

SOURCE: National Institute of Statistics and own calculations.

ESTIMATED UNEMPLOYMENT

Fourth quarter of 2007

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	879.2	78.3	9.8	115.5	15.1	45.6	6.8
Females	1,048.3	57.4	5.8	1.5	0.1	54.4	11.0
By age							
Under 25 years	447.6	–10.5	–2.3	13.5	3.1	23.2	18.8
Other	1,480.0	146.2	11.0	103.4	7.5	76.8	7.4
By personal situation							
Long-term unemployment	515.8	54.0	11.7	–7.3	–1.4	26.8	–
Seeking first job	185.6	–24.5	–11.7	–16.2	–8.0	9.6	–
Other	1,226.2	106.2	9.5	140.4	12.9	63.6	–
TOTAL	**1,927.6**	**135.7**	**7.6**	**117.0**	**6.5**	**100.0**	**8.6**

SOURCE: National Institute of Statistics and own calculations.

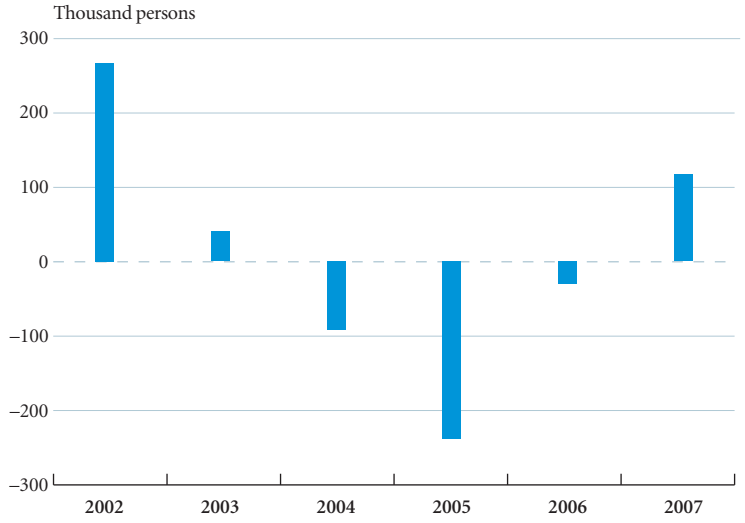
The labour force rose by 2.7% to 22.4 million persons at the end of 2007. Among males the increase was 2.2% while among females it was 3.4%. The activity ratio for females in the 16-64 age bracket reached 62.8%, an all-time record, although this was below the total activity ratio of 72.8%. In addition, the foreign worker group rose by 11.4%, which meant an increase of 337,600 persons, or 57.0% of the total. This shows how attractive the Spanish labour market is for immigrant workers.

As a result, of the higher increase in the labour force than in employment, there

All-time high in female employment rate.

UNEMPLOYMENT RECORDS BIGGEST INCREASE IN LAST FIVE YEARS

Annual change in estimated number of unemployed



SOURCE: National Institute of Statistics and own calculations.

Unemployment up 15% among foreign workers putting unemployment rate at 12.4%.

was an increase in unemployment of 117,000 persons in 2007 due to the sharp rise of 135,700 persons in the fourth quarter. This was the first annual increase since 2003. The unemployment rate for Spanish nationals stood at 7.95% while for foreign workers it was 12.4%.

Unemployment showed an uneven trend by sector. The biggest increase came in agriculture (47.7%). Construction also reported a sharp increase in unemployment with a rise of 39.3%. The increase in services was much more moderate at 6.6%. On the other hand, the number of unemployed in industry was down by 4.4%. At the same time, unemployment among those seeking their first job was down with a drop of 8.0% while those unemployed for more than one year showed a drop of 1.4%.

Increase in registered unemployment especially in construction.

In geographical terms, the trend in unemployment was quite uneven. The biggest increases in unemployment took place in the Balearic Islands, with a rise of 51.7%, and in Andalusia with a rise of 19.5%. On the other hand, in Cantabria the number of unemployed was down by 20.8% while the drop in La Rioja was 18.5%.

Registered unemployment in January marks up biggest rise in decade

The number of unemployed registered at public employment services rose by 132,378 in the first month of 2008, the biggest rise of the decade putting the total at 2,261,925. This figure represents an annual increase of 8.6%, which meant a continuation of the upward trend in registered unemployment.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

January 2007

	No. of unemployed	Change over December 2007		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	75,361	6,549	9.5	12,576	20.0	3.3
Industry	289,695	9,714	3.5	5,908	2.1	12.8
Construction	292,797	8,930	3.1	62,505	27.1	12.9
Services	1,382,354	98,104	7.6	100,750	7.9	61.1
First job	221,718	9,081	4.3	–2,322	–1.0	9.8
By sex						
Males	935,597	50,458	5.7	126,338	15.6	41.4
Females	1,326,328	81,920	6.6	53,079	4.2	58.6
By age						
Under 25 years	262,507	22,124	9.2	8,622	3.4	11.6
All other ages	1,999,418	110,254	5.8	170,795	9.3	88.4
TOTAL	**2,261,925**	**132,378**	**6.2**	**179,417**	**8.6**	**100.0**

SOURCE: INEM and own calculations.

Prices

CPI marks up highest level since 1995

In the first month of the year, the consumer price index (CPI) continued the climb begun in the last quarter of 2007 pushed up by more costly oil and food. The year-on-year change rate moved up one decimal in January going to 4.3%, thus marking up the highest level in the past 12 years. On the other hand, the more stable core of inflation, so-called underlying inflation, calculated by excluding the most volatile elements such as energy products and unprocessed foods, was down by two decimals to 3.1%.

Year-on-year CPI change rate up one decimal to 4.3% in January...

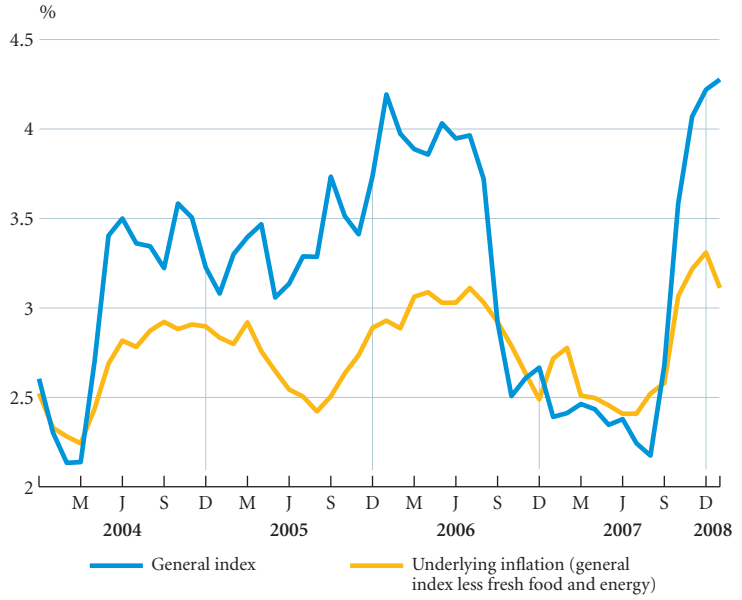
Energy products continued to rise to a greater degree at year-on-year rate compared with a period of decreases at the beginning of 2007. The price of these goods rose by 13.4% compared with January one year earlier. Fuels and fuel-oils were up 16.9% in the past 12 months. Within this group the increase in gas was half this at 7.0%. In turn, electrical power costs rose by 3.2%. As a result, the impact of the rise in energy products was two decimals in the year-on-year change rate of the CPI in January.

...due to more costly energy products...

Fresh foods also had an inflationary effect in the first month of the year going

DROP IN UNDERLYING INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

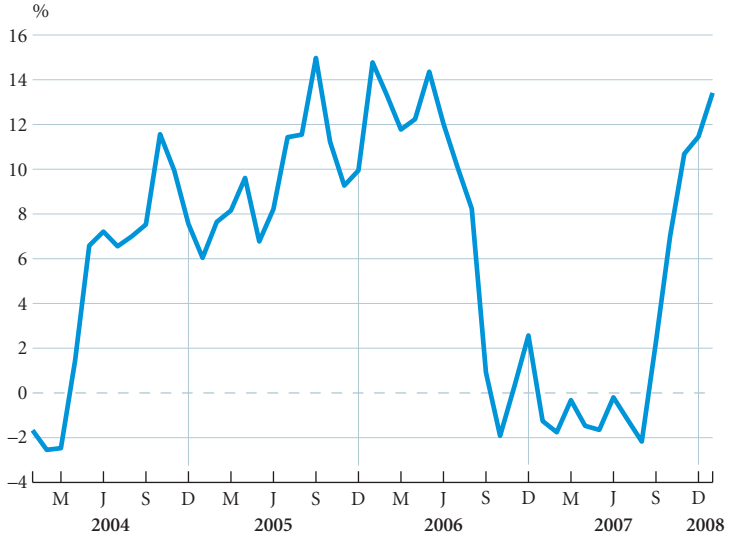
	2007			2008		
	% monthly change	% change over December 2006	% annual change	% monthly change	% change over December 2007	% annual change
January	–0.7	–0.7	2.4	–0.6	–0.6	4.3
February	0.1	–0.6	2.4			
March	0.8	0.1	2.5			
April	1.4	1.5	2.4			
May	0.3	1.8	2.3			
June	0.2	2.0	2.4			
July	–0.7	1.3	2.2			
August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

SOURCE: National Institute of Statistics.

up 5.5% compared with 12 months earlier, 6 decimals more than in December. We should mention the annual increase of 10.5% in eggs. On the other hand, pork remained depressed with a year-on-year increase of only 0.9%. In turn, processed food prices slowed to some extent although they showed an annual rise of 7.0%. Among this group, there was a notable annual rise if 28.9% for milk and 13.0% for bread. These increased reflect the rise in

SHARP RISE IN ENERGY PRODUCTS IN RECENT MONTHS

Year-on-year change in energy product prices



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

January

	Indices (*)	% monthly change		% annual change	
		2007	2008	2007	2008
By type of spending					
Food and non-alcoholic beverages	108.7	0.2	0.5	2.4	7.0
Alcoholic beverages and tobacco	109.7	5.0	2.1	8.9	3.1
Clothing and footwear	95.4	–11.7	–11.9	1.3	0.9
Housing	107.2	1.2	1.7	3.9	5.3
Furnishings and household equipment	103.7	–0.2	–0.2	2.9	2.5
Health	98.9	0.2	0.4	1.6	–1.9
Transport	105.4	–0.1	0.1	0.2	7.3
Communications	100.3	0.5	0.4	–1.3	0.7
Recreation and culture	98.1	–1.8	–1.4	–0.8	–0.4
Education	107.4	0.3	0.1	4.6	3.9
Restaurants and hotels	106.9	0.8	0.7	4.6	4.8
Other goods and services	104.8	1.4	0.9	3.8	2.4
By group					
Processed food, beverages and tobacco	108.6	1.0	0.7	2.9	7.0
Unprocessed food	109.1	0.0	0.6	3.5	5.5
Non-food products	103.5	–1.1	–1.0	2.2	3.6
Industrial goods	101.5	–2.8	–2.5	0.6	3.4
Energy products	*109.1*	*–0.3*	*1.4*	*–1.3*	*13.4*
Fuels and oils	*109.8*	*–1.3*	*0.9*	*–2.9*	*16.9*
Industrial goods excluding energy products	*98.9*	*–3.6*	*–3.8*	*1.2*	*0.1*
Services	105.6	0.6	0.5	3.8	3.7
Underlying inflation (**)	103.8	–0.8	–1.0	2.7	3.1
GENERAL INDEX	**104.7**	**–0.7**	**–0.6**	**2.4**	**4.3**

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

farm commodities in international markets as a result of supply limitations and increased demand, especially from emerging countries like China and India.

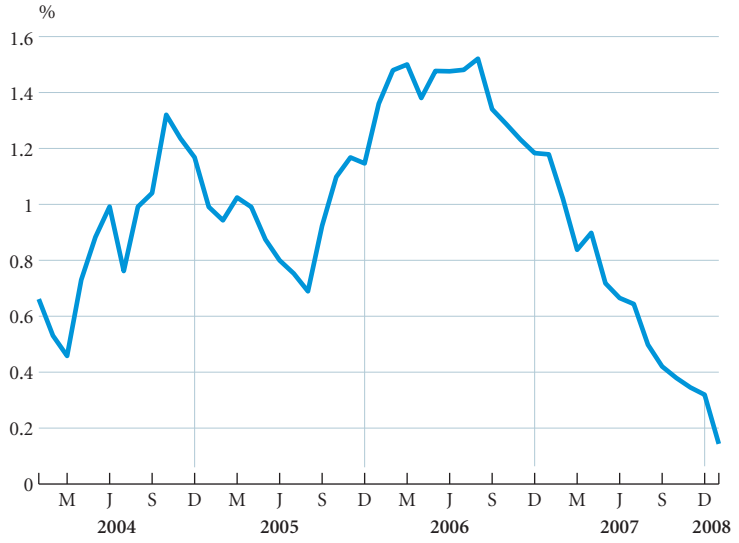
But not all prices are up. Thanks to globalization, the strength of the euro and some drop in demand, prices of non-energy processed goods continued to follow a course of moderation to the point where they showed an annual increase of only 0.1%. The winter sales were slightly more intense than the year before with a reduction in clothing prices of 13.1% in the month and 8.0% in the case of footwear. Car prices were also down 0.7% in an attempt to boost weak sales.

Services also had a positive effect on inflation with a reduction in the annual inflation rate to 3.7% in spite of the fact that a lower drop in organized travel in January raised the year-on-year change

...and rise in fresh food prices whose contribution to increase...

INFLATION ON NON-ENERGY INDUSTRIAL GOODS NEARLY NIL

Year-on-year change in prices of non-energy industrial goods



SOURCE: National Institute of Statistics.

...goes above negative impact of non-energy processed goods and services.

rate to 3.6% from 1.1% in December. In fact, there were decreases in annual change rates of prices for child and secondary education, medical services, home goods and communications.

The harmonized CPI of the European Union showed a slightly higher change rate than Spain's general rate going to 4.4%. The differential with the Euro Area held at 1.2 percentage points, more than twice the low in mid-2007 but six decimals below the high at the beginning of 2006.

Prospects for CPI are for gradual drop during year if oil does not stand in way.

The upward trend in the CPI may have been close to the annual maximum as indicated by the drop in underlying inflation in January. In any case, upward pressure from food will likely continue given the conditions of supply and demand in world markets. In any case, if there is no rise in oil prices, inflation will gradually tend downward as a result of a drop in demand.

Industrial prices show biggest year-on-year rise since 1995.

Upward pressure on wholesale prices

In recent months there has been continuing pressure on wholesale prices. These pressures come largely from the increased prices of commodities due to various reasons of supply and demand.

Industrial prices were up 6.6% in the last 12 months ending January 2008. This was the biggest year-on-year rise since 1995. The component to show the biggest pressures was energy with a rise of 13.3% compared with January 2007, as a result of the rise in crude oil. Other intermediate goods also showed upward pressures with an increase of 5.7% due to the rise in other commodities. This rise was also passed through to consumer goods to some extent with an annual increase of 5.4%. The only component to show lower inflation in January than at the end of 2007 was capital goods (2.7%) thanks to heavy world competition and increased productivity.

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											
November	0.8	3.6	2.4	2.5	6.8	1.0	2.5	0.0	–0.3	8.9	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	7.3	–
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	6.8	–
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	0.2	5.6	3.2
June	2.6	2.6	1.8	3.1	5.8	–1.4	1.1	1.0	0.0	5.9	–
July	2.5	2.3	1.9	3.1	5.6	–2.6	0.7	1.0	–0.1	4.2	–
August	5.1	2.3	2.4	3.1	5.4	–2.9	0.7	1.5	0.4	3.9	2.9
September	12.1	3.4	3.2	3.2	5.4	0.8	2.0	1.0	0.2	3.0	–
October	13.8	4.7	4.2	3.2	5.3	6.1	3.1	0.7	0.1	1.9	–
November	15.7	5.4	4.5	3.1	5.1	9.8	4.1	0.9	–0.1	0.8	2.9
December	…	5.9	4.8	2.9	4.9	11.6	5.0	1.2	–0.1	0.9	–
2008											
January	…	6.6	5.4	2.7	5.7	13.3	…	…	…	…	–

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

Import prices also showed a sharp rise in the final months of 2007 which lifted them from a mere annual inflation rate of 0.2% in April to 5.0% at year-end. Nevertheless, this rise was almost entirely due to the rise of 28.6% in energy. The other components showed low inflation levels partly thanks to the appreciation of the euro.

Finally, latest available figures up to November for farm prices also show big increases up to 15.7% on average. The biggest increases came in livestock product prices such as milk, with increases of 36.3%. On the other hand, livestock slaughter animal prices were still depressed with a drop of 2.9% over the past year.

Sharp rise in livestock products while slaughter livestock prices stay depressed.

Foreign sector

Trade deficit in 2007: new all-time high

Trade deficit continues to increase in 2007.

In 2007, the trade deficit amounted to 98.95 billion euros, a figure 10.3% higher than that recorded in 2006 and equivalent to 9.4% of gross domestic product. While the trade imbalance stands at an all-time high, we should mention the positive fact that 2007 was the second year in which the imbalance is lower than that for the year before, a sign of incipient correction.

Strong trade growth with emerging countries.

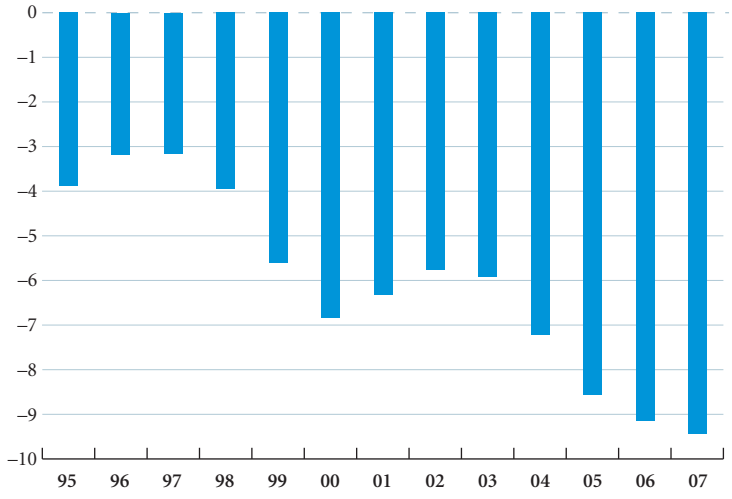
The strong level of imports (8% growth in 2007) combined with an insufficient increase in exports (up 6.8%) has meant that the export/import ratio was down by two percentage points in 2007 going to 64.7%. As has happened in recent years, the sharp growth of national demand (more than 4% in 2007) lies behind the increase in purchases from abroad.

By product, we should mention that the main group, non-energy immediate goods, which represents roughly half of both exports and imports, was also the most dynamic. In 2007, exports in that group grew by 12% while imports were up 11%. Somewhat lagging, trade in food consumer goods also recorded significant growth rates (6% in exports and 9% in imports).

The key international markets were again those in Europe. The European Union was the destination of 70% of exports and the source of 60% of

TRADE DEFICIT ABOVE 9% OF GDP

Trade balance as percentage of gross domestic product



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

FOREIGN TRADE

January-December 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	41,788	2.6	14.9	7,918	4.9	4.4	–33,870	18.9
Consumer goods	76,977	6.1	27.4	64,814	2.9	35.7	–12,163	84.2
Food	*15,831*	*8.7*	*5.6*	*21,077*	*6.0*	*11.6*	*5,246*	*133.1*
Non-foods	*61,146*	*5.1*	*21.8*	*43,737*	*–2.4*	*24.1*	*–17,409*	*71.5*
Capital goods	29,705	7.1	10.6	16,755	–1.8	9.2	–12,949	56.4
Non-energy intermediate goods	131,961	11.3	47.1	91,991	11.8	50.7	–39,970	69.7
By geographical area								
European Union EU-25	165,729	8.5	59.1	127,146	5.5	70.1	–38,583	76.7
Euro area	*138,390*	*9.0*	*49.3*	*101,512*	*5.8*	*55.9*	*–36,878*	*73.4*
Other countries	114,701	7.4	40.9	54,332	10.0	29.9	–60,369	47.4
Russia	*7,893*	*7.5*	*2.8*	*2,086*	*38.2*	*1.1*	*–5,807*	*26.4*
United States	*9,927*	*17.1*	*3.5*	*7,569*	*0.9*	*4.2*	*–2,358*	*76.2*
Japan	*6,039*	*3.4*	*2.2*	*1,331*	*–1.2*	*0.7*	*–4,708*	*22.0*
Latin America	*14,689*	*0.8*	*5.2*	*10,056*	*–3.6*	*5.5*	*–4,633*	*68.5*
OPEC	*21,508*	*–4.1*	*7.7*	*5,430*	*20.8*	*3.0*	*–16,078*	*25.2*
Rest	*54,646*	*13.5*	*19.5*	*27,861*	*15.7*	*15.4*	*–26,785*	*51.0*
TOTAL	**280,431**	**8.0**	**100.0**	**181,479**	**6.8**	**100.0**	**–98,952**	**64.7**

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

imports. In spite of this, we should point out that, over a longer period, in the past four years the EU has lost four percentage points as Spain's main export market and six percentage points as its import market. This was largely due to the major growth of three geographical areas, namely Europe outside the EU, the Americas and Asia. Specifically, from an export point of view, in 2007 markets such as Russia, India and the OPEC countries showed very significant rates of increase. With regard to import sources, we should mention major increases from China, India and Brazil.

Balance of payments: current account imbalance easing

While still growing, current account deficit shows slowdown.

In November, the current account balance reached a deficit of 11.64 billion euros, a figure 13.3% higher than that one year earlier. The main cause of this higher imbalance was the increase in the deficit in the incomes balance. The drop in the services surplus and the decrease in the current transfers balance and in the goods balance had less impact.

Apart from this specific trend, what are the background trends? If we take the cumulative figures for the twelve months

BALANCE OF PAYMENTS

November 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	–79,191	6.3	–84,820	–3,967	4.9
Services					
Tourism	*26,475*	*1.1*	*27,741*	*335*	*1.2*
Other services	*–4,735*	*–3.2*	*–5,144*	*114*	*–2.2*
Total	21,740	2.1	22,597	449	2.0
Income	–29,763	42.6	–29,869	–6,960	30.4
Transfers	–9,682	32.5	–8,131	–1,207	17.4
Total	**–96,897**	**19.0**	**–100,222**	**–11,685**	**13.2**
Capital account	**3,640**	**–13.0**	**5,629**	**–574**	**–9.3**
Financial balance					
Direct investment	–38,387	–24.1	–43,336	13,521	–23.8
Portfolio investment	105,229	–46.2	108,085	–97,444	–47.4
Other investment	17,776	–	25,470	67,004	–
Total	**84,619**	**–16.8**	**90,219**	**–16,919**	**–15.8**
Errors and omissions	–3,221	26.4	–3,583	–1,398	64.0
Change in assets of Bank of Spain	11,859	–	7.958	30,576	–

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

Big drop in inflows for portfolio investment.

ending in November, we find that the current account imbalance has tended to grow at a lower rate, given that it went from a level of 98.85 billion euros the month before to the present 100.22 billion. In year-on-year terms, this imbalance went from growth of 18.9% in the 12 months ending in October 2007 to 13.2% as the cumulative figure for the 12 months ending November 2007. This movement was due to the fact that the transfers balance had stabilized its deficit while the other imbalances (incomes balance and trade balance) were down and the services balance was up.

With regard to financial flows, we should point out that net outflows for direct investment, in cumulative figures for 12 months, amounted to 43.34 billion euros, a figure 24% less than that reported one year earlier. In turn, net inflows for portfolio investment were approximately half those one year earlier, amounting to 108.09 billion euros.

This sharp adjustment points to one of the key current questions: the impact of the subprime mortgage crisis on the surplus in Spain's economy with regard to international financial markets. Since last August inflows for portfolio investment going into bonds and obligations (as a 12-month figure) showed a sharp downward adjustment, a process that continued up to

November. On a much smaller scale, the entry of funds going into money market instruments was also down from the start of the financial crisis. On the other hand, portfolio investment in shares and investment funds rose in August but since then has shown a positive but flat trend.

Is it possible to know who is manipulating the exchange rate?

In April 2005, US senators Schumer and Graham accused the Chinese authorities of maintaining an undervalued exchange rate and proposed an across-the-board tariff of 27.5% on Chinese imported goods. This way they hoped to correct the competitive disadvantage of American products vis-à-vis Chinese imports. In order to avoid a trade war with the Asian giant, the Bush Administration did not support the bill and it was not approved. In spite of the fact that the Chinese renminbi has appreciated 15% against the dollar since then, it is still quite usual to hear the complaints of US politicians and business executives (some Europeans as well) proposing measures against those countries that, in their view, are «manipulating» their exchange rates in order to compete with advantage in international markets. The Chinese authorities defend their position alleging that it is not clear that their currency is undervalued and that, in any case, it has appreciated significantly in the past two years. The debate continues because it is very difficult to accurately estimate the «correct» value for the exchange rate of a currency.

At the request of all parties involved, especially of the United States, the International Monetary Fund (IMF) has become something of a referee evaluating possible manipulation of exchange rates by its members. A recent paper explains the methodology used to estimate the equilibrium exchange rate for each country while admitting it is a difficult task[1]. In general, the various methodologies are aimed at evaluating the Real Effective Exchange Rate (REER), an index number constructed as a weighted average of exchange rates of a country's currency against its main trading partners and takes into account the price level differentials. That is to say, it is a weighted real exchange rate. In practice, the REER of countries with similar productivity growth rates tends to fluctuate around a more or less constant value over time, because in the long run prices of the same good tend to equalize between countries with similar characteristics. Nevertheless, the deviations from this value can be important and it might take years before they are fully corrected.

The simplest methodology used to evaluate an exchange rate (that is the REER) consists in comparing its current value with its average value over the long term, which may be considered its «equilibrium» value. The following graph shows the REER for the largest economies. All series have been normalized such that their average over the past 20 years is 100. What does this graph show? First, the currencies that seem to be most undervalued are the dollar and the yen, with a value of around 10% less than their historical average. The euro would be at its long-term value while the Chinese currency, the renminbi, would be 5% overvalued.

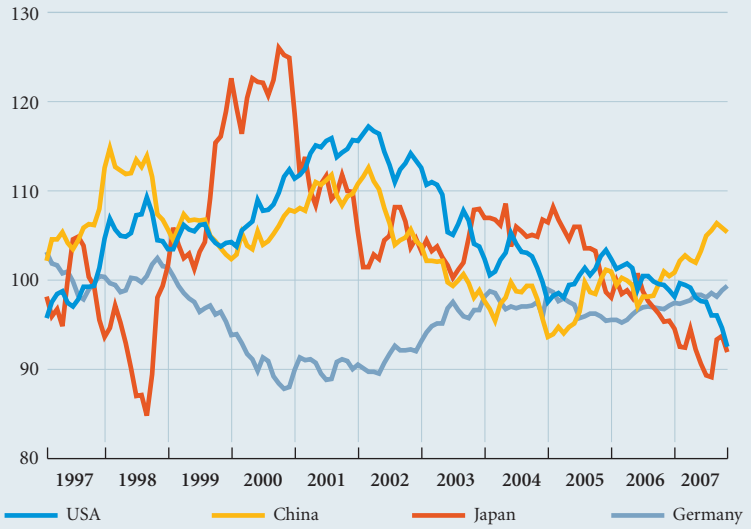
Then, how can we understand american criticism of Chinese foreign exchange policy? Economists recognize that the above methodology is not very useful for comparing countries that are not very similar. There are a

(1) See «Methodology for CGER Exchange Rate Assessments», International Monetary Fund, November 2006, Washington, DC, USA.

number of reasons for this. It is a well established fact that emerging countries experimenting a process of opening up have higher productivity growth rates than industrialized countries, as is the case of China and India, and their foreign exchange rates show a tendency to appreciate. As a result, faced with the evidence of the previous graph, senators Schumer and Graham and their followers would reply that, while it is true that China's REER has appreciated, it should do so to an even greater extent.

REAL EFFECTIVE EXCHANGE RATES COME CLOSER IN VALUE OVER THE LONG TERM

REER, average 1987-2007 = 100



SOURCE: IMF.

Furthermore, the equilibrium exchange rate over the medium term also depends on the economic policies that countries adopt. For example, if a country conducts an expansionary fiscal policy, the increase in domestic demand would tend to cause a trade deficit. Depreciation of its currency would then be needed in order to foster exports and raise the cost of imports so that external balance is restored. This is the case of the United States and for this reason some analysts suggest that the dollar should depreciate even more.

These examples show the need for a more sophisticated approach to determine the «right» value of a currency. For this reason, the IMF has developed a battery of models that take into account the effects discussed above. They also include other effects, such as those arising from commodity prices for those countries that are large exporters and importers, and from considerations of external debt sustainability over the long term, to mention just a few.

What does the IMF have to say about the value of the main currencies? For the US currency, it estimates a slight overvaluation of up to 10% and, therefore, the dollar should depreciate slightly in order to improve the foreign position of the United States[2]. In the case of the euro, the IMF suggests it is close to its balance value based on the foreign position of the European economy. For China and Japan, the IMF mentions that these currencies are

(2) See Isard, P., «Equilibrium Exchange Rates: Assessment Methodologies», IMF Working Paper 07/296, Washington, D.C., USA.

undervalued but it avoids going into numerical values. Such omissions reflect the serious political tension the issue of the exchange rate can generate, especially the bilateral exchange rate with the dollar.

To summarize, it seems possible to estimate, even though imprecisely, the degree of undervaluation or overvaluation of a currency with presently available tools. Another matter is who should referee international disputes over the manipulation of exchange rates and if measures should be applied to countries suspected of manipulation. It would appear reasonable that the IMF or the World Trade Organization (WTO) were the arbitrators. However, it is to be expected that those countries choosing an undervalued exchange rate as part of their economic development strategy would strongly oppose those bodies being given adequate means to apply sanctions.

Public sector

General government attains highest surplus in recent decades

Extent of public debt drops to lowest level in last 20 years.

The sharp growth of the economy in 2007 brought about a notable surplus in general government of 23.37 billion euros, which represents 2.23% of gross domestic product (GDP). This was the third consecutive annual surplus and the highest level in recent decades. As a result, the extent of the government debt in terms of GDP continued to drop going to 36.2% of GDP, the lowest level in the past 20 years.

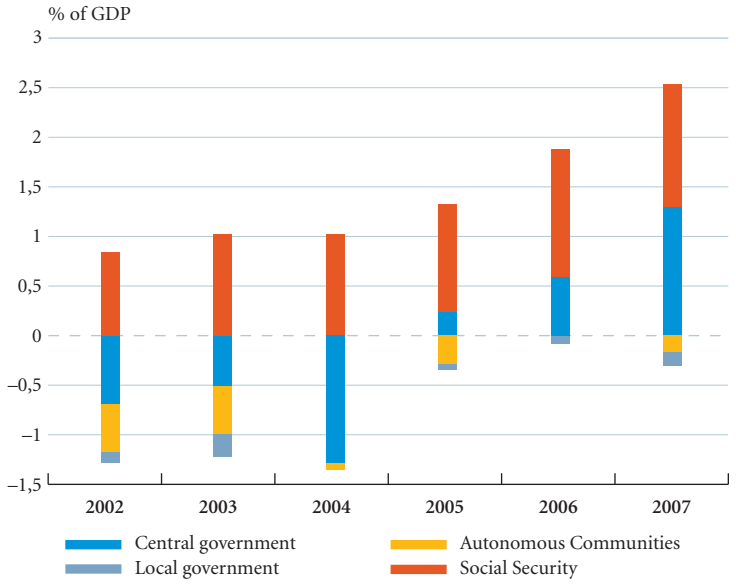
Heavier tax load in spite of tax reform of personal income and company tax.

The surplus for general government as a whole in 2007 involved a major contribution of 1.29% of GDP from central government, more than twice that of the previous year. The contribution from Social Security was of like kind (1.25% of GDP) although this ratio was slightly lower than in 2006. The surplus obtained in recent years made it possible for the Social Security reserve fund to reach 45.72 billion euros at the end of 2007. This figure meant 4.35% of GDP. Furthermore, on February 8 Cabinet approved an allocation of 4.7 billion euros. On the other hand, the balances of the Autonomous Communities and local government showed slight deficits.

The increase in the central government surplus was largely due to the good state of tax revenue that grew more than

IMPROVED BALANCES OF GENERAL GOVERNMENT

Balance of general government



SOURCE: Ministry of Economy and Finance.

nominal GDP so that the tax load showed an increase. Direct taxes and Social Security contributions were up 18.1%. Collections for personal income tax rose by 15.7% reflecting the limited impact of the reforms that came into force in January 2007. Revenues from company tax were up 20.5% which also shows the small effect of the new rules on this tax.

Indirect taxes were up 3.4% in 2007. This was largely due to the fact that the main tax heading, value added tax (VAT), was up by only 2.2%, partly under the effect of a slowdown in private consumption. Special taxes showed a substantially higher increase of 6.4%. Among these taxes, the one to show the biggest rise was that on tobacco which was up by 12.8%.

Non-financial spending by the central government in 2007 rose by 7.2%. Staff costs were up by 6.6%. The increase in current spending on good and services was much higher at 17.2% reflecting the effect of spending related to the elections. Real investment was up 11.8% while capital transfers rose by 23.5%. Financial spending was the only large heading to show a drop (6.9%) due to the maturities calendar for the public debt.

In 2008 the government surplus will likely drop due to a less expansionist economic situation which will bring higher spending to cover unemployment. Available figures for January 2008 all go in this direction. The surplus in terms of National Accounting, using accounting criteria of amounts receivable and amounts payable, was down from 0.28% to 0.13% of GDP in the first month of the current year.

Collections for value added tax ease because of drop in private consumption.

Government surplus for 2008 likely to drop because of less expansionist economic situation.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

December 2007

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**11,431**	**20.5**	**159,839**	**12.7**
Non-financial revenue adjusted (*)				
Personal income tax	4,101	5.4	72,614	15.7
Corporate tax	4,283	22.4	44,823	20.5
VAT	2,580	28.1	55,851	2.2
Special taxes	1,652	3.2	19,787	6.4
Other	2,980	28.1	21,169	18.5
Total	**15,596**	**17.0**	**214,244**	**12.1**
Non-financial spending	**15,400**	**2.1**	**139,704**	**7.2**
Treasury balance	**–3,969**	**–29.1**	**20,135**	**75.5**
Surplus (+) or deficit (–) (**)	***–11,942***	***–20.0***	***13,523***	***209.1***

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

Savings and financing

Funding granted to private sector up 16% in 2007

Loan interest rates rise in nominal terms in 2007.

Interest rates on loans and credits granted to the private sector in 2007 continued the upward path begun in the second half of 2005 gradually reflecting the increases in the European Central Bank official rate. Nevertheless, in the final quarter of 2007 loan interest rates were practically stable with the disappearance of prospects of further reference rate increases in the Euro Area. As a result, the average interest rate on loans to companies and households ended the year at 6.03%, an increase of 0.9 percentage points.

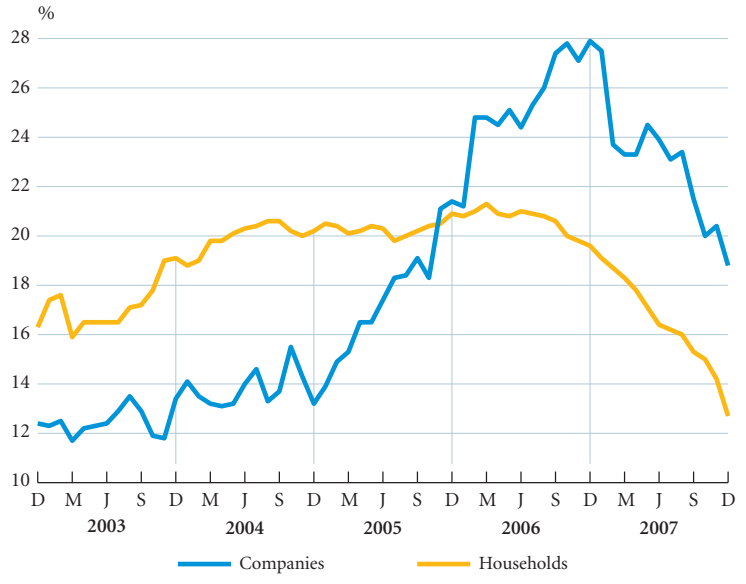
In fact, in real terms the interest rate on loans ended 2007 below the level seen the year before given that the inflation rate was 1.5 percentage points higher.

Loan terms tighter, according to latest Bank of Spain survey of loans.

In spite of this decrease in interest rates in real terms, in the three last months of 2007 conditions for obtaining loans tightened, according to figures from the latest survey on bank loans published by the Bank of Spain. According to this survey, the restriction was harshest in the case of companies and for households buying a home. This trend was mainly brought about by changes in the perception of economic risks, as well as higher funding costs and less availability

SHARP DROP IN FUNDING GRANTED TO COMPANIES AND HOUSEHOLDS

Year-on-year change in funding to companies and households



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

December 2007

	Total	Change over 12 months		% share
	Million euros	Million euros	%	
Commercial credit	90,818	5,442	6.4	5.2
Secured loans (*)	1,068,373	145,397	15.8	60.7
Other term loans	497,913	83,324	20.1	28.3
Demand loans	40,582	6,469	19.0	2.3
Leasing	46,293	5,580	13.7	2.6
Doubtful loans	16,236	5,377	49.5	0.9
TOTAL	**1,760,215**	**251,589**	**16.7**	**100.0**

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

of funds in wholesale markets because of the upsets in financial markets as a result of the high-risk mortgage crisis in the United States. On the other hand, we also note a general drop in loan demand.

In this framework, funding granted to the private sector in the final months of 2007 showed a sharpening of the decline begun the year before. The annual change rate dropped to 16.1% in December 2007, some 8.1 percentage points less than 12 months earlier. In any case, this was still high annual growth, higher than that of the Euro Area as a whole. Prospects for 2008 are for a continuation of the slowdown, keeping in mind the easing off expected in domestic demand. Furthermore, the Bank of Spain survey on bank loans foresees a tightening of borrowing terms in the early months of 2008.

Funds granted to non-financial companies showed a sharp decrease in growth rate. The figures moved up by 18.8% in 2007, some 9.1 points less than one year earlier. The easing in funds granted may be seen in all types of financing. Leasing, which is used for investment, was up by 13.7%, less than the total, but the slowdown here was less marked being only 2.7 points less than 12 months earlier.

Prospects for 2008 are for continuation of drop in credit to private sector.

Household debt also showed signs of wearing out. Funding of households rose by 12.7%, some 6.9 points less than the rate in 2006. The main source of this drop came from housing which went from an annual increase of 20.4% in 2006 to 13.2% in 2007. The increased financial effort required to buy a house because of the rise in housing prices and interest rates resulted in a drop in effective demand. But other loans to individuals also showed a similar decrease to show annual growth of 11.2% in 2007.

By type of institution, banks maintained their share at 43.6% of the total thus breaking with a downward trend in recent years. Savings banks raised their share in this market segment slightly to 47.3%. Credit unions continued with 5.2% of the total while other financial entities were down by three decimals.

The change in the stage of the financial cycle was also noted in the trend in default. The doubtful loans rate rose very

Slight rise in default rate in 2007 but still below 1%.

Private sector deposits up 16% in 2007, nine points less than one year earlier.

slightly to stand at 0.92% just two decimals above the all-time low in December 2006. It thus held below 1% and remains substantially below the European average. In 2008, an increase is expected starting out from very low levels but Spanish financial institutions are backed by high provisions against these risks.

Savers prefer time deposits

Deposits for less than two years up 43% in 2007 as result of new tax rules on savings.

The drop in loans was reflected in slower growth in bank deposits attracted by these financial institutions in 2007. Deposits by the private sector in financial entities rose by 15.6% last year, some 9.5 points less than the year before. This drop in growth rate of deposits took place in spite of all the campaigns by financial institutions to attract them. This involved an increase in returns but even so average return was below the inflation level at year-end.

In view of stock market drops savers taking refuge in short-term money-market funds and deposits.

Nevertheless, the interest rate on time deposits rose more and went to 4.4% in December to stand above inflation. Term deposits for up to two years were the type to show greatest growth with an annual increase of 43.1%. They were also aided by the end of tax discrimination depending on type of product and term as of January 2007 under the new tax regulations on savings. Sight accounts, on the other hand, were down by 2.3% under the effect of low interest rates.

Banks continued to regain ground in this deposit segment putting their share at 41.9% whereas as credit unions and savings banks showed a slight drop in share. Nevertheless, savings banks maintained their leading position in this market segment with a share of 51.6%.

January was a negative month for mutual funds which showed losses of 5% in total assets which went to 226.85 billion euros also with a reduction of 5% in the number of participants. Net withdrawals from funds were high totalling 7.80 billion euros. In general, given the unfavourable performance in share markets, savers showed aversion to risk and took refuge in short-term bond-based funds and bank deposits.

On the other hand, the volume of pension funds at the end of 2007 stood at

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

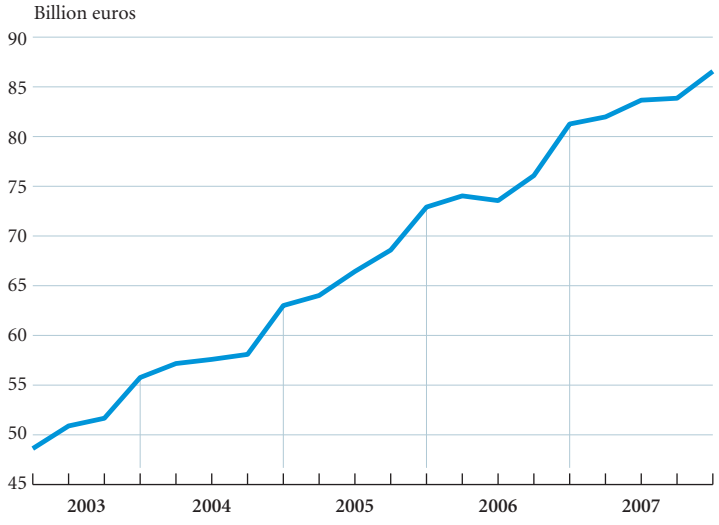
December 2007

	Total	Change over 12 months		% share
	Million euros	Million euros	%	
On-demand savings (*)	438,057	-10,280	-2.3	33.1
Up to 2 years	352,706	106,300	43.1	26.7
More than 2-year term	402,004	69,155	20.8	30.4
Repos	85,611	1,787	2.1	6.5
Total	**1,278,378**	**166,962**	**15.0**	**96.7**
Deposits in currencies other than euro	**43,844**	**11,127**	**34.0**	**3.3**
TOTAL	**1,322,222**	**178,089**	**15.6**	**100.0**

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

UPWARD TREND IN PENSION FUNDS CONTINUES

Total assets of pension funds



SOURCE: Inverco.

86.56 billion euros. This figure represents an annual increase of 6.5%. As opposed to investment funds, net contributions to pension funds in 2007 were positive by an amount of 3.08 billion euros. It is logical that the growth of pension plan contributions is more constant than net flows to mutual funds as these are instruments with a long-term purpose. Although average annual return in 2007 was disappointing (2.1%), over the long term it was well over inflation with an average annual return of 6.35% for the past 17 years.

Pension funds reach average return of 6.35% for last 17 years.

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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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