MAY 2006

THE SPANISH ECONOMY

Monthly Report

NUMBER 291

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2004	2005	2006	2005				2006		
				1Q	2Q	3Q	4Q	1Q	2Q	3Q
INTERNATIONAL ECONOMY			Forecast						Forecast	
Gross domestic product										
United States	4.2	3.5	3.5	3.6	3.6	3.6	3.2	3.5	3.6	3.5
Japan	2.3	2.7	3.2	1.1	2.7	2.8	4.3	4.3	3.5	2.9
United Kingdom	3.2	1.8	2.2	1.9	1.7	1.9	1.8	2.2	2.3	2.3
Euro area	1.8	1.4	2.0	1.2	1.2	1.6	1.8	1.9	2.0	1.9
Germany	*1.1*	*1.1*	*1.6*	*0.6*	*0.8*	*1.5*	*1.6*	*1.4*	*1.7*	*1.6*
France	*2.1*	*1.4*	*1.8*	*1.7*	*1.0*	*1.7*	*1.5*	*1.6*	*2.0*	*1.8*
Consumer prices										
United States	2.7	3.4	2.6	3.0	2.9	3.8	3.7	3.6	2.8	2.5
Japan	0.0	–0.3	0.1	0.4	0.0	0.1	0.1	0.2	0.2	0.2
United Kingdom	2.2	2.3	2.3	2.2	2.2	2.4	2.2	2.2	2.2	2.4
Euro area	2.1	2.2	2.3	2.0	2.0	2.3	2.3	2.3	2.4	2.3
Germany	*1.7*	*2.0*	*1.8*	*1.7*	*1.7*	*2.1*	*2.3*	*2.0*	*1.9*	*1.7*
France	*2.1*	*1.7*	*1.8*	*1.7*	*1.7*	*1.9*	*1.6*	*1.8*	*1.7*	*1.8*
SPANISH ECONOMY			Forecast						Forecast	
Macroeconomic figures										
Household consumption	4.4	4.4	3.6	4.6	4.6	4.3	4.0	3.8	3.6	3.5
Government consumption	6.0	4.5	4.4	5.2	4.0	4.2	4.6	4.5	4.4	4.3
Gross fixed capital formation	4.9	7.2	5.9	7.0	7.6	7.3	6.8	6.4	6.1	5.7
Capital goods	*3.7*	*9.5*	*8.1*	*9.8*	*10.4*	*8.9*	*9.1*	*8.7*	*8.3*	*7.9*
Construction	*5.5*	*6.0*	*4.8*	*6.0*	*6.2*	*6.3*	*5.6*	*5.2*	*4.9*	*4.6*
Domestic demand (contribution to GDP growth)	4.9	5.3	4.7	5.5	5.4	5.3	5.0	4.8	4.6	4.3
Exports of goods and services	3.3	1.0	3.8	–1.4	1.3	2.1	1.9	3.2	3.5	3.7
Imports of goods and services	9.3	7.1	7.4	6.2	7.9	7.8	6.6	7.2	7.0	7.2
Gross domestic product	**3.1**	**3.4**	**3.2**	**3.3**	**3.4**	**3.5**	**3.5**	**3.5**	**3.4**	**3.2**
Other variables										
Employment	2.6	3.1	2.8	3.0	3.2	3.2	3.1	3.0	2.9	2.8
Unemployment (% labour force)	11.0	9.2	9.0	10.2	9.3	8.4	8.7	9.1	9.0	8.9
Consumer price index	3.0	3.4	3.7	3.3	3.2	3.4	3.6	4.0	3.8	3.5
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	–7.1	–8.4	–7.8	–6.7	–6.8			
Not lending or net borrowing rest of the world (% GDP)	–4.8	–6.5	–6.2	–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	4.9	2.4	2.9	3.4	4.0	4.4	4.9	5.2
ECB repo	2.0	2.0	2.7	2.0	2.0	2.0	2.1	2.3	2.6	2.8
10-year US bonds	4.3	4.3	5.0	4.3	4.2	4.2	4.5	4.6	5.1	5.1
10-year German bonds	4.1	3.4	4.0	3.6	3.3	3.2	3.4	3.5	4.0	4.1
10-year Spanish bonds	4.1	3.4	4.0	3.6	3.3	3.2	3.4	3.5	4.0	4.1
Exchange rate										
$/Euro	1.24	1.25	1.24	1.31	1.26	1.22	1.19	1.20	1.24	1.26

THE SPANISH ECONOMY
MONTHLY REPORT
May 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, 2005

FINANCIAL ACTIVITY	Million euros
Total customer funds	169,470
Receivable from customers	113,857
Profit attributable to Group	1,495

STAFF, BRANCHES AND MEANS OF PAYMENT	Million euros
Staff	25,254
Branches	5,053
Self-service terminals	7,208
Cards	8,408,956

COMMUNITY PROJECTS: 2005 BUDGET	Million euros
Activities	
Social	160
Cultural	70
Science and environmental	54
Educational	19
TOTAL BUDGET	**303**

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Contents

Story of three consumers

«The consumer is king» is an aphorism that has come into use in English. This is particularly true in the United States since in the Fifties the development of production-line manufacturing and marketing techniques began to substantially change values related to consumer spending and household savings. It is not now an exaggeration to state that it is the US consumer who is driving the world economy. Households no longer are saving, they spend all their income on consumer products and the odd month they even have recourse to borrowing to fill in where the pocket-book does not quite reach. The domestic manufacturing sector does not manage to meet demand and to fill the shopping centre aisles it is necessary to bring in foreign products. The result is an enormous deficit in the trade balance (more than 700 billion dollars in 2005) which is covered by the Asian economies, with China in the lead, Europe and neighbouring Canada and Mexico. It is said that the United States consumes and China produces. The imbalance troubles the main international bodies but the balance is more stable than may be thought. In any case, it is the countries that sell to the United States that are financing the excess spending and they are well aware that any decrease in that credit would hurt their sales.

On this side of the Atlantic, the story is quite different. In the European Union, and more precisely, in the large economies on the Continent, the consumer has a sadder look. The future is unclear because unemployment is much greater than a few years ago, the average age of the population is higher and higher and some are fearful that the Welfare State that ensured a comfortable old age may be dismantled. The economy is growing much less than in the buoyant United States and grows only thanks to orders from other countries (Asian and American) which allow industry to operate at an acceptable rate. The public sector is in the grip of an excessive deficit but in any case those responsible for economic policy are aware that the traditional Keynesian prescriptions for stimulating demand that had worked at other times today bring more problems than otherwise. Spain is an example. In the past five years consumer spending has grown by an average of 3.6% real, a figure even higher than in the United States, thus constituting the main engine of demand, along with the buying of houses.

If the European consumer remains downcast and, on the other hand, it is felt that the US consumer no longer has much margin to keep driving the world economy, we may wonder about the future. The answer, of course, lies with China. This is not something for the immediate future but over the medium and long term the Chinese consumer will come to change the world. At this time, the Chinese consumer represents only one third of the economy whereas in the developed countries the norm is for it to account for two-thirds. The Asian giant is deep into industry and investment in infrastructures. But this will change. It is hard to imagine the number of cars, refrigerators, cell phones and tourist package tours that a population of 1,300 million will be able to consume when they begin to come close to the levels of the developed countries. And, of course, this constitutes a real environmental challenge. But, why not? This is the route Japan followed a few decades ago and that followed by what we now call the «Asian Tigers». The consumer will remain king, here, in the United States or in China.

April 27, 2006

OVERALL SUMMARY

Oil again a threat

Oil again goes up to all-time highs because of fears of supply cut-off...

Once more oil appears to be putting the current world growth cycle in jeopardy. In April the per barrel price rose to new all-time highs (at times more than 75 dollars) following the relative truce following the *Katrina* and *Rita* hurricanes in the Gulf of Mexico at the end of summer last year. In this new period of instability the detonator was widespread comment about the possibility that the United States might decide to launch an attack on Iran in reprisal to that country's developing a programme of uranium enrichment. The risk of interruption of oil supply came up again in view of the possibility of a new war in the Middle East. This fear came on top of further problems in another major exporter (Nigeria) and the low level of additional pumping possible, world refinery capacity, etc.

...and strong growth of world economy, sharper than forecast just months ago.

All of these supply problems probably would not come up if it were not for the impressive boost in demand for crude. This increase arises from stronger than expected world economic growth. The International Monetary Fund (IMF) has had to make a notable increase (from 4.3% to 4.9%) in its growth forecasts for 2006 issued back in the autumn. Where the revision has been moved up is in the group the IMF lumps into the emerging economies and the developing countries, namely, China, India, Brazil, Mexico, Russia, etc. Here expected growth in 2006 is put at 6.9% and we should not forget that these are countries where the propensity to consume energy is often higher than in the developed countries.

Still no sign of problems in area of inflation but central banks keep tightening monetary policies.

This month saw publication of China's growth in the first quarter at more than 10%. The boost in demand is also to be seen in raw material markets (naturally enough with great help from speculation money) so that the prices of some industrial raw materials such as copper and zinc have gone sky-high, even higher than the 25% recorded by oil.

If the rise in crude oil were largely a problem of demand, it would seem less of a problem. On the one hand, an eventual slowdown in economic activity would be enough to bring back per barrel prices to more moderate levels. On the other hand, high prices could even be beneficial in order to cool down the frenetic growth rate of some economies. In any case, there still remains another key question: inflation. Of course, we are not now living in the Seventies or in the Eighties. Consumer price indices reflect the rise in prices of petrol, diesel oil and other derivatives but these increases are scarcely being shifted to other goods and services, at least for now. The central banks have begun to tighten their monetary policies but long-term interest rates, while leaving behind the range of very low levels, are still running on gentle ground.

The most illustrative case is that of the United States. As a result of the rise in interest rates and more costly oil we may expect some restraint by the US consumer. Nothing of the kind is happening. Contrary to what was forecast by the market, the Conference Board index, which measures consumer confidence levels, showed a substantial

increase in April. We feel that down the road US families will end up moderating their exuberant consumerism but, in any case, the current momentum in this area would seem to ensure growth scarcely lower than the 3.5% seen in 2005. Problems such as the foreign deficit and the government deficit remain but for the moment jobs are being created (nearly 600,000 new jobs in the first quarter), companies are generating high profits and inflation is not getting out of hand.

Curiously enough, what seems to trouble the United States most of all is the big trade deficit with China. The overwhelming competitiveness of Chinese manufactures in the US market is raising protectionist reflexes that President Bush is finding difficult to contain. The recent visit of Chinese President Hu Jintao did not resolve very much although important contracts were signed for sales of US aircraft and software to the Asian giant. One of the most insistent demands both from academic and political circles in the United States is a revaluation of China's currency, the yuan, which is considered to be undervalued and therefore may constitute a factor of unfair competition.

Something of this situation seems to have been dealt with at the meeting of the G-7 (made up of the world's richest countries) with the emerging countries held in Washington as part of the Spring meet of the IMF and the World Bank. Rodrigo Rato, head of the IMF, advocated a realignment of exchange rates which would contribute to moderating the big imbalances in the balance of payments. The logic is clear enough. High and persistent surpluses in current account in the case of the Asian economies should lead to an increase in exchange rates, while the run-away US deficit should require a devaluation of the dollar. And it would be better to see a controlled devaluation than a collapse that could provoke a sudden increase in interest rates on long-term bonds and the flight of capital.

United States seems more concerned about flood of imported products from China than rise in oil prices.

For the moment, the main consequences of these proposals seem to have been a notable strengthening of the euro in recent times. The euro exchange rate has gone above 1.25 dollars, the highest level in seven months. But this is not just a matter of political statements. The weakness of the dollar reflects the announcement of the near end of the upward stage in the Fed's reference interest rates as well as the good news on economic activity indicators for the euro area.

Excessive strengthening of the euro is not exactly what the euro area needs now that the rather fragile recovery begun last year appears to have been consolidated. Opinion surveys in Germany have been surprising in view of the good results showing up and business optimism seems to be spreading to key sectors of the economy. In France, the young people's rebellion against proposed labour reforms may have affected some indicators in March but the favourable background trends have not been halted. So far as Italy is concerned, the big unknown lies in the policies to be adopted by the government formed by Romano Prodi following the victory of the centre-left coalition in the recent elections.

Dollar drops against euro in light of good news on European economy.

Spain's economy: good results in first quarter

Spain's economy is maintaining the full-steam ahead situation seen at the end of 2005 with growth of the gross domestic product close to 3.5%. Domestic demand may have lost some of the drive seen in the first two months of the year in the

Growth of Spain's economy holding strong.

Signs of improvement in exports after year of stagnation and loss of market share.

area of private consumption but the background strength is still appreciable. Spending in the construction sector continues to show very strong although the real estate market continues to give off some signs of moderation, such as a lower increase in housing prices. Capital goods investment is maintaining its expansionist stage although it also shows some tendency to moderate the high rates seen in previous months.

On the other hand, exports of goods seem to be halting the dip noted in recent months. Sales abroad in January and February showed more acceptable results. These are figures that still should be treated with prudence but they have made it possible to recover some optimism after a year 2005 when Spanish industry suffered a major drop in its share of the export market. No doubt, consolidation of the improvement in the European economy is helping Spain's sales in what are considered its more traditional markets. In any case, the trade deficit has not shown the improvement in exports because purchases abroad continue very strong and prices of imported energy go against the overall figures.

High level of job creation, favourable borrowing terms and good corporate results mark current state of Spain's economy...

The drive being maintained by Spain's economy is making it possible to keep creating jobs at a good rate. These are not jobs requiring high qualifications that could increase productivity but they do help sustain the notable growth in household spending, both in consumer goods and in investment goods. With the help, of course, of very favourable financing conditions, despite the slight increase in interest rates. In February, loans to households for home purchase were still showing a year-to-year growth rate of more than 24%. Companies also are enjoying a good financial situation which is underlined by the excellent results of listed companies and the sample of quarterly balance sheets drawn up by the Bank of Spain.

...but threat of inflation and maintenance of growth cycle call for pace of structural reforms to be maintained.

The darkest side of the current economic situation, along with the foreign deficit, continues to be inflation. With the first four months of the year barely gone, hopes for a substantial moderation in price increases have begun to fade. The blame lies with oil. Filling up the petrol tank was never so costly. However, we still note strong resistance to lower prices in processed foods (cooking oil, beef, fish) and in services (postal services, public transport, hospital services, motor vehicle repairs).

Demand pressure and the lack of any great response to price increases in a situation of economic optimism does not exactly help to contain inflation. Economic policy is discovering clear limitations when it comes to dealing with the problem of prices. At the last meeting of Cabinet in April, the government gave the green light to a new series of economic measures to be implemented over coming months, one of the objectives being precisely to improve the efficiency of certain markets and thus fight against inflation. These deal with the energy sector and rail transport of goods. In the area of budgetary policy, measures deal with limiting growth of government spending in line with growth of the gross domestic product. Changes have also been proposed in the mortgage market aimed at making it cheaper to change a mortgage and promoting the use of mixed-rate mortgage loans in a future context of interest rates higher than those now current. Finally, we should point out the agreement in principle now in the making between business organizations, trade unions and government with the objective of reducing the level of temporary work contracts in current labour hiring.

CHRONOLOGY

2005

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	**17**	Increase in **special taxes** on alcohol and tobacco to finance health (BOE 17-9-05).
	20	**Federal Reserve** raises reference rate a quarter-point to 3.75%.
October	**4**	IBEX 35 index for **Spanish stock exchange** marks up annual high (10,919.2) with cumulative gains of 20.2%.
	13	Government approves **National Reform Programme for Spain**.
November	**1**	**Federal Reserve** raises reference rate to 4%.
	28	**Slovak crown** joins Exchange Rate Mechanism.
December	**1**	**European Central Bank** raises official interest rate to 2.25%.
	13	**Federal Reserve** raises reference rate to 4.25%.
	17	European Council approves **2007-2013 Budget**.
	18	Hong Kong Summit of **World Trade Organization** agrees to removal of all aids to agricultural exports of developed countries in 2013.

2006

January	**20**	Government presents bills for reform of **personal income tax** and **corporate tax.**
	31	**Federal Reserve** raises reference rate to 4.50%.
March	**2**	**European Central Bank** raises official interest rate to 2.50%.
	24	IBEX 35 index for **Spanish stock** market marks up annual high (11,954.4), a cumulative gain of 11.4% over the end of December 2005.
	28	**Federal Reserve** raises reference interest rates to 4.75%.
	31	Government approves **economic policy package** including budgetary measures and others on mortgage market, energy sector and rail transport.
April	**21**	One-month **forward** price of Brent quality oil goes up to all-time high of 73.85 dollars a barrel.
	27	Dow Jones index for **New York stock exchange** records annual high (11,382.5), a rise of 6.2% compared with end of 2005.

AGENDA

May

- **4** Meeting of Governing Board of European Central Bank.
- **5** Industrial Production Index (March).
- **10** Meeting of Open Market Committee of Federal Reserve.
- **11** Early GDP (1st Quarter). Early GDP for euro area (1st Quarter).
- **12** Consumer price index (April).
- **17** Harmonized CPI for European Union (April).
- **24** GDP (1st Quarter).
- **25** Producer price index (April).
- **30** Early HCPI indicator (May).

June

- **1** Meeting of Governing Board of European Central Bank.
- **5** Industrial production index (April).
- **13** Consumer price index (May).
- **14** Quarterly survey of labour costs (1st Quarter).
- **15** HCPI for European Union (May).
- **26** Producer price index (May).
- **29** Early HCPI indicator (June). Meeting of Open Market Committee of Federal Reserve.

INTERNATIONAL REVIEW

IMF forecasts: growth solid despite oil rises and trade deficits

IMF expecting higher world growth in 2006.

In its April report on prospects for the world economy, the International Monetary Fund (IMF) raised its growth forecasts for 2006 from 4.3% to 4.9% and for 2007 left growth at 4.7%. World growth is turning out stronger than expected, thanks to easy financing terms which greatly compensate for natural disasters and the rise in energy costs. Industrial production, trade, consumer confidence and labour markets are getting stronger.

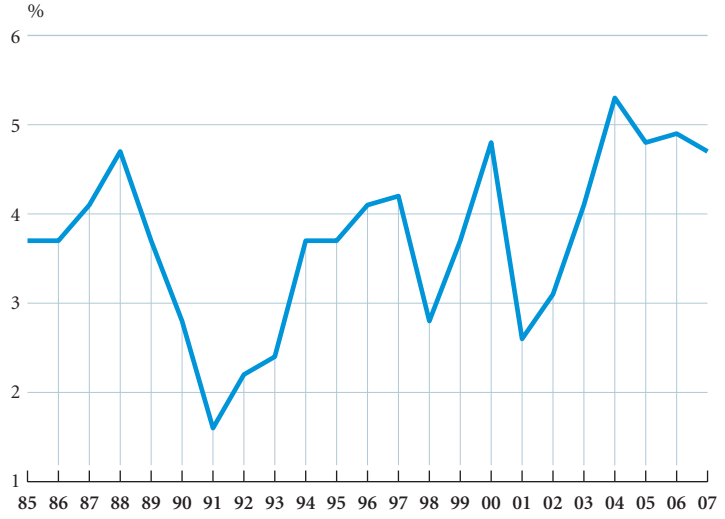
Growth balancing out, with Japan and emerging countries adding to leading group made up of China and United States.

Growth is also being more balanced. As well as the United States and China, there is now Japan and the emerging economies. In the United States 2006 growth is expected to be 3.4% with 3.3% in 2007. Employment, capital goods and industrial production orders indicate that the slowdown at the end of 2005 was merely temporary. In 2006 there will be some moderation in the strong level of private consumption because of the weakening of the housing market. Some worsening in government finances is also forecast.

A slight improvement is expected in the level of economic activity in Europe with the expectation that growth in 2006 will go up from 1.8% to 2.0%. Growth will not go higher and an advance of 1.9% is forecast for 2007. In spite of the upward revision, European demand remains an unknown factor (mainly focused on Germany), with expected growth of 1.3%

WORLD GROWTH HOLDING TO HIGH LEVELS

Year-to-year change in gross domestic product (*)



NOTES: (*) 2006 and 2007 are forecasts.
SOURCE: International Monetary Fund.

IMF FORECASTS

Annual change as percentage

	2004	2005	2006 (1)	2007 (1)
GDP				
United States	4.2	3.5	3.4	3.3
Japan	2.3	2.7	2.8	2.1
Germany	1.6	0.9	1.3	1.0
France	2.1	1.4	2.0	2.1
Italy	0.9	0.1	1.2	1.4
United Kingdom	3.1	1.8	2.5	2.7
Spain	3.1	3.4	3.3	3.2
Euro area	**2.1**	**1.3**	**2.0**	**1.9**
Advanced economies	**3.3**	**2.7**	**3.0**	**2.8**
World total	**5.3**	**4.8**	**4.9**	**4.7**
Developing countries	*7.6*	*7.2*	*6.9*	*6.6*
Latin America	*5.6*	*4.3*	*4.3*	*3.6*
Eastern and Central Europe	*6.5*	*5.3*	*5.2*	*4.8*
Russia	*7.2*	*6.4*	*6.0*	*5.8*
China	*10.1*	*9.9*	*9.5*	*9.0*
Consumer prices				
United States	2.7	3.4	3.2	2.5
Japan	0.0	–0.3	0.3	0.6
Germany (2)	1.8	1.9	1.8	2.5
France (2)	2.3	1.9	1.7	1.8
Italy (2)	2.3	2.3	2.5	2.1
United Kingdom (2)	1.3	2.1	1.9	1.9
Spain (2)	3.1	3.4	3.4	3.1
Euro area (2)	**2.1**	**2.2**	**2.1**	**2.2**
Advanced economies	**2.0**	**2.3**	**2.3**	**2.1**
Developing countries	*5.7*	*5.4*	*5.4*	*4.8*
Unemployment rate (3)				
United States	5.5	5.1	4.9	5.1
Japan	4.7	4.4	4.1	4.0
Germany	9.2	9.1	8.7	8.8
France	9.5	9.6	9.6	9.1
Italy	8.3	8.1	7.8	7.6
United Kingdom	4.8	4.8	4.9	4.8
Spain	11.0	9.2	8.6	8.5
World trade by volume (4)	**10.4**	**7.3**	**8.0**	**7.5**
Oil price ($ per barrel) (5)	**30.7**	**41.3**	**14.8**	**2.9**

NOTES: (1) Forecasts in April 2006.
(2) Harmonized consumer price index.
(3) Percentage of labour force.
(4) Goods and services.
(5) Average spot prices for Brent, Dubai and West Texas Intermediate oil. Average oil price in dollars per barrel forecast at $61.25 in 2006 and $63.00 in 2007.
SOURCE: International Monetary Fund.

Prospects for Europe improve but doubts about Germany and Italy persist.

for 2006 and a slim 1.0% in 2007. Growth prospects for France and the United Kingdom are slightly better but things continue to get worse in the case of Italy. Spain continues as a positive exception with a forecast of 3.3% for 2006 (revised upward) and 3.2% for 2007.

Japan's growth is stronger than it seemed at first, this time thanks to its being based on domestic demand. Growth for 2006 has been revised upward from 2.0% to 2.8%. Nevertheless, Japan has ahead of it the move to a new monetary policy framework, the recovery of a budgetary balance and the recovery of advances in productivity. These are factors which could drain off strength from growth leaving the forecast for 2007 at 2.1%. Increased growth is also expected in the case of China. Review of the method of measuring gross domestic product (GDP) has put greater weight on services and an increase in growth rates, which for the period 1993-2004 showed an average rate of 10%. In 2006, the rate expected is 9.5%. The real estate sector should strengthen the rate of economic activity but avian flu constitutes a significant risk with important potential effects, apart from human losses, on the public budget and payment systems.

Inflation remains under control in spite of oil.

The positive factor has been the continuing moderation of prices in view of the pressure from the oil markets. Globalization has had a compensatory effect but this could be coming to an end because of the high levels of utilization of production capacity. The increase in prices, along with somewhat less easy financial terms and interest rates on the rise, should have a negative effect on high corporate profits. In the United States, however, these are running alongside weak corporate investment spending.

Trade imbalances present main risk with readjustment of dollar seen as solution.

The main risks for growth are the trade deficits, with a bias in world savings excessively focused in the emerging countries. Correction of these deficits will come about only through a downward adjustment of the dollar exchange rate. Other major risks are fiscal imbalances and the lack of decided policies to right them at this especially propitious moment.

In 2006, the expected average per barrel price of oil is 61.25 dollars, in line with the previous forecast. The crises in Nigeria, Iraq and Iran, which together account for 11% of world oil production, will have their effect on supply and in 2007 an average per barrel price of 63.00 dollars is expected. Russia must be added to the list of risks as an unreliable supplier of gas. The increase in investment to adapt supply to consumption needs is not being as productive as might be hoped, due to smaller and smaller supply sources, lack of qualified personnel following years of cheap oil and legal barriers in some countries.

Three reasons behind Chinese frugality

Ambassador Macaurtney presented his gifts to the emperor Qien Long but to the surprise of the British diplomat, his majesty exclaimed that, while he was thankful for the tribute from such a far-off vassal country, he did not need any of it because he already had everything he wanted. Since then, many have seen frustrated their hopes of selling something to Chinese consumers in great quantity. This anecdote from the end of the 18th century, however, shows the three points defining the crossroads of Chinese consumption in our time. First, paying attention to the attitude of its ancient ruler, the traditional Chinese propensity to frugality and saving seems to be well surviving the passage of time. Present-day China is investing huge sums with figures going as high as 45% of the gross domestic product but its level of savings is even greater going above 10%. Because of this, China has a troublesome foreign surplus but the most unique factor in this situation is that private consumption represents only one-third of the economy whereas in the rest of the world it makes up two-thirds and, furthermore, it also misses a beat in terms of public spending. Can we then declare that there is no solution for all these confirmed savers?

RICH CHINA, POOR CHINA

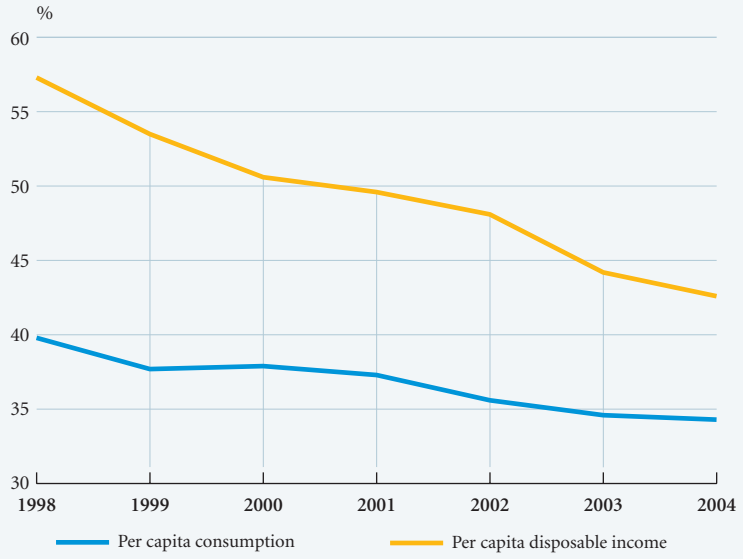
SOURCE: Chinese National Office of Statistics and internal figures.

To answer this question we may find a clue in the second aspect of our little story. The emperor Qien Long was not strictly Chinese but Manchu and thus represented only the dominant barbarian elite from the north-east and the fact is that in China there are many Chinese but especially there are many *Chinas*. There does not exist a single market but many markets and these are substantially more diverse than those that make up Europe as a whole. Since 1978, with the start of the reforms introduced by Deng Xiao Ping, a sharp rift between the rich and the poor of marked geographical vein has been superimposing itself on the existing melting pot of ethnic groups and languages. Rampant capitalism has turned the coastal regions into the advance guard of the reforms while the interior remains stuck in the past. As a result, in 2005 per capita income in Shanghai was four times the national figure while, by way of example, the western provinces of Sichuan, Gangsu and Guizhou (with 173 million population) failed to reach half. The biggest problem in China's current economy is that two-thirds of the Chinese have had almost a "nil" share in the economic development of recent years.

Furthermore, the interior-coast differences and the country-city differences continue to increase in the midst of a process of divergent growth. In 1998, consumption in real terms of a household in the rural areas represented only 57% of its equivalent in an urban situation. Far from improving, by 2004 that proportion had dropped to 42%. At the end of 2005, the GDP of the coastal provinces (36% of the total population) was already close to 60% of the total, also with a tendency to rise. The huge geographical size of the country and the lack of means of transport, especially in the interior regions, go against change and bring out the full magnitude of the cumulative backwardness of this giant country. In spite of huge investment carried out, the density of the road network is still very low. Even ignoring the underpopulated regions of Xingjiang, Tibet and Quinhai, the density of road kilometres does not reach half that of the United States with a population density six times less than the areas considered. Railway lines are clearly insufficient with the world's highest degree of utilization (ten times higher that the European average or that of any other rich country). When one speaks of bottlenecks in China, it is for real reasons.

COUNTRY AND CITY FOLLOWING DIVERGENT ROADS

Trend in rural consumer spending and disposable income compared with that of city



SOURCE: Chinese National Office of Statistics and internal figures.

These two realities of the Chinese colossus are reflected in the type of consumption. In the rural areas, spending on food always takes up the greater part at close to 60% of basic consumer spending. In the period 1999-2004, this grew by 45% whereas spending on clothing held at 20% and services and household goods stayed at 8%. The only heading to grow more than food in these recent years was transport, which reflects the already mentioned difficulties of the interior provinces. In coastal Shanghai, the biggest city in the country and a symbol of the growth in recent years, things are quite different. In 2005, food represented 36% of basic consumer goods, well below the figure of 44% in 2000. Last year, food consumption in Shanghai grew by 8% while spending on clothing was up 17%. The question is, if the inhabitants of Shanghai are more concerned about their appearance than expected, could it be that Chinese frugality is not as unchangeable as it seemed?

The third insight of our story is to be found in the broad lines that marked the long rule of Qien Long, a counter-reformist characterized by a turning back and looking inward. The China of today, a member of the World Trade Organization and committed to continuing its economic reforms, is showing signs that are clearly better. Nevertheless, institutional improvement remains to be carried out. This will require strengthening property rights, especially in the rural regions, giving people more freedom to give up farm activity and move to the cities and, finally, improvements in local government. Then, perhaps, it could be that the Chinese living in the interior might become as concerned about their appearance as those who live in bustling Shanghai.

US engine functioning but needs some fixing

In the passages of the Capitol, one man's name was being heard a lot. That man was not Chinese president Hu Jintao, who recently visited the United States, nor the all-powerful political advisor Karl Rove, but Rob Portman, former trade supervisor and now head of the Management and Budget Office. He is the US president's best bet.

Thanks to Portman, the Bush administration has been able to fairly successfully resist the call of the protectionists who, in looking for scapegoats, are accusing China of being the main cause of the growing foreign deficit. This is the blot on an economy which, on the other hand, is growing by 3.2% without causing inflation. No doubt, an appreciation of the renminbi and higher domestic consumption would help reduce China's bilateral surplus with the United States but the excessive consumption of the Americans themselves lies closer at hand and is more relevant for correcting the foreign balance.

United States growing strongly with no inflation pressures...

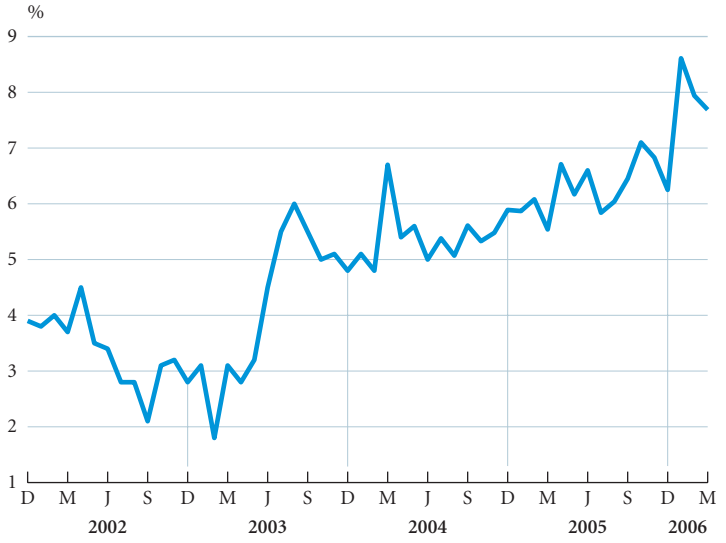
A good way to begin would be to put some kind of order in the public purse and that is where the appointment of Portman comes in. Since 2000, the combination of tax cuts and increased government spending, criticized from all points of view, has not done any good either to the budgetary balance or the trade balance. Without Portman, it would have been necessary to take notice of possible protectionist outpourings.

...but mounting concern about trade and foreign deficits.

Another major factor responsible for the foreign deficit is private consumption. It does not matter whether it is cold or hot or whether oil goes sky-high, consumption not only is holding up but increasing. Retail sales in March, excluding the volatile headings of motor vehicles and higher-cost petrol, grew by 8.7% year-to-year whereas a year ago they rose by 4.8%. As a result, up to now,

UNITED STATES: CONSUMPTION KEEPS AFLOAT

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



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

Consumer indicators show strength and optimism.

consumer extravagance is well above the more and more powerful assault of energy on household budgets. On top of the oil problem comes the higher cost of electrical energy generated in gas-fuelled power stations, which offer more flexible production, and here price acts as a goad to other prices.

In spite of solid growth and that the slowdown is much gentler than expected, despite the enthusiasm of consumers and

UNITED STATES: MAIN ECONOMIC INDICATORS

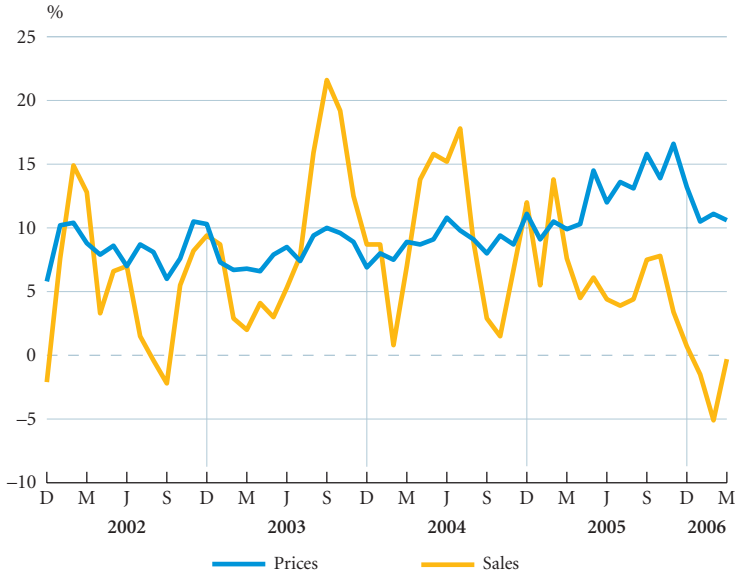
Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006	
			1Q	2Q	3Q	4Q	January	February
Real GDP	4.2	3.5	3.6	3.6	3.6	3.2	–	...
Retail sales	6.2	7.2	6.4	7.9	8.2	6.2	9.4	7.5
Consumer confidence (*)	96.1	100.3	104.2	102.3	98.9	95.8	106.8	102.7
Industrial production	4.1	3.2	4.0	3.1	2.7	3.0	2.9	3.0
Industrial activity index (ISM) (*)	60.5	55.5	55.7	53.2	56.0	57.0	54.8	56.7
Sales of single-family homes	10.0	6.7	5.1	6.9	11.5	3.5	1.1	–13.4
Unemployment rate (**)	5.5	5.1	5.2	5.1	5.0	4.9	4.7	4.8
Consumer prices	2.7	3.4	3.0	3.0	3.8	3.7	4.0	3.6
Trade balance (***)	–618	–724	–651	–672	–695	–724	–734	–740

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

UNITED STATES: CONSTRUCTION MAKING «SOFT LANDING»

Year-to-year change in prices and sales of existing housing



SOURCE: Federal Housing Board and internal figures.

the price increases in raw materials and energy, inflationary pressures are not showing up. The consumer price index (CPI) for March was down to 3.4% year-to-year while the underlying component (excluding energy and food) remains stuck at 2.1%. The figure was somewhat worse than expected because of clothing. But the complaints come not from the CPI itself but rather from the risk that in coming months these problems will show up in high levels of production capacity and, paradoxically, in the cooling down of the real estate market.

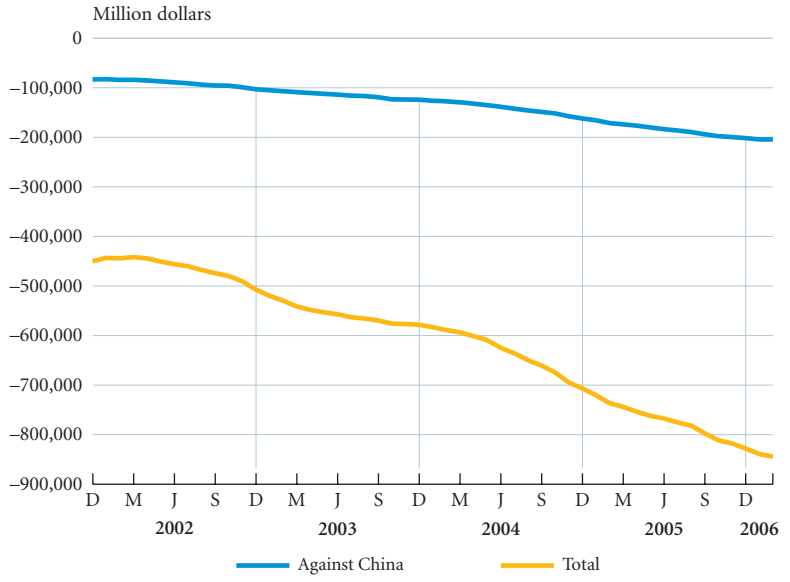
Housing is slowing down gradually, just as the Fed wanted to see. Sales are down and prices are rising less although still above 10% year-to-year. Behind this slowdown lies the increase in the average rate for mortgage loans which now is 6.5% for fixed term loans as against 5.8% a year ago so that to buy a house now is 7% more difficult than it was last Spring. This is bringing about a relative improvement in financial costs for those who live in rental housing, making this option more attractive, although it could result in rent increases.

Thus, the present inflation on real estate assets will be replaced by consumer inflation, with an effect on the underlying component. In any case, the pressure on prices would coincide with factors in favour of a cooling down rather than those of overheating: a drop in housing prices, with a decrease in wealth effect as an aid to consumption, and smaller household budgets. All these factors would involve less consumer splurging, an hypothesis already present in general public feeling, as reflected in the confidence indices published by the Conference Board, where the perception of the current situation is much higher than one year ago, but not in the evaluation of expectations. More moderate consumption would put a clamp on the much-feared increase in prices.

Inflation under control but high levels for utilization of production capacity and rise in rentals seen as major risk.

UNITED STATES: NOT EVERYTHING ENDS WITH CHINA

US trade balance as total for past 12 months



SOURCE: Department of Commerce and internal figures.

Imports from China increase foreign deficit but high levels of public and private consumption also add.

In the same way, wage pressures seem to be under control. Some 590,000 new jobs were created in the first quarter of 2006, an enviable figure but below the 73,000 jobs created one month earlier. Job creation is still not pushing up wages which are scarcely maintaining their purchasing level. Indices for corporate activity and perception of conditions also testify to the present good economic situation. But it should be remembered that, as a result of low interest rates, contained wage levels and capital goods prices, profits stand at highs in terms of nominal GDP. Any change would take us away from these highs and bring about more cooling off.

The trade deficit stands at more than 6% of the gross domestic product (GDP), continues to increase and for the moment no end of this is in sight. In spite of the enormous bilateral deficit with China, which is in deficit with the rest of the world, the foreign imbalance is not a Chinese anomaly but rather an American one. Less fierce demand by consumers, a loss of strength in housing, a balanced budget and perhaps not such high corporate profits might contribute to the reduction of this imbalance.

Japan rejoins leading group of growth economies...

Japan: land of rising optimism

The hard drivers of world growth have been able to welcome a new associate, a prodigal son absent for a long time. Japan is that prodigal son of the world economy which, after a decade without any periods of lasting growth, is back on track. The GDP grew by 2.7% in 2005 but the news of the month is that the prodigal son has returned changed and redeemed.

The change is that the biggest contributor to recovery is private consumption, the traditional poor cousin of Japan's economy. The current recovery is based on factors of domestic demand and this is something new. Beyond the numbers of the national accounts, this implies a

JAPAN: MAIN ECONOMIC INDICATORS

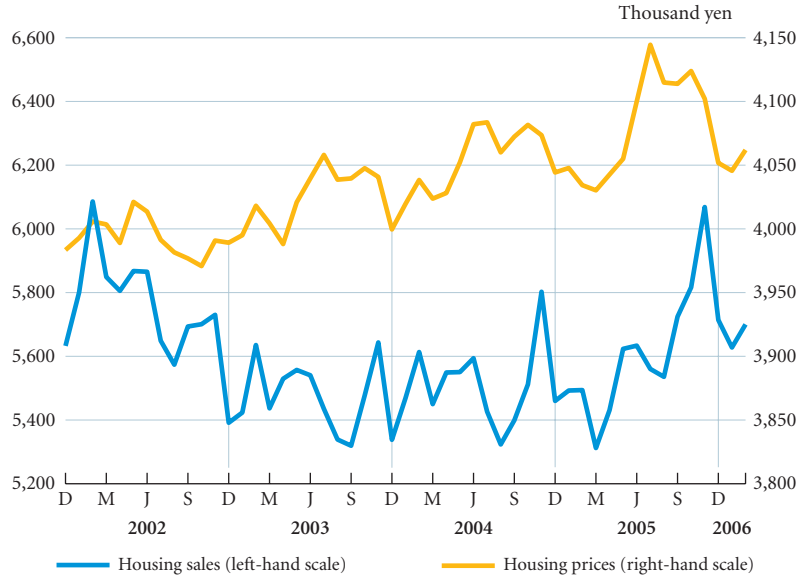
Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006	
			1Q	2Q	3Q	4Q	January	February
Real GDP	2.3	2.7	1.1	2.7	2.8	4.3	–	...
Retail sales	–0.9	1.4	0.6	3.1	1.1	0.7	0.0	0.9
Industrial production	5.3	1.5	2.3	0.3	–0.1	3.6	2.8	2.5
Tankan company index (*)	20.5	18.0	14.0	18.0	19.0	21.0	–	20.0
Housing construction	2.6	3.8	1.4	2.2	4.9	6.9	–2.4	13.7
Unemployment rate (**)	4.7	4.4	4.5	4.3	4.3	4.5	4.5	4.1
Consumer prices	0.0	–0.3	–0.2	–0.1	–0.3	–0.5	0.5	0.4
Trade balance (***)	13.8	10.3	13.2	12.1	10.9	10.3	9.9	9.8

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

JAPAN: WILL HOUSING SET RECOVERY COURSE?

Housing in Tokyo area (*)



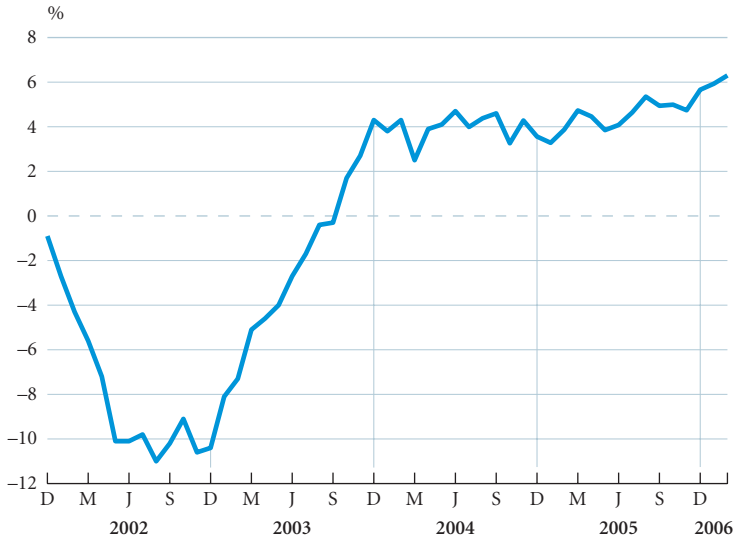
NOTES: (*) Cycle-trend series.
SOURCE: Japanese Institute of Real Estate Economy and internal figures.

change toward a more optimistic attitude, as suggested by recent government surveys which show the highest confidence levels in the past 15 years. This confidence, which because it deals with Japanese caution could not be otherwise, is based on objective reasons. One is the improvement in the labour market with an unemployment rate in February of only 4.1% and with appreciable improvement in wages. Another factor is the better performance in the real estate sector which now is not dropping but rather showing a moderate recovery.

...and consumers gain confidence.

JAPAN: MACHINERY ORDERS MARKING CHANGE

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



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

These expectations in consumption, however, have not yet shown up in the indicators. Retail sales have still not recovered the upward trend predominating in 2005. One of the reasons is that the prudent Japanese, although they now see things fairly clearly, first prefer to replace their savings accounts that are in poor shape following so many years of economic slack. This is crucial because without the consumers a continuation of the expansionist cycle is impossible.

Recovery of investment expected.

Investment slowed down all last year and at this time the level of utilization of production capacity is very high, as shown by the latest Tankan surveys of economic sentiment. The rise in machinery orders, both domestic and foreign (the most volatile) signals a recovery of drive in investment. This, however, will need to have support in domestic demand, that is to say, in the Japanese consumer, because the strong contribution of the foreign sector to growth in the final quarter of 2005 is more like hitting the bottom than a prelude to future growth. The goods and services balance for the past 12 months shows a slight downward trend, eased by the recovery in exports but always dominated by the strength of imports.

Energy prices raise inflation but what matters is psychological effect.

The end of deflation is another reason for optimism. The CPI excluding foods rose by 0.4% year-to-year in February. This coming to the end of the tunnel, however, has three ifs and buts. With the rise in the cost of energy, Japan is importing inflation which, when this ends, should pull the indices down; the GDP deflators are still not reflecting price increases, and, furthermore, prices in Tokyo in March showed nil growth. In spite of everything, the psychological effect has now taken place and perhaps that is the most important.

The high level of utilization of production capacity, consumer expectations and the end of deflation mark out a course which the central bank is quite clear about but this is still a thorny path.

In the first place, still to be resolved is the matter of the high government debt accumulated during the years of stagnation which could drain away from growth. Also still waiting is reform of the banking system and the matter of Japan's growth potential. With an aging population, productivity and the reduction of unit labour costs are basic elements for increasing this potential yet these indicators lately have not gone very well. Without meeting these challenges, Japan's recovery, while solid and optimistic, may have a relatively lower ceiling than that of other advanced economies.

Japan cannot ignore reforms still needed in debt and low productivity.

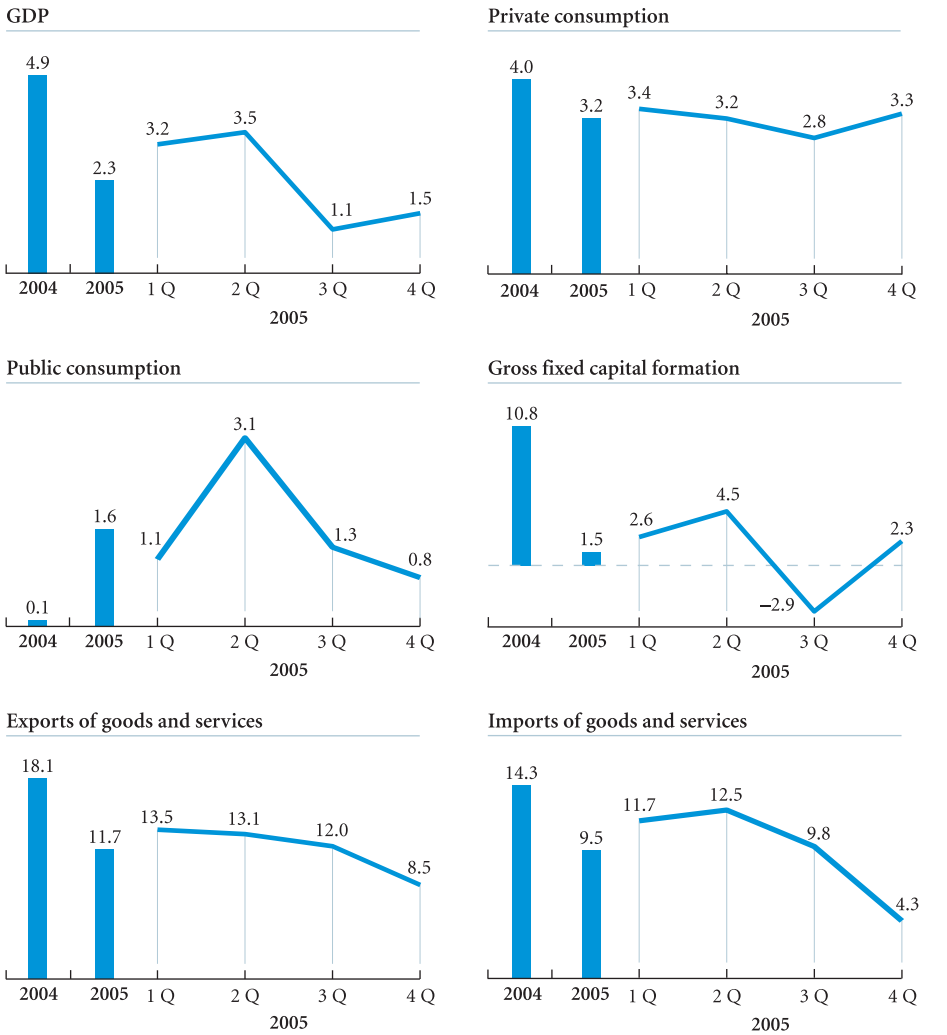
Brazil: a balance with higher growth still waiting

Brazil recovers ground but only partly.

At the end of last year, the Brazilian economy recovered lost ground but growth continues low. In contrast to Argentina, it is growing less but inflation is under control and the foreign sector is

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-to-year change in real terms



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

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	4.9	2.3	3.2	3.5	1.1	1.5	–	...	–	–
Industrial production	8.3	3.1	3.9	6.1	1.4	1.3	3.2	5.4	...	...
Unemployment rate São Paulo (*)	18.8	17.0	17.0	17.5	17.2	17.2	15.7	16.3	...	...
Consumer prices	6.3	5.8	6.0	6.6	5.2	5.3	4.8	4.6	4.2	...
Trade balance (**)	33.7	44.8	35.9	38.3	41.2	44.8	45.4	45.5	45.8	44.2

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

performing better than in the case of its neighbour.

Foreign sector continues to show surplus but exports flagging.

The GDP in the fourth quarter rose by 1.5% year-to-year. This is a modest rate but breaks with the marked slowdown in the previous quarter. Private consumption and investment recovered ground although only partly, especially in the latter case. In fact, 2005 was a year with a strong slowdown in gross capital formation, in spite of the country's great need for infrastructures. On the positive side, macroeconomic stability remains a priority. Public consumption is still dropping sharply as a result of the austerity measures taken to set right the burden of debt contracted in the past. The foreign sector also showed a good performance although in this case the main factor was the weakness in imports.

Retail consumption and industrial production point toward recovery.

Latest monthly demand indicators point to increased growth in the first quarter. Retail sales moved up slightly to show 5.3% year-to-year growth in February. Car sales also back these upward views. In spite of a weak performance in March these sales began the year on a good footing with much sharper increases than those recorded in the second half of 2005.

Inflation under control runs alongside high unemployment levels.

We also find support for this upward hypothesis on the supply side. Industrial production, and especially the capital goods component, also began the year more strongly than they ended the last one, with increases in February at 5.4% and 10.8% year-to-year respectively.

While hoping for greater growth, Brazil wants to keep putting things in order and the best proof of this is to be seen in price stability. Inflation in March was 4.2% year-to-year, an historically low figure. The performance in wholesale prices, which in February were below the level for the same period last year, strengthens the scenario. While prices are the good side, the persistence of a high level of unemployment is the dark side, with an unemployment rate in São Paulo going up to 16.3% in February.

In turn, the trade balance continued to show the highest surplus on the South American continent at 44.24 billion dollars in the past 12 months ended in April. Imports in the first quarter were dominated by capital goods. Exports, however, show a marked slowdown which sharpened in April and, without strong exports, any improvement in domestic demand that increases imports will change this situation.

Argentina riding high

The Argentine economy is maintaining a high level of recovery. With the 2002 recession now far behind, the biggest risks are growing inflation and a foreign sector that is still not progressing.

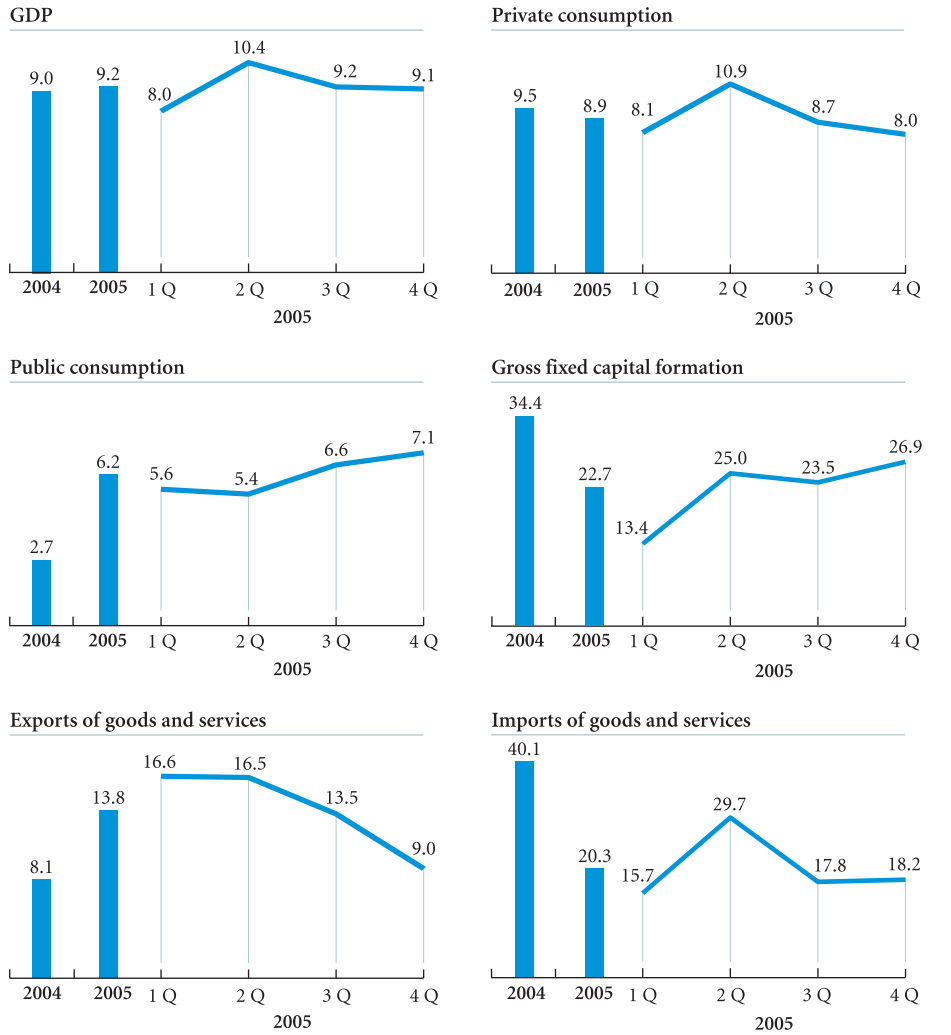
The Argentine GDP grew by 9.1% in the fourth quarter of 2005, thus ending its third year of growth. Although private consumption continued to show strength, with increases of 8.0%, in the course of 2005 this was somewhat taken over by investment as the biggest contributor to growth. The investment component thus came to represent 22% of the economy, which turns Argentina into one of the biggest investors in the region, a welcome process in economies that were formerly characterized by an excess of consumption and a deficit in infrastructures. On the other hand, the foreign sector made a negative contribution to growth, mainly because

Argentina grows by 9.1% and ends third year of strong growth.

Investment moves up front.

TREND IN ARGENTINA'S GDP BY COMPONENT

Percentage year-to-year change in real terms



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

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
Real GDP	9.0	9.2	8.0	10.4	9.2	9.1	–	...	–
Industrial production	6.9	7.3	7.0	7.8	7.2	7.1	6.4	7.3	5.8
Unemployment rate (*)	13.6	11.6	13.0	12.1	11.1	10.1	...	...	...
Consumer prices	4.4	9.6	8.2	8.8	9.8	11.7	12.1	11.5	11.1
Trade balance (**)	12.1	11.3	11.9	11.0	11.4	11.3	11.3	11.3	...

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

Demand continues strong progress.

of the slowdown in exports, whose competitiveness has been affected by the inflation differential with other countries in the region.

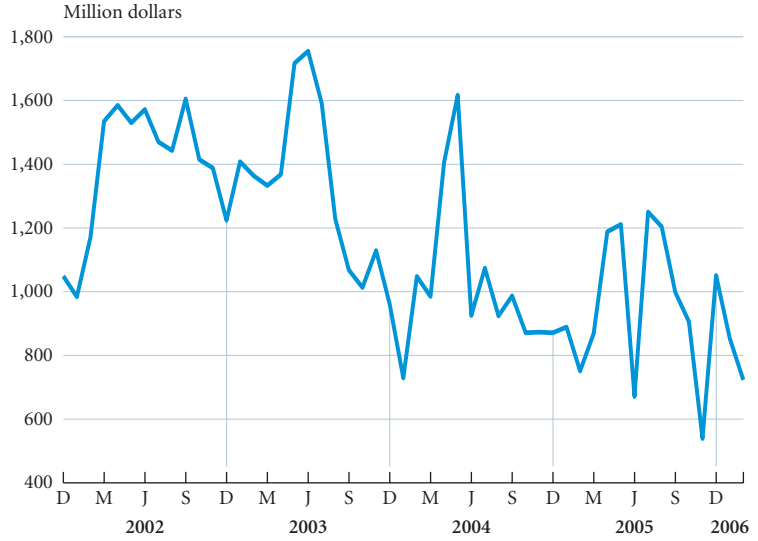
Demand indicators continue to show signs of growth with retail sales in February marking up growth of 29.6% year-to-year. Car sales in March also were up by 22.9% and are keeping to this upward trend following a start to the year with explosive growth.

Argentine inflation well above that of neighbours.

Nor on the supply side, has there been any departure from this upward trend although increases have been more moderate. Industrial production in March was up 5.8% year-to-year, a rate which, while far from the rates typical of the current recovery, were higher than normal in the advanced economies. By sector, mining remains strong but this is not so in metals. It is in paper and energy where we see the weakest start to the year. Activity

ARGENTINA: FOREIGN SECTOR LOSING COMPETITIVENESS

Monthly figure for Argentina's trade balance



SOURCE: INDEC and internal figures.

indicators in industry and construction maintained sharp growth rates in February.

High inflation continues as the main risk to sustaining recovery although the dangerous upward trend that was the rule in 2005 has now disappeared. The CPI grew by 11.1% year-to-year in March, mainly because of raw materials and food. This rise was in contrast to the moderation in prices now to the fore in most Latin American countries and is hurting the competitiveness of exports. In this respect, while the trade balance of the past 12 months as of February still shows a surplus, the fact is that for three months exports have reported very small increases and the positive balance is getting lower and lower.

Raw materials: demand pushing prices to new highs

Foreign sector worsening.

The all-time highs in oil prices was the most notable news. On April 21, the one-month forward per barrel price of Brent quality crude was 73.85 dollars, a figure never before reached. Far from being a passing figure, this level marked the whole month of April when oil rose by 9%, practically without any swings. Furthermore, this rise came within a trend running over a long period which has taken *black gold* to show a total increase of 25% so far in 2006.

Raw materials, and not only oil, show notably sharp upturn.

While this sharp rise was mainly due to geo-political tensions brought about by the question of Iran's nuclear programme, the basic reason is the growing strength of the emerging

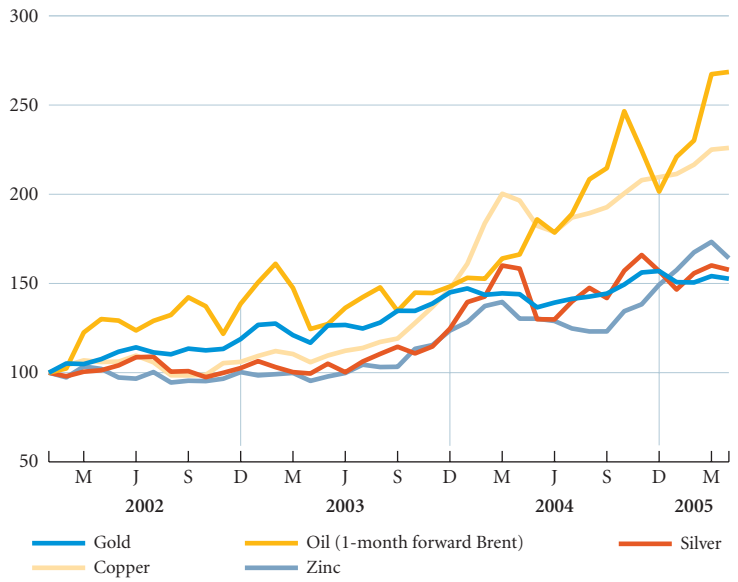
RAW MATERIALS PRICES

	2004	2005	2005				2006			
			1Q	2Q	3Q	4Q	January	February	March	April
«The Economist» index in dollars (*)										
General	**17.4**	**3.6**	**–2.3**	**–1.8**	**6.2**	**12.1**	**19.8**	**22.2**	**12.6**	**21.4**
Food	11.2	–1.3	–8.5	–7.7	3.2	8.0	12.6	14.3	2.4	5.6
Industrials	26.1	9.7	5.9	6.3	10.0	16.8	28.0	31.3	24.7	39.7
Non-food agricultural	*9.2*	*–1.9*	*–10.7*	*–8.6*	*0.8*	*10.9*	*16.9*	*17.4*	*12.6*	*15.0*
Metals	*38.2*	*16.5*	*16.1*	*15.5*	*15.0*	*19.5*	*33.3*	*37.9*	*30.3*	*51.3*
«The Economist» index in euros (*)	**6.7**	**4.0**	**–6.4**	**–6.0**	**6.6**	**22.0**	**30.0**	**32.8**	**24.0**	**28.3**
Oil (**)										
Dollars/barrel	38.0	55.1	47.8	53.1	62.0	57.7	63.5	61.9	63.2	70.6
Change rate	34.4	46.5	52.7	50.9	52.5	29.9	44.2	34.8	18.6	31.8
Gold										
Dollars/ounce	409.6	445.1	427.3	427.8	439.6	485.6	549.3	555.6	557.7	607.7
Change rate	12.7	8.6	4.6	8.6	9.4	11.9	29.5	31.1	28.5	41.4

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

RAW MATERIALS GO SKY-HIGH

January 2002 = 100. Monthly averages (quotations in US dollars)



SOURCE: Thomson Financial Datastream and internal figures.

Factor behind increase in raw materials is heavy demand by emerging economies.

economies, with China setting the pace. This is a situation which reflects the fact that highs in oil prices are being accompanied by further record prices in other raw materials, especially for metals. The year-to-year rise in oil (32% year-to-year in April) looks pale against the figure reached by the metals group in «The Economist» index (51%). In raw materials as a whole, measured by that index in dollars, they rose by 21% year-to-year. In euros, the increase was 28% year-to-year.

The immediate prospects are not positive. Going back to the first player mentioned in these comments, namely oil, while geo-political tensions may ease off, which would bring about a withdrawal of the more speculative investors from the market, the basic conditions are unlikely to improve in coming months. World growth, especially that of Asia, is going to continue strong. The lack of sufficient world oil production capacity will not be improved over the short term, which makes the market vulnerable to any threat to supply in the Middle East or other oil-producing areas. Refining capacity will also continue to have its difficulties. In the United States, especially, the change in environmental regulations applying to petrol is putting limits on refineries, stopping them from operating at full capacity and requiring the supply of crude with lower sulphur content, the most in demand in the market.

EUROPEAN UNION

Euro Area: Spring is here

In the first quarter, economic activity in the Euro Area showed new strength, as confirmed by the fact that the economic sentiment indicator for March stood at the highest level since 2001. Leading this recovery was the twin factor investment-exports while the drive in consumption is more uncertain.

An indicator, such as industrial production of capital goods, which grew by more than 4% year-to-year in January, suggests that the drive in investment remains strong. On the other hand, with regard to consumption, up to this point the main sign of increased drive in spending still rests among qualitative indicators based on household surveys.

Specifically, the consumer confidence index for the first quarter was consolidated at the –11 points level, an improvement of one point over the fourth quarter. On the other hand, the more moderate growth of retail sales, scarcely above 1% year-to-year in the early months of the year, qualifies the impression of a sharp rise that could be read from qualitative indicators.

What are the sectors capitalizing on the better state of the economy? The most notable increase is showing up in industry for which both current indicators (industrial production grew by 2.6% year-to-year in January in line with the December figure) and early indicators (the portfolio of industrial orders have shown two months together,

Euro Area recovery moves ahead in first quarter mainly thanks to drive in investment and exports.

Consumption still not joining growth despite consumer surveys anticipating early rise.

STATE OF EURO AREA ECONOMY ON RISE

Economic sentiment index

SOURCE: European Commission.

Why is Europe not consuming more?

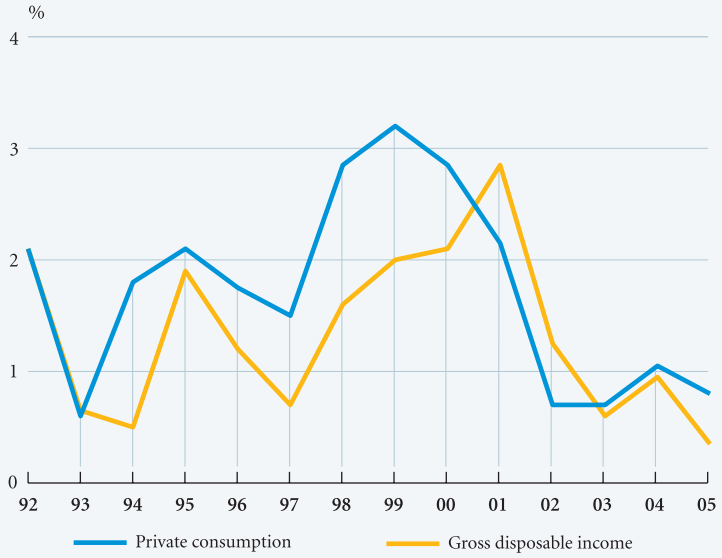
Growth in Europe is troubling, which is a logical concern if we remember that in the past five years the gross domestic product (GDP) of the Euro Area has grown by a mere 1.4% on annual average, practically half that in the United States, to cite a reference example. One of the immediate reasons behind this slim economic performance is that approximately 60% of the Euro Area economy is showing poor growth. In the period 2001-2005 private consumption in the Euro Area in real terms grew by a modest 1.3% on annual average, far from the long-term average (2.2% on annual average from 1981-2000). Where does the problem of European consumption lie?

Economic theory can provide us with some initial indications on how to examine this question. According to theoretical models, consumption depends on permanent income, that is, on present and future income consumers expect to receive either as the result of their labour or as returns on assets they own. To be more specific, the fundamental determinants of consumption are real disposable household income (earnings from labour, other income, such as interest, dividends or rentals, etc. less income tax), net financial wealth, non-financial wealth (mainly real estate) and the real interest rate.

Without downplaying the importance of the other determinants, the most significant relation takes place between consumption and gross disposable income (see graph below). According to a recent econometric exercise carried out by Barrell and Davis (2004) regarding five major industrial economies, it was found that, in spite of the fact that three determinants (income, wealth and real interest rate) are significant, the elasticity of consumption with respect to income is much higher than that of consumption with respect

LOSS OF STRENGTH IN DISPOSABLE INCOME HAMPERING CONSUMPTION IN EURO AREA

Percentage real annual change



SOURCE: European Commission.

to wealth or the real interest rate[1]. Recent studies by the Bank of Spain show a similar result for the Spanish economy.

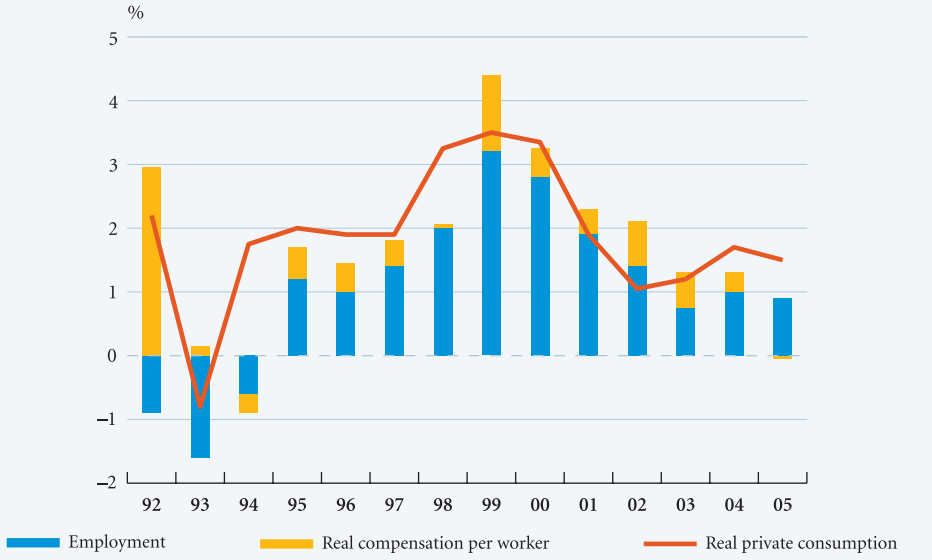
We may therefore centre the question of what are the determinants of the low growth rate of spending by European households in the problem of the poor trend in disposable income. Given that, according to European Commission estimates, income from wage work and self-employment represent approximately two-thirds of total disposable gross income in the Euro Area, it is possible to analyze the causes of the lack of growth of consumption by examining the trend in wage incomes.

If we break down those wage incomes by the changes in the number of those employed and real wages per worker (which includes wages and social security contributions paid by companies) it is possible to determine whether consumption has grown to a limited extent due to the fact that little employment has been created or, on the other hand, to a situation where wages have risen very little.

According to European Commission estimates, in the period 1970-2005, the contribution of employment has been far higher than that of wage levels. Thus, each percentage point of increased growth of employment generates a rise in real private consumption of 0.8 percentage points. On the other hand, an increase of one percentage point in real wages brings about a real increase in consumption of only 0.2 percentage points. In recent years, this sharp relation between consumption and employment, far from losing significance, has tended to sharpen (see accompanying graph). In fact, it is the growth of employment, rather than the trend in wages, which ends up determining the course of consumption. It should be noted that this performance fits in with the theory of the life cycle. Obtaining a job makes a

EMPLOYMENT MAIN FACTOR RESPONSIBLE FOR WEAKNESS OF EURO AREA CONSUMPTION

Percentage annual change



SOURCE: European Commission.

(1) Ray Barrell and E. Phillip Davis (2004) «Consumption, financial and real wealth in the G-5», NIESR Discussion Paper Number 232.

change in the expectations of future income and may modify consumption to a greater extent than a change in real wages, which may be purely transitory.

These results make it possible to point out some future trends which are important because of their effects. If consumption is critically dependent on employment (and this has been growing less than 1% year-to-year since the first quarter of 2005), can we expect Europe's recovery, at the dawn of which we now stand, to be sustained by household spending? Or, on the other hand, will the twin export-investment factor continue as the only support? If the forecasts of most international bodies actually come to pass, the prospects for consumption in the Euro Area are the least cloudy for several years. The European Commission forecasts 1.2% growth of employment for 2006 and 1.1% for 2007. In turn, the Organization for Economic Cooperation and Development maintains forecasts of 1.1% and 1.2%, respectively, for 2006 and 2007.

Starting out from growth of employment estimated at 0.8% for 2005, consumption should grow by 2-3 more decimals over the rate of increase seen in 2005 (1.4%), which would bring about a rate of increase at 1.6%-1.7% for 2006. For 2007, again starting out from the estimates mentioned above, consumption would again grow in the range of 1.6%-1.7%. This could have two results. The first result (on the positive side) could be that, due to the fact that European households likely will prudently keep increasing their rate of spending in the current year 2006 and in 2007, thanks to the more expansionist trend in employment, the present stage of recovery would turn out stronger than on previous occasions due to the relative weight and momentum characterizing private consumption. The other result (less propitious) might be that the recovery of consumption could be moderate, which at the same time would establish a relatively low ceiling for European recovery.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
GDP	1.8	1.4	1.2	1.2	1.6	1.8	–	...	–
Retail sales	1.5	1.3	1.7	0.8	1.6	1.2	1.3	1.0	...
Consumer confidence (*)	–14	–14	–13	–14	–15	–12	–11	–10	–11
Industrial production	1.9	1.2	0.6	0.7	1.5	2.0	2.6	...	...
Economic sentiment indicator (*)	99.4	98.1	98.7	96.1	97.7	100.1	101.5	102.7	103.5
Unemployment rate (**)	8.9	8.6	8.8	8.7	8.5	8.3	8.3	8.2	...
Consumer prices	2.1	2.2	2.0	2.0	2.3	2.3	2.4	2.3	2.2
Trade balance (***)	80.4	45.5	64.3	50.0	39.3	28.5	14.1	...	...

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

Industry and services benefit from improved state of economy and even faltering construction may be about to change step.

February and March, clearly improving) point to a stage of definite growth which could continue over coming months. The situation in services is not quite as strong although the background trend is also one of recovery. Finally, construction continues to consolidate a gradual improvement which has been correcting the sharp drop suffered by the sector in recent years.

With regard to prices, for the moment the impact of higher oil prices and other raw materials is relatively modest. In March, the harmonized consumer price index (HCPI) grew by 2.2% year-to-year, as against 2.3% the month before. After discounting energy, the resulting rate shows an even more contained course standing at 1.3% year-to-year in March. The trend in the labour market was less favourable. While in February the unemployment rate dropped one decimal to 8.2%, the prospects for coming months are uncertain.

Inflation rides out latest boost in oil prices and eases to 2.2% in March.

Germany: tax package in sight

Following several months during which qualitative indicators showing clear increases have been running side-by-side with a lack of positive real figures, that is to say, showing a gap between what the Anglo-Saxons call *soft* and *hard* data, the breach has begun to narrow. While indicators, such as the industrial activity index of the IFO Institute, are standing at highs for recent years (in April this index marked up its highest level since 1991), the recent trend in retail sales and industrial production, for example, is the best in recent times. With regard to the former, these went from growth of 0.2% year-to-year in the fourth quarter to jump up to 1.5% on average in January and February. Industrial production in January, in turn, added a fifth consecutive month at growth levels of more than 3% year-to-year.

The improved economic situation also showed up in two key sectors, namely construction and services. In the first case, the sharp rise in building permits for new houses in December and January suggests more drive in a sector that has been very much hurt in recent years. Services are running a similar course with a confidence indicator that moved up to the level of 17 points on average in the first quarter, six points more than in the previous quarter.

Recovery anticipated by confidence indicators in Germany beginning to be confirmed by real figures.

The trend in the labour market is less satisfactory. While the unemployment rate has been dropping moderately in recent months, neither the level reached (11.4% of the labour force in March, an historically high figure) nor the increase recorded that month end up being

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
GDP	1.1	1.1	0.6	0.8	1.5	1.6	–	...	–
Retail sales	2.1	1.4	1.0	2.6	1.7	0.2	1.9	1.1	...
Industrial production	2.4	2.9	1.8	1.9	3.3	4.5	3.7	6.4	...
Industrial activity index (IFO) (*)	95.4	95.5	95.1	93.0	95.4	98.7	101.8	103.4	105.4
Unemployment rate (**)	10.5	11.7	11.8	11.9	11.7	11.4	11.3	11.3	11.4
Consumer prices	1.7	2.0	1.7	1.7	2.2	2.3	2.2	2.1	1.8
Trade balance (***)	149	157.1	156.6	154.4	157.2	160.2	158.8	158.1	...

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

Industry, services and construction recording higher growth rates but burden remains of labour market still doing poorly.

positive.With regard to inflation, Germany has not departed from the dominant pattern in the European Union and recorded a further drop in inflation in March (down to 1.8% year-to-year), three decimals below the figure for the month before.

Although, as noted, the short-term picture is positive overall, the prospects for 2007 are more uncertain. Particularly troubling are the possible negative effects of the tax adjustment package the Merkel government approved at the end of February. Aimed at reducing the government deficit, this package combines an increase in the ordinary rate of the value added tax (VAT) from 16% to 19% with a reduction in taxation on wages for work through a reduction of two points in unemployment contributions.

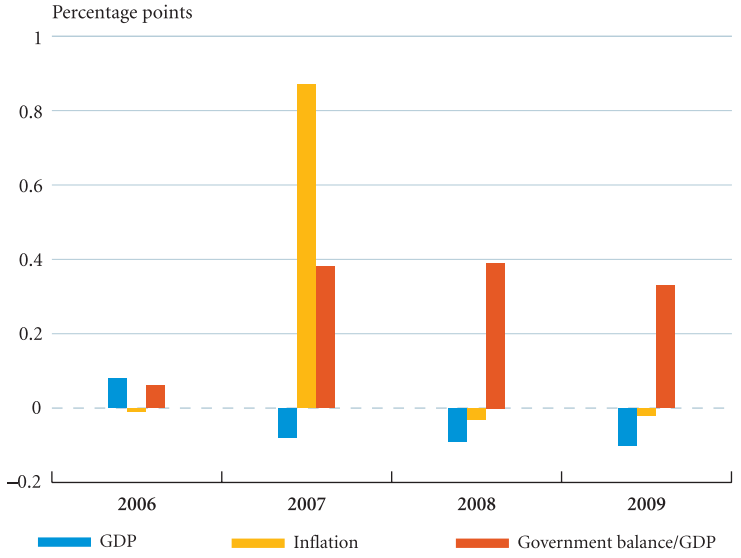
While impact of fiscal adjustment will be specific and limited, uncertainty lingers about Germany's prospects for 2007.

According to official estimates, these measures, along with others of less importance, will make it possible to reduce the government deficit by the equivalent of 0.4% of the GDP in 2007. Nevertheless, two additional effects arising from these tax adjustments will be earlier buying decisions by households and an increase in consumer prices. The question is, will these two factors have a decisively adverse effect on Germany's economic results in coming years?

If we can go by all available estimates, the answer is "No". According to simulations by Euroframe, a trans-European consortium of economic research institutes, the fiscal package will cause scarcely 1% of consumption in one quarter to be moved forward from 2007 to 2006, that is to say, it will have a very moderate impact. The effect on prices will be more noticeable. According to Euroframe, inflation will move up by close to one percentage point in 2007 although this increase in prices may not be repeated in 2008 or 2009. In overall terms, the fiscal adjustment will scarcely subtract 0.1% to Germany's growth in each of the next three years.

GERMANY'S FISCAL ADJUSTMENT WILL AFFECT PRICES BUT NOT GROWTH

Difference with regard to situation before tax measures



SOURCE: Euroframe.

France: student hang-over

The period of social protest has begun to take its toll. In March, in a move running against that in the other large countries of the Euro Area, consumer confidence fell by more than three points. While we see this drop as temporary, it certainly does not help to consolidate the much-needed recovery of consumption suggested in the early months of the year. In this respect, the government decision to the *de facto* withdrawal the «First Job Hiring Contract» may ease conflict and facilitate a move toward a stage of increased growth.

In fact, French indicators show two quite different facets depending on whether we take the first quarter as a whole or we concentrate on March, the month when social protest was at its height. On the demand side, domestic consumption that month lost part of its drive to grow by 3.5% year-to-year, a half-point less than in February. Nevertheless, on average the quarter the increase in domestic consumption was 3.2% as against 2.4% in the fourth quarter.

Most of the supply indicators showed a similar performance. The more global of all those indicators, economic sentiment, fell by two points in March but rose by nearly one point on average in the first quarter. Industrial production also lost some of the ground recovered since last autumn with the increase in the first quarter. Our overall evaluation is that the momentum of growth is sharper than the temporary weakness at the end of the quarter and, therefore, the course of recovery is continuing clear.

To end this look at the current economic picture, we must review the areas of prices and the labour market. In the first case, France is showing signs of limited increases in inflation while the CPI was down by four decimals in March going to 1.5% year-to-year. With regard to the labour situation, the unemployment rate continued stuck at 9.6% in February while job creation (rise of 0.3% year-to-year in the fourth quarter) continued at very low levels.

Social conflict in France provokes worsening of prospects, especially in first quarter.

Background trend in French economy holding solid and economic upswing expected in coming quarters.

Moderate inflation and reduction of unemployment still stagnant reveal opposing sides of French economic situation.

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
GDP	2.1	1.4	1.7	1.0	1.7	1.5	–	...	–
Domestic consumption	3.2	3.0	3.4	1.7	4.4	2.4	2.0	4.0	3.5
Industrial production	1.7	0.1	0.7	–0.3	0.4	–0.8	0.0	–0.6	...
Unemployment rate (*)	10.0	9.9	10.1	10.1	9.9	9.7	9.6	9.6	...
Consumer prices	2.1	1.7	1.7	1.7	1.9	1.6	2.0	1.9	1.5
Trade balance (**)	0.1	–1.4	–0.8	–1.3	–1.6	–1.8	–2.0	–2.1	...

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

Narrow victory of centre-left coalition seems very slim for making major reforms needed in Italian economy.

Italy: a turn to the left

After the narrow victory of the centre-left coalition that brought it a majority in both the House of Deputies and the Senate, the challenge now for the government to be led by Romano Prodi is to lift Italy out of its economic slump (in 2005 growth was only 0.1%, one of the worst in the Euro Area). What solutions will *Il Professore* come up with? In spite of the confusion of messages put out during the election campaign, some points in his programme are worth mentioning.

Economic plans of new government not very clear although they appear to lean toward combination of fiscal austerity and raising competitiveness.

The model which the left coalition has mentioned as a reference is that of Scandinavia with its virtuous combination of innovation, competitiveness and the Welfare State. While the prescription being put together by the centre-left to achieve this is quite unknown at this point, some specific factors have been put forward. These involve a reduction of 5% in unit labour cost (to be financed from the public purse), moderate tax cuts, the incorporation of new budget control measures and a programme to encourage those over 50 to stay in the labour market. The big doubt is whether a country electorally divided in two is able to maintain a process of economic reform of some such importance.

Some improvement seen in recent months but this fails to remove picture of economy in bad shape.

At least the new government finds itself in the best situation for some months. It should be remembered that in the fourth quarter of 2005 the Italian economy grew by 0.5%, its best rate since the last quarter of 2004. This moderate recovery came through the foreign sector which made the first positive contribution to the change in the GDP since the third quarter of 2004. On the other hand, the slowdown in private consumption, investment and public consumption brought about a further easing off in domestic demand.

The indicators for the first quarter suggest a continuation of these trends. Retail sales, which were up by 1.5% year-to-year in February, indicate a contained rate of household spending while the increase in exports (more than 14% year-to-year in February) confirms that the level of foreign sales continues to be good. This is helping industry which, following two years of decreases, has begun to regain ground. Industrial production in February rose to 3.1% year-to-year, the highest level since the far-off month of January 2001. Finally, we should mention that inflation in March did not follow the downward trend seen in other European economies and held at 2.1% year-to-year.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
GDP	0.9	0.1	–0.3	0.1	0.1	0.5	–	...	–
Retail sales	–0.4	0.4	0.1	–1.2	0.3	1.9	2.0	1.5	...
Industrial production	–0.5	–0.9	–2.6	–1.3	–0.1	0.4	2.4	3.1	...
Unemployment rate (*)	8.0	7.7	7.8	7.7	7.7	7.7	–	...	–
Consumer prices	2.2	1.9	1.9	1.8	2.0	2.2	2.2	2.1	2.1
Trade balance (**)	2.0	–5.8	–1.9	–5.1	–7.0	–9.3	–11.7	–13.4	...

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

United Kingdom: slow improvement

The British economy seems to have left the worst behind following growth of 2.2% year-to-year in the first quarter. If we are to go by the recovery in retail sales in March, consumption is beginning to come out of the depressed state in which it was stuck in the second half of 2005. In any case, the definitive consolidation of recovery is still far off seeing that consumer confidence also worsened unexpectedly in March. The recovery of investment (industrial production of capital goods in February stood at its highest since August 2005) and the rise in exports rounded out a picture of demand indicators going in the right direction.

The swing to greater activity on the supply side is less evident. Only services, with the confidence indicator toting up four consecutive months (December to March) showing definite growth, point to an incipient British recovery. Quite to the contrary, industry remains stagnant. Industrial production in February stood at levels 1.4% lower than those for one year earlier, showing no change over January.

With regard to prices, both the CPI and producer prices eased in March, with year-to-year growth of 2.1% and 2.5% respectively. Finally, this review of the British economic situation should end with a note of warning about the worsening of the labour market. While the unemployment rate is only 3.0% of the labour force there has been another year of progressive increases over the all-time lows in 2005. Nor is the drop in registered employment in the fourth quarter of 2005 very positive seeing that it went from a rise of 0.9% year-to-year in the third quarter to growth of 0.6%.

First quarter confirms that British economy could be coming out of rut.

Lack of drive in industry and weak labour market indicators underline that consolidation still a long way off.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
GDP	3.1	1.8	1.9	1.7	1.9	1.8	–	2.2	–
Retail sales	6.0	1.9	2.7	1.4	0.6	2.7	1.0	1.6	2.6
Industrial production	0.6	–1.9	–1.3	–2.0	–1.6	–2.8	–1.4	–1.4	...
Unemployment rate (*)	2.7	2.7	2.6	2.7	2.7	2.8	2.9	2.9	3.0
Consumer prices	2.2	2.2	2.2	2.2	2.4	2.3	2.3	2.3	2.1
Trade balance (**)	–55.6	–63.2	–61.8	–62.9	–63.5	–64.7	–66.8	–67.7	...

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

FINANCIAL MARKETS

Monetary and capital markets

Expectations of interest rate increases by ECB and Fed still hold

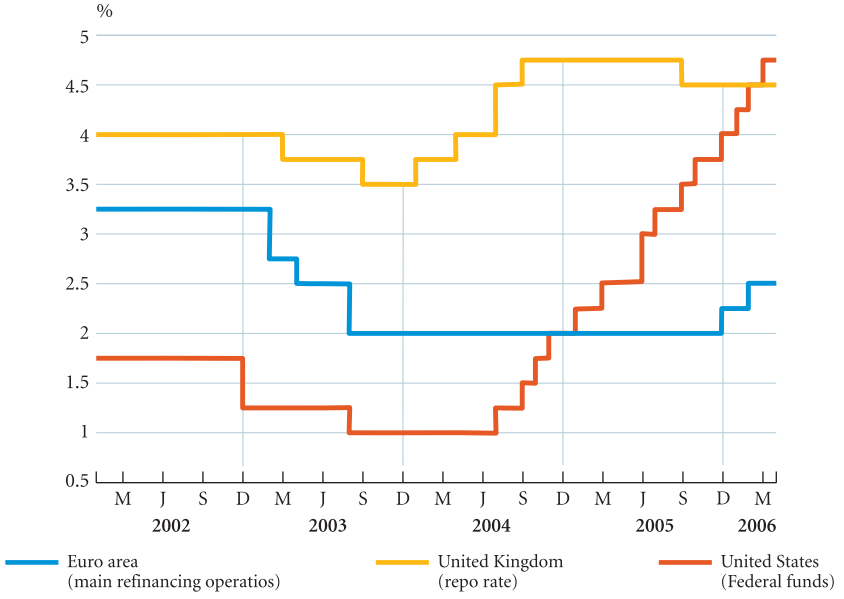
Fed raises interest rates at first meeting chaired by Bernanke and indicates this will not be last increase...

The Federal Open Market Committee of the US Federal Reserve raised the objective level of the overnight interbank rate by 25 basis points to 4.75% at its first meeting chaired by Ben Bernanke on March 28. This was the fifteenth consecutive increase of 25 basis points since the Fed embarked on its upward course in June 2004. That was no surprise but the habitual press release on the meeting stepped hard on those who had been expecting a more gradual move. In fact, the press release added that it might be necessary to tighten monetary policy still further in order to keep the economy on a course of sustained growth with price stability.

As a result, prospects of further rises in the Fed's official interest rate increased. Nevertheless, release of the detailed minutes of the meeting of the Fed on April 18 brought about a change of feeling as it made known that a majority of committee members believed that the end of the upward cycle was near. As a result, the prospect of further increases in the Fed reference rate cooled off again. Later, the figures for underlying inflation (the stable core) in March, which was worse than expected, again started up forecasts that the last rate rise would not be the one taking place on May 10.

FEDERAL RESERVE BOARD RAISES INTEREST RATE TO 4.75%

Monetary policy reference interest rates



SOURCE: National central banks.

Nevertheless, on April 27 Bernanke pointed out that the Fed could soon make a halt to the upward course of interest rates. This tended to again depress upward expectations on interest rates.

In fact, the Federal Reserve has left open its decisions at upcoming meetings depending on how figures on the economic situation show up. However, a rise to 5% at the next meeting is practically certain. Furthermore, given the rise in the price of oil and other raw materials, it is most likely that the reference interest rate will rise to 5.25%, as is currently being discounted by the market.

The broad money supply in Euro Area increased in February as did credit to the private sector, which moved up to an annual growth rate of 10.3%. This increased expectations that the chairman of the European Central Bank (ECB), Jean-Claude Trichet, would announce an increase in the Eurosystem interest rate in May at the press conference following the meeting of the Governing Board of the ECB on April 6. However, these expectations were not met although Trichet indicated there might be an increase at the following meeting in June.

...although end of upward stage could be close.

Trichet frustrates expectations of rise in Eurosystem interest rates in May...

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euribor (5) 3-month	Euribor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2005									
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	2.31	2.60	2.91	4.50	4.76	0.11	4.50	4.58	1.09
March (*)	2.56	2.72	3.11	4.54	4.92	0.12	4.50	4.59	1.21
April (1)	2.58	2.83	3.31	4.75	5.15	0.14	4.50	4.66	1.33

NOTES: (*) Provisional figures.
(1) April 27.
(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%), 2-3-06 (2. 50%).
(3) Latest dates showing change: 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%), 28-3-06 (4.75%).
(4) Latest dates showing change: 10-7-03 (3.50%), 6-11-03 (3.75%), 5-2-04 (4.00%), 6-5-04 (4.25%), 10-6-04 (4.50%), 5-8-04 (4.75%), 4-8-05 (4.50%).
(5) Interbank offer rate.
SOURCE: European Central Bank, Thomson Financial Datastream and internal figures.

...but rate will likely end year above 3%.

Later on, during the last week of April the money market again tightened following publication of favourable economic indicators for the Euro Area. In any case, it is very likely that the official ECB interest rate will end the year above 3%, going up from the current 2.50%.

On the other hand, on April 25 the Bank of Canada again raised its reference rate by 25 basis points putting its overnight rate at 4%. This move was already expected in view of indications of overheating of the economy. Two days later, the Bank of China raised its 1-year reference rate by 27 basis points, putting it at 5.85%, in an attempt to halt the fast growing demand for credit.

Dollar heading down

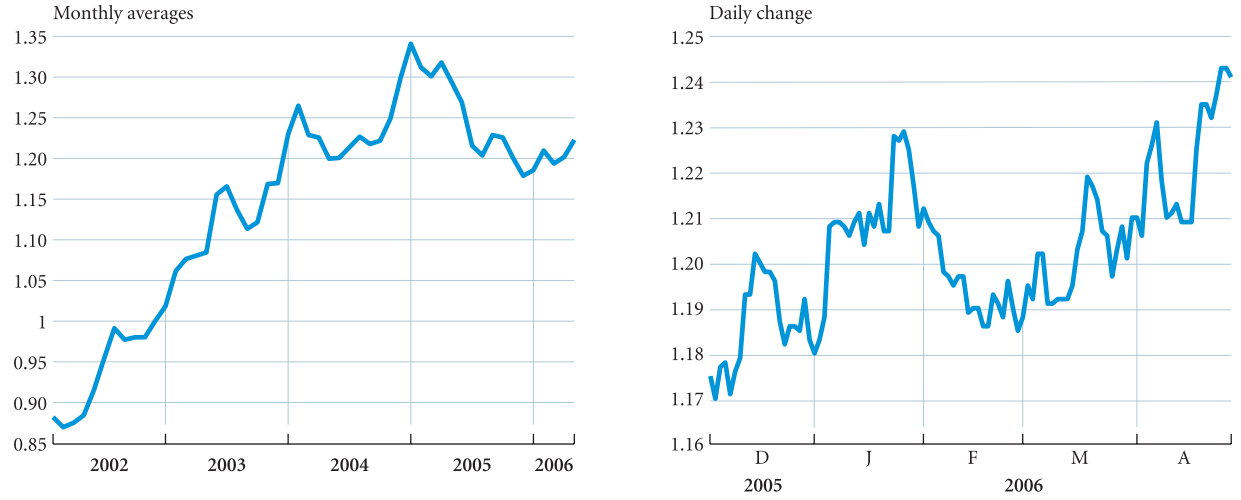
G-7 and IMF again applaud drop in dollar.

Downward pressure on the dollar has increased in recent weeks. As a result, the effective exchange rate for the dollar in the last week of April showed a depreciation of 3.0% compared with the end of December 2005 having dropped to the level of March last year. The need for a correction of the massive US foreign imbalance has come to the fore in spite of a slight improvement in the trade deficit in February. At the Washington meetings of the G-7 (the group of seven most industrialized countries) and the International Monetary Fund (IMF) at the end of the fourth week in April there were increased calls for making exchange rates more flexible (in allusion to Asian currencies) in order to contribute to correction of the big trade imbalances that present a risk for the global economy. As a result, the international bodies proceeded to applaud the drop in the dollar.

In a new move, the International Monetary Fund took on another role in which it is to exercise a multilateral watch over exchange rates which incorporates the emerging countries. This could be the start of a new course

EURO MARKS UP HIGH AGAINST DOLLAR IN PAST SEVEN MONTHS

US dollars to euro



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

EXCHANGE RATES OF MAIN CURRENCIES

March 2006

	Final session of month		Monthly figures				*Exchange rate April 27, 2006*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2)			
				Monthly	Over December 2005	Annual	
Against US dollar							
Japanese yen	117.8	1.7	117.3	–0.5	–0.9	11.4	*114.2*
Pound sterling (1)	1.737	–0.9	1.744	–0.2	–0.1	–8.4	*1.801*
Swiss franc	1.304	–0.5	1.305	–0.1	–0.1	10.9	*1.260*
Canadian dollar	1.168	2.8	1.157	0.7	–0.4	–4.8	*1.123*
Mexican peso	10.90	4.2	10.75	2.5	1.1	–3.6	*11.10*
Nominal effective index (4)	*110.7*	*0.7*	*110.6*	*0.1*	*–1.0*	*1.5*	*108.5*
Against euro							
US dollar	1.210	1.9	1.202	0.7	1.4	–8.8	*1.241*
Japanese yen	124.4	3.1	141.0	0.1	0.3	1.6	*142.7*
Swiss franc	1.580	0.9	1.569	0.7	1.3	1.2	*1.581*
Pound sterling	0.696	2.5	0.689	0.9	1.5	–0.5	*0.696*
Swedish krona	9.432	–0.2	9.402	0.6	–0.3	3.4	*9.333*
Danish krone (3)	7.462	0.0	7.461	0.0	0.1	0.2	*7.460*
Polish zloty	3.943	4.1	3.884	2.4	0.9	–3.4	*3.874*
Czech crown	28.60	1.0	28.65	0.9	–1.1	–3.9	*28.45*
Hungarian forint	265.7	4.9	260.8	3.7	3.3	6.5	*265.4*
Nominal effective index (5)	*102.3*	*2.0*	*101.5*	*0.8*	*0.8*	*–4.2*	*103.0*

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

that will overcome the shortcomings in recent times. Nevertheless, some aspects of this new role still remain to be worked out.

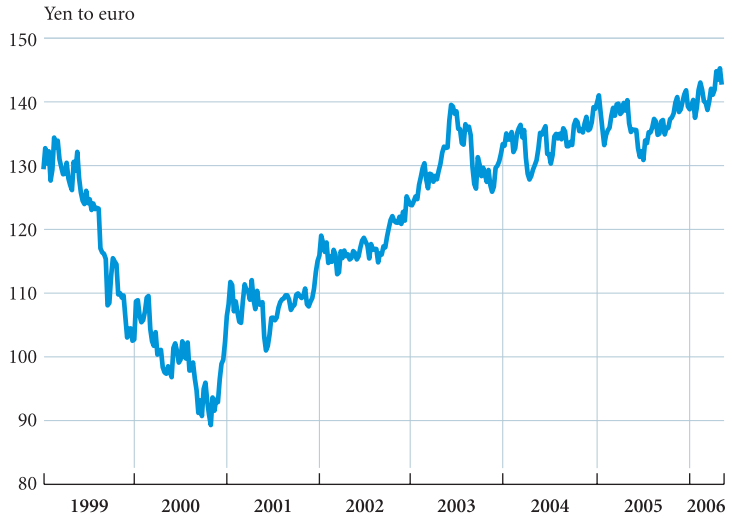
Furthermore, there are reports that some central banks, such as that of Sweden, are reducing the share held by the dollar in its total foreign currency reserves, which also may have contributed to the drop in the US currency. The greenback counts on the support of an interest rate differential in its favour against the main currencies but prospects are that this will continue to narrow, which is taking away some of its strength. It is therefore likely that the US currency will depreciate over the medium term.

IMF takes on new role of multilateral watch over exchange rates.

The euro has benefited from the state of weakness of the dollar given that it is the main alternative. Furthermore, consolidation of economic recovery and the prospects of a progressive increase in interest rates by the European Central Bank have also pushed up the European single currency. As a result, in the last week of April the euro showed a cumulative appreciation of 2.6% against

Euro appreciates 2.6% against broad basket of currencies in first four months of year.

EURO RECORDS ALL-TIME HIGH AGAINST YEN



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

the currencies of its main trading partners. It is notable that on April 20 it marked up an all-time high against the Japanese currency running at 145.3 yen to one euro. At the same time, the greenback went above the level of 1.24 dollars to the euro, thus showing the highest quote in the past seven months.

As of the end of April, the yen had risen by 3.7% in overall terms from the low in December 2005, following signs of an end to the 0% interest rate policy. Nevertheless, it should be pointed out that, of this increase, more than 2 points came about since the end of the second last week in April as a result of the Washington meetings mentioned above. This sharp rise of the Japanese currency was behind the position taken by Japan's minister of finance who came out against a sudden rise in the currency, suggesting that there could be interventions ahead.

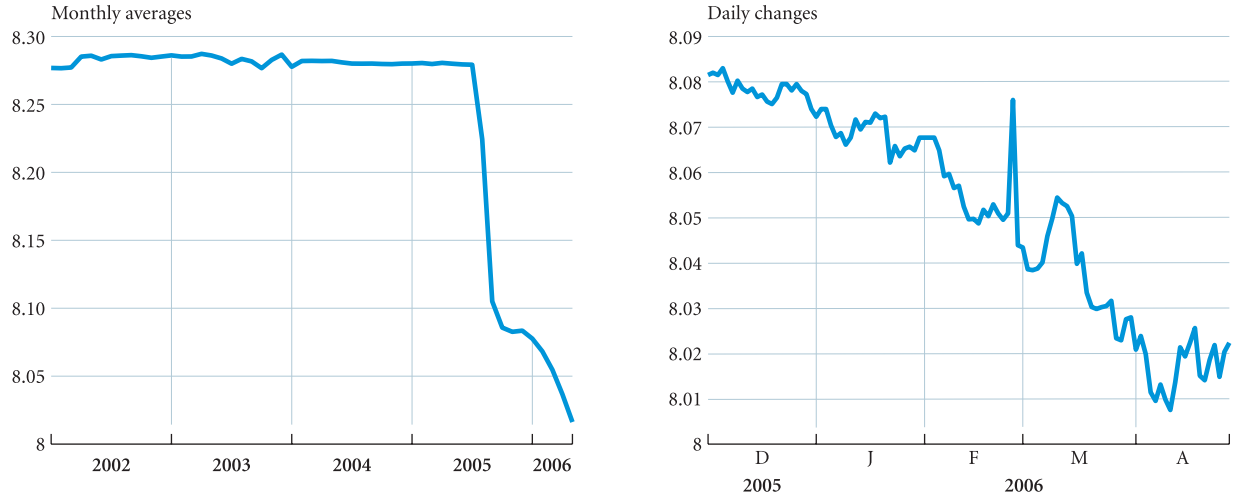
Yuan rises only 1.2% against dollar since revaluation of 2.1% on July 21, 2005...

When the Chinese authorities announced on July 21, 2005 that the yuan would be freed of its tie to the dollar there were expectations that finally it would be revalued and that this would help correct the main world foreign imbalances. Nine months have now gone by and the fabled rumbling of the mountain has given birth to a mouse. In fact, the controlled flotation of the yuan began with a revaluation of 2.1% against the dollar. Since then, the currency, also called the renminbi, has merely risen an additional 1.2% against the greenback. It should be pointed out that in recent months the appreciation of the yuan has moved up to some extent seeing that, since the end of January, the Chinese currency has risen by 0.6% against the US dollar to stand at 8.02 units to the USD.

This, however, was probably because of increasing political pressure by the United States, given that two US senators were proposing the levying of a 27.5% customs duty on Chinese products in order to equalize the artificial depreciation of the yuan, according to their estimates. Do the Americans have reason to complain? In

GRADUAL APPRECIATION OF YUAN TESTS PATIENCE OF UNITED STATES

Chinese yuan to US dollar



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

fact, in 2005 the Chinese authorities announced that as of that moment the quotation of the yuan would be established in relation to a basket of currencies although they did not specify the weighting of the currencies indicated. It is possible that the renminbi has held more or less stable in terms of that basket. In any case, while to start with the daily swing of the yuan against the dollar is limited to ±0.3%, the trend as recorded has been disappointing, seeing that it seems clear that this is not a flotation set by the market. The massive accumulation of foreign currency reserves by China, which in February became the world's leading holder in this regard even beating out Japan, testifies to this fact.

The call by the G-7 in favour of a revaluation of the yuan must be seen in this context. However, positions taken within the group of developed countries are not all alike. In Europe, for example, there is concern that any sudden appreciation of the yuan could provoke a sharp rearranging of international capital flows which could increase upward pressure of the euro against the dollar. On the other hand, the Chinese authorities do not seem to be in a hurry to make changes. Various steps have been taken to make the system of foreign payments somewhat more flexible but the effects have been very limited. Political pressure from the West may possibly continue. The situation could take time to change but over the medium term it would seem very likely that there will be a noticeable appreciation of the yuan against the dollar.

...given that Chinese authorities continue to control exchange rate, thus generating world's highest foreign reserves.

Has the Greenspan enigma been resolved?

In a situation with prospects of a notable growth in the world economy, along with a rise in raw materials prices, the yield on government bonds has continued to follow a moderately upward trend in view of the likelihood

Europe fears that sharp depreciation of yuan against dollar could overly push up euro.

US interest rate curve up for all terms in past two months...

that the central banks will keep on tightening monetary policy in order to control inflationary risks. As a result, the interest rate on US Treasury bonds went above the 5% level toward the middle of April and by the last week of the month rates stood at 5.1%, going back to levels in May 2002. It should be pointed out that in the last week of April the yield curve on government bonds had again become normal and was showing a positive slope, that is to say, the highest values applied to the longest terms.

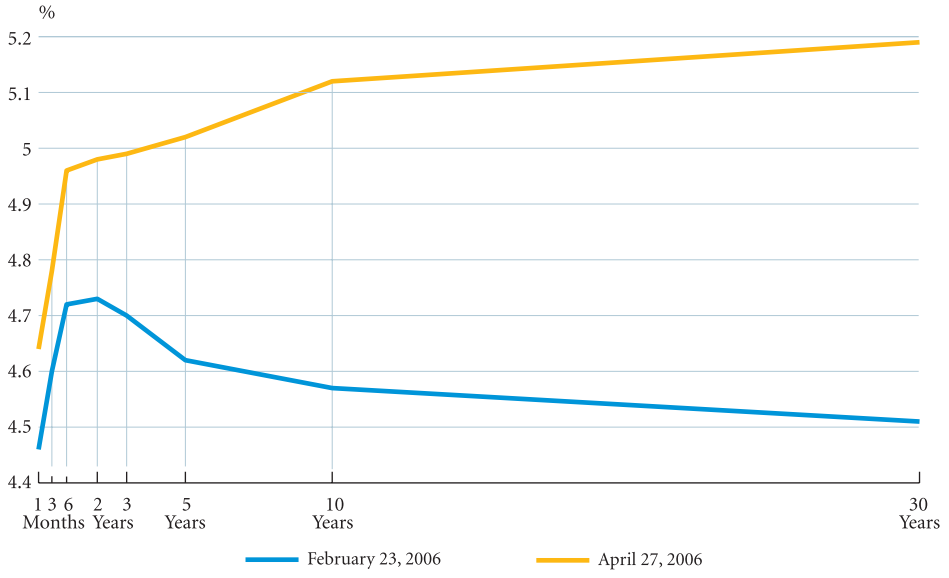
...including longest terms, thus normalizing rate structure following period when short-term yields went above long-term yields for some terms.

Bringing the yield curve back to positive levels could resolve the «Greenspan enigma», as it has been called since the previous chairman of the Federal Reserve Board expressed his surprise about the failure of long-term interest rates to react to the rise in short-term rates brought about through the tightening of monetary policy. In October 2005, after more than a year of short-term interest rate increases in the United States, the yield on US Treasury bonds stood slightly below the level before the start of the restrictive upward move by the Federal Reserve and kept holding at abnormally low levels.

In the box headed «The interest rate mystery» published in the Monthly Report for November 2005, we came out saying that it appeared that the downturn in yields on US bonds had been broken and that we foresaw a moderate upturn as of then on the basis of an analysis of underlying factors, which could be summarized as inflation prospects, oil prices, the credibility of the central banks, the accumulation of foreign currency reserves, investment demand, globalization and the behaviour of institutional investors (see the abovementioned box for more details). Now it seems that the situation has begun to normalize with the yield on US long-term Treasury bonds above 5% and the interest rate curve showing a positive slope for all terms, suggesting that the «Greenspan enigma» may have

US YIELD CURVE TENDING TO RETURN TO NORMAL

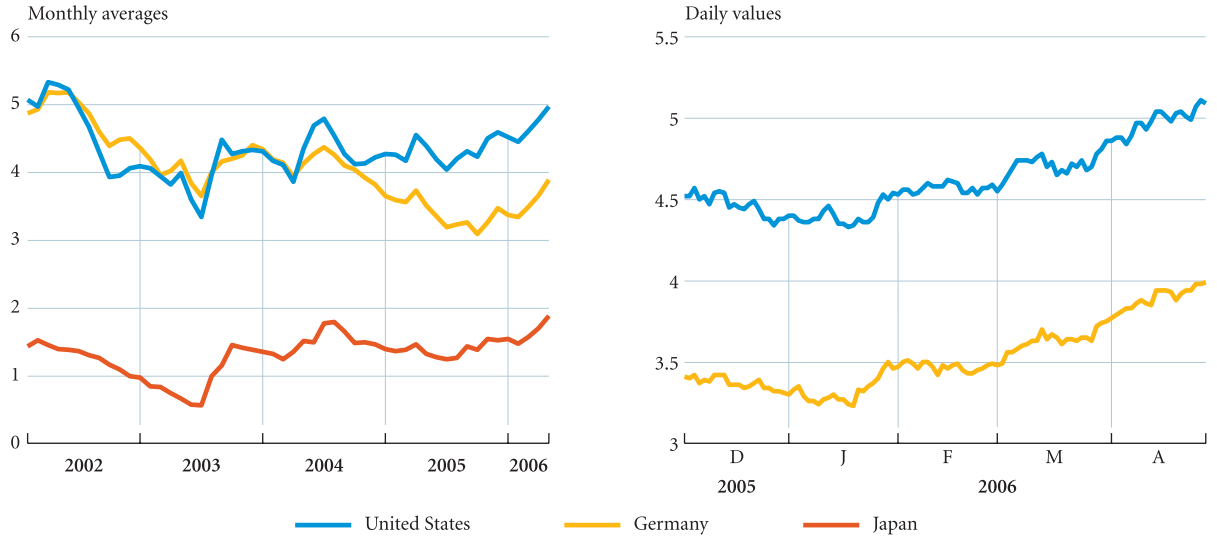
Yield on government securities



SOURCE: Reuters.

YIELD ON US TREASURY BONDS MARKS UP HIGHEST LEVEL SINCE MAY 2002

Yield on 10-year Treasury bonds as annual percentage



NOTES: Figures go up to April 27.
SOURCE: Bank of Spain and Thomson Financial Datastream.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2003	2004	2005			2006			
			2Q	3Q	4Q	January	February	March	April 27
United States	4.04	4.31	4.21	4.25	4.54	4.45	4.61	4.78	5.09
Japan	0.99	1.50	1.28	1.36	1.53	1.47	1.57	1.70	1.96
Germany	4.10	4.07	3.35	3.19	3.37	3.34	3.49	3.66	3.99
France	4.13	4.10	3.38	3.23	3.39	3.34	3.51	3.68	4.05
Italy	4.24	4.24	3.53	3.40	3.56	3.55	3.70	3.87	4.27
Spain	4.12	4.10	3.36	3.18	3.37	3.33	3.48	3.65	4.00
United Kingdom	4.53	4.93	4.50	4.32	4.34	4.12	4.21	4.36	4.66
Switzerland	2.47	2.57	2.04	1.90	2.05	2.02	2.18	2.35	2.72

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

been a transitory matter. In any case, the yield on long-term government bonds appears to have left behind the low rate of 3.1% recorded in 2003.

On this side of the Atlantic, the yield on German government bonds has shown a similar course in recent weeks. It thus stood at around 4% in the final week of April, a level not recorded since October 2004. As a result, the differential with similar US bonds widened very slightly in recent weeks going to 110 basis points although it is likely that it will have narrowed by the end of the year.

Yield on European bonds goes above 4%.

Risk premium on emerging country bonds marks up new all-time low in April.

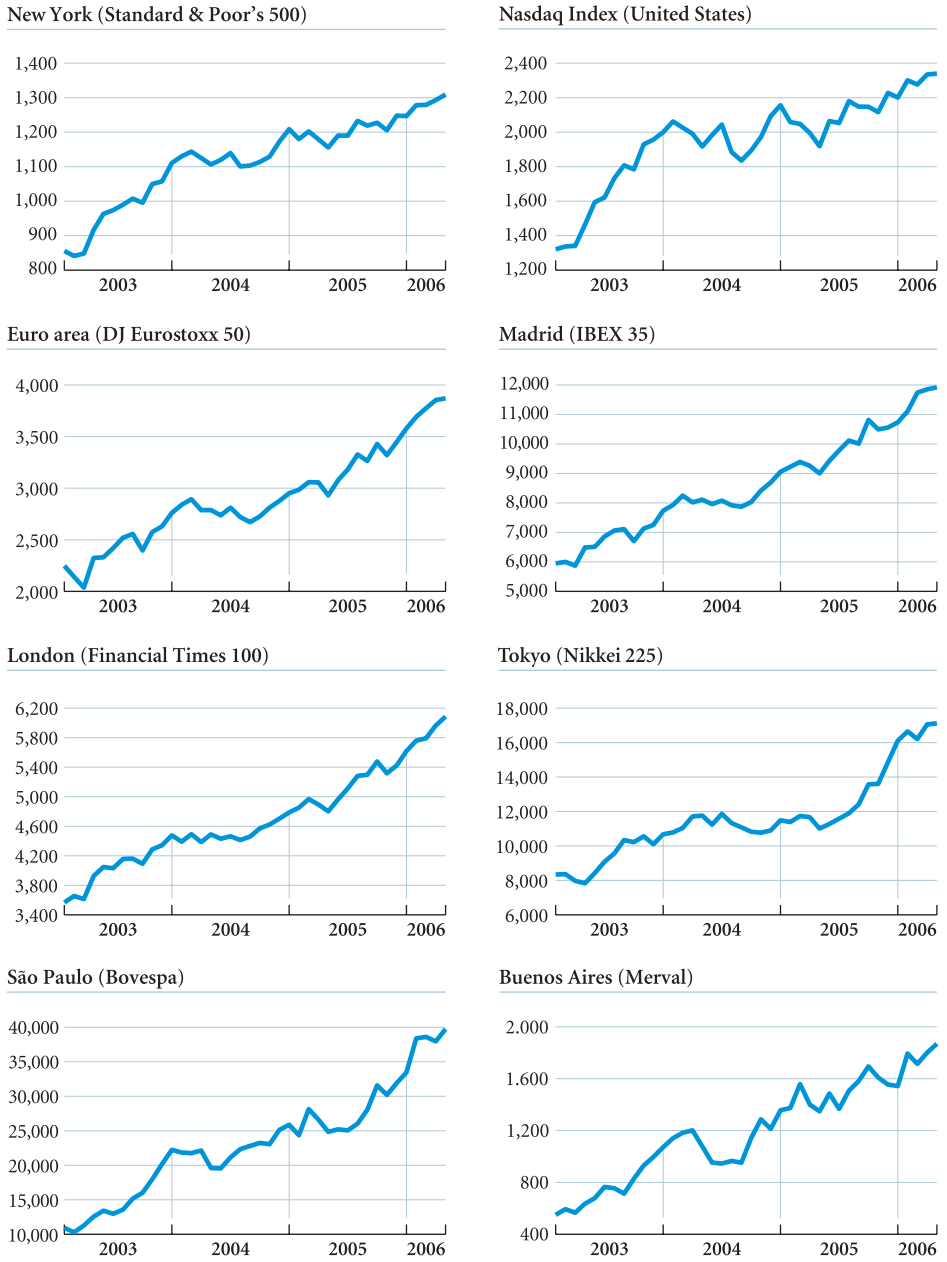
In addition, the risk premium on emerging country bonds, measured by the JP Morgan EMBI+ index, dropped to the all-time low of 179 basis points above US government bonds in the fifth week of April.

Emerging market stock exchanges mark up all-time highs in April

Close to the end of the first four months of the year, the stock markets are generally showing a very favourable

INTERNATIONAL STOCK EXCHANGES

Indices at month-end



NOTES: April 27, 2006.
SOURCE: Thomson Financial Datastream.

INDICES OF MAIN WORLD STOCK EXCHANGES

March 31, 2006

	Index (*)	% monthly change	% cumulative change	% annual change	*Figures on April 27, 2006*	
					% cumulative change	*% change over same date in 2003*
New York						
Dow Jones	*11,109.3*	*1.1*	*3.7*	*5,8*	*6.2*	*37.0*
Standard & Poor's	*1,294.8*	*1.1*	*3.7*	*9.7*	*4.9*	*45.7*
Nasdaq	*2,339.8*	*2.6*	*6.1*	*17.0*	*6.3*	*63.5*
Tokyo	17,059.7	5.3	5.9	46.2	6.2	122.3
London	5,964.6	3.0	6.2	21.9	7.9	56.6
Euro area	3,853.7	2.1	7.7	26.1	8.0	70.1
Frankfurt	*5,970.1*	*3.0*	*10.4*	*37.3*	*12.2*	*113.8*
Paris	*5,220.9*	*4.4*	*10.7*	*28.3*	*10.6*	*81.9*
Amsterdam	*468.7*	*2.2*	*7.3*	*26.8*	*8.6*	*70.5*
Milan	*29,309.0*	*1.8*	*9.5*	*18.9*	*10.7*	*70.8*
Madrid	*11,854.3*	*1.0*	*10.4*	*28.0*	*10.8*	*83.2*
Zurich	8,023.3	1.7	5.8	35.3	6.5	80.5
Hong Kong	15,805.0	–0.7	6.2	16.9	12.5	99.1
Buenos Aires	1,800.6	5.0	16.7	28.6	21.1	180.7
São Paulo	37,951.0	–1.7	13.4	42.6	18.8	227.8

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.

balance, in many cases with increases for the year as a whole higher than expected back in January. In April, many stock exchange indices marked up the highest levels in recent years. The rise on the stock markets was especially due to the good state of corporate profits and current favourable prospects. A wave of corporate mergers and acquisitions, that even affected companies operating the stock exchanges themselves, such as the London Stock exchange, also contributed to enliven markets.

Relatively low interest rates also helped to drive the stock market. The rise on the market came about in spite of the increase in interest rates and the boost in raw materials prices.

Stock exchange indices chalk up highs for recent years despite rise in interest rates and raw materials prices.

Nevertheless, the rise in prices of raw materials has favoured emerging country markets which have marked up the highest capital gains. As a result, markets in Brazil, Mexico, Indonesia, South Africa and Poland, among others, beat all records in the last week of April.

Stock exchanges in Brazil, Mexico, Indonesia, South Africa and Poland set new records.

SPAIN: OVERALL ANALYSIS

Economic activity

Spain's economy continues to grow although high price of oil and chronic problems (foreign deficit and excessive inflation) must qualify optimism.

Excellent economic situation with some dark clouds ahead

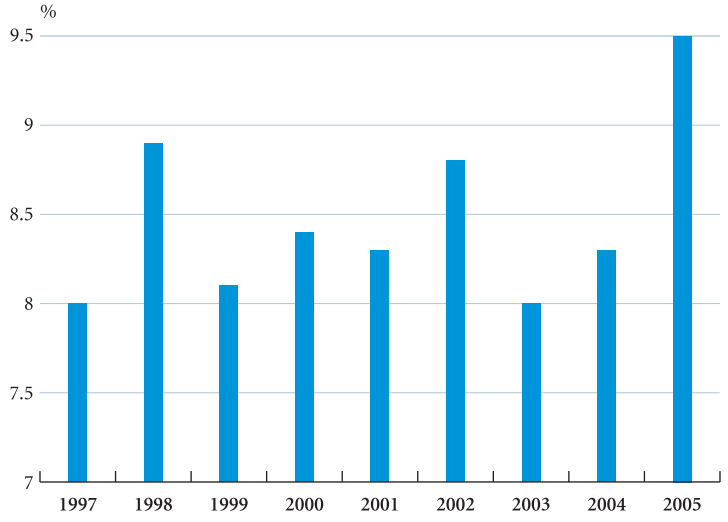
Spain's economy continues to sail full-steam-ahead but the dark clouds to be seen on the horizon are not going away. The rise in oil prices is again throwing a shadow over Spain's economic activity which, it should not be forgotten, suffers from much greater dependence on that energy than neighbouring countries. In addition, the chronic problems troubling it (too much inflation and a foreign deficit as examples of its loss of competitiveness) are still not on the way to being solved, which over the medium term could set off a sharper readjustment than would be desirable.

For the moment, however, things could not be better as shown, for example, by now healthy corporate profits. According to the Quarterly Composite Balance Sheet figures prepared by the Bank of Spain, net profit of companies tabulated grew by nothing less than 26.2% in 2005, an absolute all-time high. But, take care, all that glitters is not gold! If we look carefully at these figures prepared by the Bank of Spain, we see that the main sources of income during the year under review arise from very volatile factors.

In fact, financial income (largely arising from dividends from subsidiaries located outside the country) grew by 23%, extraordinary income was up 62%

PROFITABILITY OF COMPANIES REACHES ALL-TIME HIGHS

Return on net assets (net return on average assets)



SOURCE: Bank of Spain and internal figures.

(partly due to capital gains generated in transactions involving sale of shares) and, on top of this, in 2005 a substantial amount of provisions allocated in previous years was released as a result of the recovery in the value of investments made, mainly those in Latin America. If we exclude these headings, gross operating profit (which represents the most stable core of business activity) recorded growth of 5.2%, which is not so bad but much more moderate and even stands below the figure for 2004.

In any case, between one thing and another, companies obtained exceptional returns in 2005. Return on net assets that year rose to 9.5% while return on equity went to 14.6%, the highest in the whole series. The year 2005, however, is now past history and it will be difficult for these results to be repeated in the near future in a global context getting tougher and tougher. In the group of companies included in the Bank of Spain sample, those coming under the energy sector (which have major representation in the sample) were those to obtain the best results, followed well behind by the groups covering retail trade, repairs and transport and communications.

Right now, business situation is excellent.

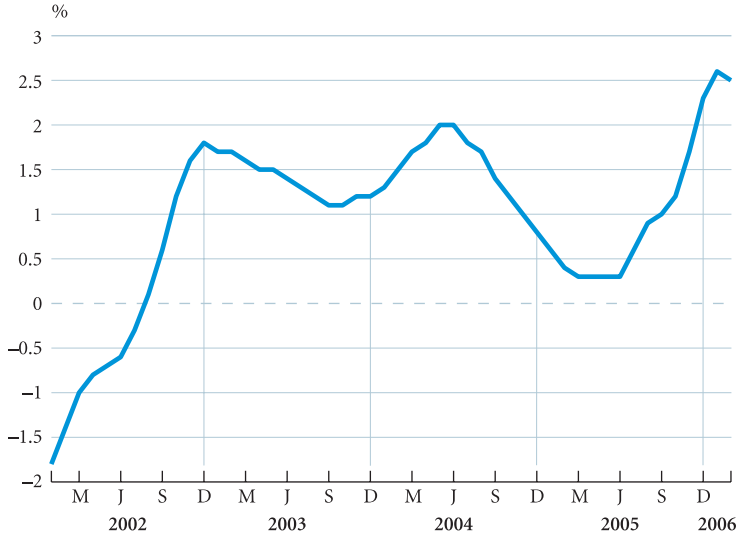
The only sector to go flat was industry which recorded a drop in ordinary net profit of more than 6%. The narrowing of margins brought about by the competitiveness of markets and the weakness of foreign demand sets the situation of great difficulty under which this sector is operating. As indicated by the Bank of Spain, the short-term and medium-term trend in this sector will depend on its capacity to adapt its production structure to the new situation of the globalized market.

Industrial companies are those facing most difficult situation with hopes for confirmation of recovery indicated in recent months.

Looking strictly at the present situation, it would appear that the recovery in

RECOVERY IN INDUSTRY LOSING STEAM

Year-to-year change in industrial production index



NOTES: Cycle-trend statistical series corrected for calendar differences.
SOURCE: INE and internal figures.

industry has now been consolidated although it has lost some strength in the early months of 2006. This may be seen in the previous graph which shows the trend in the industrial production index. On the other hand, in spite of the boost in recent months, confidence sentiment in the sector has not shown any clear improvement and continues to record negative levels, according to the survey by the European Commission.

On other hand, both construction and services continue to show considerable drive.

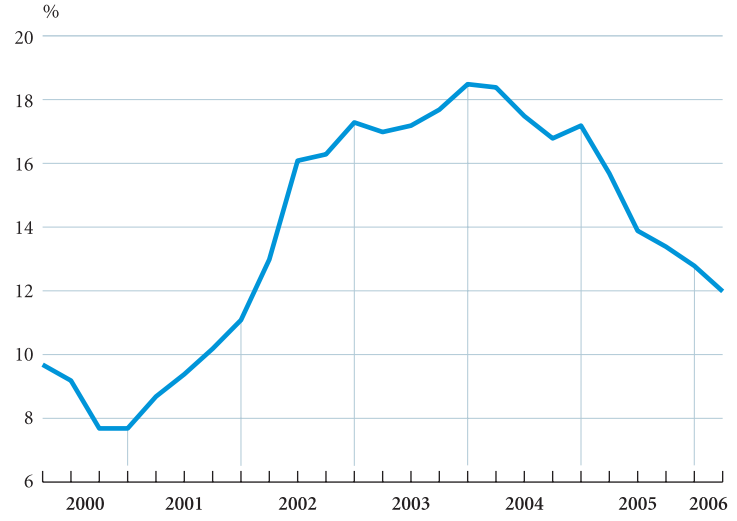
The construction sector, in turn, continues very strong, if we are to go by the sustained increase in the main activity indicators. In any case, the real estate market continues to give off signs of some moderation. Prices of non-subsidized housing, for example, are maintaining the gentle but gradual slowdown noted during 2005. In the first quarter of 2006 they rose by 12.0%, eight decimals less than at the end of 2005 and around 3.7 percentage points less than one year earlier. In addition, foreign investment in real estate continues to decrease, according to figures from the Bank of Spain. The total amount of this investment over the past 12 months was down 15% in January, thus consolidating the negative trend noted in previous months.

The services sector also is showing a fairly positive overall state, if we follow the trend in business volume drawn up by the National Institute of Statistics (INE). Information and communications technology and company services remain as the most dynamic sectors. Along with these, retail trade and transport continue to grow at a good rate having moved back to following a clearly upward trend in recent months.

Tourism is the only sector showing some stagnation in the growth rate of business volume (around 4% nominal growth in recent months), according to INE figures. The first quarter was fairly slack with practical stagnation in overnight hotel stays and a drop in spending by foreign tourists despite the

GROWTH OF HOUSING PRICES CONTINUES TO MODERATE

Year-to-year change in price per m² of non-subsidized housing



SOURCE: Ministry of Housing and internal figures.

SUPPLY INDICATORS

Percentage change over same period year before

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
Industry									
Electricity consumption (1)	4.0	3.5	4.5	2.7	3.2	3.7	3.2	3.6	1.6
Industrial production index (2)	1.6	0.7	0.3	0.1	0.7	1.6	3.4	2.3	...
Confidence indicator for industry (3)	–2.5	–4.9	–3.6	–7.0	–4.8	–4.0	–7.3	–6.0	–3.0
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	1.1	–0.8	12.6	...
Construction									
Cement consumption	3.7	5.1	–0.2	11.2	5.2	3.7	14.3	12.5	...
Confidence indicator for construction (3)	13.6	22.4	23.7	15.0	22.7	28.3	21.0	6.0	19.0
Housing (new construction approvals)	8.0	6.2	3.7	7.6	2.8	10.6	24.6	...	...
Government tendering	18.3	18.5	5.8	36.6	3.1	36.9	18.8	...	...
Services									
Retail sales	5.5	4.4	4.1	5.4	4.4	3.8	4.7	3.9	6.1
Foreign tourists	3.1	6.2	8.2	4.6	7.0	4.9	–0.1	2.0	0.0
Tourist revenue inflows	3.8	5.8	4.1	–3.9	13.9	4.9	–13.7	...	...
Goods carried by rail (km-tonnes)	–3.5	–3.2	–14.3	–4.7	–2.3	11.0	...	...	...
Air passenger traffic	8.0	9.1	8.4	8.5	10.2	9.1	7.7	5.5	3.0
Motor vehicle diesel fuel consumption	7.2	4.8	2.5	7.5	4.9	4.2	9.4	...	...

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

slight increase in tourist numbers. In any case, the touchstone for the sector continues to be the results for the high season with current prospects for this year standing slightly above those for 2005.

On the demand side, the situation showing up in consumption is fairly uneven. For example, car registrations seem to have overcome the dip seen in recent months, with a year-to-year increase of 2.5% in the first quarter, although a comparison between 2005 and 2006 is not sufficiently representative due to the different dates on which the Easter Week holidays fell. Registrations of motorcycles, in turn, maintained a strong growth rate (more than 43% increase in the reference period) brought about by recent changes in regulations.

On the other hand, retail sales showed a very moderate increase in the first quarter in real terms, while consumer confidence failed to move out of the negative state in which it has been stuck in recent times. Overall, it would appear that the growth rate of consumption is tending to moderately ease off although still holding to an appreciably strong base, helped by the prevailing favourable conditions

Level of consumption remains fairly positive although tending to gradual slowdown of high current growth rate.

Growth of consumption in Spain: is it excessive?

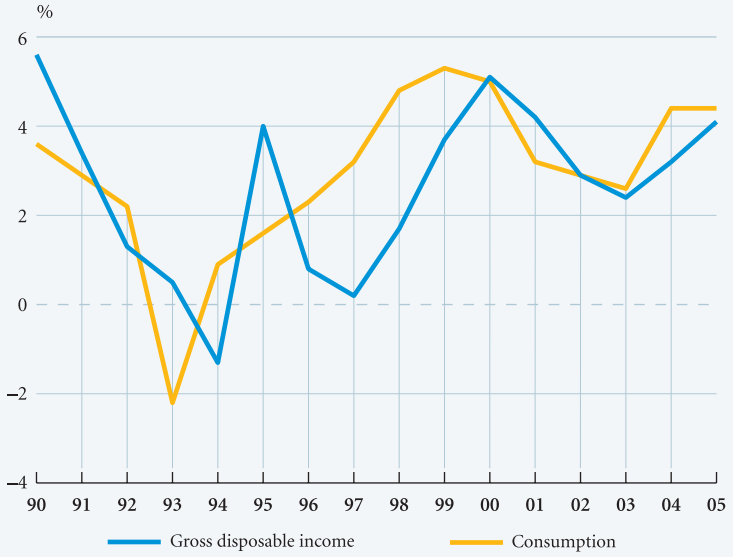
To some extent, consumption is the figure-head of the economy. Its importance is beyond doubt. In Spain, for example, it represents close to 60% of the GDP, a very similar proportion to that of most of its neighbouring states. Certainly, the strength of consumption is a very important factor in driving the economy, given that, apart from its direct contribution to overall growth, it is a definite stimulus to production-related investment. On the other hand, in developed countries a slack in consumption sometimes has given rise to prolonged periods of stagnation (as in the case of Japan) or poor growth (as we are seeing in Europe).

According to the postulates of economic analysis, private consumption depends on *permanent income* (understood as the flow of present and future income obtained over the life-cycle of the consumer). In practice, it is usual to link consumer decisions to certain observable variables, such as disposable income, total net worth and real interest rates, attributing observed variations to prospects of future income of consumers. For Spain's economy, the Bank of Spain puts the elasticity of household consumption to labour income for non-durable consumer goods at 0.5 and at around one in the case of durable goods. The wealth effect is also significant but less so than in the case of income, as is the case of response to changes in real interest rates.

In fact, as may be seen in the following graph, the trend in consumption in Spain maintains a close relation to growth of gross disposable household income. This growth may be largely explained by the increase in wage incomes related to the sharp rise in employment, in which the immigrant population has played a notable role. As well, other factors, such as the decrease in interest rates, the revaluation of financial assets and real estate assets and the sharp increase in credit, have had appreciable temporary effects on consumption.

CONSUMPTION GREATLY AFFECTED BY TREND IN INCOME

Real change in consumption and disposable income of households

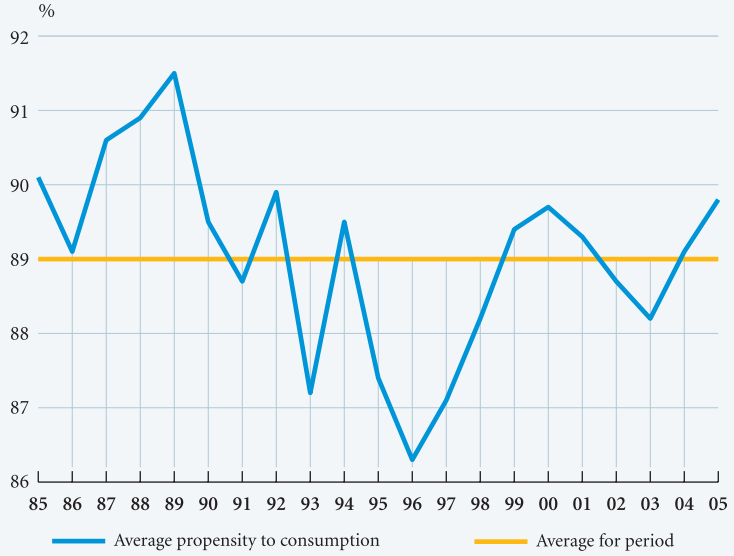


SOURCE: INE, Bank of Spain and internal figures.

In total, between one thing and another, consumption of Spanish households has shown notable growth in the past five years, with real growth close to 3.6% on annual average and a contribution to GDP growth of close to 60%. Is there thus any reason for concern? If we look at this question from the point of view of propensity to spend (the proportion of disposable income going into consumer spending), this concern would not seem to be especially justified. As shown by the graph below, the present level is only slightly above the historical average over the past 20 years. From this perspective, it does not seem that there has been the *consumer splurge* some people have been pointing to. The problem arises in that gross savings generated (the part not spent) by Spanish households is clearly insufficient today to finance growth in investment spending (mainly in housing) to the point where in 2005 the final result (initial gross savings less investment carried out) turned out to be negative. From this particular point of view, then, it does seem reasonable to propose greater moderation in the growth rate of spending, given the investment it is desired to carry out.

PROPENSITY TO CONSUMPTION VERY CLOSE TO ALL-TIME AVERAGE

Consumption spending of households over gross disposable income each year



SOURCE: INE, Bank of Spain and internal figures.

The trend in Spanish household consumption in the past ten years has also been characterized by the major transformation in the structure of spending. In general terms, the dominant trend has been a reduction in the relative weight of spending on food in favour largely of spending on services. Of special note is the sharp real increase in spending on communications, which has almost tripled, and higher than average increases recorded under the headings of health, transport, leisure and culture and those related to personal care and services. On the other hand, there has been a notably lower increase in spending considered of prime necessity (such as food and clothing), which in this period has shown real growth of close to 18%, half the average growth of total spending. This pattern of behaviour is in keeping with the level of development reached by Spain.

BREAKDOWN OF HOUSEHOLD SPENDING

Million euros (at current prices)

Group	1995	2004	% change		% share		
			Prices	Amount	1995	2004	Difference
Foods and non-alcoholic beverages	48,586	71,541	29.4	17.6	17.7	14.2	–3.5
Alcoholic beverages and tobacco	7,527	15,530	60.7	27.0	2.7	3.1	0.3
Articles of dress and footwear	18,676	27,753	27.0	18.2	6.8	5.5	–1.3
Housing, water, electricity, gas and other fuels	40,383	80,962	38.5	29.1	14.7	16.0	1.3
Furniture, home goods and home maintenance costs	17,082	26,782	21.8	30.4	6.2	5.3	–0.9
Health	9,056	17,651	27.3	48.9	3.3	3.5	0.2
Transport	31,804	60,404	28.7	49.2	11.6	12.0	0.4
Communications	4,931	13,534	–6.7	180.0	1.8	2.7	0.9
Leisure, theatre and culture	23,343	46,808	21.9	48.2	8.5	9.3	0.8
Education	4,636	7,386	42.5	15.8	1.7	1.5	–0.2
Hotels, cafés and restaurants	51,802	94,057	44.3	28.9	18.9	18.6	–0.2
Other goods and services	16,615	42,063	20.0	59.9	6.1	8.3	2.3
Total	**274,441**	**504,471**	**30.5**	**35.8**	**100.0**	**100.0**	

SOURCE: INE and internal figures.

Under the food heading there are some very marked trends, such as a preference for fish and shell-fish (with a real increase of 20% in the period) to the detriment of meat (7%) and for fruit (21%) going against greens (7%). Records also show very big increases in the prepared foods group and in certain complementary articles of less food value (sugar, jams, honey, chocolate and confectionary). Under other headings, there was a notable increase in pharmaceutical products and therapeutic materials (63%), vehicles (82%), telephone equipment (168%) and audio and data-processing equipment (96%).

Finally, private consumption in Spain has lately demonstrated unusual strength and furthermore has undergone a major qualitative change following a pattern similar to that noted in other countries with a similar level of development, although in this sphere, as in others, the rate of change in Spain has been especially sharp during this period. Looking toward the future, it is foreseeable that this trend will continue although at a more gentle rate and we can also expect greater containment of the contribution of consumption to the GDP.

(growth of employment, increase in credit and interest rates still very low).

With regard to capital goods investment, the main activity indicators are maintaining on the growth side although also with a tendency to moderate the high rates seen in previous months. This is so, for example, in registrations of commercial vehicles which were up 7.5% year-to-year in the first quarter as against the 13.2% recorded in 2005 as a whole and in imports of goods of this type which

DEMAND INDICATORS

Percentage change over same period year before

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
Consumption									
Production of consumer goods (*)	–0.1	0.9	0.1	1.1	1.4	0.9	0.3	0.8	...
Imports of consumer goods (**)	13.4	7.9	6.5	8.4	7.8	8.6	40.4	9.3	...
Car registrations	9.8	0.8	–0.0	4.9	2.3	–4.5	–0.3	–2.3	8.3
Credit for consumer durables	5.5	12.5	8.8	13.7	17.2	10.1	–	–	–
Consumer confidence index (***)	–10.5	–10.8	–9.3	–11.3	–11.4	–11.2	–12.4	–13.0	–12.0
Investment									
Capital goods production (*)	1.9	–0.1	–0.8	0.6	–1.3	0.8	10.2	4.5	...
Imports of capital goods (**)	14.9	20.4	28.6	36.0	13.5	8.2	20.7	10.0	...
Commercial vehicle registrations	11.7	13.2	9.2	17.9	13.9	11.5	–5.8	6.5	19.2
Foreign trade (**)									
Non-energy imports	9.8	6.0	5.7	9.0	4.7	4.5	14.7	11.5	...
Exports	5.2	0.2	–3.1	2.5	1.2	0.1	12.2	11.6	...

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.

were up by 15.1% real in the first two months, as against 20.4% in 2005.

Murcia heads regional growth in past five years

The year 2005 was one of sustained growth, somewhat higher than the year before. The good state of the economy spread over most autonomous communities with the exception of the Balearic Islands and La Rioja, which grew somewhat less than in 2004, and Andalusia and Cantabria, which grew at the same rate at the year before, according to regional accounting figures prepared by the National Institute of Statistics.

The most dynamic autonomous community in 2005 was Madrid Community, with growth of 4.0%, six decimals higher than the Spanish average. Also above that level were Murcia and Extremadura (both with 3.8%), the Basque Country (3.7%) and, finally, Aragon, Andalusia and Castile-La Mancha (all three with 3.5%). At the opposite extreme came the Balearic Islands with 2.4% and Asturias and the Canary Islands (both showing 2.9%).

In the last five years, the autonomous community to show most dynamic was Madrid, which grew at an annual average of 3.9%, practically twice the rate for the Balearic Islands, the region with the lowest cumulative growth since 2000. The sharp differential in construction, along with the different performance in the tertiary sector lay behind these major gaps. In the leading group we also find Andalusia (3.7% on annual average), Canary Islands, Castile-La Mancha and Extremadura, all three at 3.4%. Once more, the notable strength of construction (except in the case of the

Slight slowdown also in growth rate of capital goods investment.

Notable disparities in regional growth in 2005 with Madrid, Murcia and Extremadura in lead and Balearic Islands, Asturias and Canary Islands at tail-end.

GROSS DOMESTIC PRODUCT BY AUTONOMOUS COMMUNITY

2005

	Gross domestic product (*)		% real change		Per capita GDP	Gross disposable income per capita
	Million current euros	% of total	2005	2000-2005	Current euros	Spanish average = 100 / 2003
Andalusia	124,407	13.8	3.5	3.7	16,100	80.0
Aragon	28,013	3.1	3.5	3.2	22,403	109.1
Asturias	19,610	2.2	2.9	2.7	18,533	96.2
Balearic Islands	22,286	2.5	2.4	2.0	22,947	114.1
Basque Country	55,866	6.2	3.7	2.9	26,515	125.0
Canary Islands	36,433	4.0	2.9	3.4	18,879	92.3
Cantabria	11,383	1.3	3.0	3.3	20,554	102.0
Castile-La Mancha	30,567	3.4	3.5	3.4	16,314	84.8
Castile-Leon	48,894	5.4	3.3	3.1	19,782	98.9
Catalonia	170,426	18.8	3.3	3.0	24,858	114.2
Valencian Community	87,221	9.6	3.0	3.0	19,057	94.7
Extremadura	15,026	1.7	3.8	3.4	14,051	75.2
Galicia	45,780	5.1	3.3	2.7	16,870	87.1
Madrid Community	160,297	17.7	4.0	3.3	27,279	120.5
Murcia	22,812	2.5	3.8	3.9	17,322	83.8
Navarre	15,472	1.7	3.1	3.0	26,489	124.2
La Rioja	6,705	0.7	3.0	2.9	22,548	111.6
Ceuta	1,345	0.1	3.4	3.1	18,860	94.4
Melilla	1,221	0.1	3.1	3.0	18,304	93.9
Total	**904,323**	**100.0**	**3.4**	**3.2**	**20,838**	**100.0**

NOTES: (*) Total does not coincide with sum of all autonomous communities because it includes GDP figures which cannot be broken down by region.

Construction playing major role in boosting certain regions of Spain in recent years.

Canary Islands) is the factor behind this difference. Also above the Spanish average stand Cantabria, Madrid and Aragon, thanks to the relative boost in industry in the first case and construction in the other two. In Madrid, the energy sector was also a significant factor, while in Aragon industry showed growth above the Spanish average.

At the opposite end of the scale, that is to say, among those autonomous communities to lose specific weight in the Spanish economy as a whole, in the first place we find the Cantabrian Rim (Galicia, Asturias and the Basque Country) along with La Rioja, Catalonia, Valencian Community and Navarre. In the case of Catalonia and the Valencian Community, the difficulties in the manufacturing industry lie behind the drop below the Spanish average, given that construction maintained a strong level. Castile-Leon, in turn, grew at practically the same rate as Spain's economy (3.1% cumulative average in the past 5 years) and showed some strength in industry.

The dynamic of regional development has tended to moderate the differences between the various autonomous communities, although in 2005 the differences in terms of per capita GDP

were substantial. Madrid Community, with 27,279 euros per capita, led Spain as a whole, followed closely by the Basque Country and Navarre. Somewhat further behind, although also above the Spanish average, came Catalonia, with 24,858 euros per capita. These four autonomous communities were the only ones to show figures above the average for the European Union (EU-25) which came to 23,400 euros per capita.

At a lower level, but still higher than the Spanish average, we find the Balearic Islands, La Rioja and Aragon. Below the Spanish average (but less than 10% lower) came Cantabria, Castile-Leon and Valencian Community. At the opposite extreme, Extremadura and (slightly higher) Andalusia, Castile-La Mancha and Galicia, complete the map of those regions with a lower per capita GDP.

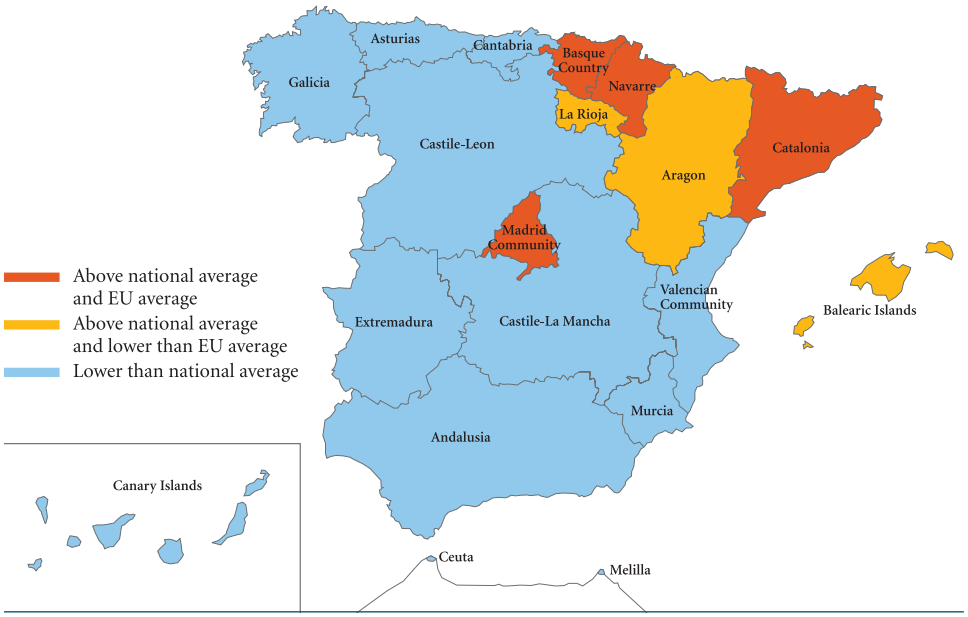
The regional disparities in per capita GDP are relatively softened if we take into consideration disposable household income, an indicator that serves to incorporate the effects of the central government's redistribution policy, among other factors. In fact, whereas the most developed autonomous community, Madrid Community, shows a per capita GDP 94% higher than that of the least developed (Extremadura), in the matter of income the differential goes down to 66% between the Basque Country and Extremadura, which show a per capita income of 14,902 and 8,964 euros respectively.

Differences in regional product per capita figure being reduced but these remain significant in worst cases.

Income differences much narrower than in case of products.

MADRID AND NORTH-EAST SPAIN REACH EUROPEAN PER CAPITA GDP

Per capita GDP in 2005



SOURCE: National Institute of Statistics and internal figures.

Labour market

Employment strong in first quarter of 2006

Registrations with Social Security up 2.9% after discounting «black» employment coming to surface as result of process of giving regular status to immigrant workers.

Employment continues to show notable strength in the early months of 2006, if we are to go by figures for registrations with Social Security which have kept moving at a high rate and growing slightly. In fact, at the end of March, those registered as working totalled 18,360,036, some 5.6% more than in the same month last year. This sharp increase is biased by the process of giving normal status to foreign workers, a process that began in February 2005 and ended with more than 550,000 new registrations at Social Security.

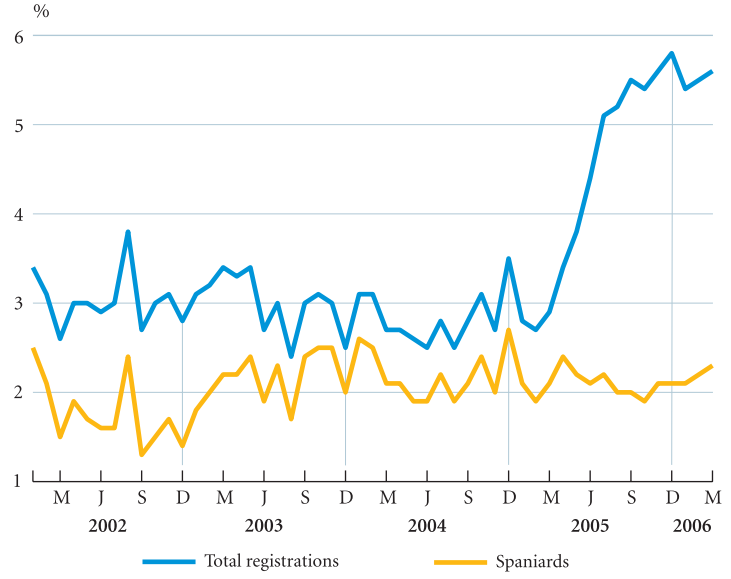
A more accurate estimate of the increase in registrations with Social Security is obtained by discounting the registrations arising from the process mentioned above. As a result, the increase in registrations would stand at 2.9%, an increase of 2.3% in the case of Spanish workers and 10.7% for foreign workers. Figures for registrations in March confirm the profile of sustained growth seen in recent months.

Part-time work pushes up hiring.

The strength of the labour market may also be seen in the sharp rise in hirings recorded at Public Employment Service offices. In the first three months of 2006 hiring contracts recorded were up 15.0%, both because of the sharp increase in permanent contracts and those of a temporary nature and, in both cases, falling within the area of part-time work. This hiring formula applied to 21.8% of

GROWTH OF EMPLOYMENT STABLE

Annual change in number of persons registered with Social Security



SOURCE: Social Security and internal figures.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	January	February	March
Persons registered with Social Security									
Wage-earners	2.7	4.8	2.8	4.2	5.9	6.3	6.2	6.2	6.4
Industry	*–0.5*	*–0.5*	*–0.8*	*–0.7*	*–0.3*	*–0.4*	*–0.5*	*–0.5*	*0.1*
Construction	*5.6*	*8.6*	*5.6*	*7.9*	*10.0*	*10.9*	*10.8*	*10.8*	*11.5*
Services	*3.9*	*5.7*	*4.2*	*5.2*	*6.4*	*6.8*	*6.6*	*6.6*	*6.6*
Non-wage-earners	3.2	2.6	2.9	2.7	2.5	2.4	2.3	2.3	2.2
Total	**2.8**	**4.4**	**2.8**	**3.9**	**5.3**	**5.6**	**5.4**	**5.5**	**5.6**
Persons employed (*)	**3.9**	**5.6**	**5.1**	**5.8**	**5.9**	**5.6**	**–**	**–**	**–**
Jobs (**)	**2.6**	**3.1**	**3.0**	**3.2**	**3.2**	**3.2**	**–**	**–**	**–**
Hiring contracts registered (***)									
Permanent	11.8	8.7	0.6	9.2	10.0	16.1	33.6	18.8	25.3
Temporary	11.4	4.6	–9.8	10.1	9.7	8.9	12.6	10.1	18.2
Total	**11.5**	**5.0**	**–8.8**	**10.0**	**9.8**	**9.5**	**14.6**	**11.1**	**19.0**

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

new hirings in the first quarter of the year as a whole.

Registered unemployment holding stable

The substantial strength in employment had a positive effect on the level of unemployment. In March, registered unemployment rose moderately because of seasonal effects and showed practically the same figure as in March 2005. The number of persons registered at the Employment Institute at the end of the month (2,148,530), as happened in February, still held at 0.2% above March 2005.

The stagnation in unemployment was mainly due to the negative effect on the total figures coming, on the one hand, from the strong increase in farm unemployment and, on the other, from the sharply upward trend those seeking a first job. In fact, non-farm unemployment, excluding those seeking a first job, is continuing to drop at a moderate stable rate (specifically 1.2%) which is in keeping with the real growth of the labour market.

Non-farm unemployment continues moderate decline.

The sharp increase in those seeking a first job seems to be more as a result of the general improvement in job prospects that is helping those still outside the workforce to seek a job rather than the process of integrating foreign workers into the labour market. In fact, foreign workers represented only a small part (5.5%) of the sharp increase in those seeking a first job in the first quarter.

Number seeking a first job up sharply, probably because of improved work prospects.

From a geographical point of view, the least favourable figures showed up in Andalusia where in the past three months unemployment has shown a sharp upward trend not linked to

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

March 2006

		Change over December 2005		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	67,894	2,667	4.1	11,441	20.3	3.2
Industry	299,694	–1,625	–0.5	–10,803	–3.5	13.9
Construction	227,740	–17,360	–7.1	–19,665	–7.9	10.6
Services	1,316,339	49,950	3.9	8,172	0.6	61.3
First job	236,863	11,961	5.3	14,550	6.5	11.0
By sex						
Males	833,844	–18,119	–2.1	–29,324	–3.4	38.8
Females	1,314.686	63,712	5.1	33,019	2.6	61.2
By age						
Under 25 years	287,058	12,708	4.6	7,674	2.7	13.4
All other ages	1,861,472	32,885	1.8	–3,979	–0.2	86.6
TOTAL	**2,148,530**	**45,593**	**2.2**	**3,695**	**0.2**	**100.0**

SOURCE: INEM and internal figures.

Performance in unemployment especially poor in Andalusia.

immigration. In this autonomous community, only 3.6% of unemployed are foreign workers, a percentage much lower than the levels of 20% recorded in the Balearic Islands or between 10% and 15% in areas where the immigrant group represents a substantial proportion of employment (La Rioja, Madrid, Catalonia, Murcia and Valencian Community).

In addition, Andalusia, along with Aragon, Valencian Community and the Canary Islands, although to a lesser degree in the latter three, the level of unemployment stood above the figure recorded in March 2005. In the rest of Spain, the most favourable situations showed up in Cantabria, Madrid, Balearic Islands, Navarre and Galicia, given that rate of decrease in unemployment showed a clearly downward profile.

Prices

Oil again threatening CPI

The consumer price index (CPI) gave some slight signs of moderating in March which, in order to so continue in coming months, will require the contribution of cheaper energy and lower oil demand. For the moment, the slight improvement in the inflation rate (down one decimal to 3.9% year-to-year) made it possible to reduce the differential with the euro area by the same amount to 1.7 percentage points.

The improvement in the CPI in March showed up in the less stable components, that is to say, in prices of fresh foods and fuels, which gave a more favourable performance than in March 2005 thus contributing to contain inflation. On the other hand, core inflation suddenly rose to 3.1%, the highest figure for three years.

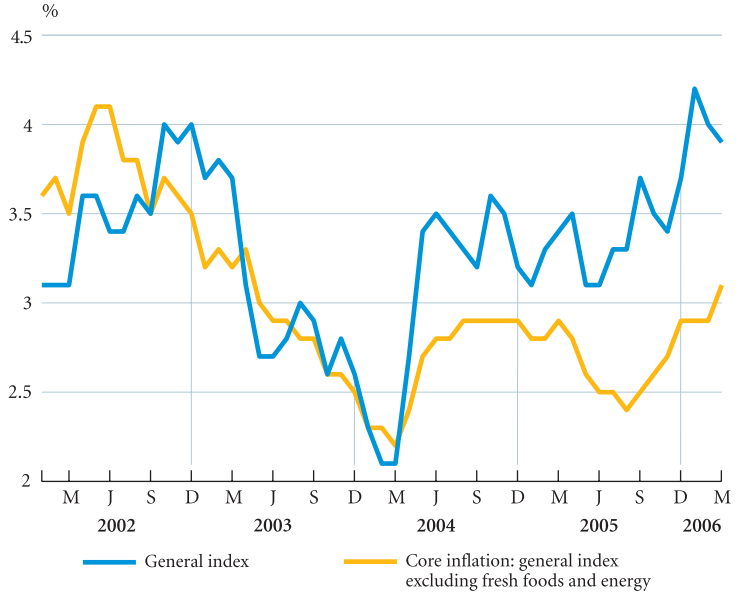
CPI down to 3.9% in March...

The increase in core inflation does not seem to be especially alarming to the extent that it may be attributed entirely to a specific factor such as the price of tobacco, which in the early months of 2006 has shown sharp swings because of «price wars» between the tobacco companies. If we exclude tobacco, the levels of the previous month would have been maintained thanks to the containment of industrial goods and the slight moderation in services in spite of

...but core inflation goes over 3% barrier because of rise in tobacco prices.

CPI IMPROVES IN SPITE OF RISE IN CORE INFLATION

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



SOURCE: National Institute of Statistics.

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	0.0	–0.4	4.0
March	0.8	0.2	3.4	0.7	0.3	3.9
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.

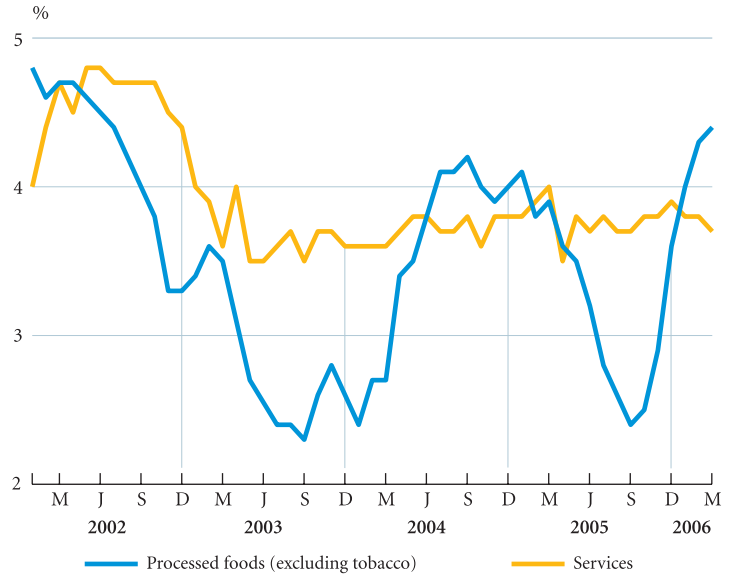
Products of industrial origin show well-contained inflation.

some rise in processed foods, which reached the highest figures in the past four years (4.4% year-to-year excluding tobacco) because of the rise in cooking oil.

Moderation in prices of goods of industrial origin is being maintained in spite of some increases in wholesale prices. This has been possible thanks to certain product groups, normally

PROCESSED FOODS MORE INFLATIONARY THAN SERVICES

Year-to-year change in some CPI components



SOURCE: National Institute of Statistics.

CONSUMER PRICE INDEX BY COMPONENT GROUP

March

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2005	2006	2005	2006	2005	2006
By type of spending							
Food and non-alcoholic beverages	120.3	0.4	0.0	0.9	0.7	3.4	3.9
Alcoholic beverages and tobacco	122.2	–0.0	5.6	0.3	0.3	5.4	5.1
Clothing and footwear	109.0	3.2	3.3	–9.4	–9.5	1.6	1.3
Housing	120.8	0.8	0.5	1.7	3.2	4.4	7.5
Household equipment	109.7	0.3	0.5	0.0	0.4	2.0	2.6
Health	106.7	–0.7	–0.3	–0.4	0.3	0.6	1.4
Transport	120.0	1.3	0.6	2.6	2.8	6.2	6.4
Communications	91.3	–0.8	–0.3	–0.8	–0.2	–1.2	–1.1
Recreation and culture	102.3	0.8	–0.2	–0.1	–1.6	0.6	–0.8
Education	121.5	0.0	0.0	0.5	0.3	4.2	3.9
Hotels, cafés and restaurants	123.1	0.9	0.6	1.8	1.8	4.4	4.3
Other	117.8	0.3	0.6	2.3	2.4	3.0	3.4
By group							
Processed foods	119.0	0.4	1.4	1.0	1.6	4.0	4.5
Unprocessed foods	123.4	0.3	–0.9	0.6	–1.3	2.9	3.3
Non-food products	114.9	0.9	0.7	–0.0	0.2	3.3	3.8
Industrial goods	110.5	1.2	0.9	–1.6	–0.9	2.7	3.9
Energy products	*123.8*	*1.9*	*0.6*	*3.1*	*4.8*	*8.2*	*11.8*
Fuels and oils	*129.4*	*2.7*	*0.7*	*3.6*	*5.0*	*10.5*	*14.4*
Industrial goods excluding energy products	*106.4*	*1.0*	*1.0*	*–3.0*	*–2.7*	*1.0*	*1.5*
Services	120.0	0.6	0.5	1.7	1.5	4.0	3.7
Underlying inflation (**)	114.7	0.7	0.9	–0.2	0.0	2.9	3.1
GENERAL INDEX	**116.3**	**0.8**	**0.7**	**0.2**	**0.3**	**3.4**	**3.9**

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

imported products, which, because of sharply downward prices, are compensating for other more upward trends. In any case, sharp competition in industrial product markets are also contributing to containing price increases.

In the area of services, the key factor is the stabilization of inflation at high levels although the group index in March moderated by one decimal with growth going to 3.7% year-to-year. The hotel and restaurant trade and organized travel had an effect on this performance, given that other services such as telecommunications, postal services, insurance, hospital services, motor repairs and urban public transport continued to rise in some cases and even at a somewhat higher rate than in previous months.

In this respect, the key to moderation in the CPI over coming months will lie in the trend in energy products which, if

Oil threatens possibility of reducing CPI over mid-term.

Producer prices reduce growth rate to 5.8% year-to-year in March.

Farm prices begin year with some increases.

they do not ease, could lift inflation at the end of the year to above 3%.

Food and energy moderating wholesale producer prices

The producer price index eased significantly in March to show an increase of 5.8%, a half-point less than in the month before. The containment of energy prices, still falling within very high growth rates, and lower increases in the food area, have more than compensated for increases in prices of non-energy intermediate goods. Worthy of special mention are non-food consumer manufactures and capital goods which continued to show a stable price increase of around 2% year-to-year.

The performance of farm prices in January was less favourable with an increase going to 4.0% year-to-year. The gradual recovery of prices for livestock products and particularly for slaughter livestock lay behind this performance although prices of agricultural products were also up slightly to 2.8%.

INFLATION INDICATORS

Percentage change over same period year before

	Farm prices	Producer price index					Import prices				GDP deflactor (*)
		General index	Consumer goods	Capital goods	Intermediate goods	Energy goods	Total	Consumer goods	Capital goods	Intermediate goods	
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	4.0	6.3	3.5	2.1	3.6	20.6	1.5	–6.5	–5.1	7.5	–
February	...	6.3	3.6	2.1	3.8	20.1	6.6	2.5	3.2	9.2	...
March	...	5.8	3.3	2.0	4.5	16.4	...	...	...	...	...

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

Foreign sector

Exports improving

Exports continued to show notable strength in the second month of the year although this was not enough to compensate for the rise in imports also boosted by oil prices. The trade deficit thus continued to rise sharply going to 13.09 billion euros in the January-February period, 26.2% more than in 2005. The increase in the deficit must be largely blamed on the worsening of the energy balance which includes a rise in oil imports of 63.4% (in euros) over the past year. In any case, the greater part of the trade deficit continues to be due to the non-energy foreign trade.

Foreign deficit for energy products now accounts for 3% of GDP.

The rise in exports at the beginning of 2006 has the basis of comparison running in its favour seeing that the beginning of 2005 was very poor in foreign sales. Furthermore, a specific transaction involving ships introduced a notable upward bias in sales of capital goods and, as a result, contributed to

Exports up but comparison against very low base level.

FOREIGN TRADE

January-February 2006

	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	6,490	50.4	16.3	1,192	52.6	4.5	–5,298	18.4
Consumer goods	11,594	21.3	29.1	10,166	11.5	38.0	–1,428	87.7
Food	*1,937*	*8.3*	*4.9*	*3,319*	*2.3*	*12.4*	*1,382*	*171.3*
Non-foods	*9,657*	*23.7*	*24.2*	*6,847*	*14.3*	*25.6*	*–2,810*	*70.9*
Capital goods	3,898	14.0	9.8	2,706	52.6	10.1	–1,192	69.4
Non-energy intermediate goods	17,851	10.7	44.8	12,683	11.5	47.4	–5,168	71.0
By geographical area								
European Union (EU-15)	23,477	12.1	58.9	19,277	8.4	72.1	–4,200	82.1
Euro area	*19,675*	*11.2*	*49.4*	*15,241*	*7.0*	*57.0*	*–4,434*	*77.5*
Other countries	16,356	31.0	41.1	7,469	41.8	27.9	–8,887	45.7
Russia	*1,054*	*36.5*	*2.6*	*183*	*37.8*	*0.7*	*–872*	*17.3*
United States	*1,339*	*17.5*	*3.4*	*1,138*	*42.8*	*4.3*	*–202*	*84.9*
Japan	*914*	*–4.0*	*2.3*	*219*	*34.3*	*0.8*	*–695*	*23.9*
Latin America	*1,949*	*52.2*	*4.9*	*1,483*	*54.2*	*5.5*	*–466*	*76.1*
OPEC	*3,353*	*49.3*	*8.4*	*693*	*33.6*	*2.6*	*–2,660*	*20.7*
Rest	*7,747*	*27.1*	*19.4*	*3,754*	*39.3*	*14.0*	*–3,993*	*48.5*
TOTAL	**39,833**	**19.2**	**100.0**	**26,746**	**16.1**	**100.0**	**–13,087**	**67.1**

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

Imports, especially consumer goods, also rise sharply but against higher starting-point.

making things look better. In spite of this, we note a recovery in exports related to industrial sectors such as motor vehicles, chemicals, pharmaceuticals, consumer electronics and clothing, which, should this continue, would make for a more solid base to improve the foreign trade balance. For the moment, the growth of exports in the January-February period came to 16.1% nominal, equivalent to 11.9% real.

The improvement in exports was mainly concentrated in markets outside the European Union (EU), areas where growth by volume came to 28.3%, more than 20 points above the increase recorded by shipments to the EU. By country, the most spectacular increases showed up in transactions with the United States, Japan, the countries in the Organization of Petroleum Exporting Countries, China and the Confederation of Independent States (CIS). Within the European Union, the greatest strength continued to be demonstrated by sales to the new member states.

Imports, in turn, grew by 19.2% nominal or, what is the same thing, by 12.3% by volume in the first two months of the year. Apart from the energy bill, which made up a notable proportion of total imports (16.3% in the January-February period), we also see very sharp growth in purchases abroad of other goods, particularly non-food consumer goods. In the first two months of 2006 these goods rose by 26.6% by volume because of the extraordinary growth in purchases abroad of textile and clothing products, consumer electronics and footwear.

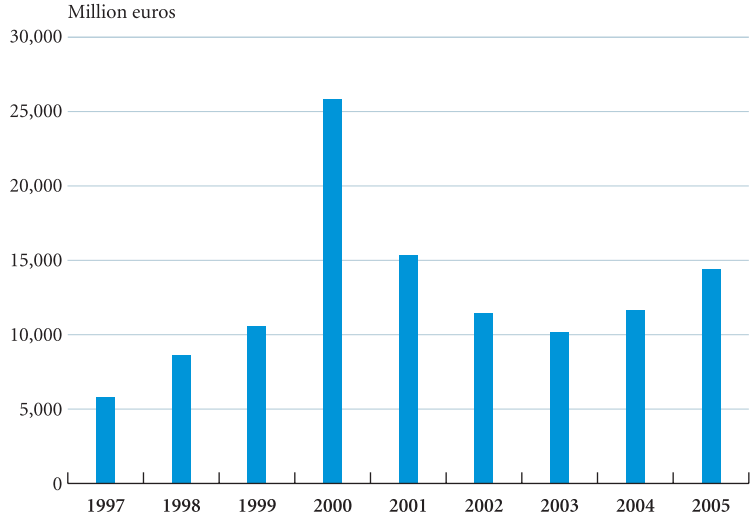
Favourable balance in direct foreign investment in 2005

Current account deficit holds at 7.4% of GDP in January.

The current account balance began 2006 with some slight signs of improvement over recent months, although without moving away from a clearly negative figure. In fact, January reported a deficit if 6.77 billion euros, down 1.2% from the same month in 2005. This slight

FOREIGN INVESTMENT IN COMPANIES RECOVERS IN 2005

Gross foreign investment in Spanish companies (*)



NOTES: (*) Excludes those channelled through so-called «foreign securities holding companies».
SOURCE: Foreign Investment Registry and internal figures.

BALANCE OF PAYMENTS

Cumulative figure for last 12 months in million euros

	January 2004	January 2005	% change
Current account balance			
Trade balance	–54,923	–70,249	27.9
Services			
Tourism	*26,572*	*25,786*	*–3.0*
Other services	*–4,639*	*–4,367*	*–5.9*
Total	21,932	21,420	–2.3
Income	–13,001	–16,100	23.8
Transfers	–1,455	–1,618	11.2
Total	**–47,447**	**–66,548**	**40.3**
Capital account	**8,715**	**7,811**	**–10.4**
Financial balance			
Direct investment	–30,561	–10,954	–64.2
Portfolio investment	86,775	64,668	–25.5
Other investment	–13,566	20,787	–
Total	**42,648**	**74,501**	**74.7**
Errors and omissions	600	–629	–
Change in assets of Bank of Spain	–4,516	–15,135	235.1

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.

improvement was based on a reduction of the negative figures for transfers and incomes, which compensated for the increase in the trade imbalance and the sharp drop in the surplus for services.

In spite of the slight improvement, the cumulative deficit for the past 12 months (66.55 billion euros) came to represent 7.4% of the gross domestic product (GDP), a figure equal to that recorded at the end of the year and also an all-time high. On the other hand, net world borrowing of Spain's economy, that is to say, the current account balance plus the capital balance, showed a slight rise to stand at 58.74 billion euros, equivalent to 6.5% of the GDP.

In the financial sphere, January was weak in terms of foreign investment in Spain as well as for Spanish investment abroad. It is still too early to predict trends for 2006. In any case, the balance for 2005 was not unfavourable as was duly shown by the Bank of Spain figures and more recently by the much more detailed figures supplied by the General Directorate for Trade and Investment of the Ministry of Economy and Finance.

Direct foreign investment moves up for third year in a row.

According to these figures, gross foreign investment in Spanish companies was 16.62 billion euros in 2005, of which 2.19 billion was channelled through so-called foreign securities holding companies (ETVE) which are non-resident multinationals which concentrate their direct investment going into third countries in Spain in order to take advantage of certain tax advantages. As a result, to be exact, investment in Spanish companies should be stated at 14.43

billion euros, a figure 23.6% higher than the year before.

The positive balance of foreign investment is much higher if we take into account only net investment, that is to say, discounting disinvestment. In fact, net investment in Spanish companies coming from abroad, excluding ETVE amounts, came to 8.31 billion euros, some 257.5% more than in 2004. In any case, the figures for foreign investment include both funds for setting up new companies (a small proportion of the total) and funds intended for acquisitions or capital increases in resident companies.

France, United States, United Kingdom and Germany make up more than 78% of all foreign investment in Spanish companies in 2005.

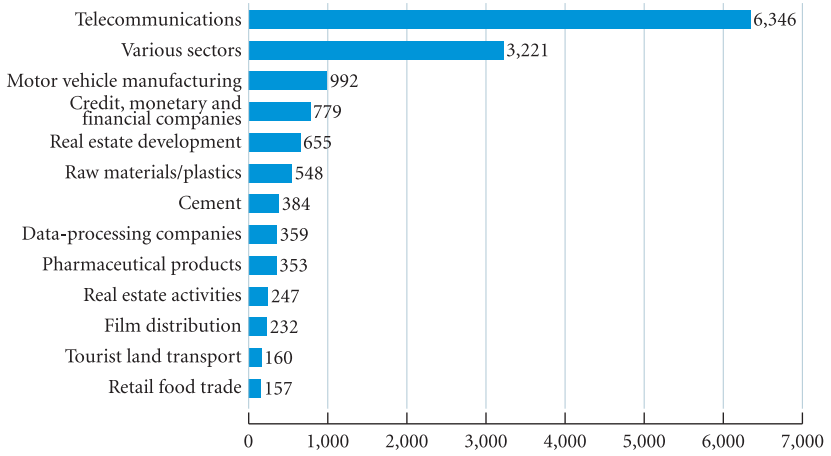
Most foreign investment transactions in 2005 were aimed at the telecommunications sector which, with the purchase of Amena by France Télécom as a star operation, lumped together 44.0% of total gross investment, not counting ETVE. Also significant, although to a much lesser degree, were investments in the motor vehicle industry (6.9% of the total), financial and credit institutions (5.4%), real estate developments (4.5%), raw materials/plastics (3.8%) and cement (2.7%).

Foreign investment came mainly from the European Union and, looking at its exact origin among the various countries, from France (44.7% of the total because of the transaction mentioned above), the United States (17.1%), the United Kingdom and Germany, the latter two countries making up 8.3% of the total.

The main recipient areas were Madrid Community, with 30.9% of total gross investment (excluding ETVE) and Catalonia, with 17.8%. The largest proportion, however, was for investment which could not be attributed to any particular region or was spread right across Spain, which made up 42.9% of the total.

TELECOMMUNICATIONS MAIN RECIPIENT OF FOREIGN INVESTMENT

Gross foreign investment, excluding foreign securities holding companies (ETVE), in 2005, in million euros



SOURCE: Ministry of Economy and Finance and internal figures.

Public sector

Sharp growth of government revenues

Central government non-financial revenues amounted to 33.26 billion euros in the first quarter of 2006, some 7.2% more than in the same period in 2005.

The biggest increase came in direct taxes (10.6%) thanks to the good situation in tax collections for personal income tax. The increase in revenues from indirect taxes was somewhat lower at 7.7%, these being affected by the drop in collections for value added tax (VAT) on import transactions. Under special taxes, the tax on tobacco was helped by the increase in applicable rates and collections rose by 4%.

Tax collections growing at rate of economy.

Central government non-financial spending was down by 3.0% to show a figure of 33.02 billion euros. This reduction was brought about largely by the sharp decrease in interest payments and capital transactions seeing that personnel costs, especially, and purchases of goods and services rose notably. The central government Treasury balance as of March, that is to say, the difference between non-financial revenue and spending was positive for an amount of 244 million euros.

Central government ends first quarter with surplus.

CENTRAL GOVERNMENT BUDGETARY IMPLEMENTATION

March 2006

	Month		Cumulative for year	
	Million euros	% change over same month year before	Million euros	% change over same month year before
Non-financial revenue	**4,889**	**–10.1**	**33,260**	**7.2**
Non-financial revenue adjusted (*)				
Personal income tax	3,569	14.6	16,760	10.3
Corporate tax	–58	–	896	4.9
VAT	2,417	–9.7	18,417	9.0
Special taxes	1,451	5.6	4,368	2.1
Other	1,217	–22.8	3,938	–4.0
Total	**8,596**	**–3.1**	**44,379**	**7.4**
Non-financial spending	**8,809**	**4.6**	**33,016**	**–3.0**
Treasury balance	**–3,920**	**31.4**	**244**	**–**
Surplus (+) or deficit (–) (**)	***–6,273***	***22.1***	***4,584***	***46.0***

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

Savings and financing

Demand for funding to private sector not easing

Good state of economy and easy financing terms continue to boost credit.

Financing obtained by companies and households continues to show strong growth. The year-to-year change rate was 20.8% in February showing the same level as in the previous three months. The good state of the economy boosted by very low interest rates continues to foster demand for credit which, in turn, increases the strength of economic activity.

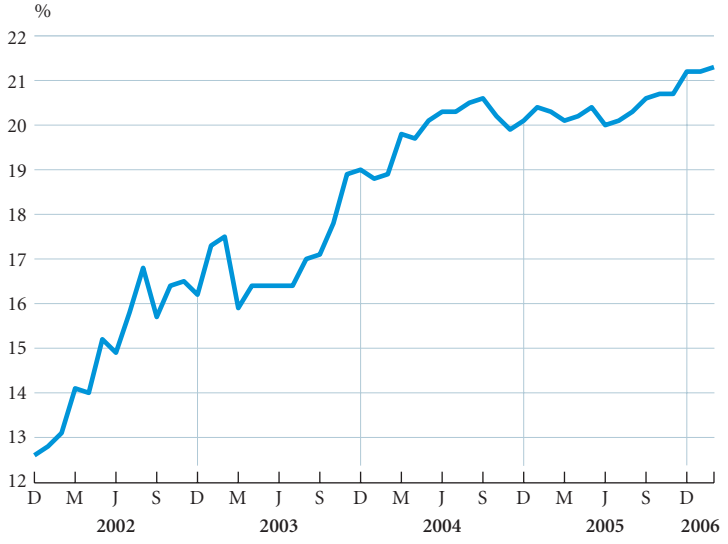
Mortgage loans scarcely slowing down.

Funds going to companies rose by 20.4% in February compared with the month before. This rate was slightly higher than that recorded in January although it stood somewhat lower than the figure for December. Of total funding received by non-financial companies, that part made up of bank credit rose still higher in the past 12 months going to 25.1%.

Households were not far behind. Funding granted to households rose by 21.3% in February compared with the same month in 2005, the highest year-to-year rate in the past decade. The main purpose was for housing with loans of this type going to 24.4% in the last 12 months, a mere three decimals less than in October 2005. The forecast slowdown in mortgage loans is thus taking place very slowly. Other loans to households are also notably strong although at a

GROWTH OF FUNDING TO HOUSEHOLDS MARKS UP HIGHEST LEVEL IN RECENT DECADE

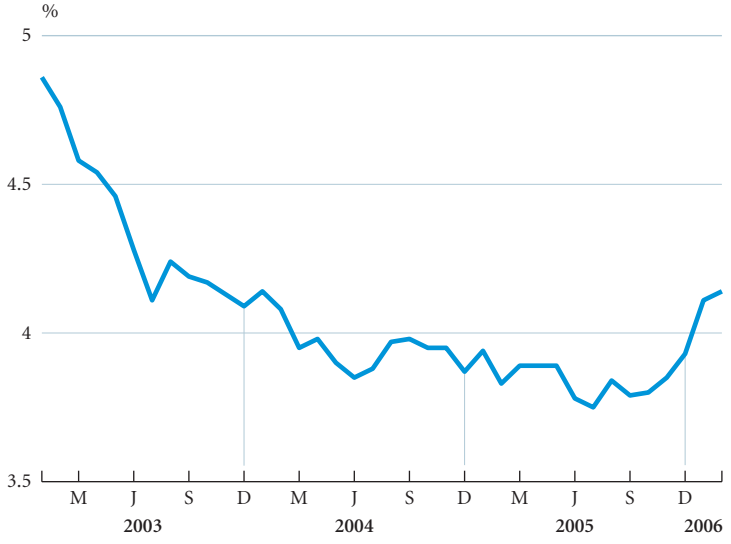
Year-to-year change in funding granted to households and non-profit bodies serving housholds



SOURCE: Bank of Spain.

MODERATE RISE IN LOAN INTEREST RATES

Interest rates on loans and credits granted by credit institutions to private sector.
New business



NOTES: Annual percentage rate of change.
SOURCE: Bank of Spain.

lower growth rate of 13.7% year-to-year in February.

The Bank of Spain recently published somewhat more broken-down figures going up to December 2005. According to these figures, funding by banks, savings banks and credit cooperatives for the purchase of consumer durables (cars, motorcycles, appliances, furniture, etc.) grew by 4% in the final quarter of last year compared with the same period the year before, thus showing an easing off.

In spite of the sharp growth of credit to the private sector, the default rate remains at very low levels and even went down in the final quarter of 2005, according to latest available figures. The default rate for credit to the private sector thus stood at 0.76% at the end of December 2005. The level for the loan default rate for mortgage housing loans was even lower, less than half the total rate, to stand at 0.37%.

The good state of the economy and low interest rates have meant that default has dropped to very low levels.

Default rate remains at very low levels.

In fact, the average interest rate on bank loans and credits to the private sector was 4.14% in February, less than 2 decimals above the inflation rate. Nevertheless, we note a moderate upward trend following the gradual increase in interest rates by the European Central Bank. As a result, compared with July 2005, interest rates charged to companies and households rose by 39 basis points.

Bank interest rates still very low in real terms but starting to rise.

Growth of bank deposits remains very high

Total deposits of residents and households are growing very sharply reaching growth rates comparable to those in the case of loans. As a result, these reflect the high level of liquidity

In investment funds, investor preference concentrated in global funds in first quarter.

which still exists in spite of the upward trend in rates followed by the European Central Bank. Deposits for terms of more than 2 years, which enjoy a tax benefit of 40% on interest, continue to show an extraordinary increase. In addition, on demand and savings accounts were up by 12.4% in the past 12 months, a rate very little lower than that recorded in January.

Investment funds also continue to show progress. The assets of investment funds rose by 8.66 billion euros in the first quarter to reach 254.51 billion euros, according to figures supplied by Inverco, the sector association. As a result, total assets of investment funds rose by 13.3% in March compared with the same month last year. Cumulative net subscriptions as of March totalled 4.74 billion euros, while the rest of the increase in assets came from capital gains obtained especially by the favourable trend on the stock markets.

Share-based funds in emerging markets mark up capital gains of 61%.

Preferences among savers has shown up in terms of prospects for returns on products. In the course of the first three months of the year, the biggest net inflows of money were concentrated in global funds, which have a flexible investment pattern and attempt to take advantage of opportunities in international markets. Share-based funds also marked up major new inflows. On the other hand, the biggest withdrawals showed up in bond-based funds both short-term and long-term.

With regard to yields obtained by investment funds in the 12 month period ending in March, these show a wide range although all types reported positive yields. The biggest gains came in share-based funds of emerging countries, with a spectacular increase of 60.6% followed by Japanese funds with 41.8%. National share-based funds also recorded an excellent 29.1%. At the other end of the scale, guaranteed bond-based funds showed only 1.0% and money market funds reported 1.2%. Average yield was 5.7%.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

February 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (**)	390,347	–6,008	–1.5	42,919	12.4	42.0
Up to 2 years (*)	194,305	3,789	2.0	28,564	17.2	20.9
More than 2-year term (*)	253,498	16,742	7.1	122,087	92.9	27.3
Repos	72,535	–517	–0.7	–573	–0.8	7.8
Total (*)	**910,686**	**14,007**	**1.6**	**192,999**	**26.9**	**97.9**
Deposits in currencies other than euro	**19,391**	**3,752**	**24.0**	**13,427**	**225.1**	**2.1**
TOTAL (*)	**930,077**	**17,759**	**1.9**	**206,426**	**28.5**	**100.0**

NOTES: (*) As a result of the coming into force of new regulations in application of the International Financial Reporting Rules, 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 household indebtedness in 2005

Disposable income of households (including non-profit institutions serving households, such as religious, beneficent, trade union institutions, etc.) rose by 7.3% in 2005, according to estimates by the National Institute of Statistics. Given that, in the same period, household consumption grew somewhat more (8.1%), household savings, which is arrived at by subtracting spending from income, showed a low level of 10.4% compared with gross disposable income, a rate even lower than in 2000. One of the factors behind this trend was the lower levels of interest rates, both in nominal and real terms, which removed the incentive to save and boosted consumption.

As a result, net financial household savings, which is obtained by deducting investment spending from savings, was negative (1.4% of the gross domestic product), thus marking up the lowest level since the Bank of Spain began to prepare separate financial accounts for households. This result was due to heavy investment in housing by households along with a low level of savings. As a result, households are no longer a source of funding for the rest of the economy (companies, public sector) as used to be traditional.

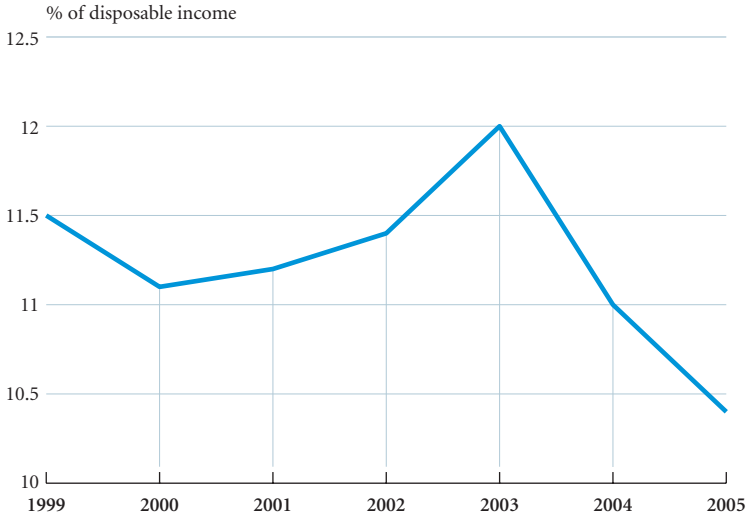
Further drop in household savings in 2005.

On the other hand, financial savings by households is equivalent to the net acquisition of financial assets less net financial liabilities assumed. The value of the financial assets portfolio at market prices in 2005 totalled 1,560 billion euros, 11.8% more than in 2004, representing 173.0% of the gross domestic product (GDP). Financial assets per person amounted to 35,479 euros, an annual increase of 9.4%. The trend in the assets portfolio of families is described below along with liabilities.

Households no longer source of funding for rest of economy.

DROP IN HOUSEHOLD SAVINGS

Savings rate of households and non-profit institutions serving households



SOURCE: National Institute of Statistics.

NET HOUSEHOLD FINANCIAL WEALTH (*)

	2005			Annual change		Change over 5 years	
	Million euros	Structure as %	% of GDP	Million euros	%	Million euros	%
Financial assets							
Cash	84,241	5.4	9.3	14,209	20.3	31,479	59.7
Deposits	511,501	32.7	56.6	40,285	8.5	147,435	40.5
Securities other than shares	52,032	3.3	5.8	11,092	27.1	25,379	95.2
Shares and participations in investment funds	640,636	40.9	70.8	78,969	14.1	217,569	51.4
Insurance technical reserves	226,160	14.5	25.0	18,458	8.9	81,143	56.0
Other	50,360	3.2	5.6	1,556	3.2	12,718	33.8
Total	**1,564,930**	**100.0**	**173.0**	**164,570**	**11.8**	**515,722**	**49.2**
Financial liabilities							
Loans	653,955	93.2	72.3	113,651	21.0	362,810	124.6
Other	47,429	6.8	5.2	–3,384	–6.7	–1,863	–3.8
Total	**701,384**	**100.0**	**77.6**	**110,267**	**18.7**	**360,947**	**106.0**
Net financial worth	**863,546**	**–**	**95.5**	**54,303**	**6.7**	**154,775**	**21.8**

NOTES: (*) Includes non-profit institutions serving households.
SOURCE: Bank of Spain and internal figures.

Bank deposits losing share in total financial assets.

Net accumulation of bank deposits totalled 40.38 billion euros, the highest among the various types of financial assets held in 2005 not taking revaluations into account. Nevertheless, total bank deposits lost something in terms of relative weight in the total going to 32.7%.

Households show renewed interest in stock markets following crisis at beginning of decade.

The share portfolio, including participations in investment funds, rose by 14.1% while the participation in the total went up to 40.9%. Net purchases of listed shares held directly by households amounted to 1.21 billion euros following two years showing net sales. As a result, we note a renewed interest in the stock market on the part of households following the crisis at the beginning of the decade. The market value of listed shares moved up by 19.5% while that of unlisted shares rose by 15.5%. The share of the total thus rose to 24.2%.

Net purchases of participations in investment funds amounted to 17.01 billion euros, well above net purchases of shares. Participations in investment funds rose by 13.8% to reach an all-time high going above levels at the end of the Nineties. Their relative weight in the total increased to 12.5%.

Products linked to insurance showed notable growth at an annual rate of 8.9%. Their participation in the total, however, was down slightly for the third consecutive year going to 14.5%. By type, the most dynamic were pension funds, which rose by 12.2% with their relative weight in the total going up to 6.1%. Both life insurance and other than life showed lower growth than the average.

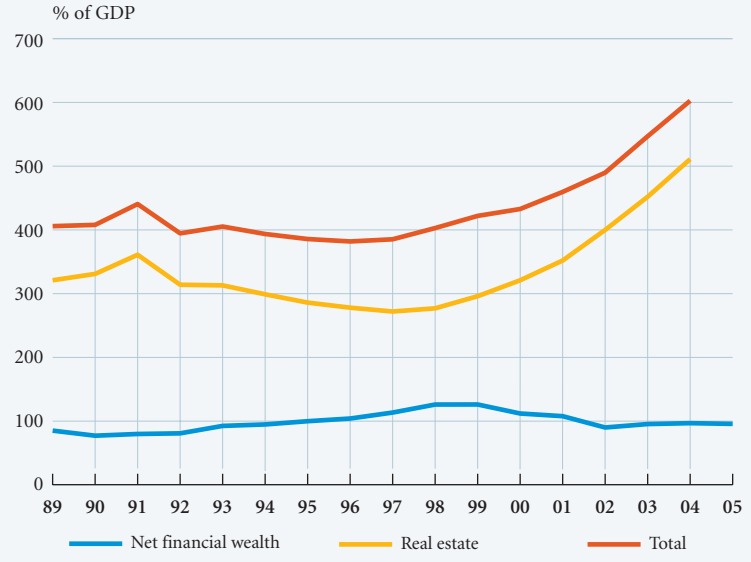
In 2005, the importance of household financial liabilities took on a greater role than financial assets. Household indebtedness rose by 18.7% to 701.38 billion euros, or 15,901 euros per capita. As a result, debt continued to increase more rapidly than financial assets. The greater part of household financial

Modernization of financial markets increases wealth effect

There is no doubt that household consumption is largely determined by disposable income, as discussed in boxes on pages 24 and 46. But there are other factors which have a marginal influence on household consumption. For example, a rise on the stock market or in the price of housing can increase the propensity to spend because we feel economically more comfortable, we think that saving is less important and we decide to buy a more expensive car than we at first considered or we make a trip we have dreamed of for a long time. This is what is known as the wealth effect. If wealth (financial or real estate assets) increases more than expected, spending may also grow more than planned, depending on the trend in disposable income. That is to say, it is possible that, in view of a substantial increase in real estate or financial wealth, people decide to spend part of that increase in the value of their assets or to borrow against those assets in order to follow a higher level of spending.

BIG INCREASE IN WEALTH IN RECENT YEARS

Household wealth (at end of period)



SOURCE: Bank of Spain.

Among the various financial assets of households, those most susceptible to sharp revaluation are shares. Quotations for these may rise because of the prospect of higher corporate profits through gains in productivity. In this case, it is normal that shareholders anticipate increased future wealth and therefore raise their spending.

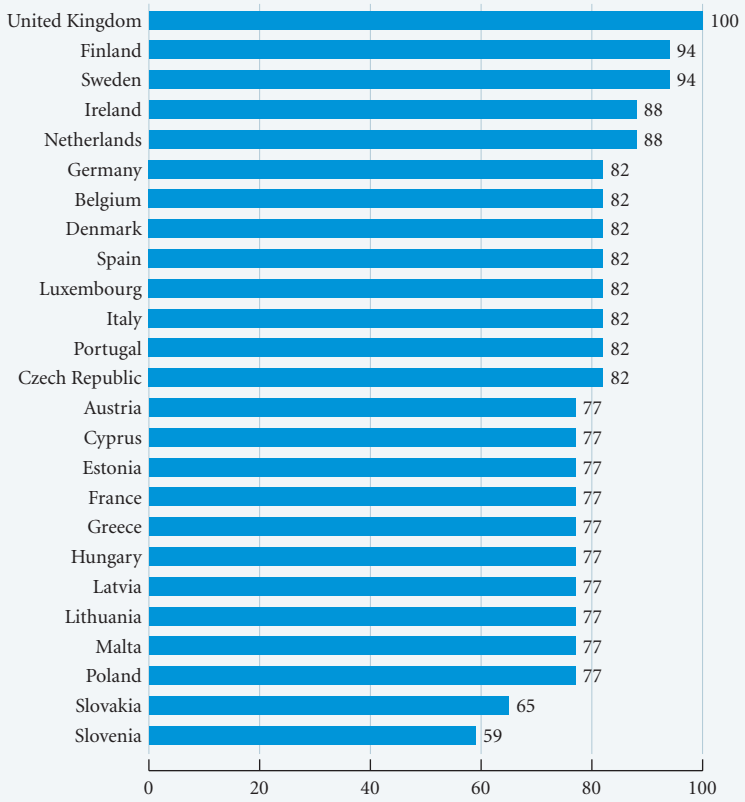
The other major component of household wealth is real estate property. Its effect on consumption may be considered similar to that produced by the financial segment. Nevertheless, it has certain peculiarities. In fact, the most common element in real estate property of households is a person's own residence which usually has been so for many years. As a result, the fact that normally we do not intend to sell our own home means that

the increase in the market price does not at first generate the wealth effect mentioned. In any case, it is possible to benefit from an increase in the value of the house. We can sell it and buy one that is cheaper and usually smaller. Or we can go and live in a rented house or a home or else turn the increase in the value of the house into cash and go into the financial market. In the latter case, there are various possibilities. If we have a mortgage, we can refinance it for a higher amount, thus obtaining liquid funds. In addition, there are mortgage loans which make it possible to have access to the amount of the loan already amortized for current spending. In this way, households can have easy access to credit for the purchase of consumer goods at favourable interest rates. One may also have recourse to an inverse mortgage, a product that is appropriate for the elderly segment of the population that owns a home but has a low income level. With an inverse mortgage, the mortgagor receives a supplementary income through monthly payments which may be for life or for a stipulated period in exchange for an eventual hand-over of the home to the financial institution granting the transaction. The signor maintains the ownership of the home and may even leave it to his/her heirs who, of course, must pay off what is still owing in order to recover the property.

Obviously, the effect of a rise on the stock market directly affects only those who hold shares and the same may be said of the real estate boom. It is therefore logical to think that the wealth effect depends on the distribution

WIDER RANGE OF PRODUCTS IN MORE DEVELOPED MORTGAGE MARKETS

Mortgage product availability index (*). 2005



NOTES: (*) This index synthesizes the availability of various types of mortgage and for various types of borrowers (young families, borrowers with low property means, self-employed persons, second mortgages, etc.).
SOURCE: London Economics.

of wealth among the population as well as the age structure involved. At the same time, following what is stated above, it may affect the degree of development of the financial markets and other variables, just as the greater or lesser aversion to risk. In order to determine the importance of the wealth effect, recourse must be had to empirical estimating, given that economic theory is unable to offer conclusive results with regard to amount.

Empirical estimates indicate that the wealth effect varies by country and may not be constant over time. In general, the wealth effect is relatively small, just a few cents more spending for each monetary unit of increase in wealth. As a result, recent OECD estimates put the marginal propensity to spend arising from the wealth effect at between 0% and 8% for the main developed countries. Nevertheless, in boom periods assets may turn out to be notable. The effect of the rise on the stock market may have added around one percentage point to the annual growth rate of the gross domestic product in the United States on average between 1995 and 1999, according to estimates by the Federal Reserve. Broadly, it may be stated that the wealth effect is greater in those countries with highly developed financial markets. Specifically, the wealth effect arising from the real estate market is more important in those countries where mortgage facilities make it easy to obtain liquidity.

In Spain, the availability of statistics on household financial worth has improved in recent years, which makes it possible to carry out more reliable studies on the wealth effect. Notable among these are the studies carried out by the Bank of Spain. These come to the conclusion that the wealth effect in Spain is appreciable, both that coming from financial wealth and that from real estate. It is estimated that marginal propensity to spend arising from real estate wealth is 1.5%. Nevertheless, its size may be considered lower than that in those countries where financial markets are more highly developed.

In recent years, the wealth of Spanish households has risen sharply especially as a result of the sharp increase in housing prices. Furthermore, it should be mentioned that in Spain the proportion of owner-occupied homes is one of the highest among the developed countries. At the same time, in recent years there has been strong development of the mortgage market and the range of products available has broadened and become more within popular reach. Products such as mortgages which allow for consumer credit or inverse mortgages already exist on the Spanish market. As a result, Spanish households now have more instruments to facilitate when they will make purchases according to their own preferences and it is very possible that these institutional changes will increase the size of the wealth effect in the future.

liabilities is made up of loans, this being 93.2% of the total in 2005. Loans increased by 21.0%. Among these, loans taken out for the short term were up by 17.6% whereas long-term loans, largely for home purchase, rose by 21.2%. In relation to gross household disposable income, loans rose to 112.5%, a level lower than that in the United Kingdom and the United States but higher than the euro area average.

Thus the net financial worth of households, defined as financial assets less financial liabilities, amounted to 863.55 billion euros in 2005, an increase of 6.7% compared with the year before. Nevertheless, it was down slightly in terms of the GDP. Among other factors, this decrease was due to negative financial savings. In per capita terms, financial worth was 19,578 euros, 4.5% more than in 2004.

Per capita financial wealth up 4.5% to 19,578 euros.

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