

business  
environment





## FINANCIAL AND ECONOMIC ENVIRONMENT

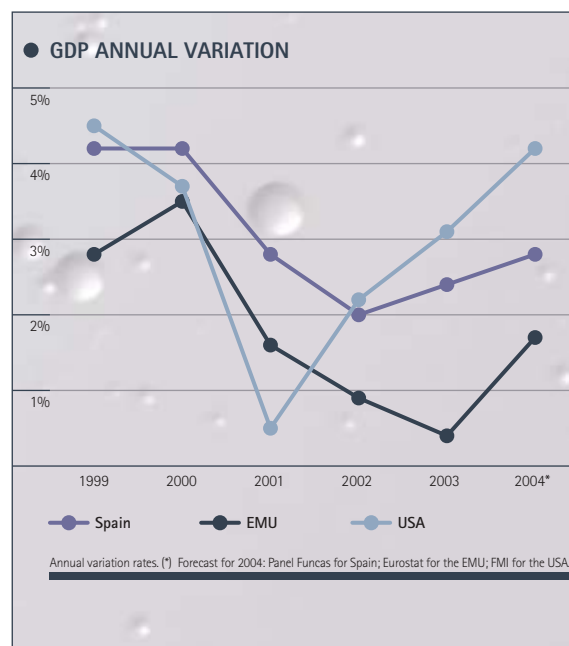
### ECONOMIC ENVIRONMENT

The world economy issued clear improvement signs in 2003, especially in the United States where GDP grew by 3.1%. This growth was led by internal demand and particularly by consumer spending, supported by the tax refund programme and historically low interest rates, as well as, by the greater public spending arising from the war in Iraq.

This growth contrasts with the economic lethargy in the Euro zone, where weak consumer spending reduced investment in capital goods and difficulties in the export sector almost reached the point of producing a recession in the first half of the year. However, the year closed with a minor growth of 0.4%, as a result of the improvements in the last two quarters, which point to the possibility of a slow acceleration for 2004. Within this context, the Spanish economy overcame the slowdown experienced in 2002 and improved its growth rate by four decimal points reaching 2.4%, and continuing with the upward trend in the second quarter. This allowed Spain to maintain the positive differential with the Euro zone and achieve new advances in convergence. This behaviour was based on strong internal demand, which compensated the imbalance in the export sector. The Spanish public continues to demonstrate a high consumer trend based on three factors applying since 2002: Strength of the labour market, reduced interest rates and an inflation rate of approximately 2.6% at year-end, 1.4% below 2002.

The economy in Galicia matched the growth rate of the country in general, overcoming the negative effects arising from the "Prestige" catastrophe, which had caused a slow start for the year. However, the acceleration occurring in the second half-year, when growth was above the national average, caused a GDP growth of 2.3% for the full year in 2003.

The weakness of the European markets, destination of three quarters of exports from Galicia, caused a slowdown in the export sector, which was compensated by high consumer spending as a result of higher employment and moderate inflation. GDP in Galicia rose by 2.3% or three decimal points less than the country in general and two decimal points less than at December 2002.



It is hoped that in 2004 the world economy will show strong growth. The relaxed monetary and tax conditions in the United States and in Europe should encourage consumer spending and business investment, while the export sector will be favoured by an international commercial take-off. However, the economic cycle will continue to be more dynamic in the United States. Within this context, the Spanish economy will continue to maintain a differential with the Euro zone with some changes in the growth rate, where capital item investment will take over from consumer spending. GDP growth for next year will approach 3%.

Galicia will grow at more than the national rate supported by continued consumer spending, higher public investment within the Plan Galicia and the impact of the Xacobeo 2004 Holy Year celebrations.

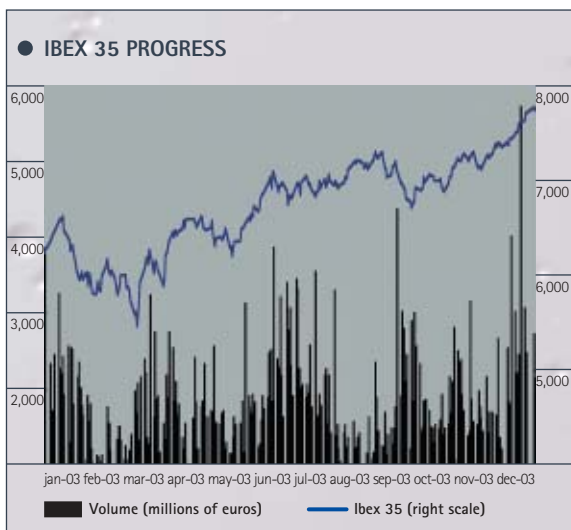
## FINANCIAL ENVIRONMENT

The euro/dollar exchange rate and the stock exchanges, this time in a positive way, were the main actors in the financial field

The European currency achieved a 20.4% rise against the dollar in the course of the year, in spite of the low growth in the zone. The Euro benefited from the investors' low confidence in the sustainability of the enormous trade deficit in the US and of the reluctance of the Asian central banks to depreciate their currencies.

Likewise, the main stock exchanges recovered strongly after three consecutive years of decline. The defusing of the geopolitical instability after the end of the war in Iraq, the favourable macro data from the United States and South-east Asia, the end of the adjustments in the IT and Communications sectors and the good prospects for business surplus in 2004 and 2005 supplied a sustained rally from the minimum levels reached in March.

The US stock markets took the lead in the rises, with strong revaluations (Dow Jones 25%) especially notable in the technology sector (Nasdaq 51%). In Europe, Frankfurt, the most castigated market in the preceding years, took a leading role with an increase of 37%. Madrid took second place with an increase of 28% favoured by its higher exposure to the Latin American economies, which showed stabilising signs of during the year.



Likewise, interest rates reached historic lows both in Europe and in the United States. Central banks practically exhausted the small arsenal of monetary measures at their disposal to maintain demand, and reference rates finished the year at the lowest levels in the last half century: 1% in the United States and 2% in the Euro zone, after respective annual drops of 25 and 75 basic points.

Market rates reacted with minimums in the first half-year. The 1-year Euribor reached the lowest level in the month of June (1.93%) since its creation 1999, although it rose in the last quarter in anticipation of improved prospects for 2004.

In longer-term areas, public debt acted as a refuge security in the first half of the year, leading to sharp yield declines. However, as from April, investors recovered their appetite for risk and there was a pronounced shift in capital to stock markets, reducing the demand for safe securities with the consequent rise in returns. The Spanish 10-year bond closed at 4.32%.

● **FINANCIAL ENVIRONMENT**

	1st-03	2nd-03	3rd-03	4th-03
ECB open market operations	2.75	2.50	2.00	2.00
Fed Funds	1.25	1.25	1.00	1.00
Euribor 1 year	2.39	2.06	2.13	2.31
Spain 10 years	4.05	3.91	4.03	4.32
Euro/dolar	1.09	1.14	1.17	1.26

Values registered at each of each quarter.

### Operating risks

During 2003 the Spanish financial sector developments continued in the same line as in the last two years: a sharp growth in credit especially in mortgages, less dynamism in capturing resources, a low bad debt rate and an increase in market share by the savings banks at the cost of the traditional banks. All of this occurred at an inflexion point in the economic cycle, as explained earlier, which showed a gradual acceleration over the year.

A more in depth analysis of these general lines indicates the following. In assets, growth in credit to

customers accelerated compared to 2002 and the year closed with a year on year growth rate of 13.7%. For the savings banks this rate was 16.4%, leading to an increase in market share to 46.7% compared to 48.1% for the traditional banks.

The continued high housing demand in the context of historically low interest rates explains the fact that mortgage loans lead in this area, showing an increase of 21.4%, or two points higher than in the previous year. Moreover, bad debts remained at historically low levels (below 1% of the credit balance) and coverage levels rose.

The sharp growth in credit was paralleled by a slowdown in the securities portfolio, where growth was 12.4%. The continuance of low interest rates detracts from the appeal of long-term fixed-rate positions, explaining this slowdown.

Customer funds also grew at a lower rate than lending , with an increase of 11.4%. Again, the growth

rate in term deposits declined while sight facilities were favoured by the low opportunity cost in maintaining liquid resources. Within the total funds captured from customers, the savings banks increased their share by 1.35 points during the year, reaching a market share of 48.3% compared to 46.8% for the banks. The share exceeds 50% in sight and term deposits.

The recovery of investment funds, after three consecutive years in decline, was the principal novelty in the year. Prompted by the stock market recovery, the funds' capital increased by 20% in the year, a percentage that reached 25% in savings banks.

This business growth led to healthier financial results than in 2002. The reduction in financial costs, recovery in commissions and in market operation margins, as well as control of operating expenses, led to a 5.9% increase in net surplus for the banks and the savings banks.

## LEGAL ENVIRONMENT

The following is a list of the legal regulations that were issued or came into force during 2003 and that affect Caixa Galicia's activities.

### 1. Laws and rules with the law status (Chronological order)

- LAW 7/2003 of 1 April, covering Limited Companies - New companies which modifies Law 2/1995 of 23 March-Limited Responsibility Companies (State Gazette 2 April 2003)
- ROYAL DECREE-LAW 2/2003 of 25 April, on financial reform measures (State Gazette 26 April 2003)
- LAW 10/2003 of 20 May, on urgent liberalisation measures in the real estate and transport sectors (State Gazette 11 May 2003)
- LAW 19/2003 of 4 July, on the legal aspects of capital movements and foreign economic transactions and on certain measures to prevent money laundering (State Gazette 5 July 2003)
- ORGANIC LAW 8/2003 of 9 July, on Bankruptcy Reforms, modifying Organic Law 6/1985 of 1 July on Judicial Power (State Gazette 10 July 2002)
- LAW 22/2003 of 9 July, on Bankruptcy (State Gazette 10 July 2003)
- Law 26/2003 of 17 July, modifying Law 24/1988 of 18 July on the Securities Market and the adapted text of Limited Companies, approved by Royal Legislative Decree 1564/1989 of 22 April, aimed at increasing transparency in listed limited companies) State Gazette 18 July 2003)
- AUTONOMOUS COMMUNITY OF GALICIA LAW 4/2003 of 29 July, on Galicia Homes (DOGA 6 August 2003)
- LAW 32/2003 of 3 November, on telecommunications in general (State Gazette 4 November 2003)
- LAW 33/2003 of 3 November, on the Patrimony of Public Administrations (State Gazette 2 November 2003)
- LAW 34/2003 of 4 November, on the modification and adaptation of the community norms on private insurance legislation (State Gazette 5 November 2003)
- LAW 35/2003 of 4 November, on Collective Investment Institutions (State Gazette 5 November 2003)
- LAW 36/2003 of 11 November, on economic reform measures (State Gazette 12 November 2003)
- LAW 38/2003 of 17 November, on subsidies in general (State Gazette 18 November 2003)
- LAW 47/2003 of 26 November, on Budgets in general (State Gazette 27 November 2003)
- LAW 58/2003 of 17 December, on Taxation in general (State Gazette 27 November 2003)
- LAW 59/2003 of 19 December, on electronic signatures (State Gazette 20 December 2003)
- ORGANIC LAW 19/2003 of 23 December, modifying Organic Law 8/1985 of 1 July on Judicial Power (State Gazette 26 December 2003)
- AUTONOMOUS COMMUNITY OF GALICIA LAW 9/2003 of 23 December, on tax and administration measures (DOGA of 29 December 2003)
- LAW 60/2003, of 26 December on Arbitrage (State Gazette 26 December 2003)
- LAW 61/2003 of 26 December, on General State Budgets for the year 2004 (State Gazette 31 December 2003)
- LAW 62/2003 of 30 December, on tax and administration measures and social order (State Gazette 31 December 2003)

### 2. Decrees and Royal decrees ( in chronological order)

- ROYAL DECREE 27/2003 of 10 January, modifying the Rules on Personal Income Taxes, approved by Royal Decree 214/ 1999 of 5 February (State Gazette 11 January 2003)
- ROYAL DECREE 116/2003 of 31 January, modifying the Rules on taxation of non-residents, approved by Royal Decree 326/1999 of 26 February and royal decree 1080/1991 of 5 July determining the countries or territories referred to in Art 2, section 4 of Law 17/1991 of 27 May on Urgent Tax Measures and Art 62 of Law 31/1990 of 27 December on General State Budgets for 1991 (State Gazette 1 February 2003)
- REAL DECREE 252/2003 of 28 February, modifying the Rules on Corporate Taxes approved in Royal Decree 2281/1998 of 23 October, which expanded the rules applicable to certain obligations to supply information to the tax administration and the rules on Pension Plans and Funds were modified, approved

by Royal Decree 1307/1988 of 30 September and royal decree 2027/1995 of 22 December regulating the annual declaration of operations with third parties (State Gazette 13 March 2003)

- DECREE OF THE AUTONOMOUS COMMUNITY OF THE BALEARIC ISLANDS 42/2003 of May, modifying decree 92/1989 of 19 October, regulating the governing bodies of the Savings Banks with registered addresses in the Balearic Islands and regulating the Community Projects of the savings banks operating in the Balearic Islands (State Gazette 3 May 2003)
- ROYAL DECREE 1248/2003 of 3 October, modifying the General Tax Collection Rules approved by Royal Decree 1648/1990 of 20 December (State Gazette 15 October 2003)
- ROYAL DECREE 1270/2003 of 10 October, approving the Regulations for application of the tax rules for non-profit entities and the tax incentives for sponsorship (State Gazette 23 October 2003)
- ROYAL DECREE 1496/2003 of 28 November, regulating the obligations on invoicing, and modifying the

Tax Regulations on Added Value Tax (State Gazette 29 November 2003)

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### 3. MINISTERIAL ORDERS

#### (in chronological order)

- ORDER by the Autonomous Community of the Murcia Region of 28 February, applying the agreement of the Governing Council of 21 February 2003 on establishing guidelines on the savings banks' Community Projects for the year 2003 and issuing rules for their application (Murcia Region Gazette 14 February 2003)
- ECO ORDER/805/2003 of 27 March, on the rules for valuation of real estate and on certain rights concerning certain financial ends (State Gazette 9 January 2003)

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### 4. NOTIFICATIONS BY THE BANK OF SPAIN

- NOTIFICATION 5/2003 of 19 December, to approved valuation companies and services on information to be submitted to the Bank of Spain (State Gazette 8 January 2004)

## THE PROCESS OF APPLYING INTERNATIONAL ACCOUNTING STANDARDS (IAS) IN CAIXA GALICIA

In 2003, Caixa Galicia began the study and preparatory work to allow its adaptation to the requirements contained in EC Regulation 1725/2003 by the Commission, adopting certain International Accounting Rules (hereinafter IAS) in accordance with EC Regulation 1606/2003 by the European Parliament and Council, which impose the obligation on listed companies, including credit institutions and insurance companies, to present their consolidated annual accounts in accordance with IAS, from 1 January 2005 onwards.

### Objective of the reform

The final objective of the reforms launched by the EC Council is to have a **single high quality body of accounting rules to facilitate comparison of financial statements and to give greater transparency to the information**, and in this way to contribute to the efficient performance of the community capital market and to the protection of investors.

### Current status of the IAS application process

EC Regulation 1725/2003 approved all of the IAS and the corresponding interpretation/clarification notes in effect at the time it was published, except for IAS 32 and 39. These two standards, the content of which is particularly significant for financial institutions, are **pending approval** by the European Union, when the International Accounting Standards Board (IASB), the body that issues IAS, has verified their modification. It is expected that the European Union will accept all of the IAS in force at the end of March 2004 (when it is expected that IAS 32 and 39 will have been approved in their final format) as the latest date to oblige their application in 2005.

Because of EC Regulation 1725/2003, in 2005 all Spanish financial institutions will be obliged to present their consolidated financial statements in line with IAS. In practice, to allow the issue of comparative financial statements, the **application of IAS will also affect the financial statements for the year 2004 retroactively**.

### Effect of IAS on the financial sector

For Spanish financial institutions, the most significant change introduced by the new accounting policies with the application of IAS will be that the fair-view principle will take precedence over the prudence principle. This latter has been the dominant principle in the accounting rules applied in Spain until now (reflected, for financial institutions, in Notification 4/91 by the Bank of Spain).

The following are the most notable **effects** that the application of IAS will have on the financial statements of credit institutions:

- Changes, which could be significant, in the **earnings statements** and in reserve accounts, due principally to the fact that certain assets and liabilities in the entities will be reflected in the financial statements at "fair value", meaning that a valuation close to market value will be applied to these assets and liabilities.
- Substantial modifications in the criteria applied in **calculating provisions** for depreciation of assets, bad debts and other general provisions.
- New criteria related to the accounting treatment of **goodwill** in business mergers and acquisitions.
- Changes in the structure of the **balance sheet and the income statements**. One of the most important is the obligation to reflect the derivatives portfolio on the balance sheet (products that up to now were reflected in off balance sheet memorandum accounts).
- A different method in determining the **composition of companies which are to be included in the consolidated accounts**.
- New accounting statements are approved, such as "changes in net worth" or "cash flow statements". Likewise, the amount of **information requirements** to be included in the notes to the financial statements increases considerably.

In short, a new regulation framework is introduced that should be thoroughly analysed and studied and that will profoundly affect the **strategic business decisions** of financial institutions.

Moreover, the application of IAS will demand important efforts in IT, organisation and issue of information by companies.

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#### **Actions taken by Caixa Galicia**

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In 2003 the IAS Commission was created, composed of management personnel from the principal area affected by the process of implementing and applying IAS. The commission has initiated a **systematic process to analyse each IAS rule** based on the following basic objectives:

- To allow the Entity to **adapt to the IAS within the time limits** set out in the EC Regulation 1725/2003, including development and adaptation of all the IT processes, review and modification of the operating processes and the design of procedures that allow the generation of accounting information that fully complies with IAS.

- To gain **in-depth knowledge of the consequences of adapting to the various IAS** through a preliminary evaluation of the possible impact and to establish communication channels with all business and organisation areas and with top management that will provide exact information and allow them to anticipate the effects on strategic decisions.
- To promote the acquisition of **knowledge of IAS internally by all the entity's personnel**, placing special emphasis on those areas directly involved in preparing, handling or analysis of accounting and financial information.

The overall objective is the correct implementation and strict compliance to all the time limits and requirements, closing the process with the issue of **Financial Statements as at 31 December 2005 that are fully compliant with IAS.**