OCTOBER 2006

THE SPANISH ECONOMY

Monthly Report

NUMBER 295

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2005	2006	2007	2005		2006			
				3Q	4Q	1Q	2Q	3Q	4Q
INTERNATIONAL ECONOMY		Forecast						Forecast	
Gross domestic product									
United States	3.2	3.4	2.8	3.4	3.1	3.7	3.5	3.1	3.4
Japan	2.6	2.6	1.9	2.8	4.0	3.4	2.5	2.6	2.1
United Kingdom	1.9	2.4	2.4	1.8	1.9	2.3	2.6	2.5	2.3
Euro area	1.5	2.4	1.8	1.7	1.8	2.1	2.6	2.4	2.5
Germany	*1.1*	*2.1*	*1.3*	*1.5*	*1.7*	*1.7*	*2.4*	*2.0*	*2.1*
France	*1.2*	*2.2*	*1.9*	*1.4*	*1.0*	*1.4*	*2.6*	*2.5*	*2.4*
Consumer prices									
United States	3.4	3.6	2.7	3.8	3.7	3.7	4.0	3.6	3.2
Japan	–0.3	0.3	0.4	–0.3	–0.7	–0.1	0.2	0.7	0.7
United Kingdom	2.3	2.7	2.4	2.4	2.2	2.2	2.8	3.0	2.5
Euro area	2.2	2.2	2.1	2.3	2.3	2.3	2.5	2.2	2.0
Germany	*2.0*	*1.8*	*2.3*	*2.1*	*2.3*	*2.0*	*1.9*	*1.7*	*1.6*
France	*1.7*	*1.8*	*1.8*	*1.9*	*1.6*	*1.8*	*1.5*	*1.8*	*2.2*
SPANISH ECONOMY		Forecast						Forecast	
Macroeconomic figures									
Household consumption	4.2	3.5	3.0	4.1	3.8	3.8	3.6	3.4	3.2
Government consumption	4.8	4.4	4.4	4.5	4.9	4.4	4.4	4.5	4.4
Gross fixed capital formation	7.0	6.1	5.2	7.1	6.6	6.3	6.1	6.1	6.0
Capital goods	*9.0*	*8.9*	*7.6*	*8.3*	*8.6*	*8.6*	*9.1*	*9.1*	*8.8*
Construction	*6.0*	*5.6*	*4.0*	*6.3*	*5.6*	*5.8*	*5.7*	*5.6*	*5.4*
Domestic demand (contribution to GDP growth)	5.2	4.7	4.1	5.2	5.0	5.0	4.8	4.6	4.5
Exports of goods and services	1.5	6.2	4.8	2.5	2.3	9.5	5.3	5.1	5.0
Imports of goods and services	7.0	8.8	6.5	7.7	6.6	12.4	7.9	7.5	7.4
Gross domestic product	**3.5**	**3.6**	**3.2**	**3.6**	**3.6**	**3.6**	**3.7**	**3.6**	**3.5**
Other variables									
Employment	3.1	3.0	2.6	3.3	3.2	3.2	3.1	3.0	2.9
Unemployment (% labour force)	9.2	8.6	8.7	8.4	8.7	9.1	8.5	8.4	8.5
Consumer price index	3.4	3.7	2.8	3.4	3.6	4.0	3.9	3.6	3.1
Unit labour costs	2.2	2.5	2.2	1.9	2.3	2.4	2.6		
Current account balance (% GDP)	–7.5	–8.8	–8.3	–6.8	–7.0	–10.6	–8.1		
Not lending or net borrowing rest of the world (% GDP)	–6.5	–8.0	–7.5	–6.0	–5.9	–10.3	–7.6		
Government balance (% GDP)	1.1	0.9	0.5						
FINANCIAL MARKETS		Forecast						Forecast	
Interest rates									
Federal Funds	3.2	5.0	5.1	3.4	4.0	4.4	4.9	5.3	5.3
ECB repo	2.0	2.8	3.7	2.0	2.1	2.3	2.6	2.9	3.3
10-year US bonds	4.3	4.8	4.9	4.2	4.5	4.6	5.1	4.9	4.7
10-year German bonds	3.4	3.8	4.2	3.2	3.4	3.5	4.0	3.9	3.8
10-year Spanish bonds	3.4	3.8	4.2	3.2	3.4	3.5	4.0	3.9	3.8
Exchange rate									
$/Euro	1.25	1.26	1.33	1.22	1.19	1.20	1.26	1.27	1.29

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2005

FINANCIAL ACTIVITY	Million euros
Total customer funds	169,470
Receivable from customers	113,857
Profit attributable to Group	1,495

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	25,254
Branches	5,053
Self-service terminals	7,208
Cards	8,408,956

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2006	Million euros
Social	160
Cultural	70
Science and environmental	54
Educational	19
TOTAL BUDGET	**303**

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Contents

Immigration: a blessing or a curse?

Dug-out canoes full of people from Black Africa. Street demonstrations by young descendents of immigrants in the suburbs of French cities. «Wet-backs» detained by US border guards. The image of immigration in recent times has taken on almost apocalyptic connotations. The «First» world is attracting young people from underdeveloped regions willing to risk their lives to reach the «Eldorado» of the developed nations in order to find the future their own countries cannot offer them. The flow of immigrants is now taking place at unheard of speed, illegal immigration is reaching unexpected proportions and it does not seem as if the pressure will ease off in the near future.

Spain is a case worth studying. Traditionally a country of emigration (to the Americas and to Europe), in just a few years it has become the main receiving country for immigrants in the European Union. The biggest immigration wave in history has halted the population drop in the second half of the Nineties and is taking us toward a total population count of 45 millions in 2010. The transformation of the labour market has also been spectacular. Coming from Latin America, Morocco, Eastern Europe and even from China as well as Black Africa, these immigrants have rapidly changed the face of sectors such as construction, agriculture, hotels and restaurants. The same thing has taken place in domestic service, such as personnel for cleaning, home services and care of the old. Immigration has given a new look to Spanish cities as a result of ethnic businesses, including mixed stores, restaurants, food stores, telephone calling services, textile stores, etc.

The immigrants do not appear to have taken jobs away from Spanish workers. The capacity of the economy to create jobs has been so strong that it has made it possible to assimilate this flow of immigrants and, as the same time, notably reduce the total unemployment rate. Nor is there any evidence that wages have been affected to any relevant degree although we shall never know how the labour market and the economy in general would have developed without the fact of immigration. It is quite clear that these new workers have to a great extent filled temporary and seasonal jobs, accepting below-average wages. In sectors such as those mentioned which are of low value added and poor productivity. As a result, immigration has slowed down the growth of per capita income. However, as we are dealing here largely with young people available to work immediately, immigrants raise the rate of those making up the labour force and through this other mechanism have a positive effect on per capita income. Furthermore, over the short term immigration contributes to improve the public accounts. The surplus showing up in the Social Security budget, which serves to balance the accounts of various levels of government, would not exist without the contribution of registrations by those of foreign origin. Certainly, spending on education and health has increased but for the moment the balance is positive.

Finally, from the point of view of the economy, the incorporation of the flow of immigrants in recent years has been beneficial although there are some doubts about its effect over the long term. At this moment, it is necessary to consolidate, put in order and rationalize this new reality as well as future inflows, while suitably facing up to the challenges this social change means in terms of competitiveness of Spain's economic model and, particularly, for the labour market and the Welfare State.

OVERALL SUMMARY

Drop in oil prices unexpectedly improves world economic scene in terms of inflation risk...

...although uncertainty about future per barrel price still as high as ever.

Concern about trend in US real estate sector not diminishing and latest figures not reassuring.

Oil brightens up the Autumn

In mid-summer, the world economy was buoyant but there were still some black clouds around threatening the course of the second half-year, namely inflation and the slowdown in the real estate sector in the United States. Unexpectedly, the drop in the per barrel price of oil came to the rescue of growth and world inflation. The crude oil market showed a sharp increase between mid-July and the beginning of August because of nervousness resulting from Israel's attack on Lebanon, the conflict around Iran's nuclear programme and other supply problems. The market reached a price of 78.5 dollars a barrel and it seemed that 80 dollars was just around the corner. Then, suddenly, everything changed. At the end of September, the oil price went below 60 dollars. Early figures for the consumer price index show the impact of this with a notable cut in inflation rates.

The problem is the high level of uncertainty around oil prices. The highs reached in August seemed excessive but futures markets were betting on an even higher price. It is possible that this moderation will continue in coming months because of the slowdown in world growth and an increase in supply but the Organization of Petroleum Exporting Countries may react and manage to turn around the trend. In addition, we have recently tended to look not only at nominal inflation but also at the core component, that is to say, excluding energy. In that respect, the indices have scarcely changed.

In the meantime, the drop in the real estate market in the United States remains a threat. On the one hand, this could allow the Federal Reserve System to apply a less aggressive monetary policy with the decrease in inflation risk. Lower interest rates would naturally provide a safety net for the drop in housing sales. Furthermore, the US consumer would feel safer if the petrol price per gallon went to more normal levels. The consumer confidence index prepared by the Conference Board showed an upward jump in September, something very much connected to the cut in fuel prices.

The cooling down of housing in the United States is continuing. The drop in economic activity has been very rapid, greater than in previous episodes of falling markets as happened at the beginning of the Eighties and Nineties. Housing starts dropped by 20% in August compared with the same period last year. A similar thing is happening with housing sales, both new and existing. For the moment, house prices are holding up well enough although in some states slight drops are being reported.

What is more, inflation is not offering any consolation. Growth of the consumer price index in the United States dropped from 4.2% in July to 3.8% in August at year-to-year rate. The bad news was that the core component (excluding energy and food) rose to 2,8%, the highest in eleven years. This trend is reason for concern among those responsible for monetary policy who may even be obliged to raise interest

rates a bit higher in spite of the weakness in housing. In the meantime, the dollar has recovered some strength although the massive trade deficit scarcely shows any sign of being corrected.

On the other hand, in the Euro Area the Eurostat estimate of consumer price index for September was the good surprise for the month. Some cut had been expected but the reality was well above expectations. Inflation went from 2.3% in August to 1.8% in September, the lowest level for two years. In Frankfurt, in the European Central Bank building the must have been rubbing their hands together. Inflation has dropped below 2%, the objective of the monetary authorities, something they did not expect to reach until well into 2007. We shall have to see the reaction of Jean-Claude Trichet to this unexpected turnaround in inflation prospects.

With inflation under control, the favourable indicators for the state of economic activity take on greater significance. Consumer and corporate confidence is holding at a good level, unemployment rates are tending to drop progressively and all growth forecasts are being revised upward to the range of 2.5%. This appreciable improvement in the state of the economy is even reaching the «black beast» of most of the EU economic authorities, namely the government deficit. Along these lines, the German minister of finance recently announced that in 2006, for the first time in four years the country's government deficit would stand below 3% of the gross domestic product, as required under the EU Stability and Growth Pact.

Curiously, the debate is now centred more on the performance of the economy next year as it is felt that the cards for 2006, which are quite good, are now out on the table. There is concern about the make-up of growth in the Euro Area because private consumption is not showing up as the key factor. If this does not take off we run the risk that the flight of European recovery may be a bit short-lived should the international economy slow more than desired during 2007. At the moment, the financial markets offer an ambiguous interpretation. Bond yields are holding at low levels with the yield curve inverted in the United States and flat in Europe while the stock markets are again strong following the dip seen in May and June.

In Euro Area, sudden cut in inflation comes on top of good indicators on trend in economic activity.

Spain's economy: inflation provides a breather

Spain's consumer price index has benefited from the drop in oil prices. From 3.8% year-to-year in August, inflation went down to 3.0%, according to the early harmonized index prepared by the National Institute of Statistics. A breakdown by component is not yet available but the relief shown by those responsible for economic policy is evident. The differential with the Euro Area is still high but ending the year with inflation not much above 3% will be good news both for the public sector (spending on pensions and other items linked to consumer prices) and for corporations (implementation of wage guarantee clauses, etc.).

Curiously, biggest concern turns around economic situation next year, given that results for 2006 seem fairly well assured.

Just a few days after the inflation rate was announced, Pedro Solbes, minister of economy, presented the 2007 Budget estimates. These were calming estimates in as much as growth of the economy will be somewhat higher than 3% and the public accounts will end up showing a surplus for the third year in a row. On the revenue side, a notable point was the expected coming into force of reforms of two of the most important tax headings, personal income tax and corporation tax

In Spain as well, early figures for inflation in September come as pleasant surprise.

Main figures for 2007 Budget unlikely to create big controversy given good state of Spain's economy.

as well as possible increases in tax on tobacco and fuel. On the spending side, the government has put emphasis on increases in headings such as research, development and innovation, education, infrastructures and social spending, the latter representing half of total spending. These increases are possible because of the drop in one of the more important spending headings, spending for interest on the public debt, thanks to still low interest rates.

Stock market shoots up because of transactions in energy and real estate sectors while real economy remains in good shape...

In this context, Spanish stock markets showed a sudden rise in September which led the Ibex 35 to break previous highs reached back at the time of the hi-tech bubble some six and a half years ago. On this occasion, the shares which pushed up the indices were much more tangible, namely energy and real estate. Take-over bids and rumours of major corporate transactions have enlivened stock markets in a context of high corporate profits.

...which shows up in strong job creation, high demand for credit and buoyant tax collections.

With the end of summer, the non-financial economy has run within more foreseeable parameters than in the case of the stock markets. Economic activity remains strong, buoyed up by foreign demand thanks to the recovery of the Euro Area. This trend is very noticeable in industry where recovery now seems to be well consolidated following the dip in 2005. Construction is maintaining a strong rate which likely will continue for the rest of the year. In services, the upward trend in tourism is becoming clear as indicators for the high season become known. On the demand side, investment in machinery and industrial equipment continues to show great strength while transportation equipment is growing at a somewhat gentler rate.

With regard to employment, the rate of registrations with Social Security remains high, at 3.4% annual in August, which becomes 3.7% if we take into account only wage employment. These figures are not now distorted by the effects of the process of giving legal status to foreign workers begun in 2005 and therefore more accurately indicate the strength of the job creation process. In any case, out of the more than 600,000 net new registrations with the Social Security system in one year somewhat more than one-third were foreign workers and, out of these, three-quarters were from outside the EU, which underlines the size of the phenomenon of immigrant integration in the labour market.

The strong growth rate in the labour market at this time is compatible with relatively contained labour costs although one notices a slightly upward profile in certain wage indicators. Where things seems to be clearly expansionist is in demand for credit. This is not only so in the case of households for home purchase. According to Bank of Spain figures, in the past 12 months ending in July funding granted to companies rose by nearly 25%, a very high rate in historical terms. Finally, the growth of economic activity is also reflected in the growth of tax collections, thanks to the trend in headings such as personal income tax, corporation tax and value added tax.

September 29, 2006

CHRONOLOGY

2005

September	**17**	Increase in **special taxes** on alcohol and tobacco to finance health (BOE 17-9-05).
	20	**Federal Reserve** raises reference rate to 3.75%.
October	**4**	IBEX 35 index for **Spanish stock exchange** marks up annual high (10,919.2) with cumulative gains of 20.2%.
	13	Government approves **National Reform Programme for Spain**.
November	**1**	**Federal Reserve** raises reference rate to 4%.
	28	**Slovak crown** joins Exchange Rate Mechanism.
December	**1**	**European Central Bank** raises official interest rate to 2.25%.
	13	**Federal Reserve** raises reference rate to 4.25%.
	17	European Council approves **2007-2013 Budget**.
	18	Hong Kong Summit of **World Trade Organization** agrees to removal of all aids to agricultural exports of developed countries in 2013.

2006

January	**20**	Government presents bills for reform of **personal income tax** and **corporate tax.**
	31	**Federal Reserve** raises reference rate to 4.50%.
March	**2**	**European Central Bank** raises official interest rate to 2.50%.
	28	**Federal Reserve** raises reference interest rates to 4.75%.
	31	Government approves **economic policy package** including budgetary measures and others on mortgage market, energy sector and rail transport.
May	**4**	Agreement between government, business organizations and trade unions on **labour reform** aimed at reducing extent of temporary work.
	10	**Federal Reserve** raises reference rate to 5%.
June	**8**	**European Central Bank** raises official interest rate to 2.75%.
	29	**Federal Reserve Board** increases reference rate to 5.25%.
July	**11**	European Council authorizes **Slovenia** to adopt euro as currency as of January 1, 2007.
	24	Multilateral negotiations in **Doha Round** of World Trade Organization, aimed at greater liberalization of international trade, indefinitely suspended.
August	**3**	**European Central Bank** raises official interest rate to 3.00%.
	8	One-month forward price of Brent quality **oil** goes up to all-time high of 78.49 dollars a barrel.
	12	UN Security Council approves resolution for **cease-fire in Lebanon** in conflict between Israel and Hezbollah.
September	**26**	European Commission gives go-ahead to entry of **Romania and Bulgaria** into European Union on January 1, 2007.
	27	IBEX 35 index for **Spanish stock exchange** marks up all-time high (12,950) with cumulative capital gains of 20.6% over end of December 2005.
	28	Dow Jones index for **New York stock exchange** records annual high (11,718.5) with rise of 9.3% compared with end of 2005.

AGENDA

October

- **3** Social Security registrations and registered unemployment (September).
- **5** Industrial production index (August).
  Governing Council Meeting, European Central Bank.
- **11** Consumer price index (September).
- **12** Meeting of Open Market Committee, Federal Reserve System.
- **16** Balance of payments (July).
- **17** Harmonized CPI for European Union (September).
- **24** Central government revenue and spending (September).
  Federal Open Market Committee meeting.
- **25** Producer price index (September).
- **26** Foreign trade (August).
- **27** Labour force survey (3rd Quarter). US GDP (3rd Quarter).
- **30** Early CPI (October).

November

- **2** Governing Council Meeting, European Central Bank.
- **3** Registrations with Social Security and registered unemployment (October).
- **6** Industrial production index (September).
- **14** Early Spanish GDP (3rd Qtr.) Euro Area GDP (3rd Qtr.)
- **15** CPI (October). Balance of payments (August).
- **16** Harmonized CPI for EU (October).
- **21** Central government revenue and spending (October).
- **22** Quarterly national accounts (3rd Qtr.).
- **23** Foreign trade (September).
- **27** Producer price index (October).
- **30** Early CPI (November).

INTERNATIONAL REVIEW

IMF forecasts: strong growth but some risks remain

IMF expecting world growth at around 5% in 2006 and 2007...

In its report on prospects for the world economy put out in September, the International Monetary Fund (IMF) raised its growth forecasts for 2006 from 4.9% to 5.1%. For 2007 it expects a very slight easing off which would set the increase at 4.9%. World growth is strong thanks to low interest rates up until now and the growth of world trade. In spite of a positive main scenario, there are higher risks of a downward revision of growth because of rising interest rates, possible increases in oil prices, the slowdown in the US housing market and imbalances in the current account balance which could bring about protectionist pressure.

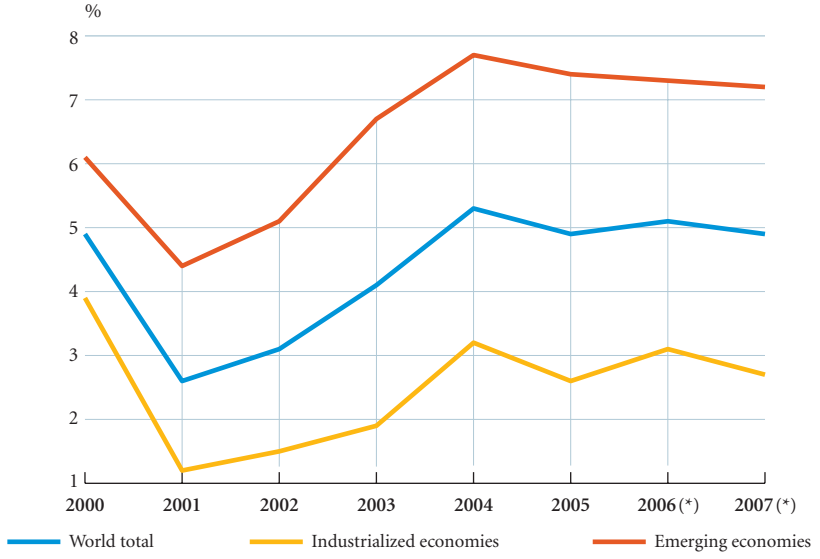
...but increasing risks from interest rates, slowdown in housing in United States and current account imbalances.

By geographical region, the United States is losing some strength while Europe is growing stronger and this is especially so in the emerging countries with China in the lead. In the United States growth of 3.4% is expected in 2006 with a drop to 2.9% in 2007. Japan is maintaining its growth with increases of 2.7% in 2006 and 2.1% in 2007 while the economic contribution forecast for the Euro Area has been revised from 2.0% to 2.4% for 2006 and stays at 2.1% for 2007. But it is the emerging countries which see their prospects of economic growth raised most with an overall increase of 7% this year, a level that will be maintained in 2007.

China will maintain sharp growth at around 10%. The economies of Latin

WORLD GROWTH BUOYANT BUT DOWNWARD RISKS REMAIN

Year-to-year change in gross domestic product (**)



NOTES: (*) Forecasts.
(**) Weighting growth of countries by purchasing power parities.
SOURCE: International Monetary Fund.

IMF FORECASTS

Annual change as percentage

	2004	2005	2006 (1)	2007 (1)
GDP				
United States	3.9	3.2	3.4	2.9
Japan	2.3	2.6	2.7	2.1
Germany	1.2	0.9	2.0	1.3
France	2.0	1.2	2.4	2.3
Italy	1.1	0.0	1.5	1.3
United Kingdom	3.3	1.9	2.7	2.7
Spain	3.1	3.4	3.4	3.0
Euro area	**2.1**	**1.3**	**2.4**	**2.0**
Advanced economies	**3.2**	**2.6**	**3.1**	**2.7**
World total	**5.3**	**4.9**	**5.1**	**4.9**
Developing countries	*7.7*	*7.4*	*7.3*	*7.2*
Latin America	*5.7*	*4.3*	*4.8*	*4.2*
Eastern and Central Europe	*6.5*	*5.4*	*5.3*	*5.0*
Russia	*8.4*	*6.5*	*6.8*	*6.5*
China	*10.1*	*10.2*	*10.0*	*10.0*
Consumer prices				
United States	2.7	3.4	3.6	2.9
Japan	0.0	–0.6	0.3	0.7
Germany (2)	1.7	2.0	2.0	2.6
France (2)	2.3	1.9	2.0	1.9
Italy (2)	2.3	2.3	2.4	2.1
United Kingdom (2)	1.3	2.0	2.3	2.4
Spain (2)	3.1	3.4	3.8	3.4
Euro area (2)	**2.1**	**2.2**	**2.3**	**2.4**
Advanced economies	**2.0**	**2.3**	**2.6**	**2.3**
Developing countries	*5.6*	*5.3*	*5.2*	*5.0*
Unemployment rate (3)				
United States	5.5	5.1	4.8	4.9
Japan	4.7	4.4	4.1	4.0
Germany	9.2	9.1	8.0	7.8
France	9.5	9.6	9.6	9.5
Italy	8.1	7.7	7.6	7.5
United Kingdom	4.8	4.8	5.3	5.1
Spain	11.0	9.2	8.6	8.3
World trade by volume (4)	**10.9**	**7.5**	**9.4**	**7.8**
Oil price ($ per barrel) (5)	**30.7**	**41.3**	**29.7**	**9.1**

NOTES: (1) Forecasts in September 2006.
(2) Harmonized consumer price index.
(3) Percentage of labour force.
(4) Goods and services.
(5) Average spot prices for Brent, Dubai and West Texas Intermediate oil. Average oil price in dollars per barrel forecast at $69.20 in 2006 and $75.50 in 2007.
SOURCE: International Monetary Fund.

Growth dropping in United States, rising in Europe and leaping ahead in emerging countries.

America can expect to grow by 4.8% this year and 4.2% in 2007, in both cases being revised upward by around a half percentage point. Russia and the countries of Eastern Europe have also had their growth corrected upward in a similar manner.

As for Europe, some of the unknowns about Germany have been eased. This was the country about which there have been most doubts and it has now been given a growth forecast of 2.0% for 2006 and 1.3% for 2007. Growth prospects for France and United Kingdom have again been improved while those for Italy are maintained. Spain continues to stand in the lead of European growth rates with a forecast of 3.4% for 2006 and 3.0% in 2007.

Heavy utilization of production capacity bringing about price increases.

Leaving apart inflationary risks from oil, the sharp world growth rates are bringing about higher utilization of production capacity. It is mainly this fact that has brought about an increase in core inflation with levels generally above the objectives of the central banks. In this regard, what stands out are unit labour costs in the United States which could lead the Federal Reserve System to be on the lookout in spite of lower growth. As a result, the prospects for inflation have been revised upward and it is expected that prices will go up by 3.6% this year and 2.9% next year. The situation of the European Central Bank is similar with less inflation expected (but also revised upward above the central bank's objective) at 2.3% in 2006 and 2.4% in 2007.

United States growing at 3.6% with lower inflationary pressures.

The biggest risk for growth continues to be the trade imbalances. Correcting these means the possibility of a sharp adjustment of the dollar exchange rate. On top of this risk comes the correction of the real estate market in the United States and doubts about the strength of the emerging economies in a less favourable world environment with higher interest rates and lower-priced raw materials, of which they are net exporters. There still remain fiscal imbalances and a lack of decided policies to correct them at a moment that is specially appropriate.

United States for now bearing up under end of housing cycle

In recent weeks, Richard Fisher, chairman of the Federal Reserve Bank of Dallas, has been concerned. At the end of August he had obtained first-hand information from professionals in the real estate sector that indicated that we were facing the most drastic adjustment in memory. The US economy is dropping gently, with year-to-year growth of 3.6% in the second quarter and less of a threat from inflation than was expected only a few months ago. The latest figures for the housing market, however, confirm Fisher's concerns, although it must be said that these worst fears have not come about yet. We may ask why.

The slowdown in the real estate market has been sharp but it has been more in volume of economic activity than in prices. The drop in sector activity has been very rapid, much more so than in earlier downward markets such as those at the beginning of the Eighties and Nineties that showed bigger decreases in trend, so that what cannot be discarded now is the return to an upward move. Housing starts in August were down 19.8% over the same period last year whereas for the whole of 2005 they had risen by 6.3% over the previous year. A similar thing is happening with housing sales, new or existing, that in August dropped by 17.4% year-to-year and 12.6% respectively. In prices things are somewhat different. Rather than an easing off we should speak of a sharp slowdown. Prices of new housing and existing housing were down by 1.7% year-to-year and 1.3%. These are figures much lower than growth of the

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006				
			3Q	4Q	1Q	2Q	July	August	September
Real GDP	3.9	3.2	3.4	3.1	3.7	3.6	–	...	–
Retail sales	6.2	7.2	8.1	6.2	8.3	6.6	4.8	6.7	...
Consumer confidence (*)	96.1	100.3	98.9	95.8	105.7	106.6	107.0	100.2	104.5
Industrial production	4.1	3.2	2.7	3.0	3.3	4.6	5.2	4.7	...
Industrial activity index (ISM) (*)	60.5	55.5	56.0	57.0	55.6	55.2	54.7	54.5	...
Sales of single-family homes	10.1	6.6	11.9	3.1	–11.6	–14.0	–26.2	–17.4	...
Unemployment rate (**)	5.5	5.1	5.0	4.9	4.7	4.6	4.8	4.7	...
Consumer prices	2.7	3.4	3.8	3.7	3.7	4.0	4.2	3.8	...
Trade balance (***)	–611	–717	–689	–717	–740	–762	–771	...	...

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion dollars.
SOURCE: OECD, national statistical bodies and internal figures.

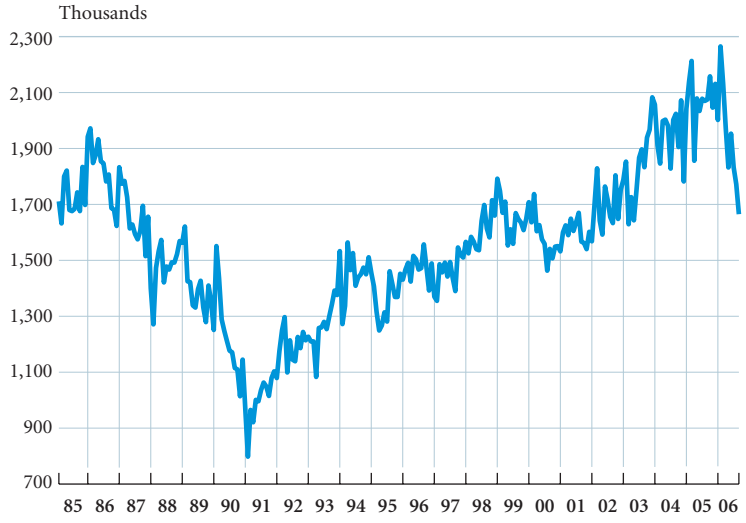
order of 10% at the beginning of the year but are still far from meaning an appreciable loss of value.

This difference between prices and sector activity is important. Weakness in volume of business and investment in the residential sector affects 6% of the total gross domestic product (GDP) in current dollars which, although it is not small, is far from the two-thirds represented by consumption. The US

Housing sees sharpest drop in economic activity in recent decades...

UNITED STATES: DROP IS REALLY SHARP

Housing starts in annual terms



SOURCE: Federal Housing Board, National Association of Realtors and internal figures.

...but real estate still holding values.

consumer has been one of the most important supports, if not the most important, of current growth not only of US growth but also in world terms. Wages have until recently been slipping and the increases in oil prices have undermined consumer budgets. In this theoretically unfavourable context, the wealth effect arising from the appreciation of real estate assets combined with low interest rates which has made it possible to rewrite home mortgages to finance other spending has been a crucial support for continuing to buy all over. The drop in building activity now is being felt in GDP growth but without any significant drop in prices, something which has not yet come about, and furthermore, if oil prices help a bit and wages come out of their lethargy, as seems to be happening, the slowdown in the economy is a long way from taking on melodramatic overtones.

Consumption remains strong with confidence somewhat higher thanks to dip in oil prices.

Retail sales continue to show notable strength. If we exclude sales of cars and petrol, because of their volatile volume in the first case and volatile price in the second, retail consumption grew by 6.9% year-to-year in August. However, there is something of a slowdown so far in 2006 with a trend toward increases of 6%. The slowdown is concentrated in construction materials and home goods, a logical result of the current situation in housing. Another sign of some weakness is the drop in consumption of food and drink in bars and restaurants and the fact is that, when things are not clear, it is better to eat at home and watch a video. After dropping in July, levels of consumer confidence found some support in August mainly thanks to the easing of oil prices mentioned above.

Business executives still see strength in state of economy.

In turn, while somewhat disappointing in August, industrial production is in better form than one year ago with growth at 4.7% year-to-year. While manufacturing jobs are not being created, there is a tendency in the sector to offer higher qualified jobs as a result of

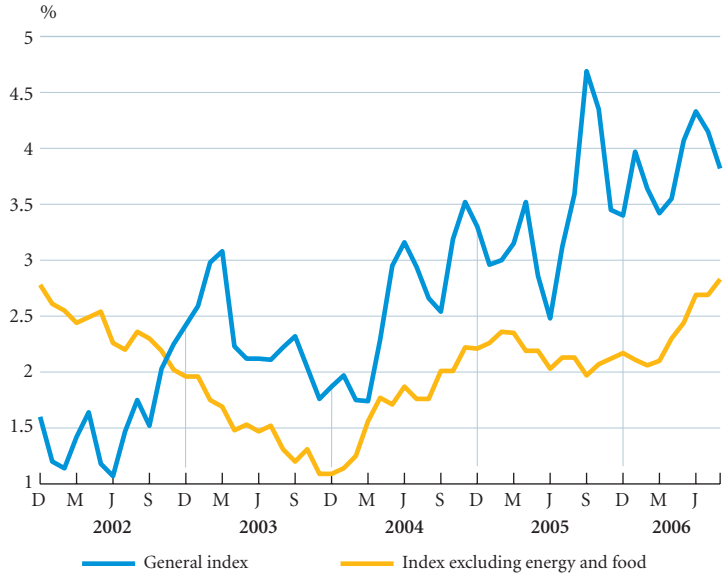
UNITED STATES: CONSUMERS KEEP ON SPENDING

Real retail sales excluding cars and petrol, annual change (*)

NOTES: (*) Figures deflated by price index excluding energy and food.
SOURCE: Departament of Commerce and internal figures.

UNITED STATES: UNDERLYING INFLATION GETS WORSE

Year-to-year change in CPI



SOURCE: Department of work and internal figures.

gains in productivity. Surveys on sector activity and business sentiment reflect this improved performance in the manufacturing sector with the index issued by the Institute of Supply Management for manufactures holding practically at stable levels in the high band as is also the case in services. The levels for August at 54.5 and 57.0 points respectively, both above 50, indicate that those who see improvement predominate over those who foresee a worsening of the situation.

The labour market is moderating with job creation that during the current growth period has never reached levels similar to that seen in other cycles. Wages are coming out of their lethargy without any great strength. Following the August revision, unit labour costs rose somewhat higher than expected. This either indicates inflationary pressures or lower corporate profits. The slowdown of the economy, the position taken by the Federal Reserve System, and corporate profits at all-time highs compared with wages indicate some moderation in wages is most likely.

On the prices front, things continue to improve. Growth of the consumer price index (CPI) in August stood at 3.8% year-to-year, down from the previous 4.2% thanks to oil prices and a base effect because of the distortion resulting from the Katrina hurricane disaster. In the core component there is an opposite situation. Growth in August was 2.8% year-to-year there continues to be an upward trend which, at this time, comes from negative base effects. Nevertheless, the latest monthly changes show a trend to moderation which, supported by a lower level of economic activity, should continue to take shape. Producer prices also support the thesis of lower increases.

Inflation down but no change in tendency yet.

The enormous trade deficit continues. The road to its correction is still not

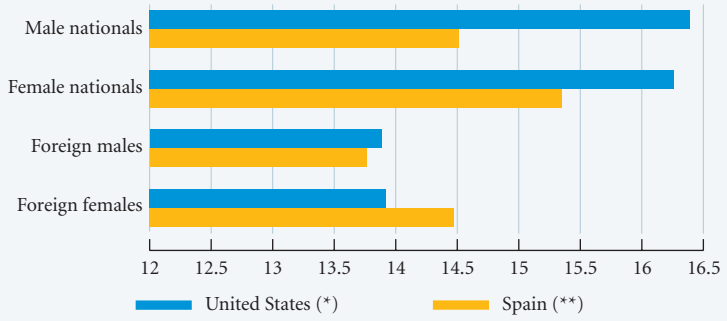
Immigration in Spain and United States: a question of gender

In May 1903 a boatload of immigrants reached the port of New York. Still suffering from the terrible conditions of the trans-Atlantic voyage, one of the immigrants was a Sicilian boy of six with the surname Capra. In only 30 years Frank Capra was to become the most successful film director of his time, the conscience of America in the harsh moments of the Great Depression and a firm believer in the ability of ordinary people to make things better.

Immigration can be a blessing or a problem. More immigrants means more people working and probably increased economic growth. The question is whether this growth also carries with it an increase in productivity and per capita income. A good academic education and being able to complement the local labour force, as well as the initiative already shown by the effort in leaving behind one's native country, all help to ensure the second aspect.

IMMIGRANTS IN SPAIN ARE RELATIVELY WELL QUALIFIED

Years of schooling (***)



NOTES: (*) 2003.
(**) Second quarter of 2006.
(***) Number of years is in terms of educational level reached.
SOURCE: National Institute of Statistics, US Census and internal figures.

The qualifications of foreign workers in Spain is relatively good although there is indeed a downward trend. One indicator of the level of qualification is the years of schooling weighted in terms of educational level reached. In 2003, in the United States, a country where immigration is of special importance, the period of schooling of foreign workers was nearly 14 years, well below the 16 and a half years for the rest of the population. The situation in Spain in June 2006 was surprising with a foreign worker population showing 14 years of schooling, only 9 months less than that of Spaniards. We do not take into account here the quality of schooling received nor its suitability for the demands of the labour market, although it is necessary to add that half of the immigrants in Spain come from Latin America so that language is not a problem.

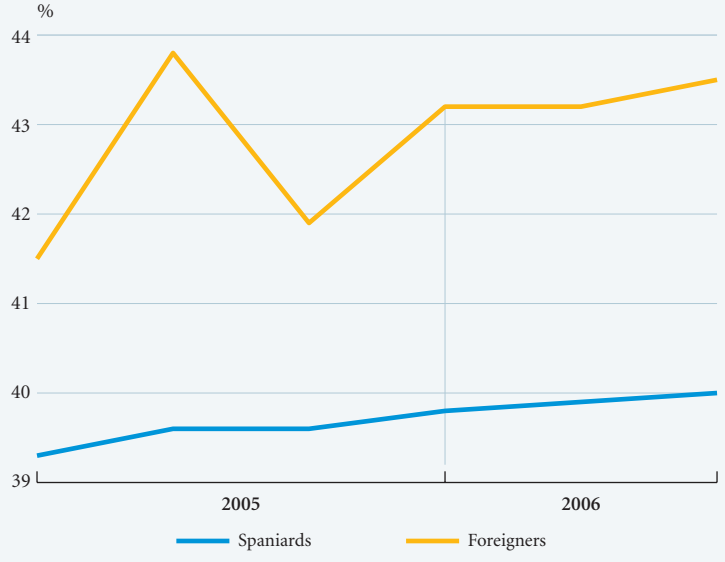
The downside is that, while in the case of the United States there was stability between 1998 and 2003, the situation in Spain seems to have deteriorated since the beginning of 2005, given that the difference in schooling between foreigners and Spaniards has gone up by three months. The main cause of this worsening lies in the change of origin of immigration, with a decrease in the percentage of Europeans, maintenance of the proportion of Latin Americans and an increase in those coming from other parts of the world.

Even with good academic credentials, many foreigners are underemployed because they have not mastered Spanish or because of the preferences of business executives in favour of national workers. It is not true, however, the idea that immigrants carry out work Spaniards do not want to do. Spaniards may reject jobs done by immigrants at the wages they obtain. But, if there were no foreign workers, a low job offer would increase the wages being offered in vacant jobs to the point where there were people ready to fill them. Therefore, there is the possibility that some sectors may exist that are hurt by the presence of foreign workers.

The key factor for lowering these costs is that recent arrivals be complementary to local workers. It would be difficult for the average American to emulate Frank Capra. Knowing whether nationals or immigrants are complementary is difficult to measure but a comparison of their respective job profiles, in what sectors one or the other is employed, may give us a clue. If we look at the percentage each sector represents out of total employment for each of the two groups, national or foreign, we can calculate the difference for each sector. If we add up the absolute values of these differences we obtain an indicator that, in the absence of other measurements, gives us a

FOREIGN WOMEN IN SPAIN JOIN LABOUR FORCE

Proportion of women working compared with total number holding jobs, according to origin



SOURCE: National Institute of Statistics and internal figures.

broad idea of the degree to which both groups are complementary. In the American case, if we take six macro-sectors of employment, the degree to which they are complementary thus measured grew by 12% between 1998 and 2003. For Spain, taking 45 sectors between the beginning of 2005 and June 2006, the difference held stable with a slight downward trend, which would appear to give some advantage to the United States.

It is interesting to examine the differences by sex. In the American figures, the degree to which a worker is complementary in employment in the case of male foreigners and US workers goes up by 26.1% in the case of women who make up 48.5% of immigrants. The story does not end here given that, while in academic qualifications women immigrants were merely one and a half months below men in 1998, in 2003 they had

gone just a little higher than men. Thus, in the absence of any disadvantage in qualifications and with a higher degree of being complementary, women seem to be the better bet for growth in the American case.

In the case of Spain, there has not been any exhaustive study of the degree to which females are complementary but the differential factor is that female immigrants work proportionally more than Spanish women, are better trained than their male counterparts and furthermore this characteristic is increasing. A growing 43.5% of all immigrants working are women as against a figure of only 40.0% that women represent of all Spanish workers. Their academic qualifications are close to one year higher than those of males.

It may be that, for many recently arrived Black Africans, Spain may not be the dreamed-about Shangri-La in the film by the famous director Capra but the female group, although less noted, is growing, is better trained and probably with a higher degree of being complementary to female Spanish workers. Thus, according to official figures, many immigrants, better qualified and with more potential than often supposed, may already be contributing to economic growth, silently and without excessive cost, while overcoming difficulties just as did the popular heroes of Frank Capra's films.

appearing clearly on the horizon but at least it has reached some stability. The doubt for many of those who are especially concerned (this applies to the Asian countries as well as to Europe) shows up in how gentle any future adjustment will be and whether this will come about through lower growth or by ceding to calls for protectionist policies with the dollar as the invited star playing an uncertain role.

Japan: growth based on investment

In Japan investment up 9% with 2% rise in consumption.

The Japanese economy continues its own particular growth cycle resting mainly on domestic demand. If before this private consumption was the main engine of the economy, at this time investment in capital goods is the most active component and in the second quarter this moved up by 9.2% year-to-year. This investment is still mainly directed toward the foreign sector, recently hurt by energy prices, a sector that took away from growth in the same period. Japan continues to be an economy of producers rather than one of consumers.

Stagnant retail sales and drop in car sales show private consumption at low ebb.

On the demand side, private consumption is holding up although more and more with a lower profile. In the second quarter it grew by 1.8% year-to-year, an acceptable rate but one below the norm for the present growth cycle. Showing a similar pattern, confidence levels continue in the high band although in the second quarter they lost ground compared with the high in the first quarter. Demonstrating greater weakness, retail sales in July were down by a sharp 1.6% over June and remained unchanged compared with the same period the year before while facing a downward trend. Also significant is the fact that, with prices moving into positive ground, retail consumption in terms of volume is now dropping.

Car sales have been losing ground over the past year and a half and in the 12 months ending in August they were 7.1% lower than the high for the current growth period which took place in mid-2005, some 25% lower than the absolute highs at the beginning of the Nineties. Housing was also down with a reduction in the volume of transactions in Tokyo in

JAPAN: MAIN ECONOMIC INDICATORS

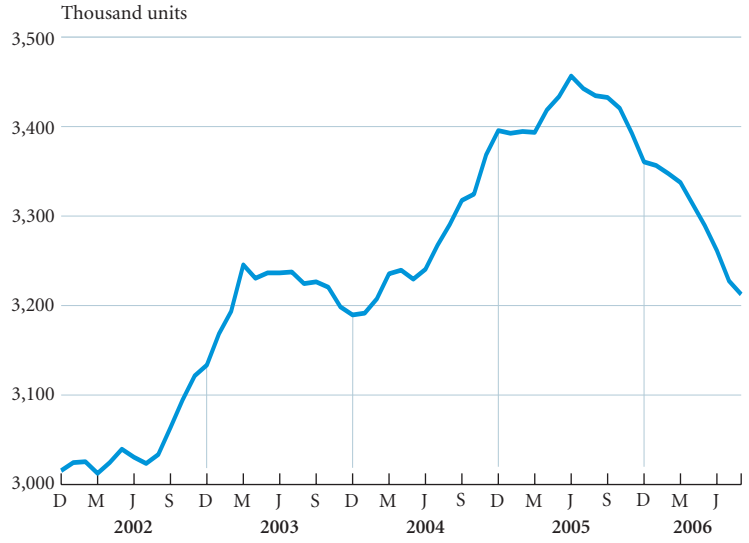
Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006				
			2Q	3Q	4Q	1Q	April	May	June	July
Real GDP	2.3	2.6	2.7	2.8	4.0	3.4	–	2.5	–	–
Retail sales	–0.9	1.4	3.1	1.1	0.7	0.6	–1.3	0.3	0.2	0.0
Industrial production	5.3	1.5	0.3	–0.1	3.6	2.8	3.3	2.8	5.1	5.0
Tankan company index (*)	20.5	18.0	18.0	19.0	21.0	20.0	–	21.0	–	–
Housing construction	2.6	3.8	2.2	4.9	6.9	4.9	15.2	6.7	4.7	–7.7
Unemployment rate (**)	4.7	4.4	4.3	4.3	4.5	4.2	4.1	4.0	4.2	4.1
Consumer prices	0.0	–0.3	–0.1	–0.3	–0.7	–0.1	–0.1	0.1	0.5	0.3
Trade balance (***)	13.9	10.2	12.1	10.9	10.2	9.5	9.1	9.2	9.1	9.2

NOTES: (*) Value.
(**) Percentage of labour force.
(***) Cumulative balance for 12 months. Billion yen.
SOURCE: OECD, national statistical bodies and internal figures.

JAPAN: CAR SALES DROPPING

Car sales in past twelve months (*)



NOTES: (*) Excluding vehicles under 550 cc.
SOURCE: Japanese Ministry of Communications, National Statistics Office and internal figures.

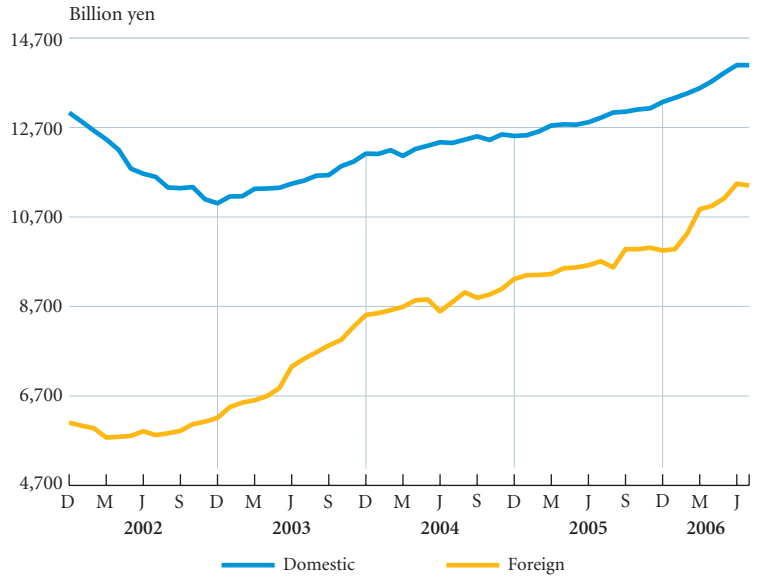
August at half those in July and with prices stagnant. The present moment is not comparable with the drop in the first half of the Nineties but the sector is draining away from growth and offers no stimulus to consumption.

On the supply side, things are definitely going better. Industrial production grew by 5.0% year-to-year in July to stand at the highest rate of increase in the current growth period. Machinery orders, both for foreign and domestic origin, are

Industrial production and machinery orders form positive side.

JAPAN: MACHINERY ORDERS GOING FULL-STEAM-AHEAD

Machinery orders in past 12 months



SOURCE: Japanese Ministry of Communications and internal figures.

following a clearly upward trend which is keeping up the strength of investment. In view of these figures, the traditional Japan, that is more involved in investment than in consumption, shows up more and more strongly although growth rates for investment are still a long way from previous growth figures at the beginning of the Nineties. In turn, the labour market remains stable with an unemployment rate of 4.1% in July. Worth noting here is the increase in manufacturing productivity which in Japan always coincides with the recovery of industrial production which shows that the country continues to be a competitive force in exports of the first order.

Brazil again goes flat with growth of 1.7%.

Somewhat less clear is the performance on inflation and how this is bringing about the end of the deflationary period. Following revision of the index, the component excluding fresh foods showed an increase of 0.2% year-to-year in August. This updating has put rates for price increases down so that the end of deflation is coming later than it was initially stated, with June showing up as the first month with price increases, thus coinciding more with the gross domestic product (GDP) deflator. It would therefore seem that the more restrictive monetary policy of the central bank could have been premature, which, along with the containment of government spending in recent quarters, is draining off from growth. The foreign sector continues to show strength based on the competitiveness of exports although imports and energy prices for the moment are darkening the picture.

Consumption holding up but investment failing.

Brazil losing strength

The Brazilian economy is beginning to see its macroeconomic situation becoming more complicated. Growth has slipped below 2% year-to-year with no important increases. In an economy with an unemployment rate of more than 15% it is not much use having inflation

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
Real GDP	4.9	2.3	0.9	1.5	2.6	1.7	–	...
Industrial production	8.3	3.1	1.4	1.3	4.6	0.8	3.2	...
Unemployment rate São Paulo (*)	18.8	17.0	17.2	16.4	16.3	16.9	16.7	16.0
Consumer prices	6.6	6.9	6.2	6.1	5.5	4.3	4.0	3.8
Trade balance (**)	3.7	44.8	41.2	44.8	45.7	44.6	45.2	46.1

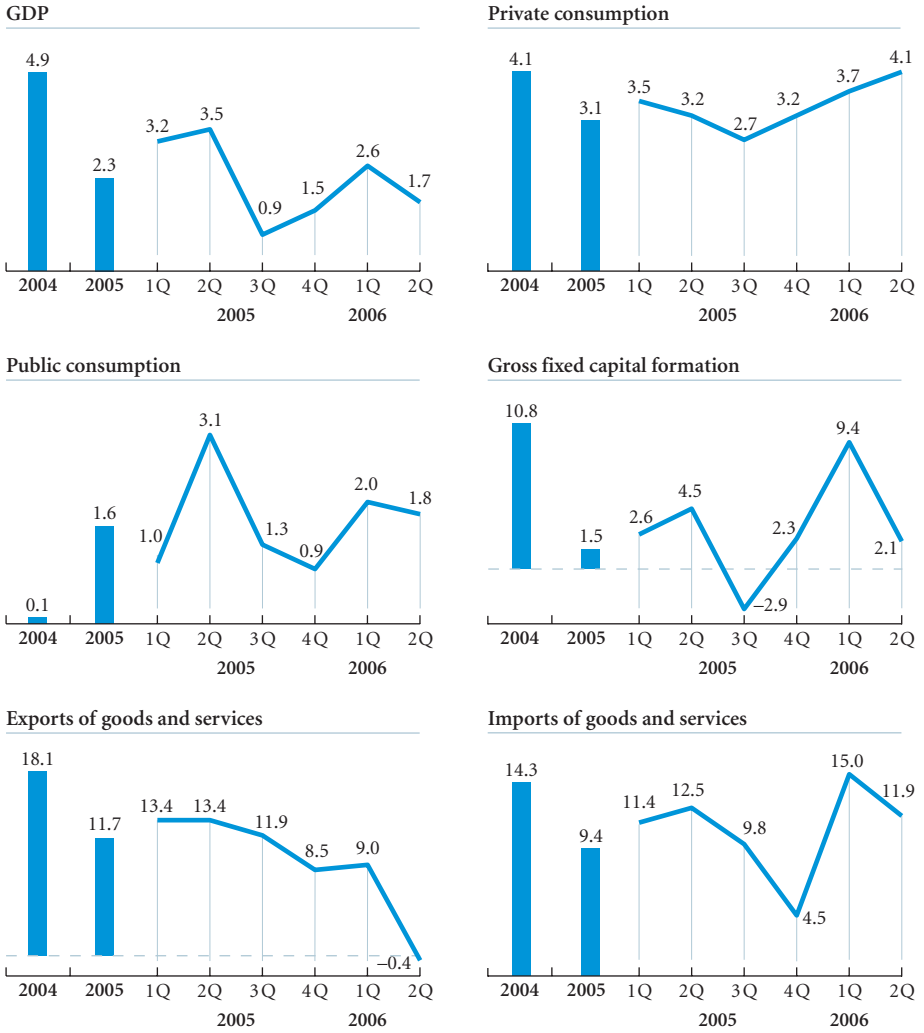
NOTES: (*) Percentage of labour force.

(**) Cumulative balance for 12 months. Billion dollars.

SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and internal figures.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-to-year change in real terms



SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and internal figures.

Demand indicators stay stuck in slack.

under control in order to quieten criticism of the government's management.

The GDP in the second quarter rose by 1.7% year-to-year. Private consumption was the component to show most strength with an increase of 4.1% although investment again showed signs of weakness with growth of a slime 2.1%, which puts the sustainability of the current cycle in doubt. The foreign sector also had a poor performance, mainly because of the stagnation in exports following a good trend in the past two years. The weak figure for the second quarter raises doubts about competitiveness and also reflects Brazil's dependence on purchases by economies such as China and the United States.

Inflation stands below 4% but unemployment still 16%.

Following the situation in recent months, the monthly indicators for demand and supply show a low profile with some stagnation. Retail sales in July continued to sharpen their slowdown with growth at a slender 2.3% year-to-year although car sales continued to show strong. Industrial production grew again in July after decreases in previous months but the rise of 3.2% year-to-year is not a big enough figure for the Brazilian economy.

Argentina grows by 8% thanks to consumption and investment.

Inflation continues to drop with prices, helped by a lower rate of economic activity, grew by a mere 3.8% year-to-year in July. A negative picture shows up in the high unemployment rate which in the São Paulo district held at 16.0% of the labour force in August.

Argentina running full-steam-ahead

Consumption maintains lead but inflation still a risk.

The Argentine economy continues its growth with something of a logical slowdown following various months of strong growth which has taken it above levels before the 2002 recession. Nevertheless, inflation and unemployment continue to be the two big unresolved questions troubling the public in Argentina and represent a latent risk to recovery which, up until now, has been surprisingly favourable.

The Argentine GDP grew by 7.9% year-to-year in the second quarter of 2006. Private consumption continued relatively stronger than the rest of the economy, stabilizing growth above 8%. The relative moderation in public consumption is positive thus cutting off a growth trend that had been gaining strength. The crucial investment in productive capital continued to advance strongly going up by 18.5% year-to-year and with signs of continued growth. The foreign sector was still showing a surplus but the drop in exports was somewhat disappointing in an international context that up to now has been favourable.

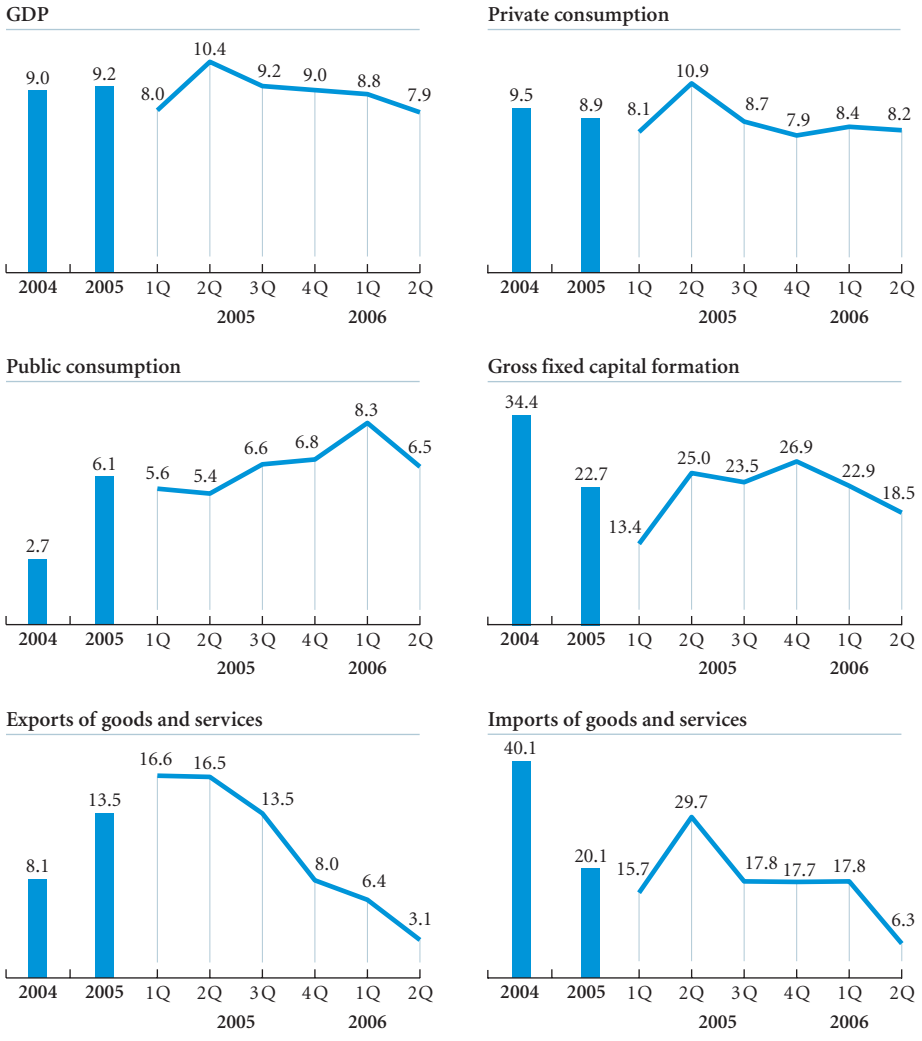
Demand indicators are consistent with the strength of growth. Retail sales slowed down in July but even so grew by 16.3% year-to-year while car purchases in the past 12 months ending in August moved up by 25%, gradually recovering levels of consumption before the recession.

On the supply side, growth is continuing although will less strength than some months back. Industrial production in August slowed to 5.7% year-to-year although indicators for industrial activity and construction were maintained.

Inflation in Argentina continues as the biggest risk for the stability of the current growth cycle. In May, the increase of 10.7% year-to-year meant a relative improvement compared with the levels at the beginning of 2006 but even so the increase in prices continues high, especially in the present context where

TREND IN ARGENTINA'S GDP BY COMPONENT

Percentage year-to-year change in real terms



SOURCE: National Institute of Statistics and Census of Argentine Republic (INDEC) and internal figures.

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
Real GDP	9.0	9.2	9.2	9.0	8.8	7.9	–	...
Industrial production	6.9	7.8	7.0	7.6	5.5	7.2	7.4	5.7
Unemployment rate (*)	13.6	11.6	11.1	10.1	11.4	10.4	...	...
Consumer prices	4.4	9.6	9.8	11.7	11.6	11.4	10.6	10.7
Trade balance (**)	12.1	11.4	11.5	11.4	11.4	11.8	11.5	11.3

NOTES: (*) Percentage of labour force.

(**) Cumulative balance for 12 months. Billion dollars.

SOURCE: National Institute of Statistics and Census, Republic of Argentina (INDEC) and internal figures.

ARGENTINA: FOREIGN SECTOR MANAGES TO MAINTAIN SURPLUS

Monthly figure for Argentine trade balance

SOURCE: INDEC and internal figures.

most of the Latin American economies have been able to install practical price stability. Another important problem is the unemployment rate which, while it went down to 10.4% of the labour force in the second quarter, still remains at a high level. The trade surplus has stabilized in recent months in spite of the fact that exports are slowing down.

Unexpected drop in oil prices

Oil drops 24% in less than two months...

On August 8, 2006, the one-month forward price of Brent quality oil per barrel stood at 78.49 dollars, an all-time high. On September 27 the per barrel price was 59.79 dollars. In a little less than two months, oil had plummeted by 24%. There had not been such a sharp correction at any time during the long upward climb of oil that began at the start of 2001. How do we explain this sharp downward move?

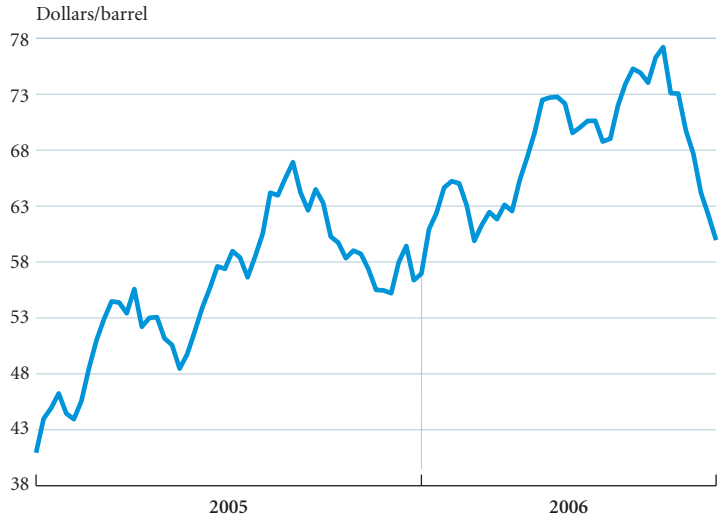
First, the geopolitical agreement bringing about a cease-fire in Lebanon and some easing of the conflict between Iran and the western powers. Second, expected oil demand was lower than anticipated due to the situation of world slowdown that has been the general consensus in recent times, a situation characterized by the combined economic slowdown in United States, Europe and China although in the latter case it has been of lesser degree.

In this respect, the Organization of Petroleum Exporting Countries and the International Energy Agency have substantially revised downward oil demand expected for 2006 and 2007. Finally, factors of a seasonal nature have also intervened such as the end of the high mobility season in the United States, known as the *driving season*, and a trend in inventories of distilled petroleum products which confirms a higher refinery margin, also in the United States.

Do these answer all the questions about the correction? Certainly not, given that the sharpness of the adjustment would rather seem to suggest a process of rapid

OIL PRICES: ARE THEY IN A FREE-FALL DECLINE?

1-month forward price of Brent oil as weekly average



SOURCE: Thomsom Financial Datastream.

change in expectations among those involved in the oil market. One measure of this process is the number of futures contracts being traded with a «buy» position, that is to say, the position of those investors who are expecting further increases in oil prices. If we take as a reference those players of a more speculative type in the New York market, the number of these contracts dropped by 18% from the highs at the beginning of August. This therefore seems to be the catalyst which must be added to the background factors mentioned above and the one that ends up causing the sharp drop in prices.

Other raw materials, on the other hand, have largely escaped from the sharply downward trend seen in oil. In September, «The Economist» index in dollars, which records the trend in raw materials as a whole, stood at levels 30% higher than those one year ago, a similar rate to that recorded in July and August. This sharp rate was mainly due to the heavy demand for metals which, as a whole, were up by 50% year-to-year in September. In any case, the specific trends in metals have been varied. In recent months, nickel, copper and silver have tended to drop while aluminium and zinc have held stable.

...due to reduced geopolitical tensions and some change in prospects for world economy.

Metal prices up 50% in one year.

EUROPEAN UNION

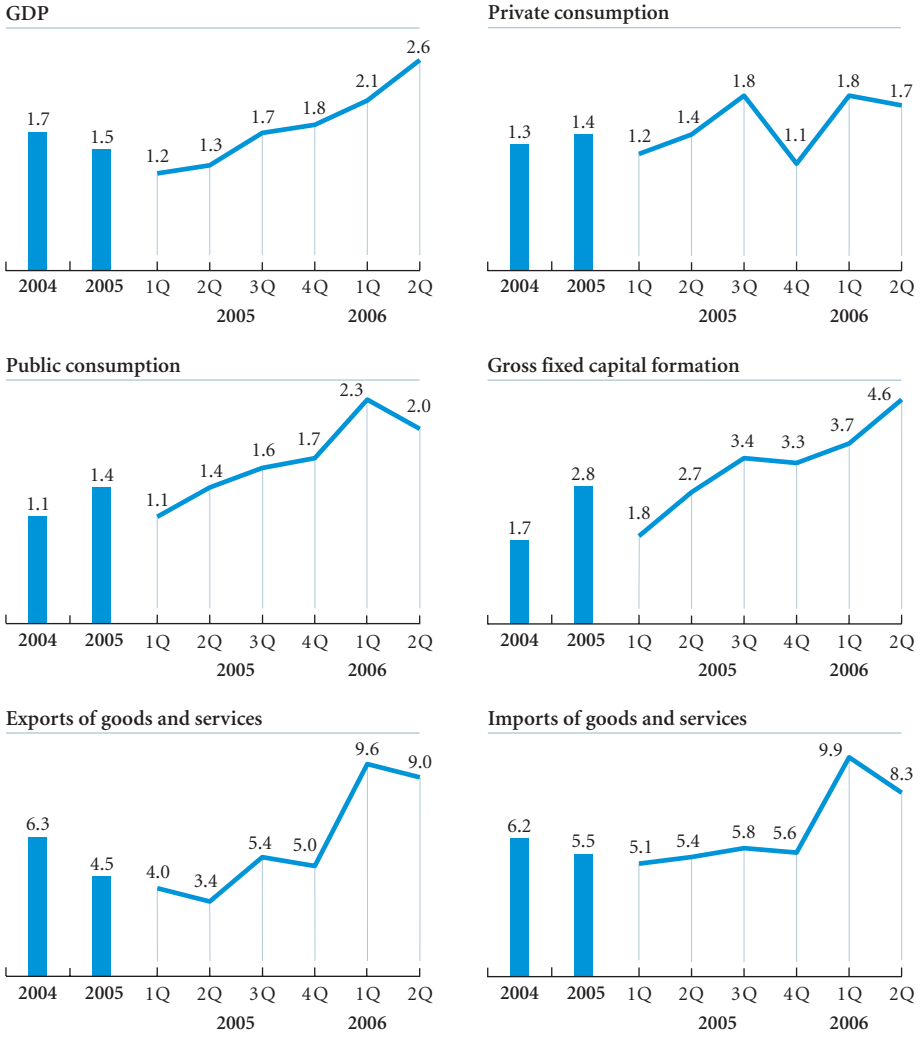
Sharp growth in Euro Area, 2.6% in second quarter, a favourable surprise.

Euro Area: economic recovery of short duration

Present indicators for the euro area are clearly positive. Economic growth at 2.6% year-to-year in the second quarter was the best since the first quarter of 2001. Immediate prospects, up to the end of the year, are also favourable, a shown by the revised forecasts by the main international bodies. The European Commission, which was expecting

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-to-year change



SOURCE: Eurostat and internal figures.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
GDP	1.7	1.5	1.7	1.8	2.1	2.6	–	...
Retail sales	1.5	1.3	1.5	1.2	0.9	1.7	2.5	...
Consumer confidence (*)	–14	–14	–15	–12	–11	–9	–8	–8
Industrial production	2.0	1.2	1.4	2.1	3.4	3.8	3.1	...
Economic sentiment indicator (*)	99.4	98.1	97.7	100.1	102.6	106.5	107.8	106.7
Unemployment rate (**)	8.9	8.6	8.5	8.4	8.2	7.9	7.8	...
Consumer prices	2.1	2.2	2.3	2.3	2.3	2.5	2.4	2.3
Trade balance (***)	80.4	43.5	36.4	25.1	6.9	–6.0	–17.2	...

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

growth of 2.1% for 2006 last Spring, now is predicting 2.5% and the same figures show up in the forecasts by the European Central Bank. The same change has been put out by the International Monetary Fund which, in its Autumn report, forecast 2.4% as against 2.0% expected in April. Finally, the Organization for Economic Cooperation and Development has gone slightly higher than the others, both for expected growth rate (2.7% in 2006) and for having revised its previous forecast by a half percentage point.

The big question now is whether this growth will last beyond the end of the year. The reply is not altogether favourable. A slowdown in 2007 could already be showing up somewhat strongly due to the fact that economic growth is being based on sources which could be of short duration. The make-up of growth in the second quarter shows that the increase in gross domestic product (GDP) was entirely due to the bigger contribution by the foreign sector and an increase in investment. Specifically, foreign demand went from contributing 0.1% to the change in the GDP in the first quarter to 0.4% in the second quarter, while gross fixed capital formation grew by 5% year-to-year, nearly one percentage point more than in the first quarter. On the other hand, both private consumption and public consumption slowed down slightly in the second quarter.

Dependence on foreign sector and lack of drive in consumption makes it difficult to maintain this growth rate...

Three main questions arise from this growth pattern so far as the sustainability of recovery is concerned. First, the growing dependence on the foreign sector is linking European growth to two developments which are seen as negative, namely the expected slowdown in the United States in 2007 and, to a lesser extent, in those emerging markets which are critical for European exports (mainly China and Russia) and the counter-competitive pressure on exports which will continue to result from the path of appreciation being followed by the euro.

A second consideration arises from the absence of any recovery in private consumption. Strong growth of household consumption would foster the development of a notable fund of

...although third quarter will no doubt be positive.

Consumer prices ease slightly while unemployment rate down.

resistance, if we take into account that it is a component that exhibits notable inertia. Unfortunately, the weak growth rate of private consumption does not make it possible to have the benefit of this effect.

Finally, a third consideration is that the remaining path of investment is expected to be moderate following five consecutive quarters on the rise, especially if we consider that its two key determinants (expected demand and financing terms) will tend to worsen in coming quarters.

These considerations do not imply a rapid slowdown. In fact, the most recent monthly indicators fully show the good state of economic activity at this moment. On the demand side, consumer confidence in July rose by one decimal and held to this figure in August, which points to some improvement in private consumption. On the supply side, recovery is more apparent with the trend in the economic sentiment indicator in July and August confirming that growth is extending into the third quarter. Nevertheless, industrial production provided a note of caution given that, after two consecutive months (May and June) with growth rates above 5% year-to-year, it slowed down to 3.1% in July.

Two other favourable factors could accompany this orderly slowdown in economic activity, namely some easing of inflationary pressures and recovery of the labour market. After marking up an annual high last June (2.5% year-to-year), the harmonized consumer price index (HCPI) dropped by two decimals to stand at 2.3% in August. On top of this recovery of the general index comes the notable stability shown by core inflation, that is excluding the most volatile components. With regard to the labour market, we should mention that the unemployment rate dropped to 7.8% in June and July, one decimal below the May figure, while job creation in the first quarter stood 0.9% above the level seen one year earlier.

Germany enjoying strong growth although prospects less optimistic.

Germany: present situation good but prospects uncertain

Germany exemplifies the two faces of the current European economic situation. The present situation is positive, in fact the most favourable for many years, but future prospects are worsening relatively fast, which points to a period of slowdown in the coming year. Available indicators for the third quarter underline the current strong points of the current economic situation. On the demand side, investment continues to grow, as shown by the trend in the capital goods component of industrial production (growth of 5.6% year-to-year in July as against 5.2% year-to-year on average in the second quarter).

On the supply side, the main beneficiary of growth has been the secondary sector. So far this year, industrial production has been running on a very strong growth path which rose to an increase of 4.7% year-to-year in July. This is a sector that is largely capitalizing on the good state of foreign markets (exports have been increasing by more than 10% year-to-year since the beginning of 2006).

With regard to prices, the trend, which has never been considered overly troubling, has been put straight. In September the CPI went down to 1.0% year-to-year largely due to the fact that the rise in energy is lower than that recorded one year earlier. The trend in unemployment is also better going from

GERMANY'S RECOVERY SHOWING SLOWER GROWTH

Figure for IFO industrial activity index

SOURCE: IFO Institute.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006				
			3Q	4Q	1Q	2Q	July	August	September
GDP	0.8	1.1	1.5	1.7	1.7	2.4	–	...	–
Retail sales	2.1	1.2	1.4	0.1	0.9	0.6	0.0	1.0	...
Industrial production	2.4	2.9	3.1	4.7	4.6	4.9	4.7	...	
Industrial activity index (IFO) (*)	95.5	95.5	95.4	98.7	103.6	106.1	105.6	105.0	104.9
Unemployment rate (**)	10.5	11.7	11.7	11.4	11.3	11.0	10.6	10.6	10.6
Consumer prices	1.7	2.0	2.2	2.3	2.0	1.9	2.0	1.7	1.0
Trade balance (***)	149	157.2	157.2	160.3	157.5	154.1	150.7	...	

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

the 11.4% level last January to 10.6% in September.

Another exponent of the current good state of the economy is the recent announcement by the German minister of finance, Peer Steinbrück, that Germany's government deficit in 2006 would be 2.8% of the GDP due to the fact that tax collections are 8% higher than forecast which represents between 16 and 18 billion euros more than anticipated in the federal budget. This is the first time in four years that the

Industrial sector big beneficiary of growth.

Improved tax collections will allow government deficit to drop below 3% of GDP in 2006.

imbalance in Germany's finances will go below the level required by the EU Stability and Growth Pact.

In spite of this current good situation, economic circles still see significant uncertainties about the future. The IFO indicator for industrial activity reflects the cooling down of prospects shown over the past three months (from June to September) when it has dropped by close to two points. Underlying this dip are risk factors perceived (the trend in the foreign exchange rate, tax adjustments, and the slowdown in the world economy) along with other more tangible factors such as the drop beginning to show up in industrial orders. Other indicators of a qualitative nature, such as the ZEW index, which reflects the opinion of a broad sample of economic and financial analysts, point in the same direction of worsening prospects.

In France, growth stage will continue until presidential elections in Spring 2007.

France: presidential elections on horizon

An important political race has begun with all eyes on the presidential elections in the Spring of 2007. In this context, the economic situation will run in line with government moves in economic policy which will have as its main innovation reform of personal income tax to come into force as of January 2007. The general economic situation will be positive given that in the second quarter France grew by 2.6% and this drive is expected to continue well into 2007. Nevertheless, in line with the other large Euro Area economies, medium-term prospects are for less growth.

Domestic demand clearly recovering.

French recovery is being based mainly on the strength of domestic demand which, if we are to go by available indicators, is holding up in the third quarter. In August, domestic consumption was up 6.4%, a very expansionist rate and higher than that shown in June and July. The recovery of consumer confidence, close to four points in July, raises hopes that household spending will tend to keep rising in coming months. The gradual reduction in the unemployment rate (8.9% in July) and the better trend in employment are the factors lying behind this strong drive in consumption. Along with these factors, price stability (inflation held at 1.9% year-to-year between June and August) should

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
GDP	2.0	1.2	1.4	1.0	1.4	2.6	–	...
Domestic consumption	3.8	2.9	4.1	2.3	2.9	4.7	3.7	6.4
Industrial production	2.0	0.0	0.3	–0.7	0.4	1.8	1.3	...
Unemployment rate (*)	10.0	9.9	9.9	9.7	9.6	9.1	8.9	...
Consumer prices	2.1	1.7	1.9	1.6	1.8	1.9	1.9	1.9
Trade balance (**)	0.1	–1.3	–1.5	–1.8	–2.0	–2.1	–2.3	...

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

contribute to giving some stability to growth.

On the other hand, the weakness in industry (in July industrial production rose by 1.3% at year-to-year rate, half that of June) confirms the difficulties to be seen in the secondary sector. While the poor trend in car production has been subject to much attention, the all of the main branches of activity are now moving into a downward trend.

Industrial production remains at low ebb.

broadest of supply indicators, the economic sentiment index, rose in July and August adding a rise of close to four points. As a significant exception to this improvement on the supply side, we should mention that industrial production came out with a negative surprise in August. That month it dropped to 0.8% year-to-year in clear contrast to growth of more than 2% year-to-year recorded in June and July. The worsening shown in the trade balance, a sign of export problems, is a determining factor in this poor state of the secondary sector.

Italian consumption seems to be leaving worst behind.

Italy: a minor recovery

The Italian economy began the third quarter along the same lines as that seen in the first half of 2006, namely a gradual recovery with progressively greater involvement of domestic demand. At least this is suggested by some recovery in retail sales which were up by 1.1% year-to-year in August, as against an average rise of 0.5% year-to-year in the second quarter. The slight improvement in consumer confidence in August raises hopes of a continuation of this trend in household consumption.

At the same time, on the supply side, recovery continues to take shape. The

With regard to prices, the CPI moved up by 2.2% year-to-year in August, a rate approximately the same as has been showing up since the beginning of the year. The unemployment rate, in turn, continued to benefit from the better state of the economy and in the third quarter recorded a drop to 7.0% of the labour force (7.3% in the second quarter). Overall, immediate prospects for the Italian economy are moderately favourable although the budgetary adjustment forecast, some 30 billion euros, could contribute to reduce growth in 2007.

Export problems continue to be hampering industrial activity.

Inflation still in range of 2.2% while unemployment drops to 7%.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
GDP	0.1	0.9	0.0	0.1	0.5	1.6	–	1.5
Retail sales	2.0	–0.4	–1.2	0.3	1.9	0.5	1.3	1.1
Industrial production	–0.6	–0.5	–1.3	–0.1	0.4	2.9	2.3	0.8
Unemployment rate (*)	8.4	8.0	7.8	7.6	7.5	7.3	–	7.0
Consumer prices	2.7	2.2	1.8	2.0	2.2	2.1	2.3	2.2
Trade balance (**)	2.3	–5.3	–6.4	–9.2	–12.2	–15.9	–18.0	–19.7

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

United Kingdom: consumption running wild

British recovery based on private consumption which continues to grow.

The rise in growth in the second quarter (the GDP grew by 2.6% year-to-year, three decimals more than in the first quarter) was basically due to the strong performance in consumption. Now it is a matter of trying to see if this upward move will continue. Available indicators for the third quarter show that indeed private consumption continues in a growth stage, given that the most significant indicator, retail sales, was up by more than 4% year-to-year in July and August. While consumer confidence had slightly worsened as of August, maintenance of the unemployment rate at all-time low levels (3.0% in August) puts a limit on decreases in this area.

Inflationary pressures not easing.

From a sector point of view, growth is mainly benefiting services. Industry, on the other hand, has stayed in the band of year-to-year decreases since last April (specifically in July the drop was 0.5% year-to-year).

With regard to foreign demand, the trade imbalance continues to widen. In July, as a cumulative balance for 12 months, the trade deficit reached 78.4 billion pounds sterling, a figure 23% higher than that recorded one year ago. The flood of imports, natural in a situation of strong growth in domestic demand, was behind this continuing deficit. Another result of the growth of domestic demand is to be seen in the persistent inflationary pressures. In August, the CPI rose by two decimals to 3.3% year-to-year.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
GDP	3.3	1.9	1.8	1.8	2.3	2.6	–	...
Retail sales	5.9	1.9	0.9	2.7	1.8	3.5	4.2	4.3
Industrial production	0.8	–1.8	–1.6	–2.6	–1.0	–0.7	–0.5	...
Unemployment rate (*)	2.7	2.7	2.7	2.8	2.9	3.0	3.0	3.0
Consumer prices	2.2	2.2	2.4	2.3	2.2	2.8	3.1	3.3
Trade balance (**)	–56.1	–64.6	–65.1	–67.3	–72.1	–76.0	–78.4	...

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion pounds.
SOURCE: OECD, national statistical bodies and internal figures.

Where is the Polish plumber? Myth and reality on immigrant flood from the East

The reference to the «Polish plumber» came to the fore during the French campaign on the European Constitution. It reflected the fear that a wave of people from the new member states of the European Union (EU) from Central and Eastern Europe would take jobs away from nationals of the 15 countries making up the EU before the extension coming into force on May 1, 2004.

This fear has come about every time a relatively less prosperous state has joined the EU, as in the case of Spain and Portugal in 1986. The fact that in the case of Spain, to cite a relevant example, there was no significant movement of workers was due, according to those who are in favour of establishing some restrictive mechanism on the free circulation of persons, to the fact that Spain's per capita income level at that time stood at two-thirds of the EU average. Now, the new member states as a whole scarcely reach 40% of that average.

This reasoning ended up led to all the member states of the EU-15, with the exception of the United Kingdom, Sweden and Ireland, opting to restrict the free circulation of workers during a transition period which, if fully applied, could last over a period of 7 years up to 2011. Is this fear and restriction based on objective reality? Is there indeed a flood of immigrants taking place from Central and Eastern Europe to those countries where there are no restrictions? Are they taking jobs away from national workers? Are they pushing wages down in the countries that accept them?

LIMITATIONS TO FREE CIRCULATION OF WORKERS FROM COUNTRIES INCLUDED IN LAST EXTENSION

From May 2004 to April 2006	The free circulation of workers from these countries was not applied with the exception of those member states which voluntarily decided to allow the same: Ireland, United Kingdom and Sweden. In the others, national quotas arising from bilateral agreements prior to extension were maintained.
From May 2006 to April 2009	Before May 2006 member states had to communicate if they continued to apply the restriction. If this was in the affirmative, the member state could abandon the prohibition at any moment up to April 2009. As of this time, Spain, Finland, Greece and Portugal have announced the end of the restriction on free circulation of workers.
From May 2009 to April 2011	As a general principle, in 2009 the free circulation of workers must be fully applied although up to 2011 there is a safeguard clause which allows a return to restrictions. As the same time, if a member state considers that there are exceptional upsets it can delay full application of restrictions to 2011.

SOURCE: Internal figures.

Flow of immigrants

To answer these questions calls for prudence in using the few statistics available, statistics which were not specially conceived for recording those flows. Of the three member states to which the new European citizens may freely immigrate, the British case is the one that is of most interest, both because of its economic size and the fact that it has precisely introduced a specific permit to control worker immigration from the new member states. As a result, workers from Slovakia, Slovenia, Estonia, Hungary, Latvia, Lithuania, Czech Republic and Poland (hereinafter called the EU-8) must register in the *Worker Registration Scheme* (WRS) during the first 30 days of occupying a job. According to available figures, between May 2004 and September 2005, some 290,000 workers from the EU-8 settled in the United Kingdom.

This figure must be taken with some caution as it is upwardly biased. A considerable number of EU-8 nationals who were already living in the United Kingdom before May 1, 2004 opted to register in the WRS. According to some estimates, this group could represent a third of the total, that is 100,000 persons. In any case, even taking the official figure as it is, this is a group which scarcely represents 0.4% of the British population of working age. In fact, in 2004, the first year of the extension, the number of Polish plumbers in the United Kingdom was a mere 95 persons. It does not seem that the anti-European slogan has any bearing on reality or that British plumbers are seriously threatened.

Nevertheless, before the extension, the government put out forecasts for the entry of workers from the EU-8 that were substantially lower, of the order of 15,000 persons a year. These estimates were surely a combination of wishful thinking intended to ease acceptance of a socially controversial measure and economic analyses available at that time. In most cases, available estimates gave a figure of the order of 200,000 immigrants a year for the whole of the EU-15 in the early years following the extension which would then drop substantially with the trend finally turning around over the long term. One of the factors that could explain the error in the forecasts is that the setting of restrictions in practically all cases of the EU-15 has diverted immigration to those few states with no restrictions.

This has brought about a lively debate in the United Kingdom, especially on the need now to establish restrictions on the free movement of workers from those states which will make up the EU in the future. Specifically, both social spokespersons and politicians are suggesting the application of measures to limit the entry of workers from Romania and Bulgaria which are to join the EU in 2007.

Finally, and here we refer to the possible flood of immigrants, the conclusion to be reached is that indeed the arrival of persons has been higher than forecast but, if we take into consideration the size of the British economy, it does not seem that there are any significant problems in absorbing those workers.

Taking away jobs

The second fear, namely the replacing of national labour by new recent arrivals, is quickly discounted if we analyze the British case. If the replacement of one group by the other had taken place, the employment rate of the group of workers from the EU-8 in the United Kingdom would have shown an increase whereas that for British nationals would have decreased. According to an analysis by Portes and French there has indeed been an improvement in the employment rate of workers from the EU-8 in the United Kingdom since the opening of the borders with the figure going from 60% to 75% approximately.[1] Nevertheless, this improvement does not appear to have taken place at the cost of British workers given that in this group the employment rate has remained at 75% since the extension.

There are two explanations for this phenomenon. First of all, the EU-8 workers are settling into sectors where there is a scarcity of labour. A second factor is that the work qualifications of the immigrants is precisely that suitable for the labour markets of the receiving countries. It is noted that labour immigration from countries of Central and Eastern Europe is clearly complementary in nature and not a substitute for national labour.

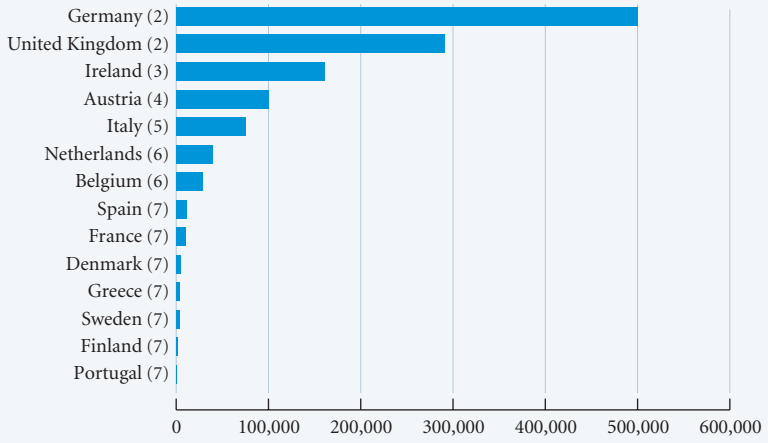
(1) Portes, Jonathan; French, Simon (2005). «The impact of free movement of workers from Central and Eastern Europe on the UK labour market: early evidence», Working Paper No. 18, Department for Work and Pensions (DWP).

Wages

Finally, the third case of fear, that immigration would depress wages, has not been proven, according to available reports. According to the study by Portes and French quoted earlier, average wages in the British economy have continued to grow at the rate they showed before May 2004. Indeed, in the farm sector, where a large part of employment of workers from the EU-8 is concentrated, we note a growth trend in wages. In fact, these are logical results if we take into account that, as mentioned earlier, the arrival of immigrant workers from Central and Eastern Europe has been relatively small and is not a matter of workers who displace but of workers who complement. For this reason, the possible pressure on wages must also be moderate or nil. In any case, both in terms of the effect on employment and on wages, empirical analysis is complex, given that it is very difficult to evaluate how these variables may have changed in the absence of immigration.

IMMIGRATION FROM CENTRAL AND EASTERN EUROPE LIMITED AND GEOGRAPHICALLY CONCENTRATED

Number of immigrants from EU-8 (1) since joining European Union



NOTES: (1) EU-8: Slovakia, Slovenia, Estonia, Hungary, Latvia, Lithuania, Czech Republic and Poland.
(2) From May 2004 to September 2005.
(3) From May 2004 to November 2005.
(4) From January 2004 to June 2005.
(5) From January 2004 to September 2005.
(6) From January 2004 to December 2005.
(7) From January to December 2004.
SOURCE: European Commission based on administrative figures supplied by member states.

Up to what point can these conclusions based on the British case be extrapolated to the countries of the European Union as a whole? Available evidence, while limited, would suggest that most of the above results hold for the other member states. According to a recent study by the European Commission, the hypothesis of the complementary nature of immigrant workers and the local labour force holds up at the level of distribution by sector and skills.[2] As in the British case, this is a matter of coherent results involving a relatively moderate movement of persons.

(2) European Commission (2006). Report on the functioning of the transitional arrangements set out in the 2003 Accession Treaty (period from May 1, 2004 to April 30, 2006). COM (2006) 48 final. Brussels.

FINANCIAL MARKETS

Monetary and capital markets

Trichet fearful of inflation

Central banks not dropping guard.

In recent weeks, the price of oil has dropped considerably from the all-time high recorded in the second week of August and inflation prospects have eased to some degree. Nevertheless, the central banks are not letting down their guard as they feel that there are still increasing risks of inflation. In any case, given the different position of the various economies in the cycle and in their corresponding monetary policies, a variety of responses on the part of central banks are been seen.

Federal Reserve System maintains interest rate and upward bias.

In the United States, the rise in labour costs brought fears of a further rise in official interest rates. Nevertheless, new more moderate figures on inflation and the drop in oil prices calmed things down making a tightening of monetary policy less likely. The Federal Reserve System did not change official interest rates at its meeting on September 20, as had been anticipated, due to the cooling down of the real estate market and the easing of inflationary pressures. Nevertheless, in its press release it continued to leave open the possibility of a later rise should inflationary risks break out.

Monetary authorities in Hungary, Sweden and Switzerland raise official interest rates...

The Governing Board of the European Central Bank also made no change in its reference rate at its meeting at the end of August. Nevertheless, chairman Jean-Claude Trichet toughened his anti-inflation message indicating a possible further tightening at the beginning of October and that this could be continued. This move would be based on economic growth forecasts of 2.2%-2.8% in 2006 and 1.6%-2.6% in 2007, figures corrected upward. It would also be based on inflation forecasts of 2.3%-2.5% in 2006 and 1.9%-2.9% in 2007, figures also corrected slightly upward because of oil prices. Trichet was very clear in pointing out that inflation risks were high due to a possible rise in oil prices, the shift of raw materials prices to other prices and wages. As a result, it seems likely that the Eurosystem interest rate will end the year at 3.50%. The question is: will Trichet change his predictions following the drop in crude oil prices?

In Japan, expectations of a further early rise in official interest rates have cooled off. This was due to the fact that the revised consumer price index showed a slim annual increase in prices and to publication of other moderate economic indicators. In any case, while it may have been postponed, the next rise in the official interest rate is being held in reserve and could happen toward the end of the year if economic recovery is not derailed.

At the end of August, the Central Bank of Hungary raised its reference rate by 50 basis points to 7.25% in view of the worsening situation on inflation. Two days later, the Central Bank of Sweden raised its official rate by 25 basis points to 2.50%. In the middle of September, the Bank of Switzerland rose its reference bad by 25 basis points to 1.25%-2.25% thus gradually continuing the normalization of its monetary policy position.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euríbor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2005									
August	2.05	2.13	2.22	3.43	3.80	0.09	4.53	4.59	0.76
September	2.06	2.14	2.22	3.60	3.91	0.09	4.50	4.60	0.76
October	2.06	2.20	2.41	3.75	4.17	0.09	4.50	4.59	0.81
November	2.06	2.36	2.68	4.00	4.35	0.09	4.50	4.62	0.95
December	2.28	2.47	2.78	4.16	4.49	0.09	4.50	4.64	1.02
2006									
January	2.30	2.51	2.83	4.26	4.60	0.10	4.50	4.60	1.01
February	2.31	2.60	2.91	4.50	4.76	0.11	4.50	4.58	1.09
March	2.56	2.72	3.11	4.54	4.92	0.12	4.50	4.59	1.21
April	2.58	2.79	3.22	4.75	5.07	0.13	4.50	4.63	1.28
May	2.58	2.89	3.31	5.00	5.18	0.19	4.50	4.70	1.40
June	2.76	2.99	3.40	5.03	5.38	0.31	4.50	4.73	1.48
July	2.80	3.10	3.54	5.25	5.50	0.40	4.50	4.73	1.53
August (*)	2.98	3.22	3.61	5.25	5.42	0.44	4.75	4.94	1.61
September (1)	3.00	3.41	3.72	5.25	5.37	0.44	4.75	5.07	1.81

NOTES: (*) Provisional figures.
(1) September 28.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 6-3-03 (2.50%), 5-6-03 (2.00%), 1-12-05 (2.25%), 2-3-06 (2.50%), 8-6-06 (2.75%), 3-8-06 (3.00%).
(3) Latest dates showing change: 9-8-05 (3.50%), 20-9-05 (3.75%), 1-11-05 (4.00%), 13-12-05 (4.25%), 31-1-06 (4.50%), 28-3-06 (4.75%), 10-5-06 (5.00%), 29-6-06 (5.25%).
(4) Latest dates showing change: 10-7-03 (3.50%), 6-11-03 (3.75%), 5-2-04 (4.00%), 6-5-04 (4.25%), 10-6-04 (4.50%), 5-8-04 (4.75%), 4-8-05 (4.50%), 3-8-06 (4.75%).
(5) Interbank offer rate.
SOURCE: National central banks, Thomson Financial Datastream and internal figures.

On the other hand, the improvement in inflationary prospects led the Bank of Brazil to cut its reference rate to 14.25% at the end of August. In the second week of September the Central Bank of Indonesia again dropped its official interest rate by 50 basis points setting it at 11.25%.

Yen at very low levels

Following a slight depreciation in July and August, the dollar rose to some extent in the early weeks of September aided by an interest rate differential in its favour in terms of the main currencies. In sum, so far this year it has shown a drop of around 3% in terms of a broad basket of currencies. With regard to future prospects for the US currency, it will likely have a tendency to continue along a path of depreciation, under the pressure of its massive foreign deficit. The recent G7 meeting in Singapore examined the matter of global imbalances and interest rates and came out hoping for greater exchange rate flexibility, referring to some Asian currencies, such as the yuan. The Chinese authorities, however, scarcely acknowledged they had heard.

...while Brazil and Indonesia make cuts.

EXCHANGE RATES OF MAIN CURRENCIES

August 2006

	Final session of month		Monthly figures				*Exchange rate September 28, 2006*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2)			
				Monthly	Over December 2005	Annual	
Against US dollar							
Japanese yen	117.4	2.4	116.0	0.2	–2.1	4.9	*117.8*
Pound sterling (1)	1.904	1.9	1.893	2.6	8.5	5.5	*1.876*
Swiss franc	1.232	0.1	1.232	–0.3	–5.6	–2.4	*1.248*
Canadian dollar	1.104	–2.5	1.119	–0.8	–3.7	–7.1	*1.111*
Mexican peso	10.91	0.0	10.87	–1.1	2.3	1.8	*11.05*
Nominal effective index (4)	*107.7*	*–0.3*	*107.8*	*–0.7*	*–3.6*	*–2.6*	*108.1*
Against euro							
US dollar	1.285	0.7	1.281	1.0	8.1	4.2	*1.271*
Japanese yen	150.6	3.3	148.5	1.3	5.7	9.2	*149.6*
Swiss franc	1.575	0.2	1.578	0.6	1.9	1.6	*1.584*
Pound sterling	0.674	–1.5	0.677	–1.6	–0.4	–1.3	*0.677*
Swedish krona	9.267	0.4	9.210	–0.1	–2.4	–1.4	*9.262*
Danish krone (3)	7.459	0.0	7.461	0.0	0.1	0.0	*7.460*
Polish zloty	3.938	0.0	3.905	–2.3	1.4	–3.4	*3.979*
Czech crown	28.21	–1.1	28.19	–0.9	–2.7	–4.7	*28.43*
Hungarian forint	274.7	0.9	274.4	–1.1	8.6	12.2	*273.3*
Nominal effective index (5)	*104.7*	*0.4*	*104.4*	*0.2*	*3.7*	*2.1*	*104.2*

NOTES: (1) Units to pound sterling.
(2) Percentages of change refer to rates as shown in table.
(3) Danish krone has central parity of 7.46038 against euro with fluctuation band of ±2.25%.
(4) Broad nominal effective index of US Federal Reserve Board. Calculated as a weighted average of the foreign exchange value of the US dollar against the 26 currencies of those countries with greatest volume of trade with the United States. Base: 1-1997 = 100.
(5) European Central Bank nominal effective exchange rate index for the euro. Calculated as a weighted average of the bilateral value of the euro against the currencies of the 23 main trading partners of the euro area. Base: I-1999 = 100.
SOURCE: Thomson Financial Datastream and internal figures.

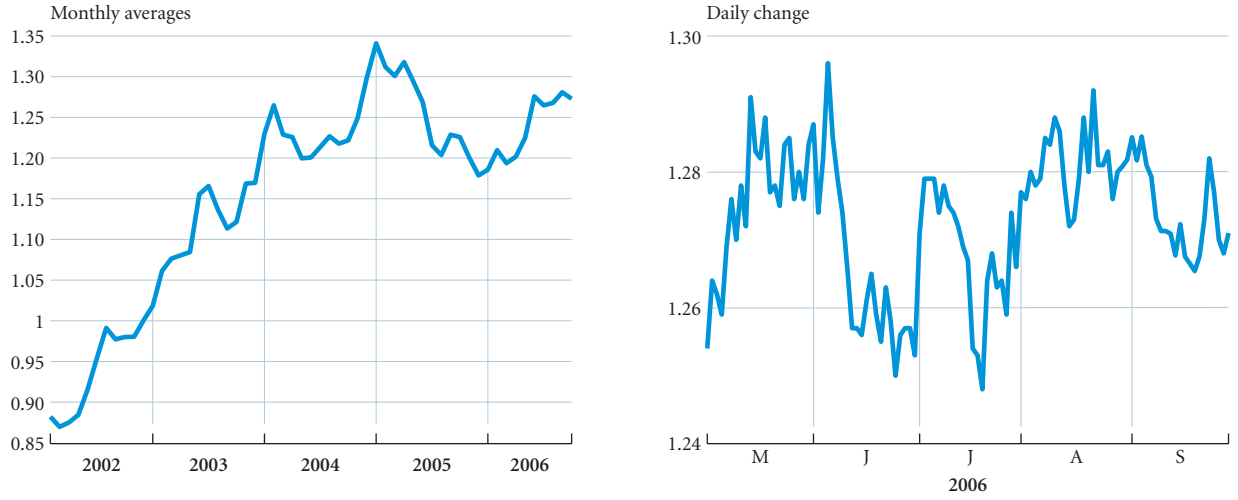
Lower economic growth prospects in Euro Area have negative effect on euro.

The euro marked up an annual high in relation to the currencies of its main trading partners at the beginning of the fourth week in August. Nevertheless, the euro later dropped slightly with the lower prospects for economic growth. Nevertheless, it maintained an appreciation of more than 3% compared with a broad basket of currencies compared with December 2005. In terms of the dollar, the European currency went from 1.29 dollars in mid-August to around 1.27 in the last week of September. In any case, the euro showed a rise of 8% in against the greenback in the course of the year. In terms of the Japanese yen, the euro recorded an all-time high at the end of August with an exchange rate of 150.6 yen. Since then it has depreciate only slightly against the yen. The coordinated efforts of the European Central Bank and Japanese political leaders to force greater depreciation of Japan's currency later gave way to declarations of indifference by the country's new finance minister Koji Omi.

The pound sterling tended to strengthen in the early weeks of September with

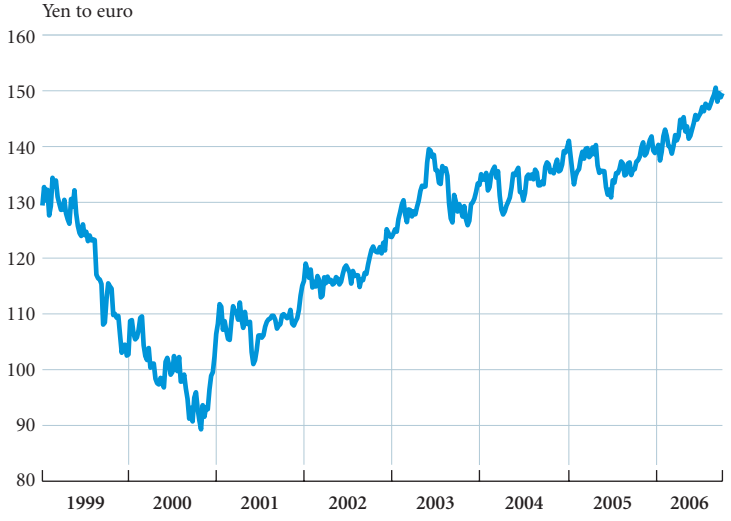
EURO DROPS AGAINST DOLLAR

US dollars to euro



NOTES: Figures go up to September 28.
SOURCE: OCDE, Thomson Financial Datastream and internal figures.

EURO MARKS UP ALL-TIME HIGH AGAINST YEN AT END OF AUGUST



NOTES: Figures go up to September 28.
SOURCE: Thomson Financial Datastream.

increasing prospects of a further rise in the Bank of England official interest rate this year following the increase in inflation in August. Nevertheless, in the final week of the month it dropped substantially following the downward revision of inflation on goods and services produced by British companies. Against the dollar, the pound dropped slightly although it maintained a rise of 9% since the beginning of the year.

Pound sterling has ups and downs.

Euro Area and Japanese politicians put pressure in favour of appreciating yen but later Japan's new finance minister adopts position of indifference.

The Japanese yen hit its lowest level since October 1998 compared with a broad group of currencies in the fourth week of September, depressed by expectations of a postponement of rate increases by the Bank of Japan. As a result, the yen was hurt by unfavourable high interest rate differentials which brought about moves in borrowing in yen and investment in other currencies with higher interest rates. At the same time, in real effective rates, that is to say, taking into account inflation differences as well as the nominal exchange rate, the yen stood at its lowest level in twenty and a half years and remains undervalued.

Further drops in government bond yields

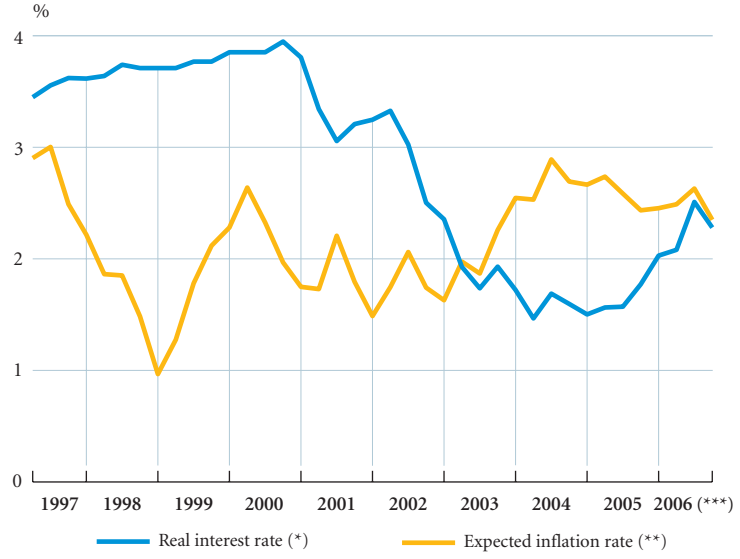
Interest rate on US long-term Treasury bonds down half-point in three months.

Returns on long-term government bonds continued to drop at the end of summer following a trend begun at the end of June. Expectations of some moderation in inflation, with a drop in oil prices, and the pause instituted by the US Federal Reserve System after 17 consecutive interest rate increases contributed to this performance. As a result, midway through the last week of September the yield on US Treasury bonds stood at around 4.6%, a drop of a half-point in terms of the high for the last four years recorded in June but still 20 basis points above the level at the beginning of January.

As a result, the inversion of the yield curve in the United States, although the negative slope (showing long-term rates lower than short-term rates) is not very marked. Long-term yields could move up again in a few months although there is the risk of a collapse of the real estate market which could lead to a recession.

In Europe, the yield on long-term government bonds has remained fairly stable in recent weeks. Statements by various executives of the European

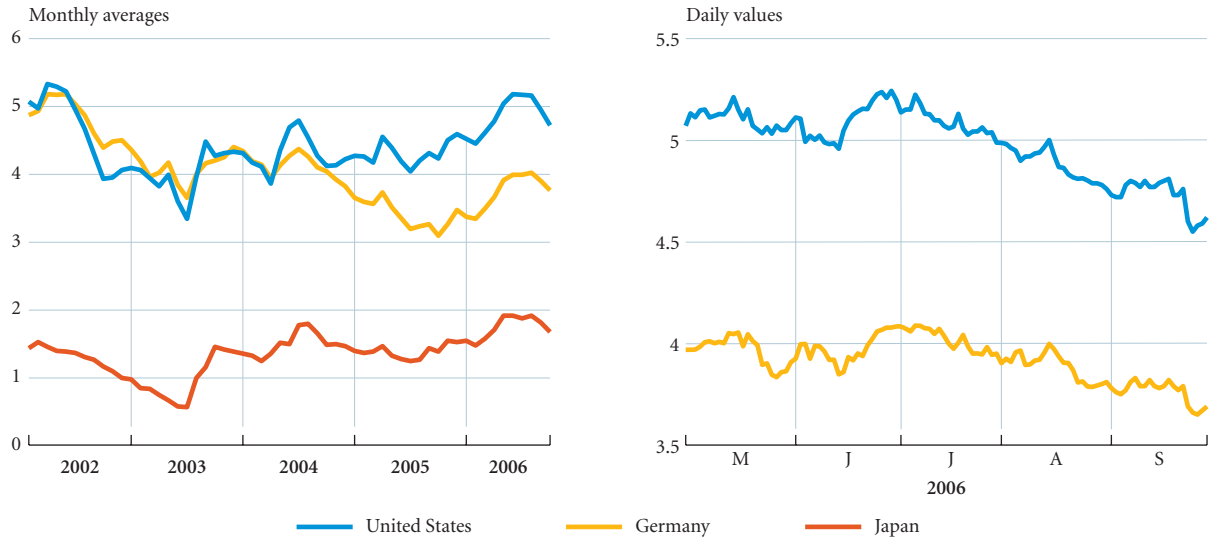
INFLATION PROSPECTS EASE IN UNITED STATES



NOTES: (*) According to bond indices indexed for inflation (Merrill Lynch).
(**) Based on nominal interest rate for Treasury bonds and real interest rate.
(***) September 28.
SOURCE: Merrill Lynch, Thomson Financial Datastream and internal figures.

LONG-TERM INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO MOVES DOWN

Yield on 10-year government bonds as annual percentage



NOTES: Figures go up to September 28.
SOURCE: Bank of Spain and Thomson Financial Datastream.

Central Bank favouring tighter money have contributed to halt the downward trend induced by developments in similar bonds on the other side of the Atlantic. In this way, the long-term interest rate differential between the dollar and the euro dropped slightly to below 100 basis points. At the same time, there has been a flattening out of the yield curve.

Yield curve flattens out in Europe.

The default rate on sovereign bonds stood at its lowest level since 1980, according to Standard & Poor's rating agency. Nevertheless, in the last week of September the risk premium on sovereign bonds of emerging economies stood slightly above the all-time low level recorded at the beginning of May following certain events which distressed the market, such as the coup d'état in

All-time low default rate on global speculative-grade corporate bonds.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

10-year government bonds: average for period as annual percentage

	2004	2005	2006				
			1Q	2Q	July	August	28 September
United States	4.31	4.33	4.61	5.13	5.16	4.95	4.62
Japan	1.50	1.39	1.58	1.90	1.91	1.81	1.65
Germany	4.07	3.38	3.50	3.96	4.02	3.90	3.69
France	4.10	3.41	3.51	3.99	4.03	3.90	3.70
Italy	4.24	3.56	3.71	4.27	4.31	4.18	3.97
Spain	4.10	3.39	3.49	3.97	4.02	3.89	3.69
United Kingdom	4.93	4.47	4.23	4.65	4.70	4.71	4.49
Switzerland	2.57	2.04	2.18	2.67	2.79	2.61	2.33

SOURCE: Bank of Spain, Thomson Financial Datastream and internal figures.

Thailand and demonstrations in Hungary. According to the same rating agency, the doubtful rate on global speculative-grade corporate bonds went to an all-time low in the past 12 months ended in August. As a result, the differential in interest rate between these bonds and government bonds remained relatively low.

Drop in long-term interest rates and good corporate profits aid stock market recovery.

Spanish stock market hits all-time high

In recent weeks, international stock exchanges have continued the recovery begun in June following the dip in May. The calming of existing uncertainties, partly thanks to the decrease in oil prices since the second week in August, the drop in long-term government bond rates and the good situation in corporate profits went in favour of a recovery in the stock markets. This recovery should continue in coming months although there remain some risks linked to the trend in oil prices and uncertainty about the slowdown in the world's biggest economy.

The main stock market indices in the United States showed a favourable trend in the early weeks of September, although there was the odd surprise such as when publication of the rise in labour costs brought about some immediate concern about inflation. As a result, both the traditional Dow Jones Industrial index and Standard & Poor's 500 index showed notable capital gains over December in the fourth week of

INDICES OF MAIN WORLD STOCK EXCHANGES

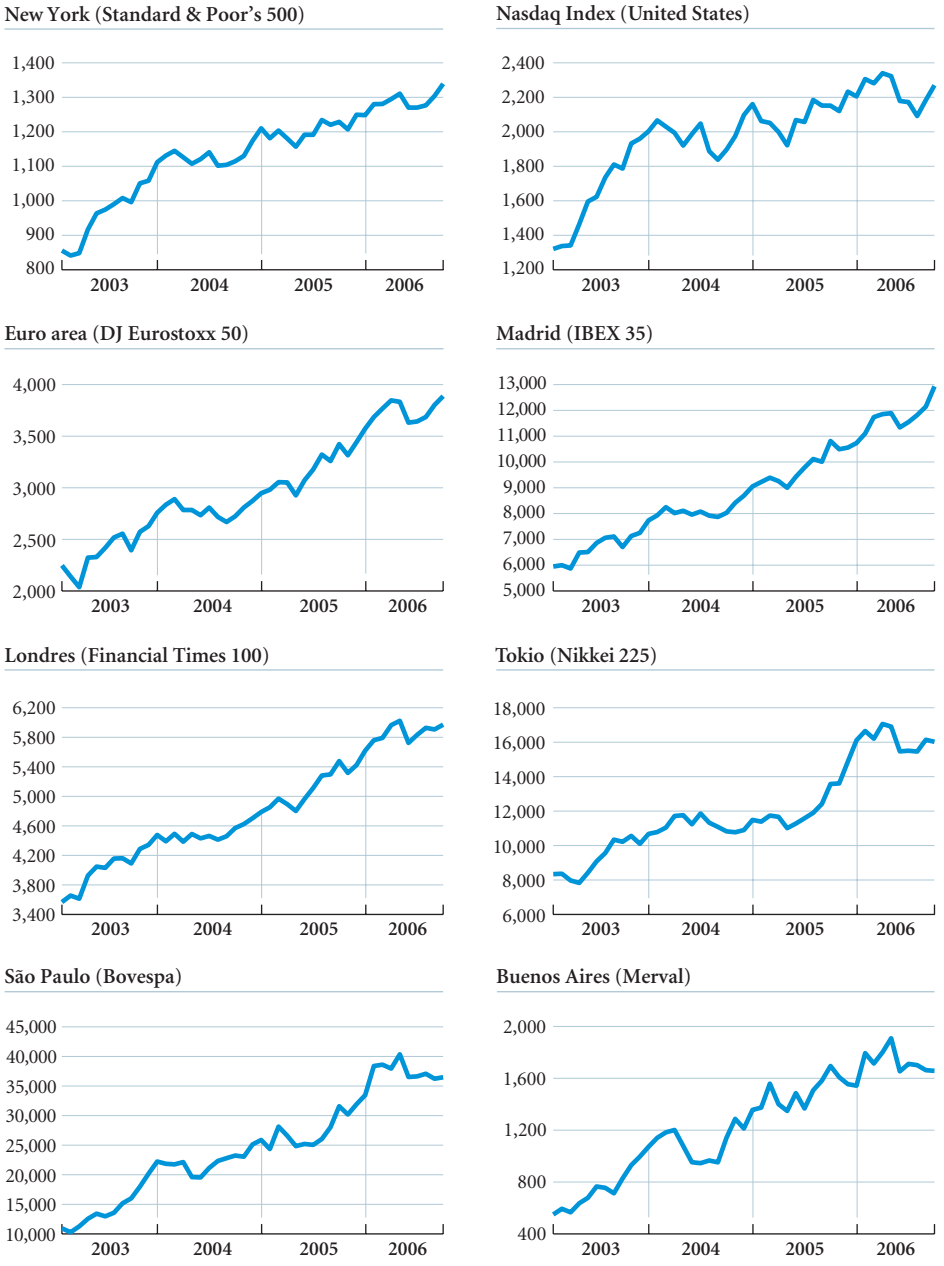
August 31, 2006

	Index (*)	% monthly change	% cumulative change	% annual change	*Figures on August 28, 2006*	
					% cumulative change	*% change over same date in 2003*
New York						
Dow Jones	*11,381.2*	*1.7*	*6.2*	*8.6*	*9.3*	*25.8*
Standard & Poor's	*1,303.8*	*2.1*	*4.4*	*6.8*	*7.3*	*34.3*
Nasdaq	*2,183.8*	*4.4*	*–1.0*	*1.5*	*2.9*	*26.7*
Tokyo	16,140.8	4.4	0.2	30.0	–0.5	*55.3*
London	5,906.1	–0.4	5.1	11.5	6.3	43.6
Euro area	3,808.7	3.2	6.4	16.7	8.8	*59.1*
Frankfurt	*5,859.6*	*3.1*	*8.3*	*21.3*	*10.7*	*80.1*
Paris	*5,165.0*	*3.1*	*9.5*	*17.4*	*11.3*	*63.2*
Amsterdam	*469.0*	*3.3*	*7.4*	*20.4*	*10.5*	*53.7*
Milan	*29,036.0*	*3.4*	*8.4*	*13.1*	*9.7*	*56.7*
Madrid	*12,144.7*	*2.8*	*13.1*	*21.3*	*20.5*	*89.9*
Zurich	8,168.0	2.8	7.7	25.3	11.0	*64.0*
Hong Kong	17,392.3	2.5	16.9	16.7	17.8	*55.3*
Buenos Aires	1,662.8	–2.3	7.7	5.1	7.4	*104.6*
São Paulo	36,232.0	–2.3	8.3	29.2	9.1	*130.8*

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: National stock exchanges and internal figures.

INTERNATIONAL STOCK EXCHANGES

Indices at month-end



NOTES: September 28, 2006.
SOURCE: National stock exchanges.

September with both indices reaching highs for recent years. The Nasdaq index, which is representative of hi-tech shares, also showed a cumulative increase although not to the same extent. By sector, we should mention the spectacular rise by telecommunications companies in recent months with a rise of more than 20% over December, going well above the losses seen in 2005. At the

Spectacular rise of telecommunications companies in US stock market.

other extreme, information technology companies failed to go above the inflation rate.

In the Euro Area, the DJ Eurostoxx 50, which includes the main companies in this area, also showed a good balance close to the end of third quarter after recording its highest level in recent years. Stock exchanges in Madrid, Frankfurt, Paris and Amsterdam even reported two-digit increases over the course of the last nine months.

Spanish and Swiss stock markets mark up all-time highs.

The IBEX 35 index for the Spanish stock market continued to reach new high levels, going above 12,900 points and marking up an all-time high. As well as the spectacular increase in corporate profits, take-over moves or rumours about corporate operations enlivened the markets. The energy sector and real estate were especially active.

Some emerging country stock markets, such as Mexico, Venezuela and South Africa, also record all-time highs.

Outside the Euro Area, of special note was the fact that in the fourth week of September the Swiss market marked up an all-time high. The London stock exchange had a negative response to the prospect of a further increase in the Bank of England interest rate this year. Nevertheless, the Footsie 100 index has continued to maintain a notable rise in the course of the year. The Japanese stock market has not done too well and continued in the red all this year.

Share markets in emerging economies generally continued to move up in September although this was not always regular. The drop in the price of raw materials had a negative effect on those markets most dependent on those goods but in general emerging market stock exchanges continued to reflect the improved economic situation in these countries although the indices were a long way from the annual highs. Nevertheless, there were some exceptions, such as the stock markets in Mexico, Venezuela and South Africa which recorded all-time highs.

SPAIN: OVERALL ANALYSIS

Economic activity

Industry, construction and tourism driving economy

Following a very expansionist second quarter in terms of economic activity, the summer months followed a similar pattern. It would seem that there is still a tendency for national demand to slow down slightly so that it will again be the foreign sector which sets the profile for economic activity in the third quarter. For the moment, the figures for July show stagnation in exports of goods in real terms with a significant growth in imports, although this information is still insufficient to draw definitive conclusions. In any case, it is likely that growth of the gross domestic product (GDP) has finally reached a ceiling following the 3.7% year-to-year figure seen in the second quarter.

Apart from this, the growth rate of Spain's economy continues very high, if we take into account electrical power consumption, which is showing a strongly upward growth profile. Another point to note is the consolidation of recovery in industry, as shown by the growth trend in the general production index for the sector. The chemical industry, metallurgy, machinery, motor vehicles and furniture are, among others, the branches of industry showing the strongest growth in the first seven months of the year. At the opposite extreme, the textile sector, clothing, as well as furs and leather remain in recession, although the drop being shown has eased considerably.

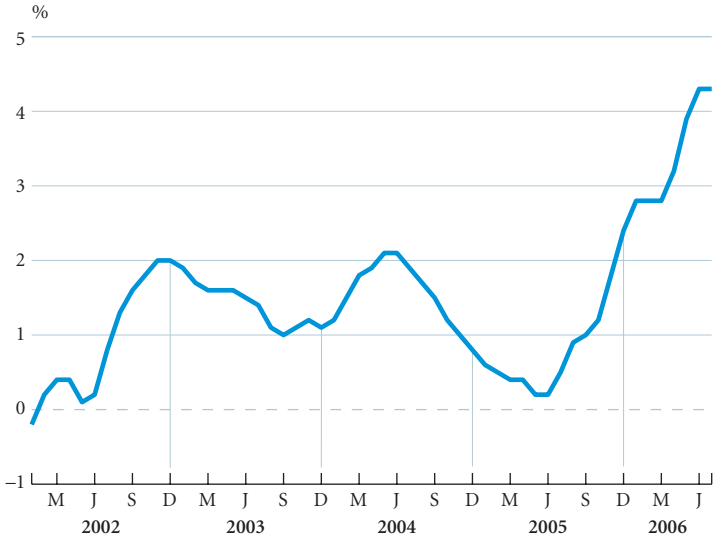
National demand tending to ease slightly although growth rate of economic activity remains very high.

With regard to construction, growth in cement consumption has tended to drop

Industry confirms recovery...

RECOVERY IN INDUSTRY BECOMING CONSOLIDATED

Year-to-year change in industrial production index



NOTES: Cycle-trend statistical series adjusted for calendar differences.
SOURCE: INE and internal figures.

...and construction still holding very strong.

considerably in recent months although other indicators, such as the approvals for new public works and government tendering, has performed in a fairly expansionist fashion. Finally, the expected slowdown could be delayed or, at least, take on a very moderate profile from now until the end of the year.

In services, the general picture is for some stability although with quite varied performances in the various sectors, according to indices based on business figures prepared by the National Institute of Statistics (INE). In general, we note an upward growth trend in tourism, stable growth in retail trade and a drop (although starting out from a very high level) in information and communications technology and in company services.

In tourism, in particular, the balance for the summer season has been very positive. In the July-August period overnight stays in Spanish hotels were up 6.0% compared with the same period last year. Stays by non-residents were up by 6.9% while those attributed to residents rose by 4.9%, according to figures from the survey of hotel occupancy carried out by INE.

In August, occupancy stood at 74.5% of total space available, an increase of 1.3

SUPPLY INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
Industry								
Electricity consumption (1)	4.1	2.8	1.5	1.9	2.8	4.0	6.1	5.0
Industrial production index (2)	1.6	0.7	0.7	1.6	2.6	4.0	4.7	...
Confidence indicator for industry (3)	–2.5	–4.9	–4.8	–4.0	–5.4	–2.7	–2.0	–5.0
Utilization of production capacity (4)	79.8	80.2	81.1	80.7	79.7	80.5	–	80.3
Imports of non-energy intermediate goods (5)	6.6	1.6	0.6	1.1	10.3	6.4	11.6	...
Construction								
Cement consumption	3.9	7.2	7.8	6.1	16.8	2.9	7.8	4.0
Confidence indicator for construction (3)	13.6	22.4	22.7	28.3	15.3	11.7	20.0	8.0
Housing (new construction approvals)	8.0	6.2	2.8	10.6	18.5	6.3	19.4	...
Government tendering	18.3	18.5	3.1	36.9	14.9	34.8	1.6	...
Services								
Retail sales	5.5	4.4	4.4	3.8	5.2	3.8	5.4	7.2
Foreign tourists	3.1	6.5	7.8	4.9	0.6	9.5	3.0	3.3
Tourist revenue inflows	3.8	5.8	13.9	4.9	–7.6	3.0	...	...
Goods carried by rail (km-tonnes)	–3.5	–3.2	–2.3	11.0	8.1	–2.7	–4.0	6.7
Air passenger traffic	8.0	9.2	10.2	9.1	5.2	10.1	3.9	...
Motor vehicle diesel fuel consumption	6.7	5.0	4.9	4.3	8.7	4.5	...	...

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.
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 internal figures.

points compared with the same month in 2005. Expectations for occupancy in October and November are also optimistic. These results came in a context characterized by some moderation in prices. In August, income obtained per room occupied rose by only 2.7% annual, close to one percentage point less than one year earlier.

Summer tourist season shows positive result.

On the demand side, we note that consumption is maintaining a downward trend, if we are to go by the slowdown in imports and the containment of growth in domestic production. This slowdown is more pronounced in some durable goods. Passenger car registrations, for example, were down by 4.6% year-to-year in the July-August period.

On the other hand, investment in capital goods continues to show great strength, if we take into account the growth trend in domestic production and the sustained growth in imports. Standing outside this trend, registrations of commercial vehicles have recorded very moderate growth in recent months.

On demand side, consumption tending to moderate while investment remains strong.

DEMAND INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
Consumption								
Production of consumer goods (*)	–0.1	0.9	1.4	0.9	0.6	2.2	1.4	...
Imports of consumer goods (**)	13.4	7.9	7.8	8.6	20.5	5.9	3.4	...
Car registrations	9.8	0.8	2.3	–4.5	2.4	–4.3	–5.1	–3.8
Credit for consumer durables	5.5	15.0	17.3	19.7	17.6	...	–	–
Consumer confidence index (***)	–10.5	–10.8	–11.4	–11.2	–12.5	–12.7	–14.0	–13.0
Investment								
Capital goods production (*)	1.9	–0.1	–1.3	0.8	6.7	7.6	7.4	...
Imports of capital goods (**)	14.9	20.4	13.5	8.2	10.0	–5.0	12.3	...
Commercial vehicle registrations	11.7	13.2	13.9	11.5	7.4	–0.1	1.8	1.9
Foreign trade (**)								
Non-energy imports	9.8	6.0	4.7	4.5	13.7	4.7	8.9	...
Exports	5.2	0.2	1.2	0.1	12.7	3.7	0.1	...

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 internal figures.

Labour market

Employment continues at top speed

Registrations with Social Security growing at stable rate of 3.4%.

Employment maintained a sharp stable growth rate in August, if we are to go by figures for registrations at Social Security. In fact, the total number of those registered at the end of August came to 18.58 million, that is to say, 3.4% more than in the same month last year. For the first time in recent months, this increase is not affected by the impact of the process of giving normal status to foreign workers that began in February 2005 and therefore more accurately indicates the strength of the job creation process.

Foreign workers make up 35% of new employment.

The removal of this distorting factor, on the other hand, underlines the real dimension of the impact of immigration on the labour market. Out of the 615,076 persons by which net registrations with Social Security has grown, some 34.9% are of foreign origin. Of these, practically three-quarters are from outside the EU.

The biggest increase in employment, and usually the biggest grouping of the foreign population, takes place in those areas of highest economic activity, particularly those where growth in the construction sector remains strong and

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006			
			3Q	4Q	1Q	2Q	July	August
Persons registered with Social Security								
Wage-earners	2.7	4.8	5.9	6.3	6.3	5.3	3.7	3.7
Industry	*–0.5*	*–0.5*	*–0.3*	*–0.4*	*–0.3*	*–0.0*	*–0.2*	*–0.1*
Construction	*5.6*	*8.6*	*10.0*	*10.9*	*11.0*	*9.5*	*7.8*	*7.4*
Services	*3.9*	*5.7*	*6.4*	*6.8*	*6.6*	*5.8*	*4.3*	*4.3*
Non-wage-earners	3.2	2.6	2.5	2.4	2.3	2.2	2.1	2.1
Total	**2.8**	**4.4**	**5.3**	**5.6**	**5.5**	**4.8**	**3.4**	**3.4**
Persons employed (*)	**3.9**	**5.6**	**5.9**	**5.6**	**4.9**	**4.2**	**–**	**–**
Jobs (**)	**2.6**	**3.1**	**3.3**	**3.2**	**3.2**	**3.1**	**–**	**–**
Hiring contracts registered (***)								
Permanent	11.8	8.7	10.0	16.1	25.6	16.1	44.7	52.0
Temporary	11.4	4.6	9.7	8.9	13.7	5.5	3.3	–1.9
Total	**11.5**	**5.0**	**9.8**	**9.5**	**15.0**	**6.4**	**6.4**	**1.9**

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

REGISTRATIONS WITH SOCIAL SECURITY BY AUTONOMOUS COMMUNITY AND NATIONALITY

August 31, 2006

	Persons registered		% annual change			% foreign workers over total
	Spaniards	Foreigners	Spaniards	Foreigners	Total	
Andalusia	2,830,250	188,324	3.1	7.2	3.3	6.2
Aragon	498,386	59,831	2.1	14.7	3.3	10.7
Asturias	378,563	12,196	2.6	7.8	2.7	3.1
Balearic Islands	401,678	87,251	2.1	8.5	3.2	17.8
Canary Islands	676,976	93,838	2.6	8.2	3.3	12.2
Cantabria	212,148	11,442	3.6	11.2	4.0	5.1
Castile-La Mancha	648,801	63,308	4.4	10.1	4.9	8.9
Castile-Leon	896,224	51,415	2.4	17.2	3.1	5.4
Catalonia	2,898,179	426,112	1.4	15.1	2.9	12.8
Valencian Community	1,683,037	218,200	2.3	12.7	3.4	11.5
Extremadura	372,771	9,920	3.0	6.4	3.0	2.6
Galicia	1,015,849	33,025	3.0	19.7	3.5	3.1
Madrid Community	2,482,406	411,449	2.5	17.7	4.4	14.2
Murcia	468,729	95,049	3.1	13.4	4.7	16.9
Navarre	242,962	27,108	2.2	2.8	2.2	10.0
Basque Country	883,445	38,779	1.7	9.4	2.0	4.2
La Rioja	113,478	15,663	1.8	3.2	1.9	12.1
Ceuta and Melilla	31,176	5,584	–0.5	16.9	1.8	15.2
TOTAL	**16,735,058**	**1,848,494**	**2.5**	**13.1**	**3.4**	**9.9**

SOURCE: Social Security and internal figures.

where there is a good situation in services. In fact, the three autonomous communities showing the biggest increase in employment (Castile-La Mancha, Murcia and Madrid) show a substantial increase in the foreign worker population registered with Social Security. On the other hand, those autonomous communities showing the lowest increase in registrations (Basque Country, Navarre and La Rioja) show a much lower inflow of foreign workers.

The incidence of immigration on the labour market is therefore varies a lot by region but its impact is especially relevant in the Mediterranean region and in Madrid. In that autonomous community and Catalonia more than 50% of net jobs created in the past year has involved foreign workers. At the other extreme, immigration is much less relevant in Extremadura, Asturias, Navarre, Cantabria, Andalusia and Galicia, autonomous communities where in the best of cases immigration accounted for little more than 15% of new jobs.

Immigration key to new employment in Mediterranean region and Madrid.

Labour market and immigration: where are we going?

In just a few years, Spain has come to be a country where immigration carries considerable weight. What in other countries on the European continent has taken decades to take shape and develop in step with the various economic cycles has happened in Spain with people hardly realizing it. Apart from the special cases of Luxembourg and Switzerland, Spain is the country in the Organization for Economic Cooperation and Development (OECD) whose labour force includes the highest proportion of foreign workers.[1]

FOREIGN WORKERS IN LABOUR FORCE OF VARIOUS OECD COUNTRIES

Thousand foreign workers

	1999	2004	% change	% of total labour force
Germany	3,446	3,539	2.7	9.0
Austria	367	320	–12.7	8.4
Belgium	380	357	–6.0	8.0
Denmark	97	107	10.3	3.9
Spain	359	1,852	416.4	9.3
United States	9,957	12,978	30.3	8.9
Finland	31	41	33.9	1.5
France	1,587	1,444	–9.0	5.4
Greece	171	303	77.2	6.4
Ireland	57	112	95.0	5.9
Italy	224	759	238.6	3.2
Japan	126	192	52.8	0.3
Luxembourg	75	88	17.4	45.0
Norway	68	88	30.0	3.8
Netherlands	268	299	11.8	3.6
Portugal	64	150	134.7	2.9
United Kingdom	1,116	1,557	39.6	5.4
Sweden	179	204	13.7	4.5
Switzerland	805	889	10.5	22.0

SOURCE: OECD and internal figures.

The sudden appearance of the immigration phenomenon has meant a notable impact on the labour market because recent immigration has come as a result of being attracted by existing job opportunities. A good part of this immigrant flow comes from lower income countries, has entered the country by irregular means and, as pointed out by the OECD, the existence of a relatively high degree of «black labour» has facilitated its integration in the labour market. Immigration has therefore had a sharp impact on the labour market by driving up the activity rate (those in the labour market in relation to the population of working age). Nevertheless, over the medium term it is expected that the immigration phenomenon will normalize and stabilize. What will then happen to the labour market?

(1) OECD (2006) «International Migration Outlook».

One way of trying to anticipate the future situation of immigration in Spain is to observe what is happening in those countries where the immigrant or foreign population is more settled and compare this reality with the present situation in Spain. We refer to countries such as France, Belgium, Germany, Switzerland, Austria, United Kingdom, etc. keeping well in mind that the factors creating the national reality of each country are many and quite varied.

POSSIBLE EFFECTS OF IMMIGRATION ON LABOUR MARKET

	Initial effect	Over medium term
Female activity rate	Rapid increase	Some decrease
Youth unemployment	Decrease	Increase
Elderly unemployment	No effect	Possible increase
Sectors of economic activity	Construction, agriculture, retail trade, restaurants, hotels, domestic service	Tendency to increase in tertiary activity
Self-employment	Decrease	Increase
Temporary nature of employment	Increase	Some stabilization

SOURCE: Internal figures.

One of the traditional deficiencies of the Spanish labour market has been the low activity rate. Nevertheless, in recent years this aspect has improved a lot, especially thanks to the increased number of women entering the labour market, with the progressive increase in professional qualifications as well as the higher activity rate among the foreign population. In fact, the activity rate for foreign females in Spain in 2004 was 65% as against 56% for Spanish women. Nevertheless, this is not the case in those European countries with a longer tradition of immigration, such as the United Kingdom, France, Germany, Belgium and Sweden where the rate of participation in the labour market for foreign women is substantially lower than that for nationals. It is thus possible that the effect of immigration on the activity rate may disappear or even work in the opposite direction because of the effect of factors, such as, for example, reunification of families.

Youth employment, another of the major problems in Spain's labour market, has improved considerably in recent years, which have shown sustained economic growth, although the unemployment rate for young people remains much higher than the average. One aspect that stands out in this group is that youth unemployment is higher among nationals than among foreigners. Nevertheless, this is not the norm in those countries with a longer history of immigrant inflows. In those countries, the unemployment rate for foreign youth is substantially higher than for young nationals. In addition, in Spain, as in other countries with recent immigration, such as Italy and Greece, the unemployment rate for all immigrants is not substantially higher than that for Spaniards. Nevertheless, the difference is considerably greater in other EU countries.

Another segment of the population with difficulties in the labour market is that made up of the elderly. In general, these workers have a substantially higher unemployment rate not only than the average but also than the youth segment. In the Spanish case, the unemployment rate for workers over 55 is a little higher than those born outside the country. In this respect, the figures coincide with the situation in other EU countries with the notable exceptions of France and Italy where unemployment among elderly foreigners is higher than that among nationals.

With regard to those sectors where foreign worker employment is concentrated, in Spain these are construction, domestic service, retail trade, hotels, restaurants and agriculture. In the developed countries, the participation of immigrants in sectors such as construction, hotels, restaurants and health and social services in general is higher

than the share of total employment in those sectors. Nevertheless, the distribution of employment among immigrants is quite different depending on the country. The trend to tertiary activity in the economy has also affected the employment of immigrants so that most jobs are now to be found in services. A notable proportion of posts occupied by immigrants are unqualified jobs especially in the area of hotels and restaurants. In many cases, these are jobs not acceptable to the national population because of working conditions and pay.

Another trend is the growing importance of self-employment among the immigrant population. In some countries such as Belgium and United Kingdom, the proportion of immigrants working as self-employed persons is relatively higher than that for the overall population with jobs. This may reflect a greater entrepreneurial spirit but it may also be due to difficulty in finding a wage-paying job because of difficulties of language, recognition of diplomas or lack of experience in the labour market of the receiving country. In Spain, in any case, the proportion of self-employed foreigners is relatively low although the tendency is on the rise.

One characteristic of Spain's labour market is the high proportion of temporary work. The temporary nature of work affects immigrants to an even greater degree. Nevertheless, this is no different from the general situation in neighbouring countries. In those countries where temporary work is most common, such as Spain, there are relatively more foreigners with temporary hiring contracts. With regard to part-time work, available statistics do not show any notable imbalance with regard to nationality.

Therefore, if we consider that the trend for immigrants in Spain's labour market could follow the model of neighbouring developed countries, as would seem plausible, there are reasons to believe that the initial effects of the incorporation of massive immigration in the labour market may become modified over the course of time. This could be partly due to the fact that patterns of behaviour in the population change once family reunification takes place and that the immigrants also grow older.

Registered unemployment continues gradual drop

Unemployment continuing gradual drop.

Registered unemployment rose in August as has been normal in recent years because of jobs normally lost at the close of the summer holidays. But compared with the same month the year before the rate of decrease in employment was up slightly to stand at 1.8% year-to-year. At the end of August, those registered at Public Employment Service offices came to a total of 1,983,677.

Foreign workers show lower propensity to go onto unemployment benefits.

Of this figure, some 6.8% were foreign workers, a proportion well below that representing registered foreign workers in terms of the whole population registered with Social Security (9.9%). Furthermore, this situation is normal in those autonomous communities where foreign workers make up a higher proportion of the total employed population.

In any case, the good situation in unemployment in recent months has made it possible for the overall balance for the year so far to be much more favourable than the January-August period in 2005 and, what is more, puts it among the best for this decade.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

August 2006

	No. of unemployed	Change over December 2005		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	61,613	–3,614	–5.5	2,655	4.5	3.1
Industry	285,012	–16,307	–5.4	–12,658	–4.3	14.4
Construction	228,587	–16,513	–6.7	–1,843	–0.8	11.5
Services	1,196,743	–69,646	–5.5	–11,296	–0.9	60.3
First job	211,722	–13,180	–5.9	–12,291	–5.5	10.7
By sex						
Males	768,370	–83,593	–9.8	–21,733	–2.8	38.7
Females	1,215,307	–35,667	–2.9	–13,700	–1.1	61.3
By age						
Under 25 years	229,555	–46,340	–16.8	–17,667	–7.1	11.6
All other ages	1,754,122	–72,920	–4.0	–17,766	–1.0	88.4
TOTAL	**1,983,677**	**–119,260**	**–5.7**	**–35,433**	**–1.8**	**100.0**

SOURCE: INEM and internal figures.

Wages: upward trend but still below inflation

The main wage indicator do not bring excessive optimism from the perspective of an improvement in competitiveness. In fact, both the survey of wage costs and the results of National Accounting indicate a moderate upward trend in wage increases. Nevertheless, up to this point, the increase in wages, by whatever indicator selected, is holding below the increase in the CPI.

The upward trend in wages is clearly to be seen in services, basically in market services, according to figures for National Accounting prepared by the National Institute of Statistics. This is not so in industry or construction where the wage increase in the quarter moderated slightly. The same conclusions are arrived at from the wages survey.

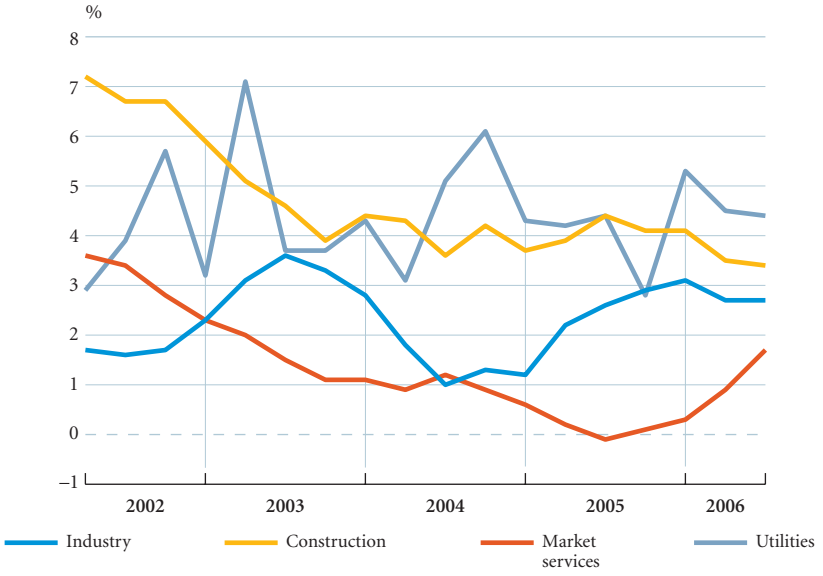
Wages tending to rise.

In spite of these trends, the increase in wages in construction and in industry are still above those recorded in market services. Wages in non-market services deserve separate mention as they continued to grow at a very high rate with no sign of easing.

Highest wage increases show up in utilities.

WAGES RISING IN MARKET SERVICES

Wage increase by equivalent job



SOURCE: INE and internal figures.

WAGE INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006		
			3Q	4Q	1Q	2Q	3Q
Increase under general wage agreements (*)	**3.0**	**3.1**	**2.9**	**3.1**	**3.1**	**3.2**	**3.2**
Wage per job equivalent to full-time work (**)	**3.1**	**2.6**	**2.2**	**2.7**	**2.9**	**3.2**	**...**
Quarterly labour cost survey							
Wage costs							
Total	2.8	2.6	1.9	2.5	3.0	3.1	...
Industry	*3.3*	*2.7*	*1.5*	*3.0*	*3.8*	*3.1*	...
Construction	*4.2*	*2.3*	*1.3*	*2.0*	*3.8*	*3.1*	...
Services	*2.5*	*2.9*	*2.6*	*2.8*	*3.0*	*3.4*	...
Average wages per hour worked	3.6	3.2	2.8	2.9	0.0	7.1	...
Other labour costs	3.6	3.6	3.7	3.1	4.4	4.9	...
Work day (***)	–0.8	–0.6	–0.9	–0.4	3.0	–3.8	...
Farm wages	**2.8**	**3.1**	**2.7**	**3.0**	**2.9**	**2.6**	...
Labour cost in construction	**3.5**	**4.3**	**4.2**	**4.3**	**3.4**	**3.5**	...

NOTES: (*) Does not include wage revision clauses.
(**) 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 internal figures.

The effects of immigration on employment and wages

From a conceptual perspective, immigration is equivalent to an increase in the labour supply and therefore, *a priori*, depresses wages. This is supported by recent empirical studies by leading researchers on this matter, such as George J. Borjas. Nevertheless, this negative effect of immigration on wages does not affect all national workers but only those with training and a level of work experience similar to that of immigrants. Furthermore, the entry of immigrant flows may have a positive effect on those workers with characteristics quite different from those of the newcomers. For example, the entry of workers who carry out manual tasks such as cleaning may allow those workers with a higher level of education and productivity to devote more hours to produce those goods and services most suitable to their characteristics. Borjas concludes that an increase of 10% in the labour supply of a specific group of workers reduces the wage of national workers who belong to the same group by 3 to 4 percent and increases the wage of other groups of workers by 0.5%. The following table shows the degree of substitution and complementarity between national and foreign production factors.

		NATIONAL PRODUCTION FACTORS		
		Unskilled workers	**Skilled workers**	**Capital**
FOREIGN PRODUCTION FACTORS	**Unskilled workers**	Substitutes	Complements	Complements
	Skilled workers	Complements	Substitutes	Complements/Substitutes
	Capital	Complements	Complements/Substitutes	Substitutes

NOTES: An increase in the supply of a specific factor has a negative effect on the wages of those factors which substitute it and a positive effect on the wages of those which complement.
SOURCE: Internal figures.

It is important to underline that immigration affects not only wages but also many other variables such as, labour demand, and product prices. These have an indirect effect on wages and welfare. For example, owners of capital may gain with the entry of immigrants due to a complementary relationship between capital and a specific kind of labour (see table above). In turn, companies may decide to invest part of their additional profits in the creation of new companies which would involve an increase in the demand for labour, making it still more difficult to isolate the direct effects of immigration. Other variables affected by immigration are the prices of goods and services, since a decrease in wages ends up affecting costs and prices and a lower level of prices means an increase in wages in real terms. These indirect effects show that it is very difficult to examine the effects of immigration on wages in particular, and on a country in general.

If we concentrate on the case of Spain, in the past six years there has been a massive entry of young labour power without secondary education. To be specific, between the first quarter of 2000 and the second quarter of 2006 around 2.3 million foreigners entered the Spanish labour force, nearly five times the number of foreigners in Spain's labour force in 2000. This is equivalent to a 12% increase in the labour supply. If we use the parameters estimated by Borjas, and assuming that the foreigners who come into Spain have the same characteristics as the average Spanish worker, we could conclude that immigration had brought about a reduction in the annual growth rate of the average worker's wage of approximately 0.7 percentage points.

LABOUR FORCE BY NATIONALITY AND AGE GROUP

2006

	Spaniards	Foreigners
From 16 to 24 years	10.99%	15.08%
From 25 to 34 years	28.65%	39.25%
From 35 to 44 years	27.24%	28.72%
From 45 to 54 years	21.23%	13.26%
From 55 years and over	11.90%	3.70%

SOURCE: National Institute of Statistics.

Nevertheless, if we analyze in some detail the characteristics of those foreigners who come to Spain to work, we see that they do not correspond to those of the average Spanish worker. Specifically, the immigrants are younger (see previous table) and have a lower level of education. Around 21% of immigrants coming to Spain in the period 2000-2006 had primary school education as against 15% of Spanish workers with that level in 2006. Some 21% had higher education as compared with 32% in the case of Spanish workers. As a result, projections based on Borjas' parameters overvalue the real effect of immigration. This affects only a small sub-group of national workers.

Furthermore, Borjas' parameters are based on figures for the US labour market which is more flexible than that of Spain. The effect of immigration on the labour market does not have to be only through wages but may also come through amounts (hours worked and/or employment rate). In this respect, a recent study by Carrasco, Jimeno and Ortega,[1] following the methodology used by Borjas, analyzes the effect of immigration on the employment rate of native-born Spanish workers. According to these authors, the entry of immigrants to Spain has brought a very small decrease in the employment rate of Spanish workers. In the specific Spanish case, we may deduce that at most the employment rate of the average worker has decreased by 0.04 percentage points in the past six years due to immigration. This is a low figure and it also probably overestimates the true figure given that it again, does not take into account that the average immigrant coming into Spain does not have the same characteristics as the average national worker. Therefore there do exist positive direct effects of immigration in the employment rate of those workers that are complementary to immigrant workers.

In conclusion, in spite of the competition it involves for some national workers, immigration may favour the population as a whole thanks to the complementary nature of tasks and indirectly through its effects on labour demand and price levels. In any case, given the size of immigration flows being recorded and empirical evidence available on the quantitative impact of immigration on labour markets, the effect of immigration on wages and employment rates of Spanish workers at this point does not appear to have been of great importance.

(1) Carrasco, Raquel; Juan F. Jimeno; Ana Carolina Ortega. «The effect of Immigration on the Employment Opportunities of Native-Born Workers: Some Evidence for Spain». Mimeo 2004.

Prices

CPI moderates in August

The annual inflation rate, measured by the consumer price index (CPI), showed a notable reduction in August going to 3.7%, three decimals below the month before, according to figures issued by the National Institute of Statistics. The cut may be attributed to the course taken by energy prices which did not rise to the same extent as in August last year.

In general, the August CPI continues to show the constants seen in recent months with high sustained growth in services prices and a resistance to any moderation in prices of non-energy industrial goods. In the first case, the strength of demand and the lack of competition in certain personal market services, education and social services were behind this situation. In the area of industrial goods, the problems arise from cost pressures although the impact on final prices is limited because of strong competition in the market.

Drop in energy prices eases background pressure on CPI.

The only notable factor in the August CPI was the moderation seen in processed foods. In this case, the good news, apart from the slight easing in the price of cooking oil (still at high levels), seems to be the result of the downward move noted in tobacco, thanks to the

Rise in services prices continues high while industrial goods hold stagnant despite increase in competition.

IMPROVEMENT IN CPI BUT BACKGROUND PRESSURES REMAIN

Year-to-year change in CPI

SOURCE: National Institute of Statistics and internal figures.

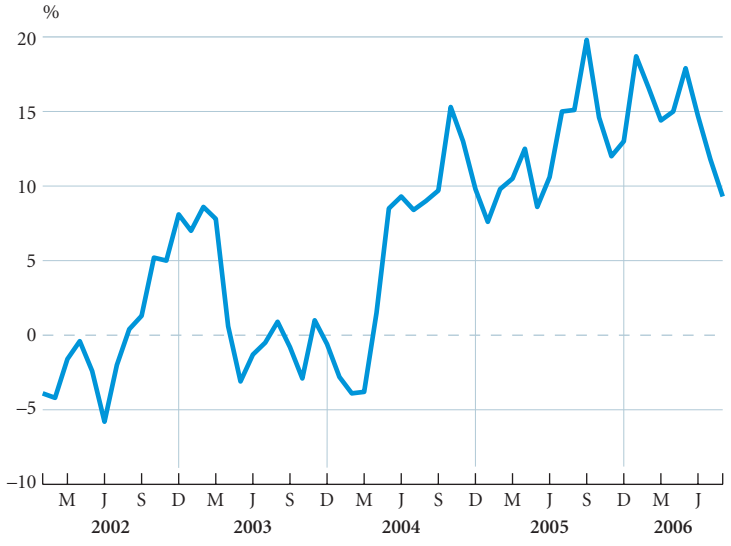
CONSUMER PRICE INDEX

	2005			2006		
	% monthly change	% change over December 2004	% annual change	% monthly change	% change over December 2005	% annual change
January	–0.8	–0.8	3.1	–0.4	–0.4	4.2
February	0.3	–0.6	3.3	0.0	–0.4	4.0
March	0.8	0.2	3.4	0.7	0.3	3.9
April	1.4	1.6	3.5	1.4	1.8	3.9
May	0.2	1.8	3.1	0.4	2.1	4.0
June	0.2	2.1	3.1	0.2	2.3	3.9
July	–0.6	1.5	3.3	–0.6	1.7	4.0
August	0.4	1.9	3.3	0.2	1.9	3.7
September	0.6	2.5	3.7			
October	0.8	3.4	3.5			
November	0.2	3.5	3.4			
December	0.2	3.7	3.7			

SOURCE: National Institute of Statistics.

FUELS AND OILS BEGIN TO IMPROVE

Year-to-year change in fuel and oils component



SOURCE: National Institute of Statistics and internal figures.

Little margin for moderation of core inflation.

policy of the tobacco companies, which are tending to reduce prices in order to compensate for tax increases, and the drop in consumption as a result of health measures aimed at curbing smoking.

At this moment, core inflation, that is to say, excluding energy products and fresh foods, has shown some slight moderation (a tenth of a point) but exhibits no sign of breaking away from the full-steam-ahead course of recent months at 3.0%.

CONSUMER PRICE INDEX BY COMPONENT GROUP

August

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2005	2006	2005	2006	2005	2006
By type of spending							
Food and non-alcoholic beverages	122.1	0.4	0.2	1.8	2.2	2.6	4.6
Alcoholic beverages and tobacco	122.6	0.1	–0.4	4.0	0.6	4.0	1.7
Clothing and footwear	106.1	–0.5	–0.6	–11.7	–12.0	0.9	1.1
Housing	123.3	0.4	0.1	4.8	5.2	5.9	6.4
Furnishings and household equipment	110.6	0.0	0.1	0.8	1.3	2.1	2.7
Health	107.8	0.0	0.0	0.6	1.3	0.9	1.5
Transport	123.9	1.1	0.2	7.6	6.1	7.0	4.8
Communications	90.7	–0.1	0.1	–1.3	–0.9	–1.9	–1.2
Recreation and culture	105.5	1.2	1.2	1.6	1.5	–0.5	0.5
Education	121.7	0.0	0.0	0.6	0.4	4.2	3.9
Restaurants and hotels	126.8	0.9	0.8	4.7	4.9	4.3	4.4
Other goods and services	118.8	–0.0	0.1	2.7	3.2	3.1	3.9
By group							
Processed food, beverages and tobacco	119.4	0.1	–0.3	2.2	2.0	2.8	3.6
Unprocessed food	127.8	0.9	0.9	2.0	2.2	2.7	5.4
Non-food products	116.7	0.5	0.2	1.8	1.8	3.5	3.6
Industrial goods	111.6	0.4	–0.0	0.1	0.1	3.3	3.2
Energy products	*131.0*	*1.9*	*0.2*	*12.7*	*10.9*	*11.5*	*8.2*
Fuels and oils	*139.1*	*2.5*	*0.3*	*16.7*	*12.9*	*15.1*	*9.3*
Industrial goods excluding energy products	*105.7*	*–0.1*	*–0.1*	*–3.7*	*–3.3*	*0.7*	*1.5*
Services	122.7	0.6	0.5	3.7	3.7	3.7	3.9
Underlying inflation (**)	115.6	0.2	0.1	0.7	0.8	2.4	3.0
GENERAL INDEX	**118.0**	**0.4**	**0.2**	**1.9**	**1.9**	**3.3**	**3.7**

NOTES: (*) Base 2001 = 100.
(**) General index excluding energy products and unprocessed food.
SOURCE: National Institute of Statistics.

Another matter is the future trend in the general CPI. In September, the index will again be helped by energy prices which could end up taking between three and four decimals off the general index. Nevertheless, this downward move will tend to ease off after the summer unless a continuation of the drop in crude oil prices makes it possible for fuels to go down in the final quarter more sharply than they did last year (between September and December 2005 this heading was down by 7.0%).

Furthermore, underlying inflation does not seem as if it is going to show any substantial decrease, unless the price of cooking oil drops sharply, seeing that both prices for services and industrial goods will likely move in the current direction.

Nevertheless, we should point out that maintenance of prices of non-energy industrial goods at 1.5% year-to-year has come about in spite of the fact retail sales campaign in July was much

Drop in price of crude oil will help CPI in coming months.

Bigger differential with Euro Area due to food, communications and restaurants and hotels.

firmer than last year. This effect could indicate some upward trend in manufactured goods, which would be in keeping with what is happening with producer prices.

The inflation differential with the Euro Area dropped by one decimal in August going to 1.5 percentage points, according to the harmonized consumer price index prepared by Eurostat. The performance of prices in Spain was more unfavourable in practically all components of the index except in alcoholic beverages and tobacco and medical costs. In other groups, the higher differential was due to food, communications and restaurants and hotels.

Manufactured goods stabilize price rise at 2.5%, below cost increases.

Notable improvement in prices at origin for first time in recent months

Factory-gate prices for non-food industrial consumer goods continue to be relatively moderate, in spite of the adverse circumstances they have had to deal with in recent months, such as the continuing high increases in intermediate goods and high energy prices. In this respect, the increase of 2.5% increase in non-food consumer goods, according to the National Institute of Statistics, turns out to be a good result if we take into account that the price of energy has moved up 10.2% (now slowing down), that the price of intermediate goods has gone up 7.3% (and rising) and wages in industry are up more than 3%.

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	
2005											
June	–11.9	4.4	2.2	2.1	3.1	13.5	5.3	3.6	–1.3	7.7	–
July	–5.1	4.6	2.1	1.9	3.0	15.7	8.2	0.6	10.4	11.7	–
August	9.2	4.9	2.5	1.8	2.9	16.4	6.1	–0.2	–0.4	11.0	4.2
September	6.7	5.4	2.6	1.9	3.2	17.9	4.3	–0.6	4.2	7.0	–
October	–0.8	5.0	3.0	1.9	3.1	15.2	4.8	0.8	14.0	5.3	–
November	2.0	4.9	3.1	2.0	3.2	14.7	3.8	3.3	–0.8	5.6	4.1
December	2.1	5.2	3.2	2.0	3.2	15.6	7.1	0.9	10.2	8.9	–
2006											
January	4.0	6.3	3.5	2.1	3.6	20.6	5.6	–6.5	–5.1	15.2	–
February	0.8	6.3	3.6	2.1	3.9	20.1	6.6	2.5	3.2	9.2	4.1
March	–10.2	5.8	3.3	2.0	4.6	16.4	6.0	2.7	7.5	7.2	–
April	–8.1	5.7	2.9	2.2	5.1	15.4	7.4	3.2	–4.2	11.7	–
May	–3.6	6.6	3.2	2.3	6.1	17.8	6.1	4.2	–0.6	8.2	4.0
June	6.0	6.3	3.5	2.3	6.8	14.6	1.7	–1.5	–3.2	4.2	–
July	...	6.4	3.6	2.4	7.0	13.9	1.1	0.5	–7.3	3.1	–
August	...	5.7	3.2	2.5	7.3	10.2	...	...	...	...	...

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

The performance in wholesale prices of food consumer goods was less favourable although it is showing some signs of improving. In fact, food prices in August eased growth to 3.9%, a half-point less than in the previous month. This improvement may be particularly relevant in terms of final consumer prices if we take into account the relative weight of this component in the CPI.

The drop in import prices for food consumer goods may be even more significant. In the first seven months of the year these recorded an average decrease of 0.8%. Along the same lines, although not as sharp, came the containment seen in import prices for non-food consumer manufactured goods (increase of 1.0% in the January-July period).

Moderation and even drop in import prices should aid CPI.

Farm prices, on the other hand, rose substantially in June in response to the sizeable drop in the same month in 2005. Nevertheless, in the half-year as a whole, the balance was definitely down with a drop of 2%. The notable decrease in agricultural farm prices was behind this performance, given that livestock products were stagnant.

Farm prices drop 2% in first half-year.

Foreign sector

Positive export figures as of July as result of relatively stronger drive in markets outside European Union.

Rise in oil prices accounts for 70% of increase in trade deficit

The trade deficit continued to grow at a sharp rate in July with a rise in imports considerably above that for exports. The cumulative imbalance for the first seven months of the year was 50.39 billion euros, 18.8% more than in the same period in 2005. A good part of the increase, specifically 70%, was due to the energy balance for which the negative figure increased by somewhat more than 40.7%, as against 8.3% recorded for the non-energy balance. The increase in price of imported crude in euros (42.2%) in the first seven months of the year lay behind this performance.

The export balance in the January-July period was significantly more positive than for the year before. The increase in foreign sales (6.8% by volume) was in contrast to the drop recorded in the same period last year. Such a significant change came mainly from the better

FOREIGN TRADE

January-July 2006

	Imports			Exports			Balance	Export/ Import ratio (%)
	Million euros	% annual change in value	% share	Million euros	% annual change in value	% share	Million euros	
By product group								
Energy products	23,927	40.6	16.0	4,541	39.9	4.6	–19,386	19.0
Consumer goods	41,830	12.1	27.9	36,856	8.1	37.0	–4,974	88.1
Food	*7,958*	*3.7*	*5.3*	*11,777*	*7.3*	*11.8*	*3,819*	*148.0*
Non-foods	*33,872*	*13.9*	*22.6*	*25,079*	*6.4*	*25.2*	*–8,793*	*74.0*
Capital goods	15,407	1.7	10.3	10,003	21.0	10.0	–5,405	64.9
Non-energy intermediate goods	68,842	11.2	45.9	48,217	11.0	48.4	–20,625	70.0
By geographical area								
European Union (EU-25)	88,750	9.5	59.2	70,428	8.0	70.7	–18,322	79.4
Euro area	*74,306*	*8.6*	*49.5*	*56,185*	*7.1*	*56.4*	*–18,121*	*75.6*
Other countries	61,257	21.7	40.8	29,188	22.6	29.3	–32,068	47.6
Russia	*4,331*	*51.7*	*2.9*	*784*	*34.6*	*0.8*	*–3,547*	*18.1*
United States	*5,106*	*5.2*	*3.4*	*4,429*	*30.9*	*4.4*	*–678*	*86.7*
Japan	*3,375*	*–2.5*	*2.2*	*770*	*14.6*	*0.8*	*–2,605*	*22.8*
Latin America	*8,204*	*42.5*	*5.5*	*5,886*	*40.9*	*5.9*	*–2,317*	*71.8*
OPEC	*12,702*	*40.7*	*8.5*	*2,454*	*4.0*	*2.5*	*–10,248*	*19.3*
Rest	*27,539*	*12.9*	*18.4*	*14,865*	*17.7*	*14.9*	*–12,674*	*54.0*
TOTAL	**150,007**	**14.1**	**100.0**	**99,617**	**11.9**	**100.0**	**–50,390**	**66.4**

SOURCE: Department of Customs and Special Taxes and internal figures.

state of markets outside the Euro Area (Latin America, United States and countries of the former Soviet Union and newly industrialized Asian countries) but also from some EU member states (France, Benelux and, to a lesser extent, Italy). As a whole, the European Union market recorded growth of 3.7% by volume, which was still a long way from that seen for third countries at 14.7% real.

The better export situation showed up in capital goods with growth of 15.9% by volume, nearly 10 points higher than that seen in foreign sales of consumer goods. Among these goods, the biggest figure was for food followed some distance behind by non-food consumer goods. The weak state of car exports, with a nominal drop of 0.9%, weighed heavily on the total export balance. On the positive side, we note the rise in exports of consumer electronics (67% nominal), medicines (38%), clothing (22%) and motor vehicle parts (14%).

Imports continued to show strong growth at a higher rate than in 2005 at 8.9% real as of July. The strongest components were non-food consumer goods, such as clothing, footwear and consumer electronics which have progressively increased their share of the domestic market thanks to their competitiveness and the strength of domestic demand. As a whole, imports of this kind rose by 13.2% by volume although there are signs of a more moderate profile. The increase in foreign purchases of intermediate goods was not as great although still high, which supports the feeling of a certain level of industrial and construction activity. Purchases of iron and steel, other metals and construction materials are showing major increases. On the other hand, imports of capital goods are up very modestly, indicating some easing of the investment cycle.

Sustained rise in imports, especially in non-food consumer goods.

Current account deficit down slightly in June

The balance of payments continued to show an increasing gap in June although at a somewhat lower rate than in previous months. The cumulative deficit in the first half-year rose to 44.6 billion euros, 27.1% more than in the same period the year before. The increase in the trade deficit and the drop in the services surplus were determining factors in this development, given that both the transfers balance and the incomes balance showed only a slight improvement in their negative figures.

The drop in the services balance came both from the tourist sector and trade in other services. In the case of tourism, a drop in financial inflows of 1.9% as of June came on top of an increase in payments of 12.2% in the same period. All in all, we note some tendency to an improvement in financial inflows compared with previous months which could firm up in coming months, if we are to go by the acceptable balance to be expected for the summer season. Nevertheless, this improvement may be dimmed in terms of balance because of the increase in payments arising from Spanish tourism abroad which is also much on the rise.

Current account deficit up 27% in first half-year.

The improvement in the income balance deficit may largely be attributed to the general government sector which is reducing the bill for interest payments on the government debt and to financial and monetary institutions because of increased returns obtained on their foreign assets.

Some signs of improvement in tourist balance but surplus below 2005.

BALANCE OF PAYMENTS

12-month rolling sum in million euros

	June 2005	June 2006	% change
Current account balance			
Trade balance	–61,626	–75,616	22.7
Services			
Tourism	*25,391*	*25,429*	*0.2*
Other services	*–3,614*	*–5,976*	*65.3*
Total	21,776	19,454	–10.7
Income	–15,180	–16,947	11.6
Transfers	–1,801	–3,035	68.5
Total	**–56,830**	**–76,144**	**34.0**
Capital account	**8,234**	**6,017**	**–26.9**
Financial balance			
Direct investment	–34,657	–37,525	8.3
Portfolio investment	117,201	125,532	7.1
Other investment	–27,216	2,166	–
Total	**55,328**	**90,173**	**63.0**
Errors and omissions	–921	–2,801	203.9
Change in assets of Bank of Spain	–5,811	–17,246	196.8

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 internal figures.

Foreign investment in corporations stabilizing but investment in real estate down notably while Spanish investment abroad shows very strong growth.

Finally, the transfers balance is affected by the stagnation seen in general government receipts from the European Union (this is not so in the case of private receipts) and by the sharp increase in payments for remittances abroad by foreign workers. Remittance payments came close to a quarter of total payments for transfers abroad.

In the financial sphere, direct foreign investment by corporations stood at the same level as in the first half of 2005, whereas investment in real estate was down sharply by 15.7%. Portfolio investment, on the other hand, was up sharply. Spanish direct investment abroad showed strong growth mainly in the corporate domain but also in real estate. In this case, the total amount (973 million euros) scarcely reached 2.4% of total direct investment.

Public sector

Tax collections growing above domestic demand

Central government tax revenues amounted to 113.14 billion euros in the first eight months of 2006 with a rise of 10.5% compared with the same period last year, according to the tax collections report of the Taxation Agency. This growth would be higher, precisely 12.4%, if it were calculated in homogeneous terms, that is to say, if we eliminate the distortions arising from changes in the calendar of maturities for interest on the public debt and the rate of making tax refunds. Tax collections thus continue to rise nearly four points above the nominal growth rate of domestic demand.

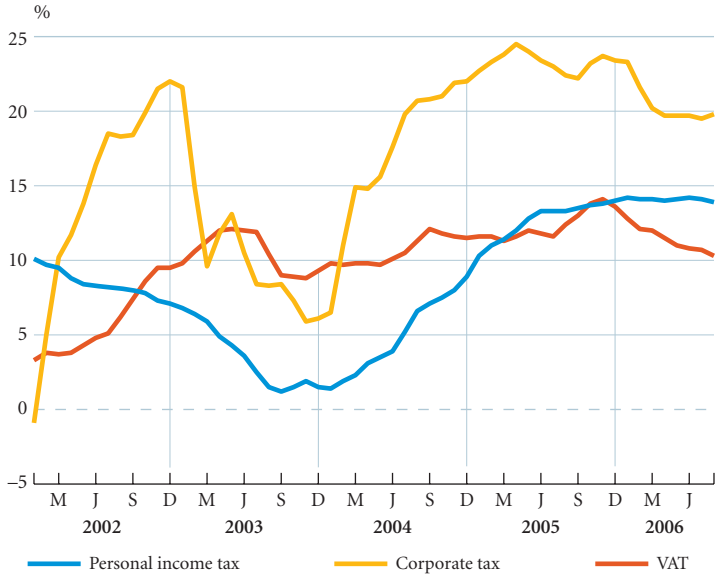
The strength of tax collections is spread over the main tax headings with the exception of special taxes. Collections for personal income tax thus grew by 14.8% in homogeneous terms, especially notable being the increase in withholding taxes on mutual investment funds and those for income on capital. In the first case, rises on the stock market and, in the second case, increased interest rates and increased dividend payments were behind the sharp increases (36% and 18% respectively). Withholding taxes for wage and salary earnings, which make up the basic core of revenue, were up by 12% as a result of the strength of employment and wage increases. Finally, withholding taxes for rental income were up substantially owing to the fiscal

Good economic situation favours growth of tax collections.

Direct taxes grow at spectacular rate partly because of rise in corporate tax revenue.

DIRECT TAX COLLECTIONS SHOW HIGHER GROWTH

Year-to-year change in homogeneous tax revenues by tax heading (*)



NOTES: (*) 12-month rolling sums.
SOURCE: Ministry of Economy and Finance and internal figures.

Sharp increase in VAT collections while special taxes suffer from poor collections under two main headings, fuel and tobacco.

obligation to advise the nature of the taxpayer's residence on income tax returns.

Revenues from corporate tax were also up considerably (16.9% in homogeneous terms) because of the good performance in interim tax payments, a figure related to corporate profits for the year before. In any case, there was something of a drop in the rate of increase in revenues from this tax compared with the high levels shown last year.

In indirect taxes, total revenues for value added tax (VAT) were up by 11.7% in homogeneous terms, somewhat lower than in previous months. Revenues from special taxes, on the other hand, recovered slightly although the cumulative increase in homogeneous terms held at very low levels (1.7%). The two main headings, that is to say, the special tax on fuels and the general tax on tobacco, showed very modest increases, which may be explained in the first case by the drop in demand for petrol (replaced by consumption of diesel-oil which carries a lower tax rate) and, in the second case, by less consumption. Collections for the tax on electric power, on the other hand, was up by 11.5% due to an increase in supply prices.

How does immigration affect the Welfare State?

The rapid growth of immigration in Spain in recent years has generated much debate about its possible impact on the Welfare State.

Immigration affects the Welfare State of the recipient country both in its spending components and in its income. To measure the overall impact it is necessary to bear in mind the effect of each on those components. Furthermore, what the government spends in benefits must be paid in taxes, either today or tomorrow, and therefore the society should be concerned about the net effect of immigration on the Welfare State over the long term. Even if immigration were to represent a negative balance for the Welfare State today, this effect could be compensated by a surplus in the future.

The difficulty in estimating the net impact over the long term is obvious as it involves predicting the future of many crucial components, such as population trends of the recipient country, the size of immigration flows, education, age distribution, level of social integration and performance in the labour market. In addition, we need to anticipate the duration of immigration flows given that the effects on the Welfare State are not the same if immigration happens to be transitory or permanent.

A useful tool to measure the quantitative impact of immigration is generational accounting. According to this method, the government must ensure that all its spending is paid out of taxes or other sources of revenue, either now or in the future. The key question is whether this intertemporal restriction is more or less difficult to hold given the presence of immigrants. This calls for evaluating each component of the restriction and how these are modified by the presence of immigration.

How does immigration affect tax collection?

The tax revenues most affected by immigration are those taxes on wages and contributions to Social Security. Each year, the government collects a proportion of the income of both the national and immigrant working population. That income depends on the hours worked by each group and its productivity. Naturally, the government obtains more revenue the higher the labour force at work and the higher its productivity.

A determining factor in *activity rate* is the *population trend*. One expects a higher activity rate the younger the population. Immigration is now easing the aging of the national population given that the average age of that population is higher than that of the immigrants. Furthermore, the fertility rate of immigrants is also higher. Therefore, over the short term it is expected that demographic factors of immigration will have a positive effect on the labour force. Over the long term, this effect will be lower.

Nevertheless, whether the immigrant population is younger does not always imply that its labour force is higher if, for example, for cultural reasons immigrants show a low female activity rate. Furthermore, rather than the participation rate, what really matters is the *employment rate*, given that the government obtains revenue only from those individuals who are working. At this time, the employment rate for immigrants is higher than that for nationals but it is possible that this tendency could change in the future (see box on page 46).

With regard to *productivity*, this is determined by the level of education of both populations and the degree of integration of immigrants. For the same number of hours worked, the government collects more tax from the population with the higher productivity. Over the short term, the productivity of nationals is higher than that of immigrants for two reasons. Nationals on average have higher qualifications than immigrants and immigrants need time to make their qualifications compatible. Nevertheless, over the long term, it is quite possible that both populations will converge in productivity.

On the other hand, empirical studies show that the diversity of qualifications of workers from different cultures increases investment in research and development, especially among the most qualified workers. This implies that the productivity index for both groups, both national and immigrant, will rise thanks to the positive complementary factors the two groups bring to production.

How does immigration affect government spending?

The socioeconomic characteristics of the population mean that between the national and immigrant populations there is a substantial difference in the receiving of social security benefits. It is also essential to recognize that those characteristics will change in the future, along with government spending.

For example, at present the immigrants receive less transfers than nationals in the form of pensions because they are younger. But, in time, as the immigrant population ages this trend will change.

On the other hand, the immigrant population has more children than the national population, which carries with it higher spending on family support, education and health. What is more, as immigrants need more special education, the costs of their training are proportionally higher. With the passage of time, as the fertility rate equalizes and the process of integration moves along, this pressure on spending will tend to decrease.

Finally, the state spends on unemployment benefits. In 2005, the unemployment rate among immigrants was higher than that for nationals. With time, more immigrants will meet the requirements for receiving unemployment benefits which could bring about a substantial increase in those costs.

Are immigrants net contributors to or net beneficiaries of the Social Security system?

Having determined how immigration affects the components making up the Welfare State and bearing in mind the importance of concentrating on the long term, the next step is to quantify and find the magic figure that will show us whether immigration helps to finance the Welfare State. The evidence from other countries is positive or negative depending on the methodology and assumptions made. Some studies emphasize that immigration is beneficial for the Welfare State when immigrants stay a limited number of years in the recipient country.

EFFECTS OF IMMIGRATION ON DETERMINANTS OF SUSTAINABILITY OF THE WELFARE STATE

Short term	Long term
Labour force ↑	Labour force ↓
Productivity ↑	Productivity ↑
Spending on pensions ↑	Spending on pensions ↓
Social assistance spending (family, education and health) ↑	Social assistance spending (family, education and health) ↓
Spending on unemployment benefits ↓	Spending on unemployment benefits ↑

SOURCE: Internal figures.

Studies of the Spanish case fail to provide clear conclusions. In general, those studies that find immigration beneficial are based on meeting population forecasts in terms of fertility, life expectancy and age of immigrants and suppose that the national and immigrant populations are equal in terms of their contribution to the production process. On the other hand, those studies taking a more pessimistic view take into account the fact that national and immigrant workers are not perfectly interchangeable in production.

Savings and financing

Financing granted to private sector continues unabated

Financing granted to companies and families continues to grow at very high rates, the highest for the past decade. In the 12 months ended in July, funding to the private sector rose by 23.0%, with no sign of a slowdown. This reflects current economic growth and low interest rates in real terms, that is, discounting inflation.

In fact, in spite of the upward move by the European Central Bank beginning in December, bank interest rates continue at relatively low levels. The average interest rate on bank loans and credits to households and companies stood at 4.6% in July, although it had risen by 87 basis points since the same month in 2005. The interest rate on housing loans was 4.29%, slightly above the inflation rate, while the consumer credit rate was higher at 6.87%. With regard to financing for companies, the interest rate for loans of more than 1 million euros was even below the current inflation rate, that is, the real interest rate was negative.

As a result, it is not surprising that in July credit granted by resident lending institutions to non-financial companies recorded the highest change rate for at least the past ten years with annual growth at 26.4%. Total funding granted to companies rose slightly less (24.7%) but remained very strong.

Good state of economy and low interest rates continue to drive demand for credit.

CREDIT TO COMPANIES GROWING AT HIGHEST RATE IN PAST DECADE

Year-to-year change in credit granted to non-financial companies by resident credit institutions (*)

NOTES: (*) Including off-balance sheet securitized loans.
SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

July 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	77,770	2,409	3.2	3,996	5.4	5.6
Secured loans (*)	845,683	116,396	16.0	185,017	28.0	61.2
Other term loans	378,453	53,157	16.3	72,453	23.7	27.4
Demand loans	30,471	2,413	8.6	3,565	13.2	2.2
Leasing	39,054	4,060	11.6	6,186	18.8	2.8
Doubtful loans	10,527	896	9.3	1,307	14.2	0.8
TOTAL	**1,381,957**	**179,329**	**14.9**	**272,524**	**24.6**	**100.0**

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

Mortgage loans for home-purchase easing but other credit granted to households on increase.

Finance granted to households also continued to increase at a good rate although somewhat less. The main segment, mortgage loans for housing, showed some slowing down. In the period July 2005-July 2006, it rose by 22.8%, some 1.8 points less than in November. We should point out that, in view of the upward trend in rates, financial institutions have adapted mortgage loan terms being offered with products that now provide cover for interest rates. In addition, in view of the foreseeable slowdown in mortgage lending, financial institutions have increased their marketing efforts in the consumer credit segment (for purchase of cars, motorcycles, furniture, appliances, etc.) making loan terms more flexible and, in some cases, with an increase in repayment periods. As a result, non-mortgage loan finance to individuals in July rose by 15.8% compared with the same month last year, more than five points above the annual change in July 2005.

Savings banks continue to gain market share in loan segment.

In addition, in the 12 months ending in July total credit to the private sector granted by savings banks was up by 27.8% whereas that granted by banks rose by 22.2%. As a result, the savings banks continued to gain market share in this segment.

Default rate for loans to private sector hits all-time low in June.

In spite of the major growth of credit in recent years, the default rate stands at very low levels. In June, the rate for doubtful loans to the private sector fell to 0.72%, setting an all-time low level. The default rate for housing loans was even lower at 0.39%.

Strong growth in bank deposits

On the other side of the balance sheet of banking institutions, deposits continued to show sharp growth, only slightly less than that for loans. In fact, the financial institutions have lately put more emphasis on deposits because they have been able to offer higher yields following latest increases in the European Central Bank official interest rate. In any case, the average interest rate for bank deposits was still at a very low level in July.

Deposits by companies and households at credit institutions were up by 23.1% in the past 12 months ending in July. Deposits in foreign currency showed an extraordinary increase largely due to

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

July 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	418,815	22,625	5.7	38,363	10.1	40.6
Up to 2 years	219,693	29,173	15.3	41,094	23.0	21.3
More than 2-year term	296,106	56,624	23.6	90,686	44.1	28.7
Repos	69,740	–3,306	–4.5	3,011	4.5	6.8
Total	**1,004,354**	**105,116**	**11.7**	**173,155**	**20.8**	**97.3**
Deposits in currencies other than euro	**28,329**	**12,690**	**81.1**	**20,521**	**262.8**	**2.7**
TOTAL	**1,032,684**	**117,807**	**12.9**	**193,677**	**23.1**	**100.0**

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

interest rate differentials in their favour. Deposits for more than two years, which enjoy a 40% tax deduction on interest, were also up more than average.

In this market segment, banks have shown higher growth than savings banks in recent times. In July, total private sector deposits at banks had risen by 27.8% as against 18.9% at savings banks. As a result, the banks have recovered some ground although the share held by savings banks continues to be higher.

With regard to securities mutual funds, another important channel for investor savings, total assets stood at 255.77 billion euros at the end of August, an increase of 7.2% compared with the same month last year. As a result, the figure for assets continues to recover following the dip in May and June, thanks to the favourable trend in financial markets.

Net inflows of new money going into participations in securities mutual funds in August amounted to 672 million euros. There was something of a split between the more conservative savers who bought shares in short-term bond-based funds and guaranteed bond-based funds and those investors more ready to take risks who looked to Euro Area share-based funds.

Average annual yield on securities mutual funds stood at 3.6% in August. It should be pointed out that returns were quite varied depending on type. Share-based funds (emerging markets) recovered top place in the classification with capital gains of 23.7%, followed by national share-based funds at 21.5%. On the other hand, international bond-based funds and long-term bond-based funds showed slight capital losses as a result of the increase in long-term interest rates and the subsequent drop in bond prices.

Banks recover ground in deposits segment.

Share-based mutual funds (both those in emerging country and national shares) head classification for annual yield.

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