

Monthly Report



NUMBER 297

What factors make convergence with the EU possible? [Page 20](#)

Since joining EU, Spain has notably reduced income differential with EU average

Euro, «Club Med» and the promised macroeconomic stability [Page 33](#)

Adoption of euro has been success for Spain but same results not seen in Portugal or Italy

Is Spain commercially integrated with Europe? [Page 57](#)

Spain's foreign trade still very much oriented toward EU

European Funds: Is their useful life over? [Page 63](#)

Spain to stop receiving large part of European transfers aimed at reducing economic backwardness

Forecast

% change over same period year before unless otherwise noted

	2005	2006	2007	2005		2006			
				3 Q	4 Q	1 Q	2 Q	3 Q	4 Q
INTERNATIONAL ECONOMY	Forecast								
Gross domestic product	Forecast								
United States	3.2	3.3	2.6	3.4	3.1	3.7	3.5	3.0	3.0
Japan	2.7	2.8	1.9	2.9	4.1	3.6	2.7	2.7	2.1
United Kingdom	1.9	2.6	2.4	1.8	1.9	2.3	2.6	2.7	2.7
Euro area	1.5	2.6	1.9	1.7	1.8	2.2	2.8	2.7	2.7
Germany	1.1	2.5	1.3	1.5	1.7	1.9	2.7	2.8	2.6
France	1.2	2.0	1.8	1.4	0.9	1.4	2.6	1.8	2.1
Consumer prices	Forecast								
United States	3.4	3.2	1.9	3.8	3.7	3.7	4.0	3.3	1.9
Japan	-0.3	0.3	0.4	-0.3	-0.7	-0.1	0.2	0.6	0.7
United Kingdom	2.3	2.8	2.6	2.4	2.2	2.2	2.8	3.2	3.1
Euro area	2.2	2.2	2.0	2.3	2.3	2.3	2.5	2.1	1.8
Germany	2.0	1.7	2.4	2.1	2.3	2.0	1.9	1.6	1.4
France	1.7	1.7	1.7	1.9	1.6	1.8	1.5	1.8	1.9
SPANISH ECONOMY	Forecast								
Macroeconomic figures	Forecast								
Household consumption	4.2	3.6	3.2	4.1	3.8	3.8	3.6	3.6	3.5
Government consumption	4.8	4.2	4.3	4.5	4.9	4.3	4.2	4.2	4.2
Gross fixed capital formation	7.0	6.3	6.0	7.1	6.6	6.3	6.2	6.3	6.5
Capital goods	9.0	9.2	8.2	8.3	8.6	8.6	9.1	9.5	9.6
Construction	6.0	6.0	5.6	6.3	5.6	5.8	5.8	6.1	6.2
Domestic demand (contribution to GDP growth)	5.2	4.8	4.4	5.2	5.0	4.9	4.8	4.8	4.7
Exports of goods and services	1.5	5.2	4.2	2.5	2.3	9.5	4.9	3.2	3.5
Imports of goods and services	7.0	7.9	6.3	7.7	6.6	12.4	7.6	6.0	6.0
Gross domestic product	3.5	3.7	3.5	3.6	3.6	3.6	3.7	3.8	3.8
Other variables	Forecast								
Employment	3.1	3.1	2.7	3.3	3.2	3.2	3.1	3.0	3.0
Unemployment (% labour force)	9.2	8.5	8.1	8.4	8.7	9.1	8.5	8.1	8.2
Consumer price index	3.4	3.5	2.5	3.4	3.6	4.0	3.9	3.5	2.7
Unit labour costs	2.2	2.6	2.2	1.9	2.3	2.5	2.7	2.6	
Current account balance (% GDP)	-7.5	-8.8	-9.7	-6.8	-7.0	-10.6	-8.2	-8.5	
Not lending or net borrowing rest of the world (% GDP)	-6.5	-7.9	-8.8	-6.0	-5.9	-10.3	-7.7	-7.9	
Government balance (% GDP)	1.1	1.5	1.2						
FINANCIAL MARKETS	Forecast								
Interest rates	Forecast								
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	5.2	4.2	4.5	4.6	5.1	4.9	4.7
10-year German bonds	3.4	3.8	4.3	3.2	3.4	3.5	4.0	3.9	3.8
10-year Spanish bonds	3.4	3.8	4.3	3.2	3.4	3.5	4.0	3.9	3.8
Exchange rate	Forecast								
\$/Euro	1.25	1.26	1.35	1.22	1.19	1.20	1.26	1.27	1.29

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Y PENSIONES
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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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Europe suits us quite well

The European Union (EU) is now going through one of its finest moments. In 2007, it will celebrate 50 years since the signing of the Treaty of Rome but even the logo to be used at the celebrations has caused dissension among the member states. The European Constitution, the text that was to set out the values, principles, jurisdiction and institutions of the Union over the long term, stands in obedience. It was to come into force at the end of 2006 but now it has even been taken off the main EU Internet web-site. Furthermore, the enlargement to 27 member states as of January 1 and the prospect of future extensions, to include Turkey, is doing nothing to cultivate a feeling of being European among ordinary citizens.

In Spain, however, the general perception of the EU continues to be favourable. The Constitution gained a definite «Yes» vote in the referendum held (while participation was indeed low) as against the major doubts it aroused in other countries. Public opinion in Spain holds that forming part of the EU is a good thing and, if the advantages and disadvantages are weighed, the overall balance is definitely positive. According to the latest Eurobarometer survey, Spaniards are the most enthusiastic after the Greeks about the enlargement bringing Bulgaria and Roumania into the EU, whereas in France and Germany, for example, most people are against it.

What is the basis of this European feeling in Spain? Perhaps it is a reaction after having lived so many years quite outside the European and international scene. And the situation of freedom, democracy and prosperity that the construction of Europe represented in the years Spain began to move ahead must have had its influence. Undoubtedly, however, the key factor has been the economy. Twenty years as a member of the EU has meant greater economic growth for Spain and a reduction in the per capita income gap with the EU average. Spain has received a major flow of funds going into its more backward regions and into investment in basic infrastructures. Inflation and unemployment have been spectacularly reduced. Direct investment abroad is comfortably higher than the inflow of direct foreign capital. Spain's economy has become consolidated on the world economic map.

To be part of the UE, however, is not a lottery prize. Even before Felipe González put his signature on the Treaty of Accession he had to initiate complicated reforms in order to adapt an interventionist regulated economy to the market parameters imposed by the EU code of values. Liberalizing foreign trade, opening sectors of production to domestic and foreign competition, modernizing governmental structures, reducing the relative weight of government-run enterprises in the economy along with many other measures marked out the years during which Spain waited to become a member of the EU club. Companies, trade unions, public servants and many other groups were ready to sacrifice some of their interests for the common good. When it came time to change over to the euro, the Spanish economy again met the challenge and the result has been a long period of GDP growth and improvement in economic indicators, something that some other countries who shared a similar position to that of Spain have not been able to achieve.

Forming part of the EU offers little guarantee. It is the discipline and serious intent of all economic segments that makes it possible to move along the path of convergence in the direction of prosperity. This is the lesson that Spain can offer to the new countries that recently became part of the European Union.

OVERALL SUMMARY

European economy growing more than that of USA, something of a novelty.

Europe growing faster than United States

If it were a boxing match, the news report would put the accent on the unexpected recovery of the boxer who seemed on the point of throwing in the towel then managed to win his first round after many failures. The triumphant boxer in this case is the European economy which until now has been running behind the United States, the heavy-weight in the ring. For the first time, the European economy has managed to get in a telling blow in the form of a higher growth rate. To top things off, the dollar, the United States' powerful weapon is losing its punch and showed a notable drop at the end of November.

Response of US consumers uncertain in view of drop in housing sector.

The fact is that the latest figures for the US economy have given rise to pessimistic scenarios in which the recession in housing is shifting to consumers while the Federal Reserve System sees itself obliged to raise interest rates to halt inflation, which in turn adds to the negative trend in economic activity and is even creating instability in financial markets. The reality, however, is not quite so dramatic. Employment continues to rise, unemployment stands at low levels and the financial markets reflect the good performance of companies. Even the trade deficit has improved. The political situation is putting pressure on Bush (Iraq and the Democratic party victory in the recent elections) but the economy is still holding up.

On opposite side of Atlantic, Euro Area economy in 2006 to reach highest growth since 2000.

The key lies in the performance of US consumers in the context of the drop in the real estate market. Households drive

more than two-thirds of the economy and for the moment it would seem that the free spending seen in the first half of the year has cooled off considerably. Now that the Christmas season is beginning, a time when retail merchants get in a good part of their take for the whole year, we shall see up to what point we can still believe in the ability of the US consumer to drive the world economy.

The other key question is inflation. Ben Bernanke, the US central bank system chairman, has expressed his fears on this matter. The consumer price index dropped to 1.3% in October from 4% in the summer and the core component was also down although very little. No one has paid much attention to the good news but rather the trend in underlying inflation mentioned and the rise in labour costs have created some concern about the response from the Fed if things get worse.

In the other corner of the ring we find the Euro Area economy. Following a number of failures, it seems that this time recovery is going to become consolidated. The Organization for Economic Cooperation and Development (OECD) confirms this as follows: «The main scenario for the next two years is for stable growth somewhat above potential with modest inflation, in a context of progressively overcoming the weakness in aggregate demand». The European Commission also draws a rosy picture in its Autumn forecasts. After confirming that in 2006 the Euro Area will reach its highest growth since 2000 (2.6%), it predicts rates above 2% for the next two years, which would be a good level.

The macroeconomic results in the Euro Area for the third quarter have not been exactly those expected. The gross domestic product grew by 2.6% at year-to-year rate, one decimal less than in the three previous months. But in the second quarter growth showed a sharp rise and, therefore, we believe that the present result confirms recovery. A significant new factor is that for the first time since 2001 the German economy is growing more than the Euro Area average, perhaps returning to its old and almost forgotten role as engine of the Continent. On the negative side comes France which went through an unexpected slowdown in the third quarter.

In the final part of the year we can expect similar results. Retail sales reflect some buying enthusiasm among consumer, the worsening of the trade balance in recent months seem to be slowing down and the main sectors of economic activity, such as industry, construction and services, are looking good. In the meantime, prices are contained, thanks to the sudden weakness in the per barrel price of oil, and core inflation (the general index less food and energy) is holding fairly flat below 2%.

The fears brought about by the US slowdown, combined with the spate of good news from the Euro Area, have sent the euro up against the dollar. In fact, the US currency had a generally poor November. Hanging over the greenback is the threat of the diversification of reserves by the emerging Asian economies which, with China in the lead, have accumulated a huge volume of assets expressed in dollars. The only alternative would be the euro although a process of this nature would be very gradual.

The advance of the euro in the final part of November, however, had a very direct effect on further increases in Eurosystem reference interest rates in view of a

scenario of maintaining and cutting rates for the US currency as of mid-2007. The euro has gone above 1.31 dollars thus marking up a high for nearly two years. The strength of the euro has also been noted in the Swiss franc and the Japanese yen. But the strength of the euro is a double-sided weapon for the European boxer. If taken to extremes, it could hurt recovery by making exports more difficult and cutting the cost of imports even further. For the moment, the ministers of finance in the Euro Area have not raised a hew and cry but, if the trend is not corrected, no doubt all eyes will be on the European Central Bank demanding that its moves do not feed the flames of revaluation.

Spain's economy: more reasons for optimism

It is beginning to become a routine. When it seems that growth of Spain's economy has reached a ceiling and that a stage of slowdown has begun, the National Institute of Statistics (INE) comes out with an even more positive figure. In the third quarter, the gross domestic product (GDP) grew by 3.8% year-to-year, one decimal more than in the previous quarter and a rate that had not shown up in the past five years. As inflation has been reduced and the European economy is showing good prospects, Pedro Solbes, Minister of Economy, has dared to predict that the current growth stage will continue for the next two or three years.

The engine of the economy continues to be domestic demand, in all its components. We should especially note investment in machinery and capital goods by companies which has again risen going to rates above 9%. Also worthy of note was the increase in growth rate for construction which stood at one decimal above 6% real. In this case, all types of

For first time in five years, German economy growing more than Euro Area average.

Euro gains ground against dollar because of prospect of rise in interest rates.

Strength of domestic demand keeps driving growth of Spain's economy.

Far from slowing down, investment in capital goods and construction maintaining very strong performance.

In past three years, more than 1.5 million net jobs created, entirely in services sector (nearly 70% of total) and construction (close to 30%).

Surprising positive growth of productivity although at cost of stagnation in industrial employment.

construction are doing well, especially infrastructures and non-residential building construction. With regard to household consumption, the growth rate is high at 3.6%, in spite of the fact that spending on certain durable goods, such as cars, is weak. On the other hand, we note a more dynamic performance in food, services and semi-durable goods which is contributing to even out the overall result. Finally, the consumption of the public sector has stabilized at high levels of more than 4% annual.

Indicators for the last quarter of the year are still few and far between and cover only October. The impression, however, is good. Electrical power consumption continues to rise as is the case with cement, commercial vehicle sales and loan demand. In October, sale of passenger cars in turn broke away from their downward trend although the figure for October 2005 was unusually low and this comparison could lead to incorrect conclusions.

With regard to the foreign sector, the figures for Quarterly National Accounts show a slowdown both in imports and exports of goods and services. For this reason, the negative contribution of this component to GDP growth eased slightly. In any case, for the nine months of the year now completed the current account deficit amounted to 9.1% of the GDP, close to 1.5 points more than in the whole of 2005.

With regard to employment, the INE figures show a slight slowdown profile with growth of the figure for jobs equivalent to full-time work at 3.0%, which means more than half a million jobs created in the past year. Construction is the sector showing the biggest drive with a rate going to no less than 8%. Private services also show a high rate (4%) although in this case we note something

of a slowdown. On the other hand, public services have tended to rise in recent months although the rate of increase stands at just 2.1%. In industry, on the other hand, the state of the labour market is still negative, as is the case in agriculture and fishing.

According to the figures for National Accounting, in the past three years some 1.5 million jobs equivalent to full-time work have been created entirely in the services sector (nearly 70% of the total) and in construction (close to 30%), which again underlines that those sectors are the real support of Spain's current growth model.

In prices, the increases in the third quarter were fairly limited with a rise in the GDP deflator still close to 4% year-to-year, although in this case the trend points to a slight slowdown. We should point out, however, the improvement in the apparent productivity of the labour factor (GDP per full-time worker) which rose by two decimals over the previous quarter to stand at 0.8%, thanks to the drive in industry, thus compensating for practically no improvement in private services and the negative figure for construction.

Spain's economy is suffering from a low productivity rate, a big differential in prices with the Euro Area, poor competitiveness with abroad and an overly high foreign deficit. The overall result and future prospects, however, are positive. Proof of this is to be seen in the latest report of the OECD. This report indicates that the biggest risk over the short term lies in the real estate sector. This would not be because of the possibility of the bursting of any real estate bubble. On the contrary, the risk would lie in increased demand for housing.

November 28, 2006

CHRONOLOGY

2005

- 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.
- October** 5 **European Central Bank** raises official interest rate to 3.25%.
- November** 17 Dow Jones index for **New York stock exchange** records all-time high (12,342.6) showing rise of 15.2% over end of 2005.
22 IBEX 35 index for **Spanish stock exchange** marks up all-time high (14,294.6), with cumulative capital gains of 33.2% compared with the end of December 2005.
29 Publication in the BOE Official Bulletin of Law 35/2006 on **Personal Income Tax** and partial changes in Law on Corporation Tax, Income of Non-residents and on Property.

AGENDA

December

- 4 Registrations with Social Security and registered unemployment (November).
5 Industrial production index (October).
7 Meeting Governing Council, European Central Bank.
12 Meeting Open Market Committee, Federal Reserve System.
15 CPI (November). Balance of payments (September).
Harmonized CPI for EU (November).
19 Central government revenue and spending (November).
20 Labour cost (3rd Quarter).
26 Producer prices (November). Foreign trade (October).
29 Early CPI (December).

January

- 10 Industrial production index (November).
11 Meeting Governing Board of European Central Bank.
12 CPI (December).
15 Balance of payments (October).
17 Harmonized CPI European Union (December).
25 Producer prices (December).
26 Labour Force Survey (4th Quarter).
31 Meeting Open Market Committee, Federal Reserve System.

INTERNATIONAL REVIEW

Democratic Party win changes political scene in United States.

United States: land however you can

Nancy Pelosi, the new leader of the Democratic majority in the Congress following the legislative elections, not only will be appearing in president George Bush's dreams but also in those of Tom Schoewe, financial director of Wal-Mart, the world's biggest distributor, of the Chinese authorities and of Ben Bernanke, chairman of the Federal Reserve System. The Democratic party victory in November comes at a special moment when the US economy is adjusting its growth rate and also its expectations, with the trade deficit as background. The question is whether the slowdown will be a «soft landing» or something else again.

Housing market still not at end of tunnel...

The housing market, the main contributor to the economic

slowdown, continues to show signs of weakness and the end of that slowdown seems somewhat farther off than a few weeks ago. Housing starts showed sharper drops in October with a decrease of 27.4% year-to-year while building permits were down another sharp 25.9%. The slight increase in new housing sales in September was less significant than the drop of 9.7% in prices, given that real estate agents, who are quite troubled by the housing stock now on the market, are offering major discounts in order to speed up settlements. The areas most affected are those that have shown biggest growth are Florida, Las Vegas and especially the urban areas of California, which started out from already high prices before the upward cycle.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006					
			4 Q	1 Q	2 Q	July	August	September	October
Real GDP	3.9	3.2	3.1	3.7	3.5	–	2.9	–	–
Retail sales	6.2	7.2	6.3	8.3	6.6	4.8	6.3	5.2	4.5
Consumer confidence (*)	96.1	100.3	95.8	105.7	106.6	107.0	100.2	105.9	105.4
Industrial production	4.1	3.2	3.0	3.3	4.6	5.0	5.0	5.8	4.9
Industrial activity index (ISM) (*)	60.5	55.5	57.0	55.6	55.2	54.7	54.5	52.9	51.2
Sales of single-family homes	10.1	6.6	3.1	–11.6	–14.4	–28.0	–19.7	–14.2	...
Unemployment rate (**)	5.5	5.1	4.9	4.7	4.6	4.8	4.7	4.6	4.4
Consumer prices	2.7	3.4	3.7	3.7	4.0	4.2	3.8	2.1	1.3
Trade balance (***)	–611	–717	–717	–740	–762	–771	–782	–781	...

NOTES: (*) Value.

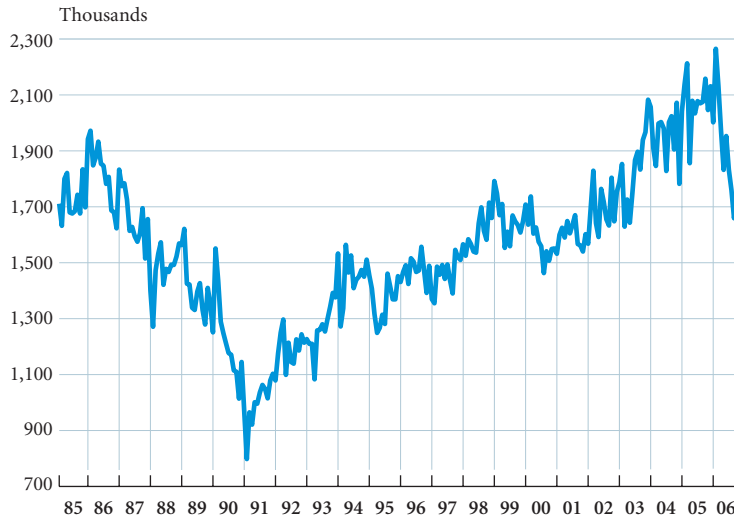
(**) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

UNITED STATES: HOUSING CONTINUES TO DROP

Housing starts in annual terms



SOURCE: Federal Housing Board, National Association of Realtors and own calculations.

The key question is how all this may effect the behaviour of US consumers, responsible through their purchases of 71% of economic activity. The weakness in housing comes on top of a gradual reduction of household savings which now is a lack of savings, given that US households spend 0.5% more than their disposable income. As a result, it seems that the public is gradually beginning to pull back from its buying spree.

Retail sales in October, excluding the important but erratic components of cars and petrol, were up by 5.0% year-to-year (or 2.2% if we exclude non-energy price increases), a clear downturn compared with the previous month. On top of this relative weakness came downward revisions for previous months so that the sustained strong trend that was dominant up to the end of summer clearly came to an end. In this context, the worsening prospects for Wal-Mart, the world's biggest retail outlet, along with its rivals Home Depot and Target, are significant because of the weakness of the domestic

market. As a result, the slogan «Wake-up Wal-Mart» used in the Democratic party campaign (demanding that the company live up to its social responsibilities) could indeed cause many to lose some sleep.

Corporate sentiment is generally more calm with the Institute for Supply Management index for manufactured goods in October down slightly to 52.1 points but moving up in services to 57.1 points, the highest since May. The prices component continues to ease sharply while export orders are gaining strength. Industrial production is also holding at a relatively high level. In spite of the temporary drop in October, it grew by 4.9% year-to-year, showing especially strong in goods of high value added.

Inflation in October, which was better than expected, also brought some calm to the scene. There was one big slowdown and another quite small but it was precisely the latter that was the most important. The general index was up by 1.3% year-to-year (whereas in the

...while consumers seem unready to spend more in view of lack of savings.

Business sentiment and industrial production still indicating gradual slowdown.

UNITED STATES: CONSUMERS EASE OFF SPENDING

Year-to-year change in real retail sales, excluding cars and petrol (*)



NOTES: (*) Figures deflated by price index excluding energy and foods.
SOURCE: Department of Commerce and own calculations.

Moderation in inflation will avoid pressures, labour market permitting.

summer the rate of increase had been 4%) because of the easing in oil prices and base effects. In the autumn of 2005, the combination of hurricane Katrina, with the parallel pressure on energy markets, raised prices to a peak that, viewed from October 2006, still seem very high and this has meant low year-to-year increases. It is the moderation in the underlying component, however, that must mark a trend taking pressure off the Federal Reserve System where chairman Bernanke's plan to establish a specific inflation objective are not well viewed by the new Democratic majority in Congress. By sector, recreation, food and health are showing a tendency to stabilize while education and rentals are on the rise.

In the centre of the debate on the future trend in prices stands the labour market. Job creation in October was better than expected, along with the upward revisions for previous months. The unemployment rate of 4.4% is historically low and the

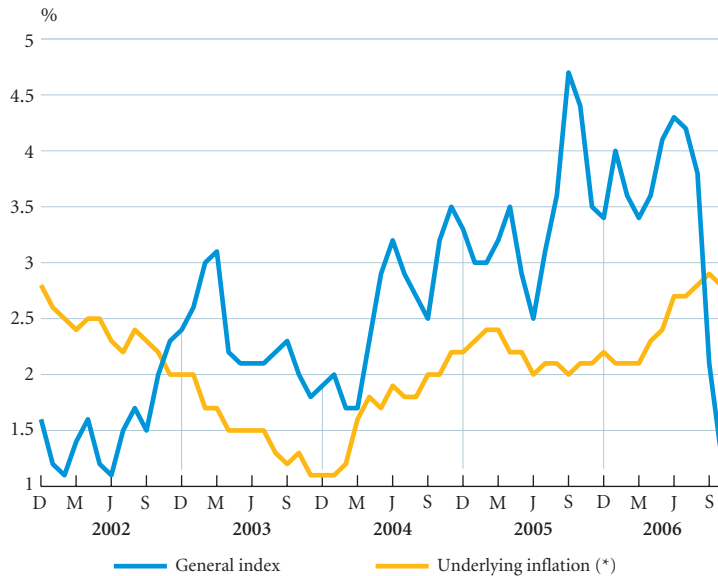
upward revisions announced suggest that the strength of the labour market is greater than would appear from the statistics. This should give support to consumption and partly compensate for the effects of the drop in housing. The most inflationary aspect of the labour market is the increase in unit labour costs but, in a situation of lower consumption, companies will have some difficulty in shifting cost increases to the consumer.

The foreign deficit for August was 1.0% less than in the same period last year, something that had not happened since March 2002. The slowdown in imports, which rose by 9.4% year-to-year, was the main cause of the reduction in the deficit while exports showed increased growth at 15.8% year-to-year. The trend in domestic demand and the continuation in oil prices should keep this process going and calm down protectionist demands being heard in Congress. The US economy is thus facing a landing with lower consumption but with prices and a

Trade deficit moderating in line with lower domestic demand and strength in exports.

UNITED STATES: DROP IN CPI

Year-to-year change in CPI



NOTES: (*) Excluding foods and energy.

SOURCE: Department of Labour and own calculations.

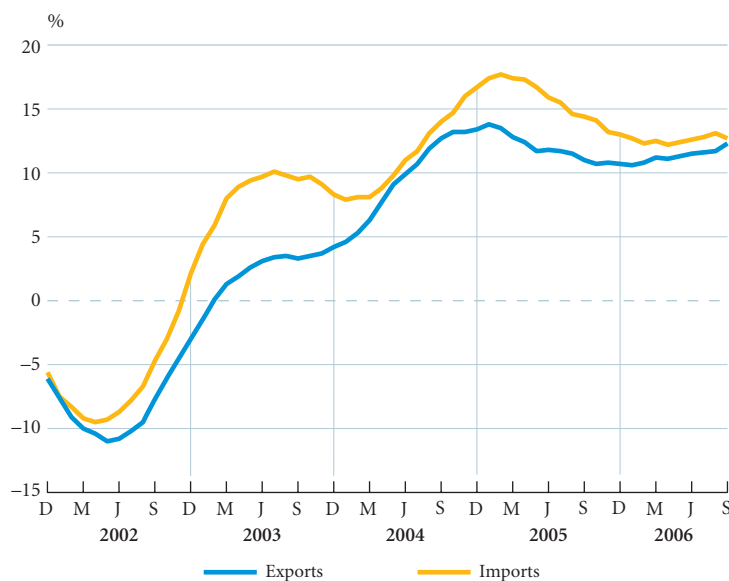
foreign sector on a path of moderation that should make things easier. The Democratic victory should not overly affect the economic agenda in its fight

against inflation and reduction of the deficit. The case of Wal-Mart, which shows that the biggest risk lies in lower growth, is another matter.

Drop in growth bigger risk than inflation.

UNITED STATES: EXPORTS CLOSING GAP

Year-to-year change in monthly average for last 12 months



SOURCE: Department of Commerce and own calculations.

Japan's economy grows by 2.7% but domestic consumption weakens.

Japan maintaining cycle thanks to exports

Shimzo Abe, Japan's brand-new prime minister, has an ambitious agenda that goes far beyond the achievements of his popular predecessor, Junichiro Koizumi. After playing a more than usual role in the North Korean crisis, Abe's plans include nothing less than attempting to end Japan's dual economy, thanks, among other factors, to a selective reduction of taxes. In Japan's economy

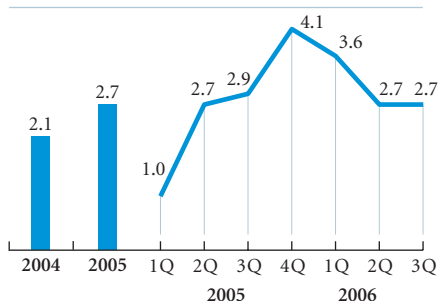
we find side by side a very competitive export sector and agriculture and services sectors that are relatively backward, which often ends up affecting growth of domestic demand.

In view of the figures for the gross domestic product (GDP) for the third quarter, the prime minister's plans could not be more opportune. The economy continues to grow (2.7% year-to-year) thus improving on some of the expectations in the market that even

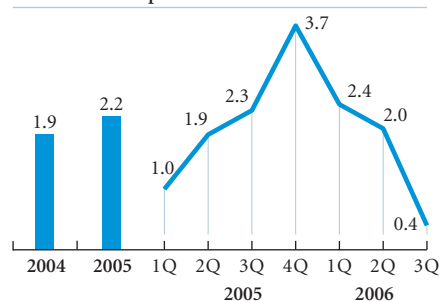
TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-to-year change in real terms

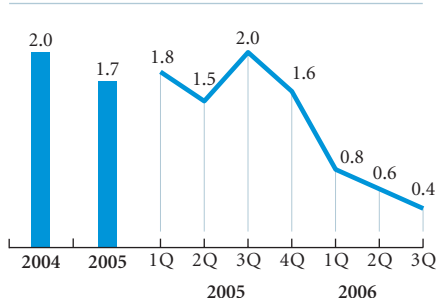
GDP



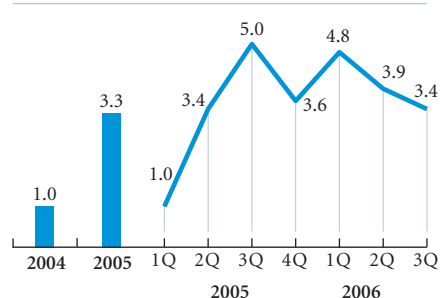
Private consumption



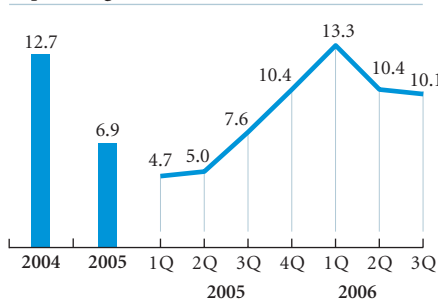
Public consumption



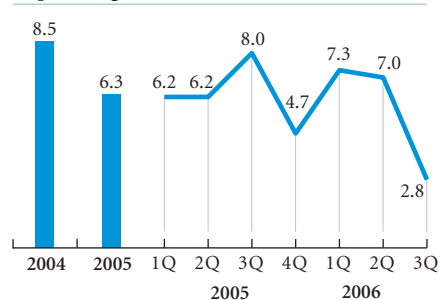
Gross fixed capital formation



Exports of goods and services



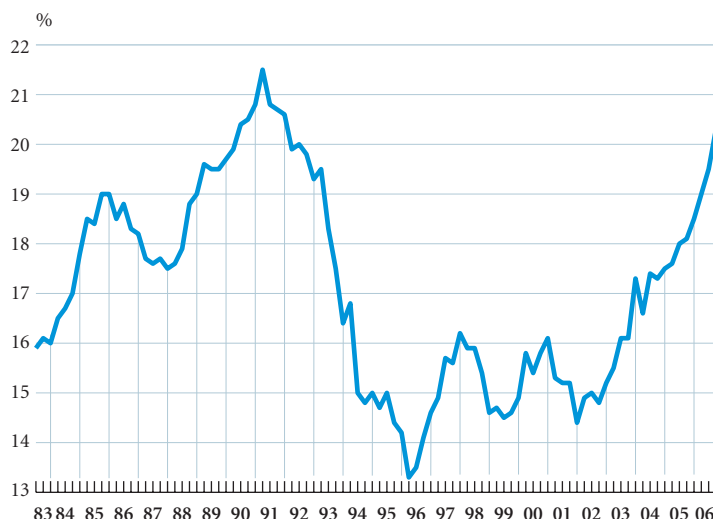
Imports of goods and services



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

JAPAN: A WELL-KNOWN PATTERN

Share of foreign sector in gross domestic product plus capital goods investment



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

indicated an end to the growth cycle. Nevertheless, the good news ends right there. The recovery in principle is backed by the foreign sector under the shelter of strong growth in China and the United States. This revitalized domestic demand and in 2005 private consumption showed its leadership in matters of growth. Nevertheless, this did not last long and now the pillars supporting growth are again the traditional ones, specifically the foreign sector and capital goods investment, mainly by the export-oriented companies.

Both sectors contributed to practically all growth over the previous quarter. Private consumption took away from growth but this was compensated by the upward cycle in the accumulation of inventories. Strengthening this pattern, the participation of investment in capital goods and the trade balance in the total figures for the economy in the past five years has gone from 14.4% to 20.3%, the highest level since 1991. All this with the difference that in 1991 private

consumption grew by around 3% year-to-year while it is now 0.4%, a lack-lustre rate even considering the unfavourable weather conditions in the third quarter. The public sector, limited by the cumulative borrowing levels reached, also continues to weaken progress. Housing is stagnant although for the moment it is not putting excessive blocks in the way of growth.

Demand indicators have been confirming the weakness in consumption for some time. Retail sales moved ahead by a mere 0.3% in September within a trend leading to stagnation which, if we keep the trend in prices in mind, is settling into a downturn. Car sales over the past 12 months ending in October also continued to drop. The real estate market is putting out somewhat more ambiguous signs. In Tokyo, the drop in number of sales continues but prices, apart from short-term swings, are still holding to a very slight upward trend. The poor showing in the demand

Capital goods investment and foreign sector behind all growth.

Retail sales weak and car sales continue to drop.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006					
			4 Q	1 Q	2 Q	3 Q	July	August	September
Real GDP	2.1	2.7	4.1	3.6	2.7	2.7	–	2.7	–
Retail sales	–0.9	1.4	0.7	0.6	–0.2	0.5	0.0	1.1	0.3
Industrial production	5.3	1.5	3.6	2.8	3.7	5.3	5.0	5.8	4.9
Tankan company index (*)	20.5	18.0	21.0	20.0	21.0	24.0	–	24.0	–
Housing construction	2.6	3.8	6.9	4.9	8.8	–0.7	–7.7	1.9	4.0
Unemployment rate (**)	4.7	4.4	4.5	4.2	4.1	4.1	4.1	4.1	4.2
Consumer prices	0.0	–0.3	–0.7	–0.1	0.2	0.6	0.3	0.9	0.6
Trade balance (***)	13.9	10.2	10.2	9.5	9.1	8.9	9.2	9.2	8.9

NOTES: (*) Value.

(**) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

Good performance in labour market coincides with increased savings.

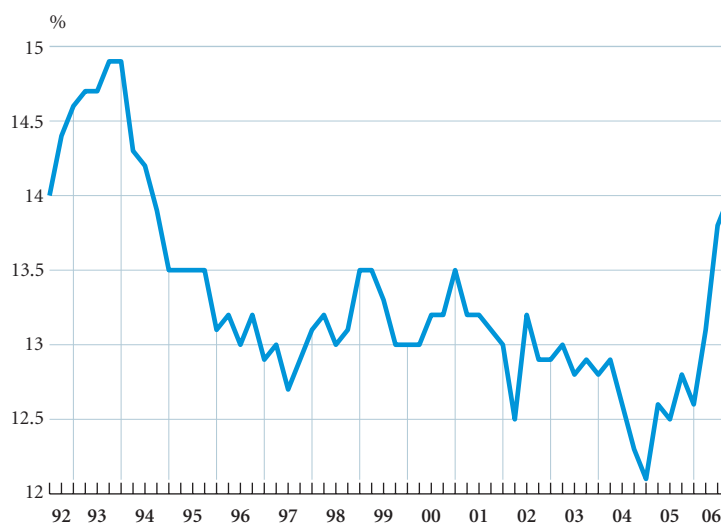
indicators is in contrast to the support coming from the labour market, with an unemployment rate at 4.2% of the labour force and wages on a rising trend. This contrast can only be explained by

the increase in household savings which has been dominant all through 2006.

Industrial production is now giving off a more vigorous picture of the strength of

JAPANESE REMAIN CAUTIOUS

Savings rate of employees in terms of income (*)



NOTES: (*) Average for past 12 months.

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

the economy with growth of 4.9% year-to-year which puts it in the high band for the last three years. In the same context, machinery orders continue upward in spite of occasional adverse knocks and point to some continuity in the strength of investment although in this respect the total of bank loans to large companies continued to drop in October down from the levels seen in July.

Prices held on positive ground. If we discount volatile fresh foods, prices were up by 0.2% year-to-year. The upward trend continues although this is less than forecast in the summer and we shall have to see how they behave once the effects of oil prices have worn off. Where this will have a clearly positive effect is in the foreign sector. The ups and downs as a result of imported energy prices are taking steam away from the trend in the trade surplus but in recent months leadership has definitely come with the growing strength of exports which now account for nearly 15% of the total GDP and are a faithful exponent of the Japan that at this time is contributing to the progress of the economy. The problem with this pattern is the high level of dependence on China and the United States at a moment when both of those countries

are facing a slowdown in their respective demand levels.

Brazil gaining abroad what it is losing at home

Brazil's economy has come upon very low growth levels which are not helping Lula's new government to maintain macroeconomic stability although a recovery in growth is expected for the third quarter.

Monthly demand indicators provide a better picture for growth in the third quarter with retail sales going up to 10.1% year-to-year in October. Car sales have also come sharply out of their lethargy with growth of 14.8%. The down side is in supply, with industrial production showing weak in October. Nevertheless, the slight drop in capital goods production may be attributed to a pause along the way after two previous months of sharp growth.

Inflation continues along a line of moderation, thanks to the lower rate of economic activity and the task of containing government spending, with prices moving up by 3.3% year-to-year in October. According to figures for the São

Brazil expecting recovery of growth in third quarter.

Demand gains strength in recent months with unemployment down but still high.

Control of inflation continues to bear fruit.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006					
			4 Q	1 Q	2 Q	July	August	September	October
Real GDP	4.9	2.3	1.5	2.6	1.7	—	...	—	—
Industrial production	8.3	3.1	1.3	4.6	0.9	3.5	3.2	1.3	...
Unemployment rate São Paulo (*)	18.8	17.0	16.4	16.3	16.9	16.7	16.0	15.3	...
Consumer prices	6.6	6.9	6.1	5.5	4.3	4.0	3.8	3.7	3.3
Trade balance (**)	33.7	44.8	44.8	45.7	44.5	45.1	46.0	46.1	46.3

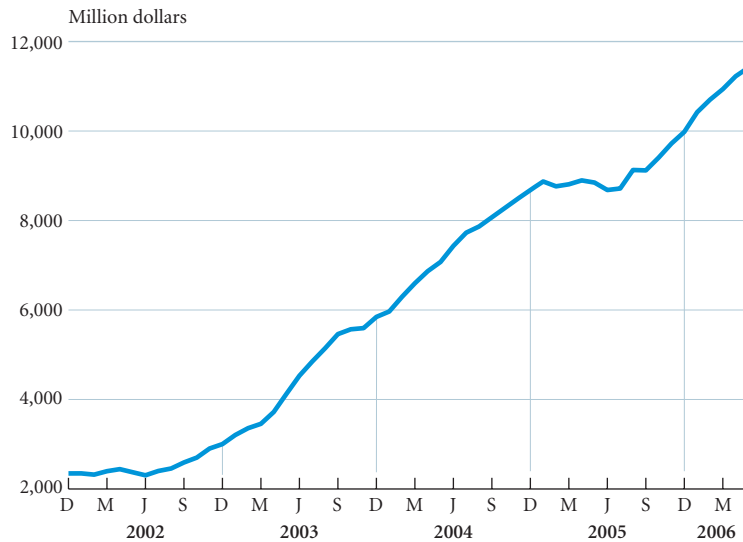
NOTES: (*) Percentage of labour force.

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

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

BRAZIL: CHINA CONTINUES TO OFFER OPPORTUNITY

Goods exports to China in past 12 months



SOURCE: International Monetary Fund and own calculations.

Foreign sector remains strong point thanks to China and raw materials.

Paulo region, the unemployment rate also improved in September going to 15.3% of the labour force, an improvement which, however, must continue if stability is to be maintained.

Nevertheless, this improvement also underlines a double dependence on the foreign sector, both on China's growth and on raw materials prices.

Argentina expecting continued growth in third quarter.

It is in the foreign sector where the Brazilian economy is showing its best face. Following a pause in the second quarter, exports again showed a strong level with growth of 18.5% year-to-year in October. As a result, the trade surplus for the past 12 months ending October grew to 46.3 billion dollars. This shows the significant advantages the Brazilian economy is obtaining from China's strong economy as exports of goods to the Asian giant have not only practically multiplied by six in five years but each time represent a bigger share. In 2001, only 0.9% all goods landing in China came from Brazil whereas by mid-2006 this figure had reached 1.6%. In recent months the trade relation has also changed with exports being more expensive than imports, largely due to the trend in raw materials markets.

Argentina expecting continued growth

The Argentine economy continues to show strong growth and the country is expecting a robust third quarter that will continue this trend, based on indicators appearing in recent months. Inflation remains the main part of the Argentine locomotive still to be adjusted.

Retail sales continue to grow as a very strong rate following some timid sputters at the beginning of summer. In the Buenos Aires region last September they grew by 26.5% year-to-year. Department store sales were up 21.6% in the same period. Car sales provides an example of the recovery in Argentina and its situation in terms of levels before the recession. In the past 12

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3 Q	4 Q	1 Q	2 Q	July	August	September	October
Real GDP	9.0	9.2	9.2	9.0	8.8	7.9	—	...	—	—
Industrial production	6.9	7.5	6.0	8.1	5.7	7.2	9.6	6.9	7.7	...
Unemployment rate (*)	...	...	11.1	10.1	11.4	10.4	...	10.2	...	...
Consumer prices	4.4	9.6	9.8	11.7	11.6	11.4	10.6	10.7	10.4	10.5
Trade balance (**)	12.1	11.4	11.5	11.4	11.4	12.1	11.8	11.7	11.5	11.6

NOTES: (*) Percentage of labour force.

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

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

months ending in October sales were up 28.3% which puts them at 61.5% of the all-time high in March 1998. There is still some way to go but it should be remembered that in 2004 the level stood at 37% while the lowest point was 14%.

On the supply side, growth continued with renewed strength. Industrial production in October rose to 7.7% year-to-year, with maintenance of the

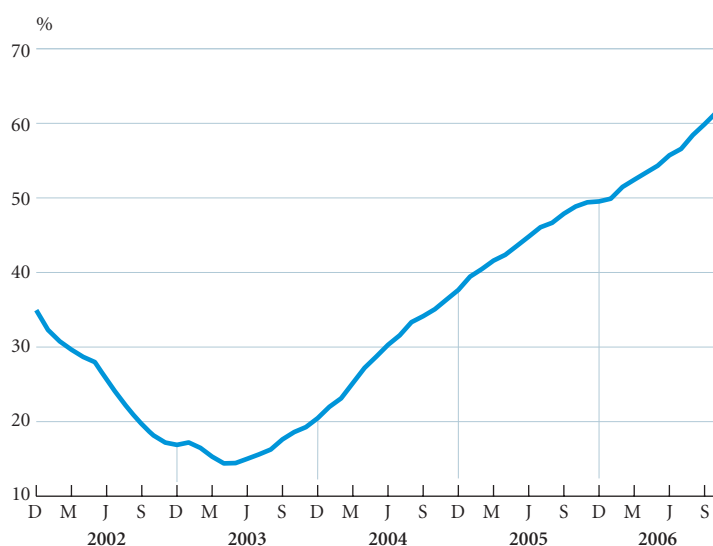
industrial activity index and some moderation in construction.

Inflation in Argentina remains the dark shadow hanging over the current growth cycle. In October, the increase of 10.5% year-to-year meant continuation of a level that is still high for the region. The unemployment rate in the third quarter was down slightly to 10.2% of the labour force while the trade surplus continued stable.

Inflation remains biggest risk.

ARGENTINEANS AGAIN BUYING CARS

Car sales in past 12 months compared with high in 1998



SOURCE: INDEC and own calculations.

EUROPEAN UNION

European Union forecasts growth of 2.6% in Euro Area in 2006 and 2.1% in 2007...

...with no major pressure on prices.

European Commission predicting less expansionist 2007

The Autumn forecasts of the European Commission sketch out a good scenario for the European Union (EU) and the Euro Area. After confirming that growth this year will be the best since 2000, reaching 2.8% and 2.6% respectively in the EU and the Euro Area, prospects for the next two years are more contained. To be specific, it is expected that the EU will grow by 2.4% in 2007 and 2008 while the Euro Area will reach 2.1% in 2007 and 2.2% in 2008.

This growth rate, above growth potential, will not take place at the cost of worse inflation so long as the increase in the

harmonized consumer price index (HCPI) drops by three decimals between 2006 and 2008, both in the EU and the Euro Area. Significantly, in spite of the high prices of energy, inflationary pressures are not expected to shift to other CPI components, that is to say, no second round effects are expected.

This path of gradual economic slowdown comes about from a positive world economic situation but immersed in a moderate slowdown with some tightening of economic policy, both monetary and fiscal. In any case, there are positive factors which will provide support for growth: easy financing conditions and a positive trend in corporate profits. All of this should lead to a pattern of growth where the two

MACROECONOMIC PROJECTIONS FOR EURO AREA ⁽¹⁾

	2004	2005	Current forecasts Autumn 2006			Difference with Spring 2006 ⁽²⁾	
			2006	2007	2008	2006	2007
Gross domestic product	2.0	1.4	2.6	2.1	2.2	0.5	0.3
Consumption	1.5	1.4	2.0	1.6	2.1	0.3	0.2
Investment	2.3	2.5	4.3	3.0	3.0	0.1	0.6
Employment	0.7	0.7	1.4	1.2	1.1	0.5	0.4
Unemployment rate ⁽³⁾	8.9	8.6	8.0	7.7	7.4	-0.4	-0.5
Inflation ⁽⁴⁾	2.1	2.2	2.2	2.1	1.9	0.0	-0.1
Government balance (% of GDP)	-2.8	-2.4	-2.0	-1.5	-1.3	0.4	0.8
Government debt (% of GDP)	69.7	70.6	69.4	68.0	66.9	-1.1	2.1
Current account balance (% of GDP)	0.8	0.0	-0.1	0.1	0.1	0.4	0.4
<i>Growth of GDP in EU-25</i>	<i>2.4</i>	<i>1.7</i>	<i>2.8</i>	<i>2.4</i>	<i>2.4</i>	<i>0.5</i>	<i>0.2</i>

NOTES: (1) Annual change as percentage unless otherwise indicated.

(2) Plus sign (+) or minus sign (-) indicates a higher (or lower) positive figure or lower (or higher) negative figure compared with Spring 2006.

(3) Percentage of labour force.

(4) Harmonized consumer price index.

SOURCE: European Commission.

MACROECONOMIC FORECASTS OF EURO AREA COUNTRIES

Autumn 2006

	GDP (*)			Inflation (**)			Unemployment (***)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Belgium	2.7	2.3	2.2	2.4	1.8	1.7	8.6	8.5	8.4
Germany	2.4	1.2	2.0	1.8	2.2	1.2	8.9	8.4	7.8
Greece	3.8	3.7	3.7	3.3	3.3	3.3	9.3	8.9	8.6
Spain	3.8	3.4	3.3	3.6	2.8	2.7	8.1	7.9	7.4
France	2.2	2.3	2.1	2.0	1.8	1.9	9.3	9.0	8.7
Ireland	5.3	5.3	4.3	2.9	2.7	2.2	4.3	4.5	4.8
Italy	1.7	1.4	1.4	2.3	2.0	1.9	7.1	7.0	7.0
Luxembourg	5.5	4.5	4.2	3.2	2.2	1.8	4.6	4.4	4.1
Netherlands	3.0	2.9	2.6	1.6	1.8	2.3	3.9	3.0	2.7
Austria	3.1	2.6	2.1	1.8	1.8	1.7	5.1	5.1	5.1
Portugal	1.2	1.5	1.7	2.9	2.2	2.1	7.6	7.7	7.7
Slovenia	4.8	4.2	4.5	2.5	2.5	2.6	6.1	6.1	6.0
Finland	4.9	3.0	2.6	1.3	1.5	1.6	7.7	7.4	7.3
Euro area	2.6	2.1	2.2	2.2	2.1	1.9	8.0	7.7	7.4

NOTES: (*) Percentage real change.

(**) Percentage change in harmonized consumer price index.

(***) Percentage of labour force.

SOURCE: European Commission.

MACROECONOMIC FORECASTS FOR EU COUNTRIES OUTSIDE EURO AREA

Autumn 2006

	GDP (*)			Inflation (**)			Unemployment (***)		
	2006	2007	2008	2006	2007	2008	2006	2007	2008
Czech Republic	6.0	5.1	4.7	2.5	2.7	2.9	7.4	7.1	6.9
Denmark	3.0	2.3	2.2	2.0	2.0	1.9	3.8	3.5	3.5
Estonia	10.9	9.5	8.4	4.4	4.2	4.6	5.4	3.8	3.1
Cyprus	3.8	3.8	3.9	2.4	2.0	2.4	5.4	5.5	5.6
Latvia	11.0	8.9	8.0	6.7	5.8	5.4	7.4	7.2	7.0
Lithuania	7.8	7.0	6.5	3.8	4.6	3.3	5.9	5.2	5.2
Hungary	4.0	2.4	2.7	3.9	6.8	3.9	7.3	7.7	7.7
Malta	2.3	2.1	2.2	3.0	2.6	2.4	7.0	7.0	6.9
Poland	5.2	4.7	4.8	1.4	2.5	2.8	13.9	12.2	11.6
Slovakia	6.7	7.2	5.7	4.5	3.4	2.5	14.3	13.3	12.9
Sweden	4.0	3.3	3.1	1.5	1.6	1.8	7.3	7.4	7.1
United Kingdom	2.7	2.6	2.4	2.4	2.2	2.0	5.3	5.0	4.8
EU-25	2.8	2.4	2.4	2.3	2.3	2.0	8.0	7.6	7.3
<i>United States</i>	3.4	2.3	2.8	3.4	2.5	1.9	4.7	5.1	5.4
<i>Japan</i>	2.7	2.3	2.1	0.3	0.4	0.7	4.3	4.3	4.3

NOTES: (*) Percentage real change.

(**) Percentage change in harmonized consumer price index, except United States and Japan, in which cases it is national consumer price index.

(***) Percentage of labour force.

SOURCE: European Commission.

Concern that world growth may be lower than forecast and fears about oil prices and real estate trends.

main engines will be gross fixed capital formation and the contribution of the foreign sector in 2007, which will lead to greater involvement of consumption in 2008.

The scenario set out, while favourable, presents some risks in the view of the EU executive body, notable among which is the possibility of a greater than expected world slowdown, especially the risk of a worse than expected performance in the United States, further strong growth episodes in oil prices and a hypothetical correction in the real estate market.

Another significant factor in the European Commission forecasts is that relating to the distribution of growth by country. In line with what has happened in recent years, those countries with the highest level of economic activity continue to be most of the countries of the recent extension, along with Greece and Ireland. Nevertheless, the main new factor is

that a bigger contribution is expected from the two large economies of the Euro Area, Germany and France, in 2008. In general terms, as the scenario is played out, the differences in growth within the EU tend to be partly reduced.

Finally, we should point out that the improvement in economic activity will allow a higher than expected rate of tax collections, which will allow for some correction of budgetary imbalances. In the Euro Area it is expected that the government deficit will go from 2.0% of the GDP in 2006 to 1.3% in 2008 and a similar path likely will be followed in the EU as a whole.

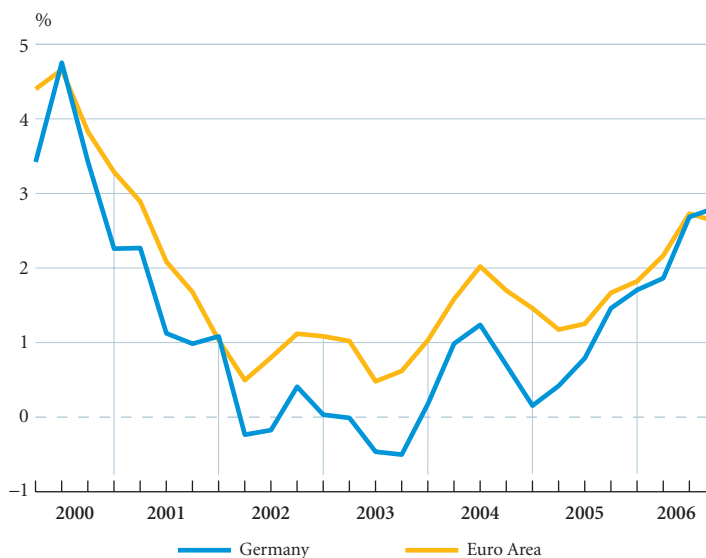
Euro Area: growth consolidating

The Euro Area grew by 2.6% year-to-year in the third quarter, according to early estimates. While this shows something of a slowdown compared with 2.7% in the second quarter, it is a result to be

Euro Area grows by 2.6% in third quarter, a rate it will maintain up to year-end.

GERMANY GROWING MORE THAN EURO AREA FOR FIRST TIME IN FIVE YEARS

Year-to-year change in gross domestic product in real terms



SOURCE: Eurostat, Federal Statistics Office and own calculations.

expected following the sharp increase in growth in the first half-year and, in fact, consolidates economic growth. A significant event in the third quarter was that this was the first time the German economy had grown more than that of the Euro Area since 2001, which is an indication of the increased role of Germany in European economic growth. The negative counterpart came with France which underwent an unexpected slowdown in the third quarter.

As of this point, forecasts indicate a year-end at a rate similar to that for the third quarter which will later move into a stage of lower growth as we advance into 2007. Although we still lack details by component, available indicators suggest that domestic demand will have been one of the key elements in this cyclical consolidation.

This is indicated, for example, by the better relative situation in the third quarter, a trend that could continue over the short term, if we are to go by the slight recovery in consumer confidence as of October. Another

demand component in good shape is investment. The most significant indicator of this, industrial production of capital goods, recorded an increase of 4.8% year-to-year in September, not greatly different from the average for the second quarter.

While domestic demand is progressively recovering, foreign demand continues to capitalize on the favourable international environment. Exports in September stood at levels 9.5% higher than one year ago. This development, along with a moderate drop in imports, made it possible to ease the widening of the trade deficit, as a cumulative total for 12 months, in September.

Supply indicators also confirm that growth is spreading to most sectors. Along with the good situation in industry (the gradual slowdown in industrial production in September was basically a correction of the atypically good result in August) we now have evidence of a better situation in services and construction. In both cases, the respective confidence

Domestic demand begins to take off while foreign sector still holds its fundamental role.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3 Q	4 Q	1 Q	2 Q	July	August	September	October
GDP	1.7	1.5	1.7	1.8	2.2	2.7	–	2.6	–	–
Retail sales	1.5	1.3	1.5	1.3	0.8	1.6	1.9	2.5	1.3	...
Consumer confidence (*)	–14	–14	–15	–13	–11	–10	–8	–9	–8	–8
Industrial production	2.0	1.2	1.4	2.1	3.3	4.1	3.4	5.5	3.3	...
Economic sentiment indicator (*)	99.8	98.4	98.0	100.6	103.0	107.2	108.6	108.5	109.3	110.3
Unemployment rate (**)	8.9	8.6	8.6	8.5	8.1	7.8	7.8	7.8	7.8	...
Consumer prices	2.1	2.2	2.3	2.3	2.3	2.5	2.4	2.3	1.7	1.6
Trade balance (***)	80.4	43.6	36.6	24.9	6.2	–7.3	–18.1	–20.5	–19.8	...

NOTES: (*) Value.

(**) Percentage of labour force.

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

SOURCE: Eurostat, European Central Bank, European Commission and own calculations.

Energy helps inflation drop to 1.6%.

indicators suggest that the recovery in the second and third quarters is holding good at the beginning of the fourth quarter.

The trend in prices is also satisfactory. The harmonized CPI continues to benefit from the trend in energy. Thanks to the fact that this component has fallen by 0.5% in year-to-year terms, the general index was down by

one decimal in October going from the 1.7% seen in September to 1.6%. In spite of this positive move, prospects for the rest of the year are for some bigger increases, partly due to the fact that the drain-off shown by energy will keep reducing during the final stages of the year. The unemployment rate, in turn, held at 7.8% of the labour force in September for the fifth month in a row.

What factors make convergence with the EU possible?

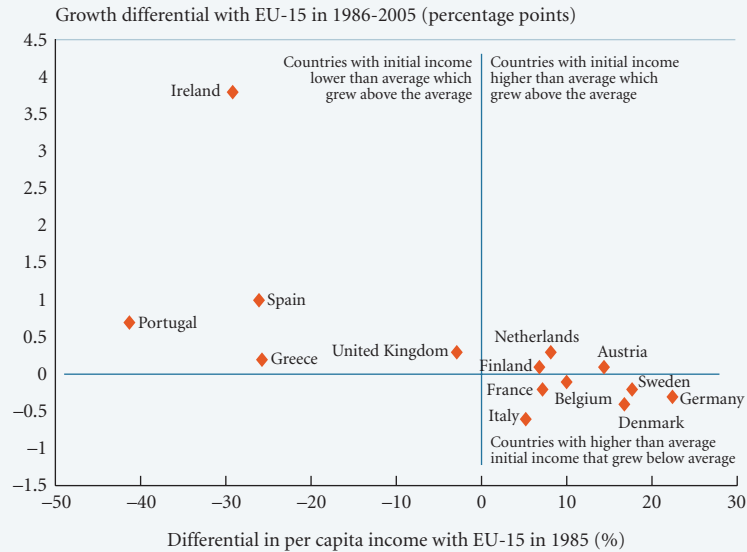
The great hope of the countries aspiring to join the European Union (EU) is the so-called real convergence. The dream shared by Bulgaria and Roumania to reduce their income differential with the EU countries was also the dream of Spain and Portugal in 1985. Is this hope justified? In this box we review the theoretical basis for that optimism and analyze whether convergence has really taken place in the past 20 years.

A wide range of theoretical economic growth models predict that the growth rate of a country is inversely related to its income level. The fundamental reason why poor countries tend to grow more rapidly is the existence of decreasing returns to the accumulation of capital. That is, the increase in production resulting from an investment in capital tends to be greater the smaller the amount of capital existing in the economy. Nevertheless, this hypothesis does not imply convergence to the same income level because countries may differ in fundamental aspects that determine their income level over the long term. The so-called conditional convergence only postulates that countries will tend to grow more rapidly the farther apart they are from their long term income level. What has this to do with the EU?

This analytical framework suggests that a country that joins the EU may increase its growth rate through two mechanisms: first, joining the EU may foster an improvement in the fundamental aspects that determine the income level over the long term. Among these factors are increased political and macroeconomic stability, improvements in the regulatory and judicial framework, investment in infrastructures and an opening up of foreign trade. Secondly, the free flow of capital and labour within the EU may increase the rate of convergence given that labour and capital will tend to move toward those countries where their returns are higher (the rich countries for workers and the poorer countries in the case of capital).

Experience over the past 20 years confirms the existence of real convergence. As the following graph shows, the five countries with per capita income below that of the EU-15 in 1985 (Portugal, Ireland, Spain, Greece and United Kingdom) had above average growth rates in the following 20 years. Statistically, the correlation between the initial income level and growth is negative and significant (especially if we exclude Luxembourg, which being relatively rich has experienced very high growth as a result of a booming financial sector).

COUNTRIES WITH LOWER INCOME LEVEL IN 1985 GREW ABOVE THE AVERAGE IN 1986-2005

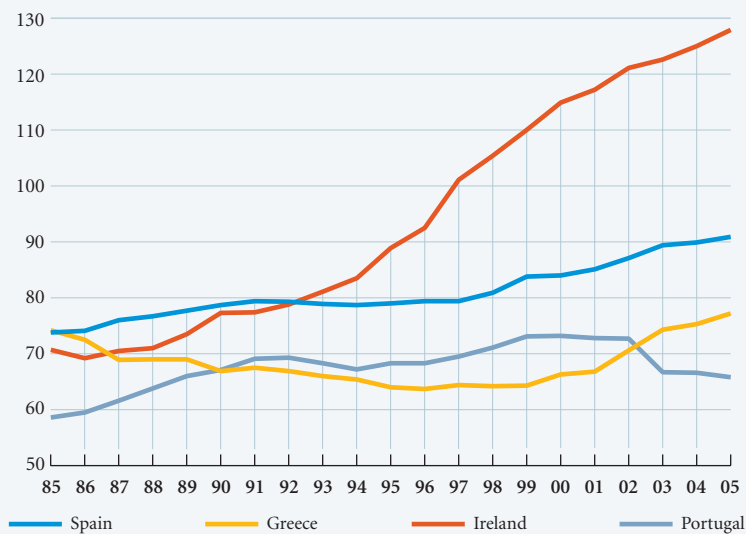


SOURCE: European Commission and own calculations.

Nevertheless, with the exception of Ireland, the rate of convergence has been slow. Spain, for example, took 17 years to cut by half its income differential with the EU, something that Portugal and Greece have not achieved yet. After a promising start, Portugal has undergone stagnation in its relative income level since the beginning

TREND IN PER CAPITA GDP IN FOUR POOREST COUNTRIES OF EU IN 1985

As percentage of per capita GDP of EU-15



SOURCE: European Commission and own calculations.

of the Nineties. Ireland, on the other hand, with spectacular growth rates since the beginning of 1990, has become the richest country in the EU-15 after Luxembourg. According to various observers, the miracle of the «Celtic Tiger» was based on taking good advantage of transfers from the EU, a series of reforms in labour and product markets agreed upon by business and labour and fiscal consolidation compatible with a reduction in taxes for both workers and companies. All of these reforms are still to be carried out in Spain's neighbouring country Portugal.

Spain's convergence has speeded up since the end of the Nineties raising per capita GDP to 91% of the EU-15 level. The spectacular increase in the employment rate from 50% to 65% of the population of working age in the past ten years has been key in reducing the income differential. Still, there remains some margin for increasing the employment rate further. The bad news is that labour productivity not only has failed to contribute to convergence but actually has made a negative contribution. Partly, this has been a result of the rapid growth of employment which has meant that persons with less education and training have moved into the labour market and, given the costs of adjustment in the stock of capital, the slow progress in the accumulation of capital per worker. But it is also symptomatic of more fundamental problems related to the quality of education in Spain, the lack of investment in research and development and rigidity in product and labour markets that limit the capacity for innovation.

The lessons for the new members of the EU are quite clear. Forming part of the club is no panacea and countries continue to have a wide margin for applying right or wrong policies that affect growth. Welcome and be careful what you choose.

INCOME DIFFERENTIAL BETWEEN SPAIN AND EU-15

Percentage points

	1985	2005
Differential in per capita GDP at current prices	44.2	21.1
Differential in per capita GDP adjusted for purchasing power	26.2	9.1
<i>Contributions from:</i>		
Differences in population of working age	3.1	-3.0
Differences in employment rate	23.2	3.8
Differences in product per worker	-0.1	8.3

NOTES: For the breakdown of the income differential the following equation is used:

$$\frac{\text{GDP}}{\text{person}} = \frac{\text{Population of working age}}{\text{Total population}} \times \frac{\text{Total employment}}{\text{Population of working age}} \times \frac{\text{GDP}}{\text{Total employment}}$$

SOURCE: European Commission and own estimates.

Germany grows by 2.8% in third quarter thanks to foreign sector and recovery in consumption...

Germany: the European engine is back

Germany grew by 2.8% year-to-year in the third quarter, a slight rise above the 2.7% recorded in the second quarter. This was the biggest growth since 2000.

The increased drive in Germany was entirely due to the increased positive contribution from the foreign sector which contributed 0.7 percentage points to the change in the GDP (0.6 percentage points in the previous quarter).

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006				
			4 Q	1 Q	2 Q	3 Q	October	November
GDP	0.8	1.1	1.7	1.9	2.7	2.8	—	...
Retail sales	2.1	1.3	0.2	0.7	0.4	−0.1	...	...
Industrial production	2.4	2.9	4.7	4.6	5.8	6.5	...	...
Industrial activity index (IFO) (*)	95.4	95.5	98.7	103.6	106.1	105.2	105.3	106.8
Unemployment rate (**)	10.6	11.7	11.4	11.3	11.0	10.6	10.4	...
Consumer prices	1.6	2.0	2.2	2.1	1.9	1.6	1.1	...
Trade balance (***)	149	157.3	160.4	157.5	154.1	150.8	...	...

NOTES: (*) Value.

(**) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

On the other hand, growth of domestic demand held unchanged at 2.1% year-to-year due to the fact that the rise in private and public consumption was compensated by the slowdown in investment. The increased drive in private consumption was due to the fact that German households are bringing forward their buying decisions because of the imminent rise in the value added tax in January 2007. This process will spread into the fourth quarter which ensures that the end of the year in Germany will be positive in terms of growth.

This growth is continuing its course over the end of the third quarter and the beginning of the fourth. On the demand side, the most relevant indicator at this time for measuring the strength of the German pulse is no doubt consumer confidence. Significantly, the drop noted in October brings out the main paradox of the German economy: while the present situation is seen as progressively better, consumers perceive a less satisfactory situation in the future. Undoubtedly, this is a reflection of the

uncertainty arising from the tax increase at the beginning of 2007.

The situation is repeated on the supply side. In spite of the fact that the IFO indicator of industrial activity is holding at high levels (106.8 points in November), business executives surveyed see the present situation as being better than what awaits them in the future due to concern about the tax change mentioned above or the impact on exports of the expected appreciation of the euro. To sum up, the current moment is positive. Non-qualitative indicators such as industrial production, which grew by a strong 6.3% year-to-year in September, and inflation, standing at 1.1% year-to-year in October would so suggest. The future, however, is viewed with concern.

In any case, recovery is making it possible to ease some of the more pressing imbalances in the German economy. The increase in tax collections is making it possible to reduce the government deficit. This is a matter of correcting a situation that minister of finance Peer

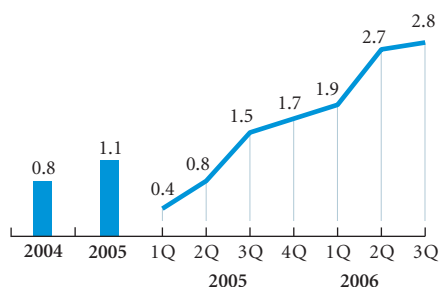
...growth that is continuing into fourth quarter.

Growth making it possible to shackle government deficit.

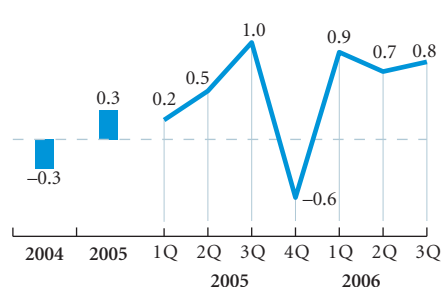
TREND IN GERMANY'S GDP BY COMPONENT

Percentage year-to-year change

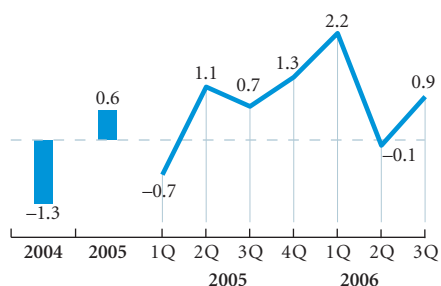
GDP



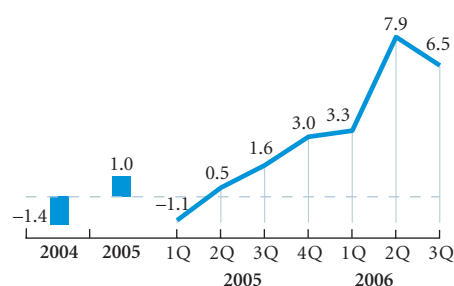
Private consumption



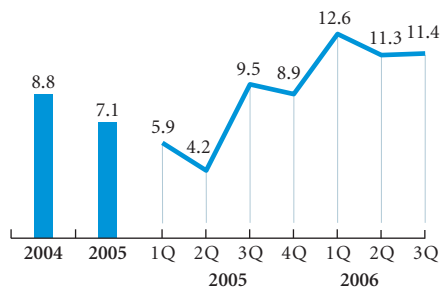
Public consumption



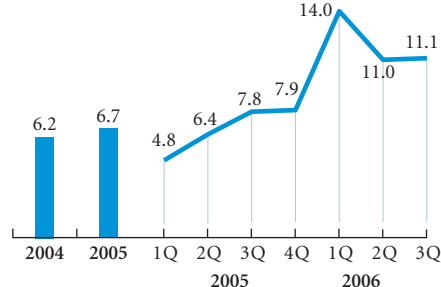
Gross fixed capital formation



Exports of goods and services



Imports of goods and services



SOURCE: Federal Statistics Office and own calculations.

French growth of only 1.8% in third quarter disappointing and darkening immediate prospects.

Steinbrück called «having lived beyond our means». The figures given by the minister are coherent with the latest estimates put out by the European Commission which could bring the government deficit for 2006 down to only 2.3% of the GDP, eight decimals less than forecast last Spring. In 2005, the government deficit was 3.2%. Another imbalance that is gradually being dealt with is unemployment. So far this year the unemployment rate has dropped by

one percentage point from 11.4% in January to 10.4% in October.

France: let-down in third quarter

In the third quarter, the French GDP showed a disappointing nil growth rate compared with the previous three months. This was an unexpected result which even surprised the staff of Minister of Economy Thierry Breton

who termed this result as a «statistical accident». Unfortunately, the composition of the macroeconomic table in the third quarter does not make it possible to dismiss the problem with such a weak argument. The loss of strength in all demand components indicates that the situation in coming quarters will not be overly positive.

At year-to-year rate, French growth was 1.8% , eight decimals less than in the second quarter. The domestic demand component to drop most was gross fixed capital formation which grew by 3.2% year-to-year as against the previous 4.5%. The drop in private and public consumption was slightly less with these two components showing a decrease of three and four decimals respectively compared with the year-to-year change in the second quarter. In turn, the drain-off for the change in the GDP attributable to the foreign sector amounted to one percentage point, higher than the figure of 0.6% in the second quarter.

Monthly indicators published scarcely compensate for the perception of a sudden worsening of the cycle. On the demand side, the most notable factor is

the modest improvement in consumer confidence which rose to the level of –8 points (–9 points in September). Also on the demand side, the figure for exports is positive seeing that it grew by 7% year-to-year in September making it possible to stabilize the cumulative trade deficit for 12 months at 2.4 billion euros.

These modest results are darkened by the poor figure, on the supply side, for industrial production which in September stood at levels 0.7% lower than one year earlier. The main culprit for this decrease in the secondary sector was car production which has shown cumulative drop of 7.5% so far this year.

With regard to prices, the tendency to stability shown in recent months is continuing. The CPI grew by a mere 1.1% year-to-year in October, similar to the 1.2% in September while the underlying core, which discounts the more volatile items, rose by only 1.2% compared with one year earlier. The unemployment rate also improved slightly dropping by two decimals in October to stand at 8.8% of the labour force.

Industrial activity indicators, hit by slump in car production, cause for concern.

Improvement in inflation and drop in unemployment rate.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3 Q	4 Q	1 Q	2 Q	July	August	September	October
GDP	2.1	1.2	1.4	0.9	1.4	2.6	–	1.8	–	–
Domestic consumption	3.8	2.9	4.1	2.3	2.9	4.7	3.7	6.3	2.8	4.2
Industrial production	2.0	0.3	0.6	–0.5	0.4	1.8	1.1	1.4	–0.7	...
Unemployment rate (*)	10.0	9.9	9.9	9.7	9.6	9.1	8.9	9.0	8.8	...
Consumer prices	2.1	1.7	1.9	1.6	1.8	1.9	1.9	1.9	1.2	1.1
Trade balance (**)	0.1	–1.3	–1.5	–1.8	–2.0	–2.1	–2.3	–2.4	–2.4	...

NOTES: (*) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

Italy gradually consolidates growth level with figure at 1.7% in third quarter.

Industry capitalizes on recovery to show best results since 2000.

Private consumption may be starting to change step after various depressed quarters.

British growth reaches 2.7% in third quarter thanks to strength of consumption...

Italy: industry leads upward move

Italy is progressively moving into a stage of economic growth. While the figures compared are very poor compared with 2005, a year the Italians themselves dubbed as an «annus horribilis», the preliminary estimate for the third quarter shows growth of 1.7% year-to-year. This figure comes with an upward revision of growth in the first half-year which is now calculated at 1.7% year-to-year. It should be remembered that the increase in the GDP in 2005 was 0.1%.

The main beneficiary has been industry which, after dropping in terms of production in each and every year from 2001 to 2005, this year is simply soaring. In September, industrial production stood at levels 1.8% higher than one year ago. The improved performance in exports was partly behind this recovery in the secondary sector.

Another area that is tending to improve is private consumption. Up to September, retail sales grew by 1.8% year-to-year, confirming the positive expectations generated by the recovery of consumer confidence in recent months. Up until now, the stronger state of domestic demand has not brought any

increase in inflationary pressures seeing that the CPI stood at 1.8% year-to-year in October, three decimals below the figure for September.

United Kingdom: concern about inflation

Growth in the third quarter at 2.7% year-to-year (2.6% in the second quarter) confirms that the stage of economic boom enjoyed by the United Kingdom is staying on. In particular, the good performance of private consumption (growth of 2.4% year-to-year, 2.3% in the previous quarter) and in public consumption (this went from 2.1% in the second quarter to the current 2.5%) comes from a fund of resistance that will only end gradually in 2007. The drive in consumption, together with a lower negative contribution from the foreign sector, has made it possible to more than compensate for the slowdown in investment.

This good result came at the same time as publication of other indicators which confirm a picture of sustained activity, especially on the demand side. Retail sales were up 4.0% in October thus extending the excellent average for the

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006						
			4Q	1Q	2Q	3Q	July	August	September	October
GDP	0.9	0.1	0.5	1.7	1.7	1.7	–	1.7	–	–
Retail sales	–0.4	0.4	1.9	0.5	1.9	1.6	1.1	2.0	1.8	...
Industrial production	–0.5	–0.9	0.4	2.7	1.7	1.4	1.1	1.4	1.8	...
Unemployment rate (*)	8.0	7.7	7.5	7.3	7.0	...	–	...	–	–
Consumer prices	2.2	1.9	2.2	2.1	2.2	2.2	2.2	2.2	2.1	1.8
Trade balance (**)	–1.2	–9.4	–8.5	–12.9	–16.5	–21.3	–20.6	–21.4	–21.9	...

NOTES: (*) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

third quarter (3.7%). In October, consumer confidence recovered the positive levels shown at the start of 2006 improving on September by more than three points.

As a result of this drive in the economy, the unemployment rate held at 3.0% between March and October. The trend in industry, with little improvement, is not so satisfactory. The minimal growth of industrial production in September (0.4% year-to-year) is too modest a recovery from the depressed levels in

the first half. In any case, the main challenge for the British economy now is how to progressively bring the situation of relatively high inflation to heel without too greatly affecting economic activity. Maintaining inflation at 3.2% year-to-year in September and October, in sharp contrast to the drop in most European economies, and forecasts of inflationary pressures on the horizon provide an explanation for the recent decision of the Bank of England to put the intervention rate at 5%.

...that is holding up at start of fourth quarter.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006						
			4 Q	1 Q	2 Q	3 Q	July	August	September	October
GDP	3.3	1.9	1.9	2.3	2.6	2.7	—	2.7	—	—
Retail sales	6.0	1.9	2.5	1.7	3.4	3.7	3.9	4.3	3.0	4.0
Industrial production	0.8	−1.8	−2.6	−1.0	−0.7	0.2	−0.6	0.6	0.4	...
Unemployment rate (*)	2.7	2.7	2.8	2.9	3.0	3.0	3.0	3.0	3.0	3.0
Consumer prices	2.2	2.2	2.3	2.2	2.8	3.2	3.1	3.3	3.2	3.2
Trade balance (**)	−56.1	−64.6	−67.3	−72.1	−76.0	−79.6	−79.1	−79.5	−80.1	...

NOTES: (*) Percentage of labour force.

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

SOURCE: OECD, national statistical bodies and own calculations.

FINANCIAL MARKETS

Monetary and capital markets

Inflation down but central banks not confident

The drop in oil prices from the all-time high reached in August has brought moderation in inflation in most countries in recent months. Nevertheless, while the various geographical regions stand in different stages of the economic cycle, the main central bank executives agree on one thing, that they should not drop their guard against inflation.

In the United States, the macroeconomic indicators appearing in recent weeks have provided contrasting information in terms of inflation and growth. As a

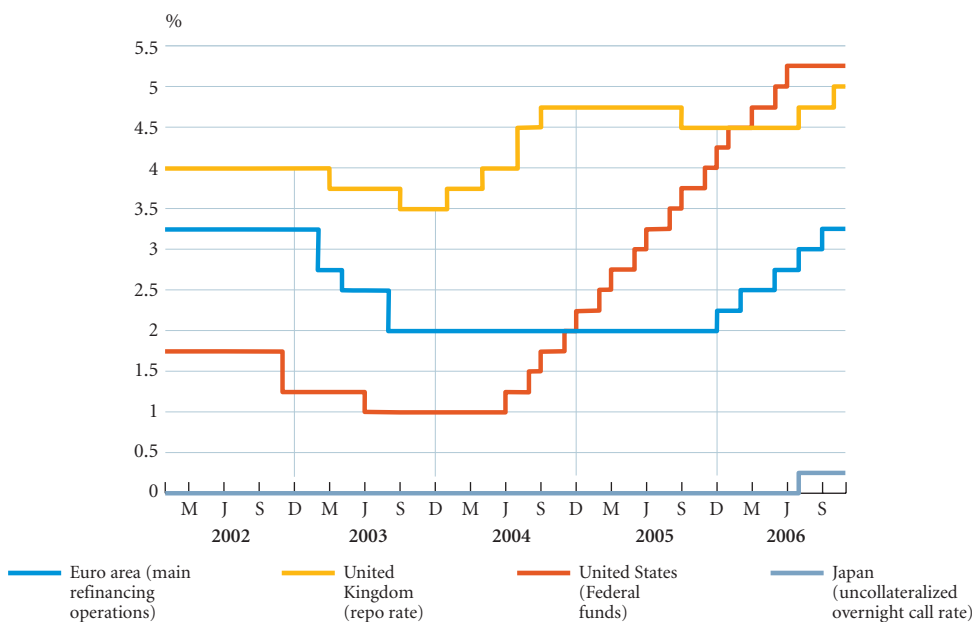
result, the Federal Reserve System continues to waver between the need to be alert to possible inflation risks and the desirability of giving support to economic activity in order to avoid a sharp slowdown by way of the real estate market. For the moment, however, it would seem that the scenario is moving toward a path of relatively gradual economic slowdown.

Within this framework, the Fed is maintaining a cautious position as shown by the minutes of the last meeting of the Federal Open Market Committee. What seems most likely is that at its meeting on December 12 the

Fed official interest rate expected to hold stable in coming months.

BANK OF ENGLAND RAISES OFFICIAL INTEREST RATE

Monetary policy reference rates



SOURCE: National central banks.

Fed will leave the official interest rate at 5.25% for the fourth consecutive time and will not change this position in the early months of 2007, before making some cut.

The European Central Bank (ECB) did not change its reference rate at its meeting early in November as had been expected. Nevertheless, chairman Jean-Claude Trichet indicated a further rise would come at the next meeting on December 7, which would put the Eurosystem rate at 3.50%. His analysis was based on the fact that, in a situation of economic recovery and high money supply figures, the correct thing to do was to keep the official interest rate close

to a neutral level. In November, several ECB executives expressed their concern about inflation in spite of the fact that it had dropped to 1.6% in October.

Trichet himself emphasized the importance of monitoring the money supply figures as indicators of future trends in price levels. Given that the broad M3 money supply figure was increasing at a year-to-year rate of 8.5% in September as against a reference rate of 4.5%, it would not be out of place to predict that the ECB interest rate will continue to rise in 2007.

The Bank of England did not fail to act at its meeting on November 9 and

European Central Bank prepares for interest rate rise on December 7.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (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									
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	3.23	3.62	5.25	5.42	0.44	4.73	4.94	1.61
September	3.03	3.34	3.72	5.25	5.38	0.44	4.75	5.03	1.74
October (*)	3.23	3.50	3.80	5.25	5.37	0.44	4.75	5.13	1.85
November (1)	3.30	3.63	3.85	5.25	5.37	0.49	5.00	5.24	1.94

NOTES: (*) Provisional figures.

(1) November 28.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 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%), 5-10-06 (3.25%).

(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: 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%), 9-11-06 (5.00%).

(5) Interbank offer rate.

SOURCE: National central banks, Thomson Financial Datastream and own calculations.

Bank of Japan also to soon raise reference rate.

proceeded to make a further increase in the interest rate it pays on bank assets by 25 basis points putting it up to 5.00%, the highest level in the past five years. The decision by the British monetary authorities was due to the fact that the current economic recovery was putting price stability in danger over the medium term. Nevertheless, it later came out with projections for inflation that put it in line with its medium-term objective which limits the scope for possible further interest rate increases.

Monetary authorities in India, Norway and Australia tighten policies.

The governor of the Bank of Japan, Toshihiko Fukui, declared that the Japanese central bank would adopt a preventive position in order to deal with inflation risks. It is therefore expected that there will be another increase in the objective interbank overnight rate which would put it at 0.50%.

Economic slowdown in United States adds to downward pressure on dollar.

In addition, other central banks have tightened the brakes on their restrictive money supply policies in recent weeks thus helping to reduce the still abundant global money supply. On October 31, the

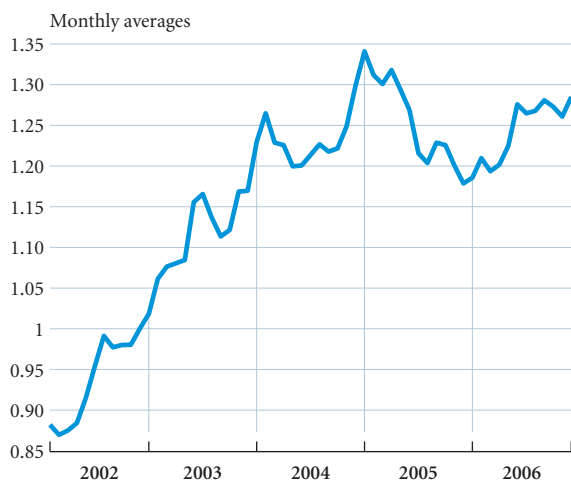
Bank of India raised its reference rate (its repurchase rate) by 25 basis points putting it at 7.25%. The next day, the Bank of Norway raised its deposit interest rate by a quarter-point to 3.25% in order to keep inflation prospects under control and to support the Norwegian crown. One week later, the Bank of Australia also increased its reference rate by 25 basis points setting it at 6.25%.

Euro regains strength

In recent weeks the dollar has been subject to some downward pressure because of some moderation in prospects on interest rates set by the Federal Reserve System and further debate about the impact of the diversification of foreign currency reserves held by central banks. On this occasion it was the remarks by the governor the Bank of China on plans to diversify its reserves, the biggest in the world, which weakened the US currency although, in fact, this was not anything new. Nevertheless, greenback has

EURO MARKS UP HIGHEST LEVEL AGAINST DOLLAR FOR PAST 20 MONTHS

US dollars to euro



NOTES: Figures go up to November 28.

SOURCE: OCDE, Thomson Financial Datastream and own calculations.

EXCHANGE RATES OF MAIN CURRENCIES

October 2006

	Final session of month		Monthly figures				Exchange rate November 28, 2006
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2)			
				Monthly	Over December 2005	Annual	
Against US dollar							
Japanese yen	116.9	−1.0	118.6	1.2	0.2	3.3	116.2
Pound sterling (1)	1.908	1.9	1.876	−0.5	7.5	6.3	1.952
Swiss franc	1.244	−0.5	1.260	1.3	−3.5	−2.1	1.203
Canadian dollar	1.123	0.4	1.128	1.1	−2.9	−4.2	1.131
Mexican peso	10.77	−1.9	10.89	−0.8	2.5	0.6	11.03
Nominal effective index (4)	107.4	−0.7	108.4	0.3	−3.0	−2.9	106.8
Against euro							
US dollar	1.270	0.3	1.261	−0.9	6.4	5.0	1.315
Japanese yen	149.6	0.2	149.7	0.4	6.5	8.4	153.0
Swiss franc	1.589	0.0	1.590	0.4	2.7	2.6	1.587
Pound sterling	0.669	−1.4	0.673	−0.4	−1.0	−1.3	0.676
Swedish krona	9.212	−0.7	9.253	−0.1	−1.9	−1.8	9.068
Danish krone (3)	7.454	−0.1	7.456	−0.1	0.0	−0.1	7.455
Polish zloty	3.873	−2.5	3.901	−1.6	1.3	−0.5	3.837
Czech crown	28.22	−0.4	28.29	−0.3	−2.3	−4.7	28.06
Hungarian forint	260.2	−4.7	267.1	−2.7	5.7	6.1	258.6
Nominal effective index (5)	103.6	−0.5	103.6	−0.5	2.9	2.2	105.4

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 $\pm 2.25\%$.

(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: 1-1999 = 100.

SOURCE: Thomson Financial Datastream and own calculations.

withstood this pressure fairly well with the support of an interest rate differential in terms of the main currencies in its favour and figures for the trade deficit for September that were better than expected. In any case, in the final week of November the dollar stood at around 5% below its opening level for the year against a broad group of currencies.

In November, the euro tended to strengthen with the increasing prospect of a further rise in the Eurosystem interest rate early in December and other possible increases in 2007. As a result, the

single European currency recovered ground against the dollar and in the last week of the month marked up the highest level in the past 20 months (more than 1.31 dollars). In third week of the month it showed its highest rate against the Swiss franc since 2000 (1.60 francs). At the same time, the European currency reported an all-time record against the Japanese yen with an exchange rate of 153.0 yen to the euro toward the end of the month. In terms of a broad basket of the currencies of its main trading partners, the euro showed a rise of close to 5% over the end of December 2005.

EURO RECORDS ALL-TIME HIGH AGAINST YEN IN NOVEMBER



NOTES: Figures go up to November 23.
SOURCE: Thomson Financial Datastream.

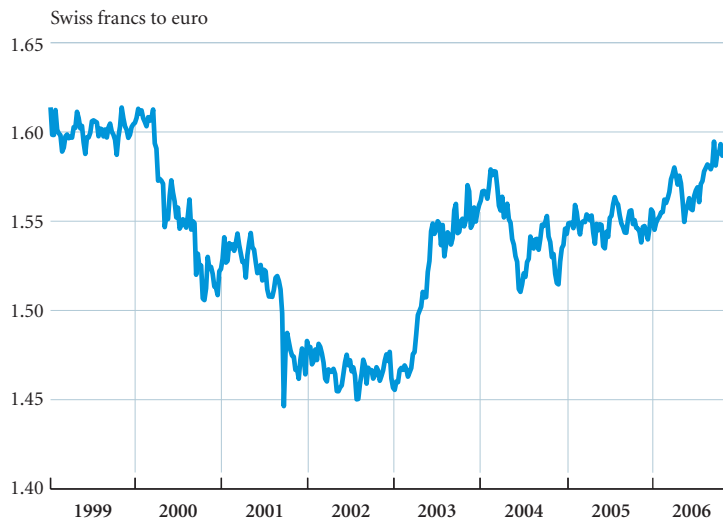
Pound sterling marks up highest exchange rate against dollar since 1992.

On the other side of the English channel, the pound sterling moved up with the increase in the official interest rate of the Bank of England on November 9. In the last week of the month it went to 1.952 dollars and against a broad group of currencies in the last week of the month showed an increase of 6% over the course of the year.

The other major reserve currency, the yen, remains depressed holding to very low levels and much undervalued. The broad interest rate differential working against it continued to put pressure on during November. As a result, against the euro it had depreciated by 9% since the beginning of 2005.

Yen remains undervalued.

SWISS FRANC DROPS AGAINST EURO



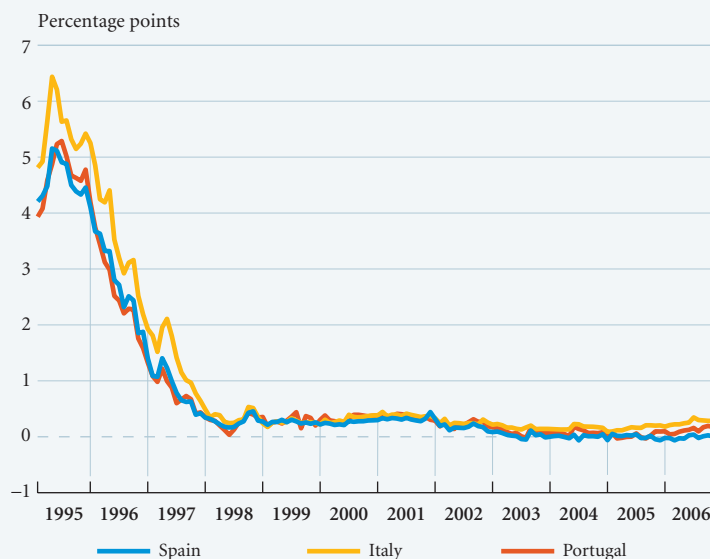
NOTES: Figures go up to November 24.
SOURCE: Thomson Financial Datastream.

Euro, «Club Med» and the promised macroeconomic stability

Adoption of the single currency had macroeconomic stability as a prior requirement in the case of those countries with a history that was rather unacceptable in this respect, such as Spain, Portugal and Italy. Countries with weak currencies, frequent competitive devaluations, central banks that had little autonomy and low prestige in matters of fighting inflation and management of the public finances that tended to make worse rather than improve the recurring imbalances in their economies. The process of moving toward the euro, culminating in the European Monetary Union (EMU), required those member states wishing to join in that group and abandon their national currencies to carry out a major effort in terms of budgetary balance, control of inflationary pressures, reach a level of interest rates relatively close to each other, show some exchange rate stability and ensure the autonomy of their central banks. Indeed, it was a matter of ensuring a sufficient degree of nominal convergence that would limit the pernicious effects of certain national practices on the stability of the future single currency.

SPAIN, ITALY AND PORTUGAL MOVE INTO THE MACROECONOMIC STABILITY CLUB

Differential in national 10-year interest rate compared with German rate



SOURCE: Thomson Financial Datastream and own calculations.

At first, eleven member states later followed by Greece were equal to the challenge. Among these countries, the three mentioned earlier must have been the big beneficiaries of the new culture of macroeconomic stability, precisely because they had not had it. In the end, this culture of macroeconomic discipline should result in greater future growth. Nevertheless, only Spain's economy seems to have capitalized on this change whereas the performance in Portugal and Italy has, at the very least, been disappointing. We may ask: why?

Let us begin with Portugal. The prospects coming from joining the EMU, the result of nominal convergence, led to a significant drop in long-term interest rates (from 11.6% in 1995 to 4.1% in 1999, in nominal terms, a course that continued until rates stood at 3.7% in 2005). The effect of this process was rapid: between 1995 and 2001, the economy grew at an average annual rate of 3.8%, as a result of a notable rise in consumption

largely due to a credit boom. The disappearance of external restrictions led to a situation where domestic imbalances such as the growth of wages above productivity with the subsequent worsening of external competitiveness did not have the compensation of a currency devaluation. The extent of the drop in external competitiveness demonstrates the fact that nominal unit labour costs (wage per product unit) in 2001 stood at levels 25% higher than in 1995. In clear contrast, the Euro Area showed an increase of 7% in the same period.

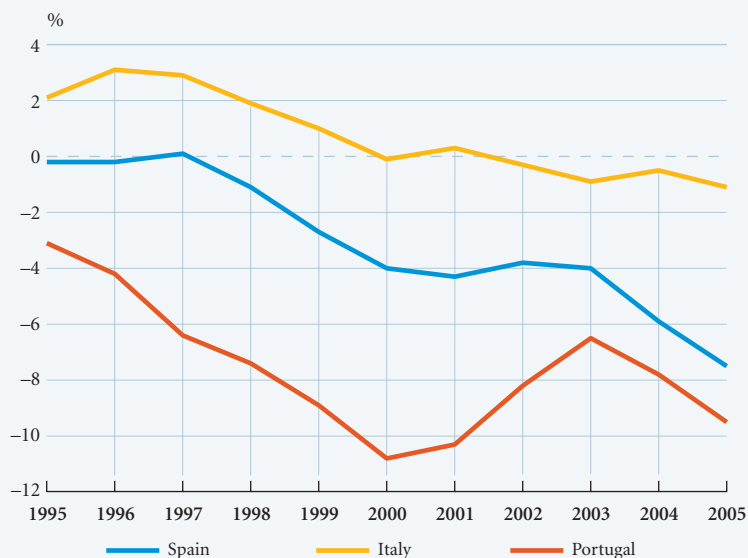
As of 2002, the Portuguese economy has been stagnant. Average annual growth between 2002-2005 was only 0.3% due to the fact that the progressive recovery of private savings depressed household consumption. This did not prevent previous imbalances from tending to become chronic. Wages continue to grow above productivity and the current account deficit is holding at high levels (9.5% of the GDP in 2005). Furthermore, other imbalances are emerging, the most threatening being the government deficit which reached 6.0% of the GDP in 2005.

The case of Italy is different. The current account deficit was scarcely 1.1% of the GDP in 2005 and the unemployment rate has been reduced by 3.5 points in the past decade. The big imbalance, however, is in the government deficit, which is very much linked to the slackness and lack of drive in the economy. In the past decade, growth has been only 1.4%. This in large measure is the result of an economy what has greatly lost competitiveness, given that nominal unit labour costs grew by 27 points between 1995 and 2005, a figure 14 percentage points higher than in the Euro Area.

Spain, on the other hand, has so far escaped the sad fate of Portugal and Italy. As is well known, Spain's growth in the past decade, especially in the period 1997-2005 when the economy was growing by 3.8% on annual average, has been notable, making it possible to reduce one of its traditional problems, a high level of unemployment. It should also be remembered, however, that, in the final stage of the current cycle, inflation

SPAIN AND PORTUGAL TAKE ADVANTAGE OF BEING IN EURO IN ORDER TO AVOID EXTERNAL RESTRICTIONS

Figure for current account balance as percentage of GDP



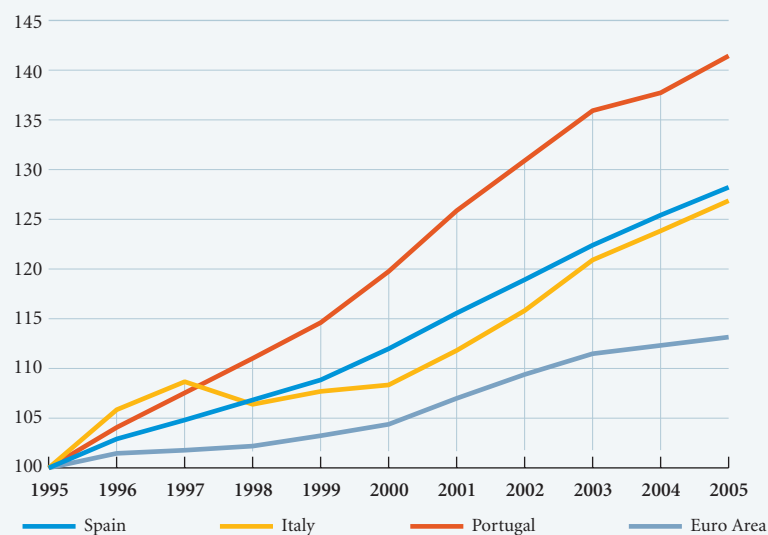
SOURCE: European Commission.

has again risen, nominal wages are above the European average although only to a moderate degree and, finally, the imbalance in the current account balance has shot up, a result of an investment drive very much oriented toward construction.

What went wrong in Portugal and Italy? If they have benefited from the new environment of stability, why have they not been able to take advantage of it? It is not easy to definitely decide on any one cause but from this overall examination we can discard some of the usual suspects. In none of these three countries has the trend in productivity helped improve external competitiveness. Nor has Spain's inflation history been an enviable one compared with that of Italy and Portugal. Having made these comments, all that remains is to conclude that a notable difference has been in budgetary discipline. With the coming of the euro, the process of nominal convergence in the key area of government finances has been inverted in the case of Portugal and Italy but not in Spain.

THREE COUNTRIES WITH PROBLEMS OF EXTERNAL COMPETITIVENESS

Index of nominal unit labour costs (1995 = 100)



SOURCE: European Commission and own calculations.

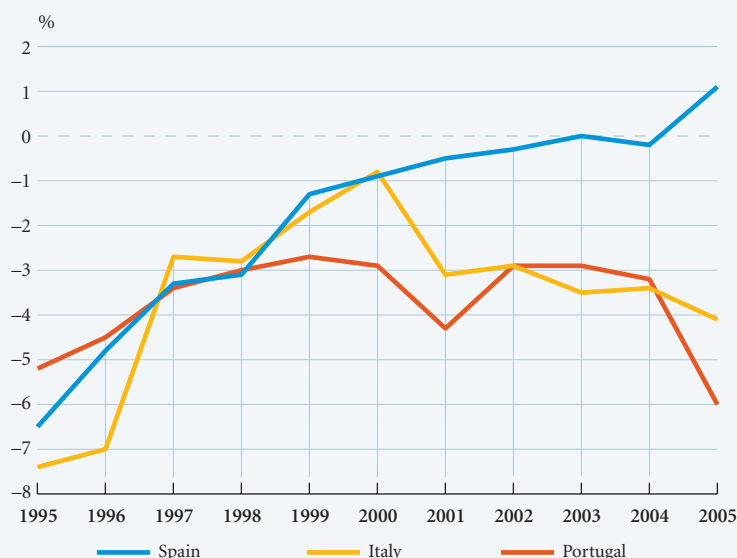
Specifically, the Portuguese government deficit is more than twice what it was in 1998 when it was about to join the EMU. Italy, in turn, recorded a higher deficit in 2005 (4.1% of the GDP) as against 2.8% in 1998. Spain, on the other hand, surprised everyone by reaching a budgetary surplus in 2005. Is this differential factor relevant? What is the role of budgetary discipline in obtaining a better economic result in Spain?

From a theoretical point of view, a commonly accepted premise is that an unsustainable course of government deficit will tend to reduce future economic growth expected due to the fact that it drains off resources that in the absence of a budgetary imbalance would go into investment. In any case, in the Euro Area national savings does not now set the limit on the country's investment capacity. What happens when countries, such as Italy and Portugal, do not control their deficits is that resources from the rest of the Euro Area are not being taken advantage of by the private sector, which is what is happening in Spain. Another way in which an excessive

government deficit can affect growth is through a country- risk premium higher than that borne by those members of the EMU following more orthodox policies, a situation that leads to a higher interest rate. Finally, a growing trend to budgetary imbalance leads economic circles to expect further increases in the tax load, something which has negative effects on investment and economic activity in general.

SPAIN WINS OVER PORTUGAL AND ITALY IN BUDGETARY DISCIPLINE

Government budgetary balance as percentage of GDP



SOURCE: European Commission.

While these effects should arise over the medium term, and therefore have only a moderate impact on the time horizon set out here, what seems clear is that the economic agents largely perceive the quality of the culture of macroeconomic stability and anticipate that the problems set out above can be avoided according to the seriousness and discipline applied in managing the government finances. In this respect, Spain's course is turning out better than that of Italy and Portugal. In other words, while it is true that the culture of macroeconomic stability, that we economists term an international public good, is what has been given to Spain through belonging to the EMU, the fact is that it has done more than its Italian and Portuguese associates to take advantage of it.

In spite of the good taste left by the excellent work done on the front of budgetary consolidation, this may not be enough when it comes to facing up our future in a monetary union. Once more we must bring up what we said earlier. Spain has benefited from the disappearance of external restriction and has absorbed inflation without excessive increases, including that in assets. At the same time, Spain's sector mix, with its strong contribution from construction and tourism, has made it possible to ride out the years following monetary integration with better results, especially in comparison with Italy, whose sector specialization has not worked as well. Nevertheless, there still remains ahead the urgent matter of recovering external competitiveness which could take place the hard way (by improving productivity) or the painful way (a slowdown in nominal wages).

Government bond yields stand at low levels

During the second half-year, US government bond yields tended to ease once the increases in Federal Reserve System interest rates were halted and the slowdown in economic growth became evident. The drop in the real estate market had more effect on the market than buoyant statements by various Fed executives and raised the sights to possible cuts in official interest rates in 2007. Furthermore, the prospect of inflation has slightly diminished. On the other hand, buying of Treasury bonds by Asian central banks and institutional investors continues to put downward pressure on government bond yields.

The US yield curve remains inverted, that is to say, short-term interest rates are higher than long-term rates, which

is not normal and suggests that there is the risk of a recession. Nevertheless, some distorting factors put limits on this view.

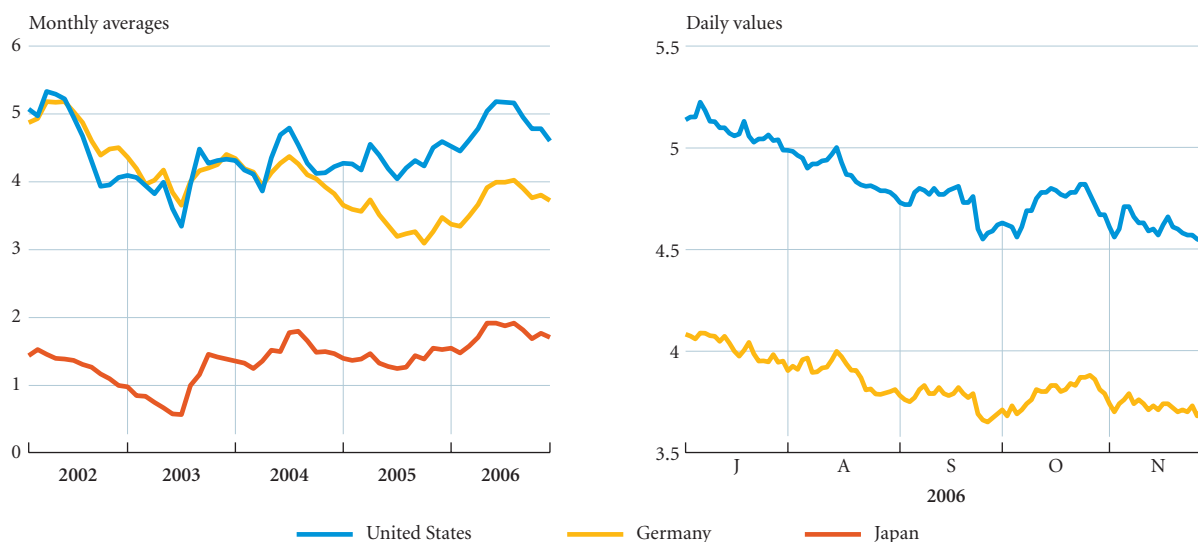
In Europe, the yield on German 10-year bonds followed US bonds in the early weeks of November. The differential in long-term interest rates between the dollar and the euro dropped slightly to 83 basis points. It should be pointed out that at the end of the second week of that month the yield curve for German government bonds of 2-10 years term became inverted because of the rise on those of shorter term because of the prospect of further increases in the official interest rate by the European Central Bank. Nevertheless, this was merely an isolated happening. In any case, the recent flattening of the yield curve indicates that operators are discounting that there is little room for further increases in Eurosystem interest rates.

Yield curve in United States remains inverted...

...while German yield curve becomes temporarily inverted in one segment.

SLIGHT REDUCTION IN LONG-TERM INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO

Yield on 10-year government bonds as annual percentage



NOTES: Rates go up to November 28.

SOURCE: Bank of Spain and Thomson Financial Datastream.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2004	2005	2006				
			1 Q	2 Q	3 Q	October	November 28
United States	4.31	4.33	4.61	5.13	4.96	4.78	4.51
Japan	1.50	1.39	1.58	1.90	1.80	1.76	1.66
Germany	4.07	3.38	3.50	3.96	3.89	3.80	3.68
France	4.10	3.41	3.51	3.99	3.90	3.81	3.70
Italy	4.24	3.56	3.71	4.27	4.18	4.07	3.93
Spain	4.10	3.39	3.49	3.97	3.89	3.81	3.69
United Kingdom	4.93	4.47	4.23	4.65	4.67	4.67	4.53
Switzerland	2.57	2.04	2.18	2.67	2.61	2.45	2.29

SOURCE: Bank of Spain, Thomson Financial Datastream and own calculations.

Good run takes many stock markets to all-time records in November.

Stock markets facing final stretch of year with optimism

Once they had successfully survived October, that some called fateful, the stock markets continued their good run in the early weeks of November. Better than expected corporate profits, abundant money supply, the drop in oil prices and a good number of mergers and acquisitions made up the recipe for success that carried many stock markets to annual or all-time highs.

In the United States, the traditional Dow Jones Industrials continued to mark up all-time records. The broader Standard & Poor's 500 index is still standing below the high in 2000 but is showing a notable cumulative balance. All economic sectors show considerable capital gains over December 2005 with telecommunications in the lead. At the other end of the scale we find the health-pharmaceutical sector which was hurt by the victory of the Democratic party in the recent legislative elections, given that some of its leaders had declared their intention to cut the prices of medicines. The Nasdaq index, which is representative

of hi-tech shares, also had a big recovery in recent months (it lost par for the year in May) although it is still far from the heights reached in 2000. In spite of these achievements, there is still the risk of a more serious than expected slowdown of the economy, which would have a negative effect on the stock markets.

In the Euro Area, the DJ Eurostoxx 50 index, made up of the largest companies in that area, also obtained considerable increases in the first 11 months of the year. The main markets on the Continent showed two-digit gains over December 2005.

It should be noted that a consortium of seven investment banks, Citigroup, Crédit Suisse, Deutsche Bank, Goldman Sachs, Merrill Lynch, Morgan Stanley and UBS have announced the early launching of a new pan-European trading platform for shares as an outcome of the EU financial markets directive (Mifid). This will mean a new challenge for European stock exchanges, now involved in the process of consolidation, given that they are considering cutting transaction fees.

Risks remain for US stock markets.

Consortium of investment banks challenge European stock exchanges with new trading platform.

INDICES OF MAIN WORLD STOCK EXCHANGES

October 31, 2006

	Index (*)	% monthly change	% cumulative change	% annual change	Figures on November 28, 2006	
					% cumulative change	% change over same date in 2003
New York						
<i>Dow Jones</i>	12,080.7	3.4	12.7	15.7	13.2	24.1
<i>Standard & Poor's</i>	1,377.9	3.2	10.4	14.2	11.1	31.0
<i>Nasdaq</i>	2,366.7	4.8	7.3	11.6	9.4	23.1
Tokyo	16,399.4	1.7	1.8	20.5	-1.6	57.0
London	6,129.2	2.8	9.1	15.3	7.2	38.8
Euro area	4,004.8	2.7	11.9	20.6	11.1	51.1
<i>Frankfurt</i>	6,268.9	4.4	15.9	27.2	16.1	67.7
<i>Paris</i>	5,348.7	1.9	13.4	20.6	12.5	54.9
<i>Amsterdam</i>	486.6	0.6	11.4	23.4	9.5	44.0
<i>Milan</i>	30,392.0	3.3	13.5	21.3	15.0	53.1
<i>Madrid</i>	13,753.0	6.3	28.1	31.1	27.9	89.3
Zurich	8,569.7	1.7	13.0	21.8	11.6	59.1
Hong Kong	18,324.4	4.5	23.2	27.4	25.3	51.3
Buenos Aires	1,781.7	8.8	15.4	10.7	23.6	91.4
São Paulo	39,262.0	7.7	17.4	30.0	22.7	103.4

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 own calculations.

In Spain, the IBEX 35 index continued to shine and ran for ten weeks with consecutive increases up to the third week in November. An impressive increase in the profits of large companies and corporate moves continued to push up this selective Spanish index to new record levels. As a result, the IBEX 35 for a brief period went above 14,000 points in the second week of November and in the final week of the month went above a cumulative increase of 27%.

Outside the Euro Area, the British market also gained an annual high in the third week of November. On the

other hand, the Japanese stock market was the only one among the leaders that failed to make a showing. In the final week of the month it was in the red, partly as an aftermath of the spectacular rise of 40.2% seen in 2005.

Markets in the emerging countries also stood at all-time highs generally reflecting the good economic situation they are now enjoying. Particularly markets in Poland, Hong Kong, India, Indonesia, Singapore, South Africa, Brazil, Mexico and Venezuela marked up all-time highs in November.

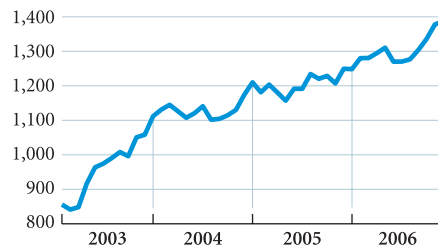
IBEX 35 runs up new all-time highs.

Emerging stock markets also stand at all-time high levels.

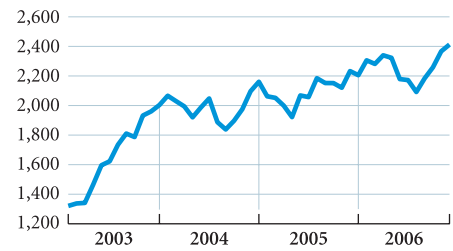
INTERNATIONAL STOCK EXCHANGES

Indices at month-end

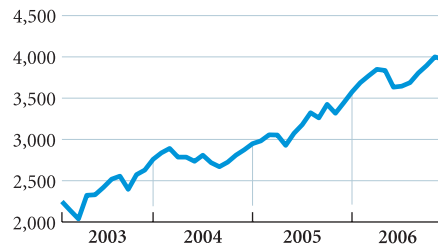
New York (Standard & Poor's 500)



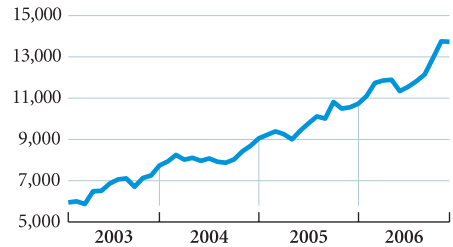
Nasdaq Index (United States)



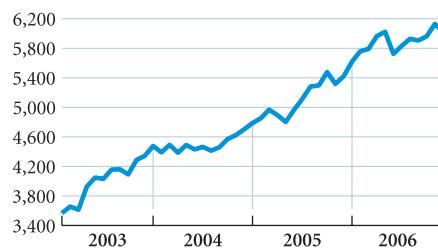
Euro area (DJ Eurostoxx 50)



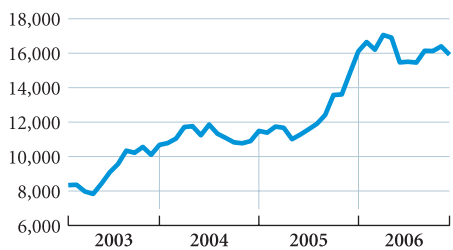
Madrid (IBEX 35)



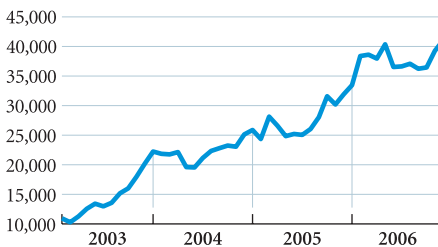
London (Financial Times 100)



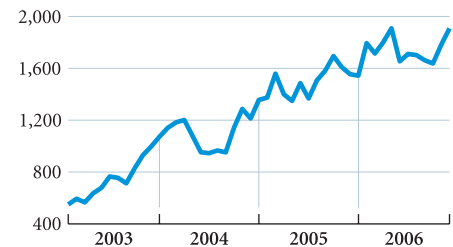
Tokyo (Nikkei 225)



São Paulo (Bovespa)



Buenos Aires (Merval)



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

SPAIN: OVERALL ANALYSIS

Economic activity

Spain's economy still showing strong growth

In the third quarter of the current year the gross domestic product (GDP) generated by Spain's economy showed an increase in year-to-year growth rate to 3.8%, one decimal more than in the previous quarter. This slight rise was entirely due to the less negative contribution of the foreign sector which took off one percentage point from GDP growth (one decimal less than in the previous quarter). The contribution from national demand held stable at 4.8 points.

The strength of domestic demand was spread over nearly all components but especially in investment, both capital goods and construction, which increased in growth rates. In turn, final household consumption stabilized overall growth at 3.6% in spite of the fact that spending was down in certain consumer durables, such as cars. On the other hand, we note a stronger performance in foods, services and semi-durable goods, which helped to even out the overall balance.

GDP growth continues to increase thanks to lower negative contribution of foreign sector.

DEMAND INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006			
			3 Q	4 Q	1 Q	2 Q	3 Q	October
Consumption								
Production of consumer goods (*)	-0.1	0.9	1.4	0.9	0.6	2.1	1.6	...
Imports of consumer goods (**)	13.4	7.9	7.8	8.6	20.5	5.9	2.4	...
Car registrations	9.8	0.8	2.3	-4.5	2.4	-4.3	-5.3	5.8
Credit for consumer durables	5.5	15.0	17.3	19.7	17.6	15.6	...	-
Consumer confidence index (***)	-10.5	-10.8	-11.4	-11.2	-12.5	-12.7	-13.7	-11.0
Investment								
Capital goods production (*)	1.9	-0.1	-1.3	0.8	6.7	7.6	7.5	...
Imports of capital goods (**)	14.9	20.4	13.5	8.2	10.0	-5.0	6.5	...
Commercial vehicle registrations	11.7	13.2	13.9	11.5	7.4	-0.2	0.5	10.0
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	1.7	...

NOTES: (*) Adjusted for difference in number of working days.

(**) By volume.

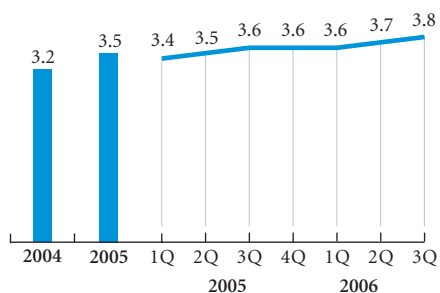
(***) European Commission survey: difference between percentage of positive and negative replies.

SOURCE: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of Economy and Finance, European Commission and own calculations.

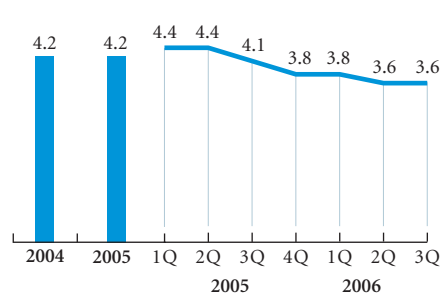
TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-to-year change (*)

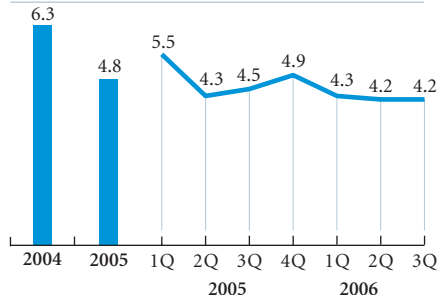
GDP



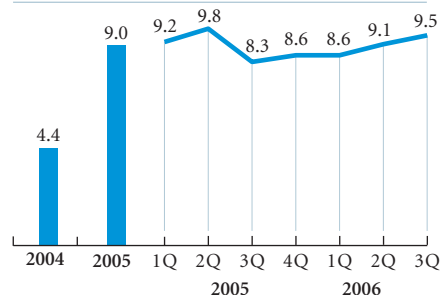
Household consumption



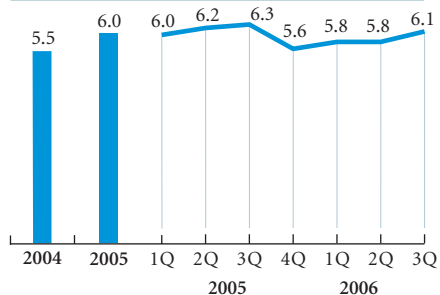
Public consumption



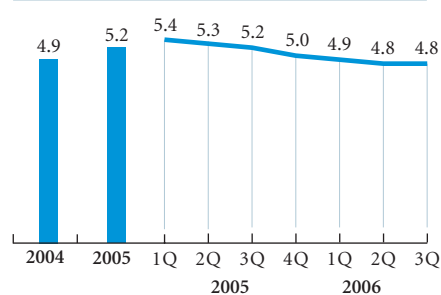
Investment in capital goods



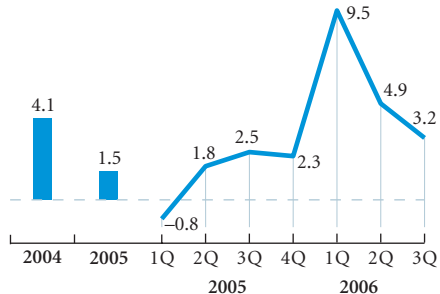
Construction investment



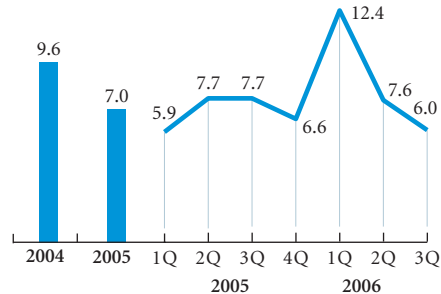
Domestic demand (**)



Exports of goods and services



Imports of goods and services



NOTES: (*) Figures adjusted for seasonal and calendar effects.

(**) Contribution to GDP growth.

SOURCE: National Institute of Statistics.

This situation has scarcely changed in the final months of the year. In this respect, it should be noted that year-to-year growth in car sales in October is of little significance seeing that it is being compared with the unusually low figure for October 2005. The stable growth being maintained in private consumption may largely be explained by the continuing rise in employment and the trend in wages without this, for the moment, having any serious effect on

the weak level of confidence being shown by consumers over a period of some months.

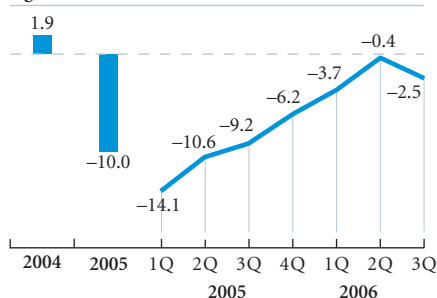
In the public sphere, the increase in wages compensated for the drop in purchases of goods and services which resulted in stabilization of the year-to-year rate at 4.2%. With regard to investment, we should point out the notable increase in demand for capital goods which marked up year-to-year

Investment in both capital goods and construction continues strong drive.

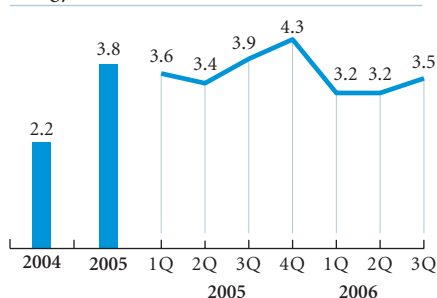
TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)

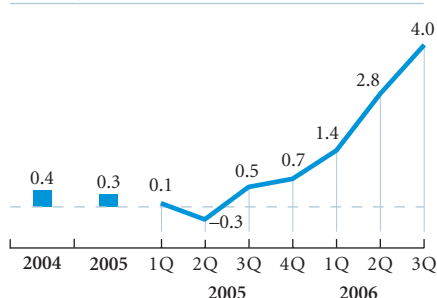
Agriculture



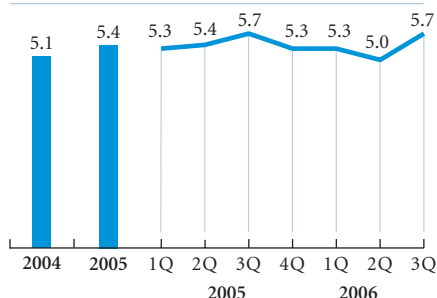
Energy



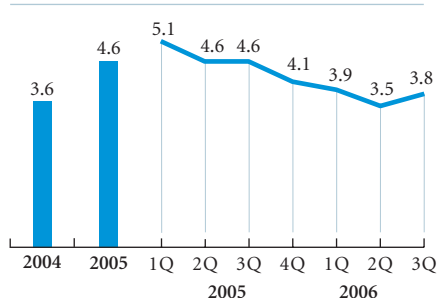
Industry



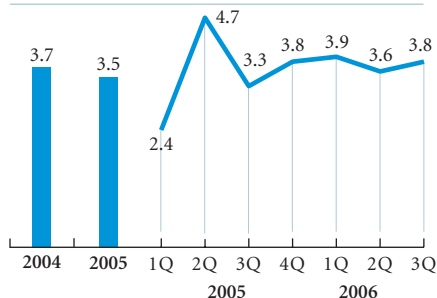
Construction



Market services



Non-market services



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

SUPPLY INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006			
			3 Q	4 Q	1 Q	2 Q	3 Q	October
Industry								
Electricity consumption (1)	4.2	3.4	2.9	2.7	2.0	3.2	5.8	4.2
Industrial production index (2)	1.6	0.7	0.7	1.6	2.6	4.0	4.0	...
Confidence indicator for industry (3)	−2.5	−4.9	−4.8	−4.0	−5.4	−2.7	−2.3	−2.0
Utilization of production capacity (4)	79.8	80.2	81.1	80.7	79.7	80.5	80.3	81.6
Imports of non-energy intermediate goods (5)	6.6	1.6	0.6	1.1	10.3	6.4	13.8	...
Construction								
Cement consumption	3.9	7.3	7.8	6.1	17.1	2.7	4.0	12.0
Confidence indicator for construction (3)	13.6	22.4	22.7	28.3	15.3	11.7	14.7	13.0
Housing (new construction approvals)	8.0	6.2	2.8	10.6	18.5	6.3	23.7	...
Government tendering	18.3	18.5	3.1	36.9	15.0	34.6	17.3	...
Services								
Retail sales	5.5	4.4	4.4	3.8	5.2	3.8	5.9	...
Foreign tourists	3.1	6.5	8.1	4.8	0.6	9.5	3.7	3.6
Tourist revenue inflows	3.8	5.8	13.9	4.9	−7.6	3.0	3.3	...
Goods carried by rail (km-tonnes)	−3.5	−3.2	−2.3	11.0	8.1	−2.7	−3.3	...
Air passenger traffic	8.0	9.2	10.3	9.2	5.2	10.1	4.5	6.1
Motor vehicle diesel fuel consumption	6.7	5.0	5.2	4.3	8.7	4.5	3.9	...

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 own calculations.

Improved growth of GVA in industry...

growth of 9.5% in the third quarter, nearly a half-point more than in the three previous months, in keeping with the trend in corresponding indicators of economic activity.

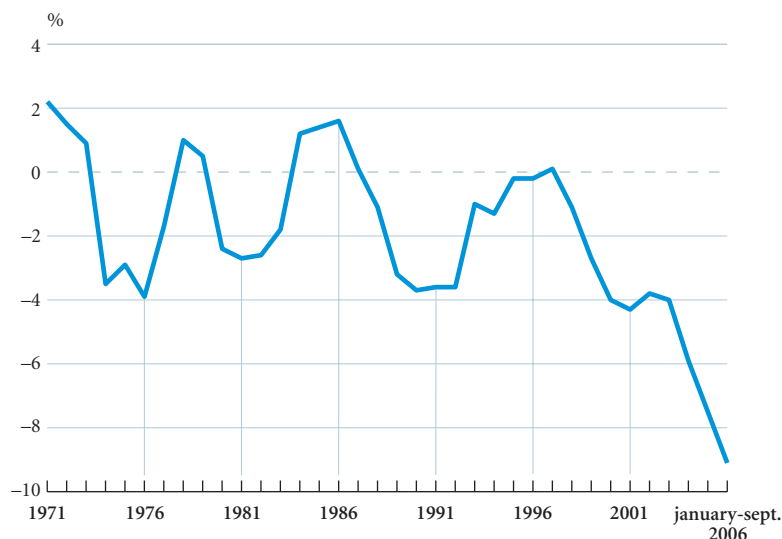
Investment in construction also showed an increase in growth rate to 6.1% (three decimals more than in the second quarter) with a significant contribution from all types of activity, but especially in public works and non-residential building construction. Latest indicators for housing construction (new building approvals) and public works (government tendering) continue to indicate a

high rate of construction in coming months.

On the supply side, along with the renewed drive in construction for which gross value added (GVA) grew by 5.7% (seven decimals more than in the previous quarter) in keeping with the strength of demand, we should also mention the increased growth in industry (this went from 2.8% to 4.0% year-to-year). The prospects in this sector in the final stages of the year remain favourable, if we are to go by the indices of utilization of production capacity and the situation in order books at the beginning of the fourth quarter.

FOREIGN DEFICIT CONTINUES TO INCREASE

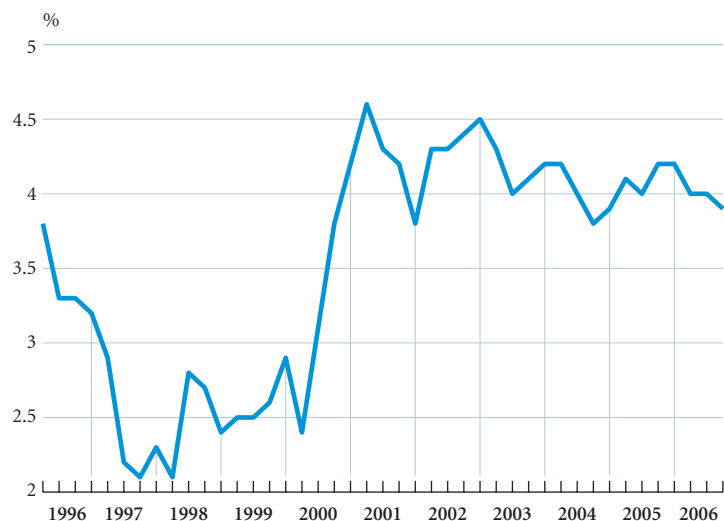
Current account deficit over GDP



SOURCE: INE and own calculations.

PRICES TENDING TO EASE SLIGHTLY

Year-to-year change in GDP deflator



SOURCE: INE and own calculations.

Services also increased in growth rate in the third quarter (from 3.5% to 3.8%) with market services and other services following very similar lines. Activities showing the most strength were those linked to tourism, financial transactions, company

services and, to a lesser degree, retail trade. Finally, standing somewhat outside the general trend in the economy, agriculture and fishing showed even more negative rates in keeping with trends in those activities.

...along with increased growth rate in services.

Foreign deficit scarcely improving...

...but growth in labour productivity up two decimals entirely due to good performance in industry.

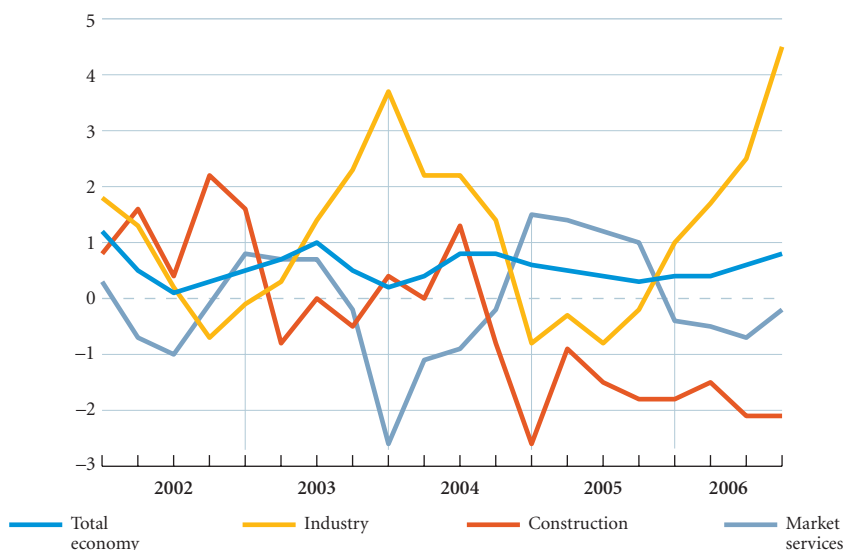
In the foreign sector, there was a substantial drop in both exports and imports but the higher level of the latter lay behind the improvement of one decimal in the contribution of the sector to GDP growth. This was very limited progress that scarcely had any effect on improving the overall imbalance in that sector. As a result, in the nine months of the year so far, the current account deficit went up to 9.1% of the GDP, close to 1.5 points more than in the whole of 2005.

In terms of prices, the increases as of the third quarter were also quite

limited with an increase in the GDP deflator still close to 4% year-to-year although in this case the trend suggests a gradual slowdown. In addition, the year-to-year in the apparent productivity of the labour factor (GDP per full-time worker) rose by two decimals to stand at 0.8%, thanks to the drive in industry where productivity rose at the rate of 4.5% in the third quarter, thus compensating for the practically nil increase in market services and the negative figure in construction, as may be seen in the accompanying graph.

SPAIN'S ECONOMY AFFECTED BY SLOW IMPROVEMENT IN PRODUCTIVITY

Percentage change in GDP by job equivalent to full-time work



SOURCE: INE and own calculations.

Labour market

Employment maintaining new strength

The excellent situation of Spain's economy is reflected in the strong level being maintained in the labour market. In this context, the total number of those registered at Social Security was up by 3.1% year-to-year in October. We should point out that the slowdown seen in this rate in recent months is more apparent than real, given that the process of giving normal legal status to foreign workers carried out in 2005 (which brought existing employment to the surface) raised registration figures for that year.

While the effects of that process have ceased to operate, the total number of foreign worker registrations still continues to grow at a very high rate (8.4% year-to-year in October). Also in the group of native Spanish workers, not affected by that normalization process, the growth of total registrations has held fairly stable in the past three years at around slightly below 2.5%, a rate which has even tended to rise in recent months.

As indicated above, the sustained growth of Spain's economy, spurred on recently by the sharp increase in the immigrant population, lies behind the spectacular

Total registrations with Social Security continues to rise...

...thanks to sustained growth of economy.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006			
			3 Q	4 Q	1 Q	2 Q	3 Q	October
Persons registered with Social Security								
Wage-earners	2.7	4.8	5.9	6.3	6.3	5.3	3.9	3.4
<i>Industry</i>	-0.5	-0.5	-0.3	-0.4	-0.3	-0.0	-0.0	0.0
<i>Construction</i>	5.6	8.6	10.0	10.9	11.0	9.5	7.5	6.9
<i>Services</i>	3.9	5.7	6.4	6.8	6.6	5.8	4.6	3.9
Non-wage-earners	3.2	2.6	2.5	2.4	2.3	2.2	2.1	2.2
Total	2.8	4.4	5.3	5.6	5.5	4.8	3.6	3.1
Persons employed (*)	3.9	5.6	5.9	5.6	4.9	4.2	3.7	-
Jobs (**)	2.6	3.1	3.3	3.2	3.2	3.1	3.0	-
Hiring contracts registered (***)								
Permanent	11.8	8.7	10.0	16.1	25.6	16.1	46.6	61.7
Temporary	11.4	4.6	9.7	8.9	13.7	5.5	0.5	6.1
Total	11.5	5.0	9.8	9.5	15.0	6.4	4.1	11.1

NOTES: (*) Estimate from Labour Force Survey (changes for 2005 adjusted for impact of methodological changes).

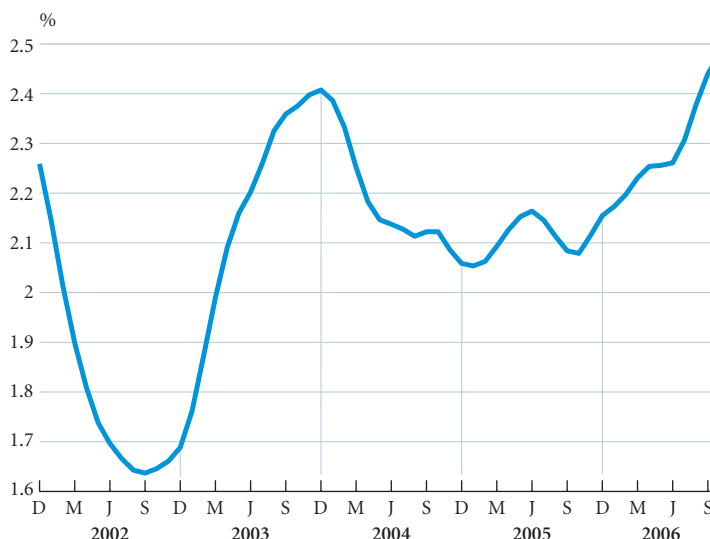
(**) Equivalent to full-time work. National Accounting estimate; figures adjusted for seasonal effects and number of working days.

(***) At INEM.

SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, Employment Institute and own calculations.

INCREASED GROWTH OF TOTAL SPANISH REGISTRATIONS WITH SOCIAL SECURITY

Year-to-year change in total Spanish workers registered with Social Security



NOTES: Cycle-trend statistical series.

SOURCE: Bank of Spain and own calculations.

Increase in permanent hiring contracts following government measures to improve growth and employment.

increase in the total number of those registered with the Social Security system. In the past three years, this increase has amounted to more than two million persons (close to 900,000 were foreign workers). Thanks to this sharp rise in registrations, it is expected that the surplus for Social Security this year will reach 11.9 billion euros (around 1.2% of the GDP), going above the most optimistic early forecasts.

The present good state of the economy, however, should not hide the major challenge to be faced by the government pension system over the medium and long term arising from the increase in life-expectancy and the low rate of reproduction reported in Spain. In spite of the oxygen balloon coming from immigration, projections carried out by the working group set up by the European Commission would indicate a sharp increase in government spending on pensions as of 2020 and, according to the figures mentioned, it could come

close to 16% of the GDP at around 2045, twice that at the present time.

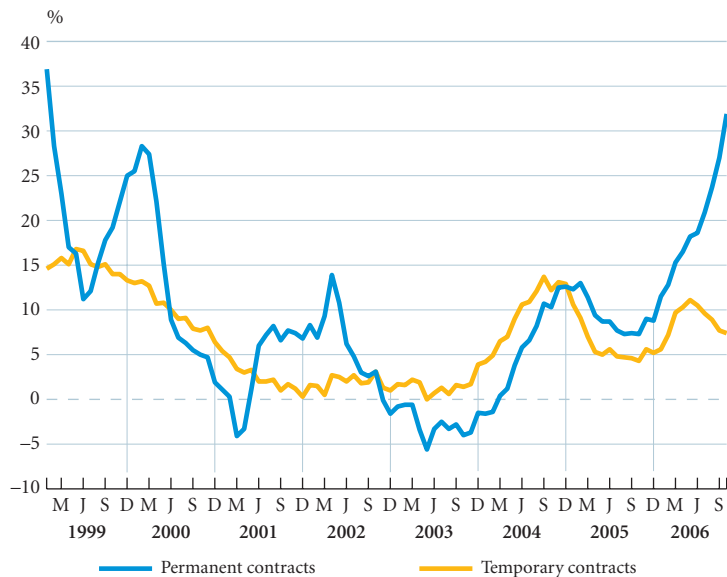
Coming back to the present moment, one of the weak points in Spain's labour market, the high rate of those on temporary work contracts, seems to have lately taken a more favourable turn. In fact, the total number of permanent contracts has been growing sharply in recent months with the help of promotion measures set out in an agreement for the improvement of growth and employment agreed upon by the government, business organizations and trade unions last May.

With regard to employment, figures for the Quarterly National Accounts confirm the impressions set out above. In the third quarter, the total number of jobs equivalent to full-time work was up by 3.0% (a rate very similar to that for registrations with Social Security) while also showing a slight downward profile. From the point of view of employment,

Construction sector maintaining sharpest job creation rate.

SHARP GROWTH IN PERMANENT HIRING CONTRACTS

Hiring contracts registered at INEM: cumulative change for last 12 months compared with same period year before



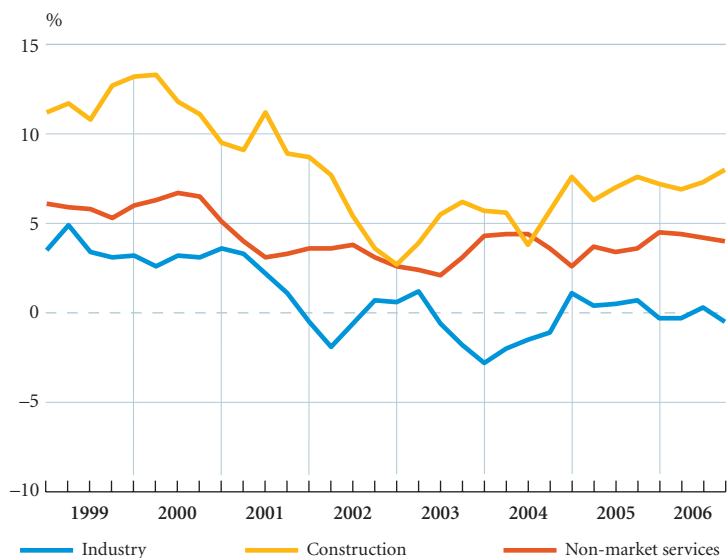
SOURCE: Employment institute and own calculations.

construction is the sector showing the greatest strength with an increase in jobs equivalent to 8.0% year-to-year, which furthermore continues to increase. Employment also recovered a more

dynamic situation in non-market services with year-to-year growth at 2.1% as against 1.0% recorded in the previous quarter. Industry, in turn, held to the situation of stagnation which marked the

SHARP JOB CREATION RATE IN CONSTRUCTION

Year-to-year change in jobs equivalent to full-time work



SOURCE: INE and own calculations.

Seasonal increase in registered unemployment in October.

preceding three quarters, this time with a slight drop of 0.5%.

If we are to go by figures for National Accounting, in the past three years more than 1.5 million jobs equivalent to full-time work have been created, entirely in the services (nearly 70% of the total) and in construction (close to 30%), which again shows that those sectors are the true supports of Spain's current growth model.

In another area, wages as a whole grew by 6.6% as a result of the increase in wage employment (3.0% year-to-year) and the increase in average earnings which stood at 3.4%, one decimal more than in the previous period. These results, together with the slow increase in the productivity of Spain's economy (in spite of the slight improvement noted in the course of the current year), meant a 2.6% growth in labour cost per production unit, one decimal below that for the year before, and still above

the figure for the European Union average.

Registered unemployment showing clear downward trend

The figure for registered unemployment at the Employment Institute (INEM) showed a seasonal increase of 26,670 persons in October compared with the month before. In keeping with their specific nature, this increase was concentrated in sectors such as services (22,294 more unemployed), under the effect of the end of the high tourist season, and among those seeking their first job (5,922), which included those moving into the labour force for the first time at the end of their educational studies.

With this proviso, the fact is that registered unemployment has shown a clearly downward trend in recent months.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

October 2006

	No. of unemployed	Change over December 2005		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	62,937	-2,290	-3.5	-3,199	-4.8	3.2
Industry	276,553	-24,766	-8.2	-16,571	-5.7	13.9
Construction	213,405	-31,695	-12.9	-7,177	-3.3	10.7
Services	1,215,596	-50,793	-4.0	-34,380	-2.8	61.0
First job	224,345	-557	-0.2	1,302	0.6	11.3
By sex						
Males	762,491	-89,472	-10.5	-41,286	-5.1	38.3
Females	1,230,345	-20,629	-1.6	-18,739	-1.5	61.7
By age						
Under 25 years	250,284	-25,611	-9.3	-27,817	-10.0	12.6
All other ages	1,742,552	-84,490	-4.6	-32,208	-1.8	87.4
TOTAL	1,992,836	-110,101	-5.2	-60,025	-2.9	100.0

SOURCE: INEM and own calculations.

Prices

CPI drops to lowest level in past two and a half years

Prices followed a positive trend in October. As a result, the inflation rate for consumer prices fell for the third consecutive time to show an annual change of 2.5%, the lowest level for inflation since March 2004. This decrease was largely due to drop in fuels and lubricants as a result of lower oil prices. Also having a favourable effect was a sharp reduction in package tour prices. Underlying inflation, which makes up the most stable core, was down by one decimal to 2.8%. As a result, general inflation stood below underlying inflation

for the first time in two and a half years.

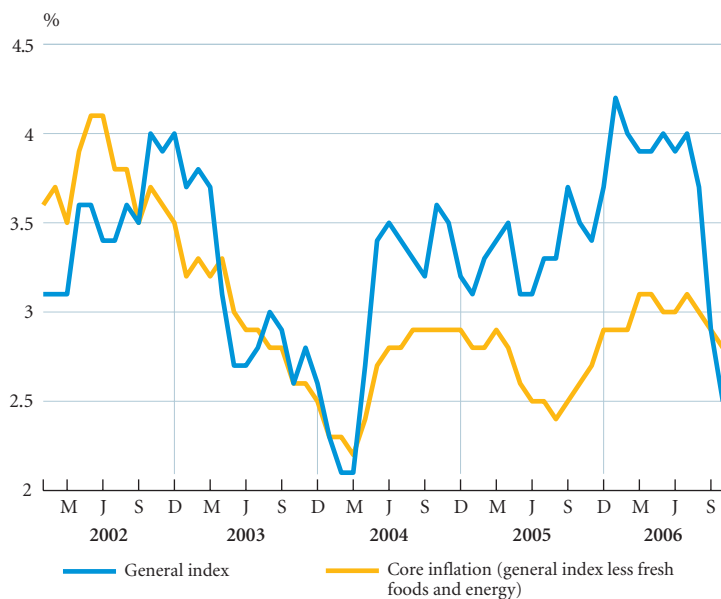
The drop in fuel prices was notable with a decrease of 7.4% in the past 12 months, the lowest annual rate since December 2001. The trend in other energy products was not quite so favourable but, all in all, energy products as a whole were down by 1.9% in the past 12 months.

Foods showed a slight easing in price increases with an annual rise of 4.4%. This was possible due to the drop in fresh food prices, with the year-to-year rate going down by four decimals, thanks to the decrease in fish and

Inflation down for third consecutive time going to 2.5%.

GENERAL INDEX DROPS BELOW CORE INFLATION

Year-to-year change in CPI



SOURCE: National Institute of Statistics and own calculations.

SHARP DROP IN FUELS IN RECENT MONTHS

Year-to-year change in fuels and lubricants group in CPI



SOURCE: National Institute of Statistics and own calculations.

Package tours and fish help ease inflation.

mutton, among other foods. In any case, unprocessed food prices rose by 5.2% over the past year. The increases in food prices seemed to be largely due to increased demand because of tourism and

population growth. Cooking oil was another matter with an annual increase of 20% because of some bottlenecks in supply. Potatoes, however, came out first with a rise of 23% in the same

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	-0.2	1.7	2.9
October	0.8	3.4	3.5	0.4	2.1	2.5
November	0.2	3.5	3.4			
December	0.2	3.7	3.7			

SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

October

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2005	2006	2005	2006	2005	2006
By type of spending							
Food and non-alcoholic beverages	122.4	0.2	−0.1	2.2	2.5	2.9	4.4
Alcoholic beverages and tobacco	122.8	0.2	0.0	4.9	0.8	4.9	0.9
Clothing and footwear	119.7	8.9	9.1	−0.5	−0.6	1.6	1.3
Housing	122.7	0.6	−0.3	5.9	4.8	5.8	4.9
Furnishings and household equipment	111.4	0.4	0.4	1.5	2.0	2.2	2.6
Health	108.0	0.0	0.1	0.7	1.5	0.8	1.5
Transport	118.7	−0.7	−1.9	9.1	1.7	7.1	−1.0
Communications	90.5	−0.1	−0.2	−1.5	−1.0	−1.9	−1.2
Recreation and culture	102.7	−0.5	−1.1	−0.2	−1.2	−0.2	−0.3
Education	125.6	2.4	2.4	3.8	3.7	4.5	4.0
Restaurants and hotels	125.9	−0.0	0.0	3.9	4.1	4.3	4.4
Other goods and services	119.2	0.2	0.2	3.0	3.6	3.2	4.0
By group							
Processed food, beverages and tobacco	119.6	0.2	0.0	2.5	2.1	2.9	3.4
Unprocessed food	128.3	0.2	−0.2	2.7	2.6	3.6	5.2
Non-food products	117.0	1.0	0.6	3.6	2.1	3.6	2.0
Industrial goods	112.6	1.8	1.1	3.8	1.0	3.5	0.4
Energy products	121.6	−0.7	−3.5	15.4	2.9	11.2	−1.9
Fuels and oils	125.9	−0.9	−4.7	20.4	2.2	14.6	−4.1
Industrial goods excluding energy products	109.8	2.8	2.7	0.3	0.4	1.1	1.3
Services	122.1	0.1	−0.0	3.5	3.3	3.8	3.8
Underlying inflation (**)	117.0	1.1	0.9	2.1	2.0	2.6	2.8
GENERAL INDEX	118.3	0.8	0.4	3.4	2.1	3.5	2.5

NOTES: (*) Base 2001 = 100.

(**) General index excluding energy products and unprocessed food.

SOURCE: National Institute of Statistics.

period. On the other hand, tobacco rose by only 0.2% in the past 12 months in spite of the rise in taxes, given that tobacco stores did not add on the full tax.

Non-energy industrial goods continued to be contained because of international competition. As a result, the annual change rate for prices of those products held at 1.3%.

Services, which enjoy more protection from competition, grew by nearly three times (3.8%) although this rate fell by one decimal. It is worth noting that, in a situation of increasing competition in communications prices, these were down by 1.2% in the past 12 months. On the other hand, hotels and restaurants continued to show price increases of 4.4% in the same period.

INFLATION DIFFERENTIAL WITH EURO AREA DOWN

Year-to-year change in percentage points



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

CPI likely to end year with rise of less than 3%.

Inflation differential with Euro Area drops to one percentage point.

Producer prices ease especially because of energy component.

The good state of prices (it should be remembered that these rose by 4.0% year-to-year in July) could continue in coming months thanks to the easing of food prices. Nevertheless, the performance of energy prices will not likely be as favourable. As a result, it is possible that the CPI will end the year close to current levels (below 3%) which would mean an improvement over the 3.7% seen in 2005.

On the other hand, the consumer price index harmonized with the EU rose by 2.6% from October 2005 to October 2006. Given that in the same period the HCPI of the European Monetary Union (EMU) rose by 1.6%, the inflation differential dropped to one percentage point, something that had not happened for a whole year. We should point out that the reduction of this differential in recent months was partly due to the higher relative weight of fuels in the Spanish CPI.

Easing of wholesale prices

Producer prices continued to moderate growth in October so that the year-to-year change rate dropped to 3.4%, the lowest level since May 2004. This decrease was largely due to the sharp drop in energy prices for which the year-to-year increase went down to 0.6%, whereas in May it stood at 17.8%. Furthermore, the easing of consumer goods prices to 2.3% year-to-year also helped to improve matters.

On the other hand, prices of intermediate goods have scarcely eased at all. The annual change rate went from 7.2% in August to 6.9% in October so that up to now the drop in energy prices has only partly shown up. It should be noted that metallurgy prices showed a year-to-year rise of 22.1% in October mainly as a result of the extraordinary rise in metal prices.

In foreign prices, we also note lower inflationary pressures. Import prices rose by only 0.8% in the past 12 months ending in September, according to Customs Office figures. According to this source, capital goods showed a drop of 5% in prices in the same period.

In addition, in mid-November the National Institute of Statistics began to publish statistical indices for export and import prices for industrial goods using a methodology based on surveys of export/import companies, similar to that used for

calculating producer price statistics. The new index for import prices shows a decrease in these prices in recent months, recording a 3.1% change in the period September 2005-September 2006. Prices of capital goods were also down but to a lesser extent at 0.2% over the same month the year before.

Finally, farm prices were contained during the summer months with a year-to-year increase of only 0.6% in August. This drop could shift to consumer food prices over coming months.

New statistical series covers import prices and shows easing in recent levels.

Farm prices at origin contained.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2005											
August	9.2	4.9	2.5	1.8	2.9	16.4	6.1	-0.3	-0.3	11.1	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	4.0
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	0.7	6.4	3.6	2.4	7.0	13.9	1.1	0.5	-7.3	3.1	-
August	0.6	5.7	3.2	2.5	7.2	10.2	2.3	-0.6	-0.5	4.0	3.8
September	...	4.2	2.7	2.5	6.7	4.1	0.8	2.4	-5.0	1.0	-
October	...	3.4	2.3	2.4	6.9	0.6	...	...	...	...	-

NOTES : (*) Figures adjusted for seasonal and calendar effects.

SOURCE: National Institute of Statistics, Ministry of Economy and own calculations.

Foreign sector

Trade deficit remains but growth rate of exports comes close to imports.

Trade deficit still a threat

The cumulative trade deficit for the past 12 months ending in September was 17.9% higher than in the same period the year before. Even if we take into consideration the level reached and the rate of increase, the path of correction at least has now begun. The incipient slowdown in imports that began in the Spring of 2005 is continuing and the main

new factor in recent months is the revival of exports. While these are still growing less than imports, as a result of continuing strong domestic demand, the rates of increase in exports have moved up from levels close to 5% operating up to the end of 2005 to current rates near 10%. The slight easing off in September at this moment seems to be temporary. Practically all of this improvement in the state of exports shows up in consumer

FOREIGN TRADE

Cumulative figures for 12 months ended September 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	39,618	32.4	15.6	7,633	28.2	4.6	−31,986	19.3
Consumer goods	71,665	10.1	28.3	61,735	5.5	37.2	−9,930	86.1
Food	14,416	5.0	5.7	19,729	6.9	11.9	5,314	136.9
Non-foods	57,250	11.5	22.6	42,006	4.8	25.3	−15,244	73.4
Capital goods	27,583	5.2	10.9	17,030	21.8	10.3	−10,553	61.7
Non-energy intermediate goods	114,435	9.7	45.2	79,675	8.9	48.0	−34,760	69.6
By geographical area								
Euro area	124,609	6.2	49.2	93,207	5.4	56.1	−31,401	74.8
Rest of European Union EU 25	24,997	12.9	9.9	23,708	8.4	14.3	−1,289	94.8
Russia	7,007	43.3	2.8	1,381	35.1	0.8	−5,626	19.7
United States	8,030	0.5	3.2	7,259	20.2	4.4	−772	90.4
China	13,197	21.2	5.2	466	119.1	0.3	−12,732	3.5
Japan	5,793	−1.5	2.3	1,249	8.3	0.8	−4,543	21.6
Rest of Asia	22,651	25.1	8.9	6,504	5.8	3.9	−16,147	28.7
Latin America	21,334	32.6	8.4	4,309	−0.5	2.6	−17,025	20.2
OPEC	14,209	46.5	5.6	10,144	37.9	6.1	−4,065	71.4
Rest	11,474	−8.8	4.5	17,846	19.0	10.7	6,372	155.5
TOTAL	253,301	12.3	100.0	166,073	9.6	100.0	−87,229	65.6

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

goods, which have moved out of their lethargy, and in the continuing strength of capital goods. Both headings have shown sharp increases in growth rate while intermediate goods (practically have of non-energy exports) are maintaining the same rates as in recent years.

Nevertheless, on the import side things are showing somewhat more inertia. The slowdown in non-energy imports (85% of the total) remains slow, if it even exists. The most significant slowdown in recent months has been in energy purchases.

By country and geographical area, exports to Latin America, which accounted for only 6.1% of the total, nevertheless contributed half of the

increase whereas those going to the Euro Area representing 56% of the total contributed only a quarter of the total.

In this respect, imports by geographical area make up the other side of the coin and the fact is that Spain's purchases from Asia in absolute terms make up a quarter of the year-to-year growth recorded in the last 12 months ending in September, practically the same as that from the Euro Area, the country's main trading partner. From China, for example, Spain imports 28 times more than it exports. Imports from the rest of the European Union are also increasing while those from the nine new member states show greater relative importance.

Export gains concentrated in Latin America but moving away from Asia.

Imports from Asia and Eastern Europe on rise.

Is Spain commercially integrated with Europe?

One of the most important economic changes Spain experienced since joining the European Economic Community (EEC) in 1986 concerned its external trade. With the Accession Treaty, Spain agreed to a gradual reduction of tariffs to be completed by January 1993, date of the consolidation of the Single European Market. Twenty years is time enough to take stock and consider whether the reduction in trade barriers led to greater integration of the Spanish market in Europe in terms of trade volume and prices.

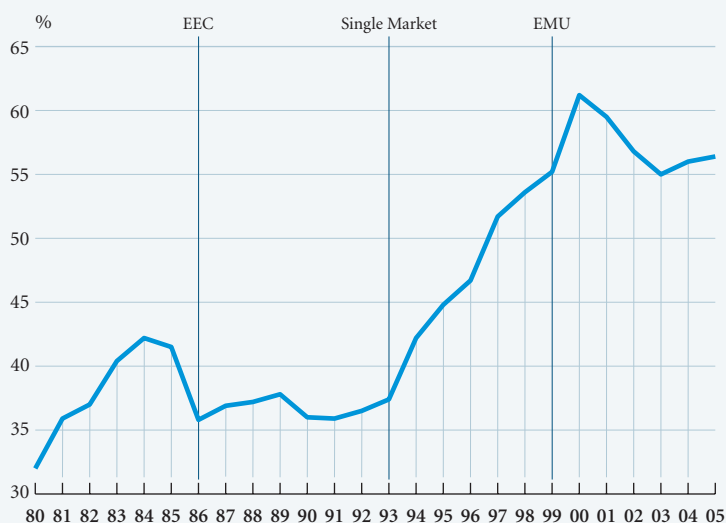
In general, when a country eliminates a tariff on a particular good, imports and domestic consumption of that good increase and its domestic production is reduced. If the tariff liberalization is preferential, that is, if the reduction of the tariff is not uniform but it is only applied to a subset of countries, as in the case of the European Union (EU), it may have a double effect: trade creation and trade diversion. If the union replaces less efficient domestic production by imports of goods from other member states, it creates trade. If, on the other hand, the preferential liberalization substitutes imports from more efficient non-member countries with imports from member states favoured by the liberalization, it diverts trade.

Spain's accession to the EEC involved not only a preferential liberalization in favour of member states but also a reduction of tariffs on non-member countries as well. This was a result of Spain adopting the EEC commercial policy, which was less protectionist than its own. Hence, we would expect a net increase in trade in spite of the possibility of trade diversion resulting from the preferential liberalization at the EU level. The evidence suggests that, in the case of Spain, both effects were important.

Although Spain's trade liberalization began much earlier, the figure below shows that most trade creation occurred since the establishment of the European Single Market in 1993. The gradual dismantling of Spanish tariffs with the EEC as well as the reduction of tariffs with the rest of the world began in 1986 and 90% of this process was completed by January 1992. Regarding quantitative restrictions (quotas) between Spain and the EEC, the deadline was 1990 and most of them were already eliminated by 1986. Given the strong growth recorded by both exports and imports since 1993, the level of trade openness of the Spanish economy, measured as total exports plus imports over GDP, in percentage terms, increased from 41% in 1985 to 56% in 2005.

MORE OPEN TO FOREIGN TRADE

Exports and imports over GDP



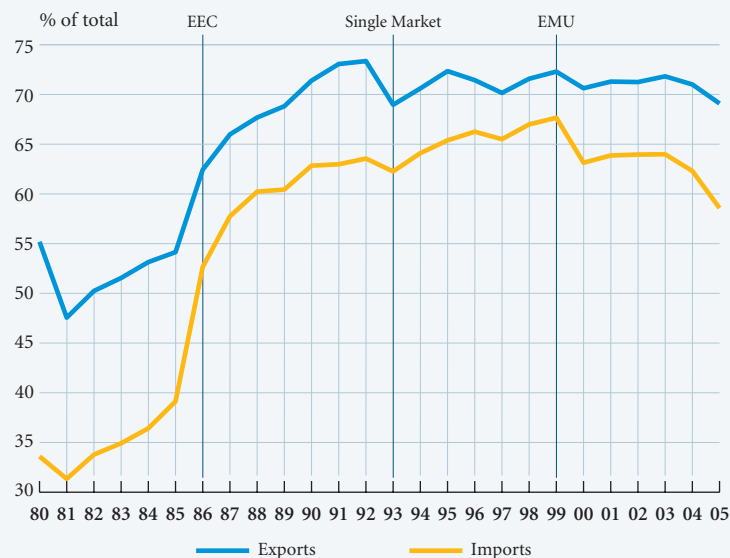
SOURCE: Eurostat and own calculations.

On the other hand, before 1993, trade diversion seems to dominate. As illustrated in the following graph, there is a remarkable change in the pattern of trade in 1986. While the overall volume of trade remained fairly stable, trade with the EU became more important. The percentage of Spain's exports towards the EU-15 increased from an annual average of 50% during the period 1976-1985 to more than 70% in 1992. Regarding imports, they increased from an average of 34% of the total in the first period to 63.5% in 1992.

In general, trade with other countries of the Organization for Economic Cooperation and Development (OECD) decreased in relative terms, with the United States being one of the most notable «victims». Between 1981 and 2005, Spanish exports towards the United States decreased from 10% of total Spanish exports to 4%, while the share of US imports in the Spanish market decreased from an initial 10.9% to 3.4% in 2005.

MORE TRADE INTEGRATION

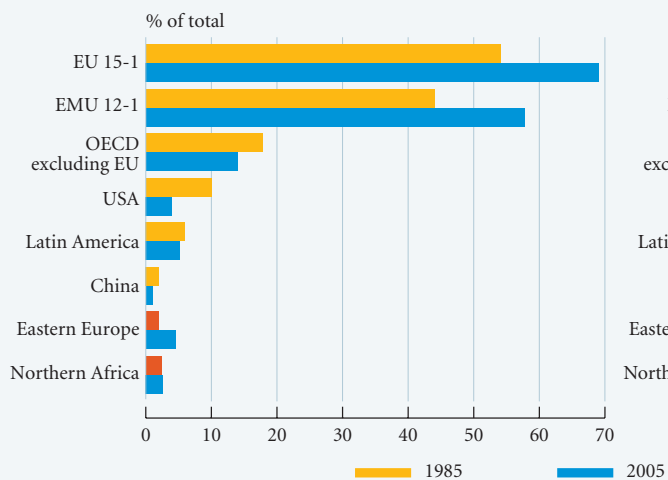
Exports and imports to and from the EU-15



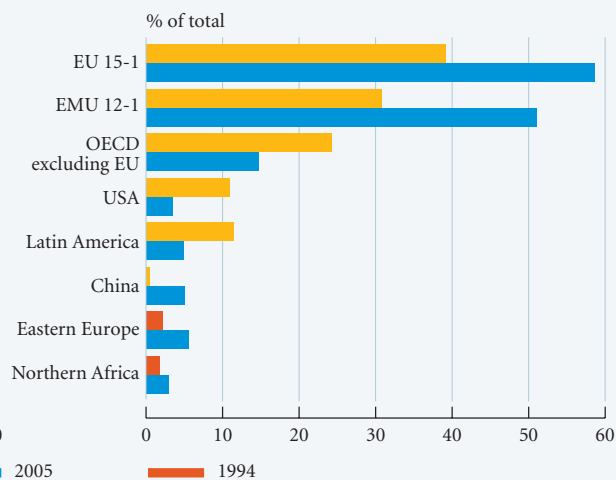
SOURCE: Ministry of Economy and Finance and own calculations.

FOREIGN TRADE EU-ORIENTED

Destination of Spain's exports



Origin of Spain's imports



SOURCE: Ministry of Economy and Finance and own calculations.

Besides higher trade with other EU member states, another expected result from lower trade barriers and greater market integration would be price convergence in tradable goods within the EU.

Consider the extreme situation where both transportation and distribution costs were zero and where taxes were the same across member states. In such scenario, the price of a car manufactured in Germany would only reflect its production cost. Hence, we would expect that price to be the same in a German, Spanish, or French dealership. It is obvious that neither transportation nor distribution costs are zero and that taxes vary from one country to another. However, it is certainly true that there are no custom barriers between Spain and the EU since 1993, transport costs are lower, Internet makes trade easier, and progress has been made in tax and policy harmonization within the EU. For all these reasons, we would expect lower dispersion of prices among EU countries.

Empirical evidence supports this hypothesis. A number of studies provide evidence indicating that price convergence in tradable goods within the EU was especially strong in the early Nineties. Despite slowing down, this convergence continued over the last decade. In a recent article, John Rogers, of the Board of Governors of the US Federal Reserve System, examines price convergence at the sector level among EU countries. He concludes that the dispersion of tradable goods' prices in Europe was remarkably reduced between 1990 and 2001, with the highest reduction taking place between 1991 and 1994.⁽¹⁾ The same study attributes the lower price dispersion to the increased harmonization of taxes and the lower dispersion in per capita incomes across European countries, and, to a lesser extent, to the increased trade openness and to the common monetary policy. Rogers argues that, as a consequence of this process, price dispersion in the Euro Area is now comparable to that in the United States.

In Spain, the prices of tradable goods have also converged with those in the European Union. As the following table illustrates, the prices of clothing and footwear, household goods, and machinery, which ranged between 84% and 93% of the EU-15 average in 1995, increased until reaching between 96% and 100% of the average in 2004. Prices of food and non-alcoholic beverages, which moved away from the EU average, are an exception to this pattern.

In a nutshell, the significant increase in Spain's trade with the EU, partly at the expense of a relatively lower volume of trade with the rest of the world, indicates higher integration of the Spanish economy with Europe. Although perhaps less conclusive, the evidence on prices also points in the same direction.

PRICES OF TRADABLE GOODS IN SPAIN

EU-15 average = 100

	1995	2004
Food and non-alcoholic beverages	90.2	81.3
Alcoholic beverages and tobacco	64.4	69.6
Clothing and footwear	92.5	100.2
Household goods	89.6	98.1
Machinery	84.0	96.3
Total goods (tradable and non-tradable)	84.5	89.6

SOURCE: Eurostat.

(1) Rogers, J., 2006, «Monetary Union, Price Level Convergence, and Inflation: How Close is Europe to the United States?», Journal of Monetary Economics (forthcoming) and International Finance Discussion Paper 2002-740, Board of Governors of the Federal Reserve System.

Current account deficit continues but headings responsible change

The current account deficit continued to grow in September with a cumulative figure for the past 12 months going above 80 million euros. The most notable factor so far in 2006 is that the component contributing most to increasing that deficit in recent years, the trade balance, thanks to inflows, is now what is holding back growth of the current account deficit, whereas it is the services balance that is contributing most to its increase. Under services, tourism, always a favourite with the media in Spain, has been showing a negative contribution since the beginning of 2006 while other services are those most helping to make the current account

balance worse. If we break down the worsening of the current account deficit of 20.39 billion euros in absolute terms over the past year, some 13 billion euros arise from the increase in the trade deficit and 3.05 billion from deficit in services.

The financial balance continues to rest on portfolio investment. Net direct investment continues to drop because of heavy Spanish investment abroad. Inflows into Spain are following a trend to gradual recovery following the low figures seen at the end of 2004 but the decline in the real estate component is continuing. That sector, which represents somewhat more than a quarter of all inflows, in September stood 31% below the high recorded in 2003.

Trade deficit eases but non-tourist services balance shows increased losses.

Direct investment inflows showing weak growth.

BALANCE OF PAYMENTS

12-month rolling sum in million euros

	August 2005	August 2006	% change
Current account balance			
Trade balance	-64,580	-77,589	20.1
Services	22,542	19,487	-13.6
<i>Tourism</i>	25,900	25,558	-1.3
<i>Other services</i>	-3,358	-6,070	80.8
Total			
Income	-16,099	-18,422	14.4
Transfers	-1,745	-3,748	114.8
Total	-59,882	-80,272	34.1
Capital account	7,661	6,139	-19.9
Financial balance			
Direct investment	-30,679	-40,629	32.4
Portfolio investment	81,711	173,571	112.4
Other investment	1,321	-35,928	
Total	51,199	97,559	90.5
Errors and omissions	146	-4,700	
Change in assets of Bank of Spain	876	-18,725	

NOTES: The figure resulting from the sum of current account balance, capital account balance and financial balance is compensated by the change in assets of Bank of Spain plus errors and omissions.

SOURCE: Bank of Spain and own calculations.

Public sector

Tax revenues growing at good clip.

Increase in government surplus as of October

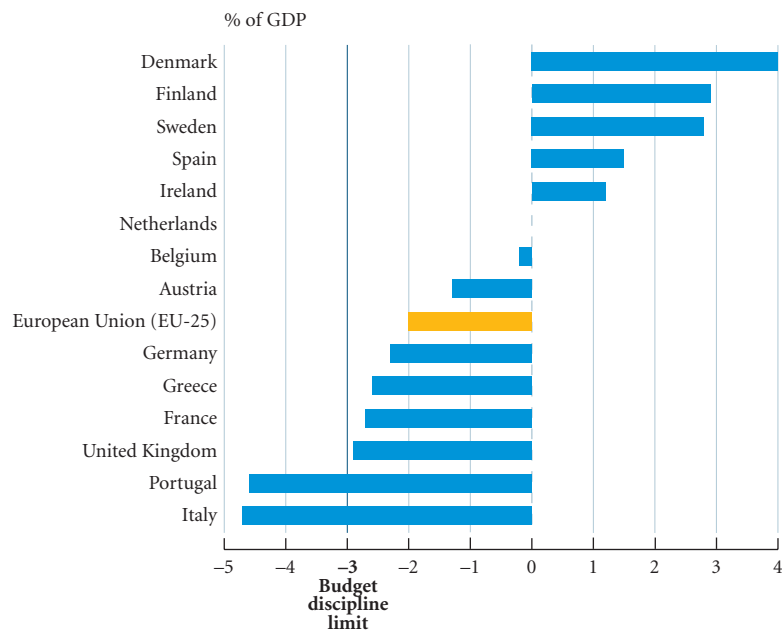
The public accounts continue to move in a favourable direction. Central government non-financial revenues rose to 123.85 billion euros in the first ten months of the year, an increase of 10.7% compared with the same period in 2005 in homogeneous terms. There was notable growth of 14.8% in collections for personal income tax, both for withholding taxes on wages and for annual settlements for 2005. Revenue from corporation tax was up by 15.9% as of October, reflecting the good state of company profits. With regard to indirect

taxes, collections were up by 8.7%. Among these, value added tax rose by 11.6% while special taxes were up by only 0.7%.

On the other hand, spending continues along a fairly contained path with cumulative growth of 5.9%, largely thanks to a drop of 11.5% in interest payments on the public debt. As a result, the central government arrived at a surplus of 18.59 billion euros. According to National Accounting, that is, calculating revenues and spending in accrual terms, the surplus recorded in the first ten months of the year amounted to 2.5% of the gross

SPAIN STANDING ON SIDE OF VIRTUE

Public sector balance forecast for 2006



SOURCE: European Commission.

domestic product (GDP) as against 2.2% of the GDP in the same period in 2005. In spite of this favourable result, it should be borne in mind that in coming months we shall see an increase in investment spending as well as in current spending so that the surplus

will likely be reduced in relative terms. As a result, the balance for general government as a whole will stand in line with European Commission forecasts, which put Spain among the leading group of this macroeconomic indicator.

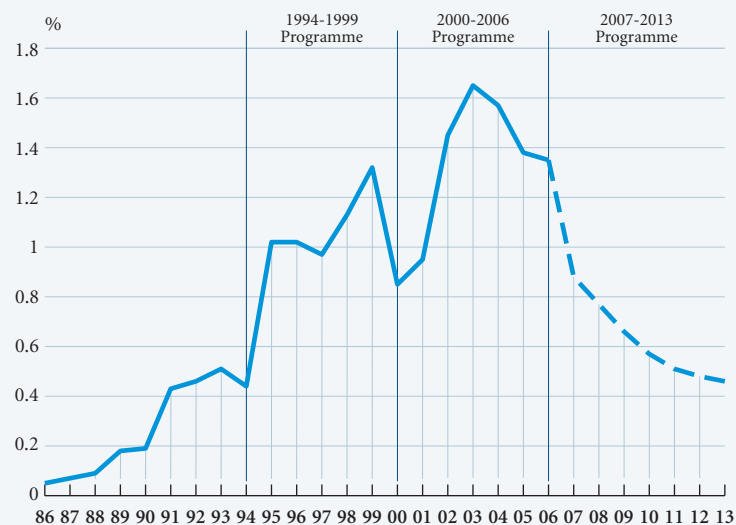
European Funds: Is their useful life over?

Since joining the European Union, Spain has received a considerable volume of European Funds. On average, these transfers represented 0.8% of the annual GDP and reached a maximum of 1.6% of the GDP in 2003. Nevertheless, the growth of Spain and the enlargement of the EU to 25 members imply a gradual reduction of funds coming from Brussels. What has been the effect of these transfers on Spanish economy and what could be the impact of their reduction in the future?

Let us begin with a brief introduction to the European Funds. The term covers various European Union transfer programmes (the so-called Structural Funds and the Cohesion Fund) whose main purpose is to reduce the economic disadvantage of the least favoured member states. Structural Funds are granted for programmes aimed mainly at the following three objectives: to facilitate the convergence of the most lagging regions, to help economic and social restructuring in areas with structural problems and, finally, to promote job creation and improve worker training. As opposed to Structural Funds, Cohesion Funds are granted for

EUROPEAN FUNDS LOSING IMPORTANCE

European Funds received by Spain in terms of GDP (*)



NOTES: (*) European Funds and GDP measured at constant 2004 prices.

SOURCE: Figures for 1986-1994, Correa y Manzanedo-Lopez (2002); figures for 1995-2005, Bank of Spain; figures for 2006-2013, European Commission and own calculations.

specific projects which may be carried out in any region of a member state. In both cases, European aid is normally dependent on co-funding part of the project through national public and private funds.

Adding up both Structural and Cohesion Funds, Spain has received more than 91 billion euros (at 2004 prices) over the last 20 years. The country started out as one of the less developed countries in the EU, with a GDP per capita equal to 73% of the EU-15 average (measured in purchasing power parities). Spain's relative position improves significantly after the enlargement of the EU to 25 member states. Therefore, the total volume of funds from Brussels will be reduced accordingly. Even in the absence of the enlargement, it is worth noting that the positive trend in Spain's economy would have triggered a reduction in European aid. On the one hand, Spain would not qualify for receiving Cohesion Funds since its GDP per capita is 91% of the EU-15 average in 2006 (the GDP per capita limit for receiving those funds stands at 90%). On the other hand, the number of regions eligible as objective 1 for Structural Funds dropped from 7 to 4 between 1995 and 2003.

Thus, what has been the role of European Funds in the economic performance of Spain? European Funds affected the Spanish economy through different channels. The most immediate effect has been on aggregate demand. To the extent that European aid is not merely a substitute for domestic investment that would have occurred anyway, public sector demand increases and so does GDP. This effect is larger the larger the idle capacity of domestic production factors. In contrast, if the economy is operating at full capacity, increases in spending just translate into higher inflation and imports.

In the long run, projects financed by European Funds also have a positive impact on output. This results from higher capital accumulation, where capital is broadly understood to include public capital (infrastructures, etc.), human capital and know-how. These «new» types of capital enhance the performance of other production factors. In particular, as «traditional» production factors become more productive, companies accumulate more of them so that output grows even faster. The magnitude of the final effect depends on the composition of these investments. In general, it is most likely that investment in productive infrastructures, human capital and R&D projects will have a greater impact than other kinds of spending, such as direct aid to companies in distress (which, by definition, have low productivity).

Several studies quantify the effects of European Funds on GDP. Their estimates suggest that aid programmes increased the annual GDP growth rate by roughly 0.3 percentage points for the period 2000-2006. This figure is consistent with the estimates for the response of output growth to increases in public capital in Spain. These

EUROPEAN FUNDS IN SPAIN

	European Funds (*)				Per capita GDP (start of period) (**)	
	Total	Infrastructures	Aid to companies	Human capital	% of EU-15	% of EU-25
1986-1993	8,182	3,956	2,097	2,129	72.50	...
1994-1999	27,763	14,496	6,209	7,058	78.70	87.40
2000-2006	54,671	27,272	17,049	10,350	84.00	92.14
2007-2013	31,457	15,692	9,810	5,955	91.72	98.67

NOTES: (*) Million 2004 euros.

(**) GDP measured by purchasing power parities.

SOURCE: Figures for total funds received come from Correa, M.D. and J. Manzanedo (2002) for period 1986-1999 and from European Commission for period 2000-2013. Figures on distribution in major areas come from estimates by De la Fuente, A. (2003) for period 1994-1999 and Sosvilla-Rivero, S. and E. García (2006) for period 2000-2006. The classification for the period 2007-2013 results from using the weights of the previous period. The figures on per capita GDP were drawn from the AMECO data base and the European Commission.

studies also find evidence of significant multiplier effects from European Funds, especially during the period 1994-1999 when the levels of public and human capital were lower. From this perspective, the returns to the funds available between 2007 and 2013 should target those obtained from European Funds in the past.

EFFECTS OF EUROPEAN FUNDS BETWEEN 2000 AND 2006

Observed GDP growth rate (as %)	GDP growth rate discounting European Funds (*) (as %)
2.88	2.60

NOTES: Growth rates are annual and cumulative.
(*) Simulation based on HERMIN model.
SOURCE: Sosvilla-Rivero, S. and E. García (2006).

To conclude, it is worth noting that European Funds do not vanish but leave behind a better environment for production. The change in infrastructures and know-how makes a permanent contribution to the country's productive capacity. Still, with the progressive decrease in European Funds the public sector will have to bear a higher proportion of the cost of these investments. This reinforces the importance of prioritizing public investment projects according to profitability.

Savings and financing

Funding granted to private sector growing at highest rate in past decade.

Funding to companies shows big rise

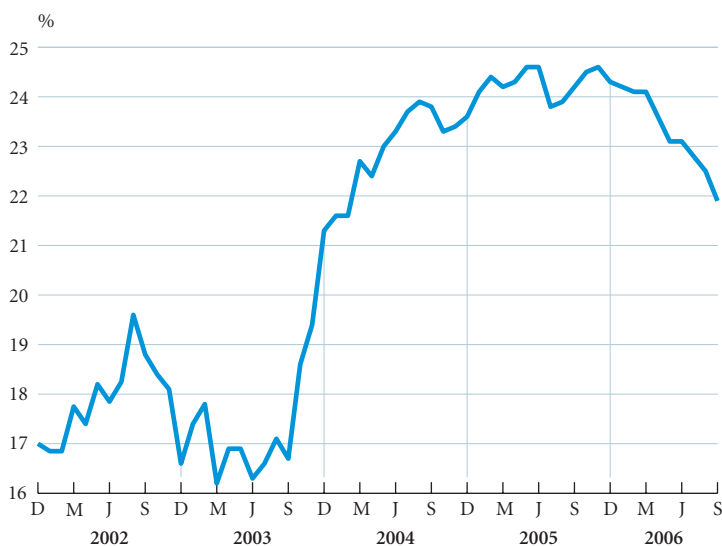
Gradually, interest rates charged on loans and credits granted to the private sector have been increasing until they have reached the highest levels in recent years. On average, they stood at 4.85% in September, some 106 basis points above the same month last year. The interest rate on housing loans was lower at 4.52%, mainly secured by property mortgage. The interest rate on consumer loans stood at 7.41%, a level that was the same as the month before in a situation of strong competition between lending institutions in this segment of the market.

Nevertheless, interest rates remain relatively low in real terms, that is, discounting inflation. Furthermore, the economic situation also continues to drive demand for credit seeing that prospects in the labour market are good. As a result, the financing of companies and households continues to grow at very high rates, with an annual change of 24.1% in September, the highest rate for at least the past decade. This rise is due to companies with funding going up to 26.9% in the last 12 months ending in September.

Under credit granted to companies, commercial credit, used to finance working capital, greatly increased its

SLOWDOWN IN BANK LOANS FOR HOUSING CONFIRMED

Year-to-year change in loans by resident credit institutions and securitized loans going into housing



SOURCE: Bank of Spain.

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

September 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	79,446	4,085	5.4	11,817	17.5	5.6
Secured loans (*)	867,434	138,147	18.9	184,738	27.1	61.1
Other term loans	393,300	68,004	20.9	81,221	26.0	27.7
Demand loans	29,692	1,634	5.8	3,765	14.5	2.1
Leasing	39,224	4,230	12.1	5,966	17.9	2.8
Doubtful loans	10,896	1,265	13.1	1,245	12.9	0.8
TOTAL	1,419,992	217,364	18.1	288,752	25.5	100.0

NOTES : (*) Greater part made up of loans with mortgage security.

SOURCE: Bank of Spain and own calculations.

growth rate in recent times with a rise of 17.5% in the past 12 months. In turn, leasing, an indicator of financing of capital goods, rose at a similar rate over the past year although with a more stable profile.

With regard to funding of households, the annual increase continued to ease in September going to 20.6%. This slowdown was due to loans for home purchase although, all together, these grew at an annual rate of 21.9%. This trend may be partly due to the high prices reached by housing units which is limiting demand in spite of favourable financing terms. This slowdown is in contrast to the rise in credit granted to companies which is largely going into the real estate sector.

In addition, doubtful loans taken out at credit institutions by the private sector have risen by 12.9% since September 2005. The default rate dropped slightly to 0.77% following two months of increases thus putting the level close to an all-time low.

Return on deposits up

The return on time deposits of individuals went above average inflation in September for the first time in recent years, thanks to the effect of the rise in Eurosystem official interest rate and the recent drop in the change rate for prices. In this context, bank deposits of the private sector continued to grow sharply in September, at twice the rate for the Euro Area in annual terms but slightly lower than that for credits. As a result, financial institutions were obliged to fund the gap between credits and deposits largely through securities issues, such as mortgage certificates or securitized bonds.

On the other hand, the assets of securities mutual funds reached 256.57 billion euros at the end of October, a rise of 6.3% in the past year. In the course of the first ten months of the year there was a shift from bond-based funds to global funds which make higher returns possible although at the expense of greater risk. Nevertheless, in October new money went especially into

Slowdown in mortgage loans to households in contrast to rise in credit granted to companies.

Private sector deposits rising at twice rate in Euro Area.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

September 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	427,730	31,540	8.0	51,821	13.8	40.5
Up to 2 years	229,446	38,926	20.4	46,119	25.2	21.7
More than 2-year term	298,465	58,983	24.6	89,204	42.6	28.3
Repos	70,284	-2,762	-3.8	-2,617	-3.6	6.7
Total	1,025,927	126,689	14.1	184,529	21.9	97.2
Deposits in currencies other than euro	29,053	13,414	85.8	16,710	135.4	2.8
TOTAL	1,054,980	140,103	15.3	201,239	23.6	100.0

NOTES: (*) Includes deposits redeemable at notice, according to ECB definition.

SOURCE: Bank of Spain and own calculations.

Average annual return on securities mutual funds more than twice inflation.

European share-based funds because of their better prospects. In fact, European share-based funds showed a high annual return of more than

20%, only exceeded by national share-based funds and those of emerging markets. The average return on securities mutual funds

TAX REFORMS ON SAVINGS

Financial product	Tax situation	
	Before reforms	As of January 1, 2007
Deposits and bonds		
Up to 2 years	At marginal rate	18%
More than 2 years	Deduction of 40% on interest	18%
Dividends	Generally calculated at 140% but deduction of 40% applied on tax payable	18% but with exemption up to 1,500 euros a year
Capital gains		
Up to 1 year	At marginal rate	18%
More than 1 year	15%	18%
Life insurance (personal)		
Benefits in form of lump-sum payment	At marginal rate but with reduction of 40% as of 2 years and 75% for more than 5 years	18%
Benefits in form of regular payments	Coefficients applied for integration in taxable base. At marginal rate	Coefficients reduced for integration in taxable base. 18%
New product: Personal Systematic Savings Plan	—	Exemption of returns up until set-up of life-long income plan (minimum of 10 years), then taxable at 18%
Pension plans		
Benefits in form of lump-sum payment	Reduction of 40% in amount of benefit	No reduction applicable

SOURCE: BOE Official Bulletin and in-house.

over the past 12 months was 5.3%, more than twice inflation.

In another sphere, at the beginning of November parliament gave final approval to the law reforming personal income tax. This law, which comes into force as of January 1, 2007, has substantial impact on tax applied to savings products and the main features in this regard are discussed below.

One of the aims of the new law is to give equal tax treatment to the various savings and financial investment instruments so that the choice of any specific instrument is based on its intrinsic return and not on consideration of its financial-tax yield. For this reason, as a general rule a single tax rate of 18% on financial returns has been established and this is not included in the rest of taxable income. This implies changes which will more or less affect the various financial products in terms of tax applicable up to now, which is summarized in the accompanying table. In addition, the tax rate is simplified from five to four segments and the maximum rate is reduced from 45% to 43%.

Up until now, interest on deposits and bonds earned during a period of up to 2 years had to be fully included in the tax base and carried tax at the marginal rate while those for more than 2 years enjoyed a reduction of 40%. As of the beginning of 2007, all will be taxed at an 18% rate without reference to holding period. With regard to dividends, the present calculation system, which includes a 40% deduction on tax payable in order to soften the effect of double taxation (as this is taxed under corporation tax) is now removed and

these will in future carry an 18% rate although with an exemption of 1,500 euros.

With regard to capital gains, which arise, for example, from buying and selling of shares of mutual fund participations, until now taxed at the marginal rate if the holding period was up to one year and 15% if they had been obtained over more than one year, will now all be taxed at 18%. This normally means better tax treatment for short-term capital gains while that reserved for long-term capital gains will be slightly worse.

With regard to life insurance, the existing reductions of 40% for returns generated as of 2 years and 75% for more than 5 years, where benefits were in the form of lump-sum payments, have been removed. This is explained according to the fact that another objective of the law is to foster the furnishing of benefits as regular income payments. Furthermore, a new insurance instrument is introduced (Personal Systematic Savings Plan) which will have a minimum duration of 10 years. With regard to pension plans, the reduction of 40% on the amount of the benefit paid in the form of a lump-sum payment has been removed.

The tax reform on savings undoubtedly has some positive aspects and makes things much simpler. Nevertheless, it has brought some criticism because it introduced certain instability in the tax treatment applied to long-term instruments, which makes planning more difficult and could cause some scepticism. At the same time, it has been suggested that the new tax treatment on interest will favour borrowing by companies.

Tax reform on savings finally approved with aim of achieving equality in terms of taxation...

...which, nevertheless, brings criticism because it favours borrowing by companies.

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