JUNE 2008

THE SPANISH ECONOMY

Monthly Report

NUMBER 314

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	1.3	1.5	1.9	2.8	2.5	2.5	1.7
Japan	2.4	2.0	1.8	3.2	1.8	1.9	1.4	1.1	2.0
United Kingdom	2.9	3.0	1.9	3.0	3.2	3.1	2.8	2.5	2.0
Euro area	2.9	2.6	1.7	3.2	2.5	2.7	2.2	2.2	1.9
Germany	*3.1*	*2.6*	*1.9*	*3.7*	*2.6*	*2.5*	*1.8*	*2.6*	*2.0*
France	*2.4*	*2.1*	*1.6*	*2.1*	*1.7*	*2.4*	*2.2*	*2.2*	*1.7*
Consumer prices									
United States	3.3	2.8	3.4	2.5	2.5	2.4	4.0	4.2	3.6
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	2.6	2.9	2.6	1.8	2.1	2.4	2.7
Euro area	2.2	2.1	3.2	1.9	1.9	1.9	2.9	3.4	3.4
Germany	*1.6*	*2.3*	*2.6*	*1.8*	*2.1*	*2.3*	*3.1*	*2.9*	*2.7*
France	*1.7*	*1.5*	*2.7*	*1.2*	*1.2*	*1.3*	*2.3*	*2.9*	*2.8*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	3.7	3.1	1.7	3.5	3.4	3.1	2.7	1.8	1.7
Government consumption	4.8	5.1	4.9	6.1	5.0	5.1	4.4	4.7	4.8
Gross fixed capital formation	6.8	5.9	0.3	6.3	6.7	5.8	4.8	3.2	0.3
Capital goods	*10.4*	*11.6*	*2.3*	*13.1*	*13.1*	*11.6*	*8.6*	*6.3*	*2.9*
Construction	*6.0*	*4.0*	*–1.5*	*4.9*	*4.6*	*3.8*	*2.9*	*1.3*	*–1.8*
Domestic demand (contribution to GDP growth)	5.1	4.6	2.0	5.1	4.9	4.5	3.9	3.0	1.9
Exports of goods and services	5.1	5.3	3.6	3.6	4.7	7.7	5.1	5.0	3.9
Imports of goods and services	8.3	6.6	2.8	6.0	6.7	8.4	5.4	5.0	3.0
Gross domestic product	**3.9**	**3.8**	**2.0**	**4.1**	**4.0**	**3.8**	**3.5**	**2.7**	**2.0**
Other variables									
Employment	3.2	3.0	0.9	3.3	3.1	3.0	2.5	1.7	0.9
Unemployment (% labour force)	8.5	8.3	9.9	8.5	8.0	8.0	8.6	9.6	9.7
Consumer price index	3.5	2.8	4.3	2.4	2.4	2.4	4.0	4.4	4.4
Unit labour costs	2.3	2.7	3.0	2.6	2.6	2.7	2.8		
Current account balance (% GDP)	–8.8	–10.0	–10.3	–10.1	–9.0	–10.2	–10.7	–12.1	
Net lending or net borrowing rest of the world (% GDP)	–8.1	–9.5	–9.9	–9.5	–8.7	–10.1	–9.8	–11.3	
Government balance (% GDP)	1.8	2.2	0.2						
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	5.0	5.0	2.2	5.3	5.3	5.1	4.5	2.8	2.0
ECB repo	2.8	3.9	3.9	3.6	3.8	4.0	4.0	4.0	4.0
10-year US bonds	4.8	4.6	3.9	4.7	4.8	4.6	4.1	3.5	3.9
10-year German bonds	3.8	4.2	4.2	4.0	4.4	4.3	4.2	3.9	4.2
Exchange rate									
$/Euro	1.26	1.38	1.53	1.32	1.35	1.39	1.46	1.53	1.55

Contents

Africa: the next global surprise?

Africa is believed to be the cradle of Humanity given that it is there the oldest vestiges of Man's presence on Earth have been found going back several million years. But, while the human species arose in Africa, this is not a continent that stands out for its development and progress. Nearly half of Africa's population lives in conditions of extreme poverty and it includes nearly three-quarters of the world's poorest countries.

This was not always so. In the middle of the 20th century the per capita gross domestic product of Latin America and Asia was not much different from that of Africa. In fact, the Asian continent bore all the trappings of economic backwardness. Nevertheless, since then both regions have shown notable growth while Africa, especially sub-Saharan Africa, has scarcely changed. We may ask why?

The articles accompanying this Monthly Report show that a number of theories have been put forward in trying to answer that question although none has managed to lay out a convincing explanation. What is clear is that many factors are working against progress on the African continent. One of the most important is geography. At one time, some 12,000 years ago, the present Sahara Desert was a fertile valley with abundant rain but progressive desertification left the lands south of the Sahara far from the political and economic centres that have marked the history of the various civilizations. The tropical climate, which exists over a large part of the continent, does not usually serve as the best ally in the development of productivity or favour the cultivation of cereals, a key for ensuring a minimum level of food production. Another factor hampering African development is the low level of institutions (mechanisms for social order and cooperation). The colonial past may lie behind the failure of some states that were artificially and capriciously drawn on the map in response to interests that lay outside the reality of the territory involved. Many of the armed conflicts that have laid waste the continent in recent times may be explained in this way, as well as long years of dictatorial governments and greed coveting an abundance of natural resources.

Perhaps partly because of a bad conscience from their colonial behaviour, since the Sixties the rich countries have tried to help the progress of these developing countries through international aid and cooperation programmes. In the case of Africa, the results have been poor. In 2000, the United Nations decided to modify its aid strategy establishing eight «development objectives for the Millennium» which ranged from reducing extreme poverty by half to halting the spread of the AIDS virus and instituting universal primary school education by 2015. It was a matter of organizing efforts and resources in order to more effectively help the world's poor which, as mentioned above, include a good number of African countries.

In spite of all this, Africa today is a continent on the move. In 2007, the African economies grew by 6%, according to the International Monetary Fund, thus consolidating a path marked by several years of high economic growth, increasing exports and tangible progress. Helped by high prices for raw materials, a number of African countries are achieving notable advances and beginning to attract funds from private investors, mainly from Asia. It may be that in the not too distant future some African country will turn out to be a success story and become an emerging country rivalling economies that, like China, India and Brazil, are now driving the world economy. Why not?

EXECUTIVE SUMMARY

Inflation adds to uncertainty in world economy

Economic situation, far from clearing up, gets worse with poorer prospects on inflation.

Far from becoming clearer, the world economic situation seems to becoming even more complicated. Up until recently, the main concern was the extent of the world subprime mortgage crisis and its effects on the real economy. There was speculation (and there still is) about a sharper effect in the United States and there are doubts about a decoupling of the other economies from the US decline. The key priorities were to save growth and avoid a bank crisis that could have unforeseeable consequences. The most recent indicators are hopeful. The pressures in the financial markets have eased although they are far from being considered under control, while figures for economic activity in the first quarter were better than expected.

Per barrel price of oil goes above 130 dollars while basic food prices sky-rocket.

However, in barely one month the situation has become much more complicated with the pressures showing up in commodity markets which, while not new, have gone to unexpectedly high levels in recent weeks. Oil, which one year ago was running in the area of 70 dollars a barrel, in two stages had jumped beyond 110 dollars. It seemed it would be difficult for this trend to keep up this tempo. Because of this, the further rise of 17% in May has left many analysts out on a limb. With oil above 130 dollars a barrel the future scenario becomes quite complicated and uncertain. Not only this. The prices of many food commodities, such as rice, wheat, soy and others, have risen to the point where they have set off major civil disturbances in some poor countries where even a small increase in the price of basic foods can condemn many people to hunger.

In many developing countries price indices are at their highest levels in recent years due to the weight of food in their shopping basket. In the developed countries, the increases have been more moderate but price indices stand at excessively high levels in terms of the objectives set by those responsible for economic policy. Furthermore, this concern has come down to ordinary people and groups affected by the rise in fuel costs (road and air transport and fishing) are loudly protesting in a number of countries in Europe. Opinion polls reflect the lack of consumer confidence in inflation staying low. In fact, the trend in commodities so far this year has meant that inflation has moved into front place in the list of economic problems, thus joining the financial crisis and the risk of a sharp slowdown or recession.

Low growth with high inflation: a return to stagflation?

An inflationary situation in the context of a slowdown in economic activity presents a very big challenge for the central banks. If they try to fight against inflation by a restrictive money supply policy they may worsen the slowdown. If the central banks try to foster growth and keep easing interest rates, the economic agents may come to feel that future inflation will go still higher and they may try to anticipate that eventuality by pushing for wage increases, for example. So people are again talking of stagflation (stagnation with inflation) as happened in the Seventies (see last month's Monthly Report). What is to be done?

The most immediate example is the dilemma faced by the Bank of England.

In the British Isles inflation is showing troublesome prospects. At the same time, the indicators unfailingly are reporting a sharp loss in growth rate. Until recently, the central bank had given notable support to economic activity through three consecutive interest rate cuts. It has now set a wait-and-see period in order to measure the extent of the crisis and economic circles are wondering what will be the next step taken by the Bank of England.

Other central banks find themselves in a similar situation. The Federal Reserve has made it understood that the cuts in reference rate are ended and that there would now be a long stage of low interest rates. Underlying inflation (excluding food and energy) seems to be under control but the markets are still anticipating interest rate increases in a few months. The European Central Bank, always leaning more on the anti-inflation side, has not changed its reference rates all through the financial crisis and is now repeating its message of tightness.

Another source of concern is on the side of financing. Some signs seem to indicate certain improvements in the credit crisis that set in at the middle of last year but generally the pressures continue to exist. The trend in the stock markets during a good part of May (rise in indices and decrease in volatility) may be interpreted as a sign that market players were assuming a good part of the bad corporate news that had to come out had now been made public. Nevertheless, in the final stages of the month profit-taking predominated thus flattening a good part of the gains. In the interbank market, pressures in the United States have eased but they continue to be present in the Euro Area, as shown by the rise in the 1-year Euribor to 5%, the highest level of the decade. The banks most affected by the subprime mortgage crisis are managing to recapitalize their balance sheets but the restraint on credit to companies and households is making itself felt. Risk premiums in the bond markets have eased slightly but normalcy is still some way off.

Central banks must resolve dilemma of giving priority to fight against inflation or boosting growth.

Paradoxically, the positive note of the month came in available growth figures for the first quarter. In Europe, indicators for investment and foreign demand for the period were considered positive. The figures published, however, especially those for Germany, exceeded the most optimistic expectations. Europe's leading economy raised its growth rate to 2.6% year-on-year while the Euro Area again showed a satisfactory 2.2%. The United States followed a similar pattern. Just when many people were sure of a drop in gross domestic product for the first three months a preliminary estimate showed an increase of 0.9% quarter-on-quarter annualized. Among the emerging countries, China announced an almost imperceptible slowdown with growth at a notable 10.6% year-on-year. In general, second-quarter figures for the main economies show a downward trend in economic activity although for the moment the starting point seen in the first quarter is favourable.

Markets indicate that worst of financial crisis now over but normalization will take time.

Spain's economy: slowdown in first quarter

Spain's economy has not shared the positive figures for the first quarter seen in other European economies. Indicators for this period point to a sharp slowdown in economic activity and, in effect, this is confirmed by the National Institute of Statistics (INE). Gross domestic product grew by 2.7% year-on-year in January-March, far from the 3.5% seen in the last quarter of 2007. With regard to the previous quarter, growth was only 0.3%, that is, below that recorded in the Euro Area, an unusual result for many years.

Spain's economic growth slows in first quarter due to lower drive in consumption and investment.

Why is the economy slowing down? Largely because households are adjusting

Labour market rapidly making sharp adjustment to phase of weaker economic drive.

their spending rate and because investment in housing is going through a notable adjustment. Consumers are turning out to be pessimistic in their evaluation of the economic situation, a foreseeable result in the context of a drop in employment and a rise in prices. Home buying has been noting a slowdown since last year, something that the rise in interest rates and tightening of credit terms have only made worse. This notable slowdown in national demand has not been compensated by the slightly lower draw-off by the foreign sector, thanks to the maintenance of exports and a weakening of imports of goods and services.

One component that is raising concern is the worsening of the labour market. Figures for INE for the first quarter of 2008 show a drop of 75,000 jobs as against growth of 67,000 in the same period in 2007. In keeping with the adjustment in investment demand in construction, it is precisely this sector, along with services, that is one of those most rapidly having to adapt. In the first quarter, these two sectors accounted for practically all job losses. The drop in registrations with Social Security, along with the increase in unemployment in April, a traditionally sound month, make up a labour market scene that is going through a period far from the boom of other times.

Inflation increasing and trade deficit keeps growing although energy imbalance is main culprit.

In this context, other bad news comes with the course of inflation so far this year. The growth rate of consumer prices (4.7% year-on-year) is above forecasts. Furthermore, immediate prospects are rather negative as it is highly unlikely this will take on a downward course of any significance before year-end. Another factor darkening figures in recent months is that the inflation differential with the Euro Area is holding unchanged. This implies that Spain is still not recovering international competitiveness through lower price increases.

Margin for manoeuvre in economic policy gets narrower.

This would be a good time to make improvements in the area of competitiveness, given the slim trend in domestic variables. Figures for the foreign sector in March are, in fact, not as negative as they may seem. Foreign trade figures show that the trade deficit does keep getting bigger and that it is doing so at an increasing rate. Nevertheless, the lack of any improvement in the trade imbalance is largely the result of a widening of the imbalance in the figure for energy products that has been negatively affected by the sharp rise in oil prices and that of other products. The non-energy balance, on the other hand, has shown a constant tendency to improve since the end of 2007.

Things being as they are, what can we hope for from economic policy? In April, at the first cabinet meeting of the new government a series of short-term measures were adopted aimed at softening the slump. The most notable decision taken was for a 400-euro deduction in personal income tax, a measure that would take effect in June. Other measures suggest greater attention to research and development, education and infrastructures, simplification of regulations in the business sphere, reform of Social Security, et cetera. At month-end, however, Pedro Solbes, Minister of Economy and Finance, warned of the rapid turnaround that could take place in the government surplus as a result of the drop in tax collections and the increase in social policy spending. For this reason, the margin for manoeuvre in economic policy, now divested of its monetary and foreign exchange aspects, becomes narrower and narrower.

May 29, 2008

CHRONOLOGY

2007

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.
	30	**Federal Reserve** reduces reference rate to 2.00%.
May	**22**	One-month forward price of *Brent* quality **oil** moves up to all-time high level of 131.52 dollars a barrel.

AGENDA

June

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

July

- **2** Registrations with Social Security and registered unemployment (June).
- **3** Governing Council of European Central Bank.
- **4** Industrial production index (May).
- **11** CPI (June).
- **16** Harmonized CPI (HICP) for EU (June).
- **22** Central government revenues and spending (June).
- **23** Producer prices (June).
- **24** Labour Force Survey (2nd Quarter). Foreign trade (May).
- **25** US GDP (2nd Quarter).
- **31** Balance of payments (May). HICP flash estimated (July).

INTERNATIONAL REVIEW

US GDP grows by 2.5% in first quarter with consumption holding up but decreased investment.

United States: when will recovery take place?

The United States gross domestic product (GDP) grew by 2.5% year-on-year in the first quarter of 2008, somewhat above forecasts. In year-on-year terms annualized the increase was 0.6%, thus repeating the rate in the previous period. Among those elements showing some strength was private consumption, the factor likely to be key for the economy in 2008 and 2009. This component continued to slow down but only slightly to show an increase of 1.9% year-on-year. Also making a positive contribution was the export sector with growth going up by 9.5% and replacement of inventories which added strength to progress instead of detracting from it. On the negative side, adding to the continuing weakness of housing investment came a slight drop in capital goods investment and especially the decrease in industrial construction.

The economy is thus skirting around the decreases although only for the moment. Nevertheless, the question is not so much if there is a recession or not but how long this period of economic weakness will last. The prospects are for continuing growth below potential as shown in the latest forecasts by the Federal Reserve for

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	April
Real GDP	2.9	2.2	1.5	1.9	2.8	2.5	–	2.5	–	–
Retail sales	5.8	4.0	3.3	4.0	3.9	4.7	3.9	2.7	2.0	2.0
Consumer confidence (1)	105.9	103.4	109.9	106.7	105.7	91.2	87.3	76.4	65.9	62.3
Industrial production	2.2	1.7	1.3	1.4	1.8	2.2	2.6	1.1	1.4	0.2
Industrial activity index (ISM) (1)	53.1	51.1	50.5	53.0	51.3	49.6	50.7	48.3	48.6	48.6
Sales of single-family homes	–18.0	–26.3	–24.6	–21.2	–26.6	–33.5	–31.8	–31.5	–36.6	...
Unemployment rate (2)	4.6	4.6	4.5	4.5	4.7	4.8	4.9	4.8	5.1	5.0
Consumer prices	3.2	2.9	2.4	2.6	2.4	4.0	4.4	4.1	4.0	3.9
Trade balance (3)	–758.5	–708.5	–747.4	–734.3	–707.6	–708.5	–710.1	–713.6	–708.8	...
3-month interbank interest rate (1)	5.2	5.3	5.4	5.4	5.4	4.9	3.1	3.1	2.7	2.9
Nominal effective exchange rate (4)	82.5	77.9	81.9	79.3	77.0	73.3	73.1	72.6	70.3	70.5

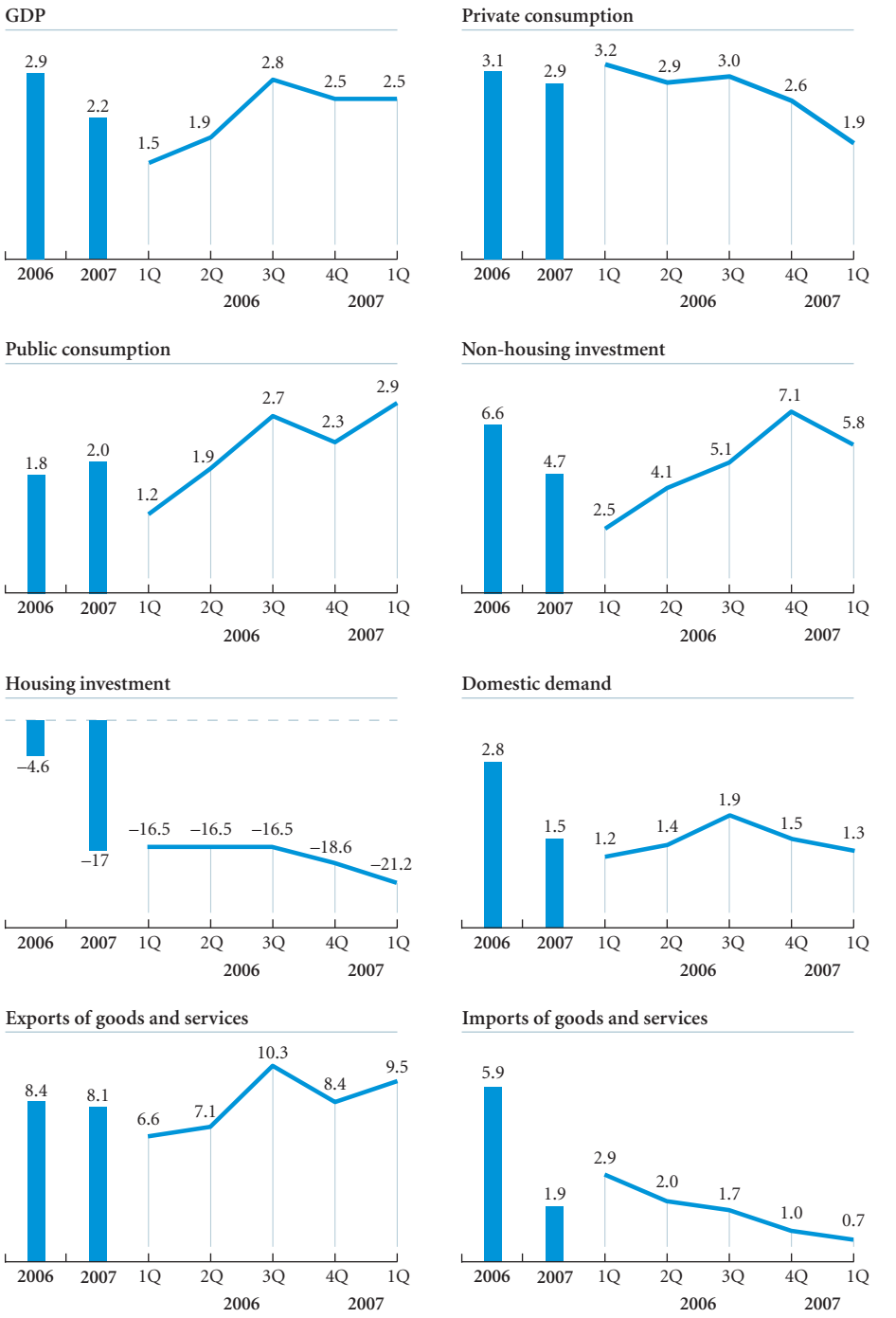
NOTES: (1) Value.
(2) Percentage of labour force.
(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.
(4) Change weighted for foreign trade movements. Higher values imply currency appreciation.
SOURCE: OECD, national statistical bodies and own calculations.

2008 and 2009 at 0.7% and 2.4% respectively. Finally, the present weakness is not so much characterized by a sudden sharp recession but, on the contrary, by continuing weakness which has already gone on for two years.

Economic weakness has now lasted two years.

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Bureau of Economic Analysis and own calculations.

With less access to credit, less real estate wealth and less employment, consumers feel pessimistic.

Private consumption, which makes up 71.6% of the GDP, has been suffering from a loss of purchasing power by the average American which, up until now, had been compensated by the wealth effect of real estate assets and easy access to credit. Over the past two years, with real estate going down in value and credit more difficult to obtain, things have changed. On top of this comes a weak labour market and increased oil prices which are contributing to cut the household budgets of indebted consumers.

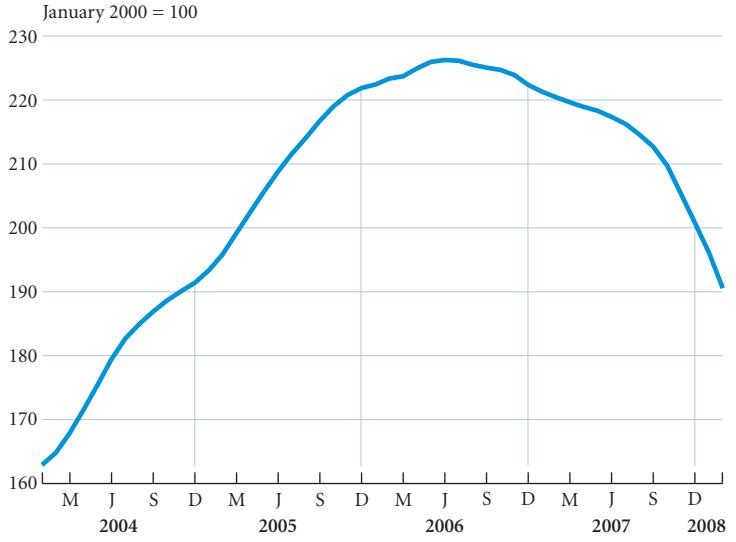
With this background it is not surprising that the consumer confidence index put out by the Conference Board dropped from 65.9 in April to the 62.3 level. The extreme weakness in expectations which stand at lows not seen since 1973, is now also being felt in the perception of the present situation which registered its third consecutive month of decreases going down from 90.6 to the 80.7 points level. Retail sales, excluding the volatile figures for cars and petrol, continued a gradual slowdown in April to show an increase of 2.6% year-on-year which, if we discount price changes, stood at 0.3%, a situation of stagnation which, however, was better than the drop in March.

In the housing sector, on the supply side, the bottom of the crisis has not yet been reached. Construction spending in the first quarter was down by 26.6% compared with the previous period in annual terms and, while more housing starts took place in April than in March they were still down by 30.6% year-on-year. Pointing in the same direction, building permits, which are an early indicator, were down by a similar 34.3%.

On the demand side, things are not very buoyant either. Real estate prices are a variable having most influence on the economy, increasing or decreasing perceived wealth of many consumers and the most representative index of this

UNITED STATES: REAL ESTATE PRICES SHOWING SHARPER DROPS

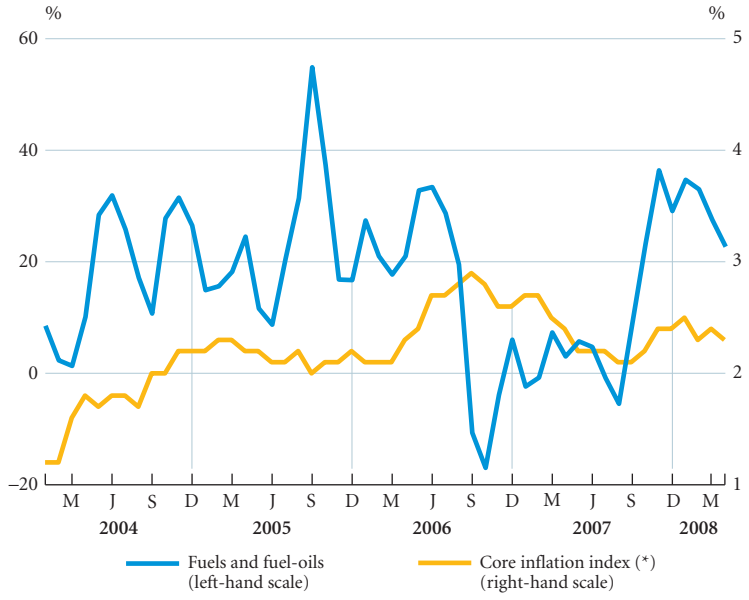
Level of Case-Shiller housing price index



SOURCE: Standard & Poor's and own calculations.

UNITED STATES: ENERGY INFLATION NOT AFFECTING OTHER PRICES

Year-on-year change in components of consumer price index



NOTES: (*) Core inflation index excludes food and energy.
SOURCE: Department of Labour and own calculations.

factor, the Case-Shiller index, continued to show further decreases in February with a cumulative drop of 15.8% compared with the high in June 2006, a decrease which, if we add the increase in the CPI, comes to 20%. Existing housing sales in March were down by 19.3% year-on-year while new housing showed greater volatility with a drop of 36.6%.

The second element affecting consumption, the labour market, also continued on a downward trend. Some 20,000 jobs were lost in April, not an excessive figure but one which means a fourth consecutive month of drops. As is the case with the general trend in the economy, the decreases are not as sharp as in previous slowdowns, so that in April employment still stood 0.3% above the same month last year. In addition, the April unemployment rate was down slightly from 5.1% to 5.0% of the labour force, a figure lower than in the 3-year period 2002-2004.

Labour market gradually moving down.

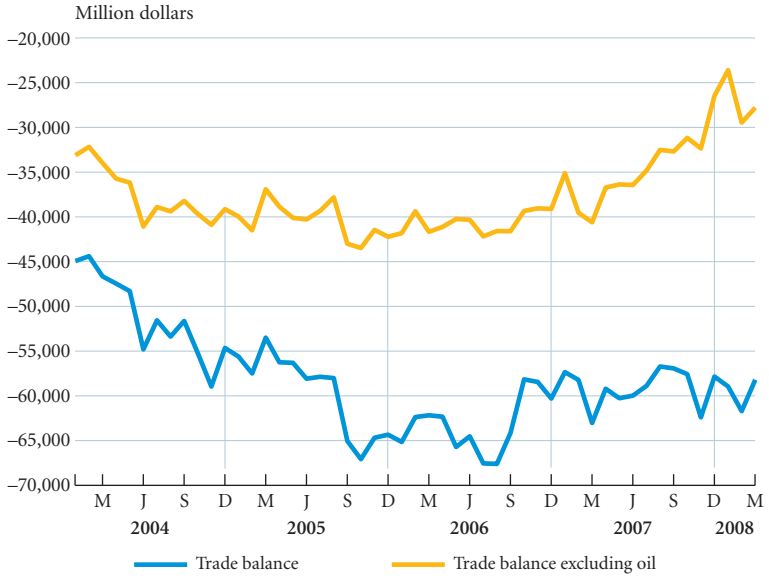
Business executives continue to hold a more biased perception of the slowdown than consumers, although we should not forget a brief showing of concern in January. The trend of the business activity index in April put out by the Institute for Supply Management for the services sector was down from 52.2 to 50.9 points. Being above 50, this level indicates that optimistic responses were ahead of pessimistic views although by very little. In manufacturing, the index was somewhat lower at 48.6 points. In both cases, the danger of major price increases may be detected. In services, the components of employment and new orders also stand above 50, while in manufactures the profile is lower with employment below the level of balance and with stronger export orders than orders of national origin.

Business executives feel their expectations worsening to moderate extent.

The weakness in manufacturing is also clearly shown in industrial production which was stagnant in April compared

UNITED STATES: TRADE DEFICIT IMPROVING

Monthly figure for trade balance in goods and services



SOURCE: Department of Commerce and own calculations.

Inflation goes below 4% in spite of rise in oil prices.

with the same period last year and in the utilization of production capacity, which at 79.7% stood at the lowest level since the weak figure for September 2005 following the effects of Hurricane Katrina.

In this process of slowdown prices presented a breather. The consumer price index (CPI) for April moderated to show growth of 3.9% year-on-year after having reached 4.4% in November and January. Even more significant was the moderation in the core component which went from 2.4% to 2.3%. If we exclude housing rentals the increase in the underlying index was 2.0%, the same increase as seen in the private consumption deflator of the GDP not including food or energy, an indicator closely watched by the Federal Reserve. These reasonable figures show the little effect energy prices (with a CPI component rising by 22.5% year-on-year) are having on the rest of the economy.

Trade deficit again improving thanks to poor domestic demand and depreciated dollar.

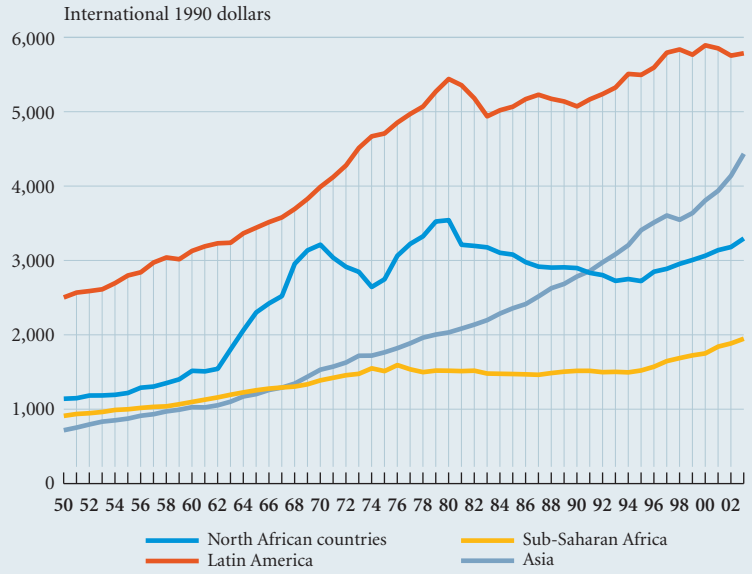
In March, the trade balance for goods and services showed a deficit of 58.21 billion dollars, a drop of 7.7% year-on-year, the result of an increase in exports which moved up by a strong 15.5% and a slowdown in imports which reduced growth rate to 7.9%. The trade deficit, excluding oil, stood at 36% below the high in April 2005. The positive trend in the trade imbalance should not make us overlook the fact that exports cannot replace the slowdown in consumption. Another doubt about correction of the deficit lies in whether this would continue with a stronger dollar and more robust domestic consumption.

Africa: the curse of the tropics

«I would have bartered a diamond mine for a glass of pure spring water!». This quotation from Jules Verne's celebrated *Journey to the Centre of the Earth*, summarizes perfectly the tragic irony of Africa today. With its minerals, landscape, plants, animals and its people, Africa is a continent rich in resources. Nevertheless, many of its inhabitants suffer from hunger and extreme poverty. The paradox is even sharper if we keep in mind the unceasing increase in living standards in the rest of the world. At the middle of the 20th century, per capita GDP in Latin America and Asia was not much different from that of Africa. Indeed, it was Asia and not Africa who won the wooden spoon. Since then, however, both those regions have shown notable growth whereas Africa (especially sub-Saharan Africa) has scarcely been able to keep up its level (see accompanying graph). Many people attribute Africa's poor growth to its geography and the way it has affected the continent's history.

SUB-SAHARAN AFRICA STANDS ALONE AT TAIL-END

Trend in per capita GDP



SOURCE: Angus Madison «Historical Statistics for the World Economy: 1-2003 AD».

In order to explain why Africa has prospered less than other developing countries, it is natural to look first at its productive factors, namely, labour, land and capital (physical and human). Expert economists in the African economy, such as Jeffrey Sachs (director from 2002-2006 of the UN Millennium Project), maintain that productivity in Africa is, in fact, very low and that this is largely due to the unfortunate location of the continent.

A large part of Africa, especially the poorest area, lies within the tropics. This location has paramount consequences on the productivity of the soil and its population and ends up affecting its ability to accumulate capital. To begin with, the hot and humid tropical climate is the ideal habitat for various potentially fatal

illnesses. Malaria, for example, is responsible for the 17.5% of infant mortality on the continent and infects many adults several times a year. While they do not always lead to death, the persistence and high morbidity of some illnesses – joined by the AIDS virus since the end of last century, – depletes the labour force and greatly reduces labour productivity. Human capital also suffers from this, since lower life expectancy reduces the incentive of people to invest in education. With regard to the land factor, the tropics do not favour the cultivation of cereals, a key for obtaining a minimal sufficiency in food production. In general, few common crops adapt well to Africa's climate and soil. Finally, most of the people live in semi-arid areas with few rivers and subject to cyclical and unpredictable rain. This increases risks for agriculture, forcing households to hold onto their savings to cover future situations of need instead of investing them in productive activities.

AFRICAN GEOGRAPHY MARKEDLY DIFFERENT FROM OTHER DEVELOPING COUNTRIES

	Sub-Saharan countries	Other developing countries
Distribution of population		
Proportion of population within 100 Km of coast	24.9%	66.3%
Proportion of population within the tropics	62.0%	34.9%
Proportion of population in arid or sub-humid areas	81.9%	38.7%
Agriculture		
Irrigated lans as % of agricultural land	0.5%	10.6%
Cereals yield (Kg/ha)	1,102	2,365
Fertilizer consumption (100 g/ha of cultivable land)	95	1,606

SOURCE: Adapted from Sachs *et al.* (2004). «Ending Africa's Poverty Trap». *Brookings Papers on Economic Activity*. 1:2004.

Apart from the direct impact of geography on growth, a number of studies defend the existence of another channel of no less importance – the quality of local institutions. That is to say, the body of laws and regulatory bodies of a country that provide the regulatory framework needed for developing any economic activity. According to this way of thinking, the location of Africa within the tropics determined the adoption of low quality institutions that hindered investment and thus reduced its capacity to adapt to a rather unfavourable environment. In order to understand the basis of those hypotheses it is necessary to go back in Africa's history and to remember the colonization era.

European colonization gave way to some successful countries, such as the United States, Canada and Australia, but also to poor ones, such as some countries in Latin America and many in Africa. Some researchers have found the explanation for such diversity in the various colonization strategies pursued. In those regions where a colon had a high probability of survival, Europeans established permanent settlements and replicated their home country institutions. The aim was to ensure private property and to monitor the power of the State. At the same time, in regions such as North America, suitable for growing wheat or maize, they were able to develop a broad middle-class which effectively distributed the powers of the government. On the contrary, in regions where diseases largely decimated the early settlers, the institutions were organized in order to ensure the efficient extraction of the natural resources. This led to a system favouring the concentration of power in the hands of an elite and investment in infrastructures was limited to communicate mining areas with the coast. As a result, the abundance of mineral resources marked the fate of Africa as much or more than did its tropical diseases.

Economic historians such as James Robinson explain how the pernicious effects of colonization perpetuated over time through various mechanisms. Following the independence of the colonies, the institutions endured thus allowing the elites in the new states to remain in power. In those countries with abundant natural resources the existence of those elites and the abuse of their power did nothing but aggravate the so-called *Dutch Disease*, a paradoxical situation where the abundance of resources leads to lower economic growth. The mechanism is simple enough: the export of natural resources tends to appreciate the exchange rate and penalizes the rest of the tradable goods sectors reducing the resources available to them. Given that these sectors are often the main driving force behind technological progress, the growth potential of the economy may be permanently reduced. In an autocracy, the lack of means for the rest of the economy is even greater, given that the minority holding power tends to waste income from natural resources on policies aimed at perpetuating their power status.

Africa's colonial status has also contributed to another of its main problems – the large number of armed conflicts. There are those who claim that colonization divided the continent into various countries in a completely artificial way, without taking into account their ethnic composition. As a result, African states are often more divided ethnically and linguistically than in the rest of the world. The combination of high ethnic diversity, the abundance of natural resources and the persistence of dictatorial governments has contributed to the outbreaks of violence that have devastated the continent.

Finally, the interaction of geography and history has obstructed other sources of growth, namely, trade and direct foreign investment. Both factors expand the economic potential of a country and spread technology and know-how. Both violence and the low quality of Africa's institutions have hindered the inflow of direct investment. In addition, the high transportation costs in most of the continent have made trade difficult, except perhaps in coastal countries. These high costs are largely due to insufficient investment in infrastructures but also to the non-existence of navigable rivers and the high proportion of the population living in mountainous regions (in large measure as a defence from the historic slave hunts). The Sahara Desert also acts as a major natural border blocking access to European markets, especially for land-locked countries and those surrounded by small countries with which they have not always had good relations. In addition, trade policies following independence, which were characterized by heavy duties between neighbouring countries, prevented the creation of domestic markets as an alternative to Europe.

To sum up, while the list of possible explanations is endless, geography and history seem to have marked out the pattern of growth in Africa. Undoubtedly, their effect has been reinforced by bad governments run by the dominant elites and their policies aimed at keeping them in power. In spite of all, the increase in growth since the end of the Nineties is encouraging and may be a signal of some countries having managed to free themselves from the corset imposed by geography. Should this be confirmed, the success of these countries should be a reason for hope for the others as it would show that fate is not yet sealed.

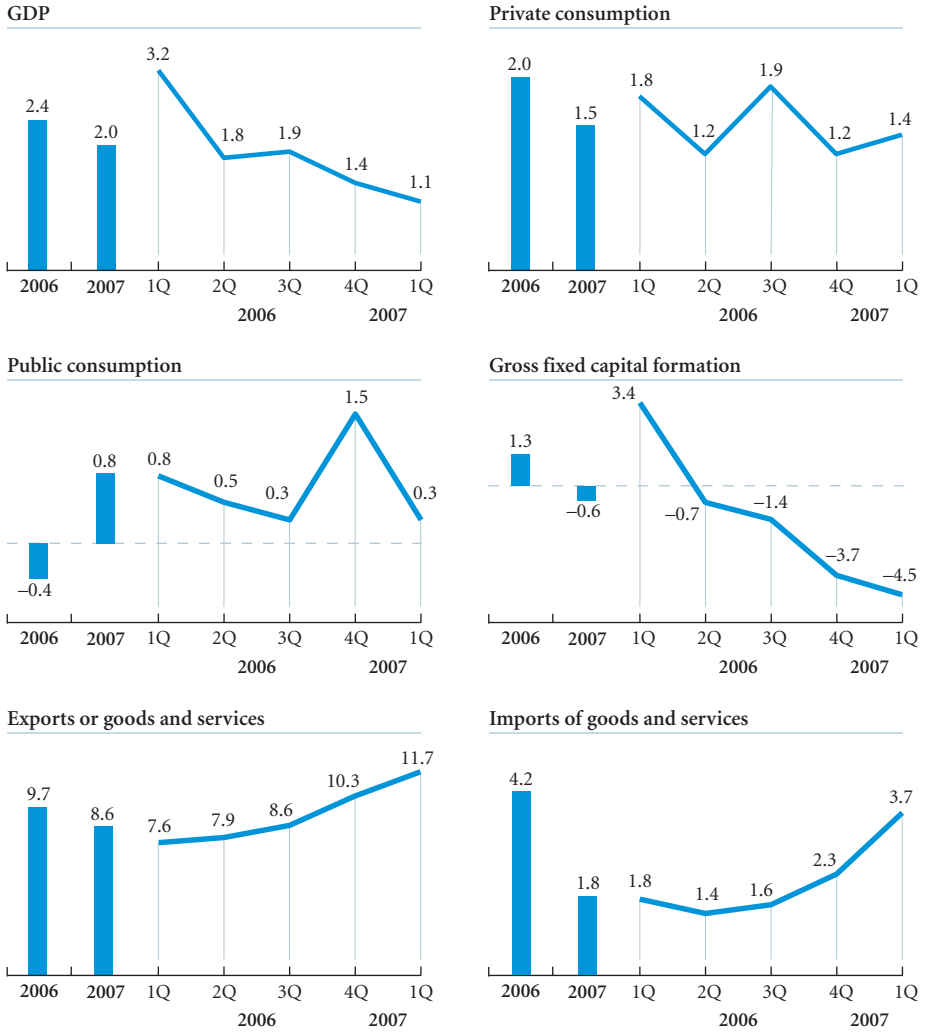
Japan's GDP grows by 1.1% thanks to private consumption and exports.

Japan: domestic demand somewhat stronger than expected

The GDP of Japan's economy grew by 1.1% year-on-year in the first quarter of 2008 somewhat higher than expected. Nevertheless, compared with the previous quarter this result represents a substantial advance of 3.3% in annualized terms. Our evaluation of the results in the first quarter is therefore positive largely thanks to the strength of exports which increased by 11.7% year-on-year and of private consumption for which growth of 1.4% was the most favourable note. On the other side of the coin was the weakness of investment in capital goods and public consumption. An excessive dependence on the foreign sector, however, continues. Exports, which represent 16.1% of the GDP, in absolute terms contributed 90% of total

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

growth of the economy compared with the fourth quarter. The trend in 2008 and 2009 will largely depend on a continuation of the strength of the Asian economies.

Construction investment rose by 19.5% over the fourth quarter of 2007 in annual terms after nine months of major losses. This recovery could, however, be short-lived given that housing starts in March were down by 15.6% year-on-year. Nor is the real estate market very bright with sales in April dropping by 40.3% in the Tokyo area. Prices, however, continued high with a year-on-year increase of 14.9%, partly as a result of the fact that following the end of Japan's real estate bubble at the beginning of the Nineties, increases have been much more moderate than in other countries. Along the same lines, in the first quarter the price of land in the six main cities rose by 7.3% year-on-year, 23% above the low at the beginning of 2005.

The weakness of capital goods investment in the first quarter will not be followed by any strong recovery given that machinery orders (an early indicator of domestic demand) were up by a poor 4.6% increase year-on-year in March. Nevertheless, given Japan's dependence on foreign trade, the positive factor showed up on the side of orders coming from domestic demand which on this occasion, with an increase of 10.5% year-on-year, showed strongest in contrast to those for the export industry which were down by 13.5% as against what has been the norm in recent months.

Construction recovering while consumer indicators compensate poor figures in industrial sector.

With the Tankan index for large manufacturing companies published by the Central Bank of Japan at the 11 points level in the fourth quarter, with consumer confidence in the first quarter at a level of 36.5 points, below the weak figure of 38.8 points in the fourth quarter and industrial production in March growing by a slim 0.5% year-on-year, prospects are not especially bright.

Economic activity prospects not especially bright.

JAPAN: MAIN ECONOMIC INDICATORS

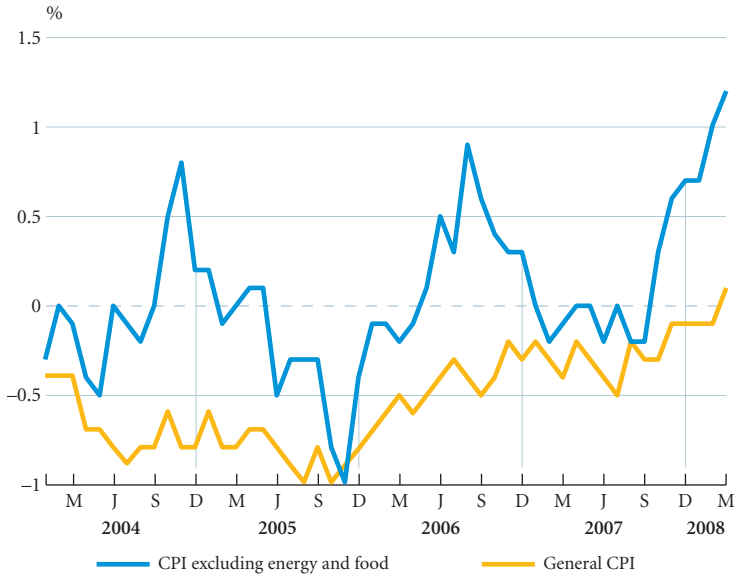
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	2.4	2.0	3.2	1.8	1.9	1.4	–	1.1	–	–
Industrial production	4.2	2.9	3.6	2.4	3.1	2.7	2.9	4.0	0.5	...
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	–15.6	...
Unemployment rate (2)	4.1	3.9	4.0	3.8	3.8	3.8	3.8	3.9	3.8	...
Consumer prices	0.2	0.1	–0.1	–0.1	–0.1	0.5	0.7	1.0	1.2	...
Trade balance (3)	9.4	12.5	10.3	11.1	12.3	12.5	12.4	12.2	11.7	...
3-month interbank interest rate (1)	0.3	0.7	0.6	0.7	0.8	0.9	0.9	0.9	0.8	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	83.9

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

JAPAN: DEFLATION BEATEN WITH HELP FROM OIL PRICES

Year-on-year change in consumer price index



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

Prices excluding energy and food rise for first time since 1998.

Nevertheless, following a good first quarter domestic consumption could still have some way to go with an increase in retail sales in March, a good figure for car sales in April following a long series of decreases.

Consumer prices also show up badly with deflation now beginning to disappear. The March CPI rose by 1.2% year-on-year and the traditionally- followed index, excluding fresh foods, by a similar amount. The most significant point was that core inflation (the general index excluding energy and food) recorded an increase of 0.1% compared with the same period the year before, the first increase since August 1998. Inflation is coming from outside with import prices in April up by 9.4% year-on-year but, as often happens, it is not important where help comes from so long as it comes.

Chinese economy grows by 10.6% but showing signs of a slowdown.

Also on the assets side, the unemployment rate in March again went down to 3.8% of the labour force, while the trade balance continued full steam ahead with a cumulative surplus for twelve months ending in March of 11,700 billion yen thanks to the continuing good state of exports which, for now, are successfully resisting the weakness of demand from the United States. Sales to the United States (18% of the total) were down by 9.1% year-on-year in April. Nevertheless, exports to Asia, which make up half the total, grew by 7.2% with those going to China and India showing increases of 14% and 37% respectively.

China: careful on inflation

The Chinese economy grew by 10.6% year-on-year in the first quarter. It thus continued the moderate slowdown sought by the government following a year with the most growth in the past decade. On the supply side, the

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	10.7	11.6	11.7	11.9	11.5	11.2	–	10.6	–	–
Industrial production	16.4	17.1	14.6	18.3	18.1	17.5	16.4	15.4	17.8	15.7
Electrical power production	14.7	15.7	12.4	17.7	16.3	16.1	12.7	18.8	17.2	13.7
Consumer prices	1.5	4.8	2.7	3.6	6.1	6.6	7.1	8.7	8.3	8.5
Trade balance (*)	177.5	261.4	200.5	228.7	253.1	261.4	265.0	249.9	256.5	256.5
3-month interbank interest rate (*)	2.8	3.6	2.8	3.4	3.5	4.7	4.8	4.5	4.7	4.6
Renminbis to dollar	8.0	7.6	7.7	7.7	7.5	7.4	7.2	7.1	7.0	7.0

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

secondary sector continues to lead advances with an increase of 11.2% year-on-year, followed by services which were up by 10.9%. The farm sector, however, keeps losing strength and showed growth of only 2.8%, the lowest since 2002.

Among the most recent economic activity indicators, industrial production was up in April by 15.7% year-on-year which also suggests some cooling off if we compare it with figures six months ago. The effects of the earthquake in Sechuan on the industrial fabric would have been limited. On the other hand, retail sales, discounting price increases, rose to 12.5%. Nevertheless, increases in consumption are to be welcomed in a country where this is still well behind investment and exports. Compared with the general index, food retail sales were up by only 2.5%, mainly the result of price increases.

The main problem of the Chinese economy today is the increasing inflation. The general CPI rose again in April to show growth of 8.5% year-on-year, the highest in the past 12 years if we exclude the record in February. In foods, the increases were sharper at 22.1%. This largely effects rural China which continues to pile up significant gaps compared with the urban scene. The emerging economies, in contrast to the developed economies that are going through a slowdown in demand, have their production fabric operating much closer to the limit of their capacity. Furthermore, because they are at an earlier stage in the development process, show higher consumption levels in energy and food, which is precisely what has cost more this year.

General inflation close to 9% while food prices up more than 22%.

In the case of China we may add the monetary factor given that the strength of exports and direct foreign investment has caused huge financial inflows that are difficult to compensate, putting central bank reserves at 1,500 billion dollars. In order to counteract the subsequent growth in money supply, the People's Bank of China raised cash ratios for the fourth time this year from 16.0% to 16.5%. With this move, some 28 billion euros in the financial system would be frozen. The forecasts suggest that, with the slowdown in economic activity and lower growth of exports, prices will end up returning to more temperate levels.

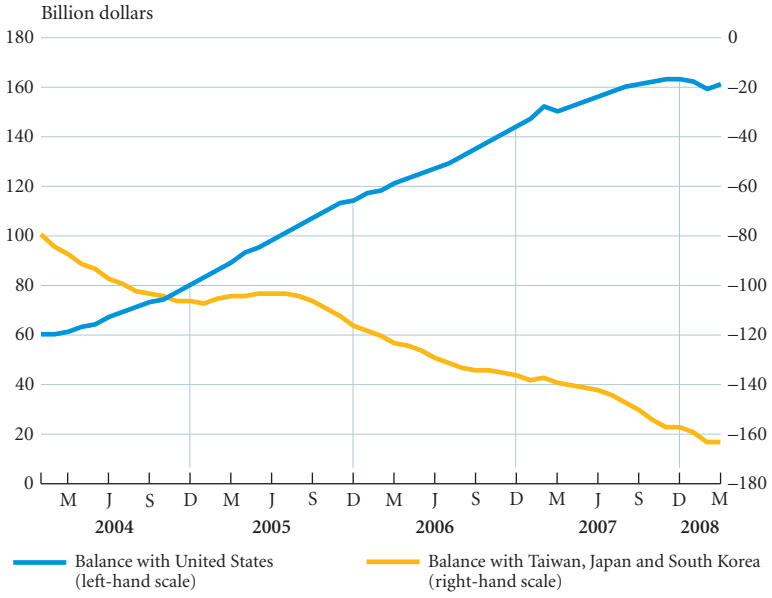
Food shortages increase gap between country and city.

Looking beyond the uncertainties, China today continues to be the main engine of

Bilateral trade surplus with United States stagnant but deficits with Japan, South Korea and Taiwan keep growing.

CHINA: AN ASYMMETRIC TRADE

China's trade balance



NOTES: Sum of past 12 months.
SOURCE: Chinese National Statistics Office and own calculations.

Mexico grows by 4.2% based on private consumption and investment.

world economic growth and, in view of the weakness of the United States, many Far Eastern economies, large and small, now depend on China's growth. The recent meetings of China's President Hu Jingtao and Japanese Prime Minister Yasuo Fukuda should surprise no one.

Supporting the above, the foreign surplus for the past 12 months ending in April was 256.5 billion dollars, 9.5 billion dollars less than the high in January. As a percentage of nominal GDP, this moderation was more noticeable with the estimate of 6.6% in April as against 7.4% in September 2007. The main cause was stagnation of the bilateral trade surplus with the United States at around 161 billion dollars for the 12 months ending in March. Meanwhile, the surplus with Europe continues to grow and the combined deficit with Taiwan, South Korea and Japan amounted to 163 billion dollars.

Mexico: a good performance with incipient signs of weakness

Mexico's economy grew by 4.2% year-on-year in the fourth quarter following the last revision, thanks to private consumption and investment. Despite robust domestic demand, inflation continues moderate. The weak points are to be found in the foreign sector which continues to show signs of problems of competitiveness. Among most recent economic activity indicators downward prospects predominate thus showing the influence of Mexico's US neighbour. In supply, general industrial production and manufactures in March were down by 4.9% and 4.1% year-on-year respectively, the lowest figures since the beginning of 2004. On the demand side, retail sales followed a similar pattern going from growth of 6.0% to drops of 0.5%.

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007				2008			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	4.9	3.2	2.5	2.6	3.4	4.2	–	...	–	–
Industrial production	5.4	1.9	1.7	0.9	1.9	3.1	2.2	6.0	–4.9	...
General unemployment rate (*)	3.6	3.7	4.0	3.4	3.9	3.6	4.1	3.8	3.8	...
Consumer prices	3.6	4.0	4.1	4.0	4.0	3.8	3.7	3.7	4.2	4.5
Trade balance (**)	–6.1	–11.1	–9.3	–11.6	–11.5	–11.1	–11.6	–13.2	–12.2	...
3-month interbank interest rate	7.3	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2	7.2
Mexican pesos to dollar	10.9	10.9	11.1	10.8	11.0	10.8	10.8	10.7	10.7	10.5

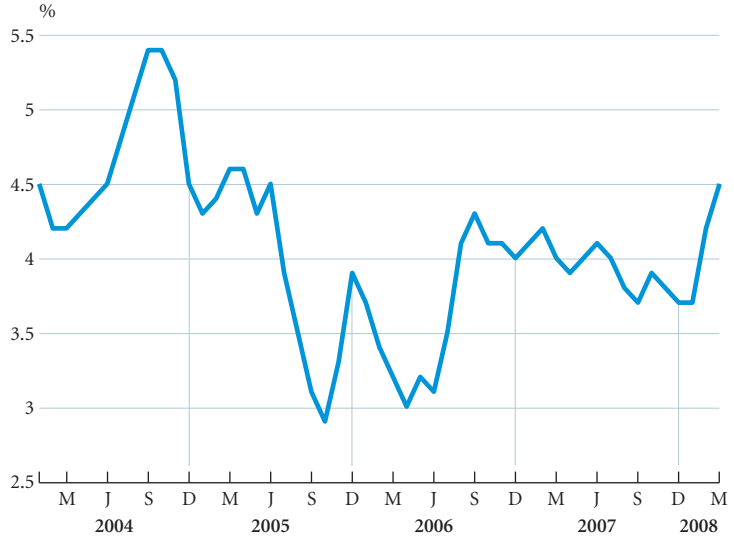
NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
SOURCE: Central Bank of Mexico and own calculations.

On the prices front, inflation is increasing but only moderately. In April, both the general CPI and core inflation (the general index excluding energy and food) was up by 4.5% year-on-year, somewhat above increases at the end of 2007. Mexico is suffering from the effects of world price increases for raw materials with effective prices for consumers that could be going above what is indicated by the general index. On the positive side we see the good performance of unit wage costs which rose by a reasonable 1.4% year-on-year in February, thanks to the increase in productivity. The general unemployment rate held at a low 3.8% of the labour force.

Industrial production and retail sales down in April.

MEXICO: INFLATION DOWN... FOR THE MOMENT

Year-on-year change in CPI



SOURCE: Central Bank of Mexico and own calculations.

Prices up 4.5% but productivity increasing.

The worsening situation in the foreign sector continued with a cumulative trade deficit for the past 12 months ending in March going to 12.2 billion dollars. Excluding oil exports, the deficit amounted to 59.52 billion dollars, nearly twice the figure for the same period last year.

Oil goes above 130 dollars a barrel...

Commodities: oil drills through to new highs

Oil hit new all-time highs in May going from levels of 110 dollars per barrel Brent quality (at one-month forward price) at the beginning of the month to stand above 130 dollars a barrel in the final stages of that period. The rise came in two stages. There was a first bump of 10 dollars at the beginning of the month followed by a stage of consolidation in the area of 121-124 dollars/barrel in the middle two weeks of the month and a further period of rises as of May 20. How can this increase of 17% in one month and 87% in one year be explained?

...result of complex combination of insufficient supply, strong demand and investment aims.

On the supply side, that is to say, the extraction stage and the distribution and refining side, it should be pointed out that, in spite of its growing (annual growth in 2008 is estimated at 2.4%), this is happening at a level that is quite insufficient to drive away the spectre of a lack of supply. Specifically, it is troubling that oil extraction capacity is extremely limited in the main producing countries, with the exception of Saudi Arabia.

A supply with problems of growth is critical in a situation of expanding demand which will go up by 1.4% in 2008, that is to say, below supply level. Supply-demand pressures have been let loose due to the fact that consumption in the emerging economies is clearly moving up and that the industrial economies are resisting the blows of the crisis better than expected.

WHERE IS OIL GOING?

1-month forward price for Brent oil per barrel

SOURCE: Thomson Financial Datastream.

This is reflected in the reduction of available inventories which in April (in the case of the OECD countries) stood 3.5% below inventory levels one year ago. Finally, with regard to financial factors, oil continues to act as an alternative investment in a situation of world financial upsets and fears of inflation. In the face of the blows from oil, prices of other commodities seem moderate. Commodities as a whole did not increase in price in May with the notable exception of some farm raw materials. Rice showed a sharp rise, followed some distance away by coffee, cotton and soy. On the other hand, metals, which had shown sharp growth in previous months, tended to drop as a group with notable decreases of more than two digits in the case of nickel and lead.

Agricultural commodities continue to rise.

After the Asian Tigers... will it be the African Lions?

Africa, the cradle of humanity, has become the most backward continent and, at the same time, the most uneven in terms of economic development and standard of living. The differences between the North of Africa and most of the countries south of the Sahara Desert are very well known (see box «Africa: the curse of the tropics»). Nevertheless, the most recent success stories from this troubled region have raised a few hopes. The uncertainty that concerns most experts is whether these are simply anecdotes or whether, on the other hand, we may one day be surprised by the «African Lions» just as happened with the Asian Tigers.

Leaving aside the African oil exporting countries whose GDP has shown spectacular growth, a group of countries, such as South Africa, Botswana, Zambia, Mozambique, Ghana, Tanzania and Uganda, have grown at a reasonably high rate. South Africa, with a consolidated democracy, a fully independent judicial system, policies favouring the market economy and a reasonable level of infrastructures, is perhaps the best known Sub-Saharan emerging country. Nevertheless, corruption and crime are preventing even higher growth.

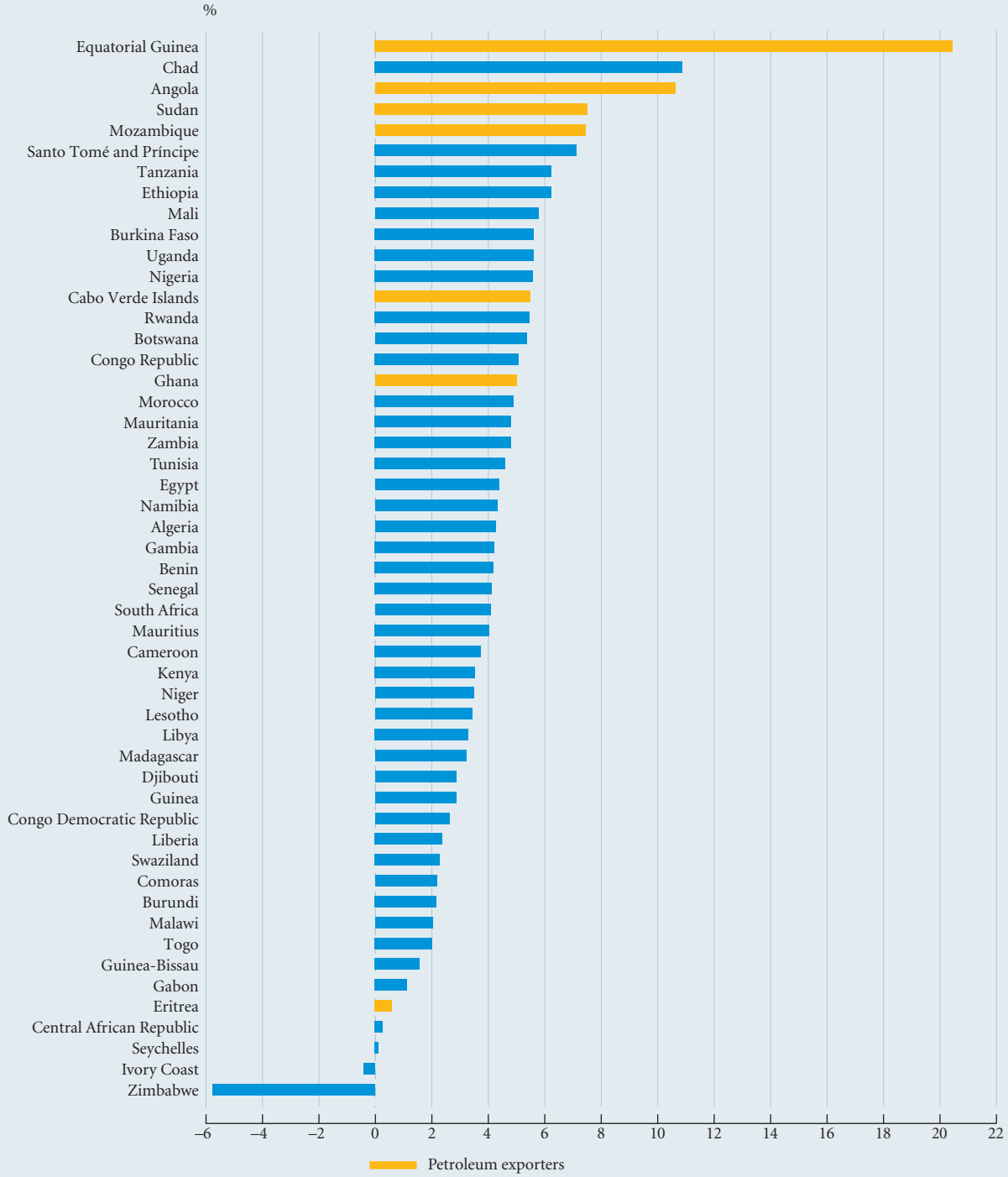
Among the other countries, Botswana, with prolonged development since independence in 1966, is turning out to be the undoubted winner and an example to follow. Its success is even more outstanding if we keep in mind that it has no outlet to the sea and that it is rich in diamonds, two of the four curses that, according to Paul Collier (an expert on African economy), are hindering growth in Africa.

In the past 20 years, average growth in Botswana has been more than 7% and in 2006 its per capita GDP was above 5,700 dollars. These spectacular figures are by no means casual but rather, in large measure, due to good policy. In the first place, the determination of the Botswana government to fight corruption has been fierce and continues to be so. It is enough to read the posters welcoming the visitor on arrival at one of its airports: «Botswana has ZERO tolerance for corruption. It is illegal to offer or ask for a bribe». This has made it not only the African country with least corruption, according to indices prepared by *Transparency International*, but also to reach levels below Hungary, Czech Republic and Italy.

In second place, the independence of the judiciary in Botswana, still fairly unusual in Africa, has been noted by experts as another key element on its road to success. Combined with the almost absence of corruption,

GROWTH STORIES RUNNING FROM SUCCESS TO FAILURE WITH MEDIOCRITY IN THE MIDDLE

Average annual GDP growth 2000-2006



SOURCE: World Bank.

that independence has helped to avoid the appropriation by a minority of the high profits coming from diamonds. This has made it possible to generate major social benefits for the whole population. In addition, investment in infrastructures has also contributed to Botswana's success. Obviously, there is still much to be done. The fight against AIDS (affecting 25% of the adult population in its most virulent and contagious form) has become a challenge of the first magnitude. In addition, it is necessary to diversify the sources of growth which today continue to be based on the extraction of diamonds and other minerals.

A LONG ROW TO HOE

SOURCE: World Bank.

Just to the north, Zambia and Mozambique have also grown considerably in recent years. Both countries have aroused great interest from Asia, Zambia because of its copper deposits and Mozambique because of its aluminium. Furthermore, investors from China and India have not overlooked the ideal location of Mozambique whose access to the Indian Ocean could turn it into a meeting point between the African continent and the east of Asia. Nor has Mozambique ignored its advantageous position and has now begun to modernize its three main ports, which could ensure its sustained growth as well as allow it to diversify its economy beyond aluminium.

Zambia, in turn, has benefited from the high price of copper in recent times but, as it lacks access to the sea, it needs to apply quite different strategies to those of Mozambique in order to ensure its long-term growth. One of the courses followed attempts to successively promote economic growth in certain regions of the country by offering, for example, tax advantages for foreign investors. At the same time, it has invested in the cultivation of maize, sugarcane, soy and tobacco, taking advantage of a decline in production in neighbouring Zimbabwe which has been immersed in a deep economic and food crisis.

The downside of China's presence in Africa is the fierce competition cheap Asian products are giving local manufacturers, in Zambia and Mozambique, for example. Because of this, while the economic links with Asia may be positive in overall terms, it should be remembered that there are those that lose out. At the same time, in spite of their commitment to continued growth, both countries still face serious difficulties, such as the high level of corruption and the widespread incidence of the AIDS virus.

Another country with a hopeful future is Ghana which, after two decades of economic failure, has begun to recover in the new millennium. The high price of gold, its main export followed by cocoa, largely lies behind its notable progress. The modest level of corruption in Ghana has also prevented the appropriation by a few of the income generated by mining that precious metal. At the same time, it enjoys a more than acceptable level of infrastructures by African standards and, as opposed to Botswana, has the benefit of a coastal location and a low level of incidence of AIDS (which appears here in a less virulent version, typical of West Africa). On the other hand, matters such as a low level of schooling and lack of access to safe drinking water are problems still to be resolved.

Finally, things have also gone well in Tanzania and Uganda in recent years although they may have problems in maintaining their high growth rates. Tanzania has grown thanks to the high price of gold but, as in the case of Uganda, it suffers from a high incidence of poverty, deficient infrastructures and considerable corruption. All of this could slow the incipient take-off of these two countries. Uganda has also to face the challenge of ensuring an equitable sharing of income that will come from the discovery of oil in the west of the country.

To sum up, Africa includes a number of countries that seem to be on the right road for achieving long-term growth whether as a reward for their own good practices or because of the driving impact of China. For the other countries of Africa the situation is not as bright, seeing that their institutional gaps and, in some cases, their geographical disadvantages make their joining the chosen few more difficult. Their hope may lie in the possibility that the new «African Lions» will push them towards a more promising future.

EUROPEAN UNION

European Commission forecasts: less growth, more inflation

In its Spring forecasts, the European Commission confirms that the European Union (EU) is moving from a period of robust growth to another with a lower rate of economic activity. The relative containment of prices in recent years is now also in doubt. The EU executive expects that the European Union will grow by 2.0% in 2008, far from the 2.8% in 2007, to later slow down to 1.8% in 2009. This trend to a slowdown also shows up in the Euro Area which will drop from 2.6% in 2007 to 1.7% in 2008 and 1.5% in 2009.

The slowdown is largely a result of the complicated world economic situation and, more specifically, of the uncertain impact of the world financial crisis on the real economy. The scenario set out by the European Commission is based on the hypothesis that uncertainty about the extent of losses from the subprime mortgage crisis will continue up to the end of 2008, spreading its effects into the first half of 2009.

All of this leads to a moderation of world growth which, however, may be eased by the resilience of emerging markets. A direct effect of the expansionist situation emerging markets will continue to show will be that demand for commodities with oil in a notable position will remain strong, which in turn will make any correction of the notable growth in prices of those products complicated.

European Commission expecting slowdown in 2008 and 2009 with price increases in 2008.

MACROECONOMIC PROJECTIONS FOR EURO AREA (1)

	2005	2006	Current forecasts Spring 2008			Difference with Autumn 2007 (2)	
			2007	2008	2009	2008	2009
Gross domestic product	**1.6**	**2.8**	**2.6**	**1.7**	**1.5**	**–0.5**	**–0.6**
Private consumption	1.6	1.8	1.5	1.4	1.5	–0.7	–0.4
Public consumption	1.5	2.0	2.3	1.9	1.7	–0.2	–0.3
Investment	3.0	5.0	4.3	2.0	1.2	–0.9	–1.4
Employment	0.6	1.4	1.6	0.9	0.5	–0.1	–0.3
Unemployment rate (3)	8.8	8.2	7.4	7.2	7.3	0.1	0.2
Inflation (4)	2.2	2.2	2.1	3.2	2.2	1.1	0.2
Government balance (% of GDP)	–2.5	–1.3	–0.6	–1.0	–1.1	–0.1	–0.3
Government debt (% of GDP)	70.2	68.5	66.4	65.2	64.3	0.2	0.9
Current account balance (% of GDP)	0.1	–0.2	0.0	–0.1	–0.1	–0.1	–0.2
Growth of GDP in EU-27	*1.9*	*3.1*	*2.8*	*2.0*	*1.8*	*–0.4*	*–0.6*

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

MACROECONOMIC FORECASTS OF EURO AREA COUNTRIES

Spring 2008

	GDP (*)			Inflation (**)			Unemployment (***)		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Belgium	2.7	1.7	1.5	1.8	3.6	2.3	7.5	7.3	7.5
Germany	2.5	1.8	1.5	2.3	2.9	1.8	8.4	7.3	7.1
Ireland	5.3	2.3	3.2	2.9	3.3	2.4	4.5	5.6	5.8
Greece	4.0	3.4	3.3	3.0	3.7	3.6	8.3	8.3	8.0
Spain	3.8	2.2	1.8	2.8	3.8	2.6	8.3	9.3	10.6
France	1.9	1.6	1.4	1.6	3.0	2.0	8.3	8.0	8.1
Italy	1.5	0.5	0.8	2.0	3.0	2.2	6.1	6.0	5.9
Cyprus	4.4	3.7	3.7	2.2	3.8	2.5	3.9	3.7	3.5
Luxembourg	5.1	3.6	3.5	2.7	4.2	2.5	4.7	4.5	4.4
Malta	3.8	2.6	2.5	0.7	3.4	2.2	6.4	6.3	6.2
Netherlands	3.5	2.6	1.8	1.6	2.7	2.9	3.2	2.9	2.8
Austria	3.4	2.2	1.8	2.2	3.0	1.9	4.4	4.2	4.3
Portugal	1.9	1.7	1.6	2.4	2.8	2.3	8.0	7.9	7.9
Slovenia	6.1	4.2	3.8	3.8	5.4	3.3	4.8	4.7	4.7
Finland	4.4	2.8	2.6	1.6	3.4	2.3	6.9	6.3	6.1
Euro area	**2.6**	**1.7**	**1.5**	**2.1**	**3.2**	**2.2**	**7.4**	**7.2**	**7.3**

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

Subprime mortgage crisis and impact on world growth constrict economic activity in Europe.

This set of circumstances outside the European Union will show up in the ways in which the slowdown will take shape. The tightening of credit terms and the worsening to be expected in demand will have a negative effect on investment, which up to now has been one of the main driving forces of growth. The second channel lies in the foreign sector. In spite of the fact that the European economies have made a notable effort to realign trade flows in the sense of pushing exports to emerging countries, foreign demand of the European Union is going to suffer from the lower growth in world trade.

Investment and foreign demand: two growth engines slowing down.

At the same time, part of Europe's problem in the matter of inflation has its causes which have little relation to domestic matters. The rise in oil and other commodities will have a negative effect on inflation in 2008 to the point that, on annual average, it will stand at 3.6% in the EU and 3.2% in the Euro Area. These are high levels not seen for many a year. Furthermore, the worse performance in other less volatile headings, such as services, will contribute to an increase in core inflation. The European Commission is expecting that the rise in inflation will be largely corrected in 2009, a year when inflation in the EU would stand at 2.4% on average. In the Euro Area the expected figure is 2.2%.

This scenario is not totally lacking in optimism especially with regard to growth forecasts. The European Commission itself recognizes that there is some risk. Because of this, it has

MACROECONOMIC FORECASTS FOR EUROPEAN UNION COUNTRIES OUTSIDE EURO AREA

Spring 2008

	GDP (*)			Inflation (**)			Unemployment (***)		
	2007	2008	2009	2007	2008	2009	2007	2008	2009
Bulgaria	6.2	5.8	5.6	7.6	9.9	5.9	6.9	6.0	5.4
Czech Republic	6.5	4.7	5.0	3.0	6.2	2.7	5.3	4.5	4.4
Denmark	1.8	1.3	1.1	1.7	3.3	2.3	3.7	3.1	3.2
Estonia	7.1	2.7	4.3	6.7	9.5	5.1	4.7	6.0	6.0
Latvia	10.3	3.8	2.5	10.1	15.8	8.5	6.0	6.4	6.9
Lithuania	8.8	6.1	3.7	5.8	10.1	7.2	4.3	4.5	4.8
Hungary	1.3	1.9	3.2	7.9	6.3	3.7	7.4	8.3	7.8
Poland	6.5	5.3	5.0	2.6	4.3	3.4	9.6	7.1	6.1
Romania	6.0	6.2	5.1	4.9	7.6	4.8	6.4	6.1	5.9
Slovakia	10.4	7.0	6.2	1.9	3.8	3.2	11.1	9.8	9.3
Sweden	2.6	2.2	1.8	1.7	2.4	1.9	6.1	6.2	6.5
United Kingdom	3.0	1.7	1.6	2.3	2.8	2.2	5.2	5.4	5.7
European Union	**2.8**	**2.0**	**1.8**	**2.4**	**3.6**	**2.4**	**7.1**	**6.8**	**6.8**
United States	2.2	0.9	0.7	2.8	3.6	1.6	4.6	5.4	6.2
Japan	2.0	1.2	1.1	0.1	0.7	0.6	3.9	4.0	4.2

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

prepared an alternative scenario which takes into consideration an even greater worsening of the real estate situation expected in the United States and in the Euro Area, and an increase in interest rate differentials that could have a negative effect on credit. In this new scenario, growth in the Euro Area in 2008 would be 1.2% and 1.4% in 2009.

Risk lies in scenario becoming even more negative.

Euro Area: first quarter better than expected

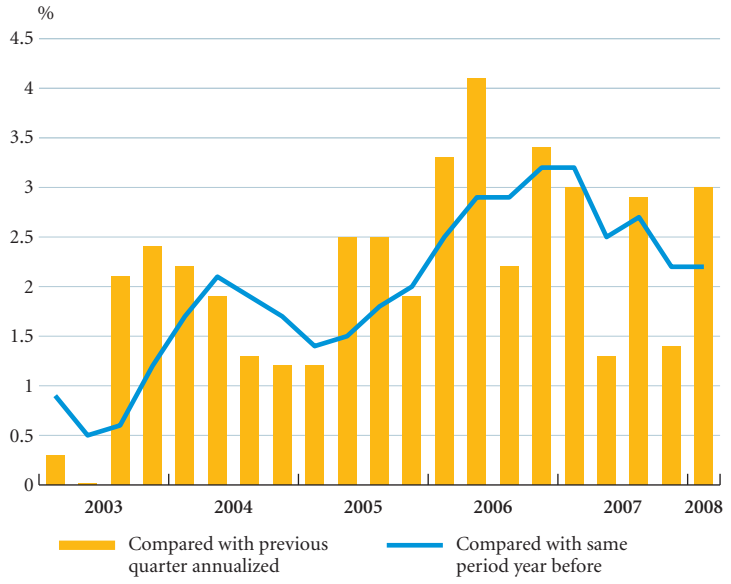
Available indicators for the first quarter suggest that economic activity is standing up better than expected only a few months ago. The early estimate for growth of the gross domestic product (GDP) confirms this view. After noting an increase of 2.2% in the first quarter, in the first three months of 2008 the single currency economy repeated the same figures. The fact that the recent drive in the economy is vigorous is especially shown by quarter-on-quarter growth annualized, which stood at 3.0%, more than double that for the fourth quarter. By country, available figures show that this increase (at quarter-on-quarter rate) was due to the situation in the big economies, especially in Germany but also in France, closely followed by some medium-sized economies such as Austria and Greece.

While figures broken down by component are not yet available, it is possible to have an idea by looking at the trend in recent indicators. Among figures for domestic demand, that which probably has contributed most to maintaining economic activity is investment, basically that for capital

Euro Area shows weak growth in first quarter...

EURO AREA RECORDS GOOD RATE OF ECONOMIC ACTIVITY IN FIRST QUARTER

Change in gross domestic product in real terms



SOURCE: Eurostat and own calculations.

...thanks to better state of domestic demand.

goods. This is suggested by industrial production of capital goods which grew by 6% year-on-year in the first quarter, going above the 5.3% seen in the fourth quarter. It also seems likely that household consumption was more dynamic. Although they were down in March, retail sales for the whole first quarter were higher than those for the last three months in 2007. Finally, foreign demand likely made a positive contribution to growth. In spite of the fact that in March the trade surplus was down by more than 10 billion euros (in cumulative figure for 12 months) due to the combined effect of the drop in exports and the increase in imports, the first two months of 2008 were definitely positive which means an overall favourable first quarter.

Economic activity likely to drop in second quarter.

Will the good situation in the first three months of 2008 continue? Probably not. In spite of the fact that the economy, growing largely thanks to domestic demand, has been benefiting from a substantial momentum in certain areas, a worsening suddenly showed up in the month of March. Mention was made earlier of the weakness in retail sales and exports in the third month of the year. Industrial production has moved along the same lines going to 2.0% year-on-year compared with 3.2% in February. Also suggesting future difficulties is the fact that, also in March, the unemployment rate remained at 7.1%.

As well as confirming this break in trends in the first quarter, we now have some indicators which suggest a second quarter with a strong slowdown. In terms of importance, we should underline the difficulties for consumption to maintain its present rate, as may be seen in the drop in consumer confidence. Specifically, this indicator dropped to –12.4 points in April, the lowest level since November 2005.

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	April
GDP	2.9	2.6	3.2	2.5	2.7	2.2	–	2.2	–	–
Retail sales	1.6	0.9	1.9	1.0	1.4	–0.4	0.8	1.3	–1.8	...
Consumer confidence (*)	–9.1	–4.9	–5.4	–2.6	–3.9	–7.7	–11.5	–12.0	–12.1	–12.4
Industrial production	4.0	3.5	4.0	2.9	4.0	3.2	3.4	3.2	2.0	...
Economic sentiment indicator (*)	106.3	108.4	109.4	111.0	108.7	104.3	101.7	100.2	99.6	97.1
Unemployment rate (**)	8.3	7.4	7.6	7.5	7.4	7.2	7.1	7.1	7.1	...
Consumer prices	2.2	2.1	1.9	1.9	1.9	2.9	3.2	3.3	3.6	3.3
Trade balance (***)	–10.4	20.1	–0.9	15.6	31.4	34.3	25.3	27.1	16.7	...
3-month Euribor interest rate	3.1	4.3	3.8	4.1	4.5	4.7	4.7	4.4	4.4	4.7
Nominal effective euro exchange rate	103.6	107.7	105.5	107.1	107.7	110.6	112.0	111.8	114.6	116.0

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

These figures, running between the end of the first quarter and the beginning of the second, show a negative balance. The exception in this analysis comes in prices. The harmonized consumer price index for April was down by three decimals to 3.3% year-on-year. Core inflation (excluding energy and fresh foods) showed the same drop going from 2.7% in March to 2.4% in April. While current levels remain high, especially for the guardian of price stability, the European Central Bank, which must try to maintain an objective of 2% over the medium term, if commodities do not show even higher increases it is likely that the worst period of inflation will be left behind.

Inflation presents a breather.

Germany: major surprise in first quarter

While first quarter indicators were favourable, figures for national accounting in the same period may be deemed exceptional. Whereas some slowing down was expected, the GDP rose from 1.8% year-on-year in the fourth quarter to 2.6% in the first quarter. At quarter-on-quarter rate annualized, a measurement that shows the latest trend, growth was up to 6.3%, an unusually high figure not seen since 1996. In spite of the fact that we do not have a breakdown by components, the Federal Statistics Office indicated that the increase in economic activity was due to a major improvement in gross fixed capital formation, followed closely behind by some increase in consumption and the continuing positive contribution from the foreign sector.

The importance of this good news about economic growth somewhat affects a reading of the latest indicators where the trend was not entirely clear. For example, retail sales in March returned to the area of year-on-year drops for the

German economy grows much more than expected in first quarter.

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	April
GDP	3.1	2.6	3.7	2.6	2.5	1.8	–	2.6	–	–
Retail sales	6.1	–7.7	–6.2	–7.7	–7.5	–9.0	1.6	2.5	–6.3	...
Industrial production	6.0	5.9	7.8	5.4	5.6	5.0	6.3	5.7	4.6	...
Industrial activity index (IFO) (*)	105.5	106.2	107.5	108.0	105.5	103.7	103.4	104.1	104.8	102.4
Unemployment rate (**)	10.7	9.0	9.5	9.2	8.9	8.5	8.2	8.0	7.9	7.9
Consumer prices	1.6	2.3	1.8	2.1	2.3	3.1	2.9	2.8	3.0	2.5
Trade balance (***)	151.5	183.5	165.5	178.3	192.0	198.1	199.9	201.9	201.6	...

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.

Differing figures as year advances indicate cycle could be changing.

first time since last December, but this figure must be measured against the increase in consumer confidence recorded in March and April. An unemployment rate at relatively contained levels (below 8% of the labour force in March and April) could contribute to sustaining consumer confidence in coming months.

Industrial production presents another figure difficult to interpret. This was down by 1.1 percentage points in March. In any case, the recent trend (close to 5%), similar to that shown by industrial orders, suggests that the industrial sector is holding up reasonably well. The trend in industry may be linked to the good situation in exports which, in spite of the toll resulting from a strong euro, is still being maintained. In March, the trade surplus (as a cumulative figure for twelve months) held practically stable compared with one month earlier.

The trend in prices is also not without some action. Taken individually, the increase in the April CPI was good given that it stood at 2.5% year-on-year, thus dropping by a half-percentage point in terms of March and holding in line with figures at the end of last summer when the rise in energy and food had still not shown up. Nevertheless, the sharp growth in producer prices and wholesale prices reminds us that there exists inflationary potential which has not yet been held at bay. Even the recent drop in the IFO index for industrial activity, which dropped by 2.4 points in April compared with the March figure, was partially relieved by the increase in May.

Possibly worse slowdown in second quarter.

We therefore find ourselves in a context fairly typical of cyclical change characterized by signs that, at times, are apparently at odds with each other. Our reading of these diverse trends is that in the second quarter economic activity will show a drop. Strong quarter-on-quarter growth does not seem to be sustainable either in the case of domestic demand or the foreign sector. Consumer expectations, which have shown up surprisingly favourable, could begin to mirror the more contained path followed by business executives. All of this should shortly begin to sort itself out although without any excess.

France: balmy growth in first quarter

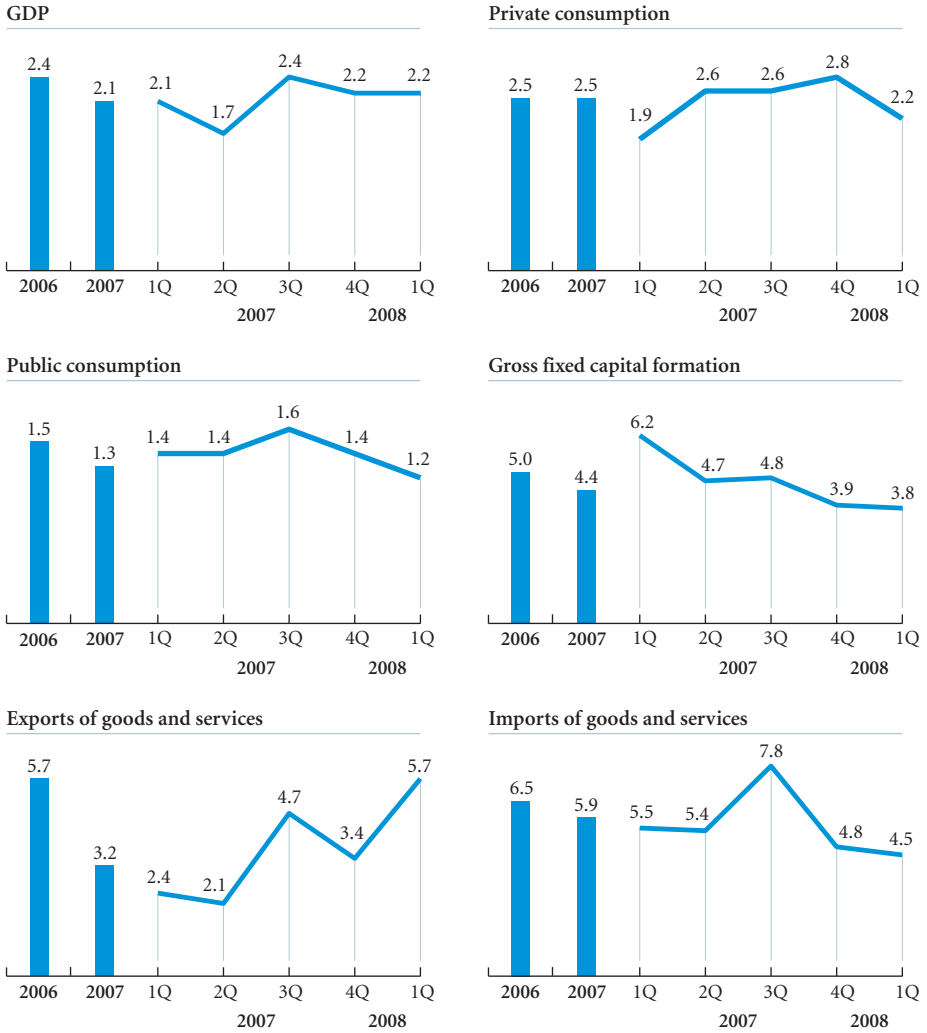
France stabilizes growth at 2.2% in first quarter.

The French economy grew by 2.2% year-on-year in the first quarter, more than expected. This was a good figure in itself but it also served to show that depressed feeling in France of being immersed in a permanent economic crisis had been eased. This explains why, after seeing the growth figure, President Sarkozy quickly told the European Commission that it should revise downward the government deficit forecast for 2008, a forecast that, if maintained, could give rise to an embarrassing warning from the EU executive about an excessive deficit.

Going back to the figures, the growth of 2.2% year-on-year in the first quarter, the same as that recorded in the previous quarter, was mainly due to the fact that the improvement in the foreign sector compensated the slowdown in domestic demand. While investment held with practically no decrease, there

TREND IN FRANCE'S GDP BY COMPONENT

Percentage year-on-year change



SOURCE: INSEE and own calculations.

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	April
GDP	2.4	2.1	2.1	1.7	2.4	2.2	–	2.2	–	–
Domestic consumption	2.7	3.4	3.6	2.8	4.1	3.2	2.3	3.8	1.2	...
Industrial production	1.0	1.7	1.1	0.3	2.2	2.6	2.8	2.3	1.0	0.4
Unemployment rate (*)	9.2	8.3	8.7	8.5	8.2	7.9	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	3.0
Trade balance (**)	–26.9	–32.7	–28.9	–30.7	–33.4	–37.7	–40.5	–40.4	–42.7	...

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

Both domestic and foreign demand showing signs of weakness.

was a drop in public and private consumption which, together with the bigger drain from inventories, meant that domestic demand grew by only 1.6% year-on-year in the first quarter (2.5% in the fourth quarter). On the other hand, foreign demand, which took off five decimals from the change in GDP in the fourth quarter, came to make a positive contribution of three decimals in the first three months of 2008.

Inflation moderating but unemployment rate stops dropping.

This relief, however, may be short-lived. As has happened to other economies in the Euro Area, at the end of the first quarter the indicators have cooled off, a trend affecting both demand and supply. In the first case, the sharp drop in household consumption and the growing year-on-year drop in industrial production of consumer goods in March suggest that household spending is resisting any forward move. A similar situation is to be seen in investment if we are to go by the drop in the capital goods component of industrial production. Foreign demand, after two months when it seemed that the trade deficit might stabilize, again rose in March.

On the supply side, we should point out that industrial production in March grew at a rate less than half that for February with a further slowdown in April. At the same time, construction indicators eased down that same month. While the services sector seemed to avoid this trend in March, it ended up following the same pattern one month later. Other supply indicators for April repeat this view with the most significant being economic sentiment which was down by two and a half points. With regard to prices and unemployment, the trend is uneven. Whereas inflation in April was down to 3.0% year-on-year (3.2% year-on-year in March), the unemployment rate held at 7.8% of the labour force in February and March so that it seems to have stopped its recent tendency to decrease.

Italy: at a low moment

Italy loses steam in first quarter.

The economic situation in Italy continues to show a number of weak flanks. Contrary to what has happened in the other large economies of the Euro Area, economic activity showed troubling signs of weakness in the first quarter which

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	April
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	2.7	...	...
Industrial production	2.4	0.0	1.3	0.7	0.8	–3.0	–1.6	–1.1	–1.5	...
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	3.3
Trade balance (**)	–17.6	–13.7	–19.1	–15.4	–11.3	–8.9	–9.9	–8.4	–8.9	...

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

have sharpened as the year has moved on. In this respect, we should mention the trend in the economic sentiment index which best indicates the state of the economy as a whole. This indicator stood at the 99.8 points level in the fourth quarter of 2007 only to drop to 95.7 points in the first quarter and go down to 92.1 points in April. This is a course of rapid decline indicating a process of slowdown that is getting stronger.

What is the root cause of the problems in the Italian economy? Looking at the overall economic situation, there is an excessive burden from the fact that domestic demand is just not moving. In spite of the fact that capital goods investment has performed well in recent times (as shown by the easing off in the wave of year-on-year decreases in industrial production of capital goods as of March) recovery on this front is not sufficiently strong to compensate the slack in private consumption. In this respect, the positive signs from retail sales in February (increase of 2.7% year-on-year) could be misleading because other indicators, such as vehicle registrations and consumer confidence, fell notably in March and April.

A second difficulty came in the combination of exports and industrial activity. The cumulative figure for 12 months put the trade deficit in March at 8.9 billion euros, an increase of 500 million euros due to the fact that exports were down more than imports. This drop in exports is challenging the country's ability to improve industrial activity. In March, industrial production fell by 1.5% year-on-year with a worse showing than the poor figure for February (year-on-year decrease of 1.1%). The collapse of industrial orders in the first quarter, which was still worse in April, threatens future possibilities for the secondary sector.

In spite of this general state of weakness, inflation is maintaining a substantial rate of increase. As opposed to the Euro Area as a whole, the Italian CPI did not slow down in April, when it repeated the 3.3% year-on-year figure. Finally, we should mention that the unemployment rate also showed no change in the fourth quarter (6.0% of the labour force) which indicates some lack of progress in cutting unemployment.

Domestic demand shows lack of support from consumers.

Weakness in exports has negative effect on industry.

United Kingdom: between Scylla and Charybdis

Squeeze between lower growth and higher inflation creates dilemma for Bank of England.

Scylla and Charybdis were two mythological giants that supposedly lived in the strait of Messina and which any sailor wanting to go through had to elude. Legend tells us that Odysseus preferred to face up to Scylla even if he had to sacrifice some of his crew rather than lose his entire ship to Charybdis. The Bank of England, as a modern Ulysses would prefer to ease the possibility of a major crisis even though inflation stands in dangerous waters. As a result, the Charybdis of recession looks like becoming a reality that is of sufficient concern that the Scylla of inflation would seem to be a lesser evil. The figures for the first quarter are indeed not too bright not only because growth has dropped to 2.5% year-on-year (2.8% in the fourth quarter) but because it has now dropped for three consecutive quarters. This loss of rate was already expected from the economic sentiment index in the first quarter, a period when the indicator was down 9.3 points. In this context, the decrease in April (a further 9.1 points) is troubling because of its size.

Sudden worsening at start of second quarter.

The slowdown is showing up in both demand and supply indicators. Among the former, we should mention that retail sales were down 1.5 percentage points in March and April putting the figure at 4.2%. Given that the unemployment rate is still at historically low levels (holding at 2.5% between November and April), it is most likely that the help coming from the labour market will slacken off in the near future. On the supply side, the most notable figure comes from industrial production. After spoiling something of a recovery in February, in March it stood at low levels of increase, namely 0.3% year-on-year.

The Scylla of inflation is no trivial matter. It seemed as if inflation had been stabilized at a band between 2.0%-2.5% in recent months, somewhat above the inflation objective of the Bank of England. In spite of this, the

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	April
GDP	2.9	3.0	3.0	3.2	3.1	2.8	–	2.5	–	–
Retail sales	3.1	4.4	4.6	4.1	4.8	3.9	6.3	5.7	4.7	4.2
Industrial production	0.3	0.3	–0.4	0.8	0.1	0.7	0.4	1.2	0.3	...
Unemployment rate (*)	2.9	2.7	2.9	2.7	2.6	2.5	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	3.0
Trade balance (**)	–74.1	–82.2	–78.4	–80.1	–83.2	–87.0	–88.9	–89.4	–89.5	...
3-month Libor interest rate (***)	4.6	5.3	5.3	5.6	6.0	6.3	6.0	5.6	5.8	6.0
Nominal effective pound exchange rate	98.0	103.9	103.9	104.0	104.3	102.2	97.6	96.3	94.3	92.6

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

central bank opted for reducing its interest rate three times since last December, giving priority to the crisis in economic activity and trusting that the rise in inflation was only temporary. However, the figure for April when the CPI showed a 3.0% rise was surprising for its amount.

Inflation goes up to 3%.

Theory of economic growth: more than the Philosopher's Stone, a barren ground

For centuries the alchemists were looking for the Philosopher's Stone which was supposed to have marvellous virtues, such as being able to transform materials into gold or to grant immortality. In a similar way, the theory of growth has been the Philosopher's Stone of economics for decades – the one finding the magic formula of economic growth, a part from wining the Nobel prize and earning a good salary for the rest of his life, would take out millions of people from extreme poverty conditions, including millions of African citizens that live with less than one dollar a day.

In fact, for years some economists believed they held the Philosopher's Stone – the theory of Harrod and Domar. According to this theory, the sustained economic growth of a country depended exclusively on the amount of capital and the labour force. In developing countries the limiting factor was the rate of investment. An increase in investment would generate more capital and reduce unemployment and so increase growth. The prescription was clear and easy to apply. It was necessary to provide each country with the difference between its savings capacity and the investment necessary to reach the desired growth rate. This difference is known as the financing gap. For years, the aid going to developing countries was calculated using this formula. International aid practically doubled between the Seventies and Nineties (see following graph) but in most developing countries, and especially in Africa, the miracle of sustained growth never took place.

Another factor that seemed to explain why the African countries failed to rise out of their poverty was the low level of education. Considerable resources were also devoted to this field and today the level of education has notably improved although undoubtedly there is still some way to go (see following table). Neither did this major effort show great fruit. In fact, a number of studies have shown that an increase in educational levels of the population is not a sufficient condition to ensure an economic take-off. For example, whereas in Botswana the increase in years of education was accompanied by an increase in the GDP per capita, in countries such as Senegal, Madagascar and Ghana, the opposite took place.[1]

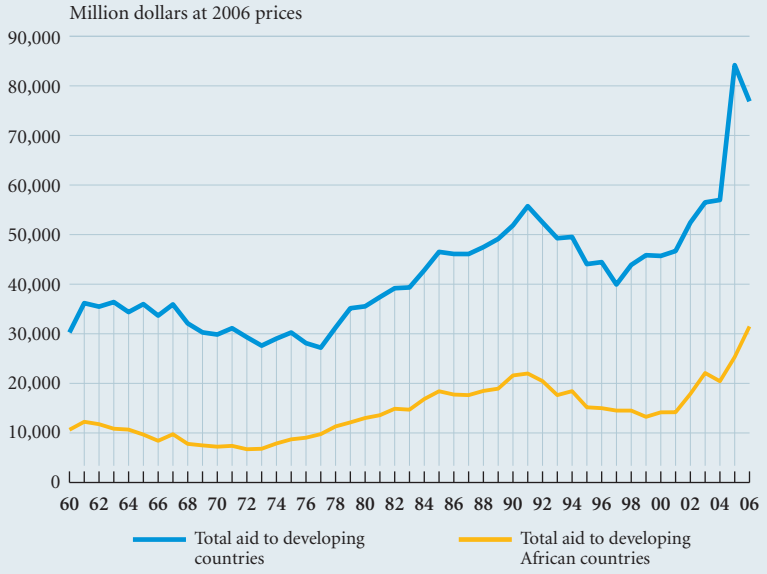
RATE OF SCHOOLING IN AFRICA CAN STILL BE INCREASED

	Rate of primary schooling	Rate of secondary schooling
Sub-Saharan Africa	66	24
Middle East and North Africa	90	65
Asia	90	56
Latin America	95	67

NOTES: (*) Figures for latest year available.
SOURCE: World Bank and own calculations.

(1) William Easterly, «The Elusive Quest for Growth».

OFFICIAL AID TO DEVELOPING COUNTRIES HAS TRIPLED



SOURCE: OECD and own calculations.

Following many years with little result, very few economists still believed that there existed any elixir of eternal growth. Nevertheless, the coordinated action of the developed countries was still considered to be fundamental. This was reflected in the eight «Millennium Development Goals» agreed upon at the United National summit meeting in 2000.

The drawing up of a strategic plan to achieve those objectives was handed to Jeffrey Sachs, economics professor at Columbia University. The plan was presented in 2005 and set forth a change of direction in the way international organizations would channel development aid. Sachs underlined that aid projects should reflect the idiosyncrasies of each country and should be developed and implemented with the close collaboration of the local authorities. Another aspect given special reference was the need to reduce corruption. Furthermore, Sachs called developed countries to open their markets to exports from the developing countries so that they could raise their own productive capacity to the maximum.

Professor Sachs estimated that in order to satisfy the Millennium Development Goals, the developed countries would have to progressively increase aid to the poorer countries as much as 0.54% of their income. In spite of the fact that these have slightly increased in recent years, we are still far from reaching that goal (see following graph). Professor Sachs felt that if sufficient aid was not put together so that the African countries could develop a sustainable industry, all of the efforts made up to now could turn out to be in vain.

Nevertheless, there are other economists who foresee a not so brilliant future for the Sachs plan and not exactly because of a lack of resources. One of the most critical is Professor William Easterly of New York University who mainly disagrees with the forms through which aid should be carried out. For him, the main problem is that international aid agencies (including the IMF and the World Bank) are not very transparent and have neither the knowledge nor the incentive to identify the projects each country needs. Another prestigious

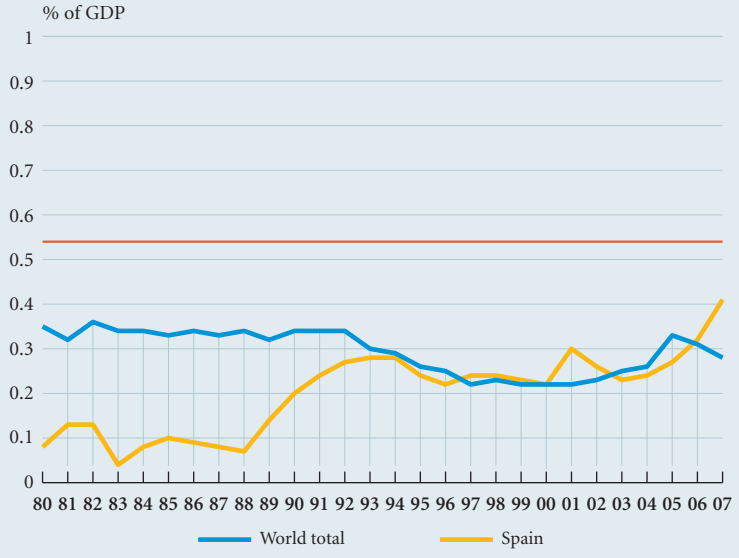
THE MILLENNIUM DEVELOPMENT GOALS FOR 2015	
1 To eradicate extreme poverty and hunger	5 To improve health of mothers
2 To reach universal primary shooling	6 To combat the AIDS virus, malaria and other diseases
3 To promote sexual equality and autonomy for women	7 To guarantee sustainability of the environment
4 To reduce infant mortality	8 To foster a world association for development

SOURCE: ONU.

economist, Paul Collier, feels that the international bodies should work so that each country is capable of adequately managing its own resources. For this purpose, Collier would focus efforts on ensuring that property rights were well defined and respected and that exploitation and management of natural resources be carried out in a transparent manner. This would give the African countries much greater resources than they would ever obtain through international aid.

It seems that after so many years seeking the Philosopher's Stone we have only come to agree that the prescription for rising out of poverty is different for each country. The search, however, should continue. The impact of increases in energy and food prices on millions of people suffering from poverty once more underlines the urgency of the situation.

OFFICIAL DEVELOPMENT AID STILL FAR FROM REACHING 0.54%



SOURCE: OCDE and own calculations.

FINANCIAL MARKETS

Monetary and capital markets

Inflation stalking central banks

The Fed lowers reference rate to 2% while warning about inflation risk.

At its monetary policy meeting on April 30, the Federal Reserve decided to cut its reference rate by 0.25 basis points putting it at 2%. In its press release it justified the decision by the weakness in economic activity. This is reflected in the labour market, in the weakening of household spending and in the difficult situations in financial markets. In addition, in its press release, while it recognized that the latest available figure on underlying inflation indicated that this showed some moderation in growth, it could not fail to note an increase in inflation expectations among economic agents.

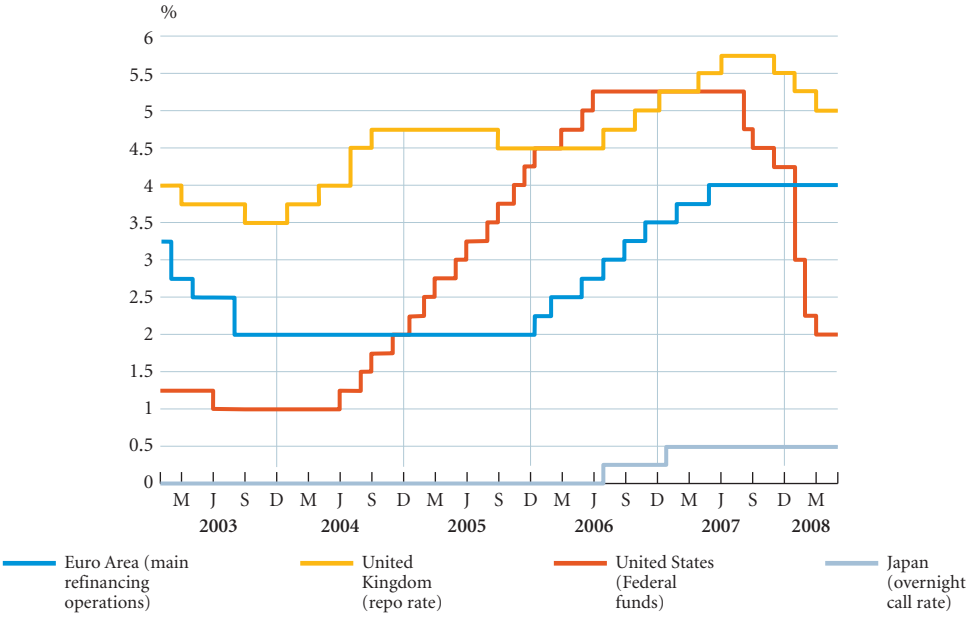
Inflation expectations of US consumers growing worse.

There are a number of surveys carried out to obtain consumer opinion on inflation prospects for the next twelve months. Among the most prestigious indices and those most keenly followed by the financial markets are the confidence indices prepared by the University of Michigan and the Conference Board.

The following graph shows that, while calculation methodologies are different, in both cases consumers state that their

HAS FEDERAL RESERVE MADE ITS LAST REFERENCE RATE CUT?

Central bank reference rates



SOURCE: Central banks.

inflation expectations have been worsening, that is to say, that they are expecting inflation to increase over the next twelve months. Such a result has not been seen in the past 28 years.

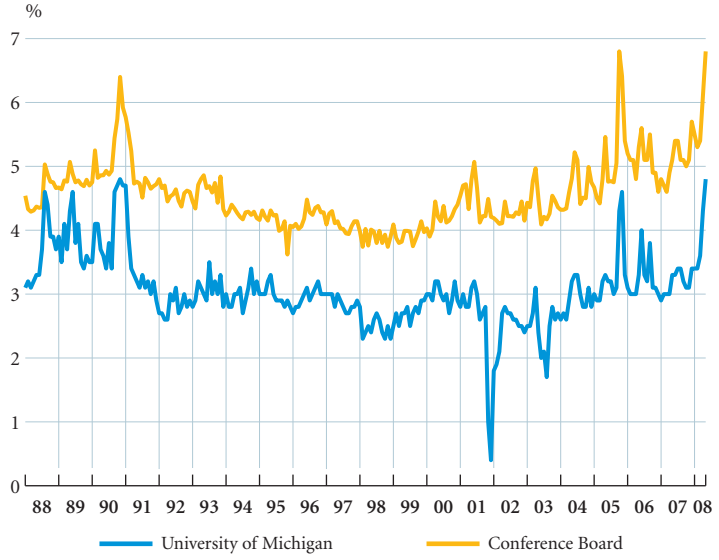
Why is the Fed so concerned about this situation? Because of the risk that price increases may take on a more permanent nature which could make it more complicated for the central bank to carry out one of its two main mandates – price stability. For this reason its press release underlined that it would sharply follow the trend in inflation given the high level of uncertainty about its future performance. This was a message that a number of members of the Fed, along with ex-governor Volcker who had fought against massive inflation at the beginning of the Eighties, that has been emphasized in individual statements over the past month. In a similar way, in the minutes for its meeting on April 30 the Federal Reserve revised substantially downward its growth forecast for this year and, furthermore, raised its inflation forecast by around one percentage point.

The prospect of a continuation of the weakness in economic growth, along with the need to prevent expectations of increased inflation becoming a reality, leads one to think that, following the interest rate cut made on April 30, there would be a period without further moves by the Federal Reserve Board. This is how things are being interpreted by futures markets which are giving a probability of around 80% that the central bank will maintain the official interest rate at the present level at coming monthly meetings. Nevertheless, this situation could end at the final monetary policy meeting for the year to be held in December. The market is assigning a probability factor of more than 50% for increases in reference rate because of the price of oil and the worsening of inflation prospects.

As result of these expectations, market beginning to discount an increase in US official rate at year-end.

CONSUMERS ANTICIPATING HIGHER INFLATION

Inflation expectations of US consumers



SOURCE: Conference Board and University of Michigan.

ECB expecting somewhat lower growth in economic activity with inflation of more than 2% in coming months.

The situation in the Euro Area is different. When appearing before the meeting of the governing council on May 8, the chairman of the European Central Bank (ECB), Jean-Claude Trichet, confirmed the central bank's position in maintaining the reference rate at 4%, a level that will have lasted for one year in June. If the subprime mortgage crisis had not broken out in August last year the reference rate might have reached 4.5%. But in view of the upsets in the financial markets members of the ECB decided to interrupt the process of increases begun in December 2005.

The governor repeated the three main messages set out at the latest meetings on monetary policy. Firstly, that he was concerned about the trend in inflation in the Euro Area due to pressure from oil prices and food commodities. He thus confirmed that inflation risks remain upward. Secondly, that the economic fundamentals supporting moderate growth in the Euro Area still held good. This idea seemed to be confirmed by growth figures for the first quarter in Germany and France which were surprisingly upward. In any case, he recognized that he expected a drop in growth in the second quarter of this year. And finally, that the granting of corporate credit in the Euro Area remained strong.

European companies using bank lines of credit because of difficulties of obtaining finance in capital markets.

Nevertheless, in the latter case he recognized that an apparent paradox had taken place. While the figure for granting corporate credit remained at very high levels, the latest qualitative survey on practices used in granting credit indicated that banks are substantially hardening terms. According to the governor, this was due to the fact that it is more difficult for companies to obtain funding through bond issues in capital markets due to the withdrawal of investors. As a result, companies are tending to seek loans in the financial system using lines of credit arranged at banks. Companies normally pay a commission for obtaining this service relating to availability of lines of credit which is a loan available with an overall limit assigned to the company for use when it is most convenient.

Finally, with growth still above what may be considered potential and a slowdown that is expected to be gradual in a situation of inflation well above the ECB objective, we may discount any immediate cuts in the official interest rate.

With inflation at 3% and in spite of economic slowdown, Bank of England not expecting further cuts in official interest rate.

The Bank of England has things more difficult as it faces the worst possible situation for a central bank – sharp economic slowdown along with an increase in inflation. Inflation in the United Kingdom reached 3% year-on-year and the central bank indicated in its quarterly report on inflation that it discounted the possibility of continuing to lower the reference rate in the next two years. The main reason is that its forecasts indicate that inflation will stand above 3% in coming months, above its objective of 2%. Governor Mervyn King recognized that the United Kingdom could perhaps see a couple of quarters with negative growth although recession is not the central bank's key scenario. The problem is that simulations indicate that inflation will not again stand below 2% until the year 2010, which will not leave any margin for manoeuvre for continuing to reduce the official interest rate.

The resurgence of inflation is a world phenomenon of which the Asian central banks are well aware. For example, in the face of an increase in inflation to a rate of

8.5% year-on-year and growth of the money supply by close to 17% year-on-year, the Central Bank of China has had no other course than to again put into effect a further increase in cash ratio of a half percentage point from 16% to 16.5%. Nevertheless, following the massive earthquake that devastated a large area of China, the central bank exempted banks in that area in order to avoid tightening monetary policy while reconstruction work was being carried out.

In turn, at its monetary policy meeting, the Bank of Japan decided to maintain the official interest rate at 0.5%. Governor Masaaki Shirakawa mentioned the four main risks faced by Japan's economy, according to its criteria. First came the volatility in financial markets. Second was the slowdown in the US economy. Another factor was the rise in oil prices which raised inflation risks. Finally, came the risk of weakness in corporate profits which would translate into lower capital investment. Not everything was negative, however, as the head of monetary policy believed that the impact of the possible losses from financial assets affected by the US subprime mortgage crisis was small and that the banks had sufficient financial strength to cover any losses without putting their capital ratios at risk.

Bank of Japan cites financial upsets, slowdown in US economy, increased price of oil and weakness of capital investment as biggest risks for Japan.

Interest rates looking upward

Interest rates in the Euro Area market have reached levels not seen in many a long day. For example, the 1-year Euribor has moved up to 5.0%, a level not seen since January 2000. The 3-month Euribor is holding at 4.86%, in spite of the 3-monthly auctions by the European Central Bank.

What is happening? The central banks are injecting liquidity into the system. Affected banks have made provision to cover losses arising from the increase in default on subprime mortgages in the United States. Furthermore, those banks are carrying out capital increases in order to strengthen their equity. These factors would seem sufficient to calm down the pressures existing in the interbank market.

Nevertheless, there are two factors preventing a return to a normal situation over the short term. The first factor has to do with the increase in default. In a situation such as the present one, out of prudence banks usually reduce the availability of credit. But companies that normally go to the capital markets through bond issues in order to obtain funding are finding difficulties in placing such issues. For this reason they are using lines of credit as mentioned by the ECB governor. In a situation where they want to reduce credit granted, although under contracts they are obliged to do so, the banks have decided to cut discretional credit. The interbank market has this characteristic so that the banks are not obliged to lend to each other. That is to say, the banks have no obligation to go to that market with a heavy liquidity load.

1-year Euribor hits 5%...

A second factor preventing any short-term return to normalcy has been added in recent weeks. This is the increase in the price of oil and the note of concern in the statements by the central banks on the course of inflation. This takes away from the capacity of the central banks to lower their reference rates. While in the past month the 3-month Libor in the United States has dropped from 2.85% at the end of April to 2.66% (aided by the cut in the Federal Reserve reference rate from 2.25% to 2.0%, as may be seen in

...while interbank rates in US have dropped thanks to moves by the Fed.

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									
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	4.00	4.86	4.96	2.00	2.85	0.92	5.00	5.84	2.86
May (1)	4.00	4.86	5.00	2.00	2.66	0.92	5.00	5.85	2.70

NOTES: (1) May 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: 11-12-2007 (4.25%), 22-01-2008 (3.50%), 30-01-2008 (3.00%), 18-03-2008 (2.25%), 30-04-2008 (2.00%).

(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.

the accompanying graph, the meeting minutes shows that the central bank is not going to make further cuts in the official interest rate.

But the banks are not only restricting credit in the interbank market but are also tightening terms for granting a loan as shown by the latest survey carried out

TERMS FOR GRANTING AND DEMAND FOR BANK CREDIT IN EURO AREA

	SUPPLY				DEMAND			
	Companies		Households		Companies		Households	
	Large	Small and medium	Housing	Consumption	Large	Small and medium	Housing	Consumption
1st Qtr 2008	Sharp tightening	Hardening	Hardening	Hardening	Sharp decrease	Decrease	Sharp decrease	Decrease
2nd Qtr 2008	Sharp tightening	Hardening	Sharp tightening	Sharp tightening	Sharp decrease	Decrease	Sharp decrease	Decrease

SOURCE: European Central Bank and own calculations.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2005	2006	2007		2008	
			September	December	April	May (*)
United States	4.39	4.70	4.59	4.02	3.73	3.81
Japan	3.31	1.69	1.69	1.51	1.59	1.62
Euro Area	1.48	3.95	4.33	4.33	4.12	4.27
United Kingdom	4.10	4.74	5.01	4.51	4.67	4.88
Switzerland	1.97	2.52	3.01	3.05	3.12	3.03

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

by the European Central Bank that is outlined in the previous table. To a large extent, the tightening of credit terms is due, among other factors, to the difficulty for banks to have recourse to funding in the interbank market and the impediments on securitization of assets that make it possible to obtain financing while at the same time take risk off the balance sheet.

According to the banks taking part in the ECB survey, the factors tightening credit to households for home acquisition in the Euro Area are especially the poor prospects in the real estate market and the worsening prospects on economic activity, as well as the lower competitiveness of banks. In the latter case, we note a move toward restraint by the entire sector which runs in favour of a situation where products with very aggressive prices are not being offered.

With regard to long-term government bond interest rates, these are holding to an upward swing brought about by two factors. First, the consolidation of stock market levels following the rises seen since mid-March has undone the phenomenon of flight to quality in which investors got out of risk assets to take refuge in government bonds of higher credit rating. With the increase in demand for bonds, prices rose and yields thus dropped. Now the process has turned around. Secondly, the worse expectations for inflation had served to increase the risk premium asked on government bonds. Finally, the investor wants a higher yield that will protect his/her money from potentially higher inflation.

Banks restricting granting of credit to companies and households.

Double switch in euro-dollar expectations

A balancing act is understood as the art of manipulating and carrying out tricks with one or more objects at the same time, turning them around, keeping them up in the air and catching them again before they fall to the ground. Who has never played with a yo-yo or bowls or clubs? This then gives some idea of what has been the performance of the dollar against the euro over the past month.

As may be noted in the following graph, after the euro reached a high of 1.60 dollars on April 22, the euro dropped by 4% to stand at 1.53 dollars only to recover later and again reach the level of 1.58. What brought about this sudden double switch in investor expectations with regard to both currencies.

Interest rates on long-term bonds tending to rise.

DOLLAR GOING BACK AND FORTH

Euro-dollar exchange rate

SOURCE: Bloomberg.

Double switch in expectations on growth and inflation brings up and down movement in euro exchange rate against dollar.

After having reached 1.60 it seemed normal to see some drop in the euro as a result of profit-taking seeing that the change since the end of February from 1.48 to 1.60 had been approximately 8%. On the one hand, economic figures becoming available confirmed the view that, following the cutting of the reference rate that put it at 2%, the Federal Reserve had hit bottom. The expectations were that now it was the turn of the European Central Bank to make cuts in the official rate.

On the other hand, when decreases in interest rates come about because of a weakening of economic activity, there is also a drop in the currency of that economy. The reason is that bonds issued in that currency offer lower yields. As a result, shares become less attractive given that economic weakness often brings about lower corporate profits. That is to say, there is reduced demand for this currency in order to buy instruments issued in that currency. As a result, the relative interchange value drops, that means there is a depreciation of that currency.

But, when it seemed that there existed the conditions for a weakening of the euro, two key matters arose to change investor perceptions about the greenback. First, the giddy increase in oil prices and other commodities indicated a higher inflation risk. That is to say, in this context the capacity of the ECB to cut its interest rate was reduced. The second factor was publication of growth figures for the Euro Area which were surprisingly strong and coincided with the lowering of growth forecasts for the United States by the Federal Reserve. Faced with all this economic information, investor came to the conclusion that the Euro Area was growing much more than they were expecting and that, as well, the risk of inflation was growing. The latter risk was shared with the United States but with a much weaker course of economic growth.

EXCHANGE RATES OF MAIN CURRENCIES

May 22, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2007	Annual
Against US dollar				
Japanese yen	103.1	0.0	–8.4	–17.9
Pound sterling	0.506	1.0	0.5	0.0
Swiss franc	1.025	2.1	–10.6	–20.0
Canadian dollar	0.985	–2.4	–1.4	–10.3
Mexican peso	10.374	–1.0	–5.2	–4.0
Against euro				
US dollar	1.580	–1.2	8.3	17.5
Japanese yen	162.9	–1.1	–0.1	–0.4
Swiss franc	1.619	0.9	–2.1	–2.1
Pound sterling	0.800	–0.2	8.9	17.5
Swedish krona	9.326	–0.1	–1.2	1.5
Danish krone	7.459	0.0	0.0	0.1
Polish zloty	3.414	0.1	–5.3	–9.8
Czech crown	25.15	0.5	–5.2	–10.9
Hungarian forint	244.2	–2.9	–3.5	–1.6

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

Stock market swings continue

Except for the Milan stock exchange and the Dow Jones stock market index for New York, both showing a drop of less than 1% in the past month, other stock markets in the developed countries not only have consolidated levels of the month before but have shown increases from the 1% in the DJ Euro Stoxx 50 to 4.3% in the German stock exchange index. In spite of the recoveries taking place since mid-March, the stock markets are still in the red since the beginning of the year. The only two exceptions are the stock exchanges in Buenos Aires and that in São Paulo.

Perhaps the most spectacular change came in the Brazilian stock exchange. The Bovespa index for São Paulo showed a monthly change of 10.5%. There were a number of reasons for this change. Notable among these was the good performance of the exporting companies aided by a tax cut plan of around 12.8 billion dollars. Furthermore, the index has benefited from the increase in oil prices and discoveries of major new oil reserves. It should be remembered that many of the companies listed in the Brazilian index are commodity extraction companies and that the biggest company in the index (with a weight of 16.5%) carries out oil exploration and production and in the past month and a half has risen by more than 50%.

Finally the rating agency S&P raised Brazil's rating from BB+ to BBB–. That is to say, it was granted investment grade rating. In many investment portfolios the policy of asset selection excludes risk

Brazil's stock market increasingly attractive.

INDICES OF MAIN WORLD STOCK EXCHANGES

May 22, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*12,601.2*	*–0.9*	*–5.0*	*–6.9*
Standard & Poor's	*1,390.7*	*1.1*	*–5.3*	*–8.8*
Nasdaq	*2,448.3*	*3.0*	*–7.7*	*–5.4*
Tokyo	13,978.5	3.2	–8.7	–20.9
London	6,193.6	2.6	–4.1	–6.3
Euro Area	3,772.3	1.0	–14.3	–15.6
Frankfurt	*7,020.8*	*4.3*	*–13.0*	*–8.3*
Paris	*4,999.1*	*2.6*	*–11.0*	*–17.9*
Amsterdam	*483.6*	*3.8*	*–6.2*	*–10.5*
Milan	*33,216.0*	*–0.8*	*–13.8*	*–23.3*
Madrid	*13,715.2*	*0.9*	*–9.7*	*–9.0*
Zurich	7,478.9	2.0	–11.9	–20.1
Hong Kong	25,043.1	0.4	–10.0	20.1
Buenos Aires	2,221.1	3.5	3.2	1.3
São Paulo	72,294.8	10.5	13.2	38.5

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.

Companies listed on Spanish continuous market increase profits in spite of complicated economic situation.

below that qualification. Now, on the other hand, Brazil may now become part of their investments so that this may also have brought about an increase in demand for assets on the Brazil stock exchange.

Turning to markets closer to home, we should point out that in the past month, in comparison with the four large stock exchanges in the Euro Area, the IBEX 35 has done better than the Italian market but has fared worse than those of France and Germany. This is normal behaviour as we have to remember that, at a relative level, since the beginning of the year the Spanish selective index has continued to run above the others. In addition, the Spanish stock market index includes a heavy weighting of the financial and real estate sectors, two sectors that have been severely hurt since the beginning of the subprime mortgage crisis.

Certainly, Spanish companies listed on the continuous market have shown net profit that was 6% higher in the first quarter than in the same period last year whereas last year showed a year-on-year increase of 28%. It should be borne in mind, however, that these results, which may seem modest, came about in spite of the sharp increase in energy and financing costs and in a context of world financial upsets.

SPAIN: OVERALL ANALYSIS

Economic activity

Private consumption and housing slow down economy

Economic activity is undergoing a sharp slowdown that is finally leaving behind a long growth cycle. Figures for the Quarterly Accounts drawn up by the National Institute of Statistics confirm what the economic indicators have been pointing to in recent months. In the first quarter, the year-on-year change in gross domestic product (GDP) was 2.7%, as against 3.5% recorded in the fourth quarter of 2007. Quarter-on-quarter growth was only 0.3%, a figure substantially below that estimated for the Euro Area as a whole.

This lower growth comes from the slowdown in growth of national demand which went from a contribution of 3.9 percentage points to an increase of only 3 points in GDP. This may be largely attributed to the drop in housing investment with the subsequent unfavourable drag effect on other sectors such as construction materials and paint and a loss of strength in consumption. In turn, the foreign sector continued to improve slightly and its negative contribution went down to 0.3 points.

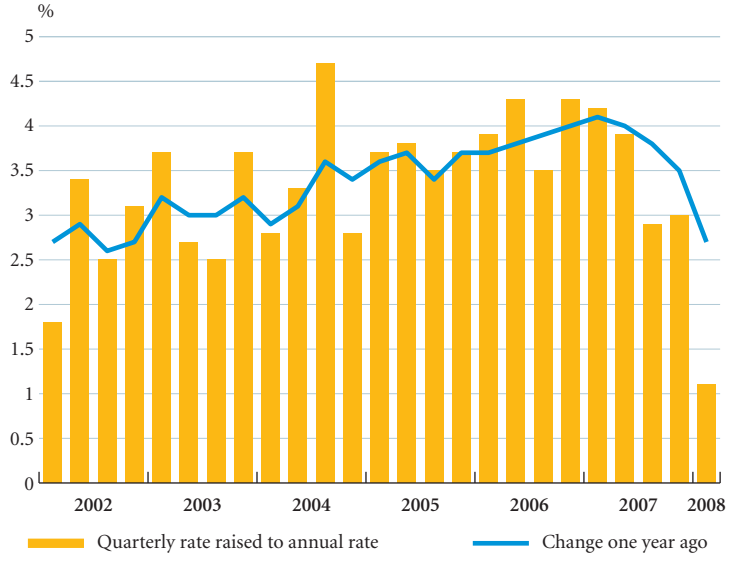
Household consumption, the main component of demand, showed a slowdown to the point where it reported

GDP rises 2.7% in first quarter compared with same period in 2007, higher growth than in Euro Area.

National demand easing along with slight improvement in negative contribution from foreign sector.

SLOWDOWN GROWING SHARPER

Change in GDP



SOURCE: INE and own calculations.

Slowdown in household consumption only partly compensated by increased public consumption.

a year-on-year increase of 1.8%, some 9 decimals less than in the previous quarter. The loss of consumer confidence played a negative role in that trend, affected as it was by a worse situation in the labour market. On the other hand, public consumption partly compensated this trend by rising to 4.7% annual due to increased acquisition of goods and services by general government.

With regard to investment, its three major components showed a slowdown. Capital goods reported a higher year-on-year change rate of 6.3% but with a tendency to decrease. Investment in other products, such as software and mining and oil prospecting, also showed notable growth of 5.2% annual. On the other hand, construction, which up until recently had been the fundamental base for Spain's economic growth, showed only a modest annual increase of 1.3%.

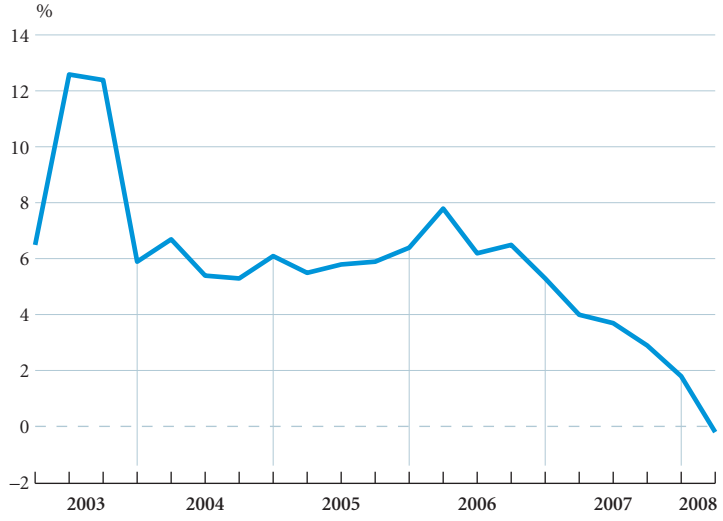
Investment also showing lower growth rate.

The construction sub-sector to show the worst performance was housing with investment recording a year-on-year drop for the first time since 2002. Quarterly growth had been negative in the fourth quarter of 2007 but the quarterly drop sharpened in the first quarter of 2008 going to 1.1%. This was due to a lower volume of works in progress due to the reduction of housing starts in 2007 because of the drop in demand. This trend will likely continue if we are to go by indicators such as the 26% year-on-year drop in housing transactions in the first two months and the sharp decrease in the number of building go-aheads in the early months of the year. On the other hand, investment in other construction areas rose, with a quarterly increase of 1.2%, thanks to the drive in railway infrastructures and highways.

With regard to the foreign sector, both exports and imports were down although to a greater extent in the latter case. As a result, as mentioned earlier, the negative contribution of the foreign sector to GDP growth improved very slightly. Nevertheless, the current account deficit continued to

FIRST DROP IN HOUSING INVESTMENT IN LAST SIX YEARS

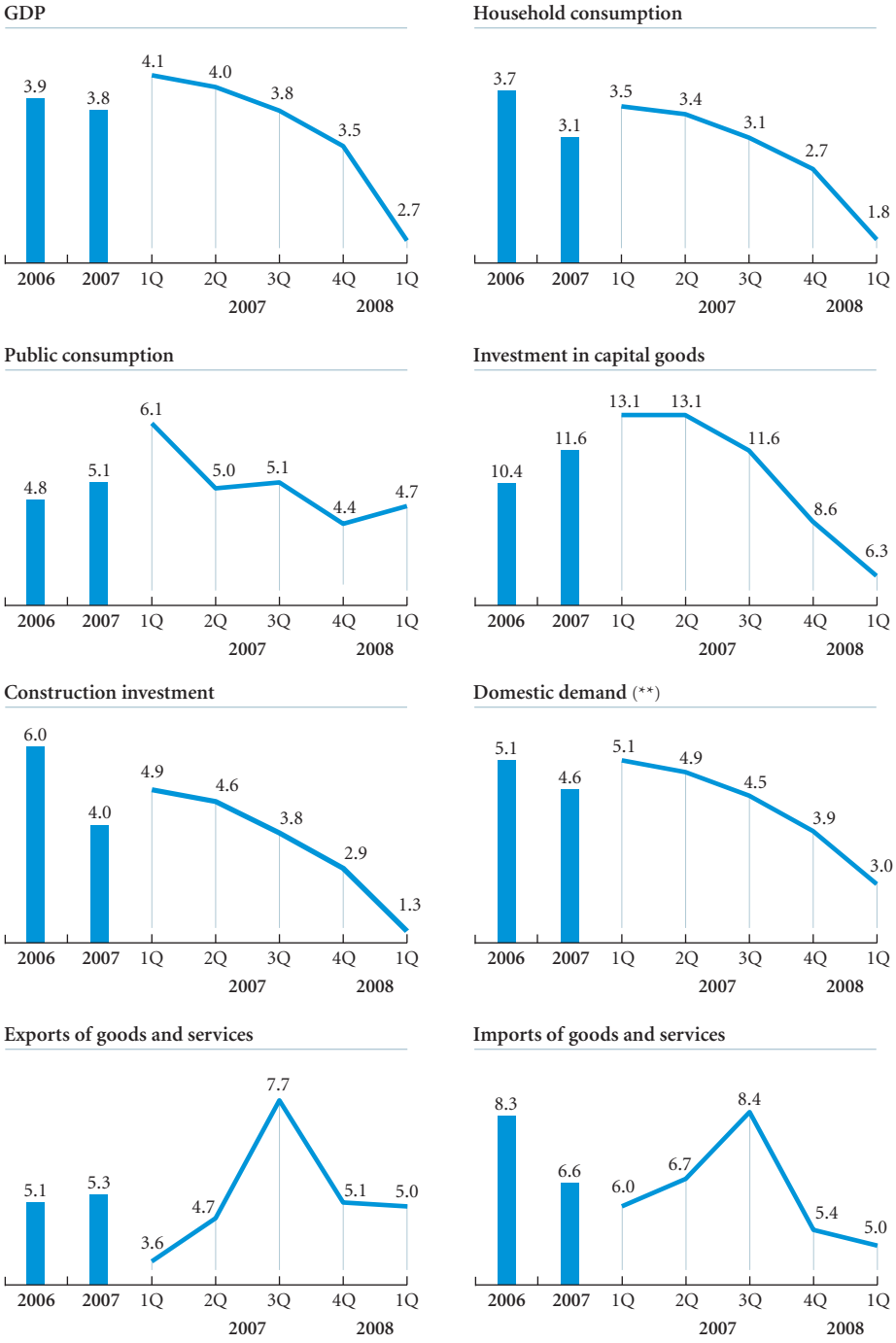
Year-on-year change in investment in housing (figures adjusted for seasonal and working days effects)



SOURCE: National Institute of Statistics.

TREND IN SPAIN'S GDP BY COMPONENT

Percentatge year-on-year change (*)



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

Foreign current account deficit continues to rise going to 12% of GDP.

rise to 12.1% in terms of GDP, due, among other factors, to the rise in the energy bill and income payments.

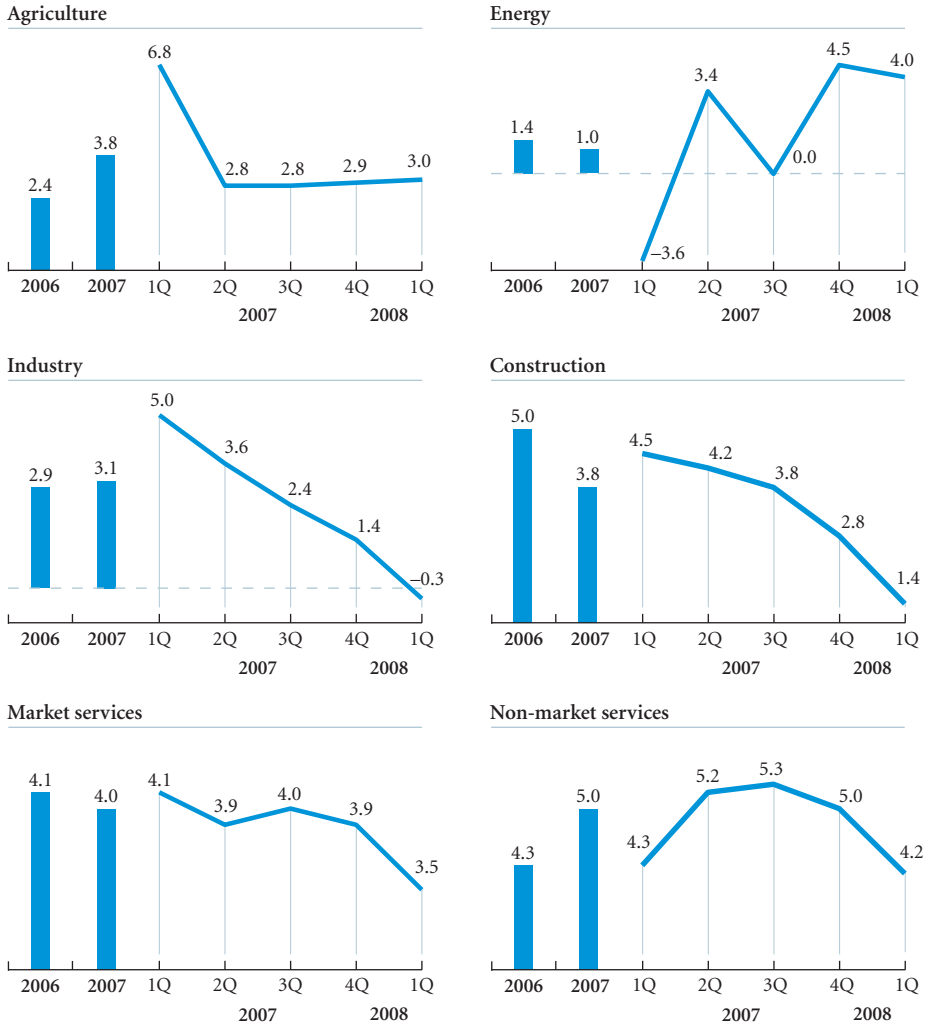
On the supply side, value added in manufacturing industry was down compared with the first quarter of last year for the first time since the fourth quarter of 2004. The worst performance showed up in consumer goods branches in keeping with the trend in demand. The slack in industry also reflects the problems of competitiveness that have been building since Spain joined the euro, as a result of higher inflation than its EU partners and because of the sharp appreciation of the single currency. Over the short term prospects in industry are not very optimistic if we are to go by the moderate annual increase in incoming orders in the first quarter.

Year-on-year drop in value added in manufacturing industry for first time since fourth quarter of 2004.

Market services slowed down but showed a considerable annual growth rate at

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentatge year-on-year change (*)



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

3.5%. The most dynamic sectors were those linked to company services, wholesale trade, air transport and the hotel/restaurant trade. Non-market services also slowed but maintained a higher year-on-year growth rate of 4.2%. On the other hand, gross value added in the farm sector rose slightly to 3.0% annual. Both the crop farming and livestock farming components enjoyed this strength.

From an income point of view, gross operating profit and mixed incomes rose to 9.5% annual. In turn, wages were up 5.9%, some 8 decimals less than in the previous quarter. This was due to a drop of 9 decimals in the level of employment and a slight increase (1 decimal) in average wages to 3.9% because of the rise in wages under collective bargaining agreements and even more as a result of the application of safeguard clauses in 2007.

As a result of the trend in GDP and employment, apparent labour productivity showed an annual increase of 1.0%, one decimal more than in the previous quarter. As a result, product unit labour costs showed an annual increase of 2.9%, one decimal more than in the previous quarter and 2 decimals below the GDP deflator.

As noted earlier, the slowdown trend will probably continue in construction, which will have negative effects on industry, employment and consumption. Available indicators for the second quarter support this view. Within this framework, toward the end of April the European Commission again reduced its growth projections for Spain's economy putting them at 2.2% in 2008 and 1.8% in 2009.

In this environment, in mid-May Pedro Solbes, central government second deputy prime minister, explained to Parliament the general lines of economic policy being followed for the next four years. He stated that over the short term, as well as the measures to stimulate the economy already approved in April, fiscal policy would let automatic stabilizers, such as unemployment benefits, enter into play while criteria of austerity would be applied to other public spending.

To deal with the challenges Spain's economy must face over the mid-term, such as increasing productivity and strengthening its production potential, the Minister of Economy and Finance has outlined that it will strengthen R&D, education and infrastructures and undertake new reforms. Other priority moves include the reframing of the services directive, reduction of bureaucratic procedures applying to companies, reform of the labour market, reform of Social Security to ensure its financial viability, reorganization of the public enterprise sector and strengthening of competition in the telecommunications sector and knowledge society. These measures are aimed at moving the country toward a more sustainable and balanced growth model.

Company services showing strong, along with wholesale trade, air transportation and hotel/restaurant trade.

Product unit labour costs up one decimal to 2.9% annual.

European Commission again reduces growth forecasts for Spain to 2.2% for 2008 and 1.8% in 2009.

Labour market

Labour market showing economic slowdown

Construction shows negative year-on-year change rate for first time in long cycle along with tendency to increase.

The drop in the rate of economic activity is reflected in the marked slowdown in job creation. This is confirmed by figures from the Labour Force Survey carried out by National Institute of Statistics, the best source for following the trend in the labour market. In the first quarter, the year-on-year change rate in the level of employment dropped to 1.7%, half that one year earlier. According to the trend, we note that net job creation is continuing but at a very moderate and decreasing rate. Quite notable was the loss of jobs in the construction sector which showed a negative year-on-year change rate for the first time in this long cycle.

Number of persons employed down by 108,200 in last 6 months ending in March.

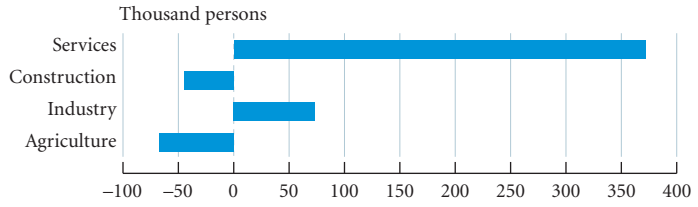
Figures for the first quarter supplied by National Accounting coincide with the Labour Force Survey. The number of full-time jobs showed an increase of 1.7% compared with the first quarter of 2007 while construction saw a drop of 1.1%. Figures for those registered at Social Security as working are also in line with the slowdown in job creation and support this view.

In fact, in the first quarter the number of unemployed dropped by 74,600 persons, according to the Labour Force Survey estimates, which along with those who lost their jobs in the previous quarter adds up to 108,200 in the past six months. This was largely due to seasonal factors but demonstrates the worse situation arising in the labour market. Loss of jobs in the first quarter of 2008 was concentrated in services and construction. The bigger number of jobs lost showed up in services (with 77,500 fewer persons employed) followed close behind by construction (73,000 less). Nevertheless, in relative terms the biggest loss took place in construction (with a 2.7% drop) with a tendency for the rate to increase.

The drop in jobs in the last quarter came mainly in among Spanish nationals with a drop of 128,700 persons (0.7%) while the number of foreign workers employed rose by 54,100 persons (1.9%). In the past 12 months employment of Spanish

DROP IN EMPLOYMENT IN AGRICULTURE AND CONSTRUCTION

Change in number of persons employed in last 12 months



SOURCE: Labour Force Survey carried out by National Institute of Statistics.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	1Q	April
Persons registered with Social Security								
Sector								
Industry	*0.0*	*2.5*	*2.2*	*2.7*	*2.5*	*2.4*	*0.3*	*–0.8*
Construction	*8.7*	*3.3*	*6.1*	*4.4*	*2.3*	*0.5*	*–2.8*	*–5.8*
Services	*5.2*	*3.5*	*4.1*	*3.7*	*3.0*	*3.0*	*2.6*	*2.3*
Job situation								
Wage-earners	*4.7*	*3.0*	*3.9*	*3.5*	*2.6*	*2.2*	*1.2*	*0.6*
Non-wage-earners	*2.2*	*2.8*	*2.5*	*2.7*	*2.9*	*2.9*	*2.3*	*1.5*
Total	**4.3**	**3.0**	**3.6**	**3.3**	**2.7**	**2.4**	**1.4**	**0.7**
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**	**1.7**	**–**
Hiring contracts registered (***)								
Permanent	41.1	2.0	25.8	15.6	–1.6	–21.1	–11.8	12.0
Temporary	4.7	0.3	2.6	–1.9	–0.5	1.2	–6.5	4.4
Total	**7.9**	**0.5**	**5.3**	**–0.1**	**–0.7**	**–2.1**	**–7.2**	**5.3**

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

nationals rose by 45,300 persons (0.3%). In the same period the number of foreign workers employed rose by 287,800 persons (10.85%).

The slowdown in the labour market affected men much more than women which may be partly explained by the fact that construction largely employs male personnel. In the period March 2007-March 2008 employment of males rose by only 0.6% whereas that of females was up 3.2%.

A different behaviour also showed up by age. Among young people under 24 employment was down more than 5% in the past year. On the other hand, in the over-50 segment, given the benefits available for hiring those over 45 years of age, the number of employees rose by more than 4%.

In the past 12 months we note a quite varied trend by autonomous community. In Asturias, the number of those employed rose by 4.6%. In Cantabria, Valencian Community and Aragon increases above 3% were recorded. On the other hand, in the Canary Islands and Extremadura there was a drop in the number of those employed.

In addition, in the first quarter of 2008 the ratio of temporary work (that is the ratio between the number of workers on temporary job contract and all wage-earners stood at 30.15%, some 77 hundredths less than in the preceding quarter. In any case, this rate was notably above European standards.

In spite of the worse situation in the labour market, the labour force continues to grow strongly. In the first

Loss of jobs sharper among Spanish nationals than among foreign workers.

Increase of more than 5% in employment of those over 50 years of age in past 12 months, thanks to benefits available.

ESTIMATED EMPLOYMENT

First quarter of 2008

	No. of employees (thousands)	Quarterly change		Annual change		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	922.4	16.6	1.8	–67.6	–6.8	4.5
Non-farm	19,479.9	–91.2	–0.5	400.6	2.1	95.5
Industry	*3,338.5*	*59.4*	*1.8*	*73.2*	*2.2*	*16.4*
Construction	*2,620.3*	*–73.2*	*–2.7*	*–44.4*	*–1.7*	*12.8*
Services	*13,521.1*	*–77.4*	*–0.6*	*371.8*	*2.8*	*66.3*
By type of employer						
Private sector	17,529.1	–34.5	–0.2	392.1	2.3	85.9
Public sector	2,873.2	–40.1	–1.4	–59.0	–2.0	14.1
By work situation						
Wage-earners	16,817.4	–59.2	–0.4	302.9	1.8	82.4
Permanent contract	*11,747.1*	*88.9*	*0.8*	*509.4*	*4.5*	*57.6*
Temporary contract	*5,070.3*	*–148.1*	*–2.8*	*–206.5*	*–3.9*	*24.9*
Non-wage-earners	3,574.7	–18.5	–0.5	33.1	0.9	17.5
Entrepreneurs with employees	*1,139.5*	*3.1*	*0.3*	*55.5*	*5.1*	*5.6*
Entrepreneurs without employees	*2,218.3*	*–36.3*	*–1.6*	*17.9*	*0.8*	*10.9*
Family help	*216.9*	*14.6*	*7.2*	*–40.3*	*–15.7*	*1.1*
Other	10.1	3.0	42.3	–3.0	–22.9	0.0
By time worked						
Full-time	17,952.4	–141.4	–0.8	378.0	2.2	88.0
Part-time	2,449.9	66.7	2.8	–45.0	–1.8	12.0
By sex						
Males	11,923.9	–73.2	–0.6	69.4	0.6	58.4
Females	8,478.4	–1.5	0.0	263.7	3.2	41.6
TOTAL	**20,402.3**	**–74.6**	**–0.4**	**333.0**	**1.7**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

Growing labour force, especially because of arrival of new immigrants, not being absorbed by labour market, with resulting rise in unemployment.

quarter, the number of persons in the labour force rose by 172,000 to 22,576,500, to show a year-on-year rise of 3.0%. The rate of inclusion in the labour force rose by two decimals in the quarter to 59.35%. This came about through the increased entrance of women in the labour market, 105,800 females as against 66,200 males. Of these numbers, only 20,900 were Spanish nationals while 151,100 were foreign workers.

With this situation of job losses and a sharp increase in the labour force, unemployment rose sharply. As a result, some 246,600 persons joined the ranks of the unemployed in the first quarter putting the total at 2,174,200, a year-on-year increase of 17.1%. The unemployment rate rose by one point to 9.6%. Among Spanish nationals the rate was 8.7% whereas among foreign workers the rate stood at 14.7%.

Finally, the trend in unemployment by autonomous community was very uneven over the past year. There were some autonomous communities where

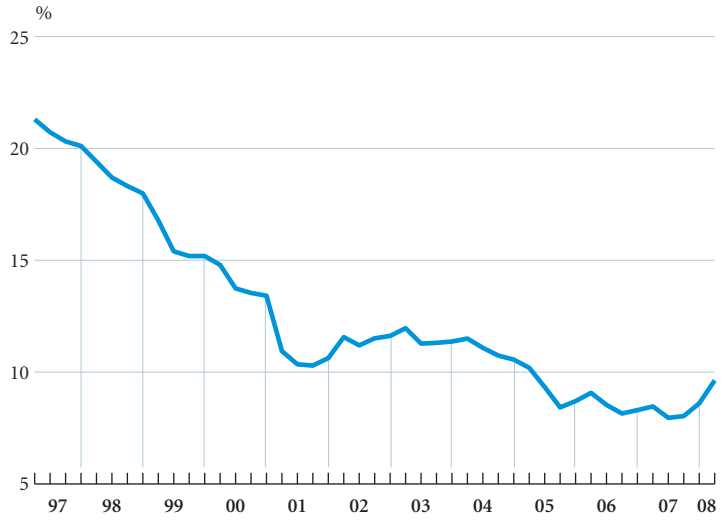
the number of unemployed dropped, as in the case of the Basque Country, Asturias, Cantabria, La Rioja and Galicia.

On the other hand, in Canary Islands and Murcia the number of unemployed jumped by more than 40%.

Big boost in unemployment in Canary Islands and Murcia in first quarter.

NOTABLE RISE IN UNEMPLOYMENT RATE

Number of unemployed compared with labour force



SOURCE: Labour Force Survey carried out by National Institute of Statistics.

ESTIMATED UNEMPLOYMENT

First quarter of 2008

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	1,018.6	139.4	15.9	218.5	27.3	46.8	7.9
Females	1,155.6	107.3	10.2	99.6	9.4	53.2	12.0
By age							
Under 25 years	500.1	52.4	11.7	77.0	18.2	23.0	21.3
Other	1,674.1	194.3	13.1	241.1	16.8	77.0	8.3
By personal situation							
Long-term unemployment	557.2	41.4	8.0	6.4	1.2	25.6	–
Seeking first job	197.8	12.2	6.6	12.4	6.7	9.1	–
Other	1,419.2	193.1	15.7	299.3	26.7	65.3	–
TOTAL	**2,174.2**	**246.6**	**12.8**	**318.1**	**17.1**	**100.0**	**9.6**

SOURCE: National Institute of Statistics and own calculations.

Prices

First decrease in inflation in eight months

Both general and underlying inflation indices down slightly in April...

Following an uninterrupted rise since August 2007, inflation took a breather in April when the year-on-year change rate in the consumer price index (CPI) went down 3 decimals to 4.2%. The inflation rate for the more stable core of prices, so-called underlying inflation that excludes unprocessed foods and energy products, was also down 3 decimals to 3.1%.

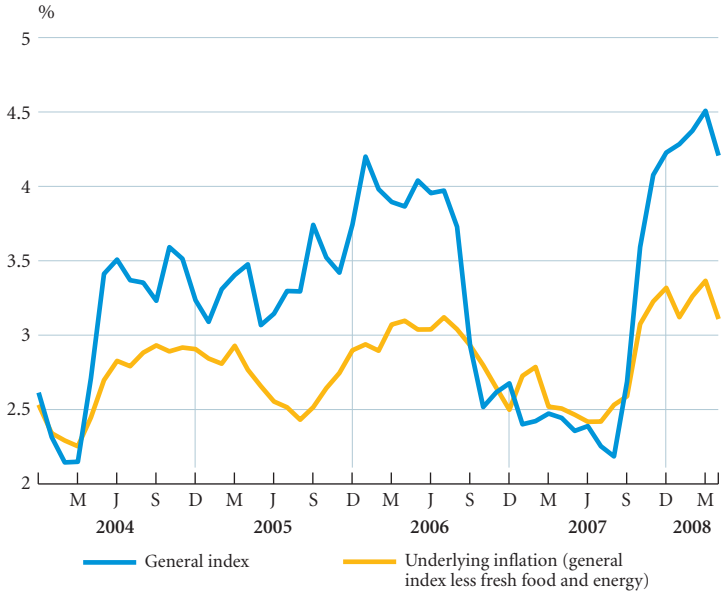
...due to effect of early Easter Week, lower increase in fuels...

To what was this decrease in annual inflation due? Following the end of the Easter Week holidays, which came early this year, the decrease in prices of organized tours and hotel/restaurant services largely contributed to the easing of inflation in April. An increase in fuel prices less marked than in April last year also favoured a decrease in inflation. At the same time, foods gave some relief with fresh food prices easing while processed foods stabilized.

The drop in consumption also tended to contain prices. Annual inflation in services thus stood at 3.5% in April, the lowest level in the past two years. Non-energy industrial goods also showed an easing in inflation rate to 0.2%, partly thanks to the appreciation of the euro and sharp competition in international markets.

INFLATION MOVES DOWN

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	1.1	1.5	4.2
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			

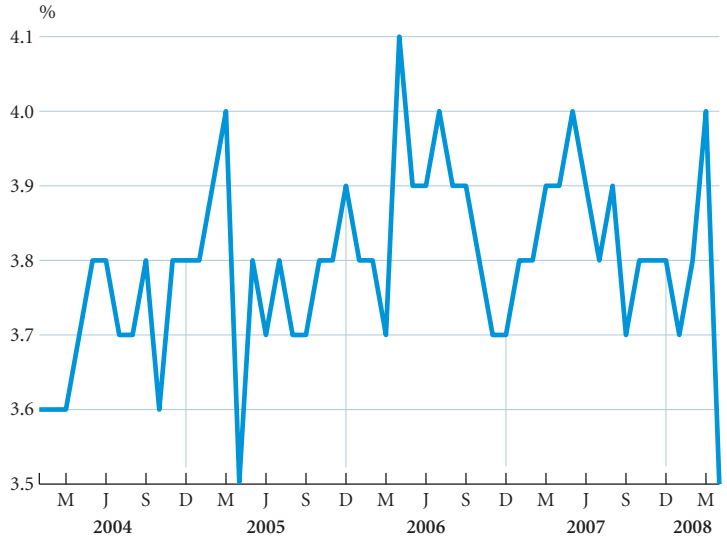
SOURCE: National Institute of Statistics.

Increased supply and imports consolidated the drop in milk prices which had shown year-on-year inflation going up to 31.7% in December 2007. But it was especially unprocessed foods that helped reduce inflation in April. The year-on-year change in vegetables and fresh produce dropped to 3.0% from the 5.2% recorded in March. There was a bigger drop in mutton for which annual

...slowdown in consumption...

PRICES OF SERVICES EASING

Year-on-year change in services component of CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

April

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2007	2008	2007	2008	2007	2008
By type of spending							
Food and non-alcoholic beverages	109.2	0.6	0.3	1.0	1.0	3.2	6.6
Alcoholic beverages and tobacco	111.2	0.1	0.2	5.4	3.4	6.3	4.1
Clothing and footwear	106.5	9.3	9.3	–1.3	–1.7	1.0	0.8
Housing	109.3	0.3	0.9	2.5	3.7	3.2	6.0
Furnishings and household equipment	105.0	0.8	0.7	1.1	1.1	2.6	2.5
Health	98.7	0.4	0.6	–3.0	0.2	–2.1	1.1
Transport	108.2	1.4	0.6	3.1	2.7	0.7	6.7
Communications	100.2	–0.2	0.0	1.4	0.3	0.3	–0.3
Recreation and culture	98.4	0.6	–1.1	–0.4	–1.0	–0.4	–1.5
Education	107.5	0.0	0.1	0.5	0.2	4.5	3.8
Restaurants and hotels	109.2	1.2	0.5	3.2	2.8	5.0	4.5
Other goods and services	106.4	0.3	0.3	2.3	2.4	3.5	3.1
By group							
Processed food. beverages and tobacco	110.0	0.2	0.2	2.0	2.1	2.2	7.4
Unprocessed food	107.9	1.1	0.4	0.4	–0.4	6.4	4.0
Non-food products	106.2	1.7	1.3	1.6	1.6	2.0	3.5
Industrial goods	105.2	2.6	2.4	0.8	1.2	0.3	3.5
Energy products	*113.5*	*1.9*	*1.2*	*3.8*	*5.6*	*–1.5*	*13.3*
Fuels and oils	*115.7*	*2.5*	*1.6*	*4.1*	*6.3*	*–3.1*	*16.7*
Industrial goods excluding energy products	*102.4*	*2.9*	*2.9*	*–0.2*	*–0.3*	*0.9*	*0.2*
Services	107.2	0.7	0.2	2.4	2.0	3.9	3.5
Underlying inflation (**)	106.1	1.3	1.1	1.4	1.2	2.5	3.1
GENERAL INDEX	**107.0**	**1.4**	**1.1**	**1.5**	**1.5**	**2.4**	**4.2**

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

...and easing seen in fresh foods, such as vegetables and fresh produce, mutton and chicken.

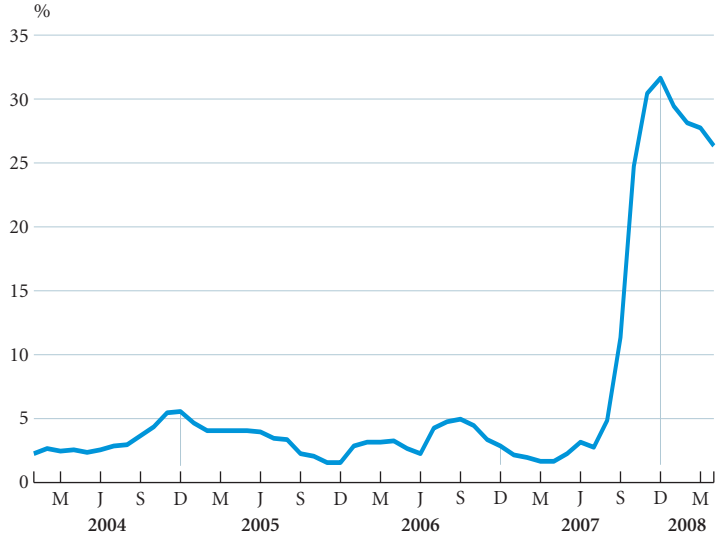
inflation dropped to 2.7% in April. A notable drop also took place in chicken which went from 8.9% to 5.4%. Potatoes showed a bigger year-on-year drop to 11.1%. As a result, the rise in fresh fruit prices was counteracted and ended up showing a year-on-year increase of 11.8%.

The annual inflation shown by the harmonized consumer price index of the European Union marked up a reduction of 4 decimals compared with the month before. This put it at 4.2%. As a result, the inflation differential with the Euro Area stood at one percentage point, the same level as one month earlier.

Will the downward trend in inflation continue? The foreseeable easing off in consumption will continue to move inflation in this direction. Nevertheless, the recent rise in oil prices to new

DECREASE IN MILK PRICES DUE TO INCREASED SUPPLY

Year-on-year change in price of milk



SOURCE: National Institute of Statistics.

all-time highs will surely bring an increase in annual inflation in May. At the same time, other commodities, such as food raw materials, show a picture of increasing pressures as a result of a sharp increase in demand and restrictions on exports in some countries. On the other hand, a review of electricity prices has been announced for the second half-year. As a result, it is likely that annual inflation will stay above 4% over coming months to go down more firmly at year-end, so long as oil does not stand in the way.

Inflation expected to rise again in May and hold above 4% for some months due to pressure from commodities.

Inflation in industrial prices his highest level in past 13 years

The increase in oil prices and the rise in prices of other commodities is putting pressure on wholesale prices. On the other hand, price increases in energy goods and intermediate goods has partly passed through to consumer goods.

The year-on-year change rate for industrial prices moved up to 7.2% in April. It thus went to the highest level since May 1995. The rise of 3 decimals in this rate in April was due to a further increase in energy products for which the year-on-year change rate rose to 16.5%. On the other hand, inflation on consumer goods, capital goods and intermediate goods dropped slightly compared with the month before. Nevertheless, the year-on-year inflation rate for intermediate goods (6.0%) reflected the rise in commodities. At the same time, the inflation rate for consumer goods stood at 5.3%, a half-point above the end of 2007.

Import prices continued to rise gradually to show an increase of 6.9% in March compared with 12 months before, one decimal more than in the month before. The increase in year-on-year rate in March may be attributed to intermediate goods, given that the other major components moved

Increase in commodity prices puts 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											
February	–6.3	2.5	1.4	2.9	6.7	–2.5	0.3	0.4	–0.3	8.1	3.4
March	1.5	2.8	1.7	3.3	6.3	–1.6	0.4	0.4	–0.2	7.2	–
April	6.7	2.7	2.2	3.1	6.5	–2.6	0.2	0.7	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	1.4	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	2.0	–
November	15.7	5.4	4.5	3.1	5.1	9.8	4.0	0.7	–0.1	0.8	2.9
December	17.6	5.9	4.8	2.9	5.0	11.6	4.9	1.1	–0.2	0.7	–
2008											
January	11.1	6.6	5.4	2.7	5.9	13.3	6.8	1.1	0.5	1.8	–
February	7.3	6.6	5.4	2.5	6.0	13.3	6.8	1.4	0.3	1.9	3.1
March	...	6.9	5.5	2.3	6.3	14.6	6.9	1.0	–0.1	2.4	–
April	...	7.2	5.3	2.2	6.0	16.5	...	...	...	...	–

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

...while strong euro eases rise in import prices.

downward. Specifically, price levels for capital goods even went below one year earlier, thanks to sharp competition in international markets and gains in productivity.

On the farm front, prices paid to crop farmers continued to ease in the early months of the year. In February, the general index showed a year-on-year increase of 7.3% as against 17.6% in December. Livestock prices (milk, eggs, etc.) continued to show lower year-on-year change rates but still high at 29.8%. On the other hand, market livestock prices were down 3.2% compared with February 2007. Farm products such as cereals, while slowing down in recent months, stood 9.5% higher than one year ago as a result of the rise in prices on international markets because of the sharp increase in world demand and export restrictions imposed by some countries.

Foreign sector

Trade deficit continues to grow

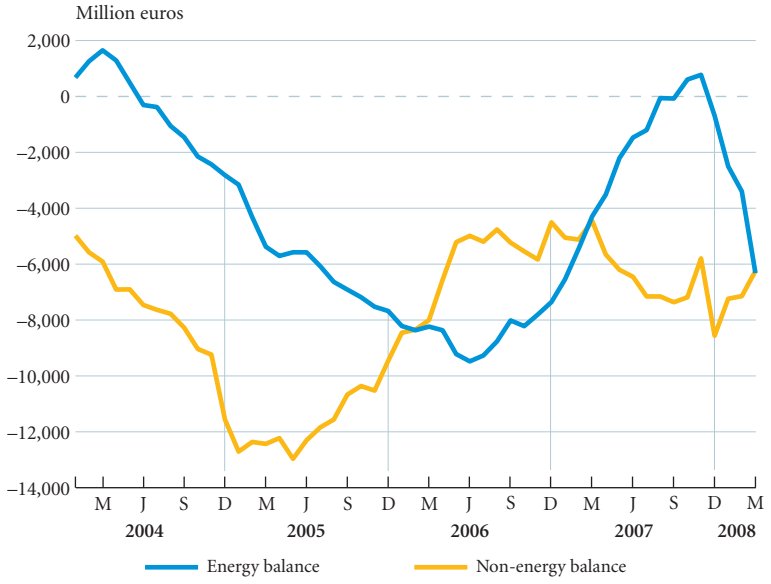
In March, the trade deficit (as cumulative balance for 12 months) stood at 103.46 billion euros, a figure 13.8% higher than one year earlier. The increase in imports and some slowing down of exports lay behind this bigger growth rate in the trade imbalance. This was the fourth consecutive month that the trade deficit has moved up faster, which would seem to put further off any correction of this major imbalance in Spain's economy. This result can only be seen as a paradox, seeing that the slowdown in Spain's growth (not a little due to the weakening of domestic demand) should show up in lower strength of imports. The export/import ratio thus stood at 64%.

What are the headings responsible for the increased trade deficit? In the past 12 months the total deficit rose by 12.58 billion euros due to contributions (in approximately equal parts) from energy products and the trade deficit in all other products. As may be seen in the following graph, the worsening of the energy balance began last November (just after the start of the last upward episode in crude oil prices) and has undermined the positive effect of the reduction in the non-energy imbalance. This trend helps us to understand the very slight pass-through of slower domestic demand to purchases abroad.

Foreign imbalance not getting lower.

WORSE ENERGY BALANCE MAKES IT DIFFICULT TO REDUCE TRADE DEFICIT

Year-on-year change in energy and non-energy trade balance (sum of last 12 months)



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

FOREIGN TRADE

Cumulative figures for 12 months as of January 2008

	Imports			Exports			Balance	Export/ Import rate (%)
	Million euros	% annual change by value	% share	Million euros	% annual change by value	% share	Million euros	
By product group								
Energy products	47,724	20.0	16.6	8,784	22.8	4.8	–38,940	18.4
Consumer goods	76,117	4.1	26.5	65,745	2.8	35.8	–10,372	86.4
Food	*16,032*	*7.6*	*5.6*	*21,249*	*4.4*	*11.6*	*5,217*	*132.5*
Non-foods	*60,085*	*2.9*	*20.9*	*44,496*	*–1.7*	*24.2*	*–15,589*	*74.1*
Capital goods	28,678	–0.5	10.0	16,582	–1.7	9.0	–12,096	57.8
Non-energy intermediate goods	134,725	10.4	46.9	92,669	9.3	50.4	–42,056	68.8
By geographical area								
European Union	166,850	7.6	58.1	128,934	5.0	70.2	–37,916	77.3
Euro area	*139,537*	*8.0*	*48.6*	*103,032*	*4.8*	*56.1*	*–36,505*	*73.8*
Other countries	120,393	10.9	41.9	54,845	9.6	29.8	–65,548	45.6
Russia	*8,353*	*10.4*	*2.9*	*2,233*	*35.6*	*1.2*	*–6,120*	*26.7*
United States	*10,671*	*24.1*	*3.7*	*7,385*	*–3.0*	*4.0*	*–3,286*	*69.2*
Japan	*5,988*	*0.3*	*2.1*	*1,329*	*–0.3*	*0.7*	*–4,659*	*22.2*
Latin America	*14,650*	*–0.4*	*5.1*	*9,609*	*–8.7*	*5.2*	*–5,042*	*65.6*
OPEC	*23,650*	*6.2*	*8.2*	*5,764*	*21.9*	*3.1*	*–17,887*	*24.4*
Rest	*57,081*	*15.3*	*19.9*	*28,526*	*17.9*	*15.5*	*–28,554*	*50.0*
TOTAL	**287,244**	**8.9**	**100.0**	**183,780**	**6.3**	**100.0**	**–103,464**	**64.0**

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

Increasing deficit in energy balance means insufficient reduction in trade imbalance.

The worsening trade balance largely comes from higher-cost energy, a factor outside Spain's economy.

If we look at a breakdown by product group, in the 12 months ending in March, we should point out the increase in exports of energy products (naturally benefiting from the increase in world demand for these goods) and of non-energy intermediate goods. The latter alone represent more than half of Spain's exports. On the other hand, two components (non-food consumer goods and capital goods) were down in year-on-year rate. With regard to imports, it is again energy products and non-energy intermediate products that make up the most dynamic headings, with year-on-year increases going above two digits.

In terms of trading partners, we continue to note the trends of some months back. The European Union (EU) is by far the origin and destination of most of Spain's trade. In any case, as an import market the EU has tended to lose weight in favour of other geographical areas. To be specific, the OPEC countries and Latin America have gained in importance as sources of supply. These are markets for raw materials which are now benefiting from the rise in prices of these products. On the other hand, as destination for Spanish products, the European Union is even gaining in importance. This trend may be linked to the fact that the Old

BALANCE OF PAYMENTS

February 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	–15,695	21.1	–92,540	–8,441	10.0
Services					
Tourism	*3,020*	*6.1*	*27,984*	*528*	*1.9*
Other services	*–501*	*–55.7*	*–5,052*	*–98*	*2.0*
Total	2,519	46.8	22,932	429	1.9
Income	–4,449	–21.4	–30,227	–6,224	25.9
Transfers	–2,877	18.7	–7,180	–571	8.6
Total	**–20,502**	**6.1**	**–107,015**	**–14,806**	**16.1**
Capital account	**1,857**	**33.4**	**4,957**	**–1,929**	**–28.0**
Financial balance					
Direct investment	–358	–84.2	–46,476	–12,376	36.3
Portfolio investment	1,287	–96.3	71,125	–125,639	–63.9
Other investment	10,853	–	47,140	101,840	–
Total	**11,782**	**–50.4**	**71,789**	**–36,175**	**–33.5**
Errors and omissions	1,160	54.0	3,662	3,388	–
Change in assets of Bank of Spain	5,704	–	26,608	49,521	–

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.

Continent continues to show an acceptable growth rate.

Balance of payments: current account deficit down

In February, the current account deficit stood at 8.55 billion euros, which represents something of a correction compared with the figure of 10.43 million euros one year ago. The improvement in the current account imbalance was largely due to the decrease in the deficit in the incomes balance. Also contributing, although to a lesser degree, were the bigger surplus in services and the smaller deficit in the current transfers balance. All of this more than compensated the increase in the trade balance.

When we focus our attention on longer term trends, something we come close to in the cumulative balance for the 12 months ending in February, the view we obtain is not significantly different. The current account imbalance, while still impressive, has been reduced compared with the situation one month ago. The bulk of the correction is concentrated in the more positive trend in the incomes balance and the transfers balance, in this order of importance. Furthermore, in terms of the cumulative figure for 12 months, the trade deficit is tending to slow its growth.

Imports from commodity producing countries on increase.

Current account deficit takes a breather but still holding at high levels.

Portfolio investment continues to ease as reflection of subprime mortgage crisis.

With regard to financial flows, looking at the figure for 12 months, the most notable feature is that new inflows of portfolio investment are growing smaller and smaller and this is happening even faster than the notable rate of decrease in previous months. This comes as a reflection of the behaviour of investors in a context of world financial upsets. In turn, direct investments have moved away from recent trends. As against the recent course followed, the reduction of net outflows of direct investment (as a balance for 12 months) broke away from this trend with an increase in negative balance of 12.38 billion euros.

Mediterranean Africa: so near and yet so far

According to the Belgian historian Henri Pirenne, the cause of the economic slide that took place in Europe following the fall of the Roman Empire is not to be found in the invasions of the Germanic barbarians but rather in the fact that, with the invasion of part of Europe by the Arabs, the Mediterranean Sea was no longer a sea of trade, one of the desirable results of the Pax Romana. Today, trade between the northern and southern shores of the sea remains meagre compared with that of other geographical blocs. Will the Mare Nostrum someday recover the mercantile splendour of those ancient times? This is precisely one of the objectives of the Euro-Mediterranean Association (or Barcelona Process), an attempt to bring about recovery of the Mediterranean area as a pacific area of free trade between Europe and Africa launched in November 1995. Its threefold aim was to establish an area of security, set up a free-trade area and improve social and cultural links between the European Union (EU) and 10 Mediterranean countries: Algeria, Egypt, Israel, Jordan, Lebanon, Morocco, Palestine Authority, Syria, Tunisia and Turkey.

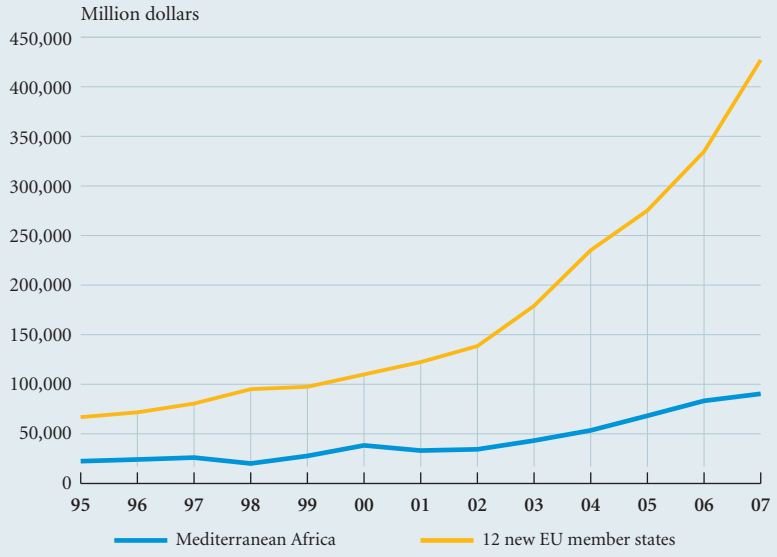
The results of the Barcelona Process have indeed been few and far between for a number of reasons. First of all, because of armed conflicts affecting some areas which generally have grown worse. Secondly, the limited advances by countries on the African side of the Mediterranean in terms of democratic mechanisms, institutional development and the growth of business and production. Thirdly, by no means less important, in recent years the European Union has gone out of its way in giving priority to the integration of the countries of Eastern Europe while partly neglecting the process of Euro-Mediterranean integration.

All of these factors mean that from an overall point of view the result has brought more dark than light. It is true that all of the states, except Algeria and Syria, have signed their respective free-trade agreements with the EU. Nevertheless, in all cases these agreements have included long transition periods for trade liberalization. In general terms, the reduction and removal of customs barriers for industrial products is broad but a lot more limited on agricultural products. Some liberalization of trade in services and freedom to establish companies is also envisaged. Nevertheless, a glance at the trend in direct investment and trade between Europe (EU-15) and Mediterranean Africa reveals a rather poor result.

Between, 2001 and 2007 inflows of direct investment into the 10 non-European Mediterranean countries amounted to 187 billion dollars, of which one-third went to Turkey. By comparison, largely as a result of their joining the EU, the 12 new member states were recipients of 281 billion dollars in investment. In the same period, exports of goods of the five Mediterranean African countries to the EU-15 amounted to 406 billion

POTENTIAL WAITING TO BE EXPLOITED

Goods exports to EU-15



SOURCE: IMF and own calculations.

dollars, an improvement over the 161 billion dollars in the period 1989-1995 which, however, pales in comparison with exports of the 12 new EU member states that went from 234 billion dollars to 1.7 trillion (USD). It is not surprising that following its first decade, the Barcelona Process is now subject to profound revision. In any case, in this situation of limited progress, it is worth pointing out the specific relationship of Spain and Morocco in which the indicators of economic and trade integration have moved ahead considerably.

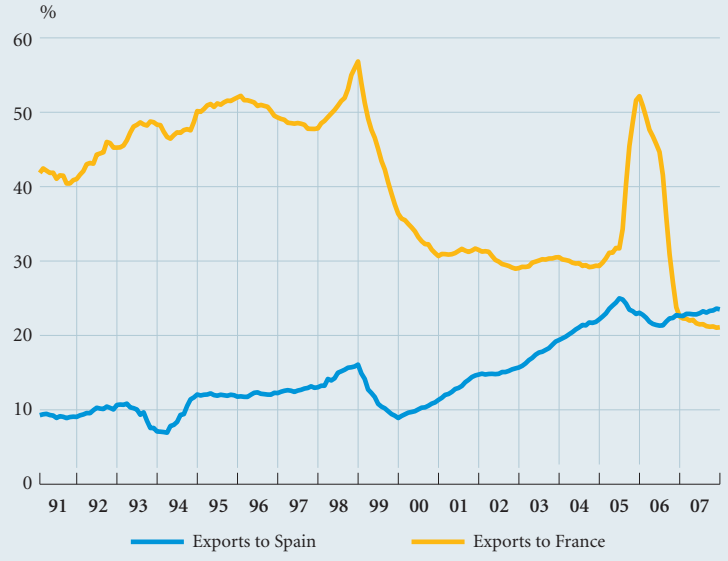
For Morocco, trade with the EU-15 represents somewhat more than 60% of the total, both in exports and imports. It main trading partners are Spain and France which in 2007 were the destinations of 23.5% and 21.1% respectively of all goods exports from Morocco. On the other hand, Germany, Europe's biggest economy, represents only 3.4%. In imports, the percentages for Spain, France and Germany were 12.7%, 15.9% and 5.5% respectively. The leading position of Spain in this trade increased between 1995 and 2007, a period when trade between Morocco and Spain grew at much faster rate.

The improved trade relations between both countries also carries weight in computing overall trade if we look at the five North African Countries and the EU-15. France is the main trading partner in the area but between 1995 and 2007 Morocco's sales to Spain contributed 20% to the growth of goods exports to the EU-15 from Morocco, Algeria, Tunisia, Libya and Egypt, whereas exports to France represented 15%.

In the bilateral relationship between Spain and Morocco, the breakdown by economic sectors shows that Spanish imports from Morocco were those undergoing the most significant change. Commodities represented 25% of those imports in 1995 whereas in 2007 that share had been reduced to 5%. In marked contrast, Spain's

MOROCCO LOOKING TOWARD SPAIN

Share of all Moroccan exports to EU-15



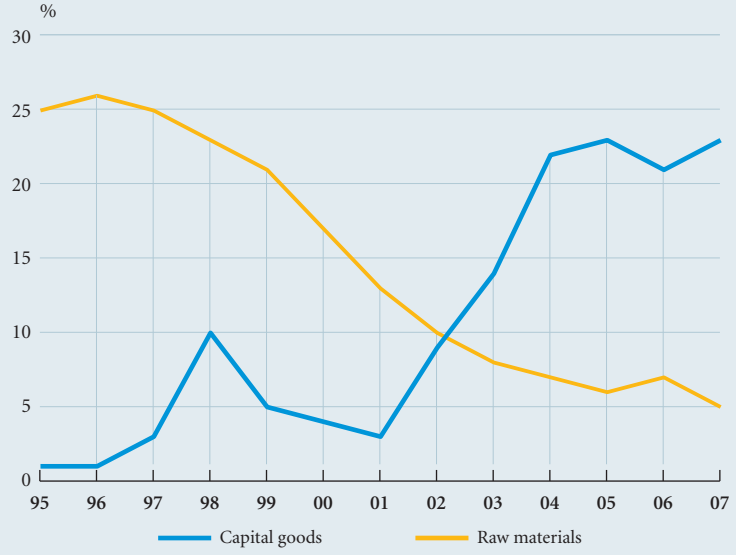
NOTES: Movable average for 12 months.
SOURCE: IMF and own calculations.

imports of capital goods went from 1% to 23% and consumer manufactures rose from 23% to 40%. In terms of Spain's exports, the profile has held more stable with manufactures and capital goods in the lead, along with the relative replacement of food by goods from the motor vehicle sector. With regard to direct investment from Spain, between 2001 and 2007 Morocco was the destination of 2.25 billion euros, four times more than that received by the other four countries of Mediterranean Africa. The tobacco industry and manufactures of non-metallic minerals made up three-quarters of the total.

In recent years, Spain and Morocco have overcome many of their old differences and have been developing closer and closer commercial and economic ties although there still exists some considerable margin for improvement. Spain has obtained a supplier of manufactures and capital goods offering good price while the Moroccan kingdom, which has fewer energy resources than its neighbours, has seen its per capita income almost double in terms of purchasing power parity since the mid-Nineties. Is this an example to be followed for the EU as a whole? European Union leaders and those from Mediterranean Africa are to meet in Paris on July 13 in order to give a boost to the Barcelona Process. Let us hope that for once the EU decides to cast its eyes southward and that it will begin to understand the potential offered by that side of the Mediterranean, which geographically is so close yet politically so remote for many European meeting rooms.

CHANGING PATTERN OF IMPORTS

Share of all Spain's imports from Morocco



SOURCE: Ministry of Industry, Trade and Tourism and own calculations.

Savings and financing

Lack of confidence in interbank market and tougher attitude of European Central Bank push up Euribor.

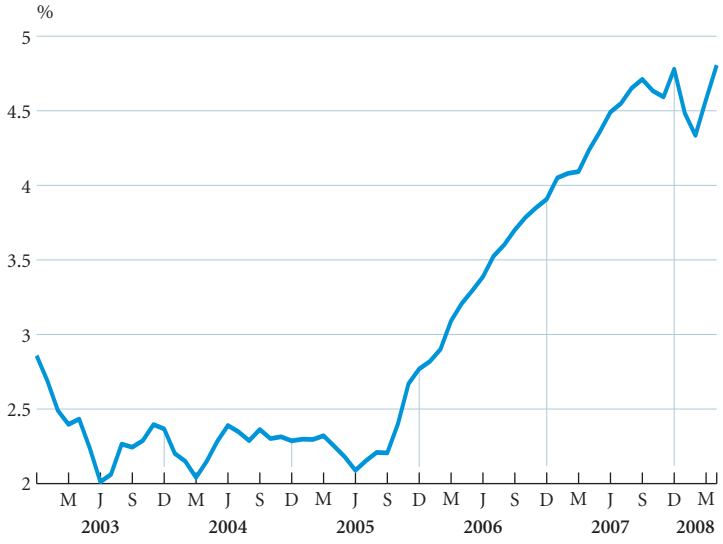
Credit slows down in view of rising interest rates

While at the beginning of the year it seemed that interest rates were easing, the reality is that for the moment this is not happening. The pressures coming into play in world financial markets in the summer of 2007 still persist and on the European Continent the European Central Bank is maintaining its rates stable, concerned as it is by rising inflation as a result of increasing inflation as a result of the boost in commodity prices. As a result, the 1-year Euribor, widely used as a reference rate, in April hit the highest average level since December 2000 reaching 4.82% and in the early weeks of May continued to rise and went above 5%.

Nevertheless, in the first quarter of the year we could still see some easing in interest rates and still more so in real terms, that is, discounting inflation. In spite of this, demand for credit continued to lose strength because of lower economic prospects. On top of this, comes some hardening of borrowing terms. As a result, financing going to the private sector continued to ease in the first quarter although it showed relatively high annual growth of 13.4% (1.7 points less than in December). In the January-March period the slowdown in loans to households was more marked than in the case of companies, given that the former was down by 2.1 points to 10.6%.

EURIBOR JUMPS TO HIGHEST LEVEL IN DECADE

12-month Euribor



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

March 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	83,657	–7,185	–7.9	2,233	2.7	4.7
Secured loans (*)	1,084,036	15,664	1.5	116,524	12.0	60.5
Other term loans	511,770	13,887	2.8	77,075	17.7	28.6
Demand loans	44,070	3,497	8.6	12,421	39.2	2.5
Leasing	46,569	276	0.6	4,465	10.6	2.6
Doubtful loans	21,578	5,327	32.8	9,791	83.1	1.2
TOTAL	**1,791,679**	**31,466**	**1.8**	**222,510**	**14.2**	**100.0**

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

Funding going to companies rose by 15.4% in the past 12 months ending in March, 1.6 points less than in December. In the period March 2007-March 2008, commercial credit granted to companies rose by only 2.7%. Leasing, used to finance company investments, showed higher annual growth (10.6%) but this was a substantial drop of nearly 3 points compared with the month before. This also reflects the trend to a slowing down in investment.

Demand for credit by households showed lower consumer confidence due to the increase in unemployment. Loans for home-buying slowed in growth rate to 11.2% in the past 12 months ending in March. There was an even bigger loss of strength in other loans to households, such as in consumer credit (for cars, furniture, travel, etc.) which showed year-on-year growth of 8.9%.

Within this framework of slowdown, default is naturally tending to increase. Nevertheless, the default rate for credit institutions as a whole stood at the relatively low rate of 1.2%, considerably below the European average. Furthermore, Spain's financial institutions enjoy high levels of provisions to meet any failures to pay.

Default rate rising but still holds at low levels.

By type of institution, in the past 3 months the slowdown in funding granted to the private sector was most marked at banks to the point where total credit granted fell below the level recorded one year earlier. The slowdown was also notable at savings banks although loans to companies and households showed annual growth slightly above average.

Bank deposits also ease off notably

The slowdown in economic activity has also shown up in a sharp drop in the growth rate of bank deposits by the private sector. These have gone from a year-on-year change rate of 26.7% in March 2007 to 10.5% in March 2008, a lower increase than in the case of loans.

The trend in yield did not help correct this slide. In fact, the average interest rate on deposits by companies and households in March showed a slight drop in nominal terms and a bigger drop in real terms, given that inflation rose.

Total credit to private sector shows appreciable drop.

Annual decreases in on-demand account balances.

Yield on time deposits of individuals, which had gone above 4.5% at the beginning of the year, dropped to 4.3% in March.

As a result, the annual change rate for deposits up to 2 years went from 44.3% in February to 41.8% in March. Total balance of on-demand accounts, which show a much lower yield, dropped below 12 months earlier. The same happened to foreign currency accounts as a result of the turnaround (or reduction) in interest rate differentials in terms of the euro.

Investors moving out of mutual funds.

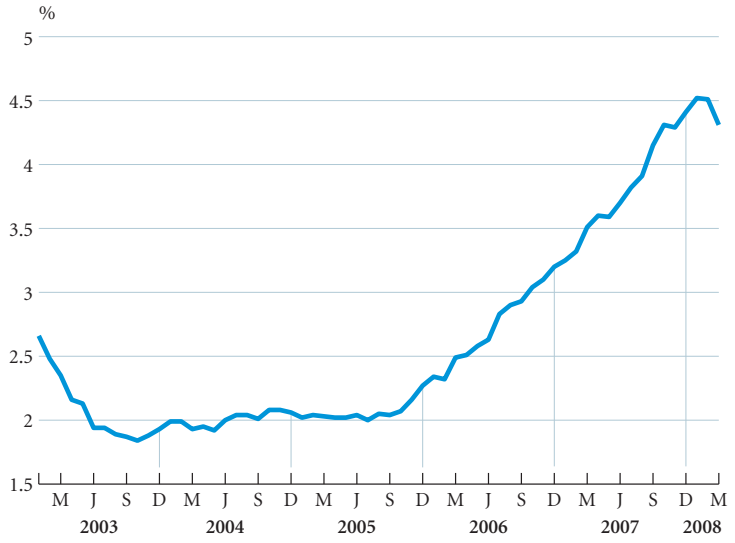
A worse result came about in another savings product, shares in mutual funds, which had been affected by the financial market upsets set off by the subprime mortgage crisis in the United States. The assets of mutual funds in April showed a drop of 3.69 billion euros, although this was lower that the decrease recorded the month before. As a result, the total value of mutual fund assets stood at 214.77 billion euros, 17.0% lower than at the end of the first quarter of 2007. The drop in assets was due to net withdrawals of participations for an amount of 5.20 billion euros, which was only partially offset by capital gains that month. Withdrawals took place in all types except guaranteed bond-based funds which shows risk aversion on the part of savers.

Average monthly yield on mutual funds was 0.85%, mainly thanks to the notable recovery of equity-based funds. Nevertheless, average annual yield stayed in the red with a decrease of 1.0%. There was a great spread in yields running between 6.6% in emerging markets to capital losses of 21.4% on Japanese share-based funds.

On the other hand, the assets of hedge funds continued to rise going to a figure of 1.28 billion euros at the end of April. It is true, of course, that this type of fund is still at an early growth stage in the Spanish market and that the total figure is still modest.

RETURN ON TIME DEPOSITS SLIPS DOWN IN FIRST QUARTER

Effective interest rate on household time deposits



SOURCE: Bank of Spain.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

March 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	421,238	–16,819	–3.8	–15,831	–3.6	31.6
Up to 2 years	393,789	41,083	11.6	116,029	41.8	29.5
More than 2-year term	395,337	–6,637	–1.7	25,149	6.8	29.6
Repos	83,495	–2,097	–2.4	1,924	2.4	6.3
Total	**1,293,859**	**15,530**	**1.2**	**127,272**	**10.9**	**97.0**
Deposits in currencies other than euro	**40,120**	**–3,724**	**–8.5**	**–574**	**–1.4**	**3.0**
TOTAL	**1,333,980**	**11,807**	**0.9**	**126,699**	**10.5**	**100.0**

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

In addition, at the end of March the volume of pension fund assets stood at 82.63 billion euros, to show a rise of 0.8% in the past 12 months. The number of participant accounts stood at 10,234,068, an annual increase of 2.9%. Contributions in the first quarter amounted to 1.03 billion euros, although this figure was exceeded by benefits paid out for retirements.

According to the ICEA association, the third quarter also showed an estimated total figure for direct insurance premiums of 15.53 billion euros. This figure meant a moderate annual increase of 5.0%. There was a bigger increase in life insurance (6.6%) while in non-life the rise was 3.8%. Among the latter, the biggest growth showed up in health insurance with a rise of 9.0% and multi-risk with an increase of 7.0%.

Moderate growth in direct insurance premiums in first quarter.

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As of December 31, 2007

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

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

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

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