MAY 2008

THE SPANISH ECONOMY

Monthly Report

NUMBER 313

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2007				2008	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	2.9	2.2	1.2	1.5	1.9	2.8	2.5	2.5	1.2
Japan	2.4	2.0	1.6	2.9	1.7	1.9	1.7	1.3	1.8
United Kingdom	2.9	3.0	2.1	3.0	3.2	3.1	2.8	2.5	2.1
Euro area	2.9	2.6	1.5	3.2	2.5	2.7	2.2	1.7	1.5
Germany	*3.1*	*2.6*	*1.5*	*3.7*	*2.6*	*2.5*	*1.8*	*1.5*	*1.6*
France	*2.2*	*1.9*	*1.4*	*1.9*	*1.4*	*2.2*	*2.1*	*1.6*	*1.4*
Consumer prices									
United States	3.3	2.8	3.4	2.5	2.5	2.4	4.0	4.2	3.5
Japan	0.2	0.1	0.5	–0.1	–0.1	–0.1	0.5	1.0	0.3
United Kingdom	2.3	2.3	2.5	2.9	2.6	1.8	2.1	2.4	2.4
Euro area	2.2	2.1	3.0	1.9	1.9	1.9	2.9	3.4	3.3
Germany	*1.6*	*2.3*	*2.5*	*1.8*	*2.1*	*2.3*	*3.1*	*2.9*	*2.6*
France	*1.7*	*1.5*	*2.5*	*1.2*	*1.2*	*1.3*	*2.3*	*2.9*	*2.6*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	3.7	3.1	2.2	3.5	3.4	3.1	2.7	2.4	2.3
Government consumption	4.8	5.1	4.4	6.1	5.0	5.1	4.4	3.5	4.0
Gross fixed capital formation	6.8	5.9	2.4	6.3	6.7	5.8	4.8	3.6	2.5
Capital goods	*10.4*	*11.6*	*5.1*	*13.1*	*13.1*	*11.6*	*8.6*	*7.5*	*6.0*
Construction	*6.0*	*4.0*	*0.9*	*4.9*	*4.6*	*3.8*	*2.9*	*1.4*	*0.4*
Domestic demand (contribution to GDP growth)	5.1	4.6	2.8	5.1	4.9	4.5	3.9	3.1	2.8
Exports of goods and services	5.1	5.3	4.8	3.6	4.7	7.7	5.1	5.1	4.9
Imports of goods and services	8.3	6.6	4.8	6.0	6.7	8.4	5.4	4.9	4.6
Gross domestic product	**3.9**	**3.8**	**2.5**	**4.1**	**4.0**	**3.8**	**3.5**	**2.8**	**2.6**
Other variables									
Employment	3.2	3.0	1.5	3.3	3.1	3.0	2.5	2.0	1.6
Unemployment (% labour force)	8.5	8.3	9.8	8.5	8.0	8.0	8.6	9.6	9.3
Consumer price index	3.5	2.8	4.0	2.4	2.4	2.4	4.0	4.4	4.2
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	–9.3	–9.5	–8.7	–10.1	–9.8		
Government balance (% GDP)	1.8	2.2	0.9						
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	5.0	5.0	2.0	5.3	5.3	5.1	4.5	2.8	1.9
ECB repo	2.8	3.9	3.9	3.6	3.8	4.0	4.0	4.0	4.0
10-year US bonds	4.8	4.6	3.2	4.7	4.8	4.6	4.1	3.5	3.1
10-year German bonds	3.8	4.2	4.0	4.0	4.4	4.3	4.2	3.9	3.7
Exchange rate									
$/Euro	1.26	1.38	1.54	1.32	1.35	1.39	1.46	1.53	1.57

Contents

Ice and fire: a return of stagflation?

«The situation where we are is between ice and fire. Ice has to do with the economic slowdown and fire has to do with inflation.» Dominique Strauss-Kahn, managing director of the International Monetary Fund, could not have been more graphic at the press conference prior to the Spring meetings of the IMF and the World Bank at the beginning of April. Following some years of extraordinary world growth, the analysts recognize that a time of slowdown has now begun. In the United States it is accepted that the economy has moved into recession. In Europe, the loss of drive is evident. In Spain, the drop in the growth profile has made it necessary to make a downward correction in forecasts for 2008.

In addition, inflation appears to have returned. Structural and cyclical factors lay behind the fact that a barrel of oil marked up new all-time highs in April. And that prices of basic foods (soy, rice, maize and wheat) have shot up in price over the past year. The inflation rate in the Euro Area in March (the latest figure available) showed the highest level since the launching of the euro in 1999. In Spain, growth of the consumer price index went to its highest level in 13 years. But the most disturbing problem is to be found in the developing countries. The increase in cost of foods basic to their diet could lead to increased poverty in broad segments of the population as well as in the emerging countries that are benefiting from globalization.

Ice and fire. Economic stagnation combined with high inflation. Is stagflation on its way back? This takes us back in time to the beginning of the Seventies. At that time, economists were convinced that unemployment and inflation developed in opposite directions. That is to say, a rise in unemployment and an excess of production capacity would lead to a drop in wages and the inflation rate. On the other hand, an increase in economic activity and corporate profits would sooner or later translate into higher wages and increases in prices. This opposing relation became known as the so-called "Phillips curve", one of the analytical centre-pieces of macroeconomic thought derived from Keynesian theory dominant at that time.

Suddenly the curve fell apart. When the Arabian and other oil exporting countries decided to establish a cartel for their sales thus creating the first oil crisis at the end of 1973, the Western economies saw their growth slow down, with some going into recession, along with a rapid rise in unemployment and, at the same time, a sustained increased in the inflation rate. The restrictive policies scarcely managed to affect inflation rates and they ended up with increased unemployment. Expansionist policies scarcely had any effect on the unemployment rate while, on the other hand, they stimulated price increases. Some years were to pass before the experts were able to better understand the mechanisms that operate in relating unemployment and inflation and to design suitable policies to deal with those imbalances.

Can we establish parallels between the stagflation of the Seventies and Eighties and the current situation? In this issue of the Monthly Report we raise this question and sketch out some of the key factors that make it possible to differentiate and distinguish between the two situations. Furthermore, closely related to the problems of stagflation, we look at the dilemmas faced by the central banks and review the case of Japan, which remains an enigma ever since the collapse of its asset markets at the end of the Eighties. The verdict will not be easy but what we learn from the difficult period of stagflation should serve to avoid our once more falling into the same errors.

EXECUTIVE SUMMARY

Trillion dollar crisis

World economy cooling off, United States moves into low or no-growth stage, Europe may hold up better while emerging countries save situation for now.

The slowdown of the world economy is now a fact and this is comes out in the economic prospects report issued by the International Monetary Fund (IMF) this month. After recording increases of around 5% in recent years, it is expected that the world economy will grow by 3.7% in 2008, a half-point below the forecast made in December. This major correction is the result of sombre expectations especially in the United States following the realization that the mortgage crisis in the leading world economy had turned into a broad ranging financial crisis that would not be easily resolved.

Rise in world prices for food and oil complicate international economic situation.

The US economy is going into its first recession since the stock market crisis at the beginning of the decade and the terrorist attacks on the Twin Towers. But it is estimated that this will be a gradual recession. What makes the situation troubling is the fact that coming out of the recession will be slow and difficult so that economically 2009 will also be a poor year. Europe will fare somewhat better and, while suffering an appreciable slowdown, this will not be one of extreme degree. If the world economy is still maintaining acceptable growth rates it is thanks to the fact that the emerging powers, with China playing a notable role, are coming through the crisis relatively unscathed.

IMF puts financial crisis cost at 945 billion dollars.

Another international concern recognized in the IMF report is inflation which is moving up to troubling levels, especially in the developing countries. And the problem is not only oil. Now part of the rise comes from the trend in basic products, especially in foods such as rice, soy, maize and wheat. These are foods that form the basic diet of the poorest population in the world for whom getting enough food to eat is the first priority.

In fact, commodity prices continue to bring surprises. With oil coming close to 120 dollars a barrel and essential products such as rice at alarming prices, the downward adjustments in certain metals have gone almost unnoticed. Behind this movement we find demand factors, especially the continuing buying pressure from emerging economies, supply blockages (including political reaction in favour of limiting exports in some producer countries) and reverberations of the financial crisis which show up in the fact that commodities continue to be considered an attractive investment as against other alternatives.

With regard to the financial crisis, both the IMF and the Organization for Economic Cooperation and Development made public new calculations about its extent. With all necessary caution, natural for a highly hypothetical year, the IMF put the cost of the financial crisis at 945 billion dollars, including direct and indirect effects. A trillion dollars in losses is not easily digested. It is now more understandable why the IMF does not believe that the crisis can be easily dealt with in a weak year and then simply go back to the trends seen in recent years.

With regard to the crisis, we should mention the somewhat better situation

in the stock markets in recent weeks. This may be interpreted as a presumption that, even if the situation does not improve, it is not going to get significantly worse either. In this respect, the latest available figures for losses and provisions of the large international banks have been valued favourably, given that it is felt they reflect that the bulk of the process of showing up losses due to the crisis is now taking place.

In any case, in other spheres it is noted that the problems are still far from being dealt with. Restrictions on liquidity still exist, as may be seen in the substantial increase in interbank interest rates with the 12-month Euribor close to 5% at the end of April. The markets, however, seem to feel that the situation is not going to get worse. In this context, the moves by the central banks are being decisive in establishing this perception in order to prevent the liquidity crisis from getting worse.

In the real economy, everything indicates that the United States is at the doors of a recession. Weak consumer indicators and the persistent real estate crisis, which shows no signs of endig, confirm this.What no one knows is what profile the drop will take. It also seems likely that the situation of stagflation will be long drawn out.

China, on the other hand, stands in a diametrically opposed situation. While the United States had a blow-out in the first quarter, the Asian giant grew by 10.6% year-on-year in the same period. Other emerging countries have maintained their strength, which is helping to sustain the rate of world economic activity.

The strength of the emerging countries is benefiting the Euro Area. The single currency economy seems to have ridden out the early months of 2008 with relative success. Its trade surplus (of note here are the flows with emerging countries) continues to grow even overcoming the hurdle of an extremely high-value euro (at all-time highs against the dollar). Furthermore, countries like Germany are showing a domestic demand that is holding up. While early indicators confirm the slowdown trend, for the moment there is no need to fear a recession in economic activity in coming months along the lines in the United States.

While financial storm continues to cause havoc, trend in stock markets seems to indicate it will not get worse.

At this time, the basic problem of the Euro Area has more to do with inflation than economic activity. With the increase in consumer prices to the highest since the setting up of the Economic and Monetary Union in 1999, the European Central Bank will have difficulty dropping its anti-inflation message. Inflation shows up in the figures month after month while the slowdown in the economy belongs in a future scenario. Furthermore, with inflation at 3.6%, a nominal interest rate at 4% does not present a very big monetary restriction so that anchoring inflation expectations definitely continues to be the present priority. It should be remembered that this is not simply a matter of oil and fresh foods given that, even discounting these components, resulting inflation has been consistently rising in recent months.

China growing close to 11% in first quarter while United States slows down considerably.

Spain's economy: slowdown sharpening

Spain's economy is also suffering from the end of a long expansionist cycle although this has been less abrupt than in the case of its European neighbours. Inflation is also a concern rising as it has to its highest level since 1995. In this case, however, a comparison with what is happening in the Euro Area (the inflation differential is holding firm) makes it seem less serious.

In Europe, faced by incipient slowdown, concern centred on rise in prices.

In Spain, evidence accumulating that slowdown getting sharper.

On the other hand, the trend in the economy in Spain reflects a growing loss of drive. Available indicators suggest that the slowdown became sharper in the first quarter. This trend is especially to be noted in the real estate field and in consumer durables. For example, there was a surprisingly sharp adjustment in car sales although it should be remembered that as Easter Week took place in March a year-on-year comparison could be biased.

Real estate and durable goods consumption bear brunt of slowdown.

Confirmation of the turn-around in the first quarter shows up in figures on the labour market. Both registrations with Social Security and registered unemployed at employment offices confirm a sharp halt to job creation in the first three months of the year. The same result shows up in the Labour Force Survey carried out by the National Institute of Statistics. According to that survey, the first quarter of 2008 saw the loss of 75,000 jobs while the unemployment rate rose by more than one percentage point compared with the previous quarter going to 9.6%.

Government makes downward revision of growth forecasts and launches programme to stimulate economy.

In this situation, it is to be hoped that there will be some correction in the foreign imbalance as a beneficial result of the present slowdown. Up to February, however, this has not taken place. Figures for foreign trade in goods show a further increase in the trade balance, a result of the rise in imports which is beating the improvement in exports. While an incipient slowdown in imports is noted as domestic demand gets weaker, the rise in prices of energy and food imports is compensating for this trend.

The rise in consumer price index in recent months may also be explained by upward pressures arising from the increase in prices for oil and agricultural commodities in world markets. Inflation continued to rise in March for the seventh month in a row, on this occasion by one decimal, the same as in the previous two months. The figure for the consumer price index in March (4.5%) was twice the annual change rate of 2.2% recorded in August 2007.

Less growth with more inflation is a scenario little to be desired by the economic policy makers. This is why at the first meeting of Cabinet this legislature the main outlines of an action Plan to deal with the economic crisis were presented. Along with certain measures already announced during the election campaign, such as the deduction of 400 euros on personal income tax, moves were taken to eliminate property tax, the lengthening of maturity dates son mortgages loans for families in financial difficulties, new supports for financing subsidized housing, increasing public works construction and facilities for workers to relocate.

These are measures that should halt the slowdown in economic activity but they will not be able to avoid the change in cycle beginning to take place in Spain's economy. The Ministry of Economy has revised official growth forecasts downward putting the increase in 2008 at 2.3%, a substantial revision compared with those being set up to this time and one decimal lower than those put out by the Bank of Spain at the beginning of the month.

April 28, 2008

CHRONOLOGY

2007

April	**13**	Publication of Law 6/2007 in Official Government Bulletin (BOE) modifying the regulations applying to **takeover bids** which come into force in mid-August.
June	**6**	**European Central Bank** raises official interest rate to 4.00%.
	14	Parliament approves new **Law on Safeguarding Competition** with creation of National Competition Commission.
	21	EU Council of Ministers approves **adoption of euro as national currency for Malta and Cyprus** as of January 1, 2008.
August	**9**	European Central Bank injects extraordinary liquidity into interbank market as early emergency move to ease pressures set off by **subprime mortgage crisis** in United States.
	13	US Federal Reserve reduces discount interest rate from 6.25% to 5.75% in order to relieve effects of **subprime mortgage crisis**.
September	**18**	**Federal Reserve** reduces reference rate to 4.75%.
October	**9**	Dow Jones index for **New York stock exchange** marks up all-time record (14,164.5), a rise of 13.7% compared with end of 2006.
	19	European Council agrees to adopt the **Treaty of Lisbon** in place of the European Constitution.
	31	**Federal Reserve** cuts reference rate to 4.50%.
November	**8**	IBEX 35 index for **Spanish stock market** marks up all-time high (15,945.7) with cumulative gains of 12.7% compared with end of December 2006.
December	**11**	**Federal Reserve** cuts reference rate to 4.25%.
	13	Central banks in United States, Euro Area, United Kingdom, Switzerland and Canada announce plan for **coordinated measures to relieve difficulties in monetary markets** brought about by financial upsets.

2008

January	**1**	Further enlargement of **Euro Area** with entry of Cyprus and Malta, making 15 member states.
	22	**Federal Reserve** reduces reference rate to 3.50%.
	30	**Federal Reserve** reduces reference rate to 3.00%.
March	**9**	Spanish Socialist Workers Party wins **general elections**.
	18	**Federal Reserve** cuts reference rate to 2.25%.
April	**18**	Government approves a **Plan for measures to stimulate the economy**.
	23	**Euro** exchange rate at 1.594 to dollar, highest figure since launching of single currency at beginning of 1999.
	25	One-month forward Brent quality **oil** price goes up to all-time high of 117.18 dollars a barrel.

AGENDA

May

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

June

- **3** Registrations with Social Security and registered unemployment (May).
- **5** Industrial production index (April). Governing Council of European Central Bank.
- **11** CPI (May).
- **16** Harmonized CPI for EU (May).
- **17** Quarterly labour cost survey (1st Quarter).
- **24** Central government revenue and spending (May).
- **25** Producer prices (May). Foreign trade (April). Fed Open Market Committee.
- **30** Balance of payments (April).

INTERNATIONAL REVIEW

IMF reduces its world growth forecast for 2008 to 3.7%, with bigger drop in developed economies.

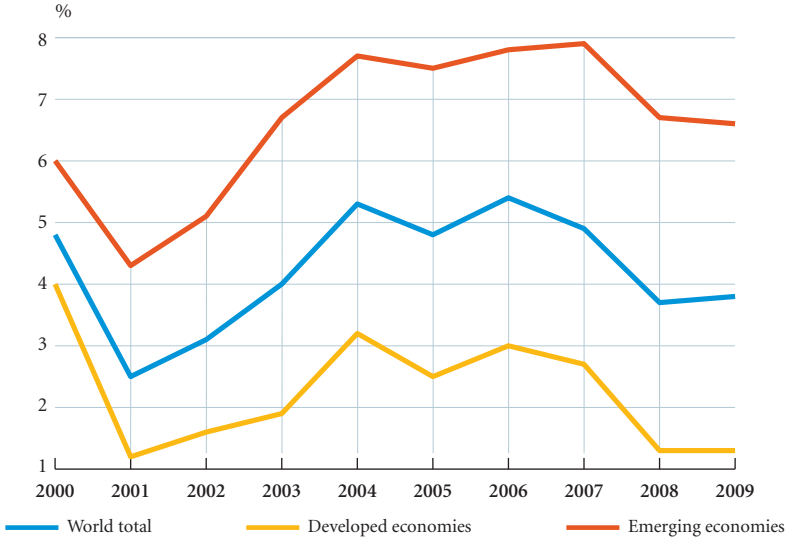
IMF forecasts: world economic activity losing steam

In its world April forecasts, the International Monetary Fund (IMF) lowered its growth forecasts for 2008 from 4.8% to 3.7% because of a financial crisis that has turned out to be more serious than many people earlier believed. In 2009, it expects a slight recovery with growth of 3.8%. The pressures, which initially were considered limited to the housing market, are having major effects on economic activity in general with growing default rates, worsening of assets used as collateral and tightening of borrowing conditions.

The slowdown has been greatest in the developed economies where growth of 1.3% is expected in 2008 and 2009. The emerging economies have been less affected by the upsets in lending and their projected growth is put at above 6.5% for the same period. The direct consequences of this financial instability have been eased more than in past crises, thanks to fiscal consolidation and strong domestic demand. At the same time, there has been a general rise in inflation. Commodity prices have continued to rise because of strong demand in emerging markets and because these areas have been seen as refuge assets by some financial players. The dollar

WORLD GROWTH FIRM BUT DOWNWARD RISKS EXIST

Year-on-year change in gross domestic product



NOTES: 2008 and 2009 are forecasts.
SOURCE: International Monetary Fund.

IMF FORECASTS

Annual change as percentage

	2006	2007 (1)	2008 (1)	2009 (1)
GDP				
United States	2.9	2.2	0.5	0.6
Japan	2.0	1.9	1.4	1.5
Germany	2.9	2.5	1.4	1.0
France	2.0	1.9	1.4	1.2
Italy	1.8	1.5	0.3	0.3
United Kingdom	2.9	3.1	1.6	1.6
Spain	3.9	3.8	1.8	1.7
Euro Area	**2.8**	**2.6**	**1.4**	**1.2**
Advanced economies	**3.0**	**2.7**	**1.3**	**1.3**
World total	**5.4**	**4.9**	**3.7**	**3.8**
Developing countries	*7.8*	*7.9*	*6.7*	*6.6*
Latin America	*5.5*	*5.6*	*4.4*	*3.6*
Eastern and Central Europe	*6.6*	*5.8*	*4.4*	*4.3*
Russia	*7.4*	*8.1*	*6.8*	*6.3*
China	*11.1*	*11.4*	*9.3*	*9.5*
Consumer prices				
United States	3.2	2.9	3.0	2.0
Japan	0.3	0.0	0.6	1.3
Germany (2)	1.8	2.3	2.5	1.6
France (2)	1.9	1.6	2.5	1.7
Italy (2)	2.2	2.0	2.5	1.9
United Kingdom (2)	2.3	2.3	2.5	2.1
Spain (2)	3.6	2.8	4.0	3.0
Euro Area (2)	**2.2**	**2.1**	**2.8**	**1.9**
Advanced economies	**2.4**	**2.2**	**2.6**	**2.0**
Developing countries	*5.4*	*6.3*	*7.4*	*5.6*
Unemployment rate (3)				
United States	4.6	4.6	5.4	6.3
Japan	4.1	3.9	3.9	3.9
Germany	9.8	8.4	7.9	7.7
France	9.2	8.3	7.8	7.9
Italy	6.8	6.0	5.9	5.8
United Kingdom	5.4	5.4	5.5	5.4
Spain	8.5	8.3	9.5	10.4
World trade by volume (4)	**9.2**	**6.8**	**5.6**	**5.8**
Oil price ($ per barrel) (5)	**20.5**	**10.7**	**34.3**	**–1.0**

NOTES: (1) Forecasts at April 2008.
(2) Harmonized consumer price index.
(3) Percentage of labour force.
(4) Goods and services.
(5) Average spot prices for Brent, Dubai and West Texas Intermediate oil. Average oil price in dollars per barrel forecast at $95.5 in 2008 and $94.50 in 2009.
SOURCE: International Monetary Fund.

Risks in scenario signalled by IMF all downward.

sharply depreciated in 2007 because of lowering confidence in dollar assets and the slowdown of the US economy.

The dangers for this main scenario all point downward with the possibility of world growth being below 3% both in 2008 and 2009. The main risk factor is that further worsening of financial conditions could spread to the real economy, especially in the United States. Europe may also follow this course although to a lesser degree. At the same time, it is possible that inflationary pressures will increase.

United States expected to grow by only 0.5% in 2008 and 0.6% in 2009 while growth forecast for Europe reduced.

By geographical area, the United States is where forecasts show most downward with the drop in growth for 2008 expected to be from 1.5% in January to 0.5%. In 2009, the forecast goes from 1.8% to 0.6% so that recovery will not come until later. In Japan, the growth projection is also slightly down at 1.4% for 2008 and 1.5% for 2009.

Emerging countries make it possible to maintain world economic growth.

For Europe, forecasts have also been reduced for almost all countries. Following growth of 2.5% in 2007, Germany has lower growth prospects with these going to 1.4% for 2008 and 1.0% for 2009. Growth prospects for France are very similar while for Italy growth is seen as being practically stagnant with increases of 0.3% for the next two years. Due to the importance of the construction sector, Spain is given a substantial adjustment in the forecasts for 2008 with a change from expected growth of 2.4% to just 1.8%. The situation will not change much for 2009 with an increase of 1.7% expected.

Recovery may be delayed as housing, credit, labour market and oil continue to slow private consumption.

For the emerging countries, with no growth problems, the main challenge will be to control inflation. According to the IMF, China and other countries with diversified economies in terms of trade relations will benefit from a higher fluctuation in their currencies in terms of the US dollar and will have greater freedom to adjust their monetary policies to their own needs. In China and other countries of Eastern Asia, well-ordered public accounts, where necessary, will make a counter-cyclical fiscal policy possible. In Latin America, major debt levels limit the capacity to use tax stimulants.

United States: How low will crisis last?

The effects of the subprime mortgage crisis continue to be noted in the economy and the key word these days is «Recession». Nevertheless, applied to the length of the period of economic weakness, the most relevant question should be «How long?» In simplistic terms, we may say that there is a recession when economic activity slows for a period of time. But there is little difference between a small advance without recession and a slight drop with recession. In the past 20 years, the gross domestic product (GDP) has grown by an average of 2.9% annual. Since the end of 1987, if each year had shown an advance at this constant rate, the GDP at the end of 2007 would be just what it is now, a rate it has reached through ups and downs.

The loss of cumulative growth in a period of weakness may be considered as the difference between theoretical growth accumulated at 2.9% annual and that actually recorded. Let us look at the past two recessions. The first, at the beginning of the Nineties, recorded seven quarters with growth below 2.9% so that the cumulative drop in terms of «full speed ahead» was 4.5%. The second

recession, that in 2001, had three alternating quarters showing negative growth but it was necessary for 11 quarters to go by before the increase in GDP reached 2.9%. In this case, the cumulative loss was 5.3%. In the current situation in the US economy, growth has been below 2.9% since March 2006. Cumulative growth since then was 3.9% whereas at full-steam-ahead it would have been 5.1%. Therefore, the cumulative loss up to now would be 1.2% of GDP, an acceptable figure but one that will get higher depending on what the recovery has in store.

What will determine the duration of this crisis? The answer is easy: private consumption. In this respect, consumer confidence, especially in expectations, is low and the slowdown in retail sales is sharpening. In March, sales, excluding cars and petrol, rose by a poor 0.9% year-on-year which, if we discount changes in non-energy prices means a drop o 1.4%. The situation should get worse before we see the light at the end of the tunnel seeing that there are four factors holding back private consumption: the real estate crisis, the restrictions on credit, the labour market and oil and food prices. Let's look at these matters one at a time.

Discounting inflation, retail sales down.

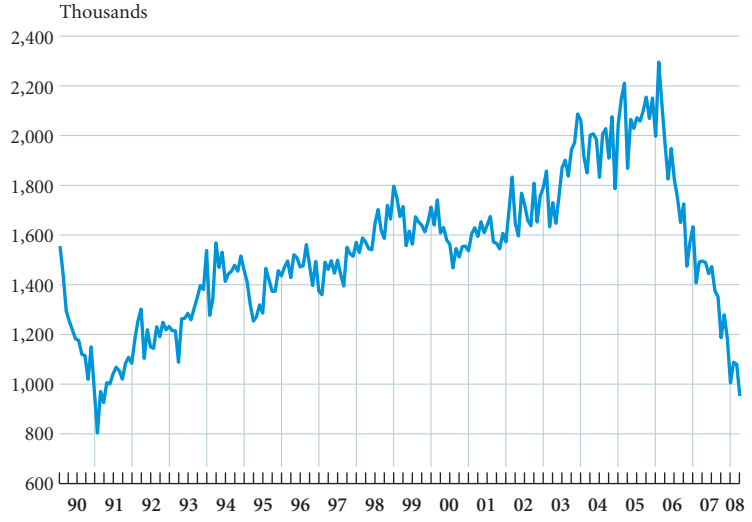
The real estate market has not yet touched bottom. In January, the Case-Schiller index for housing prices, the factor which most directly affects consumers, was 11.4% below the level at the same period last year. On the supply side, housing starts in March were down 36.5% year-on-year reaching a low not seen for over 17 years. Building permits, which are an early indicator of starts, showed an even bigger drop of 40.9%. With regard to the second question, access to credit has been a more and more important support for consumption in a period when incomes were shaky. With easy access to credit, household savings in relation to available income has been dropping and in 2007 ended up as nil. Now, the drop in housing prices leaves many families with debt higher than the value of their

Housing starts drop 36% and prices down 11%.

Many households finding debt higher than value of real estate.

UNITED STATES: CONSTRUCTION AT LOWEST LEVEL IN 17 YEARS

Housing starts in annual terms



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

Labour market sharpens slowdown while oil cuts purchasing power.

real estate and this creates a tendency to default. The attitude of banks in the future, even when they end up solving all their problems, will be greater caution in granting loans so that the consumer will have to recover the custom of saving.

The third factor, which precisely affects the income of consumers, is the labour market, its main source. Employment continues to weaken. In March, 80,000 jobs were lost adding to the drops in the two previous months. The slowdown, still relatively slow, is sharpening. Employment was up by 0.4% in the last 12 months ending in March, while in the same period last year it rose by 1.2%.

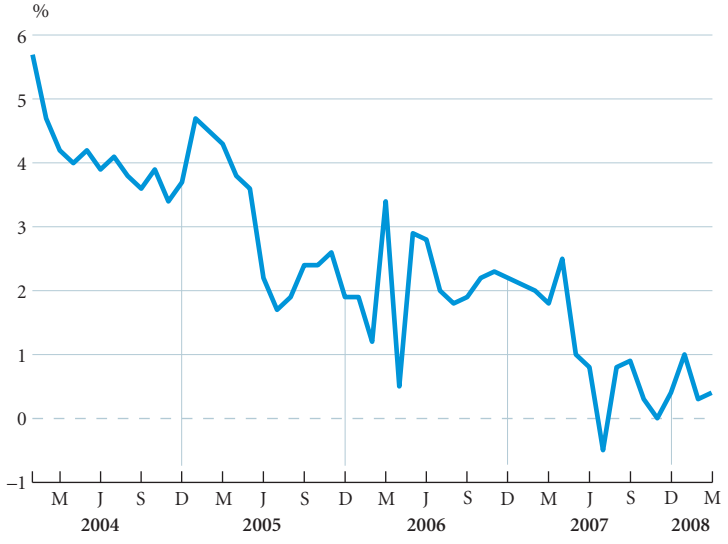
Inflation holds at 4%, ISM indicator stays close to 50 and correction of trade deficit slow.

A fourth factor has to do with inflation. The March consumer price index (CPI) rose by 4.0% year-on-year. The underlying component, the general index excluding food and energy, rose slightly to 2.4% year-on-year. The increase in the underlying index, excluding rentals, remains close to a reasonable 2.0% but the risk is that food and oil will continue to be high-priced for some time. The question here is to see that, while the pass-through of these prices to other sectors will be minimal, the real problem is the cut this represents to household budgets, that is to say, what remains after paying for petrol.

The view from the corporate side is somewhat less dramatic. The economic activity index put out by the Institute for Supply Management (ISM) for the manufacturing sector in March was up slightly to 48.6 points, a level lower than 50, and this indicates some predominance of pessimistic responses. In the case of the ISM services index, this showed a recovery from the sharp drop in January with the index reaching 52.2 points in March. In both cases, we see a continuation of upward pressure in prices and weakness in employment.

UNITED STATES: SAVINGS NON-EXISTENT

Household savings as percentage of disposable income



SOURCE: Bureau of Economic Analysis 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	4Q	January	February	March
Real GDP	2.9	2.2	1.5	1.9	2.8	2.5	–	2.5	–
Retail sales	6.2	4.1	3.6	4.0	4.1	4.6	4.0	2.9	2.0
Consumer confidence (1)	105.9	103.4	109.9	106.7	105.7	91.2	87.3	76.4	64.5
Industrial production	2.2	1.7	1.3	1.4	1.8	2.2	2.6	1.1	1.6
Industrial activity index (ISM) (1)	53.1	51.1	50.5	53.0	51.3	49.6	50.7	48.3	48.6
Sales of single-family homes	–18.0	–26.3	–24.6	–21.2	–26.6	–33.5	–32.5	–29.8	...
Unemployment rate (2)	4.6	4.6	4.5	4.5	4.7	4.8	4.9	4.8	5.1
Consumer prices	3.2	2.9	2.4	2.6	2.4	4.0	4.4	4.1	4.0
Trade balance (3)	–758.5	–708.5	–747.4	–734.3	–707.6	–708.5	–710.1	–714.2	...
3-month interbank interest rate (1)	5.2	5.3	5.4	5.4	5.4	4.9	3.1	3.1	2.7
Nominal effective exchange rate (4)	82.5	77.9	81.9	79.3	77.0	73.3	73.1	72.6	70.3

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.

In turn, the trade balance for goods and services showed a deficit of 62.32 billion dollars in February, clearly above the January figure because of a rise in imports. Correction of the deficit, excluding oil, stands at 31% of the high in 2005 and will continue. Another question is that the growth of exports, which make up 12.5% of GDP, may compensate for the weakness of consumption which accounts for 71.5%.

Stagflation: How can we stop Pandora?

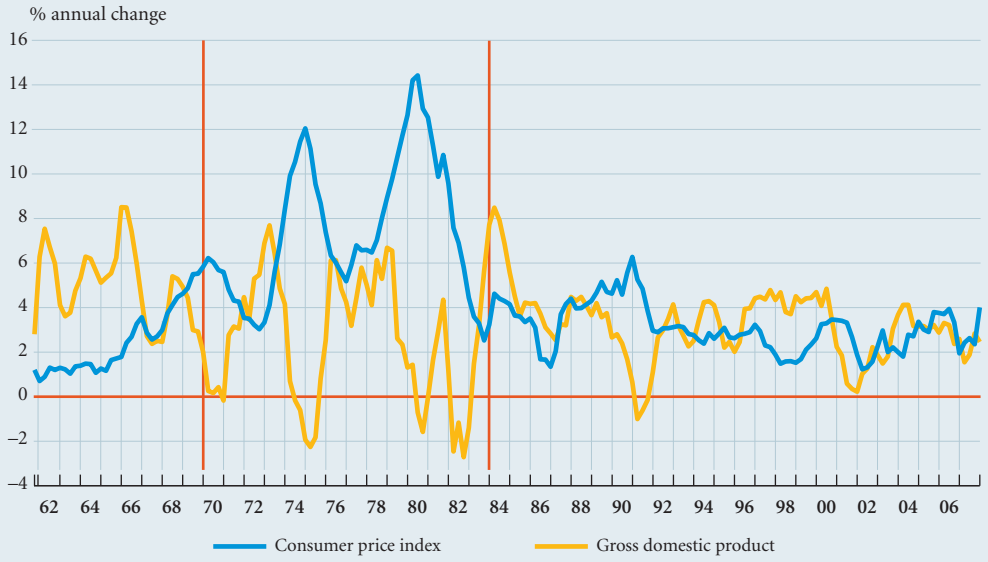
According to the myth, until Pandora opened her celebrated jar (turned into a «box» by the Renaissance) humanity had enjoyed the fullest of harmony on earth. On opening it up, Pandora released all the evils of mankind. There are those who fear that, following a period of relative calm, the spell between the subprime mortgage crisis and the imbalances in commodity markets might release one of the worst economic evils – that demon called «stagflation».

The origin of the term stagflation goes back to 1965. In a speech to Parliament, Ian McLeod, who later would become Britain's Chancellor of the Exchequer, combined the words «stagnation» and «inflation» to describe an economic situation that drew together the worst of two worlds –a rise in prices on the one hand and economic stagnation on the other– and which tormented many countries for more than a decade. The recent surge in world inflation and the slowdown of economic growth in the United States (see previous graph) and other advanced economies (including Spain) has brought back the almost forgotten memory of

that period. While the similarities between both periods are remarkable, the differences may provide the key for avoiding a return to a cursed past which many (especially the monetary authorities) would like to shut up forever.

Right at the beginning of the Seventies, the coincidence of a period of high economic growth and a series of poor harvests resulted in world commodity prices sky-rocketing. The OPEC (Organization of Petroleum Exporting Countries) embargo in October 1973 quadrupled oil prices and did nothing but to worsen a situation that ended up affecting the purchasing power of US households. All of this led the United States and, in turn, the other main economies to a recession in 1974-1975 at the same time as inflation reached all-time high records. In 1979, to darken the scene even more, instability in the Middle East brought new restrictions on oil and the second oil shock in less than 10 years.

USA: TOWARDS ANOTHER STAGFLATION WAVE?



NOTES: GDP at constant 2000 prices. Year-on-year change, quarterly figures.
SOURCE: Bureau of Economic Analysis and own calculations.

As a result, still scarcely recognized as a problem, stagflation suddenly became a reality that, according to the economic theories of the time, was a complete anomaly. The traditional Keynesian school, predominant since World War II, considered it unlikely that stagnation and inflation occurred simultaneously. In fact, historical experience had led them to associate a drop in economic activity (specifically, a rise in the unemployment rate) with a decrease in inflation, a relation known as the «Phillips curve».

The extent and duration of stagflation in the Seventies dismantled the stability of the Phillips curve and, along with it, the Keynesian models of the time. This resulted in a complete rethinking of the usual theory and macroeconomic policy recipes. Economists Milton Friedman and Edmund Phelps, both awarded the Nobel prize, were the first to present an hypothesis which explained the disappearance of the traditional relationship between inflation and unemployment. The key was to be found in inflation expectations. When monetary

authorities allow excessive inflation for too long, both firms and workers tend to anticipate higher future inflation and to incorporate that expectation in their negotiations of prices and wages. In a not too competitive environment and with a labour market not too flexible, this pushes wages and prices upward in a process that, if not controlled, might deliver an inflationary spiral.

While no absolute consensus has been reached about what was the main culprit for stagflation in the Seventies, two possible explanations stand out: a negative supply shock and the mistaken and recurring implementation of traditional Keynesian macroeconomic policies. The predominant perspective calls on both factors – the rise in commodity prices lit the fuse and the expansionary monetary policies aimed at halting recession did the rest. The inflation resulting from excessive money creation would have affected expectations and, in a more regulated and less competitive environment than nowadays, it would have easily passed through to prices and wages yielding an inflationary spiral.

Returning to the current situation, there are those who see remarkable similarities between the present economic situation in the United States and that existing in the Seventies. Certainly, the slowdown in economic growth in recent months (as a result of the subprime mortgage crisis and the subsequent disorder in financial markets) is obvious. Yet, in spite of that, inflation is holding at around 4%, that is, high relative to recent years (see previous graph). Furthermore, the Federal Reserve has been cutting interest rates in an attempt to avoid the impact of the financial crisis on the real economy. All of this makes many people wonderif we are on the edge of a new outbreak of stagflation not only in the United States but on a world scale, as ended up happening in the Seventies.

While the similarities between both periods may be troublesome and a moderate version of stagflation in the United States is possible, the return of such a harsh episode as lasting and widespread as that of the Seventies is quite unlikely. The big difference between today and the Seventies lies in inflation expectations. To begin with, the current level of inflation lies far from the two digit figures in that time, although recent expansionary policies could generate more inflation. Secondly, regulation in the United States is more flexible and the economic environment much more competitive, so that it is harder to generate inflationary spirals. Finally, and the key factor, both economic theory and policies have radically changed since then. With a better understanding of its ability to influence inflation expectations, the Federal Reserve has shown its determination to avoid any similar episode. In recent years, the growing emphasis of most central banks in maintaining low and stable inflation has been a key factor in gaining credibility and thus reducing the inflationary pressures resulting from supply shocks. It is unthinkable they would now tolerate levels of inflation as those in the Seventies which could put that reputation in danger.

Hence, while stagflation continues to pose a dilemma for conventional macroeconomic policy (used to combating a period of recession with expansionary formulas and an inflationary period with restrictive formulas), current economic theories incorporate changes in inflation expectations and offer alternative formulas to those used by central banks in the Seventies. Today, they set out from the hypothesis that long-term stagflation is entirely a consequence of a poor use of those policies and the key lies in stimulating the economy so long as inflation expectations remain well in check. So long as they continue in this way (see following graph) it is possible to understand the current emphasis of the Federal Reserve in preventing recession but, if the moment should come when the stability of those expectations should topple, there is no doubt that monetary policy would again become restrictive with the aim of avoiding an inflationary spiral. It is precisely the constant vigilance of the Fed regarding any factor that could set off inflation that maintains those expectations under control.

According to the myth, Pandora replaced the lid of the jar just before Hope flew away too. We hope that monetary authorities can stop its Pandora before she opens the box or at least in time to keep inside trust in central banks, past experience and what has been learned since then.

INFLATION EXPECTATIONS HOLD STABLE IN THE UNITED STATES, IN SPITE OF EVERYTHING

SOURCE: University of Michigan and own calculations.

Japan continues gradual growth but consumers not involved, while public purse remains in red.

End of deflation due to high-cost oil and not to domestic demand.

Japan: growth with the public purse empty

On March 31 last, the opposition to prime minister Yasuo Fukua had a curious parliamentary victory. It managed to win removal of a «temporary» tax on petrol consumption in place for 30 years. This was a Pyrrhic victory given that the Japanese treasury could not allow any free spending. With past reductions made in public consumption no further cuts could be made and, according to the Organization for Economic Cooperation and Development (OECD) the budgetary deficit for 2007 reached 3.4% of GDP while gross cumulative public sector debt came to 180% of the total economy.

With the capacity for fiscal growth limited and interest rates at 0.5% that left little room for reduction, what is really surprising is that Japan is facing its sixth year of growth, although of low profile, showing growth of 1.7% year-on-year in the fourth quarter.

Deflation, the drop in prices, has been a curse for the economy in recent years. Forecasts by the Bank of Japan predicted that growth of demand would put an end to the period of deflation. Nevertheless, what has temporarily ended the price drops has come from outside, namely, expensive oil and food. In this respect, import prices in March grew by 8.3% year-on-year in contrast to lower cost exports whose prices were

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	2.4	2.0	2.9	1.7	1.9	1.7	–	...	–
Industrial production	4.2	2.9	3.6	2.4	3.1	2.7	2.9	4.0	...
Tankan company Index (1)	22.5	22.0	23.0	23.0	23.0	19.0	–	11.0	–
Housing construction	4.5	–17.2	–1.9	–2.8	–36.9	–27.1	–5.7	–5.0	...
Unemployment rate (2)	4.1	3.9	4.0	3.8	3.8	3.8	3.8	3.9	...
Consumer prices	0.2	0.1	–0.1	–0.1	–0.1	0.5	0.7	1.0	...
Trade balance (3)	9.4	12.5	10.3	11.1	12.3	12.5	12.4	12.2	...
3-month interbank interest rate (1)	0.3	0.7	0.6	0.7	0.8	0.9	0.9	0.9	0.8
Nominal effective exchange rate (4)	81.1	77.1	77.6	75.7	76.9	78.4	82.0	82.3	85.8

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.

down by 6.8%. Thanks to this, the February CPI rose by 1.0% year-on-year while the index excluding fresh foods rose by the same amount, which represents the biggest increase in the last 10 years. Nevertheless, the underlying inflation index, the general index excluding energy and food, again recorded a decrease of 0.1% compared with the same period the year before.

The unemployment rate continues at very low levels because of the falling population. In February, it stood at 3.9% of the labour force. This does not translate into wage increases and consumer confidence remains at low levels. However, in the same month retail sales continued to rise with growth of 3.2% year-on-year. Car sales also stabilized their decreases in March although they continue to be 15% below the highs in 2005. On the supply side, industrial production was up by 4.0% in February going close to 2006 levels. What stands out under this heading is the strength of production of consumer goods which went up to growth rates of 6.9% year-on-year. Nevertheless, machinery orders, an early indicator of investment demand, increased in the same period by a slim 2.7% year-on-year and, as usual, thanks to orders in the export industry whose relative weight continues to increase and now stands at 49.9% of the total.

Industrial production up while unemployment remains low...

Publication of the Tankan industrial activity index put out by the Bank of Japan for the first quarter of 2008 watered down these slight increases. The index for large manufacturing companies went down from 19 to the 11 points level while the index for large non-manufacturing companies dropped from 16 to 12. Expectations for coming months are for a decrease in capital formation, a chapter that has been precisely one of the main engines of economic activity in recent times.

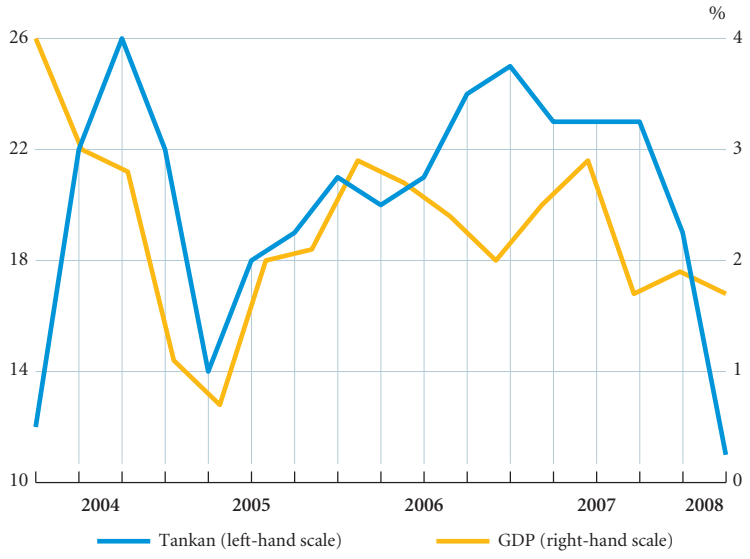
...but business executives see things bleak and show little interest in investing.

In turn, the real estate market is seeing a drop in economic activity that is not reaching prices. Real estate sales in March dropped by 33.3% year-on-year in the Tokyo area but nevertheless prices continued to rise with an increase of

Real estate market stagnant but trade surplus holding up thanks to exports to Asia.

JAPAN: TANKAN INDEX NOT SHOWING GOOD PROSPECTS

Tankan index of large manufacturing companies and year-on-year change in GDP



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

6.2% year-on-year. The increase in land prices also continued in the six largest cities with a year-on-year increase of 8.8% in the third quarter of 2007, 21.6% above the low at the beginning of 2005. Housing starts were down by 5.0% year-on-year in February but in absolute terms there were 95,866 housing starts, 58% above the September low.

The trade surplus which in the 12 months up to February reached 12,200 billion yen went back to the positive side, thanks to the strength of exports. Taking the figures for February, the decrease of 6.0% year-on-year in exports to the United States was compensated by an increase of 13.8% in those going to the rest of Asia, with a notable increase in trade with India, the countries belonging to the Association of South-East Asian Nations (ASEAN) and China, which indicates that for the moment Asia is keeping up its strength in spite of the weakness of the US economy.

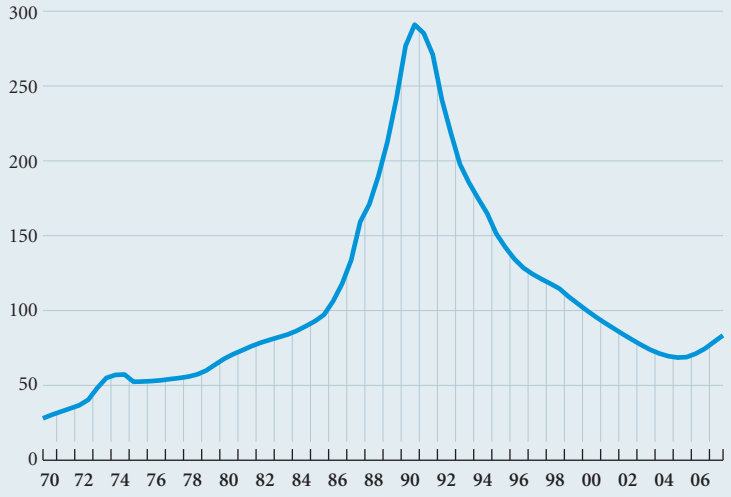
Financial and real estate bubbles: lessons from Japan's experience

At the end of the Eighties, Japan's economic growth seemed unstoppable. In terms of purchasing power parity, the country was the second biggest economy in the world with an overall economic position that went from 8.4% in 1980 to 9.3% in 1991. If Japan's economic progress was powerful the value of its assets was even greater. In 1989, fostered by a continuously appreciating currency, the capitalization of the stock market valued in dollars was more than half of the world total. Nor did real estate values seem to have any limit and many people were speculating that Japan would take over from the United States as leader of the world's economy.

Nevertheless, Japan was on the point of moving into a lost decade. Since the beginning of 1991, the «promised land» went into a long lethargy from which it has not yet clearly surfaced. In the Eighties, cumulative growth of GDP in real terms had been 43% but in the following decade the increase was a mere 9.6%. Its share of the world economy dropped to little more than 6%. Many people are asking up to what point the bursting of the Japanese stock market and real estate bubble is similar to what is now happening in the United States. Or, if the prolonged period of economic stagnation, such as that borne by Japan, could be what is now waiting for us following the heady moments in recent years. Are there lessons to be learned from Japan's experience?

LAND IN JAPAN: A RUGGED ROAD THERE AND BACK

Land price index in six largest cities



SOURCE: Japan Real Estate Institute, Tomson Datastream and own calculations.

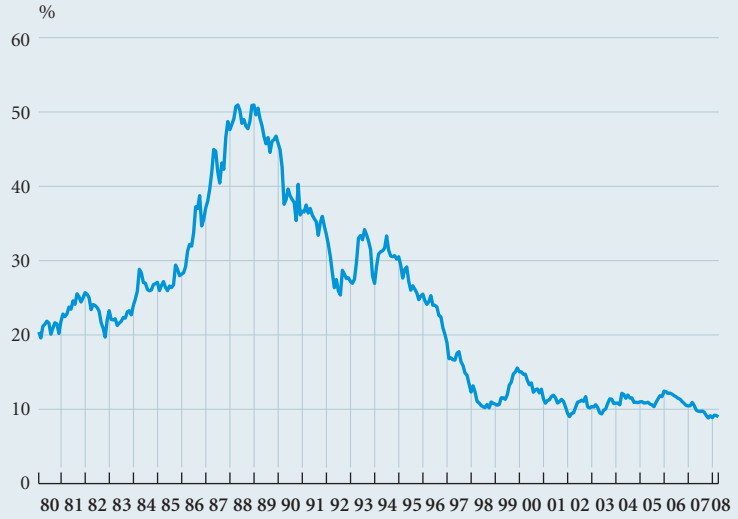
There is no easy answer. The first thing to check is why Japan suffered such a drastic interruption to its rise. What was the cause of the weakness in its domestic demand and the long period of deflation. A quick answer would be in the combination of two elements forming part of Japan's own idiosyncrasies or way of acting, that is to say, a stagnant population with a tendency to ageing and a culture tending to excessive saving.

Nevertheless, the hypothesis of idiosyncratic factors is very incomplete. The main cause of the «lost decade» was the way in which the vast financial and real estate bubble was managed. It is in this way, although to a different degree, where we can see the risk of similarities with the credit crisis originating in the US mortgage market. From a high in December 1988, when capitalization of the Japanese stock market reached an incredible 51% of the world total, it began a long period of decreases that, exactly ten years later, put this figure at 11%. The Nikkei 225 index hit a ceiling in December 1989 of 40,000 points. Less than three years later, in August 1992, it was not above 15,000 points. In 2003, it dropped to below 7,500.

The losses in the real estate sector would be even more spectacular. Prices simply collapsed following a spectacular rise. Between the beginning of 1991 and the second quarter of 2005, land prices in the six main cities as a whole fell by 75.9% and for retail property losses went to 86.9%. In the country as a whole, the

JAPAN: STOCK MARKET UPS AND DOWNS

Share of Japanese stock market capitalization in terms of world total



SOURCE: Economic Intelligence Unit and own calculations.

decreases were somewhat less drastic but this was no solace because in 2006 losses reached 55.9% of the value reached in 1991.

These decreases in asset value had important effects on the book values of those who had plenty – companies and banks. Japanese companies, through a system of close relationships with banks that gave place to low risk premiums, had traditionally enjoyed high levels of borrowing in order to make heavy investments. With the loss of asset value, debt ratios shot up to extremely high levels in many cases putting the net book value, asset value less debt, as negative. Nevertheless, in spite of the worsened situation in their balance sheets, many Japanese companies still were able to run their business well. Consumer electronics, measuring instruments, computers and cars continued and still continue to be highly competitive in international markets.

As a result, many companies found themselves in this situation. A consequence of this was a drop in corporate borrowing[1]. Beyond balance sheets, this phenomenon can also be seen in the decrease in the relative weight of investment over the GDP.

Partly following the thinking of US economist Irving Fisher (who a century ago anticipated collapse situations such as the present one), liquidation of debt brought with it an avalanche of asset sales. The scarcity of investment and excessive savings carried the country to a situation of deflation. Japan's central bank raised the money supply and nominal interest rates fell but the problem was not a lack of liquidity but a lack of companies ready to take out loans and invest.

(1) Richard C. Koo, *Balance Sheet Recession*: 2003. John Wiley & Sons (Asia) Ltd. Chapter 1.

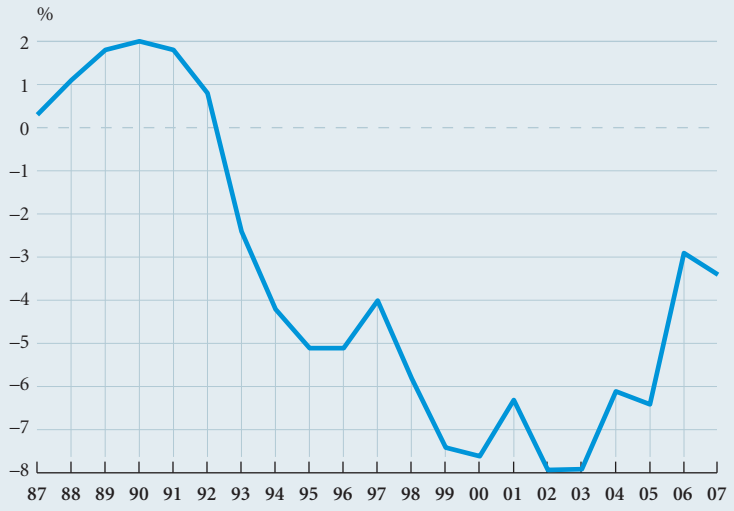
In the banking sector things were no better. According to Anil Kashyap[2], Japanese banks, with no profitable products on an international scale, had comparative advantage in the Japanese corporate sector, but as this was little willing to borrow they had few options left to them. Furthermore, their balance sheets were plagued by bad debts. Injections of liquidity by the Bank of Japan served to reestablish balance sheets but not enough for granting loans and relaunching economic growth. Furthermore, with nominal long-term interest rates at levels of no more than 1% or 2%, the interest rate curve stayed practically flat and, without any difference between long and short-term interest rates, the recovery of banks was made more difficult. The puzzle ended up being more complicated because, with the advent of deflation, the low nominal interest rates turned into relatively high real rates, generally higher than those in the United States and Europe, which finally discouraged investment.

There was only one course to try, namely, to force an increase in aggregate demand through public spending and the government deficit. The worst risk was to create inflation but in these circumstances, a rise in prices would be considered a blessing. But this didn't work. In just a few years came enormous deficits, with public debt reaching sky-high rates, but the result was disappointing in terms of growth. It was as if Japanese citizens had counteracted the huge government deficit with greater private savings, anticipating the future taxes which public spending would end up requiring.

In recent years, the situation of Japan's economy seems to be returning gradually to a situation of normalcy. Some lessons for the current situation arise from Japan's long crisis. The first is the need to react rapidly and

JAPAN ENDS UP RECURRING TO FISCAL EXPANSION

Budget balance of public sector compared with GDP



SOURCE: Economist Intelligence Unit and own calculations.

(2) Anil Kashyap, «Japan's Route to Safety», *Financial Times*, Dec. 5, 2001.

firmly in the face of outbreaks of real estate and financial bubbles. The second is the key role to be played by a rapid reestructuring of the banking sector so that the financing mechanisms of the economy are quickly reestablished.

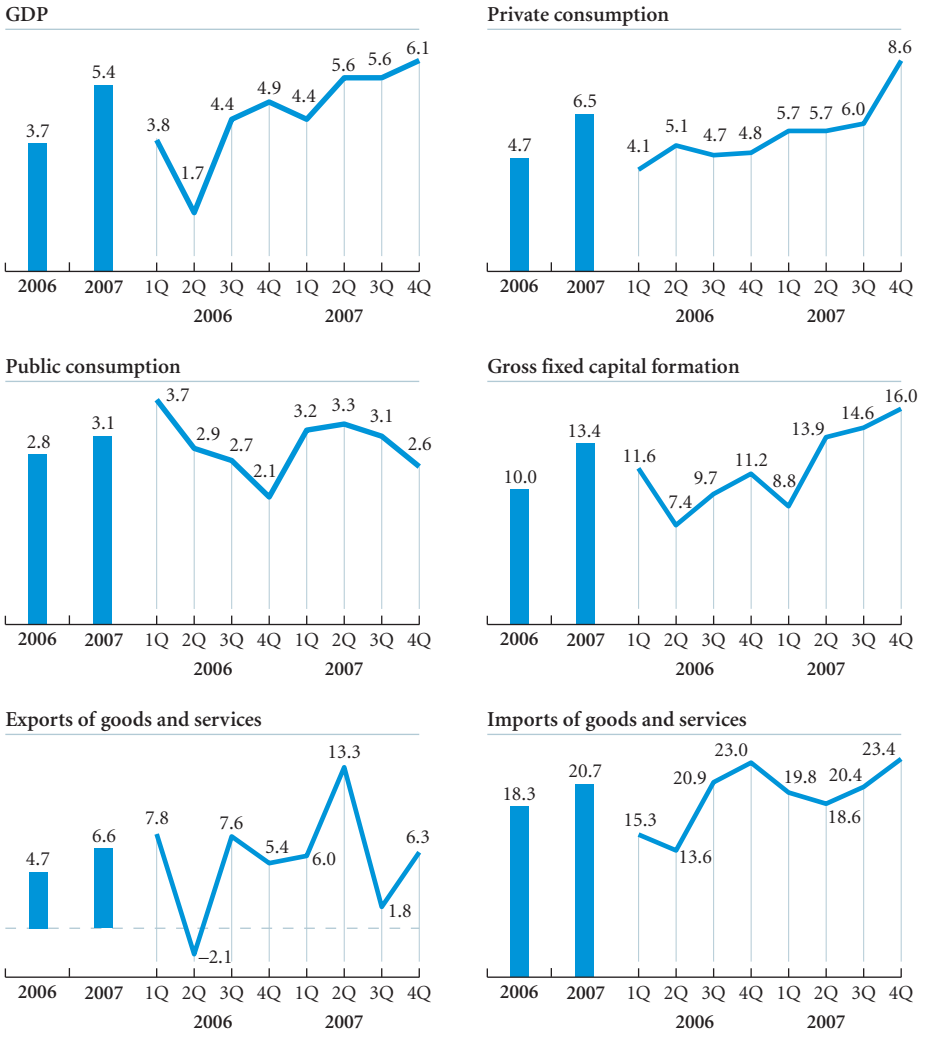
Brazil grows by 6.1% helped by private consumption and investment but foreign sector remains weak.

Brazil: domestic demand up while trade surplus down

Brazil's GDP continued its strong advance in the fourth quarter with an increase of 6.1% year-on-year which put growth for all of 2007 at 5.4%, the highest rate since 1990 with the exception of 2004. The main factor in economic activity was domestic demand.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and own calculations.

Private consumption moved up by 8.6% while investment, which keeps increasing, rose by 16.0%. Nevertheless, the foreign sector which has been strong until recently continued to show something of a crisis profile. The slight increase in exports, which grew by 6.3% year-on-year, was counteracted first of all by the 23.4% increase in imports. We should also remember that with the drop in prices exports continued to decrease in nominal terms compared with the same period last year.

Among latest economic indicators, industrial production continued the rise seen at the beginning of the year with an advance of 9.7% year-on-year in February. In turn, industrial production of capital goods, crucial to a continuation of growth, held to the strength seen in 2007 with growth in February of 25.0% year-on-year. In spite of the rise in industry, utilization of production capacity showed an almost imperceptible increase to stand at the 81.7 points level.

On the demand side, retail sales in February were up by 12.2% year-on-year maintaining the strong level seen in 2007. However, car sales in March were up by 9.9%, a rate clearly lower than normal. With this rise in domestic demand, the CPI continued its upward trend to reach an increase of 4.7% in March whereas at the beginning of 2007 it had reached a low of 3.0%. These levels continued to be acceptable in an economy such as Brazil's. Nevertheless, the upward trend could increase in view of the performance in wholesale prices which in February continued to rise with an increase of 10.6% year-on-year.

Industry moving ahead strongly, especially in capital goods, but inflation goes up to 4.7%.

The decrease in unemployment is losing strength in spite of the fact that growth in demand remains robust. In February, the unemployment rate in the Sao Paulo district was 13.6% of the labour force holding stagnant for the third consecutive month, although the figure continues to be well below that predominating only a couple of years earlier. Austerity continues in the fiscal sphere and, in the twelve months ending in February, savings in the public sector continued to compensate by more than two-thirds the interest payments on the foreign debt, putting the deficit for the period at 2.1% of the GDP in line with the process of

Public finances following course of austerity but drop in unemployment slows, while trade surplus rapidly dwindling.

BRAZIL: MAIN ECONOMIC INDICATORS

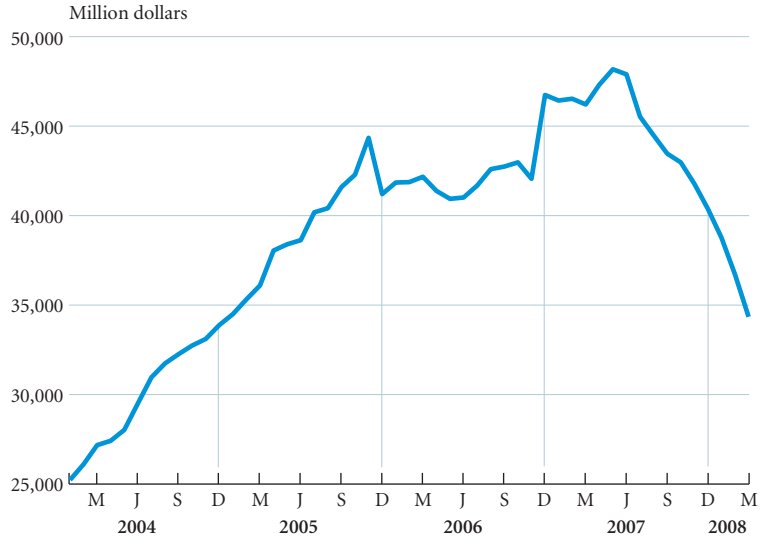
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	3.7	5.4	4.4	5.6	5.6	6.1	–	...	–
Industrial production	2.8	6.0	3.8	5.8	6.3	7.9	8.7	9.7	...
Unemployment rate São Paulo (*)	15.9	15.0	15.2	15.6	15.0	14.0	13.6	13.6	...
Consumer prices	4.2	3.6	3.0	3.3	4.0	4.3	4.6	4.6	4.7
Trade balance (**)	46.3	40.0	45.7	47.4	43.1	40.0	38.5	36.4	34.1
Central bank SELIC rate (***)	15.1	12.0	12.9	12.3	11.4	11.3	11.3	11.3	11.3
Reales to dollar	2.2	1.9	2.1	2.0	1.9	1.8	1.8	1.7	1.7

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 or last 12 months



SOURCE: Instituto da Pesquisa Economica Aplicada and own calculations.

Argentina grows by 9.1% thanks to domestic demand while foreign sector moving down.

correction carried out in recent years. In the foreign sector, the real (Brazil's currency) appears to have found some stability but the trade deficit continues to deteriorate rapidly. In the past twelve months ending in March it stood at 34.1 billion dollars, some 10.6 billion less than in the same period the year before. Here, the slowdown in exports is happening at the same time as the rise in imports which, during that period, grew by 35.9% year-on-year.

Argentina: growth with inflation

Growth is maintaining its high level with the GDP in the fourth quarter of the year growing by 9.1% year-on-year. Economic activity remains dominated by domestic demand with private consumption growing by 9.3% and investment that increased notably reaching a growth rate of 17.7% making a contribution to economic growth close to half the total. The foreign sector continued to detract from the increase (1.6% of the 9.1% total) with imports growing well above exports, although these showed something of an increase at the end of the year.

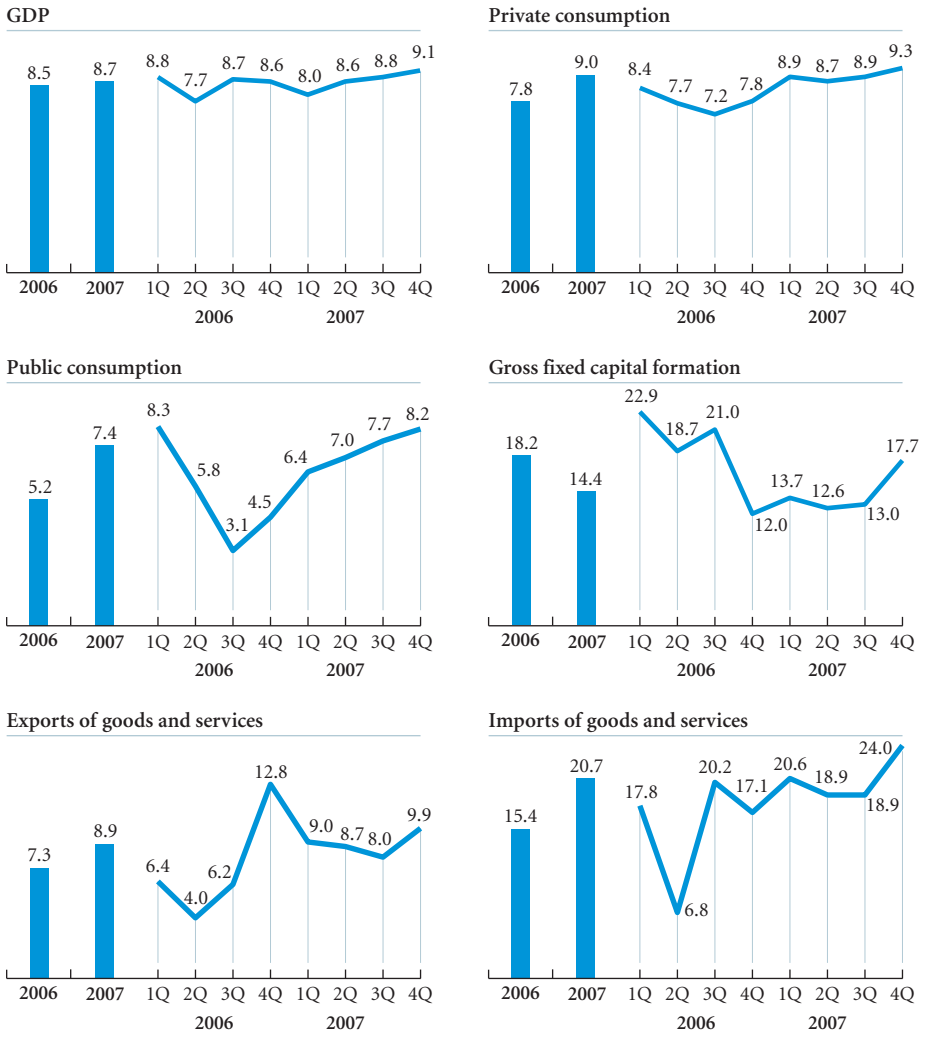
Inflation close to 9% presents biggest risk to economy.

The big challenge for the Argentine economy is still control of inflation. The increase in CPI in March was 8.8% year-on-year. Food prices, which rose by 7.7%, seem relatively moderate in view of the world situation and wholesale prices, with increases of 13.1%, were down slightly. However, real inflation could be well above official statistics. Comparison with the relatively moderate inflation of other countries in the region indicates a clear drop in Argentina's competitiveness.

Apparently removed from the problem of prices, recent demand indicators have continued to point to a continuation of the growth cycle. Retail sales in February grew by 28.1% year-on-year in the Buenos Aires region

TREND IN ARGENTINE GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: National Institute of Statistics and Census, Republic of Argentina (INDEC) and own calculations.

along with a spectacular 43.1% in the total for department stores, although it should be considered that the rise in prices is adding to the figures. Car sales slowed down in the past twelve months ending in March, although they held to a respectable rate of 18.6% year-on-year. This level stands at 14.7% below the all-time high which now seems somewhat more difficult to reach than it did some months ago. On the supply side, industrial production continued the increase begun in October with an advance of 8.5% year-on-year.

By sector, the automobile industry took a breather following some months of huge growth but the increase in the chemical industry took its place and, in February, rose by 7.3% year-on-year. On top of this came metals in general which rose by 36.6% and particularly steel with a rise of 12.2%. In turn, the Synthetic Construction Activity Indicator

Retail consumption remains strong while industry maintaining levels.

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over the same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	8.5	8.7	8.0	8.6	8.8	9.1	–	...	–
Industrial production	6.8	6.1	7.9	5.9	3.0	7.7	8.6	8.5	...
Unemployment rate (*)	10.2	8.5	9.8	8.5	8.1	7.5	–	...	–
Consumer prices	10.9	8.8	9.5	8.8	8.6	8.5	8.2	8.4	8.8
Trade balance (**)	12.3	11.2	11.8	11.5	10.5	11.2	11.9	12.1	...
3-month interbank interest rate (***)	9.9	11.3	9.7	9.4	12.6	13.7	11.1	10.2	10.9
Pesos to dollar	3.1	3.1	3.1	3.1	3.1	3.1	3.2	3.2	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.

Unemployment rate at 7.5% and trade surplus holding up for now thanks to price increases.

sharpened the rise seen in previous months with an increase of 13.9% in February, whereas the Industrial Activity Indicator for the same period lost strength with an advance of 5.9%.

In the labour market, aided by the strength of demand, the unemployment rate in the fourth quarter went down to 7.5% of the labour force, although the periodic revision of the ongoing survey of households put it above figures previously published. In turn, the trade surplus for February continued to rise, going to 12.1 billion dollars, the highest figure since 2004. It is significant that this increase coincides with the rise in domestic demand. Nevertheless, this was largely due to the increase in the price of exports following a period of decrease in prices which raised doubts about its continuation.

Oil marks up new all-time highs.

Commodities: oil hits further highs

Food commodities show major increases in April with rice in lead.

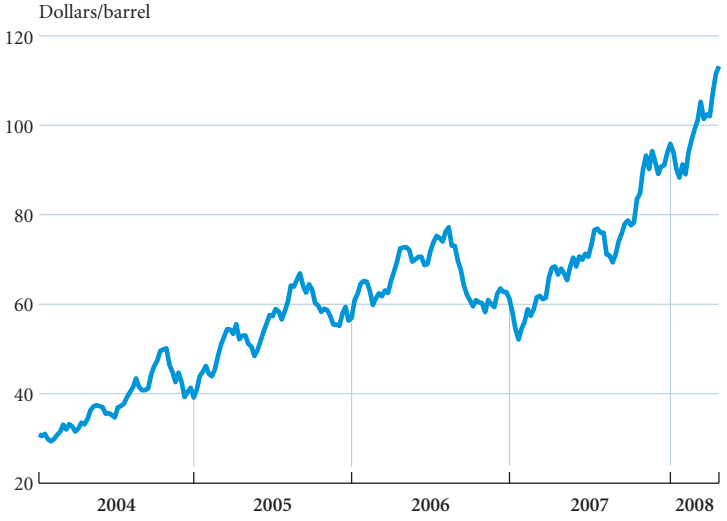
Oil registered further all-time highs in April. The month began with prices in the range of 99.8 dollars a barrel (1-month forward price for Brent quality crude) but then jumping with practically no interruptions it reached the level of 117 dollars at the end of April. In a parallel process, a barrel of West Texas oil was quoted at 100.6 dollars on the first of April and nearly 120 dollars in the final days of that month.

Some other commodities are following a similar path. In particular, food commodities are fairly closely repeating a pattern of growing demand, limitations of supply (in this case including political decisions to limit exports of products such as rice and wheat by some producer countries) and the entry of investors.

All of this has pushed up prices of food commodities as a whole which, according to the CRB index, rose by 5% in April. Among the products making up this index we should point out the growth of prices of soy (15.9% in April), cocoa (10.4%) and maize (5.8%). Nevertheless, it is rice, a product not included in this indicator, which has been the main player of the month with growth of 26.7%.

OIL SHOWS SHARP RISE IN APRIL

One-month per-barrel price of Brent quality oil in weekly averages



SOURCE: Thomson Financial Datastream.

On the other hand, the metals group which up to now had shown a very strong increase, corrected part of its recent trend in April. By product, we should mention drops in nickel (decrease of 3.9% in April) and zinc (drop of 3.6%) while, on the contrary, aluminium rose by 4.1%.

EUROPEAN UNION

Euro Area has resisted crisis so far but its defences are getting weaker and weaker...

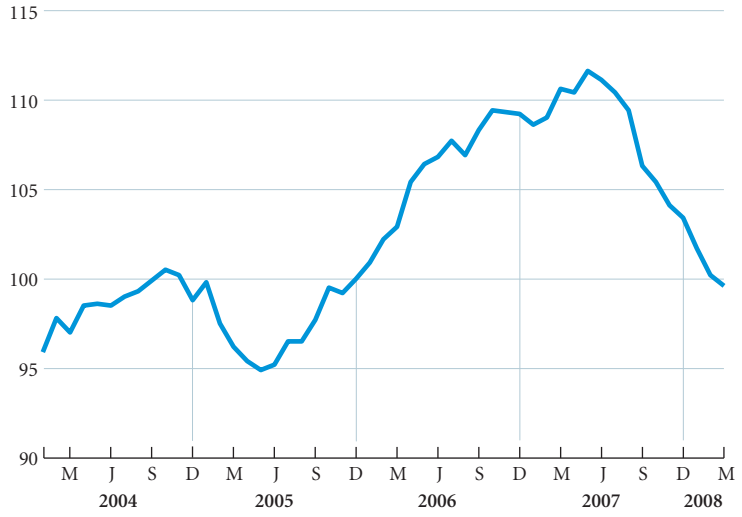
Euro Area: slowdown on top of inflation

Up until now the Euro Area economy has been showing more surprising resistance than expected to the situation of global uncertainty arising from the financial crisis. Particularly in the early months of 2008 it has shown better than forecast indicators of economic activity. Nevertheless, as the first quarter advanced we began to see some signs of a worsening situation. One of the most significant signs, because of its synthetic nature, was the gradual worsening of the economic sentiment indicator. In March this indicator stood below the 100 points level for the first time since November 2005. The drop since January has been by a couple of points.

Where is this loss of economic activity showing up? To begin with, it is to be seen in those components that already had been presenting the greatest weakness. The paradigmatic example is private consumption whose main indicators (retail sales and consumer confidence) were getting worse. Specifically, in February the first mentioned stood at levels 0.5% lower than those one year earlier. Consumer confidence lost a half-point in February and an additional decimal in March. If households do not see things clearly we can hardly expect any appreciable contribution from consumption. This applies in spite of the fact that the labour market continues to provide support to household spending in the form of a relatively low unemployment rate

NEXT STOP: A SLOWDOWN

Level of economic sentiment index for Euro Area



SOURCE: European Commission.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
GDP	2.9	2.6	3.2	2.5	2.7	2.2	–	…	–
Retail sales	1.5	0.8	1.8	0.9	1.3	–0.5	0.4	–0.5	…
Consumer confidence (*)	–9.1	–4.9	–5.4	–2.6	–3.9	–7.7	–11.5	–12.0	–12.1
Industrial production	4.0	3.5	3.9	2.9	4.0	3.2	3.3	3.2	…
Economic sentiment indicator (*)	106.3	108.4	109.4	111.0	108.7	104.3	101.7	100.2	99.6
Unemployment rate (**)	8.3	7.4	7.6	7.5	7.4	7.2	7.1	7.1	…
Consumer prices	2.2	2.1	1.9	1.9	1.9	2.9	3.2	3.3	3.6
Trade balance (***)	–10.4	20.1	–0.9	15.6	31.4	34.3	25.1	26.8	…
3-month Euribor interest rate (*)	3.1	4.3	3.8	4.1	4.5	4.7	4.7	4.4	4.4
Nominal effective euro exchange rate (*)	103.6	107.7	105.5	107.1	107.6	110.5	112.1	112.1	…

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

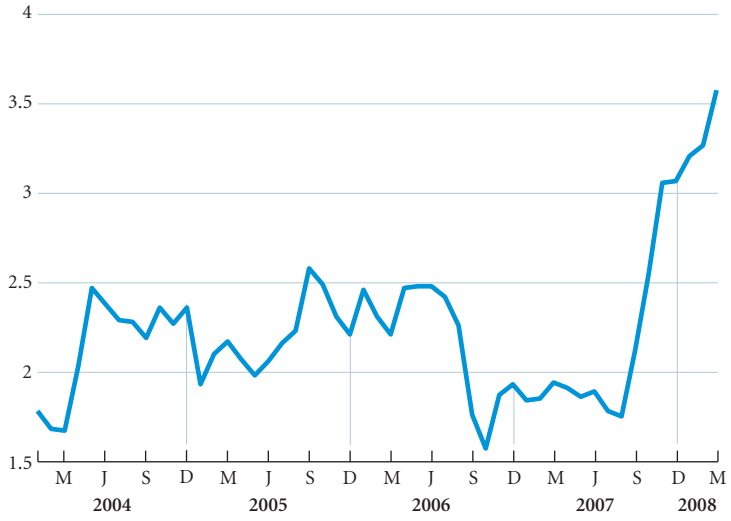
(7.1% in February) and job creation that is still positive.

If we look carefully at the extent of supply we note two relatively opposed tendencies. While the dominant situation is weakness, industry is showing unexpected resistance while services and construction are more clearly pointing downward. In February, industrial

...as reflected in slack in consumption and weakness in services and construction.

EURO AREA SHOWING SERIOUS INFLATION PROBLEM

Year-on-year change in harmonized consumer prices



SOURCE: Eurostat and own calculations.

Sharpness of rise in inflation cause for alarm.

production grew by 3.2% year-on-year, a figure only slightly worse than the 3.3% in January and in line with the average in the fourth quarter. Although the trend in industrial orders suggests that the secondary sector will likely lose strength in coming months, we would not have anticipated its present good situation some months back. On the other hand, as mentioned earlier, the decreases of more than one point in confidence in services and construction in March indicate that the adjustment is already taking place in these two sectors.

In spite of these incipient signs of slowdown, the main concern remains with inflation rather than with economic activity. This is not surprising seeing that, while the slowdown is a novelty that has only just begun to show up, the increase in prices has been with us for some months. In January, the rise in inflation put the consumer price index (CPI) above 3% year-on-year where it still stays. In March, the harmonized CPI grew by 3.6% year-on-year, a rate never before reached during the practically 10 years the single currency has been in existence. The boost in oil has been joined by other components such as foods and certain services. In view of this cross of pressures in various groups, and not only in the most volatile, it is understandable that underlying inflation should show an increase of 2.7% in March (2.4% in February).

Foreign sector showing background trend to lower growth.

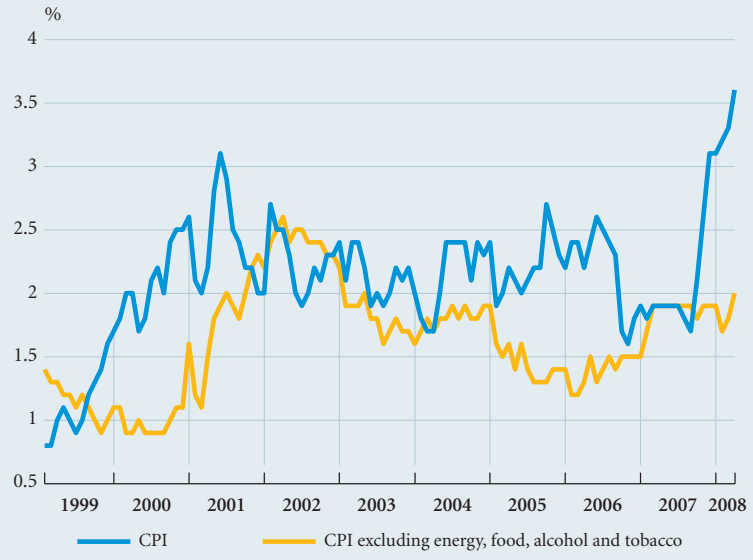
Another troubling area, although certainly to a lesser degree, is the resistance of domestic demand to the cost represented by a higher value euro. In terms of trend, the figures indicate that the foreign sector is already suffering from a loss of price competitiveness which is showing up most strongly in the drop in the export rate. Nevertheless, with regard to the short-term trend, the figures for February came as a favourable surprise as they indicated a slight rise in growth of exports and a modest increase in the trade surplus (going to 26.8 billion euros). We do not see this as more than a temporary movement and, in this

Reducing interest rates: a dilemma for the ECB?

Not many people would like to be at the cross-roads where Jean-Claude Trichet now finds himself. Inflation in the Euro Area has shot up far beyond the objective of the European Central Bank while at the same time economic activity is slowing down. In the face of this scenario, the ECB has maintained its rates unchanged at 4% since last summer whereas on the other side of the Atlantic, as a response to an economy on the edge of recession, the Federal Reserve has cut its interest rates from 5.25% to 2.25%. This increasing differential in interest rates between Europe and the United States has been partly responsible for the appreciation of the euro against the dollar (15% since August). In this context, pressure from politicians, exporters and others on the ECB to reduce interest rates have increased although, in the case of a central bank anxious to preserve its independence, these pressures have little effect and may even be counterproductive. In any case, it may be expected that as inflation and the economic growth rate decrease the ECB will lean toward easing monetary policy. This will most likely happen toward the end of the year although uncertainty is very high, given that inflationary pressures coexist with the instability related to the crisis in international financial markets.

INFLATION GOES GO RECORD LEVELS

Year-on-year change in Euro Area



SOURCE: Eurostat.

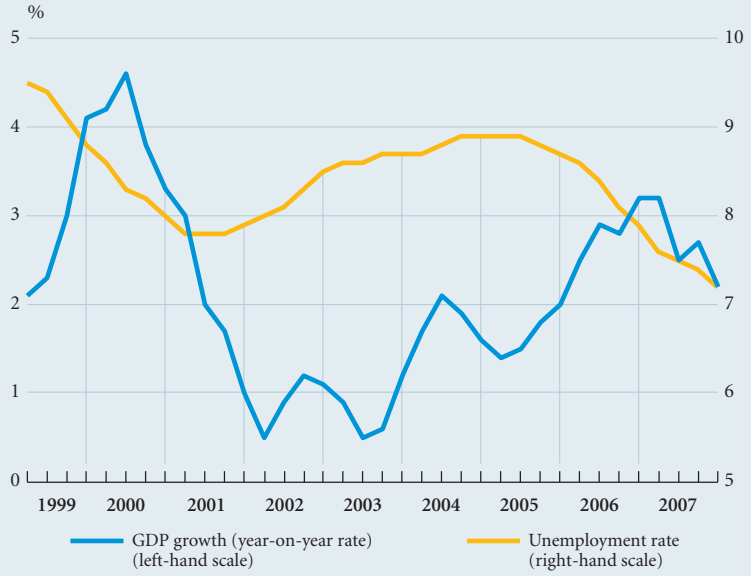
Inflation in the Euro Area in March reached its highest level since the introduction of the new single currency (3.6%). The main reason is well known: the sharp increase in prices of food and energy. The situation 12 months earlier was quite different with an inflation rate of 1.9%, just below the 2% objective of the ECB. Never before had inflation risen so much in such a short time. A more positive figure, although not mentioned as much, refers to underlying inflation (excluding food, energy, alcohol and tobacco) which has held fairly stable over the past year, increasing by only one decimal to 2.0% (see above graph). It therefore would seem that up until now the pass-through of the price shocks in energy and food to the rest of the economy has been modest. The ECB's main concern at this time is to ensure that this continues to be the case.

The ECB is afraid of so-called «second round effects». These effects take place when a temporary increase in the inflation rate (for example, arising from a shock in oil prices) broadly passes through to the price of goods and services produced by the economy, either because companies raise prices in response to the increase in costs or because wages are set taking into account past inflation and this ends up affecting the final price of goods and services. Eventually, these effects may set off a spiral in prices and wages that is prejudicial to growth of economic activity and employment. In general, second round effects tend to be greater when an economy is operating with little idle production capacity and the unemployment rate is low.

What is the situation in the Euro Area? Latest figures available show that the GDP growth rate was 2.2% in the fourth quarter of 2007, in line with potential growth of the area and that the unemployment rate at this moment stands at its lowest level in the past 25 years (See following graph). In fact, this is a situation that would tend to justify the ECB's state of alert.

GROWTH STILL STRONG WITH RELATIVELY LOW UNEMPLOYMENT

GDP and unemployment rate in Euro Area



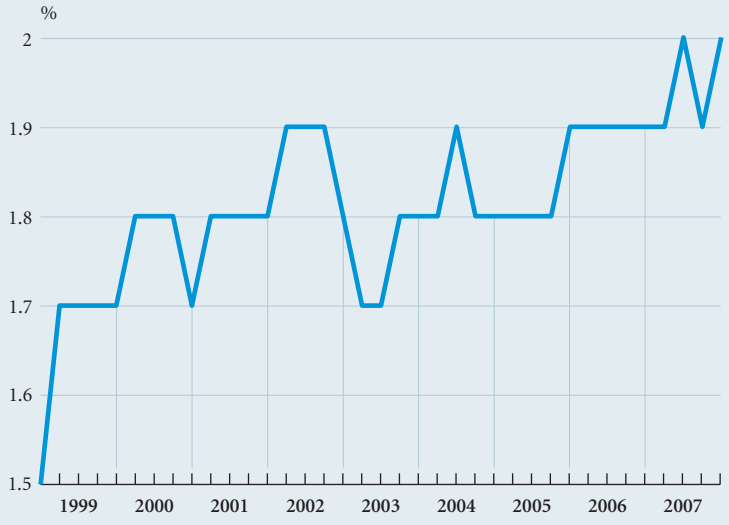
SOURCE: Eurostat.

The best strategy to minimize second round effects on inflation is to anchor inflation expectations over the medium and long term (in the case of the ECB) at 2%. It is not for nothing that the most important step forward in macroeconomic theory in the past 30 years has indeed been to recognize the crucial role of expectations in the functioning of the economy and their implications for economic policy, particularly monetary policy. If the economic agents are convinced that inflation will soon return to 2%, it is less likely that a process of re-negotiation of prices and wages will begin. Convincing the social agents that the increase is only temporary is the main task of a central bank, something done through good communications along with a good reputation. This certainly would explain the present tough position taken by the ECB, without discounting, for example, an increase in interest rates if second round effects are noted. With regard to the reputation of the ECB, we should point out that in fact inflation has held below 2% for slightly more than one month in each three months since the launching of the euro (36% of the time, to be exact), which does not seem an outstanding performance. Under a criterion not so strict, the ECB has done somewhat better. Inflation in the Euro Area has been below 2.3% for two out of every three months. Thanks to this reputation, inflation expectations in the Euro Area have remained fairly stable close to 2% (see following graph).

What then is going to happen to interest rates in coming months? Most likely they will hold at 4% until inflationary pressures ease, something forecast for following the summer. The decrease in world growth should put a brake on the rise in commodity prices, the economic slowdown forecast for the Euro Area will also reduce pressures on the demand side and in the labour market, while the financial upsets will tend to moderate growth of the money supply, an indicator that is carefully watched by the ECB. Experience suggests that it will not be necessary for inflation to reach 2% before the ECB reduces its interest rates. In May 2001, for example, following the bursting of the dot-com bubble, the reference rate went down in spite of the fact that inflation stood at 2.8% and that the latest available growth figure was 3% (see following table). The evidence that the economy was slowing down was sufficient for the ECB to decide to take action.

MEDIUM-TERM INFLATION EXPECTATIONS STILL WELL BASED

Inflation forecasts two years ahead



NOTES: ECB survey of professional analysts.
SOURCE: ECB.

To sum up, the behaviour of the ECB in recent months seems logical. With inflation very high and in view of a lack of figures confirming the extent of the economic slowdown, the ECB has taken a tough stand in order to maintain inflation expectations under control. A reduction of interest rates, however, will undoubtedly come about, as a godsend, although a few months later than many hoped for.

UNDER WHAT CIRCUMSTANCES HAS THE ECB CUT INTEREST RATES?

	▼ ECB reference rate (basic points)	Inflation (%)	GDP growth (%)	M3 growth (%)	Growth of credit to private sector (%)
April 1999	50	1.1	2.1	5.6	7.0
May 2001	25	2.8	3.0	3.9	8.6
September 2001	75	2.4	2.0	5.9	7.2
November 2001	50	2.2	1.7	7.3	6.4
December 2002	50	2.3	1.2	7.0	3.2
March 2003	25	2.4	1.1	8.1	3.6
June 2003	50	1.9	0.9	8.7	3.2
Averages		*2.2*	*1.7*	*6.6*	*5.6*
Latest figures available in April 2008		3.6	2.2	11.3	11.5

NOTES: Figures for inflation, M3 growth and credit granted to private sector refer to month prior to drop in interest rate. Figure for GDP growth refers to previous quarter.
SOURCE: Eurostat, ECB and own calculations.

German economy surprisingly positive in first quarter.

respect, it may be expected that decreases will be dominant in coming months.

Germany: resisting the blows of the crisis

The German economy continues to be largely escaping the worsening of world economic activity. While this is somewhat surprising in an economy so much integrated in globalization, by no means can it fail to be good news. The first positive note showed up in household consumption. As against a 9% year-on-year drop in retail sales in the fourth quarter of 2007, the average for January/February ended up with an increase of 0.2% year-on-year.

Industry holding up but euro not helping.

Furthermore, consumer confidence, while showing notable swings, was able to show a 1-point increase in March, which is indicative that consumer prospects are not overly negative. The trend in consumption may indeed be linked to the fact that the German economy is continuing to lower the unemployment rate. In March, the rate stood at 7.8% of the labour force, a reduction of two decimals compared with February and 1.5 percentage points in terms of one year earlier.

Rise in consumer and wholesale prices.

Industry is another sector performing better than expected. While industrial production dropped slightly in February with growth of 5.9% year-on-year (compared with 6.4% in January), its growth rate confirms that the strength shown in 2007 is spreading into the current year. If we add to this the unexpected bounce-back of the IFO indicator of industrial activity in February and March, we find that both the current situation and future prospects of industrial leaders are good.

This situation would seem to be temporary if we take into account the fact that exports are progressively losing drive. In February, exports measured as cumulative balance for 12 months moved up 8.2% year-on-year, still a significant figure, but one that does not stand comparison with the 10% rate three months back. This performance is at least partly due to the euro exchange rate which is robbing competitiveness from German exports. In any case, the

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
GDP	3.1	2.6	3.7	2.6	2.5	1.8	–	…	–
Retail sales	6.1	–7.7	–6.2	–7.7	–7.5	–9.0	0.7	–0.3	…
Industrial production	6.0	5.8	7.6	5.4	5.4	5.2	6.4	5.9	…
Industrial activity index (IFO) (*)	105.5	106.2	107.5	108.0	105.5	103.7	103.4	104.1	104.8
Unemployment rate (**)	10.7	9.0	9.5	9.2	8.9	8.5	8.1	8.0	7.8
Consumer prices	1.6	2.3	1.8	2.1	2.3	3.1	2.9	2.8	3.0
Trade balance (***)	151.5	183.5	165.5	178.3	192.0	198.1	199.9	202.0	…

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.

fact that imports are growing less is helping to improve the trade surplus for the 12 months ending in February.

All of these facts make it possible to conclude that concern in Germany, as in practically all the European economies, lies more in the area of inflation than in economic activity. The main price indicator, the CPI, rose to 3% year-on-year in March (2.8% in February). This implies that rates of increase have been running at around 3% for six months, which is beginning to be felt as too long. Furthermore, prices being paid by consumers do not reflect all existing inflationary pressures. For example, wholesale prices shot up to 7.1% year-on-year in March as against 6.0% in February. This is too much for an economy that heavily depends on maintaining competitiveness against its international rivals.

France: Treasury empty and economic engine stopped

At the beginning of his presidency Nicolas Sarkozy made a statement that caught on when he declared he had found the public purse empty. With the figures for year-end 2007 at hand, it may be said that the public purse is even emptier. Last year the government deficit was 2.7% of gross domestic product, three decimals worse than the imbalance in 2006. At the same time, the public debt as a percentage of gross domestic product (GDP) stood at 64.2%, compared with 63.6% in 2006.

In France, a poor situation in public finances...

The immediate reaction of the government was to propose a spending cut of 7 billion euros by not replacing half of the public servants taking retirement, limitation of aid to public housing and reduction of subsidies to companies for investment and development. These patches will certainly not be enough given that it does not seem that the year is going to follow the course set out in the government budget. To begin with, the government's forecast of 2.25% growth in 2008 seems unreachable. While this is higher than the 1.4% expected by the International Monetary Fund (IMF), it will be difficult for tax revenues to move along the lines forecast.

...with prospect of worsening in view of low growth expected in 2008.

All of this, however, is barely beginning to show up in the latest indicators. Household consumption rose in February which, combined with the slower decrease in consumer confidence,

First quarter shows only moderate signs of worsening.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
GDP	2.2	1.9	1.9	1.4	2.2	2.1	–	…	–
Domestic consumption	2.7	3.4	3.6	2.8	4.2	3.2	2.3	3.7	…
Industrial production	1.0	1.5	1.0	0.2	2.2	2.4	2.9	2.0	…
Unemployment rate (*)	9.2	8.3	8.7	8.5	8.2	7.9	7.8	7.8	…
Consumer prices	1.7	1.5	1.2	1.2	1.3	2.3	2.8	2.8	3.2
Trade balance (**)	–26.9	–32.4	–29.0	–30.4	–32.8	–37.3	–40.1	–40.1	…

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

New Berlusconi government must deal with economy in extremely weak state...

could be pointing to some support from household spending in the first quarter. At the same time, supply indicators show an economy that is only partly slowing down.

In turn, the unemployment rate was again 7.8% in February, a figure that was more than one percentage point less than that one year earlier, while inflation was not outside the overall trends in the Euro Area and rose to 3.2% year-on-year in March. Finally, the start to the year could be misleading given that, while the indicators are still pointing to economic activity that is managing to hold up, it is very likely that the situation could get worse within a few months.

...as confirmed by poor supply and demand indicators.

Italy: unattractive inheritance

The ample victory of the centre-right coalition led by Silvio Berlusconi in the parliamentary elections in April could provide the country with a political stability unthinkable some months ago. Nevertheless, neither the economy the new prime minister is going to find offers a sound base for government action nor will implementation of his economic programme be easy. At this moment, Italy's economic situation is even weaker than that of its Euro Area neighbours and furthermore the prospects are it will get worse.

To mention a few significant demand indicators, consumer confidence collapsed in March going to –25.1 points, the lowest level in 14 years, while car registrations were down 19% year-on-year that same month. From a supply point of view, the situation does not seem any better. Industrial production in February stood at levels 1.1% lower than those one year earlier. Confidence in services in March stood at negative levels for the first time since June 2005. As a synthesis, the economic sentiment indicator lost five points in the first quarter. Apart from the current weakness, growth forecasts for 2008 are rather slim running between the 0.6% predicted by the outgoing government and the 0.3% forecast by the IMF.

These factors seem incompatible with carrying out economic programme based on tax cuts and increased investment.

In this situation, the economic programme Silvio Berlusconi seems to be planning, based on a combination of tax cuts, improved pensions and higher public investment in infrastructures, comes up against the difficulties of a budgetary situation that is not very

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
GDP	1.9	…	2.4	1.8	1.9	…	–	…	–
Retail sales	1.2	0.5	1.0	0.1	0.2	0.5	1.0	…	…
Industrial production	2.4	0.0	1.3	0.7	0.8	–3.0	–1.6	–1.1	…
Unemployment rate (*)	6.8	6.1	6.2	6.1	6.0	6.0	–	…	–
Consumer prices	2.1	1.8	1.7	1.6	1.6	2.4	3.0	2.9	3.3
Trade balance (**)	–17.6	–13.7	–19.1	–15.4	–11.3	–8.9	–9.9	–8.4	…

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

heartening. Some estimates put a figure of 63 billion euros the outlay needed to carry out the economic programme of the winning coalition, practically equivalent to the annual accrued interest on Italy's public debt.

United Kingdom: far cry from good times

The British economy is immersed in a stage of cyclical downturn the extent of which is yet unknown. While retail sales up to February grew by a strong 5.5% year-on-year, we should put this beside the collapse in consumer confidence which went to –10 points in March. Although the labour market continues to support household spending (in March the unemployment rate held at 2.5% for the fourth month in a row), it would seem that this will not be sufficient support to save consumption.

At the same time, on the supply side, the gradual recovery of industrial production (rise of 1.3% year-on-year compared with 0.4% in January) may end up being short-lived if we look at the drop in industrial orders. In any case, it is the construction sector that most clearly shows the turnaround in the British economy, if we are to go by the drop in economic activity indicators and prices. Going by some yardsticks, prices are growing at their lowest rate in 12 years.

British economy presents gloomy prospects...

In this situation, concern about inflation seems to have moved into second place. Even with the current rate of increase in consumer prices (rise of 2.4% year-on-year in March) going above the Bank of England objective (set at 2%), the British central bank opted for a cut of 0.25 percentage points in its reference rate (down to 5.0%) in an attempt to support an economy moving into a stage with a lower rate of economic activity.

...especially going by early indicators.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
GDP	2.9	3.0	3.0	3.2	3.1	2.8	–	…	–
Retail sales	3.2	4.4	4.6	4.1	4.9	3.9	5.9	5.5	…
Industrial production	0.3	0.3	–0.4	0.8	0.1	0.7	0.4	1.3	…
Unemployment rate (*)	2.9	2.7	2.8	2.7	2.6	2.5	2.5	2.5	2.5
Consumer prices	2.3	2.3	2.9	2.6	1.8	2.1	2.2	2.5	2.4
Trade balance (**)	–74.1	–82.2	–78.4	–80.1	–83.2	–87.0	–88.9	–89.3	…
3-month Libor interest rate (***)	4.6	5.3	5.3	5.6	6.0	6.3	6.0	5.6	5.8
Nominal effective pound exchange rate	98.0	103.9	103.9	104.0	104.3	102.2	97.6	95.3	94.3

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

FINANCIAL MARKETS

Monetary and capital markets

Fed recognizes poor risk management as a main cause of crisis.

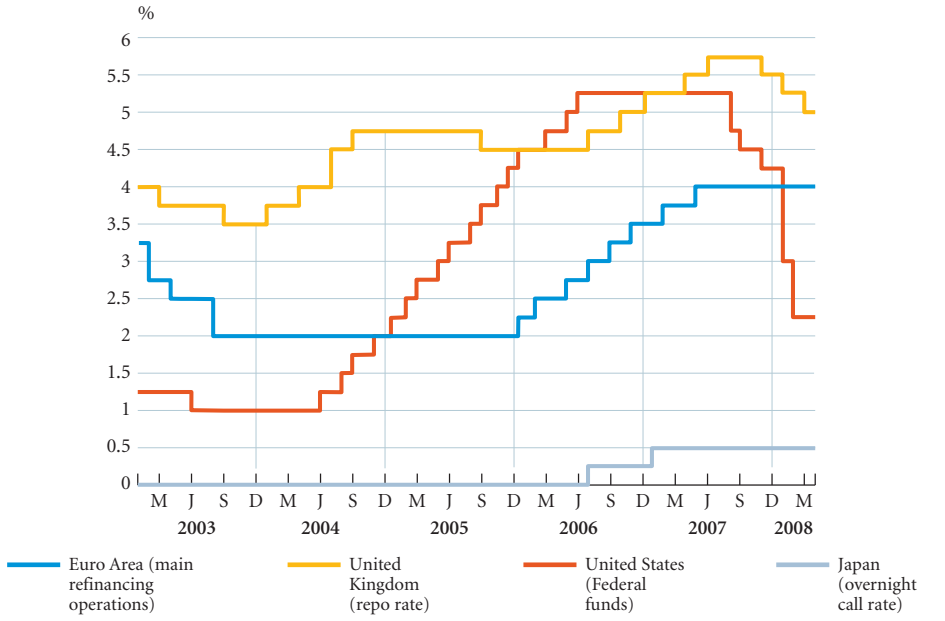
Fed: *¿mea culpa*?

The subprime mortgage crisis which began in the middle of last year is still unresolved. Meanwhile, the main players are deep in thought. This month, the International Monetary Fund put out its own estimate of potential losses directly or indirectly caused by the crisis – nearly a thousand billion dollars. Who is to blame? How is it nobody saw this coming? In the middle of the month, the vice-chairman of the Federal Reserve recognized its part of the blame concluding that there was not due diligence in evaluating the risk taken on by the banks. According to the Fed spokesman, there were three factors causing this error. The first was not to believe that housing prices in the United States could fall as much as they did. The second factor was that the banks based their decisions on risks taken in the analyses of rating agencies which proved to be erroneous. Finally, in some cases there was a surprising lack of understanding of the risks assumed in some highly complex financial products.

However, the harm is already done. In the minutes for the last meeting of the Fed's monetary policy committee published on April 8, we note the central bank's pessimism in indicating that the US economy could contract in the first quarter of this year, something which

BANK OF ENGLAND CUTS REFERENCE RATE

Central bank reference rates



SOURCE: Central banks.

Ben S. Bernanke: new measures for new problems

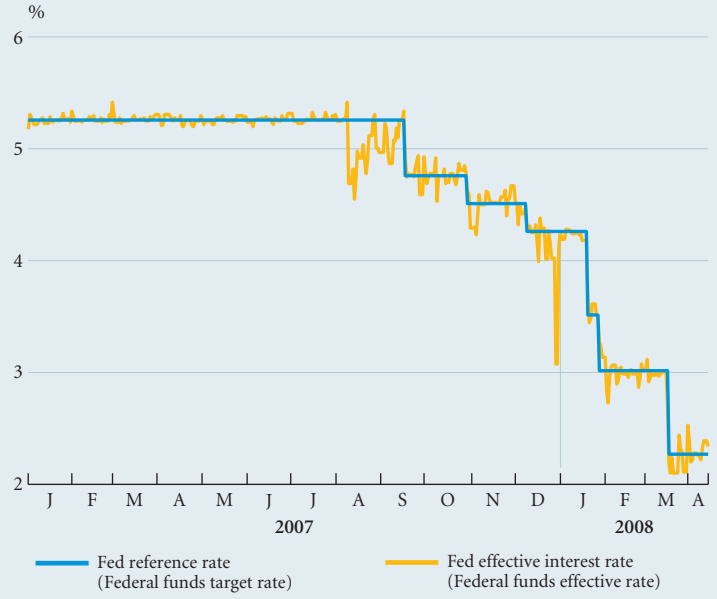
Ben S. Bernanke was named chairman of the US Federal Reserve in February 2006. The challenge he faced was to show that excellence shown in the academic field was a good guarantee for a post that demanded rapid decisions often involving much uncertainty. Above all, Bernanke had to overcome the myth surrounding Alan Greenspan who had occupied that post during two decades and, for many people, had known how to direct the US economy in one of the most prosperous periods of its history. The outgoing chairman had quickly shown his capacity for leadership given that, with only a few months in the job, he had to face up to what is now known as Black Monday, the day when the world's most significant stock exchanges collapsed. With the subprime mortgage crisis and risks of stagflation the time has come for Ben S. Bernanke to show what he is capable of. Let us see what he has done until now, what he has accomplished and what room he still has for manoeuvre.

MEASURES TAKEN BY FED SINCE BEGINNING OF SUBPRIME MORTGAGE CRISIS IN AUGUST 2007	
August 17	Lowers Primary Credit rate from 100 basis points to 50 basis points above reference rate and lengthens maximum term to 30 days.
September 18	Lowers reference rate 50 basis points.
October 31	Lowers reference rate 25 basis points.
December 11	Lowers reference rate 25 basis points.
December 12	Sets up medium-term line of credit, Term Auction Facility, with allocation of 60 billion dollars under which all commercial banks, but not investment banks, may obtain financing anonymously. Sets up line of credit with European Central Bank with allocation of 20 billion dollars and another with Swiss National Bank with allocation of 4 billion dollars.
January 22	Lowers reference rate by 75 basis points.
January 30	Lowers reference rate by 50 basis points.
March 7	Increases allocation of Term Auction Facility from 60 to 100 million dollars.
March 11	Sets up medium-term line of credit (repo), the Term Securities Lending Facility for investment banks. Increases allocation of lines of credit with ECB and SNB to 30 billion and 6 billion dollars respectively.
March 14	Approves loan to JP Morgan Chase for purchase of Bear Stearns Investment Bank (29 billion dollars).
March 16	Lowers Primary Credit interest rate from 50 basis points to 25 basis points above reference rate. Sets up a medium-term line of credit, Primary Dealer Credit Facility, for investment banks.
March 18	Lowers reference rate by 75 basis points.

In order to fully understand measures carried out by the Fed and its ability to influence the course of the economy, it is useful to examine the situation in its balance sheet before the crisis broke out and how it has changed since then. The liabilities side was mainly made up of the monetary base, the currency in circulation and deposits (or reserves) that banks have with the Fed. The assets side is made up of high-quality and very liquid assets, mainly government bonds. Furthermore, the Fed made two types of loan. The first was of very short term (overnight), totally guaranteed by the handing over of high-quality assets. This represents the main tool of monetary policy. Through so-called open market operations, liquidity auctions, the Fed injects funds into the banking system. The resulting price at these auctions is the so-called Federal

Funds Effective Rate, the Fed's effective interest rate. The second type of loan available from the Fed is Primary Credit. This loan is also of short-term but the range of assets which may be offered as guarantee is much broader. Nevertheless, the interest rate charged is slightly higher, the reference rate plus 1%. This second instrument is what the Fed had ready to help commercial banks with temporary liquidity problems but its use has been relatively limited because of the stigma involved in going to the emergency window. It is worth remembering that what makes the Fed or any central bank special is that its supply of credit can be unlimited given that it can always increase its liabilities by printing more money. Of course, increases in the size of the balance sheet create an increase in the money supply base which can compromise the inflation objective.

INSTABILITY HAS MADE IMPLEMENTATION OF MONETARY POLICY DIFFICULT



SOURCE: US Federal Reserve and own calculations.

Before the outbreak of the financial crisis the Federal Reserve was easily able to ensure that the interest rate resulting from its open market operations were practically identical to the objective set (see above graph). As of August 2007, however, when some banks began to reveal their problems related to the subprime mortgage crisis, the interbank market failed to function normally and the liquidity needs of the financial sector came to be more unpredictable. The Federal Reserve responded by reducing the Primary Credit interest rate by 50 basis points and extended the maximum term for these loans to 30 days. Furthermore, the Fed lowered the reference rate from 5.25% at the beginning of September to 4.25% in December. The objective was quite clear. It wanted to give a breath of fresh air to the financial sector by reducing its financing costs.

However, by December everything indicated that the measures taken were not sufficient to bring normalcy back to the interbank market. There were three main reasons, namely, the stigma associated with Primary Credit limited its use, the liquidity injected through open market operations did not reach all banks because many of those having problems were European banks, and the volatility of the markets made it

difficult to evaluate some financial assets, thus creating mistrust among those participating in the interbank market.

In order to resolve these problems, Bernanke took more innovative measures. He set up the Term Auction Facility (TAF), an instrument through which all banks could anonymously obtain a credit from the Fed for a period of approximately one month. Furthermore, they could offer as guarantee a wide range of assets which were valued at a price that, in some cases, was above market price. On the other hand, he made an agreement with the European Central Bank and the Swiss National Bank in order to inject liquidity into their markets in dollars and he lowered the reference rate by an additional 125 basis points. The effects were immediate but temporary, pressures in the interbank market were reduced and the implementation of monetary policy improved. In March, he created two new loan instruments, the Term Securities Lending Facility and the Primary Dealer Credit Facility which make it possible to directly inject liquidity into investment banks. That same month, the Fed approved a loan to JP Morgan in order to rescue Bear Sterns, one of the largest investment banks in the United States, whose serious liquidity problems threatened its solvency. Through this action he not only avoided its bankruptcy but also any possible spread to other institutions.

These measures managed to reduce the liquidity needs of the US financial system and this was reflected in the gradual easing of pressures in the interbank market and the lower volatility in the effective interest rate in open market operations. Nevertheless, it is also true that these variables are still far from their normal values. Furthermore, recent figures on inflation limit the Fed's capacity to continue lowering interest rates. What margin for manoeuvre does it still have? The answer is to be found in the current composition of its balance sheet. As shown in the following table, the new instruments put in motion have meant a profound change in the balance sheet's composition. Nevertheless, as they have been accompanied by a reduction of the portfolio

MEASURES TAKEN BY FED VERY GRADUALLY REDUCE PRESSURES IN INTERBANK MARKET

Difference between 3-month interbank rate and 3-month Treasury bond

SOURCE: Datastream and own calculations.

MEASURES TAKEN BY FED PROFOUNDLY CHANGE COMPOSITION OF ITS BALANCE SHEET

Million dollars

Assets	July 4, 2007	April 9, 2008	Liabilities	July 4, 2007	April 9, 2008
Government bonds	790,531	560,817	Currency in circulation	814,826	815,160
Assets given by banks	27,179	99,179	Reserves of banks	10,888	6,801
Primary Credit	18	10,182	Other liabilities and capital	83,385	96,866
Term Credit					
To commercial banks (Term Auction Facility)	–	100,000			
To investment banks (Primary Dealer Credit)	–	32,562			
Gold	11,041	11,041			
Other assets	80,330	105,046			
Total	**909,099**	**918,827**	**Total**	**909,099**	**918,827**

SOURCE: US Federal Reserve and own calculations.

of government bonds, the size of the balance sheet has not significantly increased. This is very important. These are measures that do not increase the money supply and, thanks to this, do not create inflationary pressures. While traditional monetary policy through changes in interest rates seems to be limited by an inflation level that is too high to meet the preferences of the Federal Reserve, the other measures taken by the Fed aimed at insuring liquidity over the medium term, they still have a long way to go before requiring an increase in the money supply.

At the dinner celebrating Milton Friedman's 90th birthday, Ben S. Bernanke said to him and to Anna Schwartz, co-authors of the major reference book on the Great Depression, «with regard to the Great Depression, you were correct, we (the Fed) created it. I am very sorry about this but thanks to you both we won't do it again.» Although some people hurried to compare the stress the US financial sector was going through with that of those days, the rapidity and capacity of Bernanke's response indicate that the errors of the past are not being repeated and, for the moment, Bernanke seems to have taken on Maestro Greenspan's leadership capacity. Only time will tell whether or not these innovative measures are sufficient to take us back to a situation of normalcy, although everything seems to indicate that the road taken is correct.

Bank of England cuts rate and implements new plan to increase liquidity.

now surprises no one. What is troubling is the possibility of a long and deep recession in the world's leading economy. For this reason, the market is discounting a new cut in the reference rate at the central bank's meeting on April 30.

Another player that seems to be coming to its senses is the Bank of England. On April 10 it cut its reference rate by 25 basis points putting it at 5%. The central bank justified the move by hardening access to credit for financial institutions while at the same time recognizing the risk of inflation. What stands out, however, is that the Bank of England has turned around from the initial focus with which it dealt with the financial

crisis that was, to some extent, responsible for the problems of the Northern Rock bank.

As a result, the UK central bank has launched a 50 billion pound sterling plan to provide liquidity to the interbank market. Up to this amount banks will be able to temporarily exchange mortgages for government bonds. The objective, according to Governor King, is to improve liquidity in the banking system. Announced on April 21, the plan involves certain conditions. These include the feature that the interchange would be valid for a period of one year, although this would be renewable for a total of three years. However, it would apply only to mortgages signed before the end of 2007 and the bonds could not be used in order to grant further loans. In order to avoid the British taxpayer having to end up assuming the losses on these mortgages, banks are required to provide collateral of a value higher than they would obtain from government bonds handed over in exchange.

The situation is different in the Euro Area where the European Central Bank (ECB), at the meeting of its governing council held on April 10, again maintained the official interest rate at 4.00% for the ninth consecutive month. The position of the ECB remains the same: risks of lower growth remain but inflation could rise. The latter risk prevents the ECB from cutting the reference rate. The strong growth in the M3 money supply figure, 11.3% annual, and that of loans granted to the private sector is given by the central bank as proof that there is no serious problem of restriction on the availability of credit at this time.

The central bank, gives great importance to growth of credit to non-financial companies for which the latest figure of 14.8% annual represents three times nominal growth of the gross domestic product in the Euro Area. Finally, from the ECB's point of view, the subprime mortgage crisis which began in August last year has still not substantially hurt the drive in growth of corporate credit granted in the Euro Area as a whole.

On other hand, ECB remains concerned about inflation...

Jean-Claude Trichet, ECB governor, in a press conference following the governing council meeting stated that inflation would go below 2% within a time-frame of a year and a half. It should be remembered that the ECB's mandate on price stability is set at inflation close to but below 2% over the medium term.

In view of the increase in inflation in the Euro Area, some members of the ECB Governing Council have openly spoken of an increase in the official rate. For example, Bundesbank president Weber stated that the ECB should indicate whether the present interest rate is sufficiently high to control an inflation rate whose level he considered intolerable. He is the second member to make such remarks, seeing that president Mersch of the Luxembourg Central Bank also stated that the ECB could not cut the interest rate in view of the prospect that inflation in the Euro Area would be more than 2% in 2009. Another member, governor Liikanen of Finland's Central Bank stated that the ECB has the obligation to bring inflation below 2% in the next 18 months as its main objective. All of these comments indicate that, for the moment, the ECB is not thinking of lowering the reference rate in coming months unless something unexpected should arise.

...and some members of Governing Council even speak of possibility of raising reference rate.

Turning to Asia, on April 9 the Japanese parliament named a new governor of Japan's central bank. Governor

China again increases cash reserve while Bank of Japan appoints new governor.

Interbank market still not normal in Euro Area: rising interest rates make life more difficult for companies and consumers.

Shirakawa, aged 58, is a technocrat specializing in monetary policy who has been a member of the bank's decisions committee since 2002. As an interim matter, he formed part of the bank's management committee following the end of the mandate of former governor Fukui. His international experience will be an important asset in the midst of the current financial upsets. The new governor has stated that it may be necessary to make injections of public capital in order to resolve the problems existing in the banking system in the United States. He feels that the situation has similarities with what happened in the Japanese financial system following the bursting of the financial bubble in Japan at the end of the Eighties.

In China, the central bank again decided to increase cash reserves by a half percentage point putting them up from 15.5% to 16.0%. This is the sixteenth time it has taken a similar measure since the middle of 2006. For the moment this has not served to control inflation that remains above 8% in an economy that was able to survive the heavy snowfall last March and where both retail sales and industrial production are growing at a two-digit rate. In the press release announcing its decision, the Chinese Central Bank pointed out the continuity of its monetary restriction policy in

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

As annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2007									
March	3.75	3.92	4.18	5.25	5.35	0.67	5.25	5.62	2.27
April	3.75	4.02	4.30	5.25	5.36	0.67	5.25	5.73	2.32
May	3.75	4.12	4.46	5.25	5.36	0.69	5.50	5.81	2.42
June	4.00	4.18	4.53	5.25	5.36	0.76	5.50	6.00	2.67
July	4.00	4.26	4.54	5.25	5.36	0.78	5.75	6.04	2.63
August	4.00	4.74	4.78	5.25	5.62	0.97	5.75	6.69	2.86
September	4.00	4.79	4.73	4.75	5.23	1.03	5.75	6.30	2.82
October	4.00	4.60	4.60	4.50	4.89	0.90	5.75	6.28	2.68
November	4.00	4.81	4.69	4.50	5.13	0.99	5.75	6.61	2.62
December	4.00	4.68	4.75	4.25	4.70	0.90	5.50	5.99	2.63
2008									
January	4.00	4.37	4.32	3.00	3.11	0.87	5.50	5.58	2.59
February	4.00	4.38	4.38	3.00	3.06	0.96	5.25	5.74	2.72
March	4.00	4.73	4.73	2.25	2.69	0.91	5.25	6.00	2.78
April (1)	4.00	4.79	4.80	2.25	2.91	0.92	5.00	5.89	2.85

NOTES: (1) April 21.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 3-8-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%), 8-3-07 (3.75%), 6-6-07 (4.00%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-2008 (3.50%), 30-01-2008 (3.00%), 18-03-2008 (2.25%).
(4) Latest dates showing change: 10-5-07 (5.50%), 5-7-7 (5.75%), 6-12-07 (5.50%), 7-2-08 (5.25%), 10-4-08 (5.00%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

order to channel credit toward more moderate growth.

Interest rates rise because of lower liquidity and inflation risks

The interbank market in the Euro Area has again risen going to levels seen at the beginning of the subprime mortgage crisis in August last year. For example, the 3-month Euribor rate went to 4.79%, the same level as in September 2007. The 1-year Euribor reached its highest level since the beginning of this year going to 4.80%.

Why are interest rates not normalizing? One reason is that in spite of all the ECB's efforts to inject liquidity, it has not yet managed to normalize the situation. Reigning uncertainty means that banks are still wary of lending amongst themselves. This means that the ECB has to keep injecting liquidity. A second conclusion is that the higher cost of credit falls on customers, whether these are companies or households. The former will find that the financial costs line in their profit and loss accounts will increase. Households will continue to see a situation where it is more difficult to borrow because of the increased cost of loans along with a reduction in their consumption capacity in coming months.

Nor have interbank markets in United Kingdom and United States resolved problem.

In the case of the interbank markets in the United States and the United Kingdom, it may seem that the central banks have achieved their objective, that is, to normalize their financial markets. However, while it is true that interest rate levels are lower than they were a few months ago, this is due to cuts in the reference rate, seeing that high differentials remain, which is a reflection of liquidity problems.

In the United States, if a bank wishes to seek a loan in the 3-month interbank market it must pay an interest rate of 2.91% whereas the interest rate free of risk for this term, that is to say, that on US 3-month Treasury bills, is actually 1.34%. The difference between the two interest rates is 1.57%, which is similar to the additional risk premium for the perception of possible default of the other party to whom the money was lent. The same commentary may be made about the case in the United Kingdom.

The exception has been Japan where, following the beginning of the 3-month interbank rate crisis, the rate is running within a narrow range between 0.87% and 1.03%. The reason may be that, in

Interest rates on long-term government bonds also rise to compensate inflation.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2005	2006	2007		2008	
			September	December	March	April 21
United States	4.39	4.70	4.59	4.02	3.41	3.77
Japan	3.31	1.69	1.69	1.51	1.28	1.46
Euro Area	1.48	3.95	4.33	4.33	3.9	4.13
United Kingdom	4.10	4.74	5.01	4.51	4.35	4.73
Switzerland	1.97	2.52	3.01	3.05	2.92	3.18

SOURCE: Bloomberg.

INVESTORS DEMANDING HIGHER INTEREST RATES

Interest rate on 10-year government bonds

FUENTE: Bloomberg.

Yield on long-term UK bonds goes well above inflation rate.

spite of publication of Japanese bank losses, these have been very low compared with those of European and US banks.

On the other hand, interest rates on long-term government bonds have generally risen. There are various reasons for this but the most important is the change in the perception of inflation. It should be remembered that with inflation in the Euro Area at 3.3% in February, the real 10-year interest rate, that is, the rate being paid on a 10-year government bond in euros less inflation meant an actual yield of only 0.6%. Following the increase in inflation to 3.6% in March, if the same bond interest rate had been maintained, the actual yield would have been reduced to 0.3% per annum. This is clearly an unsatisfactory yield and investors have demanded a higher return thus pushing up the interest rate on 10-year bonds in the Euro Area to 4.13%.

In the United States as well, with inflation at 4%, the real interest rate obtained by investing in that country's government bonds is negative. Furthermore, in the case of a foreign investor, it includes currency risk, that is to say, the risk that the dollar could depreciate with the investor thus losing money. On the other hand, the situation in the United Kingdom is compensated by inflation at 2.5% whereas long-term bonds are offering a nominal yield of 4.73%. In Japan, where the sharp increase in prices of oil and farm commodities has made it possible to end deflation, we see very low yields with the result that with inflation at 1%, a Japanese reference bond is now paying 1.46% per annum.

Euro-dollar exchange rate goes to 1.60

G7 statements try to halt dollar drop without success.

The G7 group, made up of the world's richest countries, at its meeting on the

EXCHANGE RATES OF MAIN CURRENCES

April 21, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2007	Annual
Against US dollar				
Japanese yen	103.3	3.6	–8.2	–14.9
Pound sterling	0.505	0.0	0.2	1.0
Swiss franc	1.010	0.0	–12.3	–19.8
Canadian dollar	1.006	–1.7	0.8	–11.5
Mexican peso	10.528	–1.9	–3.6	–4.2
Against euro				
US dollar	1.592	3.1	9.1	17.2
Japanese yen	164.4	7.0	0.8	2.0
Swiss franc	1.607	3.2	–2.8	–2.2
Pound sterling	0.803	3.1	9.3	18.4
Swedish krona	9.364	–0.6	–0.8	1.9
Danish krone	7.461	0.0	0.0	0.1
Polish zloty	3.415	–3.4	–5.2	–9.7
Czech crown	25.10	–1.3	–5.4	–10.4
Hungarian forint	252.5	–1.9	–0.2	3.0

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

second weekend in April put out a press release in which it underlined the current difficulties being caused by the financial crisis. One of its key sections included a statement on the general concern about sharp fluctuations in currencies and their possible implications for economic and financial stability. It also praised China for allowing greater appreciation of its currency, although it urged the country to step up the process.

The central bank governors and ministers of economy of the G7 issued a warning about the rapid depreciation of the dollar against the euro. Nevertheless, the foreign exchange markets took no notice. The position of the ECB in its fight against inflation is preventing it from lowering its reference rate over the short-term. Furthermore, so far as the United States is concerned, depreciation of its currency runs in its favour, seeing that its exports gain in competitiveness. All of this adds to the present trend to depreciation of the dollar against the euro which reached an exchange rate of 1.60 dollars at the end of April.

Euro appreciates against dollar, Japanese yen and pound sterling.

The euro has appreciated not only against the dollar but also against other currencies. In the past month it has appreciated 7% against the Japanese yen. The reason is that an increase in risk aversion drives investors to lower their borrowing positions in yen in order to acquire assets in other currencies, taking advantage of the differential in interest rates. The euro also appreciated by 3.1% against the pound sterling in the past month, although this is an ongoing trend seeing that the British currency has lost 9.3% of its value against the euro since the beginning of the year. The foreign currency market feels that the real estate problems in the United Kingdom will

EURO WORTH MORE PENNIES

Euro-pound sterling exchange rate

SOURCE: Bloomberg.

Eastern Europe currencies appreciate against euro as central banks raise reference rates.

mean further cuts by the Bank of England.

The currencies that have appreciated against the euro are those of Eastern Europe, among these the Polish zloty, the Czech crown and the Hungarian forint. The main reason for this is the more restrictive monetary policies in those countries. For example, Hungary's central bank raised the reference rate from 7.75% to 8% on March 31. Also in March, the Polish Central Bank raised the official rate from 5.50% to 5.75%. The reason for these increases was inflation which ranges from 4.1% in Poland to 7.1% in the Czech Republic.

Stock markets recover

Recapitalization of banks and low share prices sending investors back to stock markets.

Following the sharp drop in January, stabilization in February and a further drop in March, investors have gone back to buying shares. Two factors have helped this change in trend. The first and most important was early publication of bank losses brought about by the subprime mortgage crisis. Furthermore, many institutions have taken advantage of the situation to announce and carry out recapitalization in order to strengthen ratios in their balance sheets.

All of these recapitalization moves are a strong sign of confidence in that affected entities can correct their situation. In fact, investment is going into instruments issued by banks, whether they are shares or bonds, because it is considered that the potential yield of the investment compensates for the risk.

A second factor is the sharp drop in the market since the beginning of the year. The low prices obtained in March for many companies listed in the stock market indices were discounting an extremely negative scenario. This is a scenario that, following the interventions by the central banks and other public bodies, seems as if it may be avoided. That is to say, the expectations of

INDICES OF MAIN WORLD STOCK EXCHANGES

April 22, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,825.0*	*3.8*	*–3.3*	*–1.1*
Standard & Poor's	*1,388.2*	*4.4*	*–5.5*	*–6.5*
Nasdaq	*2,408.0*	*6.6*	*–9.2*	*–4.7*
Tokyo	13,547.8	8.5	–11.5	–22.4
London	6,053.0	10.2	–6.3	–6.7
Euro Area	3,769.9	7.5	–14.3	–14.6
Frankfurt	*6,786.6*	*7.4*	*–15.9*	*–7.6*
Paris	*4,894.5*	*8.0*	*–12.8*	*–17.6*
Amsterdam	*469.3*	*10.2*	*–9.0*	*–12.5*
Milan	*33,663.0*	*10.8*	*–12.7*	*–22.7*
Madrid	*13,728.9*	*5.9*	*–9.6*	*–9.0*
Zurich	7,358.2	5.0	–13.3	–21.7
Hong Kong	24,641.2	16.7	–11.4	19.8
Buenos Aires	2,201.6	9.3	2.3	–0.7
São Paulo	64,922.7	10.1	1.6	31.4

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.

STOCK MARKETS RECOVERING

DJ Eurostoxx 50 index of European stock markets

SOURCE: Bloomberg.

Interbank market, inflation and labour market key variables for following stock market trends.

investors have become more optimistic compared with the worse risk scenarios for corporate profits.

The recovery in the European stock markets has been strong. For example, the stock exchanges in Milan, Amsterdam and London have risen more than 10% in the past month. On the other hand, the selective Spanish index, the IBEX 35, rose by only 5.9% in the same period. However, it should be kept in mind that the Spanish stock market, along with the Amsterdam stock market, are the two markets that have dropped less since the beginning of the year compared with other European indices.

In the case of the IBEX 35, we cannot speak of sectors that have done better than others seeing that investors, without suffering loss from giving excess weight to those sectors most on the defensive, have been able to distinguish in each sector those companies they considered to have most wisely managed this difficult economic moment.

An early indicator of what could happen in coming months is the interbank market. The 1-year Euribor interest rate is widely used as a reference level to set the rate on many loans, mortgages, business contracts, etc. Normalization of this market is desirable in order to avoid that both companies and consumers would have to maintain higher financial costs of borrowing over a long period of time. In fact, the price of a share in any company reflects the expectations of future profits. If companies have to increase their financial costs and their customers have less disposable income to spend, profits can only drop.

While all economic figures provide basic information, in coming months it is important to pay greater attention to three key variables. Firstly, interbank market interest rates on both sides of the Atlantic; secondly, inflation trends worldwide; and thirdly, the strength of the labour market in the United States in order to be able to understand the decisions investors will take in coming months.

SPAIN: OVERALL ANALYSIS

Economic activity

Notable economic slowdown in first quarter

While available economic indicators for the first quarter are still incomplete, it is clear that the slowdown seen in recent months has sharpened. Furthermore, the trend is to a continuation of the slowdown in economic activity, largely due to the situation in construction investment and household consumption.

In keeping with these trends, the Ministry of Economy has cut its growth forecasts for 2008 and following years. For this year, it expects an increase in gross domestic product of 2.3% as against the 3.1% forecast in December. The slowdown will decrease job creation and raise the unemployment rate to 10.0% in 2009.

How then is the drop in economic growth affecting companies? The preliminary figures for the Bank of Spain's *résumé* of company accounts for 2007 as a whole make an initial evaluation possible. Labour costs rose less than the year before to show 4.4%, a result of the slowdown in job creation and a reduced rate of increase in average wages. Nevertheless, operating surplus slowed to annual growth of 5.5%, which was higher than that for 2005.

Financial income rose as a result of the increase in interest rates to show an annual rise of 22.8%. Financial costs

Construction and household consumption behind economic slowdown.

MACROECONOMIC SCENARIO FROM MINISTRY OF ECONOMY AND FINANCE FOR 2008-2011 PERIOD

Real change as %

	2007	2008	2009	2010	2011
Real GDP	**3.8**	**2.3**	**2.3**	**2.8**	**3.1**
Nominal GDP	7.0	5.5	5.0	5.6	6.0
Final consumption – private	3.2	2.2	2.2	2.3	2.4
Final consumption – general government	5.1	4.8	3.8	3.6	3.4
Gross fixed capital formation	5.9	1.5	1.5	3.1	4.0
National demand (*)	4.6	2.6	2.4	2.9	3.2
Export of goods and services	5.3	4.0	3.9	5.6	5.9
Import of goods and services	6.6	4.1	3.7	4.7	5.0
Foreign sector (*)	–0.7	–0.3	–0.2	–0.1	0.0
Employment (**)	3.0	1.2	1.1	1.6	1.8
Unemployment rate (***)	8.3	9.8	10.0	9.6	8.9
Productivity	0.8	1.0	1.2	1.2	1.3

NOTES: (*) Contribution to growth in percentage points.
(**) Equivalent to full-time work.
(***) Over labour force.
SOURCE: Ministry of Economy and Finance.

Companies show slight drop in operating surplus...

recorded a bigger increase (33.6%) also due to higher borrowing, partly from major share buying transactions during 2007. In any case, financial costs were up less than in 2006. As a result, ordinary net profit increased by 5.7% compared with 2006, a bigger increase than that reported in 2006. Capital gains showed a high annual increase of 95.3% although provisions and taxes were up by a high 84.2%. Net profit thus rose by 14.9% compared with 2006, although this was lower than the increase the previous year.

...but profitability holding at high levels.

As a result of this trend, profitability ratios of non-financial companies held at high levels. Ordinary profit on net assets (before tax) was 8.6%. The differential in return in terms of financial cost was clearly positive.

Modest recovery in industrial production.

If we look at the most recent economic activity indicators, from the point of view of supply, in the early months of 2008 industrial production has shown some recovery. The most dynamic industrial sectors in the first two months of the year were energy, capital goods and non-durable consumer goods while consumer durables and intermediate goods showed a contraction in annual terms. Nevertheless, production of electronic materials and equipment recorded strong growth. In addition, incoming orders in industry were up 5.8% between January and February compared with the same period in 2007. This early indicator suggests a moderate rate of industrial activity in coming months.

With regard to construction, available indicators suggest a slowdown in economic activity largely due to the housing market. As a result, apparent cement consumption in the first quarter of 2008 was down 14.5% compared with the same period the year before.

In the first quarter the average price of housing units per square metre rose by 3.8% compared with the same period in

PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES

Annual change rates

	2005	2006	2007
Value of production	12.2	10.4	5.9
Intermediate consumption	17.2	12.3	6.3
Gross value added (GVA)	**3.4**	**6.7**	**5.1**
Wage costs	4.0	5.3	4.4
Gross operating profit	**3.0**	**7.8**	**5.5**
Financial income	24.7	13.3	22.8
Financial costs	5.0	39.8	33.6
Depreciation and provisions	–0.4	2.0	–1.3
Net ordinary profit	**11.6**	**4.4**	**5.7**
Capital gains and extraordinary income	26.5	50.1	95.3
Capital losses and extraordinary costs	61.1	–27.4	26.3
Provisions and tax	–41.9	61.6	84.2
Net profit	**40.7**	**18.0**	**14.9**

SOURCE: Bank of Spain.

2007. The real price of housing, that is discounting inflation, thus turned out to be negative for the first time since the end of 1997. This was the result of lower demand following the high prices reached. As a result, the number of housing sales in January was down by 27.1% compared with the same month in 2007. At the same time, the number of mortgage loans against housing security dropped by 25.7% compared with the same month the year before. In this situation, the number of building permits for new housing was down by 50.1% in January compared with one year earlier, which indicates a sharp drop in residential construction investment in the near future.

Company services showing strength.

The situation in services is better. The volume of business in services in January-February 2008 was up 6.9% compared with the same period the year before. Those branches showing most drive were services to companies, advertising and transport. With regard to tourism, the number of foreign tourist in the first three months of the year was up by 5.3% compared with the same period in 2007.

SUPPLY INDICATORS

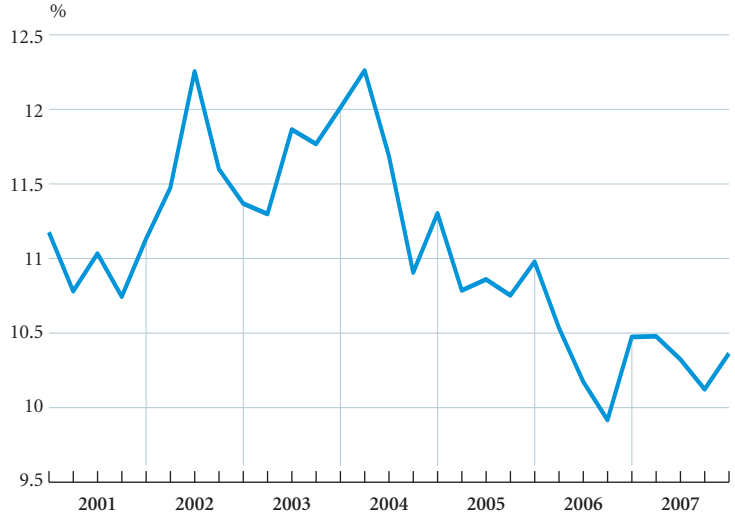
Percentage change over same period year before

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	Jannuary	February	March
Industry									
Electricity consumption (1)	3.9	4.2	5.3	4.4	2.1	4.9	3.5	3.3	2.9
Industrial production index (2)	3.9	1.9	4.2	2.5	1.1	–0.2	0.3	1.8	...
Confidence indicator for industry (3)	–2.7	–0.3	2.3	0.7	–0.7	–3.3	–4.0	–8.0	–9.0
Utilization of production capacity (4)	80.5	81.3	80.6	81.3	82.1	81.1	–	81.3	–
Imports of non-energy intermediate goods (5)	10.5	8.0	8.1	8.2	8.7	7.1	9.6	16.5	...
Construction									
Cement consumption	8.5	0.4	5.5	–1.3	–1.0	–1.5	–7.9	–6.1	–27.4
Confidence indicator for construction (3)	14.2	9.3	10.7	15.7	12.0	–1.3	–6.0	–18.0	–20.0
Housing (new construction approvals)	18.6	–24.7	8.0	–15.0	–50.7	–33.6	–50.1	...	...
Government tendering	31.3	–15.2	13.3	–2.2	–30.0	–33.1	0.0	...	...
Services									
Retail sales (6)	2.1	2.4	4.3	2.9	3.1	–0.3	–2.5	–2.7	...
Foreign tourists	4.1	1.6	4.7	0.1	1.4	1.6	0.9	6.5	7.4
Tourist revenue inflows	5.6	3.7	5.8	2.0	3.2	4.5	3.2	...	...
Goods carried by rail (km-tonnes)	–1.2	–4.4	–4.1	–6.5	–1.4	–5.3	–0.8	6.3	...
Air passenger traffic	6.8	9.0	9.5	7.1	10.5	8.6	6.9	10.1	6.8
Motor vehicle diesel fuel consumption	5.5	4.6	6.1	3.3	4.2	4.7	2.1	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for difference in number of working days.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
(6) Index deflated and corrected for calendar effects.
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.

SLIGHT RECOVERY IN SAVINGS IN FINAL QUARTER OF 2007

Gross savings over disposable income of households and non-profit bodies serving households (*)



NOTES: (*) Average of last four movable quarters.
SOURCE: INE and own calculations.

DEMAND INDICATORS

Percentage change over same period year before

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
Consumption									
Production of consumer goods (*)	2.3	1.2	4.8	2.1	0.9	–2.7	1.8	1.4	...
Imports of consumer goods (**)	8.9	5.1	–1.1	5.6	8.4	7.7	–2.6	8.8	...
Car registrations	–0.9	–1.2	–0.7	–2.4	–2.9	1.3	–12.7	0.7	–28.2
Credit for consumer durables	14.5	10.0	13.8	9.6	6.9	9.9	–	...	–
Consumer confidence index (***)	–12.3	–13.3	–10.7	–12.7	–12.3	–17.3	–20.0	–21.0	–19.0
Investment									
Capital goods production (*)	8.4	5.9	9.0	5.3	6.3	3.3	2.9	5.0	...
Imports of capital goods (**)	3.2	9.8	20.1	11.0	–0.6	9.0	–18.3	–4.1	...
Commercial vehicle registrations	1.5	0.3	1.7	–2.2	–3.0	4.7	–31.0	–13.8	–39.8
Foreign trade (**)									
Non-energy imports	9.0	7.3	6.4	7.7	7.6	7.5	2.4	11.8	...
Exports	5.6	4.2	3.0	2.8	6.7	4.6	3.0	7.3	...

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.

On the demand side, we note a slowdown in consumption, especially in durable goods. Car sales were down by 15.3% in the first quarter compared with the same period the year before. While this figure is distorted by the elimination of the Prever Plan, which fostered replacement of old cars on the road up until 2007, and other factors, it shows the weakness of demand. Motorcycle sales recorded an annual drop of 22.3% in the January-March period. At the same time, white-line appliance sales were down by 17.5% in the first quarter of 2008 in year-on-year terms, according to the sector association Anfel. This trend may be largely explained by a loss of consumer confidence which in February showed the worst level since 1994. Nevertheless, it improved slightly in March.

We should point out that, as a logical counterpart to the trend to a slowdown in consumption, household savings has shown signs of halting its decrease in terms of disposable income. After having marked up all-time lows in 2006, in the fourth quarter of 2007 the household savings rate recovered slightly as a percentage of gross disposable income.

With regard to capital goods investment, production of these goods rose 4.0% in the first two months of the year compared with the same period last year, a rate lower than that recorded in the third quarter of 2007 but higher than that for the fourth quarter. Commercial vehicle registrations, however, were down with a year-on-year drop of 29.5% in the first quarter of 2008. On the other hand, domestic sales of capital goods and software among large companies marked up a year-on-year rise of 3.0% in February following a drop of 2.5% in January.

Government approves plan to stimulate economy.

In this context, on April 18, 2008 the Spanish government approved a plan for a series of measures to stimulate the economy. The main points include a tax deduction of 400 euros in personal income tax, removal of property tax, extension of repayment periods on mortgage loans for families in difficulties, increased financial support for subsidized housing, fostering of public works construction and facilities for relocation of workers.

All autonomous communities grow above 3.5% in 2007

Aragon leads economic growth in 2007 partly thanks to Expo.

All autonomous communities in Spain showed sharp economic growth last year, substantially above the European Union average at 2.9%. Aragon led economic growth in 2007 with a robust increase of 4.5%, some 7 decimals above the national average. This was brought about by the heavy activity in construction fostered by work in preparation for Expo 2008 as well as the good state of the manufacturing sector. Also above the average were Castile-La Mancha, Galicia and La Rioja, among others. On the other hand, the lowest increases were marked up by Asturias, Valencian Community and Catalonia.

Since 2000, the autonomous community showing the highest average annual growth was Murcia with 3.9%, some 5 decimals more than the average. Next came Andalusia with 3.7%. At the other end of the scale, the Balearic Islands recorded an increase of 2.3%, followed by Asturias with 2.9%.

Seven autonomous communities show per capita GDP higher than European Union average.

The per capita GDP for Spain's economy in 2007 was 94.7% of that for the European Union with 27 member states.

GROSS DOMESTIC PRODUCT BY AUTONOMOUS COMMUNITY

2007

	Gross domestic product (*)		% real change		Per capita GDP
	Million current euros	% of total	2007	2000-2007	Current euros
Andalusia	146,093	13.9	3.8	3.7	18,298
Aragon	32,601	3.1	4.5	3.5	25,361
Asturias	22,431	2.1	3.6	2.9	21,200
Balearic Islands	25,944	2.5	3.8	2.3	25,238
Basque Country	42,386	4.0	3.8	3.4	21,004
Canary Islands	13,248	1.3	3.9	3.4	23,377
Cantabria	36,202	3.4	4.2	3.6	18,564
Castile-La Mancha	56,256	5.4	3.7	3.2	22,589
Castile-Leon	196,546	18.7	3.7	3.3	27,445
Catalonia	102,403	9.8	3.7	3.4	21,239
Valencian Community	17,302	1.6	3.9	3.6	16,080
Extremadura	53,995	5.1	4.0	3.2	19,800
Galicia	183,032	17.4	3.9	3.6	29,965
Madrid Community	27,237	2.6	3.8	3.9	19,574
Murcia	17,698	1.7	3.8	3.3	29,483
Navarre	65,147	6.2	3.9	3.1	30,599
La Rioja	7,642	0.7	4.0	3.0	24,717
Ceuta	1,578	0.2	3.9	3.4	21,994
Melilla	1,441	0.1	3.7	3.3	21,089
Total	**1,049,848**	**100.0**	**3.8**	**3.4**	**23,396**

NOTES: (*) Total does not coincide with sum of all autonomous communities because it includes GDP figures which cannot be broken down by region.
SOURCE: National Institute of Statistics.

Nevertheless, according to Eurostat figures, seven autonomous communities (Basque Country, Madrid, Navarre, Catalonia, Aragon, Balearic Islands and La Rioja) went above the European Union per capita GDP average of 24,700 euros.

Labour market

Unemployment rate goes up to 9.6%

Figures from the Labour Force Survey for the first quarter show the worsening of the labour market. Job creation has continued to drop going to a year-on-year change rate of 1.7%. Given that some 74,600 jobs were lost in the quarter and that the rate measuring those in the workforce continued to increase going to 59.4%, the ranks of the unemployed rose by 246,000 persons. As a result, the unemployment rate rose by more than one percentage point to 9.6%.

Job creation continued to slow down in March, if we are to go by figures for those registered with Social Security. At the end of the first quarter the number of those registered as working was 19,230,480 persons. This figure meant a monthly increase of 54,243 persons but only represented a year-on-year increase of 0.8%, as against an annual change rate of 2.4% in the fourth quarter of 2007, which shows the drop in the rate of job creation.

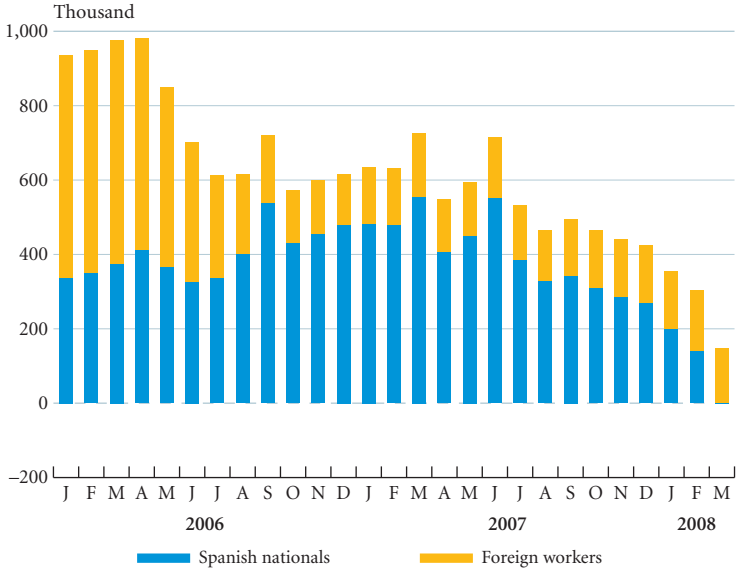
In fact, annual growth rate in March was the lowest since 1994, in spite of the fact that the March figure for the first time included several thousand care-givers looking after dependent persons as an outcome of the new Dependency Law. This reflects the slowdown in the economy which has been sharpened by the recent upsets in international financial markets.

Year-on-year increase in registrations with Social Security down to 0.8% in March, lowest figure since 1994.

Foreign workers registered with Social Security up 8% in past year.

DROP IN NUMBER OF SPANISH NATIONALS REGISTERED WITH SOCIAL SECURITY

Year-on-year change in number of workers registered with Social Security



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

Loss of jobs in construction increasing.

In fact, the number of Spanish nationals registered at the end of March was lower than 12 months earlier. The number of foreign workers showed a much slower decrease with a rise of 7.6% compared with the same month last year. Among these workers, those from the European Union rose by 17.4%, mostly coming from the new member states, while those from outside the EU showed growth of 3.0%. Construction and the hotel/restaurant trade accounted for around one-third of foreign workers registered. Retail trade, agriculture and domestic service also employ a good part of this group.

First year-on-year drop in male registrations with Social Security since at least mid-Nineties.

By sector, there was a notable sharpening in loss of jobs in construction with a 4.9% loss of jobs compared with March 2007. The decrease would have been greater if a good part of those fired by sector companies had not become self-employed persons who largely became involved in renovation work. As a result, while those registered under construction in the general Social Security scheme has dropped by 8.1% since March 2007, those coming under the special scheme for self-employed workers rose by 7.1%.

Services are also being affected by the slowdown, although the number of those registered was 2.1% higher than one year earlier. The branch creating most jobs in March was the hotel/restaurant trade, thanks to the Easter Week holidays. Nevertheless, if we look at the past 12 months, the most dynamic sub-sectors were health and social services, education and financial services. In turn, industry lost 0.6% of workers compared with 12 months earlier. On the other hand, the

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2006	2007	2007				2008		
			1Q	2Q	3Q	4Q	January	February	March
Persons registered with Social Security									
Sector									
Industry	*0.0*	*2.5*	*2.2*	*2.7*	*2.5*	*2.4*	*1.5*	*0.1*	*–0.6*
Construction	*8.7*	*3.3*	*6.1*	*4.4*	*2.3*	*0.5*	*–1.1*	*–2.5*	*–4.9*
Services	*5.2*	*3.5*	*4.1*	*3.7*	*3.0*	*3.0*	*2.8*	*2.9*	*2.1*
Job situation									
Wage-earners	*4.7*	*3.0*	*3.9*	*3.5*	*2.6*	*2.2*	*1.7*	*1.5*	*0.5*
Non-wage-earners	*2.2*	*2.8*	*2.5*	*2.7*	*2.9*	*2.9*	*2.5*	*2.3*	*2.1*
Total	**4.3**	**3.0**	**3.6**	**3.3**	**2.7**	**2.4**	**1.9**	**1.6**	**0.8**
Persons employed (*)	**4.1**	**3.1**	**3.4**	**3.4**	**3.1**	**2.4**	**–**	**1.7**	**–**
Jobs (**)	**3.2**	**3.0**	**3.3**	**3.1**	**3.0**	**2.5**	**–**	**–**	**–**
Hiring contracts registered (***)									
Permanent	41.1	2.0	25.8	15.6	–1.6	–21.1	–23.0	5.8	–13.0
Temporary	4.7	0.3	2.6	–1.9	–0.5	1.2	–0.9	0.7	–18.5
Total	**7.9**	**0.5**	**5.3**	**–0.1**	**–0.7**	**–2.1**	**–4.3**	**1.3**	**–17.8**

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

farm sector was up by 0.9%, some 6 decimals more than in February.

The slowdown affected both sexes but this showed up more among males. The number of males registered with Social Security was down 0.7% in the past 12 months, the first negative year-on-year change rate since at least the mid-Nineties. As a result, the proportion of females rose to 42.3%.

Sharp increase in registered unemployment in past 12 months

The total number of unemployed registered at public employment service offices at the end of March was 2,300,975 persons, 14,356 less than in February. Nevertheless, the figure continues to show a notable upward trend. The year-on-year change rate moved up to 11.7%, the highest figure of the decade.

Of special note was the rise in unemployment in the construction sector. At the end of the first quarter, the number of those in the sector without work (316,990) represented an increase of 44.2% compared with the same month last year. Unemployment was also up in other sectors although not as sharply. In addition, those seeking their first jobs showed an increase of only 0.4% in the last 12 months.

By national origin, there was a notable increase in the number of foreign workers registered at public employment offices. As a result, registered unemployment of foreign workers rose by 47.8% in the 12 months ending in March, although this rate was 6 percentage points lower than in February.

Registered unemployment for March marks up biggest annual change rate in decade.

Number of unemployed in construction jumps by 44% in last 12 months.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

March 2008

		Change over December 2007		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	75,692	6,880	10.0	11,691	18.3	3.3
Industry	292,313	12,332	4.4	12,698	4.5	12.7
Construction	316,990	33,123	11.7	97,194	44.2	13.8
Services	1,384,009	99,759	7.8	119,085	9.4	60.1
First job	231,971	19,334	9.1	856	0.4	10.1
By sex						
Males	968,485	83,346	9.4	187,331	24.0	42.1
Females	1,332,490	88,082	7.1	54,193	4.2	57.9
By age						
Under 25 years	270,261	29,878	12.4	18,156	7.2	11.7
All other ages	2,030,714	141,550	7.5	223,368	12.4	88.3
TOTAL	**2,300,975**	**171,428**	**8.0**	**241,524**	**11.7**	**100.0**

SOURCE: INEM and own calculations.

Prices

CPI shows biggest rise since 1995

Inflation up one decimal in March to 4.5%, twice rate seven months earlier...

Inflation continued to rise in March for the seventh month in a row, this time by one decimal, the same as in the two previous months. The figure for the March consumer price index (CPI) was 4.5%, twice the annual change rate of 2.2% marked up in August 2007. The rise in the CPI in recent months has been largely brought about by the boost in prices of oil and farm food commodities in international markets. In March, the pressures on the CPI came from energy products and other components. Core inflation, often called underlying inflation, that excludes energy products and unprocessed food, was also up one decimal to 3.4% annual.

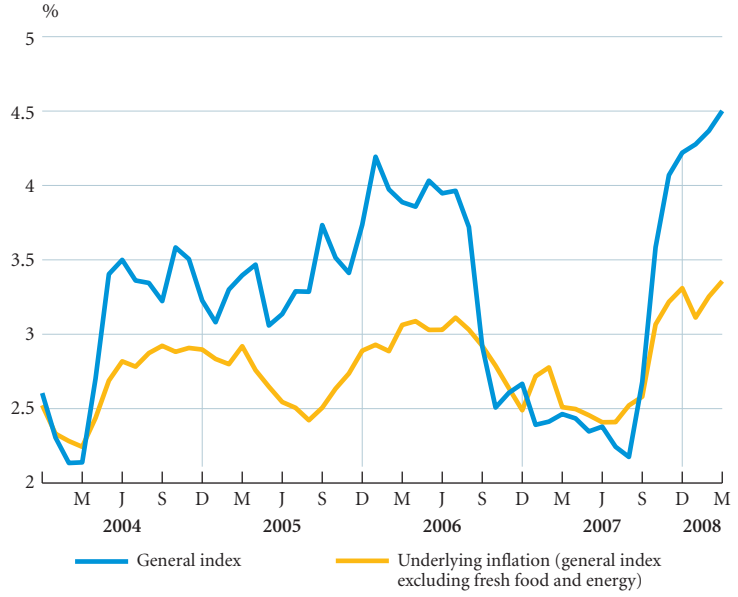
...because of rise in fuel prices...

The greater part of the increase in the year-on-year CPI change rate in March may be explained by the increased cost of fuels and lubricants for which the year-on-year rate went up to 19.0%. The annual rise in energy products as a whole was somewhat lower at 14.1%.

Also having a notable impact on the increase in annual inflation in March was the trend in medicine prices because the monthly drop of 4.4% was lower than that in the same month in 2007, although the year-on-year change rate showed a drop of 4.2%. Another

ANNUAL INFLATION UP FOR SEVENTH CONSECUTIVE MONTH

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2007			2008		
	% monthly change	% change over December 2006	% annual change	% monthly change	% change over December 2007	% annual change
January	–0.7	–0.7	2.4	–0.6	–0.6	4.3
February	0.1	–0.6	2.4	0.2	–0.5	4.4
March	0.8	0.1	2.5	0.9	0.4	4.5
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.

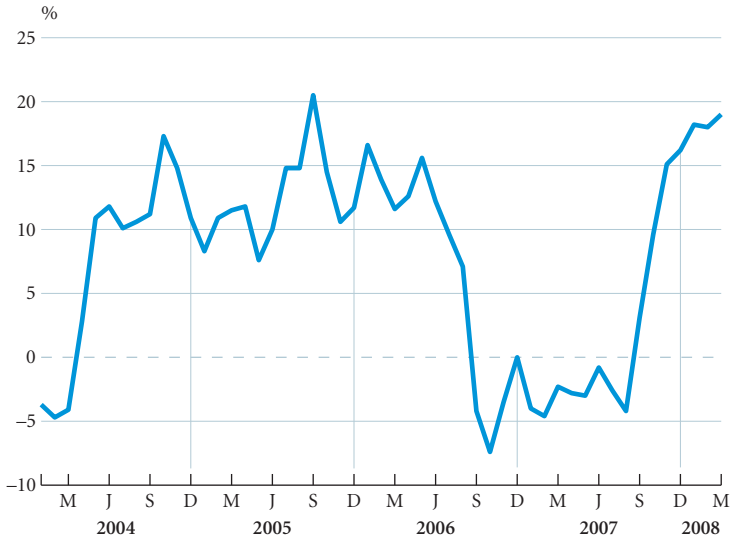
component having a marked role in the increase in inflation in March was tourist services. Due to the fact that Easter Week fell in the third week of March, the usual increase in prices of organized travel and hotels because of the holiday period came earlier than in other years.

As a result, prices of organized tours, which also reflected the rise in fuel costs, were up 7.8% in the past 12 months

...and other components...

FUEL PRICES ESCALATE

Year-on-year change in price of fuels and lubricants



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

March

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2006	2007	2006	2007	2006	2007
By type of spending							
Food and non-alcoholic beverages	108.8	0.4	0.3	0.4	0.6	2.9	6.9
Alcoholic beverages and tobacco	111.0	0.1	0.2	5.4	3.3	6.5	4.0
Clothing and footwear	97.4	3.4	3.4	–9.8	–10.0	1.0	0.8
Housing	108.3	0.6	0.7	2.1	2.8	3.9	5.4
Furnishings and household equipment	104.2	0.5	0.5	0.3	0.4	2.6	2.5
Health	98.1	–3.8	–1.2	–3.4	–0.4	–2.1	0.9
Transport	107.6	1.4	1.7	1.7	2.1	0.8	7.5
Communications	100.3	1.4	0.1	1.6	0.3	0.3	–0.5
Recreation and culture	99.5	0.5	1.2	–0.9	0.0	0.1	0.2
Education	107.4	0.0	0.0	0.4	0.2	4.6	3.8
Restaurants and hotels	108.6	0.7	1.0	2.0	2.3	4.7	5.2
Other goods and services	106.1	0.4	0.4	2.0	2.1	3.5	3.1
By group							
Processed food, beverages and tobacco	109.8	0.3	0.3	1.7	1.8	2.3	7.4
Unprocessed food	107.5	0.6	0.1	–0.7	–0.9	5.2	4.7
Non-food products	104.8	0.9	1.1	–0.1	0.3	2.2	3.8
Industrial goods	102.7	1.1	1.4	–1.8	–1.2	0.6	3.7
Energy products	*112.2*	*2.0*	*2.8*	*1.9*	*4.3*	*–0.3*	*14.1*
Fuels and oils	*113.9*	*2.7*	*3.7*	*1.6*	*4.7*	*–1.6*	*17.8*
Industrial goods excluding energy products	*99.6*	*0.8*	*0.9*	*–3.0*	*–3.1*	*0.8*	*0.3*
Services	107.0	0.6	0.8	1.7	1.8	3.9	4.0
Underlying inflation (**)	104.9	0.6	0.7	0.0	0.1	2.5	3.4
GENERAL INDEX	**105.8**	**0.8**	**0.9**	**0.1**	**0.4**	**2.5**	**4.5**

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

...while foods ease pressure for the moment.

ending in March while hotels rose by 9.4%.

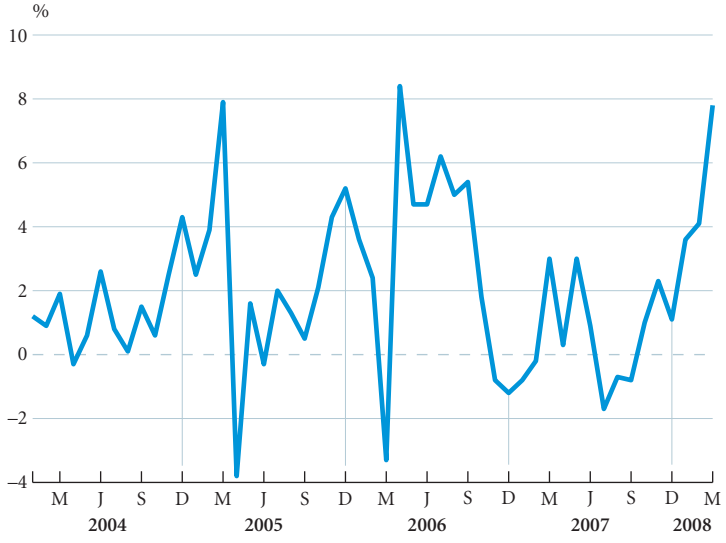
Foods, on the other hand, took a spell in March. The year-on-year change rate in fresh food prices was also down by a half-point to 4.7% given that year-on-year decreases in mutton, chicken, beef and fish counteracted the increases in eggs and fresh fruit. In turn, potatoes were down 10.1% in the course of the past 12 months.

The annual change in processed foods held at 7.4%. The price of milk dropped for the third consecutive month but the year-on-year rate stood at a high 27.8%. Cereals and cereal products, on the other hand, rose by 8.7% over the past year, nearly one point more than in February as a result of the rise in world prices.

The price of food pastas stood at 18.1% higher than in March 2007. Nevertheless,

SHARP RISE IN ORGANIZED TRAVEL COSTS

Year-on-year change in organized tour prices



SOURCE: National Institute of Statistics.

there was a drop in the year-on-year rate for bread, although it still stood at a high 11.2%.

The harmonized consumer price index (compared with the European Union) stood at an annual rate of 4.6%, an increase of one and a half decimals compared with the month before. Nevertheless, the inflation differential with the Euro Area was down two decimals to 1.0 percentage points.

Inflation differential with Euro Area down to one percentage point.

In spite of the recent rise in oil prices above 100 dollars a barrel, the CPI inflation rate could ease as of next month. Nevertheless, latent pressures in commodity markets because of the considerable rise in demand from emerging countries and some distortions in supply will mean that the inflation rate could stay above 4% for some time with a downward tendency toward 3% at year-end.

Inflation of industrial prices hikes to highest level since 1995

The rise in prices of oil and other commodities continued to put pressure on wholesale prices in March. In addition, we note some pass-through of these higher costs to prices of consumer goods.

The annual change rate of industrial prices went to 6.9% in March, the highest level since June 1995. This rise was largely due to the energy component which rose by 14.6% in the past 12 months. Intermediate goods were also up with a rise of 6.3% compared with March 2007. Metal products prices rose recording a year-on-year increase of 4.1%. Consumer goods prices were up slightly to 5.5% compared with one year ago due to the consumer durables component. Nevertheless, food and drink products showed a higher year-on-year increase at 10.9%.

CPI inflation may have hit ceiling but likely will stay above 4% for some months.

Rise in oil prices putting pressure on wholesale prices.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2007											
January	–6.7	2.7	1.4	2.9	6.3	–1.1	0.6	0.6	–0.3	7.7	–
February	–6.3	2.5	1.4	2.9	6.7	–2.5	0.3	0.3	–0.3	8.1	3.4
March	1.5	2.8	1.7	3.3	6.3	–1.6	0.4	0.3	–0.2	7.2	–
April	6.7	2.7	2.2	3.1	6.5	–2.6	0.2	0.6	0.1	6.3	–
May	0.4	2.4	2.0	3.3	6.0	–2.8	0.9	1.5	0.1	5.9	3.2
June	2.6	2.6	1.8	3.1	5.8	–1.4	1.3	1.0	–0.1	6.1	–
July	2.5	2.3	1.9	3.1	5.6	–2.6	0.7	0.9	–0.1	4.3	–
August	5.1	2.3	2.4	3.1	5.4	–2.9	0.7	1.5	0.3	3.9	2.9
September	12.1	3.4	3.2	3.2	5.4	0.8	2.0	1.0	0.2	3.1	–
October	13.8	4.7	4.2	3.2	5.3	6.1	3.0	0.6	0.0	1.9	–
November	15.7	5.4	4.5	3.1	5.1	9.8	4.0	0.8	–0.1	0.7	2.9
December	17.6	5.9	4.8	2.9	5.0	11.6	4.9	1.2	–0.2	0.7	–
2008											
January	11.1	6.6	5.4	2.7	5.9	13.3	6.8	1.1	0.5	1.7	–
February	...	6.6	5.4	2.5	6.0	13.3	6.7	1.6	0.4	1.7	...
March	...	6.9	5.5	2.3	6.3	14.6	...	...	...	...	–

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

Appreciation of euro moderating import prices.

Import prices eased their upward trend slightly in February, thanks to the appreciation of the euro. As a result, the annual change rate dropped by one decimal to 6.7%. This relatively high inflation was the result of higher energy prices (rise of 38.6% annual) given that inflation of other components did not go above 2%. Capital goods prices rose by only 0.4% in the past 12 months, which also reflects the heavy competition in world markets and improvements in productivity.

With regard to farm prices at origin, prices paid to farmer were up 11.1% in January compared with the same month the year before. Nevertheless, this rate was 6.5 points less than that reported in December 2007 thanks to an easing of agricultural and livestock prices although they were showing high annual change rates. Prices for market livestock tended to rise but showed an increase of only 0.8% over the past 12 months.

Foreign sector

Balance of payments: current account deficit continues to grow

The current account deficit stood at 11.951 billion euros in January, an imbalance 38.6% higher than that reported one year earlier. To a large extent this increase in the current account deficit was due to the increase in the trade deficit and the incomes deficit (and to a lesser extent the deficit in the transfers balance) above growth of the bigger surplus in services.

These trends are not significantly different from those showing up some months ago. In terms of cumulative figures for 12 months ending in January, a measurement that comes closer to figures over the medium term, the current account deficit rose by 25.8% year-on-year putting the total at 22.46 billion euros. Practically the whole amount of the increase in the current account imbalance was due to rises in the incomes and trade deficits, in this order of importance. All this makes the

Current account deficit grows at rate of 26% year-on-year in past 12 months ending January.

BALANCE OF PAYMENTS

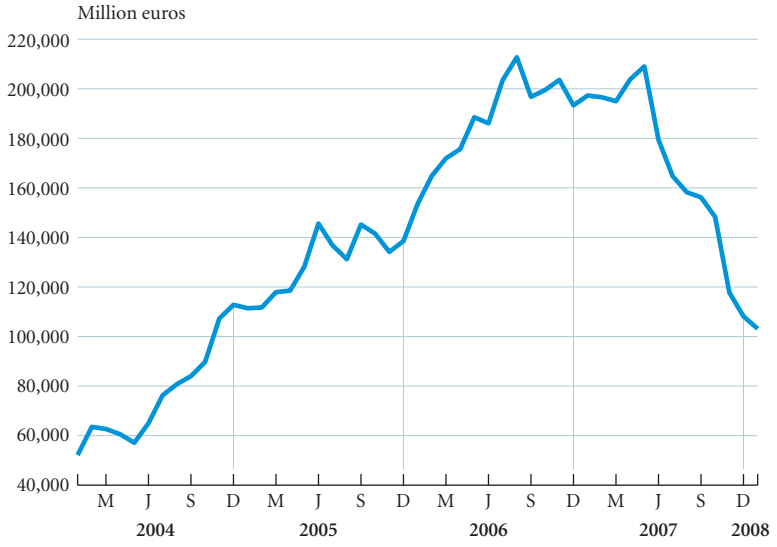
January 2008

	Cumulative for year		Last 12 months		
	Balance in million euros	% annual change	Balance in million euros	Annual change	
				Absolute	%
Current account balance					
Trade balance	–8,375	29.8	–90,383	–9,668	12.0
Services					
Tourism	*1,623*	*4.1*	*27,904*	*473*	*1.7*
Other services	*–302*	*–50.3*	*–5,164*	*–52*	*1.0*
Total	1,321	38.8	22,740	421	1.9
Income	–3,636	86.5	–34,600	–12,230	54.7
Transfers	–1,260	7.5	–7,288	–981	15.5
Total	**–11,951**	**38.6**	**–109,530**	**–22,459**	**25.8**
Capital account	**1,234**	**–5.2**	**4,745**	**–2,365**	**–33.3**
Financial balance					
Direct investment	–1,212	–42.4	–40,001	16,613	–29.3
Portfolio investment	11,437	–31.6	97,822	–99,789	–50.5
Other investment	–6,839	–14.5	26,504	71,544	–
Total	**3,386**	**–48.8**	**84,325**	**–11,632**	**–12.1**
Errors and omissions	1,829	–	1,678	3,403	–
Change in assets of Bank of Spain	5,502	428.6	18,784	33,053	–

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.

SUBPRIME MORTGAGE CRISIS DEPRESSES INFLOW OF PORTFOLIO INVESTMENT

Foreign portfolio investment in Spain as cumulative figure for 12 months



SOURCE: Bank of Spain and own calculations.

Drop in inflow of foreign portfolio investment reflecting effects of world financial crisis.

improvement in the services surplus rather unique.

Another area of special interest in the context of the current subprime mortgage crisis is financial flows. As a 12-month balance, net inflows of portfolio investment in January amounted to 97.82 billion euros, that is to say, 100 billion euros less than one year earlier. It should be remembered that up to June last year inflows of portfolio investment into Spain from abroad were showing an upward trend. From that month on, this trend was broken and has become sharper since last November. In turn, while negative, net outflows of direct investment have tended to drop putting the total for the 12 months ending in January at 40 billion euros, a figure 29.3% lower than that for one year earlier.

Public sector

Central government surplus down by half in first quarter

The economic slowdown can be noted in the trend in the public accounts. Following the sharp increase in tax revenues in 2007, non-financial receipts going into the central government coffers in the first quarter rose by only 3.4% compared with the same period last year, including those amounts ceded to autonomous community governments and local governments under the current financing system. As a result, in the first three months of the year central government revenues rose at a lower rate than nominal gross domestic product (GDP) as well as less than inflation.

Direct taxes, were up 11.5% as of March compared with the first quarter of 2007. Collections for personal income tax rose by 11.1% due to the increase in holdbacks on wages and especially those on capital. This increase would have been 12.2% taking into account adjustment of the rate of rebates to a normal period as well as corrected for the effect of the new deduction for birth or adoption of a child (which involved 288 million euros in the first three months of the year). Revenues for corporate tax were up by 20.1%.

Central government revenues up less than inflation due to economic slowdown.

On the other hand, revenues from indirect taxes showed a drop of 3.6% in the first quarter compared with the year

Drop in tax collections for domestic value added tax transactions.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

March 2008

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**6,547**	**14.1**	**38,181**	**1.1**
Non-financial revenue adjusted (*)				
Personal income tax	4,538	17.2	21,033	11.1
Corporate tax	259	0.4	1,511	20.1
VAT	2,411	16.7	19,335	–5.7
Special taxes	1,472	1.6	4,805	4.3
Other	2,373	10.0	5,009	7.1
Total	**11,053**	**12.7**	**51,693**	**3.4**
Non-financial spending	**9,106**	**–5.7**	**36,909**	**4.1**
Treasury balance	**–2,559**	**–34.6**	**1,272**	**–45.1**
Surplus (+) or deficit (–) (**)	***–6,105***	***–1.5***	***3,276***	***–51.4***

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.

13% annual increase in non-financial spending in terms of national accounting.

before in spite of the improvement in March. This decrease was brought about by lower collections from domestic transactions for value added tax (down by 7.4%) which largely reflected reduced activities of small and medium companies in construction and housing development as well as an easing off in consumption. Also having an effect in this reduction was the introduction as of January 2008 of the taxation scheme for company groups (under Law 36/2006, dated November 29) involving measures to prevent tax fraud.

Special taxes were up by 4.3% thanks to a 14.2% rise in tobacco taxes and 11.5% in taxes on electricity. On the other hand, taxes on fuels, the main heading under this group, were down 1.3% due to lower consumption of fuels because of price increases.

Other central government non-financial revenues were up 7.1%. Notable under this heading was the year-on-year rise of 22.9% rise in the preliminary payment of Bank of Spain profits. On the other hand, capital transfers from the European Union were appreciably down.

With regard to spending, current spending was up 4.9% in the first quarter of 2008. Under these amounts, personnel costs rose by 2.7% while those for goods and services were down by 1.2%. Financial costs rose by 14.6% under the effect of the maturities calendar for government bonds.

Capital payments in the same period were down by 1.8%. Real investments held at the same level as the year before seeing that the 3.0% increase in public investment was counteracted by a drop of 6.1% in investments by the Ministry of Defence. In turn, capital transfers were down by 4.3%.

Nevertheless, in terms of national accounting, that is to say, looking at revenues due and obligations pending rather than spending actually carried out, central government non-financial spending rose by 12.8%, well above the 1.3% increase in revenues. In this way, in terms of national accounting, the central government surplus recorded in the first quarter amounted to 3.28 billion euros, less than half that reported in the same period in 2007. This amounts to 0.29% of GDP, some 0.35 percentage points less than in the first quarter of 2007.

Bank of Spain governor repeats need to control public spending.

In this context, in mid-April the governor of the Bank of Spain, Miguel Ángel Fernández Ordóñez, issued warnings about the need to control spending. He stated it was important to avoid measures that could endanger a continuation of budgetary stability and that fiscal policy should maintain some margin for manoeuvre.

Savings and financing

Interest rate resisting any drop

In the first two months of this year, interest rates on loans and credits to the private sector swung around levels seen at the end of 2007. Expectations that the official rate of the European Central Bank had reached a ceiling slowed down the upward course in loan interest rates that began in mid-2005. As a result, real interest rates (discounting inflation) even dropped as a result of the rise in prices.

Nevertheless, problems of liquidity in the financial markets set off last summer by the US subprime mortgage crisis pushed up the Euribor (used as a mortgage loan reference) as monthly average in March, following two consecutive monthly decreases, thus putting the rate at 4.59%. In the early weeks of April the 1-year Euribor continued to rise going to a level of 4.80% to show an annual high.

Demand for credit by companies and households continued to slow in February under the effect of unfavourable economic prospects. As a result, funding granted to the private sector rose by 14.3% in the past 12 months ending in February, 0.9 points less than in December.

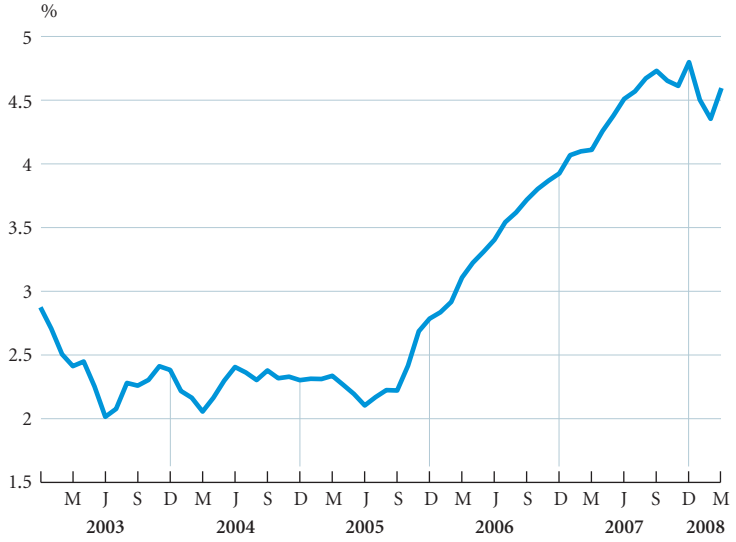
Sharp reduction in funding of non-financial companies through bond issues.

The lower growth of funding showed up in both households and companies. Nevertheless, loans to non-financial companies continued to show a substantially higher year-on-year change

Notable increase in leasing.

1-YEAR EURIBOR RISES IN MARCH

12-month Euribor



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

February 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	87,442	–3,400	–3.7	4,526	5.5	4.9
Secured loans (*)	1,078,310	9,938	0.9	130,752	13.8	60.7
Other term loans	502,844	4,961	1.0	78,862	18.6	28.3
Demand loans	40,369	–203	–0.5	7,655	23.4	2.3
Leasing	46,369	76	0.2	6,106	15.2	2.6
Doubtful loans	19,932	3,681	22.7	8,189	69.7	1.1
TOTAL	**1,775,266**	**15,054**	**0.9**	**236,090**	**15.3**	**100.0**

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

Drop in loans for home acquisition.

rate than in the case of households. We should point out that since the beginning of problems in the financial markets there has been a sharp drop in the growth of funding through bond issues. As a result, this funding went from an annual increase of more than 30% in August to 13.9% in February. Commercial credit, used to provide companies with working capital, showed a drop in annual change rate in February whereas leasing (channelled into investment) was up slightly to 15%.

Loans to households went from growth of 19.6% in 2006 to an annual growth rate of 12.0% in February 2008. Loans for home acquisition continued to slow down in February mirroring lower demand under the effect of the high prices reached and less favourable borrowing terms. But not only was there a decrease in housing loans. The drop in consumer confidence had a negative effect on growth of consumer credit. As a result, other credit to households went from annual growth of 11.2% in December to 10.3% in February.

Default rising but still at low levels.

In addition, doubtful loans (those behind in repayments) rose by 69.7% in the past 12 months, reflecting the change in stage of the economic cycle. Nevertheless, given that the default rate showed an all-time low in December 2006, this ratio stood at a relatively low level at the end of February (1.12%), well below the European average. Furthermore, it should be mentioned that Spanish lending institutions have a broad cushion of provisions enabling them to meet a rise in default.

Rise in bank time deposits

The marked economic slowdown underway is also reflected in the growth of bank deposits which went from annual change rates of more than 20% to less than 15% in a matter of months. In this respect, financial institutions have had recourse to issuing short-term bond issues (and long-term issues) in order to fill the gap for funding loans.

The slowdown in growth of deposits has come about in spite of a slight rise in average return, which however did not compensate for the rise in inflation, except in the case time deposits. In fact, the return on time deposits stood at

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

February 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	417,524	–20,533	–4.7	–9,048	–2.1	31.7
Up to 2 years	382,111	29,405	8.3	116,976	44.1	29.0
More than 2-year term	396,323	–5,651	–1.4	53,772	15.7	30.1
Repos	79,372	–6,239	–7.3	–1,549	–1.9	6.0
Total	**1,275,331**	**–3,017**	**–0.2**	**160,152**	**14.4**	**96.8**
Deposits in currencies other than euro	**41,851**	**–1,993**	**–4.5**	**5,072**	**13.8**	**3.2**
TOTAL	**1,317,182**	**–5,010**	**–0.4**	**165,224**	**14.3**	**100.0**

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

4.51% in February but this was at the same level as in January following a series of notable increases brought about by the funding needs of many financial institutions in view of the distortions in the financial markets.

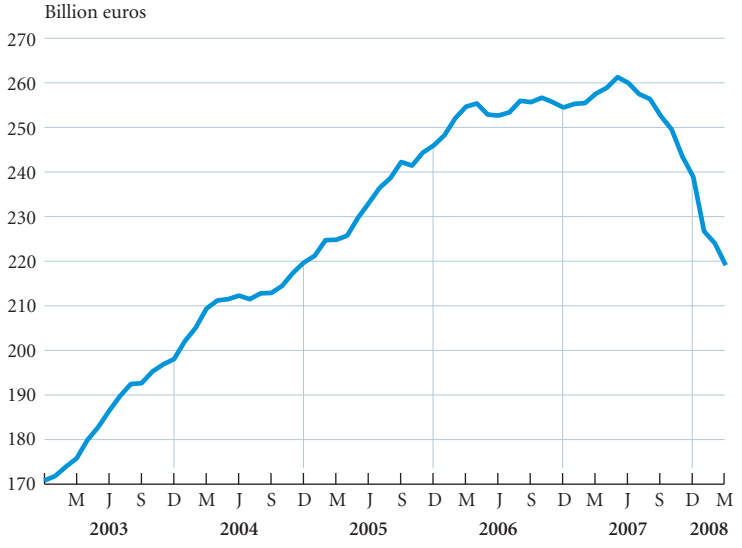
All types of account showed some drop in growth rate with the exception of deposits for a term of less than two years which reported by far the biggest annual growth at 44.1%. At the opposite end of the scale, on-demand accounts showed a year-on-year drop of 2.1% under the effect of a low return.

The strong campaigns to attract deposits waged by financial institutions had an unfavourable impact on participations in mutual investment funds, which were

Slight rise in yield on deposits in first two months of year.

FURTHER DROP IN MUTUAL FUND ASSETS

Total assets of mutual investment funds



SOURCE: Inverco.

Competition for deposits and financial upsets has negative effect on mutual funds.

also affected by the upsets in the financial markets, particularly by those in the stock markets. In fact, the assets of mutual funds dropped by 4.89 billion euros in March. Most of these decreases were due to net withdrawals of participations amounting to 3.71 billion euros, while the rest were due to capital losses because of the unfavourable performance of financial markets. Nevertheless, net withdrawals in May, along with those in February, were the lowest in the past seven months since the outbreak of the financial crisis last summer.

Hedge fund assets continue to rise.

Negative net withdrawals in March affected nearly all types of fund with the exception of guaranteed bond-based funds and US share-based funds. In the first quarter as a whole, apart from these two types of fund, there were net positive subscriptions especially in short-term bond-based funds and money-market funds which acted as refuge in a situation of sharp volatility in financial markets.

Bank deposits consolidate weight in household investment portfolios making up one-third of total.

As a result of the unfavourable trend in most financial markets, average annual return was –1.2%, although there was a wide spread depending on the various kinds of fund. Annual returns thus swung between 3.2% for guaranteed bond-based funds to –29.9% for Japanese share-based funds. It should be mentioned that average annual return over the past 17 years was 4.6%, a figure higher than inflation.

Share of insurance products drops for fifth year in a row while pension funds up slightly.

On the other hand, in spite of the fact that at a specific moment in the international financial crisis they were in the eye of the storm, the assets of hedge funds in the Spanish market continued to rise. It should be remembered that these funds were authorized only a short time ago and that they enjoy greater freedom in their investments. The total assets of these funds amounted to 1.20 billion euros at the end of the first quarter.

Net financial wealth of households down in 2007

Bank deposits of households showed notable growth in 2007 following the change in tax treatment of financial products which put all these on the same level. As a result, their weight in household financial assets was consolidated with a modest rise to 35.5%, slightly more than one-third of the total although far from the 53.8% reported at the end of 1990 before the start of the process of financial liberalization.

The share portfolio, including participations in investment mutual funds, makes up the largest share of the financial wealth of individuals with a 42.4% share of the total at the end of 2007. Nevertheless, it showed little growth (1.9%) in 2007, lower than the 5.1% of total financial assets, so that its weight decreased. Nevertheless, in the past seven years share-based products were those to increase most. The increase in these instruments in 2007 was due to price rises, seeing that net sales of these assets were recorded for a value of 6.63 billion euros, mainly due to withdrawals of shares in investment mutual funds. On the other hand, there were net acquisitions of listed shares held directly by households.

Insurance products rose by a modest 4.2%, less than the average. As a result, their weight in the total was down for the fifth consecutive year, going to 13.6%. By type, non-life was in the lead with a rise slightly above the total. The share of pension funds was up slightly to 6.0%.

NET HOUSEHOLD FINANCIAL WEALTH (*)

	2007			Annual change		Change over 5 years	
	Million euros	Structure as %	% of GDP	Million euros	%	Million euros	%
Financial assets							
Cash	88,116	4.6	8.4	1,630	1.9	40,179	83.8
Deposits	641,427	33.5	61.1	56,715	9.7	216,970	51.1
Securities other than shares	47,717	2.5	4.5	6,548	15.9	19,478	69.0
Shares and participations in investment funds	811,550	42.4	77.3	14,971	1.9	408,204	101.2
Insurance technical reserves	260,222	13.6	24.8	10,572	4.2	85,572	49.0
Other	65,034	3.4	6.2	2,957	4.8	27,157	71.7
Total	**1,914,067**	**100.0**	**182.3**	**93,395**	**5.1**	**797,560**	**71.4**
Financial liabilities							
Loans	878,187	94.1	83.6	97,397	12.5	498,418	131.2
Other	54,741	5.9	5.2	–2,676	–4.7	3,681	7.2
Total	**932,929**	**100.0**	**88.9**	**94,722**	**11.3**	**502,099**	**116.5**
Net financial worth	**981,138**	**–**	**93.5**	**–1,327**	**–0.1**	**295,461**	**43.1**

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

With regard to cash holdings, in 2007 this showed a strong drop in growth to a mere 1.9%. The weight of cash thus went down to 4.6%, a share substantially lower than the 7.8% reported at the end of 1991.

Increase in cash holdings down sharply.

On the other side of the household financial balance sheet, financial liabilities were up by 11.3%, a rate more than twice that of assets. The vast majority of liabilities is made up of loans, especially long-term loans for home purchase. The volume of loans to households has tripled in the past seven years. At the end of 2007, loans amounted to 132.1% of gross disposable income. In 2007, loans totalled 19,393 euros per capita.

As a result, net financial wealth of households, defined as financial assets less financial liabilities, showed a slight drop of 0.1% in 2007 to 981.14 billion euros, although in the past five years it has increased by 43.1%. With regard to gross domestic product it was down to 93.5%. Per capita, net financial wealth was 21,667 euros, 1.9% less than the year before.

Household borrowing goes up to 132% of gross disposable income.

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THE SPANISH ECONOMY
MONTHLY REPORT
May 2008

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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**

Design and page make-up: www.cege.es - Ciutat d'Asunción, 42 - 08030 Barcelona
Internet edition: www.comunicacions.com - Travessera de Dalt, 30 - 08024 Barcelona
D. L.: B. 21063-1980 ISSN: 1134-1920