
Quarterly report on the Spanish economy

1. Overview

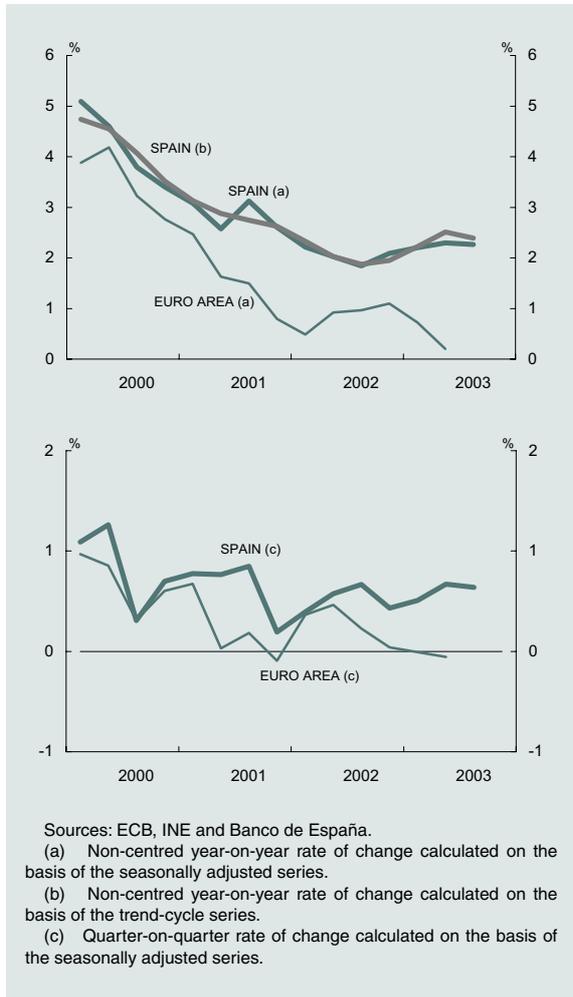
Conditions in the world economy have become more favourable as the year 2003 has unfolded. In the euro area, however, a situation of virtual flatness was the case throughout the first half of the year. That has amplified the gap in respect of economic developments globally, and means that the recovery predicted for the second half of the year in Europe may be modest and not free from uncertainty. Against this background, the Spanish economy is sustaining a considerable growth rate, underpinned by its domestic determinants, which provides it with an advantageous starting point for facing the new phase of recovery, despite the negative contribution of the external environment. While national demand has increased at a rate clearly in excess of 3% (measured taking the seasonally adjusted series) during the first three quarters of the year, the negative contribution of external demand has not dipped below one percentage point (pp). Specifically, on Banco de España estimates, real GDP posted a year-on-year increase of 2.3% in 2003 Q3, an identical rate to that released by INE for the previous quarter. This growth breaks down into an increase of 3.3% in domestic demand with net external demand subtracting 1.1 pp. In quarter-on-quarter terms, the estimated rate of change of real GDP is around 0.6%, very close to that of the preceding quarter, and likewise underpinned by domestic momentum.

The strength of employment has continued to be notable and its rate of change in Q3 has tended to increase, as revealed by the latest Labour Force Survey (EPA) data. As regards prices, following the strong decline in their rate of increase in the first half of the year, their subsequent correction is being curtailed by the strong increases in unprocessed food prices, by the trend of energy prices (albeit mitigated by the appreciation of the euro) and by the pressure exerted by unit labour costs on certain industries and productive branches which, moreover, have increased their operating margins.

The improved international financial outlook and the expansionary stance of the macroeconomic policies pursued, to differing degrees, by the main regions are feeding through unevenly to the different economies. In the United States, the real indicators available confirm that a high growth rate is being sustained, based largely on the monetary and fiscal stimuli to household and corporate expenditure, and on the strong increase in government consumption. Given the more generous financial conditions, especially in the case of corporations, business investment and, more recently, employment have also shown signs of picking up following a long period of sluggishness. Nonetheless, certain doubts persist over the sustainability of the US recov-

CHART 1

Gross domestic product

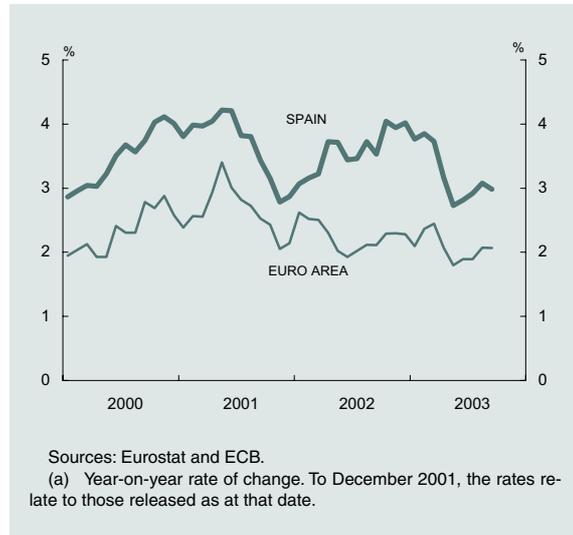


ery in the medium term owing to the persistence of sizable current-account imbalances and their potential effects on exchange and interest rates. With a view to the future, maintaining productivity gains in the US economy – beyond those arising from the recent heavy adjustment to employment – will be essential if the recovery is to firm.

The contribution of other regions to the entrenchment of the world economic expansion has been uneven. The east Asian countries, with the increasingly prominent participation of the Chinese economy, are those proving most buoyant. Japan, for its part, grew much more than expected in Q2, although the doubts about its ability to see through a sustained recovery have not been dispelled, despite the improved financial position of its firms and the strength of its exports, especially to Asian countries. The eastern European economies have generally shown fairly positive growth. On the downside, however, fiscal consolidation has slowed sub-

CHART 2

Harmonised indices of consumer prices (a)



stantially in some of these countries. In Latin America the improved financial conditions and easing of monetary policies, reflected in the narrowing of sovereign debt yield spreads and in the sound performance of stock markets, have not sufficed to prevent a further slowdown in the real economy, with the notable exception of Argentina, due to its low starting levels.

Economic activity in the euro area was virtually flat during the first half of the year owing to the considerable slackness of business investment and exports, which bore adversely on industrial activity. The expansionary stance of macroeconomic policies has eased the slowdown in consumer spending and limited the adjustment of non-industrial employment, and a modest pick-up in credit to the private sector has been discernible in recent months. Although the real indicators have not yet shown clearly positive signs, both consumer and business confidence surveys have improved in the past few months. Expectations of a recovery in the second half of the year are based on the positive contribution of external demand and on the improvement in investment. The signs of recovery emerging in world trade and the favourable financing conditions prevailing in the euro area help anchor such expectations. However, there remain risks on both fronts given the uncertainty over the future course of the euro exchange rate and the difficulty of determining to what extent companies have restored health to their balance sheets following the previous phase of sharp growth in debt.

The rate of increase of the HICP in the euro area as a whole stabilised in September at 2.1% and is expected to hold at this figure until

the end of the year. The slight rise in unit labour costs in recent quarters has been due to the lack of responsiveness of wage rises to low productivity growth, a development which saw business margins squeezed in Q2.

Given the foregoing, there have been no significant changes in monetary conditions in the area as a whole following the cut in official interest rates agreed last June. In any event, the slope of the money market yield curve has turned upwards, and is now slightly positive, without this change having substantially altered rates at the longer-dated maturities. As the budget deficit of some of the main economies has tended to widen, even in cyclically adjusted terms, the overall macroeconomic policy stance has become more expansionary, this being attenuated only in part by the appreciation of the euro.

Accordingly, as in previous quarterly reports, it is worth underscoring the need to preserve the credibility of the Stability and Growth Pact as a prerequisite for maintaining the stabilising capacity of fiscal policy and ensuring the proper functioning of the Monetary Union. The European authorities should ensure compliance with the rules and procedures established so as to promote continuing fiscal discipline in all Member States.

As the Spanish economy is ahead in the cycle and its growth differential with the euro area countries has tended to widen during 2003, the monetary conditions set by the Eurosystem are particularly generous for Spain. In this situation, the budgetary policy pursued by the Spanish authorities has aimed to consolidate the stability of public finances. Duly attesting to this are the data on the State budget outturn for the first nine months of the year, and the initial projection for 2003 and the draft 2004 budget submitted to Parliament, both of which are characterised by a balanced budget.

Tax receipts during the current year have been considerably buoyant; only on the latest data do they appear to have moderated slightly. The biggest rises in spending have been in items related to the working of the State and in public investment. For 2003 as a whole, the general government contribution to the growth of household disposable income is expected to be appreciable, as it was last year.

The estimated increase in real domestic demand in the Spanish economy in 2003 Q3 compared with the same period a year earlier was 3.3%, 0.1 pp up on the preceding quarter. Behind the notable stability of this figure were somewhat higher growth in consumer spending

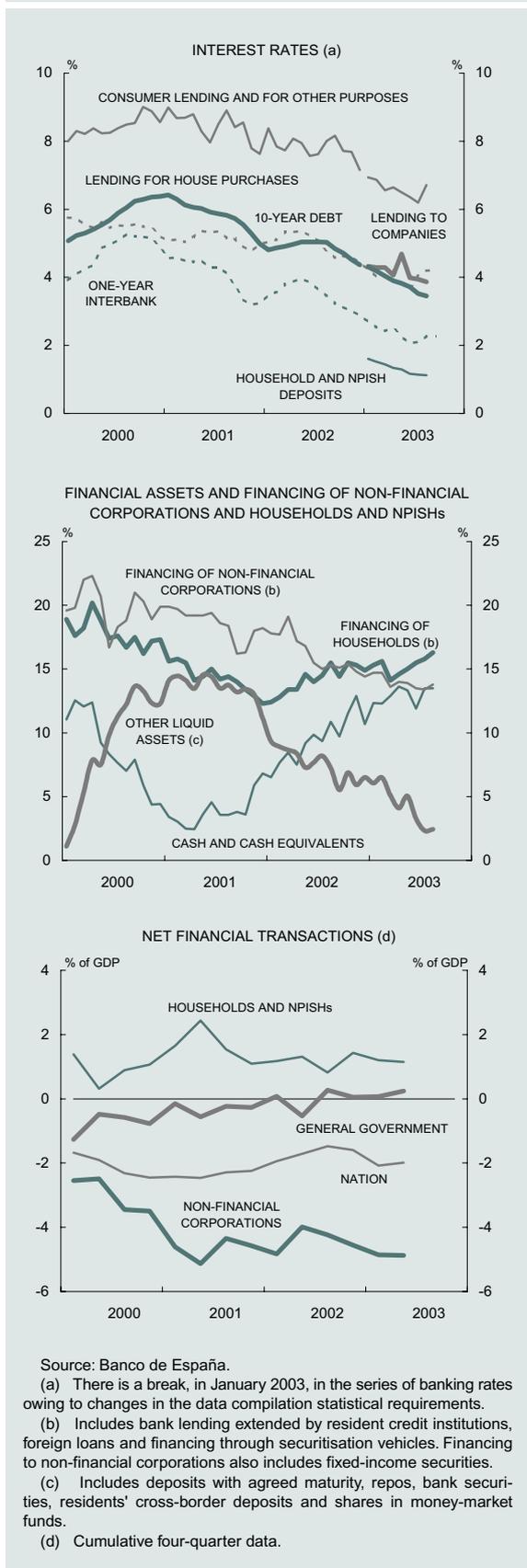


and a mild slowdown in fixed capital investment. Investment in construction has remained resilient, though it has eased off slightly, while the recovery initiated by investment in equipment in the previous quarters has tended to moderate. The most notable reflection of behaviour on the demand side in the productive branches has undoubtedly been the loss of steam in manufacturing industry.

The factors behind the continuous growth of household spending – on consumption and residential investment – during the year are similar to those identified in previous years. The growth of real disposable income is running high. And it is estimated that, on average in 2003, it will reach a magnitude similar to that of 2002, underpinned by the strength of employment and by wage income, which has been supported in turn by the payments arising from the application of the wage indexation clauses relating to 2002. In addition, regard should be had to gains in wealth, both in real terms (derived from rising property values) and financial terms (following the rally on stock markets), with the maintenance of very generous financing conditions proving a further factor here.

CHART 4

Financial indicators of the Spanish economy



Indeed, the rate of increase of financing received by households stepped up in Q3 to over 16%, supported by the trend of mortgage loans, the interest rates on which fell marginally. Consumer and other credit also increased more than in the previous quarter, albeit tenuously, there having been a slight rise in the interest rates applied to these operations. However, despite increased debt, the financial burden on households remains at comfortable levels of around 14% of their disposable income.

Financial conditions for the corporate sector are proving equally generous, with financing flows sustaining a rate of increase slightly down on that recorded in Q2 but still above 13%. The rates applied have declined somewhat and the improvement on stock markets (with higher prices and less volatility) has made it possible to raise external funds. Corporate debt ratios have continued to increase, but nor can the financial burden here be considered high in view of the low interest rates applied. The moderation in the pace of recovery of corporate investment in capital goods that is apparently discernible in the data for Q3 may thus be attributed to the uncertainty that continues to be reflected in business confidence surveys, against a background in which exports – and, thereby, industrial activity – have fallen off somewhat.

The slowdown apparent in the export data available for Q3 is in response to two factors. First, to the fact that foreign markets remained fairly depressed, especially in Europe. And further, because the comparison of the latest figures released is with a period (the second half of 2002) in which exports regained notable momentum. In any event, the slide in exports to Europe is proving fairly marked, and is being mitigated only by the more balanced trend of those to other areas, for which sale prices have had to be cut forcefully (by around 10%) so as to offset the effect of the appreciation of the euro. The indicators of tourism, for their part, have eased off to some extent during Q3.

Although the slowdown in imports has run in parallel to that of exports, the former has been for a lesser amount and has affected non-energy intermediate goods above all, in line with the behaviour observed in industry. Prices have broadly performed very favourably, with the sole exception of non-energy intermediate goods, where they are rising considerably.

Despite the fact that the expansionary behaviour of some employment indicators had slackened during Q3, the recently released EPA data have offered signs that job creation remains notably buoyant. Indeed, according to the EPA survey, employment in the summer months

increased at a rate of 2.8%, 0.2 pp up on the previous quarter. The modest rise in unemployment is therefore due to the continuing robustness of the labour force, derived from the ongoing increase in the economy's participation rate.

Turning to wages, once the impact of the payments arising from the activation of the wage indexation clauses in the opening months of the year has been absorbed, their rate of increase will tend to stabilise along the lines laid down by collective bargaining. Wage settlements in the year to date exceed those for 2002, as has also been confirmed by the results of the labour costs index. The rise in wages, combined with low productivity growth, has led the rate of increase of unit labour costs to hold at over 3% on average for the first three quarters of 2003, without any easing discernible.

This is a factor that may be hampering the slowdown in prices in the second half of 2003, especially in those industries where demand conditions or the lack of competition are conducive to operating margins widening. An additional factor has been the increase in the prices of certain foods where supply conditions,

whether for circumstantial or structural reasons, have considerably increased the related rates of increase.

Against this backdrop, the rate of increase of the CPI in September was 2.9%, the same as for the quarter as a whole, and the differential with regard to the euro area – measured with the harmonised index – has stabilised at around 1 pp (0.9 pp in September). Notable for their size are the differentials building up in unprocessed food and non-energy industrial goods, which exceed those traditionally seen in the services component.

In sum, the Spanish economy is facing the incipient recovery in the world economy from a favourable position anchored in its high capacity for generating employment. It is likewise well poised to benefit from the expansion of international markets. Nonetheless, if the possibilities of higher growth are to materialise, domestic demand must trend in step with income and employment growth, and price and wage increases must moderate, providing for continued competitiveness and growth that is investment-led to a greater extent.

2. External environment of the euro area

In 2003 Q2 the main economies of the external environment of the euro area saw activity quicken on the back of the expansionary stance of demand-side policies. However, there is still uncertainty about the soundness of the recovery, especially in the medium term, owing to the US economy's imbalances and Japan's structural problems.

Developments on international financial markets were influenced by the G-7 communiqué on 20 September, which called for greater exchange-rate flexibility and prompted a rapid depreciation of the dollar, at first, especially against the yen. That led to foreign exchange interventions by the Japanese authorities which checked the fall in the dollar, while its depreciation against the euro continued. Initially, stock markets reacted adversely, but they subsequently picked up. The rise in long-term interest rates also continued, albeit at a somewhat more moderate pace. Corporate financing conditions improved further, though less rapidly than in previous months.

In the *United States*, GDP finally grew by 3.3% (in annualised quarterly terms) in 2003 Q2, above initial expectations. This growth was based on public spending, on private consumption (3.8% in annualised quarterly terms) and on business investment, which resumed a positive growth rate for the first time since end-2002. Productivity remained notably buoyant (standing at an annualised quarterly rate of 6.8%), due in part to the poor performance of the labour market. The indicators for Q3 continue to point to a dynamic economy, especially as regards private consumption, which has been boosted by tax reductions. Consumer confidence, however, felt the effects of the slackness of the labour market, although it did improve once again in October. As regards investment demand, the signals are mixed. On one hand, corporations improved their financial position significantly. But on the other, capacity utilisation held at a low level and durable-goods orders turned negative again in August. Nonetheless, the production of capital goods increased by 5.2% between July and September. Turning to the labour market, employment continued to contract owing to the pressure on business margins brought about by the slowdown in inflation until September, when both new hires and the proportion of companies with staff increases rose. In the final weeks of the quarter, moreover, unemployment benefit claimants fell appreciably. In September, consumer prices increased by 0.1 pp to a 12-month rate of 2.3%, but underlying inflation fell once again to 1.2% year-on-year, the lowest rate in 38 years. The adverse impact on business margins is reflected even more strongly in producer prices, the underlying rate of which slowed in

September to 0.1%. The trade deficit dipped slightly again in August compared with the previous months, as a result of the slowdown in imports. Finally, the central government deficit for fiscal year 2003 stood at 3.5% of GDP, below the previous official estimates.

The *Japanese economy* rebounded strongly in Q2, posting a year-on-year rate of 3% (1% in quarterly terms). The driving force here was the buoyancy of gross capital formation (10.4% year-on-year), underpinned by the increase in business profits and by expectations of an improvement in the external environment. The indicators available for Q3 show a degree of slowdown brought on by the fall in private consumption, which has also been reflected in industrial output (0.7% month-on-month in August). As regards the labour market, the unemployment rate fell appreciably in August to 5.1%, but this was due essentially to the reduction in the labour force. However, the outlook is positive, as shown by the significant improvements in the confidence indicators and the recovery in exports. Moreover, although consumer prices reached a negative 12-month rate of 0.3% in August, 0.1 pp down on the previous month, the slowdown in the decline of the underlying rate (-0.1% year-on-year) continued. The Bank of Japan eased its monetary policy stance further, increasing its quantitative target by 2 billion yen (up to a range of 27-32 billion yen), and extended the deadline for the purchase of shares held by private banks for another year, to September 2004.

In the *United Kingdom*, growth in Q2 was significantly revised (0.6% and 2% in quarterly and annual terms, respectively, against the previous estimates of 0.3% and 1.8%) due first, to the greater buoyancy of construction and gross fixed capital formation, and second, to the contraction in imports. On preliminary National Accounts figures, growth in Q3 was 1.9% compared with the same period a year earlier, and 0.6% compared with Q2. The economic indicators available for Q3 show a degree of moderation in private consumption and a fall-off in industrial output and exports. However, business confidence was high in the past quarter and the labour market situation remained positive, with an unemployment rate of 5% of the labour force. Consumer prices declined by 0.1 pp in September to a 12-month rate of 2.8%, and the harmonised index held at 1.4%. The growth of house prices eased slightly, although the related rate remained high.

In the *EU accession countries*, GDP growth in Q2 was generally fairly positive, with the exceptions of the Czech Republic and Hungary (2.1% and 2.4% year-on-year, respectively).

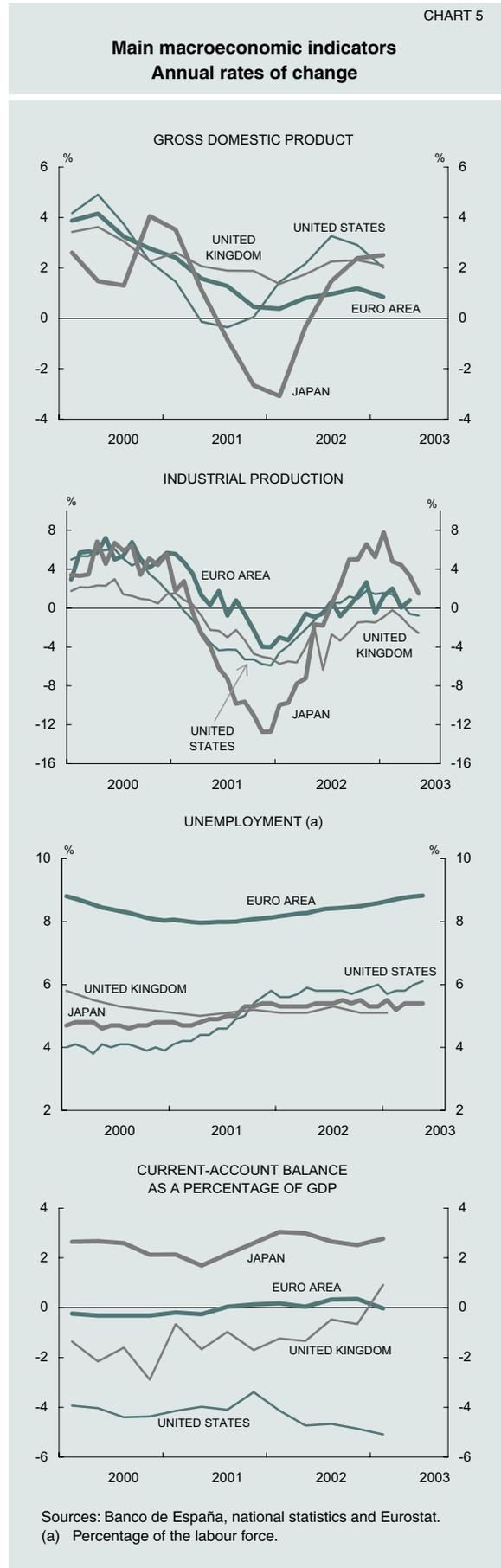
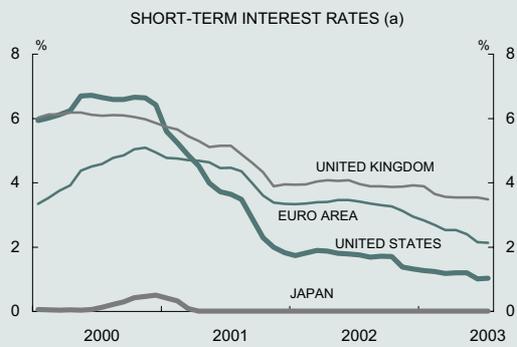
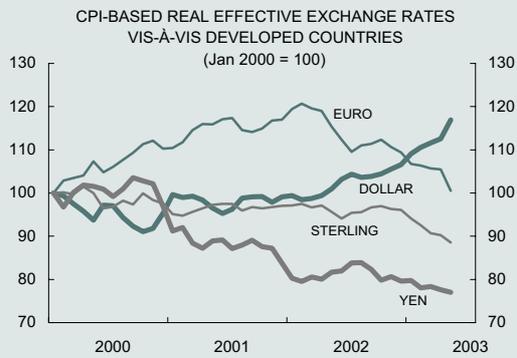


CHART 6

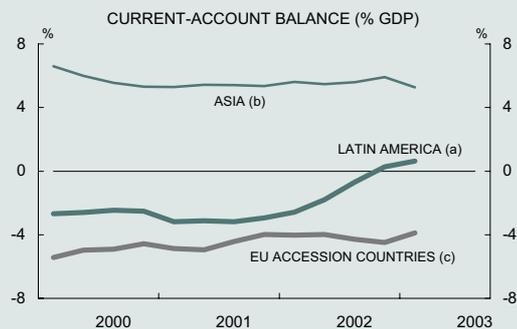
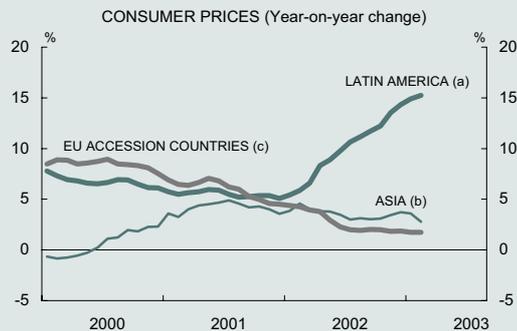
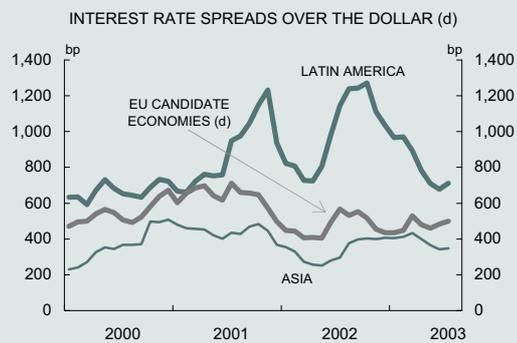
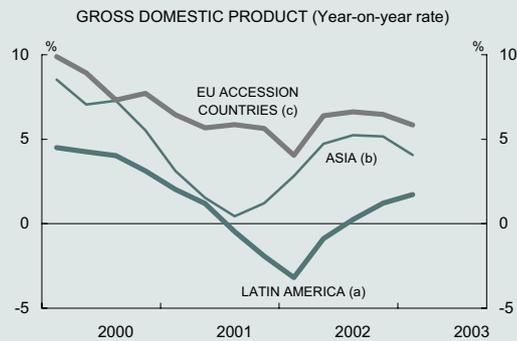
Prices, real exchange rate and interest rates



Source: Banco de España.
 (a) Three-month interbank market interest rates.
 (b) Ten-year government debt yields.

CHART 7

Emerging economies: main macroeconomic indicators



Sources: National statistics and JP Morgan.
 (a) Argentina, Brazil, Chile, Mexico, Colombia, Venezuela, Peru.
 (b) Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
 (c) Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.
 (d) JP Morgan EMBI spreads. For the EU candidate countries, an in-house estimate has been made drawing on data from Bulgaria, Hungary, Croatia, Turkey and Poland.

Growth was underpinned by exports, except in Hungary, and by consumption, except in Slovakia. Inflation accelerated in this latter country, in contrast to the rest of the region, because of the increases in administered prices and in indirect taxes, which will affect more countries in 2004. Fiscal consolidation worsened in virtually all these countries. Such factors led their respective monetary authorities – with the exception of Slovakia – to check the declining trend of interest rates. On the political front, Estonia and Latvia approved EU accession further to a referendum, thereby concluding the round of consultations made by the future member countries to their citizens.

Economic activity in *Asia* was sluggish in Q2, with the exception of Thailand and, especially, China. This was largely due to the negative effects of the SARS outbreak. However, the latest indicators show a rapid recovery, based on the end of the SARS epidemic and on the pick-up in foreign trade. Regarding China, the need for an appreciation of the yuan was discussed in numerous international fora in view of the country's high exports and the build-up in its international reserves, but the Chinese authorities have been reluctant to amend their exchange rate regime.

In *Latin America*, financial variables continued to trend favourably thanks to foreign capital inflows and to narrower corporate bond spreads in developed economies, and despite the rise in long-term rates in these countries. Stock markets posted sizable gains and exchange rates held stable, except in the case of Mexico, whose currency depreciated. Sovereign debt spreads con-

tinued to narrow, albeit at a more moderate rate, and in several cases they were close to or below historical lows. GDP growth slowed strongly in Q2 due to the sluggishness of domestic demand and the slowdown in exports, excepting those countries that had recently been in crisis, especially Argentina. Nonetheless, the easing of monetary policies and the improvement in the external environment should offer a basis for an incipient recovery which has, to date, been reflected only hesitantly in the indicators.

Across the different countries, the recovery in activity in Argentina stepped up in Q2 (7.6% on a year earlier). Such growth should continue into Q3 in the light of the available indicators, against a background of contained inflation. A new agreement with the IMF for three years was finally reached, and the outlines for the proposed restructuring of foreign debt were announced, which would entail significantly lower bond values. In Brazil, the slowdown in activity was accentuated in Q2 (GDP declined by 1.4% year-on-year), but the indicators available for Q3 show signs of a pick-up, given the improved expectations and the sharp cumulative easing of monetary policy since June (750 bp). In Mexico, growth was weak in Q2 (0.2% year-on-year), while signs of an improvement led by consumption and investment are discernible for Q3. However, exports are not yet reflecting the pick-up in industrial activity in the United States. As from the onset of October the decline in interest rates came to a halt, further to the depreciation of the peso. In Chile, financial stability underpinned growth, although there was a degree of slowdown in August judging by the latest indicators.

3. The euro area and the monetary policy of the ECB

The information available on the economic performance of the euro area in Q3 provides some signs of a modest recovery in activity after the stagnation in the first half of the year. For the time being, these signs are concentrated in the confidence indicators that measure agents' perceptions of economic performance, and have not yet been conclusively confirmed by the quantitative indicators that reflect the course of productive activity and demand. In particular, neither domestic demand nor demand by the rest of the world seem so far to have settled at a sustained level of growth. However, the current European setting is characterised by favourable financial conditions, an absence of significant macroeconomic imbalances and a gradual strengthening of the economy of the rest of the world, so it has all the ingredients needed for the progressive recovery of activity over the coming months. Among the factors that could limit the force of this recovery are the likelihood that euro area firms may continue to be engaged in balance sheet restructuring, the pressure on oil prices and the uncertain behaviour of foreign exchange markets. In addition, certain Member States are finding it difficult to reduce their budget deficits to the agreed levels, and this is an additional source of concern which in the coming months will test the mechanisms in place for the multilateral surveillance of budgetary policies. Finally, credit is due to certain countries for their more resolute steps to initiate reforms to improve the long-term sustainability of public finances and to stimulate their economies to operate more efficiently.

3.1. Economic developments

According to the most recent euro area National Accounts estimate, GDP contracted slightly by 0.1% in 2003 Q2 in quarter-on-quarter terms, as compared with no change in the previous three months. In year-on-year terms, there was a modest increase of 0.2%, down 0.5 pp on the rate in the previous quarter (see Chart 8). In quarter-on-quarter terms, the contribution of domestic demand—excluding inventories—to the expansion of GDP amounted, as in the first three months of the year, to 0.2 pp. This was the result of notably expansionary behaviour of public consumption and an uneven performance of the other two components. Thus, while the pace of private consumption moderated substantially, the fall in gross fixed capital formation was also reined in as a consequence of improvements in both the capital goods and construction components. Meanwhile, the negative contribution of external demand to GDP growth (0.4 pp) was similar to that in Q1, as a result of the opposing effects of a deceleration in the fall in exports and a somewhat more dynamic performance of imports.

At the country level, the National Accounts figures for Q2 reveal that, among the ten euro area economies for which data are available, there was negative quarter-on-quarter growth of GDP in five of them, including the three largest, i.e. Germany (-0.1%), France (-0.3%) and Italy (-0.1%). In these three cases, the external sector's contribution to growth was negative (-0.5%, -0.2% and -0.7%, respectively). As regards domestic demand, private consumption and gross fixed capital formation posted near-zero growth in Germany and France, while Italy saw greater strength of private consumption and a certain recovery in investment which, nonetheless, continued to show a negative rate of expansion. Germany and Italy—as well as the Netherlands—recorded falls in GDP in at least two consecutive quarters, which is usually considered to denote a recession.

As far as the production branches are concerned, there was a notable contraction in value added in industry (excluding construction), which, after growing by 0.1% in the first three months of the year, fell by 0.8% in Q2. Meanwhile, construction, which expanded at a rate of 0.4%, recorded the first positive quarter-on-quarter growth rate since 2001 Q4. Finally, the value added in the services sector increased by 0.2%, similar to the rate in previous quarters.

The available activity indicators in 2003 Q3 point to slightly stronger GDP growth. As regards supply indicators, the services sector confidence indicators improved substantially in Q3, reflecting somewhat more favourable prospects than those of manufacturing industry. As for the latter, the Purchasing Managers' Index, which had decreased in every month of Q2, rose uninterruptedly throughout Q3 to a level above 50 in September, indicating that the survey respondents expect a recovery in manufacturing. Similarly, the industrial confidence indicator based on the survey conducted by the European Commission moved upward, albeit moderately, in Q3. The improvement from June to September was mostly due to the component relating to future production expectations, while the other two components (current orders and finished product inventories) scarcely changed between these two dates. Additionally, the survey contains a question (the response to which does not form part of the indicator) about the perception of how production has performed in the recent past, in which the improvement is even more hesitant. In this and other confidence surveys in recent years, the expectations of future performance have become decoupled from the assessment of the current situation. This decoupling is analysed in Box 1. In any event, it should be noted that the improvements in industrial confidence indicators have barely fed through to the quan-

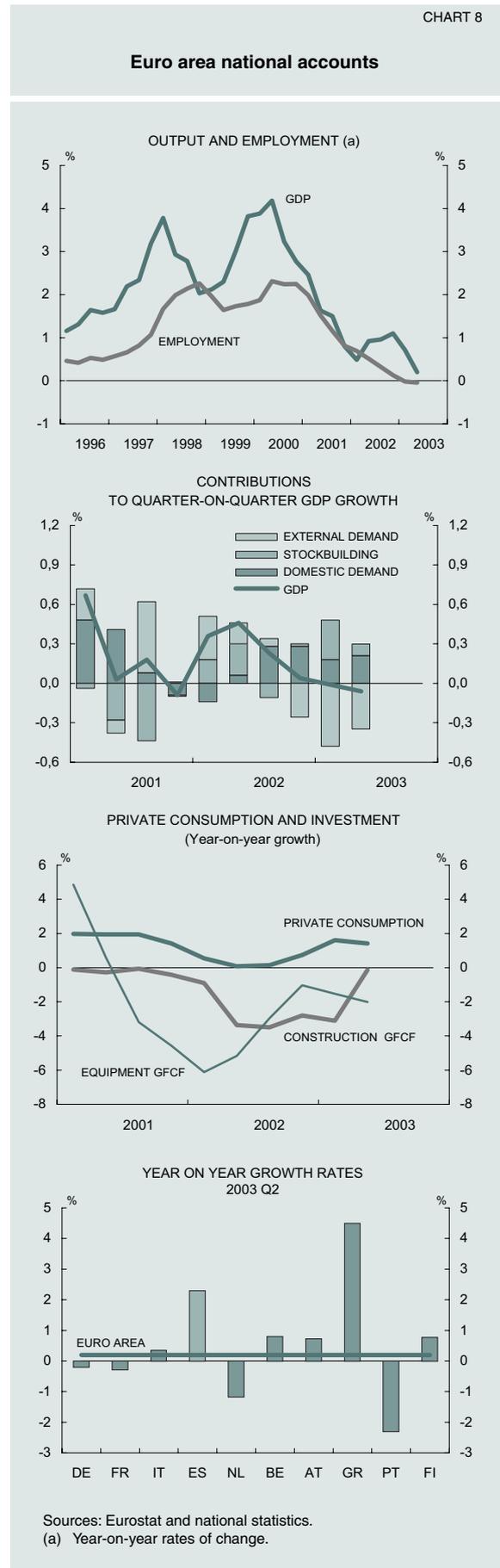


CHART 9

Euro area. Real indicators



titative industrial indicators. Thus, although the industrial production index (excluding construction) moved erratically in July and August due to seasonal factors, overall consideration of the two figures together does not seem to suggest a substantial improvement.

On the demand side, the available indicators point to a modest recovery in Q3. In particular, the private consumption indicators generally posted minor rises. Thus the last few months have seen further improvement in the indicators based on the European Commission survey of consumer and retail confidence, following the upturn initiated in spring (see Chart 9). New car registrations also showed greater strength in the summer months. However, this buoyancy has not been observed so far in retail sales, which have tended to stagnate in recent months. Regarding demand for capital goods, the immediate outlook is not very optimistic, since for the time being neither capacity utilisation nor the assessment of orders by industrial firms themselves provide firm signs of recovery. Regarding external demand, the indicators of export expectations in industry and of orders from abroad held steady in Q3 after the deterioration in spring.

As far as the euro area labour market is concerned, in the April-June period employment remained stagnant for the fourth consecutive quarter. In year-on-year terms, net job creation turned negative in the first half of the year (albeit to an insignificant extent), something which had not happened since 1994. This scarcely affected the unemployment rate in the euro area: although the gradual upward trend of this variable since mid-2001 has not been interrupted, in August it remained at 8.8% of the working population, which was the level reached last March. As regards future prospects, during 2003 Q3 the indicators of employment expectations in the various branches of production obtained from the European Commission's opinion surveys have tended to stabilise in industry, rise in services and worsen slightly in construction (see bottom panel of Chart 10).

In short, based on the behaviour of the various indicators available, a moderate strengthening of euro area GDP growth in the second half of 2003 seems plausible, although there are no clear signs of which demand component will lead this increased buoyancy. In this respect, private consumption may be favoured by the low interest rates, by the wealth effect of house and stock market price increases and by the positive influence that currency appreciation and the foreseeable decline in inflation may have on household disposable income. However, the mediocre employment prospects and the

Recent behaviour of indicators of confidence and of economic recovery prospects in the euro area

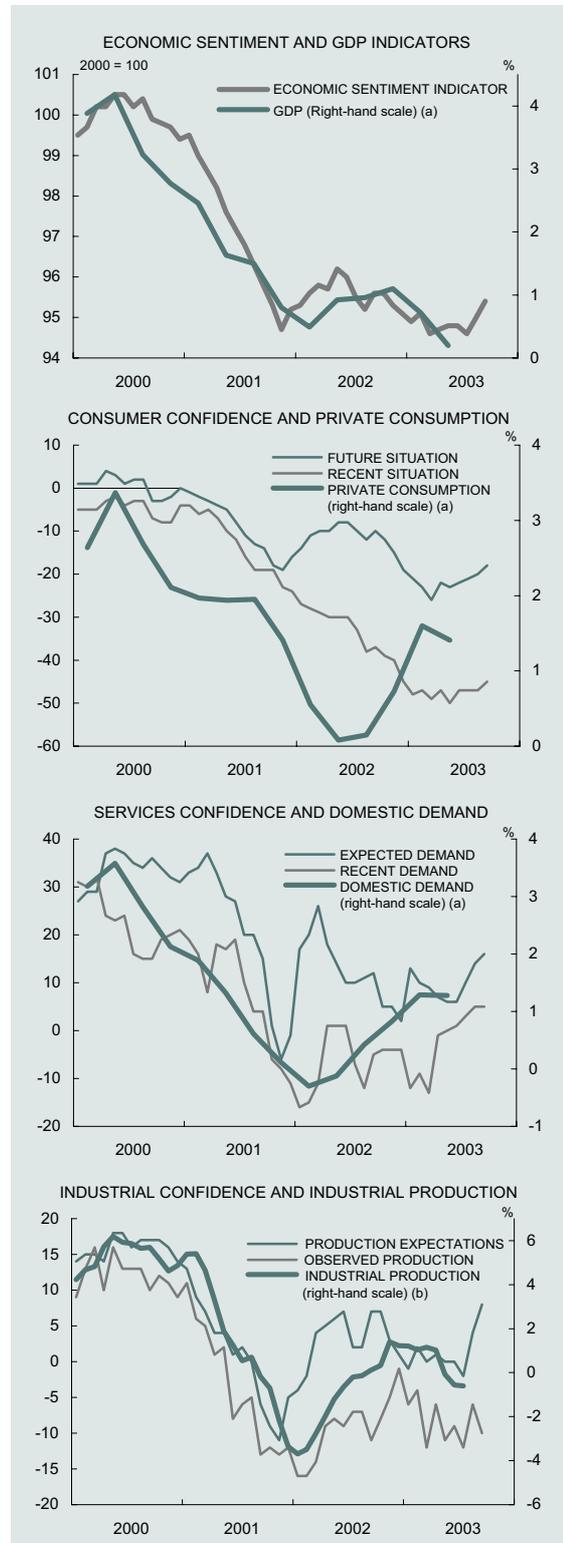
The confidence indicators reflecting the outcome of surveys conducted on private agents to gauge their perception of the economic situation tend to anticipate changes in activity. Surveys normally include questions asking for an assessment of the economic situation or of the performance of production or demand at the time the survey is conducted or in the recent past, as well as another type of question addressing future expectations. The differences in the answers to the two types of questions can be used to assess the information contained in the movements of the aggregate indicator. In principle, it seems reasonable to concede greater validity to an increase in confidence based on an increase in both types of indicator, whereas, for example, an increase based solely on more optimistic expectations may reverse if those expectations are frustrated.

The economic sentiment indicator compiled by the European Commission on the euro area—which summarises the consumer, industry, retail trade and construction confidence surveys—has improved in the most recent period, following a deterioration dating from mid-2002 (see the first panel of the accompanying chart). This improvement, which commenced in 2003 Q1 in the indicators relating to consumers, services (not included in the economic sentiment indicator) and retail trade, and which is as recent as 2003 Q3 in the case of industrial confidence, might be heralding a recovery in economic activity in the near future. However, similar behaviour of the economic sentiment indicator was seen in late 2001 and early 2002, and it was followed by a pick-up in the euro area GDP growth rate, but that improvement was short lived. This precedent casts doubt on the reliability of the signal currently being given by confidence surveys. To assess the quality of this signal, it is important to analyse the path followed in both periods by the indicators that measure expectations and those that reflect the current situation. They are shown in the accompanying charts together with the year-on-year rate of change of the economic variable to which they would be expected to be most closely related in each case.

As far as consumer confidence is concerned, the second panel shows how from end-2001 a decoupling took place between the perception of the economic situation in the near future, which improved, and the opinion about the recent past, which continued to deteriorate as it had been doing since the beginning of that year. Even so, the second half of the year saw a recovery in the growth rate of private consumption which, however, was limited to a low pace, slightly above 1%. By contrast, in 2003 the two indicators were more in step, holding steady at the beginning of the year and then both rising, more sharply in the case of the expectations indicator. In the services industry (see third panel), there was not such a large divergence, although the improvement in expected demand behaviour was earlier and sharper than that in observed behaviour, precisely the opposite to what has happened this year.

Finally, as seen in the bottom panel, the indicator of future expectations in industrial confidence rose sharply at end-2001. Months later, this rise was followed by an improvement in the assessment of the recent trend in production and by an increase in the rate of expansion of industrial production, although the latter was limited to a very moderate pace. The movement of these two indicators in recent months is somewhat similar to that in the first phase of the previous upturn, with the recent-trend indicator holding steady and significantly higher expectations.

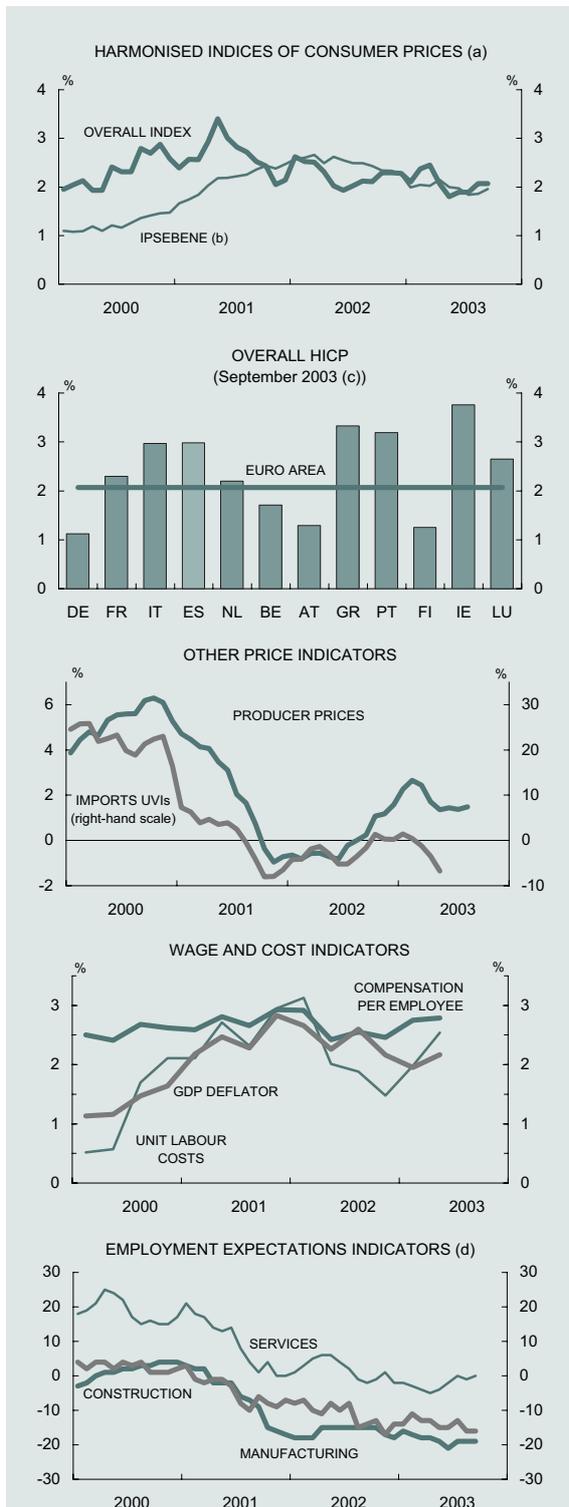
Overall, although with due caution in the case of the industrial sector, it can be seen that the recent improvement in the opinion surveys is free of the gap between the perception of expectations and the perception of the current situation that existed last year. This permits the prospect of a nearby recovery in activity to be viewed with greater confidence.



Source: European Commission.
 (a) Year-on-year rates of change.
 (b) Year-on-year rates of change of the 3-month moving average.

CHART 10

Euro area. Price, wage and employment indicators
Year-on-year percentage changes



Sources: Eurostat and European Central Bank.
 (a) There is a break in January 2002 when the series were re-based to 2001.
 (b) Index of non-energy processed goods and services prices.
 (c) For the Netherlands and Greece, the data relate to August.
 (d) Expectations based on European Commission sentiment indicators.

difficulties in stabilising the budget position of certain countries are sources of uncertainty that may induce households to curb their spending. In the case of investment, although the low interest rates and a certain improvement in financial conditions make the situation favourable, it is uncertain to what extent firms have finished adjusting their balance sheets after the last period of debt accumulation. Finally, the stimulus to external demand coming from recovery in other geographical areas may be offset by currency appreciation.

Euro area consumer prices were characterised by a modest acceleration in the growth rate of the harmonised index of consumer prices (HICP) from 1.9% in June to 2.1% in September (see Chart 10). This was mainly due to a rise in unprocessed food prices (which, together with those of energy, are traditionally the most volatile) related to the impact of the high August temperatures on the production of these goods. The growth rate of the indicator of services and non-energy goods prices (IPSEBENE by its Spanish name) remained steady at 2% from June to September. Finally, the producer price index grew by 1.4% year-on-year in August, a similar rate of increase to that seen since May. Most notable among the components was the upward trend of the energy component, which countered the greater moderation in prices of other intermediate goods; the rates of change of the industrial producer prices of consumer and capital goods remained steady.

As regards the inflation outlook, there are certain factors acting to moderate price buoyancy, such as the persistently wide gap between the levels of potential and actual production, and the evidence that the currency appreciation has not yet completely fed through to the prices of imported goods (see Box 2). However, the behaviour of domestic costs casts some doubt on this outlook. In particular, the year-on-year growth of unit labour costs accelerated by 0.5 pp in each of the first two quarters of the year to 2.5% in the April-June period. The rise in Q2 was due almost entirely to the fall in the rate of expansion of apparent labour productivity (to 0.2%), against a background in which compensation per employee was growing at 2.8%. The GDP deflator grew by 2.2% in Q2, up 0.2 pp on Q1, so the acceleration of unit labour costs signified, in addition, a narrowing of business margins.

The uncertainty over oil price behaviour also has a significant bearing on the euro area's inflation outlook. In the recent period, the price of oil has remained high at around USD 30 per barrel. This mainly reflects a number of supply factors, including the difficulty in re-establishing the sup-

Effect of euro exchange rate fluctuations on extra- and intra-euro area imports

An appreciation of the nominal exchange rate of the euro means that, in principle, export firms located in non-euro area countries can lower the euro-denominated prices of their exports to the euro area, which stimulates the demand for imports from those countries. However, these firms will probably decide not to transfer in full the currency appreciation to their euro-denominated prices, so their margins per unit of product in their currency will widen and their gain in market share will be smaller than if the new euro-denominated price fully reflected the effect of appreciation. Meanwhile, faced with the loss of competitiveness represented by the appreciation of the euro, euro area firms whose production competes in the domestic market with imports from firms located outside the euro area can either maintain their prices, in which case they will probably lose market share, or, alternatively, they can reduce their prices (and therefore their margins) to contain the loss of competitiveness. The converse is true in the case of a depreciation of the euro. In practice, the extent to which the appreciation is transferred to the euro-denominated prices of firms located both inside and outside the euro area will depend on factors such as the competitive structure of the industry in which the exporter operates, the elasticity of demand faced by the exporter, the particular circumstances of domestic demand in the euro area and the perception (and subsequent confirmation) of the persistent or temporary nature of the exchange rate movements. Exchange rate fluctuations can thus be expected to induce changes in the price and volume of imports from other euro area countries and from the rest of the world (hereafter "intra euro area imports" and "extra euro area imports"), which will depend partly on the decisions adopted by firms in each area.

Based on the movements of the nominal effective exchange rate since 1999, three stages can be distinguished: the first encompasses the first two years of the euro area's existence and is characterised by a substantial depreciation of the euro's nominal effective exchange rate (NEER); the second, extending up to 2002 Q1, featured a fairly steady NEER; and the third has been a period of sharp appreciation of the euro, amounting to nearly 20% in NEER terms, from the spring of 2002 to the present.

What first meets the eye in the top panel of the accompanying chart is the parallel movement, from one period to the next, of intra- and extra-euro area imports despite the sharp exchange rate fluctuations. This suggests that demand considerations may be more important than exchange rate movements in explaining import behaviour. However, the changes in the composition of imports by origin are significant and may be attributable to exchange rate fluctuations and, particularly, to decisions to transfer these exchange rate movements to import prices.

The first stage saw somewhat lower growth of extra-euro area imports, although the difference with respect to the increase in intra-euro area imports seems to be slight if the sharp depreciation of the euro in that period is taken into account. This was basically because the prices of intra-euro area imports rose substantially, which limited the competitiveness gains of firms located in the euro area, although these prices grew less than those of competitors (see bottom panel). The strength of domestic euro area demand obviously may have been a factor fuelling price rises in imports regardless of their origin.

The middle period saw a larger relative fall in intra-euro area imports, probably because of their simultaneous rise in price, which, in a situation of exchange rate stability, could be linked to the gradual transfer to European domestic costs of the previous euro depreciation and the sharp oil price rise.

Finally, in the third stage extra-euro area imports behaved somewhat better because the appreciation of the euro enabled firms in the rest of the world to lower their export prices to the euro area, although they only did so by approximately one-third of the change in the exchange rate, so these producers simultaneously widened their margins substantially. Intra-euro area exporters also attempted to react to the stronger euro, but any price compression that they may have introduced has been considerably more limited, so they have had to face a loss of competitiveness and of market share.

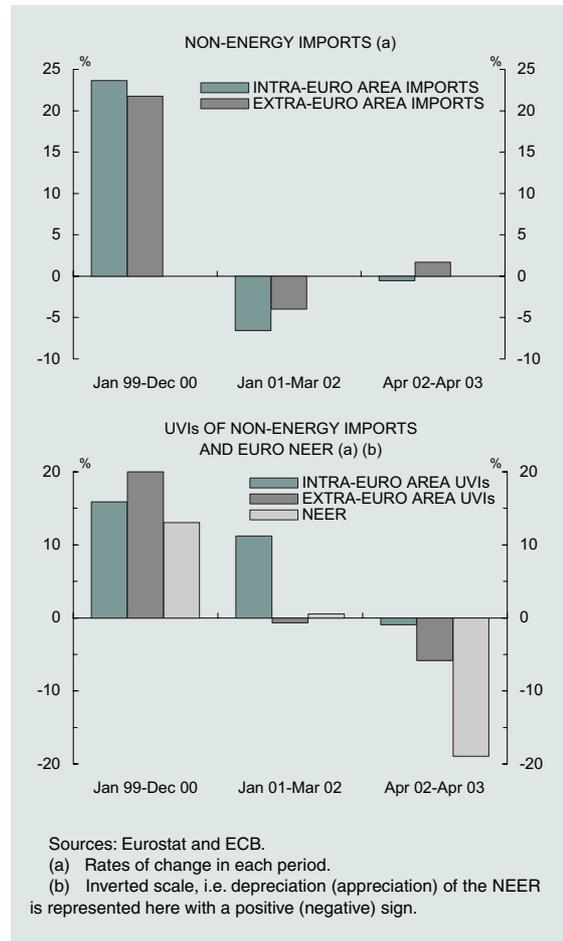


TABLE 1

Euro area economic indicators

| | 2002 | | | | 2003 | | | |
|--|-------|-------|-------|-------|-------|-------|------------|------------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 (a) | Q4 (b) |
| GDP | | | | | | | | |
| Year-on-year growth | 0.5 | 0.9 | 1.0 | 1.1 | 0.7 | 0.2 | | |
| Quarter-on-quarter growth | 0.4 | 0.5 | 0.2 | 0.0 | 0.0 | -0.1 | | |
| European Commission forecasts (c) | | | | | | | (0.0; 0.4) | (0.2; 0.6) |
| IPI (d) | -2.6 | -0.6 | -0.2 | 1.3 | 1.1 | -0.3 | 0.3 | |
| Economic sentiment | 95.6 | 96.0 | 95.4 | 95.3 | 94.9 | 94.8 | 95.0 | |
| Industrial confidence | -13.0 | -10.0 | -11.3 | -9.7 | -11.0 | -12.0 | -11.4 | |
| Manufacturing PMI | 48.3 | 51.4 | 50.5 | 49.0 | 49.3 | 47.1 | 49.1 | |
| Services confidence | 3.0 | 5.3 | -0.7 | -4.3 | -5.7 | -2.0 | 5.3 | |
| Services PMI | 52.1 | 52.9 | 50.9 | 50.5 | 48.9 | 47.9 | 51.9 | |
| Unemployment rate | 8.2 | 8.3 | 8.5 | 8.6 | 8.7 | 8.8 | 8.8 | |
| Consumer confidence | -10.0 | -8.3 | -10.0 | -14.0 | -19.3 | -19.3 | -17.3 | |
| HICP (d) (e) | 2.5 | 1.9 | 2.1 | 2.3 | 2.4 | 1.9 | 2.1 | |
| PPI (d) (e) | -0.6 | -0.8 | 0.3 | 1.6 | 2.5 | 1.4 | 1.5 | |
| Oil price in USD (e) | 23.7 | 24.1 | 28.4 | 28.2 | 30.3 | 27.6 | 27.1 | 29.9 |
| Loans to the private sector (d) (e) | 5.5 | 5.4 | 5.1 | 4.8 | 4.7 | 4.5 | 5.0 | |
| Euro area ten-year bond yield | 5.1 | 5.3 | 4.8 | 4.5 | 4.2 | 4.0 | 4.2 | 4.3 |
| US-euro area ten-year bond spread | -0.01 | -0.10 | -0.46 | -0.51 | -0.22 | -0.32 | 0.09 | 0.03 |
| Dollar/euro exchange rate (e) | 0.872 | 0.998 | 0.986 | 1.049 | 1.090 | 1.143 | 1.165 | 1.179 |
| Appreciation/Depreciation of the euro (e) | -1.0 | 13.2 | 11.9 | 19.0 | 3.9 | 9.0 | 11.1 | 12.4 |
| Dow Jones EURO STOXX Broad index (e) | 1.6 | -15.2 | -39.1 | -34.5 | -12.9 | 2.9 | 4.1 | 9.1 |

Sources: Eurostat, ECB and Banco de España.

(a) The information in italics does not cover a full quarter.

(b) Information available up to 23 October 2003.

(c) Quarter-on-quarter growth forecasts.

(d) Year-on-year growth.

(e) End-period data. Figures for exchange rate and the stock market are percentage changes over the year.

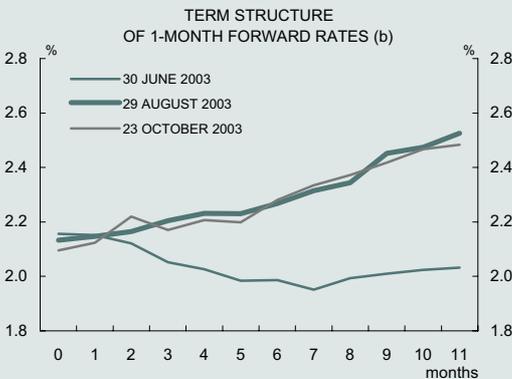
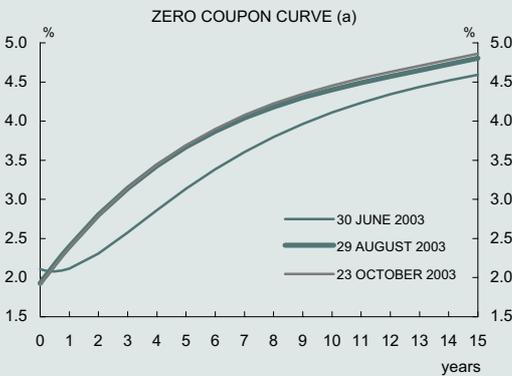
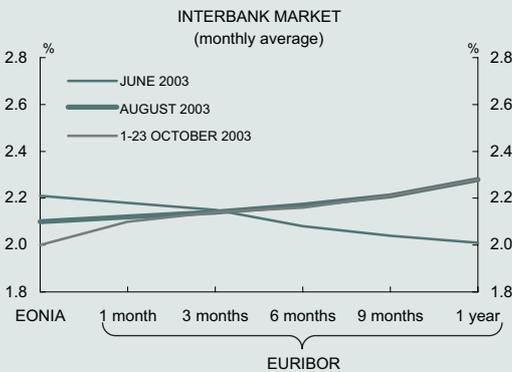
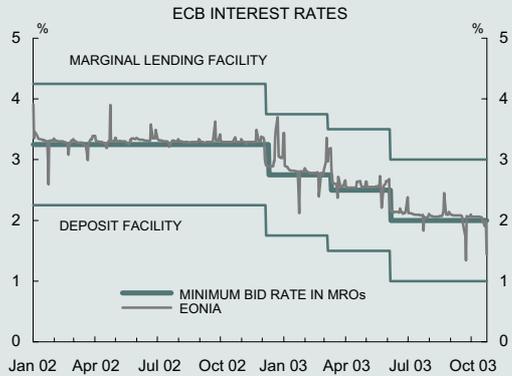
ply of Iraqi crude oil, the impact of the Nigerian and Venezuelan political crises on production in these countries and the OPEC's decision to reduce the quotas of its member countries. Moreover, US oil stocks are below their usual levels for this time of the year.

The euro area's cumulative surplus on current account in the twelve-month period ended in August 2003 amounted to €33.9 m, thereby continuing the decline initiated following the high of €67 m in 2002 Q4. This backslide is explained by the smaller surplus on the goods balance due to lower export volumes and prices as a result of currency appreciation, while the nominal level of imports remained unchanged. The decline in the cumulative twelve-month basic balance from December 2002 to August 2003 was more pronounced (down from €129 m to €59.6 m), mainly as a consequence of a lower net inflow of portfolio investment, while the lower net outflow of direct investment and the deterioration of the current account balance tended to offset each other.

With regard to fiscal policy, the estimates revealed by certain governments and the most recent budget outturn information suggest that in many cases the 2003 budget deficits will clearly exceed the levels projected in Stability Programmes and will even be higher those estimated by the European Commission last spring. This largely reflects the downward revision of economic growth in a large number of countries, which has basically manifested itself in lower tax revenue, although also in higher social protection expenditure. In some cases, however, the deterioration in public finances is also partly attributable to the measures taken to stimulate activity, particularly tax cuts. However, these actions may not serve their purpose if they lead to a deterioration of the budget position, since conceivably private agents may decide not to use the resulting additional disposable income to spend more, but rather to save more for precautionary reasons. In these circumstances, it is particularly important to take consolidation measures to ensure compliance with the Stability and Growth Pact and maintain its credibility,

CHART 11

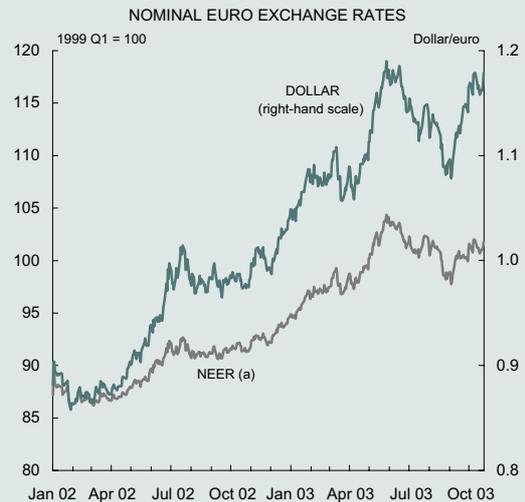
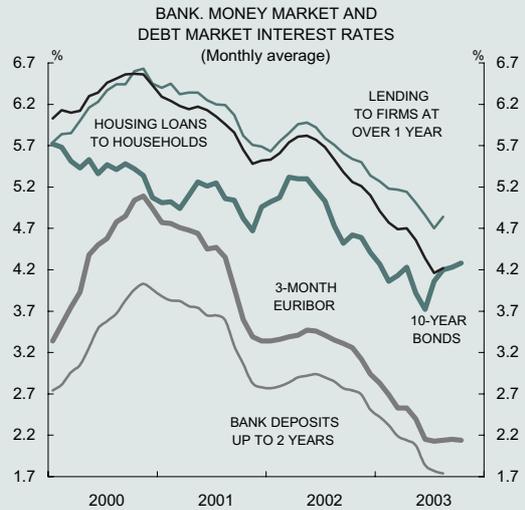
Euro area interest rates



Sources: Banco de España and European Central Bank.
 (a) Estimated using swap market data.
 (b) Estimated using Euribor data.

CHART 12

Euro area interest rates, exchange rate and stock market index



Sources: Banco de España and European Central Bank.
 (a) Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.

TABLE 2

General government budget balances of euro area countries (a)

% of GDP

| | 2000 | 2001 | 2002 | 2003 (b) | 2003 (c) |
|------------------|------|------|------|----------|----------|
| Belgium | 0.2 | 0.4 | 0.1 | 0.0 | 0.2 |
| Germany | -1.2 | -2.8 | -3.5 | -2.8 | -4.2 |
| Greece | -1.9 | -2.0 | -1.2 | -0.9 | -1.7 |
| Spain | -0.9 | -0.3 | 0.1 | 0.0 | 0.0 |
| France | -1.4 | -1.6 | -3.1 | -2.6 | -4.2 |
| Ireland | 4.4 | 0.9 | -0.4 | -0.7 | -0.9 |
| Italy | -1.8 | -2.6 | -2.3 | -1.5 | -2.6 |
| Luxembourg | 6.4 | 6.1 | 2.5 | -0.3 | -0.6 |
| Netherlands | 1.5 | 0.0 | -1.6 | -1.0 | -2.6 |
| Austria | -1.9 | 0.3 | -0.2 | -1.3 | -1.0 |
| Portugal | -3.1 | -4.2 | -2.7 | -2.4 | -2.9 |
| Finland | 7.1 | 5.2 | 4.2 | 2.7 | 2.4 |
| MEMORANDUM ITEM: | | | | | |
| Euro area | | | | | |
| Primary balance | 4.2 | 2.3 | 1.4 | | 0.7 |
| Total balance | -0.9 | -1.6 | -2.2 | -1.8 | -2.8 |
| Public debt | 69.5 | 69.2 | 69.0 | 68.6 | 70.4 |

Sources: European Commission and national stability programmes.
 (a) As a percentage of GDP. Proceeds from the sale of UMTS licences not included. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
 (b) Targets of the stability programmes presented between November 2002 and January 2003.
 (c) European Commission forecasts (spring 2003).

thereby fomenting long-term growth. Accordingly, the German government proposed measures, most of which have yet to be approved by parliament, including the rescheduling of the income tax cut initially planned for 2005 to an earlier date in 2004, the elimination of certain tax deductions, a tax amnesty for repatriated capital, extensive reform of the unemployment benefits system, changes in the pension system and diverse measures to contain health care expenditure.

The excessive deficit procedure initiated against France on 3 June gave the French government four months to adopt corrective measures. At the end of this period, the European Commission judged the measures taken—which included raising indirect taxes and reforming the pension system—to be insufficient to reduce the nominal deficit to less than 3% in 2004. In fact, the French draft budget envisages budget deficits of 4% of GDP in 2003 and of 3.6% of GDP in 2004. Furthermore, the French government has revised upwards by 1 pp to 61.4% its forecast, prepared in June, of the 2003 debt ratio. Under Article 104.8 of the Treaty establishing the European Community, the European Commission will submit to the next ECOFIN Council meeting on 4 November a recommendation that the Council decide that France has

not taken effective measures to remedy its excessive deficit before 2004. Also, further to the steps established in the excessive deficit procedure and in accordance with Article 104.9 of the Treaty, the European Commission has presented another recommendation to the Council, this time that it insist on the adoption by France of measures permitting the deficit to be reduced below 3% of GDP. The European Commission's recommendation acknowledges the negative impact of the cyclical slowdown on the French budget position and the adjustment effort planned for 2004 and proposes extending by one year, i.e. to 2005, the deadline set for remedying the excessive deficit. However, it requires a greater adjustment of the cyclically adjusted budget balance in 2004 and 2005, the specification before 15 December 2003 of the measures to be adopted for this purpose and the compulsory closer surveillance of the French government via regular reports on budgetary developments.

3.2. Monetary and financial developments

As mentioned above, recent economic behaviour has been characterised by an inflation outlook that has remained in line with the ECB's definition of price stability and by heightened

confidence in the recovery of economic activity, although doubts persist about how strong it will be. Against this background, the ECB Governing Council decided to hold official interest rates unchanged in Q3. Thus the minimum bid rate on main refinancing operations has remained at the level of 2% agreed on June 5.

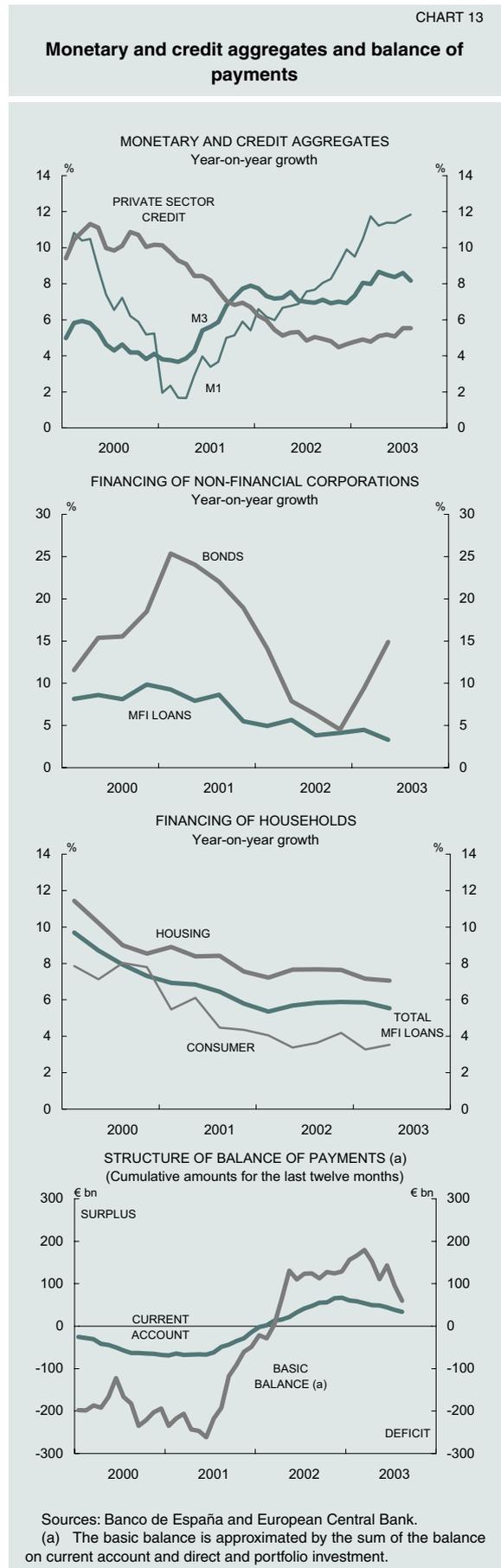
As shown by the second panel of Chart 11, the slightly negative slope of the money market yield curve in June turned positive later on. By the end of the third week, the spread between the one-year term and shorter terms was approximately 30 basis points.

These interbank market developments fed through to the one-month forward yield curve, which in the third week of October reflected moderate expectations of an upturn in interest rates some time towards next spring.

After a low of around 3.6% in June, ten-year yields on euro area debt markets started to increase and stood at 4.3% at the time of this Bulletin going to press. This might reflect greater optimism by market participants about euro area growth prospects (see Chart 12). In the period addressed by this Bulletin, the yields on US debt securities of the same term fluctuated more widely and, as a result, the spread with respect to the euro area (minus 40 basis points in June) turned positive with a high of the same magnitude in the second half of August, subsequently decreasing to zero.

The interest rates applied by euro area credit institutions to transactions with their customers decreased until July. However, in August (the latest available observation), whereas the rates on loans of up to a one-year and on deposits continued to fall, the rates on business loans at over one year and on home purchase loans turned upward for the first time since mid-2002. This may be connected with the increase in long-term rates on debt markets.

On euro area stock markets, the rally initiated in mid-March continued up to the beginning of September, when a moderate correction commenced. This adjustment, absent on the US stock market, coincided with a period of more rapid appreciation of the euro exchange rate, giving rise to conjecture that it may have been related to a downward revision of the earnings expectations of the euro area firms most highly exposed to exchange rate movements against the dollar, namely exporters and firms that have made direct investments in the United States in recent years. In any event, during October the European stock markets tended to recoup the ground lost in September. Between the March lows and the



time of this Bulletin going to press, the Euro STOXX broad index gained more than 35%.

The behaviour of the euro exchange rate on the foreign exchange markets in recent months can be divided into two clearly distinct phases. At the beginning of June the euro started to gradually weaken against the dollar and, to a lesser extent, against the currencies of the euro area's main trading partners. This depreciation, which lasted until early September, might have been related to the improved growth prospects of the US economy. However, this process subsequently reversed, largely because of the communication issued following the G-7 meeting in Dubai that greater exchange rate flexibility was desirable to facilitate orderly adjustment of global imbalances. Since the beginning of the year, the euro has appreciated against the dollar by approximately 13% in bilateral terms and by 8% in nominal effective terms.

Although the M3 monetary aggregate sustained high growth rates in July and August, similar to those in Q2, the year-on-year rate slowed

in August by 0.4 pp to 8.2%. In September, M3 again decelerated, the year-on-year rate being 7.4%. The abatement of uncertainty on financial markets may have motivated a certain portfolio reallocation from higher liquidity, lower risk assets towards long-term financial assets.

Meanwhile, the growth of credit to resident private agents picked up slightly in Q3, standing at 5.5% year-on-year in September, which may be a sign that euro area economic activity is recovering against a background of favourable financing conditions (see Chart 13). The results of the Bank Lending Survey conducted by the European Central Bank suggest that, although euro area credit institutions as a whole continued to tighten the terms of loans to firms and households in Q2, a lower proportion of institutions declared that they had done so. Moreover, a lower number of institutions expected the supply of financing to firms to decrease in Q3. That said, a reminder is given that these results should be interpreted with caution and, in particular, that it is risky to use them to assess the behaviour of activity, given the short history of this Survey.

4. The Spanish economy

On QNA figures, domestic demand in the Spanish economy held at a stable real growth rate of 3.2% year-on-year in Q2. This was the result of the renewed buoyancy of construction spending and investment in equipment, and of the sustained growth of final consumption, which reflected a slight acceleration in private consumption and less expansionary government consumption (see Chart 14). The negative contribution of the external sector to GDP growth diminished by 0.1 pp, but remained substantial (-1 pp), giving rise to a year-on-year change in GDP of 2.3%, 0.1 pp up on the figure for Q1. The information available for Q3 points to marginally more expansionary behaviour by domestic demand (3.3% year-on-year), underpinned by the ongoing growth of private consumption and investment in construction, and by a more neutral contribution from stock-building, compared with its slightly negative value in the previous quarter. The negative contribution of the external sector to growth will have stepped up 0.1 pp, against the background of the diminishing momentum of imports and, to a greater extent, exports. Consequently, GDP is estimated to have grown at a real rate of 2.3% in Q3 compared with same period in 2002.

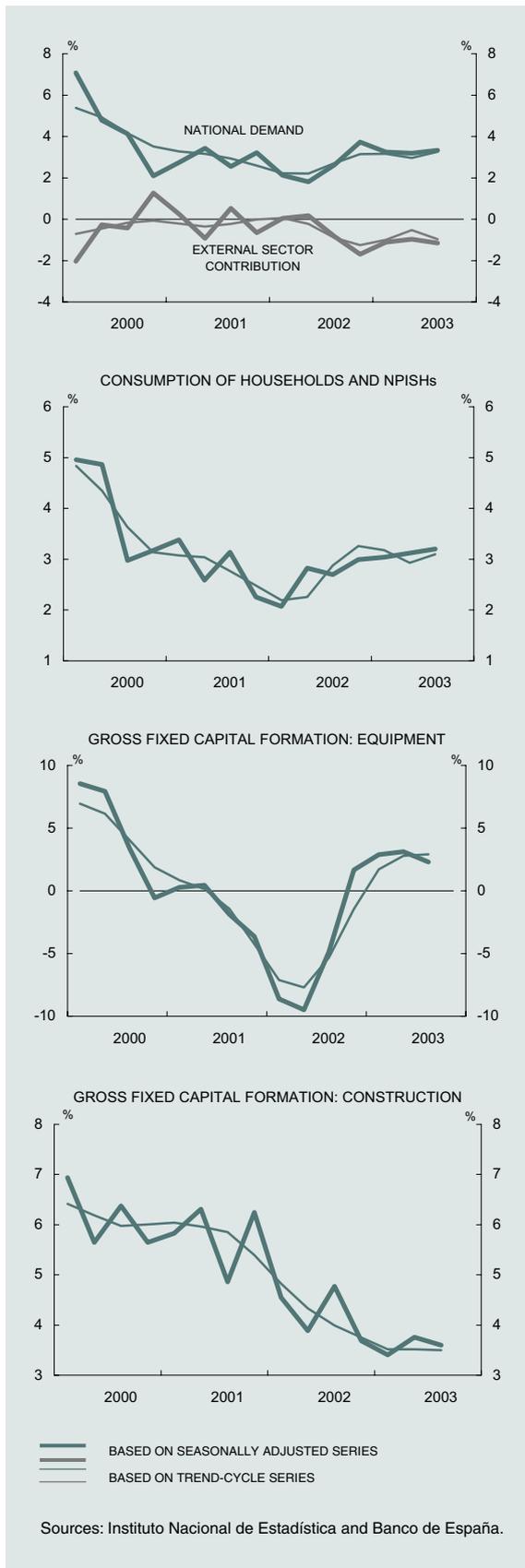
From the standpoint of value added, activity improved in Q2 in virtually all the productive branches. The rate of decline in agriculture was cut significantly, construction was boosted, taking its year-on-year growth rate to 4.1%, and the pace of services as a whole increased, with market services proving notably buoyant. However, in industry, excluding energy, the growth rate fell off. According to the indicators available, there was a further slowdown in industry in Q3, while growth in construction tended to stabilise and that in market services dipped slightly. Conversely, the ongoing pick-up in agriculture continued and energy production forged ahead, driven by the summer heat wave.

Against this backdrop, employment trended most steadily during the first three quarters of the year. The mild acceleration seen in Q2 continued into Q3, when a year-on-year increase of 1.7% was posted. The employment-generating capacity of Spanish growth thus remains high and, consequently, headway in apparent labour productivity remains limited. Nonetheless, employment developments across the different branches of activity are not uniform, as job-creation has been concentrated in construction and in services.

Wage growth in the first half of 2003 was influenced by an acceleration in wage rates and by payments arising under indexation clauses relating to 2002, which meant that compensa-

CHART 14

Main demand aggregates
Percentage change on year ago



tion per employee had already accelerated in Q1. Although this acceleration eased off slightly in Q2, it has fed through to unit labour costs, which have tended to quicken. By branch of activity, this behaviour of costs was most marked in construction and in services, while the contraction in employment in other activities (such as industry) offset the bigger rise in compensation. Overall, the expansionary trend of business margins in the market economy has lost momentum in the period to date in 2003. A further contributing factor here has been the lower growth of prices, as illustrated by the CPI, whose rate of change moderated in the first half of the year to level off subsequently at a rate close to 3%.

4.1. Demand

On QNA estimates, household final consumption spending quickened slightly in Q2 to a year-on-year rate of 3.1% in real terms. The latest information, relating to the summer months, suggests this mild acceleration will have run into Q3, giving rise to a rate of increase of 3.2% compared with the same quarter a year earlier. The buoyancy of private consumption so far in 2003 has been mainly based on the sound growth of household real disposable income, adding to which has been the persistence of generous financial conditions and the emergence of real net wealth gains in this sector. Moreover, this set of factors has come into play against the background of the progressive improvement in consumers' perception of the economic situation.

Among the most up-to-date indicators of private consumption (depicted in Chart 15), the apparent consumption of goods and services has held on a rising trend throughout the year to date, driven mainly by the expansionary behaviour of services and the food goods component, while the pace of the component of non-food goods has tended to ease. Other indicators confirm this pattern. The rising trend seen since the start of Q2 in the retail sales index, in real terms, came to a halt in August, giving rise to a course of stability very close to that reflected by the retail trade confidence indicator. This halt in the recovery by the sales index originated in the slowdown in sales of non-food goods. New car registrations, for their part, have increased notably in Q3, entrenching the recovery seen in the previous quarter. The course of this variable is in contrast to that of overall durable goods, the apparent consumption of which has tended to moderate, in line with the opinions expressed by consumers on the timeliness of purchasing these types of goods.

The main determinants of private consumption remained favourable, in a situation marked (see the lower panel of Chart 15) by the progressive increase in consumer confidence after it had touched bottom at the start of 2003. Underpinning this confidence are improved expectations about the economic situation and unemployment developments. Two factors are contributing to the growth of real disposable income in 2003: first, the more moderate behaviour of consumer prices; and further, the ongoing increase in employment, the rise in compensation per employee – based on a somewhat greater increase in wage rates and on the payments arising under the indexation clauses relating to 2002 – and the personal income tax reform, introduced at the start of the year. Nonetheless, other income components are exerting a negative contribution, such as interest payments. Overall, it is estimated that real disposable income is still growing at high rates, similar to those observed in 2002. And households, meanwhile, are expected to earmark part of this growth to financing greater consumption, although they have also continued restoring their saving ratio, after this reached a low in 2001. The continuing rise in real-estate assets, which has been joined in recent quarters by the stock market rally, means that net household wealth will once again be an additional prop to consumption, against a background of generous financing conditions.

In 2003 Q2, general government final consumption grew by 3.6% year-on-year, 0.3 pp down on the previous quarter. This slight slowdown may have run into Q3, in line with the relative containment of spending on wages and salaries that continues to be seen in the budget outturn.

Gross fixed capital formation grew at a rate of 3.4% in real terms in Q2 in relation to the same quarter a year earlier, 0.3 pp up on Q1. This saw the continuation of the path of recovery initiated in the summer of 2002. The buoyancy of investment was common to all its components: capital goods grew at a rate of 3.1% year-on-year, while spending on construction climbed by 3.8%, 0.4 pp up on the figure for Q1. Investment in other products – which mostly includes spending on services related to construction – likewise rebounded. However, the indicators point to a pause in this rising path during Q3, which will have affected investment in capital goods to a greater extent, as shown in Chart 14.

The slowdown in investment in equipment in year-on-year terms arises, in part, from the strong recovery in this aggregate in 2002 Q3, which has not been repeated this year. But it is

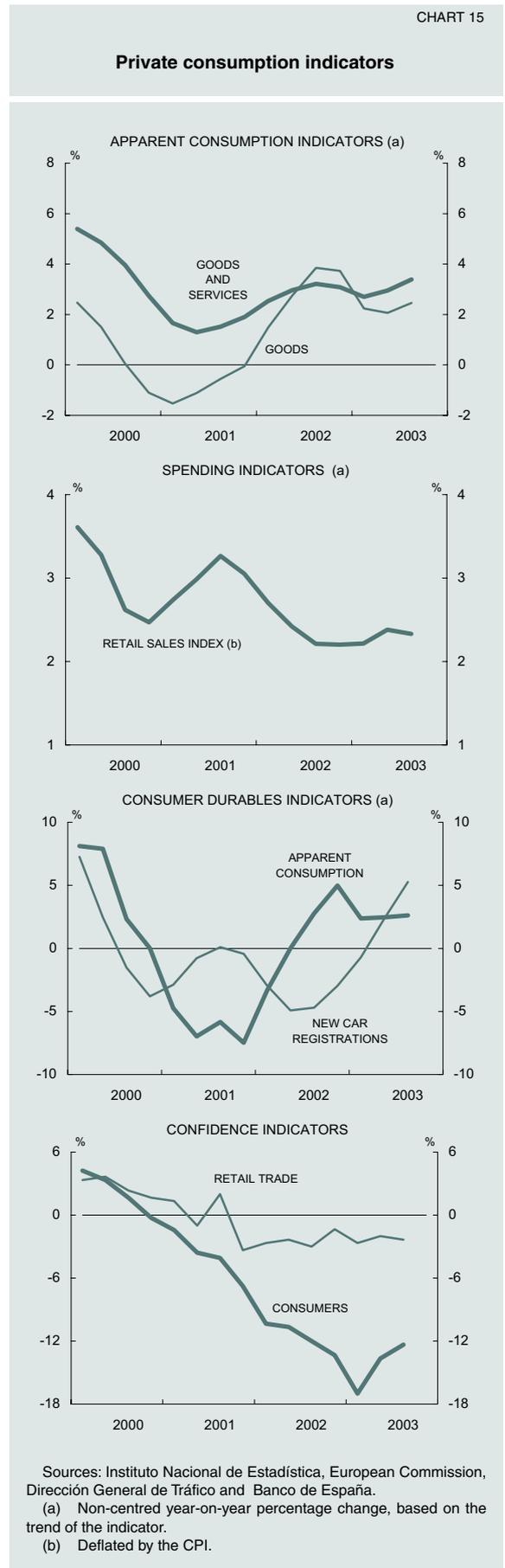
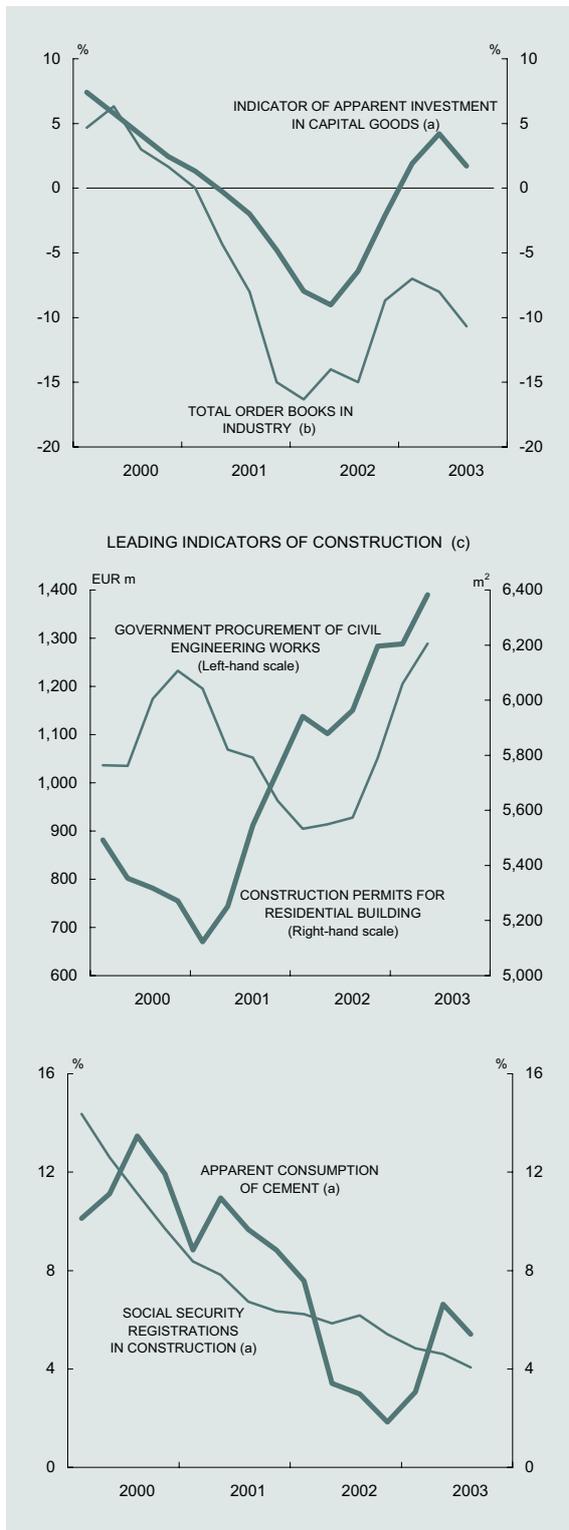


CHART 16

Gross fixed capital formation indicators



Sources: Instituto Nacional de Estadística, European Commission, Ministerio de Fomento, OFICEMEN, Instituto Nacional de Empleo and Banco de España.

- (a) Non-centred year-on-year rates based on the trend of the indicator.
- (b) Level of original series.
- (c) Annual moving averages.

no doubt also due to greater caution in committing investment, given the as yet hesitant recovery in the European economy and the loss of momentum of exports.

In any event, this profile is reflected in most of the short-term economic information available (see Chart 16). The index of apparent investment in capital goods, calculated with information for Q3 which is not yet complete, has slowed – as a result mainly of the falling off of domestic output – and, in line with this trend, both the business confidence indicator and orders in the investment good-producing industry slipped in July and August. Turning to the information on more general demand-side conditions, although capacity utilisation in industry surged in Q3 to stand more than one percentage point above its historical average, the business confidence indicator worsened in September since the production outlook for the coming 12 months was revised downwards and orders deteriorated. Likewise, the qualitative results from other surveys have reflected a degree of stability in investment, although the more forward-looking surveys continue to reflect expectations of growth.

The information from the Banco de España Central Balance Sheet Data Office quarterly survey for the first half of 2003 shows that the return on investment of the non-financial corporations represented in its sample has stabilised at a high level, while the cost of borrowing has fallen slightly (in step with the prevailing financing conditions), giving rise to a wider spread between the return on investment and cost of debt ratios compared with the first half of 2002. This wider spread, which has arisen against a background of recovery marked by a rise in activity and a certain increase in debt, illustrates the sound financial position from which Spanish corporations are facing the phase of recovery.

After having moved on a more or less pronounced slowing path since 2001, the year-on-year growth rate of investment in construction has tended to stabilise since end-2002. In step with this trend have been a slight acceleration in this aggregate in 2003 Q2 and a likewise slight slowdown estimated for Q3 (see Chart 14). The most coincident indicators of construction activity have weakened in Q3. Thus, following the notable falls in the output of certain materials used in construction and the decline in the apparent consumption of cement in August (which might stem partly from the energy restrictions during the heat wave), the September figure for the latter variable has confirmed its slowdown. The indicators of employment in this sector show a loss of buoyancy, compared with Q2,

despite the favourable movements in September (see Chart 16).

The indicators of construction project starts have, however, been expansionary in the period to date in 2003. In particular, housing starts, which had resumed positive growth rates in the summer of 2002, increased notably in the first half of 2003. That is in step with the increase in the surface area of residential building to be constructed per the statistics on building permits and approvals (with increases of 24.5% to April, in the first case, and of 22% for the whole of the first half of 2003 in the second case). This information would augur a somewhat higher pace of growth for residential investment in the coming quarters, in step with the trend of household disposable income, in a setting in which financing conditions remain very favourable.

The data on the surface area of non-residential building to be constructed, drawn from the leading indicators, would ultimately point to a modest recovery in this type of work, compared with 2002, while the value of general government tenders shows a cumulative increase of 17% to May, owing to the renewed momentum of civil engineering works.

On QNA results, investment in stockbuilding in 2003 Q2 subtracted 0.1 pp from the year-on-year growth of GDP. The information from the monthly business survey to September reflects an increase in stocks of finished products, and it is estimated that the contribution of this item to GDP growth may have been marginally positive in Q3.

According to QNA data, net external demand in 2003 Q2 subtracted 1 pp from real GDP growth in a context in which real foreign trade flows accelerated significantly in year-on-year terms, most sharply so in the case of exports of goods and services (see Chart 17). Part of this strong growth was due to the low level of exports and imports in the comparative period in 2002 Q2, while part reflected a genuine acceleration. The latter is difficult to explain in the case of exports, since the delay in worldwide activity taking off prompted a further slowdown in global trade during this period, and the indicators of competitiveness recorded fresh losses against the developed countries as a whole owing to the strength of the euro and in spite of the fall in export prices. The as yet incomplete information for 2003 Q3 points to slightly more contractionary net external demand, accompanied by considerable easing in the growth of trade, against a background marked by diminished uncertainty about the recovery in the world economy. In any event, part of the easing in the year-on-year rate could once again be explained

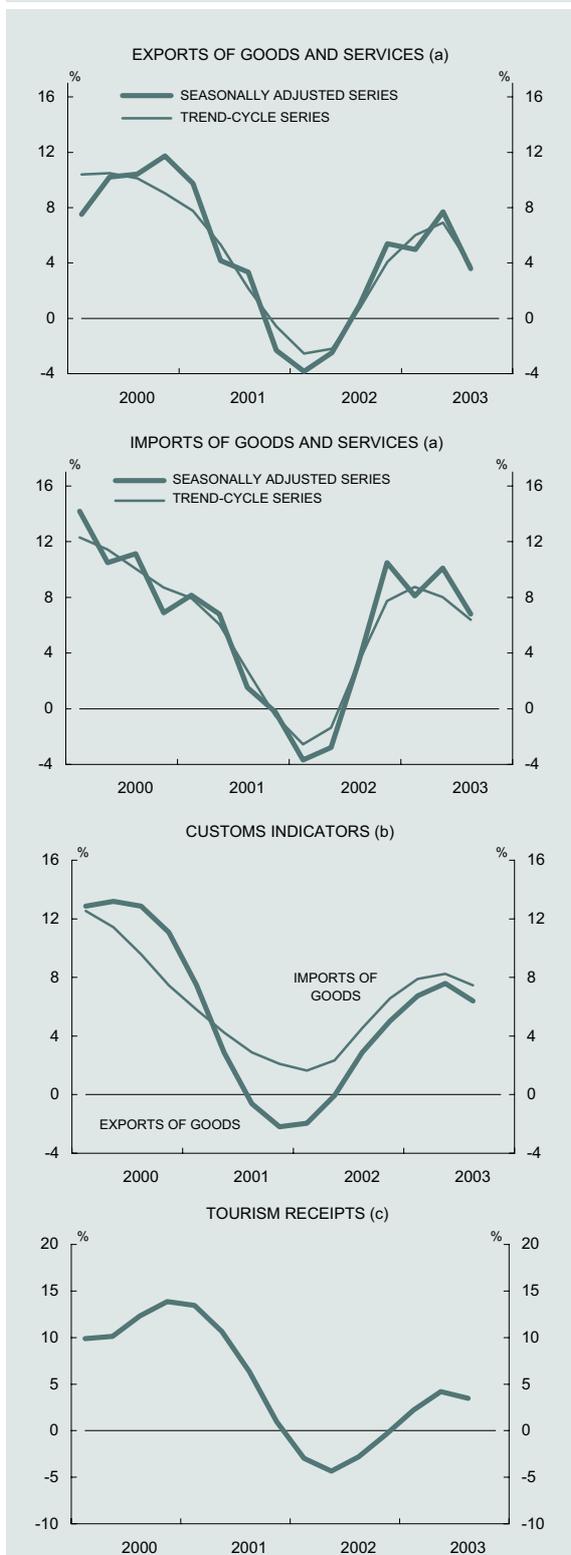
by a base effect, arising from the strong quarter-on-quarter pick-up in exports and imports of goods in the summer of 2002.

On QNA figures, the rate of increase of goods exports quickened in 2003 Q2 to 10.1% compared with the same quarter a year earlier, thus intensifying the recovery that began in mid-2002. The information from customs data for July – when exports climbed by a real year-on-year rate of 3.4% – points, however, to a moderation in the rate of increase in exports, sharper in the case of sales to the EU but significant, too, in exports to non-Community markets. While this information, relating to a single month, should be viewed with caution, it is not only consistent with the above-mentioned base effect but also with the continuing slackness of the euro area economies (Spain's main export markets) and with our diminished competitiveness vis-à-vis other markets, deriving from the sharp appreciation of the euro. Specifically, sales to Community markets increased by 1.5% in real terms in July, after posting a figure of 10.6% in Q2. The slowdown was common to all markets, although sales to Germany remained buoyant. Non-Community exports rose by a real rate of 7.3% in July, 5 pp down on the figure for Q2. Of note was the poor performance (in nominal terms) of exports to Latin America, the south-east Asian countries and OPEC. In terms of product groups, exports of capital goods remained notably resilient in July, as did car sales.

The QNA-estimated pick-up in real exports of services in Q2 reflects the slightly expansionary behaviour of non-resident consumption in this period, which increased by a year-on-year rate of 1.5% after having slipped by 4% in Q1. This recovery is consistent with the gradual normalisation of the world tourist market, following the end of the war in Iraq and the receding of the SARS outbreak. The pick-up came about, however, despite the fact that the growth of Spanish tourism prices, combined with the appreciation of the euro, prompted a further deterioration in Spanish competitiveness vis-à-vis our main customers. But the tourism indicators, which duly reflected the improvement in Q2, show that this tendency was checked during the summer months: foreign visitors lodged in hotels and the related number of overnight stays held on an improving line until August, but there was a turnaround in September when overnight stays fell back by 1.8% year-on-year, and stays by foreign visitors in camping sites and tourist apartments also contracted. Tourist arrivals at frontiers were also slack; in the first eight months of the year there was no change in relation to the same period a year earlier, after a decline of 3% in Q3. In terms of the countries

CHART 17

Foreign trade
Percentage change on year ago



Sources: INE, Ministerio de Economía, Ministerio de Hacienda and Banco de España.

- (a) QNA data at constant prices.
- (b) Deflated trend-cycle series.
- (c) Nominal trend-cycle series.

supplying tourists, numbers of Britons rose substantially, while those from our main markets, Germany, France and Italy, slipped. Regarding non-tourist services, these grew at a year-on-year rate of 3.2% in 2003 Q2 according to QNA figures, close to the figure for the preceding quarter and in line with the trend of the nominal Balance of Payments indicator.

In 2003 Q2 the year-on-year rate of increase of real goods imports climbed by 3 pp to 11.3%, driven by the robustness of exports and the pick-up in private productive investment, against the backdrop of an appreciating euro. For Q3, the July customs data point, in this case too, to somewhat greater moderation, although the real rate of increase – at 7.2% (see Chart 17) – remains high. The slowdown in imports mainly reflects the contraction in non-energy intermediate goods (-0.7% in July, set against an increase of 7.8% in Q2), while purchases of consumer and capital goods continued to grow at high rates (16.2% and 18.1%, respectively). Purchases of energy intermediate goods, which declined in the first two quarters after having been affected by the forceful rise in oil prices at the start of the year, picked up in July, posting a year-on-year rate of 13.3%. Imports of services climbed by 4.6% in real terms in 2003 Q2, below the growth observed in the six previous months owing to the slowdown in other services. On the basis of Balance of Payments figures, a considerable easing of tourist expenditure is estimated for Q3.

4.2. Output and employment

As earlier indicated, almost all the productive branches were more expansionary in 2003 Q2 than in Q1, with the exception of industry (see Chart 18). In agriculture, the good start to the hydrological year now ending, though it did not continue in the following quarters, provided momentum that helped moderate the contractionary course on which this sector ended the year 2002, and saw a turnaround firm during the first half of 2003. Specifically, the GVA of primary activities posted a negative rate of change of -0.9% year-on-year in Q2, compared with -2.2% in Q1. This improvement was based on the expansion of arable output, that most sensitive to weather conditions. The information available for Q3 suggests the ongoing recovery in the agricultural sector will continue, on the basis of the forecasts for wine and olive oil production. As regards livestock-related output, the contractionary course of milk production since late 2002 was notable.

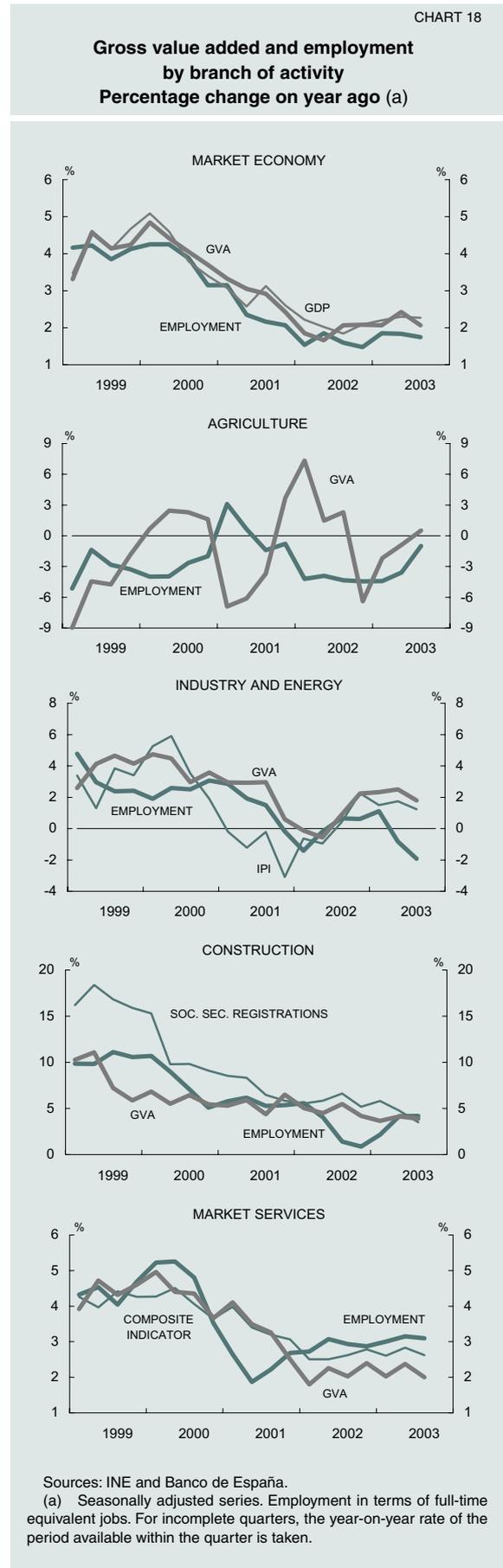
Although the value added of industry and energy showed renewed momentum in 2003

Q2, with the related growth rate rising by 0.2 pp to 2.5% year-on-year, this acceleration was solely a consequence of the recovery in the energy industry. There, GVA climbed from a growth rate of 0.6% in Q1 compared with the same period a year earlier to 2.2% in Q2. The pace of other industrial activities eased somewhat, standing at 2.6% year-on-year in Q2, 0.1 pp down on the rate in Q1. According to the information on the summer months, this trend has been maintained: the industrial production index (IPI) slowed in July and August, on a scale that became steeper if the effect of the heat wave on electricity output, which grew by 10% in August, is stripped out. Other indicators, such as incoming orders in industry, offer a similar profile to that of the IPI, while the employment indicators reveal job destruction in these activities. The business climate indicator also worsened in the summer months due essentially to the deterioration in the assessment of foreign order books. And if the IPI is analysed bearing in mind the weight of exports in respect of the end-use of industrial goods, the same conclusion about the significance of conditions abroad may be drawn. Accordingly, the recent weakness of industrial activity should be linked to the international economic situation and, in particular, to the loss of competitiveness abroad that has accompanied the appreciation of the euro.

Value added in construction increased slightly in Q2, prolonging the somewhat erratic profile of the previous quarters (see Chart 18). In any event, the year-on-year rate of increase, at 4.1%, meant construction remained the most dynamic branch. Although a modest loss of steam is estimated for this activity in Q3 (both employment and inputs weakened in the summer months), on the latest information, discussed earlier when analysing construction expenditure, the leading indicators project greater stability for the coming quarters.

For tertiary activities as a whole, growth of 2.3% was posted in Q2 compared with the same quarter a year earlier, up 0.3 pp on Q1. Here too, however, a wavering trend has been observed since early 2002, with the related rate of change oscillating between 2% and 2.3% (see Chart 18). As part of the hesitant course of this variable, the value added of market services grew by 2.4% in Q2, while overall non-market services offered firmer signs of acceleration, albeit at a less dynamic rate (2%).

In Q3, the pace of market services may have been cut slightly, in step with the trend of the main indicators available. Both the composite market services indicator (ISIS) and social security registrations have been less buoyant in this quarter, in keeping with the slight fall-off in



the confidence indicator. Among the different activities in this branch, the distributive trade and repairs were less expansionary in the July-August period, as reflected both by the retail sales index and social security registrations. In the hotel and restaurants trade, the performance was favourable in terms of the numbers of visitors lodged in hotels and overnight stays which, boosted by domestic tourism, were notably buoyant in Q3. This meant the occupancy level achieved in the summer of 2002 was exceeded by more than 1 pp. Transport and communications activities have maintained a stable rate of increase, in terms of social security registrations, although communications have shown greater sluggishness, while there was a notable rise in air transport. Lastly, the aggregate of real-estate and rental activities and corporate services has tended to grow less than in Q2, with some exceptions, such as IT and R+D activities, where social security registrations showed positive rates of change in July and August for the first time in 12 months.

On the latest QNA estimates, employment – measured in terms of full-time equivalent jobs – quickened slightly in Q2, posting growth of 1.7% on the same period a year earlier, up from 1.6% in Q1. The acceleration in employment was similar to that in GDP, meaning that the growth of apparent productivity remained modest at 0.6% year-on-year. In the market economy the growth of employment was somewhat less than in Q1, despite the fact that GVA quickened, giving rise to an apparent labour productivity gain of 0.6%, following the small increase seen in the opening months of the year (0.2%). The employment indicators evidenced certain discrepancies in respect of their trend in Q2: whereas the Labour Force Survey (EPA) showed a sharper acceleration in employment than the related QNA figures (from 2.3% to 2.6%), the pace of social security registrations diminished slightly from April to June and the INEM (National Employment Office) registered a reduction in the number of contracts entered into compared with the same period a year earlier. It is estimated that the growth rate of employment in Q3 will have held stable at around 1.7%. The short-term economic information for this period continues to show certain divergences: while employment per the EPA accelerated further (up to 2.8%), the growth of social security registrations continued to ease between July and September. As regards contracts entered into and registered unemployment, both improved during the summer.

As can be seen in Chart 18, on QNA estimates the slightly more buoyant course of employment in Q2 spread to all the branches of activity, with the exception of industry and ener-

gy, where there was a decline which interrupted the path of recovery initiated in mid-2002. Given that the momentum of industrial activity was somewhat greater than in Q1, apparent labour productivity increased substantially, with this rise extending into Q3 when, according to the EPA, the decline in employment in industry sharpened. In construction, the growth rate of employment edged up in Q2 compared with the same quarter a year earlier, giving rise to flat apparent productivity. A similar performance is expected for Q3, given that the rate of increase has tended to stabilise. Employment in market services continued to be very robust in Q2, posting year-on-year growth of 3.1%, similar to that observed in the opening months of the year. It is estimated that during the summer months, numbers of employees will have held on this stable growth path. Meantime, in non-market services, employment is undergoing very marked increases. Lastly, the process of net job destruction in agriculture eased significantly in Q2 and, according to the EPA, this improvement ran into the summer months, in step with the recovery in activity.

According to the QNA, the slight acceleration in employment in Q2 stemmed from dependent employment, whose year-on-year growth rate increased to 2.3%, while the rate of decline of self-employed workers held steady at the Q1 rate of -1.3%. The EPA data for Q3 point to a change in this behaviour, indicating that the acceleration in employment in the summer was the result of a smaller decline in self-employment, while numbers of employed workers grew at a similar rate to Q2. Within the latter, temporary employment continued to show a tendency to accelerate, in line with its behaviour in the first half of 2003, while the deceleration in the number of employees with permanent contracts signalled in the previous quarter intensified. Even so, the rate of growth of permanent employment is still above that of temporary employment. The proportion of temporary employment stood at 30.7%, 0.1 percentage points higher than in Q2, but still 0.3 percentage points down from its 2002 Q3 level. Note that the INEM contracts data continue to show a fall in the number of permanent contracts signed, while temporary contracts rose in Q3. As for working hours, part-time employment slowed significantly in Q3, although its year-on-year rate of change of 3% was still somewhat higher than that of full-time employment (2.8%).

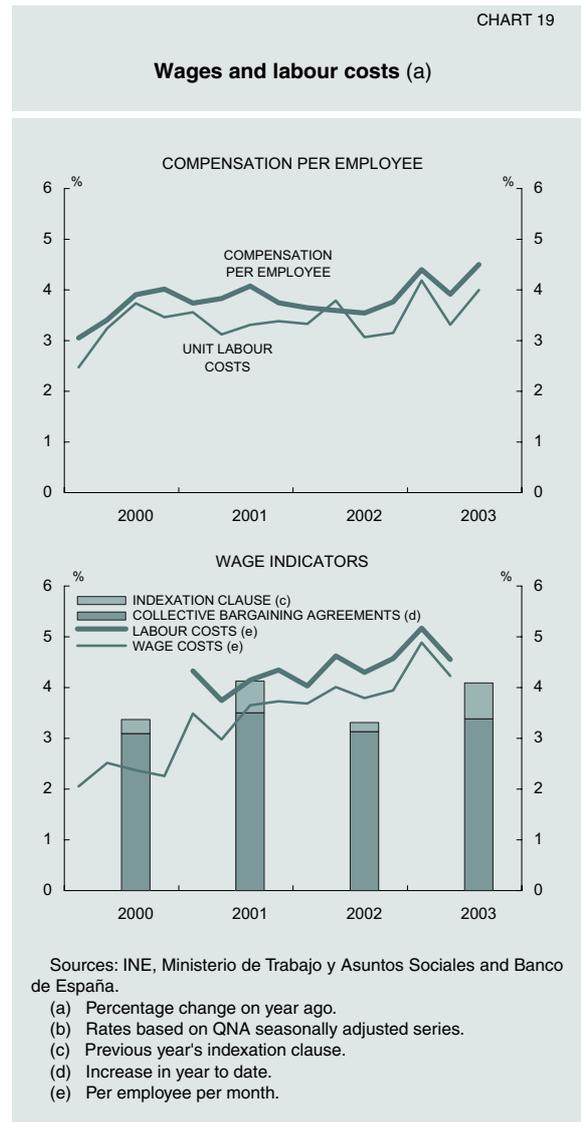
The labour force remained notably buoyant, although its year-on-year rate of growth (2.5%) was down on the preceding period (2.7%). This increase in the labour force is explained by the participation rate, which rose to 55.3%, one per-

centage point higher than a year earlier, since the population of working age continued to grow at more moderate rates (0.7%). During this period, employment grew by more than the labour force, which led to a slowdown in the growth of unemployment to 0.4%. The rate of unemployment stood at 11.2%, 0.2 percentage points down from 2002 Q3, but 0.1 percentage points up from the previous quarter. The rate of female unemployment, which was still much higher than that of males, fell by 0.8 percentage points with respect to the same period a year earlier, while that of males continued to increase, although more moderately than in the preceding quarters. Finally, the profile of EPA unemployment is compatible with the behaviour of the numbers of unemployed registered with the INEM (National Employment Office), whose year-on-year rate of change fell to 1.3% in the summer.

4.3. Costs and prices

According to QNA data, the rate of growth in the cost of labour per unit of value added fell significantly in Q2, both in the economy as a whole and, to a greater extent, in the market economy, to rates of 3% and 3.3%, respectively (see Chart 19). This behaviour was the result of a 0.5 percentage point fall in the rate of growth of compensation per employee, which grew by 3.7% in the economy as a whole and by 3.9% in the market economy, and of the slight rise in productivity in the market economy. Estimates suggest that the slowdown in compensation did not continue in Q3, when the rate of growth may have risen somewhat.

The labour cost index, the main indicator of compensation per employee in market activities, recorded a year-on-year rate of increase in the monthly labour cost per worker of 4.6% in Q2, 0.6 percentage points below the rate recorded in Q1 (see Chart 19). Both wage costs and non-wage costs grew more slowly. The rate of growth of the former fell by 0.7 percentage points, which can be partly explained by the receipt in Q1 of a significant part of the back-pay due under the indexation clauses in 2002 agreements. Ordinary wage costs, in contrast, grew by 3.2%, 0.2 percentage points less than in the previous quarter. Non-wage costs, meanwhile, continued to grow at a high rate (5.5%), although it was 0.5 percentage points down from Q1. At the industry level, the slowdown in the monthly labour cost per worker took place exclusively in services, where such costs grew by one percentage point less than in Q1 (4% year-on-year), while in industry and construction they accelerated to rates of 5.5% and 6.3%, respectively.



According to the information on collective agreements registered to 30 September, settlements held at 3.5%, 0.4 percentage points up from 2002, without including the effects of indexation clauses. The agreements already registered affect almost 7 million workers, 74% of them being revised agreements, in which the settlement was 3.4%, while that in newly signed agreements was 3.6%. The 2003 bargaining is already at a very advanced stage, with a larger volume of new agreements than last year. The effect of the indexation clauses in 2002 has been estimated to be 0.7 percentage points, raising the average growth of wage rates that year to 3.8%. In 2003, the percentage of agreements including indexation clauses will be similar to the previous year, affecting around 80% of workers subject to a collective agreement. However, given the more favourable inflation developments, their impact will be much smaller than last year.

CHART 20

Prices and costs by branch of activity (a)



Sources: INE and Banco de España.
 (a) Non-centred percentage change on year ago based on QNA seasonally adjusted data.

The slowdown in unit labour costs in Q2 was not fully passed through to the value added deflators. In fact, the deflator of value added in the market economy increased at a year-on-year rate of 4.3%, 0.4 percentage points less than in Q1 (see Chart 20). Across the various branches of activity different behaviour is seen. In industry and energy, the deflator of value added slowed considerably, partly reflecting the significant moderation in unit labour costs, which was sharpest in energy. The overall unit margin in these activities tended to widen in Q2, with a firming of the recovery that commenced in the second half of last year following a squeeze in 2001 and the first half of 2002. In construction, the modest slowdown estimated for the value added deflator in 2003 Q2, against a background of rising labour costs, reflects slower growth of the unit surplus, which is compatible with an ongoing widening of margins. Finally, the year-on-year rate of growth of the deflator in market services slowed to 4.2%, reflecting a relatively modest decline in the growth of labour costs and a certain squeezing of the unit margin.

Following the path set by the value added deflator, the rate of growth of the GDP deflator fell by 0.5 percentage points in Q2 to 4%. The final demand deflator underwent a similar slowdown to 2.7%. The further decline in import prices (-0.9% in year-on-year terms) enabled the demand deflator to continue growing at a slower rate than the GDP deflator. Thus, between April and June, the prices of energy imports continued to decline, owing to the sharp fall in oil prices on international markets (with the normalisation entailed by the end of the Iraq war) and the appreciation of the euro. However, the rate of decline in the import prices of other goods was checked.

The CPI, the main indicator of final prices, grew by 2.9% year-on-year in the period April-June, significantly below the 3.8% rate recorded in the first three months of the year. In Q3, however, the rate of increase in the CPI stabilised at 2.9% as a consequence of the acceleration in its more volatile components, which offset the slowdown in the other components. Thus, the CPI excluding unprocessed food and energy (i.e. excluding its least stable elements), decelerated by 0.3 percentage points, making for an average rate of increase in Q3 of 2.8% (see Chart 21).

Among the components of the CPI, energy reflected the rise in the oil price over the summer. Despite the moderation in September, the average price of a barrel of oil rose by two US dollars between Q2 and Q3. The prices of unprocessed food accelerated significantly last summer, from 4.6% year-on-year in the previ-

ous quarter to 6.6%. This was partly a result of the effects of the heat wave on the prices of certain fresh foods. Notable among the other components of the CPI was the stability in the growth of services prices at 3.6%, the moderation in processed food prices, which recorded a rate of increase of 2.5%, 0.3 percentage points down on Q2, and the deceleration in the prices of non-energy industrial goods, whose average rate of growth declined to 2.1%.

The Spanish inflation rate, as measured by the HICP increased by 0.1 percentage points in Q3 (to 3%, which is very close to the CPI rate). This behaviour was similar to that seen in the HICP in the euro area as a whole, so that the inflation differential held unchanged at one percentage point (see Chart 22). As regards the components of the HICP, the differential in the growth of services prices increased in Q3, as this component decelerated in the euro area, while the slowdown in the prices of non-energy industrial goods was more pronounced in Spain and the acceleration in unprocessed food less so, meaning that the differential in both cases narrowed. Meanwhile, both in the case of energy prices and in that of processed food the differential held practically unchanged, at close to zero in the latter case and in Spain's favour in the former.

The rate of increase in the producer price index held practically unchanged, at around 1%, in Q3. In fact, in September, the year-on-year increase was 0.8%. Within this overall stability there was an ongoing acceleration in the producer prices of consumer goods (whose year-on-year rate of growth reached 2.7% in September, pulled up by food prices), the prices of capital goods increased steadily, the prices of intermediate goods behaved more moderately and, finally, energy producer prices recorded a certain acceleration, which was reversed in September. In the euro area, the overall trend was very similar to that seen in Spain, with the year-on-year increase in the overall index in August (the latest available data) standing at 1.4%. At the same time, the rate of growth in the prices received by farmers moderated to July, following the acceleration in Q2, and hotel prices rose by 1.6% year-on-year in Q3, which was more than one percentage point down from the previous quarter.

4.4. The State budget

The draft State Budget Law for 2004 was submitted to Parliament at the end of last September. In accordance with the guidelines of the Budgetary Stability Law, this draft budget conforms to the multi-year budgetary stability target

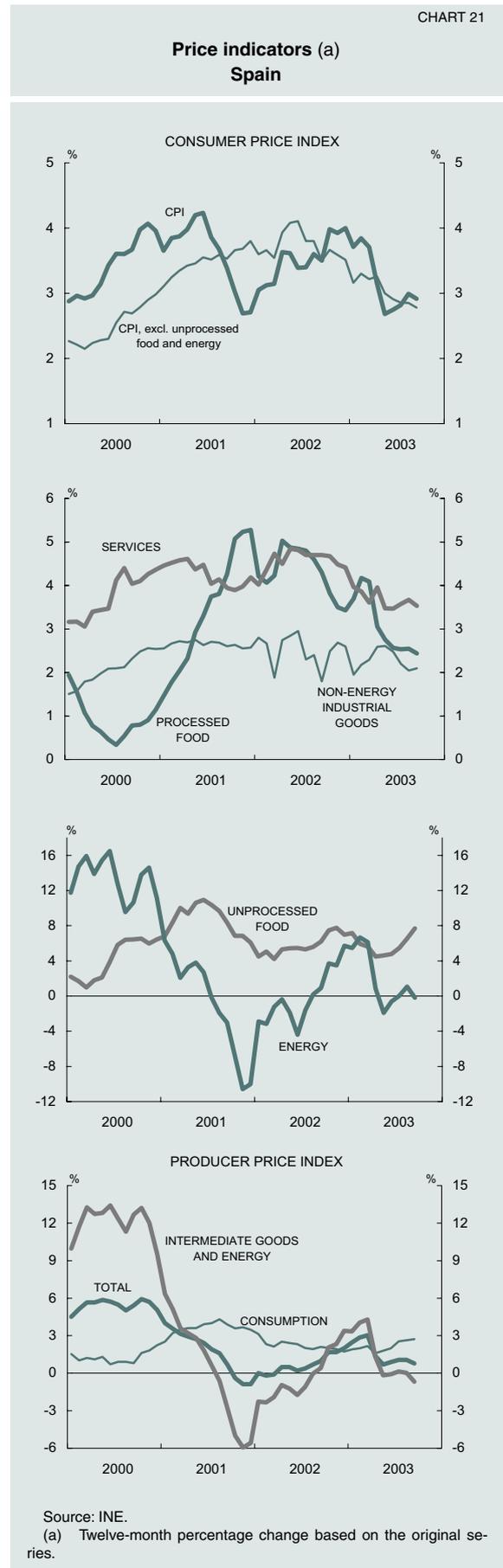
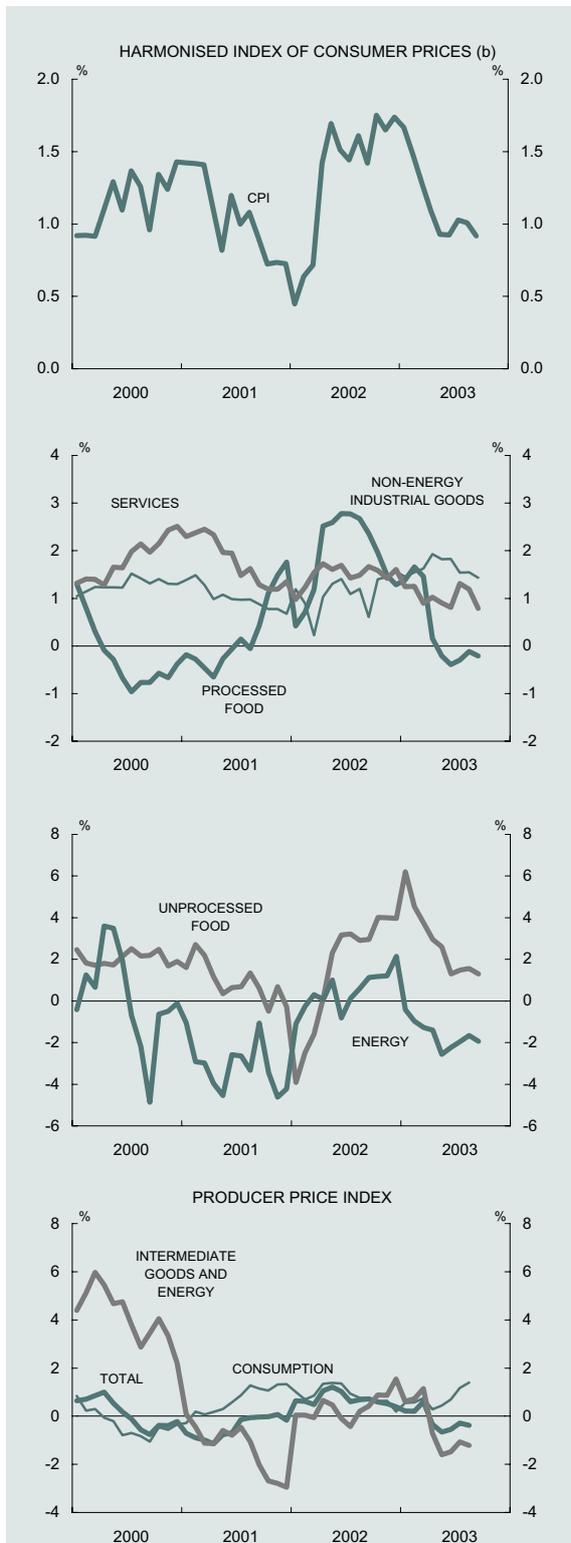


CHART 22

Price indicators
Differentials with the euro area (a)



Sources: Eurostat and Banco de España.

(a) Twelve-month percentage change based on the original series.

(b) To December 2001, the series are those published at that date

for the public sector as a whole and for each group of its agents for the period 2004-2006. Against this background, it is estimated in the draft budget that, in National Accounts terms, general government non-financial transactions will be in balance in 2004 and will show a surplus in the following two years. These budgets will fully incorporate the new financing system for local government, which will see an increase in its own funds and simultaneously reduce its dependence on transfers from the State. As for 2003, the draft budget maintains the forecast of a balanced budget for the closure of the general government sector account. The breakdown by agent shows that the State will record a deficit of 0.5 pp of GDP, which will be offset by a Social Security System surplus of the same amount, while the regional and local government finances will be in balance, meeting in all cases the targets set in the latest Stability Programme Update.

The draft State Budget also incorporates the initial projection of State revenue and expenditure, in cash-basis terms, for 2003 (see Table 3). According to this projection, the State will raise around 2.6% more than initially budgeted and will spend 0.8% less, so the cash-basis deficit will be 0.7% of GDP, notably lower than initially budgeted (1.2% of GDP). The largest deviations in revenue arise from tax receipts, while the containment of expenditure is due, first, to the use of only part of the Contingency Fund and, second, to lower capital payments. In comparison with the budget outturn figures to September, which are discussed below, the initial projection entails a slowdown in revenue in the last few months and, in contrast, a degree of acceleration in payments.

According to National Accounts methodology, the State's cumulative surplus on non-financial transactions to September was €256 million, somewhat less than the €376 million surplus in the same period of 2002 (see Table 3). Revenue decelerated, growing by 1.4% compared with 2.2% in the first half of the year, while expenses in contrast accelerated slightly in Q3 to a growth rate of 1.6%. In both cases the growth rates up to September are in line with the whole-year forecast given in the initial projection accompanying the draft State Budget Law, which estimates a State deficit for 2003 of €3.63 billion (0.5% of GDP).

In cash-basis terms, meanwhile, the State budget outturn to September 2003 was a deficit of €6.42 billion, as against the €6.61 billion deficit recorded in the same period a year earlier. This represents a reduction of only 2.8%, against a fall of 18.8% in the first half of the year, because the acceleration in revenue was

Social Security budget outturn

The Social Security System posted a surplus of €6.26 billion in the period to July 2003, up 21.8% on the same period a year earlier. This contrasted with the slight growth of the surplus envisaged in the initial budget for 2003 and bettered the result to April (see the table below). However, as in the case of the State Budget, the year-to-year comparison of these data is affected by the culmination in 2002 of the effective transfer of health-care management to all the regional (autonomous) governments. Revenue has accelerated in recent months, with growth up slightly on the first seven months of 2002, as against the reduction seen up to April and that envisaged in the budget. Meanwhile, the rate of decline in expenditure continued to slacken, with a reduction smaller than that envisaged in the budget.

Receipts from social security contributions, although growing moderately in recent months, increased by 8.5% to July, a notably higher growth rate than budgeted and appreciably quicker than in 2002. This acceleration is due only to a minor extent to slightly higher growth (3.1%) in the number of Social Security registrations to September 2003, against a rate of 3% in 2002 as a whole.

Expenditure on contributory pensions posted a growth rate of 6.9% to July, slightly higher than that budgeted for the year as a whole and more than the 2002 figure. The number of contributory pensions continues to trend very moderately, and their growth stood at 1% to July, slightly higher than budgeted and up on 2002.

Contributions received by INEM (National Employment Office) increased by 8.4% to June, compared with a budgeted projection of 13.5%. Meanwhile, rebates on contributions in respect of employment-promoting contracts rose by 12.9% in the first half of the year, contrasting with the 0.4% growth budgeted.

INEM expenditure on unemployment benefits rose by 6.1% to September 2003, a significant slowdown on the cumulative growth of 14.6% in 2002. Behind this figure lay both the slowdown in registered unemployment (which grew by 3% to August, compared with 7.4% in 2002 as a whole) and the slight decline in the eligibility ratio, which stood at 71.3% to June, against 71.6% at end-2002. As a result, the number of beneficiaries grew by 1.9% to June, against average growth of 12.3% in 2002.

Social Security System (a)
(Transfers to regional governments allocated) (b)
(Current and capital transactions, in terms of recognised entitlements and obligations)

€m and %

| | Budget | | | Outturn | Outturn JAN-JUL | | |
|-----------------------------------|---------------|---------------|--------------|--------------|-----------------|---------------|--------------|
| | 2002 (c) | 2003 | % change | % change | 2002 | 2003 | % change |
| | 1 | 2 | 3=2/1 | 4 | 5 | 6 | 7=6/5 |
| 1. Revenue | 83,282 | 77,100 | -7.4 | -1.7 | 46,768 | 47,468 | 1.5 |
| Social security contributions (d) | 67,852 | 72,174 | 6.4 | 9.3 | 40,874 | 44,345 | 8.5 |
| Current transfers | 14,389 | 4,294 | -70.2 | -62.3 | 5,551 | 2,697 | -51.4 |
| Other (e) | 1,042 | 632 | -39.4 | -6.7 | 343 | 425 | 24.0 |
| 2. Expenditure | 79,411 | 73,191 | -7.8 | -3.8 | 41,630 | 41,209 | -1.0 |
| Wages and salaries | 6,683 | 1,785 | -73.3 | -65.0 | 2,433 | 1,009 | -58.5 |
| Goods and services | 4,214 | 1,390 | -67.0 | -53.1 | 1,355 | 732 | -45.9 |
| Current transfers | 67,615 | 69,568 | 2.9 | 3.4 | 37,683 | 39,309 | 4.3 |
| Benefits | 67,615 | 69,568 | 2.9 | 3.4 | 37,683 | 39,308 | 4.3 |
| <i>Contributory pensions</i> | <i>56,231</i> | <i>60,024</i> | <i>6.7</i> | <i>6.8</i> | <i>31,736</i> | <i>33,931</i> | <i>6.9</i> |
| <i>Sickness</i> | <i>4,027</i> | <i>4,623</i> | <i>14.8</i> | <i>15.1</i> | <i>2,475</i> | <i>2,681</i> | <i>8.3</i> |
| <i>Other</i> | <i>7,358</i> | <i>4,922</i> | <i>-33.1</i> | <i>-29.8</i> | <i>3,472</i> | <i>2,697</i> | <i>-22.3</i> |
| Other current transfers | 0 | 0 | -30.7 | — | 0 | 1 | ... |
| Other (f) | 899 | 446 | -50.3 | -48.0 | 158 | 158 | -0.2 |
| 3. Balance | 3,871 | 3,909 | 1.0 | 5.9 | 5,139 | 6,259 | 21.8 |

Sources: Ministerio de Hacienda, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

(a) Only data relating to the System, not to the entire Social Security Funds sector are given. This is because the figures for other Social Security Funds are not available for 2003.

(b) Transfers from the Instituto Social de la Marina to the regional governments to finance transferred health-care and social-services responsibilities have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.

(c) The budgetary reference takes the 2002 Budget as its basis for comparison, since the full outturn for that year is not yet available.

(d) Including surcharges and fines.

(e) Excluding surcharges and fines.

(f) Reduced by the disposal of investments.

TABLE 3

State budget outturn

€m and %

| | Outturn | Percentage | Initial | Percentage | Outturn | Outturn | | |
|---|----------------|--------------|----------------|------------|-------------|---------------|---------------|------------|
| | 2002 | change | projection | change | JAN-JUN | JAN-SEP | | |
| | 1 | 2002/2001 | 2003 | 2003/2002 | change | 2002 | 2003 | Percentage |
| | | | | | 2003/2002 | JAN-SEP | JAN-SEP | change |
| | | | | | 5 | 6 | 7 | 8=7/6 |
| | | | | | | | | |
| 1. Revenue | 108,456 | -13.4 | 108,437 | 0.0 | 0.7 | 75,358 | 76,532 | 1.6 |
| Direct taxes | 55,531 | -0.3 | 57,082 | 2.8 | 7.3 | 36,267 | 37,525 | 3.5 |
| <i>Personal income tax</i> | 32,268 | -11.5 | 33,079 | 2.5 | 11.8 | 21,900 | 23,532 | 7.4 |
| <i>Corporate income tax</i> | 21,420 | 24.4 | 22,151 | 3.4 | -4.0 | 12,974 | 12,722 | -1.9 |
| <i>Other (a)</i> | 1,843 | -8.4 | 1,852 | 0.5 | -12.1 | 1,393 | 1,271 | -8.7 |
| Indirect taxes | 38,026 | -28.5 | 38,269 | 0.6 | -3.8 | 29,412 | 29,269 | -0.5 |
| <i>VAT</i> | 25,720 | -25.8 | 26,296 | 2.2 | -1.7 | 20,069 | 20,406 | 1.7 |
| <i>Excise duties</i> | 10,347 | -37.7 | 9,819 | -5.1 | -12.4 | 7,874 | 7,266 | -7.7 |
| <i>Other (b)</i> | 1,959 | 4.7 | 2,154 | 9.9 | 8.1 | 1,469 | 1,597 | 8.7 |
| Other net revenue | 14,898 | -8.8 | 13,086 | -12.2 | -3.6 | 9,679 | 9,738 | 0.6 |
| 2. Expenditure | 111,082 | -13.3 | 113,647 | 2.3 | -2.2 | 81,964 | 82,955 | 1.2 |
| Wages and salaries | 17,554 | 4.3 | 18,536 | 5.6 | 5.7 | 12,650 | 13,334 | 5.4 |
| Goods and services | 2,843 | 11.3 | 3,123 | 9.9 | 12.2 | 1,799 | 1,966 | 9.3 |
| Interest payments | 18,863 | 3.3 | 19,990 | 6.0 | -7.7 | 16,018 | 16,203 | 1.2 |
| Current transfers | 58,324 | -24.4 | 58,246 | -0.1 | -4.7 | 42,838 | 42,162 | -1.6 |
| Contingency fund | ... | ... | ... | ... | ... | ... | ... | ... |
| Investment | 7,043 | 9.0 | 7,227 | 2.6 | 6.8 | 4,493 | 4,966 | 10.5 |
| Capital transfers | 6,455 | -5.3 | 6,525 | 1.1 | 2.7 | 4,166 | 4,324 | 3.8 |
| 3. Cash-basis balance (3=1-2) | -2,626 | ... | -5,210 | ... | ... | -6,607 | -6,424 | ... |
| MEMORANDUM ITEM: NATIONAL ACCOUNTS | | | | | | | | |
| Revenue | 108,387 | -12.5 | 109,770 | 1.3 | 2.2 | 76,442 | 77,539 | 1.4 |
| Expenditure | 111,807 | -12.4 | 113,390 | 1.4 | 0.7 | 76,066 | 77,283 | 1.6 |
| Net lending (+) or borrowing (-) (c) | -3,420 | ... | -3,620 | ... | ... | 376 | 256 | ... |

Source: Ministerio de Hacienda.

(a) Includes revenue from the tax on the income of non-residents.

(b) Includes taxes on insurance premiums and tariffs.

(c) Figures as per the method used in the Excessive Deficit Procedure.

outstripped by that in expenditure over the summer months. Revenue increased by 1.6%, against the 0.7% rise to June, while expenditure grew by 1.2%, against a fall of 2.2% to June.

For the purpose of analysing revenue developments, information is available on the total receipts from the main taxes, both the share assigned to the State and that allocated to the ordinary-regime autonomous regions, which is not shown in Table 3. The figures for total receipts indicate that direct taxes decelerated appreciably in Q3, in contrast to indirect taxes and other

revenue. Personal income tax receipts rose by 7.4% to September, compared with 10.5% growth in the first six months. Disregarding certain calendar effects, the deceleration mainly reflects the reduction in withholdings due to the personal income tax reform. In this respect, the initial projection envisages that personal income tax receipts (including those of regional government) will further decelerate in the second half of the year to 5.3% at year-end. Corporate income tax receipts, in contrast, have accelerated in recent months following receipt of the net tax payable, although they continue to post nega-

TABLE 4
Balance of payments: summary (a)

| | JANUARY-JULY | |
|------------------------|----------------|----------------|
| | 2002 | 2003 |
| | Credits | Credits |
| Current account | 136,846 | 144,660 |
| Goods | 77,725 | 83,107 |
| Services | 37,303 | 38,974 |
| <i>Tourism</i> | 19,815 | 20,600 |
| <i>Other services</i> | 17,488 | 18,375 |
| Income | 12,368 | 12,862 |
| Current transfers | 9,449 | 9,717 |
| Capital account | 4,897 | 5,012 |
| | Debits | Debits |
| Current account | 144,013 | 156,340 |
| Goods | 94,713 | 103,060 |
| Services | 22,771 | 23,725 |
| <i>Tourism</i> | 3,856 | 3,898 |
| <i>Other services</i> | 18,915 | 19,827 |
| Income | 19,223 | 20,831 |
| Current transfers | 7,306 | 8,725 |
| Capital account | 634 | 618 |
| | Balance | Balance |
| Current account | -7,167 | -11,680 |
| Goods | -16,988 | -19,953 |
| Services | 14,532 | 15,250 |
| <i>Tourism</i> | 15,959 | 16,702 |
| <i>Other services</i> | -1,427 | -1,452 |
| Income | -6,855 | -7,969 |
| Current transfers | 2,143 | 992 |
| Capital account | 4,263 | 4,394 |

Source: Banco de España.
 (a) First provisional results.

tive rates of change. However, the initial projection of 3.4% growth of these receipts implies a notable acceleration in the closing months of the year. Regarding indirect taxes, VAT grew in comparable terms by 9.6% to September, practically unchanged on June, while excise taxes picked up slightly to growth of 5.0%, against 4.3% in the first six months. The initial projection envisages a mild slowdown in the case of VAT (to 7.7% at year-end), while the behaviour of excise taxes will be similar to that up to September. Other net revenue rose slightly to September (0.6%), as against a fall of 3.6% in the previous quarter, owing to the higher rate of receipt of capital transfers. The initial projection for the whole of the year is for a substantial fall (12.2% in this aggregate), mainly due to a sharp slowdown in charges.

On the expenditure side, almost all the headings posted an acceleration in Q3, except operating costs (personnel and goods and services). That said, the continued strong growth of goods and services was notable, with a rise of 9.3% to September, whereas personnel costs held steady at around 5.5%, as they had been doing all year. Interest payments, the path of which is determined by the schedule of public debt maturities, accelerated notably in Q3 (to growth of 1.2%, against a fall of 7.7% in June). Current transfers, which are still influenced by the new regional government financing arrangements, decreased by 1.6%, a more moderate fall than in the previous quarter. Capital payments accelerated in Q3, particularly in the case of real investment, which rose by 10.5%, against 6.8% in the first half of the year. According to the initial projection, the expected acceleration in expenditure for the second half of the year is mainly attributable to the interest and current transfers headings, since it is expected that operating cost growth rates will stabilise somewhat and that capital payments will slow notably.

4.5. The balance of payments and the capital account of the economy

In the period January-July 2003, the overall balance on current and capital account was a deficit of €7.29 billion, an increase of €4.38 billion on the deficit in the same period of the previous year. This outcome is explained by the increase in the current-account deficit, which widened by €4.51 billion to €11.68 billion. The surplus on capital account improved slightly in this period to €4.39 billion. Within the current account, there was a notable increase in the merchandise deficit and, to a lesser extent, in the income deficit, as well as a smaller current-transfers surplus. However, the services surplus improved, as a result of the favourable trend in the tourism surplus.

During the first seven summer months of 2003 the trade deficit increased by €2.97 billion over the level reached during the same period a year earlier. In year-on-year terms the deficit increased by 17.5%. This notable increase stemmed from the buoyancy in the flows of real imports during the period, which exceeded that of exports despite the strong momentum the latter acquired in Q2, and from the large increase in the energy bill in the early months of the year.

As for the balance on services account, in the period January-July there was a surplus of €15.25 billion, up by €717 million on the same period of 2002. This improvement, of 4.9% in year-on-year terms, stemmed from the increase of 4.7% in the tourism surplus, while the

deficit in non-tourism services increased only slightly (1.8%). The positive trend in tourism receipts that began in the last quarter of 2002 intensified during this period, with year-on-year growth of 4%, in line with the behaviour of the real indicators up to that date. Meanwhile, tourism payments increased by barely 1.1% in this period, a further moderation from that already recorded in 2002 Q4, owing to the replacement of foreign tourism by domestic tourism.

The income deficit increased by €1.11 billion over the period January-July 2003, relative to the same period a year earlier, to stand at €7.97 billion. Receipts rose by 4%, driven by the buoyancy of those of the non-financial private sector, while the decline in those of other sectors reflects the fall in profits on foreign investments, as well as the reduction in the flows of direct investment that has been taking place since last year, partly as a consequence of the social and political crisis in certain Latin American countries. Payments increased at a higher rate of 8.4% reflecting, in this case too, the notable increase in those of the non-financial private sector.

The current-transfers surplus stood at €992 million in the first seven months of the year, a notable reduction of around €1.15 billion relative to the same period of 2002. Receipts rose by 2.8%, as a result of the increase in the flows to the private sector from the EU under the EA-GGF Guarantee Section, while those to the European Social Fund fell significantly. Payments, meanwhile, increased at a very high rate of 19.4%, basically as a result of the notable increase in payments to the EU, especially in respect of additional GNP resource. Once again, the strong growth in immigrants' remittances was striking.

Finally, the capital-account surplus stood at €4.39 billion in the period January-July 2003, an increase of €130 million over the same period of the previous year. This 3.1% improvement, in year-on-year terms, stemmed from the expansion of most of the structural funds obtained from the EU, especially those to the ERDF and, to a lesser extent, to the EAGGF Guidance Section, while those relating to the Cohesion Fund fell.

5. Financial developments

5.1. Overview

The backdrop to the financial position of the private sector in 2003 Q3 was one in which interest rates remained at low levels, although at the end of that period there was a certain rise in the longer-term money market rates and in the yields on secondary public debt markets. Thus at the end of September the yield on 10-year Spanish Treasury bonds stood at 4.08%, nearly 50 bp above the end-Q2 levels. The cost of bank borrowing for households and firms held at historically low levels and the credit risk premia negotiated by Spanish firms on credit derivatives markets remained at the moderate rates recorded in June and in certain cases even decreased slightly, thereby limiting the impact of the higher medium- and long-term interest rates on the cost of this component of corporate financing (see Chart 23).

In July and August, domestic and international stock market prices continued the upward course of the previous quarter (see Chart 23). September, however, saw falls associated with episodes of instability on the foreign exchange markets. Thus at the end of that month the Madrid Stock Exchange General Index stood at around the end-June levels, with a rise of 12.5% in the year up till then, more than that of the EURO STOXX euro area stock market index (4.1%) and similar to that of the US S&P 500 (13.2%). This performance was accompanied by implied volatilities of these market prices which held steady at around the moderate levels reached in June. Meanwhile, according to the most recent information available (relating to Q2), house prices continued to grow at year-on-year rates above 17% (see Chart 23).

The spending decisions of households and firms continued to be underpinned by a sustained expansion of the demand for credit. Thus the growth rate of financing received by the private sector increased to 14.3% from April to June, up 0.5 pp on the previous quarter (see Table 6). This aggregate behaviour was not homogeneous across the various sectors since, whereas the financing received by firms held practically steady at the growth rate seen in March (13.5% in June in year-on-year terms), the volume of funds received by households accelerated significantly to 15.5%. The provisional information for Q3 points to a fresh rise, this time of more than 16%, in the growth rate of household debt, whereas that of corporate debt would appear to have diminished slightly with respect to the June levels.

The continued resort to financing by the non-financial private sector gave rise to further

increases in their debt ratios, which are now around the average for euro area countries. However, the loose financial terms allowed the burden associated with that debt to continue at moderate levels. In addition, the other indicators of household and corporate financial positions have generally evolved favourably. Thus household net wealth further increased and household gross saving after debt service continued to grow, although it is still at low levels. The profitability of firms showed signs of improvement in most industries.

In conclusion, the financial position of the private sector is not currently an obstacle to dynamic spending decisions. It is, however, becoming increasingly complex to base a major part of consumer and investment decisions on fresh resort to borrowing, due to the debt levels built up and the smaller margin for further interest rate cuts. Moreover, the debt accumulated by the private sector has made its spending decisions more sensitive than in the past to adverse shocks to its income, wealth or cost of debt.

5.2. Households

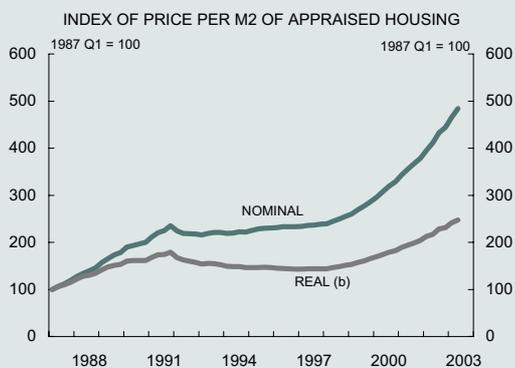
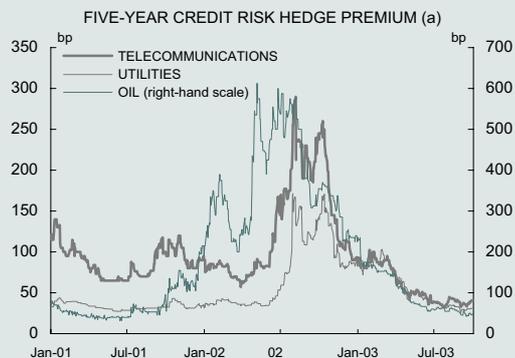
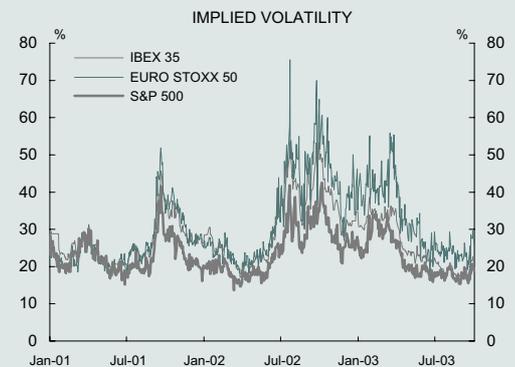
According to the provisional information available, in 2003 Q3 there was a further decrease in the lending rates charged by institutions to households for house purchases, along with a moderate increase in the cost of credit extended for other purposes. According to the Bank Lending Survey, the overall terms offered in this market from April to June were slightly more restrictive than in the previous quarter and the forecasts for Q3 pointed to a further tightening.

The growth rate of financing received by households increased in Q2 to 15.5%, up 1.4 pp on March (see Table 6 and Chart 24). In cumulative twelve-month terms, the fresh debt taken on by the sector represented 8.5% of GDP, 0.7 pp more than in the previous quarter. This rise reflects a pick-up in residential loans and, above all, in consumer and other lending. The provisional information for Q3 points to a continuation of the trend towards faster expansion of financing to households, although, unlike what happened from April to June, residential lending contributed in greater measure to the acceleration than did loans for other purposes.

Regarding portfolio decisions, financial assets acquired by households in Q2 amounted to 9.7% of GDP in cumulative twelve-month terms (see Table 6 and Chart 24). The breakdown by instrument showed a certain shift from the

CHART 23

Price indicators of various assets



Sources: Bloomberg, Credit Trade and Banco de España.
 (a) Average asset-weighted premia. On 22/6/03 a change came into effect in the contractual terms of European firms. The new contract carries lower associated premia (around 10%).
 (b) Deflated by the CPI.

TABLE 5

**Net financial transactions and inter-sectoral flows
(Cumulative four-quarter data)**

% GDP

| | NET FINANCIAL TRANSACTIONS | | | | | | | | |
|---|----------------------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|-------------|
| | 1998 | 1999 | 2000 | 2001 | 2002 | | | 2003 | |
| | | | | | Q2 | Q3 | Q4 | Q1 | Q2 |
| National economy | 0.2 | -1.0 | -2.5 | -2.2 | -1.7 | -1.5 | -1.6 | -2.1 | -2.0 |
| Non-financial corporations and households and NPISHs | 2.1 | -0.3 | -2.4 | -3.5 | -2.7 | -3.4 | -3.1 | -3.7 | -3.7 |
| Non-financial corporations | -1.1 | -2.3 | -3.5 | -4.6 | -4.0 | -4.2 | -4.6 | -4.9 | -4.9 |
| Households and NPISHs | 3.3 | 2.0 | 1.1 | 1.1 | 1.3 | 0.8 | 1.4 | 1.2 | 1.1 |
| Financial institutions | 1.1 | 0.5 | 0.7 | 1.5 | 1.5 | 1.7 | 1.5 | 1.5 | 1.5 |
| General government | -3.0 | -1.2 | -0.8 | -0.3 | -0.5 | 0.3 | 0.1 | 0.1 | 0.2 |
| | INTER-SECTORAL FLOWS (a) | | | | | | | | |
| Households and NPISHs | 3.3 | 2.0 | 1.1 | 1.1 | 1.3 | 0.8 | 1.4 | 1.2 | 1.1 |
| Vis-à-vis: | | | | | | | | | |
| Credit institutions (b) | -4.6 | 0.5 | -0.2 | -1.5 | -2.9 | -3.5 | -2.8 | -3.3 | -3.6 |
| Institutional investors (c) | 7.6 | 0.9 | 0.4 | 3.6 | 3.3 | 3.0 | 2.9 | 3.9 | 4.3 |
| Non-financial corporations | -1.1 | -2.3 | -3.5 | -4.6 | -4.0 | -4.2 | -4.6 | -4.9 | -4.9 |
| Vis-à-vis: | | | | | | | | | |
| Credit institutions (b) | -4.5 | -4.1 | -6.8 | -3.9 | -4.4 | -4.0 | -3.2 | -4.0 | -4.2 |
| Rest of the world | 0.7 | -0.7 | 2.0 | -2.3 | -1.6 | -1.3 | -0.9 | -0.8 | -0.4 |
| General government | -3.0 | -1.2 | -0.8 | -0.3 | -0.5 | 0.3 | 0.1 | 0.1 | 0.2 |
| Vis-à-vis: | | | | | | | | | |
| Credit institutions (b) | 1.4 | 1.4 | 2.2 | -2.3 | -0.3 | 0.9 | 1.0 | -0.6 | -0.3 |
| Institutional investors (c) | -2.6 | 1.7 | 3.9 | 2.8 | 1.3 | 0.8 | 0.5 | 0.7 | 0.4 |
| Rest of the world | -1.1 | -4.3 | -5.9 | -1.6 | -1.6 | -1.6 | -1.1 | 0.1 | -0.2 |
| Rest of the world | -0.2 | 1.0 | 2.5 | 2.2 | 1.7 | 1.5 | 1.6 | 2.1 | 2.0 |
| Vis-à-vis: | | | | | | | | | |
| Credit institutions (b) | 7.1 | 1.9 | 5.1 | 3.8 | 4.1 | 3.4 | 2.9 | 4.6 | 4.3 |
| Institutional investors (c) | -6.3 | -3.6 | -5.7 | -4.9 | -3.7 | -3.3 | -2.3 | -3.1 | -2.7 |
| Non-financial corporations | -0.7 | 0.7 | -2.0 | 2.3 | 1.6 | 1.3 | 0.9 | 0.8 | 0.4 |
| General government | 1.1 | 4.3 | 5.9 | 1.6 | 1.6 | 1.6 | 1.1 | -0.1 | 0.2 |

Source: Banco de España.

(a) A positive sign denotes the extension of financing to the counterpart sector. A negative sign indicates financing received from the counterpart sector.

(b) Defined in accordance with the First Banking Directive.

(c) Insurance corporations and collective investment undertakings.

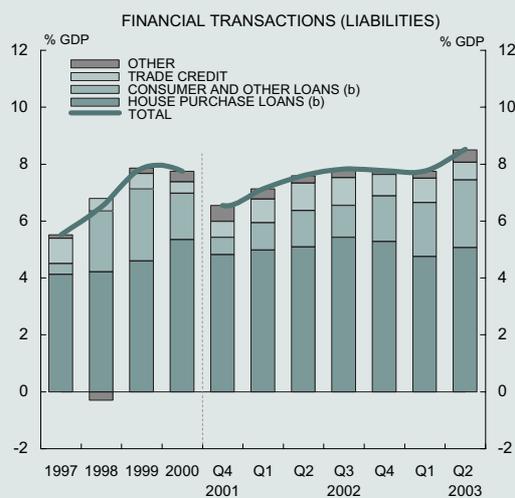
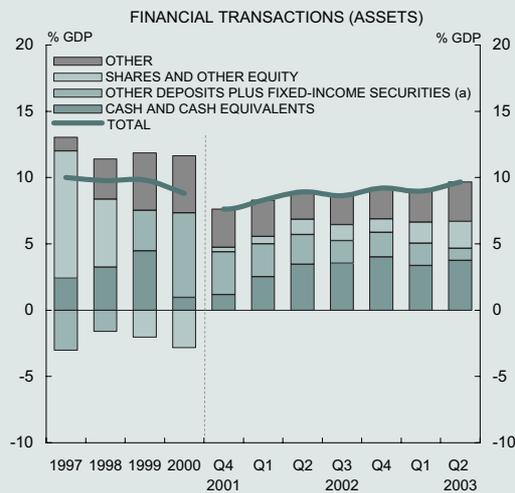
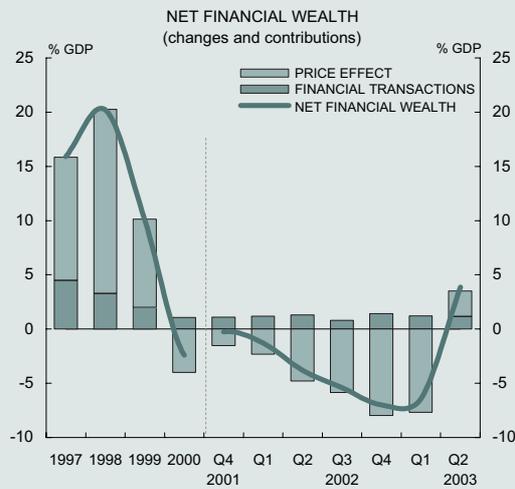
“Other deposits and fixed-income securities” caption to “Cash and cash equivalents” and “Mutual funds”. Thus net purchases of mutual funds amounted to 1.4% of GDP, against 1.1% in Q1. This increase was due entirely to growth in FIM (capital market) mutual funds, which received funds equal to 0.7% of GDP. Meanwhile, the “Shares and other equity” component recovered slightly.

In Q2 household financial saving declined slightly in cumulative twelve-month terms to 1.1% of GDP (see Table 5 and Chart 24). However, the sector’s gross saving not used for debt

service, which excludes resources absorbed by loan repayments, remained on the path of recovery seen since mid-2001 (see Chart 25), although it is still at relatively low levels. Household debt increased further to 87% of GDI, slightly higher than the euro area average, and the provisional information for Q3 points to an additional rise in this ratio. Nevertheless, the financial burden associated with this debt remained at moderate levels thanks to the low cost of debt. Moreover, despite the higher debt, the net wealth of the sector again grew in Q2 as a result of higher house prices and the recovery of the Spanish and international stock markets.

CHART 24

**Households and NPISHs
(Cumulative four-quarter data)**



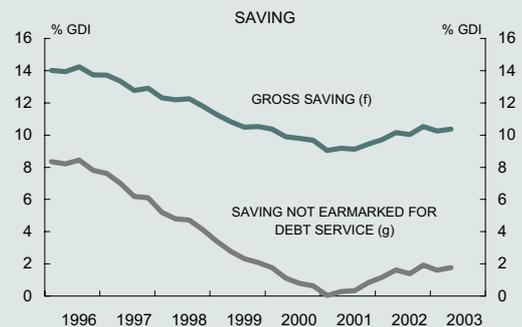
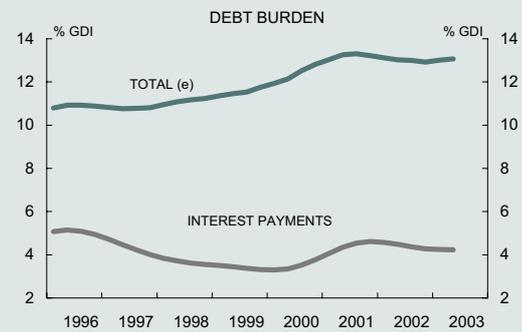
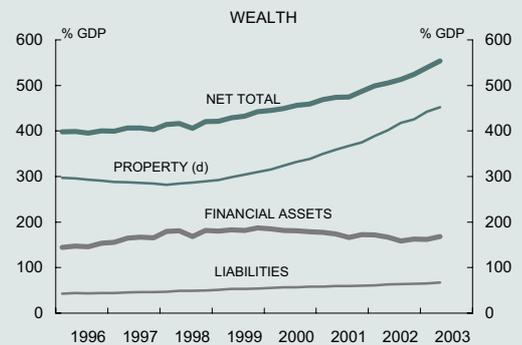
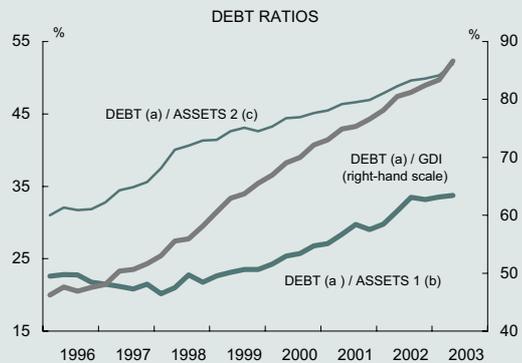
Source: Banco de España.

(a) Not including unpaid accrued interest, which is included under "other".

(b) Including securitised loans.

CHART 25

Indicators of the financial position of households and NPISHs



Source: Banco de España.

(a) Includes bank credit and securitisation.

(b) Assets 1 = Total financial assets - "other".

(c) Assets 2 = Assets 1 - shares - shares in FIM.

(d) Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre.

(e) Estimated interest payments plus debt repayments.

(f) Balance of households' use of disposable income account.

(g) Gross saving less estimated debt repayments.

TABLE 6

**Financial assets and liabilities of households, NPISHs and non-financial corporations
(Cumulative four-quarter data)**

% GDP

| | 1999 | 2000 | 2001 | 2002 | | 2003 | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|--|
| | | | | Q4 | Q1 | Q2 | |
| HOUSEHOLDS AND NPISHs: | | | | | | | |
| Financial transactions (assets) | 9.8 | 8.8 | 7.6 | 9.2 | 9.0 | 9.7 | |
| Cash and cash equivalents | 4.5 | 0.9 | 1.2 | 4.0 | 3.4 | 3.8 | |
| Other deposits and fixed-income securities (a) | 3.0 | 6.4 | 3.2 | 1.9 | 1.7 | 0.9 | |
| Shares and other equity (b) | 0.1 | 0.5 | -0.4 | 0.8 | 0.5 | 0.6 | |
| Mutual funds | -2.1 | -3.4 | 0.8 | 0.2 | 1.1 | 1.4 | |
| <i>FIAMM</i> | -1.4 | -1.3 | 1.3 | 0.7 | 0.7 | 0.7 | |
| <i>FIM</i> | -0.8 | -2.0 | -0.5 | -0.5 | 0.3 | 0.7 | |
| Insurance technical reserves | 3.3 | 3.4 | 2.5 | 2.4 | 2.5 | 2.5 | |
| Of which: | | | | | | | |
| <i>Life assurance</i> | 2.0 | 1.9 | 1.4 | 1.6 | 1.7 | 1.6 | |
| <i>Pension funds</i> | 1.0 | 1.3 | 0.9 | 0.7 | 0.7 | 0.8 | |
| Other | 1.0 | 0.9 | 0.4 | -0.1 | -0.2 | 0.4 | |
| Financial transactions (liabilities) | 7.9 | 7.7 | 6.5 | 7.8 | 7.8 | 8.5 | |
| Credit from resident financial institutions (c) | 7.1 | 7.0 | 5.4 | 6.9 | 6.7 | 7.5 | |
| House purchase credit (c) | 4.6 | 5.4 | 4.8 | 5.3 | 4.8 | 5.1 | |
| Consumer and other credit (c) | 2.5 | 1.6 | 0.6 | 1.6 | 1.9 | 2.4 | |
| Other | 0.7 | 0.8 | 1.1 | 0.9 | 1.1 | 1.1 | |
| NON-FINANCIAL CORPORATIONS | | | | | | | |
| Financial transactions (assets) | 17.8 | 27.8 | 19.0 | 14.0 | 15.2 | 15.8 | |
| Cash and cash equivalents | 0.7 | 0.9 | 1.7 | 1.4 | 1.9 | 1.4 | |
| Other deposits and fixed-income securities (a) | -0.1 | 1.2 | 1.0 | 1.8 | 2.5 | 2.5 | |
| Shares and other equity | 8.3 | 14.9 | 5.8 | 4.0 | 3.9 | 3.3 | |
| Of which: | | | | | | | |
| <i>Vis-à-vis the rest of the world</i> | 6.8 | 11.3 | 4.9 | 2.6 | 2.7 | 2.2 | |
| Other | 8.9 | 10.8 | 10.5 | 6.8 | 7.0 | 8.7 | |
| Financial transactions (liabilities) | 20.1 | 31.3 | 23.6 | 18.6 | 20.1 | 20.7 | |
| Credit from resident financial institutions (c) | 5.3 | 7.6 | 6.9 | 6.8 | 7.5 | 7.7 | |
| Foreign loans | 3.0 | 3.5 | 4.0 | 3.4 | 2.4 | 2.0 | |
| Fixed-income securities (a) | 0.5 | -0.7 | 0.1 | -0.3 | -0.3 | -0.2 | |
| Shares and other equity | 5.1 | 12.8 | 5.3 | 3.1 | 3.5 | 3.4 | |
| Other | 6.2 | 8.1 | 7.2 | 5.6 | 7.0 | 7.8 | |
| MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%) | | | | | | | |
| Financing (d) | 19.5 | 18.8 | 15.7 | 14.6 | 13.8 | 14.3 | |
| Households and NPISHs | 19.6 | 17.3 | 12.4 | 14.9 | 14.1 | 15.5 | |
| Non-financial corporations | 19.4 | 19.9 | 18.2 | 14.4 | 13.6 | 13.5 | |

Source: Banco de España.
 (a) Not including unpaid accrued interest, which is included under "other".
 (b) Not including mutual funds.
 (c) Includes securitised loans.
 (d) Includes bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation funds.

Notably in this respect, net financial wealth increased in cumulative four-quarter terms for the first time since 2000.

Consequently, the available indicators suggest that the financial position of households continues to be sound, although the low level of their saving not earmarked for debt service means that they have little margin for absorbing

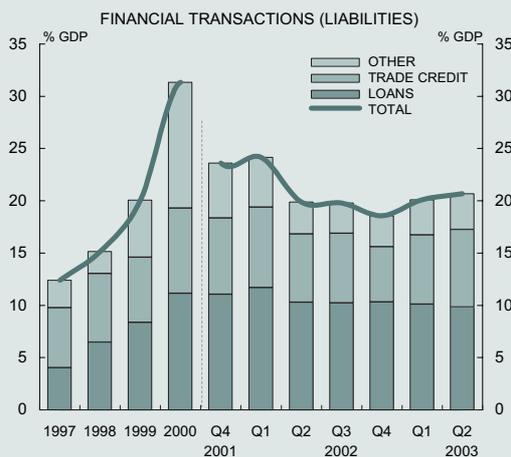
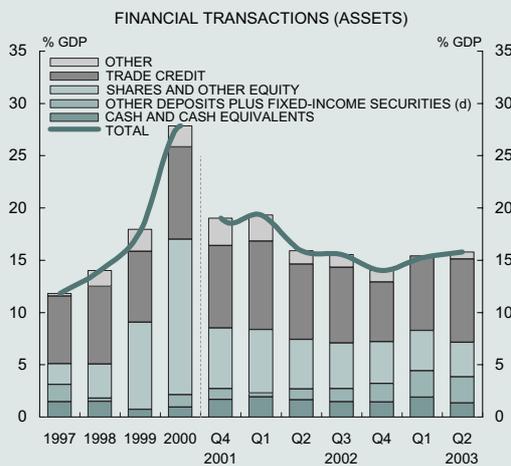
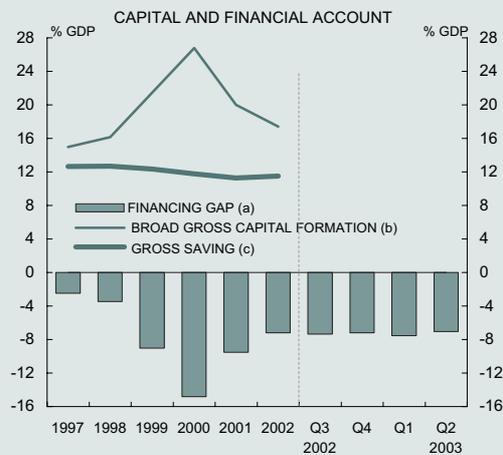
possible adverse shocks to the sector's wealth, income or cost of debt.

5.3. Non-financial corporations

Financing terms for corporations continued to be generous in 2003 Q3. Thus lending rates and the cost of funds raised by issuing bonds

CHART 26

**Non-financial corporations
(Cumulative four-quarter data)**



Source: Banco de España.

- (a) Financial resources that cover the gap between real and permanent financial investment and gross saving.
- (b) Includes gross capital formation, stockbuilding and foreign equities.
- (c) Includes capital transfers.
- (d) Not including unpaid accrued interest, which is included under "other".

remained low despite moving upwards in August. Also, in certain cases the higher yields on medium- and long-term assets did not pass through completely to the cost of financing via fixed-income securities, given the slightly downward movement in the risk premia of certain corporations. In addition, the more stable stock market prices made it easier for firms to obtain funds on these markets. However, the Bank Lending Survey for Q2 found that the general terms for corporate loans hardened slightly with respect to those from January to March.

The volume of liabilities-side transactions by non-financial corporations from March to June was relatively high, amounting to 20.7% of GDP in cumulative twelve-month terms, against 20.1% in the previous quarter. In terms of components, interest-bearing borrowed funds grew by 13.5% year-on-year, down 0.1 pp on March, and the funds obtained amounted to 9.5% of GDP in cumulative twelve-month terms; this was similar to the level in the previous quarter, although the proportions of instruments differed. Thus foreign loans again lost ground to loans from resident institutions. Meanwhile, corporations continued to make net redemptions of fixed-income securities, although in a lower amount than in the previous quarter (0.2% of GDP). The funds raised by issuing shares and other equity amounted to 3.4% of GDP. Finally, the trade credit received, which is included under the "Other" caption, also increased.

Analysis of lending by productive activity shows that the credit extended by resident institutions to the real estate industry in Q2, which includes construction and real estate services, again grew strongly. Meanwhile, bank financing for other activities quickened. This was particularly so in the case of that directed to industry excluding construction, the growth rate of which increased for the third quarter running, in line with the modest recovery of investment in capital goods in this period. The latest provisional information points to a slight slowdown in recourse to borrowed funds by corporations.

As regards the acquisition of financial assets by non-financial corporations, in the period from March to June the recovery initiated in the previous quarter proceeded and, as a result, financial investment stood at 15.8% of GDP in cumulative twelve-month terms (see Chart 26 and Table 6). As for the previous quarter, there was an increase in the amount of trade credit extended, which is included under the "Other" caption along with decreases in purchases of shares and other equity, particularly from the rest of the world, and in acquisitions of cash and cash equivalents.

Synthetic indicators of the financial position of Spanish non-financial corporations

Analysis of the financial position of firms is important in assessing macroeconomic conditions and financial stability. Thus, for example, the level of corporate debt can affect decisions regarding labour demand, investment plans or the probability of default. The financial position of firms is usually characterised by means of a wide array of ratios providing information on their profitability, indebtedness and liquidity. In this connection it is useful to have synthetic indicators to summarise the information provided by the various ratios.

The individual firm sample contained in the Annual Database of the Banco de España's Central Balance Sheet Data Office for 1985-2001 was used to construct three synthetic indicators summarising the impact that various financial variables have on corporate default probability, investment and employment. The first is calculated using a set of measures of indebtedness, financial burden, profitability, liquidity, dividend payment and sales and GDP growth. The weights allocated to components are based on the historically demonstrated capacity of these variables to anticipate default (1). The indicators relevant to employment and investment are obtained from the financial burden, profitability and, in the case of the investment indicator, the level of corporate debt. As in the previous case, the weight of these variables is determined on the basis of their estimated influence on the item of interest (employment or investment) (2).

The accompanying chart shows, for each of these synthetic indicators, how the median, the 90th percentile and the weighted average of their distribution have changed over time. In the latter case, the weights are constructed using various indicators of the relative size of firms (3). The first series characterises the behaviour of an average firm, while the top decile and the average are representative of the situation of the most vulnerable firms and of the sector in aggregate terms, respectively.

The three indicators depicted in the chart show, for each of the series, a clear counter-cyclical profile, which is particularly pronounced in the case of the top decile. Comparison of the three series also enables some interesting conclusions to be drawn. First, the median tends to be below the weighted average, which indicates that the financial position of the firms that are largest and most important from the standpoint of investment and employment has been – in the sample – somewhat more unfavourable than that of the average firm. Also, in certain periods the average behaves differently from the median. These two facts demonstrate that the behaviour of the average firm is not always sufficiently representative of the sector's behaviour. Also, comparison of the median and the 90th percentile shows how in recessions the deterioration in financial terms has been sharper in the firms that were in a more unfavourable financial position.

Finally, the chart also shows that, although in the last year of the sample the financial position of firms worsened somewhat, in historical terms the synthetic indicators stood at moderate levels (below the sample average of each of them). This suggests that the sector as a whole enjoys a sound financial position, which therefore does not seem to pose an obstacle to dynamic investment or hiring decisions.

(1) Technically, the weights are obtained from the estimate of a Probit model for the probability of corporate bankruptcy.
 (2) The weights are obtained from the co-efficients of employment and investment equations estimated by the general method of moments.
 (3) The weight of each firm in the default-probability indicator is given by the relative volume of assets, in the investment indicator it is given by the relative volume of fixed capital, and in the employment indicator by the relative number of employees.

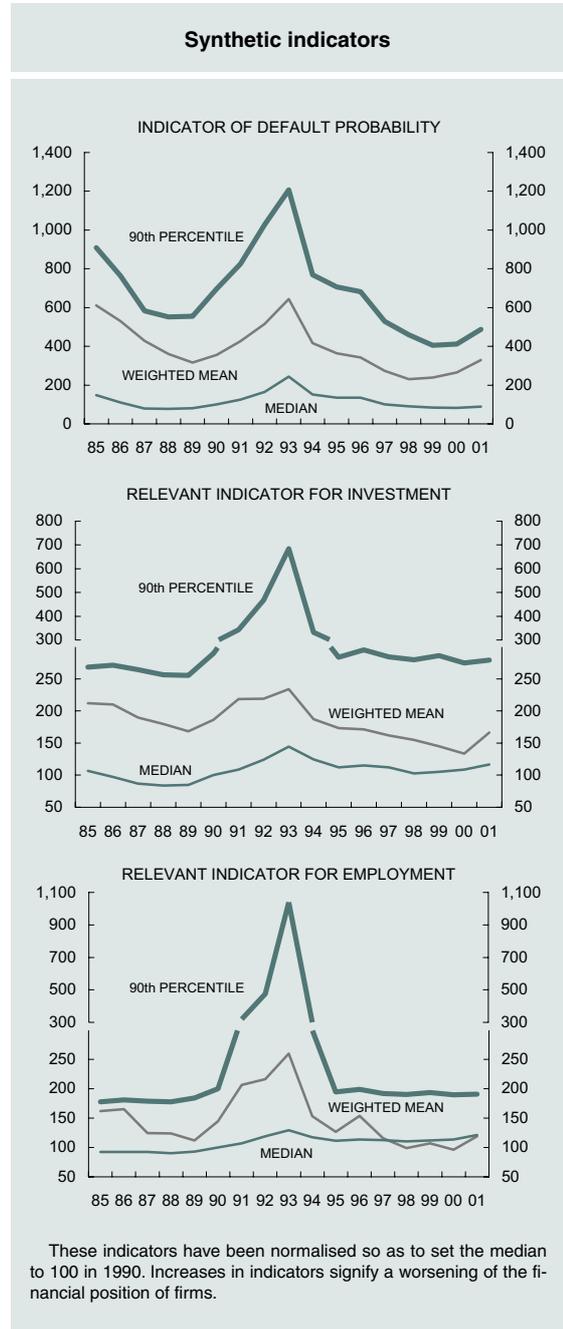
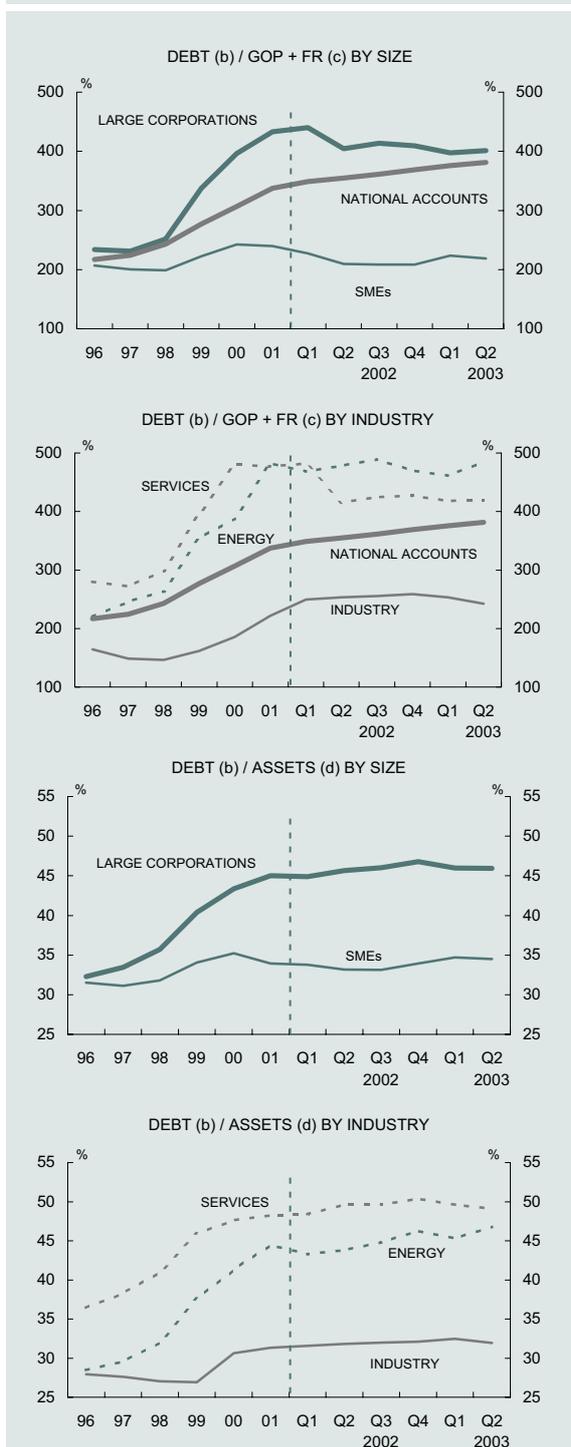


CHART 27

Debt ratios of non-financial corporations (a)


Source: Banco de España.

(a) All the series, except "National Accounts", are calculated with CBSO information. Up to 2001, the information is from the CBSO annual survey (CBA). Thereafter, the indicators have been estimated drawing on the CBSO quarterly survey (CBQ).

(b) Interest-bearing borrowed funds.

(c) Gross operating profit plus financial revenue.

(d) Defined as total inflation-adjusted assets less non-interest-bearing liabilities.

In Q2 the net financial requirement of corporations was high at 0.4% of GDP and the cumulative twelve-month debit balance was unchanged at 4.9% of GDP (see Table 5). However, the financing gap, which is the external funds required to enable permanent financial and real investment, improved slightly to 7% of GDP (see Chart 26).

The aggregate debt ratios of the sector further increased from March to June and, according to the provisional information available, also seem to have moved up in Q3 (see Chart 27). However, the low cost of debt meant that the interest burden remained moderate (see Chart 28). Meanwhile, according to the Central Balance Sheet Data Office (CBSO) Quarterly Survey, the financial burden indicator, which includes short-term debt plus interest, held relatively steady in 2003 Q2 at levels near the high in March 2002.

Corporate earnings performed favourably in the first half of 2003. Thus ordinary net profit of the firms participating in the CBSO Quarterly Survey, which excludes extraordinary revenue and expenses, grew by 10.8% with respect to the same period of 2002.

Overall, the financial position of firms remained sound and the financial terms faced by them were relaxed. Nevertheless, the sensitivity of their investment and hiring decisions to adverse shocks bearing on their financial position might be influenced by their degree of indebtedness (1).

5.4. General government

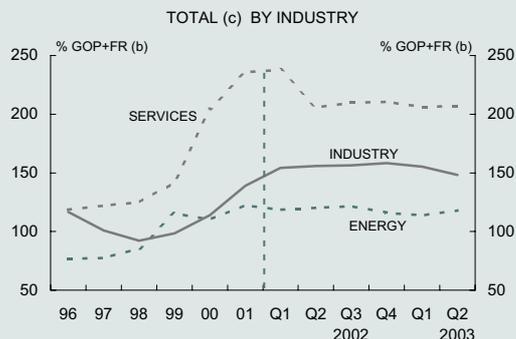
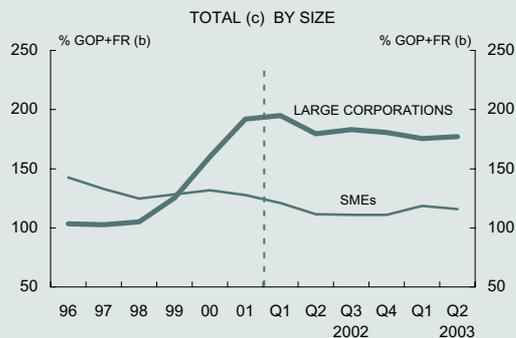
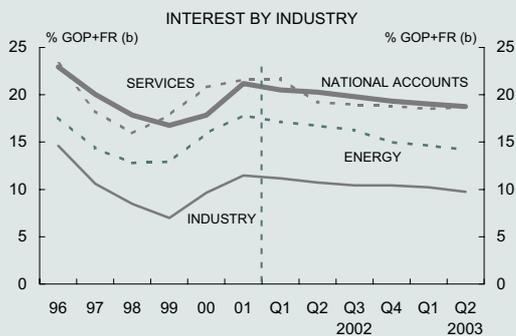
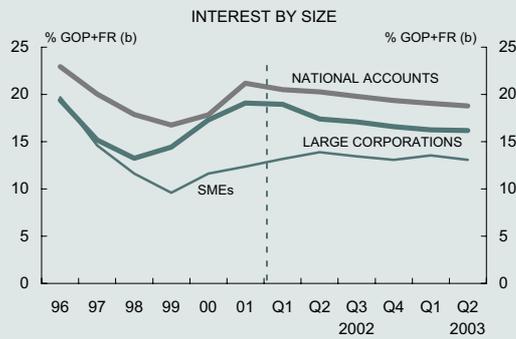
The net balance of the financial transactions of general government in 2003 Q2 was positive and, in cumulative twelve-month terms, stood at 0.2% of GDP (see Chart 29).

The net issuance of marketable securities by general government was €9.9 billion from April to June and, in cumulative four-quarter terms, amounted to 1.7% of GDP. The breakdown by instrument shows that the sector resorted to a greater extent to long-term financing, the issues of which amounted to 1.3% of GDP in the last twelve months, while the funds obtained via short-term securities represented 0.4% of GDP in the same period. The funds obtained on the markets exceeded the current financing requirements, resulting in an increase in the deposits held by general government in the financial system.

(1) See Box 4 for a discussion of the extent to which certain synthetic indicators of the financial position of firms are relevant to the assessment of macroeconomic prospects.

CHART 28

Debt burden of non-financial corporations (a)



Source: Banco de España.

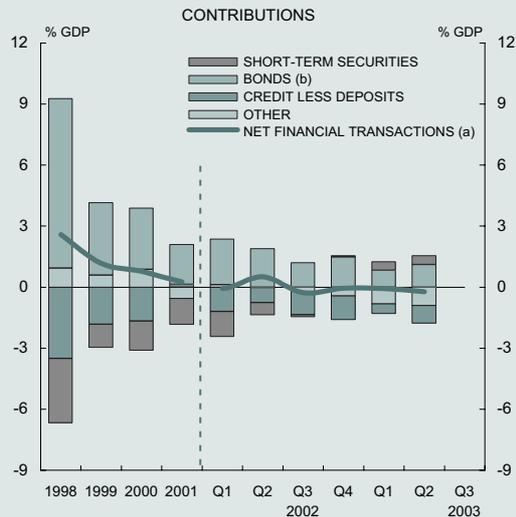
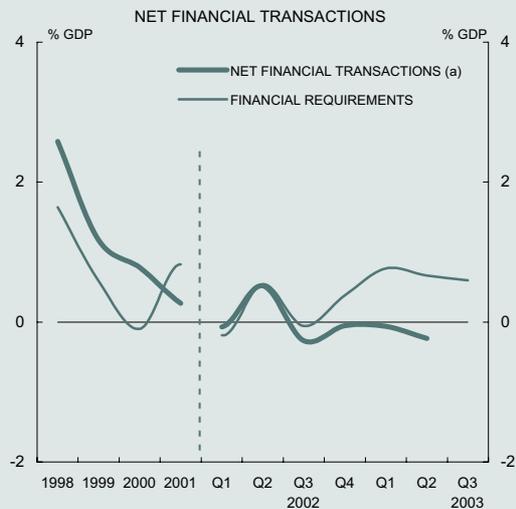
(a) All the series, except "National Accounts", are calculated with CBSO information. Up to 2001, the information is from the CBSO annual survey (CBA). Thereafter, the indicators have been estimated drawing on the CBSO quarterly survey (CBQ).

(b) Gross operating profit plus financial revenue.

(c) Includes interest plus interest-bearing short-term debt.

CHART 29

**General government
(Cumulative four-quarter data)**



Source: Banco de España.

(a) Sign changed.

(b) Not including unpaid accrued interest, which is included under "other".

Preliminary information for 2003 Q3 indicates no change in the funds obtained via net issuance of short-term securities and a slight moderation in those obtained through bonds and debentures. As a result, financial requirements, which represent recourse by general government to the financial markets and proxy the sector's saving, improved slightly from July to September.

5.5. The rest of the world

In 2003 Q2 the debit balance of the nation's financial transactions in cumulative twelve-

TABLE 7

Financial transactions of the nation (cumulative four-quarter data)

% GDP

| | 1999 | 2000 | 2001 | 2002 | 2003 | |
|---|-------------|-------------|-------------|-------------|-------------|-------------|
| | | | | Q4 | Q1 | Q2 |
| Net financial transactions | -1.0 | -2.5 | -2.2 | -1.6 | -2.1 | -2.0 |
| Financial transactions (assets) | 15.3 | 25.2 | 12.2 | 11.4 | 12.9 | 12.1 |
| Gold and SDRs | -0.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Cash and deposits | 1.7 | 2.8 | -2.7 | 3.5 | 4.0 | 2.7 |
| Credit system | 3.7 | 2.5 | -2.7 | 2.0 | 2.3 | 1.6 |
| Other resident sectors | -2.1 | 0.4 | 0.0 | 1.5 | 1.7 | 1.2 |
| Securities other than shares | 2.9 | 3.9 | 7.2 | 4.3 | 5.3 | 5.8 |
| Credit system | -0.8 | -0.3 | 2.0 | 0.6 | 0.7 | 1.4 |
| Other resident sectors | 3.7 | 4.2 | 5.2 | 3.7 | 4.6 | 4.5 |
| Shares and other equity | 10.1 | 15.6 | 5.2 | 3.1 | 3.0 | 2.2 |
| Credit system | 0.8 | 1.8 | 0.0 | 0.2 | 0.0 | -0.4 |
| Other resident sectors | 9.4 | 13.8 | 5.2 | 2.9 | 2.9 | 2.6 |
| Of which: | | | | | | |
| Non-financial corporations | 6.8 | 11.3 | 4.9 | 2.6 | 2.7 | 2.2 |
| Loans | 0.7 | 2.8 | 2.5 | 0.5 | 0.6 | 1.3 |
| Credit system | -0.2 | 0.5 | 0.8 | 0.1 | 0.2 | 0.2 |
| Other resident sectors | 0.9 | 2.3 | 1.7 | 0.3 | 0.4 | 1.1 |
| Financial transactions (liabilities) | 16.2 | 27.7 | 14.4 | 13.0 | 15.0 | 14.1 |
| Deposits | 4.1 | 6.8 | 2.8 | 4.4 | 6.0 | 4.5 |
| Of which: | | | | | | |
| Credit system | 4.1 | 6.8 | 2.8 | 4.4 | 6.0 | 4.5 |
| Securities other than shares | 5.4 | 7.0 | 3.1 | 4.2 | 4.1 | 5.3 |
| Credit system | 0.9 | 0.7 | 0.6 | 1.4 | 1.8 | 2.7 |
| General government | 4.3 | 5.7 | 1.6 | 1.1 | -0.1 | 0.3 |
| Other resident sectors | 0.2 | 0.5 | 0.9 | 1.7 | 2.3 | 2.3 |
| Shares and other equity | 4.2 | 9.4 | 4.6 | 1.8 | 2.5 | 2.0 |
| Credit system | 0.3 | 1.8 | 0.5 | 0.1 | 0.2 | 0.0 |
| Other resident sectors | 3.9 | 7.7 | 4.1 | 1.7 | 2.4 | 2.1 |
| Loans | 3.8 | 4.5 | 4.7 | 3.9 | 2.8 | 2.5 |
| General government | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 | 0.0 |
| Other resident sectors | 3.7 | 4.4 | 4.7 | 3.8 | 2.8 | 2.6 |
| Other, net (a) | -1.2 | 0.1 | -0.8 | -1.3 | -0.4 | -0.3 |

Source: Banco de España.

(a) Includes the asset-side caption reflecting insurance technical reserves.

month terms stood at 2% of GDP, against 2.1% in the previous quarter. This slight improvement was basically the result of a moderate recovery in the credit balance of general government, since the other institutional sectors did not record significant changes. Meanwhile, unlike in the previous quarter, financial asset and liability transactions both decreased in GDP terms.

Net purchases of foreign assets declined to 12.1% of GDP in cumulative twelve-month

terms, against 12.9% in the previous quarter (see Table 7), with uneven changes across the various instruments. Thus cash and deposits, along with shares and other equity, diminished significantly, whereas securities other than shares, particularly loans, continued the recovery dating from the previous quarter. According to provisional balance of payments information up to July, foreign long-term (direct) investment was down by more than 55% compared with the same period a year earlier. This

TABLE 8

Net financial assets vis-à-vis the rest of the world (a)
(Q4 data)

% GDP

| | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 (b) |
|---|--------------|--------------|--------------|--------------|--------------|--------------|
| National economy | -21.8 | -22.5 | -20.4 | -21.8 | -24.7 | -26.1 |
| Non-financial corporations and households and NPISHs | -8.7 | -8.7 | -0.4 | -1.3 | -1.2 | -1.8 |
| Non-financial corporations | -14.9 | -16.3 | -8.2 | -9.2 | -10.1 | -11.7 |
| Households and NPISHs | 6.2 | 7.6 | 7.7 | 7.9 | 8.8 | 10.0 |
| Financial institutions | 4.8 | 6.8 | 4.9 | 4.6 | 1.9 | -1.2 |
| Credit institutions (b) | -5.5 | -7.6 | -12.6 | -14.5 | -15.3 | -19.1 |
| Institutional investors (c) | 10.7 | 15.0 | 18.3 | 20.8 | 20.7 | 22.7 |
| Other financial institutions | -0.4 | -0.6 | -0.9 | -1.7 | -3.5 | -4.7 |
| General government | -17.9 | -20.6 | -24.8 | -25.0 | -25.3 | -23.1 |

Source: Banco de España.
 (a) Calculated as the difference between the stocks of financial assets and liabilities vis-à-vis the rest of the world according to quarterly financial accounts data.
 (b) Q2 data.
 (c) Defined according to the First Banking Directive.
 (d) Insurance corporations and collective investment institutions.

contraction was related to the international setting of economic and geopolitical uncertainty in the opening months of 2003. Portfolio investment abroad continued to be high and picked up notably with respect to the flows in 2002.

On the liabilities side, net flows amounted to 14.1% of GDP in cumulative twelve-month terms, against 15% in the previous quarter. This decrease was apparent in most non-resident investment, except for fixed-income issues. Ac-

ording to balance of payments information, inward foreign direct investment in Spain in the first half fell by 25% with respect to the same period a year earlier.

Finally, the provisional information on the debit position of the Spanish economy vis-à-vis the rest of the world shows that it stood at 26.1% of GDP in Q2, a deterioration of 1.4 pp relative to December 2002 (see Table 8).

31.10.2003.