OCTOBER 2005

THE SPANISH ECONOMY

Monthly Report

NUMBER 284

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2004	2005	2006	2004		2005			
				3rd Qtr.	4th Qtr.	1st Qtr.	2nd Qtr.	3rd Qtr.	4th Qtr.
INTERNATIONAL ECONOMY		Forecast						Forecast	
Gross domestic product									
United States	4.2	3.5	3.2	3.8	3.8	3.6	3.6	3.5	3.4
Japan	2.6	1.8	1.4	2.4	0.9	1.0	2.2	2.2	1.9
United Kingdom	3.2	1.8	2.1	3.0	2.5	1.7	1.5	1.8	2.0
Euro area	1.8	1.3	1.7	1.8	1.6	1.3	1.1	1.2	1.5
Germany	*1.1*	*0.9*	*1.3*	*1.1*	*0.5*	*0.8*	*0.6*	*1.0*	*1.2*
France	*2.1*	*1.5*	*1.9*	*1.8*	*2.1*	*1.9*	*1.3*	*1.3*	*1.4*
Consumer prices									
United States	2.7	3.0	2.4	2.7	3.3	3.0	2.9	3.3	2.8
Japan	0.0	–0.1	0.4	–0.1	0.5	–0.2	–0.1	–0.3	0.0
United Kingdom	2.2	2.3	2.2	2.1	2.3	2.2	2.2	2.4	2.3
Euro area	2.1	2.2	2.1	2.2	2.3	2.0	2.0	2.3	2.4
Germany	*1.7*	*1.9*	*1.8*	*1.9*	*1.9*	*1.7*	*1.7*	*2.1*	*2.3*
France	*2.1*	*1.8*	*1.7*	*2.3*	*2.1*	*1.7*	*1.7*	*1.8*	*2.0*
SPANISH ECONOMY		Forecast						Forecast	
Macroeconomic figures									
Household consumption	4.4	4.6	3.6	4.7	4.8	4.8	4.8	4.5	4.1
Government consumption	6.0	5.2	4.7	6.7	6.4	5.5	4.6	5.2	5.5
Gross fixed capital formation	4.9	7.3	5.7	5.2	6.1	7.0	7.5	7.4	7.2
Capital goods	*3.7*	*10.2*	*8.1*	*6.7*	*8.8*	*10.0*	*10.4*	*10.5*	*10.0*
Construction	*5.5*	*5.6*	*4.2*	*5.3*	*5.1*	*5.7*	*5.8*	*5.6*	*5.5*
Domestic demand (contribution to GDP growth)	5.1	5.6	4.7	5.5	5.9	6.0	6.0	5.6	5.5
Exports of goods and services	3.3	1.3	3.4	3.7	2.3	–1.9	1.9	2.2	2.9
Imports of goods and services	9.3	8.3	7.8	10.4	10.2	5.6	8.0	9.6	9.8
Gross domestic product	**3.1**	**3.3**	**3.2**	**3.1**	**3.2**	**3.3**	**3.4**	**3.4**	**3.3**
Other variables									
Employment	2.6	3.1	2.9	2.6	2.8	3.0	3.2	3.1	3.0
Unemployment (% labour force)	11.0	9.4	8.9	10.7	10.6	10.2	9.3	9.1	9.0
Consumer price index	3.0	3.4	3.3	3.3	3.4	3.3	3.2	3.4	3.6
Unit labour costs	2.8	2.7	2.9	2.8	2.6	2.4	2.5		
Current account balance (% GDP)	–5.9	–7.4	–8.5	–6.0	–6.9	–7.1	–8.0		
Not lending or net borrowing rest of the world (% GDP)	–4.8	–6.4	–7.5	–4.9	–5.8	–6.6	–6.8		
Government balance (% GDP)	–0.1	0.0	0.0						
FINANCIAL MARKETS		Forecast						Forecast	
Interest rates									
Federal Funds	1.3	3.2	4.7	1.4	1.9	2.4	2.9	3.4	3.9
ECB repo	2.0	2.0	2.3	2.0	2.0	2.0	2.0	2.0	2.0
10-year US bonds	4.3	4.3	5.0	4.3	4.2	4.3	4.2	4.2	4.3
10-year German bonds	4.1	3.3	3.7	4.1	3.8	3.6	3.3	3.2	3.2
10-year Spanish bonds	4.1	3.3	4.1	4.2	3.8	3.6	3.3	3.2	3.2
Exchange rate									
$/Euro	1.24	1.25	1.21	1.22	1.30	1.31	1.26	1.22	1.21

THE SPANISH ECONOMY
MONTHLY REPORT
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Y PENSIONES
DE BARCELONA**

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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2004

FINANCIAL ACTIVITY	Million euros
Total customer funds	143,912
Receivable from customers	93,242
Profit attributable to Group	1,020

STAFF, BRANCHES AND MEANS OF PAYMENT	
Staff	24,827
Branches	4,841
Self-service terminals	6,988
Cards	7,805,561

COMMUNITY PROJECTS: 2005 BUDGET

Activities	Million euros	%
Social	114	62
Cultural	29	16
Science and environmental	23	13
Educational	17	9
Total activities	**183**	**100**
Investment and other costs	67	
TOTAL BUDGET	**250**	

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IS A NEW OIL CRISIS HERE?

Contents

If, just a couple of years ago, when a barrel of oil cost 25-30 dollars, we had known that crude would go close to 70 dollars in 2005, economists probably would have painted a picture of stagnation and inflation in the international economy. In fact, oil has risen to these levels (and maybe it will not stop there) but the world economy has not dropped to the fires of hell in terms of unemployment, recession or an inflationary spiral. On the contrary, in its *World Economic Outlook* in September, the International Monetary Fund made practically no change to its growth forecasts for 2006 given out in April. This was in spite of the fact that it was then expecting a Brent oil price of 44 dollars a barrel and is now estimating an annual average of 62 dollars.

Very few people, however, doubt that we are facing a new oil crisis. That is to say, we are going to have to adapt ourselves to living with a notably higher energy cost than we have enjoyed up until now. This crisis is different from that in 1973 (following the Yom Kippur war between Arabs and Israelis) or that in 1979 (war between Iran and Iraq) and the more ephemeral crisis in 1991 (Gulf war). This time there is no war nor is the origin of the price rise to be found in a restriction of crude oil supply. The origin of this crisis comes from demand, from the strong drive in the world economy since the beginning of the century in which the main players are the United States and certain emerging Asian economies, headed by China, which are major energy users.

The big difference with other earlier crises is that at this stage of the game, following two years of persistent increases in oil prices, there are no signs of inflation (apart from the energy component of the indices). Given that prices are not rising, monetary policies in most countries remain easy. Long-term interest rates stand at all-time lows both in the United States and Europe. And, in spite of the evident rise in production costs (other raw materials have also moved onto an upward path), corporate profits have never been so high. Is this then an ideal world?

Not exactly. Oil dependence today is not as high as it was in the Seventies and Eighties. Asian manufactures are forcing companies in the developed countries to contain costs and improve their products. We have learned from mistakes in economic policy made in other times. The anti-inflationary and stabilizing credibility of the central banks is now a most valuable asset. Nevertheless, however much we have advanced since those days the harsh reality remains: the rise in oil prices constitutes income that the oil-dependent countries are transferring to the oil exporters. Less income means less spending, that is to say, less growth. And a bit more inflation. It will not be easy to much longer contain the effects of a «second round», that is to say, the shift of a rise in production costs to final prices.

This energy crisis is perfectly manageable. However, we should take note that it comes on top of imbalances the world economy has been maintaining for some time (in balance of payments and over-indebtedness), which increases the threat of destabilization. It would be wise not to forget the lessons of the past and to avoid the negative effects of increasing oil costs. At this time of hurricanes, every precaution may not be enough.

September 28, 2005

ECONOMIC SITUATION

'Katrina', 'Rita' and per barrel oil price

Hurricane *Katrina* hits at US energy heartland, pushes up prices of oil derivatives and threatens supply at petrol stations.

Oil rigs damaged, refineries not working, oil pipelines wrecked and thousands of workers evacuated. Prices of petrol, diesel oil, kerosene and other oil derivatives sky-high: this is the picture hurricane *Katrina* left in its path through the Gulf of Mexico at the end of August. Quite apart, of course, from the human disaster, the destruction of homes and public utilities and the flooding of most of the unique city of New Orleans. Less than one month later, the threat of a new hurricane, *Rita*, brought evacuation of the oil producing area of Houston, Texas.

Using up of extra production and refining capacity in United States brings about further rise in per barrel price and spreads impression that problem is structural, meaning high prices for some time.

The Gulf of Mexico area accounts for 30% of oil production and 50% of US refining capacity, according to JPMorgan. *Katrina* had a direct impact on this area while at the same time affecting natural gas production and port activity related to oil imports.

The problem is that refinery capacity in the United States was already at its limit before the hurricane season. The closing down of refineries brought about by the tropical storms meant some risk of cuts in fuel supply in the US market.
As a result, petrol prices at pumps on US roads and highways went above the psychological barrier of 3 dollars a gallon. Suddenly, the price of crude oil made another jump going to 70 dollars a barrel in the case of West Texas quality oil. Alarmed by the state of events, the International Energy Agency approved an emergency plan involving the use of strategic reserves to ease the scarcity.

Following the passage of *Katrina*, the oil market recovered relative calm except just before the arrival of *Rita*. The heavy demand in recent years, however, has almost fully taken up extra production and refining capacity. In mid-September, the Organization of Petroleum Exporting Countries (the cartel bringing together around 40% of world exports) offered to raise supply by 2 million barrels a day. This announcement scarcely made any change in the markets. The dominant feeling is that in recent years there has been insufficient investment in production and refining. Given the time needed for such investment to mature, it seems inevitable that the problems in the market for oil and oil derivatives should be seen as structural. That is to say, we shall have high prices for some time.

Oil prices would be lower if world economy were to slow down but this view not shared by IMF...

This will apply, of course, if current growth of the international economy continues. This is what economists from the International Monetary Fund (IMF) believe and they maintain that the world economy will grow by 4.3% in 2006, the same as in 2005. The ministers and central bank governors in Washington for the IMF and World Bank meetings in the last week of September were less optimistic. According to the pessimistic view, the risks are that growth will drop. It may be that we have already reached the top of the cycle. From now on, we are going to see problems both in energy and those arising from other imbalances in the world economy.

Alan Greenspan, chairman of the US Federal Reserve, does not seem to share this pessimistic vizew. The monetary policy committee he presides over decided on a new rise on September 20, the eleventh consecutive increase in the reference rate. While recognizing the economic damage caused by *Katrina*, which will slightly cut growth in the United States this year, the US central bank system is concerned more about the inflationary risks that the rise in oil prices may bring.

...or Alan Greenspan, chairman of the Fed, which continues to raise reference rates.

The European Central Bank has come out along the same lines and the fact is that growth in the euro area (1.2% in the first half of 2005) is far from the 3.6% in the United States. In optimistic vein, the IMF feels that things are going to improve to the point where the single currency area will reach 1.8% in 2006. We believe this is possible but for this forecast to be fulfilled it is essential that the German economy begin to take off.

In Europe, German election results raise doubts about capacity of country's economy to ensure recovery, quite the contrary to situation in Japan.

German voters, however, have not made things easy. The result of the elections on September 18 has caused concern given that no one came out a clear winner. In the weeks before the elections, it was generally felt that the Christian Democrat Angela Merkel would defeat the Social Democrat Gerhard Schröder who has been Chancellor since 1998. As a result, this would push forward the reforms needed to make the German economy equal to the needs of the global economy. Now, the virtual tie coming out of the elections leaves many big questions still open. It is feared that the future government will not push forward reforms and that, as a result, the German economy will continue to be stagnant and unable to drive the economy on the Continent.

This is the opposite of what has happened in Japan. There, the Liberal Democratic party of Junichiro Koizumi obtained a clear victory in the elections on September 11. Now the Japanese prime minister is free to carry out the profound reforms he has announced which are oriented to liberalizing markets. Finally, the Japanese economy may be coming out of the structural recession in which it fell at the end of the Eighties.

Another centre of optimism is to be found in the stock markets. This is not the case in the United States where the sustained rise in Federal Reserve interest rates has kept indices from moving up. The Japanese stock market, however, was marking up its highest levels for the last four years at the end of September based on the positive prospects now seen for the Japanese economy. European indices also are showing substantial advances so far this year. Among these indices, the Spanish IBEX reached highs not seen since the end of 2000 with some shares showing gains for the year above 50%.

European and Asian stock markets continue reaching new highs while bond yields remain very low.

In a situation of high liquidity, investors have also shifted to bonds. As a result, bond yields (the inverse of bond prices) remain at very low levels. At the end of August, US 10-year bonds reached 4% with German bonds at 3%, although both later showed increases.

Spain's economy: growth continuing

The good state of the Spanish stock market is in line with the trend in economic activity indicators. In the IMF report mentioned earlier, Spain is one of the few developed countries for which growth forecasts have been raised compared with previous forecasts in April, along with Canada. Consumption and capital equipment investment remain very strong with respective growth of 5% and 10% in the second quarter of 2005, according to the National Institute of Statistics. Construction is also showing

Drive in domestic demand in Spain's economy shows no decrease with growth for 2005 apparently assured at rates close to 3.5%.

On the other hand, foreign deficit even goes above that for United States measured as percentage of gross domestic product.

Prices remain contained despite rise in oil prices but energy dependence of Spain's economy raises risk of high inflation in present context.

strong with a rise of a 5.7%. In the macroeconomic table, we see only one negative note in the poor growth of industry (0.7%) brought about by direct competition from the emerging countries, whereas Spain's traditional markets in continental Europe remain slack.

As a result, growth of Spain's economy in 2005 may be considered assured at rates close to 3.5% for the year as a whole. Not everything, however, looks so good. It is also clear that the deficit in the balance of payments will reach an all-time high even going above that for the United States as a percentage of the gross domestic product. The sharp drive in domestic demand in terms of imports, combined with the lack of strength in Spain's export markets and the poor competitive situation of foreign sales constitutes one of the weakest elements in the economy.

On the other hand, the sharp drive in domestic demand has not so far shifted to consumer prices. The all-time high levels for petrol and diesel fuel have not spread to other goods and services. Transportation companies, bus operators and taxi drivers have been greatly concerned about the increase in fuel costs which affect them directly but, for the moment, the non-energy component in the consumer price index has tended to drop.

Will this continue much longer? Probably not. Spain's economy is one excessively dependent on oil and is not very efficient in energy terms. In recent years there has been a lack of measures necessary to reduce this dependence and Spain has followed a path opposite to other developed countries. The most recent figures from the International Energy Agency show that energy consumption per production unit in Spain in 2003 was nothing less than above that for the United States. In a stage of high energy prices, the penalty for this could be increased inflation risk.

Another way to deal with the foreign imbalance and prevent inflationary risk would be to somewhat halt the drive in domestic demand through tax policy (we no longer have monetary or exchange rate policy available). This is not going to happen. The Budget for 2006, presented by Minister of Economy Pedro Solbes at the end of September, is an expansionist one. It is true that it shows a slight surplus but spending by the central government will go well above nominal growth of the gross domestic product while revenues are to grow through the expected increase in economic activity and increases in Social Security contributions and some taxes. There remain structural reforms, many of which have already been set out in the package presented in February. It would be desirable to see their application speeded up in order to maintain the current economic drive, putting its weaker points in better shape before these take us to an undesirable «rough landing».

CRONOLOGY

2005

february	2	**Federal Reserve** raises reference rate by quarter point to 2.50%.
	25	Government approves **Economic Potential Plan**, broad programme of economic reforms aimed at increasing productivity and employment (BOE 14-3-05).
march	4	Dow Jones index for **New York stock exchange** marks up annual high (10,940.55), a rise of 1.5% over end of 2004.
	22	**Federal Reserve** raises reference rate by quarter point to 2.75%.
	23	Heads of state and government of European Union member states approve reform of **Stability and Growth Pact** introducing more flexibility.
april	20	Dow Jones index for **New York stock exchange** marks up annual low (10,012.36) with 7.1% drop compared with end of 2004.
may	2	**Cypriot pound**, **Latvian lat** and **Maltese lira** join Exchange Rate Mechanism.
	3	**Federal Reserve** raises reference rate by quarter point to 3.00%.
june	30	**Federal Reserve** raises reference rate by quarter point to 3.25%.
august	9	**Federal Reserve** raises reference rate by quarter point to 3.50%.
september	1	One-month forward price of Brent quality **oil** goes up to all-time high level of 67.48 dollars a barrel.
	17	Increase in **special taxes** on alcohol and tobacco to finance health (BOE 17-9-05).
	20	**Federal Reserve** raises reference rate a quarter point to 3.75%.
	28	IBEX 35 index for **Spanish stock market** marks up annual high (10,801.7), a cumulative gain of 19.0%.

AGENDA

October

5 Industrial production index (August).
6 Meeting of Governing Council of European Central Bank.
14 Consumer price index (September).
18 Harmonized consumer price index for European Union (September).
25 Producer price index (September). Central government revenue and spending (September).
28 Labour force survey (3rd Quarter). Early HCPI index (October). US GDP (3rd Quarter).

November

1 Meeting of Federal Reserve Open Market Committee.
3 Meeting of Governing Council of European Central Bank.
4 Industrial production index (September).
14 Preliminary Quarterly National Accounts (3rd Quarter).
15 Consumer price index (October).
16 Harmonized consumer price index for European Union (October).
22 Central government revenue and spending (October).
23 Quarterly National Accounts (3rd Quarter).
25 Producer price index (October).
29 Early HCPI index (November).
30 GDP for euro area (3rd Quarter).

IMF forecasts: growth withstanding almost all odds but trade imbalances threatening

IMF expects growth to continue despite natural disasters and rise in oil prices.

In its forecasts for the world economy in September, the International Monetary Fund (IMF) held to its growth forecasts for 2006 put at 4.3%. In 2005, growth of 4.3% is also expected. World growth is proving firm, a firmness which is solidly resisting high oil prices and natural disasters such as the tsunami and hurricane *Katrina*. Manufactures and trade, which were weak at the beginning of 2005, began to recover in the second half-year.

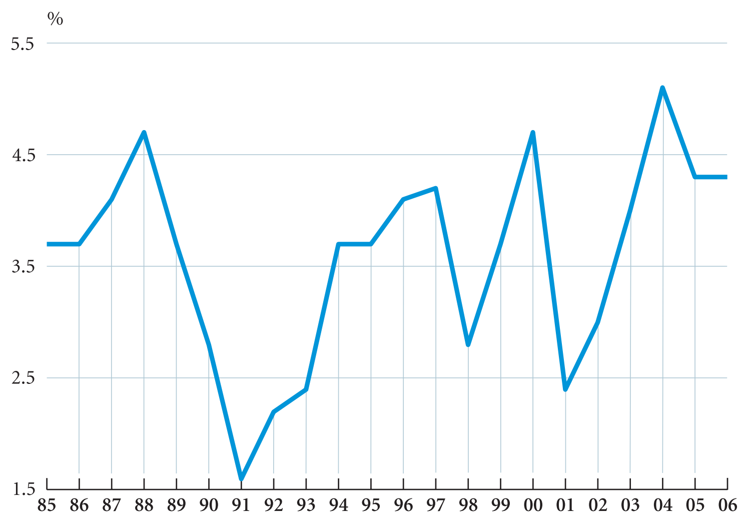
United States and China act as world engines.

Nevertheless, this growth is more and more out of balance. The United States and China continue to be the engines of the world economy, even more so than six months ago. For the United States, somewhat lower growth (3.3%) is expected in 2006 with the effects of hurricane *Katrina* being very limited in 2005 with growth of 3.5% dropping only one decimal compared with that anticipated last April. China is moving ahead more strongly than expected. All other areas have seen growth prospects reduced, with the exception of Japan and India.

While China grows more and more Europe is growing less. Prospects for growth of the euro area have been revised downward both for 2006 (1.8%) and for 2005 which stands at a poor

WORLD GROWTH TO CONTINUE IN 2006

Year-to-year change in gross domestic product



NOTES: 2005 and 2006 are forecasts.
SOURCE: International Monetary Fund.

IMF FORECASTS

Annual change as percentage

	2003	2004	2005 (1)	2006 (1)
GDP				
United States	2.7	4.2	3.5	3.3
Japan	1.4	2.7	2.0	2.0
Germany	–0.2	1.6	0.8	1.2
France	0.9	2.0	1.5	1.8
Italy	0.3	1.2	0.0	1.4
United Kingdom	2.5	3.2	1.9	2.2
Spain	2.9	3.1	3.2	3.0
Euro area	**0.7**	**2.0**	**1.2**	**1.8**
Advanced economies	**1.9**	**3.3**	**2.5**	**2.7**
World total	**4.0**	**5.1**	**4.3**	**4.3**
Developing countries	*6.5*	*7.3*	*6.4*	*6.1*
Latin America	*2.2*	*5.6*	*4.1*	*3.8*
Eastern and Central Europe	*4.6*	*6.5*	*4.3*	*4.6*
Russia	*7.3*	*7.2*	*5.5*	*5.3*
China	*9.5*	*9.5*	*9.0*	*8.2*
Consumer prices				
United States	2.3	2.7	3.1	2.8
Japan	–0.2	0.0	–0.4	–0.1
Germany (2)	1.0	1.8	1.7	1.7
France (2)	2.2	2.3	1.9	1.8
Italy (2)	2.8	2.3	2.1	2.0
United Kingdom (2)	1.4	1.3	2.0	1.9
Spain (2)	3.1	3.1	3.2	3.0
Euro area (2)	**2.1**	**2.1**	**2.1**	**1.8**
Advanced economies	**1.8**	**2.0**	**2.2**	**2.0**
Developing countries	*6.0*	*5.8*	*5.9*	*5.7*
Unemployment rate (3)				
United States	6.0	5.5	5.2	5.2
Japan	5.3	4.7	4.3	4.1
Germany	9.6	9.2	9.5	9.3
France	9.5	9.7	9.8	9.6
Italy	8.7	8.5	8.1	7.8
United Kingdom	5.0	4.8	4.7	4.8
Spain	11.5	11.0	9.1	8.0
World trade by volume (4)	**5.6**	**10.9**	**7.0**	**7.6**
Oil price ($ per barrel) (5)	**15.8**	**30.7**	**43.6**	**13.9**

NOTES: (1) Forecasts in September 2005.
(2) Harmonized consumer price index.
(3) Percentage of labour force.
(4) Goods and services.
(5) Average spot prices for Brent, Dubai and West Texas Intermediate oil. Average oil price in dollars per barrel forecast at $54.23 in 2005 and $61.75 in 2006.

While Spain grows, Europe stagnates.

1.2%. In cases such as France and Italy, the downward revisions are especially drastic. Growth prospects for the United Kingdom have also been revised downward. Spain is one of the exceptions to the slack in Europe and its growth forecast for 2006 remains intact at 3.0%. A figure of 3.2% is expected in 2005 with a rise because of revisions in the preparation of the National Accounts.

United States maintains stable growth

United States grows by 3.6% but expecting some effects of hurricane *Katrina* on consumption.

Up until the arrival of hurricane *Katrina*, the US economy was showing a level of notable activity with maintenance of high growth levels following the peaks seen last year. The manufacturing sector continued to be the weakest in the production fabric. Inflationary pressures increased slightly in August although still far from alarming levels. Few indicators are yet available to evaluate the macroeconomic effects of that disaster but the biggest effect over the short term will be on private consumption.

In the second quarter, the US economy grew somewhat less than had previously been published. Even so, following the second set of estimates from the Bureau of Economic Analysis, the GDP held to a rate of increase of 3.6% year-to-year. Private consumption and investment continued to show a vigorous trend with very slight decreases from the first estimates. It was the imports component, however, which showed the biggest changes, in this case upward. The sharp decrease in inventory levels and the subsequent need to replace them, made likely an increase in imports which seems to already have begun at the end of the quarter.

On the demand side, many indicators still did not show the effects of the hurricane. Among these indicators, retail sales for August which, while down from July, continued to show a generally very strong level. The month-to-month decrease was due to the poor trend in the erratic motor vehicle sector. Even so, the indicator was 7.9% above sales recorded in the same period last year. The *Katrina* tragedy could again put US

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005			
			3 Q	4 Q	1 Q	2 Q	July	August
Real GDP	4.2	3.8	3.8	3.8	3.6	3.6	...	–
Retail sales	4.3	7.3	6.4	8.3	7.3	8.4	10.4	7.9
Consumer confidence (*)	79.8	96.1	100.4	96.1	104.2	102.3	103.6	105.6
Industrial production	0.0	4.1	4.6	4.3	3.8	3.1	3.1	3.1
Industrial activity index (ISM) (*)	53.3	60.5	60.1	57.5	55.6	52.8	56.6	53.6
Sales of single-family homes	11.7	10.0	–0.4	10.8	5.1	7.8	27.7	...
Unemploymenr rate (**)	6.0	5.5	5.4	5.4	5.3	5.1	5.0	4.9
Consumer prices	2.3	2.7	2.7	3.4	3.0	2.9	3.1	3.6
Trade balance (***)	–532	–651	–608	–651	–686	–709	–716	...

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

consumer confidence to the test and will likely increase fuel prices bringing about a loss of purchasing power that could have consequences in retail consumption. The fact is that neither high oil prices nor the poor trend in wage purchasing power have reduced consumer strength, probably due to existing borrowing facilities, and the rise in housing prices. In this respect, the consumer confidence index published by the University of Michigan lowered the index level in September to 76.9 points from 89.1 in August. This drastic drop thus reflected the effects of *Katrina*.

Retail sales continue to grow but *Katrina* tragedy already affecting confidence indicators.

On the supply side, there was a continuation of the poor state of the industrial and manufacturing sector which still represented the weakest point in a generally vigorous economy. In August, industrial production moved up by a meager 3.1% year-to-year, very much along the poor lines seen in recent months. In a similar way, corporate prospects went back to the area of indecision with the manufacturing activity index, put out by the Institute of Supply Management, in August dropping to 53.6 points. This meant a loss of the recovery seen the month before taking it back to close to the 50.0 level, which inicates that there are as many optimists as pessimists. The counterpoint came in the non-manufacturing index which rose sharply to the 65.0 points level.

Industrial production remains weak and manufacturing executives show least optimistic.

The strength of the housing sector deserves separate consideration. For some, it acts as a support for the economy giving a sensation of wealth to homeowners while helping to finance household consumption. For others, it represents a bubble about to burst. The Federal Reserve would look kindly on some moderation in the sector which up until now is very slow in coming. While the sales of existing housing rose by a modest 4.0% year-to-year in July, sales of new housing grew by 27.7%. Existing housing prices also rose strongly by

Housing remains strong and for some people acts as support for economy giving sensation of wealth while others see it as bubble about to burst.

HOUSING PRICES REMAIN UNSTOPPABLE

Year-to-year change in existing housing prices (*)

NOTES: (*) Cycle-trend series.
SOURCE: Department of Commerce and internal figures.

Jobs being created but wages remain static.

14.6% year-to-year. Only the early indicator for building permits showed a slight drop.

The United States continued to create employment in August but the trend in wages remained weak. While new job creation was lower than in the month before, the upward revision of the latter compensated for this. In any case, if we take into consideration the nature of the indicator and the trend in recent months, it may be stated that job creation is in good shape. The situation in purchasing power of wages is somewhat different with a loss of 1.1% in August compared with the same period last year. As a result, the noose on retail sales is getting tighter. Consumers with lower purchasing power end up buying less. If we add to this the foreseeable increase in petrol, worsened by the destruction caused by the hurricane *Katrina*, at least some US consumers will have lower shopping budgets.

Energy prices not being felt in rest of economy but concern lies in drop in productivity and increase in unit labour costs.

Inflation in August continued upward because of energy prices. Nevertheless, the influence of these in other sectors of the economy was quite slight. The general consumer price index rose to 3.6% year-to-year but the index, excluding energy and food, held at 2.2%. If on the consumer prices front things seem to be in order, downward revisions in labour productivity are more troubling. Lower growth in productivity to make a specific product implies increased growth of costs per product unit. As a result, unit labour costs which are being closely watched by the Fed, rose by 4.3% year-to-year, the highest rate since 2000. All of this gives a bigger inflationary bias to the US economy although we still cannot speak of problems in prices.

The end of the problems in the foreign sector is still a long way off. While the July trade deficit was slightly lower than that in June, this is still the third month with a higher deficit. The current account balance in the second quarter

ENERGY PRICES NOT AFFECTING OTHER SECTORS

Year-to-year change in core inflation

SOURCE: Department of Labour and internal figures.

represented 6.3% of the GDP, somewhat lower than the record for the previous quarter but far from meeting any change in trend. If we take into account the replacing of inventory levels mentioned above, which partly has to come through imports, the reduction of the deficit is still a far-off challenge.

Japan gets going

2005 is becoming the year of Japan's recovery. While in 2004 the economy went down, this year the opposite is happening. On top of a situation that is gradually becoming more favourable comes the victory of the reformist ex-prime minister Koizumi which ensures the continuity of structural reforms. Both the IMF and the Japanese Central Bank see the future with some optimism although the average consumer with centuries-old pessimism does not see things that way.

In the second revision of Japan's GDP, growth in the second quarter showed a notable upward revision to reach 2.2% year-to-year. The foreign sector and the change in inventories were the components to contribute to increased growth. Private consumption eased somewhat although it should be remembered that growth of 1.5% year-to-year is still high for an economy such as that of Japan.

The most recent demand indicators show a somewhat more reticient picture of this recovery. Retail sales in July took a breather following three months of very strong activity. Car sales did the same, dropping for the second consecutive month. Even so, in both indicators we continue to see an upward background trend.

It was on the supply side where the biggest boost to recovery could be seen. Machinery orders, which for the central bank mean the prelude to investment, took off in July with a decided advance on the growth path showing an increase of 7.4% year-to-year, twice the rate for the previous month. The number of companies going bankrupt continued low compared with the average in recent years. The dark cloud in supply showed up in industrial production in July

Trade deficit takes a short breather while replacement of inventories stands in way of reduction over short term.

Japan now growing at 2.2% and victory of reformist Koizumi could give boost to economy.

Retail sales remain strong while machinery orders recover from lethargy but industrial production fails to follow.

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004			2005				
			2Q	3Q	4Q	1Q	April	May	June	July
Real GDP	2.6	3.1	2.4	0.9	1.0	–	2.2	–	–	–
Retail sales	–1.7	–0.9	–1.7	–0.5	–0.4	1.1	3.6	3.1	3.0	0.6
Industrial production	3.3	5.3	7.8	6.6	1.6	2.7	1.5	–0.9	0.2	–1.1
Tankan company index (*)	–21.0	–0.5	0.0	2.0	1.0	–2.0	–	1.0	–	–
Housing construction	0.6	2.6	–3.5	9.4	–0.1	1.5	0.7	2.9	2.6	8.2
Unemployment rate (**)	5.2	4.7	4.6	4.8	4.6	4.6	4.4	4.4	4.2	4.4
Consumer prices	–0.3	0.0	–0.3	–0.1	0.5	–0.2	0.0	0.2	–0.5	–0.3
Trade balance (***)	12.0	13.7	13.7	14.1	13.7	13.3	13.0	12.5	12.3	11.9

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

What impact do higher oil prices have on the GDP and inflation?

Conventional economic wisdom on the expected impact on a rise in the price of oil maintains that the two most immediate consequences for countries importing crude oil are a reduction of income and an increase in inflation. Up to this point, practically all economists would be in agreement. Now, the most interesting question lies in quantitatively expressing that impact on both variables. In this respect, two of the international institutions with the most proven world macroeconomic models, the International Monetary Fund (IMF) and the Organization for Economic Cooperation and Development (OECD), have carried out simulations setting out the impact numerically.

EFFECTS OF 20% INCREASE IN OIL PRICES

Difference in percentage points (*)

	Year 1	Year 2	Year 3	Year 4	Year 5
United States					
Real GDP	–0.3	–0.4	–0.4	–0.2	–0.1
CPI	0.8	0.5	0.3	0.2	0.1
Euro area					
Real GDP	–0.2	–0.4	–0.4	–0.2	–0.1
CPI	0.7	0.5	0.4	0.3	0.1
Japan					
Real GDP	–0.1	–0.2	–0.3	–0.2	–0.1
CPI	0.3	0.2	0.1	0.1	–

NOTES: (*) Results compare a scenario with oil at a reference price and one in which oil is 20% more costly estimating the effects on level of real GDP and CPI.
SOURCE: International Monetary Fund.

In both cases, the level of the gross domestic product (GDP) in real terms and inflation (measured by the consumer price index – CPI) are compared with and without an increase in the price of oil. In the case of the IMF (see table) the simulation contemplates a rise of 20% in the price of oil compared with a starting situation and the effects over a period of five years are simulated, whereas the OECD supposes a variable behaviour in oil prices for the three years of the scenario but overall supposes growth of approximately 10%.

If we look at the comparison for United States, Japan and the euro area, the results of the simulations by both institutions are similar. The IMF estimates that the increase of 20% in oil prices in the first year, on average for the five periods considered, would generate a reduction in the real GDP of 0.3% a year and an increase of 0.4% in the CPI both in the United States and the euro area, with Japan, as will be explained later, falling outside this pattern.

In spite of the fact that the performance of both the United States and the euro area is similar, what is significant is the time difference. Whereas the US economy suffers a greater initial impact on income and prices than the euro area, over the whole scenario that impact eases with greater speed. On the other hand, in the euro area, the effect is lower at the initial moment but more persistent over time. Behind this different behaviour lies the greater flexibility of the US economy and more specifically the role of taxes on energy and fuels which are substantially higher on the Old Continent.

Still much more different is the case of Japan, where the impact is substantially less, so that the reduction in the GDP and the rise in inflation are approximately half that in the other two economies. This is the result of the higher energy efficiency of Japan's economy which is more than twice that of the United States and nearly 90% higher than that of the European Union.

Let us now move from the simulation to reality going back a year and putting ourselves in the autumn of 2004. At this time, the IMF forecast that in 2005 the United States would grow by 3.5% and that inflation would be 3.0%. The oil price considered in that forecast was 37.3 dollars a barrel. One year later, the IMF revised its forecast. It now estimates that in 2005 the per barrel price will be 54.2 dollars, a rise of 46% compared with that initially foreseen.

If we use the figures of the simulation given earlier we may conclude that the upward shift in crude oil prices would mean growth of less than 7 decimals for the current year and an increase in inflation of more than 1.8 percentage points, that is to say, the US GDP would grow by 2.8% and inflation would be 4.9%, always taking as reference the IMF estimates made in the autumn of 2004. On the other hand, what are the latest IMF forecasts? The United States will grow by 3.5% in 2005, that is to say, without any change compared with what was expected a year ago while inflation will be 3.1%, only one decimal higher. Apparently, oil has not taken its toll on income and inflation.

While it may be argued that the utilization of the IMF simulations reviewed here suffer from some degree of simplification (in fact, a proportional effect is given to the starting figures), the truth is the distance between reality and simulation is too wide to justify it only in these terms. Something more is taking place and the models, which only take advantage of available statistical history and therefore the past, do not adequately reflect this fact.

What is radically new in the macroeconomic picture now that was not present in the two previous oil crises? Basically, the way in which companies and consumers construct their inflation expectations. In contrast to the Seventies and Eighties of last century, the institutional design of the central banks (now highly independent) and the processes for setting wages (with the practical disappearance of wage indexing) ensure background stability in inflation which avoids the oil shock from bringing about a general increase in price levels in the economy.

In addition, two factors end up bringing about a lower than expected impact. In the first place, the progressive opening up of international trade is facilitating the taking advantage of productivity gains in those countries where these are happening and their shift in the form of cheaper marketable goods to most economies on the planet. A second element is the current high volume of liquidity which makes it possible to maintain a level of spending which more than compensates for the effect on our income of more onerous oil imports. Unfortunately, this is a circumstantial factor which may thus stop acting as temporary relief from the shock of oil prices. Should the stage of expensive oil continue, the adjustment on income and inflation will tend to approximate what the economists' models imply but still fail to meet.

RETAIL SALES MOVE UP FIRMLY

Year-to-year change in retail sales (*)

NOTES: (*) Cycle-trend series.
SOURCE: Japanese Ministry of Economy, Commerce and Industry and internal figures.

Housing costs beginning to rise.

Shadow of deflation remains in spite of good prospects.

Unemployment low but productivity improvement also poor.

Trade surplus continues to drop because of lower demand from China.

which continued to languish with a drop of 1.1% year-to-year.

The housing market also joined the generally upward trend in August. The number of housing units sold in Tokyo moved upward and average prices especially stepped up sharply. What is notable here is that, particularly in prices, there is now a clear trend to sustained growth which is gradually taking the Japanese economy out of one of its most fearful phases in the recent past when the weakness in the real estate market played a very important role in the stagnation dominating a large part of the Nineties.

Another problem in the Japanese economy that has still not completely disappeared is deflation, the downward trend in prices with the effect of inhibiting spending. Many experts agree that by the end of the year prices will be rising but for the moment prices in July continued to drop by a mere 0.3% year-to-year.

In the labour market, the unemployment rate stood at 4.4% of the labour force. This indicator has a positive note but the poor trend in labour productivity is troubling. In July, this again was down to stand at clearly lower levels than at the beginning of 2004.

The final doubt in this positive picture comes in Japan's trade surplus which, in July, continued to move down. This worse situation was practically entirely due to the reduction in exports to China and not to any weakness in Japan's competitive situation. Services and inflows from foreign investment, on the other hand, helped to compensate this reduction until things improved.

Surplus of the three myths and how China is now making watches

If for macroeconomics there were to be an annual prize for the most outstanding figure, the trade balance of the People's Republic of China would win in 2005. People attribute China with the disorder in raw materials and foreign exchange markets, responsibility for the US trade imbalance and crises in specific sectors, and on top of this the blow from the effect of flotation of the renminbi in terms of the dollar.

It is understandable. China has burst into the global village. Up until June 2004, China's trade surplus was showing a slight downward trend in keeping with the fact that, with its move into the World Trade Organization, foreign products would be able to enter its market with fewer difficulties. Since that moment the opposite has happened. The cumulative trade balance for 12 months between June 2004 and August 2005 multiplied by seven, an increase of 74.03 billion dollars. The distribution of this increase, both because of changes in China's bilateral balance with various countries and because of products, presents us with three surprises: it is not only a question of the United States, nor of Chinese exports, nor of raw materials.

CHINA'S TRADE SURPLUS SOARING

Cumulative figure for trade balance for past 12 months

SOURCE: Chinese National Statistics Office.

By country and geographical area, the worsening of the US bilateral deficit with China would explain 46.4% of the increase in China's trade balance. The first surprise, however, is that Europe would account for the same amount – another 46.0%. If we add 7.1% for the reduction of the surplus which Japan had with China, the increase is fully explained. The case of Germany deserves special mention because it alone accounts for 10.4% of the increase in the balance.

The second surprise is that the main engine of the explosive increase in the surplus is the slowdown in Chinese imports and not an increase in its exports. The emphasis in the press on aggressive competitiveness coming from China's exports, while not incorrect, hides the real cause of the increase in the surplus which lies not in what China is selling but in what it is not buying from the developed world.

The third surprise comes from the fact that the slowdown in imports is due mainly to a drop in manufacturing imports. It is not that imports are down but that they are increasing to a lesser degree. In the twelve months ended in July 2005, China imported 65.7 billion dollars more in manufactures than in the same period the year before but in 2004 the increase had been 107.4 billion dollars, a much greater increase. In raw materials, in both cases, we are talking about figures close to 35 billion dollars.

But there is still more. The manufactures which China is failing to buy are those with value added which supports the hypothesis that something is changing in China's production fabric. The old idea about cheap labour and nothing else must be changed to cheap labour and something more. China had bilateral deficits with Germany and Japan, countries specializing in manufactures of high value added, as well as with South Korea which exports cheaper manufactures. In one year, the deficit from the first two has been drastically reduced and in the case of Germany has disappeared but the deficit with South Korea has risen sharply.

Supporting this thesis, the sharpest decreases came in imports of precision instruments, musical instruments and watches, electronic equipment, high technology products and, deserving special mention, transportation equipment, imports of which are now dropping. As a result, the figures suggest that China is now beginning to make its own watches and cars, a situation very different from that China presented in the past.

HOUSING PRICES ON INCREASE

Year-to-year change in average housing prices in Tokyo (*)

NOTES: (*) Cycle-trend series.
SOURCE: Japanese Institute of Real Estate Economy.

Brazil continues boom growth

The severe political corruption crisis in Brazil for the moment is not affecting growth. The good news for the economy, however, comes in the foreign debt and the interest this generates, a constant sword of Damocles. The negative side is that the political crisis could weaken the government's capacity to undertake reform. Latest monthly indicators have been weak but do not cloud the generally positive picture.

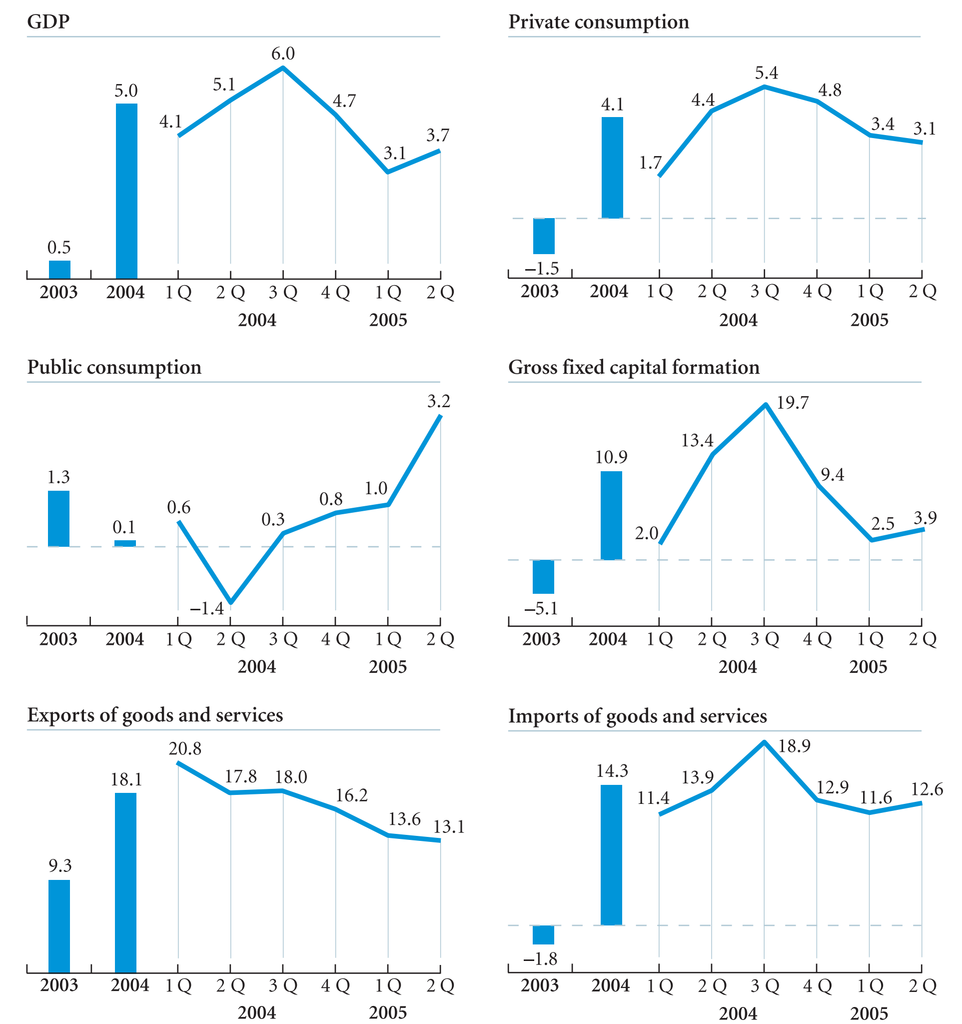
Brazil's economy grew by 3.7% year-to-year in the second quarter leaving behind the slight gap shown at the beginning of the year. On top of relatively strong private consumption, recovering investment and a very favourable foreign sector came more vigorous public consumption which is

Brazil growing by 3.7% unaffected by political crisis.

Retail sales and industrial production scarcely grow.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-to-year change in real terms



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

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005			
			3 Q	4 Q	1 Q	2 Q	July	August
Real GDP	5.0	6.0	4.7	3.1	3.7	–	...	–
Industrial production	0.1	8.3	10.4	6.3	3.9	6.1	0.5	...
Unemployment rate São Paulo (*)	19.9	18.8	18.2	17.4	17.0	17.5	17.5	...
Consumer prices	17.0	6.3	6.3	5.9	6.0	6.6	5.5	5.0
Trade balance (**)	24.8	33.7	32.1	33.7	35.9	38.3	39.9	39.9

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
SOURCE: Brazilian Institute of Geography and Statistics, Central Bank of Brazil and internal figures.

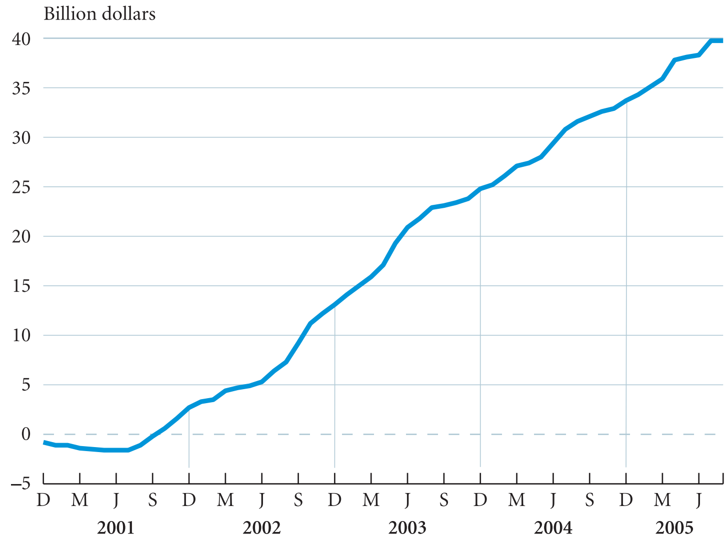
Brazil's problem: it is obliged to grow for two basic reasons – to pay off its debt and maintain political and social stability.

regaining growth rates not seen since 2000.

Nevertheless, recent monthly indicators for supply and demand make it necessary to view this positive trend in the national accounts with some caution. On the demand side, retail sales in July merely maintained their level and car sales were down in the same period. On the supply side, industrial production in July was practically stagnant with growth of 0.5% year-to-year. This clear slowdown puts the indicator back to the worst levels in 2003 and this is now following a downward trend. Industrial production of capital goods dropped and is showing a similar profile. Brazil's problem is that it is obliged to grow for two key reasons: to pay its debt and maintain some political and social stability.

BRAZIL MORE AND MORE COMPETITIVE ON WORLD SCENE

Cumulative trade balance for twelve months



SOURCE: Brazilian Institute of Geography and Statistics and internal figures.

On a more positive note, inflationary trends seem to be more and more under control with inflation in August easing to 5.0% year-to-year. Wholesale prices, in turn, held at 1.2%. While price moderation is no longer new, this does not mean it is less welcome in an economy in which average inflation in 2003 went above two digits and only a decade earlier was recording hyper-inflation. On the other hand, unemployment continued at 17.5% of the labour force and is still showing downward resistance.

Brazil's foreign sector continued to shine in August with a trade balance for the past twelve months close to 40 billion dollars, the biggest in the whole Latin American continent. Taking advantage of the improvement of the sector, direct investment, which had hit bottom in 2004, in July continued to show marked recovery.

Also showing positive, the primary balance for the public sector in the first quarter, which excludes payment of interest on the public debt, showed a surplus of 4.9% of the GDP. Nevertheless, if we add interest payments, the public sector showed a deficit of 2.6% of the GDP (which also meant an improvement over the past), this shows the enormous importance for Brazil of servicing its debt (7.5% of the GDP). As corollary to this improvement in the fundamentals of borrowing conditions, the initiative taken in issuing bonds denominated in reals and not in US dollars (as has been the case) is significant. In this way, currency risk is eliminated for the lender who holds both asset and liability in the same currency.

Primary fiscal surplus maintained but interest on public debt is major burden.

Argentina running at top speed

Argentina is the country in Latin America growing most rapidly. The quick recovery of domestic demand coexists with a trade surplus and this represents an important success. Argentina's two weaknesses are its foreign debt and the rise in inflation which now is close to two digits.

Argentina growing by 10% with strong investment and private consumption...

In the second quarter, Argentina grew by 10.1% year-to-year. Private consumption and exports are showing strong but the most significant component was investment which reported growth of 24.4% year-to-year. Argentina is a country in special need of investment and the fact that in the past quarter this component, for the first time, went above the high investment

...but foreign debt and inflation are to be watched.

ARGENTINA: MAIN ECONOMIC INDICATORS

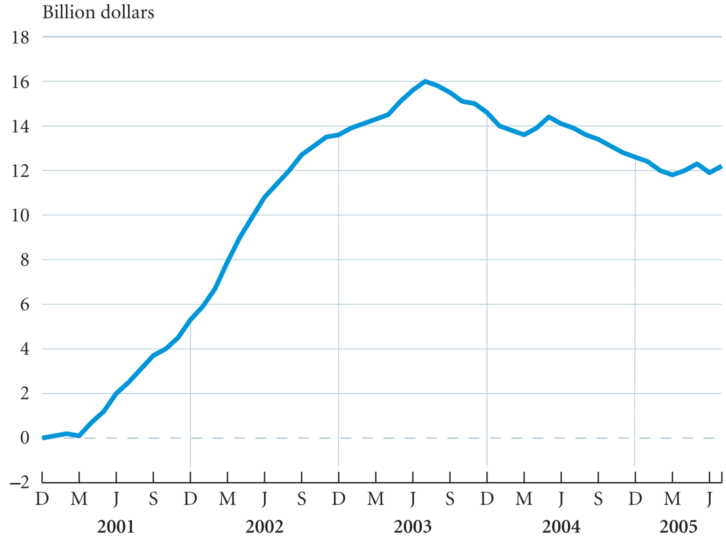
Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005			
			3 Q	4 Q	1 Q	2 Q	July	August
Real GDP	8.8	9.0	8.7	9.3	8.0	10.1	–	...
Industrial production	12.0	8.2	9.5	7.2	6.2	6.9	6.4	...
Unemployment rate (*)	17.3	13.6	13.2	12.1	13.0	12.1	...	...
Consumer prices	13.4	4.4	5.4	5.7	8.2	8.8	9.6	9.7
Trade balance (**)	15.7	12.1	12.6	12.1	11.8	11.0	11.2	...

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

ARGENTINA MAINTAINING TRADE SURPLUS

Monthly trade balance annualized (*)



NOTES: (*) Cycle-trend series.
SOURCE: Argentina National Institute of Statistics and internal figures.

Retail sales up 33% confirming recovery.

figures reached before the crisis is good news which should continue.

Demand indicators show the spectacular recovery of Argentina's economy. Retail sales in the Buenos Aires area grew by 33.6% year-to-year in July. Supermarket sales and car sales also showed strong growth although not as marked. With these growth rates, retail consumption now stands close to levels before the 2002 crisis and in the case of the Buenos Aires area has gone well above.

Supply indicators continued their upward path but less so than those for demand. Even so, industrial production grew by 6.4% in July. The mining industry and metals were the leaders and it should be borne in mind that, in recent months, steel production has dropped notably as a result of swings in world demand. The fact that industry is continuing to grow without hesitation in spite of the weakness of a component that had been very solid all through 2004 is another sign of the strength of the Argentine cycle. The unemployment rate in the second quarter dropped to 12.1%, a relatively high figure but far from the highs in 2002.

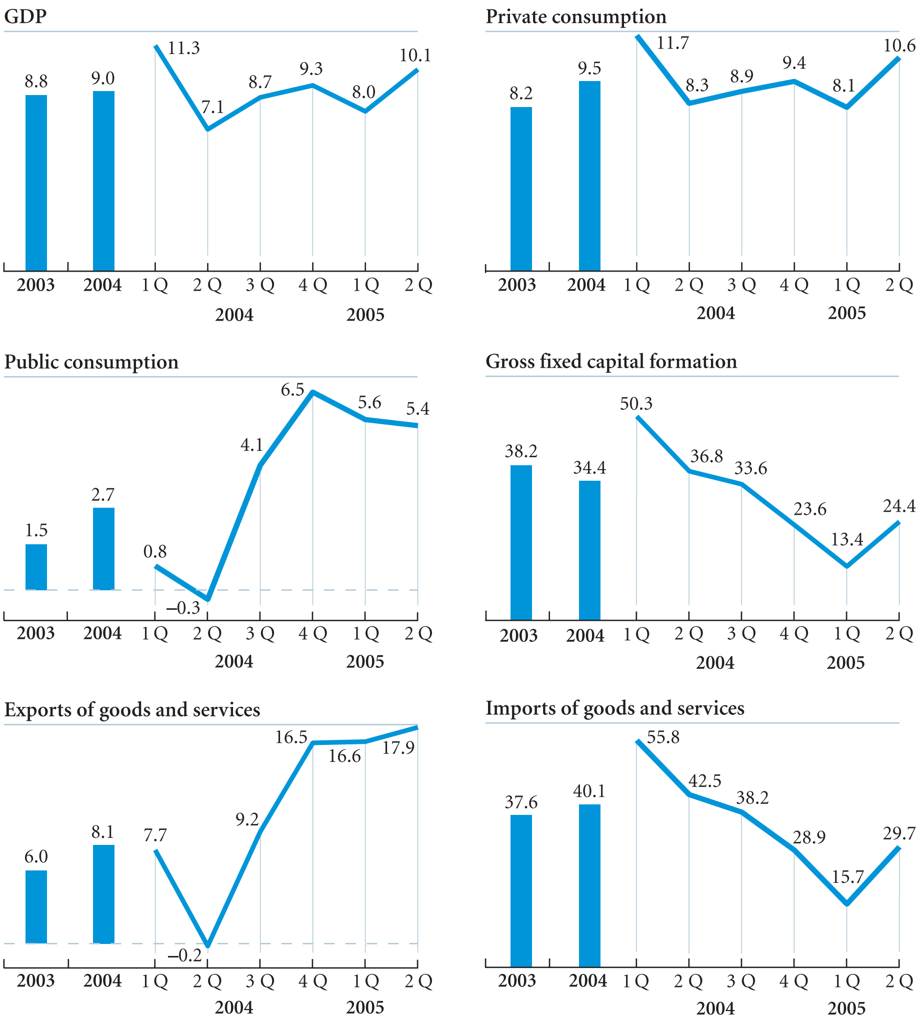
Industrial production up by 6% and withstanding drop in steel.

As mentioned. consumer products are one of the clouds showing over this drive. In August, year-to-year inflation reached 9.7%, spurred on by energy and food prices. The concern is more for the trend than for the level. At this time. the Argentine figures are high and comparison with the inflation reached in 2002 could make the present figure seem rather small. Nevertheless, in the present context, in which inflationary pressures in the area are a thing of the past, the competition for foreign investment is rough and interest on the public debt weighs heavily, inflationary risks are a poor companion.

The trade surplus is showing a halt in its downward move. In the twelve months up to July it stood at 11.17 billion

TREND IN ARGENTINA'S GDP BY COMPONENT

Percentage year-to-year change in real terms



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

dollars, which was below previous highs. However, in view of the strength of domestic demand which is pushing imports up, the very fact of having a surplus is already in itself a success.

Oil very close to all-time highs

Following the sharp boost in prices in July and August, when they went up by 6% and 11% respectively, oil has now stabilized and in September swung in the range of 63-64 dollars a barrel for Brent quality oil. In any case, these levels are close to the all-time high recorded on September 1 (67.48 dollars). What is more important, there is still uncertainty about the capacity of supply to adequately satisfy the strong demand.

As a result, even when the International Energy Agency reduced its estimates of demand for 2005 as a whole, which in principle should have partially relieved pressure on prices, other events

Oil stabilizes at 64 dollars a barrel in September, a level still too close to all-time highs, due to supply difficulties in ensuring delivery in a stage of strong demand.

OIL PRICES STUCK AT AROUND 64 DOLLARS A BARREL

1-month forward price of Brent quality oil per barrel as weekly average

SOURCE: Thomson Financial Datastream.

RAW MATERIAL PRICES

	2003	2004	2004		2005				
			3Q	4Q	1Q	2Q	July	August	September
«The Economist» index in dollars (*)									
General	11.7	17.4	16.0	1.5	–2.3	–1.8	2.8	7.6	8.2
Food	9.1	11.2	9.4	–7.3	–8.5	–7.7	–0.2	4.9	4.8
Industrials	15.9	26.1	25.1	13.8	5.9	6.3	6.8	10.9	12.1
Non-food agricultural	*21.8*	*9.2*	*6.8*	*–11.2*	*–10.7*	*–8.6*	*0.9*	*–0.8*	*2.3*
Metals	*11.8*	*38.2*	*38.3*	*31.5*	*16.1*	*15.5*	*10.2*	*17.4*	*17.5*
«The Economist» index in euros (*)	**–6.7**	**6.7**	**6.9**	**–6.5**	**–6.4**	**–6.0**	**4.8**	**7.1**	**7.9**
Oil (**)									
Dollars/barrel	28.4	38.0	40.7	44.7	47.8	53.1	58.1	64.0	64.0
Change rate	13.1	34.4	44.4	53.8	52.7	50.9	54.1	54.0	49.5
Gold									
Dollars/ounce	364.0	409.6	401.9	434.0	427.3	427.8	424.7	438.1	456.2
Change rate	17.3	12.7	10.6	10.6	4.6	8.6	6.7	9.1	12.3

NOTES: (*) Year-to-year change rate.
(**) Brent quality: one-month forward price.
SOURCE: «The Economist», Thomson Financial Datastream and internal figures.

counteracted this news. In the first place, there were doubts about the impact of the new hurricane *Rita* which could again have affected refineries in the Gulf of Mexico. At the same time, the decision of the Organization of Petroleum Exporting Countries (OPEC) to maintain present official production quotas ended up convincing economic players that conditions in the oil market are continuing the trend to increase prices.

Other raw materials are showing a similar profile although not going to the same levels as oil. Raw material prices as a whole, measured by «The Economist» index in dollars, was 8% high in September than one year earlier. The group to rise most was metals with growth more than double the global index. At the opposite extreme we find non-food agricultural raw materials with growth of only 2% year-to-year. Behind this trend we basically see the sharp increase in demand coming from a world economy which clearly continues to grow.

With metals in lead, other raw material prices also showing drive in demand.

EUROPEAN UNION

Euro area: waiting for renewal of growth

Upward trend in euro area growth ends in mid-2004.

The euro area stands at a stage involving a change in trend. It would appear that the worst of the recent period of economic slowdown is now over but there still remains much uncertainty about the future growth rate. It should be remembered that the notable weakness in the economy in the first half-year, a period when the euro area grew by a mere 1.2%, came on top of the worst year in terms of economic growth since 1993.

Perhaps the most troubling element in the current European cycle, however, has been the break in the upward growth trend. In mid-2004 recovery appeared to be on track. From growth of 0.4% year-to-year in the second quarter of 2003 it had moved up to a growth rate of 2.1% in the gross domestic product (GDP) in the second quarter of 2004. At that time, it moved into an unexpected stage of a decrease in economic activity which cost one percentage point in growth in one year, so that the growth rate stood at 1.1% in the second quarter of 2005. Following this disappointing trend we see progressively more depressed domestic demand, especially in investment, given that private consumption had already stopped showing strong growth rates along with a notable slowdown in exports.

Investment and exports raise hopes.

At this time, the downward trends seem to be easing as a result of investment and exports. A look at the composition of GDP growth in the second quarter would indicate the start of hoped-for recovery. To begin with, following

EURO AREA: MAIN ECONOMIC INDICATORS

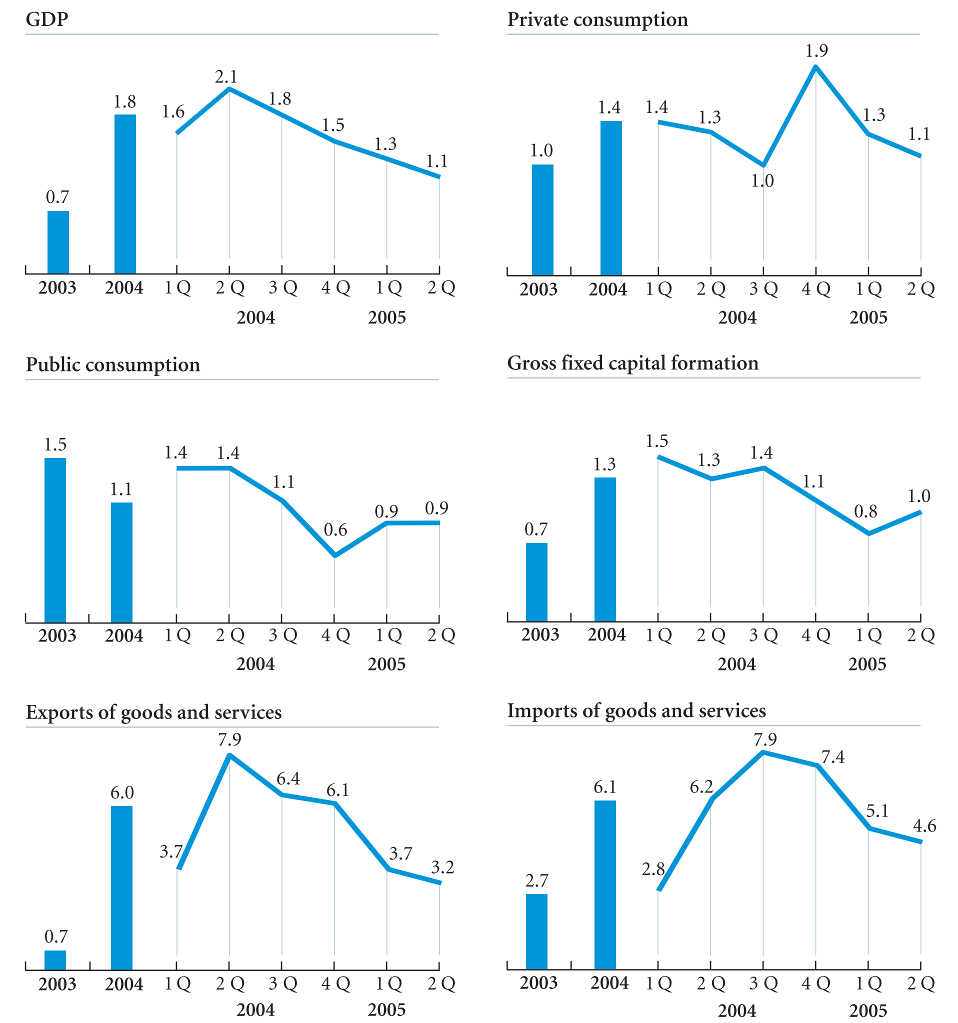
Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005			
			3 Q	4 Q	1 Q	2 Q	July	August
GDP	0.7	1.8	1.8	1.5	1.3	1.1	–	...
Retail sales	0.3	0.8	0.7	0.9	1.0	0.6	0.0	...
Consumer confidence (*)	–18	–13.8	–14	–13.0	–13.1	–14.3	–15	–15
Industrial production	0.3	2.0	2.8	1.1	0.8	0.6	0.5	...
Economic sentiment indicator (*)	93.4	100.0	100.6	100.9	99.0	96.3	97.3	97.6
Unemployment rate (**)	8.7	8.9	8.9	8.8	8.8	8.7	8.6	...
Consumer prices	2.1	2.1	2.2	2.3	2.0	2.0	2.2	2.2
Trade balance (***)	80.3	81.0	85.2	74.1	65.2	51.6	43.1	...

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

TREND IN GDP IN EURO AREA BY COMPONENT

Percentage year-to-year change



SOURCE: Eurostat and internal figures.

a slowdown in growth from 1.3% year-to-year in the first quarter to 1.1% year-to-year in the second quarter, we find private consumption as being the main factor because of a downturn in the second quarter.

On the other hand, the increase in investment and a better situation in exports (not seen in the trend compared with one year earlier but evident in the sharp growth compared with the first quarter) represent a significant change over previous quarters.

Does this confirm the earlier trends in the third quarter? It does to a large extent. Household consumption remains static, if we are to go by zero year-to-year growth in retail sales in July and stagnation in consumer confidence as of August. The trend in investment appears to be better if we look at the increase in industrial production of capital goods as

First signs of recovery in industry on top of early revival in construction sector.

Forecasts indicate economic recovery in second half will become reality although growth rate to remain low.

recorded up to July. The trend in exports is also extending the recovery path followed in the second quarter with growth of around 6% year-to-year in exports between May and July.

Sector indicators also confirm the impression of a gradual recovery under way. Industry remains weak but figures for industrial production in June and July (with growth stable at 0.5% year-to-year) indicate an incipient recovery. Services are showing a growing rate of activity. Construction may also be leaving behind a period of stagnation, according to the more favourable trend in the sector confidence indicator. The gradual reduction in the unemployment rate would also tend to confirm this situation. The rate went from 8.8% at the beginning of the year to 8.6% in July, thus reflecting a slightly more dynamic labour market.

To date, rise in energy prices not changing inflationary trend.

One element which, in any case, should not impede growth is the trend in prices. The lack of any repercussions from the big increase in oil prices at origin in the general harmonized consumer price index (HCPI) was largely due to the contained trend in other components. As a result, in August, a month in which oil was 54% higher than one year earlier, inflation held at 2.2% year-to-year due to the fact that the trend in the energy component (year-to-year increase of 11.6%) was more than compensated by the stability in all other components.

Germany: lack of sufficient parliamentary majority greatly complicates twin challenge of consolidating recovery now underway and speeding up structural reforms...

To sum up, recovery is underway. This is a widely held impression to the point where a similar evaluation was made by Jean-Claude Trichet, chairman of the European Central Bank, in a recent appearance before the Economic and Monetary Affairs Committee of the European Parliament when he forecast a recovery of economic activity over the short term.

The main unknown is whether the increase in growth will be gradual or sharp. Qualitative indicators of the best forecast quality, such as the economic sentiment indicator, point to a gradual recovery. Similarly, the European Commission estimates that in the second half of the year, year-to-year growth will stand within a range of between 1.2% and 1.8%, that is to say relatively gradual.

Germany: political uncertainty complicating recovery

Up until September 18, the political and economic situation in Germany could be seen in the following terms: the economy was beginning to recover and the government coming out of the elections, over a period of time, would have to guarantee consolidation of recovery through further efforts at structural reform which would make it possible to improve capacity for economic growth over the medium and long term. Given the notable political capital to be invested in this twin economic challenge, the indispensable condition was that one of the two large political parties, Gerhard Schröeder's Social Democratic party or Angela Merkel's Christian Democrats would obtain a solid parliamentary majority.

As is now known, the results did not lead to this scenario and, unless there is a «broad coalition» of the two parties, the other parliamentary balances do not appear to be sufficiently cohesive in economic matters. All of this increases uncertainty and reduces the prospect of the much needed refloating of Europe's economic engine and especially the capacity of the new government to rebuild confidence in the country, a factor which has frequently been put forward as an explanation for the poor

GERMANY: MAIN ECONOMIC INDICATORS

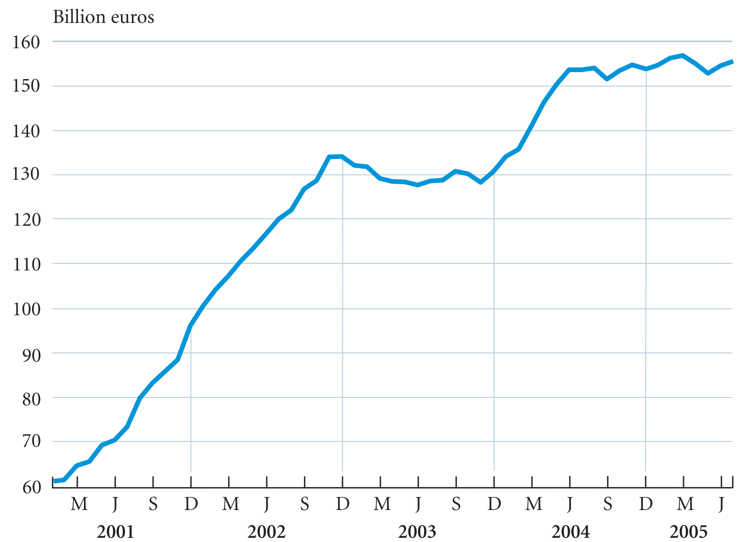
Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005				
			3 Q	4 Q	1 Q	2 Q	July	August	September
GDP	–0.2	1.1	1.1	0.5	0.8	0.6	–	...	–
Retail sales	–0.5	0.9	0.7	0.9	0.2	1.6	–3.0	...	...
Industrial production	0.1	2.4	3.8	1.4	2.4	1.9	3.0	...	...
Industrial activity index (IFO) (*)	91.7	95.7	95.3	95.2	95.3	93.2	95.0	94.6	96.0
Unemployment rate (**)	10.5	10.6	10.6	10.7	11.7	11.8	11.6	11.6	...
Consumer prices	1.0	1.7	1.9	2.0	1.7	1.7	1.9	1.9	2.4
Trade balance (***)	130	149	153	154	156	154.2	155.6	...	...

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

GERMAN FOREIGN SECTOR REMAINS BASIS OF RECOVERY

Trade surplus: cumulative balance for 12 months



SOURCE: Deutsche Bundesbank and internal figures.

rate seen in private consumption and investment.

This complicated political picture should not make us forget that the economic situation to be encountered by the new government will be the best in recent times. While normally it is maintained that this improvement would come about entirely on the basis of a recovery in corporate confidence in the mid-summer months (the IFO indicator of industrial activity rose sharply in July, consolidated this increase in August and again rose in September) there now begins to be firmer evidence showing something of a break from recent trends. In this respect, it should be remembered that in 2003 and 2004 domestic demand showed a major drop,

...but situation encountered by new government will be the best in recent times.

Industry, key sector in German economy, showing recovery.

France: Villepin government launches reform of income tax aimed at improving spending capacity of French households.

Doubts exist about sustainability of recovery in consumption.

concentrated especially in private consumption and construction investment. The only factor which contributed to maintaining the economy was exports.

Starting out from this situation, what may be stated is that in the first half of 2005 the dynamic began to change. Exports have continued to show growth and, as the main new factor, capital goods investment has begun a recovery. In both cases, the third quarter indicates continuation of this improvement, if we are to go by available figures. Exports up to July grew by nearly 6% year-to-year while industrial production of capital goods was up by the order of 5% year-to-year.

On the other hand, private consumption does not seem to be improving although the fact that consumer confidence rose in August for the first time in three months is a good sign which could be reflecting a slightly more positive situation in the labour market (the unemployment rate has eased slightly going to 11.6% in August with creation of 72,000 new jobs from May to July). In any case, the worsening of inflation which held at 1.9% year-to-year in July and August but rose to 2.4% in September, is a negative factor for an improvement in consumption.

What are the sectors most clearly showing the improvement in the economic situation? To begin with, one key sector, industry, has notably increased its growth rate as seen in industrial production which grew at 3% year-to-year in June and July. The improved relative trend in building permits may also indicate that the construction sector could be beginning to recover after several negative years.

France: fiscal reform aimed at recovery in consumption

If we had to point out one characteristic factor in France's recent economic policy it would be the efforts carried out to ensure that households maintained sufficient spending capacity. Household consumption has acted as the engine of growth in recent years but since the third quarter of 2004 it has been more up and down. This lies behind the orientation of Dominique de Villepin's new government, aimed at improving employment and income tax, two factors which have a direct effect on middle-class consumer capacity.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005			
			3 Q	4 Q	1 Q	2 Q	July	August
GDP	0.9	2.0	1.8	2.1	1.9	1.3	–	...
Domestic consumption	1.9	3.3	2.5	4.0	3.2	1.1	3.6	5.7
Industrial production	–0.4	1.8	1.8	1.6	1.0	–0.2	–0.7	...
Unemployment rate (*)	9.8	10.0	10.0	10.0	10.1	10.2	9.9	...
Consumer prices	2.1	2.1	2.2	2.1	1.6	1.6	1.7	1.8
Trade balance (**)	0.2	–0.1	–0.1	–0.6	–1.2	–1.6	–1.8	...

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

As a result, after introducing various measures to make labour laws more flexible for small French companies, on September 14 the Minister of Economy, Thierry Breton, made public the general features of income tax reform. These involved a reduction in the number of tax tables from the current 7 to 5; a reduction in the highest rate which goes to 40% as against the 48% now being applied; and finally, establishment of a limit on the direct tax load equivalent of a maximum of 60% of taxpayer income. If this reform goes ahead it will be applied on income generated in 2006 so that taxpayers will fully see results in 2007, an election year.

Apart from these economic policy measures, the latest available indicators, specifically the monthly figure for domestic consumption (growth of 6% year-to-year in August, an annual high), would seem to support some recovery in consumption. Nevertheless, the low level of consumer confidence as of July throws some doubt on the sustainability of recovery. In this respect, recovery of the labour market is seen as fundamental. Whereas in June and July the unemployment rate was down by three decimals to 9.9%, growth of employment continues low.

With regard to other recent indicators, it should be pointed out that industrial production was even weaker in July (drop of 0.7% year-to-year) and that consumer prices scarcely showed any signs of increasing with growth of 1.8% year-to-year in August, only marginally higher than the increase in rate recorded in June and July.

Italy: investment and exports driving economy

Italy: unexpected economic recovery in second quarter which should continue for rest of year.

Italy may be coming out of the worst stage of its recent economic recession. Whereas a further quarterly drop in the GDP was expected, in the second quarter the economy grew by 0.7% compared with the first quarter. At year-to-year rate, the GDP increase was 0.1% due largely to the growth of private consumption, investment and exports.

Now the big question is to find out if recovery can be consolidated. Available information is not very conclusive. The increase in private consumption seems to be ephemeral, given that consumer confidence again worsened at the beginning of the summer and the same happened in July. On the other hand, the main supply indicator, industrial

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005			
			3 Q	4 Q	1 Q	2 Q	July	August
GDP	0.4	1.0	1.2	0.8	–0.2	0.1	–	...
Retail sales	2.0	–0.4	–1.3	–1.1	0.1	–1.2	–2.1	...
Industrial production	–0.6	–0.6	–0.8	–1.9	–2.3	–1.5	–1.6	...
Unemployment rate (*)	8.4	8.0	7.9	7.9	7.8	7.7	–	...
Consumer prices	2.7	2.2	2.2	2.0	1.9	1.8	2.1	2.0
Trade balance (**)	4.1	1.6	2.3	–0.9	–2.2	–4.7	...	...

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

production, is lately showing a slightly stronger trend which may be related to the definite improvement in exports in May and June.

The absence of inflationary pressures (the CPI grew by 2.0% year-to-year in August, a level around which it has hovered since September 2004) and the gradual but continuing reduction in unemployment (7.7% in the second quarter) are positive factors which would seem to lean the balance in favour of a continuation of cyclical recovery which should be more noticeable in 2006, a year when general elections are to be held.

UK domestic demand, once the main engine of growth, loses strength while foreign sector fails to take its place.

Easier monetary policy may end up strengthening recovery.

United Kingdom: lower growth stage ending

The summer months confirmed that the British economy continues to run out of steam. In spite of maintaining an acceptable level of confidence, households have reduced their spending rate to the point where retail sales grew by a mere 0.8% year-to-year in August, far from the 3.5% seen in January. Industrial production of capital goods is erratic indicating weak drive in investment. All of this has an influence on the worsening of domestic demand which will not be more than partially compensated by the recent rise in exports.

In any case, the stabilization of industrial production and especially the recovery of economic sentiment, largely thanks to the better drive in services, may indicate that the end of the slowdown is near. This evaluation does not ignore the better performance of prices (both consumer prices and producer prices moved down in August) and a labour market which continues to show a very low unemployment rate of 2.8% between June and August, scarcely above the all-time low.

What could also contribute to consolidating recovery is the recent change in monetary policy which showed up in a decrease in the Bank of England intervention rate on August 4 when it went from 4.75% to 4.50%.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005			
			3 Q	4 Q	1 Q	2 Q	July	August
GDP	2.5	3.2	3.1	2.7	2.1	1.8	–	...
Retail sales	3.0	6.1	6.7	4.7	2.9	1.5	1.4	0.8
Industrial production	–0.5	0.8	0.4	0.0	–1.1	–1.8	–1.6	...
Unemployment rate (*)	3.0	2.7	2.7	2.7	2.6	2.7	2.8	2.8
Consumer prices	2.8	2.2	2.1	2.3	2.2	2.2	2.4	2.3
Trade balance (**)	–46.8	–55.3	–57.4	–59.7	–61.5	–62.6	–61.8	...

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

FINANCIAL MARKETS

Monetary and capital markets

Federal Reserve to continue raising interest rates

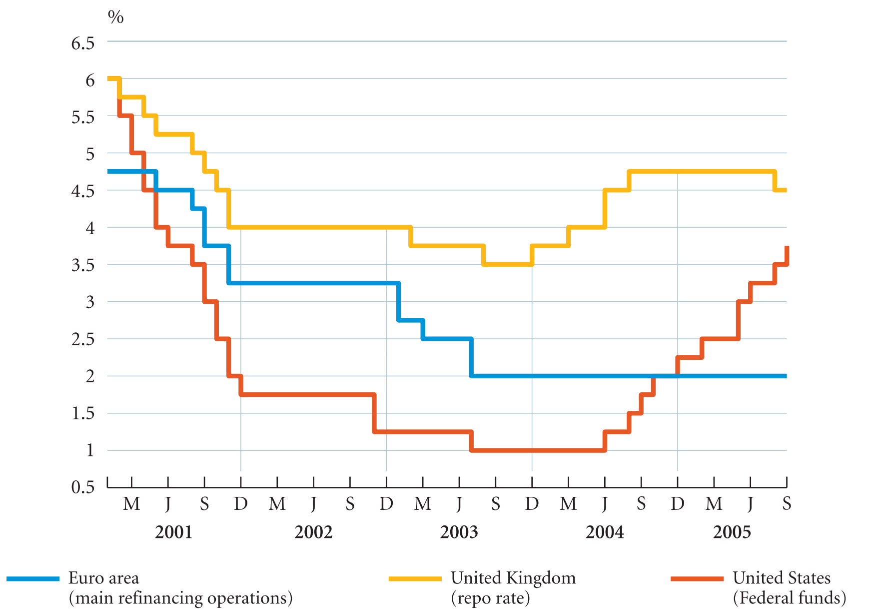
Upward movements in interest rates by the main central banks were again predominant factors in September. Both the Federal Reserve and the Bank of Canada raised their reference rates continuing to bring them to normal levels although rates continue at all-time lows. The progress of the US and Canadian economies is coming close to potential level, that is to say, sustainable economic growth without generating inflation, along with the substantial increase in oil prices, were behind these moves. On the other hand, the moderate drive in the euro area economy and the deflationary situation in Japan brought maintenance of easier monetary policies in those areas.

Hurricane *Katrina* cools off prospects of interest rate rise but Greenspan makes no change of plan.

In the United States, following the disastrous effects of hurricane *Katrina* in various southern states at the beginning of September, the market speculated that the Federal Reserve would make a pause in its round of reference rate increases once it was known that the chairman of the Federal Reserve, Alan Greenspan, had met with president George W. Bush following the impact of *Katrina*. Nevertheless, once the initial shock had passed the predominant opinion was that the macroeconomic effects of the hurricane would not be great and, while

FEDERAL RESERVE AGAIN RAISES OFFICIAL INTEREST RATE IN SPITE OF 'KATRINA'

Monetary policy reference rates



SOURCE: National central banks.

Market discounting only one or two more increases of 25 basis points by Fed in coming months...

...nevertheless, Fed reference rate could rise to 4.50% in coming year.

it could have a negative effect on growth in the fourth quarter, subsequent reconstruction would bring about increased economic growth.

In this framework, the Federal Open Market Committee of the Federal Reserve at its meeting on September 20 decided to again raise official interest rates by 25 basis points. As a result, the reference rate for overnight interbank deposits rose to 3.75%. This was the eleventh consecutive increase in this rate.

In its press release, the Federal Reserve held largely to the wording used in recent months. It stated that it would still continue to raise interest rates gradually although at this meeting one of the committee members, Mark W. Olson, voted against an interest rate rise. In these circumstances, the market is discounting that the USA reference rate will rise once more to 4% before the end of the year.

Nevertheless, the US official interest rate could go to 4.50% in 2006 if pressures in the labour market are confirmed, given that the Federal Reserve would be obliged to react in order to avoid a price-wage spiral which, while up to now this has been avoided, among other reasons because of the anti-inflationary credibility won in the fight against inflation in the Eighties and Nineties of

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor 3-month	Euribor 1-year	Federal Reserve Board target leval (3)	3-month	3-month	Bank of England intervention rate (4)	3-month	3-month
2004									
August	2.01	2.11	2.30	1.43	1.70	0.00	4.72	4.88	0.54
September	2.02	2.12	2.38	1.59	1.88	0.00	4.75	4.85	0.67
October	2.03	2.15	2.32	1.75	2.06	0.00	4.75	4.81	0.71
November	2.05	2.17	2.33	1.92	2.28	0.00	4.75	4.79	0.75
December	2.07	2.17	2.30	2.25	2.47	0.00	4.75	4.78	0.75
2005									
January	2.06	2.15	2.31	2.25	2.64	0.00	4.75	4.79	0.74
February	2.06	2.14	2.31	2.50	2.80	0.00	4.75	4.80	0.75
March	2.05	2.14	2.34	2.59	2.99	0.00	4.75	4.90	0.75
April	2.05	2.14	2.27	2.75	3.12	0.00	4.75	4.86	0.76
May	2.05	2.13	2.19	2.99	3.24	0.00	4.75	4.81	0.76
June	2.05	2.11	2.10	3.01	3.40	0.00	4.75	4.76	0.75
July	2.05	2.12	2.17	3.25	3.59	0.00	4.75	4.57	0.75
August (*)	2.05	2.13	2.22	3.43	3.78	0.00	4.53	4.51	0.76
September (1)	2.06	2.14	2.27	3.75	3.98	0.00	4.50	4.56	0.76

NOTES: (*) Provisional figures.

(1) September 27.

(2) Marginal interest rate. Latest dates showing change in minimum rate: 6-3-03 (2.50%), 5-6-03 (2.00%).

(3) Latest dates showing change: 10-11-04 (2.00%), 14-12-04 (2.25%), 2-2-05 (2.50%), 23-3-05 (2.75%), 3-5-05 (3.00%), 30-6-05 (3.25%), 9-8-05 (3.50%), 20-9-05 (3.75%).

(4) Latest dates showing change: 10-7-03 (3.50%), 6-11-03 (3.75%), 5-2-04 (4.00%), 6-5-04 (4.25%), 10-6-04 (4.50%), 5-8-04 (4.75%), 4-8-05 (4.50%).

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

last century. Given that at the end of January Alan Greenspan will step down as president of the Federal Reserve, it is likely that the new head of monetary policy will want to establish his own reputation so that the Federal Reserve interest rate could possibly continue upward in the coming year.

In the euro area, the European Central Bank (ECB) revised downward its economic growth projections for 2005 and 2006 to the range of 1.0%-1.6% and 1.3%-2.3% respectively. At the same time, it raised figures for inflation to 2.1%-2.3% in 2005 and 1.4%-2.4% in 2006, largely because of higher than expected oil prices. The European Central Bank has maintained the opinion that the Eurosystem interest rate stands at the proper level to ensure price stability over the medium-term below 2%. In fact, harmonized inflation in August held at 2.2% at year-to-year rate while core inflation (excluding the more volatile elements) stood at 1.3%.

ECB revises downward economic growth projections for euro area but raises those for inflation because of oil...

The ECB indicated that risks for growth rather suggest a downward trend while inflation risks pointed upward. Nevertheless, ECB president, Jean-Claude Trichet, maintains that price stability is not in danger at least while wage increases remain contained. As a result, the monetary policy of the euro area continues to be very easy, with interest rates, both nominal and real, at historically very low levels.

The 1-year Euribor rose by 5 hundredths on monthly average in August going to 2.22% although it stood 8 hundredths below 12 months earlier. In the early weeks of September, the 1-year Euribor tended to stand at around this level. The interest rate curve is not indicating an upward swing by the European Central Bank until the second half of 2006. Nevertheless, the ECB could be obliged to bring forward a tightening of monetary policy to the first half-year if oil prices go up even higher, as is likely, and these begin to shift to the core of consumer prices.

...and could begin an upward round in the first half of 2006 if economic situation improves.

Rise in Fed interest rates aids dollar over short term

The dollar appreciated by 2.7% in the first eight months of the year measured against a broad group of currencies. This rise was based on a favourable interest rate differential against the euro and the yen and relatively high economic growth. As a result, the US currency was able to overcome downward pressures arising from the massive foreign imbalance in the US economy.

In the early days of September, however, speculation that the Federal Reserve would make a pause in the process of raising interest rates because of the effects of hurricane *Katrina* weakened the greenback. Nevertheless, later on, once those expectations wore out, the dollar recovered strength. At the same time, the July figure for the trade deficit, lower than expected, helped the dollar in mid-September. However, over the medium term the dollar should make a downward correction, especially against Asian currencies, in order to decrease the foreign imbalance.

Dollar should depreciate against Asian currencies over the mid-term to correct foreign imbalance.

Euro depreciated by 5.7% in the January-August period against the currencies of its main trading partners after having appreciated strongly in the fourth quarter of 2004. The moderate economic growth in the euro area, the unfavourable widening of the interest rate differential against other currencies and rejection of the European Constitution in referendums held in France and the Netherlands in May and June with the subsequent political crisis

EXCHANGE RATES OF MAIN CURRENCIES

August 2005

	Final session of month		Monthly figures				Exchange rate September 27, 2005
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2) Monthly	Over December 2004	Annual	
Against US dollar							
Japanese yen	110.6	–1.6	110.6	–1.2	6.6	0.3	*113.3*
Pound sterling (1)	1.804	2.6	1.795	2.4	–7.0	–1.4	*1.768*
Swiss franc	1.253	–2.7	1.262	–2.4	10.2	0.0	*1.295*
Canadian dollar	1.189	–2.9	1.205	–1.5	–1.0	–8.2	*1.178*
Mexican peso	10.79	1.8	10.69	0.1	–4.6	–6.2	*10.89*
Nominal effective index (4)	110.8	–0.8	110.8	–1.3	1.7	–3.9	*111.7*
Against euro							
US dollar	1.220	0.9	1.229	2.1	–8.3	1.0	*1.201*
Japanese yen	136.1	0.1	136.0	0.9	–2.3	1.1	*136.0*
Swiss franc	1.549	–0.8	1.553	–0.3	1.1	0.9	*1.558*
Pound sterling	0.683	–0.9	0.685	–0.3	–1.4	2.4	*0.680*
Swedish krona	9.340	–0.7	9.340	–0.9	4.0	1.7	*9.388*
Danish krone (3)	7.458	0.0	7.460	0.0	0.3	0.3	*7.462*
Polish zloty	4.032	–1.0	4.044	–1.3	–2.2	–8.7	*3.896*
Czech crown	29.57	–1.9	29.59	–1.9	–3.4	–6.4	*29.38*
Hungarian forint	244.5	–0.2	244.5	–0.8	–0.5	–1.8	*247.3*
Nominal effective index (5)	*101.9*	*0.1*	*102.3*	*0.6*	*–4.5*	*–0.4*	*101.0*

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

Election results in Germany making progress in structural reforms difficult hurt euro.

hurt the European currency. In the early weeks of September, the euro lost positions.

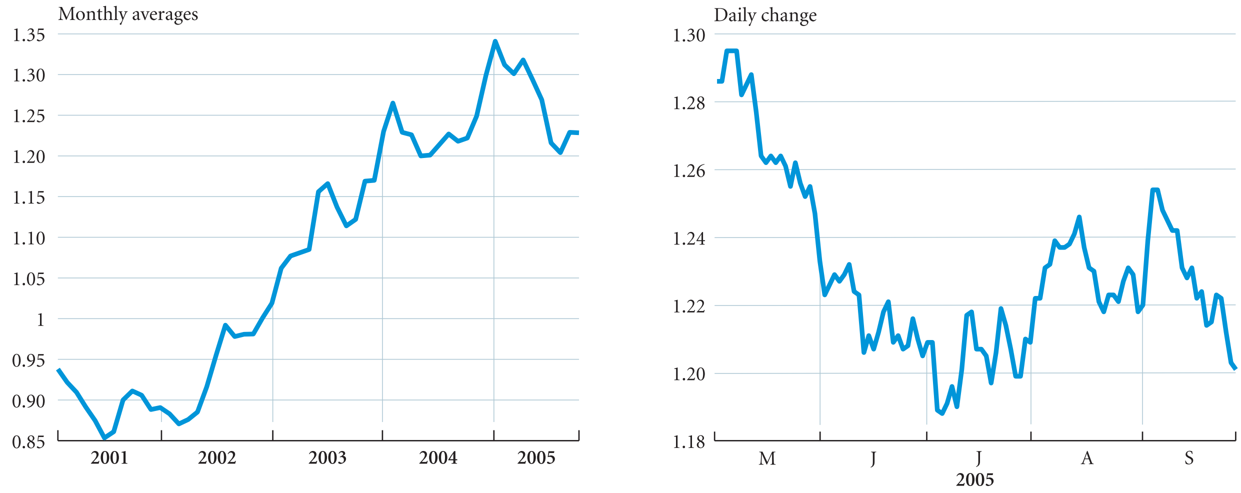
In terms of the dollar, the euro showed swings in the early weeks of September. On September 2, it was running at 1.254 dollars, a level not seen since May. Nevertheless, the single European currency moved down going to the level of 1.20 dollars.

The pound sterling showed a cumulative increase of 1.6% as of August in terms of a broad basket of currencies. In the early weeks of September, the British currency rose slightly in overall terms following the failure of the Bank of England official rate to repeat the cut which took place in August and the cooling off of prospects of further decreases. So far this year, however, while the pound has appreciated against the euro it has dropped in terms of the dollar.

The yen fell by 4.1% in the first eight months of the year in terms of the main group of currencies as it was weakened by an unfavourable differential in interest rates in terms of other

EURO DROPS AGAINST DOLLAR

US dollars to euro

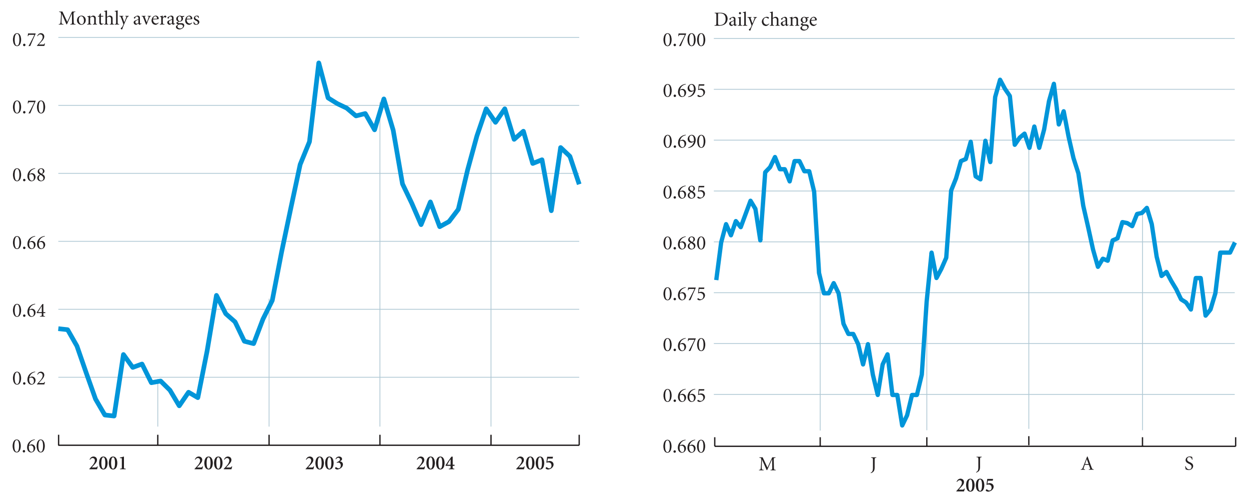


NOTES: Figures go up to September 27.
SOURCE: OECD, Thomson Financial Datastream and internal figures.

currencies with Japan's official interest rate continuing at 0%. In the early weeks of September, the Japanese currency tended to rise as a result of the victory by Koizumi in the early elections held on September 11 thus opening the way to suitable structural reforms. Nevertheless, it later lost ground in view of the rise in the dollar. In the fourth week of the month, the yen stood considerably

POUND STERLING HOLDS UP AGAINST EURO

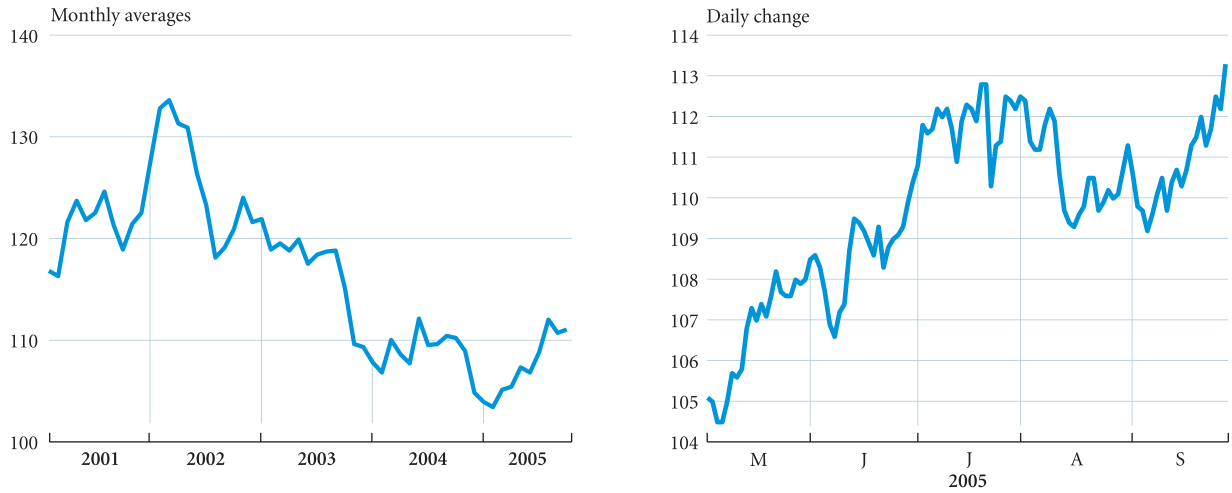
Pound sterling to euro



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

YEN MARKS UP LOW FOR PAST 16 MONTHS AGAINST DOLLAR

Yen to dollar



NOTES: Figures go up to September 27.
SOURCE: OECD, Thomson Financial Datastream and internal figures.

below its initial level for the year in terms of the dollar although it was showing appreciation against the euro.

Yield on German bonds marks up low for recent decade

Notable flattening out of US interest rate curve in 2005.

The yield on US 10-year Treasury bonds fell to 4.02% on September 1, the lowest level since the end of June, with the appearance of figures which indicated lower economic growth than expected. Nevertheless, the bond yield later tended to move up slightly with the disappearance of prospects that the Fed would take a pause in its upward path. It should be pointed out that the interest rate curve has flattened out substantially so far this year with the rise in short-term interest rates, whereas long-term yields stand at levels similar to the end of 2004. The enigma with regard to bonds still hangs over the world economy seeing that, given international economic conditions, the yield on US bonds is exceptionally low.

Yield on long-term European bonds could still reach new lows.

The interest rate on German 10-year government bonds fell to 3.02% in the fourth week of September, recording the lowest level in recent decades as it played the role of refuge asset in view of the uncertainty about the effect of hurricanes in the southern United States on oil supply and refining. While in coming weeks the yield on European long-term government bonds could still mark up further lows over the medium term, it likely will rise to levels more in keeping with economic fundamentals moving up from the unusually low current figures.

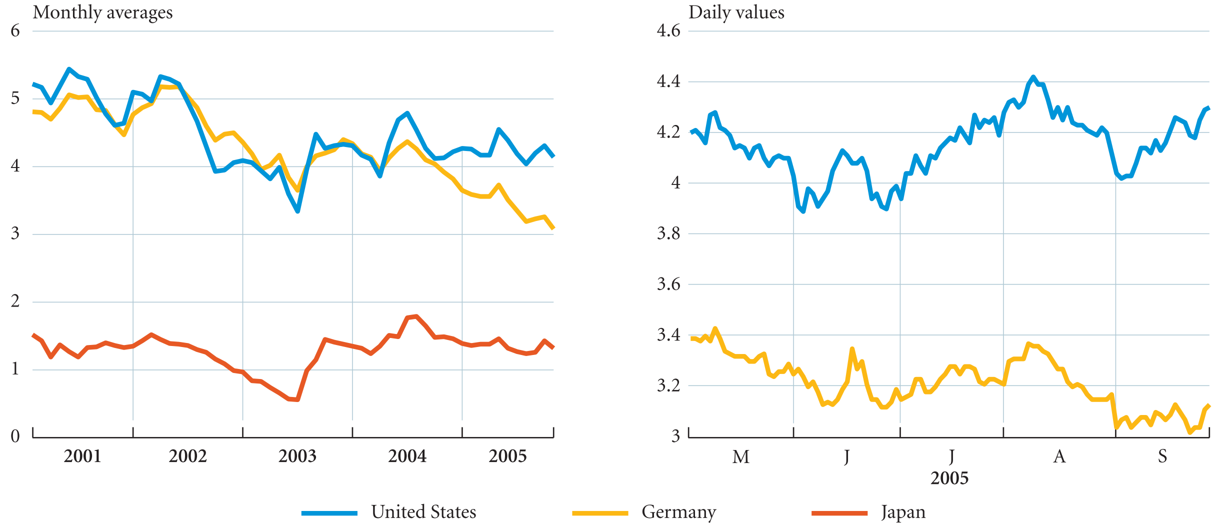
Stabilization of oil prices eases stock markets

Better-than-expected corporate profits and low interest rates driving stock markets...

Better-than-expected corporate profits and low interest rates continued to boost stock markets in the summer in spite of the high oil prices reached. As a result, many stock market indices marked up new all-time highs in September (or highs for recent years) following some

SLIGHT RISE IN US LONG-TERM INTEREST RATES

Yield on 10-year government bonds as annual percentage



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

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2003	2004	2005				
			1 Q	2 Q	July	August	September 27
United States	4.04	4.31	4.34	4.21	4.20	4.31	4.30
Japan	0.99	1.50	1.41	1.28	1.26	1.43	1.37
Germany	4.10	4.07	3.63	3.35	3.23	3.26	3.13
France	4.13	4.10	3.64	3.38	3.27	3.30	3.17
Italy	4.24	4.24	3.75	3.53	3.44	3.46	3.33
Spain	4.12	4.10	3.63	3.36	3.22	3.23	3.10
United Kingdom	4.53	4.93	4.72	4.50	4.34	4.36	4.29
Switzerland	2.47	2.57	2.15	2.04	1.95	1.94	1.88

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

moderation in oil prices. As a result, most of the main stock markets ended the summer showing sharp revaluation for the year (higher than forecast at the beginning of the year), with the exception of the US markets.

The exception was in the United States where the stock markets are showing a mediocre trend. Following the major gains recorded in 2004, US shares were showing some over-valuation compared with other markets. Furthermore, the continuing rise in Federal Reserve interest rates has hurt the US stock market. In September, the effects of hurricane *Katrina* were compensated by speculation that the Federal Reserve might not raise its interest rates as much as expected. The Standard & Poor’s 500

...although US markets showing mediocre trend in 2005.

Substantial capital gains in European stock markets so far this year.

index showed a modest rise over December in the final week of September. On the other hand, the traditional Dow Jones Industrials index and the Nasdaq general index (which is representative of hi-tech shares) are showing slight losses so far this year.

In the energy sector, due mainly to the increase in oil prices, the oil companies and public utility companies marked up major capital gains over December. On the other hand, companies in telecommunications, materials and cyclical consumption showed notable cumulative drops.

On the other hand, the DJ Eurostoxx 50, which includes the largest companies in the euro area, in the final week of September showed a rise of two digits over December. Depreciation of the euro in the course of 2005 and maintenance of European Central Bank interest rates at very low levels, along with big increases in European company profits and corporate take-over operations in various sectors, such as electricity, boosted share markets on the Continent. At the end of the second week of September, the Xetra Dax index for Frankfurt marked up its highest level since May 2002 spurred on by the prospect of progress in structural reforms. The expected victory of the Christian Democrats on September 18 opened the prospect of significant changes in economic policy. Nevertheless, these prospects later faded and, as a result of the tight election

INDICES OF MAIN WORLD STOCK EXCHANGES

August 31, 2005

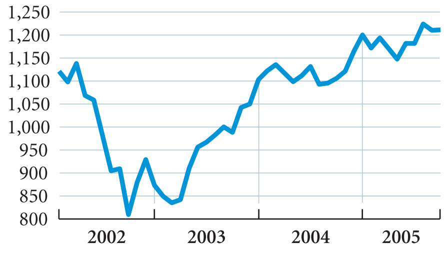
	Index (*)	% monthly change	% cumulative change	% annual change	Figures on September 27, 2005: % cumulative change	Figures on September 27, 2005: *% change over same date in 2002*
New York						
Dow Jones	*10,481.6*	*–1.5*	*–2.8*	*3.0*	*–3.0*	*35.8*
Standard & Poor's	*1,220.3*	*–1.1*	*0.7*	*10.5*	*0.3*	*46.9*
Nasdaq	*2,152.1*	*–1.5*	*–1.1*	*17.1*	*–2.7*	*76.5*
Tokyo	12,413.6	4.3	8.0	12.0	15.9	39.7
London	5,296.9	0.3	10.0	18.8	13.1	39.4
Euro area	3,263.8	–1.9	10.6	22.2	14.7	44.4
Frankfurt	*4,829.7*	*–1.2*	*13.5*	*27.6*	*16.7*	*70.1*
Paris	*4,399.4*	*–1.2*	*15.1*	*22.4*	*19.0*	*54.1*
Amsterdam	*389.6*	*–1.6*	*11.9*	*20.6*	*14.4*	*26.1*
Milan	*25,682.0*	*–0.3*	*9.1*	*26.0*	*13.4*	*59.2*
Madrid	*10,008.9*	*–1.1*	*10.2*	*27.2*	*17.6*	*89.7*
Zurich	6,517.2	–1.3	14.5	20.2	20.4	*39.6*
Hong Kong	14,903.6	0.2	4.7	16.0	6.7	*63.4*
Buenos Aires	1,581.7	4.9	15.0	66.1	21.3	*323.9*
São Paulo	28,044.0	7.7	7.1	23.0	17.9	*254.3*

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: Thomson Financial Datastream and internal figures.

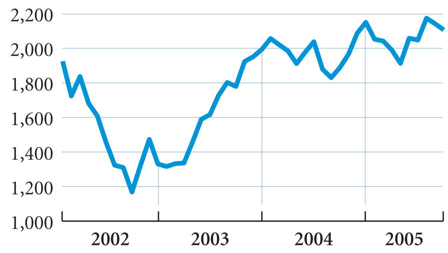
INTERNATIONAL STOCK EXCHANGES

Indices at month-end

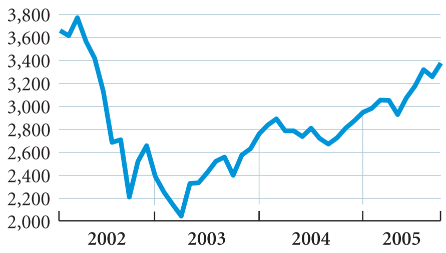
New York (Standard & Poor's 500)



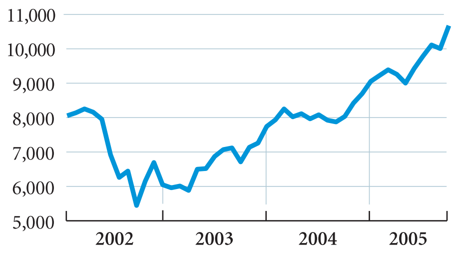
Nasdaq Index (United States)



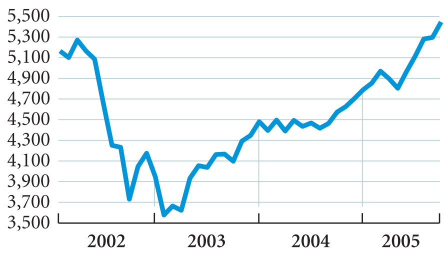
Euro area (DJ Eurostoxx 50)



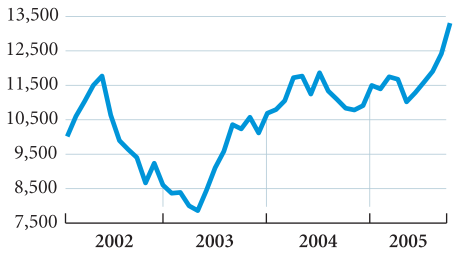
Madrid (IBEX 35)



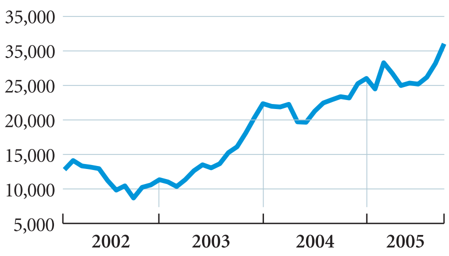
London (Financial Times 100)



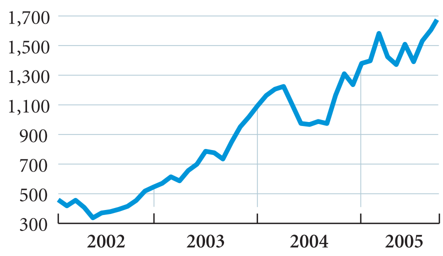
Tokyo (Nikkei 225)



São Paulo (Bovespa)



Buenos Aires (Merval)



NOTES: September 27, 2005.

SOURCE: Thomson Financial Datastream.

Recovery of Japanese stock market aided by Koizumi's election victory opening way to reform.

result which complicates matters of government, the Dax index lost ground although it showed a sharp increase over the end of 2004. Most of the main stock markets in the euro area also showed substantial gains during the year, headed by the Paris Bourse.

With regard to the Spanish stock exchange, the IBEX 35 index continued to move up in September, to which the takeover bid for Endesa by Gas Natural at the beginning of the month made its contribution. At the beginning of the fifth week of the month, the IBEX 35 index marked up its highest level since October 2000. It should be pointed out that in the final week of the month, only three of the 35 shares in this selective index stood below par for the year, whereas some shares showed spectacular gains of more than 50% as in the case of Metrovacesa, Sacyr Vallehermoso, Ferrovial and Abertis.

Many emerging stock exchanges, including those of India, Brazil, Mexico and Argentina mark up new all-time highs.

Outside the euro area, the Financial Times 100 index for the London stock exchange marked up its highest level in the past four years at the beginning of the final week in September. The SMI index for the Swiss stock exchange also showed a high trend in the first three quarters. In addition, the Japanese stock market continued to improve positions in September and in the fifth week of the month the Nikkei 225 index showed its highest level in the last four years thanks to the better economic climate and optimism with regard to progress in economic reform following the victory of the party led by ex-prime minister Koizumi.

With regard to emerging markets, these generally showed a bright performance during the year reflecting the current good economic situation and the flow of international funds going to those markets. A number of stock exchanges in emerging countries continued to mark up all-time highs in September, as was the case in India, Brazil, Mexico and Argentina.

SPAIN: OVERALL ANALYSIS

Economic activity

Sharp growth but with low productivity and alarming foreign deficit

Spain's economy is maintaining a notable situation of «full speed ahead», as is confirmed by detailed results of National Accounting for the second quarter of 2005. Nevertheless, the brilliant performance of Spain's economic situation (the gross domestic product showed an annual growth rate of 3.4%) should not hide the existence of major structural imbalances which, if not dealt with soon, could darken Spain's economic picture over the medium term. In this context, the central government Budget for 2006 will need to play a more active role in combating these imbalances than that assumed in the estimates presented by the government.

The present drive in Spain's economy is based on the surprising strength of domestic demand which, in the second quarter, contributed 6.0 percentage points to GDP growth, the same as in the previous period. Product consumption, which represents two-thirds of total demand, is the real engine behind the current growth cycle with a consolidated rate of increase of around 5% in recent months.

The paradox is that the sharp increase in consumption is taking place in a climate of confidence which could, at least, be described as very discreet. In fact, starting out from figures for the monthly survey conducted by the European Commission, the confidence sentiment of Spanish consumers still lies below the level of –10 points. Does this mean that consumers are being foolish? Not at all. Their response is totally coherent with the formidable monetary drive to which they are being subject.

Spain's economy maintaining notable growth rate thanks to considerable strength of domestic demand...

In the face of real short-term interest rates (nominal rates discounting inflation) which are really negative and the abundance of credit available, their conduct cannot by any means be considered foolish. As if this were of no importance we are also seeing the effects of a heavy flow of immigrants taking place over the past five years which has notably increased growth of Spain's labour force and employment, factors which have a great deal of influence in total household spending.

...boosted, among other factors, by growth in employment and rapid increase in foreign worker group.

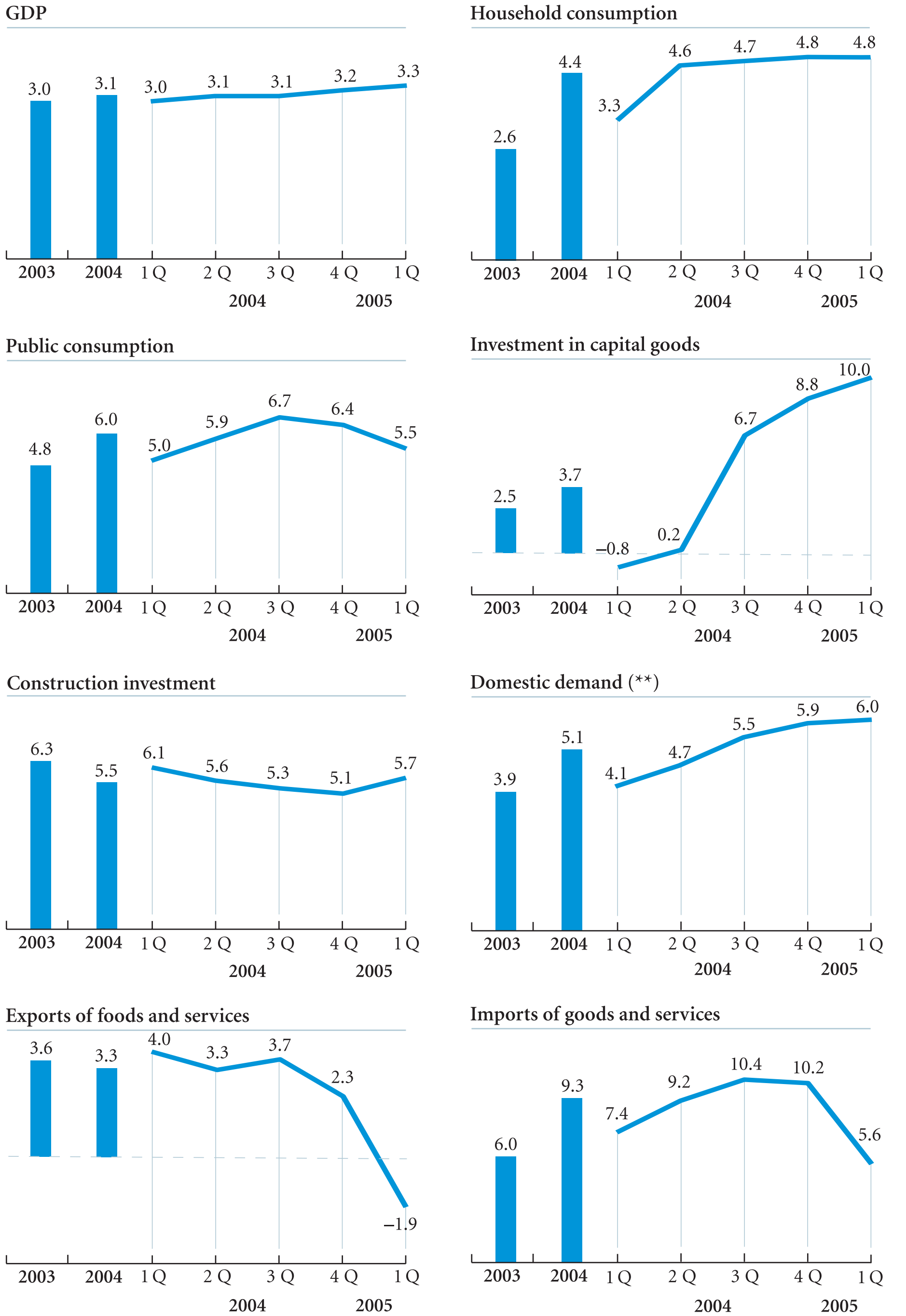
The euphoria in consumption, however, has an undesirable counterpart, namely the drop in the savings rate. Gross household savings in 2004 (disposable household income less consumption in goods and services) dropped to 6.4% of the GDP. If we take off investment carried out (basically in housing) from gross household savings we go directly into the red which means that in consumption and investment Spanish households are really spending more than they are earning.

Consumption euphoria among Spanish families growing at cost of less propensity to save.

There has also been a considerable rise in the growth rate in investment in all its components. Investment in capital goods grew by more than 10% year-to-year in the first half of 2005. This is certainly a high rate but it has to be weighed against the low rates recorded

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-to-year change (*)



NOTES: (*) Figures adjusted for seasonal effects and number of working days.
(**) Contribution to GDP growth.

SOURCE: National Institute of Statistics.

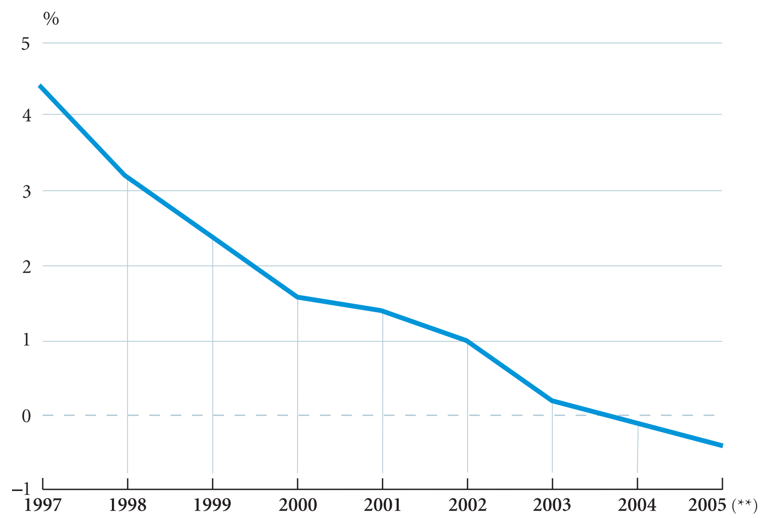
CONSUMER CONFIDENCE STILL AT LOW LEVELS

Difference between percentages of positive and negative responses

SOURCE: European Commission.

SPANISH FAMILIES SPENDING MORE THAN THEY EARN

Net savings (*) as percentage of GDP

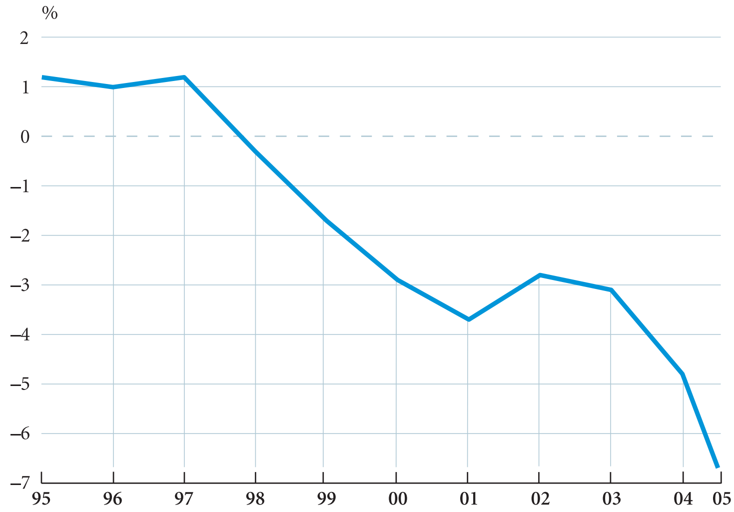


NOTES: (*) Net savings = net disposable income – consumption – investment (in housing and other non-financial assets).
(**) 1st Quarter.
SOURCE: Bank of Spain, INE and internal figures.

in previous years. In fact, in the past five years average annual growth of investment in capital goods was merely just above 1.5%, clearly insufficient to meet the capitalization needs of Spain's economy.

FOREIGN DEFICIT CONTINUES TO GROW

Surplus (+) or deficit (–) in net world borrowing of Spain's economy as percentage of GDP



SOURCE: National Institute of Statistics and internal figures.

Increasing investment in capital goods and construction continues to grow at sustained rate...

Investment in construction also maintained a very strong growth rate in the first half-year, only slightly below 6% year-to-year. The duration of the current expansionist cycle in construction and the strong growth rate in this sector (nearly a whole decade of uninterrupted advance with average annual growth of close to 7%) has no precedent in Spain's recent history. In the housing sector, as well as for the reasons mentioned above (low interest rates, increased immigration) there were other relevant factors, such as the trend in Spain's population pyramid (the «baby boom» generation of the Sixties and Seventies which is now providing potential home buyers) along with the drive in foreign investment.

...while foreign deficit increasing to levels never before seen in recent history.

Apart from these considerations, there is no doubt that the foreign sector is the real Achilles heel of Spain's economy. In the first half of 2005, the deficit in the current account balance amounted to 7.6% of the GDP (the highest for many decades). There are a number of reasons for this troubling situation.

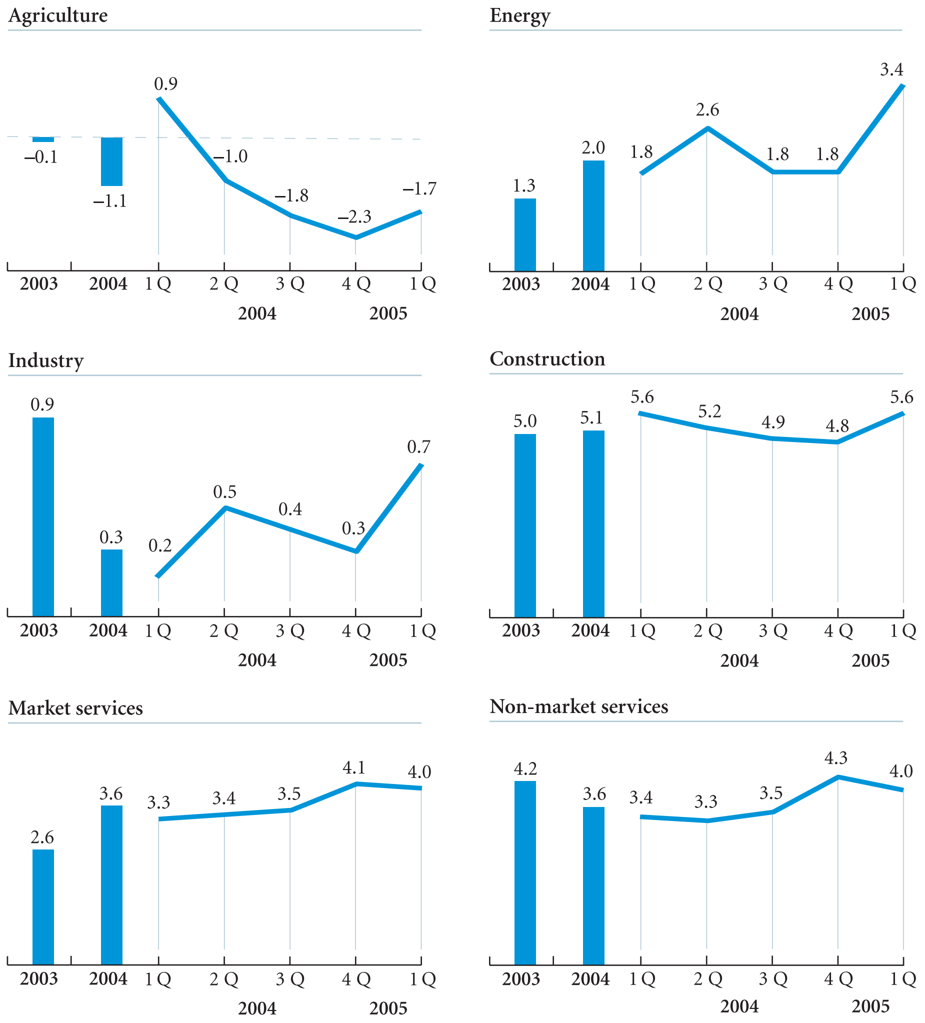
Undoubtedly, factors involved include the increase in Spain's domestic demand along with the weakness of the country's traditional export markets (75% of foreign sales are directed to the European Union) but also, as a permanent background, there is the loss of Spain's competitiveness arising from persistently higher inflation than other industrialized countries. Since 1999 this loss amounts to nearly 10%, according to the index drawn up by the Bank of Spain.

Net world borrowing by Spain's economy (which also includes the balance of capital account) in the period under consideration came to 6.7% of the GDP, also a record figure. Indeed, the situation is quite clear. Spain is living above its possibilities without generating the savings necessary to meet the needs of capitalization of the Spanish economy which can only be covered through the contribution of foreign savings.

In these circumstances we must be thankful for the protective umbrella of

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



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

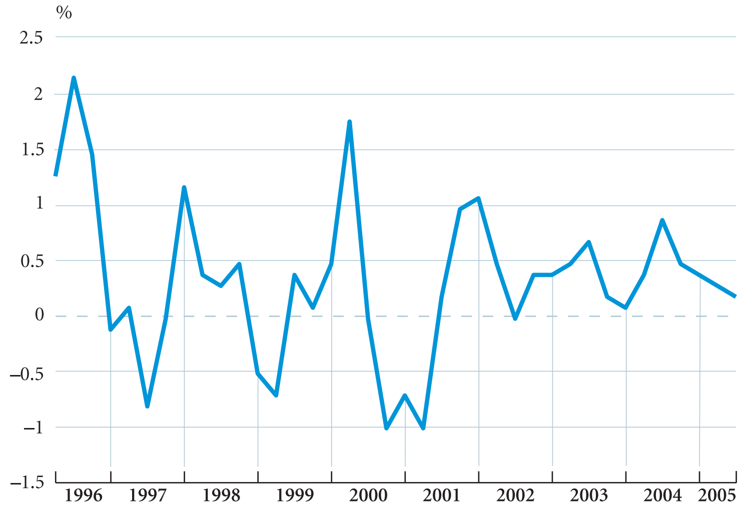
the euro which has helped Spain avoid a worse situation. Outside the Economic and Monetary Union (EMU) Spain's currency would at this point already have suffered drastic devaluation and interest rates would again be very high. Within the EMU, the consequences are naturally much less dramatic but care should be taken that the adjustments do not take place through loss of jobs and the closing down of companies in the real economy (that which is closest to people).

To some extent we are beginning to see something of this in the growing difficulties some industrial sectors are going through. On the supply side, industry is, in fact, the production sector showing the most troubling trend (leaving aside the traditional cyclical swings in agriculture) with growth

Industrial production remains quite stagnant with some sectors (textiles, electronics and motor vehicle industry, among others) in difficult situation.

SLOW GROWTH OF PRODUCTIVITY DENOTES LOW LEVEL OF EFFICIENCY IN SPAIN'S ECONOMY

Change in GDP per job equivalent to full-time work



SOURCE: National Institute of Statistics and internal figures.

scarcely going above 0.5% year-to-year in the first half of 2005.

Quite the opposite is taking place in services (mainly market services) which, together with construction, make up the driving force in Spain's economic activity at this time.

Poor improvement in productivity puts in question the degree of efficiency of Spain's economy.

The slow growth of apparent labour productivity (GDP per job equivalent to full-time work) is certainly another troubling factor, especially for the recent tendency of this to become embedded. In the past twelve months, the average increase in overall productivity has dropped to 0.4% year-to-year. The modest growth of industrial productivity in this twelve month period (0.5%), in spite of the workforce adjustments carried out, is surprising. Increases in other sectors (1.0% in market services, 0.6% in non-market services, –2.4% in construction and 3.3% in energy branches) round out a less-than-brilliant picture under this heading in Spain's economy.

There are still few figures for the third quarter of 2005 but available indicators, as a whole, show the prospect of a continuation of trends mentioned by National Accounting to which we referred earlier. If these trends continue it is likely that domestic demand will have tended to slightly moderate its high growth rate and that the foreign sector will similarly show a drop in its negative contribution to GDP growth, thanks to a somewhat more lively situation in exports. The final result would be an annual rate of increase similar to the previous quarter, slightly below 3.5%.

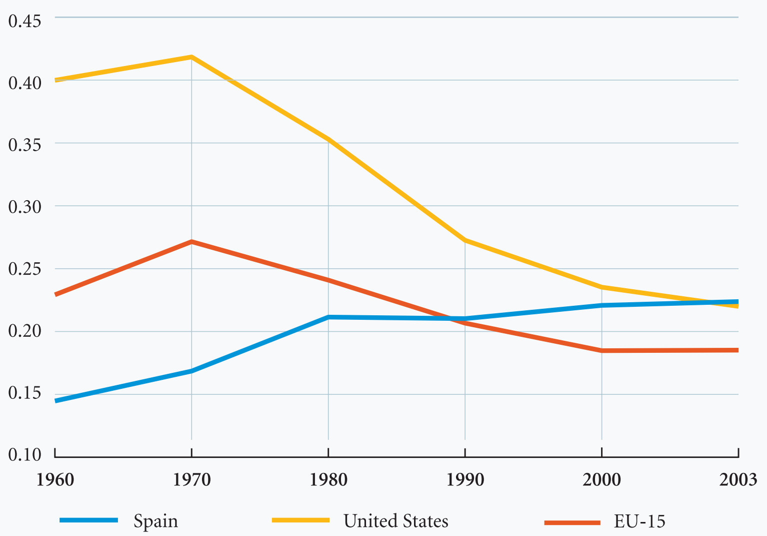
Spain showing major gaps in energy

Energy is a key strategic factor in economic activity. In fact, the functioning of modern societies would be impossible without sufficient energy resources to feed large-scale production processes and the complex transportation networks linking them. In the present context, marked by concern about increased crude oil prices, it is worthwhile evaluating Spain's situation in terms of energy without losing sight of other neighbouring countries. Initial conclusions are certainly not very hopeful:

- Spain's energy efficiency is very low (consumption per GDP unit is higher in Spain than in most developed countries).
- Spain's degree of self-sufficiency (percentage of national production over total energy consumption) has done nothing but drop year after year.
- Spain's oil dependency is also well above that of other countries.

SPAIN IS COUNTRY WITH LOW EFFICIENCY IN TERMS OF ENERGY

Oil equivalent tonnes per GDP unit (in thousand constant 2000 dollars)



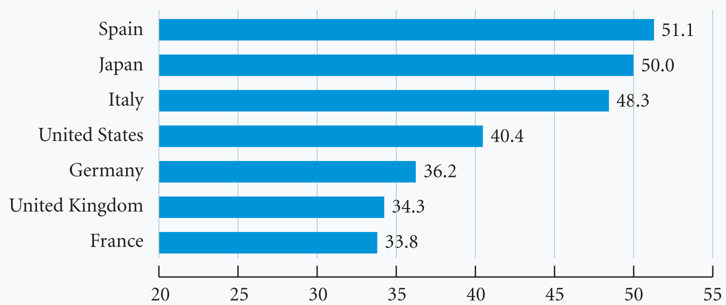
SOURCE: International Energy Agency and internal figures.

As may be seen in the above graphic, in matters of energy efficiency in the past 30 years Spain has followed a path opposite to that of other developed countries. Whereas most of these have achieved substantial progress, Spain, which started out with less energy consumption per GDP unit (which may be initially explained by its lower level of development) has increased consumption gradually to the point where it even goes above the United States, a country that for historical reasons has always made very intensive use of energy resources. To be specific, Spain's performance in this matter is difficult to justify as of the Nineties when it began to clearly move away from the European average.

With regard to supply, national production in 2004 covered only 20% of Spain's energy consumption, the lowest percentage in recent history. The continued decrease in the level of self-sufficiency may be explained by the decline in nuclear energy output and the stagnation seen in hydro-electrical power generation in recent years. In these circumstances, the increase in energy needs has had to be covered through imports of oil and natural gas. To be specific, the share of natural gas in Spain's energy balance has risen spectacularly (close to 18% in 2004, more than double that of ten years earlier), although the contribution from that energy source still stands below the European average. Furthermore, although in relative terms the proportion of oil has also decreased, this has been clearly insufficient (in 2004 it went above 51%, nearly 12 points more than the European average).

SPAIN'S ECONOMY CONTINUES TO SHOW HEAVY OIL DEPENDENCE

Percentage of oil in overall energy consumption (2003)

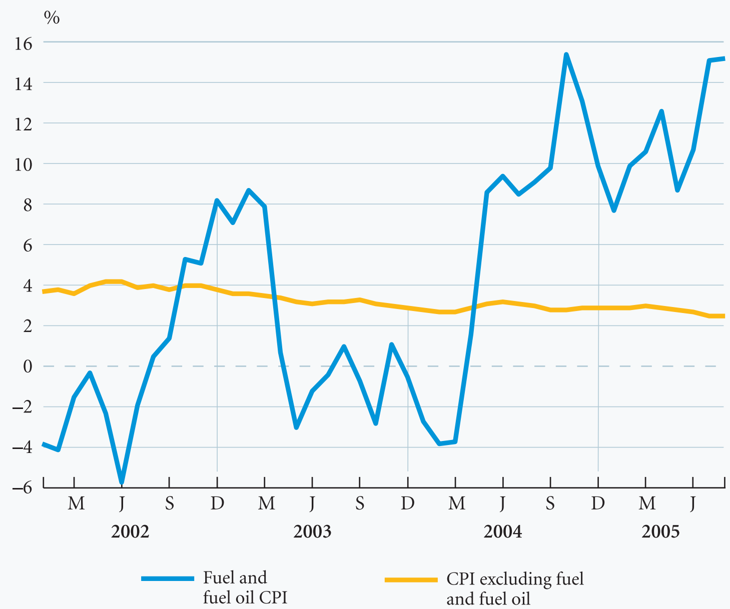


SOURCE: International Energy Agency and internal figures.

The Spanish economy's heavy dependence on oil makes it very vulnerable to recurring crises involving crude oil markets. The current rise in prices could mean that the increase in the oil bill will go above 0.5% of the GDP weighing even more heavily on Spain's massive trade deficit. Its impact on household budgets is also quite significant. Keeping in mind that energy represents 5% of consumption of Spanish households, the increases could cut nearly 0.5% from their spending capacity. For the moment, increased energy costs have not shifted to other components of the CPI which are showing great stability as may be seen in the accompanying graph. Nevertheless, if the increase in energy costs persists, we cannot discount the possibility that a further inflationary outbreak of greater or lesser level could take place. The increase in wage costs in the second quarter may be seen as a first warning in this respect.

INCREASES IN ENERGY PRICES NOT SHOWING UP SO FAR IN OTHER CPI COMPONENTS

Year-to-year change in general CPI and fuel and fuel oil component



SOURCE: INE and internal figures.

Labour market

Construction employment up 8%.

Employment holds strong in summer

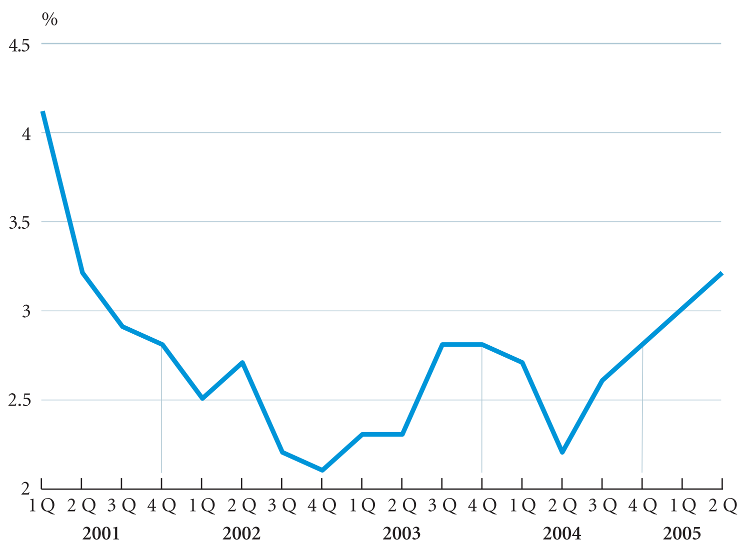
The labour market continued to show notable strength half way through the summer, if we are to go by available indicators. On the one hand, according to National Accounting, employment measured in jobs equivalent to full-time work rose at a rate of 3.2% in the second quarter, thus improving on figures for previous months. In addition, figures for registrations with Social Security (now for August) also showed a favourable level in spite of the bias introduced by the process of granting legal job status to foreign workers which began in February.

The strength of employment as shown by National Accounting was based on the extraordinary growth which continues to show up in construction at more than 8% year-to-year for the third consecutive quarter. On the other hand, industry is showing notable weakness, which may be partly explained by the effect of foreign competition in certain economic sectors. Finally, services continues to display firm growth, particularly in the public sector, given than in terms of full-time work growth stood above 3%. Market services, on the other hand, showed something of a slowdown, mainly due to the relative rise in part-time work.

In the case of Social Security, registrations were down in August as has been normal in that month in recent years but less sharply than last year. This meant that the

SHARP RECOVERY IN EMPLOYMENT

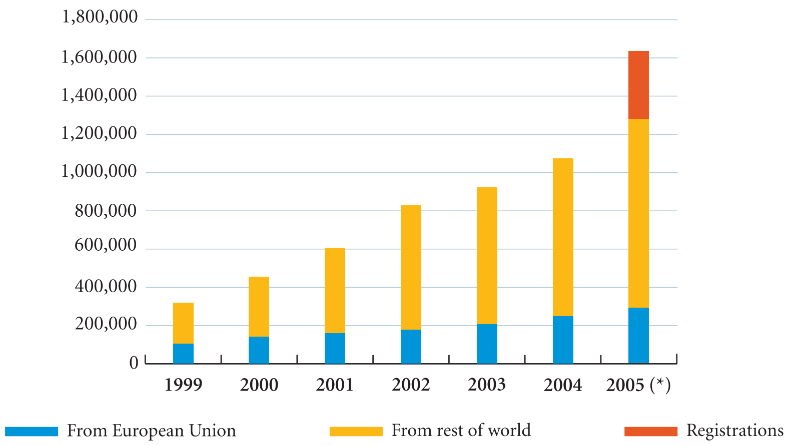
Percentage annual change in jobs equivalent to full-time work



SOURCE: INE and internal figures

FLOW OF FOREIGN WORKERS CONTINUES

Number of foreign workers registered with Social Security at end of period



NOTES: (*) Figures up to August.
SOURCE: Ministry of Labour and Social Affairs.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2003	2004	2004		2005			
			3 Q	4 Q	1 Q	2 Q	July	August
Persons registered with Social Security								
Wage-earners	3.2	2.7	2.6	3.1	2.8	4.2	5.6	5.9
Industry	*–0.5*	*–0.5*	*–0.6*	*–0.5*	*–0.9*	*–0.7*	*–0.3*	*–0.1*
Construction	*4.3*	*5.0*	*4.6*	*6.8*	*5.0*	*7.9*	*9.9*	*11.0*
Services	*4.1*	*4.1*	*4.0*	*4.4*	*4.5*	*5.1*	*5.5*	*5.5*
Non-wage-earners	2.3	3.2	3.2	3.2	2.9	2.7	2.6	2.5
Total	**3.0**	**2.8**	**2.7**	**3.1**	**2.8**	**3.9**	**5.1**	**5.2**
Persons employed (*)	**4.0**	**3.9**	**3.8**	**4.1**	**5.1**	**5.8**	–	–
Jobs (**)	**2.5**	**2.6**	**2.6**	**2.8**	**3.0**	**3.2**	–	–
Hiring contracts registered (***)								
Permanent	–1.0	11.8	18.2	4.4	0.6	9.2	4.9	...
Temporary	3.9	11.4	14.7	4.0	–9.8	10.1	5.6	...
Total	**3.4**	**11.5**	**15.0**	**4.0**	**–8.8**	**10.0**	**5.6**	**...**

NOTES: (*) Estimate from Labour Force Survey.
(**) 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, National Employment Institute and internal figures.

increase in registrations rose to 5.2% year-to-year, a figure greatly biased upward by the increase in foreign workers having their status made normal. If these registrations (352,522 to the end of July) are discounted, seeing that in fact they do not constitute new employment but merely the surfacing of already existing

Foreign workers make up more than 40% of new employment.

work, registrations would have grown by 3.2%, a figure which coincides with that supplied by National Accounting.

Immigration continues to be the key for meeting the existing demand for labour. If we exclude those who have just gained normal work status, the growth in registrations among foreign workers goes above 21% as against 2% for Social Security registrations by native Spaniards. This means that 41.6% of new registrations between August 2004 and 2005 were of foreign workers and that, as a whole, these now make up 9.1% of total registrations with Social Security, nearly three points more than in August last year.

August increase seasonal in nature and makes no change in downturn.

This favourable state of affairs is also confirmed by hirings registered at employment offices. In the first eight months of the year these hiring contracts rose by 2.6%, with permanent contracts showing up more strongly than temporary contracts in spite of the fact that the latter were in the majority.

Registered unemployment continues downward trend

The good state of the labour market is also seen in registered unemployment figures. In August, in spite of rising as usual this month, the number of persons registered at employment offices rose less sharply than in 2004. As a result, registered unemployment (2,019,110 at month-end) was 1.5% lower than last year.

In any case, the cumulative balance for the year did not turn out as favourable as that for the first eight months of 2004, the best for the current decade. The notable increase in farm unemployment and the performance in industrial unemployment, with a much lower decrease than last year, lay behind most of the difference. In construction and services, the cumulative decrease in unemployment came close to slightly more than last year but failed to reach that figure.

REGISTERED UNEMPLOYMENT: SLIGHT IMPROVEMENT IN AUGUST

Percentage year-to-year change in registered unemployment

SOURCE: Public Employment Services and internal figures.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

August 2005

	No. of unemployed	Change over December 2004		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	58,958	8,666	17.2	8,938	17.9	2.9
Industry	297,670	–5,912	–1.9	–4,375	–1.4	14.7
Construction	230,430	–22,269	–8.8	–10,920	–4.5	11.4
Services	1,208,039	–56,746	–4.5	–5,535	–0.5	59.8
First job	224,013	–17,344	–7.2	–18,636	–7.7	11.1
By sex						
Males	790,103	–87,917	–10.0	–36,466	–4.4	39.1
Females	1,229,007	–5,688	–0.5	5,937	0.5	60.9
By age						
Under 25 years	247,222	–21,591	–8.0	–8,395	–3.3	12.2
All other ages	1,771,888	–72,014	–3.9	–22,134	–1.2	87.8
Total	**2,019,110**	**–93,605**	**–4.4**	**–30,528**	**–1.5**	**100.0**

SOURCE: National Institute of Statistics and internal figures.

By autonomous community, the situation is relatively uneven with some regions showing levels of registered unemployment well below those in 2004 alongside those showing a similar or decidedly worse state. Notable in the first group were Madrid Community, the Basque Country, Cantabria and Extremadura. At the other end of the scale, that is to say, with relatively higher unemployment, came the three central regions of the Ebro Valley and Castile-La Mancha, all of which are noted for a relatively large farm sector.

Containment of labour costs

According to the quarterly wage cost survey, the average increase in total wage cost per person per month broke with the path of moderation shown over the past year to stand at 3.4% in the second quarter of 2005, nine decimals more than in the previous quarter. Nevertheless, the uneven performance of this statistical series would suggest waiting for further figures before pointing to a change in trend. For example, the different placing of Easter Week in this year's calendar may have had an effect on these results.

Wage costs contained with growth below inflation.

More credibility should be given to the figures from National Accounts which point to lower pressure from wage costs than indicated by the quarterly wage cost survey. As a result, average wages per worker showed an increase going down to 2.7% in the second quarter of 2005, eight decimals less than in the same period in 2004. This trend to containment is spread over all sectors but is especially strong in construction and industry, sectors where foreign workers represent a notable proportion of all new employment. Services show a similar trend but not as strong, along with wage increases well above those in non-market services compared with those in market services.

Wages rise less in construction and industry.

WAGE INDICATORS

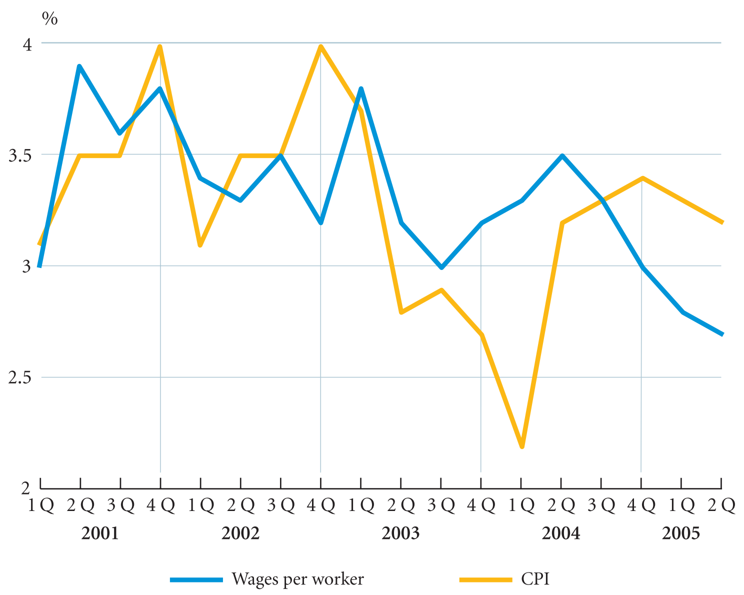
Percentage change over same period year before

	2003	2004	2004		2005	
			3Q	4Q	1Q	2Q
Increase under general wage agreements	**3.5**	**3.0**	**2.9**	**3.0**	**2.9**	**2.9**
Wage per job equivalent to full-time work (*)	**3.4**	**3.3**	**3.3**	**3.0**	**2.8**	**2.7**
Quarterly labour cost survey						
Wage costs						
Total	3.8	2.8	2.2	2.6	2.5	3.4
Industry	*4.4*	*3.3*	*3.3*	*3.3*	*3.2*	*3.1*
Construction	*5.0*	*4.2*	*4.6*	*3.1*	*2.4*	*3.3*
Services	*3.5*	*2.5*	*1.6*	*2.5*	*2.5*	*3.8*
Average wages per hour worked	4.3	3.6	2.0	5.7	5.8	1.5
Other labour costs	5.4	3.6	3.4	3.0	4.2	3.5
Work day (**)	–0.5	–0.8	0.2	–3.0	–3.1	1.9
Farm wages	**2.6**	**2.8**	**2.7**	**2.9**	**3.6**	**2.6**
Labour cost in construction	**5.0**	**4.8**	**3.5**	**3.5**	**1.4**	**1.4**

NOTES: (*) Quarterly National Accounts, corrected gross figures.
(**) Effective hours worked per worker per month.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fishing and Food, Ministry of Public Works and internal figures.

WAGE RISE LESS THAN INFLATION

Annual change in represented indicators



SOURCE: INE and internal figures.

Prices

Fuels up 17% so far this year.

CPI holds stable despite rise in energy

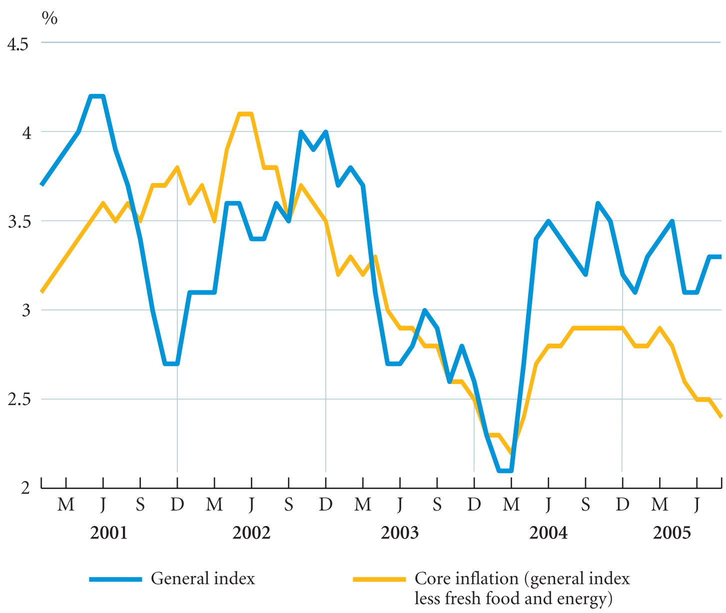
The August figure for the consumer price index (CPI) showed no substantial change from a situation marked by the progressive moderation of core inflation and was thrown out of balance only by pressure on fuel prices. As a result, the annual inflation rate held at the 3.3% year-to-year seen the month before and only one decimal above the figure recorded at the end of last year.

From this perspective, the August figure continues to put the question of the real impact of oil price increases on Spain's economy. So far this year, at least from figures going up to June, imported crude rose by 31.5% per tonne in euros while those derivatives most closely linked to consumers, namely fuels, rose by 16.7% as of August, according to the CPI. If we take into account the contribution to the shopping basket (somewhat more than 5%) and the pressure on cost of production of inputs related to the price of energy (especially in transportation), the effect on the inflation rate could have been much greater.

Up to now, however, certain components of the CPI have acted as compensatory factors. First of all, this is so in the case

DROP IN CORE INFLATION STABILIZES GENERAL FIGURE

Year-to-year change in CPI



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX

	2004			2005		
	% monthly change	% change over December 2003	% annual change	% monthly change	% change over December 2004	% annual change
January	–0.7	–0.7	2.3	–0.8	–0.8	3.1
February	0.0	–0.7	2.1	0.3	–0.6	3.3
March	0.7	0.0	2.1	0.8	0.2	3.4
April	1.4	1.4	2.7	1.4	1.6	3.5
May	0.6	2.0	3.4	0.2	1.8	3.1
June	0.2	2.2	3.5	0.2	2.1	3.1
July	–0.8	1.4	3.4	–0.6	1.5	3.3
August	0.4	1.8	3.3	0.4	1.9	3.3
September	0.2	2.0	3.2			
October	1.0	3.1	3.6			
November	0.2	3.3	3.5			
December	–0.1	3.2	3.2			

SOURCE: National Institute of Statistics.

FUELS UP AGAIN IN PAST FOUR MONTHS

Year-to-year change in fuel and fuel-oil component of CPI

SOURCE: National Institute of Statistics.

of non-energy industrial goods. Their year-to-year growth has progressively moderated to reach a rate of 0.7%, a half-point lower than in December 2004. Sharp competition in industrial product markets, low-cost imports and, in some sectors, the reduction of corporate margins are at the base of this performance.

Foods have also played a major role in containing inflation. Processed foods have managed to moderate year-to-year growth in prices to 2.8%, that is to say, one and half points since the highs in April. The reasons behind this performance are to be found in tobacco, which rose less than last year, olive oil, food pastes and certain conserves. Fresh foods, in turn, also showed a sharp drop since the beginning of the second quarter thanks to the drop in prices of poultry and fresh fruit. In general terms, this decrease was helped by the decrease seen in imported food prices and the relatively positive performance in farm prices before the summer.

The drop in core inflation, down one decimal to 2.4% year-to-year, was not greater because of the downward resistance of services prices. In fact, in August they stood at 3.7% year-to-year, practically in line with the past two years. The conditions of competition in some markets (repairs, personal services, home services and recreational) and the pressure of wage costs, apart from the sharp rises in some controlled prices (public sanitation, transportation), seem to be behind this lack of movement which, in addition, is preventing any effective correction in the inflation rate, given that the contribution of this component comes to somewhat more than 35% of the GDP.

From this perspective, the future of the CPI over the short term will remain closely linked to energy prices and how it shifts to consumer energy products and fresh foods. In the latter case, the matter will depend on the final balance resulting from very moderate or decreasing import prices as against domestic farm prices for which it is difficult to see the year-to-year rate going down in view of the sharp decreases in prices in the second half of 2004.

In addition, there are no signs that core inflation will change substantially away

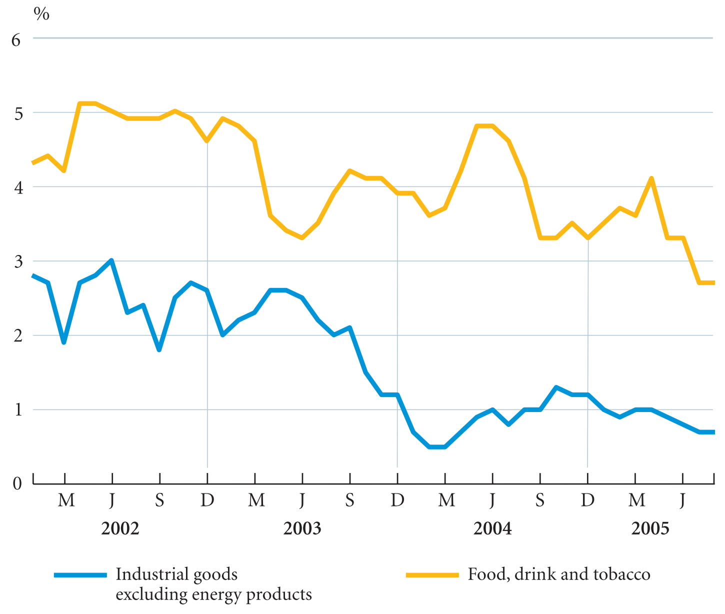
Foods play key role as counterweight to rise in energy...

...along with non-energy industrial goods which have seen progress limited by factors of competition.

Biggest inflation risks over short-term come from energy prices and fresh foods.

FOODS AND NON-ENERGY INDUSTRIAL GOODS HOLDING DOWN CPI

Year-to-year change in CPI by component



SOURCE: National Institute of Statistics and internal figures.

CONSUMER PRICE INDEX BY COMPONENT GROUP

August

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2004	2005	2004	2005	2004	2005
By type of spending							
Food and non-alcoholic beverages	116.8	0.3	0.4	2.3	1.8	3.9	2.6
Alcoholic beverages and tobacco	120.6	0.0	0.1	5.5	4.0	5.6	4.0
Clothing and footwear	104.9	–0.4	–0.5	–10.6	–11.7	1.8	0.9
Housing	115.8	0.4	0.4	3.1	4.8	3.8	5.9
Household equipment	107.7	–0.0	0.0	0.5	0.8	1.6	2.1
Health	106.3	0.1	0.0	–0.0	0.6	0.2	0.9
Transport	118.2	1.1	1.1	6.6	7.6	5.8	7.0
Communications	91.8	–0.1	–0.1	–0.1	–1.3	–0.9	–1.9
Recreation and culture	104.9	1.6	1.2	2.0	1.6	0.2	–0.5
Education	117.1	0.0	0.0	0.6	0.6	3.9	4.2
Hotels, cafés and restaurants	121.5	0.9	0.9	4.6	4.7	4.0	4.3
Other	114.3	0.0	0.0	2.5	2.7	3.1	3.1
By group							
Processed foods	115.3	0.2	0.1	3.5	2.2	4.2	2.8
Unprocessed foods	121.2	0.3	0.9	1.1	2.0	3.8	2.7
Non-food products	112.7	0.5	0.5	1.5	1.8	3.1	3.5
Industrial goods	108.1	0.4	0.4	–0.5	0.1	2.5	3.3
Energy products	*121.0*	*1.8*	*1.9*	*8.6*	*12.7*	*7.0*	*11.5*
Fuels and oils	*127.3*	*2.4*	*2.5*	*11.2*	*16.7*	*9.0*	*15.1*
Industrial goods excluding energy products	*104.1*	*–0.1*	*–0.1*	*–3.2*	*–3.7*	*1.0*	*0.7*
Services	118.0	0.6	0.6	3.8	3.7	3.7	3.7
Underlying inflation (**)	112.2	0.3	0.2	1.2	0.7	2.9	2.4
GENERAL INDEX	**113.8**	**0.4**	**0.4**	**1.8**	**1.9**	**3.3**	**3.3**

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

from its gradual downward trend, apart from the impact of tax increases on alcohol, tobacco and from fuels. In any case, the possibilities of moderation in services prices are seen as limited, not so much because of the lack of margin as for the rigidity of certain markets. Finally, non-energy industrial goods have little margin to continue taking off decimals from the general index although low-cost imports should help the downward trend in this CPI component.

Inflation differential with euro area holds at 1.1 points.

The inflation picture in Spain does not differ greatly from that in the euro area in terms of trend although the inflation differential remains stable at a high 1.1 points.

From the oil well to the CPI: How the rise in crude prices is shifted

The price of oil has doubled in the past year and a half to reach an all-time high level, thus presenting an economic shock in supply comparable to those seen in the Seventies. Nevertheless, as opposed to those at that time, the impact on inflation has been very moderate.

The first impact from the rise in oil prices is seen on fuels. Variations in crude oil prices are rapidly shifted to prices at the service station pumps although in overall terms exchange rates may have an influence, given that crude oil prices are quoted in dollars. According to a recent study by the European Central Bank, this shift normally takes place within one or two weeks in the euro area. As a result, the sharp increases in oil in recent months would be reflected in fuel (petrol and diesel-oil) indices. Nevertheless, these increases are influenced by the effect of special taxes placed on fuels. In fact, as these taxes involve a fixed amount per litre, the percentage increase on a litre of fuel is lower than the increase in oil and fuels before taxes.

PRICES OF PETROLEUM PRODUCTS AND TAXES

8-8-05

	United States	Germany	United Kingdom	France	Italy	Spain
Petrol (*)						
Price per litre in euros	0.51	1.29	1.30	1.21	1.25	1.02
Special tax	0.08	0.65	0.68	0.59	0.56	0.40
VAT (%) (**)	4.00	16.00	17.50	19.60	20.00	16.00
VAT in euros (**)	0.02	0.18	0.19	0.20	0.21	0.14
Total taxes	0.10	0.83	0.87	0.79	0.77	0.54
% taxes	19.51	64.72	66.98	65.13	61.92	52.73
Motor vehicle diesel-oil						
Price per litre in euros	0.51	1.11	1.35	1.05	1.13	0.93
Special tax	0.09	0.47	0.68	0.42	0.41	0.29
VAT (%) (**)	4.00	16.00	17.50	19.60	20.00	16.00
VAT in euros (**)	0.02	0.15	0.20	0.17	0.19	0.13
Total taxes	0.11	0.62	0.88	0.59	0.60	0.42
% taxes	22.05	56.04	64.78	56.19	53.12	45.42

NOTES: (*) «Regular grade» in USA and Super 95 Octane in EU.
(**) Tax on sales in New York as for United States.
SOURCE: US Department of Transportation, European Commission and internal figures.

In fact, the amount of tax on a litre of fuel varies greatly from country to country although in the European Union there is some harmonization. In the United States total tax on fuels make up around 20% of the price to the customer whereas in the United Kingdom this rises to close to 65% (see accompanying table). As a result, changes in the fuel index in the United States are usually sharper than in Europe. For example, the year-to-year change rate in USA for this figure in August was 31.3% compared with 12.3% in the European Union (EU-15).

On the other hand, the weighting of costs related to oil in the consumer price index is low. In the European Union (EU-15) it amounts to 4.4%, including motor vehicle fuel and heating fuel whereas in the United States it is 4.3%. As a result, it is not so strange that consumer price indices are not raised very much by this factor, although it has affected the general US index more. In fact, the sharp rise in fuel prices has had an impact on other components. Core inflation (the most stable part of inflation) stands at 2.2% in the United States and 1.4% in the EU-15.

But as well as direct effects there are indirect effects. In fact, in the first place, the increase in oil prices involves a rise in cost of inputs for chemical companies and other manufacturing companies and in transportation. If the increase in costs is not absorbed by corporate margins and must be reflected in prices other sectors find their production costs increased. As a result, the initial effect may be shifted right across the economy. On the other hand, workers who see their purchasing power reduced may wish to recover it through wage increases to compensate this loss. In this way, all this may begin a price-wage spiral resulting in an increase in inflation.

Up to now, these effects, called «second round effects», have not occurred in the main developed countries. This is due to a number of reasons. On the one hand, oil dependence is now much lower than in the Seventies while at the same time energy intensity has diminished, measured as the amount of energy per unit of gross domestic product, given that the importance of services has increased to the detriment of industry. In addition, markets for factors and goods and services have been more liberalized and deregulated. In recent years, many indexing mechanisms have disappeared although they still exist in some countries. In Belgium, Luxembourg and Spain, wages in most sectors are indexed. At the same time, in contrast to the first shock in the Seventies, the economies are not over-heated and, in the case of the European Union, the economy stands considerably lower than its potential level (the level which ensures sustainable growth without inflation).

Furthermore, and no less important, the central banks have gained credibility following decades of fighting against inflation, so that prospects regarding future inflation appear to be contained. In fact, the increase in oil prices represents a loss of real national income in favour of the net oil exporting countries, given that the trade relation is deteriorating as prices of imports increase relatively more than those of exports. This inevitable loss of income may set off inflation if all economic operators try to shift this decrease in real income to other agents.

In the current oil crisis it is important to avoid the errors of economic policy made in the first oil shocks in the Seventies, given that monetary and fiscal policies of too lax a nature brought about a situation of «stagflation» with an increase in inflation and unemployment. Because of this, the finance ministers of the EU recently agreed not to lower taxes on fuels in order to compensate for the increase in prices. If taxes were lowered it would increase oil demand thus preventing higher oil costs from leading to more efficient use of this energy source.

In spite of the EU directives, some European governments have taken steps in this direction. In September, France announced a subsidy of 75 euros for home heating in the case of French households exempt from paying personal income tax. It is also planned to increase the deduction for kilometres travelled for work purposes in personal income tax which will come into force in 2007. A reduction in tax on agricultural fuels has also been announced. At the same time, in the case of transportation operators, with retroactive effect to January 1, 2005, there has been an increase in tax benefits for professional operators (a local tax) of up to 700 euros (previously 366 euros) and up to 1,000 euros, in the case of low consumption vehicles. Transportation contracts are to be modified to ensure they reflect the effect of fuel prices in invoiced prices. Belgium has also announced a series of similar measures to help families and transport operators.

Wholesale prices again rise

Producer prices strengthened their upward trend in August with a moderate increase in food products in the context of the recognized sustained rise in energy prices. As a result, the year-to-year growth in producer prices reached 4.9%, seven decimals higher than the relative lows in May. All other components showed notable stability in terms of previous months.

Import prices also continued to be affected by oil prices and cumulative year-to-year growth went up another notch to stand at 4.4% in the first half-year as a whole.

Foods increase pressure on producer prices from energy.

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	
2004											
June	12.0	4.0	3.2	1.3	4.8	7.1	1.4	–2.9	3.2	3.3	–
July	11.2	4.1	2.8	1.6	5.3	7.2	3.8	5.0	–9.8	6.4	–
August	–5.4	4.4	2.2	1.7	5.7	9.0	6.8	4.4	–1.8	9.9	4.1
September	–10.4	4.6	2.1	1.6	5.9	11.0	5.4	0.8	–3.1	9.6	–
October	–5.1	5.4	2.3	1.8	6.2	14.2	5.2	1.7	–7.3	9.7	–
November	–0.4	5.2	2.2	1.5	6.3	12.6	4.6	1.8	–3.0	7.5	4.1
December	2.5	5.0	2.8	1.6	6.2	10.6	5.8	4.2	–3.7	9.4	–
2005											
January	8.4	4.8	3.2	1.8	6.2	8.8	5.0	3.4	–1.6	7.2	–
February	12.2	4.9	3.2	1.9	5.5	11.0	5.4	1.0	–1.9	9.3	4.3
March	13.2	5.1	2.8	2.0	4.9	13.1	5.3	2.6	–7.6	9.7	–
April	6.6	5.0	2.8	2.0	3.7	14.5	4.6	0.9	–7.5	9.1	–
May	–0.9	4.2	2.5	2.1	3.3	11.0	0.9	–3.2	–6.5	4.7	4.2
June	–11.7	4.4	2.2	2.1	3.1	13.5	5.3	3.6	–1.3	7.7	–
July	...	4.6	2.0	1.9	3.0	15.7	8.2	0.6	10.4	11.7	–
August	...	4.9	2.5	1.8	2.9	16.3	...	...	...	...	...

NOTES: (*) Gross figures corrected.
SOURCE: National Institute of Statistics, Ministry of Economy and internal figures.

Foreign sector

Weak exports, higher oil prices and pressure from third country imports raise trade deficit to unheard of levels.

Trade deficit continues to rise in July

The trade deficit of Spain's economy continued a spectacular rise in July to reach 42.4 billion euros in the first seven months of the year, 33.6% above 2004. This increase came about because of the sharp drop in exports in a context of notable increase of imports although this was lower than in previous periods.

The weakness in exports was especially notable in the case of the main countries of the European Union where, on top of the slack in the respective economies, must be added the loss of competitiveness of Spain's economy not only in terms of those markets but in view of products coming from the rest of the world.

The poor level of foreign sales, particularly in the European scene, was clearly visible in motor vehicles, appliances and various consumer goods, mainly textiles and footwear. In addition, the decrease in food exports, a

FOREIGN TRADE

January-July 2005

	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	17,020	35.6	13.0	3,246	15.9	3.6	–13,774	19.1
Consumer goods	37,324	8.3	28.4	34,079	–2.9	38.3	–3,245	91.3
Food	*7,671*	*4.5*	*5.8*	*10,979*	*1.1*	*12.3*	*3,308*	*143.1*
Non-foods	*29,654*	*9.0*	*22.6*	*23,100*	*–6.4*	*25.9*	*–6,553*	*77.9*
Capital goods	15,152	22.4	11.5	8,270	5.8	9.3	–6,882	54.6
Non-energy intermediate goods	61,929	5.5	47.1	43,428	6.9	48.8	–18,500	70.1
By geographical area								
European Union (EU-15)	78,270	5.6	59.6	62,389	1.0	70.1	–15,881	79.7
Euro area	*68,399*	*5.7*	*52.0*	*52,483*	*1.6*	*59.0*	*–15,916*	*76.7*
Other countries	53,155	21.0	40.4	26,635	8.5	29.9	–26,521	50.1
Russia	*2,855*	*51.4*	*2.2*	*583*	*14.2*	*0.7*	*–2,272*	*20.4*
United States	*4,856*	*11.8*	*3.7*	*3,382*	*1.7*	*3.8*	*–1,474*	*69.7*
Japan	*3,463*	*4.2*	*2.6*	*672*	*–9.2*	*0.8*	*–2,791*	*19.4*
Latin America	*5,759*	*22.8*	*4.4*	*4,179*	*1.9*	*4.7*	*–1,581*	*72.6*
OPEC	*9,030*	*29.3*	*6.9*	*2,360*	*22.6*	*2.7*	*–6,670*	*26.1*
Rest	*27,192*	*19.7*	*20.7*	*15,459*	*10.8*	*17.4*	*–11,733*	*56.8*
TOTAL	**131,425**	**11.3**	**100.0**	**89,024**	**3.1**	**100.0**	**–42,400**	**67.7**

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

key heading in Spain's foreign trade, also contributed to this poor result. In overall terms, exports in the first seven months of the year amounted to 89.02 billion euros, 3.1% more than in 2004. This increase was entirely due to price factors given that the volume of exports was down by 1.1%.

Imports, in turn, tended to some moderation although nominal growth still stood at high levels (11.3% as of July). This sharp increase was naturally linked to the increase in prices of oil and oil derivatives. In fact, energy imports made up one-third of the increase in total imports in the first seven months of the year. If we disregard the price effect brought about by energy, the increase in imports by volume was 6.1% as of July, nearly five points less than in 2004. By geographical area, the practical stagnation of purchases from the European Union was in contrast to the sharp growth of those from third countries.

Current account deficit continues to worsen

The current account balance continues to reflect the notable worsening of the state of Spain's economy in terms of abroad to the point where the cumulative deficit for the past 12 months as of June reached 58.9 billion euros.

The sharp worsening of the situation was due to the general drop in the various headings of the balance of payments. In the first place, the trade balance continued to grow by leaps and bounds underlining the impact of the rise in oil and the difficulties coming from the increase in imports in a context of relatively weak exports. In the first half-year, the increase in the trade imbalance was more than 43%.

In second place, the services balance was adversely affected by the poor state of the tourist balance which was hurt by the sharp growth in payments and a drop in revenue inflows. The increased propensity of Spaniards to travel abroad, on the one hand, and the characteristics of the Spanish tourist model lie behind this performance. In fact, revenue inflows from tourism were down by 0.5% in the first half-year whereas payments rose by 27.7%.

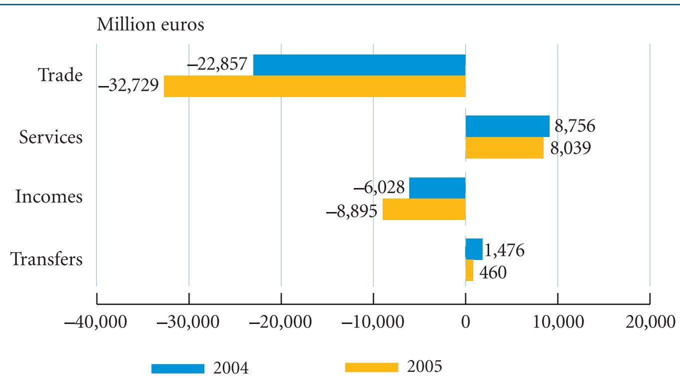
The transfers balance, in turn, also showed a drop in surplus following a

One-third of rise in imports caused by higher value of imported energy products.

Balance of payments reflects troubling worsening of Spain's economic position in terms of abroad under all headings...

FOREIGN SECTOR WEAKENING ON ALL FRONTS

Cumulative figure for balance of payments headings in first half of 2005



SOURCE: Bank of Spain and internal figures.

BALANCE OF PAYMENTS

Cumulative figure for last 12 months in million euros

	June 2004	June 2005	% change
Current account balance			
Trade balance	–44,672	–62,809	40.6
Services			
Tourism	*26,334*	*25,369*	*–3.7*
Other services	*–4,177*	*–3,855*	*–7.7*
Total	22,157	21,514	–2.9
Income	–11,878	–16,568	39.5
Transfers	777	–1,059	–
Total	**–33,616**	**–58,923**	**75.3**
Capital account	**8,114**	**8,421**	**3.8**
Financial balance			
Direct investment	–11,030	–30,831	179.5
Portfolio investment	10,129	116,080	–
Other investment	28,577	–28,192	–
Total	**27,676**	**57,057**	**106.2**
Errors and omissions	1,134	–833	–
Change in assets of Bank of Spain	–3,308	–5,722	73.0

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

...as well as less attraction for foreign capital.

substantial weakening of the balance with the European Union both for inflows and outflows, as well as a sharp increase in foreign worker remittances abroad.

Capital account, in turn, showed an appreciable surplus in June although this was not enough to bring the cumulative balance for the first half-year above that for the same period last year.

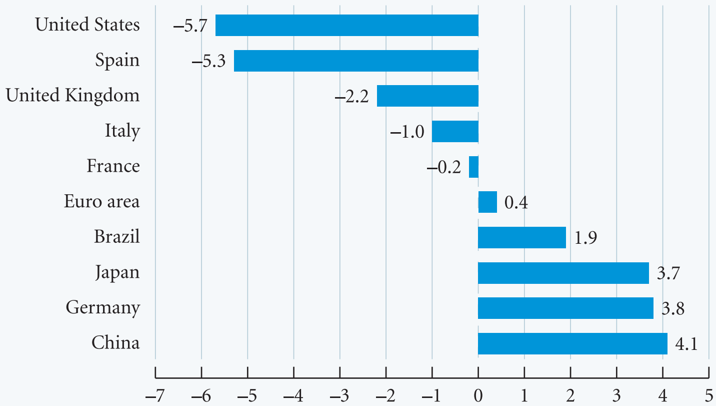
In the financial sphere, direct foreign investment in Spain was sharply down both in the corporate sphere and in real estate. In this case, the drop in the first half was 17%, a substantial figure if we take in to account the rise in prices in the sector. Only foreign portfolio investment showed sharp progress. Spanish direct investment abroad, on the other hand, was up notably, especially in real estate but also in portfolio investment.

Foreign balance worsens rapidly

«Spain is different». This expression has often been used in a cynical way, nearly always negatively and at times with some exaggeration. Right now, the statement is correct and furthermore in positive vein. Spain is different because it is showing strong growth while surrounded by a Western Europe in a state of stagnation. It is different because, in a world which is saving more than it needs to, Spain belongs to the minority of countries which have insufficient savings for their needs. In this it stands so much apart from the others that it almost seems like that most special case – the United States.

SPAIN IS DIFFERENT

Current account balance for 2004 as percentage of GDP



SOURCE: Economist Intelligence Unit and International Monetary Fund.

Everything has its downside and the downside of growth of Spain's economy is precisely that the country is borrowing more and more. Spain buys more from abroad than it sells, it consumes and invests more than it earns and not just a little, but quite a lot. As a result, Spain's current account balance, the indicator which reflects an excess or lack of savings, presents a runaway deficit that in 2004 amounted to 5.3% of its gross domestic product (GDP). Among the larger economies, only the United States goes above this figure. In marked contrast, the euro area showed a moderate surplus of 0.4% of the GDP. The problem is that, far from being corrected, this imbalance is increasing given that in the first half of 2005 Spain's deficit reached 7.6% of the GDP.

There are three reasons for the worsening of the foreign sector – appreciation of the euro, the growth differential, especially with Europe, and loss of competitiveness. The appreciation of the euro, over which Spain has no control, has had special importance in the case of imports from Asia with its currencies very much linked to the dollar. Nevertheless, in recent months it does not seem that this factor is the most decisive.

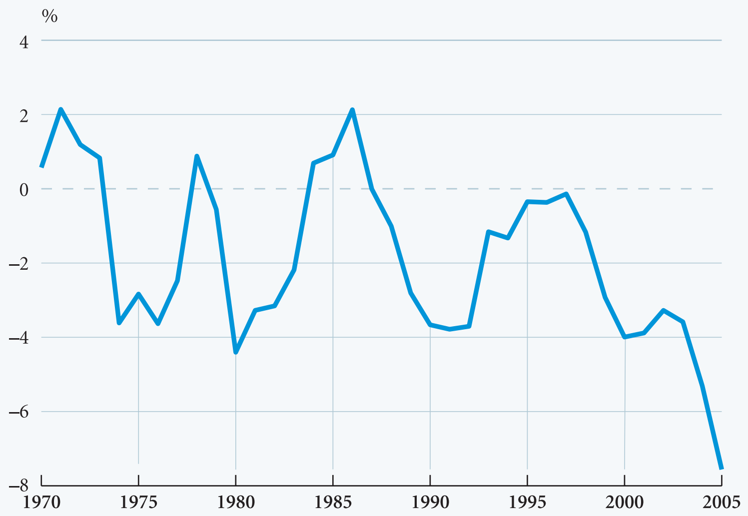
The second cause, the differential in growth, is showing a great deal of importance and this is increasing. The strength of consumption and the construction sector are having their effect. It cannot be denied that growth is good and it should be remembered that, thanks to adoption of the euro, Spain not only has all-time low interest rates but has revised downward its prospects on the future level of interest rates. This accounts for the strength of consumption and construction. The big question is why these low interest rates are not stimulating more capital investment.

It is the third reason which is of most concern. Spain is losing competitiveness, its products are more expensive than those of other countries and, not only because of the strong euro but also because it is not reducing the time needed to make products as rapidly as other countries, that is to say, Spain's productivity is falling behind. The bulk of the worsening in the current account balance lies in the trade balance, in trade in goods, which more and more is suffering from greater competition. When the peseta was current this had a simple solution. The loss of competitiveness was compensated by currency depreciation. Now, this alternative no longer exists and sooner or later Spain will have to adapt its income and wages to its level of competitiveness. This implies lower wage increases which could be painful.

Should we be concerned? The answer is yes but without being alarmist or overreacting. Comparisons with the past, or with the United States, lead nowhere. The United States has been financed with inflowing dollars for some time. Spain has a shared currency in the euro. While much bigger than Spain, the United States directly shows in its currency the doubts of investors but in the case of Spain, doubts and fears are spread more widely over the whole euro area. Furthermore, the rules of the game have changed drastically for Spain. Financing with pesetas involved considerable risk premiums which today have disappeared. Today, financing in euros means easier and cheaper access to foreign credit. Borrowing today is simpler and less costly but, without being alarmist, we should not forget that, with euros or with pesetas, debts end up having to be paid.

WORSENING OF SPAIN'S FOREIGN BALANCE CONTINUES

Figure for Spain's current account balance in relation to GDP



SOURCE: National Institute of Statistics and Bank of Spain.

Public sector

Economic boom in public accounts continues

Central government non-financial revenues continued to rise at a very high rate in August so that the cumulative figure at month-end came to 83.04 billion euros, 17.3% more than in the first eight months of 2004. If we include revenues ceded to the autonomous communities, collections amounted to 110.51 billion euros, an increase of 14.9% over the year before.

The main source of revenue continued to be direct taxes which furthermore grew to a spectacular degree (20.2%) boosted by collections for corporate earnings tax. Collections for personal income tax, which continued to make up the basic core of this heading, also rose sharply by 16.4%.

The increase in indirect tax revenues was somewhat lower although calendar factors may have changed the direction taken by these figures. In any case, value added tax (VAT) continued to be the main heading with a cumulative increase of 15.8%, well above the nominal increase in the economy. Under special taxes, most headings rose at a very modest rate. Collections for fuel tax may have been affected by lower consumption of petrol, partly attributable to the increase in fuel prices even with the increase in consumption of diesel oil, which contributed to this

Central government revenues growing well above nominal rate of economy...

...boosted by direct taxes and VAT.

CENTRAL GOVERNMENT BUDGET IMPLEMENTATION

August 2005

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**9,095**	**24.8**	**83,045**	**17.3**
Non-financial revenue adjusted (*)				
Personal income tax	99	19.3	34,536	16.4
Corporate tax	11,160	32.1	18,858	28.4
VAT	–1,571	–	33,158	15.8
Special taxes	1,552	–2.4	11,871	1.8
Other	1,288	122.1	12,090	5.3
Total	**12,528**	**19.8**	**110,513**	**14.9**
Non-financial spending	**13,252**	**84.1**	**80,637**	**7.9**
Treasury balance	**–4,157**	**–**	**2,408**	**–**
Surplus (+) or deficit (–) (**)	***–9***	***–90.4***	***7,383***	**–**

NOTES: (*) Includes tax segments ceded to autonomous communities under financing system in operation as of 2002.
(**) In terms of National Accounting.
SOURCE: Ministry of Finance and internal figures.

figure to a much lower degree. In addition, the increase in revenues from the tax on insurance premiums rose by 7.0% in keeping with the good state of the motor vehicle market. Finally, revenues coming from foreign trade were also up sharply because of increased imports and, of course, from the effect of increased prices for imported oil.

Apart from tax collections, fees and public service charges showed a substantial increase in contrast to the drop in government property earnings which were due to lower profits declared by the Bank of Spain.

Central government non-financial spending rose by 7.9% to reach 80.64 billion euros. This figure does not include the cross-entry for those revenues corresponding to the tax segments ceded to the autonomous communities. The increase in spending applied both to current transactions, except purchases of goods and services, and capital transfers, particularly real investments.

Notable surplus in public accounts as of August.

The central government Treasury balance as of August, that is to say, the difference between revenue and non-financial spending, was positive in the amount of 2.41 billion euros and thus a turnaround from the negative figure for the same period last year. This balance, added to the sharp net decrease in financial assets, gave rise to a surplus of 8.66 billion euros. In terms of National Accounting, the budgetary balance was also positive in the amount 7.38 billion euros, well above the figure for the same period in 2004.

Savings and financing

Sharp growth of financing to private sector

Interest rates on bank loans and credits continued a generally downward path in July. As a result, the composite lending rate at credit institutions, obtained as an average of interest rates on new loan and credit transactions for the private sector weighted by balances in euros, dropped by 3 basis points to 3.75% thus putting it 13 basis points below the same month in 2004. The decrease in bank loan interest rates came about in a situation of prospects that the European Central Bank would maintain its reference rate at the present low level of 2% at least until the beginning of next year.

On the other hand, in August 2005 the loan rate on mortgages of longer than a 3-year term for acquisition of non-subsidized housing for credit institutions as a whole dropped very slightly by 1 basis point going to 3.19%. It thus marked up another all-time low to stand 2 decimals below the same month last year.

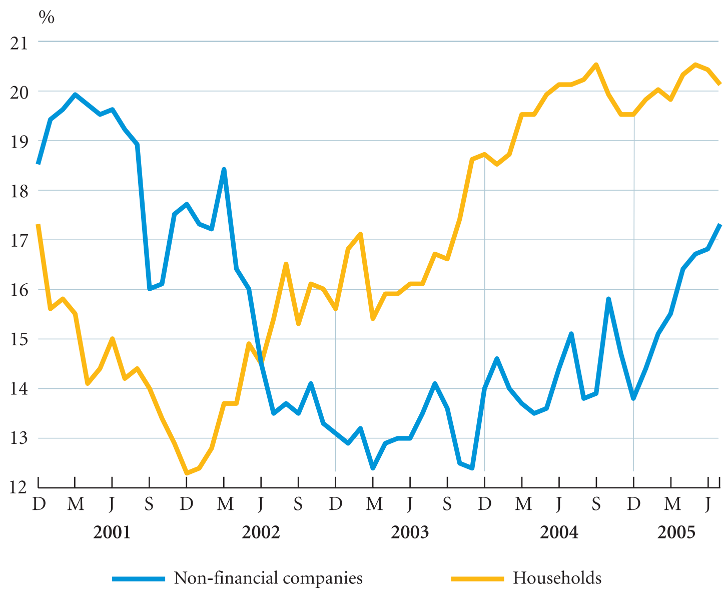
Stimulated by such low interest rates, even below the inflation rate in some cases, financing going to companies and households rose at a year-to-year rate of 18.5% in July, slightly above that recorded the month before, according to Bank of Spain figures. As a result, financing to the private sector, including

Prospects of long wait for upward move by European Central Bank brings drop in loan rates for companies and households.

Interest rate on housing loans marks up low of 3.2% in August.

INCREASE IN FUNDING TO COMPANIES

Year-to-year change in total funding, by institutional sector



SOURCE: Bank of Spain.

Excellent borrowing conditions stimulate demand for funding from private sector.

loans from the financial system both domestic and foreign, securitizations and bond issues (but not share issues) advanced at the highest rate since September 2000 and notably higher than in the euro area as a whole. The biggest year-to-year increase was for loans to households (20.1%), slightly lower than that recorded in previous months. Financing obtained by households, largely bank loans, continues to be based on mortgage security.

Private sector deposits growing at higher rate than in euro area and higher than securities mutual funds.

With regard to funds received by non-financial companies, these were up 17.3% compared with the same month in 2004, a rate a half-point higher than in the previous month. Of total funding, credit granted to non-financial companies by resident credit institutions rose by 22.0% in the past twelve months, the highest rate in recent years.

Sustained increase in bank deposits

Big increase in time deposits and deposits in currencies other than euro.

Total deposits of the resident private sector in euros and foreign currency rose notably in July compared with the same month last year and at a rate well above that recorded in the euro area. Nevertheless, the increase in the past 12 months was considerably lower than that for loans. To counteract this imbalance, the financial institutions issued securities or had recourse to the foreign market.

In addition, the new accounting rules for credit institutions as a result of adoption of the International Financial Information Regulations by the European Union came into force in June. As a result, the balance of time deposits, mainly long-term deposits, rose as a re-deposit balancing entry on the assets side of securitization funds which had been taken out of the balance sheet. This overvalues the year-to-year growth rate of time deposits and the total figure. Nevertheless, it is clear that the biggest annual increase came in time deposits of more than two years which enjoy a tax reduction of 40% on interest. Deposits in currencies other than euros also showed a major rise. On-demand and savings accounts, in turn, recorded notable growth of 12.6%.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

July 2005

	Total	Change this year		Change over 12 monts		% share
	Million euros	Million euros	%	Million euros	%	
On-demand and savings (**)	379,806	34,732	10.1	42,543	12.6	45.6
Up to 2 years (*)	179,301	18,834	11.7	25,060	16.2	21.5
More than 2-year term (*)	198,898	71,430	56.0	93,144	88.1	23.9
Repos	66,998	–13,651	–16.9	–9,451	–12.4	8.0
Total (*)	**825,002**	**111,344**	**15.6**	**151,295**	**22.5**	**99.1**
Deposits in currencies other than euro	**7,809**	**1,962**	**33.6**	**2,611**	**50.2**	**0.9**
TOTAL (*)	**832,811**	**113,306**	**15.7**	**153,907**	**22.7**	**100.0**

NOTES: (*) As a result of the coming into force of new regulations in application of the International Accounting Standards, as of June 2005, increases in time-deposits as a cross-entry to entries on the assets side of securitizations that had been taken out of the balance sheet make comparison difficult.
(**) Includes deposits redeemable at notice, according to ECB definition.
SOURCE: Bank of Spain and internal figures.

With regard to bank deposit interest rates paid to companies and households, these showed very slight swings in the first half-year going to a level just above the low in October 2003. The composite interest rate for non-financial companies dropped to 1.17% in June but was 3 basis points above one year earlier. The composite interest rate for households rose slightly in July going to 1.14%, some 3 basis points above 12 months earlier.

The assets of securities mutual funds rose by 2.2 billion euros in August going to 238.5 billion euros, an increase of 12.1% compared with 12 months earlier. This increase in assets took place thanks to net share subscriptions, discounting sales, of 2.2 billion euros, given that the negative trend in the US stock markets and the euro area during the month prevented them from showing capital gains. Net cash inflows in July settled between the more conservative funds (money-market funds and short-term bond-based funds) and global funds, which involve more risk but often report greater yields.

Saver preference settles between more conservative securities mutual funds and global funds.

The total number of participants rose to 8,222,431 at the end of August. This figure represents an increase of 3.30% over the past 12 months. In this period, the types of fund to show greatest increase in participants were guaranteed bond-based funds and share-based funds with year-to-year increases of 17.7% and 10.4% respectively.

The average weighted yield arrived at by securities mutual funds in the period August 2004-August 2005 was 5.3%, thus going substantially above inflation. While all types of fund showed positive annual yields there were great differences. Whereas international share-based funds in emerging markets marked up a spectacular yield of 43.2% and national share-based funds recorded a 29.1% yield, money-market funds reported a yield of only 1.2%.

Securities mutual funds reach average annual yield of 5.3%.

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