FEBRUARY 2006

THE SPANISH ECONOMY

Monthly Report

NUMBER 288

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2004	2005	2006	2005				2006	
				1Q	2Q	3Q	4Q	1Q	2Q
INTERNATIONAL ECONOMY		Forecast						Forecast	
Gross domestic product									
United States	4.2	3.5	3.4	3.6	3.6	3.6	3.1	3.7	3.5
Japan	2.3	2.4	1.7	1.1	2.7	2.8	3.0	2.2	1.8
United Kingdom	3.2	1.8	2.1	2.0	1.6	1.7	1.7	2.1	2.2
Euro area	1.8	1.4	1.8	1.2	1.2	1.6	1.7	1.8	1.9
Germany	*1.1*	*1.0*	*1.6*	*0.6*	*0.7*	*1.4*	*1.5*	*1.5*	*1.7*
France	*2.1*	*1.5*	*1.8*	*1.8*	*1.1*	*1.8*	*1.3*	*1.7*	*1.8*
Consumer prices									
United States	2.7	3.3	2.5	3.0	2.9	3.8	3.4	2.9	2.5
Japan	0.0	–0.3	0.0	–0.2	–0.1	–0.3	–0.5	–0.1	0.0
United Kingdom	2.2	2.3	2.4	2.2	2.2	2.4	2.2	2.5	2.3
Euro area	2.1	2.2	2.2	2.0	2.0	2.3	2.3	2.4	2.1
Germany	*1.7*	*1.9*	*1.9*	*1.7*	*1.7*	*2.1*	*2.3*	*2.2*	*2.0*
France	*2.1*	*1.7*	*1.7*	*1.7*	*1.7*	*1.9*	*1.6*	*2.0*	*1.6*
SPANISH ECONOMY		Forecast						Forecast	
Macroeconomic figures									
Household consumption	4.4	4.4	3.7	4.6	4.6	4.4	4.2	4.0	3.8
Government consumption	6.0	4.7	4.4	5.4	4.3	4.6	4.5	4.5	4.4
Gross fixed capital formation	4.9	7.3	6.3	7.2	7.6	7.4	7.1	6.8	6.5
Capital goods	*3.7*	*9.3*	*6.5*	*10.1*	*10.4*	*8.8*	*8.0*	*7.3*	*6.7*
Construction	*5.5*	*6.3*	*5.8*	*6.0*	*6.2*	*6.3*	*6.4*	*6.3*	*6.1*
Domestic demand (contribution to GDP growth)	4.7	5.2	4.6	5.2	5.3	5.2	5.0	4.8	4.6
Exports of goods and services	3.3	0.5	2.8	–2.1	1.1	1.3	1.6	2.0	2.5
Imports of goods and services	9.3	7.6	7.3	5.7	8.5	7.7	8.7	7.7	6.8
Gross domestic product	**3.1**	**3.4**	**3.2**	**3.3**	**3.4**	**3.5**	**3.4**	**3.3**	**3.2**
Other variables									
Employment	2.6	3.1	2.9	3.0	3.2	3.2	3.1	3.0	2.9
Unemployment (% labour force)	11.0	9.2	8.4	10.2	9.3	8.4	8.7	8.5	8.4
Consumer price index	3.0	3.4	3.2	3.3	3.2	3.4	3.6	3.5	3.0
Unit labour costs	2.8	2.4	2.4	2.5	2.4	2.4			
Current account balance (% GDP)	–5.8	–7.4	–8.5	–7.1	–7.9	–6.9			
Not lending or net borrowing rest of the world (% GDP)	–4.8	–6.4	–6.4	–6.6	–6.7	–6.0			
Government balance (% GDP)	–0.1	0.8	0.2						
FINANCIAL MARKETS			Forecast						Forecast
Interest rates									
Federal Funds	1.3	3.2	4.7	2.4	2.9	3.4	4.0	4.4	4.8
ECB repo	2.0	2.0	2.7	2.0	2.0	2.0	2.1	2.3	2.6
10-year US bonds	4.3	4.3	4.9	4.3	4.2	4.2	4.5	4.6	4.8
10-year German bonds	4.1	3.4	3.7	3.6	3.3	3.2	3.4	3.5	3.6
10-year Spanish bonds	4.1	3.4	3.7	3.6	3.3	3.2	3.4	3.5	3.6
Exchange rate									
$/Euro	1.24	1.25	1.21	1.31	1.26	1.22	1.19	1.20	1.20

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Y PENSIONES
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"la Caixa" GROUP: KEY FIGURES

As of December 31, 2004

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

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

COMMUNITY PROJECTS: 2005 BUDGET

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

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Contents

Population, employment and productivity: a puzzle still unresolved

In the European Union, Spain was the country to receive most immigrants in 2005, some 652,300 (net) to be exact, according to Eurostat. This was not an exceptional year because since 1998 the same story has been repeated. Spain has become the country with the highest population growth in Europe, thanks to an immigration flow which has broken all predictions made at the end of the Nineties. At that time, when the number of foreigners resident in Spain was scarcely above 600,000, the experts were foreseeing a population in decline in the 21st century. The reality is that on January 1, 2006 the total population was well over 44 million, nearly five million more than in 1998.

The fact that Spain could absorb a volume of population practically equivalent to that of a city the size of Seville in just one year and that this could be repeated over the past seven years cannot be merely by chance. It is obvious that immigration follows the lure set by a labour market that could be called almost explosive. Whereas in 1998 Spain gave employment to only 14 million persons, at the end of 2005 the figure was over 19 million. While at the beginning of 1998 the unemployment rate was still close to 20% of the labour force, it has now dropped to close to 8% (although it is true that methodological changes in calculating unemployment give an excessively downward bias). In any case, it is clear that the labour market has undergone a radical change in recent years which has made possible the highest job creation in the European Union.

The metamorphosis has been essentially in quantitative terms. That is to say, many of the structural problems troubling the labour market at the end of the Nineties are still there. For example, its two-sided nature: the segmentation existing between those workers with permanent hiring contracts, protected by very high severance indemnities, and those workers on temporary hiring, with little job security. In Spain, some 33% of all employees are in this situation, by far the highest figure in the European Union. The Organization for Economic Cooperation and Development (OECD) has stated that this duality not only involves problems of equity but also is limiting improvements in productivity of the economy, given that neither those with permanent or temporary jobs have sufficient stimulus to improve their training and efficiency.

In the matter of unemployment, some big questions also arise. How can we account for the persistence of a still high unemployment rate and, at the same time, a heavy inflow of immigrant labour? How do we explain the big disparities in unemployment rates between various provinces and autonomous communities? Why is there a lack of geographical mobility? Do unemployment benefits remove the incentive to look for work? At the same time, wage negotiation is a key matter now that globalization has put Spain in the position of an economy with intermediate labour costs, neither very high nor very low. Why is Spain's inflation rate taken as the bargaining reference and not that of Europe or European wage increases?

To sum up, reform of the labour market remains an unresolved problem which must be dealt with if we want to see improvements in productivity and competitiveness. Along with improvements in progress and well-being. In his work *Principles of Political Economy* John Stuart Mill stated that a competitive labour market does not mean low wages but quite the opposite, it makes it possible to raise them and thus boost the level of prosperity in an economy. It would be useful not to forget his words.

January 26, 2006

OVERALL REVIEW

World economy: facing the challenges

Interest rates higher and oil keeps giving shocks but world economy moving ahead firmly...

The year 2006 has begun with a world economy sailing before favourable winds. The state of the sea and the weather are slightly worse than last year. Interest rates are higher and the price of energy remains high with the odd scary increase. But it does not seem that this is going to change the general course in view of the ability to absorb the energy shock shown by the world economy in 2005. Nor are interest rates going to rise to any extraordinary degree so that the voyage should be completed without any big developments.

...because of strength in Asia, US solidity, recovery in Europe and good progress in emerging countries.

In any case, we should not drop our guard in the face of the risk of a new tempest in energy. In January, the per barrel price of oil broke the relative calm it had shown in November and December going close to the all-time highs in September. On this occasion the cause lay in some difficulties in crude oil supply because of guerrilla attacks in Nigeria and the situation in Iraq. And also as a result of fears brought about by Iran's threat to set off an energy crisis if sanctions were imposed because of renewing its nuclear programme. Furthermore, the cold wave from Siberia affecting Russia and the gas conflict with the Ukraine also made their contribution.

China revises GDP upward while becoming world's fourth economic power and spreading strength over its area of influence.

Confidence in the route being followed by the good ship world economy is supported by a number of factors: strength in Asia, the solidity in the United States, the recovery in Europe and the favourable progress in the emerging economies. In the latter case, high prices for raw materials ensure returns from exports while at the same time still low interest rates (and current low country risk) make it possible to meet foreign debt commitments.

But the most outstanding case in undoubtedly China's growth. Its National Statistics Office has revised figures for the gross domestic product (GDP) after bringing the 2004 population census up to date. The result was an increase of 17% by volume in China's economy and a rise in growth rates for recent years. If we keep in mind that it has announced that the 2005 GDP grew by 9.9% in real terms, it seems clear that China's economy now stands in fourth place in world ranking, going above Italy, France and the United Kingdom. Exports from that Asian country boosted growth last year with a trade surplus that was three times that for the year before. The accumulation of foreign reserves was above 800 billion dollars, a figure that came close to Japan's, which showed up as the world's highest.

China's strong growth is being spread around the Pacific periphery of the Asian continent. Japan is one of the beneficiaries. Its recovery in recent quarters is consolidating and is now extending to consumers to show a notable improvement in consumer confidence. Industry is also showing positive figures along with the real-estate sector. Inflation remains the unsolved question. It is hard to understand that in the present circumstances the consumer price index continues to drop in spite of the rise in energy prices. We must put our confidence, however, in the optimistic point of view of Japan's central bank which anticipates the end of the period of deflation during the course of this year.

In the United States, most recent figures show no new factors indicating any moderation of the still high rates for consumption and investment. It is interesting to point out the incipient containment of the real-estate market to be drawn from the latest sales figures for existing housing and housing starts. This slowdown is desirable because high prices and growth of the market are stimulating consumer spending and reducing savings as a result of the wealth effect generated when the owner is aware of owning an asset whose value is constantly increasing. Undoubtedly the Federal Reserve, the US central bank system, is hopefully watching this trend which makes it possible to expect a gradual slowdown in this sector, thus dispelling fears of a hypothetical bursting of the real-estate bubble.

United States continues to grow at good rate while real-estate sector seems to be starting gradual easing off...

In addition, job creation continues to show a gradual but firm pace and, if we deduct the energy component, inflation does not present big problems. The trade deficit in November even went down compared with the previous month although this was due to specific factors and not to the beginning of any correction of the main imbalance troubling the US economy, now above 6% of the GDP. In this context, the Federal Reserve will complete its review of monetary policy to make it less easy, apart from an increase of a quarter-point to 4.50% in the reference rate at the meeting on the final day of January, the last to be chaired by Alan Greenspan before the take-over by Ben Bernanke.

...which does not stop Federal Reserve from continuing to make monetary policy less easy.

In the euro area, the pessimism unleashed by weak growth and high unemployment in the main economies (Germany, France and Italy) is gradually beginning to disappear. Economic sentiment expressed by business executives and consumers in surveys by the European Commission has risen to levels seen in 2000. In any case, the take-off in private consumption is still not certain, if we are to go by household spending indicators.

With regard to business executives, they express somewhat more optimism (depending on country), probably due to foreign demand. Specifically, German business executives surveyed by the IFO Institute in January indicate a sharp improvement in business expectations. The only cold water poured over this feeling comes from Germany's central bank, the Bundesbank, which in its latest report states that growth of Germany's economy in the final quarter of 2005 was down substantially. In any case, the European Commission has raised its growth forecasts and is expecting that, finally, 2006 will be the year in which recovery is consolidated.

In euro area, major economies seem to be gradually moving into recovery stage with notable new business optimism in Germany.

Spain's economy: is growth of low quality?

In between the medium and large European economies, the Spanish economy continues to be the most dynamic in terms of growth and employment. In the absence of official figures for the fourth quarter, all estimates for GDP growth in 2005 end up close to 3.4%. The drive in private consumption and construction is boosting domestic demand that more than counteracts the gradual worsening seen in the foreign sector.

In spite of this, for a number of reasons the overall balance of Spain's economy is

Spain's economy continues firm growth although growth model causing concern, particularly lack of innovation and competitiveness.

often put in question. First of all, because of the persistence or worsening of imbalances such as in the foreign balance and inflation. Secondly, because of doubts about Spain's competitive capacity in an open globalized environment.

In this respect, the study dealing with innovation carried out by the European Commission has had a notable impact. This study measured the level of research and development, the innovation by a company, the application of innovations and their effects on value added, etc. According to this study, Spain stands in a backward position in 23rd place among 33 countries. Spain falls into the backward group losing ground, along with Estonia, Bulgaria, Poland, Slovakia, Romania and Turkey. Somewhat higher, in the group of backward countries but still making progress, we find Portugal and Greece, among others. From here upward we see the other states of the European Union (EU) along with the United States and Japan which were also included in the study.

These deficiencies show up in increasing trade deficit and have affect on inflation results where surprises may still lay ahead.

The problems of competitiveness show up in the slack state of the industrial sector which is not replacing the manufacturing fabric being destroyed in sensitive sectors by foreign competition. In turn, this lack is being converted into a growing trade deficit due to the trend to stagnation in exports of goods and the strong demand for imported products.

The lack of competitiveness may also largely be attributed to the worsening of inflation. The differential in inflation rates with the euro area has been stuck at one percentage point for a number of years. What is more, in 2005 Spain turned out to be the most inflationary member state in the euro area and was exceeded only by Lithuania and the Czech Republic in the 25-member EU. Furthermore, the question remains open on the effects on prices of last year's oil shock. The indirect impact may already be noted in the worsening of core inflation. So-called "second round" effects seem to be guaranteed because of the automatic adjustment at the beginning of the year in most collective bargaining agreements (the consumer price index ended up at 3.7% as against the reference of 2%).

Public sector accounts, on other hand, show major surpluses coinciding with important reform measures on corporate tax and income tax.

The good situation shows up in the public sector accounts, which ended 2005 with a surplus of 1% of the GDP. The bright news does not end there. In bringing up to date the 2005-2008 Stability Plan, the Ministry of the Economy foresees substantial surpluses in the overall period. True enough, this may be a good time to propose fiscal reform. This is what the government has done beginning with a study of reform in corporate tax and income tax. In the case of companies, the plan is for a progressive reduction in tax on profits from the present 35% to 30% in 2011. This is a well conceived measure given that current rates penalize Spanish companies which must compete with low labour cost countries and low tax rates, some of them being members of the EU. Nevertheless, there are those who argue that the reduction takes place at the cost of removing specific deductions. In the matter of income tax, the intent is to slightly reduce the tax load although the complexity of the reform makes it difficult to evaluate it at this time. In any case, in macroeconomic terms, in the present circumstances, it does not seem desirable to reduce taxes and thereby boost domestic demand which, in part, is the cause of the imbalances mentioned above.

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%.
	28	**Slovak crown** joins Exchange Rate Mechanism.
December	1	**European Central Bank** raises official interest rate to 2.25%.
	13	**Federal Reserve** raises reference rate to 4.25%.
	17	European Council approves **2007-2013 Budget**.
	18	Hong Kong Summit of **World Trade Organization** agrees to removal of all aids to agricultural exports of developed countries in 2013.

2006

January	20	Government presents bills for reform of **personal income tax** and **corporate tax.**

AGENDA

February

2 Early HCPI indicator (January). Meeting of Governing Council of European Central Bank.
3 Industrial production index (December).
14 Preliminary Quarterly National Accounts (4th Quarter).
16 Consumer price index (January).
22 Quarterly National Accounts (4th Quarter).
27 Producer price index (January).
28 Harmonized consumer price index for European Union (January). Early HCPI indicator (February).

March

1 Meeting of Governing Council of European Central Bank.
2 GDP of euro area (4th Quarter).
6 Industrial production index (January).
14 Consumer price index (February).
15 Quarterly labour cost survey (4th Quarter).
16 Harmonized consumer price index for European Union (February).
22 Ongoing survey of household budgets (4th Quarter).
27 Producer price index (February).
28 Meeting of Open Market Committee of Federal Reserve.

INTERNATIONAL REVIEW

United States: very slight moderation

Signs of easing off in U.S. real estate sector.

The strength of the US economy and the imbalances it is suffering from remain a constant in recent months. However, we now see some slight signs of moderation in the trade deficit and an incipient loss of strength in housing sales. While the first point may last only a short while, a continuation of the second point (backed by confirmation of the containment of prices) should lead to a «soft landing» situation bringing about a macroeconomic environment with fewer risks than those now present. Nevertheless, there is still a long way to go with a trade deficit still to be dealt with.

Retail sales remain strong in spite of budget cut which means high-cost petrol.

On the demand side, retail sales in December continued strong and again enjoyed notable strength. However, the slight upward trend in recent times has been lost although for the moment we cannot talk of moderation. Excluding the volatile figures for motor vehicle sales, growth was 8.1% year-to-year and, if we exclude petrol purchases, it was up by 6.7%. Among those components showing most strength in recent months, sales of construction materials and food services outside the home continued to show appreciable increases close to 10% and 8% year-to-year respectively and, furthermore, are keeping up something of a growth trend. Another component showing strength, sales in department stores, showed a more moderate trend with rates at 5% along with a tendency to maintain this level. Sectors such as clothing and food, which in previous

UNITED STATES: MAIN ECONOMIC INDICATORS

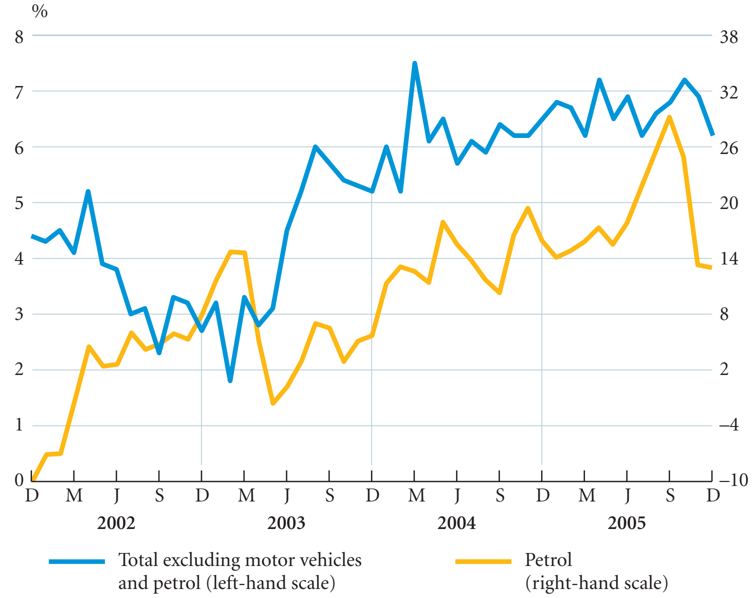
Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005					
			4Q	1Q	2Q	3Q	October	November	December
Real GDP	2.7	4.2	3.8	3.6	3.6	3.6	–	...	–
Retail sales	4.3	7.3	8.4	7.3	8.4	8.4	5.9	6.8	6.4
Consumer confidence (*)	79.8	96.1	96.1	104.2	102.3	98.9	85.2	98.3	103.6
Industrial production	0.6	4.1	4.3	4.0	3.1	2.7	2.3	2.9	2.8
Industrial activity index (ISM) (*)	53.3	60.5	57.5	55.6	52.8	56.5	59.1	58.1	54.2
Sales of single-family homes	11.7	10.0	10.8	5.1	6.9	11.8	7.5	6.0	...
Unemployment rate (**)	6.0	5.5	5.4	5.2	5.1	5.0	4.9	5.0	4.9
Consumer prices	2.3	2.7	3.4	3.0	2.9	3.8	4.3	3.5	3.4
Trade balance (***)	–495	–618	–618	–652	–673	–699	–711	–716	...

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

UNITED STATES: CONSUMPTION STILL HOLDS STRONG

Retail sales, month-to-month change annualized (*)



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

months had shown poorer growth, have gained strength in recent months.

All of this denotes the persistence of consumer strength among the broad public which has its merit, in view of household budgets reduced by higher petrol prices as a result of more expensive oil. This spending, while it has lost some of its strength at the end of summer is still running at rates close to 15% year-to-year. Motor vehicle sales, in turn, showed a slight recovery from the previous month and are now close to coming out of the sharp dip brought about by energy prices.

In keeping with this strong performance, consumers continued to gain fervour as shown by consumer confidence indicators put out by the Conference Board in December. These figures were very close to the peaks in summer and went higher than those in terms of the perception of the present situation.

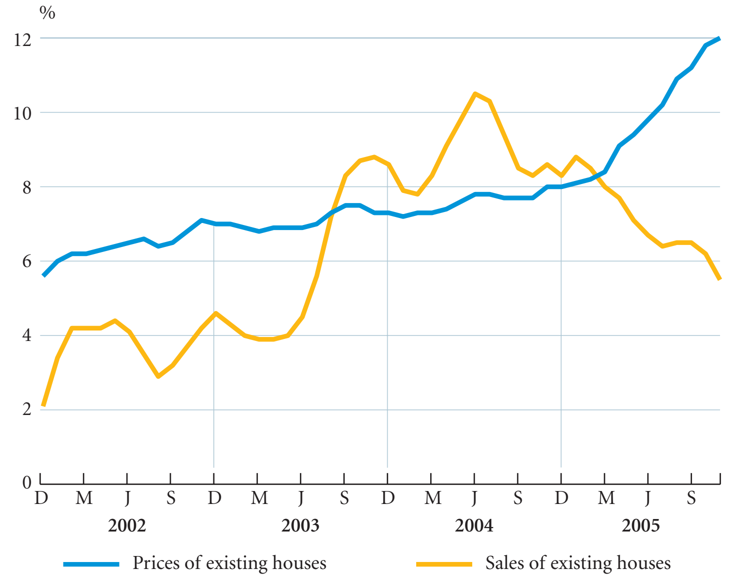
On the supply side, the continued weakness of industrial production stands in contrast to consumer strength. The rate of increase in December again stood below 3% in the framework of a process of slight slowdown which has been going on since the beginning of summer. The fact is, recovery of industrial production has stopped mid-way if compared with the path followed in other expansionist cycles. More in keeping with the general level of activity, the opinion of business executives remains positive, according to the index of the Institute of Supply Management in December.

Housing sales moderating with still no drop in prices.

The housing market at present is showing a cycle of special significance. The high prices of assets has injected great liquidity into the system as a result of new home mortgages obtained at low rates. This liquidity, along with the wealth effect of home owners, is giving strength to consumption and reducing savings. The lack of savings and the possibility of

UNITED STATES: HOUSING SALES EASE OFF BUT NOT PRICES

Year-to-year change as percentage (*)



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

increased volatility in prices presents a risk which the Federal Reserve would like to gradually reduce. In recent months there have been signs of moderation which point to such a desirable gradual slowdown in the sector. What is significant is the loss of strength in sales of existing housing. In November, this recorded a drop of 0.5% year-to-year, a figure lower than expected.

Along the same lines, housing starts, an early indicator which in October had lost predictive power because of the need to repair damage caused by *Katrina* dropped by 5.7% year-to-year in November. There is still a long way to go as well as the question of prices which although not as strong are still growing at around 13% year-to-year, but the fact is that the sector appears to be preparing for less exhilarating stages. This is understandable given that for an average family, taking into account income, mortgage payments and down-payments, it is now 22.4% more difficult to acquire a home than it was two years ago. A great part of macroeconomic stability in coming months will depend on the gradualness of this process.

Employment continues to rise and wages begin to emerge from slack.

Employment continues to gain ground with 108,000 new jobs in December, a slight disappointment in terms of what was expected, compensated though by an upward revision of the November figure. Employment grew by 1.5% year-to-year with a well established upward trend although this is still less than in previous recoveries. The unemployment rate in December dropped to 4.9% of the labour force maintaining the downward line in recent times. Wages remain an unsolved matter although things now are on a better track. With nearly two years of sustained slow decrease September brought a cumulative loss of 3.0% in purchasing power of wages. Since then there has been a recovery of 1.6% which must be seen positively in the present environment of gains in work productivity and moderate inflation.

The real challenge facing US employment

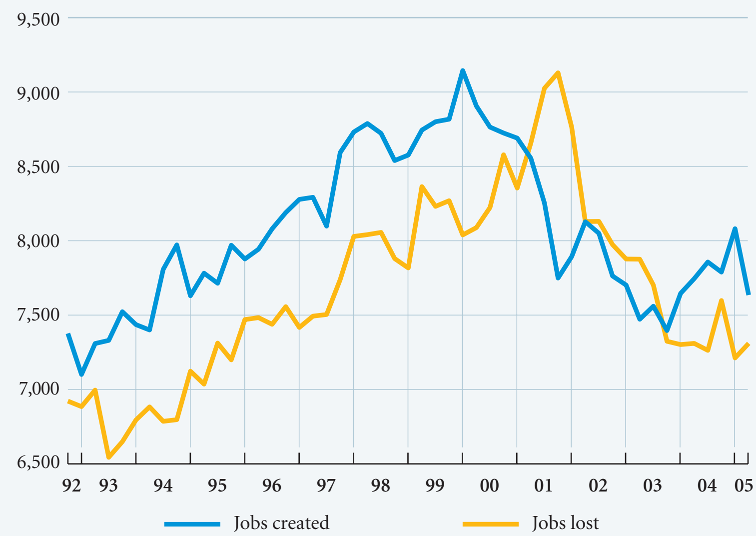
Detroit is collapsing, the shops are full of goods showing *Made in Japan* and *Made in China* and India is beginning to make itself felt. It is precisely in the manufacturing sector, where there was more productivity and less inflation, that things are getting worse. Fierce foreign competition is hitting hard and with the resulting loss of jobs the ills are truly beginning to show up. In spite of all this, the real challenge for the United States is not in manufacturing, which accounts for 12.7% of private employment, but in services which accounts for 80.2%.

The recovery in employment is now a fact. The United States is creating more than 2 million net jobs a year and even the blow from *Katrina* seems to have been overcome. Leaving aside the matter of wages, however, there are three questions about job creation still to be resolved: slow growth, a very troubling manufacturing sector and a services sector which should be of much more concern with more jobs.

Net employment grew by 1.5% in 2005 but in the expansionist period 1993-1999 average growth was 2.6% year-to-year. This weakness may be partly explained by possible restructuring moves. During recession periods there is some resistance to losing jobs with high value added in view of the difficulties in obtaining and training qualified employees when things improve. But in the face of profound changes in the production structure this resistance disappears seeing that whoever may be there will have to learn the new processes starting from scratch. Furthermore, the skills of unemployed workers readily become obsolete and therefore it costs more to find the workers desired. If we break down net job creation into gains and losses in the booming Nineties both evolved with a strong rise in a process of *creative job loss*, as stated by J.A. Schumpeter. But the trend has turned around drastically downward in terms of job creation since the end of 1999 and in job losses since the fatal September 2001. If we add to this a higher proportion of long-term unemployed, the hypothesis of restructuring operations gains strength. The current literature on this matter, nevertheless, is cautious preferring to deal with specific sectors.

DOWNWARD TREND

Thousand jobs created or lost per quarter

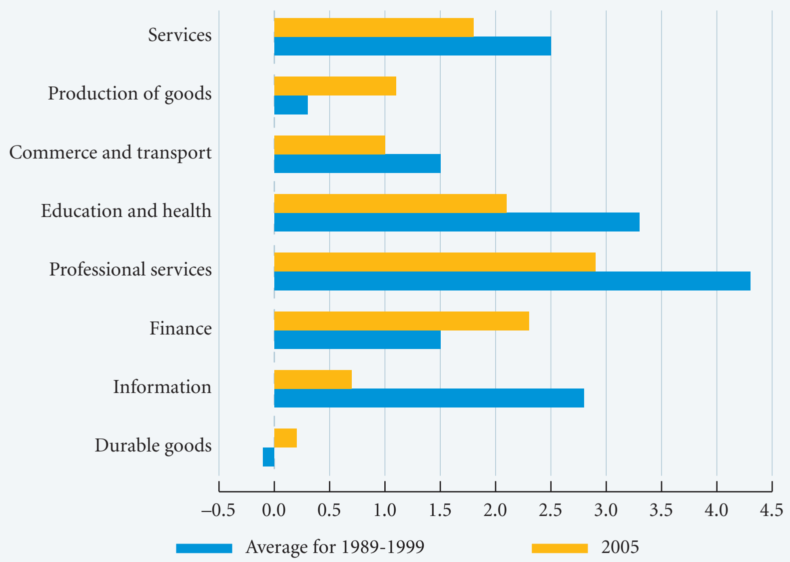


SOURCE: Bureau of Labour Statistics (Business Employment Dynamics) and internal figures.

What are the sectors with problems? Manufacturing of durable goods is the first candidate. It provides 8.7% of all private jobs with wages above average. Between May 1998 and October 2003, it lost more than 2 million jobs, more than two-thirds of the total losses. Since then it has only gained 123,000. Nevertheless, considering the long-term downward trend in the sector, these losses are not so exceptional. At the end of 2005, manufacture of furniture, clothing, cars and other durable goods represented 8.0% of total private employment, below the 10.4% shown by the last high in 1998 but light years away from the 25% predominant in 1980. In terms of growth, this production has recovered more than the large services sectors. The modest advance of 0.2% in 2005 is, however, higher than the average in 1989-1999, which excludes the last downward period in order to avoid bias. Among the large sectors, only finance and construction also grew above the average for the decade 1989-1999. But important sectors in services, such as retail sales, education and professional services, even grew well below that period. Nor did non-durable goods (food, drink, etc.) reach the average level of the reference period. The real challenge lies in services. Employment in goods production, a fifth of the total, is growing at 1.1% year-to-year, well above the

SERVICES SECTORS STILL MISSING LAST EXPANSIONIST DECADE

Year-to-year growth of employment as percentage of various sectors



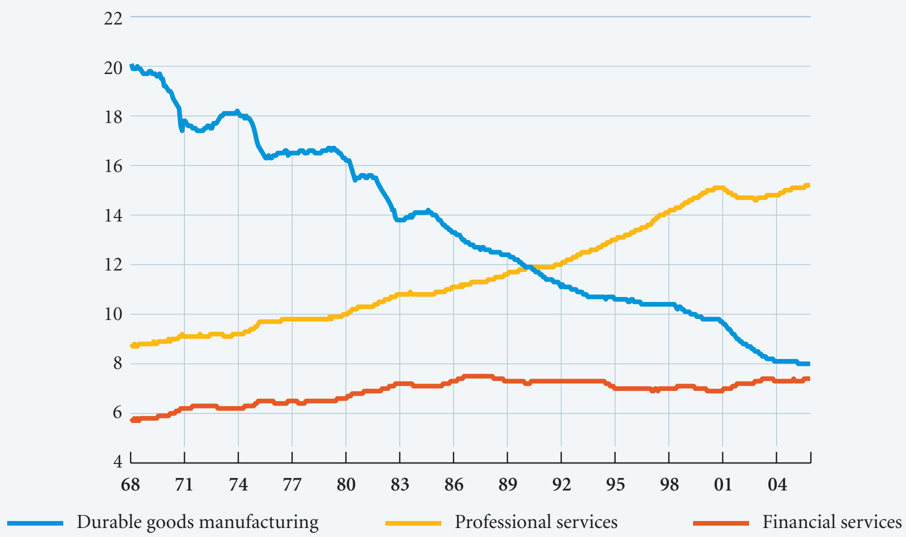
SOURCE: Bureau of Labor Statistics and internal figures.

average for 1989-1999. But employment in services, four-fifths of the total, while growing more (by 1.8%) still stands below the 2.5% for the 1989-1999 period. If services were only to recover the growth in the 1993-1999 period in two years they would more than compensate for the 2 million jobs lost in the dismal 5-year period in manufacturing. Things are getting worse seeing that, in the various sectors, people are looking back longingly to the past expansionist decade. In professional services (which provides one-sixth of employment with wages higher than in durable manufactures) employment is growing by 2.9%, more than in manufacturing but in contrast to that sector well below the 5.7% seen in 1993-1999 and clearly below its long-term trend as opposed to durable goods manufacturing. In the case of information services, a small sector but one providing employment of high value added with wages 39% above average, the level of employment moved up by only 0.7% year-to-year in 2005 as against 4.7% in the expansionist period mentioned earlier.

There is a double challenge. In the first place, it is a matter of recovering past growth, something which implies better and increased application of technological improvements to sectors such as finance, professional services and information services, especially in terms of high value added. In the second place, it is a matter of managing incipient globalization. Up to now, this process has taken place in goods with the proportion of imports growing by three times in thirty years to reach 45% of total consumption with jobs being reduced to a third of the total. Outsourcing a product is checking specifications and nothing else. A service is more complicated. It is something bought over a period, there are complications of regulations, accounting, improvements in services rendered and, furthermore, it is necessary to manage information and multicultural aspects. In spite of this, the process has already begun and in view of what has taken place in manufacturing it is unstoppable.

A CHANGING WORLD

Participation of various sectors in total private employment as percentage



SOURCE: Bureau of Labor Statistics and internal figures.

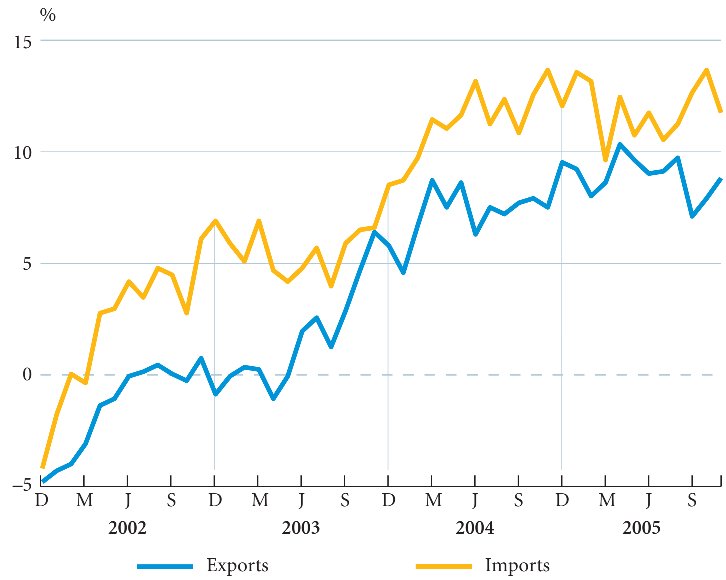
Moderation in inflation confirmed with figure at 3.4%.

Inflation continued to drop following pressures brought about by energy prices. The general price index in December rose by 3.4% year-to-year, a figure well below expectations which are rampant in-an overall scene increasingly clear in this aspect. The core component, which excludes energy and food, more volatile and more in keeping with the general trend, showed a slight rise to reach a rate of 2.2%. Nevertheless, the generally predominant trend continues to point to a continuation of moderate rates. Producer prices, which exclude retail margins, rose more strongly and, in December, more than recovered losses seen in November. The year-to-year increase, which again rose to 5.7%, was the most troubling figure in December.

The trade deficit in November was 5.7% lower than the record figure seen in October. Exports for the month grew by an appreciable 10.8% year-to-year, somewhat above imports, which is something new. Nevertheless, this was largely due to the end of the strike at Boeing which, in December, brought

UNITED STATES: IMPORTS STILL DOMINANT

Month-to-month change in exports and imports as percentage (*)



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

Aircraft improve foreign deficit in December but no change in trend.

about an accumulation of deferred sales that therefore will not continue. Also helping this improvement was the fact that imports lost some strength because of energy prices. November thus did not show the much–awaited start of a change in trend in the trade balance, with a deficit that, in the past twelve months, came close to 6.3% of the gross national product.

Japan: growth based on consumers

Japan gains strength from consumer optimism.

Japan's growth gained some strength at the end of the year. The better prospects were based on private consumption which has been the base giving most support to the present recovery. Following some hesitation and breaking away from the traditional fatalism attributed to the Japanese, there is an increasing number who believe in the optimism of the central bank. Inflation, or rather the lack of it, remains the hurdle to be overcome although industry appears to be coming out of its slump.

On the demand side, retail sales showed an upward trend with a resistant background. As a result, the decreases in recent months did not manage to break the path of gradual recovery established and in November the indicator returned to positive ground with an increase of 0.5% year-to-year. Nevertheless, car sales (volatile but significant) continued without adding anything to the signs of recovery. December was the sixth consecutive month of year-to-year decreases showing a drop of 12.0%.

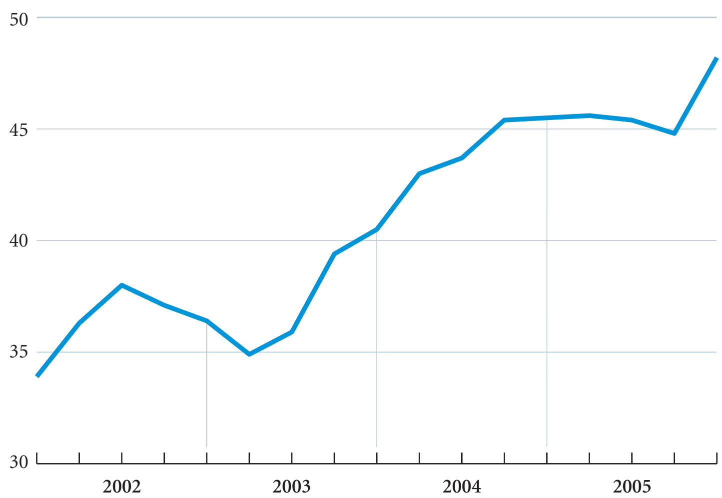
Of more general reach and with a clearly upward trend, consumer confidence in the fourth quarter rose to a level of 48.2 points. Apart from the sharp rise over the previous quarter, the improvement in prospects and the breakaway from something of an accommodating trend, the current figure has not shown up since 1991 which would suggest that something may be changing in the perception the Japanese have of their economy. It would seem that Toshihiko Fukui, governor of Japan's Central Bank, is gaining supporters for his optimistic outlook.

Supply indicators also supported the better prospects although rather tentatively. Industrial production in November held at an increase of 3.4% year-to-year, a figure that, while indicating a slight rise because of base effects, failed to show all of the strength of the sector in recent months. Machinery orders, an early indicator of investment, also gained strength in November although this was based on the always volatile foreign sector. The

Retail sales maintain upward trend and industry coming out of doldrums.

JAPAN: CONSUMERS SEEING THINGS MORE CLEARLY

Index of confidence of the consumer



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

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005				
			4Q	1Q	2Q	3Q	October	November
Real GDP	1.8	2.3	0.6	1.1	2.7	2.8	–	...
Retail sales	–1.7	–0.9	–0.4	1.1	3.2	0.8	–0.4	0.5
Industrial production	3.3	5.3	1.6	2.7	0.3	0.2	3.0	3.4
Tankan company index (*)	–1.8	20.5	22.0	14.0	18.0	19.0	–	21.0
Housing construction	0.6	2.6	–0.1	1.5	2.1	5.0	8.9	12.9
Unemployment rate (**)	5.2	4.7	4.6	4.6	4.3	4.3	4.5	4.6
Consumer prices	–0.3	0.0	0.5	–0.2	–0.1	–0.3	–0.7	–0.8
Trade balance (***)	12.0	13.7	13.7	13.3	12.2	10.8	10.6	10.5

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

JAPAN: HOUSING STARTS MARK OUT ROAD TO RECOVERY

Number of housing starts per month (*)

NOTES: (*) Cycle-trend series.
SOURCE: Japanese Institute of Real-Estate Economics and internal figures.

Housing confirms recovery.

background trend is for sustained growth at around levels of 5.0% with a slight bias in favour of foreign orders as against those of a national nature which lately appear to have lost some strength.

The housing market continues to move ahead slowly. Following a weak performance in November real estate sales in Tokyo again moved up in December although this was not so with prices. Housing starts also rose with growth of 12.9% year-to-year in November showing a clear upward trend in keeping with the present situation in the sector.

Deflation to continue in coming months.

Deflation remains a matter still to be dealt with. Prices dropped by 0.8% year-to-year in November. In Tokyo, prices also dropped by 0.6% in December. The general component, excluding unprocessed foods, is now coming close to positive ground but two effects should be kept in mind. On the one hand, energy prices have raised the general level but a return to normalcy is to be expected at least in growth rates. On the other hand, restructuring operations carried out have brought about gains in efficiency and therefore lower costs and lower prices. All of this makes difficult a definitive end to deflation in coming months. In the labour market, the unemployment rate continued to increase slightly going to 4.6% of the labour force.

Japanese exports are recovering. These grew by 11.8% in November compared with the same period the year before. Nevertheless, the trade balance in year-to-year terms was down because of the strength of imports which must be interpreted in terms of stronger domestic demand than was seen previously.

Brazil: history of a slowdown

The Brazilian economy is clearly slowing down. In contrast to previous periods the

Slowdown in Brazil with growth at 0.9%.

economic figures are more in balance but the South American giant is like a bicycle (if you don't pedal you fall) and without growth the situation of Lula's government could become unsustainable.

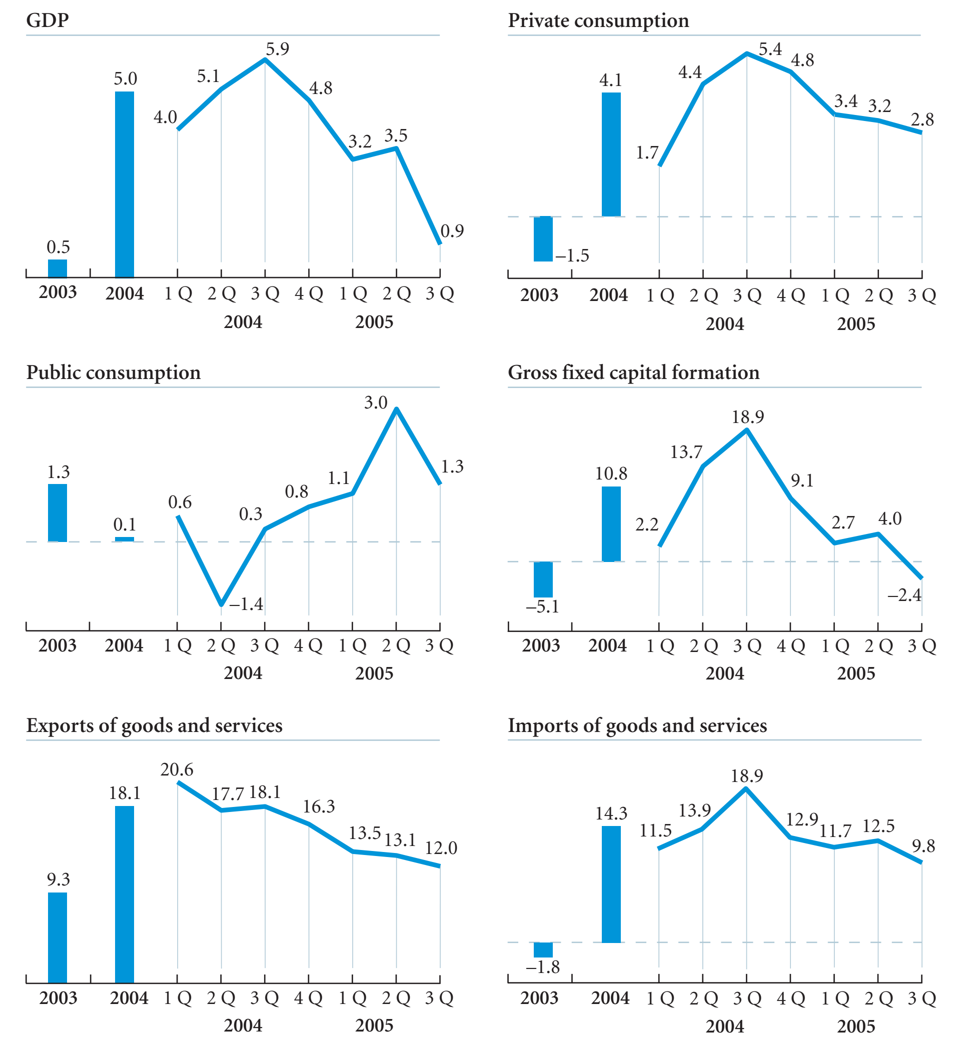
The gross domestic product in the third quarter rose by a meagre 0.9% year-to-year marking the end of the growth stage. Private consumption dropped to 2.8% year-to-year. Public consumption, as a result of government austerity measures, was down drastically to 1.3%. Gross fixed capital formation, in turn, dropped by 2.4%. The foreign sector, one of the pillars of the recent expansionist period, continued to behave well with exports which, in spite of lower growth at 12%, are still running above imports.

Investment down but foreign sector holding up with drop in public consumption.

Latest monthly demand indicators show levels of activity somewhat better than those reflected in the national accounts. Retail sales in November grew by 4.9%

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-to-year change in real terms



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

BRAZIL: RETAIL SALES STILL KEEP IMPROVING

Year-to-year change in retail sales as percentage

SOURCE: IPEA and internal figures.

Retail sales grow by nearly 5%.

year-to-year, a figure which, although below the double digits seen in 2004, is still far from slack. Clearly in this direction, car sales in December grew by a strong 10.9% year-to-year, recovering from a poor autumn affected by energy prices.

Inflation continues to moderate but unemployment rate above 16%.

On the supply side, industrial production in November moved up by 0.6% year-to-year while industrial production of capital goods rose by 4.0%, a figure that, while far from the growth in 2004, would indicate that the slowdown may have hit bottom.

On the positive side, inflation continues to drop showing an increase of 5.0% year-to-year in December. This, together with the slowdown in public consumption, indicates that the government remains faithful to its policy of giving priority to macroeconomic stability. The unemployment rate in São Paolo continued to drop reaching 16.4% in

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005					
			4 Q	1 Q	2 Q	3 Q	October	November	December
Real GDP	0.5	5.0	4.8	3.2	3.5	0.9	–	...	–
Industrial production	0.1	8.3	6.3	3.9	6.1	1.5	0.4	0.6	...
Unemployment rate São Paulo (*)	19.9	18.8	17.4	17.0	17.5	17.2	16.9	16.4	...
Consumer prices	17.0	6.3	5.9	6.0	6.6	5.2	5.4	5.5	5.0
Trade balance (**)	24.8	33.7	33.7	35.9	38.3	41.2	41.9	43.9	44.8

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.

November, a level which, however, remains high.

The foreign sector, another of the supports of Brazil's economy in recent times, continued to give out positive signs. The biggest trade surplus of the Latin American continent marked up a new record of 44.76 billion dollars in 2005.

Argentina keeps on surprising

The Argentine economy continues to maintain the high rate of activity that has allowed the country to go well above the levels before the last recession. The sharp rise in economic activity goes along with a foreign sector on the increase but inflation continues to be the main risk. Payment of the debt with the International Monetary Fund as a charge against reserves can be seen on two levels given that, on the one hand, it is proof of the re-established health of the economy but, on the other hand, will leave the country with an excessively low level of foreign reserves at least for the moment.

Argentina maintains growth now lasting three years.

The Argentine economy grew by 9.2% year-to-year in the third quarter. Beyond the strong rates recorded it is significant that the country is about to end its third year of growth. Private consumption grew by 8.9% in the same period while public consumption was up by 6.8%. The investment component rose by 23.1%, a notable rate although naturally less than in previous quarters because of base effects. Exports grew by 13.3% while imports, although showing a higher rate of increase at 17.8%, indicate a clearly downward trend which gives support to the foreign sector.

Retail sales up strongly.

The most recent demand indicators give out clear signs that the expansionist cycle will continue. Retail sales moved up in November with growth of 36.2% in year-to-year terms. Sales at supermarket chains continued a similar path although car sales took a breather in December with growth of 3.3% thus leaving behind a long period of sharp increases.

Industry continues growth but recovery still has some way to go.

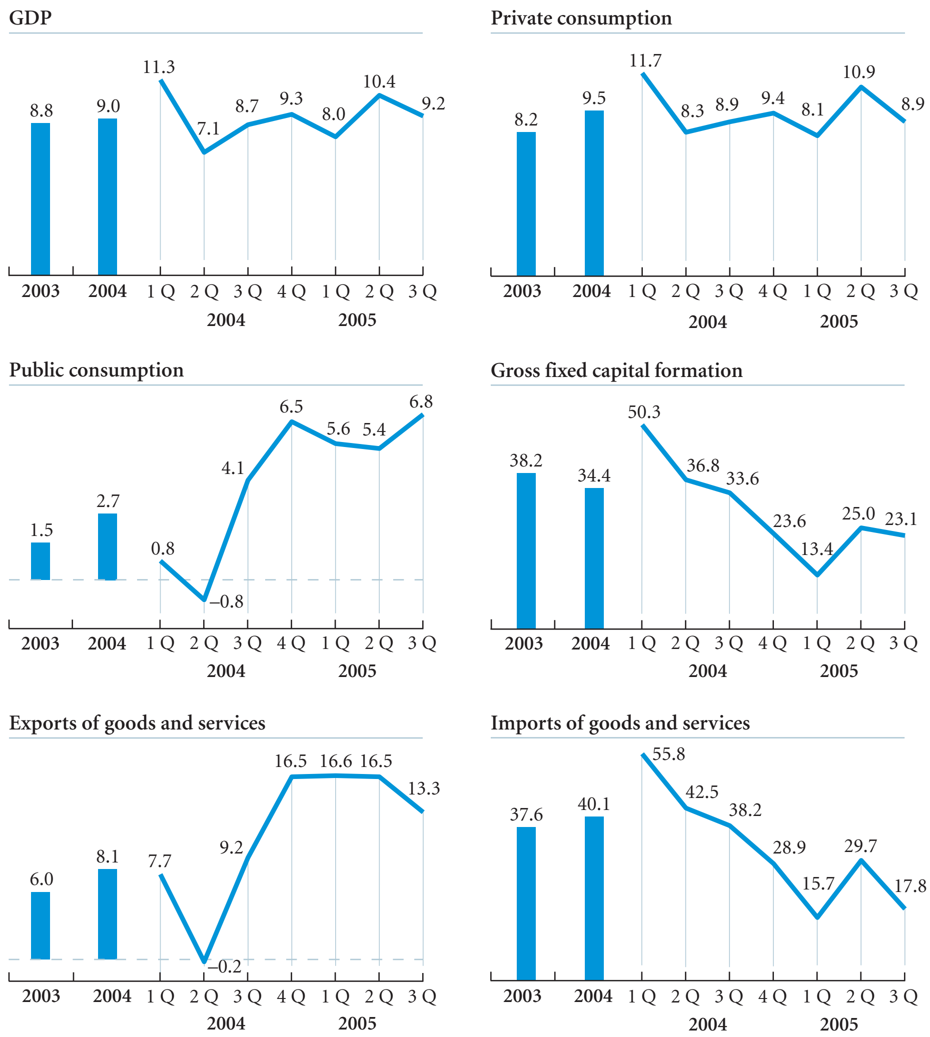
On the supply side things are running along a similar path. Industrial production continues to increase although at more moderate rates. It grew by 7.3% year-to-year in November, a rate close to levels in the first half of 2005. Repeating the performance at the end of summer, mining and metals were again the most active sectors, whereas steel continued to drop. Strongly joining those in November was the energy sector. The industrial activity indicator moved up by 8.9%, clearly maintaining the sharp expansionist rate in a sector which still has some way to go in the process of recovering from the last recession.

Inflation goes above 12% still holding upward trend.

The most troubling aspect of the Argentine economy is prices. In 2005 these grew by 12.3%, a rate which continues to rise and furthermore is well above the average for other economies in the region which, we must add, are not going through an expansionist cycle such as that in Argentina. Neither the slight drop in energy prices, which are rising at 13% whereas at the end of summer they were growing by more than 30%, nor the slowdown in wholesale import prices have had any effect on the general index which is making inflation a growing risk. On the bright side, the trade balance for the twelve months ending in November continued to show a positive balance of 11.14 billion dollars, a level which is moving only slightly downward in spite of strong domestic demand.

TREND IN ARGENTINA'S GDP BY COMPONENT

Percentage year-to-year change in real terms



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

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005					
			IV	I	II	III	October	November	December
Real GDP	8.8	9.0	9.3	8.0	10.4	9.2	–	...	–
Industrial production	12.7	7.5	7.0	8.0	6.3	6.9	6.6	7.3	...
Unemployment rate (*)	17.3	13.6	12.1	13.0	12.1	11.1	...	...	...
Consumer prices	13.4	4.4	5.7	8.2	8.8	9.8	10.7	12.0	12.3
Trade balance (**)	15.7	12.1	12.1	11.9	11.0	11.4	11.5	11.1	...

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: INDUSTRIAL PRODUCTION RECOVERS DRIVE

Year-to-year change in industrial production

SOURCE: INDEC and internal figures.

Raw materials: further upturn in oil

Oil prices grew by 13% in January thus breaking the relative calm shown by the market in November and December. As a result, the one month forward per barrel price of Brent quality oil went from 58 dollars at the end of December to the range of 64-65 dollars at the end of January, very close to the all-time high in nominal terms reached last September (67.5 dollars).

Following this increase we note the difficulties that have emerged in three sensitive parts of the globe: the build-up of statements regarding the nuclear question between Iran and western countries, the guerrilla conflict in Nigeria and increased instability of oil supply from Iraq. It should be remembered that these three countries between them supply approximately one-third of the increase in production that analysts assign to the Organization of Petroleum Exporting Countries in the next five years. On top of these three problems comes the wave of cold Siberian air affecting Russia, which is unusually harsh even by Russian standards. Prospects for coming months are not positive in view of the strength being maintained in crude oil demand (this will grow by 2.2% in 2006, according to forecasts by the International Energy Agency).

Oil again close to all-time highs due to problems in major producer countries such as Iran, Nigeria and Iraq.

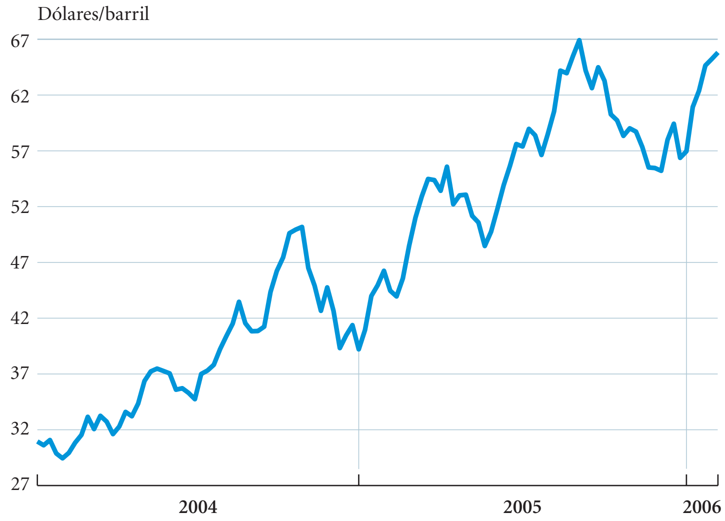
Other raw materials continue to follow a similar path. As a whole, raw materials measured by *The Economist* index in dollars, increased growth to 20% year-to-year in January, more than 5 percentage points above the figure for December. Behind this increase were industrial raw materials including metals.

In the metals category, we may distinguish two groups with trends affected by different conditions. First, the increase in precious metals, and here we should point out the cases of gold (year-to-year growth of 30% in January) and silver (46%), is a reflection of the entry of money of a more speculative kind.

Metal prices jump with overall growth of 30% in past year.

OIL PRICES AGAIN CLOSE TO ALL-TIME HIGHS

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



SOURCE: Thomsom Financial Datastream.

RAW MATERIALS PRICES

	2003	2004	2004	2005						2006
			4Q	1Q	2Q	3Q	October	November	December	January
«The Economist» index in dollars (*)										
General	**11.7**	**17.4**	**1.5**	**–2.3**	**–1.8**	**6.2**	**11.1**	**10.9**	**14.3**	**19.6**
Food	9.1	11.2	–7.3	–8.5	–7.7	3.2	9.7	6.7	7.5	12.5
Industrials	15.9	26.1	13.8	5.9	6.3	10.0	12.7	15.6	22.0	27.8
Non-food agricultural	*21.8*	*9.2*	*–11.2*	*–10.7*	*–8.6*	*0.8*	*10.5*	*9.2*	*13.0*	*16.9*
Metals	*11.8*	*38.2*	*31.5*	*16.1*	*15.5*	*15.0*	*13.8*	*18.7*	*26.1*	*33.0*
«The Economist» index in euros (*)	**–6.7**	**6.7**	**–6.5**	**–6.4**	**–6.0**	**6.6**	**15.4**	**21.6**	**28.9**	**29.8**
Oil (**)										
Dollars/barrel	28.4	38.0	44.7	47.8	53.1	62.0	59.3	56.4	57.5	63.5
Change rate	13.1	34.4	53.8	52.7	50.9	52.5	20.6	26.0	43.2	44.2
Gold										
Dollars/ounce	364.0	409.6	434.0	427.3	427.8	439.6	470.0	476.9	509.9	549.3
Change rate	17.3	12.7	10.6	4.6	8.6	9.4	11.7	8.5	15.4	29.5

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

On the other hand, the rise in metals of industrial use, notable among which are zinc (85%) and copper (55%), is due mainly to the rise in demand.

Euro area: recovery confirmed

Following a surprising spate of growth in the third quarter, the euro area showed signs of an easing off at the start of the fourth quarter. The latest figures have scratched off this analysis and brought back confidence in the recovery scenario. One of the broader indicators and that which more precisely shows the cyclical trend in the euro area, namely the economic sentiment index, bounced back to 100.5 points in December so that in the fourth quarter as a whole this indicator stood at 100.2 points, a result which had not shown up as a recurring figure since the very good year in 2000. Another supply indicator has driven home the current optimism. Industrial production grew by 2.6% year-to-year in November as compared with the increase of 0.2% in October.

All this has contributed to bringing about an upward revision of short-term forecasts by the European Commission. According to its latest report, the EU executive body expects that in the fourth quarter of 2005 growth stood in the range of 0.4%-0.8% quarter-to-quarter, a figure that is to be repeated in the first quarter of 2006. In the second quarter, the increase in the gross domestic product (GDP) would stand at quarter-to-quarter rates of 0.4%-0.9%. Expressed in year-to-year terms, growth would be 2.0% in the fourth quarter, 2.3% in the first quarter and 2.6% in the second quarter. These forecasts must be seen as very optimistic although most analysts are expecting growth slightly below 2%

Euro area dispels doubts about recovery as it leaves behind relative dip at beginning of fourth quarter...

...leading to upward revision of European Commission forecasts for first half of 2006 when it could show growth above 2%.

ECONOMIC ACTIVITY IN EURO AREA MOVES BACK TO GROWTH PATH

Value of economic sentiment index

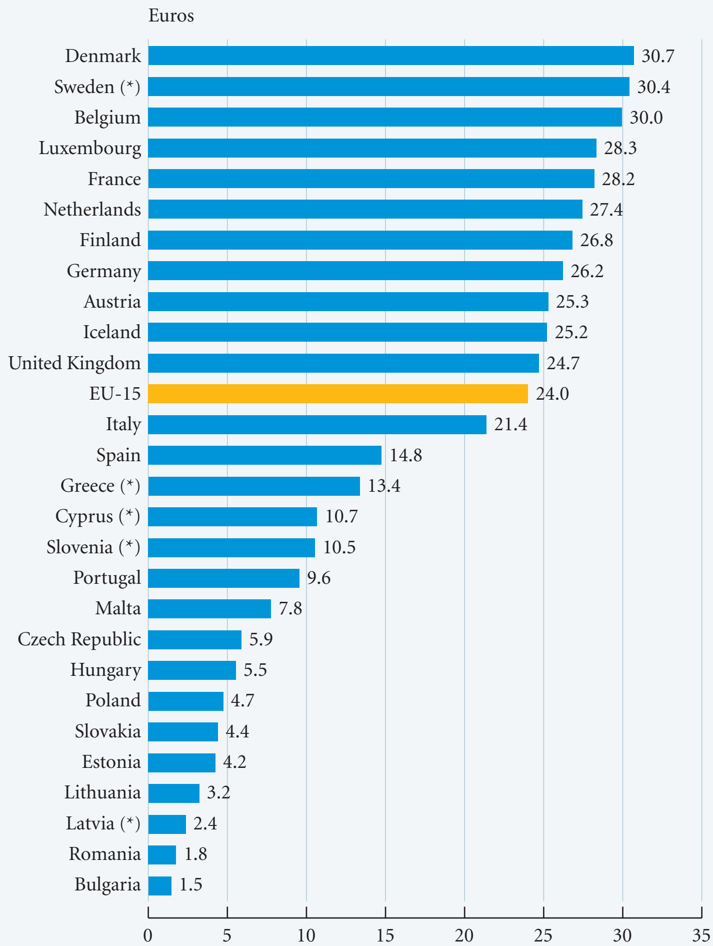
SOURCE: European Commission.

Labour market in EU: globalization on a small scale

Europe is a very diverse reality from a labour point of view. Over the course of history, cultural factors and those of a sociological, economic and legal nature have fostered the making up of local realities which differ substantially from each other. If this were of little account, the enlargement of the European Union (EU) to 25 member states has added sharp points of difference to a mosaic which until recently was relatively homogeneous and, in labour matters, noted for a rather comfortable situation for those employed.

WHO OFFERS LEAST?

Labour cost per effective hour worked in 2004



NOTES: (*) Figure for 2003.
SOURCE: Eurostat.

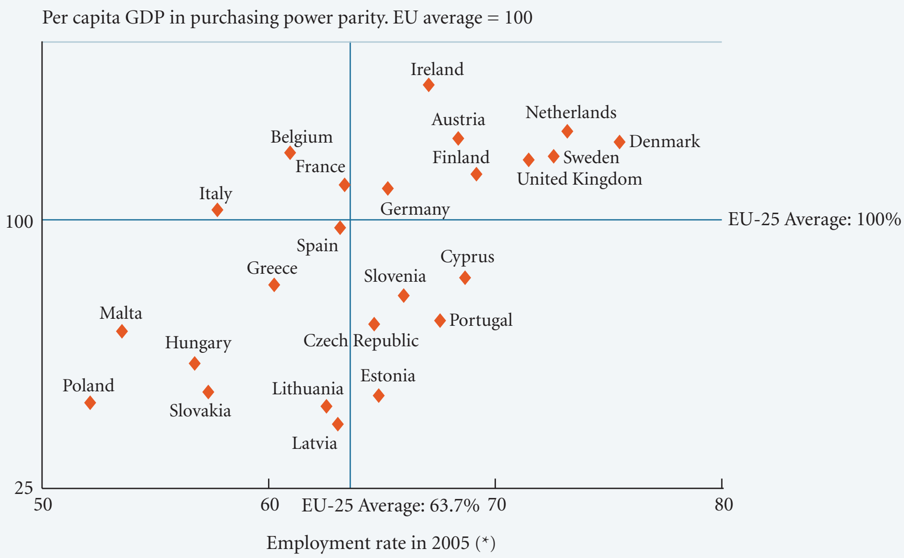
In fact, labour conditions in the new member states of the EU are much more competitive than those existing in the countries making up the former EU-15. It would be difficult find any of the countries in the enlarged

EU where the average work week for any job did not exceed 40 hours a week, as against work weeks not above 37 hours in the larger countries, with the exception of Spain and Italy. In the same way, labour costs per hour worked also show sharp differences with minimums of around 2-3 euros in Latvia and Lithuania (or lower than two euros in the candidate countries) and maximums well above 25 euros in France, Germany, United Kingdom and the Nordic countries.

These big differences, which have a significant impact on production costs but do not strictly determine competitiveness (which is dependent on many other factors), at the same time provide an opportunity and a threat for the industrial fabric of the EU. In fact, those companies with a strong presence internationally can adapt their production strategies and locations to those competitive advantages whereas, on the other hand, those production sectors and regions with certain manufacturing specialization, not without some difficulty, will have to change their production structure.

For the moment, the richer countries, with higher labour costs and shorter work weeks, still show the highest employment rates in the EU. In Denmark, the working population in terms of the group of working age is the highest in the European Union at 75.5%. Also above 70% come the Netherlands, Sweden and the United Kingdom. What are the most characteristic factors of the labour market in those countries?

THE MORE WEALTH THE MORE JOBS... OR IS IT THE OTHER WAY AROUND?



NOTES: (*) Persons employed as % of population of working age.
SOURCE: Eurostat and internal figures.

First of all, as a basic characteristic, the economies with a high level of employment are noted for a clearly predominant services sector and a public sector of notable size. Secondly, there is a clear correlation between the degree of integration of women in the labour market and the overall labour rate. In the Nordic countries, the high employment rate may be explained by the high proportion of women with jobs, more than 70% of the population of working age. On the other hand, two of the largest countries in the EU with the lowest employment rates, Poland and Italy, show very low female employment at around 46% of the population of working age (ten points less than the EU average), which may be explained, as in the case of Greece, by sociological factors. Spain, in line with the Mediterranean model, has made a jump forward in this matter in recent years although female employment still stands 20 points below the leading countries in Europe.

The high level of integration of women cannot be understood outside the development of work formulas making it possible to combine family life and work, formulas that are much used in the more developed countries. In Europe, some 32.5% of working women have part-time work but this proportion rises to 75% in the Netherlands and around 40% in Belgium, Germany, Sweden, United Kingdom and Austria. In Spain and Italy the rate is around 25% while in the countries of the EU enlargement this would scarcely go above 10%.

In addition, the growing need to combine studies and work and the opportunity to partly take advantage of the experience of those in the latter years of their working life has also fostered part-time work among young people and those over 55 years of age, quite apart from sex, which naturally has raised the overall employment rate.

Finally, labour flexibility also seems to be an important factor in explaining high employment rates, at least in the Anglo-Saxon countries. The United Kingdom and Ireland show extraordinarily low rates for temporary work, well below the central EU countries (at around 12% of the wage-earning population) and, of course, totally opposed to the rates currently seen in Spain's economy where some 33% of hiring contracts are of a temporary nature.

What will be the effects of enlargement of the European Union in the labour sphere? At this moment, the fears of a possible massive wave of workers from the new member states were defused through the Joining Treaty. A seven-year transition period allowed the existing member states to limit the free circulation of workers to those countries that so decide. As a result, the effects on the labour market will be very gradual. Another question is knowing to what point companies will opt for locating their plants in low labour cost countries, something which has already begun. And whether that will mean a shock when it comes to making the labour markets of the more regulated member states more flexible and dynamic.

Private consumption fails to respond although reduction of some inflationary pressures at end of 2005 may help on this front.

year-to-year for the first half of 2006, a figure in line with our own forecasts at 1.9%.

Are there signs of any negative factor in this overall positive scenario? No doubt the variable that has failed to take off is private consumption. The latest indicators continue to be far from bright. Retail sales grew by a moderate 0.3% year-to-year in November, car registrations were down by 0.2% at year-to-year rate in October and consumer confidence, in spite of some improvement, was still at the –11 points level in December.

The other demand components are following more satisfactory paths. Investment remains notably strong, if we are to go by growth of of the capital goods component of industrial production at 4.1% year-to-year in November. In turn, within a generally erratic frame, exports are showing a background growth trend. Nevertheless, the strength of imports has led to a progressive reduction of the trade surplus which, in cumulative balance for 12 months, stood at 28.3 billion euros in October, as against 39.4 billion in the third quarter.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005					
			4 Q	1 Q	2 Q	3 Q	October	November	December
GDP	0.7	1.8	1.6	1.2	1.2	1.6	–	...	–
Retail sales	0.4	0.9	1.0	1.3	0.6	1.0	0.2	0.3	...
Consumer confidence (*)	–18	–13.8	–13.0	–13.2	–14.4	–14.8	–13	–13	–11
Industrial production	0.3	2.0	1.1	0.6	0.7	1.4	0.2	2.6	...
Economic sentiment indicator (*)	93.5	99.5	100.5	98.7	96.1	97.8	100.2	99.9	100.5
Unemployment rate (**)	8.7	8.9	8.8	8.8	8.6	8.4	8.3	8.3	...
Consumer prices	2.1	2.1	2.3	2.0	2.0	2.3	2.5	2.3	2.2
Trade balance (***)	80.3	80.4	73.1	64.5	50.4	39.4	33.2	28.3	...

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

Another factor that may help solidify recovery is the relative calm shown on the prices front. In the last two months the harmonized consumer price index (HCPI) has left behind the 2.5% levels reached in October to slip down to levels close to 2%. Specifically in December, inflation stood at 2.2% year-to-year. The unemployment rate is showing fewer changes and in November held at 8.3% of the labour force for the third consecutive month.

Germany: economy recovering drive

German recovery is continuing its course. We should not give excessive importance to a negative assessment of growth in 2005 as a whole. According to figures from the Federal Statistics Office, during that year Europe's leading economy grew by only 0.9%, considerably below the 1.6% in 2004. Nevertheless, this apparent slowdown was due entirely to the fact that in 2005 there were 1.3 fewer days worked than in 2004. After the GDP figures were adjusted for these calendar differences it turned out that Germany grew by 1.1% both in 2005 and 2004.

With regard to the pattern of growth, in 2005 the key components continued to be investment in capital goods and exports while consumption and construction investment remained very weak. At the same time we should note confirmation that Germany's government deficit amounted to 3.5% of the GDP in 2005, which meant that it failed to meet the Stability and Growth Pact level for the fourth consecutive year.

Looking at the most recent period, latest available indicators tend to ratify Gemany's economic growth, especially on the supply side. Industrial production took off in November going to 4.7% year-to-year, the highest level since February 2001 while in January the IFO index of industrial activity marked up its highest level since 2000. There is less good news in demand which continues to be dominated by consumer apathy which is reflected in the 0.6% drop in retail sales in November and the collapse of car sales (decrease of 8.3% year-to-year in December).

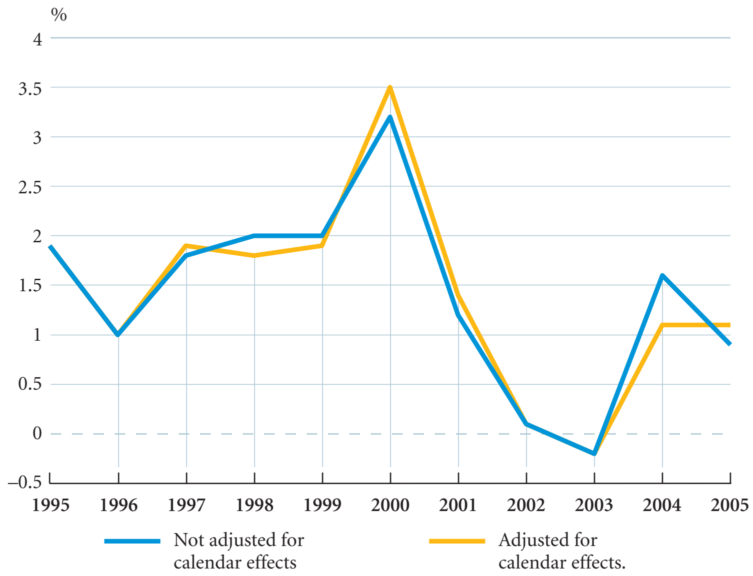
In turn, foreign demand is keeping up its positive contribution to economic

Germany consolidates recovery with 2005 growth at 1.1% thanks to exports and capital goods investment.

Industrial production grows by close to 5% in November reflecting better state of secondary sector in past four years.

NOTABLE DIFFERENCE IN GERMANY'S GDP IN 2005 GOING BY DAYS WORKED

Real annual change in gross domestic product



SOURCE: Federal Statistics Office.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005					
			4 Q	1 Q	2 Q	3 Q	October	November	December
GDP	–0.2	1.1	0.5	0.6	0.7	1.4	–	...	–
Retail sales	–0.5	1.1	1.3	0.6	2.2	1.1	–1.1	–0.6	...
Industrial production	0.1	2.4	1.5	1.8	2.0	3.0	4.0	4.7	...
Industrial activity index (IFO) (*)	91.7	95.7	95.0	95.2	93.3	95.3	98.8	97.8	99.7
Unemployment rate (**)	10.5	10.5	10.8	11.7	11.7	11.6	11.6	11.4	11.2
Consumer prices	1.0	1.7	2.0	1.7	1.7	2.1	2.3	2.3	2.1
Trade balance (***)	130	149	155	157	154.4	157.2	159.6	161.3	...

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

activity with a further increase in the trade surplus to 161.3 billion euros in November, as cumulative balance for the past 12 months. We may also give a positive evaluation to the drop in unemployment rate (down two decimals in December to 11.2%) and the decrease in inflation (2.1% year-to-year in December, compared with 2.3% year-to-year in November).

In another sphere, we should mention that the German government has spelled out one of the key measures in its economic programme. On January 9 the German government approved a package aimed at stimulating the economy to the extent of 25 billion euros in the period 2006-2009. Among it main features, this package includes a contribution of 9.4 billion euros to the fund for refloating small and medium-sized companies, a package for government investment in research and development equivalent to 6 billion euros and the injection of government investment in transportation infrastructures amounting to 4.3 billion euros.

Angela Merkel government presents package of measures to stimulate economy mainly centred on public investment to reach 25 billion euros in 2006-2009 period.

France: doubts about strength of recovery

Questions being raised about the strength of French recovery are not going away, given that all through the fourth quarter the most troublesome indicators failed to suficiently improve. To be specific, domestic consumption, the support of which seems essential for consolidating growth, slowed to 1.4% year-to-year in December (2.7% in November). In any case, we should point out that in December consumer confidence recovered part of the drop seen in previous months. Other consumption indicators, such as industrial production of consumer goods and passenger car registrations, have shown a similar trend.

In the matter of industrial activity, the trend is more satisfactory. Industrial production in November grew by 1.3% year-to-year in sharp contrast to the decrease of 1.7% year-to-year in October, a trend which should continue in view of the recovery of confidence in secondary industry recorded as of December. On the other hand, confidence in the services sector has lost some of its former good level and in December showed its lowest figure since April 2004.

In France, consumption fails to take off thus limiting confidence in recovery.

In December, inflation marked up its third consecutive month to show a reduction. After reporting an increase of 2.2% year-to-year in September, in the three-month period October-December, the CPI dropped by seven decimals going to 1.5% year-to-year at year-end. In turn, the unemployment rate was down by one decimal in November to show a figure of 9.6%.

In matters of economic policy, the most significant news is the announcement by the Minister of Economy, Thierry Breton, of plans to carry out cuts in

Favourable trend in industrial activity and prices which drop below 2% at end of 2005.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005					
			4 Q	1 Q	2 Q	3 Q	October	November	December
GDP	0.9	2.1	2.0	1.8	1.1	1.8	–	...	–
Domestic consumption	1.9	3.3	3.9	3.0	1.0	4.2	1.9	2.7	1.4
Industrial production	–0.4	1.8	1.5	0.7	–0.5	0.3	–1.7	1.3	...
Unemployment rate (*)	9.8	10.0	10.0	10.1	10.2	9.9	9.7	9.6	...
Consumer prices	2.1	2.1	2.1	1.6	1.6	1.9	1.8	1.6	1.5
Trade balance (**)	0.2	–0.1	–0.5	–1.0	–1.5	–1.8	–1.9	–2.1	...

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

Minister of Economy Thierry Breton announces commitment to reach zero deficit in 2010 through reduction of public spending.

public spending which will make it possible to reach a nil deficit in 2010. This plan, which involves annual savings of some 10 billion euros, will be carried out through growth of government spending of one percent below inflation in each budget year. In addition, Breton proposes a new programme of privatizations the amount of which (30 billion euros) will go to reducing the government debt to 60% of the GDP in 2010, six points less than reported in 2005.

Italy: slightly better prospects

Italy's economy showing some improvement in fourth quarter with somewhat more active household spending as main factor.

While Italy continues to show a lack of economic strength, the end of 2005 brought some moderately positive signs. The poor state of consumption, although not yet ended, may be moving into a less depressed stage, as indicated by the increase in retail sales in October (1.4% year-to-year as against 1.1% in September) and the recovery of consumer confidence.

Industrial recovery and easing down of consumer prices other positive signs.

On the supply side, the poor performance in secondary industry, which saw industrial production drop by 1.7% year-to-year in October, partly improved in November when this indicator went down by only 0.6% year-to-year. Nevertheless, so long as exports do not appreciably improve (increase of 5.1% year-to-year in November), Italian manufacturing, which is very much oriented toward the international market, will still be without one of its fundamental supports.

If we take into account all the above factors, the overall drive in the economy is the best in recent months and this is reflected in economic sentiment which rose to the level of 102.8 points in the fourth quarter, nearly five points higher than in the previous quarter. Furthermore, as one more positive factor, we should mention the reduction of inflationary pressures which put the rise in consumer prices at 2% year-to-year in December.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005					
			4 Q	1 Q	2 Q	3 Q	October	November	December
GDP	0.4	1.0	0.8	–0.3	0.2	0.1	–	...	–
Retail sales	2.0	–0.4	–1.1	0.1	–1.2	0.3	1.4	...	...
Industrial production	–0.6	–0.6	–2.0	–2.6	–1.2	–0.2	–1.7	–0.6	...
Unemployment rate (*)	8.4	8.0	7.9	7.8	7.7	7.7	–	...	–
Consumer prices	2.7	2.2	2.0	1.9	1.8	2.0	2.2	2.2	2.0
Trade balance (**)	4.1	2.0	–0.8	–1.9	–5.1	–7.0	–8.7	–9.2	...

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

United Kingdom: all eyes on consumption

The notable slowdown in consumption up to the third quarter, which put that component at its lowest level in 10 years, has been the centre of attention in trying to work out if household consumption would recover in the fourth quarter. The conclusion is not definitive. Whereas retail sales rose to 2.6% year-to-year in the fourth quarter (1.0% in the third quarter), industrial production of consumer goods and consumer confidence scarcely showed improvement. The stagnation in the GDP in the fourth quarter (1.7% year-to-year, according to early estimates) also fails to remove existing doubts.

If we look at basic factors once more, what we see is not very positive either. Specifically, the labour market, in spite of showing a moderate unemployment rate (at 2.9% between October and December), is also reporting stagnation in employment rates, a decrease in the number of job vacancies and lower growth in average wages.

The worsening of the labour scene is due not only to the persistent weakness of the industrial sector, shown most clearly in the year-to-year drop in industrial production of 2.4% in November, but also in the recent worsening of the services sector. On the other hand, the trend in inflation, which had substantially moved away from the annual highs reported last summer (2.0% year-to-year in December), may facilitate the transition toward a stage of increased spending by British households.

Apart from the cyclical situation, another sign of Britain's difficulties is the progressive worsening of the government finances. After reporting a government deficit of 3.3% of the GDP in the fiscal year from April 2004 to March 2005, in the current year ending in March 2006 the imbalance will stand at 3.4% of the GDP. In spite of the fact that the government has announced measures to contain spending, the European Commission foresees a deficit equivalent to 3.2% of the GDP in 2007. All of this has led the European Commission to request the opening of an excessive deficit procedure, an initiative which, if approved by the Council of Ministers, need not lead to sanctions but could indeed damage the budget implementation of Tony Blair's government.

With private consumption at worst level in decade, all attention turned to performance in fourth quarter.

Labour market begins to erode reflecting both weakness in industry and recent drop in services.

Brussels warns about excessive UK government deficit.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005					
			4 Q	1 Q	2 Q	3 Q	October	November	December
GDP	2.5	3.2	2.7	2.0	1.6	1.7	–	1.7	–
Retail sales	3.0	6.2	4.7	3.0	1.5	1.0	1.7	2.4	4.0
Industrial production	–0.5	0.8	0.1	–1.1	–1.6	–1.2	–1.9	–2.4	...
Unemployment rate (*)	3.0	2.7	2.7	2.6	2.7	2.8	2.9	2.9	2.9
Consumer prices	2.8	2.2	2.3	2.2	2.2	2.4	2.4	2.3	2.0
Trade balance (**)	–46.8	–55.5	–59.8	–61.6	–62.5	–63.0	–63.1	–63.8	...

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

FINANCIAL MARKETS

Monetary and capital markets

End of Federal Reserve upward cycle near

Federal Reserve rise to 4.50% on January 31 was broadly discounted and will not be the last.

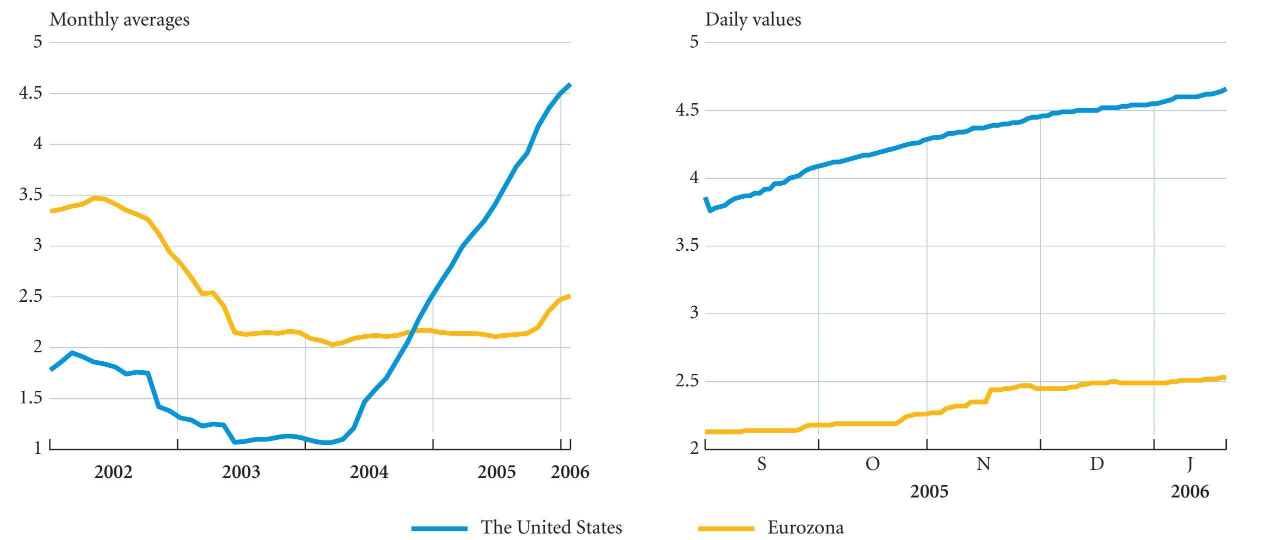
In 2005 the US Federal Reserve raised its reference rate eight times, each of 25 basis points. As a result, the objective level of the overnight interbank rate rose from 2.25% at the end of 2004 to 4.25% last December. As they had announced, the US monetary authorities thus put the reference rate close to a neutral level. In fact, the minutes of the last meeting of the Federal Open Market Committee of the Fed, published at the beginning of 2006, confirmed that monetary policy was not now considered easy. At the same time, the minutes suggested that there could be the odd further increase but that the end of the upward cycle was near.

As a result, the increase in the official interest rate to 4.50% at the last meeting of Greenspan's mandate as chairman of the Fed at the end of January 2006 was broadly discounted by the market. While there are some doubts about the level to be reached by the Fed reference rate, we are betting on 4.75%. We believe that the new chairman Ben Bernanke will want to reaffirm his anti-inflationary reputation with a further increase but this will not continue given the signs of a slowdown in the economy.

As expected, the Governing Council of the European Central Bank (ECB) made

SLIGHT WIDENING OF SHORT-TERM INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO

3-month interbank interest rates as annual percentage



NOTES: Rates go up to January 26.
SOURCE: Bank of Spain and Thomson Financial Datastream.

no change in its reference rates at its meeting on January 12. The financial markets, however, were very attentive to the announcement which followed and the press conference given by Jean-Claude Trichet. The tone of the press release was not very different from the previous one but, as it did not include the words «sharp watch» related to prices, the market interpreted this as an easing of the aggressiveness of the ECB position. The 1-year Euribor, which stood at 2.79% on monthly average in December, thus dropped very slightly following the ECB meeting. Nevertheless, there were some strong statements by ECB executives and the 1-year Euribor rose slightly. As a result, the market is expecting a rate rise by the ECB in March and at least one more as of June, which seems reasonable enough.

Further increase in European Central Bank reference rate expected in March.

In addition, inflation in the euro area ended the year 2005 at 2.2%, according to early figures from Eurostat. As a result, for the sixth consecutive year, the inflation rate has stood above the 2% medium-term objective limit for inflation set by the ECB. Nevertheless, it must be recognized that the inflation rate is not very far from the objective and that in 2005 inflationary pressures caused by

Inflation in euro area ends 2005 above 2% objective for sixth consecutive year.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euríbor (5) 3-month	Euríbor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2004									
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	2.06	2.36	2.68	4.00	4.35	0.09	4.50	4.62	0.95
December (*)	2.28	2.47	2.79	4.25	4.49	0.09	4.50	4.64	1.02
2006									
January (1)	2.30	2.53	2.86	4.25	4.66	0.10	4.50	4.59	1.01

NOTES: (*) Provisional figures.
(1) January 26.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 6-3-03 (2.50%), 5-6-03 (2.00%), 1-12-05 (2.25%).
(3) Latest dates showing change: 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%), 13-12-05 (4.25%).
(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.

After three years of decreases dollar rises 3.5% in 2005.

Prospects of increases in European Central Bank official interest rates give support to euro.

the boost in oil prices were very strong. Perhaps what is most important is the fact that for the moment inflation prospects over the medium and long term are contained.

With regard to other main central banks, neither the Bank of Japan nor the Bank of England changed their positions at their respective meetings in January. Nevertheless, the Bank of Sweden raised its intervention rate by 25 basis points to 1.75% on January 20. In this way, it partly turned back the cut made last summer. The recent decision of the Riksbank, the world's oldest central bank, was due to inflationary pressures in a framework of improved economic prospects. Furthermore, on January 24 the Bank of Canada raised its reference rate by 25 basis points to 3.50%.

Dollar weak in early stages of year

Following three years of drops, the dollar rose by 3.5% in 2005 against a broad basket of currencies. Against the euro, the greenback was running at 1.36 dollars to the euro at the end of 2004. At that time most forecasts were that the dollar would continue to drop against the euro in 2005. This has not happened which shows the difficulty in foreseeing the trend in foreign exchange rates. This does not mean that the dollar will not have to be substantially corrected downward, especially against the Asian currencies, in order to reduce the massive US foreign deficit which was the underlying argument for the depreciation of the dollar in 2005. This only means the correction has been delayed. The weakness of the dollar in the early stages of 2006 could be indicative of the future course of this currency.

The euro fell by 7.1% in 2005 against a group of currencies of the main trading partners of the euro area and 13.4% against the dollar. In the early weeks of January the prospects for an increase in the European Central Bank reference rates following better economic

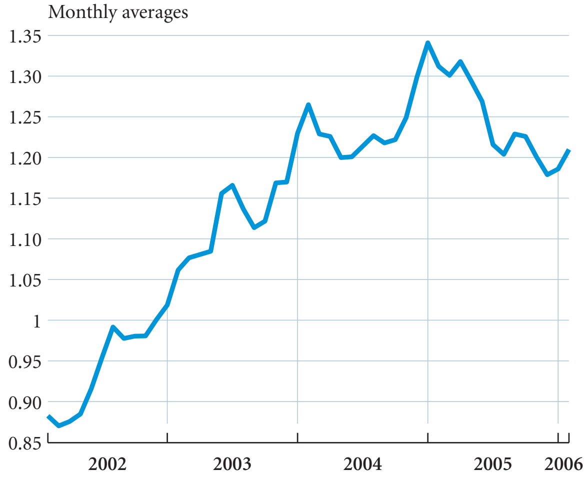
DOLLAR BREAKS DOWNWARD TREND IN 2005

Effective nominal dollar exchange rate

NOTES: Figures go up to January 26.
SOURCE: US Federal Reserve.

EURO BEGINS 2006 STRONGLY

US dollars to euro



NOTES: Figures go up to January 26.
SOURCE: OCDE, Thomson Financial Datastream and internal figures.

EURO DROPS IN 2005

Effective nominal euro exchange rate

NOTES: Figures go up to January 26.
SOURCE: European Central Bank.

prospects in the euro area boosted the European currency which came to stand at 1.229 dollars per unit as against 1.18 dollars at the end of 2005.

The pound sterling ended 2005 with a slim appreciation of 0.5% against a broad group of currencies. In the early part of the year it rose by 4.2% but later on the prospect of a cut in the Bank of England official rate, which took place in August, hurt the British currency. In the early weeks of January the pound held its position against the euro but appreciated

EXCHANGE RATES OF MAIN CURRENCIES

December 2005

	Final session of month		Monthly figures				*Exchange rate January 26, 2006*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2) Monthly	Over December 2004	Annual	
Against US dollar							
Japanese yen	117.9	–1.6	118.4	0.0	14.1	14.1	*116.5*
Pound sterling (1)	1.723	–0.4	1.746	0.6	–9.6	–9.6	*1.780*
Swiss franc	1.316	0.1	1.306	–0.3	14.0	14.0	*1.270*
Canadian dollar	1.163	–0.4	1.162	–1.6	–4.6	–4.6	*1.151*
Mexican peso	10.63	0.5	10.63	–0.4	–5.1	–5.1	*10.50*
Nominal effective index (4)	*111.8*	*–0.3*	*111.8*	*–0.6*	*2.6*	*2.6*	109.7
Against euro							
US dollar	1.180	0.2	1.186	0.6	–11.6	–11.6	*1.225*
Japanese yen	138.9	–1.3	140.5	0.6	1.0	1.0	*141.9*
Swiss franc	1.555	0.4	1.548	0.2	0.8	0.8	*1.550*
Pound sterling	0.685	0.5	0.679	0.0	–2.2	–2.2	*0.686*
Swedish krona	9.389	–1.5	9.433	–1.3	5.0	5.0	*9.251*
Danish krone (3)	7.461	0.1	7.454	–0.1	0.3	0.3	*7.463*
Polish zloty	3.860	–1.2	3.850	–3.0	–6.9	–6.9	*3.828*
Czech crown	29.00	0.2	28.97	–1.0	–5.4	–5.4	*28.40*
Hungarian forint	252.9	0.1	252.6	0.6	2.8	2.8	*249.5*
Nominal effective index (5)	*100.5*	*–0.2*	*100.7*	*0.0*	*–5.9*	*–5.9*	*102.0*

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

substantially against the dollar, taking advantage of that currency's weakness.

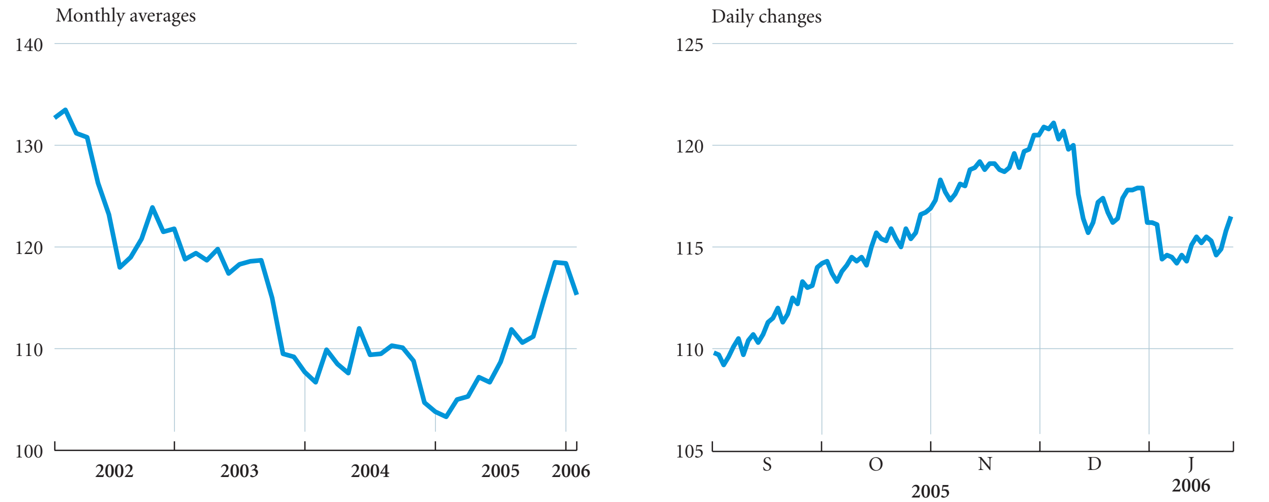
Yen depreciates 8% in 2005 but recovers in January.

The yen dropped by 8.1% in 2005 against a wide group of currencies. Also keeping in mind inflation, that is to say, in effective real terms, the Japanese currency marked up its lowest level since the beginning of the 1986. The differential in interest rates, which was not in its favour against the other currencies as Japan's interest rates were around 0%, significantly weakened it. In the early weeks of 2005, however, the yen recovered positions due to the drop in the dollar.

The Chinese authorities have continued to show signs of making their exchange rate policy more flexible although very slightly. At the beginning of January they modified the system of establishing the opening price of the currency. Now, it is based on the average of prices quoted by five western banks and eight local banks although the Chinese authorities continue to limit the daily change at ±0.3% against the dollar. In practice, the fluctuations are very limited. In the third week of January the yuan reached a high against the dollar running at 8.062 units to the dollar, up from the controlled

YEN MOVES UP AGAINST DOLLAR IN JANUARY

Yen to dollar



NOTES: Rates go up to January 26.
SOURCE: OCDE, Thomson Financial Datastream and internal figures.

flotation established in July 2005 when the opening rate was set at 8.11 yuan to the dollar.

On the other hand, the head of the Research Department of the Chinese Central Bank, Tang Xu, dismissed speculation that China would reduce its dollar holdings in foreign currency reserves which are estimated at more than 70% of the total. As is well-known, China's current foreign exchange reserves are the second largest in the world and could come to hold first place ahead of Japan at the end of 2006. In fact, the possible disinvestment of holdings in dollars by Asian foreign banks is a risk factor for the value of the US currency.

Intervention by Chinese authorities in favour of yuan may raise foreign reserves to top world place in 2006.

Differential in bonds of emerging countries drops to all-time low

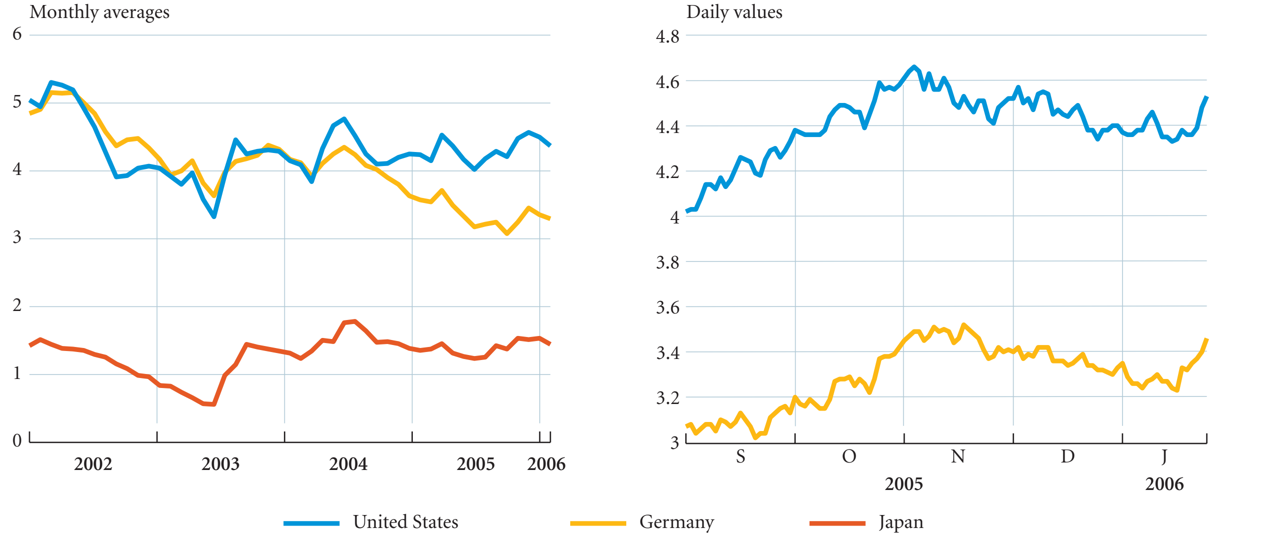
The yield on US 10-year Treasury bonds, considered a reference for long-term bonds, ended 2005 at 4.40%, some 18 basis points above 12 months earlier but slightly below June 2004 at the beginning of the restrictive upward turn by the Federal Reserve. In 2006 it is likely it will continue to rise but only slightly given that it is not expected that the Federal Reserve's reference rate will go beyond 4.75%. In the early weeks of January the yield on US 10-year Treasury bonds showed slight swings in view of expectations on the level to which the Fed's rate might go with an upward tendency noted in the fourth week.

As a result, in the early weeks of January there was a temporary switch-around in the interest rate curve for US government bonds between the 10-year and 2-year terms, that is to say, the yield on 2-year bonds was higher than that on 10-year bonds, something that rarely occurs. Nevertheless, the differential between 10-year and 3-year bonds is still positive although it has dropped a lot in recent months with the resulting flattening out of the interest rate curve. The latter indicator is considered a forerunner of a depression should it again become negative.

Flattening out of US interest rate curve brings fears of recession.

SLIGHT NARROWING OF LONG-TERM INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO

Yield on 10-year government bonds as annual percentage



NOTES: Rates go up to January 26.
SOURCE: Bank of Spain and Thomson Financial Datastream.

Yield on UK 50-year government bonds falls to very low level in real terms.

The yield on German 10-year bonds rose slightly at the end of the fourth week in January with confirmation of prospects of a hardening in the position of the European Central Bank. The long-term interest rate differential between the dollar and the euro thus dropped slightly. This trend should continue as the economic growth rates of both geographical regions converge.

Interest rates on long-term government bonds continue at relatively low levels. The same may be said of real long-term interest rates. In the third week of January the real yield on UK 50-year bonds dropped to 0.5%, an extremely low level. This was partly due to demand pressure from British pension funds on a relatively small offer. These institutional

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2003	2004	2005						2006
			1 Q	2 Q	3 Q	October	November	December	January 26
United States	4.04	4.31	4.34	4.21	4.25	4.50	4.59	4.52	4.53
Japan	0.99	1.50	1.41	1.28	1.36	1.54	1.52	1.54	1.50
Germany	4.10	4.07	3.63	3.35	3.19	3.26	3.47	3.37	3.46
France	4.13	4.10	3.64	3.38	3.23	3.29	3.49	3.38	3.46
Italy	4.24	4.24	3.75	3.53	3.40	3.45	3.66	3.56	3.66
Spain	4.12	4.10	3.63	3.36	3.18	3.27	3.48	3.37	3.41
United Kingdom	4.53	4.93	4.72	4.50	4.32	4.40	4.36	4.25	4.17
Switzerland	2.47	2.57	2.15	2.04	1.90	1.93	2.18	2.04	2.10

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

investors have increased their long-term bond buying in order to reduce the gaps between long-term assets and liabilities arising from regulatory changes.

The differential between emerging economy bonds and US government bonds fell to an all-time low of 215 basis points in the fourth week in January, measured by the JP Morgan Embi+ index. This trend reflects an improvement in the economic situation in the emerging countries but it was also due to the search for higher returns by investors with little concern for risk. On the other hand, in December the global default rate for high-yield bonds recorded the lowest level since 1997, according to Moody's rating agency. In 2006 a moderate increase is expected. With regard to the default rate for «junk bonds» issued in dollars, there was a rise in 2005. The differential with high-yield US bonds thus left behind the lows recorded in March 2005.

Low interest rates and excellent corporate profits boost stock markets in 2005.

Upset in stock markets following three years of consecutive increases

The stock markets ended 2005 with favourable balances for the third consecutive year. Low interest rates and better-than-expected economic prospects and corporate profits boosted the stock markets. As a result, the upsets caused by the rise in oil prices were left behind.

Emerging markets again head classification of most profitable stock markets in 2005.

The results on the various stock markets show major differences. In 2005 the emerging markets again headed the most profitable group. These stock markets reflect the improved economic situation in those countries but also the hunger of investors for assets offering higher yields in a framework of low interest rates. The indices for Egypt, Colombia and Saudi Arabia doubled during the year. Other Middle East countries, such as Jordan and Oman, also benefited from petro-dollars. Oil-exporting countries, such as Russia, Norway and Mexico also come into this classification. Recent member states of the European Union and candidate countries for the next enlargement of the EU enjoyed investor preference. Markets of other European countries such as Iceland, Austria and Denmark showed major capital gains. Nevertheless, not everything was golden, as showed up in the cases of Venezuela and Bangladesh which reported annual decreases for the year of 32% and 20% respectively.

Further rise in oil prices and doubts over growth of corporate profits jolt stock markets in January.

The stock markets began 2006 in lively fashion. Nevertheless, later on there came another price increase for crude oil and some disappointing figures for corporate profits cooled off feelings in the market thus bringing about some drops and certain indices briefly lost par for the year.

In the United States, in the middle of the fourth week in January the index showing the best performance in 2006 was the Nasdaq. Nevertheless, both the traditional Dow Jones index and the broader Standard & Poor's index showed advances. This advance came as a result of a good start to the year by hi-tech companies, which are well represented in the Nasdaq index.

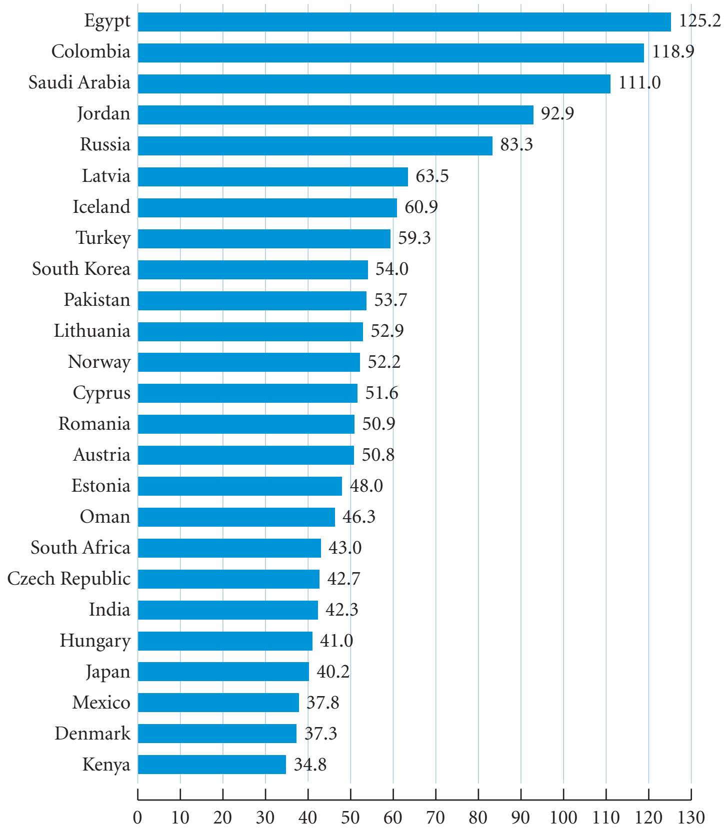
The DJ Eurostoxx 50 index, which is made up of the biggest companies in the euro area, also had some jolts following a good start to the year. Among the main stock markets, the Italian and French markets showed the highest gains.

IBEX 35 index up 18% in 2005.

The Spanish market obtained a brilliant result in 2005 with the IBEX 35 being revalued by 18.2%. Of those companies in this selective index, six showed

THE MOST PROFITABLE STOCK MARKETS IN 2005

Annual change in representative national stock market indices as percentage



SOURCE: Thomson Financial Datastream and internal figures.

Accounting scandal at Internet company brings 6% loss on Nikkei 225 in two days.

increases of more than 50%, including some construction companies, and only four ended the year below the starting level. The year 2006 also began well for then IBEX 35, which went close to 11,000 points but later lost its drive.

Outside the euro area the most notable upsets came in the Japanese market. The Nikkei 225 index ended 2005 with an annual rise of 40.2% to stand among the most profitable group for the year, thanks to the economic recovery and the improved prospects in view of the structural reforms announced by prime minister Koizumi's government. On January 13 the Japanese index showed an increase of 2.1% over the end of December. Nevertheless, later on the discovery of an apparent accounting scandal at the Livedoor Internet server unleashed a selling spree which meant the Nikkei index would lose 5.7% in just two days, although it later regained.

Many emerging markets hit new all-time highs in January.

With regard to emerging markets, many began the year very brightly expecting that the upswing would continue. As a result, some markets, such as Mexico, Brazil, South Korea, India, Indonesia and Poland marked up new all-time highs in the first month of the year.

INDICES OF MAIN WORLD STOCK EXCHANGES

December 30, 2005

	Index (*)	% monthly change	% cumulative change	% annual change	Figures on January 26, 2006	
					% cumulative change	*% change over same date in 2002*
New York						
Dow Jones	*10,717.5*	*–0.8*	*–0.6*	*0.9*	*32.9*	
Standard & Poor's	*1,248.3*	*–0.1*	*3.0*	*2.0*	*47.9*	
Nasdaq	*2,205.3*	*–1.2*	*1.4*	*3.5*	*70.1*	
Tokyo	16,111.4	8.3	40.2	–1.4	82.0	
London	5,618.8	3.6	16.7	1.8	58.8	
Euro area	3,578.9	3.8	21.3	1.7	63.0	
Frankfurt	*5,408.3*	*4.1*	*27.1*	*2.6*	*104.2*	
Paris	*4,715.2*	*3.2*	*23.4*	*3.4*	*68.2*	
Amsterdam	*436.8*	*4.3*	*25.5*	*1.6*	*50.0*	
Milan	*26,778.0*	*3.4*	*13.8*	*3.4*	*66.4*	
Madrid	*10,733.9*	*1.7*	*18.2*	*1.5*	*73.7*	
Zurich	7,583.9	2.4	33.2	2.2	73.1	
Hong Kong	14,876.4	–0.4	4.5	4.3	64.0	
Buenos Aires	1,543.3	–0.7	12.2	11.7	209.1	
São Paulo	33,455.0	4.8	27.7	13.6	252.5	

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.

SPAIN: OVERALL ANALYSIS

Economic activity

Spain's economy maintaining very strong growth rate but excessive inflation and increase in foreign deficit threaten viability over medium and long term.

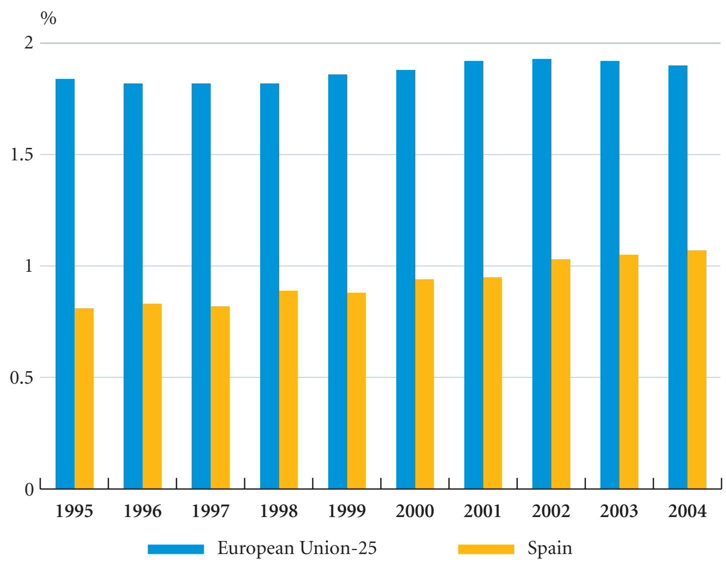
Economic activity shows growth but at cost of major imbalances

In the absence of final figures on National Accounting, everything would indicate that the growth rate of economic activity held very high in the final quarter of 2005 (although with signs of now having reached a ceiling), along the lines of the excellent performance noted throughout the year. The overall balance of Spain's economy, however, is clouded by the major imbalances created. The increase in the inflation differential with the rest of Europe and the widening of the foreign gap are taking on quite troubling dimensions and if they are not checked within a reasonable period they will become a burden to future development of Spain's economy. In recent months the European Commission has brought certain matters to notice and the commissioner for Economic Affairs, Joaquín Almunia, has recognized that there is greater concern than what may be drawn from official analyses and reports.

The big challenge for Spain's economy is how to increase competitiveness as has been recognized in public and private by leading economic players, but in practice progress has been quite lacking. In the matter of Research and Development (R&D), for example, Spain's total spending in 2004 stood at around 1.07% of the gross domestic product (GDP), approximately half that of the European Union (EU) and around one-third of that in Japan and the United States. In spite of efforts made (in 2001 the

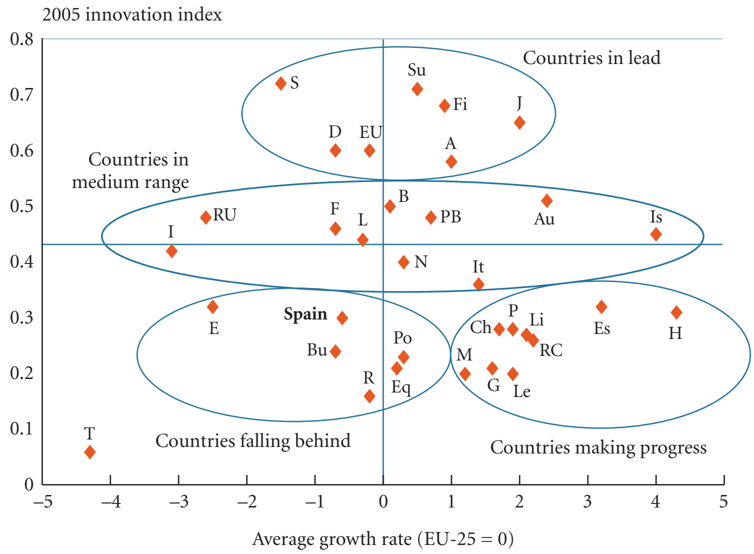
INVESTMENT IN R&D IN SPAIN STILL FAR FROM EUROPEAN AVERAGE

Spending on R&D as percentage of GDP



SOURCE: Eurostat, INE and internal figures.

SPAIN STANDS AT TAIL-END OF DEVELOPED COUNTRIES IN FIELD OF INNOVATION



NOTES: **Countries in lead:** Su = Switzerland, Fi = Finland, S = Sweden, D = Denmark, A = Germany, EU = United States, J = Japan; **Countries in medium range:** F = France, L = Luxembourg, I = Ireland, RU = United Kingdom, PB = Netherlands, B = Belgium, Au = Austria, N = Norway, It = Italy, Is = Iceland; **Countries making progress:** Es = Slovenia, H = Hungary, P = Portugal, RC = Czech Republic, Li = Lithuania, Le = Latvia, G = Greece, Ch = Cyprus, M = Malta; **Countries falling behind:** E = Estonia, Bu = Bulgaria, Po = Poland, Eq = Slovakia, R = Romania, T = Turkey.
SOURCE: European Commission.

percentage applied stood at around 0.95%), there continues to exist a major gap with regard to the main developed countries.

In the matter of innovation, Spain again stands within the group of most backward countries. A recent report by the European Commission that evaluates the situation of a group of 33 countries puts Spain in 21st place behind countries such as Slovenia and Hungary. What is serious is that Spain appears within the group of countries falling behind together with Estonia, Bulgaria, Poland, Slovakia, Romania and Turkey. In top position we find the group of seven countries considered leaders (Sweden, Switzerland, Finland, Denmark and Germany, together with Japan and United States). The countries next in line are those showing a mid-way performance including the United Kingdom, France, Ireland and Italy. In the lower part of the classification, we first find those countries in a below-average situation but making progress (including Portugal and Greece) while the list ends with those countries falling behind among which, as mentioned earlier, is Spain, the only country in the EU-15 in this position.

Among the various partial indicators making up the innovation index, Spain obtains the worst results in those aspects referring to the spread of innovation in companies: R&D spending in the corporate sector scarcely amounts to 45% of the average for the EU and the rate for registration of patents by Spanish companies does not reach 20% of the European average. Other weak points are the low investment in information and communications technology (17% lower than the EU average) and the development of on-going training (48% lower). Finally, as the European

Spending on R&D and innovation in Spain well below that of other developed countries thus hurting future growth potential of Spain's economy.

Very weak growth in industry while prospects better for coming months.

Commission itself points out, the lack of innovation hinders the long-term growth potential of Spain's economy which is very much oriented toward construction and services of low value added.

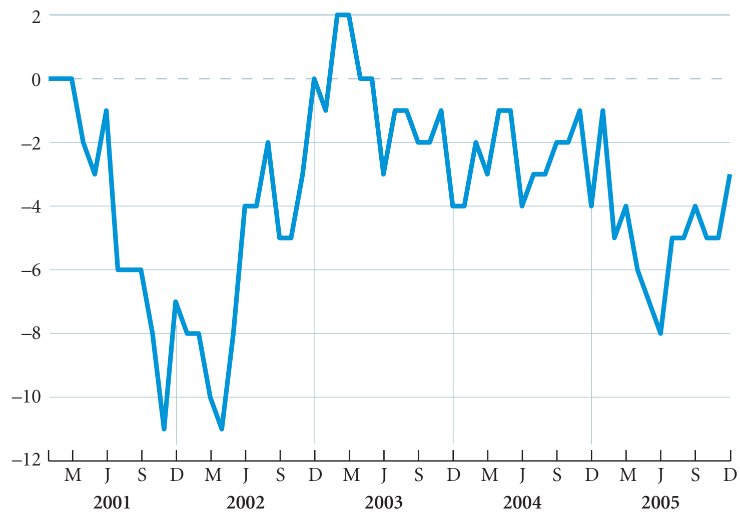
The sluggishness of the industrial sector, while it may partly be blamed on the weakness of European demand, to some extent shows the problems of competitiveness mentioned. In any case, the figure for the industrial production index for November, which was better than expected, reopens prospects of a moderate recovery in 2006, as the slight improvement seen in the industrial confidence index in December would appear to confirm. The textile sector has been one of those faring worst in 2005. According to the estimated balance drawn up by the Intertextil Council, production fell by 30% with a loss of 22% of jobs. For the sector, the year was marked by the increasingly worse state of foreign trade due to the fact that the increase in imports (those from China were up by 50%) coincided with practical stagnation in exports. Another sector on the downturn was the motor vehicle industry with an overall production drop of nearly 9% (more than 13% in the passenger car segment) in the first eleven months of the year.

Construction and services continue to show great strength.

On the other hand, construction continued to show great strength. The trend in the sector confidence index (in November this was close to an all-time high) is clear evidence of this, as also is the trend in employment. It should be pointed out that registrations with Social Security showed a progressive increase up to December, even discounting the effect of the process of granting normal status to immigrants. Nevertheless, we note that early indicators lately reflect a moderate improvement. From January to October the number of housing approvals grew by 5.0% year-to-year as against the 8.5% reported in the same period the year before. The slowdown was sharper if measured by total surface area approved (3.2% in the period in 2005 under consideration as against 10.3% in 2004). In the same way, government tendering for public works

PROSPECTS FOR INDUSTRY IMPROVING

Difference between percentage positive and negative responses



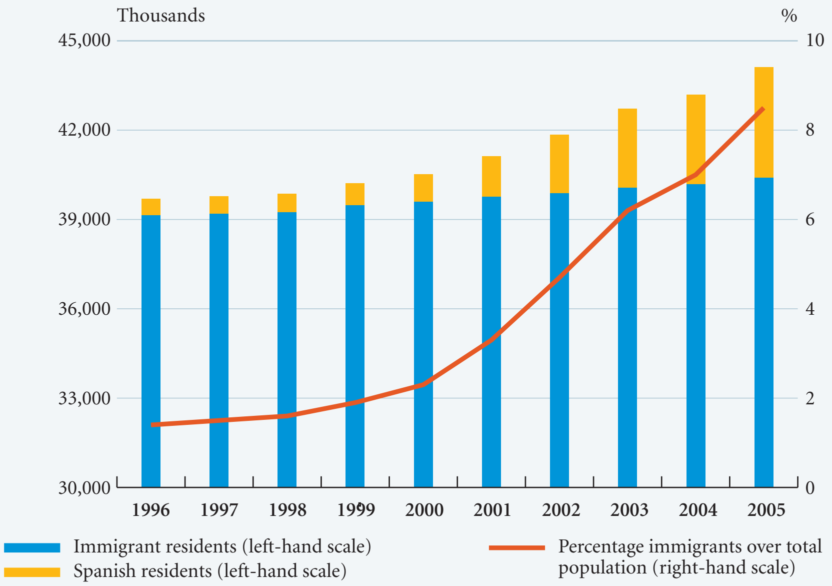
SOURCE: European Commission.

Immigration stimulating Spain's economic growth

In just a few decades, Spain has gone from being a net source of emigrants to become the recipient of a strong influx of immigration. Apart from political ups and downs (in the 19th century Larra wrote that to be a liberal in Spain was to be a potential emigrant), emigration from Spain in the modern era took place in two main stages. The first began in the final decades of the 19th century and ended following the crash in 1929. Nearly 5.5 million Spaniards crossed the Atlantic «to make it good in the Americas» as they used to say at that time, although there was a relatively high number of people who returned (net migration in that period has been put at around 700,000 persons). Population pressure (improvements in food, health and medicine rapidly reduced the death rate, breaking the balance known in the past), the rural exodus brought about by the modernization of agriculture (which involved a drastic reduction of the utilization of farm labour) and the lack of sufficient development in industry which was unable to absorb this surplus labour, were some of the determining factors in this process. The second great wave of emigration took on special strength in the decade of the Sixties. Between 1961 and 1973, nearly a million and a half left Spain going mainly to countries in north and central Europe. These countries were a major focus of attraction because of the strong economic growth they were experiencing and their inability to fully supply their own labour, in contrast to the situation existing in Spain, which was very backward following the dismal autarchic period after the Civil War before the turnaround resulting from the implementation of the Stabilization Plan in 1959.

IMMIGRANT POPULATION DOUBLES IN 4 YEARS

Total residents in Spain

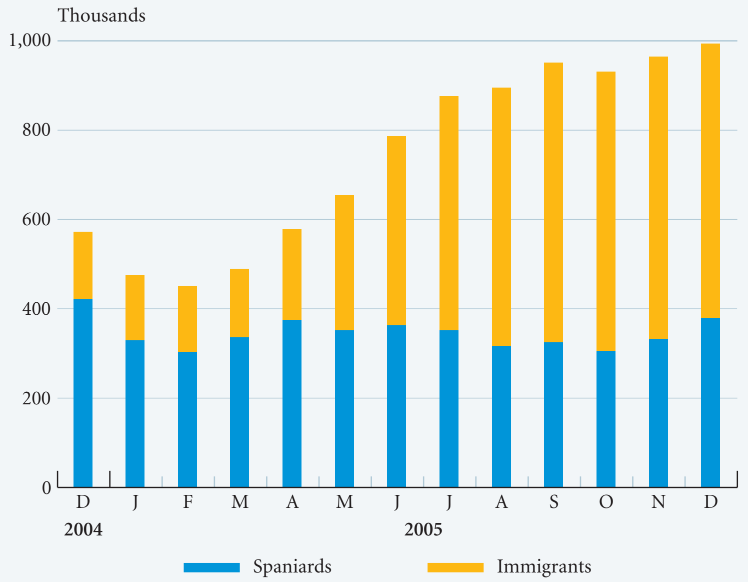


SOURCE: INE and internal figures.

The beginning of the 1973 oil crisis marked the end of massive emigration from Spain toward Europe and the return of many Spanish emigrants because of increasing unemployment affecting nearly all the recipient countries. The reestablishment of democracy coincided with a stage of relative balance in net migratory figures which lasted until practically the end of the Nineties. In that stage, the process of transformation of Spain's economy took place (favoured first by joining the European Union and then by adoption of the euro) which laid the bases for the major growth seen in recent years. The extraordinary strength shown by Spain's economy in this period has made possible and at the same time has helped to foster the strong growth of foreign immigration. According to municipal rolls, foreigners living in Spain on January 1, 2005 totalled more than 3,700,000, equivalent to 8.5% of the total population, nearly double that in 2002. If we look at country of origin, the main groups were Moroccans (with nearly 511,000 persons), Ecuadorians (498,000), Romanians (317,000), Colombians (271,000) and British (227,000). As a whole these represented nearly half of all foreigners on municipal rolls. Five autonomous communities together made up the destination of 75% of this group, namely Catalonia (with 21.4%), Madrid Community (20.9%), Valencian Community (15.6%), Andalusia (11.3%) and Canary Islands (6.0%). Given that at the end of September 2005, the number of those living in Spain with current residence permits (issued by the competent authorities apart from figuring on municipal rolls) was close to 2,600,000, the total number of immigrants still without regular status could be around one million persons (600,000 less than at the end of 2004), in spite of the process for gaining normal status which began in February 2005.

SPECTACULAR GROWTH IN IMMIGRANT REGISTRATIONS WITH SOCIAL SECURITY FOLLOWING PROCESS OF GAINING NORMAL STATUS IN 2005

New registrations with Social Security (cumulative figure for last 12 months)

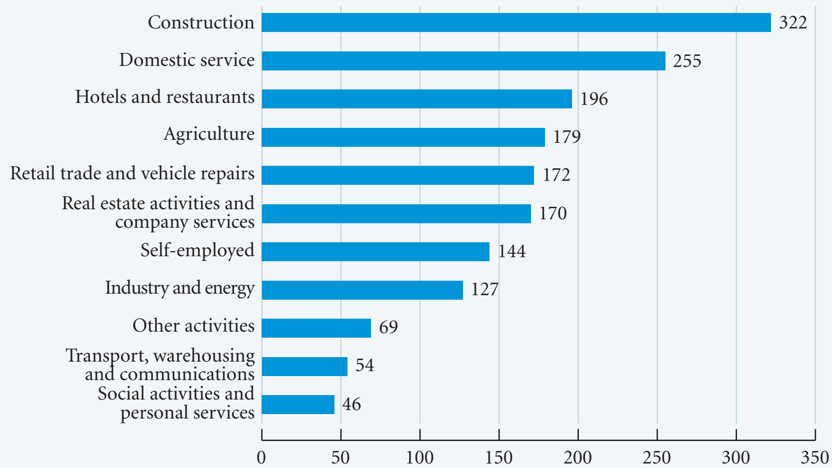


SOURCE: Ministry of Labour and Social Affairs and internal figures.

There is no doubt that the majority of immigrants come to Spain in search of work. According to the Labour Force Survey, in the third quarter of 2005 nearly 2,267,000 immigrants were employed mainly in services (59%) and construction (21%). In industry and agriculture, the proportion was much lower (12% and 8% respectively). The greater part (around 85%) held a job with low qualifications clearly below their educational level, which in 80% of cases stood at a medium or higher level). As may be expected, the increase in immigrant labour has had a favourable effect on total registrations with Social Security to the point where close to 45% of those registering in the past four years were immigrant workers. This trend has notably increased as a result of the 2005 process of gaining normal status as may be seen in the previous graph. In general terms, figures for registration by sector coincide with the results of the Labour Force Survey with the advantage of providing a higher degree of detail as indicated in the following graph.

CONSTRUCTION AND SERVICES TAKE UP 80% OF ALL IMMIGRANT REGISTRATIONS WITH SOCIAL SECURITY

Total immigrant registrations with Social Security by economic sector on 30-11-05, in thousands



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

Having reached this point various pertinent questions must be raised. Has this process been beneficial to Spain's economy and will it be in the future? In a first approach to the matter, we must start out with a statement. Nearly half the jobs created in the past five years have been filled by immigrant workers. As a result, we may in principle suppose that their contribution to GDP growth in that five year period (3.1% annual average in real terms) must have been quite significant. Apart from this effect, there is no doubt that the increase in the work force has brought about an increase in tax collections related to employment (mainly through Social Security contributions), although it should not be forgotten that this group also becomes a beneficiary of the advantages (health, unemployment benefits, social assistance, etc.) available to the general population. In addition, given that immigrant employment has been concentrated mainly in sectors where the national supply of labour appears to be lacking, it is very likely that, as the Bank of Spain points out, immigration has contributed to ease the rigidity of that supply thus limiting the appearance of inflationary pressures in a labour market which still suffers from a high level of structural unemployment (made up mainly of those persons who have no incentive to accept jobs held by immigrants) and the low mobility of the labour factor. Although the overall effect of this process on wage moderation is not yet precisely known, it is likely that it has potentially been sharper on that segment of workers who are less qualified, close to the situation of immigrant workers.

The demographic impact is one of the questions receiving most attention. Projections by the INE carried out on the basis of the 2001 census show that, even counting on very heavy immigrant inflows in the future (400,000 immigrants a year in the second half of this decade and 250,000 between 2010 and 2070) all that is achieved is to relieve the contractile effect of other determining factors of a demographic kind. Under these hypotheses, Spain's population will continue to grow during the first half of this century (something which would not take place without this expected inflow of immigrants). Nevertheless, the impact on the age structure would not be of such great importance. Specifically, the ratio between those over 65 years of age and the population of working age, which now is 0.25, would gradually increase to 0.56 in 2050. As a result, it is not to be expected that immigration will contribute to satisfactorily resolve the problems of financing pensions over the medium and long-term. Starting out from these suppositions, it is practically unanimously believed that the financial adequacy of the system is guaranteed up until the horizon of 2020. But the danger is that if necessary reforms are not undertaken, growing deficits could be generated as of that year and these could be more or less serious according to the performance in some basic variables among which the expected immigrant inflows and growth of employment and productivity stand among the most relevant.

The influence of immigration on the growth rate of productivity is indeed another much debated question. It may be supposed that, over the short term, the personal characteristics of immigrants and their moving into the labour market will have contributed to reduce the growth rate of that figure to some extent. But with a view to the future what is important is the development of an efficient process of integration which will facilitate the improvement of trade qualifications and make possible a positive process of increasing human capital. This aspect has a special importance if we keep in mind the need, shared by nearly everyone, that Spain's current growth model (very much biased toward construction and services and intensive in labour with low qualifications) will move toward economic activities of greater value added and higher technological levels than at present.

(not taking into account that for buildings) showed a growth rate well below the year before.

Services also are maintaining notable strength although tending to moderate the high growth rate in most cases. Information and communications technology and company services are those areas continuing to record the highest growth rates in billing figures, followed by retail trade and transport, according to the activity indicator drawn up by the National Institute of Statistics.

Moderately positive balance in tourism in 2005 but business margins narrowing.

With regard to tourism, the figures for 2005 becoming available are also moderately positive. The number of foreign tourists came to more than 55.5 million (again marking up an absolute record), 6.0% more than in 2004. Overnight stays by those tourists were up by 3.3%. Nevertheless, the tendency to a reduction in average stay and the price war set off by an excess of hotel space in some tourist areas has brought about a substantial reduction in margins. According to the survey by the National Institute of Statistics, receipts per room occupied in 2005 rose by 1.9% on average, below the increase in the inflation rate. The increase in domestic tourism comes within increased consumption in Spain. In the last 3 years there has been very high growth in overnight stays by Spanish residents within national borders (an increase of 6.3% in 2005) while tourist spending abroad by Spaniards has shot up with growth of 25% year-to-year in the first 10 months of 2005.

In more overall terms, we note that the growth in consumption of some durable goods and services continues to be very high based on certain basic factors (job

SUPPLY INDICATORS

Percentage change over same period year before

	2003	2004	2004	2005					
			4 Q	1 Q	2 Q	3 Q	October	November	December
Industry									
Electricity consumption (1)	5.5	4.0	3.8	5.3	3.4	2.5	1.1	4.1	5.7
Industrial production index (2)	1.4	1.6	0.4	0.3	0.1	0.6	–0.1	0.8	...
Confidence indicator for industry (3)	–0.9	–2.5	–2.3	–3.3	–7.0	–4.7	–5.0	–5.0	–3.0
Utilization of production capacity (4)	79.1	79.8	80.5	79.4	79.5	81.1	–	80.7	–
Imports of non-energy intermediate goods (5)	6.2	6.6	4.7	0.7	3.6	0.6	–0.7	–1.4	...
Construction									
Cement consumption	4.8	3.7	3.8	–0.2	11.2	5.2	4.1	1.6	6.7
Confidence indicator for construction (3)	10.3	13.6	24.0	23.7	15.0	22.7	23.0	39.0	23.0
Housing (new construction approvals)	21.4	8.0	0.5	3.7	7.6	2.8	7.0	...	...
Government tendering	–10.9	17.9	37.7	5.8	36.6	2.1	49.5	...	...
Services									
Retail sales	5.7	5.5	5.5	4.1	5.4	4.4	3.3	3.6	4.2
Foreign tourists	–1.0	1.2	7.7	7.2	4.6	7.0	4.6	7.7	2.8
Tourist revenue inflows	4.4	3.8	8.5	–0.8	–0.3	6.6	8.4	...	...
Goods carried by rail (km-tonnes)	1.7	–3.5	–16.7	–14.3	–4.7	–2.3	27.9	–4.3	...
Air passenger traffic	7.5	7.9	8.4	8.4	8.5	10.2	8.2	10.5	8.8
Motor vehicle diesel fuel consumption	7.5	7.2	5.7	2.5	7.5	4.9	3.4	...	...

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

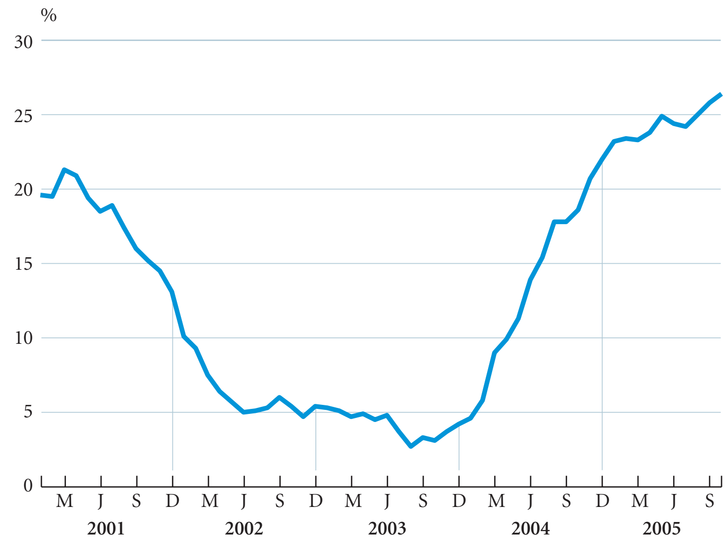
creation and the sharp increase in credit among other factors). Nevertheless, the growth rate is tending to slow down in other headings. This increasing moderation may be noted, for example, in the trend in the index of retail sales which reflects very weak real growth (that is, discounting inflation) in the second half of 2005. The same is happening in the indicator for availability of consumer goods drawn up by the Bank of Spain which shows a slight slowdown in growth trend in recent months, according to latest available information on domestic production and imports and exports of goods of this type.

A specific case is that of passenger car sales which again set an absolute record in 2005 with registration of more than 1.5 million vehicles, an annual increase of 0.8%. In the second half of the year, however, sales were practically stagnant setting what would seem to be a difficult ceiling to exceed. In addition, while the trend in the consumer confidence index reflects a somewhat cautious attitude (during almost the whole year it has swung at around values below –10 points), we should take note of the 3-point improvement recorded in December.

Finally, with regard to capital goods demand, the expansionist rate shown by

TOURIST SPENDING ABROAD BY SPANISH RESIDENTS UP SHARPLY

Cumulative change for past 12 months compared with same period year before



SOURCE: Bank of Spain and internal figures.

DEMAND INDICATORS

Percentage change over same period year before

	2003	2004	2004	2005					
			4 Q	1 Q	2 Q	3 Q	October	November	December
Consumption									
Production of consumer goods (*)	0.2	–0.2	0.1	0.1	1.1	1.4	0.0	0.4	...
Imports of consumer goods (**)	10.9	13.4	8.3	6.5	8.4	7.8	6.8	7.7	...
Car registrations	3.8	9.8	4.7	–0.0	4.9	2.3	–9.6	–4.0	–0.4
Credit for consumer durables	1.6	5.5	9.2	8.8	13.7	17.2	–	–	–
Consumer confidence index (***)	–13.7	–10.8	–10.3	–9.7	–11.3	–11.3	–11.0	–13.0	–10.0
Investment									
Capital goods production (*)	0.6	1.8	–1.7	–0.8	0.6	–1.3	–0.8	–2.0	...
Imports of capital goods (**)	14.8	14.9	29.0	28.6	36.0	13.5	–4.0	47.9	...
Commercial vehicle registrations	13.5	11.7	9.4	9.2	17.9	13.9	1.6	10.9	22.1
Foreign trade (**)									
Non-energy imports	8.8	9.8	9.0	5.7	9.0	4.7	1.4	7.8	...
Exports	6.9	5.2	4.3	–3.1	2.5	1.2	–2.4	1.5	...

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.

most indicators continues to be very high although with a clearly downward growth profile as reflected by the indicator for availability of goods issued by the Bank of Spain. To sum up, domestic demand of consumer and capital goods continues to show great strength but is tending to progressively reveal a slower rate of increase. If, as expected, the European economy gradually takes on greater strength the improvement in the foreign sector could compensate for this slight loss of drive and Spain’s GDP could keep growing at above 3% in the course of 2006.

Slowdown in domestic demand during 2006 may be compensated by recovery of exports.

Labour market

Employment strong in 2005

Employment holds sustained rate of increase, according to figures for Social Security registrations...

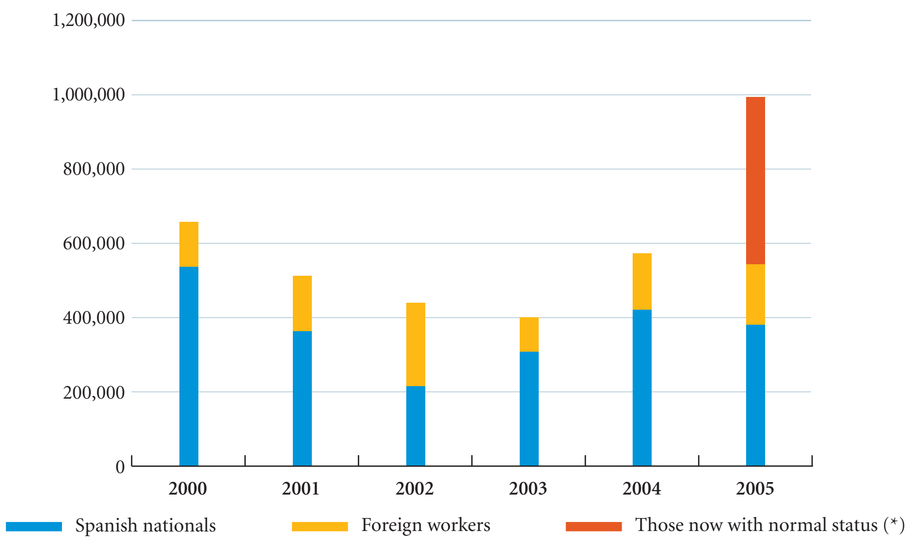
Employment continued to grow at a very high rate in the final month of 2005, if we are to go by figures for registrations with Social Security. Altogether, those registered reached a figure of 18,156,182 at the end of December, an increase of 5.8% over the year before. This spectacular increase was biased upward by the process of giving normal work status to foreign workers which began in February of that year.

It is estimated that, if we subtract registrations which do not represent new jobs but rather the coming to the surface of pre-existing jobs, growth of registrations would stand somewhere above 3%, also a very high rate which still does not faithfully represent the trend in employment which would be somewhat lower. In absolute terms, the increase in registrations in 2005 was 994,262 persons, of which 613,804 were foreign workers. Of those workers, it is estimated that close to half a million had successfully gone through the process of getting normal work status which began in February and ended in May.

If we look at registrations by Spanish national workers, the core of employment not affected by the distortions arising from this process, the growth rate of these registrations showed very strong signs of stability. In fact, at year-to-year rate, the increase in the number of those registered with Social Security held with very slight swings all

NORMAL WORK STATUS FOR IMMIGRANTS BOOSTS SOCIAL SECURITY REGISTRATIONS

Annual change in registrations with Social Security



NOTES: (*) Estimate.
SOURCE: Social Security and internal figures.

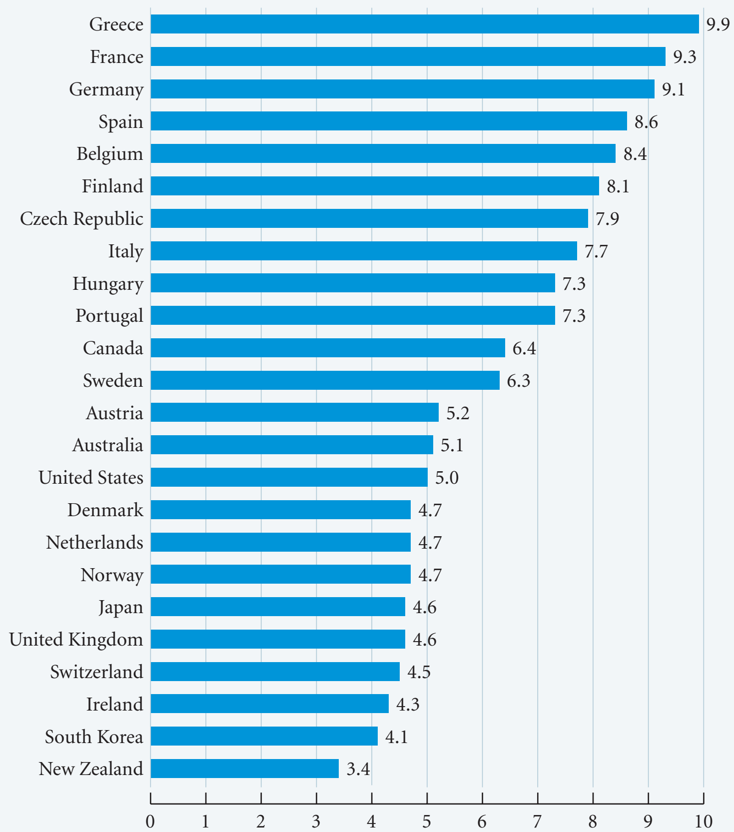
Labour market reform: a 10-point programme

In recent years there have been major differences in the labour markets in the highly developed countries. While some markets have shown great strength, creating many jobs and have brought their unemployment rates close to those for full employment, other markets continue to show high levels of unemployment. Specifically, unemployment in some advanced European countries presents signs of persistence and of being long-term in nature. This type of unemployment may be considered as structural, as opposed to cyclical unemployment, which disappears with an improvement in economic activity.

The main international economic bodies, such as the Organization for Economic Cooperation and Development and the International Monetary Fund have put things plainly. In many countries, operation of the labour markets is faced with obstacles because of rigidities arising from excessively restrictive regulations, exaggerated government intervention and a high level of protection. In order to foster the creation of employment their assessment is clear: it is necessary to introduce more structural reforms in order to ease those rigidities.

WIDE UNEMPLOYMENT DISPARITIES WITHIN OECD

Unemployment as percentage of labour force at standardized rates
(latest figures available at end of 2005)



SOURCE: OECD.

Now, while there is a consensus on the need for labour markets to be sufficiently flexible in order to absorb economic change, a lively debate is going on regarding the model to follow. To oversimplify, we could define an Anglo-Saxon liberal paradigm, which was very flexible, with little government intervention and a low level of worker protection. On the other hand, there is the Continental European model with much government intervention and a high degree of worker protection. In between comes the Scandinavian model with a very flexible labour market compatible with high worker protection.

Reform attempts have not always gone in the right direction. We may recall France's adoption some years ago of the 35-hour work week which was based on the erroneous supposition that there was a fixed «stock» of work and it was hoped to spread it around equitably among all those in the labour force (that is, without reducing wages). The results were not those hoped for and now France is one of the countries with the highest level of unemployment in the European Union.

Therefore, reforms must be carried out with prudence. This box sets out briefly, as a 10-point programme, certain basic lines for action, drawn up on the basis of some of the most recent theoretical and empirical studies, in keeping with the recommendations customarily issued by the international bodies mentioned above and particularly aimed at those economies suffering from excessive levels of unemployment.

1) **Minimum wage.** The empirical studies are not conclusive although the theory is that introduction of a minimum wage has negative effects on employment, especially for young people and less qualified adults. Where it is introduced, the minimum wage should show very contained growth rates in order to avoid negative effects and should include a special range for young people. As an alternative, those workers with lower wages could have lower social security contributions and be subject to lower income tax.

2) **Collective bargaining.** Since the end of the Eighties, based on an important empirical study, the prevailing view has been that results at the macroeconomic level were better if they were drawn up in a centralized manner at the national level or else at a very decentralized corporate level. Nevertheless, studies carried out in recent years seem to question this point of view, partly because of interactions observed among other bodies. In any case, collective bargaining should establish wages keeping more in mind the production differential of the various sectors, companies and workers. Wages should not rise more than productivity. Indexing (the linking of wages to the increase in consumer prices) is an especially negative practice for controlling inflation and macroeconomic stability.

3) **Severance costs.** Worker protection, such as severance costs, should not be excessive to the point where it promotes a sharp duality in the labour market between those segments with permanent hiring contracts and those on temporary work.

4) **Unemployment benefits.** These should encourage the active search for work, with reform of conditions for access to a job while avoiding any abuse in terms of refusal to accept job offers.

5) **Part-time work.** Development of this is recommended because it makes it possible to carry out other activities at the same time, such as studies or family care, thus providing greater flexibility to the labour market. In order to achieve this, it is essential that the part-time worker have the same rights and duties proportionally as a full-time worker.

6) **Labour mobility.** One of the secrets of success in the US labour market when it comes to job creation is the high degree of geographical mobility of workers, something quite different from the case in Europe.

7) **Special hiring.** It is recommended that specific measures be introduced to facilitate the hiring of those groups with special difficulties, such as young people, women, handicapped persons and those over 50 years of age, by means of reductions in Social Security contributions and other benefits.

8) **Early retirement.** Measures to discourage retiring before 65 years of age. Experience is of key importance in many jobs and early retirement does not create jobs.

9) **Active job creation policies.** These involve establishing mechanisms to help the search for a job: broad and specific announcement of job vacancies, measures aimed at particular groups (young people, women, etc.), facilitating job training, etc.

10) **Fostering the entrepreneurial spirit.** The creation of new companies should be encouraged by removing unnecessary bureaucratic procedures.

These recommendations naturally should be adapted to the situation in each country, given that there is no single miraculous recipe for all the ills of the labour market. In general, it is a matter of carrying out reforms aimed at the market while maintaining some degree of job security. The conclusion is that labour reforms of a structural nature are needed in many countries although they are not sufficient alone and must be accompanied by many other measures in different spheres. Specifically, the liberalization of goods and services markets often strengthens the positive effects coming from deregulation of the labour market.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2003	2004	2004	2005					
			4Q	1Q	2Q	3Q	October	November	December
Persons registered with Social Security									
Wage-earners	3.2	2.7	3.1	2.8	4.2	5.9	6.1	6.3	6.6
Industry	*–0.5*	*–0.5*	*–0.5*	*–0.9*	*–0.7*	*–0.2*	*–0.4*	*–0.4*	*0.0*
Construction	*4.3*	*5.0*	*6.8*	*5.0*	*7.9*	*10.7*	*11.5*	*11.7*	*12.7*
Services	*4.1*	*4.1*	*4.4*	*4.5*	*5.1*	*5.6*	*5.6*	*5.9*	*6.2*
Non-wage-earners	2.3	3.2	3.2	2.9	2.7	2.5	2.4	2.4	2.3
Total	**3.0**	**2.8**	**3.1**	**2.8**	**3.9**	**5.3**	**5.4**	**5.6**	**5.8**
Persons employed (*)	**4.0**	**3.9**	**4.1**	**5.1**	**5.8**	**5.9**	–	–	–
Jobs (**)	**2.5**	**2.6**	**2.8**	**3.0**	**3.2**	**3.2**	–	–	–
Hiring contracts registered (***)									
Permanent	–1.0	11.8	4.4	0.6	9.2	10.0	16.0	14.5	18.3
Temporary	3.9	11.4	4.0	–9.8	10.1	9.7	10.8	7.9	7.9
Total	**3.4**	**11.5**	**4.0**	**–8.8**	**10.0**	**9.8**	**11.2**	**8.5**	**8.7**

NOTES: (*) Estimate from Labour Force Survey.
(**) Equivalent to full-time work. National Accounting estimate; figures adjusted for seasonal effects and number of working days.
(***) At INEM.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Services, National Employment Institute and internal figures.

year at around 2.1%, a rate practically the same at the 2004 average.

...and figures for placements handled at Public Employment Services.

The same favourable situation is indicated by placements registered at Public Employment Services offices. In 2005, hiring contracts registered were up by 5.0%, there being greater drive in contracts of a permanent nature than in temporary contracts in spite of the fact that these were in the majority. Part-time work, in turn, continued to be the hiring formula to show the biggest growth (8.3% year-to-year) coming to represent 23.5% of all placements.

Registered unemployment down in 2005 although very moderate drop.

Registered unemployment down slightly in 2005

The favourable state of the labour market was partly reflected in figures for registered unemployment to the extent that there was a continuation of the downward trend seen in previous months although this was more and more moderate. In fact, in December the number of persons registered at offices of Public Employment Services rose by 7,357, which was in contrast to the decrease in the same month in 2004.

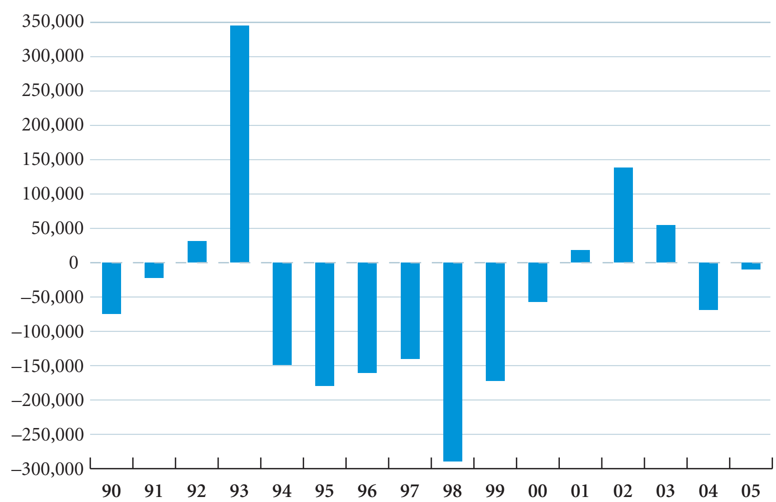
The balance for the year as a whole nevertheless was positive although not as much as the year before. In fact, registered unemployment rose to 2,102,937 persons, 0.5% less than in 2004. The increase in unemployment in agriculture and services and the lower decrease in industry, construction and those seeking a first job were decisive factors in changing the annual balance in unemployment.

Unemployment had relatively less effect on the foreign worker group. Only 7.3% of those unemployed were of non-Spanish nationality, a lower proportion than that representing foreign workers over the total (close to 10%).

The drop in unemployment in 2005 was fairly generally spread over the

DECREASE IN REGISTERED UNEMPLOYMENT MODERATES IN 2005

Year-to-year change in number of persons



SOURCE: Public Employment Services and internal figures.

autonomous communities with the exception of Andalusia, Asturias, La Rioja and Valencia, where unemployment in December 2005 was higher than the level at the end of the previous year. The most significant improvements took place in Asturias, Cantabria and the Basque Country as well as in Madrid Community and, to a lesser extent, in Catalonia.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

December 2005

	No. of unemployed	Change over December 2004		% share
		Absolute	%	
By sector				
Agriculture	65,227	14,935	29.7	3.1
Industry	301,319	–2,263	–0.7	14.3
Construction	245,100	–7,599	–3.0	11.7
Services	1,266,389	1,604	0.1	60.2
First job	224,902	–16,455	–6.8	10.7
By sex				
Males	851,963	–26,057	–3.0	40.5
Females	1,250,974	16,279	1.3	59.5
By age				
Under 25 years	275,895	7,082	2.6	13.1
All other ages	1,827,042	–16,860	–0.9	86.9
TOTAL	**2,102,937**	**–9,778**	**–0.5**	**100.0**

SOURCE: INEM and internal figures.

Prices

CPI ends year with sharp rise both in core inflation and in rest of index.

Inflation differential with euro area goes up to 1.5 percentage points.

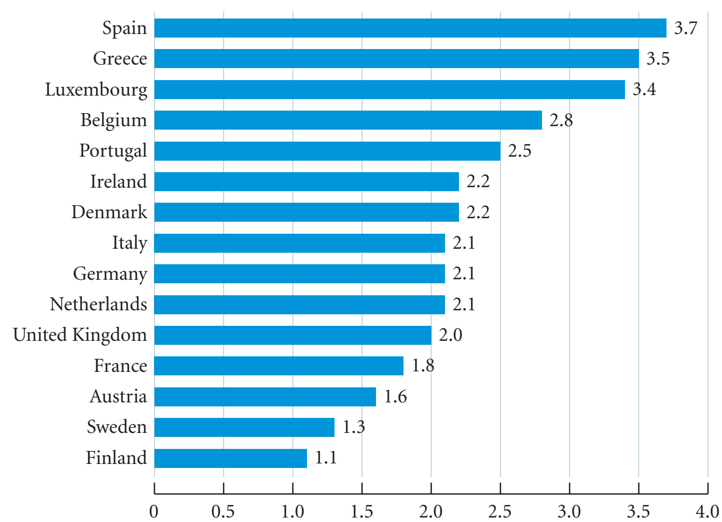
Spain becomes most inflationary country in euro area in 2005

Inflation in Spain in 2005 did not show a good balance. The consumer price index (CPI) ended up at 3.7% in December, the highest figure in the past three years and a half-point above the rate for December the year before. Far from moving down, core inflation (the total figure less energy and fresh foods) seemed to have received the indirect impact of energy price increases on the rest of the economy and in just five months lost all the ground gained earlier since the beginning of the year.

The relative worsening of the situation meant that, for the first time since the introduction of the euro, Spain became the most inflationary country in the Monetary Union, if we go by the harmonized consumer price index (HCPI), with only Lithuania and the Czech Republic showing worse in the whole European Union. The differential with the euro area reached 1.5 percentage points while the gap with the main countries of the EU was close to two points. The increase in the differential was especially evident in the case of core inflation. If we look at the HCPI for the euro area, this indicator stabilized in the late stages of 2005 and even dropped by one decimal in December going to 1.4%. In the case of Spain, an opposite course was followed.

SPAIN STANDS IN LEAD IN TERMS OF INFLATION

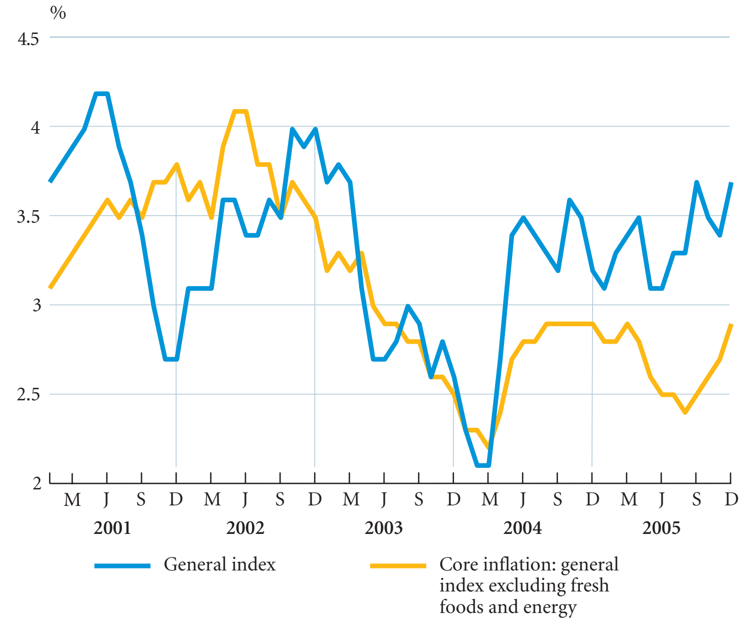
Percentage year-to-year change in harmonized CPI in December 2005



SOURCE: Eurostat.

CPI ENDS YEAR WITH RISE

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



SOURCE: National Institute of Statistic.

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	0.2	3.5	3.4
December	–0.1	3.2	3.2	0.2	3.7	3.7

SOURCE: National Institute of Statistics.

The poor balance for inflation in Spain compared with its EU partners was not due to any particular factor but rather arises from the general boom situation in demand and from an economic structure which facilitates some laxity in price-setting policies both at the public and private level. Only prices for medical

Higher inflation in Spain result of structural factors and stronger state of domestic demand.

services showed lower growth than in neighbour countries.

The main factor in the increase in prices in Spain in 2005 was undoubtedly the cost of personal transport which was boosted by the rise in fuels and fuel-oils. This component added nearly nine decimals to the general inflation rate with growth of more than 6% year-to-year at year-end, close to two points more than in the euro area as a whole.

Secondly, tourist and hotel services also had an important impact on the general index and accounted for 14.4% of the year-to-year inflation rate. Also in this case the growth in prices was nearly two points above the euro area average. Other services running along the same lines were education and especially communications which, in spite of moderating prices, did so to a lesser extent than in the case of Europe.

Foods also showed an unfavourable performance with an increase of 4.3% because of the sharp rise in unprocessed foods. Substantial increases in fresh vegetables and produce, along with beef and mutton and fish were decisive in this respect. In the case of processed foods, cooking oil was also a clearly inflationary product as it contributed 5% of the rise in the general inflation index.

Of less importance in terms of the inflation differential were non-energy industrial goods seeing that prices of these products rose more sharply than in the euro area, although within very modest parameters. In overall terms, prices of non-energy industrial goods

TREND IN CONSUMER PRICE INDEX

Percentage change in December over December previous year

	Total		Special groups							Core inflation	Inflation differential with euro area (**)
			Food (*)			Industrial goods			Services		
	Annual average	Year-end	Processed	Unprocessed	Total	Non-energy	Energy	Total			
1991	5.9	5.5	4.4	2.0	3.3	4.7	1.9	4.2	9.6	6.5	
1992	5.9	5.3	5.6	–3.5	1.3	5.0	10.1	5.9	10.4	6.8	
1993	4.6	4.9	4.8	3.7	4.4	3.3	6.4	3.9	6.8	5.0	
1994	4.7	4.3	5.0	4.7	4.9	3.6	1.8	3.2	5.2	4.5	
1995	4.7	4.3	6.2	1.9	4.5	4.2	3.0	4.0	4.5	4.8	
1996	3.6	3.2	3.2	2.4	2.9	2.4	6.5	3.1	3.6	3.0	
1997	2.0	2.0	0.4	3.2	1.5	1.4	0.6	1.2	3.5	2.0	
1998	1.8	1.4	0.4	0.9	0.6	1.6	–6.6	0.1	3.7	2.2	
1999	2.3	2.9	2.6	2.0	2.4	1.3	11.5	3.1	3.2	2.4	1.1
2000	3.4	4.0	1.1	6.5	3.2	2.5	11.2	4.1	4.4	3.0	1.4
2001	3.6	2.7	5.3	6.1	5.6	2.6	–10.0	–0.4	4.2	3.8	0.5
2002	3.1	4.0	3.4	7.0	4.7	2.5	5.7	3.3	4.4	3.5	1.3
2003	3.0	2.6	2.7	6.4	3.9	1.2	–0.1	0.9	3.6	2.5	1.0
2004	3.0	3.2	4.1	1.8	3.3	1.2	7.6	2.6	3.8	2.9	1.0
2005	3.4	3.7	3.8	5.2	4.3	1.1	9.9	3.2	3.9	2.9	1.2

NOTES: (*) Includes alcoholic drinks and tobacco.
(**) Percentage points calculated on basis of average annual change in HCPI.
SOURCE: National Institute of Statistics.

ended the year at a rate of 1.1% year-to-year, thus halting the gradual upward trend begun in the middle of the year. Sharp competition in the industrial products market, the very moderation of domestic producer prices and low-cost imports make this core of the CPI the least troubling both in a Spanish context and in a European context because of the difficulties in shifting increased costs to final prices.

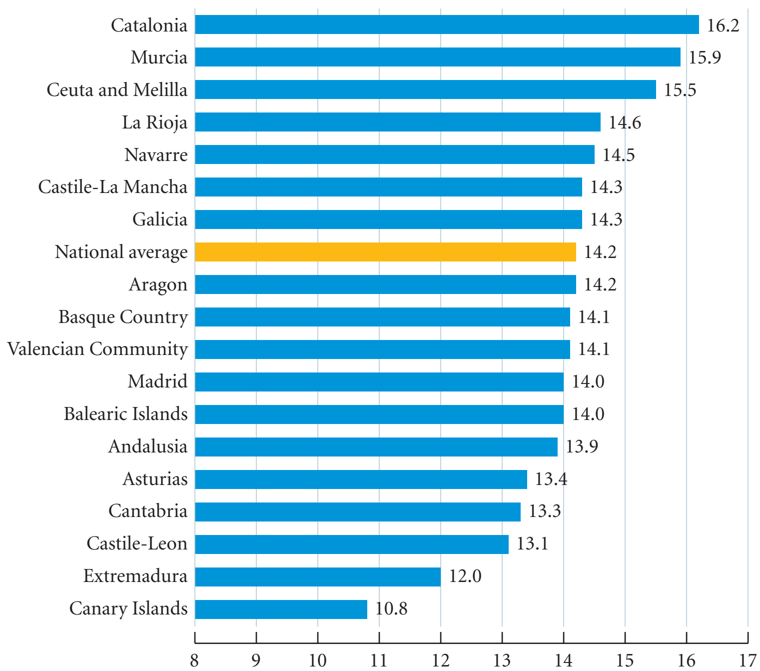
The rise in prices in 2005 was relatively homogeneous by autonomous community given that in most of these the annual inflation rate stood at around one or two decimals from the Spanish national average. Nevertheless, five autonomous communities showed a somewhat more extreme performance. La Rioja, Catalonia and Murcia reported an increase in prices of more than 4% year-to-year. At the opposite end of the scale, the Canary Islands (with 2.8%) and Extremadura (3.1%) were the least inflationary areas.

Increasing inflation differentials between Spain's autonomous communities.

These inflation differentials do not tend to be levelled out with the passing of time but rather, in general terms, with notable frequency each autonomous community reproduces its own dynamic in terms of the Spanish average. Catalonia has thus become the most inflationary autonomous community in Spain systematically recording a positive inflation differential with Spain as a whole. On the other hand, Canary Islands, Extremadura, Castile-Leon, Cantabria and Asturias have consistently presented inflation rates lower than or equal to the Spanish average. This shows the importance of differences accumulated with the passing of time which in the past four years amount to more than five

CATALONIA MOST INFLATIONARY AUTONOMOUS COMMUNITY IN PAST FOUR YEARS

Percentage cumulative change in CPI between December 2001 and 2005



SOURCES: National Institute of Statistics and internal figures.

Inflation prospects for 2006 favourable if scenario of oil market stability holds good.

Prices of manufactured goods moderate but not food prices.

percentage points in the highest case, that is to say between Catalonia and Canary Islands. In fact, between December 2001 and December 2005 prices grew by 16.2% in Catalonia as against 10.8% in Canary Islands (14.2% in Spain as a whole).

The poor balance for inflation in 2005 should not be repeated at the end of the current year. In a scenario of stability or even modest growth of oil prices in euros, the energy component of the index should take off a few decimals from the general index as a result of the effect of the comparison of year-to-year growth. The performance in services and non-energy industrial goods will be more neutral, in both cases with a low margin for containment, especially in the former case, because of competition and wage-cost pressures. The future for food prices is more uncertain particularly because of the irregularity of fresh products. In any case, improvement of the CPI is not going to be immediate, especially as from January on the index will reflect sharp increases in prices of certain controlled products.

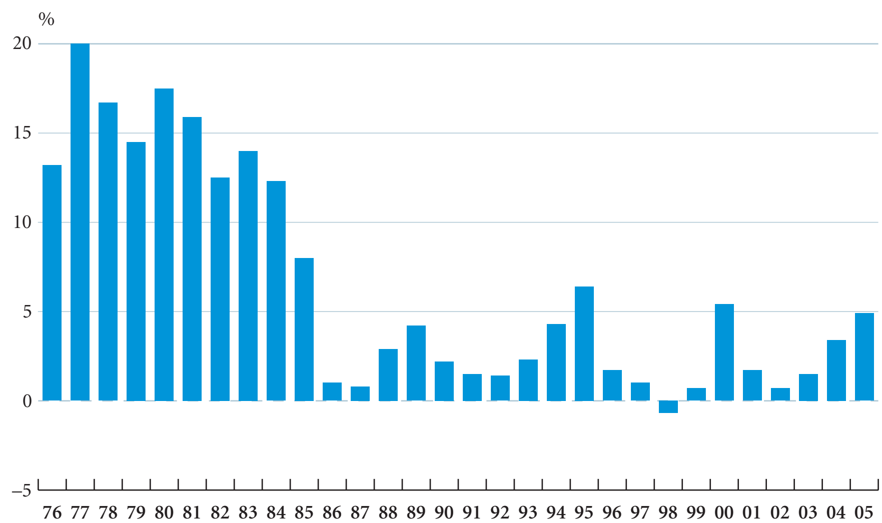
Wholesale prices moderate except for energy

The rise in energy prices hurt the balance of wholesale prices for industrial products in 2005. Sharp growth of these prices (15.6% year-to-year in December) distorted the course of the general index which ended the year with growth of 5.2% year-to-year. On annual average, the increase stood at 4.9%, the highest figure in the past five years and one and a half points above 2004.

The sharp increase in energy prices has practically had none of the much-feared effects on other industrial goods, at least up until now. In the first place, consumer manufactures (excluding foods), which are presumably more sensitive to the impact of energy costs, have notably moderated prices since the beginning of the second half-year and ended the year with an increase of 2.3%,

INDUSTRIAL PRICES: HIGHEST INCREASE SINCE 2000

Average annual change in producer price index



SOURCES: National Institute of Statistics and internal figures.

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											
October	–5.1	5.4	2.3	1.8	6.2	14.2	5.2	1.7	–7.3	9.7	–
November	–0.4	5.2	2.2	1.5	6.3	12.6	4.6	1.8	–3.0	7.5	4.1
December	2.5	5.0	2.8	1.6	6.2	10.7	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	4.2
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	16.4	6.1	–0.2	–0.4	11.0	4.4
September	6.7	5.4	2.6	1.9	3.2	17.9	4.3	–0.6	4.2	7.0	–
October	–0.8	5.0	3.0	1.8	3.1	15.2	4.8	0.8	14.0	5.3	–
November	...	4.9	3.1	2.0	3.1	14.7	3.8	3.3	–0.8	5.6	...
December	...	5.2	3.2	2.0	3.3	15.6	...	...	...	...	–

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

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

more than two points lower than the highs at the middle of the year and also below the level at the end of 2004. Pressure from foreign competition probably prevented the shift of the whole of cost increases to prices.

Secondly, capital goods have not shown any substantial rise and remain at very moderate levels (2.0%) although somewhat higher than in 2004. In addition, prices of non-energy intermediate goods ended 2005 at 3.3%, nearly three points lower that at the end of the year before.

An exception among wholesale prices came in foods which, since the middle of the year have shown a significant increase in rate of increase, going to 3.9%, three points more than the rate recorded in the middle of 2005. The impact of farm prices and, partly, pressure from energy costs related to commercial distribution may have had an effect on this performance.

Prices of imported consumer goods up by around 1%.

Import prices of consumer goods showed slight increases in November but cumulative year-to-year growth held at very low levels (around 1%) with increases somewhat higher in non-food products. This increase is well below that for imports as a whole which naturally include the rise in oil prices. In this respect, the average cost per imported ton in the first eleven months of 2005 reached 285.9 euros, some 34.8% more than in the same period in 2004.

In turn, farm prices moderated in October to show cumulative growth of 3.1% for the year, that is to say, more

Better prospects in farm prices.

than two points above the average in 2004. The increases were concentrated in agricultural products seeing that livestock products showed a cumulative decrease of 5.7%, partly because of the crisis situation in poultry. Expectations, however, are relatively favourable as of the beginning of 2006 given that it is difficult to see price increases of the size recorded at the beginning of 2005.

Foreign sector

Trade deficit continues to grow sharply as of November

The cumulative trade deficit for the first eleven months of 2005 amounted to 70.63 billion euros, some 29.7% more than in the same period the year before. This sharp increase came largely from the impact of the rise in energy prices. In fact, the negative figure in the energy balance accounts for 47.6% of the increase in the trade imbalance for the first eleven months of 2005. In 2004, on the other hand, the spectacular increase in the deficit (similar in amount to what may be expected for the following year) was due mainly to the heavy traffic in non-energy products. In fact, the energy imbalance accounts for only 18.2% of the increase seen in that period.

Increase in energy prices accounts for nearly 50% of rise in trade deficit.

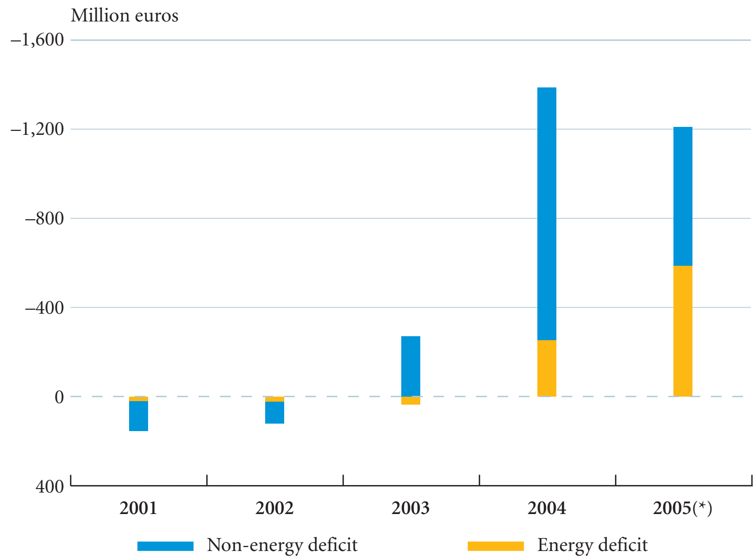
Apart from the energy question, trade in goods with abroad is characterized by a moderation in exports in a context of relative strength in imports. What is more, available figures as of November seem to anticipate a relatively weak final quarter with regard to foreign sales in contrast to a sustained level in imports.

Rest comes mainly from sharp weakening in exports which show drop in EU market share with very modest rise in trade with third countries.

Growth of exports as of November (4.6% nominal) was practically entirely due to the price factor given that the increase by volume was a mere 0.1%. The stagnation in foreign sales was due to a contraction of shipments to the European Union (EU) which showed a

ENERGY BALANCE ACCOUNTS FOR HALF INCREASE IN 2005 TRADE DEFICIT

Contribution to change in trade deficit on monthly average



NOTES: (*) January-November average.
SOURCE: Departament of Customs and internal figures.

FOREIGN TRADE

January-November 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	29,376	38.9	13.9	5,737	22.4	4.1	–23,639	19.5
Consumer goods	60,821	8.7	28.8	53,778	–0.6	38.3	–7,044	88.4
Food	*12,716*	*6.0*	*6.0*	*16,801*	*3.0*	*12.0*	*4,086*	*132.1*
Non-foods	*48,106*	*9.1*	*22.8*	*36,976*	*–4.0*	*26.4*	*–11,129*	*76.9*
Capital goods	24,549	25.1	11.6	13,020	11.0	9.3	–11,528	53.0
Non-energy intermediate goods	96,153	4.7	45.6	67,734	6.5	48.3	–28,419	70.4
By geographical area								
European Union (EU-15)	127,930	5.1	60.7	101,608	2.0	72.4	–26,322	79.4
Euro area	*107,371*	*5.3*	*50.9*	*81,333*	*1.5*	*58.0*	*–26,038*	*75.7*
Other countries	82,970	24.0	39.3	38,661	12.0	27.6	–44,309	46.6
Russia	*4,680*	*39.5*	*2.2*	*998*	*21.9*	*0.7*	*–3,682*	*21.3*
United States	*7,234*	*4.7*	*3.4*	*5,501*	*6.4*	*3.9*	*–1,733*	*76.0*
Japan	*5,354*	*3.1*	*2.5*	*1,061*	*–2.5*	*0.8*	*–4,293*	*19.8*
Latin America	*10,502*	*36.7*	*5.0*	*7,014*	*9.3*	*5.0*	*–3,488*	*66.8*
OPEC	*15,691*	*35.1*	*7.4*	*3,754*	*17.5*	*2.7*	*–11,938*	*23.9*
Rest	*39,508*	*22.9*	*18.7*	*20,333*	*14.1*	*14.5*	*–19,175*	*51.5*
TOTAL	**210,900**	**11.8**	**100.0**	**140,269**	**4.6**	**100.0**	**–70,631**	**66.5**

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

Consumer demand and especially investment pushing up non-energy imports.

decrease of 1.5% real which was compensated by a somewhat more receptive situation in markets of third countries, with the exception of the odd country in the Middle East and Brazil. The biggest increase in foreign demand in goods came from China and Russia, both of which are in a favourable economic position, and from oil exporters, thanks to the improvement in their real trade relations.

The drop in exports by volume in the EU market was concentrated in consumer goods and, to a greater extent, in non-food goods despite the notable moderation in export prices for this group of products. Logically enough, this situation suggests a loss of market share for Spanish exports in the European market which is recovering although very slowly. This becomes especially true in the case of motor vehicles, a sector in which nominal figures for exports have dropped notably below the year before (by 8.9% including motorcycles).

Moderation in foreign purchases of intermediate goods indicates weakness in industry.

Imports, in turn, increased in growth rate in November raising the nominal cumulative rise for the first eleven months of the year to 11.8%, equivalent to 6.7% by volume (6.2% if we take only non-energy products into account). The biggest increase came in capital goods (25.2% cumulative by volume) boosted mainly by purchases of ships and aircraft and data-processing equipment. Foreign purchases of non-food consumer goods, on the other hand, maintained a more moderate trend with growth of 8.2% by volume. Manufactured products (textiles, footwear, toys, etc.), furniture and cars were the goods gaining most relative market penetration in the Spanish market. Finally, purchases of non-energy intermediate goods showed definite stagnation, in keeping with the state of industry in Spain.

Current account deficit: still moving up to all-time highs

The current account imbalance continued to grow in October because of the increasing trade deficit and incomes deficit and as a result of the worsening in the services balance which, on top of all, weighed in more heavily than the improvement in the transfers balance. This meant that the cumulative deficit for the first ten months of the year stood at 54.11 billion euros, some 62.2% more than in the same period the year before. If it continues along these lines, the current account deficit could be around 7.5% of the gross domestic product for 2005 as a whole, a figure not previously reached.

The trade deficit shows up as the main factor in the notable increase in the current account balance although the other headings also show a worse balance than in the January-October period in 2004. In this respect, what is significant is the turnaround in the transfers balance which changed to a deficit in 2005. Foreign worker remittances and the worsening of the positive balance of flows from the EU, both public and private, account for the change.

Trade deficit and private transfer payments abroad are main reasons for higher current account imbalance.

In addition, the services balance fell by 4.7% because of the poor results in the tourist balance which, on the one hand,

BALANCE OF PAYMENTS

Cumulative figure for last 12 months in million euros

	October 2004	October 2005	% change
Current account balance			
Trade balance	–50,071	–67,385	34.6
Services			
Tourism	*26,747*	*25,610*	*–4.3*
Other services	*–4,353*	*–4,320*	*–0.8*
Total	22,395	21,290	–4.9
Income	–12,633	–18,024	42.7
Transfers	–169	–1,077	–
Total	**–40,478**	**–65,196**	**61.1**
Capital account	**8,162**	**8,104**	**–0.7**
Financial balance			
Direct investment	–14,813	–21,517	45.3
Portfolio investment	56,719	81,660	44.0
Other investment	11,060	–12,377	–
Total	**52,966**	**47,766**	**–9.8**
Errors and omissions	317	–1,613	–
Change in assets of Bank of Spain	–20,967	10,939	–

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.

Tourist balance shows increasing propensity of Spaniards to travel abroad and lower average spending by foreign tourists.

reflects the increasing propensity of Spaniards to travel abroad plus the low level of spending by foreign tourists. As a result, inflows from tourism rose by only 3.3% nominal, well below the increase in prices for tourist services, and the number of foreign tourists. Payments, on the other hand, were up by 25.5%.

Direct foreign corporate investment in Spain recovering along with renewed real-estate investment abroad.

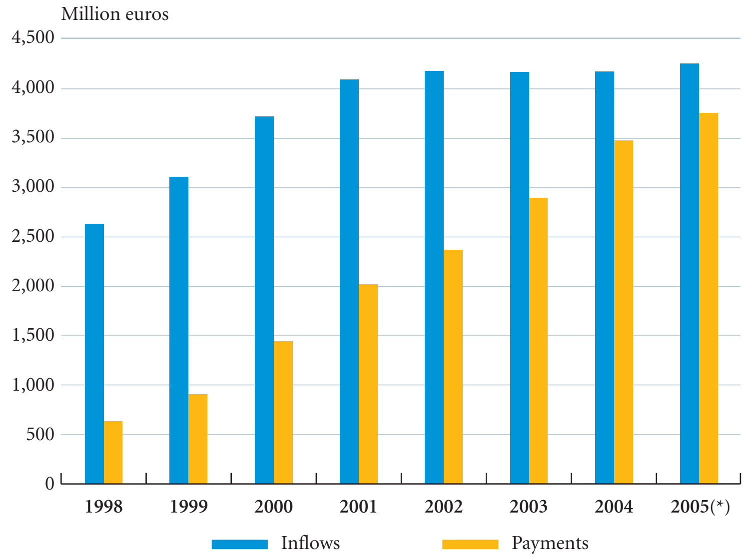
Capital account, in turn, showed a surplus in October that was lower than in the same period the year before because of lower inflows from the EU. The cumulative balance in the first ten months of the year also fell below the figure for the same period in 2004 and was insufficient to cover the current account deficit.

This meant that net world borrowing of Spain's economy, the result of adding the current account balance and the capital balance, rose to 48.1 billion euros in the January-October period, some 78.2% more than in the same period the year before.

In the financial sphere, direct foreign investment in Spain recovered notably in October in the corporate sector so that the cumulative balance was substantially better than in 2004 to show a rise of 26.4%. However, real-estate investment was 15.6% lower than the year before. In addition, Spanish direct investment abroad was 11.2% lower than the year before while real-estate investment showed sharper growth.

IMMIGRANT WORKER REMITTANCES REDUCE BALANCE OF FOREIGN TRANSFERS

Inflows and payments under foreign worker remittances



NOTES: (*) Balance for 12 months ended October.
SOURCE: Bank of Spain and internal figures.

Savings and financing

Funding granted to private sector grows at highest rate in last five and a half years

Funding granted to companies and households in November 2005 rose by 19.9% compared with the same month the year before growing at more than twice the rate in the euro area as a whole. As a result, in spite of the prospect of an upward path in interest rates from the European Central Bank, which came at the beginning of December, private sector demand for loans remained strong. In fact, even after the rise in Eurosystem reference rates, loan rates are still sat all-time low levels, both in nominal terms and especially in real terms, that is to say, after discounting inflation. Furthermore, the good state of the economy is also contributing to push up demand for funding.

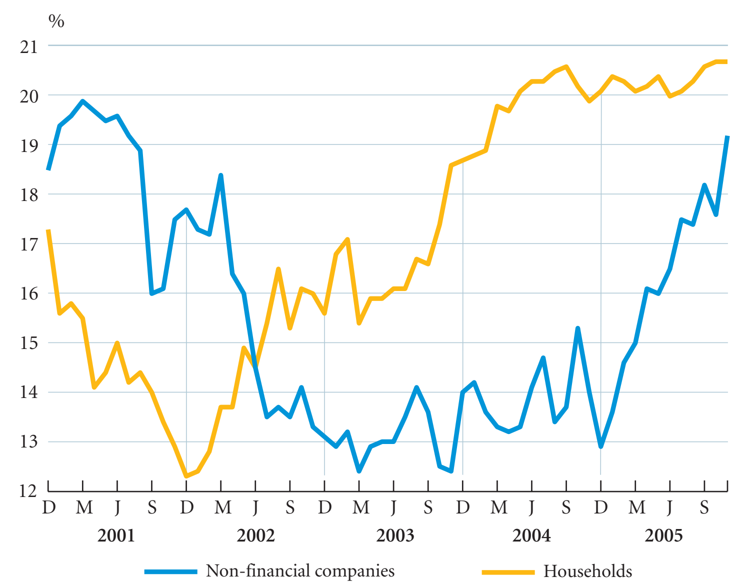
Funds granted to companies rose by 19.2% in November compared with 12 months earlier, the highest rate since July 2001. The part of this funding provided by domestic bank credit also rose sharply at 24.6% in year-to-year rate, the highest rate in more than 10 years.

Bank credit granted to companies in November grows at highest rate in more than 10 years.

Funds going to households were up by 20.7% in the period November 2004-November 2005 thus continuing to show a sharp rise. The main drive continued to come from mortgages. Apart from low and even negative real interest rates, demand for mortgage loans stimulated by

FUNDING GRANTED TO COMPANIES SHOWING STRONG

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



SOURCE: Bank of Spain.

Good state of economy, low interest rates and easy borrowing terms push up mortgage loans.

various socioeconomic factors amd easy borrowing terms. In this respect, we should point out the existence of mortgage loans for home-purchase with terms up to 50 years, increasing the extent of the mortgage loan to the full property value in some cases, granting of no-principal-repayment periods during which borrowers pay only interest, as well as application of flexible repayments. In this way, supply has been adapted to the demand of certain groups which have difficulty in acquiring home-ownership, as in the case of young people.

Total loans to households for home acquisition up 25% in 12 months ended November.

As a result, total housing loans, including corresponding securitizations, amounted to 465.22 billion euros, an increase of 24.6% compared with the same month the year before. This rate was the highest in recent years.

Consumer credit interest rates down in situation of sharp competition.

In addition, the total of new loan and consumer credit transactions granted to households for buying cars, motorcycles, appliances, furniture, travel, etc. came to 4.28 billion euros. This figure meant a year-to-year increase of 22.9%. In the January-November period, total new transactions for these loans and credits to households rose by 22.5%. This shows the strength of this market segment.

Interest rates on bank loans and credits generally rose slightly in November. The exception came in consumer credit and other non-mortgage loans for which interest rates dropped by 20 basis points to 6.07% in a situation of sharp competition. As a result, it stood 22 basis points below the same month in 2004. The interest rate for households stood at 4.12% on average, some 24 basis points less than one year earlier. On the other hand, the average interest rate for companies rose slightly by 12 basis points to 3.55%, some 4 hundredths more than 12 months earlier.

On the other hand, the interest rate charged by credit institutions as a whole

SHARP DRIVE IN BANK HOUSING LOANS

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

SOURCE: Bank of Spain.

on mortgage loans for non-subsidized home purchase for a term of more than three years rose by 14 basis points in December to reach 3.40%. As a result, it was equal to inflation that same month which indicates its abnormally low level. In fact, it is likely to rise in coming months once the more restrictive upward turn by the European Central Bank begins although it is expected that the increase will be of moderate size.

Bank deposits show strong growth

Total deposits by resident companies and households grew sharply in the past 12 months at a rate well above that in the euro area as a whole. Deposits for a term of more than two years, which enjoy a 40% tax deduction on interest earnings, showed a sharp rise. On the other hand, on-demand and savings accounts rose by 12.7% over the past 12 months.

The assets of securities mutual funds rose by 1.68 billion euros in December to reach 245.89 billion euros, according to the sector organization Inverco, and recorded a new all-time high. It thus rose by 12.0% in 2005. In December, net subscriptions to participations in securities mutual funds came to 322 million euros, with a drop in bond-based funds and increases in global funds and others based on international shares. In 2005 as a whole, net resources going into securities mutual funds amounted to 16.61 billion euros. The highest net subscriptions went into short-term bond-based funds, on the one hand, and global funds, on the other. It should be pointed out that in the second half-year investor preferences moved toward share-based funds.

The total number of participants in securities mutual funds at the end of December stood at 8,477,425, some 436,634 more than at the end of 2004. As a result, the number of participants rose by 5.4% in 2005. The biggest increase in participants last year showed up in guaranteed bond-based funds, with a rise of 26.0%, followed by guaranteed share-based funds which reported a rise of 9.3%.

Assets of securities mutual funds up 12% in 2005 with biggest net subscriptions in short-term bond-based funds and global funds.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

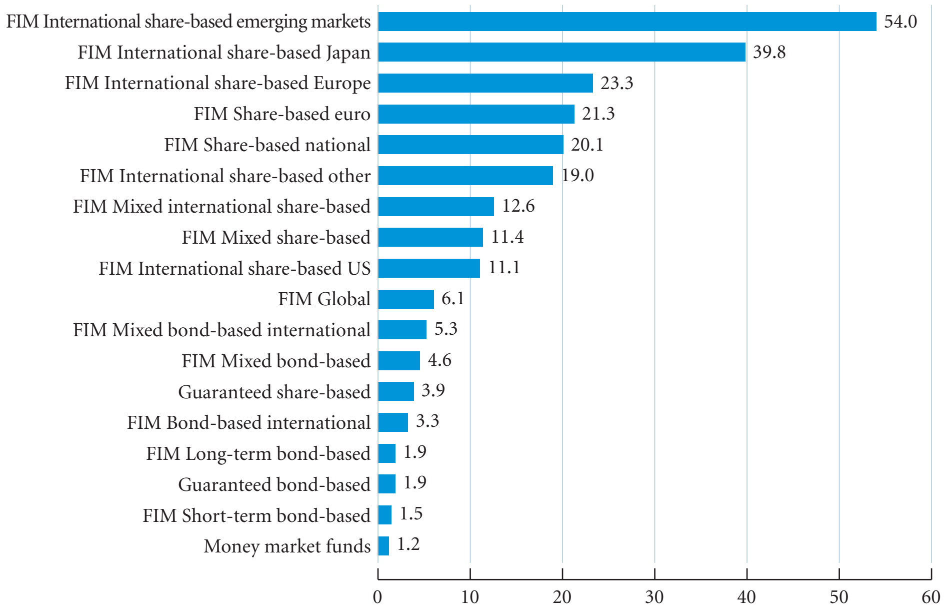
November 2005

	Total	Change this year		Change over 12 month		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (**)	382,543	37,469	10.9	43,161	12.7	44.0
Up to 2 years (*)	187,921	27,454	17.1	30,303	19.2	21.6
More than 2-year term (*)	215,157	87,689	68.8	93,753	77.2	24.7
Repos	69,201	–11,448	–14.2	–4,236	–5.8	8.0
Total (*)	**854,822**	**141,164**	**19.8**	**162,981**	**23.6**	**98.3**
Deposits in currencies other than euro	**15,150**	**9,303**	**159.1**	**9,365**	**161.9**	**1.7**
TOTAL (*)	**869,972**	**150,467**	**20.9**	**172,346**	**24.7**	**100.0**

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

INTERNATIONAL SHARE-BASED FUNDS IN EMERGING MARKETS SHOW BIGGEST YIELDS IN 2005

Annual yield on securities mutual funds in 2005 as percentage



SOURCE: Inverco.

Securities mutual funds mark up average annual yield of 4.75% in 2005.

Average annual weighted yield on securities mutual funds in 2005 was 4.75%. All types of fund showed positive annual yields although with wide differences. Share-based funds in emerging markets reached capital gains of 54.0% whereas money-market funds reported gains of 1.2%.

With regard to mutual investment companies, an instrument commonly used by the most wealthy, total assets amounted to 27.75 billion euros at the end of the third quarter of 2005, showing a cumulative increase of 10.6%. At that date, the number of shareholders was 418,250. In addition, total assets of real-estate investment funds ended 2005 at 6.48 billion euros, some 47.9% more than at the end of the year before. The number of participants in these funds rose to 135,646, some 27.7% more than in 2004. Average weighted yield on this type of fund was 5.4%. Average annual weighted yield in the past three and five years was 6.4% and 7.0% respectively.

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