JANUARY 2007

THE SPANISH ECONOMY

Monthly Report

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RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2005	2006	2007	2006 1Q	2006 2Q	2006 3Q	2006 4Q	2007 1Q	2007 2Q
INTERNATIONAL ECONOMY		Forecast						Forecast	
Gross domestic product									
United States	3.2	3.3	2.6	3.7	3.5	3.0	3.0	2.6	2.6
Japan	1.9	2.0	1.5	2.7	2.2	1.7	1.4	1.2	1.3
United Kingdom	1.9	2.7	2.4	2.4	2.7	2.9	2.8	2.4	2.6
Euro area	1.4	2.6	2.1	2.2	2.8	2.7	2.7	2.3	2.0
Germany	*1.1*	*2.5*	*1.4*	*1.9*	*2.7*	*2.8*	*2.6*	*1.7*	*1.3*
France	*1.2*	*2.0*	*2.0*	*1.3*	*2.6*	*1.9*	*2.1*	*2.2*	*1.6*
Consumer prices									
United States	3.4	3.2	1.9	3.7	4.0	3.3	1.8	2.0	1.5
Japan	–0.3	0.3	0.4	–0.1	0.2	0.6	0.4	0.4	0.4
United Kingdom	2.3	2.8	2.6	2.2	2.8	3.2	3.1	3.1	2.5
Euro area	2.2	2.2	2.0	2.3	2.5	2.1	1.8	2.2	1.8
Germany	*2.0*	*1.7*	*2.3*	*2.0*	*1.9*	*1.6*	*1.3*	*2.5*	*2.3*
France	*1.7*	*1.7*	*1.6*	*1.8*	*1.9*	*1.7*	*1.3*	*1.4*	*1.3*
SPANISH ECONOMY		Forecast						Forecast	
Macroeconomic figures									
Household consumption	4.2	3.6	3.2	3.8	3.6	3.6	3.5	3.3	3.2
Government consumption	4.8	4.2	4.3	4.3	4.2	4.2	4.2	4.3	4.3
Gross fixed capital formation	7.0	6.3	6.0	6.3	6.2	6.3	6.5	6.3	6.3
Capital goods	*9.0*	*9.2*	*8.2*	*8.6*	*9.1*	*9.5*	*9.6*	*9.2*	*8.7*
Construction	*6.0*	*6.0*	*5.6*	*5.8*	*5.8*	*6.1*	*6.2*	*6.0*	*5.8*
Domestic demand (contribution to GDP growth)	5.2	4.8	4.4	4.9	4.8	4.8	4.7	4.6	4.5
Exports of goods and services	1.5	5.2	4.2	9.5	4.9	3.2	3.5	3.8	4.1
Imports of goods and services	7.0	7.9	6.2	12.4	7.6	6.0	6.0	5.8	6.2
Gross domestic product	**3.5**	**3.7**	**3.5**	**3.6**	**3.7**	**3.8**	**3.8**	**3.8**	**3.6**
Other variables									
Employment	3.1	3.1	2.7	3.2	3.1	3.0	3.0	2.9	2.8
Unemployment (% labour force)	9.2	8.5	8.0	9.1	8.5	8.1	8.2	8.1	8.0
Consumer price index	3.4	3.5	2.5	4.0	3.9	3.5	2.6	2.6	2.3
Unit labour costs	2.2	2.6	2.2	2.5	2.7	2.6			
Current account balance (% GDP)	–7.5	–8.8	–9.7	–10.6	–8.2	–8.5			
Not lending or net borrowing rest of the world (% GDP)	–6.5	–7.9	–8.8	–10.3	–7.7	–7.9			
Government balance (% GDP)	1.1	1.4	1.0						
FINANCIAL MARKETS		Forecast						Forecast	
Interest rates									
Federal Funds	3.2	5.0	5.0	4.4	4.9	5.3	5.3	5.3	5.1
ECB repo	2.0	2.8	3.8	2.3	2.6	2.9	3.3	3.6	3.8
10-year US bonds	4.3	4.8	5.1	4.6	5.1	4.9	4.6	4.8	5.0
10-year German bonds	3.4	3.8	4.4	3.5	4.0	3.9	3.8	3.9	4.3
10-year Spanish bonds	3.4	3.8	4.4	3.5	4.0	3.9	3.8	3.9	4.3
Exchange rate									
$/Euro	1.25	1.26	1.35	1.20	1.26	1.27	1.29	1.36	1.37

CAJA DE AHORROS
Y PENSIONES
DE BARCELONA

Research Department

Av. Diagonal, 629,
planta 6, torre I
08028 BARCELONA
Tel. 34 93 404 76 82
Telefax 34 93 404 68 92
www.research.lacaixa.com
e-mail:
informemensual@lacaixa.com

"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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2007: facing up to globalization and its risks

Contents

They say that a pessimist is an optimist who has become tired of being so. In terms of international economic trends, the opposite would seem more to the point. In recent years, the results on growth and inflation have systematically been better than initial forecasts. At the end of each year, the pessimists, those who put risks above opportunities, have to end up admitting that the optimists were right. The world economy is going through one of the most brilliant stages in recent decades while overcoming such disturbing threats as collapses on the stock market, financial crises, raw materials prices at all-time highs, terrorist attacks, wars and natural disasters. As we face the beginning of 2007, as usual there are plenty of predictions. And, as is also traditional, the most widely held is that there will be some slowing down of growth, stabilization of imbalances, moderation in the markets, and so on. Are we going to make the same mistakes?

Beyond the details of these predictions and the correctness of such forecasts, the most important thing is to understand the present stage of the economy and the bases on which this growth cycle rests. In its report on world economic prospects for 2007, the World Bank explains the current situation as a result of the globalization of economies. The high growth rates, the strong progress in the emerging economies and the improvement in standard of living by figures without precedent may be explained by the progressive integration of trade, finance, technology, ideas and people. The report wonders if this process of integration will continue. If its key hypothesis is met, globalization will continue for some time yet. Between 2006 and 2030, world economic growth will be higher than that recorded between 1980 and 2005, per capita income in developing countries will also increase more rapidly and world poverty will drop considerably in spite of the increase in population.

But without looking so far ahead, the current context of globalization also presents two serious risks. One lies in the very high imbalances in current account balance. The enormous US deficit, brought about by consumer spending, calls for huge amounts of foreign savings which come almost exclusively from the emerging Asian economies. As is repeated over and over again in all the reports on the international economy, this imbalance cannot go on increasing indefinitely. Correction of this imbalance, if it happens suddenly, either through a halt to US consumption or through a switch in exchange rates, could bring about the end of the current growth cycle.

The other risk lies in the growing pressures posed by the globalization process itself. Abundant money supply, low interest rates and widespread optimism have brought about an inflation of assets which mainly shows up in the exuberance to be seen in the real estate sector in many countries. Furthermore, the growth of corporate profits and favourable financing conditions are promoting a massive wave of take-over operations as well as the proliferation of high-risk financial instruments. On the other hand, competitive pressure from emerging countries is pushing down wages in unskilled jobs in the developed countries, is forcing certain industries to relocate in low-cost countries and fostering the immigration of foreign workers ready to accept low wages, thus broadening the wage range and increasing inequalities. In fact, the pressures of globalization raise significant risks which must be taken into account if its positive effects are to continue for many more years.

OVERALL SUMMARY

What awaits us in 2007

Growth prospects for international economy remain very favourable.

Growth continues with risk of a drop. In 2006, the developing countries grew by 7% in real terms, more than twice that for the developed countries. The same story will be repeated in 2007 although at a somewhat lower rate and the same stands good for 2008. There is no reason to believe that the extraordinary increase in growth and world trade in recent years is going to slowdown to any substantial degree. Interest rates may go somewhat higher, the US foreign deficit may become somewhat more contained, the real estate market could drop more, the engine of China could slowdown a bit and we cannot rule out some financial upsets. But all the analyses are generally unable to identify the type of risk that could wreck the present strong state of the international economy. Unless there occurs some unfortunate combination of all these risks or some unexpected factor of a geopolitical nature turns up to scuttle these forecasts.

One of main risks lies in United States because of uncertainty about extent of collapse in housing construction.

United States: hit but not knocked out. When it comes to naming the risks to the world economy, the lead must be taken by the US real estate market. The sequence of events begins with the collapse of the sector that would engender much concern in households who would slow down consumer spending and thus set off a recessive spiral. The first stage, the collapse of the sector, it is happening at this time with a drop of 25% in activity and a cut of 4% in prices. Nevertheless, for the moment there is no evidence that consumers are cutting down on spending. The purchasing power of households is rising thanks to the increase in employment and the drop in inflation. The Fed is watching ready to come up with an emergency cure, a cut in interest rates. For now, we are inclined to see a scenario of a gradual slowdown (growth of 2%-2.5% in 2007) as against a pessimistic one (less than 1.5%).

China: keeps firing up. The sparkling star of the world economy in recent years keeps on shining. The other BRICs (large emerging economies, such as Brazil, Russia, India and China), with the exception of Brazil are doing likewise although China is setting the pace with real annual growth rates of two digits. Nevertheless, the sharply growing export orientation of Chinese industrial machinery cannot fail to be an anomaly as behind this there is a huge labour reserve depending on subsistence farming with levels of consumption that have not kept up with industrial development. In 2007, we should see some signs of change (naturally gradual following the Oriental approach) which indicate less predominance of investment over consumption, less importance of the state conglomerates, some better ordering of the banking system, a revaluation of the yuan and even an improvement in institutional lacks, such as property rights, transparent accounting, bank supervision, etc.

One positive note is Germany's recovery after many years of poor results.

Germany recovering. For some time, the former engine of the European economy had turned into a drag on the Continental economy. Difficulties in absorbing the 1990 reunification and resistance to accepting necessary structural reforms brought about an economy with much unemployment, a high government deficit and little growth. But the poor years now seem to have been left behind. The IFO industrial confidence index for December surprisingly went back to levels at the time of reunification. Germany's economy has surpassed the highest predictions for 2006 and is heading in the same direction for 2007. Private consumption is reviving and the surplus of the world's biggest exporting country is growing. This is good news for economies such as that of Spain which find Germany an important destination for exports of goods and services.

EU goes to 27, € now in 13. On January 1, 2007, Bulgaria and Romania were added to the European Union (EU) which now is made up of 27 member states. With this move, the EU brings in nearly 30 million more people so that the total population comes close to 500 million (492.8 million). In economic terms, the gross domestic product (GDP) goes up less than 1% given that the two new economies have a very modest per capita income level (around 33% of the EU-25 average). Both show an inflation rate higher than the EU-25 average and higher unemployment but the rates for the EU-27 do not change due to the little relative weight of the new member states. In the monetary sphere, the Euro Area also has been extended thanks to the entry of Slovenia, one of he new EU member states following the extension in May 2004. Nevertheless, this former part of Yugoslavia with 2 million population and a GDP similar to that of the province of Seville, will not change the situation of the single currency.

Interest rates on rise but enigma not resolved. With the probable exception of the Fed, a good number of central banks will raise their reference interest rates during 2007. In the Euro Area, the European Central Bank (ECB) is clearly in an upswing. The end result could be close to 4% and this could be reached in the early months of the year now starting up if indicators for inflation and economic activity keep up their good results. The Bank of England also could raise its key rate. In Japan, the monetary authorities did not dare raise the reference rate (now at 0.50%) in December but if the progress of Japan's economy does not stop we could see more than one upward move. The big question continues to be long-term interest rates. The increases in monetary interest rates during 2006 have not pulled long-term rates along with them so that the yield curves (the difference between short and long-term rates) have flattened out or even have been inverted, as in the case of the United States. Are these market yield curves pointing to a recession? In its latest monthly bulletin the ECB indicated a reduction in premiums for maturity term in the case of the Euro Area. In this Monthly Report, we discuss the change of preferences with regard to overall savings and investment products as being a key to understanding the mystery of interest rates.

Immigration: blessing or problem? In schools of economics they teach that the factors of production are capital (tangible or intangible) and labour. In Spain, the positive surprises that the economy has shown in recent years have basically come from from the unexpected contribution of the labour factor. The panorama of the labour market had been radically changed since the end of the Nineties when the national population clearly pointed to a downward future. From then on, large numbers of immigrants have covered the surprisingly high demand for labour, have moved into the consumer society and have even joined the national custom of applying for a mortgage to buy a flat. They also send money to their families in their countries of origin so Spain is now the biggest sender of immigrant remittances. When making predictions, the problem is that information about immigration is not complete and arrives too late due to irregular immigration. In 2005, there were more than 600,000, in 2006 the figure seems it will not be lower. Given the favourable prospects for growth and employment, there could be little change in 2007.

Year 2007 begins with extension of EU from 25 to 27 member states (Bulgaria and Romania) and with Euro Area going from 12 to 13 (Slovenia).

With likely exception of United States, increases in reference rates of main central banks expected but trend in long-term interest rates remains big unknown.

Immigration flows into Spain a basic factor behind recent economic trends.

Domestic demand will continue to drive economy although some slowdown in construction may be expected along with steadier rise in consumer spending.

Construction: another year to go? In comments on Spain's economy it has been common to downplay the «growth model excessively dependent on construction» and to regret the lack of growth based on high value added sectors and high technology exports. Well, 2007 is not going to bring some big changes in this respect. The consensus of forecasts drawn up by the Savings Bank Foundation predicts a contained slowdown in construction which will go from 6.2% in 2006 to 5.4% in 2007. If we keep in mind that activity in public works will remain high, it is residential construction that will have to carry most of the moderation. We can already see some signs of this such as the longer sales period for new flats. It is also true that in the latter part of 2006 there has been a big rise in approvals for new construction and loans to housing developers, although this could be a result of the coming into force of the Building Code in the near future.

Favourable prospects for inflation in 2007 but foreign imbalance will continue to worsen.

National demand acts as drive. Nor should we overdramatize the «economic model». Investment in capital goods is growing and will move up more than that going into construction, which is a good sign. Spending on research is rising at the rate of the nominal GDP, which is not to be dismissed. Private consumption will moderate slightly in 2007, still with the fund of strength provided by wage incomes, increased purchasing power and still easy borrowing facilities. And the minor tax reform recently approved which will provide some small margin for extra household spending.

Spain's economy close to convergence with EU average but considerable margin still remains for improving productivity.

Heads of the Hydra. In Greek mythology, the Hydra was a terrifying kind of sea-serpent with several heads. In Spain's economy, the Hydra traditionally had four heads: unemployment, inflation, foreign deficit and government deficit. Fortunately, some of those heads have been cut off. The government deficit seems to have passed into history thanks to the efficient management of recent governments. The unemployment rate is still high but it is now close to the EU average. Inflation presents a considerable differential with regard to the Euro Area average but prospects for 2007 are for moderation so that the average for the year could drop to 2.5%, one point less than in 2006. There still remains the foreign deficit. In this we do not see any improvements, quite the contrary. Exports are not doing badly but the drive in domestic demand is adding to the imbalance. This Hydra head, however, is not what it used to be given that a deficit in euros, with Spain as just another member of the Monetary Union, has a significance that cannot be compared with the traditional deficit in pesetas.

Convergence: something continuous. One of the last actions of the government in 2006 was to present the Stability Programme, a document which must be approved by the Council of Ministers of the EU. Spain's economy is an advanced pupil in terms of economic growth and Economy Minister Pedro Solbes has taken advantage of this to underline that the country will shortly reach the EU average per capita GDP. According to the latest Eurostat figures, Spain stood at 98% of the average in 2005, one point more than in 2004. It should be recognized, however, that the latest EU extension has brought the challenge closer, seeing that the new member states are of low income. Compared with the average of the old EU-15, Spain is still at 93%. The move toward convergence is slow because of productivity, which is showing a lower rate and slower progress in Spain. In the Stability Programme, however, there is a ray of hope. Production per worker is gradually showing growth going from 0.4% in 2005 to 1.0% in 2009. This result will be possible thanks to reforms of a structural nature already carried out and those planned. Let us hope that these good proposals turn into reality.

December 27, 2006

CHRONOLOGY

2005

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	29	Publication in BOE Official Bulletin of Law 35/2006 on reforms to **Personal Income Tax** and partial modification of laws on Corporate Tax, Non-resident tax and Property Tax.
December	7	**European Central Bank** raises official interest rate to 3.50%.
	15	**Spanish stock exchange** IBEX 35 index marks up all-time high (14,387.6) with cumulative gains of 34.0% compared with December 2005.
	27	Dow Jones index for **New York stock exchange** records all-time high (12,510.6) with rise of 16.7% compared with end of 2005.

AGENDA

January

3 Registrations with Social Security and registered unemployment (December).
10 Industrial production index (November).
11 Governing Board of European Central Bank.
12 CPI December.
15 Balance of payments (October).
19 Harmonized CPI for EU (December).
25 Industrial prices (December).
26 Labour force survey (4th Quarter).
31 US GDP (4th Quarter). Open Market Committee of Fed.

February

2 Registrations with Social Security and registered unemployment (January). Industrial production index (December).
8 Governing Board European Central Bank.
13 Preliminary GDP for Spain (4th Quarter).
14 GDP for EU (4th Quarter).
15 Balance of payments (November).
20 CPI (January).
21 Quarterly national accounts (4th Quarter).
26 Producer prices (January).
28 Harmonized CPI for EU (January).

INTERNATIONAL REVIEW

OECD forecasts: rearrangement of growth components with close look at foreign imbalances

OECD sees moderate slowdown in 2007 with recovery in 2008.

The Organization for Economic Cooperation and Development (OECD) is forecasting growth of 3.2% in 2006 for its 30 member countries as a whole. For 2007, the OECD is expecting a drop in growth rate to 2.5%, a figure four decimals lower than its previous forecast in the spring. In 2008, economic activity will show some recovery going to 2.7%. Rather than a slowdown, we are facing a redistribution of growth, with the United States and Japan involved in a soft landing process, whereas the Euro Area is partly taking over the helm with the strength of consumption consolidating its recovery. For their part, China, India and Russia will continue to show robust growth.

Europe should take over from United States with China close behind.

The United States will slow down substantially. With the weakness of the real estate market and core inflation dropping, helped by the end to oil price rises, in spite of some pressures in the labour market, growth will drop from 3.3% in 2006 to 2.4% in 2007 and will then recover to 2.7% in 2008. The funding of the foreign deficit will continue to be sufficient, thanks to the low returns investors will accept in dollars and to maintenance of the foreign deficit position of the United States, because of profits on assets abroad as result of the depreciation of the dollar. Correction of the trade deficit will be slow. In turn, Japan should grow by around 2.0%, although the weakness in wages stands as a decreasing risk.

Europe will take over with estimated growth revised upward. In 2007, it is expected that, thanks to consumption, the economies of the Euro Area will grow 2.2%, which should hold up in 2008. Germany has also seen its prospects improved, with a gross domestic product (GDP) that should rise by 1.8% in 2007, a situation clearly better than the 1.0% previously forecast. In 2008, economic activity will continue to gain strength with growth of 2.1%. France will also maintain the pace with increases of 2.2% and 2.3%. Italy is to see improvements in prospects which a few months back did not seem very brilliant, whereas Spain will scarcely slow down from the strong level of economic activity shown in 2006 (3.6%) with growth of 3.3% in 2007 and 3.1% in 2008.

Oil price pressures easing...

Oil prices will stop putting upward pressure because of an easing of demand, mainly in the United States, the incipient effect of substitutes such as natural gas and a perception that geopolitical tensions, are either discounted or will not get worse. Nevertheless, the time needed to mount infrastructures complicates supply and this could stand in the way of major price decreases.

...while disequilibriums in balance of payments and housing remain high risk.

The scenario remains positive but the main risk lies in foreign imbalances. A change of perception that could make financing difficult and a gradual

OECD: ECONOMIC OUTLOOK (1)

	2004	2005	2006	2007	2008
GDP (2)					
United States	3.9	3.2	3.3	2.4	2.7
Japan	2.3	2.7	2.8	2.0	2.0
Germany	0.8	1.1	2.6	1.8	2.1
France	2.0	1.2	2.1	2.2	2.3
Italy	0.9	0.1	1.8	1.4	1.6
United Kingdom	3.3	1.9	2.6	2.6	2.8
Spain	3.2	3.5	3.7	3.3	3.1
Euro area	**1.7**	**1.5**	**2.6**	**2.2**	**2.3**
OECD	**3.2**	**2.7**	**3.2**	**2.5**	**2.7**
Inflation (3)					
United States	2.7	3.4	3.3	2.3	2.3
Japan	0.0	–0.6	0.3	0.3	0.8
Germany	1.8	1.9	1.7	1.9	1.0
France	2.3	1.9	2.0	1.4	1.6
Italy	2.3	2.2	2.2	1.9	2.0
United Kingdom	1.3	2.0	2.2	2.0	1.9
Spain	3.1	3.4	3.5	2.7	3.2
Euro area	**2.2**	**2.2**	**2.2**	**1.9**	**1.8**
OECD	**2.3**	**2.0**	**2.2**	**2.2**	**2.1**
Unemployment (4)					
United States	5.5	5.1	4.6	4.8	5.1
Japan	4.7	4.4	4.2	3.9	3.6
Germany	9.2	9.1	8.0	7.7	7.2
France	10.0	9.9	9.1	8.5	8.2
Italy	8.1	7.8	7.1	6.8	6.5
United Kingdom	4.7	4.8	5.5	5.7	5.8
Spain	10.5	9.2	8.4	7.8	7.6
Euro area	**8.9**	**8.6**	**7.9**	**7.4**	**7.1**
OECD	**6.7**	**6.5**	**6.0**	**5.8**	**5.7**
Current account balance (5)					
United States	–5.7	–6.4	–6.6	–6.5	–6.6
Japan	3.7	3.7	3.8	4.5	5.3
Germany	3.7	4.2	4.0	4.8	5.2
France	–0.4	–1.6	–1.7	–1.8	–1.8
Italy	–0.9	–1.6	–2.2	–2.2	–2.6
United Kingdom	–1.6	–2.2	–2.4	–2.0	–2.1
Spain	–5.3	–7.4	–8.8	–9.2	–9.6
Euro area	**0.8**	**0.0**	**–0.3**	**–0.1**	**–0.1**
OECD	**–1.2**	**–1.7**	**–2.0**	**–1.9**	**–1.8**
World trade (6)	**10.3**	**7.5**	**9.6**	**7.7**	**8.4**

NOTES: (1) Starting hypothesis: a) Fiscal policies in force or announced will not change; b) Exchange rates will not change from level on November 13, 2006 (1 dollar = 118.1 yen = 0.780 euros); c) Closing date of publication and for including figures was November 20, 2006.
(2) All percentage change rates in real tems.
(3) Percentage change rates in GDP deflator.
(4) As percentage of labour force.
(5) As percentage of GDP.
(6) Arithmetical average of percentage annual growth rates of world imports and exports by volume.
SOURCE: Organization for Economic Cooperation and Development.

correction of the US trade deficit could have a negative effect on the valuation of US assets, especially of housing, with its negative effects on consumption and the level of economic activity. In many countries the price of housing continues to rise and generally is still high. There exists the risk of an adjustment of prices with its subsequent effects on consumer demand. Nevertheless, the recent easing off in housing in the e United Kingdom, Netherlands, Australia and Finland have had less effect on consumption than was feared, although we should always take into account the specific situation in each country.

The restrictive monetary policy in the United States now seems to have ended whereas in the Euro Area this should develop into less easy conditions. Long-term interest rates continue to move slightly upward but to a lesser extent than at mid-year. Corporate profits are still in a good state, income differences are increasing and raw materials producers are taking in gains hard to see being sustainable. Fiscal balances are showing a general improvement but there is a lack of policy to deal with structural deficits by taking advantage of the current boom period.

OECD: FINANCIAL OUTLOOK (1)

	2003	2004	2005	2006	2007	2008
Government deficit (–) or surplus (+) (2)						
United States	–4.8	–4.6	–3.7	–2.3	–2.8	–3.0
Japan	–8.0	–6.3	–5.3	–4.6	–4.0	–3.7
Germany	–4.0	–3.7	–3.2	–2.3	–1.4	–1.3
France	–4.2	–3.7	–2.9	–2.7	–2.5	–2.3
Italy	–3.5	–3.5	–4.3	–4.8	–3.2	–3.3
United Kingdom	–3.4	–3.3	–3.4	–3.0	–2.7	–2.6
Spain	0.0	–0.2	1.1	1.4	1.2	1.4
Euro area	**–3.1**	**–2.8**	**–2.4**	**–2.1**	**–1.5**	**–1.4**
OECD	**–4.0**	**–3.4**	**–2.7**	**–2.0**	**–2.0**	**–2.0**
Short-term interest rates (3)						
United States	1.2	1.6	3.5	5.2	5.3	5.0
Japan	0.0	0.0	0.0	0.2	0.4	0.9
United Kingdom	3.7	4.6	4.7	4.8	5.0	4.8
Euro area	**2.3**	**2.1**	**2.2**	**3.1**	**3.8**	**4.0**
Long-term interest rates (4)						
United States	4.0	4.3	4.3	4.8	4.8	4.9
Japan	1.0	1.5	1.4	1.8	2.1	2.7
Germany	4.1	4.0	3.4	3.8	4.0	4.2
France	4.1	4.1	3.4	3.8	4.0	4.2
Italy	4.3	4.3	3.6	4.1	4.3	4.6
United Kingdom	4.5	4.9	4.4	4.5	4.7	4.8
Spain	4.1	4.1	3.4	3.8	4.0	4.2
Euro area	**4.1**	**4.1**	**3.4**	**3.8**	**4.0**	**4.3**

NOTES: (1) Starting hypothesis: a) Fiscal policies in force or announced will not change; b) Exchange rates will not change from level on November 13, 2006 (1 dollar = 118.1 yen = 0.780 euros); c) Closing date of publication and for including figures was November 20, 2006.
(2) As percentage of GDP.
(3) 3-month interest rates on national money markets.
(4) Government bond interest rates on most representative issues in each country.
SOURCE: Organization for Economic Cooperation and Development.

United States: fears about weakness in housing

The perception of economic observers sometimes changes as rapidly as the seasons. In the warmth of last summer, prospects for 2007 were shot through with dramatics and foresaw a slowdown with inflation, the worst of all possible worlds, which would put to the test the new chairman of the Federal Reserve, the US central bank system. With the onset of winter things looked better and a soft landing with moderate inflation seems a reasonable enough hypothesis. Months back, the end of the housing boom had the delayed effect of raising rents which came on top of higher oil and labour costs. As a result, inflation moved up at an inopportune moment just as the real estate market began to erode growth. Since then, oil has moderated its upward drive and looks like continuing that way, labour costs have been revised downward and the dangers of inflation have lessened. Furthermore, the Federal Reserve, while still bearing its anti-inflationary claws as its mandate demands, has found an unexpected ally in the financial markets which have eased the situation of money supply in the economy. Without the need for cuts in the official interest rate, economic activity has an important support, which also shows that risks with regard to the main scenario are lessening.

In United States, fear of slowdown greater than concern about inflationary pressures.

With this scenario, the US economy, which grew by 3.0% year-to-year in the third quarter and for which a rise of close to 3.3% is expected for the whole of 2006, is expected to grow close to 2.5% in 2007. The components taking the lead in this slowdown will be housing investment and private consumption, in equal parts in absolute terms. The sharp adjustment in real estate supply will thus continue for some time but consumption will follow an orderly withdrawal, with a downward trend, with supporting factors which should make the slowdown gradual. The wealth effect is drying up and the refinancing of homes through mortgages on real estate already paid off

With easier financial conditions, growth of economic activity in 2007 should be close to 2.5%.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006				
			4Q	1Q	2Q	3Q	October	November
Real GDP	3.9	3.2	3.1	3.7	3.5	3.0	–	...
Retail sales	6.2	7.2	6.3	8.3	6.6	5.5	4.9	5.6
Consumer confidence (*)	96.1	100.3	95.8	105.7	106.6	104.4	105.1	102.9
Industrial production	2.5	3.2	3.2	3.3	4.2	5.0	4.7	3.8
Industrial activity index (ISM) (*)	60.5	55.5	57.0	55.6	55.2	54.0	51.2	49.5
Sales of single-family homes	10.1	6.6	3.1	–11.6	–14.4	–22.5	–25.4	...
Unemployment rate (**)	5.5	5.1	4.9	4.7	4.6	4.7	4.4	4.5
Consumer prices	2.7	3.4	3.7	3.7	4.0	3.3	1.3	2.0
Trade balance (***)	–611	–717	–717	–740	–761	–779	–772	...

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

Slowdown concentrated in housing while consumption still holding up although likely to move slightly down.

at low interest rates aimed at consumption and we find ourselves in a situation of minimal savings, but the relative strength of the labour market and improved borrowing conditions are easing the decreases. Mortgage loan rates have gone from 6.8% at the end of July to 6.1% in December while the risk premium on corporate bonds is close to all-time lows. The problem is not so much 2007 but what comes afterwards, seeing that the situation of low savings may for some time prevent a return to the robust situation ruling in 2005. The better financial conditions also add to hopes that investment does not put spokes in the wheels. The foreign deficit will be gradually corrected but, in line with recent quarters, it should not reduce growth.

In view of business executives, industry down more than services.

Retail sales, excluding cars and petrol consumption, rose by 6.1% year-to-year in November, a rate higher than expected although it did not regain the robust trend in summer, reveals a fund of appreciable strength. In real terms, discounting the rise in non-energy prices, it still went from growth of 2.2% to 3.5%. The sectors continuing to show strong were electronics, food and retail trade. In turn, the volatile car sales seem to be coming out of the tunnel, with an increase of 5.0% year-to-year. The Conference Board consumer confidence index was down two points going to the 102.9 level, a moderate loss that left it above the low for August.

From a business point of view, things show a distinct bias depending on the sector of interest. In manufacturing, the index of the Institute for Supply Management dropped to 49.5 points, to stand below the threshold of 50 points for the first time since April 2003, which means that those who foresee lower economic activity are in the lead. In services, the situation is turned around given that the index recovered to the convincing level of 58.9 points. Overall, the business verdict continues to point to a moderate slowdown, something to be valued if we remember that profits

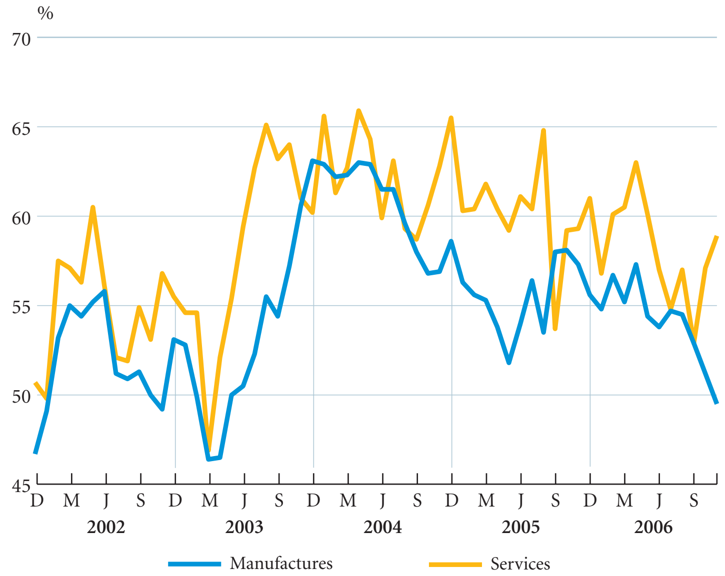
UNITED STATES: CONSUMERS HOLDING FIRM

Retail sales excluding cars and petrol as year-to-year change

SOURCE: Department of Commerce and own calculations.

UNITED STATES: SERVICES MAKING BETTER SHOWING THAN INDUSTRY

Level of ISM indices



SOURCE: Institute for Supply Management and own calculations.

are still running at highs in terms of the GDP.

Weakness in real estate business continues...

The drop in activity in the real estate market continues, with a reduction in supply that should. Contribute to limiting the drop in prices. We are also beginning to see weak signals of stabilization. Housing starts in November showed a slight upward response, a continuation of which cannot be guaranteed, although they are still 25.4% below the same period the year before. The same upward reaction was seen in existing housing in October, although the drop in prices sharpened to 3.5% year-to-year. In new housing, which is more volatile, there was a slight drop of 1.8%. In turn, industrial production rose by 3.8% year-to-year, thus clearly losing the good state it had shown in previous months.

...jobs being created and wages recovering purchasing power.

The labour market, together with easier financing conditions, is the other key pillar supporting consumption. The unemployment rate remains low at 4.5% of the labour force in November and new job creation (132,000 in November) is consistently going beyond the expectations observers. More in keeping with previous figures that have been the norm, wage purchasing power has been growing progressively since August and in November was up by 2.3% year-to-year. To complete the positive picture, unit labour costs, whose moderation gives some idea of the capacity of the economy to grow without inflation, slowed to year-to-year growth of 2.3% in the third quarter.

Non-energy prices moderating slowly.

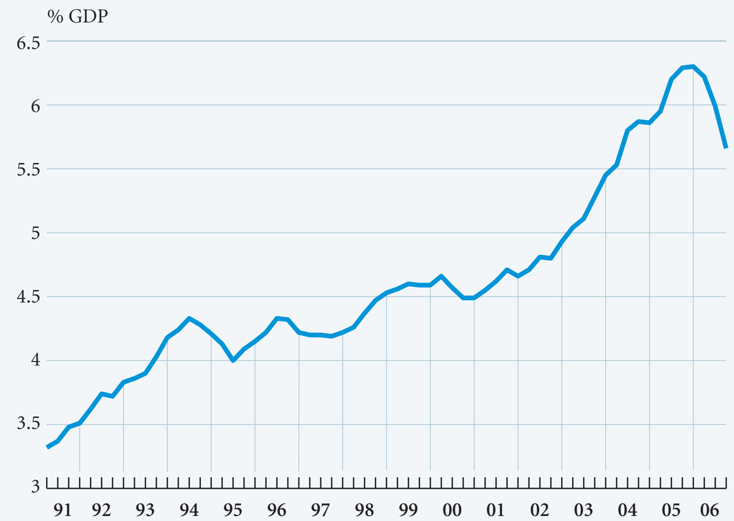
The consumer price index for November was up 2.0%. Apart from the general index, which was excessively affected by fluctuations in the energy bill, what dominated was the sustained moderation in the core component (excluding energy and food), with an advance of 2.6% in November. Since the summer, core inflation has been showing a trend to moderation in clear contrast to the

Real estate sector and the slowdown of the US economy

For some time the real estate sector has been one of the main components of household wealth. Moreover, its recently acquired importance in developed countries has turned the sector into one of the main players in the economy. Therefore, when bad news arise from the real state sector, all the alarms turn on, especially when the country involved is the US.

REAL ESTATE: SPEARHEAD OF GROWTH

Residential investment in USA



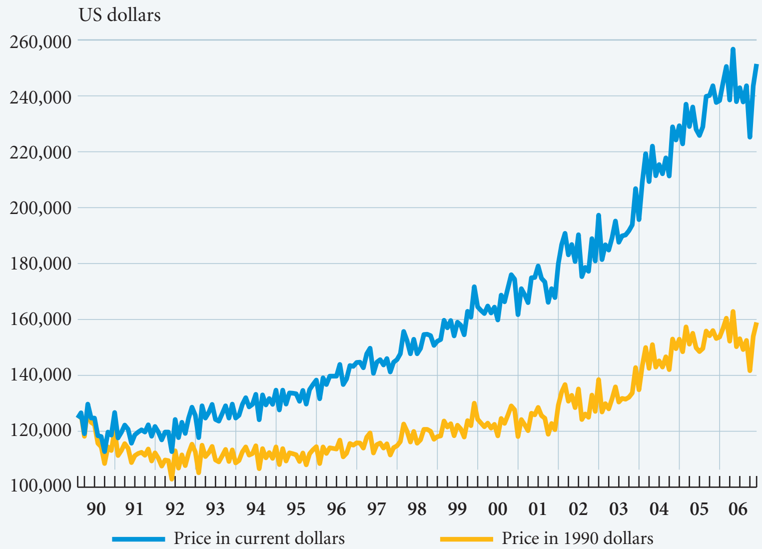
SOURCE: Bureau of Economic Analysis and own calculations.

In order to see how the real estate sector spearheaded US growth it is enough to observe the strong residential investment. This has been continuously growing as a percentage of GDP during the past 15 years (see graph above) and especially as of 2002, coinciding with a period of very low interest rates. The other important factor to bear in mind is the historic rise in housing prices, which have been growing systematically above the CPI and they doubled in the past 10 years (see graph below). As a consequence, many US households felt that their wealth was soaring, leading them to increase their consumption significantly. Moreover, housing is the main collateral for credit available to most households, hence, the increase in prices allows them to increase their borrowing, which in most cases is used to consume even more. This new form of financing, which was very rare at the beginning of the Nineties, has become nearly 6% of the disposable income.

Following such a lengthy period of expansion in the real estate sector, what everybody thought that was impossible, is beginning to happen. The price of new housing, which in the past decade has been growing at an annual average rate of 5.7%, fell by 10.9% in the first three quarters of 2006 while the price of existing housing has become stagnant. The rate of activity in residential construction has dropped sharply and new housing starts, after 15 years of growth at an annual average rate of 5.6%, dropped by 23% in the

SHARP INCREASE IN HOUSING PRICES

New housing prices in USA

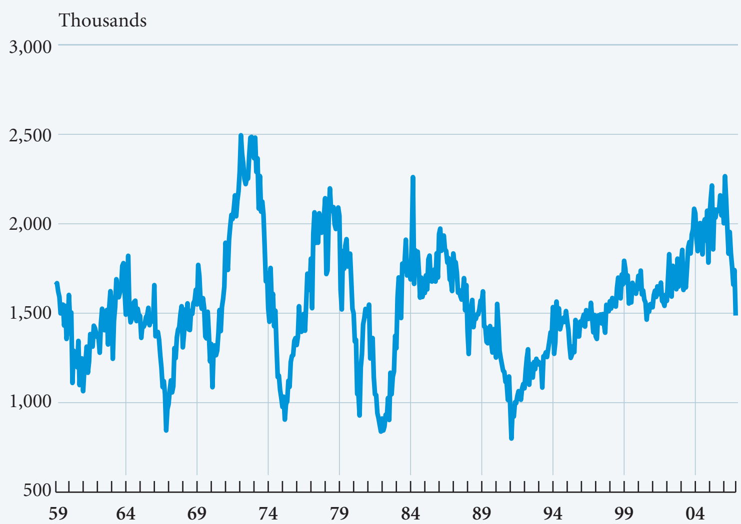


SOURCE: National Association of Realtors and own calculations.

first three quarters of 2006 (see graph below). This cascade of negative figures is raising the fear of a slowdown in the US economy. Not only because of the drop in residential investment but especially for the effects that it could have on consumption, the big US growth engine. It seems that the building-blocks of housing are beginning to make the pillars of the economy shake. Will they turn out to be earthquake-proof?

END OF LONG GROWTH CYCLE STARTING IN NINETIES

New housing starts in USA in annual terms



SOURCE: Bureau of the Census.

Nevertheless, if there is one economy in the world that is efficient and capable of adjusting rapidly, it is the US economy. A good sign of it is the rapid correction that has shown up in new housing starts, where production is traditionally inelastic over the short-term (see previous graph). This is the point of view that has been taken in our main forecast scenario. In this scenario, we expect a moderation of private consumption growth and a drop in fixed-asset residential investment so that, in overall terms, it is expected that the US economy will still grow by 2.6% in 2007.

Be as it may, in order to discern the transmission channels of a shock in the real estate sector and the extent of its possible effects, it is very illustrative to consider a scenario of major, though not catastrophic, adjustment. In this alternative scenario, on the one hand, we consider a further drop of 10% in prices, in line with the drop that has taken place in the first three quarters of 2006 (although prices have somewhat recovered in recent weeks). On the other hand, we consider that residential investment as a proportion of the GDP returns to the levels seen in the Nineties (which would mean a drop of 15%). The drop in investment would mainly affect the construction and manufacturing sectors which would take off 0.4 points from GDP growth in terms of the main scenario (see accompanying table). In addition, the drop in prices would generate a negative wealth effect on consumption (and to a lesser degree on imports), which would grow below expected and take off another 0.6 points from GDP growth. The US economy thus seems to be sufficiently flexible to withstand a harsh blow from the real estate sector and would end up growing by 1.6%. This, of course, would leave it exposed to possible future eventualities.

It would thus be hit, but not knocked out, and with a reduced margin for manoeuvre to face up to possible adverse situations. Inflationary pressures still persist and will limit the capacity of the Federal Reserve to revive the economy through reductions in the price of money. Furthermore, fiscal policy is also limited by the high fiscal deficit. In any case, we should point out that prospects on inflation have held stable and the drop in oil prices may provide a breath of fresh air which would be welcomed by the Fed.

The US economy seems to be moving down and what is bringing about this drop is the very pillar that has sustained the powerful engine of the economy. In any case, the efficiency with which the construction sector is responding should make a soft landing possible, so long as there are no last-minute surprises.

UNITED STATES: MACROECONOMIC FORECASTS

	2006		2007			
			Main scenario		Alternative scenario	
	% real change	% GDP	% real change	% GDP	% real change	% GDP
GDP	3.2	100.0	2.6	100.0	1.6	100.0
Private consumption	3.1	71.0	2.6	71.0	1.6	71.1
Private investment	4.6	17.0	3.3	17.1	–0.2	16.7
Non-residential fixed asset investment	*7.8*	*11.6*	*6.3*	*12.0*	*6.3*	*12.1*
Residential fixed asset investment	*–2.8*	*5.2*	*–3.5*	*4.9*	*–15.0*	*4.3*
Public consumption and investment	2.0	17.6	2.0	17.4	2.0	17.6
Net exports	–0.2	–5.6	–0.1	–5.6	0.1	–5.4
Exports	8.5	11.4	6.6	11.8	6.6	12.0
Imports	6.7	17.0	5.1	17.4	3.6	17.4

SOURCE: Own calculations.

upward beginnings of the year. The most inflationary component of the underlying index continues to be the price of rentals imputed to home owners, which was up by 4.3% year-to-year. This component is included in the index because it is considered to be part of household consumption although it does not constitute an effective outlay by homeowners.

In the foreign sector, the current account balance showed a deficit equivalent to 6.8% of the GDP. Nevertheless, the path of correction is now marked out. Partly helped by the weakness of the dollar and the moderation in the price of imported oil, November brought a clear decrease in the trade deficit which went to 58.87 billion dollars, a solid 8.4% lower than the month before. Since the end of 2004, the foreign sector has taken some 1.1% off the GDP in current dollars because of the increased cost of imported energy. If we assume the perspectives of the oil market, without upward price pressures, and in view of the sustained strength of exports, which in November grew by 13.8% compared with the same period the year before, the deficit should continue to be corrected in 2007.

Trade deficit improves in November but steady process of correction still awaited.

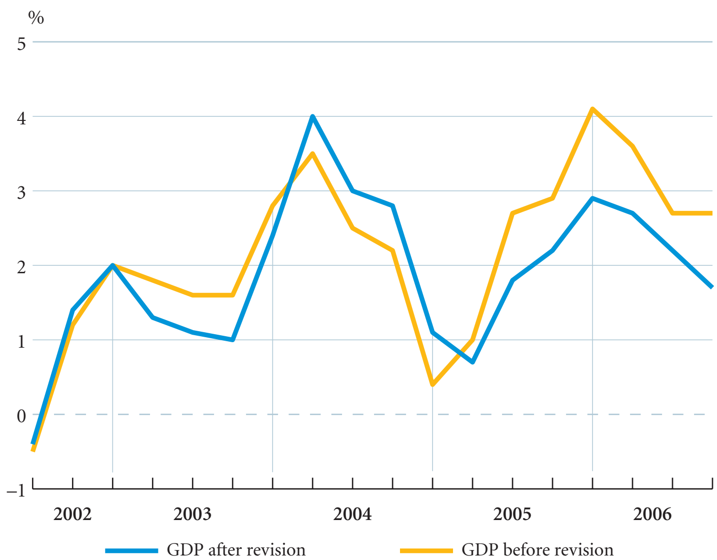
Japan: consumer joy in a hole

With the latest recovery, begun at the end of 2005, it seemed that Junichiro Koizumi, the previous prime minister, had begun to change Japan. Domestic demand, especially private consumption, was the main support of the economy and this was a big departure. The central bank sharpened its weapons because, following the end of deflation, the economy could quickly show signs of overheating. Only one thing went wrong. Japan's figures sometimes play tricks. After a period of some inconsistency, when consumer indicators were pointing downward, the revision of the national accounts for the past two years proved them correct and recovery practically disappeared. Furthermore, behind the

In Japan, review of national accounts reveals weaker consumption and more dependence on foreign trade.

JAPAN: REVIEW OF GDP GOBBLES UP RECOVERY

Year-to-year change in gross domestic product



SOURCE: Japanese Ministry of Communications and own calculations.

fog of lively agitation, we see a reappearance of old Japan where the producers rule over consumers tending toward pessimism, who fail to increase in number, and where the dependence on exports continues to be heavy.

2007 growth to be close to 1.5%.

With the revision, since the end of 2003, Japan's economy grew by 5.2% and not by 6.3%, as was believed and the component revised downward most was private consumption which, in the same period, showed growth going to nearly half, from 4.0% to 2.6%. Although in lesser proportion, capital goods investment was also revised downward (especially in 2006) even though it had been showing special strength. Private construction also ceded ground although its contribution to growth had been very small. Public spending and the foreign sector are the components to stay practically the same. All of this left the economy with growth of 1.7% year-to-year in the third quarter, with consumption now in a slight downturn but with capital goods investment advancing by 7.7% and 9.6% respectively. In 2007, the economy should grow somewhat above 1.5% with the low profile of domestic demand continuing and with its main trading partners, United States and China, both in processes of slowdown, although of different intensity. For the second half of the year, the growth trend will run to around 2%.

As against poor retail sales, industry recovering and corporate profits holding up.

Retail sales in October were up by 0.3% year-to-year, once more below the increase in prices following the low profile of recent months. Car sales followed a similar pattern dropping by 6.1% year-to-year in November with no increase since June 2005. In turn, consumer confidence in the third quarter held at 45.6 points, an acceptable level that, however, drops below the highs seen in the previous nine months. Nor is the housing sector showing very strong with prices in Tokyo stagnant in November and sales down by 22.9%. The other side of the coin is the renewed strength of industrial production which rose by 6.1% year-to-year in November, a component which is part of the traditional Japan that is strong in manufacturing and with its eye on

JAPAN: MAIN ECONOMIC INDICATORS

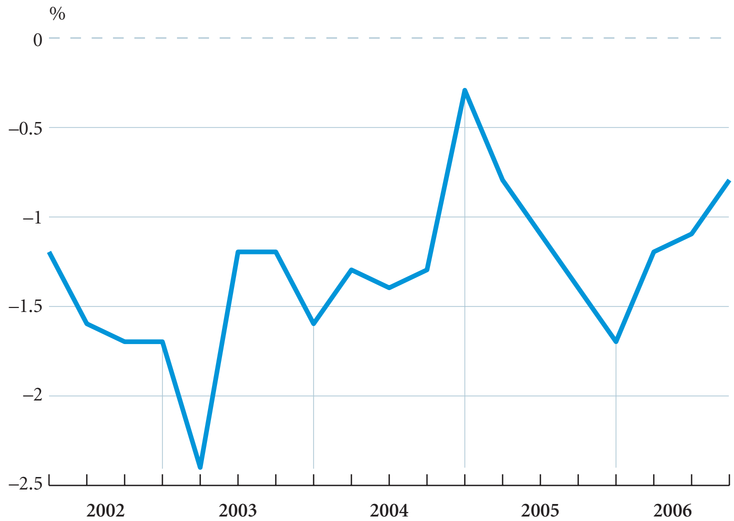
Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006				
			3Q	4Q	1Q	2Q	3Q	October	November
Real GDP	2.7	1.9	2.2	2.9	2.7	2.2	1.7	–	...
Retail sales	–0.9	1.4	1.1	0.7	0.6	–0.2	0.4	0.3	...
Industrial production	5.3	1.5	–0.1	3.6	2.8	3.7	5.3	6.1	...
Tankan company index (*)	20.5	18.0	19.0	21.0	20.0	21.0	24.0	–	25.0
Housing construction	2.6	3.8	4.9	6.9	4.9	8.8	–0.7	2.1	...
Unemployment rate (**)	4.7	4.4	4.3	4.5	4.2	4.1	4.1	4.1	...
Consumer prices	0.0	–0.3	–0.3	–0.7	–0.1	0.2	0.6	0.4	...
Trade balance (***)	13.9	10.2	10.9	10.2	9.5	9.1	8.9	9.0	...

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

JAPAN: END OF DEFLATION NOT YET CLEAR

Low unemployment rate fails turn into wage rises



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

exports. In this respect, machinery orders from abroad made a strong recovery in October and continued to gain ground over those aimed at domestic demand which has been weak since the summer. At the same time, the Tankan business survey for the fourth quarter, in the case of large manufacturing companies, went to 25 points, showing that Japan's increased strength continues to lie in its big companies whose profits continue strong, which, along with heavy investment and the price of some assets, provides the central bank with its argument for a rise in interest rates, a move not without some dissent.

In October, inflation was 0.4% year-to-year and the less volatile index excluding fresh foods went up only 0.1%. After some considerable time, the GDP deflator for private consumption stood on positive ground in the third quarter, although helped by energy. The unemployment rate in October stood at 4.1%, but wages have been losing purchasing power for three months, which, together with the renewed tendency of households to save lies behind the primacy of producers over consumers.

Low unemployment rate fails turn into wage rises.

The foreign sector continued to be a bastion of strength, with the trade balance that in the past 12 months as of October reached 9,000 billion yen, with a recovery from energy price effects. The foreign sector should continue to increase in coming months but exports have lost some of the strength they showed in the first half of 2006, confirming the trend to moderation in global growth.

China: the strange case of growth without consumption

The figures for China seem to leave no room for ambiguity. Growth in the third quarter was 10.4% year-to-year, with agriculture growing by4.9%, services by 9.5% and industry by 13.0%. There has been something of a slowdown

China slows advance but still growing by 10.4%.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006				
			3Q	4Q	1Q	2Q	3Q	October	November
Real GDP	9.5	9.9	9.8	9.9	10.3	11.3	10.4	–	...
Industrial production	16.3	15.9	16.2	16.4	16.8	18.0	16.2	14.7	14.9
Electrical power production	15.0	13.4	13.6	11.8	13.4	13.2	16.5	15.6	15.7
Consumer prices	3.9	1.8	1.3	1.4	1.2	1.4	1.3	1.4	1.9
Trade balance (*)	32.1	102.0	96.6	102.0	108.8	123.5	143.3	155.2	167.6

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

compared with the second quarter but no doubt strong growth is the dominant note. Chinese growth is moving more and more toward investment and exports, while consumption hangs behind and this will create five problems which will come in 2007 whether they begin to be corrected preventatively or not.

Strong investment and exports coexist with a weak private consumption.

In the first place, investment represented 42.3% of the GDP in 2005, a higher rate than in other emerging economies which raises serious doubts about its profitability. Secondly, this investment is creating excessive capacity especially in structures and sectors intensive in raw materials, such as steel. Industrial production in November rose by 14.9% year-to-year, a slight drop from the 16% which has been the norm in recent times, thus partly reflecting measures taken by the authorities to moderate economic activity. Nevertheless, the heavy industry component, which comes close to 70% of the total, grew by 16.6% in the same period. In the third place, growth is capital intensive, which means heavy consumption of energy but no growth in employment where China has a labour reserve coming from the unproductive farm sector which is gradually getting smaller.

In the fourth place, excessive investment without any profitability would increase the problems of the banking sector which is carrying out successful privatizations, but where the guarantee that the principal of loans will be repaid is unacceptably low. In this respect, it came as good news in November that the proportion of all industry represented by the state conglomerates, which are highly in debt and showing little profit, dropped to 34.0% although there is some doubt whether this proportion is dropping sufficiently fast. Finally, the primacy of investment is complemented by an orientation clearly more and more aimed at exports. Exports in the last 12 months up to November amounted to 35.1% of the GDP and the trade surplus could go above 6% of the total for the whole economy. This dependence on the foreign sector is aggravated in the sense that it is asymmetric, that is to say, the surplus is concentrated in Europe and heavily in the United States. As a result, with a total surplus of 155 billion dollars in the 12 months up to October, the bilateral surplus with the United States amounted to 138 billion dollars. The US trade deficit is not due only to Chinese exports but it is true that this bilateral imbalance is creating tensions which could bring about cries of protectionism with all their subsequent losses.

CHINA: IS INFLATION ON RISE?

Year-to-year change in food consumer price index

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

The good news is that the Chinese government is well aware of all of this, but the problem lies in whether the solutions are sufficient, requiring as they do the stimulation of private consumption in the population with a tendency to saving. Consumption in 2005 represented 38.7% of the economy, a figure exceptionally low even for an emerging economy that, furthermore, continues to decline. Retail sales in November grew by 14.1% year-to-year, but beyond these specific figures the increases are always lower than those for industrial production and, on top of this, as opposed to the latter, we see a clear slowdown compared with 2004 and 2005. Increasing spending on health, education and pensions is a first step being taken with too much hesitancy. Obliging companies to pay more dividends would be another measure. Apart from this is the institutional deficit which includes clearer property rights, especially for farmers and small entrepreneurs, accounting transparency and better banking supervision.

With excessive capacity and the farm worker labour reserve (although the latter is not so easily moveable to more productive sectors), inflationary trends would be sustainable. Official inflation in November stood at 1.9% year-to-year, which in the case of food showed a more credible 3.7%. The choice of the future is whether to allow the exchange rate to fluctuate so that appreciation might help to contain prices and limit the subsidy currently received by exporters at the cost of consumers. The big doubt about China in 2007 is not so much in its growth rate but in putting into operation suitable measures for reviving consumption as opposed to investment and exports, with a gradual improvement in institutional deficits.

Heavy industry continues to dominate growth although industrial production slowing down slightly.

Question about 2007 is whether authorities will be able to revive consumption.

Mexico: growth continues while trade weakens

The Mexican economy continued to grow in the third quarter reaching 4.6%

MEXICO: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	July	August	September	October
Real GDP	4.2	3.0	3.4	2.7	5.5	4.7	–	4.6	–	–
Industrial production	4.2	1.6	0.8	2.7	7.0	3.9	6.1	5.6	5.0	4.6
General unemployment rate (*)	3.9	3.6	3.8	3.1	3.5	3.2	4.0	4.0	4.0	4.0
Consumer prices	4.7	4.0	4.0	3.1	3.7	3.1	3.1	3.5	4.1	4.3
Trade balance (**)	–8.8	–7.6	–9.5	–7.6	–5.0	–4.5	–4.1	–4.2	–5.3	–5.8

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

Mexico growing by 4.6%, led by private investment.

Construction takes over from manufacturing.

Prices continue to rise.

year-to-year. The upward cycle begun at the end of 2005 is thus continuing. Mexican growth is supported mainly by private consumption which is growing by 5.4%, although in recent months public consumption appears to be increasing. Investment is growing by around 10% year-to-year, mainly in the private sector. By component, on the supply side construction and manufacturing were the most active sectors in the third quarter with advances of 7.7% and 5.9% year-to-year respectively. Within the manufacturing sector what stands out is the strength of machinery and metals although the tendency here is to something of a slowdown.

Among the most recent demand indicators, industrial production in October grew by 4.6% year-to-year and continues at a good rate, although since June there has been a slight trend to a slowdown. Here we see the gradual process of a shift in emphasis from manufacturing to construction which began in July. In turn, industrial production by the «maquiladoras» lost the strength shown last summer and again went into a slump with growth of 2.0%.

The stability of prices continues to be a more and more important question about the Mexican economy with inflation in October continuing the process of increases at the end of summer with growth at the rate of 4.3% year-to-year. The underlying component, excluding energy and foods, maintained an increase of 3.4%, which seems to be reasonable, although the GDP deflator for the second quarter grew by 8.5% year-to-year.

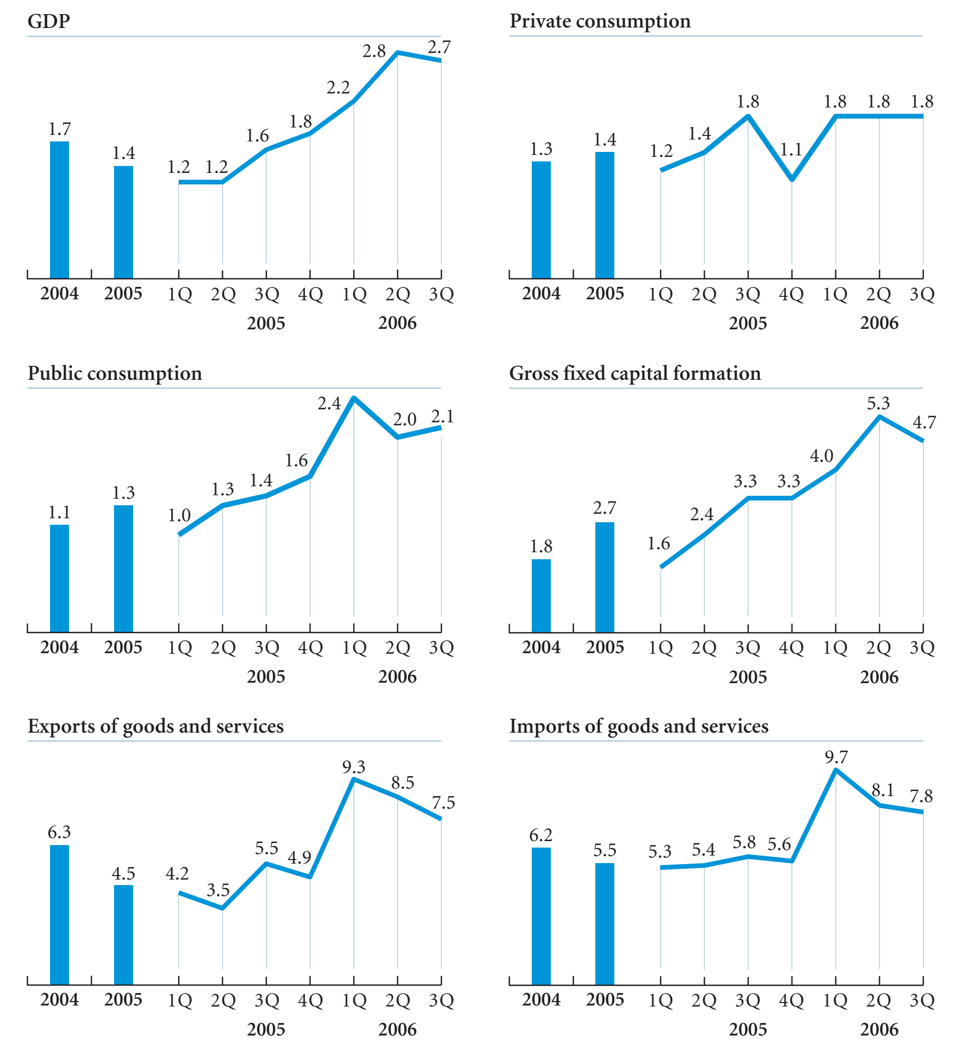
Euro Area: clear horizons

The Euro Area will end 2006 in excellent shape, above its growth potential. In the third quarter, some trends were confirmed (basically the driving role of investment) while at the same time some other good news has appeared. The most significant aspect is that private consumption is beginning to take on a more notable role in economic growth.

Euro Area ends year in excellent form with consumption playing increasing role.

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-to-year change



SOURCE: Eurostat and own calculations.

Economic activity holds strong in fourth quarter.

Specifically, following publication of the detailed results for the third quarter, which came along with the revised figures for the first half-year, we note that private consumption was up 1.8% in the first three quarters, which was more than initially estimated. Investment, in turn, in spite of some slowing down, showed growth of 4.7% year-to-year in the third quarter. Public consumption held to a similar rate as in the second quarter, of the order of 2% year-to-year. Overall, domestic demand grew by 2.7% year-to-year, two decimals more than in the previous quarter. The increase in domestic demand also pushed up imports so that, in spite of the good performance in exports, the contribution of the foreign sector to the change in the gross domestic product (GDP) was nil. Finally, the Euro Area grew by 2.7% year-to-year in the third quarter and 2.6% in the whole year so far reported.

Attention focussed on inflation and impact of German VAT increase.

Everything would suggest that the current rate will not drop in the final quarter. Economic sentiment, an overall indicator of the state of the Euro Area, continued to move up in October and November. As against a level of 108.8 points in the third quarter, economic sentiment stood at 110.4 points as the average for the two first months of the fourth quarter. The increase in consumer confidence as of November and the boost in industrial production in October, both on the demand side and the supply side, confirm that growth is being maintained in the final stages of the year. As a result, after five consecutive months at 7.8%, the unemployment rate dropped by one decimal in October.

The year 2006 will therefore likely show as a good one for the economy. But what about 2007? There are two main short-term concerns. The first, related to economic growth, deals with the possible negative impact of Germany's fiscal adjustments. The increase in the value added tax rate (up three points as of January 1, 2007) is causing uncertainty about its effects on economic activity, especially on German consumers who may have brought forward a significant part of their spending to the second half of 2006 thus causing a

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006				
			4Q	1Q	2Q	3Q	October	November
GDP	1.7	1.4	1.8	2.2	2.8	2.7	–	...
Retail sales	1.5	1.3	1.3	0.8	1.7	1.8	1.0	...
Consumer confidence (*)	–14	–14	–13	–11	–10	–8	–8	–7
Industrial production	2.0	1.2	2.1	3.4	4.1	3.9	3.6	...
Economic sentiment indicator (*)	99.8	98.4	100.6	103.0	107.2	108.8	110.4	110.3
Unemployment rate (**)	8.8	8.6	8.5	8.2	7.8	7.8	7.7	...
Consumer prices	2.1	2.2	2.3	2.3	2.5	2.1	1.6	1.9
Trade balance (***)	80.4	42.1	22.2	3.3	–9.6	–20.9	–18.9	...

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

temporary halt to buying in the first quarter of 2007. Taking into account that Germany's recovery is playing an important role in European growth, this uncertainty is by no means insignificant.

Another focus of attention is prices. For much of the Autumn the energy component of the harmonized consumer price index (HCPI) helped reduce inflationary pressures to the point where the general index stood at 1.6% year-to-year in October. Now the course is turning around. In November, the contribution from energy brought about an increase to 1.9% year-to-year. This trend will continue over coming months. Furthermore, the inflationary impact of the increase in the German VAT mentioned above will also contribute to holding prices in the Euro Area above the 2% reference rate set by the European Central Bank.

All of this, along with other specific factors, such as lower growth of exports, which could come from a world situation undergoing a gradual slowdown as well as the euro showing a rise in value, explains why a gradual slowdown can be expected in 2007. Certainly, it will still grow above 2% annual but everything points to 2006 as an exceptionally positive year, especially if we take into account that the structural reforms that would make an improvement in growth potential possible are scarcely making any progress.

It its first annual report on economic reform, the European Commission, in a generally positive approach, recognizes that the drive in reforms is still limited. Specifically, the EC executive points out three areas of greatest priority. The first is the need to introduce greater competition in services, among which the Commission points out energy. A second area of concern is the excessive segmentation of the labour market, especially among workers enjoying stable conditions and those in a more precarious situation.

Full advantage of economic growth not being taken to hasten structural reforms.

Finally, and this is probably linked to the previous factor, the Commission expressed its concern about the excessive rigidity still to be noted in the labour market. The call for so-called «flexi-security», that is a combination of flexibility in labour relations and strong outside support to facilitate job shifts, does not seem to be taking place to any significant degree in most European countries. To sum up, does not seem that the boom period is serving to work for the future. In the words of European Commission chairman José Manual Barroso, «there is no room for complacence». In another sphere, it should be remembered that as of January 1, 2007 Slovenia will become the 13th member state of the EU to adopt the euro as its own currency.

Germany: first-quarter bottleneck can be handled

German consumption recovers partly in anticipation of increase in indirect taxes.

Germany has gone above and beyond the brightest predictions and at the end of 2006 is maintaining notable growth. Partly as a response to the increase in VAT on January 1, 2007, private consumption has shown a rate increase, if we are to go by indicators such as car registrations (increase of 10% year-to-year in October-November) and consumer confidence, which added two points in November. Furthermore, it was not only a matter of domestic demand, seeing that in October, for the second consecutive month, the trade balance (as the cumulative figure for 12 months) was up again. Behind this growth we note the massive rise in exports, above the 18% year-to-year average for September and October.

Sharp growth in exports benefiting industry.

GERMANY SHOWS BEST PROSPECTS SINCE REUNIFICATION

SOURCE: IFO Institute.

IFO index at highest since 1991 points to positive 2007.

On the supply side, the situation is also positive. Although industrial production has shown somewhat reduced growth, this was a logical correction in view of the sharp cumulative growth during the year. In any case, with the industrial production index at a growth rate of 3.2% year-to-year in October and producer prices growing by more than 8.5% that same month, the strength of industry seems without question. The situation in services was also positive and, after some weakness in August and September, this recovered positions as of November.

As a result of the economic recovery, the pressing problem of unemployment has begun to partly ease. The unemployment rate is tending to

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006					
			4Q	1Q	2Q	3Q	October	November	December
GDP	0.8	1.1	1.7	1.9	2.7	2.8	–	...	–
Retail sales	2.1	1.3	0.4	0.6	0.2	0.3	–0.8	...	...
Industrial production	2.4	2.9	4.7	4.6	5.8	6.4	3.2	...	...
Industrial activity index (IFO) (*)	95.4	95.5	98.6	103.6	106.1	105.2	105.4	106.8	108.7
Unemployment rate (**)	10.5	11.7	11.5	11.3	11.0	10.6	10.4	10.2	...
Consumer prices	1.6	2.0	2.2	2.1	1.9	1.6	1.1	1.5	1.3
Trade balance (***)	149	156.3	158.4	155.2	152.3	149.9	155.3	...	...

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

progressively come close to 10% of the labour force (10.2% in November). While this level is still high, we should point out that in the past two months the unemployment rate has gone down by one percentage point. In addition, inflation is repeating the upward move in the Euro Area as a whole and, under the impact of the energy component, rose to 1.5% year-to-year in November (1.1% in October). Nevertheless, the preliminary estimate for December showed a further change with the figure going to 1.3% year-to-year.

Given the good end to 2006, we could feel that the horizon was all clear. Yet, while the previous trends will continue to a large degree, it is true that the increase in the VAT in January 2007 raises considerable uncertainty about Germany's performance in the first quarter. In a recent report, the International Monetary Fund joined the consensus held at this moment. The impact on growth and prices will be transitional and in 2007 as a whole this will be absorbed without excessive difficulty. Factors such as the good prospects for capital goods exports should provide a fund of strength for the German economy in 2007. This is also the opinion of business executives. The IFO indicator for December rose to 108 points, the highest level since the early Nineties, due mainly to the prospects component. This would imply that a rising economy is expected over the next six months.

France: trend to improvement

In France, final stretch of year seems to be leaving slack in third quarter well behind.

After marking up nil quarter-to-quarter growth annualized in the third quarter, the fourth quarter would seem fundamental for getting some idea of France's economic possibilities over the short term. Monthly indicators available suggest that the worst may now be over. One of the key supports of the French economy, namely consumption, which had lost some strength, began to improve in the fourth quarter, if we are to go by the increase in domestic consumption and the recovery of consumer confidence, also in November. At the same time, investment could be moving into a stage of increased growth, given that the capital goods component of industrial production in October went to 8.1% year-to-year, the highest figure since November 2000.

With end of motor vehicle slack, industrial production recovering.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006				
			4Q	1Q	2Q	3Q	October	November
GDP	2.0	1.2	1.0	1.3	2.6	1.9	–	...
Domestic consumption	3.8	2.9	2.2	2.9	4.7	4.2	4.0	4.3
Industrial production	2.0	0.2	–0.5	0.4	1.8	0.6	2.3	...
Unemployment rate (*)	10.0	9.9	9.7	9.6	9.1	8.9	8.8	8.7
Consumer prices	2.1	1.7	1.6	1.8	1.9	1.7	1.1	1.4
Trade balance (**)	0.1	–1.3	–1.8	–2.1	–2.1	–2.4	–2.5	...

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

Recovery of labour market and containment of inflation will help strengthen consumption.

Even industrial production, which was badly hurt by the drop in the motor vehicle sector, has shown its best figure since last June with growth of 2.3% year-to-year in October. In any case, prospects in industry are not free of uncertainties, given that they mix together the recovery industrial confidence and the worsening of industrial orders. The situation in services and construction is also moderately more expansionist in the final months of the year.

Consumption in Italy offering bigger boost to recovery.

Another positive factor is inflation which, in spite of the rise in November due to the contribution of energy, is holding at contained growth rates (1.4% year-to-year in November). The positive effect that this low level of inflationary pressure could have in the form of higher real incomes, along with a slow but continuing re-routing of the unemployment rate (8.7% in November, substantially better than the level of 9.6% at which it began 2006), should provide a solid base for consumption. Furthermore, it should be remembered that in 2007 we shall begin to note the effects of the latest fiscal reforms dealing with personal income tax.

Fourth quarter showing good indicators but up-coming trends less optimistic.

Italy: year-end on rise

Italy's growth in the third quarter has brought some relief about the recent state of the economy. As has happened in the Euro Area as a whole, the figures for the national accounts for the third quarter, together with the revised figures for the first half-year estimates, have revealed the picture of an economy that is more dynamic than it was believed. And while the year-to-year GDP growth rate has been holding at 1.7% in the first three quarters of 2006, we note that consumption has had a key role in growth.

Specifically, in the third quarter, private consumption grew by 1.9% year-to-year, similar to figures for the previous quarter, while the other components of domestic demand (public consumption and investment) slowed down considerably. The foreign sector, in turn, took off six decimals from the change in the GDP.

As of this moment, the prospects are not so clear. Current indicators point to a year-end in a stage of moderation growth. To cite only two key indicators

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006				
			4Q	1Q	2Q	3Q	October	November
GDP	0.9	0.1	0.5	1.7	1.7	1.7	–	...
Retail sales	–0.4	0.4	1.9	0.5	1.9	1.6	0.4	...
Industrial production	–0.5	–0.9	0.4	2.7	1.7	1.4	3.3	...
Unemployment rate (*)	8.0	7.7	7.5	7.2	6.9	6.8	–	...
Consumer prices	2.2	1.9	2.2	2.1	2.2	2.2	1.8	1.8
Trade balance (**)	–1.2	–9.4	–8.5	–12.9	–16.5	–21.3	–22.5	...

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

of demand and supply, consumer confidence rose to the level of –17 points in November while industrial production in October rose to 3.3% (1.9% in September).

On the other hand, those indicators of a more anticipatory nature, such as economic sentiment and the composite index of early indicators, suggested some weakness as the fourth quarter advanced. In another sphere, we should point out that inflation has broken away from the situation in the Euro Area as a whole in that it held at 1.8% year-to-year in November, with no change over October.

United Kingdom: near peak of cycle

The big question about the British economy is when it will begin to slow down. After growth of 2.9% year-to-year in the third quarter, which was higher than expected, the question now is whether the fourth quarter will finally be one of adjustment. If we are to go by available indicators, even though the last quarter ends up in the clear, the beginning of 2007 certainly will show lower economic drive.

In United Kingdom big question mark is whether top of cycle has passed.

With the advance of the fourth quarter, domestic demand is losing its shine. Retail sales grew by 4.0% in October but by only 3.2% in November. Consumer confidence recovered in October but this was followed by a drop the following month. Passenger car registrations recovered in October but dropped in November. Although this pattern is not fully repeated on the supply side, the trend in key indicators does not clearly reject it either.

As fourth quarter advances economic activity loses some of its shine.

On the prices and labour market fronts there is less news to report. To be specific, consumer prices are repeating recent rises (in November the CPI rose to 3.4% year-to-year, two decimals more than in October), while the unemployment rate in November was again 3.0%.

November inflation still too high at 3.4%.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005	2006				
			4Q	1Q	2Q	3Q	October	November
GDP	3.3	1.9	2.0	2.4	2.7	2.9	–	...
Retail sales	6.0	1.9	2.5	1.7	3.4	3.7	4.0	3.2
Industrial production	0.8	–1.9	–2.6	–1.0	–0.6	0.3	0.6	...
Unemployment rate (*)	2.7	2.7	2.8	2.9	3.0	3.0	3.0	3.0
Consumer prices	2.2	2.2	2.3	2.2	2.8	3.2	3.2	3.4
Trade balance (**)	–56.1	–64.6	–67.4	–72.5	–77.0	–81.1	–82.5	...

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

ECB ends year raising its rates

Official interest rate of European Central Bank to continue rising in 2007.

On December 7, the Governing Board of the European Central Bank (ECB) decided to raise its reference rates by 25 basis points, thus putting the Eurosystem rate at 3.50%. This was the sixth rise since it began its upward stage one year earlier. This move came as no surprise and had already been discounted by the market.

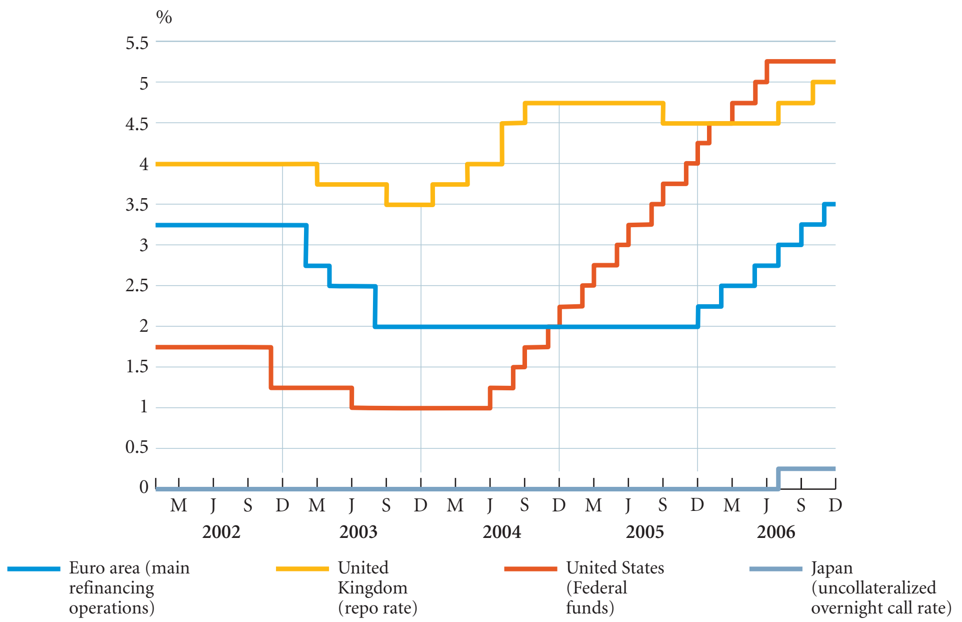
US Federal Reserve to maintain position of caution over coming months before making possible cut.

ECB chairman Jean-Claude Trichet revealed economic growth projections for the Euro Area for 2007 of between 1.7% and 2.7%, revised slightly upward, and between 1.8% and 2.8% in 2008. With regard to inflation, the range runs from 1.5% to 2.5% in 2007, with a slight drop from previous projections in September and from 1.3% to 2.5% in 2008. With this scenario and taking into consideration that the central bank itself has stated that inflation risks remain high and that the M3 broad money supply figure is growing substantially above the reference level, it is most likely that the official interest rate will continue close to the neutral level in the early months of 2007, given that the ECB itself recognizes that it is still at a low level.

With regard to the Federal Reserve, as expected, at its meeting on December 12 it maintained the overnight

EUROPEAN CENTRAL BANK RAISES OFFICIAL INTEREST RATE

Monetary policy reference rates



SOURCE: National central banks.

interbank reference rate at 5.25% for the fourth consecutive time. The press release issued after the Federal Open Market Committee meeting scarcely included any changes from its previous one and maintained the same upward bias. Nevertheless, the markets were not ready to believe it and on the whole are betting on an easing of monetary policy toward the second quarter of 2007. For the moment, in fact, the most likely is that the Federal Reserve will maintain its cautious stance over coming months with a balance between the danger of a sharper slowdown in the economy and inflationary risks. Later on, depending on how the economic situation develops, it could make some cut.

Bank of England likely to again raise interest rate.

Nor did the Bank of England change its key interest rate in the second week of December. Nevertheless, the new rise in inflation in November, above the objective of 2.5% annual, could persuade it to make a further tightening of monetary policy in the early stages of 2007.

Japanese monetary authorities to renew upward path of reference rate in 2007.

The monetary authority of Japan also made no move to change its reference rate at its meeting in mid-December following the downward revision of economic growth in the

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euríbor (5) 3-month	Euríbor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2005									
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 (*)	3.31	3.60	3.86	5.25	5.37	0.48	4.93	5.23	1.90
December (1)	3.58	3.72	4.00	5.25	5.36	0.54	5.00	5.32	2.08

NOTES: (*) Provisional figures.
(1) December 27.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 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%), 7-12-06 (3,50%).
(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.

third quarter. As a result, it is maintaining the rate at 0.25% in an economic context with its bright points and its shadows and with pressure from the government against another rise in the official interest rate. In any case, the most likely course is it will continue along an upward course in 2007.

In 2007 dollar expected to still be under downward pressure because of foreign imbalance.

On the other hand, in the early weeks of December a number of central banks continued to tighten their monetary policies generally starting out from slack levels. On December 7, the Bank of Denmark raised its reference rates by 25 basis points, putting the 14-day loan rate at 3.75%. One week later, the Bank of Switzerland raised its reference band by a quarter-point to 1.5%-2.5%. One day later, the oldest central bank, the Bank of Sweden, raised its main interest rate by 25 basis points to 3.0%.

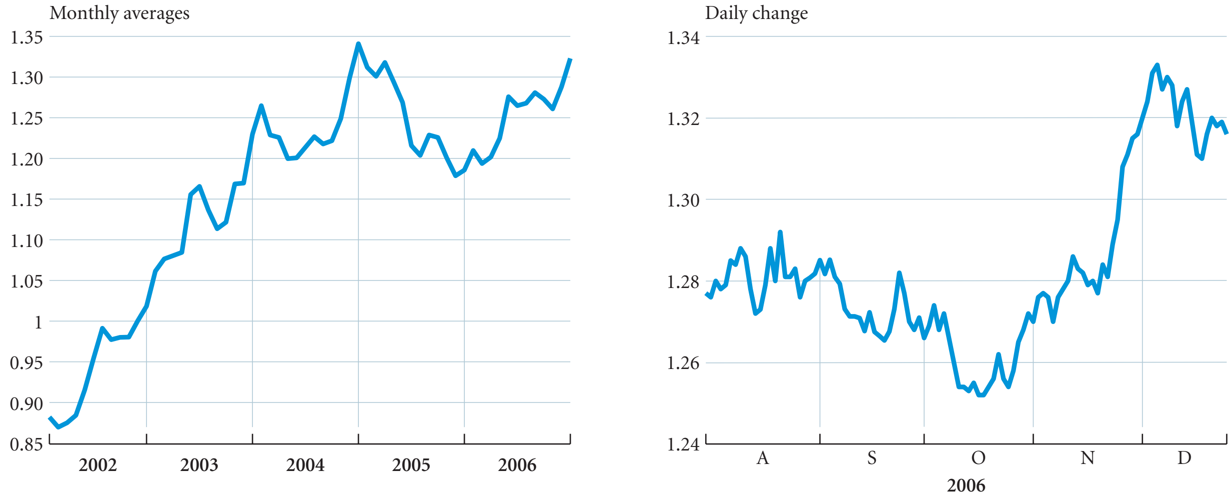
As a result, it seems that in 2007 there will be a gradual reduction of the current degree of easy monetary conditions. Nevertheless, the tightening will likely take place gradually at the global level and in the case of the United States could go in the opposite direction seeing that the US economy is more advanced in the economic cycle.

Extreme weakness of yen because of low interest rates

The dollar marked up its lowest level since October 1997 against a broad basket of currencies at the beginning of December because of fear of sharp slowdown in the US economy. Furthermore, the debate about diversification of currency reserves held by the central banks contributed to the weakness of the greenback. Nevertheless, publication of a series of positive indicators for the US economy, such as a notable figure for job creation, eased concern about a possible rough landing and put off the possibility of an interest rate cut by the Federal Reserve. Secretary of the Treasury Paulson also supported the currency with statements in its favour. In this way, the dollar was strengthened to some extent.

EURO RECORDS HIGHEST EXCHANGE RATE AGAINST DOLLAR IN LAST 20 MONTHS

US dollars to euro



NOTES: Figures go up to December 21.
SOURCE: OCDE, Thomson Financial Datastream and own calculations.

EXCHANGE RATES OF MAIN CURRENCIES

November 2006

	Final session of month		Monthly figures				*Exchange rate December 27, 2006*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2) Monthly	% change (2) Over December 2005	% change (2) Annual	
Against US dollar							
Japanese yen	115.8	–1.0	117.3	–1.1	–1.0	–1.0	*118.6*
Pound sterling (1)	1.965	3.0	1.913	1.9	9.6	10.2	*1.958*
Swiss franc	1.198	–3.7	1.235	–2.0	–5.4	–5.7	*1.225*
Canadian dollar	1.141	1.7	1.136	0.7	–2.2	–3.8	*1.162*
Mexican peso	11.00	2.2	10.92	0.2	2.7	2.3	*10.88*
Nominal effective index (4)	*106.5*	*–0.9*	*107.5*	*–0.8*	*–3.8*	*–4.5*	*107.1*
Against euro							
US dollar	1.320	4.0	1.288	2.1	8.6	9.3	*1.316*
Japanese yen	153.3	2.5	151.1	1.0	7.6	8.2	*156.1*
Swiss franc	1.592	0.2	1.592	0.2	2.8	3.1	*1.606*
Pound sterling	0.674	0.9	0.674	0.2	–0.8	–0.8	*0.671*
Swedish krona	9.066	–1.6	9.101	–1.6	–3.5	–4.8	*9.023*
Danish krone (3)	7.455	0.0	7.456	0.0	0.0	0.0	*7.454*
Polish zloty	3.811	–1.6	3.825	–2.0	–0.6	–3.7	*3.839*
Czech crown	27.97	–0.9	28.03	–0.9	–3.2	–4.2	*27.59*
Hungarian forint	256.3	–1.5	258.8	–3.1	2.5	3.1	*253.5*
Nominal effective index (5)	*105.5*	*1.9*	*104.4*	*0.7*	*3.6*	*3.7*	*105.5*

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

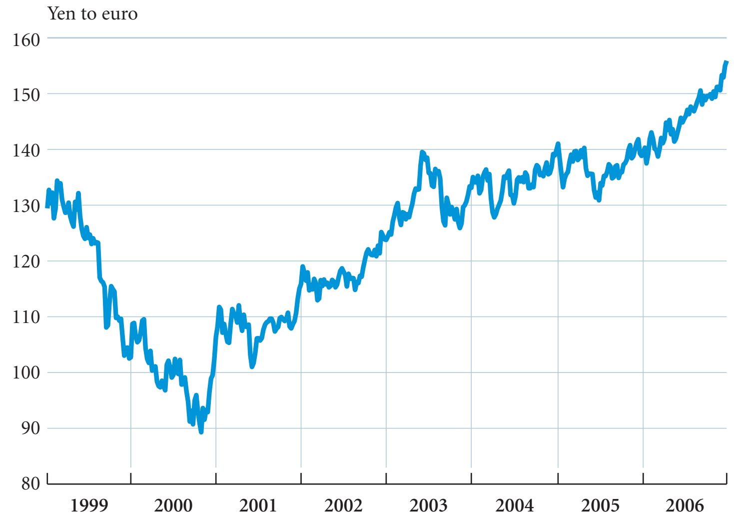
Nevertheless, in the fifth week of the month it stood at 4% below the starting level for the year. The prospects for 2007 are for a continuation of this trend as a result of the pressure for a needed correction of the massive foreign deficit.

The depreciation of the dollar has been distributed in various ways. The European currencies in general appreciated significantly more than the Asian currencies in 2006. In the final week of December, the euro showed a rise of 12% against the dollar since the end of 2005. On the other hand, the yen depreciated slightly in terms of the US currency in the same period, while the yuan showed a rise of only 3%. As a result, the euro marked up an all-time high against the yen in the second-last week of the year with the rate running at 156 yen.

Main Asian currencies still undervalued.

In fact, the Japanese currency continued to accentuate its weakness brought about by the substantial differential in interest rates unfavourable to it. The yen recorded an all-time low since October 1998 in terms of a broad group of currencies and

EURO MARKS UP ALL-TIME HIGH AGAINST YEN IN DECEMBER

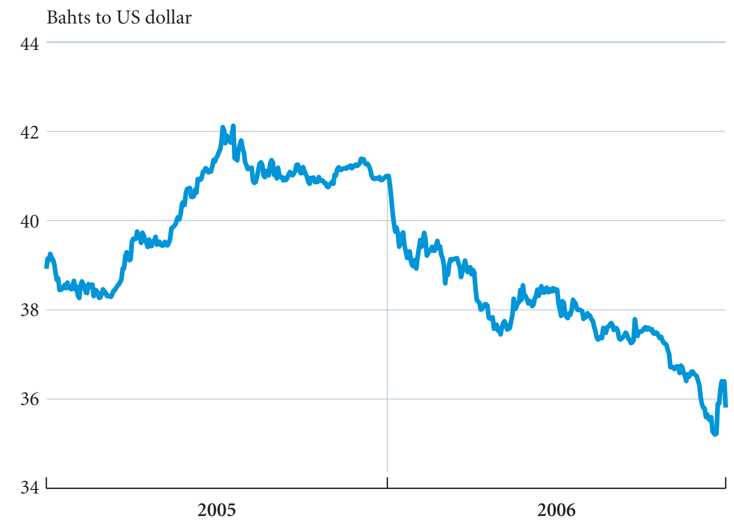


NOTES: Figures go up to December 21.
SOURCE: Thomson Financial Datastream.

continues to be notably undervalued, as is the case with the yuan. In fact, in mid-December, Ben Bernanke, chairman of the US Federal Reserve added his voice to the chorus of critics of the undervaluation of the Chinese currency calling it a hidden subsidy which was distorting global production and trade.

On the other hand, other Asian currencies appreciated against the dollar in 2006, although they are currencies of much less importance. In mid-December, the Thailandese baht had appreciated by 16% in terms of the dollar since the end of 2005, which induced the monetary authorities of that

APPRECIATION OF THAI BAHT AGAINST DOLLAR IN 2006



NOTES: Figures go up to December 27.
SOURCE: Thomson Financial Datastream.

country to establish a penalty on foreign short-term capital investment in order to halt the appreciation of its currency out of concern for its negative impact on foreign trade. In this way, the rise of the baht against the dollar during the year went down to 14% in the middle of the final week of December.

Another currency that was also strengthened in recent months was the pound sterling favoured by prospects of a further increase in interest rates by the Bank of England. The British currency reached its highest level since May 2000 in terms of a broad group of currencies in the early weeks of December. In terms of the US currency it went to 1.98 dollars at the beginning of the second week in December, its highest level since September 1992.

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

Slight rise in government bond yields

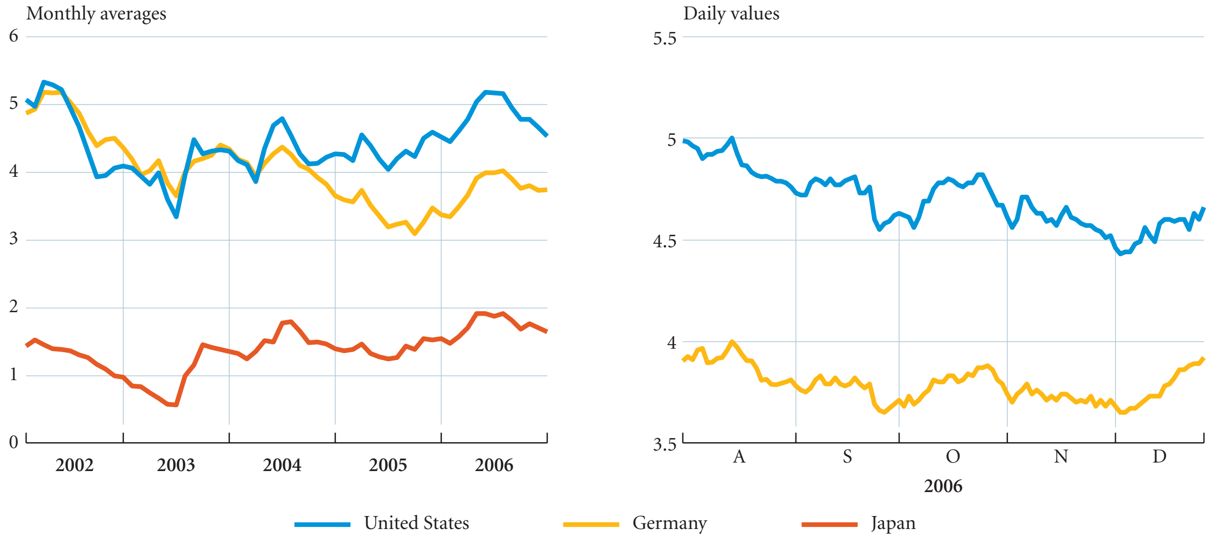
In recent weeks, the yield on US long-term Treasury bonds has tended to bounce back with the disappearance of concern about a recessive economic horizon. Nevertheless, in the middle of the final week in December, the yield on 10-year Treasury bonds stood at around 4.65%, only 25 basis points above the level at the beginning of 2006.

In Europe, interest rates on German government bonds also rose following in the wake of similar bonds on the other side of the Atlantic although to a greater extent due to the improvement in the Euro Area economic horizon. As a result, in the final week of 2006, the yield on German 10-year bonds stood at 3.9%, some 60 basis points above the start level

Yield on German long-term government bonds will tend to rise moderately in 2007.

DECREASE IN LONG-TERM INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO

Yield on 10-year government bonds as annual percentage



NOTES: Rates go up to December 27.
SOURCE: Bank of Spain and Thomson Financial Datastream.

Will real interest rates remain low in 2007?

In spite of recent increases in official interest rates, real long-term rates in the advanced economies remain at historically low levels. This situation is even more surprising given the persistent growth of the emerging countries, including the Asian giants, India and China, countries in major need of capital and which therefore must be putting upward pressure on interest rates. As the low interest rates have undoubtedly contributed to maintaining the long period of world economic growth, it is logical to ask if we can expect to continue to enjoy this very favourable environment. To answer this question, we must first understand why interest rates are so low. Only then can we evaluate how likely it is that some of the determining factors of this situation may change.

In the first place, the growing stability of prices and the increased sophistication of the financial system has made it possible to reduce the risk premiums associated with long-term interest rates. In fact, the level and volatility of inflation both in Europe and the United States have dropped notably in the past decade, with the help of globalization and the increased credibility of the central banks. Low stable inflation reduces the risk presented by buying a bond offering a nominal fixed rate of interest given that higher-than-expected inflation erodes the return in real terms. With regard to the sophistication of the financial system, the incorporation of the latest technological developments for handling information and the appearance of more and more complex financial instruments has made it possible to improve the allocation of risk in general and, in this way, reduce premiums linked to this factor.

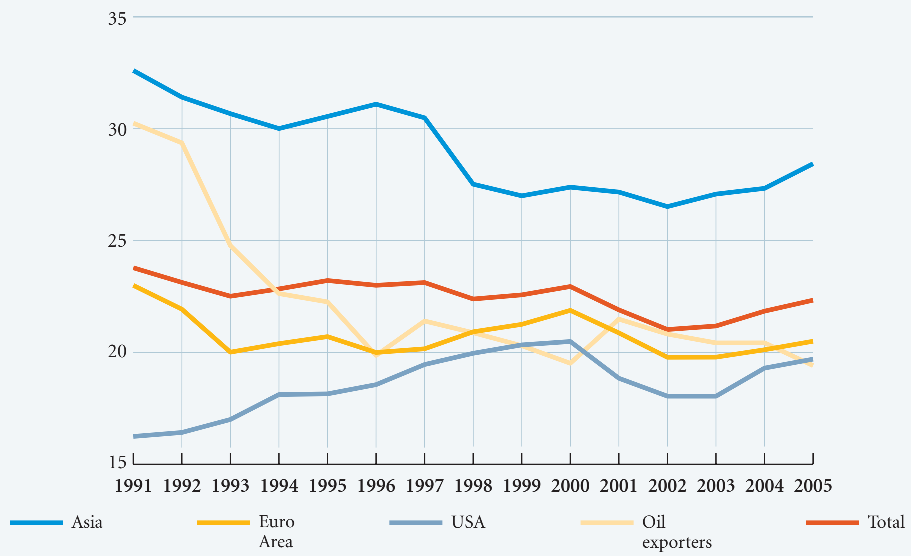
While the effects mentioned have had an influence on the long-term trend in interest rates, the key to explaining its more recent developments lies in investment and global savings. We know that, just as in desired savings, a drop in desired investment tends to reduce the interest rate and the savings/investment balance. As we have noted in recent years, there has been a tendency to a decrease in savings/investment together with a drop in interest rates, which implies that desired investment has necessarily dropped. There are signs that desired savings have increased, thus contributing to the decrease in interest rates and offsetting the drop of savings/investment.

The drop in desired global investment is clearly seen since the Asian crisis of the second half of the Nineties. In Asia, even today, investment stands below levels before 1997. In the United States and Europe desired investment also dropped since 2000 with the bursting of the technological bubble. In these two areas, especially in Europe, investment has recently recovered.

On the other hand, savings have also gone through significant changes. While they have decreased sharply in the United States with the rise in fiscal deficit, it has been increasing very significantly in the oil exporting countries since 2000 and in the Asian countries as they recovered from the crisis. In the oil exporting countries, the rise in consumption has not matched the increase in revenues from higher oil prices, which may be explained because, at least initially, they may have seen the rise as a temporary phenomenon or because it takes time to adjust to a rise in the pattern of consumption. The nature of the increase in savings in the Asian countries, especially in China, is quite different. On the one hand, these countries have maintained very competitive exchange rates through the intervention of their central banks in foreign exchange markets, which has tended to depress domestic consumption and increase exports. In the case of China, reform of the public corporate sector also led to the collapse of the most important social assistance system and has meant

TREND IN INVESTMENT RATE

Percentage of GDP



SOURCE: World Bank and own calculations.

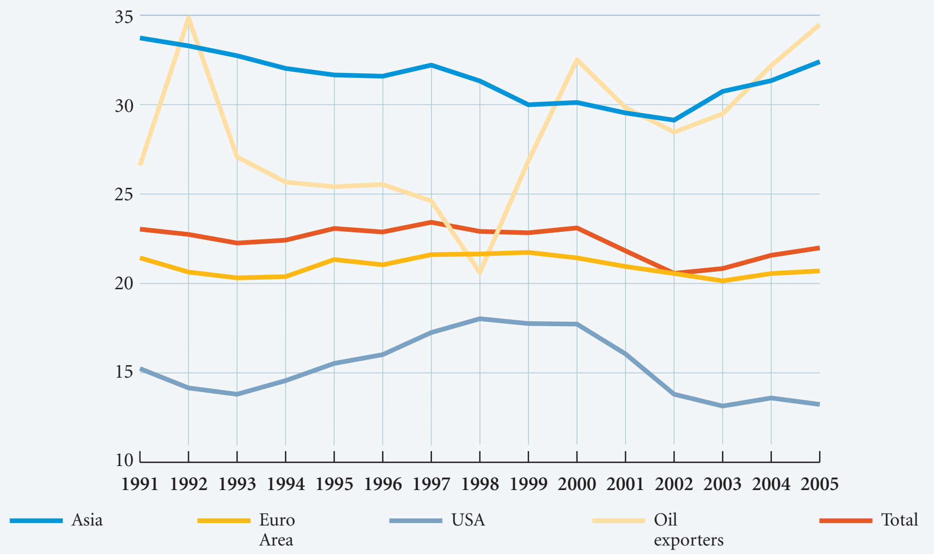
that households have to increase their savings very significantly. Those same public corporations have retained a large amount of their profits which they have not fully reinvested.

A review of the factors having an influence on the drop in real interest rates would suggest that these do not necessarily need to remain at current levels and that they could increase. An increase in inflation (as a consequence, for example, of a halt to globalization with downward pressure on prices of imported manufactured goods) or a major financial crisis would make risk premiums rise again and, as a result, push interest rates up. But these are not the most likely scenarios. More likely would be that changes in savings and investment would lead to an increase in interest rates. For example, a significant appreciation of the Asian currencies (that could happen at any moment if those currencies are unpegged from the US dollar) would give a major push to consumption and investment in the non-tradable sectors in those countries. The Chinese government is also considering a substantial increase in social spending and requiring dividend payments by the public corporations. In the case of the oil exporting countries, if prices continue as high as expected, patterns of consumption and investment will be adjusted upward, as we are already beginning to see. On top of this, we should add that the continued growth of the large emerging countries (China, India, Brazil and Russia) will require large amounts of investment.

The rise in real interest rates could have a major effect on world growth. Sooner or later, the rise in mortgage costs will tend to reduce the price of housing and depress the consumption of home-owners, specially those who have to meet variable-rate loans. Given the importance of housing in many economies, this effect could on its own slow down world growth. The impact would be especially sharp in the US economy given that increased external interest payments would worsen the massive external deficit and could set off a major

TREND IN SAVINGS RATE

Percentage of GDP



SOURCE: World Bank and own calculations.

adjustment of the dollar. In the case of Spain, where growth has been much favoured by low interest rates, the adjustment of those rates would make the urgent need for improving productivity more evident.

To sum up, we have lived through an unusual period of very low long-term interest rates. It is not possible to know if this will end in 2007 but the mechanisms that could bring back a more normal situation seem to be in motion.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2004	2005	2006					
			1Q	2Q	3Q	October	November	December 27
United States	4.31	4.33	4.61	5.13	4.96	4.78	4.51	4.66
Japan	1.50	1.39	1.58	1.90	1.80	1.76	1.66	1.64
Germany	4.07	3.38	3.50	3.96	3.89	3.80	3.68	3.92
France	4.10	3.41	3.51	3.99	3.90	3.81	3.70	3.95
Italy	4.24	3.56	3.71	4.27	4.18	4.07	3.93	4.19
Spain	4.10	3.39	3.49	3.97	3.89	3.81	3.69	3.94
United Kingdom	4.93	4.47	4.23	4.65	4.67	4.67	4.53	4.78
Switzerland	2.57	2.04	2.18	2.67	2.61	2.45	2.29	2.44

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

for the year. The differential in long-term interest rates between the dollar and the euro continued to narrow going to 75 basis points.

In addition, we should point out that bond risk premiums generally stood at lower levels in the final week of the year. To be specific, the risk premium on emerging country sovereign bonds marked up an all-time low toward the end of December. Nevertheless, it will probably go up again in 2007. At the same time, the yield on German long-term bonds will also tend to rise moderately while the differential with the dollar will keep on decreasing.

Low levels of bond risk premiums seem unsustainable.

Brilliant stock market year, especially in Spain

In the early weeks of December, the stock markets continued the recovery which began toward the middle of the year, thus putting the finishing touches to a brilliant 2006 which took a number of indices to all-time highs. Long-term interest rates at relatively low levels, containment of oil prices, the support of healthy corporate results and lively corporate moves have driven up the stock markets. This positive note should continue in 2007 although the increase will probably be of lesser importance.

Prospects for stock markets in 2007 positive.

INDICES OF MAIN WORLD STOCK EXCHANGES

November 30, 2006

	Index (*)	% monthly change	% cumulative change	% annual change	*Figures on December 27, 2006* % cumulative change	*Figures on December 27, 2006* % change over same date in 2003
New York						
Dow Jones	*12,221.9*	*1.2*	*14.0*	*13.1*	*16.7*	*21.2*
Standard & Poor's	*1,400.6*	*1.6*	*12.2*	*12.1*	*14.3*	*30.2*
Nasdaq	*2,431.8*	*2.7*	*10.3*	*8.9*	*10.2*	*23.2*
Tokyo	16,274.3	–0.8	1.0	9.4	6.9	*65.3*
London	6,048.9	–1.3	7.7	11.5	11.1	*40.5*
Euro area	3,987.2	–0.4	11.4	15.7	15.5	*51.7*
Frankfurt	*6,309.2*	*0.6*	*16.7*	*21.5*	*22.2*	*69.3*
Paris	*5,327.6*	*–0.4*	*13.0*	*16.6*	*17.5*	*57.8*
Amsterdam	*477.7*	*–1.8*	*9.4*	*14.1*	*14.0*	*49.9*
Milan	*30,997.0*	*2.0*	*15.8*	*19.6*	*18.7*	*60.0*
Madrid	*13,849.3*	*0.7*	*29.0*	*31.2*	*32.3*	*84.5*
Zurich	8,484.6	–1.0	11.9	14.5	16.3	*62.9*
Hong Kong	18,960.5	3.5	27.5	26.9	32.6	*58.4*
Buenos Aires	1,967.0	10.4	27.5	26.5	35.4	*100.0*
São Paulo	41,931.0	6.8	25.3	31.4	33.1	*104.2*

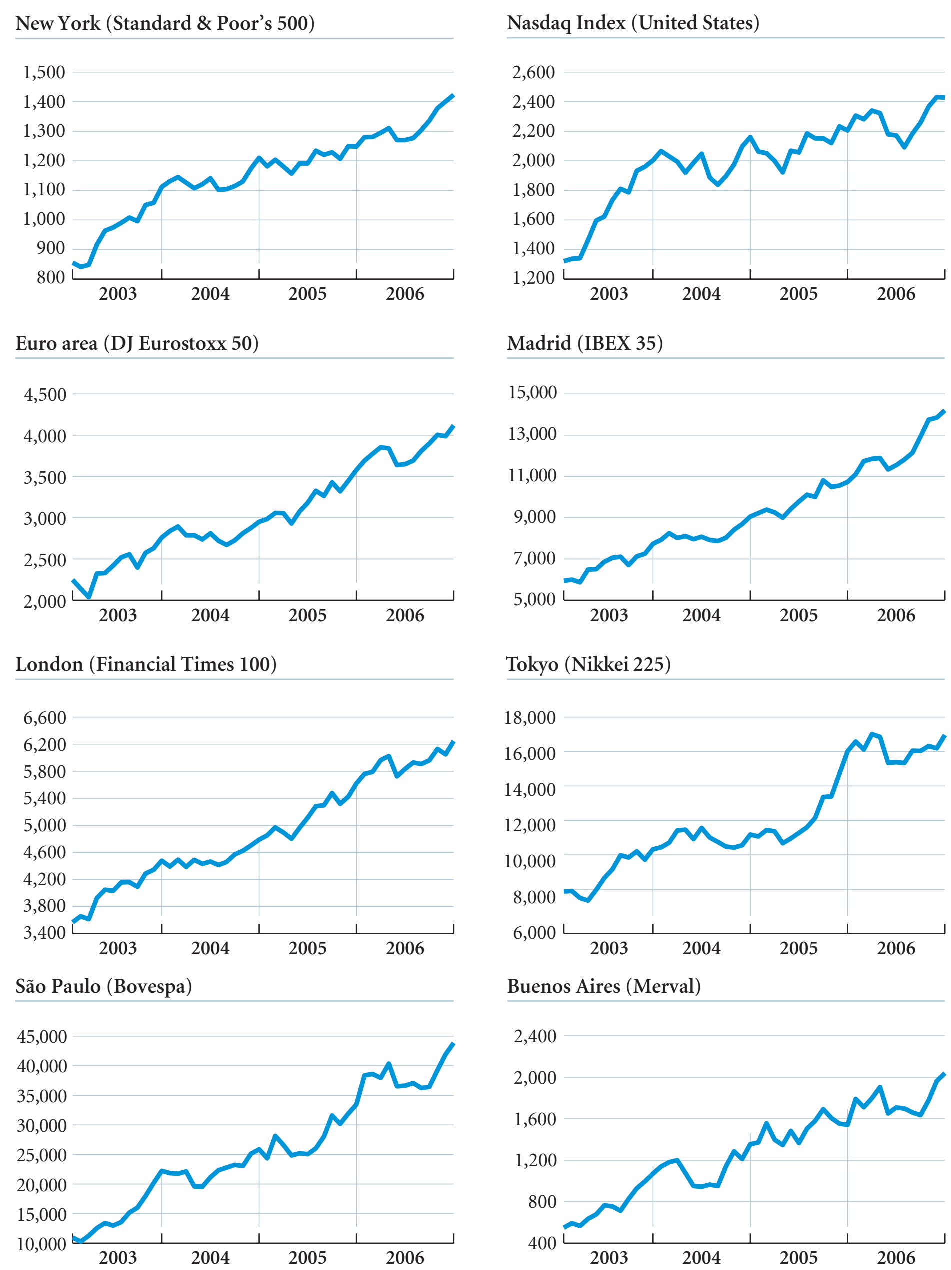
NOTES: (*) New York: Dow Jones Industrials, Standard & Poor's Composite, Nasdaq Composite; Tokyo: Nikkei 225; Euro area: DJ Eurostoxx 50; London: Financial Times 100; Frankfurt: DAX; Paris: CAC 40; Amsterdam: AEX; Milan: MIBTEL; Madrid: IBEX 35 for Spanish stock exchanges; Zurich: Swiss Market Index; Hong Kong: Hang Seng; Buenos Aires: Merval; São Paulo: Bovespa.
SOURCE: National stock exchanges and own calculations.

Dow Jones index continues to mark up all-time high records...

In the United States, the Dow Jones Industrials index continued to mark up new all-time highs. The Standard & Poor's index also showed the highest levels in the last 6 years although it stood below the highest level registered in 2000. The boom on the stock market was reflected in all sector indices with telecommunications and energy heading up gains for the year. On the other hand,

INTERNATIONAL STOCK EXCHANGES

Indices at month-end



NOTES: December 27, 2006.
SOURCE: National stock exchanges.

the Nasdaq index, which is representative of hi-tech shares, dropped after reaching its highest levels in recent years in November, and still stood at around half the peak in 2000. The optimism on the stock markets is based on expectations that inflation will moderate in 2007 with the gradual slowing-down of the economy and that things could then recover. Nevertheless, one risk could be that an economic slowdown might occur, arising from complications in the real estate market.

In the Euro Area, the DJ Eurostoxx 50 index, which includes the biggest companies in that area, reached its highest level since the year 2000 in the middle of December, although it still stood at nearly 25% below its record for the year. The main Euro Area stock markets showed notable annual gains with the Spanish stock market holding first place, reporting extraordinary capital gains of more than 30%.

In Spain, near the end of the year, the IBEX 35 index showed a series of gains for the seventh month in a row, having gone well above the 14,000 level, thus marking up all-time highs. The sharp growth of corporate profits and corporate moves in the energy, construction and banking sectors pushed up the Spanish selective index.

...as happening with IBEX 35.

Outside the Euro Area, the British stock market continued to rise going to its highest level in the past six years. In turn, the Japanese stock market recovered, driven by an improvement in export companies which were benefiting from a very weak yen.

Markets in the emerging countries generally marked up all-time highs toward the end of December in a favourable economic environment and thanks to increases in raw materials prices. As a result, they overcame the shock on December 19, following the 19% drop on the Bangkok stock market after the Thailandese authorities had announced the penalization of short-term capital movements, a move that brought a nervous response from foreign investors as well as heavy selling. In any case, the Thailandese market largely recovered the next day, following the revocation of the restriction as applied to shares. Among other stock markets, those in Poland, India, Indonesia, Hong Kong, Singapore, South Africa, Brazil, Mexico, Argentina and Venezuela recorded all-time highs in December.

Many emerging stock markets go to all-time highs.

Economic activity

Corporate situation remains excellent

Growth rate of activity of Spanish companies in first nine months of 2006...

The Quarterly Composite Company Balance Sheet figures issued by the Bank of Spain show the brilliant results obtained by non-financial companies in the first nine months of 2006. The sharp increase in production (12.5% year-to-year) and in intermediate consumption (15.4%) is in keeping with the sustained growth of Spain's economy. In overall terms, gross value added (GVA) of those companies included in the sample grew by around 6.9%, practically twice that in the same period the year before.

...pushing up return on equity to all-time highs.

The increase in economic activity was spread over all sectors, with its own peculiar characteristics in each case. The increase in GVA in retail trade (7.2%) is further evidence of the strength of consumption in that period. Having considerable influence on the sharp increase in GVA of energy companies (14.4%) was the reduction in production costs of electrical power companies. The most decisive factor in GVA growth in transport and communications companies (4.2% as against 0.7% in the same period of 2005) was growth of national demand. In turn, industrial GVA was up by 2.4%, close to one point more than one year earlier largely due to the increase in domestic demand for capital goods and greater strength in exports in general.

Contributing to the rise in labour costs (4.9% as against 3.7% in the same

PROFIT AND LOSS ACCOUNT OF NON-FINANCIAL COMPANIES

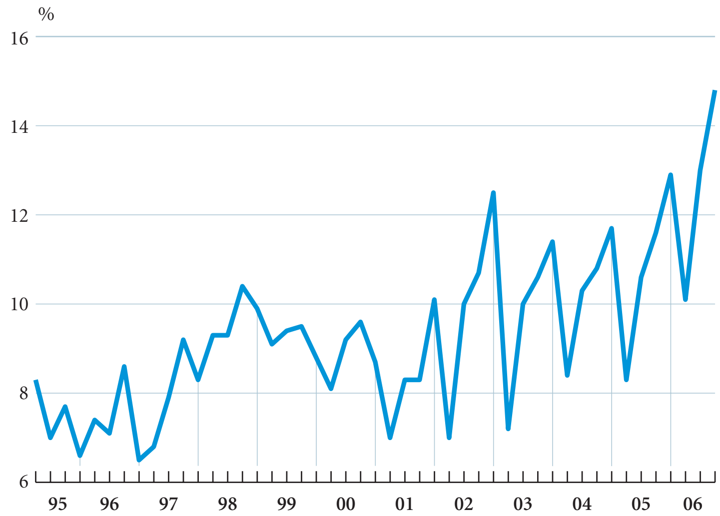
Annual change rates

	2005	Quarters: 1, 2 and 3	
		2005	2006
Value of production	12.8	12.4	12.5
Intermediate consumption	17.9	17.6	15.4
Gross Value Added (GVA)	**3.7**	**3.4**	**6.9**
Labour costs	3.8	3.7	4.9
Gross operating costs	**3.6**	**3.3**	**8.4**
Financial income	35.0	29.5	7.0
Financial costs	5.0	5.0	29.1
Depreciation and provisions	–0.1	–0.9	2.3
Net ordinary profit	**14.7**	**12.4**	**6.1**
Capital gains and extraordinary income	31.8	84.6	81.1
Capital losses and extraordinary costs	72.9	86.4	–7.2
Provisions and tax	–23.6	–19.6	92.8
Net profit	**27.7**	**25.9**	**19.4**

SOURCE: Bank of Spain (Quarterly Composite Balance Sheet Figures).

ALL-TIME HIGH RETURN ON EQUITY

Ordinary net return on equity before tax



SOURCE: Bank of Spain and own calculations.

period the year before) were the growth in employment (1.7%) and increase in average wages (3.1%, the same as one year earlier). The overall performance in economic and labour costs meant that gross operating profit grew at around 8.4%.

In the first three quarters of 2006 there was a much more contained increase in financial income (7.0%) than that recorded in 2005. On the other hand, financial costs rose sharply with an increase of 29.1%, brought about by the rise in borrowing by one large company in the telecommunications sector to finance taking control of another European company in the sector. This explains why growth of net ordinary profit was limited to 6.1%, sufficient nevertheless to raise the return on equity to 14.1%, a new all-time record.

Finally, the sharp increase in extraordinary income and capital gains (arising mainly from the sale of shares by some large companies) and the parallel increase in allocations to portfolio provisions in order to restore market value to certain foreign investments brought about an increase in net profit of 19.4%. Indeed, these were excellent results which consolidate the strong financial situation of Spanish companies and allow them to face their future plans with assuredness.

Growth stage of Spain's economy still extending

Spain's economy maintaining sharp growth rate at end of 2006.

At the final stages of 2006, Spain's economy continues to show great strength and even a profile of gradual increase in growth. National demand continues to show great strength, mainly in the investment component although in overall terms there are signs of a gradual moderation in growth rate due mainly to greater containment of consumption. The improvement in the foreign environment has meant some realignment in favour of a less negative contribution from the foreign sector which more than compensates for the smaller contribution from national demand.

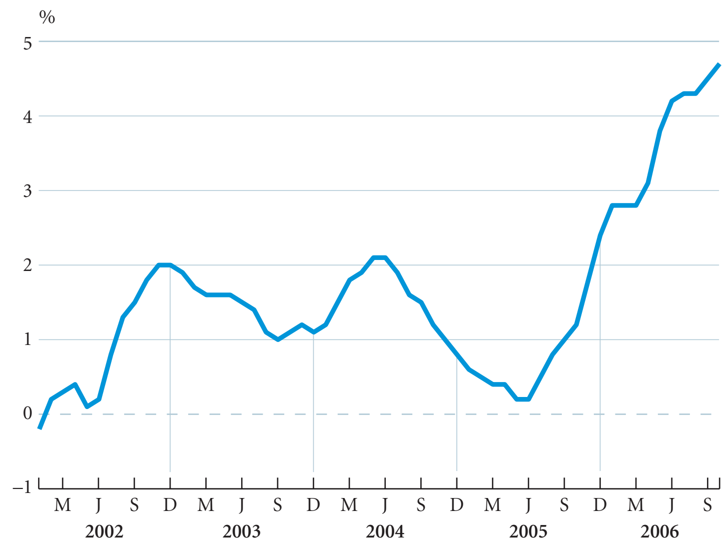
Industry consolidating recovery while construction maintains sharp growth.

On the supply side, something to point out is the consolidation of recovery in industry. In fact, latest figures confirm the profile of growth in the sector production index which, with adjustment for calendar differences, grew by 5.4% year-to-year in October. In the first 10 months of 2006 significant growth was recorded in nearly all main branches of activity, such as machine building (year-to-year increase of 11.0%), metallurgy (6.2%), metal products (5.1%). The food and drink sector, with a more moderate increase of less than 1%, and publishing, with a drop of 1.2%, were the most notable exceptions in this group. Among other activity indicators, with a lower relative weight in the whole, such as sharp growth in machinery and electrical material (18.6%), medical equipment (1.5%) and furniture (11.7%) came in contrast to the drops in the textile industry (4.5%), tobacco (14.4%), leather (1.2%) and computer equipment (0.5%), each due to specific situation in each case.

Construction in turn is still showing considerable vigour, greater than was foreseen in principal for this stage. Nevertheless, we note a somewhat contradictory situation. Some current indicators, such as cement consumption, point rather to a slowdown of growth although still remaining at high levels. The easing of housing and land prices are other signs coming from the real estate market running in the same direction. On the other hand, some later indicators, such as government tendering and approval for new projects have taken on considerable drive in recent months. The latter figure, however, should be taken with some caution linked as it is with the coming into force as of September of the new Building Code which, as it imposes tougher conditions, could have brought

INCREASING GROWTH OF INDUSTRIAL PRODUCTION

Year-to-year change in industrial production



NOTES: Cycle-trend series adjusted for calendar differences.
SOURCE: INE and own calculations.

about the bringing forward of some building projects.

With regard to services, we note a sustained growth overall with a tendency to moderate in certain cases. Retail trade, transportation and especially services to companies are maintaining a very expansionist state in contrast to that shown by information technologies which have lost strength in recent months. Tourism has reflected a somewhat irregular performance over the year but the overall balance may be considered moderately positive. While the number of foreign tourists and overnight stays in hotels grew at a good rate, the increase in financial inflows was much more moderate due to a drop in average spending per tourist.

On the demand side, the less dynamic performance in private consumption must be linked to losses of purchasing power brought about by high inflation rates in the first half of 2006 and the toughening of financial conditions following the successive increases in official interest rates by the European Central Bank. In any case, strong job creation and the increase in household wealth, arising from the revaluation of financial assets and real estate assets have

SUPPLY INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006				
			3Q	4Q	1Q	2Q	3Q	October	November
Industry									
Electricity consumption (1)	4.2	3.4	2.9	2.7	2.1	3.3	5.8	4.3	1.9
Industrial production index (2)	1.6	0.7	0.7	1.6	2.6	4.0	4.2	5.4	...
Confidence indicator for industry (3)	–2.5	–4.9	–4.8	–4.0	–5.4	–2.7	–2.3	–2.0	–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	16.9	...
Construction									
Cement consumption	3.9	7.3	7.8	6.1	17.2	4.0	4.0	12.0	6.8
Confidence indicator for construction (3)	13.6	22.4	22.7	28.3	15.3	11.7	14.7	13.0	16.0
Housing (new construction approvals)	8.0	6.2	2.8	10.6	18.5	6.3	49.5	...	...
Government tendering	18.3	18.5	3.1	36.9	15.0	34.8	19.3	...	...
Services									
Retail sales	5.5	4.4	4.4	3.8	5.2	3.8	5.9	4.4	...
Foreign tourists	3.1	6.6	8.1	5.1	0.6	9.5	3.7	3.6	1.4
Tourist revenue inflows	3.8	5.8	13.9	4.9	–7.6	3.0	3.9	...	...
Goods carried by rail (km-tonnes)	–3.5	–3.2	–2.3	11.0	8.1	–2.7	–3.3	–4.4	...
Air passenger traffic	8.0	9.2	10.3	9.2	5.2	10.1	4.5	6.1	6.4
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.

acted as a containing dyke thus justifying the strength still being seen in this figure.

Consumption tending to slight slowdown but investment continues to show very strong.

In the final months of the year, passenger car registrations again reported positive change thus breaking the chain of decreases recorded in the previous part of the year, while the consumer confidence index tended to improve slightly following the drop seen in previous months. In the same way, national production of consumer goods (particularly consumer durables) showed a somewhat more expansionist situation in this later stage. With regard to investment in capital goods, the profile of increase both in domestic production and imports reflects the strength of demand based on the recovery of industry, the better situation of companies and financial conditions which are still favourable.

Favourable growth prospects for Spain's economy in 2007.

Following 13 years of uninterrupted growth, the prospects for Spain's economy for 2007 are still very positive, based on a continuation of low real interest rates, positive effects on supply and demand figures from immigration and recovery of Spain's export markets. Optimism has also settled into the government which has revised upward its forecasts for coming years. In bringing up to date the Stability Programme for 2006-2009, the Spanish government raised its growth forecasts to 3.8% in 2006, 3.4% in 2007 and 3.3% in 2008 and 2009. The upward revision of growth forecasts will also show up in the performance in the labour market and better budgetary results than those forecasts some months back. In addition, according to the government, the pattern of growth will enjoy better balance in coming financial years, thanks to the greater relative weight which will be seen in production investment and

DEMAND INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006				
			3Q	4Q	1Q	2Q	3Q	October	November
Consumption									
Production of consumer goods (*)	–0.1	0.9	1.4	0.9	0.6	2.1	1.9	5.1	...
Imports of consumer goods (**)	13.4	7.9	7.8	8.6	20.5	5.9	2.4	13.6	...
Car registrations	9.8	0.8	2.3	–4.5	2.4	–4.3	–5.3	5.8	0.1
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	–10.0
Investment									
Capital goods production (*)	1.9	–0.1	–1.3	0.8	6.7	7.6	8.0	9.6	...
Imports of capital goods (**)	14.9	20.4	13.5	8.2	10.0	–5.0	6.5	31.5	...
Commercial vehicle registrations	11.7	13.2	13.9	11.5	7.4	–0.2	0.5	9.9	–0.2
Foreign trade (**)									
Non-energy imports	9.8	6.0	4.7	4.5	13.7	4.7	8.9	17.5	...
Exports	5.2	0.2	1.2	0.1	12.7	3.7	1.7	9.3	...

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.

exports, with a drop in construction. Nevertheless, no new moves are foreseen to correct one of the main weak points of Spain's economy: low productivity. According to forecasts of the programme mentioned above, growth of this figure will increase moderately in 2006 (to 0.6%) and will rise slightly to 0.8% in 2007. No appreciable progress is expected in correcting the foreign imbalance: the current account deficit will go above 8% of the GDP in 2006 and will be close to 9% in the following three years.

Labour market

Employment continues to show very strong growth...

...among Spanish-born workers and those of other nationalities.

Labour market continues to show very strong

At the end of 2006 the labour market was maintaining considerable strength in keeping with the good state of Spain's economy. In November, total registrations with Social Security grew by 3.3% year-to-year, with a consolidated rate of increase both in the group made up of Spanish-born workers and among foreign workers. In the last three months we have noted a fairly stable proportion of registrations for both groups. Close to 75% of new registrants in the period mentioned had Spanish nationality.

On November 30 the number of Spanish registrants came to 17 million persons, equivalent to 90% of total registrations (four percentage points less than three years ago). In this segment, the growth rate, which held relatively stable throughout 2004 and 2005, tended to gradually increase during 2006 to the point where it finally went above 2.5% year-to-year, as can be seen in the following graph. On the other hand, among the group of foreign workers (1.9 million persons), following the boom in registrations seen in 2005 as a result of the process of normalizing work status that year, the growth rate

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2004	2005	2005		2006				
			3Q	4Q	1Q	2Q	3Q	October	November
Persons registered with Social Security									
Wage-earners	2.7	4.8	5.9	6.3	6.3	5.3	3.9	3.4	3.5
Industry	*–0.5*	*–0.5*	*–0.3*	*–0.4*	*–0.3*	*–0.0*	*–0.0*	*0.0*	*0.2*
Construction	*5.6*	*8.6*	*10.0*	*10.9*	*11.0*	*9.5*	*7.5*	*6.9*	*6.5*
Services	*3.9*	*5.7*	*6.4*	*6.8*	*6.6*	*5.8*	*4.6*	*3.9*	*4.1*
Non-wage-earners	3.2	2.6	2.5	2.4	2.3	2.2	2.1	2.2	2.2
Total	**2.8**	**4.4**	**5.3**	**5.6**	**5.5**	**4.8**	**3.6**	**3.1**	**3.3**
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	62.3
Temporary	11.4	4.6	9.7	8.9	13.7	5.5	0.5	6.1	0.1
Total	**11.5**	**5.0**	**9.8**	**9.5**	**15.0**	**6.4**	**4.1**	**11.1**	**5.8**

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.

gradually eased to stabilize at around 8.5% year-to-year in the past two months.

From a broader point of view, we note that the total number of those registered with Social Security showed a increase of more than 600,000 persons in the past 12 months. Close to half of these new registrations showed up in such fields as real estate business, company services and construction, once more showing the importance of those sectors in growth of Spain's economy. The group of freelance workers and those related to the retail trade and motor vehicle repair also played a notable role in this increase with these together contributing nearly a third of this increase.

Another facet of employment worth noting is the satisfactory trend in permanent hiring following recent changes in the current regulations. In the past two months, contracts of this type have risen at a rate of more than 30% year-to-year in contrast to the slower growth of temporary hiring contracts although the latter continue to make up most contracts in absolute terms.

Real estate business, company services and construction take up half employment created in past 12 months.

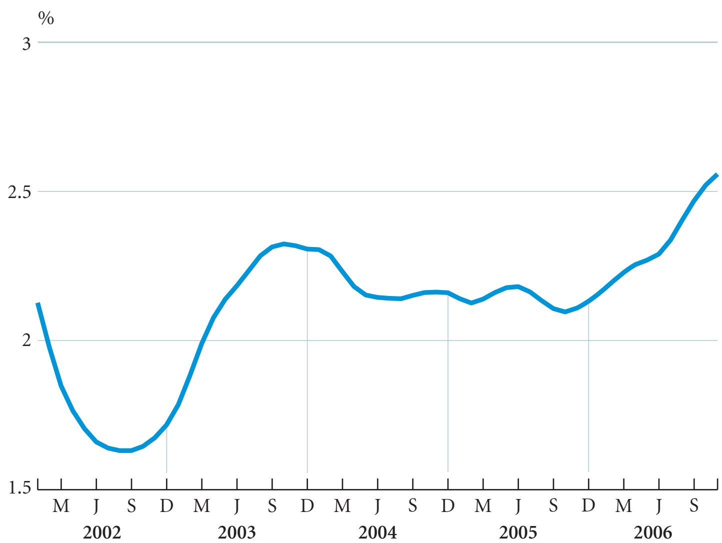
Downward trend in registered unemployment

At the end of November, the number of registered unemployed at Public Employment Service offices was up by 30,328 persons compared with the month before so that the figure for total unemployment was again above two million. Nevertheless, the increase reported in November was lower than that for the same month in 2005, along with the added factor that, in seasonally-adjusted terms, unemployment in fact continues to decrease. In any case, the total number of registered unemployed at the end of November (2,023,164 persons) is 3.5%

Permanent job contracts keep increasing.

GROWING NUMBER OF SPANIARDS REGISTERED WITH SOCIAL SECURITY

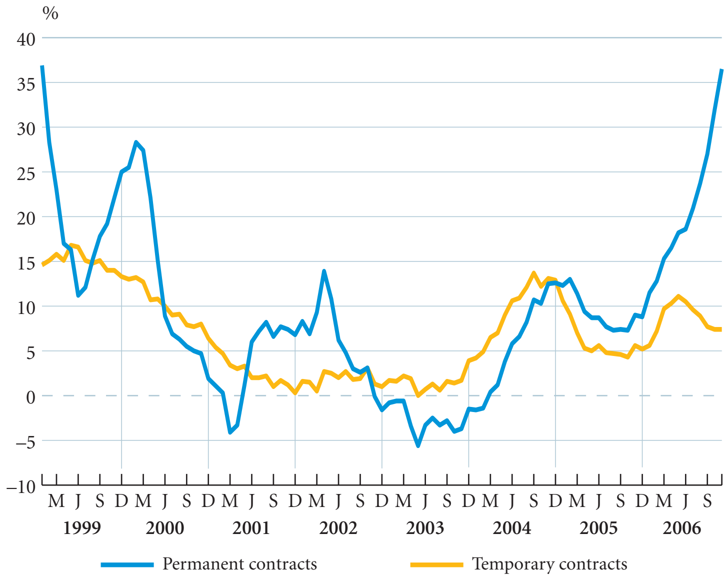
Year-to-year change in number of Spanish workers registered with Social Security



NOTES: Cycle-trend statistical series.
SOURCE: Bank of Spain and own calculations.

INCREASE IN PERMANENT JOB CONTRACTS

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



SOURCE: INEM and own calculations.

lower than one year earlier and, furthermore, is showing a downward trend.

Compared with November 2005, unemployment dropped more sharply among the male group (decrease of

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

November 2006

	No. of unemployed	Change over December 2005		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	63,888	–1,339	–2.1	–2,849	–4.3	3.2
Industry	275,517	–25,802	–8.6	–18,014	–6.1	13.6
Construction	216,746	–28,354	–11.6	–7,087	–3.2	10.7
Services	1,238,456	–27,933	–2.2	–44,344	–3.5	61.2
First job	228,557	3,655	1.6	–122	–0.1	11.3
By sex						
Males	777,062	–74,901	–8.8	–43,973	–5.4	38.4
Females	1,246,102	–4,872	–0.4	–28,443	–2.2	61.6
By age						
Under 25 years	255,580	–20,315	–7.4	–31,090	–10.8	12.6
All other ages	1,767,584	–59,458	–3.3	–41,326	–2.3	87.4
TOTAL	**2,023,164**	**–79,773**	**–3.8**	**–72,416**	**–3.5**	**100.0**

SOURCE: INEM and own calculations.

5.4%) than in the female group (2.2%) and among those under 25 years of age (10.8%) than in all other ages (2.3%). Among less favourable aspects, we should point out that nearly half of those unemployed show a profile related to some degree of low or very low occupational level. This refers to the likelihood of their finding a job related to three basic variables: length of unemployment, geographical range of job search and the number of jobs asked for.

By sector of economic activity, what is particularly significant is the sharp decrease registered in industry (6.1% year-to-year) in keeping with the vigorous recovery being seen in this sector. The decrease in construction and services (more than 3% year-to-year) is holding to the same trend as in recent months. Finally, we should point out that unemployment was down in all autonomous communities except Andalusia where it rose by 1.1%. In all the others, the biggest decreases were recorded in Aragon, Cantabria, Galicia and the Basque Country (between 8% and 12%).

Registered unemployment tending to drop...

Rise in wage costs

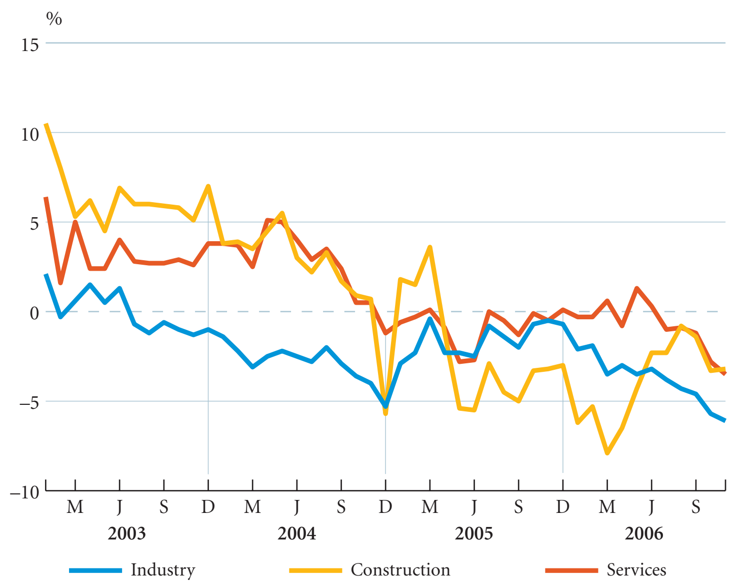
Wage costs per worker underwent a sharp rise in the third quarter of 2006, according to figures from the quarterly labour cost survey. The year-to-year growth rate stood at 4.0%, nine decimals more than in the previous quarter and nearly twice that for one year earlier. This upward trend may also be noted in figures for the national accounts although with a gentler growth profile in this case. The upward trend in wages, if confirmed in coming months, could prove an obstacle to consolidating the drop in inflation noted recently.

The increases were spread over all economic sectors, with growth rates standing above 4% in all cases. From a

...with especially sharp decrease in industry.

SHARP DROP IN UNEMPLOYMENT IN INDUSTRY

Change in registered unemployment compared with same period year before



SOURCE: INEM and own calculations.

WAGE INDICATORS

Percentage change over same period year before

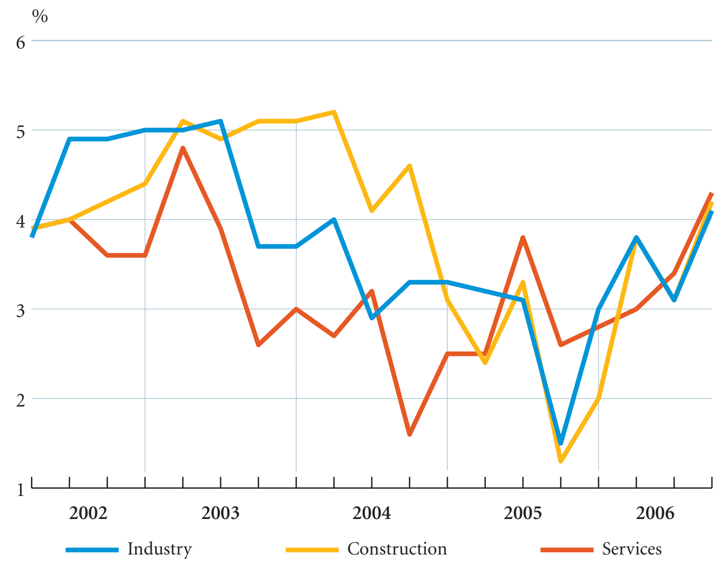
	2004	2005	2005 3Q	2005 4Q	2006 1Q	2006 2Q	2006 3Q
Increase under general wage agreements (*)	**3.0**	**3.1**	**2.9**	**3.1**	**3.1**	**3.2**	**3.2**
Wage per job equivalent to full-time work (**)	**3.1**	**2.6**	**2.2**	**2.7**	**2.9**	**3.3**	**3.4**
Quarterly labour cost survey							
Wage costs							
Total	2.8	2.6	1.9	2.5	3.0	3.1	4.0
Industry	*3.3*	*2.7*	*1.5*	*3.0*	*3.8*	*3.1*	*4.1*
Construction	*4.2*	*2.3*	*1.3*	*2.0*	*3.8*	*3.1*	*4.2*
Services	*2.5*	*2.9*	*2.6*	*2.8*	*3.0*	*3.4*	*4.3*
Average wages per hour worked	3.6	3.2	2.8	2.9	0.0	7.1	4.4
Other labour costs	3.6	3.6	3.7	3.1	4.4	4.9	2.6
Work day (***)	–0.8	–0.6	–0.9	–0.4	3.0	–3.8	–0.3
Farm wages	**2.8**	**3.1**	**2.7**	**3.0**	**2.9**	**2.6**	**3.2**
Labour cost in construction	**3.5**	**4.3**	**4.2**	**4.3**	**4.2**	**4.5**	**4.4**

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

geographical point of view, the highest rates were recorded in Aragon (6.1% year-to-year) and Castile-La Mancha (5.8%) while the lowest were seen in the

INCREASING GROWTH OF WAGE COSTS

Year-to-year change in wage cost per worker per month



SOURCE: Quarterly Labour Cost Survey and own calculations.

Basque Country (1.8%) and Navarre (1.7%). In absolute value terms, the highest wage costs were reported in the Basque Country (1,880 euros per worker per month), Madrid (1,857) and Navarre (1,721). At the opposite extreme came Canary Islands (1,300 euros) and Murcia (1,311).

Given that total effective hours worked dropped slightly (0.3% year-to-year), the increase in average earnings per hour worked (4.4%) was higher than that indicated by wages. On the other hand, growth of other labour costs (compulsory contributions to Social Security, among others) was down appreciably going to 2.6%, which explains that total labour cost of companies falls within a growth trend somewhat lower than that indicated earlier for wages.

Wage costs rising...

To sum up, it should be remembered that the excessive growth of wages, along with the very slow increase in productivity, is a rather undesirable combination for improving the competitiveness of Spain's economy. In the past two years, unit labour costs in Spain have grown by around 2.3% year-to-year on average, nearly one percentage point more than in the Euro Area.

...presenting further problems for improving Spain's competitiveness.

Prices

Drop in core inflation

Lower drop in fuels in November brings slight rise in general inflation index.

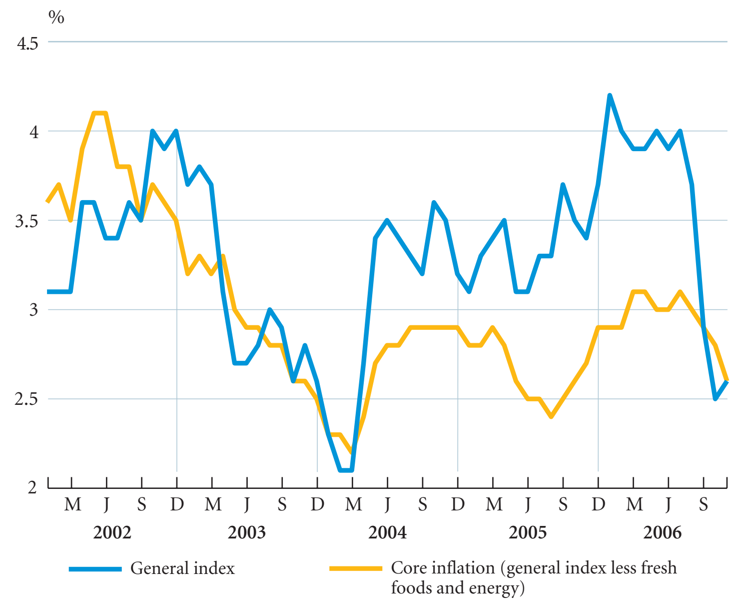
In November, the core of consumer prices continued the downward trend begun in August. As a result, underlying inflation, which excludes the most volatile elements of the general index (unprocessed foods and energy products), was down to 2.6%. Nevertheless, the decrease in fuels was not as sharp as in November 2005 so that the year-to-year change in the general inflation index rose by one decimal to 2.6%. As a result, the general inflation index and that for underlying inflation stood at the same level.

As a result of the less favourable trend in fuels and fuel oils, energy products showed an increase of 0.3% in the last 12 months as against a drop of 1.9% in October. In turn, fresh foods eased slightly. The drop in mutton, in contrast to the rise seen in the same month the year before, contributed to this moderation in prices. Nevertheless, unprocessed foods still showed an annual increase of 5.0%. These increases seem to be largely due to higher demand as a result of tourism and population growth.

Processed foods, including drink and tobacco, continued to ease and their

GENERAL INFLATION IN LINE WITH CORE INDEX

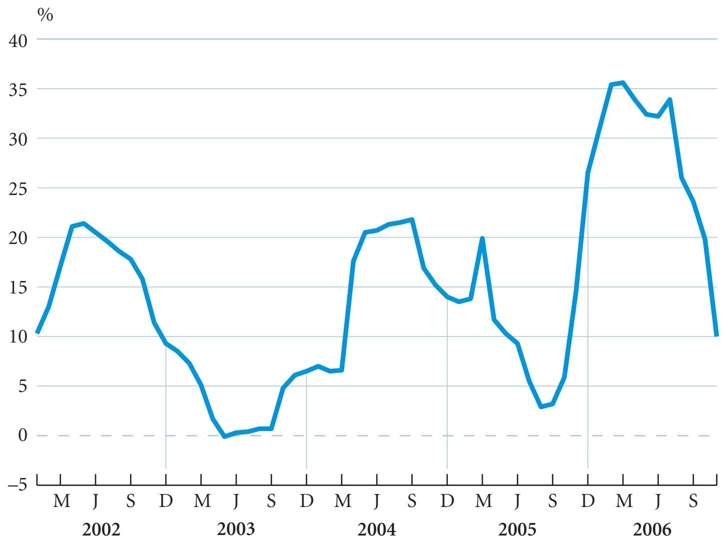
Year-to-year change in CPI



SOURCE: National Institute of Statistics and own calculations.

SHARP DROP IN COOKING OIL PRICES

Year-to-year change in cooking oils included in CPI



SOURCE: National Institute of Statistics and own calculations.

inflation rate dropped by a half-point to 2.9%. The drop in cooking oils during the month was notable as it brought a sharp moderation in the year-to-year change rate from 20% to 10% as a result of the drop in prices at origin of olive oil in view of the prospects of a good olive harvest. On the other hand, the price of tobacco rose by two decimals in November following increases in taxes on cheaper brands under government decree in view of the fact that previous

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	0.2	2.4	2.6
December	0.2	3.7	3.7			

SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

November

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2005	2006	2005	2006	2005	2006
By type of spending							
Food and non-alcoholic beverages	122.6	0.6	0.2	2.9	2.6	3.1	3.9
Alcoholic beverages and tobacco	122.9	0.1	0.1	5.0	0.9	5.0	1.0
Clothing and footwear	123.2	2.9	2.9	2.4	2.3	1.6	1.3
Housing	122.8	0.2	0.0	6.1	4.8	6.0	4.7
Furnishings and household equipment	111.9	0.4	0.4	1.9	2.4	2.2	2.7
Health	108.1	0.0	0.1	0.7	1.6	0.8	1.6
Transport	118.4	–1.8	–0.3	7.2	1.4	5.8	0.5
Communications	90.3	–0.0	–0.2	–1.5	–1.2	–1.6	–1.4
Recreation and culture	101.8	–0.5	–0.8	–0.7	–2.0	0.1	–0.7
Education	126.4	0.3	0.6	4.0	4.3	4.1	4.3
Restaurants and hotels	125.8	–0.0	–0.0	3.9	4.1	4.2	4.4
Other goods and services	119.2	0.1	0.1	3.1	3.6	3.2	3.9
By group							
Processed food, beverages and tobacco	119.6	0.5	0.0	3.0	2.1	3.2	2.9
Unprocessed food	128.9	0.6	0.4	3.3	3.0	3.6	5.0
Non-food products	117.3	0.0	0.3	3.6	2.4	3.4	2.3
Industrial goods	113.2	0.0	0.6	3.8	1.6	3.1	1.0
Energy products	*120.7*	*–2.9*	*–0.7*	*12.0*	*2.2*	*9.3*	*0.3*
Fuels and oils	*124.7*	*–3.8*	*–1.0*	*15.8*	*1.1*	*12.0*	*–1.4*
Industrial goods excluding energy products	*110.9*	*1.1*	*1.0*	*1.3*	*1.4*	*1.2*	*1.2*
Services	122.1	0.0	0.0	3.5	3.2	3.8	3.7
Underlying inflation (**)	117.4	0.5	0.3	2.6	2.3	2.7	2.6
GENERAL INDEX	**118.6**	**0.2**	**0.2**	**3.5**	**2.4**	**3.4**	**2.6**

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

Communications and package tours continue to drop over past 12 months.

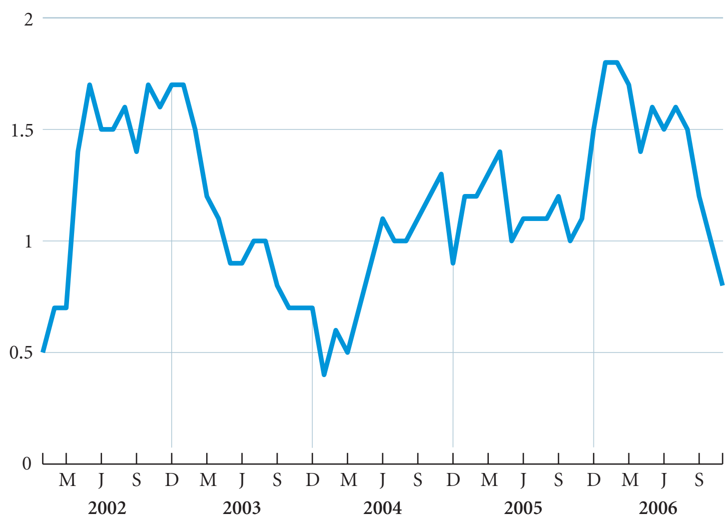
increases had scarcely been applied by the tobacco companies. In any case, tobacco alone showed an annual increase of 0.4%.

Non-energy industrial goods showed a some slight moderation as a result of heavy foreign competition. As a result, the change rate in the past 12 months dropped by one decimal to 1.2%.

Services also continued to slightly lower their rate of price increases and the change rate in this case stood at 3.7%. In November, we should point out the drop in communications of 1.4% over the past year, 2 decimals less than in the month before. At the same time, package tours sharpened the reduction in prices. On the other hand, the annual change rate in education rose by 3 decimals to 4.3% because of increases in education at the kindergarten, primary and secondary levels. The fact that they are less subject to foreign competition partly explains why services prices

THE INFLATION DIFFERENTIAL WITH THE EURO AREA DROPS TO LOWEST LEVEL IN PAST TWO AND A HALF YEARS

Percentage points year-to-year change



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

generally grow substantially above the average.

Underlying inflation in December will remain contained. As a result, the general CPI index will likely end the year at around its current level, substantially below 3%, which will mean a notable improvement over the 3.7% seen in 2005. In 2007, increases of 2.8% in electrical power and gas tariffs have already been announced which will have some impact in January. Nevertheless, prospects for prices in 2007 are relatively favourable so that the CPI could end the year at a level similar to that for 2006 if oil prices do not bring any unpleasant surprises.

In addition, the harmonized consumer price index for the European Union rose by 2.7% from November 2005 to November 2006. During the same period, the harmonized CPI for the European Monetary Union rose by 1.9% as against 1.6% in October so that the inflation differential dropped to 0.8 decimals, the lowest figure since May 2004. While it still has not gone away, we can see some moderation in this problem that harms the competitiveness of Spain's economy.

Halt to moderation in wholesale prices in November

The downward trend in the annual change rate for producer prices was broken in November. In fact, the general index showed a year-to-year increase of 3.6% that month, two decimals more than in October. This slight rise was due to a lower monthly drop in energy prices compared with November 2005 and to a relatively worse performance in consumer goods and capital goods.

In any case, energy prices showed an annual rise of 1.0% and, among these, coke and refined oil products showed a drop of 5.8%. In turn, inflation in annual terms for consumer goods and capital goods stood at the same level, namely

CPI likely to end 2006 at around current inflation level.

Price prospects for 2007 relatively favourable.

Rise of 3.6% in producer prices in past 12 months ending November, especially in intermediate products.

Import prices continue to ease in October.

October shows slight rise in farm prices at origin.

2.5%. What is notable is that some sectors with sharp increases in productivity reduced prices over the past year, such as in the manufacture of computer equipment and electronic and communications equipment. On the other hand, intermediate goods had shown an increase in prices of more than twice that amount (6.8% in the last 12 months ending in November) although the annual rate was down by one decimal. Metallurgy prices eased somewhat but stood at 19.3%, above one year ago as a result of the sharp increase in metal prices.

On the other hand, import prices continued to moderate in October, according to figures from the survey carried out by the National Institute of Statistics. The annual change rate of the general index for import prices was down three decimals to 2.9%. According to this source, consumer goods and capital goods showed very low annual inflation, (below 1%) due to strong world competition. On the other hand, intermediate goods showed an annual price increase of 8.9% due to the rise in many raw materials.

With regard to farm products, prices obtained by agricultural farmers rose slightly in October after having fallen below the level of one year earlier in September. They thus showed an annual increase of 2.7%, substantially less than the corresponding heading in the CPI.

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											
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	0.4	5.7	3.2	2.5	7.2	10.2	2.3	–0.6	–0.5	4.0	3.8
September	–0.2	4.2	2.7	2.5	6.7	4.1	0.8	2.4	–5.0	1.0	–
October	2.7	3.4	2.3	2.4	6.9	0.5	1.7	0.1	–8.2	4.5	–
November	...	3.6	2.5	2.5	6.8	1.0	...	...	...	...	...

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

Foreign sector

Trade deficit again increases in October

The trade deficit brought some surprises in October. The most significant were as follows. After 16 consecutive months in which the year-to-year change in the cumulative trade deficit for 12 months had slowed down, in October that trend was turned around.

To be specific, the growth of the trade deficit (cumulative total for 12 months) compared with one year earlier was 18.3% in October, as against 17.9% in September. The export/import ratio has also dropped slightly going to 65.4% in October, two decimals less than in September. Behind this performance we find a further increase in imports (growth of 13.3% year-to-year as cumulative

Trade deficit stops easing off due to sharp increase in imports.

FOREIGN TRADE

Cumulative figure for 12 months ended October 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	40,335	31.5	15.7	7,530	23.4	4.5	–32,805	18.7
Consumer goods	72,494	10.6	28.2	62,387	6.6	37.1	–10,107	86.1
Food	*14,551*	*4.9*	*5.7*	*19,881*	*7.3*	*11.8*	*5,330*	*136.6*
Non-foods	*57,943*	*12.2*	*22.5*	*42,506*	*6.2*	*25.3*	*–15,437*	*73.4*
Capital goods	28,019	6.1	10.9	17,268	23.9	10.3	–10,751	61.6
Non-energy intermediate goods	116,265	11.3	45.2	80,936	10.5	48.1	–35,329	69.6
By geographical area								
Euro area	126,096	7.5	49.0	94,584	7.0	56.3	–31,511	75.0
Rest of European Union EU 25	25,130	12.8	9.8	24,012	9.4	14.3	–1,118	95.5
Russia	7,162	44.7	2.8	1,439	38.6	0.9	–5,723	20.1
United States	8,130	2.4	3.2	7,235	18.7	4.3	–895	89.0
China	13,595	22.1	5.3	557	124.1	0.3	–13,037	4.1
Japan	5,882	0.2	2.3	1,258	8.3	0.7	–4,625	21.4
Rest of Asia	23,004	25.3	9.0	6,608	7.5	3.9	–16,436	28.7
Latin America	21,867	33.2	8.5	4,306	1.0	2.6	–17,562	19.7
OPEC	14,552	43.3	5.7	10,347	40.9	6.2	–4,205	71.1
Rest	11,654	–7.7	4.5	17,775	17.5	10.6	6,121	152.5
TOTAL	**257,112**	**13.3**	**100.0**	**168,120**	**10.7**	**100.0**	**–88,992**	**65.4**

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

Capital goods and consumer goods most dynamic export segments while energy group leads imports.

figure for 12 months) which beat imports (year-to-year increase of 10.7%).

This increased strength in imports, arising from the notable drive in domestic demand, was mainly due to the contribution of non-energy intermediate goods. In terms of growth, in spite of a further drop, energy imports continued to be the most dynamic group, followed by non-food consumer goods.

In turn, the performance in exports is still being led by the capital and energy groups, both with growth of more than 23% year-to-year, as usual as a cumulative figure for 12 months. The group contributing most was non-energy intermediate goods.

Improvement in Europe reflected in increased trade.

The most dynamic foreign markets continue to be those of lower relative size. Exports to show the most growth were those going to China but this trading partner represents scarcely 0.3% of Spanish exports and, furthermore, the value of goods imported is 24 times that of Spanish sales to the Asian giant. With regard to Spain's main trading partners, the recovery of the Euro Area is favouring a 7% year-to-year growth of exports, a rate of increase slightly lower than that seen in Spain's imports from the Euro Area.

Outside the Old Continent, there was notable strength in exports to United States (year-to-year increase of 19%) and to OPEC (Organization of Petroleum Exporting Countries) with an increase of 41% year-to-year with an important difference in figures. Spain's imports from the United States were up by a mere 2.4% year-to-year while those to the OPEC countries were up 43%.

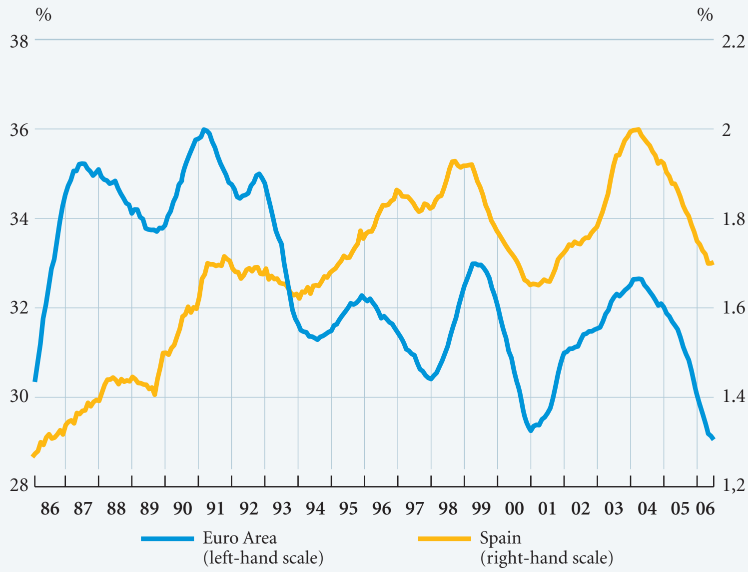
Spain's foreign competitiveness holding up... for the moment

Patronius told Count Lucanor the story of a man who had only lupin seeds to eat. Complaining all the while, he kept throwing away the empty shells along the way. Then, he noticed someone who followed behind was quietly picking them up, so he stopped complaining. This 14th century fable synthesizes Spain's competitive position in the world today. With the world's second largest trade deficit in absolute terms, the competitiveness of exports to compensate its big imports is a crucial question. Spain is like the man who ate lupin seeds. In this box, we shall see that it looks good compared to most of its closest trading partners. The problem is that these are the ones that eat the shells due to a serious worsening in their exports position. With the Asian economies and, to a lesser extent, those of Eastern Europe, the comparison is not as favourable.

In order to tackle a comparative analysis of foreign competitiveness, we may observe the behaviour of the exports share over the world total. The share may vary because of relative changes in labour costs or productivity, specific internal factors or modifications in exchange rates. In any case, the share of exports in the world in current terms indicates the relative attraction enjoyed by products of national manufacture in world markets. This share may grow because of an increase in export prices if combined with an increase or maintenance of volume and, vice versa, something that is only possible with gains in competitiveness. Highpriced exports offering products with little attraction could make us feel rich for a time but the share in current terms would end up dropping through lower volumes of exports and the country would end up suffering the consequences. We therefore consider that the share of global exports is an indicator of the level of health of the foreign sector, beyond that of the domestic demand cycle itself, which more directly affects imports.

SPAIN DOING BETTER THAN OTHERS

Export of goods in relation to world total in current dollars



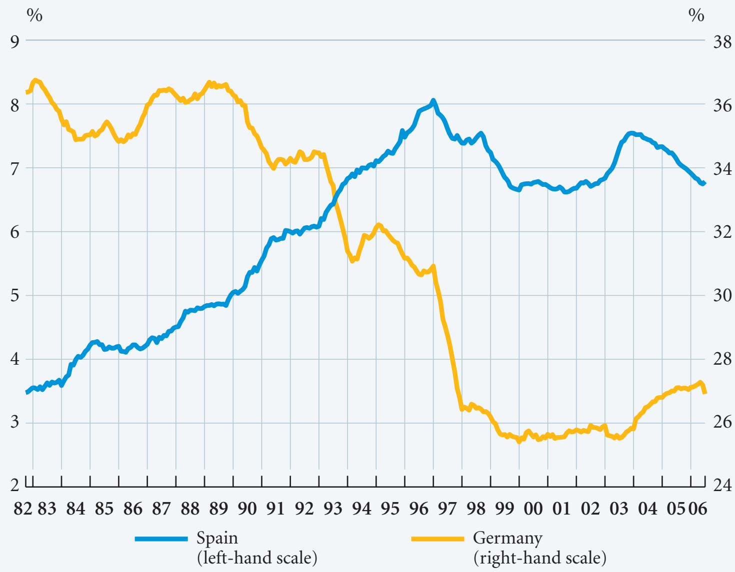
SOURCE: International Monetary Fund and own calculations.

The share of the world total held by Spain's exports has thus been growing constantly and reached 2% of total world exports at the end of 1998 and in June 2006 was 1.8%. Since Spain's economy adopted the euro, the upward trend was lost and the share has hovered around the latter rate with notable swings, as the graph shows. This relative stability in market share seems good when compared with the downward trend in the main economies, which eat the shells left by China. Since the end of 1998 to June 2006 the United States has gone from 12.6% to 8.8%, the United Kingdom from 5.0% to 3.5%, Japan from 7.2% to 5.6% and the Euro Area from 32.5% to 29.1%. Germany, still the leading world exporter of goods, has also seen its share drop from 10.0% to 9.1%. Things thus do not seem to fare so badly for Spain's economy.

But other things happen in this world that complicate any final verdict about the health of the export sector. Goods examples of it are the rapid rise of China's exports, that starting from a 2% of global exports in current dollars at the beginning of the Nineties reached 7.7% in 2006, the rise in oil prices and other raw materials which swells the share of exporting countries against the rest, or exchange rate fluctuations, with an euro that appreciated a 57% against the dollar since October 2000 and against all those currencies that in some way or another are tied to the dollar.

MONETARY UNION BENEFITS GERMAN EXPORTS MOST

Exports of goods to the Euro Area compared with total imports from other members (*)



NOTES: (*) In current terms.

SOURCE: International Monetary Fund and own calculations.

To overcome these mentioned distortions and to have an accurate track of the competitive course of Spain's exports, we may try to compare Spain with other countries of the Euro Area. In recent decades, the share Spain's exports represent in the internal trade of the Euro Area has been growing continuously, going from 3.4% in 1980 to a high of 8.1% in 1996. The increased opening up of the economy and the process of modernization got support from an exchange rate that, following successive devaluations, kept Spanish products at low price levels. With the euro, the recourse to a weak peseta disappeared whereas relative efficiency of the production fabric became more important. As a result, the upward trend flattened out with a slight downward shift that led to a 6.8% in June 2006, as the accompanying graph shows. Germany and the Netherlands represent the opposite case. Without further appreciations of the deutschemark and the florin, the drop in their shares turned an upward trend. Once more those who eat the shells of lupin seeds cheer us up as in this case they are precisely all Spain's main importers but Germany. France, Italy and Portugal take 36.3% of Spain's total exports of goods and have seen substantial drops in their share of trade between those in the Euro Area. This even worse situation of these three important trading partners improves the verdict for Spain's exports.

The other side of the coin lies in East Asia which, excluding Japan, includes a large part of the World's most dynamic economies. Nevertheless, the share of Spanish goods in the region total imports is extremely small (0.2% in June 2006) and furthermore is on a downward trend. Here, there is no one to compare with. Spain's exports to China are a 14th of Germany's, a quarter of those from France and a third of Italy's. They also stand below Dutch exports and even small Finland does it better. Another weak point lies in Eastern Europe. Spanish exports reach only a 1.6% of the ten new EU member states foreign purchases and, furthermore, the ratio goes downward since 2003. A stark contrast is the strong position of Germany, that exports a quarter of the new EU partners total purchases.

With a somewhat more positive balance, the export share of Spanish goods in purchases by the United States is holding up. Exchange rates, oil prices and China are shifting the share downward but, if we exclude the special case of Ireland, Spain stands ahead of most countries in the Euro Area, only behind Ireland and Austria, even with Portugal and Greece, and better than the performance of the other large European countries. The trend in the share of Spain's world exports thus comes up with a better-than-expected verdict. Aggregate drops are small although there are significant challenges to be addressed: East Asia and Eastern Europe. This positive view is largely due to the relatively poor performance of European economies such as France, Italy and Portugal, although looking at the one who eats shells of lupin seeds has its risks.

For the future ahead there is a positive factor and a warning. Exports had been growing in terms of the gross domestic product up to the end of 2000. Later there was a drop, less in the case of goods, which ended in March 2005, afterwards things are getting well back to normal. The warning comes from the settled tendency of the large multinationals, whether US or Japanese, to relocate their production toward Asian markets, seeking the competitive advantages these offer. While in Spain, with smaller companies, this in process is of less importance, the trouble is the little weight held in exports by companies within the high-technology content branches of industry, which also have the highest potential for growth. And the point is that, in order to keep moving ahead, you need to eat something else than just lupin seeds.

Balance of payments: marginal easing off in worsening trend

In the first three quarters of 2006 the cumulative deficit in the balance of payments amounted to 64.75 billion euros, close to 30% higher than one year earlier. This growth rate is slightly less than in the cumulative figure for January-August when the year-to-year increase was 31%.

The main factors responsible for this imbalance, in order of importance, are the increase in the trade deficit, the reduction of the surplus in the services balance, the increase in the deficit in the incomes balance and, finally, the increased imbalance in current transfers.

With regard to the trade balance specifically, the increase in the deficit, more than 18% compared with the first nine months of 2005, was due to the drive in imports. In the cumulative figure for the year imports were up 13% year-to-year as against a rise of 10.6% year-to-year in exports. In turn, the services balance continued to reflect the gradual downward trend in the contribution from the tourist sector. The tourist heading stood at 20.52 billion euros in the first three quarters of 2006, a figure 2.7% lower than for the same period one year earlier. In any case, it should be pointed out that the worsening process was sharper a month earlier.

Current account deficit increases by 30% year-to-year in first 9 months of 2006.

Between January and September, the imbalance in the incomes balance rose by 11.9% year-to-year going to 15.42 billion euros, while the deficit in the incomes balance came to 5.34 billion euros, a drop of more than 15% year-to-year compared with the figure for the first nine months of 2005.

BALANCE OF PAYMENTS

September 2006

	Cumulative for year		Last 12 months		
	Balance	% annual change	Balance	Annual change: Absolute	Annual change: %
Current account balance					
Trade balance	–59,322	18.4	–78,197	–13.034	20.0
Services					
Tourism	*20,520*	*–2.7*	*25,792*	*–694*	*–2.6*
Other services	*–5,180*	*88.4*	*–6,165*	*–2,544*	*70.3*
Total	15,341	–16.4	19,628	–3,238	–14.2
Income	–15,425	11.9	–18,851	–2,308	14.0
Transfers	–5,345	15.3	–3,793	–1,746	85.3
Total	**–64,751**	**29.1**	**–81,214**	**–20,325**	**33.4**
Capital account	**3,164**	**–42.1**	**5,673**	**–2,151**	**–27.5**
Financial balance					
Direct investment	–41,414	274.7	–43,052	–13,652	46.4
Portfolio investment	157,562	194.2	161,894	69,565	75.3
Other investment	–37,902	–	–29,521	–38,646	–
Total	**78,246**	**54.2**	**89,321**	**17,267**	**24.0**
Errors and omissions	–4,260	132.1	–3,321	–775	30.4
Change in assets of Bank of Spain	–12,399	195.2	–10,459	5,984	–36.4

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.

Net portfolio investment inflows more than three times imbalance in direct investment.

In the financial sphere, we should point out that outflows for direct investment were well above figures recorded in the first three months of 2005. In this period, the deficit was 11.05 billion euros whereas the equivalent period of 2006 showed a deficit of 41.41 billion euros. In clear contrast, net inflows for portfolio investment came to 157.56 billion euros, more than three times the surplus in the first three quarters of 2005.

Public sector

Notable central government budget surplus in 2006

Central government non-financial revenues in Treasury terms, that is to say, measured according to their becoming effective in the period under consideration, rose by 132.36 billion euros in the January-November period. This figure meant a rise of 10.5% compared with the same period the year before. In homogeneous terms, that is, including the share of regional governments and corrected for calendar effects, central government non-financial revenues rose by 10.8% compared with the same period in 2005.

This notable increase in funds coming to the central government was due to sharp rises in tax collections, a reflection of the favourable trend in the economy. Collections for personal income tax were up 15.1%, in homogeneous terms, as a result of the increase in wages and job creation. It should be pointed out that withholding tax on capital and on returns on mutual funds showed sharp increases. Corporation tax was up 16.0% because of the big increase in company profits.

Central government non-financial revenues up 11% as of November...

With regard to indirect taxes, value added tax was up by 11.4% in the first 11 months of the year, due to the good state of consumption and investment. On the other hand, special taxes were up by only 2.6%. We should point out the recovery of taxes on tobacco in November as a result

...as result of tax collections, reflecting strength of economy.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

November 2006

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**8,512**	**38.9**	**132,362**	**10.5**
Non-financial revenue adjusted (*)				
Personal income tax	5,582	17.9	58,932	15.1
Corporate tax	31	–	33,593	16.0
VAT	2,686	10.2	52,520	11.4
Special taxes	1,651	21.6	17,353	2.6
Other	1,880	–1.8	15,198	–5.2
Total	**11,830**	**13.4**	**177,596**	**10.8**
Non-financial spending	**10,029**	**9.7**	**115,292**	**6.2**
Treasury balance	**–1,517**	**–49.7**	**17,070**	**52.3**
Surplus (+) or deficit (–) (**)	***–2,373***	***–52.0***	***21,951***	***49.2***

NOTES: (*) Includes segments ceded to Autonomous Communities under current system of financing and other adjustments.
(**) In terms of National Accounting.
SOURCE: Ministry of Economy and Finance and internal figures.

Spending up by only 6% thanks to drop in outlays for interest on government debt.

of the increased tax rate on cheap brands effective that month which put the cumulative tax at only 1.4%. Similarly, fuel tax showed little increase (1.8%). On the other hand, tax on alcohol and spirituous liquors were up 8.1%.

With regard to other revenues, capital transfers were down because of the lower inflow of EC funds. The increase in government property earnings of 34.4%, due to higher profits of the Bank of Spain in 2006 could not fully compensate the negative trend in other headings, so that other non-financial revenues were down 5.2% in adjusted terms.

Non-financial spending was up 6.2% as of November. This relatively favourable trend came about by the drop of 11.9% in interest payments on the government debt. At the same time, capital transfers were down 11.4% and real investment was up by only 1.6%. On the other hand, current transfers rose by 13.7% and staff costs by 7.4%.

Budget surplus up 49% and now represents 2.3% of GDP.

As a result of these trends in revenue and spending, the cumulative budget surplus amounted to 17.07 billion euros, which meant a rise of 52.3% compared with the same period in 2005. In national accounting terms, applying the accrual principle of accounting, that is, recording amounts at the moment rights and obligations actually take place independently when payments or receipts occur, there was an accumulated surplus of 21.95 billion euros, an increase of 49.2% over the same period the year before. In terms of the gross domestic product, the surplus was 2.26%, as against 1.62% for the same period in 2005. While it should be borne in mind that investment spending increases and certain extraordinary outlays take place in December, budget forecasts for year-end are favourable.

Finally, the net change in Treasury terms amounted to 11.92 billion euros for the first 11 months of the year. Among other headings, this was due to various financial contributions, including those for railway infrastructures, loans for funding research, development and scientific and technical innovation.
As a result, net central debt was down by 5.14 billion euros as of the end of November as against the increase of 575 million euros in 2005.

Fiscal policy for 2007: spending takes on leading role

The government is forecasting a fiscal surplus of 1% of GDP in 2007 for the general government. This came out in the recent update of the *2006-2009 Stability Programme*. At first sight, another year of fiscal surplus would seem to confirm the soundness of Spain's public accounts and is reason for satisfaction. On the other hand, this objective, which was revised upward from 0.7% in the Budget, is significantly below the surplus expected for 2006, close to 1.5% of gross domestic product (GDP). It is therefore logical to ask if, in the present macroeconomic context, fiscal policy should not have set out some more ambitious objectives in order to counteract the imbalances in the Spanish economy – inflation and the external deficit. This, for example, is the opinion of both the Organization for Economic Cooperation and Development and the International Monetary Fund.

SURPLUS (+) OR DEFICIT (–) IN FINANCING GENERAL GOVERNMENT

% GDP

	2005	2006	2007
Central government and Autonomous Bodies	0.5	0.6	0.3
Social Security	1.1	1.1	0.9
Regional government bodies	–0.4	–0.3	–0.2
Total	**1.1**	**1.4**	**1.0**

SOURCE: Ministry of Economy and Finance.

Prospects for short-term growth remain favourable. The government has revised upward its estimates for GDP growth in 2006 to 3.8% (up from 3.4% in the Budget). For next year, it foresees a slight drop (to 3.4%) but growth will remain around the potential of Spain's economy. National demand will continue as the main engine of growth although its importance will decrease. It is expected that there will be a reduction in inflation (measured by the GDP deflator) from 3.8% to 3.4%, so that the differential with the Euro Area would still be 1 percentage point with the increase in the external deficit going to 8.2% of the GDP. While everything indicates that the European Central Bank will raise its interest rates somewhat more in 2007, real interest rates in Spain will continue to be relatively low. In this context of high growth and a monetary policy that cannot be called restrictive, fiscal policy should play a major role in containing inflation and the external deficit along with structural policy. Is this happening? Well, it is difficult to consider the budget as restrictive when public consumption continues to grow faster than real GDP, as has been happening in the past five years, and when the primary balance will fall by 0.5% of GDP.

MACROECONOMIC SCENARIO

	2005	2006	2007
National demand	5.2	4.7	4.3
Private consumption	4.2	3.7	3.4
Public consumption	4.8	4.2	4.0
Gross fixed capital formation	7.0	6.3	5.4
Change in inventories (contribution to growth)	0.0	0.1	0.0
Foreign balance (contribution to growth)	–1.7	–1.1	–0.9
GDP (% real change)	3.5	3.8	3.4
GDP deflator (% change)	4.1	3.8	3.2
GDP at current prices (% change)	7.8	7.7	6.7

SOURCE: Ministry of Economy and Finance.

In fact, the central government budget is growing sharply reflecting the social priorities of the government. Spending in the consolidated budget is up by 7.2% compared with the 2006 budget (8.3% excluding interest payments). The increase is concentrated in the social headings and in those for research, development and innovation (R&D&i). Spending on pensions, which takes up one third of the budget, is up by 8% (close to 7 billion euros) as a result of an increase in the number of recipients and an increase in the minimum pension. In spite of the reduction in the unemployment rate, spending on active and passive policies in the labour market is also up by the same percentage (1.6 billion euros in absolute terms). Spending on R&D&i, which could strengthen the technological level of Spain's productive system, is up 23% (1.6 billion in absolute terms) thus reaching 0.8% of the GDP. Finally, note should be taken of the sharp increase in allocations for Official Aid to Development (39%) bringing it up to 0.3% of the GDP. If we include spending of regional bodies and debt forgiveness, Spain's Official Aid to Development will reach 0.4% of the GDP.

On the revenue side, fiscal reforms will reduce the tax burden very slightly. Changes in the personal income tax and corporate income tax (see table below) will involve a cost to the central government of close to 0.2% of the GDP. In any case, these losses will be partly compensated by the good state of company profits and employment and its impact on collections for corporate taxes and Social Security contributions. Thus, consolidated revenue of the central government, autonomous bodies and Social Security will drop only slightly as a proportion of the GDP (0.1%). Could the government have gone farther in fiscal reform and lowered taxes more? Perhaps, but this would have required a major effort to contain spending in order to prevent the external deficit and inflation from getting out of hand. For the time being, further tax cuts (which should give better treatment to savings) will have to await a change in the macroeconomic environment.

MAIN ELEMENTS OF FISCAL REFORM
Personal income tax
• Reduction of number of tax rates (from 5 to 4) while broadening rates.
• Reduction of maximum marginal rate from 45% to 43%.
• Introduction of fixed tax rate of 18% for income on savings.
• Substantial increase in minimum levels of exemption.
Corporate tax
• Reduction in the tax rate of 5 percentage points (2.5 points in general rate for 2007 and 2008 respectively; 5 points for small and medium businesses in 2007).
• Gradual elimination of most deductions between 2007-2011.
• Limitation of reduction for reinvestment of capital to production activities.

SOURCE: Ministry of Economy and Finance.

As happened in 2006, it is likely that budget implementation will bring some positive surprises. Tax revenues, for example, could overshoot budget forecasts, which could be called conservative. In addition, some underspending may occur, especially in programmes for which substantial increases are foreseen and in the contingency fund. As for the future, the design of fiscal policy still faces two major challenges: ensuring the sustainability of the Social Security system and strengthening the competitiveness of the economy through better spending and a lower tax burden on labour and on companies.

BUDGETARY PROJECTIONS FOR GENERAL GOVERNMENT

% GDP

	2005	2006	2007
Revenues			
Direct taxes	10.9	11.4	11.4
Social Security contributions	13.0	13.0	13.0
Indirect taxes	12.1	12.1	12.0
Other revenue	3.4	3.3	3.2
Total	**39.4**	**39.8**	**39.6**
Spending			
Primary spending	36.4	36.8	37.1
Gross fixed capital formation segment	3.6	3.7	3.9
Interest	1.8	1.6	1.5
Total	**38.2**	**38.4**	**38.6**
Total balance	**1.1**	**1.4**	**1.0**
Primary balance	**2.9**	**3.0**	**2.5**

SOURCE: Ministry of Economy and Finance.

Savings and financing

Credit to private sector continues to grow at high rate

Rise in bank interest rates...

Loan interest rates continue along an upward course, gradually reflecting the increases in the European Central Bank reference rate since December 2005. The average interest rate charged by credit institutions on loans to the private sector rose to 5.0% in October, to stand at the highest level in recent years.

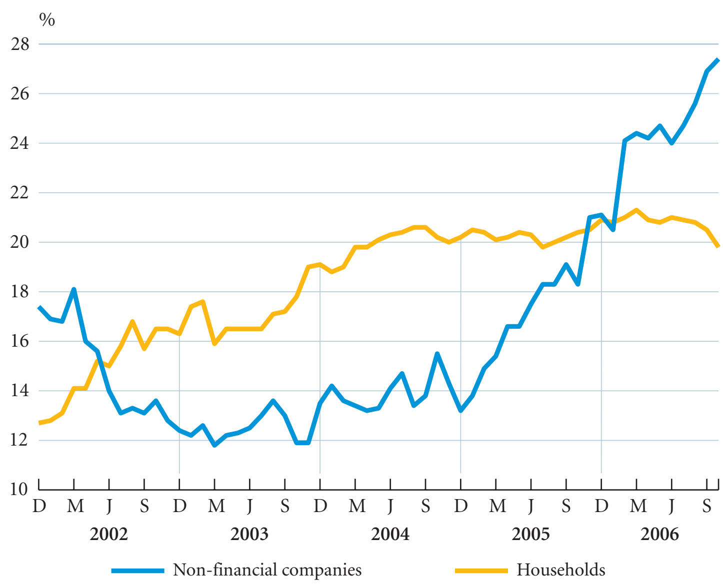
...no obstacle to growth of credit.

This has not stopped growth of credit. Funding obtained by the private sector in the past 12 months ending in October rose by 24.0%, the highest rate reported in the past decade. Nevertheless, this was due to the sharp increase in funding provided to companies (27.4% in the past year), the highest change rate at least since 1996. As a result, non-financial companies continue to shore up their finances, partly in order to meet various corporate moves, such as take-overs and mergers. It is also true that return on assets expected in the present economic situation is well above current interest rate levels and it is on this that borrowing for investment purposes is based.

As a result, leasing, which is commonly used to finance capital goods and real estate, presents a rise of 15.6% over October 2005. On the other hand, commercial credit, used to finance working capital, shows substantially lower growth at 10.2%.

CREDIT TO COMPANIES SHOWS BOOST WHEREAS LOANS TO HOUSEHOLDS EASE OFF

Year-to-year change in credit by resident credit institutions (*)



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

CREDIT GRANTED TO COMPANIES AND HOUSEHOLDS

October 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
Commercial credit	76,329	968	1.3	7,038	10.2	5.3
Secured loans (*)	883,038	153,751	21.1	185,327	26.6	61.1
Other term loans	404,825	79,529	24.4	85,923	26.9	28.0
Demand loans	30,749	2,691	9.6	4,963	19.2	2.1
Leasing	38,663	3,669	10.5	5,227	15.6	2.7
Doubtful loans	10,956	1,325	13.8	1,194	12.2	0.8
TOTAL	**1,444,562**	**241,934**	**20.1**	**289,673**	**25.1**	**100.0**

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

Where we note some moderation is in credit to households. In fact, at the end of October total loans granted to individuals had risen by 19.8% compared with the same month last year. While this is a high growth rate, it is 1.5 points lower than in March. The slowdown in loans to households was mainly due to loans for housing which went from annual growth rates of 24.6% in November 2005 to 20.8% in October 2006. Nevertheless, the good economic climate and job creation is continuing to support demand for mortgage loans and what most likely will happen is that 2007 will continue along a course of gradual moderation.

DROP IN BANK LOANS FOR HOUSING

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

SOURCE: Bank of Spain.

Loan default holds at low levels.

On the other hand, the other components of loans to households show an upward trend. As a result, in the past 12 months ending in October 2006 this component was up by 17.2% whereas in 2005 it rose by 12.5%. Thos growth may partly be due to marketing policies of financial institutions in order to compensate for the lower growth rate in mortgage loans. They have eased conditions for obtaining consumer credit and have speeded up the loan approval process. At the same time, they are taking full advantage of all sales channels, such as Internet and even cell phones. As a result, consumer credit, whether it is obtained by a loan, a credit or a credit card, is now in vogue. Credit for other purposes, such as for buying shares, lands, etc., is also showing a notable increase.

Rise in wages aids growth of bank deposits.

In spite of the increase in interest rates, for the moment, the default rate for all credit granted to the private sector is holding at low levels. In October, it was down for the second month in a row, to stand at 0.76 %. According to break-downs going up to September, it would appear that doubtful loans for home purchase also stands at a low rate (0.41%), although this was very slightly above December 2005 when it was 0.38%.

Rise in bank deposits

On the other side of the balance sheet of financial institutions, bank deposits are showing major growth. As a result, private sector deposits rose by 24.0% in the last 12 months ended in October. Contributing to this sharp increase was the rise in incomes, brought about by the increase in the official interest rate of the European Central Bank. Nevertheless, the growth of deposits was not sufficient to cover loans granted and financial institutions had to have recourse to outside funding, especially to bond issues.

In this corner of the market, the banks are showing greater activity in recent times. In the period from October 2005 to October 2006, deposits at banks rose by 26.6% compared with 21.5% at savings banks. As a result, the banks recovered market share in this segment which, nevertheless, continues to be led by the savings banks.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

October 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	415,232	19,042	4.8	40,468	10.8	39.0
Up to 2 years	236,348	45,828	24.1	51,897	28.1	22.2
More than 2-year term	311,898	72,416	30.2	94,489	43.5	29.3
Repos	72,158	–888	–1.2	5,191	7.8	6.8
Total	**1,035,637**	**136,399**	**15.2**	**192,046**	**22.8**	**97.2**
Deposits in currencies other than euro	**29,526**	**13,887**	**88.8**	**14,078**	**91.1**	**2.8**
TOTAL	**1,065,162**	**150,285**	**16.4**	**206,124**	**24.0**	**100.0**

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

In fact, the improved attractiveness of bank deposits in recent times has had unfavourable results for participations in securities mutual funds, another product popular with savers. The assets of mutual funds rose by only 4.6% last year ending in November 2006. In the past three months withdrawals have run above money inflows. Withdrawals from funds have been substantial in bond-based funds, because of low returns. On average, the annual return came to a notable 4.8% although the spread was very great. Only Japanese share-based funds showed negative. The highest return was obtained from national share-based funds with an extraordinary 31.1%.

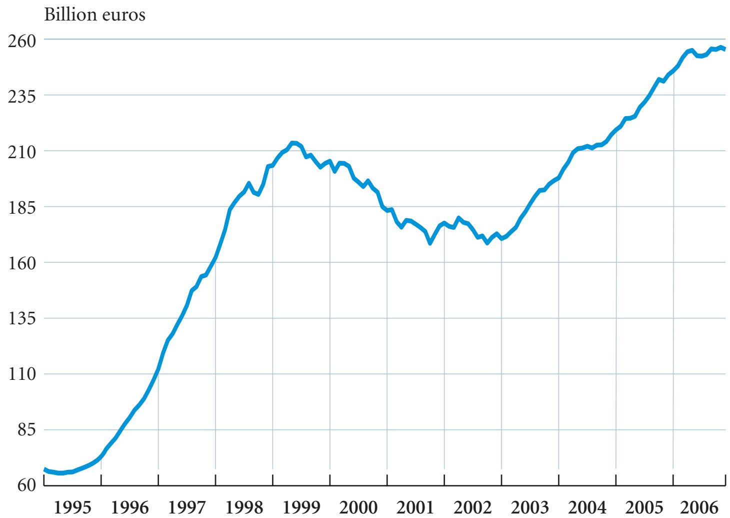
In another sphere, premiums in the direct insurance sector went above 37 billion euros in the first nine months of 2006, according to figures from the ICEA insurance research organization. They thus grew by 4.5% compared with the same period the year before. By type of insurance, life showed a rise of only 1.2% while non-life was up 6.8%. In this group, multi-risk and health insurance showed increases of around 10%, while the car insurance field was up by only 4.6% in a framework of sharp competition. In addition, savings managed in the life field, specifically under technical provisions, stood at 129 billion euros in September 2006, an increase of 5.0% compared with the same period last year.

Securities mutual fund participations report net withdrawals for three months running.

Insurance premiums up 5% in first three months of 2006.

DECREASE IN MUTUAL FUND ASSETS IN NOVEMBER BECAUSE OF COMPETITION FROM DEPOSITS

Total assets of mutual funds



SOURCE: Inverco.

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