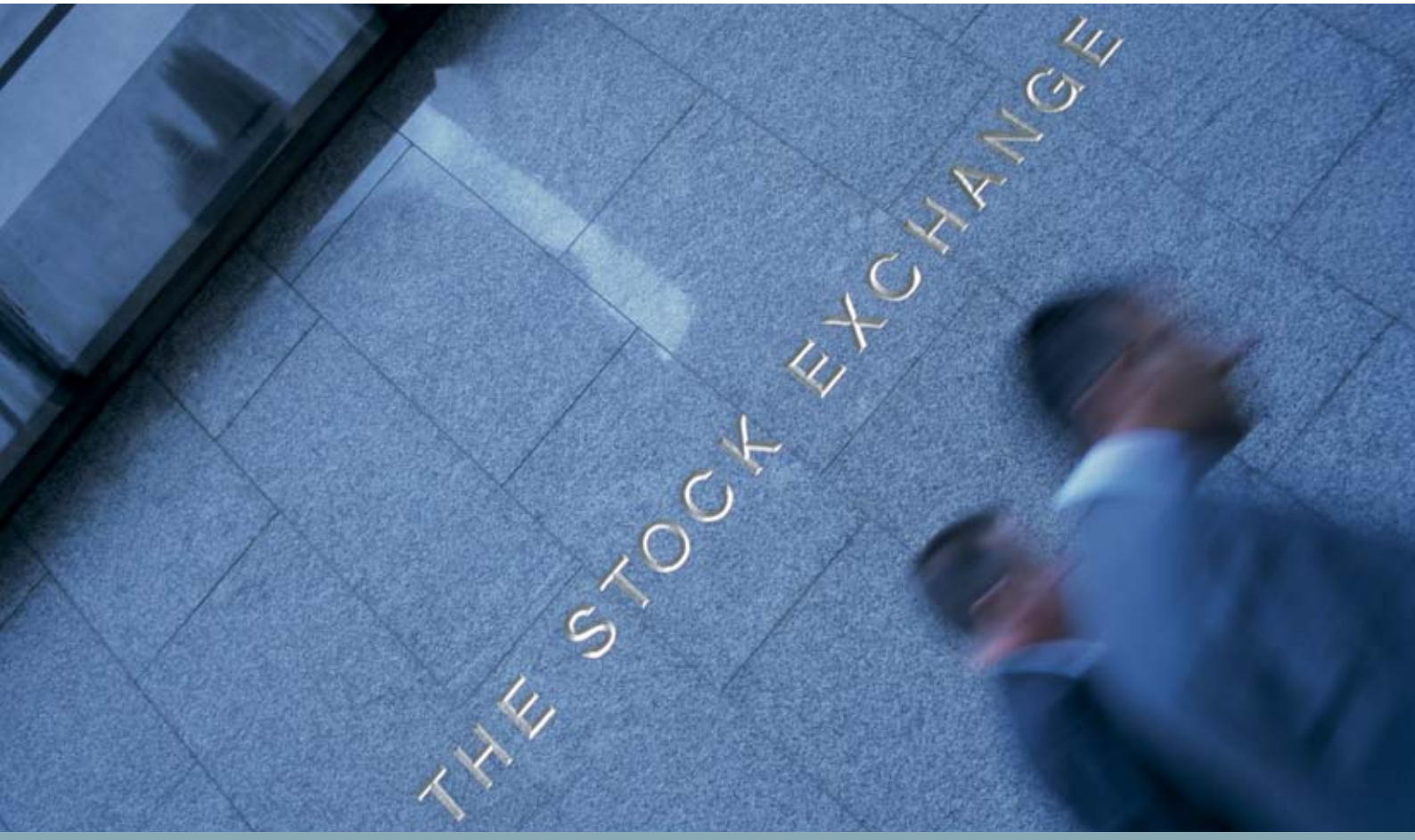
OCTOBER 2008

THE SPANISH ECONOMY

Monthly Report



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Upheaval in the financial system Page 10
Crisis that began in the summer of 2007, far from being resolved, threatens to be the worst since 1929

Financial regulation: heading toward Basel III? Page 29
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How should central banks respond to changes in asset prices?

Relationship banking vs. the markets: a return to origins? Page 69
Subprime mortgage crisis reveals vulnerability and risks of a banking model far removed from traditional lines

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2007	2008	2009	2007	2008			
				4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast					Forecast	
Gross domestic product								
United States	2.0	1.8	1.3	2.3	2.5	2.1	1.3	1.3
Japan	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
United Kingdom	3.0	1.2	1.7	2.9	2.3	1.5	0.7	0.5
Euro area	2.6	1.4	0.9	2.1	2.1	1.4	1.0	0.9
Germany	*2.6*	*1.7*	*0.8*	*1.7*	*2.6*	*1.7*	*1.2*	*1.2*
France	*2.1*	*1.2*	*1.0*	*2.2*	*2.1*	*1.1*	*0.6*	*0.9*
Consumer prices								
United States	2.9	4.6	3.0	4.0	4.1	4.4	5.3	4.4
Japan	1.7	1.5	1.4	1.6	1.4	1.6	1.5	1.5
United Kingdom	2.3	3.6	2.8	2.1	2.4	3.3	4.6	4.0
Euro area	2.1	3.5	2.5	2.9	3.4	3.6	3.8	3.2
Germany	*2.3*	*2.8*	*2.1*	*3.1*	*2.9*	*2.9*	*3.1*	*2.4*
France	*1.5*	*3.0*	*2.0*	*2.3*	*2.9*	*3.3*	*3.2*	*2.7*
SPANISH ECONOMY		Forecast					Forecast	
Macroeconomic figures								
Household consumption	3.4	1.1	0.6	2.9	2.2	1.2	0.7	0.2
Government consumption	4.9	4.2	5.0	4.4	3.6	3.8	4.3	5.0
Gross fixed capital formation	5.3	–1.0	–3.4	4.5	2.5	–0.2	–2.4	–3.8
Capital goods	*10.0*	*1.5*	*–2.0*	*7.1*	*5.2*	*2.3*	*0.5*	*–2.0*
Construction	*3.8*	*–3.5*	*–5.7*	*2.9*	*0.3*	*–2.4*	*–5.1*	*–6.4*
Domestic demand (contribution to GDP growth)	4.4	1.1	0.3	3.8	2.8	1.5	0.5	–0.2
Exports of goods and services	4.9	3.8	3.2	4.0	4.3	4.1	3.5	3.1
Imports of goods and services	6.2	2.2	1.3	4.9	4.1	2.3	1.5	0.8
Gross domestic product	**3.7**	**1.4**	**0.7**	**3.3**	**2.6**	**1.8**	**0.9**	**0.4**
Other variables								
Employment	2.9	0.0	–0.9	2.2	1.4	0.4	–0.5	–1.3
Unemployment (% labour force)	8.3	10.7	12.7	8.6	9.6	10.4	10.8	11.8
Consumer price index	2.8	4.4	2.9	4.0	4.4	4.6	4.9	3.8
Unit labour costs	2.9	3.4	2.7	3.0	3.9	3.6		
Current account balance (% GDP)	–10.1	–10.2	–10.0	–10.5	–12.0	–9.5		
Net lending or net borrowing rest of the world (% GDP)	–9.7	–9.8	–9.8	–9.6	–11.2	–9.0		
Government balance (% GDP)	2.2	–1.5	–2.2					
FINANCIAL MARKETS		Forecast					Forecast	
Interest rates								
Federal Funds	5.0	2.2	2.1	4.5	3.2	2.1	2.0	2.0
ECB repo	3.8	4.1	4.3	4.0	4.0	4.0	4.2	4.3
10-year US bonds	4.6	3.8	4.5	4.3	3.6	3.9	3.8	3.9
10-year German bonds	4.1	3.9	4.1	3.9	3.4	4.1	4.1	4.0
Exchange rate								
$/Euro	1.37	1.52	1.44	1.45	1.50	1.56	1.51	1.50

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Wall Street is burning

Could anyone have predicted what would happen in September, a month *horribilis* for global finance? It is not very likely. In a mere three weeks we have witnessed the biggest ever financial bailout operation by a US government which on the first Sunday of the month took over management of the two huge mortgage lending institutions in the country, Fannie Mae and Freddie Mac. Just one week later the investment bank Lehman Brothers went into receivership and another well-established investment bank, Merrill Lynch, was acquired by the Bank of America in order to avoid its collapse. On Tuesday, September 16, the US government along with the Federal Reserve, the country's central bank, organized a bailout operation to avoid the bankruptcy of American International Group, the world's leading insurance company. On September 17, one of the big mortgage lending banks in the United Kingdom and the top bank in deposits, HBOS, had to merge with Lloyd's in order to avoid a worse situation. Next, on September 18, the main central banks again coordinated a move in order to provide liquidity to markets on the edge of a nervous breakdown. On September 25, Washington Mutual announced its bankruptcy, the biggest in the history of commercial banking in the United States. The story does not stop there but still goes on...

What happened? The chain of events leading up to the present situation is a long one. The origin, of course, came in an asset bubble, in this case in housing prices in the United States, boosted by the sudden increase in subprime mortgages granted to customers with limited resources and stimulated by extremely easy borrowing terms that pushed up the indebtedness of households and financial institutions. If we examine the development of the problem, we find irresponsible banking practices developed by a parallel banking system made up of investment banks, off-balance sheet entities and other financial networks that generate a huge volume of «toxic» assets, all sustained by untenable leverage levels. The valuation of these assets is practically impossible and now they are spread all over the world because they enjoyed the highest blessing of the risk rating agencies and were guaranteed by some of the institutions now in receivership. Right at the bottom of the problem are the regulatory bodies of the US financial system which seemed incapable of seeing the time-bomb developing right before their eyes.

The initial consequences have been more than a year of severe problems in the financial markets. The institutions to suffer the worst effects of this *tsunami* are those that depend most on the wholesale markets as a source of funding, those with a greater exposure to «toxic assets», and those whose degree of financial leverage has meant that their losses have brought about a sharp worsening in their capital ratios. No one, however, is going to come out of this crisis unscathed. The scarcity of credit, following a period of heavy borrowing, does not auger well for the real economy. The solutions are not going to be rapid or cheap and for the moment it is not possible to make reliable forecasts. It is essential to halt the drop in asset prices in order to repair bank balance sheets, restore investor confidence and normalize the functioning of the financial markets. This is an emergency seeing that the development of the crisis recalls the Great Depression in 1929. Once the situation in the financial markets is back on track it will be time to draw the appropriate lessons. Banking regulation, particularly, should ensure that innovative financial initiatives are backed by sufficient capital and that exposure to risk is reasonable and, furthermore, that transactions are sufficiently transparent at all stages. The subprime mortgage crisis has exposed the vulnerability and enormous risks of a method of carrying on banking business that is a long way from the traditional model.

EXECUTIVE SUMMARY

Financial markets: under severe strain

September will go down in annals of financial history.

In September, world finances lived through one of the most convulsed months in history. The epicentre of the crisis was in the United States in the summer of 2007 in a small segment of the mortgage loan market. Its reverberations, however, have reached nearly every corner of the planet and, far from easing off, its repercussions get bigger and bigger. The giddy swings in the markets and the exceptional measures taken in September have turned it into a period that will be hard to repeat. Let us look at these events.

In ten-day period, US government intervenes in Fannie Mae and Freddie Mac mortgage bodies, Lehman Brothers forced into bankruptcy...

The first bombshell was the announcement by the US Treasury of the nationalization of the mortgage lending agencies Fannie Mae and Freddie Mac, backed by the Federal Reserve, the central banking system, and other economic bodies. On Sunday, September 7, in order to avoid the bankruptcy of two institutions that together guarantee nearly half of the mortgage lending market in the country, the government took over their temporary management. What is more, it decided to inject up to 200 billion dollars in what must be the biggest bailout in the financial history of the United States. The bailout did not come as such a big surprise to the markets (in fact the legal basis for the intervention dates back to a measure passed by Congress last July) that had already sharply cut back the prices of their respective shares and as a result the markets reacted positively.

...and world's biggest insurance company nationalized.

If there had been any doubt up to this point, the bailout of these two mortgage institutions underlined the core of the problem, a real estate crisis that will likely go down in history as one of the most virulent ever and one whose end is still not in sight. This is the Gordian knot that up to now it has been impossible to break. While housing prices do nothing but drop (latest figures remind us that prices and number of settlements are still going down), the US banking system is going to continue under severe strain unless exceptional measures are adopted.

But the drama has only just begun. During the weekend of September 13-14, marathon negotiation sessions were aimed at finding a buyer for Lehman Brothers, a long-established investment bank urgently in need of recapitalization. The absence of possible candidates forced the institution to go into receivership the following Monday (September 15) when it presented liabilities of nearly 700 billion dollars, the biggest contingency ever seen in the United States. At the same time, the Bank of America, the leading US commercial bank at the time, acquired another of the big investment banks on the edge of the precipice, namely, Merrill Lynch. This decision, partly sponsored by the Treasury and the Federal Reserve, hoped to anticipate a sharp move in the markets in their search for the next weak link in investment banking.

The cease-fire, however, was short-lived. Doubts about the solvency of the world's leading insurance company, American International Group, forced the taking of an exceptional measure, the nationalization of 80% of the capital of that group on September 17. At the same time, an emergency loan was arranged from the Federal Reserve amounting to

85 billion dollars. This meant another financial giant passing into State hands as the authorities pondered the dangers of its collapse to the overall stability of the financial system, that is to say, its presenting a system risk. It was too big to let it fall.

Almost at the same time, the monetary authorities carried out a major coordinated operation for injecting liquidity. In spite of this, the lack of confidence and the flight to quality disturbed the functioning of the market. The stock markets suffered substantial drops and the interest rate on US government bonds (the most secure for the investor) stood at its lowest level since the bombing of London in World War II.

It was precisely the City that would mount a new episode in the financial crisis. If there is any parallel to the situation in the US economic situation, it is to be found in the case of Britain which is characterized by a severe real estate crisis and a sophisticated financial sector that carries much weight in overall economic activity. It was not surprising therefore that the biggest UK mortgage lending institution, HBOS, was bought up by Lloyds TSB on September 17 with the blessing of the UK economic authorities, which were even ready to put aside some regulations on the defence of competition. With many fronts now open, along with inflation out of control and the economy at the gates of recession due to the collapse of domestic demand, Gordon Brown's government is trying to find urgent solutions to a situation that threatens to overwhelm him.

In spite of the transcendental government moves in the United States and the coordinated measures by the central banks, the dominant perception in the markets was that the situation was far from being under control. On September 18, a Copernican turnaround in the management of the crisis began to be organized. It was leaked to the press that a major plan was being drawn up to bail out the distressed US credit system. Next day, September 19, Secretary of the Treasury Henry Paulson officially presented the plan. In this early draft, the basic measure was to be the creation of a fund aimed at the buying up of «toxic» assets in bank balance sheets for a maximum of 700 billion dollars. The reaction of the markets, with notable increases on the stock exchanges, suggested that stabilization of the markets, one of the aims of the plan, might be realized.

All these measures not enough to return confidence to markets and central banks have to make huge injections of liquidity.

On the days following, details of the plan became known and political negotiations started between the Democrats and the Republicans so that parliamentary handling of the measures would be successful. As the specific aspects became known and negotiations turned out to be fruitful some calm showed up in the markets. The presidential candidates gave their explicit support to the plan. At the end of the month, the plan now to be known as the Law on Emergency Stabilization of the Economy 2008 was about to be approved by Congress and it was expected that the Senate would give it its backing shortly afterwards.

US government opts for announcing massive plan to bail out «toxic» assets in bank balance sheets for amount of 700 billion dollars.

Simultaneously, the last two investment banks (Goldman Sachs and Morgan Stanley) applied for commercial banking status thus turning themselves into conventional bank holdings and thus practically ending their stage as investment banks in the US banking system. At the same time, corporate moves have intensified. JP Morgan Chase took over the country's leading savings bank, Washington Mutual, which was close to bankruptcy. The Japanese financial holding Nomura would acquire the Asian divisions, the Middle East and European divisions of Lehman Brothers. The Mitsubishi UFJ bank would take 20% of Morgan Stanley. Finally, the

Corporate panic not ending...

...and Europe fails to escape world crisis as shown by upsets in various institutions.

financier Warren Buffet announced his decision to buy 9% of Goldman Sachs.

Europe has not escaped the tempest. Its financial markets have followed in the wake of those in the United States. While there are major national differences, some banking systems are especially sharply suffering the effects of the subprime mortgage crisis. To mention some major cases, three institutions had to be bailed out using various formulas. These were Bradford & Bingley in the United Kingdom, Fortis in Belgium and Hypo Real Estate in Germany.

In this context, the stability of Spanish banks is notable. This was due to the low exposure to the US mortgage derivatives that set off the problem and thanks to a regulatory policy of the central bank that is much more rigorous with regard to risk management and the capitalization of institutions. The high level of capitalization and provisions set aside in times of boom have put Spanish banks in a more favourable position to resist the buffeting of financial upsets although the fierceness of these upsets does not mean that any financial system will be totally immune to them.

Economy on Continent faces major slowdown in activity.

Furthermore, the idea that the European economic cycle would resist the worsening of the international context without excessive problems has vanished. The contraction of credit and the decrease in confidence, which has affected banks, companies and consumers, are two problems that are now having a substantial effect on domestic demand on the European Continent. Furthermore, something of an overall slowdown in foreign demand is threatening to decrease exports, an important factor in European growth.

End of crisis heavily depends on US real estate market, the ability of emerging economies to hold up and normalization of credit.

It is therefore not surprising that even the European Commission admits the fact of a technical recession, that is, two consecutive quarters showing a drop in gross domestic product, in Germany, United Kingdom and Spain. Spain's economy is suffering from the coming together of the financial upsets and the end of a long real estate growth cycle, a combination that has meant a sharp halt to economic growth and a sudden increase in unemployment. Furthermore, it shares with its EU partners the reality of a rapid slowdown in consumption and capital goods investment. In this context, the easing of inflation that began with the drop in oil prices has come as a blessing from heaven, especially if forecasts that the improvement in inflation will continue in coming months actually come true.

It is to be desired that the events in September turn out to be the high point of the financial storm and that the essential climate of confidence be re-established as soon as possible. However, the extent of the crisis means we must revise downward the growth forecasts for the developed economies. Even allowing for the approval of the extraordinary bailout plan for US finances and the exceptional measures adopted by European authorities, the bill for the real economy is going to be considerable. So that recovery is not excessively delayed it is also necessary that the emerging economies continue their growth course. Russia's difficulties in recent months are a reminder we are dealing with a group of countries with limited ability to resist a global contraction of growth and financial flows. Another condition, as mentioned above, is that the readjustment in real estate in the United States would begin to show some life and thus repair the damage inflicted on consumer confidence. The economic horizon does not have to be as dark as some apocalyptic voices are now declaring. Perhaps we should recall the words of Winston Churchill at one of the most critical moments of World War II when he stated: «This is not the end. It is not even the beginning of the end. But it is, perhaps, the end of the beginning».

September 29, 2008

CHRONOLOGY

2007

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.
September	**19**	US government presents **bailout plan for country's banking system** amounting to 700 billion dollars.

AGENDA

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).

November

- **4** Registrations with Social Security and registered unemployment (October).
- **6** Industrial production index (September). Governing Council of European Central Bank.
- **12** CPI (October).
- **13** Advance GDP(3rd Quarter).
- **14** EU GDP (3rd Quarter). Harmonized CPI for EU (October).
- **19** Quarterly National Accounts (3rd Quarter).
- **25** Producer prices (October). Central government revenue and spending (October).
- **26** Foreign trade (September).
- **28** Balance of payments (September). Advance harmonized CPI (November).

INTERNATIONAL REVIEW

United States: propping up financial system and economic activity

US GDP grows by 2.2% but financial crisis will be heavy drag on economic activity.

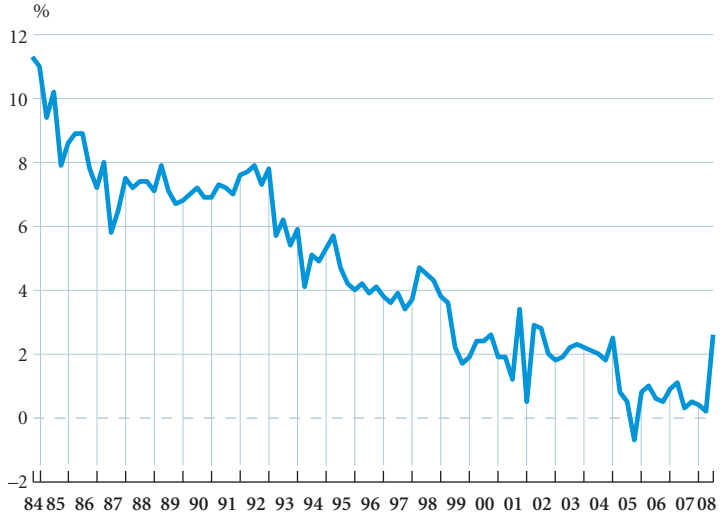
The recurring dilemma in economic policy of deciding which is the most pressing of the two traditional ills, low growth or inflation, this time has been resolved in favour of the former. US gross domestic product (GDP) grew by 2.2% year-on-year in the second quarter and, in quarter-on-quarter terms annualized, the increase was an apparently strong 3.3%. Nevertheless, the huge government intervention in aid of the financial institutions shows that right now the priority is to save the system and prevent a total freeze-up of credit. First came the provision of up to 200 billion dollars to support the mortgage loan institutions Fannie Mae and Freddy Mac. Then came the Fed's taking over of control of the AIG insurance company with a loan of 85 billion dollars and, finally, the decision to back «toxic» assets with public funding which, according to an early estimate, could cost 700 billion dollars, or 5% of the nominal GDP.

Weakness of private consumption and budget deficit will be long lasting.

These moves, however, will have long-lasting consequences. The apparent demise of independent investment banking should mean more savings and less leverage but the starting point is still far from this objective. According to the Organization for Economic Cooperation and Development (OECD), the structural public deficit in 2008 will

UNITED STATES: HAS RECOVERY IN SAVINGS ALREADY BEGUN?

Household savings in terms of disposable income



SOURCE: Bureau of Economic Analysis and own calculations.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007			2008			
			2Q	3Q	4Q	1Q	2Q	July	August
Real GDP	2.8	2.0	1.8	2.8	2.3	2.5	2.2	–	...
Retail sales	5.8	4.0	4.0	4.1	4.7	3.0	2.6	2.1	1.6
Consumer confidence (1)	105.9	103.4	106.7	105.7	91.2	76.5	57.3	51.9	56.9
Industrial production	2.2	1.7	1.4	1.8	2.1	1.9	0.3	–0.4	–1.5
Manufacturing (ISM) (1)	53.1	51.1	53.0	51.3	49.6	49.2	49.5	50.0	49.9
Sales of single-family homes	–18.0	–26.8	–22.1	–27.3	–33.7	–33.1	–39.0	–35.3	...
Unemployment rate (2)	4.6	4.6	4.5	4.7	4.8	4.9	5.3	5.7	6.1
Consumer prices	3.2	2.9	2.7	2.4	4.0	4.1	4.4	5.6	5.4
Trade balance (3)	–753.3	–700.3	–730.7	–701.4	–700.3	–697.8	–699.6	–704.4	...
3-month interbank interest rate (1)	5.2	5.3	5.4	5.4	4.9	3.0	2.8	2.8	2.8
Nominal effective exchange rate (4)	82.5	77.9	79.3	77.0	73.3	72.0	70.9	70.9	74

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

be 5.2% of GDP, a figure that, following events, will likely go up. On the other hand, in the second quarter consumers saved 2.6% of disposable income, more than in previous periods but still well below desirable levels. As a result, private consumption, the anchor of the economy, continues to slow down in this process of strengthening savings that is still in its initial stages. Investment in capital goods is also slowing down while the sharp drops in housing investment continue. The foreign sector has become the strongest support for growth thanks to the weakness of import demand and increasing competitiveness of exports as a result of a cheaper dollar. For the moment, a recession is being dodged but the real problem remains the accumulation of quarters of weak growth with prospects for 2009 that, in the best of cases, suggest a low profile.

Supporting this thesis of a prolonged slowdown is consumer sentiment for which the most used indicator, the consumer confidence index published by the Conference Board, rose from 51.9 points to 56.9 points in August, a level that holds within the low band for the past 30 years. What is characteristic of recent months is the shift of the weakness in the expectations component to the component of the perception of the current situation. As a result, while the former are up slightly from all-time lows, the latter continue to lose ground. In keeping with the low sentiment level of consumers, retail sales in August lost practically all the rise seen in the past three months thus confirming the downward trend. If we exclude cars and petrol, sales in August were down compared with the month before, which reduce the cumulative increase for the

Consumer pessimism shifting from future prospects to the present.

Business executives see lower price pressures in current downturn.

past 12 months to 3.0% year-on-year, a figure which, discounting price changes, turns into a very slim 0.4%. In turn, car sales in the same period showed a cumulative drop of 13.5 % year-on-year.

The corporate view, while more biased in principle, also runs within this downward trend, as can be seen from the index of business activity put out by the Institute for Supply Management which in August continued very close to a balance of 50 points in which there are as many optimistic responses as pessimistic ones. The manufacturing index stood at the 49.9 points level while services rose to 51.6 points. The best news in both cases was the easing of the prices index, although this remains at high levels, and the rise in manufacturing exports. But, while employment and new orders remain in an unclear situation, the general tendency is still to a sustained drop.

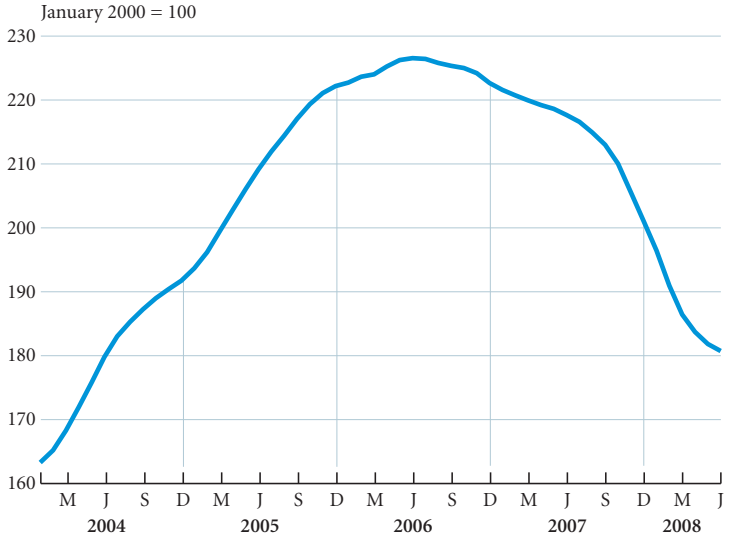
Housing still not hitting bottom and real estate values show cumulative drop of 20%.

Construction spending in the second quarter was down 15.8% compared with the previous period in annual terms and, while this is better than the drop in earlier quarters, it is a long way from hitting bottom. In this situation, the latest supply indicators showed bigger decreases. Housing starts were down 33.1% in August compared with the same period last year. Pointing in the same direction, building permits, an early indicator of starts, were down a similar 36.4%.

On the demand side, the situation is more troubling. Real estate prices keep reducing the perceived wealth of many consumers and in July the Case-Shiller index kept dropping with a cumulative decrease of 20.3% compared with the high in June 2006 which, if we add the increase in the CPI, means a loss of 26.0% in value. Nor is the liquidity of homes improving seeing that in July

UNITED STATES: REAL ESTATE PRICES STILL DROPPING

Case-Shiller index of housing prices



SOURCE: Standard & Poor's and own calculations.

UNITED STATES: DROP IN EMPLOYMENT GROWING WORSE

Job creation in last 12 months

SOURCE: Department of Labor and own calculations.

it took an average of 11.2 months to sell a home, twice the time needed only two years ago, the highest level since the indicator was established in 1999. The sharpness of the drop is not increasing as it was in previous months but the improvement is very slight and it would be premature to conclude that prices had hit bottom. While sales seem to have stabilized their drops, which should bring about stabilization and then a reduction in the number of vacant housing units, the weakness of the labour market will continue to effect demand.

The fact is employment is growing worse. Some 84,000 jobs were lost in August which, along with downward revision of the two previous months, put total jobs lost this year at 605,000. As a result, the number of private non-farm jobs was down by 0.2% year-on-year. The fact is that since October 2007 more and more there has been a constant drop in the labour market. In line with this sober picture, the unemployment rate in August went up to 6.1% of the labour force, 30% higher than in the corresponding period last year and with wages that have lost 2.2% of their purchasing power and continue at 2001 levels.

Labour market heads down, unemployment moves up to 6.1% and inflation hits 5.4%.

In spite of the drop in economic activity, the pressures on the consumer price index (CPI) are failing to moderate and moved up 5.4% year-on-year in August. Nevertheless, the key variable is the underlying component (the general rate less food and energy) which is holding at 2.5%. In the same period, producer prices rose by 9.7% year-on-year which has still not been passed on to consumers.

In turn, the trade balance for goods and services showed a deficit of 62.20 billion dollars in July. This increase of 8.5% year-on-year was mainly due to oil given that in the same period the deficit excluding oil and derivatives was

Trade deficit in non-oil sectors down by 43%.

Upheaval in the financial system

The world financial crisis is now one year old beginning as it did in the summer of 2007 and, far from being resolved, its seriousness has led to its being compared with the famous Great Depression following the stock market crash in 1929. For this reason, it is important to understand the development of the upsets that are affecting the world economy as a whole.

Before reviewing the causes, the impact and institutional responses to deal with the crisis, it is worth remembering what was the make-up of the financial instrument that acted as the fuse starting it all, namely, subprime mortgages in the United States. This is a mortgage loan granted to customers of low solvency which therefore present a higher default risk than «normal» customers. The «subprime» rating is applied when they are granted to persons with a problematical credit history or do not supply the necessary documentation (for example, setting out their income sources). The mortgage loan is also considered to be subprime when the amount borrowed represents a very high percentage of the price of the home being financed (more than 85%) or monthly payments are more than 55% of available income. As these are riskier, customers must pay a differential above the reference rate of between 2% and 3% higher than in the case of a standard or «prime» mortgage loan.

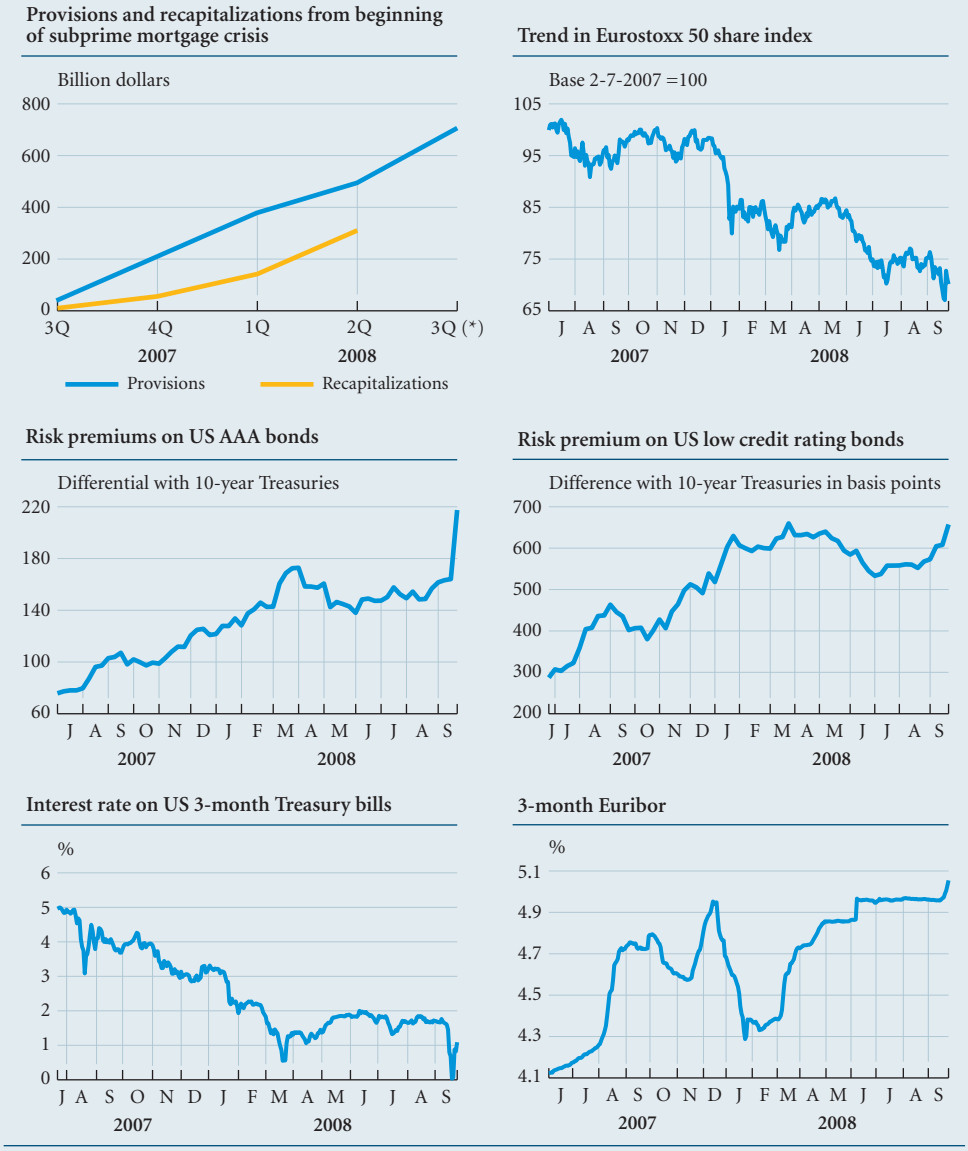
The subprime mortgage crisis is believed to have begun in August 2007 although its origins go back to preceding years. What were the causes? Four main factors stand out. In the first place, the huge speculative bubble in real estate assets in the United States. The increase in housing prices in the years prior to the outbreak of the crisis was spectacular to the point that families used to extend their mortgage loans in order to finance current costs such as holidays or to buy cars. The security was the value of the home which kept going up.

A second factor starting off the crisis was the absence of any regulation of subprime mortgage loans in the United States. Neither the central bank nor any other regulatory body had designed even the most minimal regulation to avoid abuses in the granting of this type of mortgage loan. This was a dangerous situation given that this mortgage loan segment carried higher risk and ended up causing the process of contagion we have witnessed.

A third factor was the poor design of incentives for granting subprime mortgage loans. The salespersons of lending institutions had their salaries linked to the volume they managed to place. Their objective was to negotiate the highest number of subprime mortgage loans and they cared little about whether the risk could be assumed by the bank or savings bank. That is to say, without evaluating whether the ability of the customer to repay the loan was reasonable.

Up to this point, an erroneous risk policy would not have gone farther than those directly involved. But the securitization of these loans became the channel through which the subprime mortgage «toxic virus» was spread around the world. What constitutes securitization? In the box «Relationship banking vs. the markets: a return to origins?» we explain in detail the characteristics of this phenomenon. In the case before us, we should make clear that most of these low quality mortgage loans were granted by financial institutions that were not deposit-taking. In order to obtain the financing to boost their activity, those institutions divested themselves of these mortgage loans by selling them to commercial banks or investment banks. These, in turn, packaged the mortgage loans together in blocks and issued securitization bonds that used the original subprime mortgage loans as security or collateral. These new bonds were sold to all kinds of institutional investors (investment funds, insurance companies, credit institutions, etc.) in many countries.

EXTRAORDINARY PRESSURES IN THE MARKETS



NOTES: (*) Estimate.
SOURCE: Bloomberg and own calculations.

Another factor favouring the spread and multiplication of the «subprime virus» was the increasing degree of leverage or borrowing by the financial sector in a situation of extremely lax monetary policies. It will be remembered that, following the bursting of the hi-tech bubble in the stock market in 2000, the Federal Reserve lowered the official interest rate to 1% with the aim of supporting the economy. After a few years, when the economy stabilized and began to grow solidly around 2004, the central bank began to raise the reference rate from 1% until it reached 5.25% in 2006. The increase in the official rate had a double impact on the economy.

First, it stopped short the increase in housing prices and even turned the trend around so that it began to drop. Second, default began to increase because a good percentage of families that had contracted these mortgages were unable to meet the increase in their mortgage payments.

Another fatal complication was that, as the subprime mortgage bonds were not quoted on organized markets and were so complicated, sophisticated mathematical models were normally used to calculate their price. Nevertheless, the increase in mortgage loan default made it essential to recognize that some of the financial products would not return the capital invested. Uncertainty about the real value of these assets and the viability of the institutions guaranteeing the mortgages brought about a crisis of confidence that spread to all financial markets. The interbank market, where banks lend money to each other, began to show sharp pressures with the growth of a lack of confidence about the ability of participants to meet their financial obligations. Parallel to this, there was a sharp increase in credit differentials on private corporate bonds and a sharp drop on the stock markets, yet another clear sign of a «flight to quality».

In view of this situation, the central banks began to intervene in a coordinated manner to inject liquidity into the international financial system. These interventions began as of August last year. Some central banks, such as the Bank of England and the US Federal Reserve, had to modify their intervention strategies opening their liquidity windows and making them available to credit institutions suffering from these problems.

In this context, the banks began to recognize that they should allocated provisions for the losses brought about by these financial instruments. Provisions so far announced amount to more than 500 billion dollars and that is not the end of it. In view of the depreciation of the assets in their balance sheets and the worsening of their capital ratios, some banks have managed to defend themselves through capital increases in which some of the notable players have been sovereign funds of various Asian countries and of petroleum exporting countries. The need of banks to increase their liquid assets has brought about a global drop in bank leverage levels, that is to say, a reduction in their degree of borrowing. This process, as it is widespread, creates a negative spiral in which the sale of assets forces down their price and brings about an even worse situation in bank balance sheets and the banks are thus obliged to keep selling assets that are rapidly losing their value.

Not all institutions have managed to weather the storm and there have been a series of bankruptcies and bailouts. Those institutions to suffer most from the consequences of this financial crisis are those that depended most on the wholesale markets as a source of financing, those with most exposure to «toxic assets» and those whose degree of financial leverage has meant that their losses have brought about a sharp drop in their capital ratios.

The cascade of institutions that have not been able to survive the «toxic virus» began before the crisis officially began in August 2007. In fact, April 2, 2007 saw the bankruptcy of New Century Financial, the entity that was biggest of all in granting subprime mortgage loans. This was the first warning of what was to follow. On August 16, 2007, the biggest mortgage loan company in the United States, Countrywide, just managed to avoid bankruptcy by obtaining a loan of 11 billion dollars granted by various banks. Just four days later the bad news jumped across to the other side of the Atlantic with the announcement of a bailout of the German regional public bank, Sachsen LB, by a group of savings banks for an amount of 17.3 billion euros. Also in August came the bailout of the German bank IKB Deutsche Industriebank with an injection of 3.5 billion euros which in the end proved to be insufficient and on August 21, 2008 it was acquired by the private capital firm Lone Star Funds.

However, perhaps the most dramatic bankruptcy came about on September 13, 2007 when the Bank of England had to go to the rescue of Northern Rock, the country's fifth largest mortgage bank, when long queues of customers formed up at its doors to withdraw their deposits.

In view of the way things were going, on October 10, 2007 the entity Hope Now Alliance was formed by the US government and members of the financial sector. This was a programme for renegotiating subprime mortgage loans that was intended to avoid the possible repossession of more homes. The year 2008 began without any clear picture of a solution of the crisis. The reality indeed outdid the most pessimistic forecasts. Between March 14-16, 2008, the Federal Reserve took the unusual step of drawing up a bailout plan (with government guarantee) for the fifth largest investment bank in the country, Bear Stearns, which finally was acquired by JP Morgan Chase.

At first it seemed that the bankruptcy of Bear Stearns and the decided action of the Fed had managed to make the crisis touch bottom. But nothing could have been farther from reality. September has probably been the worst month in the financial history of the United States. In view of the progressive worsening of the problems of decapitalization, the drop in value of shares and the high lack of confidence reigning in the markets, on September 5, 2008 the US government decided to take over the mortgage agencies Fannie Mae and Freddie Mac. These agencies guaranteed about half of the total mortgage loan market in the United States which amounts to 12,000 billion dollars. The government temporally took over their management and the management executives were removed. It is expected the government will inject 200 billion dollars to avoid their bankruptcy which makes this the biggest bailout operation in the country's history.

To carry on the list, on September 15 the acquisition of the investment bank Merrill Lynch by Bank of America was made public along with the bankruptcy of the US investment bank Lehman Brothers. On September 17 came the partial nationalization of the AIG insurance company by the Federal Reserve which acquired 79.9% of the shares of the world's largest insurer while at the same time granting it a loan of 85 billion dollars. On September 25, Washington Mutual went into bankruptcy, the biggest failure in the history of commercial banking in the United States. That institution had assets valued at 309.73 billion dollars and 2,600 branches. The financial regulatory body took over the bank which was finally acquired by JP Morgan Chase.

Faced with this distressing picture, the Secretary of the Treasury, in agreement with the Federal Reserve, presented a bailout plan for the financial system involving the creation of a fund of up to 700 billion dollars to buy up low-value assets, especially mortgage bonds, with the aim of stabilizing the financial markets and putting bank balance sheets in order. Will this manage to halt the carnage? It would be best to do it for the sake of the US economy and, therefore, for the world economy. A collapse of the financial system would have devastating effects on the rest of the economy. The central banks and other world institutions with financial responsibilities are trying to ensure that the gears of the financial engine are not seized up. In any case, the recovery of normalcy will be slow and costly. It will be slow because an increase in bank default can take a long time to resolve and more so if the extent of bank failures is of the present dimensions. The cost will be high because the funds that would be needed to start up new investment projects will be devoted to repairing the health of the financial system. For this reason, it is important to find a rapid world solution as soon as possible to make it possible to restore bank balance sheets, normalize the present anomalous situation in loan markets and, in the case of households and companies, make available the resources they need to finance their projects.

Japan's GDP up 0.8% while private consumption, exports and investment drop.

own 43.5%. Exports continue to increase at a good rate with growth of 20.1% year-on-year but imports were close behind with an increase of 16.8%. The recent easing in commodity prices, especially oil, improves prospects for the foreign sector over the short term. Over the long term, this will depend on saving by consumers and government.

Japan: umbilical cord of exports getting shorter

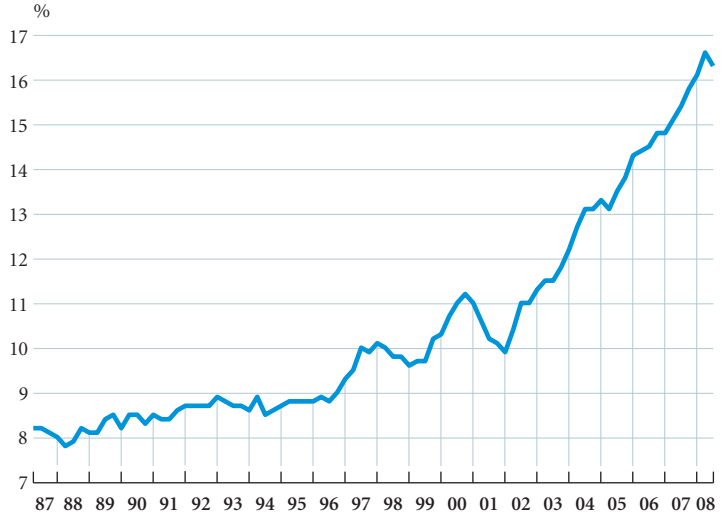
According to latest estimates, in the second quarter the GDP grew by 0.8% year-on-year thus sharpening its slowdown path. The biggest downward corrections showed up in exports and capital goods investment, whereas there was a continuation of the extreme weakness in private consumption. The dependence on the foreign sector is illustrated by the fact that exports and investment in capital goods stood at 31.9% of the total Japanese economy while 10 years ago they stood at 24.0%. The relative importance of these two components has long been increasing but since 2002 there has been a sharper rise, largely due to the strength of exports. With world demand dropping, the most dynamic force in the economy is running at a clear disadvantage.

Real estate market paralyzed but prices fail to drop.

The real estate market, on the other hand, makes up only 3.3% of economic activity. Nevertheless, its biggest effect on the long-suffering consumer is in the trend in prices, through the wealth effect, and in the Tokyo area these continued to rise in August. This would indicate that there are no major dangers but the volume of sales is now a more consistent indicator of the state of Japan's real estate market. In the first eight months of this year sales were down by a strong 39.3% year-on-year. On the supply side, housing starts from January to July were down by 6.6% year-on-year which, while relatively

JAPAN: THE IMPORTANCE OF EXPORTS

Exports in terms of GDP share



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

moderate, shows that the sector has still not found a clear road to recovery.

Among the most recent demand indicators, what stands out is consumer confidence at all-time lows and retail sales still stagnant in July. In turn, car sales in the January-August period were up 0.7% year-on-year and their recovery is losing strength.

On the supply side, things are still sluggish at best and justify the pessimistic turn in the Bank of Japan's view of things. Industrial production showed modest signs of recovery following various months of dull times and showed 1.2% year-on-year growth in July. Industrial production of consumer goods sin that period showed a more convincing increase of 6.3%. In the area of capital formation, prospects for coming months remain bleak because of the drop in exports.

On the inflation front, what continues to set the indices is rise in commodity prices (mainly oil) and the strength of domestic demand. Whereas the July CPI rose by 2.3% year-on-year, the highest in the past 16 years, the underlying index (the general index less energy and food) reported an increase of 0.2% year-on-year. This suggests that, in view of the trend in oil prices in international markets, the course of inflation in Japan in coming months will be one of moderation.

In turn, the unemployment rate in July showed a minor drop to stand at 4.0% of the labour force, putting an end to a modest upward move. The problem in the Japanese labour market remains focussed on wages which showed a cumulative drop of 3.8% year-on-year in July, with a big drop in the past month in wages in the manufacturing sector.

Industry keeping low profile with no signs of recovery in sight.

Oil raises prices 2.3% while unemployment holds at around 4%.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007			2008			
			2Q	3Q	4Q	1Q	2Q	July	August
Real GDP	2.4	2.0	1.8	1.8	1.4	1.2	0.8	–	...
Industrial production	4.2	2.9	2.4	3.1	2.7	2.5	1.0	1.2	...
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	–10.9	19.2	...
Unemployment rate (2)	4.1	3.9	3.8	3.8	3.8	3.8	4.0	4.0	...
Consumer prices	0.2	0.1	–0.1	–0.1	0.5	1.0	1.4	2.3	...
Trade balance (3)	9.4	12.5	11.1	12.3	12.5	11.7	10.3	9.8	...
3-month interbank interest rate (4)	0.3	0.7	0.7	0.8	0.9	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	82.6	80.6	80.7

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.

Exports recover slightly thanks to sales to Asia.

In the foreign sector, in view of the reduced demand for imports by the United States, increased hopes are being placed on Asia which is the destination of half of Japan's exports. The cumulative surplus in the 12 months ending in July went down to 9,800 billion yen , 12.7% below the level for the same period last year. In July, exports recovered with growth of 5.1% year-on-year but were still well below levels that used to be normal. Latest customs figures for July show a recovery in exports going to the rest of Asia, especially to China, which should compensate for the reductions in sales as a result of the economic weakness of Europe and United States.

Brazil: growth with risk of inflation

Brazil grows by 6.2% based more on investment than consumption while foreign sector keeps dropping.

In the second quarter, Brazil's GDP showed robust progress with an increase of 6.2% year-on-year, above the average in recent years. The main player in economic activity was still domestic demand but with less consumption and more investment. Private consumption was up 6.2% year-on-year but, within this line of strength, showed a clear tendency to slow down while investment maintained its high level with something of an upward trend ending up with growth of 16.2%. The reduced foreign sector continued to show an erratic profile seeing that, while exports reported a recovery and moved up 5.1% year-on-year, their growth remained well below imports which continued very strong moving ahead by a big 25.8% year-on-year. Public consumption, in turn, maintained the rise in the first quarter with growth of 5.1% compared with the same period last year, well above what had been the norm.

Inflation goes up to 5.8% and fiscal and monetary measures unlikely to bring figure down below 5% in 2008.

Among latest economic activity indicators what stands out is industrial production which maintained the recovery begun at the beginning of the second quarter and in July showed growth of 8.5% year-on-year. Along stronger lines, industrial production of capital goods continued to show two-digit growth with a gain of 22.3% year-on-year. This made clear the rise in private investment to be seen in the national accounts. As a result of these trends, the utilization of production capacity moved up to 83.9%, close to the highs reported in the second half of 2007.

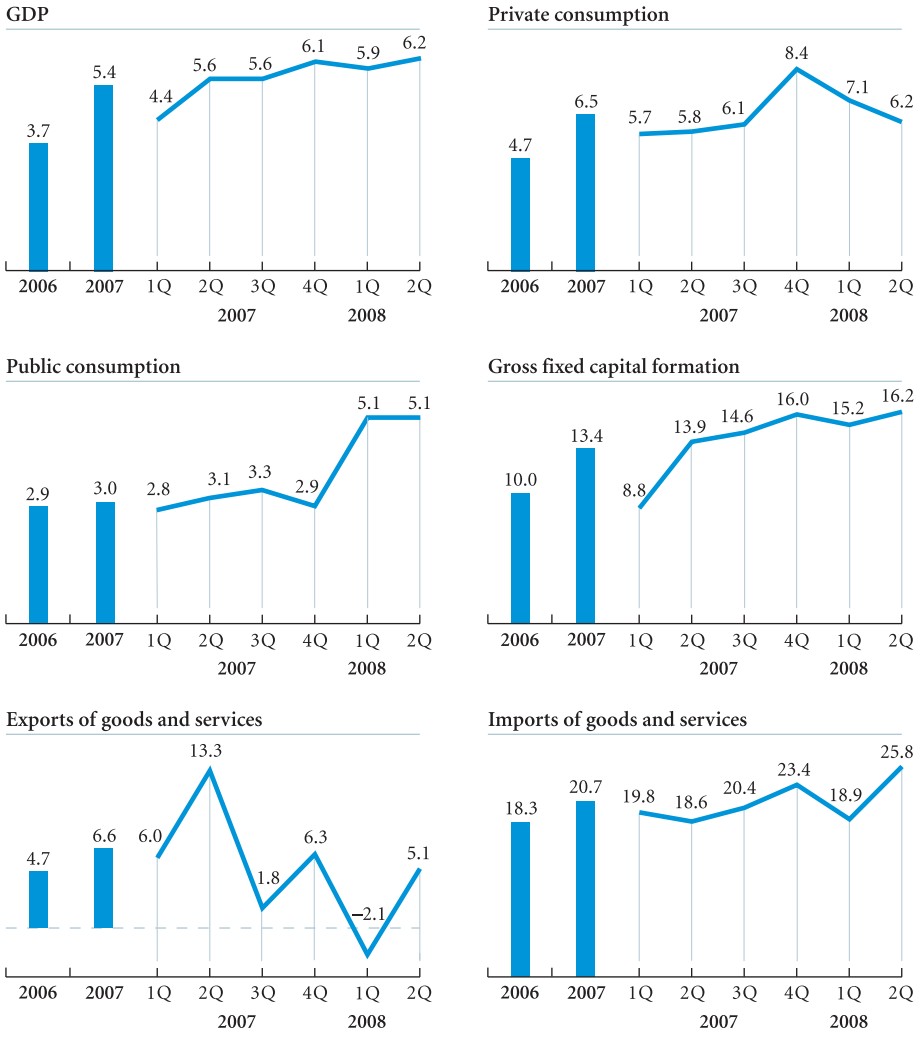
On the demand side, retail saless grew by 11.0% year-on-year in July thus maintaining a strength all through the current year that has not been seen in recent years. Car sales in the January-August period were up 25.1% year-on-year which, in spite of being a strong rate, showed something of a slowdown in recent months compared with the vigor at the beginning of the year.

This strength in domestic demand, along with the world-wide rise in cost of energy and food, continues to cause inflationary pressures although in recent months we cannot speak of increases. In August the CPI rose by 6.2% year-on-year stabilizing the upward trend begun in mid-2007. Nevertheless, there are still pressures seeing that wholesale prices rose by 15.7% compared with the same period one year ago. In order to ease this increase in prices, the central bank has been gradually raising the reference rate to the current 13.0%. The government is also trying to apply fiscal austerity measures.

Even so, in the past 12 months ending in July the fiscal surplus before interest on debt was 4.4% of the GDP thanks to revenues coming into the public purse because of the strong economic activity and the improved rating applied to

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-on-year change in real terms



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

Brazilian bonds, which should help reduce interest rates on those bonds. This would help to reduce the total government deficit which in the 12 months ending in April stood at 1.9% of the GDP. In turn, the labour market has turned around its slight negative trend and, with the help of strong domestic demand, the unemployment rate in the São Paulo district continued to drop going to 12.7% of the labour force in July. In the foreign sector, the appreciation of the real continued to contribute to the worsening level in the trade surplus which in the past 12 months up to August was 29.48 billion dollars, 14.58 billion less than in the same period last year.

While unemployment again drops, trade surplus continues to slide down.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007			2008			
			2Q	3Q	4Q	1Q	2Q	July	August
Real GDP	3.7	5.4	5.6	5.6	6.1	5.9	6.2	–	...
Industrial production	2.8	6.0	5.8	6.3	7.9	6.4	6.1	8.5	...
Unemployment rate São Paulo (*)	15.9	15.0	15.6	15.0	14.0	13.8	13.7	12.7	...
Consumer prices	4.2	3.6	3.3	4.0	4.3	4.6	5.6	6.4	6.2
Trade balance (**)	46.3	40.0	47.4	43.1	40.0	34.1	30.8	30.7	29.5
Central bank SELIC rate (***)	15.1	12.0	12.3	11.4	11.3	11.3	11.9	13.0	13.0
Reales to dollar	2.2	1.9	2.0	1.9	1.8	1.7	1.6	1.6	1.6

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

BRAZIL: TRADE SURPLUS RAPIDLY DROPPING

Cumulative trade surplus for last 12 months

SOURCE: Banco Central do Brasil and own calculations.

Argentina: a long growth period tormented by prices

Argentina grows by 7.5% thanks to domestic demand.

The growth of the Argentine economy is continuing with a GDP that grew by a notable 7.5% year-on-year in the second quarter. Nevertheless, this portentous strength in economic activity, dominated by domestic demand, confirms a tendency to slow down, especially in private consumption which dropped to a rate of 7.6% year-on-year. Investment abruptly broke the upward trend seen in recent times with growth of 12.4% whereas in the first quarter it had reached 20.3%. In turn, the foreign

sector was dominated by a sharp correction in exports which dropped by 1.8% year-on-year in contrast to the two-digit increases at the end of 2007. On the other hand, imports continued strong growth with a rise of 22.8%.

The big danger for Argentina's economy is still inflation. In August, the CPI went down very slightly to stand at 9.0% year-on-year. This is a high figure which, nevertheless, could be underestimating real inflation. Upward pressure on prices continue although somewhat more moderate than last May. Wholesale prices for national goods rose by 11.6% and prices of imported goods went up a masssive 16.6%. Secondly, the conflict with the farmers continues to create bottlenecks that add to price pressures.

The most recent demand indicators are still not showing any break in the growth cycle. Retails sales in the Buenos Aires region grew by 18.7% year-on-year in July and rose by 32.2% in the total for department stores, a slight drop but starting out from massive growth rates that, in terms of volume discounting price increases, seem more reasonable.

Car sales in the past 12 months ending in August continued to ease although the increase held at a respectable 12.9% year-on-year. This was a logical slowdown to the extent that figures are reaching more normal levels only 10% below the all-time high. On the supply side, industrial production shows a slowdown trend that is more and more clear, with a rise of 2.4% year-on-year, well below the dominant figure in 2007 and at the beginning of 2008.

By sector, the motor vehicle sector recovered from a pause with renewed strength to show an increase of 42.0% year-on-year in July. The metal industries and food lost steam but this did not happen in the steel production sector which was up by 44.3% year-on-year. The chemical industry remained slack while the energy sector continued down. In turn, the Synthetic Indicator of Construction Activity kept up some of the increase in previous months with a rise of 9.7%, while the Industrial Activity Indicator moved up 9.4%.

In the labour market, unemployment in the second quarter dropped to 8.0% of

Inflation continues at 9% and upward pressures continue.

Retail consumption and industrial production slowing down but construction recovering.

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007			2008			
			2Q	3Q	4Q	1Q	2Q	July	August
Real GDP	8.5	8.7	8.6	8.8	9.1	8.3	7.5	–	...
Industrial production	7.7	5.7	5.9	2.9	6.2	4.9	2.7	2.4	...
Unemployment rate (*)	10.2	8.5	8.5	8.1	7.5	8.4	8.0	–	...
Consumer prices	10.9	8.8	8.8	8.6	8.5	8.5	9.1	9.1	9.0
Trade balance (**)	12.3	11.1	11.5	10.4	11.1	12.0	10.8	11.3	...
3-month interbank interest rate (***)	9.9	11.3	9.4	12.6	13.7	10.7	14.2	14.1	13.9
Pesos to dollar	3.1	3.1	3.1	3.1	3.1	3.2	3.1	3.0	3.0

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

TREND IN ARGENTINE GDP BY COMPONENT

Percentage year-on-year change in real terms

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

Unemployment rate at 8.4% and trade surplus dropping.

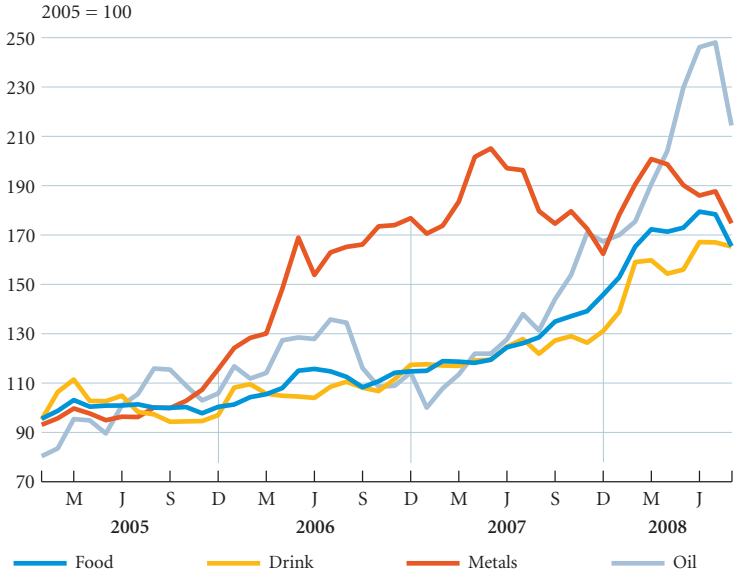
the labour force. In the foreign sector, the trade surplus for the past 12 months up to July went down to 11.3 billion dollars.

Commodities: quotes show downward correction

In September, commodities continued to drop. Whereas oil has taken the limelight, the fact is that all the large groupso commodities are going through a notable readjustment. As may be seen from *The Economist* commodities index, which does not include oil, commodities as a whole were down 5% in the first three weeks of September. The trend in metal prices (month-on-month decrease of more than 7%) was notable. On the other hand, food and non-food farm commodities were down to a lesser extent (4% and 2% respectively) in the same period.

COMMODITY PRICES CHANGE DIRECTION

Monthly quotations in dollars



SOURCE: International Monetary Fund.

Some products that individually showed appreciable decreases were platinum (a drop of 17% in the first three weeks of September), nickel (drop of 17%) soya beans (adjustmentof 14%). Oil began September in the area of 115 dollars a barrel (one-month forward price for *Brent* quality product) and, after some sessions going below 90 dollars a barrel, at the end of the month stood at values of the order of 103 dollars a barrel. This meant a drop of 10% in the first three weeks of September and a dip of 28% compared with the all-time highs in July.

Commodities down considerably in September.

EUROPEAN UNION

Euro Area: sudden drop in economic activity

Economic growth rate contracting with unexpected speed...

The speed with which the growth rate is dropping in the Euro Area has surprised everyone. In just a few months people have changed from betting that Europe could readily overcome the world financial upsets and the US economic crisis to recognizing that the Old Continent is so weak that it will be difficult for is to avoid a much-feared recession. Recently, two such prudent spokesmen as those for the European Central Bank (ECB) and the European Commission have been obliged to revise their growth forecasts downward.

...obliging ECB and European Commission to make downward revision of growth forecasts for 2008.

The ECB is predicting that growth in the Euro Area will be 1.4% in 2008 and 1.0% in 2009. Last June both figures were of the order of a half percentage point higher. In turn, the EU executive view is not far off this scenario as it believes that the gross domestic product (GDP) of the Euro Area will grow by 1.3% year-on-year in 2008. Furthermore, according to the European Commission, three major economies of the European Union (Germany, United Kingdom and Spain) would show two consecutive quarters with a drop in quarter-on-quarter GDP in 2008, that is to say, they would go into recession according to the generally accepted definition. In prices, the picture is also a converging one, given that both institutions are expecting that inflation will stand in the range of 3.5%-3.6% as annual average for 2008.

With these prospects in mind, the ministers of economy and finance in the Euro Area (the so-called Eurogroup) met on September 12 last to analyze a possible coordination of anti-recession measures. While recognizing that the recession was much worse than

EUROPEAN COMMISSION MACROECONOMIC FORECASTS

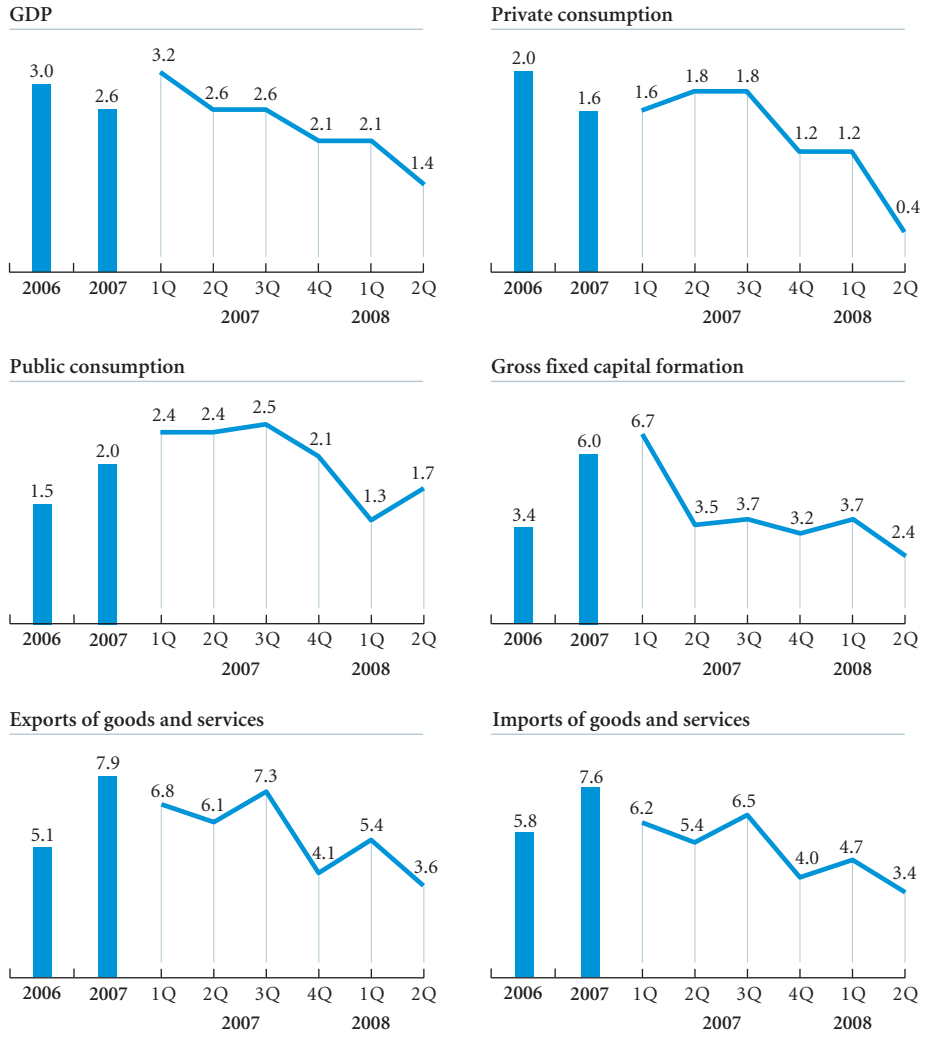
Percentage annual change

Country	Growth		Inflation (*)	
	Current forecast for 2008	Difference over previous forecast (**)	Current forecast for 2008	Difference over previous forecast (**)
Germany	1.8	0.0	3.0	0.1
Spain	1.4	–0.8	4.5	0.7
France	1.0	–0.6	3.5	0.5
Italy	0.1	–0.4	3.7	0.7
Euro area	**1.3**	**–0.4**	**3.6**	**0.5**
United Kingdom	1.1	–0.6	3.6	0.8
European Union	**1.4**	**–0.6**	**3.8**	**0.2**

NOTES: (*) Harmonized consumer price index.
(**) April, 2008.
SOURCE: European Commission.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-on-year change



SOURCE: Eurostat and own calculations.

expected, the Eurogroup limited itself to pointing out that the exceptional decisions made in the past had not contributed to relieving the effects of earlier episodes of a similar nature, given that the results came about when the economy itself was recovering and the cost of those measures (in the shape of more deficits and public debt) still remained. For this reason, the ministers preferred to recommend perseverance with classical measures (mainly wage moderation and control of public finances) and take advantage of the situation to make further reforms in goods and services market and in the labour market.

Eurogroup decides not to take coordinated action.

In any case, figures published up to now certainly show an economy still showing various flanks open. Up to now, the relatively poor performance of private

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	July	August
GDP	3.0	2.6	2.6	2.1	2.1	1.4	–	…
Retail sales	1.6	0.9	1.3	–0.3	–0.2	–1.5	–2.7	…
Consumer confidence (*)	–9.1	–4.9	–3.9	–7.7	–11.9	–14.6	–19.7	–19.2
Industrial production	4.0	3.4	4.0	3.0	2.5	0.9	–1.7	…
Economic sentiment indicator (*)	106.3	108.4	108.7	104.3	100.5	96.5	89.5	88.8
Unemployment rate (**)	8.3	7.4	7.4	7.3	7.2	7.3	7.3	…
Consumer prices	2.2	2.1	1.9	2.9	3.4	3.6	4.0	3.8
Trade balance (***)	–10.4	20.1	31.4	34.3	23.5	11.5	–3.9	…
3-month Euribor interest rate	3.1	4.3	4.5	4.7	4.5	4.9	5.0	5.0
Nominal effective euro exchange rate	103.6	107.7	107.7	110.6	112.8	115.6	115.8	113.5

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

Domestic demand losing strength by great strides.

consumption has been more than compensated by the positive contribution of the foreign sector and an acceptable situation in investment. Figures for the second quarter clearly indicate that this pattern has changed. The Euro Area GDP dropped by 0.2% in that period compared with largely due to quarter-on-quarter drops in private consumption and investment and the nil contribution of foreign demand. The picture for the mid-term, which is clearer if we follow the year-on-year rate, confirms the earlier view. The notable slowdown in private consumption and gross fixed capital formation, along with the reduction by half of the contribution of the foreign sector to the change in GDP, mean that growth comes to 1.4% year-on-year, far from the 2.1% in the first quarter.

The latest available indicators, those for the third quarter, far from dismissing the poor economic situation, rather tend to confirm it. Consumption thus is sinking (retail sales were down by 2.7% year-on-year in July, consumer confidence was stuck in the area of –19 points in July and August while investment indicators also showed no signs of improving. On the supply side, the situation is equally complicated. Industrial production stands at its lowest since June 2003 (a drop of 1.7% year-on-year in July) while confidence in construction and services continues to slide down as of August.

Inflation beginning to moderate although levels still high.

In this situation, the fact that inflation has begun to leave the range of 4%, the highest in the history of the single currency, it is now showing up as the only relatively positive factor when we look at the overall situation. While the year-on-year increase in harmonized consumer prices (HCPI) continues to be relatively high (3.8% in August), the fact is that the drop in pressures in the components of energy and, to a lesser extent, in foods seems likely to continue, which would go in favour of a shift toward more moderate levels in coming months. If this should be confirmed, it

would be a major relief given that the Euro Area does not have excessive drive for trying to deal with both inflation and an economic slowdown.

Germany: a time of upsets

The IFO index of business activity dropped to the 92.9 points level in September, which means its fourth consecutive month showing a decrease while representing its lowest level in five years. In an appearance before the Bundestag on September 17, Angela Merkel stated that the world financial crisis would scarcely affect Germany. Who was right, the government or the business executives? Probably both, although it depends on the time frame we choose.

The present economic situation in Germany is certainly not positive. In the third quarter it is expected that the GDP will ease slightly compared with the previous quarter so that there will be a run of two consecutive quarters with negative growth (the much-feared recession). This is what German executives are reflecting in the IFO survey, namely, that the present moment is complicated. The indices are in agreement with this qualitative impression. To quote two of the most significant, retail sales in July held at the same level as one year ago whereas industrial production was down 0.6% year-on-year in July (they had not been on negative terrain since 2003).

German economy combines present difficult moment with not-so-negative prospects.

Nevertheless, beyond this short-term horizon, the German situation will benefit from certain positive background factors. The first factor is the progressive drop in inflation pressures. While we could discern the beginning of this process in August (inflation stood at 3.2% year-on-year, one decimal less than in July), the forecasts suggest that this tendency will sharpen in coming months. This is a key factor in a country that heavily depends on its foreign competitiveness.

Economy most likely to go into recession in third quarter.

GERMANY LOOKING GRIM OVER SHORT TERM

IFO index of business activity

SOURCE: IFO Institute.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	July	August
GDP	3.2	2.6	2.4	1.7	2.6	1.7	–	…
Retail sales	6.1	–7.6	–7.5	–8.8	–0.8	–0.2	0.0	…
Industrial production	6.0	5.9	5.7	5.0	5.0	2.6	–0.6	…
Industrial activity index (IFO) (*)	105.5	106.2	105.6	103.7	104.0	102.3	97.5	94.8
Unemployment rate (**)	10.7	9.0	8.8	8.5	8.1	7.9	7.7	7.6
Consumer prices	1.6	2.3	2.3	3.1	2.9	3.0	3.3	3.2
Trade balance (***)	151.5	183.5	192.0	198.1	201.1	202.2	198.1	…

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.

Improvement in inflation and weakness of euro may contribute to restoring foreign competitiveness.

In this respect, it should be pointed out that the weakness of the euro against the dollar comes at a good moment seeing that between January and August exports were down from growth rates of around 8% to close to 6% and a more favourable exchange rate could contribute to reversing that trend. Furthermore, the continuing reduction in the unemployment rate (dropping to 7.6% in August) could help set a bottom for the drop in consumption. If all these factors are taken together, it seems quite clear that over the short term the negative opinion of business executives is well founded but, with the passing of coming quarters, which could be critical, the economy should regain its shine.

French government presents weak growth forecast for 2008...

France: domestic demand in distress

«Little more than 1%.» This was the expression used by French Prime Minister François Fillon in referring to the forecasts put out by the government for growth in 2008. Latest official figures put growth in the range of 1.7% to 2%. What could have happened so that France's economic prospects may have deteriorated to such an extent that even the government expects a year of minimum growth? Basically, the key engine in the French economic pattern, domestic demand, has run out of fuel. The worsening of gross disposable income and corporate profits is affecting households and companies. Furthermore, the tightening of credit is weighing on the spending and investment decisions of both segments.

...because of drop in consumption affected by inflation and slack in wages.

In this situation, consumers are not spending (household consumption scarcely grew by 1% year-on-year in June) nor does it seem they are going to start spending over the short term, given that consumer confidence in July stood at its lowest level since June 2003. A burden that complicates the situation of households is the rise in inflation in recent months. Whereas the August CPI slowed to 3.2% year-on-year (3.6% in July), growth of wages was below 3% year-on-year, which implies a real cut in purchasing power. In this context, the easing off in the process of reducing the unemployment rate (which stood at 7.3% in July) comes at a quite unsuitable moment.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	July	August
GDP	2.4	2.1	2.4	2.2	2.0	1.1	–	…
Domestic consumption	3.3	4.4	4.9	3.7	2.3	1.3	…	…
Industrial production	0.9	1.3	2.0	2.2	1.7	–0.2	–2.0	…
Unemployment rate (*)	9.2	8.3	8.1	7.9	7.6	7.5	7.3	…
Consumer prices	1.7	1.5	1.3	2.3	2.9	3.3	3.6	3.2
Trade balance (**)	–27.0	–32.4	–33.0	–37.4	–40.6	–44.9	–48.1	…

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

And, if households are weak, companies are also not investing as they used to do. To cite some significant figures, industrial production of capital goods was down in year-on-year terms in July for the first time since August 2003 while the level of utilization of industrial production capacity in the third quarter was the lowest since the beginning of 2007. In this situation, it is not surprising that industrial production remained stuck in the 2% range of year-on-year decreases in the three months from May to July.

Investment also turning down.

Italy: further drop in economic activity

Italy's economy began the third quarter badly. On the demand side, the most notable feature is the slack in consumption shown by such indicators as the consumer confidence index (at levels of –24 points in August) and car registrations, which were down a substantial 26% year-on-year in August. Neither did the other big domestic demand component, investment, show signs of recovery while a significant indicator such as industrial production of capital goods now shows three months from May to July in the range of year-on-year decreases.

Neither are supply indicators offering signs of relief. Industrial production was down 3.9% year-on-year in July, worse than the poor figure for June (year-on-year drop of 2.4%). What is more, the worst may be still to come given that the portfolio of industrial orders is dropping sharply. In August, industrial orders were down 22% year-on-year. To make the situation even more complicated and in contrast to other countries in the Euro Area, the unemployment rate is increasing while inflation shows no let-up. As a result, in the first quarter (the latest figures available) the unemployment rate reached 6.5% of the labour force, three decimals more than in the fourth quarter of 2007.

Poor start to third quarter in Italy.

With regard to prices, in spite of the readjustment of oil prices in August, inflation remains stuck at 4.1% year-on-year showing no improvement over July. Starting out from this base, it is not surprising that the Italian business organization, Confindustria, has warned that it expects a drop in GDP from 0.1% for this year as a whole and a slight increase in growth in 2009 (a rise of 0.4%).

Industrial activity down while unemployment rate climbing.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	July	August
GDP	1.9	1.4	1.6	0.1	0.3	–0.1	–	…
Retail sales	1.2	0.5	0.2	0.5	0.9	–1.7	…	…
Industrial production	2.4	0.0	0.8	–3.0	–1.3	–1.6	–3.9	…
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	4.1	4.1
Trade balance (**)	–17.6	–13.7	–11.3	–8.9	–9.1	–8.6	…	…

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

United Kingdom: too many flanks open

British economy facing difficult situation and expected to go into recession...

The same day that prime minister Gordon Brown announced a package of measures designed to revive the real estate sector, with the main aim of increasing the deductions in taxes for home purchase, the Organization for Economic Cooperation and Development announced that it forecast that the United Kingdom would go into recession due to the drop in GDP in the third and fourth quarters of 2008. Just a few days later, the European Commission published a similar forecast. One week earlier, minister of economy Alistair Darling stated that his would be the worst recession in the past 60 years, pushing down the pound sterling to its lowest level against the euro since 1999.

To make the situation more complicated, the Treasury must deal with criticism about the rapid worsening of the public finances. The cost of the lower taxes on home buying, which amounts to some 600 million pounds, is one more factor contributing to put the government deficit close to 6% of the GDP in 2009, according to some estimates. This

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	July	August
GDP	2.9	3.1	3.1	2.8	2.3	1.4	–	…
Retail sales	3.1	4.3	4.9	3.9	5.4	4.5	2.0	3.4
Industrial production	0.7	0.4	0.3	1.0	0.6	–1.1	–1.9	…
Unemployment rate (*)	2.9	2.7	2.6	2.5	2.5	2.6	2.7	2.8
Consumer prices	2.3	2.3	1.8	2.1	2.4	3.3	4.4	4.8
Trade balance (**)	–72.5	–83.2	–84.7	–88.4	–90.9	–92.9	–93.7	…
3-month Libor interest rate	4.6	5.3	6.0	6.3	6.0	6.0	5.9	5.8
Nominal effective pound exchange rate	98.0	103.9	104.3	102.2	97.6	92.6	92.8	92.5

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

quickly recalls that in 1975 a public deficit of around 7% brought a rescue package from the International Monetary Fund, a measure of ill memory in the history of the British economy. Finally, in mid-September Mervyn King had by law to send a letter to the Chancellor of the Exchequer when inflation went one percentage point above the Bank of England objective in which he recognized that the CPI would go to 5% (in August it was 4.7%). This announcement was interpreted as an early indication that the Bank of England would not lower its interest rates in spite of the economic crisis.

All of this, along with a series of recent poor economic figures, suggests that the United Kingdom has found a balanced way of giving support to the economy without exacerbating other problem imbalances. As a result, along with the alarming figures for inflation already mentioned, the publication of negative figures for consumption (retail sales in July stood at their lowest level since 2006), industrial production (with a third consecutive year-on-year drop in July) and the unemployment rate (up for the second consecutive month in August) have all come together in just a few weeks.

...while public deficit goes up to troublesome levels with inflation close to 5%.

Poor figures for consumption, industrial production and unemployment.

Financial regulation: heading toward Basel III?

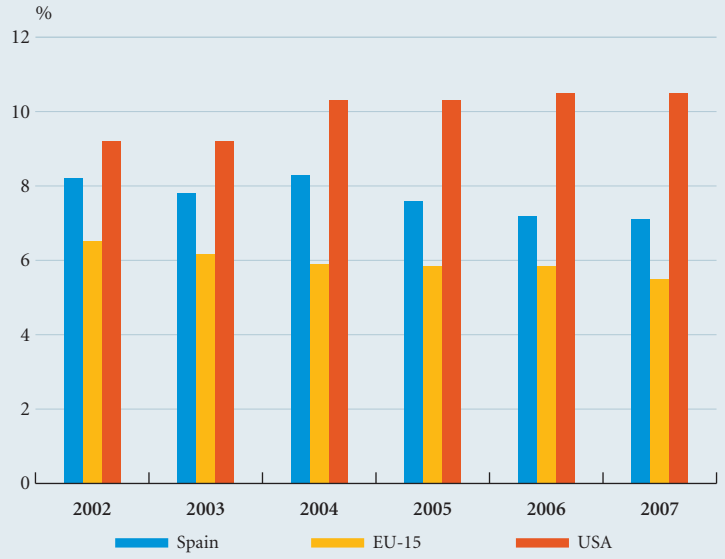
Of all sectors of the economy, the banking sector is one of the most regulated. Even if there is not a complete unanimity, there is a broad consensus that the importance of the sector for the good conduct of the economy makes it necessary to have a regulatory framework that ensures its stability. The international financial crisis over the past year has brought about an increase of voices critical of the present regulatory framework. Without looking farther afield, at the annual meeting of the Dallas Federal Reserve Bank held last August, Ben S. Bernanke recognized that the regulatory framework had to be substantially improved. What then went wrong? And what are the new proposals?

Above all, we should note that risk taking is inherent in the business activity carried out by financial institutions. Many entrepreneurs were able to carry out their projects and convert their small businesses into large companies thanks to the financial institutions that accepted the risk of granting them credit. Then, if the regulatory framework tried to reduce the risk institutions take to zero, the subsequent drop in credit supply would have vast economic costs. On the other hand, it is also true that in a totally unregulated market the risk each institution might like to take would be too high, given that it would not keep in mind the collateral effects of its possible problems of solvency. The ideal regulatory framework should find a mid-point between these two extremes.

The main regulatory instrument has been to link the capital an institution must hold with the risk it decides to take. The greater the risk, the more capital needed to handle possible losses. If a bank decides to increase the risk of its assets, its capital needs will be greater so that the risk for the depositors remains the same, given that it is the shareholders who absorb the losses. This is the main characteristic of the regulatory framework that the Bank for International Settlements (BIS) proposed in 1988, known as the Basel Regulation, and which ended up being adopted by more than 100 countries. The key point consists on defining the amount of capital needed for each level of risk that will ensure, with a high level of probability, the solvency of financial institutions. The Basel Regulation classifies financial assets in specific groups according to risk and each is assigned a minimum capital requirement. For example, if a bank holds only sovereign bonds, as these are a

CAPITALIZATION OF SPAIN'S FINANCIAL SECTOR STANDS ABOVE EU AVERAGE

Ratio of capital to total assets



SOURCE: International Monetary Fund.

very safe asset, the minimum regulatory capital is equal to zero. On the other hand, if a bank's assets are made up of corporate bonds, which are more risky, 8% of its assets must be covered by capital.

This regulatory framework was questioned on various fronts. On the one hand, the capital requirements for each type of asset are not sensitive to the economic cycle although the level of risk undoubtedly varies during the cycle. Furthermore, the distinction of assets by groups according to risk is limited given that it does not catch the real risk of each asset. To deal with these limitations, in 2005 the BIS proposed a new regulatory framework (Basel II) which now has been adopted by the countries of the EU (the United States expects to do so progressively). One of the most important new features is that capital requirements are now a function of the estimated risk of the assets of each institution. Naturally, the higher the estimated risk, the greater the capital requirement. This significantly increases the efficiency of the regulatory framework since each institution provides the capital to cover the real (estimated) risk of its assets.

In any case, this new proposal has also been the subject of criticism by economists such as Charles Goodhart (ex-member of the board of governors of the Bank of England) and Raghuram Rajan (former head economist for the International Monetary Fund). On the one hand, the fact that capital requirements are set as a function of estimated risk makes them excessively «counter-cyclical». In periods of economic boom there is a tendency to underestimate risk, which reduces capital needs. The opposite happens during recessions when requirements shoot up. This implies that during recessions banks are obliged to reduce the supply of credit with the subsequent effects on the rest of the economy. Furthermore, the fact that capital requirements are «counter-cyclical» does not make it possible for regulation to act in a preventative way. In this respect, we should point out the system of «pro-cyclical» provisions favoured by the Bank of Spain which has covered this deficiency and is making it possible for Spanish banks and savings banks to face up to a period of recession from a position of relative strength.

The recession has also underlined the fact that not all financial intermediaries are treated equally by the existing regulatory framework. The investment banks, for example are left aside. The absence of a regulatory framework similar to that of the commercial banks is, in part, the culprit in the taking of excessive risk and the present woes of this sector, which is seeing its business model being questioned.

To judge by the proposals that are currently being discussed in various international forums, the new regulation of the financial sector must move forward in three main areas. First, it should reduce the «counter-cyclical» nature of capital requirements. This could be obtained, for example, by obliging financial entities to hold an insurance policy that injects capital when the balance sheet slips down by more than a predetermined limit. Secondly, it should introduce minimum liquidity requirements, reducing the dependence on wholesale market institutions and on injections of liquidity by the central banks in times of recession. Regulation of this type would have a preventive nature as it would ensure that financial entities had a liquidity cushion available to them following a growth period. Thirdly, it should increase the transparency of the financial system, standardizing new products and increasing the level of breakdown of information in balance sheets. This would reduce uncertainty during periods of recession.

Nevertheless, none of these proposals can be easily implemented. Defining the formula to reduce the «counter-cyclical» nature of capital requirements is no easy task, nor is grouping together assets according to their liquidity, given that this could change suddenly in times of instability. At the same time, to oblige institutions to increase the breakdown level of their balance sheets, a part from being a very complicated task in view of the variety of financial instruments in existence, could impair the business strategies of the institutions.

It seems that the need to improve the present regulatory framework will mean that the life of Basel II, in its current format, will end up being rather short. Nevertheless, before giving birth to Basel III it is essential to have rigorously analyzed the costs and benefits of each new provision. Furthermore, the new regulatory framework must be sufficiently flexible to allow for progress in the course of financial innovation while, at the same time, controlling risk.

FINANCIAL MARKETS

Monetary and capital markets

Central banks remain in fray struggling to find end to crisis.

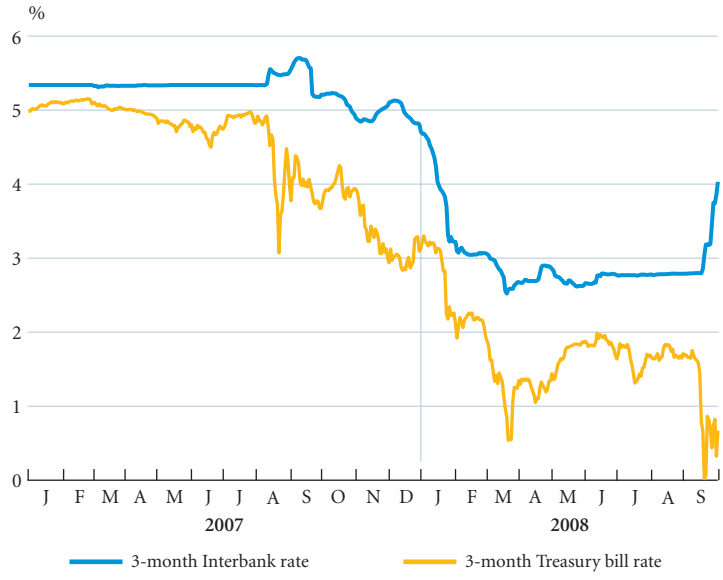
Financial crisis upsetting monetary markets

The financial crisis is not giving any respite to the central banks which did everything possible in September to prevent the international financial system from finally collapsing. Precisely to prevent the credit gears from seizing up, the monetary authorities had to again intervene injecting liquidity in a coordinated way. Nevertheless, until they reached this point, the various central banks had been making their own separate responses to a crisis the intensity of which was affecting them to an unequal extent.

The current situation is comparable to that of an earthquake with devastating consequences whose epicentre lies in the United States where the damage is vast. A situation of decreasing growth and high inflation puts the Federal Reserve in a difficult position, as was recognized by the central bank in the press release issued following its last meeting on September 16. In this press release, it admitted the increased pressures in financial markets and stated that both the risk of a slowdown and inflation continued to concern members of the Federal Reserve. Finally, it was decided to maintain the reference rate at 2%.

PRESSURES IN MONETARY MARKETS GROW WORSE

Monetary interest rates in United States



NOTES: Latest figure: September 30.
SOURCE: Bloomberg.

The month of September, however, has been critical for a number of decisions adopted by the Federal Reserve in collaboration with the US Treasury. Of these decisions, four stand out as the most important. Firstly, on September 7 the government, through the Treasury, took over the mortgage lending agencies Fannie Mae and Freddie Mac making use of the powers granted by the US Congress under a law passed on July 24. Both agencies guarantee or have in their balance sheet nearly half of the country's mortgage lending market which amounts to some 12 billion dollars. From that moment on, the government assumed their temporary management and was ready to inject up to 200 billion dollars in order to avoid their bankruptcy. Up to now, this is the biggest bailout operation ever in the country's history.

Secondly, on September 15 the acquisition of the investment bank Merrill Lynch by the Bank of America was made public and another investment bank Lehman Brothers went into receivership, making this the biggest bankrupcty in the corporate history of the United States.

Thirdly, on September 17 there also took place the bailout of the world's biggest insurer, the US company AIG. This company could not ride out the storm of

September sees Treasury and Fed take over Fannie Mae and Freddie Mac and take control of biggest US insurance company.

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									
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	4.25	4.96	5.34	2.00	2.81	0.88	5.00	5.75	2.7
September (1)	4.25	5.12	5.48	2.00	3.77	0.92	5.00	6.27	2.7

NOTES: (1) September 21.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 3-8-06 (3.00%), 5-10-06 (3.25%), 7-12-06 (3.50%), 8-3-07 (3.75%), 6-6-07 (4.00%), 03-07-2008 (4.25%).

(3) Latest dates showing change: 11-12-07(4.25%), 22-01-2008 (3.50%), 30-01-2008 (3.00%), 18-03-2008 (2.25%), 30-04-2008 (2.00%).

(4) Latest dates showing change: 10-5-07 (5.50%), 5-7-7 (5.75%), 6-12-07 (5.50%), 7-2-08 (5.25%), 10-4-08 (5.00%).

(5) Interbank rate.

SOURCE: National central banks, Bloomberg and own calculations.

US Treasury presents extraordinary program to bail out «toxic» assets.

bankruptcy through recapitalization because of its heavy exposure to insurance on mortgage loan derivatives. The government made its calculations and realized that if it let this insurer fail there was a risk of an implosion of the financial system. This was when the State decided to intervene and take up 79.9% of the company's capital in exchange for providing a loan arranged through the Federal Reserve of 85 billion dollars for 24 months at a punitive interest rate linked to the 3-month interbank rate plus 850 basis points (100 basis points is 1%). The loan is to be guaranteed by the assets of AIG.

Latest moves change structure of US financial system.

In spite of these moves, the financial upsets did not stop and on September 19, in view of the risk the system might collapse, the US Secretary of the Treasury presented a plan to save the country's credit system and stabilize the financial markets. This financial bailout programme would be the biggest since the Great Depression that began in 1929 and, first of all, it proposed to create a fund of up to 700 billion dollars which would be authorized to buy «toxic» assets in bank balance sheets (mainly mortgage bonds). Secondly, it would create a line of credit to help money market investment funds up to an amount of 50 billion dollars in order to temporarily guarantee the value of these assets. These funds are vital as they provide short-term financing to private companies and banks.

The US financial system was based on the division created under the Glass-Steagall law passed in 1933 between the commercial and investment banks. As opposed to the commercial banks, investment banks are not allowed to take deposits. This law was revoked in 1999. Nevertheless, a number of independent investment banks continued. But, following the bankruptcy of most of these institutionss, the last two big investment banks, Goldman Sachs and Morgan Stanley on September 21 asked the Federal Reserve for standard commercial banking status, that is, to be considered as bank holdings. The Fed gave orders to its New York branch to the effect that, in order to facilitate the transition of these institutions, it should provide the necessary funds to the two banks. As a result, it may be said that this is the end of an era and the start of a banking structure that is now closer to the Continental European model.

European Central Bank revises growth forecasts downward and raises inflation forecast.

The European banks have not been immune to these upsets and the European Central Bank (ECB) has also had to take firm action. At the meeting of the Governing Council on September 4 it decided to maintain the reference rate in the Euro Area at 4.25%. At the later press conference, the ECB made public the latest forecasts by its research service. In these forecasts it revised downward growth of the gross domestic product in the Euro Area for 2008 from 1.8% to 1.4% and raised its estimate for inflation from 3.4% to 3.5%. It also modified upward inflation expected in 2009 from 2.4% to 2.6%. As a result, no one was surprised when the ECB chairman stated that the economic figures published suggested that inflation would continue above the ECB's definiton of price stability, that is, 2%. Furthermore, in the judgment of the monetary authority, the monetary analysis based on growth of the credit supply confirms its thesis that the risk with regard to prices lies in their increase.

The ECB sees the economic situation in the Euro Area as a period of weak activity characterized by a sharp increase in commodity prices. This has affected consumer confidence and demand although it expects this period to be

short and that there will be a recovery in the state of the economy. It is also paying attention to the financial upsets that have increased uncertainty about the future development of the economy. This is why the ECB has stopped raising the official rate following the increase from 4% to 4.25% in July. In spite of this, the central bank again repeated its message about the need to prevent the increase in prices from ending up bringing about a rise in wages. Nevertheless, it qualified its tough position on inflation when Trichet stated that at this time the central bank had no bias with regard to monetary policy.

Furthermore, the European Central Bank had revised its conditions for valuing assets used by banks at its liquidity window to obtain financing. For a year, the interbank markets have been extremely tight and in order to obtain liquidity credit institutions have gone to the body in Frankfurt with assets they could not place in the secondary market thus converting it into lender of last resort. In order to avoid abuses, the central bank has tightened the system of guarantees it applies to banks in the Euro Area in order to provide them with liquidity. This change will go into effect as of February 1, 2009. The new rules imply that the ECB will lend less money in exchange for the financial assets banks provide as collateral.

ECB revises evaluation of assets banks may use to obtain liquidity.

In view of the serious tightening of the interbank market, the central banks in the United States, the Euro Area, the United Kingdom, Japan, Switzerland and Canada acted jointly on September 18 injecting liquidity in dollars. While it was made public that the amount applied by the Fed was 180 billion dollars, the calm in the markets lasted merely two days.

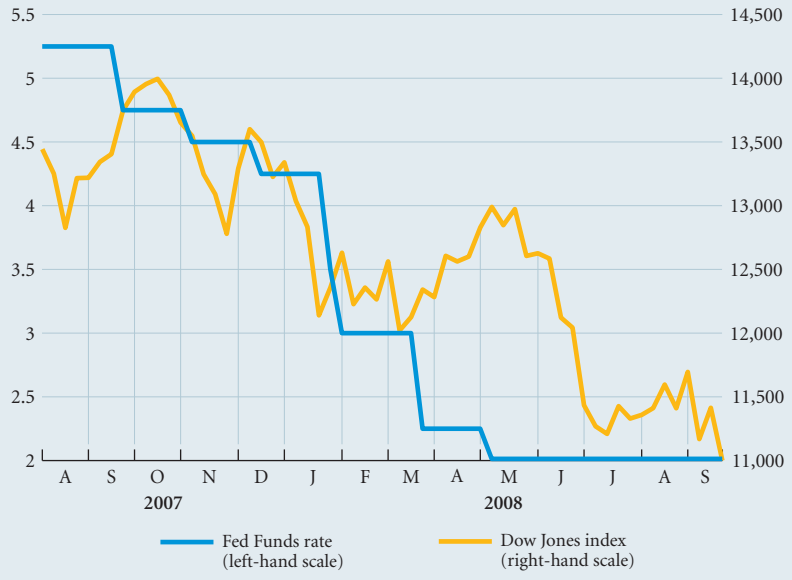
Major injections of liquidity continue in effort to avoid interbank market collapse.

Do the Fed and the ECB react to movements in financial markets? Should they do so?

The debate on how should central banks respond to a collapse in financial markets has taken on special significance over the past year. During the period of major increases in asset prices the debate was centred on the role the central banks should play in attempting to burst bubbles. Ever since the current financial crisis broke out on August 9, 2007 the world's two largest central banks have applied differing responses to the crisis. As may be seen in the following graph, the Federal Reserve has lowered interest rates from 5.25% to 2% over the past year as the New York stock exchange Dow Jones index was collapsing. On the other hand, the ECB has kept its reference rates constant at 4% since August 2007 and even raised them to 4.25% at its meeting in July 2008, in spite of the drop in the DJ Eurostoxx 50 index. In view of this, may we thus conclude that the Fed reacts to stock market fluctuations whereas the ECB ignores them? What does economic theory have to say about this different reaction? In this box we attempt to explain the responses of the two central banks to the crisis and the pros and cons of each strategy.

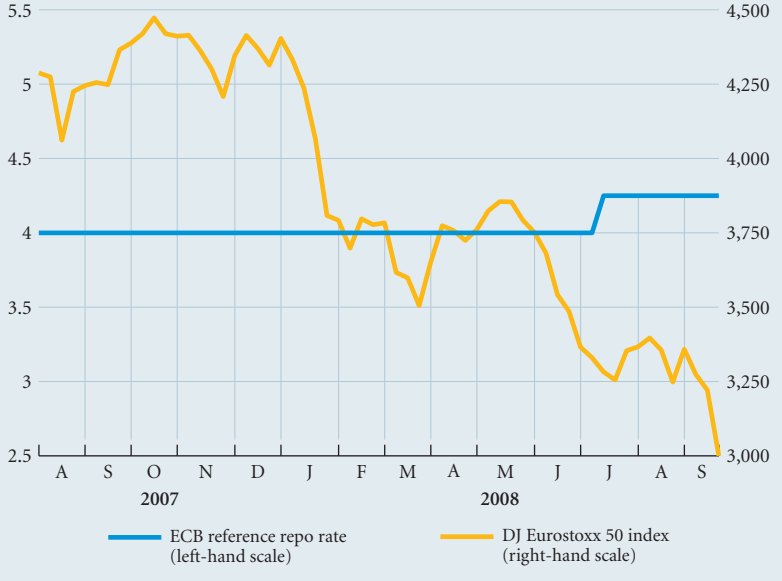
In the first place, it should be remembered that the ECB and the Fed have different mandates. The main mandate of the ECB is consumer price stability. The ECB has not lowered its rate over the past year because inflation has held at values well above the 2% objective. In fact, when the crisis broke out the ECB had already announced there would be an increase in interest rates in September 2007, due to growing inflation in the Euro

AS DOW JONES COLLAPSES THE FED RESPONDS...



SOURCE: Thomson Financial Datastream.

...WHILE ECB FAILS TO LOWER INTEREST RATES



SOURCE: Thomson Financial Datastream.

Area. This increase was put off until July 2008 in order to give something of a breather to the financial system. In view of the crisis, the ECB chose to use the two main tools available to it to meet two different objectives. By maintaining its reference rate, the ECB has tried to show the markets its firmness in controlling inflation. Furthermore, the ECB has injected large amounts of liquidity in the interbank market through repos in order to reduce pressure on interest rates in that market (the *Euribor* for various terms).

On the other hand, the Fed has a double mandate of price stability and maximum sustainable employment. In an attempt to ease the economic and financial crisis and avoid a rise in unemployment, the Fed has gone all out and reduced its interest rate by 325 basis points over the past year, and it has created new instruments for injecting more liquidity into the financial system and lowering interest rates in the interbank market.[1] For these reasons, the Fed seems to have temporarily abandoned its inflation objective, for which the figure has risen to 5.4% as of August 2008, in order to concentrate on avoiding a recession in the United States.

Does this mean that the Fed «follows the wishes of Wall Street» lowering interest rates when the financial markets have problems? Not necessarily. If both the central bank and the stock markets are anticipating a recession, it is possible that at the same time we observe a drop in share prices (because of the decrease in future corporate profits) and a cut in interest rates without this implying that the Fed is following Wall Street.[2] In fact, the chairman of the Federal Reserve, Ben Bernanke, during his term as professor at Princeton University was a fervent defender of the thesis that the central banks should not pay attention to the prices of financial assets in order to set the reference policy rate.[3] The central bank should respond only when the rise in asset prices (in the stock market and in the housing market) brings about an overheating of the economy through the wealth effect. That is to say, the central bank should react only when the increase in the price of assets led to a rise in consumption and investment that finally shows up as increased inflation.

The theses maintained by Bernanke and his co-authors conclude that the central banks should not have an objective for the inflation rate of asset prices such as they have for the inflation rate of consumer goods prices because the former are subject to financial bubbles. This involves two problems. First, it is difficult to distinguish in real time if the price of an asset carries a bubble component and what its size may be. Secondly, the changes in policy interest rates needed to eliminate a financial bubble are large and they could seriously destabilize the rest of the economy. A refinement of this theory is what may be called the «Greenspan doctrine» of an asymmetric response of monetary policy to the financial markets. Given that we cannot determine what is the speculative component of asset prices, the central bank should not respond to asset prices when these rise (aside from their inflationary effect) but indeed it should respond when these prices drop and we know for certain that the bubble has burst.

The problem with this approach comes to the fore when the economy is under the effect of various bubbles, as has happened in the US economy over the past decade (in the stock markets, in the housing market, commodities, etc.). Furthermore, it is possible that low interest rates will set off further bubbles as, for example, in the real estate market. Because of this, other economists (such as Steven Cechetti, currently at the

(1) See Monthly Report for May 2008.
(2) Nevertheless, the cut of 75 basis points announced by the Federal Open Market Operations Committee (FOMC) at its surprise meeting on January 22, 2008, in a context of drops in largest world stock market indices, has helped supporters of the thesis that the Fed does follow what Wall Street does.
(3) See, for example, B. Bernanke and M. Gertler, 2000, «Monetary Policy and Asset Price Volatility», NBER working paper 7559.

BIS) suggest that the central bank should definitely respond by raising interest rates when it suspects that bubbles exist, even before there are signs of overheating in the rest of the economy. While it is true that it is difficult to detect a financial bubble, the symptoms often make themselves evident, at least qualitatively.

Finally, a third body of opinion emphasizes the role that may be played by the central bank or the financial regulatory authority to take counter-cyclical measures in order to reduce the impact of financial bubbles on real economic activity without the need to change policy rates. For example, it is possible to oblige the commercial banks to provision additional funds or to increase their capital before financing those activities which may be suspected of fuelling a bubble.[4] Some of the proposals for a change in bank regulation now being discussed run precisely in this direction.

To conclude, the ECB has spent the past year in trying to keep inflation under control and has not paid special attention to the stock market. On the other hand, the Fed has used all its ammunition in trying to avoid a recession at all costs and this has increased the perception that it was reacting to what was happening on Wall Street, although this does not seem to be so. As suggested by Governor Mishkin in a recent address, what the Fed has done is react to the economic consequences of a drop in asset prices.[5] This response may make sense if we believe that the structures of the European and North American economies are different. In the United States there is more participation in financial markets and more financial products related to the mortgage loan market, and the economy thus is more exposed to asset price fluctuations. In any case, let us hope that the new era of low interest rates does not lead to the creation of new bubbles in other markets.

(4) See Buiter, W., 2008, «Central Banks and Financial Crises», paper presented at conference organized by Federal Reserve Bank of Kansas City in Jackson Hole, Wyoming, in August 2008.
(5) See F. Mishkin, 2008, «How should we respond to Asset Price Bubbles?», talk given in Philadelphia, USA, on May 15, 2008.

Convulsions in bond markets

The uncertainty in the financial markets because of this crisis has brought about movements in the short-term bond market that may be called real financial tsunamis. The most violent movements have taken place in government bond markets and the short-term interbank markets in the United States, United Kingdom and the Euro Area.

In the United States, in view of the panic arising from the succession of financial entities with problems in September, investors decided to get out fast from assets of higher risk and take refuge in short-term government bonds. Three-month US Treasury bills ended up showing a yield of only 0.04% on September 17. This was something unheard of since the London Blitz between September 1940 and May 1941 during World War II.

We must go back to Forties to see similar yields on US Treasury bills.

That is to say, investors drastically changed the objective of their portfolios. Now it was not a matter of obtaining the maximum possible yield by assuming a preestablished level of risk but rather the final aim was to safeguard capital. For this reason, the yield obtained on investment is the least important, what really matters is that investment is in Treasury bills and what investors want is maximum safety. To get an idea of the change this shift means in the markets we should remember that 3-month Treasury bills usually are quoted at a yield of close to the central bank

TREASURY BILLS ACT AS REFUGE

Interest rate on US 3-month Treasury bills

NOTES: Latest figure: September 30, 2008.
SOURCE: Bloomberg.

reference rate. In the case of the United States, this is currently 2%. On the other hand, the 3-month interest rate in the US interbank market reached a high of 3.77% on September 21. That is to say, the banks were asking other banks for a premium of 177 basis points in order to lend them money.

In Europe, the tightening of the interbank market continues to increase. Whereas at the beginning of the crisis in August 2007 the differential between the official ECB interest rate and the 3-month interbank market was 74 basis points, in September it went to a differential of 87 basis points. This situation was repeated even more strongly in the 1-year Euribor rate. In August 2007 this was 78 basis points while now it is 123 basis points, so that the 1-year Euribor has gone to 5.48%. Nor has the United Kingdom escaped from reduced liquidity in the interbank

Interbank markets in Europe and United Kingdom still under severe pressure.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

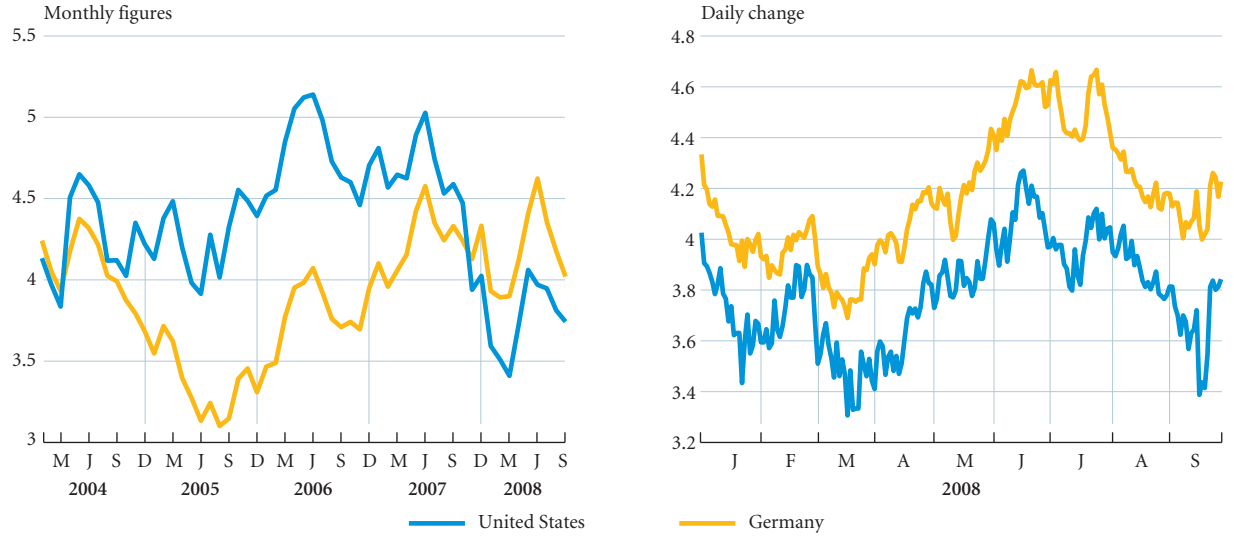
10-year government bonds at end of period as annual percentage

	2005	2006	2007		2008	
			September	December	August	September (*)
United States	4.39	4.70	4.59	4.02	3.81	3.84
Japan	3.31	1.69	1.69	1.51	1.42	1.49
Germany	1.48	3.95	4.33	4.33	4.18	4.22
United Kingdom	4.10	4.74	5.01	4.51	4.48	4.61
Switzerland	1.97	2.52	3.01	3.05	2.89	2.81

NOTES: (*) September 25.
SOURCE: Bloomberg.

SHARP MOVES IN YIELD ON GOVERNMENT BONDS

Interest rate on 10-year government bonds as annual percentage



NOTES: Latest figure: September 25.
SOURCE: Bloomberg.

Long-term interest rates on government bonds highly volatile.

market and the 3-month interest rate in that market has reached 6.27%.

All this is happening is spite of injections of liquidity by the central banks which have also acted in a coordinated manner to stabilize markets that have been gripped by the fear of a collapse of the international financial system and a freeze-up of credit markets.

The picture seems to be somewhat different in long-term interest rates on US and Euro Area bonds seeing that, if we take the quotations on August 29 and compare these with those at the end of September, the levels are very close. For example, 10-year Euro Area bonds were being quoted at 4.22% on September 25 whereas at the end of August they stood at 4.18%. Nevertheless, this analysis does not reflect the sharp movement in the day-to-day quotation in September. It has reached nearly the same point as it started out with but the way has been quite tortuous, as may be seen in the above graphic.

Foreign exchange market maintaining great volatility

The euro-dollar exchange rate has seen a month of sharp changes in September in the wake of the news about bank failures and the plan to bailout US banks. In the first half of the month the rate strengthened in view of the poor economic news about the Euro Area. In mid-June the prevailing view was that the United States would come out of the crisis before the Euro Area, which was six months behind in the economic cycle, and so the USA would recover earlier, whereas Europe would stay within a slowdown trend for a longer period.

On September 11, the euro marked up a low of 1.40 against the dollar and that moment saw the start of a trend to appreciation of the European currency which reported an exchange rate of 1.48 on September 22. The main reason for this was expectation of the creation of a 700 billion dollar fund (the major basis of the plan to bail out US banks) to

which, if we add the spending on fiscal policy to aid households and the funds to be used on specific financial entities, such Fannie Mae and Freddie Mac and AIG, the figure goes sky-high to more than 1,000 billion dollars in additonal borrowing by the US public sector. A boost in the public debt of this amount means that international investors may lose interest in an asset that, while it may be acting as a haven, runs the risk of an enormous increase in supply.

It is very unlikely that the volatility of foreign exchange market quotations will calm down in coming months because the draconian measures that must be taken to stop the system risk are not settling down markets that are uncertain about how the big holders of dollar bonds, such as China and the big oil exporters that have huge foreign reserves in dollars invested in these assets, will react. Any change in their investment policies could have major consequences for the value of the dollar in international markets.

Situation of extreme uncertainty in stock markets

Shares have not been untouched by the current situation and the best indicator of risk aversion seen in the markets is the volatility index of the markets. On both sides of the Atlantic, the share markets have reached levels seen only at the beginning of the crisis in August 2007 and in the early months of this year when there was sharp initial drop in shares. These indices are similar to the market risk price and, as may be seen in the following graph, stand at very high levels, another indication of the level of uncertainty about the months ahead.

Risk that massive bond issue in United States could affect dollar.

EXCHANGE RATES OF MAIN CURRENCIES

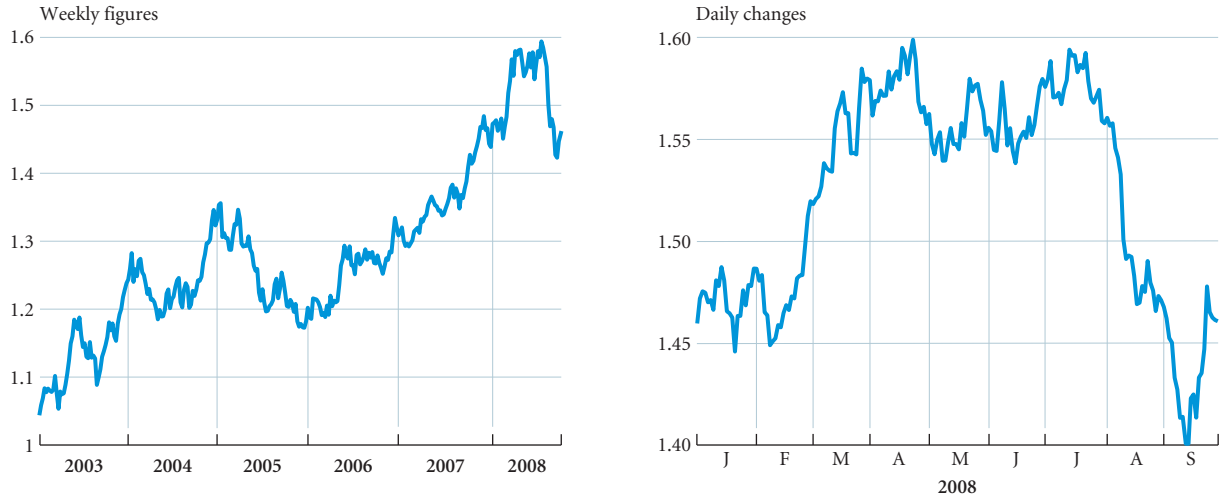
September 26, 2008

	Exchange rate	% change (*)		
		Monthly	Over December 2007	Annual
Against US dollar				
Japanese yen	106.1	–3.3	–5.4	–9.0
Pound sterling	0.543	–0.2	7.7	9.4
Swiss franc	1.087	–1.2	–4.3	–7.7
Canadian dollar	1.035	–1.3	3.5	3.0
Mexican peso	10.773	5.7	–1.2	–1.4
Against euro				
US dollar	1.462	–0.2	0.2	3.5
Japanese yen	155.1	–3.5	–4.9	–5.0
Swiss franc	1.589	–1.4	–3.9	–3.9
Pound sterling	0.793	–0.4	7.9	13.2
Swedish krona	9.673	3.1	2.5	4.7
Danish krone	7.461	0.0	0.0	0.1
Polish zloty	3.360	1.0	–6.5	–11.1
Czech crown	24.39	–0.7	–8.1	–11.7
Hungarian forint	240.3	1.9	–5.0	–4.1

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

ANOTHER MONTH OF SHOCKS FOR DOLLAR

US dollars to the euro



NOTES: Latest figures: September 26.
SOURCE: Bloomberg.

Stock markets highly volatile, reflecting investor concern.

Most stock markets are showing losses since the beginning of the year which run from 16% in Brazil to 33% in Amsterdam. While in the past month the stock markets have shown some efforts at recovery, or at least have put a floor on the drops, they have not been able to succeed because of the massive withdrawal of capital. For example, the European stock markets in Paris and Frankfurt have dropped by around 4.5%.

Spanish stock market does better than the rest.

The rejection by the US Congress of the plan drawn up by the Treasury in the vote on September 29 worsened the situation and managed to dissipate the little confidence remaining in the share markets.

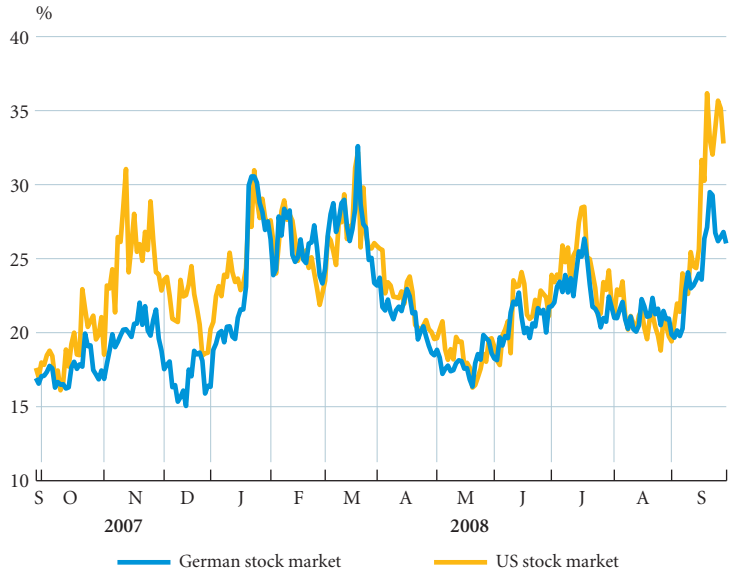
Emerging country stock markets also suffer waves of instability.

Nevertheless, the Spanish stock market has behaved much better than the rest, seeing that over the past month it has dropped by only 0.1%. The sharp increases in market quotes for Spain's banking sector have bolstered the selective Spanish index IBEX 35, a trend that has included a good performance in the telecommunications sector because of its defensive nature in situations like the present.

With regard to emerging country stock markets, we should mention the trend in the Russian stock market which has been one of the most severely hurt in recent months. Geo-political problems that have brought about the withdrawal of international investors and the effects of the international crisis has resulted in a sharp correction in spite of promises of an injection of capital by the government. Nor has the Chinese stock market recovered significantly from the sharp drop that has taken place all year.

HIGH RISK AVERSION

Volatility of markets



NOTES: Latest figures: September 25.
SOURCE: Bloomberg.

NEW ATTEMPT TO STABILIZE MARKETS FAILS

Trend in stock market indices

NOTES: Latest figures: September 26.
SOURCE: Bloomberg and own calculations.

INDICES OF MAIN WORLD STOCK EXCHANGES

September 26, 2008

	Index (*)	% monthly change	% cumulative change	% annual change
New York				
Dow Jones	*10,992.9*	*–3.7*	*–17.1*	*–20.8*
Standard & Poor's	*1,197.7*	*–5.8*	*–18.4*	*–21.5*
Nasdaq	*2,158.5*	*–8.6*	*–18.6*	*–20.0*
Tokyo	11,893.2	–6.9	–22.3	–27.6
London	5,108.9	–6.6	–20.9	–20.6
Euro Area	3,168.8	–3.9	–28.0	–27.4
Frankfurt	*6,075.3*	*–4.2*	*–24.7*	*–22.2*
Paris	*4,170.7*	*–4.5*	*–25.7*	*–26.7*
Amsterdam	*359.1*	*–11.0*	*–30.4*	*–33.4*
Milan	*27,271.0*	*–2.5*	*–29.3*	*–31.9*
Madrid	*11,405.9*	*–0.1*	*–24.9*	*–21.4*
Zurich	6,854.0	–3.4	–19.2	–22.6
Hong Kong	18,682.1	–11.3	–32.8	–29.3
Buenos Aires	1,678.4	–4.6	–22.0	–22.9
São Paulo	50,182.6	–7.7	–21.5	–16.0

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.

RUSSIAN AND CHINESE STOCK MARKETS FAIL TO ESCAPE SHARE CORRECTIONS

Trend in stock market indices

NOTES: Latest figures: September 26.
SOURCE: Bloomberg.

SPAIN: OVERALL ANALYSIS

Economic activity

Economy at low point

Spain's economy has suffered a triple blow that continues to affect its future development, namely, an overall contraction of credit, an increase in commodity prices and a sharp collapse in housing construction. Some positive figures for this past summer, such as a partial reversal of the price rise in commodities and a somewhat weaker euro, have brought some relief. Nevertheless, the trend to a slowdown in national demand continued all through the summer months.

Trend to slowdown in national demand continues over summer months.

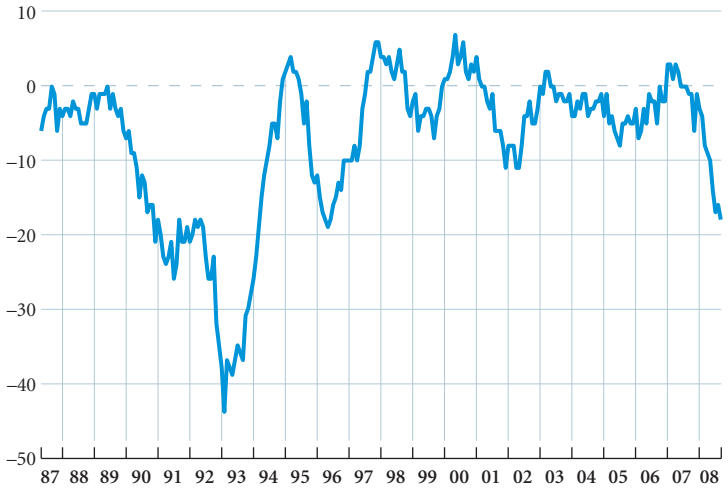
In July, there was less of a dip in the secondary sector and the general industrial production index recorded a year-on-year decrease of 4.4%, adjusted for the number of working days, as against the drop of 9.0% seen in June. In any case, production of consumer durables was down 16.6% compared with the same month in 2007. Nevertheless, some branches of industry showed notable strength, as was the case in electronic equipment manufacture which recorded a year-on-year increase of 24.9% while medical/surgical equipment and precision equipment rose by 5.4%.

Industrial confidence continued to grow worse in August marking up the lowest level in the past 12 years. In addition, new industry orders rose by only 3.7% in July compared with the same month last

Industrial production down.

INDUSTRY SHOWS DROP IN CONFIDENCE

Confidence index for industry (*)



NOTES: (*) Difference in percentages of positive and negative replies.
SOURCE: European Commission survey.

Construction continuing readjustment process.

year although this rate represents an improvement over the year-on-year drop recorded in June.

Construction continued to follow a process of readjustment. Land prices were down 7.8% in the second quarter compared with the same period in 2007. Cement consumption in July-August went down 26.7% compared with the same months last year as against a year-on-year drop of 17.8% in the second quarter. The July construction climate index was down to its lowest level since 1997 although there was a considerable recovery in August.

With regard to services, it does not seem they are going to take up the slack. In August, the confidence index for the sector was down to the lowest level of the decade. The volume of business in the tertiary sector showed a drop of 0.5 % in July compared with the same month last year. In spite of the general slack, some branches showed very strong, as in the case of investigation and security, data-processing, industrial cleaning and sea transport which showed annual rates of increase of 8%. On the other hand, motor vehicles trade and technical services showed decreases of more than 10%.

SUPPLY INDICATORS

Percentage change over same period year before

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	July	August
Industry								
Electricity consumption (1)	4.0	4.4	2.5	4.9	3.3	2.7	1.6	2.2
Industrial production index (2)	3.9	1.9	1.1	–0.2	–0.5	–5.1	–4.4	...
Confidence indicator for industry (3)	–2.7	–0.3	–0.7	–3.3	–7.0	–11.9	–16.0	–18.0
Utilization of production capacity (4)	80.5	81.3	82.1	81.1	81.3	80.3	–	79.3
Imports of non-energy intermediate goods (5)	10.5	8.0	8.7	7.1	11.4	6.9	...	...
Construction								
Cement consumption	8.5	0.2	–1.1	–1.9	–14.1	–17.8	–23.8	–30.2
Confidence indicator for construction (3)	14.2	9.3	12.0	–1.3	–14.7	–17.3	–30.0	–15.0
Housing (new construction approvals)	18.6	–24.7	–50.7	–33.6	–59.8	–52.5	...	...
Government tendering	31.3	–14.9	–30.0	–33.1	27.7	–13.3	...	...
Services								
Retail sales (6)	2.1	2.4	3.1	–0.3	–3.6	–5.6	–6.0	...
Foreign tourists	4.1	1.5	1.5	1.6	5.3	0.9	–8.0	–1.8
Tourist revenue inflows	5.6	3.6	3.3	4.5	5.0	1.0	...	...
Goods carried by rail (km-tonnes)	–1.2	–4.4	–1.4	–5.3	–2.7	–0.7	...	...
Air passenger traffic	6.8	9.0	10.6	8.6	7.9	–0.7	–3.7	–2.4
Motor vehicle diesel fuel consumption	5.5	4.8	4.2	4.7	–0.9	–2.8	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for difference in number of working days.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
(6) Index deflated and corrected for calendar effects.
SOURCE: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of Economy and Finances and own calculations.

DEMAND INDICATORS

Percentage change over same period year before

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	July	August
Consumption								
Production of consumer goods (*)	2.3	1.2	0.9	–2.7	–0.8	–5.6	–3.6	...
Imports of consumer goods (**)	8.9	5.1	8.4	7.7	–1.2	–6.9	...	...
Car registrations	–0.9	–1.2	–2.9	1.3	–15.3	–19.6	–27.4	–41.3
Credit for consumer durables	14.5	10.0	6.9	9.9	8.8	7.1	–	…
Consumer confidence index (***)	–12.3	–13.3	–12.3	–17.3	–20.0	–31.3	–39.0	–37.0
Investment								
Capital goods production (*)	8.4	5.9	6.3	3.3	2.0	–3.1	–2.2	...
Imports of capital goods (**)	3.2	9.8	–0.6	9.0	–16.0	–16.4	…	...
Commercial vehicle registrations	1.5	0.3	–3.0	4.7	–29.5	–34.0	–46.6	–57.0
Foreign trade (**)								
Non-energy imports	9.0	7.3	7.6	7.5	4.3	0.2	...	...
Exports	5.6	4.2	6.7	4.6	2.2	6.6	...	...

NOTES: (*) Adjusted for difference in number of working days.
(**) By volume.
(***) European Commission survey: difference between percentage of positive and negative replies.
SOURCE: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of Economy and Finance, European Commission and own calculations.

Business volume in tourism was down 0.5% in July compared with the same month last year. Foreign tourist arrivals were down 8.0% in July and 1.8% in August compared with 12 months earlier. Nevertheless, overnight stays at hotels rose by 0.9% in July compared with the same month in 2007 while figures for non-residents were up 2.9%.

On the demand side, consumption is still depressed due to the worsening of confidence in view of prospects of a rise in unemployment and lower share prices on the stock market and lower prices in the real estate market. There has been a notable collapse in passenger car sales with a year-on-year drop of 32.6% in July-August. The performance in retail sales, excluding cars, was not as unfavourable with a drop of 4.8% in July compared with the same month in 2007 at constant prices adjusted for number of working days, as against a bigger drop in June. In July, the consumer confidence index hit its lowest level in recent decades and showed only a slight improvement in August.

With regard to investment, this is being negatively affected by the weakness in consumption and the slowdown in foreign demand. Production of capital goods was down 2.2% in the past 12 months although less than in June. Registrations of commercial vehicles dropped even more and in July-August was down by 50.8% compared with those two months the year before.

Within this framework, the European Commission recently published its forecasts for the trend in gross domestic product (GDP) for Spain's economy which showed a quarter-on-quarter drop of 0.1% and 0.3% in the third and fourth quarters of 2008. GDP growth for the year as a whole was given as an increase of 1.4%.

Services fail to compensate for weakness in industry and drop in real estate.

Summer brings collapse in passenger car sales and significant dip in retail sales.

European Union forecasts Spain to move into technical recession while government takes new measures to deal with situation.

Given this situation, Minister of Economy Pedro Solbes has recognized the risk of recession and, in order to deal with this, Prime Minister José Luis Rodríguez Zapatero in the second week in September announced further measures to ease the complicated situation in real estate. Under these measures a new line of financing has been established by the Official Credit Institute making available some 3 billion euros to extend credits for developers who convert housing units to rental properties. At the same time, the government announced the creation of companies dedicated to investment in real estate rental assets that are to be listed on the stock exchange and will enjoy tax benefits.

Labour market

Drop in employment slows in August

At the end of August, the total number of persons registered with Social Security as employed stood at 19,055,340, only slightly above one year earlier. This means a worse situation compared with August 2007 when the number of those registered grew by 2.5%, although it represents some relief following the negative year-on-year rates recorded in June and July.

In spite of this improvement, industry and especially construction continued to show a trend to loss of jobs. In the past 12 months ending in August the number of those registered with Social Security under the industry heading was down 2.2% while in construction the drop was 12.2%. On the other hand, under services the number of those registered was up 2.7%, only 2 decimals less than in August 2007.

Services keeping up employment levels.

The various trends in employment by sector meant a year-on-year drop of 2.2% in the number of males registered while the number of females rose by 3.1% putting their share at the all-time high of 42.7%. In turn, the number of foreign workers registered was up 5.5% in the past year, 2 points less than in August 2007. However, while the year-on-year change rate for male foreign workers was down 6 points to 2.4%, the rate for women was up more than 4 points to 10.2%. Workers from the

Percentage of foreign workers registered with Social Security stands at 11.0%, one decimal less than all-time high in June.

LOSS OF JOBS IN CONSTRUCTION

Month-on-month change annualized in number of those registered at Social Security under construction heading

NOTES: Cycle-trend series.
SOURCE: Ministry of Labour and Social Affairs and own calculations.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2006	2007	2007		2008			
			3Q	4Q	1Q	2Q	July	August
Persons registered with Social Security								
Sector								
Industry	*0.0*	*2.5*	*2.5*	*2.4*	*0.3*	*–1.4*	*–2.4*	*–2.2*
Construction	*8.7*	*3.3*	*2.3*	*0.5*	*–2.8*	*–7.8*	*–11.4*	*–12.2*
Services	*5.2*	*3.5*	*3.0*	*3.0*	*2.6*	*2.0*	*1.6*	*2.7*
Job situation								
Wage-earners	*4.7*	*3.0*	*2.6*	*2.2*	*1.2*	*0.0*	*–0.9*	*0.1*
Non-wage-earners	*2.2*	*2.8*	*2.9*	*2.9*	*2.3*	*1.1*	*0.1*	*–0.2*
Total	**4.3**	**3.0**	**2.7**	**2.4**	**1.4**	**0.2**	**–0.7**	**0.0**
Persons employed (*)	**4.1**	**3.1**	**3.1**	**2.4**	**1.7**	**0.3**	**–**	**–**
Jobs (**)	**3.2**	**2.9**	**2.9**	**2.2**	**1.4**	**0.4**	**–**	**–**
Hiring contracts registered (***)								
Permanent	41.1	2.0	–1.6	–21.1	–11.8	–5.6	–11.3	–23.5
Temporary	4.7	0.3	–0.5	1.2	–6.5	–7.4	–6.9	–17.9
Total	**7.9**	**0.5**	**–0.7**	**–2.1**	**–7.2**	**–7.2**	**–7.3**	**–18.4**

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

Number of hiring contracts shows drop of 18% year-on-year in August due to slowdown in economic activity.

European Union increased at a higher rate, 7.6% compared with 4.4% for non-EU workers. The percentage of foreign workers registered with Social Security stood at 11.0%, one decimal less than the high in June.

The trend in the number of hiring contracts registered at public employment offices continued to show the freezing up of the labour market in recent months. In August, the total number of such contracts was down 18.4% compared with the same month last year. Of these, permanent job contracts were down 23.5%. Nevertheless, the weight of 9.3% in stable job contracts in total hiring may be seen as notable. In the first eight months of the year some 11,234,640 hiring contracts were signed, a decrease of 8.4% compared with the same period in 2007.

Number of registered unemployed goes above two and a half million

As a result of reduced job creation and the increase in the labour force, the number of unemployed persons registered at public employment offices continued to rise at a strong rate in August going to 2,530,001, the highest level in the decade. This figure meant an increase of more than half a million compared with the same month in 2007 (up 24.7%).

Unemployment was up in all sectors in August, including those seeking a first job. In the past 12 months the number of unemployed increased especially in construction with a rise of 71.0%. Nevertheless, in absolute terms the biggest increase came in services with 242,544 more unemployed (up 19.9%).

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

August 2008

	No. of unemployed	Change over December 2007		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	83,524	14,712	21.4	18,183	27.8	3.3
Industry	322,284	42,303	15.1	45,287	16.3	12.7
Construction	429,060	145,193	51.1	178,177	71.0	17.0
Services	1,461,265	177,015	13.8	242,544	19.9	57.8
First job	233,868	21,231	10.0	17,514	8.1	9.2
By sex						
Males	1,162,191	277,052	31.3	362,406	45.3	45.9
Females	1,367,810	123,402	9.9	139,299	11.3	54.1
By age						
Under 25 years	289,532	49,149	20.4	63,211	27.9	11.4
All other ages	2,240,469	351,305	18.6	438,494	24.3	88.6
TOTAL	**2,530,001**	**400,454**	**18.8**	**501,705**	**24.7**	**100.0**

SOURCE: INEM and own calculations.

Nor did industry have a better showing with an increase of 16.3% in unemployment.

In addition, according to Eurostat figures, in July Spain's unemployment rate continued as the highest in the European Union going to 11.0% of the labour force. Prospects are for a continuation of the upward trend in unemployment with the weakening of economic activity not only in construction but also in industry, as confirmed by restructuring plans recently announced in the motor vehicle sector.

Labour costs show highest growth in past five years

The rise in inflation in recent months is being passed through to labour costs. This is happening not only through wage indexing clauses, which are widespread in Spain's labour market, given that the increase agreed on in collective bargaining agreements continued to rise going to 3.5% in the second quarter, not including wage review clauses.

Labour costs for companies rose by 5.3% in the second quarter compared with the same period last year, according to the Quarterly Survey of Labour Costs carried out by the National Institute of Statistics. This was the highest increase since the first quarter of 2003. Total wage costs were up 5.1% to 1,772.1 euros on average per worker per month. Non-wage costs were up by 5.7%. The biggest share of those costs, that for compulsory Social Security contributions, was up by 4.6%. Other costs showed a bigger rise mainly due to firing indemnities.

Wage increases were spread over all sectors. Ordinary wages, excluding overtime and back-pay, amounted to 1,524.6 euros on average, with year-on-year increases of 5.4% in industry and 5.2% in construction and services. As a result, worker purchasing power showed a year-on-year increase of 0.6%.

According to Eurostat, Spain's unemployment rate rose to 11.0% in July, the highest in European Union.

Increased inflation in recent months being passed through to labour costs.

WAGE INDICATORS

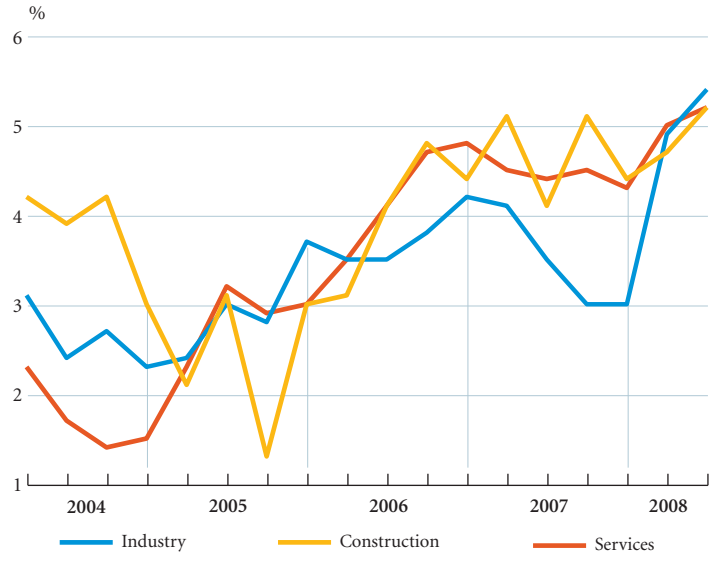
Percentage change over same period year before

	2006	2007	2007				2008	
			1Q	2Q	3Q	4Q	1Q	2Q
Increase under general wage agreements (*)	**3.3**	**3.1**	**2.9**	**2.9**	**2.9**	**3.1**	**3.4**	**3.5**
Wage per job equivalent to full-time work (**)	**3.9**	**3.7**	**3.5**	**3.5**	**3.8**	**4.1**	**5.1**	**5.1**
Quarterly labour cost survey								
Wage costs								
Total	3.4	3.9	4.3	3.8	3.8	3.7	5.3	5.1
Industry	*3.6*	*3.0*	*3.7*	*3.1*	*2.3*	*2.8*	*5.8*	*5.1*
Construction	*3.7*	*4.8*	*5.5*	*3.9*	*4.8*	*5.1*	*4.8*	*6.5*
Services	*3.7*	*4.2*	*4.5*	*4.3*	*4.2*	*3.8*	*5.1*	*4.8*
Average wages per hour worked	4.2	4.4	4.6	4.2	4.6	4.1	9.0	1.9
Other labour costs	3.6	4.4	3.2	4.0	5.2	5.3	4.5	5.7
Work day (***)	–0.6	–0.4	–0.2	–0.3	–0.9	–0.3	–3.5	3.1
Farm wages	**2.8**	**3.1**	**3.1**	**2.5**	**3.3**	**3.5**	**4.6**	**5.2**
Labour cost in construction	**4.4**	**2.4**	**2.5**	**2.4**	**2.3**	**2.3**	**0.8**	**6.4**

NOTES: (*) Does not include wage revision clauses. Cumulative figures.
(**) Quarterly National Accounts: figures adjusted for seasonal and calendar differences.
(***) Effective hours worked per worker per month.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fishing and Food, Ministry of Public Works and own calculations.

WAGE INCREASES NOTED IN ALL SECTORS

Year-on-year change in ordinary wage cost per worker



SOURCE: Quarterly survey of labour costs and own calculations.

Prices

Inflation eases thanks to drop in oil prices

Following a whole year of sharp inflationary pressures, mainly due to the rise in oil and other commodity prices, the sharp drop in oil prices as of mid-July brought about a downturn in inflation in August. After having reached the highest level since 1992 in July, the year-on-year change rate in the consumer price index (CPI) went down by 4 decimals in August to stand at 4.9%. In any case, this rate was more than twice the level of 2.2% twelve months earlier.

The decrease in inflation in August may be attributed to the price drop in fuels and fuel-oils. The inflation rate for these products dropped by 25.1% in July and 20.0% in August, reflecting the collapse of oil prices in international markets.

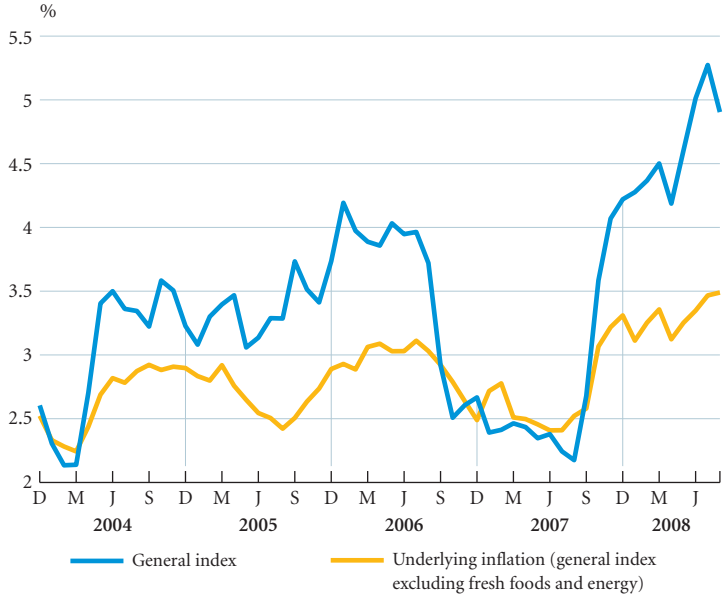
Annual CPI change rate down 4 decimals in August to 4.9%...

Unprocessed foods, the other major volatile component of the CPI, also eased its annual inflation to 4.2% in August from the 4.4% the month before. There was a notable drop in the price of fresh fish as against the rise seen in August 2007. As a result, the price of fresh fish showed a year-on-year decrease of 0.4%. At the same time, potatoes reported an

...due to drop in fuel and fuel-oil prices.

INFLATION DIPS AFTER THREE MONTHS OF INCREASES

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	–0.2	2.1	4.9
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.

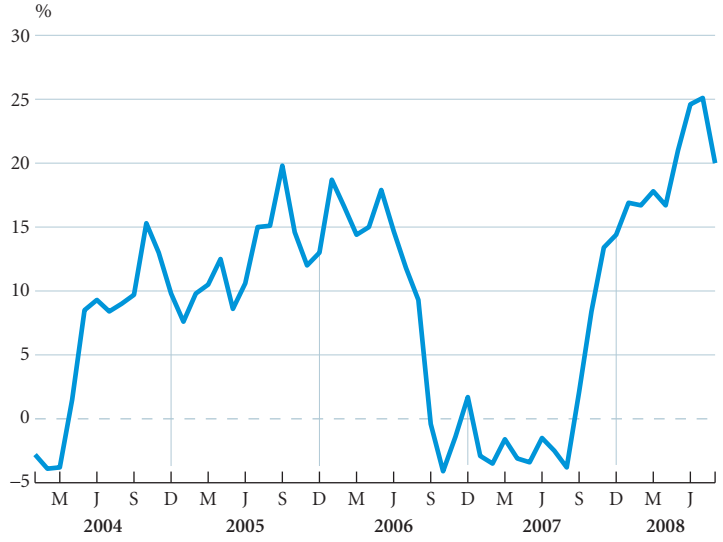
Easing in prices of fresh fish and potatoes compensates for rise in mutton, beef and pork.

easing of inflation to 3.2% year-on-year. This compensated increases in mutton, beef and pork.

The more stable core of inflation, so-called underlying inflation, held at the 3.5% level. Recently, however, it has been affected by the increased cost of

FUELS AND FUEL-OILS EASE

Year-on-year change in fuel and fuel-oil prices



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

August

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2007	2008	2007	2008	2007	2008
By type of spending							
Food and non-alcoholic beverages	110.3	0.3	0.1	1.9	2.1	2.8	6.8
Alcoholic beverages and tobacco	111.4	0.0	0.0	5.7	3.6	6.5	4.0
Clothing and footwear	94.3	–0.7	–0.7	–12.3	–12.9	1.0	0.4
Housing	112.3	0.1	–0.3	3.4	6.5	3.1	7.9
Furnishings and household equipment	105.1	0.0	0.0	1.2	1.2	2.6	2.5
Health	98.6	0.0	0.0	–2.5	0.1	–2.2	0.5
Transport	111.3	–0.5	–2.3	4.2	5.7	–0.1	8.6
Communications	100.1	–0.1	–0.1	1.1	0.2	0.5	–0.1
Recreation and culture	101.5	1.3	1.4	1.1	2.1	–0.9	0.2
Education	107.6	0.0	0.0	0.6	0.4	4.5	3.9
Restaurants and hotels	112.0	0.8	0.8	5.5	5.5	5.0	4.9
Other goods and services	107.0	0.0	0.0	2.5	3.0	3.1	3.5
By group							
Processed food, beverages and tobacco	110.9	0.3	0.2	2.6	2.9	2.8	7.6
Unprocessed food	109.4	0.2	0.0	1.6	0.9	4.0	4.2
Non-food products	106.6	0.1	–0.3	1.1	2.0	1.8	4.4
Industrial goods	104.0	–0.4	–1.2	–1.6	0.0	–0.2	4.7
Energy products	*120.0*	*–0.8*	*–3.9*	*5.8*	*11.6*	*–2.2*	*17.6*
Fuels and oils	*121.9*	*–1.0*	*–5.1*	*6.8*	*12.0*	*–3.8*	*20.0*
Industrial goods excluding energy products	*98.8*	*–0.3*	*–0.2*	*–4.0*	*–3.9*	*0.5*	*0.5*
Services	109.4	0.6	0.6	3.9	4.1	3.9	4.0
Underlying inflation (**)	105.9	0.2	0.3	0.9	1.0	2.5	3.5
GENERAL INDEX	**107.6**	**0.1**	**–0.2**	**1.4**	**2.1**	**2.2**	**4.9**

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

commodities and rigidity in price formation, so that it was up appreciably compared with the 2.4% seen in June 2007.

The persistence of inflationary pressures is notable in the services sector. Prices for tourism and hotels/restaurants were up 4.9% in the 12 months ending in August, one decimal more than the month before.

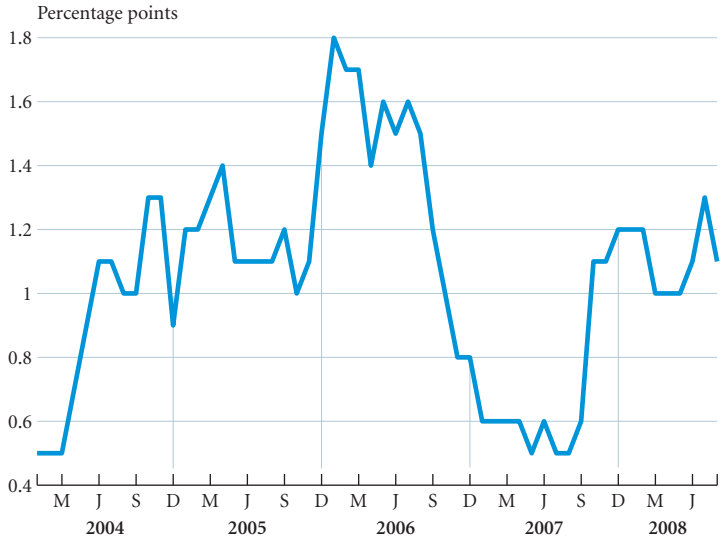
Processed foods were down two decimals in August putting year-on-year inflation at 7.6%. This reflected some normalization in international markets for farm commodities in recent months following sharp increases. In any case, milk prices still showed a year-on-year change of 19.1%.

The other large segment of underlying inflation, non-energy industrial goods,

Prices of non-energy industrial goods increase but only by 0.5% year-on-year.

INFLATION DIFFERENTIAL WITH EURO AREA IMPROVES

Difference between Spain and Euro Area in year-on-year change in harmonized CPI



SOURCE: Eurostat, National Institute of Statistics and own calculations.

Inflation likely to end year below 4%.

continued to rise although starting out at very low levels. In August, this showed year-on-year inflation of 0.5% as against 0.3% in July. The level of discounting in the end-of-season sales was similar to that last year and inflation on clothing and footwear held at a low 0.4% due to fierce competition.

The inflation index harmonized with the European Union also rose by 4.9% in the 12 months ending in August. Given that inflation in the Euro Area was down to a lesser extent, the differential dropped by two decimals to 1.1 points. This decrease may be partly explained by the higher weight of fuels in the Spanish shopping basket and the fact that taxes on these products carry less weight in the case of Spain with the result that the drop in fuel prices has a bigger impact on the national CPI.

Recent drop in commodity prices beginning to show up in industrial prices.

What are the prospects for inflation? The drop in prices for oil and other commodities will make it possible for the moderation of inflation to continue in coming months. As a result, if there is no sudden change in oil markets, what is most likely to happen is that the inflation rate will end the year below 4%.

Wholesale prices beginning to drop

After having reached the highest levels in recent years, wholesale prices are beginning to reflect the downturn seen in commodity prices since July. The sharp decrease in oil prices from record levels has been of special significance but other raw materials, such as farm commodities, have also dropped considerably.

Industrial prices dropped by 0.8% in August in contrast to the rise of 0.2% in the same month in 2007. As a result, the year-on-year inflation rate went to 9.2%, some 1.1 points less than the figure for July 2008, the highest level since October 1984. The biggest decrease came in

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	3.2	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	2.4	–
May	15.2	7.9	5.3	2.0	5.9	21.2	9.2	0.7	–0.1	3.2	3.4
June	8.7	9.0	5.4	2.1	6.3	25.5	10.3	1.1	–0.3	3.6	–
July	...	10.3	5.2	2.3	7.4	30.3	10.7	0.4	–0.1	4.9	–
August	...	9.2	4.9	2.3	7.4	25.6	...	...	...	...	...

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

energy with year-on-year inflation going down 4.7 points to 25.6%. Inflation in consumer goods was lower by 4 decimals putting the figure at 4.9%. Inflation rates for capital goods and intermediate goods in August held at earlier levels.

By branches, the most inflationary were those affected by the increase cost of raw materials. Coke production and oil refining prices rose by 40.3% while extraction of energy products showed a 14.6% rise. Metallurgy prices were up 14.2% and those in the food industry rose by 8.8%. On the other hand, prices for manufactures of office machinery and computer equipment were down by 1.2% in the past 12 months thanks to gains in productivity and strong competition in world markets.

Year-on-year inflation in import prices in July continued to rise going to 10.7%, some 4 decimals more than in the previous month. Nevertheless, the main inflationary component, energy, began to ease downward although the annual change rate still stood at 53.6%. On the other hand, intermediate goods rose by 4.9% compared with July 2007, some 1.3 points more than in June. Prices of imported consumer and capital goods were still very much contained thanks to the strength of the euro which reached an all-time high in July.

Inflation in import prices continues to rise in July in spite of euro at all-time high.

Foreign sector

Trade deficit up 8.4% because of continued worsening of energy balance.

Correction of non-energy trade deficit continuing

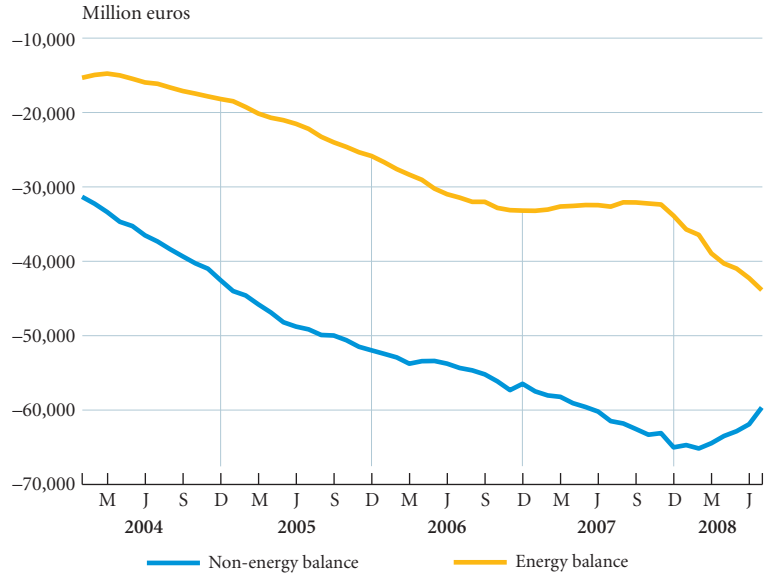
In the period January-July 2008, the trade deficit was 59.51 billion euros, an increase of 8.4% year-on-year, which confirms a continuing reduction of the tendency to grow worse. With regard to the export/import ratio, this stood at 65.8%, slightly below the 66.1% figure in the same period last year.

The increase in the trade imbalance continued to be the result of a worsening of the energy trade balance for which the negative balance in the January-July period rose by 53.1% year-on-year, going from 18.85 million euros to 28.86 million. This increase of 10 billion euros is not compensated by the reduction of 5.37 billion euros in the non-energy balance. In the January-July period, this balance stood at 30.66 million euros, 14.9% less than in the same period last year. This improvement in the non-energy trade balance was mainly due to the consumer goods balance followed by the balance in capital goods. The balance for intermediate goods, however, continued to worsen.

In terms of inflows and outflows, we should point out that in the first seven months of the year exports were up 7.2% year-on-year while imports rose by 7.6%. If we exclude the energy sector,

NON-ENERGY TRADE DEFICIT BEING CORRECTED

Trade balance by product type (*)



NOTES: (*) Total for lasts 12 months.
SOURCE: Department of Customs and Special Taxes and own calculations.

FOREIGN TRADE

January-July 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	35,517	56.0	20.4	6,661	69.6	5.8	–28,857	18.8
Consumer goods	41,776	–5.5	24.0	40,922	4.8	35.7	–854	98.0
Food	*9,079*	*4.2*	*5.2*	*13,269*	*7.0*	*11.6*	*4,190*	*146.1*
Non-foods	*32,697*	*–8.4*	*18.8*	*27,653*	*0.1*	*24.1*	*–5,043*	*84.6*
Capital goods	14,828	–12.8	8.5	10,084	1.8	8.8	–4,744	68.0
Non-energy intermediate goods	82,063	5.4	47.1	57,002	5.4	49.7	–25,060	69.5
By geographical area								
European Union	95,965	–0.5	55.1	80,312	5.4	70.0	–15,652	83.7
Euro area	*80,199*	*–1.2*	*46.0*	*64,248*	*4.6*	*56.0*	*–15,951*	*80.1*
Other countries	78,219	19.6	44.9	34,357	11.6	30.0	–43,862	43.9
Russia	*5,419*	*12.6*	*3.1*	*1,695*	*52.3*	*1.5*	*–3,724*	*31.3*
United States	*6,939*	*23.9*	*4.0*	*4,497*	*–0.7*	*3.9*	*–2,442*	*64.8*
Japan	*3,353*	*–8.2*	*1.9*	*851*	*3.2*	*0.7*	*–2,502*	*25.4*
Latin America	*9,270*	*13.0*	*5.3*	*5,402*	*–11.9*	*4.7*	*–3,868*	*58.3*
OPEC	*17,305*	*42.4*	*9.9*	*3,835*	*30.4*	*3.3*	*–13,470*	*22.2*
Rest	*35,934*	*16.0*	*20.6*	*18,078*	*18.5*	*15.8*	*–17,856*	*50.3*
TOTAL	**174,184**	**7.6**	**100.0**	**114,669**	**7.2**	**100.0**	**–59,514**	**65.8**

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

the situation turns around drastically given that the increase in exports was 4.8% year-on-year while imports were down by a symbolic 0.3%. In the same period, in real terms discounting price increases, the gap between exports and imports of goods widened in favour of the former seeing that exports were up 5.1% year-on-year while imports rose by 3.6%. By sector, the most dynamic group of products in exports was made up of energy, foods, chemical products and industrial machinery. With regard to imports, while energy products showed a rise of 56.2%, the purchase of finished vehicles from abroad was down 18.7%.

Finally, the breakdown in trade by geographical area is following recent trends. In the January-July period, the European Union continued to be Spain's main trading partner seeing as it was the destination of 70.0% of all exports and origin of 55.1% of Spain's purchases abroad. Of special note was the 14.8% year-on-year growth in imports from Asia, which now amount to 18.0% of the total, with the notable continuing increase in bilateral trade volume with China. The effects of the weakness of the dollar are still being felt seeing that, while exports to the United States dropped by 0.7% year-on-year, imports rose by a notable 23.9%.

Non-energy deficit down while, in real terms, exports up more than imports.

Current account balance keeps worsening.

Balance of payments: less portfolio investment and more direct investment

Incomes balance leaves sharp growth behind but still maintains weight.

The current account balance recorded a deficit of 8.47 billion euros in June, 16.6% above the level for the same period last year. The increase in the current imbalance was due to a bigger deficit in the incomes balance overall, given that without this component there would have been a slight correction. The increase in the trade deficit, which had been losing level, was compensated by the sharp decrease in the negative balance for non-tourist services.

Net portfolio investment inflows practically nil but other investment takes their place.

Over a longer time frame, the trend in the cumulative figure for 12 months shows some moderation in recent trends. The current account deficit is maintaining the slowdown taking place in the existing process of worsening and in the 12 months ending in June it grew by 17.9% year-on-year, a rate that has been dropping because of the less vigorous increase in the incomes balance and the current transfers balance.

With regard to financial flows, the most notable development in recent months was the sharp drop in the balance of portfolio investment which is still continuing. Portfolio investment inflows in the past 12 months ending in June amounted to 3.82 billion euros, whereas in the same period last year the figure was 169.27 billion. This decrease is compensated by a net drop of 44.68 billion euros in net assets of the Bank of

BALANCE OF PAYMENTS

June 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	–46,731	12.7	–95,070	–10,470	12.4
Services					
Tourism	*11,954*	*3.2*	*28,186*	*735*	*2.7*
Other services	*–2,019*	*–36.2*	*–4,512*	*893*	*–16.5*
Total	9,935	18.1	23,674	1,629	7.4
Income	–15,710	15.6	–33,626	–7,135	26.9
Transfers	–6,110	40.2	–8,486	–1,250	17.3
Total	**–58,615**	**14.9**	**–113,508**	**–17,227**	**17.9**
Capital account	**3,662**	**112.8**	**6,457**	**503**	**8.5**
Financial balance					
Direct investment	12,939	–	–8,763	35,558	–80.2
Portfolio investment	–3,999	–	3,818	–165,450	–97.7
Other investment	31,090	–	62,169	69,335	–
Total	**40,029**	**–39.5**	**57,224**	**–60,557**	**–51.4**
Errors and omissions	3,959	54.8	5,146	3,385	192.1
Change in assets of Bank of Spain	10,965	–	44,680	73,896	–

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.

Spain as against an increase in assets of 29.22 billion euros in the same 12 months last year. Still more important was the increase in the account for other investment which went from a negative balance of 8.86 billion euros to a positive figure of 80.21 billion.

The heading «Other investment», mainly includes loans, deposits and repos of other resident sectors, general government and financial institutions. These amounts are gaining importance because of the change in the method of covering the liquidity needs of Spain's financial institutions. In turn, direct investment in the past 12 months ending in June showed a net balance of outflows down to 8.76 billion euros, less than a fifth of the figure at the end of the year. This improvement was almost entirely due to the increase in entries (foreign investment in Spain) which rose by 167.4% year-on-year in the same period.

Direct investment inflows recovering while investment abroad shows little change.

Public sector

Increasing deficit in central government accounts

Progressive slowdown in economic activity and tax measures to stimulate economy put central government accounts in worse state.

The progressive slowdown in economic activity and central government tax measures to stimulate the economy are resulting in a worsening of the deficit in government accounts. In the January-August period, central government revenues in Treasury terms (that is, according to actual flows being recorded) amounted to 122.89 billion euros before taking into account amounts ceded to autonomous communities and local governments under the current financial system. This amount represents a year-on-year drop of 10.2%.

Both direct and indirect taxes down 11% in first eight months of year.

The decrease in central government revenues up to August was mainly due to the unfavourable performance in tax collections which make up more than 90% of the total. In the first eight months of the year both direct and indirect taxes showed year-on-year decreases of 11.3%.

The main tax heading, that for personal income tax, brought in 45.70 billion euros in cumulative terms. This figure meant a drop of 0.5% compared with the same period last year. This decrease reflects the impact of the deduction of up to 200 euros in hold-backs as an advance payment on the 400 euro deduction allowed against tax payable,

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

August 2008

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**4,824**	**–65.2**	**81,588**	**–18.1**
Non-financial revenue adjusted (*)				
Personal income tax	45	150.0	45,698	–0.5
Corporate tax	10,986	–37.2	20,237	–29.6
VAT	–4,570	156.6	30,536	–15.8
Special taxes	1,823	0.0	13,011	0.0
Other	1,045	51.9	13,410	4.3
Total	**9,329**	**–48.8**	**122,892**	**–10.2**
Non-financial spending	**9,308**	**–6.6**	**96,625**	**4.5**
Treasury balance	**–4,484**	**–**	**–15,037**	**–**
Surplus (+) or deficit (–) (**)	***–4,673***	**–**	***–14,638***	**–**

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.

as well as early deduction for each birth or adoption, benefits which did not exist in the first half of 2007. Also having a negative effect were 19.0% of tax rebates made and the unfavourable trend in earnings on government property. Corporate tax collections were down 29.6% in a context of a drop in company profits and a reduced tax rate under fiscal reforms made in 2007.

The decrease in indirect taxes was due to the performance in the most important heading in this group, value added tax (VAT). This tax showed a drop of 15.8% due to the weakness in consumption and the collapse of the real estate market as well as the new system of fiscal consolidation for groups of companies and an increase in rebates. In turn, special taxes recorded a state of stagnation. On the other hand, other central government revenues were up by 4.3% thanks to the increased profits of the Bank of Spain.

With regard to central government non-financial spending, this amounted to 96.62 billion euros up to August, an increase of 4.5%. Spending for current operations rose by 5.1% to 86.18 billion euros while that for capital transactions was down by 0.1%.

Among current operations, total staff wages was up by 6.7%. The biggest increase in these headings was for financial spending which was up by 10.4% to 13.42 billion euros.

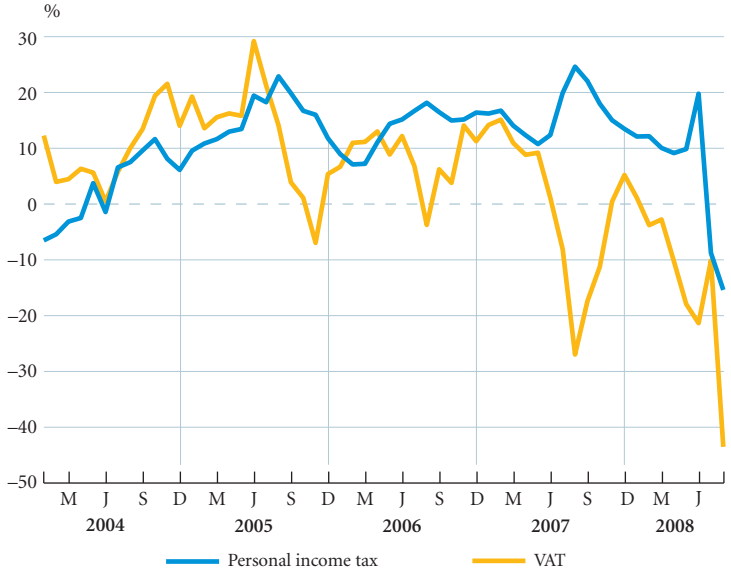
In capital transactions, real investment was up by 9.3%. On the other hand, capital transfers were down 11.2% because of lower transfers to autonomous bodies. In this regard, the Institute for the Restructuring of the Coal Mining Industry did not receive any transfer and the Council for Scientific Research received only 16 million euros as against 115 million euros last year.

Personal income tax collections stagnant...

...while weakness in consumption and collapse of real estate market cause 16% drop in VAT figures.

SHARP DROP IN TAX COLLECTIONS

Year-on-year change rate in moving average for four months



SOURCE: Ministry of Economy and Finance and own calculations.

Central government deficit goes up to 1.3% of GDP as of August.

In view of the drop in revenues and the rise in spending, the central government accounts showed a non-financial Treasury deficit of 15.04 billion euros. In terms of National Accounting, that is, taking into account all rights and obligations arising, the deficit came to 14.64 billion euros. The deficit represents 1.31% of gross national product (GDP), which is in contrast to the 1.12% surplus recorded in the same period in 2007, thus illustrating the turnaround that has taken place with the worsening of the economic situation.

On the other hand, in the January-August period, the accounts of Social Security showed a positive balance of 15.97 billion euros. This surplus came about as a result of an increase of 8.9% in recognized rights and growth of recognized obligations of 10.1%. Spending is thus growing more than revenues, largely due to the worsening of the labour market with a downward trend in the number of working contributors. All of this points to a reduction of the Social Security surplus in the near future.

Prospects government deficit will worsen.

In view of this situation, after having recorded a surplus in general government of 2.2% of GDP in 2007, future prospects have been growing worse. Given the downturn in the economic situation, in mid-September Minister of Economy Pedro Solbes indicated that the central government deficit could reach 2% of GDP in 2009.

Savings and financing

Credit granted to private sector slows down sharply

Funding granted to the private sector continued to ease in July to show a year-on-year change rate of 8.9%, less than half the rate one year earlier in a situation of tighter terms on the supply side and weakness in demand from households and companies. Recently, this slowdown has been very sharp. In the first seven months of 2008, total loans rose by 81.70 billion euros, less than half the increase in the same period in 2007, a trend that has sharpened in the most recent months.

The slowdown in funding granted to companies sharpened in July to 9.7% year-on-year. By sector, according to Bank of Spain figures up to June, the slowdown trend is widespread. Of note is the slowdown in credit granted to construction which went from year-on-year growth of 24.4% in June 2007 to 7.6% at the end of the first half of 2008. The drop in the growth rate in real estate activities was even greater with funding going from an increase of 41.8% to 11.0% in the past 12 months. Fresh credit to industry in the second quarter was down 60.0% compared with one year earlier. On the other hand, credit granted to services excluding real estate activities showed scarcely any drop in growth rate with a year-on-year change rate of 21.8% in June 2008.

The growth of credit granted to households also kept losing strength

Credit granted to services scarcely showig lower growth rate.

FURTHER SLOWDOWN IN FUNDING GRANTED TO COMPANIES

Year-on-year change in funding granted to non-financial companies

SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

July 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	82,952	–7,890	–8.7	–4,886	–5.6	4.5
Secured loans (*)	1,103,053	34,681	3.2	79,133	7.7	59.9
Other term loans	519,837	21,954	4.4	46,358	9.8	28.2
Demand loans	47,203	6,631	16.3	11,966	34.0	2.6
Leasing	48,030	1,736	3.8	3,205	7.1	2.6
Doubtful loans	40,840	24,589	151.3	27,594	208.3	2.2
TOTAL	**1,841,915**	**81,702**	**4.6**	**163,368**	**9.7**	**100.0**

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

with a year-on-year increase of 7.8% in July, less than half that one year earlier. Looking at somewhat more of a breakdown in figures up to June, we note a sharp drop in funding granted for home acquisition and renovation, showing year-on-year growth of 8.7%. In this case also the expectation of a drop in real estate prices has had an influence.

Figures for mortgages signed provided by the National Institute of Statistics

CREDIT TO PRIVATE SECTOR BY PURPOSE

Second quarter of 2008

	Balance (*)	Change this year		Change over 12 months	
	Million euros	Million euros	%	Million euros	%
Financing of production activities					
Agriculture, livestock raising and fishing	25,727	482	1.9	1,433	5.9
Industry	148,218	6,647	4.7	16,073	12.2
Construction	155,600	2,147	1.4	11,049	7.6
Services	661,762	38,945	6.3	93,579	16.5
Total	**991,307**	**48,221**	**5.1**	**122,134**	**14.1**
Financing to individuals					
Acquisition and renovation of own home	639,975	21,763	3.5	51,281	8.7
Acquisition of consumer durables	57,726	1,150	2.0	3,828	7.1
Other financing	119,101	4,639	4.1	6,967	6.2
Total	**816,802**	**27,552**	**3.5**	**62,076**	**8.2**
Financing to private non-profit institutions	**5,952**	**–136**	**–2.2**	**–2**	**0.0**
Other unclassified	**23,840**	**2,053**	**9.4**	**1,344**	**6.0**
TOTAL	**1,837,902**	**77,690**	**4.4**	**185,551**	**11.2**

NOTES: (*) By credit institutions as a whole: banking system, loan finance establishments and official credit.
SOURCE: Bank of Spain and own calculations.

confirm this trend. The number of homes under mortgage was down 37.7% in June compared with the same month the year before as against a year-on-year drop of 29.6% in the first half-year. Furthermore, in the same period the average loan amount granted was down 3.9%.

Number of mortgages down 38% in June compared with same month in 2007.

The loss of strength in credit for buying durable goods (motor vehicles, furniture, appliances, etc.) was less marked. In the second quarter this showed a year-on-year increase of 7.1%, some 2.5 points less than one year earlier.

On the other hand, the worsening economic situation has also brought about an increase in default. In the past 12 months up to July total doubtful loans has tripled although the figure started out at very low levels. The default rate has risen to 2.2%. In turn, the default rate for mortgage loans for acquisition of new homes stood at a lower level (1.3%) in June.

With regard to interest rates, the 12-month interbank rate was down a mere 7 basis points on monthly average in August after having marked up an all-time high in July. The possibility that the European Central Bank official rate may have now reached a ceiling at 4.25% following the increase in July had an effect on easing the 1-year Euribor rate. In any case, pressures in the international financial markets still continue in spite of the fact that it is now more than a year since the outbreak of the subprime mortgage crisis in the United States which does not go in favour of any easing of lending terms.

As a result, the average interest rate on loan transactions at credit institutions continued to increase in July going to 6.36%, thus marking up the highest level in recent years, in keeping with the trend in the Euro Area reference rate. Nevertheless, in the past 12 months ending in July the loan interest rate has risen by 73 basis points, close to a half percentage point more than the increase in the official rate in the same period. The explanation lies in the increase in risk premium incorporated in the interbank rate. In fact, the 1-year Euribor has risen by 83 basis points in the past 12 months ending in July.

Interest rate on loan transactions at credit institutions in July goes up to highest level in recent years.

Time deposits star of bank liabilities

The difficulties being faced by banks in getting funds in the wholesale market because of the crisis in international financial markets has revived interest in attracting deposits from the private sector. As a result, interest rates on bank deposits by companies and households has tended to rise in the past 12 months ending in July. The highest returns were reached in time deposits by individuals which stood at an average of 4.79% in July, nearly 1% above that for 12 months earlier.

As a result, the increased annual growth of total deposits was noted in time deposits for up to two years which showed an increase of 48.4% while deposits as a whole rose by 9.5%, practically the same as the month before. Recently, however, the change rate in deposits has dropped considerably (in July 2007 it was 22.0% year-on-year), thus reflecting the slowdown in economic activity. On-demand and savings accounts were down 3.7% as a result of low yield levels offered. The drop in foreign currency deposits was still greater at 8.6%, partly due to less attractive interest rate differentials with abroad.

Notable increase in yield on time deposits favours sharp rise in total.

The tough competition for bank deposits and the instability of international

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

July 2008

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	419,992	–18,065	–4.1	–15,944	–3.7	30.5
Up to 2 years	451,048	98,342	27.9	147,205	48.4	32.7
More than 2-year term	400,659	–1,315	–0.3	6,764	1.7	29.1
Repos	65,274	–20,318	–23.7	–14,778	–18.5	4.7
Total	**1,336,973**	**58,644**	**4.6**	**123,248**	**10.2**	**97.0**
Deposits in currencies other than euro	**41,646**	**–2,198**	**–5.0**	**–3,914**	**–8.6**	**3.0**
TOTAL	**1,378,619**	**56,446**	**4.3**	**119,335**	**9.5**	**100.0**

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

Net withdrawals from mutual funds continue in August although at reduced rate.

financial markets continued to have a negative effect on another product, namely mutual funds. As a result, the assets of these funds dropped by 24.6% in the 12 months ending in August to stand at 193.20 billion euros. The biggest decreases came about in international funds and share-based funds. The draining off through net withdrawals of participations continued in August although at a lower rate, namely 1.70 billion euros, as against a total of 37.97 billion euros in the first eight months of the year. The number of participations also kept dropping going to 6,992,867, a decrease of 21.2% in the past 12 months.

Average monthly yield on mutual funds was 0.3% which was not sufficient to bring the annual average back into the black. The highest annual yield showed up in money market funds (3.0%) followed by guaranteed bond-based funds. The biggest capital losses came in Japanese share-based funds at 24.2%. Nevertheless, over the past 17 years the average annual return on mutual funds as a whole was 4.3%.

In turn, the assets of hedge funds continued to grow. At the end of August these amounted to 1.34 billion euros as against 818 million at the end of 2007. This sharp growth rate may be partly explained by the fact that this product is still in the early stages of development in the Spanish market.

Life insurance shows strong in first half-year.

With regard to insurance, another instrument in the portfolio of savers, the total volume of direct insurance premiums was up by 6.1% in the first half-year compared with the same period last year. The strongest activity came in life insurance with an annual increase of 9.2%. In non-life insurance, health insurance and multi-risk insurance rose by more than 8% annual. On the other hand, car insurance premiums were stagnant in a situation of fierce competition.

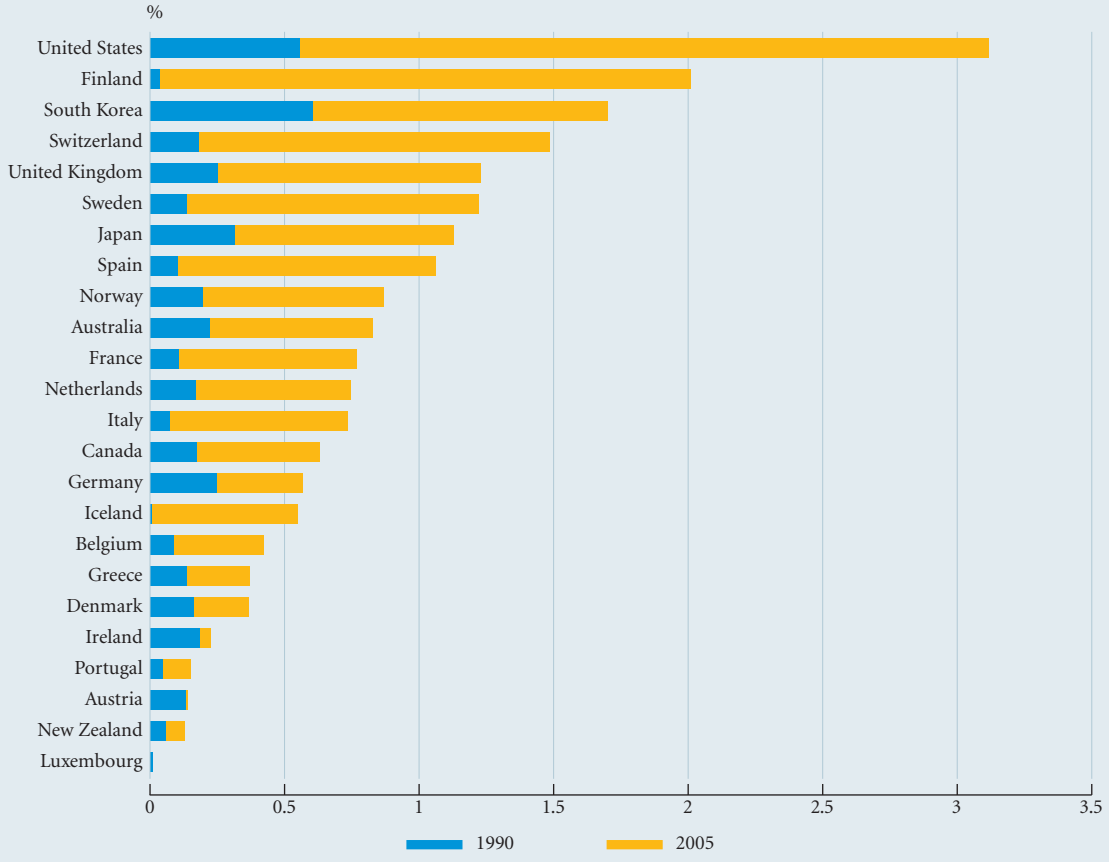
Relationship banking vs. the markets: a return to origins?

In recent weeks the subprime mortgage hurricane has reached category 5 level. Its causes are well known: the easing of credit standards, the bursting of the real estate bubble and the uncertainty about who is exposed to the losses. At a more fundamental level, many analysts agree in identifying the sharp growth of a non-traditional banking model as one of the reasons behind the biggest financial crisis in at least 75 years. This is a matter of the «originate-to-distribute» model, which has been making use of a number of financial innovations, such as securitization, in order to grant credit without worrying greatly about the credit quality. After all, the loans were sold to the market with the support of rating agencies and investment banks.

Until recently, there was a fairly clear distinction between market-based financial systems and those intermediated by traditional commercial banks. In a traditional system, the banks establish long-term relations with their customers, attracting deposits that are used to grant loans. This long-term relationship allows banks

INCREASING ORGANIZATION OF FINANCIAL SYSTEMS AROUND THE MARKET

Ratio of total transactions negotiated in financial markets over private credit granted by deposit-taking institutions



SOURCE: Thorsten Beck, Asli Demirgüç-Kunt and Ross Levine (2000), «A New Database on Financial Development and Structure», *World Bank Economic Review* 14, 597-605. Revision in August 2007.

to gather the information needed to evaluate the profitability of projects financed with loans and exercise the necessary control to ensure their being repaid. In a market-based system, the evaluation and control of these projects is carried out in a totally decentralized manner. Those seeking credit go to the market issuing bonds whose price is set according to the profitability that the investors attribute to the project, and consequently to the probability of repayment. The control over the projects is largely exercised by the shareholders. Each country has chosen to organize its own financial system to a greater or lesser extent based on one of these two methods (see Graph 1).

The «originate-to-distribute» model has contributed to blur the border between these two methods of organization. On the one hand, this is a banking model that creates «retail» credits. On the other hand, the institution granting these loans transfers them to the capital markets through securitization. When a bank turns part of its loan portfolio into bonds and then sells these in the financial markets it achieves two things: it obtains liquidity and shifts the loan risk. The economy may benefit from an expansion of the available credit and potentially from a wider distribution of risk among a larger number of holders and toward those who can bear it at a lower cost (pension funds, sovereign funds, etc.).[1] In practice, the problem has arisen from the lack of incentives this type of banking has had to ensure that the customer is solvent and thus to minimize the credit risk. The lack of transparency in the securitizations, which were packaged in a very complicated way through the famous CDOs (collaterized debt obligations), has also contributed to the problem. It has now been established that the market had placed excessive confidence in the quality control of bonds that could be exercised by the rating agencies and investment banks that placed them.

Nevertheless, the financial crisis has put in question the solidity of the «originate-to-distribute» business model. On the one hand, the institutions that originated these loans have found themselves with no buyers for their securitizations. Furthermore, not having a strong deposit base to finance themselves, the withdrawal of available wholesale funds has obliged them to sharply curtail their business activities. On the other hand, the increasing default in the portfolio of loans that they were unable to securitize has eaten up their scarce capital (scarce because it often concerned institutions that did not take deposits and therefore were not regulated as were other commercial banks). Last but not least, their reputation may have been hurt to the extent that they originated excessively risky loans, such as *subprime* mortgages.

Investment banking, in turn, is also suffering the consequences of the crisis and its business model is being questioned, at least partly. On the one hand, the assets of these banks contain bonds they wanted to package and sell. With the shut-down of the market for these products it is now not possible to sell them. On the other hand, their investment portfolio also contains subprime mortgage bonds. The liabilities side of these institutions does nothing but worsen the situation, since investment banks are very much leveraged and their financing depends greatly on short-term instruments for which the markets have dried up. As happened with Bear Stearns, this lack of liquidity has led to the disappearance of some of these banks. Those still surviving will have to maintain a very high capital level and will probably favour a downstream integration with commercial banks in order to gain access to financing through deposits. The merger of Merrill Lynch with Bank of America and the acquisition of commercial banking licences by Goldman Sachs and Morgan Stanley are an example of steps in this direction.

(1) In contrast to North American securitizations, most loan securitizations in Spain (95% since 2004) are held in the balance sheets of the financial entities that originate them, since they retain the lowest quality tranches.

The situation of the commercial banks (with the exception of those banks that have invested in subprime mortgage bonds) is relatively less dramatic, although they are also suffering over the short term from the increase in default rates and the reluctance of investors to take on any kind of securitization. Nevertheless, those institutions possessing a broad deposit base as a source of financing will be able to better overcome the liquidity crisis.

To sum up, the subprime mortgage crisis seems to have proved the vulnerability and risks of a banking model that is far removed from the traditional concept of commercial banking. Knowing the customer, offering him the best service and being able to count on his trust and savings over the long term return as core principles for the banking model at the dawn of the 21st century.

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THE SPANISH ECONOMY
MONTHLY REPORT
October 2008

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