NOVEMBER 2005

THE SPANISH ECONOMY

Monthly Report

NUMBER 285

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Labour costs in manufacturing sector growing much more than among Spain's competitors

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Transactions of financial nature make it possible to round out budget figures

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2004	2005	2006	2004 3 Q	2004 4 Q	2005 1 Q	2005 2 Q	2005 3 Q	2005 4 Q
INTERNATIONAL ECONOMY		Forecast						Forecast	
Gross domestic product									
United States	4.2	3.6	3.3	3.8	3.8	3.6	3.6	3.6	3.6
Japan	2.6	1.8	1.4	2.4	0.9	1.0	2.2	2.2	1.9
United Kingdom	3.2	1.7	2.1	3.0	2.5	1.7	1.5	1.6	1.8
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*	*1.8*	*1.8*	*2.1*	*1.9*	*1.3*	*1.3*	*1.4*
Consumer prices									
United States	2.7	3.5	2.8	2.7	3.3	3.0	2.9	3.8	4.0
Japan	0.0	–0.2	0.2	–0.1	0.5	–0.2	–0.1	–0.3	–0.3
United Kingdom	2.2	2.3	2.3	2.1	2.3	2.2	2.2	2.4	2.2
Euro area	2.1	2.2	2.2	2.2	2.3	2.0	2.0	2.3	2.5
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*	*1.9*	*1.9*
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	5.7	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**	**3.4**	**3.2**	**3.1**	**3.2**	**3.3**	**3.4**	**3.5**	**3.4**
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	9.1	8.4	10.7	10.6	10.2	9.3	8.4	8.4
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	2.4	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	4.6
10-year German bonds	4.1	3.4	3.7	4.1	3.8	3.6	3.3	3.2	3.4
10-year Spanish bonds	4.1	3.4	3.7	4.2	3.8	3.6	3.3	3.2	3.4
Exchange rate									
$/Euro	1.24	1.25	1.21	1.22	1.30	1.31	1.26	1.22	1.20

THE SPANISH ECONOMY
MONTHLY REPORT
November 2005

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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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Brussels or Frankfurt? We have a problem

Just a week earlier, the Bank of Spain had carried out massive interventions (close to 20 billion dollars) to support parity of the peseta in the European Monetary System. But it was not to be. After eleven hours of deliberation, the Monetary Committee decided on a 7% devaluation of the central parity of the peseta putting the exchange rate against the deutschemark at 85.07 pesetas. That was a little after one o'clock on the morning on Monday, March 6, 1995. It was the last devaluation of the peseta because the Spanish currency would be replaced by the euro in 1999. Almost immediately, the Bank of Spain, which only a few months before had been given status as a body independent of the government, raised interest rates in order to dispel inflationary prospects.

More than ten years later, Spain's economy is showing strong growth and creating employment but there are some signs of overheating, inflation is systematically higher than in the euro area and, more than anything else, the foreign deficit is headed toward astronomical levels. Up until very recently, the idea that the trade deficit could reach 10% of the gross domestic product in 2006 would have been regarded as ridiculous. Now, it has become a plausible hypothesis. Plausible but difficult for the economic authorities to accept. The classic remedy to halt this trend would be to devaluate the currency or to raise interest rates. But neither one or the other is now possible. Under the rules of the Economic and Monetary Union, decisions on the exchange rate of the euro are adopted in Brussels by the ECOFIN, the Council of Ministers of Economy and Finance. The decisions on interest rates, however, fall to the Governing Council of the European Central Bank which meets in Frankfurt on the first Thursday of each month. Spain scarcely represents 11% of the economy of the Twelve and its problems are nothing like those of the main economies of the euro area. The solution is not going to come from there.

As we cannot have recourse to traditional remedies we shall have to rely on alternative medicine of slower effect but, if properly applied, this could more adequately cure the sickness as diagnosed. In this respect, the therapy would, on the one hand, involve applying those structural reforms which would make it possible to recover Spain's lost foreign competitiveness. Or, on the other hand, use could be made of the last instrument for managing demand now left to the government – a budgetary policy which would somewhat relieve the pressure of domestic demand on imports.

In the matter of competitiveness, the key lies in industry. Whereas construction and services continue full steam ahead, manufacturing companies, which are subject to fierce international competition, are suffering from a situation which does merit greater attention. Situations of relocation and disinvestment are more and more frequent and now involve key sectors such as motor vehicles and components. The market penetration of low-cost imports from emerging countries is taking some economic activities, such as textiles, to a critical point. For this reason, it is necessary to redouble efforts in two directions which are being debated at this very time – strengthening research and development policy and labour reform. It is not possible to save companies which are unable to compete in the globalized world, although it is possible to aid the efforts of more competitive investors and provide them with greater support and a more flexible and efficient environment.

October 26, 2005

ECONOMIC SITUATION

Fears of inflation

Consumer price indices show considerable rise in September setting off alarm in central banks.

October was marked by some alarm due to inflation. During the month, as consumer price indices for September became known, they showed a sharp increase in prices of oil by-products. The CPI figure for the United States went from a rate of 3.6% in August to 4.7% in September, a level not reached since July 1991. In the euro area, the harmonized index moved up from 2.2% to 2.6%, the highest rate since January 2002. In the main countries of the euro area, including Spain, year-to-year rates added between four and five decimals to that for August.

If inflation expectations increase, rise in oil prices will likely spread to other prices in economy, including wages.

The central banks are concerned. One of the biggest successes of the recent decade in terms of economic policy has been disinflation, that is to say, the decrease in inflation rates to low levels. Measures taken by the central banks in a context of independence from their respective finance ministries, has been a key in this matter. Following an 80% rise in raw materials prices in the last four years, however, those responsible for monetary policy face the risk that inflation expectations will move up. This would give rise to increases in prices and wages more than desirable with the risk of unleashing an inflationary spiral, which was the nightmare of economic policy in the Seventies and Eighties.

While core inflation holding stable in context of growth or recovery, shift of price increases in raw materials becoming easier.

If we are to go by the performance of core inflation, these figures may be considered exaggerated. That is to say, if we deduct from price indices the more volatile components, normally food and energy, in order to observe the more stable component, we find that both in the United States and the euro area inflation stands at low levels. In the first case, core inflation is running at rates somewhat above 2%, a higher level than the lows seen in 2003, when it scarcely went above 1%, but acceptable from a mid-term perspective. In the euro area, core inflation stands at a very low level (1.5%). Therefore, the jump in oil prices has not shifted to other prices. From this point of view, we are not lodged in a period of general price increases which is what we understand as inflation.

We know, however, that the shift in the rise in oil prices and prices of other raw materials to the core of inflation, when it does happen, takes place slowly. We also know that in a context of strong growth, as is the case in the United States, or at the beginning of recovery as we believe is taking place in Europe, it is easier for the increase in raw material costs to affect other final prices or wages. Those in charge of the central banks are doing well to protect us from inflation risks.

The first measures adopted have been warning statements. Members of the Federal Reserve, the Bank of England, the Bank of Switzerland and the European Central Bank (ECB) have considerably toughened their monetary stance. Other central banks have opted for directly raising their reference rates, as in the case of South Korea and Canada.

In fact, for more than a year the Federal Reserve has been raising its reference rate at each meeting of its Monetary Committee. It will continue to do so in spite of the impact of the hurricanes in August and September which at first raised the possibility of a halt. In fact, the US economy is not showing any sign of moderating its growth. This was stated in the latest issue of the Beige Book, a document published by the Fed eight times a year just before the meetings of the above mentioned committee. Some problems were seen only in those areas affected by the hurricane devastation. Ben Bernanke, who takes over from Alan Greenspan as president of the Fed in February, will inherit the tightest monetary policy since the height of the hi-tech bubble at the end of 2000.

In the euro area, the ECB is holding up, still maintaining its reference rate fixed at 2% since June 2003. Up until quite recently, pressure, both from private interests and from the International Monetary Fund itself, was in favour of the ECB lowering its rates even more in order to consolidate recovery. Now, fear of inflation is more pressing and the markets are already discounting rate increases in coming months. The euro area, however, must still show that economic recovery is actually taking place. Some signs of this improvement may be seen in industrial production, in passenger car registrations and in retail sales. Employment, however, is scarcely growing and furthermore we note weakness in foreign demand which up until now has sustained the scarce progress seen in the EU as a whole.

Inflation also a problem in Spain

Spain also has had its own inflationary scare. The consumer price index (CPI) showed a sharp increase in September which put the year-to-year rate at 3.7%, the highest figure since 2003. The cause of this was the fuel and fuel-oils group which together brought a rise of 22% so far this year. Also contributing to the monthly figure was the performance in some fresh foods and the government decision to raise taxes on alcoholic beverages and tobacco, a measure aimed at obtaining funds to finance the deficit generated by public health.

This is not merely a temporary situation. Inflation is turning into a headache coming on top of the anxiety caused by the unstoppable foreign deficit. The Ministry of Economy openly admits that the year will end with a CPI very close to 4%, twice the official objective. The blame lies with the per barrel price of oil. If we remove the increase in fuels from the index, we may consider that inflation is holding at a more or less stable rate. In October, the price of crude oil tended to moderate which raises a ray of hope. The Ministry of Industry has requested the oil companies to narrow their business margins and to encourage the use of renewable energy.

The government, however, has little margin for manoeuvre. In October, the situation in the energy market made it necessary to authorize an increase in gas tariffs of 6% for domestic consumers and 18% for industry. Bottled gas also rose in October for the third time this year. On the other hand, the drought is slowing production of power at hydro-electrical stations and it is necessary to burn more oil to produce the same power levels so that government is studying the matter of raising electrical tariffs for the first time in nine years.

All of this is contributing to increase fears that the rise in energy costs will spread to other prices in the economy. Wage-indexing mechanisms which exist in Spain's economy are still very strong.

Ben Bernanke, who succedes Alan Greenspan in February, to inherit tightest monetary policy since days of hi-tech bubble.

In euro area, markets anticipating rate increases by European Central Bank in coming months.

Alarm in Spain as inflation also shows considerable rise in September because of oil prices.

Higher than expected CPI means automatic rise in pensions and wage increases due to step-up clauses.

The excess in the CPI will automatically bring about a complementary increase in government pensions with a cost estimated at more than one billion euros. In addditon, most collective bargaining agreements contain automatic step-up clauses covering the situation where inflation goes above the official objective so that the effect of oil prices on wages is inevitable.

Truck-driver strike spreads fuel increase to other goods and services.

The increase in fuel costs has brought about protests by certain groups which feel directly affected. For some days in October, truck-drivers coming under the largest operator group in the sector stopped their trucks thus having a notable effect on supply to factories and retail outlets. The stoppage was called off following agreements between the truck-drivers and the government, which involved a slight reduction in fuel taxes paid by the sector, as well as other advantages, and agreements between truck-drivers and loader organizations who accepted a rise of 14% in rates. The example spread further afield. Fishermen began a strike aimed at lowering the cost of diesel fuel while members of some farm organizations also carried out demonstrations.

Negative real interest rates brings continuation of spending spree.

Higher inflation means lower consumer purchasing power. However, if consumers manage to recover lost purchasing power through the indexing clauses mentioned above, spending pressure could increase the risk of inflation. Furthermore, if monetary conditions do not compensate these pressures through, for example, an increase in interest rates, the situation becomes more complicated. At this time, yields on Spanish government bonds of whatever term stand below the 3.7% inflation rate. Only 30-year bonds are showing a yield of 3.75% in the secondary market. With negative real interest rates, companies and households continue to borrow at very high levels. And they continue to spend. There is no halt to consumption. It seems that the increase in fuel prices is being ignored by car owners given that car sales are moving ahead firmly beating all-time highs.

National Reform Programme suitable instrument over medium term but fails to solve more immediate problems.

If we are to go by the 2006 central government budget now under discussion in parliament, government measures will not contribute to cooling off consumer spending or investment. However, at least we should point out the presentation of the National Reform Programme which perhaps has not received the attention it deserves. This is a move which comes under the so-called Lisbon Agenda, a plan for European Union measures aimed at ensuring that the EU does not fall behind the more dynamic world economies. The Programme sets out a broad range of measures to improve income, productive capacity and efficiency. This is surely the way to remedy existing imbalances over the medium and long term. Over the short term, however, it will be necessary for all those involved in the economy to be aware of the times in which they are living so that small individual gains today do not mean widespread losses tomorrow.

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%.
October	4	IBEX 35 index for **Spanish stock market** marks up annual high (10,919.2), a cumulative gain of 20.2%.
	13	Government aproves **National Reform Programme** for Spain.

AGENDA

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).

December

1 Meeting of Governing Council of European Central Bank.
2 Industrial production index (October).
13 Meeting of Open Market Committee of Federal Reserve.
13-18 6th Inter-ministerial Conference of World Trade Organization.
15 Consumer price index (November).
15-16 Meeting of European Council.
16 Harmonized consumer price index for European Union (November).
20 Central government revenue and spending (November).
21 Quarterly survey of labour costs (3rd Quarter).
22 On-going survey of household budgets (3rd Quarter).
26 Producer price index (November).

United States survives hurricanes and energy crises, for the moment

United States maintaining economic activity and energy prices not shifting to other sectors.

The vitality of the US economy seems able to survive anything. The effects of hurricane *Katrina* on the level of economic activity have been much less than initially expected. So far as concerns prices, that is another story as one thing adds to another. The hurricanes have put pressure on already high energy prices bringing about a notable rise in inflation. This rise, however, is not shifting to other sectors of the economy. At this time, the worst effect of the rise in oil prices is not in a reduction in growth nor in widespread inflation but in the increasingly worse state of a trade balance already in deficit.

Retail sales remain strong with only a drop in car sales.

On the demand side, the latest available indicators show that the effects of *Katrina* on consumption are turning out to be limited. In September, retail sales were strong. Apart from motor vehicles, a key but erratic component, retail sales were up by 10.3% over the same period last year and are showing a profile not simply holding up but presenting some increase. This vitality comes in contrast to the drastic drop recorded in the Conference Board consumer confidence index in September which went down from 105.5 points to 86.6. Naturally enough, the fears and doubts of the US consumer are being concentrated on durable consumer goods while at the same time people are holding strongly to the levels of consumption reached in other products.

On the supply side, the industrial and manufacturing sector continues to be the ugly duckling of the strong 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	3 Q	July	August	September
Real GDP	2.7	4.2	3.8	3.8	3.6	3.6	–	...	–
Retail sales	4.3	7.3	6.4	8.3	7.3	8.4	10.3	8.1	6.5
Consumer confidence (*)	79.8	96.1	100.4	96.1	104.2	102.3	103.6	105.5	86.6
Industrial production	0.0	4.1	4.6	4.3	3.8	3.0	3.0	3.1	2.0
Industrial activity index (ISM) (*)	53.3	60.5	60.1	57.5	55.6	52.8	56.6	53.6	59.4
Sales of single-family homes	11.7	10.0	–0.4	10.8	5.1	7.1	24.4	6.2	...
Unemploymenr rate (**)	6.0	5.5	5.4	5.4	5.3	5.1	5.0	4.9	5.1
Consumer prices	2.3	2.7	2.7	3.4	3.0	2.9	3.1	3.6	4.7
Trade balance (***)	–532	–651	–608	–651	–686	–709	–716	–723	...

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

RETAIL SALES PRESENT STRONG GROWTH

Month-to-month change in retail sales index, excluding motor vehicles (*)

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

economy. In September, the poor growth of industrial production (2.0% year-to-year) falls within the marked downward trend taking place since the Spring of 2004. The truth is that the sector has had a weak and very short recovery compared with past periods. Nevertheless, business executives are seeing things with rather more optimism, as shown by the recovery in the manufacturing activity index put out by the Institute of Supply Management for August, which rose to 59.4 points, a level well above the 50 reference figure which indicates a predominance of optimists over pessimists. The non-manufacturing activity index went the other way with a drastic drop to 53.3 points, a loss which likely will be compensated in coming months.

Industrial production remains weak.

The housing sector, one of the key players at this time, continues to show a broad picture of strength which also helps the consumer to maintain levels of consumption, whether by increasing the sense of wealth or by making access to borrowing easier. All indicators for the real-estate market continue to move up, especially the price of existing houses, which showed an increase of 16.2% annual in August. Nevertheless, while not changing the general picture, housing demand seems to be easing in some parts of the country. In this respect, the passing of *Katrina*, which has generated an increased need for building in shelter areas and for reconstruction, could be masking part of this slowdown, constituting a «soft landing» which would be looked kindly upon by the Federal Reserve.

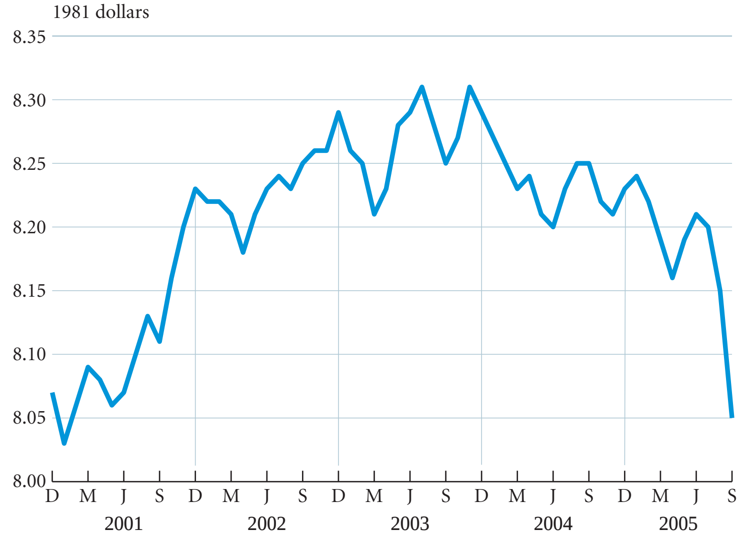
Strong real-estate market shows some signs of easing.

In the labour market, the US economy continues to create jobs. Some 35,000 jobs were lost in September, the first drop since May 2003. This decrease, however, quite small in itself, was much less than expected, if we take into account current circumstances. Furthermore, the figure for August was revised upward. Finally, the picture we are left with is that of a labour market undoubtedly quite vigorous. In spite of

Employment being created but wages losing purchasing power.

WAGES LOSING PURCHASING POWER

Real hourly wage (*)



NOTES: (*) Discounting inflation.
SOURCE: Department of Commerce and internal figures.

robust job creation, in September wages lost 2.4% of the purchasing power they had in the same period last year. The negative effect of this reduced spending capacity on retail sales is being compensated by the strength shown in housing. On the positive side, this wage moderation is helping to avoid inflationary pressures.

Increased inflation holding to energy sectors, thanks to containment of wages and retail margins.

Energy prices meant that inflation shot up to 4.7% year-to-year in September. This was a rate in line with the Nineties seeing that this level had not been reached since July 1991. In spite of this very notable rise, the effects on other sectors of the economy have been practically nil. In this respect, the core inflation component, which excludes energy and food, dropped slightly with an increase of 2.0% compared with 2.2% the month before. Wage moderation, mentioned earlier, is the main cause of the trend in the broad component of prices but not the only one. Producer prices for finished products went higher than consumer prices, going up by 6.7% year-to-year in September. In this case, the reduction in retail margins was the factor preventing such price increases from reaching the consumer. We may ask how long the containment of margins and wages will last but, for the moment, the sharpest effect energy prices are having is on as simple a matter as the trade deficit.

High-cost oil increasing foreign deficit.

The foreign sector is far from hitting bottom. Following a slight respite in the second quarter, it again sharpened its worsening state. Energy raised the price of imports and this sent up the trade deficit in August making it worse than July. The cumulative deficit for the past 12 months reached a record figure of 723 billion dollars. A return to more moderate levels in oil prices could bring about some reduction in the foreign deficit but the prospects are not going in this direction and it should be considered that US household savings represent only 0.3% of disposable income, which does nothing to help work against this sword of Damocles hanging over the US economy and its trading partners.

Japan's economy continues recovery

Japan is continuing to consolidate recovery. At this time, the challenge lies in maintaining the strength of domestic demand, up until now the main factor in growth. Over the past decade, Japan's growth has been too much biased in favour of the foreign sector which brought about a number of disappointments. Today, the continuation of Japanese growth will have to be based on the strength of domestic consumption.

Demand indicators are showing moderate growth and, while not presenting spectacular rises, are reporting more and more sustained increases. In this respect, retail sales are holding strong. In August they recovered the drive they had lost in July and confirmed the upward trend that has been dominant in recent months. Car sales dropped in September in year-to-year terms for the third consecutive month although they had increased up to June. Consumer confidence continues to show a more than acceptable rate in terms of the Japanese pessimistic outlook. The slight drop in the third quarter must be seen as being within a process of stabilization at highs for the decade. Even so, levels of confidence are lower than at the beginning of the Nineties when Japan had not yet begun its lost decade.

On the supply side, it is domestic demand on which most optimism is based and this is something new. Domestic machinery orders, an early indicator of investment, grew by 6.6% year-to-year in August and are following a sustained growth profile with a slight upward trend but orders from abroad have been suffering a notable slowdown. Japan will have to pursue growth more concentrated in domestic demand, something which has not been the case until this year. In the past 15 years foreign orders have increased their relative weight to 37.6% of the total.

As a positive note, corporate bankruptcies in September dropped

Machinery orders in Japan showing favourable trend thanks to domestic demand.

Retail sales holding up.

JAPAN: MAIN ECONOMIC INDICATORS

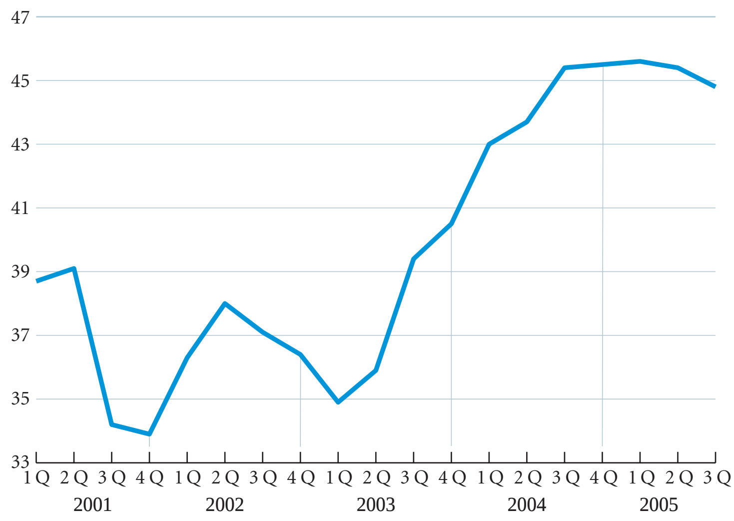
Percentage change over same period year before unless otherwise indicated

	2003	2004	2004			2005			
			2 Q	3 Q	4 Q	1 Q	2 Q	July	August
Real GDP	1.4	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	3.2	0.6	1.6
Industrial production	3.3	5.3	7.8	6.6	1.6	2.7	0.3	–1.1	0.3
Tankan company index (*)	–21.0	–0.5	0.0	2.0	1.0	–2.0	1.0	–	2.0
Housing construction	0.6	2.6	–3.5	9.4	–0.1	1.5	2.1	8.2	7.0
Unemployment rate (**)	5.2	4.7	4.7	4.8	4.5	4.6	4.3	4.4	4.3
Consumer prices	–0.3	0.0	–0.3	–0.1	0.5	–0.2	–0.1	–0.3	–0.3
Trade balance (***)	12.0	13.7	13.7	14.1	13.7	13.3	12.2	11.8	11.2

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

JAPANESE CONSUMER CONFIDENCE HOLDING AT HIGH LEVELS

Consumer confidence levels



SOURCE: Japanese Ministry of Economy, Trade and Industry and internal figures.

below 1,000 for the second time this year and, adding weight to this, the Tankan company index improved in the third quarter, although less than expected. Following restructuring programmes carried out, the health of Japanese companies is the best in recent years although the banking sector is still awaiting solution. Industrial production in August continued to represent the weakest side of the present recovery, reporting practically nil year-to-year growth.

Real-estate sales up in Tokyo.

The housing market continued its gradual recovery in September with real-estate sales in Tokyo showing the most notable growth at 22.2%, along with maintenance of the upward trend in all indicators. Clearly, the sector is now no longer the block to growth it represented in the Nineties.

Deflation refuses to disappear.

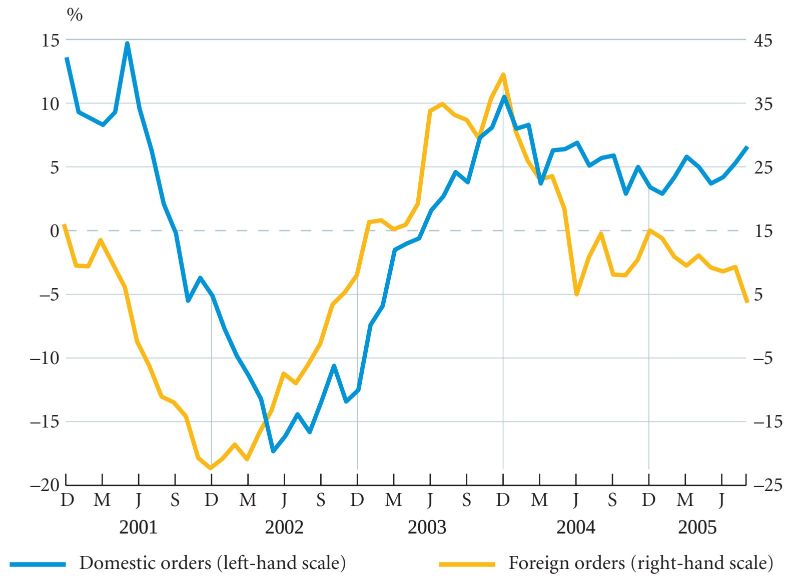
On the prices front, the danger of deflation has not yet been put to rest. In August, the consumer price index again dropped by 0.3% year-to-year. The central bank asserts that deflation will have disappeared by year-end but the truth is that prices in Tokyo in September again dropped by 0.6%, which does not mean we can presume that September prices for the whole economy rose and the end of the year is not far off. The unemployment rate was down slightly in August to stand at 4.3% of the labour force. The biggest job creation came in the services sector while the largest job losses showed up in construction.

Energy prices reduce surplus.

Japan's trade surplus continued to shrink in August but the causes of this reduction have changed. Oil has been raising import prices, which grew by 13.5% year-to-year, while export prices have risen by only 0.6%, with the understandable negative effect on the trade surplus. On the positive side, the reduction of exports to China, the main cause of the worse foreign balance this year, is now easing.

TURN OF DOMESTIC MACHINERY ORDERS TO SHOW IMPROVEMENT

Year-to-year change in machinery orders (*)



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

China continues to grow but without inflationary pressures

China's economy grew by 9.4% in the first nine months of 2005 which suggests a continuation of the high rate of economic activity in the third quarter. Investment and exports continue as the main engines of growth, well above private consumption which remains the big unresolved question in the economy of this Asian giant and the central bank has publicly expressed its concern about this matter. A major part of investment is going into removing bottlenecks in infrastructures and energy production, so that inflation pressures still seem far off, as the figures would indicate.

On the supply side, in the third quarter the industrial sector continued to lead with highest growth while services increased their progress slightly. In this respect, as in so many others, China has a unique economy. Industry represents 56.9% of its nominal gross domestic product, a rate which does not stop growing, whereas services are tending to drop.

Supply indicators are coherent with the surprising macroeconomic stability shown in the statistics. Industrial production, especially important in China due to the relative weight of industry, continued to grow above 16.0% in September. At this time, China seems able to absorb nearly all the overall growth of this indicator which is diminishing in countries such as the United States and Japan. Heavy industry continues to grow more rapidly than light industry, while the relative weight of the state sector compared with total industry in August held at the same figure of 39.8% seen in July, which demonstrates the rigidity being encountered in reducing the state conglomerates.

China growing through investment and exports while avoiding inflation.

Industry, mainly heavy industry, dominates.

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004			2005				
			2 Q	3 Q	4 Q	1 Q	2 Q	July	August	September
Real GDP	9.4	9.5	9.6	9.1	9.5	9.4	9.5	–	...	–
Industrial production	16.7	16.3	17.6	15.8	15.0	14.5	16.5	16.1	16.0	16.5
Electrical power production	14.2	15.0	16.5	12.9	14.6	14.7	13.7	14.8	12.6	...
Consumer prices	1.2	3.9	4.4	5.3	3.2	2.8	1.7	1.8	1.3	0.9
Trade balance (*)	25.5	32.0	13.6	20.4	32.0	57.1	79.2	87.8	93.9	96.4

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

Trade surplus shows explosive growth because of easing off in imports.

The strength of China's awakening is also confirmed by the level of various production figures. In the past 12 months ending in August, compared with the same period last year, electrical power generation continued its upward move. Production of motor vehicles and cement, which appeared to be slowing down at the beginning of summer, is now showing new drive. Finally, production of personal computers deserves special attention with year-to-year growth of 70.5%, a rate into which it has settled for three consecutive years. The amount of value added on each computer of specifically Chinese origin may still be small but this is growing.

Retail sales growing but not as fast because of moderate domestic consumption.

It is on the demand side that China's economy shows up weakest and this is the cause of the central bank's concern. Retail sales in August grew by 12.7% year-to-year. Even taking into consideration the high level, the profile shows something of a slowdown.

In spite of the level of economic activity, prices continue to show more moderate increases. In September, consumer prices rose by 0.9% year-to-year. Such moderation can only be understood in a situation where consumption is growing less than investment.

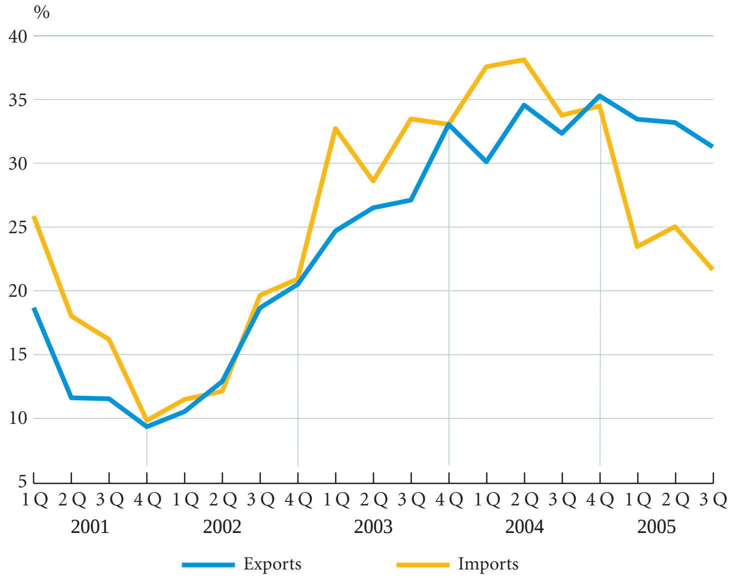
The foreign sector holds a notable place in China's overall economy and is the cause of fairly common pressures. The most closely watched indicator is the explosive trade surplus. In the 12 months ending in September, it reached 96.38 billion dollars, an amount five times higher than in the same period last year and it has now come to represent 5.0% the Chinese economy. The sharp increase in the trade surplus is expected to contribute 30% to the growth of the economy in 2005. These are big figures but they are increased by the current renmimbi exchange rate. The trade balance is valued at international prices which are higher than the prices operating inside China and this means that in real terms, discounting price differences, the effect is much lower.

In this respect, growth rates are high but their peaks have lagged behind. Exports rose by 32.2% year-to-year while imports were up by 19.2%. Within this sharp growth we cannot now speak of an upward trend but rather of an easing off, especially in the case of imports, this being the main cause of the rapid increase in the trade surplus.

By product, exports of manufactured goods in the 12 months ended August grew by 33.6% while imports were up

CHINA'S EXPORTS AND IMPORTS STABILIZE

Year-to-year change in quarterly exports and imports (*)



NOTES: (*) Cycle-trend series.
SOURCE: Chinese National Statistics Office.

15.4%, half the January figure. What is significant is the sharp drop in imports of machinery and electronic equipment. If we compare growth in August with January, we find 3.8% in Germany as against 30.1%; in Japan 4.6% as against 26.0%: in Taiwan 15.3% as against 30.8% and in Spain 17.7% as against 58.9%. In raw materials, imports are growing at a considerable rate but less than in 2004. Steel imports rose to 10.8%, a fifth of the average in 2004.

Mexico recovering but losing competitiveness

The Mexican economy grew by 3.1% year-to-year in the second quarter of 2005 thus recovering part of the situation in 2004. This recovery was based on investment, replacement of inventories and a better situation in exports. Under the heading of investment, it is the government that is playing the biggest hand, which raises some doubts about sustainability.

By sector, bank and financial services, construction and transportation are showing the most strength.

Retail sales in Mexico holding up while *maquiladoras* lead in industrial production.

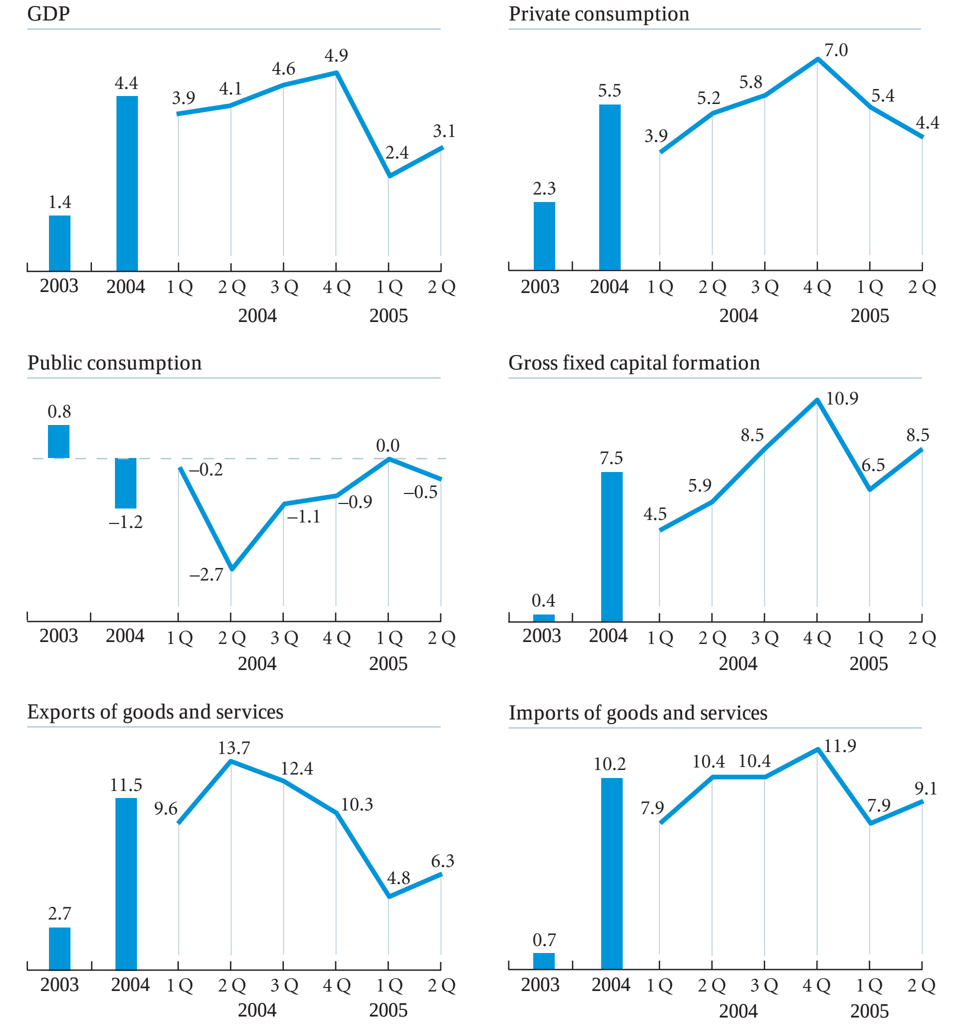
On the demand side, retail sales in June grew by 3.3% year-to-year, a rate somewhat lower than the average for recent months. On the supply side, industrial production in August moved up 2.1% year-to-year which meant a recovery compared with the decreases seen in previous months. The positive side of this growth lies in the leadership of the manufacturing component. Always ahead of local industry, the industrial production of the *maquiladoras* (foreign companies manufacturing in Mexico and exporting to the United States) moved ahead by 5.7%.

Growth without inflationary pressures.

The general employment rate rose to 4.1% of the labour force in August but

TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-to-year change in real terms



SOURCE: Central Bank of Mexico.

Unemployment under control but unit labour costs growing and hurting competitiveness.

manufacturing productivity stopped losing ground although it is still early to speak of real recovery. The most troubling note comes with the sharp increase in unit labour costs which was up 12.0%. This figure causes concern because Mexico has been suffering from a lack of competitiveness for some time. The sharp increase in unit costs, added to the fact that the Mexican peso is among those Latin American currencies which have lost least value, means growing difficulties for the trade balance which already is in deficit.

Consumer prices remain moderate.

On the positive side, consumer prices in September rose by 3.5% year-to-year. The moderation that was maintained during the first half of 2005 is thus being continued. The core component, excluding food and energy, went in the same direction for that month holding at a rate of 3.2%.

The Mexican foreign sector is the most negative in an economy that, on the other hand, is growing without showing inflationary pressures. The trade deficit for the 12 months up to August 2005 held

MEXICO: MAIN ECONOMIC INDICATORS

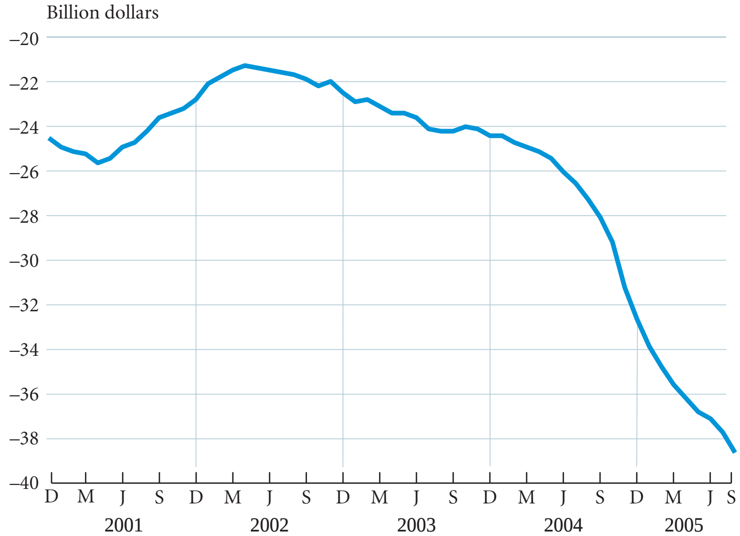
Percentage change over same period year before unless otherwise indicated

	2003	2004	2004			2005				
			2 Q	3 Q	4 Q	1 Q	2 Q	July	August	September
Real GDP	1.4	4.4	4.1	4.6	4.9	2.4	3.1	–	...	–
Industrial production	–0.2	3.8	3.7	4.8	3.6	–0.2	2.8	–1.3	2.1	...
General unemployment rate (*)	3.2	3.7	3.6	4.0	3.5	3.9	4.0	3.5	4.1	...
Consumer prices	4.5	4.7	4.3	4.8	5.3	4.4	4.5	4.5	3.9	3.5
Trade balance (**)	–5.8	–8.8	–5.6	–6.2	–8.8	–10.2	–9.8	–9.6	–9.5	...

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

LOSS OF COMPETITIVENESS WEIGHS ON MEXICO'S TRADE BALANCE

12-month cumulative figure for trade balance, excluding oil exports



SOURCE: Central Bank of Mexico and internal figures.

at 9.5 billion dollars, but if we exclude oil exports it come to 38.4 billion dollars and it is the loss of competitiveness that counts. The Mexican deficit especially draws attention at a moment when the overall group of economies in the region are showing trade surpluses.

Foreign sector worsening.

Oil prices provide some relief

Following notable increases in July and August and the great uncertainty in September due to the impact of hurricane *Katrina*, oil prices in October have given temporary relief. Evidence that inventories of oil and refined products are holding above expected and that the impact of hurricane *Wilma* in terms of oil supply would not be appreciable (and therefore that the risks regarding oil supply to the US market had been reduced) sent prices below the psychological barrier of 60 dollars a barrel for one-month forward Brent quality oil on average in October.

Better-than-expected supply situation in United States sends oil below 60 dollars a barrel.

In any case, it should not be forgotten that current levels remain historically high and are even 20% above those reported one year ago. Furthermore, fundamental conditions in the oil market have not improved significantly. The supply/demand ratio remains very narrow and the trend in both variables for 2006 does not imbue much optimism. While it is expected there will be an increase of 1.8% in supply in the coming year, demand will grow by two decimals more at 2.0%.

Metals moderating but raw materials overall stand 11% more expensive than one year ago.

Nor should we forget the trend in other raw materials. As opposed to oil, raw materials measured by *The Economist* index in dollars for October showed a growth increase of 11% year-to-year as against 8% in September. The main culprits for this increase were food raw materials and non-food farm materials whereas metals, which were recording a very strong upward trend, showed a slowdown in growth rate. Gold deserves separate mention as it came close to 470 dollars an ounce with more than 11% growth in the past 12 months.

OIL PRICES DROP BELOW 60 DOLLARS A BARREL

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

SOURCE: Thomson Financial Datastream.

RAW MATERIALS PRICES

	2003	2004	2004		2005					
			3 Q	4 Q	1 Q	2 Q	July	August	September	October
«The Economist» index in dollars (*)										
General	**11.7**	**17.4**	**16.0**	**1.5**	**–2.3**	**–1.8**	**2.8**	**7.6**	**8.2**	**11.0**
Food	9.1	11.2	9.4	–7.3	–8.5	–7.7	–0.2	4.9	4.8	9.6
Industrials	15.9	26.1	25.1	13.8	5.9	6.3	6.8	10.9	12.1	12.6
Non-food agricultural	*21.8*	*9.2*	*6.8*	*–11.2*	*–10.7*	*–8.6*	*0.9*	*–0.8*	*2.3*	*10.6*
Metals	*11.8*	*38.2*	*38.3*	*31.5*	*16.1*	*15.5*	*10.2*	*17.4*	*17.5*	*13.7*
«The Economist» index in euros (*)	**–6.7**	**6.7**	**6.9**	**–6.5**	**–6.4**	**–6.0**	**4.8**	**7.1**	**7.9**	**15.4**
Oil (**)										
Dollars/barrel	28.4	38.0	40.7	44.7	47.8	53.1	58.1	64.0	64.0	59.3
Change rate	13.1	34.4	44.4	53.8	52.7	50.9	54.1	54.0	49.4	20.5
Gold										
Dollars/ounce	364.0	409.6	401.9	434.0	427.3	427.8	424.7	438.1	456.2	468.7
Change rate	17.3	12.7	10.6	10.6	4.6	8.6	6.7	9.1	12.3	11.4

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

EUROPEAN UNION

European Union: recovery taking shape but inflation threatens

Conclusion: as 2005 ends, incipient recovery under way...

As we come close to the end of the year, more and more evidence is available to confirm recovery in the euro area. Supply indicators, which are much more sensitive to cyclical swings, have been showing this economic recovery since the beginning of summer. The most general of all indicators, that for economic sentiment, marked up an annual low last June but later added 2.3 points as of September. This increase was the result of an improvement in confidence in all sectors –industry, services and construction.

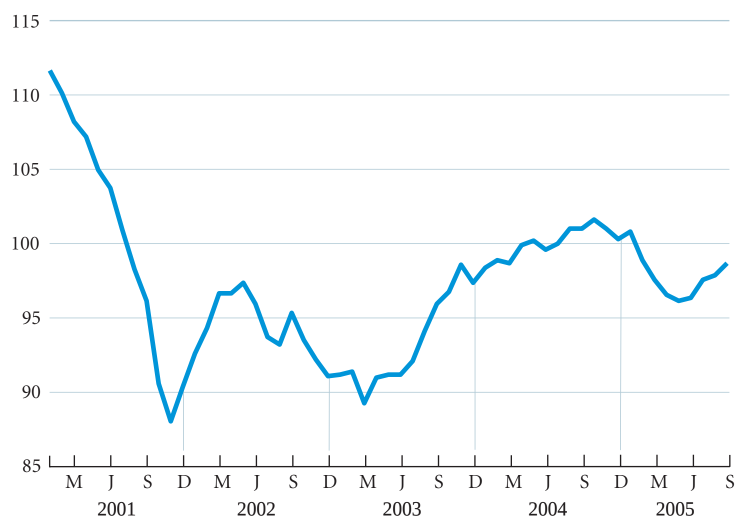
...given that both supply indicators (with notable figures in industrial production)...

Following on the qualitative indicators, based on surveys of economic players, have come real figures, among which we should mention the trend in industrial production, which first of all consolidated its gradual recovery in June and July (with growth of 0.7% and 0.5% year-to-year respectively) to later move up to 2.7% year-to-year in August.

The most hopeful news, however, comes on the side of domestic demand. Industrial production of capital goods had already shown a more expansionist performance of corporate investment (growth of the order of 2% year-to-year from June to August). Now the main component lacking from the recent European cycle is beginning to show up in less depressed household consumption.

ECONOMIC ACTIVITY IN EURO AREA RECOVERS GROWTH PATH

Figure for economic sentiment index



SOURCE: European Commission.

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	September
GDP	0.7	1.8	1.9	1.6	1.3	1.1	–	...	–
Retail sales	0.4	0.9	0.7	1.1	1.1	0.5	–0.2	2.0	...
Consumer confidence (*)	–18	–13.8	–14	–13.0	–13.2	–14.4	–15	–15	–15
Industrial production	0.3	2.0	2.8	1.1	0.7	0.6	0.5	2.7	...
Economic sentiment indicator (*)	93.3	99.9	100.6	100.9	99.0	96.3	97.5	97.8	98.6
Unemployment rate (**)	8.7	8.9	8.9	8.8	8.8	8.7	8.5	8.6	...
Consumer prices	2.1	2.1	2.2	2.0	2.0	2.0	2.2	2.2	2.6
Trade balance (***)	80.3	80.7	84.9	64.8	64.8	51.5	44.2	39.1	...

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

While we cannot yet say the weak stage of consumption is all over, some key indicators are beginning to look better. The rise in retail sales, especially appreciable in August, and car registrations (which have run up three very positive months from June to August) would confirm the better state of households.

Nevertheless, the persistent weakness of consumer confidence presents a troubling other side. The definitive consolidation of consumption will have to wait until employment proves more dynamic (it grew by a mere 0.7% year-to-year in the second quarter) and until the unemployment rate moves away from present levels (8.6% of the labour force in August).

Having reviewed the more favourable elements on the economic scene, it is worth paying attention to two less promising factors: the recent weakening of foreign demand and the rise in inflation. The contribution of the foreign sector has been negative since the third quarter of 2004 and further worsened in the second quarter of 2005.

Figures for the trade balance in recent months show that imports continue to grow above exports, partly the result of the higher level of domestic demand mentioned above, so that the cumulative trade balance for 12 months in August was 46% lower than one year earlier.

With regard to the threat of inflation, this gained much attention in October. Latest available figures allow for a fairly broad interpretation. The harmonized consumer price index (HCPI) stood at 2.6% year-to-year in September. This is four decimals higher than the August figure and the highest recorded since January 2002. Nevertheless, if we take the energy component (which rose by 15% year-to-year in September) off the general index, the resulting rate shows an increase of 1.4% year-to-year, merely one decimal higher than in August.

The European Central Bank (ECB), working in its role of guarantor of price stability in the euro area, has stated its concern about the rise in oil and its effect on prices, both current prices and especially future prices. What is troubling is that high energy prices

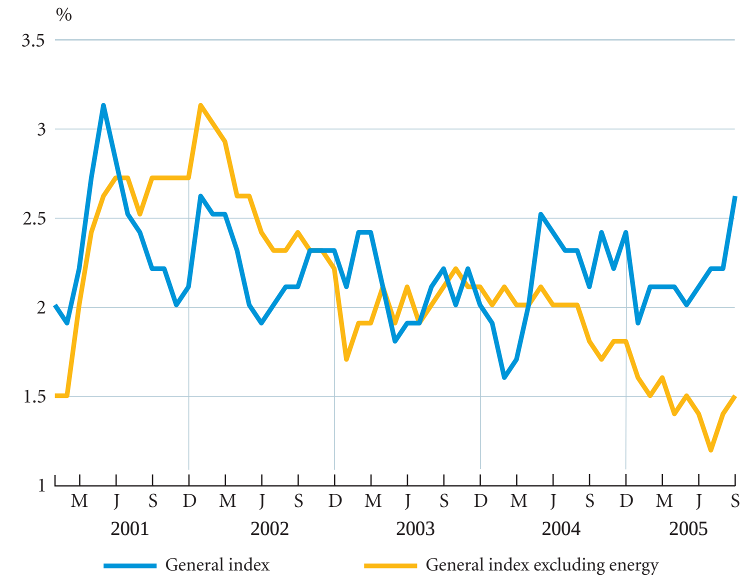
...and demand indicators (with new factor that consumption seems to be leaving behind slack stage) point to recovery.

Rundown on risks: one, loss of strength in exports, while not alarming, does complicate overall scene...

...two, inflation jumps to 2.6% because of oil with effects over medium term troubling...

INFLATION UP IN EURO AREA BECAUSE OF OIL

Year-to-year change in harmonized consumer price index



SOURCE: Eurostat and internal figures.

...such effects likely to take place, thus limiting growth potential as of second half of 2006.

could end up shifting to more permanent increases in overall prices in the economy, something known as «second round effects». This led the chief economist of the ECB, Otmar Issing, to state that, while official forecasts of the central bank continue at 1.9% for 2006, he considered it likely that inflation would end up standing above 2%, the central reference rate of the common monetary policy. On the other hand, Joaquín Almunia, the European Commissioner for Economic Affairs, denied that we were at the beginning of an inflationary spiral and that the recovery now under way is not in any way threatened.

What is our position? In view of oil prices that are still high and with no clear prospects of correction to be seen on this front, «second round effects» will indeed end up taking place, perhaps less sharply than they have in the past. This lesser impact may be explained by changes in the institutional environment of the economy (credible anti-inflationary policy of central bank officials and less shifting of inflation to wages thanks to reduced indexing, etc.). The effect will be appreciable not so much in the immediate recovery in coming quarters as over the longer term. As a result, although we foresee that the euro area will increase its growth rate so that in the first half of 2006 it goes to levels of increase in the gross domestic product (GDP) of the order of 1.8% year-to-year, from then on we likely will move into a stage with a lack of growth stability.

Germany: Does «Grand Coalition» mean grand reforms?

October 10 brought about the «Grand Coalition» between the Christian Democratic Party (CDU/CSU) and the Social Democratic Party (SPD). If the past may serve as an example, it should be remembered that in the history of the

Federal Republic of Germany the only precedent was the CDU-SPD coalition which lasted from December 1966 to October 1969, the results of which in economic terms were satisfactory.

The immediate challenge at that time was to lift Germany out of economic recession and consolidate what, back in 1966, was the embryo of recovery and over time to reduce the public deficit that was considered excessive. The precondition, as perceived in the mid-Sixties, was to restore the German people's own confidence in their economic future. Nearly 40 years later, the economic and political context shows little similarity but the basic historical analogy, overcoming the crisis of confidence, is indeed relevant.

Will the new coalition be able to consolidate recovery, as much at an early stage as in 1966, thanks to an improvement in corporate confidence as well as in consumer confidence? Apart from the figure of Angela Merkel, the first woman to be chancellor in German history, and the breakdown of cabinet posts (with 8 Social Democrat ministers and 7 from the CDU/CSU as well as post of chancellor), the basic factor is the economic content of the government programme, which is still under negotiation as we go to press.

Leaving electoral rhetoric aside, both parties coincide in the need to increase fiscal consolidation in order to put the government deficit back under the limit of 3% of the GDP set under the EU Stability and Growth Pact and to increase government spending on research and development. There is also agreement on simplifying income tax and a reduction of corporate taxes.

The differences, however, would seem greater than the areas of agreement. The CDU is proposing a cut in income tax, in sharp contrast to a desire to increase the tax load on higher income levels, as advocated by the Social Democrats. At the same time, the Christian Democrats are proposing an increase in value added tax (VAT) from 16% to 18%, and using the increase in collections to compensate for the drop in revenues that would come from a reduction in social security contributions, a measure aimed at

Germany tries out first coalition between Christian Democrats and Social Democrats since 1966-69.

Then, as now, big challenge was to recover country's self-confidence, something handsomely achieved.

Now, differences among partners of «Grand Coalition», especially in tax and labour matters, outweigh points of contact in other questions, which likely will hinder reform hopes of new German government.

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	1.1	1.0	1.4	0.7	1.9	–2.7	2.2	...
Industrial production	0.1	2.4	3.8	1.4	2.4	1.9	3.0	2.1	...
Industrial activity index (IFO) (*)	91.6	95.7	95.3	95.2	95.3	93.2	95.0	94.6	96.0
Unemployment rate (**)	10.4	10.6	10.6	10.8	11.7	11.8	11.6	11.6	11.7
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	155.9	156.3	...

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

At least, economic situation presents more favourable state which may facilitate some costly political decisions.

reducing non-wage costs falling on companies. The most likely solution, according to early reports of the negotiations, will be to postpone the main fiscal reforms to the next legislature.

There is also strong opposition from the SPD to the CDU proposal to allow, under certain circumstances, that companies can withdraw from some aspects of their individual collective bargaining agreements (basically wage reviews and work days) established under sector labour agreements. The policy gaps also spread to reconsideration of the closing of nuclear power stations decided in 2000 and how to reduce the cost of the public health system. There is thus a lot of negotiation still to be done before the second half of November (after both the extraordinary congress of the CDU and that of the SPD have agreed to the government pact) for Angela Merkel to be invested as chancellor of the federal parliament.

In this situation, the improvement in the economic situation, that now is starting to be noticeable, could facilitate stronger measures by the government than might be hoped for in view of the major differences between the coalition partners. Recovery seems to be taking a shape that is usual in the German economic cycle: the rise in foreign demand is leading companies to increase their rates of investment. Later on, increased corporate activity will lead to improvements in employment and private consumption. For the moment, the export-investment flow channel is what seems to be operating.

In this respect, exports in July and August grew above 8% year-to-year, nearly twice the rate in the second quarter, while the capital goods component in industrial production and industrial orders, although erratic, appear as a background trend in the maintenance of investment growth in the first half-year. Even the weak private

PROSPECTS IMPROVE IN GERMANY

Value of IFO industrial activity index

SOURCE: IFO Institute.

consumption level, which still shows no signs of recovery, likely will end up reflecting the improvement in consumer confidence reported in August and September.

The improvement in industry (industrial production grew by 2.5% year-to-year on average in July and August), together with the recovery of corporate confidence measured by the IFO index (going to the 98.7 points level in October), are other elements supporting a recovery scenario. Nevertheless, in keeping with what has happened in the euro area as a whole, the increase in consumer prices (2.4% in September compared with 1.9% in August) and a still high unemployment rate (11.7% in September) are negative factors dragging down the potential of the German economy.

Recovery of industry and corporate confidence confirm improved German scenario.

France: budget with hopes of lifting country out of stagnation

The French government presented its 2006 budget on September 28 last. It was a reasonably rigorous budget with a forecast increase in government spending of close to nil in real terms, apart from a new package of measures to foster employment. At the same time, it provides for other austerity budget measures, the most important being a reduction of 10,000 public servants in the government work force. The proposed income tax reform, which would reduce both the number of tax tables and the maximum rate applicable, will not come into effect until 2007 so that its impact on government revenues in 2006 is postponed. The deficit in 2006 is forecast at 2.9% of the GDP.

Unfortunately, the Achilles' heel of the budget lies in the growth forecasts on which it is based. The government has drawn up its budget starting out with a range of growth at 2.0%-2.5% in 2006, which is above the forecasts of most analysts and especially higher than the 1.8% we have put forward in our own forecasts.

While the economy seems to have passed through the period of greatest weakness in the cycle, as shown by the continuing recovery of the economic sentiment index from June to September, the weak state of private consumption in the middle stretch of 2005 and the lack of strength in exports in the first half-year

France: 2006 budget appears rigorous with major effort to contain spending but will be affected by optimistic growth forecasts on which it is based.

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	September
GDP	0.9	2.1	1.8	2.1	1.9	1.3	–	...	–
Domestic consumption	1.9	3.3	2.5	4.0	3.2	1.1	3.6	5.5	4.2
Industrial production	–0.3	1.7	1.9	1.6	0.9	–0.4	–0.5	1.0	...
Unemployment rate (*)	9.8	10.0	10.0	10.0	10.1	10.2	9.9	9.9	...
Consumer prices	2.1	2.1	2.2	2.1	1.6	1.6	1.7	1.8	2.2
Trade balance (**)	0.2	–0.1	–0.1	–0.5	–1.0	–1.5	–1.7	–1.8	...

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

French recovery consolidating with better relative performance in domestic consumption, industrial production and exports, a trend which lies behind recovery of business confidence.

make it practically impossible to see growth of above 1.5% in 2005, a figure also backed by the INSEE, the French statistics office.

A similar reading (recovery, certainly, but rather contained) comes from the positive trend seen in the most recent indicators for household spending (domestic consumption grew by 4.2% year-to-year in September), industrial production (year-to-year increase of 1.0% in August) and exports (with increase to 5.9% in August although the bigger increase in imports at 8.2% would suggest that the foreign sector is continuing to take away from growth).

The trend in consumer prices is also favourable. While France has not escaped from the rises due to the rise in oil prices, the increase has been lower compared with other euro area economies. In September, the CPI grew by 2.2% year-to-year (1.8% in August) but, after discounting energy and other volatile components of the index, it stood at a contained 1.0% year-to-year. The reading of the labour market is less satisfactory as it continued to show an unemployment rate of 9.9% in August with no improvement over July and very close to the high relative levels reported since 2003.

In another sphere, we should point out that the timid economic reforms proposed by the French government (particularly the partial easing of hiring terms for small and medium-sized companies) brought the calling of a general strike by the French trade unions. Finally, although this involved more than 800,000 workers in some 143 demonstrations across the country, support for the strike on October 5 was lower than expected.

Italy: political scene darkens recovery

In Italy, following first signs of recovery in second quarter, third-quarter indicators confirm that economy now regaining strength, in spite of lack of drive in private consumption...

The Italian economy is recovering. Macroeconomic figures for the second quarter show recovery, still indeed modest, of consumption, investment and exports. And indicators for the third quarter point to a continuation of recovery, as may be seen from the trend in industrial production (year-to-year growth of 1.6% in August, its highest level since May 2004) and the increase of more than five points in the economic sentiment indicator in the third quarter, to mention only two representative figures.

The reduction in the unemployment rate in the second quarter to 7.7% (7.8% in the first quarter) and maintenance of inflation at 2.0% in August and September are other positive factors which should contribute to consolidate this new stage of economic growth.

...while worsening of foreign sector also not helping.

On the other hand, the lack of recovery in consumer confidence, stuck at the –21 points level all through the third quarter, and the poor performance in retail sales (these dropped by 2.1% year-to-year in July) make it clear that that the level of private consumption remains weak. Nor is the slowdown in exports very favourable with growth going from 6.4% in the second quarter to only 3.7% as the average for July and August. In any case, the overall balance continues to point to a higher rate of economic activity in coming months, as is underlined, for example, by the fact that the composite index of early indicators put out by the Organization for Economic Cooperation and Development (OECD) for August stood at its highest level since the beginning of 2004.

Nevertheless, this better economic drive has been left in second place in view of

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	September
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	–0.9	–1.9	–2.7	–1.3	–0.7	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	2.0
Trade balance (**)	4.1	1.2	1.7	–1.9	–3.1	–5.6	–6.1	–6.6	...

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

events at the political level. Just as parliament was about to approve the budget, the main instrument of economic policy, Minister of Economy Doménico Siniscalco resigned on September 22. More than because he had lost his battle to obtain the resignation of the chairman of the Bank of Italy, Antonio Fazio, in face of the polemical position Fazio had adopted regarding the take-overs of the Antonveneta and Nazionale del Lavoro banks, the real cause was political differences maintained by Siniscalco on the budget.

His replacement, Giulio Tremonti, who held that portfolio on two previous occasions, has drawn up a budget which has been dubbed by analysts as unambitious. To begin with, it starts out from growth forecasts of 1.5% for 2006, close to a half-point higher than those put out by the analysts as a whole, which reduces the possibility of putting the deficit at 3.8% of the GDP (4.3% in 2005), the most notable challenge in the budget. It has also raised doubts about the government's real ability to bring about the key measure in the budget, namely, to cut 11.5 billion euros from government spending. In addition, the cut in the regional tax on economic activities, a measure constantly demanded by business and regarded as certain, was left out of the budget.

But current economic situation takes second place in view of complications of Italy's broad economic picture, along with resignation of Minister of Economy Siniscalco as budget about to be approved and appointment of Tremonti in his place, all pointing to adoption of unambitious budget.

United Kingdom: rise in inflation complicates monetary policy

The British economic picture continues to become complicated as the year ends. After growing by a modest 1.5% year-to-year in the second quarter, prospects are for a contained improvement in the second half-year and the initial publication of the GDP for the third quarter, with growth of 1.6% year-to-year, confirms this scenario.

In any case, available indicators for the third quarter continue to show a troubling weakness in private consumption. With retail sales growing at a modest 0.7% year-to-year in September, consumer confidence at annual lows as of September and industrial production of consumer goods dropping by 0.5% year-to-year in August, the drive in household consumption will necessarily be limited. On the positive side stands investment which seems to be settling into an upward path.

In United Kingdom, after hitting bottom in second quarter, economy moves into modest recovery mode in third quarter, although poor state of consumption reduces recovery potential.

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	September
GDP	2.5	3.2	3.0	2.5	1.7	1.5	–	1.6	–
Retail sales	3.0	6.1	6.7	4.7	2.9	1.5	1.4	1.0	0.7
Industrial production	–0.5	0.8	0.4	0.0	–1.1	–1.8	–1.7	–1.9	...
Unemployment rate (*)	3.0	2.7	2.7	2.7	2.6	2.7	2.8	2.8	2.8
Consumer prices	2.8	2.2	2.1	2.3	2.2	2.2	2.4	2.3	2.5
Trade balance (**)	–46.8	–55.3	–57.4	–59.7	–61.5	–62.6	–62.2	–62.5	...

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

In situation of weakness in economic activity combined with rise in prices, monetary policy faces dilemma of helping consolidate recovery or halting inflationary spiral before it starts. Bank of England watches while making no change in interest rates at past two meetings.

Nor can we expect any sharp recovery from the foreign sector. Although growth of exports is satisfactory, with an 11% year-to-year rate of increase in the second quarter and a similar rate in the July-August period, the recent rise in imports is increasing the British trade deficit.

A review of supply indicators, which are more sensitive for determining changes in cycle, shows a slightly better situation, with economic sentiment regaining ground in the third quarter, mainly because of the trend in industrial confidence and in services. Nevertheless, industrial production figures remain negative (year-to-year drop of 1.9% in August).

In this situation of gradually emerging from a stage of low growth, the rise in prices has complicated the scene. In September, the CPI grew by 2.5% year-to-year, whereas producer prices rose by 3.3%. Although the increased price of oil was the main culprit for the rise in inflation, the truth is that this is making it difficult for the Bank of England to orient its monetary policy.

To start with, its stated inflation objective which establishes that consumer prices must not go above 2% year-to-year, has been exceeded by a half percentage point. Furthermore, forecasts indicate that the current inflation level will scarcely be reduced in coming quarters and that it is not expected it will go below 2% all through 2006. The dilemma of the Bank of England, whether to contribute to consolidate recovery or to urgently halt inflation, is patent. For the moment, in its last two meetings on September 6 and October 8 respectively, it opted for maintaining the reference rate at 4.5%.

FINANCIAL MARKETS

Monetary and capital markets

European Central Bank showing signs of upward move

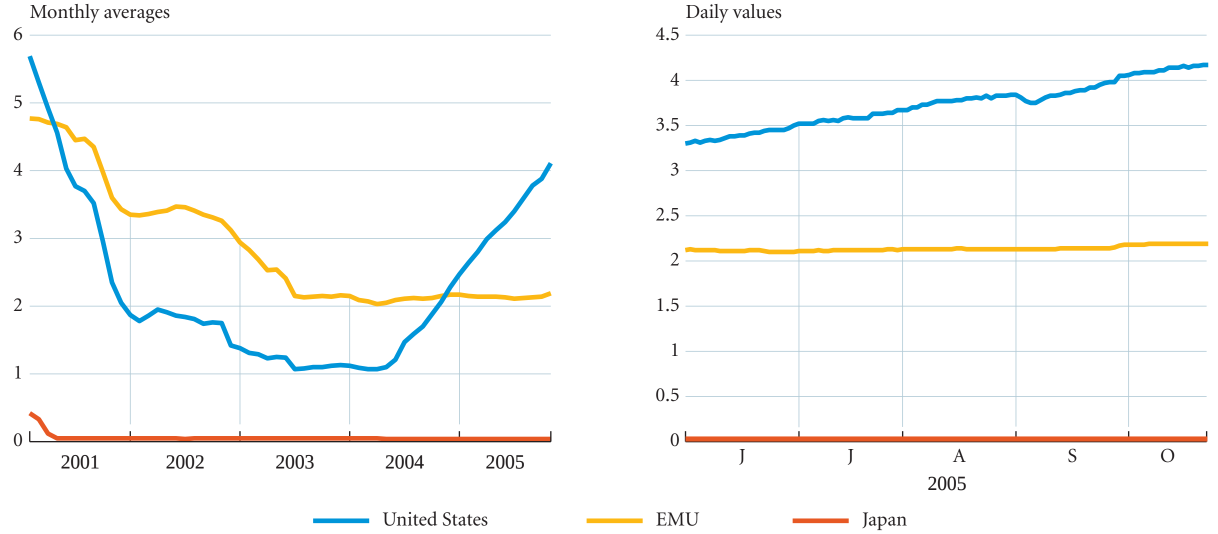
Recent increases in consumer price indices, which reflect the rise in oil in recent months, have put the monetary authorities on the alert. While for the moment the rise in prices of oil products has not shifted to the more stable core of inflation, so-called underlying inflation, it has set off alarm bells. Nevertheless, the reply from the central banks has been qualified by the varying economic situations in each region. In the United States, the Federal Reserve will likely take a firmer stand in monetary policy than the market was anticipating. In Europe, the European Central Bank (ECB) has begun to prepare the market for an upward move which could still be postponed for some months. At the same time, the central bank of Japan has given off increasing signs of the end of interest rates at 0% although not immediately.

Recent figures for consumer price indices put monetary authorities on alert.

In the United States, in the first weeks of October, a number of statements were made by chairmen of banks within the Federal Reserve Board, including those from Dallas, Philadelphia and St. Louis, indicating an upward trend. Publication of the minutes of the latest meeting of the Federal Open Market Committee on September 20 confirmed the Federal Reserve Board's concern about inflationary pressures.

DIFFERENTIAL IN SHORT-TERM INTEREST RATES WIDENS BETWEEN UNITED STATES AND EUROPE

3-month interbank rate as annual percentage



NOTES: Rates go up to October 25.
SOURCE: Bank of Spain and Thomson Financial Datastream.

US monetary markets anticipating official interest rate to stand at around 4.5% in 2006.

In this context, the market increased its expectations of interest rate increases. While up until then discussion was centred on where the «neutral» interest rate (the rate in keeping with a path of maximum economic growth without inflationary pressures) would stand, people began to speculate that the Federal Reserve would possibly put the official interest rate higher than the neutral level in order to counteract inflation. In fact, the head of the Federal Reserve Bank of San Francisco, Janet Yellen, considered that the neutral interest rate stood in the range of 3.5%-5.5%. As a result, the interest rate on 1-year interbank deposits showed a substantial increase in the early weeks of October going above 4.5%. Money market operators are thus already anticipating that the Fed's reference rate will stand at around this level in 2006.

It is very likely that the Fed will raise interest rates on November 1 and December 13, the dates set for the two other meetings this year so that the objective interest rate level for Federal Funds, overnight interbank deposits, could stand at 4.25% at the end of 2005. The subsequent meeting of the Federal Reserve would take place on January 31, the date on which the current chairman, Alan Greenspan, steps down. President George W. Bush has named Ben Bernanke, who holds the post 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 level (3)	3-month	3-month	Bank of England intervention rate (4)	3-month	3-month
2004									
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 (*)	2.06	2.14	2.22	3.60	3.88	0.00	4.50	4.52	0.76
October (1)	2.06	2.19	2.43	3.75	4.17	0.00	4.50	4.53	0.83

NOTES: (*) Provisional figures.
(1) October 25.
(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.

Director of the President's Economic Policy Advisory Board and previously had been on the Federal Reserve Board, as his successor. Given that the new chairman of the Federal Reserve will probably wish to confirm his anti-inflationary credibility, it would be reasonable to think that the Federal Reserve will raise its interest rate at least to 4.5% in the early months of next year.

In the euro area, the Governing Council of the European Central Bank decided to maintain the main interest rate of the Eurosystem at 2%, unchanged since June 2003. Nevertheless, ECB chairman Jean-Claude Trichet hardened his rhetoric stating that, while interest rates stood at the correct level, risks of inflation were clearly on the rise. At the same time, he expressed concern about the expansionist path being taken by money supply figures and credit to the private sector. In fact, the annual growth rate of the broad M3 money supply figure stood at 8.1% in August, far from the reference growth rate of 4.5%. In turn, the year-to-year increase in loans to the private sector was 8.4%.

The ECB's main concern is that the increase in the general CPI for the euro area, which reached 2.6% at year-to-year growth rate in September, could shift to core inflation. This rose by 2 decimals in September but still stands at the low level of 1.5%. In this context, the 12-month Euribor, which held at 2.22% on average in September, by the early weeks of October had risen to above 2.4%. In this way, the market has moved forward the point at which it expects to see the restrictive turn in the ECB's monetary policy, placing that moment at the beginning of 2006. In fact, the ECB will probably not raise its interest rates until there is confirmation of recovery of the economy in the euro area and there are no «second-round» effects, that is to say, increases in wages and prices.

The Bank of England also held its intervention rate at 4.5% at the meeting of its Monetary Policy Committee at the beginning of October. Although there later was speculation that a new downward move was imminent, publication of the minutes of the previous meeting which showed the unanimity of committe members on the decision adopted, somewhat cooled prospects of a further easing of monetary policy. Furthermore, inflationary pressures are increasing.

European Central Bank beginning to prepare market for increase in Eurosystem rate.

In addition, in the second week of October, the Bank of South Korea announced that it was raising its official interest rate for the first time in more than three years, putting it up by 25 basis points to 3.5%, in order to deal with inflationary pressures. This measure came about in a framework of economic recovery in this Far-East country. On October 18, the Bank of Canada also again increased its reference rate and put the overnight rate at 3.00%.

Main ECB concern is that rise in inflationary pressures could spread to core inflation.

Central banks of South Korea and Canada raise interest rates in October.

Investor demand for US bonds continues to support dollar

The dollar rose by 3.0% in the January-September period compared with a broad basket of currencies. This appreciation was especially brought about by the favourable differential in interest rates against the euro and the yen and by relatively high economic growth. Foreign investors continued to buy US securities, especially bonds, in sufficient quantity to fund the foreign imbalance. As a result, the US currency was able to counter downward pressure coming from the huge foreign deficit of the US economy.

EXCHANGE RATES OF MAIN CURRENCIES

September 2005

	Final session of month		Monthly figures				Exchange rate October 25, 2005
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2) Monthly	Over December 2004	Annual	
Against US dollar							
Japanese yen	114.0	3.0	111.2	0.5	7.2	1.0	*115.0*
Pound sterling (1)	1.765	–2.2	1.808	0.7	–6.3	0.8	*1.784*
Swiss franc	1.293	3.2	1.266	0.3	10.5	0.3	*1.276*
Canadian dollar	1.168	–1.7	1.178	–2.2	–3.2	–8.5	*1.176*
Mexican peso	10.79	0.0	10.78	0.9	–3.8	–6.2	*10.84*
Nominal effective index (4)	*111.2*	*0.3*	*110.7*	*–0.1*	*1.6*	*–3.6*	*111.6*
Against euro							
US dollar	1.204	–1.3	1.226	–0.3	–8.6	0.3	*1.202*
Japanese yen	136.3	0.1	136.1	0.1	–2.2	1.2	*138.8*
Swiss franc	1.556	0.5	1.550	–0.2	0.9	0.4	*1.544*
Pound sterling	0.682	–0.1	0.678	–1.1	–2.5	–0.5	*0.677*
Swedish krona	9.327	–0.1	9.334	–0.1	3.9	2.7	*9.488*
Danish krone (3)	7.462	0.1	7.458	0.0	0.3	0.3	*7.459*
Polish zloty	3.919	–2.8	3.916	–3.2	–5.3	–10.5	*3.927*
Czech crown	29.55	–0.1	29.32	–0.9	–4.3	–7.2	*29.67*
Hungarian forint	249.6	2.1	245.8	0.6	0.0	–0.7	*253.1*
Nominal effective index (5)	*101.3*	*–0.6*	*101.8*	*–0.5*	*–4.9*	*–1.2*	*101.4*

NOTES: (1) Units to pound sterling.
(2) Percentages of change refer to rates as shown in table.
(3) Danish krone has central parity of 7.46038 against euro with fluctuation band of ±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.

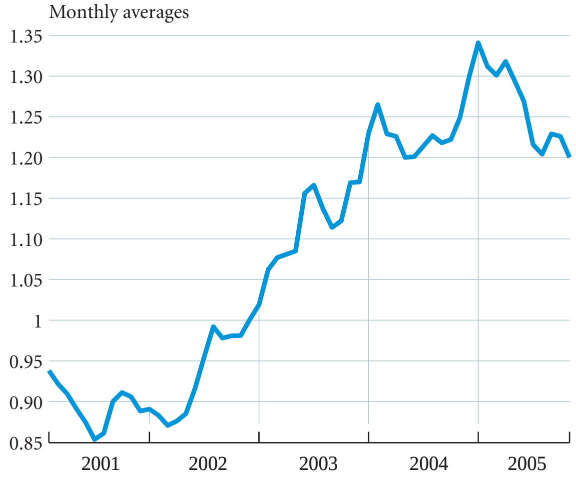
Increased interest rate differentials favouring dollar strengthen that currency.

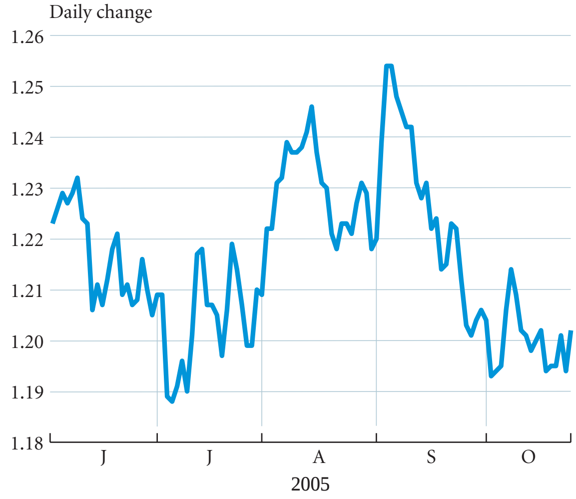
In the early weeks of October the greenback appreciated with the increasing prospect of official interest rate rises by the Federal Reserve with a subsequent widening of interest rate differentials. At the same time, repatriation of profits under a law which provides tax advantages if they take place before the end of this year also went in its favour. Furthermore, publication in mid-October of a trade deficit in August that was lower than expected also aided the dollar. In any case, the dollar will probably drop over the mid-term, especially against the Asian currencies.

The euro dropped by 6.3% in the first nine months of the year compared with the group of currencies of its main trading partners following a substantial rise in the last quarter of 2004. The modest economic growth of the euro area, the increase in differential in interest rates, which went against it with regard to other currencies, and the «No» vote on the European constitution in referendums held in France and the Netherlands in May and June setting off a political crisis, hurt the European single currency. In the early weeks of October, the euro held its positions with

EURO RESISTS BOOST IN DOLLAR

US dollars to euro





NOTES: Figures go up to October 25.
SOURCE: OECD, Thomson Financial Datastream and internal figures.

the prospect of an upward turn in interest rates by the European Central Bank and with the contribution of buying by Asian central banks wanting to diversify their foreign currency reserves. In relation to the dollar, the European currency showed some swings finding its point of downward resistance at around the level of 1.19 dollars.

Euro reaches point of downward resistance at around 1.19 dollars.

The yen dropped by 5.2% in the first three months of the year in terms of a group of main currencies, having been hurt by an unfavourable differential in interest rates compared with other currencies, due to an official rate close to 0%. In the early weeks of October, the Japanese currency tended to depreciate in spite of the improvement in economic prospects. This trend may be explained by the outflow of capital in search of higher yields abroad. As a result, in the third week of the month, the yen marked up its lowest level against the dollar since September 2003. Nevertheless, the yen showed a rise against the euro since December. In the future, the Japanese currency likely will rise as a result of the improvement in the economy.

Yen depreciates substantially so far this year but will likely rise because of economic improvement.

End to downward trend in bond yields

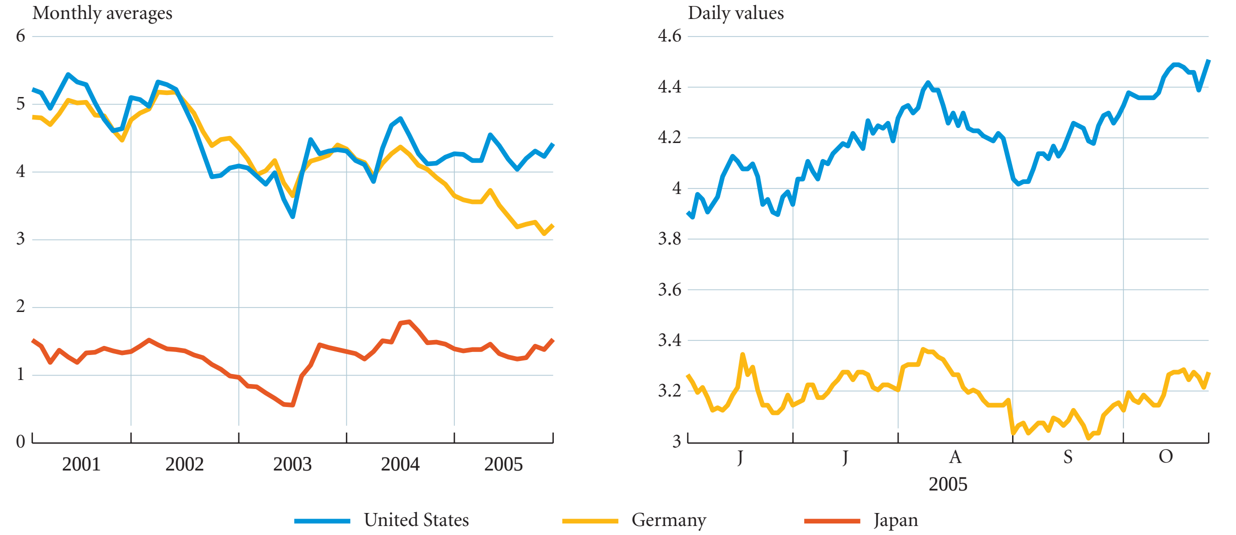
The yield on US 10-year Treasury bonds has tended to rise since the beginning of September as a result of the increase in prospects of higher Federal Reserve interest rates. As a result, in the fourth week of Ocober, the yield stood close to 4.5% returning to the level seen in March.

The yield on German 10-year government bonds rose in the fourth week in September after having marked up 3.02%, the lowest level in recent decades. This increase was brought about by growing concern about the trend in inflation and the expected bringing forward of the date of an increase in the ECB offical interest rate. As a result, the interest rate on German long-term government bonds stood at around 3.3% in the third week in October. On the other hand, the

Yield on US Treasury bonds moves up with growing prospects of interest rate increases by Fed.

DIFFERENTIAL IN LONG-TERM INTEREST RATES BETWEEN DOLLAR AND EURO CONTINUES TO WIDEN

Yield on 10-year government bonds as annual percentage



NOTES: Rates go up to October 25.
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	October 25
United States	4.04	4.31	4.34	4.21	4.20	4.31	4.23	4.51
Japan	0.99	1.50	1.41	1.28	1.26	1.43	1.38	1.52
Germany	4.10	4.07	3.63	3.35	3.23	3.26	3.09	3.28
France	4.13	4.10	3.64	3.38	3.27	3.30	3.13	3.31
Italy	4.24	4.24	3.75	3.53	3.44	3.46	3.29	3.47
Spain	4.12	4.10	3.63	3.36	3.22	3.23	3.09	3.25
United Kingdom	4.53	4.93	4.72	4.50	4.34	4.36	4.25	4.40
Switzerland	2.47	2.57	2.15	2.04	1.95	1.94	1.82	1.92

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

Various European, Asian and emerging markets mark up highs for recent years at beginning of October.

differential with similar US bonds has continued to widen in recent weeks going to 120 basis points.

Widespread corrections in stock markets in October

As a result of better than expected corporate profits and low interest rates, a number of stock markets in Europe, Asia and emerging markets reached their highest levels in recent years at the beginning of October in spite of high oil prices. They thus showed revaluations better than forecast at the beginning of the year. Nevertheless, increasing concern about inflation and the rise in long-term interest rates ended up bringing about a widespread correction in the stock markets.

In this context, stock markets in the United States showed a worse performance. Following gains obtained in 2004, US shares showed some overvaluation in terms of other markets. Another differential factor was the successive increases in the Federal Reserve interest reference rate during the year which have hurt the markets. As a result, in the fourth week of October, the main US stock market indices stood below par for the year.

Main US indices stand below par for year...

By sector, largely as a result of revaluations of oil company shares because of increased oil prices, the energy sector and public utility companies showed major capital gains over December. On the other hand, telecommunications companies and those in cyclical consumer goods and materials have reported capital losses so far this year.

On October 4, the DJ Eurostoxx 50 which includes the largest companies in the euro area, marked up its highest level since May 2002 to show a cumulative capital gain of 17.4%. The drop in the euro during the year, maintenance of interest rates by the European Central Bank at very low levels and major profit increases by European companies pushed up stock markets on the Continent. In spite of corrections in October, most of the main markets in the euro area showed considerable capital gains in the fourth of the month, headed by the markets in Madrid and Paris.

...while European markets record substantial cumulative gains over December...

INDICES OF MAIN WORLD STOCK EXCHANGES

September 30, 2005

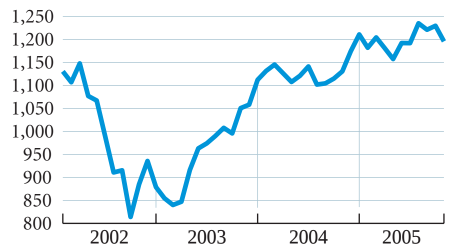
	Index (*)	% monthly change	% cumulative change	% annual change	*Figures on October 25, 2005* % cumulative change	*% change over same date in 2002*
New York						
Dow Jones	*10,568.7*	*0.8*	*–2.0*	*4.8*	*–3.8*	*22.9*
Standard & Poor's	*1,228.8*	*0.7*	*1.4*	*10.2*	*–1.3*	*33.3*
Nasdaq	*2,151.7*	*0.0*	*–1.1*	*13.4*	*–3.0*	*58.5*
Tokyo	13,574.3	9.4	18.2	25.4	15.6	*52.2*
London	5,477.7	3.4	13.8	19.8	7.6	*27.9*
Euro area	3,428.5	5.0	16.2	25.8	11.6	*34.0*
Frankfurt	*5,044.1*	*4.4*	*18.5*	*29.6*	*14.5*	*57.1*
Paris	*4,600.0*	*4.6*	*20.4*	*26.4*	*15.1*	*43.8*
Amsterdam	*403.0*	*3.4*	*15.8*	*24.4*	*11.7*	*17.6*
Milan	*26,846.0*	*4.5*	*14.1*	*27.6*	*6.5*	*44.6*
Madrid	*10,813.9*	*8.0*	*19.1*	*34.7*	*15.4*	*72.0*
Zurich	6,898.9	5.9	21.2	26.2	21.9	*40.5*
Hong Kong	15,428.5	3.5	8.4	17.6	1.4	*48.4*
Buenos Aires	1,694.8	7.2	23.2	48.3	14.7	*255.1*
São Paulo	31,583.0	12.6	20.6	35.9	12.6	*194.6*

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.

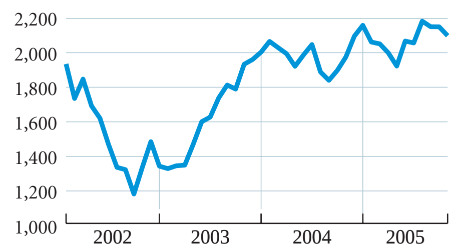
INTERNATIONAL STOCK EXCHANGES

Indices at month-end

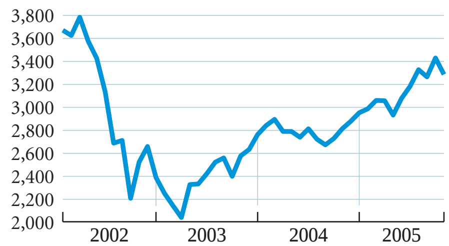
New York (Standard & Poor's 500)



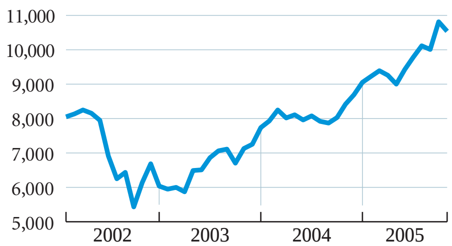
Nasdaq Index (United States)



Euro area (DJ Eurostoxx 50)

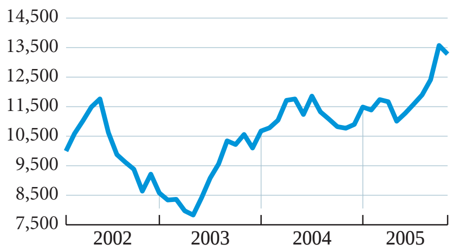


Madrid (IBEX 35)

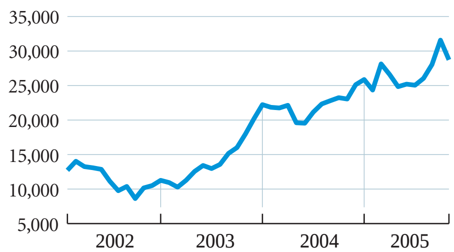


London (Financial Times 100)

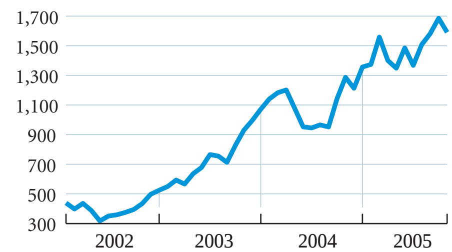
Tokyo (Nikkei 225)



São Paulo (Bovespa)



Buenos Aires (Merval)



NOTES: October 25, 2005.

SOURCE: Thomson Financial Datastream.

With regard to the Spanish stock market, the IBEX 35 index reported its highest level for the past five years on October 4, thanks to favourable corporate profits. Later on, it dropped somewhat but, in any case, in the fourth week of October this index was showing increases of 15% over December. It should be pointed out that in the final week of the month, only 7 of the 35 shares in the selective index stood below the level at the beginning of the year.

Outside the euro area, the Financial Times 100 index for the London stock exchange recorded its highest level since August 2001 at the beginning of October. The SMI index for the Swiss stock exchange showed a rise of more than 21% over December, in spite of the corrections taking place in October. On the other hand, on October 4, the Nikkei 225 index for the Japanese stock exchange marked up its highest level since May 2001 driven up by the improvement in economic prospects. Following later decreases, it was still showing cumulative revaluations of two digits.

...along with Japanese stock market.

With regard to emerging markets, some of these, such as India, South Korea, Brazil and Argentina, showed all-time highs at the beginning of October thus reflecting their present good economic situation and the flow of international capital going into those markets. As a result, many emerging stock markets showed major capital gains in the first ten months of the year.

Some emerging markets, such as India, South Korea, Brazil and Argentina record all-time highs at beginning of October but later drop back.

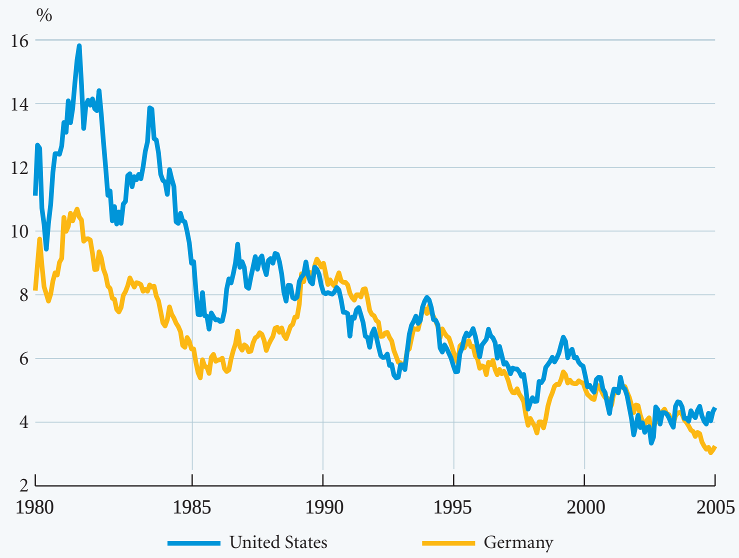
The interest rates mystery

When the Federal Reserve began the restrictive trend in its monetary policy in June 2004 the yield on US 10-year Treasury bonds stood at 4.6%. Since then, the Fed's reference rate has risen from 1% to 3.75%, that is to say, it has shown an incresae of 275 basis points. Now, in the third week of October 2005 the yield on US Treasury bonds stood at 4.5%, slightly below the rate at the beginning of the contractile move in monetary policy. This is anomalous, seeing that normally long-term interest rates go up when short-term interest rates begin to rise. The chairman of the Federal Reesrve Board, Alan Greenspan, himself admitted that the performance of long-term bonds was an enigma. In the euro area, long-term government bond interest rates stand at still lower levels with German bonds going to their lowest level in recent decades in the fourth week of September.

What is the explanation of this strange development? It should be remembered that, following the oil shocks in the Seventies, government bond yields rose strongly as may be seen in the accompanying graph. The central banks had to work their hardest in order to break the inflationary prospects of the Eighties through restrictive monetary policies. Thanks to the disinflationary process in the Eighties and Nineties, inflation rates fell to very low levels (see graph) and the central banks gained in credibility, something that increased as they took on greater independence.

LONG-TERM INTEREST RATES STAND AT VERY LOW FIGURES

Yield on 10-year government bonds as annual percentage

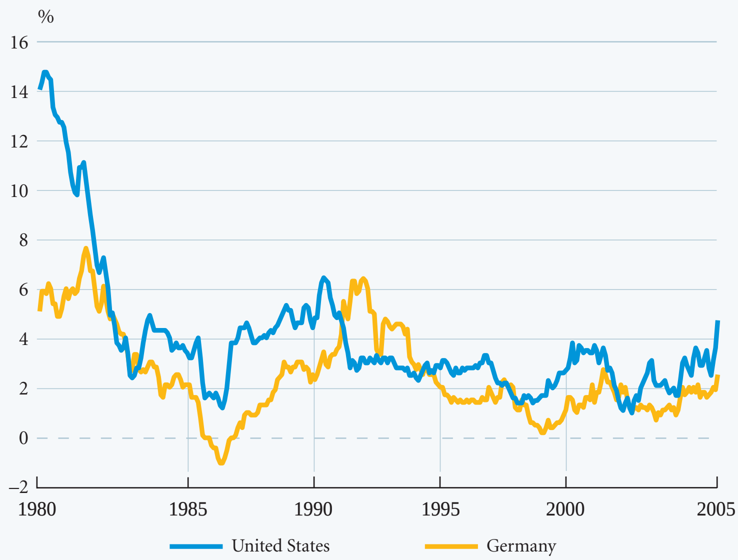


NOTES: Rates go up to October 20.
SOURCE: Thomson Financial Datastream.

Evidently, this is a factor that has contributed to maintenance of bond yields at low levels in order to contain inflation prospects and to lower the inflation risk premium by reducing uncertainty about the future trend in prices. But this alone does not fully explain the present low levels. Another reason lies in the fact that in recent years there has been a sharp increase in international foreign reserves, especially on the part of Asian countries with currencies linked to the dollar. A good part of these reserves are held in US Treasury bonds. Heavy buying of US bonds by Asian central banks has contributed to depress yields on these securities. In addition, there seems to be excessive world savings in relation to investment demand which could serve to push down long-term interest rates.

INFLATION ALSO AT LOW LEVELS

Year-to-year change in CPI



SOURCE: Thomson Financial Datastream.

No doubt, an important factor is to be found in inflation prospects. Measured by the difference in nominal bond yields and those indexed to inflation, these prospects would appear to be contained, although they are recently tending to show a moderate rise. One factor contributing significantly to the holding down of inflation is the increase in world competition and imports from low labour-cost countries. In any case, this excessive liquidity has brought about a sharp rise in some real assets, such as housing.

On the other hand, in recent years institutional investors, such as pension funds and insurance companies, have tended to increase the share of their portfolios held in bonds so that demand has increased, bond prices have tended to rise and, as a result, their yields, which move in the opposite direction to prices, have tended to drop.

Although it now seems that the downward trend in bond yields has stopped, we may ask which of the factors mentioned really bring about a change in trend. Oil prices probably will tend to rise in coming years because of structural problems which may have an effect on inflation prospects. The excess in savings may also be redirected once demand for investment increases with economic recovery. Nevertheless, the other factors would seem to be more permanent. Because of this, our forecasts are for a moderate rise in bond yields, but naturally not reaching the levels seen in the Eighties. In any case, the performance of bonds will remain a mystery.

SPAIN: OVERALL ANALYSIS

Economic activity

Growth continuing but imbalances fail to improve

Spain's economy maintaining high growth rate although it may have begun to reach ceiling.

Spain's economy continued full steam ahead in the third quarter of 2005, according to the main economic activity indicators. In the absence of confirming figures from National Accounting, available information so far would indicate stable growth in recent months. This may be seen in the following graph which shows the trend in the composite economic activity indicator prepared by the Ministry of Economy and Finance from a broad range of indicators.

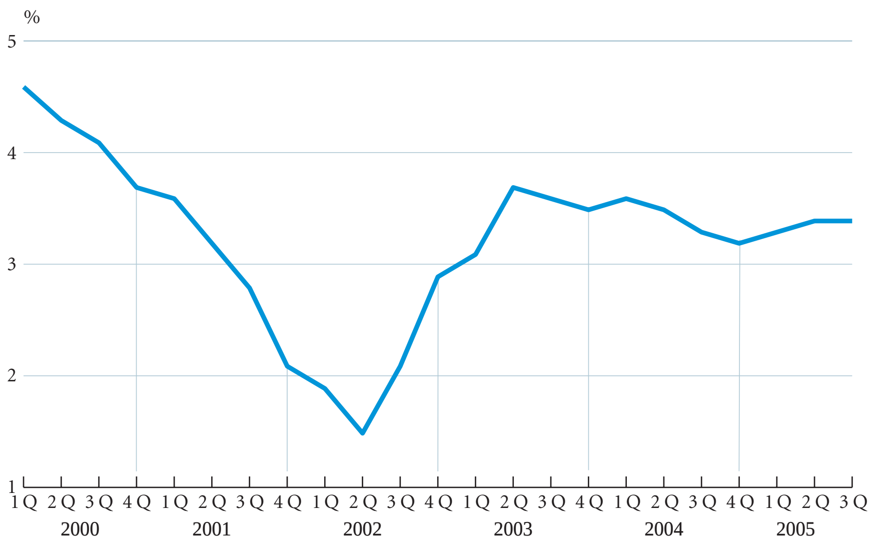
Good figure for industry in August fails to hide delicate situation in some sectors (textiles, electronics and motor vehicles, among others).

Is it possible to say then that growth of economic activity has hit a ceiling? With due caution, the answer is «Yes». Except in the case of an unexpected turn-around in current trends we could move into a more moderate path in coming months which, in its most positive aspect, could contribute to relieve the pressure on the major imbalances now being shown by Spain's economy (the inflation rate has jumped above the level of 3.5% and the current account balance has beaten all records in the first seven months of the year).

In August industry showed the first positive sign in this direction seen in a long time. In fact, the industrial production index recorded year-to-year growth of 3.2% that month (keeping in mind calendar adjustments), thus breaking with the earlier regressive trend. Nevertheless, this figure should be taken with some caution because it refers to a

GROWTH OF ECONOMIC ACTIVITY TENDING TO STABILIZE

Year-to-year change in composite index of economic activity



NOTES: Cycle-trend series.
SOURCE: Ministry of Economy and Finance.

month characterized by low seasonal activity. What has not changed at all is the delicate situation in some branches of industry, including textiles, clothing and furs, and the electronics industry with decreases of close to 10% year-to-year on average in all of these as of August. Because of its significance, we should mention the drop of nearly 6% in the index for motor vehicles over that 8-month period.

The increase in utilization of production capacity, which went above 81% in the third quarter (an historically high value), is a figure which allows for no simple interpretation in current circumstances. In principle, it could indicate a prudent attitude on the part of companies with regard to expanding production capacity. For the moment, the most positive sign is the slight improvement in order books reported by the European Commission survey, although it is yet to be seen if this will be confirmed in coming months.

On the other hand, construction continues to show considerable strength, as seen in most indicators, including cement consumption, and the maintenance of high confidence indices in the sector. In any case, while housing construction continues to rise, some signs of wearing out of the boom seen

SUPPLY INDICATORS

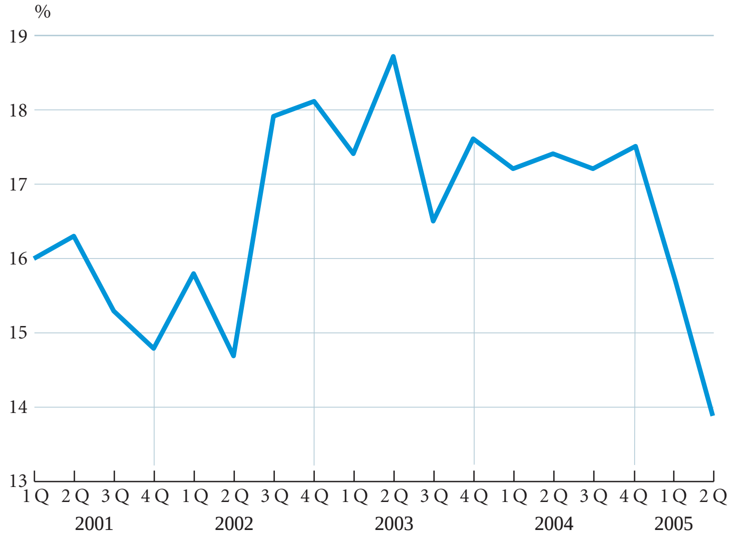
Percentage change over same period year before

	2003	2004	2004		2005				
			3 Q	4 Q	1 Q	2 Q	July	August	September
Industry									
Electricity consumption (1)	5.4	3.3	3.0	2.4	5.2	4.0	4.7	4.1	1.2
Industrial production index (2)	1.4	1.6	2.2	0.4	0.3	0.1	–0.5	3.2	...
Confidence indicator for industry (3)	–0.9	–2.5	–2.7	–2.3	–3.3	–7.0	–5.0	–5.0	–4.0
Utilization of production capacity (4)	79.1	79.8	80.5	80.5	79.4	79.5	–	81.1	–
Imports of non-energy intermediate goods (5)	6.2	6.6	6.0	4.7	0.7	3.6	–5.6	4.3	...
Construction									
Cement consumption	4.8	3.8	3.7	3.9	–0.2	11.1	–3.3	13.3	0.9
Confidence indicator for construction (3)	10.3	13.6	16.0	24.0	23.7	15.0	17.0	25.0	26.0
Housing (new construction approvals)	21.4	8.0	14.9	0.5	3.7	7.6	–11.0	4.2	...
Government tendering	–10.9	17.9	65.5	37.7	5.8	37.0	–30.4	17.3	...
Services									
Retail sales	5.7	5.5	4.4	5.5	4.1	5.4	1.8	6.3	...
Foreign tourists	–1.0	1.6	–1.5	10.0	7.4	4.6	7.7	5.5	8.3
Tourist revenue inflows	4.4	3.8	5.2	8.5	–0.8	–0.3	7.9	...	...
Goods carried by rail (km-tonnes)	1.7	–3.5	–8.5	–16.7	–14.3	–4.7	–10.5	–4.1	...
Air passenger traffic	7.5	7.9	6.6	8.3	8.4	8.5	11.8	8.6	10.2
Motor vehicle diesel fuel consumption	7.5	7.2	9.0	5.7	2.5	7.5	1.7	...	...

NOTES: (1) Adjusted for number of working days and temperature.
(2) Adjusted for difference in number of working days.
(3) European Commission survey: difference between percentage of positive and negative replies.
(4) Business survey: percentage of utilization inferred from replies.
(5) By volume.
SOURCE: Red Eléctrica Española, OFICEMEN, AENA, National Institute of Statistics, Bank of Spain, European Commission, Ministry of Public Works, Ministry of Industry, Commerce and Tourism, Ministry of Economy and Finances and internal figures.

HOUSING PRICES MODERATE GROWTH

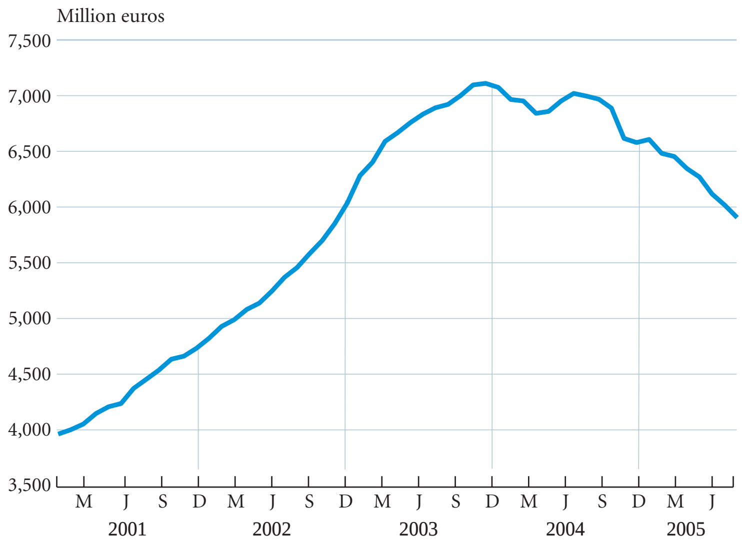
Year-to-year change in average price of non-subsidized housing per square metre (*)



NOTES: (*) New methodology starting first quarter of 2005.
SOURCE: Ministry of Housing and internal figures.

FOREIGN INVESTMENT IN REAL-ESTATE IN SPAIN SLOWS

Cumulative total for last 12 months



SOURCE: Bank of Spain and internal figures.

in recent years are beginning to show up. If we look at the trend in prices, which is a sure sign of the state of the sector, we recently note more moderation in the growth rate, as may be observed in the accompanying graph. Another significant fact is the slowdown of foreign investment which is one of the factors which has fed into this boom in the past.

With regard to services, the situation is generally positive with information technology and communications, company services and retail trade among the most dynamic sectors. Tourism, of major importance in Spain's economy as a whole, is maintaining a somewhat more positive performance than was forecast at the beginning of the season. Domestic tourism continues to grow at a very notable rate and the inflow of foreign visitors has also risen considerably (growth of low-cost airlines has undoubtedly worked to foster this) but there is a trend to a reduction in spending and to shorter average stays.

In order to complete the present picture of Spain's economy, from a demand perspective, we should add that both private consumption and investment continue to grow at a sustained rate and there is no reason for this to cut out over the short term. The only reason for concern is the persistence of high oil prices. For the moment, the impact on economic activity has been fairly moderate given that the factors driving Spain's economy have been able to counteract the negative effects of the rise in crude oil prices. Nevertheless, if pressures on fuel prices fail to ease, growth potential and prices (the most stable components of the CPI) could be affected to a greater or lesser extent in coming months.

Moderation in rise of housing prices and slowdown in foreign investment could mark beginning of less dynamic stage in real-estate sector.

Increase in oil prices not for moment causing visible damage in Spain's economic activity but, if situation continues, growth potential (along with prices) could finally be affected.

DEMAND INDICATORS

Percentage change over same period year before

	2003	2004	2004		2005				
			3 Q	4 Q	1 Q	2 Q	July	August	September
Consumption									
Production of consumer goods (*)	0.2	–0.2	0.1	0.1	0.1	1.1	0.9	4.4	...
Imports of consumer goods (**)	10.9	13.4	9.7	8.3	6.5	8.4	4.4	10.5	...
Car registrations	3.8	9.8	5.3	4.7	–0.0	4.9	–2.8	9.5	4.6
Credit for consumer durables	1.6	5.5	4.4	9.2	8.8	...	–	–	–
Consumer confidence index (***)	–13.7	–10.8	–11.7	–10.3	–9.7	–11.3	–11.0	...	...
Investment									
Capital goods production (*)	0.6	1.8	4.7	–1.7	–0.8	0.6	–3.9	4.1	...
Imports of capital goods (**)	14.8	14.9	19.2	29.0	28.6	36.0	–8.0	44.3	...
Commercial vehicle registrations	13.5	11.7	9.4	9.4	9.2	18.0	10.3	22.4	11.8
Foreign trade (**)									
Non-energy imports	8.8	9.8	8.9	9.0	5.7	9.0	–2.7	11.1	...
Exports	6.9	5.2	6.7	4.3	–3.1	2.5	–6.0	5.2	...

NOTES: (*) Adjusted for difference in number of working days.
(**) By volume.
(***) European Commission survey: difference between percentage of positive and negative replies.
SOURCE: ANFAC, National Institute of Statistics, Bank of Spain, Ministry of Economy and Finance, European Commission and internal figures.

Both consumption and investment growing at very stable rates in recent months with notably sharp rise in imports.

With regard to consumption, the indices as a whole point to relatively stable overall growth although they show big differences between them. For example, passenger car registrations rose by 2.3% year-to-year in the third quarter, a rate lower than that for the previous quarter although, in absolute figures, levels recorded continue to be the highest in history. On the other hand, retail trade showed a good figure in August with a year-to-year increase in constant prices of close to 3% (above 4.5% in department stores) thus breaking the mediocre situation seen in previous months.

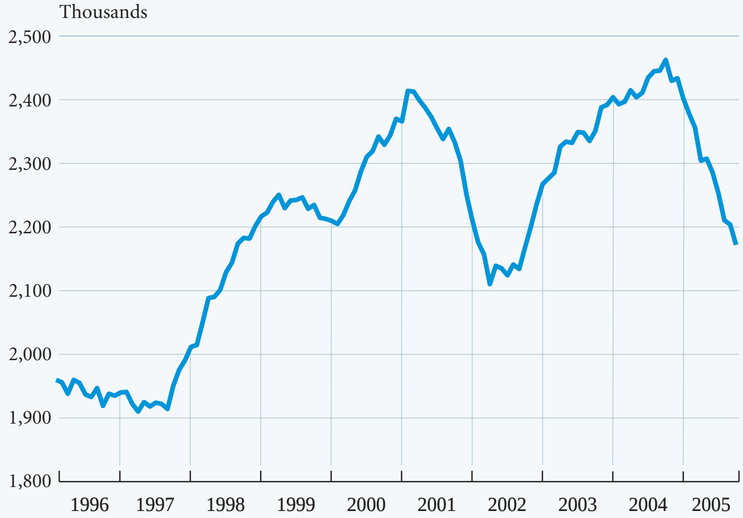
Finally, with regard to capital goods investment, the rate of increase in nearly all indicators continues to be very high but there has been a halt to the earlier sharp rise. Under this heading, the strength of imports, which rose by more than 27% in the first eight months of the year, was in contrast to the stagnation in domestic production.

Spain's motor vehicle industry at the crossroads

The motor vehicle sector, until recently considered the flag-ship of Spanish industry, is not now going through one of its brightest moments. In fact, in the first nine months of the year, motor vehicle production in Spain showed a cumulative drop of nearly 10% compared with the same period last year. If we limit our view to passenger cars, the line of greatest volume (more than three-quarters of total production), the drop was even greater with a decrease of more than 12.5% (200,000 units less than in 2004).

PASSENGER CAR PRODUCTION DOWN IN SPAIN

Number of cars produced (cumulative figure for 12 months)



SOURCE: ANFAC, Bank of Spain and internal figures.

Is this a passing phase or does it reflect a more deep-seated crisis? In fact, the causes are of various kinds – the weakness of foreign demand is one of the main reasons but, as a background to this, there is the excess capacity of the world motor vehicle industry within the current competitive framework characterized by supply pressure from the Asian block. As may be seen from the following table, the total production share of the European Union (EU-15), United States and Japan has dropped by nearly 10 percentage points in the past five years, mainly to the benefit of the emerging countries of Asia. Nor has Spain been able to escape this trend and has shown a loss of share amounting to nearly a half percentage point in the period under consideration.

The drop in Spain's exports of passenger cars (more than 12.5% as of September) was partly due to the stagnation in its main export markets but note should be taken that the drop is far greater than would have been brought about by containment of demand. It should be pointed out that, in the first nine months of 2005, the increase in passenger car registrations in the EU-15 was very limited (it did not reach 1% year-to-year) but still held to an increase in contrast to the decrease in Spanish sales abroad. No doubt the specialization of Spain's motor vehicle industry in the medium and low-range segments means that it is more sensitive to market swings, as has been evident on previous occasions, but this time around this effect has turned out to be much sharper. In industry circles it is felt that the age of some models, now at the end of their market cycle, may also have contributed to these poor results.

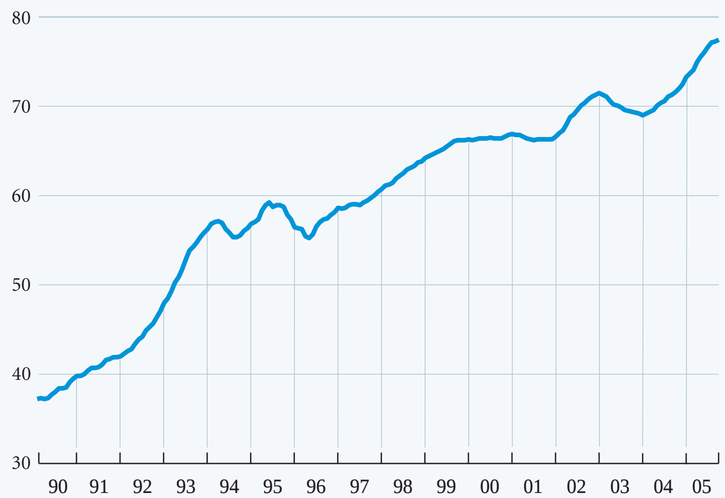
WORLD PRODUCTION OF MOTOR VEHICLES (UNITS)

Share by geographical area

	% of total production		
	1999	2004	Difference
UE 15	**31.0**	**26.3**	**–4.8**
Germany	10.1	8.7	–1.4
France	5.4	5.7	0.3
Spain	5.1	4.7	–0.4
Other countries	10.5	7.2	–3.3
NAFTA	**30.7**	**25.3**	**–5.4**
United States	23.1	18.7	–4.4
Canada and Mexico	7.6	6.7	–0.9
Asia block	**29.4**	**37.5**	**8.2**
Japan	17.6	16.4	–1.2
China	3.2	7.9	4.7
South Korea	5.0	5.4	0.4
Other countries	3.6	7.8	4.3
Other countries	**8.9**	**10.8**	**2.0**
TOTAL	**100.0**	**100.0**	

PROPORTION OF PASSENGER CARS IMPORTED INTO SPAIN ON INCREASE

Percentage of imports over total registrations



SOURCE: ANFAC, Bank of Spain and internal figures.

In the Spanish domestic market, demand remains buoyant but the tendency in recent years also points to a progressive loss of market share by the national industry (at present nearly 80% of passenger cars registered are imported, twice the figure at the beginning of the previous decade). All of this certainly makes up a very complex picture. If we limit ourselves to very recent events, in the United States (with a very flexible economy offering easy labour force adjustment processes) General Motors made an agreement with the unions for a 25% cut in non-wage benefits and announced the firing of 25,000 employees. Ford has gone into losses and is preparing a broad restructuring plan that includes significant plant closures and the wiping out of jobs. In Spain, SEAT is threatening to open a labour force regulation process (certainly less dramatic than simple firings) if the work-day and wages are not cut by 10%.

Without becoming alarmist, we shall have to carefully follow trends in this sector on which, it should not be forgotten, one out of every ten jobs in Spain depends and which contributes nearly 6% to the GDP. While, according to widespread opinion, the 18 production plants operating in Spain enjoy a proper technological and competitive level, it will be necessary to reconsider certain aspects such as labour flexibility, taxation, professional training and investment in research, development and innovation in order to ensure a future without major setbacks.

Labour market

Employment maintaining positive note following summer

Employment showing stable and sustained growth at end of third quarter.

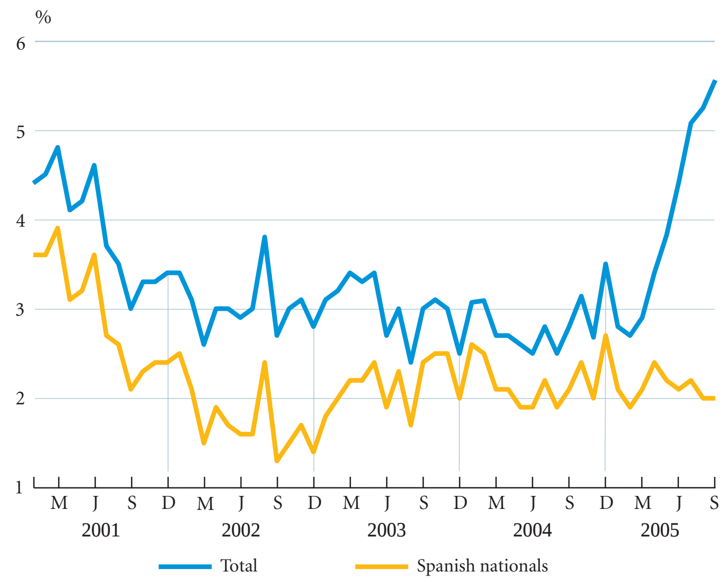
The labour market apparently continued to show a favourable state in the final stages of the third quarter, if we are to go by information available from registrations with Social Security. Nevertheless, the process of giving normal employment status to foreign workers significantly distorts this indicator which in itself showed spectacular growth (5.6%), higher than in previous months.

Process of giving normal job status to foreign workers ending.

In view of the information so far available, it is not possible for the moment to accurately isolate the effect of the process of giving such normal job status. Nevertheless, it may be estimated that the rate of increase in registrations with Social Security would stand between 2.8% and 3.5%, if we discount those registrations which are not for job creation but rather for giving legal status to existing jobs. In fact, once this process is completed it may end up giving rise to the registration of 474,477 foreign workers with Social Security, workers who previously were employed outside the system. Up until July 27, those applications given approval, that is to say, which ended up having registration with Social Security, totalled 352,522. With regard to other applications filed (somewhat more than 120,000) the

GIVING REGULAR STATUS TO FOREIGN WORKERS DISTORTS SOCIAL SECURITY REGISTRATION FIGURES

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



SOURCE: Ministry of Labour and Social Affairs and internal figures.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2003	2004	2004	2005		
			4 Q	1 Q	2 Q	3 Q
Persons registered with Social Security						
Wage-earners	3.2	2.7	3.1	2.8	4.2	5.9
Industry	*–0.5*	*–0.5*	*–0.5*	*–0.9*	*–0.7*	*–0.2*
Construction	*4.3*	*5.0*	*6.8*	*5.0*	*7.9*	*10.7*
Services	*4.1*	*4.1*	*4.4*	*4.5*	*5.1*	*5.6*
Non-wage-earners	2.3	3.2	3.2	2.9	2.7	2.5
Total	**3.0**	**2.8**	**3.1**	**2.8**	**3.9**	**5.3**
Persons employed (*)	**4.0**	**3.9**	**4.1**	**5.1**	**5.8**	**...**
Jobs (**)	**2.5**	**2.6**	**2.8**	**3.0**	**3.2**	**...**
Hiring contracts registered (***)						
Permanent	–1.0	11.8	4.4	0.6	9.2	10.0
Temporary	3.9	11.4	4.0	–9.8	10.1	9.7
Total	**3.4**	**11.5**	**4.0**	**–8.8**	**10.0**	**9.8**

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.

effect on registrations in August and September, apparently quite high, is still unknown.

A picture closer to the trend, although with a downward bias, is available from registrations by Spanish national workers. The rate of increase in registrations in this group held at 2.0% in September, somewhat lower than in the middle months of the year while showing notable stability compared with registrations throughout the year. As a result, the trend in employment in recent months may be regarded as positive.

The favourable state of the labour market is also confirmed by hirings registered through offices of Public Employment Services. In the first nine months as a whole, hiring contracts registered were up by 3.4% with permanent contracts showing a more positive situation than temporary contracts, in spite of the fact that the latter were in the majority. Part-time work, in turn, continued to be the hiring formula enjoying the highest growth (6.9% year-to-year) coming to represent 22.7% of all job placements.

Registered unemployment continues slightly downward trend

Favourable trend in registered unemployment continues after summer.

The favourable state of the labour market may also be seen in figures for registered unemployment. The number of those registered at Public Employment Services offices in September was down slightly, which meant a change over the normal increase during this period seen in recent years. As a result, registered unemployment (2,013,286 at the end of the month) stood 1.8% below the year before.

In spite of this improvement, the cumulative balance for the year was

REGISTERED UNEMPLOYMENT: IMPROVEMENT CONTINUES IN SEPTEMBER

Percentage year-to-year change in registered unemployment

SOURCE: Public Employment Services and internal figures.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

September 2005

	No. of unemployed	Change over December 2004		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	60,744	10,452	20.8	11,564	23.5	3.0
Industry	290,639	–12,943	–4.3	–5,789	–2.0	14.4
Construction	218,645	–34,054	–13.5	–11,419	–5.0	10.9
Services	1,207,863	–56,922	–4.5	–16,302	–1.3	60.0
First job	235,395	–5,962	–2.5	–15,281	–6.1	11.7
By sex						
Males	784,260	–93,760	–10.7	–37,963	–4.6	39.0
Females	1,229,026	–5,669	–0.5	735	0.1	61.0
By age						
Under 25 years	263,228	–5,585	–2.1	–6,283	–2.3	13.1
All other ages	1,750,058	–93,844	–5.1	–30,945	–1.7	86.9
TOTAL	**2,013,286**	**–99,429**	**–4.7**	**–37,227**	**–1.8**	**100.0**

SOURCE: INEM and internal figures.

somewhat less favourable than in the first nine months of 2004, the best for the present decade. The notable increase in farm unemployment and the performance in industrial unemployment, with a decrease well below that for last year, would account for most of the difference. In construction and services, the cumulative decrease in unemployment came somewhat closer to the previous year although still not reaching that figure.

By autonomous community, the improvement in the situation was especially notable in Madrid Community, the Basque Country and the Balearic Islands where the level of unemployment was substantially below that for the preceding year.

The increasing drop in unemployment in Castile-Leon, Galicia and Catalonia, while somewhat less sharp was also appreciable. On the other hand, we note a decrease in unemployment in Extremadura, Andalusia, Aragon and Castile-La Mancha, regions where the farm sector has a relatively greater importance than in the rest of Spain's economy.

Prices

Sharp rise in CPI in September

Energy prices push CPI up to 3.7% in September.

The consumer price index (CPI) showed a notable increase in September, well above the same month in 2004, which meant an increase in year-to-year inflation of four decimals putting it at 3.7%, the highest figure since the beginning of 2003. It was mainly energy, but also fresh foods, that muddied a picture marked by relative containment of core inflation, which excludes the more volatile elements of the index (energy and fresh foods).

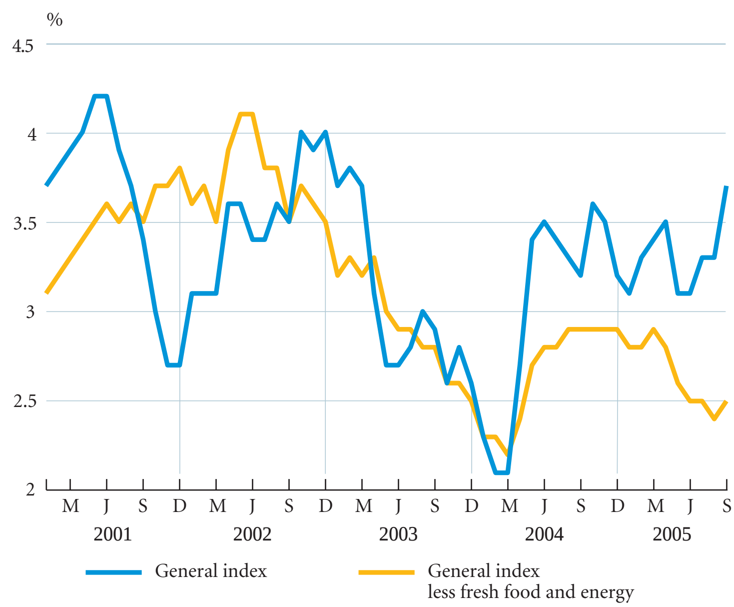
Core inflation fails to compensate for rise in prices of industrial goods and downward resistance in services.

Core inflation, which rose by one decimal to stand at 2.5%, benefited from the stability in prices of services and processed foods, which continued to grow at the same rate as the month before, in the latter case in spite of the increase in indirect taxes on alcohol and tobacco. Nevertheless, this stability is not a specially hopeful sign to the extent that prices of services are continuing to grow at very high rates (3.7% year-to-year) due to increases in prices in certain controlled markets and public services (sanitation, transport, etc.) and the low level of competition in other sectors (personal and household services) where the fragmentation of the market makes it fairly easy to pass on cost increases, especially wage costs.

Following several months of containment, the discordant note comes

CPI AT HIGHEST LEVEL IN 30 MONTHS

Year-to-year change in general CPI and core inflation



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	0.6	2.5	3.7
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 SHOW SHARP RISE IN SEPTEMBER

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

SOURCE: National Institute of Statistics.

in prices of non-energy industrial goods, especially clothing, footwear and home goods, which showed some increase in spite of holding at the very modest growth of 0.9% year-to-year. The return of families to normal life following the summer holiday period ended up with price increases higher than last year, probably because of maintenance of a good level of private consumption.

The performance in fresh food prices was clearly negative as, to some extent, these came to reflect certain pressures in

Prospects for year-end CPI come close to 4%.

prices at origin. In any case, growth figures held at relatively low levels although higher than in the two previous months. The biggest imbalance, however, came from a continuation of the rise in prices of oil and its by-products. The increase in fuels thus stood at 19.8% year-to-year and had a decisive effect on the rise in the general index.

The rise in inflation in September meant a slight change from the situation in recent months. The impact of the increase in fuels in the past four months had been eased by the slight moderation in core inflation. In September, this trend toward a gradual drop in the more volatile core of the CPI was cut short precisely because of an upturn in prices of industrial goods, in keeping both with pressures seen in prices at origin, domestic and import, and with the strength of consumption aided by very easy monetary conditions. Altogether, forecasts for the year-end now stand

CONSUMER PRICE INDEX BY COMPONENT GROUP

September

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2004	2005	2004	2005	2004	2005
By type of spending							
Food and non-alcoholic beverages	117.0	0.0	0.2	2.3	2.1	3.0	2.8
Alcoholic beverages and tobacco	121.4	0.1	0.7	5.6	4.8	5.7	4.7
Clothing and footwear	108.5	3.0	3.4	–7.9	–8.7	2.1	1.2
Housing	116.3	0.2	0.4	3.3	5.3	4.0	6.1
Household equipment	108.1	0.2	0.4	0.6	1.1	1.5	2.3
Health	106.3	0.1	0.1	0.0	0.7	0.2	0.9
Transport	120.8	0.2	2.2	6.8	9.9	6.0	9.1
Communications	91.8	–0.1	–0.1	–0.2	–1.4	–1.0	–1.9
Recreation and culture	103.5	–1.3	–1.3	0.7	0.3	0.5	–0.6
Education	117.9	0.8	0.7	1.4	1.3	4.0	4.1
Hotels, cafés and restaurants	120.6	–0.8	–0.7	3.8	4.0	4.0	4.3
Other	114.5	0.2	0.2	2.6	2.9	2.9	3.1
By group							
Processed foods	115.5	0.2	0.2	3.7	2.3	4.3	2.8
Unprocessed foods	121.8	–0.2	0.5	0.9	2.5	1.4	3.4
Non-food products	113.5	0.2	0.7	1.8	2.6	3.2	4.0
Industrial goods	110.1	0.8	1.8	0.3	1.9	2.6	4.2
Energy products	*124.8*	*0.1*	*3.1*	*8.7*	*16.2*	*7.5*	*15.0*
Fuels and oils	*132.6*	*0.1*	*4.2*	*11.4*	*21.5*	*9.7*	*19.8*
Industrial goods excluding energy products	*105.5*	*1.1*	*1.3*	*–2.2*	*–2.4*	*1.0*	*0.9*
Services	117.6	–0.4	–0.4	3.4	3.3	3.8	3.7
Underlying inflation (**)	112.6	0.2	0.3	1.4	1.0	2.9	2.5
GENERAL INDEX	**114.5**	**0.2**	**0.6**	**2.0**	**2.5**	**3.2**	**3.7**

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

DIFFERENTIAL WITH EURO AREA UP ONE DECIMAL

Difference in year-to-year change in harmonized consumer price index

SOURCE: National Institute of Statistics and internal figures.

very close to a year-to-year increase of 4%, a notable deviation from the official objective of 2%.

In September, the upward trend in prices in Spain was somewhat higher than in the European Union as a whole, if we follow the harmonized consumer price index. In fact, the differential rose to 1.2 percentage points because of the heavier impact of prices for transport and education. The rise was not greater because of the relative containment of prices for alcoholic beverages and tobacco in Spain in spite of tax increases.

Prices at origin show sustained increases

Industrial prices heightened their upward trend in September with the continuation of certain increases in prices of food products and further pressure from energy prices and other intermediate goods. As a result, year-to-year growth of industrial prices reached an annual high to stand at 5.4%. Other components showed more stability and a more moderate performance.

Import prices also continued to be affected by oil prices and cumulative year-to-year growth went up to stand at an average of 4.9% for the first seven months of the year, nearly five points more than in the same period in 2004. This boost did not come entirely from energy but was also fostered by increases in other industrial intermediate goods. The performance in consumer goods was less troubling although the average increase in prices (1.2%) was in contrast to the decrease shown in 2004.

Farm prices showed an unfavourable performance in July although in year-to-year terms they continued to present a decrease. The worsening of the situation likely will continue until year-end as it will be difficult to improve on results seen in the second half of 2004. In any case, the average increase in farm prices as of July held at a modest 2.3%, a figure somewhat more favourable than that for the same period last year.

Inflation differential with euro area increases slightly.

Intermediate goods, food and energy push industrial prices to annual highs.

Situation worsens in import and farm prices.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflector (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2004											
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	8.7	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	–11.9	4.4	2.2	2.1	3.1	13.5	5.3	3.6	–1.3	7.7	–
July	5.2	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	...	...	...	...	...
September	...	5.4	2.6	1.8	3.2	17.9	...	...	...	...	–

NOTES: (*) Gross figures corrected.

SOURCE: National Institute of Statistics, Ministry of Economy and internal figures.

Foreign sector

Trade deficit continues to rise

The trade deficit continued to rise in August reaching 49.59 billion euros in the first eight months of the year, some 33.6% more than in 2004. The appreciable recovery of exports in August failed to prevent a worsening of the foreign balance because of the continuing sharp growth of imports.

The recovery in exports in August did not change the cumulative balance for the year. In fact, growth of sales abroad in the first eight months of 2005 stood at 3.9%, somewhat more than two points below the same period last year. Furthermore, this growth was entirely due to price factors given that the volume of exports was 0.5% lower than last year. The drop in exports was centred in the European Union (EU) in contrast to third country markets which grew by 3.1% real in overall terms, aided by the strength of countries like China and some Eastern countries because of

Weakness in exports on top of heavy imports widening trade deficit.

FOREIGN TRADE

January-August 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	20,251	39.0	13.6	3,834	18.3	3.9	–16,417	18.9
Consumer goods	42,360	8.6	28.5	37,709	–1.7	38.1	–4,651	89.0
Food	*8,849*	*5.1*	*6.0*	*12,155*	*2.0*	*12.3*	*3,306*	*137.4*
Non-foods	*33,511*	*9.2*	*22.6*	*25,554*	*–5.2*	*25.8*	*–7,957*	*76.3*
Capital goods	17,082	24.5	11.5	9,049	7.3	9.1	–8,034	53.0
Non-energy intermediate goods	68,843	5.9	46.3	48,353	7.0	48.9	–20,490	70.2
By geographical area								
European Union (EU-15)	87,679	6.4	59.0	69,317	2.2	70.1	–18,363	79.1
Euro area	*76,220*	*6.2*	*51.3*	*57,691*	*1.8*	*58.3*	*–18,529*	*75.7*
Other countries	60,857	21.9	41.0	29,628	8.2	29.9	–31,229	48.7
Russia	*3,318*	*50.1*	*2.2*	*666*	*16.2*	*0.7*	*–2,651*	*20.1*
United States	*5,436*	*11.4*	*3.7*	*3,822*	*3.4*	*3.9*	*–1,614*	*70.3*
Japan	*3,828*	*3.6*	*2.6*	*746*	*–8.6*	*0.8*	*–3,082*	*19.5*
Latin America	*6,764*	*26.7*	*4.6*	*4,748*	*3.4*	*4.8*	*–2,016*	*70.2*
OPEC	*10,684*	*32.1*	*7.2*	*2,653*	*21.1*	*2.7*	*–8,031*	*24.8*
Rest	*30,828*	*19.9*	*20.8*	*16,993*	*9.6*	*17.2*	*–13,835*	*55.1*
TOTAL	**148,537**	**12.2**	**100.0**	**98,945**	**3.9**	**100.0**	**–49,592**	**66.6**

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

EU market offsets good progress in exports to third countries.

the improvement in relative income levels of oil producers.

The poor situation in foreign sales was clearly seen in cars and motorcycles, appliances and consumer manufactures, mainly footwear and toys. In addition, there were weaknesses in the area of capital goods in some sectors, such as office equipment, where there were general price decreases. Foreign sales of foods, traditionally one of the main backbones of exports, also showed a slight contraction in volume.

Poor situation in industry, some moderation in consumption and strength of investment behind performance in imports.

Imports in August recovered some of the strength lost in the two previous months putting nominal cumulative growth up to 12.2%, equivalent to 6.8% by volume. The notable increase in import prices (5.1%) came mainly from the rise in oil and oil by-products given that non-energy purchases abroad presented a price increase of 2.1%. The recovery of imports in August, which must be viewed with care because this is a holiday month, was mainly in oil and oil by-products, consumer electronics, clothing and ships.

So far in 2005, the main features of purchases abroad indicate, first of all, a notable weakness in purchases of non-energy intermediate goods, in keeping with the poor state of industry. Secondly, we note weaker growth in imports of consumer goods (strong growth at 7.4% by volume but half the figure for the January-August period in 2004). Finally, there was an increase in capital goods that was practically three times the figure for last year, which underlines the high level of this component of domestic demand. Foreign purchases of transportation equipment, particularly aircraft and railway equipment, contributed to this increase.

Current account deficit showing no limit

Balance of payments continues to show drops going further and further into red.

The current account balance continued along a worsening path in July with a deficit going above that for the same period last year although the rate of increase in the foreign imbalance moderated slightly. In any case, the cumulative deficit for the past 12 months in July amounted to 59.6 billion euros. The poorer situation was due to the general worsening under the various headings. The trade balance rose by 40% in the first seven months of the year, reflecting the impact of the boost in oil and the unstoppable increase in imports in a context of export difficulties.

Secondly, the services balance was down by 5% because of the poor results shown in the tourist balance which reflects the increased trend of Spaniards to travel abroad and the low level of spending by foreign tourists. Tourist revenue inflows rose well below the number of foreign tourists (1.3% as against 6.0%) whereas payments grew by close to 25%.

The surplus in the transfers balance, in turn, showed a major drop from the decrease in the balance with the European Union and, on the other hand, remittances abroad by immigrants were up sharply. Finally, under the incomes heading, the increase in the deficit may be attributed to the drop in inflows and the increase in payments. Capital account, in turn, showed a notable surplus in July although this was lower than in the same period last year because of inflows from the European Union. The cumulative balance as of July was also below the figure seen in the same period in 2004 and was not sufficient to cover the current deficit. This meant that the deficit resulting from the current account balance and the capital balance

Spanish exports losing competitiveness

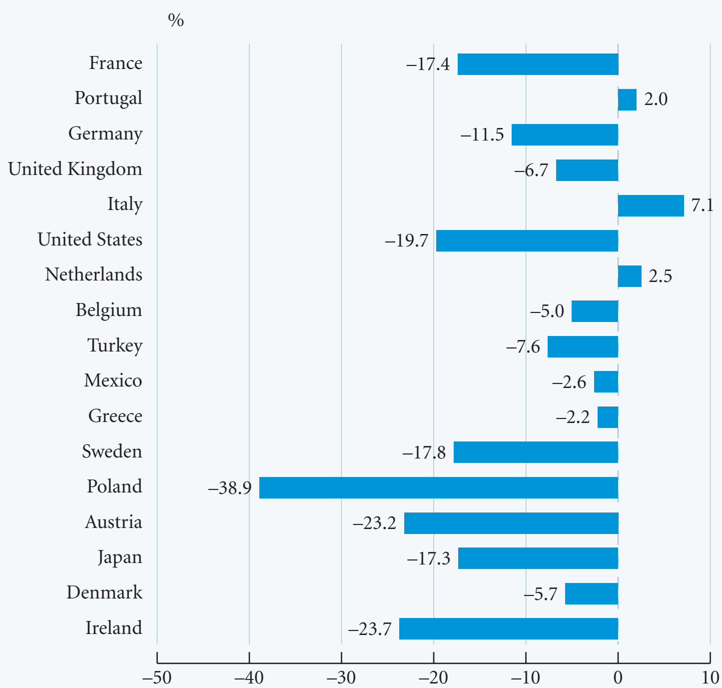
In recent times, the trade deficit has become the most troubling imbalance in Spain's economy. It is not without reason. In the early months of 2005 it went above 7% of the GDP, thus in percentage terms exceeding that of the United States which has caused so much comment in the press. This may be due to the fact that we are importing a lot and probably saving very little or that we are exporting little, possibly because we are not competitive. Strong domestic demand is driving the rash of imports while exports are failing to compensate for the gap created by purchases abroad.

The point is that Spain has a serious and growing problem of competitiveness in world terms. Since 1998, in terms of unit labour costs in the manufacturing sector, Spain's main customers have lowered the cost of their products by 8.1% compared with Spanish costs. Before the adoption of the euro, this loss of competitiveness could be supplemented through currency devaluations but this in no longer possible. Spain's competitiveness in terms of Portugal and Italy has been maintained but with regard to Germany it has dropped by 11.5% and against France (where 19.4% of the country's exports go) it has slipped by a dramatic 17.4%. The worsening situation is especially significant in terms of one new EU member state, namely Poland, which has cut its costs by 38.4% in terms of Spanish costs.

With this drop in competitiveness, it is not surprising that Spain has stopped making gains in its share of international trade. At least, however, the country has managed to not lose ground which, given the

SPAIN LESS COMPETITIVE THAN ITS TRADE RIVALS

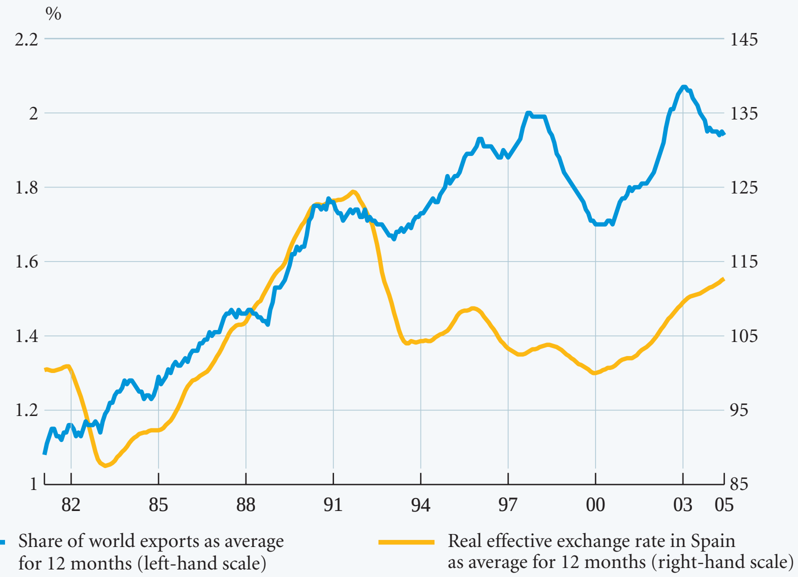
Relative trend compared with Spanish unit labour costs for manufactures since 1998.
Main destinations of Spanish exports in order of greater or lesser relative importance over total



SOURCE: Organization for Economic Cooperation and Development, Ministry of Trade and internal figures.

circumstances, is of some merit. Spain's exports in nominal terms have maintained their share of the world total, a share which had been increasing continually from 1.3% in 1985 and 1.7% in 1994 to 2.0% at the end of 1998, the date when the euro came into use. From that time on there was a decline which ended up with a drop to 1.7% at the beginning of 2001, followed by a strong recovery since then, in spite of ups and downs over the past years which have put it at 1.9%. In this respect, Spain contrasts favourably with countries like France, United Kingdom, United States and even Japan. All of those countries saw their share of nominal

SPANISH EXPORTS HOLDING UP



SOURCE: International Monetary Fund and internal figures.

world exports drop appreciably. Among the large countries, only China shows a better export balance. Things are not so bad.

In terms of market penetration by geographical area, the result is identical. The share of Spanish exports in total imports of the euro area went from 4.1% from 1994 to 4.5% in 2004. In areas of growing importance, such as between the new member states of the European Union, including Poland, Spain went from 1.1% to 1.8% and, among the rest of Eastern Europe, from 0.9% to 1.9%. This good situation is not restricted to Europe. Market share is increasing in Africa and Oceania and is holding up in Latin America and Asia, excluding the Far East. In two key areas, such as the Far East and the United States, which are engines of the world economy, the decrease in recent years has switched to an advance, especially in the case of China where, since the beginning of the year, Spain's exports have doubled their share of total imports. It may be assumed that, in areas of major growth, Spain's share would be lower but, if this bias were so marked and such a determinant, its share of world exports would drop, something which is not happening.

Also having an effect on these events, and to a considerable extent, has been the trend in exchange rates. The sharp devaluations of the peseta in the Nineties raised Spain's foreign competitiveness, a situation which was consolidated by the move into the euro. At the beginning of 1999, Spain was a cheap country compared with its partners in the Monetary Union and in terms of its main trading partners. This represented a considerable boost for Spain's exports, giving them an extension of time which has served to mask the problem of competitiveness and has delayed the consequences.

These consequences are now beginning to be felt. In spite of a generally favourable trend, Spain's exports are showing some dark spots. Exports by such relevant sectors as furniture, textiles, toys, footwear and motor vehicles are dropping or are stagnant. What is happening in imports is even worse. The penetration of foreign products in the Spanish market is making the country's lack of competitiveness even more evident. What is troubling is that at this time Spain's economy is not greatly specialized in high value added and growth sectors but quite the opposite. The exchange rate gave Spain a breathing space but the challenge now lies in taking advantage of this in order to improve our competitiveness before it is too late.

Foreign real estate sector attractive to Spanish capital.

rose to 33.28 billion euros in the January-July period, some 85.9% more than in 2004.

In the financial sphere, direct foreign investment in Spain was down sharply both in the corporate field and in real estate. In the latter case, the drop in the first half-year stood at 17%, a substantial figure if we take into account the rise in prices in the sector. Only foreign portfolio investment moved ahead strongly. Spanish direct investment abroad, on the other hand, was up notably, thanks to investment in real-estate and especially in portfolio investment.

BALANCE OF PAYMENTS

Cumulative figure for last 12 months in million euros

	July 2004	July 2005	% change
Current account balance			
Trade balance	–45,607	–63,843	40.0
Services			
Tourism	*26,442*	*25,547*	*–3.4*
Other services	*–4,329*	*–3,903*	*–9.8*
Total	22,112	21,644	–2.1
Income	–11,848	–16,452	38.9
Transfers	621	–943	–
Total	**–34,722**	**–59,595**	**71.6**
Capital account	**8,358**	**8,316**	**–0.5**
Financial balance			
Direct investment	–10,838	–27,373	152.6
Portfolio investment	32,488	91,876	182.8
Other investment	15,670	–16,820	–
Total	**37,320**	**47,683**	**27.8**
Errors and omissions	434	–1,689	–
Change in assets of Bank of Spain	–11,390	5,285	–

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.

Public sector

Central government budget for 2006

As its priority economic policy objective, the 2006 central government budget presents a growth model that is balanced, sustainable and competitive. According to the budget, this economic policy is based on a decided improvement in productivity, on budget stability and the strengthening of the social fabric.

In order to achieve its objectives the 2006 budget presents consolidated spending by the central government, Social Security, autonomous bodies and public corporations amounting to 301.3 billion euros. This figure represents an increase of 7.7% compared with the year before, that is to say, one point above the nominal growth forecast for the economy. This consolidated spending does not include that carried out by other levels of government (autonomous communities and municipalities) nor operations of the corporate public sector or public foundations or other public bodies, such as Spanish Radio and Television.

The two largest headings of consolidated government spending are pensions, which make up 31.4% of the total and transfers to other levels of government,

Central government, Social Security and other central government bodies to spend 300 billion euros in 2006.

NON-FINANCIAL DEFICIT AND BORROWING REQUIREMENT IN CENTRAL GOVERNMENT BUDGET FOR 2006

Million euros

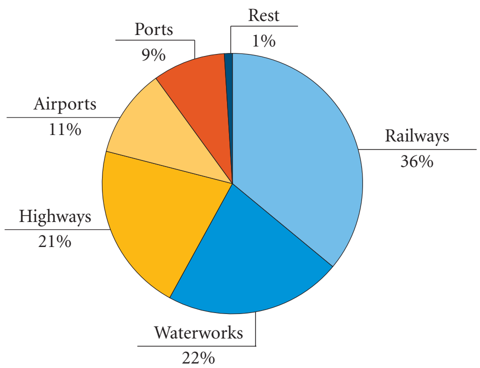
	Spending	% change (*)
Current operations		
Staff costs	27,381	8.0
Current goods and services	7,248	6.9
Financial costs	17,490	–9.5
Current transfers	176,366	8.5
Total	**228,484**	**6.8**
Capital operations		
Contingency fund	3,323	33.4
Real investment	12,467	6.2
Capital transfers	7,794	15.0
Total	**20,261**	**9.5**
Total non-financial operations	**252,068**	**7.3**
Financial assets	17,695	21.6
Financial liabilities	31,569	4.2
Total financial operations	**49,263**	**9.8**
TOTAL BUDGET	**301,332**	**7.7**

	Revenue	% change (*)
Current operations		
Direct taxes and Social Security contributions	184,190	9.8
Indirect taxes	45,302	5.2
Fees and other revenue	4,233	0.6
Current transfers	12,537	2.7
Government property earnings	3,511	11.8
Total	**249,773**	**8.4**
Capital operations		
Disposal of real investments	564	–0.6
Capital transfers	2,773	6.8
Total	**3,337**	**5.5**
Total financial operations	**253,110**	**8.4**

NOTES: (*) Change over initial 2005 budget.
SOURCE: Ministry of Economy and Finance.

GOVERNMENT INVESTMENT IN INFRASTRUCTURES

Breakdown of investment by general government and central government corporate public sector for measures in 2006, as percentage of total



SOURCE: Ministry of Economy and Finance.

Main government spending headings show little margin for manoeuvre.

which involve 20.8%. Following far behind comes servicing the public debt at 6.5% of the total and unemployment measures with 5.0% which make up the next largest headings. In fact, four major headings take up 60% of all spending.

Most spending programmes are expansionist and benefit from margin created by lower interest payments on public debt.

In addition, it should be pointed out that the greater part of spending programmes enjoy allocations which are growing above the nominal rate of the economy, thanks to the contraction in interest payments. The only allocations showing less growth than the nominal gross domestic product (6.6%) are for agriculture and fishing, financial and tax administration, programmes to foster employment and defence services.

Investment in infrastructures amounts to 1.7% of GDP while funds going into R&D&i stand at 0.7%.

At the other end of the scale, that is to say, among those showing very expansionist trends we should point out the economic measures in the area of retail trade, tourism and small and medium-sized business (38% increase), research, development and innovation (29.7%), foreign policy (23.2%), access to housing (20.0%), transportation subsidies (19.0%) and education (16.6%) although in the latter case the allocation in absolute terms is relatively small if we take into account the administrative decentralization of the system. Programmes related to infrastructures, in turn, are up by 12.4% to reach 12.69 billion euros. This figure does not include certain measures falling outside the budget as a result of which real investment in infrastructures will be substantially higher going to 16.12 billion euros, that is to say, 1.69% of the GDP estimated for 2006. Priority is given to railways and the continuation of investment in waterworks.

The increase in spending in the area of retail trade, tourism and small and medium-sized business may largely be explained by international promotion measures and the relatively small allocations to those programmes. In the area of R&D&i, the main effort shows up in various programmes and projects among which of special note is the Avanz@ programme for developing the information society with an allocation of 634 million euros. As a whole, budget allocations of all types amount to 6.5 billion euros, that is to say, 0.7% of the GDP.

In housing, the greater part of spending is to go into subsidies, supports and amelioration of interest for an amount close to 900 million euros. In addition, measures are set out for fostering construction and rental housing development within the framework of the 2005-2008 housing programme which, among other measures, involves intervention in 277,900 housing acquisition transactions, 164,600 rental operations and 159,500 renovations.

The ample figures shown by the 2006 central government budget in its various spending measures is largely based on favourable revenue forecasts. In consolidated terms, revenues from non-financial operations will amount to 253.1 billion euros, an increase of 8.4% over the initial 2005 budget. This increase would be lower if it were to be calculated on effective collections in 2005 which will be higher than initially forecast.

The tax load (direct taxes, indirect taxes and Social Security contributions) in terms of the initial budget will reach 24.0% of the GDP in 2006, a half-point more than in the initial budget for 2005.

The increase in tax collections will be due mainly to the increase in direct taxes, both personal income tax (in spite of the reduction in rate) and in corporate income tax. Compared with the initial budget, the increase in direct taxes stands at 12.6% (9.7% if this is calculated on forecast tax collections). Indirect taxes will grow by 5.2% (5.1% in the second case), a surprisingly lower percentage than the increase in domestic demand and rather unlikely in view of the increase in special taxes on alcohol and tobacco. The increase in collections for Social Security contributions stands at 7.7% and may be explained by the updating of contribution bases and an increase in registrations.

Seeing that spending will exceed revenues, the result of the economic measures planned by the central government will be a net deficit of 14.08 billion euros, equivalent to 1.5% of the GDP.

Formally, the 2006 central government budget shows a consolidated surplus of 2.87 billion euros in terms of National Accounting, that is to say, 0.3% of the GDP. This surplus arises from the surplus in the Social Security accounts (0.7% of the GDP) which compensates for the central government deficit (0.3%) and that of other central government bodies (0.1%). If we add to these figures the deficit forecast for other levels of government (0.1%), the final balance for general government as a whole in 2006 would be positive at 0.2% of the GDP.

Tax load from direct taxes, indirect taxes and Social Security contributions to rise to 24% of GDP.

Budget presents consolidated surplus of 0.3% of GDP.

Central government to borrow in spite of budget surplus

In consolidated terms, the 2005 central government budget shows a surplus of 0.3% of the GDP. This positive balance arises from the compensation between the surplus in Social Security and the respective deficits of the central government, autonomous bodies and other public bodies, such as the Nuclear Safety Council, the Economic and Social Council, the Central Government Taxation Agency, the Cervantes Institute, the Spanish Agency for Protection of Information, the Foreign Trade Institute, the National Intelligence Centre and the Prado Museum.

NON-FINANCIAL DEFICIT AND BORROWING REQUIREMENT IN CENTRAL GOVERNMENT BUDGET FOR 2006

	Million euros		As % of GDP	
	Central Government	Consolidated	Central Government	Consolidated
Non-financial revenues	128,591	253,110	13.4	26.5
Non-financial spending	133,947	252,068	14.0	26.4
Treasury deficit (+ surplus, – deficit)	–5,356	1,041	–0.6	0.1
Net change in financial assets	8,726	15,124	0.9	1.6
Net borrowing requirement	–14,082	–14,082	–1.5	–1.5
Change in financial liabilities	31,348	31,569	3.3	3.3
Borrowing requirement	45,430	45,651	4.8	4.8
Memo-item: balance according to National Accounting	**–3,946**	**2,876**	**–0.4**	**0.3**

SOURCE: Ministry of Economy and Finance.

In spite of this positive balance, the budget shows a net borrowing requirement, that is to say, a financial imbalance of 14.08 billion euros, equivalent to 1.5% of the GDP. This situation is not something new this year but rather is a normal recourse in the presentation of the public accounts. Year after year the central government net financial requirement has exceeded total revenues.

Why does this discrepancy take place? Accounting regulations make possible, for example, that certain opening amounts are registered as financial investments which, because of their nature, would come closer to real investment spending. An example would be the provision of funds by the central government to the Railway Infrastructures Administrator which is more like a non-repayable investment (as are public investments in infrastructures) than a financially recoverable investment.

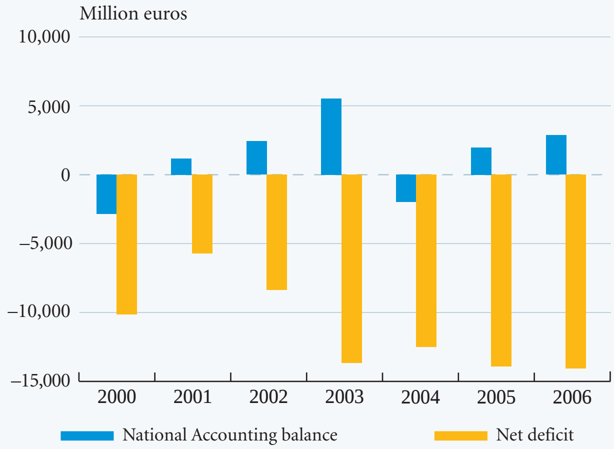
Remaining recourse to an increase in financial assets is oriented along similar lines. In general, this involves the granting of loans or property allocations to companies forming part of the corporate public sector, to those institutions belonging to the public foundations sector and to a series of entities operating under public law which do not have their own legal entity, such as the Development Aid Fund, the Foreign Investment Fund, Micro-Credit Fund (social development programmes abroad), Tourist Infrastructure Modernization Fund and the Fund for Foreign Investment by Small and Medium-sized Businesses.

Specifically, the most notable allocations in the 2006 budget, among other purposes, go into programmes of research and development under the Ministry of Industry (2.77 billion euros) and the Ministry of Education and Science (860 million euros), Railway Infrastructures Administrator (1.85 billion euros), Development Aid Fund (850 million euros), loans to highway infrastructures promoters (679 million euros), to RENFE operating company (404 million euros), the new central government corporation for Land Transport Infrastructures (400 million euros), to programmes for reindustrialization of depressed areas (215 million euros) and the Tourist Infrastructure Modernization Fund (70 million euros). These transactions would appear to be closer to spending than to financial investment.

Apart from measures undertaken through financial accounts, the budget also contains authorization of guarantees which involve further government spending to the extent that they cover the losses of Spanish Radio and Television and government corporations showing losses. These guarantees, which show up as deficits in the figures for National Accounting, do not, however, appear in the financial accounts shown in the budget.

GOVERNMENT SURPLUS IN CONTRAST TO INCREASE IN PUBLIC SECTOR DEFICIT

Budgetary balance according to National Accounting and net deficit (*)



NOTES: (*) Consolidated figures excluding other levels of government.
SOURCE: Ministry of Economy and Finance and internal figures.

The amounts guaranteed, on the other hand, are very large: 226.59 billion euros to cover losses attributed to Spanish Radio and Television (apart from an operating subsidy for an amount of 578.58 million euros) or 180.3 million for RENFE operating company. Of more significance is the amount of guarantees which may be applied by SEPI (Sociedad Estatal de Participaciones Industriales) for the benefit of companies in which it has holdings for certain credit or guarantee transactions. The maximum amount to be guaranteed is 1.21 billion euros, a figure higher than estimated net losses of the public corporate sector (1.02 billion euros).

In spite of these high deficits, the fact is that in terms of the GDP they have lost relative importance, given that nominal growth of the economy has exceeded the volume of these public deficits. This explains the downward trend shown by the public debt in relation to the GDP, a trend which is indicative of the health of the government accounts in recent years which in 2006 are expected to drop to 43.0% as against 46.6% in 2004.

Savings and financing

Sharp increase in loans to households

Reduced prospects of cut in European Central Bank official rate brings rise in interest rates.

Interest rates on bank loans and credits generally rose slightly in August. As a result, the composite reference rate at banks and savings banks rose by 9 basis points to 3.84%, somewhat below that twelve months earlier. The rise in bank rates came following disappearance of prospects of a cut in the European Central Bank official rate.

In addition, the interest rate on mortgage loans held at 3.2% in September 2005. As a result, it stood 17 basis points below the same month in 2004.

Housing loan rate also moves up slightly.

Funding of the private sector continued to rise at a strong rate. In August, loans to companies and households showed growth of 18.6% compared with the same month last year, some 2.5 points more than the annual rate recorded in December. Demand for finance was boosted by the good economic climate and easy borrowing conditions. As a result, funding going to companies and households, including loans from the financial system, both domestic and foreign, securitizations and bond issues (but not share issues) grew at the highest rate since September 2000, doubling the rate for the euro area as a whole. The biggest year-to-year increase came in loans to households (20.3%), slightly higher than that recorded in previous months. Mortgage loans continued to boost financing to households.

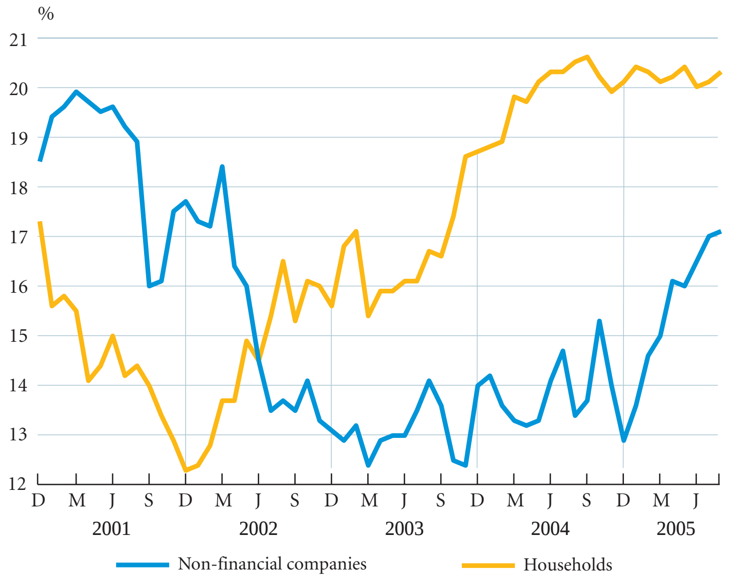
SLIGHT RISE IN INTEREST RATES ON BANK LOANS AND CREDITS

Composite loan and credit rate applied to new transactions at credit institutions. Equivalent annual rate

SOURCE: Bank of Spain.

FUNDING TO COMPANIES GETS BOOST

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



SOURCE: Bank of Spain.

With regard to funds obtained by non-financial companies, this figure rose by 17.1% compared with the same month in 2004. Of total funding, credit granted to non-financial companies by resident credit institutions and securitization funds rose by 22.0% in the past year.

Funding of private sector growing at twice rate seen in euro area.

Bank deposits continue to grow at high rate

Total deposits of companies and households continued to rise at a sharp rate in August compared with the same month last year and much more rapidly that in the euro area. Nevertheless, the increase in absolute terms in the past 12 months was notably lower than in the case of loans. In order to compensate this difference in balances, the credit institutions issued bonds or had recourse to foreign markets.

Private sector deposits grow more than in euro area but less than loans.

On the other hand, the new accounting regulations for credit institutions came into force in June as a result of adoption by the European Union of the International Financial Information Regulations relating to application of the International Accounting Standards. As a result, the balance of time deposits, mainly long-term deposits, was increased as a cross-entry for the return to the balance sheet of some securitized assets which had been removed when the previous regulations were in force. As a result, the year-to-year increase in time deposits and in the total appear to be overvalued. Nevertheless, there is no doubt that the biggest annual increase came in time deposits for more than two years which enjoy a tax benefit of 40% on interest. Deposits in currencies other than the euro also showed a big increase. In addition, on-demand and savings accounts showed a considerable rise of 11.7%.

On-demand and savings accounts up 12% in past 12 months.

With regard to bank deposit interest rates for the private sector, these scarcely rose in August holding at very low levels. The composite interest rate for non-financial companies rose by 7 hundredths to 1.23%, some 4 basis points above one year earlier. The composite rate for households rose by 3 basis points to 1.14% to stand at the same level as 12 months earlier.

Assets of securities mutual funds rose by 3.5 billion euros in September going to 242.07 billion euros, showing growth of 13.8% over the same month last year, according to Inverco, the sector organization. This increase in assets may be attributed to major capital gains due to the good performance on the stock markets during the month and also to net subscriptions to shares (after deducting sales) of 1.08 billion euros. The biggest inflows of new money in September went into global funds, guaranteed bond-based funds and European share-based funds. On the other hand, the funds to mark up the biggest withdrawals were money-market funds, guaranteed share-based funds and short-term bond-based funds. However, in the January-September period net subscriptions were concentrated on short-term bond-based funds (for an amount of 6.08 billion euros), some 43% of the total, thus reflecting the risk aversion stand among many savers.

Biggest inflows of new money into securities mutual funds in September go into global funds, guaranteed bond-based funds and European share-based funds.

The total number of participants in securities mutual funds rose to 8,341,634 at the end of September. As a result, there was an increase of 4.7% in the past 12 months. In this period, the types of fund to show most growth in number of participants were guaranteed bond-based funds and national share-based funds, with year-to-year increases of 20.6% and 14.2% respectively.

The average annual weighted yield obtained by securities mutual funds was 6.1%, substantially above inflation. While all types of securities mutual fund recorded positive annual yields there was a wide range. Whereas international share-based funds in emerging markets reported an extraordinary annual yield of 55.5% and national share-based funds showed 35.6%, money-market funds earned only 1.2%.

Total assets of securities mutual funds (SICAV and SIM) amounted to 26.9

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

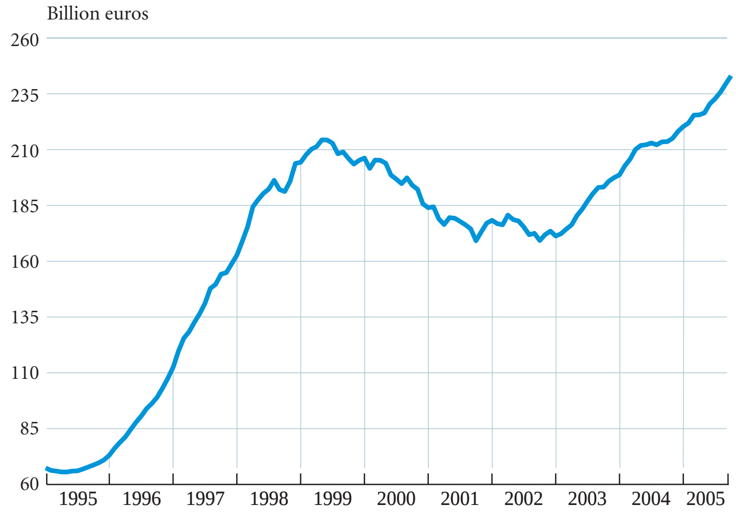
August 2005

	Total	Change this year		Change over 12 monts		% share
	Million euros	Million euros	%	Million euros	%	
On-demand and savings (**)	367,012	21,938	6.4	38,409	11.7	44.4
Up to 2 years (*)	181,360	20,893	13.0	25,738	16.5	21.9
More than 2-year term (*)	200,133	72,665	57.0	93,396	87.5	24.2
Repos	70,745	–9,904	–12.3	–7,281	–9.3	8.6
Total (*)	**819,250**	**105,592**	**14.8**	**150,262**	**22.5**	**99.1**
Deposits in currencies other than euro	**7,774**	**1,927**	**33.0**	**2,639**	**51.4**	**0.9**
TOTAL (*)	**827,024**	**107,519**	**14.9**	**152,901**	**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.

BIG INCREASE IN ASSETS OF SECURITIES MUTUAL FUNDS

Total assets of securities mutual funds



SOURCE: Inverco.

billion euros at the end of July 2005. The number of shareholders on June 30, 2005 was 395,412.

In turn, as a result of the real-estate boom, real-estate mutual funds have shown major growth. The assets of this type of investment fund at the end of September amounted to 6.02 billion euros, an increase of 37.6% over December. The number of participants was 126,566, an increase of 19.1% so far this year. The annual average weighted yield for the past year was 5.7%.

Securities mutual funds mark up average annual yield of 6.1%, substantially above inflation.

Foreign deficit from the inside, or where savings we import are going

When a country presents a deficit in its current account balance, this is because it is living beyond its means. It is spending more than it produces, and, as happens in a household or a company, it must resort to borrowing in order to maintain its rate of spending. At times, this is good if it happens to be a developing country which presents a broad growth potential and concentrates its spending on investments that will pay off in the future and increase its growth capacity. It is not usually so good if the imbalance arises from mere consumer spending so that there is an increasing debt (which must be paid back in the future) in order to pay for current spending. It may be a case of «eat today and starve tomorrow».

Spain's economy is suffering from a run-away trade deficit which is bringing about a growing gap in the current account balance. We are spending more than we earn. In order to maintain this imbalance, we must borrow more and more from abroad. That is to say, as the balance of payments has to be settled, the figures in the red arising from current transactions must be compensated by capital inflows. It should be pointed out that Spain has no problems in obtaining finance. Being within the euro area has radically changed the traditional picture of Spain's economy which formerly found getting foreign financing to be an insuperable bottleneck. In spite of everything, however, we should be asking if it is sustainable to have increasing recourse to the surplus savings of other countries.

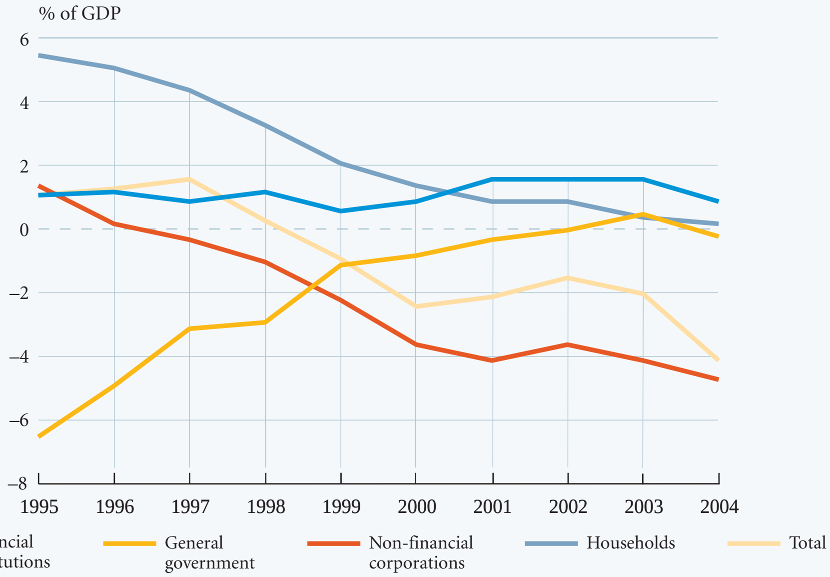
In order to help clarify this key problem, we must break down this borrowing into the different segments of the national economy. This breakdown of net borrowing of the private and public sectors comes from the financial accounts of the Bank of Spain. In 2004, this net borrowing amounted to more than 30 billion euros to stand at 4.2% of the gross domestic product, a figure which coincides with the current account deficit plus capital transfers in the balance of payments. Up until a few years ago, the usual scheme of things was, on the one hand, households, which used to provide a very substantial surplus to the rest of the economy thanks to the fact that home acquisition (the only investment spending by households) was well below gross savings, that is to say, lower than whatever income was left over after paying consumption costs. In addition, there were the non-financial corporations whose position with regard to the rest of the economy changed according to the current economic situation. Finally, there was the public sector with continuing deficits which involved huge borrowing requirements. The sum of these three factors, plus the position of the financial institutions, meant a positive or negative foreign balance depending on the then current situation.

In recent years, this pattern has changed. As may be seen in the accompanying graph, the public sector has corrected its deficit and now does not need to borrow. On the other hand, companies have moved into the negative area with net borrowing close to 5% of the GDP. The most notable change, however, is that households have followed a similar path so that in 2004 all of that sector's surplus had practically disappeared. That is to say, correction of the government imbalance has not been sufficient to compensate for the major worsening of the private sector's financial position. What then brought about this trend in the private sector?

The answer is investment. The figure for gross household savings has dropped but the main change is that households have swung heavily into buying homes, stretching their capacity to the hilt. Something similar is

ALL INSTITUTIONAL SECTORS REDUCING NET LENDING

Net lending (+) or net borrowing (–) in institutional sectors of Spain's economy



SOURCE: Bank of Spain and internal figures.

taking place in the case of companies. They have slightly reduced their savings while at the same time increasing investment, within which investment in construction is very substantial. The drop in interest rates and the spiralling rise in land and housing prices are among the reasons for this trend.

If the foreign deficit were due to an increase in investment, this deficit could be seen with good eyes. But to the extent that it is exclusively because of the construction component, the verdict must change. In 1995, the specific weight of capital goods in the GDP was 6.0% and went up to 6.7% in 2004. On the other hand, in the same period construction went from 12.3% to 16.2%. In today's globalized world, investment in information technology and communications is said to have the greatest future. On the other hand, investment in housing would not seem to be raising the future growth potential of Spain's economy.

With regard to companies, a good part of investment is also going into activities linked to construction. But now it would be most relevant to ask questions about the low capacity of non-financial companies to generate savings. Compared with what is happening in the United States, for example, where corporate savings is quite positive, we could point to the insufficient ability to boost productivity as an explanation of this discrepancy. Finally, the increasing need for funding arises from the growth model followed in recent years, a model characterized by a low capacity to improve productivity in the case of industry and excessive investment in the construction sector.

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