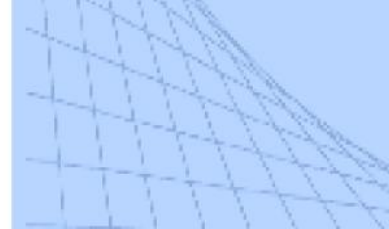


July 2008

**Review of  
OCEI  
Forecast**



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## 1. ESTADOS UNIDOS

### Review of Forecasts for 2008: Small Changes... Except in Prices

In the first half of 2008, the US economy has performed more or less as we forecast in January, but with one clear exception: both external and internal price trends, which have risen well above the level expected a few months ago in practically all countries around the world. Moreover, high prices are seen to be more persistent too.

In any case, despite the corrections to our forecast detailed below, we confirm our primary scenario of a very strong slowdown that could lead GDP to drop in one quarter but probably not two, and which will pave the way for a slow and not particularly energetic economic recovery.

Table 1: OCEI Revised Forecasts for 2008

| VARIABLE   | 2008<br>Forecast |
|--|------------------|
| ▲ GDP  | 1.4%             |
| ▲ Private Consumption                              | 1.3%             |
| ▲ Non Residential Investment                       | 2.0%             |
| ▲ Residential Investment                           | -18.0%           |
| ▲ Federal Govt. Spending                           | 5.0%             |
| ▲ State and Local Govt. Spending                   | 1.0%             |
| Inventories (contribution to ▲)                    | 0.0%             |
| Net Exports (contribution to ▲)                    | 0.6%             |
| Oil (barrel of WTI; annual average)                | 120\$            |
| Natural Gas<br>(million BTU; annual average)       | 10.5\$           |
| Unemployment Rate (annual average)                 | 5.4%             |
| Reference Interest Rate (end of year)              | 2.5%             |
| Inflation Rate (annual average)                    | 4.4%             |
| Core Inflation Rate (annual average)               | 2.6%             |
| \$/€ Exchange Rate<br>(annual average/end of year) | 1.53 / 1.49      |
| Federal Govt. Budget Balance<br>(% GDP)            | -4.0%            |
| State and Local Govt. Budget Balances (% GDP)      | -1.5%            |

|   |       |
|---|-------|
| Current Account Balance<br>(% GDP)      | -4.5% |
| ▲ Productivity (annual average)         | 1.75% |
| ▲ Profits after Tax (annual average)    | -5.0% |
| ▲ Unit Labour Costs<br>(annual average) | 1.5%  |

Source: own elaboration

1) As always, the first point of our top ten forecasts refers to **energy prices**, but on this occasion the importance of this indicator is also the priority. Particularly oil prices are not only putting production costs under pressure and, therefore, global inflation in the United States and the rest of the world, but are also forcing an abrupt change in the tone of monetary policy and a sharp fall in confidence.

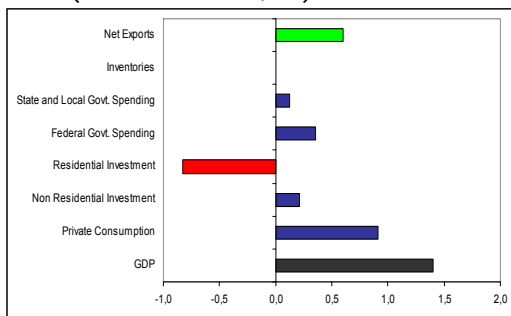
Our forecast for oil to reach 82 dollars a barrel on average over this period was destroyed by reality (111 dollars on average over the first half of the year). We maintain our idea that the upturn in prices could stop once financial markets get back to normal – and some of the dealers who have disembarked onto the oil market return. We also believe that the economic slowdown in the West and the reduction of consumption subsidies in emerging and developing nations (which should reduce these countries' demand) will help to curb further price rises. Notwithstanding, we now forecast the annual average cost of a barrel of oil to reach 120 dollars, with a clear possibility of rising further.

A relatively similar situation and analysis, bearing in mind that natural gas is an alternative hydrocarbon and the relationship between oil and gas contracts, lead us to raise our forecast for natural gas prices from \$6.30 to \$10.50 per million BTU, after averaging \$9 in the first half of the year.

2) As regards **economic activity**, when this report was written the only final data available referred to the first quarter, together with some preliminary estimates for the second quarter. As a whole, data are better than anticipated. However, the outlook for the second half of the year has deteriorated (confidence, energy prices, labour market...) forcing us to lower our forecast for **GDP** growth slightly from 1.6% to 1.4%.

As far as the breakdown of GDP growth is concerned (see Figure 12 for the contributions made by each demand component to reach the 1.4% growth rate forecast above), we also expect growth in **private consumption** to drop by two decimal points (1.5% to 1.3%), with a different trend to that indicated in January. Private consumption performed more favourably than expected in the first half of the year, but is expected to be extremely weak in the second half, particularly towards the end of the year when the tax cuts end, monetary policy is tougher and energy and food prices failing to drop as we had expected.

Figure 1: Contributions to GDP Growth in 2008 (OCEI Forecasts; %)



Source: own elaboration

In relation to the rest of items, only **Federal Government spending** (which we have raised from 3% to 5%, following a 4.5% rise in the first quarter) undergoes a significant

change. Despite the Bush administration being reluctant, the main tax stimulus already in progress could be joined by further aid if the recovery does not consolidate and monetary policy becomes unable to maintain such accommodating conditions.

We maintain our forecast for timid growth in **non residential investment** (2%), which will not be able to sustain the strength displayed in the first quarter due to consumption declining and **State and Local Government expenditure**, legally obliged to present a balanced Budget preventing further anti-cyclical measures from being taken.

As a result of the dollar growing weaker still and above all the slowdown in domestic demand, we have raised our forecast for the contribution of **net exports** to GDP growth (from four to six decimal points for the year as a whole). We also maintain our forecast that **inventories** will have no impact (in annual terms, apart from the marked quarterly fluctuations that are occasionally recorded).

We have once again increased the percentage that we expect **residential investment** to detract from GDP to eight decimal points and forecast this variable to record an 18% decrease in 2008. Despite this, the OCEI remains among the least pessimistic experts where this item is concerned.

3) In the labour market, we expect the average **unemployment rate** to increase from 5% to 5.4% (after the 5.1% average recorded in the first quarter). For the year as a whole, net jobs will be lost but at a moderate rate in line with a sharp slowdown, but not a recession. The truth is that jobs are being lost (in manufacturing and

construction), but the number of hours worked remain unchanged. In contrast, wage restrictions should help prevent the rate at which jobs are lost from increasing.

4) Not much else can be said with respect to **monetary policy**. The Fed lowered interest rates excessively (in our opinion), albeit in line with our forecast in January<sup>1</sup>. Even then we were practically the only ones to assert that the Federal Reserve would (and should) raise the Fed Funds Rate before the end of the year. This stance is now shared by almost all analysts and of course by markets as well, which are now adjusting for rises of 75 basis points.

We at the OCEI expect a smaller rise in 2008, to around 2.5%, while observing developments in the real estate and financial markets and always under pressure from energy prices and the worsening of agents' inflation outlook. Two 25bp rises on behalf of the Fed after summer would begin to normalize interest rates, a process that will nevertheless be gradual, as in the case of the recovery.

What we do expect, when growth rises to near potential, is for interest rates to rise to a neutral level hastily and for the hindrance of monetary policy that has been behind inflation trends for years to disappear once and for all.

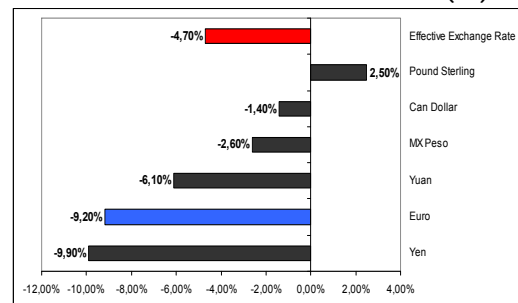
5) The update of our forecast for **inflation**, in light of developments over the last few months, can be nothing but

<sup>1</sup> More than a few analysts at the time anticipated decreases to between 1% and 1.25%. In our opinion this was complete madness, but more because it would have entirely irresponsible on behalf of the Fed had they taken that decision than for being impossible.

drastic. We have upwardly revised our forecast for the annual average from 2.7% to 4.4%, following an average of 4.1% during the first half of the year. The response by the book on behalf of workers and companies, accepting the increase in international prices and barely passing it on to wages and domestic prices, together with the change in the message transmitted by the Federal Reserve, lead us to believe that the increase in core inflation will be much more moderate than in the case of headline inflation (we raise our forecast from 2.2% to 2.6%).

6) Unsettled doubts in the short term regarding the US economy, relative strength of the largest countries in the Euro area (France and, above all, Germany) and the much more categorical policy implemented by the ECB with respect to the Fed when it came to confronting the risk of inflation – which led to an interest rate gap that has widened over the first half of the year, has seen the **value of the dollar** sink further with respect to the Euro, more specifically, by 9.2% over the first half of the year (Figure 2).

Figure 2: Dollar Exchange Rate against Selected Currencies: 1<sup>st</sup> half of 2008 (%)



Note: a negative sign implies the dollar has depreciated

Source: own elaboration with data from FRED II

The US economy cannot be expected to improve a great deal, but the Euro-zone could grow less and the interest rates

in the two regions could converge if the Fed raises its reference rate and the ECB maintains the minimum bid rate (after the 25bp rise agreed at its meeting on July 3). For this reason, we continue to forecast the dollar to recover moderately, albeit starting out from a lower level. We have raised our forecast for the average dollar-euro exchange rate in 2008 from 1.43 to 1.53 (from 1.37 to 1.49 at the end of the year).

As regards the rest of currencies, while China allowed the appreciation of the Yuan to accelerate slightly (although this leeway will be reduced in the second half of the year), the relatively favourable prospects in Japan and the extremely weak initial value of its currency have made the Yen appreciate the most against the dollar of the main currencies in the first half of the year (see Figure 2). However, it does not seem likely that Japan will be able to sustain growth capable of forcing this trend to continue.

The pound sterling, subject to factors that are the exact opposite to the case of the Yen (overvalued and a poor economic outlook for Great Britain) is the only large currency that has lost ground with respect to the green back and this trend will foreseeably continue throughout the second half of 2008.

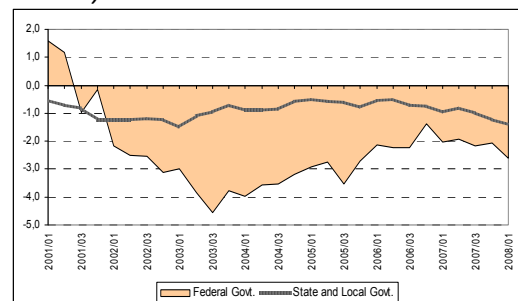
Finally, US neighbours, with growth at risk of going down with the flu as a result of the economic slowdown the superpower is suffering, have only seen their currencies appreciate slightly, a situation that could well be inverted before the year is out, particularly if their Central Banks make further cuts in interest rates, as the Bank of Canada has been doing.

7) We continue believe that the US **current account** will continue to recover steadily, although the average deficit for 2008 of 4.5% we had forecast (5% in the first quarter), which we thought was conservative at the beginning of the year may be the best result possible, despite the decrease in domestic demand due to the hefty energy bill. All in all, we maintain that 4.5% forecast as a reference.

8) We have raised our forecast for the **Federal Government deficit** by half a point to 4% for 2008 (January – December), as a result of an increase in spending (despite the Government rejecting this under pressure for not achieving its objectives in this area) and a decrease in income.

**Lower levels of government**, in light of the fact that many are required to present balanced accounts, the deficit should not rise higher than 1.5% as we forecast in January. But with less taxes being collected, we are talking about an unavoidable effort to cut costs and, therefore, about pro-cyclical policy that is highly unsuited to the current situation.

Figure 3: Government Budget Balances (% of GDP)



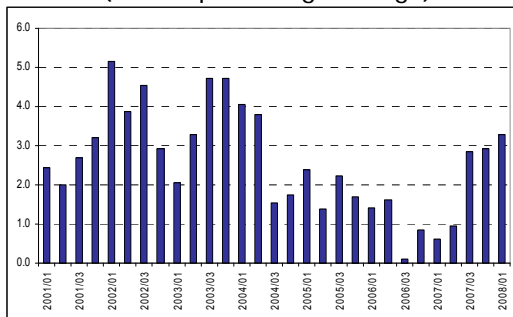
Source: own elaboration with data from BEA

Of course, such budget restrictions are the result of irresponsible management during times of bonanza when the deficit was never eliminated, a practice that we have denounced on repeated

occasions in these reports (see Figure 3).

9) Perhaps the nicest surprise in the first few months of 2008 was the recovery observed in **productivity** growth (Figure 4). Although we do not believe the close to 3% growth rate recorded over the last three quarters can be sustained (unless there is a marked increase in job losses), it appears that, following a period in which the progress made between 2002 and 2004 was digested, the growth rate of this variable is back on track. As a result, we forecast productivity for 2008 as a whole to increase by 1.75%.

Figure 4: Non Farm Productivity per Hour Worked (annual percentage change)



Source: own elaboration with data from FRED II

The trend observed in productivity and the remarkable moderation of wages lead is to cut our forecast for growth in **unit labour costs** markedly (from 2.5% to 1.5%).

As regards **corporate profits**, the decrease has occurred even more quickly than we had anticipated, despite the weakness of the dollar implying that results obtained in other currencies contributed extra dollars to the profits of large US companies.

After already falling by more than 3% in the first quarter, we forecast an overall slide of 5% for 2008 as a whole, instead of the flat growth rate we anticipated in January.

10) **What's in store for 2009?** We reiterate what was written in January: next year will witness weak growth as part of a much slower and less dynamic recovery than normal in the United States, due to a combination of factors: the negative impact of international energy, industrial raw material and food prices, the unavoidable increase in interest rates on behalf of the Fed before the recovery consolidates, a payback for the tax cuts – and consumption they have entailed – and internal deficits that remain to be corrected, particularly where savings are concerned.

In fact, awaiting the proposals of the new Government to be elected in November, the situation will be so precarious that if price or financial tensions are prolonged only slightly, the recession we clearly rejected in 2007 (correctly) and considered unlikely in 2008 (apparently correct to date) could occur in 2009<sup>2</sup>.

Therefore, dark grey skies for next year... with a risk of getting even darker.

**Vicente J. Pallardó**  
OCEI Director

Valencia, 8 July 2008

<sup>2</sup> As always, when referring to a potential recession, normal criterion aside (two consecutive quarters of negative GDP growth), in the United States it is the National Bureau of Economic Research that decides, some time later and taking into account a series of variables, whether there has been a recession, when it began and how long it lasted.

## 2.- EURO-ZONE

The worldwide economic panorama has become a lot gloomier due to the increasingly negative and long-lasting effects of the international financial crisis, soaring raw material prices (both food and energy) thanks to speculators, the lack of regulation in financial markets and the gloomy situation in certain countries such as the United States, the United Kingdom, Japan as well as the Euro-zone itself. In contrast, both Latin American and also emerging Asian nations continue to grow strongly. As a result, world growth will moderate in relation to last year and could stand around 4%, thus curbing growth in international trade.

The forecasts for GDP growth in the Euro-zone have been downwardly revised. While analysts agreed at the beginning of the year that GDP would grow by around 1.8% in 2008, they now forecast 1.7% with a fluctuation margin of between 1.3% and 2.4%. Official institutions and private sector analysts coincide in forecasting a growth rate of 1.7%, except for the IMF, which has cut its forecast to 1.4%.

Table 2.1: GDP Forecasts for 2008

|              | January | July |
|--------------|---------|------|
| ABN          | 2,4     | 1,7  |
| BANESTO      | 1,8     | 1,8  |
| UNICREDIT    | 1,5     | 1,6  |
| JP MORGAN    | 1,9     | 1,7  |
| NATIXIS      | 1,7     | 1,6  |
| BARCLAYS     | 2,2     | 2,7  |
| BNP          | 1,3     | 1,7  |
| CITIBANK     | 1,9     | 1,6  |
| LEHMAN       | 1,5     | 1,7  |
| REUTERS CONS | 1,8     | 1,7  |
| IMF          | 1,5     | 1,4  |
| OECD         | 1,9     | 1,7  |
| EC           | 2,2     | 1,7  |

Source: own elaboration

As regards inflation, all institutions have raised their forecasts significantly. On average, they forecast inflation to stand at 3.3%, with predictions ranging from 3.8% to 2.7%. The average forecast in January stood at 2.1%.

In the case of the ECB minimum bid rate, institutions have also raised their forecasts, particularly following the latest rise and the comments made by Trichet. At the beginning of the year, financial institutions forecast a decrease of 25bp in interest rates, due to the outlook for a slowdown in the Euro-zone economy in relation to last year. At present, institutions are more inclined for interest rates to remain at 4.25%, although some analysts forecast a second 25bp rise before the end of the year. Financial markets themselves are discounting interest rates of 4.5% for the end of the year.

As regards long term interest rates, current rates are expected to be raised again. While the 10-year Bund currently stands at 4.37%, forecasts average 4.55%.

Table 2.2: CPI Estimates for 2008

|              | January | July |
|--------------|---------|------|
| ABN          | 2,4     | 2,7  |
| BANESTO      | 2,1     | 3,2  |
| UNICREDIT    | 2,5     | 3,5  |
| NATIXIS      | 2       | 3,5  |
| BARCLAYS     | 2,1     | 3,7  |
| BNP          | 1,8     | 3,6  |
| CITIBANK     | 1,9     | 3    |
| LEHMAN       | 2,1     | 3,5  |
| REUTERS CONS | 2,1     | 3,3  |

Source: own elaboration

Table 2.3: Estimates for the End-of-Year ECB Minimum Bid Rate

|           | January | Latest Available |
|-----------|---------|------------------|
| BANESTO   | 3,5     | 4,5              |
| UNICREDIT | 3,5     | 4,25             |
| SCH       | 3,5     | 4,25             |
| BAYERN    | 4       | 3,5              |
| BNP       | 3,5     | 4,25             |
| SG        | 4       | 3,75             |
| BARCLAYS  | 3,5     | 4                |
| CALYON    | 4       | 4,5              |
| NATIXIS   | 3,5     | 4,5              |
| BBVA      | 3,5     | 4                |

Source: own elaboration

As far as the euro/dollar exchange rate is concerned, current forecasts augur the euro to depreciate slightly against the dollar from the current spot rate of 1.59 to around 1.50.

Table 2.4: 2008 Forecast for 10-year Bund

|           | January | Latest Available |
|-----------|---------|------------------|
| BANESTO   | 4,3     | 4,93             |
| UNICREDIT | 3,6     | 4,25             |
| SCH       | 4,6     | 4,6              |
| BNP       | 4,6     | 4,63             |
| BARCLAYS  | 3,8     | 4,57             |
| NATIXIS   | 4       | 4,35             |

Source: own elaboration

### Review of OCEI Forecasts for 2008

OCEI forecasts made at the beginning of the year in reference to GDP growth and interest rates were more optimistic than the market average. In line with the rest of institutions, the OCEI has lowered its forecasts. The forecast for GDP growth is lowered from between 2.1% to 2.3% to between 1.8% and 2%.

Fixed investment will continue to grow strongly at a rate ranging from 3.3% to 3.6%, despite weak confidence indicators, on the back of increasing corporate profits, growth in loans and the need to increase productive capacity. Employment will rise by between 1.4% and 1.5%.

Private consumption is forecast to increase by between 1% and 1.2%. Weak consumer confidence indicators and negative real wage growth, despite an increase in net Jobs of between 1.35% and 1.5%, justify this forecast. Government spending will increase by 1.4%.

Exports will grow by between 4.5% and 6.5%, taking into account an increase in international trade of around 6%-7%. Imports will depend on domestic demand, but are forecast to rise by between 4.4% and 6%.

The average unemployment rate for 2008, bearing in mind the forecast for net job creation, could stand between 7.2% and 7.3%.

The average inflation rate for 2008 as a whole will stand between 3.3% and 3.5%, well above initial forecasts and previous years.

As far as interest rates are concerned, if we take economic growth, the labour market, the outlook for inflation and current interest rates, the ECB will continue to raise the minimum bid rate this year. Interest rates are expected to reach between 4.5% and 4.7%, that is an increase of between 50 and 75 basis points since the beginning of the year. As regards long term rates, the 10-year Bund will stand towards the end of the year at between 4.60% and 4.80%.

Finally, in reference to the Euro/Dollar exchange rate, our forecast is for an end-of-year rate of between 1.40 and 1.50.

Table 2.5: Summary of OCEI Forecasts for the Euro-zone in 2008

|                     | January | July     |
|---------------------|---------|----------|
| GDP                 | 2.1-2.3 | 1.8-2    |
| Private Consumption | 1.2-1.3 | 1-1.2    |
| Govt. Spending      | 1.8-2   | 1.4      |
| Fixed Investment    | 3.4-4   | 3.3-3.6  |
| Exports             | 7.5-6.5 | 4.5-6.5  |
| Imports             | 6.-7    | 4.4-6    |
| Employment          | 1.4-1.5 | 1.35-1.5 |
| Inflation           | 2.4-2.5 | 3.3-3.5  |
| Unemployment        | 7-7.1   | 7.2-7.3  |
| Labour Productivity | 0.6-0.9 | 0.6-0.9  |
| ECB Rates           | 4       | 4.5-4.75 |
| 10-year Bund        | 4.1-4.3 | 4.6-4.8  |
| Euro/Dollar         | 1.30    | 1.4-1.5  |

Valencia, 13 July 2008

Nicolás Jannone

### 3.-SPAIN

This section of the report will address the review of the macroeconomic forecasts for 2008 that we made in January. Since then, the overall situation has deteriorated to such an extent, particularly in Spain (along with other countries that had also enjoyed a real estate boom over the last few years, such as the US, the UK and Ireland). The combination of financial turmoil since summer last year, inflationary tensions caused by the upturn in oil and raw material prices and the slump in the US economy have slowed down worldwide economic growth and made the outlook for future economic growth much more uncertain. As a result, the main institutions and agencies have downwardly revised their forecasts for world economic growth. In this scenario, we will clearly lower our January forecasts for 2008 (see January report at [www.ocei.es](http://www.ocei.es)), which already anticipated a marked slowdown in economic activity.

The Spanish economy, which has recorded robust growth over recent years on the back of strong domestic demand, is currently suffering an abrupt slowdown. Over the last few months, activity has slowed remarkably due to weak private consumption and the slump in real estate. As discussed in more detail in the section devoted to the current economic climate in this report, the intrinsic characteristics of the Spanish economy have accentuated the negative impact of the international shocks mentioned above, resulting in a considerably worse economic situation than in the countries in Spain's immediate vicinity. Table 1 below displays the downward review of growth forecasts made by the main

international institutions and the government itself, and which range from 0.8 to 1.1 percentage points.

Table 1: Macroeconomic Forecasts (real growth rates, unless indicated otherwise)

|                         | [1]   |       | [2]   |       | [3]   |       | [4]   |       |
|-------------------------|-------|-------|-------|-------|-------|-------|-------|-------|
|                         | [1.a] | [1.b] | [2.a] | [2.b] | [3.a] | [3.b] | [4.a] | [4.b] |
| <b>GDP</b>              | 3.1   | 2.3   | 3.0   | 2.2   | 2.5   | 1.6   | 2.7   | 1.8   |
| Private Consumption     | 2.8   | 2.2   | 2.7   | 2.2   | 2.7   | 1.2   | 2.2   | 2.0   |
| Government Spending     | 5.2   | 4.8   | 5.0   | 5.0   | 4.1   | 5.1   | 4.4   | 5.7   |
| Fixed Investment        | 3.1   | 1.5   | 3.0   | 1.4   | 1.2   | 0.0   | 3.0   | -1.1  |
| <b>Domestic Demand*</b> | 3.5   | 2.6   | 3.4   | 2.6   | 2.7   | 1.6   | 3.0   | 1.7   |
| Exports of G&S          | 5.4   | 4.0   | 4.7   | 4.0   | 6.5   | 4.3   | 4.0   | 3.9   |
| Imports of G&S          | 5.5   | 4.1   | 5.2   | 4.5   | 5.6   | 3.6   | 4.0   | 3.0   |
| <b>Foreign Demand*</b>  | -0.4  | -0.3  | -0.5  | -0.4  | -0.2  | 0.0   | -0.3  | 0.0   |
| Unemployment Rate       | 8.2   | 9.8   | 8.5   | 9.3   | 8.1   | 9.7   | 8.2   | 9.5   |
| Inflation [HICP]        |       |       | 2.9   | 3.8   | 3.6   | 4.6   | 2.8   | 4.0   |
| GDP Deflator            | 3.4   | 3.1   | 3.1   | 2.6   | 3.3   | 3.2   |       |       |
| Public Deficit (% GDP)  | 1.2   |       | 1.2   | 0.6   | 1.5   | 0.7   | 0.8   | 0.5   |
| Current Account Balance | -8.9  | -9.6  | -9.1  | -10.6 | -10.0 | -10.1 | -10.2 | -10.5 |
| (% GDP)**               |       |       |       |       |       |       |       |       |

\* Contribution to growth

\*\* Borrowing capacity/requirement (% GDP) in [1] and [2]

[1] Ministry of Economic and Financial Affairs  
[1,a] December 2007

[1,b] Review of Forecasts, April 2008

[2] European Commission, *European Economy*.  
[2,a] November 2007

[2,b] May 2008

[3] OECD *Economic Outlook*.

[3,a] N°. 82, November 2007

[3,b] N°. 83, June 2008

[4] IMF, *World Economic Outlook*

[4,a] September 2007

[4,b] April 2008

### Worldwide Economic Scenario and the Spanish Economy

World aggregate production has been extraordinarily dynamic, recording growth rates in excess of 5% uninterruptedly over the last four years, mainly due to the strong growth in emerging economies. Since summer 2007, when the financial turmoil and inflationary tensions began, the economic outlook has become gloomier in a scenario of mounting uncertainty.

The main causes of this situation include the following: in the first place, doubts over how capable developed economies are of recovering, particularly where the United States is concerned. In the second place, doubts over whether or not emerging economies will be able to resist a slowdown in developed nations. In the third place, doubts over the evolution of the euro-dollar exchange rate. In the fourth place, doubts over the outcome of international financial tensions that have led to a credit crunch, particularly affecting Spain as a whole, due to how dependent the country is on foreign savings, as well as Spanish households and companies as a result of the access to credit becoming more difficult and expensive. In the fifth place, the upward trend in the price of raw materials, mainly energy, and food. Towards the end of the section on the current economic climate in this report, "Global Shocks, Economic Adjustment and the Role of Economic Policy (and Public Accounts)" we discussed the specific and far reaching effects of this global macroeconomic situation on the Spanish economy.

In the current context of financial turmoil, inflationary tensions and the risk of a severe slowdown in some economies, a dilemma that has not been an issue in recent years must now be faced: governments must decide between implementing expansive policy to boost activity and curb the slowdown or restrictive policy (particularly monetary policy) in order to curb inflation and anchor agents' expectations regarding the trend in prices.

As regards monetary policy, it is worth recalling that interest rates decisions are not based on the situation in Spain,

but adapted to the weighted average of the Euro-zone. As a result, the period during which interest rates were low (and even negative in real terms) that began in 2000 contributed to the boom in the real estate sector (and to consumption expenditure in general) and the upturn in housing prices, also resulting in strong overall growth that saw resources being reallocated from investment in other productive activities (industry and services) to residential investment. In contrast, currently tighter monetary policy together with global shocks are increasing the magnitude of the slowdown in a situation where economic policy options in the Euro-zone are minimal. The increase in interest rates may further dampen demand and accentuate the slump in construction.

### **World Growth, Oil Prices and \$/€ Exchange Rate**

Our reference global scenario assumes activity will slow down substantially in countries where the real estate sector has boomed in recent years, particularly the United States, Ireland and the United Kingdom, while the situation will remain somewhat dynamic in the main European economies, mainly in Germany. Likewise, we do not expect the slowdown to be significant in emerging economies.

Moving on, there has been a significant upturn in the price of crude oil (and other agricultural raw materials) over the last few months. In the case of oil, causes for this trend include an increase in demand from emerging nations, which generally use energy products inefficiently, together with aspects related to supply due to the low capacity for production and refining surpluses. Similarly, both the financial crisis and also the uncertainty regarding

future supply have led to part of excess international liquidity being invested in safe assets, including oil. Notwithstanding, speculation does not appear to have played a particularly significant role in the upturn in prices, although academics are still at odds over just how influential this aspect has been. As a result of the above, the average price of a barrel of Brent between January and June 2008 reached \$109.40. For the year as a whole, we forecast the barrel of Brent to average around \$100 (see Table 2) bearing in mind that the slowdown in world activity, particularly in the United States and also in China in the aftermath of the Olympic Games and the increase in output in some oil producing countries could see oil prices moderate towards the end of the year.

In reference to the euro-dollar exchange rate, we expect the euro to remain strong against the greenback due to the large difference in interest rates between the two regions, along with the fact that the US is suffering a sharper slowdown than Europe in 2008. We therefore raise our January forecast of 1.40 dollars to the euro on average to 1.55, similar to the average of 1.53 dollars to the euro over the period dating from January to June 2008.

### Macroeconomic Forecasts for the Spanish Economy

#### Far-reaching Slowdown

This section revises all our forecasts as the “main negative risks” to the base macroeconomic scenario we outlined in January ([www.ocei.es](http://www.ocei.es)) have been fully confirmed. In the first place, gaining access to credit has become more difficult, which is negatively affecting households (consumption and residential investment) and

accentuating the extent of the slump in real estate, a situation which, in the words we used in January “could even cause a mini-recession”. In the second place, we highlighted the risk of inflationary tensions becoming considerably more pronounced, with the addition effect this has on household expenditure and employment. In the third place, we also mentioned the possibility of the slump in the real estate sector getting worse.

Our macroeconomic forecasts for Spain in 2008 are now as follows:<sup>3</sup>

1) The forecast we made in January for **economic growth** implied a substantial slowdown (of 1.2 percentage points) in real GDP to 2.6%. However, the situation has been considerably worse over the first half of 2008. As a result, we have lowered our forecast for growth to 1.6% with a slump in the second and third quarters of the year and a slight recovery towards the end of 2008. As a result of this temporary trend, annual GDP growth will drop below 1% in the fourth quarter.

We lowered our forecast because the aspects that are behind the current slowdown will continue to deteriorate in the short term: weak household spending (consumption and residential investment) and a slump in the real estate sector (which will drag down the economy as a whole). Both domestic demand items have been negatively affected by the financial turmoil. Furthermore, inflationary tensions are eroding purchasing power, filtering into the productive system further curbing job creation and have also led the

<sup>3</sup> See Table 2, which includes the recent trends in the main macroeconomic variables and our forecasts for 2008.

European Central Bank to raise interest rates.

However, our main scenario assumes the economy will not go into recession as discretionary tax stimulus will boost household spending and investment in infrastructures, along with dynamic services and exports..

2) **Breakdown of growth:** the marked slump Spain is experiencing is the result of a decrease in the rate of growth in domestic demand, particularly private consumption and residential investment. Reality has well and truly surpassed our forecast for debilitation as mentioned previously in this report. Moreover, the collapse of the real estate sector has further accentuated this downturn. For this reason, parallel to the decrease in our forecast for GDP growth, we will also lower our forecasts for the contribution on behalf of domestic demand and foreign trade. More specifically, we believe domestic demand will contribute around 1.8 percentage points to growth and foreign trade between -0.1 and -0.2pp, due to a slowdown in imports triggered by weak household spending and also to the fact that exports are expected to slow down less as the slowdown in growth in European countries is not as pronounced as in Spain.

3) **Private consumption and government spending** will display opposing trends, the former slowing down considerably, while the latter will be remarkably strong.

Private consumption is suffering a marked slump in growth, greater than anticipated in January, as a result of lower growth in real disposable income and household real and financial wealth

and a downturn in confidence due to the following factors.

In the first place, the marked deterioration of the labour market over the last few months, with employment growth dropping, along with a decrease in the number of people liable to social security payments and an increase in unemployment. In the second place, it is more difficult to obtain credit, while the increase in cost along with the increase in the EURIBOR have raised the financial burden of those households deep in debt. The increase in the ECB minimum bid rate further accentuates this trend. In the third place, the slowdown in the rate at which real wealth (due to slower growth in housing prices) and financial wealth (due to decreases in stock market listings) also undermines household spending. In the fourth place, The marked increase in inflation reduces household purchasing power and shrouds future income in uncertainty.

As a result of the scenario described above, we forecast private consumption to grow by 1.8% (compared to the 2.5% estimate made in January).

On the other hand, we expect **public sector final consumption** to remain strong as a result of the effort being made by the government and other government bodies to curb the slump in economic activity. We therefore believe government spending may rise by around 5.5%.

4) **Investment**, as is the case with the rest of items within domestic demand, will register a substantial decline in growth with respect to previous years (see Table 2), particularly investment in construction (of houses). We forecast investment to growth by around 0.9%

(a marked downward review with respect to our January forecast), as a result of negative growth in investment in construction and a substantial downturn in activity where investment in equipment is concerned.

As regards investment in construction, the downturn in household spending determinants has drastically cut the demand for housing in a situation of excess supply. As a result, the abrupt fall in real estate has depressed confidence and lowered the rate at which real estate assets revalue, as well as making the situation in the labour market even worse. Moreover, the financial turmoil has made credit more difficult to obtain for a sector that is particularly dependent on borrowing. As a result of the above, real estate investment will fall this year.

Table 2: Recent Trend and OCEI Forecasts (Real growth rates, unless indicated otherwise)

|  | 2006 | 2007 | 2008*       |         | Forecasts 2008** |       |
|--|------|------|-------------|---------|------------------|-------|
|  |      |      | 2008 Period |         | Jan.             | Jul.  |
| (Real) GDP                               | 3.9  | 3.8  | 2.7         | Q1      | 2.6              | 1.6   |
| Private Consumption                      | 3.8  | 3.2  | 1.8         | Q1      | 2.5              | 1.0   |
| Govt. Spending                           | 4.8  | 5.1  | 4.7         | -       | 5.3              | 5.5   |
| Fixed Investment                         | 6.8  | 5.9  | 3.2         | -       | 3.0              | 0.9   |
| <u>Domestic Demand*</u>                  | 5.1  | 4.6  | 3.0         | -       | 2.9              | 1.8   |
| <u>Foreign Demand*</u>                   | -1.2 | -0.8 | -0.3        | -       | -0.3             | -0.2  |
| * Contribution to growth                 |      |      |             |         |                  |       |
| Employment (QNA)                         | 3.2  | 3.0  | 1.7         | -       | 1.6              | 0.5   |
| Unemployment Rate                        | 8.5  | 8.3  | 9.6         | Q1      | 8.6              | 10.4  |
| Labour Productivity                      | 0.7  | 0.8  | 1.0         | Q1      | 1.0              | 1.1   |
| Inflation [CPI]                          | 3.5  | 2.8  | 4.4         | Jan-May | 3.2              | 4.1   |
| Borrowing capacity / requirements (%GDP) | -7.8 | -9.5 | -11.3       | Q1      | -8.5             | -10.2 |
| US\$/€ Exchange Rate                     | 1.26 | 1.37 | 1.53        | Jan-Jun | 1.4              | 1.55  |
| Interest Rates                           | 3.50 | 4.0  | 4.25        | Jul     | 4.0              | 4.25  |
| Brent Oil Price/Barrel (\$)              | 65.2 | 72.5 | 109.4       | Jan-Jun | 75               | 100   |

Source: own elaboration with data from INE and Banco de España.

\*average over the period for which data are available.

\*\* annual average

In addition, investment in equipment will also slow down this year due to weak productive activity, the credit crunch and a decline in corporate profits and expectations. The factors that will prop up investment in equipment include government investment in infrastructure and a possible boost from foreign demand from Euro-zone countries.

5) **Labour market.** Employment has increased spectacularly over the last few years, with the unemployment rate dropping to 7.95% in the second quarter of 2007, despite marked rises in the labour force due to immigration and the incorporation of women into the economically active population. However, labour market conditions have worsened dramatically over the last few months and the unemployment rate rose to 9.63% in the first quarter of 2008. Furthermore, the number of people registered as unemployed has increased by 425,000 over the last year, and annual growth in persons liable to make social security payments was negative in June for the first time since August 1994.

The abrupt slump in real estate, a sector that is intensive in labour, and the effect this has on the rest of productive activities, together with weak domestic demand, has undermined both activity and employment. Indicators available to date suggest that this trend has become even more pronounced over the last few months and that it will continue over the next few.

For this reason, we have lowered our January forecasts for the labour market. Employment equivalent to full time will increase in 2008 by 0.6%, while the unemployment rate will rise to around 10.4%.

6) **Interest rates** are mainly being conditioned by the significant risk of inflation and the dynamic growth in Euro-zone countries. The financial turmoil cut liquidity remarkably, increased risk premiums in international markets and made conditions for obtaining credit tougher. As a result, financing conditions have become progressively tighter despite the reference interest rate remaining unchanged at 4% up to July 2008. In this scenario, the ECB decided to carry out isolated interventions to boost liquidity in markets without changing interest rates.

The recent upturn in inflationary tensions has pushed up the risk of second round effects in wage negotiations and price fixing, at the same time as they have also increased the risk of the outlook for inflation coming unstuck in the medium and long term. In addition, the relative favourable growth data in the first quarter resulted in the ECB raising interest rates by 25bp.

In our opinion, inflationary tensions will continue for some months, although the risk of a slowdown in activity remains high. As a result, we forecast interest rates to rise to 4.25% by the end of the year.

7) The inflation rate (annual rise in the CPI) remained high in the first half of 2008 (averaging 4.4% between January and May). Moreover, the leading indicator suggests inflation will rise above 5% in June.

This trend is the result of an increase in inflation worldwide following price increases in oil and certain agricultural raw materials that have pushed up processed food prices. Furthermore, the outlook for inflation will remain high for

some months, as growth in wages in the first few months of the year illustrate that inflation has spread to costs through wage pressure. In addition, those sectors less exposed to competition have recorded a larger increase in the price of their goods. In contrast, the slowdown in economic activity in Spain, particularly where household spending is concerned, the recent increase in interest rates on behalf of the ECB and the economic slowdown worldwide, lead us to believe inflation will drop somewhat towards the end of the year. As a result, we forecast prices to rise by an average of 4.1% in 2008.

8) **Current account deficit.** The foreign deficit will increase, albeit at a slower rate than in previous years, due to an increase in the trade deficit (caused by the negative trend in price-competitiveness in Spain and the upturn in the price of imports such as oil and other raw materials), and to the increase in foreign payments for investment yields and the increase in foreign debt in recent years.

In January we anticipated that the slowdown in domestic demand, along with the relatively strong growth in exports could even reduce borrowing requirements (in relation to 2007). However, data released in the first few months suggest that not only has borrowing not decreased, but that it has increased to 11.3% of GDP.

The marked slump in the Spanish economy can be expected to correct this significant imbalance throughout the rest of the year. This aspect is crucial bearing in mind current international credit restrictions, with tougher conditions for capturing foreign savings, and could further curb growth in Spain. Over the last few month,

borrowing requirements (that is, the lack of savings to finance investment) have been covered by capturing the liquidity that the ECB had injected into the system. Moderating household spending and corporate investment should raise saving rates and thus reduce Spain's borrowing requirements.

We therefore consider that the current account deficit may approach 10.4% of GDP and Spain's borrowing requirements 10.2% of GDP.

9) **Productivity.** Economic growth in 2007, as was the case in previous years, was intensive in employment, while productivity grew at a rate of 1%.

As indicated in January, we expect apparent labour productivity to recover in 2008 in terms of its contribution to growth. Growth in productivity per worker will more than likely pick up as a result of jobs being lost as a result of the slump in construction and more temporary workers being unemployed (these workers are less productive on average). As a result, we forecast apparent labour productivity to grow by 1.1%.

10) The **budget deficit** depends on developments in public income and expenditure. In 2007, the Budget surplus amounted to 2.2% of GDP, boosted by an upturn in income, particularly through direct taxation.

The budget surplus has been highly cyclical in recent years, related to the strong economic growth and job creation on the back of household consumption and residential investment. As a result, revenue stemming from direct and indirect taxation and social security contributions recorded a marked increase.

In 2008 the situation is radically different. Income from indirect taxes is dropping due to consumption waning and the decrease in real estate transactions. Direct taxation is also increasing more slowly due to household income and corporate profits moderating, along with the tax cuts introduced to stimulate activity. Furthermore, government spending is increasing remarkably due to the effect of automatic stabilisers (unemployment benefits) and the discretionary action taken by the government to curb the drop in activity. As a result, we expect the budget surplus to practically vanish this year, dropping to 0.1% of GDP.

### **Main Risks of Things Getting Worse**

As mentioned on repeated occasions, the international economy is in the midst of a slowdown in a context of great uncertainty. Therefore, our forecasts for the Spanish economy are also subject to a great deal of uncertainty and the main risks are for things to get worse. In the first place, the most significant risk stems from a slump or a non recovery in household consumption in the last quarter of the year. In the second place, worldwide economic activity (mainly in the US, Euro-zone and emerging economies) could slowdown more abruptly due to financial instability and inflationary tensions and could dampen exports, which could be vital for Spain in the current scenario.

In the third place, if borrowing remains difficult and the cost of doing so rises in international markets, household consumption and corporate investment could become even weaker and make the slump in the real estate sector even more pronounced, with the subsequently negative and direct effect

on employment and the impact this has on the rest of activities. Moreover, from a macroeconomic point of view, if national savings fail to increase, the difficulty of gain foreign credit could become a real “bottleneck” for economic growth in light of Spain's enormous borrowing requirements. Up to now, the ECB has injected liquidity into the system, thus providing Spain with the necessary resources to finance the country's large foreign deficit.

In the fourth place, the outlook for inflation in the short and medium term is related to the expected trend in oil and agricultural raw material prices. However, the existence of wage and income indexing mechanisms and collective negotiation and the lack of competition in certain sectors of the Spanish economy could make passing inflationary tensions permanent. As a result, inflation could rise further in forthcoming months, a situation that would further damage consumption and job creation (see discussion on the effects of inflation on the Spanish economy in the OCEI July 2008 report).

Finally, the only positive risk to our base scenario stems from an upturn in worldwide activity, particularly in Spain's main trading partners. This would boost Spanish exports (which have registered a relatively favourable trend throughout this year).

Silviano Esteve

9 July, 2008

#### **4.-FRANCE & GERMANY**

De acuerdo con lo que acabamos de decir, el buen comportamiento de las economías francesa y alemana en lo que llevamos de año, lleva a que la revisión de nuestras previsiones de crecimiento de enero para ambas economías sea mínima. En sentido contrario, como no podía ser de otra forma, la revisión de nuestra previsión de inflación, ampliamente desbordada por la realidad, será total.

No obstante, aunque nuestra previsión de crecimiento se ha revelado bastante acertada, vamos a proceder a algunas revisiones menores relativas a la composición del mismo, a tenor del comportamiento de los componentes del PIB que se ha producido en lo que llevamos de año.

#### **Crecimiento Económico**

Entrando ya al detalle, vamos a mantener la previsión de crecimiento económico para el año en curso para Alemania. Como se recordará, ésta consistía en una tasa de crecimiento entre el 1.7 y el 2.0%. Dados los buenos resultados germanos del primer trimestre, hubiera sido posible incrementar un poco la previsión, en un par de décimas, pero lo enrarecido del clima económico mundial hace aconsejable la prudencia en este terreno, especialmente en el caso de la economía alemana, tan dependiente del comportamiento del sector exterior.

En cuanto a la economía francesa, vamos a reducir mínimamente nuestra previsión de enero en un par de décimas. El comportamiento de la economía francesa en el primer trimestre no ha sido malo, sin llegar a la excelencia del caso alemán, pero la elevación a anual de sus cifras actuales de crecimiento tampoco permiten

mayores alegrías. Por todo ello, formulamos una tasa de crecimiento para la economía francesa en 2008 entre el 1.5 y el 1.8%, estando ambos límites dos décimas por debajo de los de la previsión de enero.

#### **Componentes del PIB**

Como hemos señalado antes, la descomposición del crecimiento en sus distintos componentes requiere alguna matización con respecto a la previsión de enero. En el caso alemán dicha matización consiste en rebajar la tasa prevista de incremento del consumo privado e incrementar la tasa de crecimiento prevista de la inversión privada. Así, nuestra previsión de crecimiento para el primero es que la tasa a final de año oscilará entre el 1.0 y el 1.5%, cuando en enero la formulábamos medio punto por encima, es decir, entre 1.5 y 2.0%. Al mismo tiempo, la inversión privada, que hasta el momento está verificando un comportamiento excelente, presentará una tasa de crecimiento entre el 3.5 y el 4.0%, cuando en enero la cifrábamos entre el 2.5 y el 3.5%. El resto de los componentes del PIB ven mantenidas sus previsiones de enero, que recordamos que eran que el consumo público presentaría una tasa de crecimiento a final de año entre el 1.2 y el 1.7%, las exportaciones entre el 6.5 y el 7.5% y las importaciones entre el 6.0 y el 7.0%.

Por lo que respecta a la economía francesa, rebajamos también las previsiones de crecimiento del consumo privado, de un intervalo del 1.5-2.0 a otro del 1.3-1.7% y rebajamos también nuestra previsión de crecimiento del consumo público de una tasa entre el 1.5 y el 2.0% a una tasa entre el 1.0 y el 1.5%. Mantenemos las previsiones relativas al resto de los componentes

del PIB. Así, seguimos considerando que la tasa de crecimiento de la inversión privada estará entre el 2.0 y el 2.5%, que las exportaciones lo harán entre el 2.5 y el 3.0% y que, a su vez, las importaciones lo harán entre el 3.0 y el 3.5%.

### Tasa de Desempleo

Para ambos países nuestras previsiones acerca de la tasa de desempleo se van a ver mejoradas, dado que en ambos ha proseguido el proceso de reducción de la tasa de desempleo a pesar del marco general de crisis, cuyo efecto nos llevó a ser más prudentes en enero en relación a esta cuestión. Así, rebajamos nuestra previsión para la tasa de desempleo alemana a final de año desde un rango de valores del 8.0 y 8.5% a otro entre el 7.3 y el 7.7%. Por su parte, también en el caso de la economía francesa rebajamos la previsión de un intervalo del 8.1-8.6% al mismo intervalo del 7.3 y el 7.7%.

### Déficit Público

Mantenemos para ambas economías nuestra previsión de evolución del déficit público. Así, la economía alemana presentará a final de año sus cuentas cuadradas o incurrirá en un déficit público de hasta el 0.2% del PIB. Por lo que respecta a la economía francesa, seguimos considerando que presentará un déficit a final de año que oscilará entre el 2.0 y el 2.5% del PIB.

### Inflación

legamos al gran incumplimiento de nuestras previsiones, que no es otro que la tasa de inflación, como ya hemos señalado anteriormente. El repunte de precios ha llevado a que nuestras previsiones de inflación para todo el año hayan sido altamente erróneas. Así, creemos ahora que la

inflación en Alemania estará entre el 2.8 y el 3.1% a final de año y en Francia entre el 3.0 y el 3.3%. Además, dada la reciente evolución de los precios, creemos sinceramente que éstas son unas previsiones realistas (incluso optimistas) en cuanto a la evolución de los mismos.

Como se puede ver, a pesar de la crisis económica, tanto Francia como Alemania mantienen un relativo buen tono de crecimiento, que les permite proseguir reduciendo significativamente sus tasas de desempleo. El punto negro de su evolución, como en el de otras muchas economías en este período de crisis, es la elevada tasa de inflación, que va a cerrar el año en el 3% o muy cerca de la misma.

Tabla 1: Previsiones para el año 2008.  
Alemania

|                  | Enero |      | Julio |      |
|------------------|-------|------|-------|------|
|                  | Mín   | Máx  | Mín   | Máx  |
| PIB              | 1.7   | 2.0  | 1.7   | 2.0  |
| Componentes PIB  |       |      |       |      |
| Consumo priv.    | 1.5   | 2.0  | 1.0   | 1.5  |
| FBK              | 2.5   | 3.5  | 3.5   | 4.0  |
| Consumo pub.     | 1.2   | 1.7  | 1.2   | 1.7  |
| Exportaciones    | 6.5   | 7.5  | 6.5   | 7.5  |
| Importaciones    | 6.0   | 7.0  | 6.0   | 7.0  |
| Tasa Desempleo   | 8.0   | 8.5  | 7.3   | 7.7  |
| Déf. Pbco. % PIB | 0.0   | -0.2 | 0.0   | -0.2 |
| Tasa Inflación   | 1.8   | 2.2  | 2.8   | 3.1  |

Fuente: Elaboración Propia

Tabla 2: Previsiones para el año 2008.  
Francia

|                  | Enero |      | Julio |      |
|------------------|-------|------|-------|------|
|                  | Mín   | Máx  | Mín   | Max  |
| PIB              | 1.7   | 2.0  | 1.5   | 1.8  |
| Componentes PIB  |       |      |       |      |
| Consumo priv.    | 1.5   | 2.0  | 1.3   | 1.7  |
| FBK              | 2.0   | 2.5  | 2.0   | 2.5  |
| Consumo pub.     | 1.5   | 2.0  | 1.0   | 1.5  |
| Exportaciones    | 2.5   | 3.0  | 2.5   | 3.0  |
| Importaciones    | 3.0   | 3.5  | 3.0   | 3.5  |
| Tasa Desempleo   | 8.1   | 8.6  | 7.3   | 7.7  |
| Déf. Pbco. % PIB | -2.0  | -2.5 | -2.0  | -2.5 |
| Tasa Inflación   | 1.8   | 2.2  | 3.0   | 3.3  |

Fuente: Elaboración Propia

Antonio Cutanda  
Valencia, 9 de Julio 2008

## 5.-CHINA

The Chinese economy is still growing at rates of more than 10%, although there are beginning to signs of moderation. This year is turning out to be a difficult one for the country. The international economic slowdown, with the subsequent downturn in foreign demand, along with natural disasters<sup>4</sup> are some of the causes behind the moderation in growth. The weather in winter alone has caused more than 20,800 million dollars in losses and the earthquake on May 12 was estimated to have cost hundreds of millions.

The following are further causes that could explain the possible decrease in GDP growth:

- Increase in export costs due to changes in tax return policy
- Appreciation of the currency
- Increase in labour costs

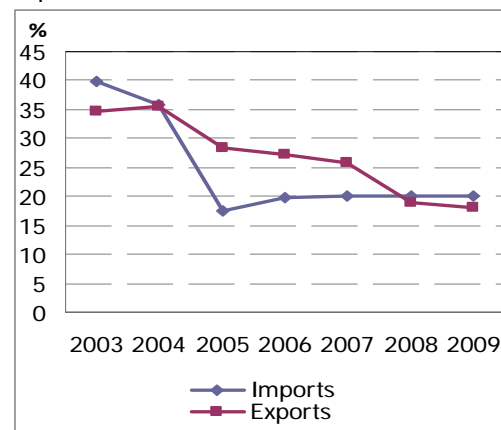
The People's Bank of China (PBC) dares to state that growth will remain strong, although "there could be a moderate slowdown". Other official organisations, such as the National Bureau of Statistics, go a little further and describe the situation as "the beginning of a stage of cyclical adjustment". Note that in growth peaked in 2007 at 11.9%, and although this cycle is not over yet, less activity is forecast for the next few years, starting with 2008. Chief economist at the State Centre of Information forecasts the economy to grow by 10.3% in 2008, a figure that in our opinion is somewhat more realistic than the prediction on behalf of the World Bank (WB).

<sup>4</sup> The cold spell during January and February and the recent earthquake in the southeast of the country.

The WB recently raised its forecast for China from 9.6% at the beginning of the year and the downward review in April to 9.4% to the current figure of 9.8%, based on the strong growth in the services sector. However, inflation will be one of China's Achilles' heels: the WB expects prices to rise by 7%, in contrast to the 4.6% inflation rate forecast in February.

In addition, the WB believes exports will remain strong due to being highly competitive on the international scene, although the current international economic environment will dampen growth somewhat (Figure 1). The WB also issues a warning that if inflation remains at current levels, domestic demand, which the government has tried so hard to revive, could suffer.

Figure 1: Growth in Commodity Exports and Imports



Source: Asian Development Bank

Despite the slowdown, as can be observed in Table 1, all forecasts are well and truly above the official target of 8% established at the beginning of the year. Even still, the ebbs and flows of Chinese growth forecasts are logical due to the uncertainty surrounding the current economic situation in the USA, with regard to the mortgage crisis.

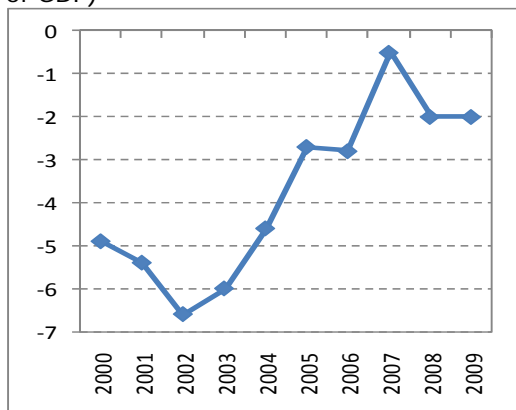
Table 1: Growth Forecasts for 2008

|              | GDP   | CPI  |
|--------------|-------|------|
| <b>PBC</b>   | 9.8%  | 4.8% |
| <b>WB</b>    | 9.8%  | 7%   |
| <b>ADB*</b>  | 10%   | 5.5% |
| <b>Other</b> | 10.4% | 7.1% |

\*ADB, Asian Development Bank

The State Budget for 2008 registers a slight deficit. Total expenditure is forecast to rise by 22%, particularly where health, education and social security are concerned. As in previous years, both income and expenditure will be considerably higher than budgeted.

Figure 2: Government Budget Balance (% of GDP)



Source: World Bank

China has received 1,510 million dollars from the World Bank during the 2008 financial year<sup>5</sup> in order to embark on the following projects:

- Rural Health Project: the aim is to improve the rural population's health conditions.
- Rural Immigrant Development Project: the goal is to train and develop the skills of immigrant workers
- Programme for Sustainable Urban Transport: stops will be

taken to improve buses and bicycle lanes to reduce car traffic

- Construction of a new high-speed passenger railway line

China is still one of the countries that asks for the most loans from the World Bank; the projects above will improve the network of infrastructures and the massive immigration from rural areas.

In the second half of the year, Beijing will host the Olympic Games, which are not forecast to damage the economy once they have finished. According to Chinese economists, the country is prepared to growth strongly after the Olympic Games because steps are already being taken in this direction. The construction of sporting headquarters and other infrastructures only represent 3% of total investment in fixed assets in China and, therefore, will have only a minimal effect.

### Macroeconomic Measures

The priorities of the government have not undergone significant changes since the beginning of the year, the following figuring prominently:

- Reduce the enormous balance of payments surplus
- Control inflation

The inflation rate was expected to drop in the second half of the year, but official organisations say the "devastating earthquake" has not made this possible. Notwithstanding, some Chinese economists forecast inflationary pressure to diminish towards the end of 2008, when the economic situation in neighbouring countries improves and the US dollar appreciates. Even still, the 4.8% target

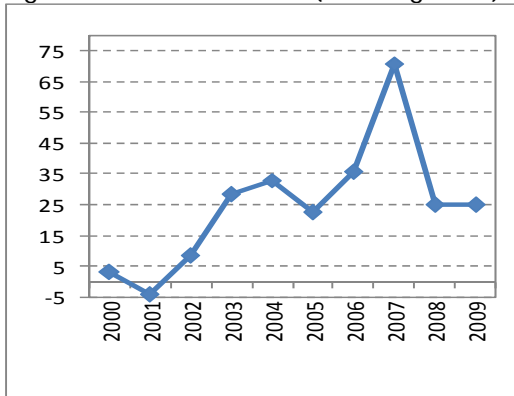
<sup>5</sup> The financial year runs from 1 July, 2007 to 30 June, 2008

rate set by the government will be difficult to achieve.

In our opinion, the natural disaster is just another factor on top of the economic aspects that were already resulting in prices getting out of control. We expect upward pressure on prices to continue throughout the year, as the cost of goods and services, along with food could continue to rise.

In order to fight the upturn in prices, the PBC has decided to maintain strict monetary policy, carrying out an extensive control of bank loans, increasing resources and loans for innovating companies and penalising those that pollute or overproduce (Figure 3). In addition, the PBC suggests the government should foster an increase in the supply of grain, oil, meat, eggs and vegetables in order to control rising prices.

Figure 3: Domestic Credit (annual growth)



Source: World Bank

In 2007, the government took various steps to control food prices, that have been complemented by further action in 2008. The minimal or nonexistent effect of all these measures can be observed in the results obtained.

The World bank believes the Chinese government should increase consumer subsidies in order to offset the upturn in the price of normal consumer goods.

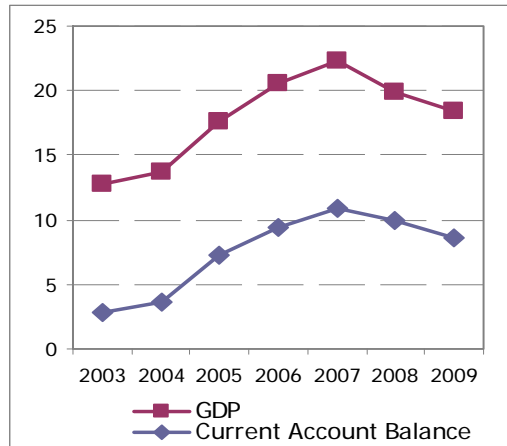
In addition, the Yuan is expected to appreciate by 7% over the rest of the year, which will favour a decrease in import prices, thus helping to control inflation.

The main culprit for the foreign trade surplus is still the current account, although the recent inflow of speculation capital has increased significantly (Figure 4). According to the World Bank, growth must be reoriented towards services and consumption in order to change this trend, to the detriment of industry and investment. In order to achieve this, policies that foster such a change must be oriented towards:

- Strengthening the exchange rate
- Shifting public spending to health, education and social security
- Furthering financial reform
- Forcing State companies to pay dividends and strengthen good corporate governance
- Improving price fixing for resources, energy and land
- Increasing incentives for local governments to rebalance growth

As regards the influx of speculation capital, there is much debate. There is no agreement regarding its possible consequences. On the one hand, some believe it is a serious problem that demands changes in exchange rate policy to alter expectations. However, on the other hand, another current of thought is of the opinion that an influx of speculation capital is not a risk to China, making exchange rate changes unnecessary.

Figure 4: GDP and Current Account (% of GDP)



Source: Asian Development Bank

The government has been applying reforms and opening up the economy for three decades now and this continues to favour industrialisation in the present, which is still developing in coastal and eastern parts of the country. Moreover, this policy, backed by large reserves, is boosting investment abroad, which will not only benefit China, but also the rest of the world.

This situation is resulting in a change in China's current image as a great manufacturer and exporter, but a small consumer. Domestic consumption is expected to boom as a result of growth over the last few years and the stops taken by the government to foster domestic demand.

The macroeconomic climate in the first quarter led us to change some of the forecasts we at the OCEI made at the beginning of the year:

Table 2: OCEI Forecasts for 2008

|                       | January 2008 | July 2008 |
|-----------------------|--------------|-----------|
| <b>GDP</b>            | 10.8-11      | 10.8-11   |
| <b>Inflation</b>      | 4.4-4.8      | 7-7.5     |
| <b>Interest Rates</b> | 7.8-8        | 8         |
| <b>Exchange Rate</b>  | 7-7.1        | 6         |

M<sup>a</sup> Luisa Martí Selva and  
Rosa Puertas Medina  
Valencia, 8 July, 2008

## 6.-MEXICO

Difficult times for the economy and difficult times to make forecasts.

The economic situation is so changeable that in just a few weeks, any short term estimate can be proven entirely inaccurate. However, we will review the forecasts we made in January and will attempt to predict developments in the second half of the year to provide an annual figure.

### GDP

The latest estimates on behalf of the Secretariat of Public Loans and Finance and the OECD coincide in forecasting the Mexican economy to grow by 2.8% this year.

Using the indicators mentioned above as a basis, we believe that the slowdown will become more pronounced in the second half of this year. The downturn in loan growth will curb domestic consumption and, as a result, economic growth.

The increase in the cash rate will have a similar effect, on attempting to shrink aggregate demand and, in this way, curb inflation.

In addition, the economic difficulties in the United States and the minimal investment that has been made in recent times, lead us to maintain our forecast for a 2% growth rate made at the beginning of the year.

### Inflation

The OECD forecasts an inflation rate of 4.4% for 2008.

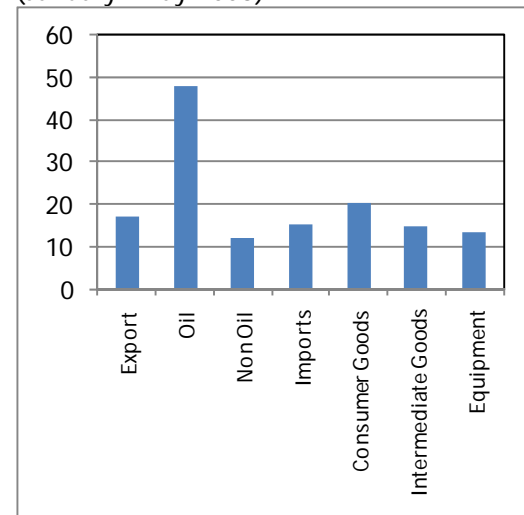
In January, we forecast an inflation rate of 4%, which we now raise to 4.6%, in light of the figure observed over the first half of the year, mainly as a result

of the increase in food prices, a phenomenon that, at least in the short term, shows no signs of letting up.

### Foreign Trade

Over the first five months of the year, exports have amounted to 123,105 million dollars, up by an annual 17.1%. Oil exports rose by an annually adjusted 47.9% while non oil exports were up by 11.8%.

Figure 1: Annual Percentage Change (January –May 2008)



Source: elaborated with information from INEGI

Mexico imported goods and services to the value of 125,901 million dollars, 15.4% more in annual terms. Within imports, consumer goods recorded the greatest rise (20.3%), followed by intermediate goods (14.7%) and equipment (13.6%).

We believe oil income will remain high, while non oil export growth will drop further. On the other hand, imports will remain strong on the back of the appreciation of the peso against the dollar.

### Interest Rates

At the beginning of the year we forecast CETES interest rates to

average 7% and the cash rate between 6.25% and 6.5%. It is now highly likely that following the increase in inflation, monetary policy makers will become tougher and the Banco de Mexico will probably raise the interbank rate over the next few months (if not in July).

As a result, we forecast the CETES and interbank rates to range from 7.5% to 8% on average this year.

### **Exchange Rate**

The increase in interest rates will further boost the peso against the dollar, as will the inflow of foreign currency stemming from oil exports, remittances, foreign direct investment and tourism.

At the beginning of the year, our forecast was for 11.00 pesos per dollar. We now lower this figure to 10.50-10.80 to the dollar.

### **Employment**

We maintain our forecast for 400,000 jobs to be created in the formal sector over 2008.

### **Oil**

We estimated a price of \$60 dollars per barrel in January, a figure that has been well and truly surpassed by reality. As a result of the constant upturns in price, we now forecast the barrel of Mexican Export Mix to stand at 95 dollars.

### **FDI**

We forecast a figure of 17 billion dollars in January and maintain this estimate.

### **Remittances**

Our forecast in January was for 22 billion dollars. In light of the fact that growth in remittances has begun to

decline, we maintain our previous forecast.

**Hector Ruiz Ramirez**  
Toluca, Mexico 7 July, 2008