SEPTEMBER 2006

THE SPANISH ECONOMY

Monthly Report

NUMBER 294

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	3.2	3.4	2.8	3.3	3.1	3.4	3.1	3.7	3.6	3.1
Japan	2.6	2.5	1.9	1.1	2.7	2.7	4.0	3.4	2.2	2.6
United Kingdom	1.8	2.4	2.4	1.9	1.7	1.9	1.8	2.2	2.6	2.4
Euro area	1.5	2.4	1.8	1.2	1.3	1.7	1.8	2.1	2.6	2.4
Germany	*1.1*	*2.1*	*1.3*	*0.4*	*0.8*	*1.5*	*1.7*	*1.7*	*2.4*	*2.0*
France	*1.2*	*2.0*	*1.9*	*1.6*	*0.8*	*1.4*	*1.0*	*1.4*	*2.6*	*2.1*
Consumer prices										
United States	3.4	3.5	2.9	3.0	3.0	3.8	3.7	3.7	4.0	3.5
Japan	–0.3	0.2	0.3	0.0	–0.1	–0.3	–0.7	–0.1	0.2	0.3
United Kingdom	2.3	2.5	2.4	2.2	2.2	2.4	2.2	2.2	2.8	2.8
Euro area	2.2	2.3	2.2	2.0	2.0	2.3	2.3	2.3	2.5	2.4
Germany	*2.0*	*1.8*	*2.3*	*1.7*	*1.7*	*2.1*	*2.3*	*2.0*	*1.9*	*1.7*
France	*1.7*	*1.8*	*1.8*	*1.7*	*1.7*	*1.9*	*1.6*	*1.8*	*1.5*	*1.8*
SPANISH ECONOMY		Forecast								Forecast
Macroeconomic figures										
Household consumption	4.2	3.5	3.0	4.4	4.4	4.1	3.8	3.8	3.6	3.4
Government consumption	4.8	4.4	4.4	5.5	4.3	4.5	4.9	4.4	4.4	4.5
Gross fixed capital formation	7.0	6.1	5.2	6.8	7.4	7.1	6.6	6.3	6.1	6.1
Capital goods	*9.0*	*8.9*	*7.6*	*9.2*	*9.8*	*8.3*	*8.6*	*8.6*	*9.1*	*9.1*
Construction	*6.0*	*5.6*	*4.0*	*6.0*	*6.2*	*6.3*	*5.6*	*5.8*	*5.7*	*5.6*
Domestic demand (contribution to GDP growth)	5.2	4.7	4.1	5.4	5.3	5.2	5.0	5.0	4.8	4.6
Exports of goods and services	1.5	6.2	4.8	–0.8	1.8	2.5	2.3	9.5	5.3	5.1
Imports of goods and services	7.0	8.8	6.5	5.9	7.7	7.7	6.6	12.4	7.9	7.5
Gross domestic product	**3.5**	**3.6**	**3.2**	**3.4**	**3.5**	**3.6**	**3.6**	**3.6**	**3.7**	**3.6**
Other variables										
Employment	3.1	3.0	2.6	2.9	3.1	3.3	3.2	3.2	3.1	3.0
Unemployment (% labour force)	9.2	8.6	8.7	10.2	9.3	8.4	8.7	9.1	8.5	8.4
Consumer price index	3.4	3.8	3.1	3.3	3.2	3.4	3.6	4.0	4.0	3.8
Unit labour costs	2.2	2.5	2.2	2.4	2.3	1.9	2.3	2.4	2.6	
Current account balance (% GDP)	–7.5	–8.8	–8.3	–8.5	–7.7	–6.8	–7.0	–10.6	–8.1	
Not lending or net borrowing rest of the world (% GDP)	–6.5	–8.0	–7.5	–8.0	–6.4	–6.0	–5.9	–10.3	–7.6	
Government balance (% GDP)	1.1	0.9	0.5							
FINANCIAL MARKETS		Forecast								Forecast
Interest rates										
Federal Funds	3.2	5.0	5.2	2.4	2.9	3.4	4.0	4.4	4.9	5.3
ECB repo	2.0	2.8	3.7	2.0	2.0	2.0	2.1	2.3	2.6	2.8
10-year US bonds	4.3	5.0	5.5	4.3	4.2	4.2	4.5	4.6	5.1	5.1
10-year German bonds	3.4	3.9	4.5	3.6	3.3	3.2	3.4	3.5	4.0	4.0
10-year Spanish bonds	3.4	3.9	4.5	3.6	3.3	3.2	3.4	3.5	4.0	4.0
Exchange rate										
$/Euro	1.25	1.27	1.35	1.31	1.26	1.22	1.19	1.20	1.26	1.28

THE SPANISH ECONOMY
MONTHLY REPORT
September 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	
Staff	25,254
Branches	5,053
Self-service terminals	7,208
Cards	8,408,956

COMMUNITY PROJECTS: BUDGET FOR ACTIVITIES IN 2006	Million euros
Social	160
Cultural	70
Science and environmental	54
Educational	19
TOTAL BUDGET	**303**

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Contents

Good times for balances of payments

Current account balances are going through a change. Ten years ago, the biggest imbalances between developed countries showed up in Australia and New Zealand, with a current account deficit with abroad equal to 5-6% of the gross domestic product (GDP). At the other extreme, Switzerland enjoyed a surplus of close to 7% while the Netherlands and Belgium reached a meritorious positive figure of 5-6%. In recent years, the spread of current account imbalances has increased considerably. In 2005, Island's current account deficit went to no less than 16.5% of its GDP, brought about by a dangerous overheating of its economy. Alongside this, the deficits of New Zealand and Greece (above 8%) almost seem like deviations of little importance. On the good side, Norway raised its already high current account surplus to 17% of the GDP thanks to oil prices and it is estimated that in 2006 this will go above 20%. Switzerland had a surplus of «only» 13% of the GDP.

This growing spread of current account deficits may be seen as a sign of the good operation of international financial markets. Are we now working within a more efficient framework of relocation of savings and investment at the international level? The reduction of barriers to the free circulation of capital, the entry of large countries formerly excluded (for example, China) into the global trade and financial scene and the monetary integration of the Euro Area provide some clues for explaining one of the most surprising phenomena among economic trends in recent years.

But this is not any capricious study. When the United States can incur a current account deficit of more than 800 billion dollars in a single year (more than half Spain's GDP) the alarm bells start ringing. It scarcely represents 6.4% of the GDP, nothing out of this world going by the imbalances mentioned earlier, and more so if we take into account the excellent performance trend in US productivity. Nevertheless, its upward trend, its origin in consumer spending and borrowing taking place in the household sector set a growing risk for economic stability. Any brusque adjustment, set off by some unexpected event, could have an impact on the economy and world financial markets.

Spain also stands in the red. Its current account deficit in mid-2006 was already at 8% and at year-end will reach 9% of the GDP. World bodies, analysts and the economic authorities themselves all consider it a serious problem. There is more controversy about its root causes. The loss of competitiveness accounts for part of the problem. Spain's share of exports in world trade was down to 1.79% in 2005 as against 1.99% the year before. The rise in energy costs weighs heavily on this in one of the few developed countries which has not been able to reduce its energy dependence in recent decades. The stage in the economic cycle, that is to say, the sharp growth of the economy probably accounts for the greater part of this weakness. The upward trend in the negative balance is taking place not because of greater consumption but rather because of higher investment, which could be good news. However, this must be quickly qualified because it consists of investment mainly in the housing sector. This is a pattern of growth which, as has been said many times, poses some unknowns regarding its sustainability in a globalized world. The only certainty is that, with no exchange rate risk in the Euro Area, foreign capital will continue to finance Spain's growing foreign deficit, although any increased cost in such funding in the future, sooner or later, will end up putting a brake on borrowing.

August 30, 2006

OVERALL SUMMARY

A lively summer

Summer events (war in Lebanon, record high oil prices) create anxiety but overall state of economy favourable...

War in Lebanon, all-time record in oil prices, collapse of Doha Round, rumours of recession in the United States. The ingredients of the 2006 summer salad cannot be called very stimulating. But this must be qualified. Following the cease-fire between Israel and the Hezbollah militia, the per-barrel price of crude oil dropped considerably and the stock markets recovered from their slump. Furthermore, the Euro Area is showing stronger than expected growth, China continues its two-digit growth unchanged and Japan is maintaining relatively high growth. Where do we stand, then? In terms of growth, the world economy is maintaining a high point although the forecasts are for a gradual slowdown. In matters of inflation, the rise in oil continues to have little effect on non-energy indices. With regard to imbalances (balance of payments and public accounts), prospects are relatively good.

...although increasing risk that slowdown in United States may be sharper than desired because of drop in housing sector.

One matter generating much debate in coming months is the risk of recession in the United States. Following a brilliant first quarter, the US economy showed a notable slowdown in growth rate in the April-June period. In quarter-to-quarter rate annualized, it went from 5.6% to 2.5% although the later revision put the latter figure at 2.9%. All demand components are tending to moderate growth which, in any case, is still considerable. It is real estate that has set off alarm bells. Everyone believed there would be a gradual slowdown but latest figures suggest a sharp drop. New housing sales are down 20% while prices are the same as one year ago.

For now, Federal Reserve halts succession of reference rate increases as it awaits new figures...

Companies continue to do well, given that profits are still hitting highs. Consumers, however, do not see things so clearly. Consumer confidence indicators for August showed notable decreases. The rise in petrol that month and the weakness in real estate, which could turn around the wealth effect, are not unconnected to this result. Even Bernanke (chairman of the Federal Reserve) does not seem to see things all that clearly. The Federal Reserve raised its reference rate to 5.25% at the end of June in the seventeenth consecutive increase since June 2004. Nevertheless, when the chairman of the Fed appeared before Congress in mid-July he was already opening up the possibility of halting the chain of increases at the next meeting in August, as actually took place. The Fed does not want to take the risk of precipitating a halt in the economy although it is carefully watching the slightest sign of any change in inflation. Our forecast scenario points toward a still gradual slowdown in the second half-year which could put growth for the year above 3% but with a further rise in the Fed rates to 5.50% in the final quarter.

The past two years of increases in short-term interest rates have put US monetary policy at a more neutral level. Other central banks of the main countries have also opted for tightening monetary policy. In July, the Bank of Japan decided to raise the objective level of its overnight interbank interest rate for the

first time since 2001 from 0% to 0.25% as it considered that the long stage of deflation in the Japanese economy had come to an end. China again raised its reference rate for 1-year loans to 6.12% in a move aimed at gradually containing the overheating of its economy. In turn, the Bank of England made a surprise increase in its official interest rate at the beginning of August putting it up 25 basis points to 4.75% in view of the risk of inflation.

The European Central Bank (ECB) also is keeping to an upward wave. At the beginning of August it raised its reference to 3%, one percentage point above the floor reached in the 2003-2005 period. This came as no surprise. Jean-Claude Trichet had already given an inkling of this at the press conference held following the governing board meeting in July. What was new was the more aggressive tone he employed in August which is interpreted as a foretaste of a further tightening in October. The excellent results in the gross domestic product (GDP) and the risk of inflation provide sufficient margin for further rate increases in the Eurosystem.

In fact, growth in the Euro Area in the second quarter came to 2.4% at year-to-year rate, the highest rate in five years and well above what the experts were expecting. These results provide some margin to continue tightening monetary policy. In terms of inflation, the prospects are not too bad but inevitably the year is going to end up with rates above the 2% desired by the bank in Frankfurt. In July, the harmonized consumer price index (HCPI) stood at 2.4% (one decimal less than in May and June) and it is possible that toward the end of the current year the year-to-year rate will add on the odd decimal, as against the ECB forecast band of 2.1% to 2.5%.

In any case, economic prospects in the Euro Area are not entirely clear. Some confidence indicators do not anticipate a brilliant second half-year. In the case of Germany, the stagnation in consumption in April-June, in spite of the improvement in the labour market, was surprisingly negative. Fears are worse for 2007 when the effect of tighter money joins up with a strong euro in a context of slowdown in international economic activity. On top of this comes the increase in indirect taxation in Germany the effects of which on consumer spending are uncertain. For this reason, growth forecasts for 2007 remain contained awaiting further figures.

...while Japan abandons policy of zero interest rates and ECB maintains tight money policy in view of favourable Euro Area economy.

Spain's economy: more and more solid!

While the results for the Euro Area in the second quarter were favourable, those for Spain were excellent. Account to early figures released by the National Institute of Statistics, year-to-year growth was 3.7%, following three quarters which held at 3.6%, according to the upward revision of the GDP series carried out by the statistics body. While at the beginning of the year we were anticipating a slowdown as of mid-year, the fact is that the improvement in the foreign sector has not only invalidated this forecast but could be an indication of a recovery of economic activity.

Second quarter results for Euro Area better than expected but some doubts remain whether these trends will continue in coming months.

In fact, national demand is showing a profile of definite moderation although with growth still at high levels (increase of 4.8% in the second quarter). Household consumption recorded a rise of 3.5%, nearly one percentage point less than one year before. Investment in construction is moving ahead at a fairly stable rate, with a very positive performance in civil works and housing

Excellent growth results in Spain in second quarter thanks to contribution of foreign sector.

Recovery of industrial sector to be noted following sharp adjustment in 2005.

construction showing high but flat growth, with some signs of wearing out. On the other hand, investment in capital goods is showing a clearly expansionist profile putting year-to-year growth at around 9% since the end of 2004.

One of the most notable factors in the recent trend is the recovery of the industrial sector. Following a year of stagnant growth in 2005 with tough competition from imports from low-cost countries and an export market in the doldrums due to the weakness of most of Spain's main trading partners, industry appears to be beginning to come out of the slump. This was anticipated by the industrial production index over recent months. The recovery of exports and the continued growth of capital goods demand have been crucial factors in this recovery, led by chemicals, metals, machine-building, medical equipment and motor vehicles. Furthermore, the figures for the Quarterly National Accounts show a notable rise in the labour production factor (GDP generated by full-time employment). In any case, we should not ignore those branches which are subject to sharp competition, such as textiles, clothing, furs and leather.

Tourism also contributing its grain of sand to sustaining economic activity in spite of low inflows per tourist.

The export of services, led by tourism, is also responsible for the mini-recovery in the second quarter. This year will again beat the statistics for tourists and hotel occupancy has hit high levels, thanks to the improvement in the two main source countries, Germany and United Kingdom. It is true that average inflows per tourist is down but total inflows continue to contribute to an improvement in the contribution of the foreign sector to growth.

Apart from high growth and job creation, the strong drive in capital goods investment, improvement in productivity in industry and recovery in exports make up the most hopeful factors at this juncture.

The present positive economic situation is even more meritorious if we take into account the fact that monetary conditions and not working in its favour. Interest rates continue low but, since the beginning of the year, the increases by the ECB are making their effect felt. The euro has also revalued notably against other currencies thus making imports cheaper and putting up the price of sales abroad. This economic drive is making it possible to continue showing the favourable results of budgetary policy which in 2006 is on the way to repeating the 1% surplus in the GDP reported in 2005.

In this expansionist situation, job creation has held at the level of 3% in recent quarters, which is equivalent to net creation of more than a half-million jobs in one year. Construction is still the leading mother-lode of employment but we note something of an improvement in the industrial sector and a certain drop in services. On the other hand, prices continue to bring surprises given that the effect of fuel increases and resistance in other goods and services put the increase in the consumer price index at 4% year-to-year in recent months, although the early indicator for August (3.8%) makes it possible to foresee some moderation in the final months of the year.

Finally, the current situation continues to be marked by strong economic growth with high job creation. But the most notable factors are the signs of improvement in the industrial sector in terms of business activity and productivity coming as a result of capital goods investment and exports. We need to watch this trend which could indicate a change in direction from the traditional pattern of growth in the past 10 years, based on private consumption and construction, to one more concentrating on investment and taking advantage of opportunities opening up in the global economy.

CHRONOLOGY

2005

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	**4**	Agreement between government, business organizations and trade unions on **labour reform** aimed at reducing extent of temporary work.
	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%.
July	**11**	European Council authorizes **Slovenia** to adopt euro as currency as of January 1, 2007.
	24	Multilateral negotiations in **Doha Round** of World Trade Organization, aimed at greater liberalization of international trade, indefinitely suspended.
August	**3**	**European Central Bank** raises official interest rate to 3.00%.
	8	One-month forward price of Brent quality **oil** goes up to all-time high of 78.49 dollars a barrel.
	12	UN Security Council approves resolution for **cease-fire in Lebanon** in conflict between Israel and Hezbollah.
	30	IBEX 35 index for **Spanish stock market** marks up annual high (12,171.9) with cumulative gains of 13.4% compared with end of December 2005.

AGENDA

September

1 EU GDP (2nd Quarter).
4 Social Security registrations and registered unemployment (August).
8 Industrial production index (July).
13 Consumer price index (August).
15 Balance of payments (June). EU CPI (August).
19 Central government revenue and spending (August).
20 Labour cost survey (2nd Quarter).
Federal Open Market Committee meeting.
25 Producer price index (August).
26 Foreign trade (July).
28 Early CPI (September).

October

3 Social Security registrations and registered unemployment (September).
5 Industrial production index (August).
Governing Council Meeting, European Central Bank.
11 Consumer price index (September).
16 Balance of payments (July).
17 Harmonized CPI for European Union (September).
24 Central government revenue and spending (September).
Federal Open Market Committee meeting.
25 Producer price index (September).
26 Foreign trade (August).
27 Labour force survey (3rd Quarter). US GDP (3rd Quarter).
30 Early CPI (October).

INTERNATIONAL REVIEW

Housing market in United States slows economy.

Growth rate in United States eases with drop in housing

When a locomotive runs for a long time it is logical that it will begin to overheat. In that case, a good engine-driver would try to gradually reduce speed. This is how we may understand the cautious optimism of Ben Bernanke, governor of the Federal Reserve, in view of the slowdown in the US economy in the second quarter. Slower growth should moderate the inflationary signs showing up and, furthermore, if moderation should come along with some normalization of a real estate market that was beginning to get somewhat dizzy, so much the better. To make things even brighter, the slowdown in housing should reduce the strength of consumption. With lower consumer desire to buy, imports might ease off, and the rest would be up to a weaker dollar which should give a boost to exports so that the trade deficit, the threat to which we have all become accustomed although it still remains a threat, should be able to move into a path of correction. What more can we ask?

Just two things. First, that the halt is not brusque and that it really is able to lower the temperature, that is, reduce inflation. The slowdown does exist although it was masked by a strong first quarter which, along with the downward correction for growth in 2005 in the normal July revision carried out by the Bureau of Economic Analysis, could put economic activity in 2006 above that for 2005. But the gross domestic product (GDP) for the second quarter was down more than

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	June	July
Real GDP	3.9	3.2	3.1	3.4	3.1	3.7	–	3.6	–	–
Retail sales	6.2	7.2	7.9	8.2	6.2	8.3	7.0	7.6	5.4	4.8
Consumer confidence (*)	96.1	100.3	102.3	98.9	95.8	105.7	109.8	104.7	105.4	106.5
Industrial production	4.1	3.2	3.1	2.7	3.0	3.3	4.6	4.4	4.4	4.9
Industrial activity index (ISM) (*)	60.5	55.5	53.2	56.0	57.0	55.6	57.3	54.4	53.8	54.7
Sales of single-family homes	10.1	6.6	6.8	11.9	3.1	–11.6	–8.7	–11.1	–11.1	...
Unemployment rate (**)	5.5	5.1	5.1	5.0	4.9	4.7	4.7	4.6	4.6	4.8
Consumer prices	2.7	3.4	3.0	3.8	3.7	3.7	3.6	4.1	4.3	4.2
Trade balance (***)	–611	–717	–664	–689	–717	–739	–746	–754	–760	...

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

TREND IN UNITED STATES GDP BY COMPONENT

Percentage year-to-year change in real terms

SOURCE: Bureau of Economic Analysis and internal figures.

expected growing by a rather slim 2.9% quarter-to-quarter annualized, although at annual rate (3.6%) the slowdown appears to be much more modest. Consumption also moved up by 2.6% quarter-to-quarter (increase of 3.0%

Prices stagnant while sales drop...

year-to-year), far from the rate at the beginning of the year and the foreign sector improved with the best contribution to growth of the decade, with the exception of 2001. As opposed to the end of 2005, the slowdown came about in all components of domestic demand but with greater emphasis in capital goods investment and investment in software (which went from growth rates of 15% to a drop), especially in the slowdown in construction which was down by 9.8% compared with the previous quarter. If these decreases should continue, they could mean that the slowdown was less gradual than expected. Could this be true?

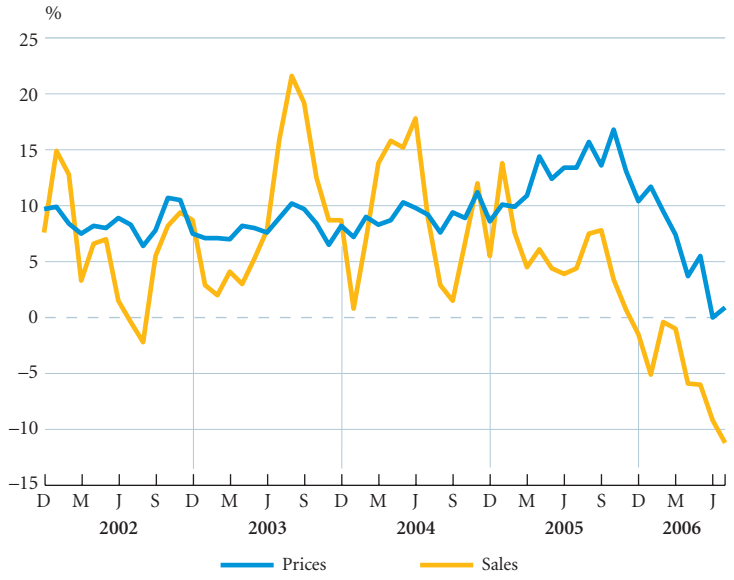
...but consumption holds up even without support from mortgage market.

The housing market is definitely slowing down. Up to July, the latest indicators for existing housing, making up four-fifths of sales in monetary terms, lent support to the hypothesis of a gradual slowdown but the figures were undoubtedly weak. At the beginning of 2006 there was a sharp drop as a reaction to the peak in the summer of 2005 with a return to the general trend. Nevertheless, sales in July accentuated the decrease with a drop of 11.2% year-to-year and prices are stagnant in terms of the same period the year before, whereas at the end of 2005 they were moving up by 10%. In new housing the situation is even more accentuated with drops of 21% in the number of units sold. Housing starts and building permits also point in the same direction – downward.

The weakness in real estate, with a possible reversion of the wealth effect and the financing of spending by means of increasing mortgages which, up until now, has helped the consumer to a considerable degree, today constitutes the biggest risk that the slowdown in the economy could be greater than desired. Nevertheless, for the moment, these effects are still limited and consumers continue to act as before. In July, confidence levels were maintained and retail sales (excluding erratic

UNITED STATES: SLOWDOWN IN HOUSING NOT NOW GRADUAL

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



SOURCE: Federal Housing Board, National Association of Realtors and internal figures.

UNITED STATES: CONSUMERS STILL ACTIVE

Year-to-year change in retail sales excluding cars and petrol

SOURCE: Departament of Commerce and internal figures.

components such as cars and petrol) continued to show strength with a year-to-year increase of 7.8%. In August, however, the indices were down notably.

The good state of the economy is getting support from a sector which, until recently, has been very slack. Industrial production in July moved up by 4.9% year-to-year and the trend is upward. This feeling of improvement, which goes beyond the statistics, is shared by business executives, with the ISM manufacturing index for industrial sentiment and business activity moving up to the 54.7 points level in July in a framework of some stability. Nevertheless, business executives in the non-manufacturing sector, which is of growing importance, stuck to the scenario of a slowdown although still a gradual one. Activity indices in that sector are even above the 50 level and therefore those predicting improvements exceed those seeing a worsening although the tendency is downward. The engine is slowing down gradually thanks to housing but there is still the question of prices.

Industry improves positions and companies even see maintenance of business activity.

The increase in the consumer price index in July stood at 4.2% year-to-year, a rate which should be come down so long as oil moderates its increases. Of more significance are the increases in the underlying inflation index (not including energy or food) which with 2.7% in July repeated the figure for the previous month and reached a peak in an upward trend as did the GDP deflator. The July figures, however, have been relatively good with industrial prices lower than expected. Base effects, high levels of utilization capacity, oil and especially an incipient tightening of the labour market are keys to the trend in inflation.

In recent months job creation has slowed down. Nevertheless, wages are beginning to gain ground after having lost purchasing power for many months. Unit wage costs, in spite of acceptable productivity levels, showed an increase of 4.2% year-to-year. It is true, however,

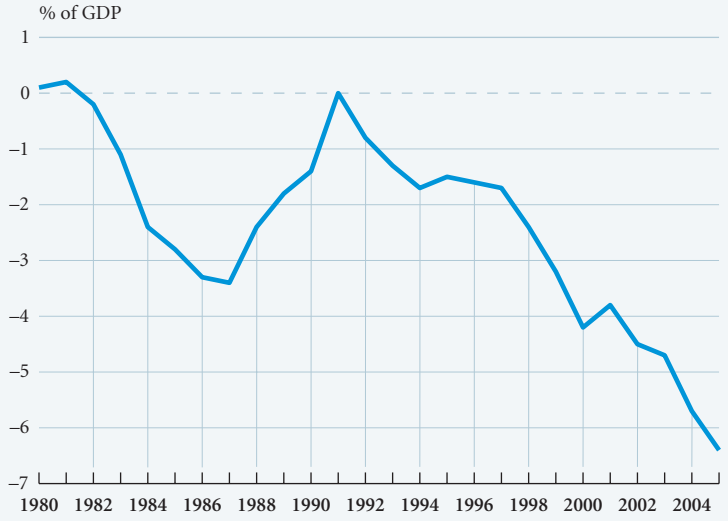
Prices stabilize increases but labour market tightens.

United States: a positive view of current account deficit

The growing trend in the deficit of the US current account balance has been the subject of concern and debate. In 2005 it reached 6.4% of the GDP, or 804.95 billion dollars in absolute terms.

THE UNENDING DEFICIT

US current account balance



SOURCE: International Monetary Fund (IMF).

To what extend the worsening of the current account deficit is worrisome? Having a surplus or a deficit in itself is neither good nor bad. If the deficit is sustainable, in other words, if in the future the United States is able to return the funds borrowed without dramatic adjustments in the real economy, this should not trouble us. A positive reading of the deficit shows that one major cause of the US imbalance is the expected increase in the level of productivity. If these expectations of growth are met, the deficit could easily be absorbed, so that it could be seen as a sign of economic prosperity. To assess the sustainability of the deficit an analysis of its background causes is needed. Thus, what are these causes?

Expected economic growth

For the 2002-2005 period, the growth rate for the US was larger that the one for the overage OECD country, 3.7% versus 3.2%, according to OECD figures. If we expect for this growth trend to continue in the future, there will be an upward revision of expectations for the returns on investment, thus, increasing the desire to invest in US assets. We should point out that the increase in immigration is also a factor that may be affecting economic growth. Particularly, during the Nineties, around 13 million immigrants arrived in the United States, close to 5 million more than in the previous decade, according to figures from the US Census Office.

Nevertheless, the expectations on future growth are not based only on past growth but on other information which could indicate whether this growth may be seen as a long-term phenomenon or a short term one. A

fundamental characteristic of US growth in recent years is that it can be broadly explained by the increase in growth of total factor productivity (TFP). That is to say, by the increase in production not brought by changes in the use of classical production factors, that is, capital and labour. In particular, if we look at the second column of the following table we see that in the 1990-1995 period average annual growth of the TFP was 0.50, in 2000-2004 this was 1.90. This increase is a key factor in obtaining sustained growth (over the long term) and therefore a sustainable deficit.

CURRENT ACCOUNT DEFICIT AND PRODUCTIVITY OF FACTORS IN UNITED STATES

	Average figure for current account balance (% GDP)	Average annual growth of TFP (*)
1987-90	–2.25	0.60
1990-95	–1.12	0.50
1995-00	–2.43	1.40
2000-04	–4.58	1.90
	Correlation: –0.67	

NOTES: (*) Increase in production not explained by changes in the use of classical production factors – capital and labour. Excludes public sector.
SOURCE: International Monetary Fund, Bureau Labor Statistics and internal figures.

Increase in world savings

Since the financial crises in the second half of the Nineties, we have seen an increase in world savings that has brought low long-term interest rates. Thus, facilitating the flow of capital to those countries with larger than average returns on investment, as is the case of the United States. In 1994, those countries known as the new Asian industrial economies plus other emerging economies (such as China, Hong Kong, South Korea, Singapore, Taiwan and most of the Middle East countries) incurred a deficit of 61.8 billion dollars, while by 2005 this deficit had turned into a surplus of 508.8 billion dollars, according to the IMF. Approximately three-quarters of the US deficit that same year. The present governor of the Bound of governors of the Federal Reserve system, Ben Bernanke, has pointed to two key factors explaining this increase in world savings: (1) increased savings by the Asian countries for fear of new financial crises, and (2) the increase in oil prices which has pushed up revenues in oil exporting countries.[1] Although there are other arguments which could explain this «excess» in savings, we shall leave that study for another occasion. The increase in world savings is important for the United States, since as figures seem to indicate, the US deficit is made possible thanks to inflows of capital from those countries.

The opening of the capital account

The capital market has undergone a process of constant opening up, as shown by some indicators, such as the «Code for liberalization of capital movements» established by the OECD. This liberalization has made possible for some countries to incur in higher current account deficits, given that there are more foreign funds available. In other words, in closed economies there exists a perfect relationship between investment and savings, so that a country can only invest what it saves. This relationship weakens as economies open up,

(1) Bernanke B. (2005) «The global savings glut and the US current account». (Remarks at the Sandridge Lecture, Virginia Association of Economics, Richmond, VA, March 10.)

and therefore, a country, in spite of not saving, can increase its level of investment using the savings of other countries. This is exactly the process which allows countries, such as the United States, to borrow in greater amount.

Increased stability and lower perception of risk

Increased stability and greater investment protection in a country implies that less risk is associated with the investment in assets in that country, lowering investment costs and therefore increasing net expected returns from those assets. The history of economic stability and continuing growth in the United States, as well as, the fact that investments are in dollars, means that US assets appear to be relatively more attractive from the point of view of risk factor.

Is the deficit sustainable or not?

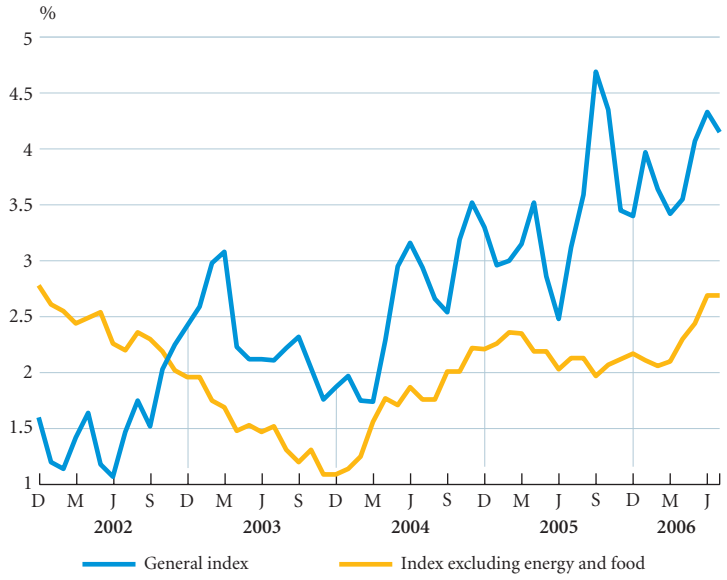
With a better idea of what are the basic factors that may have contributed to the increase in the US current account deficit, we should go back to our initial question about its sustainability. Whether it is sustainable or not, on one hand, will depend on the accuracy of forecasts of economic growth and returns. On the other hand, it will depend on the persistence of the external factors which have contributed to low investment costs (for example, large global savings, the opening up of capital markets, etc.). Finally, it is necessary to underline the importance of a continuation of the willingness of giving credit on the part of foreign investors as another component which could affect sustainability. That is to say, the fact that foreign economies continue to have confidence in the United States as a centre for investment depends not only on the future growth expectations but also on factors such as transparency and legal security in US capital markets.

In order to increase the likelihood of repaying the debt contracted, and assuming that we cannot modify factors of an «external nature» that affect the figure for the current account balance, it is necessary to ensure that the profitability of US assets meets projections and continues to be favourable. For this reason we must go back to the origin of the change in growth expectations and study whether that growth is transitory or long-term. Looking back to the previous table, we see that there is a negative relationship between the current account balance and the increase in productivity. The first column reflects average balances in various periods. In 1987-1990, they amounted to –2.25% of the GDP, whereas for the 2000-2004 period they were –4.58%. The second column shows the average annual change in productivity or TFP in the various periods. We note that when there is a growth in productivity the current account deficit also increases (see correlation). While from a correlation we cannot derive a causality assuring the sustainability of the US deficit, certainly, this simple exercise should attenuate the concerns that the increase in the deficit cause in many people. If this is linked to an increase in productivity, it may be easily financed by the extra profits linked to larger productivity.

Finally, it is necessary to point out that concentrating a study of the current account balance and its sustainability on the performance in productivity may be somewhat dangerous, given that economic growth models are complex and do not depend only on quantitative variables, like the TFP, but also on qualitative ones. In spite of everything, the trend in productivity in recent years is an important factor to keep in mind when evaluating the long-term growth of the US economy, as well as, its financial sustainability.

UNITED STATES: INFLATION REMAINS A RISK

Year-to-year change in CPI



SOURCE: Department of work and internal figures.

that at the end of every growth cycle wages gain ground in terms of corporate profits whose part of the pie stand at all-time highs. As these costs coincide with a slowdown, companies will not be able to pass them on to the consumer.

The relation between the sharpness of the slowdown and prices is dominating the scene but the background of the trade deficit is always there. In June, this was slightly less negative than in May (around 69 billion dollars) down from the high of 71.3 billion in October 2005, 5.9% of the total economy as against 6.2% in November. In the last ten months, the figure has remained relatively stable and, although we cannot yet say that we are in a process of correction, it remains clear that the downward trend has held back partly thanks to a process of weakening in the parity of the dollar since the autumn of 2005.

Japan growing but to less extent

Japan is slowly leaving behind the high segment of its economic cycle and is on the way to growth more in keeping with the potential of its economy which is marked by an aging population and the persistence of some old vices that are difficult to erradicate. While its growth potential does not seem to have suffered big changes, the limitations it imposes have the positive effect of helping to consolidate prices with positive growth.

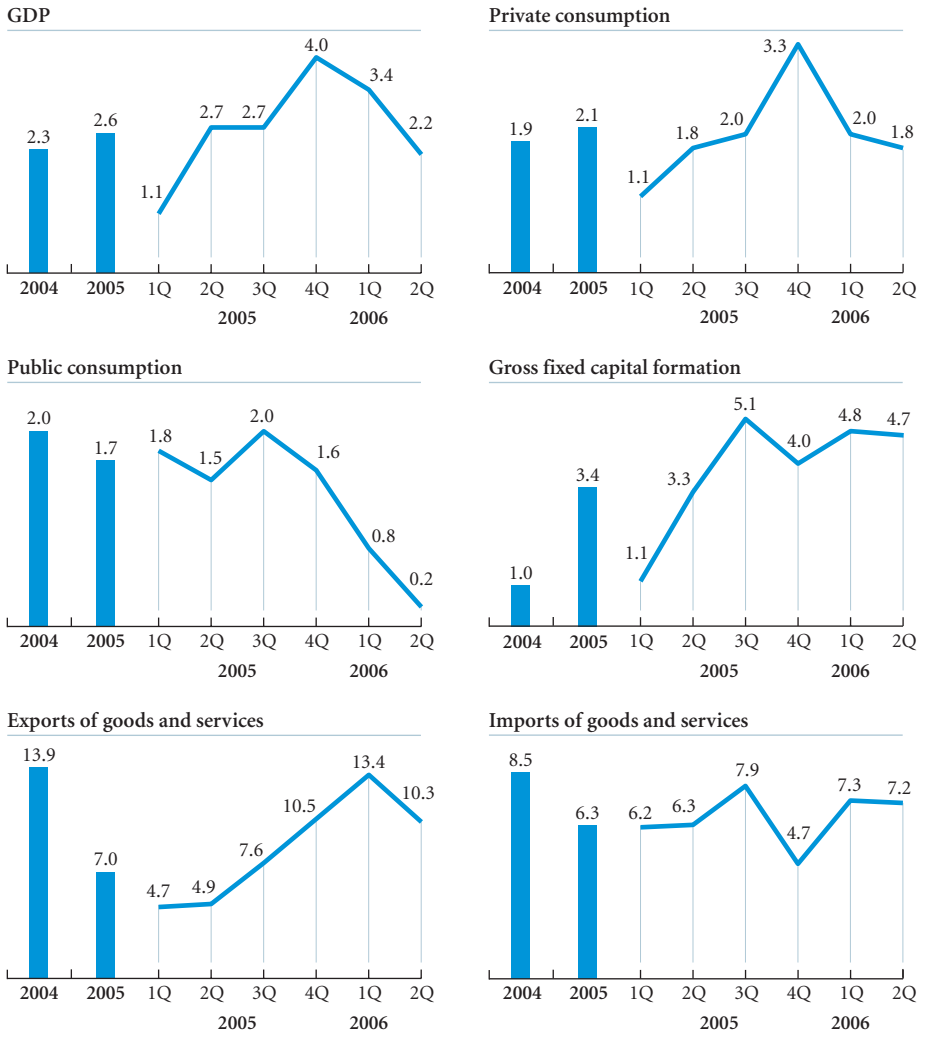
Foreign sector stops getting worse.

The second quarter brought a slowdown in the economy with growth in annual terms of 0.8% compared with the first quarter which, in turn, corrected growth from 3.1% to 2.7%. The three components which took off most growth were the public sector (half the slowdown in absolute terms), the reduction in inventory levels and the foreign sector. In the first case, debt

Japan showing slowdown because of public sector and some loss of strength in foreign sector.

TREND IN JAPAN'S GDP BY COMPONENT

Percentage year-to-year change in real terms



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

Private consumption holding up while capital goods investment remains strong.

contracted in the deflationary period has its own effect. The drop thus forms part of a long process of reducing spending which has still not finished. The foreign sector was hurt by increases in prices of the oil Japan imports and by more measured buying by its main customers.

On the positive side, what stands out is the recovery of private consumption although at a much lower level than was being predicted at the beginning of the year, given that the growth of 1.9% compared with the previous quarter in annual terms did not compensate for the downward revision for that period. The strength of investment may be seen in more ambiguous terms. Higher investment spending is good news in most countries but, in the case of Japan, when it is combined with a drop in exports, it indicates that the yield on investment continues to be relatively low

JAPAN: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006				
			2Q	3Q	4Q	1Q	April	May	June	July
Real GDP	2.3	2.6	2.7	2.7	4.0	3.4	–	2.2	–	–
Retail sales	–0.9	1.4	3.1	1.1	0.7	0.6	–1.3	0.3	0.2	...
Industrial production	5.3	1.5	0.3	–0.1	3.6	2.8	3.3	2.8	5.1	...
Tankan company index (*)	20.5	18.0	18.0	19.0	21.0	20.0	–	21.0	–	–
Housing construction	2.6	3.8	2.2	4.9	6.9	4.9	15.2	6.7	4.7	...
Unemployment rate (**)	4.7	4.4	4.3	4.3	4.5	4.2	4.1	4.0	4.2	...
Consumer prices	0.0	–0.3	–0.1	–0.3	–0.7	–0.1	–0.1	0.1	0.5	0.3
Trade balance (***)	13.9	10.2	12.1	10.9	10.2	9.5	9.1	9.2	9.1	...

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

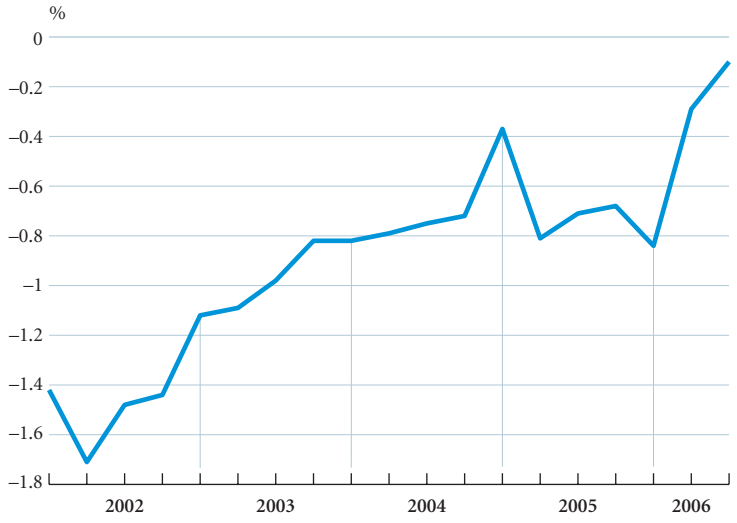
compared with the majority of developed countries. The Japanese continue to invest outside looking for something not available at home and, for the first time, income from foreign investment is higher than the trade surplus in absolute terms.

Latest demand indicators coincide with reduced expectations, with retail sales remaining stagnant in June, car sales down by 11.4% and consumer confidence in the second quarter still at high levels but losing strength compared with the two previous periods. Along similar lines, the real estate sector showed

Demand indicators slack but industrial production recovers strength.

JAPAN: MOVE TOWARD NORMALCY IN PRICES

Year-to-year change in GDP consumption deflator



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

an ambiguous performance with sales clearly down although with prices continuing a gradual upward trend. On the supply side, however, there were greater signs of strength with industrial production now growing at 5.1% year-to-year and machinery orders which are keeping the recovery in investment active.

Inflation practically nil.

Inflation figures for July were weaker than expected with the index, excluding fresh foods, showing decreases for two consecutive months with a figure of year-to-year growth at 0.2%, in line with what the Bank of Japan considers normal. In spite of the low figure for inflation, the private consumption deflator for the GDP is now on positive ground compared with the previous quarter. The unemployment rate rose slightly to 4.2% of the labour force. The trade balance for the last 12 months ending June was 9,062 billion yen, somewhat lower than the level in May because of oil purchases but with exports showing a strong base.

China: all that glitters is not gold

China growing by 11%, led by industrial sector and investment.

China's economy has two faces. First there is opulent growth with official figures which leave no room for doubt. Whereas many people were expecting a slowdown, the economy grew by 11.3% year-to-year in the second quarter, a rate which is among the highest in the decade. As is usual, the game was led by the industrial sector which moved up by 13.2%, although services also were vigorous with growth at 9.4%. Backing up this robust growth, industrial production in July was 16.7% higher than in the same period last year while retail sales for the same month rose by 13.7%.

In spite of the fact that official inflation stands at more contained figures (prices rose by a slim 1% year-to-year), there are signs of overheating and the government is making efforts to moderate growth. In August, the central bank raised interest rates on loans and deposits by 0.27%, putting rates at 6.5% and 2.5% respectively. The currency also gained ground against the dollar in an attempt to contain the volume of credit. The results of these various measures up to now have been limited with investment in the first seven months of 2006 growing by 30.5% compared with the same period last year. One of the dangers of raising interest rates on deposits, along with the expected upward trend in the currency, is that this

CHINA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006				
			2Q	3Q	4Q	1Q	April	May	June	July
Real GDP	9.5	9.9	10.1	9.8	9.9	10.3	–	11.3	–	–
Industrial production	16.3	15.9	16.5	16.2	16.4	16.8	16.6	17.9	19.5	16.7
Electrical power production	15.0	13.4	13.7	13.6	11.8	13.4	11.9	13.0	14.7	15.5
Consumer prices	3.9	1.9	1.7	1.7	1.4	1.2	1.2	1.4	1.5	1.0
Trade balance (*)	32.1	101.4	79.3	96.0	101.4	108.3	114.5	118.5	123.2	127.2

NOTES: (*) Cumulative balance for 12 months. Billion dollars.
SOURCE: National Statistics Office of China, Thomson Financial Datastream and internal figures.

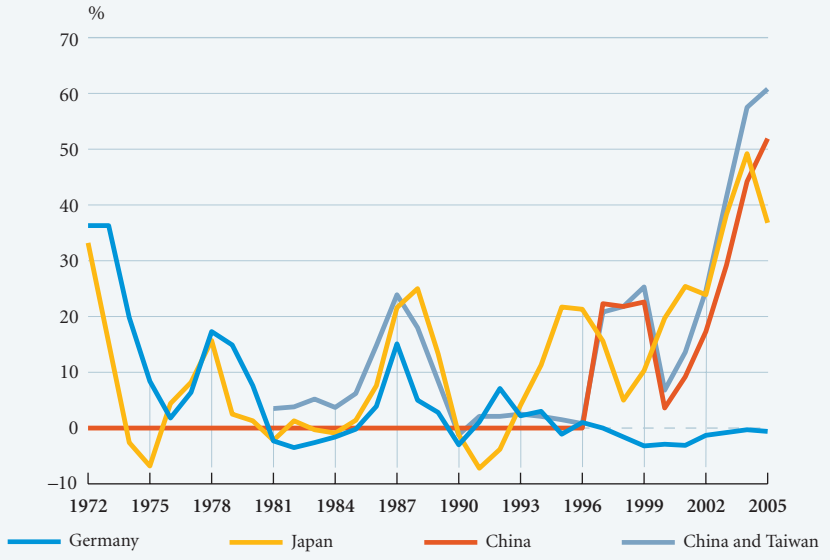
America and China, or the fable of the cicada and the ant

Napoleon, it is said, climbed a mountain, looked to the East and in a celebrated phrase exclaimed: «Let China sleep because when it wakes up the world will shake». The problem with this statement is that, at that time, the United States was still young and unknown. In the world there are cicadas and ants. The cicadas spend, the ants work hard and save and, according to the fable, end up winning the day. In today's world economy it could well be the cicada that comes off best. The United States buys more than it sells abroad and this difference, a mere trifle equal to two-thirds of Spain's economy, has to be financed. Formerly, this financing came from private portfolio investment in bonds and stocks but in recent times the main financiers of the US cicada have been the Asian central banks which have been accumulating foreign exchange reserves, mainly in dollars.

The global increase in central bank reserves has been spectacular. Since 1970, foreign reserves have multiplied by 89, whereas the nominal world GDP has multiplied by only 14. But, compared with world exports the situation is not so giddy seeing that the latter have multiplied by 35. Furthermore, decade after decade, the relation between the growth rate of accumulated reserves and world trade has remained fairly constant at around 1.2-1.3. Why then is there so much concern about the foreign reserves held by the central banks? Is it that they are now more concentrated? But here also there have not been great changes seeing that the sum of the balances of the ten top holding countries continues to be around two-thirds of the world total. Indeed, we have one new leader. In 1980, the country with most foreign currency reserves was Germany, a leadership it held until 1987. From then on, Japan moved into first place and stayed there until 2005 when leadership went to China.

RISE IN CHINA'S RESERVES IS GIDDIEST OF ALL

Contribution to triennial increase in world reserves compared with volume of trade



SOURCE: International Monetary Fund, national statistics offices and internal figures.

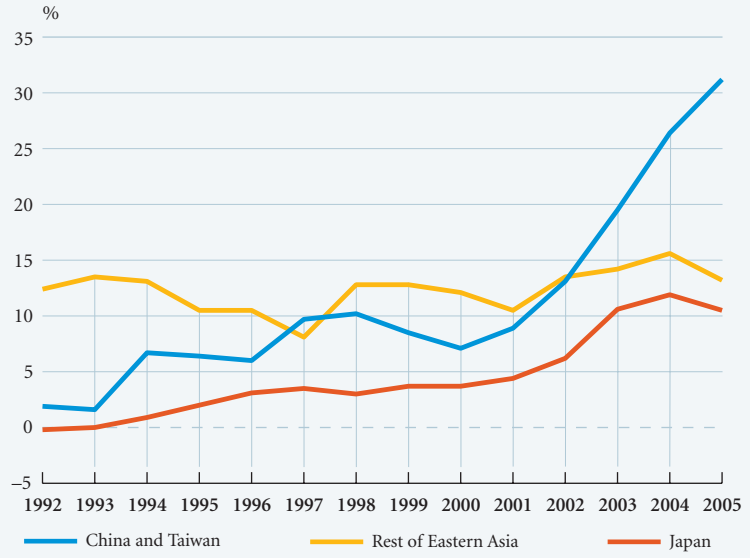
The first notable difference in the recent lead taken by China is the speed with which this has taken place. Its contribution to world growth of reserves in the last three years has been extremely strong. Only at the end of

1973, a key moment following the collapse of the Bretton Woods system, Germany had a relatively bigger share. But, if we look at the relative importance of the total amount of central bank reserves in relation to the world economy, things change. And the fact is that China's access to the throne as the biggest holder of world reserves has been faster and of greater volume since the introduction of flexible exchange rates. Furthermore, the China we see in the statistics is not totally alone, seeing that the island of Taiwan, with a high level of trade relations with continental China, has its own central bank and this bank has been the fourth highest contributor to the increase in foreign reserves in recent years.

The accumulation of reserves is, therefore, more a question of Greater China (China and Taiwan) than of the Asian countries in general. In the first place, the present increase goes beyond reasons of aversion to risk arising from the 1997 Asian recession and others coming later. The current process began in 2003 and the economies of China and Taiwan were the least affected by those recessions. In the second place, the only two countries that in absolute terms may be compared with the course followed by China (namely, Japan and South Korea) are now returning to normalcy, while in China and Taiwan the process does not seem to have yet ended. The accumulation of reserves by their central banks, as a result of the inflow of investment, goes well above their trade surplus.

CHINA'S HUNGER FOR RESERVES OVERSHADOWS THAT FOR REST OF ASIA

Balance of central bank reserves in terms of GDP in current dollars



SOURCE: Economist Intelligence Unit and internal figures.

Having established that the increase in foreign currency reserves is a Chinese matter, we may ask why. An initial response is to be found in the weakness of domestic consumption in both economies, the growth of which is running well behind the total growth of the economy. Taiwan has recently had periods of deflation and, officially, China's inflation is extremely moderate if we consider GDP growth. The accumulation of foreign currency reserves helps to maintain a competitive exchange rate in order to be able to sell abroad the products that the frugal domestic consumers do not buy. At the same time, the inflow of foreign currency encourages the growth of domestic credit without, for the moment, bringing about inflationary pressures.

But this also has its risks. If the US currency loses value, the assets of the central banks (their reserves in dollars) will devaluate in terms of the local currency thus incurring a loss, quite the contrary to what would happen in the United States, which, owing dollars, would show a gain. As a result, a sharp decrease in the US trade deficit, accompanied by a sudden depreciation of the dollar would have a twin effect on China. In the first place, it would mean that foreign demand for its exports would go down, a problem it would share with the whole world. In addition, however, the central bank would incur losses at a most delicate moment, thus increasing the eventual contractile effects on domestic economic activity. On top of this, we should add that, while in terms of volume the Asian giant's economy is big, in current dollars it is not so huge, due to low domestic prices. Thus, while the level of Japan's foreign currency reserves is around 10% of its economy, in the case of China this relation goes above 30%.

Why then is the country of the wise Confucius running such a risk? This is where one of the greatest weaknesses of our hard-working ant comes into play because it could catch a cold if the cicada should sneeze. Contrary to the case of Japan and especially of Germany, the Chinese giant has a quite undeveloped financial system. The umbrella of the dollar lends it some stability without which it would be more precarious. But there are other things to consider, many other things. The biggest banks in the country are state-owned and they finance the large industrial conglomerates, also state-owned, inefficient companies which have been inherited from earlier times. This means a high volume of loans which may not be repaid because of bankruptcies (30% of the GDP as a conservative estimate). The Chinese know that this constitutes a potentially greater risk than the foreign currency reserves so that a new use for part of the reserves would be the capitalization of the big state-owned banks in preparation for their privatization with the involvement of international capital.

For the moment, all is well. The Bank of China, one of the four large banks, has been successfully privatized and the US deficit still remains. But as always in economics, whether things turn out good or bad depends on the speed of any adjustment. If the United States continues to act as the cicada and this gives China time to put its banking system in order, that is fine. But, if the Americans change their attitudes rather quickly, the multitude of Chinese ants, all carefully saving, could end up drowning in a sea of dollars.

could increase the inflow of speculative capital from abroad.

Nevertheless, the Chinese economy has another face. Consumption continues to go nowhere and represents only one-third of the economy while retail sales, in spite of showing two-digit increases, continue to clearly show a slowdown trend compared with rates in 2004 and 2005. Furthermore, there continues to be an enormous gap between urban and rural China. Growth is more and more focussed on the export sector and not on domestic consumption, bringing about a trade surplus, which expressed in current dollars, now goes above 5% of the GDP.

While this facet of consumption is well known, what is noticeable is that imports by volume of key materials for the electrical industry, telecommunications and construction, such as copper, aluminium and steel, have been going down so far this year. In an economy that largely grows thanks to the industrial sector, this lower appetite for the vital juices that feed it raises a shadow of doubt about official statistics.

Inflation holds at 1%.

Consumption still fails to take off while dependence on foreign sector increasing.

CHINA: ENIGMA OF LOWER IMPORTS

Monthly imports by volume

SOURCE: Chinese National Statistics Office, London Market and internal figures.

Imports of raw materials down by volume.

Mexico growing at 4.7% with no inflation.

For the moment, the opulent face is to the fore and the consensus is that monetary policy must take on a restrictive orientation, but the Chinese giant could be more volatile than it appears.

Mexico: strong economy with some uncertainties

The Mexican economy is growing without inflation but its dependence on oil and the electoral mayhem could darken the picture. It was said that the

MEXICO: MAIN ECONOMIC INDICATORS

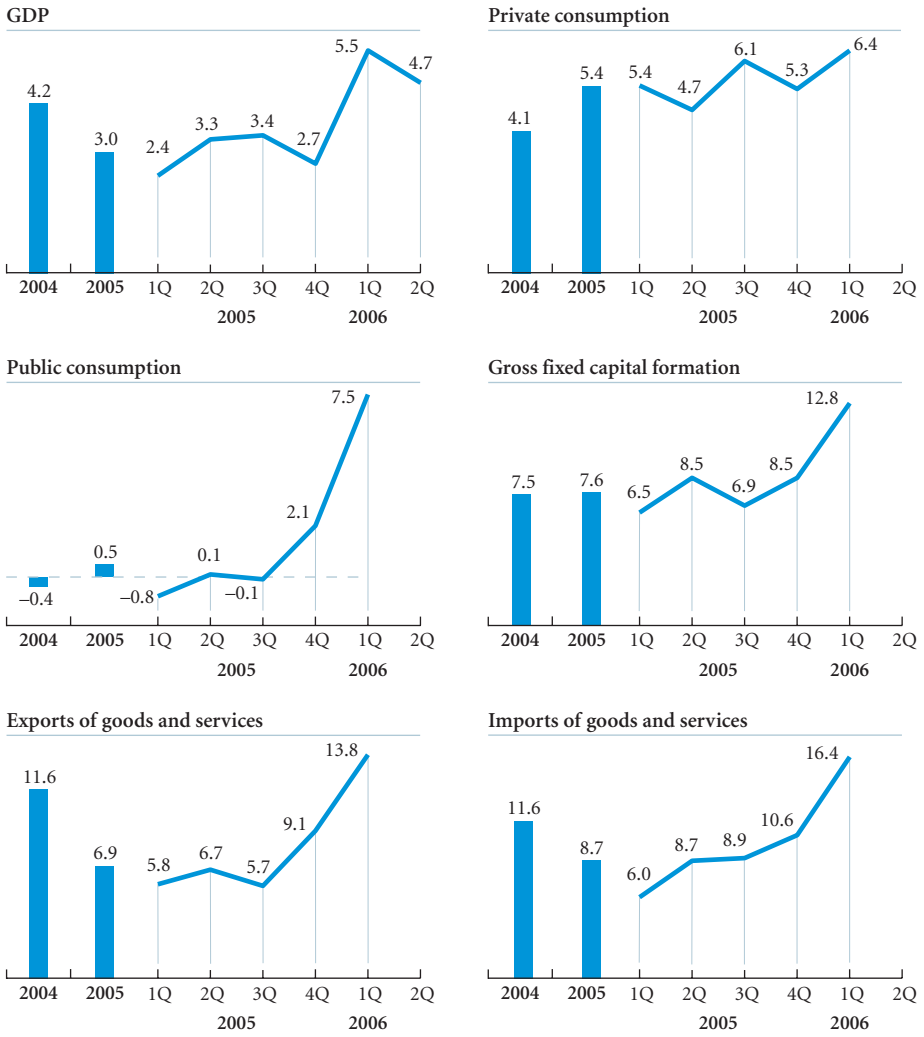
Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006				
			2Q	3Q	4Q	1Q	April	May	June	July
Real GDP	4.2	3.0	3.3	3.4	2.7	5.5	–	4.7	–	–
Industrial production	4.2	1.6	3.1	0.8	2.7	7.0	–1.0	5.8	7.0	...
General unemployment rate (*)	3.9	3.6	3.5	3.8	3.1	3.5	3.3	2.9	3.3	...
Consumer prices	4.7	4.0	4.5	4.0	3.1	3.7	3.2	3.0	3.2	31
Trade balance (**)	–8.8	–7.6	–9.7	–9.5	–7.6	–5.0	–4.1	–4.2	–4.5	–4.1

NOTES: (*) Percentage of labour force.
(**) Cumulative balance for 12 months. Billion dollars.
SOURCE: Central Bank of Mexico.

TREND IN MEXICO'S GDP BY COMPONENT

Percentage year-to-year change in real terms



SOURCE: Central Bank of Mexico and internal figures.

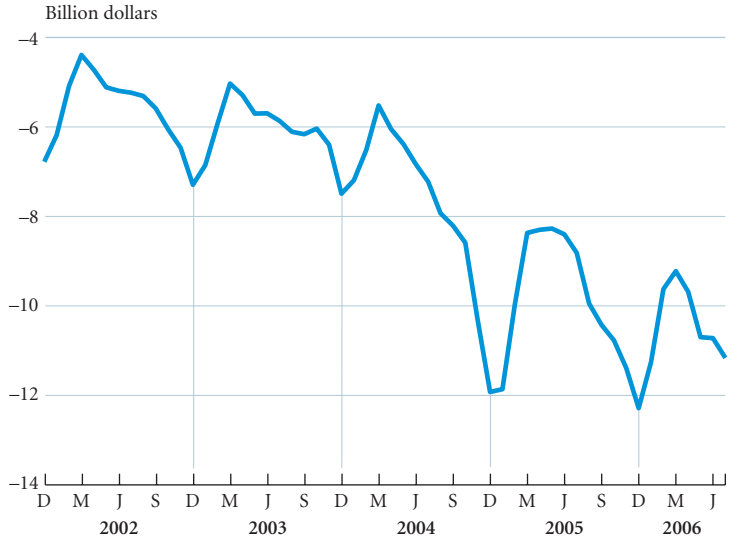
result of the 2006 elections, whoever won, would not have any major effect on Mexico's economy. However, the election results have generated some uncertainty in an economy that otherwise is enjoying a relatively good period.

GDP growth in the second quarter was up by 4.7% year-to-year, somewhat less than in the first quarter but still holding at values showing strong economic activity. By component, all sectors contributed to the rise with a notable growth in investment of more than 12% and exports up close to 15%. The economy is thus showing signs of great strength which are reinforced by the good figure for industrial production that grew by 7.0% year-to-year in June with a clear upward trend. Furthermore, in this sector domestic industry now dominates, which reduces dependence on its American friends.

Investment grows more than 12% in first quarter.

MEXICO: WITHOUT HELP FROM OIL, TREND IS DOWN

3-month cumulative figure for trade balance excluding oil exports



SOURCE: Central Bank of Mexico and internal figures.

Foreign sector depends on oil.

In spite of the rapid growth reported, the trend in prices (3.1% year-to-year in July) was more than contained, which puts Mexico as one of the leading examples of the new growth in the region based on macroeconomic stability. Reinforcing this good picture in prices, unit labour costs were down by 1.9% year-to-year in May, which should give increased support to foreign competitiveness.

The foreign sector is the biggest hurdle at the moment. While the trade deficit is relatively contained, Mexico's problem is that of someone who wins the lottery – that person's dependence on the prize. The increase in oil prices has given strong support to the foreign sector but this dependence shows up clearly in the trade deficit if we do not include oil, which in recent months has gone back to a trend to progressive decreases, something which shows the need for greater improvement in productivity and costs.

Lively summer in oil market: prices go to all-time highs and later drop more than 10%.

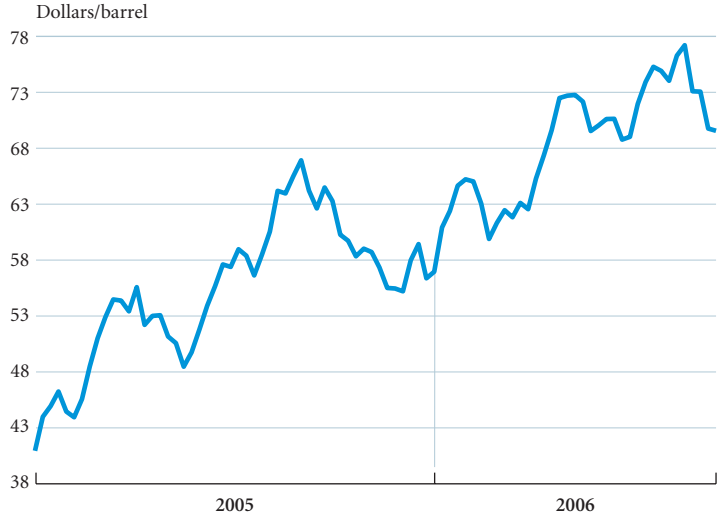
Raw materials: summer storm

Oil was one of the key economic factors in the summer. At the beginning of the season, the 1-month forward price for Brent quality oil per barrel stood in the area of 70 dollars, a level at which it was running in May and June. In an initial upward move, in the first half of July oil rose to 77 dollars, dropping slightly on following days. At the end of July, however, the increase was repeated and it went up to the all-time high of 78.5 dollars on August 8. After a couple of market sessions, the Brent per barrel price was notably corrected and it ended the month of August at 70 dollars. It had gone through a series of comings and goings although nobody discounts that in the near future, with the hurricane season at its initial stage, there could be new surprises.

How do we explain this summer storm? The answer is an unfortunate combination of the economy and the

OIL PRICES BREAK THROUGH CEILING BUT LATER DROP

1-month forward price of Brent oil as weekly average



SOURCE: Thomson Financial Datastream.

world political scene. The chronology followed suggests that the all-time high price coincided with the closing (later reviewed) of the Prudhoe Bay oilfield in Alaska, which supplies 8% of crude oil consumption in the United States. It also indicates that the price of oil has moved in keeping with how the conflict in Lebanon developed, in the 40 days it lasted. The rally in price began with the confrontation between Israel and Hezbollah and its end coincided with the precarious ceasefire agreed upon in August. These were, in fact, two threats to future security of oil supply in a situation of an extremely narrow gap of supply and demand for crude, basically due to notable world economic growth.

Other raw materials, while free from the geopolitical clouds affecting oil, have responded to sharp world demand. As a result, the raw materials index published by «The Economist» in July and August stood at levels 31% higher than those one year ago. This move was especially sharp in metals. In spite of signs of correction, nickel and copper have again gone up to the area of all-time highs, while other metals, such as platinum and aluminium, while they have left those highs behind, are staying at historically high levels. Metals as a whole were 81% more expensive in August than one year ago.

Metals hold at historically high levels, 74% above those one year ago.

EUROPEAN UNION

Euro Area enjoying best moment for decade

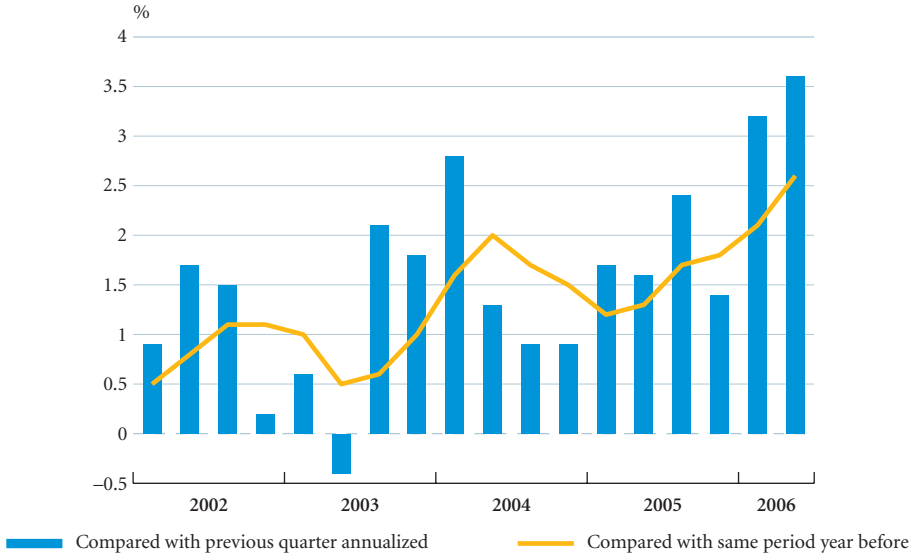
Euro Area growth in second quarter brings positive surprise...

Economic growth in the Euro Area in the second quarter brought a big surprise. Whereas it was expected that the gross domestic product (GDP) would grow slightly above 2% year-to-year, the rate of increase was 2.6%. This growth rate has not been seen for five years. The positive result was basically due to the improve growth rate in Germany which went from 1.7% in the first quarter to 2.4% in the second quarter. At quarter-to-quarter rate annualized, growth in the Euro Area was 3.6%, a very sharp rate which is indicative of strength of economic activity in the second quarter. Furthermore, the increase in first quarter growth was revised upward from 1.9% to 2.0%.

And where do we go from here? The European Commission forecasts for the next three quarters paint an optimistic scenario. If its key forecast holds good, growth will continue well above 2.5% year-to-year in the next three quarters. This forecast would seem to be slightly wishful thinking given the fact that the current rise in economic activity depends on what takes place in Germany, a country which is going to experience an important fiscal adjustment in 2007 whose effects are still uncertain. Nevertheless, what does not seem in doubt is that during the rest of the year we are going to see the best months so far this decade.

RECOVERY IN EURO AREA RUNNING FULL-STEAM-AHEAD

Change in gross domestic product in real terms



SOURCE: Eurostat and internal figures.

EURO AREA: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005			2006				
			2Q	3Q	4Q	1Q	April	May	June	July
GDP	1.7	1.5	1.3	1.7	1.8	2.0	–	2.6	–	–
Retail sales	1.5	1.2	0.8	1.5	1.2	0.9	2.2	1.4	1.6	...
Consumer confidence (*)	–13	–13	–14	–14	–12	–10	–10	–9	–9	–8
Industrial production	2.0	1.2	0.6	1.4	2.0	3.4	1.6	5.2	4.3	...
Economic sentiment indicator (*)	99.4	98.1	96.1	97.7	100.1	102.6	105.7	106.7	107.1	107.7
Unemployment rate (**)	8.9	8.6	8.7	8.5	8.3	8.1	8.0	7.9	7.8	...
Consumer prices	2.1	2.2	2.0	2.3	2.3	2.3	2.4	2.5	2.5	2.4
Trade balance (***)	80.4	43.5	48.6	36.5	25.2	6.7	–1.0	–6.3	–11.0	...

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

The monthly figures do not provide a great deal of additional information given that the merely confirm a strong end to the second quarter and the start of a third quarter along the same lines. One of the broader indicators, the economic sentiment figure, was up by four decimals in June and added on another four decimals in July. This meant a recovery that was based both on demand and supply. To be specific, retail sales grew by 1.6% year-to-year in June, a positive trend that should continue over coming months, if we are to go by the clear recovery of consumer confidence taking place between May and July. In this context, the poor figure for car registrations recorded in June must be seen as a temporary situation directly brought about by the rise in fuel costs and not as something of a nature generally applicable to private consumption as a whole.

On the supply side, there is also abundant evidence. Industrial production has chalked up two consecutive months in the range of notable growth (5.2% year-to-year in May, 4.3% in June). The fact that industrial executives continue to see the future with optimism, as may be seen from the high for business confidence recorded in July, is an additional guarantee for a continuation of recovery in the secondary sector. Services and construction are running along the same lines. The latter, particularly, is moving far away from the rough period in 2004 and part of 2005.

...and current rate at 2.6% will hold for rest of year.

On the consumer prices front as well we note something of a let-up in the recent trend to increased inflationary pressure. After growth of 2.5% year-to-year in May and June, the harmonized consumer price index (HCPI) eased moderately in July going to 2.4%. Available forecasts suggest that it could end the year at levels no higher than those at present, which would mean that the period of increases in oil costs would have had a relatively moderate impact. In this respect, it should be remembered that underlying inflation, that is, discounting the segments of energy and food, tobacco and alcohol, has held at clearly lower levels with the July figure one point below the general index.

Economic sentiment in third quarter continues upward course.

Consumer prices let up in July dropping to 2.4%.

Germany growing more than expected thanks to investment and foreign sector.

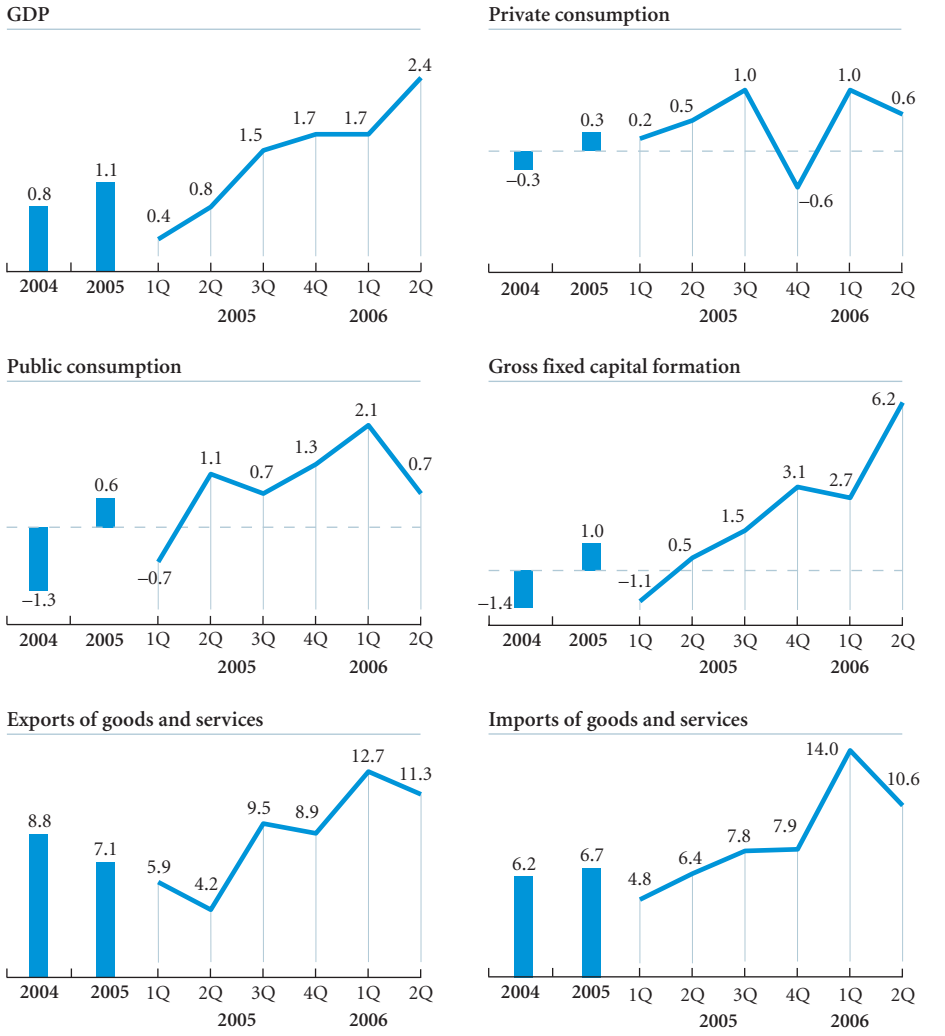
The labour market is another area which seems to be facing a better stage. Following many months with very low growth in employment and high unemployment levels, in recent months both these trends have begun to change. With regard to employment, in the first quarter (the latest figure available) growth moved up to 0.9% year-to-year, thus turning around the lack of progress shown all through 2005. With regard to the unemployment rate, in June this stood at 7.8% of the labour force, eight decimals less than one year ago. Both in employment and the unemployment rate it is expected that the trends mentioned will sharpen over the rest of the year.

Germany: following World Cup celebrations, is hangover on the way?

«Germany has stopped being the sick man of Europe», declared Angela Merkel on August 20. The German chancellor was referring to the fact that Germany

TREND IN GERMANY'S GDP BY COMPONENT

Percentage year-to-year change



SOURCE: Federal Statistics Office and internal figures.

GERMANY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	0.8	1.1	1.5	1.7	1.7	2.4	–	2.4	–	–
Retail sales	2.1	1.2	1.4	0.1	0.9	0.2	–2.2	3.2	–0.4	...
Industrial production	2.4	2.9	3.1	4.7	4.6	4.9	4.3	6.0	4.5	...
Industrial activity index (IFO) (*)	95.5	95.5	95.4	98.7	103.6	106.1	105.9	105.6	106.8	105.6
Unemployment rate (**)	10.6	11.7	11.7	11.4	11.3	11.0	11.3	11.0	10.8	10.6
Consumer prices	1.7	2.0	2.2	2.3	2.0	1.9	1.9	1.9	2.0	2.0
Trade balance (***)	149	157.2	157.2	160.3	157.5	154.1	154.9	155.1	152.3	...

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

economic growth reached its highest rate since 2000 to show 2.4% year-to-year in the second quarter. This was a recovery that surprised everyone. The pattern of German growth, however, is not making it possible to correct the main outstanding weakness, namely, that German households are still not willing to spend, which implies something of a ceiling on recovery.

To be specific, the main factor in domestic demand which has boosted growth has been investment, something that doubled its growth rate over the second quarter going from 2.7% to 6.2%. Of special significance because it comes as something new is that the good performance being shown in capital goods investment has now been joined by a clearly expansionist trend in construction investment. On the other side of the scale we find the factor mentioned earlier of private consumption which, contrary to what was expected, slowed down in the second quarter. The foreign sector, in turn, increased its contribution to GDP growth to eight decimals, compared with 0.1% in the first quarter.

Starting out from this situation, which keeps reminding us that recovery is something practically exclusive to the twin factor of exports-investment, immediate prospects are for some moderation of growth and this is exactly what economic circles are expecting. This is supported both by the drop in the industrial activity indicators (the IFO index was down six decimals in August) and in the consumer index which was down by a half-point in July.

Prospects for coming months are for moderate slowdown.

The other monthly indicators provide little additional information. Perhaps the most significant factor is the good state of German industry which must be linked to the boost in the foreign sector. In the second quarter, industrial production grew by 4.9% year-to-year while industrial orders were up 12%, which should have its impact on this positive situation in coming months.

Also favourable is the progressive adjustment of the high unemployment rates recorded in Germany up until now. From the annual high of 11.4% of the labour force last January, the rate has gradually slipped down to stand at 10.6%

Excellent situation in industry and gradual improvement in unemployment rate show up as two results of recovery.

Sharp rise in French economic activity in second quarter...

in July. Inflation, in turn, held stable at 2.0% year-to-year both in June and July.

France: domestic demand again comes to life

The French economy exceeded all expectations in the first half-year. After growing by a modest 1.0% year-to-year in the final quarter of 2005, the GDP grew by 1.4% in the first quarter only to later rise to 2.6% in the second quarter. The strong current boost comes from the fact that the economy grew by nearly 4% quarter-to-quarter annualized, a rate that more accurately reflects the latest trend.

...thanks to notable recovery in private consumption and investment.

What lies behind this notable recover? The breakdown for the second quarter shows that the recovery is basically being supported by private consumption and investment, which has made it possible for domestic demand to practically double its growth rate in one quarter. Foreign demand, on the other hand, after dropping substantially in the first quarter is tending to progressively increase its negative contribution. This is a logical situation if we take into account the strength of imports which comes along with the boost in domestic demand.

Stronger drive in industry represents significant change in recent months.

The few indicators available for the end of the second quarter and the start-up of the third quarter point to a continuation of recovery, although a more moderate rates. If we are to go by the trend in domestic consumption and industrial production of capital goods for June, we note the development of some stabilization of the high growth rates, both in consumption and investment. In any case, the drop in household confidence suggests something of a cap on growth in the first of these components.

On the supply side, economic sentiment in the months between April and July stood in the range of 107 points, swinging slightly around this level. In fact, this is another factor supporting the hypothesis of a continuation of recovery without any additional increase in economic activity. Industry is pointing in the same direction with two consecutive months of growth at rates of the order of 3% year-to-year.

The positive economic horizon in France is capped by the improvement of two basic elements in balance, namely prices and unemployment. Inflation fell below 2% year-to-year in June and July (specifically to 1.9%) while the

FRANCE: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	2.0	1.2	1.4	1.0	1.4	2.6	–	2.6	–	–
Domestic consumption	3.8	2.9	4.2	2.2	3.0	4.9	3.5	5.7	5.6	...
Industrial production	2.0	0.0	0.3	–0.9	0.5	1.9	–0.3	3.1	2.8	...
Unemployment rate (*)	10.0	9.9	9.9	9.7	9.6	9.1	9.3	9.1	9.0	...
Consumer prices	2.1	1.7	1.9	1.6	1.8	1.9	1.7	2.1	1.9	1.9
Trade balance (**)	0.1	–1.5	–1.7	–2.0	–2.2	–2.2	–2.1	–2.2	–2.2	...

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

unemployment rate has dropped by six decimals since the beginning of the year (9.0% in June).

Italy: at tail-end of recovery

When it comes to soccer, Italy is the great world champion but it would be hard to pin this impressive prize on the country in terms of the economy within Europe. Clearly in contrast to Germany and France, which have been able to bring about a definite recovery so far this year, the Italian economy stopped any increase in growth rate in the second quarter. This is a troubling situation in itself but, what is worse, is the fact that the growth rate reached is very slim. If we look simply at the figures, the increase in the GDP in the first quarter was 1.6% year-to-year while this dropped by one decimal to 1.5% in the second quarter.

Without having a breakdown of the components, available indicators suggest that the lack of drive in domestic demand and an export sector at a low ebb have ended up strangling economic recovery. At least this is borne out by the lack of progress in consumer confidence (in July this was at the same level as at the beginning of the year) and the gradual increase in the trade deficit.

Italy grows by 1.5% in second quarter, well behind best European economies.

Does anything escape in this rather gloomy review? Two notable factors stand out which may indicate a turnaround in the second half of 2006. First, the economic sentiment indicator, which has something of an anticipatory nature, jumped by three points in June and later consolidated this important increase in July. Indeed, this is a fairly strong sign of a transition toward a more dynamic stage.

Lack of drive in domestic demand likely culprit for this poor growth.

The second favourable element is that industry has managed to mark up two consecutive months of recovery in May and June. Along with these two factors, the fact that inflation has held practically unchanged at 2.2% year-to-year between January and July may work in favour of the long-awaited recovery of the Italian economy.

Improvement in economic sentiment may be precursor of better second half in 2006.

ITALY: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	0.9	0.1	0.1	0.5	1.6	1.5	–	1.5	–	–
Retail sales	–0.4	0.4	0.3	1.9	0.5	1.7	2.7	1.5	1.3	...
Industrial production	–0.5	–0.9	–0.1	0.4	2.9	1.7	0.3	2.4	2.4	...
Unemployment rate (*)	8.0	7.7	7.6	7.6	7.4	...	–	...	–	–
Consumer prices	2.2	1.9	2.0	2.2	2.1	2.2	2.2	2.2	2.3	2.2
Trade balance (**)	2.0	–5.8	–7.0	–9.3	–13.2	...	–15.1	–16.4	...	...

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

United Kingdom: return to growth

Domestic demand pushes British growth up to 2.6%.

The British economy has come out of the rut of relatively low growth in 2005 at a higher rate than expected. In the second quarter of the year, the GDP rose to 2.6% year-to-year (2.3% in the previous quarter) due to the combined drive in public and private consumption and investment. Domestic demand as a whole grew by 3.2% year-to-year, one point higher than the figure for the first quarter. On the other hand, the foreign sector, which had made a positive contribution to GDP growth in the fourth quarter of 2005 and the first quarter of 2006, ended up showing a negative contribution and taking off seven decimals.

Renewal of growth comes alongside relatively high price levels...

...which lies behind recent hardening of Bank of England monetary policy.

This increase in economic activity has come at the same time as a relatively high level of prices, a combination that explains the increase in the Bank of England intervention rate by a quarter-point putting it at 4.75% on August 9. To be specific, consumer prices went from levels of 2.3%-2.4% in the early months of the year to jump up to 2.9% in May and 3.1% in June and July.

This more mature stage in the economic cycle characterized by a sharper growth rate and higher inflationary pressures will continue into coming quarters. The first indicators for the third quarter clearly show the characteristic features of the current stage. On the demand side, consumption is the main driving force for growth whereas, on the supply side, it is services that are leading recovery. With regard to the former trend, retail sales rose again in July (going to 4.0% year-to-year, four decimals more than in June). With regard to trends by sector, we should point out the continuing relative drop in industry (industrial production in June was down by 0.7% year-to-year).

UNITED KINGDOM: MAIN ECONOMIC INDICATORS

Percentage change over same period year before unless otherwise indicated

	2004	2005	2005		2006					
			3Q	4Q	1Q	2Q	April	May	June	July
GDP	3.3	1.9	1.8	1.8	2.3	2.6	–	2.6	–	–
Retail sales	5.9	1.9	0.9	2.7	1.8	3.5	2.9	4.2	3.6	4.0
Industrial production	0.8	–1.9	–1.7	–2.6	–0.9	–0.9	–1.1	–0.8	–0.7	...
Unemployment rate (*)	2.7	2.7	2.7	2.8	2.9	3.0	3.0	3.0	3.0	3.0
Consumer prices	2.2	2.2	2.4	2.3	2.2	2.8	2.4	2.9	3.1	3.1
Trade balance (**)	–56.1	–64.1	–64.6	–66.2	–69.9	–72.5	–70.8	–72.4	–74.3	...

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

The Fed holds off interest rate increases

The countries that are most advanced in the economic cycle, such as the United Kingdom and the United States, have normalized their monetary policies following a period of extraordinary liquidity which began at the end of the Nineties due to the bursting of the stock market bubble linked to new technologies, such as Internet. As a result, their official interest rates stood close to a neutral level and at the maximum of the upward stage. On the other hand, other central banks, such as the European Central Bank and the Bank of Japan which began their tighter money trend later, still have some way to go to reduce the slack in their monetary policies and face up to inflationary risks which, in the first place, arise from the jump in oil which reached a new all-time high in August.

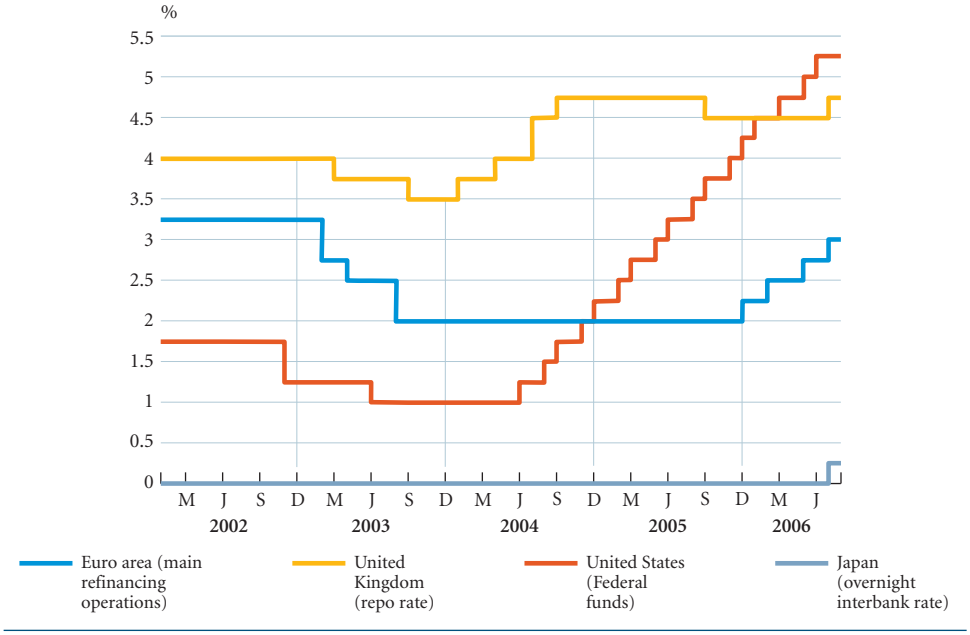
Monetary policies of main central banks at different stages.

As expected, the US Federal Reserve raised its official interest rates at its meeting on June 29. As a result, the objective interest rate on overnight interbank deposits rose by 25 basis points to 5.25%. This was the seventeenth consecutive rise since June 2004 with a cumulative increase of 425 basis points. In its press release, the Fed left the door open to further increases if the economic situation so warranted.

Fed takes breather after seventeen consecutive increases.

MAIN CENTRAL BANKS RAISE INTEREST RATES

Monetary policy reference interest rates



SOURCE: National central banks.

Nevertheless, in his appearances before Congress at the last but two weeks in July, chairman Ben Bernanke suggested that the Fed could halt the succession of interest rate increases at the second meeting in August, given that it expected a trend toward moderation in inflationary pressures.

As a result, on August 8 the Fed left its interest rates unchanged due to the current slowdown of the economy. Nevertheless, it did not discard a rise in the future if inflationary pressures again grew worse.

ECB puts reference rate at 3% and will continue to raise it in coming months.

In the Euro Area, the Governing Board of European Central Bank (ECB) decided to tighten monetary policy at its August 3 meeting which did not come as any surprise following the statements by ECB chairman Jean-Claude Trichet at the July press conference. As a result, the ECB reference rate stood at 3%, one point above the floor reached in the 2003-2005 period.

On the other hand, what did mark a new stage was the rather strong tone employed in August, which suggested that the Eurosystem interest rate likely would again increase at the beginning of October. In fact, both the prospect that the Euro Area inflation rate will stay above the 2% inflation objective of ECB

SHORT-TERM INTEREST RATES IN NATIONAL MARKETS

Monthly averages as annual percentage

	Euro area			United States		Japan	United Kingdom		Switzerland
	ECB auctions (2)	Euríbor (5) 3-month	Euríbor (5) 1-year	Federal Reserve Board target level (3)	3-month (5)	3-month (5)	Bank of England repo rate (4)	3-month (5)	3-month (5)
2005									
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	2.76	2.99	3.40	5.03	5.38	0.31	4.50	4.73	1.48
July (*)	2.80	3.10	3.54	5.25	5.50	0.40	4.50	4.73	1.53
August (1)	3.05	3.25	3.61	5.25	5.40	0.44	4.75	4.97	1.65

NOTES: (*) Provisional figures.
(1) August 28.
(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%), 3-8-06 (3.00%).
(3) Latest dates showing change: 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%), 29-6-06 (5.25%).
(4) Latest dates showing change: 10-7-03 (3.50%), 6-11-03 (3.75%), 5-2-04 (4.00%), 6-5-04 (4.25%), 10-6-04 (4.50%), 5-8-04 (4.75%), 4-8-05 (4.50%), 3-8-06 (4.75%).
(5) Interbank offer rate.
SOURCE: National central banks, Thomson Financial Datastream and internal figures.

in coming months and the sharp increase in the broad money supply figure (which is well above the reference level) would justify its continuing to adjust its monetary policy in the upcoming period.

Another event in the monetary policy field during the summer was the effective end of the policy of close to zero per cent interest rates carried out by Japan since 2001. While it had announced in March that this would come about in the near future, even at the beginning of July some cabinet ministers continued to stand up against this move. Nevertheless, on July 14 the Japanese monetary authorities put the new objective overnight interbank rate at 0.25% and the discount rate at 0.40%.

Japan puts end to 0% interest rate policy.

The governor of the Bank of Japan, Toshiniko Fukui, was quick to state that the change in monetary policy would be gradual and would not follow the recent model adopted by the Fed. The truth is that the end of the long period of deflation has left the very low interest levels in Japan somewhat out of step.

The Bank of England, in turn, made a surprise increase in its official interest rate on August 3, putting it up 25 basis points to 4.75%. As a result, the rate went back to the level of one year ago. The sharp increase in the inflation rate in June (going up to 2.5%), substantially above the objective level of 2%, brought this measure about. Furthermore, given the expectations of the central bank itself that inflation would stay above this level both for the rest of 2006 and in 2007, it is likely that a further rise will take place.

Bank of England makes surprising rate rise following cut a year ago.

In the summer months other central banks joined the move to tighter monetary policies. In July, the monetary authorities of Iceland, Turkey and India raised their official interest rates in order to deal with inflationary pressures. In August, the monetary institutions of Australia, Denmark, South Korea, Norway, Iceland and China also raised their reference rates.

In the latter country, the Central Bank of China again raised its reference rate on loans up to one year by 27 basis points putting it at 6.12%. At the same time, it raised the rate on 1-year deposits by a similar amount setting it at 2.52% In this way, and also by raising the cash ratio of banks it was attempting to contain the overheating of the economy. This task is seen as being complicated by maintenance of the yuan at an undervalued level. In fact, the massive purchases of dollars to hold down the exchange rate of the renminbi are flooding the economy of this Asian giant with liquidity.

China also increases its official interest rates.

Euro recovers attractiveness during summer

The dollar tended to weaken in the summer months with the growing signs of an economic slowdown and increasing prospects that the Federal Reserve's official interest rate had reached a ceiling after the rise at the end of June. As a result, after the US currency had risen by 3.5% in overall terms in 2005, this year the greenback has renewed its downward trend recording a drop of similar size to that so far this year measured against a broad basket of currencies. The US currency is being pushed down by its continuing foreign imbalance.

In recent months, the euro has recovered strength thanks to rate increases by the European Central Bank and the prospect that these will continue with the recovery of the Euro Area economy. Since the beginning of the year, the single European currency thus

Dollar tends to weaken in summer with vanishing prospects of new Fed rate rises.

EXCHANGE RATES OF MAIN CURRENCIES

July 2006

	Final session of month		Monthly figures				*Exchange rate August 28, 2006*
	Exchange rate	% monthly change (2)	Average exchange rate	% change (2)			
				Monthly	Over December 2005	Annual	
Against US dollar							
Japanese yen	114.6	0.2	115.7	0.9	–2.3	3.4	*117.2*
Pound sterling (1)	1.868	1.0	1.845	0.1	5.7	5.3	*1.894*
Swiss franc	1.231	0.6	1.236	0.3	–5.3	–4.4	*1.236*
Canadian dollar	1.132	1.4	1.129	1.3	–2.9	–7.8	*1.111*
Mexican peso	10.92	–3.3	10.99	–3.5	3.4	3.0	*10.93*
Nominal effective index (4)	*108.0*	*–0.2*	*108.5*	*–0.2*	*–2.9*	*–3.3*	*107.9*
Against euro							
US dollar	1.277	0.4	1.268	0.3	7.0	5.4	*1.280*
Japanese yen	145.8	0.0	146.7	1.1	4.4	8.9	*149.9*
Swiss franc	1.571	0.3	1.569	0.5	1.3	0.7	*1.580*
Pound sterling	0.684	–1.1	0.688	0.2	1.2	0.0	*0.676*
Swedish krona	9.233	–0.1	9.218	–0.2	–2.3	–2.2	*9.247*
Danish krone (3)	7.462	0.0	7.460	0.0	0.1	0.0	*7.461*
Polish zloty	3.937	–2.9	3.996	–0.8	3.8	–2.5	*3.935*
Czech crown	28.53	0.1	28.45	0.2	–1.8	–5.7	*28.16*
Hungarian forint	272.2	–3.9	277.5	1.9	9.8	12.6	*276.3*
Nominal effective index (5)	*104.3*	*–0.2*	*104.3*	*0.3*	*3.5*	*2.5*	*104.5*

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.

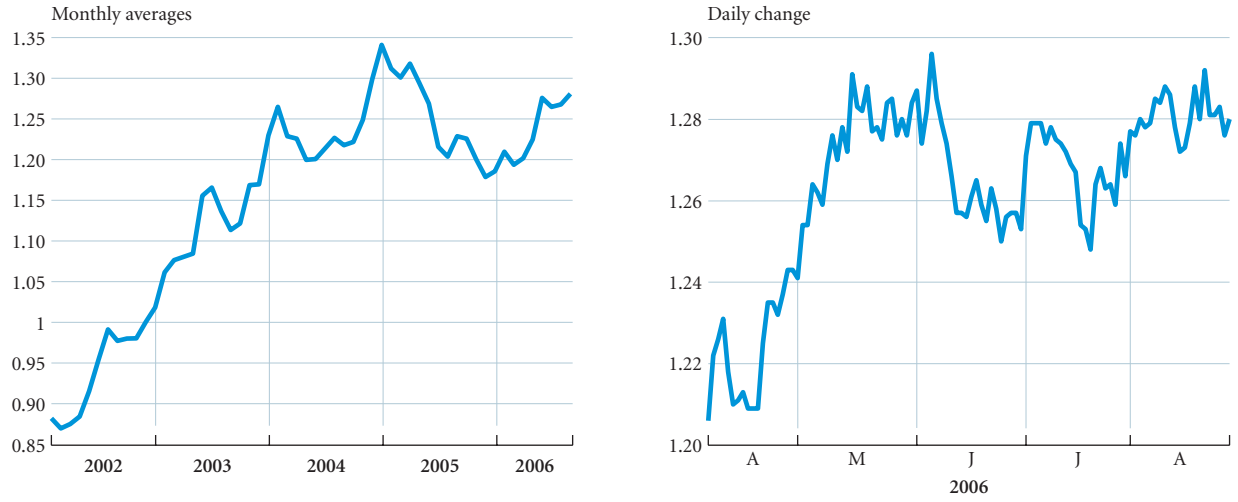
Japanese yen extremely weak.

appreciated by more than 4% compared with the currencies of its main trading partners. In terms of the US currency, the euro ended up at an exchange rate of more than 1.29 dollars at the beginning of the fourth week in August, thus coming close to the annual high in June. Compared with the Japanese yen, the euro recorded a new all-time high in the last week of August with an exchange rate of 149.9 yen.

In spite of the rise in the official interest rate in Japan in mid-July, the yen has shown signs of weakness as a result of the predominating view that the unfavourable differential in interest rates will last for some time. As a result, in terms of a broad group of currencies, in the second last week of August the Japanese currency marked up its lowest level since October 1998. It should be pointed out that the trend in the Japanese currency is linked to some extent to the Chinese yuan, which, in spite of further pressure from the United States, has been appreciated by only 1.6% against the dollar in the 12 months following the revaluation on July 21, 2005.

EURO COMES CLOSE TO ANNUAL HIGH AGAINST DOLLAR IN AUGUST

US dollars to euro



NOTES: Figures go up to August 28.
SOURCE: OCDE, Thomson Financial Datastream and internal figures.

The pound sterling appreciated as a result of the unexpected increase in the Bank of England reference rate at the beginning of August. As a result, at the start of the second week of that month it marked up its highest appreciation in terms of a broad group of currencies for the past two years. Nevertheless, the British currency later dropped to some extent with the appearance of some unfavourable economic indicators. In the middle of the last week of August the pound was running at 0.68 units to the euro, an increase of 1% over the beginning of the year. Against the US currency, the British pound stood at 1.89 dollars, more than 9% above the level at the beginning of the year.

Pound sterling marks up highest appreciation in past two years against broad basket of currencies.

Yield on government bonds showing downward move

At the end of June, the yield on US 10-year Treasury bonds recorded its highest level since May 2002 going to 5.24%. Nevertheless, from then on it began a downward path going to around 4.8% toward the end of August. Contributing to this was the somewhat gentler tone of messages coming from the Federal Reserve, such as the halt this had made in the upward course of interest rates. At the same time, bonds attracted some of the capital looking for refuge in view of the international conflicts set of in the Middle East and with Iran.

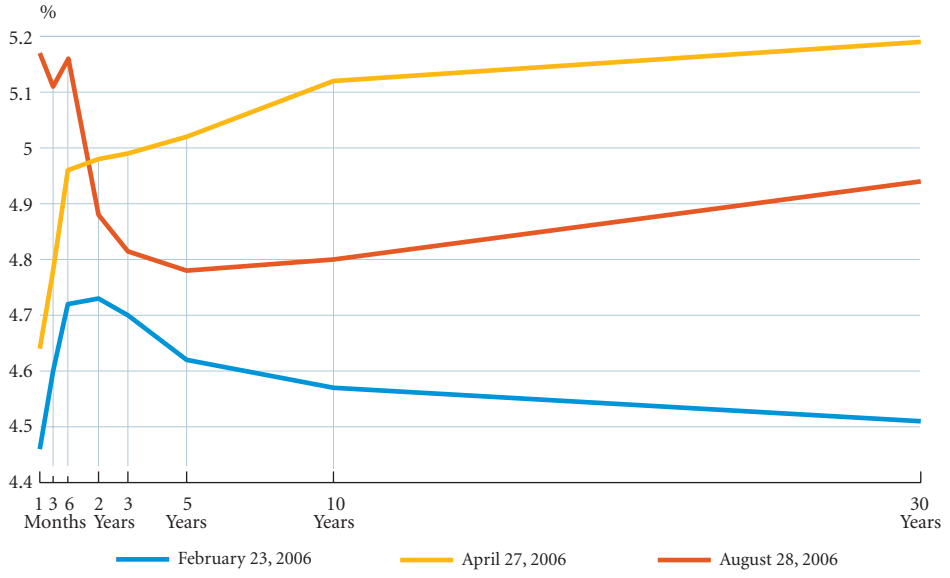
As a result, following the increase in short-term interest rates in the United States and the drop in long-term rates there has been a slightly more inverted interest rate curve. That is to say, long-term interest rates stand below the level of short-term rates. This situation is unusual and commonly indicates increased possibilities of a coming recession, especially if the reversal of the interest rate curve is very marked and persistent, something which, for the moment, is not the case.

In Europe, yields on government bonds have also slid downward in recent weeks in the wake of those on the other side of the Atlantic. Nevertheless, the decrease in yields on government bonds has not

Yield on US 10-year Treasury bonds drops after recording high for past four years.

YIELD CURVE IN UNITED STATES SLIGHTLY INVERTED

Yield on government bonds

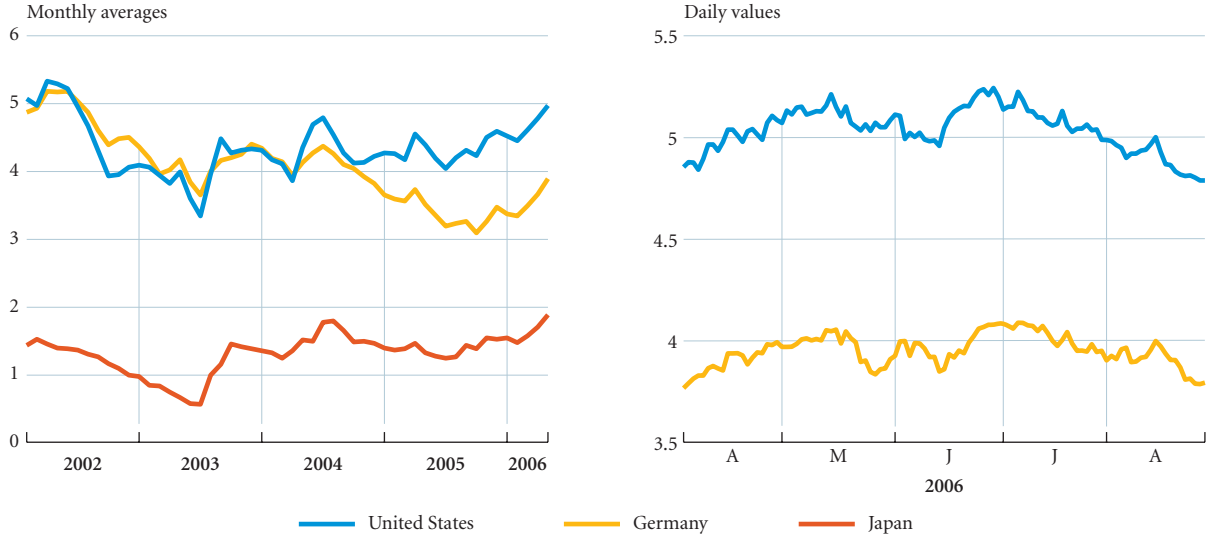


SOURCE: Reuters.

been quite as marked, in keeping with the prospects of further increases in the official rate by the European Central Bank. As a result, the differential in long-term interest rates between the dollar and the euro has dropped slightly to stand at 100 basis points in the final week of August.

LONG-TERM INTEREST RATE DIFFERENTIAL BETWEEN DOLLAR AND EURO NARROWS

Yield on 10-year government bonds as annual percentage



NOTES: Figures go up to August 28.
SOURCE: Bank of Spain and Thomson Financial Datastream.

LONG-TERM INTEREST RATES IN NATIONAL MARKETS

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

	2004	2005	2006					
			I	April	May	June	July	August 28
United States	4.31	4.33	4.61	5.04	5.18	5.17	5.08	4.80
Japan	1.50	1.39	1.58	1.91	1.91	1.87	1.90	1.69
Germany	4.07	3.38	3.50	3.91	3.99	3.99	4.01	3.79
France	4.10	3.41	3.51	3.95	4.01	4.01	4.03	3.80
Italy	4.24	3.56	3.71	4.23	4.29	4.30	4.31	4.09
Spain	4.10	3.39	3.49	3.92	3.99	3.99	4.03	3.80
United Kingdom	4.93	4.47	4.23	4.56	4.70	4.70	4.64	4.54
Switzerland	2.57	2.04	2.18	2.59	2.73	2.70	2.79	2.51

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

Since the end of June the yield on Japanese 10-year government bonds also dropped in spite of the fact that the Bank of Japan had effectively put an end to its 0% short-term interest rate policy at of mid-July. As a result, in the final week of August the yield on Japanese 10-year government bonds stood at around 1.7% , some 20 basis points below the end of the first half-year. This may be explained by statements from the central bank to the effect that the upward course of reference rates would be very gradual and that it would continue to by government bonds to the same amount, along with lower than expected inflation figures in July.

Interest rate on Japanese government bonds also drops.

Stock markets recover

In July and August, most international stock markets managed to largely recover from the period of instability in May as a result of the renewal of upward prospects on interest rates in the United States and concern about inflationary risks. The trend on stock exchanges during the summer was not exempt from some obstacles, such as the international tension over North Korea, Iran and Lebanon and further possible terrorist attacks on international airline flights, such as those averted in the United Kingdom. At the economic level, the new all-time high in oil prices in the second week of August also had a negative effect on the stock markets, although subsequent price decreases calmed things down.

The recovery of the stock markets was mainly due to the decrease in long-term interest rates and the good trend in corporate profits. As a result, while generally there was no going over the highs marked up in the second week of May, most stock exchanges showed notable cumulative gains over December as we came close to the end of August.

Stock markets manage to ride out dip in May and June with help of good trend in corporate profits.

Among the main US stock market indices, the traditional Dow Jones Industrials showed the better balance so far this year with a rise of more than 5%. The Nasdaq index, which is representative of hi-tech shares, showed a more erratic trend and was still unable to recover par for the year.

The Nikkei 225 index also stayed in the red toward the end of August. In any case, it has shown a path of recovery since the annual low seen in mid-June.

Japan's Nikkei 225 index stays in red in spite of recovery.

INDICES OF MAIN WORLD STOCK EXCHANGES

July 31, 2006

	Index (*)	% monthly change	% cumulative change	% annual change	*Figures on August 28, 2006*	
					% cumulative change	*% change over same date in 2003*
New York						
Dow Jones	*11,185.7*	*0.3*	*4.4*	*5.1*	*5.9*	*21.1*
Standard & Poor's	*1,276.7*	*0.5*	*2.3*	*3.4*	*4.3*	*29.8*
Nasdaq	*2,091.5*	*–3.7*	*–5.2*	*–4.3*	*–2.0*	*20.0*
Tokyo	15,456.8	–0.3	–4.1	29.9	–2.2	*54.2*
London	5,928.3	1.6	5.5	12.2	4.6	*40.0*
Euro area	3,691.9	1.2	3.2	11.0	6.4	*47.8*
Frankfurt	*5,682.0*	*0.0*	*5.1*	*16.3*	*8.3*	*67.6*
Paris	*5,009.4*	*0.9*	*6.2*	*12.5*	*9.2*	*54.9*
Amsterdam	*454.1*	*3.1*	*4.0*	*14.7*	*7.1*	*41.3*
Milan	*28,086.0*	*0.7*	*4.9*	*9.0*	*7.9*	*52.8*
Madrid	*11,818.0*	*2.3*	*10.1*	*16.8*	*12.9*	*68.9*
Zurich	7,941.8	3.8	4.7	20.3	7.1	*56.1*
Hong Kong	16,971.3	4.3	14.1	14.0	13.8	*57.3*
Buenos Aires	1,701.6	–0.6	10.3	12.9	8.2	*133.6*
São Paulo	37,077.0	1.2	10.8	42.4	8.7	*141.5*

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

IBEX 35 marks up highest level since March 2000.

Corporate operations also animated European stock markets around, for example, the energy sector (Endesa take-over bid) and banking (merger of Intesa and Sanpaolo). As a result, European stock exchange indices obtained notable results compared with December, helped along by sharp increases in corporate profits.

In this context, at the beginning of the final week of August, the IBEX 35 index for the Spanish stock exchange marked up its highest level since March 2000, going above the 12,000 points level. In this way, near the end of August this selective Spanish index showed the highest capital gains of the year among the main European market indices. In any case, 10 companies out of the 35 making up the index stood below the starting level for the year.

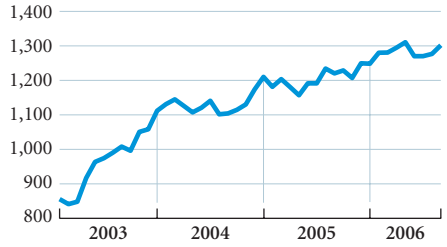
Emerging markets recover buoyancy.

Emerging stock markets recovered their buoyancy in the summer months thus taking them out of the sharp correction that in many cases had put them onto negative ground. The rise in prices of raw materials and the containment of interest rate prospects in the United States contributed to this favourable trend. As a result, as the last week in August advanced, their representative indices generally showed notable advances over the end of December 2005. As a result, stock exchanges in Moscow, Mexico City, Shanghai and Hong Kong, for example, showed two-digit cumulative gains.

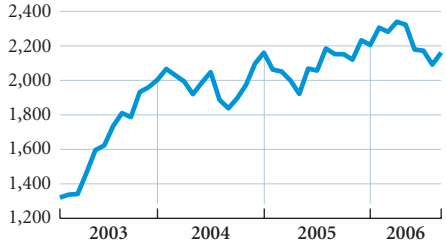
INTERNATIONAL STOCK EXCHANGES

Indices at month-end

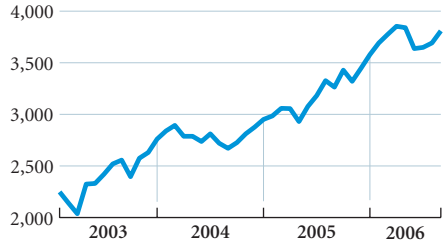
New York (Standard & Poor's 500)



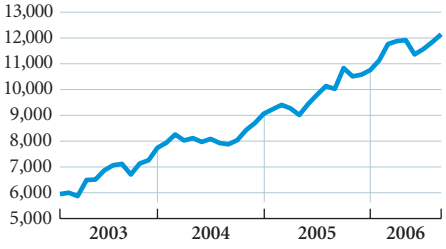
Nasdaq Index (United States)



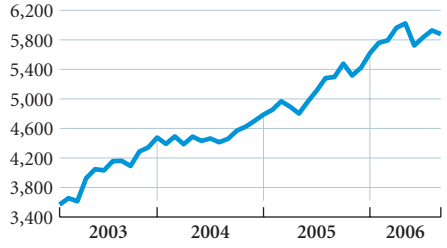
Euro area (DJ Eurostoxx 50)



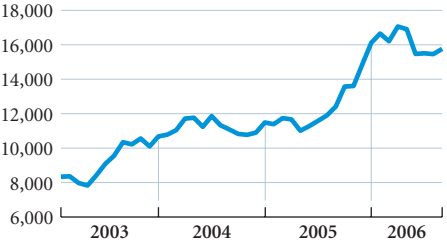
Madrid (IBEX 35)



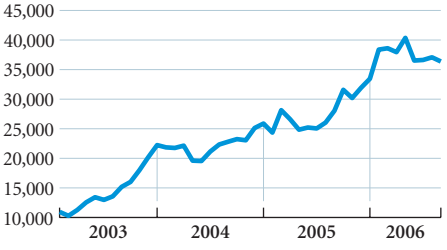
Londres (Financial Times 100)



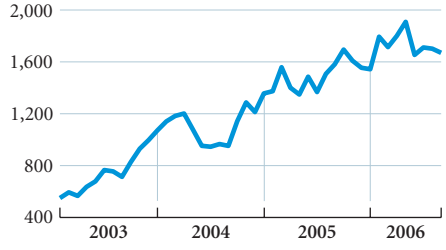
Tokio (Nikkei 225)



São Paulo (Bovespa)



Buenos Aires (Merval)



NOTES: August 28, 2006.
SOURCE: National stock exchanges.

SPAIN: OVERALL ANALYSIS

Economic activity

Following revision by INE, Spain's GDP in second quarter grows at highest rate since 2001.

Spain's economy grows above forecasts

In the second quarter of 2006, the gross domestic product (GDP) generated by Spain's economy grew by 3.7% year-to-year, one decimal more than in the previous quarter. The new figures supplied by the Quarterly National Accounts incorporate the updated annual estimates for the period 2001-2005 carried out by the National Institute of Statistics (INE). This revision was brought about by the incorporation of new statistical sources and the replacing of some provisional figures with those now definitive.

As a result of this updating, real GDP growth has been revised upward by one decimal for the years 2001, 2004 and 2005 while that for 2002 and 2003 has remained unchanged. In the quarterly figures series, year-to-year GDP growth was revised upward between one and two decimals in the period 2003 and 2004 and around one decimal in 2005 and the first quarter of 2006, as may be noted in the graph.

According to figures for the newly revised series, the increase in GDP growth in the second quarter was due to the lower negative contribution of the foreign sector (1.1 points, three decimals less than in the first quarter), which was partially compensated by the moderation seen in national demand, which contributed 4.8 points to GDP growth, as against 5.0% in the preceding period.

GDP GROWTH REVISED UPWARD

Year-to-year change in real GDP

SOURCE: INE and internal figures.

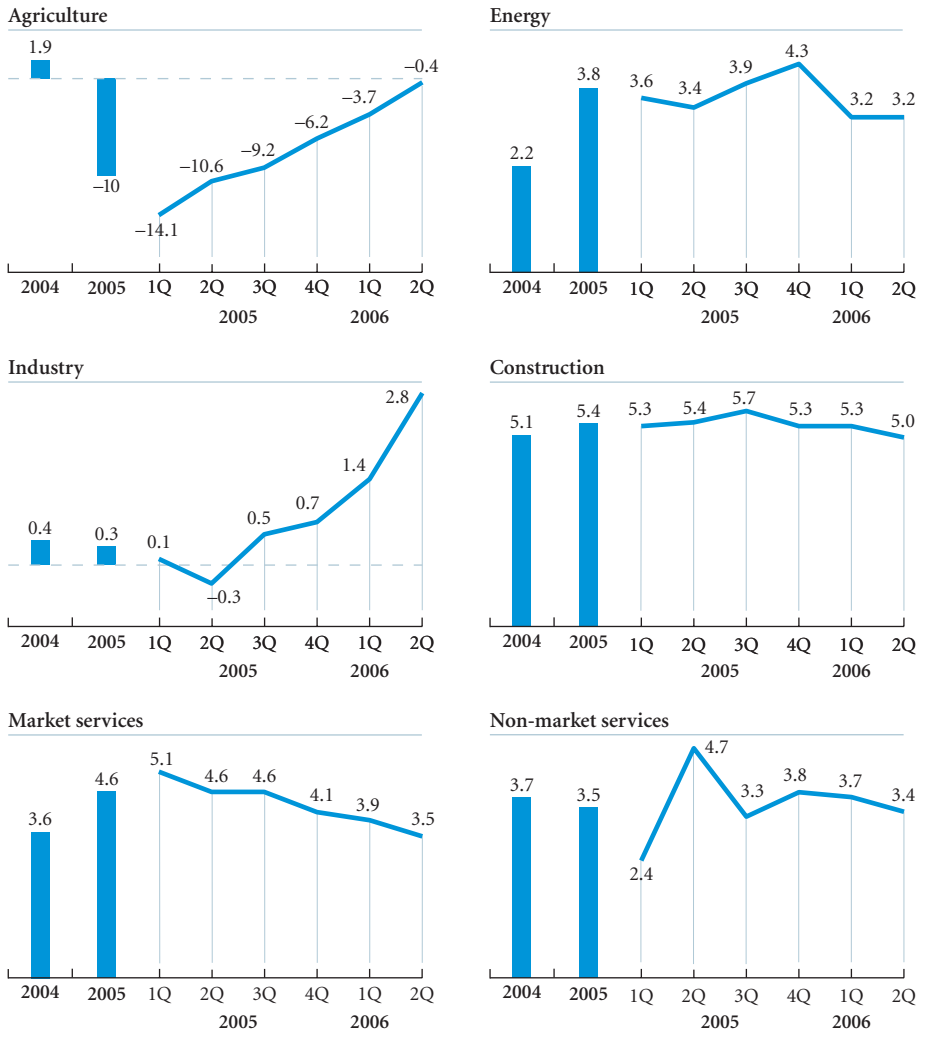
TREND IN SPAIN'S GDP BY COMPONENT

Percentage year-to-year change (*)

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

TREND IN SPAIN'S GDP BY SUPPLY SECTOR

Percentage year-to-year change (*)



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

Negative contribution of foreign sector down while domestic demand moderating.

The reduction of the negative contribution from the foreign sector to total growth of the economy came about as a result of the slowdown in imports (growth of 7.9% as against 12.4% in the previous quarter) which was somewhat sharper than that taking place in exports (5.3% as against 9.5%). In spite of this specific improvement, there continues to be a troubling trend to an increase in Spain's foreign imbalance. To be specific, the current account deficit rose to 9.3% of the GDP in the first half of 2006, more than one percentage point higher than that recorded one year earlier.

The lower contribution of national demand to GDP growth, in turn, was due to the moderation of growth, both in final consumer spending and in gross capital formation. In the case of final household consumption, year-to-year

growth was down to 3.6% (two decimals less than in the previous quarter) due to the less expansionist state of spending on durable goods and services. It seems that this trend is being maintained during the third quarter, if we are to go by the tendency in some indicators. One notable case is that of passenger car registrations which fell by 5.1% year-to-year in July. In this context, the consumer confidence index was stuck at a very low level (-14 points in July, for the third consecutive month).

Consumer growth tending to slow down...

On the other hand, public consumption recorded relatively stable growth in the first half-year (4.4% year-to-year, both in the first and the second quarter) as a result of the trend in wages and purchases by various levels of government.

The slowdown in growth of gross fixed capital formation (6.1% in the second quarter, two decimals less than in the first quarter) was due to moderation in growth of construction (5.7% as against 5.8% earlier) and, to a greater extent, to the slowdown in growth of investment in other products (3.3% as against 4.8%). On the other hand, capital goods investment is showing a clearly expansionist profile (9.1%, a half-point more than in the previous quarter) in all components.

...but investment in construction and capital goods maintaining considerable strength.

Investment going into housing construction maintained a high growth rate in the second quarter (6.5% year-to-year) which, although for the moment down from the previous quarter (7.2%), is very similar to the average recorded in the past three years. In any case, the trends in the main indicators suggest a slight moderation of growth in coming months, as (from another perspective) is also indicated by the gradual decrease in real-estate prices. To complete the picture, the performance in civil works continues to be very positive with prospects that this will continue into the immediate future.

On the supply side, the most notable factor is the consolidation of the recovery in the industrial sector, for which value added grew by 2.8% year-to-year in the second quarter, twice that in the first quarter, according to that indicated by the trend in the industrial production index. The recovery of exports has been a crucial factor in this recovery with leadership by the chemical industry, metallurgy, machine-building, medical equipment and motor vehicles. On the contrary, there continues to be a drop in the textile industry, clothing, furs and leather although partly tending to moderate this decrease. The tobacco industry, on the other hand, continues to be in a free-fall state under the effect of legal restrictions imposed in this field.

With regard to services, we note signs of a slowdown in nearly all branches although we still are seeing relatively high growth rates in nearly all segments, particularly in transport, information technology and communications and company services. The tourist sector is also showing a moderately positive balance with significant increases up to the moment in the number of foreign visitors and in hotel stays reported (both for residents and foreign visitors). Nevertheless, the trend noted in recent years of some containment in average spending per tourist still persists.

Following the revision of figures carried out, the weak results for Spain's economy in productivity have improved slightly. In any case, in overall terms, progress in this field continues to be quite insufficient, as a result of the poor performance in this respect in

Industry consolidating recovery.

Slow increase in productivity and excessive inflation, along with foreign deficit, form Achilles' heel of Spain's economy.

construction and services. On the other hand, in recent months industry has again shown a more satisfactory trend.

Another structural imbalance dragging back Spain's economy is excessive inflation. The GDP deflator, which is representative of the level of prices in the whole economic system, is showing a very stable growth trend in recent years. It has not been possible to reduce the existing differential with the countries within Spain's orbit and we should bear in mind the overall drop in competitiveness this situation involves.

Labour market

Employment eases growth while holding at high levels

Employment continued to show strong growth in the second quarter although with an easing off in rate of increase compared with earlier quarters. According to the Labour Force Survey for the second quarter of 2006, total estimated employment rose at a rate of 4.2%, seven decimals below the previous quarter.

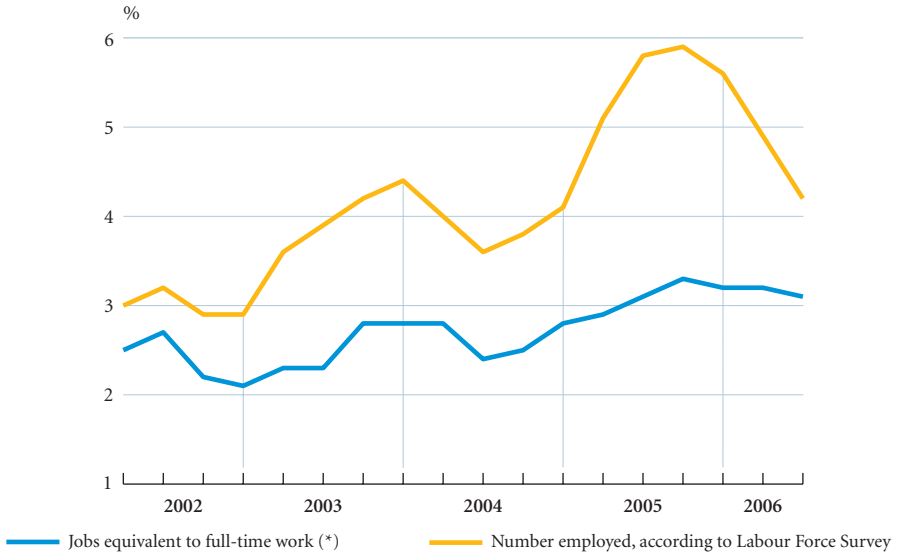
Figures for the second quarter supplied by National Accounting ran long the same lines of a slight easing off. In fact, employment equivalent to full-time work adjusted for seasonal and calendar effects showed moderation in growth rate to the extent of one decimal putting the figure at 3.1% year-to-year. This meant net job creation of 550,000 full-time jobs in one year.

The slowdown in employment showed by the Labour Force Survey results was largely the result of the progressive normalization of the process of incorporating foreign workers in the labour market following the measures carried out last year. In spite of this, employment of foreign workers continued to increase at a high annual rate, 18.7% in the second quarter, as against 3.2% for Spaniards and 3.0% if we exclude those persons with double nationality, mainly those from Latin America. In absolute terms, this meant

Employment showing strong growth and foreign workers take up nearly half new jobs.

EMPLOYMENT GROWS BY 3% ANNUAL

Year-to-year change in employment



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

ESTIMATED EMPLOYMENT

Second quarter 2006

	No. of employees (thousands)	Quarterly change		Cumulative change		Annual change		% share
		Absolute	%	Absolute	%	Absolute	%	
By sector								
Agriculture	957.4	–27.4	–2.8	–49.4	–4.9	–29.2	–3.0	4.9
Non-farm	18,735.7	320.4	1.7	428.3	2.3	827.3	4.6	95.1
Industry	*3,286.9*	*13.3*	*0.4*	*–1.6*	*–0.0*	*24.1*	*0.7*	*16.7*
Construction	*2,521.7*	*85.0*	*3.5*	*98.9*	*4.1*	*182.4*	*7.8*	*12.8*
Services	*12,927.1*	*222.1*	*1.7*	*331.0*	*2.6*	*620.8*	*5.0*	*65.6*
By type of employer								
Private sector	16,839.3	302.5	1.8	393.0	2.4	787.9	4.9	85.5
Public sector	2,853.8	–9.5	–0.3	–14.2	–0.5	10.3	0.4	14.5
By work situation								
Wage-earners	16,111.5	222.6	1.4	269.8	1.7	671.4	4.3	81.8
Permanent contract	*10,570.7*	*–22.3*	*–0.2*	*79.4*	*0.8*	*265.4*	*2.6*	*53.7*
Temporary contract	*5,540.8*	*244.9*	*4.6*	*190.4*	*3.6*	*406.0*	*7.9*	*28.1*
Non-wage-earners	3,565.9	84.4	2.4	119.7	3.5	137.6	4.0	18.1
Entrepreneurs with employees	*1,088.0*	*35.2*	*3.3*	*58.5*	*5.7*	*116.7*	*12.0*	*5.5*
Entrepreneurs without employees	*2,194.1*	*43.5*	*2.0*	*42.5*	*2.0*	*50.0*	*2.3*	*11.1*
Family help	*283.8*	*5.7*	*2.0*	*18.7*	*7.1*	*–29.1*	*–9.3*	*1.4*
Other	15.7	–14.0	–47.1	–10.7	–40.5	–10.8	–40.8	0.1
By time worked								
Full-time	17,288.8	302.5	1.8	289.8	1.7	812.0	4.9	87.8
Part-time	2,404.3	–9.6	–0.4	89.0	3.8	–13.8	–0.6	12.2
By sex								
Males	11,704.0	128.4	1.1	154.4	1.3	386.2	3.4	59.4
Females	7,989.1	164.6	2.1	224.4	2.9	412.0	5.4	40.6
TOTAL	**19,693.1**	**293.0**	**1.5**	**378.9**	**2.0**	**798.2**	**4.2**	**100.0**

SOURCE: National Institute of Statistics and internal figures.

Notable adjustment in certain manufacturing sectors does not stop industrial employment from showing slight growth, thanks to strength of some branches of economic activity.

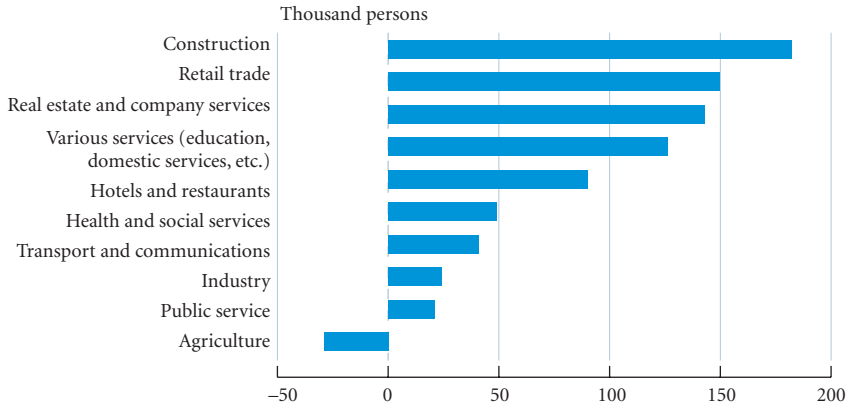
that, out of the 798,200 new jobs created in the past 12 months, 381,400 (nearly half) were taken up by foreign workers.

In addition, the weaker state of employment must be related to the process of transformation being undergone by Spain's economy. At this time, consumer manufactures of low value added are undergoing major adjustments. This so in the case of furniture and timber, clothing, leather and footwear, plastics, graphic arts and consumer electronics. On the other hand, the relative strength in economic activities such as manufacture of metal products, food and drinks, non-metallic minerals and some chemical sub-sectors, along with certain industries specializing in precision machinery, is contributing to ease the situation in industrial employment as a whole, which is holding at low positive changes of 0.7% year-to-year.

The weakness in industry is in contrast to the growing strength of employment

CONSTRUCTION AND SERVICES BOOSTING EMPLOYMENT

Year-to-year change in estimated employment in second quarter of 2006



SOURCE: Estudios y Análisis Económico 28-07-2006/CE-TO050-ES.

ESTIMATED UNEMPLOYMENT

Second quarter 2006

	No. of unem-ployed	Quarterly change		Cumulative change		Annual change		Share %	Unemployment rate over labour force %
		Absolute	%	Absolute	%	Absolute	%		
By sex									
Males	795.5	–50.9	–6.0	–25.7	–3.1	–94.6	–10.6	43.3	6.4
Females	1,041.5	–47.9	–4.4	21.4	2.1	–13.1	–1.2	56.7	11.5
By age									
Under 25 years	451.8	–2.4	–0.5	–4.5	–1.0	–56.3	–11.1	24.6	18.2
Other	1,385.2	–96.4	–6.5	0.2	0.0	–51.4	–3.6	75.4	7.3
By personal situation									
Long-term unemployment	525.4	–5.4	–1.0	–31.7	–5.7	–68.3	–11.5	28.6	–
Seeking first job	210.5	6.8	3.3	–9.8	–4.4	–47.6	–18.4	11.5	–
Other	1,101.1	–100.2	–8.3	37.2	3.5	8.2	0.8	59.9	–
TOTAL	**1,837.0**	**–98.8**	**–5.1**	**–4.3**	**–0.2**	**–107.7**	**–5.5**	**100.0**	**8.5**

SOURCE: National Institute of Statistics and internal figures.

in construction and the good state of services in which the large sectors show appreciable increases in employment. The bulk of employment in the tertiary sector is being provided by company services, hotel and restaurant trade, retail trade, domestic service, health and social services.

The greater part of new employment was of an employer-dependent nature so that wage-earners accounted for 81.8% of all those employed. Among wage-earners, temporary work was predominant. In fact, this type of contract made up 60.5% of all wage employment created in the past 12 months so that at this time the temporary-work ratio has not been reduced. In the second quarter of 2006 this ratio stood at 34.4%.

Bulk of employment generated in construction and more traditional service branches.

LABOUR FORCE, EMPLOYMENT AND UNEMPLOYMENT BY AUTONOMOUS COMMUNITY

Second quarter 2006

	In work force			Employed			Unemployed			Unemployment rate (%)
	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	Total (thousands)	Annual change	% annual change	
Andalusia	3,548.2	132.6	3.9	3,098.7	153.9	5.2	449.6	–21.2	–4.5	12.7
Aragon	610.8	5.0	0.8	575.8	8.1	1.4	35.0	–3.0	–8.0	5.7
Asturias	468.5	20.1	4.5	430.6	30.7	7.7	37.9	–10.6	–21.9	8.1
Balearic Islands	542.6	25.8	5.0	506.6	21.0	4.3	36.0	4.8	15.6	6.6
Canary Islands	995.0	59.1	6.3	881.5	61.5	7.5	113.5	–2.4	–2.0	11.4
Cantabria	265.0	5.9	2.3	247.3	11.7	5.0	17.7	–5.8	–24.8	6.7
Castile-Leon	1,133.1	18.0	1.6	1,038.4	19.5	1.9	94.8	–1.5	–1.6	8.4
Castile-La Mancha	869.4	32.8	3.9	791.5	33.2	4.4	77.8	–0.4	–0.5	8.9
Catalonia	3,650.1	122.2	3.5	3,413.9	137.3	4.2	236.2	–15.1	–6.0	6.5
Valencian Community	2,337.5	100.2	4.5	2,154.9	124.4	6.1	182.6	–24.3	–11.7	7.8
Extremadura	457.9	1.5	0.3	395.2	8.0	2.1	62.7	–6.5	–9.3	13.7
Galicia	1,261.3	8.7	0.7	1,152.8	39.4	3.5	108.5	–30.7	–22.1	8.6
Madrid Community	3,175.5	90.3	2.9	2,953.8	80.5	2.8	221.7	9.8	4.6	7.0
Murcia	652.0	33.6	5.4	600.4	31.8	5.6	51.6	1.8	3.6	7.9
Navarre	297.0	10.6	3.7	280.5	8.7	3.2	16.5	1.8	12.5	5.6
Basque Country	1,058.0	25.0	2.4	982.8	28.1	2.9	75.1	–3.1	–4.0	7.1
La Rioja	152.7	1.6	1.1	143.4	2.0	1.4	9.3	–0.4	–4.5	6.1
Ceuta and Melilla	55.6	–2.5	–4.0	45.0	–1.5	–3.0	10.6	–0.9	–7.8	19.1
TOTAL	**21,530.1**	**690.4**	**3.3**	**19,693.1**	**798.2**	**4.6**	**1,837.1**	**–107.7**	**–5.5**	**8.5**

SOURCE: National Institute of Statistics and internal figures.

Notable drop in estimated employment, according to Labour Force Survey.

The good performance in employment has favoured a reduction in estimated unemployment of 5.5% putting the figure at 1,837,000 persons in the second quarter. This in spite of the sustained increase in the activity rate (rate at which people move into the labour force) which, calculated as the relation between labour force and the population 16 years or older, came to 58.3%, an historically record level. The rise in the activity rate was due to the increased move of females into the labour market. In spite of this, the female rate (47.9%) was still lower than the male rate at 69.1%.

The unemployment rate stood at 8.5%, eight decimals lower than in the same quarter last year. The differences between male and female rates (6.4% and 11.5%) held stable although remaining far apart. The level of unemployment among those under 25 years, in turn, stood at 18.2%, somewhat more than two points less than in the second quarter of 2005.

From a geographical perspective, the situation presents notable differences. Those autonomous communities showing the biggest growth in employment were Asturias, Canary Islands, Valencian Community, Murcia and Andalusia.

Registered unemployment: appreciable reduction as of July

Registered unemployment also down.

Figures for unemployment supplied by the Public Employment Service show a

continuation of the process of gradual but sustained easing of unemployment. In fact, the total number of those registered stood at 1,954,984 persons in July, 1.7% less than in the same month in 2005, according to the information system of the Public Employment Service.

The figures for the first seven months of the year are also more favourable than for the same period in 2005 with a cumulative decrease of 147,953 persons. Foreign workers unemployed rose to 133,109, representing 6.8% of the total, a proportion lower than the figure they make up in the case of employment.

REGISTERED UNEMPLOYMENT BY SECTOR, SEX AND AGE

July 2006

	No. of unemployed	Change over December 2005		Change over same period year before		% share
		Absolute	%	Absolute	%	
By sector						
Agriculture	62,461	–2,766	–4.2	3,681	6.3	3.2
Industry	276,777	–24,542	–8.1	–10,928	–3.8	14.2
Construction	213,255	–31,845	–13.0	–4,911	–2.3	10.9
Services	1,186,054	–80,335	–6.3	–12,386	–1.0	60.7
First job	216,437	–8,465	–3.8	–9,889	–4.4	11.1
By sex						
Males	739,653	–112,310	–13.2	–23,875	–3.1	37.8
Females	1,215,331	–35,643	–2.8	–10,558	–0.9	62.2
By age						
Under 25 years	227,120	–48,775	–17.7	–17,137	–7.0	11.6
All other ages	1,727,864	–99,178	–5.4	–17,296	–1.0	88.4
TOTAL	**1,954,984**	**–147,953**	**–7.0**	**–34,433**	**–1.7**	**100.0**

SOURCE: INEM and internal figures.

Prices

Inflation close to 4%

CPI resisting any drop.

The beginning of the summer period did not bring major changes in the price picture in Spain. In July, the inflation rate measured by the consumer price index (CPI) recovered the one-decimal loss seen the month before to stand at 4% at year-to-year rate, that is to say, around what seems to be the reference figure for 2006, which is well above the average for last year.

Core inflation stands above 3%.

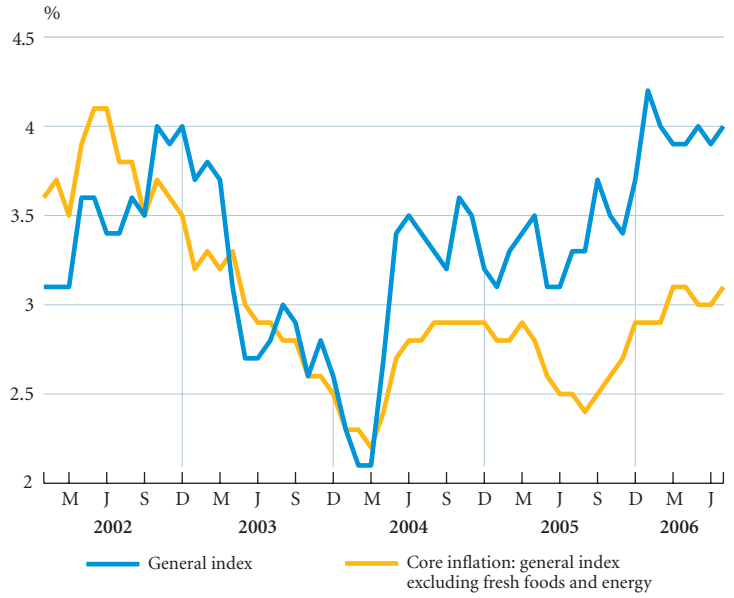
Core inflation moved along the same lines, although at a lower level, and continued to clearly show resistance to any drop to the plateau of 3% where it had settled since last February.

The sustained high growth of prices for services and processed foods, increased by cooking oil among other items, and the absolute stability of prices of non-energy industrial goods precluded any improvement in the situation.

Nevertheless, we should point out that the maintenance of prices of non-energy industrial goods at 1.5% year-to-year came about in spite of the fact that the July retail sales were stronger than last year. This situation could be indicative of something of an upward trend in manufactures in keeping with the pressures being exhibited by producer prices.

CPI STUCK AT 4% IN 2006

Year-to-year CPI rate



SOURCE: National Institute of Statistics and internal figures.

CONSUMER PRICE INDEX

	2005			2006		
	% monthly change	% change over December 2004	% annual change	% monthly change	% change over December 2005	% annual change
January	–0.8	–0.8	3.1	–0.4	–0.4	4.2
February	0.3	–0.6	3.3	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	0.2	2.3	3.9
July	–0.6	1.5	3.3	–0.6	1.7	4.0
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.

The relative stability of services prices masks a more complex picture as a very wide range of markets coexist. In the area of personal services and repairs and household maintenance, the fragmentation of the market and the occasional nature of consumption make the play of competition difficult and therefore any moderation in prices. In services of a public nature, the situation appears to be showing some sluggishness in contracting and regulation and even in the progressive move of prices close to service costs (education, transport, etc.). On the other hand, in services where there is more competition, finance and telecommunications, the situation is somewhat more favourable but not enough to significantly moderate this group within the CPI.

This precarious balance was broken by the brusque rise in fresh foods since the beginning of summer although, in terms of the index, the situation did not get worse because of the compensation exercised by fuel prices which in June and July showed a less inflationary performance than last year. The rise in fresh food products was due to those products for which demand increases in the tourist season, such as certain meats, mainly chicken, and potatoes.

Strength of demand allows cost increases to be shifted to prices.

In these circumstances, prospects for the CPI are uncertain although the energy component could take off the odd decimal in coming months. Nevertheless, as of September energy will again put pressure on the CPI if market conditions do not change. We may expect some moderation in prices of industrial goods and services but the existing sluggishness in that case and the strength of demand could limit its effects. We can only hope for a positive contribution from processed foods but not before the final months of the year.

The inflation differential with the Euro Area eased by one decimal in July to stand at 1.6 points, according to the harmonized consumer price index (HCPI). The increase in prices in Spain

Uncertain prospects for CPI with complications likely as of September.

CONSUMER PRICE INDEX BY COMPONENT GROUP

July

	Indices (*)	% monthly change		% change over previous December		% annual change	
		2005	2006	2005	2006	2005	2006
By type of spending							
Food and non-alcoholic beverages	121.9	–0.2	0.4	1.5	2.1	2.5	4.8
Alcoholic beverages and tobacco	123.1	0.0	0.0	3.9	1.0	3.9	2.1
Clothing and footwear	106.7	–10.7	–11.0	–11.2	–11.5	1.1	1.1
Housing	123.1	0.8	0.3	4.4	5.1	5.8	6.8
Household equipment	110.6	–0.8	–0.6	0.7	1.2	2.0	2.7
Health	107.8	0.1	0.2	0.5	1.3	0.9	1.5
Transport	123.7	1.7	0.8	6.4	6.0	6.9	5.8
Communications	90.6	–0.2	–0.2	–1.2	–0.9	–2.0	–1.4
Recreation and culture	104.2	1.2	1.2	0.3	0.3	–0.1	0.5
Education	121.7	0.0	0.1	0.6	0.4	4.2	3.9
Hotels, cafés and restaurants	125.8	0.9	0.9	3.8	4.0	4.3	4.5
Other	118.7	–0.1	0.0	2.7	3.2	3.1	3.9
By group							
Processed foods	119.8	–0.0	0.1	2.1	2.3	2.9	4.0
Unprocessed foods	126.6	–0.5	0.9	1.1	1.3	2.1	5.4
Non-food products	116.4	–0.8	–0.9	1.3	1.6	3.5	3.8
Industrial goods	111.6	–2.0	–2.4	–0.3	0.1	3.3	3.6
Energy products	*130.7*	*3.3*	*1.5*	*10.5*	*10.7*	*11.4*	*10.1*
Fuels and oils	*138.8*	*4.4*	*1.7*	*13.8*	*12.6*	*15.0*	*11.8*
Industrial goods excluding energy products	*105.8*	*–3.7*	*–3.7*	*–3.5*	*–3.2*	*0.8*	*1.5*
Services	122.0	0.6	0.7	3.1	3.2	3.8	4.0
Underlying inflation (**)	115.5	–1.1	–1.0	0.5	0.7	2.5	3.1
GENERAL INDEX	**117.8**	**–0.6**	**–0.6**	**1.5**	**1.7**	**3.3**	**4.0**

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

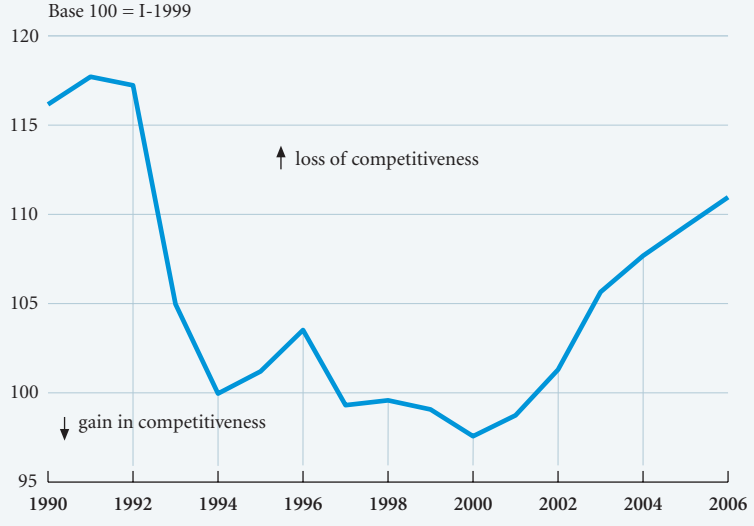
was higher in practically all components of the index with the exception of alcoholic drinks, tobacco and medical costs. In other groups, the differential stood practically at around two percentage points, with the highest being foods, communications, hotels, cafés and restaurants.

Poor results in competitiveness

International competitiveness depends on many factors. Business executives must be able to adapt to the new and ever-changing international environment, looking into the comparative advantages of their products and making correct decisions on introducing them to the market. In an economy like that of Spain whose exports of marketable goods and services are of a medium technological level, also important is the trend in prices and relative costs. The trend in competitiveness from this point of view may be quantified through indices of competitiveness compiled by comparing the trend in inflation and the exchange rates of one country vis-à-vis those of its main trading partners.

SPAIN LOSING COMPETITIVENESS AGAINST DEVELOPED COUNTRIES

Index of the Spanish consumer price competitiveness against



NOTES: 2006 (first half-year).
SOURCE: Bank of Spain and internal figures.

Spain's index of competitiveness compared with the developed countries measured by consumer prices during the past 15 years has varied significantly, with various periods being observed. At the beginning of the Nineties this index showed a sharp loss of competitiveness following the entry of the peseta in the European Monetary System at a high exchange rate. The successive devaluations taking place as of September 1992 meant a major gain in competitiveness. The macroeconomic stability of the years preceding the incorporation of the euro in 1999 contributed to maintaining the competitive level of Spain's economy. Furthermore, the devaluation of the euro in the early years of its existence also favoured the index level. Nevertheless, as of the present decade there has been a continuing loss of competitiveness, as may be noted in the accompanying graph, given that it has not been possible to compensate for the higher inflation differential with the developed countries through depreciation of the exchange rate.

Of special significance is the trend in competitiveness against countries of the Euro Area, which are Spain's main trading partners. In this case, the trend in the index as of the launching of the euro is reduced to the

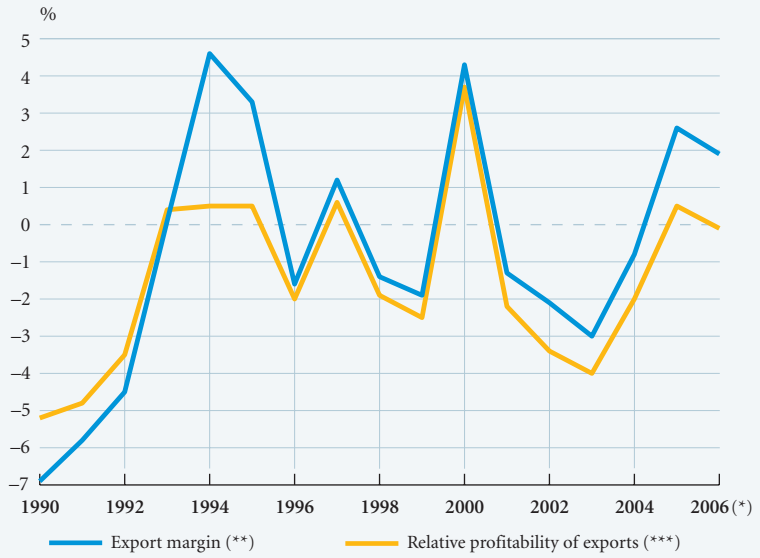
performance of the inflation differential with these countries, which has constantly been higher. As a result, since the end of the Nineties Spain has undergone a substantial loss of competitiveness against the countries of the Euro Area.

If in the preparation of the index we use unit labour costs, in the current decade we also note an unfavourable trend, both against the developed countries and vis-à-vis the countries of the Euro Area. This was due both to higher growth in wages per worker and to a poor increase in productivity.

The picture changes if, instead of taking relative consumer prices, we consider export prices. In this case, we also note the stages of loss of competitiveness at the beginning of the Nineties and a major gain following the devaluations in the period 1992-95. Nevertheless, the situation has remained fairly stable since 1999, especially against the countries of the Euro Area. This may be explained by the fact that, with the sharpening of competition as a result of globalization, the prices of marketable goods and services have tended to level out in international markets.

LOW RELATIVE PROFITABILITY OF EXPORTS

Year-to-year change



NOTES: (*) First quarter.
(**) Export deflator divided by unit labour cost.
(***) Export deflator divided by gross domestic product deflator.
SOURCE: National Institute of Statistics, Ministry of Economy and Finance and internal figures.

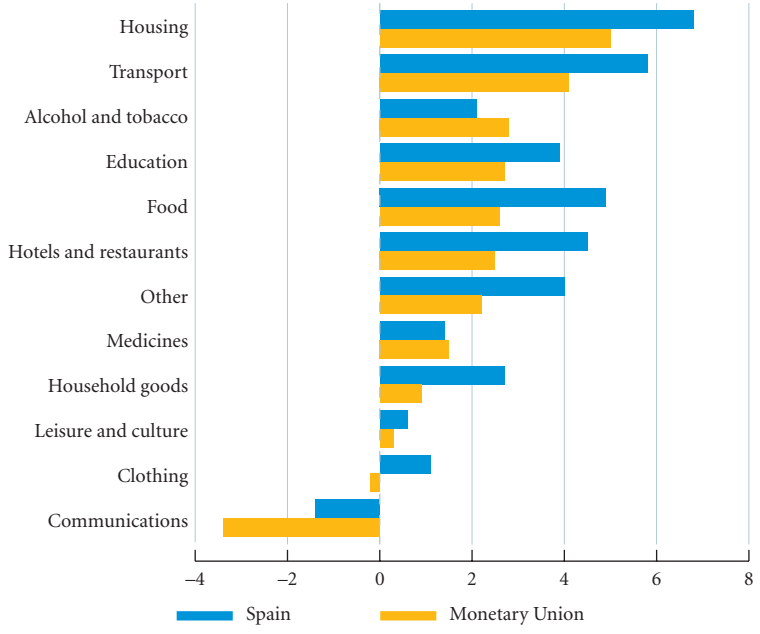
This suggests that in this situation the margins of exporting companies may have suffered. As a result, the export margin estimated from the export deflator divided by unit labour cost showed decreases in the early years of the present decade. Nevertheless, last year it began to show some recovery. On the other hand, the relative profitability of exports, estimated from the export deflator divided by the gross domestic product deflator, shows a similar trend, as may be noted in the accompanying graph.

Given that marketable products, the subject matter of international competition, are concentrated in the manufactured products sector, it is worth analyzing the trend in relative prices and costs under this heading. The index of competitiveness against the developed countries measured by using industrial costs shows a similar profile to the index using consumer prices although the loss of competitiveness in recent years is slightly less. On the other hand, if we use manufacturing unit labour costs, the loss of competitiveness in recent years is higher even in the case of whole-economy unit labour costs.

To sum up, we find that there does exist a competitiveness-cost problem in Spain's economy although the drop in terms of its trading partners at this moment is not excessive. This deficit in competitiveness arises partly from higher inflationary pressures and from low productivity. In order to deal with export competitiveness, companies need to bring into play their best tools in terms of management, technology, marketing and financing. However, given that recourse to competitive devaluation of the exchange rate is not now possible, it is also necessary to provide suitable conditions so that the course of prices and labour costs will aid company efforts.

MOST PRICES BEHAVING WORSE IN SPAIN THAN IN EURO AREA

Year-to-year change in HCPI by component in July 2006



SOURCE: INE and internal figures.

Contained rise in prices of manufactured goods

Producer prices of industrial products continued to show high growth in July (6.4% year-to-year) with no sign of easing off. The sharp growth in prices was due to energy and especially to intermediate goods for which the rate of increase was 7%, practically twice that at

Manufactures show moderate price increases despite sharp pressure from energy costs and intermediate goods.

Moderation and even some drop in import prices means further pressure for industrial sector.

the beginning of the year. On the other hand, consumer manufactures (non-food) and capital goods managed to maintain relatively modest price increases.

From this point of view, the contained rise in manufactures is not a serious threat to final distribution prices although, of course, it does not work in favour of their moderation. In fact, a situation such as the present one with heavy pressure on production costs (wages also are growing above wholesale prices of manufactures) poses a bigger threat to profitability and the future of industry than to the well-being of the consumer, who after all benefits from growing international competition and import prices that are low or dropping.

In this respect, with figures for the first six months of the year, we note that import prices are following the course mentioned. Prices of non-food consumer manufactured goods rose by only 1.1% whereas imported foods and capital goods showed a moderate decrease. In addition, the performance of farm prices (with a definite drop in the period up to May) was clearly favourable. This drop (3.7%) was due to agricultural farm prices seeing that livestock prices were quite stable in the first five months of 2006.

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											
June	–11.9	4.4	2.2	2.1	3.1	13.5	5.4	3.6	–1.3	7.7	–
July	–5.1	4.6	2.1	1.9	3.0	15.7	8.2	0.6	10.5	11.7	–
August	9.2	4.9	2.5	1.8	2.9	16.4	6.1	–0.3	–0.3	11.1	4.2
September	6.8	5.4	2.6	1.9	3.2	17.9	4.3	–0.6	4.1	6.9	–
October	–0.8	5.0	3.0	1.9	3.1	15.2	4.8	0.9	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	4.1
December	2.1	5.2	3.2	2.0	3.2	15.6	7.0	0.9	10.2	8.8	–
2006											
January	4.0	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	4.1
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	–4.2	6.6	3.2	2.3	6.1	17.8	6.1	4.2	–0.6	8.2	4.0
June	...	6.3	3.5	2.3	6.7	14.6	1.7	–1.5	–3.2	4.2	–
July	...	6.4	3.5	2.4	7.0	13.9	...	...	...	...	...

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

Foreign sector

Trade deficit slows growth in June

The trade deficit continued to sharply increase in June although not to the same extent as in previous months. In spite of this, the imbalance in foreign trade in goods in the first half-year reached 43.2 billion euros, 19.1% more than in the same period in 2005. The lower relative worsening of the situation was due to the recovery of exports in a context of a sustained increase in imports.

The recovery in exports came as a result of the strength of the Latin American market, the US market as well as that in countries of the former Soviet Union and the newly industrialized Asian markets. In any case, the European Union (EU) market showed an incipient improvement which meant it recorded a 4.5% growth by volume, still a long way from that seen in third countries at 16.8% real. The total increase in sales abroad in the first half-year stood at 7.9% real, which shows a brighter

Market in non-EU countries currently developing more favourably than that of European Union although this beginning to recover.

FOREIGN TRADE

January-June 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	20,544	44.1	15.9	3,883	41.8	4.5	–16,662	18.9
Consumer goods	36,082	13.5	27.9	32,089	9.0	37.3	–3,993	88.9
Food	*6,786*	*4.2*	*5.3*	*10,302*	*6.5*	*12.0*	*3,517*	*151.8*
Non-foods	*29,296*	*15.6*	*22.7*	*21,786*	*8.1*	*25.3*	*–7,510*	*74.4*
Capital goods	13,271	1.3	10.3	8,488	23.6	9.9	–4,783	64.0
Non-energy intermediate goods	59,336	11.2	45.9	41,560	11.8	48.3	–17,776	70.0
By geographical area								
European Union (EU-25)	76,640	9.7	59.3	60,994	8.1	70.9	–15,646	79.6
Euro area	*64,050*	*8.7*	*49.6*	*48,645*	*6.7*	*56.6*	*–15,404*	*75.9*
Other countries	52,593	23.3	40.7	25,026	26.3	29.1	–27,567	47.6
Russia	*3,657*	*52.2*	*2.8*	*658*	*35.7*	*0.8*	*–2,999*	*18.0*
United States	*4,265*	*0.5*	*3.3*	*3,796*	*33.9*	*4.4*	*–468*	*89.0*
Japan	*2,944*	*–1.7*	*2.3*	*676*	*17.9*	*0.8*	*–2,268*	*23.0*
Latin America	*7,150*	*46.7*	*5.5*	*4,976*	*43.5*	*5.8*	*–2,174*	*69.6*
OPEC	*10,827*	*42.5*	*8.4*	*2,130*	*7.3*	*2.5*	*–8,697*	*19.7*
Rest	*23,750*	*15.6*	*18.4*	*12,789*	*22.2*	*14.9*	*–10,961*	*53.8*
TOTAL	**129,233**	**14.9**	**100.0**	**86,020**	**12.9**	**100.0**	**–43,213**	**66.6**

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

Imported non-food consumer goods finding firm place in Spanish market.

situation than in the first half of 2005 when exports were in a state of stagnation.

The strength of exports was especially concentrated in capital goods although sales of consumer goods held at high levels. In the January-June period, these exports were up by 8% real while capital goods rose by 17.3%. In the case of consumer goods, of special note were the increases in consumer electronics (75% nominal), medicines (45%), clothing (22%) and motor vehicle parts (15%). On the negative side of the balance we find exports of furniture, appliances and toys with moderate decreases along with cars which, in spite of holding stable in terms of 2005, continued to be the country's main export heading (12.4% of value of all exports).

Current account deficit grows by 31% as of May boosted by various headings of foreign balance.

Imports continued to grow sharply at 8.9% real in the first half-year, going above the figure for the same period last year. The most dynamic component was the group of non-food consumer goods, boosted by the strength of domestic demand. Furthermore, the sharp increases in imports of clothing, footwear and consumer electronics are indicative of the loss of competitiveness in certain industrial branches compared with low-cost producer countries. In this respect, imports from China now are well above those from the United States and Japan together and are equal to all those from Latin America or those from the United Kingdom, which means a radical change in the picture as it existed just a couple of years ago.

Increasing travel abroad by Spaniards affecting tourist balance while foreign debt of households and companies raises incomes deficit.

In any case, part of the big increase in imports may be accounted for by the energy component. Some 60.2% of the nominal increase in foreign purchases is due to the factor. Indeed, the average cost of a ton of imported oil in the first half-year hit 364.5 euros, 46.1% more than in 2005.

Bigger imbalance in current account deficit

The balance of payments continued to show an increased state of imbalance in May although at a somewhat lower rate than in earlier months. In spite of this, the cumulative deficit in the first five months of the year rose to 37.8 billion euros, 31.1% more than in the same period the year before. The worsening of the current account balance and the services balance was across the board in the various headings although the trade balance and the services balance between them accounted for more than 90% of the increase in the deficit. In the case of the goods balance, the increase in the deficit was due to the strength of imports in spite of the better state of exports, as noted in the previous paragraph.

The services balance, in turn, saw a drop in surplus both because of the tourist sector balance and trade in other services. In the case of tourism, as well as a moderate drop in revenue inflows (3.6% as of May) there was a substantial increase in payments at 13.6% for the same period. The greater propensity of Spaniards to travel abroad, combined with lower spending by foreign tourists visiting the country, was behind this situation.

Under the incomes balance, what stands out is the sharp increase in payments abroad by companies and households, which has a direct effect on the deficit in this institutional sector. The impact on the incomes balance was not greater because of the sharp reduction of the

BALANCE OF PAYMENTS

Cumulative figure for last 12 months in million euros

	May 2005	May 2006	% change
Current account balance			
Trade balance	–60,523	–74,615	23.3
Services			
Tourism	*25,832*	*25,365*	*–1.8*
Other services	*–3,905*	*–5,492*	*40.7*
Total	21,927	19,873	–9.4
Income	–14,899	–17,282	16.0
Transfers	–1,652	–3,564	115.7
Total	**–55,147**	**–75,589**	**37.1**
Capital account	**7,270**	**7,179**	**–1.3**
Financial balance			
Direct investment	–31,307	–37,016	18.2
Portfolio investment	110,438	113,086	2.4
Other investment	–31,305	13,747	–
Total	**47,826**	**89,817**	**87.8**
Errors and omissions	–1,743	–2,072	18.9
Change in assets of Bank of Spain	1,794	–19,336	–

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.

deficit in the financial sector and some containment in payments by general government for interest on the public debt. Investment income accounted for the greater part of the deficit under this heading with a residual part being due to payments for salaries.

Finally, the transfers balance was adversely affected by the sharp increase in remittances abroad by foreign residents. In any case, these figures are well below the total volume of funds moved in public transfers, particularly those from the European Union, a heading which was strongly in deficit in the first five months of 2006.

In the financial sphere, direct foreign investment in Spain tended to stabilize although in the first five months of the year the total volume was 12.7% below last year. Real estate investment ran long the same lines. The picture in direct Spanish investment abroad was radically opposite to this and practically tripled that for the January-May period in 2005. This drive was partly due to the rise in real estate investment which nearly doubled the figures for the year before.

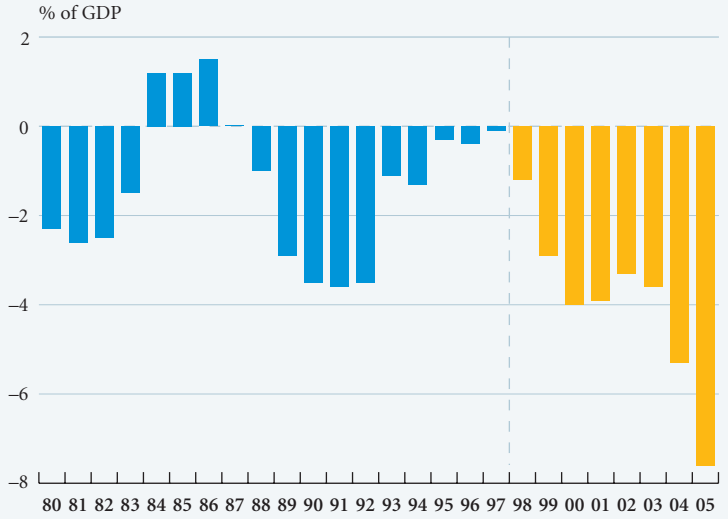
Direct foreign investment going down as against boost in Spanish investment abroad, especially in real estate.

Spain's current account deficit: is there light at the end of the tunnel?

Since 1998, the figure for Spain's current account balance has worsened until reaching an all-time high of 7.6% of the gross domestic product (GDP) in 2005. For 2006, the European Commission forecasts point to an even higher percentage.

CURRENT ACCOUNT DEFICIT AT HIGH LEVEL

Current account balance



SOURCE: IMF, Bank of Spain and internal figures.

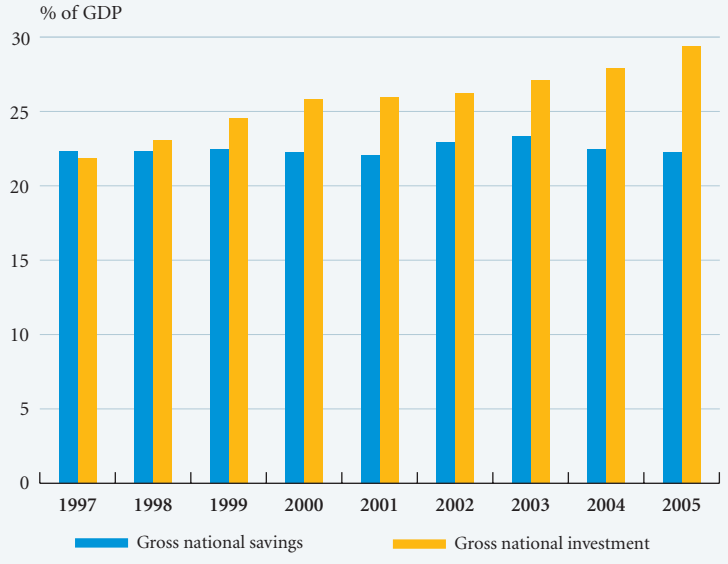
This trend, the beginning of which coincides with Spain's entry in the Economic and Monetary Union (EMU), has notably worsened the net international investment position of the country. In other words, the difference between net foreign assets held by Spaniards and net Spanish assets held by foreigners increased progressively to the point that, by 2005, Spain's debtor position amounted to 47% of the GDP. This has raised some concern and caused a sharp debate about the future sustainability of this deficit.

What does it mean to have a current account deficit? From its most common view, the current account balance is no more than a broad measure of what a country trades with the rest of the world. Being negative, Spain's balance indicates that we buy (or import) more than we sell (or export) abroad.

From another perspective, the current account balance may be interpreted as the difference between savings and national investment. In this case, Spain's current account deficit indicates that we are investing more than we are saving. In the following graph, we can see that savings have remained stable at around 22% of the GDP, while investment has increased from 23% of the GDP to more than 29%. Which factors have led the country to this high current account deficit and kept it high since late Nineties?

INVESTMENT INCREASES MORE THAN SAVINGS

Savings and investment in Spain's economy



SOURCE: Bank of Spain and internal figures.

Determinants of Spain's current account deficit

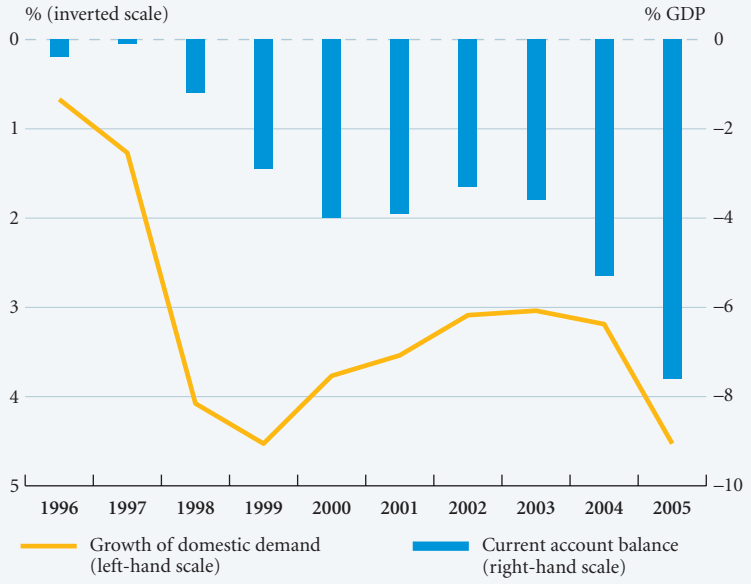
At first glance, it seems obvious that the immediate determinant of the change in trend observed in Spain's current account balance was the country's commitment to enter the EMU. With a more controlled *inflation* and the elimination of *exchange rate risk*, Spanish interest rates dropped from 9% in 1996 to 4.25% in 1999. At the same time, the real interest rate dropped from the initial 2% to practically 0%. To this we must add a greater inflow of international capital resulting from lower barriers to capital within the EMU, and higher expectation on growth and returns to investment in Spain, as a result of the real convergence expected within a monetary union.

The greater availability of credit at a lower cost derived in higher consumption (and lower savings) while the higher expected returns and the lower cost of financing led to increased domestic investment. Up until now, the growth expectations were met and Spain has grown at an average of 3.5% year-to-year since 2002, higher than the 2% reported for the European Union (EU-15) average. Nevertheless, there are signs suggesting that this higher growth is due to a more dynamic domestic demand and not to a more productive supply. On the one hand, Spain's productivity has dropped since the mid-Eighties so that increased economic growth has been mastry sustained by a more intensive use of capital and labour. On the other hand, the inflation differential with the European Union has increased notably since 1997, which points more towards inflationary pressures, arising from higher growth pulled by demand factors, than to growth brought about by supply and from gains in productivity.

There are two main factors contributing to this increased drive in demand –the greater *availability of capital at low cost* mentioned above, and the *immigration factor*. In Spain, immigration has notably increased in the

GROWTH OF DOMESTIC DEMAND PUSHES UP CURRENT ACCOUNT DEFICIT

Current account balance and growth of real domestic demand



SOURCE: INE, IMF, Bank of Spain and internal figures.

past decade thus contributing to greater availability of labour force and to higher domestic demand. On December 31, 1996, the number of foreigners considered to be economic residents was 257,037 while, according to recent figures, the number of foreigners on municipal rolls was up to 3.88 millions.

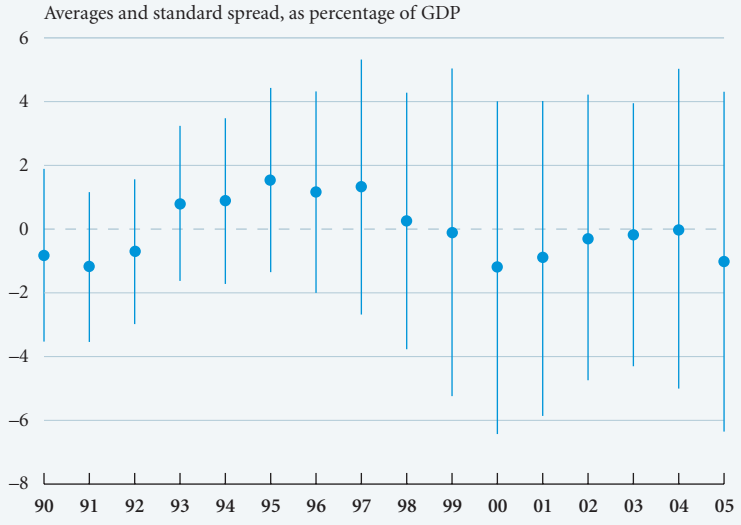
Apart from factors linked to Spain's move into the EMU and the effect of immigration, we should mention factors of an external nature which may have influenced the trend in the country's current account. Specifically, we refer to the increase in world savings largely attributable to increased savings in some Asian countries and oil exporting countries (see box on page 10) which may have an indirect effect through its repercussion at the EMU level. Nevertheless, the net flow of foreign capital to Spain came largely from the EMU itself, so that the higher level of savings in some member states (especially Germany), as well as the lower growth and lower expected returns to domestic investment in those countries, would have probably played a more important role because of its contribution to the lower interest rate and to the greater availability of capital at the EMU level.

Why is the deficit troubling?

Spain's current account deficit takes place in a world of growing spread of current account imbalances both at the world level and within the EMU, as may be seen in the accompanying graph. There are those who believe that this increased spread is no more than a reflection of a more efficient reassignment of savings and investment at the world level, consequence of the reduced barriers to the flow of capital. Therefore, they argue, the increased current account imbalances may be seen as a sign of good functioning of international financial markets.

GROWING SPREAD OF CURRENT ACCOUNT BALANCES WITHIN EMU

Averages and spread of current account balances in Euro Area (*)



NOTES: (*) For each year, the central point corresponds to the average while the extremes correspond to ± one standard spread.
SOURCE: IMF and internal figures.

The current account deficit may also be seen as a sign of prosperity. An of intertemporal equilibrium approach to the balance of payments allows for the possibility of a deficit as long as imported savings are invested in such a way that it makes it possible to repay the funds borrowed. From this perspective, the deficit would be no more than the result of the optimum allocation of future resources toward current consumption while incorporating the obligation to return funds borrowed, thus ensuring solvency. This line of thought is based on two key assumptions, namely, that the economic players make optimum decisions in a consistent and rational way and that they understand, interpret and correctly incorporate the information available. There are those who question both assumption, hence the condition of solvency would not be assured. Even if these assumptions were met, sustainability would still depend on the foreign creditor is willingness to continue financing the deficit and on no doubts arising on his part regarding the ability or willingness to repay the debt in the future.

Therefore, what is troubling about the deficit is, on the one hand, whether the increased borrowing it involves is employed in such a way that it ensure future solvency and, on the other hand, the possibility of a sudden adjustment of the foreign imbalance with notable effects on domestic demand and growth.

Solvency

When a country incurs in current account deficit, it is getting indebled with the rest of the world. As with any debt, it comes with the obligation of future repayment, which means that at some time it is necessary to generate a current account surplus in order to settle the debt. If foreign borrowing is used to improve productive capital so that in the future it makes it possible to grow in a sustained manner without inflationary pressures and recover foreign competitiveness, it makes more likely the ability to adjust the current account balance and repay the debt. If, on the other hand, the increased availability of capital is employed in financing

consumer credit, little will be done for the ability to repay what was borrowed and solvency may be compromised. At the same time, the more indebted the economy and the more doubts there exist about the employment of that credit and the ability to repay the debt in the future, the more vulnerable that economy will be to a change in expectations on the part of the foreign lender.

Sudden adjustments

Finally, what is really troubling is what could happen if suddenly the foreign investor decides to restructure his portfolio and the availability of foreign credit to Spain is interrupted. In that event, Spain's demand for foreign capital would have to rapidly adjust to the drop in available credit. This would imply less domestic investment and/or consumption with which the financial adjustment would translate into a real adjustment of the economy.

With regard to the mechanisms that could set off such a real adjustment, in Spain's case they world most likely be three. In the first case, there could be an upward revision in the premiums applied to Spanish loans by foreign lenders arising, for example, from an upward revision of the risk assigned to Spanish investments. These higher premiums would make credit more costly and, in turn, increase the cost of investment and consumption, thus decreasing their demand and, in turn, aggregate the demand and the difference in savings-investment. A second scenario, with the same effects, would arise from an increase in interest rates by the ECB aimed at easing inflationary pressures at the EMU level. Finally, the loss of foreign competitiveness as a consequence of the continued appreciation of the real foreign exchange rate could also set off an adjustment. In this case, the higher relative price of Spain's exports would put a brake on foreign demand for the country's goods and the current account balance. In turn, lower demand would lead companies to invest less and to tightly control production costs (either through employment or wages) which would also lower investment and consumption bringing about an even greater reduction in aggregate demand and in the current account deficit.

In any of these scenarios, aggregate supply would have to adjust to lower the demand. Given that Spain does not have the option of using nominal changes in the foreign exchange rate to ease a possible adjustment, this can only work through prices and employment. In other words, companies could adapt to the lower demand by maintaining employment levels and cutting wages or by maintaining wages and reducing workforces. Should such a sudden adjustment be necessary, it is most likely that it would work through an adjustment in employment, given the great rigidity of nominal wages especially over the short term. For this reason, following the dictum that «prevention is better than cure», we should concentrate our efforts on maximizing our guarantees of future solvency and on minimizing the vulnerability of Spain's economy to sudden adjustments in the level of foreign financing because of what this could mean for the real economy.

Spanish investors discovering Europe

The predominant colour in Spain's balance of payments is red, due to the deficits showing up in most of the accounts making this up. But a more stimulating red is that for the direct investment account. This means that capital outflows, that is to say, direct Spanish investment abroad (in shares, funding of related companies, real estate, reinvested profits and other participations) is higher than that coming in, that is, than direct foreign investment in Spain, which is a positive sign in a globalizing world. But this is not new. For a number of years Spain has been one of the leading countries in terms of direct international investment.

DIRECT FOREIGN INVESTMENT IN OECE COUNTRIES

Cumulative flows 1996-2005 (*)

Inflows			Outflows			Net investment (difference)		
1	United States	1,539.7	1	United States	1,414.1	1	France	379.1
2	Belgium/Luxembourg	948.8	2	United Kingdom	1,021.1	2	United Kingdom	368.0
3	United Kingdom	653.1	3	Belgium/Luxembourg	962.0	3	Japan	244.0
4	Germany	424.5	4	France	782.1	4	Netherlands	177.3
5	France	402.9	5	Netherlands	489.9	5	Switzerland	154.4
6	Netherlands	312.6	6	Germany	459.0	**6**	**Spain**	**107.8**
7	Canada	228.3	**7**	**Spain**	**332.4**	7	Canada	65.8
8	**Spain**	**224.6**	8	Japan	304.1	8	Italy	47.1
9	Mexico	164.2	9	Canada	294.1	9	Germany	34.5
10	Sweden	157.2	10	Switzerland	242.2	10	Sweden	23.7

NOTES: (*) Billion dollars.
SOURCE: OECD.

In fact, the internationalization of Spanish companies is a relatively new phenomenon and up until the change of century its main area of operation was the South American market and sectors such as telecommunications, energy and water. At that time, large Spanish multinationals, mainly Repsol and Telefonica and some public utility companies, like Endesa and Agbar, took up relevant positions in a market which, for cultural and linguistic reasons, offered a strategic option for Spain's economy.

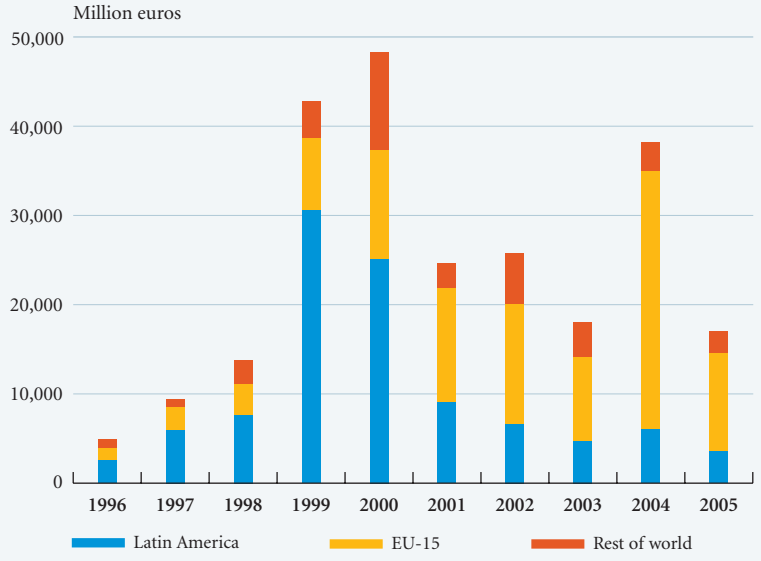
The stock market crash in 2000, the difficulties of the Latin American economies and the consolidation of Spanish investment in the area itself cooled off this option at a moment when international financial flows generally showed a notable drop. As of 2001, the European Union (EU) would become the Spanish economy's basic reference for direct foreign investment putting the Latin American region at a second level. Some distance behind in third position come investments in the United States and next those going into the countries of the extended European Union.

Spain's foreign investment in recent years has been directed largely to the tertiary sector although the share going into industry cannot be downplayed, particularly in 2003. Investment in the services sector has mainly gone into banks and communications, sectors which carried out a notable strategy of positioning themselves internationally. Foreign investment in the EU banking sector has made this a main area aimed at in the past five years. Also of note are transactions involving the new member states of the EU as of 2003.

In the case of telecommunications, Latin America was key in this respect up until the year 2000 given that practically all foreign investment in the sector was aimed at that region. On the other hand, since 2002, only 20% of investment in telecommunications goes to Latin America while the greater part is directed to the EU and, especially in 2005, to the countries of the EU extension. Investment in the retail sector, mainly in the wholesale trade, in air transport and in 2005 in real estate, has been of some importance. Finally, more recently, the real estate sector has also attracted the interest of Spanish investors, particularly in the EU (United Kingdom) and, to a lesser extent, in some Latin American countries.

EU TAKES OVER FROM LATIN AMERICA AS DESTINATION FOR SPAIN'S FOREIGN INVESTMENT

Gross direct investment abroad (*)



NOTES: (*) Not including foreign asset holding institutions.
SOURCE: Ministry of Economy and internal figures.

In the industrial sphere, the turn of the century marked a new phase in Spain's direct investment abroad. As of the year 2000, investment in energy and water on the Latin American continent lost its lead in favour of the EU and other economic sectors, mainly construction materials and food and beverages, and in the odd year to chemicals.

Transactions with other countries are also making a tentative appearance. Investment in member states of the EU extension took on some importance as of 2000 and amounted to between 4% and 6% of total investment between 2000 and 2004. In a similar way, although with less regularity, there were some notable transactions in non-EU developed countries. Industrial investment transactions in low-cost producing countries were of much less importance in the total, although these have proliferated in recent years. In fact, industrial investment in Asian countries other than Japan has chosen China as an important destination, especially since 2002. The main sectors to which investment went in China were the food industry, cars (parts), non-metallic mineral products and metallurgy.

Is this a search for competitiveness, the creation of new markets, a matter of survival or growth? Most likely Spanish companies are seeking their place in the world because of the demands of the globalization scenario and a sign of maturity of one of the world's oldest economies.

Public sector

Tax collections growing more than economy

Central government tax collections for general taxes are going full-steam-ahead boosted by the good state of the economy, growth of employment and the positive situation in financial markets. In the first half of 2006 tax revenue reached 78.28 billion euros, to show growth of 11.9% over the same period last year. This growth would be somewhat higher (specifically 12.7%) if it were calculated using homogeneous figures, that is to say, basically eliminating the distortions arising from changes in calendar and the rate of rebate payments. As a result, tax collections increased by around four points more than the nominal growth rate of domestic demand.

The good state of tax collections is to be seen in all the main tax headings with the exception of special taxes. Revenues for personal income tax thus grew by 14.1% in homogeneous terms, of special note being the increase in hold-backs on mutual investment funds and those on income from capital. In the first case, stock market rises and, in the second case, interest rate rises and the increase in dividend payments were behind the sharp increases (36% and 18% respectively).

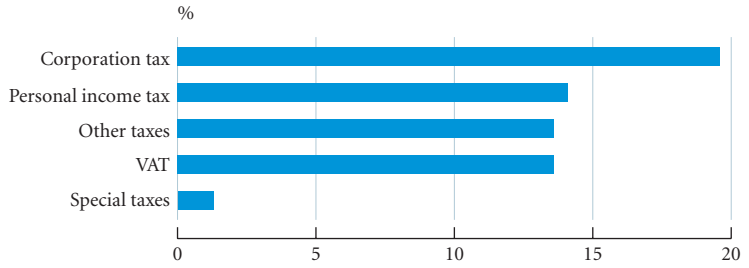
Good economic situation favouring growth of tax revenues.

The bulk of personal income tax collections was for hold-backs on work for wages which overall showed growth of 11.8%. The most notable growth under this heading was for hold-backs on wages of public service employees (12.9% putting the figure at 5.7 billion euros) with those from small and medium-sized companies coming next (12.6% with total going to 7.88 billion euros). The increase in collections in the large company segment was very similar at 11.1% with the figure at 14.29 billion euros. Finally, hold-backs for rentals were up by 10% with the figure at 716 million euros.

Direct taxes growing at high rate, particularly corporation tax.

DIRECT TAXES GROWING MORE STRONGLY

Homogeneous tax revenues by taxation heading. First half of 2006 compared with same period year before



SOURCE: Ministry of Economy and Finance and internal figures.

Sharp rise in VAT collections while special taxes show poor collection figures under two main headings –fuel and tobacco.

Under direct taxes, collections for corporation tax were also up strongly (19.6% in homogeneous terms) because of the good trend in partial payments, a figure related to corporate profits for the year before. We should also mention the major increase in collections as a result of inspections carried out.

Under indirect taxes, total collections for value added tax (VAT) increased growth to 13.6%, of special note being the spectacular increase in revenues from large corporations and exporters (18.4%) and imports (12.2%). Special taxes, on the other hand, grew by only 1.3% in homogeneous terms under the effect of the low level in the two main tax headings, the special tax on fuels and the general tax on tobacco products. In the first case, the drop in demand for petrol (practically entirely replaced by diesel fuel which carries a lower tax) and secondly the drop in consumption were behind the poor level of collections.

Savings and financing

Boost in funding to companies and households

Bank loan rates continue to rise reflecting the upward trend begun by the European Central Bank in December and the prospect that this will continue in coming months. As a result, the 1-year Euribor, widely used as a reference index especially for mortgage loans, rose by 14 basis points in July to 3.54%, a cumulative increase of 137 basis points in the past 12 months. In any case, it continues to hold below the inflation rate of 4.0% in July, which means negative real interest rates.

At a more broken down level using figures going up to June, we note that generally interest rates on loans and credits granted to customers of financial institutions continued to rise going to 4.52% on average. Interest rate charged to companies stood at 4.11% while that for individuals was 4.91%. The rate for housing loans was 4.19% while consumer loans were substantially higher at 8.70% although this was a slight drop of 5 basis points compared with two months earlier as a result of increased competition in this market segment.

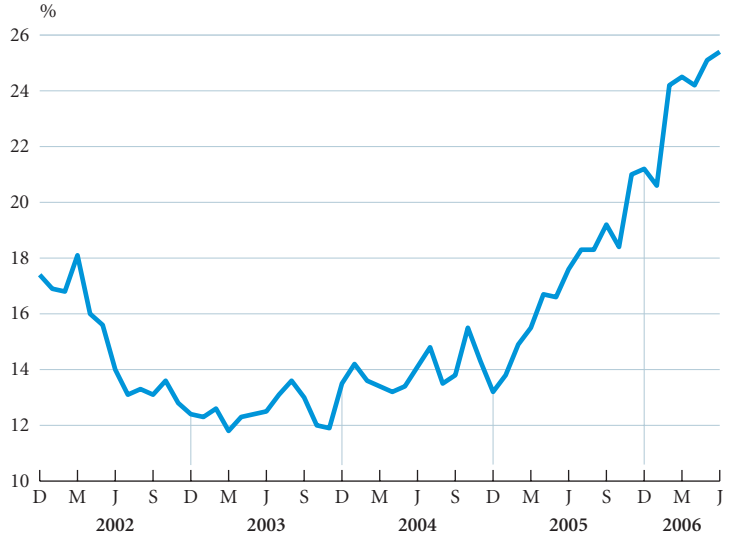
1-year Euribor up 137 basis points in past 12 months but stays below inflation rate.

In spite of the rise in interest rates, funding granted to the private sector rose by 23.4% at the end of the first half-year compared with the same period the year before. This is the highest rate seen for at least the past 10 years and is twice that for the Euro Area. This drive was

Growth rate of funding granted to private sector twice that of Euro Area.

FUNDING GRANTED TO COMPANIES GROWING AT HIGHEST RATE IN PAST 10 YEARS

Year-to-year change in funding to non-financial companies



SOURCE: Bank of Spain.

SLIGHT SLOWDOWN IN BANK LOANS FOR HOUSING PURPOSES

Year-to-year change in loans by resident credit institutions and off-balance-sheet securitized loans for housing

SOURCE: Bank of Spain.

Loan default holds at very low levels.

especially due to companies which reported an annual increase in funding of 25.4%.

Funding granted to households was up less, at 21.0% over the past year, but still remains very high. The main component, mortgage loans for housing purposes, grew by a sharp 23.0% although showing signs of some moderation if we compare it with rates of 24.6% reported in 2005. Given this situation, financial institutions have turned their attention to consumer credit, making terms more flexible for buying cars, furniture, appliances, etc. As a result, in the first half-year the amount of new consumer credit transactions rose by 15.3% compared with the same period last year.

Private sector deposits at credit institutions above 1,000 billion euros for first time.

In spite of the major growth of credit in recent years, loan default remains at historically very low levels. According to latest available figures, the loan default rate for companies and households dropped to 0.75% at the end of March. The default rate for home-purchase loans was still lower at 0.39% although it showed a very slight increase of one-hundredth of a point.

Banks regain ground in deposit segment

Interest rates on bank deposits have also shown a rise in recent months. In any case, the average rate on bank deposits was still holding at a relatively low level at the end of June.

In a situation of strong economic growth, bank deposits had continued to grow at very high rates, just slightly below rates reported for loans. As a result, deposits by the private sector at credit institutions for the first time went above 1,000 billion euros in June, an increase of 21.0% in the past 12 months. Especially notable was the spectacular increase in deposits in foreign currency due to interest rate differentials in their favour. Deposits for terms of more than

two years, which enjoy favourable tax treatment for interest earned also showed a big annual increase of 42% which dropped down to 20% for shorter terms. On demand and savings accounts grew by a notable 11% from June 2005 to June 2006.

On the other hand, while savings banks continue to maintain a market share in this segment higher than in the case of banks, the banks have recovered ground in the past 12 months. Deposits by the private sector in banks thus rose by 24.6% over the past year as against 18.3% for savings banks.

Another financial instrument enjoying favour with savers is investment funds. According to provisional figures supplied by Inverco, the sector organization, the volume of assets in investment mutual funds stood at 252.1 billion euros at the end of July, an increase of 2.6% compared with the end of 2005. In the course of the first seven months of 2006 cumulative net subscriptions (discounting withdrawals from funds) amounted to 4.8 billion euros, in spite of net reimbursements of 608 million euros in July.

National shares head ranking of investment funds by yield.

The average yield recorded by investment funds was 3.5% over the past 12 months as of July although there was a wide range depending on category.

In the area of long-term savings, aimed at meeting financial needs following retirement, pension funds continue to make progress. At the end of the first half-year the volume of assets of these funds reached the figure of 73.56 billion euros, an increase of 10.7% in the past 12 months. The number of participant accounts rose to 9,539,076, an increase of 8.5% compared with June 2005. Net contributions in the first six months of the year totalled 503 million euros. The weighted average annual yield obtained in the past 16 years was 6.6%, substantially higher than the inflation rate.

Pension funds mark up average annual yield of 7% in past 16 years, well above inflation.

DEPOSITS OF COMPANIES AND HOUSEHOLDS AT CREDIT INSTITUTIONS

June 2006

	Total	Change this year		Change over 12 months		% share
	Million euros	Million euros	%	Million euros	%	
On-demand savings (*)	419,845	23,655	6.0	42,761	11.3	41.3
Up to 2 years	212,077	21,557	11.3	35,033	19.8	20.9
More than 2-year term	289,351	48,744	20.3	85,692	42.1	28.5
Repos	69,737	–3,309	–4.5	–4,246	–5.7	6.9
Total	**991,011**	**90,647**	**10.1**	**159,242**	**19.1**	**97.5**
Deposits in currencies other than euro	**25,181**	**9,542**	**61.0**	**17,390**	**223.2**	**2.5**
TOTAL	**1,016,192**	**100,189**	**10.9**	**176,632**	**21.0**	**100.0**

NOTES: (*) Includes deposits redeemable at notice, according to ECB definition.
SOURCE: Bank of Spain and internal figures.

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