DECEMBER 2005

THE SPANISH ECONOMY

Monthly Report

NUMBER 286

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2004	2005	2006	2004 3Q	2004 4Q	2005 1Q	2005 2Q	2005 3Q	2005 4Q
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	2.3	1.5	2.4	0.9	1.0	2.3	2.9	2.9
United Kingdom	3.2	1.7	2.1	3.0	2.5	1.7	1.5	1.7	1.7
Euro area	1.8	1.4	1.8	1.8	1.6	1.3	1.1	1.5	1.7
Germany	*1.1*	*0.9*	*1.3*	*1.1*	*0.5*	*0.6*	*0.7*	*1.4*	*1.2*
France	*2.1*	*1.5*	*1.8*	*1.8*	*2.0*	*1.8*	*1.1*	*1.8*	*1.4*
Consumer prices									
United States	2.7	3.5	2.8	2.7	3.3	3.0	2.9	3.8	4.1
Japan	0.0	–0.2	0.1	–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*	*2.0*	*1.8*	*1.9*	*1.9*	*1.7*	*1.7*	*2.1*	*2.4*
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	4.4	3.7	4.7	4.7	4.6	4.6	4.4	4.2
Government consumption	6.0	4.7	4.4	6.6	6.3	5.4	4.3	4.6	4.5
Gross fixed capital formation	4.9	7.3	6.3	5.3	6.2	7.2	7.6	7.4	7.1
Capital goods	*3.7*	*9.3*	*6.5*	*6.7*	*8.8*	*10.1*	*10.4*	*8.8*	*8.0*
Construction	*5.5*	*6.3*	*5.8*	*5.3*	*5.2*	*6.0*	*6.2*	*6.3*	*6.4*
Domestic demand (contribution to GDP growth)	4.7	5.2	4.6	5.1	5.4	5.2	5.3	5.2	5.0
Exports of goods and services	3.3	0.5	2.8	3.5	2.3	–2.1	1.1	1.3	1.6
Imports of goods and services	9.3	7.6	7.3	10.7	10.1	5.7	8.5	7.7	8.7
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	3.2	3.1
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	3.3	3.0	3.3	3.4	3.3	3.2	3.4	3.5
Unit labour costs	2.8	2.4	2.4	2.8	2.6	2.5	2.4	2.4	
Current account balance (% GDP)	–5.8	–7.4	–7.3	–5.9	–6.7	–7.1	–7.9	–6.9	
Not lending or net borrowing rest of the world (% GDP)	–4.8	–6.4	–6.4	–4.8	–5.7	–6.6	–6.7	–6.0	
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	4.0
ECB repo	2.0	2.0	2.4	2.0	2.0	2.0	2.0	2.0	2.1
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	1.19

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MONTHLY REPORT
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CAJA DE AHORROS
Y PENSIONES
DE BARCELONA

Research Department

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

"la Caixa" GROUP: KEY FIGURES

As of December 31, 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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Contents

ECB raises rates. Is this the right moment?

It is a bit like driving a car with your eyes shut or just looking in the rear-view mirror. That is a common explanation of how monetary policy decisions are taken. We do not see what is ahead (the future) but rather only what has just gone by (and furthermore the figures arrive late) but we have to keep going at the risk of running off the road. Jean-Claude Trichet, chairman of the European Central Bank (ECB) must have felt something like that when his announcement of an increase in the euro reference rate caused such a commotion. Indeed, the criticisms have increased. We are scarcely beginning to note the depth of a still-weak recovery in the euro area. Prices are running above 2%, although only because of oil, as there are no prospects of a rise in inflation. Why, then, be in such a hurry to raise interest rates? Would not a rise before its time interfere with the hoped-for recovery?

It should be pointed out that this is the first time the euro area central bank has clearly made known its next move on monetary policy ahead of time, something which up until now was exclusive to the Federal Reserve. Perhaps Trichet had read some of the very laudatory biographies of Alan Greenspan recently appearing now that the «Master» is about to relinquish his post. And among the virtues ascribed to Greenspan was how he connected with the markets, how he was in tune with the world of money and finance, that gave him an enviable credibility. To achieve this it is necessary to be transparent and predictable, which demands coherence over time along with serious and effective communication. As a result, Trichet's early announcement is an element of transparency which must be considered positively in an institution such as the ECB, a body still quite young and one created along the lines of the Bundesbank, the German central bank, an institution not particularly noted for its open communication policy.

But, even before Trichet made his announcement, the Ministers of Economy and Finance of the Euro Group had warned that it was too early, that the oven was not yet ready for baking the loaves. And, when he went to the European Parliament to explain his point of view, Trichet had to clarify that it was not a matter of beginning a series of increases along the lines followed by the Fed, which in 18 months had made twelve reference rate increases. The fact is that the ECB did not feel comfortable with such low monetary policy rates. For two and a half years it had held them at 2% with heavy pressure to lower them even more (the Fed dropped interest rates to 1%). With figures confirming an improvement in the euro area economy, the ECB has not wasted time in leaving behind the range of historically low rates.

Whether or not it was precipitate, the decision of the central bank in Frankfurt will be received with much relief by Spain's economic and monetary authorities. Along with Greece and Ireland, Spain is recording the highest inflation rates in the euro area. This means that real interest rates, that is to say, nominal rates with inflation deducted, are negative. In an economy where a good part of incomes are indexed to inflation, this situation means an almost irresistible stimulus to increase spending with a spectacular rise in indebtedness, both of households and companies. Somewhat higher interest rates may begin to ease this situation without bringing about any halt in economic activity. This is not the optimum remedy but it is a step forward, a welcome move.

November 28, 2005

ECONOMIC SITUATION

Prospects improving

Favourable prospects for world economy in final stages of 2005.

The world economy is facing the end of 2005 in an optimistic vein. The United States is showing unabated growth and the macroeconomic figures have not been affected by the hurricanes in August and September; figures for Japan confirm the general improvement of the economy, thanks to a recovery of domestic demand; the euro area finally seems to be recovering. Furthermore, inflation is slightly less troubling than a few months ago due to a drop in oil prices in November and the rise in fuel prices does not seem to be shifting to other prices.

Risk of inflation lies behind series of rate increases applied by Federal Reserve in last 18 months.

Not everything, of course, is coming up roses. General Motors has announced the lay-off of 30,000 workers in the United States and a reduction of a million vehicles in its total production. At the same time, US consumers continue to buy cars made in Japan to such an extent that this is contributing to blow up the unstoppable trade deficit of the US economy. This is not even mentioning imports of shirts, pants and underclothes made in China, articles for which Washington has reached an agreement on import limits with the Asian giant in order to protect what little remains of the US textile industry.

Industry, however, is suffering in all developed countries because of cost pressures it has to bear from products coming from emerging countries. This is globalization. The good side of the coin is that, thanks to globalization, a good part of the products being consumed by households are not showing price increases because of the fierce competition from imported products. This gives households greater purchasing power and makes it possible that the overall end result is positive, if the economy is sufficiently flexible to readjust itself. In the United States, for example, the underlying inflation rate, that is to say, deducting the more volatile components such as food and energy, is not going above 2% in spite of the notable increases in industrial raw materials and energy.

Control of inflation is a key factor for macroeconomic stability and the prolongation of the expansionist stage of the cycle. The Federal Reserve had no qualms about making drastic cuts in monetary interest rates when the risk of recession appeared. At the same time, Greenspan did not hesitate when the moment came to raise them, once growth was confirmed and inflationary risks began to show up. Twelve consecutive increases since June 2004 have taken them to 4% and they will not stop there. It is difficult, however, to see them going above 5% in 2006. The Federal Reserve has indicated that the end of the increases is coming close once interest rates have moved into a more neutral area. In addition, a troubling factor is the flattening out of the interest rate curve (short-term interest rates are almost equal to long-term rates) and the possibility of this being turned around (with short-term rates higher than long-term rates), a situation which could be the precursor of a future recession.

Central banks of Japan and euro area also plan to raise reference rates.

While some central banks (the Federal Reserve) have already arrived at this point, others (the Bank of Japan and the European Central Bank) are now beginning to take the road of tighter monetary policy. The Japanese central bank seems to want to put an end to its monetary policy of maximum easy money (with rates at 0 percent) once the country's recovery seems established. The problem is that Japan is still in a state of deflation because prices keep dropping in spite of the rise in oil. The intentions of the governor of Japan's central bank have caused bitter discussion with members of the governing party who do not see Japan's recovery as being quite so evident and do not understand the hurry to put an end to easy money.

In spite of the differences, somewhat the same thing is happening in the euro area. The European Central Bank (ECB) is concerned because the money supply is going above the desired figure, as is also the case with credit, and prices are above the 2% limit. Publication of growth figures for the third quarter, somewhat lower than expected, along with the European Union forecasts which were relatively optimistic, has provided arguments to announce an increase in interest rates. The immediate reaction of the economic authorities of the Euro-group (the ministers of economy and finance of the euro area) was a clear rejection. International bodies such as the International Monetary Fund and the Organization for Economic Cooperation and Development have been very critical while analysts have been more divided in their views.

Could monetary policy impede the incipient recovery in the euro area? On the one hand, the euro has depreciated during 2005 which, in financial terms, is the equivalent of an interest rate cut. We do not feel that the rise in rates in 2006 (a half point or three-quarters of a point, that is, not going up to 3%) would abort the improvement desired. In 2006, monetary policy in the euro area will still be easy, member countries have announced that they will postpone fiscal adjustment until 2007, the financial situation of companies and households is generally favourable and the international environment is seen as expansionist. Furthermore, we should keep in mind the delayed effect any tightening of monetary policy may have on the economy so that its influence will not be felt until well into next year.

Tightening of monetary policy will not hurt economic recovery in euro area.

For the moment, the indicators are not against us. In France, the gross domestic product (GDP) grew by 1.8% in the third quarter, a very positive surprise in which the improvement in domestic demand played a decisive role. In Germany, the growth figure in the same period was 1.4% year-to-year, well above the 0.7% in the second quarter. It is to be hoped that the new coalition government is able to consolidate the expectations of companies and consumers and that the German economy holds to its present path.

Spain: more growth and more employment

In Spain's economy, tighter monetary policy will help moderate inflationary pressures and contain trade imbalance.

In Spain's economy, the increase in interest rates has not been at all poorly received. This is one of the economies of the euro area that is growing most and where, for several years, the difference in growth rate with the average rate has been quite favourable. Somewhat less easy monetary conditions could contribute to moderating inflationary pressures and to contain growth of the trade imbalance.

Third quarter figures show economy with strong growth thanks to slightly lower domestic demand but with construction industry still buoyant and high household consumption spending.

Figures for the third quarter of 2005 are conclusive. The National Institute of Statistics (INE) estimates GDP growth at 3.5% at year-to-year rate, the highest since the end of 2001. Prospects for the final months of 2005 point to maintenance of the main trends so that the year will end with growth of the order of 3.4%, higher than expectations held at the beginning of the year.

A positive aspect of the INE estimate is somewhat less of an imbalance between domestic demand and foreign demand, apart from the unexpected correction which the INE has made to its previous figures. Specifically, the sharp drive in household consumption was down slightly with growth of 4.4%, a few decimals lower than figures for the previous quarters. Investment in capital goods also slowed after having reached two-digit growth in the first half of 2005. On the other hand, both public consumption and construction investment showed a slight increase in growth rate, with rates already high. In the latter case, year-to-year growth stood at 6.3% thus continuing to hold its role as the engine of economic activity. We could expect some moderation in this sharply expansionist growth rate in coming months if we keep in mind the trend in the main economic activity indicators and the slight containment of housing prices.

Labour market still creating high job figures with drastic reduction in unemployment although productivity scarcely increasing.

As cause and effect of the strength of supply and demand we again are finding a favourable trend in the labour market. According to the Labour Force Survey carried out by the INE, in the year ending with the third quarter of 2005 no less than 930,000 persons joined the labour market, an increase of 5.1%. In terms of work equivalent to full-time jobs, the quarterly figures estimate growth of 3.2%, that is to say, somewhat less than 600,000 jobs in one year. The difference in the survey figures reflects the importance now shown by part-time jobs which have rapidly become a key factor in moving into the labour force. In addition, what is notable is the low growth of productivity in the quarter mentioned (a mere 0.3%), a development linked to the proliferation of part-time hiring contracts and the notable importance of temporary contracts which often is the case in those sectors of low value added in services and construction.

While the jobs being created are not of high value added, at least they have the virtue of normalizing one of the parameters that has traditionally troubled Spain's economy, namely unemployment. According to the survey for the third quarter, unemployment affected nearly 1.8 million people representing 8.4% of the labour force, a level not reached for many years. This figure is even lower than the European Union average although we shall have to wait for the homogeneous figures from Eurostat, the EU statistics office, to confirm this notable event.

Inflation not quite as bad as expected, trade deficit has stopped growing worse and financial state of government accounts seems quite favourable.

The other two main imbalances in Spain's economy, inflation and the foreign deficit, have slowed the process of getting worse, according to most recent figures. The decrease in fuel prices in recent weeks has taken pressure off the consumer price index which now could end the year somewhat lower than the 4% which was expected just a couple of months ago. With regard to the foreign imbalance, the good state of markets outside the EU and the drop in the euro exchange rate in the course of 2005 has ended up slightly favouring Spain's exports which in August and September seemed to recover some of their lost strength.

The government accounts, in turn, are enjoying good health. Revenues from personal income tax, corporate tax and value added tax raised collections by 14% in the first ten months of the year which made it possible to obtain a notable surplus in the period mentioned. The volatility of the monthly figures makes it difficult to fully evaluate these results but they represent one more indication of the strength of the economic situation at this moment.

CHRONOLOGY

2005

February	2	**Federal Reserve** raises reference rate by quarter point to 2.5%.
	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%.
June	30	**Federal Reserve** raises reference rate by quarter point to 3.25%.
August	9	**Federal Reserve** raises reference rate by quarter point to 3.5%.
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 exchange** marks up annual high (10,919.2) with cumulative gains of 20.2%.
	13	Government approves **National Reform Programme for Spain**.
November	1	**Federal Reserve** raises reference rate to 4%.

AGENDA

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).
30 Early HCPI index (December).

January 2006

10 Industrial production index (November).
12 Meeting of Governing Council of European Central Bank.
13 Consumer price index (December).
19 Harmonized consumer price index for European Union (December).
25 Producer price index (December).
27 Labour Force Survey (4th Quarter).
US GDP (4th Quarter).
28 Early HCPI index (January).
31 Meeting of Open Market Committee of Federal Reserve.

United States confirms economic strength

United States grows at 3.6% without inflation but with imbalances.

The United States continues its unabated growth. This is growth which, for the moment, is not creating any appreciable inflationary pressures, helped by the performance in the labour market. The biggest risk continues to be the lack of household savings and saving by the Administration, all of which is generating a growing foreign deficit, an imbalance which has still not even begun to be remedied.

In the third quarter, the gross domestic product (GDP) grew by 3.6% year-to-year, according to an early estimate by the Bureau of Economic Analysis, so that the slowdown predicted by the analysts still remains at least something for the future. By component, the main player continues to be private consumption which grew by 3.8% year-to-year. Investment is taking something of a breather although housing remains very strong. The foreign sector was worse compared with the second quarter because of the drop in exports but, although down, it again made a positive contribution to growth. However, we can expect further worsening of the trade deficit because of replacement of inventory levels.

Government spending up, more under local authorities than for defence.

Special mention should be made of public consumption and investment. Public consumption, which is more inflationary, is growing by 7.2% year-to-year in current dollars and has been locked into a growth pattern since the end of 2003. We should not look for the causes either in the effects of hurricane *Katrina*, still not being fully reflected, or in military spending for the war in Iraq, which has been easing off since the sharp increases in preparation for the war which hit a peak in mid-2003 with the fall of Saddam Hussein. The fact is that since 2004 spending by local and state levels of government has been increasing its contribution to growth thus taking top place away from military spending. This is a contribution now reaching levels seen in 2001 when the public sector was propping up an economy in difficulties, a situation quite different from that today.

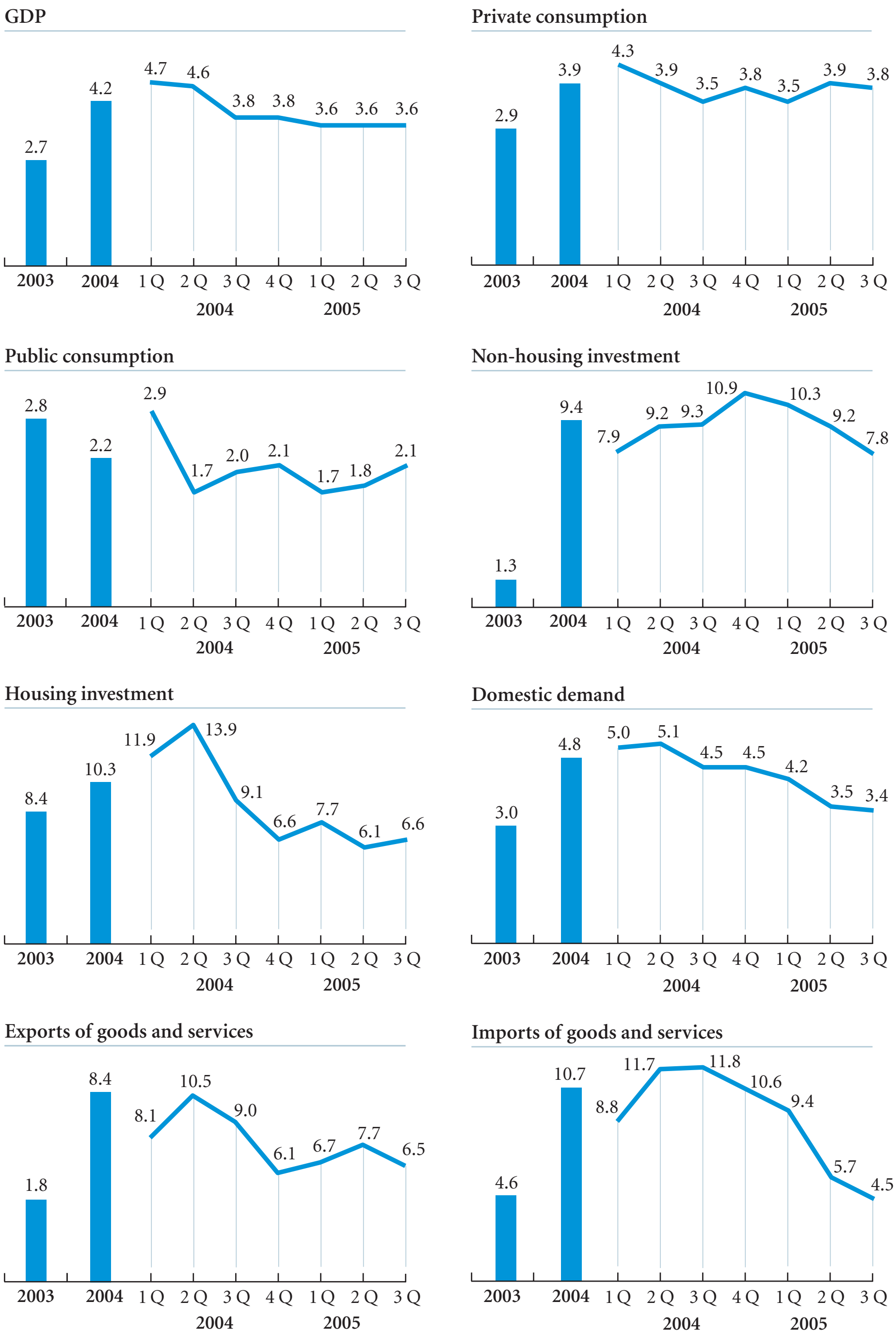
Spending cuts fail to find support in Congress.

On top of increased government spending comes the Bush Administration's plan for tax cuts. Weakened by the poor view taken of its response to hurricane *Katrina* and cases of corruption, the Administration contributed to Republican party defeats in New Jersey and Virginia. All of this, in turn, took away strength and support from the Republican party which meant that proposals for a reduction in social services spending were rejected by Congress. Without this reduction in spending, the tax cuts, while popular, are unsustainable and in fact it is the public sector which contributes half of the current account deficit. In this respect, the director of the International Monetary Fund, Rodrigo Rato, stated that if the fiscal imbalance was not controlled the consequences could be serious.

On the demand side, retail sales in October continued to show off their undeniable strength. Clothing,

TREND IN UNITED STATES GDP BY COMPONENT

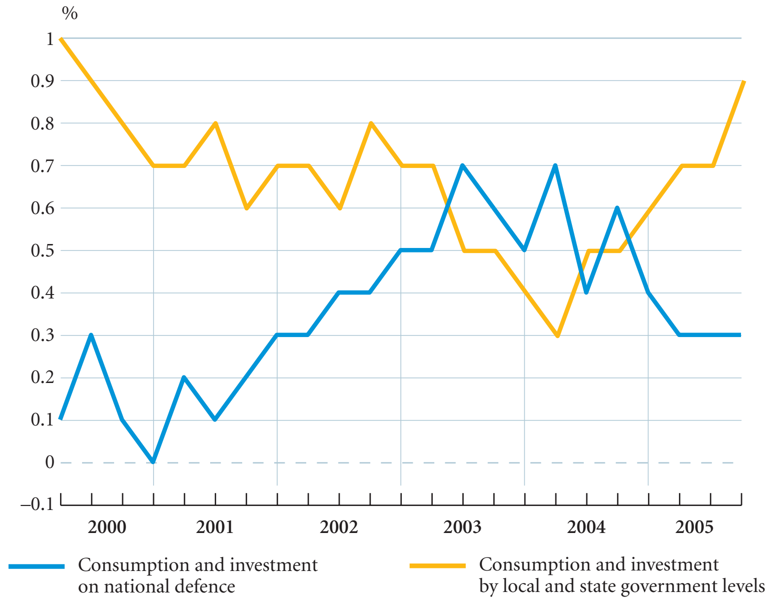
Percentage year-to-year change in real terms



SOURCE: Bureau of Economic Analysis and internal figures.

UNITED STATES: SPENDING BY LOCAL AUTHORITIES TAKES PLACE OF DEFENCE

Contribution to year-to-year growth of nominal GDP



SOURCE: Bureau of Economic Analysis and internal figures.

Consumption main player in growth.

Business executives optimistic.

Housing construction giving support to consumption, for the moment.

department store sales and home goods were the strongest components while cars continued a downturn. This is a crisis which showed up in poor profits by Ford and General Motors. GM, whose share of the US market dropped from half in 1980 to only a quarter today, could lay off 30,000 employees and lose its position as the world's leading car-maker to Toyota. Its models are not now selling as they used to do because of high fuel consumption and lack of attractive style, and they are being sold for their low prices, with very narrow margins, so that any drop in volume has disastrous effects on profits. On the positive side, the drop in fuel sales over September indicates some return to normalcy. In keeping with the current good situation, the big chains are expecting a good Christmas retail sales season. In spite of such forecasts, the Conference Board confidence index in October did not improve the already weak level seen in September. The fact is the consumer has not yet regained confidence, perhaps recalling that now not-so-correct saying that what is good for General Motors is good for the United States.

On the supply side, industrial production showed some recovery but the growth rates still remain low. Nevertheless, business executives are enjoying higher confidence than consumers, if we are to go by the manufacturing activity index of the Institute of Supply Management for October. Both in manufactures and services, the optimists have once more clearly predominated over the pessimists.

The housing sector at this time continues to be one of the key supports of the US economy. While the price of existing homes rose by 14.1% year-to-year in September, sales did not slacken but rose by 7.2%. It is significant that, for the moment, there are no reductions in the size of homes but rather the opposite. In contrast to the situation in Spain, prices are not expressed in square

UNITED STATES: DEPARTMENT STORES OPTIMISTIC

Retail sales in department stores, year-to-year change (*)

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

metres but by home acquired so that if one buys smaller homes, prices go up less. Even so, some observers see signs of a slowdown in the market basing this on the fact that housing starts in October were down by 2.3% year-to-year. Nevertheless, in view of the trend in prices and sales it is still early to speak of any real slowdown in the sector.

Employment is another variable moving ahead strongly. Some 56,000 new jobs were created in October. The increase was less than expected but was compensated by the practical wiping out of the loss initially observed in September. The fact is that today the employed group is 1.4% higher than one year ago and the effects of hurricane *Katrina* on employment have been practically nil. Wages in October recovered 0.4% in purchasing power over September but the situation is still one of containment, aided by low immigrant-worker wages, with increased immigration in recent months. On the quite positive side comes the good figure for labour productivity which rose by 3.0% year-to-year in the third quarter, a fact that helps round out the anti-inflationary nature of the US labour market.

Employment remains strong while productivity growing.

Inflation in October was down from 4.7% to 4.3% year-to-year because of the relative easing of energy prices. The underlying component, which excludes energy and foods and represents a more reliable guide to the general trend, was practically unchanged at 2.0%. Producer prices continued a similar course dropping from 6.9% to 5.9%. We should mention that it is the underlying components that are setting the trend, a situation very different from that in the Seventies when all prices ended up following the energy component. Energy, which continues to have an undeniable strategic importance, has undergone a gradual reduction in relative weight in private consumption since the mid-Eighties. If we add onto this monetary policies, the change in inflationary expectations and the effects of globalization, we can understand the

Inflation moderates with easing of energy prices.

UNITED STATES: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005					
			3 Q	4 Q	1 Q	2 Q	July	August	September	October
Real GDP	2.7	4.2	3.8	3.8	3.6	3.6	–	3.6	–	–
Retail sales	4.3	7.3	6.4	8.3	7.3	8.4	10.3	8.2	6.6	5.7
Consumer confidence (*)	79.8	96.1	100.4	96.1	104.2	102.3	103.6	105.5	87.5	85.0
Industrial production	0.6	4.1	4.6	4.3	4.0	3.1	3.1	3.0	1.7	1.9
Industrial activity index (ISM) (*)	53.3	60.5	60.1	57.5	55.6	52.8	56.6	53.6	59.4	59.1
Sales of single-family homes	11.7	10.0	–0.4	10.8	5.1	6.9	22.6	2.7	–0.1	...
Unemploymenr rate (**)	6.0	5.5	5.4	5.4	5.3	5.1	5.0	4.9	5.1	5.0
Consumer prices	2.3	2.7	2.7	3.4	3.0	2.9	3.1	3.6	4.7	4.3
Trade balance (***)	–532	–651	–608	–651	–686	–709	–716	–723	–738	...

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

reduced sensitiveness of the general level of prices to energy prices.

Foreign deficit worsens because of weak exports.

The trade deficit again marked up new highs going above 738 billion dollars in the 12 months ended in September. Imports are recovering, not only because of the buying of still high oil, but because of the logical need to keep replacing inventory levels which in recent months had dropped notably. At the same time, and this is something quite serious, exports have now dropped.

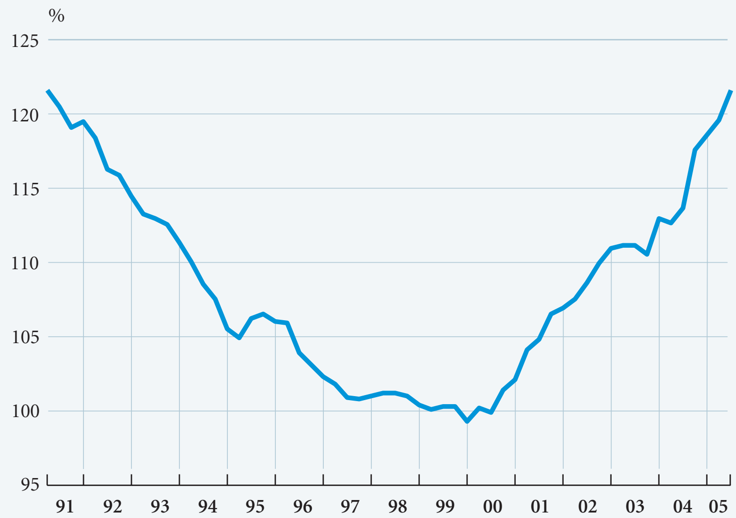
Rational exuberance and three communicating vessels

It is said that Americans usually do things on a grand scale. Lately, they are also said to be somewhat exuberant, in the celebrated phrase of Alan Greenspan, the outgoing chairman of the Fed. Grandeur and exuberance sound like clichés but they well describe the current situation of the world economic engine which is growing at 3.8%. The US consumer, unjustly characterized as a gobbler of hamburgers with extravagant tastes, is contributing three-quarters of this growth and, furthermore, is compensating compulsive savers in other parts of the world. We may ask if this exuberance in spending is rational and whether a change in economic conditions could alter the existing imbalances.

No single factor alone explains everything, but the rise in the price of housing, pushed up by until-now low interest rates, could shed some light. A real-estate sector on the rise aids general growth through three communicating vessels. Investment spending in housing stimulates activity in other sectors; secondly, because of the wealth effect, the high price of housing gives confidence to consumers; and, thirdly, the refinancing of mortgages with lower rates means an injection of liquidity for households. The fact is that, until now, these three communicating vessels have been flowing at a higher than normal level.

UNITED STATES: HOUSING PRICES AGAIN HIGH

Housing prices in terms of nominal GDP (1999 = 100)

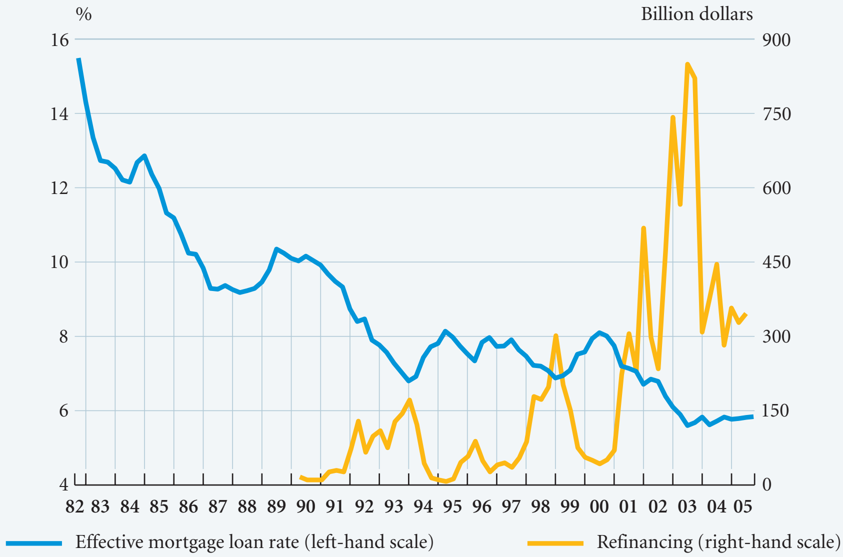


SOURCE: Office of Federal Housing Enterprise Oversight, Bureau of Economic Analysis and internal figures.

Investment in housing not only represents 6% of the GDP in current terms, the highest in the past 50 years, but makes up 9.1% of GDP growth. Prices in the second quarter of 2005 grew by 13.4% and, in some key areas such as the New York conurbation or California, the increase came to 17.6% and 21.5% respectively. Since 1999, prices have risen 21% more than the GDP. Far from stopping, sales of existing housing are even moving up firmly, a clear sign of the strength of the market. The third communicating vessel, refinancing, involves new mortgages which, taking advantage of lower interest rates, increase the amount of funds lent without greatly increasing the regular payment. The increase is not to buy more housing but for consumer spending. In the second quarter of 2005, according to the Mortgage Bankers Association, half the amount lent on mortgage was for refinancing transactions which, although its highs are over, meant 11% of the GDP and 16% of consumer spending. With such a flow, the engine of consumption still seems to have lots of fuel.

In the light of such all-time highs, are we faced with an irrational phenomenon? The reply is "No". Investment in housing has taken the place of investment in the new technology field which went from a period of very high levels to a stock market crash. It is not extraordinary that housing has thus been an attractive alternative investment. The prices of such assets are not towers of Babel which must inexorably topple and, furthermore, are the result of the double success of banking efficiency and low interest rates, fruit of the victory over inflation. In the early Eighties, in order to buy a flat you had to pay bank fees to open a mortgage of 2.5% of the capital lent while now it is only a seventh of that. Mortgage loan interest has gone from 16% to 6%. If we also consider the increase in the average repayment term, mortgage instalments in real terms have gone up by only a moderate 10% since 1999 and are 14% lower than the highs in 1989 and 20% lower than in 1982. Refinancing of mortgages evidently increases household debt but in the United States some 73% of mortgage loans granted are at fixed rates, in contrast to the situation in Spain, where variable rates predominate. Looked at in this light, things are not so inclined to make one reel.

LOW INTEREST RATES ENCOURAGE REFINANCING



SOURCE: Federal Housing Finance Board, Mortgage Bankers Association and internal figures.

The exuberance is therefore rational but the problem is that just one variable can simultaneously cut off the flow of the three communicating vessels and this is the interest rate. With higher interest rates, the well of refinancing would dry up. Furthermore, today the sensitivity of mortgage payments to interest rates is high. An increase of 1% in rates would raise repayments on new home purchases by 11%, would not create defaulters among those who already enjoyed fixed rates but sales and prices would suffer. With higher financial costs and lower prospects of appreciation, investment in housing would also be affected.

Without such spirit, with households unable to save and facing repayment of debt contracted, now at an all-time high of 14% of disposable income, consumption would have few trump cards and so would growth. It should be remembered that the outstanding balance of mortgage loans is nearly equal to corporate debt, something which has never before happened. And, if the lights go out in the United States, many others could also suffer. Up to now, mortgage rates have not been greatly affected by the successive increases by the Federal Reserve but this could now be beginning to change as shown by the weak signs of moderation in early indicators, such as housing starts. The exuberance is rational but this does not mean that it is without risk. The risk of growth today lies in its extraordinary dependence on the interest rate.

Japan renews its recovery but not its prices

Hidenao Nakagawa, political leader of the governing Liberal Democratic party, recently had a bitter argument with Toshihiko Fukui, governor of Japan's central bank, over the latter's plans to curtail the country's easy monetary policy. The fact is that Nakagawa is more doubtful than Fukui about the strength of growth, doubts also shared by prime minister Koizumi. Of the two, it is hard to know who is right. Japan's situation is certainly unusual in recent history and this applies to any observer.

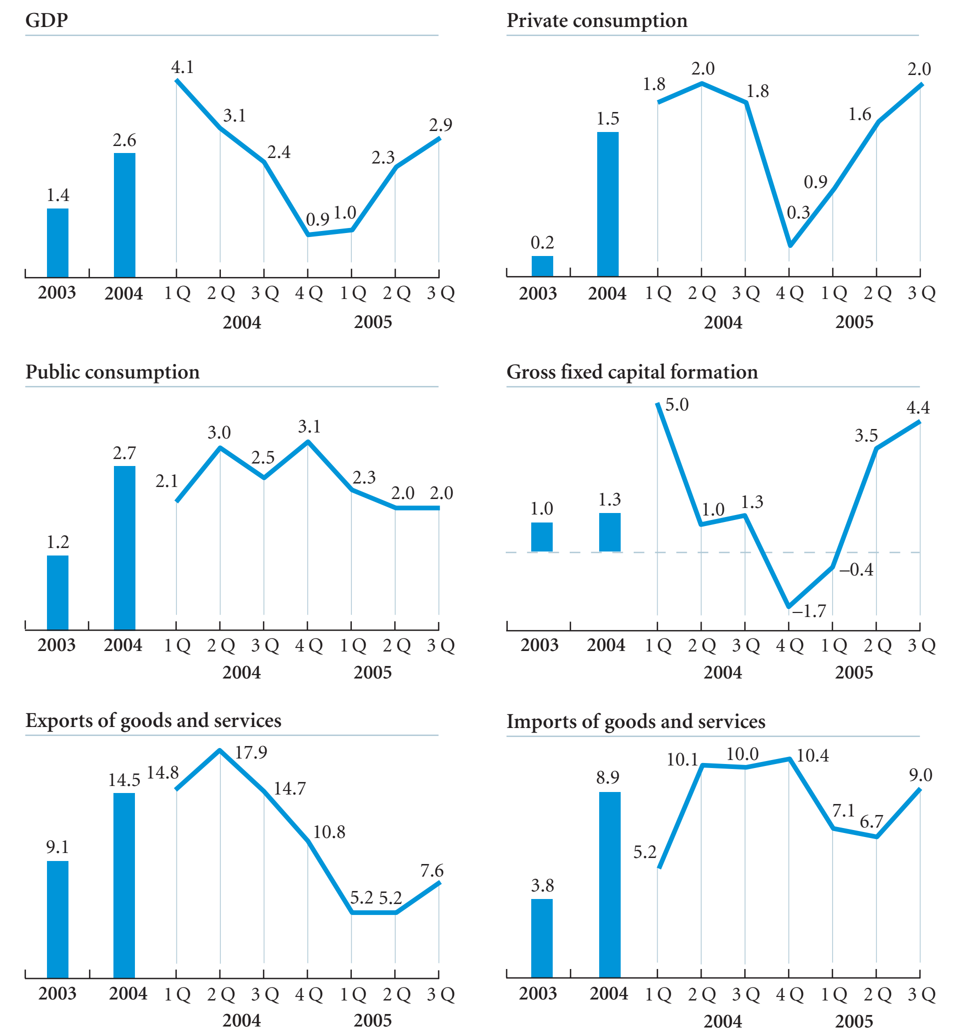
Domestic demand comes out more and more as the main engine of growth but at the same time the drop in prices continues, something which precisely should discourage that demand.

In spite of such discussions, Japan's economy grew by 2.9% year-to-year in the third quarter, helped along by private consumption and investment. But the foreign sector, the traditional engine driving the economy, again took strength away from growth. The recovery of growth, however, has its Achilles' heel in prices. The GDP deflator dropped by 1.2% in year-to-year terms and thus helped to put annualized nominal growth over the previous quarter at a mere 0.7%. Decreasing prices encouraged the putting off of purchases seeing that things would be cheaper in the future. The robust trend in private consumption is therefore surprising. The central bank feels that at the end of the year prices will then be rising although the trend in the GDP

Japan showing more and more solid recovery with growth at 2.9%... but deflation persists.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-to-year change in real terms



SOURCE: Economic and Social Research Institute and internal figures.

Retail sales easing off.

deflator is making this more and more difficult.

In spite of the good GDP figures, the latest demand indicators do not point to strong growth. Retail sales are down, with September practically repeating the figures for the same period last year although not really breaking the upward trend. In keeping with this low profile, car sales were down in October for the fourth consecutive month. The picture is a long way from that of an economy in full swing.

Housing up in Tokyo.

Machinery orders growing but industrial production weak.

On the supply side, the sparkle is somewhat brighter. Machinery sales recovered strongly in September with growth of 17.6% year-to-year although the figure is somewhat distorted by the explosive recovery in foreign orders under the effect of large unique commissions such as ships and trains. Industrial production rose but is still progressing at very moderate levels. Nor were corporate bankruptcies especially bright in October with a rise over September although the positive trend is being maintained.

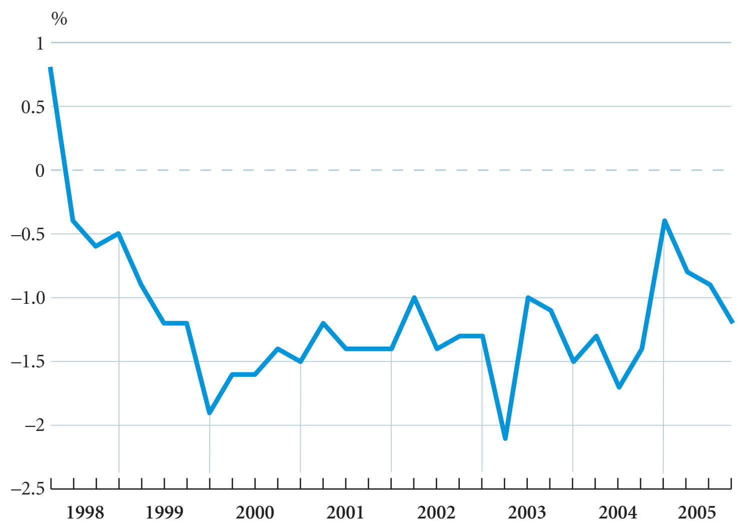
The housing market certainly is being coherent with the strength seen in the national accounts. Housing sales in Tokyo were up again in October with growth of more than 20% year-to-year for the third consecutive month. While prices and housing starts are following a gentler trend in the rest of the country, the forecast is for sustained recovery.

Deflation refuses to go away.

In the difficult area of inflation, prices were again down dropping by 0.3% year-to-year in September. The immediate future does not offer any bright prospects given that prices in Tokyo (an early indicator for the general index) were also down by 0.9% in October. In the labour market things are turning out better. The unemployment rate was down to 4.2% of the labour force in September, something which has not happened since 1998, with 1.2% more non-farm jobs than in the same period last year.

JAPAN: LONG DEMISE OF INFLATION TROUBLING

Year-to-year change in GDP deflator



SOURCE: Japanese Ministry of Communications, National Statistics Office and internal figures.

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	September
Real GDP	1.4	2.6	3.1	2.4	0.9	1.0	2.3	–	2.9	–
Retail sales	–1.7	–0.9	–1.7	–0.5	–0.4	1.1	3.2	0.6	1.6	0.1
Industrial production	3.3	5.3	7.8	6.6	1.6	2.7	0.3	–1.1	0.3	1.3
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	–0.2
Unemployment rate (**)	5.2	4.7	4.6	4.8	4.6	4.6	4.3	4.4	4.3	4.2
Consumer prices	–0.3	0.0	–0.3	–0.1	0.5	–0.2	–0.1	–0.3	–0.3	–0.3
Trade balance (***)	12.0	13.7	13.7	14.1	13.7	13.3	12.2	11.8	11.2	10.9

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

Japan's trade surplus continued to drop in September with exports which, while they have been hitting bottom, still have not found the right road.

Trade surplus not growing.

Brazil growing but dangers lay ahead

Brazil's economy is growing by 3.7% year-to-year with inflation well under control. Up to the present, the corruption crisis the country is going through has not been affecting the economy. Nevertheless, this could change following recent pressure for the resignation of finance minister Antonio Palocci, the person responsible for the fight against inflation and outspoken supporter of the austerity programme of Lula's government. Not only is economic stability in the balance but also interest on the foreign debt.

Political crisis in Brazil ends up affecting economic stability.

Latest monthly demand indicators suggest that levels of economic activity are being maintained. Retail sales are holding up with growth of 5.6% year-to-year in the third quarter, an

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005					
			3 Q	4 Q	1 Q	2 Q	July	August	September	October
Real GDP	0.5	5.0	6.0	4.7	3.1	3.7	–	...	–	–
Industrial production	0.1	8.3	10.4	6.3	3.9	6.1	0.5	3.8	0.2	...
Unemployment rate São Paulo (*)	19.9	18.8	18.2	17.4	17.0	17.5	17.5	17.1	16.9	...
Consumer prices	17.0	6.3	6.3	5.9	6.0	6.6	5.5	5.0	5.0	5.4
Trade balance (**)	24.8	33.7	32.1	33.7	35.9	38.3	39.9	40.1	41.3	41.9

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

Retail sales holding up but stagnation in industrial production poor sign.

improvement over the previous period. Nevertheless, car sales have now been stagnant for two months, undoubtedly affected by oil prices.

On the supply side, the dark clouds are in the ascendancy with industrial production in September practically repeating the figures for the same period last year and showing a drop for the third quarter as a whole with very modest growth of 1.5%. Given the correlation of this indicator with the GDP, the prospects are not overly brilliant. Industrial production of capital goods also followed a similar pattern with a clearly downward trend, something especially troubling in view of the country's great need for investment.

Inflation under control but unemployment still high.

On the positive side, inflationary pressures continue under control with prices growing by 5.4% year-to-year in September, a very good sign for Brazil's economy. While unemployment continues to drop, going to 16.9% of the labour force in September, the slow rate of decrease is putting pressure on the government as well as on the position of Palocci, the great defender of price stability.

Trade surplus growing but direct investment comes to halt in September.

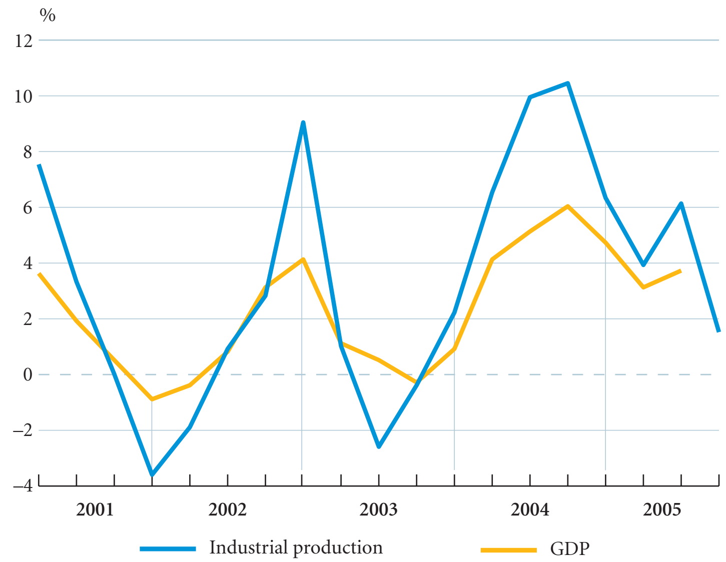
Brazil's foreign sector continued full-steam-ahead in September with a surplus in the trade balance close to 42 billion dollars, the highest on the Latin American continent. Nevertheless, direct investment dried up completely in September, perhaps reflecting the first effects of the political crisis.

Argentina maintaining strong demand

Argentina's economy is managing to maintain a high growth rate which is taking it above the levels of economic activity seen before the 2002 crisis. In spite of growth in demand, the trade surplus is being maintained. The biggest risk for Argentina's economy lies in

BRAZIL: WEAK INDUSTRIAL PRODUCTION BAD OMEN

Year-to-year change in industrial production and GDP in real terms



SOURCE: IPEA and internal figures.

Argentina maintaining sharp growth.

growing inflation. This is affecting macroeconomic stability and interest on its debt. In this context, a notable event was dismissal of Minister of Economy Roberto Lavagna, the man behind economic recovery since 2002 and up to now the main spokesman before the International Monetary Fund.

Retail sales move up sharply.

In any case, demand indicators continue to show clear signs of the vigorous recovery of the economy with retail sales moving up 27.0% year-to-year in September. Sales of supermarket chains continue to rise while car sales are even growing by more than 30%.

Supply indicators are also continuing to show a considerable level of economic activity. Industrial production was up 6.1% year-to-year in September which points to a continuation of growth. The mining and metals industry were again the most active sectors while steel

ARGENTINA: MAIN ECONOMIC INDICATORS

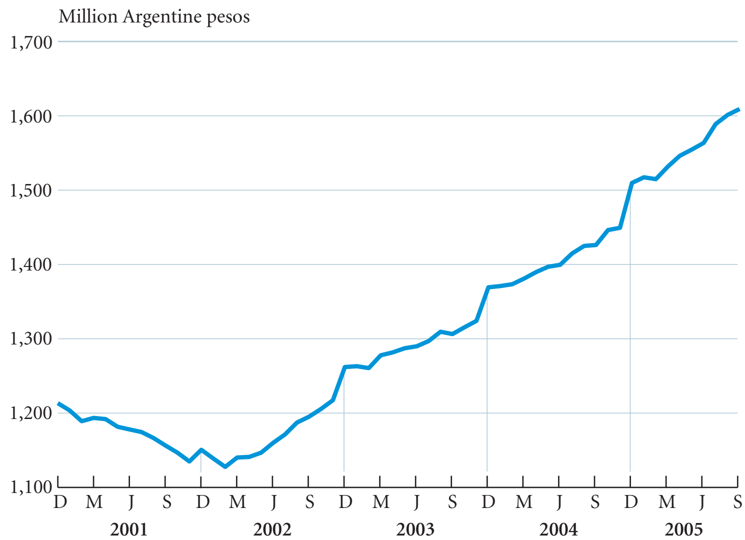
Percentage change over same period year before unless otherwise indicated

	2003	2004	2004		2005					
			3 Q	4 Q	1 Q	2 Q	July	August	September	October
Real GDP	8.8	9.0	8.7	9.3	8.0	10.1	–	...	–	–
Industrial production	12.6	7.5	8.3	7.0	8.0	6.1	8.0	5.5	6.1	...
Unemployment rate (*)	17.3	13.6	13.2	12.1	13.0	12.1	...	11.1	...	...
Consumer prices	13.4	4.4	5.4	5.7	8.2	8.8	9.6	9.7	10.3	10.7
Trade balance (**)	15.7	12.1	12.6	12.1	11.9	11.0	11.2	11.4	11.5	...

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

ARGENTINA: DEMAND CONTINUES TO GROW

Retail sales in supermarket chains (*)



NOTES: (*) Cycle-trend series.
SOURCE: INDEC and internal figures.

Industry growing and employment continues recovery.

Inflation, close to 11%, presents increasing risk.

Trade surplus holds up through strong exports.

continued to drop. In 2005, the industrial activity index, with an increase of 8.6%, has been showing a growth trend which exemplifies the continuation of recovery.

The unemployment rate in the third quarter dropped to 11.1% thus continuing the recovery of the labour market which still is showing high levels of under-employment. Wages have also been increasing all through 2005, giving support to demand but also bringing about some risk of inflation.

In this respect, consumer prices continue to rise and now present a serious risk for macroeconomic stability. In September, inflation moved up to 10.7% year-to-year. These increases should not be attributed so much to import and energy prices as to primary domestic goods. Even if we take into account Argentina's special situation, with its faster than initially expected recovery, rising inflation at this moment is the country's weakest point.

The trade balance continued to provide reason for satisfaction, seeing that it has been maintaining its surplus levels with exports (largely concentrated in farm products) moving ahead at more than 38%. As a result, the growth in exports is compensating for imports which are also moving up as a result of strong domestic demand.

EUROPEAN UNION

European Commission forecasts: limited recovery

First the history. After having recorded the highest growth in four years in 2004, the European Union (EU economy) went into a slump in the first half of 2005 when the gross domestic product (GDP) scarcely showed an average advance of 1.4%. Behind this poor performance we find the usual culprit, the persistent slack in domestic demand.

From this point on, in its autumn forecasts the European Commission is expecting progressive recovery which will make possible growth of 2.1% in the EU in 2006 and 1.9% in the euro area with a further increase in 2007 to 2.4% and 2.1% respectively. This implies that the European economy in 2006 and 2007 will stand above the potential growth estimated by the European Commission itself which underlines the difficulties of the European economic model to reach sustainable rates of economic activity in line with other large world economies, such as the United States and China.

Following slowdown in first half of 2005, European Commission predicts progressive recovery with European Union growing above 2% in 2006 and 2007...

On what is this scenario based? The European Commission identifies maintenance of a very accommodating economic policy as the main factor behind recovery combined with the easy monetary policy of the European Central Bank (ECB) and a fiscal policy far from restrictive. In this respect, the reduction of the government deficit in the euro area, scarcely equivalent to one decimal of the GDP, comes almost entirely from the

MACROECONOMIC PROJECTIONS FOR EURO AREA (1)

Autumn 2005

			Current forecasts Autumn 2005			Difference with Spring 2005 (2)	
	2003	2004	2005	2006	2007	2005	2006
Gross domestic product	**0.7**	**2.1**	**1.3**	**1.9**	**2.1**	**–0.3**	**–0.2**
Consumption	1.1	1.6	1.4	1.4	1.9	–0.2	–0.4
Investment	0.9	2.3	1.7	3.1	3.2	–1.1	–0.6
Employment	0.3	0.7	1.0	1.2	1.1	0.3	0.3
Unemployment rate (3)	8.7	8.9	8.6	8.4	8.1	–0.2	–0.1
Inflation (4)	2.1	2.1	2.3	2.2	1.8	0.4	0.7
Government balance (% of GDP)	–3.0	–2.7	–2.9	–2.8	–2.8	–0.3	–0.1
Government debt (% of GDP)	70.4	70.8	71.7	71.7	71.8	0.0	–0.2
Current account balance (% of GDP)	0.5	0.6	0.0	–0.1	–0.1	–0.6	–0.7
Growth of GDP in EU-25	*1.2*	*2.4*	*1.5*	*2.1*	*2.4*	*–0.5*	*–0.2*

NOTES: (1) Annual change as percentage unless otherwise indicated.
(2) Plus sign (+) or minus sign (–) indicates a higher (or lower) positive figure or lower (or higher) negative figure compared with Spring 2005.
(3) Percentage of labour force.
(4) Harmonized consumer price index.
SOURCE: European Commission.

...thanks to positive combination of factors: easy money policy, favourable international climate, good corporate profits, propitious financing conditions and low exchange rate.

increase in growth rate without implying any budgetary adjustment.

A second factor that will act as an aid to recovery is the positive trend in the world economy. While some slowdown in overall growth compared with the exceptional rate seen in 2004 is expected, the world economy in 2005 and 2006 will even go above 4% while international trade will increase by more than 7% in both years which will benefit the exporting economies of the European Union.

Finally, other factors will create a favourable framework for economic growth: the satisfactory trend in corporate profits, easy financing conditions and some containment of the exchange rate (in effective nominal terms) which will aid exports.

On risk side, high oil prices still loom as main threat although inflation trend not being notably affected.

Some threats could, however, alter the outcome of this relatively optimistic scenario. The most evident is the increase in oil prices. The European Commission is not expecting any substantial change on this front. Following 45% growth of the per barrel price in 2005, putting the annual average at 55 dollars, in 2006 there will be a further rise of 12% so that the price will be 61.4 dollars on average for the year. In 2007, this will scarcely change with the price going to 60.3 dollars a barrel.

The effect of this process on prices in any case will be moderate due to the fact that this is not shifting to higher expectations on inflation on the part of economic players. As a result, inflation in the euro area will go from 2.3% in 2005 to 2.2% in 2006 and 1.8% in 2007. A similar trend will be seen in the European Union as a whole going from 2.3% in 2005 to 1.9% in 2007.

Finally, a brief review by country would be useful in order to compare the

MACROECONOMIC FORECASTS OF EURO AREA COUNTRIES

Autumn 2005

	GDP (*)			Inflation (**)			Unemployment (***)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Belgium	1.4	2.1	2.0	2.7	2.6	1.9	8.0	7.9	7.8
Germany	0.8	1.2	1.6	2.0	1.6	1.1	9.5	9.3	9.1
Greece	3.5	3.4	3.4	3.5	3.1	3.0	10.4	10.0	9.7
Spain	3.4	3.2	3.0	3.6	3.3	2.6	9.2	8.5	8.1
France	1.5	1.8	2.3	2.0	2.1	1.9	9.6	9.3	8.9
Ireland	4.4	4.8	5.0	2.2	2.5	2.4	4.3	4.4	4.5
Italy	0.2	1.5	1.4	2.2	2.1	1.9	7.7	7.6	7.5
Luxembourg	4.2	4.4	4.5	4.1	4.4	2.2	5.3	5.6	5.8
Netherlands	0.5	2.0	2.4	1.7	2.0	1.9	5.1	4.9	4.2
Austria	1.7	1.9	2.2	2.2	2.1	1.7	5.0	5.0	5.1
Portugal	0.4	0.8	1.2	2.2	2.7	2.2	7.4	7.7	7.8
Finland	1.9	3.5	3.1	1.0	1.4	1.3	8.4	7.8	7.2
Euro area	**1.3**	**1.9**	**2.1**	**2.3**	**2.2**	**1.8**	**8.6**	**8.4**	**8.1**

NOTES: (*) Percentage real change.
(**) Percentage change in harmonized consumer price index.
(***) Percentage of labour force.
SOURCE: European Commission.

MACROECONOMIC FORECASTS FOR EU COUNTRIES OUTSIDE EURO AREA

Autumn 2005

	GDP (*)			Inflation (**)			Unemployment (***)		
	2005	2006	2007	2005	2006	2007	2005	2006	2007
Czech Republic	4.8	4.4	4.3	1.7	2.9	2.6	7.9	7.5	7.4
Denmark	2.7	2.3	2.1	1.7	2.0	1.9	4.6	4.2	4.0
Estonia	8.4	7.2	7.4	4.1	3.3	2.6	7.2	6.0	5.4
Cyprus	3.9	4.0	4.2	2.3	2.1	2.1	4.9	4.8	4.6
Latvia	9.1	7.7	7.1	6.8	6.0	4.8	9.7	9.4	9.3
Lithuania	7.0	6.2	5.8	2.6	2.8	2.9	9.0	8.1	7.5
Hungary	3.7	3.9	3.9	3.7	2.0	3.0	7.0	6.9	6.7
Malta	0.8	0.7	1.1	3.1	2.6	2.2	7.2	7.1	7.1
Poland	3.4	4.3	4.5	2.2	2.3	2.5	17.8	16.8	15.5
Slovenia	3.8	4.0	4.2	2.6	2.5	2.5	5.8	5.7	5.6
Slovakia	5.1	5.5	6.3	2.9	3.6	2.1	16.7	16.2	15.8
Sweden	2.5	3.0	2.8	0.7	1.4	1.8	6.8	5.9	5.6
United Kingdom	1.6	2.3	2.8	2.4	2.2	2.0	4.6	4.9	4.7
EU-25	**1.5**	**2.1**	**2.4**	**2.3**	**2.2**	**1.9**	**8.7**	**8.5**	**8.1**
EU-15	**1.4**	**2.0**	**2.2**	**2.3**	**2.2**	**1.9**	**7.9**	**7.7**	**7.4**
United States	*3.5*	*3.2*	*2.7*	*3.3*	*2.9*	*2.2*	*5.1*	*5.0*	*5.3*
Japan	*2.5*	*2.2*	*1.8*	*–0.2*	*0.3*	*2.0*	*4.5*	*4.2*	*4.2*

NOTES: (*) Percentage real change.
(**) Percentage change in harmonized consumer price index, except United States and Japan, in which cases it is national consumer price index.
(***) Percentage of labour force.
SOURCE: European Commission.

notable differences in growth taking place within the European Union. In 2006, three of the four large EU economies (Germany, France and Italy) will grow below the EU average which, it will be remembered, will stand at 2.1%. The British economy, the fourth largest, will beat this by scarcely two decimals. Spain, in turn, will go above 3% in 2006. Standing within the high range of growth, along with Ireland, will be most of the new member state economies with Latvia showing the highest GDP growth rate in the EU at 7.7%.

Low growth continuing in Germany, France and Italy with UK scarcely higher, all far below Spain which will go above 3% growth in 2006.

Euro area: positive surprise in third quarter

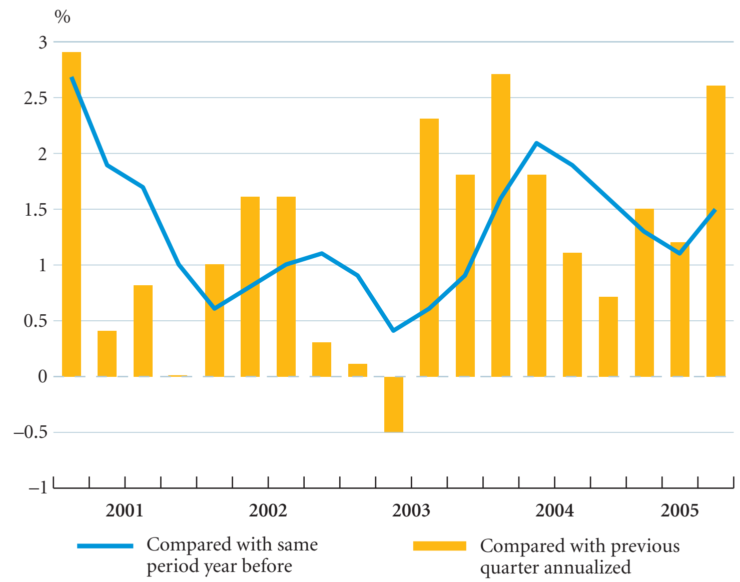
For some months everything has pointed to increased economic activity in the third quarter. The figures have not failed to come through. As a result of better than expected growth in Germany and France, the increase in the GDP in the euro area in the third quarter reached 1.5% year-to-year, four decimals above the rate in the second quarter. In quarter-to-quarter rates annualized, which are of most use for detecting the most recent trend, the increase in growth is even more visible, given that it went from 1.2% in the second quarter to 2.6% in the third quarter.

In the absence of a breakdown by component, latest available indicators provide information on what factors lie behind European recovery. In keeping with the disappointing trend in consumption indicators, with retail sales growing by only 0.6% in the third

Euro area giving first clear signs of coming out of slump: third quarter growth at 1.5%, considerably higher than expected.

GROWTH MOVING UP IN EURO AREA

Change in gross domestic product in real terms



SOURCE: Eurostat and internal figures.

Behind good result lies recovery in investment and acceptable state of exports.

quarter and consumer confidence not improving in one whole year, household consumption has not been a determining factor in the growth of economic activity.

On the other hand, the improved relative performance in investment, which may be taken, for example, from the more positive situation in the capital goods component of industrial production in the third quarter (growth of 2.1% year-to-year, thus consolidating the increase in the first half of 2005), would have been one of the factors operating as an engine of growth.

The trend in the foreign sector is less clear. While exports have not performed badly in recent months (increase of 9.3% year-to-year in the third quarter), the increased strength in imports (year-to-year increase of 14.1% in the third quarter) may have more than compensated the increase in exports.

Growth benefiting all main economic activity sectors with recovery in industry and services now being joined by construction.

While the current situation in demand is confirming recovery, supply indicators show that growth is benefiting production sectors as a whole. Industrial production has thus consolidated its trend to recovery showing growth of 1.3% year-to-year in the third quarter, a figure above the 0.5% for the April-June period.

Services are also recording a higher rate of economic activity. The tertiary sector confidence indicator stood at the 14.5 points level in October, the highest figure since July 2001. Construction may also be moving into a stronger growth path if there is confirmation of recovery in the sector confidence indicator which stood at the –8 level in October as against –9.5 points in the third quarter.

Fewer new developments are to be seen on another two relevant fronts, namely prices and the labour market. With regard to the former, the harmonized consumer price index (HCPI) grew by

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	October
GDP	0.7	1.8	1.9	1.6	1.3	1.1	–	1.5	–	–
Retail sales	0.4	0.9	0.8	1.1	1.1	0.6	–0.3	1.3	0.9	...
Consumer confidence (*)	–18	–13.8	–14	–13.0	–13.2	–14.4	–15	–15	–14	–13
Industrial production	0.3	2.0	2.7	1.1	0.5	0.5	0.6	2.7	1.0	...
Economic sentiment indicator (*)	93.3	99.9	100.5	100.9	99.0	96.3	97.5	97.8	98.6	100.5
Unemployment rate (**)	8.7	8.9	8.8	8.8	8.8	8.7	8.5	8.5	8.4	...
Consumer prices	2.1	2.1	2.2	2.3	2.0	2.0	2.2	2.2	2.6	2.5
Trade balance (***)	80.3	80.2	84.5	72.9	64.2	50.6	43.1	38.5	37.4	...

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

2.5% year-to-year in October, a mere one decimal less than in September. While practically the entire increase in prices arises from energy (if this is discounted, the resulting rate is 1.5%, in line with figures for previous months), the fact is that current levels are clearly higher than the reference figure which the ECB considers indicative of price stability (2% year-to-year).

Consumer prices stay above ECB reference at high 2.5% year-to-year in October while labour market continues to show no appreciable signs of improvement.

With regard to the labour market, the lack of substantive improvements in unemployment and the poor rate of job creation continue to be characteristic factors. In September, the unemployment rate stood at 8.4% of the labour force, one decimal less than in August, while employment in the second quarter grew by 0.7% year-to-year, offering no change over the previous quarter.

Germany: new government coincides with recovery

Germany now has a new chancellor, Angela Merkel, whose investiture took place in the Bundestag on November 22, a new government with 8 ministers from the Social Democratic party and 7 ministers from the Christian Democratic and Social Christian parties as well as the post of chancellor, and a new agreement ensuring lasting government during the legislative period. This was the result of nearly two months of negotiation which, in the economic sphere, had the single purpose of hauling Germany out of recession and establishing the bases for improved future growth.

Investiture of Angela Merkel as chancellor ends difficult negotiations on economic programme.

It is to be seen whether the economic programme of the new government represents a decisive support for fully consolidating the recovery already underway and guarantees reforms of sufficient significance to ensure future competitiveness of the German economy while, at the same time, removing the bottlenecks it faces, especially the ageing of the population and modernization of the welfare state. Is this the economic package Germany needs in order to resolve its problems?

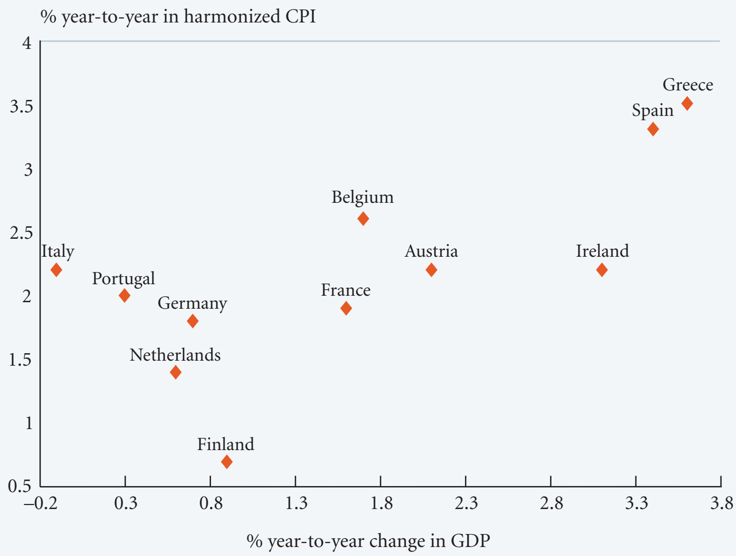
The legislative agreement reached on November 11 and confirmed by the extraordinary congress of the SPD (Social Democrats) and the CDU/CSU

One for all and all for one

Last June, the Liga Norte, one of the parties of the Silvio Berlusconi coalition, proposed that Italy break away from the euro and return to the former Italian lira linking it to the dollar. The proposal was immediately rejected on practically all sides and was attributed to the breakaway and extravagant nature of this party. However, many people must have felt that outside the euro, that is to say, without the rigidity and conditions composed by belonging to the single currency, Italy's economic situation would not be as disastrous as it is now. The fact is that those countries in the euro area with low growth want lower interest rates, a weaker currency and greater margin for manoeuvre in fiscal terms, whereas those countries with higher growth would be happier with the opposite. In fact, there are notable differences in GDP growth rates and inflation rates among members of the euro area, as may be seen in the accompanying graph. This lack of conformity in the economic cycles of the various countries presents notable difficulties in the work of the European monetary authorities. In the first half of 2005, the countries with leading growth in the Economic and Monetary Union (EMU) were Greece, Spain and Ireland (paradoxically located on the geographic and economic periphery of the Union) with GDP growth rates higher than 3% year-to-year in the first half of 2005.

WIDE RANGE OF GROWTH AND INFLATION IN EURO AREA

2005 (*)

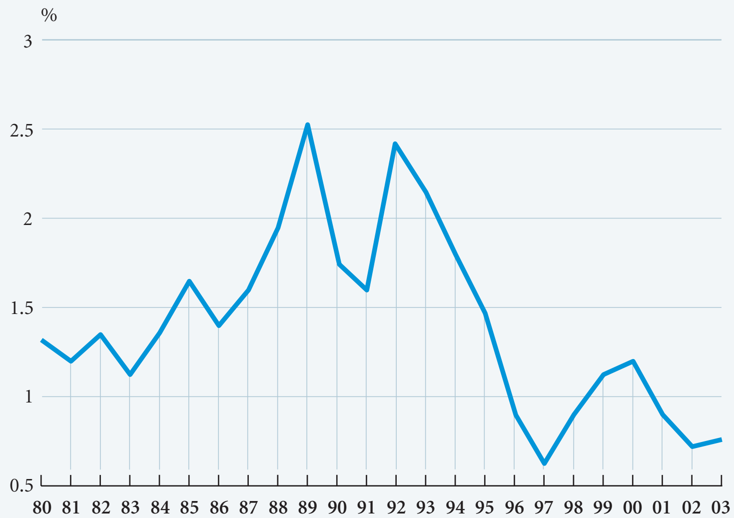


NOTES: (*) GDP for first half of 2005, average CPI for January-September 2005.
SOURCE: Eurostat and internal figures.

After these countries came Austria, Belgium and France with growth rates running between 1.5% and 2%, figures which were still higher than the euro area average (1.2%). Below this level stood Finland, Netherlands and Germany (with growth between 0.5% and 1%) and coming far behind were Portugal and Italy with practically nil growth. In terms of inflation, we note a similar spread with inflation going above the objective of 2% in Greece, Spain and Belgium along with more troubling results in Portugal and Italy, taking into account the low level of growth in these two countries. In any case, it should be pointed out that, according to the European Commission, in spite of the notable differences existing and the ups and downs experienced, both the range of inflation and the divergences in the economic cycle (measured by the standard deviation of output gaps in each country) have tended to be reduced in recent years as shown in the following graph.

CYCLICAL DIFFERENCES BETWEEN EMU COUNTRIES BEING REDUCED

Standard deviation between production gaps in each country (excluding extreme cases of Italy and Luxembourg)



SOURCE: European Commission.

In these circumstances, what should be the optimum monetary policy? The ECB must deal with the EU situation as a whole without being able to fully satisfy the specific needs of each country. How does this work out in practice? In present monetary policy this turns out very suitably for overheating some economies, such as those of Spain and Greece but it is excessively restrictive in the case of the stagnation operating in other countries (particularly Germany and Italy). This contradiction again lies at the centre of criticism of the EMU now that the ECB has begun to raise interest rates in order to hold down inflationary expectations arising from increases in the price of oil.

Here it is worth recalling the debate carried on in academic circles about the desirability of the EMU in the years prior to its coming into operation. In light of theory on optimum monetary areas, developed by Mundell, McKinnon and Kenen, among others, it was stated that fiscal integration, mobility of the labour factor and wage flexibility were some of the indispensable requisites to successfully meet the situations of real divergence existing among the candidate countries. In general, scepticism was the prevailing note in the analyses coming from the other side of the Atlantic. Eichengreen and Bayoumi, among others, warned that the European Union was a long way from being an optimum monetary area so that renouncing monetary policy and a national exchange rate would make it extremely difficult to absorb asymmetrical shocks in supply and demand. Naturally, the opinion of the European Commission was quite different as set out in the document *One market, one money* published in 1990. According to the European Commission, the benefits coming from the Union (the disappearance of transactional costs in foreign exchange operations, elimination of exchange rate risk, integration of financial markets, the increase in price transparency and greater certainty about future trends, etc.) more than outweighed the disadvantages mentioned. Indeed, it was accepted that, due to the different starting points of the candidate countries, full convergence in inflation and synchronization of the economic cycle would only be achieved over the medium and long-term.

After nearly six years of the EMU being in operation, we note that in terms of growth the results have been worse than those recorded in the United States and the United Kingdom. The EMU shows a degree of rigidity much higher than the Anglo-Saxon economies mentioned and, furthermore, it has not been able to control government deficits. But not all the responsibility can be attributed to the single currency. Right from the beginning it was clear that an essential component in achieving success for the EMU was to carry out necessary structural reforms, in product and factor markets, in order to increase the efficiency and flexibility of the euro area economies. It is in this area where the advances have not been sufficient because of the great resistance encountered by any policy along these lines. Harking back to national currencies and putting the blame on the euro is nothing more than a ploy to avoid assuming one's own responsibility.

Basic programme measure a 3-point rise in VAT which, with other personal income tax adjustments, should put government deficit below 3% of GDP in 2007.

(Christian Democrats) included the key measure of fiscal reform which should make it possible to bring the German government deficit down from 4.0% of the GDP in 2005 to below 3% in 2007.

For this purpose it was decided to increase the value added tax (VAT) rate from the present 16% to 19% in 2007 and to apply two-thirds of the increase in collections (estimated at 20 billion euros), to reduce the Federal government deficit and that of the Federal states. The remaining third would be used to reduce non-wage labour costs by means of lowering the cost of unemployment insurance. The increase in taxes is rounded out with a rise of 3% in the rate applied to the highest income levels for personal income tax.

The other measures under the agreement are of lesser importance.

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	October
GDP	–0.2	1.1	1.1	0.5	0.6	0.7	–	1.4	–	–
Retail sales	–0.5	1.1	0.9	1.4	0.6	2.1	–3.2	2.7	–0.7	...
Industrial production	0.1	2.4	3.8	1.4	1.9	1.8	2.8	2.0	3.6	...
Industrial activity index (IFO) (*)	91.7	95.7	95.4	95.1	95.3	93.3	95.1	94.7	96.0	98.8
Unemployment rate (**)	10.5	10.5	10.6	10.7	11.7	11.7	11.6	11.6	11.7	11.6
Consumer prices	1.0	1.7	1.9	2.0	1.7	1.7	1.9	1.9	2.5	2.3
Trade balance (***)	130	149	154	155	157	154.4	156.0	156.3	159.1	...

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

Among initial proposals for making the labour market more flexible the only one left is an increase in the trial period for persons newly hired which goes from the current 9 months to 24 months. At the same time, unemployment insurance is cut slightly although the amount of contribution for unemployed in the eastern *Länder* is increased. There was also agreement to increase the retirement age as of 2012 in order to reach 67 years in 2035. Finally, a programme of government investment amounting to 35 billion euros for the next four years was approved.

These measures may be insufficient to meet what must be their twin objective: to consolidate recovery and encourage microeconomic reform which could make it possible to increase the growth potential of the German economy. As a result, the tax adjustment could have a negative effect on the main factor missing in the incipient German recovery taking place since the end of summer, namely household spending.

With regard to the improvement in the competitive bases of the German economy, the application of part of the increase in tax collections to reducing non-wage labour costs goes in the right direction but the amount involved, which is not sufficient, will have little effect over the medium and long-term.

In terms of modernization of the pension and public health systems, the only measure actually set out, the increase in retirement age, falls very much short of dealing with future challenges within the welfare state and the delayed moment for its application makes one doubt its efficacy.

The above does not imply, however, that recovery is going to come unstuck because of the action of the government. Basically, the pattern of recovery will continue along current trends. Details of GDP growth in the third quarter, when it reached 1.4% year-to-year (0.7% in the second quarter), shows that the export-investment channel, that is to say, the shift from an increase in foreign demand to a rise in investment is taking place. As a result, investment increased by 0.9% year-to-year (with the new positive factor that along with the increase in capital goods investment construction is also recovering) while the foreign sector contributed 1.2% to GDP growth. What then is still missing? Consumption, which is still not growing.

In this respect, the few available indicators for the fourth quarter may be evaluated positively. Consumer confidence in October rose by nearly three points and the slight drop in consumer prices from 2.5% year-to-year in September to 2.3% in October should help household spending to recover. Nevertheless, in spite of the reduction of one decimal in October, putting the figure at 11.6%, a significant decrease in the unemployment rate is lacking.

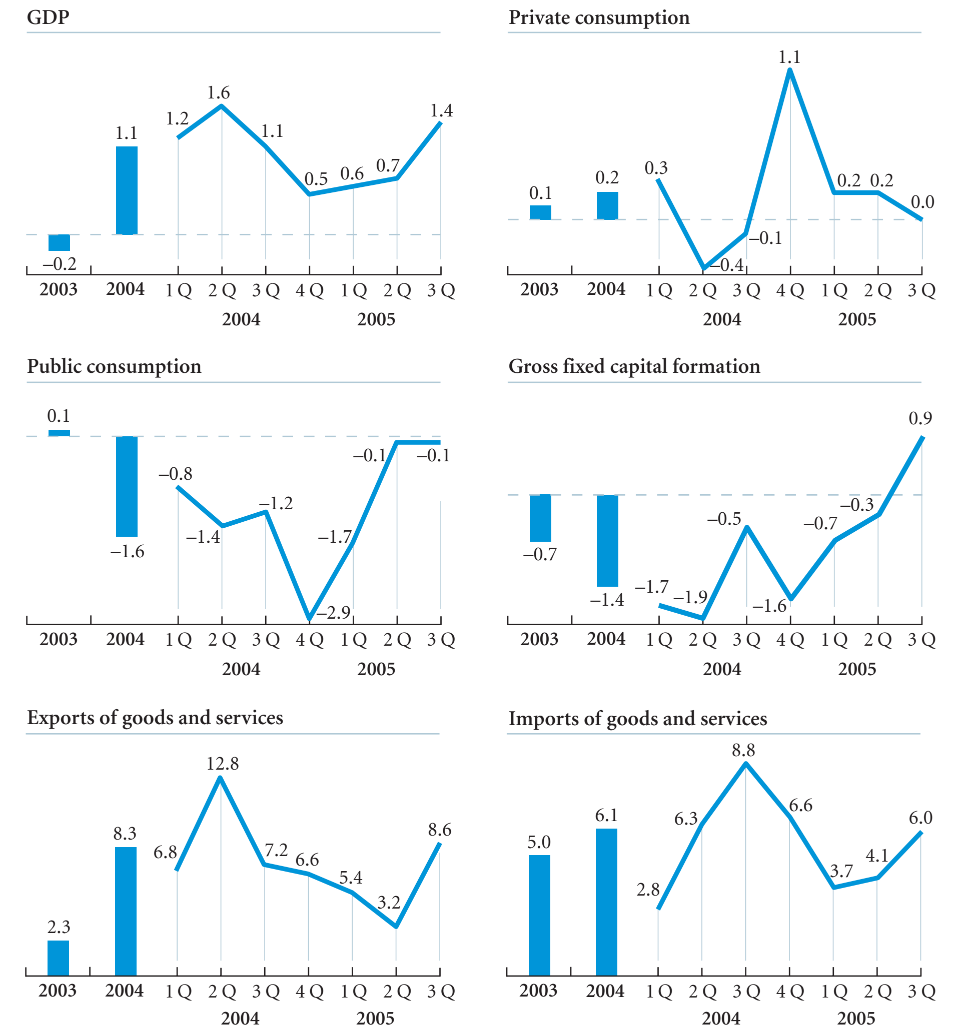
Finally, we should end with the most recent figures for corporate activity, especially because of how this anticipates the future trend in Germany's economy. Industrial production in September rose to 3.6% year-to-year, the highest since September 2004. Consolidation of the IFO industrial activity index at present high levels (of the order of 98 points in October and November) and the clear recovery in industrial orders confirm the continuation of corporate recovery in Germany.

Fiscal adjustment could have negative effect on private consumption, precisely factor missing in recent years, while also failing to deal with root of growing imbalances affecting pensions and public health system.

German recovery in third quarter now shows more positive profile than before with more and more satisfactory trend in foreign demand and investment.

TREND IN GERMANY'S GDP BY COMPONENT

Percentage year-to-year change



SOURCE: Federal Statistics Office and internal figures.

Growth of French GDP in third quarter up more than most optimistic forecasts going to 1.8% thanks to recovery in domestic demand and less slump in foreign sector...

France: sudden increase in economic activity

While indicators were showing that the French economic cycle had hit bottom in the second quarter, reality has changed upward even the most optimistic forecasts. In the third quarter, the GDP showed surprising growth of 1.8% year-to-year, 7 decimals higher than in the preceding quarter. Behind this upward shift, on the domestic demand side we note an increase in private consumption, public consumption and investment so that only the negative contribution of inventories has acted as a brake on domestic growth. With regard to the foreign sector, growth of exports has fostered a reduction in the negative contribution of foreign demand to its lowest level since the first quarter of 2003.

The relevant question now is to work out if we are witnessing something more than a solitary good quarter. Indicators for the fourth quarter, while few in number, suggest that this positive note is not going to be suddenly interrupted. Recovery of confidence indicators in industry and services in October would confirm that both sectors are going to continue consolidating the growth trend begun in the third quarter. At the same time, maintenance of consumer confidence in October, at levels similar to those in the August-September period, seem to confirm that household spending is again exercising the central role it has carried out in French growth in recent years.

An additional factor which would make it possible to improve growth prospects could be the very slight increase taking place in prices. The French CPI was down by four decimals in October to stand at 1.8% year-to-year, a figure which in itself is moderate. However, after discounting the more volatile segments of the index (which include energy), the resulting rate was even more contained at 0.9% year-to-year.

Nevertheless, these good indicators, both those referring to national accounting and monthly figures, got less attention than that given to the unfortunate incidents in the suburbs of the main French cities. Without trying to explain here something which goes beyond a strict analysis of the economic situation, it does seem convenient to point out some aspects connected to the French economic cycle and its immediate prospects.

An initial point is that the social outbreak underlines one of the weaknesses in the recent pattern of French growth: the difficulty of generating employment and reducing unemployment, especially among the more vulnerable groups, many of which are broadly represented in the suburbs affected by the disturbances. It should be remembered that last September the national unemployment rate was 9.8% of the labour force, although unemployment among young people was above 20% and, according to some estimates, the level of unemployment in some of the areas affected stood above 40%.

A second point refers to the possible effect of the social outbreak on trends in the economy. Both in terms of a possible drop in confidence and through the impact on the Budget, it is estimated that the effect will be practically marginal. As a result, in spite of the notable process of social and public

...and everything indicating fourth quarter to also record positive rate of economic activity without inflationary imbalances showing up.

Positive economic trend outshone by attention given to social unrest in French city suburbs but this not expected to have appreciable negative impact on government spending or corporate and consumer confidence.

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	October
GDP	0.9	2.1	1.8	2.0	1.8	1.1	–	1.8	–	–
Domestic consumption	1.9	3.3	2.4	4.0	3.2	1.2	3.7	5.5	4.2	1.8
Industrial production	–0.4	1.8	1.8	1.5	0.7	–0.5	–1.1	1.5	0.2	...
Unemployment rate (*)	9.8	10.0	10.0	10.0	10.1	10.2	9.9	9.9	9.8	...
Consumer prices	2.1	2.1	2.2	2.1	1.6	1.6	1.7	1.8	2.2	1.8
Trade balance (**)	0.2	–0.1	–0.1	–0.5	–1.0	–1.5	–1.7	–1.8	–1.8	...

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

debate that the disturbances unleashed, it does not seem that the path of recovery in corporate and consumer confidence will show any significant drop. Nor will the series of palliative measures the government has decided to implement which, according to some estimates will be around 300 million euros as a maximum, have any effect on efforts at budgetary consolidation, given that they will be shifted from other spending headings already established.

United Kingdom: economic activity stagnating while inflation increases

United Kingdom: troubling weakness in private consumption which stands at lowest level in more than 10 years and, along with weak state of industry, points to moderate growth rate...

In the final stages of 2005, the British economy is still failing to leave its recent problems behind. While in the third quarter the GDP grew by 1.7% year-to-year, two decimals more than in the second quarter, prospects for economic activity are still contained. The basis of the British growth model in recent years, private consumption, continues to be stuck at a stage of all-time weakness. In the third quarter, it grew by 1.6% year-to-year, similar to the rate in the second quarter, which represents its lowest level in more than 10 years. As a result, the better relative performance in investment (growth of 2.8% year-to-year, 6 decimals more than in the second quarter), as well as in exports, has scarcely shifted to increased growth.

The trend in household consumption is troubling seeing that the labour market is showing an unemployment rate close to all-time lows (2.8% in October). With retail sales moving up at an historically low rate (increase of 1.5% year-to-year in October) and consumer confidence in October falling down to below the level of –4 points, there is nothing to indicate that an upward shift in household spending is close.

While consumption is not moving ahead, the drop in industrial production of capital goods in September (decrease of 0.4% year-to-year), which would indicate weak investment, shows still more troubling factors. In this situation, the recovery in exports, which is capitalizing on a positive world environment and some depreciation of the pound, is unable to compensate for the weakness in domestic demand. In any case, if the current rate of exports is maintained (growth of more than 10% year-to-year in the second and third quarters), the foreign sector could end up solidifying the recovery once consumption revives.

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	October
GDP	2.5	3.2	3.0	2.5	1.7	1.5	–	1.7	–	–
Retail sales	3.0	6.1	6.7	4.7	2.9	1.5	1.4	1.0	0.7	1.5
Industrial production	–0.5	0.8	0.4	0.0	–1.1	–1.8	–1.4	–1.5	–1.1	...
Unemployment rate (*)	3.0	2.7	2.7	2.7	2.6	2.7	2.8	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	2.4
Trade balance (**)	–46.8	–55.3	–57.4	–59.7	–61.5	–62.6	–62.1	–62.6	–63.1	...

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

Nor do supply indicators present any signs of a clear improvement. Economic sentiment, the most far-reaching of all, dropped by more than one point in October putting the promising recovery in September in question. Behind this poor performance we note that services and industry are failing to recover. In this respect it is significant that industrial production in September stood 1.1% below the level for one year earlier, thus breaking with forecasts of an increase as prophesied by most analysts.

In this situation of practically flat economic activity, inflation is holding at threatening levels. The CPI in October stood at 2.4% year-to-year. Beyond the figure in itself, a troubling aspect is the fact that other prices in the economy, such as producer prices, are also showing relatively high (year-to-year growth of 2.6% in October).

...while prices not moving into stage of lower increases thus going above official Bank of England monetary policy objective.

The dilemma for the British central bank is clear. Consumption stands at its worst situation in years, manufacturing is failing to take off and fiscal policy is again about to be more contractile to the extent that measures for containing spending already announced become consolidated. It is also true that inflation is holding at levels 4 decimals above the reference rate specifically assigned by the Bank of England. For the moment, the option taken has been to maintain rates unchanged although perhaps the economy requires something else in order to get back on a growth path.

Combination of inflationary pressures and low level of economic activity complicates monetary policy now swinging between sharply cutting inflation prospects or contributing to recovery of growth.

Monetary and capital markets

Imminent rise in European Central Bank interest rates

Fears of inflation above objectives justify tighter monetary policy.

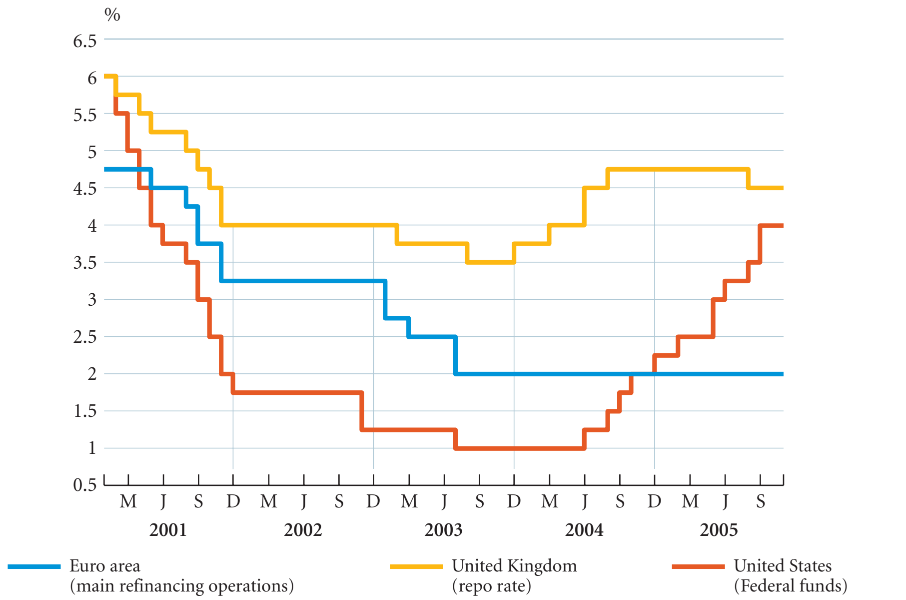
Inflation above the desired level, along with low or very low interest rates in most countries, is fostering a higher degree of restraint in monetary policies. As this goes to press, the reference rate in the euros area stands at 2% but a rise on December 1 is certain. At the same time, debate is raging in Japan over the desirability of ending the policy of interest rates close to 0%. The Bank of England presents an exception due to the fact that the British economy stands at a more advance stage of the economic cycle and its interest rates are now 4.50%.

In the United States, as expected, the Open Market Committee of the Federal Reserve again raised its reference rate by 25 basis points at its meeting on November 1. This was the twelfth consecutive increase since the upward move began in June 2004. As a result, the objective rate on overnight interbank deposits stood at 4%, four times that at the beginning of June 2004. In its press release, the Federal Reserve indicated it would continue to raise interest rates at subsequent meetings given that it felt that monetary policy was still too easy.

On the other hand, Ben Bernanke, who takes over from Alan Greenspan as head of the Federal Reserve on February 1,

FEDERAL RESERVE RAISES REFERENCE RATE TO 4%

Monetary policy reference rates



SOURCE: National central banks.

once his appointment is confirmed by Congress, indicated in statements before the Senate Committee on Banking that he would support a continuation of current monetary policy. While stating he was in favour of publishing an inflation objective, he indicated he was in no hurry to adopt this.

In this respect, the interest rate on US 1-year interbank deposits rose to 4.80% in mid-November in anticipation of the official interest rate rising to 4.75% in the coming year.

In the euro area, the Governing Council of the European Central Bank (ECB) made no change in its interest rates on November 3. Nevertheless, chairman Jean-Claude Trichet repeated that they could rise at any moment given that inflationary pressures had to be watched carefully. Other ECB executives made comments indicating increases were ahead and in favour of preventive action, given that it was «better to prevent than to cure», in the words of Christian Noyer, governor of the Bank of France. At the same time, publication of figures showing better than expected economic growth in the third quarter in Germany, France and the euro area as a whole and the weakness of the euro strengthen upward expectations.

US official interest rate keeps rising.

With confirmation of economic recovery in euro area, ECB considers conditions right for upward move on monetary policy.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England intervention rate (4)	3-month (5)	3-month (5)
2004									
October	2.03	2.15	2.32	1.75	2.08	0.09	4.75	4.90	0.71
November	2.05	2.17	2.33	1.92	2.31	0.09	4.75	4.88	0.75
December	2.07	2.17	2.30	2.25	2.50	0.09	4.75	4.87	0.75
2005									
January	2.06	2.15	2.31	2.25	2.66	0.10	4.75	4.87	0.74
February	2.06	2.14	2.31	2.50	2.82	0.10	4.75	4.89	0.75
March	2.05	2.14	2.34	2.59	3.03	0.09	4.75	4.99	0.75
April	2.05	2.14	2.27	2.75	3.15	0.08	4.75	4.94	0.76
May	2.05	2.13	2.19	2.99	3.27	0.08	4.75	4.89	0.76
June	2.05	2.11	2.10	3.01	3.43	0.08	4.75	4.84	0.75
July	2.05	2.12	2.17	3.25	3.61	0.09	4.75	4.66	0.75
August	2.05	2.13	2.22	3.43	3.80	0.09	4.53	4.59	0.76
September	2.06	2.14	2.22	3.60	3.91	0.09	4.50	4.60	0.76
October (*)	2.06	2.20	2.41	3.75	4.17	0.09	4.50	4.59	0.81
November (1)	2.08	2.45	2.73	4.00	4.40	0.09	4.50	4.62	0.97

NOTES: (*) Provisional figures.
(1) November 24.
(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: 14-12-04 (2.25%), 2-2-05 (2.50%), 22-3-05 (2.75%), 3-5-05 (3.00%), 30-6-05 (3.25%), 9-8-05 (3.50%), 20-9-05 (3.75%), 1-11-05 (4.00%).
(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%).
(5) Interbank offer rate.
SOURCE: European Central Bank, Thomson Financial Datastream and internal figures.

Following interest rate increase on December 1, other rises to follow in 2006.

Political quarrel in Japan over end to 0% interest rates.

As a result, the 1-year Euribor, which had stood at 2.41% on monthly average in October, rose to 2.78% on November 21 in anticipation of a rise of 25 basis points on December 1, another of the same size in the first quarter and other later increases until it reached 3%. That same day, in the afternoon, in his quarterly appearance before the European Parliament, chairman Trichet repeated that the ECB was ready to act immediately but, in view of criticism from deputies, he qualified his comments saying there was no plan for a series of interest rate increases. These statements brought about a slight drop in interbank interest rates so that the following day the Euribor went to 2.76%. As a result, the market is continuing to discount interest rate increases in the Eurosystem as of December although not as a continuous series as in the case of the Federal Reserve which set out from a lower level (1%).

As was to be expected, the signs given out by the Bank of Japan of an early lifting of the monetary policy of maximum easy money did not go down well in official economic circles. Hidenao Nakagawa, the person responsible for economic policy of the Democratic Liberal party now in power, ended up threatening to introduce a new law to withdraw the independence of the Japanese central bank. As a result, any monetary restraint may be delayed until the economic recovery now under way is confirmed.

In addition, on October 27 the Bank of New Zealand raised its reference rate by 25 basis points to 7%. Six days later the Bank of Norway raised its official interest rate by the same amount to 2.25%.

Central banks more open to public

Under the gold standard, the function of the central bank was to maintain the value of the currency in relation to gold at legally established levels (so many pounds sterling per ounce of gold, for example). This was a principle that was clear and easy to understand and the system functioned between the end of the 19th century and the beginning of the 20th. Milton Friedman, who won the Nobel prize for economics in 1976, liked the gold standard because of its simplicity, predictability and credibility but especially because it took management of monetary policy out of the hands of the politicians. Milton Friedman was aware of the impossibility of returning to the gold standard and because of this at the beginning of the Sixties he advocated that the actions of a central bank be guided by a formula that was simple and known to the general public which allowed almost no margin of discretion to the monetary authorities.

No one listened to those arguments. All through the Sixties, Seventies and Eighties of last century, monetary policies have been characterized by their discretionary nature in an environment of notable economic, financial and technological change. And one with major outside shocks such as the energy crises. At the same time, these were years of high inflation with two-digit rates in most of the developed countries. The lack of control over inflation made it necessary to rethink the principles and strategies of monetary policy while opting for a path mid-way between some fixed rule (gold or other standard) and complete discretion. The reference could be no other than the stability of the currency or, to put it another way, the establishing of a low and stable inflation rate to which the central bank had to be decidedly committed. In order to meet this objective in a coherent way over the long term it was essential that the central banks be independent of political control.

Independence from political control and the commitment to an inflation objective makes it essential that the central bank (whose officials are not elected democratically but appointed directly) be transparent and clearly communicate the reasons for its actions. At the New Year reception for the press given by Jean-Claude Trichet at the beginning of 2005, he stated that efficient communications «reduces inflationary expectations of the financial markets and the public… contributes to the correct formation of prices in financial markets…reduces uncertainty about future interest rates… and even improves the operation of the labour market». Ben Bernanke, who will probably succeed Alan Greenspan as chairman of the Fed, stated a couple of years ago that the operation of monetary policy could be divided into two parts: «what you do», that is to say, the operational aspects of monetary policy such as setting interest rates and «what you say», that is, how things are explained to the public. Undoubtedly, he placed much greater importance on the latter.

TRANSPARENCY AND PUBLIC ACCOUNTABILITY PROCESS OF MAIN CENTRAL BANKS

	ECB	US Federal Reserve	Bank of Japan
Objectives			
Setting of objective overriding aim	Price stability	No	Price stability
Quantification of objective overriding aim	Not to go above 2% over medium term	No	No
Strategy			
Relevant indicators	Reference value for M3 money supply growth	No	No
Instrumental variable	Very short-term interbank interest rate	Objective level of interest rate on Federal Funds	Treasury assets to ensure that overnight interbank rate comes close to 0% while deflation persists
Publication of inflation forecasts	Projections	Yes	Yes
Publication of macroeconomic models	Some	Yes	Some
Indications about future measures	At times	Evaluation of risks	At times
Accountability process			
Appearances before Parliament	At least quarterly	At least twice a year	At least twice a year
Public reports	Monthly	Monthly	Monthly
Participation of government representatives at meetings of central bank body (as observers)	President of ECOFIN and European Commission	No	Minister of Finance and Economic Planning Agency
Publication of summary of minutes	No	Three weeks later	Five weeks later
Publication of detailed minutes	No	Five years later	No
Press conferences	Monthly	No	Monthly

SOURCE: ECB, US Federal Reserve, Bank of Japan and internal figures.

How do the central bankers communicate with the public? The normal thing is that the person responsible for monetary policy appears periodically before Parliament to explain his actions. The governor or member of the governing council appears at public events or makes statements at which they suitable messages are given out. They publish reports, bulletins, forecasts, opinions or minutes of meetings which help the public to understand the working of the central bank. We still find notable differences, however, in the action of the central banks, not just in terms of strategy but purely in matters of communication. For example, the ECB does not publish the minutes of the governing council meetings as opposed to what happens with the Fed, the Bank of England or the Bank of Japan. While the Bank of England is completely transparent in terms of setting a specific inflation objective, the ECB sets a medium-term objective and the Fed does not put out any objective. Discussion about which is the best system still continues but, in any case, during the Nineties and the beginning of this century transparency and communication have improved notably. The central banks are no longer those once reserved and distant institutions but have opened themselves up to the public and the positive results are clearly to be seen.

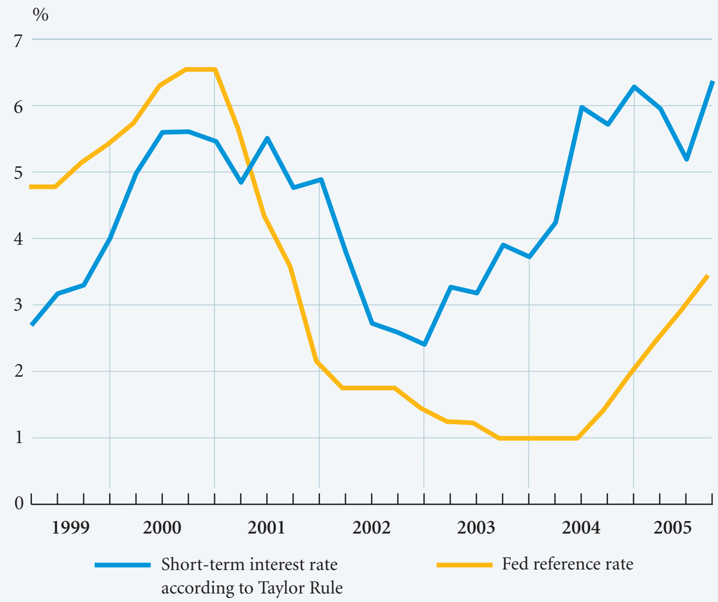
Monetary policy: a suit made-to-measure?

While during the Middle Ages the knights of the cross went tirelessly searching for the Holy Grail, the chalice of the Passion, we may say that today the central bankers are trying to find the ideal formula to follow in order to keep inflation low and economic growth high. But it is not an easy task. Monetary policy tries to reach objectives which are not always compatible, such as high stable real economic growth, a high employment rate and price stability. To do this, it exerts an influence on financial conditions of the economy through various instruments, among which are interest rates. It is precisely the level of interest rates set by the central bank that is the best known and most used in order to evaluate the actions of the various central banks and the degree of restraint shown by monetary policy. What then is the proper level for interest rates?

One of the replies which has had most success is the so-called Taylor Rule. This was proposed in 1993 by Prof. John B.Taylor, of the University of Stanford in the United States, an academic whose previous experience as an analyst in the New York consulting firm of Townsend-Greenspan, at that time headed by Alan Greenspan, allowed him to acquire a profound knowledge of the monetary markets. What is the Taylor Rule? It is a simple equation which determines the central bank reference interest rate according to a few economic parameters. This interest rate would equal the sum of four factors. First, the real interest rate of equilibrium which is compatible with growth over the long term; second, the objective inflation rate; third, the deviation of inflation from the central bank objective; and, finally, the output gap or the percentage deviation of the gross domestic product for the period from its potential path. The latter two additional elements are each weighted by relative factors.

The Taylor Rule gained popularity after its appeared because it was relatively simple and made it possible to make forecasts of central bank interest rates with just a few variables. Prof. Taylor calibrated the monetary policy rule bearing his name with figures for the US economy from 1984 to 1992 and in that period the correctness of results proved high. Furthermore, it turned out that other central banks seemed to adjust their monetary policy *ex post* to the dictates of the Taylor Rule.

TAYLOR RULE AND FEDERAL RESERVE INTEREST RATE: UPWARD TREND

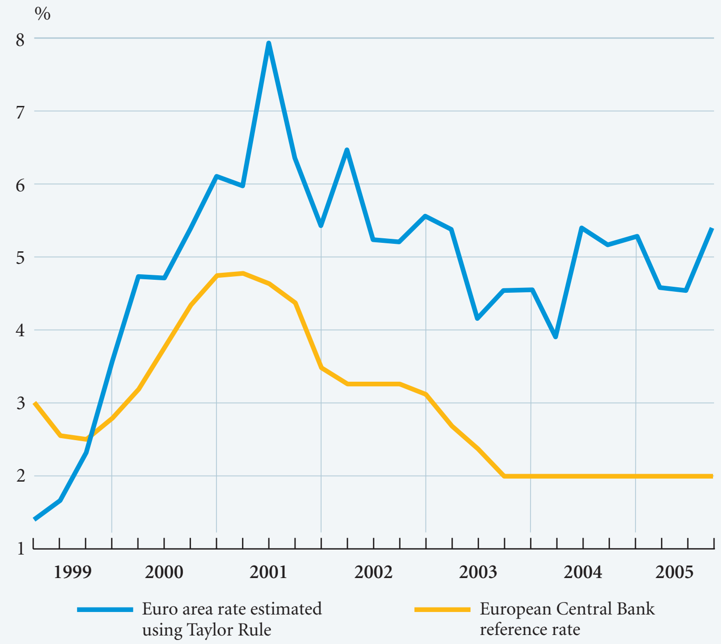


NOTES: Deviation in inflation and the production gap are weighted by 1.5 and 0.5 respectively. Inflation is measured by the GDP deflator.
SOURCE: Federal Reserve and internal figures.

Well then, do the central banks use this rule to establish their interest rates? While the Taylor Rule may repeat the path followed by reference rates in some countries like the United States and New Zealand in some periods, the central banks do not explicitly acknowledge that they follow any monetary policy rule. The central banks maintain that a monetary policy rule such as the Taylor Rule does not take into account other relevant variables such as, for example, survey and confidence indicators, the trend in government finances, the trend in the labour market, the yield on government bonds, the price of other financial assets, credit and the exchange rate. They also make the point that one cannot rely too much on rules based on concepts or indicators which are susceptible to measurement errors, such as the output gap. In any case, what is clear is that the ECB does not go by the Taylor rule, as may be seen in the following graph.

Of course, with the Taylor Rule it would be possible to carry out the exercise of calculating what short-term rates would be in Spain if it had control over monetary policy. Now, supposing that the Bank of Spain had established an inflation objective of 2%, as at present, it would turn out that the central bank reference rate would stand above 7%. There is no doubt that, with this level of interest rates, the current economic situation in Spain would be substantially different.

TAYLOR RULE WOULD REQUIRE ECB TO RAISE INTEREST RATES



NOTES: Deviation in inflation and the production gap are weighted by 1.5 and 0.5 respectively. Inflation is measured by the HCPI.
SOURCE: European Central Bank and internal figures.

Federal Reserve boosts dollar

Widening differential in interest rates benefits dollar.

The US currency appreciated by 3.8% in the first ten months of the year measured against a broad group of currencies. In the early weeks of November the dollar continued to rise with the help of an exchange rate differential in its favour in terms of many currencies and with the prospect that this would widen in coming months. Investors and speculators continue to prefer US securities and as a result the greenback has been able to overcome downward pressures arising from the increase in the foreign imbalance. While over the short term the dollar may continue to rise, over the medium term its prospects are not very bright seeing that the foreign imbalance has to be corrected partly through depreciation of the dollar, especially in terms of the Asian countries.

Yen continues to drop in November with delay in expected end to 0% interest rates.

The euro, in turn, fell by 6.1% in the January-October period compared with the currencies of the main trading partners of the euro area, following a substantial increase in the last four months of 2004. In the early weeks of November the weakness of the single European currency continued under the effect of an unfavourable interest rate differential compared with most currencies and the disturbances in France. Specifically, the euro fell substantially in the face of the rise of the dollar. As a result, on November 15 the euro was running at 1.167 dollars, the lowest rate in two years.

EXCHANGE RATES OF MAIN CURRENCIES

October 2005

	Final session of month		Monthly figures				Exchange rate November 24, 2005
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2) Monthly	Over December 2004	Annual	
Against US dollar							
Japanese yen	116.6	2.3	114.9	3.3	10.7	5.5	*118.9*
Pound sterling (1)	1.768	0.2	1.765	–2.4	–8.6	–2.3	*1.722*
Swiss franc	1.290	–0.3	1.287	1.7	12.4	4.4	*1.316*
Canadian dollar	1.182	1.2	1.177	–0.1	–3.3	–5.6	*1.172*
Mexican peso	10.79	0.0	10.83	0.5	–3.3	–4.9	*10.62*
Nominal effective index (4)	*112.0*	*0.8*	*111.8*	*1.0*	*2.6*	*–1.2*	*112.5*
Against euro							
US dollar	1.202	–0.2	1.201	–2.0	–10.4	–3.8	*1.178*
Japanese yen	139.6	2.5	138.1	1.5	–0.8	1.5	*140.0*
Swiss franc	1.546	–0.7	1.549	0.0	0.8	0.4	*1.550*
Pound sterling	0.677	–0.8	0.681	0.6	–2.0	–1.5	*0.683*
Swedish krona	9.536	2.2	9.422	0.9	4.9	4.0	*9.511*
Danish krone (3)	7.462	0.0	7.462	0.0	0.4	0.3	*7.462*
Polish zloty	3.979	1.5	3.923	0.2	–5.1	–9.2	*3.925*
Czech crown	29.60	0.1	29.67	1.2	–3.1	–5.8	*29.16*
Hungarian forint	250.5	0.4	251.8	2.4	2.5	2.1	*251.8*
Nominal effective index (5)	*101.5*	*0.2*	*101.4*	*–0.4*	*–5.3*	*–2.7*	*100.7*

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.

Later on, increased expectations of an immediate upward rate move by the European Central Bank put a halt to this trend.

The yen dropped by 7.4% in the course of the first ten months of the year measured against the more important currencies. In the early weeks of November the Japanese currency continued to weaken as a result of postponement of the expected end of the monetary policy holding interest rates close to 0%.

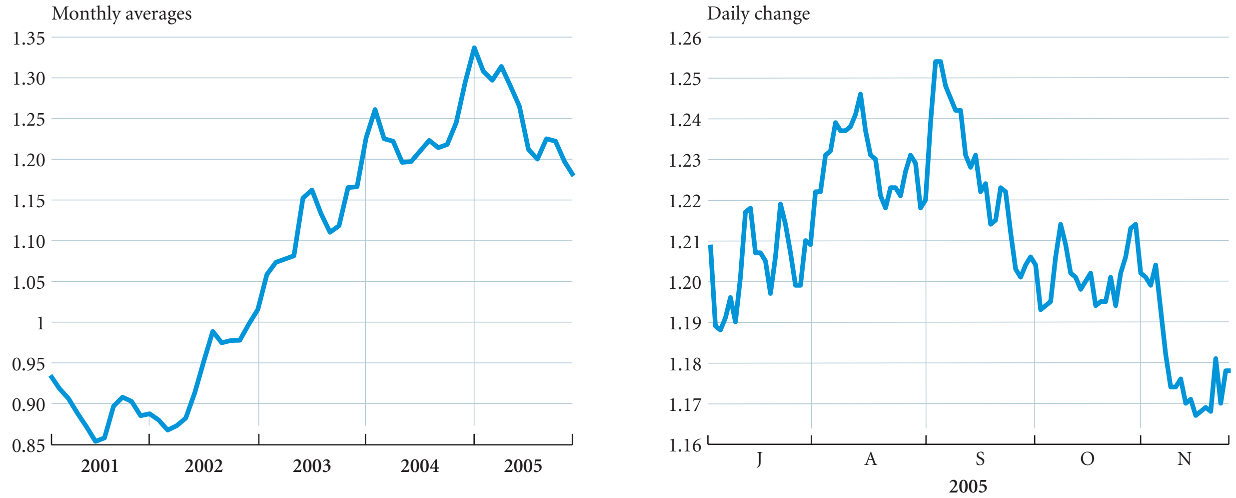
Decrease in oil prices moderates bond yields

The yield on US Treasury bonds rose to 4.66% on November 4, the highest level since the beginning of the restrictive round started by the Fed at the end of June 2004. The yield on US government bonds was boosted by increased upward expectations on US official interest rates following the statement by the Fed that it would open the way to further increases. Nevertheless, expectations of official interest rate increases later eased to some extent with publication of more

Interest rate curve flattens out in United States.

EURO MARKS UP LOWEST LEVEL AGAINST DOLLAR FOR PAST TWO YEARS

US dollars to euro



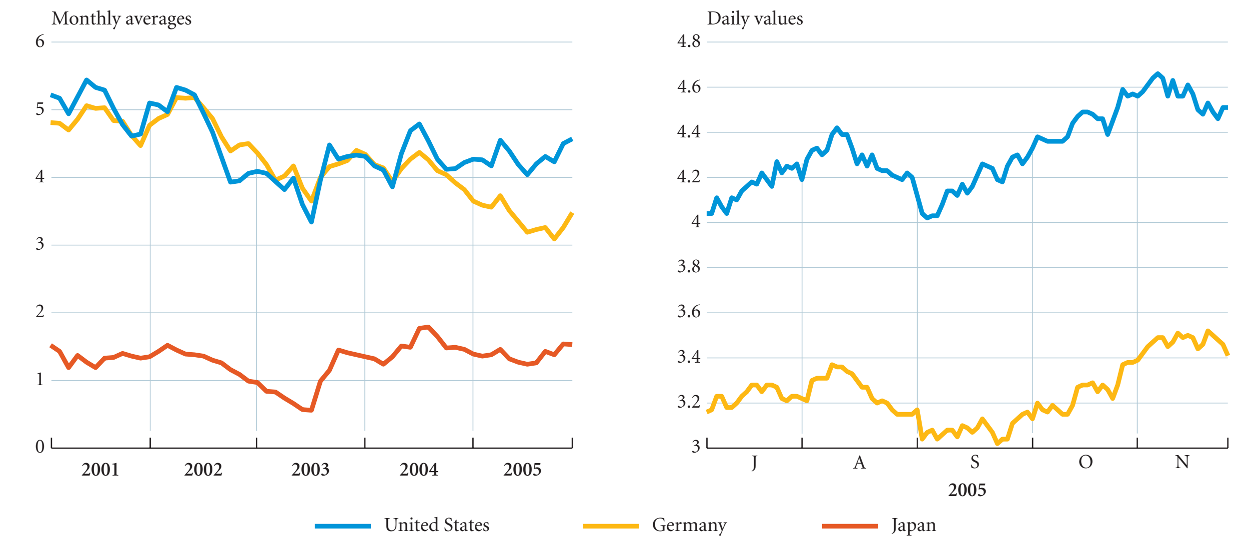
NOTES: Figures go up to November 24.
SOURCE: OECD, Thomson Financial Datastream and internal figures.

moderate figures for inflation with the decrease in oil prices.

As a result, at the end of the fourth week in November the interest rate on US 10-year Treasury bonds stood at around 4.5%. In any case, this move must be seen as a correction stage within an upward trend. Nevertheless, we note a flattening out of the US interest rate curve, given that the 10-year/three-month slope has shifted from 166 basis points at the beginning of the year to 11.

REDUCED DIFFERENTIAL IN LONG-TERM INTEREST RATES BETWEEN DOLLAR AND EURO

Yield on 10-year government bonds as annual percentage



NOTES: Rates go up to November 24.
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	3 Q	October	November 24
United States	4.04	4.31	4.34	4.21	4.25	4.50	4.51
Japan	0.99	1.50	1.41	1.28	1.36	1.54	1.44
Germany	4.10	4.07	3.63	3.35	3.19	3.26	3.41
France	4.13	4.10	3.64	3.38	3.23	3.29	3.44
Italy	4.24	4.24	3.75	3.53	3.40	3.45	3.61
Spain	4.12	4.10	3.63	3.36	3.18	3.27	3.48
United Kingdom	4.53	4.93	4.72	4.50	4.32	4.40	4.20
Switzerland	2.47	2.57	2.15	2.04	1.90	1.93	2.17

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

The yield on German 10-year government bonds rose to 3.52% on November 18 thus recovering levels in April with the increased likelihood of a rate increase by the European Central Bank on December 1. Later on, the yield on German government bonds moved slightly downward with the perception of a lower increase in Eurosystem interest rates following statements by chairman Jean-Claude Trichet before the European Parliament. In any case, in the early weeks of November the long-term differential between the dollar and euro dropped from 117 basis points at the end of October to 111 basis points at the end of the fourth week in November.

Yield on German government bonds rises in anticipation of Eurosystem interest rate increase.

Stock markets recover and face year-end on optimistic note

The stock markets underwent widespread corrections in October in a context of fears of inflation and growing expectations of increases in interest rates. Nevertheless, thanks to a drop in oil prices and publication of better than expected corporate profits, the stock markets reacted in the early weeks of November. As a result, a number of stock markets marked up highs for recent years and investors are facing the year-end optimistically with the possibility of ending the year with substantially higher gains than were being foreseen in most cases at the beginning of the year.

In this framework, the main stock market indices in the United States again recovered par for the year in November and obtained modest advances over December 2004. Contributing to this was the drop in yield on long-term government bonds. The cumulative balance by sector shows notable disparities. Due largely to revaluations of oil companies because of the increase in oil prices, the energy sector and utility companies obtained substantial capital gains over December. On the other hand, companies involved in telecommunications and cyclical consumption, such as motor vehicles, showed the biggest decreases in the course of the year.

US indices recover par for year.

In the fourth week of November, the DJ Eurostoxx 50 index, which includes the largest companies in the euro area, stood at its highest level for the past three years. The weakness of the euro, to the extent that it meant an improvement in the competitiveness of exports, counteracted the negative effect of the increase in interest rates on corporate profits. As a result, the DJ Eurostoxx 50 index presented substantial gains over

Decrease in oil prices and vigorous growth of company profits boost stock markets.

INDICES OF MAIN WORLD STOCK EXCHANGES

October 31, 2005

	Index (*)	% monthly change	% cumulative change	% annual change	*Figures on November 24, 2005* % cumulative change	*% change over same date in 2002*
New York						
Dow Jones	*10,440.1*	*–1.2*	*–3.2*	*4.1*	*1.2*	*24.0*
Standard & Poor's	*1,207.0*	*–1.8*	*–0.4*	*6.8*	*4.4*	*36.0*
Nasdaq	*2,120.3*	*–1.5*	*–2.5*	*7.4*	*3.9*	*53.9*
Tokyo	13,606.5	0.2	18.4	26.3	28.3	*68.1*
London	5,317.3	–2.9	10.4	15.0	14.5	*32.0*
Euro area	3,320.1	–3.2	12.5	18.1	17.2	*30.6*
Frankfurt	*4,929.1*	*–2.3*	*15.8*	*24.5*	*21.9*	*56.2*
Paris	*4,436.5*	*–3.6*	*16.1*	*19.7*	*20.0*	*38.8*
Amsterdam	*394.2*	*–2.2*	*13.2*	*19.3*	*20.0*	*16.9*
Milan	*25,061.0*	*–6.6*	*6.5*	*15.4*	*10.8*	*40.8*
Madrid	*10,493.8*	*–3.0*	*15.6*	*24.7*	*17.1*	*62.6*
Zurich	7,036.7	2.0	23.6	31.2	31.3	*44.8*
Hong Kong	14,386.4	–6.8	1.1	10.2	6.0	*49.9*
Buenos Aires	1,608.9	–5.1	17.0	25.0	18.6	*235.3*
São Paulo	30,193.0	–4.4	15.3	31.0	21.9	*207.0*

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.

Swiss stock market obtains increase of more than 30% over December.

IBEX 35 shows cumulative gains of more than 17%.

December. Some markets in the euro area reported capital gains of more than 20% so far this year, headed by the German, French and Dutch stock markets.

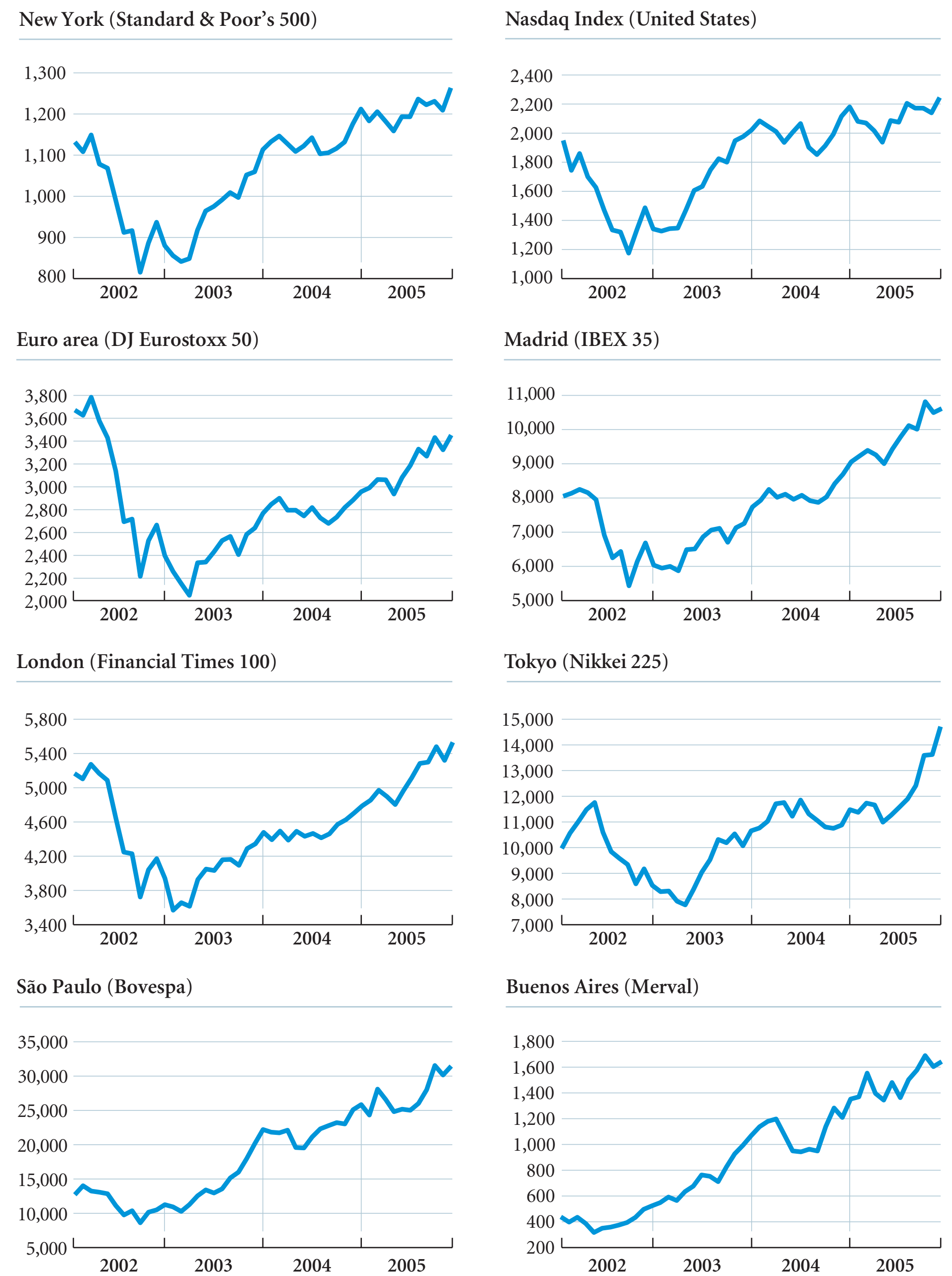
With regard to the Spanish stock market, in the early weeks of November the IBEX 35 index recovered strength and regained the 10,500 level although it failed to reach the high at the beginning of October. While spectacular corporate profits in the first three quarters gave it support, a takeover bid viewed negatively by the market took away some of its strength. In any case, at the end of the fourth week in the month, the selective Spanish index reached an increase of more than 17% over December.

Outside the euro area, the Financial Times 100 index for the London stock exchange marked up its highest level since August 2001 in the fourth week in November. In the final week of November, the SMI index for the Swiss stock market reached its highest level since June 2001 thus leading the increases among the main stock markets on the Continent to show an increase of more than 30% over December. In addition, during the same week the Nikkei 225 index for the Japanese stock market recorded its highest level since December 2000 boosted by the improvement in economic prospects and the easing of bond yields. In this way, the Japanese index has obtained gains of more than 28% so far this year.

With regard to emerging markets, some markets, such as Mexico, South Korea and Brazil, reported all-time highs in the

INTERNATIONAL STOCK EXCHANGES

Indices at month-end



NOTES: November 24, 2005.
SOURCE: Thomson Financial Datastream.

fourth week of November as a result of the good economic situation and the inflows of international investment going to these markets. Other emerging markets, such as Argentina, reflected the increases in international interest rates and failed to recover levels seen at the beginning of October although, in any case, they recorded substantial increases as of November.

New all-time highs in stock markets in Mexico, South Korea and Brazil.

SPAIN: OVERALL ANALYSIS

Economic activity

Spain's economy continues strong growth

GDP grows by 3.5% in third quarter of 2005, highest rate since end of 2001.

In the third quarter of 2005, the GDP sharpened its annual growth rate to 3.5%, the highest since the end of 2001 but showing more balanced contributions from national demand and the foreign sector. The latter reduced its negative contribution to GDP growth to 1.7 points, thus compensating for the slight drop in consumption and investment. Prospects for the final months of 2005 indicate a continuation of these trends so that average growth for the current year as a whole would stand at around 3.4%, which is higher than initial expectations.

National demand continues to drive economic activity with less negative contribution from foreign sector.

The better performance in the foreign sector was brought about by the reduction in the negative balance for trade in goods and services which, in turn, may be accounted for by the slight increase in exports and the slight loss of drive in imports. As a result of this, the deficit for current transactions with abroad dropped to 6.9% of the GDP (as against the 7.5% recorded in the first half-year) and net world borrowing dropped to a level equivalent to 6% of the GDP in terms of National Accounting.

The National Institute of Statistics (INE) has revised its criteria for estimating the contribution from the foreign sector. Since the last change in base for National Accounting, the INE set out from domestic demand, a figure which included consumption of non-residents in Spain less consumption of Spaniards abroad. These concepts, however, were in fact calculated as an export or import of services, respectively. As a consequence, the result brought about confusion regarding the effective relative weight of national demand in the economy as a whole and furthermore exaggerated the negative contribution of the foreign sector to GDP growth.

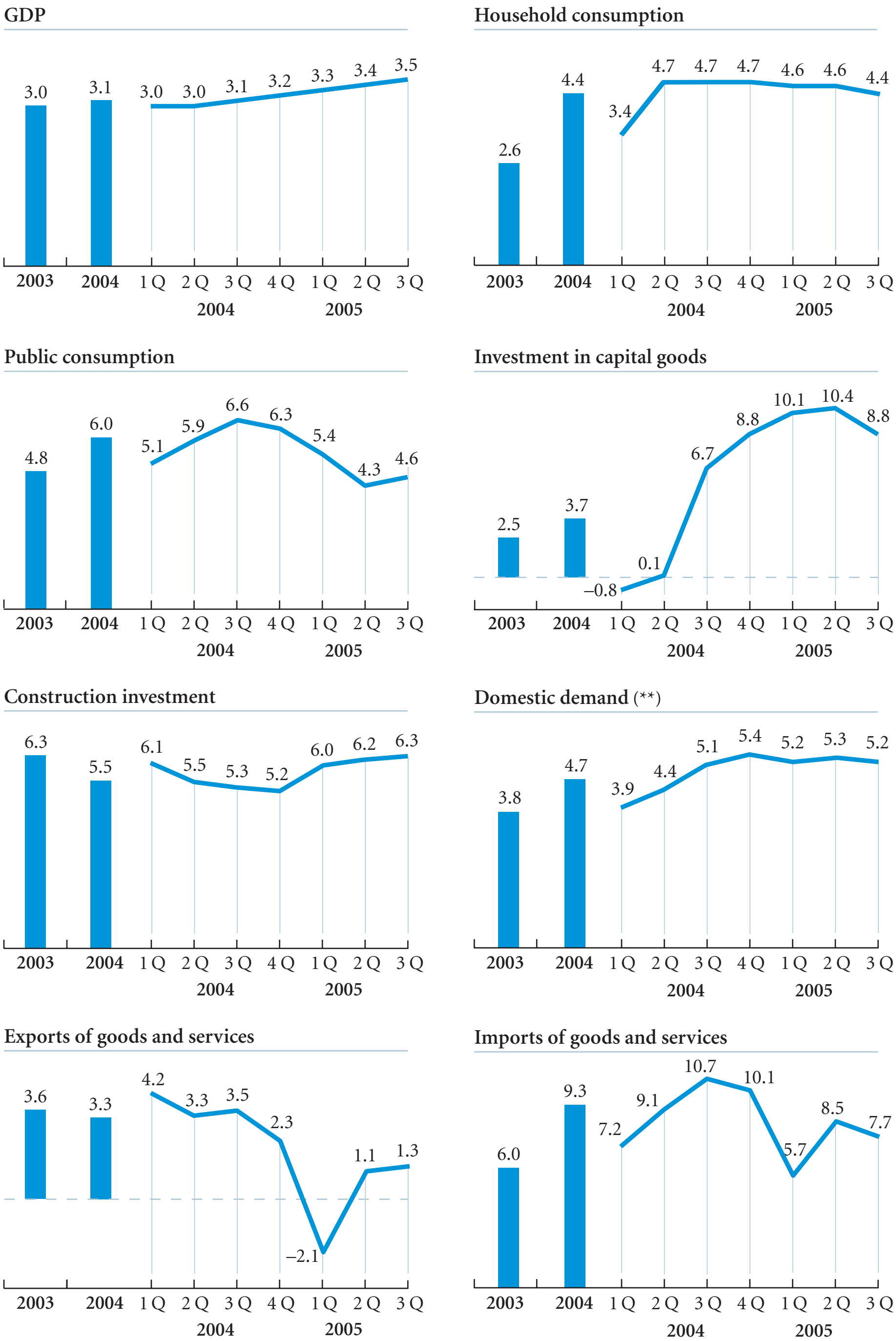
Consumption slightly moderates rate of increase while capital goods investment slows high growth rate...

On the demand side, we note that final household consumption dropped by 4.4% in year-to-year growth rate in the period under consideration, two decimals less than in the preceding quarter, due to the reduced strength of spending in some services and durable goods. This growth rate (still high if measured in historical terms) continued to be based on the favourable trend in employment (which, according to National Accounting, continued to grow by above 3%) and the sharp growth of credit linked to low interest rates. But, if we are to go by current trends, it is likely that consumption will continue to moderate growth over coming months, especially if we take into consideration that consumer confidence has been stagnant at very low levels all through the year (close to –11 points), according to the European Commission survey.

In addition, overall consumption of general government increased growth to 4.6% year-to-year (three decimals more than in the second quarter) due to the drive seen in current purchases of goods and services. With regard to investment, the capital goods component slowed its growth (8.8% year-to-year increase as against 10.4% earlier), which is understandable if we take into account

TREND IN SPAIN'S GDP BY COMPONENT

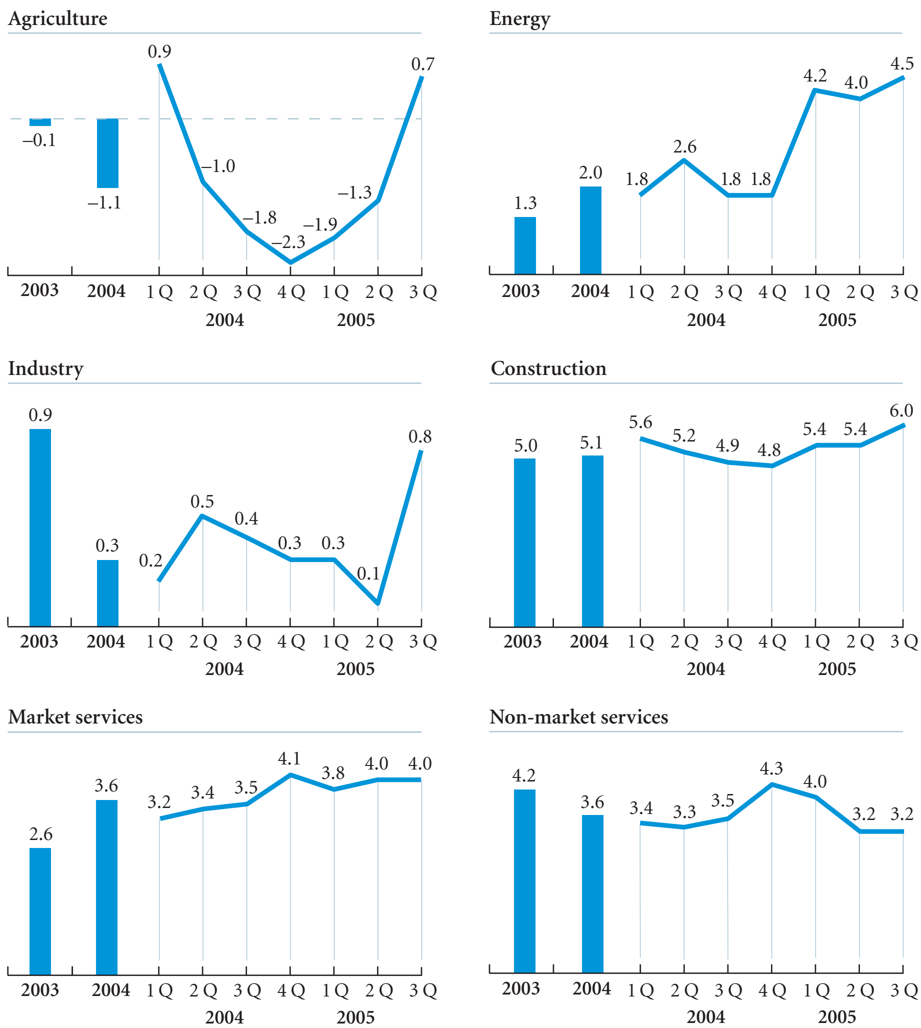
Percentage year-to-year change (*)



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

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



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

the sharp rise in previous months. The loss of drive had a similar effect both on investment in machinery and in transportation equipment, mainly under the imports heading.

On the other hand, gross capital formation in construction showed a gradual increase in growth (going up to 6.3% year-to-year) due mainly to the drive in building construction. In any case, we may expect some easing of the sharp growth rate in this heading over coming months, if we are to go by the trend in the main activity indicators (cement consumption and new project approvals, among others). In the real-estate market, prices also are continuing a downward trend but a very moderate one, in any case. The price per square metre of non-subsidized housing rose by 13.4% as against 15.7% and 13.9% reported in the first two quarters of the year.

GROWTH RATE OF CEMENT CONSUMPTION SLOWS

Year-to-year change in cement consumption

NOTES: Cycle-trend series.
SOURCE: Officemen, Ministry of Economy and Finance and internal figures.

DEMAND INDICATORS

Percentage change over same period year before

	2003	2004	2004		2005					
			3 Q	4 Q	1 Q	2 Q	July	August	September	October
Consumption										
Production of consumer goods (*)	0.2	–0.2	0.1	0.1	0.1	1.1	0.9	3.4	0.7	0.2
Imports of consumer goods (**)	10.9	13.4	9.7	8.3	6.5	8.4	4.4	10.5	9.0	...
Car registrations	3.8	9.8	5.3	4.7	–0.0	4.9	–2.8	9.5	4.6	–9.6
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	–12.0	–11.0	–11.0
Investment										
Capital goods production (*)	0.6	1.8	4.7	–1.7	–0.8	0.6	–3.4	4.9	–2.7	–2.4
Imports of capital goods (**)	14.8	14.9	19.2	29.0	28.6	36.0	–8.0	44.3	17.0	...
Commercial vehicle registrations	13.5	11.7	9.4	9.4	9.2	17.9	10.1	22.3	11.8	1.8
Foreign trade (**)										
Non-energy imports	8.8	9.8	8.9	9.0	5.7	9.0	–2.7	11.1	7.3	...
Exports	6.9	5.2	6.7	4.3	–3.1	2.5	–6.0	5.2	5.9	...

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.

...but construction demand rather tends to increase.

Along with construction, private services are the most dynamic.

Prices holding excessively upward trend.

On the supply side, the sharpest growth showed up in construction, in line with the above. In other fields, we should point out that economic activity in the primary sectors recorded a positive year-to-year change (0.7%), something not seen since the beginning of 2004, thanks mainly to the good performance of summer crops. Nevertheless, prospects for autumn and winter crops are much more pessimistic, with these being affected up to this point by unfavourable weather conditions (especially in the case of grapes and olives).

Industrial branches also showed a slight increase in value added although growth was still below 1% year-to-year. Finally, activity in services continues to grow at a very stable rate (3.8%) with market services showing greater strength than non-market services. Among the former, we should mention the improvement seen in the tourist sector and the strength of activities related to information and communications technology.

Finally, we are seeing a continuation without any appreciable change of the pattern of current growth being shown by Spain's economy, based on the strength of those production sectors less subject to international competition (construction and services) while those related to manufactured goods (which indeed must measure up in the global market) are showing much poorer strength. As for the rest, the trend in prices continues to be the Achilles' heel of Spain's economy. The growth rate of the GDP deflator has maintained a constant growth path for the past two years going to the by-all-means excessive current figure of 4.4%.

Labour market

Employment keeps up as fourth quarter begins

The labour market continues to show notable strength. In the last 12 months more than 930,000 persons have joined the number of those employed, an increase of 5.1%, according to the Labour Force Survey. Part of this group is made up of those with part-time work while most come under temporary jobs. Furthermore, these jobs are mainly in the tertiary sector and in construction which gives the impression that the employment being created by Spain's economy is not of a very high level.

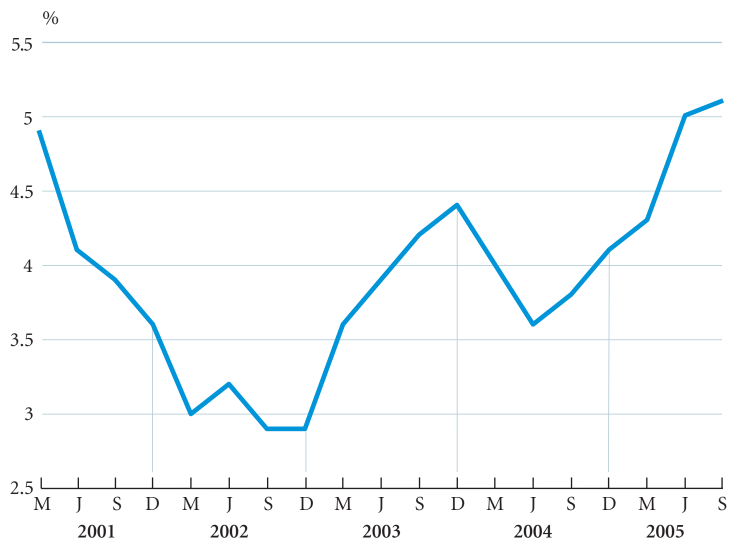
The shorter workday appears to be a key factor in getting people working, especially in the case of women. Somewhat more than 30% of female employment comes within this heading. This proportion is far from that seen in male employment which showed 4.5% in the third quarter of 2005. The degree of part-time work depends on each sector. Domestic service comes first in the use of this type of hiring and makes up 48% of employment in this work area. Social and personal services, services to companies, fishing and the hotel and restaurant trade come next in line with shares of close to 20%. Lower down the scale we find retail trade, education and health services with somewhat more than 12% of total employment. Construction, industry and the public service, on the other hand, show a very low degree of part-time work, below 5%.

The second area helping to improve the labour market is temporary work which

Nearly a million new jobs created in one year but temporary work and part-time contracts predominate in construction and services.

STRONG JOB CREATION IN THIRD QUARTER

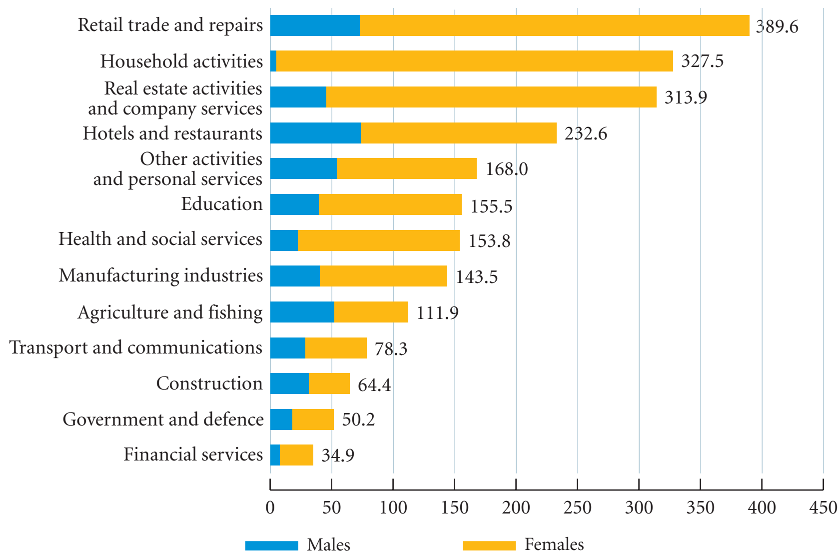
Year-to-year change in estimated employment



SOURCE: National Institute of Statistics and internal figures.

PART-TIME WORK KEY FACTOR IN SERVICES

Thousands of persons on temporary work contract



SOURCE: INE and internal figures.

Industry maintaining very modest growth at 1% year-to-year.

Hiring of foreign workers also helps explain sharp rise in employment figures.

rose by 13.1% year-to-year, well above permanent job hiring, going to more than 34.4% of wage employment (33.1% in the third quarter of 2004). Under wage employment, the private sector showed stronger than the public sector, which overall made up 2,913,600 persons, that is to say, 18.5% of all wage employment or equivalent to 15.2% of total employment.

Thirdly, the strength shown by the Labour Force Survey arises from the sharp growth of employment in construction and services although such high rates may be difficult to maintain over the short-term. Under services, where part-time work is significant, retail trade, transport and communications show the relatively weakest state. On the other hand, services to companies and personal services are very strong. Industry improved slightly while still showing modest growth in employment at 1% year-to-year. There was also a good performance in agriculture, mainly because of the switch from full-time jobs to part-time jobs.

The high rate of increase shown by the Labour Force Survey may also be explained by the level of employment of foreign workers which in the past 12 months accounted for 43.6% of new employment. The nature of the group interviewed could also distort the results. If we take into consideration only the growth of employment among Spanish nationals, the rate of increase drops to 3.2%, a rate more in keeping with the growth rate of the gross domestic product of 3.5% put out by National Accounting.

In addition, registrations with Social Security, also adjusted for the impact of normalization of the status of immigrants, shows a stable profile and levels more in line with the growth rate of the economy. In October, the increase in the rate of registrations as a whole

ESTIMATED EMPLOYMENT

Third quarter 2005

	No. of employees (thousands)	Quarterly change		Annual change (*)		Annual change (**)		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	992.2	5.6	0.6	25.7	2.7	28.0	2.9	5.2
Non-farm	18,199.0	290.6	1.6	904.2	5.3	1,034.2	6.0	94.8
Industry	*3,311.0*	*48.2*	*1.5*	*34.2*	*1.1*	*88.0*	*2.7*	*17.3*
Construction	*2,396.3*	*57.0*	*2.4*	*179.7*	*7.9*	*113.4*	*5.0*	*12.5*
Services	*12,491.7*	*185.4*	*1.5*	*690.3*	*5.9*	*832.8*	*7.1*	*65.1*
By type of employer								
Private sector	16,277.5	226.1	1.4	...	...	978.4	6.4	84.8
Public sector	2,913.6	70.1	2.5	...	...	83.6	3.0	15.2
By work situation								
Wage-earners	15,749.5	309.4	2.0	950.4	6.4	873.6	5.9	82.1
Permanent contract	*10,333.1*	*27.8*	*0.3*	*304.6*	*3.1*	*384.9*	*3.9*	*53.8*
Temporary contract	*5,416.4*	*281.6*	*5.5*	*645.9*	*13.1*	*488.7*	*9.9*	*28.2*
Non-wage-earners	3,421.4	–6.9	–0.2	–57.9	–1.8	189.8	5.9	17.8
Entrepreneurs with employees	*977.0*	*5.7*	*0.6*	...	...	*8.8*	*0.9*	*5.1*
Entrepreneurs without employees	*2,156.5*	*12.4*	*0.6*	...	...	*157.5*	*7.9*	*11.2*
Family help	*287.9*	*–25.0*	*–8.0*	...	...	*23.5*	*8.9*	*1.5*
Other	20.2	–6.3	–23.8	37.5	174.1	–1.4	–6.5	0.1
By time worked								
Full-time	16,963.3	486.5	3.0	661.8	4.0	413.8	2.5	88.4
Part-time	2,227.8	–190.3	–7.9	268.1	17.0	648.2	41.0	11.6
By sex								
Males	11,524.9	207.1	1.8	461.5	4.2	500.6	4.5	60.1
Females	7,666.2	89.1	1.2	468.4	6.6	561.4	7.9	39.9
TOTAL	**19,191.1**	**296.1**	**1.6**	**930.0**	**5.1**	**1,062.1**	**5.9**	**100.0**

NOTES: (*) Adjusted for effect of methodological changes introduced in first quarter of 2005.
(**) Not adjusted for effect of these changes.
SOURCE: National Institute of Statistics and internal figures.

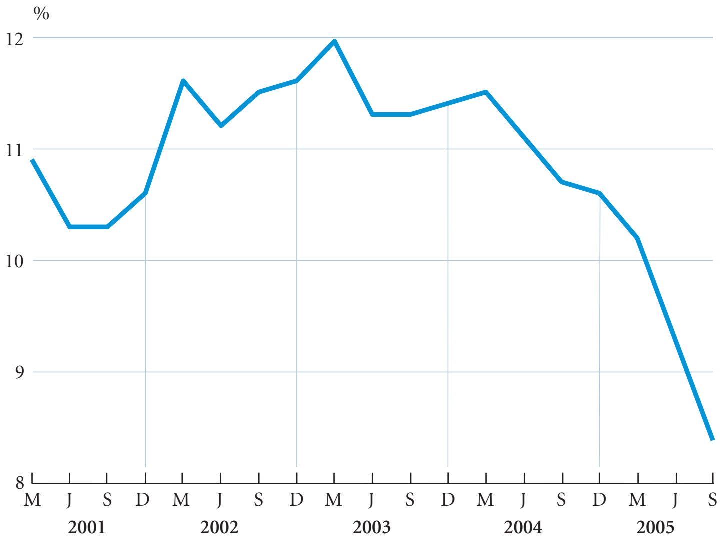
reached 5.4%, thus easing off from the previous month by one decimal. If we discount immigrants registering as a result of the normalization process, the increase in registrations would be around 3.0%. Registrations by Spanish nationals, the most stable indicator, continued to show growth of 2.0%, the same rate as for the three previous months.

Estimated unemployment, according to the Labour Force Survey, amounting to 1,765,000 persons in the third quarter, was down 15.5% compared with one year earlier. The sudden drop in growth rate of the labour force lies behind this sharp drop in unemployment. As a result, the unemployment rate stood at 8.4%, a level not seen since the end of the Seventies. In any case, there continued to be notable differences between the indices for the male and female groups at 6.5% and 11.2% respectively. The level of unemployment among those under 25 years of age stood at 18.0%.

Notable drop in unemployment putting it at lowest levels for many years.

UNEMPLOYMENT RATE DROPS MORE SHARPLY

Estimated unemployment over labour force



SOURCE: National Institute of Statistics and internal figures.

ESTIMATED UNEMPLOYMENT

Third quarter 2005

	No. of unemployed	Quarterly change		Annual change (*)		Annual change (**)		Share %	% of labour force
		Absolute	%	Absolute	%	Absolute	%		
By sex									
Males	799.2	–90.9	–10.2	–150.3	–15.5	–171.3	–17.7	45.3	6.5
Females	965.8	–88.8	–8.4	–187.2	–15.5	–244.5	–20.2	54.7	11.2
By age									
Under 25 years	465.8	–42.3	–8.3	...	...	–72.4	–13.5	26.4	18.0
Other	1,299.3	–137.3	–9.6	...	...	–343.3	–20.9	73.6	7.1
By personal situation									
Long-term unemployment	522.3	–71.4	–12.0	...	...	–64.6	–11.0	29.6	–
Seeking first job	250.6	–7.5	–2.9	...	...	–97.6	–28.0	14.2	–
Other	992.1	–100.8	–9.2	...	...	–253.6	–20.4	56.2	–
TOTAL	**1,765.0**	**–179.7**	**–9.2**	**–337.5**	**–15.5**	**–415.8**	**–19.1**	**100.0**	**8.4**

NOTES: (*) Adjusted for effect of methodological changes introduced in first quarter of 2005.
(**) Not adjusted for effect of these changes.
SOURCE: National Institute of Statistics and internal figures.

The good situation was also reflected in the small proportion of households where all members were unemployed, a figure which went down to 2.5% of the total. The situation also improved in the case of heads of family for whom the unemployment rate dropped to 5.4% and among spouses and offspring of that reference person, although unemployment rates were higher at 7.8% and 14.1%. Long-term unemployment, that is to say, that lasting for more than one year, applied to 522,300 persons, or 29.6% of those persons without work.

Registered unemployment: improvement eases off

The impression that we may have reached something of an upper limit in the trend to an improvement in the labour market given by the main employment indicators also shows up in figures from the Public Employment Services offices. In fact, the number of persons registered in October was well above that for the same month last year. As a result, unemployment reached 2,052,861 persons at the end of October, according to the Information System of the Public Employment Services, thus putting it 1.1% below the same month in 2004.

The gradual worsening of the situation in October was spread over the various sectors and contributed to reduce the respective cumulative balance. Only in the case of those seeking their first job did registrations show a bigger drop, something difficult to explain, although it may be because of the smaller number of registrations as a result of a worsening of job prospects among the group which had not previously been employed. The overall drop in unemployment as of October was 59,854 persons, practically half that for the first ten months in 2004.

Downturn in registered unemployment also shows some wearing out.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

October 2005

	No. of unemployed	Change over December 2004		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	66,136	15,844	31.5	16,467	33.2	3.2
Industry	293,124	–10,458	–3.4	–2,194	–0.7	14.3
Construction	220,582	–32,117	–12.7	–7,443	–3.3	10.7
Services	1,249,976	–14,809	–1.2	–1,270	–0.1	60.9
First job	223,043	–18,314	–7.6	–28,509	–11.3	10.9
By sex						
Males	803,777	–74,243	–8.5	–30,284	–3.6	39.2
Females	1,249,084	14,389	1.2	7,334	0.6	60.8
By age						
Under 25 years	278,101	9,288	3.5	1,126	0.4	13.5
All other ages	1,774,760	–69,142	–3.7	–24,076	–1.3	86.5
TOTAL	**2,052,861**	**–59,854**	**–2.8**	**–22,949**	**–1.1**	**100.0**

SOURCE: INEM and internal figures.

Prices

Background pressures on prices gradually increase in wake of indirect effects of higher cost of fuels and raw materials.

Fuels give CPI breather in October

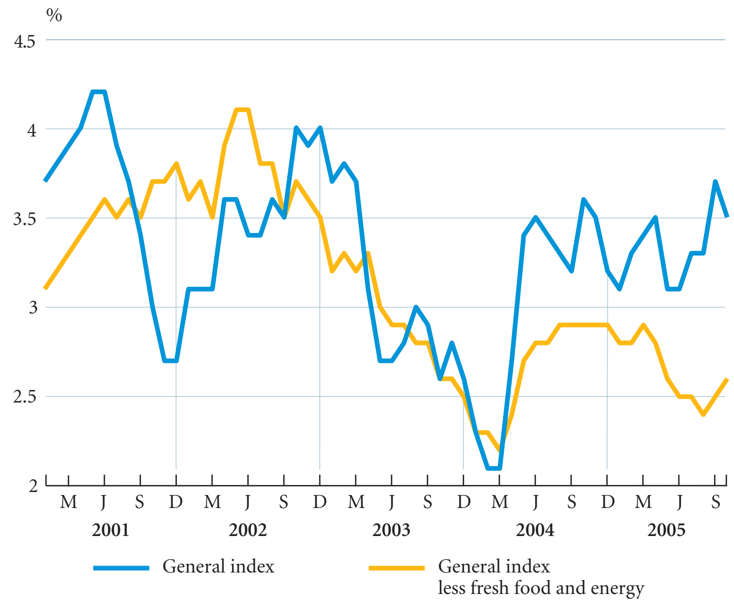
The consumer price index (CPI) showed a notable increase in October although less than in the same month in 2004, which gave something of a breather to the year-to-year inflation rate which dropped by two decimals to stand at 3.5%. The drop in fuel prices was decisive in this regard and the effects were not greater because of the slight rise in fresh foods and core inflation for the second consecutive month.

The slight rise in core inflation, which rose another decimal to stand at 2.6%, was not something apart from pressures shown by prices of non-energy industrial goods which, to some extent, began to reflect certain increases in production costs. In any case, the relative importance of final consumption of products imported at moderate prices continued to largely compensate for those increases and the year-to-year increase of this component held at very contained levels (1.1%).

In a similar way, services prices also moved gradually upward although within the same pattern followed in recent months, that is to say, very stable at a year-to-year rate of more than 3.5%. Price increases in some public services (sanitation, transport, education, etc.),

MOMENTARY EASING OF CPI

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	0.8	3.4	3.5
November	0.2	3.3	3.5			
December	–0.1	3.2	3.2			

SOURCE: National Institute of Statistics.

NON-ENERGY INDUSTRIAL GOODS HELP MODERATE CPI

Year-to-year change in industrial goods component of CPI (*)

NOTES: (*) Excluding energy components.
SOURCE: National Institute of Statistics and internal figures.

the progressive increase in the cost of financial services and sharp increases in certain personal services, repairs and household services would explain the stabilization of this very important CPI component at such high levels.

Processed foods also failed to make any positive contribution to the October CPI following the halt to the downward trend that had been noted since the end of the first quarter. The rise in cooking oil, tobacco and liquors, in the latter two

Food and beverages fail to contribute to containing of general index.

On other hand, fuels perform better than expected.

cases mainly for tax reasons, lay behind this slight increase. In any case, the balance of this component for the year as a whole is clearly positive seeing that there has been a decrease of more than one point in growth compared with the end of last year.

Finally fresh food, at least partially, picked up the increases seen in markets at origin and, as in keeping with forecasts, this index went to annual highs of 3.6% year-to-year. The situation was not worse thanks to the drop in poultry prices which were affected by fears brought about by avian flu. This likely will have a positive effect on the November CPI if it is not compensated by sharp increases in substitute foods.

The only bright spot came in fuel prices which dropped slightly in October in contrast to the sharp increase in the

CONSUMER PRICE INDEX BY COMPONENT GROUP

October

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2004	2005	2004	2005	2004	2005
By type of spending							
Food and non-alcoholic beverages	117.2	0.0	0.2	2.4	2.2	3.0	2.9
Alcoholic beverages and tobacco	121.6	–0.0	0.2	5.5	4.9	5.7	4.9
Clothing and footwear	118.2	8.5	8.9	–0.0	–0.5	2.8	1.6
Housing	117.0	0.9	0.6	4.2	5.9	4.6	5.8
Household equipment	108.5	0.5	0.4	1.1	1.5	1.6	2.2
Health	106.4	0.1	0.0	0.1	0.7	0.2	0.8
Transport	119.9	1.2	–0.7	8.1	9.1	8.1	7.1
Communications	91.7	–0.1	–0.1	–0.2	–1.5	–0.9	–1.9
Recreation and culture	103.0	–0.9	–0.5	–0.2	–0.2	–0.2	–0.2
Education	120.8	2.0	2.4	3.4	3.8	3.7	4.5
Hotels, cafés and restaurants	120.6	–0.0	–0.0	3.8	3.9	4.0	4.3
Other	114.6	0.1	0.2	2.7	3.0	2.9	3.2
By group							
Processed foods	115.7	0.1	0.2	3.7	2.5	4.0	2.9
Unprocessed foods	122.0	–0.0	0.2	0.9	2.7	1.8	3.6
Non-food products	114.7	1.4	1.0	3.2	3.6	3.7	3.6
Industrial goods	112.1	2.6	1.8	3.0	3.8	3.7	3.5
Energy products	*123.9*	*2.6*	*–0.7*	*11.6*	*15.4*	*11.6*	*11.2*
Fuels and oils	*131.4*	*3.5*	*–0.9*	*15.3*	*20.4*	*15.3*	*14.6*
Industrial goods excluding energy products	*108.4*	*2.6*	*2.8*	*0.3*	*0.3*	*1.3*	*1.1*
Services	117.7	0.0	0.1	3.4	3.4	3.6	3.8
Underlying inflation (**)	113.8	0.9	1.1	2.4	2.1	2.9	2.6
GENERAL INDEX	**115.4**	**1.0**	**0.8**	**3.1**	**3.4**	**3.6**	**3.5**

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

same month in 2004. Because of this, the energy group index dropped notably (nearly four percentage points) going to a still very high level of 11.2%.

The moderation of prices in October was greater in Spain than in the Monetary Union as a whole, going by the harmonized consumer price index. In fact, the differential dropped by one decimal that month to stand at 1.1 percentage points. The greater containment of transport prices in Spain was decisive in this respect although CPI growth was still higher than in the euro area. Those components showing a relatively more favourable performance in Spain were alcoholic beverages and tobacco, leisure and culture and medical services.

Prices at origin contained except in agriculture

Industrial prices showed a lower increase in October although continuing to grow at the very high rate of 4.9% year-to-year, The sharp drop in energy prices was a key factor in this containment which might have been greater but for the unfavourable performance in food product prices. On the other hand, consumer goods and capital goods showed greater stability at relatively moderate levels.

Import prices also continued to be affected by oil costs with cumulative year-to-year growth going up to stand at an average of 5.0% for the first nine

Inflation differential with euro area holds at 1.1 points.

Producer prices show halt to upward trend.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflator (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
2004											
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	4.2
December	2.5	5.0	2.8	1.6	6.2	10.6	5.8	4.2	–3.7	9.4	–
2005											
January	8.4	4.8	3.2	1.8	6.2	8.8	5.0	3.4	–1.6	7.2	–
February	12.2	4.9	3.2	1.9	5.5	11.0	5.4	1.0	–1.9	9.3	4.3
March	13.2	5.1	2.8	2.0	4.9	13.1	5.3	2.6	–7.6	9.7	–
April	6.6	5.0	2.8	2.0	3.7	14.5	4.6	0.9	–7.5	9.1	–
May	–0.9	4.2	2.5	2.1	3.3	11.0	0.9	–3.2	–6.5	4.7	4.3
June	–11.9	4.4	2.2	2.1	3.1	13.5	5.3	3.6	–1.3	7.7	–
July	5.1	4.6	2.1	1.9	3.0	15.7	8.2	0.6	10.4	11.7	–
August	9.2	4.9	2.5	1.8	2.9	16.3	6.1	–0.2	–0.4	11.0	4.3
September	...	5.4	2.6	1.9	3.2	17.9	4.3	–0.6	4.2	7.0	–
October	...	4.9	3.0	1.8	3.0	15.2	...	...	...	...	–

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

Moderation in import prices while prospects for farm prices poor.

months of the year, three and a half points more than in the same period in 2004. This boost did not come entirely from energy costs but also was brought about by increases in other industrial intermediate goods. Consumer goods prices, on the other hand, eased to show an average increase of 0.8%, a very low rate but one which, after all, was in contrast to the decrease shown in 2004.

Farm prices exhibited an unfavourable performance in August but the cumulative increase for the first eight months (3.3%) was six decimals lower than in 2004. In spite of this improvement, prospects are not positive to the extent that it will be difficult to improve on the figures for the second half of 2004 which will contribute to worsening the balance for this year compared with that reported last year.

Foreign sector

Exports show some slight signs of recovery in third quarter

At the end of the third quarter, one of the most notable features of foreign trade was the incipient recovery of exports in a context of relative moderation in imports. In fact, foreign sales in September increased by more than 10% for the second consecutive month, thanks to recovery of markets outside the European Union. At the same time, in spite of showing sharp growth, purchases abroad eased, which meant a slight slowdown in the increase in the trade deficit, which in the first nine months of 2005 went to 56.7 billion euros, some 30.7% above 2004.

The recovery in exports in September made it possible to raise cumulative growth to 4.8% although this was largely due to price increases seeing that the increase in volume was just 0.2%. The better situation in foreign sales showed up in third countries, mainly United

Trade deficit continues to increase at very high rates in spite of fact that exports seem to be picking up thanks to markets outside EU.

FOREIGN TRADE

January-September 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	23,450	39.3	13.9	4,458	21.2	4.0	–18,992	19.0
Consumer goods	48,463	8.5	28.6	42,874	–0.8	38.1	–5,588	88.5
Food	*10,062*	*5.2*	*5.9*	*13,431*	*2.7*	*11.9*	*3,369*	*133.5*
Non-foods	*38,401*	*9.1*	*22.7*	*29,444*	*–4.2*	*26.2*	*–8,957*	*76.7*
Capital goods	19,359	24.2	11.4	10,196	9.4	9.1	–9,163	52.7
Non-energy intermediate goods	77,887	5.8	46.0	54,932	7.5	48.8	–22,955	70.5
By geographical area								
European Union (EU-15)	99,220	6.0	58.7	78,549	2.4	69.8	–20,671	79.2
Euro area	*86,623*	*6.3*	*51.2*	*65,624*	*2.2*	*58.4*	*–20,998*	*75.8*
Other countries	69,939	22.4	41.3	33,911	10.9	30.2	–36,028	48.5
Russia	*3,780*	*46.1*	*2.2*	*763*	*18.2*	*0.7*	*–3,017*	*20.2*
United States	*6,021*	*9.6*	*3.6*	*4,352*	*5.8*	*3.9*	*–1,669*	*72.3*
Japan	*4,342*	*4.2*	*2.6*	*866*	*–3.7*	*0.8*	*–3,476*	*19.9*
Latin America	*7,697*	*22.4*	*4.6*	*5,403*	*4.8*	*4.8*	*–2,294*	*70.2*
OPEC	*12,596*	*35.6*	*7.4*	*2,958*	*21.7*	*2.6*	*–9,638*	*23.5*
Rest	*35,501*	*21.2*	*21.0*	*19,568*	*12.8*	*17.4*	*–15,933*	*55.1*
TOTAL	**169,159**	**12.2**	**100.0**	**112,460**	**4.8**	**100.0**	**–56,699**	**66.5**

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

Imports tending to lose strength, particularly non-energy intermediate goods.

States, Japan, China, the former Soviet Union and petroleum exporting countries. Sales to the European Union fell by nearly 2%. The improved situation in exports was widely spread over products but in some important sectors, such as motor vehicles, sales were clearly down from last year.

Imports in September held to the levels seen the month before and nominal cumulative growth rose to 12.2%, equivalent to 6.9% by volume. This increase varied considerably by product type. On the one hand, foreign purchases of consumer goods tended to show some stabilization at relatively high levels but well below those a few months earlier, which could reflect some moderation in consumption. In capital goods, there also seems to be the beginnings of a drop although the level still remains high. What showed up was a clear decrease in the trend in imports of non-energy intermediate goods, which grew by a very modest 0.6% real in the third quarter in the wake of the poorer state of industry.

Trade deficit opens gap in foreign accounts not being covered by lack-lustre tourist sector.

Current account deficit continues to rise

The current account deficit continued to increase by giant steps in August, in the wake of the turnaround in the transfers balance to negative figures and the bigger trade deficit and incomes deficit that was not compensated by the improvement in the services balance. As a result, the cumulative deficit for the past 12 months rose to 62 billion euros, that is to say, 7.1% of the gross domestic product.

BALANCE OF PAYMENTS

Cumulative figure for last 12 months in million euros

	August 2004	August 2005	% change
Current account balance			
Trade balance	–47,218	–65,516	38.8
Services			
Tourism	*26,366*	*25,524*	*–3.2*
Other services	*–4,640*	*–3,636*	*–21.6*
Total	21,726	21,888	0.7
Income	–12,122	–17,395	43.5
Transfers	739	–1,027	–
Total	**–36,875**	**–62,049**	**68.3**
Capital account	**8,588**	**7,891**	**–8.1**
Financial balance			
Direct investment	–11,515	–26,678	131.7
Portfolio investment	39,645	80,381	102.8
Other investment	15,439	478	–96.9
Total	**43,569**	**54,181**	**24.4**
Errors and omissions	873	–1,021	–
Change in assets of Bank of Spain	–16,155	999	–

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.

The worse situation was due to a general drop in the various headings of the balance of payments. First, the trade deficit in the first eight months of the year rose by 39.2%, reflecting the rise in the oil bill and the increase in imports in a context of weak exports.

Secondly, the services balance fell by 2.3% because of the poor results in the tourist balance which reflects an increasing trend for Spaniards to travel abroad as well as the low level of spending by foreign tourists. As a result, tourist revenues rose by only 2.2% nominal, which was well below prices of tourist services, and arrivals of foreign tourists (6%). On the other hand, payments abroad for tourism were up by 26.2%.

The transfers balance, on the other hand, improved slightly returning to a slight surplus, well below that for the first eight months in 2004. The total of public funds coming from the European Union made possible this change seeing that immigrant remittances abroad continued to put pressure on this heading of the balance. Finally, in the incomes balance, the increase in the deficit may be attributed to the drop in inflows and the increase in payments.

Capital account, in turn, showed a surplus in August that was lower than in the same period last year because of lower inflows from the European Union. The cumulative balance for the first eight months was also below that recorded in the same period in 2004 and was insufficient to cover the current deficit. This meant that net world borrowing for Spain's economy, the result of adding the current account balance and the capital balance, went up to 37.4 billion euros in the January-August period, practically twice that for the year before.

Foreign investment in Spain collapses.

In the financial sphere, direct foreign investment in Spain dropped sharply both in the corporate field and in real estate, down by 40% and 18% respectively. Only foreign portfolio investment rose sharply. Spanish direct investment abroad was also down but not in real estate or in portfolio investment.

Public sector

Government revenues show strong growth as of October

Government revenues up six points above nominal growth of economy...

Central government non-financial revenues continued to show a strong growth rate in October going to 113.6 billion euros in the first ten months of the year, some 15.7% more than in 2004. This figure does not include the 37.3 billion euros corresponding to those segments of collections for personal income tax and the greater part of indirect taxes ceded to autonomous communities and local government so that this is of little significance as an indicator of the revenue capacity of the government through general taxes. If we include the revenues ceded, collections rise to 150.9 billion euros, which means an increase of 14.1% over the year before.

The main source of revenue continued to be direct taxation which rose spectacularly (19.2%) boosted by collections for company profits tax. Revenues from personal income tax, which are still the main core of this heading, were also up sharply at 16.7%.

Somewhat lower was the increase in collections for indirect tax with value added tax (VAT) being the main factor. We should point out the increase in collections for this tax for domestic transactions (23.6%), well above the nominal growth of the economy which cannot be explained apart from a lack of

CENTRAL GOVERNMENT BUDGET IMPLEMENTATION

October 2005

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**21,550**	**15.8**	**113,643**	**15.7**
Non-financial revenue adjusted (*)				
Personal income tax	7,042	17.5	46,725	16.7
Corporate tax	10,069	23.1	28,957	25.4
VAT	7,833	6.8	45,565	12.7
Special taxes	1,801	24.4	15,232	4.7
Other	1,202	–2.7	14,463	1.7
Total	**27,947**	**15.5**	**150,942**	**14.1**
Non-financial spending	**10,927**	**–15.8**	**99,421**	**4.6**
Treasury balance	**10,623**	**89.0**	**14,222**	**357.4**
Surplus (+) or deficit (–) (**)	***11,907***	***64.8***	***20,015***	***156.2***

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

homogeneity in the figures. Among special taxes, most headings showed a very modest increase except in tax on tobacco which recently was subject to a rate increase. Collections for fuel tax were stable under the effect of the change in the structure of fuel consumption. Finally, revenues from foreign trade also grew sharply because of the increase in imports and, naturally, from the effect of the rise in oil prices.

Apart from tax revenue, fees and public service prices showed a substantial increase which was in contrast to the drop in government property earnings which were affected by the lower profits of the Bank of Spain. Current transfers, in turn, rose modestly in contrast to the sharp decrease in capital transfers.

Central government non-financial spending was up 4.6% going to 99.4 billion euros. This figure does not include the balancing entry for revenues corresponding to taxes ceded to autonomous communities. The relative moderation in spending was due to the modest increase in current transfers and the drop in purchases of goods and services.

...boosted by direct taxes and VAT.

The central government Treasury balance as of October, that is to say, the difference between revenues and non-financial spending, was positive at 14.2 billion euros, well above the same period the year before. In spite of the significant net increase in financial assets, this balance gave rise to a surplus of 4.4 billion euros. In terms of National Accounting, the budgetary balance was also positive with a figure well above the same period in 2004, to reach an amount of 20 billion euros.

Notable surplus in government accounts as of October.

Savings and financing

Low loan interest rates boost demand for bank credit.

Funding to private sector moves up at sharpest rate in past five years

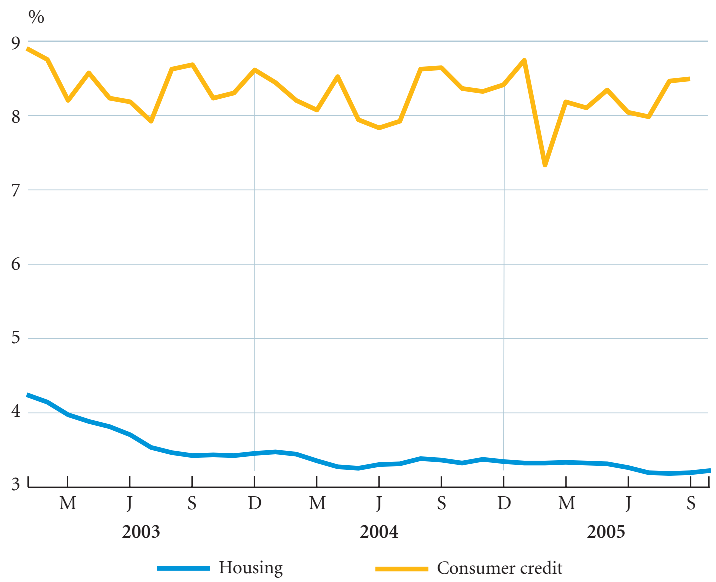
Interest rates on bank loans and credits held at low levels in September and even tended to generally drop slightly following a slight rise in August. Average interest rate for households stood at 4.14%, close to the low recorded in July. Average interest charged to companies stood at 3.41%, close to the low in June. The current very low interest rates may be explained by the holding of the European Central Bank interest rate at 2% since June 2003 and a competitive banking environment.

Some interest rates have begun to rise in keeping with the prospect of an increase in the Eurosystem rate in coming months. As a result, the interest rate on consumer credit in September stood at 8.5%, a half-point more than in July. On the other hand, in October 2005 the interest rate on mortgage loans of more than a 3-year term for purchase of non-subsidized housing (at credit institutions as a whole) rose slightly by 3 basis points to 3.23% but this rate was only 4 hundredths away from the all-time low reported in August. As a result, it stood 11 basis points below the same month in 2004.

In this context of low interest rates and with the boost coming from a favourable economic climate, funding to the private sector in September rose at

SLIGHT RISE IN CONSUMER CREDIT INTEREST RATES

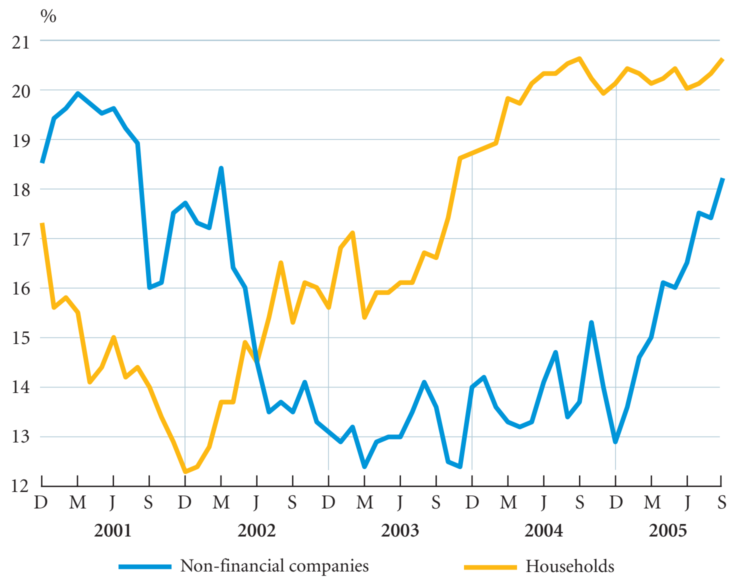
Interest rates on loans and credits to households. New transactions at credit institutions



SOURCE: Bank of Spain.

INCREASE IN FUNDING TO BOTH COMPANIES AND HOUSEHOLDS

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



SOURCE: Bank of Spain.

the highest rate since April 2000 to show an annual change rate of 19.3%. So far, the often forecast slowdown in loan demand continues to be noted for its absence although this will likely happen once we see a rise in real interest rates, equivalent to nominal rates less expected inflation.

Funding to companies rose by 18.2% in September compared with the same month in 2004, which represents 5.3 points more than the annual rate reported in December. With regard to funds going to households, these increased by 20.6% over the same month last year. Of total funding going to households, the greater part continued to be for mortgage loans which kept increasing at a sharp rate. Consumer credit (to buy cars, motorcycles, appliances, furniture, travel, etc.) was also up considerably. As a result, the total for new consumer credit transactions for households in the January-September period rose by 21.5% compared with the same months last year. With regard to other purposes, total new loans granted in the first nine months of 2005 showed an annual change rate of 14.1%.

Sharp growth of bank deposits

Funding to companies up by 18%.

Total private sector deposits rose at a sharp rate in September compared with the same month in 2004, well above the rate in the euro area. Deposits in currencies other than the euro recorded the highest annual increase. Time deposits for more than two years, which enjoy a tax benefit of 40% on interest, also showed a spectacular rise. Furthermore, on-demand and savings accounts rose by 11.5% over the past 12 months.

Amount of new consumer loan transactions up 21% as of September compared with same period in 2004.

On the other hand, assets of securities mutual funds stood at 241.3 billion euros at the end of October, a monthly drop of 763 million euros. This decrease

Spectacular increase in deposits in currencies other than euros and time deposits of more than 2 years.

Average annual yield on securities mutual funds stands at 4.7%.

New stage opening up for mutual funds and investment companies with free investment funds and listed funds among new features.

was due to capital losses recorded because of the negative trend in financial markets during the month, given that net subscriptions amounted to 1.08 billion euros. Compared with December, assets of securities mutual funds rose by 21.7 billion euros or 9.9%. In the first ten months of the year net subscriptions amounted to 15.03 billion euros. Average weighted annual yield of securities mutual funds came to 4.70%. All types of fund showed positive annual yields although there were wide differences. The highest gains showed up in emerging market share-based funds which stood at 46.0%.

Also of note, new regulations covering mutual fund institutions came into force on November 9 under Royal Decree 1309/2005. As a result, certain aspects of the new legal framework for these institutions were set out in keeping with Law 35/2003 (dated November 4) which modernized the judicial set-up for these bodies by introducing greater flexibility while also incorporating the latest EU directives in this matter. The new regulations involve some new aspects relating to funds and investment companies, the most relevant being set out below.

Under the new regulations some changes in classification are introduced. Fixed capital mutual fund companies (SIM) now disappear, and there is a new name for variable capital mutual fund companies (SICAV) previously known as SIMCAV. Another matter to disappear is the obligation of those companies involved in investment of a financial nature, represented by shares as opposed to mutual funds, for their shares representing capital to be traded on the stock markets. Furthermore, they may also be listed in a special market organized for this purpose or else be made liquid along the lines of investment funds. In addition, as of now there can be mixed mergers between investment funds and investment companies if these are of the same type (financial or non-financial) whereas up until now investment companies could merge only with each other, as in the case of funds.

Another novelty is the development of groups or compartments in investment funds and investment companies.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

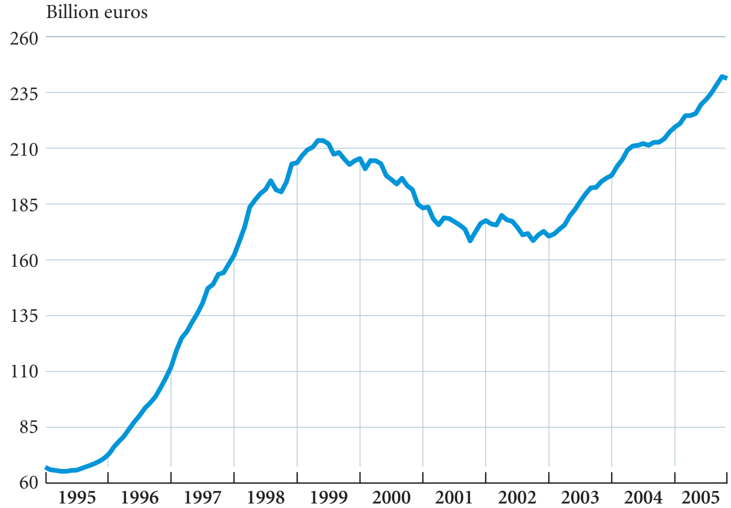
September 2005

	Total	Change this year		Change over 12 monts		% share
	Million euros	Million euros	%	Million euros	%	
On-demand and savings (**)	375,922	30,848	8.9	38,904	11.5	44.3
Up to 2 years (*)	183,313	22,846	14.2	27,717	17.8	21.6
More than 2-year term (*)	203,529	76,061	59.7	94,068	85.9	24.0
Repos	72,901	–7,748	–9.6	–2,586	–3.4	8.6
Total (*)	**835,664**	**122,006**	**17.1**	**158,102**	**23.3**	**98.5**
Deposits in currencies other than euro	**12,343**	**6,496**	**111.1**	**7,092**	**135.1**	**1.5**
TOTAL (*)	**848,007**	**128,502**	**17.9**	**165,193**	**24.2**	**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.

SLIGHT DROP IN ASSETS OF SECURITIES MUTUAL FUNDS IN OCTOBER

Total assets of securities mutual funds



SOURCE: Inverco.

Generally, these must have a minimum of 20 participants. Each compartment can have its own investment policy as well as a corresponding system of commissions and a different yield.

Hedge funds also come under these regulations. These can follow alternative strategies with fewer restrictions than traditional funds. Listed investment funds are also introduced into the Spanish market with participations listed on the stock exchanges and therefore their value fluctuates during market sessions as opposed to the traditional liquidation value. There are also changes in this respect. As of now, the liquidation value can be only that for the same day of the order or the following day (not that for the day before as previously) and it cannot be previously known to the investor in order to avoid possible situations of arbitrage.

In another sphere, total pension fund assets reached a figure of 68.58 billion euros at the end of the third quarter, according to information supplied by the sector organization Inverco. As a result, this figure was up 18.1% compared with 12 months earlier. With regard to average weighted annual yield of pension funds, this stood at 9.0% at the end of September.

Total pension fund assets up 18% in September compared with one year earlier.

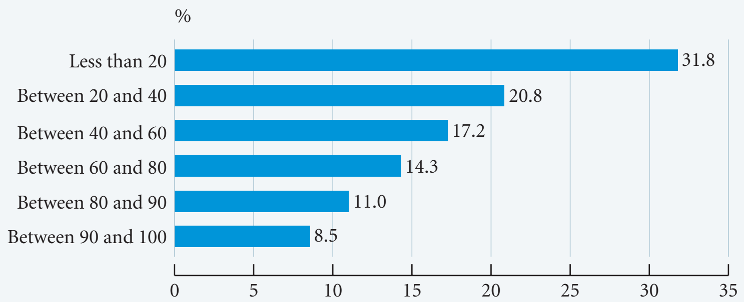
Interest rate increases present only modest risk for household consumption

The prospect of moderate increases in interest rates in 2006 raises the question of what could be the effect of these on household consumption spending and construction, the two main pillars on which the spectacular growth path of Spain's economy is based. According to the survey of household finances carried out by the Bank of Spain, the proportion of households in debt is relatively high at 43.6% of the total while average debt owing is 22,000 euros, a figure that is not excessive seeing that it represents a relatively modest proportion of household wealth at 17.8% on average. This situation, however, varies notably depending on the nature of each household. Those households most in debt are those with the highest income level, those where the head of the household is less than 45 years old (nearly two-thirds of households of this type are in debt) and those where two members of the family unit are working. With regard to relative solvency, on the other hand, debt may come to represent as much as 63% of household wealth in the poorer families.

More than the level of debt, the key point is the ability to meet commitments arising from this situation. According to the survey, amounts going to carry debt (amortization plus interest) account for 15.2% of disposable income of households in debt. This relatively modest figure would increase very slightly with the foreseeable rise in interest rates and, therefore, would not excessively affect the financial capacity of households to deal with those increases, except in the case of relatively low incomes and households especially vulnerable to change because they find themselves at levels requiring major financial efforts.

CARRYING CHARGE ON DEBT MORE THAN 30% OF FAMILY EARNINGS IN LOW-INCOME HOUSEHOLDS

Carrying charge on debt over household income for each percentile of income level



SOURCE: Bank of Spain and internal figures.

According to the Bank of Spain, the percentage of households that find themselves in a vulnerable situation, defined as those devoting more than 40% of their income to pay off loans, is relatively small at 7.2% of the total. This situation of vulnerability is substantially greater in low-income households given that the proportion goes to 30.2% and is appreciable in households of medium-low income levels (14.8% of the total).

In addition, it is in the younger and older households where we find the highest proportion of families with a debt load of more than 40% of family income, in the first case, because of the size of the debt and, in the second, because of relatively low income level.

Finally, a rise in interest rates in Spain's economy will not have the same effects on Spanish households. The biggest difficulties, in any case, will be felt by the population group with the lowest levels of income and wealth and those households with the youngest heads of family, generally those under 45 years but particularly those under 35.

From the point of view of effects on final demand, the most important could apply to the real-estate market, mainly by moderating the rate of future demand and consequently price levels. The heavier financial load arising from real-estate could have a marginal effect on other facets of private consumption, mainly on spending on the less necessary goods and services. In any case, the adjustment would have to take place in qualitative rather than in quantitative terms, probably in lower cost travel during holiday periods or lower price-range cars in the case of buying a private vehicle, for example. In any case, the final result of the rise in interest rates will depend on the amount of increase and how this is spread over time. In this respect, gradualism would be a key element in the coming period of tighter money.

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