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THE SPANISH ECONOMY

Monthly Report

NUMBER 316

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2006	2007	2008	2007			2008		
				2Q	3Q	4Q	1Q	2Q	3Q
INTERNATIONAL ECONOMY			Forecast						Forecast
Gross domestic product									
United States	2.8	2.0	1.8	1.8	2.8	2.3	2.5	2.2	1.3
Japan	2.4	2.0	1.1	1.8	1.8	1.4	1.2	1.0	1.1
United Kingdom	2.9	3.1	1.2	3.3	3.1	2.8	2.3	1.4	0.7
Euro area	2.9	2.7	1.4	2.6	2.7	2.2	2.1	1.5	1.0
Germany	*3.2*	*2.6*	*1.7*	*2.5*	*2.4*	*1.7*	*2.6*	*1.7*	*1.2*
France	*2.4*	*2.1*	*1.2*	*1.7*	*2.4*	*2.2*	*2.0*	*1.1*	*0.6*
Consumer prices									
United States	3.2	2.9	4.6	2.7	2.4	4.0	4.1	4.4	5.7
Japan	0.2	0.1	0.9	–0.1	–0.1	0.5	1.0	1.4	1.0
United Kingdom	2.3	2.3	3.5	2.6	1.8	2.1	2.4	3.3	4.3
Euro area	2.2	2.1	3.5	1.9	1.9	2.9	3.4	3.6	3.8
Germany	*1.6*	*2.3*	*2.8*	*2.0*	*2.3*	*3.1*	*2.9*	*3.0*	*3.1*
France	*1.7*	*1.5*	*3.1*	*1.2*	*1.3*	*2.3*	*2.9*	*3.3*	*3.3*
SPANISH ECONOMY			Forecast						Forecast
Macroeconomic figures									
Household consumption	3.9	3.4	1.1	4.1	3.0	2.9	2.2	1.2	0.7
Government consumption	4.6	4.9	4.2	5.0	4.8	4.4	3.6	3.8	4.3
Gross fixed capital formation	7.1	5.3	–1.0	5.8	4.6	4.5	2.5	–0.2	–2.4
Capital goods	*10.2*	*10.0*	*1.5*	*11.3*	*8.5*	*7.1*	*5.2*	*2.3*	*0.5*
Construction	*5.9*	*3.8*	*–3.5*	*4.2*	*3.3*	*2.9*	*0.3*	*–2.4*	*–5.1*
Domestic demand (contribution to GDP growth)	5.3	4.4	1.1	4.9	3.9	3.8	2.8	1.5	0.6
Exports of goods and services	6.7	4.9	3.8	3.9	8.2	4.0	4.3	4.1	3.5
Imports of goods and services	10.3	6.2	2.2	6.2	7.6	4.9	4.1	2.3	1.5
Gross domestic product	**3.9**	**3.7**	**1.4**	**3.9**	**3.6**	**3.3**	**2.6**	**1.8**	**0.9**
Other variables									
Employment	3.2	2.9	0.0	3.2	2.8	2.2	1.4	0.4	–0.5
Unemployment (% labour force)	8.5	8.3	10.7	8.0	8.0	8.6	9.6	10.4	10.8
Consumer price index	3.5	2.8	4.6	2.4	2.4	4.0	4.4	4.6	5.0
Unit labour costs	3.2	2.9	3.4	2.7	3.1	3.0	3.9	3.6	
Current account balance (% GDP)	–9.0	–10.1	–10.2	–9.1	–10.4	–10.5	–12.0	–9.5	
Net lending or net borrowing rest of the world (% GDP)	–8.4	–9.7	–9.8	–8.9	–10.2	–9.6	–11.2	–9.0	
Government balance (% GDP)	1.8	2.2	0.0						
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	5.0	5.0	2.2	5.3	5.1	4.5	2.8	2.0	2.0
ECB repo	2.8	3.9	4.1	3.8	4.0	4.0	4.0	4.0	4.3
10-year US bonds	4.8	4.6	3.9	4.8	4.6	4.1	3.5	3.9	4.0
10-year German bonds	3.8	4.2	4.4	4.4	4.3	4.2	3.9	4.4	4.5
Exchange rate									
$/Euro	1.26	1.38	1.52	1.35	1.39	1.46	1.53	1.56	1.51

Contents

Once again it's oil

In July the per barrel price of oil reached a new all-time high. A year ago, when the price was barely hitting half of the 146 dollars seen in July, such a level seemed possible only in a situation where oil supply had been suddenly cut. But that was not so, the flow of buying and selling was following its normal course except for the usual inevitable odd problems of supply. From that moment on, in just a few weeks the price of oil was sharply corrected and went down to 110 dollars, a level that in any case was still well above that expected one year earlier. Why is the price of oil going so high? And why is it so volatile?

These are questions that operators and analysts have been trying to answer now for many years ever since the first oil crisis at the beginning of the Seventies sharply hit the industrialized economies. In recent years, it is clear that one of the factors in this rise is to be found in the boost in demand from the emerging countries. The rapid industrialization of those countries has turned them into hungry oil consumers. China, of course, heads the list as the main country responsible for the rise in consumption. On the other hand, in the advanced economies, which still represent 60% of world demand, oil consumption seems to have become stable since 2006 as a result of the rise in prices and economic slowdown.

While oil demand has kept going up sharply, supply has barely been able to cover buyer requirements. It should be borne in mind that over the short term supply is relatively inflexible given that increasing production capacity is a long and costly process. It requires a considerable initial investment in oil-field exploration and then it takes an average of between five and ten years before these can be made productive. Furthermore, oil exports are confined to just a few countries and these often suffer from internal or geopolitical instability, as is the case of the Middle East, Nigeria, Venezuela and Russia. There is plenty of oil but as it is a finite resource there is a growing fear that supply will soon reach a ceiling (the peak oil theory) so that the current price is nothing more than a foretaste of what inexorably lies ahead.

Increased demand and rigidity of supply could account for the upward trend in the per barrel price in recent years but this does not quite explain the sky-rocketing rise seen over the past year. Inevitably, attention has shifted to commodity investors. In recent years, many of these have included oil in their portfolios, a trend that seems to have been stepped up following the world financial crisis that began in August 2007. The meteoric price rise in the past year has coincided with the boost in funds being invested in oil futures. The recent price drop is being attributed to a withdrawal of investors from this market.

The correction of oil prices, however, does not remove a situation that could be termed an oil shock, given that it is a matter of a 70% increase in one year. Traditionally this has meant more inflation, lower growth and less employment. However, more and more the impact of the energy crisis seems to be of lower degree. In fact, as of 2000 the price rise in oil has coincided with the sharpest and longest growth cycle in the world economy in 30 years, in a context of low inflation and low-level unemployment. We should not lower our guard but it certainly would seem that the oil-dependent economies are more and more able to withstand the blows from the per barrel price of oil.

EXECUTIVE SUMMARY

Start of another difficult period

One year after start of financial crisis, problems far from solved...

What began around July 2007 as a problem concerning only a limited group of players and financial assets has ended up turning into an international crisis. The fire that started in the segment of subprime mortgages in the United States spread rapidly to the rest of the US financial system. Years of easy lending terms and regulatory negligence made it possible for imprudent bank practices to develop, practices that turned into a deadly fuel. The flames have eaten up a large part of the provisions made by those institutions directly involved but the list of those hurt stretches far beyond the United States and has spread to a large part of the international financial system. Bloomberg estimates that provision for losses put into effect by all institutions since the beginning of the crisis goes above 500 billion dollars, of which half was for institutions domiciled outside the United States.

...and no clear end of crisis in sight.

The problem does not stop there, because fear and lack of confidence continue as characteristics of financial market operations. As a result, interest rate differentials and risk premiums remain at abnormally high levels while the moves by the monetary authorities have failed to calm spirits. The generous facilities to ensure liquidity offered by the central banks in a coordinated fashion have not solved the drought in interbank markets nor avoided something of a state of credit restriction noted in many economies. The decided move by the Federal Reserve, the US central bank system, to rescue the investment bank Bear Sterns seemed to mark a turnaround in the situation of lack of confidence and fear in financial circles. But only a few months later it must be recognized that there has been little change in the scene.

The poor profit picture in US banks and in some European banks continues to be a drag on stock exchanges. Every apparent recovery of the share markets has been followed by a move in the opposite direction. The last episode with the rise in stock market prices shown between mid-July and the beginning of August was partially compensated by a later drop. In this respect, bond markets have continued to act as a financial refuge which explains the drop in bond yields.

To further complicate the situation, it seems that the financial stage of the crisis is giving way to a dangerous second stage, namely the pass-through of the crisis to the real economy. How is this happening? There are two main factors – less availability of credit and a drop in confidence among companies and consumers. These processes, which have now begun to show up, will grow sharper in coming months. All of this, garnished with the already high prices for commodities with oil leading the way. In spite of the fact that between mid-July and mid-August oil dropped by 40%, the biggest monthly percentage decrease since the Gulf War in 1991, current levels in the area of 115 dollars a barrel will continue to drain away incomes and raise prices at a delicate moment of the economic cycle.

Impact of crisis begins to show up in real economy through tighter credit and loss of confidence.

The real impact of the financial crisis, however, will clearly be different depending on the world region where we happen to be. The epicentre, the United

States, has so far been able to avoid the much-feared recession. The government's fiscal boost (equivalent to somewhat more than 1% of gross domestic product) and the easing of monetary policy by the Federal Reserve for the moment have helped maintain growth at levels much better than expected (3.3% quarter-on-quarter annualized in the second quarter). The continuation of the real estate recession, for which no end is yet in sight, stands in the way of any hope that the economy will hold at this rate in coming quarters.

Europe, that seemed to be sheltered from the US recession and outside the reach of its mortgage problems, has suddenly presented a worse situation. The European Central Bank has followed a monetary policy diametrically opposed to that in the United States. Reference rates were kept unchanged up to July when the Frankfurt authorities opted for a quarter-point increase (up to 4.25%), a reverse of the Fed's position. Nor has fiscal policy followed the strong moves taken in the United States. In this context, with confidence in economic circles disappearing and the international scene worsening, there has been a sharp adjustment of economic activity that has brought about decreases in gross domestic product (GDP) in the second quarter in Germany, France and Italy, the three major Euro Area economies. As a whole, the Euro Area dropped by 0.2% quarter-on-quarter.

We believe that the Euro Area will be able to avoid recession but with decreasing investment, weak private consumption and poor foreign demand, Europe is left without the engines needed for economic growth. The worsening of prospects in the Old Continent, in contrast to the stronger resistance of the US economy, partly explains why the dollar has stopped dropping and begun to recover from the low of 1.60 to the euro.

Given this pessimistic scene, are there reasons for hope? Yes, in the emerging economies. For the moment, they remain dynamic. Apart from China, a global vector, we are reminded of the more recent growth figures of the larger emerging economies, India (8.8%), Russia (8.5%) and Brazil (5.8%). According to the latest forecasts by the International Monetary Fund, world growth will hold somewhat below 4% both in 2008 and 2009. This is far from the exceptional figures seen in the early years of this century (of the order of 5%) but, in any case, still quite notable.

United States so far manages to escape recession while Europe moves into stage of lower economic activity.

Spain's economy: toward a change in model

The negative international scene has had a sharp effect on Spain's economy whose growth has been based on an exceptional growth cycle in construction and strong growth in consumption. The second quarter saw a sharpening of the process of adjustment now underway with the GDP showing an increase of 1.8% compared with the second quarter of 2007, eight decimals less than three months earlier. Compared with the previous quarter, the GDP grew by just one decimal, which practically indicates stagnation, this being the lowest quarterly increase since the last recession in 1993.

Emerging economies consolidate as strongest scene of world growth at this time.

The sharp slowdown in the economy was due to domestic demand, given that the contribution of the foreign sector went from subtracting two decimals to adding three. This half-point improvement came about thanks to a sharper slowdown in imports of goods and services than that in exports so that the difference between the growth rates of both increased in favour of the latter. This is a significant result given that improvement in the foreign sector is fundamental for solving key questions regarding the growth model as seen up to this time. In the first place, it is important to halt the

Sharp slowdown of Spain's economy worsens in second quarter almost going into stagnation.

Two positive factors arise: a halt to worsening of foreign sector...

worsening of the foreign deficit in a context of increasingly tough international credit terms. Secondly, it is essential to ensure a parcel of demand that, at least in part, will take the place of the worn-out drive in construction and private consumption.

Private consumption is precisely one of the demand components that is weakest. In the April-June period, it grew by a mere 0.1% compared with the previous quarter. The lower increase in real incomes, high debt levels in a context of rising interest rates and an increase in unemployment are all undermining consumer confidence. On the other hand, public consumption has been playing an anti-cyclical role and this partly compensated the weakness in private consumption.

...and substantial improvement in productivity per worker at cost of rapid worsening of labour market indicators.

Construction continues on a doubtful course due to the halt in the housing segment. Spending on housing was down by 5.6% compared with the first quarter. Investment in capital goods was also down sharply due to the drop in expected demand. Within this framework, the industrial situation has worsened considerably. Value added for the industrial branches was down 2.8% compared with the second quarter of 2007. On the other hand, services were able to resist the general economic slowdown.

The marked economic slowdown is having a definite effect on the labour market. According to the latest figures for the Labour Force Survey, the first half-year saw the loss of 51,800 jobs. The level of employment in the private sector shows a clear downward trend. The decreases are concentrated in construction and agriculture. In spite of the fact that these sectors employ a relatively high number of foreign workers, this group of employees rose by 7% in the past year while the number of Spanish nationals employed was down slightly. The worsening of the labour market did not deter those seeking jobs. The labour force thus continued to increase at a good rate with an annual increase of 3.1% largely as a result of the number of women and foreign workers joining the labour force. In this context, unemployment rose and the unemployment rate went up to 10.4%, some 2.5 points above the low recorded one year ago and showed an upward trend. According to Eurostat, at the beginning of the summer the unemployment rate in Spain became the highest in the European Union.

On the other hand, the negative trend in the labour market had its positive side in a substantial improvement in productivity. This is a fundamental change which should become consolidated in coming quarters, given that, after having stood at very low levels in recent years, apparent productivity should now stand at much higher levels in order to face the end of the current adjustment.

Economic authorities trying to contain slowdown through increase in public spending, structural reforms and call for social dialogue.

Meanwhile, the course of the adjustment is continuing to exact a heavy penalty in terms of a worsening of the public deficit. In the first seven months of 2008 the central government showed a deficit of 0.9% of GDP as against a surplus of 0.7% in the same period the year before as a result of the economic slowdown but also because of measures taken to deal with it. In mid-August, the central government approved a new package of measures to deal with the economic situation, measures which are to go hand-in-hand with a process of social dialogue aimed at changing Spain's production model and in an attempt to relaunch the economy on solid bases.

August 28, 2008

CHRONOLOGY

2007

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**.
	30	**Federal Reserve** reduces reference rate to 2.00%.
July	**3**	**European Central Bank** raises official rate to 4.25%.
	11	One-month forward price of *Brent* quality **oil** goes up to all-time high of 146.6 dollars a barrel.
	15	**Euro** exchange rate hits 1.599 dollars, highest value since launching of European Single Currency at beginning of 1999.
August	**14**	Government puts into effect its **programme of 24 economic measures** for 2008 and 2009.

AGENDA

September

- **2** Registrations with Social Security and registered unemployment (August).
- **3** EU GDP (2nd Quarter).
- **4** Governing Council of European Central Bank.
- **5** Industrial production index (July).
- **11** CPI (August).
- **16** Fed Open Market Committee. EU harmonized CPI (August).
- **19** Quarterly labour cost survey (2nd Quarter).
- **23** Central government revenues and spending (August).
- **25** Producer prices (August). Foreign trade (July).
- **29** HCPI estimate (September).
- **30** Balance of payments (July).

October

- **2** Registrations with Social Security and registered unemployment (September). Governing Council of European Central Bank.
- **3** Industrial production index (August).
- **14** CPI (September).
- **15** EU harmonized CPI (September).
- **23** Foreign trade (August).
- **24** Labour Force Survey (3rd Quarter).
- **27** Producer prices (September).
- **28** Central government revenues and spending (September).
- **29** Fed Open Market Committee.
- **30** HCPI estimate (October). US GDP (3rd Quarter).
- **31** Balance of payments (August).

INTERNATIONAL REVIEW

US GDP grows by 1.8% with slowdown in domestic demand while foreign sector on rise.

United States: more exports and less consumption

The US gross domestic product (GDP) grew by 2.2% year-on-year in the second quarter. In quarter-on-quarter terms annualized, the advance was 3.3%, somewhat above forecasts taking into account the tax boost approved in April. The July revision of figures previously published put the last quarter of 2007 at negative quarter-on-quarter growth. The anchor of the economy, private consumption, continued to slow with an advance of 1.4% year-on-year. A poor figure that might have been lower but for the tax relief mentioned and it indicates a downward move. Under non-residential investment, while structures showed a good performance, investment in equipment (with more weight in the economy) was down compared with the level in the previous quarter while the sharp decreases in housing investment continued.

The foreign sector has become the strongest pillar of growth thanks to weaker demand in imports and the renewed competitiveness that comes from a cheaper dollar. Exports thus were up 11.2% year-on-year whereas imports dropped by 2.0%. The problem is that domestic demand in the second quarter

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007			2008				
			2Q	3Q	4Q	1Q	April	May	June	July
Real GDP	2.8	2.0	1.8	2.8	2.3	2.5	–	2.2	–	–
Retail sales	5.8	4.0	4.0	4.0	4.7	3.0	2.8	2.0	3.4	2.6
Consumer confidence (1)	105.9	103.4	106.7	105.7	91.2	76.5	62.8	58.1	51.0	51.9
Industrial production	2.2	1.7	1.4	1.8	2.1	1.8	0.4	0.2	0.2	–0.1
Manufacturing (ISM) (1)	53.1	51.1	53.0	51.3	49.6	49.2	48.6	49.6	50.2	50.0
Sales of single-family homes	–18.0	–26.8	–22.1	–27.3	–33.7	–33.1	–40.2	–37.8	–33.2	...
Unemployment rate (2)	4.6	4.6	4.5	4.7	4.8	4.9	5.0	5.5	5.5	5.7
Consumer prices	3.2	2.9	2.7	2.4	4.0	4.1	3.9	4.2	5.0	5.6
Trade balance (3)	–753.3	–700.3	–730.7	–701.4	–700.3	–695.6	–695.9	–695.6	–693.3	...
3-month interbank interest rate (4)	5.2	5.3	5.4	5.4	4.9	3.0	2.9	2.7	2.8	2.8
Nominal effective exchange rate (5)	82.5	77.9	79.3	77.0	73.3	72.0	70.5	70.8	71.4	70.9

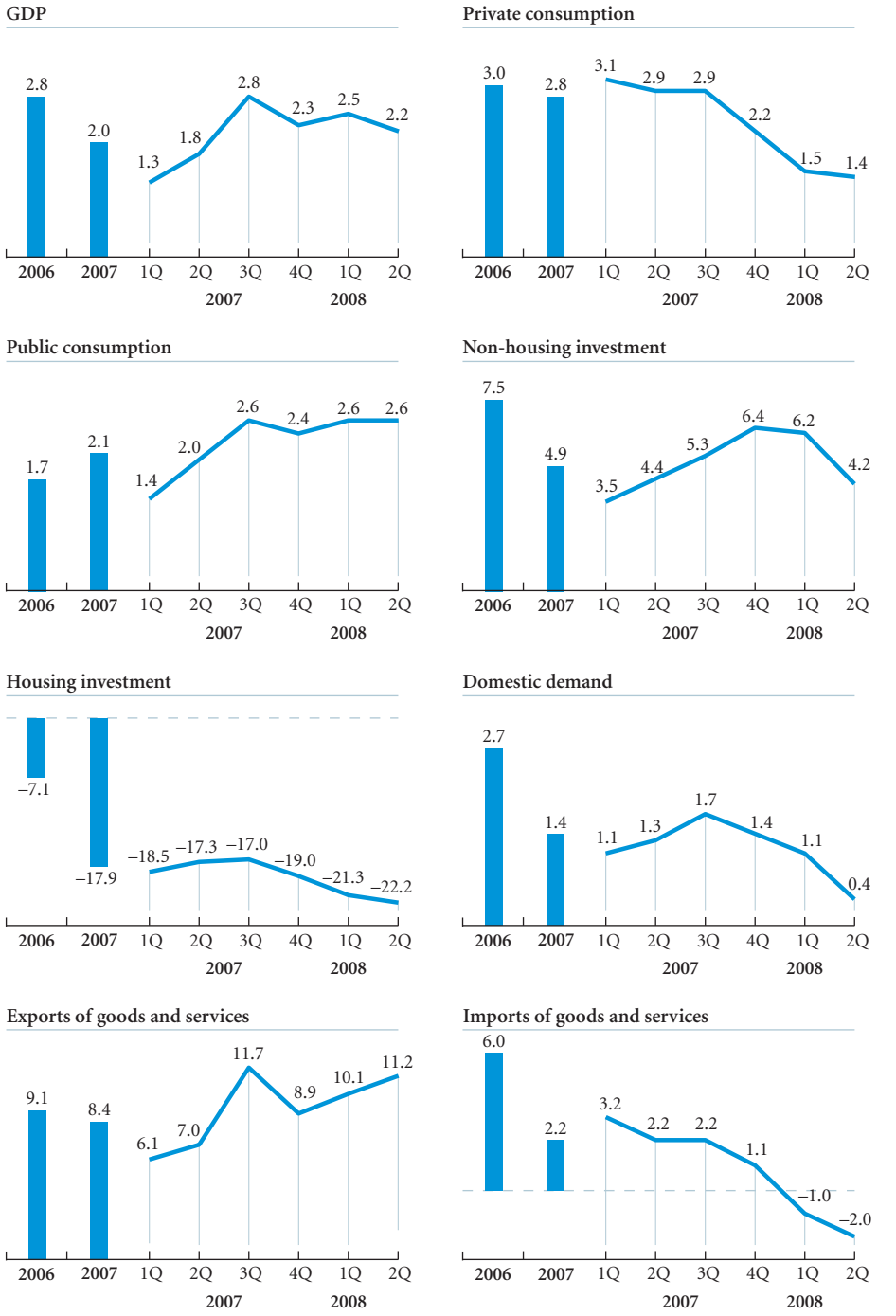
NOTES: (1) Index value.
(2) Percentage of labour force.
(3) Cumulative figure for 12 months in goods and services balance. Billion dollars.
(4) Percentage.
(5) Change weighted for foreign trade movements. Higher values imply currency appreciation.
SOURCE: OECD, national statistical bodies and own calculations.

contracted compared with the first quarter and it remains to be seen whether growth completely based on the foreign sector is sustainable in an economy as large as the United States. It avoids recession but in the last two

Consumers pessimistic about today and especially about tomorrow.

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Bureau of Economic Analysis and own calculations.

Economic weakness has lasted for two years.

months the risk again lies on the side of growth rather than on inflation. While this does not imply that price increases have been brought to heel, 2009 is shaping up as a year of weak economic activity and not one of recovery.

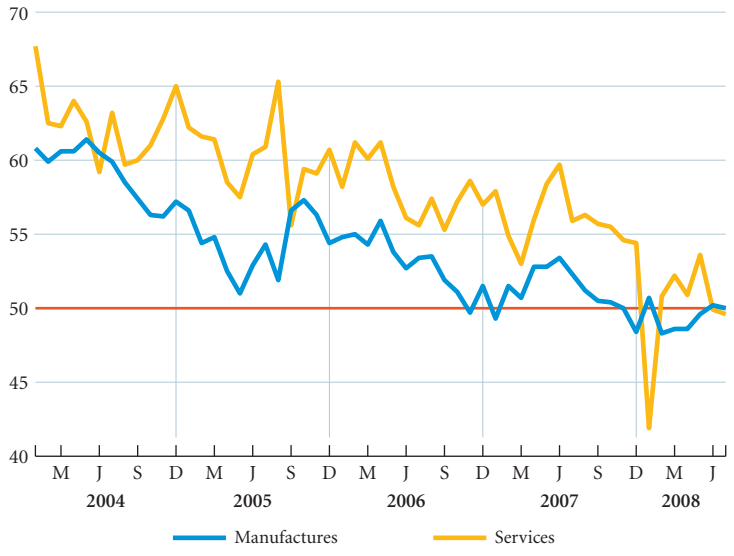
Supporting this view is consumer sentiment for which the most watched index, the consumer confidence index of the Conference Board, stood at 51.9 points in July, a level that, while somewhat above the figure for the month before, in the past 30 years has only been this low in the first two months of 1992. The big difference with that period lies in expectations. In 1992 these were well above the current perception whereas at this moment the opposite applies. In keeping with consumer sentiment, retail sales in July (not including the fluctuating purchases of cars and petrol consumption) moved up 3.4% year-on-year which, discounting price changes, turns out to be a weak 0.8%. In turn, car sales continued to show a bigger drop with a cumulative decrease of 10.5% year-on-year. What is troubling in this general development is not so much the degree of the slowdown as the marked downward trend.

Business executives forecasting fewer orders with prices on rise.

The corporate view, while somewhat more biased to begin with, also took on this downward trend as shown by the July business activity index of the Institute for Supply Management. In manufacturing the index was down slightly to the 50.0 points level of balance with as many optimistic responses as pessimistic replies. In turn, the services index moved down to 49.2 points. In both cases, the modest recovery in the employment component was spoiled by the persistence of price increases and the increased weakness in new orders. In contrast to previous periods of

UNITED STATES: BUSINESS EXECUTIVES SEE DOWNWARD TRENDS

Level of ISM indices (*)



NOTES: (*) A level of 50 implies that there are as many optimistic responses as pessimistic ones.
SOURCE: Institute for Supply Management and own calculations.

slowdown when these indices reacted rapidly and with sharp drops, this time nothing of this sort is happening but the index is showing a gradual but definite downward trend.

The trend in the housing sector, apart from the consequences directly arising from its reduced activity in the national accounts and in employment, will set the pace of private consumption through the trend in housing prices. Construction spending in the second quarter was down 15.6% compared with the previous period in annual terms, so that, while better than the drop of 25.0% in the previous period, it is far from hitting bottom. In this situation, housing starts in July were down 29.6% compared with the same period last year. Pointing in the same direction, building permits, which are an early indicator of starts, showed a similar drop of 32.4% and the question here is not about the rate of decrease but the low levels already reached.

On the demand side, the situation is more troubling. The price of real estate continues to reduce the perceived wealth of many consumers and in May the most representative index, the Case-Shiller index, continued to show more decreases with a cumulative drop of 19.8% compared with the high in June 2006, which, if we add the rise in the CPI, means a loss of 24.7%. Nor did the liquidity of real estate improve with sales of existing housing in June showing a 15.5% year-on-year drop while new housing with bigger swings was down by 33.3%. The result is that in June it took 11.1 months on average to sell a house, twice as long as it took only two years ago.

Housing still not hitting bottom and home values mark up cumulative loss of 16%.

Another key factor acting on consumption is the labour market and

Labour market on downturn, unemployment up to 5.7% and inflation hits 5.6%.

UNITED STATES: PATIENCE NEEDED TO SELL A HOME

Average number of months needed to sell an existing home

SOURCE: US Census and own calculations.

Higher oil costs prevent improvement of trade deficit but in other sectors this drops to half the highs in 2005.

prospects here are not improving either. In July, for the first time since 2003 there were fewer non-farm workers compared with the same month last year. In the first seven months of 2008 there was a net loss of 463,000 jobs. In July, the unemployment rate rose to 5.7% of the labour force, one percentage point above the same period last year while, taking into consideration price increases, wages are not above 2001 purchasing power levels.

Nevertheless, this downturn in economic activity is still not easing pressure on the consumer price index (CPI) which rose by 5.6% year-on-year in July. It is enough that upward pressure on food and energy prices continues and it does not help that the underlying component is also moving up, going from increases of 2.4% to 2.5%. Producer prices in the same period rose by 9.8% year-on-year although there is still no pass-through to consumers. In any case, as a positive note the effect of energy prices on other sectors of economic activity are much more limited than expected although the prospect of prices rising at levels close to 2.0% is still somewhat farther away.

Japan's GDP grows by 1.0% while private consumption and exports weaken.

In turn, the trade balance in good and services showed a deficit of 56.77 billion dollars in June, a decrease of 4.0% year-on-year. This was somewhat less than expected because of oil. In the past 12 months up to June the foreign deficit in oil and oil-derived products made up 64.0% of the total deficit in goods and services for the period. Nevertheless, the positive note is that the non-oil negative balance was down to 47.0% of the high reached in October 2005 in current dollars.

Real estate market paralyzed but prices fail to drop.

Japan: slowdown on both domestic and foreign scene

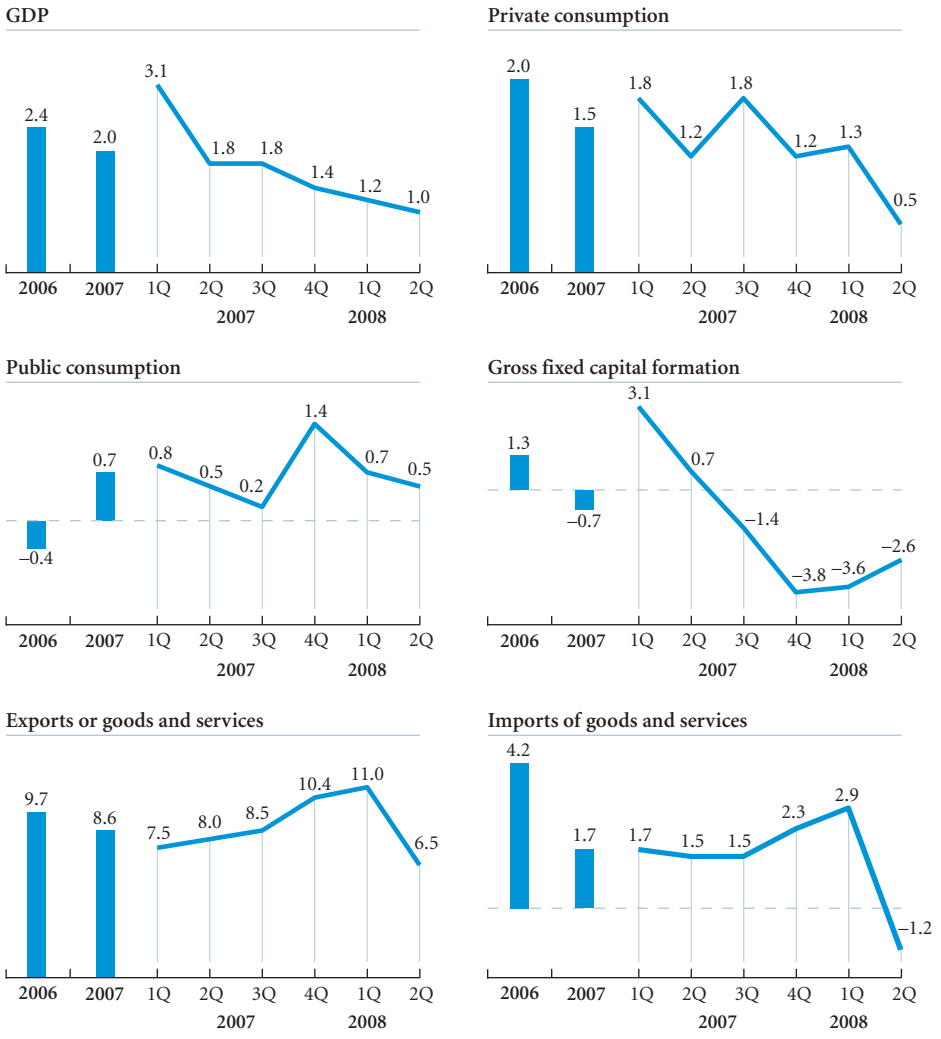
The national accounts for the second quarter showed a downward correction to the good forecasts for the first quarter, thus confirming the complicated situation of Japan's economy whose heavy dependence on exports is troubling in a context of world slowdown. The GDP grew by 1.0% year-on-year, showing a clear downturn according to the revision of figures for previous quarters already published. The biggest slowdown showed up in private consumption and exports which had been the components most on the rise in the first quarter. The lowest profile was still the weakness in investment with investment in equipment quite slack, coinciding with a halt to the improvement in construction and public investment again showing a downward trend.

The real estate market, one of the factors that could have most influence on the weak state of consumption, remains in a deep slump. While prices are holding up, given that average prices in Tokyo were practically equal to the same period last year, sales were down 59.9% year-on-year showing that the market is practically static. On the supply side, housing starts in June dashed the weak signs of recovery to nothing with a drop of 16.7%.

Among most recent demand indicators, what stands out is the drop in consumer confidence in the second quarter, going from 36.5 points to the 32.3 points level, an all-time low since this indicator was set up back in the early Eighties. At a slower pace, retail sales moved up by a slim 0.3% year-on-year in June while,

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.

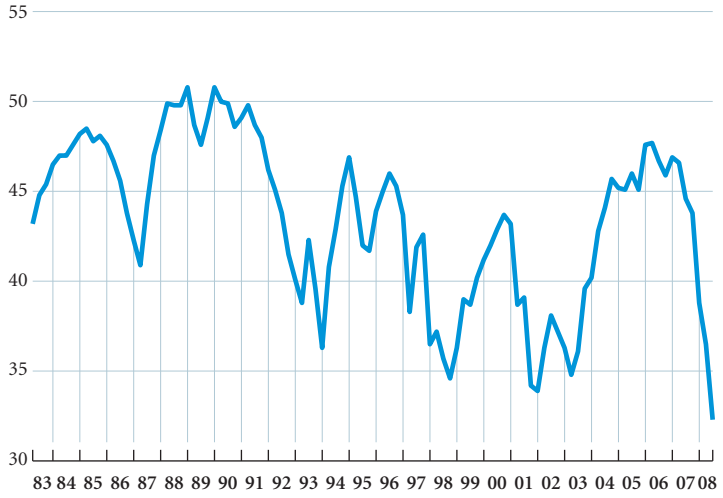
on a more positive note, car sales in the first seven months of the year were up by 2.2% compared with the same period last year. The year 2008 is thus showing a tenuous recovery of the sector following three years of decreases in a row.

On the supply side, in most cases slack is the norm, which justifies the pessimistic turn in the views of the Bank of Japan. Industrial production in June remained unchanged in terms of the same month last year while industrial production of consumer goods dropped all the increase shown in previous months ending up with a rise of 0.7% year-on-year. Publication of the Tankan business activity index prepared by the Bank of Japan for the second quarter ended up making the picture worse. The index for large manufacturing companies was down from 11 points to the 5 points

Consumer confidence reaches all-time lows.

JAPAN: CONSUMER FATALISM GETS WORSE

Consumer confidence index



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

Business sentiment drops again while investment for exports down.

level while the index for large non-manufacturing companies went from 12 points to 10 points thus going to the low levels seen in 2003. Under capital formation, prospects for coming months are bleak because of the drop in machinery orders with exporting companies, practically half of the total, that in recent times have been the main driving force in capital goods investment.

On the inflation front, the end of deflation is not being brought about by a recovery of demand but is coming from outside. Oil and food are the active factors driving the indices. In June, the CPI rose by 2.0% year-on-year, a figure not seen since 1992. The traditionally followed index excluding fresh foods followed suit with a rise of 1.9%. Nevertheless, the underlying index (the general index excluding energy and foods) reported a minor increase of 0.1% year-on-year. In turn, the unemployment rate in June rose to 4.1% of the labour force, a moderate figure that, nevertheless, has shown increases for three consecutive months.

Oil pushes prices up 2.0% and unemployment hits 4.1%.

In the foreign sector, Japan is getting important support and, in view of the reduced demand for imports from the United States, its best hopes continue to lie in Asia which takes half of Japanese exports. The cumulative surplus for the 12 months ending in June dropped to 10,300 billion yen. In June, exports were up by a modest 3.7% year-on-year, well below what used to be the norm because of the slowdown in sales to the rest of Asia, while imports rose by 18.1%. Latest customs figures for July show a recovery of exports going to the rest of Asia, especially China, which should continue if we see further evidence confirming the hypothesis of decoupling, namely the capacity of the East Asian economies to grow in a situation of economic weakness in Europe and the United States.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007			2008				
			2Q	3Q	4Q	1Q	April	May	June	July
Real GDP	2.4	2.0	1.8	1.8	1.4	1.2	–	1.0	–	–
Industrial production	4.2	2.9	2.4	3.1	2.7	2.5	0.7	2.3	0.0	...
Tankan company Index (1)	22.5	22.0	23.0	23.0	19.0	11.0	–	5.0	–	–
Housing construction	4.5	–17.2	–2.8	–36.9	–27.1	–8.9	–8.7	–6.5	–16.7	...
Unemployment rate (2)	4.1	3.9	3.8	3.8	3.8	3.8	4.0	4.0	4.1	...
Consumer prices	0.2	0.1	–0.1	–0.1	0.5	1.0	0.8	1.3	2.0	...
Trade balance (3)	9.4	12.5	11.1	12.3	12.5	11.7	11.2	11.1	10.3	...
3-month interbank interest rate (4)	0.3	0.7	0.7	0.8	0.9	0.8	0.8	0.8	0.9	0.9
Nominal effective exchange rate (5)	81.1	77.1	75.7	76.9	78.4	83.4	83.9	83.0	81.0	80.6

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

Chinese dragon still strong but spitting less inflationary fire

The Chinese economy grew by 10.1% year-on-year in the second quarter. The economic slowdown is thus continuing to take shape. At the same time, inflation, which in the first half year was increasing sharply seems to be moderating in recent months with the CPI showing a rise of 6.3%. Whereas only a few months ago it was evident that the aim to be followed by the government was the fight against inflation, today this is not so clear and this implies a less restrictive monetary policy and possibly a currency that does not continue to appreciate at the rate seen up to now. On the supply side, the secondary sector continues to lead increases with a rise of 11.3% year-on-year, followed by services (up 10.5%), although these increases are revealing the slowdown. In turn, while recovering from a weak first quarter, the farm sector moved ahead slightly to show growth of 3.5%.

Among the most recent activity indicators, industrial production grew by 14.7% year-on-year so that a cooling-off is taking shape if we look at the trend over the current year. By contrast, retail sales in the same period, discounting price increases, continued to rise going to 16.0%. This is an increase to which the more backward rural area seem to have recently joined. All of this shows the upward course still to be followed by Chinese domestic consumption. While a great leap forward has already taken place in cell phones and computers, the process of replacing bicycles with cars is still in the initial stages.

Exports slowing down and hopes centred on Asia.

Chinese economy grows by 10.1% but shows signs of slowdown.

Inflationary problems seem to be gradually easing off. The general CPI of 6.3% year-on-year in July seems moderate compared with the big increase in February when it reached 8.7%. The food component, which in China has special importance as a cost of living indicator, is also moving into more tranquil waters with an increase of

Industrial production grows below 15% but retail consumption keeps on rising and reaches 16%.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008		
			3Q	4Q	1Q	2Q	July
Real GDP	10.7	11.6	11.5	11.2	10.6	10.1	–
Industrial production	16.4	17.1	18.1	17.5	16.5	15.9	14.7
Electrical power production	14.7	15.7	16.3	16.1	16.0	11.9	9.6
Consumer prices	1.5	4.8	6.1	6.6	8.0	7.8	6.3
Trade balance (*)	177.5	261.9	253.6	261.9	256.5	247.9	248.8
3-month interbank interest rate (*)	2.8	3.6	3.5	4.7	4.6	4.6	4.4
Renminbis to dollar	8.0	7.6	7.5	7.4	7.1	6.9	6.8

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

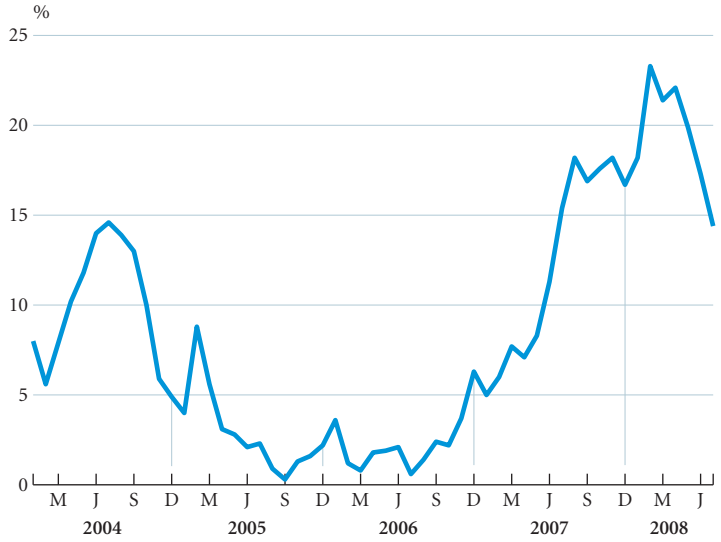
Inflation moderates to 6.3% while foods up by 14.4%.

14.4% year-on-year, well below the 23.3% figure five months earlier.

In the foreign sector, the surplus for the past 12 months ending in July reached 248.8 billion dollars, some 16.6 billion less than the ceiling in January and the bilateral surplus with the United States for the 12 months ending in June was stagnant at around 164 billion dollars. As a result, exports were down very slightly and in the first seven months of 2008 grew by 22.6% compared with the same period last year. This rate was below what has been the norm in a component that represents somewhat more than 30% of the total growth of the economy in nominal terms.

CHINA: RISE IN FOOD PRICES COOLING OFF

Year-on-year change in consumer food price index



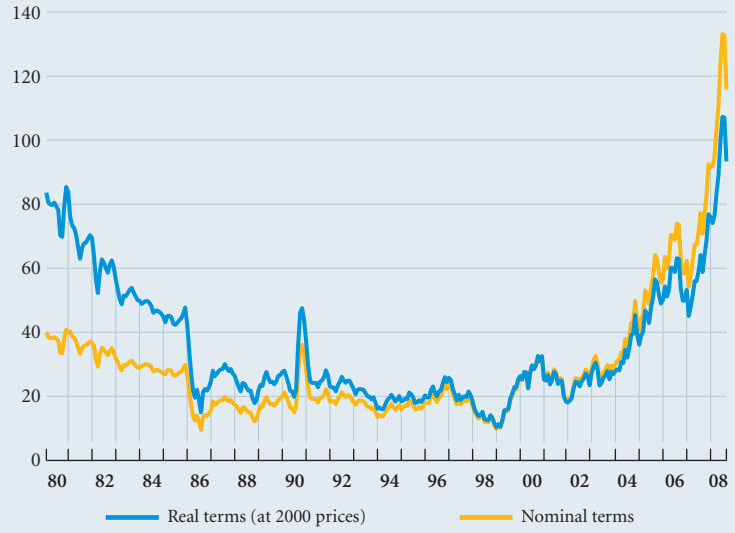
SOURCE: Chinese National Statistics Office, London Market and own calculations.

Oil-thirsty emerging economies

In 2008, the price of oil has reached levels that until very recently could only be imagined in a scenario where the oil supply had suddenly been shut off. However, the big oil tankers have continued to pass normally through Hormuz Strait and even so the price has hit all-time highs both in nominal and real terms (see graph below). No doubt, the depreciation of the dollar and certain characteristics of supply have contributed to the price rise (see box «Few answers from oil supply») and probably part of what we have observed over the past 12 months is no more than a speculative bubble (see box «Oil bubbles»), but a fundamental reason behind the rise in the price of crude oil has been the boost in demand.

OIL PRICES GO TO RECORD LEVELS IN 2008

Brent Oil price (dollars per barrel) (monthly average)

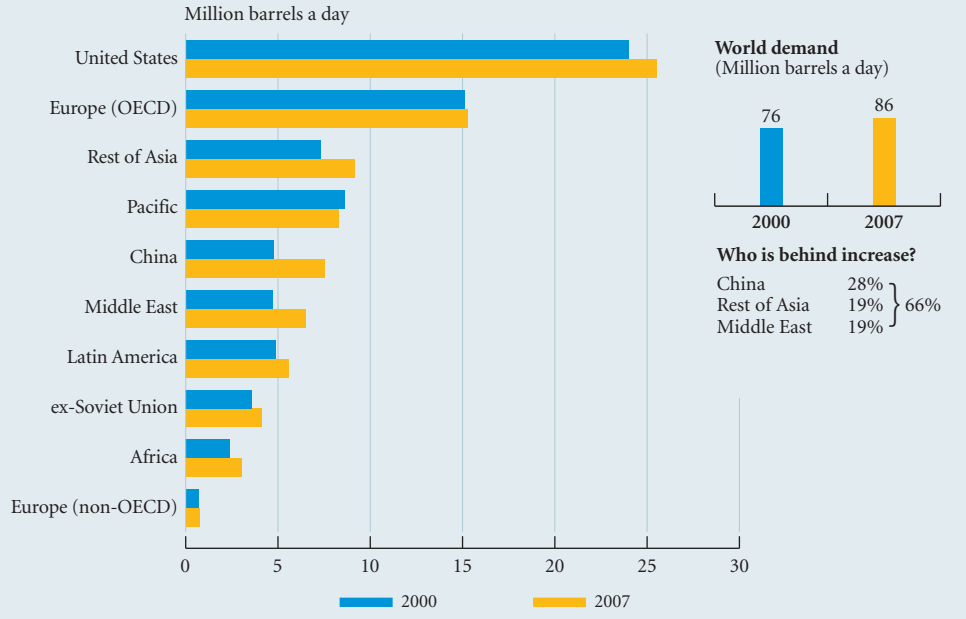


SOURCE: IMF and International Energy Agency (IEA) (figures up to August 12).

The sharp growth of emerging countries, especially China, is the explanation for the big rise in prices most repeated in meetings and opinion articles. But has their demand for oil increased all that much in recent years? The answer is a clear yes. Between 2000 and 2007, world oil demand rose by some 10 million barrels a day (mbd) and China alone was responsible for 28% of that increase with consumption growing to close to 3 mbd. The other Asian countries and the Middle East together account for nearly 40% of the increased demand (see following graph).

In part, demand by many of these countries has held buoyant because subsidized fuel prices have not fully reflected the increased price of crude. The Chinese consumer, for example, pays 53 euro-cents for a litre of petrol which implies a subsidy of around 20%. The growing fiscal cost of these measures, however, has meant that many countries, such as India, Malaysia and Indonesia, have decided to revise upward their regulated fuel prices which should contribute to a reduction in the growth rate of demand.

DRIVE IN EMERGING ECONOMIES BEHIND GOOD PART OF INCREASE IN DEMAND



SOURCE: International Energy Agency.

In any case, oil consumption per capita in the emerging countries is still a long way from the level in the more advanced economies which would suggest that demand still has a strong rise lying ahead. For example, while Spain consumes around 13 barrels of crude per person per year, China consumes little more than 2 barrels. The differences with the United States, where each person consumes an average of 25 barrels a year, are still much greater (see following graph). The expectation that demand of the emerging countries can continue growing sharply for a long time has added to the perception that the price of crude will continue high on a permanent basis. Few analysts foresee that oil will again be priced below 100 dollars a barrel unless there is a sharp world economic downturn that affects the emerging countries. Nevertheless, everyone is aware that uncertainty regarding the long-term trend in demand is quite high, thanks to technological innovations that make it possible to improve energy efficiency. For example, the United States now consumes less than half the oil per unit of GDP it did at the beginning of the Seventies.

In the advanced economies, which still represent 60% of world demand, oil demand seems to have become stagnant since 2006 as a result of the rise in prices and the economic slowdown. As may be expected, the reaction of demand, however, has been slow and, for the moment, not very notable, given that over the short term oil consumption does not greatly respond to an increase in price (demand is very inelastic). Nevertheless, the sharp increase in world sales of lighter vehicles and hybrid cars, the announcement of closing of plants making trucks and SUV, whose sales have collapsed, or the boost in R&D for alternatives to the combustion engine suggest that a change in pattern has already begun in consumer and company decisions aimed at saving oil. The extent of this move, especially in the United States, the world's biggest oil consumer (21 mbd), will be key to the future development of demand.

Another factor, while secondary, that may have affected the oil price over the past year has been the questioning of the policy of subsidies for bio-fuels. Following the sharp increase in cereal prices, many people have protested against these subsidies that tend to reduce the food supply in favour of the energy supply. Such questioning may have increased forecasts for future oil demand and thus the oil price, seeing that part of the demand many were predicting could be met by bio-fuels after all will now have to be met by oil.

CHINA AND INDIA: A LONG UPWARD TREND

NOTES: 2006.
SOURCE: BP, IMF.

Finally, some analysts declare that demand for precautionary inventories, as a result of geopolitical uncertainty, is adding to the pressure of current demand. While it is true that we have not seen an increase in oil inventories, this may simply be a result of the fact that supply has not been able to satisfy this extra demand which, in any case, would have brought about an increase in price.

To sum up, the growing influence of the emerging countries in world oil demand is showing up as a strong factor behind the rise in oil prices. Along with the low elasticity of demand in the industrialized countries and a supply that has not provided a satisfactory response, the price of crude has climbed to levels not before seen. Nevertheless, over the short term the world economic slowdown and improvements in energy efficiency promoted by the high price of oil over the long term could offer some respite in the oil market on the demand side. The drop in oil prices in recent weeks would seem to be the start of such a development.

Exports ease climb while imports still massive.

Imports, on the other hand, continued to increase with growth of 31.1% year-on-year in the first seven months of the year, which shows the strength of domestic demand, something more and more vital for world demand. According to the US consulting firm Global Insight, in 2009 China will replace the United States in first place in world manufacturing production, which implies that Chinese growth is still very strong. China is a giant not without its risks seeing how the Shanghai stock market lost 60% in terms of the highs recorded in September 2007, with the price of housing shooting up and control on the granting of mortgages relatively lax. Nevertheless, there are also strengths, given that Chinese savings are higher than debt and, in the second quarter, total mortgage borrowing was no more than 12% of GDP.

Mexico: slowdown along with higher inflation

Mexico grows by 2.6% with slowdown in investment and consumption.

Publication of the national accounts for the first quarter and revision of the figures for previous years reveal a clear drop in economic activity. The GDP is showing a turnaround in trend moving toward clearly lower growth figures with growth of 2.6% year-on-year in the first quarter, well below the 4.2% seen in the previous period. All components showed a similar trend with private consumption reporting growth of 3.7% year-on-year, the lowest rate since the beginning of 2004, along with a sharp drop in public consumption. Following the revision of figures, investment presents a much lower picture converting what previously was a recovery into a marked slowdown putting growth of fixed capital formation at a slim 2.7% year-on-year.

The foreign sector, which has been the weak point of growth in recent years, also moved down with a sharpening of the slowdown in exports along with relative stability in imports. This is a situation which should be partly corrected in the second quarter taking into consideration the reduction in the trade deficit in recent months. The higher value of oil exports reduced

MEXICO: MAIN ECONOMIC INDICATORS

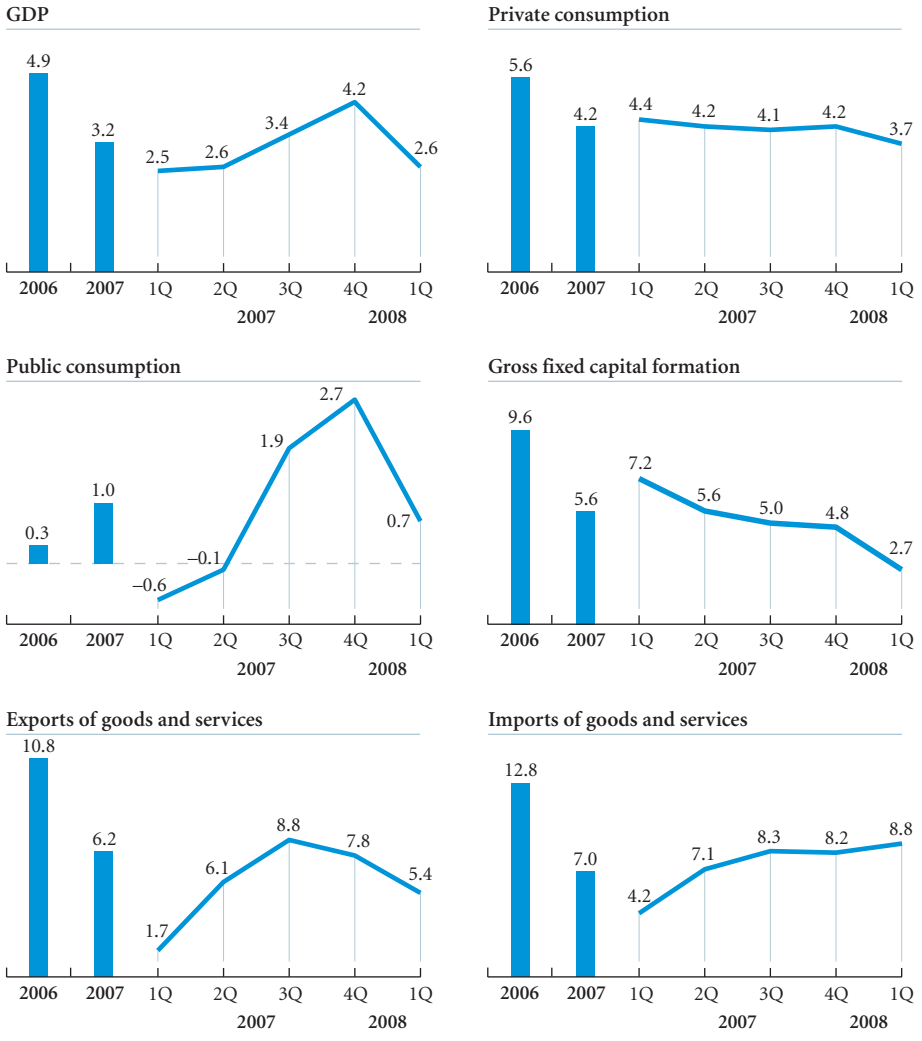
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007			2008				
			2Q	3Q	4Q	1Q	April	May	June	July
Real GDP	4.9	3.2	2.6	3.4	4.2	2.6	–	...	–	–
Industrial production	5.4	1.9	0.9	1.9	3.1	0.9	5.7	–1.2	...	...
General unemployment rate (*)	3.6	3.7	3.4	3.9	3.6	3.9	3.6	3.2	3.6	...
Consumer prices	3.6	4.0	4.0	4.0	3.8	3.9	4.5	4.9	5.3	5.4
Trade balance (**)	–6.1	–10.1	–11.5	–11.2	–10.1	–9.3	–9.6	–8.9	–7.8	...
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	10.8	11.0	10.8	10.7	10.5	10.3	10.3	10.0

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

TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-on-year change in real terms



SOURCE: Central Bank of Mexico and own calculations.

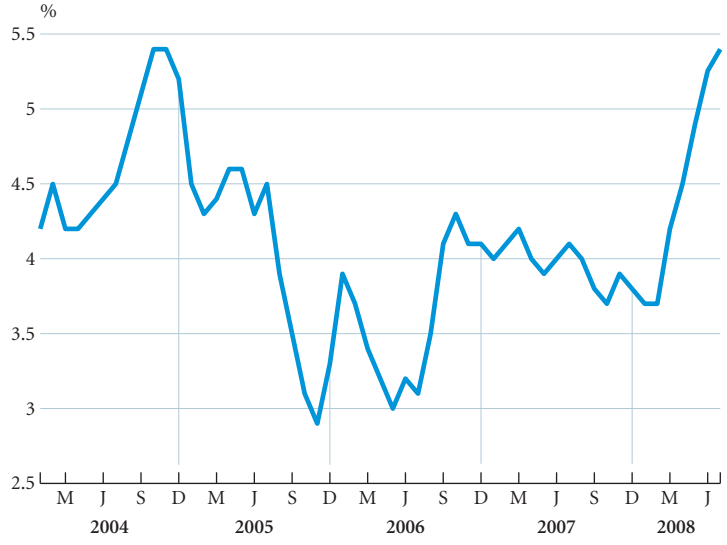
the trade deficit in the first six months of 2008 to 2.52 billion dollars, 47% below the figure for the same period last year. The problem lies in the difficulty of maintaining this correction given that the deficit in the trade balance, excluding oil exports, continues to grow, showing an increase of 30% year-on-year in the first half-year.

In the most recent economic activity indicators, downward prospects continue to dominate, which shows the influence of the weakness in its neighbour to the North. On the supply side, general industrial production was down by 1.2% year-on-year in May while the figure for manufactures slowed sharply going from growth of 9.8% to

Oil exports hold up foreign sector still on a slide.

MEXICO: INFLATION MORE AND MORE THREATENING

Year-on-year change in CPI



SOURCE: Central Bank of Mexico and own calculations.

Industrial production down and retail sales slowing.

1.2%. On the demand side, retail sales in the same month also lost strength, going from growth of 7.3% to a more modest 3.3% year-on-year.

Inflation hits 5.4% in spite of slowdown but unemployment remains under 4%.

On the inflation front, the increase in prices in just a few months changed from a gentle moderation to a serious threat to macroeconomic stability. The general CPI moved up in June with growth of 5.4% year-on-year while the underlying CPI (the general rate excluding energy and food) rose to 5.1% year-on-year. On top of the effects of higher cost materials came the increase in unit labour costs which rose again in May to record increases of 7.6% year-on-year. In turn, the general unemployment rate rose to the relatively low figure of 3.6% of the labour force.

Oil goes above 145 dollars a barrel but later shows sharp correction.

Oil: ups and downs

The price of oil continues to be locked into a stage of high volatility which has meant that in one month it has recorded an all-time high to later show a drop of 40 dollars a barrel. On July 11, one-month forward Brent oil was priced at 146 dollars a barrel, an all-time high. During the following four weeks oil dropped to 110 dollars a barrel. The monthly drop between July 15 and August 15 was close to 30%, the biggest percentage downward move recorded since the Gulf War in 1991. Starting out from these values around 110 dollars there has been some rise which has put the price at around 115 dollars a barrel.

What has been behind such a sharp and rapid up and down move? While the

OIL PRICE HITS CEILING THEN SHOWS DOWNWARD CORRECTION

One-month forward per barrel price of Brent quality oil

SOURCE: Thomson Financial Datastream.

various factors underlying this trend are quite varied there seems to be some consensus that the upward episode that began in February 2008 was largely due to the entry of short-term capital that, in a context of global financial crisis, was seeking assets with fast revaluation potential.

These funds seem to have been withdrawn from the market when prices reached levels that market operators themselves felt were excessive and alternative investments (particularly the stock markets and the dollar) offered some improvement in returns. This change took place in the early weeks of July when there arose the perception that, if oil were to stay at around 150 dollars a barrel, the price of oil would cause a downward adjustment in demand.

Other commodities have followed a similar course to oil, thus reinforcing the hypothesis that the essential factor dominating in these markets in recent months is primarily of a financial nature. The biggest correction in prices took place in metals which overall dropped more than 10% in August. Of special note was the drop in precious metals (platinum, silver and gold) and some industrial metals such as aluminium and copper. In all these cases the drop has been of two digits. There was also an appreciable adjustment in agricultural food commodities which, as a group, dropped by 9% in August. Maize and soy beans have been the big players because of the sharp drop in prices, more than 20% in the first case and 16% in the latter.

Sharpness of price change suggests predominance of financial factors as key determinant.

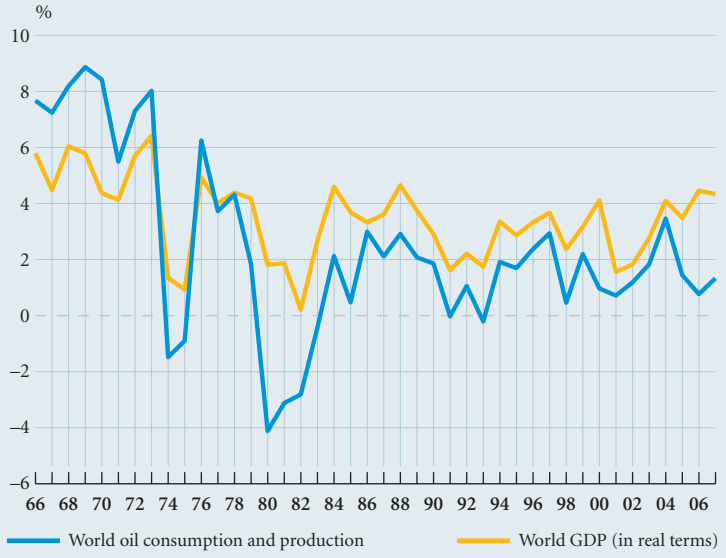
Other commodities copy drop in oil price although dip not as sharp.

Few answers from oil supply

In view of the rise in oil demand, the reaction on the supply side has become a crucial factor in either easing or increasing upward pressure on the oil price. A supply that had been able to respond rapidly to the growth of demand would have significantly eased the price rise but the quite rigid reaction we have seen has done no more than exacerbate pressures coming from the demand side. Reasons of a structural kind have joined together with others of a geopolitical type to bring this about.

DEMAND PUTS ON PRESSURE WHILE SUPPLY REMAINS RIGID

Annual growth rate



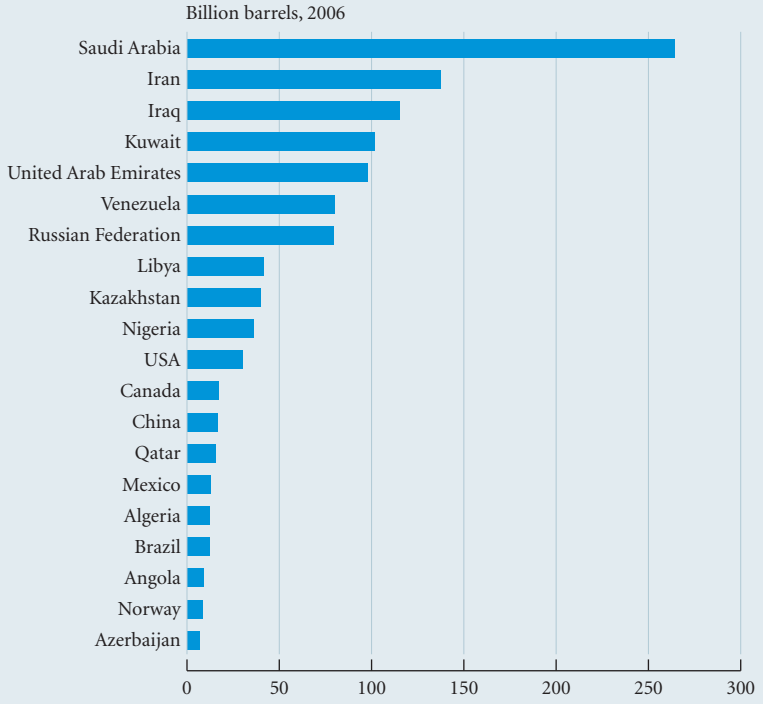
SOURCE: BP and World Bank.

One fundamental characteristic of oil is that, over the short term, supply is relatively inelastic so that increasing production capacity is a long and costly process. Firstly, it requires a considerable initial investment in exploration of the area where the precious mineral is expected to be found. Once its presence is confirmed it takes between 5 and 10 years on average to begin exploiting a field.

Another peculiarity of oil supply is its high concentration in just a few countries. To be specific, more than 30% of all oil comes from the Middle East with Saudi Arabia being the main world producer with 13% of all production. If we consider all proven reserves in the world, the preponderance of this region, which controls 63% of total oil reserves, becomes clearer.

This heavy concentration of supply has two consequences that can have an effect on price. First, geopolitical instability in some of the producer countries may easily destabilize world oil supply. Lately, there are no lack of

OIL RESERVES AND THE SUPREMACY OF THE MIDDLE EAST



SOURCE: BP.

examples:the constant conflicts in the Niger delta between ethnic minorities and the foreign oil companies, which have reduced the flow of crude from Nigeria by up to 40%; the nuclear energy tensions in Iran and its confrontation with Israel, which could put Iranian production in danger as well as shipments through Hormuz Strait; the violent situation in Iraq; or the legal risks for foreign companies in Venezuela, Russia and other countries. While it may seem that these days the extent of the geopolitical problems is not as big as in past oil crises, some analysts such as Daniel Yergin of the specialist consulting firm Cambridge Energy Research Associates (CERA) argue that the accumulation of various hot-spots with geopolitical tensions can bring about major disruptions in overall supply. It is enough to show that the total oil production of the countries mentioned above is higher than the production of Saudi Arabia.

Secondly, the concentration of reserves makes it easier for the producer countries to coordinate moves to vary world supply and thus change prices. This type of move, in particular, the reduction of supply or limitation of any increase, was seen by many as the main factor responsible for the price rises in the Seventies. Nevertheless, today most of the producer countries (with the exception of Saudi Arabia) are producing at full capacity levels (see following table), which would indicate that collusion between these countries to restrict supply was not what set off the rise in prices.

What is more, the ageing of existing oil fields along with the difficult access of many new discoveries increases the final oil price as it limits supply and raises production costs. The image of James Dean in «Giant» completely covered in crude and jumping for joy beside a big oil spout that comes gushing out without any

EXTRACTING AT FULL CAPACITY

	Production	Estimated capacity	Capacity in use (%)
Saudi Arabia	9,530	10,800	88%
Iran	3,850	4,100	94%
Kuwait	2,585	2,600	99%
United Arab Emirates	2,650	2,650	100%
Venezuela	2,340	2,500	94%
Libya	1,735	1,750	99%
Total OPEC – 13	**32,520**	**34,780**	**94%**

NOTES: Figures in thousand barrels a day, June 2008.
SOURCE: Bloomberg.

effort is far from the reality of the oil extraction process. Nowadays, it is more and more necessary to use costly sophisticated methods to extract the much-wanted commodity from the bowels of the earth. In areas such as the Middle East it is still common to find oilfields where extraction is by natural lift, that is to say, where it is not necessary to use gases, flooding with water or other methods. Nevertheless, in areas such as the United States, Northern Europe and the Gulf of Mexico artificial lift techniques are absolutely necessary.

With regard to new discoveries, most of these are deepwater fields (such as the Carioca field in Brazil or those located in the Gulf of Mexico) and thus require drilling of up to 3,000 metres below the sea. This makes exploration and exploitation of new fields more difficult and more expensive.

To the increased cost arising from the ageing of fields and new discoveries we must add that the costs of developing a new field have doubled in the past four years, according to CERA, especially in the case of deepwater fields where the cost of renting a deep-sea drilling ship has gone up five times in the same period. The very low prices for oil in the Eighties and Nineties lie behind this increase in costs. The situation of low prices led producers to do less exploration and, as a result, very few engineers and specialized personnel were trained and there was little investment in research into new equipment. It is clear that the lack of investment, oil specialists and equipment over so many years is now having its effect.

Another factor adding pressure on the supply is the increase in royalties and taxes on the oil companies in some countries, such as Algeria and Venezuela, as high as 90% of production. This tax load and the risk of further increases reduces the profitability of new exploration and thus weakens the incentive to carry it out.

The large number of state-run companies in the oil sector is a notable characteristic which may be also affecting productivity in the industry and in turn the supply. Some of these companies tend to be more concerned about the transfer of funds to the State budget over the short term than in maximizing revenues over the long term, which would require more investment in exploration and research.

Finally, fear that supply may hit a ceiling (which some analysts put at 120 million barrels a day around 2020-2030) may also be affecting prices (the peak oil theory). Nevertheless, this theory may undervalue some of the

possible technological improvements that in the future may make it possible to access fields now out of reach because of their remote location.

To sum up, on top of the relative lack of elasticity in the short-term oil supply we must add other factors that have limited growth of supply in recent years, such as geopolitical instability, the ageing of existing wells and increases in production costs. Faced with constantly increasing demand, supply that has not been able to maintain the same growth rate has irrevocably turned into a rise in prices. All of this has happened without a major conflict in the Middle East that would have restricted supply, a risk we cannot ignore.

EUROPEAN UNION

Euro Area: is it heading into recession?

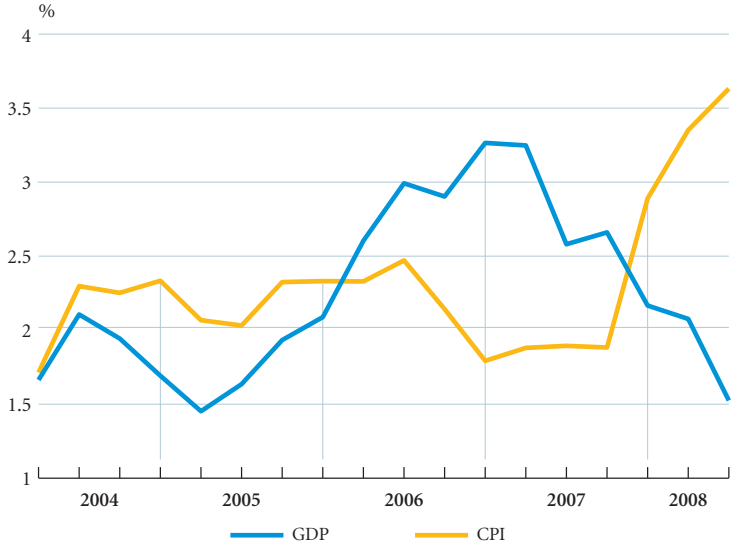
Euro Area GDP down in second quarter...

The Euro Area economy was down by 0.2% in the last quarter, according to Eurostat. Does this mean the Euro Area is heading into the first recession in its short history? To dig deeper into this possibility it would be useful to begin from latest available figures. And while this is the latest trend, the background picture is just as negative, as may be seen from the slowdown of the economy to 1.5% year-on-year. While this was partly a matter of compensation for the sharp increase in the first quarter (0.7% quarter-on-quarter; 2.1% year-on-year), from the trend in both demand components and by country, we may draw some troubling conclusions.

Let us begin with the trend by country. The most recent figures indicate that Germany, France and Italy, the three big economies of the Euro Area, recorded decreases in gross domestic product (GDP) in the second quarter. Furthermore, in the other countries of the single currency area for which we have figures for the second quarter (the Netherlands and Spain) quarter-on-quarter growth has been nil or only marginally positive. An initial idea to keep in mind, therefore, is that the slowdown is spreading over many countries, some of which make up the hard economic core of Europe.

EURO AREA BATTLING ON TWO FRONTS: STAGNATION AND INFLATION

Year-on-year change rate



SOURCE: Eurostat.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	2.9	2.7	2.7	2.2	2.1	1.5	–	1.5	–	–
Retail sales	1.6	0.9	1.3	–0.3	–0.2	–1.5	–1.8	0.3	–3.1	…
Consumer confidence (*)	–9.1	–4.9	–3.9	–7.7	–11.9	–14.6	–12.4	–14.6	–16.7	–19.7
Industrial production	4.0	3.4	3.9	3.0	2.5	0.9	4.0	–0.5	–0.8	…
Economic sentiment indicator (*)	106.3	108.4	108.7	104.3	100.5	96.5	97.1	97.6	94.8	89.5
Unemployment rate (**)	8.3	7.4	7.4	7.3	7.2	7.3	7.2	7.3	7.3	…
Consumer prices	2.2	2.1	1.9	2.9	3.4	3.6	3.3	3.7	4.0	4.0
Trade balance (***)	–10.4	20.1	31.4	34.3	23.4	11.4	18.0	12.1	4.0	…
3-month Euribor interest rate	3.1	4.3	4.5	4.7	4.5	4.9	4.7	4.9	4.9	5.0
Nominal effective euro exchange rate	103.6	107.7	107.7	110.6	112.8	115.6	116.0	115.5	115.4	115.8

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

The trend in demand is not helping to calm pessimism. In spite of not having a breakdown of components of national accounting for the second quarter, indicators suggest where the European economy is floundering. One key area with loss of economic activity is domestic demand. While the trend in private consumption has been relatively contained up to now, latest figures indicate a significant worsening. To cite a representative indicator, retail sales dropped by 3.1% year-on-year in July. The decrease in consumer confidence and the lack of progress in reducing the unemployment rate (stuck at 7.3% in May and June) suggest that the trend ahead will be for increased weakness in household spending. On top of this worse situation comes the drop in the rate of investment demand, a component that has held up well until now.

Foreign demand is showing a similar profile. For a long time this has acted as a bulwark of growth but now it has begun to weaken. In June, the trade surplus as a balance for 12 months was a bare 4 billion euros, a notable decrease compared with the 12.1 billion euros in May. The situation of cyclical weakness is also reflected in the latest supply indicators. Industrial production in June was down 0.8% year-on-year, far from the increases of 4.0% year-on-year recorded only two months earlier.

...due to decreases in Germany, France and Italy.

The figures for economic activity in the second quarter show a troubling downturn which has caused alarm and raised doubts about whether it will be possible to avoid a recession. While forecasts suggest that quarter-to-quarter growth will likely again be positive in the third quarter, it will show such low growth that the perception of a recession will be around for some time, especially if we remember that the loss of economic activity is being accompanied by a high-intensity inflationary episode.

Indicators for supply and demand remain weak.

Inflation holds at 4%.

Latest figures for the harmonized consumer price index (HCPI) indicate that this is holding at 4% year-on-year in the Euro Area (July at 4%; August at 3.8%). This is a high level that is practically twice the inflation objective of the European Central Bank. As in earlier months, the problem continues to be due to the complicated combination of high-cost energy and foods on the rise. The general economic situation is therefore complex given that trying to both halt inflation and sustain economic activity is usually a balance difficult to bring about.

German economy down 0.5% in second quarter.

Germany: a leaking ship in second quarter

In the second quarter the German economy reported a drop of 0.5% in GDP, compared with the first three months of 2008. While the first quarter had indeed been exceptionally good, the drop has been sharp. In year-on-year terms, a measurement that comes close to the background trend in the economy, Germany went down to growth of 1.7%, far from the 2.6% in the previous quarter. Where shall we find the key to explain this drop in economic activity? The worse situation is to be seen in both domestic and foreign demand. By demand component, we should underline the year-on-year slowdown in private consumption and investment which is not compensated by the increase in public consumption. In turn, the foreign sector reduced its positive contribution to the change in GDP.

Notable adjustment in industrial activity.

Latest figures available, far from raising hopes, tend to confirm that the tendencies to worsen are increasing as the year draws on. The trend in demand confirms that at the domestic level private consumption and investment are still very low. Behind this adjustment lie various fundamental factors (such as the fact that the unemployment rate seems to have hit bottom at 7.8% in June and July) and a drop in expectations. In this respect, the announcement by Finance Minister Peer Steinbrück that the government was reconsidering the income tax reduction to be applied in 2010 has been no help. Nor is foreign demand playing the support role it has been showing for several quarters.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	3.2	2.6	2.4	1.7	2.6	1.7	–	1.7	–	–
Retail sales	6.1	–7.6	–7.5	–8.8	–0.8	–0.7	0.9	1.0	–3.9	…
Industrial production	6.0	5.9	5.7	5.0	5.0	2.6	5.2	1.2	1.6	…
Industrial activity index (IFO) (*)	105.5	106.2	105.6	103.7	104.0	102.3	102.3	103.4	101.2	97.5
Unemployment rate (**)	10.7	9.0	8.9	8.5	8.0	7.9	7.9	7.9	7.8	7.8
Consumer prices	1.6	2.3	2.3	3.1	2.9	3.0	2.5	3.0	3.3	3.3
Trade balance (***)	151.5	183.5	192.0	198.1	201.1	202.2	203.2	200.4	203.0	…

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

Perhaps were we can most clearly note the speed with which the economic cycle has turned around and moved onto a downward path is on the supply side. After enjoying an exceptional growth stage, the factory of Europe is losing steam. Industrial production grew by a poor 1.6% year-on-year in June, far from the 5.2% in April. In this context, with demand expected to be downward, it is not surprising that the IFO indicator for business activity has dropped by more than 8 points in only three months, from June to August. The secondary sector is not the only one to suffer. Confidence in services and construction indicators show that these two sectors are also reporting a substantial drop in rate of economic activity.

In this context, inflation comes as the last straw. With the CPI at 3.3% in June and July, a figure 1.2 percentage points higher than one year ago, consumers are seeing their purchasing power being undermined. With producer prices growing by 10% year-on-year in July, companies see their ability to compete internationally at threat. In view of this sheaf of poor economic figures, which are even more perplexing because of their rapid development, the Bundesbank has tried to clarify the future course of the economy. To begin with, it does not expect the third quarter to be satisfactory in terms of growth. As against this bad news, that confirms what most analysts are expecting, there is some hope on the prices front. According to the German central bank, the worst episode of inflation may already have shown up. While it does not expect an early reduction of price pressures, it feels that the upward trend will be stopped in coming months.

Bundesbank expecting downturn to continue but less positive on prices.

France: worse than expected

Contrary to expectations, France shows negative growth in second quarter.

If the first quarter represented some relief with better than expected growth, in the second three months of the year the tables have turned. Whereas a slight positive growth was expected, the figures have shown an unexpected drop in GDP, specifically 0.3% quarter-on-quarter. In year-on-year terms, the growth rate of the economy was reduced to practically half going from 2% in the first quarter to 1.1% in the second. By component, we should point out that the recession has cut private consumption and investment while public consumption has shown some slight growth in the second quarter. Foreign demand, in

Household spending losing steam.

FRANCE: MAIN ECONOMIC INDICATORS

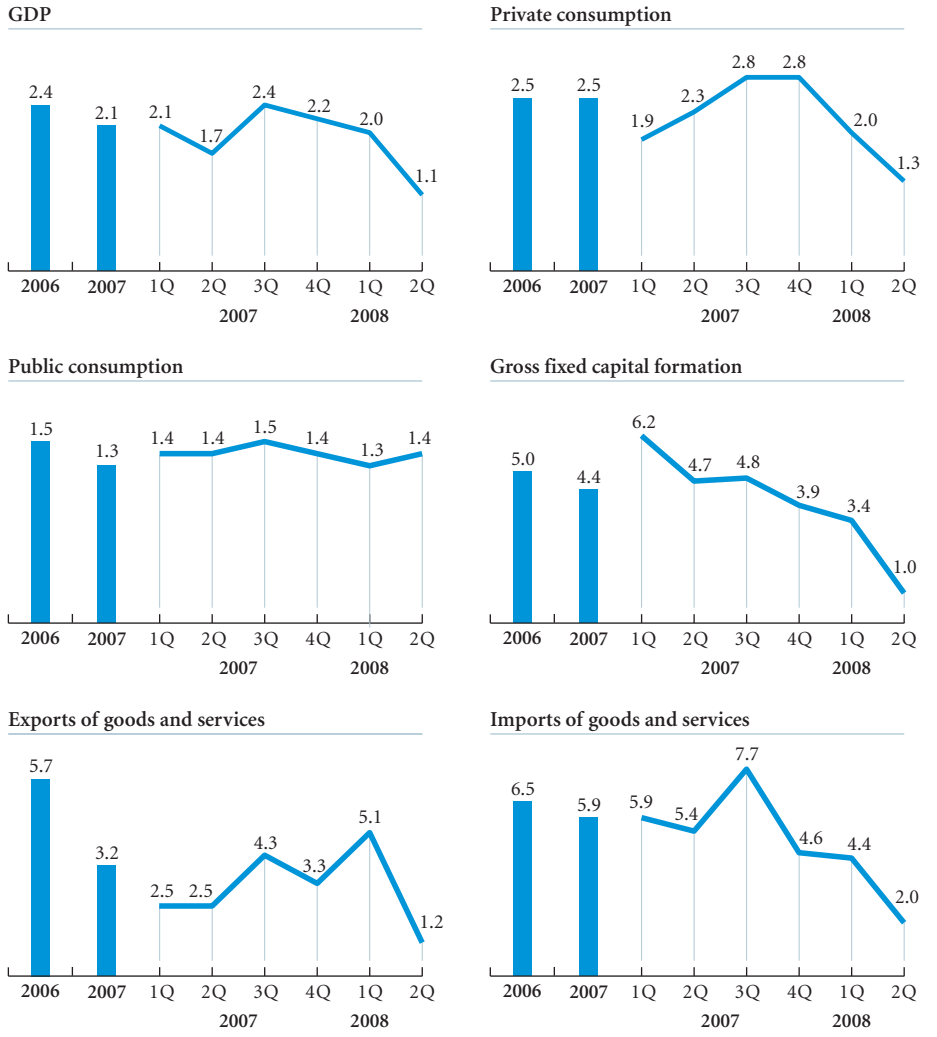
Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	2.4	2.1	2.4	2.2	2.0	1.1	–	1.1	–	–
Domestic consumption	3.3	4.4	4.9	3.7	2.3	1.3	0.2	2.8	1.0	…
Industrial production	1.0	1.3	1.9	2.2	1.6	–0.2	2.9	–1.8	–1.6	…
Unemployment rate (*)	9.2	8.3	8.1	7.9	7.6	7.5	7.5	7.5	7.5	…
Consumer prices	1.7	1.5	1.3	2.3	2.9	3.3	3.0	3.3	3.6	3.6
Trade balance (**)	–27.0	–32.3	–32.9	–37.3	–40.7	–45.3	–43.1	–45.4	–47.5	…

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

TREND IN FRANCE'S GDP BY COMPONENT

Percentage year-on-year change



SOURCE: INSEE and own calculations.

Prime minister Fillon calls for anti-recession measures coordinated at EU level.

turn, cut three decimals from the change in GDP due to the big drop in exports.

Latest available indicators confirm the trend to worsening of the economy. To mention only the most significant indicators, on the demand side the slowdown in retail sales (1.0% year-on-year in June, far from the 2.8% in May) and the decrease in consumer confidence of more than 10 points between May and July confirm the lack of drive in this sphere. At the same time, the year-on-year drop in industrial production (1.6% in June) reinforces the view of an economy well on a downward course. Inflation, which was up 3.6% year-on-year in July, and unemployment that held without change in June (7.5% of the labour force), round out a scenario that is not too optimistic.

In this situation, the French government called a special meeting of the six ministers responsible for the government's economic policy in August. Following this meeting, prime minister François Fillon made a call for coordinated moves at the European Union level to deal with the recession while stating that this package of measures would be given priority in the present period when France was presiding over the European Union. In contrast to the focus being given in Spain, Fillon discounted that France would opt for increasing public consumption as the core of its anti-recession measures. The announcement by the Bank of France that it expected third-quarter growth to again be positive, riding out the much-feared recession, has been a voice of hope in a landscape marked by sombre prospects.

Italy: further drop in economic activity

Italy has now had a run of three quarters with the economy in serious difficulties. Following the drop in GDP in the fourth quarter of 2007 (–0.4% quarter-on-quarter), the increase in the first three months of 2008 (0.5%) was not continued in the second quarter, a period when the GDP dropped by 0.3%. This implies that in terms of the second quarter of 2007 the economy has not grown.

Second drop in Italy's GDP in last 3 quarters.

Far from being a temporary problem, Italy's hobbling economic situation is a chronic one, given that, if the most likely predictions are confirmed, within a few months Italy will suffer its fourth recession in the past 10 years. Certainly, the latest figures confirm that it is going to be difficult for Italy not to show two consecutive quarters with a drop in growth. There will likely be sharp decreases in car registrations up to July, industrial production at levels 2.1% below those of last June and a rising unemployment rate in the first quarter.

Consumption weak while unemployment increasing.

The situation in prices demands special mention. In spite of the slack in domestic demand, in July the CPI stood at 4.1% year-on-year, the worst figure since June 1996. Producer prices were also going up reporting a figure above 8% year-on-year in June. In both cases, after riding out the first four months of the year relatively stable, inflation trends have since arisen.

Substantial rise in inflation.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	1.9	1.4	1.6	0.2	0.3	0.0	–	0.0	–	–
Retail sales	1.2	0.5	0.2	0.5	0.9	…	–2.3	0.5	…	…
Industrial production	2.4	0.0	0.8	–3.0	–1.3	–1.6	–0.2	–2.4	–2.1	…
Unemployment rate (*)	6.8	6.1	6.2	6.2	6.5	…	–	…	–	–
Consumer prices	2.1	1.8	1.6	2.4	3.1	3.6	3.3	3.6	3.8	4.1
Trade balance (**)	–17.6	–13.7	–11.3	–8.9	–9.1	…	–8.6	–7.9	…	…

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

United Kingdom reports nil growth in second quarter...

...due to slowdown in private consumption.

Poor situation in real estate sector and financial difficulties drag down economic possibilities.

United Kingdom: former strengths and present weaknesses

In recent years, the United Kingdom has enjoyed an economic boom considerably higher than the large economies on the European Continent. This period has now ended. What had been major forces behind the UK's strength (consumption, the real estate sector and financial globalization) are now dragging down Britain's economic potential. As opposed to the constantly reluctant consumers on the Continent, British families had shown themselves to be easy-spending shoppers. Latest figures for national accounting show that this is no longer so. Nil quarter-on-quarter growth in the second quarter was largely due to the poor performance in consumption.

If we take a longer view, we may point out that in that quarter there was a year-on-year increase of 1.4% (2.3% in the first quarter). Also over this time-frame the slowdown was largely due to a drop in private consumption. Certainly, the decrease in investment and private consumption contributed to the adjustment, along with a lower contribution from the foreign sector, but the bulk of this decrease fell to households. Increased unemployment in July and year-on-year inflation of 4.4% that month represent two key burdens causing the consumer to change the recent trend.

A second engine of growth in difficulties is the construction and real estate field, especially the housing sector. While neither industry nor services are in great shape either, the poor situation in construction and factors linked to this, such as the negative trend in real estate prices, is putting the brakes on the British economy. Finally, a third long-lived support, the beneficial role of the very much globalized British financial sector, with the City in a dominant world position, has fallen victim of the global financial crisis. There is nothing to stop the British economy from re-emerging over the medium term (indeed it is one of the most flexible in the European Union), but over the short term the prediction of the British Chamber of Commerce (recession within one year) seems the most likely.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	2.9	3.1	3.1	2.8	2.3	1.4	–	1.4	–	–
Retail sales	3.1	4.4	5.0	3.8	5.4	4.6	3.6	8.1	2.1	2.0
Industrial production	0.3	0.3	0.1	0.7	0.4	–1.1	0.0	–1.7	–1.6	...
Unemployment rate (*)	2.9	2.7	2.6	2.5	2.5	2.6	2.5	2.6	2.6	2.7
Consumer prices	2.3	2.3	1.8	2.1	2.4	3.3	3.0	3.3	3.8	4.4
Trade balance (**)	–74.1	–82.9	–84.0	–88.4	–90.9	–92.4	–91.8	–92.3	–93.0	...
3-month Libor interest rate	4.6	5.3	6.0	6.3	6.0	6.0	6.0	5.8	5.9	5.9
Nominal effective pound exchange rate	98.0	103.9	104.3	102.2	97.6	92.6	92.6	93.1	92.2	92.8

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

FINANCIAL MARKETS

Monetary and capital markets

Economic scene worsens for central banks

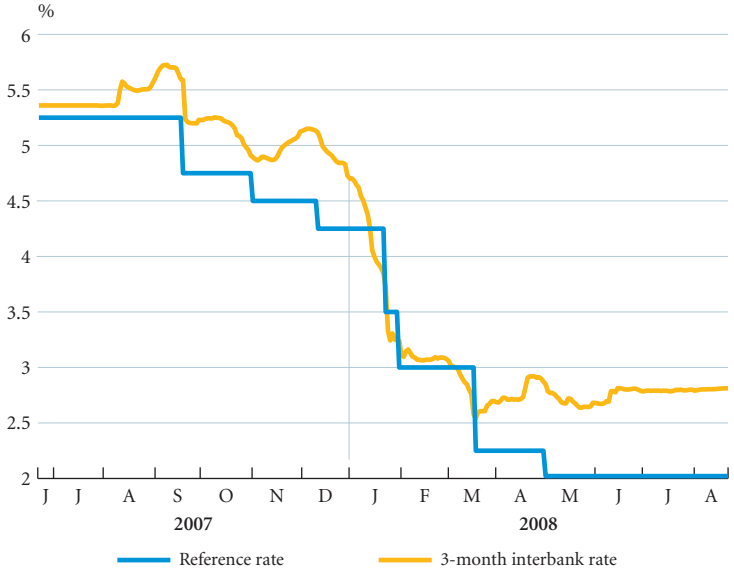
The subprime mortgage financial crisis has now been with us one year after it began in the summer of 2007. At first, the increase in mortgage default affected the valuation of bonds that were backed by subprime mortgages. Later on, the banks had to make substantial allocations to provisions in order to cover possible losses. The lack of transparency regarding who held these assets and their value brought about a crisis of confidence in the international financial system.

In view of the uncertainty, the banks decided to restrict the volume of funds they would lend in the interbank market. This restriction of liquidity is still operative in the interbank market in the United States, for example, as may be seen in the following graph. The differential between the 3-month interbank market interest rate and the central bank reference rate is well above the historic average before the start of the crisis of 12 basis points (100 basis points is 1%). A number of banks that depended on this source of funding had to be intervened in order to avoid their failure. Among these were Northern Rock in the United Kingdom and the fifth largest investment bank in the United States (Bear Stearns). That is to say, the crisis of confidence became a crisis of solvency.

Subprime mortgage crisis now one year old with no sign of improving.

LIQUIDITY PRESSURES IN THE US INTERBANK MARKET

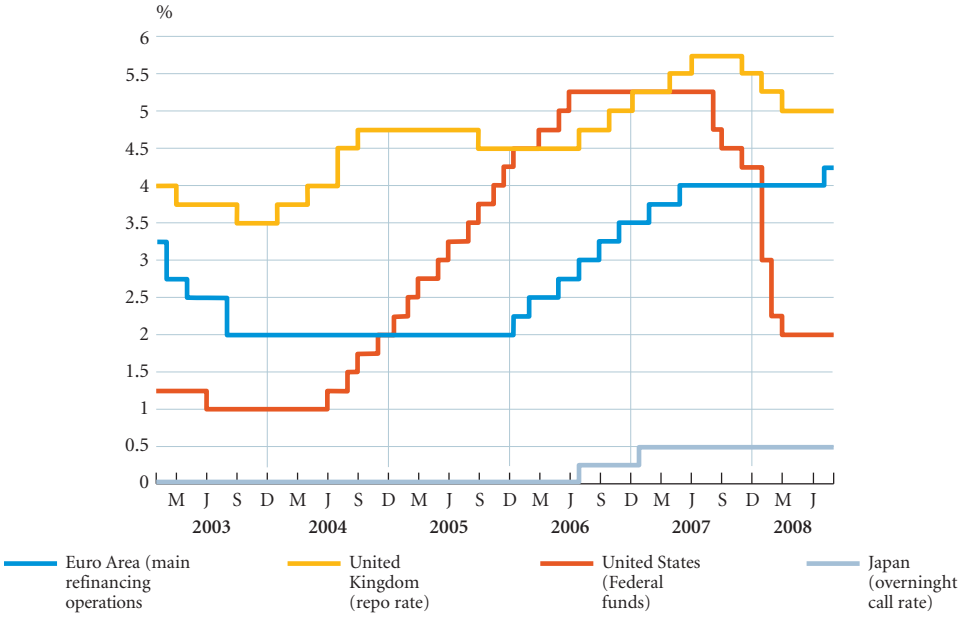
Reference rates and the 3-month interbank market



SOURCE: Bloomberg.

EUROPEAN CENTRAL BANK RAISES INTEREST RATE IN JULY

Central bank reference rates



SOURCE: Central banks.

Credit restrictions begin to have impact on households and companies.

Now, the impact of the restrictions on credit are being felt by households and companies that are cutting consumption and investment. What had begun as a local financial crisis and, due to financial globalization, turned into a crisis in the international financial system, is now affecting the real economy. This has meant consolidation of prospects of a world economic slowdown.

This situation makes the work of the central banks more difficult given that the lower economic growth foreseen is being added onto the shock in commodity prices for food and oil which has brought about a rise in price indices around the world. This is the worst combination for the institutions that decide on monetary policy because they find themselves up against a wall. On the one hand, they must raise the official interest rate to control inflation and, on the other hand, tightening monetary policy does not make sense when an economy is slowing down.

Division of opinion among members of Bank of England monetary policy committee.

This is what happened at the Bank of England at the latest monetary policy meeting on August 7. Out of its six members, one voted in favour of an immediate rise in the reference rate in order to control the risk of inflation while another voted for a cut following the reduction in growth forecasts by the central bank itself. The others voted in favour of maintaining the current level of 5%. This is an atypical situation as it is not normal for them to vote on three possibilities with regard to possible changes in the official interest rate. This difference of opinions reflects the high level of uncertainty about the future course of the British economy.

In the Euro Area, the European Central Bank (ECB) carried out its warning at its meeting on July 3 by raising the official

interest rate from 4% to 4.25%. In its press release issued following the meeting of the governing council, the ECB gave an indication that there was a possibility of again raising the interest rate around September.

At the meeting on August 7, however, at the usual press conference, ECB chairman Jean-Claude Trichet put more emphasis on the economic slowdown in the Euro Area. The markets took it that the central bank was not going to make a further increase in interest rates this year. Trichet stated that at the September meeting he would make public the new ECB forecasts on growth and inflation but emphasized that some of the risks for lower growth the ECB had identified in June and July had materialized. Furthermore, he indicated that at this time the central bank had no clear direction for the reference rate over coming months.

If we take into account that up until now the ECB's communications policy has been to prepare the markets before any change in the official rate, it seems most unlikely that there will be any change in the Euro Area reference rate in coming months. In any case, it will depend on the economic figures that become available. Furthermore, the forecasts prepared by its research department will be of fundamental importance at the next meeting of the ECB on September 4.

Nor does the Bank of Japan see things clearly and at its meeting on August 19 it decided to maintain its interest rate at 0.5%. Also at that meeting it took the opportunity to lower its evaluation of Japan's economic prospects. The growth of commodity prices, the instability brought about by the financial crisis and the economic slowdown in the United States were factors mentioned in terming economic growth as «weak». One of the most important factors in coming to this conclusion was the sharp slowdown in Japan's exports in June, the latest figure available, with the sharpest drop since 2001.

ECB deflates prospects of further rise in official interest rate.

Nevertheless, the Japanese central bank warned that if the risk of economic slowdown decreased it would raise the reference rate due to the fact that, as it was abnormally low it fostered the creation of financial bubbles. Although the central bank would like to raise the official rate, it is likely that it will not have an opportunity to do so this year seeing that inflation is only 1.8%. And there is no sign of a troubling price-wage spiral whereas, on the contrary, the risk of an economic slowdown is high.

Bank of Japan and Fed also have doubts about economic growth.

In the United States, the Federal Reserve has its doubts about the next steps to take in monetary policy decisions. At its last meeting in August 4, one member voted in favour of an immediate rise whereas the others chose to maintain the official interest rate at 2%. In the press release issued after the meeting, they reached the same conclusion as the other more important central banks around the world. That is to say, there are upward risks in prices and downward risks in growth. Its next meeting on September 16 is awaited with great expectation to see if the Fed maintains its position or goes for a more agressive role after publication of producer price indices for which the underlying index is growing at a year-on-year rate of 10.2%, the highest in the past 27 years. These prices also also warn of the risk that these could end up with a pass-through of a bigger increase in consumer prices.

On other hand, trend in emerging economies is rather to raise interest rates.

Nevertheless, apart from the central banks mentioned, the other central banks

Problems of liquidity in interbank market continue...

are aware that the main problem is inflation and they have begun to raise official interest rates as is the case, for example, of the central banks of Bulgaria, Argentina, Mexico and India.

Government bonds acting as refuge

As mentioned above, short-term interest rates in the interbank market reflect the liquidity problems brought about by the financial crisis and that, in spite of all the efforts by the central banks, these have not been eliminated. For example, the differential between the 3-month Euribor rate and the ECB official rate is holding at 71 basis points. That is to say, the banks collect 0.71% more between themselves for lending money for 3 months than the price at which they can get funding at the ECB window. This is happening in spite of the fact that the market has largely given up its expectations that the ECB is going to raise the reference rate in coming months.

The differential is higher in the United States seeing that the 3-month interbank rate is running at 2.81% while the Fed is maintaining the reference rate at 2%. We find the same situation in the United Kingdom where, while the 3-month interbank rate is 5.76%, the official Bank of England rate remains stationary

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									
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	4.00	4.86	5.10	2.00	2.68	0.92	5.00	5.87	2.78
June	4.00	4.95	5.39	2.00	2.78	0.93	5.00	5.95	2.73
July	4.25	4.97	5.37	2.00	2.79	0.90	5.00	5.78	2.78
August (1)	4.25	4.96	5.31	2.00	2.81	0.87	5.00	5.76	2.77

NOTES: (1) August 21.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 3-08-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%), 8-03-07 (3.75%), 6-06-07 (4.00%), 3-07-08 (4.25%).
(3) Latest dates showing change: 11-12-07 (4.25%), 22-01-08 (3.50%), 30-01-08 (3.00%), 18-03-08 (2.25%), 30-04-08 (2.00%).
(4) Latest dates showing change: 10-05-07 (5.50%), 5-07-07 (5.75%), 6-12-07 (5.50%), 7-02-08 (5.25%), 10-04-08 (5.00%).
(5) Interbank rate.
SOURCE: National central banks, Bloomberg and own calculations.

at 5%. There the situation seems more serious seeing that investors feel it is likely that the UK central bank will cut the interest rate.

Why is this liquidity problem reflected in the interest rates demanded for various terms in the interbank markets? The reason is the worse situation in bank balance sheets which is underlined by the fact that provisions to cover possible losses because of the subprime mortgage crisis reached the astonishing figure of 504 billion dollars. We may compare this figure with Spain's GDP at 1,500 billion dollars. That is to say, it represents approximately 34% of the wealth generated in Spain in one year. Half these provisions were made by US banks while European banks made most of the rest while provisions by Asian banks was small compared with the overall figure of 500 billion dollars.

Well then, are the banks afraid of lending among themselves because of the fear of bankruptcy and therefore are restricting the supply of credit? Not exactly. Perhaps some institutions have had their access to the interbank market cut because of the drop in their credit standing. But the real problem is that this massive increase in bank losses has meant that many institutions have seen their capital available for lending in the interbank market diminished. Various international institutions are dealing with this difficulty through capital increases and a reduction of their banking business, that is, by restricting the granting of credit. This situation is reflected in the higher cost of money in interbank markets which now stands above the normal terms applying in the market.

...brought about by reduction of capital available because of worse balance sheets shown by banks.

On the other hand, investors have taken refuge in assets free of credit risk and of the highest rating. That is to say, government bonds of countries like the United States, the Euro Area, the United Kingdom and Switzerland. As the movement in bond prices is inverted, when there is an increase in demand for bonds and the price rises, bond yields go down. As a result, US 10-year bonds showed a drop in yield from 3.97% at the end of June to 3.79% on August 21.

The movement in Euro Area 10-year government bonds has been even sharper. While at the end of June it was running at 4.62%, at the end of August was barely above 4.1%.

With inflation in the Euro Area at 4%, it is significant that investors are willing to buy an asset that, while it holds no risk at all, is offering a real yield of only 0.1%. This reflects the level of risk aversion among investors whose aim is to take

Investors take refuge in government bonds of highest credit rating...

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

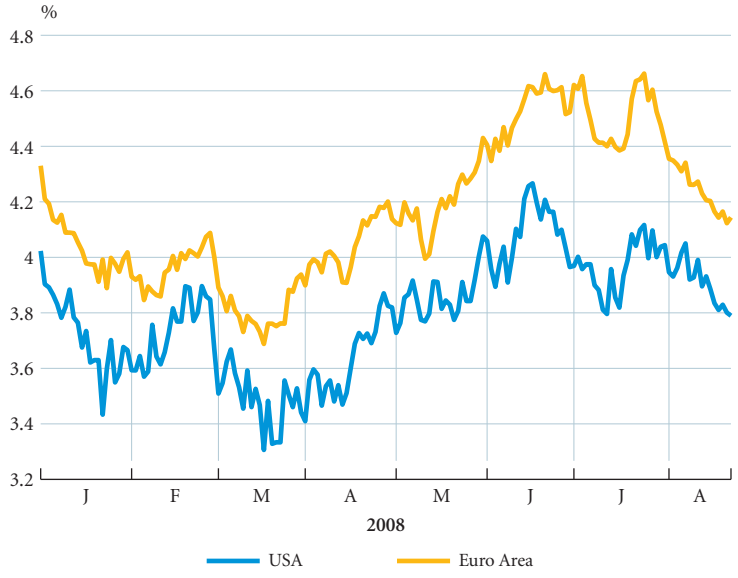
10-year government bonds at end of period as annual percentage

	2005	2006	2007		2008	
			September	December	June	August (*)
United States	4.39	4.70	4.59	4.02	3.97	3.79
Japan	3.31	1.69	1.69	1.51	1.60	1.42
Euro Area	1.48	3.95	4.33	4.33	4.62	4.14
United Kingdom	4.10	4.74	5.01	4.51	5.13	4.56
Switzerland	1.97	2.52	3.01	3.05	3.29	2.81

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

YIELD ON GOVERNMENT BONDS FAILS TO SOAR

Interest rate on 10-year government bonds



SOURCE: Bloomberg.

...although yields very low.

short-term refuge in government bonds in order to ride out the storm. That is to say, the objective is to avoid losing money and not trying to obtain a high return on investment.

Dollar recovers positions

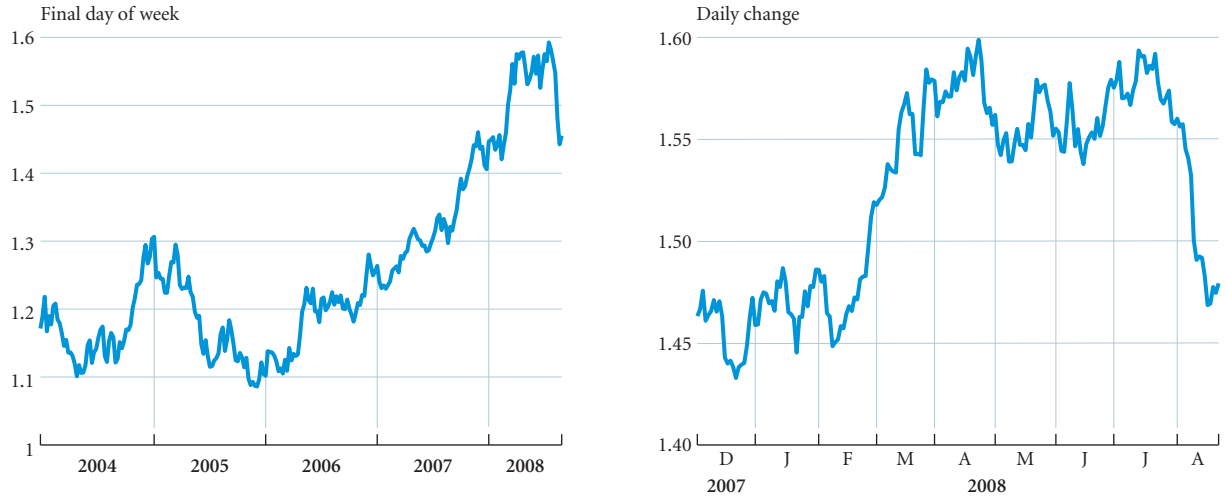
Dollar strengthens in view of bad news dribbling from United Kingdom, Euro Area and Japan.

The most significant change in the foreign exchange market in the past two months has been the sudden and rapid revaluation of the dollar against the euro and the Japanese yen. Whereas in July the euro-dollar exchange rate had gone to 1.60, an all-time high for the euro (a level it almost exceeded a couple of times but failed to accomplish), at the end of August the euro dropped to the rate of 1.48. That is to say, this was an 8% revaluation of the dollar against the Euro Area currency in just a few weeks. While moderate, this movement also took place against the Japanese yen. Whereas on July 14 a dollar could buy 105 yen, just one month later on August 14 it could obtain 110 yen.

What is the reason for this change in the value of the dollar? Two factors help explain this. First, the statements by the Bank of Japan and the ECB that coincided in declaring that the risk of lower growth was becoming real. In both cases, the statements by the two central banks led the markets to believe that no increases were likely in the official interest rates in both areas in coming months. In addition, the other factor (lower growth) made it possible to reconsider the point at which the various areas were situated in the economic cycle. The new perception is that, if the various areas are beginning to see a slowdown in their economies following the lead of US economy, as that economy was the first to slow down it would be the first to come out in first place in the economic recovery.

EURO-DOLLAR EXCHANGE RATE: EURO GOES AS HIGH AS 1.60

Euro-dollar exchange rate



SOURCE: Bloomberg.

EXCHANGE RATES OF MAIN CURRENCIES

August 21, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2007	Annual
Against US dollar				
Japanese yen	108.7	2.0	–2.8	–5.3
Pound sterling	0.535	7.2	6.2	6.0
Swiss franc	1.094	6.9	–3.6	–10.3
Canadian dollar	1.057	5.4	5.6	–0.5
Mexican peso	10.143	0.1	–7.5	–9.9
Against euro				
US dollar	1.479	–7.1	1.4	9.9
Japanese yen	160.8	–5.1	–1.4	4.3
Swiss franc	1.618	–0.2	–2.2	–0.4
Pound sterling	0.791	–0.4	7.7	16.5
Swedish krona	9.385	–0.7	–0.5	0.0
Danish krone	7.460	0.0	0.0	0.2
Polish zloty	3.316	2.9	–7.8	–13.9
Czech crown	24.33	5.9	–8.4	–12.1
Hungarian forint	233.8	2.3	–7.5	–10.7

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

Stock markets fail to maintain March lows and go back to old ways.

As may be seen in the above table, the dollar has also become much stronger against the pound sterling with that currency depreciating by 7.2% in barely one month. The pessimistic scenario drawn by Bank of England governor, Mervyn King, brought the pound down to its lowest level against the dollar in the past 22 months. Foreign exchange traders had not been as negative about the future trend in the British currency since the beginning of the year. Nor did the Canadian dollar escape as this currency depreciated by 5.4% against the US dollar in one month.

In spite of these sharp movements it is still not clear if we are faced with a new trend in the foreign exchange market.

Stock markets suffering from economic uncertainty

The present economic picture, involving two big uncertainties, is not ideal for a good performance of the stock markets. The first uncertainty in economic terms is what will be the low-point of the economic slowdown? That is to say, what will be the impact on the real economy of households and companies of the restriction of credit now current in the interbank markets? Secondly, how long will it take to return to the full-steam-ahead growth of all these economies? The quid of the question lies in estimating the material damage and the recovery time following the shock of this crisis.

INDICES OF MAIN WORLD STOCK EXCHANGES

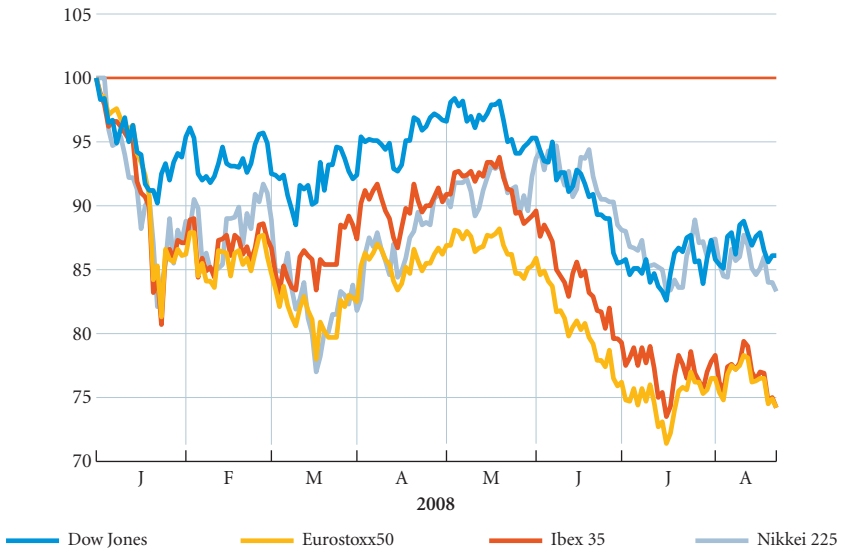
August 21, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*11,417*	*–0.4*	*–13.9*	*–12.8*
Standard & Poor's	*1,275*	*1.2*	*–13.2*	*–11.9*
Nasdaq	*2,389*	*4.8*	*–9.9*	*–5.2*
Tokyo	12,752	–0.4	–16.7	–19.8
London	5,336	–1.3	–17.4	–12.3
Euro Area	3,264	–2.1	–25.8	–21.8
Frankfurt	*6,265*	*–2.5*	*–22.3*	*–15.6*
Paris	*4,317*	*–0.2*	*–23.1*	*–20.3*
Amsterdam	*399*	*–0.3*	*–22.6*	*–21.0*
Milan	*27,953*	*–0.9*	*–27.5*	*–28.2*
Madrid	*11,272*	*–4.4*	*–25.8*	*–20.8*
Zurich	7,031	2.5	–17.1	–18.3
Hong Kong	20,392	–9.5	–26.7	–6.2
Buenos Aires	1,740	–12.2	–19.1	–11.3
São Paulo	55,377	–8.9	–13.3	11.2

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.

WHERE IS THE BOTTOM?

Trend in stock markets with base 1-1-2008 = 100



SOURCE: Bloomberg and own calculations.

As may be seen in the previous table, in the past month most stock markets in the developed countries have run between the 4.4% drop in Spain's selective Ibex 35 index and the 4.8% in the US Nasdaq high-tech index. But this reference does not give us full information about the real situation of the performance in shares during this year. It is more interesting to examine the trend in the stock markets from the beginning of the year. The stock markets did not hold at the lows recorded in March and now we find that the absolute lows were marked up in July. So long as the two key variables (the impact and duration of the crisis) are not clear it will be difficult to see any strong and durable recovery.

Nor have emerging economy markets managed to maintain the gains showing up at the middle of the year. With the exception of China, until recently they had represented a refuge for investment. It is true, the indices for Mexico and Brazil have behaved relatively much better than stock markets in the developed countries. But even so they are showing capital losses of around 10%-12%. The Chinese stock market is also looking black seeing that an investment made on January 1 would have lost more than 50% by the end of August. It is true that the quote for that investment was not sustained by a reasonable evaluation of the companies represented in the index. In fact, this is the method used by Chinese families to channel their savings in a situation where inflation is higher than the interest rate offered by traditional bank products. That is to say, there had been a bubble but in any case the sharp drop, however reasonable, did not fail to have its impact.

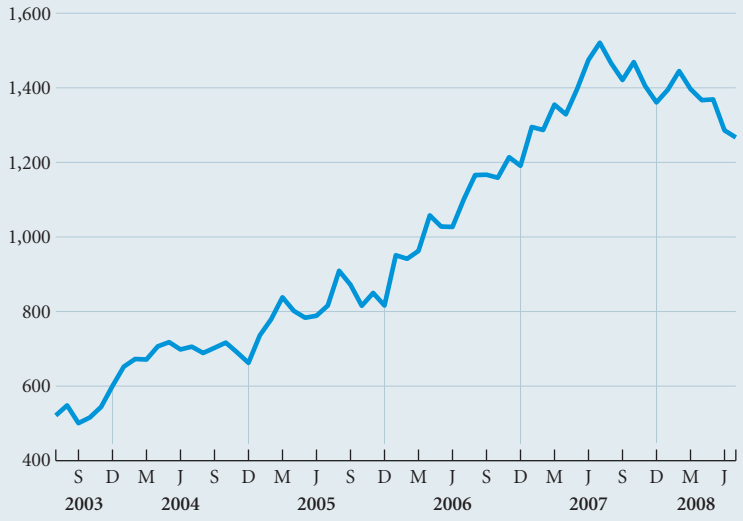
Nor do indices of emerging stock markets escape poor economic prospects.

Oil bubbles

No one would deny that in recent years the price of oil has had something to do with fundamental factors related to supply and demand. Many analysts, however, also are right in spotting signs of a speculative bubble. In a recent appearance before the US Senate, George Soros, a supreme speculator, explained how the inclusion of oil in the portfolios of pension funds and other institutional investors through the buying of futures has exposed the price of oil to the volatility of the expectations of investors and, in his opinion, has facilitated the creation of an oil bubble. While this explanation has gained fairly general acceptance, eminent economists such as Paul Krugman have vehemently held to the opinion that speculation has had no impact whatsoever on the price of oil.

OIL FUTURES CONTRACTS HAVE SHOT UP

Thousands of open interest contracts for oil futures on NYMEX



SOURCE: Bloomberg.

Let us begin by establishing what we understand by a speculative bubble – a situation in which the price of a good, such as oil, or a financial asset moves up not for fundamental reasons but thanks to the enthusiasm of investors who hope that the price will continue to go up, something that back in the Nineties the former chairman of the Fed, Alan Greenspan, called «irrational exuberance». Identifying a bubble, however, is not easy because normally investor enthusiasm is based, even though only partially, on fundamental factors. The quid of the question is to determine whether the enthusiasm is justified or exaggerated. In the second half of the Nineties, for example, the price of Yahoo multiplied by more than 150 in less than five years during a technological revolution that was promising vast profits for dot com portals. In 2001, with the bursting of the technological bubble, the price of Yahoo fell by 95% and even now its price is 80% below its all-time highs. Now it seems clear that the expectations of investors were not well based. However, bubbles make themselves known only after they have burst.

In the case of oil there has also been a revolution, in this case in demand by the emerging countries which, in combination with a supply that has failed to grow sufficiently, would justify an increase in prices. In this context, many investors have included oil in their investment portfolios in recent years, a trend that seems to have increased following the world financial crisis beginning in August 2007. According to those who believe there exists a bubble in the oil market, like Soros, these investors have exaggerated the impact of the forces of supply and demand on the price of oil. The fact is, the meteoric rise in oil prices over the past year has coincided with the upturn in those funds that invest in oil futures while, at the same time, the star analysts of major investment banks were predicting continuous price increases. In terms of fundamentals, it is difficult to identify any new factors in the past 12 months that might justify the extent of the rise in prices. China is growing but that is something we have all known about for years.

There are figures, however, that do not seem to support the impact of investors on the price of crude oil. A recent report by the agency responsible for supervising the commodity futures market in the United States (Commodity Futures Trading Commission) points out that while the number of oil futures contracts has tripled since 2004, investors considered to be speculators (those that do not belong to a related industry or make extensive use of oil) have combined long positions (those that bet on an increase in oil prices) with short positions (betting on a price drop) but it has not observed an overwhelming majority of the former. In fact, the report indicates that most open positions in the first half of 2008 were short positions. In any case, this evidence is not conclusive for two main reasons. First, because there are doubts about the classification of investors as speculators and non-speculators and, still more important, because the analysis includes only those contracts made through the New York Mercantile Exchange and, therefore, does not take into account other international markets or operations settled outside organized markets (over-the-counter transactions).

Krugman argues, in denying any influence of speculators on oil prices, that oil stocks have not increased while the price of crude has been going up. If speculation had pushed up prices of futures to an artificially high level, well above the level equalling oil supply and demand in the spot market, buying oil for cash, storing it and selling it in the 1-year futures market would have been good business. In fact, there is an arbitrage argument that relates the spot price and the future price. The difference between the latter and the former should not go above the cost of storing the crude and the interest rate although there may arise additional differences in a situation of risk.For example, if it costs 10 dollars to store a barrel of oil for a year, if the interest rate is 5% and the spot price is 100 dollars, the quote for a 1-year oil future should be close to 115 dollars. It is precisely the accumulation of inventories that drives up spot prices in a situation of speculation. The fact that we have not observed such a build up of stocks seems to discard the bubble hypothesis. Some analysts, however, have pointed out that, while it is true that inventories have not increased, this does not include crude held by oil producers either in barrels or still in the ground. Perhaps it is they who are speculating!

We shall only know if there is a bubble and how big it is after it has burst. For now, the drop in crude prices in recent weeks from close to 150 dollars to around 115 dollars seems to confirm that there was something of a bubble. While it remains to be seen if it has now completely burst, supply and demand should not be long in giving a verdict.

SPAIN: OVERALL ANALYSIS

Economic activity

Rise in commodity prices and continuation of international financial crisis contributing to sharpen economic slowdown.

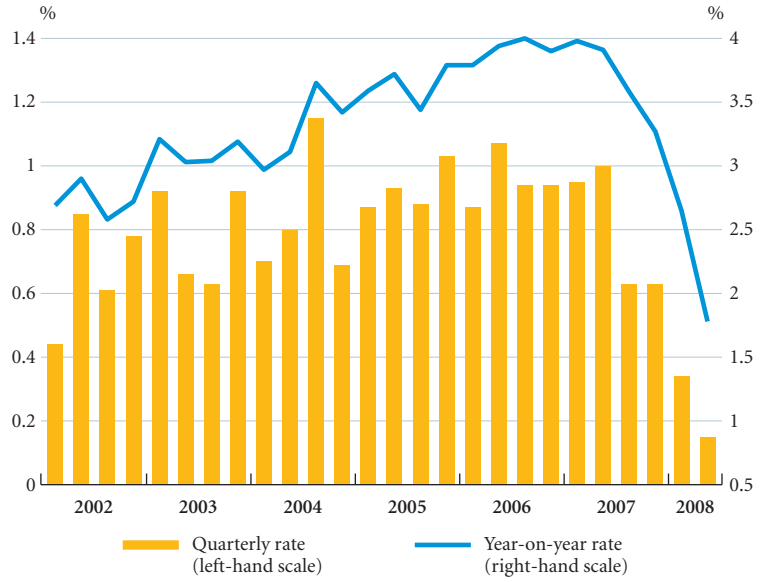
Economy moving into severe process of adjustment

The second quarter brought a sharpening of the economic slowdown begun last year added to by the rise in commodity prices and the international financial crisis. According to figures from the quarterly national accounts published by the National Institute of Statistics, the gross domestic product rose by 1.8% compared with the second quarter of 2007, some 8 decimals less than three months earlier. This rate was slightly higher than that reported for the European Union as a whole and the Euro Area. Nevertheless, this year-on-year rate does not really reflect the sharp drop in the economy in recent months, underlined by quarter-on-quarter growth of only one decimal, the lowest since the last recession in 1993 which indicates that the GDP is close to stagnant.

Figures for quarterly GDP statistics now include the normal annual revision for recent years, which include the latest available statistical information. On this occasion, the revision lowered annual GDP growth in 2007 by one decimal putting this at 3.7%. Changes in the make-up of growth were slightly more marked. The contribution of national demand to GDP growth was reduced by 0.15 decimals to 4.4%. The downward revisions in the components of investment and public consumption

GDP CLOSE TO STAGNATION

Change in GDP



SOURCE: National Institute of Statistics.

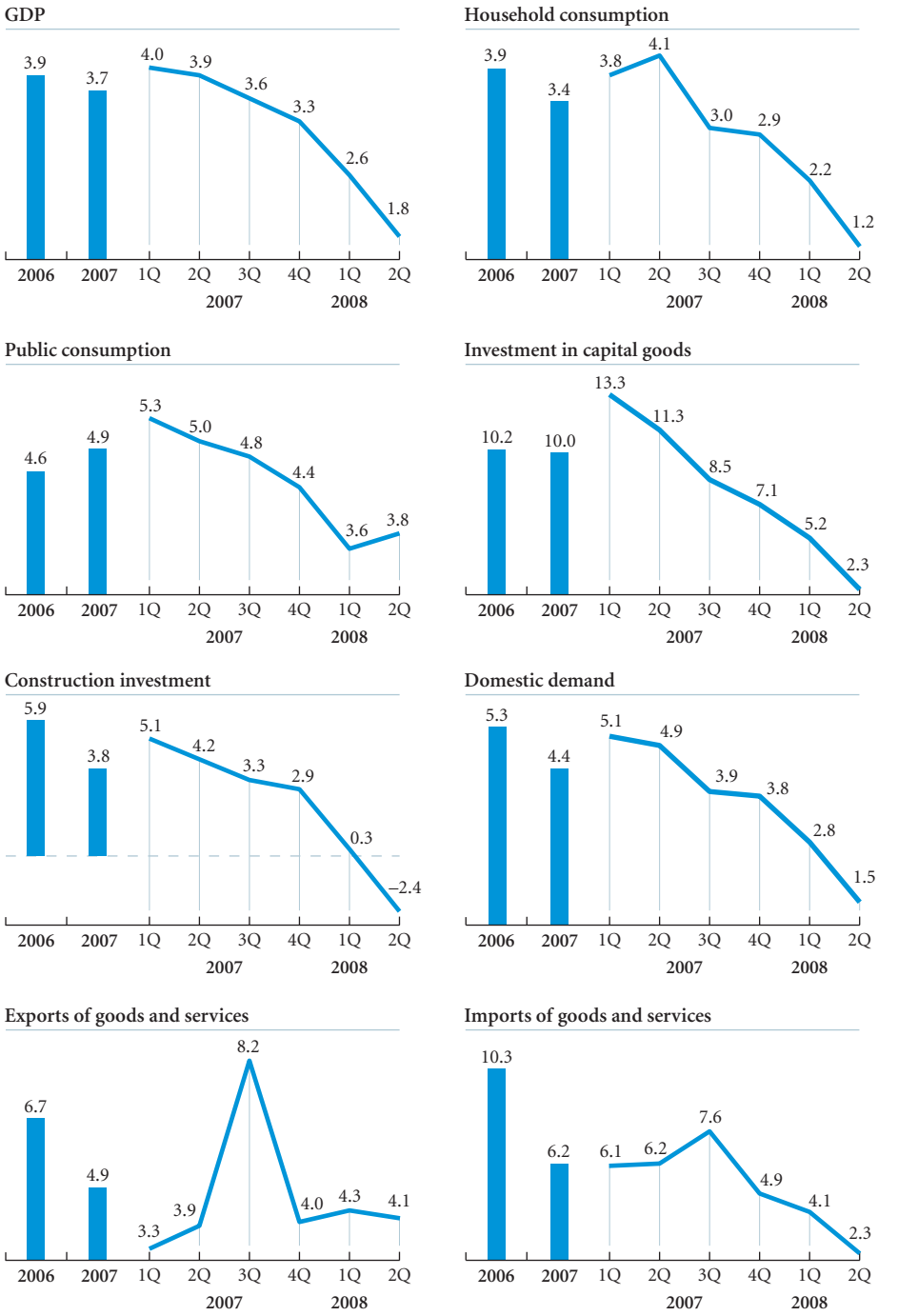
were only partially compensated by a higher estimate for private consumption.

The drop in GDP may be attributed to the continuing loss of drive in domestic demand. This went from a contribution

Foreign demand in second quarter goes from taking 2 decimals off GDP to adding 3 decimals.

TREND IN SPAIN'S GDP BY COMPONENT

Percentatge year-on-year change (*)



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

Current account deficit with abroad corrected after reaching high in first quarter.

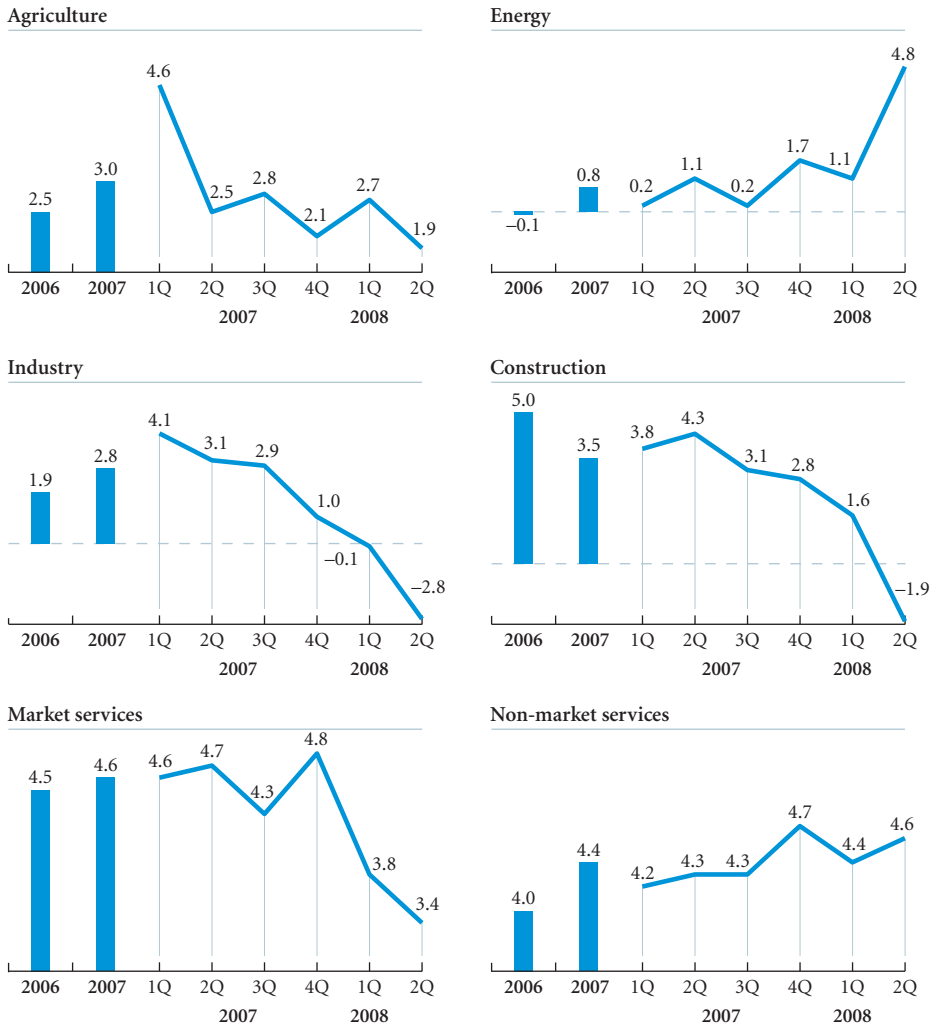
of 2.8% to GDP in the first quarter to 1.5% in the second quarter. On the other hand, foreign demand changed from taking off 0.2 points to adding 0.3 points.

This half-point improvement in the contribution from foreign demand came about because of a sharper drop in imports of goods and services than was the case in exports so that there was a wider gap between growth rates of both headings in favour of the latter.

As a result, the current account deficit with abroad, which had reached an all-time high of 12.0% of GDP in the first quarter, in the second quarter went to 9.5% of GDP largely due to seasonal factors but also reflecting that it was not getting worse. In any case, it remains very high and represents one of the biggest imbalances in Spain's economy taking on increased importance in the present situation of international financial crisis that makes its financing more difficult.

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.

Returning to the components of national demand, household consumption suffered a sharp slowdown in the second quarter reporting modest year-on-year growth of 1.2%, one point less than in the January-March period. The lower increase in real incomes due to a higher cost shopping basket, high levels of debt in a context of interest rate hikes and increased unemployment undermined consumer confidence. In fact, it is likely that consumption will remain depressed if we are to go by the all-time low reported in the consumer confidence index for July.

Brake on household consumption with consumer confidence marking up all-time low.

On the other hand, public consumption increased its growth rate to 3.8% year-on-year thus partly counteracting the drop in private consumption. The increase in public consumption was based on the growth of pay for public servants. As a result, public consumption played a counter-cyclical role.

Public consumption playing counter-cyclical role.

Investment was down even more sharply than consumption to the point where gross fixed capital formation fell by 0.2% compared with the second quarter of 2007. All components of investment slowed down significantly in response to the weakness of demand, both internal and external, to the drop in corporate profits and the subsequent dip in business confidence.

Gross fixed capital formation in capital goods went from showing a year-on-year increase of 11.3% in the second quarter of 2007 to 2.3% twelve months later. Investment in other products, such as data-processing programmes and oil exploration, reported a drop in annual rate of increase to nearly half in the last quarter to show an annual increase of 3.3%. With regard to prospects for industrial investment, these do not seem favourable in coming months due to a further drop in the level of utilization of production capacity in the third quarter.

But it is in construction where we are to find the cause of the drop in investment. Construction investment was down 2.4% compared with the second quarter of last year. The contraction in housing construction sharpened with a year-on-year drop of 6.3%. Projections indicate a continuation of the adjustment in this sector given the large volume of housing still unsold, which led to a slight drop in housing prices in the second quarter compared with the previous quarter. This is confirmed by the construction confidence index which reported a new low in July.

Other construction (public works and non-residential building), however, maintained year-on-year growth of 1.9%. In addition, tendering of public works was up 11% in the first five months of the year compared with the same period last year. As a result, public investment will likely compensate the dip in housing construction although only in part.

On the supply side, the main development in the second quarter was the worsening of the recession in industry on top of that in construction. Value added in the industrial manufacturing branches was down 2.8% compared with the second quarter of 2007, even more than that reported in construction. As well as the negative drag effect of construction on sub-sectors such as manufacture of construction materials and durable goods there were other problems. The worsening of the labour market, with the epicentre of job loss being construction, has had a negative effect on consumption. What is more, the weakening of foreign demand because of the slowdown in the world economy and the loss of competitiveness

Drop in investment due to contraction in housing construction.

CENTRAL GOVERNMENT'S MAIN ECONOMIC POLICY MEASURES TO DEAL WITH RECESSION
• Deduction of 400 euros from personal income tax (total spending: 6 billion euros).
• Early VAT rebates to companies (6 billion euros).
• Broadening of government guarantees, aid and funding for small and medium companies and subsidized housing.
• Construction of 150,000 subsidized housing units a year (medium-term objective).
• Plan for measures to foster home rental.
• Support for renovation and restoration of buildings and housing.
• Lengthening of mortgage maturity terms at no cost (elimination of tax costs, registry and notarial costs).
• Removal of property tax (as of 1-01-2008).
• Plan to replace cars more than 15 years old (15 billion euros a year).
• Liberalization of certain rail transport services.

SOURCE: Ministry of Economy and Finance and own calculations.

Recession in industry growing worse.

made worse by the strength of the euro have also hurt industry.

Services are holding their own. Market services as a whole reported annual growth of 3.4%, some 4 decimals less than in the first quarter. Prospects indicate a continuation of the slowdown. Air passenger traffic in July was down 3.7% compared with the same month last year and the number of foreign tourists was down 8.0% year-on-year. Nevertheless, overnight stays in hotels in July rose by 0.9% compared with the same month in 2007 while the figure for non-residents was up by 2.9%.

Recovery in apparent labour productivity but especially as result of readjustment in employment.

In addition, apparent productivity of labour factor continued the recovery seen in recent quarters after having held at very low levels in the last few years. Apparent productivity of labour for the economy as a whole showed an annual increase of 1.4% in the second quarter, twice that for the same quarter in 2007. This improvement, however, was largely due to an adjustment in employment. Construction, which up to the third quarter of 2007 was showing decreases in productivity, in the second quarter of 2008 showed a big increase after having undergone a sharp loss of jobs. On the other hand, productivity continued to decrease in industry, something that does not auger well.

As a result of the severe worsening of the economic situation, toward the end of July the central government had to make a downward revision of the economic growth forecasts that would provide the framework for its 2009 budget. GDP growth forecast for 2008 was changed from 2.3% to 1.6% while the figure for 2009 was reduced from 2.3% to 1.0%.

At the same time, in mid-August the government approved a new package of economic measures on top of those put into effect in April and June this year in order to deal with the economic recession. Part of these measures are to stimulate the economy. Others are aimed at carrying out reforms to increase the competitiveness of the economy. These measures go hand-in-hand with a process of social dialogue intended to change Spain's production model and prepare the relaunching of the economy on a solid basis. Some measures, such as possible reform of the labour market among others, however, are still in abeyance.

Labour market

Employment weakens and unemployment up sharply

The cooling off in the economy has shown up clearly in the labour market. The number of persons employed rose by only 22,900 in the second quarter of 2008 compared with the previous quarter, according to figures from the Labour Force Survey published by the National Institute of Statistics. This job creation was much below that usual in the second quarter. As a result, the annual change rate dropped from 1.7% in the first quarter to only 0.3%.

In the first half-year the number of persons employed was down by 51,800. The trend thus indicates a definite loss of employment. The most recent figures for registrations with Social Security support this view given that in July the number of persons registered stood 0.7% below the same month in 2007.

Number of persons employed down 51,800 in first half-year underlining trend to loss of jobs.

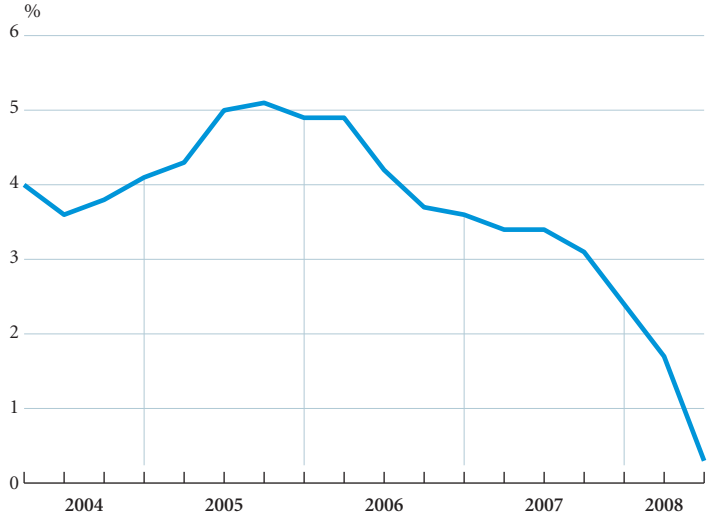
In the past 12 months job creation estimated by the Labour Force Survey stood at 57,800 persons. This was the result of an increase of 189,300 in the number of foreign workers employed (6.9%) and a drop of 131,400 in the number of Spanish nationals working (0.75%). As a result, foreign workers now represent 14.4% of all those employed.

This has come about in spite of the collapse in the construction sector which involves the largest number of foreign workers. In fact, the collapse of the housing sector meant the loss of

In past 12 months Spanish workers employed down 0.8% whereas number of foreign workers up 6.9%.

SHARP DROP IN EMPLOYMENT

Year-on-year change in employment



NOTES: Figures adjusted for impact of methodological changes introduced in first quarter of 2005.
SOURCE: INE and own calculations.

ESTIMATED EMPLOYMENT

Second quarter 2008

	No. of employees (thousands)	Quarterly change		Cumulative change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	880.9	–41.8	–4.5	–24.9	–2.7	–40.1	–4.4	4.3
Non-farm	19,544.2	64.7	0.3	–26.9	–0.1	98.0	0.5	95.7
Industry	*3,273.2*	*–68.4*	*–2.0*	*–5.9*	*–0.2*	*29.4*	*0.9*	*16.0*
Construction	*2,498.0*	*–122.4*	*–4.7*	*–195.5*	*–7.3*	*–215.7*	*–7.9*	*12.2*
Services	*13,773.0*	*255.5*	*1.9*	*174.5*	*1.3*	*284.2*	*2.1*	*67.4*
By type of employer								
Private sector	17,483.3	–45.8	–0.3	–80.3	–0.5	–9.3	–0.1	85.6
Public sector	2,941.8	68.6	2.4	28.5	1.0	67.1	2.3	14.4
By work situation								
Wage-earners	16,853.0	35.6	0.2	–23.6	–0.1	73.7	0.4	82.5
Permanent contract	*11,900.5*	*153.4*	*1.3*	*242.3*	*2.1*	*465.0*	*4.1*	*58.3*
Temporary contract	*4,952.5*	*–117.8*	*–2.3*	*–265.9*	*–5.1*	*–391.4*	*–7.3*	*24.2*
Non-wage-earners	3,562.0	–12.7	–0.4	–31.2	–0.9	–16.7	–0.5	17.4
Entrepreneurs with employees	*1,175.4*	*35.9*	*3.2*	*39.1*	*3.4*	*65.7*	*5.9*	*5.8*
Entrepreneurs without employees	*2,188.4*	*–29.9*	*–1.3*	*–66.2*	*–2.9*	*–57.8*	*–2.6*	*10.7*
Family help	*198.2*	*–18.7*	*–8.6*	*–4.1*	*–2.0*	*–24.6*	*–11.0*	*1.0*
Other	10.1	0.0	0.2	3.0	42.3	0.8	9.2	0.0
By time worked								
Full-time	17,975.9	23.5	0.1	–117.9	–0.7	48.7	0.3	88.0
Part-time	2,449.2	–0.6	0.0	66.1	2.8	9.1	0.4	12.0
By sex								
Males	11,859.4	–64.5	–0.5	–137.7	–1.1	–148.3	–1.2	58.1
Females	8,565.8	87.4	1.0	86.0	1.0	206.1	2.5	41.9
TOTAL	**20,425.1**	**22.9**	**0.1**	**–51.8**	**–0.3**	**57.8**	**0.3**	**100.0**

SOURCE: National Institute of Statistics and own calculations.

Reduction of employment in past year concentrated in construction and agriculture.

215,700 construction jobs since the second quarter of 2007 (7.9%), mostly in the second quarter of 2008. Agriculture, another sector with a relatively high proportion of foreign workers, has also lost jobs over the past year with a drop of 40,100 (4.4%).

Those working in industry rose by 29,400 over the past 12 months. Nevertheless, the performance by sub-sector was quite uneven. The food industry was the most dynamic in job creation with a net increase of 37,000 persons working, followed by wood and cork, chemicals and metallurgy. On the other hand, manufacturing of electrical material and equipment lost 14,000 workers. Machine-building and mechanical equipment, leather and footwear and oil refining also lost jobs. Nevertheless, we should point out that the worse state of the industrial sector in the past quarter meant a net loss of 68,400 jobs in secondary industry in the second quarter of 2008.

In the services sector, employment was up by 284,200 in the past year (2.1%)

as against an annual increase of 4.3% in the second quarter of 2007. Most tertiary sub-sectors increased their employment levels with retail trade in the lead with 158,500 jobs. Nevertheless, transport and communications showed a drop in employment while there was a lesser drop in the hotel and restaurant business.

Another sign of the worse situation in the labour market was the drop in employment in the private sector with an estimated decrease of 9,300 persons working. Employment in the public sector compensated that drop with an increase of 67,100 persons (2.3%).

The number of wage-earners continued to rise slightly more than the total number of persons employed. Over the past year, the number of wage-earners on permanent contract rose by 465,000 while those on temporary work dropped by 391,400. As a result, the temporary work rate, that is to say, the proportion between the number of workers on temporary work contract and the total number of wage-earners dropped to 29.4%, the lowest level since the first quarter of 1990, although this is well above European standards.

The worsening of the labour market did not deter those looking for jobs. The labour force continued to increase at a good rate with an annual rise of 3.1%. This partly reflects the fact that women continue to join the labour force given that the total number of females rose by 4.6% while for males the increase was 2.0%. As a result, the labour force rate for females reached 50.25% thus cutting down the gap from 69.6% for males. In addition, there has been very little slowing down of foreign workers joining the labour market with this showing an annual increase 12.6%.

In this context of sharp increase in the work force and little seasonal increase in jobs, unemployment has shot up. In the second quarter the number of unemployed rose by 207,400 persons, an all-time high for this quarter, so that it went up to 453,900 in the first half of the year. The number of unemployed went to 2,381,500 persons, a year-on-year

Drop in number of those employed in private sector in past year compensated by job creation in public sector.

Difficult situation in labour market fails to stop most sensitive groups (women and foreign workers) from joining labour force.

ESTIMATED UNEMPLOYMENT

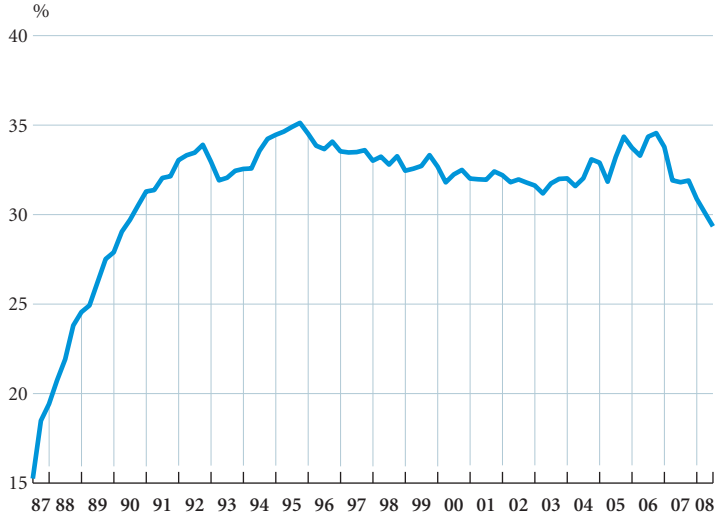
Second quarter 2008

	No. of unemployed	Quarterly change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%		
By sex							
Males	1,182.9	164.3	16.1	402.3	51.5	49.7	9.1
Females	1,198.6	43.1	3.7	219.3	22.4	50.3	12.3
By age							
Under 25 years	573.9	73.8	14.8	131.7	29.8	24.1	23.9
Other	1,807.6	133.5	8.0	489.9	37.2	75.9	8.9
By personal situation							
Long-term unemployment	586.6	29.4	5.3	90.1	18.1	24.6	–
Seeking first job	222.5	24.7	12.5	11.2	5.3	9.3	–
Other	1,572.4	153.2	10.8	520.3	49.5	66.0	–
TOTAL	**2,381.5**	**207.4**	**9.5**	**621.6**	**35.3**	**100.0**	**10.4**

SOURCE: National Institute of Statistics and own calculations.

TEMPORARY WORK RATE DROPS TO LOWEST IN PAST 18 YEARS

Workers with temporary hiring contract over total wage-earners



SOURCE: INE and own calculations.

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Second quarter 2008

	In work force			Employed			Unemployed			Unemployment rate (%)
	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	
Andalusia	3,798	123	3.4	3,180	–55	–1.7	618	179	40.6	16.3
Aragon	660	12	1.9	615	2	0.3	45	10	30.2	6.8
Asturias	494	23	4.8	455	27	6.2	39	–4	–9.5	7.8
Balearic Islands	574	18	3.2	525	0	0.1	48	18	57.3	8.4
Canary Islands	1,038	13	1.3	872	–52	–5.7	166	66	65.8	16.0
Cantabria	280	6	2.2	260	4	1.4	20	2	13.4	7.0
Castile-Leon	1,174	24	2.1	1,065	–2	–0.1	109	25	30.2	9.3
Castile-La Mancha	955	49	5.4	855	20	2.4	100	29	40.8	10.5
Catalonia	3,843	106	2.8	3,550	41	1.2	293	65	28.7	7.6
Valencian Community	2,531	106	4.4	2,238	24	1.1	293	82	38.6	11.6
Extremadura	484	14	3.0	417	4	1.0	67	10	17.4	13.9
Galicia	1,310	16	1.2	1,201	5	0.4	109	11	11.4	8.3
Madrid Community	3,355	116	3.6	3,061	24	0.8	295	92	45.5	8.8
Murcia	719	35	5.1	638	–1	–0.2	82	37	81.2	11.3
Navarre	309	3	1.1	292	2	0.7	17	1	8.0	5.6
Basque Country	1,065	7	0.6	1,006	11	1.1	59	–5	–7.2	5.6
La Rioja	159	5	3.1	148	2	1.1	11	3	42.0	6.8
Ceuta and Melilla	60	4	7.5	49	4	9.2	11	0	0.9	18.8
TOTAL	**22,807**	**679**	**3.1**	**20,425**	**58**	**0.3**	**2,382**	**622**	**35.3**	**10.4**

SOURCE: National Institute of Statistics and own calculations.

increase of 35.3%. The unemployment rate rose to 10.4%, some 2.5 points more than the low recorded one year earlier.

In terms of geographical area, we see notable differences in employment trends. Over the past 12 months employment in Asturias rose by 6.2% while in Castile-La Mancha the rise was 2.4%. On the other hand, the number employed was down 5.7% in the Canary Islands and 1.7% in Andalusia under the effect of the recession in housing construction. These two communities head the list of unemployment rates for the autonomous communities although the order turns around at 16.0% for Canary Islands and 16.3% for Andalusia. On the other hand, the Basque Country and Navarre showed the lowest unemployment rates at 5.6%.

Number of registered unemployed continues to rise sharply

Figures for registered unemployed at public employment offices in July indicate that unemployment is growing worse. Unemployment lists swelled by 36,492 persons that month, the worst figure for the month of July in the current statistical series. Registered unemployment thus rose by 23.2% compared with the same month last year.

Unemployment in year-on-year terms continued to increase in all sectors although there were substantial differences in degree. The biggest increase came in construction with an annual rise of 70.7%. The change rate among those seeking a first job was much lower at 5.6%.

Unemployment jumps in second quarter with year-on-year increase of 35.3%.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

July 2008

	No. of unemployed	Change over December 2007		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	81,698	12,886	18.7	17,267	26.8	3.4
Industry	306,403	26,422	9.4	40,336	15.2	12.6
Construction	390,529	106,662	37.6	161,734	70.7	16.1
Services	1,414,921	130,671	10.2	224,762	18.9	58.3
First job	233,365	20,728	9.7	12,479	5.6	9.6
By sex						
Males	1,086,102	200,963	22.7	330,727	43.8	44.8
Females	1,340,814	96,406	7.7	125,851	10.4	55.2
By age						
Under 25 years	277,978	37,595	15.6	57,454	26.1	11.5
All other ages	2,148,938	259,774	13.8	399,124	22.8	88.5
TOTAL	**2,426,916**	**297,369**	**14.0**	**456,578**	**23.2**	**100.0**

SOURCE: INEM and own calculations.

Prices

Annual inflation of consumer prices up 4 decimals in June and another 3 in July putting rate at 5.3%.

Inflation goes up to highest level since 1992

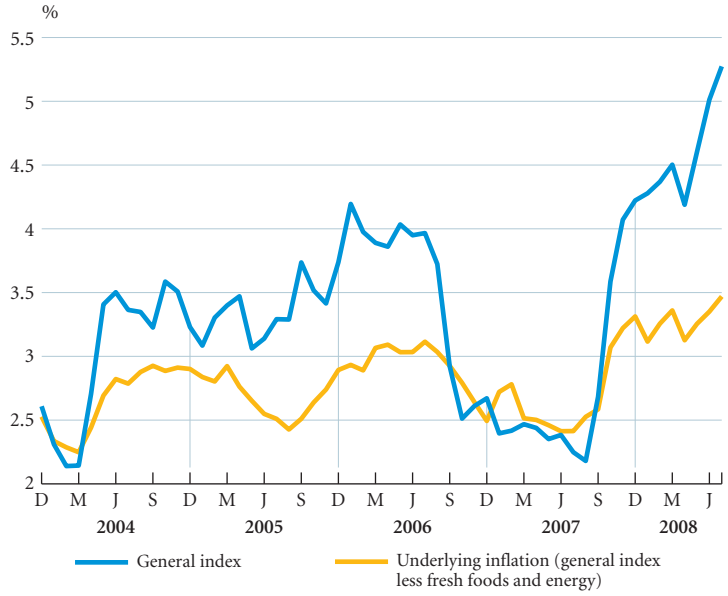
There has been no let-up on the inflation front at the beginning of summer. The upward trend in consumer prices that began toward the middle of last year with the jump in oil prices and other commodities gained strength in recent months when the price of crude climbed to a new all-time high in the second week of July. The year-on-year change rate in the consumer price index (CPI) thus rose by four decimals in June and three more in July going up to 5.3%, the highest rate since December 1992.

Energy products were the main culprits for the CPI rise in the early summer months when they went from an annual change rate of 16.5% in May to 21.4% in July. There was a notable rise in fuels and lubricants that reported an annual rise of 25.9% in July. We should also mention a further rise in electrical power in July on top of the increase in January thus making a year-on-year increase of 10.2%.

Another volatile component of the CPI, fresh foods, also made an appreciable contribution to inflationary pressures with the year-on-year rate going up one point in June to 5.1%, partly due to the

FUELS AND FOOD BOOST INFLATION

Year-on-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2007			2008		
	% monthly change	% change over December 2006	% annual change	% monthly change	% change over December 2007	% annual change
January	–0.7	–0.7	2.4	–0.6	–0.6	4.3
February	0.1	–0.6	2.4	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	0.7	2.2	4.6
June	0.2	2.0	2.4	0.6	2.8	5.0
July	–0.7	1.3	2.2	–0.5	2.3	5.3
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.

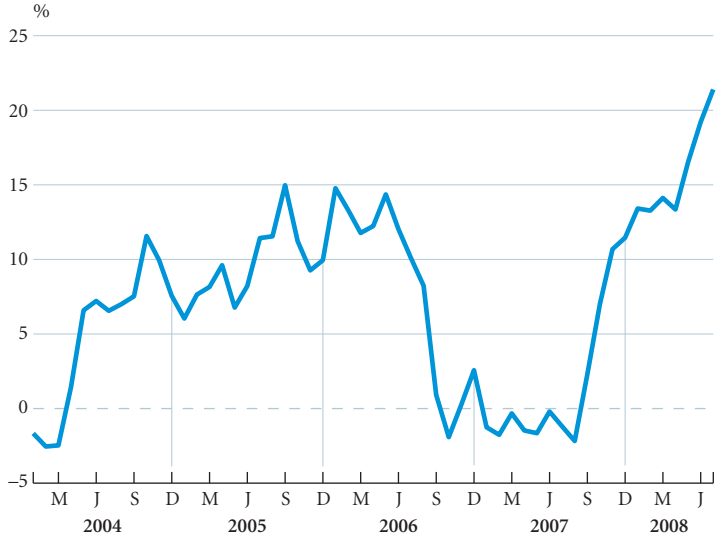
transport strike in the first half of the month which had an effect on distribution. This rise was turned around in July but only partially with the figure going to 4.4%.

In any case, while the biggest part of the CPI increase may be attributed to the more erratic components, the more stable core, so-called underlying inflation, also showed upward pressure

Underlying inflation hits highest level since 2002.

SHARP RISE IN ENERGY PRODUCTS AS OF JULY

Year-on-year change in energy product prices



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

July

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2007	2008	2007	2008	2007	2008
By type of spending							
Food and non-alcoholic beverages	110.2	0.3	0.1	1.5	1.9	2.6	7.0
Alcoholic beverages and tobacco	111.4	0.1	0.0	5.7	3.6	6.1	4.0
Clothing and footwear	94.9	–11.1	–11.3	–11.7	–12.3	1.0	0.4
Housing	112.6	0.3	1.7	3.3	6.9	3.1	8.4
Furnishings and household equipment	105.1	–0.6	–0.6	1.2	1.2	2.7	2.5
Health	98.5	0.2	0.3	–2.5	0.0	–2.2	0.5
Transport	113.9	0.2	0.7	4.7	8.1	0.6	10.6
Communications	100.2	–0.2	0.0	1.3	0.3	0.7	–0.2
Recreation and culture	100.1	0.8	1.1	–0.2	0.7	–1.0	0.1
Education	107.6	0.1	0.1	0.6	0.4	4.6	3.9
Restaurants and hotels	111.1	0.9	1.0	4.7	4.6	5.0	4.8
Other goods and services	106.9	–0.1	–0.1	2.4	2.9	3.1	3.5
By group							
Processed food, beverages and tobacco	110.7	0.1	0.2	2.3	2.7	2.2	7.8
Unprocessed food	109.4	0.5	–0.1	1.4	0.9	4.7	4.4
Non-food products	107.0	–1.0	–0.6	1.0	2.3	2.0	4.8
Industrial goods	105.3	–2.7	–2.0	–1.2	1.2	0.2	5.6
Energy products	*124.9*	*0.5*	*2.3*	*6.6*	*16.1*	*–1.2*	*21.4*
Fuels and oils	*128.5*	*0.6*	*1.1*	*7.9*	*18.0*	*–2.5*	*25.1*
Industrial goods excluding energy products	*98.9*	*–3.8*	*–3.6*	*–3.7*	*–3.7*	*0.6*	*0.3*
Services	108.7	0.6	0.7	3.3	3.5	3.8	4.0
Underlying inflation (**)	105.6	–1.0	–0.9	0.6	0.8	2.4	3.5
GENERAL INDEX	**107.8**	**–0.7**	**–0.5**	**1.3**	**2.3**	**2.2**	**5.3**

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

Inflationary pressures continue in services, a sector more sheltered from foreign competition.

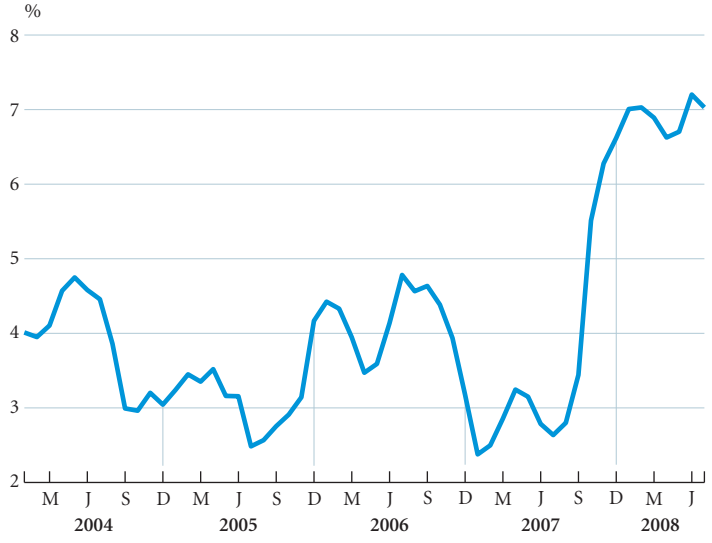
over the past two months with a rise of two decimals putting it at 3.5%, the highest rate since December 2002. We should point out that underlying inflation has risen by 1.1 points in the past 12 months with the pass-through of the rise in commodity prices. In any case, the differential with general inflation widened to 1.8 points, the highest level since 1981.

In underlying inflation we see a continuation of inflationary pressures from services which are somewhat sheltered from foreign competition. Annual inflation in services thus went up to 4.0% in July, 2 decimals more than in May. There was a notable annual rise of 21.2% in air transport. Hotels and other lodgings show a lower increase at 5.5%, this being above the average.

In the other large blocks of underlying inflation we should mention that processed foods also contributed to an increase in the CPI with the annual

FOOD MARKS UP HIGH FOR RECENT YEARS IN JUNE

Year-on-year change in food and non-alcoholic beverage prices



SOURCE: National Institute of Statistics.

change rate going from 7.5% in May to 7.8% in July. On the other hand, the annual rate for non-energy industrial goods rose by 2 decimals in July going to 0.3%. This came about in spite of the fact that summer clothing and footwear sales this year were stronger than last summer. The relative containment of non-energy industrial goods was favoured by the strength of the euro and tough competition in international markets.

The year-on-year inflation rate in terms harmonized with the European Union in July stood at the same level as the general CPI for that month (5.3%). As a result, the inflation differential with the Euro Area rose to 1.3 percentage points, the highest level in the past two years.

Nevertheless, inflation prospects show signs of improving, mainly thanks to the recent sharp drop in the price of oil and other commodities which will be added to the dip in consumption. The annual inflation rate may have hit a ceiling in July and could begin to ease as of August going to close to 4% at the end of the year.

Inflation differential with Euro Area hits highest level in past two years at 1.3 percentage points.

Wholesale prices reach new high

The high price of oil and other commodities brought about sharp inflationary pressures in industrial goods and imported goods in the early summer months. Nevertheless, the recent moderation in commodity prices in international markets suggests that inflationary pressures in wholesale markets will likely decrease as of August.

Inflation of producer prices reached a high since October 1984 when it went to 10.2% in July. The sharp rise in producer prices was mainly due to the energy component with an annual inflation rate going up to 30.3%. Intermediate goods also rose considerably with an annual increase of 7.3%. On the other hand, consumer goods showed a reduction in annual change rate to 5.2%, the lowest

Annual inflation rate likely reached ceiling in July.

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											
June	2.6	2.6	1.8	3.1	5.8	–1.4	1.3	0.9	–0.1	6.1	–
July	2.5	2.3	1.9	3.1	5.6	–2.6	0.7	0.9	–0.2	4.3	–
August	5.1	2.3	2.4	3.1	5.4	–2.9	0.7	1.4	0.2	3.9	3.0
September	12.1	3.4	3.1	3.2	5.4	0.8	2.0	1.0	0.3	3.1	–
October	13.8	4.7	4.2	3.2	5.3	6.1	3.1	0.6	0.0	2.0	–
November	15.7	5.4	4.5	3.1	5.1	9.8	4.1	0.7	0.0	0.7	3.0
December	17.6	5.9	4.8	2.9	5.0	11.6	4.9	1.1	–0.1	0.7	–
2008											
January	11.1	6.6	5.4	2.7	5.9	13.3	6.7	1.1	0.4	1.8	–
February	7.3	6.6	5.4	2.5	6.0	13.3	6.8	1.4	0.3	1.8	3.2
March	10.5	6.9	5.5	2.3	6.3	14.6	6.7	0.7	–0.2	2.1	–
April	8.5	7.2	5.3	2.3	6.0	16.5	6.8	0.6	–0.2	2.5	–
May	15.2	7.9	5.3	2.0	5.9	21.2	9.2	0.9	–0.1	3.2	3.4
June	8.6	9.0	5.4	2.1	6.3	25.5	10.4	1.4	–0.3	3.7	–
July	...	10.2	5.2	2.3	7.3	30.3	...	...	...	...	–

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

Inflation rate for producer prices records highest level since 1984.

level since December, due to the drop in consumption. On the other hand, inflation in capital goods rose slightly by a few decimals but was contained at 2.3% thanks to strong international competition.

Import prices also showed high increases in June largely due to energy which was up 55.0% over the past 12 months. On the other hand, inflation in capital goods and consumer goods held at very low levels with a decrease of 0.3% and an increase of 1.4% respectively, thanks to the appreciation of the euro.

Drop in wholesale milk prices in first half-year but market livestock prices rebound.

On the other hand, prices paid to farmers moderated somewhat after showing sharp increases. In June they reported a year-on-year increase of 8.6% as against 15.2% in May. The main brake came from agricultural products although livestock products with a marked drop in milk also made their contribution. On the other hand, prices for market cattle bounced back after having dropped below the level one year earlier.

Oil... does it count?

At the end of 2007 the Organization for Economic Cooperation and Development (OECD) published its usual report on economic prospects. The international body had forecast that the per barrel price of Brent quality oil would stand at 90 dollars. This forecast was not far from what most analysts were expecting. Barely a year later, oil had climbed to 145 dollars. That is to say, it had practically doubled in one year. While later on there was a significant correction with prices going down to the area of 115 dollars, on average so far in 2008 prices have increased by 70% over one year ago. The episode has therefore been of such an intensity that we may assume that its macroeconomic effects (inflation, growth and employment) will be significant.

RISE AND FALL OF OIL PRICES: OIL STILL VERY COSTLY

Per barrel price Brent quality

SOURCE: Thomson Financial Datastream and own calculations.

What are the channels by which an oil shock is passed through an economy? The main impact shows up in the shift of income in importing countries to producer countries. If we have to pay more for fuel, we have less spare income for other purchases so that both consumption and investment will be lower than when no oil shock exists. Such adjustments in turn generate indirect negative effects on employment. All of this implies a reduction of growth in the gross domestic product (GDP). On the other hand, this loss of income may be partly compensated if the gains in income of the oil producers are used to buy manufactures from those countries that are dependent on imported oil.

Another immediate effect would be an increase in the economy's price indices, both consumer and producer, given that the energy component in these is considerable. Through the mechanisms of price formation and the rigidities of the economy the increase in fuel costs may affect the prices of other goods and services or

generate more demands for wage increases. In this case, we are faced with so-called «second round effects» which bring an increase in inflation. Higher inflation brings about an economic imbalance that sooner or later has to be paid for in lower economic activity and loss of income. If the monetary authorities consider that this involves a permanent inflation effect, the response will be an increase in the economy's interest rate so that once more we can foresee a negative effect on consumption and investment (which, in turn, will bring about a further toll in terms of employment).

In order to go from these theoretical channels to an estimation of the quantified effect on the reference economies, one available instrument is the estimates published by the International Monetary Fund (IMF) from time to time. According to its calculations, an increase of 20% in the price of oil would bring about lower growth of three decimals in the United States and two decimals in the Euro Area in the first year and a reduction of four decimals in growth in each following year, both in the United States and in the Euro Area. With regard to the inflationary impact, the increase in oil price in the United States would bring about an 8-decimal increase in prices the first year that would moderate in following years. In the Euro Area the impact would be slightly less the first year but then would last longer.

And if the shock were to be 70% such as we are experiencing in 2008? Starting out from these earlier estimates and supposing that the effect would be proportional, the US economy would suffer a reduction in growth in 2008 of the order of one percentage point while in the Euro Area it would be seven decimals. With regard to inflation, this would be more than 2.8 percentage points higher in the United States and up 2.5 percentage points in the Euro Area. While the figures could be lowered a little, taking into account that the effect of oil price increases is not proportional, it remains clear that in 2008 we are experiencing a major shock. These figures imply that, in the absence of the upward episode in oil in 2008, growth in the Euro Area, instead of being in the region of 1.5% year-on-year, would be above 2%, that is to say, close to growth potential. In turn, inflation would be far from the current figures of 4% to stand within the 2% objective of the European Central Bank. What a relief that would be for Mr Trichet!

Although these figures have the virtue of including both direct and indirect effects of a rise in oil prices and an explicit analytical framework, they are only exercises subject to the simplifications inherent in economic models. Other simpler calculations, purely arithmetical in nature based on available data, also help to underline the magnitude of the shock. In the case of Spain's economy, from the 5.3% year-on-year increase in the consumer price index (CPI) in July the contribition of the energy component was 2.1 percentage points. That is to say, this component that represents less than 10% of the shopping basket has contributed nearly 40% to the year-on-year change.

In the case of the higher bill for energy imports, as of May 2008 Spain's net energy imports amounted to more than 40.98 billion euros (cumulative 12-month figure) so that the bill rose by 26%, whereas in terms of volume purchases were up by only 12%.

Taken as a whole, the above figures suggest that we are face to face with a major oil shock. Nevertheless, from an historical perspective this is not a crisis comparable with those in the Seventies and the early Eighties. Oil has been going through a chain of increases since 2000 that the oil-dependent countries up to now have overcome without special difficulty. In fact, the present upward stage beginning in 2000 has coincided with the strongest and most prolonged growth cycle in the world economy in 30 years in a context of low inflation and unemployment at very low levels.

The capacity to absorb oil impacts is getting better and better, oil dependence is dropping and alternatives to oil are being developed. We may therefore ask if oil is essential to the Western economies. The answer is yes over the short term, especially if, as happened in 2007-2008, there is a very sharp price rise but over the medium-long term we may assume that it certainly counts but less and less.

Foreign sector

Trade balance still getting worse due to energy

Trade deficit grows 11.4% due to worsening energy balance.

In the first half of 2008 the trade balance was 51.50 billion euros, an increase of 11.4% year-on-year as part of the continuing process of worsening seen in recent months although this was somewhat more moderate. With regard to the export/import ratio, this stood at 65.4%, slightly below the 66.5% in the same period last year.

The increase in the trade imbalance was due to the energy trade balance whereas the other components showed a tendency to stabilize, especially in capital goods and consumer goods. In the cumulative figure as of June, the energy deficit was 24.33 billion euros and amounted to 47.2% of the entire trade deficit. With regard to the same period last year, the trade deficit was up by 5.29 billion euros but, although the energy trade deficit rose by 8.40 billion

FOREIGN TRADE

January-june 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	29,794	55.3	20.0	5,467	67.6	5.6	–24,326	18.4
Consumer goods	35,679	–5.0	23.9	35,076	4.5	36.0	–603	98.3
Food	*7,685*	*4.2*	*5.2*	*11,593*	*6.5*	*11.9*	*3,909*	*150.9*
Non-foods	*27,995*	*–7.8*	*18.8*	*23,483*	*–0.1*	*24.1*	*–4,512*	*83.9*
Capital goods	12,866	–13.0	8.6	8,330	–1.7	8.5	–4,536	64.7
Non-energy intermediate goods	70,644	6.5	47.4	48,607	4.9	49.9	–22,037	68.8
By geographical area								
European Union	82,793	0.3	55.6	69,202	5.7	71.0	–13,591	83.6
Euro area	*69,261*	*–0.1*	*46.5*	*55,321*	*4.9*	*56.8*	*–13,940*	*79.9*
Other countries	66,190	19.6	44.4	28,279	7.9	29.0	–37,911	42.7
Russia	*4,685*	*14.1*	*3.1*	*1,375*	*51.9*	*1.4*	*–3,309*	*29.4*
United States	*5,865*	*24.2*	*3.9*	*3,690*	*–3.8*	*3.8*	*–2,176*	*62.9*
Japan	*2,982*	*–5.4*	*2.0*	*658*	*–4.8*	*0.7*	*–2,324*	*22.1*
Latin America	*7,689*	*11.5*	*5.2*	*4,464*	*–16.5*	*4.6*	*–3,225*	*58.1*
OPEC	*14,759*	*43.6*	*9.9*	*3,058*	*22.5*	*3.1*	*–11,701*	*20.7*
Rest	*30,210*	*15.4*	*20.3*	*15,034*	*16.2*	*15.4*	*–15,177*	*49.8*
TOTAL	**148,983**	**8.1**	**100.0**	**97,480**	**6.4**	**100.0**	**–51,502**	**65.4**

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

euros, the non-energy deficit was down 3.12 billion euros. At the same time, the deficit in consumer goods and capital goods continued to lose weight in the total.

In terms of trade flows, we should point out that in the first half of the year exports grew by 6.4% year-on-year whereas imports were up 8.1%. If we exclude the energy sector, the situation is turned around, given that the increase in exports was 4.1% year-on-year, whereas the growth in imports showed a slim 0.4%. In the same period, in real terms discounting price increases, goods exports rose by 4.4% year-on-year whereas imports were up by 4.2%. By sector, the most dynamic groups of export products were energy products, food and non-chemical semi-manufactured goods, while all others slipped down. With regard to imports, energy products continued to rise.

Finally, a breakdown of trade by geographical area accentuates recent trends. In June, the European Union continued as the Spanish economy's main trading partner, being the destination of 70.0% of all exports and the origin of 53.4% of purchases abroad. Nevertheless, two facts stand out. First, the growth of 14.7% year-to-year in imports from Asia which now represent a fifth of all Spain's imports because of the continuing increase in bilateral trade with China. Secondly, imports from North America rose by a notable 20.2% because of the weakness of the dollar.

Balance of payments: portfolio investment inflows down

The current account balance showed a deficit of 9.02 billion euros in May, 11.0% above the level for the same period last year. The widening of the current account imbalance was almost entirely due to the higher deficit in the incomes balance. The slight increase in the trade account deficits and current transfers was compensated by an improvement in the services surplus.

Non-energy deficit down but fails to compensate rise in oil.

Over a longer time frame, the trend in the cumulative figure for 12 months shows some moderation of recent trends. The worsening of the current account deficit slowed somewhat and in the 12 months ending in May it grew by 18.0% year-on-year, a lower rate than in previous months, because of a less substantial increase in the negative figure for the incomes balance. In the past 12 months the deficit in the incomes balance went from 26.07 billion euros to 32.34 billion, an increase of 6.27 billion euros, 35% below the increase in the second half of 2007.

Imports from China and United States on rise.

With regard to the area of financial flows, the key note is the decrease in the balance of portfolio investment. Inflows for portfolio investment in the 12 months ending in May amounted to 10.93 billion euros while in the same period last year they were 181.42 billion euros. This drop is compensated by a net decrease of 76.17 billion euros in assets of the Bank of Spain and especially by an increase of 80.82 billion euros in the other investments account which is basically made up of loans, deposits and other transactions of a financial nature.

Current account balance continues to grow worse.

It is this third component that is taking on more and more importance reflecting the change in how the liquidity needs of Spain's economy are being covered. In turn, direct investment in the past 12 months showed a 27.44 billion euro drop in net balance of outflows compared with the same period last year, mainly because of an increase in inflows which doubled.

Net entries of portfolio investment down but compensated by other investment inflows.

BALANCE OF PAYMENTS

May 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	–38,855	14.6	–94,741	–10,547	12.5
Services					
Tourism	*9,078*	*3.4*	*28,107*	*697*	*2.5*
Other services	*–1,947*	*–29.2*	*–4,856*	*637*	*–11.6*
Total	7,131	18.2	23,251	1,334	6.1
Income	–12,498	7.2	–32,344	–6,272	24.1
Transfers	–5,923	41.3	–8,465	–1,674	24.6
Total	**–50,144**	**14.6**	**–112,300**	**–17,159**	**18.0**
Capital account					
Financial balance	**3,424**	**111.2**	**6,319**	**260**	**4.3**
Direct investment	5,336	–	–19,386	27,439	–58.6
Portfolio investment	–11,683	–	10,931	–170,493	–94.0
Other investment	37,722	–	65,553	80,823	–
Total	**31,375**	**–45.5**	**57,098**	**–62,231**	**–52.2**
Errors and omissions	3,091	36.1	4,564	2,962	184.8
Change in assets of Bank of Spain	12,253	–	44,318	76,169	–

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.

Public sector

Central government accounts show deficit in first half-year

The sharp slowdown in the economy is strongly reflected in the central government accounts. In the first half-year, revenues arising from central government non-financial transactions in Treasury terms, that is to say, with regard to actual monetary flows, amounted to 92.65 billion euros before taking into account taxes ceded to autonomous community and local governments under the current financing system, which meant a year-on-year decrease of 0.9%, as compared with an increase of 11.9% in the same period in 2007.

In the first six months of the year, central government tax collections were down 1.7% compared with the same period last year. This drop was due to indirect taxes given that direct taxes showed a year-on-year increase of 7.5%.

Sharp economic slowdown results in lower central government revenues.

The main tax heading, collections for personal income tax, was up by 14.9%. This rise was mainly due to the sharp increases in tax withheld on capital and wages, as well as lower tax rebates. This growth came about in spite of the negative impact of the new deduction applicable for the birth or adoption of children for an amount of 518 million euros that did not exist in the first half of 2007. In turn, corporation tax was down

Increase in personal income tax collections compensates for drop in corporation taxes.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

June 2008

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**5,701**	**58.2**	**65,624**	**–5.1**
Non-financial revenue adjusted (*)				
Personal income tax	3,778	91.4	36,220	14.9
Corporate tax	616	17.3	7,368	–17.6
VAT	2,712	50.6	29,011	–14.2
Special taxes	1,632	–3.9	9,609	1.3
Other	1,467	–12.2	10,442	6.6
Total	**10,205**	**33.1**	**92,650**	**–0.9**
Non-financial spending	**10,952**	**2.8**	**67,689**	**4.2**
Treasury balance	**–5,251**	**–25.5**	**–2,065**	**–**
Surplus (+) or deficit (–) (**)	***–7,405***	***–11.6***	***–4,683***	**–**

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

Decrease in VAT collections because of easing off in consumption and collapse in housing market.

17.6%. This was due to the decrease in corporate profits but also to changes in regulations and to the second part of the reduction in tax rate and various measures to boost economic activity introduced in April this year.

The decrease in collections for indirect taxes (10.4%) was largely due to value added tax (VAT) which was down 14.2%. This decrease reflected the slowdown in consumption and the collapse in the housing market. Furthermore, the performance in VAT was also due to simplifying rebates and the new system of fiscal consolidation for business groups. If the latter effect is ignored, the drop in gross revenue for VAT would be only 3.2%.

Collections for special taxes on petroleum products and alcoholic beverages show drop.

Special taxes were up 1.3%. The biggest heading, that for petroleum products making up more than half of the figure, suffered a drop of 2.5% as a result of the drop in demand because of rising prices for fuels and fuel-oils. There were also decreases in taxes on alcoholic beverages. On the other hand, collections for taxes on tobacco and electrical power were up notably.

Other central government revenues were up 6.6%. Profits from the Bank of Spain showed considerable growth. On the other hand, capital transfers from European Union funds were down substantially.

With regard to central government non-financial spending, in the first half-year these amounted to 67.69 billion euros, 4.2% more than last year. Of this figure, those amounts for current transfers rose by 6.1% while capital transfers were down 8.9%.

June deficit partly due to seasonal factors...

Staff costs were up by 7.5%. Current spending on goods and services showed a drop of 2.6%. Financial spending was up by 15.3% because of the calendar of bond maturities.

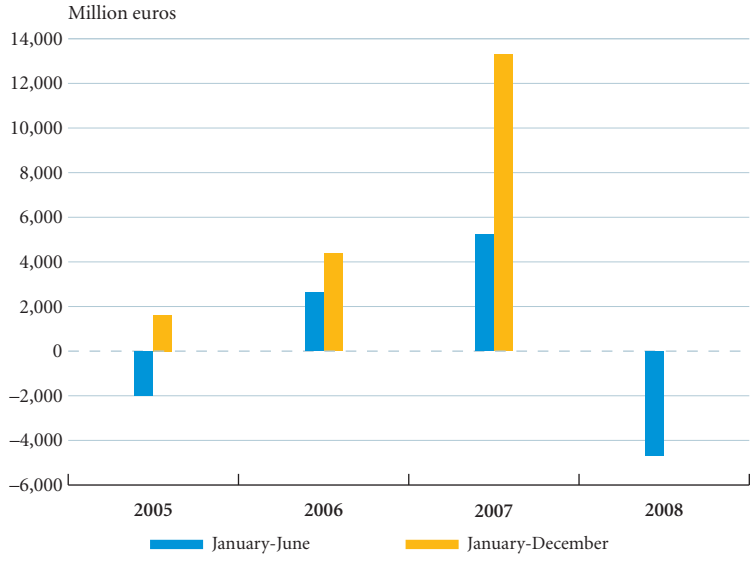
As a result of the drop in revenues and the cumulative increase in spending up to June, the central government non-financial balance in Treasury terms was in the red 2.06 billion euros as against a surplus of 4.17 billion euros in the same period in 2007. Such a deficit in the first half-year had not been reported since 2005. In terms of National Accounting, that is to say, taking into account rights and obligations instead of spending actually carried out, the deficit amounted to 4.69 billion euros, as against a surplus of 5.22 billion euros in the first half of last year. The deficit reported amounted to 0.42% of the gross domestic product (GDP) whereas in the same period in 2007 the surplus was 0.50%.

Was the deficit showing up in the central government accounts in June due to a sudden worsening of the public finances? The answer is no. The cause is rather to be found in seasonal factors which in June normally make spending greater than revenues. In terms of National Accounting, the deficit in June actually was down by 11.6% compared with the same month in 2007 as resources rose by 60.7% versus an increase of 12.2% in uses. What is more, the cumulative deficit in the first half of 2005 was followed by a surplus for that year as a whole.

Nevertheless, prospects are not all that bright. The tendency to a decrease in the public surplus due to the progressive worsening of the economic situation (especially with the effect of the anti-cyclical measures to stimulate the economy through fiscal means as adopted by the central government, such as the new deduction in personal income tax for an amount of 400 euros).

CENTRAL GOVERNMENT ACCOUNTS GROW WORSE

Deficit (–) or surplus (+) in central government financing



SOURCE: Ministry of Economy and Finance.

For 2009, the review of the macroeconomic scenario as published by the central government on July 24 foresaw a public deficit of 0.34% of the GDP. This figure is the result of a forecast increase in non-financial spending (excluding that for unemployment) of 3.5%, in line with the official growth projection of nominal GDP and unemployment spending of 1.5 billion euros. The orientation of budgetary policy for 2009 may be stated as austerity, solidarity (social spending is guaranteed, particularly spending for unemployment and dependency) and the improvement of productivity in order to contribute to a relaunching of economic growth. While these measures seem praiseworthy, it is possible that the forecast for the public deficit may not go far enough given the worsening of the economic situation, which could mean a weakening of revenues and higher unemployment costs.

...but prospects far from bright.

Savings and financing

Slowdown in funding to private sector continues

Sharp economic slowdown and loss of confidence among economic groups weakens demand for credit.

The 12-month Euribor, widely used as a reference rate for contracts, showed an all-time high monthly average of 5.39% in July following the rise in the European Central Bank official rate to 4.25% at the beginning of the month. Nevertheless, in the early weeks of August the 1-year Euribor stood slightly below the average level in July with the disappearance of prospects of further increases in the European Central Bank reference rate although pressures in interbank markets still persist a year after the outbreak of the subprime mortgage crisis in the United States.

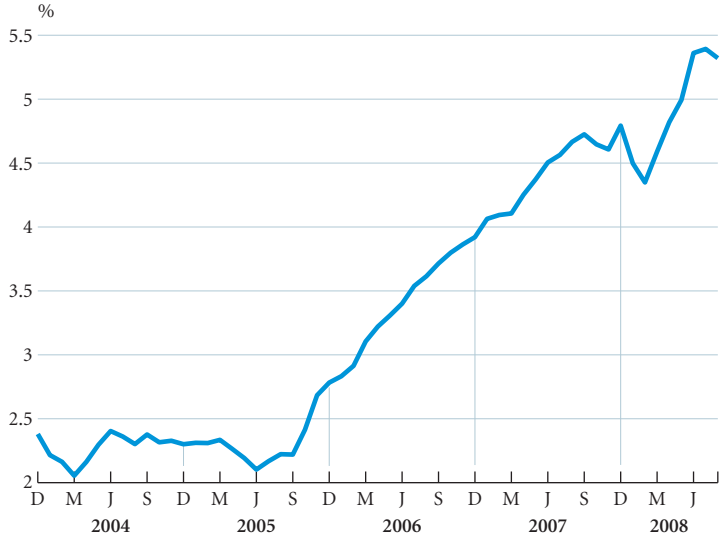
Financing granted to private sector up 10% annual in June, less than half that one year earlier.

In this context, the average interest rate on loans and credits granted to companies and households tended to rise in the second quarter going to 6.17% in June, the highest rate in recent years. Nevertheless, in real terms, that is, discounting inflation that stood at 5.0% that same month, loan interest rates were relatively low.

This did not stop loan demand from continuing to weaken due to the sharp economic slowdown and the drop in confidence in economic agents. On the supply side, financing terms are not as easy as they were before. As a result, financing of the private sector continued to ease in the second quarter to show an annual change rate of 10.1%

EURIBOR DROPS SLIGHTLY AFTER HITTING RECORD LEVEL IN JULY

12-month Euribor



NOTES: August 22.
SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

June 2008

	Total	Change this year		Change over 12 months		% participación
	Million euros	Million euros	%	Million euros	%	
Commercial credit	81,162	–9,680	–10.7	–6,297	–7.2	4.4
Secured loans (*)	1,101,347	32,975	3.1	93,438	9.3	59.9
Other term loans	522,363	24,480	4.9	61,469	13.3	28.4
Demand loans	54,655	14,083	34.7	15,218	38.6	3.0
Leasing	47,428	1,135	2.5	3,327	7.5	2.6
Doubtful loans	31,220	14,969	92.1	18,669	148.7	1.7
TOTAL	**1,838,175**	**77,963**	**4.4**	**185,824**	**11.2**	**100.0**

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

in June, less than half that one year ago and very close to the growth rate of credit in the Euro Area whereas 12 months ago the rate was nearly double that figure. In view of the weakening of economic activity it is likely that we shall see a continuation of the slow-down trend in credit to the private sector in coming months.

Both funding to companies and households has seen a sharp drop in growth rate over the past year although the annual change rate for non-financial companies (11.2%) stood higher than that for households at 8.5%. Under corporate financing, commercial credit used to finance working capital was down 7.2% in the 12 months ending in June, the biggest drop since February 1994, another sign of the poor state of economic activity. Naturally, investment has also suffered as may be seen from the drop in leasing which showed an annual increase of 7.5% in June, some 6 percentage points less than in December.

With regard to loans to households, for the first time since 2003 the annual change rate for housing loans in June (8.2%) stood below that for all other loans (8.5%). High housing prices, which means a major block to home ownership, the rapid worsening of the labour market with a sharp increase in unemployment and the prospect of a drop in housing prices has lowered demand for mortgage funding. According to figures from the National Institute of Statistics, the number of home mortgages signed in May was down 36.2% compared with one year earlier while the average amount was 6.6% lower than in the same month the year before.

Commercial credit records biggest annual drop since 1994.

The slowdown in credit to the private sector has had its effect on both banks and savings banks. Nevertheless, in the past 12 months loans to companies and households by banks showed slightly higher growth than those by savings banks (11.2% as against 10.8%). As a result, the savings banks lost some market share although they continued to lead in this lending segment.

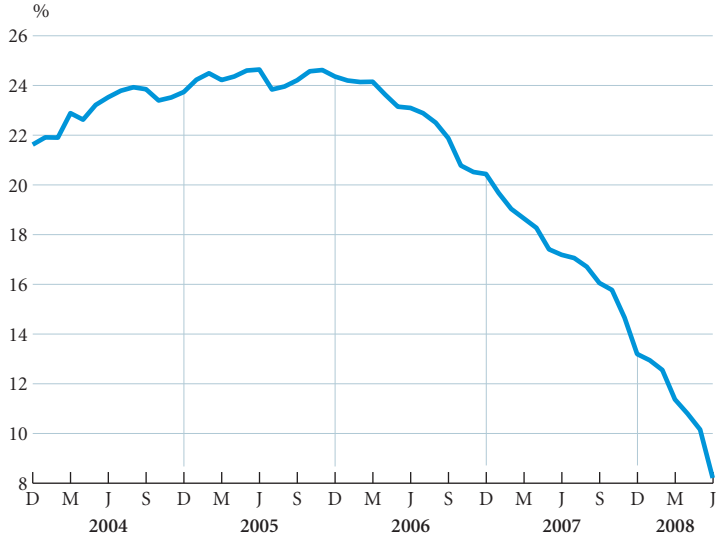
Sinking demand for mortgage finance from households.

Another result of the economic slowdown has been the rise in default which had reached an all-time low. At the end of the first half-year the default rate of lending institutions as a whole stood at

Default on rise although level still moderate.

DROP IN HOUSING LOANS GETS SHARPER

Year-on-year change in housing loans to households



SOURCE: Bank of Spain.

Increase in bank deposits in line with that in Euro Area.

1.7%, a level that is still moderate and below the European average. Furthermore, Spain's financial institutions have made ample provision in this regard.

Assets of mutual funds continue to drop

The rapid worsening of the economic situation has also had its effect on the growth of bank deposits. In fact, the annual change rate for private sector bank deposits was 9.3% in June, less than half that one year ago and in line with that in the Euro Area.

Time accounts up 45% in last 12 months due to drive by financial institutions to attract deposits.

This slowdown came about in spite of growing competition between financial institutions to attract private sector deposits in view of the difficulty in obtaining funds in the wholesale market because of the financial crisis. As a result, interest rates on time deposits by individuals reached 4.64% in June, the highest level in recent years, although below inflation that month.

Time deposits for up to 2 years won most favour among savers seeking low risk given that the total was up 45.0% as of June. On the other hand, sight deposits and savings deposits were down 4.6% because of low yields. Deposits in foreign currency stood below the level one year ago in a context of relatively high euro interest rates.

By type of institution, private sector deposits at savings banks were up 11.2% as against 7.6% at banks. As a result, the savings banks increased their dominance in this market segment.

Sharp competition for bank deposits and the upsets in the financial markets continued to have a negative effect on participations in mutual funds. Assets of these funds at the end of June stood at 195.18 billion euros, 2.7% less that at the end of the previous month. This decrease

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

June 2008

	Total	Change this year		Change over 12 months		% participación
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	429,211	–8,846	–2.0	–20,904	–4.6	31.1
Up to 2 years	435,671	82,965	23.5	135,149	45.0	31.6
More than 2-year term	400,223	–1,751	–0.4	14,250	3.7	29.0
Repos	71,975	–13,617	–15.9	–11,647	–13.9	5.2
Total	**1,337,079**	**58,750**	**4.6**	**116,847**	**9.6**	**97.0**
Deposits in currencies other than euro	**41,085**	**–2,759**	**–6.3**	**–97**	**–0.2**	**3.0**
TOTAL	**1,378,164**	**55,991**	**4.2**	**116,750**	**9.3**	**100.0**

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

was due to continuing net withdrawals of participations amounting to 5.39 billion euros during the month. Annual yields obtained on the various fund categories swung between 3.0% on money-market funds to –24.2% on euro share-based funds.

On the other hand, the trend in hedge funds was more favourable. At the end of the first half-year these fund reported assets of 1.33 billion euros as against 818 million at the end of December. It should be pointed out, however, that hedge funds are still at early stages of development in the Spanish market.

The upset in the financial market also affected pension funds for which assets stood at 82.14 billion euros at the end of June, a drop of 1.8% in the past 12 months. In the second quarter the volume of net contributions rose to 89 million euros. Average annual yield in the past 18 years, in keeping with the type of contingency covering this financial product, was 5.8%, higher than the inflation rate for the period.

Savings banks increase lead in deposits by companies and households.

Relatively low yield on mutual funds fails to attract savings.

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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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