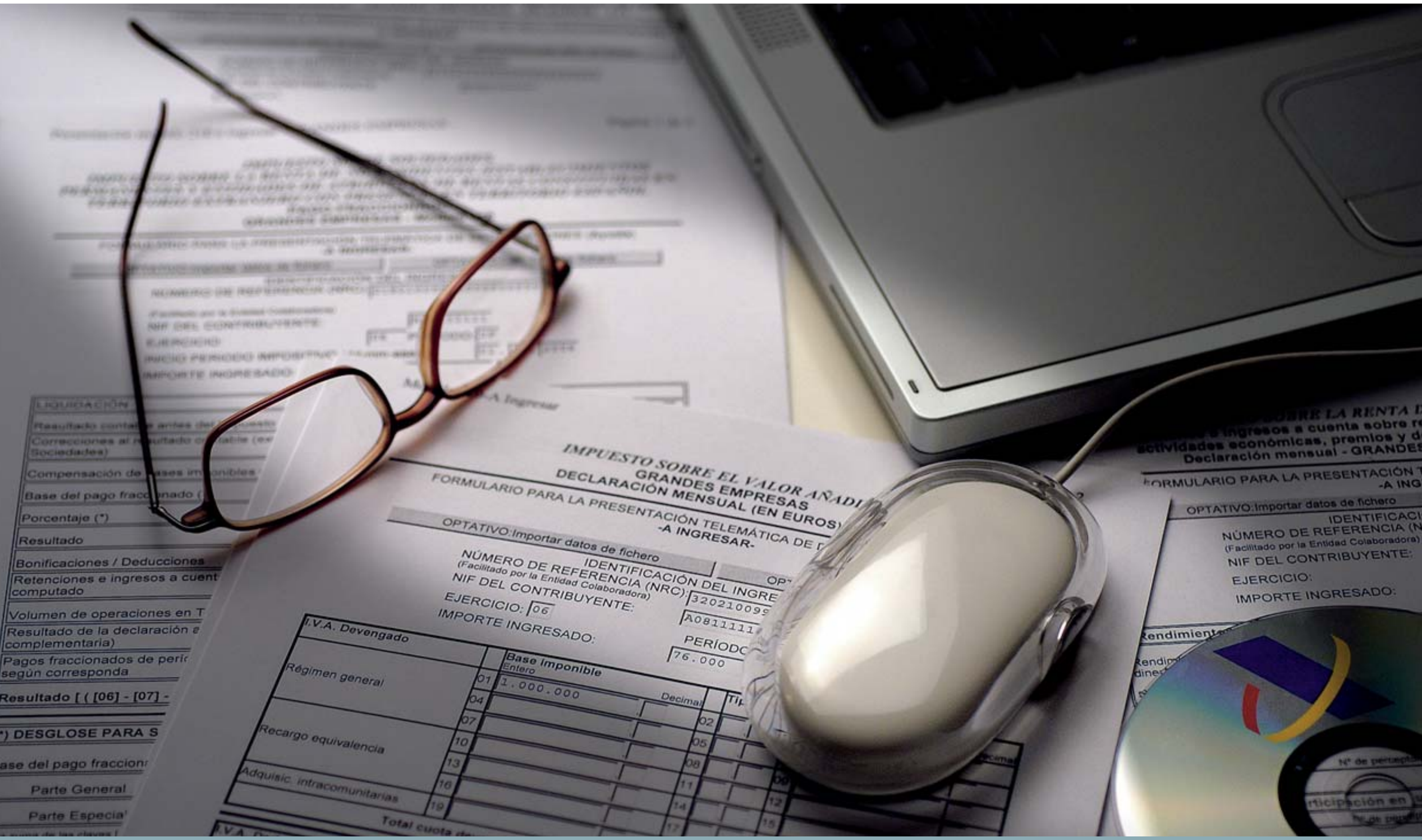
MARCH 2006

THE SPANISH ECONOMY

Monthly Report



NUMBER 289

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2004	2005	2006	2005 1Q	2005 2Q	2005 3Q	2005 4Q	2006 1Q	2006 2Q
INTERNATIONAL ECONOMY			Forecast					Forecast	
Gross domestic product									
United States	4.2	3.5	3.4	3.6	3.6	3.6	3.1	3.4	3.5
Japan	2.3	2.8	3.2	1.1	2.7	2.8	4.5	4.3	3.5
United Kingdom	3.2	1.8	2.0	2.0	1.6	1.8	1.8	1.9	2.1
Euro area	1.8	1.4	1.8	1.2	1.2	1.6	1.7	1.8	1.9
Germany	*1.1*	*1.1*	*1.6*	*0.6*	*0.8*	*1.5*	*1.6*	*1.4*	*1.7*
France	*2.1*	*1.4*	*1.7*	*1.7*	*1.0*	*1.7*	*1.2*	*1.4*	*1.7*
Consumer prices									
United States	2.7	3.4	2.7	3.0	2.9	3.8	3.7	3.7	2.9
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	2.2	2.2	2.2	2.4	2.2	2.1	2.1
Euro area	2.1	2.2	2.1	2.0	2.0	2.3	2.3	2.3	2.0
Germany	*1.7*	*2.0*	*1.7*	*1.7*	*1.7*	*2.1*	*2.3*	*2.0*	*1.8*
France	*2.1*	*1.7*	*1.7*	*1.7*	*1.7*	*1.9*	*1.6*	*2.0*	*1.5*
SPANISH ECONOMY			Forecast					Forecast	
Macroeconomic figures									
Household consumption	4.4	4.4	3.4	4.6	4.6	4.3	4.0	3.8	3.5
Government consumption	6.0	4.5	4.4	5.2	4.0	4.2	4.6	4.5	4.4
Gross fixed capital formation	4.9	7.2	5.7	7.0	7.6	7.3	6.8	6.4	5.9
Capital goods	*3.7*	*9.5*	*7.9*	*9.8*	*10.4*	*8.9*	*9.1*	*8.7*	*8.0*
Construction	*5.5*	*6.0*	*4.6*	*6.0*	*6.2*	*6.3*	*5.6*	*5.2*	*4.8*
Domestic demand (contribution to GDP growth)	4.9	5.3	4.6	5.5	5.4	5.3	5.0	4.8	4.5
Exports of goods and services	3.3	1.0	2.8	–1.4	1.3	2.1	1.9	2.0	2.5
Imports of goods and services	9.3	7.1	6.8	6.2	7.9	7.8	6.6	6.3	6.5
Gross domestic product	**3.1**	**3.4**	**3.0**	**3.3**	**3.4**	**3.5**	**3.5**	**3.4**	**3.2**
Other variables									
Employment	2.6	3.1	2.7	3.0	3.2	3.2	3.1	3.0	2.9
Unemployment (% labour force)	11.0	9.2	8.7	10.2	9.3	8.4	8.7	8.7	8.6
Consumer price index	3.0	3.4	3.4	3.3	3.2	3.4	3.6	4.1	3.4
Unit labour costs	2.8	2.3	2.5	2.5	2.4	2.0	2.2		
Current account balance (% GDP)	–5.8	–7.4	–7.2	–8.4	–7.8	–6.7	–6.8		
Not lending or net borrowing rest of the world (% GDP)	–4.8	–6.5	–6.3	–7.8	–6.6	–5.8	–5.8		
Government balance (% GDP)	–0.1	1.1	0.5						
FINANCIAL MARKETS			Forecast					Forecast	
Interest rates									
Federal Funds	1.3	3.2	4.8	2.4	2.9	3.4	4.0	4.4	4.9
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

THE SPANISH ECONOMY
MONTHLY REPORT
March 2006

**CAJA DE AHORROS
Y PENSIONES
DE BARCELONA**

Research Department

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

"la Caixa" GROUP: KEY FIGURES

As of December 31, 2004

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

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

COMMUNITY PROJECTS: 2005 BUDGET

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

Design and page make-up: www.cege.es - Ciutat d'Asunción, 42 - 08030 Barcelona D. L.: B. 21063-1980 ISSN: 1134-1920
Internet edition: www.comunicacions.com - Travessera de Dalt, 30 - 08024 Barcelona

The dilemma of taxes

Contents

Taxes are not what they used to be. Last January, Cabinet approved a rise in taxes on tobacco consumption. This was a small increase as it has been calculated that at most it would raise the price of a pack of cigarettes by 10 cents of a euro. What was the result? It was surprising. The tobacco companies started a price war which lowered the price of cigarettes to the horror of those who supported the anti-tobacco law that had just gone into effect. Up until this point we had believed that under certain circumstances a cut in taxes could lead to an increase in tax collections. But for an increase in taxes to bring about a drop in prices was something new. The case with tobacco no doubt is an anecdote of no great significance but it does show the sharp controversy any change in fiscal policy can leave in its wake or generate. At this time, the government has put forward new proposals for tax reform and once more this has raised a polemic. What should be done with taxes?

Raise them? It would seem that Jean-Claude Trichet, chairman of the European Central Bank, so believes. During his recent appearance before the monetary committee of the European Parliament he expressed the need to review tax incentives for home-purchase in order to avoid an excessive rise in real-estate prices. From a broader perspective, focusing on Spain's economy, the two big imbalances drawing the attention of the authorities and economic analysts are the foreign deficit and inflation. We are unable to make use of the traditional instruments of economic policy such as the exchange rate or customs duty policy because economically we are just one region in the euro area. What is left to us? Fiscal policy and structural reforms. The latter are complicated to carry out and their effects show up very slowly. They are not useful as short-term economic policy. Therefore, all that remains is fiscal policy. Raising taxes would cool off the economy, ease demand and could partly correct the imbalances mentioned. There is some margin remaining. Spain has one of the lowest tax loads in the European Union (EU-15).

Lower them? It is true that Spain has one of the lowest tax loads among the originals of the EU but it seems that we do not march in step. The weighting of taxes in Spain's gross domestic product has tended to grow in recent decades whereas in the EU as a whole, in the United States and in Japan it has tended to drop so far this century. In a context of the opening up of world markets and the incorporation of low-cost economies in these markets, the tax load on companies in Spain has become an important factor in competitiveness. And, in our view, Spain is not over-blessed in terms of competitiveness. Furthermore, it is becoming harder and harder to tax companies and capital because their increasing mobility means that if taxes are raised the tax base is automatically reduced. There is also a tendency to reduce taxes on employment. This is a matter of equity because this is tax that tends to fall on those with medium incomes, for reasons of efficiency, so that the results of the reforms applied in 1998 and 2003 may be considered as positive.

Finally, when it comes to taxes, there are arguments to suit everyone. The question is up for discussion.

February 27, 2006

OVERALL SUMMARY

World economy: Japan returns to growth club

Good international economic situation in spite of existing threats.

The world economy continues to prosper in spite of the threats, not to be disregarded, represented by trade imbalances, insecure energy supply, and possible bursting of real-estate bubbles. Indicators for the first quarter now becoming available show a buoyant United States, Japan growing vigorously, the European Union consolidating its recovery and some emerging countries in Latin America and Asia in an excellent economic situation.

United States weakens in fourth quarter of 2005 but spending again revives in early months of 2006.

In the United States, macroeconomic figures for the fourth quarter of 2005 came like a cold shower. Growth was only 1.1% in annualized terms compared with the previous quarter as against an increase of 4.1% in the third quarter of that year. A more detailed analysis of the figures drawn up by the Bureau of Economic Analysis shows that the drop was due to volatile factors in consumer spending and investment. That is to say, we are not facing a change in trend. However, the US economy continues to show a slight downturn from relatively high rates which can be seen in total growth for the year: from 4.2% in 2004 to 3.5% in 2005.

Japan gets on wagon of world growth although deflation still present.

Economic activity indicators for 2006 becoming available, however, are particularly strong. January was the hottest month in memory and this encouraged US consumers to go shopping and allowed construction to maintain its level of activity, something not common at this time of year.

Growth expectations for the gross domestic product (GDP) for the first quarter have therefore notably improved making it possible to quickly forget the poor end to last year. Another sign of strength in US spending is the 2005 trade deficit, a record figure of more than 700 billion dollars, with a tendency to worsen, which put it at 6.2% of the GDP in the fourth quarter.

All of these figures have raised prospects of increases in reference interest rates by the Federal Reserve, the US central bank system. Since mid-2004 rates have risen by a quarter-point at each meeting of the monetary committee chaired up until now by Alan Greenspan. His replacement by Ben Bernanke has scarcely changed the situation and two more increases are expected this year in spite of the fact that the current level of Federal Funds at 4.50% may be considered close to what is considered neutral in terms of monetary policy.

Another source of good news in February was Japan. Announcement of a year-to-year increase in the GDP in the fourth quarter was surprising because of its high level, 4.5% as against 2.8% for the third quarter. Private consumption, investment and imports combined to obtain the highest economic growth in the past 10 years. The figures seem to mean an end to the long years of stagnation or recession which began in the Nineties, except for one detail. Prices continue to drop although this goes against the normal rules for a conventional economic recovery. The Bank of Japan is confident that deflation will disappear in coming months and that monetary policy will be able to abandon its extremely easy cast although, for the moment, available figures do not end up going in that direction.

In the European Union, on the other hand, figures for the fourth quarter were much more modest. GDP growth in Germany stood at 1.6% year-to-year, a relatively good figure in view of its history over the past year. What was disappointing was the poor result in household consumer spending which was down by 0.7%. On the other hand, the business sector was euphoric, if we are to go by the February figure for the IFO industrial index, the highest seen in the past 15 years, an indicator that usually correctly anticipates the trend in the GDP.

On the other hand, the French GDP in the fourth quarter was lower than expected (1.2%) thus raising questions about immediate prospects for the French economic situation. GDP growth in 2005 was even worse than in 2004, which does not help to increase confidence in the recovery of one of the main economies in the euro area.

In spite of the bitter-sweet taste left by the macroeconomic figures at the end of 2005, early indicators for 2006 make it possible to maintain confidence in the recovery of the euro area during the current year. We may expect growth in 2006 to be slightly above 2% (increase of 1.4% in 2005). For this to happen it will be necessary for consumers to come to the party and that companies maintain their good financial state. It is a matter of conditions that are by no means assured. The European Central Bank has already clearly expressed that it wants higher interest rates, the euro exchange rate points to some hardening and the «second round» effects of higher energy prices are by no means to be discounted. The international environment, however, is working in favour of improving the European economy while we wait for the Central-European consumer to see a somewhat clearer future.

In Europe, figures for fourth quarter of 2005 not brilliant but prospects point to continued recovery...

...so long as consumers in big economies on Continent decide to increase spending.

Spain's economy: growth with some doubts

How should we evaluate Spain's economic situation? On one side of the scale we find one the best growth figures in all of the European Union, a strong rate of job creation and an impressive surplus in the government accounts. On the other side of the scale is the persistent inflation differential, the nearly non-existent gain in productivity and the growing trade deficit. The pointer of the scale would incline to a positive result over the short term but it would go dangerously close to negative territory over the medium and long term.

In Spain, results very good in terms of growth, employment and public deficit but disappointing in inflation, productivity and foreign deficit.

At mid-month the National Institute of Statistics confirmed the year-to-year growth figure for the fourth quarter already given out earlier by the Bank of Spain at 3.5% real. In the year 2005 as a whole the GDP grew by 3.4%, the highest figure in four years and 1.7 points above growth in the European Union. In any case, the growth rate mentioned was the same as in the third quarter, thus halting the upward trend and pointing to stabilization or even a slowdown. This is the hypothesis being put forward by most analysts so that the forecasts for 2006 are for somewhat lower growth with a gradually downward profile.

By component, we should point out some reshaping of growth. Domestic demand moderated its contribution to GDP growth from 5.5 points in the first quarter to the still considerable 5.0

GDP up 3.4% in 2005, highest rise in four years, with spectacular job creation.

Public accounts end year with surplus of 1% of GDP, thanks to favourable state of labour market.

Problem is inflation differential increasing, foreign imbalance not being compensated by gains in productivity and Spain's competitive position inexorably growing worse.

points in the fourth quarter. On the other hand, foreign demand is tending to reduce its negative contribution to the GDP. In any case, the drive in private consumption and investment is still considerably high. This trend may be explained by a very low interest rate situation, high job creation, and firm household confidence in future economic prospects which shows up in runaway figures for household indebtedness.

Another achievement of the economy is strong job creation. The year 2005 was another brilliant period in this respect with creation of more than a half-million jobs equivalent to full-time work, according to figures from National Accounting. In fact, part-time hiring contracts increased considerably which meant that more than 800,000 persons moved into the labour market, largely women. Immigration also played a leading role in a year when a good part of this group was able to obtain regular work status. The Labour Force Survey estimated an increase of 25% in the number of foreign workers with jobs in 2005, which raised their share of total employment to 11.3%. The unemployment rate at the end of the year stood at 8.7%, a figure close to the European Union average.

The third achievement of Spain's economy was a record surplus in the government accounts, of the order of 1% of the GDP, according to provisional figures. This is a result that comes mainly from the good state of the accounts of Social Security due to the big increase in registrations by Spanish nationals and especially by foreign workers. From another point of view, we may compare the budgetary figures in Spain with other EU countries, many of which are caught in a public deficit spiral.

The problem of the present growth model of Spain's economy is whether it is sustainable over the medium term. In January, the consumer price index climbed up to a rate of 4.2% because of the combined effect of energy prices and increases in controlled prices. The fact is that the differential with the euro area index reached an all-time high of 1.8 points. The gap between Spain's inflation rate and the average for its monetary reference means a constant loss of competitiveness.

This trend would to some extent be logical if we were to take into account that price levels in Spain are notably lower than the euro area average. In a situation of free circulation of products and production factors, it is not surprising that prices are tending to equalize. At the same time, however, we should have to wait for Spain's productivity to rise above that of its partners in the euro by reducing the distances still separating them in this regard. But this is not happening. Spain's productivity is showing insignificant growth, well below the average for the euro area.

It is therefore not surprising that the foreign sector has worsened in recent years to reach all-time highs in terms of the trade deficit and current account deficit. Some industrial sectors have serious problems of competitiveness and export of goods by volume is tending to become stagnant. The economy is growing and generating employment through the private sector but the big question is up to what point can the worsening of the foreign sector continue.

CHRONOLOGY

2005

Month	Day	Event
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

Month	Day	Event
January	20	Government presents bills for reform of **personal income tax** and **corporate tax.**
	31	**Federal Reserve** raises reference rate to 4.50%.
February	22	Dow-Jones index for **New York stock exchange** records annual high (11,137.2) with rise of 3.9% compared with end of 2005.
	27	IBEX 35 index for **Spanish stock exchange** marks up annual high (11,832.8) with cumulative gains of 10.2% compared with end of December 2005.

AGENDA

March

- **2** Meeting of Governing Board of European Central Bank. 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.
- **30** Early HCPI indicator (March).

April

- **5** Industrial production index (February).
- **6** Meeting of Governing Board of European Central Bank.
- **12** Consumer price index (March).
- **20** Harmonized consumer price index for European Union (March).
- **25** Producer price index (March).
- **28** US GDP (1st Quarter). Early HCPI indicator (April).

United States: slowdown less troubling than would appear

US economy slowing down because of drop in car sales.

For months the analysts have been correcting their forecasts upward speculating on the trade deficit and the real estate market. This brought us to the last quarter and the news was lower than expected growth. Nevertheless, the concerns remain the same. Far from showing a change in trend, the downturn is smaller than it first seemed, the trade deficit remains high, consumers are failing to save and Ben Bernanke, the new flamboyant governor of the Federal Reserve, says he is concerned about inflation. Only housing is on the way toward the desired moderation.

The US gross domestic product (GDP) slowed notably in the fourth quarter with growth of 1.1% real in annualized terms compared with the third quarter when it grew by 4.1%. In spite of such a large difference in rates, the slowdown, if it really exists, is a lot lower than would be suggested by aggregate figures. The decrease in motor vehicle sales and the lower investment in transportation equipment would fully explain the slowdown. But excluding this effect, the economy would have moved up by more than 4%. Taking into account the volatile nature of this type of consumption and the ups and downs in oil, it does not seem that we are seeing any major change in trend yet.

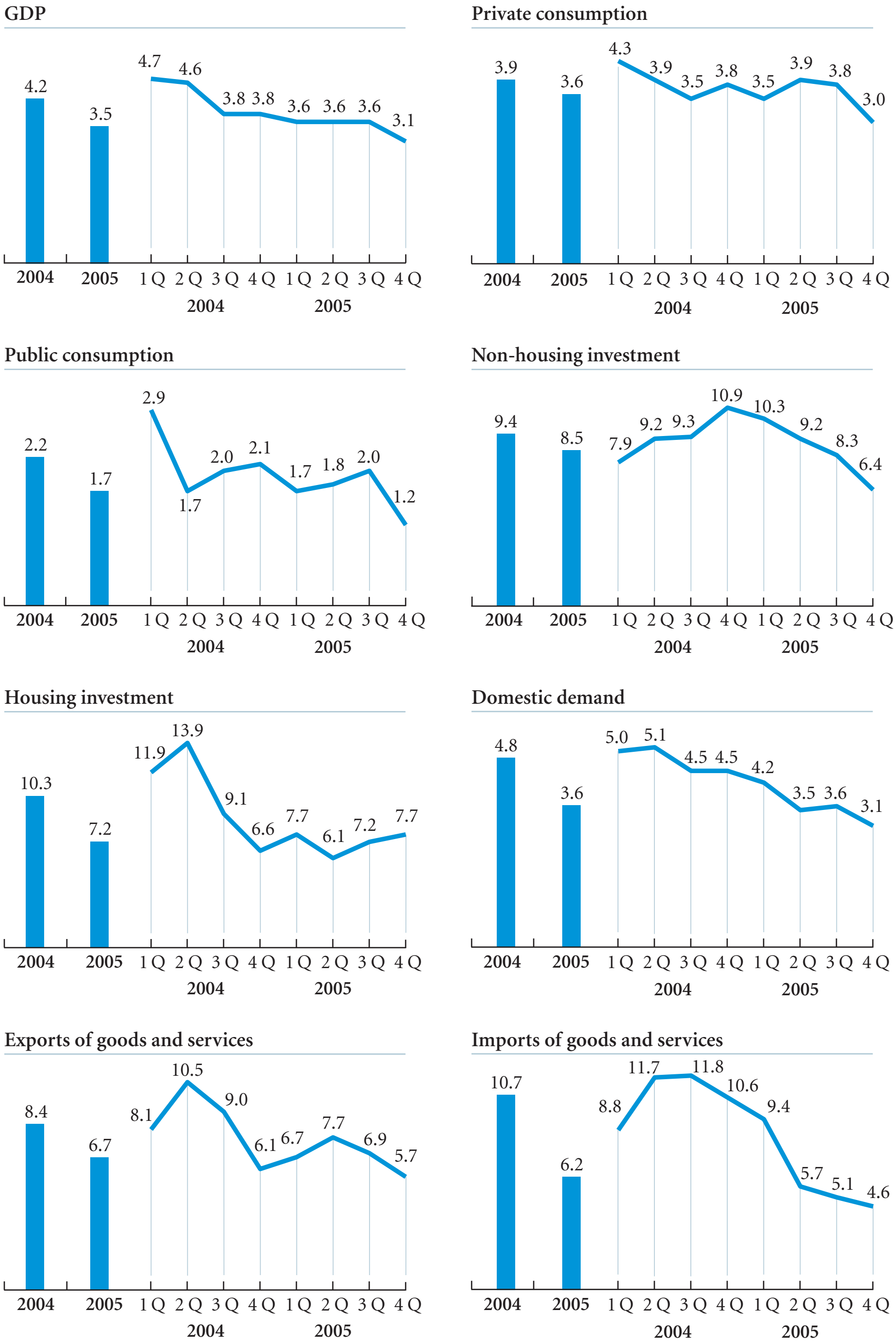
GROWTH STRONGER THAN WOULD APPEAR

Real quarter-to-quarter change annualized

SOURCE: Bureau of Economic Analysis and internal figures.

UNITED STATES: CONSUMPTION, PETROL AND GOOD WEATHER

Percentage year-to-year change in real terms



SOURCE: Bureau of Economic Analysis and internal figures.

High-cost oil affecting growth more than inflation.

The other components of consumption and investment practically repeated their contribution to growth in the previous quarter, and only the housing sector continued to show some signs of wearing out, both of which trends are not reflected in year-to-year increases because of base effects. What does seem clear is that in the United States the increase in oil costs has been more prejudicial to growth than to inflation. The pressure from high-cost petrol has not been on prices but on the budgets of families who live in suburban houses which are large and expensive to heat and who move around in «gas-guzzling» four-wheel drive vehicles. Thus ends a long debate which, in the Seventies, had a very different outcome. The foreign sector has worsened with exports stagnant and rising imports, partly because of the replacement of inventory levels following reductions over various quarters and because of the increase in government spending.

Consumers renew buying habit.

In spite of everything, in January consumers saw things fairly clearly, that is to say there was confidence, optimism and strength in retail sales, so long as we leave out petrol and cars. Petrol consumption continued to increase notably and car sales are going through a period of redefinition, and the fact is these are not good times for the big car makers. It may be deduced that the exceptionally mild temperatures in January had a lot to do with consumer pretensions but the fact is that we have to go a long way back to see similar rates of increase and levels of confidence (Conference Board Index). Business executives continued to join the general optimism although with less ardour than in previous months and industrial production continued to languish, which is not new but falls within a long-term downward trend.

UNITED STATES: MAIN ECONOMIC INDICATORS

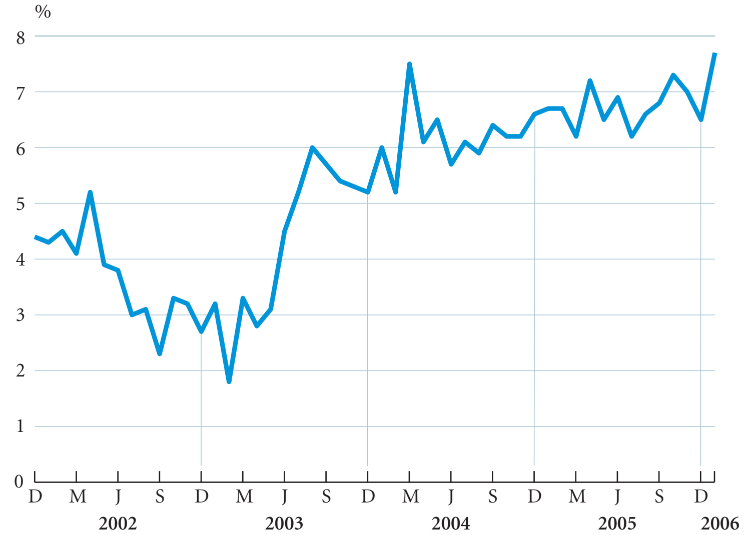
Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006
			1Q	2Q	3Q	4Q	January
Real GDP	4.2	3.5	3.6	3.6	3.6	3.1	–
Retail sales	7.3	7.5	7.2	8.4	8.4	6.2	8.8
Consumer confidence (*)	96.1	100.3	104.2	102.3	98.9	95.8	106.3
Industrial production	4.1	3.2	4.0	3.1	2.7	3.1	3.1
Industrial activity index (ISM) (*)	60.5	55.5	55.7	53.2	56.0	57.0	54.8
Sales of single-family homes	10.0	6.7	5.1	6.9	11.5	3.5	...
Unemployment rate (**)	5.5	5.1	5.2	5.1	5.0	4.9	4.7
Consumer prices	2.7	3.4	3.0	3.0	3.8	3.7	...
Trade balance (***)	–618	–726	–651	–672	–697	–726	...

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

UNITED STATES: CONSUMPTION, PETROL AND GOOD WEATHER

Month-to-month change annualized for retail sales excluding cars and petrol (*)



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

Sales and prices in real estate market only moderating gradually.

Housing, the high prices of which were troubling the Fed and helped consumers to spend, is now definitely slowing down. Fewer houses are being sold and prices are rising less, something coherent with a market that has worn out in which the effort, in terms of household income, needed to buy a home has risen notably in recent times. As desired by the monetary authorities, the slowdown is orderly for now as shown by the maintenance of figures for housing starts in January.

Employment gains strength in second half-year.

The labour market continues to show positive signs which are helping consumption but this obliges the monetary authorities to remain vigilant. Employment continued to gain ground with 193,000 new jobs in January and the unemployment rate dropped to 4.7%, the lowest figure reached since 2001. In spite of the continuing improvement, it should be remembered that at this time employment is growing at 1.6% year-to-year, a rate that is half that seen in the second half of the Nineties. A review of the statistical series does indeed reflect the progressive strengthening of the labour market in the course of 2005, given that the increase in unemployment in the first half of the year was corrected downward while job creation was corrected upwards in the second half-year.

Producer prices, which exclude retail margins, continue an upward trend with growth in January of 5.7% compared with the same period the year before. This indicates that inflationary trends, while moderate, have still not been checked. The trade deficit reached a record figure of 726 billion dollars in 2005, 5.8% of the GDP. Things are getting worse, given that in the fourth quarter it stood at 6.2% of the GDP. The problem is that the poorer figure in December was a return to normalcy with exports slowing down and imports on the rise.

Japan: growth with deflation

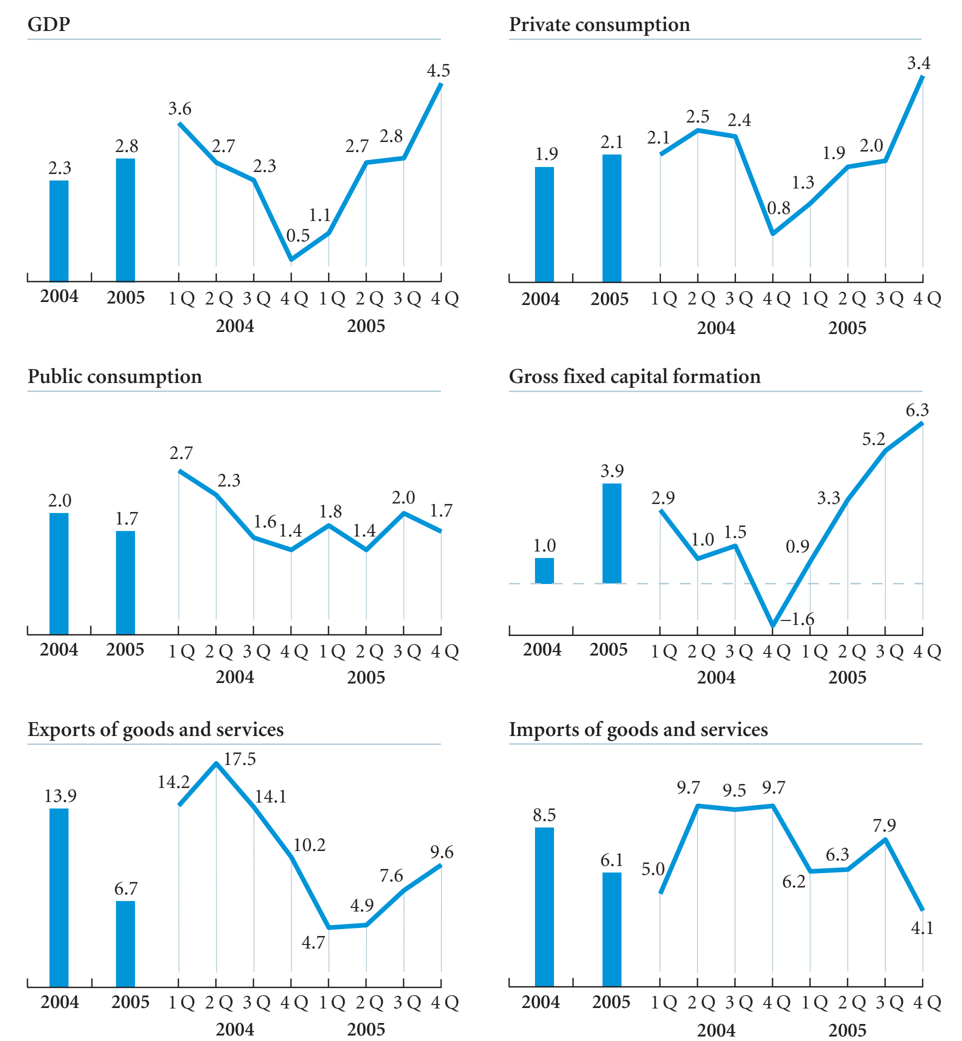
Japan's economy grows more than expected, now also aided by foreign sector...

Takeo Fukui is a happy man. The governor of Japan's central bank, appointed by prime minister Junichiro Koizumi, had predicted the end of Japan's deflation around the beginning of 2006 and the figures seem to be showing he was correct, although only partly. Growth continues to become more and more solid, prices seem to be moving into positive ground and, perhaps the most significant of all, the Japanese are becoming somewhat more optimistic. Nevertheless, there is always a fly in the ointment, and the Japanese economy is no exception. While consumer price indices are getting into positive ground, the GDP deflator continues to show dips which put into question the much desired end of deflation. On top of this comes another question of no less importance – politics.

Koizumi's popularity is at a low level because of a series of scandals within his party, the Liberal Democrats. These

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-to-year change in real terms



SOURCE: Institute of Economic and Social Investigation and internal figures.

include the manipulation of financial information to his own advantage and they come closer and closer to those persons responsible for Koizumi's economic programme. What is prejudicial is not so much the political upheaval or who is to blame but rather the identification of corruption with the government's liberalization measures now grudgingly accepted in spite of the electoral victory last September. The problem is that, in spite of the fact that a buoyant economy can hide many things, there continued to be many urgent matters still to be resolved, notable among which is reform of the banking system and its lax system of granting loans. These are urgent matters in a country that, in a few years, will have the most aged population on the planet, which is going to generate high costs for the Social Security system.

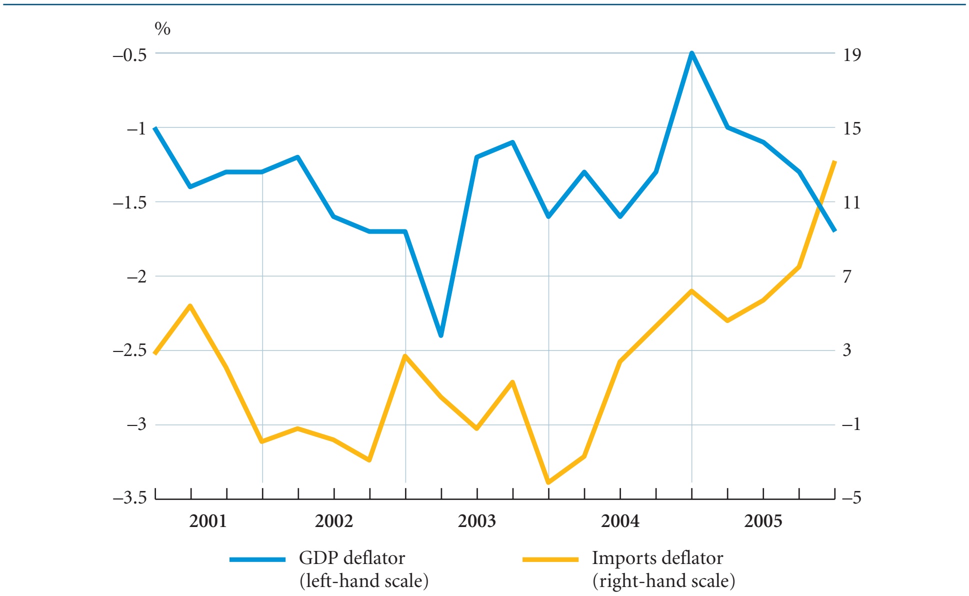
True enough, the economy showed a surprising rise in the fourth quarter and recovered the steam lost in the autumn with growth of 4.5% year-to-year, the highest rate in the decade. If up until now the main role has been taken by domestic demand, what stands out is the contribution to growth coming from the foreign sector which had been negative. Both in nominal and real terms, the recovery of domestic demand remains far from the rates at the beginning of the year and it is the improvement in exports that is taking over.

The figures have something of an aura of mystery given that, in the face of such an undeniable show of strength, alongside there continues to be a sharpening of the drop in prices with a deflator of the gross domestic product down by 1.7% year-to-year, the worst figure since the beginning of 2003. The decrease in prices is even more mysterious because, at this time, Japan is importing inflation as a result of oil prices. Imports now represent 14% of the economy, whereas only three years ago they were 10%, and in the last quarter they climbed to 13.2% year-to-

...but political scene unsettled and prices continue to drop despite higher-cost oil.

JAPAN: PRICES STILL DROPPING

Year-to-year change



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

Renewed optimism among Japanese, with wages moving up, an aid to growth.

year, a figure well above what has been customary in Japan's economy.

Inflation, or rather the lack of it, is the main cloud floating over Japan's economy. Latest indices show a clear improvement in line with the optimistic theses of the central bank. Nevertheless, based on available information things are not as clear as the bank would like. In the first place, the indices for Japanese prices do not exclude the energy component and, in view of the deflator for imports, it is logical to suppose that oil has exercised a strong upward pressure on prices with a likely return to normalcy in the future. On top of this comes the question of the GDP deflator represented by a basket of products broader than the CPI which remains stuck on negative ground. The sharp swings in the general index in recent months only add more doubts.

Leaving aside the enigmatic question of prices, the general level of wages continues to move up more in line with the robust national accounts, something which may be compensating the dissuasory effect exercised by the drop in prices. Following years of decreases this improvement, in nominal terms, is an important contribution at this time to helping the Japanese catch the winds of optimism now blowing over their economy.

The demand side continues to be active with retail sales recovering the gradual upward trend that has been dominant in recent months in keeping with the renewed optimism of consumers. On the supply side, the industrial sector is gradually joining the general trend with production recovering rates of increase close to 5%. This improvement, however, is a long way from the leading role assumed in past times when similar growth of the economy implied increases of 10%.

With the start of 2006, the housing sector has suddenly ended the upward move in prices and sales in Tokyo. Housing starts across the country are also following the same course. Nevertheless, we may still talk of a background of recovery which should give support to domestic demand.

JAPAN: 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	1.8	2.3	0.5	1.1	2.7	2.8	–	4.5	–
Retail sales	–1.7	–0.9	–0.4	1.1	3.2	0.8	–0.4	0.5	1.2
Industrial production	3.3	5.3	1.6	2.7	0.3	0.2	3.0	3.4	4.9
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	1.4	2.1	4.9	8.8	13.2	–1.2
Unemployment rate (**)	5.2	4.7	4.5	4.6	4.3	4.3	4.5	4.6	4.4
Consumer prices	–0.3	0.0	0.5	–0.2	–0.1	–0.3	–0.7	–0.8	–0.1
Trade balance (***)	12.0	13.7	13.7	13.3	12.2	10.8	10.6	10.5	10.3

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

Recovery is slower, however, than seemed to be suggested by figures in the summer.

Latin America consolidating growth cycle

The Latin American region as a whole showed robust growth of 4.3% in 2005, somewhat above the 4% forecast the year before, according to estimates by the Economic Commission for Latin America and the Caribbean (CEPAL). A slight moderation to 4.1% is forecast for 2006 as a result of the normalization of the growth rates of countries which have just come out of very recessive periods so that it is not a matter of a slowdown. If present growth continues in 2006, it will bring a per capita GDP as much as 11.0% above that in 2003.

South America is growing more than the countries in the Caribbean (Honduras, Guatemala, etc.) which have been penalized by Chinese competition in the US market. Argentina and Venezuela led growth in 2005 and it is expected they will also do so in 2006, along with Chile, although with lower rates. The growth in Argentina in 2005 was surprising, being three percentage points higher than forecast. The Chilean economy is the one enjoying the most stable growth and higher rates of investment. Since 1995, its per capita GDP has increased by 43% as against an average of 10% in the other large countries. Helped by oil exports, Mexico is expected to grow by 3.5% in 2006 while Brazil, the biggest unknown at this time is forecast to grow by 3.0%, a slight recovery over the unexpectedly slack 2005.

The present growth cycle is different from previous periods because of two basic factors. In the first place, growth coexists with a positive figure in current account balance. In the second place, governments are taking advantage of the economic boom to clean up debts and not to spend more as used to be the norm in the region. Unemployment, however, continues high, general wellbeing is improving very slowly and, in spite of the boom, growth is lower than in other emerging regions.

The positive figure in the current account balance for the region not only

Growth in Latin America expected at 4.3% for 2005 and 4.1% for 2006.

Surprising growth of Argentina, Chile is stronger while Brazil doubtful.

Continuing current account surplus now helped by recovery of direct investment.

GROWTH OF LATIN AMERICAN GDP

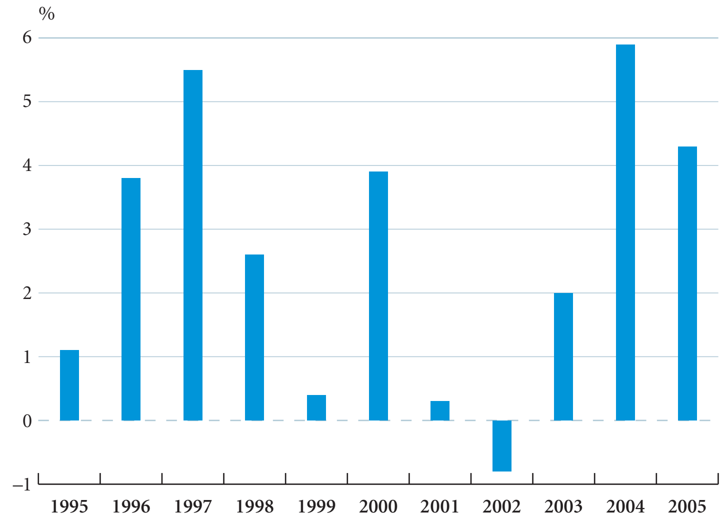
Year-to-year change in retail sales as percentage

	2002	2003	2004	2005 (*)	2006 (**)
Argentina	–10.9	8.8	9.0	8.6	6.0
Brazil	1.9	0.5	4.9	2.5	3.0
Xile	2.2	3.7	6.1	6.0	5.5
Colombia	2.7	4.1	3.3	4.3	4.5
Costa Rica	2.7	6.4	4.1	3.5	4.0
Guatemala	2.2	2.0	2.6	3.2	4.0
Mexico	0.8	1.4	4.2	3.0	3.5
Uruguay	–11.0	2.2	12.3	6.0	4.5
Venezuela	–8.9	–7.7	17.9	9.0	5.5
Total Latin America	**–0.8**	**2.0**	**5.9**	**4.3**	**4.1**

NOTES: (*) CEPAL preliminary figures on December 2005.
(**) CEPAL forecasts in December 2005.
SOURCE: CEPAL.

LATIN AMERICA CONFIRMS GROWTH

Year-to-year change in real gross domestic product



NOTES: 2005 represents forecasts.
SOURCE: Economic Commission for Latin America and Caribbean (CEPAL) based on official figures.

has held for the third consecutive year but increased to 1.3% of the GDP. The leading support for the foreign surplus is the growing volume of exports which is close to 8%. In second place is the improvement in the trade ratio aided by the increased prices for raw materials except in the countries of the Caribbean. This is thus bringing about a notable change over the previous five years when, following drastic currency depreciation, the effective average exchange rate went down by 13%. The sharp growth of remittances is also helping the foreign sector. Nevertheless, any explanation of the foreign surplus beyond quantitative factors must include giving up populist policies, the institutional changes still pending in many countries and the performance in the flow of savings.

Governments now more frugal but unemployment dropping slowly.

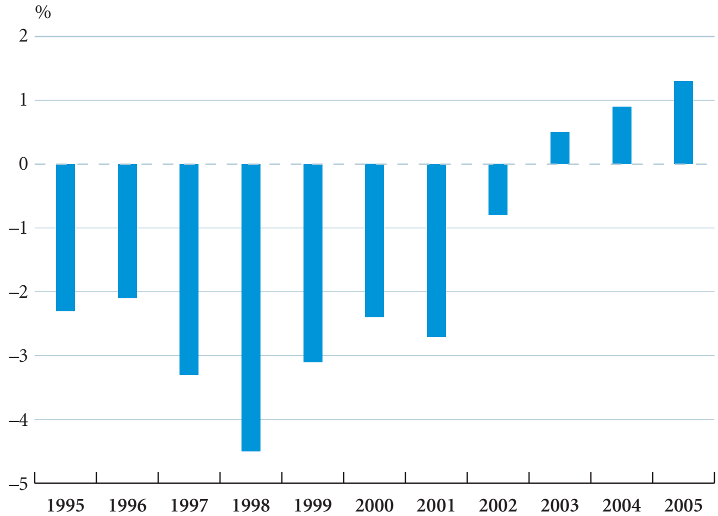
Another especially important source of growth in the region is the strength of investment. In 2005, investment in the region grew by 10%, increasing its share in the GDP. This growth, however, is unequal given that investment represents 26.6% of Chile's economy but does not reach 20% in other large countries, except in the case of Mexico, while in Uruguay it is only 11%.

What is also notable is the recovery of net flows of direct foreign investment following a period of sharp decreases suggesting a general perception that something is changing in Latin America. The 47.3 billion dollars coming in from abroad in 2005 is still far from the highs in 1999 and also far from the flows going to Asia, but there was growth of 50% compared with 2004. Keeping in mind the competition from China, this was quite an achievement.

Government finances are enjoying abundance but, as opposed to other periods, those in power are not falling into populist temptations and are working at reducing the foreign debt instead of wild spending. This is the predominant destination of the primary surplus (the difference between revenue and spending without taking into

CURRENT ACCOUNT SURPLUS CONTINUES UPWARD

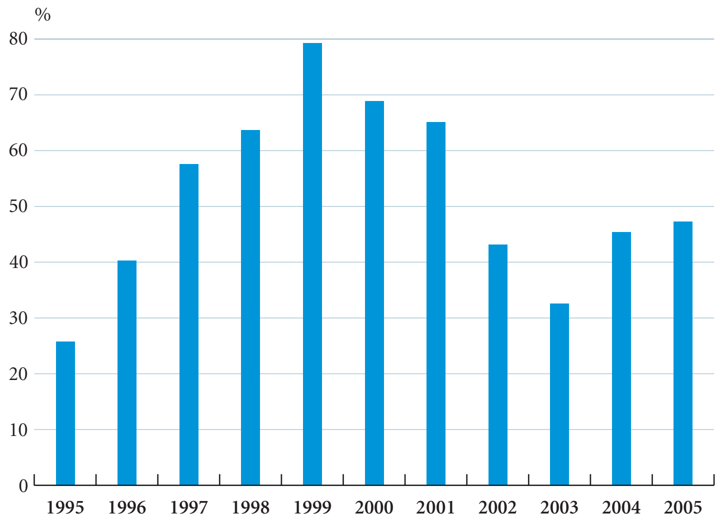
Current account balance over gross domestic product



NOTES: 2005 represents forecasts.
SOURCE: Economic Commission for Latin America and Caribbean (CEPAL) based on official figures.

DIRECT INVESTMENT RECOVERING

Direct investment in region



NOTES: Estimate for first quarter 2005.
SOURCE: Economic Commission for Latin America and Caribbean (CEPAL) based on official figures.

account the payment of interest on debt). The average for the region stood at 1.3% of the GDP, well over the revised figure of 0.7% in 2004, a fiscal discipline quite in contrast to the lax approach of other emerging countries and the majority of the rich countries as well. As a result, the foreign debt went from representing 228% of exports in 1995 to only 118% in 2005.

In this positive context, the level of wellbeing is still not generally growing, something which is always a source of potential tension. Here, the reduction of unemployment is key but the unemployment rate has only gone from 11% to 9.3% in three years. Another problem in the labour market continues to be the poor growth of productivity, the real matter to be resolved in a globalized world that is very necessary in order to sustain better terms of trade, maintain the continuity of growth and improve the income level of the population.

EUROPEAN UNION

European Commission forecasts: growth without inflation

In its early spring forecasts, the European Commission has slightly revised upward its growth forecasts for the European Union (EU) for 2006 (2.2% in place of the 2.1% given out last November) while still maintaining those for the euro area (1.9%). In both cases, this implies an increase in growth recorded in 2005. With regard to prices, the EU executive body confirms its previous forecast which represents growth in the harmonized consumer price index (HCPI) in 2006 the same as last year – 2.2% both in the euro area and the EU.

On what is this recovery scenario based? In presenting the forecasts, Joaquín Almunia, commissioner for economic and monetary affairs, emphasized three key factors, namely positive expectations in demand, favourable financing conditions and corporate profits in a good state. All of this means that, as opposed to the increase in growth occurring in the second half of 2005, it will be domestic demand that forms the basis of recovery. At the same time, in spite of the fact that oil prices forecast will stay at high levels, the hypothesis is held that the rise in oil prices will not shift to wages.

Commission makes moderate upward revision of 2006 growth forecasts for European Union while noting that recovery appears to have more solid base than expected some months ago.

The risks for the scenario set out by European Commission to be carried out are not new. There is still concern about the trend in oil, both because of the volatility seen in other periods and because of possible further price increases. It also continues to mention the threat posed by global imbalances in current account. In spite of these concerns, the European Commission feels that recovery is stronger than anticipated last autumn.

EUROPEAN COMMISSION MACROECONOMIC FORECASTS

	Growth				Inflation (*)			
Country	2005	Current forecast for 2006	Previous forecast for 2006 (**)	Difference	2005	Current forecast for 2006	Previous forecast for 2006 (**)	Difference
Germany	0.9	1.5	1.2	0.3	2.0	1.6	1.6	0.0
Spain	3.4	3.1	3.2	–0.1	3.4	3.5	3.3	0.2
France	1.4	1.9	1.8	0.1	1.8	2.0	2.1	–0.1
Italy	0.1	1.3	1.5	–0.2	2.2	2.1	2.1	0.0
Euro area	**1.3**	**1.9**	**1.9**	**0.0**	**2.2**	**2.2**	**2.2**	**0.0**
United Kingdom	1.8	2.4	2.3	0.1	2.0	2.0	2.2	–0.2
EU-25	**1.5**	**2.2**	**2.1**	**0.1**	**2.2**	**2.2**	**2.2**	**0.0**

NOTES: (*) Harmonized consumer price index.
(**) Date of forecast: November 2005.
SOURCE: European Commission.

Fourth quarter growth at 1.7% consolidates recovery noted in mid-2005 in contrast to «false recovery» in 2004.

Euro area: recovery is a fact

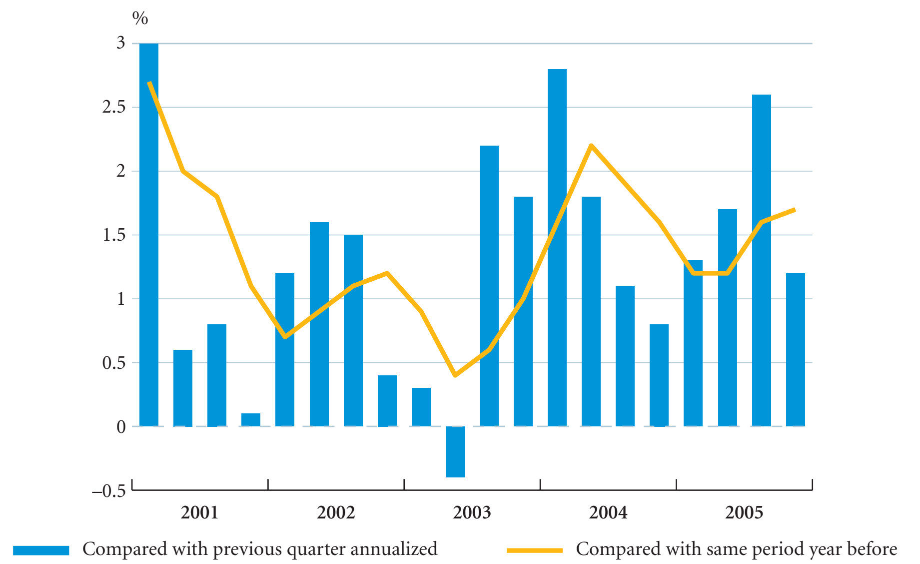
Up to now, the euro area has been showing an economic performance characterized by a low rate of economic activity and constantly pointing to a recovery that did not end up taking place. We well remember the «false recovery» that took place in the first half of 2004 which gave rise to an unexpected slowdown in the economy lasting nearly a year. Circumstances are now different. In two quarters the euro area economy has moved from bordering on disappointing growth levels scarcely above 1% in the first quarter of 2005 to rapidly come close to 2%, a rate of economic increase close to its growth potential.

Specifically, in the fourth quarter of 2005, the gross domestic product (GDP) for the euro area stood at 1.7% year-to-year (1.6% year-to-year in the previous quarter). This is an acceptable growth rate which, furthermore, has the virtue of consolidating the drive in economic activity taking place in the third quarter, as shows up in the quarter-to-quarter growth rates of the GDP annualized, which reflects the recent strength of growth with greater precision. The figure for the third quarter, a notable 2.6%, was accompanied by an acceptable 1.2% in the fourth quarter. Finally, the year 2005, with overall growth of only 1.4%, included a weak first half-year and a second half-year moving along good lines.

What of the future? The forecasts given out are favourable. The overall view of analysts points to growth of around 2% in 2006 which is to come largely from maintenance of strength in exports and strong investment helped, although to a rather poor extent, by consumption less depressed than in previous quarters. Should this factor, the recovery of household consumption, be missing or if it is only moderate, recovery could rapidly lose strength.

EURO AREA CONSOLIDATING RECOVERY

Change in gross domestic product in real terms



SOURCE: Eurostat and internal figures.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005						2006
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	0.7	1.8	1.6	1.2	1.2	1.6	–	1.7	–	–
Retail sales	0.4	1.2	1.3	1.3	0.7	1.1	0.4	0.7	1.0	...
Consumer confidence (*)	–18	–13.8	–13.0	–13.2	–14.4	–14.8	–13	–13	–11	–11
Industrial production	0.3	1.9	1.1	0.6	0.7	1.5	0.2	2.9	2.5	...
Economic sentiment indicator (*)	93.5	99.5	100.5	98.7	96.1	97.8	100.2	99.9	100.6	101.8
Unemployment rate (**)	8.7	8.9	8.8	8.8	8.6	8.4	8.3	8.3	8.4	...
Consumer prices	2.1	2.1	2.3	2.0	2.0	2.3	2.5	2.3	2.2	2.4
Trade balance (***)	80.3	80.4	73.0	64.4	50.2	39.4	33.2	29.8	23.4	...

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

Prospects for 2006 tend to confirm scenario of moderate economic growth, a situation being backed by available indicators.

For the moment, going by available figures, the scenario described looks as if it will happen. Investment and the foreign sector are performing strongly, as may be seen in the growth rate in the capital goods component of industrial production (3.8% year-to-year in December) or the growth of exports (rise of 10% year-to-year in December). Supply indicators also confirm the stronger growth rate of the economy with industrial production growing by 1.9% in the fourth quarter and economic sentiment in January at its highest since June 2001.

Improvement in consumption still awaited, a block failing to dispel doubts about sustainability of recovery.

For consumption to recover, however, we shall have to wait longer. For the moment, consumer confidence, an indicator that usually anticipates the course of consumption, is leaving behind the low values seen in the second quarter of 2005 and has now recovered positions going to the level of –11 points in January. The definitive consolidation of a stage of greater strength in private spending will require a much more expansionist labour market. In this respect, in spite of the rise in the unemployment rate to 8.4% in December, prospects of any reduction of unemployment in 2006 are not poor.

The relative containment of inflation may also help to contribute to a better tone in consumption. In January, the HCPI grew by 2.4% moving up two decimals over December. These levels, still higher than the European Central Bank reference rate, have come largely as a result of the continuing contribution of energy which is still following the course of increased oil prices affecting the world economy.

Working in Europe a costly business: taxes related to employment

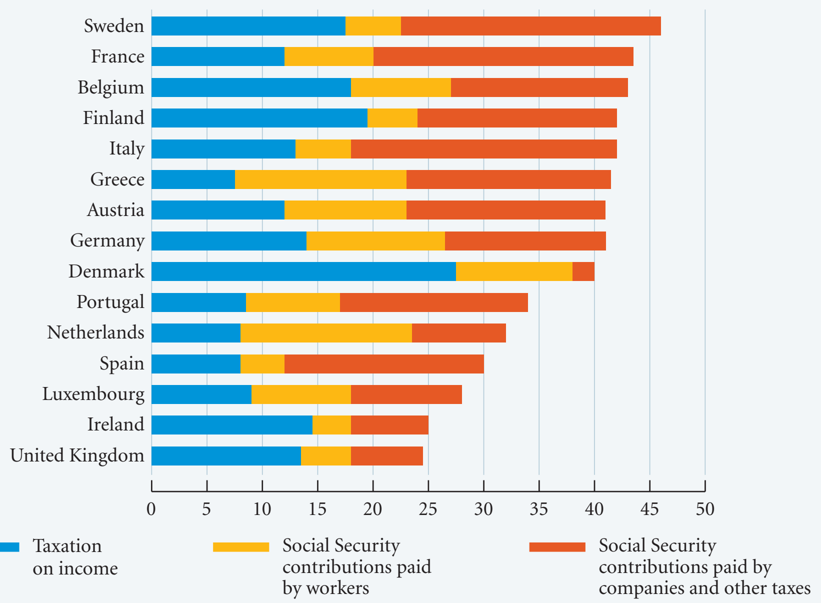
When the differences in taxation between the United States and Europe are discussed, the question is often posed in the following terms: on the Old Continent more taxes are paid to fund a Welfare State that is more generous than that in North America. We cannot object to this, given that each society has the level of income distribution it prefers. Nevertheless, the continuing weakness of growth in the European Union (EU) raises constant doubts about whether taxation in the EU is affecting the creation of wealth more than desirable.

In fact, overall tax collections by government, including Social Security contributions, represent 41% of the GDP in the EU, nearly 15 percentage points higher than in the United States and Japan. Furthermore, and this is less well known, in spite of efforts to reduce taxes in some economies differentials have worsened over the past 10 years.

It is not a mere question of tax load. Not only do we Europeans pay more but we are using a combination of revenue sources with major distortion effects. Specifically, the labour market, which is showing an unsatisfactory rate of job creation and a level of unemployment that is too high, may be being penalized by taxation. In the EU, the tax load on the work factor is nearly 50% higher than that in the United States and Japan. According to figures published by the European Commission, the implicit tax rate on work (that is the sum of personal income tax, Social Security contributions paid by workers and companies and other taxes linked to earnings expressed as a percentage of the corresponding tax base) in 1999 was 37% on average in the EU as against 25% in the United States and 23% in Japan.

SHARP DIFFERENCES IN TAX LOAD ON WORK IN EUROPEAN UNION

Implicit tax rate on work in 2003 (*), as percentage



NOTES: (*) Sum of all taxes due on income from wage work as percentage of corresponding tax base.
SOURCE: Eurostat.

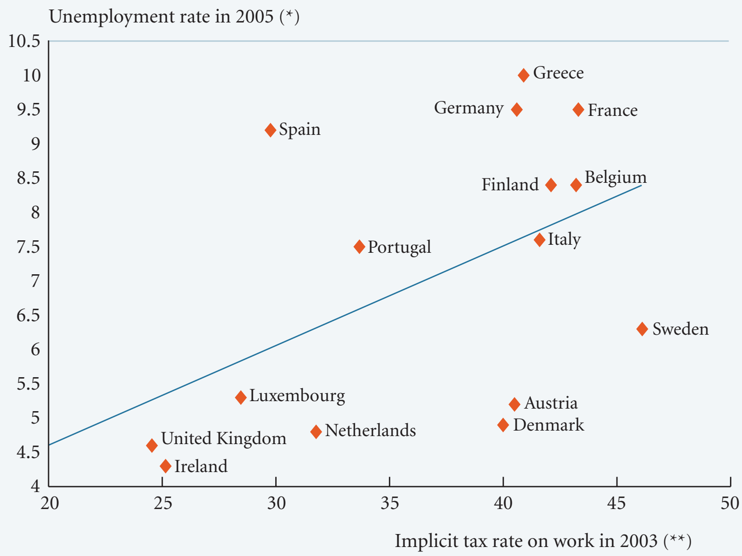
At the same time, the differences between member states within the EU are notable, both as refers to total tax load and its composition. Nine states out of the old EU-15 stand above the average level of 37%. Of the six remaining countries, however, we should point out that four (Spain, Luxembourg, Ireland and the United Kingdom) have chosen a point significantly far from this average.

What is the impact of this heavy tax load on work? From a theoretical point of view, the greater tax load on work ends up shifting to labour costs, thus provoking two negative effects. In the first place, in a situation of a rigid labour market, such as that of Europe, the higher labour costs bring about a decrease in demand for labour and, as a result, an increase in unemployment. In the second place, companies substitute the more costly factor in relative terms (work) for the less costly factor (capital) which involves an economic model which tends not to take advantage of the full potential of human capital.

The evidence would suggest that, in Europe, we are seeing a process of this type. According to estimates by Daveri and Tabellini (2000)[1], each percentage point of increase in taxation on work carries with it an increase of a half-percentage point of unemployment on Continental Europe. They conclude that taxation on work was responsible for half the increase in unemployment in Europe between 1970-1995. Other empirical studies have found a slightly lower sensitivity of unemployment to taxation but always a significant one. For example, the technical services of the European Commission, making use of recent figures, estimate that the increase of one point in taxation on work brings about an increase of 0.3 percentage points in the unemployment rate.

In this situation, the poor economic performance of the EU in recent years has undoubtedly much to do with taxation. Given the high degree of sensitivity of labour variables to taxation, the margin for improvement is

THE HIGHER TAX LOAD ON WORK THE HIGHER UNEMPLOYMENT, ALTHOUGH SPAIN IS DIFFERENT



NOTES: (*) Percentage over labour force in harmonized terms.
(**) Sum of all taxes levied on income for wage work as percentage of corresponding tax base.
SOURCE: Eurostat and internal figures.

(1) Daveri, F. and G. Tabellini (2000): «Unemployment, Growth and Taxation in Industrial Countries». Economic Policy, No. 30, 47-104.

quite high. Nevertheless, the immediate question is how to finance this reduction in taxes because, if we opt for shifting from one tax base to another, that is to say, taxing capital or consumption instead of work, a positive effect on the economy might not take place. The European Commission prefers to recommend an orthodox solution. In the face of lower revenues a corresponding adjustment should be made in public spending. According to its estimates, a reduction in public consumption equivalent to 1% of the GDP combined with a reduction of an equivalent amount in taxation on work would generate an increase of 1% in employment and 0.8%.

Germany continues to benefit from strong export-investment tandem, as shown by growth of 1.6% in fourth quarter...

Germany: a need for consumption

GDP growth in the fourth quarter, 1.6% year-to-year, reminds us that Germany continues to depend entirely on the investment-export binomial. This is not a poor base when we take into account that Germany is the world's leading exporter, a privileged position that probably was confirmed in 2005 when the trade surplus grew by 3.3% over 2004, with a figure of 160 billion euros. Nevertheless, Germany will need something more in order to break out of the low level of economic activity in which it has been stuck since the far-off year 2000, a time when the economy grew by more than 3%. The critical years 2002 and 2003 when the economy became stagnant are not so far away. Growth in 2005 at 1.1% does not cast away all doubts.

Where will this extra drive come from that will make it possible to consolidate present growth rates? Given that the government is trying to constrain the government deficit (3.3% of the GDP in 2005) so that it comes near the limit of 3% of the GDP set under the EU

GERMANY: MAIN ECONOMIC INDICATORS

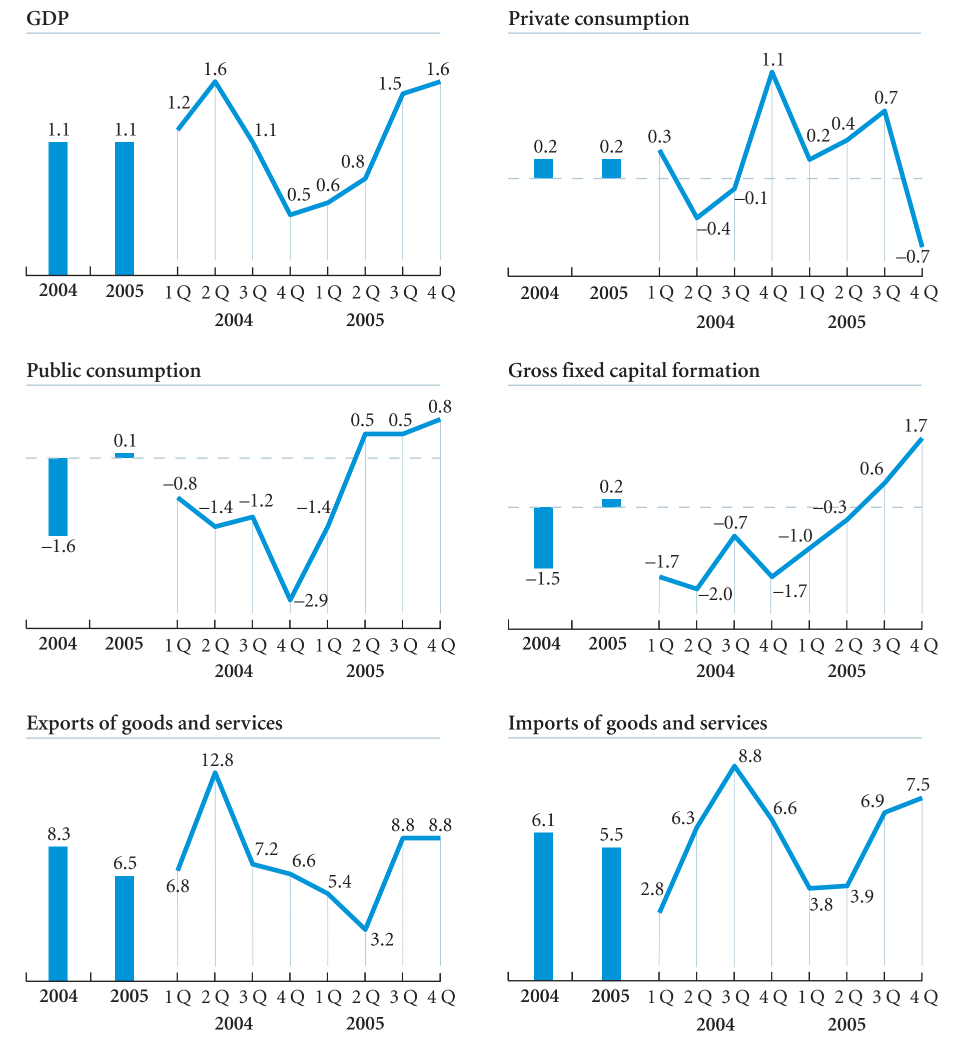
Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005						2006
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	–0.2	1.1	0.5	0.6	0.8	1.5	–	1.6	–	–
Retail sales	–0.5	2.1	2.2	0.8	2.4	1.5	–0.4	0.3	–0.9	...
Industrial production	0.1	2.4	1.5	1.9	2.0	3.2	4.3	5.0	3.4	...
Industrial activity index (IFO) (*)	91.8	95.4	95.4	95.0	93.0	95.4	98.5	97.7	99.6	101.7
Unemployment rate (**)	10.5	10.5	10.8	11.9	11.9	11.7	11.6	11.4	11.2	11.3
Consumer prices	1.0	1.7	1.9	1.7	1.7	2.2	2.4	2.3	2.2	2.2
Trade balance (***)	130	149	155	157	154.4	157.2	159.6	161.3	160.0	...

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

TREND IN GERMANY'S GDP BY COMPONENT

Percentage year-to-year change



SOURCE: Federal Statistics Office and internal figures.

Stability and Growth Pact, the other objectives are construction investment and private consumption.

The composition of growth in the fourth quarter shows that private consumption was again disappointing, given that it stands at levels of 0.7%, lower than those in the fourth quarter of 2004. In any case, the increase in investment and, to a lesser extent, public consumption, brought more joy to domestic demand. As a result of this domestic demand, the foreign sector slightly reduced its positive contribution to the increase in the GDP, given that imports were up more than exports. In any case, exports continued to show a notable rise in growth rate.

Finally, consumption continues as something to be adjusted and the element that must end up consolidating recovery. Available forecasts suggest a slight increase in household spending as a combined result of a series of factors, among which we may mention early

...but German families need to start spending more freely in order to bring solid recovery.

German business executives have no doubts about describing economic situation as best since 1991.

spending in anticipation of the increase in value added tax in 2007 by three points, the containment of inflation (the CPI grew by 2.2% year-to-year in January) and prospects of some improvement in employment (although the unemployment rate in January was 11.3%). In this respect, the recovery of consumer confidence, which in January stood at its highest levels since September 2002, would seem to support the above forecasts.

A favourable factor to mention, in order to round out the German economic scene, is the recovery taking place in two key sectors, namely industry and services. In spite of a slight drop in December largely compensating the rise in November, industrial production is capitalizing on the favourable international environment. Business executives continue to put out very favourable expectations as reflected in growth of the IFO index which in February stood at its highest levels since 1991.

Following unexpectedly good performance in French economy in third quarter, fourth quarter cools off expectations.

To summarize, prospects in Germany are positive without being affected by the strike in the public sector at the beginning of February. In spite of the fact that that strike enjoyed the role as the first in the public sector in 14 years, the truth is that its effect was limited and it does not seem as if it will change the direction of current economic policy or affect the more optimistic expectations of company executives or households.

France: start of decisive year

The first quarter of 2006 will be decisive in order to make out the possibilities of the present French economic cycle. The previous two quarters, the third and fourth quarters of 2005, went in opposite directions so that everyone is still on the alert. Whereas the third quarter brought a surprise by going above growth forecasts, in the fourth quarter, on the other hand, the reality was below expectations. In the last three months of 2005, the increase in the GDP in year-to-year terms was 1.2%, a result of month-to-month growth of only 0.9%.

The structure of growth is also less satisfactory than the level itself. In the fourth quarter there was a drop in all domestic demand components with the exception of the contribution of the change in inventories. Specifically, the correction in private consumption was

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005						2006
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	0.9	2.1	2.0	1.7	1.0	1.7	–	1.2	–	–
Domestic consumption	1.8	3.2	4.1	3.4	1.7	4.4	2.1	3.1	2.1	2.5
Industrial production	–0.4	1.8	1.8	0.7	–0.3	0.4	–3.0	1.1	–0.4	...
Unemployment rate (*)	9.8	10.0	10.0	10.1	10.2	9.9	9.7	9.6	9.5	...
Consumer prices	2.1	2.1	2.1	1.6	1.6	1.9	1.8	1.6	1.5	2.0
Trade balance (**)	0.2	–0.1	–0.5	–1.0	–1.4	–1.8	–2.0	–2.1	–2.2	...

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

especially sharp with a drop to the level in the third quarter. The foreign sector, in turn, while still reducing growth of the GDP, was no worse than in the third quarter. Altogether the picture is troubling.

All of this gives great importance to the start of the current year. For the moment, the figures indicate that the verdict will be moderately positive, which opens up the possibility of ending 2006 in a situation of recovery. In January, domestic consumption rose and economic sentiment consolidated the recovery in December. On the negative side, while still in terms of December 2005, we find industrial production which lost ground that month with a drop of 0.4% year-to-year as a result of a substantial worsening in the motor vehicle sector. Also troubling was the rise in inflation in January (to 2% year-to-year) although the containment in the underlying core has helped to reduce concern about this matter.

Nevertheless, as we move away from the very short-term perspective, the main trump card for recovery will have to come from a revival of private consumption or at least that is the economic policy approach of Villepin's government. Since last summer the government has introduced a series of moves the crux of which is to have a positive effect on the spending capacity of French households through a combination of tax measures (reduction of direct tax on individuals) and labour measures, with the most notable being making the 35-hour week more flexible.

Now the French National Assembly has approved the so-called «First Job Contract» aimed at making it easier for young people to get jobs. Basically, it aims at reducing the barriers for those under 26 years to get into the labour market through a type of hiring contract that is very flexible in matters of firing in the first two years while allowing for a later move to a more stable work situation, a contract applicable to companies with more than 20 employees.

This is a measure with economic logic given that in France the unemployment rate among those under 25 is more than twice the national average at 22.7% against 9.5% in December. The lack of social protest following adoption of this measure may indicate increasing public sensitivity to difficulties of a structural nature that are inhibiting France's economic potential.

Year begins better than last year-end with consumption apparently showing recovery although drop in industrial activity represents major setback.

Approval of «First Job Contract», an instrument which should facilitate making jobs for young people without excessive protest.

Italy: everything giving way to elections

On April 9-10 Italy will be celebrating general elections. While the polls point to a situation giving some advantage to a central-left coalition led by Romano Prodi over the centre-right of the current prime minister Silvio Berlusconi, this is an election fight with the result wide open. Because of this, the latest economic indicators have taken second place beside the political scene.

True enough, the news on the economic front has not been great. Consumption is tending to be a little stronger, investment is holding a moderately upward trend and the foreign sector, one which has performed negatively in recent times, seems to be slowing its downturn, something which is benefiting industrial activity. All of this in a context of price moderation (the CPI grew by 2.2% year-to-year in January, similar to the average for the second half of 2005) and with the unemployment rate stable, although at relatively high levels (7.7% in the third quarter).

Calling of general elections in Italy on April 9-10 leaves latest news on economic situation somewhat in second place...

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005						2006
			4Q	1Q	2Q	3Q	October	November	December	January
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	1.7	2.4	...
Industrial production	–0.6	–0.6	–2.0	–2.7	–1.2	–0.2	–1.6	0.0	2.0	...
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	2.2
Trade balance (**)	4.1	2.0	–0.8	–1.9	–5.1	–7.0	–8.7	–9.2	–10.4	...

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

...although it is true that recent trends pointing to some improvement within a framework of low economic activity, are continuing.

This improvement in the most recent indicators allows us to estimate that the fourth quarter would have ended with a slight recovery in growth. Nevertheless, prospects for 2006 are weak. According to most analysts, Italy will grow by 1.3% to stand among the bottom group of the large European Union economies and this analysis of recovery is getting the support of some improvement in the economic sentiment index which rose in January.

United Kingdom shows growth of 1.8% in fourth quarter with no improvement over the previous quarter and without resolving weakness of private consumption...

United Kingdom: fourth quarter fails to dispel doubts

The last big growth stage in the British economy, from 1993 to 2004, benefited from notable growth in private consumption. Because of this, the realization that in the third quarter of the year British households were tightening their belts putting spending at the lowest level in 10 years, for the moment removes any prospect of an economic recovery.

...a situation that also may have grown worse following a disappointing Christmas season.

GDP growth in the fourth quarter (1.8% year-to-year) showing no change over the previous quarter did not help to dispel uncertainty. While private consumption grew moderately (by 1.7% year-to-year as against the previous 1.4%), this was more than compensated by the unexpected collapse of investment which fell by 1.7% year-to-year (compared with an increase of 3.8% in the third quarter). All of this has brought about a substantial drop in domestic demand which was only compensated by the first positive contribution from the foreign sector to the change in the GDP since the first quarter of 2000.

Furthermore, the start of the year has brought a clear cooling down of expectations. Whereas it was expected that the Christmas season would mean the consolidation of the rise in consumption, the figures for retail sales in January have gone well below forecasts with a slowdown of close to three percentage points compared with the December figures. In spite of some recovery in January, consumer confidence is practically five points below the position held one year ago.

Nor is the recent strength of the labour market, which was the main pillar of support for the now-gone strength of household spending, ending up as positive given that while not at alarming rates it combines positive factors, such as a still low level of unemployment

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2003	2004	2004	2005						2006
			4Q	1Q	2Q	3Q	October	November	December	January
GDP	2.5	3.2	2.7	2.0	1.6	1.8	–	1.8	–	–
Retail sales	3.1	6.1	4.7	2.8	1.3	0.7	1.4	1.9	4.2	1.4
Industrial production	–0.5	0.8	0.1	–1.0	–1.8	–1.4	–2.2	–2.7	–2.7	...
Unemployment rate (*)	3.0	2.7	2.7	2.6	2.7	2.8	2.9	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	2.3
Trade balance (**)	–46.8	–55.5	–59.8	–61.5	–62.9	–63.7	–64.0	–64.7	–65.5	...

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

(2.9% in January with other indicators stagnant (such as job creation) or in recession (as in the case of job vacancies).

Finally, we should point out that the rise in consumer prices in January (to 2.3% year-to-year) and maintenance of weakness in industry (industrial production fell by nearly 3% year-to-year in November and December) rounds out a scenario that leans more to the negative side that to the bright side.

Some increase in prices and persistent weakness in manufacturing cast further clouds over situation that fails to dispel uncertainty.

FINANCIAL MARKETS

Monetary and capital markets

Further increase in US reference rate puts it at 4.50%.

Bernanke pilots Federal Reserve toward further rate increases

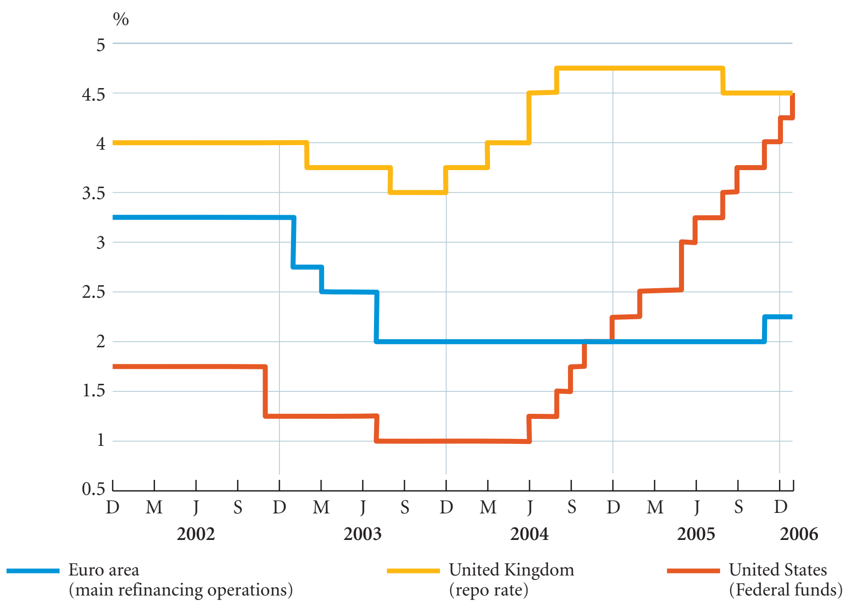
On January 31, the Federal Open Market Committee of the Federal Reserve, the central bank system in the United States, decided to raise its official interest rate by 25 basis points to 4.50%, as expected. This was the fourteenth consecutive increase since June 2004. Furthermore, it was the last meeting under the chairmanship of Alan Greenspan who had taken the reins of the Federal Reserve in August 1987.

In the press release issued following the meeting the door was left open to further interest rate increases. In fact, it stated that the Committee felt that it might be necessary to tighten monetary policy slightly more in order to maintain a balance in risks standing in the way of securing sustainable growth and price stability. Inflationary pressures came from possible increases in use of production facilities as well as from high energy prices.

Two weeks later, in his first appearance before Congress, the brand-new chairman of the world's most powerful central bank, Ben Bernanke, drew a picture in line with the press release issued by the Federal Open Market Committee. The biggest change from Greenspan was in the language used which was much clearer than the habitually obscure and cryptic tone used by the «Magician». As a result, he pointed

FEDERAL RESERVE AGAIN RAISES INTEREST RATES

Monetary policy reference rates



SOURCE: National central banks.

the way to a further increase in the Federal Reserve reference rate at its next meeting on March 28, which would not be the last.

In fact, after statements by Greenspan at a private dinner with investment bankers became known, in the second week of February the market increased its upward expectations on Federal Reserve interest rates. This move sharpened follow the statements by Bernanke before Congress. As a result, operators in the interbank market are anticipating that the Federal Reserve official interest rate will very likely go to 5%.

In the euro area, at its meeting on February 2 the Governing Board of the European Central Bank (ECB) did not change its reference rates. Nevertheless, at the following press conference the chairman, Jean-Claude Trichet, indicated that a new increase in March was imminent while stating his agreement with market expectations in this direction. These forecasts are supported by an analysis that confirms economic recovery in the euro area along with some upward inflationary risks. In the second week of February a member of the ECB Governing Board, Klaus Liebscher, suggested that it was drawing up a series

Rise in Eurosystem official rate on March 2 sets it at 2.50%.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euríbor (5) 3-month	Euríbor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2005									
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	2.33	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	2.78	4.16	4.49	0.09	4.50	4.64	1.02
2006									
January (*)	2.30	2.51	2.83	4.26	4.60	0.10	4.50	4.60	1.01
February (1)	2.32	2.64	2.96	4.50	4.81	0.11	4.50	4.57	1.13

NOTES: (*) Provisional figures.
(1) February 24.
(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: 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%), 31-1-06 (4.50%).
(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.

End near to Japan's very easy monetary policy.

of interest rate increases to deal with inflationary pressures. In fact, this is what the market is discounting as it is betting on a reference rate of around 3% at the end of the year as against the current 2.25%.

With regard to the Bank of Japan, on February 9 its monetary policy committee decided not to change its policy of interest rates at close to 0%. Nevertheless, two members voted against this, something which has been happening since the end of July. Recently, however, other voices have joined the call of those who argue that the time has come to put an end to this extra-easy monetary policy. In the second week of February, Nobuo Kuroyanagi, chairman of Mitsubishi Tokyo UFJ, the world's biggest bank, advocated that the Bank of Japan begin draining off liquidity as soon as possible and that it raise interest rates. The possibility that the end of deflation may be near suggests that the increase in interest rates could take place this year.

With regard to other central banks, on February 23 the Bank of Sweden raised its intervention rate 25 basis points to 2.0%. This was the second increase in this official interest rate so far this year.

Dollar refusing to drop

Renewed upward prospects for Fed interest rates aids dollar.

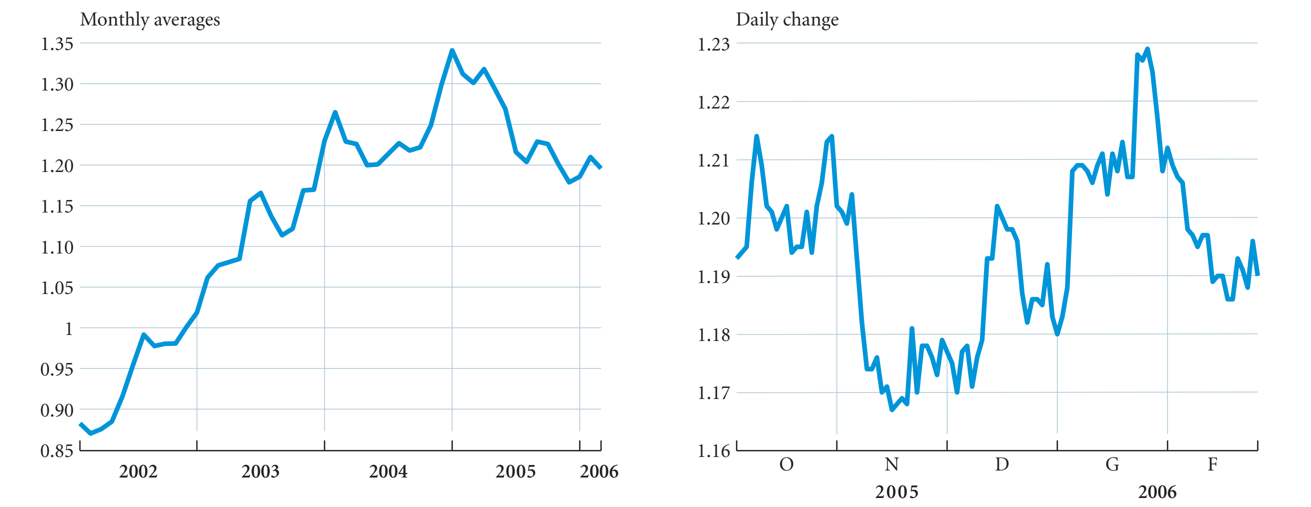
Following a weak start to the year, the dollar recovered in the early weeks of February. The strengthening of the US currency came as a result of increasing upward prospects for Federal Reserve interest rates. As a result, the US currency is refusing to drop and this tendency could continue over coming months.

Euro weakens against dollar in February as result of wider interest rate differential.

The euro lost ground in the early weeks off February after an overall rise of 1.0% in January. The decrease was specially marked in terms of the dollar as it was hurt by the increase in the interest rate differential. After ending January at above 1.21 dollars to the unit, the euro weakened to a rate around the level of 1.19 dollars.

EURO DROPS AGAINST DOLLAR

US dollars to euro



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

EXCHANGE RATES OF MAIN CURRENCIES

January 2006

	Final session of month		Monthly figures			*Exchange rate February 24, 2006*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2) Monthly	% change (2) Annual	
Against US dollar						
Japanese yen	117.3	–0.5	115.6	–2.4	11.9	*116.8*
Pound sterling (1)	1.779	3.2	1.766	1.2	–6.0	*1.745*
Swiss franc	1.279	–2.8	1.279	–2.1	8.4	*1.317*
Canadian dollar	1.139	–2.0	1.157	–0.4	–5.5	*1.149*
Mexican peso	10.44	–1.8	10.55	–0.8	–6.3	*10.48*
Nominal effective index (4)	*109.7*	*–1.9*	*110.3*	*–1.4*	*0.7*	*110.5*
Against euro						
US dollar	1.212	2.7	1.210	2.1	–7.7	*1.190*
Japanese yen	142.2	2.4	139.8	–0.5	3.1	*139.1*
Swiss franc	1.555	0.0	1.549	0.1	0.2	*1.560*
Pound sterling	0.684	–0.1	0.686	1.0	–1.8	*0.680*
Swedish krona	9.250	–1.5	9.311	–1.3	2.9	*9.420*
Danish krone (3)	7.464	0.0	7.461	0.1	0.3	*7.460*
Polish zloty	3.838	–0.6	3.820	–0.8	–6.4	*3.785*
Czech crown	28.41	–2.0	28.72	–0.9	–5.2	*28.36*
Hungarian forint	252.7	–0.1	250.7	–0.8	1.7	*252.8*
Nominal effective index (5)	*101.5*	*1.0*	*101.4*	*0.7*	*–4.2*	*100.4*

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

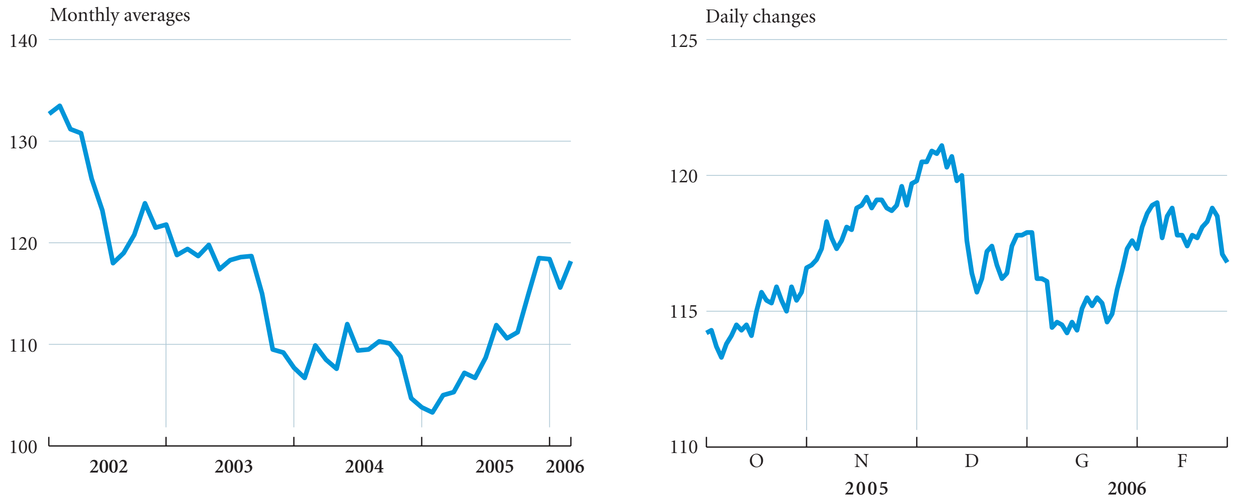
Pound sterling loses attractiveness against dollar with levelling of short-term interest rates.

The pound sterling lost its attractiveness against the dollar once short-term interest rates levelled out following the increase by the Fed on January 31. Furthermore, there was the effect of the prospect of a possible cut in the Bank of England intervention rate as against an almost certain rise in the Federal Reserve reference rate. These prospects were strengthened following publication in the third week of February of the January inflation rate at 1.9%, below the 2% objective set by the Bank of England. As a result, the British currency has depreciated against the dollar in recent weeks. On the other hand, in terms of the euro the pound sterling has held positions.

The yen fell to more than 119 units to the dollar at the beginning of the second week of February with the growing interest rate differential going against it, along with lower aversion to risk among Japanese investors which sent them buying foreign financial assets. Nevertheless, the Japanese currency later regained strength with the growing possibility that the Bank of Japan would in the near future abandon

YEN UP AND DOWN AGAINST DOLLAR

Yens by dollar



NOTES: Rates go up to February 24.
SOURCE: OCDE, Thomson Financial Datastream and internal figures.

its policy of holding interest rates at close to 0%.

Government bond yields hold at low levels

Interest rates on long-term government bonds fail to move up.

The yield on US 10-year Treasury bonds rose in the second last week of January with increasing upward prospects of interest rate rises by the Federal Reserve and publication of economic indicators suggesting notable economic strength. Nevertheless, toward the middle of February the yield on US bonds again dropped putting it at around 4.5% for a 10-year term. As a result, long-term interest rates held at relatively low levels. They will likely tend to rise in coming months but only moderately.

US Treasury again issuing 30-year bonds.

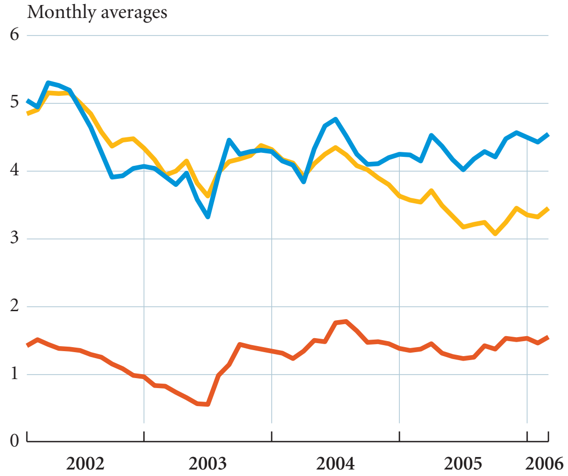
In addition, on February 9 the US Treasury carried out an auction of 30-year bonds for the first time since August 2001. At that time, in a situation of budget surpluses, those issues were halted. The new very long term issue was received with heavy demand by the market. The yield on the new bonds stood at around 4.5%, slightly below that for 2-year bonds which implied an inverted interest rate curve between these terms.

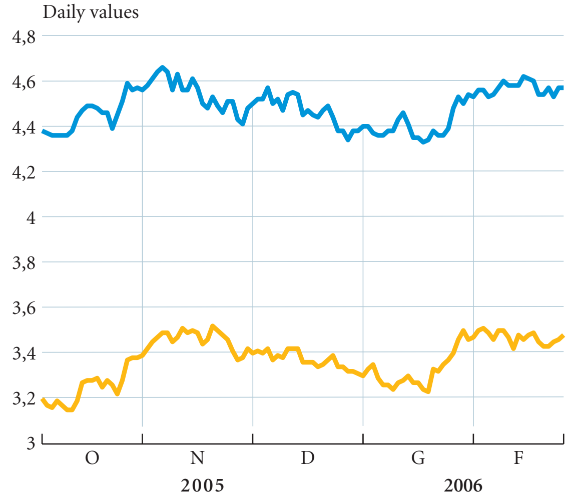
The yield on German 10-year government bonds has followed in the wake of similar US bonds in recent weeks. The differential in long-term interest rates between the dollar and euro increased slightly, going to 110 basis points.

In addition, in mid-February Russia launched a 30-year bond issue in roubles. This reflects the improvement in the Russian economy since the summer of 1998 which brought default on bond interest. There was considerable demand for these bonds. Nevertheless, only slightly less than half the forecast objective was issued because the Ministry of the Economy set a low marginal interest rate.

SLIGHT INCREASE IN INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO LONG-TERM BONDS

Yield on 10-year government bonds as annual percentage





NOTES: Rates go up to February 24.
SOURCE: Bank of Spain and Thomson Financial Datastream.

Russia launches 30-year bond issue in roubles reflecting improvement in economy.

The default rate on high-yield (and high risk) corporate bonds dropped in January to 1.8% as against 1.9% the month before, according to Moody's rating agency. Nevertheless, it is expected that this ratio will rise moderately during the course of the year.

The risk premium on these bonds has dipped slightly in recent weeks although not going to the low levels seen in the first quarter of 2005. On the other hand, the risk premium on emerging market bonds continued to mark up new all-time lows in February. This reflects the good economic situation in those countries with the rise in raw materials prices and also because of the hunt for better yields by investors, given the present low interest rates on government bonds.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2003	2004	2005				2006	
			I	II	III	IV	January	February 24
United States	4.04	4.31	4.34	4.21	4.25	4.54	4.45	4.57
Japan	0.99	1.50	1.41	1.28	1.36	1.53	1.47	1.60
Germany	4.10	4.07	3.63	3.35	3.19	3.37	3.34	3.48
France	4.13	4.10	3.64	3.38	3.23	3.39	3.34	3.49
Italy	4.24	4.24	3.75	3.53	3.40	3.56	3.55	3.70
Spain	4.12	4.10	3.63	3.36	3.18	3.37	3.33	3.46
United Kingdom	4.53	4.93	4.72	4.50	4.32	4.34	4.12	4.16
Switzerland	2.47	2.57	2.15	2.04	1.90	2.05	2.02	2.22

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

RISK PREMIUM FOR EMERGING COUNTRIES DROPS TO ALL-TIME LOWS

Differential between sovereign bonds of emerging countries and US Treasury bonds measured by JP Morgan EMBI + index

NOTES: Figures go up to February 24.
SOURCE: JP Morgan and Thomson Financial Datastream.

Easing of oil prices, low bond yields and good corporate profits boosting stock markets.

Telecommunications and energy sectors head increases in United States.

IBEX 35 index recovers 11,000 points level lost back in October 2000.

Stock markets continue to show strong drive

The drop in oil prices, maintenance of bond yields at low levels and good corporate results in general have helped the stock markets in recent weeks. A number of indices in Europe and United States have marked up highs for the past four and a half years and some emerging markets have shown all-time highs.

In spite of the prospect of further reference rate increases by the Federal Reserve, signs that notable economic growth is continuing have boosted the main US stock market indices. The cumulative balance in the early months of the year is favourable. All the main sector indices are showing increases over December, led by telecommunications and energy services.

In Europe, the DJ Eurostoxx 50 index, which brings together the biggest companies in the euro area, shows a notable improvement over December, even greater than the US stock markets. The Spanish and German markets led the increases in the main stock exchanges. We should point out that the improving economic picture and some corporate operations, such as the take-over bid for Arcelor by Mittal Steel and the counter-offer for the Endesa electric power company by E.ON have boosted the European stock markets.

The Spanish stock market continues to reflect the good state of the economy and corporate profits. Corporate take-over deals under way and rumours of others have boosted the markets. The IBEX 35 index thus recovered the 11,000 points level toward the end of January, something which had not happened since October 2000. Only four companies in the IBEX 35 have shown a negative change in prices so far this year.

INDICES OF MAIN WORLD STOCK EXCHANGES

January 31, 2006

	Index (*)	% monthly change	% annual change	Figures on February 24, 2006: % cumulative change	Figures on February 24, 2006: % change over same date in 2003
New York					
Dow Jones	*10,864.9*	*1.4*	*3.6*	*3.2*	*40.8*
Standard & Poor's	*1,280.1*	*2.5*	*8.4*	*3.3*	*54.9*
Nasdaq	*2,305.8*	*4.6*	*11.8*	*3.7*	*72.9*
Tokyo	16,649.8	3.3	46.2	–0.1	88.0
London	5,760.3	2.5	18.7	4.3	58.3
Euro area	3,691.4	3.1	23.7	6.9	77.1
Frankfurt	*5,674.2*	*4.9*	*33.4*	*8.6*	*128.3*
Paris	*4,948.0*	*4.9*	*26.4*	*7.6*	*82.1*
Amsterdam	*450.5*	*3.1*	*25.0*	*6.4*	*73.6*
Milan	*27,811.0*	*3.9*	*15.4*	*8.4*	*69.8*
Madrid	*11,104.3*	*3.5*	*20.4*	*9.8*	*98.0*
Zurich	7,810.9	3.0	35.3	4.9	90.2
Hong Kong	15,753.1	5.9	14.8	6.6	71.6
Buenos Aires	1,794.0	16.2	30.6	11.9	191.2
São Paulo	38,382.0	14.7	57.6	15.4	276.6

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

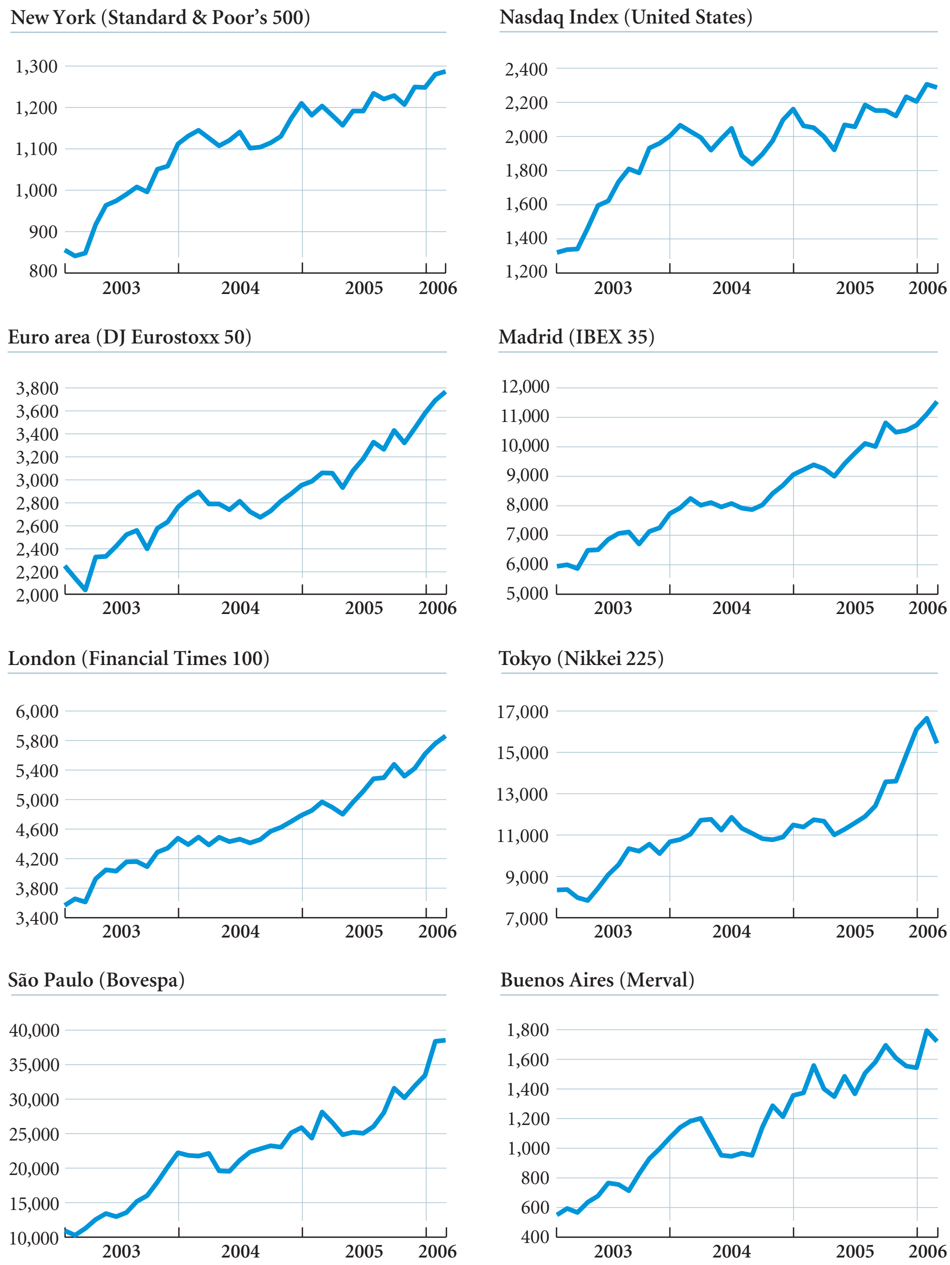
Outside the euro area, the London stock exchange also showed considerable gains, half-way between those on the Continent and those in the United States. The exception among the leaders was the Japanese stock exchange. After going up 40% in 2005, the Nikkei 225 has moved into troubled waters. It suffered notable losses in mid-January as a result of the discovery of an accounting scandal in the Livedoor Internet service company. Later on, the prospect of an early end to the zero interest rate policy of the Bank of Japan also did not help. As a result, at the end of the fourth week in February the Nikkei index stood below par for the year.

With regard to emerging markets, these continue to enjoy a generally good situation. The stock markets in Brazil and India showed all-time highs in the second month of the year.

After going up more than 40% in 2005, Nikkei 225 index moves into troubled waters.

INTERNATIONAL STOCK EXCHANGES

Indices at month-end



NOTES: February 24, 2006.
SOURCE: Thomson Financial Datastream,

SPAIN: OVERALL ANALYSIS

Economic activity

National Accounting shows two sides of Spain's economy

Notable growth in Spain's economic activity...

Figures provided by National Accounting relating to the last quarter in 2005 underline both the strong and weak points of Spain's economy. On the positive side, undoubtedly stands the strong drive in economic activity. In the course of 2005, domestic demand contributed 5.3 percentage points to growth of the gross domestic product (GDP), thanks to the sharp growth rate of household consumption and general government as well as the drive in investment.

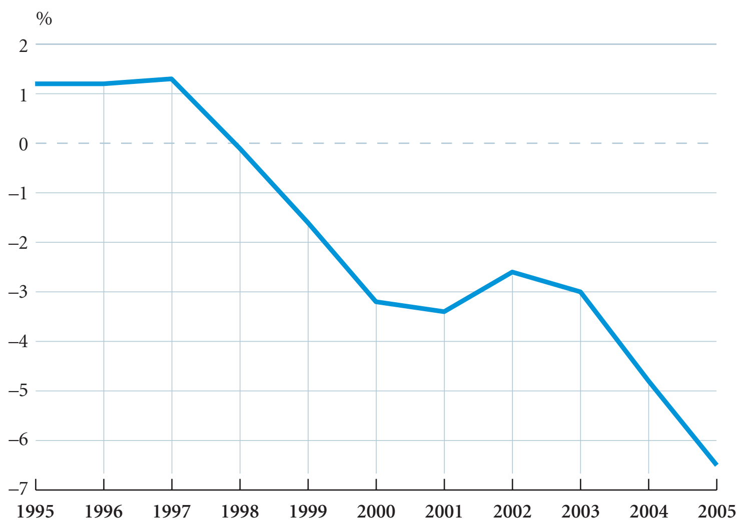
In 2005, Spain's economy completed a decade of uninterrupted growth which has been particularly strong in the past five years. In the latter period, the rate of increase in the GDP was around 3.2% on annual average (more than double that for the euro area), which made possible and, at the same time, kept up the spectacular growth in employment. During those five years nearly 2,300,000 net jobs, more than half of all those created in the whole euro area.

...but increasing foreign deficit and rising prices raise doubts whether growth rate can be maintained in future.

On the other side of the coin, the uncontrolled growth of the foreign deficit and the rise in prices raised serious doubts about whether this growth pattern could be maintained in the future. From 1998, the Spanish economy's need for foreign financing has gone on increasing, as may be seen in the following graph, going above 6% of the GDP in 2005. This clearly shows

FOREIGN IMBALANCE OF SPAIN'S ECONOMY INCREASING

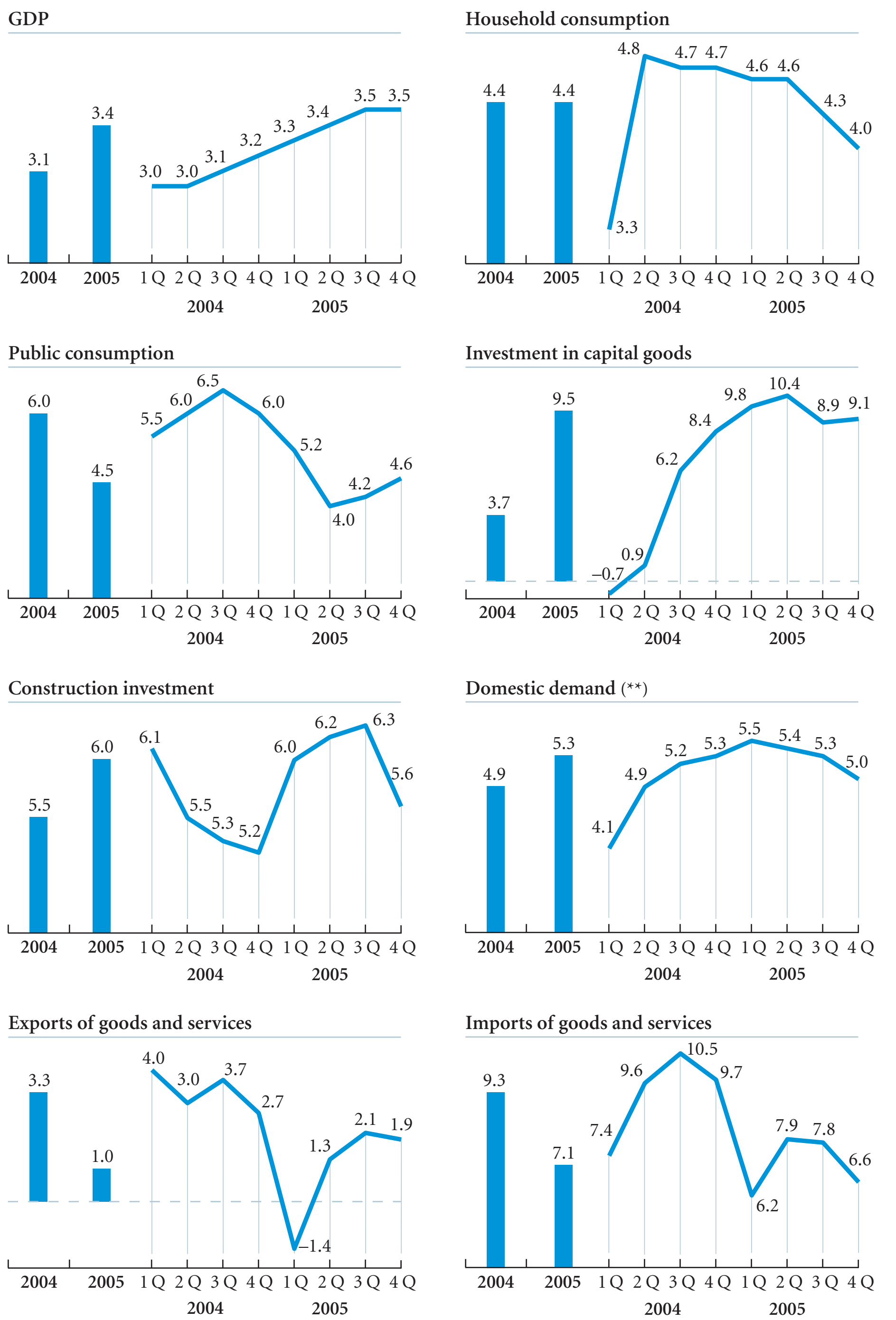
Spain's net world financing with relation to the GDP



SOURCE: INE and internal figures.

TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-to-year change (*)



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

(**) Contribution to GDP growth.

SOURCE: National Institute of Statistics.

that the country as a whole is living beyond its means. Put another way, domestic savings turn out to be quite insufficient to finance the investment needs of Spain's economy in which construction holds a notable place (especially that concerned with home purchase).

Another particularly negative aspect is the continuing increase in prices. The trend in the GDP deflator (representative of the broad mass of prices in the economy), shown in the following graph, speaks for itself. The increase of close to 4.5% recorded in 2005 (in the past five years this has generally stood above 4%) is quite counter-productive if we take into account its negative effects on the overall competitiveness of Spain's economy.

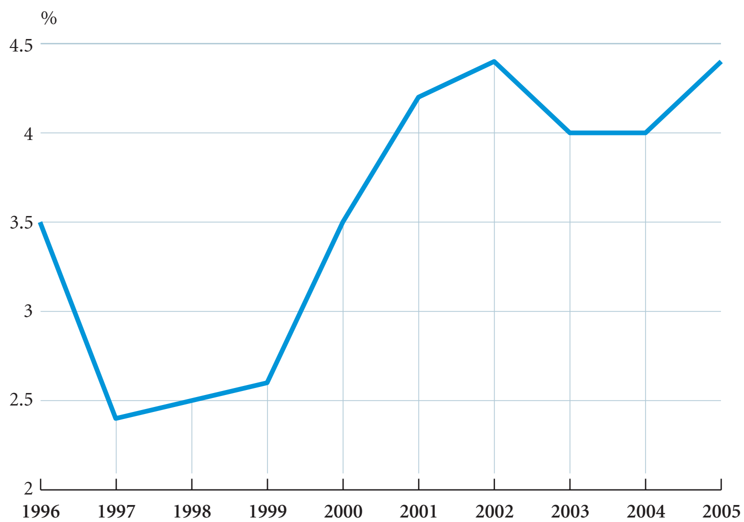
This trend is being noted with concern both inside and outside Spain's borders. The latest warning came from the chairman of the European Central Bank in his appearance before the Economic Affairs Committee of the European parliament. Without directly mentioning Spain, but with a clear allusion to this country, the monetary authority head warned of the loss of competitiveness of «certain economies» with growing foreign deficits and high inflation. He also voiced his concern about the «abnormal phenomenon» of the real estate boom.

Are all these fears justified? The answer in part is yes but it is not likely to have any effect. It must be admitted, however, that the vulnerability of Spain's economy is high, given that the heavy dependence of its growth on consumption and construction is a factor of considerable weight. The contribution of construction demand to GDP growth in recent years has swung at around one percentage point (approximately one-third of total growth), without taking into account the multiplier effect this has on the rest of economic activity.

Heavy dependence of Spain's economic growth on consumption and construction make it somewhat more vulnerable...

RISE IN PRICES CONTINUES

Change in GDP deflator



SOURCE: INE and internal figures.

...although current conditions very different from past when some periods of sharp growth preceded others with sharp readjustment.

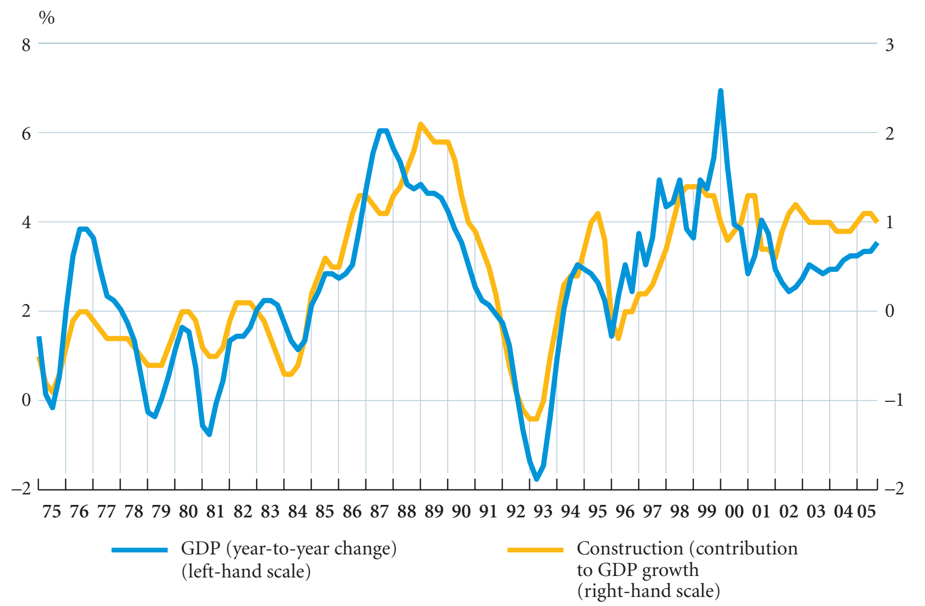
As may be seen in the following graph, the expansionist stages in the construction cycle very often preceded periods of very sharp readjustment which ended up dragging down the whole of the economy. Empirical evidence also shows a close relation between the slowdown in prices in the real estate market and the sharpness of those readjustments. In these circumstances, the rapid increase in household indebtedness (basically involving mortgage loans at variable interest and therefore very sensitive to interest rate changes) adds a new factor of instability.

Does this mean we are headed for a sharp halt in economic activity? By no means is this the most likely hypothesis. In spite of the fact that the current situation is fairly complicated, the coordinates are now quite different. The key lies in the fact that the problems which wracked Spain's economy in earlier periods are now losing their virulence under the protective umbrella of the euro. If Spain were not in the EMU, there is no doubt that the foreign deficit and the excessive inflation Spain is now suffering would have devastating effects. As happened many times in the past, the currency's exchange rate would drop sharply and interest rates would go sky-high. In this context, Spain would be in recession.

Circumstances, however, are now different. The foreign deficit and excessive inflation in Spain are no more than a regional anecdote within the framework of the euro area. Neither the euro exchange rate nor interest rate levels are affected by Spain's particular situation, given that their trend is dictated by the overall conditions in the area as a whole. Are these imbalances therefore totally innocuous? Not at all, but the consequences are less dramatic. This does not imply that we should accept them

PERFORMANCE IN CONSTRUCTION SIGNIFICANTLY AFFECTING GDP GROWTH

Percentage year-to-year change in GDP and contribution of construction sector to growth of this figure



SOURCE: INE and internal figures.

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)

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

passively, given that if we continue in this way for very much longer the erosion in the competitiveness of Spain's economy could end up weakening its production structure and bring about the loss of part of the ground won in recent years.

What is the way out of this situation? In the forecast scenario of progressive moderate increases in increase rates by the European Central Bank, if Spain's economic policy takes advantage of the margin for manoeuvre it still has and the problems mentioned are dealt with decisively, it is perfectly possible to correct them without any great trauma. At least it would be desirable to firmly maintain the current balance in the government accounts and to urgently continue to make the structural reforms still pending, in order to give the economy greater flexibility and improve competitiveness in product and services markets. In addition, the moderation foreseen in national

In scenario including moderate interest rate rises most likely hypothesis is gradual slowdown in growth rate of national demand and improvement of current imbalances.

demand and consumption (confirmed by the tendencies reported by National Accounting and the recent trend in the main economic activity indicators) may help to facilitate matters.

Along the same lines, we may expect a gradual easing off of the increase in housing prices within the framework of moderate increases in interest rates mentioned earlier.

In this way, it would be possible to deactiviate what some people are calling a veritable time-bomb under Spain's economy. In addition, the expected recovery in Europe could help, by means of an increase in exports, to put Spain's foreign position in better balance while, at the same time, reinforcing the incipient recovery in industry which is shown by National Accounting.

SUPPLY INDICATORS

Percentage change over same period year before

	2004	2005	2005						2006
			1 Q	2 Q	3 Q	October	November	December	January
Industry									
Electricity consumption (1)	4.0	3.6	4.5	2.7	3.2	1.1	4.1	5.7	3.2
Industrial production index (2)	1.6	0.6	0.3	01	0.6	–0.1	1.0	4.1	...
Confidence indicator for industry (3)	–2.5	–4.8	–3.3	–7.0	–4.7	–5.0	–5.0	–3.0	–7.0
Utilization of production capacity (4)	79.8	80.2	79.4	79.5	81.1	–	80.7	–	79.7
Imports of non-energy intermediate goods (5)	6.6	1.6	0.7	3.6	0.6	–0.7	–1.4	5.9	...
Construction									
Cement consumption	3.7	5.1	–0.2	11.2	5.2	4.1	1.6	6.7	...
Confidence indicator for construction (3)	13.6	22.4	23.7	15.0	22.7	23.0	39.0	23.0	21.0
Housing (new construction approvals)	8.0	6.2	3.7	7.6	2.8	7.0	9.2	15.6	...
Government tendering	18.3	18.6	5.8	36.6	3.1	63.3	42.9	15.7	...
Services									
Retail sales	5.5	4.4	4.1	5.4	4.4	3.3	3.6	4.2	...
Foreign tourists	3.1	6.1	7.6	4.6	7.0	4.6	7.7	2.8	–0.1
Tourist revenue inflows	3.8	3.8	–0.8	–0.3	6.6	8.4	10.0	...	...
Goods carried by rail (km-tonnes)	–3.5	–3.2	–14.3	–4.7	–2.3	27.9	–4.4	14.6	...
Air passenger traffic	8.0	9.1	8.4	8.5	10.2	8.2	10.5	8.8	7.7
Motor vehicle diesel fuel consumption	7.2	4.8	2.5	7.5	4.9	3.4	4.0	...	...

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.

DEMAND INDICATORS

Percentage change over same period year before

	2004	2005	2005						2006
			1 Q	2 Q	3 Q	October	November	December	January
Consumption									
Production of consumer goods (*)	–0.2	0.9	0.1	1.1	1.4	0.0	0.4	2.3	...
Imports of consumer goods (**)	13.4	7.9	6.5	8.4	7.8	6.8	7.7	11.5	...
Car registrations	9.8	0.8	–0.0	4.9	2.3	–9.6	–4.0	–0.4	–0.3
Credit for consumer durables	5.5	13.3	8.8	13.7	17.2	–	–	–	–
Consumer confidence index (***)	–10.8	–10.9	–9.7	–11.3	–11.3	–11.0	–13.0	–10.0	–12.0
Investment									
Capital goods production (*)	1.8	–0.2	–0.8	0.6	–1.3	–0.9	–1.2	4.1	...
Imports of capital goods (**)	14.9	20.4	28.6	36.0	13.5	–4.0	47.9	–11.9	...
Commercial vehicle registrations	11.7	13.2	9.2	17.9	13.9	1.6	10.9	22.1	–5.8
Foreign trade (**)									
Non-energy imports	9.8	6.0	5.7	9.0	4.7	1.4	7.8	4.1	...
Exports	5.2	0.2	–3.1	2.5	1.2	–2.4	1.5	1.3	...

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

Who pays taxes in Spain?

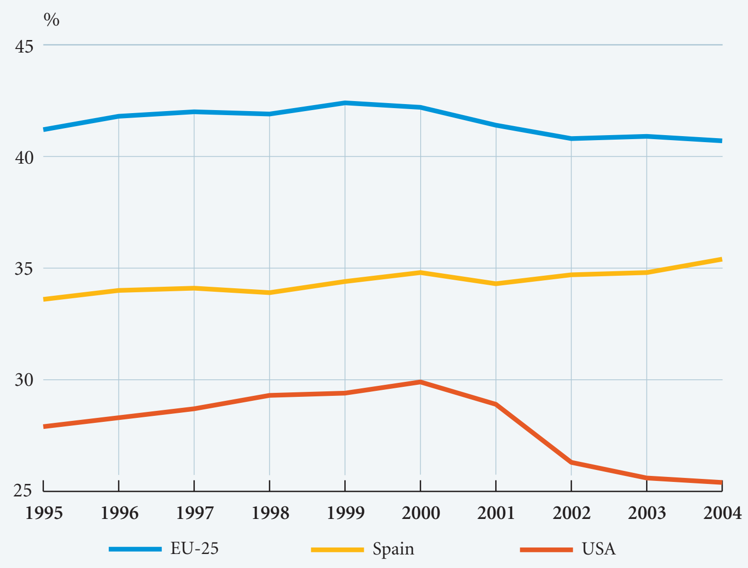
When it comes to taxes, this is a matter that is very sensitive in the economy. Rivers of ink have been spent in trying to justify taxes within the economic order and its effects on that order, almost always looking at two basic concepts – equity and efficiency. But apart from any theoretical disposition, all of us have very direct experience of taxes in our daily lives. Benjamin Franklin on one occasion stated, not without irony, that the only thing certain in this life was death and taxes.

In making a first assessment of Spain's tax system we come up against an evident paradox: tax rates are relatively high in comparison with the average for neighbouring countries but the effective tax load is one of the lowest in Europe. Something, therefore, must be going wrong. According to figures from Eurostat, revenues of general government in Spain from taxes and Social Security contributions represented 35.4% of the GDP in 2004 to stand well below the average for the European Union made up of 25 member states (40.7%). In fact, the tax load in Spain is very similar to the average of the new member states of the EU from Eastern Europe but holds the second-last place in the ranking of countries within the euro area, only ahead of Ireland.

Within the framework of the OECD, Spain stands behind leading countries, such as the United States and Japan, where the tax load swings at around 25% of the GDP. It is necessary to relate the greater growth potential of the US economy compared with that of Europe with the higher tax pressure borne by the Old Continent as a whole. Spain stands in a situation intermediate between Europe and the United States. While the tax load in Spain is still far from the European average, there is a progressive trend toward convergence. Taking into account the above considerations, is the European model the one to follow?

TAX LOAD IN SPAIN INCREASING BUT STILL FAR FROM EUROPEAN AVERAGE

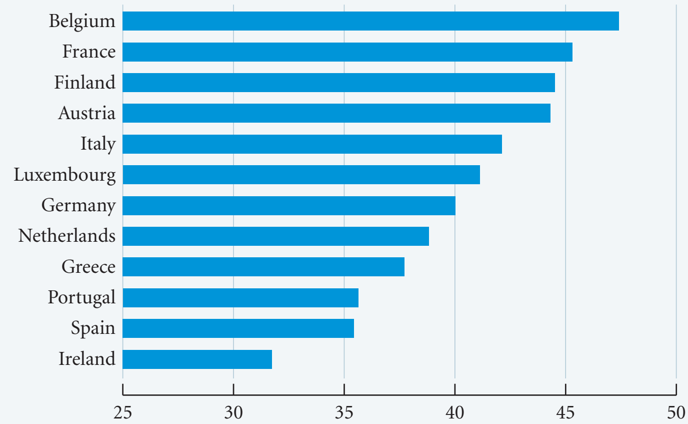
Taxes and Social Security contributions as percentage of GDP



SOURCE: EUROSTAT, OECD and internal figures.

SPAIN AT BOTTOM OF TAX LOAD RANKING IN EURO AREA

Taxes and Social Security contributions as percentage of GDP



SOURCE: EUROSTAT and internal figures.

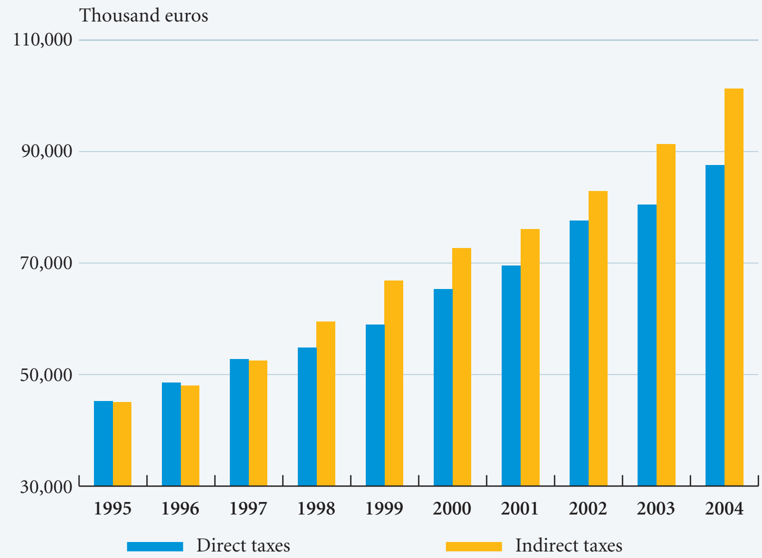
In the middle of the Nineties in Spain, the load from the main direct taxes, such as personal income tax, corporate tax and succession duties, was slightly higher than that from indirect taxes, such as value added tax (VAT), among others, and those levied by local authorities. Following the major reforms in 1998 and 2002, however, the situation was turned around and indirect taxes are now gaining ground, particularly in the past three years. This trend lies well within the framework of international taxation trends which went through a spectacular change following the reforms applied in the United States and the United Kingdom, in the two year period 1984-1986. In 2004, the share of direct taxes in total tax collections (excluding Social Security contributions) had fallen to 46%, four percentage points less than in 1995. Personal income tax and VAT are the main supports of Spain's tax system (between the two they provide nearly 55% of total collections by general government), although we should also point out the clearly upward trend in corporation tax in the past ten years.

The personal income tax is the most controversial. According to figures from the Taxation Agency, income from work in 2003 represented somewhat more than 80% of total net earnings declared, those relative to business activities were slightly above 10% and the rest (including those earned on capital) made up the remaining 10%. What is notable is that net earnings declared on work for wages amounted to around 17,624 euros on average, whereas that corresponding to self-employed persons and small entrepreneurs was under 12,000 euros. The excessive tax load borne by those on wages may be evaluated through figures from National Accounting. According to that source, wage incomes in that year amounted to around 67% of gross household income, a percentage lower than the tax load imposed. Nevertheless, it is necessary to take into account that the mobility of the capital factor, of which all countries are in favour, means it obtains a more favourable treatment in practically all of them.

Leaving aside the origin of income taxed, another feature of the personal income tax cries out for attention, namely the polarization of tax on middle incomes. Those declaring tax with income levels between 21,000 and 60,000 euros, which in 2003 represented 22% of all taxpayers, contributed 48% of total collections to the

INCREASING SHARE OF INDIRECT TAXES IN TOTAL TAX COLLECTIOS

Taxes obtained by Spanish general government as a whole



SOURCE: National Institute of Statistics and internal figures.

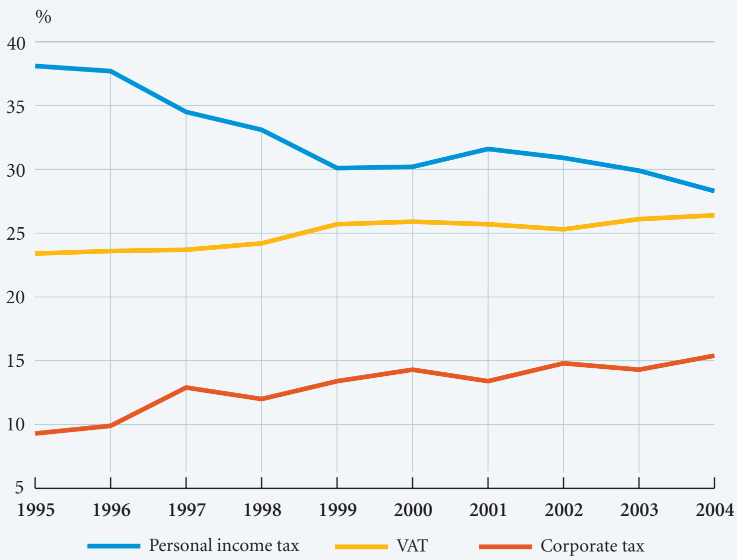
public purse (those taxpayers with income levels higher than 60,000 euros were less than 350,000 in number, about 2% of the total). How do we explain these anomalies? There are very many reasons but, at least, we should cite some of them: tax fraud and the lower level of control exercised over non-wage incomes; the high tax rates applicable in the upper income levels (the present maximum is 45% while the current corporate tax at 35% is much lower), something which favours a move away from personal income tax on the part of those who can lawfully take advantage of a legal entity and, naturally, the distortion that taxation bases undergo due to the complicated system of deductions and benefits applicable.

The real proof of the coherence of any tax system is to be found in the maxims enunciated by Adam Smith in the second half of the 18th century. According to the father of modern economics, taxes should meet four fundamental rules: «the subjects ought to support the treasury in proportion to their respective abilities» (maxim of equality); «the tax each individual is bound to pay ought to be certain and not arbitrary» (maxim of certainty or transparency); «tax ought to be levied … when it is likely to be most convenient for the contributor to pay it» (maxim of convenience); «every tax ought to take out and keep out of the pockets of the people as little as possible over and above what it brings into the public treasury» (principle of efficiency). Does the Spanish tax system meet these requirements? We have already seen that it does so only partly. The main problem is that not everyone pays and that those who do pay, pay too much. On the other hand, simplicity is not precisely its main virtue. It is undoubtedly difficult for the taxpayer to understand the plethora of deductions, benefits and tax privileges of all kinds involved.

As things stand, it does not seem that the reforms recently put forward by the government will bring about effective solutions to resolve the defects indicated. Some of the measures announced go in the right direction

PERSONAL INCOME TAX AND VAT MAKE UP MAIN SUPPORTS OF SPAIN'S TAX SYSTEM

Share of each tax in total tax collections



SOURCE: National Institute of Statistics and internal figures.

but lack the necessary intention to promote the serious reforms that Spain's tax system requires. What is surprising, for example, is that it proposes a cut in the maximum rate for the personal income tax (it would go from 45% to 43%), which would be lower than the decrease made in the rate applicable to corporation tax (from 35% to 30%). Far from reducing the distance between these two rates it will increase them, thus perpetuating the tendency to the negative incentives mentioned above.

Labour market

Number employed goes above 19 million at end of 2005.

Signs of slight drop in employment with change in year

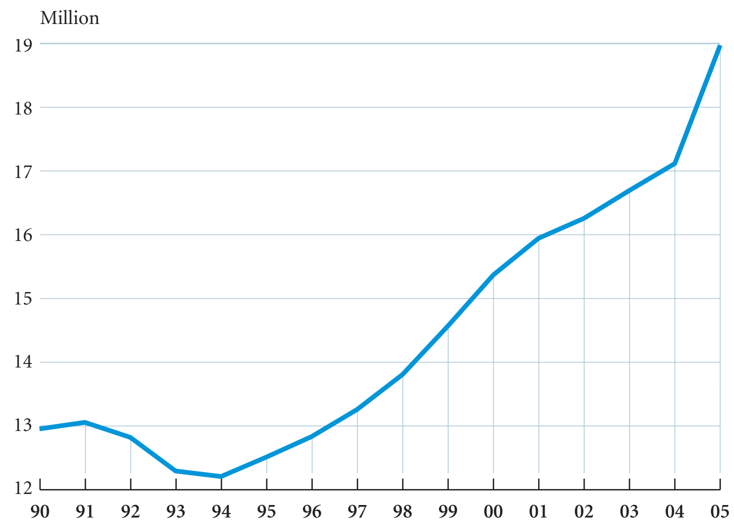
At the end of 2005, the number of those employed amounted to 19.31 million persons, with more than a million jobs being created during the year, according to the Labour Force Survey. When adjusted for the methodological changes introduced by the National Institute of Statistics at the beginning of the year the figure stood at 894,100 new jobs, a year-to-year increase of 4.9%. This was extraordinarily high growth that is difficult to tally with an economy growing by around 3.5%. A more detailed look at these figures shows that a large part of this growth came from part-time hiring contracts with an average work-period of slightly more than 16 hours a week. If we homogenize the work-period, the growth rate of employment finally works out at slightly above 3%, a figure closer to that estimated by National Accounting.

In addition, the immigration factor also played an important role in a year when moves were made to give normal work status to foreign workers in Spain. The Labour Force Survey indicates an increase in employment of foreign workers of around 25% on average in 2005, which raised their share of total employment to 11.3%.

In any case, the rate of job creation at the end of the year showed some signs of moderating. If we look only at full-time work, the various economic sectors, with the exception of

1995-2005: THE EMPLOYMENT DECADE

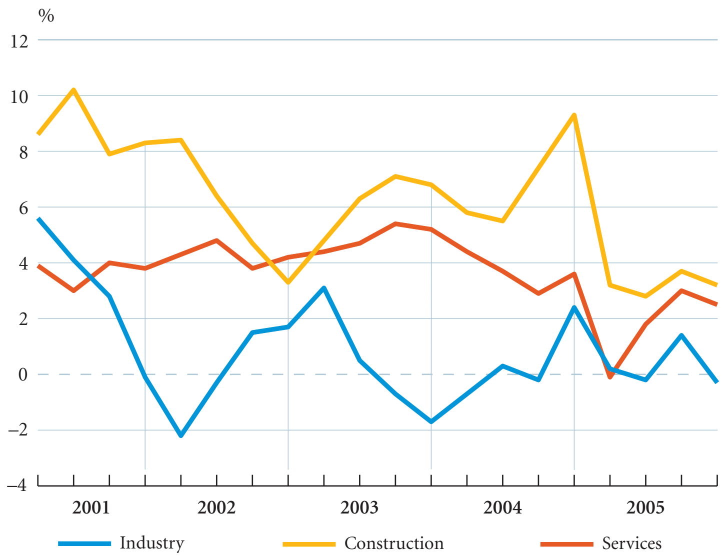
Number of occupied



SOURCE: National Institute of Statistics.

MODERATION IN EMPLOYMENT SPREAD OVER ALL SECTORS

Year-to-year change in estimated full-time employment



SOURCE: National Institute of Statistics.

agriculture, recorded rates of increase in employment lower than in previous quarters. Construction remained strong but less so. Industry continued its process of readjusment while services seemed to be losing steam although full-time work was up by 2.5%. To some extent the fourth quarter may have been a turning point in the strong course followed by employment.

Employment losing strength in various sectors although performance quite varied depending on branch of economic activity.

In industry, however, performances were very uneven depending on the branch of economic activity. The most negative figures showed up in transportation equipment, electrical and electronic equipment, clothing and paper and graphic arts. On the other hand, chemicals and plastics manufacturing reported a definite recovery as was the case in leather and footwear. In services, the sitution of slowdown was especially notable in the area of the public service and in non-air transportation, given that in other economic activities the rates of increase in employment were generally high.

Another relevant factor in 2005 was a continuation of the entry of women into the labour market. The rate of female employment reached 52.8% of those of working age, nearly three points more than the year before. In any case, these figures are still a long way from those for countries of northern Europe, at more than 70%. The use of part-time work has shown up to be a key vehicle for women to enter the labour market and is likely to continue to be so, given the still relatively low use of this hiring formula.

Part-time work playing decisive role in getting women into jobs.

In fact, in spite of the major growth of part-time hiring formulas, the proportion is relatively low compared with certain European countries. At the end of 2005, part-time work accounted for 12.0% of total employment (8.8% in 2004). This proportion rose to 23.3% in the female population as against 4.4% among males.

Temporary job status at all-time highs.

Finally, the notable growth of employment in 2005 did not in any way contribute to the reduction of temporary work situations. What is more, at the end

ESTIMATED EMPLOYMENT

Fourth quarter of 2005

	No. of employees (thousands)	Quarterly change		Annual change (*)		Annual change (**)		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	1,006.8	14.6	1.5	24.2	2.5	26.4	2.7	5.2
Non-farm	18,307.5	108.5	0.6	869.9	5.0	999.9	5.8	94.8
Industry	*3,288.5*	*–22.5*	*–0.7*	*–12.1*	*–0.4*	*41.7*	*1.3*	*17.0*
Construction	*2,422.8*	*26.5*	*1.1*	*158.0*	*6.8*	*91.6*	*3.9*	*12.5*
Services	*12,596.1*	*104.4*	*0.8*	*724.0*	*6.2*	*866.5*	*7.4*	*65.2*
By type of employer								
Private sector	16,446.3	168.8	1.0	...	...	1,026.1	6.7	85.2
Public sector	2,868.0	–45.6	–1.6	...	...	0.1	0.0	14.8
By work situation								
Wage-earners	15,841.6	92.1	0.6	896.0	6.0	819.2	5.5	82.0
Permanent contract	*10,491.3*	*158.2*	*1.5*	*337.2*	*3.4*	*417.4*	*4.1*	*54.3*
Temporary contract	*5,350.4*	*–66.0*	*–1.2*	*558.8*	*11.3*	*401.9*	*8.1*	*27.7*
Non-wage-earners	3,446.2	24.8	0.7	–48.3	–1.5	199.4	6.1	17.8
Entrepreneurs with employees	*1,029.5*	*52.5*	*5.4*	...	...	*64.1*	*6.6*	*5.3*
Entrepreneurs without employees	*2,151.6*	*–4.9*	*–0.2*	...	...	*119.7*	*5.9*	*11.1*
Family help	*265.1*	*–22.8*	*–7.9*	...	...	*15.6*	*6.3*	*1.4*
Other	26.4	6.2	30.7	46.5	247.6	7.5	39.7	0.1
By time worked								
Full-time	16,999.0	35.7	0.2	558.6	3.4	310.6	1.9	88.0
Part-time	2,315.3	87.5	3.9	335.5	21.0	715.7	44.7	12.0
By sex								
Males	11,549.6	24.7	0.2	432.9	3.9	472.0	4.3	59.8
Females	7,764.7	98.5	1.3	461.2	6.4	554.3	7.7	40.2
TOTAL	**19,314.3**	**123.1**	**0.6**	**894.1**	**4.9**	**1,026.3**	**5.6**	**100.0**

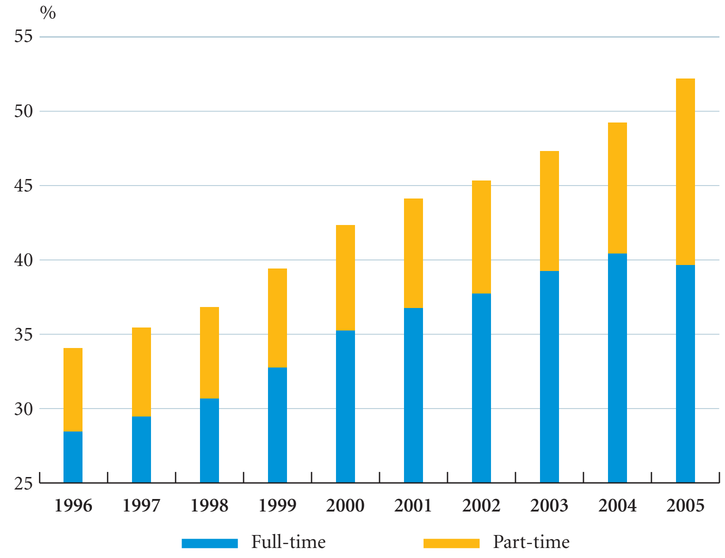
NOTES: (*) Adjusted for effect of methodological changes introduced in first quarter of 2005.
(**) Not adjusted for effect of these changes.
SOURCE: National Institute of Statistics and internal figures.

of 2005 the proportion of temporary hiring contracts over total wage-earners reached 33.8%, the highest figure at year-end in recent history. Also in this case, there was still a vast gap compared with Spain’s neighbour countries.

In addition, registrations with Social Security, adjusted for the impact of the process of applying normal work status to foreign workers, showed a slower profile and is more in keeping with the growth rate of the economy. In January, Social Security registrations grew by 5.4%, down three decimals from the previous month. If we discount foreign workers joining Social Security as a result of the process mentioned above (totalling 550,136 as of December 31, 2005), the increase in registrations stands at 2.6%. The figure for registrations of foreign workers obtaining work papers has practically reached its upper limit given that there are only 3,236 applications still awaiting decision and 23,134 possible registrations in those

FEMALE EMPLOYMENT RATE INCREASING AS RESULT OF PART-TIME WORK

Females employed over total female population between 16 and 64 years



SOURCE: INE and internal figures.

cases approved but still not actually registered.

The good performance in employment has helped bring about a sharp reduction in estimated unemployment (11.1% in homogeneous terms) putting the total at 1,841,300 persons in the fourth quarter. As a result, the unemployment rate stood at 8.7%, at the level of the European average. In any case, there were still notable differences between indices for the male and female groups, at 6.6% and 11.6% respectively. The level of unemployment among those under 25 years of age stood at 18.6%.

The porportion of households where all members were without work stood at 2.6%, a relatively low rate. In addition, the unemployment rate among heads of family stood at 5.8% while for spouses and offspring of the reference person the figures went up to 8.0% and 14.5% respectively. Long-term unemployment, that is to say, that with a duration of more than one year, affected 557,100 persons, some 30.3% of those without work.

Estimated unemployment down sharply while unemployment reaches European levels.

From a geographical perspective, the situation shows notable differences between autonomous communities. Those autonomous communities with the most dynamic profile, after adjustment of figures, were La Rioja, Murcia, Andalusia, Cantabria and Castile-La Mancha, all showing increases in employment of more than 6%. Among the lower group, above 5%, came Canary Islands, Valencian Community, Catalonia and Madrid Community. At the opposite end of the scale, Galicia, Asturias, Extremadura and Aragon showed the lowest increases in employment. In any case, the limitations applied to growth rates for Spain as a whole must apply here even more strongly, particularly in those autonomous communities of relatively small size.

La Rioja, Murcia, Andalusia, Cantabria and Castile-La Mancha record highest employment rate in 2005.

ESTIMATED UNEMPLOYMENT

Fourth quarter of 2005

	No. of unemployed	Quarterly change		Annual change (*)		Annual change (**)		Share %	% of labour force
		Absolute	%	Absolute	%	Absolute	%		
By sex									
Males	821.2	22.0	2.8	–89.4	–9.6	–110.3	–11.8	44.6	6.6
Females	1,020.1	54.3	5.6	–150.4	–12.3	–207.7	–16.9	55.4	11.6
By age									
Under 25 years	456.3	–9.5	–2.0	...	...	–50.4	–9.9	24.8	18.6
Other	1,385.0	85.8	6.6	...	...	–267.6	–16.2	75.2	7.4
By personal situation									
Long-term unemployment	557.1	34.8	6.7	...	...	–52.6	–8.6	30.3	–
Seeking first job	220.3	–30.3	–12.1	...	...	–90.5	–29.1	12.0	–
Other	1,063.9	71.8	7.2	...	...	–174.9	–14.1	57.8	–
TOTAL	**1,841.3**	**76.3**	**4.3**	**–239.8**	**–11.1**	**–318.0**	**–14.7**	**100.0**	**8.7**

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

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Fourth quarter of 2005

	Labour force			Employet			Unemployed			Unem-ployment rate (%)
	Total (thousands)	Annual change (*)	% annual change (*)	Total (thousands)	Annual change (*)	% annual change (*)	Total (thousands)	Annual change (*)	% annual change (*)	
Andalusia	3,510.5	150.6	4.4	3,025.2	179.6	6.3	485.3	–29.0	–5.3	13.8
Aragon	602.9	10.5	1.8	568.8	13.4	2.5	34.1	–2.8	–8.8	5.7
Asturias	457.0	9.5	2.2	413.3	8.5	2.2	43.7	1.0	2.2	9.6
Balearic Islands	494.1	14.6	3.0	457.1	16.7	3.7	37.0	–2.1	–5.3	7.5
Canary Islands	966.3	28.7	3.1	863.2	47.7	5.8	103.1	–19.0	–19.2	10.7
Cantabria	265.9	10.8	4.3	244.4	14.6	6.5	21.5	–3.8	–13.3	8.1
Castile-Leon	1,128.0	22.1	2.0	1,031.7	32.9	3.4	96.3	–10.8	–9.4	8.5
Castile-La Mancha	861.9	55.5	6.8	781.0	45.8	6.3	80.9	9.7	11.7	9.4
Catalonia	3,598.2	135.8	3.9	3,359.2	175.1	5.6	239.0	–39.3	–12.1	6.6
Valencian Community	2,289.0	61.8	2.8	2,105.7	100.5	5.0	183.3	–38.7	–17.2	8.0
Extremadura	454.3	0.8	0.2	384.7	8.5	2.3	69.6	–7.7	–9.6	15.3
Galicia	1,251.7	–1.7	–0.1	1,137.4	16.5	1.5	114.3	–18.2	–11.5	9.1
Madrid Community	3,084.2	78.6	2.7	2,901.5	138.9	5.1	182.7	–60.3	–29.5	5.9
Murcia	631.7	37.0	6.0	584.8	39.3	7.1	46.9	–2.3	–3.7	7.4
Navarre	299.3	12.3	4.4	281.5	10.8	4.0	17.8	1.6	10.9	5.9
Basque Country	1,048.4	17.8	1.7	981.3	33.9	3.6	67.1	–16.1	–17.1	6.4
La Rioja	153.7	9.5	6.8	143.7	9.5	7.1	10.0	0.0	0.1	6.5
Ceuta and Melilla	58.5	...	...	49.8	...	...	8.7	...	...	14.9
TOTAL	**21,155.6**	**654.4**	**3.2**	**19,314.3**	**894.1**	**4.9**	**1,841.3**	**–239.8**	**–11.1**	**8.7**

NOTES: (*) Corrected of the impact of the introduced methodologic changes in the first trimester of 2005.
SOURCE: National Institute of Statistics and internal figures.

Registered unemployment: increase in January

Figures for unemployment supplied by offices of the Public Employment Service also point to some cooling off in the situation in the initial month of 2006. In fact, the number of those registered rose that month somewhat above the same month the previous period so that unemployment reached 2,171,503 persons, according to the statistics supplied by the Information Department of the Public Employment Service, putting it 0.2% below the same month in 2005.

The worsening of the situation in January came as a result of those seeking a first job, a figure that rose sharply. On the other hand, the performance of unemployment in the various production sectors was more favourable than in the same month in 2005.

Increase in registered unemployment also points to cooling off in labour market.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

January 2006

	No. of unemployed	Change over December 2005		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	66,401	1,174	1.8	10,697	19.2	3.1
Industry	305,207	3,888	1.3	–6,436	–2.1	14.1
Construction	241,161	–3,939	–1.6	–15,895	–6.2	11.1
Services	1,329,141	62,752	5.0	–4,105	–0.3	61.2
First job	229,593	4,691	2.1	10,643	4.9	10.6
By sex						
Males	864,667	12,704	1.5	–27,892	–3.1	39.8
Females	1,306,836	55,862	4.5	22,796	1.8	60.2
By age						
Under 25 years	288,603	12,708	4.6	8,452	3.0	13.3
All other ages	1,882,900	55,858	3.1	–13,548	–0.7	86.7
TOTAL	**2,171,503**	**68,566**	**3.3**	**–5,096**	**–0.2**	**100.0**

SOURCE: INEM and internal figures.

Prices

CPI shows worst start to year since 1994.

Most inflationary components in January are energy, processed foods and non-energy industrial goods.

Inflation rate reaches 4.2% in January

The figure for Spain's consumer price index (CPI) for January was bad, the worst since 1994. At year-to-year rate, the increase was 4.2% and, furthermore, the differential with the countries in the euro area also continued to rise. This time it went to 1.8 percentage points, the highest in any month of January in the past 20 years.

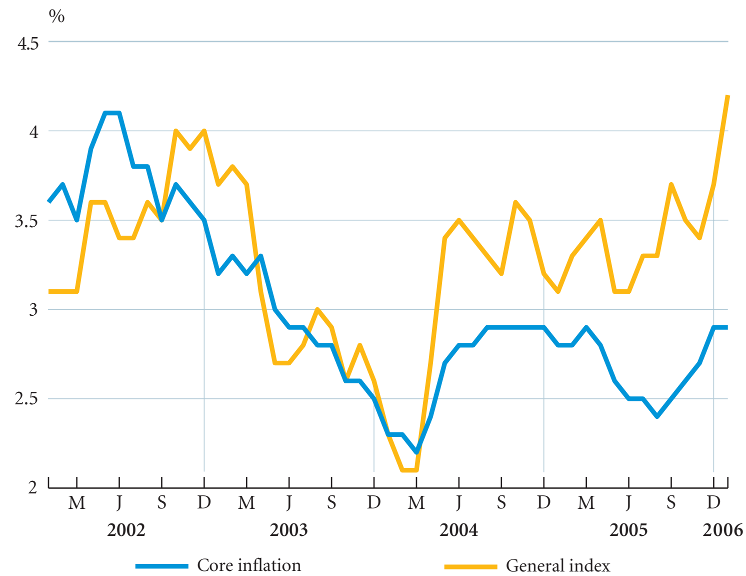
Concern about the trend in prices led the government to weigh the possibility of bringing in a series of measures specifically to halt inflation.

The increase in prices in January had its definite culprits, namely energy, processed foods and non-energy industrial products. In the first case, the continuing rise of oil was a determining factor as well as the sharp rise in electricity rates, a controlled price. The same thing happened with public transport which, with the excuse of the rise in fuel prices, showed a substantial increase. In the case of processed foods, the problems came with the price of olive oil which went up more than 30%, with a notable effect on the general index.

In turn, the upward move in non-energy industrial goods seemed to be due to the difficulty in absorbing increases in energy costs and other increases. Furthermore, the rise in prices of non-energy industrial goods

CPI SETS OFF ALARM BELLS

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



SOURCE: National Institute of Statistics and internal figures.

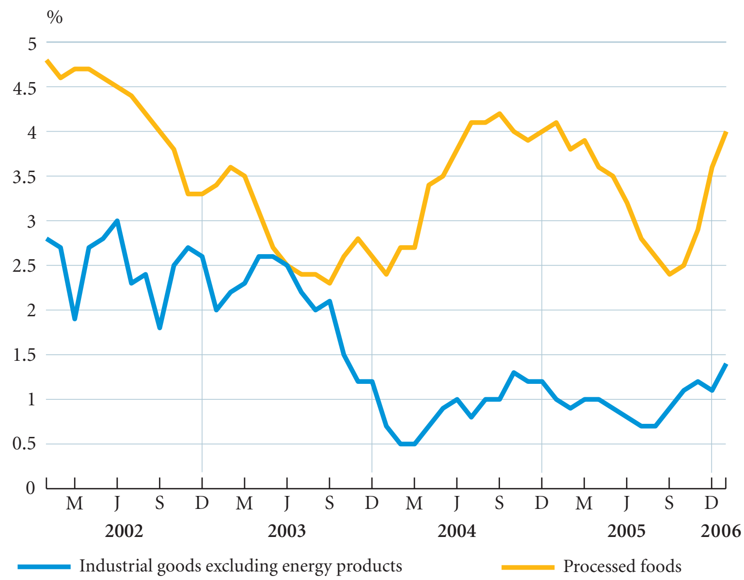
CONSUMER PRICE INDEX

	2005			2006		
	% monthly change	% change over December 2004	% annual change	% monthly change	% change over December 2005	% annual change
January	–0.8	–0.8	3.1	–0.4	–0.4	4.2
February	0.3	–0.6	3.3			
March	0.8	0.2	3.4			
April	1.4	1.6	3.5			
May	0.2	1.8	3.1			
June	0.2	2.1	3.1			
July	–0.6	1.5	3.3			
August	0.4	1.9	3.3			
September	0.6	2.5	3.7			
October	0.8	3.4	3.5			
November	0.2	3.5	3.4			
December	0.2	3.7	3.7			

SOURCE: National Institute of Statistics.

INDUSTRIAL GOODS AND PROCESSED FOODS MOVING UP

Year-to-year change in components of CPI



SOURCE: National Institute of Statistics and internal figures.

to a modest 1.4% came in a context in which reductions at the January retail sales were sharper than last year so that the potential rise in this CPI component could have been much higher.

Tobacco temporarily improves aspect of CPI.

In this respect, the price of tobacco also appreciably helped to compensate increases in the January CPI. In fact, price reductions by some manufacturers to ease the effects of anti-tobacco legislation and the rise in taxes cut the

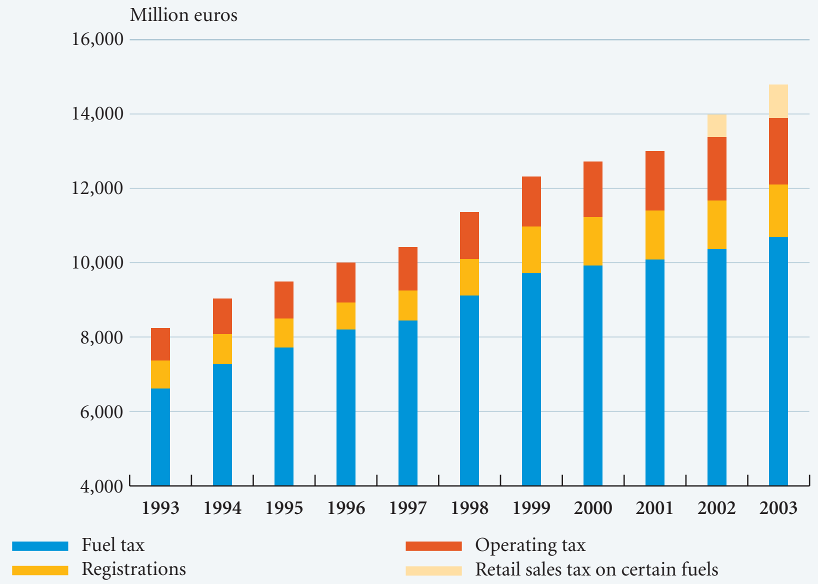
Taxes on motor vehicles: reforms needed

The car is one of the main sources of tax funding for general government both in Spain and the developed countries as a whole. The European Association of Car Manufacturers estimates the annual amount collected by governments of the European Union (EU-15) thanks to cars at 350 billion euros, or 3.7% of the gross domestic product (GDP). In Spain, the taxes coming from the car, according to the same source, are around 23.7 billion euros, that is to say, around 3.0% of the GDP using figures for 2003. This figure includes both the general tax rate and specific taxes, the amount for general taxes being more of an estimate as opposed to greater accuracy in the case of the specific tax component.

General tax levied on the car is equivalent to that borne by any other consumer good acquired, used, maintained or transferred and therefore should not be considered as unique so far as concerns a specific evaluation of fiscal policy. This component of tax collections mainly includes tax arising from value added tax (VAT) when buying a vehicle, using it (VAT on fuels and oils), maintaining it (VAT on repairs) or when it changes owners. Finally, notable as a tax of a general type is that payable on insurance premiums.

TAX ON KEEPING A CAR ON THE ROAD

Budgetary figures for various taxes



SOURCE: Ministry of Finance and internal figures.

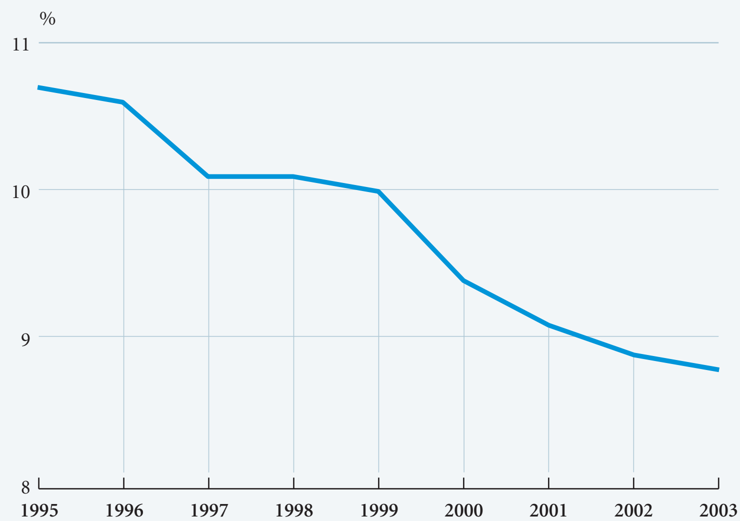
Specific taxes, on the other hand, apply to various situations such as the purchase, operation and use of a car. Purchase is taxed with a special tax on means of transport, a one-time *ad valorum* payment commonly known as registration and paid at the autonomous community level. Ownership is covered by the tax on mechanical traction vehicles, more commonly known as operating tax, which is an annual payment, and of variable rate depending on the type of vehicle. This comes under the jurisdiction of the local authority. Vehicle use is taxed indirectly by the special tax on fuels, at a fixed rate depending on the type of fuel, which is incorporated in the sale price at the pump and partly collected by the autonomous community governments. Finally, there is the retail sales tax on various fuels which came into force in 2002. This tax is at a fixed rate and is made up of a central government segment that is obligatory and an optional segment which may be applied by autonomous communities.

In 2003, the last year for which complete figures are available, total collections for special taxes amounted to 14.8 billion euros, that is to say, 1.9% of the GDP or, what amounts to the same thing, 8.8% of total tax collections, excluding social security contributions, by all general government (except Social Security). We should point out that in recent years this proportion has tended to drop, mainly because of the sharp growth in the general tax load and the freezing of tariffs applying to special taxes on fuels in the two years prior to Spain's joining the European Monetary Union.

The magnitude of this figure from an economic or budgetary point of view has no clear counterpart from the point of view of specific policies linked to mobility or outside effects arising from use of the car. The tax on means of transport in 1993 thus took the place of the former luxury tax (that VAT did not compensate for) which in economic terms, at least today, lacks any significance to the extent that it would now be difficult to generally define the car as a luxury good. In addition, the special taxes on fuels in their original concept did not incorporate the consideration of any outside negative social factors from the consumption of fuels, whether of an environmental, health or traffic congestion nature. Only the tax on mechanical traction vehicles, at the autonomous community level, takes into consideration the purpose of support for the financing of health costs. In this way, pure tax-collection aims seem to almost exclusively dominate the present organization of taxation on the car in Spain.

TAXATION ON THE CAR GROWING LESS THAN OTHER TAXES

Taxation on cars over total taxation by general government (*)



NOTES: (*) Excluding Social Security contributions.
SOURCE: Ministry of Finance and internal figures.

Nevertheless, this picture could change appreciably in the near future. Last July the European Union presented a proposed directive to reform taxation on private vehicles which had two main objectives. In the first place, it was designed to contribute to the development of the single market by avoiding distortions which both for consumers and manufacturers involve as many tax peculiarities as there are member states. Secondly, it was intended to use tax policy as an instrument of environmental policy.

In the first place, these objectives would be reached through suppression of the registration tax in those countries which now apply it in order to contribute to equalizing prices of vehicles at the factory gate in the various countries. The consequences should be notable in terms of lower prices to the consumer and, furthermore, this would foster the replacement of cars now on the road with subsequent improvements in safety and energy efficiency. The second aim deals with reform of tax on vehicle operation (ownership) based on objective conditions of respect for the environment by each and every vehicle, establishing tax based on CO_2 emissions.

Approval of this directive and the subsequent process of legislative implementation could prove a good opportunity for rationalizing taxes on motor vehicles in Spain. The main aim of taxation should also open up consideration of other objectives consistent with international commitments on questions of the environment and the needed improvement of policy on mobility and safety.

general index by around one decimal which, undoubtedly will have to be added to the CPI in the month of February, due to the brief period those measures have been in effect.

In addition, prices of services continue to show high growth, remaining stable with no sign of moderation, at around 3.5%-4.%. It is true that some of these prices began the new year somewhat less upward, particularly in insurance, financial services and some segments of education. Many others, however, are still a long way from showing any signs of containment. Fields in which there is little competition, markets for public services where attempts are being made to bring rates close to costs and the need to adjust final prices to increases in rentals of commercial premises, work in favour of these sharp sustained price rises.

CPI should improve as of March if energy situation no worse.

Finally, fresh foods are not helping inflation. The sharp increase in these prices, above 5%, although relatively stable, have put pressure on the CPI, Nevertheless, the presumed containment of farm prices at the beginning of 2006 may ease the road to moderation. In spite of everything, the CPI should begin a gradual course of moderation as of March. The main players in this scenario of lower inflation will be energy and, very likely, fresh foods. On the other hand, it will be more difficult to re-direct core inflation, especially over the short term, given the changes in taxes on tobacco and compensatory increases in prices previously reduced, some difficulties in processed foods and the odd non-energy industrial product. The unknown remains in services but there are no signs that these prices are going to moderate appreciably.

CONSUMER PRICE INDEX BY COMPONENT GROUP

January

	Indices (*)	% monthly change		% annual change	
		2005	2006	2005	2006
By type of spending					
Food and non-alcoholic beverages	120.6	0.7	0.9	3.2	4.4
Alcoholic beverages and tobacco	119.2	0.2	–2.2	5.5	2.7
Clothing and footwear	106.4	–11.4	–11.7	1.7	1.1
Housing	119.7	0.5	2.2	4.0	7.8
Household equipment	108.8	–0.4	–0.4	2.0	2.2
Health	106.7	0.3	0.3	0.2	0.7
Transport	118.4	–0.1	1.5	5.1	7.9
Communications	91.8	0.2	0.3	–0.4	–1.5
Recreation and culture	102.3	–1.2	–1.6	0.1	0.2
Education	121.3	0.4	0.2	4.3	3.8
Hotels, cafés and restaurants	121.6	0.4	0.6	4.0	4.5
Other	116.8	1.5	1.5	2.5	3.4
By group					
Processed foods	117.5	0.4	0.3	4.2	3.7
Unprocessed foods	126.4	1.0	1.0	2.3	5.3
Non-food products	113.7	–1.4	–0.7	2.9	4.2
Industrial goods	109.4	–3.1	–1.9	2.2	4.5
Energy products	*122.3*	*–0.8*	*3.5*	*6.0*	*14.8*
Fuels and oils	*127.3*	*–1.7*	*3.3*	*7.6*	*18.7*
Industrial goods excluding energy products	*105.4*	*–3.8*	*–3.6*	*1.0*	*1.4*
Services	118.8	0.6	0.5	3.8	3.8
Underlying inflation (**)	113.5	–1.0	–1.0	2.8	2.9
GENERAL INDEX	**115.4**	**–0.8**	**–0.4**	**3.1**	**4.2**

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

Energy continues to push up wholesale prices

The producer price index began 2006 on a poor footing. Year-to-year growth in January reached 6.2%, the worst figure for any month of January since 1984. The sharp increase in the general index was mainly due to the price of energy which added three percentage points to the annual rate. In addition, food consumer goods, which have shown a sharp rise since mid-2005, made a notable contribution to the rise in wholesale prices. On the other hand, consumer manufactures showed a substantial price drop as a result of increased pressure of competition in the Spanish market. In only six months, the rise in prices of consumer products went down to 2.3% from levels of more than 4% in mid-2005, in spite of increases in production costs, factors which likely complicated the profitability of many companies.

Producer price index shoots up but consumer goods moderate, along with non-energy imported products.

This situation of moderation is also showing up in the area of import prices, also affected negatively by energy prices. If we look at consumer goods, average price increases in 2005 as a whole were modest at 1.3% for food and 1.1% for non-food products.

Farm prices in December continued along a path of moderation largely due to the drop in livestock prices. Nevertheless, the balance for the year as a whole, while moderate, was worse than the year before. This situation should tend to improve especially because of the spectacular increases seen in these prices in the first four months of 2005.

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											
December	2.5	5.0	2.8	1.6	6.2	10.6	5.8	4.2	–3.7	9.4	–
2005											
January	8.4	4.8	3.2	1.8	6.2	8.7	5.0	3.4	–1.6	7.2	–
February	12.2	4.9	3.2	1.9	5.5	11.0	5.4	1.0	–1.9	9.3	4.4
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	4.4
June	–11.9	4.4	2.2	2.1	3.1	13.5	5.3	3.6	–1.3	7.7	–
July	–5.1	4.6	2.1	1.9	3.0	15.7	8.2	0.6	10.4	11.7	–
August	9.2	4.9	2.5	1.8	2.9	16.3	6.1	–0.2	–0.4	11.0	4.5
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	2.0	4.9	3.1	2.0	3.2	14.7	3.8	3.3	–0.8	5.6	4.4
December	2.1	5.2	3.2	2.0	3.2	15.6	7.1	0.9	10.2	8.9	–
2006											
January	...	6.3	3.5	2.0	3.6	20.6	...	...	...	...	–

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

Foreign sector

Trade deficit hits all-time high

The trade deficit in 2005 reached all-time highs going to 77.82 billion euros, that is to say, 8.6% of the gross domestic product (GDP). This huge imbalance was no doubt added to by the rise in energy prices but the other headings of the trade balance also showed sharp worsening. The energy imbalance accounted for 44.8% of the increase in the trade deficit in 2005. Much more costly oil made a decisive contribution to the increase in the trade deficit given that the average cost of a tonne of imported oil reached 289.3 euros, 36.4% more than in 2004.

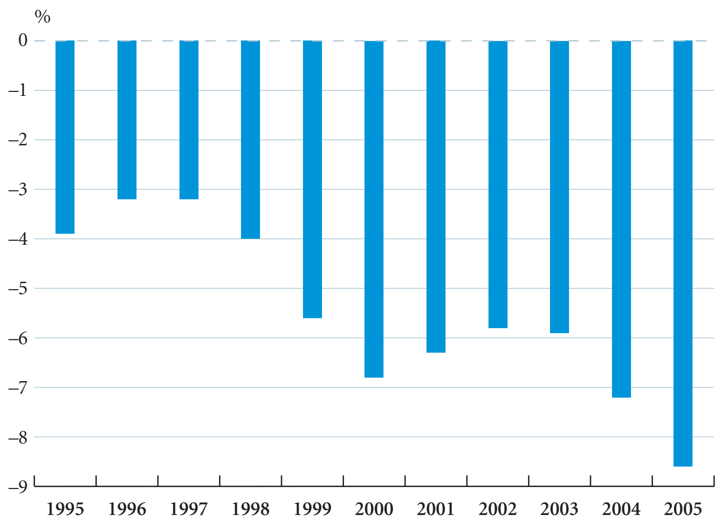
Nevertheless, the bad news did not come only on the energy front. The worsening of the situation was general in all large product groups, mainly in the area of non-food consumer goods. Between 2004 and 2005 the trade imbalance in this segment practically doubled, thus underlining not only the loss of foreign market share by Spanish industry but also the massive rise in certain imported products in Spain, mainly in the field of low-cost goods. Whether this is from a loss of competitiveness or the inevitable result of globalization, this is the trend, something practically irreversible, noted in recent years.

Rise in energy prices increases trade deficit...

...but worsening trend in foreign balance also shows up in other products...

TRADE DEFICIT AT ALL-TIME LEVELS

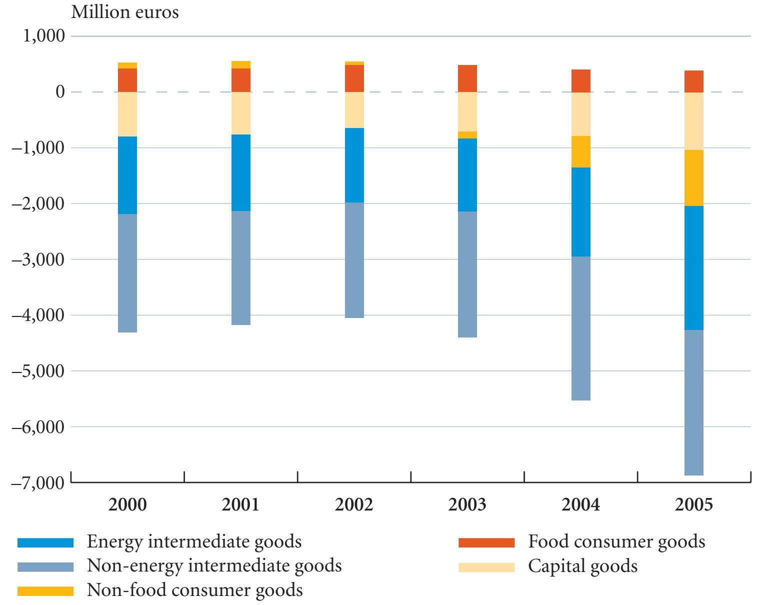
Trade balance as percentage of gross domestic product



SOURCE: Department of Customs and internal figures.

ONLY FOODS SLOWING TRADE DEFICIT RISE

Trade balance by product group as monthly average



NOTES: Monthly averages.
SOURCE: Department of Customs and internal figures.

...especially in non-food consumer goods where gain in market share of imports now showing up.

The worsening was also noted in the capital goods balance and this appeared not so much in exports, which reported appreciable growth similar to last year, but from the rise in imports. Furthermore, a large part of this increased deficit came from those sectors more linked to office equipment and telecommunications equipment, which undoubtedly puts in question the ability to find positions in markets with a high technological component or greater value added because of research and innovation. On the other hand, the relatively positive performance in the transportation equipment balance (ships, aircraft and railway equipment) underlines the notable role government buying can play in these sectors.

Food balance maintaining surplus but less each year.

The situation in the food sector has also worsened but to an even greater extent, this being one of the big headings in the trade balance where there is still a surplus which, however, seems inevitably to be declining. Fish and processed foods are the main cause of the drop in the trade surplus in this sector.

Geographically, apart from the energy question, the increase in the trade deficit is mainly the result of the weakening of export capacity to Spain’s main market, the European Union (EU) in a context of an appreciable increase in imports. In 2005 sales to the EU were down 1.4% by volume. Whether it is the economic weakness in the European economy or increased competition from the rest of the world, the loss of market share is only partially compensated by sales to markets outside the central core of the EU. Latin America, Russia (CIS) and China (today a more important market than Russia, Japan or Brazil) underline the importance of globalization in maintaining a certain strength in exports.

FOREIGN TRADE

January-December 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	32,111	37.8	13.9	6,303	21.8	4.1	–25,808	19.6
Consumer goods	66,834	9.1	28.9	58,595	–0.5	38.2	–8,239	87.7
Food	*14,030*	*6.0*	*6.1*	*18,678*	*3.2*	*12.2*	*4,648*	*133.1*
Non-foods	*52,805*	*9.6*	*22.8*	*39,917*	*–4.1*	*26.0*	*–12,888*	*75.6*
Capital goods	27,301	21.6	11.8	14,856	13.4	9.7	–12,445	54.4
Non-energy intermediate goods	105,126	5.0	45.4	73,806	6.5	48.1	–31,320	70.2
By geographical area								
European Union (EU-15)	140,723	5.2	60.8	110,701	2.2	72.1	–30,022	78.7
Euro area	*117,890*	*5.1*	*51.0*	*88,570*	*1.7*	*57.7*	*–29,320*	*75.1*
Other countries	90,650	23.5	39.2	42,858	12.1	27.9	–47,791	47.3
Russia	*5,151*	*39.4*	*2.2*	*1,098*	*21.4*	*0.7*	*–4,053*	*21.3*
United States	*7,825*	*4.8*	*3.4*	*6,103*	*5.2*	*4.0*	*–1,721*	*78.0*
Japan	*5,871*	*2.9*	*2.5*	*1,154*	*–2.8*	*0.8*	*–4,717*	*19.7*
Latin America	*11,370*	*37.1*	*4.9*	*8,049*	*13.2*	*5.2*	*–3,321*	*70.8*
OPEC	*17,372*	*35.9*	*7.5*	*4,142*	*9.0*	*2.7*	*–13,230*	*23.8*
Rest	*43,061*	*21.5*	*18.6*	*22,312*	*14.9*	*14.5*	*–20,749*	*51.8*
TOTAL	**231,372**	**11.7**	**100.0**	**153,559**	**4.8**	**100.0**	**–77,813**	**66.4**

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

Current account deficit reaches 7.5% of GDP

The current account imbalance continued to rise progressively in November given that the sharp increase in the trade deficit and the more moderate increase in deficits in the incomes and transfers balances could not be compensated by the very modest increase in the services surplus. The cumulative surplus for the first eleven months of 2005 thus reached 60.75 billion euros, 58.6% more than in the same period last year, according to the Bank of Spain. Should this trend continue, the current account imbalance will end 2005 at around 7.5% of the GDP, a level never before reached, which coincides with the deficit estimated by the National Institute of Statistics in the results of National Accounting.

The increase in the current account imbalance is mainly due to the trade deficit, given that the rise in this heading accounts for 71.2% of the total boost in the deficit. In any case, the other balances also show a worse result than in the January-November 2004 period. The surplus in services was down by 4.3% because of the poor results in the tourist balance under the effect of a sharp increase in payments in a situation of weakness in inflows due the drop in average receipt per tourist. In fact, inflows from tourism rose by 3.8%, well below the increase in prices of tourist services and the actual number of foreign tourists coming to Spain.

Trade deficit accounts for 71% of increase in current account deficit while 20% comes from incomes deficit.

Tourist balance showing greater propensity of Spaniards to travel abroad and low spending by foreign tourists.

BALANCE OF PAYMENTS

Cumulative figure for last 12 months in million euros

	November 2004	November 2005	% change
Current account balance			
Trade balance	–51,151	–68,906	34.7
Services			
Tourism	*26,707*	*25,692*	*–3.8*
Other services	*–4,353*	*–4,381*	*0.6*
Total	22,354	21,311	–4.7
Income	–12,563	–18,205	44.9
Transfers	232	–1,089	–
Total	**–41,128**	**–66,889**	**62.6**
Capital account	**8,246**	**8,038**	**–2.5**
Financial balance			
Direct investment	–25,526	–5,163	–79.8
Portfolio investment	75,812	52,671	–30.5
Other investment	–10,596	8,948	–
Total	**39,690**	**56,456**	**42.2**
Errors and omissions	–873	0	–
Change in assets of Bank of Spain	–5,935	2,394	–

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

The transfers balance also showed a deficit nearly five times higher than in 2005 because of the increasing importance of remittances sent home by immigrants and the worsening of the positive balances with the EU, both public and private. The incomes balance, on the other hand, also showed a substantial increase in deficit, with payments for earnings on government bonds held by foreigners being the main reasons for this rise. In addition, the increase in the imbalance under this heading was boosted by earnings due on foreign funding obtained by the financial sector, households and companies.

Sharp recovery in direct foreign business investment in past two months.

Capital account, in turn, showed a lower surplus in November than in the same period last year because of lower inflows from the EU. The cumulative balance for the first eleven months of the year was also below the figure for the 2004 period and did not manage to cover the current deficit. This accounts for the fact that net world financing of Spain's economy, obtained by adding the current account and capital balances, amounted to 54.39 billion euros in the January-November period, 73.0% higher than in the same period the year before.

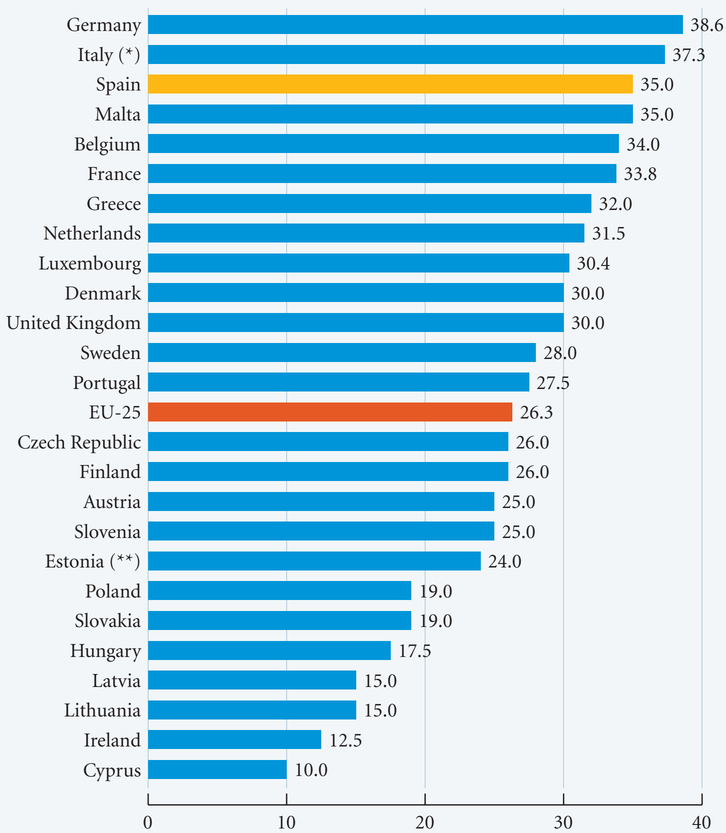
In the financial sphere, direct foreign investment in the corporate sphere in Spain showed great strength for the second month in a row. As a result, the cumulative balance as of November was practically double that for 2004, as opposed to investment in real-estate, which was 14.6% lower than last year. On the other hand, Spanish investment abroad was down by 40% while real-estate investment rose by 54.3%.

Should corporation tax be reduced?

In recent years there has been growing concern about the loss of competitiveness of Spanish companies on the world scene in a context of increasing globalization. The coming of new countries with low labour costs and taxes into the international economic system is making Spain's position in the world trade scene in manufactured goods precarious. It is not a matter of more or less exports but also a matter of loss of share in foreign markets. Without looking farther afield, the extension of the European Union to the East European block of countries which enjoy cheap specialized labour and high growth potential is a challenge of the greatest importance. In the face of these challenges many and varied responses can be put forward. One of these may be to lower company taxes.

CORPORATE TAX IN SPAIN AMONG HIGHEST IN EUROPEAN UNION

Tax statutory tasc rate on corporate income (2005)



NOTES: (*) Includes local IRAP tax of 4.25%.
(**) Applies only to distributed profits; rate on retained earnings is nil.
SOURCE: Eurostat.

In the matter of corporate tax the tendency over the past decade, especially since 2000, has been to a reduction of tax rates. In the period 1995-2005 the average nominal rate in the European Union (EU-25) dropped by 8.8 percentage points. In those same years, the nominal tax rate on corporate profits was reduced still more in the 10 new member states joining the EU in 2004, by 10 percentage points. As a result, in recent years there has been a kind of tax competition in Europe already begun before that extension in order to attract direct foreign investment. On the other hand, the general rate in Spain has shown no change in the past 10 years remaining at 35%.

What then is the competitive position of Spain's economy in terms of corporate tax within the EU? As may be seen in the accompanying graph, the general rate for Spain's corporate tax stands among the highest. In 2005, Spain's general rate was above the average for the EU-25 by 8.7 percentage points. The difference was greater compared with the 10 new member states standing at 14.4 percentage points. The case of Estonia was noteworthy. As of 2000, it reduced the tax rate to nil for retained earnings while putting the rate for distributed profits at 24%.

While it is true that the general rate is not a precise indicator of the tax load carried by companies because of the complexity of and differences between the tax systems in the various countries, Spain's competitive situation is not very different if we look at it from the point of view of effective tax rate. This rate takes into account tax reductions and generally provides a more exact analysis.

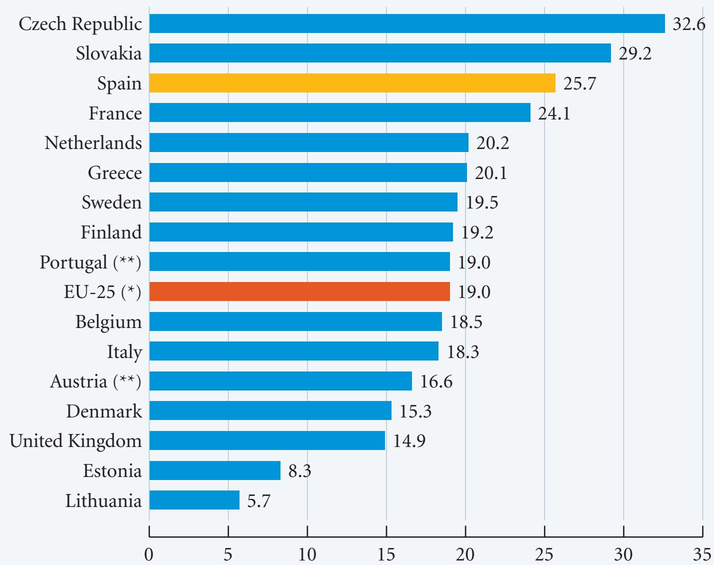
The effective tax rate may be approximately arrived at from the implicit tax rate calculated according to figures from National Accounting. The implicit rate measures those taxes actually paid against the potential taxable base. According to Eurostat, the average implicit corporate tax rate in the EU-25 in 2003 was 19%, whereas in Spain it stood at 25.7%, that is to say, 6.7 points higher. The position of Spain was also in the upper part of the classification.

As a result, we find that, from a tax point of view, the competitive position of Spanish companies is not favourable. In a situation in which Spanish companies must deal with increased competition from countries with much lower labour costs, some of which form part of the European Union, taxation is also a relevant matter.

In this respect, the bill for reform of corporate tax presented by the Minister of Economy and Finance, Pedro Solbes, on January 20 sets out the gradual reduction of the general rate from 35% to 30% from 2007 to 2011. At the same time, the reduced rate for small and medium businesses, introduced with the 1997 reforms, would go from 30% to 25% in the same period. On the other hand, most of the deductions and benefits would also gradually disappear at the rate of a fifth per year. It is therefore not clear that the effective tax load borne by companies will be reduced in the next few years. In some business circles there has been criticism about the slowness of the reforms and the impact the removal of deductions and benefits could have on some companies. In fact, this is an important reform that goes in the right direction but it should be pointed out that, even with the impact expected from this reform, the competitive position of Spanish companies will not be ideal if we take into account the present tax gap with other countries in the European Union.

DISADVANTAGE ALSO IN EFFECTIVE TERMS

Implicit corporate tax rate. Percentage of taxable base (2003)



NOTES: (*) Weighted by taxable base.
(**) Including individual entrepreneurs.
SOURCE: Eurostat.

Savings and financing

Funding granted to companies and households in 2005 shows highest growth rate in past decade

Good state of economy and low interest rates continue to drive demand for credit.

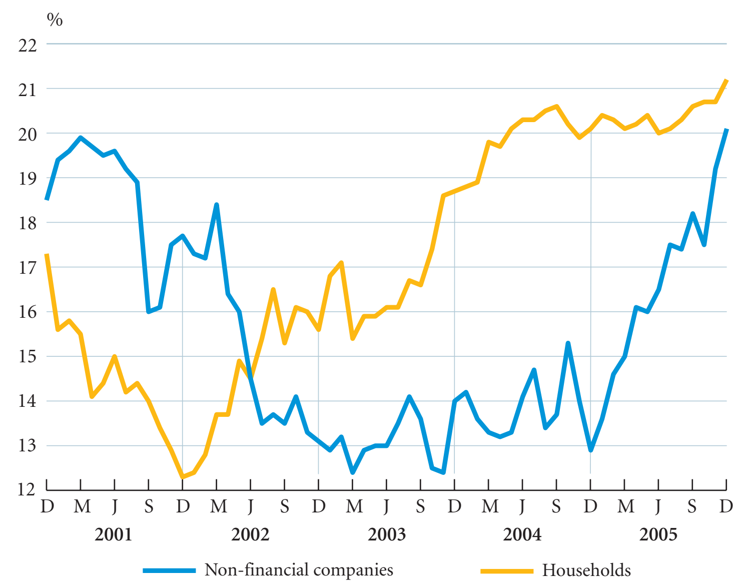
In December 2005, funding granted to the private sector rose by 20.6% compared with the year before. This growth rate was the highest at least for the past decade and more than twice that for the euro area as a whole. As a result, in spite of the beginning of an upturn in interest rates set by the European Central Bank early in December, demand for credit from companies and households remains very strong. In fact, loan interest rates are still at historically very low rates, both in nominal and real terms, that is to say, after deducting inflation. Furthermore, the good economic situation is stimulating demand for loan finance.

Funds granted to non-financial companies rose by 20.1% in December compared with the same month in 2004, the highest rate since July 1999. Among this funding, that involving domestic bank credit even rose more rapidly at 25.3% at year-to-year rate, the highest rate in more than 10 years.

Funds channelled to households were up 21.2% in 2005, the highest growth in at least the past decade. The main drive continued to come from mortgage loans. Demand for mortgage loans was fostered by low or even negative real

FUNDING TO PRIVATE SECTORS NOT SLOWING DOWN

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



SOURCE: Bank of Spain.

interest rates, by various socioeconomic factors and easy financing terms. These terms are adapting supply to demand so that access to home-ownership is being made easier for very broad segments of the population, including young people.

Loan default holding at very low levels.

In this way, total housing loans, including corresponding securitizations, in December 2005 rose to 474.4 billion euros, a rise of 24.5% over the same month the year before. This meant continuation of a very strong growth rate. In addition, mortgage loan default remains at very low levels. At the end of September 2005, the rate for doubtful home-purchase loans with mortgage security stood at 0.40%, less than half the loan default rate in the resident private sector, which stood at 0.82%. It should be pointed out that these rates are slightly higher than the levels recorded in March 2005, largely as a result of changes in the accounting regulations as of June to conform with the international standards, which introduced more restrictive criteria.

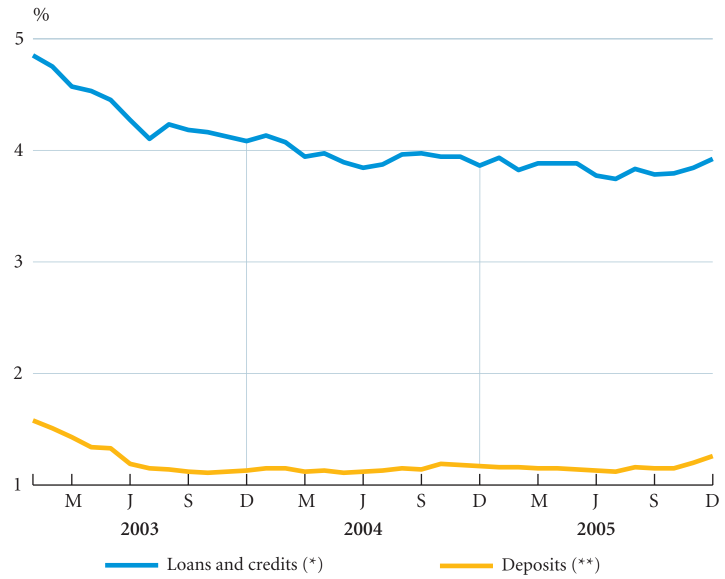
Consumer credit up in 2005.

In addition, consumer credit remains buoyant. Total new transactions for consumer loans and credit to households for buying cars, motorcycles, appliances, furniture, travel, etc. in 2005 amounted to 48.22 billion euros. This amount represents a year-to-year increase of 22.9%, an annual change twice that recorded in 2004 (11.2%). New transactions for loans and credits to households for other purposes (to buy shares, land, etc.) amounted to 58.33 billion euros, which meant an annual increase of 13.9%.

Interest rates on bank loans and credits rose slightly in December following the increase in the official interest rate by the European Central Bank at the beginning of the month after holding nearly two and a half years at 2%. In fact, interest rates on loans began to rise

SHARPENING RISE IN BANK INTEREST RATES

Interest rates of credit institutions applied to private sector. New transactions



NOTES: (*) Equivalent annual rate.
(**) Equivalent annual rate not including commissions.
SOURCE: Bank of Spain.

Bank interest rates likely to rise moderately in 2006.

in August 2005 in anticipation of an upturn by the European monetary authorities. Deposit interest rates also rose slightly as of August. In 2006, bank interest rates will likely continue this trend given that new increases in the Eurosystem interest rates are expected, although with moderate rises.

Preference of savers moving to global funds and share-based funds.

In addition, in January interest rates on mortgage loans for more than a 3-year term for purchase of non-subsidized housing rose by 19 basis points to 3.59% for credit institutions as a whole. In any case, it was below inflation for that month which indicates that the level is abnormally low.

Spectacular growth of bank deposits in 2005

Total deposits of the resident private sector showed strong growth in 2005 marking up an annual change well above that for the euro area, thus reflecting the strength of Spain's economy. Deposits for more than a 2-year term, which enjoy a tax benefit of 40% on interest, recorded an extraordinary increase. In addition, on-demand and savings deposits were up by 14.9% in 2005, considerably higher than in 2004 when they rose by 9.9%.

Apart from deposits, investment funds also enjoyed the preference of savers. Assets of securities mutual funds rose by 2.27 billion euros in January going to 248.13 billion euros, according to information supplied by Inverco, the sector organization. As a result, total assets of securities mutual funds rose by 12.2% in the past 12 months. Net subscriptions recorded in January amounted to 844 million euros while the rest of the increase came from capital gains, largely due the favourable performance of the stock markets. Most new money went into global funds and share-based funds in search of higher yields than those offered by bond-based

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

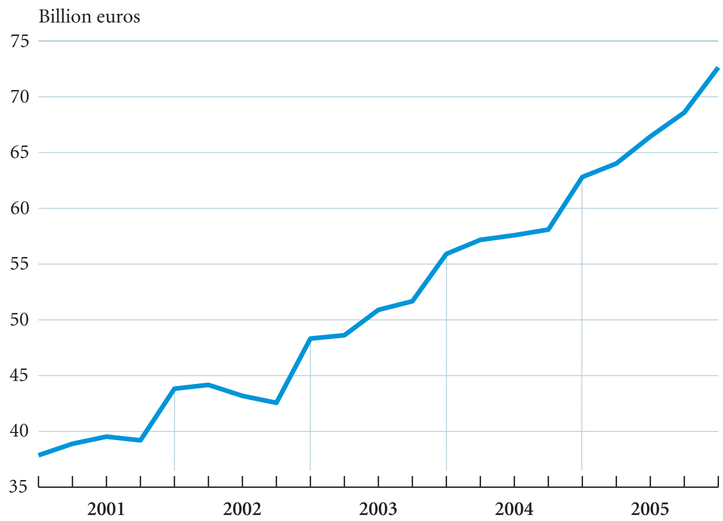
December 2005

	Total	Change this year		% share
	Million euros	Million euros	%	
On-demand savings (**)	396,355	51,281	14.9	43.4
Up to 2 years (*)	190,516	30,049	18.7	20.9
More than 2-year term (*)	236,756	109,288	85.7	26.0
Repos	73,052	–7,597	–9.4	8.0
Total (*)	**896,680**	**183,022**	**25.6**	**98.3**
Deposits in currencies other than euro	**15,639**	**9,792**	**167.5**	**1.7**
TOTAL (*)	**912,319**	**192,814**	**26.8**	**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.

SHARP INCREASE IN PENSION FUND ASSET IN 2005

Total pension fund assets



SOURCE: Inverco.

funds. In fact, there were substantial withdrawals from money-market and bond-based funds so that investors were showing lower aversion to risk.

Weighted annual average yield on securities mutual funds over the past 12 months ending January amounted to 5%. All types of fund showed positive annual yields but there were notable differences. Share-based funds in emerging markets obtained extraordinary gains of 64.2%, whereas long-term bond-based funds reported only 1.14%.

In another sphere, the volume of pension fund assets rose by 9.82 billion euros in 2005 to reach 72.63 billion euros at the end of the year, an annual increase of 15.6%. All pension plan systems recorded notable increases in assets in 2005 although the highest gains showed up in individual system plans (17.6%) and associate system plans (16.6%). In turn, total assets in the employee system grew by 12.6%. On the other hand, the number of accounts of pension plan participants continued to rise going up to 9,250,729 at the end of the past year. This total meant an increase of 7.6%. There was a notable increase in the number of participant accounts in the employee system with a rise of 20.1% putting the figure at 1,537,551. With regard to the yield obtained on pension funds, the annual average in 2005 was a notable 7.2%. The average of the past 15 years came to 6.8%, well above the inflation rate for the period.

Pension funds reach average annual yield of 7.2% in 2005, nearly twice inflation.

RESEARCH DEPARTMENT PUBLICATIONS

All publications are available on Internet:
www.estudios.lacaixa.es
E-mail:
publicacionesestudios@lacaixa.es

THE SPANISH ECONOMY MONTHLY REPORT
Report on the economic situation

INFORME MENSUAL
Report on the economic situation. Spanish version

ANUARIO ECONÓMICO DE ESPAÑA 2005
Municipal, provincial and autonomous community statistics

ECONOMIC STUDIES SERIES

1. **Estudio de la OCDE sobre el empleo** (Out of stock)
2. **La defensa de la competencia en España y en Europa** (Out of stock)
3. **Ética y progreso económico** (Out of stock) James M. Buchanan
4. **Reform of the public pension system in Spain** José A. Herce and Víctor Pérez-Díaz
5. **Población y actividad en España: evolución y perspectivas** (Out of stock) A. Blanes, F. Gil and J. Pérez
6. **El sector bancario europeo: panorama y tendencias** (Out of stock) Josep M. Liso (editor), Teresa Balaguer and Montserrat Soler
7. **El desafío de la moneda única europea** (Out of stock) Joan Elias (2nd edition)
8. **El futuro de las pensiones en España: hacia un sistema mixto** (Out of stock) José A. Herce, Simón Sosvilla, Sonsoles Castillo and Rosa Duce
9. **Spain and the euro: risks and opportunities** (Out of stock) Joaquim Muns (editor), Susan M. Collins, Manuel Conthe, Juergen B. Donges, José Luis Feito, José Luis Oller-Ariño and Alfredo Pastor
10. **La opinión pública ante el sistema de pensiones** (Out of stock) Víctor Pérez-Díaz, Berta Álvarez-Miranda and Elisa Chuliá
11. **Los beneficios de la liberalización de los mercados de productos** Antón Costas and Germà Bel (editors)
12. **La sucesión en la empresa familiar** (Out of stock) Miguel Ángel Gallo
13. **Beneficios fiscales en la empresa familiar: patrimonio y sucesiones** (Out of stock) Ernest de Aguiar
14. **El impacto del euro en los mercados financieros** Enrique Vidal-Ribas (editor), Carmen Alcaide, Javier Aríztegui, Robert N. McCauley, Blas Calzada, Francisco de Oña, Ignacio Ezquiaga and León Benelbas
15. **La cultura de la estabilidad y el consenso de Washington** Manuel Guitián and Joaquim Muns (editors), Antonio Argandoña, Miguel A. Fernández Ordóñez, Paul Krugman and John Williamson
16. **El sector bancario europeo: panorama y tendencias** (Part 2) Josep M. Liso (editor), Teresa Balaguer and Montserrat Soler
17. **La medición de la inflación en España** Javier Ruiz-Castillo, Eduardo Ley and Mario Izquierdo
18. **La economía del arte** (Out of stock) Bruno Frey
19. **La reforma de las pensiones ante la revisión del pacto de Toledo** José A. Herce and Javier Alonso Meseguer
20. **La ampliación de la Unión Europea al Este de Europa**
21. **Del real al euro. Una historia de la peseta** (Out of stock) José Luis García Delgado and José María Serrano Sanz (editors)
22. **Cómo tratar con Bruselas. El lobby en la Unión Europea** Robin Pedler
23. **Crecimiento y empleo en las empresas industriales** Ángel Hermosilla and Natalia Ortega
24. **La regulación del comercio internacional: del GATT a la OMC** (Out of stock) Montserrat Millet
25. **Quiebras y suspensiones de pagos: claves para la reforma concursal** Fernando Cerdá and Ignacio Sancho
26. **El euro: balance de los tres primeros años** Joan Elias (editor), Pere Miret, Àlex Ruiz and Valentí Sabaté
27. **European Union enlargement. Effects on the Spanish economy** (Out of stock) Carmela Martín, José Antonio Herce, Simón Sosvilla-Rivero and Francisco J. Velázquez
28. **Internet: situación actual y perspectivas** Fèlix Badia
29. **El gobierno de la empresa** Vicente Salas Fumás
30. **La banca en Latinoamérica. Reformas recientes y perspectivas** Josep M. Liso, Montserrat Soler, Montserrat Manero and Maria Pilar Buil
31. **Los nuevos instrumentos de la gestión pública** Guillem López Casasnovas (editor), Jaume Puig-Junoy, Juan José Ganuza and Ivan Planas Miret
32. **La competitividad de la economía española: inflación, productividad y especialización** Francisco Pérez (editor), Pilar Chorén, Francisco J. Goerlich, Matilde Mas, Juliette Milgram, Juan Carlos Robledo, Ángel Soler, Lorenzo Serrano, Deniz Ünal-Kesenci and Ezequiel Uriel
33. **La creación de empresas. Un enfoque gerencial** José María Veciana
34. **Política agraria común: balance y perspectivas** José Luis García Delgado and M. Josefa García Grande (editors)