

QUARTERLY REPORT ON THE SPANISH ECONOMY

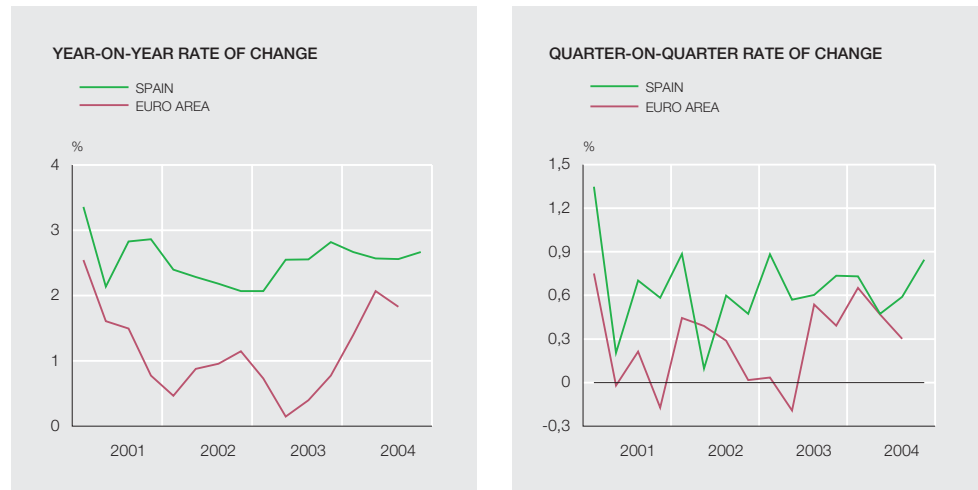
## 1 Overview

After several quarters of sustained growth running at a rate of 2.6%, the Spanish economy ended the year 2004 with a slight rise in activity. Although the year-on-year change in domestic demand is estimated to have turned down slightly, following growth of 4.4% in Q3, the improvement in tourism in the closing months of the year and a slight reduction in the notable momentum of imports have helped ease the negative contribution of external demand. GDP is thus estimated to have increased by 2.7% year-on-year in Q4, 0.1 pp up on the QNA estimate for the two previous quarters, and by 0.8% in quarter-on-quarter terms, also above the previous estimate (see Chart 1). In any event, the Spanish economy ended the year in line with previous trends: domestic demand increased notably and, despite slowing, grew by over 4%; the contribution by the external sector was strongly negative and the rate of job creation high; and inflation, measured by the CPI, was driven by dearer oil and closed the year standing at 3.2%.

Estimates in 2004 Q4 place growth for the whole of the year at 2.6%, slightly above the figure of 2.5% in 2003. Domestic demand would have quickened to a rate of increase of 4%, compared with 3.2% in 2003, reflecting higher growth in both consumption and, mainly, investment. The negative contribution of external demand would have stepped up notably, despite the improvement in Q4, standing at a negative figure of over -1.5 pp, against -0.8 pp the previous year. Employment growth exceeded 2%, compared with 1.7% in 2003, extending the path of low productivity growth, and the inflation rate, with a variable profile over the course of the year, averaged 3%, a similar rate to 2003.

On the international front, growth was very high in 2004, the outcome of a recovery that has spread to most economic areas and which has been accompanied by a vibrant increase in the volume of international trade. Nonetheless, set against this strength, a clearly slowing trend has been discernible as the year has elapsed. This is related to two factors. First, the change in economic policy stance, the expansionary nature of which has begun to be tempered by the authorities in regions as far apart as China and the United States. Further, higher oil prices, the reflection in turn of the strength of world demand, have acted as a growth-stabilising factor, possibly dampening recovery expectations. Following this gradual slowdown, the outlook for 2005 is for the expansion to hold at a more contained rate. Bearing witness in part to these bright prospects, stock markets ended the year on a rising trend, and both long-term interest rates and sovereign spreads in the emerging markets and in the markets for debt issued by the private sector in the developed countries have held at relatively moderate levels.

The expansion of the world economy has not, however, seen many improvements in the macro-financial imbalances persisting between the different economic areas. Indeed, the scale of the US external deficit appears to be the main reason for the depreciation by the dollar in the second half of 2004, the main counterpoint to which has been the rise in the euro. This trend has reversed to some extent in early 2005. The oil price peaked in October, at over \$50 per barrel, tending to ease thereafter but without abandoning levels above \$40. At the outset of 2005 the oil price rose again, and the futures markets project a very slow downward adjustment until the end of the year. Against this background, inflation rates in the main economic areas have shown a rising profile, although inflationary risks remain under control owing to the fact that there has been no surge in wages, the increases in which remain moderate, and corporate profits have picked up, allowing the higher cost of energy to be accommodated.



SOURCES: ECB, INE and Banco de España.

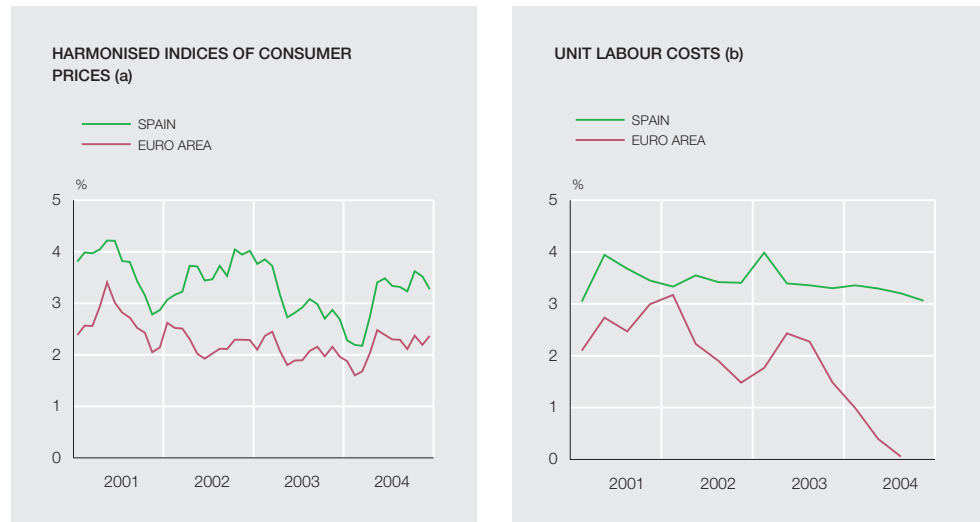
a. Seasonally adjusted series.

Across the geographical areas, Q3 data in the United States confirmed robust though slightly slowing growth, led by consumption and investment, which no doubt extended into the final quarter of the year. Although the inflation rate was on a rising trend, owing to dearer oil and to the depreciation of the dollar, underlying inflation rose only slightly and no significant deterioration in inflation expectations is perceptible. The Chinese economy continues to post growth rates of over 9%, meaning that the containment measures adopted by the authorities have had only a limited success. Finally, growth in Latin America in 2004 is shaping up to be the highest in several decades, owing to the increase in investment and exports, while sovereign spreads have held at minimum levels and central banks have significantly increased their foreign reserves.

Against the backdrop of this widespread expansion in the world economy, the euro area continues to post moderate rates of increase which depend largely on external demand. Recovery in this area is therefore vulnerable to events in the international environment, and domestic demand has so far failed to react with the necessary force. After a relatively strong first half of the year, with increases close to GDP potential, the figures for Q3 – which placed year-on-year GDP at 1.8% – and the trends suggested by the indicators for the end of the year point to a lower growth rate, tied to the sluggishness of exports, which are affected by the appreciation of the euro. Although investment has been more buoyant in recent months and the consumption indicators presage a slight improvement in Q4, the limited expectations of an increase in employment or in income appear to be weighing household expenditure down.

That said, developments across the euro area members continue to be highly diverse, since some show high growth rates (such as Finland, Belgium, Ireland and Spain) while others (such as Germany and, more recently, France) have recently faced difficulty in maintaining the pace of activity.

Higher oil prices have had an upward effect on the inflation rate in the euro area, although its scale has been cushioned by the appreciation of the euro. Overall, the HICP ended the year with a year-on-year increase of 2.4%, although expectations point to a resumption of a rate below 2% in the coming months. Moreover, underlying inflation has barely exceeded this level during 2004. The expectations of inflation holding at a level consistent with the ECB's definition



SOURCES: Eurostat, ECB and INE.

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

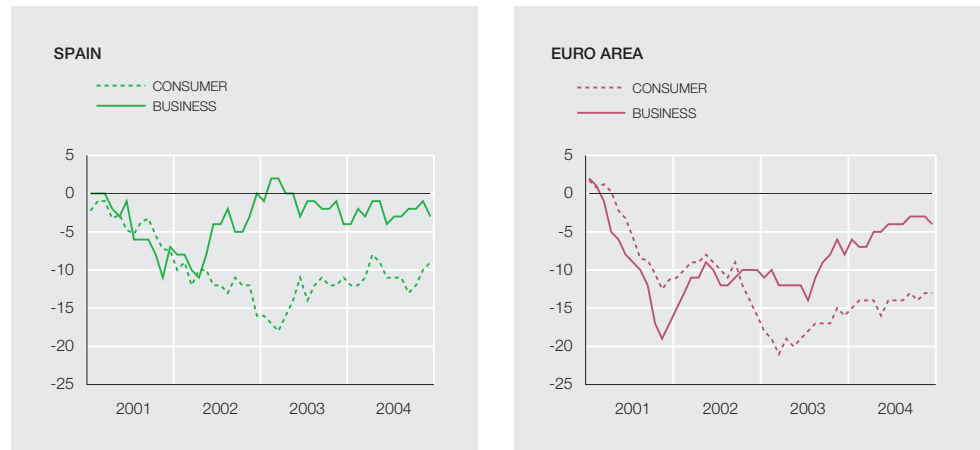
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

of price stability have been strengthened by the moderate course of wages, where the price rises linked to dearer oil do not appear to have exerted an effect. In these circumstances, the ECB has decided to keep the interest rate on its main refinancing operations stable at 2%, albeit monitoring closely the perceptible risks to the inflation rate.

As regards fiscal policy stance in the euro area, the insufficiency of the fiscal adjustments made by certain countries in the past was once again highlighted in 2004, as was the lack of sufficiently corrective measures at present. Consequently, the public deficit in the euro area as a whole stood at 2.9%. Against this background, the discussions being held by ECOFIN to reform the Stability and Growth Pact are continuing. Apart from fiscal policy co-ordination, the application of the structural reform measures agreed in Lisbon would appear to be vital if the euro area economy is to be galvanised and growth potential raised. In this connection, the European Council in March may prove most important, since it is scheduled that the reform of the Stability and Growth Pact be addressed and the strategy on structural policies in Europe reviewed, so as to give the euro area fresh momentum.

As indicated at the beginning of this report, the Spanish economy, against this background of international expansion and moderate growth in the euro area, has sustained its own dynamism and a positive and significant growth differential with the euro area. Domestic spending, underpinned by generous financial conditions, high job-creation capacity and favourable demand expectations for companies, remained forcefully buoyant in Spain in the final months of 2004, despite the moderate slowdown in private consumption and investment. The negative contribution of net external demand to GDP growth declined somewhat, giving rise to an increase in activity of 2.7%, slightly up on the previous quarter's figure of 2.6%.

The private consumption indicators for Q4 point to a slight loss of steam compared with the growth for the second and third quarters of 2004. Nonetheless, the year closed with an increase in consumption of around 3.3%, clearly up on the 2003 figure. This result was underpinned by the growth of real disposable income, the favourable financing conditions and a sizable increase in both financial and non-financial wealth, based on rising house prices and



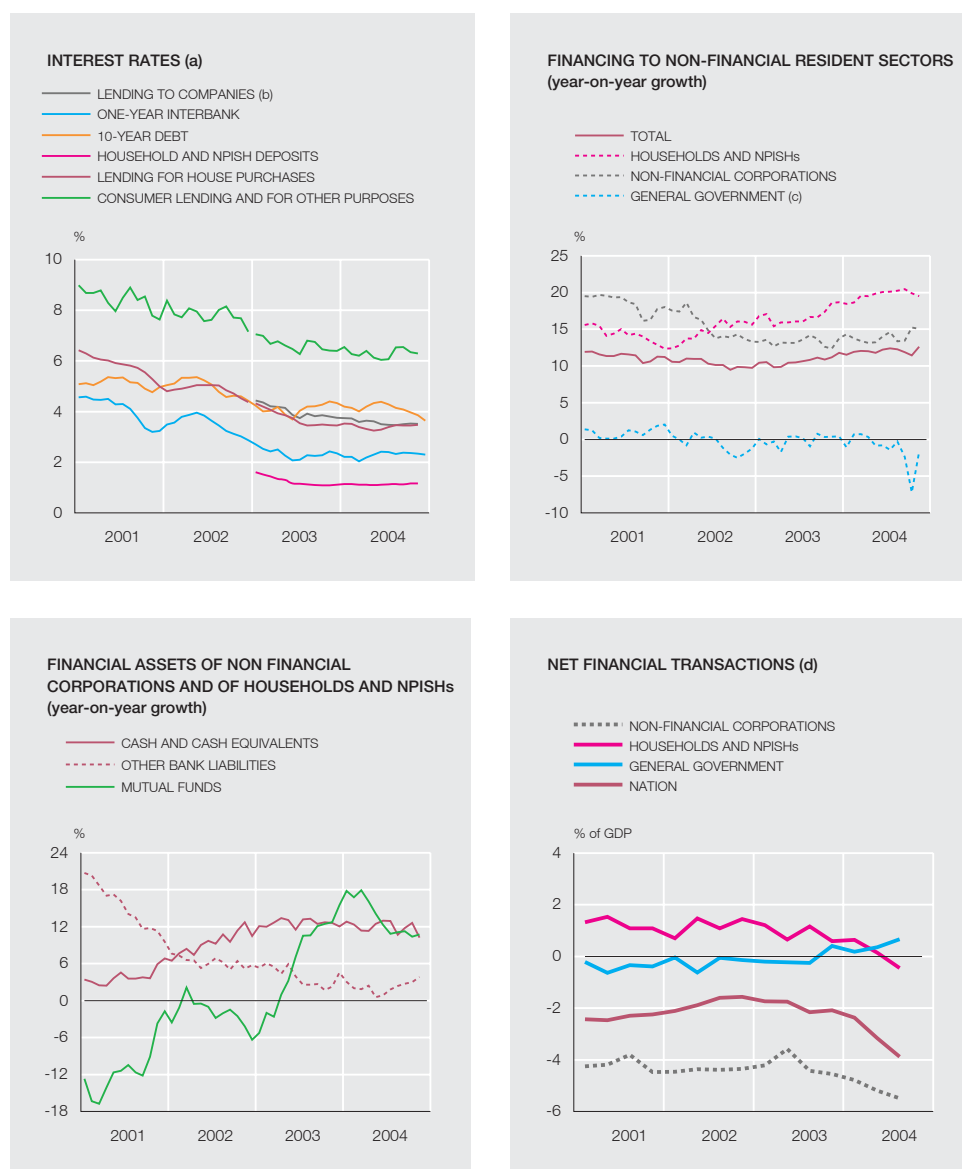
SOURCE: European Commission.

the rally on the stock market. The residential investment indicators signal that the other component of household expenditure also expanded significantly in 2004 which, combined with the growth in house prices, accounts for the increase in mortgage lending. On the figures for 2004 to Q3, household financial saving has turned negative for the first time, reflecting the growing financial pressure the sector is facing.

Fixed capital investment also ended 2004 having slowed slightly, following its notable increase in Q3. Notwithstanding, the pick-up in investment in the year as a whole was significant, especially that in capital goods (with an estimated average increase of over 5.5%), since construction grew at a very similar rate to that of 2003 (4.3%). Corporate investment has been the main driver of gross fixed capital formation, to which improved demand expectations, sustained by the recovery in the international economy against a backdrop of less financial pressure on companies and an improvement in their economic performance, have undoubtedly contributed.

The negative contribution of external demand to GDP growth moderated to some extent in 2004, after having stepped up considerably in the three previous quarters. Despite this, the subtraction from growth in Q4 was 1.6 pp. The deterioration in external demand over the year as a whole is largely attributable to losses in competitiveness arising from the appreciation of the euro over the past two years and the maintenance of positive differentials in respect of price and cost changes with Spanish producers' main competitors. Although goods exports recovered significantly in 2004, this pick-up was far less than that recorded by the markets. Tourism-related results were affected by additional adverse factors such as the weather and geopolitical tensions, the effect of which has been lessened by the strong rise in Q4. Lastly, the considerable buoyancy of final demand, the unfavourable course of competitiveness and the rise in Spanish tourism abroad, spurred by the appreciation of the euro, account for the acceleration in goods and services imports, which has only been checked in the final quarter.

The estimated slight pick-up in GDP growth in Q4 (0.1 pp in year-on-year terms) would have been accompanied by a similar rise in employment, according to the EPA (Labour Force Survey) employment figure for Q4, released as this report was going to press. In 2004 as a whole, employment is estimated to have grown by 2.1%, giving rise to an additional cut in the growth rate of labour productivity. Sector by sector, this result reflects the situation in market services, where employment has not only grown more than value added but has accelerated to a greater extent in 2004, and in construction, where both variables increased at the same rate.



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. Weighted average of interest rates on various transactions grouped according to their volume.  
 c. Consolidated financing: net of securities and loans that are general government assets.  
 d. Cumulative four-quarter data.

Conversely, in industry, where competitive pressures are greater, employment fell substantially until Q3, prompting high productivity gains. But this process has come to a halt in the closing months of the year, in which industrial employment has resumed positive rates of change.

The labour cost indicators and the results of collective bargaining in 2004 showed a moderation in wages in relation to 2003, which tended to firm over the course of the year. The QNA estimates of compensation per employee identified this slowing profile, which has fed through to unit labour costs, despite the low increase in productivity. However, the growth of compensation (3.7% in Q3 compared with a year earlier, and 3.2% in the market economy) is high when compared with other euro area economies, and has contributed to upholding the labour cost growth differential vis-à-vis Spanish producers' main competitors, adversely affecting their competitiveness. Indeed, the outlook for 2005 points to a rise in wages owing to the ef-

fect of the inflation-adjustment clauses included in many agreements, and which will enter into force as a result of the upward effect that dearer oil had on inflation in the final months of 2004. While in most economies the increase in oil prices has not affected wages, thereby limiting the effects on the inflation outlook, their incorporation in Spain into wage growth by means of the above-mentioned clauses will fuel losses in competitiveness. The endurance of indexing mechanisms reinforces an economy's inflationary inertia, curtailing its flexible response capacity to the unexpected shocks that may affect it. Consequently, having a system of this nature in place to annually revise the national minimum wage would be inappropriate, particularly if it were to become legally enforceable.

Turning to inflation developments in 2004, the 12-month rate of the CPI, which had started the year at 2.3%, ended it at 3.2%, after having peaked in October (3.5%) when the effects of dearer energy were at a height. This effect was partly offset by the favourable behaviour of unprocessed food prices. Among the least variable price components, included in the CPI excluding energy and unprocessed goods, there was also an acceleration in the second half of the year, placing this index at a 12-month rate of around 2.9%, due to slippage by processed-food and non-energy industrial goods prices. Finally, services prices held at a high rate of around 3.8%. The inflation rate averaged 3% in 2004 and the inflation differential with the euro area, measured by the HICP, which moved on a rising profile during the year, stood at 0.9 pp in December.

In the fiscal policy realm, the unveiling of the Updated Stability and Growth Pact for the 2004-2008 period confirmed the economic authorities' commitment to budgetary stability. After a deficit of 0.8% of GDP in 2004, owing to the recognition of certain extraordinary transactions in the year, projections point to successive surpluses in public finances until the year 2008, conditional upon a specific growth scenario.

For the Spanish economy to continue maintaining its positive growth differential and to sustain its real convergence with the most advanced euro area economies, it must not only hold on a path of budgetary stability but also apply measures that promote growth potential by means of a flexible and efficient functioning of the economy. In this respect, the announced raft of measures to foster competitiveness is an opportunity to achieve significant progress here. Ahead of some of these measures, a White Paper on competition protection has been published. This provides for the creation of an independent agency – the National Commission for the Protection of Competition – to watch over these aspects, thereby increasing safeguards in respect of the system's transparency and effectiveness.

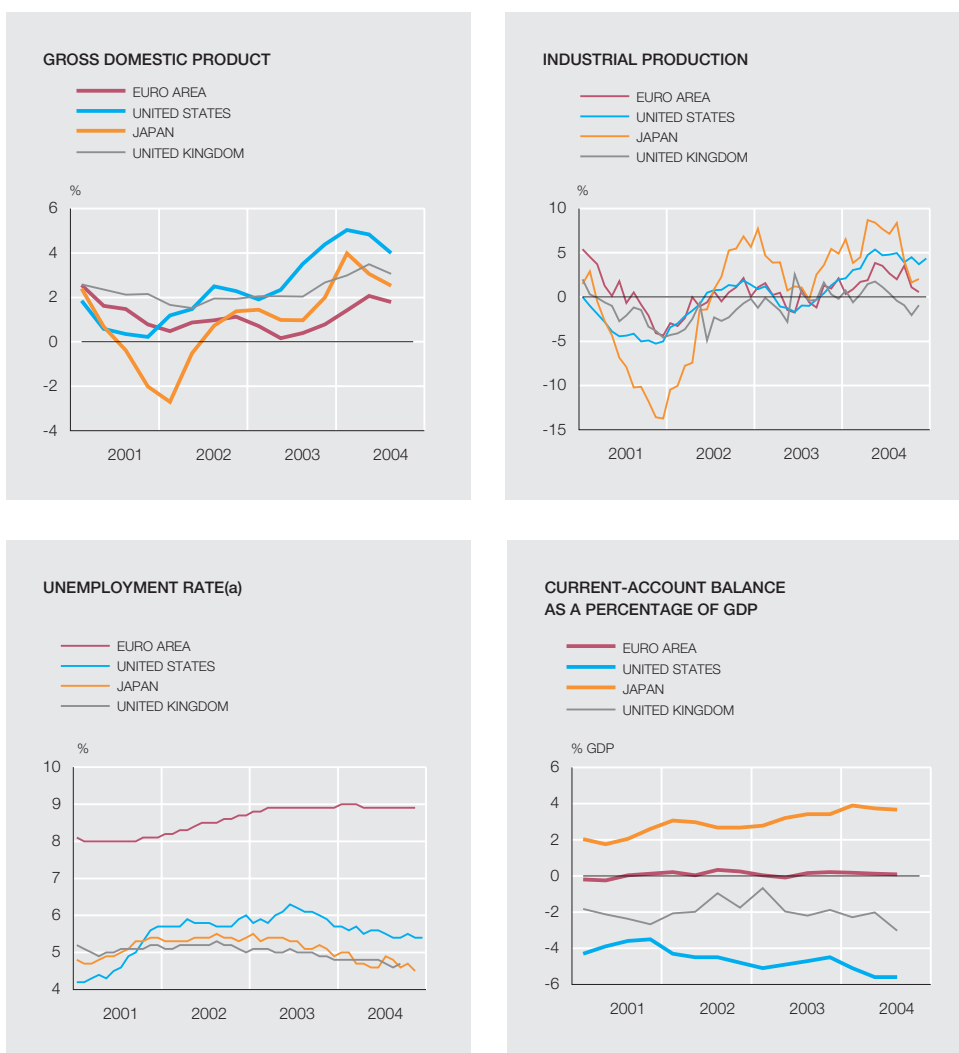
## 2 External environment of the euro area

Developments on international financial markets in the last three months of 2004 were marked by the weakness of the dollar, which reached a new low against the euro – at over \$1.36 per euro – in mid-December. The deterioration in the US external deficit and doubts about the future course of productivity, following the news of the decline in its growth rate in Q3, might have contributed to the depreciation of the US currency. In the opening weeks of January, however, the dollar appreciated significantly, in a movement attributed to the prospect of a fresh tightening of US monetary policy. As expected, the Federal Reserve increased its federal funds rate by 25 bp to 2.25%. The markets now appear to be discounting fresh interest-rate rises with greater certainty, following the scrutiny of the minutes of the last Federal Reserve Open Market Committee meeting, which were released for the first time before the following meeting and which had a more contractionary tone than expected. The movements of the dollar against the yen were similar to those against the euro, though of less intensity. US long-term interest rates increased very slightly during the quarter which, combined with the decline in euro long-term rates, prompted a widening of the related spread to 60 bp. The price of crude oil fell at the end of the year to \$40 per barrel, after peaking in October, while its volatility increased substantially. In the first fortnight of January the oil price rose owing to uncertainty related to the imminent elections in Iraq and to purely seasonal factors. Despite these vicissitudes, there have been no significant movements in long-term futures, which remain in any event at relatively high levels. The emerging economies performed very favourably during Q4, with their GDP growth rate higher than that of the developed economies, widespread declines in sovereign spreads (although they widened slightly in January), stock market rises, the appreciation of their currencies (except in those countries with fixed exchange rates) and a build-up in currency reserves by their central banks.

In the United States, the final GDP figure for Q3 was 4% in annualised quarter-on-quarter terms (year-on-year it was also 4%), up on the initially estimated figure of 3.9% and on the Q2 figure of 3.3%. Activity was essentially driven by an acceleration in private consumption and in private investment in equipment. The indicators available for Q4 point to the continuing buoyancy of the economy. On the demand side, the robustness of retail sales, combined with the recent improvement in consumer confidence, portray a favourable outlook for private consumption, while the positive trend of durable goods orders in November would suggest the continuing resilience of investment. On the supply side, indicators are likewise favourable: industrial production posted increases in the last quarter of 2004; capacity utilisation reached a four-year high in December; the confidence indicators in the manufacturing and services sectors both posted increases in November and December; and the leading indicator of economic activity showed increases for the first time in six months in November and December. On the downside, job creation was low in the last two months of the year, below the annual average and expectations. That said, the year closed with 2.2 million jobs having been created, the highest figure in five years. The trade deficit continued widening, reaching a new all-time high in November owing to the strong growth of imports. As to prices, the CPI slowed in December (3.3% year-on-year, against 3.5% in November) owing to the decline in energy prices. The underlying rate held at 2.2%. These figures confirm the easing of inflationary pressures signalled by the supply-side indicators (import and producer prices), despite the depreciation of the dollar.

In Japan, National Accounts data highlighted the slowdown in activity in Q3, with GDP posting year-on-year growth of 2.6%, compared with 3% in Q2. The differing trends of the latest indi-



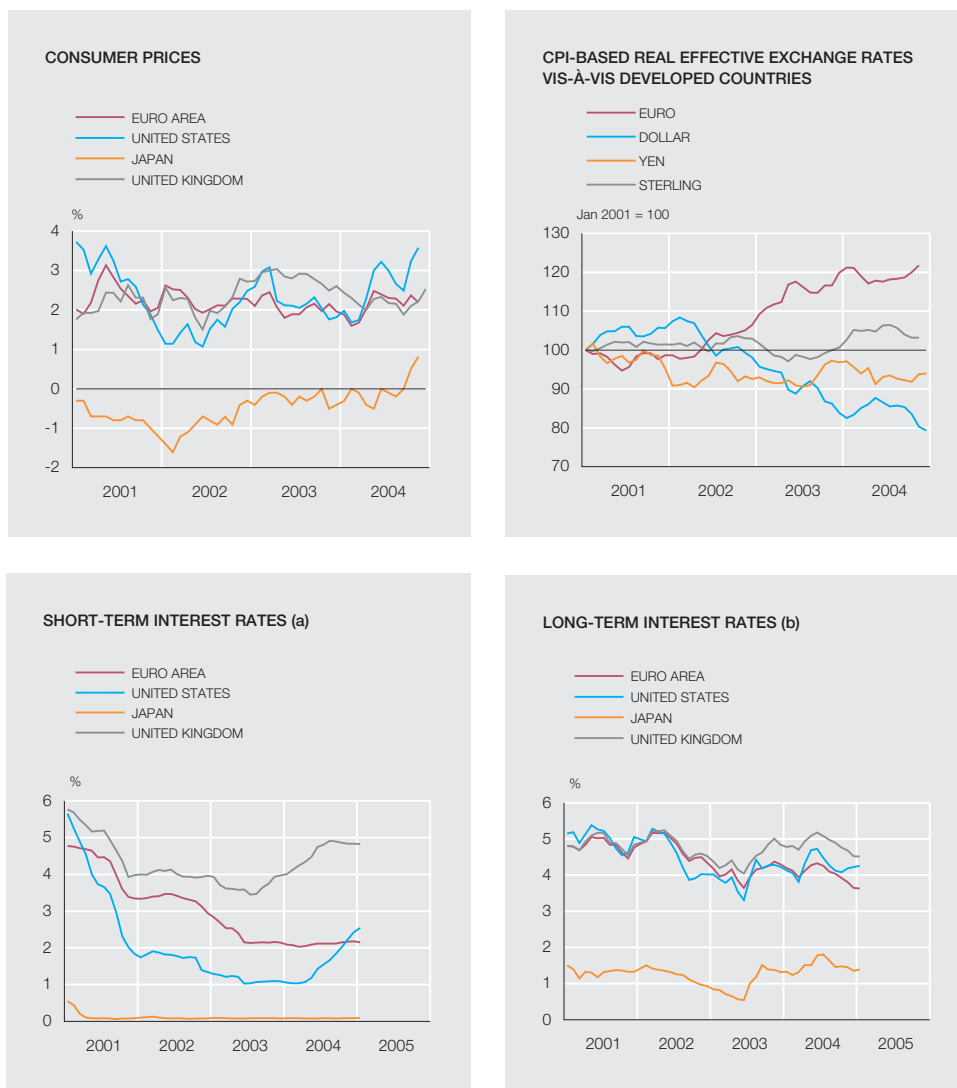


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

icators do not help ascertain whether the slowdown observed is temporary. On the supply side, the improvement in industrial output and the rise in the indicators of economic activity in November contrasted with the slight deterioration in the Tankan business expectations survey. On the demand side, the increases in retail sales and in personal income in November would suggest an improvement in private consumption, though strong job destruction that same month might limit these gains. Finally, deflationary pressures remain in place, as indicated by the course of underlying inflation in November (-0.2% year-on-year), although consumer prices grew by 0.8%, due essentially to the increase in energy prices.

GDP in the United Kingdom slowed in Q3, increasing by 0.5% in quarter-on-quarter terms (3.1% year-on-year) compared with 0.9% in Q2 (3.5% year-on-year). The indicators released for Q4 show a divergent trend; the demand indicators evidenced clear improvements (increases in retail sales in November and in consumer confidence in December), while the supply-side indicators, especially industrial production, worsened. Regarding the behaviour of prices, the harmonised CPI grew by 1.6% in December compared with a year earlier, against 1.5% in November, still below the Bank of England's target of 2%. On the property market,



SOURCE: Banco de España.

- a. Three-month interbank market interest rates.
- b. Ten-year government debt yields.

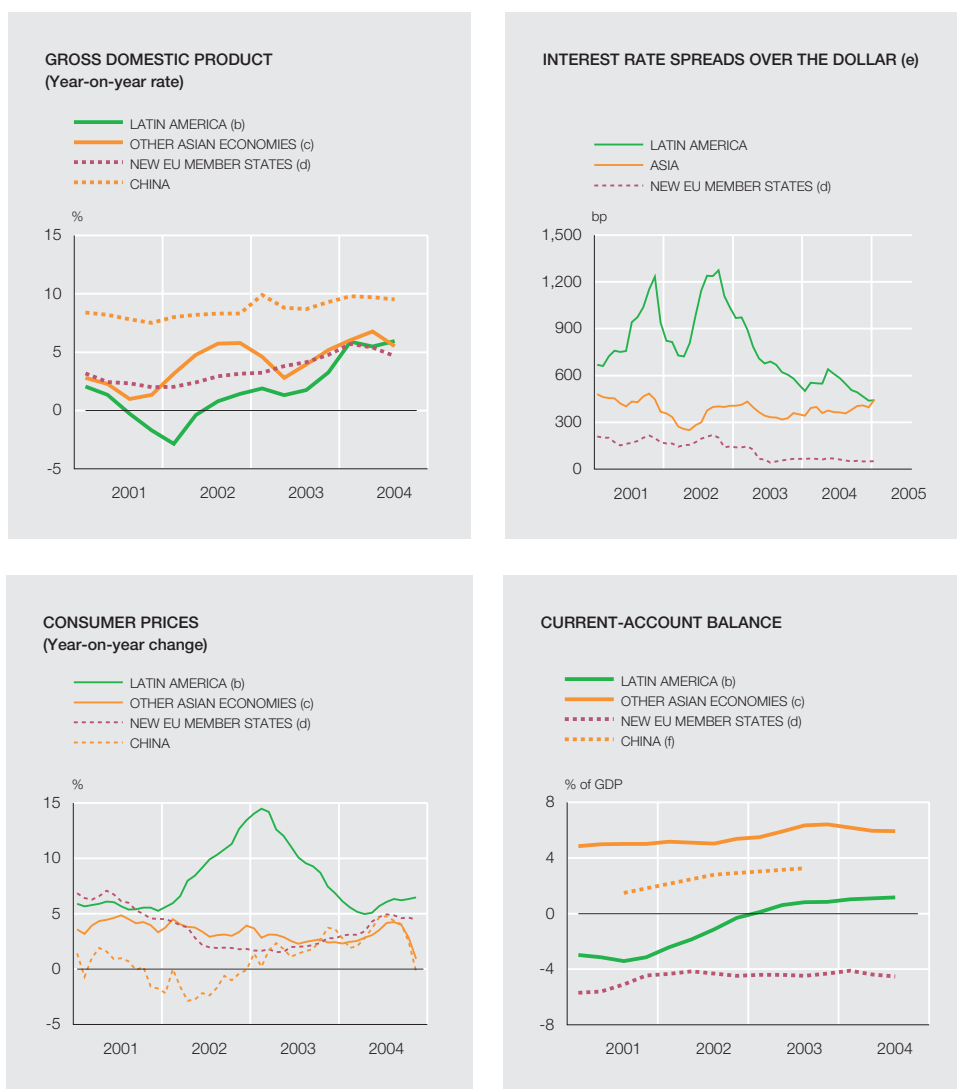
house prices held on the slowing trend seen in recent months, although they were still standing at a year-on-year rate of over 12% in December.

In the new European Union Member States, GDP growth in 2004 Q3 was slightly down on that recorded in the first half of the year, though it remained above 4% year-on-year in virtually all cases. The indicators for Q4 generally show rises in industrial production in the region. Prices in recent months have continued on a slightly easing trend, following the increases in mid-2003 due largely to factors relating to EU accession and to the rise in oil prices. Against this background, interest rates have generally remained stable in recent months, exceptions such as Hungary aside, where they were cut to 9.5%. The performance of financial markets was relatively favourable, with across-the-board rises on stock markets, a narrowing of long-term interest rate spreads and the appreciation of currencies (except in those countries belonging to the exchange-rate mechanism), thanks to strong capital inflows.

In the main south-east Asian economies, the pace of activity continued to ease in October and November. It is estimated that the economic consequences of the tidal wave in late December

**EMERGING ECONOMIES:  
MAIN MACROECONOMIC INDICATORS (a)**

CHART 7



SOURCES: National statistics and JP Morgan.

- a. The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy. Based on IMF information.
- b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c. 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 data on the new EU Member States relate to Hungary and Poland.
- f. Annual data.

will be relatively moderate and will be concentrated, on current estimates, in the first half of 2005, particularly affecting Indonesia and Thailand. Likewise, there have been no significant movements in financial indicators in these economies in the wake of the disaster. In China, the indicators of activity for Q4 show no signs of a clear slowdown, despite the contractionary measures adopted by the authorities. Although these measures led to a slight deceleration in industrial output, in investment in fixed assets and in retail sales, GDP growth for the year as a whole is estimated at 9.5%, up on the authorities' target (8%). Inflation fell by 0.5 pp in December to a year-on-year rate of 2.4%, but this was largely due to the slowdown in food prices. Currency reserves continued to increase briskly and now stand at \$610 billion, 50% up on the previous year.

In Latin America, the growth rate was high in 2004 Q3 at close to 6%. Judging by the supply and demand-side indicators available to date, this rate might continue into Q4, making for the

biggest expansion in regional GDP since 1980. The growth in activity was led by investment and, especially, by exports, which led to record trade surpluses being posted in certain countries, such as Brazil, Chile and Peru. Against this backdrop, Latin American financial markets continued to perform favourably, with historical lows in sovereign spreads that contributed to the increase in debt issues on international markets and to strong stock market rises. The Latin American currencies appreciated significantly against the dollar and the build-up in international reserves continued, rising to all-time highs in some cases. Inflation eased in December, despite which the region's central banks kept their monetary policies tight, except in the case of Colombia. These favourable developments led rating agencies to upgrade Mexican and Ecuadorian sovereign and improve the outlook for Brazil's rating. Lastly, the Argentine authorities finally made their debt conversion offer, the acceptance of which by foreign bond-holders is uncertain, and the outcome of which will be known around the first week in March.

### 3 The euro area and the monetary policy of the European Central Bank

The information available on economic developments in the euro area in the closing months of 2004 appears to suggest that the rate of recovery of activity has remained slow. In this setting there are certain signs that portray a brighter outlook for economic developments in the first half of 2005. In particular, the continuing favourable financial conditions and the pick-up in business margins provide the basis for the gradual strengthening of investment in the coming quarters. Further, the pressures in the oil market have eased recently, dispelling the fears of the potential adverse effects arising from a continuing increase in energy prices. Nonetheless, risks persist that confer a degree of fragility on the current expansionary phase. For instance, the course of net exports and of private consumption is shrouded in great uncertainty. First, it is difficult to determine to what extent the recent slowdown in sales to the rest of the world is a temporary phenomenon or whether what is rather involved is a manifestation of the delayed effects of the notable appreciation of the euro. And further, weak job creation is a sizable obstacle in the way of household spending abandoning its protracted sluggishness.

Where the outlook is now somewhat less uncertain is in the inflation domain, since the moderation of labour costs and the strength of the euro exchange rate have made for a relatively favourable outlook for the easing of inflationary pressures during the coming months. As regards fiscal policy, the European authorities face a significant challenge in the coming months to bring about improvements in the application of the Stability and Growth Pact that safeguard the credibility of the institutional framework currently in place.

#### 3.1 *Economic developments*

On the latest estimates, the quarter-on-quarter growth of GDP in the euro area slowed in 2004 to 0.3%, compared with an average rate of 0.6% in the first half of the year (see Table 1). In year-on-year terms, the increase was 1.8%, 0.3 pp below the rate observed the previous quarter (see Chart 8). In respect of components, there was a notable slowdown in the quarterly pace of expansion of exports (which increased by 1.5%, against 2.8% the previous quarter). And this, in combination with the strength of imports, led the contribution of the net external balance to GDP growth, which was 0.2 pp the previous quarter, to turn negative. Box 1 shows the breakdown of exports and imports by area and product, respectively. The contribution of domestic demand – excluding stockbuilding – increased by 0.1 pp to 0.3 pp. Behind this lay the more expansionary behaviour of gross capital formation (especially of capital goods) and of government consumption, while private consumption remained sluggish. Stockbuilding added 0.7 pp to GDP growth. This strong build-up in stocks may possibly have been involuntary, should it have come about through the slowdown in demand from abroad. However, it is also possible that it is a further indication of the strength of investment in fixed capital, insofar as it includes goods of this type in process.

Among the eight economies for which Quarterly National Accounts data are available, Germany and France posted the lowest GDP growth rates in Q3 (0.1% and 0%, respectively). Consequently, the slowdown in activity in the area as a whole was caused by the weakness of these two economies in which, moreover, there was an intense contribution of stockbuilding to the expansion of output. In both cases, private consumption was very weak. However, the trend of gross capital formation was divergent, since it improved substantially in Germany but contracted in France. Finally, mention should be made of the strong negative contribution of the net external balance to economic growth in Germany.

Across the production branches, there was a notable reduction in the rate of expansion of value added in industry, the growth rate of which eased from 1.2% quarter-on-quarter in Q2 to

	2003			2004				2005
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
<b>GDP</b>								
Year-on-year growth	0.2	0.4	0.8	1.4	2.1	1.8		
Quarter-on-quarter growth	-0.2	0.5	0.4	0.7	0.5	0.3		
European Commission forecasts (c)							(0.2 ; 0.6)	(0.3 ; 0.7)
<b>IPI (d)</b>								
Economic sentiment	91.4	94.2	97.7	98.9	100.0	100.7	100.9	
Industrial confidence	-12.0	-11.4	-7.3	-6.7	-4.7	-3.7	-3.3	
Manufacturing PMI	47.1	49.1	52.0	52.8	54.4	53.9	51.4	
Services confidence	-2.0	5.3	10.3	11.3	11.7	12.3	11.3	
Services PMI	47.9	51.9	56.7	56.0	55.2	54.4	52.9	
Unemployment rate	8.9	8.9	8.9	9.0	8.9	8.9	8.9	
Consumer confidence	-19.3	-17.3	-16.0	-14.3	-14.7	-13.7	-13.3	
<b>HICP (d) (e)</b>								
HICP (d) (e)	1.9	2.2	2.0	1.7	2.4	2.1	2.4	
PPI (d) (e)	1.3	0.9	0.9	0.4	2.4	3.3	3.6	
Oil price in USD (e)	27.6	27.1	29.9	33.8	35.3	43.3	39.9	43.9
<b>Loans to the private sector (d) (e)</b>								
Loans to the private sector (d) (e)	4.6	4.9	5.5	5.3	6.0	6.5	7.0	
Euro area ten-year bond yield	4.0	4.2	4.4	4.2	4.4	4.2	3.8	3.6
US-euro area ten-year bond spread	-0.32	0.09	-0.05	-0.11	0.28	0.14	0.36	0.66
Dollar/euro exchange rate (e)	1.143	1.165	1.263	1.222	1.216	1.241	1.362	1.296
Appreciation/Depreciation of the euro (e)	9.0	11.1	20.4	-3.2	-3.8	-1.7	7.8	-4.8
Dow Jones EURO STOXX Broad index (e)	2.9	4.1	18.1	1.9	3.7	1.5	9.9	0.5

SOURCES: Eurostat, ECB and Banco de España.

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

b. Information available up to 21 October 2004.

c. Quarter-on-quarter growth forecasts.

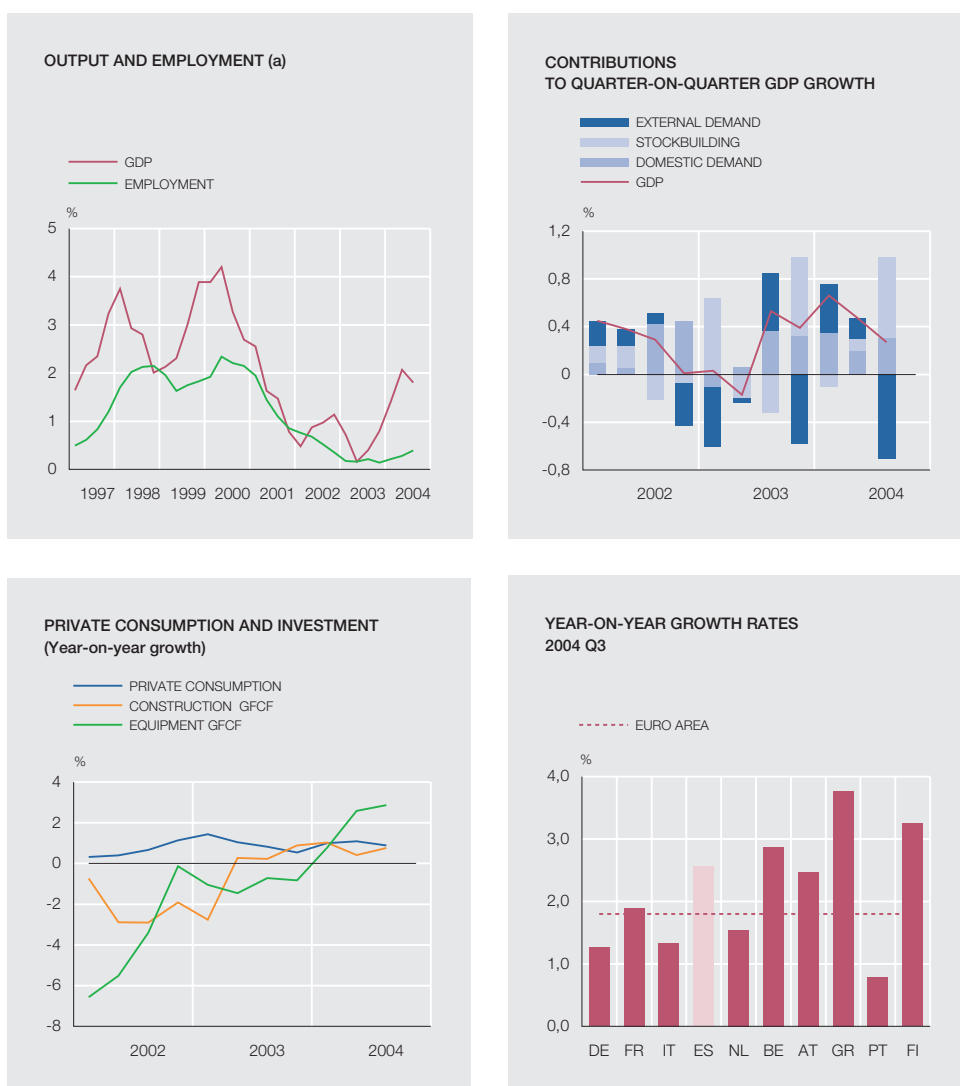
d. Year-on-year growth.

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

0.1% in Q3. Nonetheless, there was also a sharp slowdown in value added in construction and in services. As regards the labour market, employment grew by 0.1% in Q3. Underpinning this modest job-creation were the private-sector services branches, while industry and construction continued to evidence net job destruction. In year-on-year terms, apparent labour productivity continued to grow at a high rate (1.4%), albeit somewhat down on the previous quarter. In October the unemployment rate held, for the seventh month running, at 8.9%.

The indicators available on economic activity in Q4 suggest that the moderate rate of expansion of output continued in the final stretch of the year. As regards the supply-side indicators, the industrial production index, to November, reflected a progressive deterioration in activity in the sector since the summer months, while the qualitative indicators drawn from confidence surveys did not provide clear evidence about the trend of output in the sector in the most recent period (see Chart 9). The purchasing managers' index increased in December for the first time following five consecutive months of declines. Conversely, the business confidence indicator compiled by the European Commission worsened slightly in December, after having remained unchanged from September to November. The confidence indicators in the services sector showed lower average levels in Q4 than in Q3, although they remain at relatively high values.

Turning to demand, certain signs of a pick-up in private consumption have been observed. In particular, both the consumer and the retail trade confidence indicators increased timidly in Q4.



SOURCES: Eurostat and national statistics.

a. Year-on-year rates of change.

Moreover, new car registrations improved in this quarter. Retail sales also tended to recover, though their growth remains very low. As regards the demand for capital goods, the stabilising of the assessment of order books made by the corporate sector points firmly to the growing buoyancy this demand component has shown throughout the year. Lastly, in respect of external demand, assessment of export order books worsened somewhat in Q4, perhaps reflecting the consequences of the appreciation of the euro. That said, export expectations according to the quarterly business survey, relating to Q4 and published in October, improved on the previous quarter.

In sum, judging by the information available, area-wide output will plausibly expand in Q4 at a similar or slightly higher rate than in Q3, in line with the interval estimated by the European Commission, which places the foreseeable increase in GDP in Q4 at between 0.2% and 0.6%. The growth of funds generated within businesses, boosted by the widening of their margins as a result of the growing containment of their labour costs, and continuing favourable financial conditions make for an outlook conducive to more robust investment and employment, which should lead to a strengthening of activity in the first half of 2005. However, the materialisation of this scenario is conditional upon the heightened dynamism of the demand exerted by

On National Accounts data, the rate of increase in euro area goods and services exports in 2004 Q3 diminished, while imports were highly buoyant, which made for a very negative contribution of external demand to output. The related year-on-year rates, which reflect the average growth of recent quarters, stand at relatively high figures of 6.2% for exports and 8.7% for imports, if compared with the figures for previous years. It would therefore be worth analysing developments in euro area trade by means of a breakdown by type of product and country of destination.

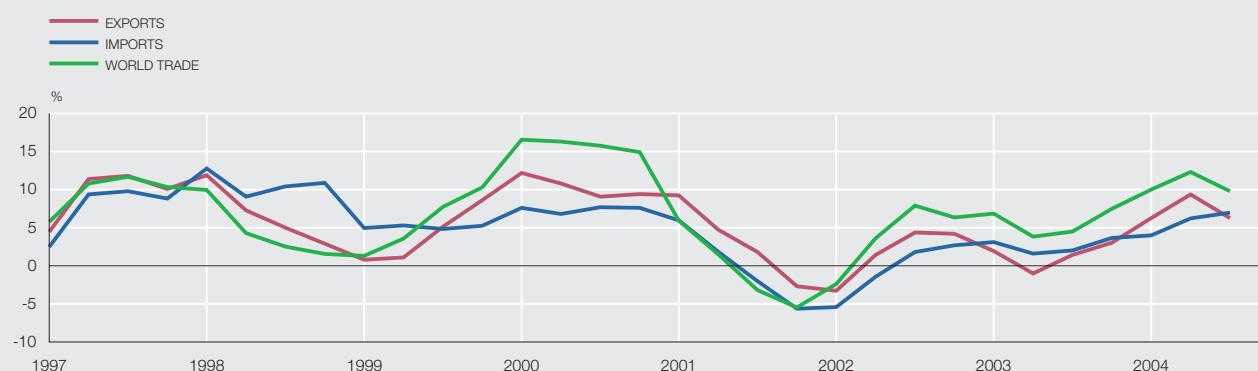
According to Eurostat, euro area merchandise trade during 2004 picked up considerably, attaining an average growth rate in the January-October period of 6.6% for exports and 5.2% for imports. The strength of exports is due to the buoyancy of external demand, which has offset the negative contribution of the appreciation of the euro, which in effective terms has posted an increase of over 20% since early 2002. Imports, meanwhile, have trended in line with the increase in internal demand and with lower attendant prices. As regards the more recent performance of trade flows, imports held on a rising trend in the summer of 2004, while this trend discontinued in the case of exports, in keeping with worldwide trade developments.

According to the breakdown of euro area exports by geographical destination, the pick-up in trade in the area in the first ten months of 2004 was more intense in extra-Community than in intra-Community flows. Although the increase in exports to outside the area was fairly

generalised, the growth rates of sales to Russia, China and south-east Asia were particularly strong, at between 15% and 20% in all cases. In any event, the relative weight of none of these areas exceeds 2% of total euro area trade, whereby the lesser buoyancy of exports to the main geographical destinations (the United States and the United Kingdom) has a bearing on the aggregate rate of change of exports not exceeding single figures. In Q3, the recent slowdown in the growth rate was partly justified by the trend of sales to the United States and to China. As regards imports, the biggest year-on-year increase in the period of 2004 in question was in those from China (23.8%), a country which has increased its relative weight in extra-area imports to almost 10% and is establishing itself firmly as the third-ranked supplier of goods to the area behind the United Kingdom and the United States.

In the breakdown by product, imports of manufactures – which account for somewhat more than three-quarters of total imports – increased strongly in the period from January to October 2004. Under manufactures, the most expansionary component was machinery and transport equipment, with an increase of 6%, which is in keeping with the strength shown by capital goods purchases in 2004. Exports of manufactures evidenced the biggest growth and, hereunder, the biggest rates of increase were for machinery and transport and for chemicals, industries in which the euro area plays a leading role in respect of world trade. Notable in Q3 was the 4.4 pp reduction in the growth rate of exports of manufactured products to 5.6%.

### 1. YEAR-ON-YEAR RATES OF CHANGE



### 2. EXPORTS - BREAKDOWN BY AREA

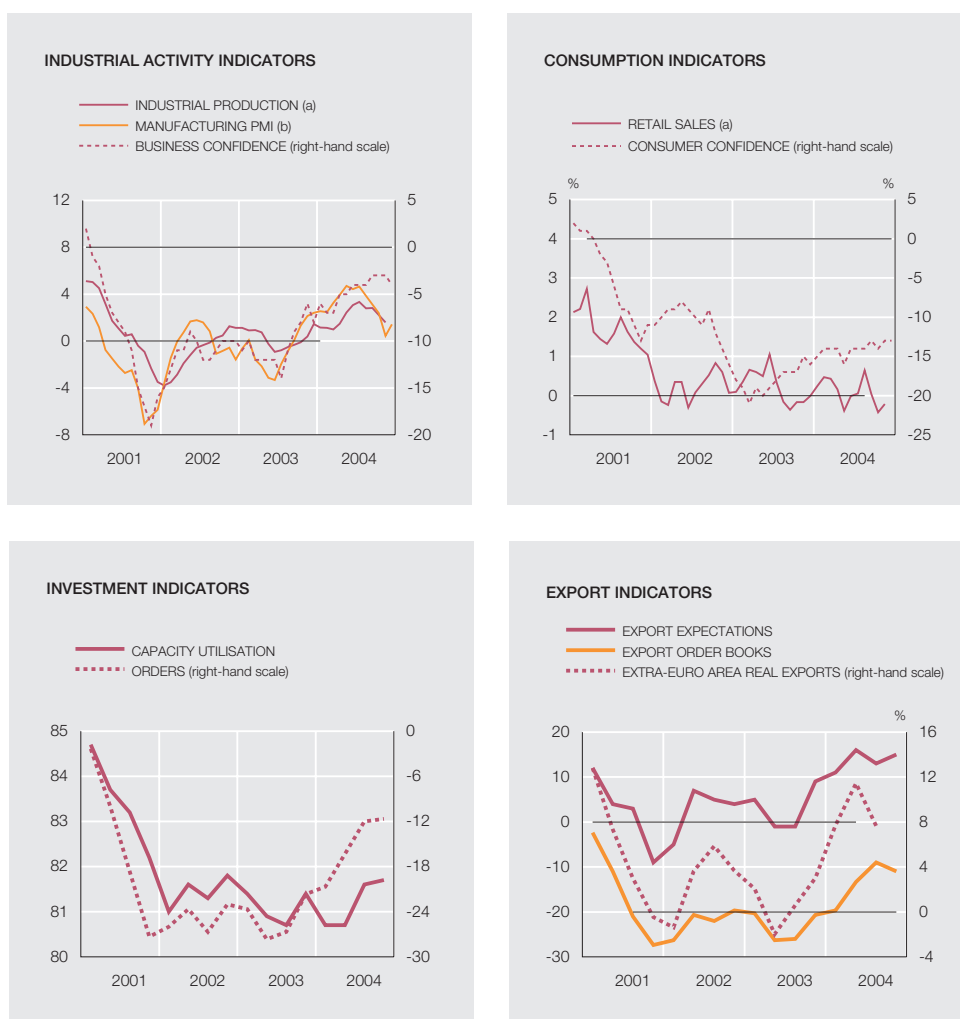
	2003		2004			
	(%)	Rate	Jan-Oct	Q1	Q2	Q3
<b>TOTAL</b>		<b>1.4</b>	<b>6.6</b>	<b>6.3</b>	<b>9.4</b>	<b>6.3</b>
INTRA-EURO AREA	49.9	1.8	5.1	4.6	7.2	5.0
EXTRA-EURO AREA	50.1	0.9	8.0	7.9	11.5	7.4
United Kingdom	9.3	-2.0	3.2	1.5	5.9	3.3
United States	8.2	-3.2	4.6	4.4	9.0	3.1
Russia	1.4	11.4	19.7	17.4	25.0	20.4
Japan	1.6	-1.0	8.3	12.9	8.4	8.9
China	1.7	20.3	17.8	18.7	30.8	8.8
South-east Asia	1.4	0.7	16.9	13.7	19.3	19.5

### 3. IMPORTS - BREAKDOWN BY PRODUCT

	2003		2004			
	(%)	Rate	Jan-Oct	Q1	Q2	Q3
<b>TOTAL</b>		<b>2.6</b>	<b>5.2</b>	<b>4.0</b>	<b>6.2</b>	<b>7.0</b>
(Of which, extra-EU)	50.5	3.6	5.4	4.7	5.5	7.8
FOOD	6.9	3.3	0.7	2.0	1.2	-0.4
COMMODITIES	3.6	0.1	1.8	1.1	0.3	6.2
OIL AND DERIVATIVES	10.1	4.4	2.3	4.8	-0.5	3.8
MANUFACTURES	75.9	2.2	4.5	2.9	6.4	5.8
Chemicals	13.1	2.3	4.1	4.8	4.8	5.2
Commodity derivatives	13.7	0.1	2.5	2.1	2.5	4.8
Machinery and transport	37.0	2.5	6.0	2.5	9.7	7.4
Other	12.1	4.0	2.7	3.1	2.6	3.2
OTHER	2.3	12.1	67.7	55.4	61.9	97.6

SOURCES: Eurostat and IMF.



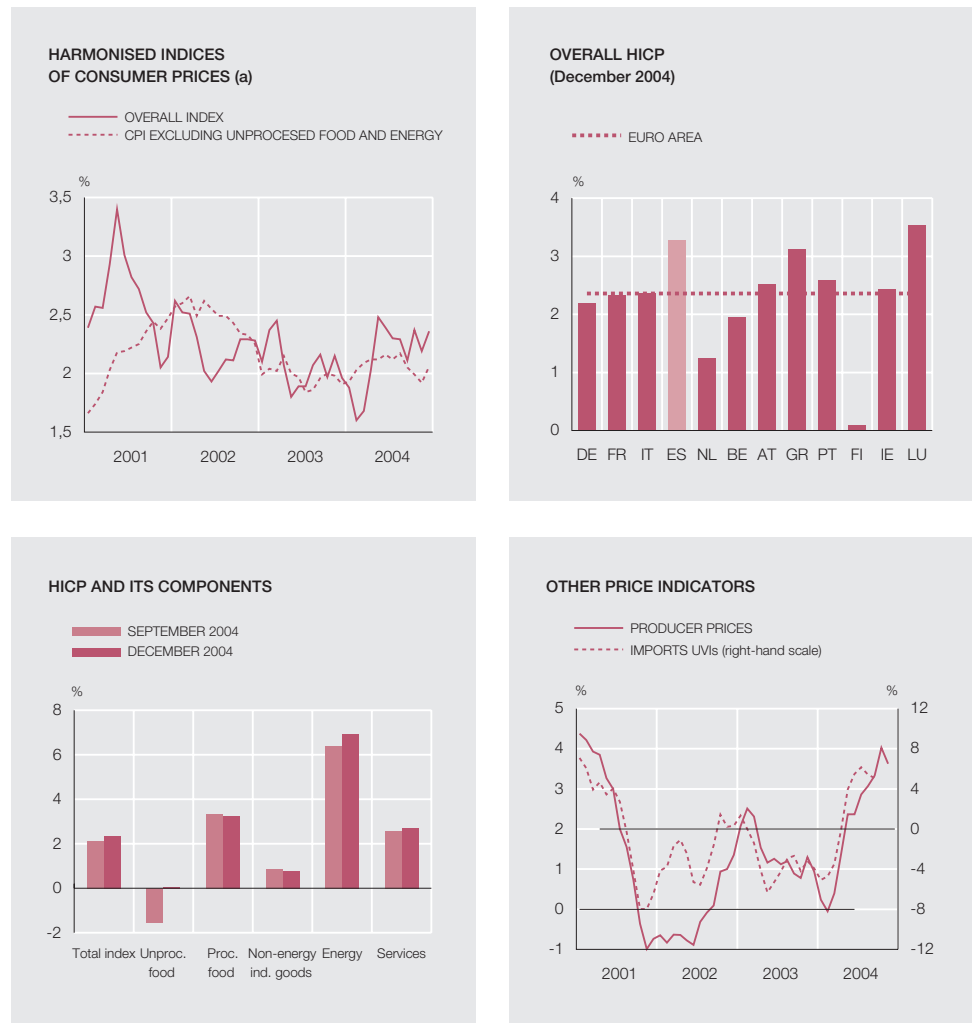


SOURCES: Eurostat and European Commission.

- a. Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.  
 b. Normalised data.

households and by agents from the rest of the world, and here there are sizable obstacles. Against a background in which the notable appreciation of the euro so far may hamper the behaviour of exports, it is crucial that private consumption gathers greater momentum. This latter component should be assisted by continuing low interest rates and by the wealth effect resulting from the rise in the value of households' real and financial assets. However, sluggish employment growth may be a drag on the expansion of these agents' disposable income, tempering their spending decisions. Consequently, any acceleration in activity in the area will hinge crucially on breaking the vicious circle that prevents companies from hiring new employees because of the slackness of demand and households from increasing their spending because of the weak growth of employment.

The year-on-year pace of the harmonised index of consumer prices (HICP) for the euro area has quickened by 0.3 pp in the period September-December 2004, closing the year at a rate of 2.4% (see Chart 10). This performance was due to the behaviour of the prices of unprocessed food and, to a lesser extent, of energy goods (the two traditionally most volatile components), which rose by 1.6 pp and 0.5 pp, respectively. The growth of the index comprising prices of services and of goods other than energy and unprocessed food also increased by



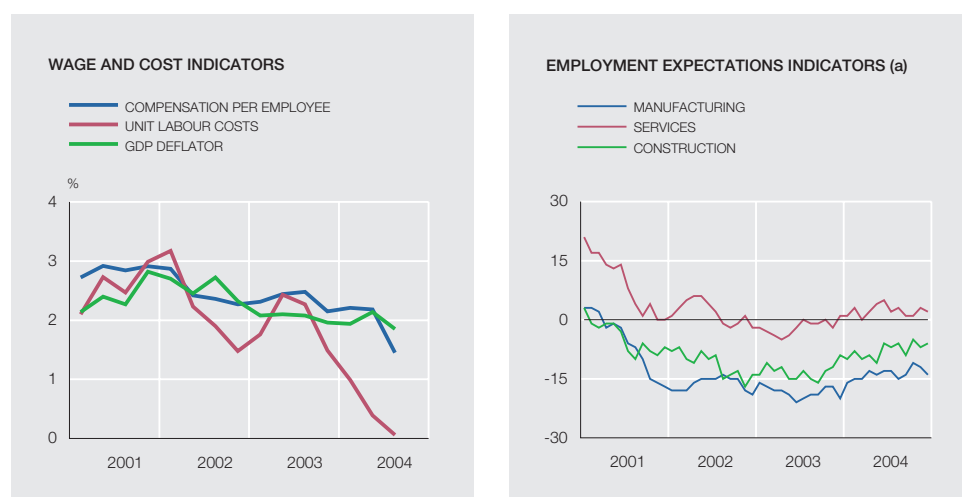
SOURCES: Eurostat and European Central Bank.

a. There is a break in January 2002 when the series was rebased to 2001.

0.1 pp during the quarter to 2.1%, a result attributable to the slight rise in services prices. The rate of increase of industrial producer prices, which had been quickening uninterruptedly since February 2004, slowed in November to 3.6%. This was thanks to the less expansionary behaviour of non-durable consumer goods and, above all, of the energy component, which included in November the decline in oil prices on international markets.

The inflationary outlook for 2005 is relatively favourable, since the downturn in wage growth exerts a significant moderating influence on price dynamics. In 2004 Q3, the year-on-year increase in compensation per employee fell to 1.5% which, given similar growth in productivity, enabled the increase in unit labour costs to slow to a rate of virtually zero (see Chart 11). While the recovery in margins will, in the future, foreseeably contribute to a sharper pace of employment generation, the slight improvement in business expectations about the behaviour of this variable would not suggest that this process is to take place soon and be of any intensity, a fact propitious to continuing wage moderation (see Box 2).

The surplus that built up on the euro area current-account balance in the period from January to October 2004 amounted to €29.9 billion, compared with €12.9 billion in the same period in



SOURCES: Eurostat and European Central Bank.

a. Expectations based on European Commission sentiment indicators.

2003. The rise was due to the increase in the surplus on the merchandise balance and to the trend of the income balance, the deficit on which fell by €9 billion despite the decline in the value in euro of income from the rest of the world as a result of the appreciation of the euro.

With regard to fiscal policy, and according to the European Commission's autumn forecasts (see Table 2), the overall general government deficit in the euro area rose in 2004, for the fourth year running, to 2.9% of GDP. This deficit is 0.6 pp higher than that resulting from the aggregation of the national stability programmes submitted in winter 2003, despite the fact these documents foresaw GDP growth as being 0.1 pp lower. Country by country, the three biggest economies in the area – Germany, France and Italy – and Greece all recorded deficits equal to or greater than 3% of GDP last year according to the Commission. In late 2004, the member countries presented the updates of their respective stability programmes. These inferred a budget deficit of 2.5% in 2005, 0.2 pp down on the Commission's autumn forecast. This difference is due, in approximately equal parts, to the fact that certain countries (Germany in particular) included budgetary consolidation measures in their programmes that had still not been disclosed when the Commission drew up its forecasts and because, in aggregate terms, the programmes envisage somewhat greater economic growth.

There were fresh developments in January in connection with the excessive deficit procedures initiated against Germany, France and Greece. In the case of Greece, the ECOFIN Council examined the degree of compliance with the recommendation made last July, in which the Greek authorities were given four months to adopt measures aimed at correcting the excessive deficit. It deemed the action taken to be insufficient, and will therefore demand in the coming weeks that the Greek authorities take further measures to remedy the situation.

In the cases of Germany and France, the Council endorsed the conclusions of a communication issued by the Commission in December on the position of these two countries in respect of their obligations under the excessive deficit procedure. In this connection, the Commission evaluated the consequences of the European Court of Justice's ruling that invalidated the conclusions adopted by the Council in November 2003. In the Commission's opinion, since these conclusions were presumed to be valid until their annulment by the Court, the action

In recent years compensation per employee in the euro area has slowed progressively, even in the recent period in which activity has picked up, falling from year-on-year growth of 3% in 2000 and 2001 to 1.5% in 2004 Q3. In this same period, real wages trended very moderately, constantly in line with – or below – the growth rate of apparent labour productivity (see panel 1). Such wage restraint has stepped up since mid-2003, the juncture at which GDP began to recover. And along with flatter employment, it has given rise to a marked rebound in productivity, which has provided for a continuous decline in the growth rate of unit labour costs and, consequently, a notable widening of business margins (see panel 2).

Among the determinants of this prolonged phase of wage moderation in the euro area are the strong reduction in the growth rate of employment, the rise in the unemployment rate – from 8% in mid-2001 to 8.9% at present (at which level it has held unchanged in recent months) – and, to a lesser extent, the downtrend in the growth of the HICP to 2004 (see panel 3). Uncertainty over the intensity of the economic recovery and the greater competitive pressures facing European companies – due partly, in turn, to the forceful appreciation of the euro in this period – may also have contributed to keeping wage increases contained. Indeed, such wage containment was clearly apparent in 2004 when, despite the notable acceleration in consumer prices (mainly as a result of the hike in oil prices), there was no sign of an increase in wage pressures, which would also be testifying to the fact that inflation expectations have held stable. However, it cannot be ruled out that some of the structural changes in the recent period in European labour mar-

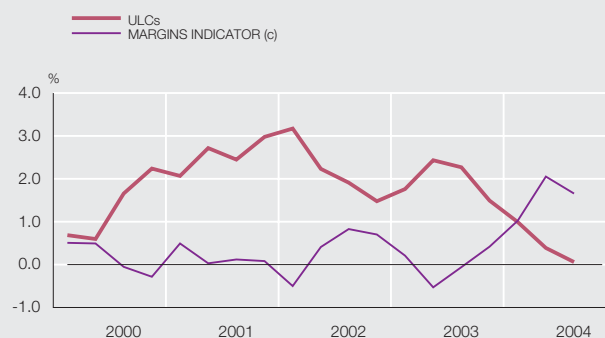
kets, aimed at making them more flexible, may also have exerted some influence on the moderate behaviour of wages. Thus, for instance, the introduction in Germany of new forms of hiring with lower labour costs (the so-called “mini-jobs”) might explain the negative year-on-year rate of change for compensation per employee in Germany in 2004 Q3 (–0.5%), which has been conducive to the notably lower growth of compensation per employee in the euro area as a whole.

Despite the expected improvement in labour markets in the area in 2005, this will foreseeably come about gradually, in step with the progressive pick-up in activity and with the behaviour shown to date by employment. This will limit the likelihood of the substantial rise in oil prices during 2004 generating second-round effects; accordingly, the period of wage moderation may be expected to continue. The figures available to date on collective bargaining agreements already signed in the euro area for 2005 and, to a lesser extent, for 2006 confirm this. Broadly, the figures suggest that in both years the wage growth agreed upon under collective bargaining will, for the euro area as a whole, hold at a similar level to that recorded in 2004 (see panel 4). Nonetheless, this aggregate behaviour will be the result of differing developments from country to country, since in some a certain increase in the growth rates of negotiated wages is expected in 2005 (the case of Germany, owing to specific factors that gave rise to smaller wage rises in 2004, or Spain, as a result of the activation of the inflation-adjustment clauses), while in others (such as Greece or Ireland, with high increases in 2004) lower wage growth is foreseen.

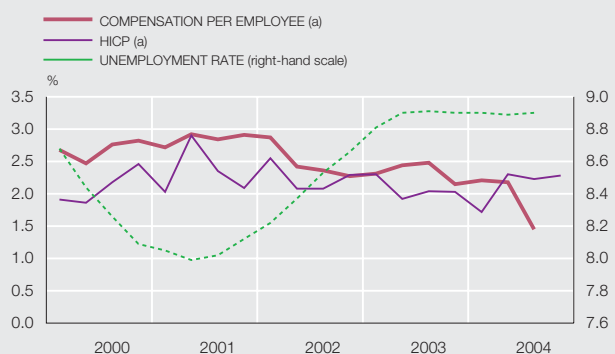
1. REAL WAGES AND PRODUCTIVITY (a)



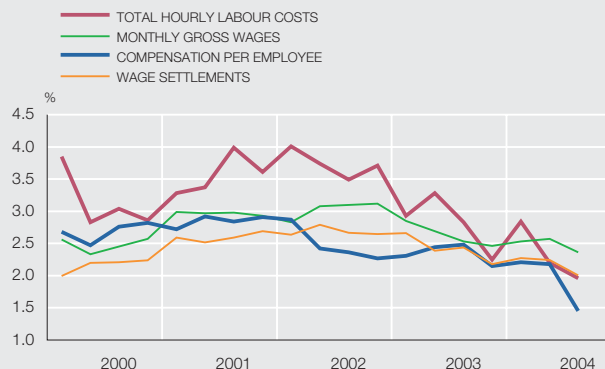
2. ULCs AND MARGINS (a)



3. WAGES AND UNEMPLOYMENT



4. INDICATORS OF LABOUR COSTS (a)



SOURCES: EUROSTAT and ECB.

- a. Year-on-year rates of change.
- b. Compensation per employee deflated using the GDP deflator.
- c. Proxied by the ratio of the deflator of GDP at factor cost to unit labour costs.

**GENERAL GOVERNMENT BUDGET BALANCES  
OF EURO AREA COUNTRIES (a)**

TABLE 2

% of GDP						
	2002	2003	2004 (b)	2004 (c)	2005 (b)	2005 (d)
Belgium	0.1	0.4	-0.1	0.0	-0.3	0.0
Germany	-3.7	-3.8	-3.9	-3.3	-3.4	-3.0
Greece	-3.7	-4.6	-5.5	-1.2	-3.6	-2.8
Spain	-0.1	0.4	-0.6	0.0	-0.1	0.1
France	-3.2	-4.1	-3.7	-3.6	-3.0	-2.9
Ireland	-0.2	0.1	-0.2	-1.1	-0.6	-0.8
Italy	-2.3	-2.4	-3.0	-2.2	-3.0	-2.7
Luxembourg	2.8	0.8	-0.8	-1.8	-1.6	-1.0
Netherlands	-1.9	-3.2	-2.9	-2.3	-2.4	-2.6
Austria	-0.2	-1.1	-1.3	-0.7	-2.0	-1.9
Portugal	-2.7	-2.8	-2.9	-2.8	-3.7	-2.8
Finland	4.3	2.3	2.3	1.7	2.1	1.8
MEMORANDUM ITEM: Euro area						
Primary balance	1.3	0.7	0.5		0.8	
Total balance	-2.4	-2.7	-2.9	-2.3	-2.5	
Public debt	69.4	70.7	71.1		71.1	

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 0.03 of GDP have been shaded.

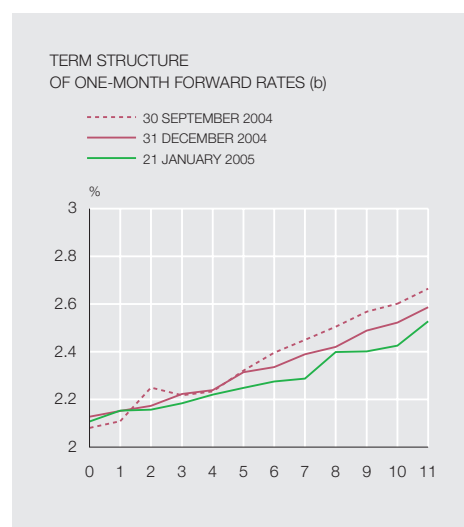
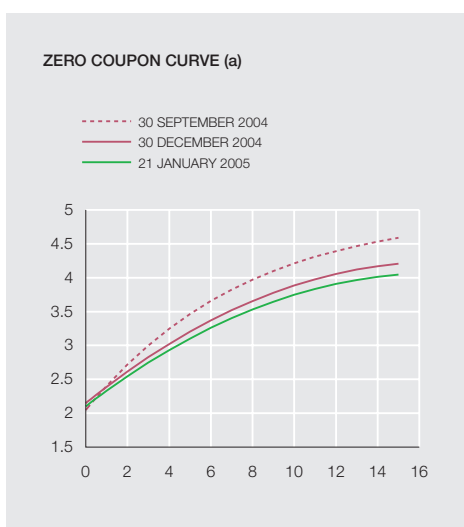
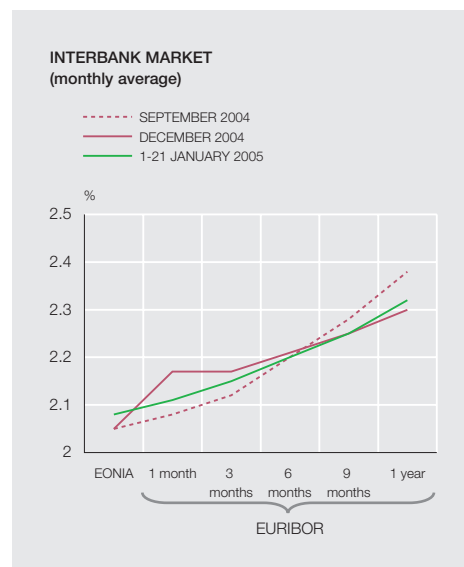
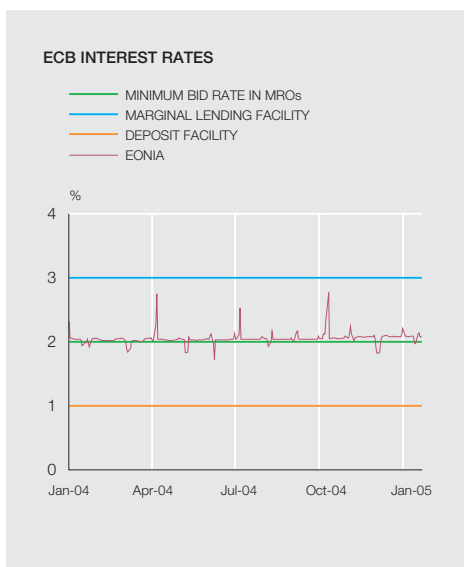
b. European Commission forecasts (autumn 2004).

c. Targets of the stability programmes presented between November 2003 and January 2004.

d. Targets of the stability programmes presented between November 2004 and January 2005.

taken by the German and French authorities should be judged on the basis of compliance with these conclusions. In particular, the Council ruled that the action taken has been consistent with the elimination of the excessive deficit in 2005 required by the aforementioned conclusions, whereby the following steps of the procedure will not for the moment be initiated. Nonetheless, the Council has noted that the vulnerability of the budgetary position of both Member States persists and, in particular, that the correction of the excessive deficits requires the effective application of all the measures envisaged. In the absence of such measures, the Commission will recommend to the Council that it should take the necessary action under the provisions of the Stability and Growth Pact.

In the case of Germany, the initial budgetary consolidation strategy for 2005 in the draft central government budget was based on a uniform lowering of the spending ceilings for all ministerial departments and on the reduction of subsidies to the private sector. However, the European Commission's autumn forecasts, which took these plans into account, pointed to a deficit of 3.4% of GDP in 2005. For this reason, the authorities unveiled a package of additional measures in November so that the budget deficit should not exceed 3% of GDP in the current year. In France, the envisaged reduction in the deficit for this year is based on the reform of the public health system, on stabilising real State expenditure and on a transfer of an amount equal to 0.5% of GDP received from the privatised gas and electric utilities in exchange for the government assuming responsibility for the future spending on their employees' pensions. In both countries, many of the measures adopted have a merely temporary effect on public finances, and even increase future deficits in some cases. In both countries the budgetary strategies designed for 2005 contain activity-stimulating elements or structural reforms bearing a budgetary cost. Thus, in Germany, the last phase of the tax reform planned in

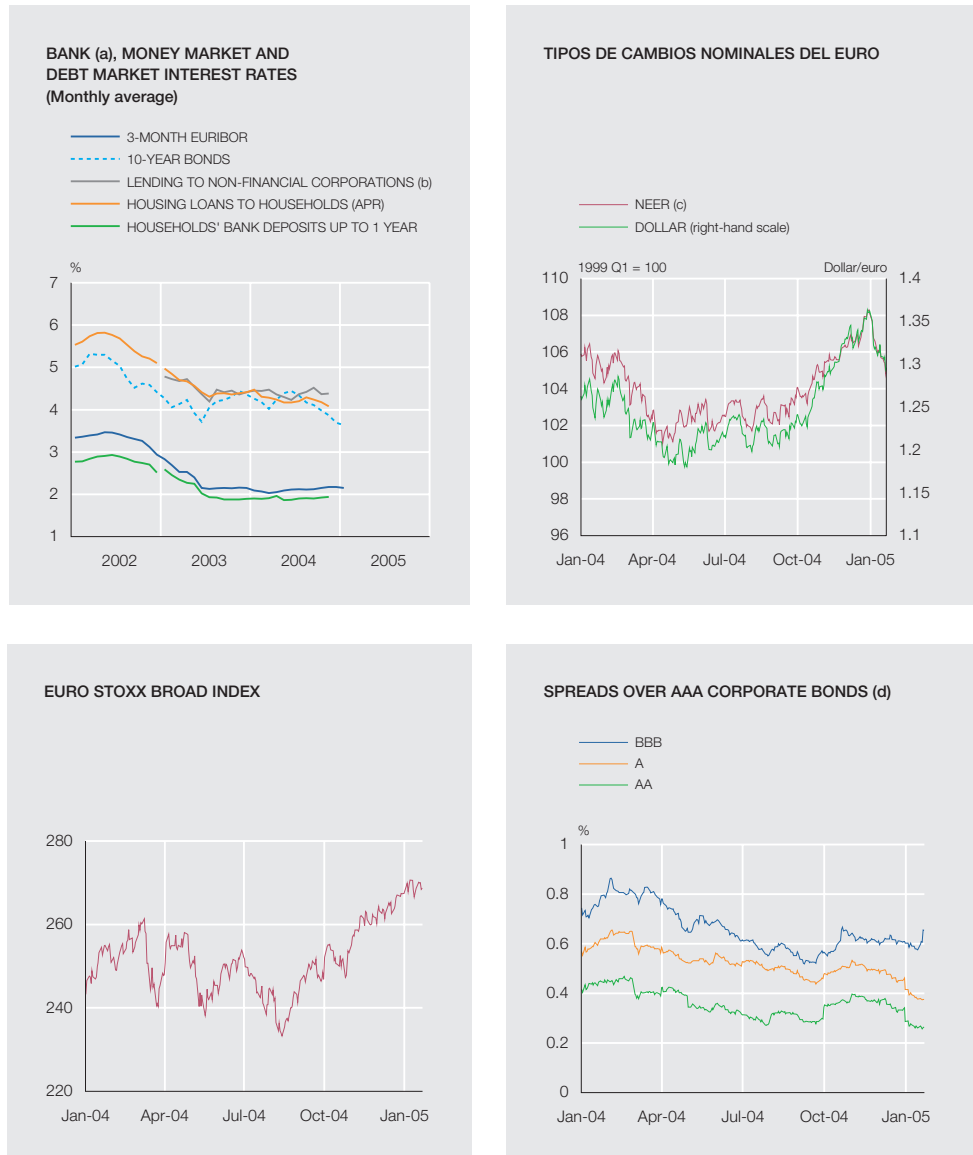


SOURCES: European Central Bank and Banco de España.

- a. Estimated using swap market data.
- b. Estimated using Euribor data.

2000 came into force on 1 January, which will entail a reduction in income tax revenue of the order of 0.3% of GDP. And in France, the application of various tax cuts (affecting, above all, corporate income tax) will have an estimated cost of 0.1% of GDP.

Finally, after summer last year, the euro area countries discussed the possible means of improving the Stability and Growth Pact. Deliberations are expected to conclude in the coming months, such that the final outcome of this debate will be agreed at the spring European Council. The most controversial aspects refer to the degree of flexibility that might be accorded to the definition first, of the exceptional circumstances or the relevant factors that have to be taken into account to determine whether a deficit higher than 3% of GDP is excessive or not; and further, of the particular conditions that would justify correction of the excessive deficit being extended beyond the two years stipulated in the Stability and Growth Pact. It is of paramount importance in a monetary union to maintain an institutional framework of fiscal discipline that steers and watches over national budgetary policies. It is therefore necessary that the final outcome of this process should address compliance with this objective.



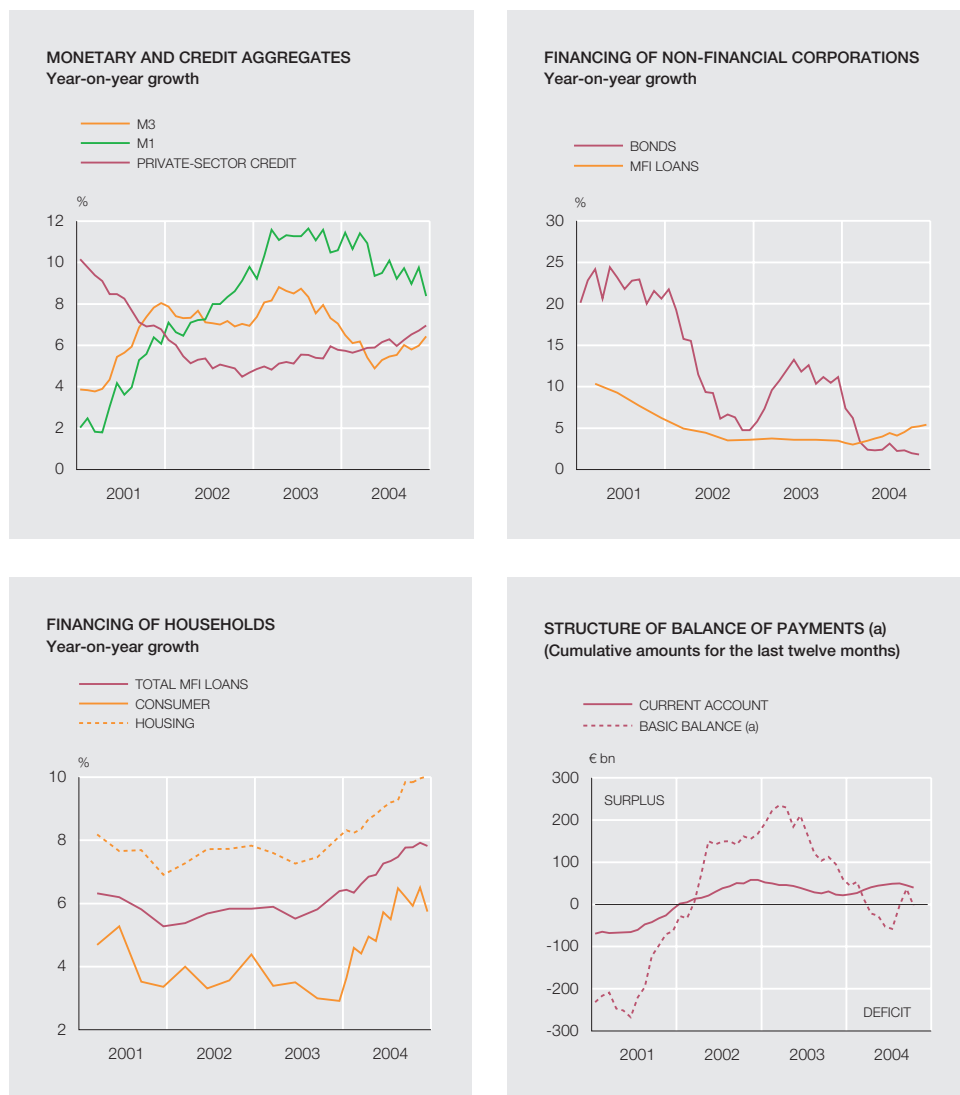
SOURCES: Banco de España and European Central Bank.

- a. Data drawn from new statistics on interest rates compiled by the ECB for new operations.
- b. Interest rates over five years.
- c. Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.
- d. Euro-denominated bonds issued by non-financial corporations.

**3.2 Monetary and financial developments**

As described in the preceding section, economic activity continued to expand in the second half of 2004, albeit at more moderate rates than those observed in the first half of the year, and the factors of uncertainty previously in place were not fully dispelled. Against this background, the ECB Governing Council considered the increase in inflation in the closing months of the year to be an essentially transitory development, arising from higher oil prices. It did not therefore expect price stability in the medium term to be endangered. Accordingly, in the final stretch of 2004 and at its first meeting in 2005, the ECB decided to hold its official interest rates at the levels ruling since June 2003. Hence the rates on the main refinancing operations, on the deposit facility and on the marginal lending facility were left unchanged at 2%, 1% and 3%, respectively.

As can be seen in Chart 12, the money market yield curve has tended to flatten slightly since September, as a result of the moderate decline at the longer end. At the end of the third week of



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.

January the spread between one-year and one-month terms was approximately 20 bp, meaning that market participants have revised their expectations downwards regarding the raising of official interest rates in the current year. In the secondary markets for public debt in the area, the decline in ten-year yields that began during the summer continued. The falls from the relative high attained in mid-June and since late September have been 90 bp and 50 bp, respectively. Conversely, in the United States, the trend which had seen a decline in the ten-year bond yield to late October turned around thereafter. This divergent trend has given rise to a widening of the spread between US debt and that of the euro area to its highest level since 2000 (70 bp).

On the private fixed-income markets, corporate bond spreads broadly held at very low levels (see Chart 13). The interest rates applied by credit institutions to operations with customers held stable to November around the levels maintained since the last cut in official interest rates in June 2003.

The rise in euro area stock market prices initiated in mid-August continued during 2004 Q4. The explanatory factors potentially behind this include the sustained growth of corporate prof-



its, the reduction in interest rates on long-term debt and, more recently, the fall in oil prices. As a result, the broad Euro Stoxx index climbed by approximately 13% from its low in August to the end of 2004, closing the year with gains of 10%. In the opening weeks of 2005, the direction of stock markets across the area has not been clear.

On the currency markets, the appreciation of the euro against the dollar that began in late August continued during the final part of the year. This trend, linked very possibly to the growing concern of financial market participants for the high and persistent US current-account deficit, saw the bilateral exchange rate between both currencies end the year at \$1.36 per euro, an all-time high. In Q4, the euro rose by almost 10% against the dollar, while in the year as a whole the depreciation was somewhat less, at around 8%. In nominal effective terms, the strengthening of the European single currency in 2004 was less marked, amounting to 3.3%. In the first three weeks of 2005, more than one-third of the depreciation by the dollar against the euro in Q4 was recouped.

In December, the year-on-year growth rate of the M3 monetary aggregate stood at 6.4%, 0.4 pp up on the end-Q3 figure, which entails something of a firming of the more dynamic phase initiated following the relative low of 4.9% reached in May. The expansion of credit to the private sector continued to strengthen gradually in the closing months of 2004, as a result of the greater vigour of bank loans granted to non-financial corporations, the rate of increase of which rose by almost 1 pp between September and December to 5.4%. Loans to households increased in December at a year-on-year rate of 7.8%, unchanged on that at the end of Q3, since the slight acceleration in lending to finance house purchases was offset by the slowdown in consumer lending. In Spain, credit to the private sector continued to expand at a much higher rate, exceeding 18%.

## 4 The Spanish economy

During 2004 Q4, the buoyancy of domestic demand in the Spanish economy remained substantial, though somewhat diminished, while the contribution of external demand to growth should have improved in relation to the sharp subtraction of 2 pp recorded in Q3. As a result of these developments, GDP is estimated to have grown by 2.7% year-on-year in Q4, slightly up on the previous quarter. Domestic demand has shown signs of slowing slightly in year-on-year terms, which has affected both household consumption and investment in construction. Investment in capital goods remained very robust, running at a somewhat lower rate than in Q3. It was underpinned by the improvement in corporate profits and rates of return during the year. Behind the pick-up in external demand is the improvement in tourism, while the losses in competitiveness that have built up, against the background of the strength of the euro, have checked the growth rate of goods exports, even though trade is notably vigorous at present.

In 2004 as a whole, the economy would have grown by 2.6%, 0.1 pp up on 2003. The year was marked by high job-creation (2.1%), which boosted household consumption and the demand for housing, and by the pick-up in investment in capital goods, the momentum of which was more in step with the cyclical situation. Despite the recovery in exports in 2004, the negative contribution of the external sector was around 1.5 pp, owing to the acceleration in imports of goods and services and to the slight slide in tourism over the year as a whole.

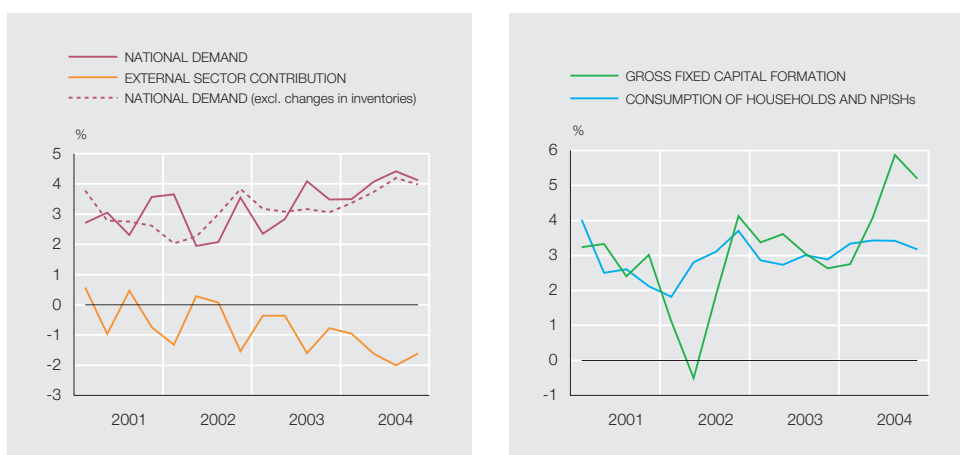
From the production standpoint, value added in the market economy grew at a similar rate in Q4 to the rest of the year. The information available points to a recovery in the agriculture and fisheries branch, while growth in market services held stable and construction slowed, albeit retaining a high growth rate. The economic indicators on employment in Q4 reflected an improvement in industry and construction, meaning that a slightly higher growth rate may be estimated for numbers employed than in Q3.

Productivity in Q4 has thus held on its habitual path of low growth. Labour costs slowed slightly, in a similar fashion to Q3. However, the acceleration in the GDP deflator shows that margins may have widened in the market economy in the closing months of the year. In respect of the CPI, a year-on-year increase of 3.2% was posted at the end of the year, following a figure of 3.5% in October, as a result of the upward impact of oil prices. For the year on average, the CPI increased by 3%.

### 4.1 Demand

Spanish household final consumption spending, in real terms, posted a high and stable year-on-year growth rate of 3.4% in the first three quarters of 2004 (see Chart 15). The latest information appears to indicate that this robustness has extended into Q4, although its pace may have eased to some extent. The buoyancy of private consumption last year was based on the sound growth of household real income, on the real net wealth gains in this sector and on the continuing generous financial conditions which, overall, contributed to checking the recovery in the household saving ratio.

The available indicators point, as mentioned, to a slight easing in the pace of private consumption in Q4 (see Chart 16). The synthetic indicator of goods and services consumption, estimated with incomplete data for this quarter, moved on a mildly slowing profile owing to the behaviour of durable consumer goods, especially cars. In particular, the considerable buoyancy of new car registrations diminished in part in Q4, despite their sound behaviour over the year as a whole. Under the remaining indicators of household spending, while there has been



SOURCES: INE and Banco de España.

a. Year-on-year percentage change based on seasonally adjusted series.

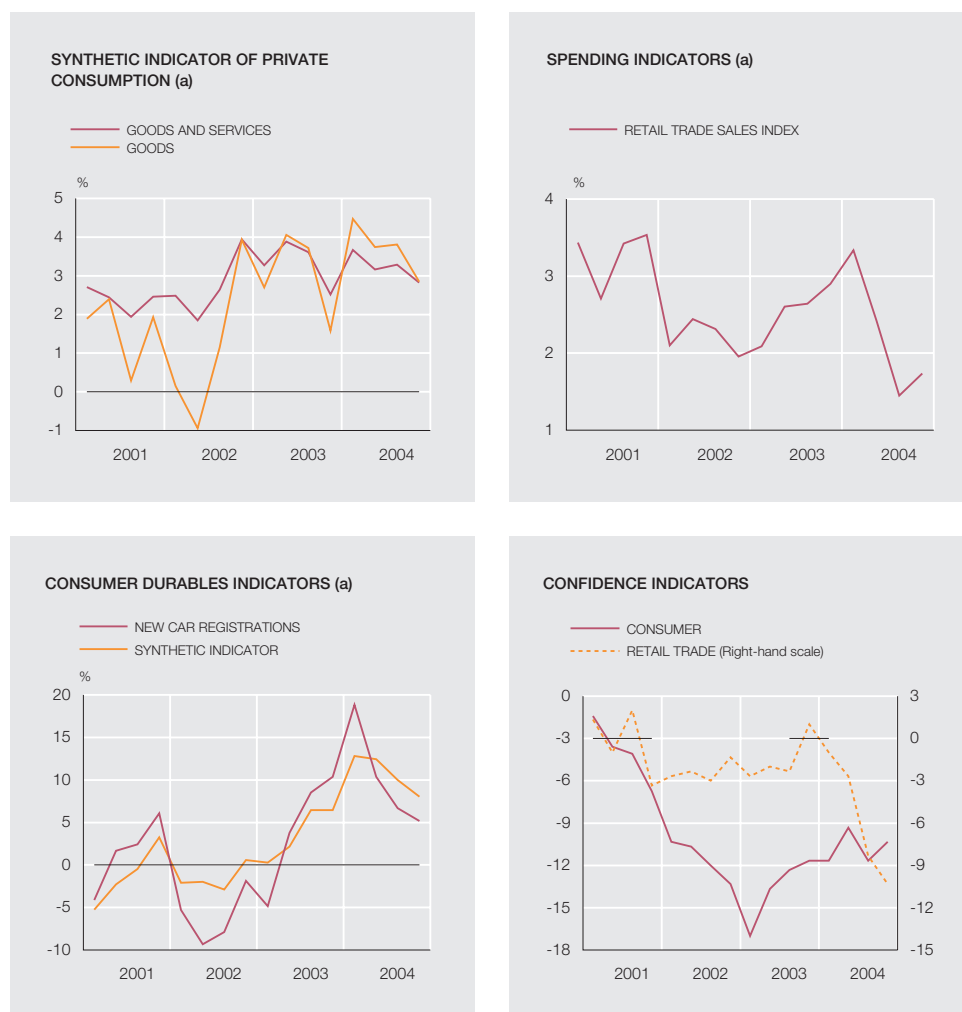
fresh slippage in the retail trade confidence indicator, the overall retail sales index increased moderately in October and November. On a more optimistic note, the consumer confidence indicator improved progressively from October to December, driven by rising expectations about households' position.

Among the determinants of private consumption, real disposable income increased in 2004 at a higher rate than the previous year, assisted by the ongoing rise in employment and by an increasingly more expansionary general government contribution to its growth. In this respect, despite the favourable impact of the 2003 personal income tax reform having run its course, there has been an acceleration in the payment of both pension and unemployment benefits, due in the latter case to the widening of the related eligibility ratio. Household wealth also supported the growth of consumption, as there was a continuing and significant rise in the value of real-estate assets due to house-price rises and an increase in household financial wealth through rising stock market prices, especially in the second half of the year.

In 2004 Q3, general government final consumption posted a year-on-year increase of 4.4%. The scant information available points to an increase in the pace of this aggregate in Q4, in step with the State budget outturn figures.

Gross fixed capital formation rose by 5.9% in 2004 Q3, accentuating the recovery initiated the previous quarter (see Chart 15). Although the acceleration in investment in capital goods was sharpest, all the components trended favourably.

As earlier mentioned, the indicators of investment in equipment point to a slight slowdown in this type of investment in 2004 Q4, after it peaked in the summer months (see Chart 17). In particular, on current information, the indicator of apparent investment in capital goods has continued to show very high growth rates (albeit somewhat lower than those in Q3) which reflect a fresh and very positive contribution of foreign trade in this type of good. On a less expansionary note, surveys on the order books of capital-goods producers worsened substantially in November and December, a negative trend which is also apparent, albeit more moderately, in the indicator of the business climate for this type of good. However, the order book of industry as a whole has improved. Capacity utilisation across industry has fallen slightly in Q4, although the proportion of companies that consider their plant capacity to be excessive has also declined.

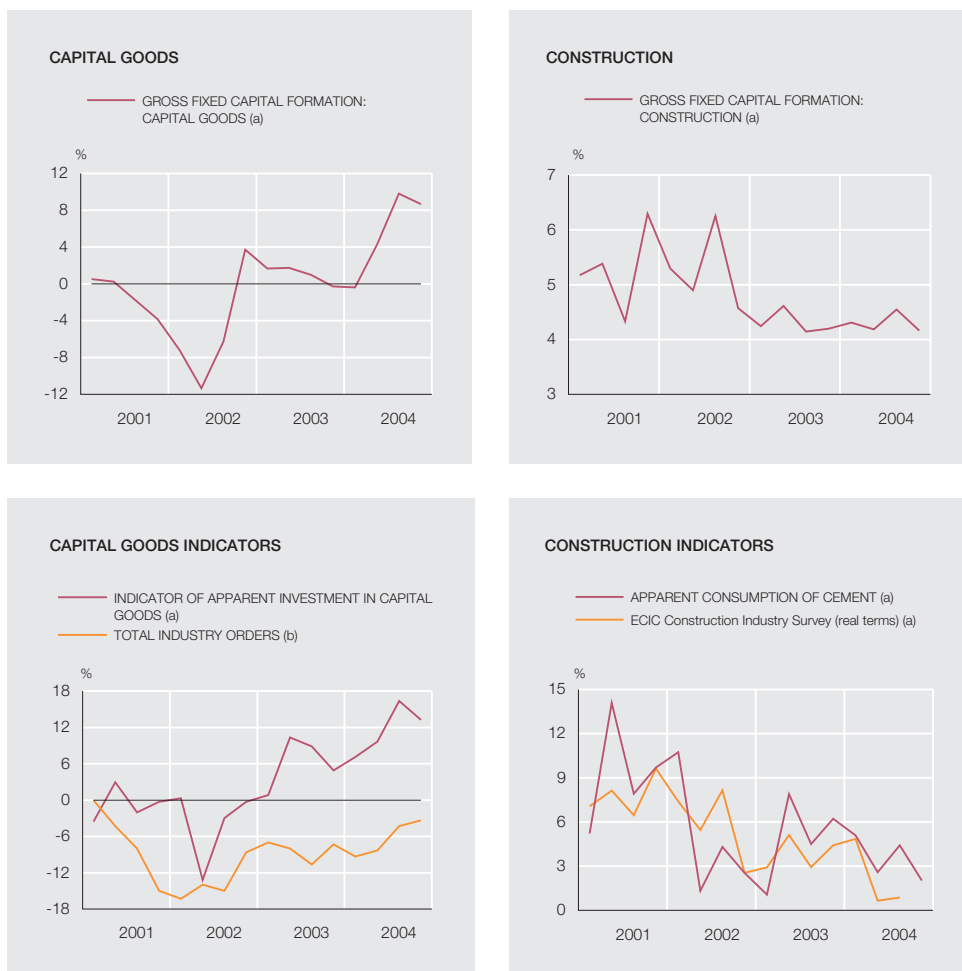


SOURCES: INE, European Commission, ANFAC and Banco de España.

a. Year-on-year percentage change based on the seasonally adjusted series.

The information on non-financial corporations compiled by the Banco de España Central Balance Sheet Data Office, running to 2004 Q3, indicates that Spanish companies have maintained a sustained growth rate during this period. Along with the increase in activity, personnel costs and financial expenses were on a declining trend, making for favourable net operating profit and profit ratios. This should underpin buoyant investment in capital goods in the coming quarters.

Investment in construction in 2004 Q3 increased by 4.5%, a growth rate not attained since 2003 Q2. However, the latest economic information, taken as a whole, would suggest a mild slowdown in the final quarter of the year. True, the confidence indicator for the sector rebounded forcefully from August onwards, holding on a growing path in the last two quarters of the year, and the indicators of registered unemployment and social security registrations were favourable in Q4. Yet the apparent consumption of cement maintained a more stable profile and the industrial production index for construction materials posted a slight slowdown in the closing months of the year. Lastly, according to the Construction Industry Survey (ECIC) the volume of work undertaken by companies in the sector, deflated by the construction costs index, showed a stable rate of change until Q3, although it was down on that recorded in 2003.



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

- a. Year-on-year percentage change based on the seasonally adjusted series.  
b. Level of original series.

Distinguishing between different types of work, the leading indicators on residential building turned around in Q4, moving onto a mildly slowing path. Thus, building approvals indicated a slowdown in the surface area to be built. Elsewhere, according to the leading indicators of non-residential building, such as project approvals or government procurement, there would have been a certain rise in the second half of the year, following the poor figures in the previous quarters. In the case of civil engineering works, too, official procurement budgets, especially in the general government sector, increased in the second half of the year. In both cases, however, the effects on construction activity will not be visible until late 2005 or early 2006.

In 2004 Q3, net external demand subtracted 2 pp from GDP growth, 0.4 pp up on the negative contribution of the previous quarter. Real exports of goods and services picked up somewhat in this period, with their year-on-year rate of increase edging up to 4.2%, while real import flows continued on the expansionary path on which they have been moving since the start of the year, with their year-on-year rate rising to 9.6% (see Chart 18). This result was against a background of notably buoyant worldwide trade, which held at a rate of over 9%. But the increase in our exports remained below the growth of our export markets, since the sharp loss in competitiveness that has built up since last year, given the considerable strength of the euro, checked their growth. As regards imports, the greater buoyancy of final demand and the



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

- a. QNA data at constant prices.
- b. Deflated seasonally adjusted series.
- c. Seasonally adjusted series.

strength of industrial activity account for the rise in purchases abroad. The as yet incomplete information for 2004 Q4 suggests something of a correction in the external imbalance in the final stretch of the year, owing to the slowdown in imports, in a setting of slightly decelerating industrial activity. That said, sales abroad are also projected to ease, affected by the forceful rise in the euro in the closing months of the year.

Turning to goods exports, their year-on-year rate of increase rose in 2004 Q3 to 6.5%. That said, Customs data drawing on QNA figures for October and November showed a slightly slowing profile. This trend is consistent with the pause in the recovery in the euro area, the main export market for Spanish products, and with the deterioration in competitiveness, both vis-à-vis the euro area and, to a greater extent, the other developed countries, further to the growing appreciation of the euro in the closing months of the year. In the first eleven months of 2004, goods exports grew by 5.5%, down on the 6.2% increase for the whole of 2003. By geographical area, sales to the EU-15 were similar to the previous year (4.2%), while extra-Community exports increased by 8.5% in real terms, slowing the notable increase seen the previous year. However, there was a strong pick-up in exports to Japan and, to a lesser extent, to Latin America and the south-east Asian countries, while exports to the central and eastern

European countries, conversely, slowed notably, and sales to the United States remained sluggish.

As to exports of services, on QNA figures for 2004 Q3 the year-on-year rate of decline of real tourism revenue lessened to -1.5% from -2.2% the previous quarter. This item remained sluggish, however, marked by the progressive loss in competitiveness vis-à-vis the tourist offer of the eastern Mediterranean countries, Spain's biggest competitors in the sun and beach segment, and against the background of the strong euro. On the latest available information, the number of overnight stays in hotels in Q4 on average picked up notably, to a positive rate of 3.5%. Yet for 2004 as a whole the indicator posted a negative rate (-1.3%), revealing a reduction in the average stay by tourists in these establishments along with a decline in their average spending. The rate of increase in the number of tourists entering Spain climbed notably in the last three months of 2004 to 10%, although over the year as a whole the increase was more modest, at 3.4%. During this period the rate of increase of the British market, from where most tourists to Spain are drawn, slowed substantially, while the German market – ranked second in importance – appeared to have initiated an incipient recovery. As to tourism from outside Europe, there was a heavy decline in the Japanese market while the US market was flat.

Exports of non-tourist services continued to slip in 2004 Q3 (-2.2%), in line with the nominal balance of payments indicator, which reflected a fresh weakening in services linked to construction, IT services and corporate services.

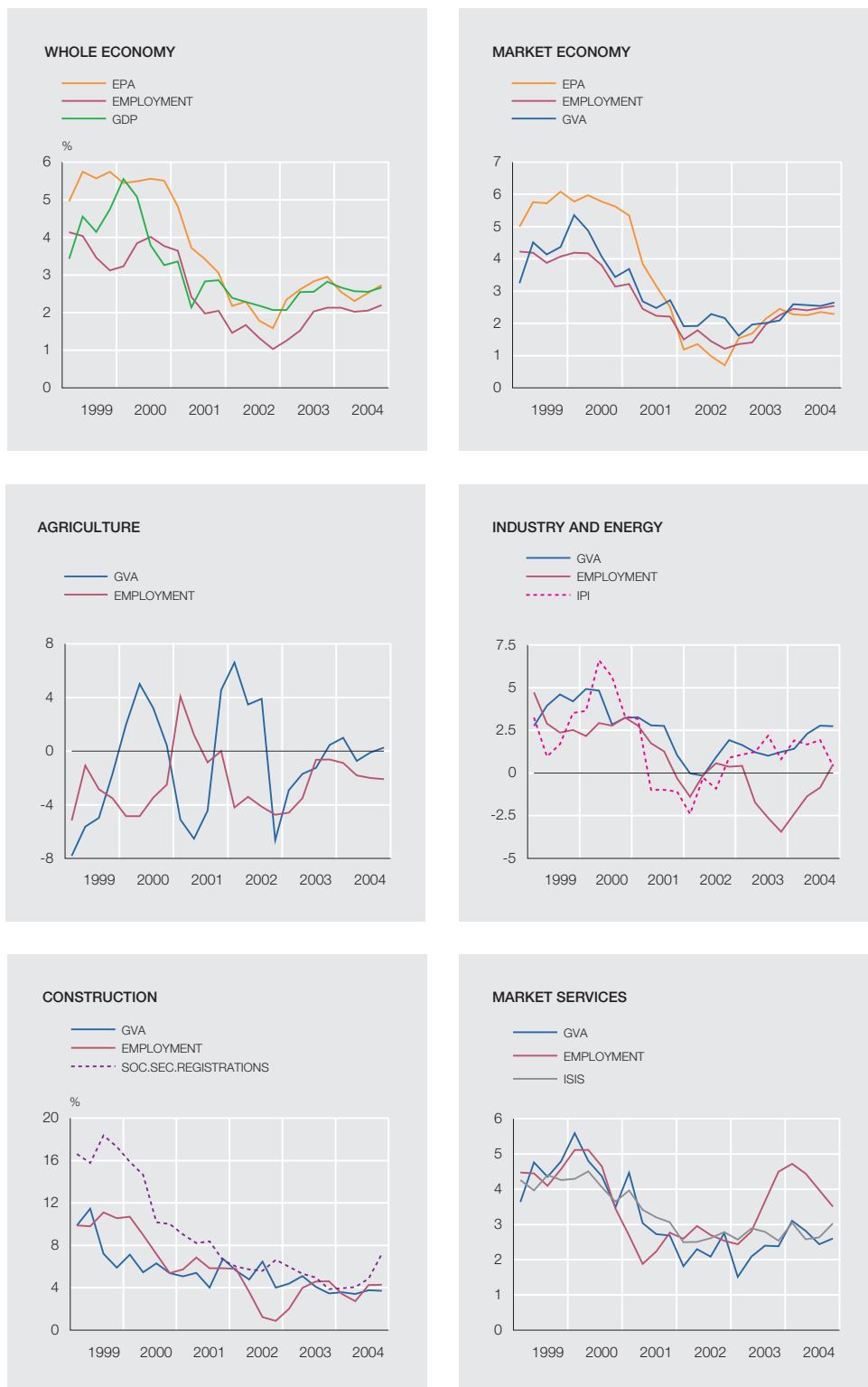
On QNA figures, the year-on-year rate of increase of real goods imports continued rising in 2004 Q3 to 10.6%, driven by the strength of final demand and the improvement in industrial activity, against the backdrop of the ongoing loss in competitiveness of domestically produced goods vis-à-vis imported products. The Customs data for October and November show that the rate of increase of external purchases eased slightly in this period, projecting a mild slowdown for Q4 as a whole, albeit retaining high rates. During the first eleven months of the year there was a real increase in imports of 10.7%, more than 3 pp up on the average for 2003, with a notably sharp increase in purchases of capital goods (19%) and of consumer goods (14.8%).

Finally, in terms of QNA, real imports of services quickened slightly in 2004 Q3 (4.4%). Purchases of non-tourist services grew at a muted rate of 1.4%, though this marked an advance on the first half of the year, while the buoyancy of imports of tourist services continued apace (17.4%). The recovery in consumer confidence and the strength of the euro would be prompting the expansionary behaviour of this item.

## **4.2 Output and employment**

The growth of value added in the market economy in 2004 was appreciably higher than in 2003 (1.9%). Following the mild slowdown in Q3 (2.5%), output is estimated to have regained a similar pace in Q4 to that seen in the first half of the year (2.6%), driven by the improvement in agriculture and in market services (see Chart 19). Activity in the agriculture and fisheries branches gathered some momentum in Q3, which did not prevent its year-on-year rate of increase from remaining at a negative value (-0.1%), though it may have turned positive in the final months of the year.

The industry and energy branch gathered steam once more in 2004 Q3, posting a rate of change of 2.8%. Value added in the industrial branches increased by 2.9%, while energy slowed slightly with growth at 2.2%. The drivers of this behaviour in industry were the robustness of investment in capital goods and of goods exports. However, the Q4 data on investment in capital goods and on sales abroad were somewhat less expansionary, which meant



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

a. Year-on-year percentage rates based on 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.



the ensuing performance of industrial activity was less buoyant. In October and November, the rate of increase of the overall industrial production index was lower than in Q3, with the slowdown centred on the non-energy component. Nonetheless, other indicators, such as that of confidence in the sector, or that of Social Security registrations, improved slightly in Q4.

The resilience of construction in terms of it not slowing was highlighted once again in 2004 Q3. In this period it gained fresh momentum, maintaining it as the Spanish economy's most dynamic industry. On QNA figures, the year-on-year growth of value added in Q3 was 3.8%, compared with 3.4% three months earlier. However, signs of weakness were detected in Q4, as discussed in the preceding section, regarding investment in these products.

Services evidenced once again in Q3 the loss of steam they underwent in Q2, posting a year-on-year rate of increase of 2.7%, 0.2 pp down on the previous quarter. This diminished buoyancy was prompted by market services, which grew by 2.4%, while non-market services quickened to a year-on-year growth rate of 3.4%. Despite this slowdown in market services, the short-term economic information available offers favourable signs for the final quarter of 2004. The composite market services indicator (ISIS) improved in Q4, following stable growth in Q3. Social Security registrations also picked up in the closing months of the year. Set against this, the sentiment indicators fell off during the quarter as a whole, although the confidence indicator compiled by the European Commission moved on a rising path and the services PMI advanced in December.

The favourable trend of market services in 2004 Q4 was specifically evident in the sound performance of transport and communications, the hotel and catering trade, and real-estate and business services. Notable among market services was the hotel and catering branch, which showed the most clearly accelerating trend. The figures on both overnight stays and Social Security registrations showed increases in their growth rates. At the opposite end of the spectrum were distribution and repair services, which lost momentum in the closing months of 2004. Under the distributive trade as a whole, the retail segment also showed signs of slowing, despite the increase in the retail sales index in the final months.

Following the profile of output, employment growth remained sustained during the period covered in 2004 (see Chart 19). In Q3, numbers employed increased by 2.1% year-on-year, in line with the rise recorded in the first half of the year. This relative stability came about against a background of flattening apparent labour productivity, which increased by 0.5% year-on-year in Q3, unchanged on the rate in the first half of the year. The growth of numbers employed in the market economy stood at 2.5% in Q3, likewise in step with the pace in the first half of the year and with that of GVA in 2004 to date. Indeed, apparent labour productivity gains posted a rate of only 0.1% in Q3.

Regarding the main economic indicators, the course of the Labour Force Survey (EPA) and that of QNA are most notably in step. For the economy as a whole, the year-on-year rate of numbers employed according to the EPA quickened by 0.2 pp in Q3 to 2.5%, after their growth had slowed in the first half of the year. The EPA data for Q4, released as this report was going to press, have confirmed the higher-growth trend of employment, and reflect an increase of 2.7% in the numbers employed in the economy as a whole. In the second half of the year, Social Security registrations rose substantially to a rate of 3.1%, although this dynamism should be viewed with caution when extrapolating to the QNA employment figures for the market economy, given the volatility this statistic exhibits, especially during holiday periods. In fact, the EPA data for Q4 point to stability in the growth of employment across the market branches, at a rate of 2.3%.

Branch by branch, employment in the market economy showed great heterogeneity in Q3: construction and market services remained to the fore in terms of job creation, while job destruction continued in agriculture and industry, although in this latter activity the rate of decline of employment has eased (see Chart 19). Specifically, the rate of decline of numbers employed in agriculture was 2%, similar to the previous quarter. Likewise, the acceleration in industrial activity during the quarter was accompanied by a 0.9% reduction in employment, although the path of recovery of 2004 was extended. Employment in construction evidenced a sizable rise during the quarter, climbing from growth of 2.7% in Q2 to 4.2% in Q3. That reduced apparent labour productivity, given that the acceleration in GVA was milder. Lastly, employment in market services grew by 4% year-on-year, a rate still high but which entails a slowdown of 0.4 pp on the summer months, during which period it had already lost momentum. The EPA data for Q4 indicate that job destruction in agriculture continued at a sharper rate in this period (-4.4%). They also confirm the pick-up in employment in industry (1.6%), after six consecutive quarters of job destruction, the sharp growth that employment in construction continues to show (5.1%) and the slowdown in employment in market services (2.7%).

With regard to dependent employment, the figures for Q3 suggest the slowdown initiated in the summer of 2003 might be coming to an end, as they show a minimal rise in the related year-on-year rate to 2%. Conversely, the slowdown in the increase in the number of self-employed, with growth of 2.3%, has broken for the moment the rising path of recent quarters. These trends are also apparent in the EPA data, having firmed in Q4. In the figure for Social Security registrations, the groupings for both employment segments accelerated by the same amount in Q3 (0.1 pp), while the rise in the growth rate for dependent employees was bigger in Q4 (0.5 pp, compared with 0.2 pp for the self-employed).

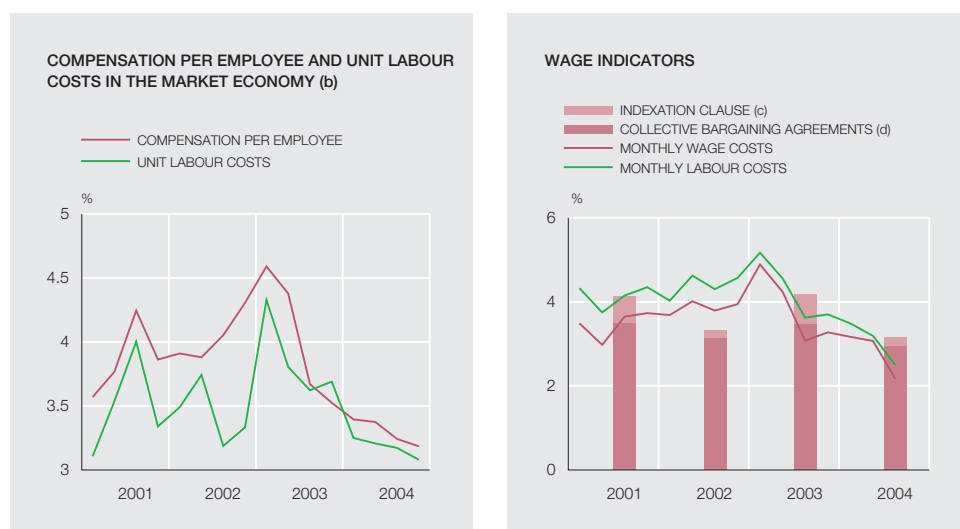
Drawing on EPA information on contract duration, the rise in total employment in 2004 Q3 was due solely to the contribution of temporary employment, which quickened notably from 1.4% in Q2 to 4.1%, while the growth rate of permanent employment was cut by 0.8 p.p. to 1.8%. Indeed, for the first time in the last four years, the growth of temporary employees was higher than that of permanent employees. This pattern held in Q4, despite the notable pick-up in permanent employment (2.7%), whereby the proportion of temporary to total employees stood at 30.9%, 0.2 pp less than in Q3, but above the related rate for 2003 Q4. From the standpoint of the length of the working day, part-time employment grew strongly (7.5%), despite the fact that its increase in Q4 moderated in relation to the year-on-year rate of 14.3% attained in Q3.

In the second half of 2004 the rate of increase of the labour force continued to moderate, though it remained substantially robust (1.8%). Intense employment creation had a sharper affect than that of the increase in the participation rate: there was thus a significant decline in joblessness and the unemployment rate fell to 10.4%, compared with 11.2% at the end of 2003. These developments were partly corroborated by the registered unemployment figures, the increase in which eased in Q3 to a year-on-year rate of 1.1% (against 2.4% in the April-June period). The trend extended into Q4, when registered unemployment fell by 1.5%.

### **4.3 Costs and prices**

On National Accounts estimates, compensation per employee in the economy as a whole grew by 3.7% in Q3, 0.2 pp down on Q2. This reduction in the growth rate was the outcome of the slowdown in both the market and non-market services branches, and of the acceleration in agriculture, industry and construction. If the market economy alone is considered, the growth of compensation was 3.2%, showing a slowdown on a similar scale to the previous quarter (see Chart 20).

If the quarterly labour cost survey (ECTL) is taken as a reference, the slowdown was even greater. In 2004 Q3, monthly labour costs per employee grew by 2.5%, 0.7 pp down on the



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

- a. Percentage change on same quarter a year earlier.
- b. Rates based on QNA seasonally adjusted series.
- c. Previous year's indexation clause.
- d. Settlement in the year to date.

previous quarter. This deceleration was essentially due to the lower growth of the wage component, which increased by 2.2%, and was above all in the services sector, where wage costs grew by 1.6% in this quarter. Given that wage settlements under collective bargaining agreements in the services branch grew by 2.8%, there would appear to be burgeoning negative drift, which might be related to the incorporation of workers with lower wage levels, against a backdrop of strong dependent-employment creation in this sector.

Taking the information on collective bargaining agreements to December, wage settlements stood at 3%, 0.5 pp down on 2003, before including the inflation-adjustment clauses. These agreements affected 7.8 million workers, 69% of whom had revised agreements; however, in recent months there has been a significant increase in the registration of newly signed agreements. On data to November, wage settlements under revised agreements stood at 2.9%, slightly below the agreed increase under newly signed agreements (3%). The rise in negotiated increases under this type of agreement might be reflecting the effect of the increase in inflation in the closing months of 2004. In any event, these figures stand at around what would be the ceiling established implicitly by social agents in the Interconfederal Collective Bargaining Agreement applicable to 2004, where the arrangements in place in previous years for setting increases in wage rates were retained.

Estimates for 2004 Q4 suggest compensation per employee in the economy as a whole will continue to behave moderately, slowing slightly on the previous quarter. In the market economy a slight acceleration in wages is estimated which, nevertheless, entails notable wage moderation for the year as a whole in relation to the growth witnessed in 2003, in line with the previously mentioned information on wage rates and the fullest indicators of wage costs.

The moderate course of compensation per employee has passed through to labour costs per unit of value added, which grew by 3.1% in Q3, 0.1 pp down on Q2. Consequently, the acceleration in the deflator (which grew by 4.1% against 3.8% the previous quarter) fed through to the unit surplus, whereby the ongoing widening of margins seen already in previous quarters

continued. There was also a widening of margins in the market economy, against a background of cost and price developments that were similar to those in the economy as a whole. The indexation mechanisms in place might, however, pass the deviation in inflation through to wage behaviour and pose an obstacle to the current moderation continuing, whereby it would not seem appropriate to extend their effect to the statutory minimum wage. The considerations made in Box 3 on the measures announced in connection with the updating of the minimum wage are along these lines.

Chart 21 shows the behaviour of the deflator and of unit labour costs in the market economy and in the main branches comprising it, with significant differences seen in Q3 in these variables across the different branches. While the acceleration of the deflator was common to all branches, with the exception of agriculture, unit labour costs only slowed in market services. Margins thus continued to widen in industry and construction, while in services there was a slight widening following several consecutive quarters of contraction. The indicators available for Q4 show a continuation of these patterns of behaviour. In the market economy, the gap between the growth rates of the deflator and those of labour costs per unit of value added would have widened slightly.

In 2004 Q3, the year-on-year pace of the final demand deflator quickened by 0.2 pp to 3.5%. The acceleration in the GDP deflator amounted to 0.3 pp, attaining a year-on-year growth rate of 4%. On the expenditure side, the private consumption deflator was more buoyant and its growth rate stood at 3.3% year-on-year, while the related rate for the gross fixed capital formation deflator held stable. The imports deflator grew less sharply than in the previous quarter, as the sizable increase in oil prices in the July-September period was offset by the very moderate behaviour of non-energy goods import prices, to which the strength of the euro contributed.

In Q4 the year-on-year rate of consumer prices rose by 0.1 pp to 3.4%, while the 12-month growth rate of the CPI excluding unprocessed food and energy held stable at 2.9% (see Chart 22). Energy prices continued to be the most inflationary component, posting a year-on-year growth rate of 9.7%. Heating and vehicle fuel prices rose markedly in October, initiating a mild downward trajectory in November, following the path of crude oil prices on international markets. Non-energy industrial goods prices posted a rate of 1.2% in Q4, 0.4 pp up on the previous quarter. This reflected, first, the greater intensity of the seasonal sales period, compared with the previous year; and further, the greater price rises at the start of the autumn season in textiles and clothing.

The year-on-year growth rate of processed food prices held virtually stable at 4.1% between Q3 and Q4 last year, while unprocessed food prices grew by 2% in Q4, 1.5 pp down on the previous period. Behind these favourable developments was the marked slowdown in the prices of eggs, fresh fruit and vegetables, and potatoes. Lastly, the growth rate of services prices held at 3.7% in Q4, which saw a reversal in the moderation observed in the summer of the items related to tourism and the hotel and catering trade.

Spanish inflation measured by the HICP increased by 0.2 pp from Q3 to Q4 last year, up to 3.5%. Inflation in the euro area as a whole increased by 0.1 pp, standing at 2.3% in the October-December period, meaning the differential between Spain and the euro area widened by 0.1 pp (see Chart 23). Significantly, the acceleration in energy prices was sharper in Spain than in the euro area as a whole, while the slowdown in processed food prices was greater in the euro area.

In recent months the national minimum wage (NMW) has been raised and changes have been made to its use as a reference index. Furthermore, discussions are under way on the procedure to determine future rises in the NMW, so that by 2008 (at the end of this legislature) it should stand at €600 per month.

Royal Decree 2388/2004 of 30 December 2004 approved a 4.5% rise in the NMW (to a monthly rate of €513), adding to the 6.6% rise on 1 July 2004. This latter increase was presented as the recouping of the loss in purchasing power in the previous four years, and it was accompanied by the decision to uncouple the amounts of all public benefits, assistance and subsidies (indexed until then to the NMW) from the increases agreed upon for the NMW. To replace this reference the so-called "public indicator of income with multiple effects" (IPREM by its Spanish abbreviation) was created, which held at the previous NMW amount (€460.5 per month)<sup>1</sup>.

To settle the procedure to be followed in future NMW rises, the government, following the Cabinet meeting at which the rise for 2005 was approved, agreed to address a document to the social partners on the matter. The proposal is pending negotiation with the social partners, under the industrial relations talks set in train further to the Declaration of 8 July 2004.

Specifically, the document proposes an annual average rise in the NMW of 5.4% over the next three years, to €600 in 2008, which entails growth clearly expected to outpace forecast inflation for this period. In an attempt to soften the impact of this measure on companies' wage costs, a monthly rebate of €10 on employers' Social Security contributions for employees contributing under the minimum bases in 2005 has been proposed. This rebate would entail a reduction equivalent to 2 pp of the Social Security contributions for employees paid in step with such minimum bases<sup>2</sup>.

In parallel, the document proposes an amendment of article 27 of the Workers' Statute in which the criteria the government has to follow in the annual revision of the NMW are laid down. The proposed criteria are very similar to those already in place (changes in the CPI, labour productivity, average wage increases under collective bargaining agreements and economic picture in general), but they expressly include an automatic NMW updating clause, provided that the increase in the overall level of prices has exceeded the rise agreed the previous year for the NMW.

Regarding the revaluation of the IPREM, the document suggests updating this indicator in 2005 by an amount equivalent to the inflation target set by the Budget (2%), which would be set in subsequent years to 2007. However, a commitment is included to evaluate purchasing power trends under this indicator at end-2006 and, in the event of a cumulative loss, to revise its amount in 2007. At the end of that year, this indicator would be reassessed on the basis of the be-

1. Nonetheless, the upper and lower limits of unemployment benefits were revised so that they might reflect a similar increase to that in the NMW in July. 2. It should be recalled that any increase in the NMW passes through automatically to the Social Security minimum contribution bases, since the NMW is maintained as the floor for these bases.

haviour of other indicators such as average income per inhabitant or social spending.

#### POSSIBLE CONSEQUENCES

This package of measures has two types of consequences for labour market workings. First, those arising from the increase in the minimum wage. And further, those associated with the change in the procedure for revaluing the NMW, if automatic and permanent indexation mechanisms related to past inflation were to be statutorily established.

Regarding the first type of consequences, rises in the NMW affect the labour market in at least three ways. Firstly, they have a direct impact on the overall increase in wages which is related to the number of workers affected by this wage reference. Further, they may exert an indirect effect on wage bargaining, since a rise in the NMW may be taken as a reference to determine the minimum wage levels set under collective bargaining. And finally, these wage increases may have a negative bearing on certain groups of low-skills and/or inexperienced employees, who might see themselves crowded out of the labour market because the minimum wage in force proves higher than their productivity.

Although the two NMW rises approved have accounted for an 11.4% increase since July, the direct impact on average wage increases should, in principle, be low, since the number of workers directly affected by this wage reference is not very high. Nonetheless, this effect tends to increase as the level of the NMW draws closer to the wages of increasingly numerous groups.

The information available on the number of workers directly affected by the NMW is not very accurate. The quarterly labour market survey estimates that some 100,000 wage-earners receive the NMW, accounting for somewhat less than 1% of estimated total dependent employees according to this same source, although this estimate may be biased downwards by certain characteristics of this survey<sup>3</sup>. Other estimates<sup>4</sup>, drawing on more lagged information, placed the proportion of total wage-earners receiving the NMW in 1994 at 5%, and the related percentage for the sub-set of wage-earners in industry at 2%<sup>5</sup>. Finally, data from the 1995 wage structure survey placed the percentage of wage-earners receiving the NMW that year at 0.9%<sup>6</sup>. In any event, these figures show that, in Spain's case, minimum wages that prove binding are those agreed under collective bargaining, and these have stood significantly above the legal minimum in recent years.

3. This survey is not directly addressed to workers and excludes certain sectors, such as agriculture, where the incidence of the NMW is probably high. 4. J.J. Dolado, F. Felgueroso and J.F. Jimeno (2000), "The role of the minimum wage in the welfare state: an appraisal", Documento de Trabajo FE-DEA 2000-12. 5. J.J. Dolado, F. Felgueroso and J.F. Jimeno (1997), "The effects of minimum bargained wages on earnings", *European Economic Review*, 41, pp. 713-721. 6. This percentage rises to 1.7% if we allow an interval of +2% around the NMW for possible errors. The availability of the disaggregated data from this 2002 survey will allow estimates to be updated.

Against this background, one of the main risks that may arise from the NMW updates is that related precisely to the fact that such a re-valuation may be taken as a reference for collective bargaining wage negotiations, especially in the case of the wages of job categories whose remuneration is very close to the NMW. There is thus a risk that attempts to maintain the structure of relative wages may extend the effects of increases in the NMW.

The NMW expressed as a proportion of the average wage had been on a declining trend in recent years, standing at around 34%<sup>7</sup> before the rise last July. The latest increases have raised this proportion to 38%, approximately, and it is estimated that the forecast rise to 2008 could place the NMW at slightly over 40% of the average wage at that date<sup>8</sup>. However, the potential effects of workers being crowded out of the labour market due to rises in the NMW do not hinge on its relationship to the overall average wage, but to those groups of low-productivity workers who are, in sum, those who may be most affected by movements in the minimum wage. To evaluate this potential impact it would be necessary to have disaggregated information on the wage structure, whereas only the intermediate aggregations released by INE in the 2002 wage structure survey are known. On this information, the NMW would account for 73.7% of the average wage of unskilled workers in services and 54.5% of the average wage paid in the hotel and catering trade. However, these data should be viewed with caution, since they do not allow the effect of part-time workers to be isolated.

In any event, the degree of accuracy of these preliminary estimations aside, it is the jobs of the groups of workers with lowest productivity

7. In relation specifically to the average wage estimated by the quarterly labour cost survey covering industry, construction and most market services. 8. Assuming annual average growth of 3% for the average wage in the economy.

that may be most put at a disadvantage by rises of some substance in the NMW. It should be borne in mind that the growth model followed by the Spanish economy in recent years has been an employment-intensive one characterised by low average productivity, which suggests a high dispersion of labour productivity and a low level of productivity in a significant segment of new jobs. Accordingly, it cannot be ruled out that sizable rises in the NMW may have an adverse bearing on employment opportunities for these groups of workers and affect the Spanish economy's capacity to sustain the current, intense job-creation process.

The legal amendment of the Workers' Statute to include an automatic NMW past-inflation-adjustment clause would be inappropriate under the workings of EMU and in the relatively low inflation setting in which the Spanish economy moves. It would entail the setting in place of a permanent, statutory indexation mechanism that would tend to reinforce the indirect effects linked to the rise in the NMW. Such a clause would provide for a feed-through of past increases in inflation (whether temporary or permanent) to the minimum wage, and might cause spiralling wage demands among those groups of workers with wages above this reference. The inclusion of such indexation would further constrain the economy's flexibility, a constraint not present in most European countries<sup>9</sup>, and this would diminish the economy's capacity to adjust to adverse situations. Finally, this legal amendment would send a signal contrary to the need to increase the flexibility of bargaining and wage-setting arrangements.

9. Only France and the Netherlands have similar minimum wage increase procedures. However, in the Dutch case the reference is not past inflation, but the average behaviour of wages under collective bargaining, and the rise is not automatic but conditional upon the economic situation. Indeed, the government and social partners agreed to freeze the minimum wage for 2004 and 2005.

Finally, the acceleration in the producer price index in Q4 was similar to that in the previous quarter. Its growth rate rose to 5% in year-on-year terms in December and to 5.2% in Q4 as a whole, compared with 4.4% in Q3. The acceleration in energy and intermediate-goods producer prices was accompanied by greater stability in the other components. In the euro area, the deterioration in producer prices to November was sharper, with the year-on-year change in the overall index rising to 3.8% compared with 3.1% in Q3 on average. Prices received by farmers trended very moderately in the closing months of 2004, and hotel prices slowed following a slight rebound in Q3.

#### 4.4 The State budget

The Government unveiled the updated Stability and Growth Programme (SGP) for the Kingdom of Spain in late December, with fiscal projections for the 2004-2008 period. The SGP has revised downwards slightly the growth scenario for the economy which acted as a basis for the preparation of the State budget for 2005, but it has kept the projections for public finances balances unchanged. A deficit of 0.8% of GDP is forecast (under National Accounts methodology) in the general government sector for 2004, and a slight surplus, of 0.1% of GDP, for 2005. In terms of the respective sub-sectors, the 2004 deficit would be caused by central govern-





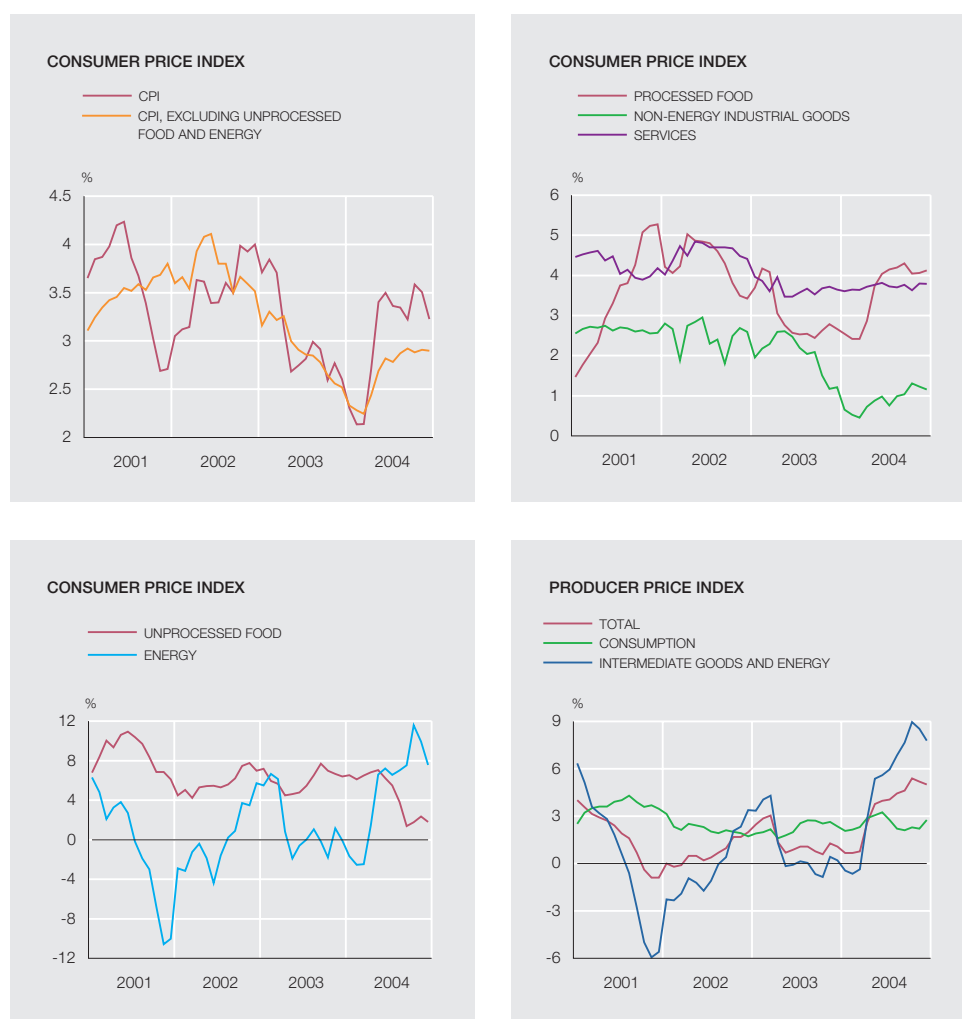
SOURCES: INE and Banco de España.

a. Non-centred percentage change on a year ago based on QNA seasonally adjusted series.

ment, for which a deficit of 1.8% of GDP is expected. Conversely, the Social Security system and the regional (autonomous) governments will run surpluses<sup>1</sup> of 0.8% and 0.2% of GDP, respectively, while local governments will close the year with a balanced budget. The 2005 surplus will be due to that projected for the Social Security system, since central government and the regional governments will post a deficit, while the local governments will maintain a balanced budget.

Following National Accounts methodology and on the information available to November 2004, the State posted a surplus of 0.2% of GDP, notably down on the figure of 0.7% of GDP a year earlier (see Table 3). That figure is in contrast to the forecast included in the projected outcome of the draft State budget, which raises the forecast State deficit to 1.8% of GDP as at the close of 2004. The figure is, however, highly influenced by the marked seasonality of the State's non-financial transactions, whereby the December balance may differ greatly from that of November. Bearing this in mind, the State is fairly likely to end the year with a lower deficit than that forecast in the projected outcome, since the November figures already include the payment cancelling the debt with the Andalusian regional government and much of the planned assumption of RENFE's debt, operations which, overall, have reached an amount close to 0.8% of GDP.

1. Much of the deficit is of a temporary nature, since it is due to the assumption by the State of RENFE debt (0.7% of GDP), as part of the restructuring of the railway sector.



SOURCE: INE.

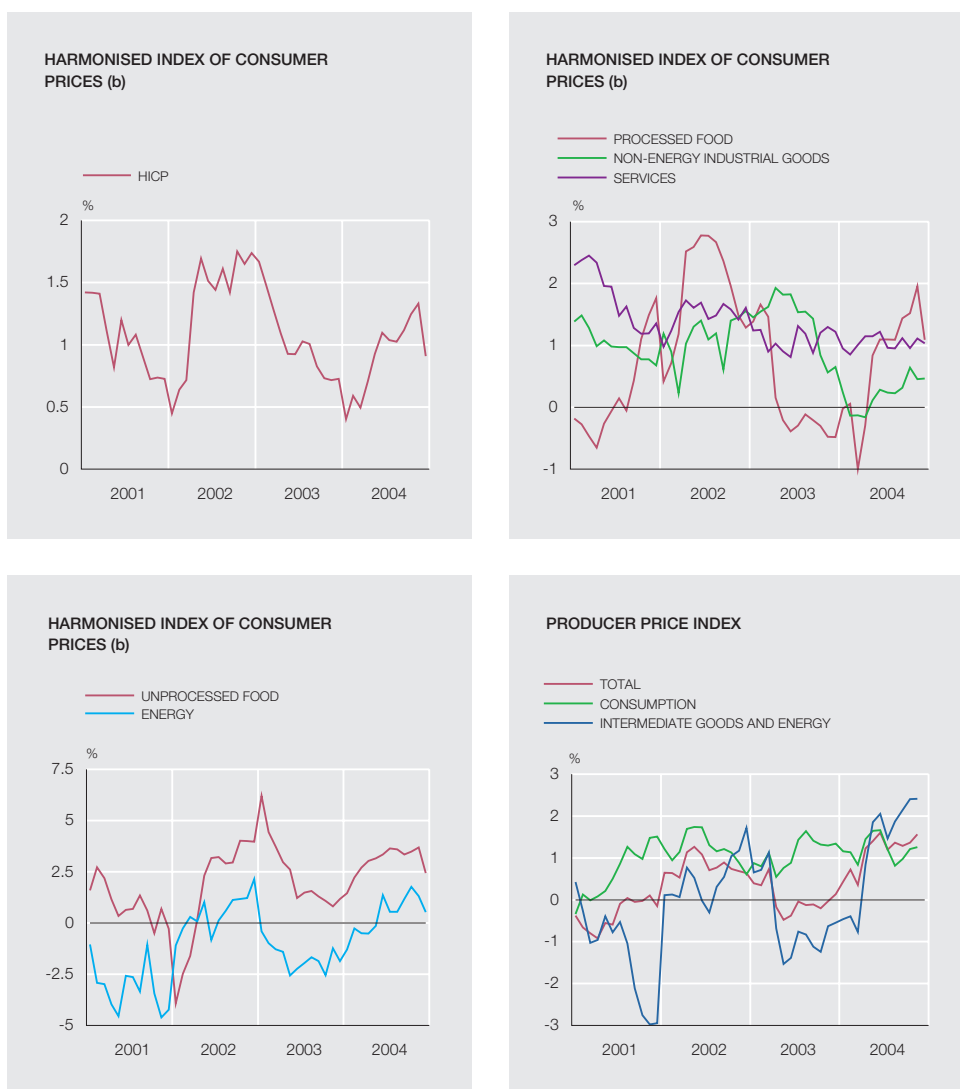
a. Twelve-month percentage change based on the original series.

In cash-basis terms, the State accounts ran a surplus of €3.22 billion to November, against a deficit of €902 million in the same period in 2003. The discrepancies between the National Accounts and cash-basis balances are due, as usual, to the adjustment for the different interest imputation criterion and to the change in receivables and payables. This year, however, the assumption of the debt of RENFE should also be taken into account. This operation does not entail any flow of funds and, therefore, does not affect the State cash-basis deficit, but it is reflected in capital transfers and in the National Accounts balance.

Under the cash-basis criterion, the growth of State revenue was slightly above the projected out-turn, while expenditure underwent a more moderate increase than indicated by the related projection. Accordingly, the cash-basis balance for the year as a whole might be better than indicated in the aforementioned projection. Higher revenue would be due to corporate income tax, to VAT and to non-tax revenue, while the containment of expenditure would be practically across the board. Compared with the figures to September, both revenue and expenditure have accelerated.

For the analysis of revenue, information is available on total takings for the main taxes in terms of both those assigned to the State and those to the ordinary-regime regional governments.





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.

According to these figures, which are not reflected in Table 3, direct taxes quickened in the closing months, as did VAT under indirect taxes. Personal income tax quickened slightly, evidencing the strong increase in withholdings on income from work, arising from the sound performance of the labour market. Nonetheless, the growth rate in the period to November (2.7%) remained low. This was due partly to the fact that withholdings in the opening months of 2003 were higher, because they did not yet reflect the reform of this tax, which also had a bearing on net tax paid in 2004; and partly, in turn, to the calendar change for revenue from certain general government sub-sectors, which temporarily raised revenue in 2003 by a notable amount. Further, corporate income tax quickened additionally because of the strong increase in the October prepayment, owing to the course of corporate profits during 2004. VAT, meanwhile, continued to accelerate in the closing months to a growth rate of 10.7% (outpacing, indeed, the outturn projection, which had forecast growth of 8.1%). Conversely, excise duties slowed slightly, holding at a moderate growth rate caused by the freeze on tax rates. Finally, other revenue dipped marginally in relation to the same period a year earlier, compared

The Social Security System posted a surplus of €11.84 billion in 2004 in the period to October, 8.7% up on the same period in 2003 and in line with the outturn to July. This increase is in contrast to the strong reduction in the surplus resulting from comparing the initial budget for 2004 with the outturn for the previous year<sup>1</sup> (see adjoining table). Both revenue and, above all, expenditure quickened in the final months. In the case of revenue, the acceleration was due to the different timing of certain interest received<sup>2</sup>, which is in the table under "Other", and this placed its growth at 7.1%. The acceleration in expenditure stemmed chiefly from temporary disability benefits and other contributory benefits, which placed its growth rate at 6.9%, in line with the figure budgeted.

Receipts from social security contributions held at a growth rate of 6.9% to October, which is something of a slowdown on the trend maintained during 2003, despite the increase in rates for the special regime for the self-employed<sup>3</sup>. The number of Social Security registrations increased by 2.8% over 2004 as a whole, only slightly below the 3% growth recorded in the two previous years.

Expenditure on contributory pensions continued to grow, moving at a rate of 6.4% to October. This was below budget, but substan-

1. This reduction is due to the fact that, as in previous years, takings relating to contributions are greatly underestimated in budgetary projections. 2. Interest on government debt securities assigned to the Reserve Fund. 3. This increase in rates is linked to financing the greater coverage for temporary disability.

tially up on the growth for 2003 as a whole. Nonetheless, and given that the difference between actual and projected inflation was considerably wider in 2004 than that of a year earlier, the annual amount of spending on pensions will foreseeably post a similar increase to that budgeted. The number of contributory pensions moved on a very moderate trend, increasing by 0.8%, somewhat below the projected figure and the growth recorded the previous year.

Regarding INEM<sup>4</sup>, the information on certain items is available with a greater lag. Contributions received rose by 6.7% to July, in line with the budgeted projection of 6.6%, while rebates on contributions in respect of employment-promoting contracts increased by 8.5% to August, compared with the 21.4% growth budgeted.

Expenditure on unemployment benefits increased by 9.3% to October, against 5.9% in 2003 as a whole. Behind this was the change in the number of beneficiaries, which grew by 5.6% to October 2004, against average growth of 3.2% the previous year. The increase in the number of beneficiaries, in contrast to the slight growth in the number of registered unemployed (1.8% in 2004 as a whole, 1 pp down on 2003), gave rise to a notable increase in the eligibility ratio, which stood at 74.1% in 2004 to October (71.9% in 2003).

4. Its current Spanish acronym is SPEE (State Employment Service).

## SOCIAL SECURITY SYSTEM (a)

### Transfers to regional governments allocated (b)

#### Current and capital transactions, in terms of recognised entitlements and obligations

EUR m and %

	Budget			Outturn		Outturn JAN-OCT		
	Outturn	2004	% change	JAN-JUL	2003	2004	% change	
	2003	2004	3=2/1	% change	2003	2004	7=6/5	
	1	2	3=2/1	4	5	6	7=6/5	
Revenue	82,503	82,221	-0.3	6.9	68,151	73,021	7.1	
Social security contributions (c)	77,332	76,753	-0.7	7.1	63,893	68,322	6.9	
Current transfers	4,267	4,672	9.5	7.5	3,711	3,989	7.5	
Other (d)	904	797	-11.9	-15.3	548	710	29.6	
Expenditure	73,511	78,691	7.0	6.3	57,256	61,182	6.9	
Wages and salaries	1,777	1,907	7.3	6.2	1,419	1,505	6.0	
Goods and services	1,496	1,497	0.1	7.1	1,083	1,109	2.4	
Current transfers	69,788	74,775	7.1	6.4	54,540	58,370	7.0	
Benefits	69,787	74,774	7.1	6.4	54,540	58,369	7.0	
Contributory pensions	60,151	64,307	6.9	6.5	46,864	49,876	6.4	
Sickness	5,154	5,312	3.1	7.5	3,996	4,468	11.8	
Other	4,481	5,155	15.0	3.6	3,680	4,025	9.4	
Other current transfers	1	1	3.0	—	0	1	—	
Other (e)	451	512	13.7	-6.0	214	198	-7.5	
Balance	8,992	3,530	-60.7	10.9	10,895	11,839	8.7	

SOURCES: Ministerio de Economía y 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 March 2004.

b. Transfers from the ISM to the regional governments to finance transferred health-care and social services 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.

EUR m and %								
	Outturn 2003	Percentage change 2003/2002	Outturn projection 2004	Percentage change 2004/2003	Outturn JAN-SEP Percentage change	2003 JAN-NOV	Outturn 2004 JAN-NOV	Percentage change
	1	2	3	4=3/1	5	6	7	8=7/6
<b>1 REVENUE</b>	109,655	1.1	110,516	0.8	4.0	101,115	105,985	4.8
Direct taxes	56,510	1.8	56,931	0.7	4.4	51,388	53,783	4.7
Personal income tax	32,824	1.7	30,549	-6.9	-4.0	30,582	28,236	-7.7
Corporate income tax	21,912	2.3	24,173	10.3	17.2	19,230	23,350	21.4
Other (a)	1,774	-3.7	2,209	24.5	33.0	1,576	2,197	39.4
Indirect taxes	39,084	2.8	40,930	4.7	5.8	37,656	40,202	6.8
VAT	27,130	5.5	28,466	4.9	6.4	26,662	29,021	8.9
Excise duties	9,787	-5.4	9,889	1.0	1.7	9,027	8,896	-1.4
Other (b)	2,167	10.6	2,575	18.8	16.2	1,968	2,284	16.1
Other net revenue	14,061	-5.6	12,655	-10.0	-3.0	12,071	12,000	-0.6
<b>2 EXPENDITURE</b>	113,787	2.4	117,754	3.5	-1.0	102,017	102,762	0.7
Wages and salaries	18,450	5.1	19,415	5.2	4.4	16,079	16,865	4.9
Goods and services	2,996	5.4	3,454	15.3	21.2	2,484	2,930	18.0
Interest payments	19,788	4.9	17,888	-9.6	-15.5	19,284	16,335	-15.3
Current transfers	58,078	-0.4	62,364	7.4	2.1	52,227	55,288	5.9
Contingency fund	...	...	...	...	...	...	...	...
Investment	7,535	7.0	7,629	1.2	-5.1	6,279	5,737	-8.6
Capital transfers	6,940	7.5	7,004	0.9	0.7	5,664	5,606	-1.0
<b>3 CASH-BASIS BALANCE (3=1-</b>	<b>-4,132</b>	<b>...</b>	<b>-7,238</b>	<b>...</b>	<b>...</b>	<b>-902</b>	<b>3,223</b>	<b>...</b>
<b>MEMORANDUM ITEM: NATIONAL ACCOUNTS</b>								
Resources	110,449	1.9	115,972	5.0	3.0	101,725	105,997	4.2
Uses	112,566	0.7	130,251	15.7	2.2	96,617	104,015	7.7
<b>NET LENDING (+) OR BORROWING (-)</b>	<b>-2,117</b>	<b>...</b>	<b>-14,279</b>	<b>...</b>	<b>...</b>	<b>5,108</b>	<b>1,982</b>	<b>...</b>
(as a percentage of GDP)	-0.3		-1.8			0.7	0.2	

SOURCE: Ministerio de Economía y Hacienda.

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

b. Includes taxes on insurance premiums and tariffs.

with an expected decline of 10%, owing to higher growth in revenue arising on charges and capital transfers.

On the State expenditure side virtually all items, with the exception of goods and services, posted lower-than-budgeted rates of change. In particular, there was a heavy decline of 15.3% in interest payments to November, compared with the expected reduction of 9.6% for the year as a whole. Current transfers quickened in the closing months owing to the above-mentioned cancellation of the outstanding debt with the Andalusian regional government (in October), though the 5.9% growth to November was notably below the figure of 7.4% forecast in the projected outturn. Finally, the decline in capital expenditure, especially under real investment, was significant and ran counter to the forecast of moderate growth included in the outturn projection.

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

In the first ten months of 2004, the overall balance on current and capital account resulted in a deficit of €23.65 billion, €14.65 billion up on the same period a year earlier. This was due to the notable widening of the current-account deficit to €30.01 billion, since the surplus on capital transactions was practically unchanged on the level of the previous year. The unfavour-

## BALANCE OF PAYMENTS: SUMMARY TABLE (a)

TABLE 4

EUR m		JANUARY-OCTOBER	
		2003	2004
CREDITS	Current account	206,227	211,377
	Goods	117,328	121,871
	Services	57,375	57,446
	<i>Tourism</i>	31,777	31,907
	<i>Other services</i>	25,599	25,540
	Income	18,575	18,624
	Current transfers	12,949	13,436
	Capital account	7,257	7,172
	Current + capital accounts	213,484	218,549
DEBITS	Current account	221,663	241,475
	Goods	147,669	163,402
	Services	33,924	35,917
	<i>Tourism</i>	6,141	7,355
	<i>Other services</i>	27,783	28,562
	Income	27,857	29,025
	Current transfers	12,213	13,131
	Capital account	816	723
	Current + capital accounts	222,479	242,198
BALANCES	Current account	-15,436	-30,099
	Goods	-30,341	-41,532
	Services	23,452	21,529
	<i>Tourism</i>	25,636	24,552
	<i>Other services</i>	-2,184	-3,023
	Income	-9,282	-10,401
	Current transfers	736	304
	Capital account	6,440	6,449
	Current + capital accounts	-8,996	-23,649

SOURCE: Banco de España.

a. Provisional data.

able current-account performance was chiefly the result of the widening of the merchandise deficit and, to a lesser extent, of the deterioration in the other main items, namely services, income and current transfers.

In the period from January to October 2004, the trade deficit widened by €11.2 billion to €41.53 billion in relation to the level in the same period a year earlier. In year-on-year terms, the deficit was 36.9% up, accentuating the deterioration already witnessed over the whole of the previous year. The notable momentum of real import flows during the year, which was far greater than that of export flows, would – in conjunction with the deterioration in the terms of trade, which were impacted by the strong rise in oil and, to a lesser extent, non-energy commodity prices on international markets – have led to this unfavourable trend of the trade imbalance.

Turning to services, the surplus in the first ten months of the year stood at €21.53 billion, €1.92 billion below that recorded in the same period a year earlier. This worse performance made for

a year-on-year decline of 8.2%, which was due to the 4.2% reduction in the tourist surplus and to the 38.4% deterioration in the non-tourist services deficit. Tourism revenue increased by scarcely 0.4% to October, affected by the terrorist bombings on 11 March and the considerable strength of the euro, which led the gap in Spanish competitiveness vis-à-vis the eastern Mediterranean countries, our main competitors, to widen. Nonetheless, as from September it held on an improving line, in step with the upward course shown in the closing months of the year by the real indicators of foreign tourists and overnight stays in hotels. Tourist payments to October rose by 19.8%, set against the resumption of normality worldwide in geopolitical terms, improved consumer confidence and the strength of the euro.

The deficit on the income balance stood at €10.4 billion in the first ten months of 2004, reflecting a deterioration of €1.12 billion in relation to the level posted in the same period a year earlier. The widening of the income deficit was the outcome of the deterioration in the balances relating to the non-financial private sector and to monetary financial institutions, while the general government deficit was slightly corrected. In terms of instruments, there was a deterioration in the balances of income linked to direct investment and other investment (loans, deposits and repos).

The surplus on the balance of current transfers stood at €304 million in the period January-October 2004, reflecting a reduction of €431 million on the level observed over the same period in 2003. Revenue rose by 3.8%, chiefly as a result of the increase in flows received by the public sector, especially EU flows under the European Social Fund, while Community funds for the private sector in connection with the EAGGF-Guarantee fund declined. Payments grew by 7.5% owing to the increase in those earmarked for Community coffers under the GNP Resource and Traditional Own Funds, and to the continuing robustness of emigrants' remittance payments.

Finally, the surplus on capital account was €6.45 billion in the first ten months of 2004, scarcely €9 million above that observed in the same period in 2003. Despite this slight improvement, net capital transfers from the EU, the biggest item in quantitative terms, declined in this period as a result of the fall-off in ERDF structural funds and in the EAGGF-Guidance Fund, while Cohesion Fund flows trended more favourably.

## 5 Financial developments

### 5.1 Highlights

The financial setting for households' and companies' economic activity in 2004 Q4 was marked primarily by the stability of money market interest rates in the euro area and by the reduction (sharper in the longer-dated terms) in public debt yields to the lowest figures of recent years. In December, the one-year EURIBOR and the ten-year government bond stood on average at 2.30% and 3.64%, 8 bp and 44 bp below the related September figures, respectively. On the latest available information, for November, the interest rates applied by credit institutions to households and firms generally underwent little change and held slightly above the minimum levels reached in mid-2003. The cost for companies of financing via fixed-income securities continued on a declining course as a result of the reduction in yields on public debt markets, since the risk premiums demanded scarcely changed from the moderate levels recorded three months earlier (see Chart 24).

On domestic and international stock markets, prices rose significantly during Q4, a movement accompanied by further declines in implicit volatilities to historically low values<sup>4</sup>. In Spain's case, the performance of stock market indices was more favourable than in most international centres, against the background of quoted companies' disclosed earnings for Q3 which were highly favourable and better than expected by analysts. From October to December the Madrid Stock Exchange General Index rose by 12.7%, meaning that the cumulative gain for 2004 totalled 18.7%, clearly up on the gains posted for the same period by the EURO STOXX broad index (9.9%) or the S&P 500 (9%).

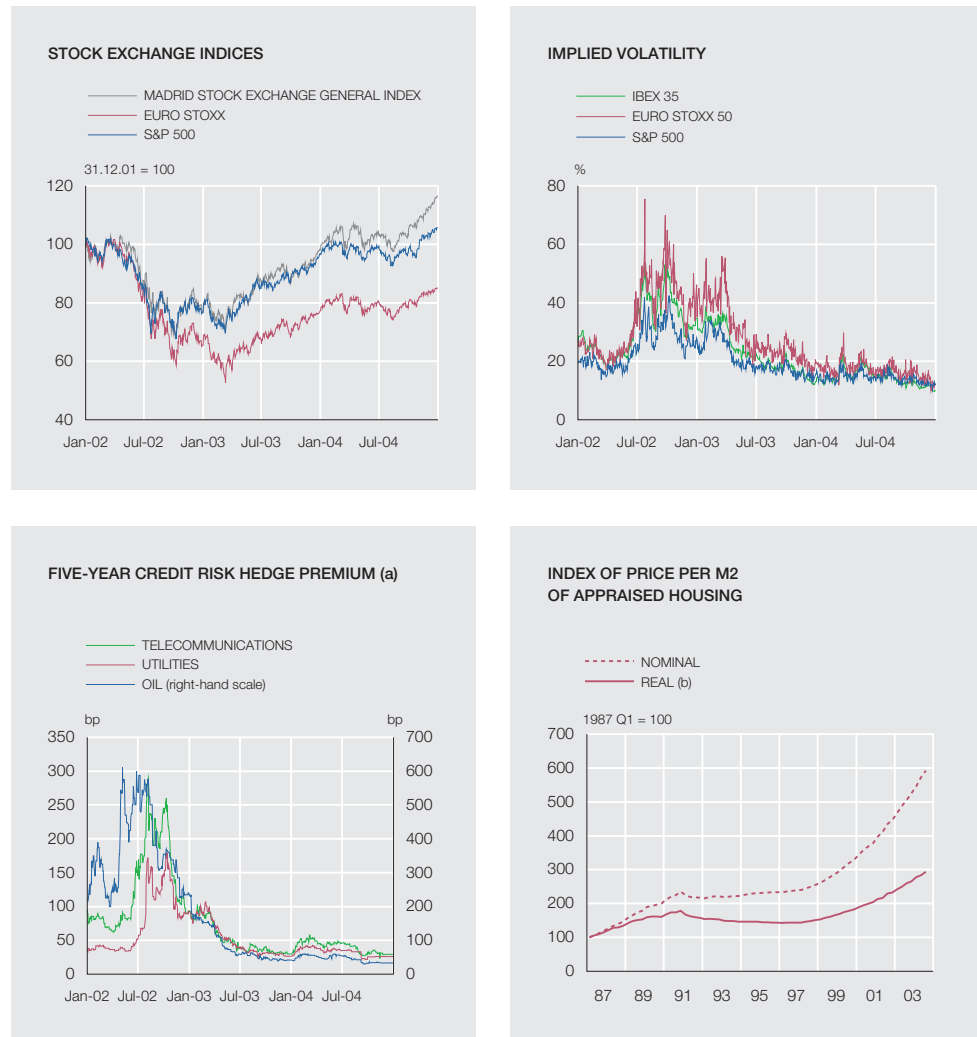
House market prices continued to grow at a high rate. On the latest information provided by the Spanish housing ministry for Q3, the average value of housing was up 17.2% on the same period in 2003, only 0.2 pp below the June figure. The breakdown by municipality size shows that this slight fall in the rate of expansion affected all categories and was somewhat sharper in the case of towns with over 500,000 inhabitants, although the rate of change for this latter sub-aggregate remained above those for the rest.

The favourable financing conditions described in the foregoing paragraphs meant, for another quarter, that the funds raised by households and firms were very buoyant. From July to September they grew at a high rate, similar to that recorded in mid-2004, with the property sector continuing to absorb a very significant portion of these resources. Provisional information for the closing months of 2004 points to a moderate slowdown in household debt (whose rate of expansion, however, should hold at over 19%) and a slight increase in the pace of borrowed funds obtained by companies.

Under these conditions, the indicators of financial pressure on households reveal a rise in such pressure between July and September 2004 which, on the latest provisional information, might have continued in the final stretch of the year. The debt/gross disposable income (GDI) and financial burden/GDI ratios thus continued on the rising path of previous quarters, coming to stand at their peak for recent years; saving not earmarked for debt service fell once more; and, according to the Financial Accounts, net household financial saving fell in Q3 in cumulative twelve-month terms, turning negative for the first time over an extensive period (-0.4% of GDP). Household financial wealth fell off once more, but this was not reflected in the sector's net wealth which continued growing thanks, once again, to the rise in property prices.

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4. Box 5 analyses the informative content of another indicator based on option prices.



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 conditions of European firms. The new contract carries lower premia (around 10%).  
 b. Deflated by the CPI.

As indicated in previous reports, the course followed by household variables such as debt, debt burden or saving is generally consistent with the substantial changes undergone by the fundamentals underpinning their behaviour. Nonetheless, it is unlikely that these trends will continue in the medium term without one of the underlying risks in the household financial position possibly materialising and adversely affecting household spending decisions. Prominent among these is that arising from the absence of clear symptoms of a significant slow-down in house prices.

In the case of companies, the sector's debt ratio continued on its rising path between July and September, although the interest burden contracted slightly. Provisional data for the closing months of 2004 point to continuity in the rising trend of the former indicator and the maintenance of the latter. In parallel, corporate borrowing needs continued to increase, though the financing gap, which measures the net resources needed to undertake gross capital formation and direct investment abroad, narrowed moderately. According to the Banco de España Central Balance Sheet Data Office, the results of its reporting firms fared very favourably in Q3, and their debt ratios and interest burden held stable. Consequently, there was a fresh decline in the

Option premiums contain information on market expectations in relation to the future behaviour of the price of the asset on which they are issued, since the return thereon depends precisely on how this price moves. Among the indicators that use this information content is the so-called "risk-neutral density function" (RNDF), which offers an estimate of the probability agents assign to changes of different amounts in the prices of the underlying asset. The RNDF, however, is calculated under the assumption that investors are risk-neutral; consequently, if they prove to be risk-averse, the RNDF will tend to provide probabilities of price falls (increases) occurring which will be biased upwards (downwards). Further, RNDFs are not directly observable, whereby it is necessary to estimate them.

In a recent paper, Alonso, Blanco and Rubio (2005) estimate RNDFs for the IBEX 35 using different, alternative methodologies<sup>1</sup>. Notable among their findings are, first, that the choice of estimation method does not significantly alter the results. Moreover, as the accompanying table shows, for a four-week forecasting horizon the estimated RNDFs approximate the ex-post probability distribution of the IBEX 35 reasonably well; however, as would be expected in the event of the

existence of risk aversion, they tend to overestimate the probability of declines taking place and to under-predict upward movements in the price of the underlying asset. Hence the average probabilities associated with declines of greater than 5%, 10% and 15% exceed the frequency with which such movements came about. The opposite is the case with increases of greater than 10%. These results show that the levels provided by the RNDFs should be viewed with some caution. In this respect, it might be worthwhile paying greater relative attention in the analysis to the changes in these levels.

In this regard, the last two columns of the table show the RNDFs estimated for the final months of 2004. As can be seen, there was a high concentration at this time of probabilities around zero, i.e. around the absence of price changes. The estimated probability for reductions (increases) greater than 5% was only 5.3% (2.6%) in December. These probabilities contrast strongly both with the average values estimated for the whole of the period available – 20.5% (22.4%) – and with the frequencies with which this event was actually observed – 16.3% (21.4%) –. This comparison indicates, in line with the recent trend of other indicators such as implied volatility, that the degree of uncertainty over the movements in prices perceived by markets declined considerably at the end of last year.

1. For greater detail see Alonso, Blanco and Rubio (2005), Banco de España Working Paper series, forthcoming.

## PROBABILITY DISTRIBUTIONS OF THE IBEX 35

%

Probability of changes (a)	Observed frequency (b)	Risk-neutral probabilities extracted from options (c)		
		Average 1996-2004	SEP-04	DEC-04
<= -5 %	16.3	20.5	9.0	5.3
<= -10 %	5.1	8.9	1.0	0.2
<= -15 %	2.0	3.8	0.0	0.0
>= 5 %	21.4	22.4	5.7	2.6
>= 10 %	12.2	7.0	0.1	0.0
>= 15 %	2.0	2.0	0.0	0.0

SOURCE: MEFF and Banco de España estimates.

a. Changes are calculated in relation to the price of the future four weeks before expiration.

b. Percentage of realisations in which the Ibex 35 future has moved by a specific percentage over a four-week horizon.

c. Estimated at a four-week horizon. The date indicates the estimation period for RNDFs.



% GDP	1999	2000	2001	2002	2003		2004		
					Q3	Q4	Q1	Q2	Q3
					National economy	-1.0	-2.5	-2.2	-1.6
Non-financial corporations and households and NPISHs	-0.3	-2.4	-3.4	-2.9	-3.3	-4.0	-4.1	-5.1	-5.9
Non-financial corporations	-2.3	-3.4	-4.5	-4.4	-4.4	-4.6	-4.8	-5.2	-5.5
Households and NPISHs	2.0	1.1	1.1	1.4	1.2	0.6	0.6	0.1	-0.4
Financial institutions	0.5	0.8	1.5	1.5	1.4	1.5	1.6	1.5	1.4
General government	-1.2	-0.9	-0.4	-0.1	-0.3	0.4	0.2	0.4	0.7

SOURCE: Banco de España.

synthetic indicators of financial pressure on investment and employment. Lastly, the latest data appear to confirm the signs of an improvement in industry seen already the previous quarter, in line with the pick-up witnessed in capital goods.

The sound aggregate balance-sheet position of corporations, the generous financing conditions in place, the bright prospect of future profits, the restructuring undertaken by large companies and the signs of a pick-up in industry all shape a scenario conducive to a rise in productive investment. However, these favourable expectations are not free from risk which, in this instance, is linked chiefly to the levels of debt attained and to the growing significance among corporate liabilities of loans granted at a floating interest rate.

## 5.2 Households

Financing conditions for households remained very generous in Q4. The interest rate on lending for house purchases stood at 3.48% in November, only 3 bp more than in September. The cost of consumer and other loans fell by 25 bp from October to November, partly correcting the rise in the previous months. In both cases, the cost of bank financing was only 25 bp above the minimum levels of mid-2004. According to the latest EPB (Bank Lending Survey), banks tightened slightly in 2004 Q3 their lending terms for house financing, but eased those for consumer and loans.

Against this background, there was a slight acceleration in household debt in 2004 Q3, meaning the related rate of increase stood at somewhat over 20%. That entails an increase of approximately 0.5 pp in relation to the level in June. In terms of purpose, the rise was sharpest in the case of loans for house-purchase, the rate of expansion of which remained very high (at around 24%). Consumer and other loans grew at around 13% compared with the same period a year earlier. Provisional information on the closing months of the year points to something of a slowdown in the resort to lending by households which, however, will end the year at a growth rate of close to 20%.

Turning to financial investment, households increased their asset portfolio in the period from July to September by an amount equivalent to 10.9% of GDP, in cumulative twelve-month terms, 0.4 pp down on the Q2 figure (see Table 6). Its composition by instrument continued to show greater buoyancy in the more liquid and low-risk assets (cash and deposits), the flow in which amounted to 5.3% of GDP. Conversely, mutual funds purchases as a proportion of GDP fell by 0.6 pp to 1.6%, as a result of the net redemptions of holdings in money market asset mutual funds and of lower net subscriptions of capital market mutual fund shares. Investment in shares and insurance technical reserves held at similar levels to those of Q2 (0.9% and 2% of GDP, respectively).

% GDP	2001	2002	2003	2004		
				Q1	Q2	Q3
<b>HOUSEHOLDS AND NPISHs</b>						
Financial transactions (assets)	7.8	8.8	10.1	10.8	11.3	10.9
Cash and cash equivalents	1.2	3.7	4.4	4.3	4.5	4.1
Other deposits and fixed-income securities (a)	3.4	1.5	-0.2	0.0	0.7	1.2
Shares and other equity (b)	-0.2	0.8	0.8	1.0	0.9	0.9
Mutual funds	0.8	0.2	2.3	2.3	2.2	1.6
<i>FIAMM</i>	1.3	0.7	0.6	0.1	0.0	-0.3
<i>FIM</i>	-0.5	-0.5	1.7	2.3	2.2	1.9
Insurance technical reserves	2.7	2.6	2.1	2.0	1.9	2.0
Of which:						
<i>Life assurance</i>	1.5	1.5	0.7	0.7	0.8	0.8
<i>Retirement</i>	0.9	0.9	1.1	1.1	0.9	0.9
Other	0.0	-0.1	0.7	1.2	1.1	1.1
Financial transactions (liabilities)	6.7	7.3	9.5	10.2	11.2	11.4
Credit from resident financial institutions (c)	5.4	7.2	9.3	9.9	10.6	11.0
<i>House purchase credit (c)</i>	4.8	5.1	7.2	7.8	8.3	8.8
<i>Consumer and other credit (c)</i>	0.6	2.1	2.1	2.1	2.3	2.2
Other	1.3	0.1	0.2	0.2	0.5	0.4
<b>NON-FINANCIAL CORPORATIONS</b>						
Financial transactions (assets)	16.4	16.5	17.0	15.1	15.4	14.9
Cash and cash equivalents	1.7	1.7	0.9	0.6	1.3	1.2
Other deposits and fixed-income securities (a)	0.7	1.8	1.5	0.6	0.1	-0.4
Shares and other equity	6.1	6.8	6.7	5.4	5.5	4.7
Of which:						
<i>Vis-à-vis the rest of the world</i>	4.6	5.1	4.6	3.2	3.6	2.9
Other	7.9	6.2	7.9	8.6	8.5	9.4
Financial transactions (liabilities)	20.9	20.8	21.6	19.9	20.6	20.4
Credit from resident financial institutions (c)	6.5	6.3	7.0	7.1	7.7	8.2
Foreign loans	4.0	3.0	2.8	2.4	2.3	1.5
Fixed-income securities (a)	0.0	-0.4	-0.1	0.0	0.0	0.0
Shares and other equity	5.3	6.0	5.0	3.7	3.5	3.5
Other	5.1	5.9	6.9	6.8	7.2	7.2
<b>MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):</b>						
Financing (d)	15.6	14.3	15.8	16.0	16.6	16.5
Households and NPISHs	12.3	15.6	18.7	19.5	20.1	20.5
Non-financial corporations	18.0	13.3	13.8	13.4	14.0	13.4

SOURCE: Banco de España.

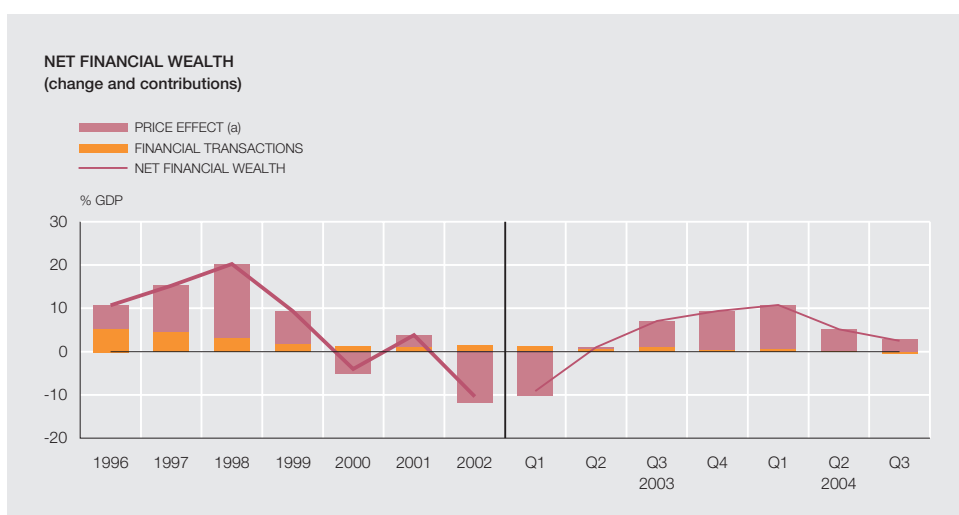
a. Not including unpaid accrued interest, which is included under "other".

b. Excluding mutual funds.

c. Including securitised loans.

d. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation vehicles.

The vigour of household financing, along with the less expansionary behaviour of household income, meant that their debt rose in September to a value equivalent to the sector's annual GDI. The associated debt burden increased to around 13.5%, the highest figure recorded in recent years. The rise in financial obligations, along with the slight contraction in gross saving, resulted in a fresh reduction in the indicator of saving not earmarked for debt service. In parallel, net financial transactions recorded in the Financial Accounts were negative in cumulative 12-month terms, for the first time in recent years, posting a negative value equivalent to 0.4% of GDP (see Table 5). This performance contributed to there being a quarter-on-quarter decline



SOURCE: Banco de España.

a. Includes revaluation and other changes in volume.

in net financial wealth<sup>5</sup>, although net worth held on a rising trajectory as a result of the upward course of house prices (see Chart 26).

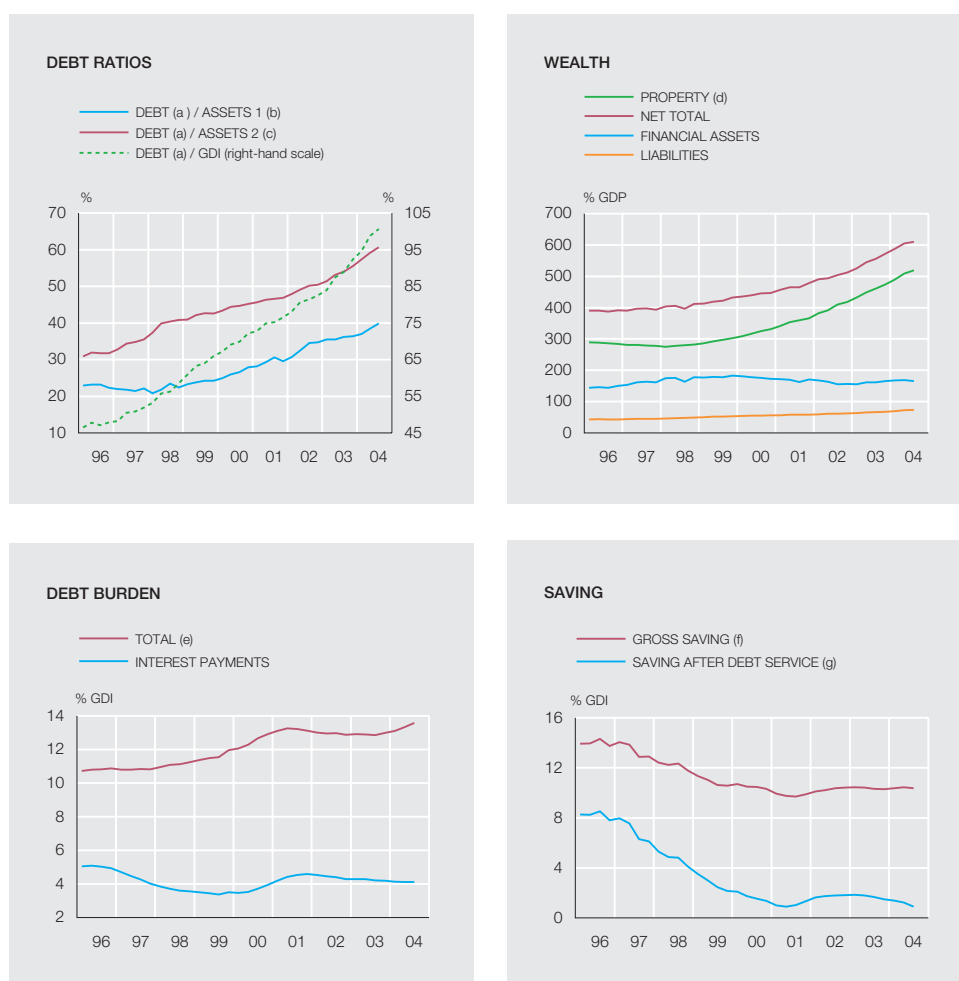
Despite the unfavourable trend of saving in aggregate terms, the period from July to September saw a slight increase in the percentage of households able to earmark money for saving, according to the Spanish Household Expenditure Survey, while the proportion of those saying that they reach the end of the month with difficulty or great difficulty fell moderately.

### 5.3 Non-financial corporations

Financing conditions for corporations also remained generous in 2004 Q4, to a greater extent even than in the previous months. Lending rates held around the low level attained in September. Specifically, the cost of bank financing stood, in November, at 4.13% for amounts below €1 million and at 0.94% for higher amounts, signifying no change and a decline of 5 bp, respectively, in relation to the September levels. According to the latest available Bank Lending Survey, credit institutions relaxed the criteria for granting loans to corporations in Q3 last year and, during the final quarter, they envisaged applying slightly more lax conditions. The cost of financing on fixed-income markets fell once again as a result of the decline in long-term public debt yields and of the stability of the moderate risk premiums demanded. The conditions for raising funds on equity markets improved as a result of the increase in stock market prices and of lower implied volatilities.

During 2004 Q3, the sector's liabilities-side transactions accounted, in cumulative 12-month terms, for 20.4% of GDP, slightly down on the mid-year figure of 20.6% (see Table 6 and Chart 26). Component by component, the expansion of interest-bearing external borrowing contracted by around 0.5 pp in relation to the level three months earlier, to a rate of around 13%. Nonetheless, provisional information on the final stretch of 2004 suggests something of an acceleration in corporate debt. The funds thus obtained accounted in September, in cumulative 12-month terms, for 9.7% of GDP, a level slightly down on that of June and with a somewhat different instrument-by-instrument breakdown. The weight of external loans thus diminished (representing 1.5% of GDP, 0.8 pp down on the previous quarter), while that of loans from credit institutions (8.2%) increased by 0.5 pp. The net issue of fixed-income securities

5. In cumulative four-quarter terms, however, it continued to grow, as evidenced in Chart 25.



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 use of disposable income account.
- g. Gross saving less estimated debt repayments.

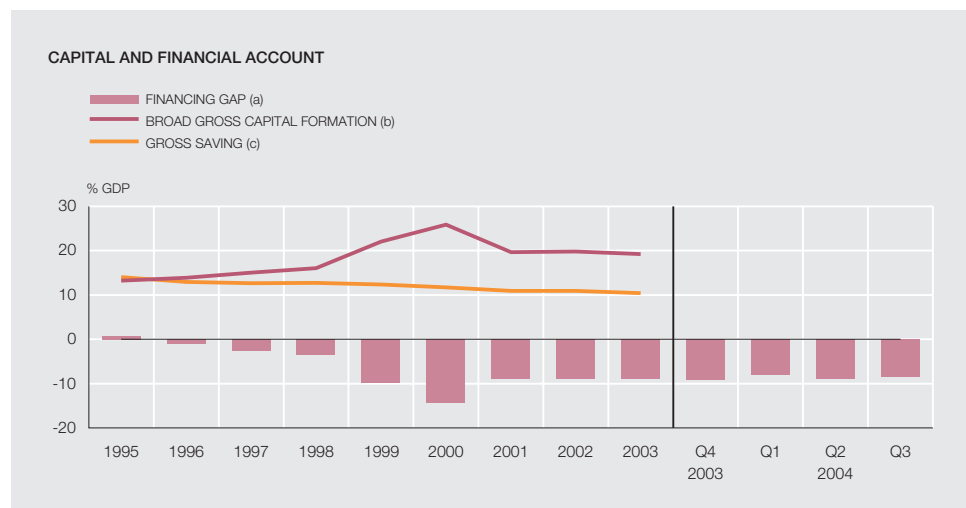
remained close to zero. Funds raised through the issuance of shares and other equity amounted to 3.5% of GDP, the same level as in mid-2004. Finally, according to quarterly data (CBQ) from the Central Balance Sheet Data Office, the debt of large corporations held at around the same level as in previous quarters.

In terms of production branches, the behaviour of bank credit obtained by corporations was heterogeneous in 2004 Q3. Funds for construction and real estate services retained the momentum of the previous months, with their respective rates of increase at 22% and 44%, slightly above the June figures. Conversely, in the remaining services, rates of expansion eased by almost 1 pp to a figure somewhat below 12%. In the case of industry, the resort to credit continued to pick up, in line with the improvement in activity in this sector. Consequently, year-on-year rates continued to be positive.

As regards the acquisition of financial assets by non-financial corporations in Q3, financial investment fell in cumulative 12-month terms to 14.9% of GDP (see Table 6). This declining course,

**NON-FINANCIAL CORPORATIONS**  
Cumulative four-quarter data

CHART 27

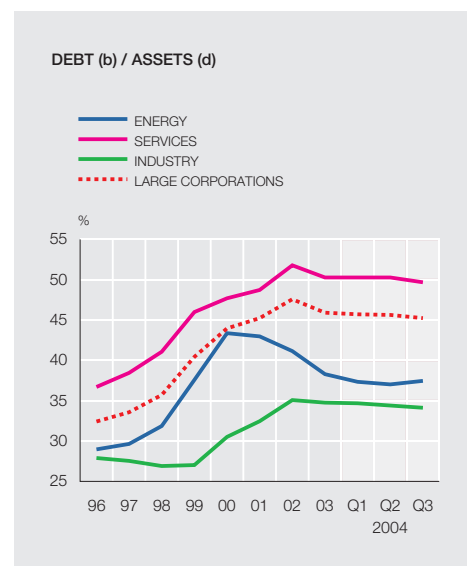
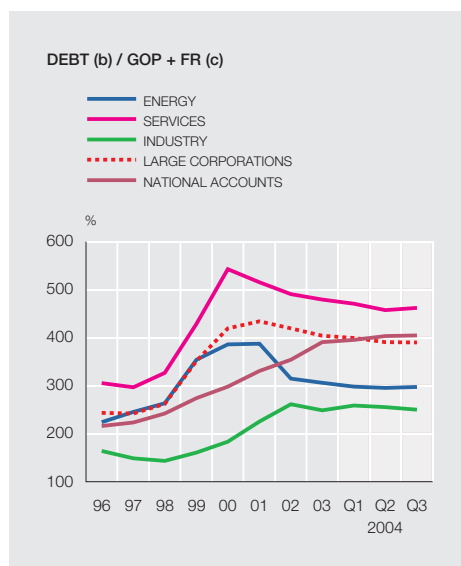


SOURCE: Banco de España.

- a. Financial resources that cover the gap between real and permanent financial investment and gross saving.
- b. Includes gross capital formation, stockbuilding and foreign equities.
- c. Includes capital transfers.

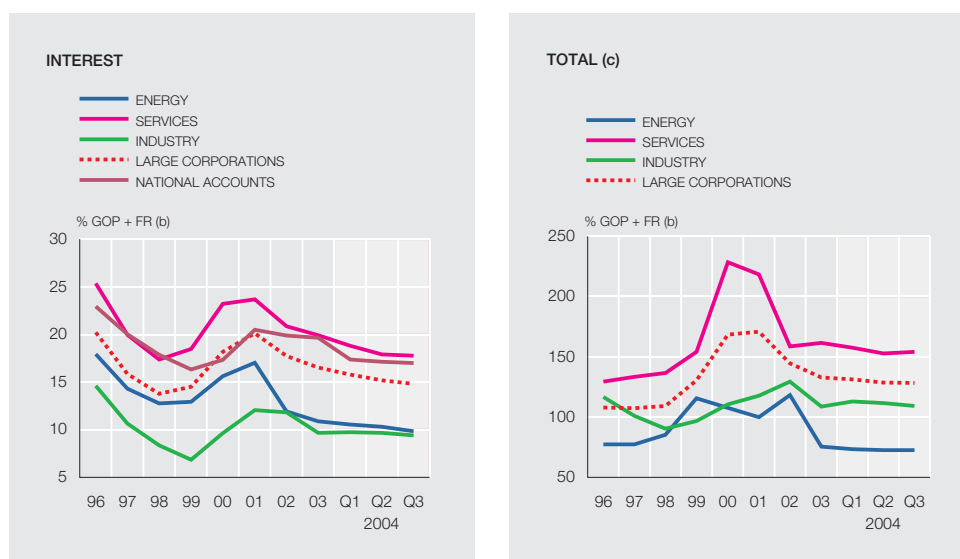
**DEBT RATIOS OF NON-FINANCIAL CORPORATIONS (a)**

CHART 28



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.



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.

which was seen in most items, was sharper in the case of deposits and fixed-income securities and the acquisition of shares and other equity, especially vis-à-vis the rest of the world.

According to the Financial Accounts, there was a fresh increase (0.3 pp) in the sector's net borrowing in 2004 Q3 to 5.5% of GDP in cumulative 12-month terms, the highest figure in recent years. However, the financing gap, which measures the net funds needed to undertake gross capital formation and direct financial investment abroad, fell slightly (0.4 pp) to 8.4% of GDP (see Chart 27).

The expansionary behaviour of external borrowing by corporations explains why, in Q3, the sector's aggregate debt ratio should have continued on a rising course, although the interest burden continued to fall, albeit moderately. On CBQ data, the total debt and interest burdens held stable during this same period in relation to the reporting corporations' gross operating surplus (plus financial revenue). At the same time, the results of these corporations improved, making for an increase in their ordinary return on equity. As a consequence, there was a fresh reduction in the synthetic indicators of financial pressure on investment and employment (see Chart 30), which was fairly extensive to all the productive branches.

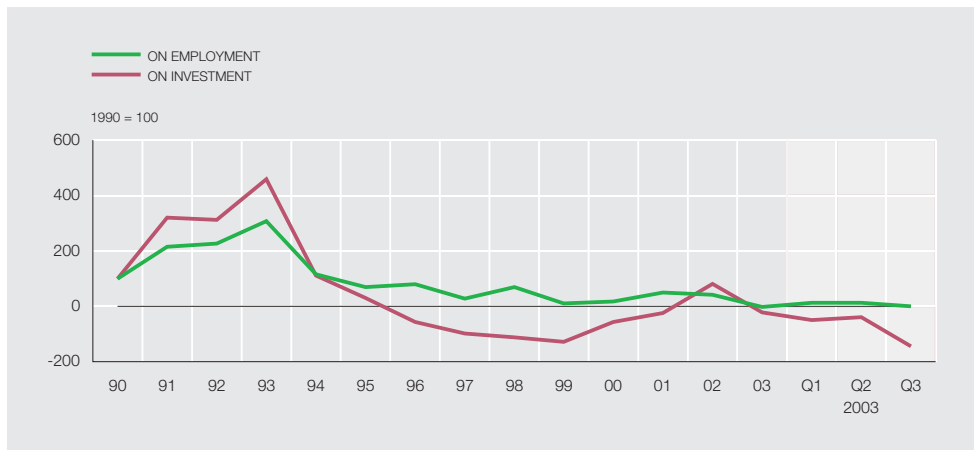
Finally, analysts' expectations about listed non-financial corporations' profits in the short term were generally revised upwards during Q4. The expected growth rate of profits in the long run remained relatively high, although it was reduced slightly.

#### 5.4 General government

The balance of the general government sector's net financial transactions in 2004 Q3 was positive whereby, in cumulative 12-month terms, the sector's financial saving increased to 0.7% of GDP, 0.3 pp up on the June figure (see Chart 31). The lower financial requirements were reflected in a fresh net redemption of short-term securities, while positive net issues of medium and long-term debt for an amount of 1.4% of GDP provided, in the absence of any

**SYNTHETIC INDICATORS OF FINANCIAL PRESSURE ON NON-FINANCIAL CORPORATIONS (a)**

CHART 30

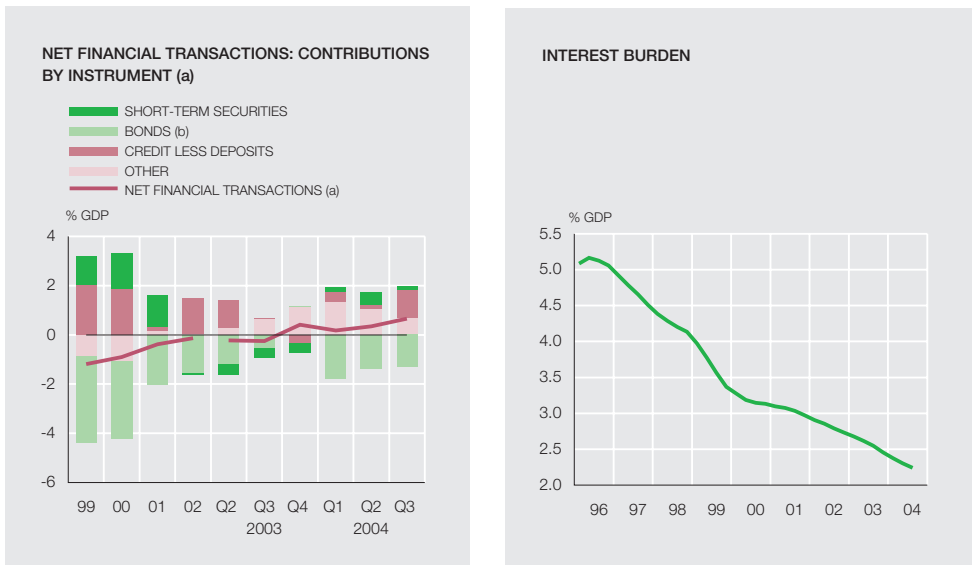


SOURCE: Banco de España.

a. A higher (lower) value than 100 denotes more (less) financial pressure than the reference level.

**GENERAL GOVERNMENT  
Cumulative four-quarter data**

CHART 31



SOURCE: Banco de España.

- a. A positive (negative) sign denotes an increase (decrease) in assets or decrease (increase) in liabilities.
- b. Includes only liabilities transactions.
- c. Includes unpaid accrued interest on bonds.

deficit to cover, for an increase in asset-side positions in deposits and in own shares, or for the purchase of public debt by the Social Security Reserve Fund.

The indicator reflecting information on the interest burden borne by the sector shows, for the last quarter, a further decline to around 2.2% of GDP, less than half the figure recorded as of the mid-nineties. This decline was the overall result of the slide in the volume of liabilities as a proportion of GDP and of the reduction in the financial cost associated with this type of debt.

% GDP	2001	2002	2003	2004		
				Q1	Q2	Q3
NET FINANCIAL TRANSACTIONS	-2.2	-1.6	-2.1	-2.4	-3.2	-3.9
FINANCIAL TRANSACTIONS (ASSETS)	12.2	13.7	13.5	12.0	13.6	10.6
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	-2.7	3.5	0.8	1.3	2.7	3.9
Securities other than shares	7.2	4.3	7.0	4.8	4.3	1.3
<i>Of which:</i>						
<i>Credit institutions</i>	2.0	0.5	3.7	3.6	3.3	0.7
<i>Institutional investors (a)</i>	5.4	3.5	3.4	1.6	0.7	1.1
Shares and other equity	5.1	5.3	4.7	4.7	5.5	4.1
<i>Of which:</i>						
<i>Non-financial corporations</i>	4.6	5.1	4.6	3.2	3.6	2.9
<i>Institutional investors (a)</i>	0.5	-0.1	1.1	1.7	1.8	1.4
Loans	2.5	0.6	1.0	1.1	1.1	1.4
FINANCIAL TRANSACTIONS (LIABILITIES)	14.4	15.3	15.6	14.4	16.7	14.5
Deposits	2.8	4.4	7.5	5.0	7.0	3.2
Securities other than shares	3.1	4.5	5.6	8.9	9.5	11.2
<i>Financial institutions</i>	1.5	3.2	6.7	7.6	8.2	9.0
<i>Rest of resident sectors</i>	1.6	1.2	-1.1	1.3	1.3	2.2
Shares and other equity	4.6	4.1	0.8	-0.6	-1.5	-0.8
<i>Of which:</i>						
<i>Non-financial corporations</i>	4.1	3.5	0.9	-0.6	-1.0	-0.2
Loans	4.3	3.4	3.2	2.8	2.8	2.2
Other, net (b)	-0.4	-1.1	-1.4	-1.7	-1.0	-1.3

SOURCE: Banco de España.

a. Insurance corporations and portfolio investment institutions.

b. Includes the asset-side caption reflecting insurance technical reserves.

### 5.5 The rest of the world

The debit balance of the nation's financial transactions increased between July and September to stand at 3.9% of GDP in cumulative twelve-month terms, 0.7 pp up on the previous quarter. This deterioration was the outcome of the greater financial requirements of households and non-financial corporations, which could not be offset by the increase in the general government credit balance. Financial saving by financial institutions did not undergo significant changes (see Table 5).

The net acquisition of external assets accounted for 10.6% of GDP in cumulative twelve-month terms, compared with 13.6% the previous quarter (see Table 7). This decline was, however, heterogeneous across the different instruments. The flows for cash and deposits and for credit extended increased, while those relating to both fixed-income and equity securities fell sharply. On provisional Balance of Payments information to October, direct investment abroad shrank by more than 80% in relation to the same period a year earlier, while portfolio investment quickened on 2003.

On the liabilities side, net flows stood at 14.5% of GDP in cumulative twelve-month terms, compared with 16.7% the previous quarter. This decline was the outcome chiefly of the behaviour of deposits and, to a lesser extent, of credit raised. According to balance of payments



**NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD (a)  
(Q4 data)**

TABLE 8

% GDP	1999	2000	2001	2002	2003	2004 (b)
National economy	-29.6	-26.2	-27.0	-30.9	-38.5	-41.6
Non-financial corporations and households and NPISHs	-17.3	-9.4	-10.2	-11.6	-15.2	-14.6
Non-financial corporations	-24.1	-16.7	-17.6	-18.9	-22.5	-22.1
Households and NPISHs	6.8	7.3	7.4	7.3	7.3	7.5
Financial institutions	8.2	8.3	8.5	6.5	-0.8	-3.0
Credit institutions (c)	-7.5	-11.6	-13.9	-14.3	-22.0	-22.3
Institutional investors (d)	16.3	20.7	24.3	24.4	27.5	28.3
Other financial institutions	-0.6	-0.9	-1.8	-3.6	-6.3	-9.0
General government	-20.5	-25.1	-25.4	-25.8	-22.4	-24.0

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.

figures, Spanish foreign direct investment declined moderately, while portfolio investment did so more sharply during the first ten months of 2004 compared with the same period a year earlier.

Finally, on the provisional information available, the debit position of the Spanish economy vis-à-vis the rest of the world stood at 41.6% of GDP in 2004 Q3, a decline of 3.1 pp from the position in December 2003 (see Table 8).

25.1.2005.