Quarterly report on the Spanish economy

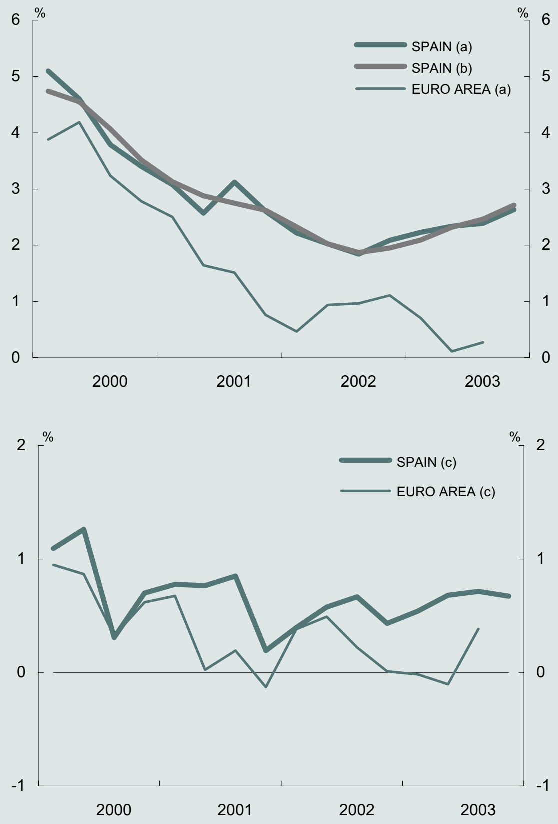
1. Overview

The lack of inflationary pressures and the favourable expectations about the course of prices saw the extension last year of the expansionary macroeconomic policies which, to differing degrees, the main economies have been pursuing. The way these economies have reacted to such impulses has been very uneven, depending on their different starting positions and on the varying degrees of flexibility with which their markets operate. At end-2003, then, the United States was in full recovery, while the euro area countries appear to have left behind more recently the stagnant phase besetting them in the first half of last year. As a result, the outlook for 2004 is brighter. Other east Asian, central European and Latin-American countries have also contributed to the pick-up in the world economy. Financial market conditions have remained conducive to a more buoyant economic picture: long-term interest rates, though fluctuating somewhat, have remained low, stock markets have picked up considerably, and the volatility of equity prices and credit risk premia has tended to diminish. The gradual depreciation of the US dollar, especially against the euro, has stepped up since last December. That has not prevented the prevalence of globally favourable financial conditions, although it may ultimately bear on trade and financial flows between the different regions and affect the contributions of external demand to growth in each area.

Against this international backdrop, with a relatively scant expansion for the year on average but with a recovery fully under way, the Spanish economy is estimated to have posted a real GDP growth rate of 2.4% in 2003, up 0.4 pp on the previous year. The increase in output was based on national demand which, with a growth rate of around 3.2%, was more than half a percentage point up on the related 2002 figure. That said, the negative contribution of net external demand widened by around 0.3 pp, subtracting approximately 0.9 pp from real GDP growth last year. The expansion of private and government consumption coupled with that of investment in construction were the two pillars underpinning the buoyancy of the economy last year. Undoubtedly, however, the most salient development was the start of the recovery in investment in equipment and a notable vigour of foreign trade flows, as a result of which the export share in Spain's foreign markets has increased and imports are serving a greater proportion of the domestic market. Job creation has been high and productivity gains limited, with unit labour costs holding at a rate of increase of over 3%. Notwithstanding, companies have increased their surpluses, but with substantial differences across the various branches. There was a 0.5 pp reduction in the annual average rate of CPI inflation, which is marginally

CHART 1

Gross domestic product



Sources: ECB, Instituto Nacional de Estadística and Banco de España.

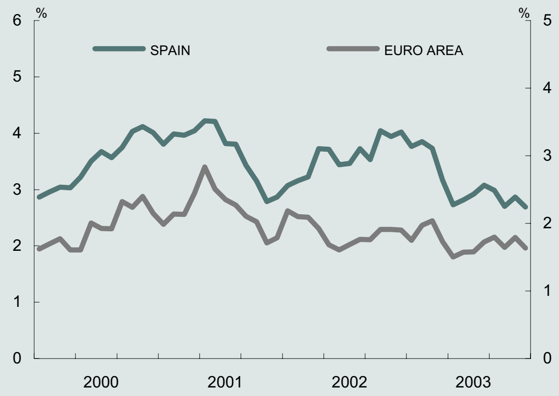
(a) Non-centred year-on-year rate of change calculated on the basis of the seasonally adjusted series.

(b) Non-centred year-on-year rate of change calculated on the basis of the trend-cycle series.

(c) Quarter-on-quarter rate of change calculated on the basis of the seasonally adjusted series.

CHART 2

Harmonised indices of consumer prices (a)



Sources: Eurostat and European Central Bank.

(a) Year-on-year rate of change. To December 2001, the rates relate to those released as at that date.

less when measured with the GDP deflator. This reduction is on a greater scale if the December outturn is taken. For that month the year-on-year rate of consumer prices was 2.6%, a significant correction on the figure of 4% at end-2002. That has narrowed the inflation differential between the Spanish economy and the euro area countries as a whole. Finally, public finances posted a far higher than expected surplus of 0.5 pp of nominal GDP.

The Spanish economy attained these results after maintaining a sustained growth rate throughout the year, but they did not significantly alter the above-mentioned domestic components on which its buoyancy was based. Indeed, the estimated year-on-year growth rate of real GDP in Q4 was 2.6%, 0.2 pp up on the previous quarter. But the quarter-on-quarter rate calculated using the seasonally adjusted series, which stood at around 0.7%, showed a repetition of the figures released by INE (the National Statistics Office) for the two preceding quarters. The year-on-year increase in national demand, if stockbuilding movements are excluded, was practically identical in the four quarters (slightly above 3%), and it was the persistent negative contribution of net external demand which set the pace for output. In Q4, this variable subtracted far less than it did in the preceding quarters, which accounts for the pick-up in the year-on-year rate of GDP.

The improved international environment during 2003 was ultimately not reflected in the figures for Spanish exports, whose growth rate was around 2%, only marginally higher than the previous year and below the growth of world trade. This is because the most buoyant markets were to be found in those areas in which the presence of Spanish products is relatively small, the US economy being a case in point.

In the United States, the latest indicators are offering mixed signals. While employment has not grown as expected, consumer and corporate expectations have improved. In any event, the expectations that a rise in interest rates will be put back and the residual expansionary effect of the tax measures passed last year are upholding the strength of the US economy into 2004. Over a longer horizon, doubts remain about the potential impact of the fiscal deficit on long-term rates (which has not occurred to date), or about the inflationary pressures (a more uncertain development) that might stem from the trend of the exchange rate of the dollar, whose weakness appears to have begun to exert some effect on the correction of the burgeoning external deficit.

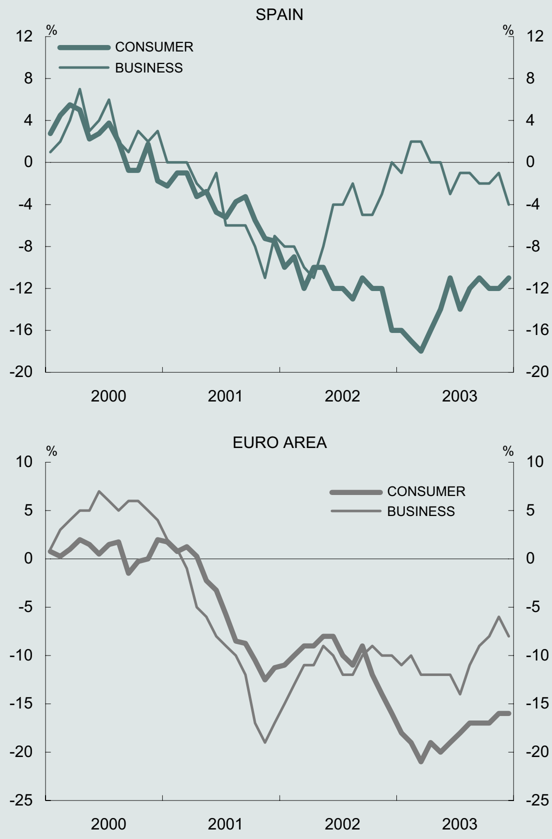
In the short run, no changes are expected either in the conditions prevailing in certain east Asian or central European countries, which are growing at high rates. There are greater doubts about the continuity of the recovery of the Japanese economy, which has so far been mainly export-led. The recovery of the main Latin American economies is turning on the favourable behaviour of financial conditions. Such behaviour is broadly providing for a narrowing of sovereign debt spreads, greater fiscal consolidation and improved current-account balances.

Turning to the euro area, the latest indicators have broadly been favourable. As a result, the rate of change of real GDP in Q4 is expected to confirm the recovery that started in the preceding quarter. The annual average growth of the area as a whole would thus be slightly below 0.5%. Given the uncertainty over the future course of the exchange rate and its impact on the contribution of foreign demand to growth, the firming of the recovery would require more robust domestic demand. The favourable monetary and financial conditions, characterised by relatively low interest rates and a sound stock market performance, should boost this variable. Nonetheless, doubts remain about private spending, as shown by the business and consumer confidence indicators which, despite having improved in recent months, are at fairly low levels compared with their historical average.

As regards budgetary policy, the European countries have recently unveiled their updated stability and convergence programmes, containing their fiscal targets for the coming years. The information from these programmes reveals that much of the increase in the budget deficit in 2003 was due to lower growth, whereas for the coming years an improvement in the budget balance is foreseen further to the implementation of a slightly restrictive fiscal policy. Broadly, the countries that have not achieved a balanced budget hope to improve their structural balances in the future by at least 0.5% of GDP, in line with the commitment reached by the Eurogroup. France and Germany have formulated budget targets that are in step with the conclusions of the Ecofin Council on 25 November where, following discussion of the fiscal position, the Commission's recommendations were rejected and the excessive deficit procedure was suspended. In this connection, the European Commission has initiated legal action before the European Court of Justice regarding the Ecofin's proceedings in order to clarify first, whether substantive decisions relating to the evaluation of fiscal policies can be taken outside the scope

CHART 3

Confidence indicators



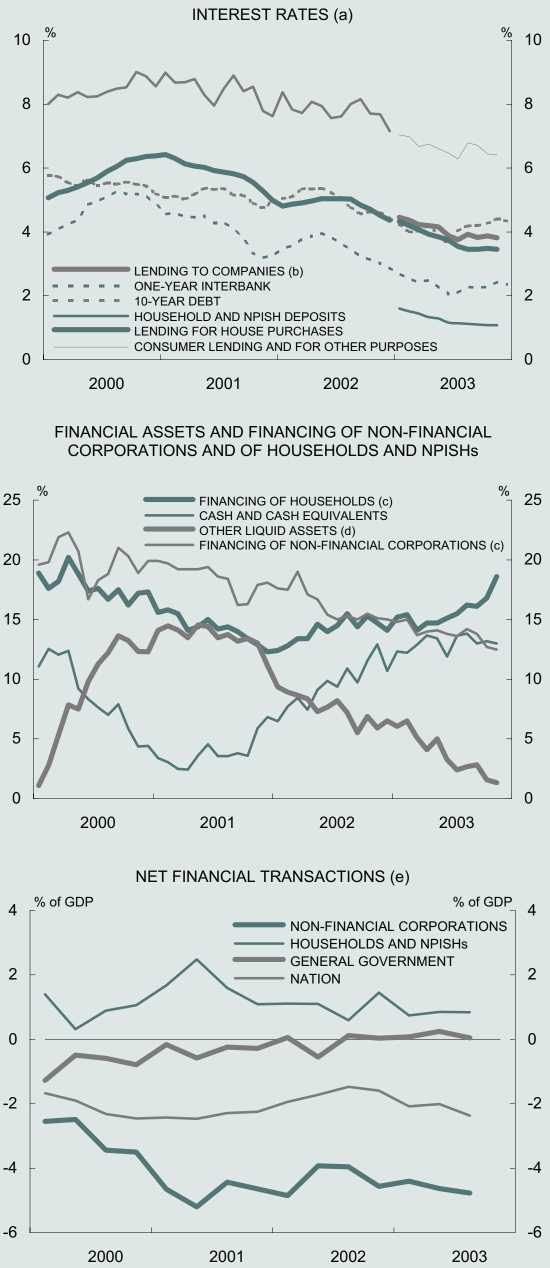
Source: European Commission.

of the excessive deficit procedure; and further, the validity of the resolutions adopted by Ecofin. In turn, the Commission has announced that in the coming weeks it will publish an initiative to improve the economic policy co-ordination mechanisms in the euro area, possibly including a proposal to improve the application of the Stability and Growth Pact.

The euro-area inflation rate, measured on the basis of the HICP, fluctuated during the year around 2%, the figure recorded last December. Foreseeably, depending on how energy and food prices (the most inflationary component) trend, the rate of increase of the HICP will tend to fall slightly in the opening months of this year. Subsequent developments will largely hinge on the behaviour of the attendant fundamentals and, specifically, on how labour costs fare. In this connection, while labour costs have held at a relatively moderate growth rate, they have remained substantially unresponsive to changes in productivity, the gains in which in recent years have been limited. Consequently, the behaviour of unit labour costs is not proving con-

CHART 4

Financial indicators of the Spanish economy



Source: Banco de España.

(a) There is a break, in January 2003, in the series of banking rates owing to changes in the data compilation statistical requirements.

(b) Calculated as a weighted average of the interest rates on various transactions grouped according to their volume. For loans exceeding 1 million, the interest rate is obtained by adding to the NEDR (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.

(c) Includes bank lending extended by resident credit institutions, foreign loans and financing through securitisation vehicles. Financing to non-financial corporations also includes fixed-income securities.

(d) Includes deposits with agreed maturity, repos, bank securities, residents' cross-border deposits and shares in money-market funds.

(e) Cumulative four-quarter data.

ducive to greater corporate profitability, thereby restricting firms' readiness to create employment and undertake the investment needed to cement the incipient expansion.

The results achieved by the Spanish economy in 2003 and its position at the onset of a new year are running counter to the situation described for the euro area as a whole and to what some of its core economies are experiencing. The difference between the respective average growth rates last year has been favourable to the Spanish economy to the tune of approximately two percentage points, a figure which might well be the case for Q4.

There have been three main factors behind the sustained buoyancy of household spending, the most dynamic component of the Spanish economy during 2003: the increase in real household disposable income, to which the Spanish economy's job-creation capacity has contributed notably as has, more recently, the slowdown in the inflation rate; financial wealth gains; and the persistence of very generous monetary conditions. The growth rate of household spending in Q4 does not differ significantly from the results for the year on average.

The growth of real household disposable income in 2003 was about 3%, similar to the figure for private consumption, whereby the saving ratio may have increased very slightly. The resilience of residential investment has meant that the share of net household financial saving in GDP is liable to have diminished last year, with household debt having increased appreciably. Against a background of low interest rates, sustained house price rises (which only began to ease slightly in Q3) and improvements in their financial wealth, households have continued resorting persistently to credit to finance their expenditure. As a result, their borrowing in Q4 grew at over 18%, signifying an acceleration of more than two percentage points compared with the rate recorded at the end of Q3. Loans for house purchases were the driving force here. In any event, household wealth remains sound and their debt burden, in relation to their gross disposable income, has remained at moderate levels.

At between 2% and 2.5%, the growth of investment in equipment in 2003 was modest. But this result is in favourable contrast to the marked decline recorded the previous year, at over 5%. The rate for Q4 may have been lower than that for the year on average since, although investment project financing conditions may have been very favourable and corporate profitability ratios high, certain large corporations are undergoing financial restructuring and remain affected by specific uncertainties associated with the international environment. Activity in industry, after having recovered in the first half of the year, has also tended to moderate, as reflected by the financial variables: credit received by companies slowed in the final three months of the year, reducing the related growth rate to around 12.5%. While the financing of activities relating to real-estate promotion and other services has grown substantially, credit to construction and that extended to the industrial sector have tended to slow.

Mention was made earlier of the estimated notable increase in cross-border trade flows during 2003. The real growth rates for exports and imports of goods and services might exceed 4% in the case of the former, and 6.5% in the case of the latter. These results are largely derived from the high rates attained in the first half of the year and which reflected, in turn, the recovery from the highly adverse results for the first half of 2002. The latest data point to a performance more in keeping with that of the relevant markets and, in Q4, it appears the loss of momentum of imports is proving somewhat greater than that of exports, hence the lesser negative contribution of the net external balance to the increase in GDP in this period. In any event, the key fact in the light of the future course of exports in a more expansionary international setting is that the appreciation of the euro has obliged exporting companies to reduce their export prices considerably in the dollar area, with the subsequent narrowing of their margins.

The final results for public finances last year marked an important step in the process of fiscal consolidation. Although fiscal policy taken as a whole was contractionary, general government conduct tended to boost those activities which were showing signs of greater robustness, namely consumption and construction. The fiscal impact on household disposable income in 2003 remained appreciable, albeit less than in 2002, and resided to a greater extent on the reduction of the habitual adverse impact exerted by direct taxation on income than on the positive contribution of net transfers to households, which have slowed. Government consumption and public-sector investment were also notable, especially investment in infrastructure routed through private companies, which is not included in the budget. Naturally, this was all possible thanks to the forceful performance of certain taxes, especially value added tax and corporate income tax, and to the strength, despite reform, of personal income tax takings.

The persistence of a substantial job-creation rate and the fall in the inflation rate in Q4 were two key economic events in 2003. The increase in employment, in uniform National Accounts terms, may have been somewhat below 2% for the year on average. And the annual percentage change in the CPI in December, at 2.6% (2.7% for the HICP), entailed a 0.3 pp reduction on the end-Q3 figure, brought about mainly by the performance of the non-energy industrial goods component, which had been posting very high rates in the previous two years. This has meant that the inflation differential with the euro area as a whole, which had stabilised at close to one percentage point (the result for the year on average), has declined to 0.7 pp in the closing three months of the year.

To entrench the slowdown in prices and for the inflation differential with the euro area countries to ease in a lasting fashion, the growth rate of unit labour costs must slacken from the current rate of over 3% at which it has stabilised. To do this, the economy's productivity needs to improve. And wages, once the impact of the indexation clauses is behind, must resume – against the background of the declining inflation rate – a moderate course that will allow the rise in employment to continue.

Likewise, however, market efficiency and competition must be extended so that their slowing costs do not translate exclusively into wider margins. The increase in corporate margins last year was once again notable, especially in those branches less exposed to competition and in which demand pressure was higher. The exporting industries, which should play a more prominent role in the Spanish economy's growth process as the global economic recovery firms, were nevertheless those that posted the worst results given the appreciation of the euro.

2. The external environment of the euro area

In 2003 Q4 economic developments in the external environment of the euro area were characterised by a more vigorous and geographically more widespread recovery, underpinned by the buoyancy that the US and South-east Asian economies have been showing since Q3 against a backdrop of expansionary demand policies.

The most notable feature of the international financial markets up to mid-January was the increasingly marked depreciation of the dollar against the major currencies, particularly the euro. In this period the dollar slumped to record lows of nearly USD 1.29 per euro, although it subsequently regained some of the lost ground. One of the factors explaining this behaviour is unquestionably the high US current account deficit. The performance of the other financial variables was reasonably sound. Long-term interest rates remained very low, favoured by fairly accommodative monetary policies. Business financing conditions continued to improve and the sovereign debt spreads of emerging market countries narrowed in certain cases to historical lows. Equities also performed very favourably both in developed and in emerging markets, rising sharply in 2003 after three consecutive years of falls in the main stock market indices.

In the United States, following strong growth in Q3 (8.2% in annualised quarterly terms), the most recent indicators have been mixed, at least as far as firms are concerned, which augurs more moderate growth in 2003 Q4. November and December saw an unexpected fall-off in demand for durable goods and, also unexpectedly, job creation stagnated. While the fall-off in investment can be interpreted as a temporary halt following earlier growth, the employment figure is particularly unfavourable because in the last three months of the year scarcely 143,000 jobs were created, a lot fewer than expected. Although the unemployment rate decreased from 5.9% to 5.7% of the labour force, this was due to the reduction of 300,000 people in the labour force. These poor data were partially offset by the favourable business opinion indicators, particularly the ISM manufacturing index, which climbed to its highest level in 20 years, and by the fact that it is a good time for firms, which in Q3 reported one of the highest profit-to-GDP ratios in history. Household spending performed better than expected, given its strength in Q3. November and December retail sales showed notable growth and the consumer sentiment indicator rallied in January to its highest level since November 2000, following the slight fall-off in December due to the weakness of employment. The external deficit shrank unexpectedly in November thanks to an increase in exports and a moderate fall in imports. Regarding prices, the CPI grew by 1.9% year-on-year in December, while the underlying rates of the consumer price, import and production indicators continued to be substantially contained at around 1%. This, along with the disappointing job creation figure, pushed back considerably the time when interest rate rises will foreseeably be forthcoming from the Federal Reserve.

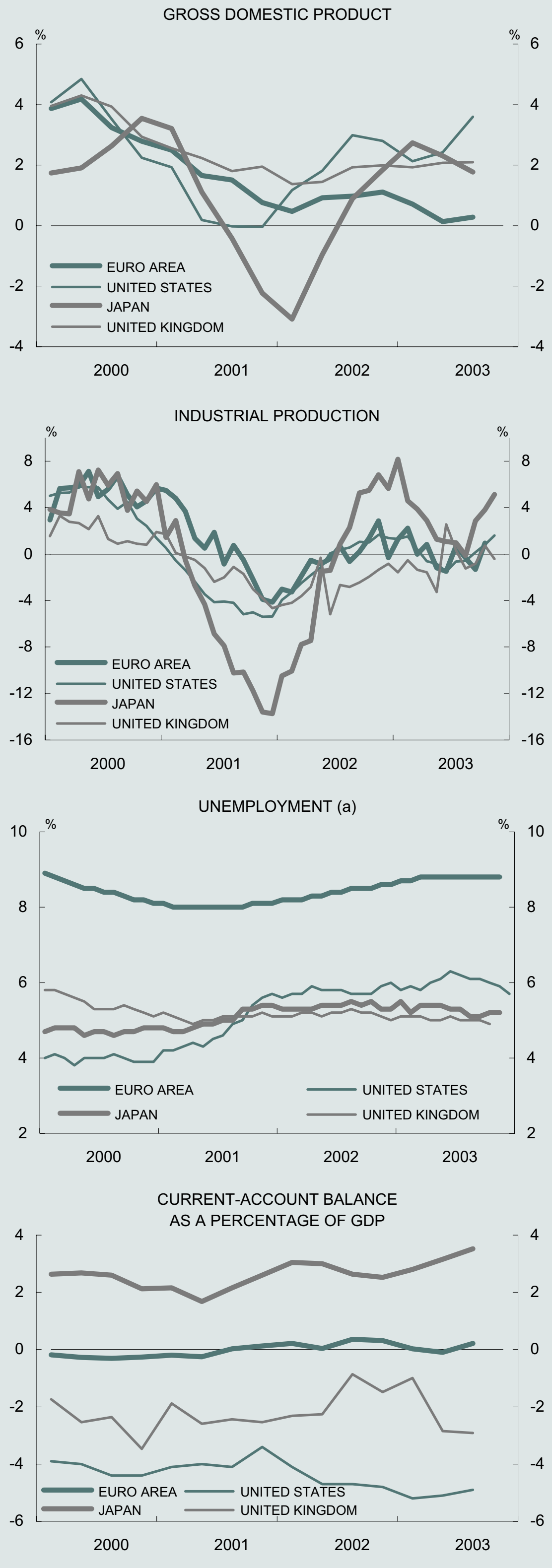
In Japan the indicators available for Q4 show an upturn in activity after the slight deceleration in Q3 (1.9% year-on-year). The improvement was underpinned by export buoyancy, which was reflected in increases in industrial production, business confidence and investment demand. However, the relatively weak private consumption persisted, with falls in retail sales in November and December and in consumer confidence in December as a result of job losses in the two preceding months, which raised the unemployment rate to 5.2% of the labour force. Deflationary pressure reappeared in November with a year-on-year fall of 0.5% in the consumer price index following upon a rate of zero in October, albeit with an underlying rate of –0.1%. The Bank of Japan decided to further ease its monetary policy by raising the target for current account balances at the central bank from a range of 27-32 trillion yen to one of 30-35 trillion yen. Finally, the government announced that there would be no supplementary pubic expenditure packages in the last part of fiscal year 2003 and presented its budget plan for fiscal year 2004. There were no major changes in its fiscal policy stance, although mention can be made of the reduction in public investment, offset by higher social security spending.

In the United Kingdom, GDP grew by 0.9% in Q4 (2.5% year-on-year), up 0.1 pp on Q3. The December Purchasing Managers' Surveys reflected continuing intense activity in services and construction, although the good prospects for industry were frustrated by the fall of 1% in industrial production in November. Household spending continued to grow sustainedly in Q4, underpinned by consumer credit and by the favourable juncture in the labour market, with an unemployment rate of 4.9% of the labour force. In the three months up to November the trade deficit continued to deteriorate, partly due to the appreciation of the pound sterling. The harmonised index of consumer prices grew at a rate of 1.3% in December, well short of the the target of 2%, while the growth of house prices quickened in December.

The EU acceding countries saw a notable acceleration of activity in Q3, which continued in Q4. Particularly striking were the high growth

CHART 5

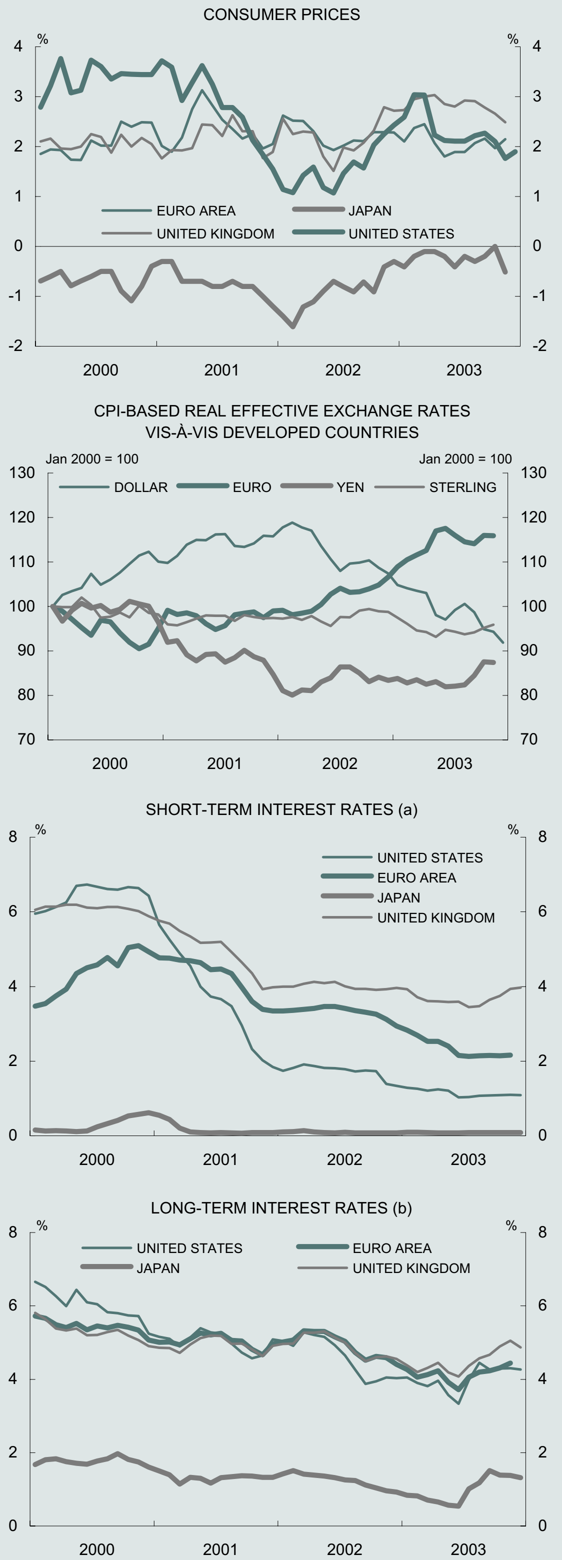
Main macroeconomic indicators
Annual rates of change



Sources: Banco de España, national statistics and Eurostat.
(a) Percentage of the labour force.

CHART 6

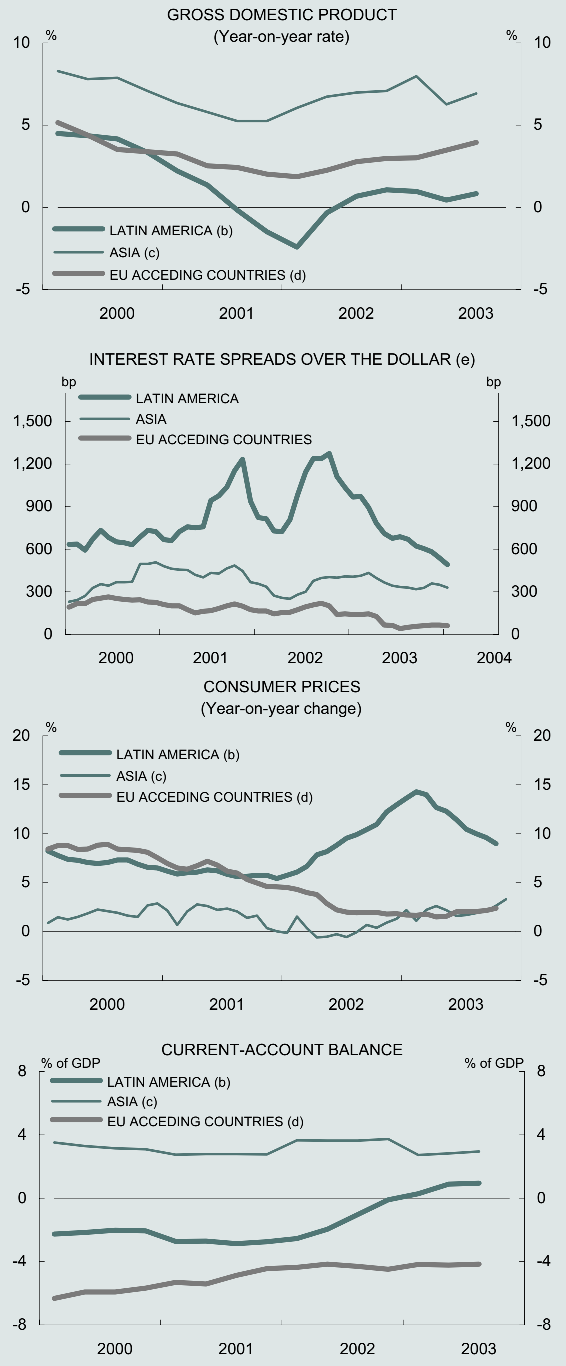
Prices, real exchange rate and interest rates



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

CHART 7

Emerging economies: main macroeconomic indicators (a)



Sources: National statistics and JP Morgan.
(a) The aggregate of the various areas has been calculated using the weight that their component countries have in the world economy, according to IMF information.
(b) Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
(c) China, Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
(d) Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.
(e) JP Morgan EMBI spreads. The EU acceding country data relate to Hungary and Poland.

of the Baltic countries, in certain cases above 6%, and the recovery of Hungary and the Czech Republic. As inflation rates edged up slightly in the closing months, the monetary authorities generally held official interest rates unchanged, except in Hungary, where they rose from 9.5% to 12.5% under strong pressure in the bond and foreign exchange markets due to the high fiscal and current account deficits. The Hungarian forint depreciated by more than 3% against the euro in Q4, while the other currencies with flexible exchange rates depreciated more moderately or even appreciated.

In Asia the recovery initiated in Q3 continued thanks to the buoyancy of exports, especially in China and South Korea. The Chinese economy is leading the growth in the region, with an estimated increase in GDP of 9.9% year-on-year in 2003 Q4 – even higher than the 9.6% recorded in Q3 – which meant that growth in 2003 was 9.1%. The indicators for Q4 confirm the acceleration of industrial production and of domestic demand, with sharp increases in fixed investment and in retail sales. All this came at the price of a rapid rise in inflation to 3% year-on-year in November. Also, the Chinese authorities commenced a bank capitalisation programme to place the financial system on a sounder footing.

The economic recovery in Latin America is progressing very slowly due to the poor results in terms of activity recorded in the region's two main economies, i.e. Brazil and Mexico. By contrast, the financial variables, particularly sovereign spreads and stock market indicators, continued to perform very favourably, to the extent that the Brazilian and Argentine stock market indices posted the highest rises in the world in 2003. This improved climate of confidence, along with the consolidation of fiscal accounts, the buoyancy of the external position (reflected in current account surpluses unusual in the region) and the downturn in inflation to 1-digit figures for these countries as a whole, enabled a year of low growth of barely more than 1% to be ended with good prospects for 2004.

Looking at individual countries, mention should be made of the vigorous recovery in Argentina, with growth of 9.8% year-on-year in Q3 which, given the strength of activity in Q4, could exceed 8% for 2003 as a whole. This reflects above all the reversal of the big cumulative fall during the past four years of recession, which also implies very low inflation. Meanwhile, private international creditors were unenthusiastic about the external debt restructuring proposed by the Argentine authorities. In Brazil, despite the favourable behaviour of the external sector and the notable interest rate cuts justified by the moderate inflation, GDP growth fell to –1.5% year-on-year in Q3, although the most recent activity indicators point to a slight improvement. The financial variables continue to be highly optimistic, buoyed by the definitive approval of the main reforms to the social security and tax systems in December. In Mexico, by contrast, Congress failed to approve the fiscal reforms, which gave rise to some turmoil in the foreign exchange markets, although it had faded by the end of the year. Growth in Q3 was lower than expected (0.4% year-on-year), although in Q4 there were signs of greater activity in the industrial sector due to its recovery in the United States. Noteworthy in the other countries in the region were: the combination of relatively high growth and low inflation in Chile, which enabled it to end the year with historically low interest rates; the referendum result rejecting fiscal and political reform in Colombia, which led to the approval of a fiscal austerity programme; and the sharp fall in activity in 2003 in Venezuela (around 9%), albeit less than initially expected.

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

The information available on the economic performance of the euro area in 2003 Q4 seems to confirm the recovery in activity that commenced in summer. This increased buoyancy has so far been underpinned basically by the growth in demand for euro area exports, which have benefited from the expansion of global output. By contrast, there are few signs that domestic demand has overcome the weakness shown during the middle quarters of 2003, despite the predominance of elements conducive to its recovery, such as favourable monetary and financial conditions. This situation still harbours, however, certain risks that could limit the extent of the rebound in activity. First, the appreciation of the euro exchange rate has recently quickened, which will probably have a moderating effect on the rate of expansion of exports, casting some uncertainty on growth prospects. Second, the difficulties in applying and fulfilling the Stability and Growth Pact are a major source of concern. In this respect, delivering on the commitments assumed within the institutional framework of the euro area's fiscal policies is a key means of strengthening the confidence of agents and achieving sustained growth of the euro area economy.

3.1. Economic developments

According to the most recent Eurostat estimate, the euro area's GDP grew by 0.4% in quarter-on-quarter terms in 2003 Q3, compared with the stagnation seen since end-2002 (see Table 1). The pace of 0.3% in year-on-year terms represented a slight acceleration compared with Q2. The breakdown by component shows that the recovery was underpinned by a sharp rise in exports, which grew by 2% quarter-on-quarter, following the fall-off suffered from 2002 Q4. This meant that, against a background of continuing sluggishness in imports, net external demand made a substantial positive contribution (0.8 pp) to output growth (see Chart 8). By contrast, domestic demand excluding inventories continued to show the scant strength characterising it throughout the whole of the year, with a contribution of only 0.1 pp to GDP expansion. The slow domestic spending was due to the scant momentum of private consumption and to the continuing fall in investment, although at a more moderate rate than in the previous two quarters. Finally, stockbuilding trimmed 0.5 pp from output growth. This reduction in inventories could be interpreted as a process not sought by firms, insofar it may have resulted from an unexpectedly strong rise in external demand.

The recovery of activity in Q3 was across the board in the nine euro area countries for

TABLE 1

Euro area economic indicators

	2002			2003				2004
	Q2	Q3	Q4	Q1	Q2	Q3	Q4 (a)	Q1 (b)
GDP								
Year-on-year growth	0.9	1.0	1.1	0.7	0.1	0.3		
Quarter-on-quarter growth	0.5	0.2	0.0	0.0	-0.1	0.4		
European Commission forecasts (c)							(0.3; 0.7)	(0.3; 0.7)
IPI (d)	-0.6	0.0	1.1	0.8	-0.5	0.1	1.1	
Economic sentiment	96.0	95.4	95.3	94.9	94.8	95.0	95.7	
Industrial confidence	-10.0	-11.3	-9.7	-11.0	-12.0	-11.4	-7.3	
Manufacturing PMI	51.4	50.5	49.0	49.3	47.1	49.1	52.0	
Services confidence	5.3	-0.7	-4.3	-5.7	-2.0	5.3	10.0	
Services PMI	52.9	50.9	50.5	48.9	47.9	51.9	56.7	
Unemployment rate	8.3	8.5	8.6	8.7	8.8	8.8	*8.8*	
Consumer confidence	-8.3	-10.0	-14.0	-19.3	-19.3	-17.3	-16.3	
HICP (d) (e)	1.9	2.1	2.3	2.4	1.9	2.2	2.0	
PPI (d) (e)	-0.9	0.2	1.5	2.4	1.4	1.1	*1.4*	
Oil price in USD (e)	24.1	28.4	28.2	30.3	27.6	27.1	29.9	31.5
Loans to the private sector (d) (e)	5.4	5.2	4.8	4.7	4.6	5.0	5.4	
Euro area ten-year bond yield	5.3	4.8	4.5	4.2	4.0	4.2	4.4	4.2
US-euro area ten-year bond spread	-0.10	-0.46	-0.51	-0.22	-0.32	0.09	-0.05	-0.03
Dollar/euro exchange rate (e)	0.998	0.986	1.049	1.090	1.143	1.165	1.263	1.254
Appreciation/Depreciation of the euro (e)	13.2	11.9	19.0	3.9	9.0	11.1	20.4	-0.7
Dow Jones EURO STOXX Broad index (e)	-15.2	-39.1	-34.5	-12.9	2.9	4.1	18.1	3.9

Sources: Eurostat, ECB and Banco de España.
(a) The information in italics does not cover a full quarter.
(b) Information available up to 20 January 2003.
(c) Quarter-on-quarter growth forecasts.
(d) Year-on-year growth.
(e) End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

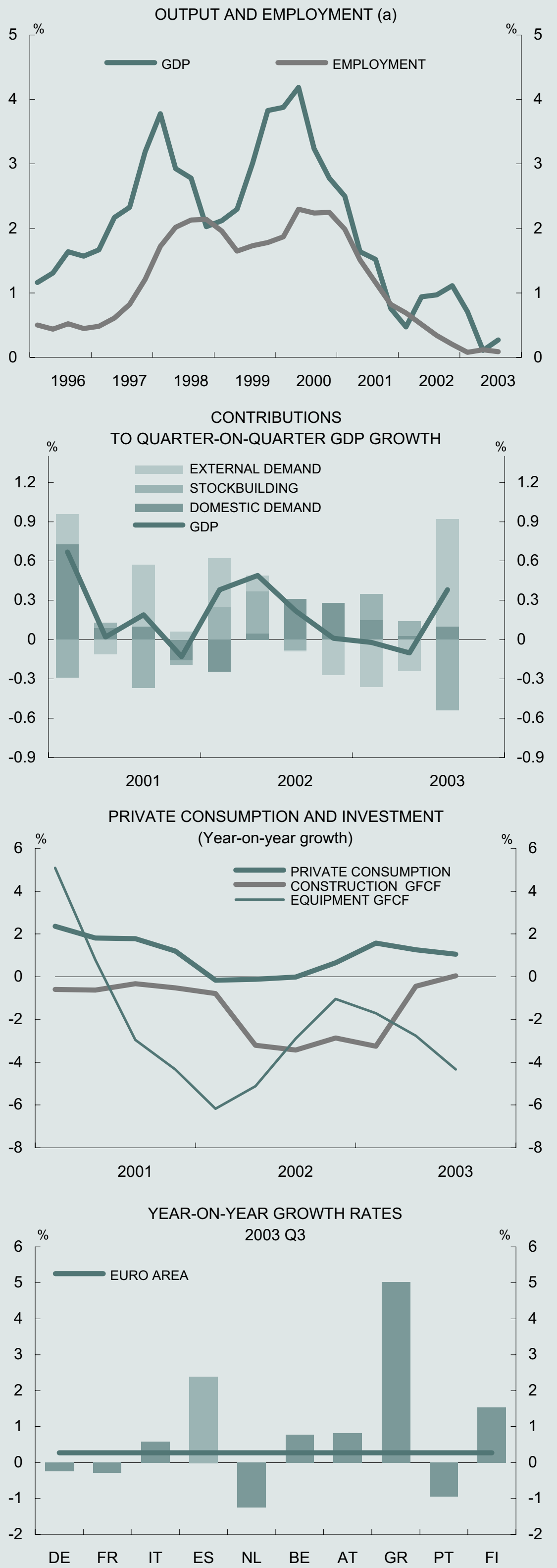
which quarterly national accounts data are available. They all recorded positive quarter-on-quarter growth in that period, except for the Netherlands, the GDP of which was unchanged. Moreover, the five countries whose output contracted in Q2 showed a strong rise in their growth rates. The expansion of exports and the consequent increase in net external demand contributed significantly to improving the results of certain economies, such as Germany and Italy, where the external sector's contribution to output growth amounted to 1.8 pp and 1.2 pp, respectively. Turning to domestic demand (excluding inventories), the three biggest euro area countries exhibited more varied behaviour: while Germany experienced a slight increase in the rate of fall of both private consumption and gross fixed capital formation, in France and Italy there was a recovery in private domestic spending.

By branch of production, all sectors except agriculture saw a perceptible recovery in Q3 in terms of value added growth. There was a notable recovery in industry (excluding construction), which returned to positive growth rates following a strong contraction in the previous quarter. The pick-up in the rates of expansion of construction and services was more moderate. The more pronounced recovery in industry than in services is consistent with the greater cyclical sensitivity of the former (see Box 1).

The information available on Q4 is consistent with a scenario of moderately strengthening demand. On the supply side, the qualitative indicators drawn from confidence surveys in manufacturing continued to show improvements in the quarterly average, reflecting a consolidation of the prospects for recovery (see Chart 9). However, although the purchasing managers' index in manufacturing moved continually upward during the whole quarter – exceeding by an increasingly broader margin the level of 50, which indicates an expansion of production – the results of the European Commission's in-

CHART 8

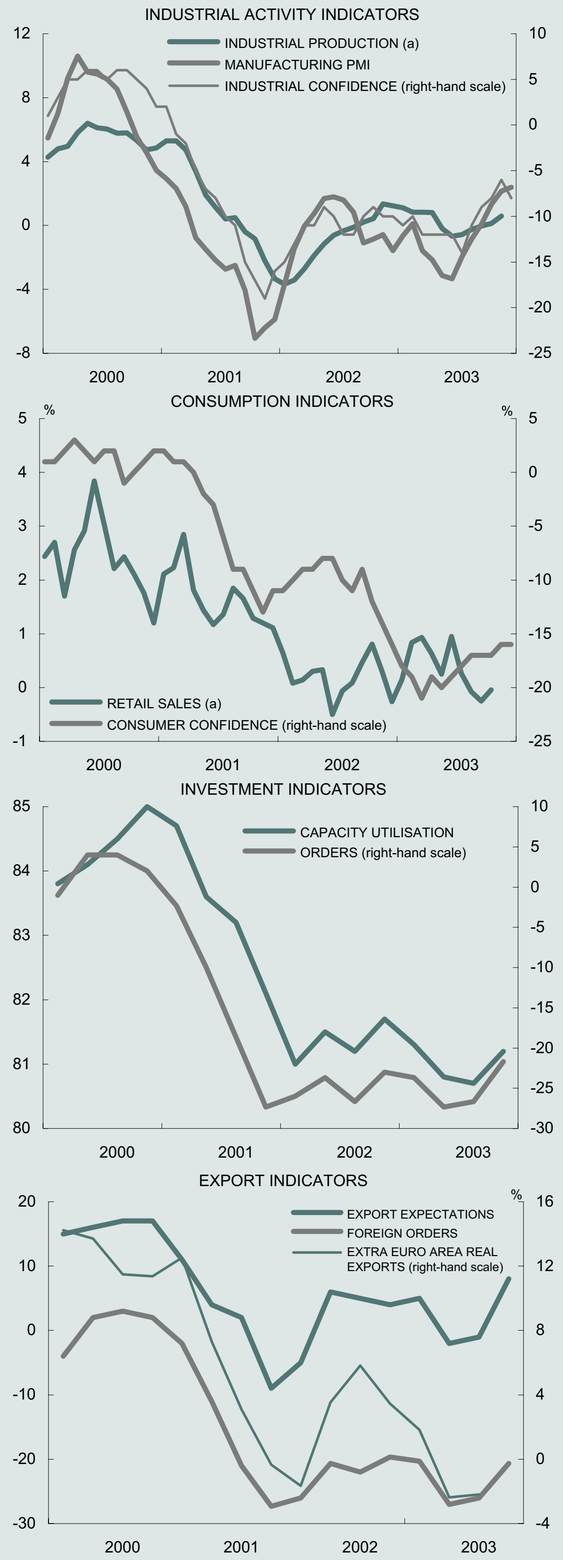
Euro area national accounts



Sources: Eurostat and national statistics.
(a) Year-on-year rates of change.

CHART 9

Euro area. Real indicators



Sources: Eurostat and European Commission.
(a) Non-centred annual percentage changes, calculated on the basis of the quarterly moving average of the seasonally adjusted series.

BOX 1

Cyclical behaviour of market services and of industry in the euro area

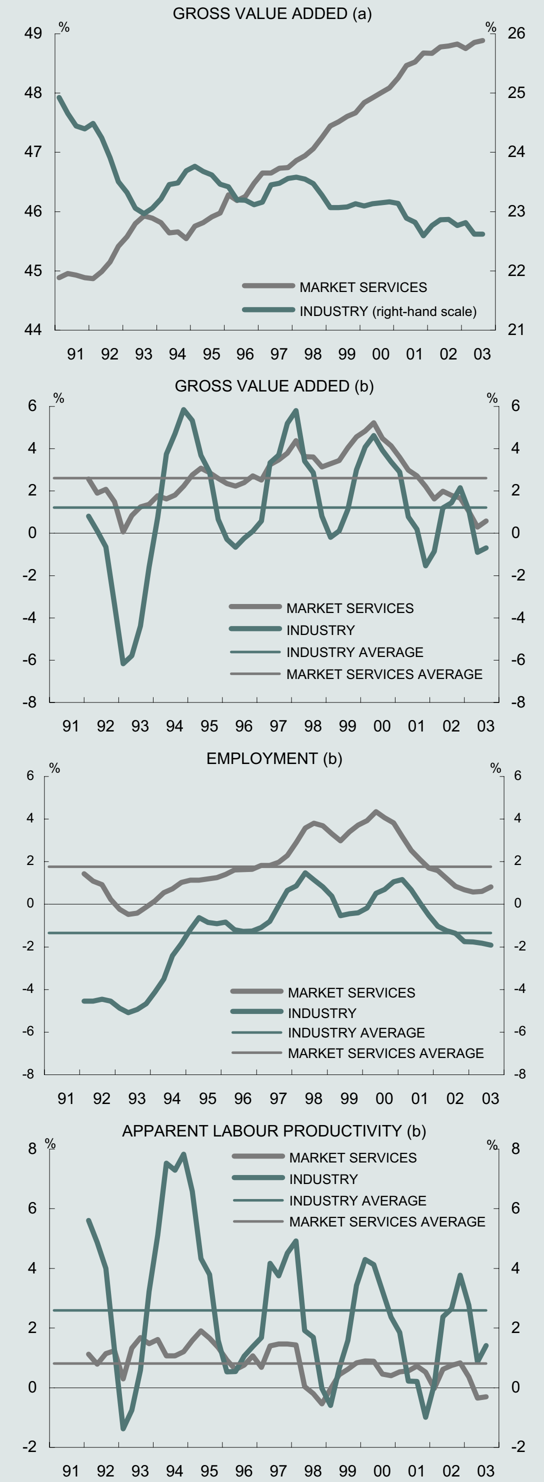
Since the early 1990s the two main branches of production in the euro area economy, i.e. market services (hereafter “services”) and industry excluding construction (hereafter “industry”) have seen a number of stylised facts that can be summarised as, firstly, an increasing weight of services – which have expanded in terms of both gross value added (GVA) and employment, at the expense of industry (and also agriculture and construction) – within the economy and, secondly, a lower relative volatility of growth of services in comparison with industry.

The weight of services in the GVA of the total economy has increased by 4 pp in the last decade, to the detriment of industry (see top panel). This is the result of a higher average year-on-year rate of change of services GVA in the period as a whole, which amounted to 2.6% against 1.2% in industry, as seen in the second panel. This phenomenon could be explained by a variety of factors. First, the relative demand for services in an economy grows as the level of income per capita rises (commensurately with, for example, needs that were previously satisfied within the household and are now met by services provided externally). Second, the growing importance of outsourcing, whereby industrial firms demand on the market a series of services that they previously provided to themselves internally, may be causing a certain shift in GVA from one sector to the other. Finally, the process of investment in countries outside the euro area in search of lower production costs and higher returns is giving rise to a certain industrial delocalisation which is reducing the weight of this sector within the euro area.

The growth of GVA in services shows, moreover, lower relative volatility. In the period considered, the standard deviation of the year-on-year rates of change of industry GVA was more than twice that recorded by services. This is probably related to the fact that services include a higher relative proportion of products the demand for which is less responsive to the business cycle – such as education or private health care – or the international tradability of which is low, meaning that they are not directly subjected to disturbances coming from abroad or generated by exchange rate movements. Also, the rates of change of services GVA show greater persistence over time than those of industry GVA, which is reflected in the longer cycle of the services sector.

The differential between the average year-on-year growth rates in the two sectors is much wider for employment than for GVA (see third panel). In the period considered, jobs have been destroyed in industry at an average annual rate exceeding 1%. In fact, only in two brief periods were jobs created in this sector in year-on-year terms. By contrast, in services employment only fell in one particularly unfavourable phase of the cycle (in 1993), while the average growth in the period was approximately 2%. This wider differential is associated with more dynamic behaviour of apparent labour productivity in industry – with annual average rises of around 2.5% – than in services, in which productivity gains are less than 1% (see bottom panel). Unlike the situation with GVA, the volatility of employment is not very different in the two sectors, suggesting that the short-term response of manufacturing firms to the high cyclical variability of their activity is basically to change the intensity with which they use labour, and not to change their workforce.

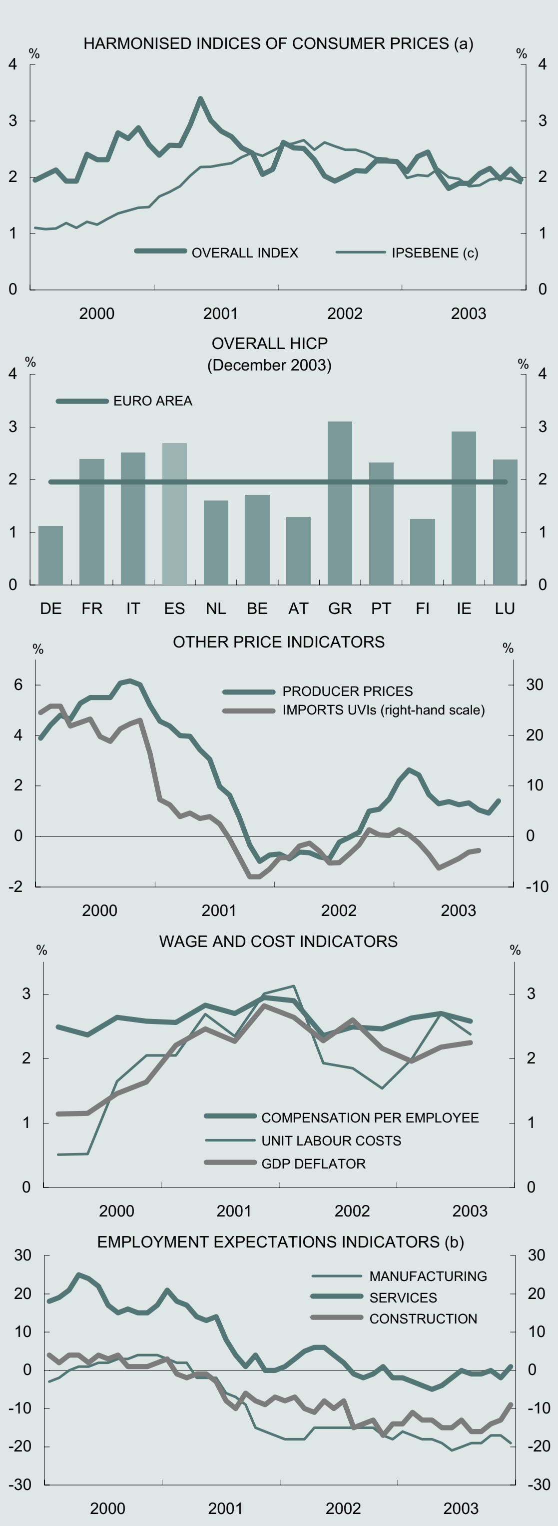
The recent pattern of GVA in the two sectors shows that they have made similar contributions to the deceleration of euro area output since mid-2000. The slowdown in activity has been more persistent in services, in which the year-on-year rates of change have progressively fallen over the last three years, following the prolonged period of acceleration from 1992 to 2000. Industry has continued to show the customary cyclical fluctuations, although within a general slowing trend in the pace of expansion of GVA. In 2003 Q3 the two sectors commenced a modest recovery which it would be premature to consider as definitive, although it seems set to continue in the immediate future given the sustained improvement in the confidence indicators (particularly those of services) since last spring.



Sources: Eurostat and European Central Bank.
(a) As percentage of total gross value added.
(b) Year-on-year rates of change.

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 was rebased to 2001.
(b) Expectations based on European Commission sentiment indicators.
(c) CPI excluding unprocessed food and energy.

dustrial confidence survey fell off in the last month of the year, as did all its components. The industrial production index available up to November reflected a trend towards progressive recovery in manufacturing during the second half of the year.

Turning to domestic demand, the available information tends to give a picture of a more faltering recovery, particularly in private consumption. In this component, consumer confidence improved very slightly in Q4, while retail confidence fell off in the last two months of the year. Among the quantitative indicators, car registrations and retail sales again failed to show clear signs of recovery. As regards demand for capital goods, there seem to be some encouraging signs compared with previous quarters in terms of trend in the degree of capacity utilisation and in the assessment of industrial order books by firms, since the best values of these indicators in 2003 were recorded in the fourth quarter. As regards external demand, the assessment of industrial orders received from abroad held on an upward trend reflecting buoyant world demand.

Regarding the euro area labour market, in 2003 Q3 employment remained stagnant at the levels reached in early 2002, which meant that the unemployment rate also remained unchanged at around 8.8% of the labour force. The indicators of employment expectations in the various branches of production point to a modest improvement in prospects in construction and, to a lesser extent, in services (see bottom panel of Chart 10).

Therefore, after the strengthening of euro area economic activity over the second half of 2003, the outlook is for a mild and progressive consolidation of recovery during the coming months. The continued corporate balance-sheet restructuring, the solid financial position of households and the timid signs of recovery in employment that are emerging make for a setting conducive to the expansion of activity. However, there are certain risks that could jeopardise consolidation of the improvement. In particular, during the second half of the year this improvement was based on factors that make it somewhat vulnerable, since, from the standpoint of composition, it was based nearly exclusively on external demand, with scant buoyancy in domestic demand. Although this is consistent with the pattern observed at the beginning of other business cycle upturns, this time it is more risky than in the past because it coincides with a quickening of the process of euro appreciation. Although the impact of this phenomenon on net external demand seems to have been eclipsed in Q3 by the buoyancy of the world

TABLE 2

General government budget balances of euro area countries (a)

% of GDP

	2000	2001	2002	2003 (b)	2003 (c)	2004 (b)	2004 (c)
Belgium	0.2	0.4	0.1	0.2	0.2	0.0	-0.4
Germany	-1.2	-2.8	-3.5	-4.0	-4.2	-3.5	-3.9
Greece	-1.9	-2.0	-1.2	-1.4	-1.7	-1.2	-2.4
Spain	-0.9	-0.3	0.1	0.5	0.0	0.0	0.1
France	-1.4	-1.6	-3.1	-4.0	-4.2	-3.6	-3.8
Ireland	4.4	0.9	-0.4	-0.4	-0.9	-1.1	-1.2
Italy	-1.8	-2.6	-2.3	-2.5	-2.6	-2.2	-2.8
Luxembourg	6.4	6.2	2.4	-0.6	-0.6	-1.8	-2.1
Netherlands	1.5	0.0	-1.6	-2.3	-2.6	-2.3	-2.7
Austria	-1.9	0.3	-0.2	-1.3	-1.0	-0.7	-0.6
Portugal	-3.1	-4.2	-2.7	-2.9	-2.9	-2.8	-3.3
Finland	7.1	5.2	4.2	2.3	2.4	1.7	1.7
MEMORANDUM ITEM:							
Euro area							
Primary balance	4.2	2.3	1.4		0.7		0.7
Total balance	-0.9	-1.6	-2.2	-2.7	-2.8	-2.4	-2.7
Public debt	70.2	69.2	69.0	70.1	70.4	70.0	70.7

Sources: European Commission, national stability programmes and Banco de España.
(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 2003 and January 2004.
(c) European Commission forecasts (autumn 2003).

markets, the resurgence of the upward trend in the exchange rate in Q4 could begin to affect euro area activity. In particular, there is certain evidence that so far export firms have passed through to their product prices only a part of the euro's appreciation. This implies a compression of their margins that will be difficult to maintain in the future.

The growth rate of the harmonised index of consumer prices (HICP) slowed by 0.2 pp between September and December, ending the year at 2%. The rate of increase of the CPI excluding unprocessed food and energy (the more volatile components) decreased during the quarter by 0.1 pp to 1.9%. This was a result of the more moderate momentum of services and non-energy industrial goods prices, since processed food prices rose by 0.6 pp, driven by the effect of the rise in excise taxes in France, particularly those on tobacco. The growth of industrial producer prices, which had been decelerating during the year, rose in November to 1.4%, due to the expansionary behaviour of energy prices, a component whose high volatility contrasts with the stability (at low levels) shown by the growth rates of the other components.

The performance of the underlying inflation trend in the second half of 2003 was moderately more favourable than expected, which meant that at the beginning of 2004 the situation in the euro area was conducive to stable inflation of below 2%. Exchange rate behaviour should contribute to this, given the existing evidence that the euro's appreciation has so far been incompletely passed through to euro area import prices. In any event, the appreciation has neutralised the impact of the oil price escalation on the prices of energy goods expressed in euros. The factors pushing up oil prices include the continuing geopolitical uncertainty, the impact on oil demand of the unexpectedly strong recovery in the global economy, the low level of stocks in certain oil consuming countries and the apparent intention of the OPEC countries to raise prices to offset the effects of the dollar's depreciation on their purchasing power.

However, throughout 2003 prices generally exhibited persistent downward stickiness, despite the fact that the scant momentum of activity resulted in production below its potential level. Against this background the behaviour of domestic costs is a crucial factor for assessing the inflation outlook. Thus unit labour costs continued growing at high rates of around 2.5% despite the slight moderation in 2003 Q3. In particular, the rate of expansion of compensation per employee has shown persistent downward stickiness and a notable lack of sensitivity to the cyclical position of the economy during the latest slowdown in activity.

The performance of the euro area balance of payments in the period January-October 2003 reflected the effects of the euro's appreciation. Thus the cumulative current account surplus decreased by approximately €28 bn in relation to the same period a year earlier, to €20 bn. This was due principally to an increase of €16 bn in the income deficit (because the value in euro of the income from the rest of the world fell as a result of the exchange rate appreciation) and to a decrease of €13 bn in the goods surplus, as a result of the value of exports falling by more than that of imports.

In the area of fiscal policy, in 2003 the euro area budget deficit deteriorated for the third consecutive year to stand, according to the European Commission's autumn estimates, at 2.8% of GDP, against 2.2% in 2002 (see Table 2). Therefore, the budget figure for the euro area as a whole differed by 0.9 percentage points of GDP from that resulting from the national stability programmes submitted in late 2002 and early 2003, largely due to the weak economic growth of the euro area.

On 25 November the ECOFIN Council rejected the European Commission's recommendations on the excessive deficit procedure against France and Germany. The Council decided to hold the procedure in abeyance and approved conclusions containing new recommendations. These called for postponement until 2005 of the deadline for correcting these countries' excessive deficits and asked for a larger reduction in the cyclically adjusted deficit than that envisaged in the latest Broad Economic Policy Guidelines. Although the content of these recommendations does not differ substantially from the proposals that had been made by the Commission, there are doubts concerning the procedure used by the Council and the binding nature of the conclusions, despite the fact that the governments of France and Germany have publicly announced their commitment to comply with them. Consequently, on 13 January the European Commission decided to appeal against the Council's decision to the Court of Justice of the European Communities to clarify to what extent the procedure used by ECOFIN conforms to that established in the Treaty. This initiative by the Commission forms part of a broader strategy aimed at clarifying and improving the mechanisms by which economic policies are co-ordinated and monitored in the euro area. The particular proposals have yet to be specified by the Commission.

Meanwhile, the Member States have submitted the updates of their stability programmes, in which they define their medium-term fiscal objectives. Aggregating the budget figures of the various countries results in a budget deficit for the euro area of 2.4% and 1.7% of GDP in 2004 and 2005, respectively. These projections are more favourable than the European Commission's autumn forecasts, according to which the euro area budget deficit would remain at 2.7% in 2004 and 2005. The differences are because the stability programmes of certain countries include more optimistic economic growth estimates and, moreover, consider fiscal consolidation measures not included in Commission forecasts. Therefore the expected improvement in the countries' public finances depends on the veracity of these two assumptions. According to stability programme figures, the cyclically adjusted budget deficit of the euro area as a whole will improve moderately in 2004, so the fiscal policy stance will foreseeably be slightly restrictive. Broadly, the budget strategies of the Member States fulfil the Eurogroup's agreement that countries with a budget deficit that is structural should reduce it by 0.5 pp of GDP each year until budget balance is reached. However, the information contained in the programmes indicates that by 2006 the euro area as a whole will still not be near to budget balance.

The worsening of public finances in a setting of unfavourably trending activity has given rise to two types of action by economic policy authorities. First, it has prompted the European Council to initiate a programme to foster investment, known as European Action for Growth, described in Box 2. Second, it has obliged Member States to seek a difficult balance between, on the one hand, measures aimed at consolidating their public finances and, on the other, those aimed at stimulating economic growth. Such is the case of Germany, which last December approved an extensive set of reforms forming part of the so-called Agenda 2010. In particular, these reforms brought forward to 2004 a portion of the marginal rate cuts under personal income tax initially planned for 2005, which was offset by reducing certain tax deductions. In the labour market, the reforms include unemployment benefits that are equal to the welfare aid for the long-term unemployed, obligatory acceptance by the unemployed of certain job offers under certain conditions and more flexible legislation on dismissals.

3.2. Monetary and financial developments

As described in the previous section, the economic setting in the euro area in 2003 Q4 was characterised by a moderate improvement

BOX 2

European action for growth

In the second half of 2003, with Italy holding the EU Presidency, a number of initiatives were undertaken to promote various investment projects. Finally, in December the European Council approved what was known as European Action for Growth, a programme to foster investment which has two aims. In the short term, it seeks to increase demand and confidence in the European Union, against a background of relative economic weakness and scant investment buoyancy. In the longer term, it seeks to further the objectives of the Lisbon Agenda, which aspires to put Europe at the head of the developed economies in terms of productivity and innovative capacity by the end of this decade. In principle, this effort will not involve an additional budget burden, and the commitments made in the Stability and Growth Pact and the financial prospects of the EU will be observed. Regarding the planned actions, it is considered crucial to work on executing trans-European transport, energy and telecommunications networks and to invest in human capital, particularly that relating to R&D investment and technological innovation.

The trans-European network projects aim to improve the connection between the Member States of the European Union in order to foster integration of the internal market. In the development of transport networks, priority has been given to cross-border sections that improve the inter-connection of existing national networks, both between current Member States and with the countries that will shortly join the EU. The European Action for Growth programme also aims to complete the single market for electricity and gas, improving the inter-connection between European electricity networks and strengthening connections with northern Africa and northern and eastern Europe, which are areas that supply energy to Community countries. The third area of action in infrastructure is telecommunications. The European Union aims to ensure widespread access to broadband communications by 2005 and to stimulate supply in distant, rural or disadvantaged regions and to boost demand by setting up or fostering services that use these technologies.

Financing committed in the various areas

AREA OF ACTION	EUR bn	% GDP	period
TRANS-EUROPEAN NETWORKS (TEN)			
Transport (TEN-T)			
Total investment	220.0	3.0	To 2020
Of which:	*160.0*	*2.2*	*To 2010*
EU funds for TEN-T networks	0.6	---	Annual
EIB funds for TEN investment facility	50.0	0.7	2004-2010
Cohesion Fund (infrastructure)	1.5	---	2000-2006
Galileo (European navigation satellite network)			
UE funds for TEN-T networks	0.6	---	2002-2005
6th R+D Framework Programme	0.1	---	2003-2006
Broadband and electronic Trans-European Networks (eTEN)			
Structural funds	5.5	0.1	2002-2007
eTEN electronic networks	0.4	---	2000-2005
6th R+D Framework Programme	4.0	0.1	2000-2006
KNOWLEDGE			
Research and Development (R+D)			
6th R+D Framework Programme	17.5	0.2	2003-2006
Structural funds	10.5	0.1	2000-2006
EIB funds for "i2i" and "Innovation 2010" initiatives	50.5	0.7	2000-2010
European Investment Fund for venture capital funds	2.5	---	---
Innovation and training related to research			
European Social Fund training	27.0	0.4	2000-2006

Source: European Commission

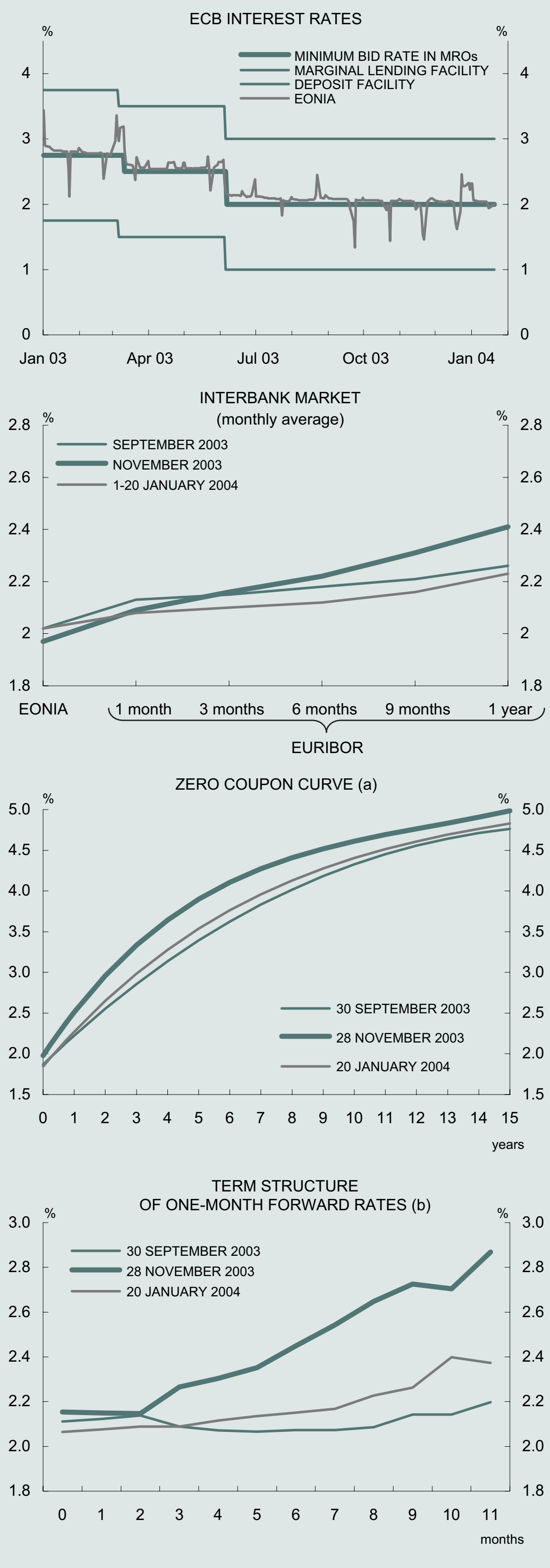
In the area of research, the programme takes note of the objective set by the Lisbon Agenda to achieve R&D investment equal to 3% of GDP by 2010 (it is currently less than 2%), which entails raising private and public investment at an annual rate of 8% (it is currently growing at 1.3%). It is expected that private initiative will make up two-thirds of this investment effort. For this purpose, investment will be fostered in infrastructure for research, scientific parks, industrial innovation, R&D projects, information and communications technologies and the financing of education and training centres, through growing investment in education and closer integration with employment and social policies.

Within this framework of action, in December the European Council approved a group of priority initiatives known as the Quick Start Programme to ensure that a substantial level of investment has been undertaken by end-2006. For this purpose mature investment projects have been selected which can be commenced immediately or within a short period, with emphasis on cross-border transport links.

To finance these projects, the countries cannot increase their public budgets; rather, they have to change their spending mix, optimise the use of Community financing and let private initiative bear most of the weight of investment. To increase the incentives for the private sector to participate in infrastructure projects, it is intended to promote associations with the public sector (known as public-private partnerships, or PPP). In this way private initiative will own the physical assets and provide the infrastructure services, and, in exchange, the State will furnish the private operators with an adequate flow of revenue. In the financing of this type of projects and in those relating to the development of human capital, consideration is being given to involving the European Investment Bank to a greater extent and developing new guarantee instruments, specialised capital funds and structured financing operations. It is also wished to foster securitisation of the financing granted by banks for infrastructure projects, which would generate liquidity that could be reinvested in other projects of this type. To give an idea of the importance of the projects, the accompanying table includes information on the funds committed in the various fields of action.

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.

in activity, along with favourable prospects for 2004, and by inflation behaviour in keeping with the definition of price stability. In light of these data, the ECB Governing Council decided that in the final stages of 2003 it would hold official interest rates at the levels set on June 5. Thus the rates for main refinancing operations, the deposit facility and the marginal lending facility remained at 2%, 1% and 3%, respectively.

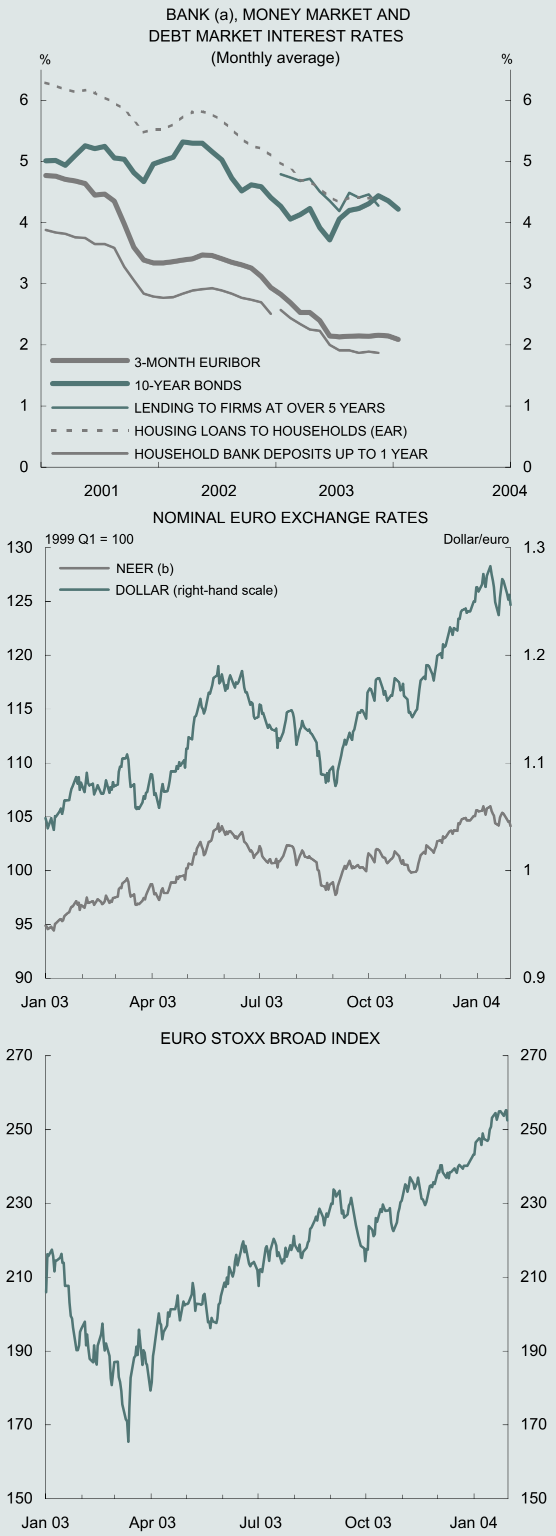
Interest rate developments on the money markets can be divided into two distinct phases since the end of 2003 Q3, as shown in Chart 11. In October and November there was an upward shift in the yield curves at terms of approximately three months and longer, reflecting expectations of interest rate rises around spring 2004 due to an economic climate promising to become more favourable and to a slight worsening of the inflation outlook. However, since the beginning of December these expectations have been revised downwards – the reasons for this may have to do with the quickening appreciation of the euro against the dollar – and, as a result, at the end of January the markets seem to consider it very unlikely that official interest rates will rise before the end of next summer. Thus 1-year EURIBOR fell back to 2.2%, similar to its level in summer 2003. In the secondary debt markets, 10-year yields moved down slightly in the quarter as a whole and in the last few days of January stood in the vicinity of 4.2% (see Chart 12).

Finally, in the corporate bond markets the improved economic climate led to a gradual narrowing of corporate bond spreads. The interest rates charged by credit institutions on loans by them to households and firms continued at historically low levels. In line with the other international stock markets, the euro area bourses have performed well recently. The Dow Jones EURO STOXX broad index rose by around 16% in 2003 Q4 and by 18% in 2003 as a whole. This upward course continued in the early weeks of 2004, buoyed by the ongoing favourable global economic outlook.

As mentioned above, the sharp appreciation of the euro against the dollar in the second half of the year was one of the most notable economic developments in the period under analysis, although in the last few days it has been subject to some fluctuations. Since end-September, following the communiqué issued by the G-7 Dubai meeting that advocated greater exchange rate flexibility as conducive to the orderly adjustment of global imbalances, the euro has appreciated somewhat less than 10% against the dollar. In nominal effective terms, the euro's appreciation is lower, at 4% in the same period.

CHART 12

Euro area interest rates, exchange rate and stock market index



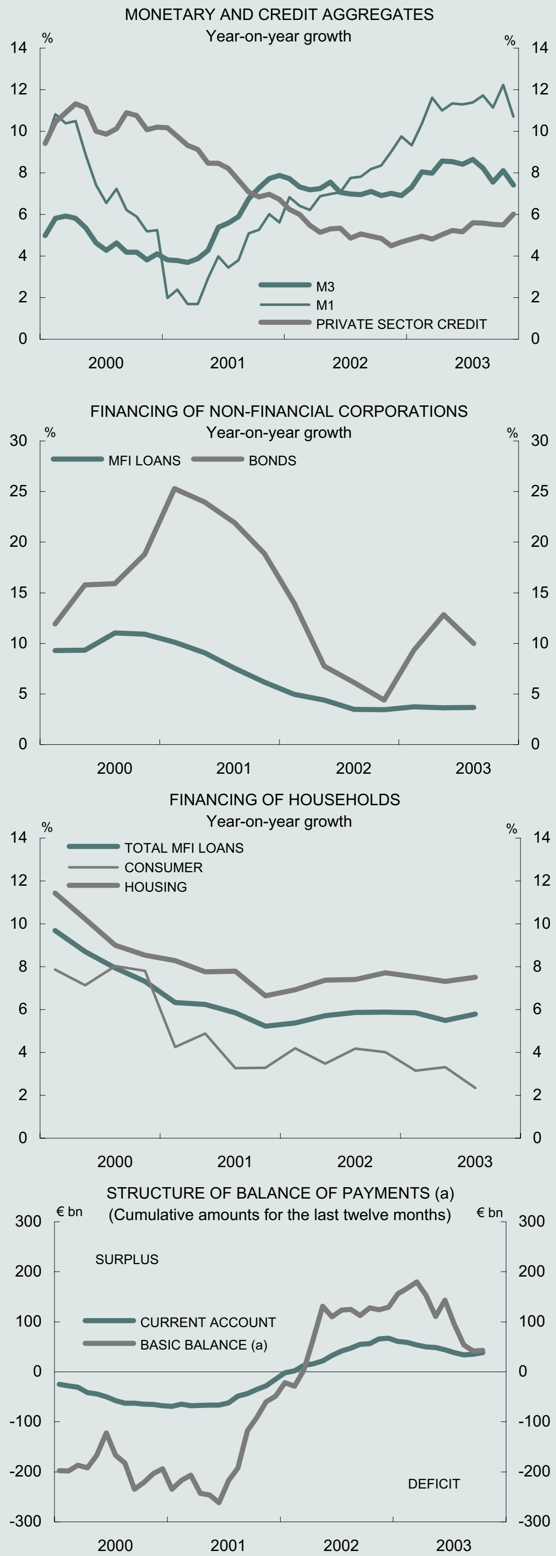
Sources: Banco de España and European Central Bank.

(a) Data drawn from new statistics on interest rates compiled by the ECB for new operations.

(b) Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.

CHART 13

Monetary and credit aggregates and balance of payments



Sources: Banco de España and European Central Bank.

(a) The basic balance is approximated by the sum of the balance on current account and direct and portfolio investment.

In the last few months the M3 monetary aggregate has decelerated moderately, although its year-on-year rate of change remained high (7.1% in December). The incipient process of reallocation of portfolios held by the public towards longer-term financial assets carrying higher yield and risk, could be consistent with the diminution of financial market uncertainty. The available data on credit to the private sector evidence the continuation of the mild acceleration that commenced in the previous quarter, the year-on-year growth rate standing at 5.7% in December. This is in line with the background of economic recovery seen during the second half of the year and with the continuing favourable financing conditions. The financing extended to households, particularly that used for house purchase, has been the most buoyant component of bank credit. As regards changes in the supply of credit by sector, the Bank Lending Survey in Q3 pointed to a decrease in the proportion of institutions stating that they had tightened the terms of loans to euro area firms. By contrast, Q3 saw an increase in the number of institutions reporting that they had adopted a tougher attitude on credit extension to households, although the institutions planned to apply easier terms to consumer credit in Q4. It has to be kept in mind, however, that the short history of this survey makes it advisable to interpret these results with caution.

4. The Spanish economy

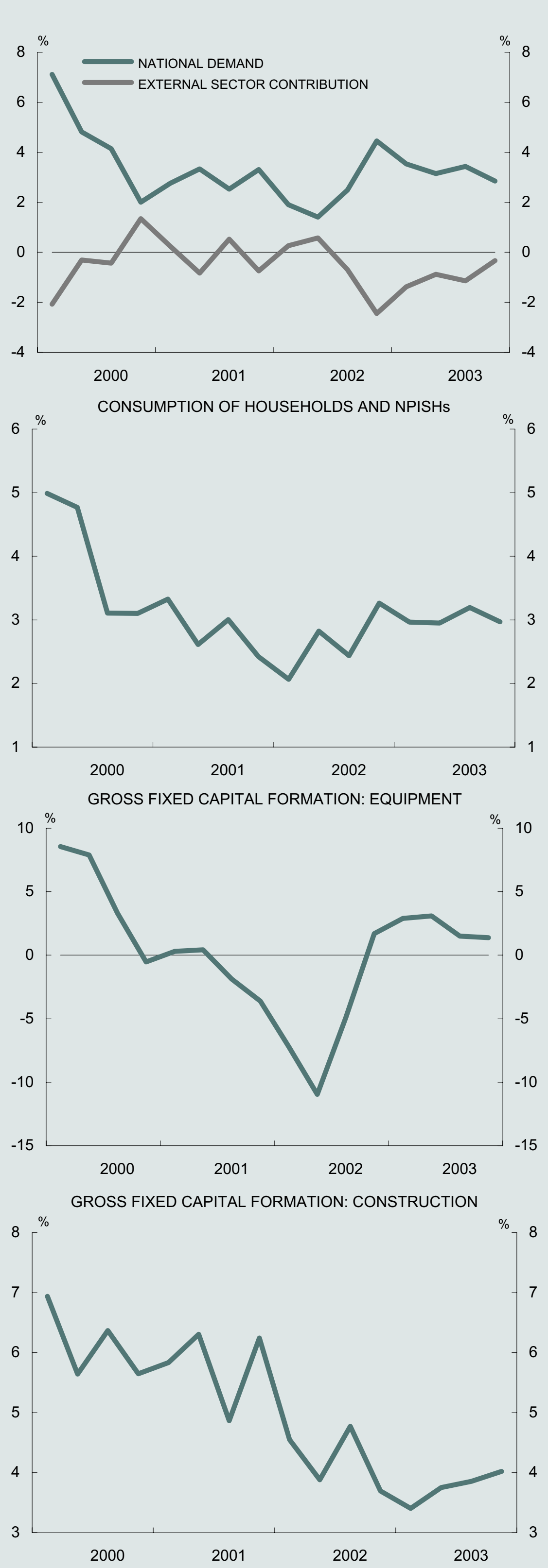
The QNA estimates for 2003 Q3 showed a strengthening of national demand in the Spanish economy during this period, in which its growth rate rose to 3.4% in real year-on-year terms. Contributing to this was the renewed buoyancy of private consumption and, to a lesser extent, of construction spending, while investment in capital goods slowed (see Chart 14). The negative contribution of the external sector to GDP growth edged up to –1.1 pp, such that the year-on-year increase in GDP stood at 2.4%, 0.1 pp up on the figure for Q2. The information available for Q4 suggests somewhat less expansionary behaviour by domestic demand, the increase in which would have been close to 3%, against a background of easing household consumption, stable expenditure on fixed capital and with a contribution of stockbuilding below that of the previous quarter. Nonetheless, the negative contribution to growth by the external sector should have abated considerably, owing to a sharper loss of momentum in imports compared with that in exports. Consequently, GDP is estimated to have increased by 2.6% in real terms in 2003 Q4 compared with the same period a year earlier, with its growth for the year on average standing at 2.4%.

The increase in output over 2003 as a whole, which was 0.4 pp up on the preceding year, was the result of resilient domestic demand, which grew by 3.2%, and, in particular, of investment in equipment, following the unfavourable performance of this variable in 2002. The growth of consumption also stepped up, underpinned by the pick-up in employment and by household wealth gains. Investment in construction, meanwhile, eased only slightly and remained the most buoyant component of expenditure. Conversely, the contribution of the external sector stood at –0.9 pp, reflecting a sharper recovery in imports than in exports, in a setting in which the Spanish economy's growth differential with the euro area widened.

From the standpoint of activity and on the indicators available, value added in 2003 Q4 would have grown at a similar year-on-year rate to the previous quarter. This is because the recovery in the agricultural branches extended into the final quarter and the weakness shown by industry in Q3 ceased. The rate of change of services tended to stabilise, while there was some slowdown in construction. Over the year as a whole the highlight was the recovery in industry, although the performance of agriculture and market services also improved in relation to 2002, while value added in construction continued to post high though somewhat lower rates than those of the previous year. Employment moved on a moderately recovering profile be-

CHART 14

Main demand aggregates
Percentage change on year ago (a)



Sources: INE and Banco de España.
(a) Calculated using the seasonally adjusted series.

tween the first and second half of 2003, with the number of jobs increasing at an estimated rate of around 1.8% during the year as a whole, 0.3 pp up on 2002. In the market economy, employment was steadier during the first three quarters of 2003, when it advanced at rates of between 1.8% and 1.9%, accompanied by very modest apparent labour productivity gains. The information available indicates that there had been a mild acceleration in numbers employed by the end of the year. Across the different branches, job creation was concentrated in construction and, to a lesser extent, in services.

The behaviour of wages in 2003 was driven by a higher growth of wage settlements than in 2002 and by back-pay arising from the indexation clauses for the latter year, which translated into a rise in compensation per employee in the market economy, especially at the beginning of the year. Nonetheless, the growth of compensation moderated progressively during the year, passing through to unit labour costs. The expansionary trend of business margins lost steam in relation to 2002. Both factors explain the cut in the growth rate of the GDP deflator over the course of 2003. Against the backdrop of the appreciation of the euro, foreign prices also contributed to easing prices. As a result, in terms of the CPI the decline in the inflation rate exceeded 1 pp, standing at 2.6% in December.

4.1. Demand

In real terms, Spanish household final consumption spending posted high growth in the first three quarters of 2003. In year-on-year terms, this growth increased slightly in Q3 to 3.2%, largely as a result of it having slowed a year earlier (see Chart 14). The information available for Q4 indicates that consumption remained strong during this period, ending the year 2003 with average growth of 3%. The buoyancy of private consumption last year was based on the sound growth of real household income, making it compatible with a slight rise in the household saving ratio, on continuing generous financial conditions and on the increase in the wealth of this sector. Likewise because of these factors, households' perception of the economic situation gradually improved.

Among the private consumption indicators, depicted in Chart 15, the index of apparent consumption of consumer goods, estimated with as yet incomplete information for Q4, has moved on a declining trend, mitigated by the course of apparent consumption of services. Other indicators more directly related to expenditure have behaved more favourably, such as the retail sales index in real terms, or the confidence indicator, which stood in December at a high for the year. Under consumption, durable goods purchases were particularly resilient; in particular, new car registrations rose substantially in Q4, entrenching the recovery seen in the previous two quarters.

Among the determinants of consumption, real disposable income grew at a rate close to that of the previous year, against a background of lower inflation. In current prices, the bigger increase in total gross wages – the outcome mainly of the higher growth of employment – was countered by a somewhat less expansionary contribution of general government net transfers and of non-wage income. As indicated, household wealth also supported the growth of consumption; the significant rise in the value of property assets continued and, in turn, stock market prices rallied, thereby boosting financial wealth. Overall, consumption quickened by 0.4 pp in 2003 compared with 2002, despite which the ongoing recovery of the household saving ratio was maintained.

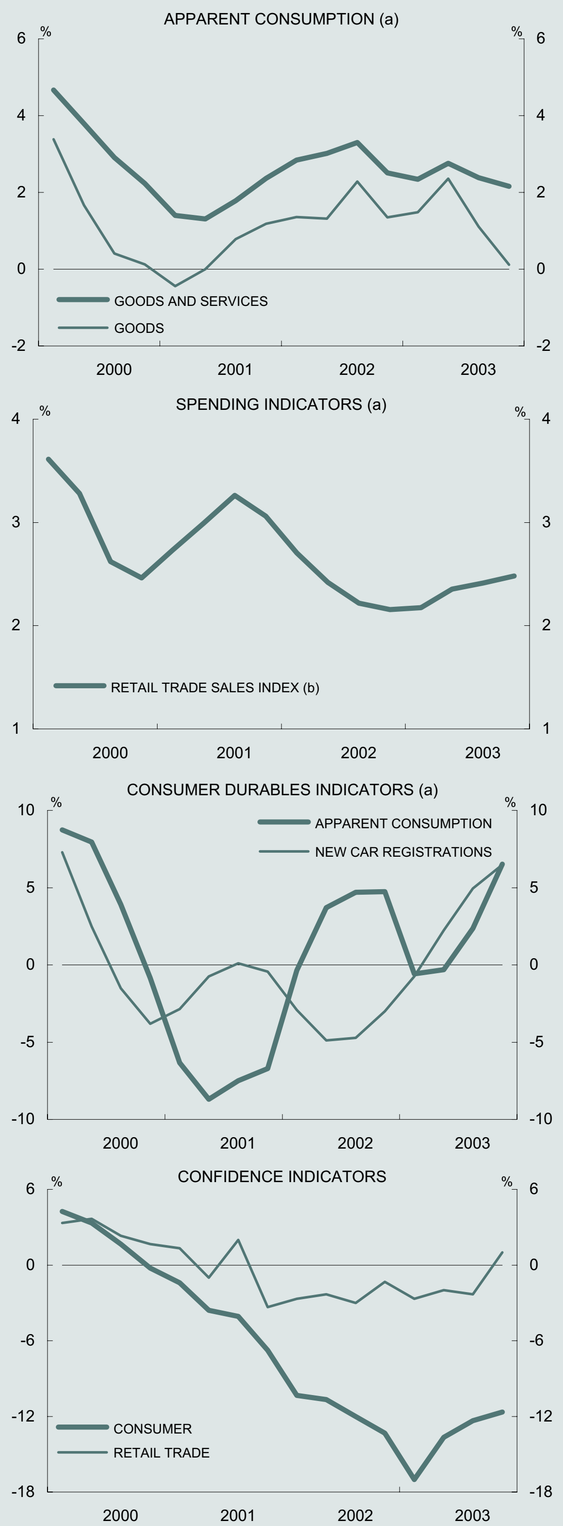
In 2003 Q3, final general government consumption posted growth of 3.6% year-on-year, 0.1 pp down on the previous quarter, and it is estimated that this slightly slowing trend may have run into Q4, in line with the course of salaries and wages observed in the State budget outturn.

Gross fixed capital formation rose by 3.1% year-on-year in Q3 last year, 0.3 pp less than in Q2, thereby checking the path of recovery initiated in the summer of 2002. The loss of momentum was confined to investment in capital goods, which slowed by 1.6 pp and grew by 1.5% in relation to the same period a year earlier. Spending on construction meanwhile, increased by 3.9%, 0.1 pp up on the previous period, and investment in other products – which mostly includes spending on services related to construction – rose by a somewhat greater degree. It may be inferred from the information available that gross fixed capital formation posted a growth rate in the final months of 2003 similar to that of the previous quarter, without significant changes in its main components.

According to the indicators for investment in capital goods, there may have been an additional slight loss of pace in 2003 Q4 (see Chart 16). In particular, with as yet incomplete information, the index of apparent investment in capital goods would have lost steam in this period, despite the sustained behaviour of domestic output. Among the most representative indicators of demand conditions, considerably

CHART 15

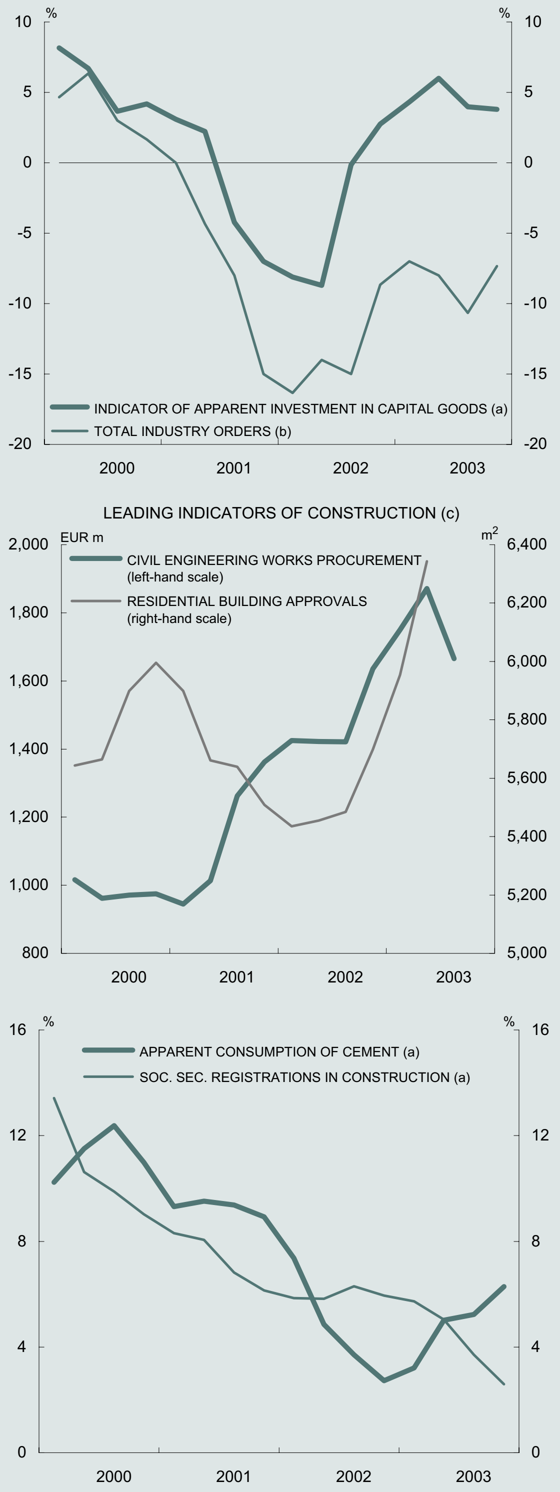
Private consumption indicators



Sources: INE, European Commission, Dirección General de Tráfico and Banco de España.
(a) Non-centred year-on-year percentage change based on the trend of the indicator.
(b) Deflated by the CPI.

CHART 16

Gross fixed capital formation indicators



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

(a) Non-centred year-on-year percentage change based on the trend of the indicator.

(b) Level of original series.

(c) Annual moving averages.

mixed behaviour is discernible. Thus, capital goods producers' forecasts for orders improved in the closing months of the year, as did orders in industry overall. However, capacity utilisation in industry has fallen slightly (though it is still above its historical average) and the business confidence indicator worsened in Q4 in relation to the previous quarter.

The information on non-financial corporations compiled by the Central Balance Sheet Data Office, referring to the first three quarters of 2003, indicates that, against a backdrop of moderately recovering activity, the corporations sampled maintained a favourable financial position. Ordinary returns on equity remain at high levels, while lower interest rates have placed the cost of borrowed funds at a historical low. Consequently, the spread between the return-on-investment and cost-of-debt ratios continued to show positive and growing values in respect of previous periods. As a result, Spanish corporations remain favourably poised ahead of the recovery in the global economy and, in particular, in the euro area.

As regards investment in construction, the robust growth by this aggregate throughout 2003 was accompanied by a slightly accelerating trend up to Q3, which may have extended into the final quarter. Attesting to this among the coincident indicators of construction are the apparent consumption of cement and the production of certain construction materials. However, the employment indicators appear to have lost momentum in relation to Q3, especially the number of social security registrations (see Chart 16).

The indicators relating to construction project starts would confirm the maintenance of a high rate of increase in construction, at least as far as residential building is concerned. The statistics on building permits and approvals (with information to October and July, respectively) indicate that the surface area of residential building to be built grew in 2003 at a far higher rate than in 2002. As to non-residential building, the indicators also point to a recovery compared with 2002. Finally, the value of civil engineering works tendered by general government and State-owned enterprises increased by only 2.9% to September owing to the loss of momentum observed in 2003 Q3 and despite the strong growth recorded in the first half of the year.

On QNA results, stockbuilding made a positive contribution of 0.2 pp to the year-on-year growth of GDP in 2003 Q3. This was consistent with the information provided by the monthly business survey, which showed an increase in actual – in relation to desired – levels of stocks in industry over the course of the year.

As earlier mentioned, net external demand subtracted 1.1 pp from year-on-year GDP growth, against a background of strongly decelerating real foreign trade flows. The slowdown was sharper in the case of exports, the growth rate of which came to stand at 2.5% year-on-year, than imports, the rate of increase in which eased to 5.7%. In any event, the advance of exports continued to outperform the growth of world trade, despite the sharp deterioration in the competitiveness of Spanish products vis-à-vis the developed countries as a whole owing to the considerable strength of the euro in this period. The as yet incomplete information for 2003 Q4 points to the somewhat less contractionary behaviour of net external demand, in an international setting marked by the incipient recovery in the euro area. According to this information, the moderation of foreign sales seen the previous quarter would have continued, while imports would have undergone a sharper slowdown, partly reflecting the comparison with the high levels attained in the same period a year earlier (see Chart 17). Nonetheless, a further contractionary effect on exports, arising from the marked appreciation of the euro in recent months, should not be ruled out.

On QNA estimates, the pace of real goods exports eased notably to a rate of 3.8% in 2003 Q3 compared with the same period in 2002, down from a rate of 10.8% the previous quarter. Customs figures also showed a slowdown in this period, which would have firmed in October when foreign sales posted a year-on-year increase of 4% in real terms, very close to the figure for Q3. A degree of caution is required when assessing this single figure for Q4, although the trend of the indicator (see Chart 17) points to easing, in step with the slowness of the pick-up in the euro area and with the loss of competitiveness derived from the sharp appreciation of the euro. Over the first ten months of the year, goods exports grew by 7% in real terms, the combination of a 5.5% increase in sales to Community markets (most notably to Germany, Italy and France) and 10.3% growth in non-Community exports, against a background of strongly declining export prices in euro. Sales to China, Africa and the central and eastern European countries were very buoyant, while exports to the newly industrialised countries weakened notably. In terms of product groups, real exports of capital goods increased by 16.8% in the January-October period. Consumer goods were also firm, mainly as a result of the expansionary behaviour of car sales. Finally, real sales of non-energy intermediate goods slowed.

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.

In 2003 Q3 the pick-up in tourism receipts observed the previous quarter slackened, increasing at a rate of 0.7% year-on-year. This result is consistent with the slowdown in the tourism indicators in this period. The as yet incomplete data for Q4 point to a fresh deterioration in the real indicators: the number of overnight stays by foreign visitors in hotels, the closest indicator of expenditure, resumed a negative course in October and November, while numbers of foreign tourists entering Spain at borders flattened out in this period. As regards countries of origin, British tourists were on the up compared with the fall-off in other European markets. Economic stagnation in the euro area would be the main determinant of this behaviour by incoming tourism, although the adverse trend of the competitiveness indicators – mainly against competitor countries – due to the growing strength of the euro would also be influential here. The slowing profile of services not related to tourism steepened in 2003 Q3, turning negative in real terms (–2.4%), in line with the continuing decline in the nominal Balance of Payments indicator.

The real rate of goods imports slackened to 7.2% year-on-year in 2003 Q3 from 11.5% the previous quarter. Goods imports nevertheless remained strong owing to the resilience of domestic demand and the notable appreciation of the euro. Customs figures also revealed a slowdown in imports during Q3 (7.8%), which became notably more severe in October, with real growth scarcely positive (0.8%). The deceleration in the final month was the outcome of the heavy slowdown in capital goods purchases and the fall-off in non-durable consumer goods and intermediate goods. However, over the course of the first ten months of 2003, the real increase in imports was high, with a notably sharp rise in capital goods purchases (17.3%). Real consumer goods imports grew by 9.9% over this same period, with purchases of foodstuffs and also consumer manufactures and cars to the fore. Nonetheless, non-energy intermediate goods were on a notably slowing path during the year, posting a cumulative increase of 5.2% to October. Real energy intermediate goods imports increased by 0.4% from January to October. They were affected by the strong decline in Q1, which coincided with a sharp climb in oil prices.

Lastly, real services imports declined by 2.6% in Q3, with the slowing profile that initiated the previous quarter steepening. There was a slide in imports of non-tourist services (–2.6%), in step with developments in this caption in the Balance of Payments. Tourism expenditure grew by 5% in real terms, boosted by the appreciation of the euro.

4.2. Output and employment

As indicated at the start of this section, activity picked up in Q3 in the main productive branches, with the exception of industry (see Chart 18). In the agriculture and fisheries branches, the improvement in activity in the first half of 2003 continued into Q3, when the related GVA grew by 1.8%, even though the weather was not as favourable as it might have been for many crops. This expansionary behaviour will have continued into the closing months of the year, favoured by the excellent olive harvest. The expansionary performance of grape and citric fruit yields will have largely offset the lower output in other crop yields. Livestock production has been losing momentum, with a notable contraction in milk output since end-2002. The initial outlook for 2004 is bright, given the start of the hydrological year, in which 23% more rainfall than the historical average was recorded for the October-December period as a whole.

After a period of stable growth, the industry and energy branch lost steam in 2003 Q3, with its year-on-year growth rate falling by 0.6 pp to 1.5%. Related to this loss of vigour was the slowdown in exports, which had been driving industrial activity. Nonetheless, in the closing months of 2003, fresh impetus is discernible. Among the conjunctural information available, the industrial production index posted improvements in October and November, leaving behind the slowdown seen in Q3. This momentum was centred on the production of capital and intermediate goods, while there was a decline in the output of consumer goods. The business confidence indicator compiled by the European Commission fell back slightly in the closing months of 2003 (although the business climate index released by the Spanish Ministry of Science and Technology tended to improve). In any event, the apparent expansion of activity would not be passing through in full to employment which, according to information on Social Security registrations, remained in Q4 on the contractionary course seen in the previous quarters.

Like construction spending, construction activity was once again highly buoyant in 2003 Q3 and even accelerated slightly. The year-on-year growth rate of its GVA increased by 0.1 pp to 4%, on QNA figures, meaning it remains the economy's most robust sector. The information available for Q4 confirms that the vigour of construction remains intact, although certain coincident indicators now point to a slowdown. As discussed in connection with expenditure, the leading indicators show that residential building retains expansionary potential, while greater slackness is the case for the other building headings. The pace of government procurement of civil engineering works also diminished notably.

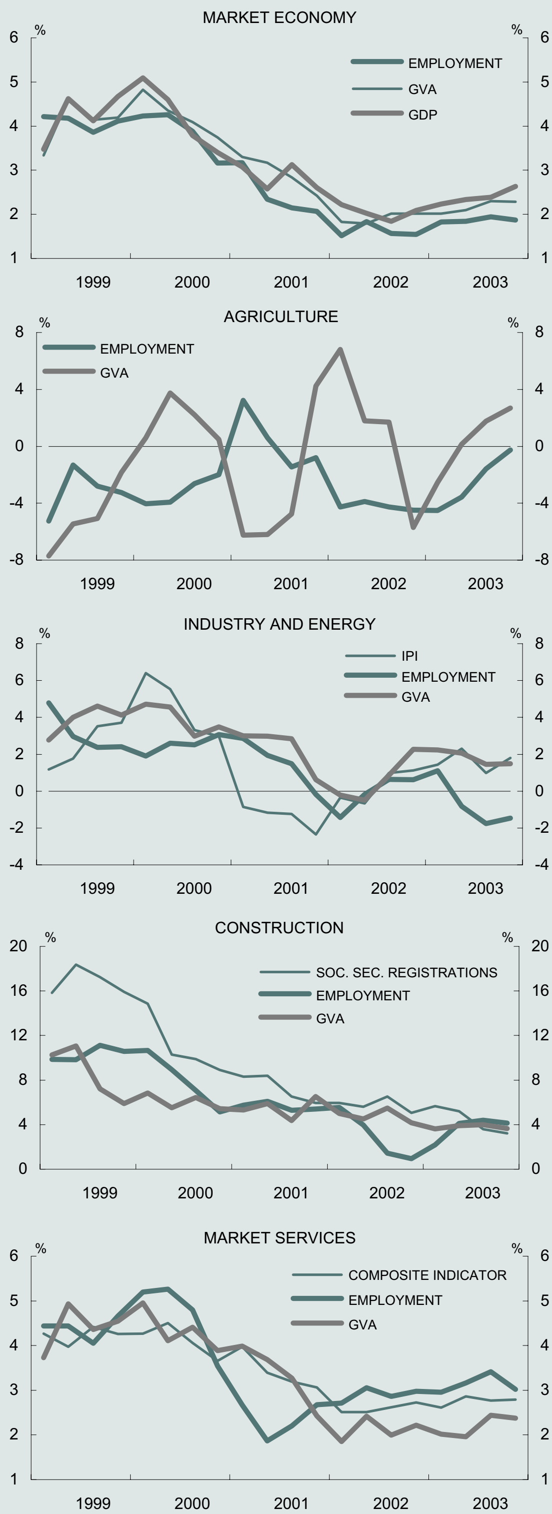
Services activity quickened by 0.4 pp in Q3, growing at a rate of 2.3% year-on-year. This acceleration was extensive to market and non-market services alike, although it was much more marked in the former, with an acceleration of 0.4 pp to 2.4%, while in the latter it was only 0.1 pp (to 1.8%). On the information available, market services would also have expanded in the final months of 2003. Specifically, the number of Social Security registrations in these activities showed renewed vigour in Q4 after having slowed in Q3, and the confidence indicator for the sector improved appreciably in this same period; the pace of the composite market services indicator (ISIS) was alone in stabilising in Q4. At the disaggregated level, most activities included in market services were more vigorous in the final quarter of the year. The distributive trade and repairs branch would have overcome the loss of momentum experienced in Q3, according to the retail sales index and Social Security registrations. And the retail trade confidence indicator also showed an improvement in Q4, based on a more favourable assessment of current business trends. In the real estate branch, rentals and corporate services likewise fared favourably, as reflected by Social Security registrations, which even increased in the IT and R+D sector. The hotel and restaurant trade also closed 2003 on a note of recovery, as reflected by Social Security registrations. However, qualifying this expansion was the loss of steam in overnight stays in October and November. Finally, registrations in transport and communications were less buoyant in Q4.

On QNA figures, the path of recovery of employment that began at the start of the year firmed in 2003 Q3; year-on-year growth of 1.9% was recorded, up from 1.7% the previous quarter. The acceleration in employment was somewhat sharper than that in GDP, whereby apparent labour productivity once again grew modestly (0.5%), in line with its behaviour in recent years. In the market economy, employment quickened slightly to 1.9% meaning that, in this case too, the gains in apparent labour productivity were very limited (0.3%), in step with the related figure for 2002, although outpacing the growth in the first half of the year.

The main indicators reflected the relative strength of employment in Q3, albeit with some differences. The EPA (Labour Force Survey) revealed a year-on-year increase in numbers employed of 2.8% in this period, 0.2 pp up on Q2,

CHART 18

Gross value added and employment by branch of activity
Percentage change on year ago (a)



Sources: INE and Banco de España.
(a) Seasonally adjusted series. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.

CHART 19

Wages and labour costs (a)

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

(a) Percentage change on year ago.
(b) Rates based on QNA seasonally adjusted series.
(c) Previous year's indexation clause.
(d) Increase in year to date.
(e) Per employee per month.

while Social Security registrations slowed slightly to 2.8%, though their growth remained high. In the final quarter of the year registrations did, nevertheless, pick up slightly, posting average growth of 2.9% for this period, despite the strong reduction in December. According to INEM hiring statistics, the number of signed contracts recovered mildly in Q3, after declining in Q2, and firmed in Q4. In this latter period, growth in the number of contracts compared with the same period a year earlier was 8.1%, due largely to temporary hires. The EPA data for Q4, released as this Bulletin was going to press, showed a fresh acceleration in employment, with a year-on-year growth rate in numbers employed of 3%, 0.2 pp up on Q3. Overall, it is estimated that employment in 2003 Q4 will have grown at an even higher rate than the previous quarter. That, set against the additional pick-up in GDP, entails a prolongation of the trajectory of limited apparent labour productivity gains in the market economy.

Across the branches of activity, the number of jobs in Q4 accelerated anew in services and agriculture, while the strong growth rate of employment in construction held stable and the process of job destruction in industry – a decline of 3% – became more severe. The trend of employment in Q4 means the very high growth of productivity in this branch is maintained, while the slippage in apparent labour productivity seen in previous quarters in construction and services will have continued.

The rise in employment in Q4 was once again notable among dependent employees, with a related year-on-year growth rate – according to the EPA – of 3.4%, against 3.5% the previous quarter. The numbers of self-employed increased by 1%, up on Q3. According to these figures, the proportion of wage-earners with a permanent contract continued to behave favourably, as in the preceding quarters, growing at a rate of 3.4%. This percentage was, however, 0.5 pp down on the previous quarter. Meanwhile, the number of workers with temporary contracts quickened again, growing by 3.3%. Overall, the positive contribution of temporary employment to the year-on-year growth of dependent employment increased, while the ratio of temporary to total employees held at 30.7%. The information on INEM contracts broadly coincides with the foregoing: in Q4 there was slight growth of 0.2% in permanent contracts (meaning they accounted for 8.3% of total signed contracts), while temporary contracts increased by 8.8%. These developments affecting contracts and wage-earners translated, however, into a fresh decline in labour market turnover. Nonetheless, the lesser weight of contracts of a duration of less than one month has been accompanied by an increase in contracts entered into for one week or less.

The labour force has retained a notable degree of dynamism. According to the EPA, it posted a year-on-year increase of 2.7% in Q3, representing a mild slowdown on the previous quarter (2.5%). The strength of the labour supply is the result of the rising path of the participation rate, which stood at 55.4% in Q4, up 1.1 pp on the previous year. This rise in labour market participation is proving more intense among women, the young and the most highly trained, although very sizable differentials persist between different groups in respect of labour participation: women, the over-45s and people with a lower level of education show notably lower-than-average participation rates. The unemployment rate in Q4 was, at 11.2%, 0.3 pp below its level a year earlier, while the average unemployment rate for 2003 was 11.3%, 0.1 pp below the related 2002 figure. Registered unemployment at INEM offices was unchanged on recent quarters, with an increase of 1.4% year-on-year, after growing by 1.3% the previous quarter.

4.3. Costs and prices

On QNA estimates, labour costs per unit of value added grew by 3.3% in Q3 across the whole economy, somewhat down on the preceding quarter. This was the result of an easing in the rise in compensation per employee, which increased by 3.7%, against a background of stable apparent labour productivity. In the market economy unit labour costs rose by 3.3% and compensation by 4%, moving on an equally moderate profile (see Chart 19).

According to the Labour Costs Index (LCI), the main indicator of compensation per employee in market activities, the increase in monthly labour costs per employee in 2003 Q3 was 3.6% compared with the same period a year earlier, the outcome of a 0.1% rise in the wage component and a 5.2% increase in non-wage costs. These figures mean labour costs have slowed by 1 pp compared with Q2. The source of this slowdown in wage costs was in ordinary wage costs and in the smaller increase in supplementary payments, while arrears quickened slightly. Other costs slowed by 0.3 pp. Across the branches of activity, the growth of average monthly labour costs fell by 1.1 pp in industry and services (to 4.4% and 2.9%, respectively), while their growth increased slightly in construction.

Regarding the information on collective bargaining agreements, those registered to 31 December 2003 incorporated an average wage settlement of 3.5%, 0.4 pp up on 2002, before including indexation clauses. These agreements affected somewhat over 8 million employees, most of them with revised agreements. On data to November, the agreed increase in revised agreements stood at 3.5%, while in newly signed agreements it was 3.6%, a rise above that agreed by the social partners in the 2003 Interconfederal Pact for Collective Bargaining. That said, the rise may, in certain cases, be reflecting the effect of the difference between actual inflation in 2002 and the official forecast. The effect of the application of the wage indexation clauses due to the deviation by inflation in 2002 from the agreed wage increase for that year is estimated to be 0.7 pp, which raises the average growth of wage rates that year to 3.8%. The proportion of collective agreements with indexation clauses in 2003 is expected to be similar to that of the previous year (higher than

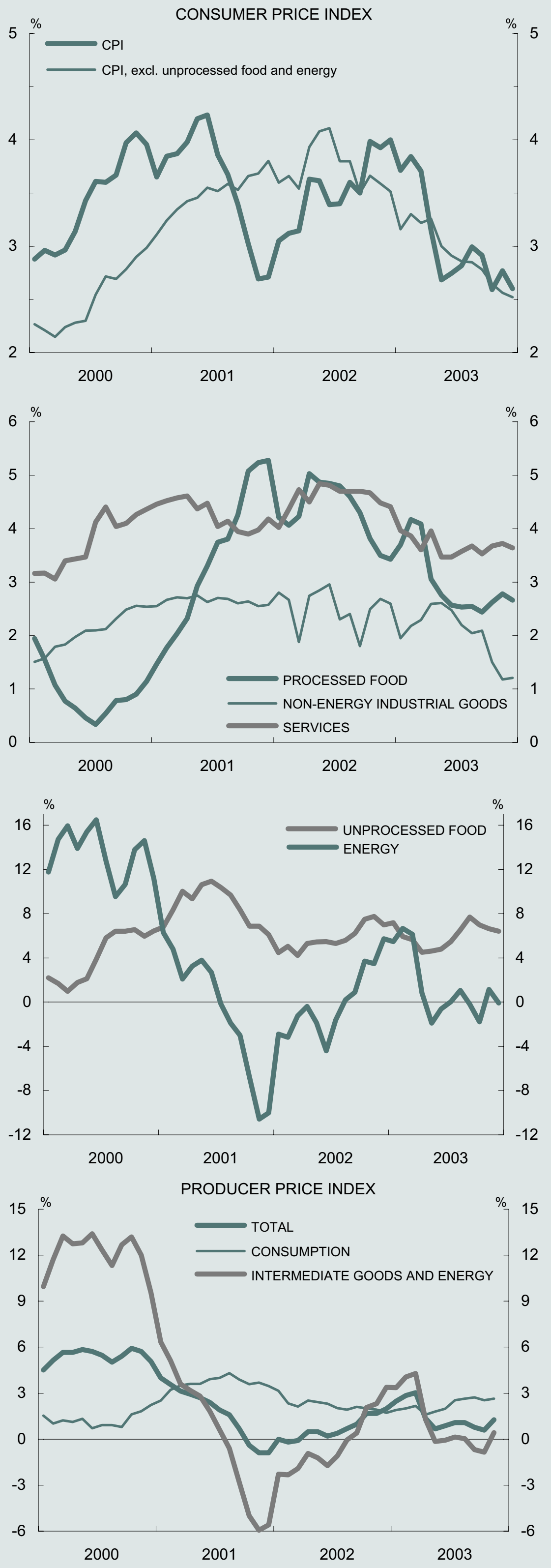
CHART 20

Prices and costs by branch of activity (a)

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

CHART 21

Price indicators (a)
Spain



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

70%), although their impact will foreseeably be much less, given the more favourable course of inflation.

Against the backdrop of the slight slowdown described above for labour costs, the increase in the value added deflator – a measure of the domestic pressures on prices – likewise tended to ease in 2003 Q3, moving on the same trajectory as in the first half of the year. However, the unit operating margin continued to widen in the economy as a whole. In the market economy, the deflator slowed by 0.1 pp (growing at a year-on-year rate of 4.2%), and there was also a rise in the unit surplus (see Chart 20). As this chart depicts, the value added deflator in industrial and energy activities slowed by 0.3 pp in Q3, to a rate of 1.5%, while unit labour costs decelerated to a lesser extent, meaning that the unit surplus recovered and sustained a higher growth rate than that of prices. As earlier indicated, there was a significant productivity gain in these activities, which lies behind the easing of labour costs and which was brought about through a net reduction in employment. In market services, the deflators grew somewhat less than in the previous quarter, while unit labour costs slowed to a greater extent with the unit margin continuing to narrow . Finally, in construction, unit labour costs quickened, accompanied by a decline in apparent labour productivity. Meanwhile, the deflator slowed, such that the widening of the unit margin was less sharp than in recent periods.

In 2003 Q3, the final demand deflator quickened by 0.2 pp to a year-on-year rate of 2.9%, in spite of the slowdown in the GDP deflator and, therefore, of domestic cost pressures. This reflects the behaviour of foreign prices, the rate of decline of which underwent a marked reduction in Q3. The strength of the euro against the dollar and the stabilising of oil prices on international markets were the main determinants of the favourable trend of import prices, particularly of energy goods. Significantly, however, the import prices of non-energy intermediate goods continued to post sustained growth rates.

Among final prices, those relating to private consumption, measured by the related deflator, quickened by 0.1 pp in 2003 Q3 to 3.1%, following the heavy downward correction they underwent in the first half of the year. This change coincides with that shown by the main indicator of these prices, namely the CPI, the growth rate of which stabilised at 2.9% in Q3. In Q4, however, the indicator slowed further, with its year-on-year rate of change standing at 2.6% in December (see Chart 21).

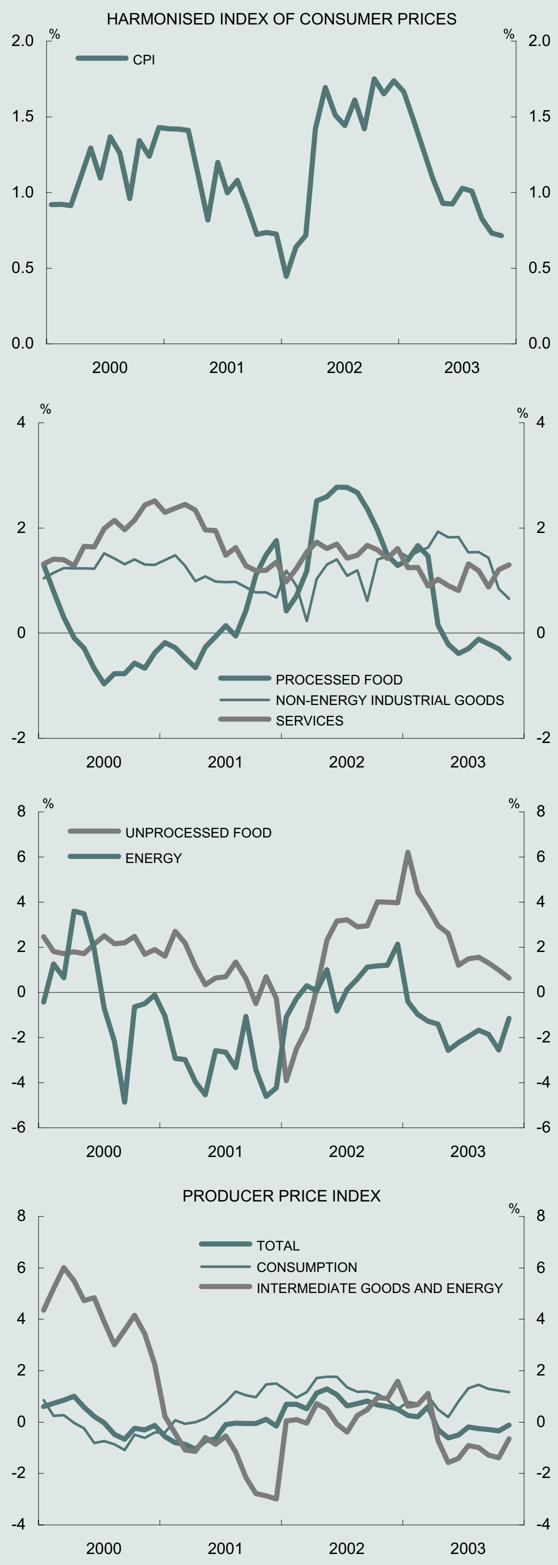
Among the CPI captions, industrial goods prices trended very favourably in Q4, especially those of non-energy goods, due to the moderate behaviour of clothing and footwear prices. Energy consumer prices, though fluctuating more, also slowed over the quarter as a whole. In this period crude oil prices on international markets showed relative stability, punctuated only by specific occasional pressures, which were more than offset by the depreciation of the dollar. Nonetheless, these pressures heightened in the opening days of 2004 when the price of a barrel of crude exceeded $32. The rise in unprocessed food prices tended to move onto a normal footing in 2003 Q4, following the marked declines in the summer months. Finally, services and processed food prices rose slightly, this being more than offset by the improvement in other components. Notably, the slowdown in the overall CPI in Q4 was accompanied by a decline in the pace of the CPI excluding unprocessed food and energy, which posted a 12-month rate of 2.5% in December.

Spanish inflation measured by the HICP fell by almost 0.3 pp from September to December, while in the euro area as a whole the reduction was 0.2 pp. As a result, the inflation differential narrowed further to 0.7 pp (see Chart 22). Component by component, the differential in the case of services has widened, while in relation to goods it has narrowed substantially. The inflation differences for both energy and processed food remained favourable to Spain, worsening somewhat in the case of the former and improving slightly for the latter. The slippage by unprocessed food prices in the euro area extended into Q4, whereas in Spain there was a correction, meaning that the related differential narrowed by more than 1 pp. Lastly, the slowdown in non-energy industrial goods prices in Spain has meant that the differential here has narrowed, standing at less than 1 pp at the close of the year.

Among the remaining price indicators, the producer price index ended 2003 with a 12-month increase in December of 1.1%, partly reversing the acceleration recorded in the previous months. The slowdown in December essentially arose as a result of the behaviour of energy producer prices. Consumer goods manufacturing prices grew steadily at around 2.6% to November, standing at 2.4% in December, while intermediate goods prices continued to perform very moderately, as did capital goods prices. In the euro area the trend of industrial output prices was fairly similar to that in Spain, posting a year-on-year rate of 1.4% in November. Nonetheless, the acceleration in energy producer prices to November was somewhat sharper in Spain, contributing to a slight deterioration in

CHART 22

Price indicators
Differentials vis-à-vis 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.

TABLE 3

State budget outturn

EUR m and %

	Outturn 2002	Percentage change 2002/2001	Initial projection	Percentage change 2003/2002	Outturn JAN-SEP Percentage change 2003/2002	Outturn 2002 JAN-NOV	Outturn 2003 JAN-NOV	Percentage change
	1	2	3	4=3/1	5	6	7	8=7/6
1. Revenue	**108,456**	**-13.4**	**108,437**	**0.0**	**1.6**	**99,585**	**101,115**	**1.5**
Direct taxes	55,531	-0.3	57,082	2.8	3.5	50,620	51,388	1.5
Personal income tax	*32,268*	*-11.5*	*33,079*	*2.5*	*7.4*	*30,362*	*30,582*	*0.7*
Corporate income tax	*21,420*	*24.4*	*22,151*	*3.4*	*-1.9*	*18,520*	*19,230*	*3.8*
Other (a)	*1,843*	*-8.4*	*1,852*	*0.5*	*-8.7*	*1,737*	*1,576*	*-9.3*
Indirect taxes	38,026	-28.5	38,269	0.6	-0.5	36,429	37,656	3.4
VAT	*25,720*	*-25.8*	*26,296*	*2.2*	*1.7*	*25,064*	*26,662*	*6.4*
Excise duties	*10,347*	*-37.7*	*9,819*	*-5.1*	*-7.7*	*9,569*	*9,027*	*-5.7*
Other (a)	*1,959*	*4.7*	*2,154*	*9.9*	*8.7*	*1,796*	*1,968*	*9.6*
Other net revenue	14,898	-8.8	13,086	-12.2	0.6	12,537	12,071	-3.7
2. Expenditure	**111,082**	**-13.3**	**113,647**	**2.3**	**1.2**	**99,917**	**102,017**	**2.1**
Wages and salaries	17,554	4.3	18,536	5.6	5.4	15,328	16,079	4.9
Goods and services	2,843	11.3	3,123	9.9	9.3	2,355	2,484	5.5
Interest payments	18,863	3.3	19,990	6.0	1.2	18,681	19,284	3.2
Current transfers	58,324	-24.4	58,246	-0.1	-1.6	52,560	52,227	-0.6
Contingency fund	--	--	--	--	--	--	--	--
Investment	7,043	9.0	7,227	2.6	10.5	5,739	6,279	9.4
Capital transfers	6,455	-5.3	6,525	1.1	3.8	5,254	5,664	7.8
3. Cash-basis balance	**-2,626**	--	**-5,210**	--	--	**-332**	**-902**	--
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Revenue	108,387	-12.5	109,770	1.3	1.4	100,469	101,677	1.2
Expenditure	111,807	-12.4	113,390	1.4	1.6	94,757	96,521	1.9
Net lending (+) or borrowing (-) (c)	**-3,420**	--	**-3,620**	--	--	**5,712**	**5,156**	--

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 in accordance with the method used in the Excessive Deficit Procedure.

the inflation differential. Prices received by farmers, though continuing to show sizable growth (11.9% in October), saw their pace notably curtailed. Finally, hotel prices trended fairly steadily at around 2% in the closing months of 2003.

4.4. The State budget

After the approval and enactment in late December of the State Budget Law for 2004 (see Box 3), the Updated Stability Programme for the Kingdom of Spain was unveiled in January, with fiscal projections for the period 2003-2007. The Programme, which does not alter the macroeconomic scenario used in preparing the Budget, augurs a 2003 budget surplus of 0.5% of GDP (compared with the figure of 0% forecast) and confirms the objective of a balanced budget for 2004. In terms of agents, the general government surplus in 2003 would have been the result of the State and Social Security balances (for which a deficit of 0.4% and a surplus of 0.9%, respectively, are projected – see Box 4), since it is assumed that the territorial government balance would remain in equilibrium. It is envisaged that the change from a surplus to a balanced position in the general gov-

BOX 3

Expenditure budget and main budgetary measures for 2004

This box briefly presents information on the State Budget relating to the various general government discretionary measures impacting economic activity. In particular, the State spending ceiling, consolidated spending policies, budget incentives for business investment and, finally, the main budgetary measures for 2004 are all reviewed.

On the expenditure side, and in accordance with the guidelines laid down in the Budgetary Stability Law, a Parliamentary Plenary Session in Spring 2003 set the State non-financial expenditure ceiling at €117.26 billion for 2004, 2.4% up on the ceiling for the previous year. This rate is lower than that forecast for nominal GDP, and should thus contribute favourably to fiscal consolidation.

The State Budget offers a comparison of the initial budget for consolidated spending of the State, its related agencies and the Social Security system by function for the years 2003 and 2004. According to this information, the spending policies evidencing most momentum, with growth higher than nominal GDP, will be those for justice and combating street crime, social spending (particularly spending earmarked for promoting employment and for temporary disability) and infrastructure and research investment measures. The weight of spending set aside for debt service and for territorial government (the latter affected by the changes in the attendant financing arrangements) will decrease. The overall result will be a reduction in consolidated spending of 0.5 pp of GDP. Nonetheless, if the items relating to debt financing and territorial government are stripped out of this total, spending will grow by 6.2%, above the forecast for nominal GDP. Against the backdrop of a pick-up in economic activity, that gives the spending budget a slightly expansionary stance.

It should be borne in mind, moreover, that the investment spending computed in the consolidated spending budget does not include investment in infrastructure by companies (public or private) that are not part of the general government sector of National Accounts, to which the State provides resources through financial transactions for the promotion of industrial infrastructure and technological projects. The volume of investment by this set of entities has grown substantially in recent years (by around 26% in annual average terms over the past three years). According to the information drawn from the State Budget, resources for this type of investment will increase by 16.9% in 2004 whereby, overall, the sum of investment by the corporate public sector and the State will grow by 11.3%.

The spending measures introduced by the 2004 Budget Law and the accompanying budgetary legislation relax, as they did last year, the restrictive criteria governing the hiring of general government personnel in force in previous years (the replacement rate remains at 100%). Also, wage rates rise in line with forecast inflation (2%), but an improvement has been made to civil servants' supplementary payments and an initial provision to the pension fund for this group, evaluated at €55 million by the Stability Programme. Regarding economic benefits, pensions are updated in step with the foreseeable performance of the CPI in 2004 (2%) and the lowest pensions, especially widows' pensions, are improved. Finally, mention may be made of the provision to the Pension Reserve Fund, which will rise to €3.01 billion this year.

Regarding revenue, there are very few changes in the State Budget. In relation to promoting employment, the forecast increase in employers' social security contribution rebates for the permanent hiring of employees is over 20% (1) (in line with what is stipulated in the Agreement for the Improvement and Development of the Social Protection System). The reduction relating to the corporate contribution to common-contingency social security contributions for workers over 60 years of age is also raised. Conversely, under personal income tax, it has been decided not to update the tax schedule (2) or the personal and family tax-free allowances, and, under corporate income tax, new tax incentives have been introduced for R+D+i activities. Finally, excise duty rates have been frozen, which will naturally have a contractionary effect on revenue.

(1) Royal Decree-Law 2/2003 on Economic Reform Measures introduced a full rebate on contributions for one year in the case of women taking up their job again after maternity. Further, among the measures approved by this legislation is the extension of temporary-disability coverage for the self-employed; the contribution rates for this contingency duly increase by 1.5 percentage points.

(2) The partial reform of personal income tax implemented in 2003 will have an additional impact of €800 million in 2004.

TABLE 4

Balance of payments: summary (a)

EUR m

	JANUARY-OCTOBER	
	2002	2003
	Credits	Credits
Current account	**196,443**	**206,109**
Goods	110,281	116,962
Services	55,754	57,650
Tourism	*30,540*	*31,777*
Other services	*25,215*	*25,874*
Income	17,280	18,522
Current transfers	13,128	12,975
Capital account	**7,970**	**7,247**
	Debits	Debits
Current account	**206,781**	**222,766**
Goods	137,264	147,756
Services	33,035	34,188
Tourism	*5,954*	*6,141*
Other services	*27,081*	*28,048*
Income	26,195	28,859
Current transfers	10,287	11,963
Capital account	**854**	**859**
	Balance	Balance
Current account	**-10,338**	**-16,657**
Goods	-26,984	-30,794
Services	22,720	23,462
Tourism	*24,586*	*25,636*
Other services	*-1,866*	*-2,174*
Income	-8,915	-10,338
Current transfers	2,841	1,012
Capital account	**7,116**	**6,388**

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

ernment accounts from 2003 to 2004 will come about due to the decline in the Social Security surplus from one year to the next.

On the information available according to National Accounts methodology, the State posted a surplus of 0.7% of GDP in 2003 to November, slightly lower than the previous year. This figure runs counter to the forecasts available for the year as a whole, although it is greatly influenced by the marked seasonality of State non-financial transactions. Conversely, in cash-basis terms the result was a deficit of €902 million to November. The discrepancy between the National Accounts and cash-basis criteria appears to be due essentially to the adjustment attributable to the different interest allocation criterion and the change in outstanding rights and obligations. Recent developments in State revenue and expenditure are discussed below using cash-basis information, due to the fact that the information published contains uniform data (1) on the revenue for fiscal years 2002 and 2003.

To November, revenue grew somewhat above the initial outturn projection, while the growth of expenditure was slightly more moderate than projected. As a result, the expected increase in the cash-basis deficit might be less than indicated in the initial projection. Greater revenue would have arisen from indirect taxes and non-tax revenue, while the containment of expenditure would be due to current expenditure, as capital expenditure grew at a higher-than-expected rate.

Compared with the figures to September, the growth of revenue has eased somewhat but expenditure has accelerated. For the analysis of revenue, information is available on total takings for the main taxes in terms both of those assigned to the State and those to the ordinary-regime autonomous communities (the data on the latter are not shown in Table 3). According to these figures, direct taxes have slowed slightly in recent months, unlike indirect taxes. Personal income tax edged down, reflecting the reduction in withholdings induced by the reform of this tax, while corporate income tax quickened notably because of the strong increase (of over 20%) in the October prepayment, owing to the course of corporate profits during 2003. VAT continued to quicken, in homogeneous terms, in the final months to a growth rate of 10.8% (far exceeding the initial projection of 7.7%). The growth of excise duties held virtually unchanged at a moderate rate, owing to the freeze on rates. Other revenue slowed over recent months due above all to the lower volume of capital transfers received by the State, virtually all of which were from the European Union.

On the expenditure side, mention should be made of the slowdown in operating expenses, particularly under the goods and services heading, which ran counter to developments in other current expenditure. Notable among the latter was the reduction in current transfers (by 0.6%), which was due to the change in territorial fi-

(1) In this respect, it should be recalled that both cash-basis and National Accounts figures are influenced by the fact that, for much of 2002, the transitory period in the application of the new autonomous (regional) government financing arrangements was in force. During this period, some ordinary-regime autonomous governments, which had not assumed responsibility for health care, received transfers from the State to finance it. As responsibility was gradually assumed, financing began to be through the indirect taxes transferred. This process hinders comparison of the figures for taxes, on the revenue side, and for transfers paid, on the expenditure side.

BOX 4

Social Security budget outturn

The Social Security System posted a surplus of €9.21 billion in 2003 in the period to September, up 17.7% on the same period a year earlier and in line with the result to July (see adjoining table). This notable improvement in the balance over the first three quarters of the year is in contrast to the reduction in the surplus forecast in the initial budget for 2003 compared with the outturn the previous year. As in the case of the State budget, the year-to-year comparison of the data on revenue and expenditure is affected by the culmination during 2002 of the effective assignment of health-care management to all the regional (autonomous) governments. Revenue accelerated once more in the final months and its growth stood at 2.8%, compared with its initially budgeted reduction. The growth rate of expenditure also rose, posting an increase of 0.5%, in contrast to the decline envisaged in the budget.

Receipts from social security contributions grew by 8.4% to September, a far higher increase than budgeted and signifying a considerable acceleration on 2002. However, the number of Social Security registrations grew over 2003 as a whole at the same rate (3%) as the previous year.

Expenditure on contributory pensions held at growth rate of 6.9% to September, slightly up on 2002. Nonetheless, and given that the deviation by inflation in 2003 was far less than in 2002, the annual amount of pensions-related spending will foreseeably and finally show a similar increase to that budgeted. The number of contributory pensions continues to trend very moderately, with their growth rate standing at 1% to October, slightly higher than budgeted and up on the growth the previous year.

Contributions received by INEM increased by 8.9% to July, compared with a budgeted projection of 13.5%. Meanwhile, rebates on contributions in respect of employment-promoting contracts increased by 13.3% to August, in contrast to the 0.4% growth budgeted.

INEM expenditure on unemployment benefits rose by 6.3% in 2003 in the period to October, significantly slower than the related figure of 14.6% for 2002. Behind this was both the slowdown in registered unemployment (which increased by 2.9% to October, compared with 7.4% for 2002 as a whole) and the eligibility ratio, which stood at 71.8% to October, practically unchanged on end-2002, after having risen substantially that year. As a result, the number of beneficiaries grew by 2.8% to October, 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 rights and obligations)

EUR m and %

	Outturn	Budget		Outturn JAN-JUL	Outturn JAN-SEP		
	2002	2003	% change	% change	2002	2003	% change
	1	2	3=2/1	4	5	6	7=6/5
1. Revenue	**80,280**	**77,096**	**-4.0**	**1.5**	**59,397**	**61,048**	**2.8**
Social security contributions (c)	71,703	72,174	0.7	8.5	52,754	57,204	8.4
Current transfers	7,701	4,294	-44.2	-51.4	6,075	3,325	-45.3
Other (d)	876	628	-28.3	28.7	569	519	-8.8
2. Expenditure	**73,374**	**73,187**	**-0.3**	**-1.0**	**51,574**	**51,842**	**0.5**
Wages and salaries	3,372	1,811	-46.3	-58.5	2,671	1,265	-52.7
Goods and services	2,361	1,403	-40.6	-45.9	1,564	936	-40.1
Current transfers	67,145	69,525	3.5	4.3	47,160	49,453	4.9
Benefits	67,131	69,524	3.6	4.3	47,159	49,452	4.9
Contributory pensions	*56,853*	*60,024*	*5.6*	*6.9*	*39,787*	*42,537*	*6.9*
Sickness	*4,754*	*4,623*	*-2.8*	*8.3*	*3,297*	*3,562*	*8.0*
Other	*5,524*	*4,877*	*-11.7*	*-22.3*	*4,076*	*3,353*	*-17.7*
Other current transfers	13	1	-89.4	—	0	1	—
Other (e)	495	448	-9.5	-0.2	180	188	4.6
3. Balance	**6,907**	**3,909**	**-43.4**	**21.8**	**7,824**	**9,206**	**17.7**

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 available only to May 2003.
(b) Transfers from the ISM 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) Including surcharges and fines.
(d) Excluding surcharges and fines.
(e) Reduced by the disposal of investments.

nancing. Once adjusted for this effect, the growth rate for this item would be 6.7%. Finally, capital expenditure is sustaining a very high growth rate, in contrast to the moderate growth forecast in the initial budget projection.

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

In the period from January to October 2003, the overall balance on current and capital account was a deficit of €10.27 billion, €7.05 billion more than the deficit in the same period a year earlier. This deterioration mainly reflects the heavy worsening in the current-account deficit, which widened by €6.32 billion to €16.66 billion. The surplus on capital transactions also worsened in the first ten months of 2003 to €6.39 million. Among the current-account items, there was a notable increase in the merchandise deficit and, to a lesser extent, in the income deficit, and a lesser surplus on current transfers. Meanwhile, the services surplus improved thanks to the favourable performance of the tourism surplus.

Over the first ten months of 2003 the trade deficit worsened by €3.81 billion in relation to the level attained a year earlier; in year-on-year terms, the deficit widened by 14.1%. The robustness of real import flows over the period as a whole – which outpaced exports despite the notable easing of imports in the last month – combined with the substantial rise in the energy bill in the opening months of the year would have been behind this notable widening of the trade deficit.

The surplus on the services balance in the period from January to October amounted to €23.46 billion, €742 billion up on the same period a year earlier. Conversely, the deficit on non-tourist services worsened. Tourism receipts performed well in this period, increasing at a year-on-year rate of 4.1%; however, the recovery slackened in the second half of the year, in line with the slowdown in the indicators of foreign visitors lodged in hotels and overnight stays. Tourism payments grew by 3.1% in this period, showing renewed momentum as from the second half of 2003, driven by the strength of the euro and against the background of the progressive normalisation of global geopolitical tensions.

The deficit on the income account deteriorated by €1.42 billion in the first ten months of 2003 compared with the same period in 2002 to €10.34 billion. Receipts rose by 7.2% thanks to the buoyancy of income flows in the non-financial private sector, while they declined in the other sectors because of lower earnings on investment abroad, the depreciation of the dollar and the fall in direct investment flows since 2002. Payments grew at a higher rate of 10.2%, in step with the notable increase in payments by the non-financial private sector.

The current-transfers surplus stood at €1.01 billion over the first ten months of the year, a marked reduction of around €1.83 billion on the level observed in the same period of 2002. Receipts declined by 1.2% as a result of the notable fall-off in Community flows from the European Social Fund, since transfers for the private sector from the EU's EAGGF Guarantee Fund behaved favourably. Payments grew at a very high rate of 16.3%, largely due to the significant rise in payments to the EU, particularly under the additional GNP resource. Prominent once again was the continuing strong rise in emigrants' remittances.

Finally, the capital-account surplus stood at €6.39 billion in the period January-October 2003, €727 million down on the figure for the same period in 2002. This deterioration, representing a year-on-year decline of 10.2%, is due to the heavy slide in Community transfers under the Cohesion Fund. The performance in respect of the other structural funds was marginally positive.

5. Financial developments

5.1. Overview

Financing terms for the private sector remained very generous in 2003 Q4. In particular, euro area money-market interest rates held at around the low levels reached between July and September, although at the longer terms there was a rise between October and November, which was reversed during the second half of December. Meanwhile, bank lending rates to the private sector were generally little changed, remaining at moderate levels. On public debt markets, yields continued the upward trend that began in Q3, although they fell in December. In the case of Spanish 10-year Treasury bonds, yields ended the year more than 20 bp above their end-September levels. Credit risk premia stayed on the downward course of previous months, which meant that the increase in interest rates on long-term public debt was not fully passed through to the cost of capital for companies issuing fixed-income securities (see Chart 23).

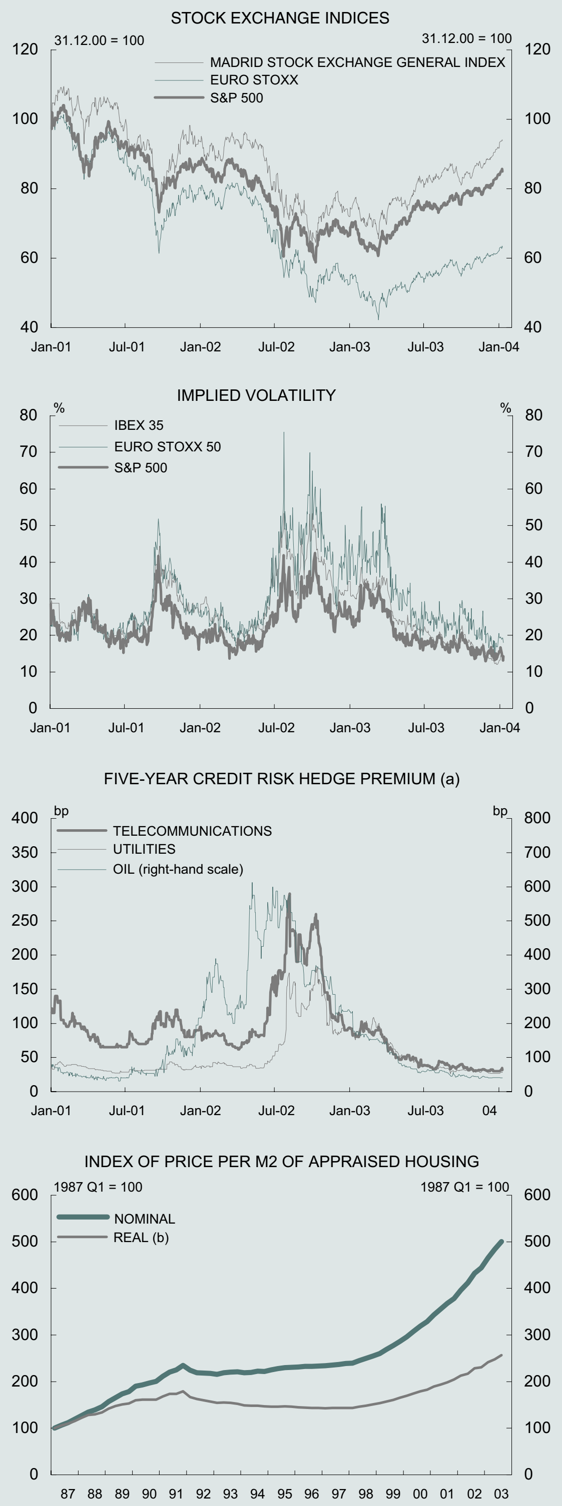
On national and international stock markets the upward path of prices during the previous two quarters continued during the last three months of 2003, reflecting the improved outlook for the world economy, so that most indices reached annual highs. The Madrid Stock Exchange General Index was up 27.4% from the beginning of the year, after posting negative returns in the preceding three years. This rise, similar to that recorded in the United States by the S&P 500 (26.4%), was larger than the increase in the euro area Euro Stoxx index (18.1%). The recovery in prices was accompanied by further reductions in volatility, which is currently below its historical average. On the housing market, prices decelerated somewhat in Q3, their year-on-year growth rate declining by 1.8 percentage points to 15.7% (see Chart 23).

Household spending decisions, in Q3 and Q4, were again underpinned by an expansion in the demand for credit. Thus, the year-on-year growth in the financing received by this sector increased between July and September by one percentage point to 16.1% and, according to the provisional information for the last three months of 2003, there may have been a further acceleration to above 18%. By contrast, the year-on-year rate of growth of corporate debt in September was unchanged from June (13.8%), and according to the initial Q4 data, it may have slowed during that period.

The latest indicators of the financial position of the private sector have been mixed. In the case of households, their net wealth continued to grow in Q3 thanks to the rise in the prices of housing and financial assets. At the same time,

CHART 23

Price indicators for 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.

their saving after debt service continued to pick up and, according to the initial Q4 data, the sector's debt burden as a proportion of its GDI remained at moderate values. However, between July and September, their financial saving was, like saving after debt service, at low levels, debt ratios continued to rise and, according to the provisional information available, carried on doing so during the last three months of 2003. In the case of corporations, between July and September, the debt service burden was again at moderate levels and profitability improved. However, their financing needs increased and, as in the case of households, their debt ratios also rose during Q3. The data available for Q4 point to a continuation of this trend.

All in all, the financial condition of the private sector does not currently seem to be an obstacle to the buoyancy of its spending. That said, the high and growing level of debt may constrain households' and firms' consumption and investment in two ways. First, the leeway for expansion to be sustained by borrowing is smaller, and second, consumption and investment decisions are more sensitive than in the past to any adverse changes in the sector's income, wealth and cost of capital. The sensitivity to interest rate changes will also have been increased in the case of households by the rise in the proportion of variable-rate loans.

5.2. Households

According to the available Q4 information, the terms of financing for households remained generous. The interest rate on bank loans to households for house purchase was unchanged in November from its September level of 3.46%, while the rate on consumer loans and loans for other purposes fell by 30 bp to 6.41%. However, according to the Bank Lending Survey in Q3, the banks were anticipating that overall supply conditions in the last three months of 2003 would be rather more restrictive than in the previous quarter in the case of housing finance and similar in that of consumer loans and loans for other purposes.

In 2003 Q3 the year-on-year rate of growth of the financing obtained by the sector accelerated by one percentage point to stand at 16.1% (see Table 6 and Chart 24). In cumulative twelve-month terms, the new funds obtained represented 9.1% of GDP, 0.8 percentage points more than between April and June. This rise is basically attributable to the behaviour of lending for house purchase, since consumer loans and lending for other purposes contributed to a lesser extent to the growth in the liabilities of the sector. The provisional information for

TABLE 5

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

% GDP

	NET FINANCIAL TRANSACTIONS								
	1998	1999	2000	2001	2002		2003		
					Q3	Q4	Q1	Q2	Q3
National economy	**0.2**	**-1.0**	**-2.5**	**-2.2**	**-1.5**	**-1.6**	**-2.1**	**-2.0**	**-2.4**
Non-financial corporations and households and NPISHs	**2.1**	**-0.3**	**-2.4**	**-3.6**	**-3.4**	**-3.1**	**-3.7**	**-3.8**	**-3.9**
Non-financial corporations	-1.1	-2.3	-3.5	-4.6	-4.0	-4.6	-4.4	-4.6	-4.8
Households and NPISHs	3.3	2.0	1.1	1.1	0.6	1.5	0.7	0.9	0.8
Financial institutions	**1.1**	**0.5**	**0.8**	**1.6**	**1.8**	**1.5**	**1.5**	**1.5**	**1.5**
General government	**-3.0**	**-1.2**	**-0.8**	**-0.3**	**0.1**	**0.0**	**0.1**	**0.2**	**0.1**
	INTER-SECTORAL FLOWS (a)								
Households and NPISHs	**3.3**	**2.0**	**1.1**	**1.1**	**0.6**	**1.4**	**0.7**	**0.9**	**0.8**
Vis-à-vis:									
Credit institutions (b)	-4.6	0.5	-0.2	-1.5	-3.6	-2.5	-3.4	-3.5	-4.1
Institutional investors (c)	7.6	0.9	0.4	3.5	3.1	3.1	3.8	4.2	4.7
Non-financial corporations	**-1.1**	**-2.3**	**-3.5**	**-4.6**	**-4.0**	**-4.6**	**-4.4**	**-4.6**	**-4.8**
Vis-à-vis									
Credit institutions (b)	-4.5	-4.1	-6.8	-3.9	-3.9	-3.5	-3.9	-4.2	-3.8
Rest of the world	0.7	-0.7	2.0	-2.3	-1.5	-1.1	-1.1	-0.6	-0.7
General government	**-3.0**	**-1.2**	**-0.8**	**-0.3**	**0.1**	**0.0**	**0.1**	**0.2**	**0.1**
Vis-à-vis									
Credit institutions (b)	1.4	1.4	2.2	-2.3	0.9	0.9	-0.6	-0.3	-2.1
Institutional investors (c)	-2.6	1.7	3.9	2.8	0.8	0.5	0.7	0.4	0.6
Rest of the world	-1.1	-4.3	-5.9	-1.6	-1.6	-1.1	0.1	-0.1	1.0
Rest of the world	**-0.2**	**1.0**	**2.5**	**2.2**	**1.5**	**1.6**	**2.1**	**2.0**	**2.4**
Vis-à-vis:									
Credit institutions (b)	7.1	1.9	5.1	3.8	3.4	2.9	4.6	4.3	6.5
Institutional investors (c)	-6.3	-3.6	-5.7	-5.0	-3.6	-2.8	-3.6	-3.2	-4.0
Non-financial corporations	-0.7	0.7	-2.0	2.3	1.5	1.1	1.1	0.6	0.7
General government	1.1	4.3	5.9	1.6	1.6	1.1	-0.1	0.1	-1.0

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 portfolio investment institutions.

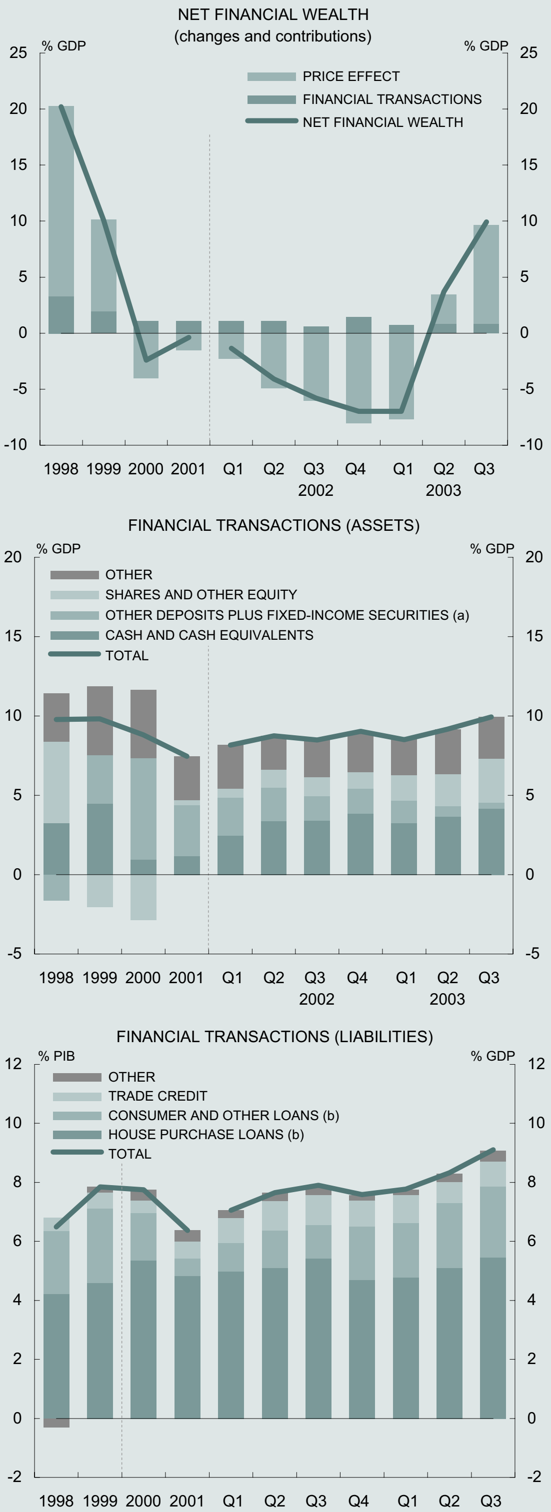
2003 Q4 points to a further pick-up in the rate of growth of household debt, especially as a result of the acceleration of housing credit

Regarding their portfolio decisions, in September, the rate of acquisition of financial assets by households stood at 9.9% of GDP, in cumulative twelve-month terms (see Table 6 and Chart 24). As for instruments, the shift seen in the previous quarter, from the heading “other deposits and fixed-income securities” towards cash and cash equivalents and, especially, shares in mutual funds, continued. Net purchases of mutual funds shares stood at 2.1% of GDP, as against 1.4% in the previous quarter. This growth was the result of greater investment in FIAMM (money-market funds) and especially in FIM (capital-market funds). Meanwhile, the acquisition of shares and other equity during the last twelve months was slightly up from June.

In Q3, the financial saving of households was negative, although in cumulative twelve-month terms it was 0.8% of GDP, a similar level to June (see Table 5 and Chart 24). The sector’s gross saving after debt service picked up again during this period, although it still remained at

CHART 24

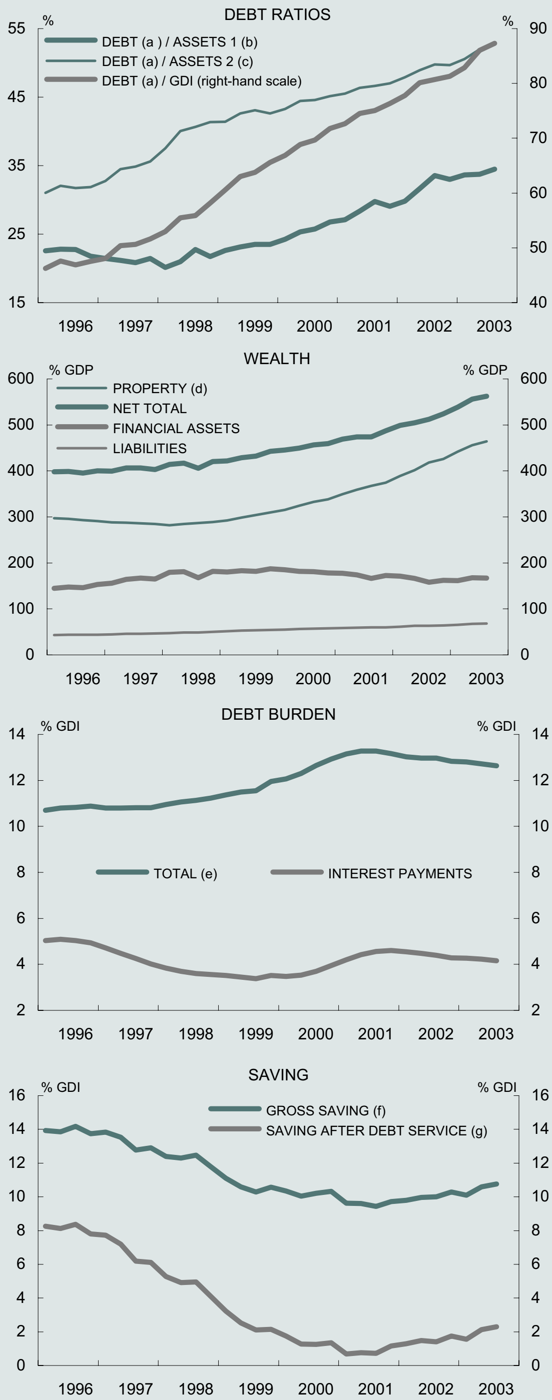
Households and NPISHs (cumulative four-quarter data)



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

	2000	2001	2002	2003 Q1	2003 Q2	2003 Q3
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	**8.8**	**7.5**	**9.0**	**8.5**	**9.2**	**9.9**
	0.9	1.2	3.9	3.3	3.7	4.2
Other deposits and fixed-income securities (a)	6.4	3.2	1.6	1.4	0.7	0.4
Shares and other equity (b)	0.5	-0.4	0.8	0.5	0.6	0.7
Mutual funds	-3.4	0.8	0.2	1.1	1.4	2.1
FIAMM	*-1.3*	*1.3*	*0.7*	*0.7*	*0.7*	*0.9*
FIM	*-2.0*	*-0.5*	*-0.5*	*0.3*	*0.7*	*1.2*
Insurance technical reserves	3.4	2.4	2.6	2.4	2.4	2.2
Of which:						
Life assurance	*1.9*	*1.4*	*1.5*	*1.3*	*1.4*	*1.3*
Pension funds	*1.3*	*0.7*	*0.9*	*0.9*	*0.8*	*0.7*
Other	0.9	0.4	0.0	-0.1	0.4	0.4
Financial transactions (liabilities)	**7.7**	**6.4**	**7.6**	**7.8**	**8.3**	**9.1**
Credit from resident financial institutions (c)	7.0	5.4	6.5	6.6	7.3	7.9
House purchase credit (c)	5.4	4.8	4.7	4.8	5.1	5.5
Consumer and other credit (c)	1.6	0.6	1.8	1.9	2.2	2.4
Other	0.8	1.0	1.1	1.1	1.0	1.2
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	**27.8**	**19.0**	**14.6**	**15.3**	**16.0**	**15.2**
Cash and cash equivalents	0.9	1.7	1.6	2.0	1.4	1.3
Other deposits and fixed-income securities (a)	1.2	1.1	1.5	2.3	2.3	2.4
Shares and other equity	14.9	5.8	4.0	3.9	3.3	3.6
Of which:						
Vis-à-vis the rest of the world	*11.3*	*4.9*	*2.6*	*2.7*	*2.2*	*2.7*
Other	10.8	10.5	7.4	7.2	9.0	7.8
Financial transactions (liabilities)	**31.3**	**23.7**	**19.1**	**19.7**	**20.7**	**19.9**
Credit from resident financial institutions (c)	7.6	6.9	7.2	7.5	7.9	7.3
Foreign loans	3.5	4.0	3.4	2.4	2.0	2.5
Fixed-income securities (a)	-0.7	0.1	-0.3	-0.3	-0.2	-0.2
Shares and other equity	12.8	5.3	3.1	3.5	3.4	3.2
Other	8.1	7.3	5.8	6.6	7.6	7.1
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (d)	**18.8**	**15.6**	**14.6**	**13.9**	**14.3**	**14.7**
Households and NPISHs	17.3	12.4	14.1	14.1	15.1	16.1
Non-financial corporations	19.9	18.1	15.0	13.7	13.8	13.8

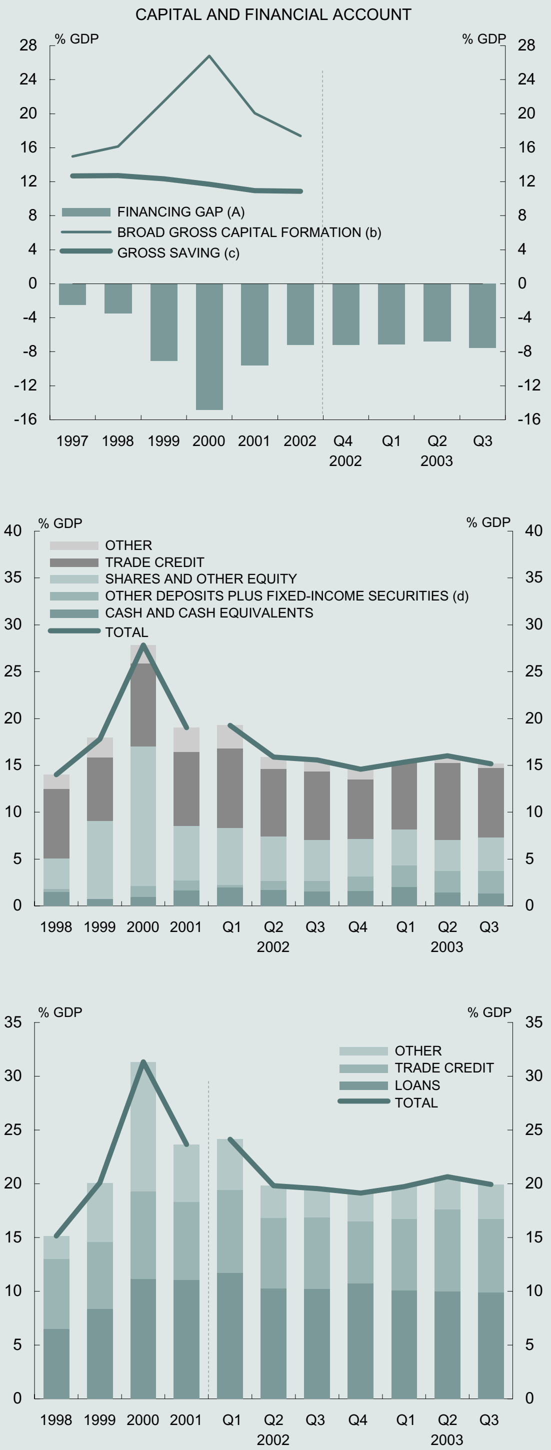
Source: Banco de España.
(a) Not including unpaid accrued interest, which is included under "other".
(b) Not including mutual funds.
(c) Not including securitised loans.
(d) Includes bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation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

low levels, slightly above 2% of their GDI (see Chart 25). Meanwhile, the relative indebtedness of the sector continued to rise to stand at 87% of their GDI, and the provisional Q4 information suggest that this ratio has increased further. However, the maintenance of the low cost of capital meant that the associated debt burden stayed at moderate levels. Despite the expansion in the liabilities incurred by the sector, the net wealth of households continued to grow, thanks to the rise in the prices of housing and shares.

In consequence, the available indicators of the financial position of households suggest that it remains solid, although the low level of saving after debt service means that the capacity of the sector to withstand an adverse change

CHART 26

Non-financial corporations (cumlative 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 equitities.

(c) Includes capital transfers.

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

in its wealth, income or cost of capital without changing its pattern of consumption and residential investment is lower now than in the past.

5.3. Non-financial corporations

The terms of financing for corporations remained generous during the last three months of 2003 and lending rates held at low levels. Specifically, in November, the cost of bank finance stood at 4.37% and 3.35% for transactions of less than and more than one million euro respectively, an increase of 2 bp and a decline of 5 bp relative to the September levels. Moreover, according to the Q3 Bank Lending Survey, the supply conditions anticipated by the institutions for Q4 were not significantly different from those in the previous three months. Meanwhile, the risk premia required on corporate finance continued to fall, which meant that the increase in the yield on long-term public debt was not completely passed through to the cost of bond finance. Likewise, the terms for obtaining funds on the equity markets improved again thanks to the rise in share prices and the reduction in their volatility.

In 2003 Q3, liabilities-side transactions in cumulative twelve-month terms stood at 19.9% of GDP, down slightly from 20.7% in June (see Table 6 and Chart 26). With regard to components, the year-on-year growth rate of interest-bearing external financing was unchanged in this period from the previous quarter (13.8%), although the provisional information for the last quarter points to a certain slowdown. The funds obtained through this channel represented 9.6% of GDP, in cumulative twelve-month terms, similar to the level in June, although with a somewhat different instrument composition. The importance of foreign loans rose to 2.5% of GDP, half a percentage point up on the preceding quarter, while the relative weight of loans from credit institutions fell. Meanwhile, the volume of net issuance of fixed-income securities stood at the same level as in the previous quarter (-0.2% of GDP). The funds raised by corporations through the issuance of shares and other equity totalled 3.2% of GDP, a slight reduction in relation to the previous quarter. Finally, there was also a fall in trade credit, which is included under the heading "other" (1).

Bank credit obtained by corporations displayed mixed behaviour across industries. Credit to property services accelerated slightly

(1) See Box 5 for an analysis of the changes in the composition of Spanish corporations' liabilities between 1990 and 2003.

BOX 5

The financing of Spanish non-financial corporations

There is a wide range of instruments available to non-financial corporations to finance their financial and real investment. The choice they make depends on factors of various kinds, such as the relative cost of the various options, the degree of development of the financial markets and the relationships they may have with financial institutions. This choice has important implications, both for the assessment of their financial position and for the way in which the monetary policy transmission mechanism is characterised.

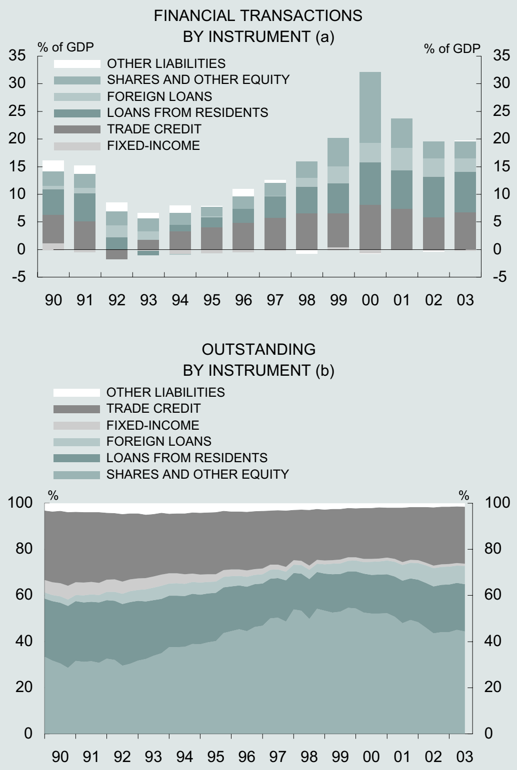
The upper panel of the adjoining chart shows the changes, over the period 1990-2003, in the liabilities transactions of Spanish non-financial corporations as a percentage of GDP, broken down by instrument. As regards the volume of these transactions, they have a strong cyclical profile, which is obviously linked to the behaviour of real and financial investment. As for their composition, the main sources of financing used by Spanish firms have been own funds (shares and other equity), trade credit and loans from residents (primarily credit institutions). On average, each of these instruments has accounted for around 30% of the funds raised, while the rest of the headings have been of merely residual importance. Fixed-income-securities issuance was negative most years, while foreign loans only began to acquire a certain weight from 1998. A significant proportion of the latter is made up of funds received by certain large Spanish firms from special purpose vehicles located abroad, which are basically financed by the issuance of fixed-income securities.

Most of the changes in the instrument composition of liabilities-side transactions seem, more than anything, to be short-term in nature. For example, the increase in the weight of loans from residents since 2000, along with the fall in equity financing, probably reflects the environment of low interest rates and higher share issuance costs, resulting from the unfavourable trend in share prices during most of this period. Meanwhile, the increase in the importance of fixed-income-securities issuance in Spain and abroad since 1998 (the latter approximated by foreign loans) is to some extent attributable to relatively temporary factors, like the increase in the fund requirements of large Spanish firms, which are those that use this form of financing. However, the possibility that other elements of a more structural nature, such as the introduction of the euro, might also have been conducive to this process, cannot be ruled out.

The middle panel of the chart shows outstanding liabilities, which change both as a result of the behaviour of the flows analysed above and of the changes in the market prices of the instruments. This analysis confirms that own funds, trade credit and loans from residents are, in relative terms, the three most important instruments. During the period there was an increase in the weight of own funds and a decline in that of the other two instruments, essentially as a consequence of the upward trend displayed by share values during most of the period. Meanwhile, financing with fixed-income securities on domestic markets has a very low weight. If the issuance of these instruments abroad (approximated, like the outstanding foreign loans) is included, an upward profile is obtained over recent years, but the levels reached at the end of the sample are close to those of 1990.

In short, the data for the stocks and flows of liabilities-side transactions over the last 15 years suggest that the structure of financing of Spanish companies has not changed significantly. The comparison made, for 2002, with euro area and United States firms (see bottom panel of the chart) shows that in Spain the degree of intermediation of corporate liabilities, approximated by the difference between the weights of credit financing and of fixed-income-securities issuance, is similar to that in the euro area, and much greater than in the United States. The main difference vis-à-vis the euro area lies in trade credit (included under the heading “other liabilities”), which is considerably more important in Spain.

Liabilities of non-financial corporations



Sources: Banco de España.
(a) The 2003 data are for the four-quarters up to Q3.
(b) The 2003 data correspond to Q3

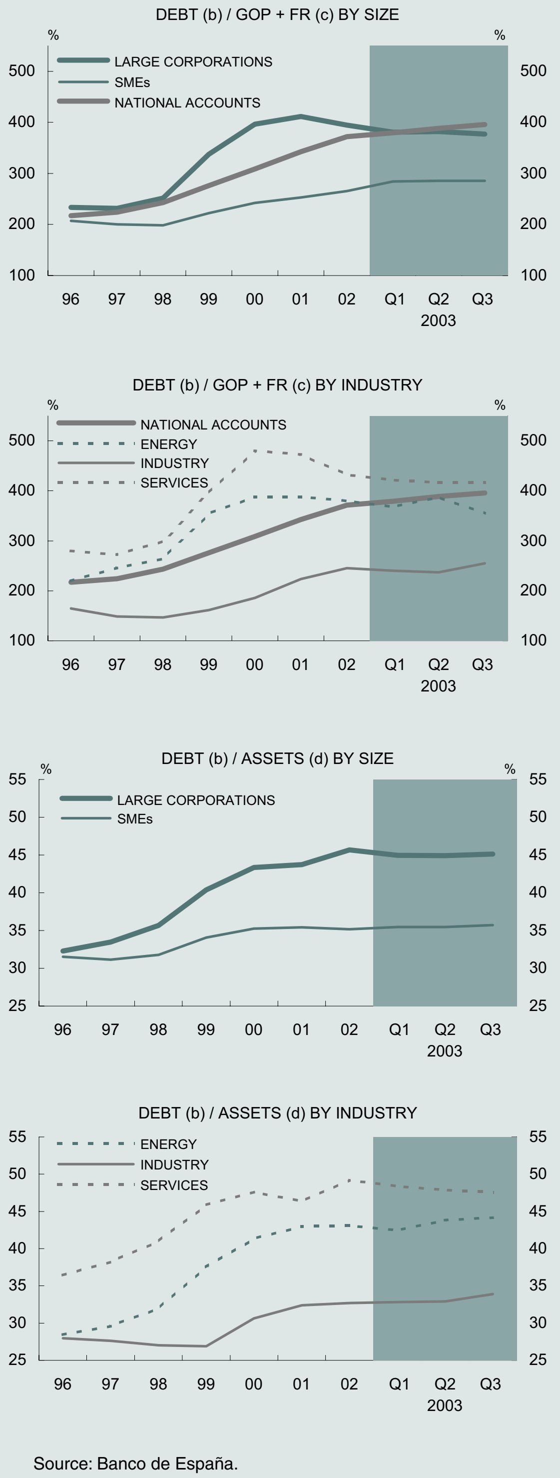
International comparison
2002

	Spain	Euro area	US
Equities (a)	44.1	48.1	37.1
Fixed-income	1.1	4.0	14.0
Loans	28.3	33.3	19.3
Other liabilities (b)	26.5	14.5	29.6

Sources: Banco de España.
(a) Including shares and other equity.
(b) Including trade credit.

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 2002, 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.

to 41.2%, while the rate of growth of credit to other activities fell, although in the case of construction the rates of expansion remained high.

As regards the acquisition of financial assets by corporations, between July and September, financial investment, in cumulative twelve-month terms, declined to 15.2% of GDP (see Table 6 and Chart 26). In relation to the preceding quarter, the most notable development was the fall in trade credit as a percentage of GDP, in cumulative twelve-month terms, included under the heading “other”, and the increase in the acquisition of shares and other equity, especially vis-à-vis the rest of the world.

The financing needs of the sector between July and September represented, in cumulative twelve-month terms, 4.8% of GDP, slightly above the level in the preceding quarter (see Table 5). Meanwhile, the financing gap, which reflects the external funds necessary to carry out the real and permanent financial investment, also increased during the period to 7.5% of GDP, more than half a percentage point above the level in June (see Chart 26).

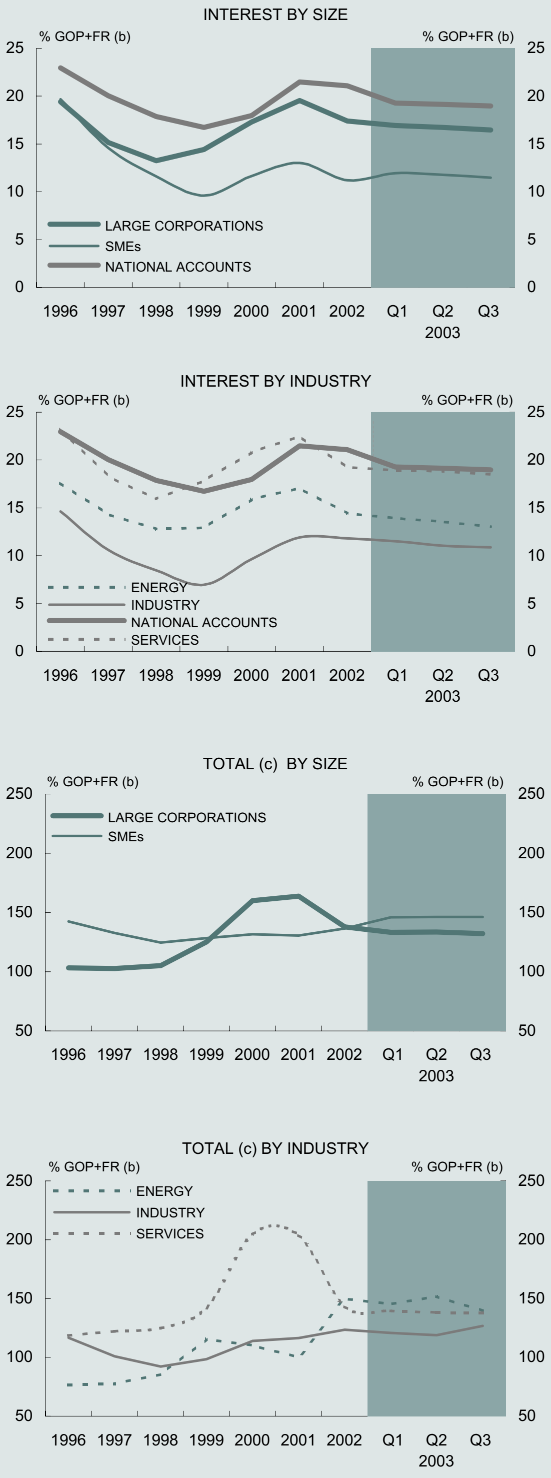
The high rate at which the financing received by the corporations grew led to a further rise, between July and September, in the sector’s aggregate debt ratios (see Chart 27). However, according to Central Balance Sheet Data Office (CBSO) data the major firms continued to reduce their relative debt levels during this period. Despite this fresh increase in aggregate debt ratios, the debt service burden again contracted slightly, thanks to the low level of the cost of financing (see Chart 28). This decline occurred across firms of all sectors and sizes. The measure of the debt burden obtained by adding short-term debt to interest also fell slightly in Q3, in all sectors except industry. The provisional Q4 information suggests that firms’ aggregate relative debt continued to expand.

Company results improved during the first three quarters of 2003. The ordinary net profit of the firms reporting to the CBSO quarterly survey, which excludes extraordinary revenue and expenses, rose by 15.4%, almost 10 percentage points more than in the same period of the previous year. This improvement was most apparent in the energy sector, while the results in industry stabilised at around the same levels as in the previous year. This favourable behaviour was reflected in an increase in the ordinary return on equity to 11%.

All in all, the solid balance sheet position of the firms, along with the generous financial conditions and the improvement in profitability, amounts to a scenario conducive to a recovery

CHART 28

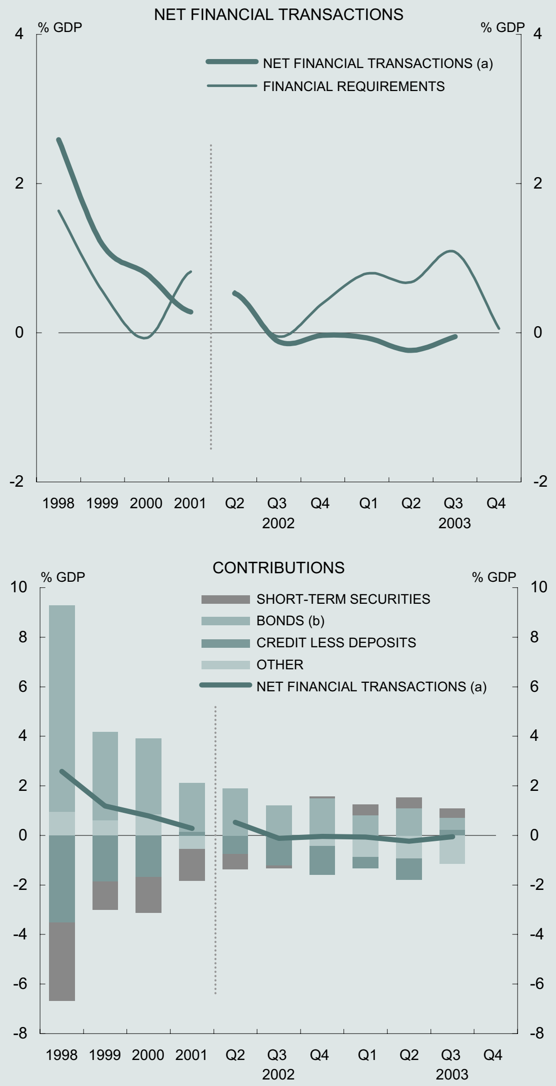
Debt burden of non-financial corporations (a)



Source: Banco de España.
(a) All the series, except "National Accounts", are calculated with CBSO information. Up to 2002, 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".

in productive investment. However, the financial adjustment undertaken by some large corporations may be constraining the expansion of their investment plans somewhat. At the same time, the sensitivity of firms' spending and hiring decisions to unanticipated changes in variables that affect their capacity to make debt payments is greater than in previous cycles, given the degree of their indebtedness.

5.4. General government

Between July and September 2003 the net

TABLE 7

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

% GDP

	2000	2001	2002	2003 Q1	2003 Q2	2003 Q3
Net financial transactions	**-2.5**	**-2.2**	**-1.6**	**-2.1**	**-2.0**	**-2.4**
Financial transactions (assets)	**25.2**	**12.2**	**11.4**	**12.9**	**12.1**	**13.0**
Gold and SDRs	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Cash and deposits	**2.8**	**-2.7**	**3.5**	**4.0**	**2.7**	**0.6**
Credit system	2.5	-2.7	2.0	2.3	1.6	-0.4
Other resident sectors	0.4	0.0	1.5	1.7	1.2	1.0
Securities other than shares	**3.9**	**7.2**	**4.3**	**5.3**	**5.8**	**8.6**
Credit system	-0.3	2.0	0.6	0.7	1.4	3.3
Other resident sectors	4.2	5.2	3.7	4.6	4.5	5.3
Shares and other equity	**15.6**	**5.2**	**3.1**	**3.0**	**2.2**	**3.2**
Credit system	1.8	0.0	0.2	0.0	-0.4	-0.3
Other resident sectors	13.8	5.2	2.9	2.9	2.6	3.5
Of which:						
Non-financial corporations	11.3	4.9	2.6	2.7	2.2	2.7
Loans	**2.8**	**2.5**	**0.6**	**0.6**	**1.3**	**0.7**
Credit system	0.5	0.8	0.1	0.2	0.2	0.3
Other resident sectors	2.3	1.7	0.4	0.4	1.1	0.4
Financial transactions (liabilities)	**27.7**	**14.4**	**13.0**	**15.0**	**14.1**	**15.4**
Deposits	**6.8**	**2.8**	**4.4**	**6.0**	**4.5**	**6.5**
Of which:						
Credit system	6.8	2.8	4.4	6.0	4.5	6.4
Securities other than shares	**7.0**	**3.1**	**4.2**	**4.1**	**5.3**	**4.5**
Credit system	0.7	0.6	1.4	1.8	2.7	3.0
General government	5.7	1.6	1.1	-0.1	0.3	-1.1
Other resident sectors	0.5	0.9	1.7	2.3	2.3	2.6
Shares and other equity	**9.4**	**4.6**	**1.8**	**2.5**	**2.0**	**1.7**
Credit system	1.8	0.5	0.1	0.2	0.0	0.0
Other resident sectors	7.7	4.1	1.7	2.4	2.1	1.7
Loans	**4.4**	**4.7**	**4.0**	**2.9**	**2.6**	**2.8**
General government	0.0	0.1	0.1	0.0	0.0	-0.1
Other resident sectors	4.4	4.7	3.9	2.8	2.6	2.8
Other, net (a)	**0.1**	**-0.8**	**-1.3**	**-0.5**	**-0.3**	**-0.1**

Source: Banco de España.
(a) Includes the asset-side caption reflecting insurance technical reserves.

balance of the financial transactions of general government was positive and, in cumulative twelve-month terms, stood at 0.1% of GDP, slightly below the level in the preceding quarter (see Chart 29).

The net issuance of marketable securities by general government during that quarter was negative, since the volume of funds raised by issuing short-term securities (102 million) was less than the net redemption of bonds (6.1 billion). This reduction in general government liabilities was partly offset by a decline in the balance of its non-transferable deposits. In cumulative twelve-month terms, however, the net issuance of marketable securities stood at 0.8% of GDP. In terms of instruments, the sector continued to issue a larger proportion of long-term securities (0.5% of GDP), although to a lesser extent than in previous quarters.

The initial 2003 Q4 data point to a decline in

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**	**-21.7**	**-24.6**	**-26.0**
Non-financial corporations and households	**-8.7**	**-8.7**	**-0.4**	**-1.3**	**-1.5**	**-2.0**
Non-financial corporations	-14.9	-16.3	-8.2	-9.2	-10.2	-11.9
Households and NPISHs	6.2	7.6	7.7	7.9	8.7	9.9
Financial institutions	**4.8**	**6.8**	**4.9**	**4.6**	**2.2**	**-0.9**
Credit institutions (b)	-5.5	-7.6	-12.6	-14.5	-15.3	-19.1
Institutional investors (c)	10.7	15.0	18.3	20.9	21.0	22.9
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**	**-25.2**	**-23.0**

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) Q3 data.
(c) Defined in accordance with the First Banking Directive.
(d) Insurance corporations and portfolio investment institutions.

the net issuance of both short and long-term securities and to an increase in the deposits held by the sector, in cumulative four-quarter terms. As a result, the general government's financial requirements, which reflect its recourse to the financial markets and which are a leading indicator of the sector's saving, have been reduced.

5.5. The rest of the world

The debit balance of the nation's financial transactions increased between July and September 2003 to stand, in cumulative twelve-month terms, at 2.4% of GDP, 0.4 percentage points higher than in the preceding quarter. This deterioration stemmed from the reduction in the credit balance of general government and the larger financing needs of non-financial corporations, since the financial saving of the other sectors did not change significantly. In cumulative four-quarter terms, the flows of assets and liabilities picked up somewhat, following their fall between April and June.

The net acquisition of external assets amounted to 13% of GDP, in cumulative twelve-month terms, as against 12.1% in the previous quarter (see Table 7). The behaviour across instruments was mixed. Thus, the positive flows of cash and deposits and of loans declined, while those in the form of securities, both fixed-income and equities, picked up. According to provisional Balance of Payments information to October, foreign long-term (direct) investment declined by more than 70% from the same period a year earlier, while foreign portfolio investment accelerated with respect to 2002.

On the liabilities side, net flows amounted, in cumulative twelve-month terms, to 15.4% of GDP, as against 14.1% in the previous quarter. This increase stemmed from the rise in the weight of deposits, which was greater than the decline in the external finance raised through the sale of securities. The rest of the headings saw no significant changes. According to the Balance of Payments, inward foreign direct investment in Spain fell by almost 30% during the first ten months of 2003, relative to the same period of the previous year.

Finally, the provisional information available on the debit position of the Spanish economy vis-à-vis the rest of the world shows that it stood in 2003 Q3 at 26% of GDP, a decline of 1.4 percentage points relative to December 2002 (see Table 8).

26.1.2004.