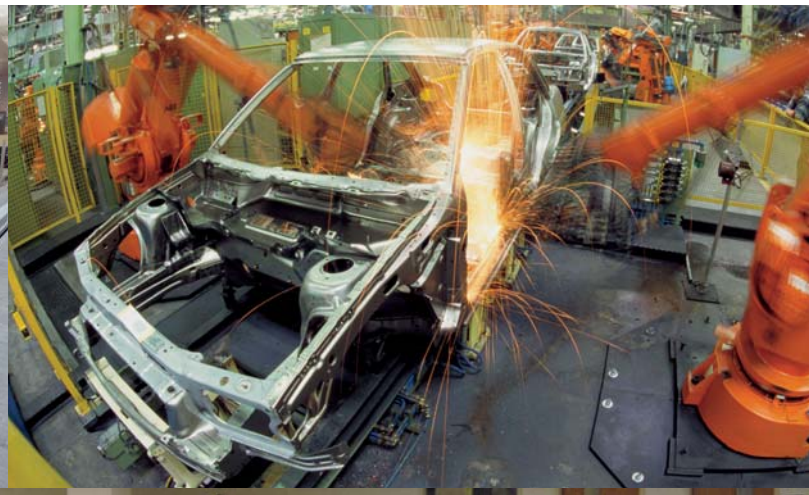
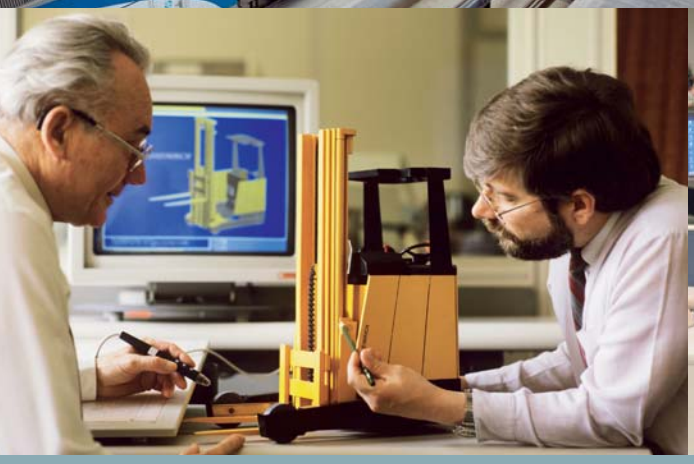
JULY-AUGUST 2006

THE SPANISH ECONOMY

Monthly Report





NUMBER 293

RESEARCH DEPARTMENT

"la Caixa"

Forecast

% change over same period year before unless otherwise noted

	2005	2006	2007	2005				2006		
				1Q	2Q	3Q	4Q	1Q	2Q	3Q
INTERNATIONAL ECONOMY		Forecast							Forecast	
Gross domestic product										
United States	3.5	3.5	3.2	3.6	3.6	3.6	3.2	3.6	3.6	3.5
Japan	2.6	2.8	2.1	1.1	2.7	2.7	4.0	3.5	2.9	2.6
United Kingdom	1.8	2.3	2.5	1.9	1.7	1.9	1.8	2.2	2.3	2.3
Euro area	1.4	2.0	1.9	1.2	1.2	1.6	1.7	1.9	2.0	1.9
Germany	*1.1*	*1.6*	*1.3*	*0.6*	*0.8*	*1.6*	*1.7*	*1.4*	*1.7*	*1.6*
France	*1.2*	*2.0*	*1.9*	*1.6*	*0.8*	*1.4*	*1.1*	*1.5*	*2.1*	*2.1*
Consumer prices										
United States	3.4	3.5	2.9	3.0	3.0	3.8	3.7	3.7	4.0	3.3
Japan	–0.3	0.4	0.3	–0.2	–0.1	–0.3	–0.5	0.4	0.4	0.3
United Kingdom	2.3	2.4	2.2	2.2	2.2	2.4	2.2	2.2	2.7	2.6
Euro area	2.2	2.3	2.2	2.0	2.0	2.3	2.3	2.3	2.4	2.3
Germany	*2.0*	*1.8*	*2.2*	*1.7*	*1.7*	*2.1*	*2.3*	*2.0*	*2.0*	*1.6*
France	*1.7*	*1.8*	*1.7*	*1.7*	*1.7*	*1.9*	*1.6*	*1.8*	*1.6*	*1.7*
SPANISH ECONOMY		Forecast							Forecast	
Macroeconomic figures										
Household consumption	4.4	3.6	3.2	4.6	4.6	4.3	4.0	4.0	3.8	3.5
Government consumption	4.5	4.5	4.4	5.2	4.0	4.2	4.6	4.7	4.6	4.5
Gross fixed capital formation	7.2	5.7	4.3	7.0	7.6	7.3	6.8	6.2	6.0	5.4
Capital goods	*9.5*	*7.6*	*5.9*	*9.8*	*10.4*	*8.9*	*9.1*	*8.3*	*7.9*	*7.4*
Construction	*6.0*	*4.8*	*3.2*	*6.0*	*6.2*	*6.3*	*5.6*	*5.8*	*5.3*	*4.5*
Domestic demand (contribution to GDP growth)	5.3	4.6	3.9	5.5	5.4	5.3	5.0	5.0	4.8	4.4
Exports of goods and services	1.0	8.4	6.4	–1.4	1.3	2.1	1.9	9.1	8.8	8.1
Imports of goods and services	7.1	11.3	8.6	6.2	7.9	7.8	6.6	12.4	11.8	11.0
Gross domestic product	**3.4**	**3.2**	**2.8**	**3.3**	**3.4**	**3.5**	**3.5**	**3.5**	**3.4**	**3.1**
Other variables										
Employment	3.1	2.8	2.4	3.0	3.2	3.2	3.2	3.2	3.1	2.7
Unemployment (% labour force)	9.2	9.0	8.9	10.2	9.3	8.4	8.7	9.1	9.0	8.9
Consumer price index	3.4	3.8	3.0	3.3	3.2	3.4	3.6	4.0	4.0	3.5
Unit labour costs	2.3	2.5	2.2	2.5	2.4	2.0	2.2	2.3		
Current account balance (% GDP)	–7.4	–8.9	–8.5	–8.4	–7.8	–6.7	–6.8	–10.6		
Not lending or net borrowing rest of the world (% GDP)	–6.5	–8.0	–7.7	–7.8	–6.6	–5.8	–5.8	–10.2		
Government balance (% GDP)	1.1	0.5	0.1							
FINANCIAL MARKETS		Forecast							Forecast	
Interest rates										
Federal Funds	3.2	5.1	5.5	2.4	2.9	3.4	4.0	4.4	4.9	5.2
ECB repo	2.0	2.7	3.6	2.0	2.0	2.0	2.1	2.3	2.6	2.8
10-year US bonds	4.3	5.3	5.7	4.3	4.2	4.2	4.5	4.6	5.1	5.5
10-year German bonds	3.4	4.2	5.0	3.6	3.3	3.2	3.4	3.5	4.0	4.5
10-year Spanish bonds	3.4	4.2	5.0	3.6	3.3	3.2	3.4	3.5	4.0	4.5
Exchange rate										
$/Euro	1.25	1.27	1.35	1.31	1.26	1.22	1.19	1.20	1.27	1.31

THE SPANISH ECONOMY
MONTHLY REPORT
July-August 2006

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"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: 2006 BUDGET	Million euros
Activities	
Social	160
Cultural	70
Science and environmental	54
Educational	19
TOTAL BUDGET	**303**

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

Contents

Productivity key to future of Spain's economy

Spain's economy has undergone a major advance in terms of real convergence in recent years. The country's level of development has been coming close to the levels of the more advanced countries. The gross domestic product (GDP) per capita in 2005 stood at 92.5% of the Euro Area average. But there is a problem. In the race for real convergence there are basically two factors at play – the *consolidation* of the labour factor and improvements in productivity. In recent years, the brilliant results mentioned have come about almost entirely due to the labour factor. The employment rate has gone from 47% of the population of working age in 1985 to 65% in 2005.

This means that the country is pedalling with only one foot. Productivity has scarcely grown in recent years. The product per person employed has practically not increased. Meantime, in neighbouring countries the growth in productivity continues its normal course. Whereas up to the mid-Eighties Spain's productivity was growing more than that for the countries of the European Union (EU-15) and ended up above the area average, since then the trend has turned around. In 2000, Spain's productivity was 96% of the EU-15 and 92% in 2005.

Why is Spain's productivity growing so little and why has it tended to drop in recent years? There have been some explanations that are not valid. One of these is that it is due to the big rise in employment in recent years. The case of Ireland, among other countries, shows that it is possible to have explosive growth in the labour market and, at the same time, a notable improvement in productivity. It is obvious that we cannot say that in Spain capital is being substituted by labour, given that investment has also increased and capital per worker has not decreased. Another false reason given is one that points to the pattern of growth that Spain's economy has followed during this cycle, that has been very much concentrated on construction and certain labour-intensive services. When we compare things with neighbouring countries sector by sector it turns out that in nearly all economic activities Spanish productivity falls behind.

There are other explanations. An insufficient or inadequate stock of public capital means lower productivity. Although public spending on infrastructures in recent years has certainly been heavy, perhaps some of the projects have not been the right ones or else spending has been inefficient. Other factors are Spain's age-old backwardness in research and development and in information technology. While this is true, we should add that there has been some improvement in recent years, progress which however which has not shown up greatly in figures for productivity. Is there also a problem of efficiency in spending effort? Finally, education and bringing it into line with the needs of a changing production system are also key elements in which what is important is probably not a high level of spending but an adequate system of incentives. Along these lines, a regulatory framework that removes restrictions and rigidities while creating an environment that is favourable to companies and innovation could be decisive in breaking the roadblock in productivity. Otherwise, it will not be possible to keep closing the gap. The employment rate has little leeway left. If productivity does not take off, real convergence will fail.

June 27, 2006

OVERALL SUMMARY

At end of first half of 2006, world economic situation holding favourable course but financial markets in grip of lack of confidence.

In recent years, we have passed through period of ample money supply combined with fast-growing process of globalization of economies.

General rise in interest rates by central banks indicates substantial change in situation...

Markets nervous

As we come to the middle of 2006, the international economy stands at a peculiar moment. On the one hand, the optimistic pictures drawn at the beginning of the year are being met so that world growth is above 4%, corporate confidence is holding strong, inflation appears to be contained and the traditional imbalances have not grown worse. On the other hand, we note some concern about a continuation of this favourable stage in the economic cycle. In financial markets and raw materials this concern has turned into open distrust. Between May and June the markets lost a good part of their gains and have broken with the course of continuous increases seen in recent years. How can we explain the apparent lack of phase between the real economy and the financial economy?

One argument that may help unravel the present contradictions is that involving the end of the stage of ample money supply we have been experiencing which has gone hand-in-hand with a sharpening of the globalization process. This is a stage which began at the end of 2000 when the US Federal Reserve Board and the European Central Bank (ECB) began rate cuts that took interest rates to historically low levels. Furthermore, at start of 2001 the Bank of Japan put its reference rate at 0%. This prolonged period of ample money supply served to overcome the bursting of the stock market bubble in hi-tech shares in 1999-2000, to deal with the effects of the terrorist attacks on September 11, 2001 and to finance the recovery of the world economy since that time.

But the era of free liquidity (often the monetary interest rate has been lower than the inflation rate) also had its negative side. It has encouraged what could be speculative bubbles in the housing market, in emerging country stock markets, in raw materials markets and again in stock market shares in developed economies. The era of free liquidity has given wrong signals to consumers and companies that have financed excessive growth of consumption and investment thanks to very generous financing conditions. At the same time, it has brought about a rapid worsening of current account balances in many economies thanks to the unceasing flow of direct portfolio foreign investment, dangerously increasing the exposure of the country to foreign exchange risk and interest rate risk.

In other circumstances, an increase in money supply would have set off notable inflationary pressures which it would have made it necessary to correct the situation. And, in fact, there has been inflation of assets. But the classic reference of inflation, that is to say, the basket making up the consumer price index, has largely been freed of this phenomenon. The world economy has received a notable deflationary impact in the manufacturing sector brought about by the rapid incorporation of countries with enormous production potential, such as China and India, which have revolutionized the situation in world trade and in broad sectors of the economy exposed to international competition.

What is happening now is that this period of ample liquidity is coming to an end. The monetary authorities of the main economies are coinciding in raising their interest rates. For two years, the United States has been raising its reference rate at each meeting of its Monetary Policy Committee. Last December, the ECB began its own cycle of increases. The Chinese monetary authorities have also taken steps in this direction. And there is some expectation about at what moment the Bank of Japan will decide to abandon its policy of 0% interest rates. Even long-term interest rates, which had hit all-time lows, are definitely moving up.

At the same time, the deflationary effect arising from globalization and the deregulation of production sectors could be losing strength without there being any decrease in the inflationary pressures from raw materials. In China, we note some wage pressures while at the same time some revaluation of the currency is expected. Japan seems to have finally come out of the deflation that has been operative over the past decade. In the developed economies, prospects of inflation have been firming up little by little. At the beginning of the year we started out from the basis that, if three years of price increases in raw materials had not managed to cause havoc in core inflation, we could now sleep peacefully. Now the situation is not so clear. Financial and capital markets, being obliged to anticipate the future, are uncertain about the implications of an environment of lower money supply, higher interest rates and greater risks to international growth.

As nearly always applies, the *quid* of the question lies in the United States because it is there that inflation signs are of greatest concern. Up until very recently, it was expected that the increase in interest rates by the Fed would hold at levels of 5%. Now, the markets are speculating whether Ben Bernanke, the chairman of the US central banking system, might raise interest rates above 5.5% in order to halt the perils of inflation. This is a level that could weaken the growth of the economy which is already showing some signs of a slowdown in the area of housing. A central bank cannot put its anti-inflationary credibility in danger and it is likely that the monetary authorities would prefer less growth than risk excessive inflation.

...while deflationary effect of globalization and deregulation of production sectors keeps losing strength with no drop in inflationary pressures from raw materials...

In the Euro Area, the picture is clearer because, on the one hand, the economy appears to be confirming its recovery and, on the other hand, inflation is clearly above the level desired by the ECB. Jean-Claude Trichet is concerned about the growth of the money supply and credit which, according to the monetary orthodoxy of the central bank in Frankfurt, signifies more inflation over the mid-term. Ignoring the appeals by the finance ministers of the Euro Group, the ECB is maintaining its course of raising its reference interest rates, the last of which was decided at the Board meeting in June. The sop for the ministers was the sudden weakening of the euro against the dollar as of the second week in June. Renewed expectations of interest rate increases in the United States have resulted in a notable recovery of the greenback which has moved up to an exchange rate of 1.30 to the euro as against 1.25 at the end of the month.

...which sets off inflationary fears and concern about measures taken by monetary authorities.

In this environment, after undergoing in May the biggest monthly drop in the past three and a half years, the stock markets scarcely caught their breath in June. Many stock market indices saw gains accumulated since December simply evaporate and go into the red although in comparison with one year earlier quotations were still largely positive.

In view of increased uncertainty, stock markets continued to lose positions in June.

Spain's economy: imbalances not being put in order

Spain's economy maintains growth but imbalances not corrected.

Within this complex international environment, Spain's economy continues to show excellent results in terms of growth and job creation. But there is growing concern about the two large imbalances going hand in hand with this expansionist stage – inflation and the foreign deficit. In fact, these are two sides of the same coin behind which lie the deficiencies in terms of foreign competitiveness and productivity.

Inflation higher than in neighbouring countries which, added to almost stagnant productivity, means continuing loss of foreign competitiveness.

The inflation differential with the Euro Area is holding at around 1.5-2 percentage points, measured at year-to-year rate. The growth of the consumer price index in May again was up to 4% thus throwing cold water on hopes for moderation. Of course, energy prices bear much of the blame although this is no excuse given that energy goes up for everyone. More troubling was the result for the producer price index in May which has brought out major inflationary pressures in manufactured products at the factory gate, which does not auger well for good results in the consumer price index in coming months.

As Spain has no problem in financing foreign deficit, this may continue to grow but a solution will call for improvements in productivity.

In spite of the fact that wages per worker are contained, their growth rate is higher than in the Euro Area. If we add to this much lower progress in productivity, the result cannot be anything but a loss of competitiveness with abroad. This shows up in the results of the balance of payments which month after month shows the worsening of its various accounts. In its latest report on Spain's economy, the International Monetary Fund estimates that 30% of the drain on the current account balance comes from the loss of foreign competitiveness, whereas another third may be accounted for by the rise in imported energy costs and the rest by the cyclical position of the economy. In any case, given that growth is expected to continue and that oil prices are not going to drop, it would seem inevitable to foresee that the problem of the foreign imbalance will be with us for some time.

In other periods, this foreign drain used to put at risk the stability of the foreign exchange rate and interest rates. This is no longer so. Ease of borrowing at very low interest rates makes it possible to sustain spending by households and companies, especially the former whose financial load keeps on growing. Another limitation used to be in the availability of domestic credit, arising from total savings of the economy. Today, the lack of domestic savings is not a problem because we can have recourse to foreign borrowing. As stated by the Bank of Spain in its latest annual report, the cost of financing outside Spain's borders has gone down and now hardly depends on the general situation of the country's economy but simply on the solidity of the assets and credit rating of the borrower.

The best way to tackle the problems of competitiveness would be to obtain a decided improvement in productivity, that is to say, the amount of product generated by each hour of work. This is also the direction taken in analyses made by the Bank of Spain and the International Monetary Fund in the reports mentioned earlier. This issue of the Monthly Report also includes various approaches which may help to clarify this complex problem. The central government itself has set out a series of action plans with the aim of eliminating those aspects of the economy which limit its potential growth. This is a long and patient task with no immediate results but these matters must inevitably be tackled if we want to prolong the current growth stage of the economy.

CHRONOLOGY

2005

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 to 3%.
June	30	**Federal Reserve** raises reference rate to 3.25%.
August	9	**Federal Reserve** raises reference rate 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 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%.
	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.
May	2	One-month forward price of Brent quality **oil** goes up to all-time high of 74.28 dollars a barrel.
	4	Agreement between government, business organizations and trade unions on **labour reform** aimed at reducing extent of temporary work.
	9	IBEX 35 index for **Spanish stock exchange** marks up annual high (12,083.3) with cumulative gains of 12.6% over end of December 2005.
	10	**Federal Reserve** raises reference rate to 5%. Dow Jones index for **New York stock exchange** records annual high (11,642.7), a rise of 8.6% compared with end of 2005.
June	8	**European Central Bank** raises official interest rate to 2.75%.
	29	**Federal Reserve Board** increases reference rate to 5.25%.

AGENDA

July

- **5** Industrial production index (May).
- **6** Governing Council meeting of the European Central Bank.
- **14** Consumer Price Index (June).
- **17** Harmonized Consumer Price Index for EU (June).
- **25** Producer Price Index (June).
- **28** Quarterly Labour Force Survey (2nd Quarter). Early HCPI indicator (July). US GDP (2nd Quarter).

August

- **3** Governing Council meeting of the European Central Bank.
- **4** Industrial production index (June).
- **8** Federal Open Market Committee meeting.
- **11** Consumer price index (July).
- **14** Early GDP for Spain (2nd Quarter). Early GDP for Euro Area (2nd Quarter).
- **17** Harmonized consumer price index (HCPI) for European Union (July).
- **25** Producer price index (July).
- **30** Quarterly National Accounts (2nd Quarter).
- **31** Governing Council meeting of the European Central Bank.

September

- **8** Industrial production index (July).
- **13** Consumer price index (August).
- **15** Harmonized consumer price index for European Union (August).
- **20** Quarterly survey of labour costs (2nd Quarter). Federal Open Market Committee meeting.
- **25** Producer price index (August).

INTERNATIONAL REVIEW

United States: private consumption continues to drive economy

Consumption stabilizes growth rate at high levels in spite of oil prices and slowdown in housing market.

The performance of the US consumer is like that of a train that, while it fails to increase speed, does not stop running. This is an impetuous race that keeps threatening to overheat the engine. Following a strong first quarter when private consumption moved up 5.2% annualized compared with the previous period and retail sales rose strongly. the growth rate of the retail sales component for May excluding cars and petrol stabilized growth to a very respectable rate of 7.4% year-to-year (4.8% if we take into account the increase in prices), a rate lower than in past months but one which nevertheless shows a strong tendency to continue. The main weakness showed up in construction materials, which were affected by the weakness in the real estate market.

Elements that should scare off consumption are showing up more and more menacing on the horizon. Oil prices remain high, interest rates are maintaining their upward trend and the housing market is slowing down more clearly than a few months ago. Nevertheless, the public seems immune to depression. Consumer confidence in May dropped to the level of 103.2 points but mainly because of the increased weakness of the future situation component, given that the evaluation of the current situation remains high. What keeps widening is the gap between the perception of the present in terms of a less brilliant future which, nevertheless, keeps holding off.

UNITED STATES: MAIN ECONOMIC INDICATORS

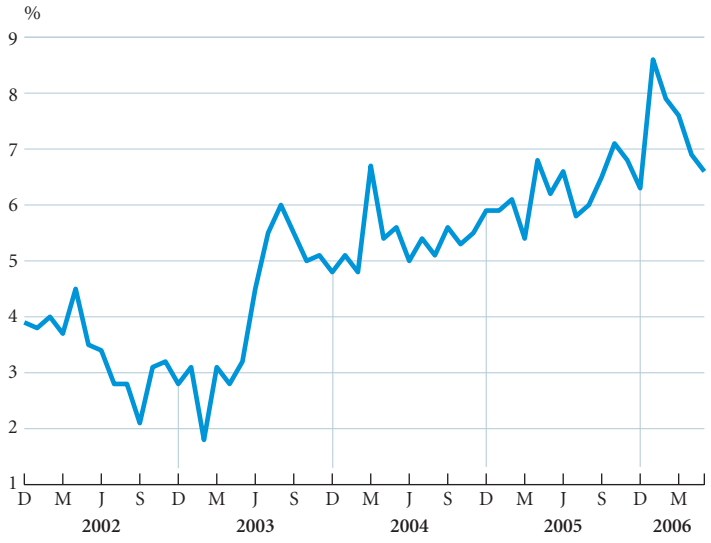
Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
Real GDP	4.2	3.5	3.6	3.6	3.2	3.6	–	...
Retail sales	6.2	7.2	7.8	8.2	6.2	8.3	7.1	7.6
Consumer confidence (*)	96.1	100.3	102.3	98.9	95.8	105.7	109.8	103.2
Industrial production	4.1	3.2	3.1	2.7	3.0	3.4	4.7	4.3
Industrial activity index (ISM) (*)	60.5	55.5	53.2	56.0	57.0	55.6	57.3	54.4
Sales of single-family homes	10.1	6.6	6.8	11.9	3.1	–11.5	–5.7	...
Unemployment rate (**)	5.5	5.1	5.1	5.0	4.9	4.7	4.7	4.6
Consumer prices	2.7	3.4	3.0	3.8	3.7	3.7	3.6	4.1
Trade balance (***)	–611	–717	–664	–689	–717	–739	–746	...

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

UNITED STATES: CONSUMPTION MANAGES TO HOLD STRONG

Year-to-year change annualized in retail sales excluding cars and petrol (*)



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

If we are to go by the level of the economic activity index and prospects put out by the Institute for Supply Management (ISM), business executives do not differ greatly from this positive perception although here we should distinguish between services and manufactures. The index for the former stands at 60.1 points while the latter is at 54.4. This is a level close to the 50 point of balance where those who see the situation worsening equal the number who envisage improvements. The fact is that, in this expansionist cycle, the manufacturers have always followed the other sectors. In this respect, after a period of some strength, industrial production in May slowed down to growth of 4.3% year-to-year.

As in most advanced economies, the manufacturing sector has long been losing relative weight compared with services but in the United States this has special importance. By their nature, manufactures are still easier to export than services and with a competitive dollar they should be the main items charged with increasing exports and helping to soften the enormous trade deficit. The positive side of this slowdown in manufacturing is that the biggest weakness shows up in cars, a sector in which the United States has seen its export hopes much decreased. Also suffering, although to a lesser degree, are construction materials while other manufacturing sectors, with greater export potential, are maintaining their lead in the first half of 2006.

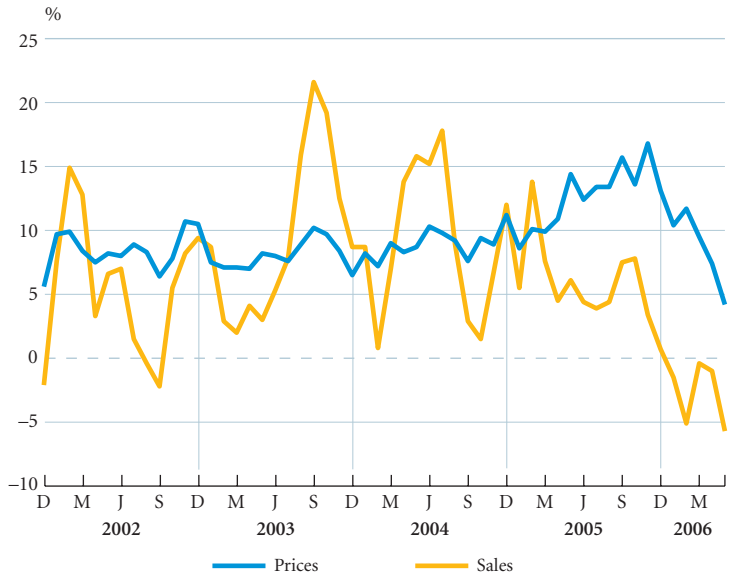
Manufactures weaken because of motor vehicle sector.

The housing market is clearly on the way to moderation with sales of existing houses down by 5.7% year-to-year in April and average prices moving up by a mere 4.2% whereas in 2005 the average rate of increase was close to 13%. This market is weaker but it does not tally with the increase in housing starts in May which was surprisingly strong. The downward path begun in housing is in contrast to the increase in construction for industrial and

Strong level of construction for commercial uses clouded by slowdown in housing.

UNITED STATES: SLOWDOWN IN HOUSING CONSTRUCTION NOW A FACT

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



SOURCE: Federal Housing Board and internal figures.

commercial purposes. Nevertheless, the weight of the former is greater so that the net effect amounts to a slowdown in construction.

Prices remain high while greater pressures expected in labour market.

Prices continue to rise, whether because of a base effect, because of oil, because of inferred incomes of home-owners or because of the more troubling other components in the consumer price index (CPI). This grouping together of factors led to growth of 4.1% in inflation in May with the underlying component (excluding food and energy) standing at 2.4% year-to-year. While the latter figure is far from being disastrous and the increase in slow, the danger lies in the fact that there is a clear growth trend and inflationary prospects are moving upward to levels that are unacceptable for meeting the macroeconomic stability objectives set by the Federal Reserve.

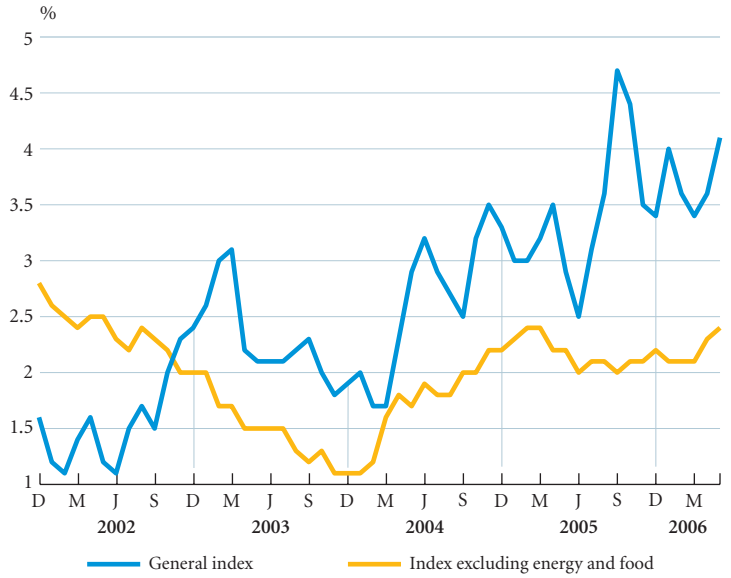
In this respect, the moderation of labour costs is showing signs of coming to an end. Job creation in May was disappointing at 75,000 new jobs while wages continue to lose purchasing power. The low unemployment rate (4.6%) and evaluations being made in various areas of the Federal Reserve system would suggest higher pressures than are showing up in the figures.

Deficit stabilizes but shows no improvement.

The foreign sector is not improving but in recent months, largely thanks to the weakness of the dollar, the worsening has stabilized. The problem is that it is not enough to halt growth of the deficit but what is needed is to start a process of reducing it. For now, North Americans are not saving and are still ignoring the warnings in favour of prudence in the face of the debt that founding father Benjamin Franklin proposed in his *Poor Richard* almanac.

UNITED STATES: INFLATION CONTINUES

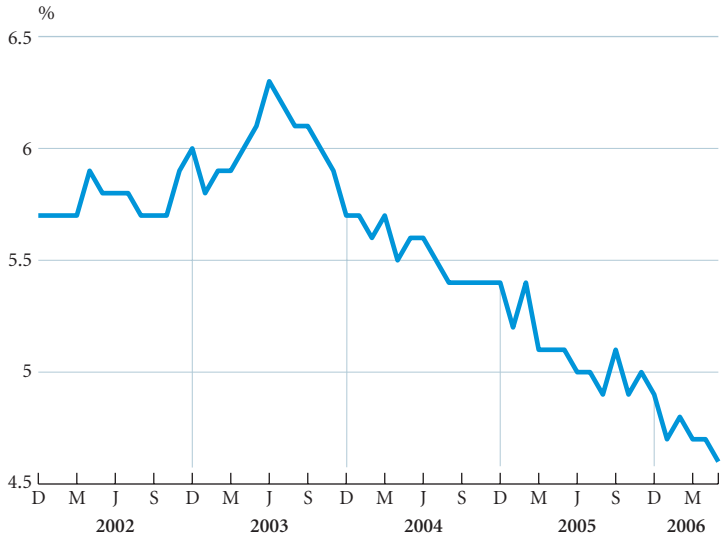
Year-to-year change in CPI



SOURCE: Department of Work and internal figures.

UNITED STATES: UNEMPLOYMENT RATE DROPPING

Unemployment rate over labour force



SOURCE: Department of Work and internal figures.

Japan: growth proceeds based on old scripts

Japan revises growth upward with investment playing bigger role.

Ice sculpture is popular in Japan perhaps because its short life allows the Japanese, who adore new things, to go back to making them again in a different way. It is a paradox but, in a country where the new is so much admired, the old economy is still so entrenched. The gross domestic product (GDP) was revised upward with predicted growth going up from 3.0% to 3.5% year-to-year, an increase in economic activity which may be explained entirely by the strength of private investment in capital goods (two-thirds) and by increased public investment (one-third). The recovery in investment, which was stronger than expected, goes far beyond recovering what was lost in 2005 and revives the traditional profile of Japan's economy – heavy investment with low yields and with the aim on exports.

Shareholder culture fails to jell while orientation to exports continues...

...but investment aimed at domestic consumption gaining strength.

The first part of the profile is being met while the shareholder culture has not yet caught on in Japan. Investment is going up more than corporate profits. The latest scandals among investment fund managers, apart from spattering the governor of the Bank of Japan, Toshihiko Fukui, himself, does not contribute to strengthen the culture of reform toward a system which pays more attention to yield on capital invested. In Japan, to do this it is necessary to invest more than in other places.

The second aspect is also true but something is changing. Machinery orders in the first quarter, an early indicator of investor interest (with a shorter and shorter time-lag) have been very strong during the early months of the year and the major drive has shown up in domestic orders which in April grew by 14.1% year-to-year, higher than those from abroad which rose by 8.5% after having increased by 77.5% in March. The former now represent 44% of the index total whereas in 2000 they were only 35%.

In the face of this investment strength and bolstering these domestic orders, the consumer remains optimistic showing a confidence index in the first quarter

JAPAN: MAIN ECONOMIC INDICATORS

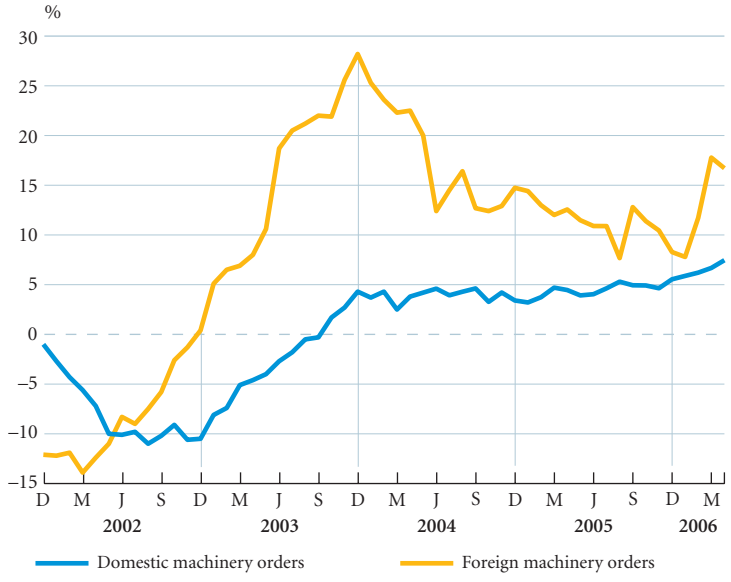
Percentage change over same period year before unless otherwise indicated

	2004	2005	2005				2006			
			1Q	2Q	3Q	4Q	January	February	March	April
Real GDP	2.3	2.6	1.1	2.7	2.7	4.0	–	3.5	–	–
Retail sales	–0.9	1.4	0.6	3.1	1.1	0.7	0.0	0.9	1.1	–1.3
Industrial production	5.3	1.5	2.3	0.3	–0.1	3.6	2.8	2.5	3.1	3.3
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	4.0	15.2
Unemployment rate (**)	4.7	4.4	4.5	4.3	4.3	4.5	4.4	4.1	4.1	4.1
Consumer prices	0.0	–0.3	–0.2	–0.1	–0.3	–0.5	0.5	0.4	0.3	0.4
Trade balance (***)	13.9	10.2	13.2	12.1	10.9	10.2	9.9	9.7	9.5	9.2

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

JAPAN: DOMESTIC INVESTMENT ALSO HAVING EFFECT

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



NOTES: (*) Cycle-trend series.
SOURCE: Japanese Ministry of Communications, National Statistics Office and internal figures.

reaching 48.2 points, the highest level in the past 15 years. Nevertheless, demand indicators still fail to reflect this positive attitude. Retail sales have been moving down for months and in April dropped by 1.3% year-to-year. The same situation, but even stronger, applies to car sales which lost 10.0% year-to-year in May thus ending the eleventh consecutive month with decreases.

On the supply side, industrial production in April was 3.3% higher than in the same period the year before, an improvement over the beginning of the year but at a low level. In the residential sector, housing starts in April maintained a clear upward trend but the housing market had a poor performance in May. If the slight drop in Tokyo prices is more than a pause after the strong start to the year and does not change the upward trend, the number of properties sold (following an appreciable drop) modifies the increase downward.

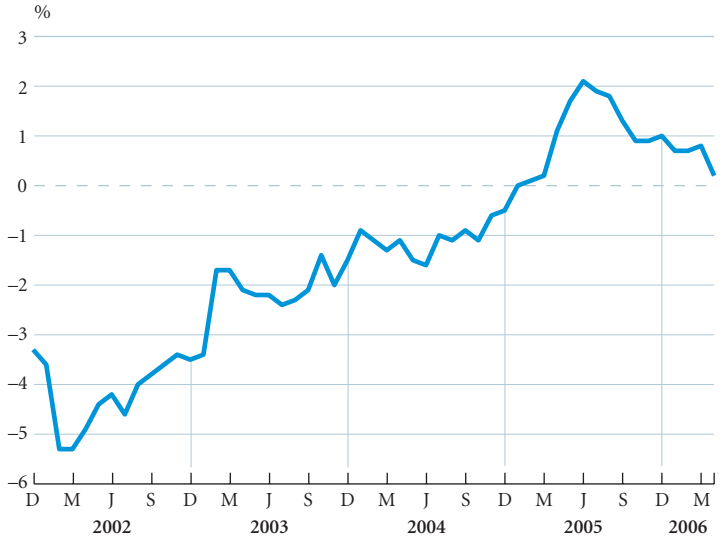
Optimism reigns but demand indicators continue to weaken.

It is in prices and in the labour market that we note gradually strengthening signs of life in the economy. The April CPI continued to increase with a rise of 0.4% year-to-year while the component, excluding fresh foods grew by 0.5%, thus reaching the eighth month with consecutive increases. The unemployment rate in April was again 4.1% indicating that pressure on the labour market was continuing. The foreign surplus in turn continued to drop because of the strength of imports which in April were up by 26.9% year-to-year. Exports held up with an increase of 14.6%, partly thanks to the weakness of the yen exchange rate.

Labour market and prices giving support to growth.

JAPAN: RETAIL SALES LOSING STRENGTH

Year-to-year change in retail sales (*)



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

Brazil recovers strength and maintains its composure

Brazil strengthens recovery with 2.9% growth.

The Brazilian economy continues to solidify growth with inflation more and more under control and public finances which, in spite of interest on debt, keep showing discipline and austerity.

The gross domestic product (GDP) in the first quarter rose by 2.9% year-to-year helped by the strength shown in investment which was up by 9.4% year-to-year and has been recovering the strong situation seen in 2004. Private consumption, with gains of 4.0% was also up to the occasion. The recovery in domestic demand also put upward pressure on imports which grew sharply while exports held up. Public consumption continued to grow at very modest rates, a result of government policy that puts the emphasis on macroeconomic stability.

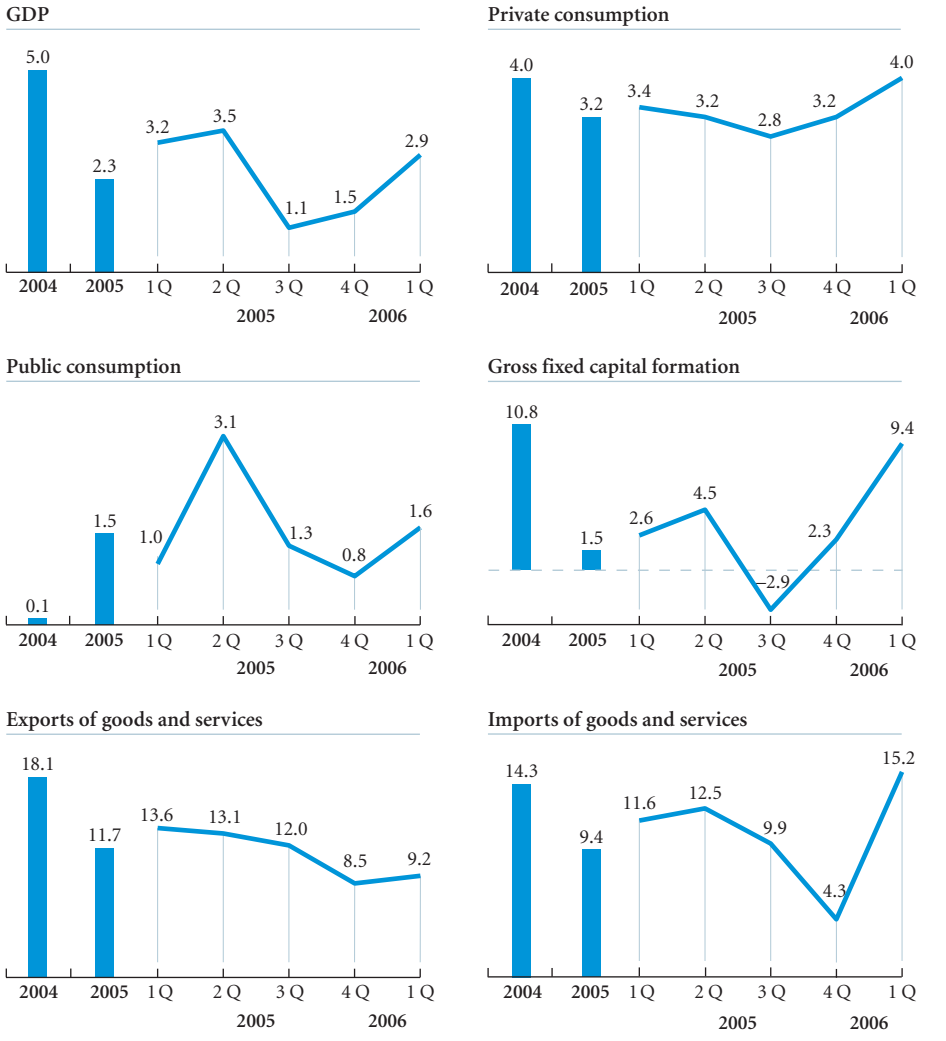
Investment gaining strength as against moderation in public consumption but demand indicators weak.

As distinct from the previous quarter, the latest monthly indicators for demand and supply, however, do not show a definite picture of increased growth which the figures for national accounting would suggest. Retail sales in March slowed down with growth of 3.0% year-to-year although car sales showed a sharp rise in May. Industrial production, however, was the weakest indicator with a drop of 1.9% in April and industrial production of capital goods was stagnant. While the slack in industry could be temporary, following the heavy construction period in the first quarter, the tendency in retail sales is weak.

Brazil continues to hold firm to the line of macroeconomic stability and inflation keeps moderating. In May, prices rose by a mere 2.8% year-to-year, a new all-time low. The other side of the coin is not merely the persistence of high unemployment but how it is increasing. The unemployment rate in São Paulo in April went up to 16.9%.

TREND IN BRAZIL'S GDP BY COMPONENT

Percentage year-to-year change in real terms



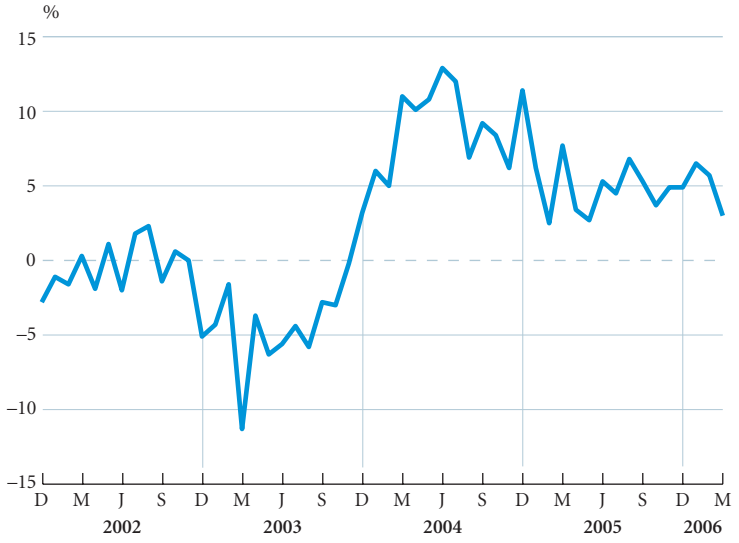
SOURCE: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and internal figures.

In turn, the trade balance continued to show the biggest surplus on the Latin American continent at 44.6 billion dollars in the past 12 months ending in May, with exports which are withstanding the heavy rise in imports and the strength of the currency, a result of fiscal austerity in the country in spite of the heavy load arising from payment of interest on the foreign debt.

Trade surplus continues to grow.

BRAZIL: DESPITE OVERALL SITUATION, RETAIL SALES STAGNANT

Year-to-year change in retail sales as percentage



SOURCE: IPEA and internal figures.

BRAZIL: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
Real GDP	5.0	2.3	3.5	1.1	1.5	2.9	–	...
Industrial production	8.3	3.1	6.1	1.4	1.3	4.6	–1.9	...
Unemployment rate São Paulo (*)	18.8	17.0	17.5	17.2	16.4	16.3	16.9	...
Consumer prices	6.3	5.8	6.6	5.2	5.3	4.5	3.3	2.8
Trade balance (**)	33.7	44.8	38.3	41.2	44.8	45.8	45.0	44.6

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
SOURCE: Instituto Brasileiro de Geografia e Estatística, Banco Central do Brasil and internal figures.

Argentina grows by 8.6% thanks to consumption and investment.

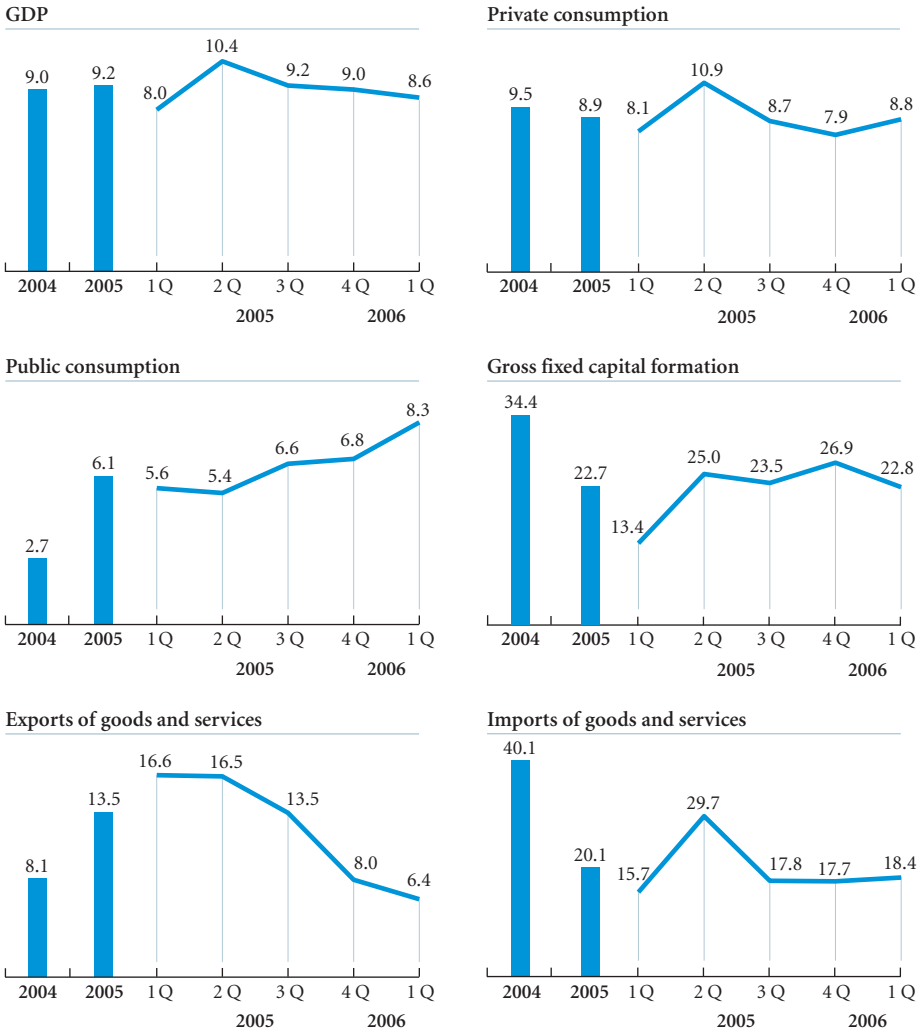
Argentina keeps moving up

The Argentine economy continues its growth process with a strength that keeps improving on the most optimistic expectations which has put the country well above the levels before the recession. Inflation, a real blotch on recovery, is high for what is now the norm in Latin America but in recent months this has put on something of a brake without affecting growth.

The Argentine GDP grew by 8.6% year-to-year in the first quarter of 2006. Leaving aside the persistence of strong growth, private consumption recovered importance following the strength of investment in the previous quarter. This, however, does not slacken and was to

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.

show an increase of 23% and, apart from seasonal factors, continues to increase its relative weight in the total economy. In the foreign sector, while it is in surplus, it continues to make a negative contribution to growth, a result of strong domestic demand and the lack of global competitors. Nevertheless, in terms of volume, the now recovered Argentina is a country much more commercially open with exports some 70% higher than the level in 1997 before the recession.

Demand indicators are consistent with the strength of private consumption. Retail sales in April grew by 28% year-to-year and what is especially significant was the increase in growth of department store sales. Purchases of cars in the past 12 months ending May were up 24%, although in this case, in spite of the sharp growth rates, figures are still far from the highs in 1994.

Industry gaining drive compared with construction which still holds strong.

ARGENTINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
Real GDP	9.0	9.2	10.4	9.2	9.0	8.6	–	...
Industrial production	7.2	7.3	6.6	7.2	7.5	7.2	9.6	...
Unemployment rate (*)	13.6	11.6	12.1	11.1	10.1	11.4	...	...
Consumer prices	4.4	9.6	8.8	9.8	11.7	11.6	11.6	11.5
Trade balance (**)	12.1	11.3	11.0	11.4	11.3	11.2	...	...

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.

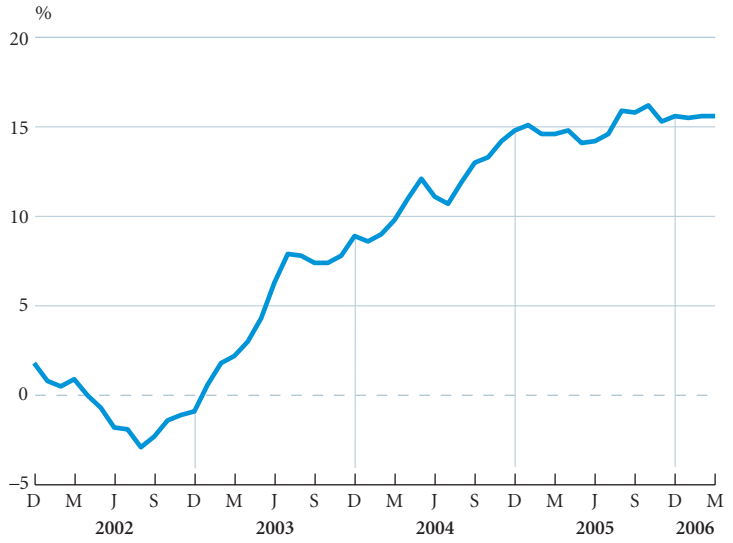
Inflation remains unresolved problem.

On the supply side, what stands out is the fact that growth is continuing and getting even stronger with industrial production in April sharpening to growth rates of 9.6% year-to-year. While the indicators for industrial activity are moving up, the indicators for construction are slowing down although they continue to show growth rates higher than 13%.

Inflation in Argentina continues to be the main factor holding the biggest risks for the economy. The increase of 11.5% year-to-year in May is high even taking into consideration the sharp growth of the economy. What is positive is that in recent months the upward trend has given rise to some stability in growth rates but the problem is that the non-

ARGENTINA: GROWTH OF EXPORTS STABILIZING

Year-to-year growth in exports (*)



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

energy components are those presenting the biggest inflationary trends. The problems of over-utilization of production capacity, the expansionist fiscal policy and the aim of maintaining a weak currency are pushing prices up, as shown by the sharp rise in import prices which went from growth of 4.3% year-to-year in April to 7.0% in May. The trade surplus continues to drop but only slowly, partly thanks to the weakness of the peso mentioned more than to tangible gains in the competitiveness of exports. And these exports are still relatively small in terms of the foreign debt.

EUROPEAN UNION

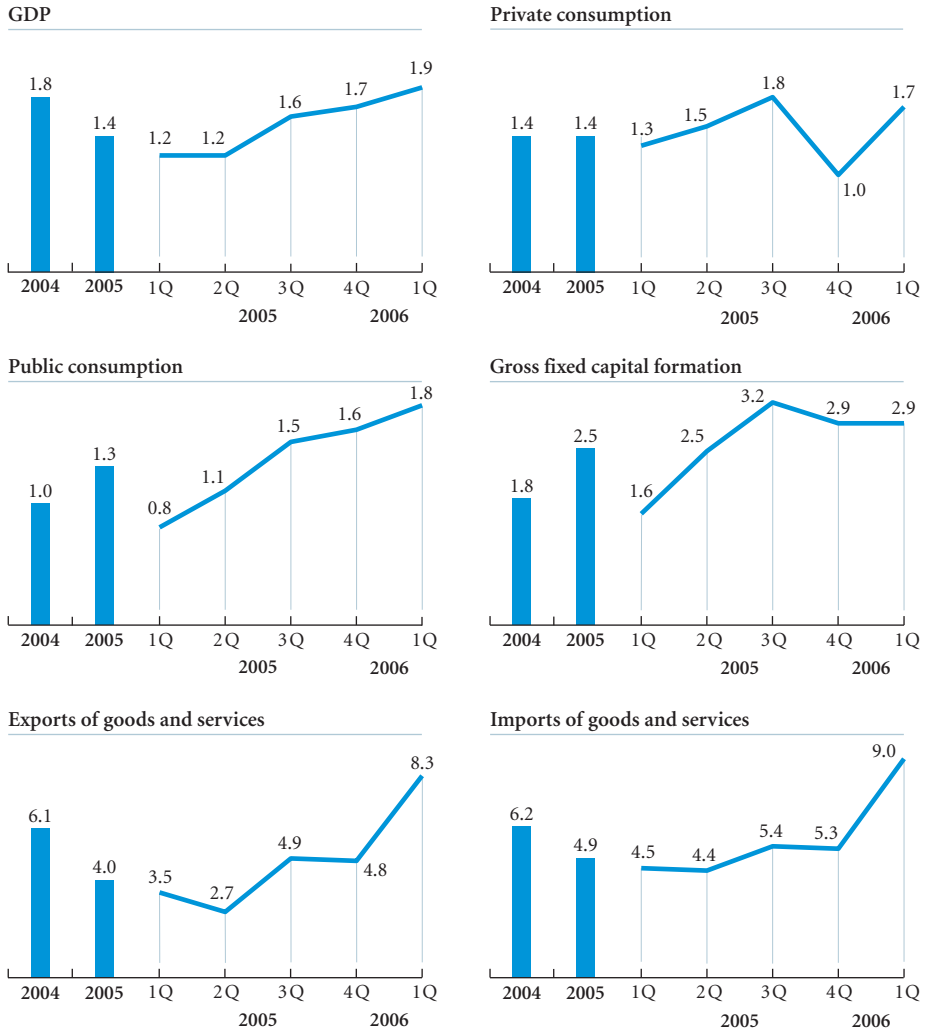
Euro Area increases growth to 1.9% with big news being increased strength of consumption.

Euro Area: blessed by recovery

Economic bliss has returned to Europe. Following many months with a surfeit of negative news, growth was up in the first quarter and, according to the latest figures to hand, growth will have extended into the second quarter. Evidently, this is not a matter of an exaggerated rise (we are talking about a

TREND IN EURO AREA GDP BY COMPONENT

Percentage year-to-year change



SOURCE: Eurostat and internal figures.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
GDP	1.8	1.4	1.2	1.6	1.7	1.9	–	...
Retail sales	1.5	1.3	0.8	1.5	1.3	0.8	2.8	...
Consumer confidence (*)	–14	–14	–14	–15	–12	–11	–10	–9
Industrial production	2.0	1.2	0.7	1.5	2.1	3.4	1.9	...
Economic sentiment indicator (*)	99.4	98.1	96.1	97.7	100.1	102.6	105.7	106.7
Unemployment rate (**)	8.9	8.6	8.7	8.5	8.3	8.1	8.0	...
Consumer prices	2.1	2.2	2.0	2.3	2.3	2.3	2.4	2.5
Trade balance (***)	80.4	45.4	50.0	39.0	28.3	9.7	1.7	...

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

rate of increase of 1.9% year-to-year in the gross domestic product (GDP) in the first three months of 2006) but the turnaround from the disappointing year 2005 is pronounced. This is not only because of the increased rate of economic growth but also because of its make-up.

In the first quarter private consumption rose to 1.7% year-to-year, seven decimals above the figure in the fourth quarter. As well as this relative coming back to life of a constant absent member from the current European cycle, the performance in public consumption is positive. As it would seem that happiness can never be complete on the Old Continent, investment was disappointing with unexpected stabilization. In any case, if the strength of spending in European households consolidates and, given the still favourable financial conditions, investment should return to a growth path in coming quarters. Finally, we should point out that the contribution from the foreign sector remained unchanged over the fourth quarter.

While this is the situation in the first quarter, available indicators suggest similar trends in the April-June period. While some demand indicators have weakened as, for example, industrial production of consumer goods, others confirm that the drive among households is the best in recent times. This is particularly so in retail sales and consumer confidence. The latter indicator has gone up to its highest level since June 2002, which, given its partly anticipatory nature, provides some basis for better prospects in consumption in coming months.

Growth extends into second quarter with retail sales and consumer confidence on rise.

The cyclical upturn is also reflected on the supply side. Industrial production, while definitely weak in April when it grew by 1.9% year-to-year (3.4% in the first quarter), should regain its upward path in the near future. At least this would be the logical result of the high level of sector confidence shown as of May. Nor are the prospects in services and construction at all negative with confidence indices moving up as the year 2006 advances.

Even the labour market may be about to start a stage of some improvement. The unemployment rate has stopped getting

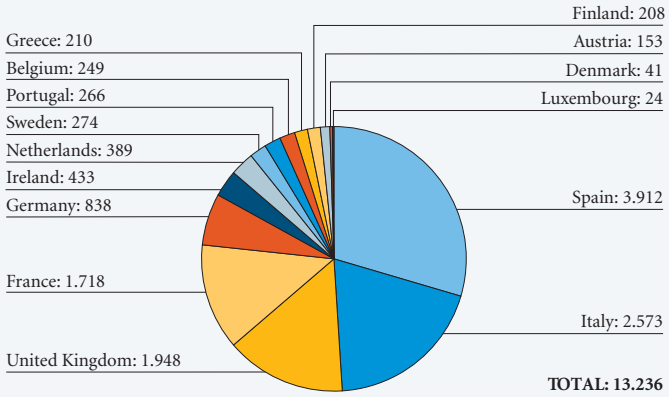
Much affected by higher oil costs, price scene notably more complex than some months ago.

Employment and productivity: are they incompatible objectives?

Spain is the country in the European Union that has created the most jobs in recent years. In the period 1998-2005, Spain's economy created nearly four million new jobs and close to one third of all new employment in the 15 countries of the European Union. While there is some distortion in the figures because of methodological changes, it cannot be denied that this extraordinary job creation is good news which has made possible a reduction from an unemployment rate that used to be the highest among the advanced countries. Today, the rate of unemployment in Spain's economy is in line with the average for the European Union and is even lower than that of large countries such as France and Germany.

SPAIN LEADS IN EMPLOYMENT IN EUROPE

Net employment created between 1998-2005 (in thousands) in the EU-15



SOURCE: European Commission and internal figures.

The downside of this development in the labour market is that labour productivity has greatly worsened in recent years. That is to say, the growth rate of the product generated by each worker has dropped substantially since the mid-Nineties coinciding with the beginning of the expansionist stage that is still under way. As a result, average annual growth of labour productivity in recent years has been much lower than that seen in the developed countries as a whole and stands at the tail-end of the classification, well below the European average.

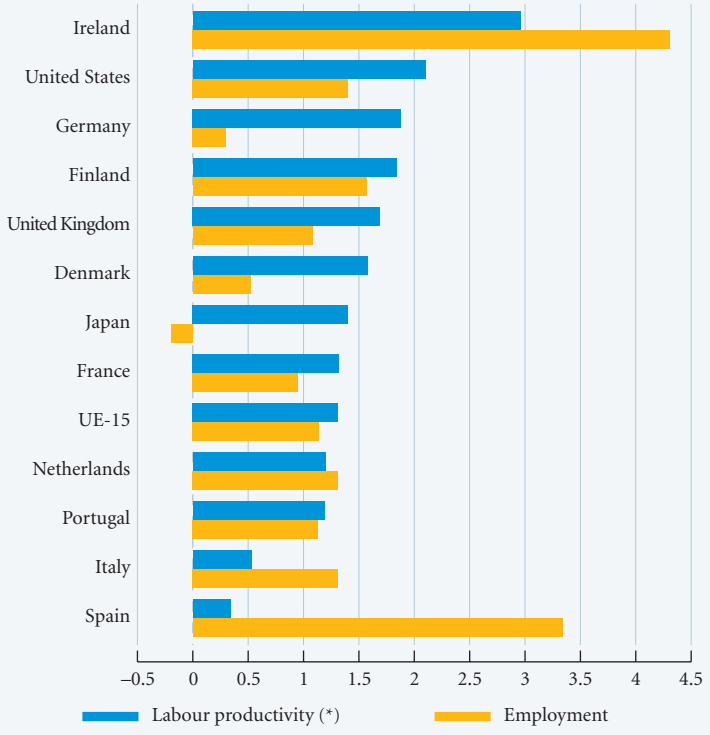
Is this a matter for concern? It certainly is. Labour productivity is measured by the product per unit of work and its growth is the base that allows per capita income to increase and therefore raise the level of well-being of the population. In this respect, the figures show that the convergence of Spain's income level toward the European average in recent years has basically been due to the mobilization of the workforce and to a higher rate of employment (the ratio between those employed and those of working age). The improvement in the productivity of those working, on the other hand, has scarcely made any contribution. If that had been the case, Spain would now stand well above the EU average. The growth in labour productivity is thus fundamental for improving the country's living standard and for closing the gap that still exists with the more developed countries.

In view of the unfavourable trend in labour productivity in Spain's economy, it has been argued that this was logical, given the spectacular job creation seen during those years. It has been said that there was a substitution of capital by labour with the increase in labour supply. Nevertheless, the relation between the volume of capital and labour has not substantially changed, that is to say, there is not less capital available per worker, seeing that investment has grown notably and there has not been a more intensive use of the labour factor.

On the other hand, major job creation does not have to imply a drop in growth of productivity. We can take the case of Ireland where job creation has gone hand-in-hand with a big increase in labour productivity. As a result, per capita income in that country has risen sharply.

EMPLOYMENT AND PRODUCTIVITY ARE NOT INCOMPATIBLE

Average annual growth in 1996-2005 as percentage



NOTES: (*) Product per employee.
SOURCE: European Commission and internal figures.

Both from a theoretical point of view and in view of economic reality, it is not true that a sharp increase in employment stands in the way of a better performance in productivity. It is evident that there exists some margin for improving productivity in Spain's economy. If we want to increase general well-being, all social and political players need to take the necessary measures so that this parameter can advance more rapidly. Only in this way will it be possible to continue the process of convergence of Spain's per capita income with the European average seen in recent decades.

According to European Commission, economic activity to increase during rest of year.

worse, as shown by its holding at the 8% level in March and April. Employment may also have hit bottom, given that in recent quarters (third and fourth quarters of 2005) growth of this heading stabilized at rates of increase of 0.7%. All of these figures, even though modest and unsatisfactory, at least represent something of a support for improved prospects on the labour front which should become real in the second half of the year.

In this overall positive scenario, the main cloud is still being cast by the trend in prices. With oil prices pushing up the contribution of the energy component and prospects of less constrained domestic demand than in previous quarters, the current level of the harmonized consumer price index (HCPI) (2.5% year-to-year in May, one decimal above the April figure) is not cause for joy. Certainly, if we discount energy, the resultant rate (1.5% year-to-year) scarcely seems any threat. But, in overall terms, inflation prospects have become rather complicated compared with the figures appearing only a few months ago.

Germany's foreign sector still forging ahead although trade gap with China is narrow.

Finally, the present situation may be considered the best for a number of quarters and the immediate prospects (with the exception of prices mentioned) are for continued improvement. In this respect, the forecasts by the European Commission show economic growth of the order of 2.2% year-to-year for each of the next two quarters (the second and third of the year) with a later increase above 2.5% in the fourth quarter. These are optimistic expectations although not too far off those shared by most economic analysts which allow us to expect 2006 to be positive overall and 2007 to be along similar lines.

Increased drive in consumption and improved sector growth improve sustainability of German recovery.

Germany: world champion (in exports)

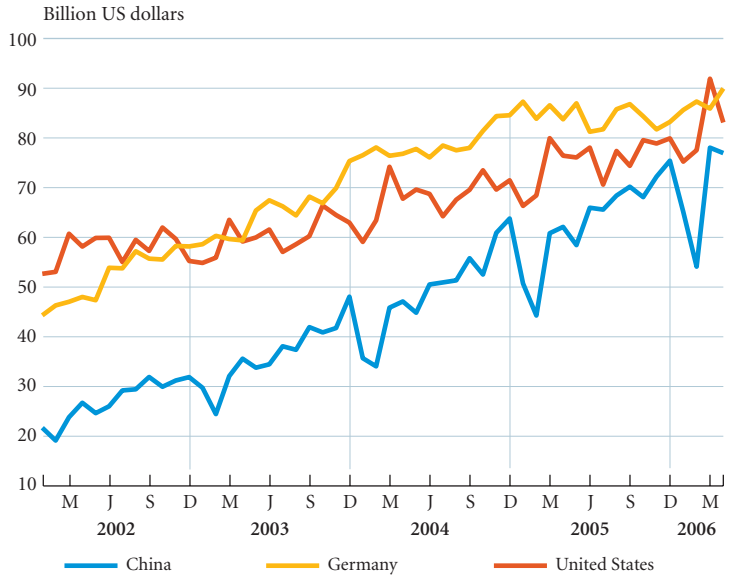
At this date we do not know who will win the world soccer cup. Perhaps it will be Germany but it certainly will not be China. On the other hand, with the figures for foreign trade as of April to hand, the year 2006 will probably go down in economic annals as when the Asian giant took first place from the country which for years has been the leading world exporter (Germany) and from the second (United States). And it is not that Germany is slacking. Quite the contrary, given that Europe's leading economy increased its rate of world sales to 17% year-to-year in April. With the drive taking place in Asia today, however, anything is possible and the narrow gap existing between Germany and the United States with China seems destined to be wiped out in favour of the Asian giant.

In any case, the present recovery in Germany up to now has largely been based on the foreign sector which has been sufficient to win over corporate investment. Available figures indicate that just this isolated twin factor (export-import) may soon be consistently accompanied by increased growth of private consumption. Two key indicators close to this variable (consumer confidence and industrial production of consumer goods) improved in the second quarter so that the upward move recorded for consumption in the first quarter may be considered as consolidated.

This fact alone substantially improves the sustainability of recovery by providing a more stable base. What is also positive is the broader sector spread of growth. On top of the now recognized industrial recovery (growth of industrial production in April was 4.8% year-to-

WORLD CHAMPIONSHIP TITLE IN EXPORTS MUCH IN DISPUTE

Exports in goods



SOURCE: National statistics offices and internal figures.

year came a better situation in services for which the May confidence indicator stood at its highest level since 2001. Construction also seems to be moving into a stage of some correction from the profound drop in previous years.

In turn, neither prices nor unemployment have much to report. The German CPI held at 1,9% year-to-year in May with no change over April. With regard to the unemployment rate, this stood at the level of 11.0% of the

Unemployment marginally better while inflation holds at levels around 2%.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
GDP	1.1	1.2	0.8	1.6	1.7	1.4	–	...
Retail sales	2.1	1.4	2.6	1.7	0.3	0.7	–1.0	...
Industrial production	2.4	2.9	1.9	3.3	4.6	4.8	4.8	...
Industrial activity index (IFO) (*)	95.5	95.5	93.0	95.4	98.7	103.6	105.9	105.6
Unemployment rate (**)	10.5	11.7	11.9	11.7	11.4	11.3	11.3	11.0
Consumer prices	1.7	2.0	1.7	2.2	2.3	2.0	1.9	1.9
Trade balance (***)	149	157.1	154.4	157.2	160.2	157.1	154.5	...

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

labour force in May, slightly down from the 11.3% in April.

Merkel government proposes some easing of corporate tax.

Nevertheless, as a reminder that not everything can be taken as a given, the IFO industrial activity index has moved into a more erratic stage. The increase in June (to 107 points) was mainly due to the retail sector component which benefited from the World Cup. If this atypical figure is discounted, the trend in the IFO in recent months suggests that the German economy could be approaching a full-steam-ahead situation and it will be difficult to expect any additional increase in the current growth rates of the GDP.

Aware of the fact that the country is undergoing a stage suitable to carry out adjustments of a more structural nature, the Merkel government, which has already increased the indirect tax load as well as income tax on higher incomes, has put forward a proposal to modify corporate tax. Should this proposal be carried out, it would mean reducing the tax rate on companies from the current 25% to 12% as of 2008. It should be remembered that only the biggest companies pay corporate tax (approximately 20% of German companies).

France: industry propped up by recovery

With the macroeconomic figures to hand, the French economy continues to soar. The increase in growth of the GDP in the first quarter seems to have continued in the second quarter, if we are to go by the substantial increase in one of the indicators which comes closest to the overall state of the economy, namely economic sentiment, in April and May. At the same time, demand indicators reflect the stronger growth rate both in consumption and investment. Domestic consumption rose by more than 5.5% year-to-year in May while the capital goods component of industrial production in April held to a year-to-year increase of 5%, similar to the average for the first quarter.

French growth gaining strength in second quarter...

The recovery is not benefiting industry which seems unable to consolidate any resurgence. French industrial production in April was down by 0.3% year-to-year converting the meagre growth in the first quarter (0.2% year-to-year) into a good result. Nevertheless, we should mention two points for some optimism about the future prospects of the secondary sector, namely, the better state of exports (exports grew by 13.5% year-to-year in

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
GDP	2.0	1.2	0.8	1.4	1.1	1.5	–	...
Domestic consumption	3.8	2.9	1.7	4.2	2.2	3.0	3.9	5.6
Industrial production	2.0	0.2	0.0	0.5	–0.7	0.2	–0.3	...
Unemployment rate (*)	10.0	9.9	10.1	9.9	9.7	9.6	9.3	...
Consumer prices	2.1	1.7	1.7	1.9	1.6	1.8	1.7	2.1
Trade balance (**)	0.0	–1.3	–1.2	–1.5	–1.7	–1.9	–1.9	...

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

April) and the trend to a gradual recovery of sector confidence, which in May stood at its highest level since December 2004.

Finally, we should point out that both unemployment and inflation in France have moved within the coordinates of most of the large economies on the Continent. The unemployment rate was down modestly in April going to 9.3% of the labour force (9.5% in March) while the CPI (pushed up by the most volatile components led by energy) rose by four decimals in May going to 2.1% year-to-year.

Italy: bitter budget medicine

The new government led by Romano Prodi has set out its first economic measures – to tighten the belt on a government deficit that threatens to get out of hand. Minister of Economy Tommaso Padoa-Schioppa has informed the European Commission that the government deficit this year will stand at the equivalent of 4.6% of the GDP, far from the reference figure of 3% established under the Stability and Growth Pact.

At the same time, Prodi asked his ministers to come up with adjustment proposals in order to reduce the internal costs of the various ministries by 10%. This effort must include certain example-setting measures, such as cutting down on the number of official cars and rationalizing means of travel for high government officials which costs the public purse nothing less than 10 billion euros a year.

...but this fails to reach industry although recovery in exports and sector confidence indicate change for better.

While this will be a bitter pill for citizens and government to swallow, at least there is the consolation that the Italian economy is moving into a stage of some economic growth which may facilitate fiscal adjustment. Following a positive surprise in the first quarter, when the GDP rose to 1.5% year-to-year, available indicators for the second quarter suggest a slight economic slowdown. This should be judged as compensation for the sharp rise in first three months of the year but it does not affect the background growth trend of the economy.

In Italy, threat of government deficit close to 5% of GDP in 2006 forces budget adjustment...

In this respect, we should point out the increase in the economic sentiment indicator for May (going to the 107 points level) which came at the same time as a substantial rise in consumer confidence that same month. On the

...although this comes in economic situation less depressed than last year.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
GDP	0.9	0.1	0.1	0.1	0.5	1.5	–	...
Retail sales	–0.4	0.4	–1.2	0.3	1.9	0.5	2.7	...
Industrial production	–0.5	–0.9	–1.4	0.0	0.4	2.7	–0.2	...
Unemployment rate (*)	8.0	7.7	7.7	7.6	7.6	7.4	–	...
Consumer prices	2.2	1.9	1.8	2.0	2.2	2.1	2.2	2.2
Trade balance (**)	2.0	–5.8	–5.1	–7.0	–9.3	–13.2	–15.1	...

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

British consumption improves although bases not seen as really solid.

other hand, a less positive aspect was the unexpected weakness in industrial production which was down by 0.2% year-to-year in April, and the increase in the cumulative trade deficit for 12 months going to 15.1 billion euros, a figure more than three times that for one year earlier.

United Kingdom: growth with leaden wings

Recovery in Britain is gaining strength as the year advances. Its main weakness, the slowdown in private consumption in the second half of 2005, seems to have been left behind. The key indicator in this area, retail sales, has again been growing at rates similar to the dynamic year 2004 (sales advanced by 4.0% year-to-year in May). All of this leads one to expect growth of the order of 2.3% for 2006 as a whole, slightly higher than the figure recorded in the first quarter of the year.

Nevertheless, a long string of risks seem to be dragging down the possibilities for the British economy. First of all, in spite of the clear recovery of consumption, its fundamentals and prospects are not clearly positive. While the unemployment rate is holding at moderate levels (3.0% in May), job creation continues to sag as of the first quarter. This would explain the notable drop seen in consumer confidence as of May.

Situation on inflation fails to be most desirable with clearly upward trend complicating task of Bank of England.

A second factor complicating the scene is the perception of growing inflationary pressures. Between April and May the CPI added eight decimals going to 2.9% year-to-year in May, the highest since August 2003. Other relevant price indicators, such as the GDP deflator and producer prices, also are pointing upward. All of this means that there is more and more speculation about a change in the Bank of England's monetary policy in the sense of making it more restrictive, which would limit the potential upward course of the economy.

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
GDP	3.1	1.8	1.7	1.9	1.8	2.2	–	...
Retail sales	6.0	1.9	1.3	0.6	2.6	1.8	3.0	4.0
Industrial production	0.8	–1.9	–1.8	–1.7	–2.6	–0.9	–1.0	...
Unemployment rate (*)	2.7	2.7	2.7	2.7	2.8	2.9	3.0	3.0
Consumer prices	2.2	2.2	2.2	2.4	2.3	2.2	2.4	2.9
Trade balance (**)	–56.1	–64.1	–63.6	–64.6	–66.2	–69.9	–71.0	...

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

Monetary policy continues to tighten

Following a period of abundant money supply and excessive world production capacity, most of the main central banks have begun to normalize their monetary policies in an environment of increasing prices for raw materials. Recent increases in inflation, greater utilization of world production capacity, the rigidity in supply of many raw materials and the subsequent increase in inflationary prospects have caused the central banks of the three main economic regions to again express their concern about price stability. As a result, the upward stage in interest rates continues to rule.

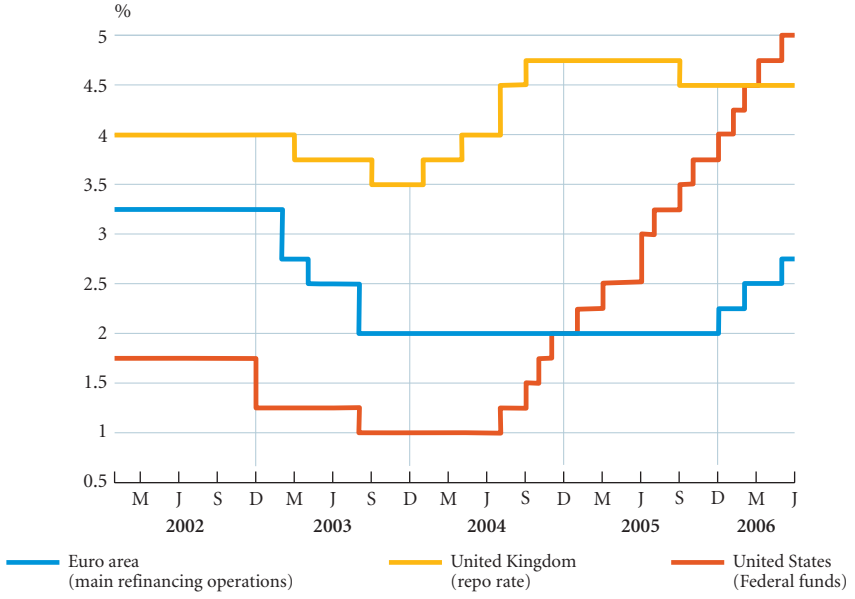
On June 8, the European Central Bank (ECB) raised its official interest rate by 25 basis points to 2.75% at the meting of the Governing Board held in Madrid. As a result, it dispelled doubts about a possible increased tightening of monetary policy by discording on higher rise and suggesting that this would not be followed by a further increase in July. This was the third increase in the Eurosystem rate since the beginning of the upturn in interest rates in December 2005. Earlier, the finance ministers of the Euro Group had asked for moderation by the ECB because of the effect of the strengthening of the euro on European exports.

Upward stage in interest rates continues spurred on by fears of inflation.

European Central Bank raises reference rate for third time ignoring appeals by finance ministers.

EUROPEAN CENTRAL BANK RAISES OFFICIAL INTEREST RATE TO 2.75%

Monetary policy reference interest rate



SOURCE: National central banks.

Concern about upward course in money supply and credit in Euro Area.

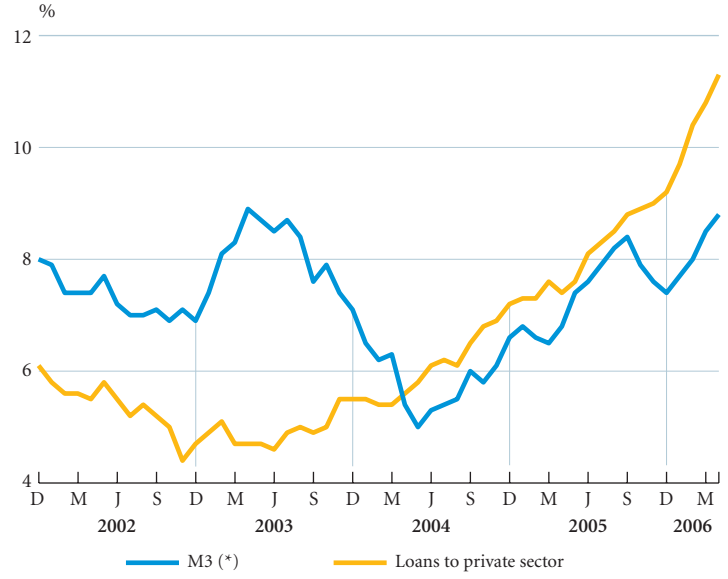
Nevertheless, according to projections by ECB experts, growth of the Euro Area gross domestic product will stand within a band between 1.8%-2.4% in 2006 and within a range of 1.3%-2.3% in 2007, as a result of a slight downward revision in the latest forecasts because of the increases in oil prices. In the case of inflation, the ECB noted that inflationary risks remain high because of possible oil price rises, increases in other controlled prices and indirect taxes, a higher than expected shift of the increased cost of raw materials and wage increases also higher than expected. Projections for inflation in 2006 stand between 2.1%-2.5% in 2006 and 1.6%-2.8% in 2007, with a slight upward revision because of rises in oil.

The European Central Bank made clear its concern about the sharp rise in the liquidity. In fact, the broad money supply figure (M3) grew by 8.8% in the last 12 months ending April, two points more than one year earlier. At the same time, loans to the private sector increased with an annual change rate of 11.3% in April, some 3.9 points more than in the same period the year before. Starting out from information contained in the monetary figures, the ECB carried out inflation projections for the medium term which went above the 2% objective, which was uncomfortable for the European monetary body. Because of all this, it is expected that the ECB will continue to raise interest rates during the year ending up with the reference rate above 3%, with the aim of gradually reducing its easy money policy.

In addition, at the beginning of June, German board member Otmar Issing was replaced on the ECB executive committee by fellow countryman Jürgen Stark. Issing had played an important role in the ECB since its founding and to some extent brought with him the monetary thinking of the Bundesbank, the German central bank.

SHARP GROWTH OF MONEY SUPPLY IN EURO AREA

Year-to-year change in monetary and credit figures



NOTES: (*) Cash in circulation, bank deposits, REPO's, participations in monetary market funds, etc.
SOURCE: European Central Bank and internal figures.

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euríbor (5)		Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
		3-month	1-year						
2005									
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	2.58	2.79	3.22	4.75	5.07	0.13	4.50	4.63	1.28
May (*)	2.58	2.89	3.31	5.00	5.18	0.19	4.50	4.70	1.40
June (1)	2.82	3.00	3.46	5.00	5.49	0.33	4.50	4.75	1.50

NOTES: (*) Provisional figures.
(1) June 26.
(2) Marginal interest rate. Latest dates showing change in minimum rate: 6-3-03 (2,50%), 5-6-03 (2,00%), 1-12-05 (2,25%), 2-3-06 (2,50%), 8-6-06 (2,75%).
(3) Latest dates showing change: 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%), 10-5-06 (5,00%).
(4) Latest dates showing change: 10-7-03 (3,50%), 6-11-03 (3,75%), 5-2-04 (4,00%), 6-5-04 (4,25%), 10-6-04 (4,50%), 5-8-04 (4,75%), 4-8-05 (4,50%).
(5) Interbank offer rate.
SOURCE: National central banks, Thomson Financial Datastream and internal figures.

In the United States, in the course of June, a series of strongly-worded statements by Ben Bernanke, chairman of the Federal Reserve Board, and other executives of that body showed their concern about the risks of inflation. The minutes of the last meeting of the Federal Monetary Policy Committee on May 10 also reflected this concern showing that they had weighed the idea of raising the official interest rate by a half-point although finally the rise was only 25 basis points. In this situation, expectations around the Federal Reserve reference rate for the meeting on June 29 have been increasing to the point where any pause on the upward course begun in June 2004 has been practically discarded. As a result, the Federal Reserve interest rate will go to 5.25% with the possibility of reaching 5.50% in the summer in order to reassert its anti-inflationary credibility.

Various central banks also restrict monetary policy in recent weeks.

In addition, other central banks also have given a further restrictive turn to monetary policy in recent weeks. At the end of May, the Bank of Norway raised its deposit interest rate by 25 basis points to 2.75%. The Bank of Denmark followed the ECB move. In mid-June the Bank of Switzerland raised the level of its reference band by a quarter point to 1.0%-2.0%. Similarly, the Bank of Sweden

Dollar bounces back breaking with weakness shown in recent months.

raised its intervention rate by 25 basis points on June 20 putting it at 2.25%. At the same time, a number of bodies tightened their monetary policies, as was the case in South Korea, India and Thailand. The Bank of Turkey raised its interest rate by 175 basis points to 15%, for the first time in nearly 5 years, in an attempt to support the Turkish lira. On June 26 it raised it again putting it at 17.25%.

Interest rate differential again supporting dollar

In the early days of June, the dollar weakened following publication of a disappointing figure for job creation in May. Nevertheless, after a series of strong statements by executives of the Federal Reserve Board in the second week of the month, the dollar obtained backing and recovered positions with the increased expectations of further

EXCHANGE RATES OF MAIN CURRENCIES

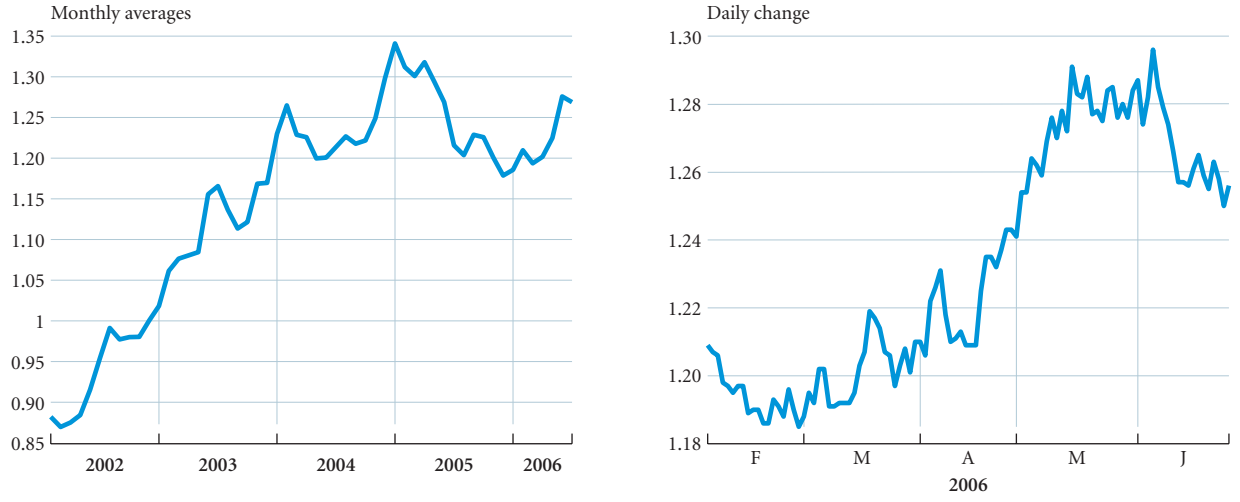
May 2006

	Final session of month		Monthly figures				*Exchange rate June 26, 2006*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2)			
				Monthly	Over December 2005	Annual	
Against US dollar							
Japanese yen	112.6	–1.1	111.9	–4.4	–5.5	4.8	*116.2*
Pound sterling (1)	1.872	2.5	1.869	5.6	7.1	0.8	*1.823*
Swiss franc	1.218	–1.6	1.219	–4.9	–6.6	0.1	*1.242*
Canadian dollar	1.101	–1.5	1.110	–3.0	–4.5	–11.6	*1.124*
Mexican peso	11.29	1.8	11.09	0.4	4.4	1.1	*11.41*
Nominal effective index (4)	*107.8*	*–0.3*	*107.5*	*–2.1*	*–3.9*	*–2.7*	*109.5*
Against euro							
US dollar	1.287	2.6	1.276	4.1	7.6	0.5	*1.256*
Japanese yen	144.3	0.7	142.7	–0.6	1.6	5.4	*146.1*
Swiss franc	1.560	–0.7	1.557	–1.1	0.6	0.8	*1.563*
Pound sterling	0.686	–1.2	0.684	–1.5	0.6	0.0	*0.690*
Swedish krona	9.276	–0.2	9.330	0.0	–1.1	1.5	*9.218*
Danish krone (3)	7.458	0.0	7.457	–0.1	0.0	0.2	*7.456*
Polish zloty	3.937	1.6	3.894	–0.7	1.2	–6.7	*4.088*
Czech crown	28.21	–0.7	28.28	–0.8	–2.4	–6.4	*28.52*
Hungarian forint	262.1	–0.8	262.4	–1.2	3.9	4.2	*280.1*
Nominal effective index (5)	*104.4*	*0.9*	*103.7*	*1.1*	*3.0*	*–0.2*	*103.7*

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

EURO MARKS UP HIGHEST EXCHANGE RATE AGAINST DOLLAR IN 14 MONTHS

US dollars to euro



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

increases in the US official interest rate. Furthermore, it was helped by the increased volatility affecting the currencies of emerging countries thus recovering its role of refuge currency. Nevertheless, un unfavourable figure for capital inflows for buying financial assets in April hurt the US currency in the middle of the month. As a result, in spite of the recovery seen in the dollar since mid-May, at the beginning of the last week in June it stood close to 2% below the level at the end of 2005, in terms of a broad basket of currencies.

The euro was running at 1.296 dollars on June 5, marking up its highest level since April 2005. Nevertheless, the later warning by the Euro Group financial ministers to the effect that they did not want to see the euro above 1.30 dollars and the decision of the European Central Bank to raise its reference rates by only 25 basis points on April 8, thus wiping out speculation about a possible increase of 50 basis points, weakened the European single currency. The euro marked up an all-time high against the Japanese yen going to 146.1 yen on June 26. The euro also recorded an all-time high against the Hungarian forint on June 23 when high public and current account deficits led to a lack of market confidence with regard to the currency of that central European country.

The yen has appeared weak since mid-May thus breaking with a trend to recovery due to the improvement in the macroeconomic position and expectations for increases in interest rates. The depreciation of the Japanese currency has been linked to the sharp drops on the Tokyo stock exchange. In addition, the scandal involving the governor of the Bank of Japan, Toshiniko Fukui, because of his participation in an investment fund implicated in a presumed fraud, also hurt the Japanese currency.

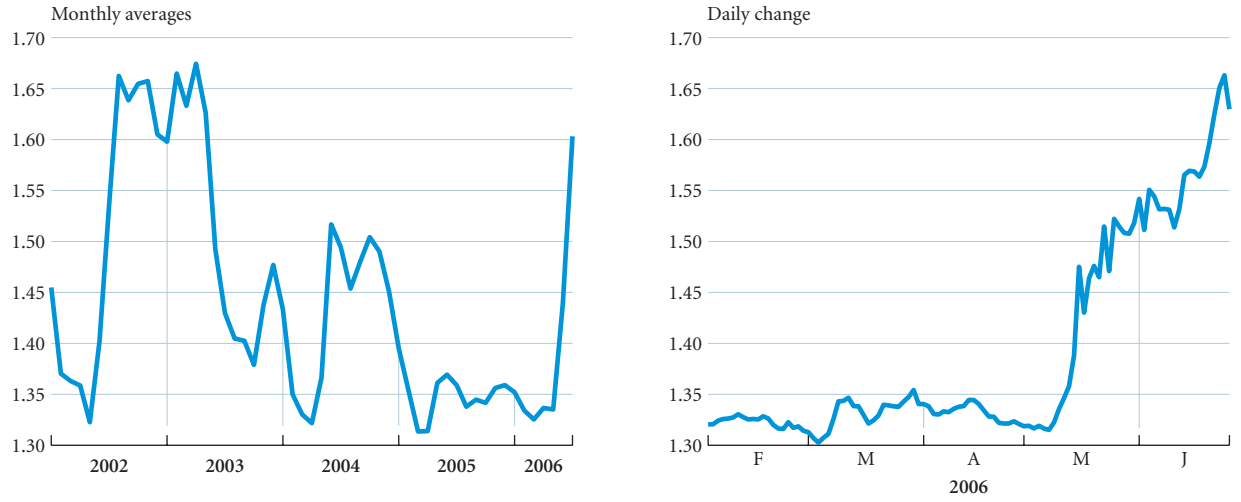
Euro marks up all-time high against Hungarian forint.

Among other emerging currencies affected by the upsets in recent weeks was the Turkish lira. When the Turkish currency was losing 15% against the dollar as of the end of April, the Turkish

Sharp drop in Turkish lira.

TURKISH LIRA DEPRECIATES

Turkish lira to dollar



NOTES: Figures go up to June 26.
SOURCE: Thomson Financial Datastream.

Yield on government bonds likely to continue moderate upward trend in coming months.

central bank raised its official interest rate by 175 basis points on June 8, as mentioned earlier. As a result, it managed to halt the collapse of the currency although it continues to suffer downward pressure due to macroeconomic imbalances involving high inflation, a foreign deficit and budgetary deficit as well as political instability. At the beginning of the last week in June the Turkish currency was running at 1.67 units to the dollar, a drop of 19% compared with the end of 2005, although it was 6% above the low recorded in March 2003.

Inflation fears raise yield on government bonds

In the early weeks of June the yield on US Treasury bonds stood below 5% following publication of a lower than expected figure for job creation and as a result of the shift of capital from the stock markets. Nevertheless, later on the upward drive arising from fears of inflation became dominant as well as that from subsequent increased expectations of interest rate increases by the Federal Reserve so that the yield on long-term government bonds again went above the 5% level. As a result, the yield on US 10-year Treasury bonds rose to 5.24% on June 26, the highest level since May 2002. This moderate upward trend will likely continue in coming months.

Standard & Poor's rating agency warns governments of industrialized countries to face up to ageing of population.

It may be pointed out that at the beginning of June the bond-rating agency Standard & Poor's issued a warning that the future bond ratings of a number of developed countries could drop to the level of low-rated bonds if their governments did not adopt serious reforms in their social security systems. This rating agency feels that the progressive ageing of the population of these countries will weaken their budgetary position in coming decades because of their commitments on pensions and health systems.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2003	2004	2005			2006			
			2Q	3Q	4Q	1Q	April	May	June 26
United States	4.04	4.31	4.21	4.25	4.54	4.61	5.04	5.18	5.24
Japan	0.99	1.50	1.28	1.36	1.53	1.58	1.91	1.91	1.89
Germany	4.10	4.07	3.35	3.19	3.37	3.50	3.91	3.99	4.07
France	4.13	4.10	3.38	3.23	3.39	3.51	3.95	4.01	4.10
Italy	4.24	4.24	3.53	3.40	3.56	3.71	4.23	4.29	4.38
Spain	4.12	4.10	3.36	3.18	3.37	3.49	3.92	3.99	4.04
United Kingdom	4.53	4.93	4.50	4.32	4.34	4.23	4.56	4.70	4.75
Switzerland	2.47	2.57	2.04	1.90	2.05	2.18	2.59	2.73	2.82

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

Volatility reigns in stock markets

After undergoing the worst monthly drop in the past three and a half years in May, the international stock markets scarcely took a breather in June. The prospect of higher than expected interest rates and doubts about economic growth in the United States and other countries have put their price on the rapid increases on the stock market in previous months. As a result, in the early weeks of June many stock market indices saw their cumulative gains over December evaporate with the appearance of figures in the red although the annual changes were broadly positive.

Among the main North American indices, the traditional Dow Jones was the one to come out best from the period of upsets and it managed to maintain slight gains over the end of 2005. The Nasdaq, which is representative of hi-tech shares, was not so lucky and it went below par for the year very near the end of the first half-year. By sector, the biggest cumulative capital gains showed up in the telecommunications and energy sectors while on the other hand the hi-tech and pharmaceutical/health sectors presented the biggest capital losses.

Prospects for interest rates higher than anticipated and doubts about economic growth affecting markets.

The European stock markets did not escape the storm and the DJ Euro Stoxx 50, which is made up of the biggest companies in the Euro Area, stood below the initial level for 2006 at the beginning of the final week of June. Nevertheless, among the main markets, only Amsterdam accumulated losses in the first half-year. Certain corporate manoeuvres, such as the acquisition of Winterthur by the AXA insurance company and the merger of the telephone infrastructure divisions of Nokia and Siemens, enlivened European stock exchanges.

Nasdaq and DJ Euro Stoxx 50 lose par for year.

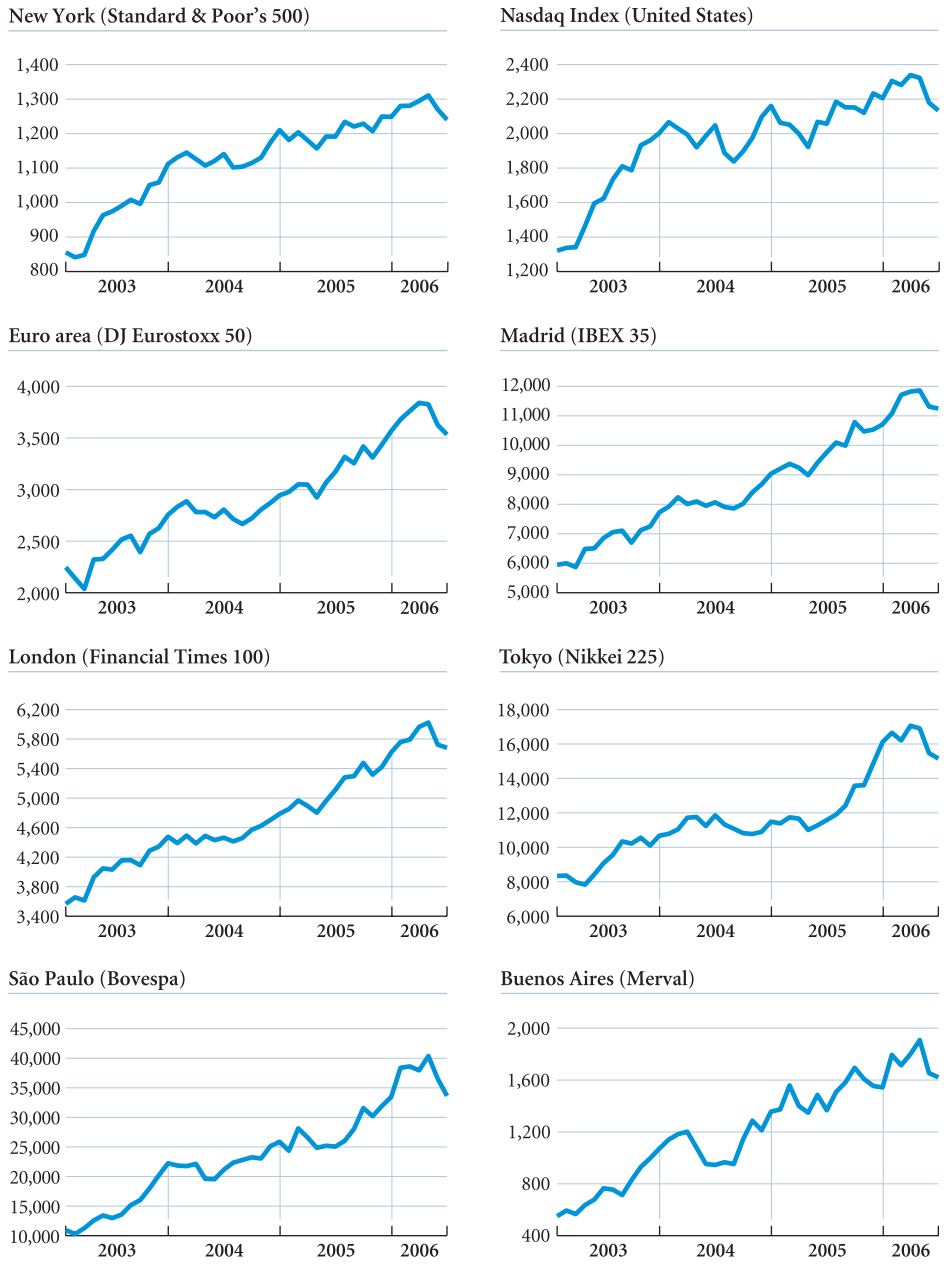
The IBEX 35 index for the Spanish stock exchange underwent a sharp blow and ended up dropping below the 11,000 points level on some days. Nevertheless, helped by the favourable trend in corporate profits, the selective Spanish index recovered that level and presented a considerable increase over December in the final week of the first half-year.

IBEX 35 manages to stay in positive figures.

Stock markets in emerging countries continued to undergo a correction in the

INTERNATIONAL STOCK EXCHANGES

Indices at month-end



NOTES: June 26, 2006.
SOURCE: National stock exchanges.

Emerging market indices stand below level at start of year.

early weeks of June. Increased aversion to risk was rife in these markets which, furthermore, had probably risen to excess in previous months. After having dropped by 11.6% from the all-time high noted in the second week of May up to the end of the month, the Morgan Stanley Capital International (MSCI) index for emerging markets went down another 5.3% up until the beginning of

the final week of June, thus standing below the level at the end of 2005. In any case, some markets, such as those of Hong Kong and Argentina, presented notable cumulative gains toward the close of the first half-year.

INDICES OF MAIN WORLD STOCK EXCHANGES

May 31, 2006

	Index (*)	% monthly change	% cumulative change	% annual change	*Figures on June 26, 2006*	
					% cumulative change	*% change over same date in 2003*
New York						
Dow Jones	*11,168.3*	*–1.7*	*4.2*	*6.7*	*3.1*	*21.7*
Standard & Poor's	*1,270.1*	*–3.1*	*1.7*	*6.6*	*0.2*	*26.9*
Nasdaq	*2,178.9*	*–6.2*	*–1.2*	*5.4*	*–3.2*	*30.6*
Tokyo	15,467.3	–8.5	–4.0	37.2	–6.0	*69.8*
London	5,723.8	–5.0	1.9	15.3	1.1	*40.6*
Euro area	3,637.2	–5.3	1.6	18.2	–1.2	*44.1*
Frankfurt	*5,692.9*	*–5.3*	*5.3*	*27.6*	*2.0*	*70.1*
Paris	*4,930.2*	*–5.0*	*4.6*	*19.6*	*1.8*	*54.7*
Amsterdam	*440.4*	*–6.2*	*0.8*	*20.8*	*–2.2*	*45.9*
Milan	*27,923.0*	*–5.1*	*4.3*	*15.1*	*1.7*	*46.2*
Madrid	*11,340.5*	*–4.6*	*5.7*	*20.3*	*5.1*	*62.4*
Zurich	7,604.4	–5.5	0.3	24.1	–1.6	*54.0*
Hong Kong	15,857.9	–4.8	6.6	14.4	6.2	*64.5*
Buenos Aires	1,653.7	–13.4	7.2	11.3	5.0	*119.6*
São Paulo	36,530.0	–9.5	9.2	44.9	3.5	*164.1*

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: National stock exchanges and internal figures.

SPAIN: OVERALL ANALYSIS

Economic activity

Construction and services continue to drive economic activity

Growth rate of economic activity hits ceiling.

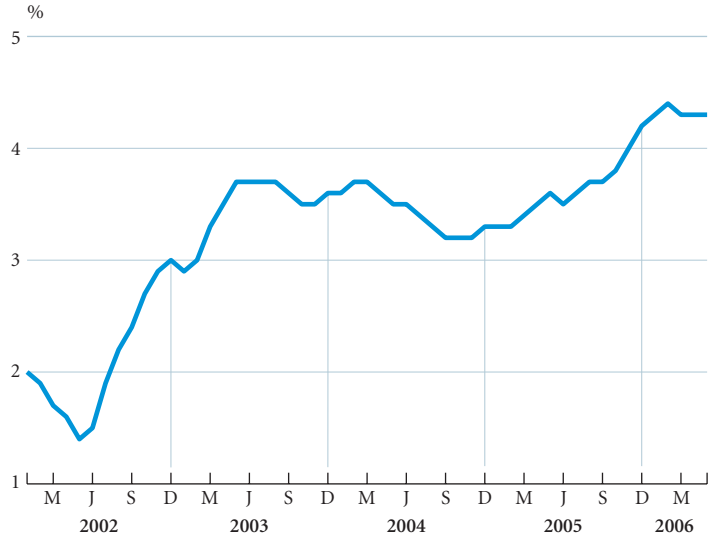
The second quarter of 2006 closed with no big changes over previous months. The rate of economic activity remains very lively but everything seems to indicate that growth has now hit a ceiling. The main indicators of economic activity are holding to growth profiles that are partly contradictory but from the sum of all these it may be inferred that the growth rate of activity is tending to stabilize or, in overall terms, to slow down slightly. This is suggested, for example, by the composite indicator of economic activity drawn up by the Ministry of Economy and Finance on the basis of broad group of partial indicators as shown in the following graph.

Recovery in industry fails to consolidate...

So far this year, the biggest disappointment has come from industry which has not fully consolidated the recovery suggested at the end of 2005. The growth rate of the industrial production index, adjusted for differences in calendar, has gradually been losing strength going to around 1.8% year-to-year in April in terms of cycle-trend. If we look at the end-use of goods, the manufacture of consumer goods is giving out signs of greater weakness due mainly to the low profile of manufactures of non-durable consumer goods (with food practically stagnant and textiles and publishing on the wane) whereas under

GROWTH OF ECONOMIC ACTIVITY TENDING TO STABILIZE

Year-to-year change in composite economic activity indicator



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

SUPPLY INDICATORS

Percentage change over same period year before

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
Industry								
Electricity consumption (1)	4.1	2.8	2.7	1.5	1.9	2.8	4.2	5.3
Industrial production index (2)	1.6	0.7	0.1	0.7	1.6	2.6	1.2	...
Confidence indicator for industry (3)	–2.5	–4.9	–7.0	–4.8	–4.0	–5.4	–5.0	–1.0
Utilization of production capacity (4)	79.8	80.2	79.5	81.1	80.7	79.7	–	80.5
Imports of non-energy intermediate goods (5)	6.6	1.6	3.6	0.6	1.1	10.3	–7.7	...
Construction								
Cement consumption	3.9	7.3	13.6	7.8	6.1	16.6	–8.1	9.2
Confidence indicator for construction (3)	13.6	22.4	15.0	22.7	28.3	15.3	11.0	12.0
Housing (new construction approvals)	8.0	6.2	7.6	2.8	10.6	18.5	–14.1	...
Government tendering	18.3	18.5	36.6	3.1	36.9	14.7	25.9	...
Services								
Retail sales	5.5	4.4	5.4	4.4	3.8	5.1	0.3	6.7
Foreign tourists	3.1	6.1	4.4	7.0	4.9	0.6	17.7	6.9
Tourist revenue inflows	3.8	5.8	–3.9	13.9	4.9	–7.6	...	...
Goods carried by rail (km-tonnes)	–3.5	–3.2	–4.7	–2.3	11.0	8.1	–19.0	...
Air passenger traffic	8.0	9.2	8.9	10.2	9.1	5.2	15.1	6.8
Motor vehicle diesel fuel consumption	7.2	4.9	7.5	4.9	4.2	7.4	...	...

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.

the heading of consumer durables the situation is somewhat more positive.

On the other hand, production of capital goods has turned out better than at first expected with a rapid increase in growth in the initial months of the year. For the immediate future, it would seem that the overall prospects of the sector are tending to improve, according to the results of the European Commission survey which shows clear progress in the situation in order books and in sector confidence itself.

In construction there has been no notable news. The rate of economic activity remains very high, going by the volume reached by some intermediate consumables, such as cement which, as shown in the following graph, is still holding to a very high growth rate. In spite of statements warning about a lower level of activity in transactions in the real estate market (referring especially to existing housing in certain urban areas), for the moment construction activity continues at a strong rate.

...while construction activity remains very strong.

In services, nearly all areas of activity are generally maintaining sustained increases. The most contradictory results show up in tourism. In the first five

Why is total factor productivity in Spain's economy slowing down?

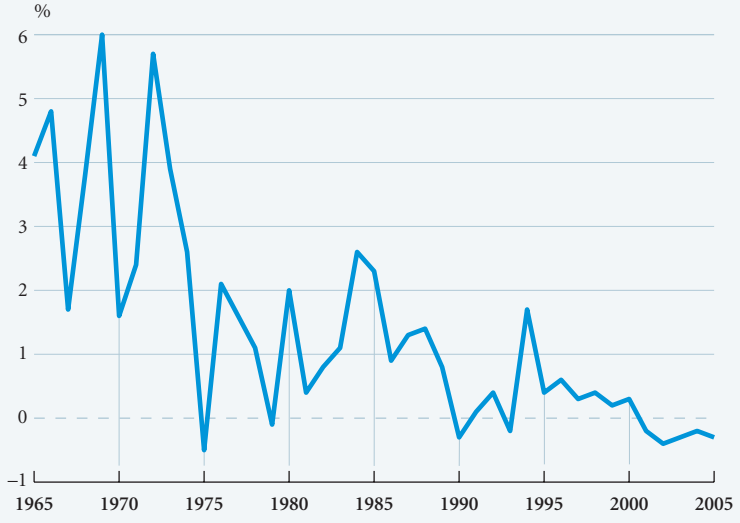
Would you like to know if your children will live better than you? If we had to seek out a single variable that would provide a rough idea of our economic future as a community, it would be technological progress. Intuitively, we understand that an economy can improve over the long term in terms of economic well-being only if it is capable of making technological progress. Well then, how do we measure technological progress? Is there a single measure to give us an approximate answer?

The reply is that indeed we do have a variable that we can liken to technological progress in the broadest sense, namely the total factor productivity (TFP). While it may sound like a secret formula (and we should recognize that in this the ability of economists to instruct has not be overly brilliant), the concept is not so complicated, especially if we use a familiar metaphor, that related to the factory. On what does the level of production of a factory depend? Basically, on the amount of capital and labour it has available and how it combines them according to the method of production it follows. Nevertheless, as well as the quantity of factors and the method of production, the results will depend on the technological level of the plant and a multitude of factors that will affect its productivity, both capital and labour. This vast rag-bag *(technological level and others)* is the TFP. And, just as this may be set out at the factory level, the concept may be applied to the economy as a whole.

On this point, let us go back to the initial question. What does our future prosperity depend on? Once we have accumulated capital and labour, all increased production will arise from the introduction of innovations of all kinds (organizational, in products, etc.) and the improvement in the quality of the factors of capital and labour. What is the situation of Spain's economy in this area? If we look at the accompanying graph, the conclusion is that Spain's technological progress, arrived at from growth of the TFP, has been on a truly troubling downward path since the Eighties.

TECHNOLOGICAL PROGRESS SLOWING DOWN IN SPAIN

Annual change in total factor productivity

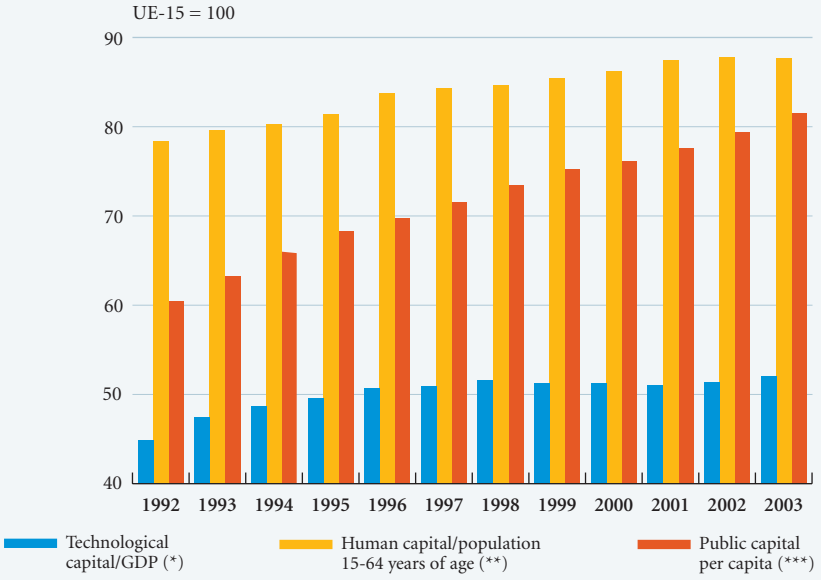


SOURCE: Bank of Spain and internal figures.

The explanation of this phenomenon demands exploring somewhat more thoroughly the determinants of technological progress. Economic theory, supported by an abundance of empirical evidence, maintains that the technological progress of a country is closely linked to the sum total of public infrastructures available, to the education of its citizens and the stock of technological capital. An immediate possibility is that the level of these three production factors, which we may label as non-conventional in order to differentiate them from the traditional factors of capital and labour, is insufficient to foster an increase in the TFP. In the case of Spain, the hypothesis quickly comes into question in the case of physical public capital and human capital. As may be drawn from the following graph, in the past decade Spain's economy has managed to arrive at levels very close to the average of the European Union (EU-15) in both areas.

SPAIN'S TECHNOLOGICAL CAPITAL IN RELATIVELY WORSE SITUATION THAN EDUCATION AND INFRASTRUCTURES

Cumulative level of technological, human and public capital in Spain's economy compared with EU-15



NOTES: (*) Cumulative balance of volume of overall spending on R&D in the economy. The depreciation rate used is 15%. Use is made of the gross fixed capital formation deflator in capital goods.
(**) Percentage of population group of working age with higher education studies. The index obtained is corrected according to quality taking into account results of the PISA report by OECD and public spending per student.
(***) Cumulative balance of volume of gross fixed public capital formation. Depreciation rate of 3.5% used.
SOURCE: Bank of Spain.

The rate of accumulation of technological capital is less positive. If this capital is understood as the available stock of technological knowledge, we can measure it as the cumulative total over time of investment in research and development. In this matter convergence with the EU-15 has definitely been lower. In 2003, while Spain's stock of technological capital was equivalent to 4.6% of the gross domestic product (GDP), in the EU it was approximately double this. We do not have to be overly dramatic. The rate of accumulation of technological capital stock has been important (the differential with the EU has been reduced by 20 points going from a level equal to 30% of the EU average in 1980 to 52% in 2003), but both the low starting point and its still meagre amount point to the decided weakness of Spain's economic model compared with international references.

However, the fact is that, apart from the gap still separating Spain from Europe, there is a second problem. If the impact of technological capital on the GDP in Spain were the similar to that of other developed economies, the substantial growth of technological stock in real terms between 1980 and 2003 would have generated an annual increase in growth rate of the TFP estimated at 1%.[1] As we have seen, the performance was precisely in the opposite direction. Not only did the TFP fail to increase growth but it halted its progress as the period advanced.

It is not easy to explain this poor result in technological capital given that it may be the result of various phenomena as, for example, the inefficient utilization of spending on research and development. On the other hand, international comparisons suggest that Spain's economy is one that is still unduly regulated with institutional restrictions that prevent taking full advantage of innovative effort and, in more general terms, of the potential dynamism of companies.

From this perspective, the lack of efficiency in Spain's economy may be due not to excessive regulation but to the very quality of that regulation. From a conceptual point of view, the relation between the efficiency of an economy and its regulation is complex. When regulation manages to correct so-called «market failures» by facilitating a proper assignment of resources, efficiency is improved.[2] Furthermore, if the market failure consists of the absence of totally competitive markets, regulation could be positive in limiting monopoly situations. In other cases, however, the effect of regulation in terms of efficiency could turn out to be negative. This would be the case where, while seeking to meet other objectives, regulation ends up creating entry barriers which stand in the way of free competition and corporate innovation.

(1) This calculation is carried out taking into consideration that the product elasticity of the technological capital of Spain's economy is 7%. That is to say, given that technological capital increased by 356% between 1980 and 2003, the contribution to growth of the GDP is 7% of this increase: 25%. This means an approximate annual increase in growth rate of the TFP of 1%. For details of this calculation, along with a broader discussion of the role of non-conventional factors in Spain's technological progress, see *Documentos de Economía "la Caixa"* nº 1.
(2) For a comparative international analysis of the effect of State intervention through aid to industry, see *"la Caixa" Economic Papers* n. 1.

Contradictory results in tourism: number of visitors up but revenue inflows stagnant.

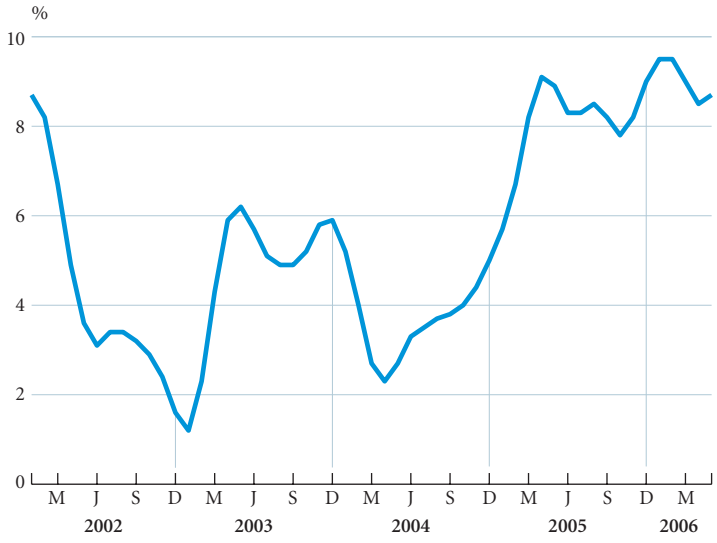
months of the year the number of foreign tourists grew by no less than 6.1% year-to-year and overnight hotel stays both for Spanish residents and foreign visitors showed a considerable increase of close to an average of 7%. Nevertheless, spending by foreign tourists is growing very little. It rose by a mere 0.7% in the first four months of the year, a drop in average spending per tourist of around 5% compared with the same period the year before. It is expected that this trend will continue over coming months.

On the demand side, the situation is far from being homogeneous although the overall trend is to a gradual slowdown. This dichotomy is to be seen, for example, in the trend in retail sales. From January to April sales for food products dropped by 0.8% year-to-year in real terms whereas for all other articles there was a rise of 0.2%. Another representative consumer indicator, passenger car registrations, is maintaining a fairly modest rate with a cumulative decrease of 0.6% in the first five months of the year compared with the record sales figure recorded in the same period last year.

On the other hand, other consumer indicators reflect a more expansionist trend as in those for most services and those for imports. Purchases of food

CEMENT CONSUMPTION MAINTAINS VERY HIGH GROWTH RATE

Year-to-year change in cement consumption



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

items from abroad grew by 6.7% real in the first four months of the year while those for other goods rose by 13.7%. Finally, consumption continues to show growth but with a tendency to moderate. We can foresee this trend extending into the immediate future, as seems to be indicated by the trend in consumer confidence sentiment which, after holding at very low levels all through this stage (even contrary to the growth levels in spending) is now tending to worsen. In May it fell to a figure of –14 points, the lowest in the past three years.

We also note a significant slowdown in growth of investment in capital goods. Imports of these goods, for example, showed a drop in annual growth rate to 3.0% from January to April which, however, should be placed beside the increase in domestic production mentioned above. Registrations of commercial vehicles reflect a similar state of moderation with a reduction in growth rate from January to May of 3.5%, well below that recorded in previous months. In overall terms, for the second half-year it is expected that the strength recovered in exports (in the first four months of 2006 exports have grown by 7.6% year-to-year) will partly compensate for the lower contribution to growth from national demand.

National demand tending to moderate...

...which could be compensated in near future by increased growth of exports.

DEMAND INDICATORS

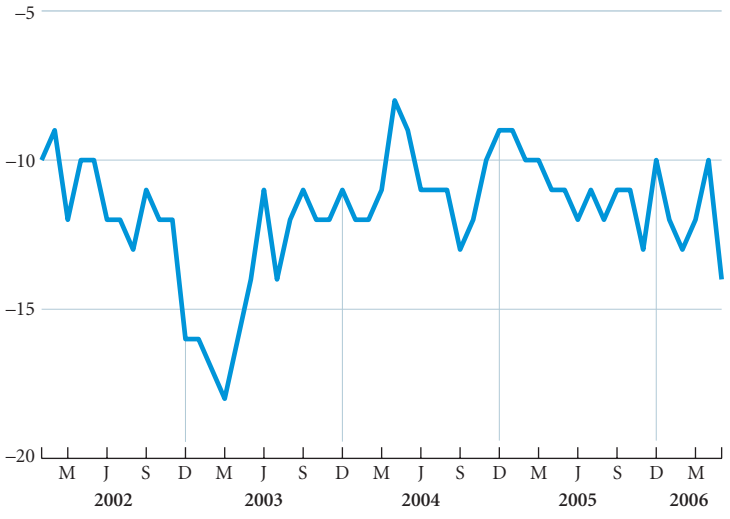
Percentage change over same period year before

	2004	2005	2005			2006		
			2Q	3Q	4Q	1Q	April	May
Consumption								
Production of consumer goods (*)	–0.1	0.9	1.1	1.4	0.9	0.6	–0.8	...
Imports of consumer goods (**)	13.4	7.9	8.4	7.8	8.6	20.4	–4.6	...
Car registrations	9.8	0.8	4.9	2.3	–4.5	2.4	–10.5	0.5
Credit for consumer durables	5.5	12.5	13.7	17.2	10.1	...	–	–
Consumer confidence index (***)	–10.5	–10.8	–11.3	–11.4	–11.2	–12.5	–10.0	–14.0
Investment								
Capital goods production (*)	1.9	–0.1	0.6	–1.3	0.8	6.7	3.8	...
Imports of capital goods (**)	14.9	20.4	36.0	13.5	8.2	10.0	–12.6	...
Commercial vehicle registrations	11.7	13.2	17.9	13.9	11.5	7.5	–12.1	6.4
Foreign trade (**)								
Non-energy imports	9.8	6.0	9.0	4.7	4.5	13.7	–7.3	...
Exports	5.2	0.2	2.5	1.2	0.1	12.7	–6.3	...

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

DROP IN CONSUMER CONFIDENCE

Difference in percentage of positive and negative responses



SOURCE: European Commission.

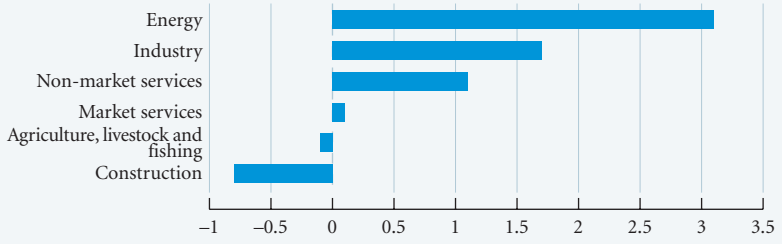
In search of lost productivity

Growing concern about the stagnation of productivity in Spain's economy is in contrast to the excellent results obtained in terms of growth and employment in recent years. The excellent current economic situation runs hard up against the fact that in the period 2001-2004 the gross domestic product (GDP) per hour worked grew by a mere 0.6% on annual average. How could there have been such a disappointing result? As we saw in the previous box, there are many factors that explain the deficiencies in productivity. In this case, we shall concentrate on the sector by sector structure of the pattern of growth.

As is well-known, the trend in Spain's economy in recent years has been marked by a high level of growth characterized by the boom in construction and the demand in certain services. Nearly half the growth of the GDP in the period under consideration was contributed by construction and some services of low value added (and little technological content), such as the hotel trade, restaurants, personal services, security, cleaning, etc. These are precisely sectors of low productivity, as may be seen in the accompanying graph. The performance of productivity in market services (practically stagnant) and construction (a decrease) in the period mentioned largely marks the mediocre results of Spain's economy in the matter under discussion. On the other hand, in industry and energy generation, the trend in productivity was much more satisfactory in keeping with the higher technological content of these sectors. Public services (health, education and general government) also come out fairly well although in this case the unique nature of these activities makes it necessary to be prudent in interpreting such results.

MARKET SERVICES AND CONSTRUCTION SLOW GROWTH OF PRODUCTIVITY

Percentage annual change in Gross Value Added (GVA) per hour worked in period 2001-2004



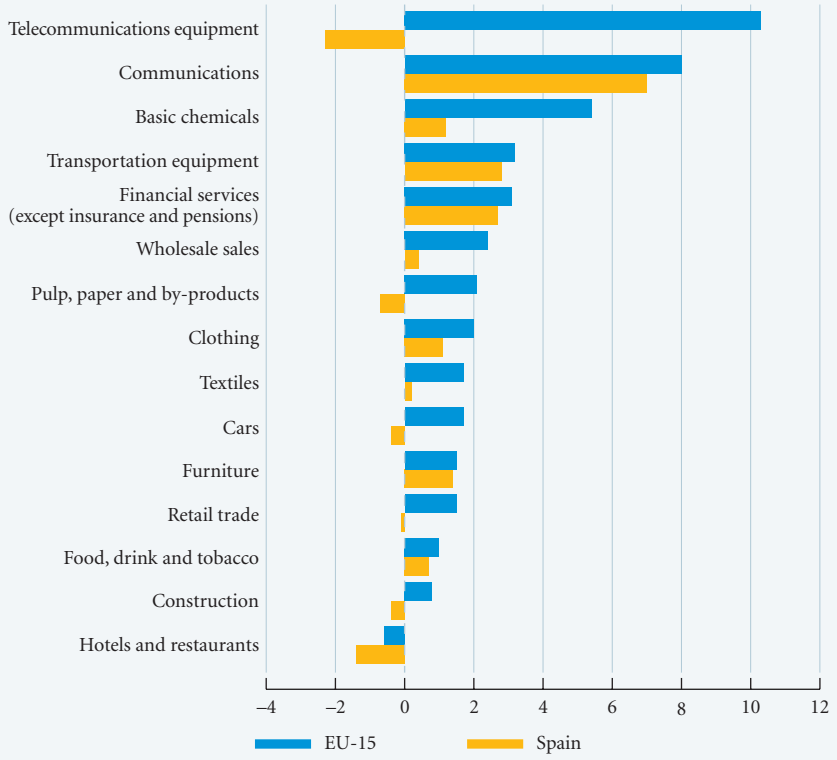
SOURCE: INE and internal figures.

At a more broken-down level, the most productive activities (those in which growth of productivity goes above 2% annual) represent only 11% of the GDP. In the first group we find energy production, up-to-the-minute industrial activities and financial services. The next group, which includes those branches with growth of productivity standing between 1% and 2%, contribute approximately 38% of the GDP. Finally, those activities undergoing an effective decrease in productivity represent not less than half of the GDP. The latter group includes construction and the bulk of services to which we made reference earlier. Indeed, the facts speak for themselves.

In the light of the above figures, there seems no doubt that that the model of growth in recent years has had an influence on the slow growth of total productivity in Spain's economy. Now, if we compare the results with those for neighbouring countries, the foregoing statement cannot be so conclusive. It should be noted with some concern that the performance of the less productive sectors is worse in Spain than in the EU-15 as a whole. And that, in those sectors where Spain's economy is making significant advances, these are well below those obtained by our European associates. The conclusion is clear: with the same pattern of sector specialization, if Spain's productivity had at least met the EU-15 standards, the results would have been much better. It is estimated that whereas between 1996 and 2003 Spain's economy grew at an average annual rate of 3.2%, if its sector-by-sector productivity had been the same as the average for the EU, average annual growth would have stood at 4.5%. This is to say that at this time Spain's per capita GDP would be comfortably above the EU average whereas the present reality is that it has not yet reached that average.

SPAIN'S PRODUCTIVITY LAGGING

Average annual GVA per hour worked in selected sectors (1996-2003)



SOURCE: Groningen Growth and Development Centre, 60-Industry Database and internal figures.

Let us take some specific examples. As we have seen, between 2001 and 2004 construction, real estate services and business services, retail trade, repairs and the hotel and restaurant trade recorded significant decreases in productivity. It is worth remembering that these four branches of activity contributed close to 45% of Spain's GDP growth in 2004. The performance of these sectors is thus systematically worse in Spain than in the rest of the EU-15. Between 1996 and 2003 (last year available) the decrease in productivity in construction, retail

trade and repairs (around 0.4% and 0.1% on annual average) was in contrast to the growth recorded in the EU-15 (0.8% and 1.5% respectively). In the same period, the decreases in the hotel and restaurant trade and real estate services in Spain (1.4% and 7.8% respectively) were much higher than those recorded in the EU-15 (0.6% and 0.2%).

In similar vein, the advances in Spain's more dynamic sectors are almost always lower than those obtained by its EU associates. For example, let us compare the increases recorded between 1996 and 2003 in financial services, communications and the chemical industry in Spain (2.7%, 7.0% and 1.2% respectively) with those relative to the EU-15 (3.1%, 8.0% and 5.4%). We in Spain thus have a problem. It is not surprising that in these circumstances the divergence with Spain's EU associates is increasing, a fact that is particularly serious if we consider that in the interconnected world of today (the Global Village as it has been called) Spain is competing not only with other members of the EU-15 but with many other developing countries coming along behind.

For this reason, the orientation of Spain's economy, which in recent years has been clearly leaning toward construction and certain services of low or medium range, has not helped to improve figures for productivity of labour. There has been rapid growth but of a kind that does not manage to set the bases for sustained growth over the medium and long term. The future growth of Spain's economy will therefore depend on correcting the present course in time so that those activities with up-to-date technology and greater value added may continue to increase their relative importance.

Labour market

Employment maintaining strong growth at mid-year

Registrations with Social Security growing at stable rate of 2.7%...

Employment continues to maintain notable strength as we move into the summer, if we are to go by figures for registrations with Social Security. As a result, at the end of May the total number registered reached 18.64 million, that is to say, 4.8% more than in the same month last year.

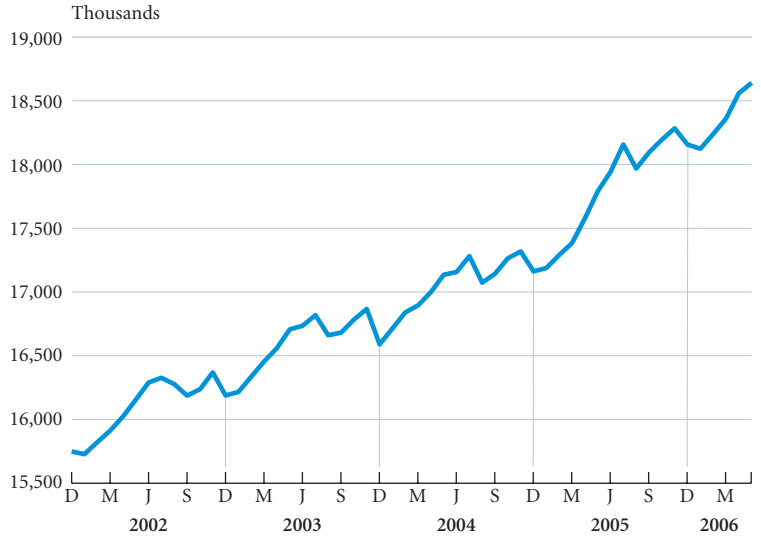
...after discounting jobs coming to surface as result of granting normal status to foreign workers.

This sharp increase was largely due to the process of granting regular work status to foreign workers begun in February 2005, which probably brought to the surface already existing jobs. At the end of May, foreign workers coming under this process still in the labour force amounted to 503,604. If we discount this figure, which does not constitute new jobs, the rate of increase in registrations in May stood at 2.7%, thus demonstrating great stability compared with previous months.

Also very favourable are the figures for hiring contracts registered through offices of the Public Employment Services. In the first five months of 2006, contracts registered rose by 11.6%, thanks to the sharp increase in permanent hiring contracts. In spite of this increase, most contracts (90% of the total) came under temporary work models. Part-time work, in turn, accounted for 22.1% of job placements.

INCREASE IN REGISTRATIONS WITH SOCIAL SECURITY BEGINNING TO NORMALIZE

Total registrations with Social Security



SOURCE: Ministry of Labour and Social Affairs.

EMPLOYMENT INDICATORS

Percentage change over same period year before

	2004	2005	2005				2006		
			1Q	2Q	3Q	4Q	1Q	April	May
Persons registered with Social Security									
Wage-earners	2.7	4.8	2.8	4.2	5.9	6.3	6.3	6.3	5.4
Industry	*–0.5*	*–0.5*	*–0.8*	*–0.7*	*–0.3*	*–0.4*	*–0.3*	*0.2*	*0.0*
Construction	*5.6*	*8.6*	*5.6*	*7.9*	*10.0*	*10.9*	*11.0*	*10.6*	*9.6*
Services	*3.9*	*5.7*	*4.2*	*5.2*	*6.4*	*6.8*	*6.6*	*6.7*	*5.8*
Non-wage-earners	3.2	2.6	2.9	2.7	2.5	2.4	2.3	2.2	2.2
Total	**2.8**	**4.4**	**2.8**	**3.9**	**5.3**	**5.6**	**5.5**	**5.6**	**4.8**
Persons employed (*)	**3.9**	**5.6**	**5.1**	**5.8**	**5.9**	**5.6**	**4.9**	–	–
Jobs (**)	**2.6**	**3.1**	**3.0**	**3.2**	**3.2**	**3.2**	**3.2**	–	–
Hiring contracts registered (***)									
Permanent	11.8	8.7	0.6	9.2	10.0	16.1	25.6	9.4	24.1
Temporary	11.4	4.6	–9.8	10.1	9.7	8.9	13.7	–2.6	13.5
Total	**11.5**	**5.0**	**–8.8**	**10.0**	**9.8**	**9.5**	**15.0**	**–1.4**	**14.5**

NOTES: (*) Estimate from Labour Force Survey (changes for 2005 adjusted for impact of methodological changes).
(**) 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.

Registered unemployment holding stable

Registered unemployment was down in May although somewhat less than in the same month in 2005. In spite of this, we should not see this as a change in the trend to stability in unemployment seen in recent months. In May, those registered at offices of Public Employment Services had dropped by 0.1% compared with the year before, standing at 2,004,528.

Of this figure, 6.4% were foreign workers, a proportion well below the figure that foreign workers represented in the overall group registered at Social Security (9.9%). In some ways, these figures suggest somewhat greater relative facility that immigrant workers may have when it comes to filling a job, something which likely is related to working conditions and type of job involved.

Registered unemployment holds at last year's levels.

The stability of registered unemployment was not spread evenly over the whole country. There are quite different situations side by side in the various autonomous communities with the most notable (on the unfavourable side) being the sharp increase in unemployment in Andalusia and the incipient worsening of the situation in Catalonia and Madrid, although in this case the levels of unemployment are lower than those last year. On the other hand, the Valencian Community, Galicia and Navarre present clearly more positive situations with sharp sustained decreases in unemployment.

Unemployment among foreign workers down.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

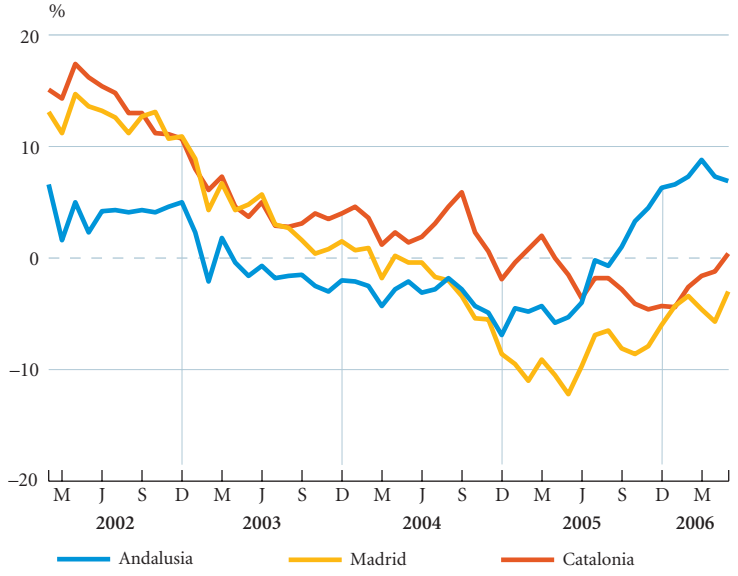
May 2006

	No. of unemployed	Change over December 2005		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	61,571	–3,656	–5.6	5,222	9.3	3.1
Industry	285,714	–15,605	–5.2	–10,214	–3.5	14.3
Construction	210,541	–34,559	–14.1	–9,378	–4.3	10.5
Services	1,222,927	–43,462	–3.4	15,236	1.3	61.0
First job	223,775	–1,127	–0.5	–3,731	–1.6	11.2
By sex						
Males	762,998	–88,965	–10.4	–19,162	–2.4	38.1
Females	1,241,530	–9,444	–0.8	16,297	1.3	61.9
By age						
Under 25 years	250,912	–24,983	–9.1	–7,939	–3.1	12.5
All other ages	1,753,616	–73,426	–4.0	5,074	0.3	87.5
TOTAL	**2,004,528**	**–98,409**	**–4.7**	**–2,865**	**–0.1**	**100.0**

SOURCE: Public Employment Offices and internal figures.

UNEMPLOYMENT WORSENS IN THREE LARGEST AUTONOMOUS COMMUNITIES

Annual change in registered unemployment



SOURCE: Public Employment Offices and internal figures.

Labour productivity and types of hiring contract

The lack of growth in productivity in Spain has sometimes been attributed to the peculiarities of the Spanish labour market and, specifically, to the characteristics of the labour contracts currently in force in the country. The types of contract have an influence on productivity in two ways, namely, investment in training by the employer and work incentives for the employee. Increased productivity is expected the more one invests in human capital and the greater degree of effort made by the worker.

The normal classification of hiring contracts in two types *(Temporary* and *Permanent)* may lead to an erroneous perception of the impact of the type of contract on labour productivity. It is fundamental to bear in mind that, in fact, there may exist at least four types of contract, namely, the temporary contract us as a means for selecting the better job candidates *(Selection Temporary)*, the temporary contract not used as a means of worker selection *(Casual Temporary)*, the permanent hiring contract involving average firing costs *(Average-cost Permanent)* and the permanent contract with high firing costs *(High-cost Permanent)*. From this perspective empirical evidence must be treated with caution given that most studies differentiate only between temporary and permanent hiring contracts.

LABOUR CONTRACTS AND PRODUCTIVITY

Contract type	Characteristics	Investment in training	Effort	Productivity
Selection temporary	Means of selection Low firing costs	Average	High	☺
Casual temporary	Not a means of selection Low firing costs	Low	Low	☹
Average-cost permanent	Average firing costs	High/Average	Average	☺
High-cost permanent	High firing costs	High/Average	Low	😐

The difference between contracts such as *Average-cost Permanent* and *High-cost Permanent* is clearly due to firing costs. The factor distinguishing *Selection Temporary* and *Short-term Temporary* is whether they are used or not used as a screening device to select workers, and not the cost of firing since in the two cases this is very low. It is possible to calibrate which of the two types of temporary hiring contract represents an economy by observing the shifs from temporary contract to permanent contract. In Spain, the evidence indicates that *Short-term Temporary Contracts* are those that predominate under temporary contracts.(1)

The fact that in an economy there exist *Short-term Contracts* in place of *Selection Temporary Contracts* is due to an imperfection in the market known as *moral hazard*. This originates because of the asymmetry of information between the worker and the employer company on the use of temporary contracts as a screening device. That is to say, the workers do not believe that their bosses will carry out the shift from temporary contract to permanent contract in spite of their making high levels of effort, which induces them to work less. Companies are aware of this and thus end up not using temporary contracts as a means of worker selection. There are measures which can reduce and even eliminate the problem of moral hazard and achieve a situation with a predominance of *Selection Temporary Contracts*. For example, rewarding those companies that make the change of status from temporary to permanent.

(1) *Güell, M. and Petrongolo, B., (2006) «How binding are legal limits? Transitions from temporary to permanent work in Spain», Labour Economics, forthcoming.*

What is the link between type of hiring contract and training?

Generally speaking, better training may be expected with a *Selection Temporary* contract than with a *Casual Temporary* contract because with the former type there is a greater probability that companies will maintain their relation with employees.

In the case of Spain, Albert, García-Serrano and Hernanz[2] show that within the same company workers with a temporary hiring contract have a lower probability of being selected for a training course than those with a permanent contract. Nevertheless, this study is in fact comparing the two characteristic hiring contracts in Spain, namely the *High-cost Permanent* contract and the *Casual Temporary* contract. In a market where the majority of temporary contracts were of *Selection Temporary* type, we should probably not find significant differences in investment in human capital between temporary and permanent contracts.

What is the link between type of hiring contract and effort?

Among the four types of contract, we should definitely expect that *Selection Temporary* contracts would be those to stimulate the greatest effort given that the worker feels that the likelihood of a transfer to permanent status depends on the level of effort shown. Nevertheless, we have already seen that it is difficult for those contracts to arise due to the problem of asymmetry of information. This shows the need for adequate policies to help correct this imperfection. In second place come *Average-cost Permanent* contracts. At the tail end we find *Casual Temporary* contracts and *High-cost Permanent* contracts, although for different reasons. *Casual Temporary* contracts supply less effort because the workers believe they are going to be fired quite apart from the level of effort made. On the other hand, workers with *High-cost Permanent* contracts may have little incentive to work hard because the likelihood of their being fired is not correlated with results.

What types of hiring contract provide the highest productivity per worker?

Once we have analyzed the link between type of contract and investment in human capital and effort, the relation between type of contract and productivity follows naturally. As may be seen in the above table, those labour markets characterized by *Average-cost Permanent* contracts and *Selection Temporary* contracts show higher productivity per worker.

The situation in Spain

Spain's labour market is today characterized by a well-known duality in labour contracts. There is a predominance of *Casual Temporary* contracts and *High-cost Permanent* contracts. The preceding analysis indicates that *a priori* they are the two forms of hiring contract showing the lowest productivity and that therefore this could help to explain the low productivity per worker in Spain.

The recent labour reform on May 9, 2006 promotes the creation of *Average-cost Permanent* contracts through a reduction of firing costs under new contracts (for example, from 45 days to 33 days per year worked). At the same time, it establishes the means for temporary contracts to operate as *Selection Temporary* contracts through tax benefits for converting contracts from temporary to permanent. If the reform achieves its objective, Spain's labour market would move into a new balance characterized by three types of contract – *Average-cost Permanent*, *Selection Temporary* and *High-cost Permanent* – and thus we could expect an improvement in productivity. Nevertheless, the measures agreed upon affect only small groups of employees and it is difficult to tell if the level of tax incentives offered will be sufficient to obtain the desired change in type of hiring contract.

(2) *Albert, C., García-Serrano, C. and Hernanz, V., (2005), «Firm-provided Training and Temporary Contracts», Spanish Economic Review, Volume 7, Issue 1.*

Wages: on upward move

The results of the labour cost survey for the first quarter of 2006 confirm the slight rise seen in wage increases in the final quarter of 2005. Inflationary pressures may have had a direct impact on wage negotiations thus changing the scenario of relative moderation operating last year.

In spite of this increase, total labour costs per worker showed a year-to-year rise of 3.4% while strictly wage costs were up 3.0%, in both cases well below average inflation for the period. The sharpest increases showed up in construction and in industry with increases in labour costs well above 4%. In services, on the other hand, the increase in wages was somewhat lower.

Inflationary pressures may have set new scenario in collective bargaining.

WAGE INDICATORS

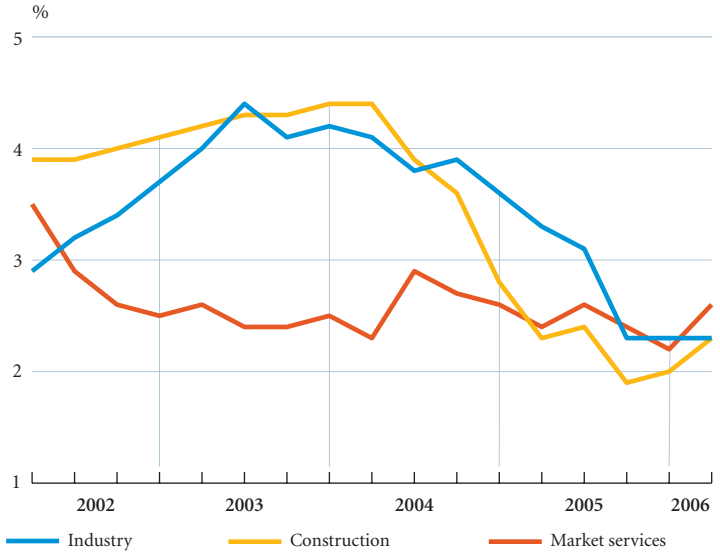
Percentage change over same period year before

	2004	2005	2005			2006	
			2Q	3Q	4Q	1Q	2Q
Increase under general wage agreements (*)	**3.0**	**3.0**	**2.9**	**2.9**	**3.0**	**3.1**	**3.1**
Wage per job equivalent to full-time work (**)	**3.3**	**2.5**	**2.6**	**2.3**	**2.4**	**2.6**	...
Quarterly labour cost survey							
Wage costs							
Total	2.8	2.6	3.4	1.9	2.5	3.0	...
Industry	*3.3*	*2.7*	*3.1*	*1.5*	*3.0*	*3.8*	...
Construction	*4.2*	*2.3*	*3.3*	*1.3*	*2.0*	*3.8*	...
Services	*2.5*	*2.9*	*3.8*	*2.6*	*2.8*	*3.0*	...
Average wages per hour worked	3.6	3.2	1.5	2.8	2.9	0.0	...
Other labour costs	3.6	3.6	3.5	3.7	3.1	4.4	...
Work day (***)	–0.8	–0.6	1.9	–0.9	–0.4	3.0	...
Farm wages	**2.8**	**3.1**	**3.0**	**2.7**	**3.0**	**2.6**	...
Labour cost in construction	**5.8**	**6.7**	**6.2**	**6.1**	**5.2**	**6.6**	...

NOTES: (*) Does not include wage revision clauses.
(**) Quarterly National Accounts: figures adjusted for seasonal and calendar differences.
(***) Effective hours worked per worker per month.
SOURCE: National Institute of Statistics, Ministry of Labour and Social Affairs, Ministry of Agriculture, Fishing and Food, Ministry of Public Works and internal figures.

HAS WAGE MODERATION COME TO AN END?

Annual change in wages per equivalent job



SOURCE: INE and internal figures.

Market sectors show wage increases higher than those in previous months but still below inflation.

From the point of view of competitiveness, the concern that might be caused by these wage increases was softened by the stability of wage cost per hour worked, which did not increase thanks to the greater number of hours worked. In any case, the effect of Easter Week may have influenced these figures so that we must wait for new data in order to confirm this situation.

The picture seen in figures from National Accounting is somewhat different given that the increase in average wages per worker in the first quarter generally slowed down in the various economic sectors except construction. Overall, average wages per worker grew by 1.7%, two decimals less than in the previous quarter.

This very modest increase and the slowdown taking place may be caused by the higher incidence of part-time work, given that, taking into consideration wages per equivalent job, we find not only greater growth but something of a tendency to increase rate, a fact more consistent with the labour cost survey. In fact, the increase in wages per job equivalent to full-time work would be 2.6% year-to-year, two decimals above the previous quarter.

Highest wage increases show up in non-market services.

The upturn in wages would be especially noted in market sectors, both in industry and construction as well as in services. In the first two cases, the increase stood at 2.3% whereas in services it came to 2.6%. In non-market services, the average increase fell to 3.2%, seven decimals below the previous period.

Prices

Disappointing CPI in May

Prices of the more volatile components in the consumer price index (CPI) again had a negative effect on the inflation rate which went up to 4.0% year-to-year in May. The harmonized consumer price index (HCPI), which makes possible comparisons with other Euro Area countries, stood at 4.1% year-to-year so that the differential with the Euro Area again increased to 1.6 points.

CPI again hits 4%.

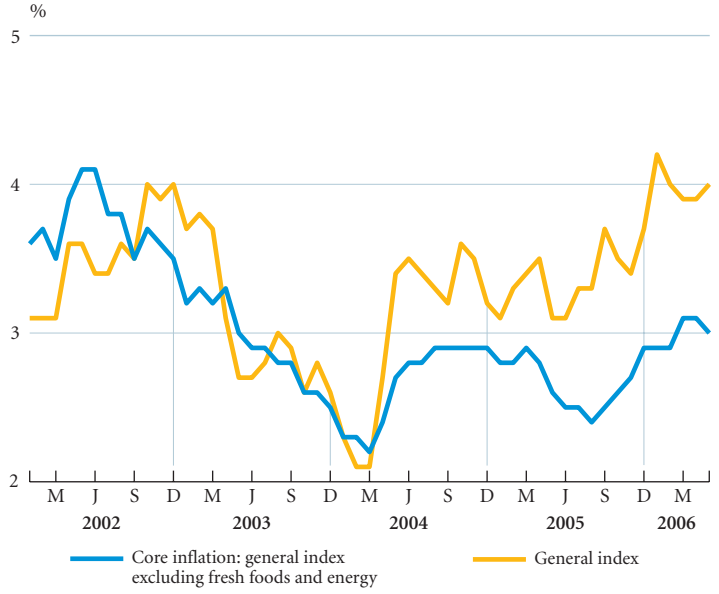
Prices of fuel and fuel-oil continue as the Achilles' heel of the CPI. Whereas between the beginning of 2004 and the present moment growth in the index has almost doubled, adding close to two percentage points to the year-to-year rate, three-quarters of this increase may be attributed to the increase in energy prices. This very heavy impact, something common in the developed countries, is turning out to be somewhat sharper in the case of Spain's economy than in the Euro Area. According to the HCPI, between January 2004 and May 2006, motor vehicle fuels rose by slightly more than 30% in the Euro Area, nearly seven percentage points less than in Spain.

Energy prices form Achilles' heel of CPI.

Fuel prices were not the only cause of the rise in the CPI. Seen over the mid-term, the most stable core of the CPI, that is to say, underlying inflation, has followed an upward course moving up nearly one percentage point since the

CPI AGAIN STANDS AT 4%

Year-to-year CPI rate



SOURCE: National Institute of Statistics and internal figures.

MOTOR VEHICLE FUELS UP MORE IN SPAIN

Harmonized consumer price index. Base 100 = January 2004

SOURCE: Eurostat and internal figures.

CONSUMER PRICE INDEX

	2005			2006		
	% monthly change	% change over December 2004	% annual change	% monthly change	% change over December 2005	% annual change
January	–0.8	–0.8	3.1	–0.4	–0.4	4.2
February	0.3	–0.6	3.3	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	1.4	1.8	3.9
May	0.2	1.8	3.1	0.4	2.1	4.0
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.

Processed foods account for greater part of increase in core inflation in recent months.

beginning of 2004. Processed foods were at the base of this increase and, although to a lesser extent, so were non-energy industrial goods. In the first case, cooking oil was a factor of constant increases and furthermore this was complemented largely by spirituous liqueurs and tobacco.

In the case of non-energy industrial goods, the increase in prices was more moderate if we take into account the

pressure from costs, both labour costs and other costs (energy, raw materials, logistics and distribution). The environment of sharp competition, the entry of low-cost imported products and the process of innovation and systematic cutting of prices in certain household products and home equipment has prevented higher price increases in this component.

Prices of services have not pushed up the CPI over the past two years, but nor have they granted any favours seeing that they have maintained a sustained increase with figures close to 4%. There are many reasons for this performance and these differ according to economic sector. In many sectors, however, the lack of competition, pressure on operational costs and new facilities costs (because of the real estate impact) have prevented

CONSUMER PRICE INDEX BY COMPONENT GROUP

May

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2005	2006	2005	2006	2005	2006
By type of spending							
Food and non-alcoholic beverages	120.8	0.1	0.2	1.7	1.1	3.2	3.6
Alcoholic beverages and tobacco	122.9	0.0	0.2	3.5	0.8	4.4	2.4
Clothing and footwear	120.6	1.1	1.2	0.1	0.1	1.2	1.4
Housing	122.6	0.0	0.4	3.1	4.6	5.1	7.5
Household equipment	111.0	0.5	0.5	1.2	1.6	2.1	2.6
Health	107.3	0.2	0.1	0.3	0.9	1.0	1.3
Transport	123.1	0.1	1.1	3.9	5.5	4.7	7.8
Communications	91.0	–0.1	–0.1	–1.0	–0.5	–2.0	–1.2
Recreation and culture	102.4	–0.4	–0.9	–1.4	–1.5	–0.4	0.6
Education	121.6	0.0	0.0	0.5	0.3	4.2	3.9
Hotels, cafés and restaurants	124.2	0.3	0.0	2.4	2.7	4.3	4.5
Other	118.3	0.1	0.2	2.7	2.8	3.1	3.5
By group							
Processed foods	119.6	0.1	0.1	2.0	2.1	3.4	3.9
Unprocessed foods	123.8	0.0	0.4	1.7	–1.0	3.0	2.4
Non-food products	117.4	0.2	0.4	1.8	2.5	3.0	4.2
Industrial goods	114.7	0.3	0.9	1.6	2.9	2.2	4.5
Energy products	*129.7*	*–0.2*	*1.7*	*5.6*	*9.9*	*6.8*	*14.4*
Fuels and oils	*137.7*	*–0.3*	*2.2*	*7.1*	*11.7*	*8.6*	*17.9*
Industrial goods excluding energy products	*110.0*	*0.5*	*0.6*	*0.3*	*0.7*	*0.9*	*1.5*
Services	120.7	0.1	–0.1	2.1	2.1	3.8	3.9
Underlying inflation (**)	116.5	0.3	0.2	1.4	1.6	2.6	3.0
GENERAL INDEX	**118.3**	**0.2**	**0.4**	**1.8**	**2.1**	**3.1**	**4.0**

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

Picture in producer prices becomes clouded...

any adjustment in prices in view of the notable strength of demand.

The only positive aspect in this period was the notable moderation (not without its ups and downs) in fresh food prices which today are growing four points less than at the beginning of 2004. Nevertheless, the extreme volatility of this component does not allow us to see consistent expectations about future performance, in spite of the apparent moderation in farm prices and prices of imported foods.

Wholesale prices at highest levels in 10 years

The picture in producer prices grew considerably darker in May. Apart from the already well-known impact of energy prices on industrial prices, other products also showed a negative performance which pushed this indicator up by 6.5% annual, the highest figure since mid-1995.

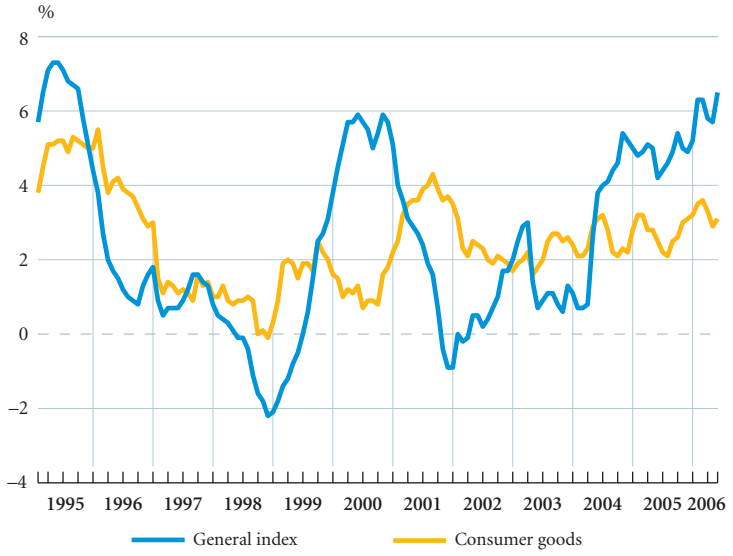
This widespread increase in factory-gate prices seems due more to the need of companies to compensate for the various increases in production costs than the possibilities that, in theory, arise from demand in a state of growth. The sustained rise in prices of energy and other intermediate goods (apart from other costs) has added an upward trend to factory prices which, naturally, could have negatives consequences not only for consumer prices but also for corporate competitiveness itself.

...but economic impact may be eased by import prices.

The impact on final consumer prices will depend on costs and margins along the distribution chain but the increases seen in base prices do not establish the best basis for containing inflation. In any case, the prices of non-food consumer manufactures are showing the greatest containment, probably because of pressure from international competition. In May, year-to-year growth held at 2.4%, practically the same level as in the five preceding

NON-FOOD CONSUMER GOODS: MODERATION ENDS

Year-to-year change in industrial price index



SOURCE: National Institute of Statistics and internal figures.

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											
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	16.4	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	1.9	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	4.1	6.3	3.5	2.1	3.6	20.6	5.7	–6.5	–5.2	15.3	–
February	0.7	6.3	3.6	2.1	3.9	20.1	6.5	2.5	3.2	9.3	4.3
March	–10.6	5.8	3.3	2.0	4.6	16.4	5.9	2.7	7.5	7.2	–
April	–8.1	5.7	2.9	2.2	5.1	15.4	7.4	3.2	–4.2	11.7	–
May	...	6.5	3.1	2.4	6.0	17.8	...	...	...	...	...

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

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

months. Nevertheless, the fact is that there seems to have been a halt in the slowdown trend which showed up in the second half of 2005.

This relatively difficult picture is partially eased by import prices. In the first four months of 2006, prices of consumer manufacturers rose by only 0.9% while imported food prices was down by 2.7%.

What is somewhat less certain is the situation in farm prices because of questions about the effect of the weather on certain products. Up until April, however, the performance in these prices was quite favourable if we take into account that the average decrease in farm products was 3.6%.

Uncertainty about future of farm prices.

Foreign sector

Increase in trade deficit moderates slightly in April

Good state of exports to third countries.

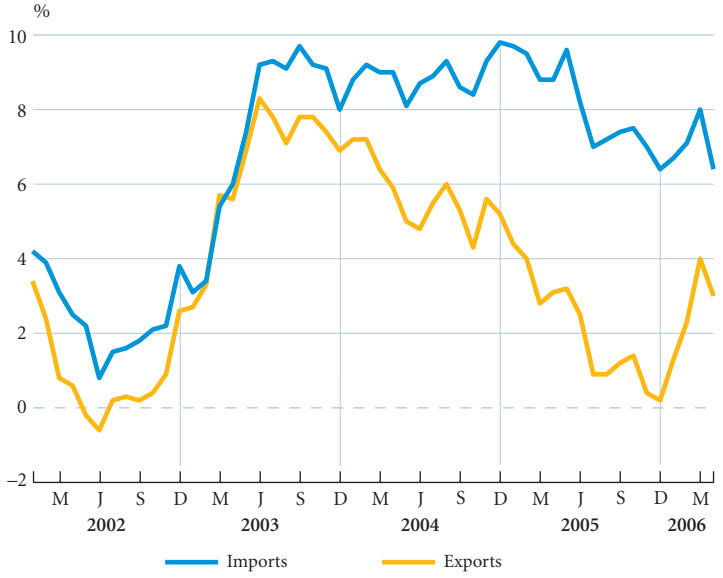
Trade with abroad in goods is showing a somewhat more positive picture than in previous months with regard to the rate of worsening of the foreign balance. In the first four months of the year the trade deficit of Spain's economy showed a substantially lower nominal increase than that seen in previous months, although it was still considerable at 20% nominal.

The slight improvement in the foreign trade picture was based on some recovery in the export situation, particularly in those countries outside the European Union. Sales to Latin America, United States and the more active group of Asian countries and Eastern Europe are turning out to be a sound pillar providing relief from a volume of business offered by the European market now substantially weaker and facing greater international competition. Exports to third countries thus grew by more than 20% in volume as against 2.9% in shipments to the European Union.

The strength of exports was very much concentrated in capital goods although sales in consumer goods held at acceptable levels. In the January-April period, exports of consumer goods grew by around 7% real (with difficulty in making price increases) while capital

IMPROVEMENT IN EXPORTS CONTAINING TRADE DEFICIT

Year-to-year change in foreign trade by volume (cumulative figure for 12 months)



SOURCE: Ministry of Economy and Finance and internal figures.

FOREIGN TRADE

January-April 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	13,478	44.0	16.2	2,571	54.7	4.6	–10,907	19.1
Consumer goods	23,464	14.2	28.1	20,609	6.5	37.2	–2,855	87.8
Food	*4,230*	*5.0*	*5.1*	*6,833*	*3.4*	*12.3*	*2,603*	*161.5*
Non-foods	*19,234*	*16.1*	*23.1*	*13,775*	*6.4*	*24.9*	*–5,458*	*71.6*
Capital goods	8,598	3.7	10.3	5,438	35.7	9.8	–3,159	63.3
Non-energy intermediate goods	37,816	9.7	45.4	26,738	9.9	48.3	–11,078	70.7
By geographical area								
European Union (EU-25)	49,371	8.8	59.2	39,377	5.7	71.1	–9,994	79.8
Euro area	*41,257*	*8.0*	*49.5*	*31,370*	*4.3*	*56.7*	*–9,887*	*76.0*
Other countries	33,985	24.5	40.8	15,979	32.4	28.9	–18,005	47.0
Russia	*2,276*	*38.1*	*2.7*	*419*	*32.6*	*0.8*	*–1,857*	*18.4*
United States	*2,909*	*15.2*	*3.5*	*2,381*	*34.5*	*4.3*	*–528*	*81.9*
Japan	*1,869*	*–8.3*	*2.2*	*454*	*17.9*	*0.8*	*–1,415*	*24.3*
Latin America	*4,416*	*47.5*	*5.3*	*3,125*	*42.9*	*5.6*	*–1,291*	*70.8*
OPEC	*7,089*	*41.5*	*8.5*	*1,357*	*6.6*	*2.5*	*–5,732*	*19.1*
Rest	*15,426*	*17.9*	*18.5*	*8,243*	*34.3*	*14.9*	*–7,182*	*53.4*
TOTAL	**83,356**	**14.7**	**100.0**	**55,356**	**12.2**	**100.0**	**–28,000**	**66.4**

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

goods rose by 30%. In the case of consumer goods, especially significant were the increases in consumer electronics (60.9% nominal), clothing and motor vehicle parts. Cars, on the other hand, showed stagnant although they represented the greater part of exports (12.0% of the total including motorcycles).

On the other side of the scale, we note some moderation in the increase in imports which, nevertheless, continued strong growth (14.7% in value as of April) affected, on the one hand, by the continued rise in imported oil costs and, on the other, by the flood of low-cost consumer products. With regard to the former, the average cost per imported ton of oil reached 358.5 euros halfway through the fourth month of the year, 49.7% more than in the first quarter of 2005. On the second point, foreign purchases of non-food consumer goods were up 15.4% by volume, an average price increase of 0.9%. In this case, textiles, clothing, footwear and consumer electronics were the groups of products showing the most significant increases.

Relative moderation in non-energy imports.

The recovery of exports and the relative moderation of imports has brought some easing in the growth of the trade deficit. This performance was due to the non-energy deficit seeing that the imbalance in energy continued to increase exponentially.

Price of energy could hamper incipient containment of trade imbalance.

Current account deficit equals nearly 8% of GDP

Current account deficit continues to get notably worse.

The balance of payments continues to run a poor course. Month after month, the deficit increases driven up by the various headings, thus reflecting the problems in the foreign sector. In March, the most negative contribution came in the trade balance although the other headings added to the increase in the imbalance which, in relative terms, came to 7.9% of the gross domestic product taking into account the cumulative balance for the past 12 months.

Trade balance and services balance behind this year's increased imbalance.

The worsening of the balance in March may partly be due to the effect of Easter Week which in 2006 was delayed to April. Naturally, this would work in favour of a rise in the trade deficit because of the increased number of working days and also against the tourist balance to the extent that this year the figures for March do not include potential inflows for tourism related to tourism linked to the Easter holidays. In any case, the worsening of the current account balance in the first quarter was substantial at 6.49 billion euros more than in 2005. Of this figure, 63% was for the increase in the trade deficit while the rest was for the services balance.

The drop in the services balance in the first quarter (2.4 billion euros in total) was largely due to the decrease in the tourist surplus (1.02 billion euros) which, in turn, may be explained almost in equal parts by the drop in inflows and the increase in payments made by Spaniards abroad.

BALANCE OF PAYMENTS

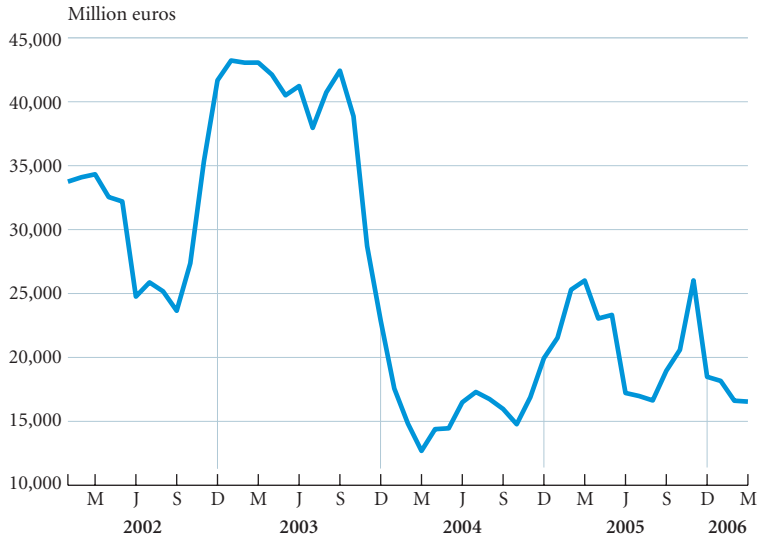
Cumulative figure for last 12 months in million euros

	March 2005	March 2006	% change
Current account balance			
Trade balance	–57,445	–73,072	27.2
Services			
Tourism	*26,314*	*25,347*	*–3.7*
Other services	*–4,173*	*–5,141*	*23.2*
Total	22,141	20,207	–8.7
Income	–14,103	–17,230	22.2
Transfers	–1,481	–3,026	104.3
Total	**–50,888**	**–73,121**	**43.7**
Capital account	**8,395**	**7,629**	**–9.1**
Financial balance			
Direct investment	–28,074	–34,625	23.3
Portfolio investment	89,707	75,495	–15.8
Other investment	–10,701	41,144	–
Total	**50,932**	**82,014**	**61.0**
Errors and omissions	–492	–2,565	421.8
Change in assets of Bank of Spain	–7,947	–13,956	75.6

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.

FOREIGN INVESTMENT IN SPAIN IN LOW STATE

Cumulative balance for 12 months



SOURCE: Bank of Spain and internal figures.

The current deficit was minimally compensated by the surplus in the capital balance amounting to 711 million euros in the first three months of the year. Net world borrowing of Spain's economy thus stood at 23.73 billion euros, 40.5% more than in 2005.

In the financial sphere, direct foreign investment in Spain was down by 20.1% in the first quarter, particularly corporate investment. In real estate, on the other hand, the downward trend noted in previous months seemed to have halted. Spanish direct investment abroad slowed its upward race in the corporate area but continued strong in real estate as a response to the need to diversify risk in assets held in other countries.

Direct foreign investment dropping while Spanish investment abroad shows positive profile, especially in real estate.

Public sector

Government revenues maintain growth in early months of 2006

Tax revenues go well above growth in domestic demand.

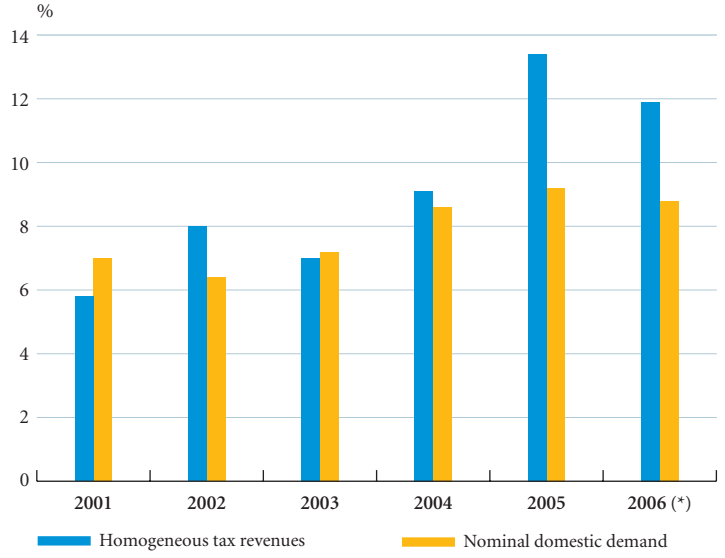
Central government collections through general taxes continue full steam ahead. In the first five months of 2006, tax revenues amounted to 72.2 billion euros, some 10.0% higher than the same period last year. This growth would be somewhat higher (specifically 12.6%) if calculated with homogeneous figures, that is to say, basically eliminating the distortions arising from changes in the calendar and the rate of rebate payments. As in previous years, tax collections are moving ahead significantly above the normal growth rate of domestic demand (8.8% in the first quarter) although there seems to be some incipient moderation showing up in growth.

Direct taxes growing at fast rate, especially corporate taxes.

The good state of tax collections applies to all the main tax headings except special taxes. Revenues from personal income tax were up by 11.8% in homogeneous terms, hold-backs on investment funds being the strongest component although not the most significant. Increases on the stock market in the early months of 2006 meant that this heading grew by 28.6%. The increase in revenues from wage hold-backs (11.9%) was not as strong but the volume covered nearly one-third of total tax collections. Under this heading, the most notable growth showed up in small and medium-sized

TAX COLLECTIONS GROWING FASTER THAN DOMESTIC DEMAND

Year-to-year change in tax collections and nominal domestic demand



NOTES: (*) Available cumulative period.
SOURCE: Ministry of Economy and Finance and internal figures.

companies and general government. Finally, hold-backs for rental incomes and earnings on capital rose at a rate slightly above 10%.

Under direct tax revenues, those for corporate tax also grew in a spectacular manner (up 20.8% in homogeneous terms) thanks to good company profits.

In the area of indirect taxes, funds coming from value added tax (VAT) reveal growth of 14.7% with the biggest strength showing up in collections from the large company segment. On the other hand, special taxes have lost pace because of the negative impact on collections for this product as a result of the drop in tobacco consumption. Nevertheless, other headings such as the special tax on fuels also present very small increases in collections (1.9%), attributable to an easing off in use and changes in fuel consumption habits.

VAT collections up considerably but revenues from tobacco and petrol down.

Savings and financing

Funding of private sector pushes ahead strongly

Bank interest rates continue to rise but still hold at very low levels.

Bank interest rates continue to rise thus gradually shifting the series of rate increases begun by the European Central Bank last December. On average, interest rates on loans and credits granted by credit institutions to the private sector rose by 41 basis points in the first four months of the year. Nevertheless, bank interest rates generally remained at low levels, both in nominal and real terms, that is to say, discounting inflation, given that rates were only a few decimals above the inflation rate.

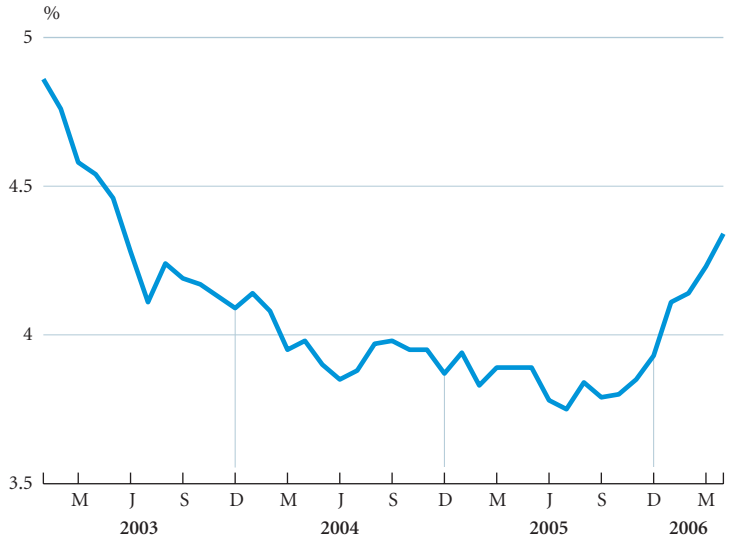
Credit to companies up 26% in past year, the highest rate in at least ten years.

The interest rate on loans and credits granted to non-financial companies by credit institutions in April stood at 3.97%, barely above inflation. The interest rate on housing loans granted to households stood at 3.93%, the same level as inflation, or practically at zero interest rate. The interest rate for acquisition of consumer goods was slightly higher (6.69%) but financial institutions have been applying easy repayment terms for this type of loan.

In this situation, the demand for funding from the private sector remains strong. Total funding to non-financial companies and households in April rose

LOAN INTEREST RATES CONTINUE TO RISE

Interest rates on loans and credits granted to private sector by credit institutions. (New transactions)



NOTES: Equivalent annual rate.
SOURCE: Bank of Spain.

by 22.1% compared with the same month in 2005, one point more than in December. Funding going to companies grew more than that channelled to households over the past 12 months at 22.8% compared with 21.4%. What stood out was credit granted to companies which rose by 25.8% compared with April last year, the highest growth rate for at least 10 years.

The main component of funding to individuals, namely housing loans, showed little sign of slowing down, with a rise of nearly 24% at year-to-year rate in April. Demand for mortgage loans remains strong, spurred on by almost zero real interest rates and the good state of the economy and employment, along with demographic variables.

Furthermore, loans to households for purposes other than housing, such as for buying consumer durables (cars, motorcycles, travel, etc.), securities and lands, continues on an upward path. As a result, such loans to households rose by 14.7% in the year ended in April, some 1.4 points more than in December.

Consumer loans also showing strong.

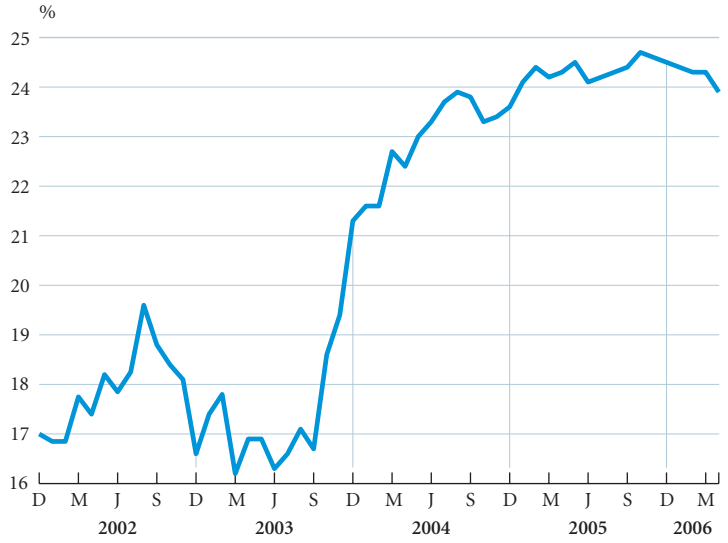
Sustained growth of bank deposits

On the other hand, bank deposits of companies and households are showing very strong growth, more than twice that in the Euro Area, thus reflecting the strength of the economy. What stands out is the growth of deposit accounts with a term of more than two years which enjoy a tax benefit of 40% on interest. On-demand and savings accounts, which have lower yields, rose by 11.7% in the last 12 months ending in April.

Another financial instrument for which specific information is available is participations in investment funds. The assets of investment mutual funds stood at 252.87 billion euros at the end of May, a drop of 2.29 billion euros compared

BANK LOANS FOR HOUSING SCARCELY SLOWING DOWN

Year-to-year change in loans by resident credit institutions and securitized loans for housing purposes



SOURCE: Bank of Spain.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

April 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (**)	396,684	494	0.1	41,573	11.7	40.9
Up to 2 years (*)	203,587	13,067	6.9	33,721	19.9	21.0
More than 2-year term (*)	275,320	34,713	14.4	127,299	86.0	28.4
Repos	69,737	–3,309	–4.5	–188	–0.3	7.2
Total (*)	**945,329**	**44,965**	**5.0**	**202,406**	**27.2**	**97.5**
Deposits in currencies other than euro	**23,776**	**8,137**	**52.0**	**17,621**	**286.3**	**2.5**
TOTAL (*)	**969,105**	**53,102**	**5.8**	**220,027**	**29.4**	**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.

Drop in total assets of investment mutual funds in May because of poor stock market results.

with April. Nevertheless, in the first five months of the year these assets rose by 7.01 billion euros (2.85% above December) marking up a rise of 10.1% over May 2005. The drop in the assets of securities mutual funds in May was due to the poor results on the stock market that month, given that net new money (excluding withdrawals) recorded came to 649 million euros.

Investor preference continued to be directed into global funds which, as a result of their flexible strategy make higher gains possible, while taking on greater risk. Nevertheless, as distinct from the first four months of the year, it was notable that a segment of savers leaned toward money-market funds and short-term bond-based funds with a conservative profile, probably influenced by the upsets in financial markets in May.

Alternative Stock Market for investment mutual fund companies begins operations.

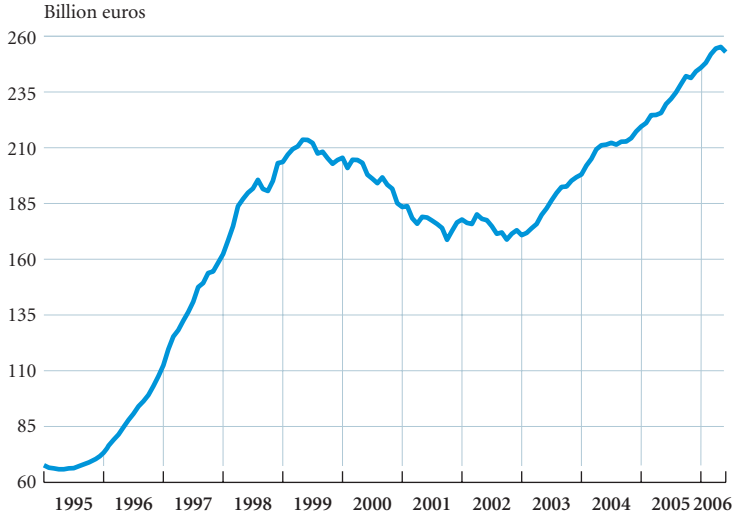
Average yield obtained by securities mutual funds in the past 12 months ending in May was 3.85% on average, although they showed a wide range depending on the various types. Long-term bond-based funds thus showed capital losses of 0.54%. Funds based on shares of emerging countries headed the classification list with 37.0% in spite of the punishment received in the last month. Japanese share-based funds came in second place with 28.8% while national share-based funds obtained 21.5%, thus stepping into third place.

In addition, the assets of mutual investment fund companies, the type of institution most used by large investors, reached 28.69 billion euros at the end of the first quarter, the latest figure available. The number of shareholders on that date was 421,522. A new development was the start-up of the Alternative Stock Market (MAB) for investment mutual fund companies which is to be expanded to include other instruments in the future. As a result, investment mutual fund companies have available to them quotations of a new market incorporating electronic trading, a fact which means lower costs compared with the traditional market floor system.

Finally, total assets of securities mutual funds rose to 7.56 billion euros in May, a

DROP IN ASSETS OF SECURITIES MUTUAL FUNDS IN MAY

Total assets of securities mutual funds



SOURCE: Inverco.

monthly increase of 2.5% and an increase of 16.8% compared with the end of 2005. This type of investment fund had 146,228 participants, some 7.8% more than in December. Average yield on these funds in the past year came to 6.20%.

Assets of securities mutual funds move up 17% in last five months.

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