1 Overview

During the first three quarters of 2005 the Spanish economy posted high and slightly rising growth, attaining a year-on-year rate of 3.5% in Q3. On the information available for the closing months of the year, the notable buoyancy of activity continued in Q4, in which GDP is estimated to have registered once more a year-on-year increase of 3.5%, consistent with an increase of 0.1 pp in the quarter-on-quarter rate of change, which would have stood at 0.9% (see Chart 1). The contribution of national demand to the increase in output was very high and stable throughout the year as a result of the expansionary behaviour of all its components. Private consumption continued to grow at a higher rate than disposable income, against a background of favourable financial conditions, although it exhibited a slight tendency to ease which became sharper in Q4. In the case of investment, whose components gained greater momentum in 2005 as a whole, the acceleration seen in the first half of the year was checked as from Q3, owing to the mild deceleration in investment in equipment and, more recently, in construction too. Conversely, net external demand remained strongly contractionary throughout the year and its negative contribution to GDP growth was scarcely corrected, although in Q4 the improvement in tourism was perceptible to a greater extent.

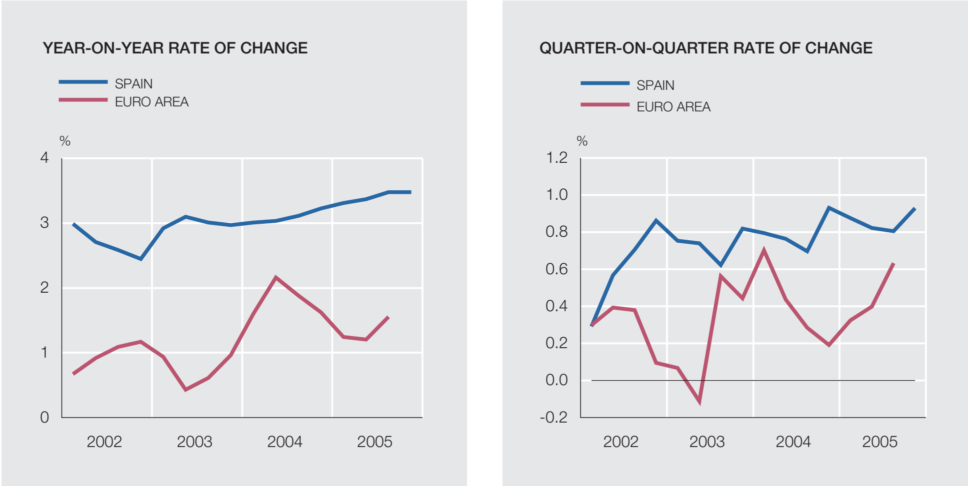
The estimates for Q4 place GDP growth for 2005 as a whole at 3.4%, above the figure of 3.1% for 2004. This was the result of higher growth in national demand and of a somewhat more negative contribution of net external demand, which drew closer to 2 pp. Employment generation remained high and the number of jobs created rose by over 3% (compared with 2.6% in 2004), which made for a very small increase in labour productivity. Among other factors, this reflects the weight of construction and of services in the sectoral composition of growth. As regards inflation, consumer prices increased at an annual average of 3.4%, 0.3 pp up on 2004, closing the year at 3.7%.

The sound performance of the world economy during 2005 continued in the closing months of the year. During this period, oil prices temporarily returned to under $60 per barrel, following their surge during the summer, while stock markets registered new rises and the financial markets generally performed favourably. Contributing to this was the mild stance of economic policies and, in particular, anticipation that the end of the upward interest rate cycle in the United States was near. Against this backdrop, economic growth in the main geographical areas broadly remained high, and inflation rates moderate.

Economic activity in the United States progressed firmly in 2005 Q3, with an annualised quarter-on-quarter rate of 4.1%. Job creation held at a high rate, despite a small dip in September and October related to the impact of the hurricanes in the south of the country. Underlying inflation remained at a rate of somewhat over 2%, without the energy rises impacting in full, while the trade deficit tended to widen in relation to 2004. Japanese growth figures also confirmed the economic recovery in that country, while the signals were more mixed in the United Kingdom. Activity in the main emerging regions, namely Asia, the new EU members and Latin America, remained notably buoyant. In particular, the Chinese economy is holding at a stable growth rate of slightly below 10%, although there is a certain risk of activity overheating. In Latin America, the sound situation of the region's economies, with the exception of the abrupt slowdown in Brazil in Q3, has resulted in a further improvement in financial indicators and a fresh cut in sovereign risk premia.

The outlook for the world economy in 2006 is favourable and points to similar growth to that seen in 2005, estimated at close to 4.5%. However, the uncertainty and risks marking the in-

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

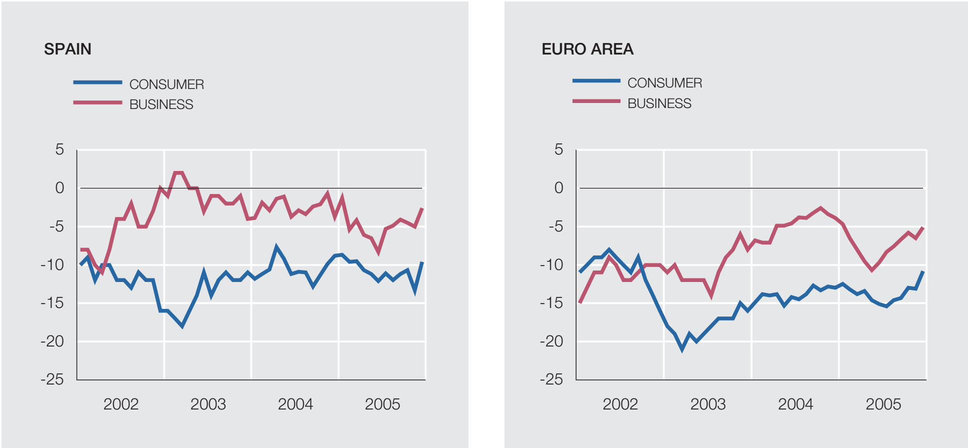
a. Seasonally adjusted series.

ternational setting last year persist. The oil market is very vulnerable to the emergence of supply problems, whether of a weather-related or geopolitical nature, in a situation in which the thrust of demand remains firm. The rise in oil prices witnessed in January, which has fed through rapidly and in full to the futures markets, has once again highlighted the presence of substantial upward risks to the price of this commodity. Further, trade imbalances have continued widening globally, leaving the way open for potential adjustments, including a significant depreciation of the dollar, while the risk of an upward adjustment of long-term interest rates persists. All these factors particularly affect the outlook for the US economy, one of the main engines of the world economy, which has still to absorb the rapid increase in interest rates implemented by the Federal Reserve since mid-2004.

In the euro area, the year 2005 ended on an optimistic note. The latest information suggests GDP would have posted an increase in Q4 close to that estimated in Q3, above the growth for the first half of the year. The greater buoyancy in the final six months originated, first, in the pick-up in fixed capital investment, which continued to benefit from the generous financial conditions and from the favourable position of European companies; and further, in the sound performance of exports, which benefited from the expansion of the economy and world trade, raising the contribution of net external demand. Private consumption, however, has not yet regained a sufficient pace of growth to provide the support needed to sustain the current rate of increase in activity over the medium term. Although the rise in consumer confidence in the final months of 2005 (see Chart 2) and the improvement in employment expectations may be auguring greater job creation and higher increases in household disposable income, there is uncertainty about the timing and intensity with which these elements – which are fundamental for anchoring consumer spending – will materialise.

Inflation in the euro area tended to diminish during 2005 Q4, assisted by the reduction in oil prices. As a result, the 12-month growth rate of the HICP stood at 2.2% in December (see Chart 3). Underlying inflation stabilised at a level slightly below 1.5%, without any significant impact on this index from the pass-through of dearer energy having so far been observed. Nor have there been perceptible second-round effects on wage developments. Nonetheless, the instability of the oil market, which raises the likelihood of further price rises, and the strengthening of activity, which means price rises may be incorporated more easily into wage increases, led

CONFIDENCE INDICATORS CHART 2



SOURCE: European Commission.

the ECB Governing Council to consider that the upside risks to price stability had increased. Accordingly, the Council decided in December to raise official interest rates by 0.25 pp, setting the interest rate on the main refinancing operations at 2.25%, after holding it unchanged at 2% for almost two and a half years. This monetary policy measure, fully consistent with the ECB's communications to date, entailed only modest changes in medium- and long-term market interest rates. In any event, monetary and financial conditions in the euro area remain generous and supportive of economic recovery.

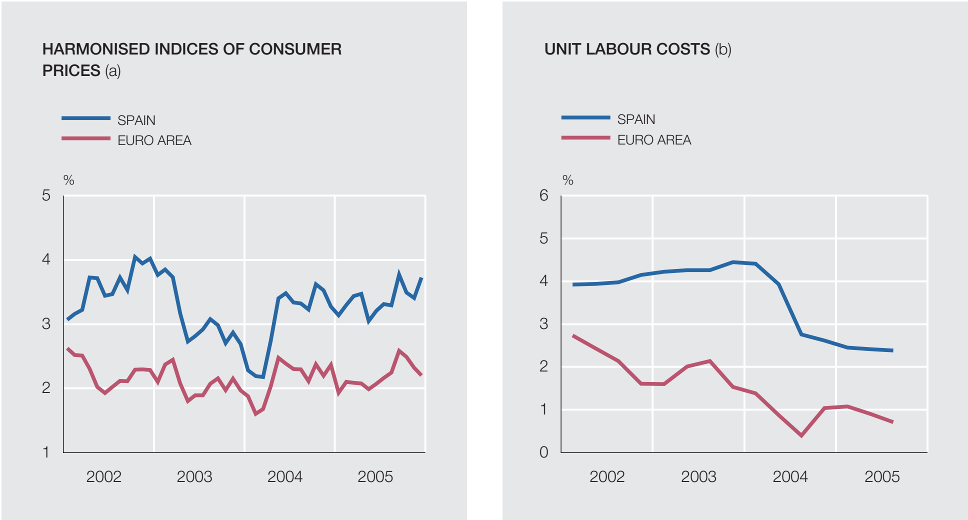
With few exceptions, the adjustment of the budgetary position of the euro area countries continues to be insufficient for the requirements of the European fiscal framework. A significant number of countries in the area have once again posted budget deficits above the ceiling of 3% of GDP in 2005, exceeding in many cases the targets set in the stability programmes, and it is estimated that the overall deficit will have risen to 2.9% of the area's GDP. The delay in introducing measures conducive to fiscal consolidation, to which the cyclical position in many countries has no doubt contributed, makes it increasingly important that the European Commission and governments rigorously apply the rules of the Stability and Growth Pact recently agreed upon.

As regards structural reforms, there have been delays in introducing measures, making compliance with the Lisbon objectives for 2010 very difficult. The submission of national reform plans, following the initiative adopted by the European Council in spring 2005 to revive this process, provides a fresh opportunity to push economic reforms through. Such reforms are needed to provide the euro area economies with a more solid base for growth and to address the tendencies towards globalisation and structural change in the world economy. Moreover, only clear action on both the fiscal policy and structural reform fronts will enable the uncertainty still overshadowing the decisions of a good number of European agents to be overcome.

The Spanish economy, with estimated growth of 3.5% in 2005 Q4, remains one of the most dynamic euro area economies and continues to be characterised by a greater capacity to generate employment. From a domestic standpoint, the buoyancy of the economy in Q4 followed on from the patterns observed in the preceding quarters, with no substantially marked changes appreciable in respect of the composition of growth; that said, there was a modest slowdown in national demand which corresponded to a likewise modest improvement in the negative contribution of external demand. In the year as a whole, there were some changes

PRICES AND COSTS

CHART 3



SOURCES: Eurostat, ECB and INE.

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

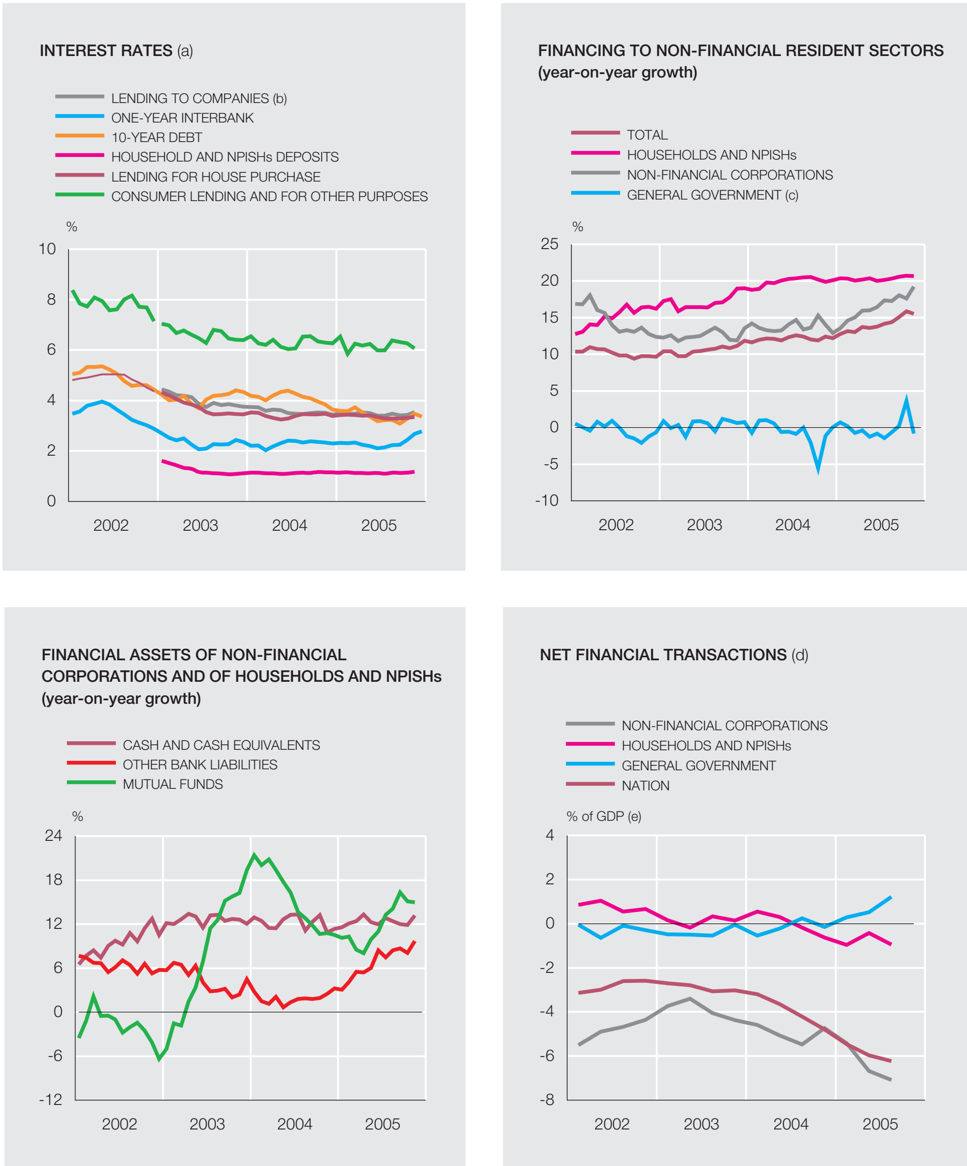
worth mentioning in relation to 2004, especially the pick-up in investment in capital goods; however, there was a prolongation of the main trends recorded in past years, such as the strength of household consumption and residential investment, these being accompanied by an increase in household debt and in the negative contribution of the external sector to growth, by a sizeable increase in the nation's financing requirements, and by a continuing high inflation differential, in terms both of costs and of prices.

In the case of households, the factors sustaining consumer spending and residential investment in recent quarters continued into Q4. Disposable income continued growing at a rate of somewhat over 3% in real terms, underpinned by the increase in employment, and financial conditions remained favourable, thanks to the substantial rise in the value of both financial and non-financial household wealth and to low lending costs (see Chart 4). Over the course of 2005, house price increases tended to ease off, albeit holding at double-figure rates. This moderate slowdown, if it continues in the coming months, could favour an orderly absorption of the current overvaluation in the property market. Financing conditions, for their part, tightened slightly at the end of the year. All these developments may have borne on the mild slowdown in expenditure seen from Q3 onwards, though they may be expected to have a sharper impact on demand in 2006. Taking the year as a whole, 2005 closed with a fresh fall-off in the household saving ratio, a sizeable increase in financing requirements and an additional rise in the debt ratio (accounting for over 110% of disposable income) and in the associated financial burden.

As inferred by the expansionary trend of spending on capital goods and on non-residential construction, business investment recovered significantly last year, although the strong growth of the first two quarters eased off in the second half of the year. Contributing to this recovery have been the expansion in demand, the notable generosity of financing conditions (which has only diminished to some extent in the closing months of the year), and the healthy position of companies, as the figures from the Banco de España Central Balance Sheet Data Office testify. Accordingly, although the increase in investment has been accompanied by an acceleration in credit, the debt levels attained do not preclude expectations that this increase will be sustained if underpinned by demand conditions.

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



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. For loans exceeding €1 million, the interest rate is obtained by adding to the NEDR (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
c. Consolidated financing: net of securities and loans that are general government assets.
d. Cumulative four-quarter data.
e. Spanish National Accounts, base 2000.

Goods exports posted very low growth in the last two quarters of 2005 (in the absence of year-end figures) which has not enabled the fall-off in the opening months to be put behind. As a result, in annual average terms, the rate of change of goods exports was scarcely positive. The performance of tourism revenue, which picked up substantially in the second half of 2005, only partly alleviated this flatness. In comparison with the buoyancy of world trade and of Spanish export markets, whose growth exceeded 5%, the slackness of sales abroad entailed a fresh decline in the market share of Spanish products, which illustrates the deterioration in their competitiveness, despite the depreciation of the euro. The effects of this loss of competitiveness were also discernible on the domestic market, as imports grew at a high rate throughout 2005, as has become habitual. That gave rise to a fresh increase in the import penetration ratio, albeit a less sharp one than in 2004. Particular mention should be made of the strength of tourism expenditure, which attained a real growth rate of around 25%. As a result of these trends, the contribution of net external demand to growth became even more negative last year although, as earlier mentioned, a slight correction was seen in the closing months of the year. The result of the foregoing was a fresh increase in the current-account deficit and in the nation's financing requirement, which stood at over 7.5% and 6.5% of GDP, respectively.

In step with the difficulties of the Spanish products most exposed to international competition, the growth of activity in the industrial branches was low in 2005, though it moved on a recovering path as from the summer that appears to have held in the closing months of the year. Conversely, activity in the construction industry expanded more sharply than in 2004, with a growth rate in value added close to 6%, which turned slightly down in the final quarter. Services moved on a slightly quickening trend, ending the year at around 4%. The pattern of increase in employment was similar to that in value added, though somewhat more pronounced, accentuating the divergences in the behaviour of apparent labour productivity. In particular, strong employment generation in construction accentuated the declines in apparent productivity in this activity, while productivity gains in industry and in market services were around 1%. In aggregate terms, employment tended to quicken during 2005, following the profile of GDP, with its growth stabilising in Q4. The recently released EPA (Labour Force Survey) data for 2005 Q4 confirm the continuing strong buoyancy of employment, with the growth rate for this quarter compared with the same period a year earlier standing at 4.9%.

The sectoral composition of employment and the significant weight that temporary hiring still accounts for help explain developments in labour costs. Although the increase in wages agreed under collective bargaining drew close to 3.6% in 2005 (an agreed 3% increase for the year and 0.6 pp more for the application of the 2004 indexation clauses), compensation per employee in the market economy increased by around 2.5%, below the increase in 2004, reflecting – at least partly – the composition of the employment created. The slowdown in compensation has passed through to unit labour costs. But against a background of very small increases in productivity, the growth differential with the costs of countries with which Spain competes internationally remains very wide, as highlighted in Chart 3. The behaviour of costs is also manifest in the inflation differential. In terms of the HICP, Spanish inflation ended 2005 at a rate of 3.7%, representing a notable opening up of the differential with the euro area, with food and services prices proving markedly more inflationary.

The persistence of the comparatively high growth of costs and prices in Spain amplifies losses in competitiveness and tends to make any future correction of the imbalances which, to date, have continued to build up, more difficult to achieve. The economic policy response to this situation should be aimed at promoting price and wage flexibility, and to fomenting gains in productivity, thus enhancing the competitiveness of the economy without impairing the growth of employment. The National Reform Programme, unveiled in October, is geared precisely along these lines, though ideally it should be accompanied by firmer resolve in labour market and collective bargaining reform (see Box 1).

On the budgetary policy front, the government presented the Updated Stability Programme on 30 December last year, defining the fiscal strategy for the period 2005-2008. The projections provided by this programme, which include the estimated effect from 2007 onwards of the recently approved indirect tax reform, revise the general government surplus upwards in relation to the latest official figures, and they point to a notable decline in the debt ratio, which

As described in Box 3 of this quarterly report, the March 2005 Spring European Council decided to step up the reform drive to push through the implementation of the Lisbon Agenda. In this connection, it was considered necessary to focus on achieving the objectives behind the Agenda, defined in terms of economic growth and employment. It was also agreed to strengthen the degree of involvement of the Member States and, to do this, it was decided, among other initiatives, that countries should submit annually a National Reform Programme (NRP) detailing and explaining the economic policy measures designed to achieve these objectives. These would be subject to subsequent oversight and multilateral evaluation. The Spanish NRP was submitted by the government on 15 October 2005.

To frame the set of measures contained in the NRP, the Programme makes a full diagnosis of the factors constraining the long-term growth of the Spanish economy, focusing in particular on discussing the determinants of low productivity growth. Against this background, it defines a strategy to promote long-term growth based on two pillars: first, to boost productivity; and further, to shore up the dynamism of employment generation. In keeping with these goals, the NRP considers two objectives to be met in 2010: to achieve convergence in per capita income with the EU 25 and to place the rate of employment at 66%, 1 pp above the current European average.

To attain these two targets, the NRP consists of seven pillars with seven intermediate or specific targets set, as shown in the accompanying table. As regards specific measures, the NRP includes some that have been adopted by the government in this legislature [drawn above all from the plan to dynamise the economy and enhance productivity, and the follow-up plans (PEIT, AGUA, Avanz@, INGENIO 2010, detailed in the table below)] and supplements them with proposals for the public sector, the labour market and small businesses. In the public sector domain, in addition to the reform of budgetary stability legislation, tax reforms and the reform of the regional government financing system, the Programme announces the reform of social security benefits and the rationalisation of health spending. Also proposed are measures aimed at improving human capital, as are a series of measures affecting the labour market, though these are conditional upon ratification by the social partners. Finally, there is an entrepreneurship programme aimed at boosting small business start-ups and at improving their productivity.

In terms both of diagnosis and of the means proposed to address the structural problems underlying the Spanish growth model, the thrust of the Programme is appropriate. The different pillars of the NRP cover the main areas of relevance for attaining the objectives in terms of real convergence and employment, although more specifics would be desirable for some of the proposals and the timing of their implementation. As in the case of the above-mentioned reinvigoration plans, the NRP provides for mechanisms to monitor the progress made towards the different objectives that may prove useful for reinforcing the effectiveness of the Programme and its disciplined implementation.

On 25 January the European Commission published the Annual Progress Report on the Lisbon Strategy. It includes a section that assesses the NRPs and makes national economic policy recommendations. The Commission believes the Spanish NRP identifies and responds to the main economic policy challenges facing the Spanish economy, it views favourably the commitment to budgetary stability, the R+D+i plan and the infrastructure investment drive, and its economic policy recommendations are centred on competition (electricity and distribution) and the labour market, where it calls for efforts to reduce segmentation and increase female employment.

PILLAR	ACTION PROPOSED	AIM
1	Strengthening of macroeconomic and budgetary stability	To significantly reduce the public debt/GDP ratio to 34% in 2010
2	Infrastructure and Transport Strategic Plan (PEIT) and Programme of Measures for Water Management and Use (AGUA)	To extend the railway network to 35 km/1,000 km^2 in 2010 (32 km/1,000 Km^2 in 2008) and to reduce road accidents by 40% by 2010
3	Increasing and improving human capital	To halve (to 15%) the early school leavers rate by 2010
4	R+D+i strategy (INGENIO 2010)	To double investment in R+D to 2% of GDP in 2010. To converge with Europe in terms of the Information Society, so that spending on ICT stands at 6.3% of GDP in 2008 and at 7% in 2010
5	More competition, better regulation, general government efficiency and competitiveness	To improve Spain's position in terms of the competitiveness indicators, converging in 2010 with the European average
6	Labour market and social dialogue	To increase the female rate of employment from 48% to 57%. To reduce the youth unemployment rate from 22.1% to 18.6%, the current average for the EU 25
7	Entrepreneurship Programme	To increase the number of business start-ups by 25% through promoting entrepreneurship, especially among the young and women

SOURCE: Programa Nacional de Reformas de España.

could fall to 36.6% of GDP in 2008. The revision of the surplus on the general government account (to 1% of GDP and 0.9% of GDP in 2005 and 2006, respectively) is in response to the continuing buoyancy of government revenue in the final months of 2005 and to their foreseeable effect on the budget outturn for 2006. These figures confirm that the surplus tax takings, in relation to the forecasts of the budgetary programme, are being earmarked to improve the general government fiscal position. That contributes to raising the stabilising potential of fiscal policy throughout the cycle, in line with the objectives underpinning the principle of budgetary stability.

2 The external environment of the euro area

Economic and financial developments in the external environment of the euro area during 2005 Q4 and early 2006 were marked by sustained high and generalised economic growth, by continuing moderate inflation and by the favourable trend of financial variables. Against this background, expectations of movements in official interest rates in the United States were revised slightly downwards. Following the two rises in the final quarter of the year to 4.25%, the markets anticipated from December the impending end of the current upward cycle of rates, although they still expect rises of at least 25 bp in the forthcoming Federal Reserve meetings. Long-term interest rates fell to below 4.5%, to the extent that, temporarily, the yield curve slope was inverted as from the two-year bond term. This change in expectations, along with the recent improvement in the growth outlook in Japan and Europe, saw the appreciating trend of the dollar interrupted in early December, and the US currency has moderately diminished in strength since against the euro and the yen. The main stock market indices continued to post gains. These were particularly marked in Japan, in the light of the better growth outlook. The sound performance of the emerging financial markets continued in 2005 Q4 and early 2006: stock markets posted strong rises and sovereign risk premiums stood at the lowest levels recorded since the related series have been compiled.

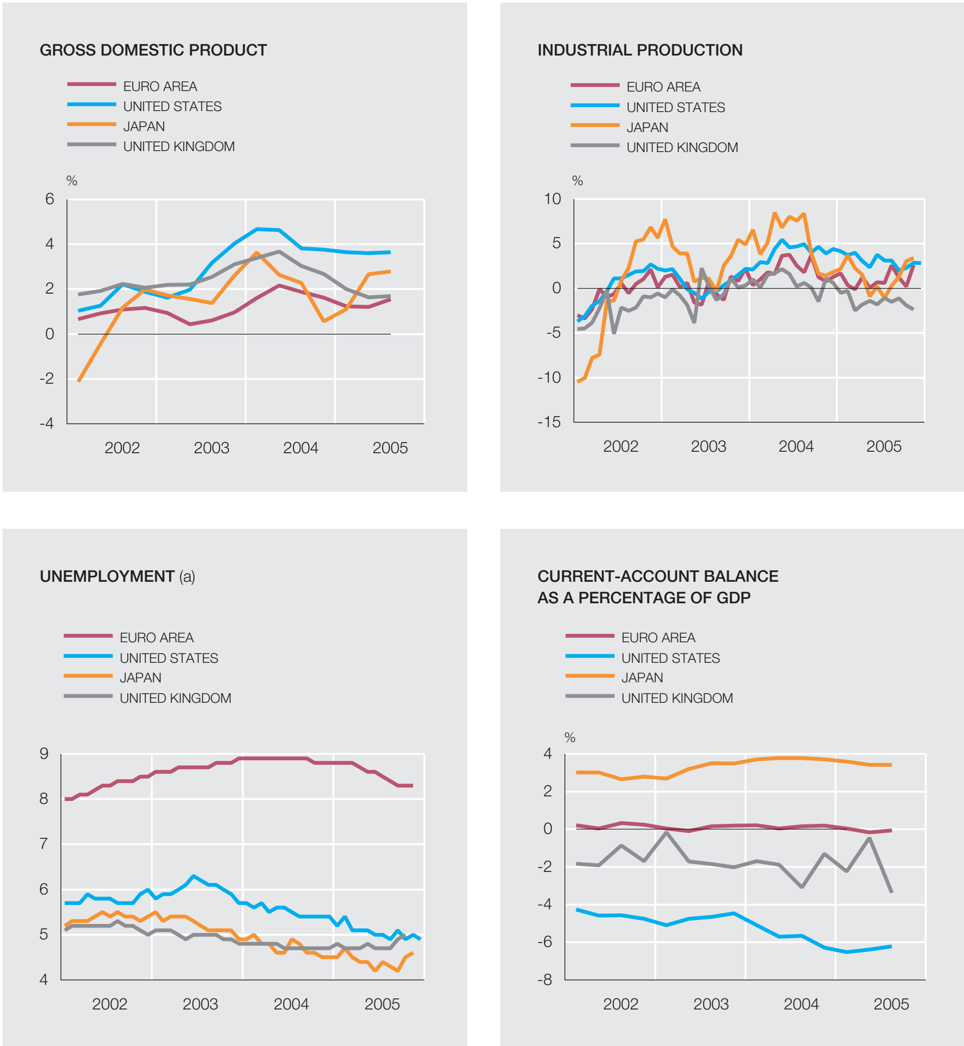
During December, oil prices stabilised at around $58 per barrel of Brent crude, following the marked fall since the all-time high of close to $69 was reached in early September. Nonetheless, during January the price of Brent rose once more to above $65 per barrel, as a result of geopolitical tensions in the Middle East and Nigeria and of the continuing strength of demand. The behaviour of the prices of long-term futures contracts ran in parallel, and the futures curve continued to show similar or higher prices to spot prices over the horizon up to two years.

According to the initial National Accounts results, activity in the United States expanded at an annualised rate of 1.1% in 2005 Q4, compared with 4.1% the previous quarter, whereby growth over 2005 as a whole would be 3.5%. This slowdown in the final quarter came about mainly due to the fall in car purchases and owing to exceptional measures reducing defence expenditure. However, the indicators towards the end of Q4 showed a brighter outlook for early 2006. Retail sales in November and December were somewhat sluggish, but consumer confidence in December increased notably. On the supply side, durable goods orders and the services ISM index improved in December, while orders for capital goods and the manufacturing ISM index worsened slightly. The labour market remained buoyant and employment grew at a similar rate to the previous quarter, which enabled the unemployment rate to end the year at 4.9%, the lowest figure in four years. As regards prices, following the rise in September and October brought on by the strong increase in energy prices, the inflation rate slowed to a year-on-year rate of 3.4% in December, while the core rate held stable at around 2.2%. With respect to the external sector, the trade deficit widened once more in November, albeit less than expected, owing to the rise in exports. Notwithstanding, in the eleven months to end-November, the deficit exceeded the total deficit recorded in 2004, which was already a historical high.

In Japan, activity continued to quicken in the closing months of the year. Real GDP grew by 2.9% in Q3 compared with the same quarter a year earlier, 0.3 pp up on Q2. Underpinning this was the robustness of investment and private consumption. The indicators for Q4 confirmed the favourable circumstances, although at a lower momentum than in previous quarters. On the supply side, the behaviour of most indicators remained favourable, while on the demand

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

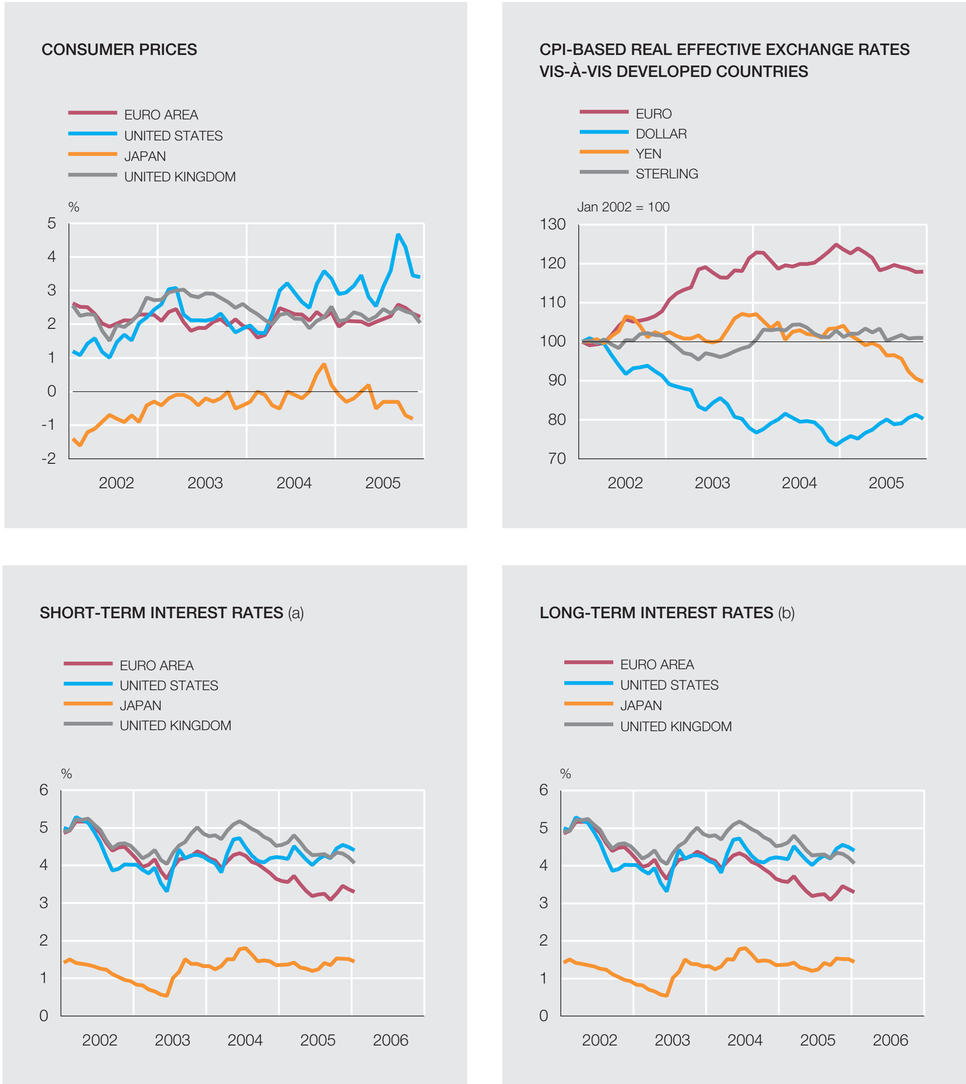
a. Percentage of labour force.

side retail sales slowed moderately, while consumer confidence dipped slightly. Of note in the labour market was the gradual slowdown in the rate of expansion of employee compensation and of job creation, which led the unemployment rate to 4.6% in November. Turning to the external sector, imports and exports were notably buoyant in 2005 Q4. The year-on-year rate of core inflation was positive in December (0.1%), although the overall index still fell by 0.1%. Signs that the long deflationary phase is possibly behind, against a backdrop of greater economic dynamism, prompted the announcement by the central bank of future changes in both the stance and implementation of monetary policy.

In the United Kingdom, the growth rate stabilised after slowing in the final quarters. According to initial results, GDP grew at a year-on-year rate of 1.7% in Q4, unchanged on Q3. Recent indicators have pointed to something of an improvement in activity. In December, the services PMI index rose notably and the distribution industry survey improved substantially, moving into non-negative territory for the first time since February 2005, although consumer confidence worsened slightly. The labour market lost some momentum and in November the unemployment rate (according to the ILO criterion) was up 0.3 pp on the end of Q3 to 5%. The current-

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



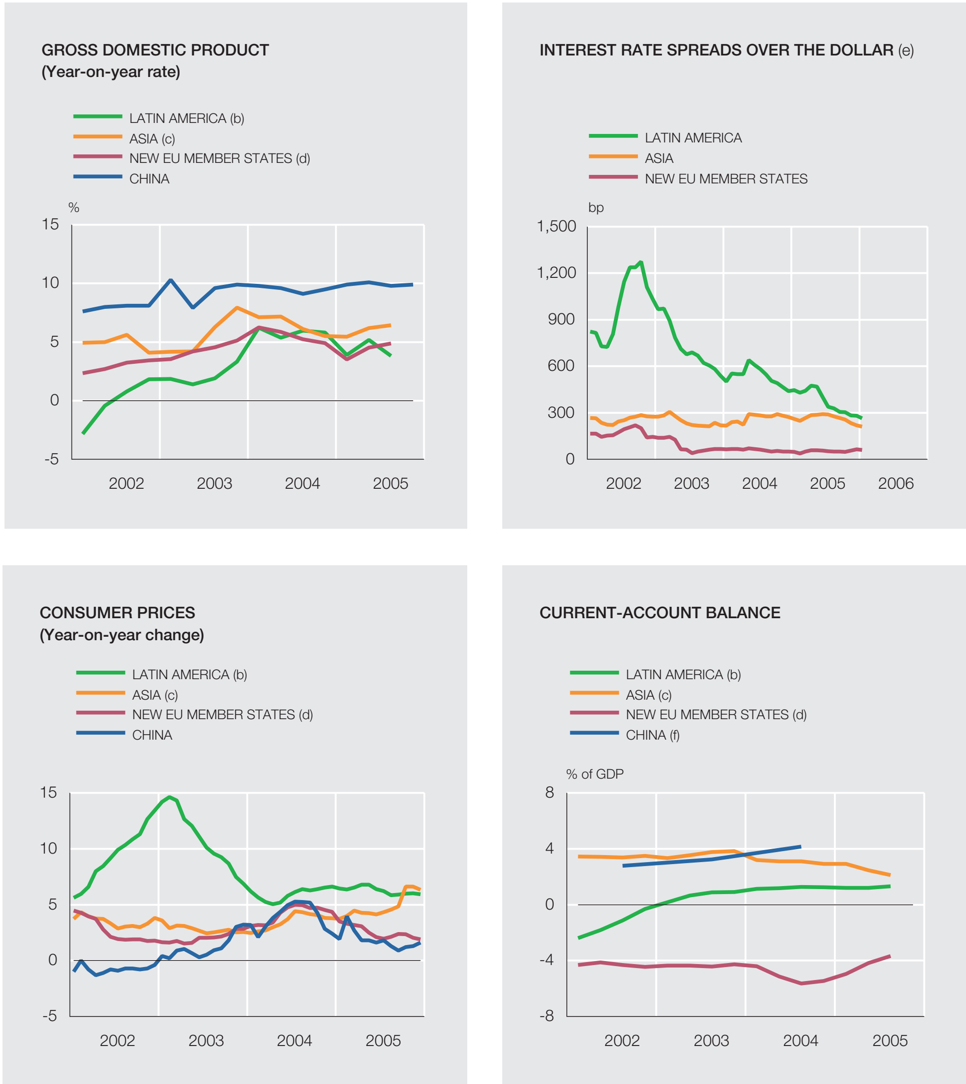
SOURCE: Banco de España.

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

account deficit widened considerably in Q3 to 3.4% of GDP, owing to temporary factors. Finally, the harmonised index of consumer prices stood at 2% in December, while house prices, which had been slowing since the second half of 2004, edged up slightly in the closing months of the year.

In the new EU Member States, GDP growth was robust in Q3 owing to the firm behaviour of external demand and the gradual recovery in domestic demand. The indicators for Q4 confirmed the soundness of activity in the region. In terms of inflation developments, a common trajectory was still not discernible: the inflation rate rose in several countries (especially in the Baltic states) owing to the increase in energy prices, while in others (such as Poland and Slovenia) it eased, due to the fall in food prices. The Czech Republic raised its official interest rate to 2%, while the remaining countries held them unchanged. Budget deficit targets for 2005, although in most cases such deficits exceeded 3% of GDP, might be attained. The exception is Hungary, whose deficit will exceed 7% of GDP. Finally, on 28 November the Slovak koruna joined the ERM II and the European Council of 16 December granted EU candidate country status to Macedonia.

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, Philippines 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. The Asia aggregate does not include China.
f. Annual data.

In China, activity remained very buoyant and GDP grew at a year-on-year rate of 9.9% in Q4, signifying growth of 9.9% for 2005 as a whole. In parallel, the methodological reforms to National Accounts, which entailed an increase in the weight of the tertiary sector in activity, prompted an upward revision (of 0.5 pp on average per annum) in the growth figures since 1993. Specifically, growth stood at 10% in 2003 and at 10.1% in 2004, against the initial estimate of 9.5% in both cases. As to the indicators of activity for the quarter, industrial production and retail sales maintained a robust growth rate, while the rate of expansion of investment in fixed assets eased. In the external sector there was a notable slowdown in exports in the quarter, while there was a gradual and moderate deceleration in imports, though the trade surplus reached $102 billion in 2005, somewhat more than triple the 2004 figure. As regards prices, CPI inflation increased in December to a 12-month rate of 1.6%. Despite the very slight appreciation in the renminbi, the central bank's external reserves continued to grow, albeit at slightly more moderate year-on-year rates, rising to $819 billion at the end of 2005.

In Latin America, the ongoing firmness of activity eased in Q3 to a year-on-year rate of 3.8%, against 5.2% in Q2. Virtually all of this reduction was due to the lower contribution of Brazil, where the year-on-year rate diminished drastically, dragged down by negative quarterly growth. Conversely, in Mexico there was a pick-up in activity and the countries that had maintained stronger rates of expansion, such as Argentina and Venezuela, once again posted very high growth rates. Inflation continued to moderate in most of the countries, with the notable exception of Argentina, where it ended the year at over 12%. Accordingly, and unlike the previous year, inflation targets were met in most of the countries. Against this background, Mexico and Brazil proceeded in the closing months of the year with their downward cycle of interest rates. Finally, Brazil and Argentina refunded the total sum of their loans with the IMF for an overall value of over $25 billion.

Economic activity in the euro area appears to have picked up in the second half of 2005 from the slackness that began to affect it in the second half of 2004. GDP growth quickened notably in Q3 and the latest available information suggests that dynamism was maintained in Q4. All the signs are that investment continued its phase of recovery, driven by very favourable financial conditions and the robustness of business profits, while exports, assisted by the strong growth of world trade and the lagged effects of the depreciation of the euro, remained a driving force of growth. Nonetheless, the absence of clear signs of a recovery in consumption remains a significant factor of uncertainty for the prospect of sustained growth in euro area activity in the short and medium-term (see Box 2). And combining with this are the risks of the persistence of high oil prices and the possibility of further increases, along with a potential disorderly correction of the global macroeconomic imbalances. However, the prospects for the first half of 2006 are compatible with the central scenario in which activity would grow at a rate around that of the euro area's potential growth.

As regards prices, while underlying inflation has held stable at a moderate rate of around 1.5%, short-term developments in the HICP have continued to reflect oil price oscillations. The decline in oil prices in the closing months of the year prompted some moderation in the growth rate of the HICP which, having peaked after the summer, stood at 2.2% in December. This slowdown incorporates, however, temporary factors which may give rise to an increase in inflation in early 2006 and to its maintenance above 2% until well into the year. Looking ahead more to the medium-term, economic agents' conviction that oil prices will hold at high levels increases the risk of dearer production costs ultimately prompting price increases across all sectors and bringing wage moderation to a halt, especially against a background of progressively strengthening economic activity and of recovery in the labour market.

Against this backdrop the ECB Governing Council, at its meeting on 1 December, considered that the risks to achieving price stability in the medium-term had increased, and it accordingly decided to raise official interest rates by 25 bp, after maintaining rates at historically low levels for two and a half years. Nonetheless,while awaiting new economic data, the ECB monetary policy stance continues to be accommodative, which is a clear stimulus for economic growth and job creation in the euro area.

In the fiscal policy realm, all the signs are that the budget deficit will exceed the 3% ceiling set in the Stability and Growth Pact in several Member States. In the cases of Germany and, potentially, in France, non-compliance would oblige the Commission to take a further step in the respective excessive deficit procedures initiated, although to date it has not announced how it will act in this connection, which will be crucial for the future credibility of the Pact. Regarding structural policies, the various European countries have submitted their National Reform Programmes, in accordance with the Lisbon strategy revised in spring 2005 (see Box 3).

3.1 Economic developments

According to the euro area National Accounts estimate for 2005 Q3[1], euro area GDP grew by 0.6% in quarter-on-quarter terms, up 0.2 pp on the previous quarter (see Table 1). This signi-

1. Starting with this estimate, Eurostat has made two significant methodological changes to the euro area National Accounts: the allocation as an intermediate input or final consuption of the different sectors and productive branches of "financial intermediation services indirectly measured", and the use of chain linking volume indices. According to the information provided by Eurostat, this change has a limited effect on the growth rates of the macroeconomic aggregates of the euro area.

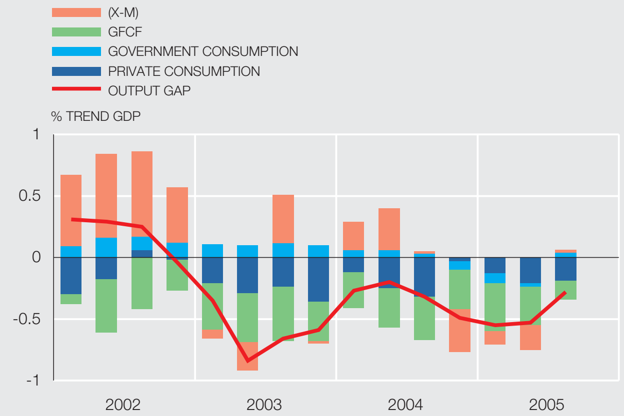
Since 2002, private consumption in the euro area has been characterised by its notable slackness, which has continued to date. This variable posted low growth of around 0.2%-0.3% in quarter-on-quarter terms in the first three quarters of 2005 against a background in which, unlike previous years, both investment spending and sales to the rest of the world were more buoyant. Accordingly, the negative contribution of consumption to the output gap has remained very sizeable, recently becoming the biggest of all the output gap components (see panel 1 below)[1].

From the standpoint of the determinants of consumption, the moderation of disposable income in 2005, stemming particularly from the low growth of employee compensation, in both the wage and job-creation components, would be in step with the hesitant course of consumption. Nonetheless, developments in other factors such as wealth or interest rates might be driving household expenditure upwards. To illustrate the interaction of these determinants, panel 2 depicts the contributions to consumption growth of its determinants, according to the Area Wide Model (AWM)[2]. As can be seen in this panel, the variables in the equation and the relationships between these and consumption explained reasonably well the course of consumption during 2005, since the actual year-on-year rate is only slightly below the rate estimated by the equation. Indeed, this difference is far lower than that in place from mid-2003 and virtually the whole of 2004. It should be stressed that this analysis must be performed with due caution given the lack of sufficiently accurate information on certain variables (such as agents' wealth) or given the possibility that there are other factors other than the habitual determinants that may have influenced household spending. In this respect, the recent trend of consumer confidence indicators, which managed to exceed their historical average only in December 2005, suggests that households may still be acting cautiously when it comes to their expenditure, albeit less markedly so than in the recent period, when these indicators reached minimum levels (see panel 3). Country by country, the sluggishness of consumption in Germany in 2005 was particularly notable, whereby, considering a euro area aggregate without Germany, consumption would have grown at rates more in

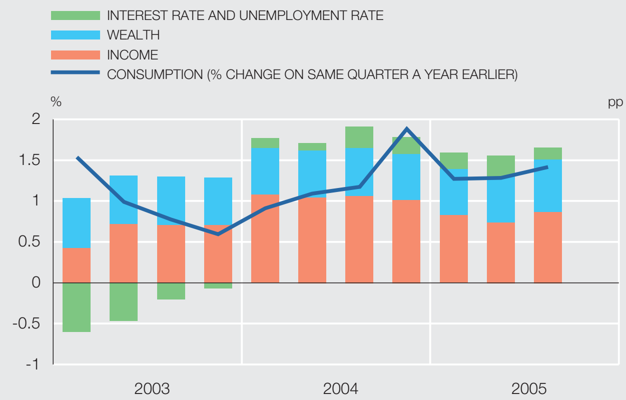
1. The output gap has been calculated as the difference between actual output and its trend level, estimated through a Hodrick-Prescott filter. The contribution of each component is measured as its difference in respect of its trend as a percentage of trend GDP.

2. For a detailed description of this econometric model, see G. Fagan, J.Henry and R. Mestre (2001), *an Area-Wide Model (AWM) for the euro area,* ECB Working Paper no. 42.

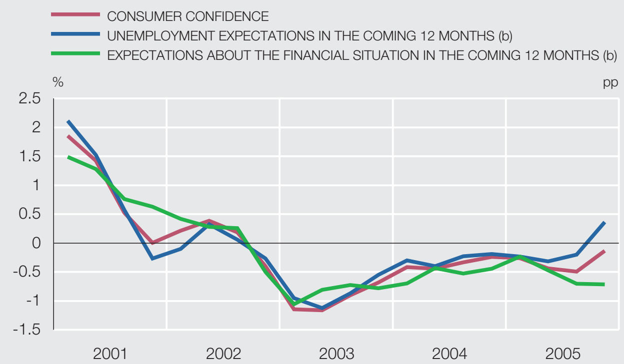
1. EURO AREA OUTPUT GAP. CONTRIBUTION BY COMPONENT



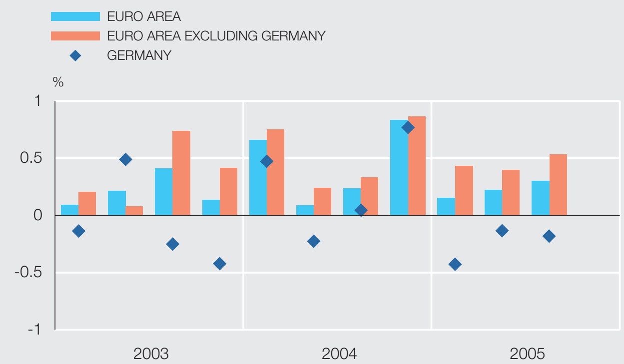
2. CONTRIBUTIONS TO YEAR-ON-YEAR GROWTH BY DETERMINANT



3. CONFIDENCE INDICATORS (a)



4. GERMANY'S CONTRIBUTION IN TERMS OF QUARTER-ON-QUARTER GROWTH COMSUMPTION



SOURCE: INE, Ministerio de Economía y Hacienda and Ministerio de Trabajo y Asuntos Sociales.

a. Normalised data.
b. Component of the synthetic indicator of Consumer Confidence.

keeping with the ongoing recovery in GDP seen in recent quarters (see panel 4).

In recent months, as mentioned in the main body of the text, most of the euro area private consumption indicators are not yet pointing to an immediate and sustained increase in household expenditure. Nonetheless, the improvement in exports and corporate spending should feed through to private consumption as the demand for labour increases and as household disposable income, therefore, improves. In principle, there are signs that this effect may have begun, since the qualitative indicators on employment expectations rose in the final months of the year. However, the recent improvement in consumer confidence does not dispel the uncertainty over households' readiness to spend, as they remain pessimistic about their financial position in the twelve coming months (see panel 3).

Against this background, the most recently published projections of the European Commission, which are in line with those of the Eurosystem, foresee a very slow pick-up in consumption. In 2006, this variable would grow at 1.4%, a very similar rate to that expected for 2005 and therefore lower than its average growth in the past decade. This moderate growth would be the outcome of a greater contribution of disposable income to the increase in consumption, as a result of improved employment and of the lower contribution of financial and non-financial wealth, insofar as house and stock market prices are expected to ease during 2006. The persistence of high deficits in the euro area generates further uncertainty over the maintenance, under the present conditions, of public pension and health care systems, in the light of population ageing. Nonetheless, the progress made in implementing structural reforms in some countries has dispelled some uncertainty and, inasmuch as such progress becomes widespread, this might help reinvigorate consumption.

fied an increase of 0.4 pp in the year-on-year rate of expansion of GDP, which stood at 1.6%. The components contributing to this acceleration in GDP were, essentially, net external demand and investment. In particular, exports rose notably, while imports accelerated more moderately, meaning the net contribution of the external sector to GDP growth increased by 0.3 pp to 0.2 pp. Gross fixed capital formation increased strongly on the previous quarter at a rate of 1.3% (up from 0.9% in Q2), the result of the marked recovery in investment in capital goods, since the rate of expansion of investment in construction, on the contrary, fell notably. That explains much of the increase in the contribution of internal demand (excluding stocks) to growth, which was 0.6 pp (0.4 pp in the previous quarter), since private consumption remained notably lacklustre. This latter variable grew by 0.3% (only 0.1 pp more than in Q2), broadly influenced by the sluggish growth of disposable income, which was due in turn to the limited contribution of both its employment and its wage components (see Box 2). Finally, while the rate of expansion of government consumption increased slightly (0.7%), the contribution of stockbuilding to GDP growth was negative of the order of 0.3 pp (see Chart 8).

The breakdown of National Accounts by country shows that the greater dynamism of economic activity in the area in 2005 Q3 was largely due to developments in the German and French economies. In Germany, the quarter-on-quarter change in GDP stood at 0.6% (compared with 0.2% in Q2), as a result of the strong acceleration in exports and the substantial buoyancy of investment, both in construction and, mainly, in capital goods. This allowed a fresh contraction in private consumption to be offset, this variable having failed to show signs of picking up, unlike in other countries. In France, all components except stockbuilding contributed positively to the acceleration in GDP, which increased by 0.7% in quarter-on-quarter terms, compared with 0.1% the previous quarter. Mention should be made of the recovery both in private consumption and in gross fixed capital formation, and of the positive contribution of net external demand to GDP growth. By contrast, the quarter-on-quarter growth rate in Italy slowed (to 0.3%, 0.4 pp down on the previous quarter), due largely to the significant negative contribution of stockbuilding, although private consumption also slowed. Lastly, the quarter-on-quarter growth rate of GDP in Spain held at 0.8%, since the greater buoyancy of private consumption and of investment offset the deterioration in the net contribution of the external sector.

The review by the European Council in spring 2005 of the progress made under the Lisbon strategy showed certain achievements in some areas, such as job creation, but also clearly insufficient headway in other fields. In order to step up the reform drive and thus attain by the end of the decade the final targets in terms of growth and employment, the European Council deemed it necessary to introduce certain changes into the process. These markedly affect, among other areas, the attendant institutional aspects. In particular, the European Council devised a three-year cycle of policy design and application, which began in June 2005 with the approval, by the Ecofin Council, of the so-called Integrated Guidelines. This document served as a basis for each Member State to draw up, last autumn, a National Reform Programme (NRP) setting out the measures that the authorities intended to implement in the period from 2005 to 2008. In drawing up their NRPs, the different countries took into account the European Council's recommendation that consultation procedures with a broad base of national players (encompassing parliaments, regional and local authorities, and social agents) should be established. Consequently, the final text of the programmes benefited from the contributions of these agents, which should be conducive to their assuming full ownership of the objectives and result, in sum, in a boost to the reform process. In their programmes the EU member states identified, from their different starting positions, a set of five priority areas for reform (see panel 1). These areas include, first, improving the workings of labour markets, where the different countries have proposed measures spanning aspects such as tax systems and social security benefits (with the particular aim of encouraging active job-search), ongoing training throughout working life and the refocusing of collective bargaining arrangements to make them more favourable to employment generation. However, only six Member States have formulated objectives relating to their rate of employment in 2008, which would involve, on average, increases of around 2 pp in comparison with 2004 levels (see panel 2).

The second area of action most mentioned by the Member States in their NRPs is research and development (R&D). In this field almost all countries have announced plans to increase public spending and to foment private spending (see panel 3). However, it is not clear whether the programmes ensure the efficiency of the public component of this expenditure, or the ability of the latter to spur private spending, which might also hamper fulfilment of the R&D objectives.

Another area where the countries identify a more pressing need for reform is the improvement of the regulatory environment for business. Here, most Member States have established catalogues listing examples of good practices, which have been useful to them in the setting of quantitative objectives for reducing the administrative burden, while observing a minimal level of regulatory quality. Fourth, many countries have announced education and continuous-training reforms in acknowledgement of the fact that a quality education is an essential ingredient for retaining the adaptability of the workforce to changes in the economic environment and for improving their skills. This is, moreover, an important ingredient for improving the efficiency of R&D spending.

Lastly, the NRPs of 19 Member States have coincided in highlighting improvements to the sustainability and quality of public finances as a relevant area for further measures. Given the current projections, in which population ageing will give rise in many countries to a most substantial increase in spending on pension and health care systems, many programmes contain reforms along these lines. Insofar as these reforms include measures to raise the actual retirement age, they overlap with those aimed at increasing labour supply. The publication by the Economic Policy Committee in February 2006 of updated long-term budgetary projections will help in assessing the degree of ambition of the measures proposed by the Member States in their NRPs.

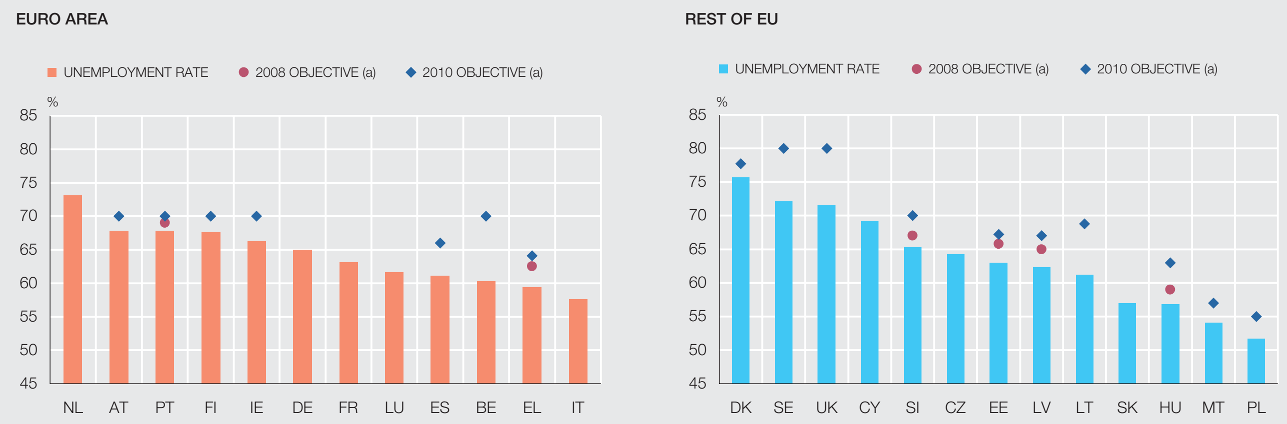
On 25 January earlier this year, the Commission released its first Annual Progress Report. This formulates indications for each Member State about the areas on which it should focus reform efforts. Further, the Report identifies four areas in which it calls on the European Council to promote specific actions. These areas encompass policies aimed at increasing employment rates, spending on research and education, the regulatory environment for business and the development of policies that ensure the availability of efficient energy sources.

Earlier, and at the request of the European Council, the Commission had unveiled the Lisbon Community Programme in July 2005. The Programme contains the complementary actions that are required at the overall EU level to attain the final objectives. As priority areas, this document establishes the creation of a true single market for services, an improved environment for innovation (in particular in respect of intellectual property rights), the effective liberalisation of international trade and, regarding competition in the Community, the completion of the European market for energy and the reduction of the regulatory burden, matters which, as indicated, are also envisaged at the national level in the Progress Report.

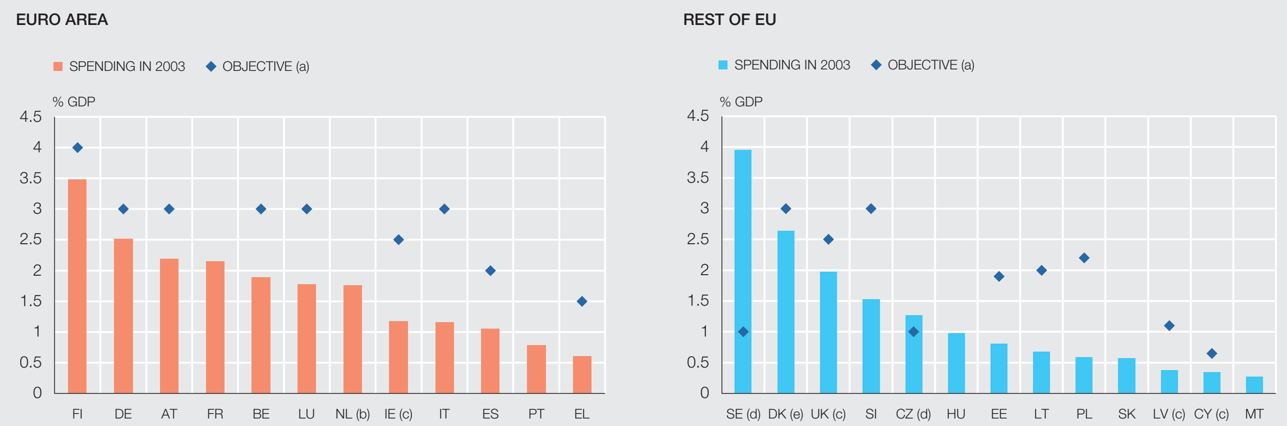
It is difficult to gauge to what extent the national strategies contained in the NRPs - and in the Community programme - are, along with the appropriate monitoring of progress made, sufficient instruments to attain the goals of the Lisbon Agenda. What is clear is that the objectives laid down in the programmes should translate into specific policies to be introduced as shortly as possible, since the comprehensive and rigorous application of the list of reforms proposed is of paramount importance for successfully placing the European economy on a path of higher growth.

1. MAIN CHALLENGES IDENTIFIED BY MEMBER STATES (a)

2. UNEMPLOYMENT RATES IN 2004 AND OBJECTIVES FOR 2008 AND 2010



3. SPENDING ON R+D IN 2003 (% OF GDP) AND OBJECTIVES FOR 2010



SOURCES: Economic Policy Committee (Report on Lisbon National Reform Programmes 2005).

a. Some countries have not presented objectives in their programmes.
b. The objective is to be among the leading five EU countries.
c. Objetives for 2008 (CY and LV), 2013 (IE) and 2014 (UK).
d. Ojectives refer only to the public component of spending.
e. Objective expressed as 3% or higher.

EURO AREA ECONOMIC INDICATORS TABLE 1

	2004			2005				2006
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
GDP								
Year-on-year growth	2.2	1.9	1.6	1.2	1.2	1.6		
Quarter-on-quarter growth	0.4	0.3	0.2	0.3	0.4	0.6		
European Commission forecasts (c)							(0,4 ; 0,8)	(0,4 ; 0,8)
IPI (d)	2.9	2.5	1.1	0.8	0.7	1.3	*1.5*	
Economic sentiment	99.2	100.2	100.5	98.7	96.1	97.8	100.2	
Industrial confidence	-5.0	-3.7	-3.7	-6.7	-10.3	-7.7	-6.0	
Manufacturing PMI	54.4	53.9	51.4	51.4	49.3	51.0	53.0	
Services confidence	10.0	11.3	11.3	10.7	9.0	11.0	13.7	
Services PMI	55.2	54.4	52.9	53.1	53.1	53.8	55.6	
Unemployment rate	8.9	8.9	8.8	8.8	8.6	8.4	*8.3*	
Consumer confidence	-14.3	-14.0	-13.0	-13.3	-14.3	-14.7	-12.3	
HICP (d) (e)	2.4	2.1	2.4	2.1	2.1	2.6	2.2	
PPI (d) (e)	2.4	3.3	3.6	4.2	4.0	4.4	*4.2*	
Oil price in USD (e)	35.3	43.3	39.7	53.3	54.0	62.6	56.5	62.8
Loans to the private sector (d) (e)	6.1	6.5	7.1	7.5	8.1	8.7	*9.0*	
Euro area ten-year bond yield	4.4	4.2	3.8	3.7	3.4	3.3	3.4	3.3
US-euro area ten-year bond spread	0.28	0.14	0.36	0.67	0.80	0.98	1.12	1.09
Dollar/euro exchange rate (e)	1.216	1.241	1.362	1.296	1.209	1.204	1.180	1.228
Appreciation/Depreciation of the euro (e)	-3.8	-1.7	7.8	-4.8	-11.2	-11.6	-13.4	4.1
Dow Jones EURO STOXX Broad index (e)	3.7	1.5	9.9	4.3	8.9	17.7	23.0	0.3

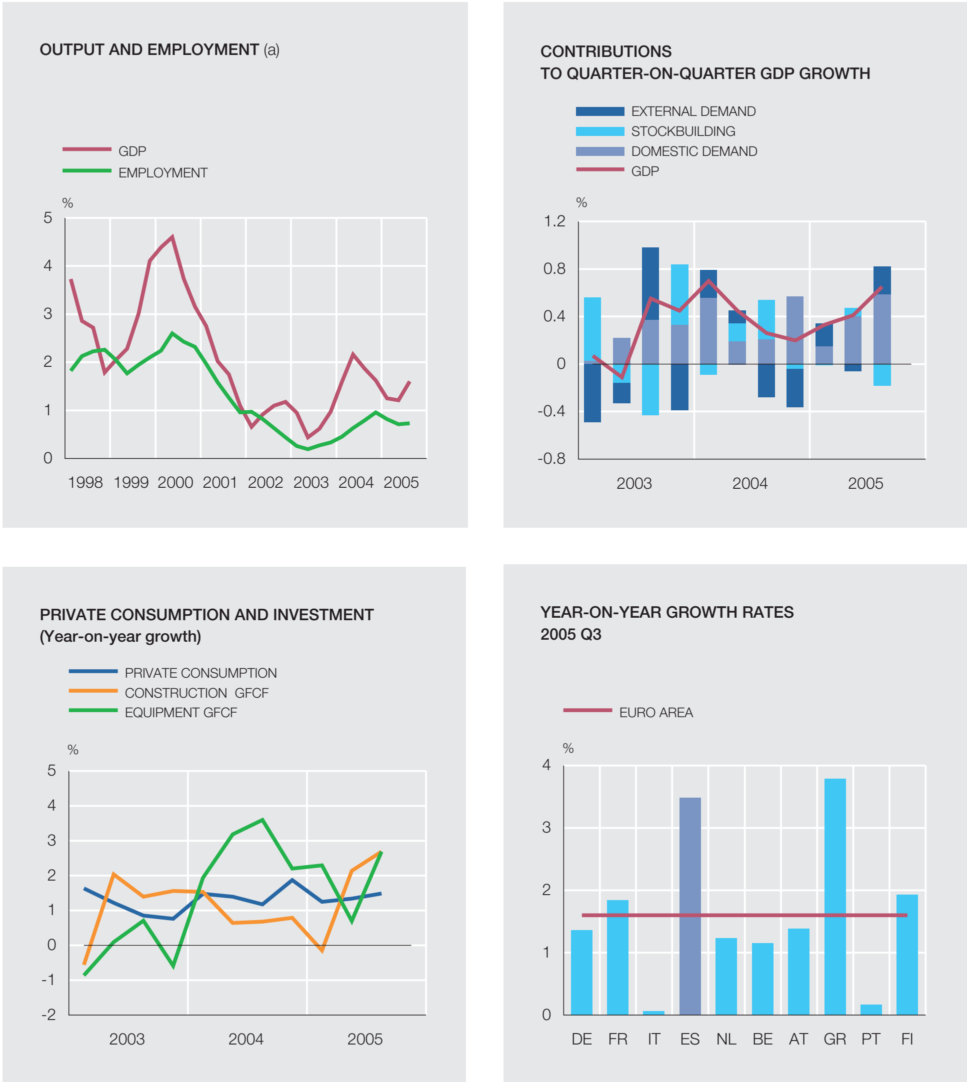
SOURCES: Eurostat, ECB and Banco de España.

a. The information in italics does not cover a full quarter.
b. Information available to 23 January 2006.
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.

In terms of production branches, the gross value added of the euro area economy grew in 2005 Q3 at a quarter-on-quarter rate of 0.5%, similar to that of the previous quarter. Activity in industry and in services remained buoyant, while the growth rate of construction was substantially cut, following its strongly expansionary behaviour in Q2. Turning to the labour market, employment increased during the quarter by 0.3%, 0.1 pp up on the previous quarter. That meant its year-on-year rate of change held at 0.7%, whereby the growth rate of apparent labour productivity stood at 0.9%, 0.4 pp up on Q2. Accordingly, and despite the slight acceleration in compensation per employee (which grew by 1.6% compared with the same quarter a year earlier, against 1.4% the preceding quarter), the rate of increase in unit labour costs moderated further to 0.7%. The growth of the GDP deflator (1.5%) outpaced that of unit labour costs for another quarter, providing for a fresh expansion in business margins (see Chart 10).

The latest conjunctural information on economic activity in the euro area in 2005 Q4 points to the economy's continuing dynamism. As to the supply-side indicators relating to the industrial branch, the industrial production index (excluding construction) picked up extensively in November, after its fall in October. As a result, for the period on average, it increased by 1.5% in relation to its average level in Q3. The qualitative indicators of activity extended their growth path in the closing months of the year, and both the European Commission's business confidence index and Reuters PMI manufacturing index improved significantly relative to the average for the previous quarter, standing at higher values than the historical average (see Chart 9). The performance of the indicators of activity in the services sector – the EC confidence

EURO AREA NATIONAL ACCOUNTS CHART 8



Sources: Eurostat and national statistics.

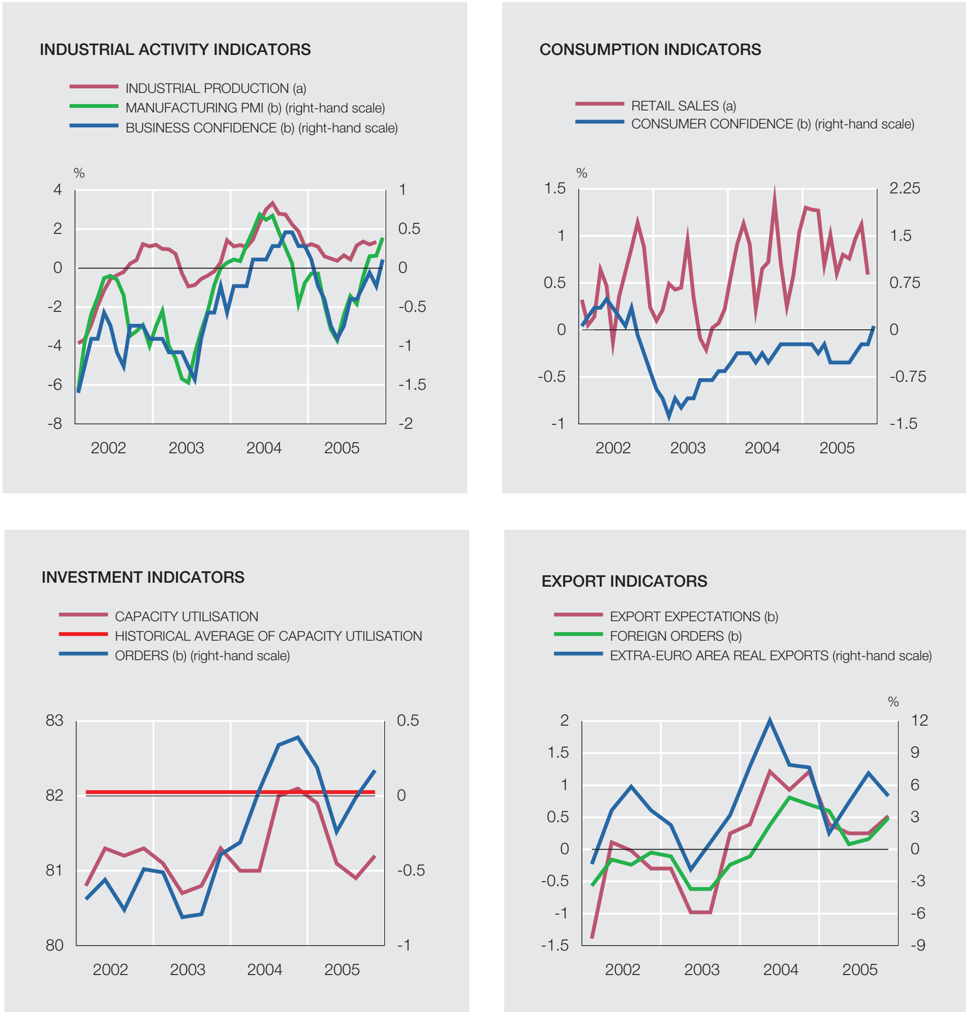
a. Year-on-year rates of change.

index and Reuters PMI index – was also very favourable (see Table 1). With respect to employment, the available indicators, likewise drawing on business confidence surveys, showed a significant improvement in employment expectations in all sectors in 2005 Q4 (see Chart 10). Also along these lines was the trend of the unemployment rate which, albeit gradually, has continued to decline, standing in November at 0.1 pp below the average for Q3 (8.3%).

From the standpoint of demand, the indicators available offer mixed signals about the course of private consumption in Q4, although they point on the whole to the continuing sluggishness of this variable. Although consumer and retail trade confidence rose, both retail sales (in the October-November period) and, especially, new car registrations worsened in relation to the average level in Q3. Conversely, the investment indicators substantiate the prolongation of the phase of firm recovery, given the increase in entrepreneurs' assessment of industrial orders and the moderate increase in the degree of capacity utilisation. As to external demand, balance of payments exports figures for October and November show something of a slowdown in the year-on-year growth rate, although exports are expected to remain buoyant, in line with the firmness in Q4 of both the EC quarterly indicator of export expectations in industry and the

EURO AREA. REAL INDICATORS

CHART 9



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.

monthly indicator of the assessment of foreign orders. Finally, according to the business confidence survey, the assessment of stock levels in 2005 Q4 stood below the historical average, which would suggest an interruption in the process of destocking, as these are below what might be considered the desired average level.

In sum, analysis of the conjunctural information on economic developments in the area in 2005 Q4 is compatible with a rate of expansion for GDP similar to that observed in the previous quarter, in line with the European Commission's estimates, which projects the quarter-on-quarter growth rate will stand in a range from 0.4% to 0.8% (see Table 1). Foreseeably, the main drivers of growth will once again be investment and the external sector, thanks to the impulse stemming from robust global economic growth, to the gains in competitiveness associated with the depreciation of the euro over the course of 2005, to generous monetary and financial conditions and to improved business profits. That said, this scenario is subject to downward risks, associated with the persistence of oil prices at very high levels and with the possibility of further rises, as well as with a potentially disorderly correction of the current global imbalances. Moreover, the limited pass-through of the external impulse to employment and to private consumption to date is a significant source of uncertainty for the future course of activ-

EURO AREA. WAGE AND EMPLOYMENT INDICATORS
Year-on-year percentage changes

CHART 10

SOURCES: Eurostat and European Central Bank.

a. Expectations based on European Commission sentiment indicators. Normalised data.

ity in the area, although the improvement in the qualitative labour market and consumption indicators in Q4 might contain this risk to some extent, especially if they were to augur a more rapid recovery in employment than expected.

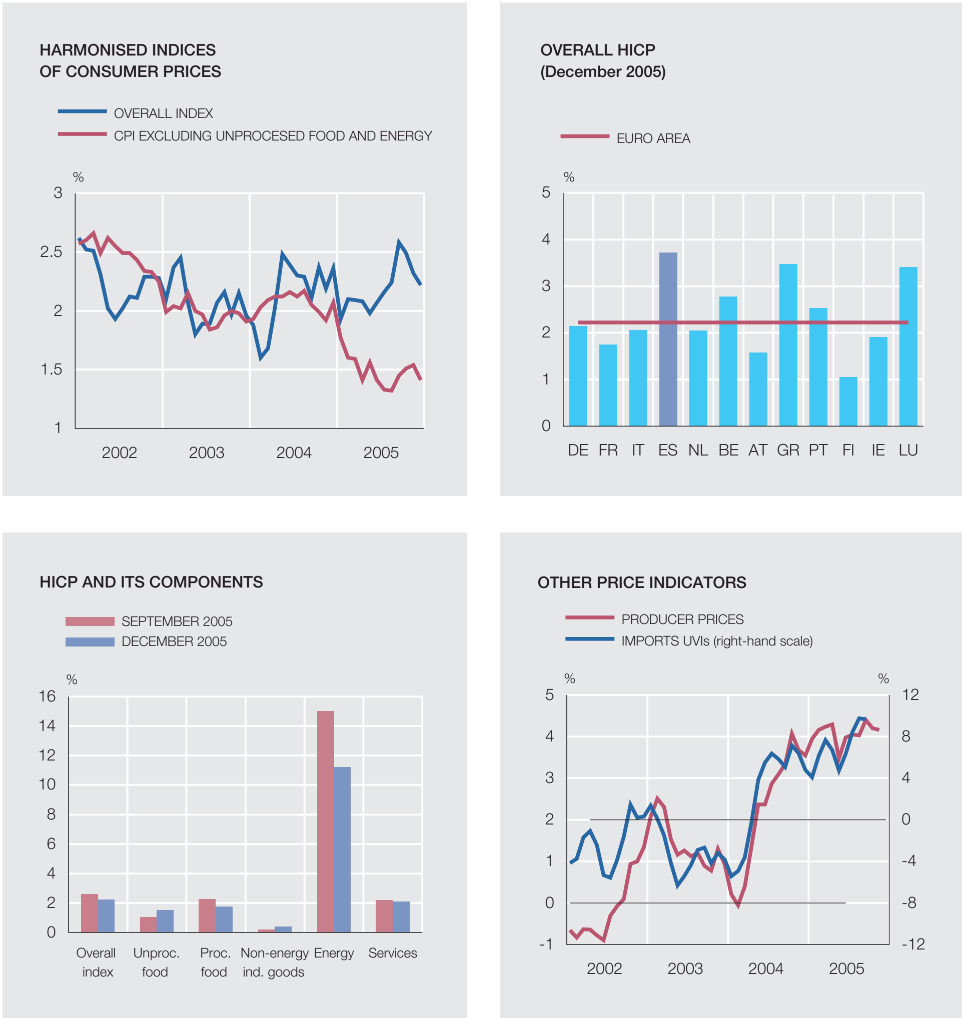
The main indicators of inflation continued to reflect developments in oil prices, which in the closing months of the year stood at lower levels compared with the peaks attained in the summer months. The harmonised index of consumer prices (HICP) posted a year-on-year growth of 2.2% in December, 0.4 pp below the September figure. This was thanks mainly to the lower contribution of the energy component, since the changes in the other components offset one another (see Chart 11). Underlying inflation, measured in terms of an index excluding the most volatile components, i.e. unprocessed food and energy, held stable during Q4, standing at 1.4% in December, unchanged on September. These patterns of behaviour of consumer prices in the euro area as a whole were broadly repeated in the different member states. Finally, producer prices grew at a year-on-year rate of 4.2% in November, 0.2 pp less than in September, owing to the slight slowdown in energy prices (which, however, continue to increase at a year-on-year rate of 14.8%). The prices of the remaining components, by contrast, are still holding at low growth rates.

Despite this recent easing in inflation in the area, risks remain on the upside owing to the uncertainty stemming from oil prices in a setting in which spare production and refining capacity is still very limited. This situation makes oil prices very vulnerable to geopolitical tension, as has indeed been observed in the opening weeks of 2006. Moreover, the strengthening of activity in the area raises the likelihood of second-round effects emerging, should greater labour market vigour prompt an increase in workers' wage demands. It also remains possible that fresh increases in indirect taxes and administered prices will be decided, especially in those member countries that have to make a fiscal consolidation drive.

According to estimates published by the ECB, the current-account deficit that built up in the period from January to October 2005 was €22.9 billion, compared with the surplus of €33.3 billion in the same period in 2004. This was mainly the outcome of the smaller surplus on the goods balance which narrowed to €53.4 billion in the period analysed, compared with the €94

EURO AREA. PRICE INDICATORS
Year-on-year percentage changes

CHART 11



SOURCES: Eurostat and European Central Bank.

billion recorded a year earlier, as a consequence of the increase in imports outperforming that in exports, although the increase in the deficit on the income and current transfers balances also contributed. Between January and October 2005, the amount of net capital inflows in the form of portfolio investment exceeded both foreign direct investment outflows and the current-account deficit, meaning that the basic balance in this period was positive of the order of €26 billion, although it was lower than that observed in the same period a year earlier (€46.3 billion).

In the field of fiscal policy, and according to the European Commission's autumn forecasts, the budget deficit for the euro area as a whole worsened by 0.2 pp in 2005 to 2.9% of GDP (see Table 2). In turn, this deficit is 0.6 pp higher than that resulting from the aggregation of the targets contained in the stability programmes presented a year ago by the different countries. However, fiscal policy retained a neutral stance in 2005, since the cyclically adjusted balance remained approximately stable, having improved by only 0.1 pp in relation to 2004. Further, the deficit is expected to have exceeded once again in several euro area countries the ceiling of 3% of GDP set in the Treaty on European Union. These countries include most notably Germany, Italy, Portugal, Greece and, perhaps, France. In Germany's case, and potentially in that of France, the existence of an excessive deficit last year would entail non-compliance with the

GENERAL GOVERNMENT BUDGET BALANCES OF EURO AREA COUNTRIES (a)

TABLE 2

% of GDP

	2003	2004	2005 (b)	2005 (c)	2006 (c)
Belgium	0.1	0.0	0.0	0.0	-0.3
Germany	-4.1	-3.7	-3.0	-3.9	-3.7
Greece	-5.7	-6.6	-3.7	-3.7	-3.8
Spain	0.0	-0.1	0.1	0.2	0.1
France	-4.1	-3.7	-2.9	-3.2	-3.5
Ireland	0.2	1.4	-0.8	-0.4	-0.3
Italy	-3.2	-3.2	-2.7	-4.3	-4.2
Luxembourg	0.2	-1.2	-1.0	-2.3	-2.0
Netherlands	-3.2	-2.1	-2.6	-1.8	-1.9
Austria	-1.2	-1.0	-1.9	-1.9	-1.8
Portugal	-2.9	-3.0	-6.2	-6.0	-5.0
Finland	2.5	2.1	1.8	1.9	1.9
MEMORANDUM ITEM: Euro area					
Primary balance	0.4	0.5		0.3	0.2
Total balance	-3.0	-2.7	-2.3	-2.9	-2.8
Public debt	70.4	70.8	70.6	71.7	71.7

SOURCES:European Commission, national stability programmes and Banco de España.

a. As a percentage of GDP. Deficit (–) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
b. Targets of the stability programmes presented between November 2004 and June 2005.
c. European Commission forecasts (autumn 2005).

conclusions of the November 2003 Ecofin Council, whereunder these countries should have corrected the situation in 2005. Given such non-compliance, the Commission is expected to communicate its course of action regarding the next steps of the procedure. In this respect, a rigorous application of the fiscal rules in force will contribute to strengthening the credibility of the revised Stability and Growth Pact.

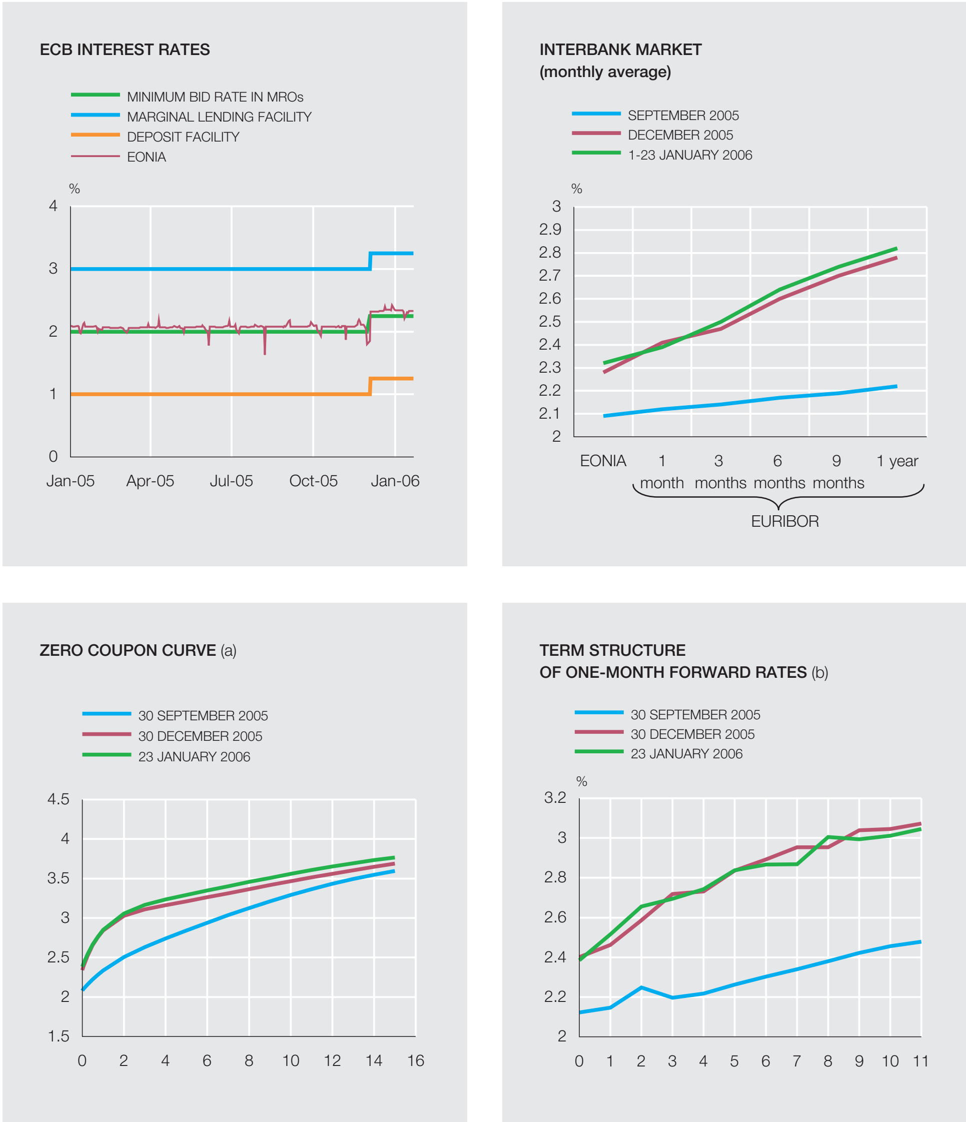
Into 2006, and according to the Commission's autumn forecasts, the deficit for the area as a whole should decline by 0.1 pp to 2.8% of GDP. In Germany, the budgetary plans laid by the new coalition government will have scarcely any influence on the 2006 deficit, which would therefore remain above the level of 3% of GDP. However, they envisage a series of measures, including most notably a 3 pp increase in the standard VAT rate in 2007, which should enable the deficit to be brought clearly below this limit in 2007. In France, the budgetary measures in the stability programme would entail only a 0.1 pp reduction in the deficit in 2006 (to 2.9% of GDP), postponing most of the fiscal consolidation drive to the 2007-2009 period. Finally, in Italy, where the budget deficit might have risen to 4.3% of GDP in 2005, the stability programme envisages a progressive improvement to a deficit of 2.8% in 2007, in which year the term granted to this country by the Ecofin Council to correct its excessive deficit finalises.

3.2 Monetary and financial developments

As earlier stated, the ECB Governing Council considered at its meeting in early December 2005 that the increased risks to achieving price stability in the medium-term, given the inflationary impact of quickening oil prices, warranted a 25 bp rise in official interest rates, after these had held unchanged for two and a half years. The measure, which had already been anticipated by the markets following the announcements the ECB had made at its previous meetings, has not entailed a change in the accommodative stance of monetary policy which,

EURO AREA INTEREST RATES

CHART 12



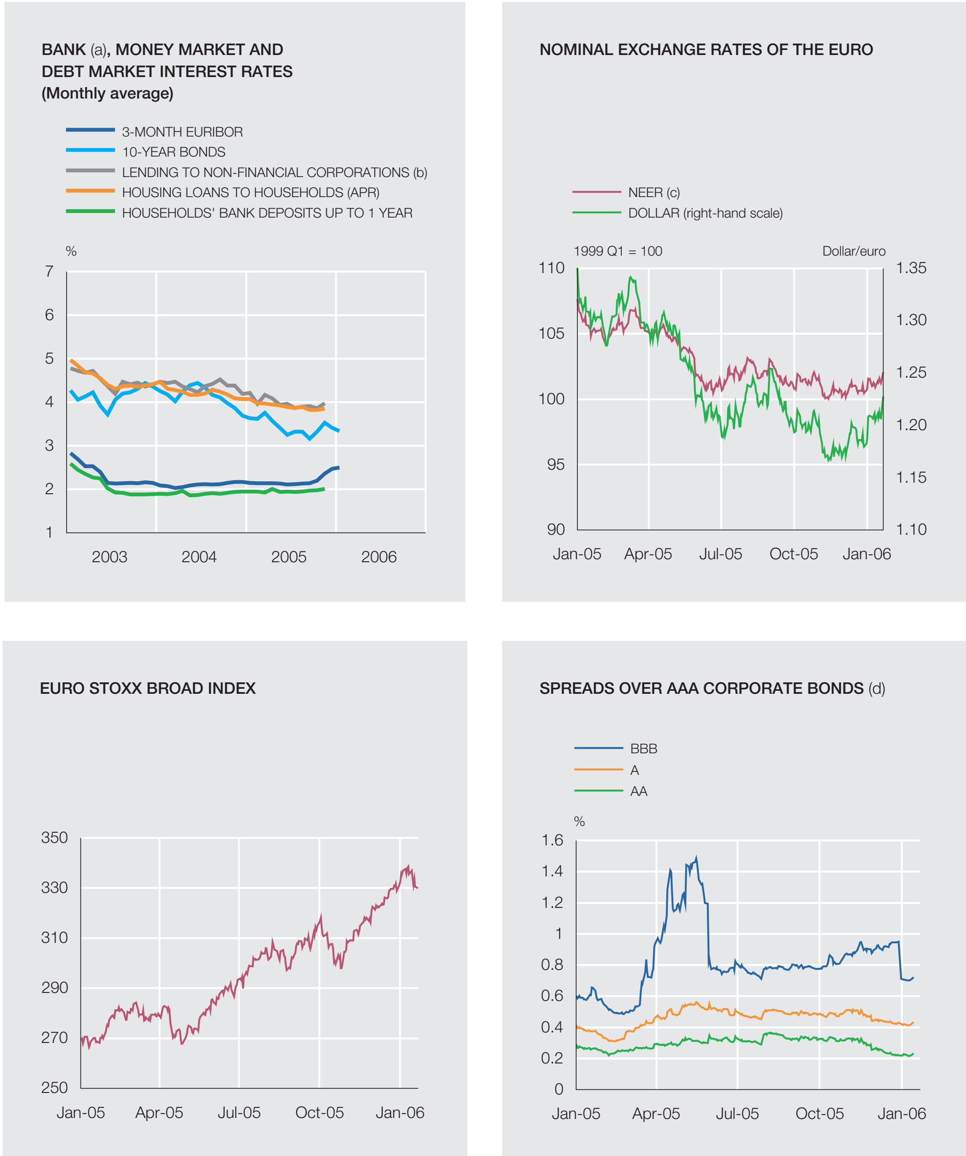
SOURCES:European Central Bank and Banco de España.

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

therefore, continues to be supportive of recovery in the area. As a result, the interest rates on the main refinancing operations, on the deposit facility and on the marginal lending facility increased in December to 2.25%, 1.25% and 3.25%, respectively (see Chart 12).

In October and November, money market interest rates increased at all maturities, albeit more so in the longer-dated ones, in step with the expectations of an imminent upward movement in official interest rates, which the markets were already discounting, and of foreseeable subsequent rises (see Chart 12). Following the December rise, there have been no significant movements in the yield curve, which means a certain delay in the markets' expectations of fresh rises. Ten-year bond yields, after rising gradually in October and November in line with the deterioration in inflation expectations, subsequently reversed their trend, standing in mid-January at a level close to 3.3% (see Chart 13). Long-term yields in the United States ended similarly in the closing months of 2005, giving rise to a widening of only 0.1 pp in the spread with the related euro area long-term yield, which stood at 1.1 pp in the opening days of January. As regards the interest rates set by credit institutions on their lending and borrowing trans-

EURO AREA INTEREST RATES, EXCHANGE RATE AND STOCK MARKET INDEX CHART 13



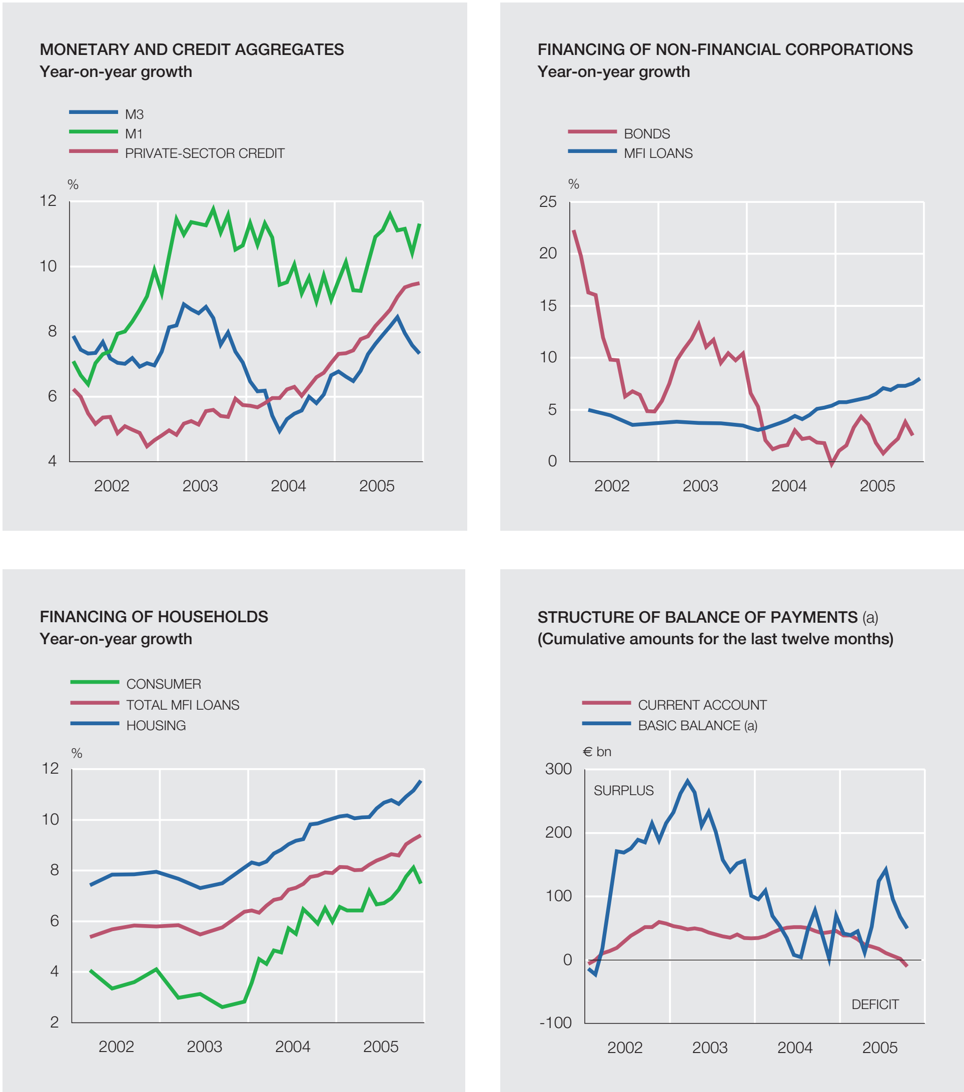
SOURCES: Banco de España and European Central Bank.

a. Data drawn from new statistics on interest rates compiled by the ECB for new business.
b. Interest rates on loans 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.

actions, these held stable according to the information available to November, although a mild rise was seen that month in interest rates on loans granted both to households and corporations, in line with the expectations of a rise in official rates.

On the foreign exchange markets, the euro moved once more in the final months of the year onto a depreciating trend against the dollar. This was due to the fact that the widening spread of US interest rates over those of the euro area and other regions, and the lesser importance attributed by the markets to the US current-account deficit, contributed to the strength of the dollar. Nonetheless, the markets' new expectations about the future course of monetary policy in the United States and the euro area have meant that, since mid-December and in January to date, this tendency has been corrected, with the euro standing once again at over $1.20. Its trend against sterling over this period was fairly similar to that against the dollar, and the

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS CHART 14



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.

opposite to that against the yen. As a result, the euro exhibited great stability in nominal effective terms in the period under study (see Chart 13).

On the euro area equity markets, the markedly upward trend of stock market prices continued into 2005 Q4, meaning that a gain of 23% was posted in the broad EURO STOXX index during 2005. This trend has continued in January to date, albeit with less intensity. Moreover, recent price developments have been accompanied by an additional decline in implied volatility. The strengthening of business confidence, reflecting the improved outlook for the growth of the area's economy, combined with sound corporate results fuelled these stock market gains. As regards the behaviour of the different sectors, there were across-the-board increases in the related sub-indices, except in that of telecommunications, where prices slipped over the course of 2005 by almost 5%. The rises recorded in the industrial, energy and, above all, financial sectors were notable.

With regard to developments in the monetary and credit aggregates in 2005 Q4, the continuously accelerating profile of M3 was interrupted and its rate of change underwent successive reductions, standing at 7.3% in December, more than 1 pp down on the rate recorded in September (see Chart 14). Conversely, credit to the private sector remained buoyant, posting a year-on-year growth rate of 9.5% in December, 0.4 pp up on September. In terms of agents, the acceleration in loans was both in those granted to non-financial corporations and those to households, and, among the latter, in both consumer credit and, especially, loans for house purchases, whose year-on-year rates of change increased by 0.3 pp and 0.9 pp, respectively (to 7.5% and 11.5%). However, the greater buoyancy of credit in the euro area as a whole was not extensive to all countries. In Germany, in particular, the rate of increase of this variable held stable in December relative to September, while it fell in Italy and France, raising certain doubts about the strength of the economic recovery in these countries. In Spain, on the contrary, both total credit and loans granted to non-financial corporations and to households continued to grow at very high rates, substantially up on those recorded in the euro area as a whole.

On the latest available conjunctural information, economic activity in Spain in 2005 Q4 tended to stabilise at a year-on-year growth rate of 3.5%, after having accelerated during the first half of the year. In quarter-on-quarter terms the increase was 0.9%, slightly up on the two previous quarters. This was the result, first, of some slowing in national demand, as a result of the lesser momentum of both household consumption and investment, which nevertheless remained notably buoyant. Further, the slowdown in demand was offset by the estimated improvement in the contribution of external demand to growth, which resided on the diminished thrust of imports, on a slight pick-up in goods exports and, above all, on the improvement in tourism as from the summer.

The estimate for Q4 places the growth of the economy in 2005 as a whole at 3.4%, 0.3 pp up on the previous year. High job creation (3.1%) and the cumulative rise in wealth in recent years underpinned the continuing strong dynamism of consumption and investment in housing. Moreover, there was a notable recovery in investment in capital goods, which moved more in keeping with the cyclical position. Conversely, the negative contribution of external demand worsened, despite the small increase in imports, owing to the fact that exports were very lacklustre, especially in the first half of the year. The growth achieved by the Spanish economy in 2005 has provided for an improvement in the indicators of real convergence with the euro area (see Box 4).

From the standpoint of production, value added in the market economy stabilised in Q4 at around the level reached in the summer months. The information available points to a strengthening of market services and to a mild easing in construction, although the rate of expansion of this latter variable remained very strong. A slowdown in growth is estimated for the remaining branches in the final months of the year.

Productivity held in Q4 on the path of small increases that has characterised it in recent years. Labour costs are estimated to have quickened in Q3 which, combined with the mild moderation of the GDP deflator, suggests that unit margins in the second half of the year might have slowed slightly in the market economy. CPI-based inflation rose to 3.6% in the final quarter of the year, posting an increase of 3.7% in December. Among other factors, this was the result of the impact of dearer oil over the course of the year. In annual average terms, the CPI grew by 3.4%, 0.4 pp more than in 2004.

4.1 Demand

Spanish household final consumption spending posted high growth in real terms in 2005 Q3, with a year-on-year rate of 4.4%, 0.2 pp down on Q2 (see Chart 15). The latest and as yet incomplete information appears to indicate that this moderation extended into the final months of the year, although private consumption continued to run at a sharper rate of increase than that of real household disposable income. The synthetic indicator of consumption of goods and services in Q4 lends support to this moderately decelerating profile, which originated in a slowdown in the consumption of both durable and non-durable goods. With data to November, the retail sales indicator points to an even sharper slowdown (see Chart 16). However, both the retail confidence indicator and the consumer confidence indicator held stable in Q4.

In the year as a whole, private consumption would have grown by around 4.4%, a similar rate to 2004. The estimates made indicate that real disposable income slowed slightly in 2005, after growing by 3.3% the previous year, as a result of a lower contribution of net interest, which was

SPANISH GDP PER CAPITA WITH THE NEW NATIONAL ACCOUNTS FIGURES

Over the past year, the EU countries' National Accounts have been rebased in a fairly generalised fashion accompanied, in many cases, by highly relevant methodological changes. As a result of this there have, among other revisions, been significant changes in the GDP per capita series of the various countries. This box briefly describes the estimates of Spanish GDP per capita in relation to the EU 25 average published by the European Commission, coinciding with the autumn forecasting exercise, which already took into account the new National Accounts figures for a large number of countries.

GDP per capita at current prices, expressed in purchasing power parity (PPP) terms, is the indicator habitually used to assess a country's level of convergence vis-à-vis a reference area. Within the EU this indicator acts, as is known, as a reference for determining which countries and regions of the Union qualify for benefiting from the structural and cohesion funds, and it is on this basis that the convergence objective has been established in the Spanish government's National Reform Plan.

According to the figures in the European Commission's autumn forecasting exercise[1], Spain's GDP per capita in relation to the EU 25 stood in 2004 at a relative level of 98.6% (1 pp higher than the figure of 97.6% estimated before making the changes in National Accounts). On as yet preliminary estimates, the relative level of GDP per capita in 2005 would have risen to 99.2%.

This change in level is the outcome of the upward revision of Spanish GDP which, in PPP terms and at current prices, stood in 2004 - with the new National Accounts base - 5.2% above the level obtained in the previous estimates. For the purposes of the calculation of GDP per capita, this increase in Spanish GDP is partly cancelled out by the revision of average GDP for the EU 25 (by 1.5% that same year) and, above all, by the inclusion in the Spanish figures of population estimates drawn from the data in the last census, which entailed a 3% upward revision of this variable in 2004.

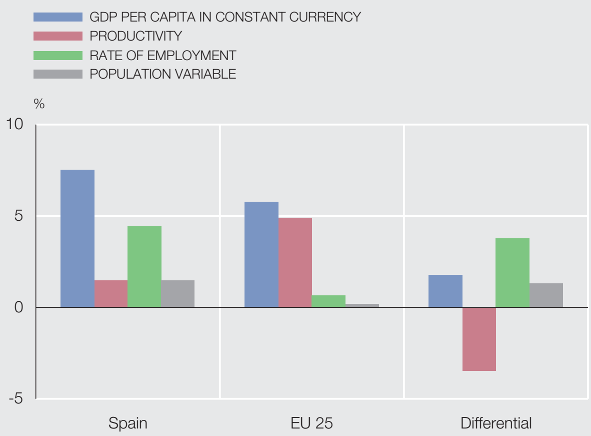
It should be pointed out that the GDP per capita series in PPP terms at current prices should not be used to obtain a diagnosis of the time profile of the convergence process, since the related trend is distorted by certain methodological problems underlying the preparation of PPPs. In their place, the GDP per capita series in PPP terms at constant prices are a more appropriate indicator of the course over time of real convergence or, expressed otherwise, of relative gains in economic welfare. This measure further provides for a breakdown into the factors behind real convergence: the population component, the

1. The data for 2004 and 2005 are provisional.

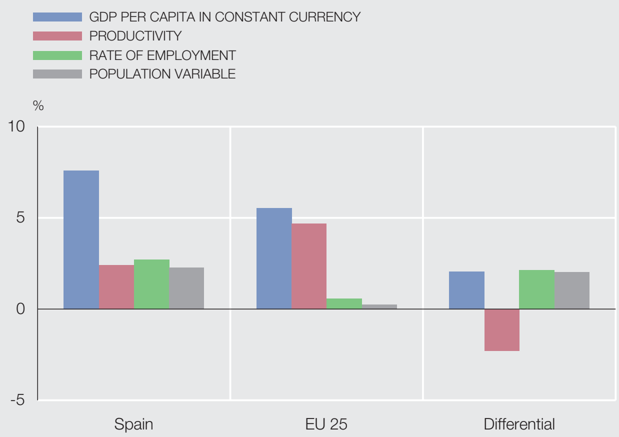
SPAIN/EU 25 LEVELS. EU25=100	2000	2001	2002	2003	2004 (p)	2005 (p)
GDP per capita in current PPPs	92.7	93.7	95.7	99.3	98.6	99.2
GDP per capita in constant PPPs (base 2005)	97.0	97.7	98.0	99.3	98.6	99.2
Apparent labour productivity	103.3	102.6	102.1	101.4	99.9	98.0
Rate of employment	92.1	93.3	93.9	94.8	95.5	97.8
Pop. aged 16-64/ total pop.	102.0	102.1	102.2	103.3	103.4	103.5

CUMULATIVE GROWTH RATES IN THE PERIOD 2000-2004

SPANISH NATIONAL ACCOUNTS (BASE 2000) ESTIMATE



SPANISH NATIONAL ACCOUNTS (BASE 1995) ESTIMATE



SOURCE: Banco de España.

a. The data for 2004 and 2005 are provisional.

relative employment rate and the relative level of apparent labour productivity[2].

The accompanying chart depicts the cumulative growth of constant GDP per capita for the period 2000-2004 and its breakdown into the three above-mentioned factors with the new National accounts figures, comparing them with the related spring estimates. As can be seen, and as was to be expected, the message that they be drawn from both estimates on the intensity and characteristics of the real convergence process is very similar, although the contribution of the different determinants is somewhat different. Behind the increase in the relative level of GDP per capita (2.4 pp in the period 2000-2004) are the strong growth of employment relative to the EU (an effect which, with the new data, is of even greater intensity) and, to a lesser extent, the rise in the population. Productivity growth in Spain continues to be less than that of the EU; however, with the new data the difference is amplified and the negative contribution of this factor to the growth of GDP per capita, in the period considered, is of greater intensity than was the case with the previous dataset.

The continuation of this declining trend in relative productivity may pose a risk for headway in real convergence, even if the current scenario of strong employment creation were to be maintained. Against this background, the adoption of various measures, such as those envisaged in the National Reform Plan unveiled by the government last October, is of paramount importance for reversing this trend.

2. The year taken as a reference for deflating GDP per capita has consequences for the level of this series. Given that the new National Accounts figures are not prepared with a fixed base, it would seem advisable to express the GDP series at constant prices in euro of the last year represented. In that year it would coincide with the latest estimated value for GDP per capita at current prices, which is the value that contains the latest available information on the structure and levels of relative prices. Note, however, that by following this procedure, and given that the latest European commission PPP estimates refer to 2003, in the subsequent years PPP runs in line with the relative level of the deflators, whereby the relative levels of current and constant GDP per capita are the same from that date onwards.

affected by the increase in household debt, and of the higher inflation rate, while the contribution of wage income and of the gross surplus held stable. Accordingly, the resilience of consumption was underpinned once more by household wealth gains, which were high due to the rise in property prices (although these were somewhat lower than in previous years) and to the strong growth of stock market prices in 2005 (approximately 20% in the case of the IBEX). These conditions, further reinforced by low financing costs which only rose slightly at the end of the year, gave rise to a fresh contraction in the household saving ratio. Box 5 briefly describes the changes that the introduction of CNE (Spanish National Accounts) base year 2000 has entailed for the estimations of income, saving and financing requirements for the different sectors.

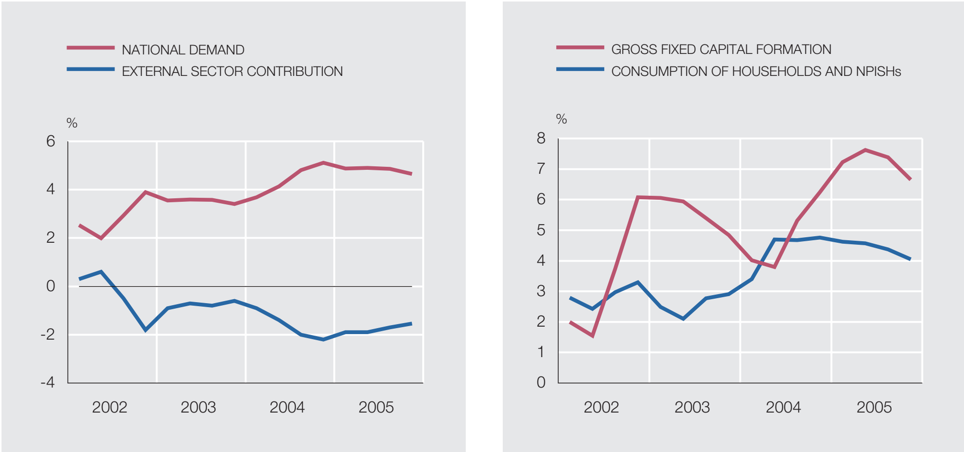
In 2005 Q3, general government final consumption posted a year-on-year increase of 4.6%. The scant conjunctural information available points to a slight acceleration in this aggregate in Q4, on the basis of the State budget outturn data.

Gross fixed capital formation continued to grow at a brisk pace in 2005 Q3, albeit at a year-on-year rate of 7.4%, 0.2 pp down on Q2. This moderation was due to the slowdown in investment in capital goods, the rate of change in which declined by 1.6 pp to 8.8%. Set against this, investment in construction and investment in other products quickened in Q3 to year-on-year rates of 6.3% and 9%, respectively. The information available indicates that the growth of investment in capital goods would have moderated once again in Q4 (see Chart 17). The year-on-year rate of increase in the indicator of apparent investment in these goods stabilised in Q4, albeit at a substantially lower rate than in the first half of the year. Moreover, both the business climate indicator for producers of capital goods and the assessment of orders and the degree of capacity utilisation fell in Q4, while the proportion of companies that consider their plant capacity to be sufficient also increased during this period.

The information on non-financial corporations compiled by the Central Balance Sheet Data Office, covering the period to 2005 Q3, points to a moderation in the growth rate of activity of

MAIN DEMAND AGGREGATES (a)

CHART 15



SOURCES: INE and Banco de España.

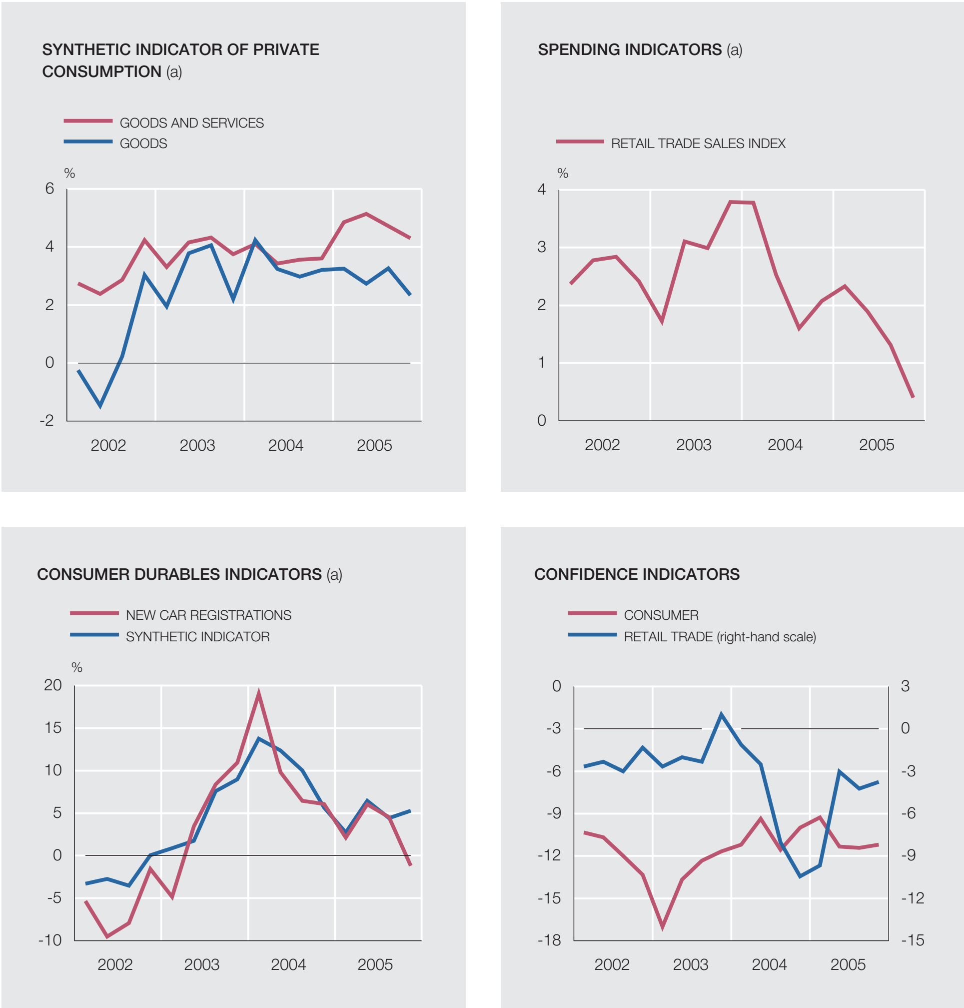
a. Year-on-year percentage change based on seasonally adjusted series.

the companies sampled in the year. Along with this, there has been something of an acceleration in personnel and financial costs which generated a slight slowdown in ordinary net profit. However, net profit and the profit ratios improved to Q3 owing to the lower volume of provisions and taxes. These figures indicate that companies have room to continue expanding their productive capacity and investing in capital goods in the coming quarters, albeit at more moderate rates than those recently observed.

Investment in construction increased by 6.3% in 2005 Q3, prolonging the notable momentum it has shown throughout the year. However, the latest conjunctural information, assessed as a whole, would suggest a mild slowdown in the final quarter of the year. The confidence indicator for the sector eased in December, although it improved over the quarter as a whole, rising to the highest average quarterly value since 2000 Q2. The other coincident indicators, namely registered unemployment, apparent consumption of cement and the industrial production index of construction materials, indicate lesser buoyancy in the final quarter of the year. The exception is Social Security registrations, which quickened in Q4, even when the impact of the regularisation of immigrants is discounted. By type of construction work, the leading indicators project a moderation in the growth rates of residential building, for the second quarter running, and confirm the recovery in non-residential building in the second half of the year. Regarding civil engineering works, the indicators estimated on the basis of government procurement budgets indicate that the real value of work executed slowed during 2005, and they project more stable – though more moderate – growth for 2006.

On QNA estimates, the contribution of net external demand to growth remained markedly negative in 2005 Q3, although it recovered slightly in relation to the previous quarter. This period saw confirmation of the mild recovery in real exports of goods and services initiated in Q2, with their year-on-year rate of increase standing at 1.3%, while the growth of real flows of imports eased somewhat to 7.7% (see Chart 18). Nonetheless, the recovery in exports was unable to prevent a further loss of share on international markets, which have expanded at far higher rates than those of Spanish sales. The as yet incomplete information for Q4 suggests the negative contribution of net external demand to growth continued to lessen, against a backdrop marked by something of a pick-up in exports, especially of services, and the slowdown in imports, in line with the diminished strength of the domestic demand for consumption and investment in capital goods.

PRIVATE CONSUMPTION INDICATORS CHART 16



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

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

During Q3 the rate of increase of goods exports declined by 1.2 pp to 0.5%. The latest official customs figures, for October and November, fell by 0.4% year-on-year in real terms. But this figure should be analysed with caution, since it is possibly biased downwards due to the effect of the transport strike in October. By geographical area, the slowdown in exports in real terms in the October-November period was concentrated in sales to the EU 25 (–3.7%), while the performance of exports to the rest of the world improved (8%).

On QNA figures, after declining for several quarters, the growth of real exports of tourist services was zero in 2005 Q3, in line with the improvement shown by the nominal balance of payments indicator. This favourable performance, which was also reflected by the real indicators of tourism, has firmed in the closing months of the year, with a 6.1% increase in total tourist spending to November in real terms. Overnight hotel stays by non-residents, with figures to December, also increased by 6.1%, while the number of tourists rose by 5.1% in Q4. However, average spending by tourists, which declined by 1.8% to November as a result of the new behavioural habits of visitors, has been one of the factors detracting from the buoyancy of tourism revenue. Real exports of non-tourist services gathered notable steam in 2005 Q3, with a year-on-year increase of 6.6%, following their sluggishness in the first half of the year. All the items under this heading performed very favourably, most particularly insurance, construction, financial and IT services.

In late 2005, INE (the National Statistics Institute) published accounts of the institutional sectors that are consistent with the changes introduced into the Spanish National Accounts, base 2000 (CNE-2000). These accounts thus completed the set of National Accounts annual statistics for the period 2000-2004 with the new base. Moreover, the information relating to the institutional sectors is notably extended as from 2006, with the publication of quarterly sectoral accounts. This box summarises the most significant changes contained in the recently released annual estimates.

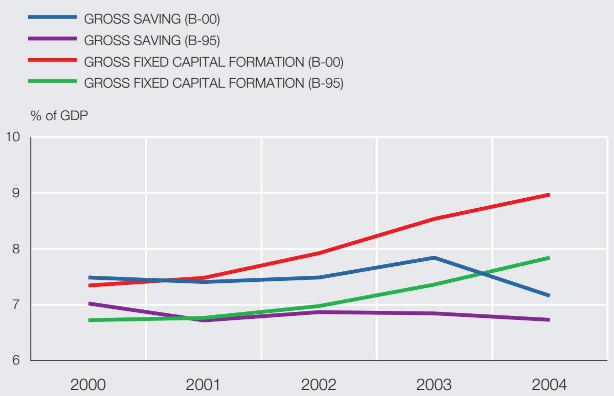
The net borrowing of the nation increases by 0.8% of GDP, on average, compared with the 1995-based (CNE-1995) estimates, entailing a similar deterioration in the period 2000-2004 to that already indicated by the estimates available on the rest of the world account (see adjoining table). The data now being published indicate that the most of this increase relates to the private non-financial sector, since the general government balance alters by only 0.1 or 0.2 pp of GDP, except in 2003, and that of financial institutions scarcely contributes to the revision of the nation's net borrowing. This revision is therefore due to the new estimates of the gap between the saving of and investment by households and non-financial corporations. At the start of the period (2000-2001) it is the increase in the net borrowing of non-financial corporations which explains most of this revision. Subsequently, by contrast, it is the net lending of households and NPISHs which most declines, showing a sharper deterioration than that offered by CNE-1995; as a result, the balance of this sector is in negative figures in 2003 and 2004, for the first time since statistical tracking of it began.

The trend of the imbalance between these two sectors' saving and investment has thus been changed. According to the new estimates, the widening of this imbalance was greater, in the case of non-financial corporations, during the first two years, owing essentially to a lower level of saving, since growth capital formation stood at a similar level in these years (see the accompanying panels). In the following two years, however, this sector's gross saving quickened to a greater extent, according to CNE-2000, with its weight in GDP standing above the CNE-1995 figure in 2003, thereby reducing the increase in the net borrowing of non-financial corporations at the end of the period. In the case of households and NPISHs, the reduction in net lending is mainly due to a sharper growth rate of gross capital formation in the CNE-2000 estimates, which has raised its weight in GDP by somewhat more than 1 pp and is consistent with the higher growth of investment in housing offered by the new accounts. Although the respective shares in GDP of household gross saving and the household saving ratio are now also higher, this increase is not enough to meet the requirements for funds arising from the higher growth of gross capital formation in the sector.

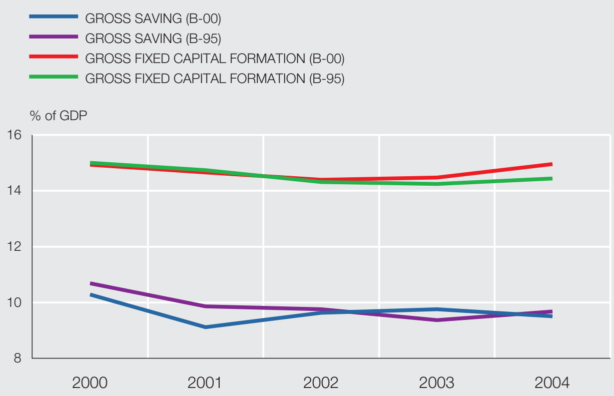
INSTITUTIONAL SECTORS ACCOUNTS: BASES 2000 AND 1995

	INE-2000					INE-1995					Differences				
	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004	2000	2001	2002	2003	2004
NET LENDING (+) OR BORROWING (-) (% of GDP)															
Nation	-3.2	-3.4	-2.6	-3.0	-4.8	-2.5	-2.2	-1.6	-2.1	-4.2	-0.7	-1.2	-1.0	-0.9	-0.6
General government	-0.9	-0.5	-0.3	0.0	-0.2	-0.9	-0.4	-0.1	0.4	-0.3	0.0	-0.1	-0.2	-0.5	0.1
Households and NPISHs	1.1	0.6	0.4	-0.3	-0.8	1.3	0.8	0.8	0.3	0.1	-0.2	-0.1	-0.5	-0.5	-0.9
Companies	-3.4	-3.5	-2.7	-2.7	-3.9	-2.9	-2.6	-2.3	-2.8	-4.0	-0.5	-0.9	-0.4	0.1	0.2
— Financial institutions	0.8	1.4	1.4	1.3	0.7	0.8	1.5	1.5	1.5	0.8	0.0	-0.1	-0.1	-0.2	0.0
— Non-financial corporations	-4.2	-5.0	-4.1	-4.0	-4.6	-3.7	-4.2	-3.7	-4.2	-4.8	-0.5	-0.8	-0.3	0.3	0.2
MEMORANDUM ITEM:															
Saving ratio of households and NPISHs	11.2	11.2	11.4	12.1	11.1	10.7	10.4	10.6	10.6	10.5	0.5	0.8	0.8	1.4	0.5

HOUSEHOLDS AND NPISHs



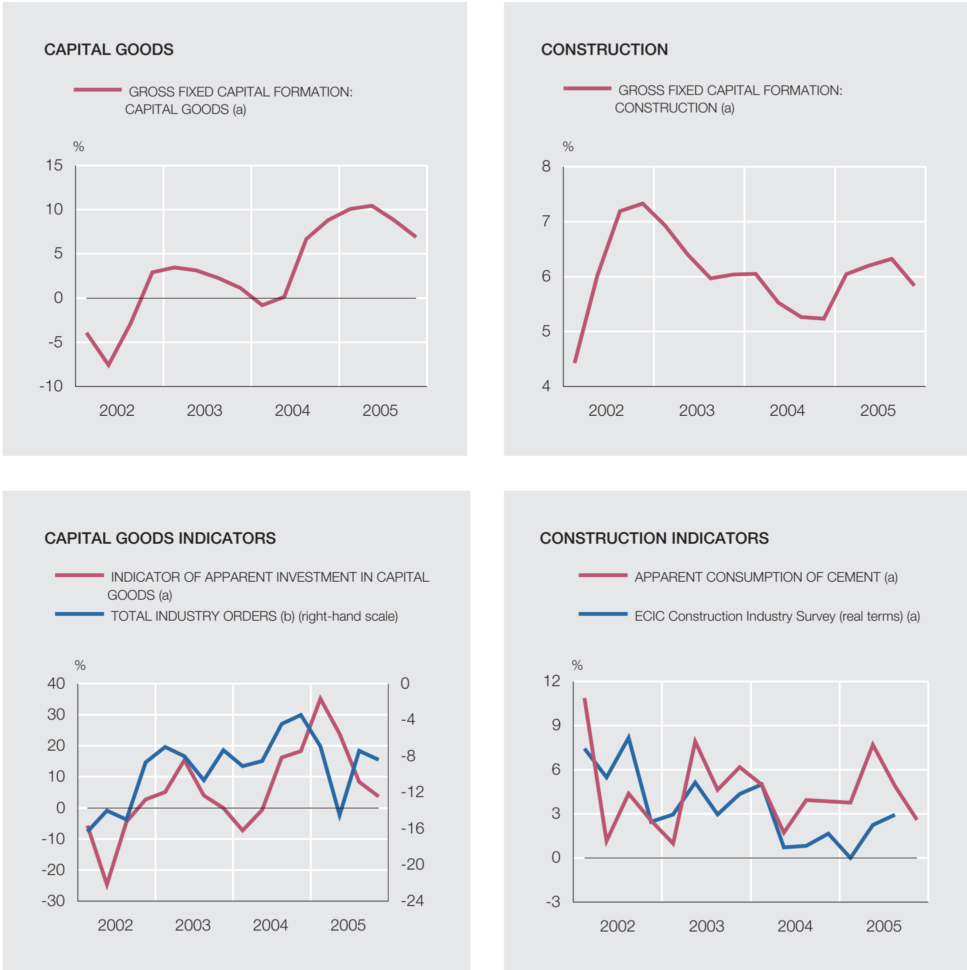
NON-FINANCIAL CORPORATIONS



SOURCE: INE.

GROSS FIXED CAPITAL FORMATION

CHART 17



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.

Real goods imports continued to show high growth (7.1%) in 2005 Q3, albeit 2.3 pp down on Q2. The acceleration in import prices and the slowdown in certain components of domestic demand, especially capital goods, contributed to this deceleration. Customs data point to some stability in imports in October and November, in step with the estimate of a mild slowdown in real goods imports in 2005 Q4, and in line with the estimated trend for consumption and investment in capital goods.

Finally, real services imports, in QNA terms, quickened by 5.6 pp in 2005 Q3, posting year-on-year growth of 10.3%. This was the result of the substantial buoyancy of real imports of tourist (27%) and non-tourist services (6.8%), both of which were consistent with the course of nominal Balance of Payments debits in Q3.

4.2 Output and employment

Value added in the market economy gathered fresh momentum in 2005 Q3, quickening by 0.3 pp in relation to Q2 and rising to a year-on-year growth rate of 3.5%. Activity accelerated across the board, with the exception of market services, whose rate of increase held stable (see Chart 19). The information available indicates that the growth of activity in the market economy tended to stabilise in Q4, meaning that for 2005 as a whole the increase would have been greater than for the previous year both at the aggregate level and in each of the branches.

FOREIGN TRADE CHART 18
Percentage change on year ago

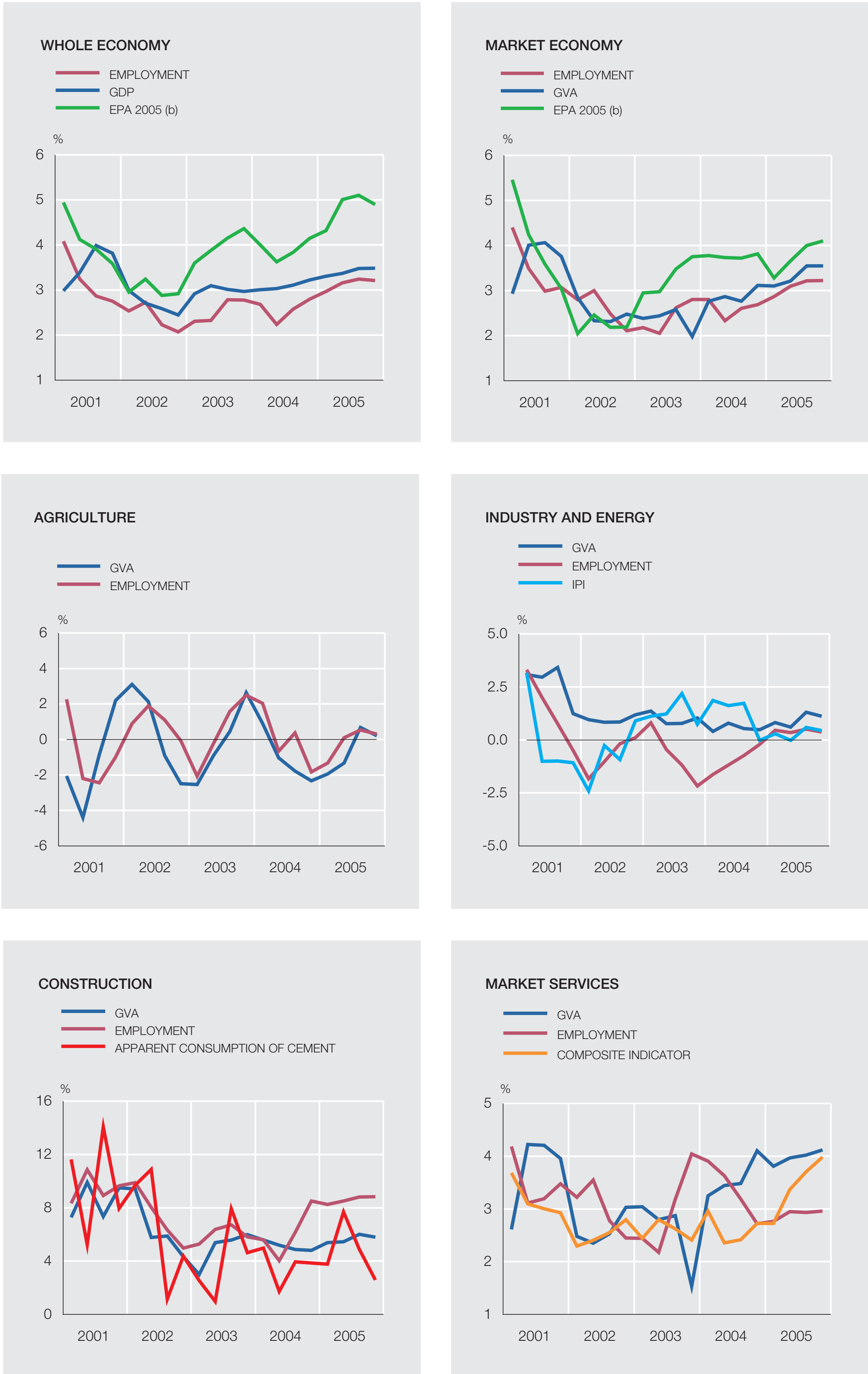
SOURCES: INE, Ministerio de Economía, Ministerio de Hacienda and Banco de España.

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

In Q3 the agricultural and fisheries branches managed to put the recent contractionary phase behind them, despite the considerable cuts in arable production due to scant rainfall. On QNA estimates, these branches posted a positive year-on-year growth rate (0.7%), 2 pp up on Q2. Nonetheless, the behaviour of the employment indicators in Q4 appears to suggest a slight slowdown at the end of the year.

Activity in the industrial and energy branches as a whole quickened in Q3 to a year-on-year growth rate of 1.3%, following the moderation seen in the previous quarter. The sectors driving growth were food consumer goods and intermediate goods, while the pace of capital goods eased off. The conjunctural information available for Q4 does not exhibit the presence of any fresh boost to industrial activity, in the light of the relative sluggishness of exports, the moderation of investment in capital goods and the diminished buoyancy of domestic consumption. In October and November, the overall industrial production index rose by 0.4% year-on-year, 0.3 pp less than in Q3. The indicators of turnover and incoming orders behaved similarly to the industrial production index in these months, as did imports of non-energy intermediate goods, which slowed. However, confidence indicators in the sector improved in Q4, especially in December.

GROSS VALUE ADDED AND EMPLOYMENT BY BRANCH OF ACTIVITY (a) CHART 19



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

a. Year-on-year percentage rates based on seasonally adjusted series except gross series in the EPA. 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.
b. Series linked by the Directorate General Economics, Statistics and Research of the Banco de España based on the control survey carried out using the methodology applied until 2004 Q4.

There was a fresh acceleration in the construction industry in Q3, with the rate of increase rising by 0.6 pp to 6% year-on-year. The long expansionary cycle in this industry thus continued. The lengthy lead times involved in construction ensure that the momentum of activity in this branch will remain buoyant in the coming quarters, although this will be increasingly less according to the information available.

In 2005 Q3 the growth of activity in services was similar to that of the previous quarter, standing at 3.8% on QNA figures. This stability was extensive to all services components, whereby GVA in non-market services grew once again at a rate of 3.2%, while the growth of GVA in market services held at 4%. The information available points to fresh momentum in activity in the market services branch in 2005 Q4. The number of Social Security registrations, the synthetic indicator of services and sales by large corporations, once deflated, quickened in this period. The confidence indicators for the sector and the PMI index also improved in the closing months of 2005. Conversely, turnover, in real terms and adjusted for calendar effects, began the quarter with lower growth. This rise in activity in the final months of the year originated in the hotel and catering trade, where there has been notable buoyancy of Social Security registrations coupled with the sound behaviour of overnight hotel stays by non-residents, and in the real estate and business services branches, where an expansion in the employment indicators has also been seen. Conversely, as in the previous quarter, wholesale and retail trade and transport are the activities contributing least to the growth of the sector as a whole.

On QNA estimates, the growth rate of employment across the economy in 2005 Q3 held at 3.2%, making for an increase in apparent labour productivity of 0.2%, in line with the modest increases seen in the past three years. The latest conjunctural information coincides in reflecting stability in growth for the second half of 2005. Social Security registrations grew at a rate of 2.8% in Q4, once adjusted for regularisation affects, a similar figure to that of Q3. Hiring was strongly dynamic in the final months of 2005, surging by 9.5%, although the growth over the year as a whole was 5%, far below the figure of 11.5% recorded in 2004. Finally, according to the EPA (Labour Force Survey), the growth rate of numbers employed remained high in the final quarter of the year (4.9%), although there was a mild easing in relation to the two previous quarters.

The general tone in Q3 was one of quickening employment in all branches, except in services, and in particular in the non-market branches, where there was a slight slowdown to a year-on-year rate of increase of 3.3%. In market services job creation stabilised at 2.9%. The pick-up in employment in agriculture and industry was confirmed by the year-on-year increase of 0.5% in both sectors. Finally, construction remained the most dynamic branch in terms of job creation, with the related rate of increase rising by 0.3 pp to 8.8%. As a result of the better performance of the market branches, the mildly accelerating profile of employment in the market economy seen in recent quarters continued, standing at 3.2%, which was compatible with an acceleration in apparent labour productivity, which grew by 0.3%. According to the EPA, employment quickened in Q4 in the services branches and remained highly dynamic in construction, though some slowing was observed. In industry, however, employment resumed negative year-on-year rates of change, following several quarters of recovery. Employment in agriculture grew by 2.5%, in line with Q3.

QNA estimates for Q3 once again signalled dependent employment as the most dynamic component, with year-on-year growth of 3.6% (0.2 pp up on Q2), compared with the 0.5 pp slowdown in the numbers of self-employed (0.9%). The EPA data for Q4 paint a similar picture, with high growth in dependent employment (6%) and a 1.5% decline in self-employment, the reflection of which was a 0.2 pp increase in dependent employees as a proportion of total numbers employed to 82%. In the statistics on registrations, the creation of self-employment outgrew that of dependent employment owing to the immigrant regularisation process, since 36% of those regularised to the end of the year belonged to the special domestic employee regime, these workers not being recorded as dependent-employee registrations.

With regard to EPA information on contract duration, the behaviour of temporary employees in 2005 Q4 was once again most dynamic, growing at a year-on-year rate of 11.2%, far outpacing permanent employment (3.4%) and placing the ratio of temporary to total employees at 33.8%, against 32.1% a year earlier. The official figures provided by INEM (the National Employment Office) on contracts, however, show that permanent hires since mid-2005 have grown more than temporary contracts, which has allowed job turnover to stabilise, in relation to the previous year. As to the length of the working day, EPA estimates have been showing very high growth rates for part-time contracts. In Q4, numbers of part-time employees grew by 20.1% year-on-year, a similar increase to that of the previous quarter. The rate of increase in the number of full-time employees slowed slightly to 3.4%. Overall, the proportion of part-time employees rose to 12%, 1.3 pp above the level a year earlier.

The growth rate of the labour force quickened by 0.3 pp in 2005 Q4 to 3.2%, after slowing sharply in Q3. This was due to the increase in the participation rate, which stood at 57.7% in Q4, 0.8 pp above its level a year earlier. Turning to the number of unemployed, the year-on-year rate of decline eased to -11.1%, and the unemployment rate stood at 8.7%, 0.3 pp above its level in Q3, but 1.5 pp down on a year earlier. The number of officially registered unemployed declined by 0.9% in Q4 in relation to the same quarter in 2004, compared with falls of up to 4% in the first half of the year, confirming the moderation in the rate of decline of unemployment.

4.3 Costs and prices

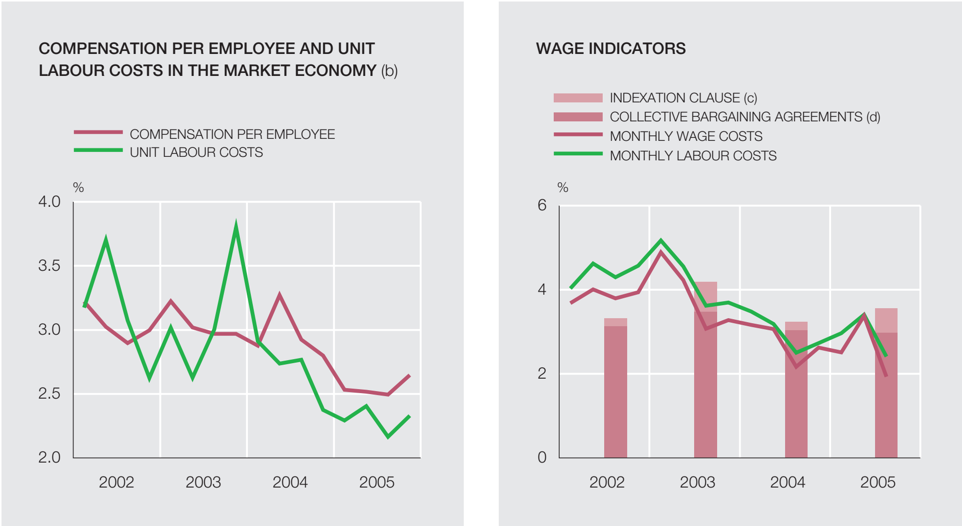
On National Accounts estimates the growth of compensation per employee stabilised in Q3, both in the economy as a whole and in the market economy, at rates of 2.6% and 2.5%, respectively. This slowdown in compensation was seen in all the branches except construction, where there was an acceleration of 0.8 pp, and in non-market services, where it rose marginally. By contrast, the quarterly labour costs survey exhibited a 1 pp slowdown in average monthly labour costs, which posted a year-on-year growth rate of 2.4% in Q3. Some quickening in compensation per employee is expected in 2005 Q4, although for the year as a whole the increase in wages will have been lower than in 2004, both for the whole economy and for the market economy.

In collective bargaining agreements registered to December, the average agreed increase in wage rates was 2.98%, a very similar figure to that in 2004 (3.04%), before including the wage indexation clauses. These agreements affect 8.4 million employees, 70% of whom had revised agreements on data to November. In recent months the thrust of negotiations was concentrated in newly signed agreements, which incorporate higher wage rises than revised agreements (3.14%, against 2.86%, to November), owing to the rise in inflation. As regards the wage indexation clauses, it is estimated that the effect of those signed in 2004 on the wage increase in 2005 was 0.6 pp, 0.4 pp higher than that of the preceding year owing to the greater deviation of inflation in 2004 from the official target (see Chart 20). These clauses are present in up to 76% of the agreements signed between January and November 2005. Since the CPI ended the year with a year-on-year increase of 3.7%, the activation of these clauses is expected to have an even greater impact on wages in 2006 than that estimated in 2005.

Despite the fact that the growth of compensation per employee stabilised in Q3, the increase in labour costs per unit of value added declined slightly to 2.4%, 0.2 pp down on the previous

WAGES AND LABOUR COSTS (a)

CHART 20



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.

quarter, owing to the mild acceleration in value added per employee. Conversely, the value added deflator was slightly more dynamic, growing at a rate of 4.1% compared with 4% the previous period. As a consequence, the ongoing widening of unit margins seen in previous quarters continued. There was likewise a widening of margins in the market economy, against a backdrop of slowing costs similar to that of the whole economy, while the deflator quickened to 4.3%.

Developments were similar to those in the market economy across virtually all the branches of activity, with an acceleration in the value added deflator and a deceleration in unit labour costs. The exception was the construction industry, where the deflator slowed slightly from rates of 10% (see Chart 21). In any event, unit margins widened in all branches of activity. The indicators available for Q4 show a continuation of these patterns of behaviour, with the growth of the deflators far outpacing that of unit labour costs, especially in construction and in market services.

In Q3 the final demand deflator quickened, due in part to the rise in the imports deflator, which had eased in Q2. Meantime, the growth of the GDP deflator rose by 0.1 pp to 4.4%. On the expenditure side, the year-on-year growth rate of the private consumption deflator held at 3.6%, in line with its stability since mid-2004, while the gross fixed capital formation deflator slowed slightly.

The rate of change of the CPI increased by 0.2 pp in 2005 to 3.4%, slightly below the rise in the consumption deflator. The inflation rate in Q4 stood at 3.6%, closing the year with growth of 3.7%. The CPI excluding unprocessed food and energy quickened by 0.3 pp in Q4 to a growth rate of 2.8% (see Chart 22), after posting lower growth in the two previous quarters. Once again, the most inflationary component was energy prices, with average growth of 10.3%, to which the rises in butane gas and in natural gas in October contributed. However, fuel prices decelerated in Q4, reflecting the fall in the average price of oil of five dollars per bar-

PRICES AND COSTS BY BRANCH OF ACTIVITY (a)

CHART 21

SOURCES: INE and Banco de España.

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

rel, following the highs reached in September. Finally, unprocessed food prices quickened by 0.5 pp in Q4 to a year-on-year rate of 4.2%, after having moderated the previous quarter.

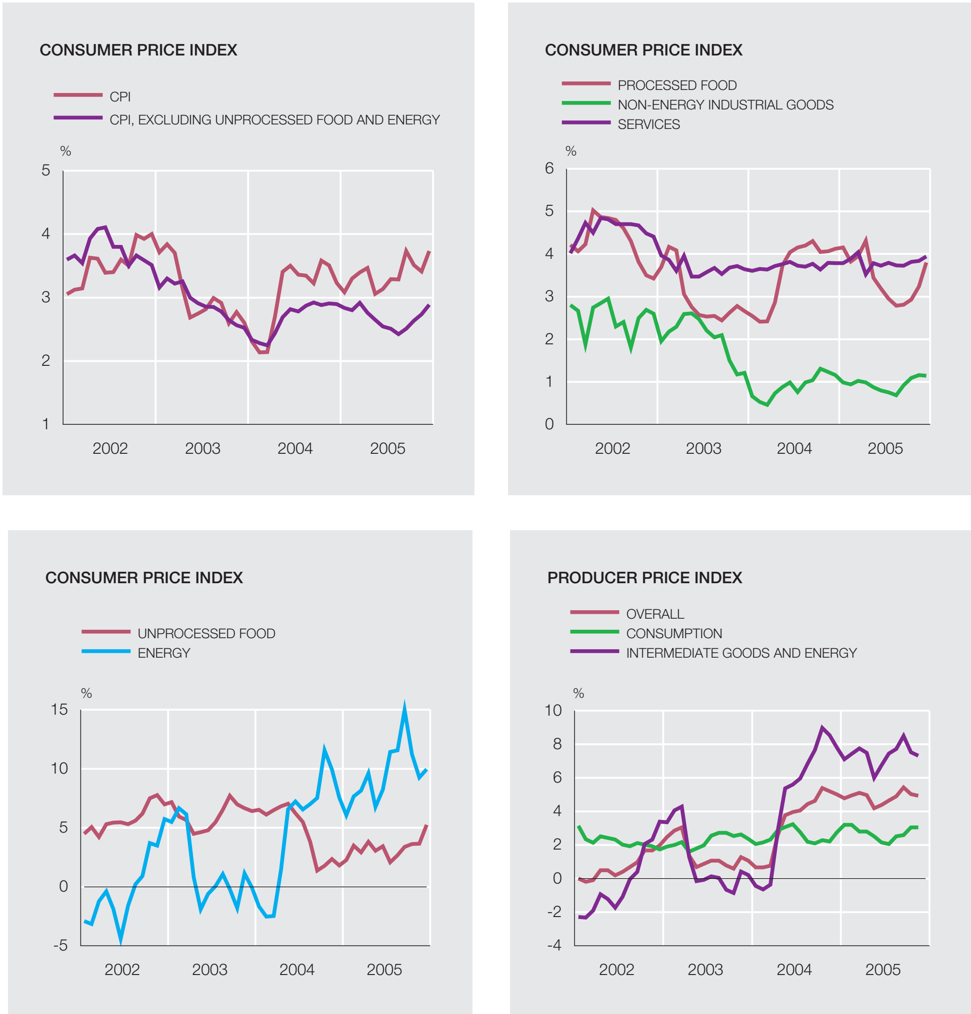
The acceleration in the CPI excluding unprocessed food and energy in Q4 was due to the higher growth of all its components, but especially processed food, which quickened by 0.5 pp to 3.3% owing to dearer cooking oil and tobacco, the latter as a result of higher excise duties. Services prices quickened by 0.2 pp. The most inflationary item here was the prices of certain air transport services, owing to the impact of dearer oil. Lastly, the year-on-year rate of increase of non-energy industrial goods prices increased to 1.1%, since clothing and footwear prices rose at the start of the winter season more than they did the previous year, and car prices resumed an expansionary path.

Inflation in Spain, measured by the HICP, held at 3.5% in Q4, compared with 2.3% in the euro area as a whole, and the differential between both rates widened slightly to 1.2 pp (see Chart 23). Component by component, the differential widened in the case of services, non-energy industrial goods and food, which underwent sharper inflation rate rises in Spain than in the euro area as a whole.

The year-on-year rate of the producer price index rose in December to 5.2%, after having trended steadily in the previous months. Energy production prices resumed their upward path

PRICE INDICATORS (a)
Spain

CHART 22



SOURCE: INE.

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

and posted a year-on-year rate of 15.6%. The producer prices of capital goods held at a moderate rate of 2%, while the producer prices of consumer goods and of intermediate goods grew at a rate of over 3%. Among the remaining price indicators, prices received by farmers moved on a quickening trend as a result of the rises in prices in source markets related to worse crop yields. Lastly, hotel prices moderated following the rise in the summer months.

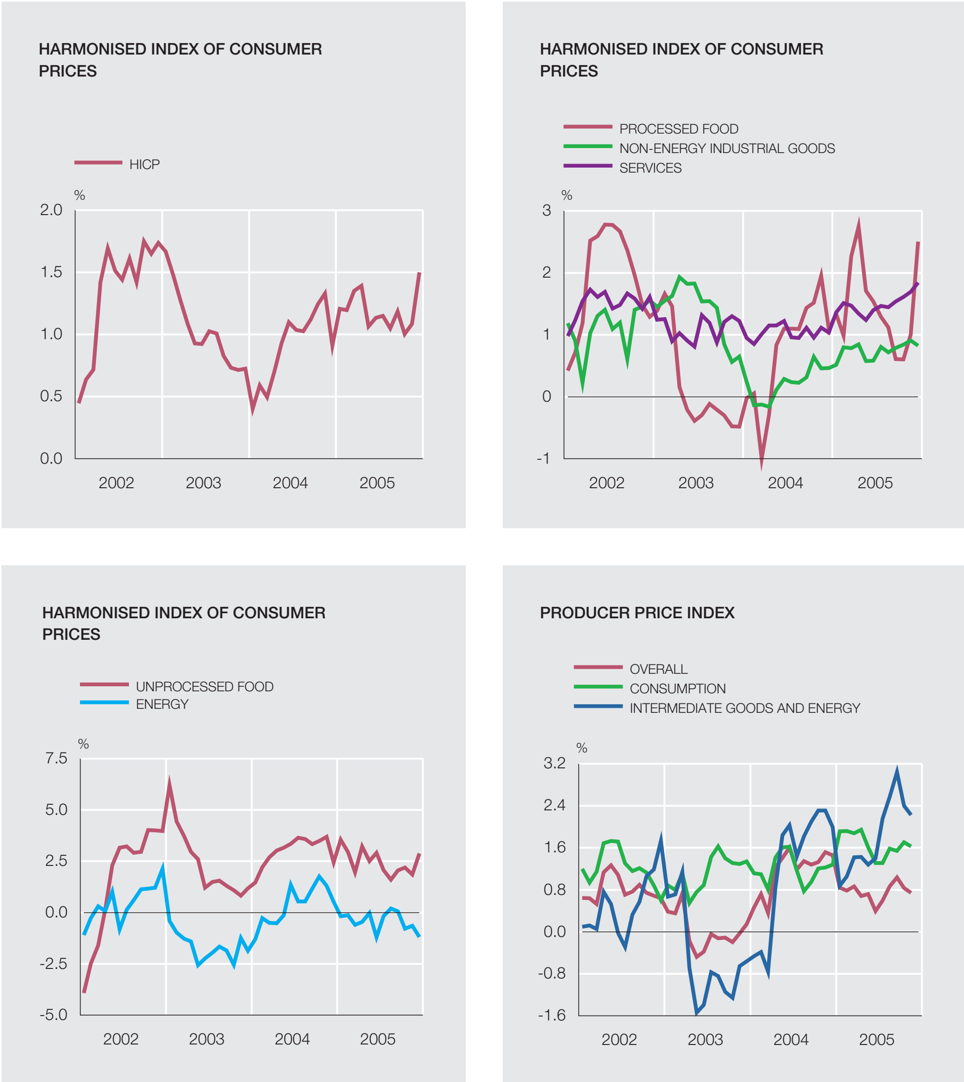
4.4 The State budget

In late December 2005 the government presented the seventh Updated Stability Programme, with macroeconomic and fiscal estimates and projections for the period 2005-2008, and using the new Spanish National Accounts 2000 base. The Programme revised estimated real GDP growth for 2005 slightly upwards (to 3.4%), but for 2006 it has retained the forecast that appeared in the growth scenario which acted as a basis for drawing up the 2006 State budget (3.3%). Moreover, the balances of the public finances accounts have been substantially revised. Thus, a general government surplus of 1% of GDP is augured for 2005, which will decline by 0.1 pp in 2006 to 0.9% of GDP. In the following years, against a background of moderately slowing activity, a slight reduction is forecast in the general government surplus to 0.6% of GDP in 2008. Across the different sub-sectors, the surplus for 2005 is essentially determined by the Social Security component, for which a surplus of 0.9% of GDP is expected,

PRICE INDICATORS

Differentials vis-à-vis the euro area (a)

CHART 23



SOURCES: Eurostat and Banco de España.

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

while there will be a central government surplus of 0.1% of GDP and the local and regional government accounts will end the year in balance. The small reduction in the overall surplus projected for 2006 is due to the deficit of 0.1% of GDP envisaged for the regional government sub-sector. In general, the estimates and projections of the Programme confirm that surplus takings on the expected figures are being earmarked to improving the general government fiscal position which, in keeping with the principle of budgetary stability, contributes to amplifying the stabilising potential of fiscal policy over the course of the cycle.

Following National Accounts methodology and on the information available to November 2004, the State ran a surplus of 1.6% of GDP, far above the surplus of 0.2% of GDP obtained a year earlier (see Table 3). This result is compatible with the Programme's estimate for the central government balance, referred to in the previous paragraph. It should be borne in mind that the State balance is subject to high seasonality, December being a month in which a deficit is clearly run. Accordingly, the surplus obtained in the eleven months to November will foreseeably fall significantly.

STATE BUDGET OUTTURN TABLE 3

EUR m and %

	Outturn 2004	Percentage change 2004/2003	Outturn projection 2005	Percentage change 2005/2004	Outturn JAN-SEP Percentage change 2005/2004	Outturn 2004 JAN-NOV	Outturn 2005 JAN-NOV	Outturn Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	114,950	4.8	122,166	6.3	15.7	105,985	119,770	13.0
Direct taxes	58,692	3.9	65,933	12.3	22.2	53,783	64,940	20.7
Personal income tax	30,412	-7.3	34,951	14.9	21.2	28,236	34,115	20.8
Corporate income tax	26,025	18.8	28,793	10.6	26.7	23,350	28,808	23.4
Other (a)	2,255	27.1	2,189	-2.9	-3.3	2,197	2,017	-8.2
Indirect taxes	41,368	5.8	43,100	4.2	12.0	40,202	43,159	7.4
VAT	29,124	7.3	30,158	3.6	15.7	29,021	31,566	8.8
Excise duties	9,751	-0.4	10,175	4.3	0.9	8,896	9,020	1.4
Other (b)	2,493	15.0	2,767	11.0	13.2	2,284	2,574	12.7
Other net revenue	14,890	5.9	13,133	-11.8	0.9	12,000	11,671	-2.7
2 EXPENDITURE	114,891	1.0	122,386	6.5	7.8	102,762	108,561	5.6
Wages and salaries	19,488	5.6	20,677	6.1	6.8	16,865	17,969	6.5
Goods and services	3,510	17.1	3,419	-2.6	-6.7	2,930	2,754	-6.0
Interest payments	16,751	-15.3	18,291	9.2	12.7	16,335	17,569	7.5
Current transfers	61,136	5.3	64,002	4.7	6.9	55,288	56,971	3.0
Contingency fund	…	…	…	…	…	…	…	…
Investment	7,104	-5.7	8,776	23.5	15.6	5,737	7,117	24.1
Capital transfers	6,901	-0.6	7,221	4.6	4.3	5,606	6,182	10.3
3 CASH-BASIS BALANCE (3 = 1 – 2)	59	…	-220	…	…	3,223	11,209	…
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Resources	113,330	4.9	120,856	6.6	14.2	104,316	117,536	12.7
Uses	122,652	11.3	123,929	1.0	4.6	102,542	102,665	0.1
NET LENDING (+) OR BORROWING (–)								
	-9,322	…	-3,073	…	…	1,774	14,871	12.6
(as a percentage of GDP)	-1.1	…	-0.3	…	…	0.2	1.6	…

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.

Following the cash-basis convention, the State posted a surplus of €11,209 million to November, up from €3,223 million a year earlier. The discrepancies between the National Accounts and cash-basis balances are mainly due, as is habitual, to adjustments for the different interest allocation criteria and for the change in outstanding rights and obligations.

Also in cash-basis terms, State revenue far outgrew the initially projected outturn, while expenditure grew somewhat more moderately than projected. The higher revenue was due, above all, to indirect taxes, while there was a certain contraction in current transfers on the expenditure side.

In the case of revenue, information is available on total takings from the main taxes levied, in respect both of the portions assigned to the State and to the ordinary-regime regional governments, although Table 3 details only the State figures. According to total takings, revenue slowed slightly in the closing months of the year (albeit maintaining a high growth rate), with the exception of ex-

BALANCE OF PAYMENTS: SUMMARY TABLE (a) TABLE 4

EUR m

		JANUARY-OCTOBER	
		2004	2005
CREDITS	Current account	212,679	224,020
	Goods	121,668	126,308
	Services	58,092	62,008
	Tourism	31,965	33,032
	Other services	26,126	28,977
	Income	19,912	22,227
	Current transfers	13,007	13,477
	Capital account	7,153	6,630
	Current + capital accounts	219,832	230,650
DEBITS	Current account	246,044	278,130
	Goods	164,088	183,176
	Services	38,124	42,982
	Tourism	8,072	10,133
	Other services	30,052	32,849
	Income	31,086	37,724
	Current transfers	12,746	14,248
	Capital account	699	619
	Current + capital accounts	246,743	278,749
BALANCES	Current account	-33,365	-54,110
	Goods	-42,419	-56,867
	Services	19,967	19,026
	Tourism	23,893	22,899
	Other services	-3,926	-3,873
	Income	-11,174	-15,497
	Current transfers	261	-772
	Capital account	6,454	6,011
	Current + capital accounts	-26,911	-48,099

SOURCE: Banco de España.

a. Provisional data.

cise duties, as the tax rates on some of these had risen in September. Personal income tax held at a growth rate of over 16%, upheld by the withholdings on gains in mutual funds and by the strong increase in withholdings on income from work, derived from developments in the labour market. However, it should be stressed that a portion of the growth of these withholdings is due to the timing of revenue from certain tiers of government. Corporate income tax[2] slowed slightly following the October prepayment, but it continues to reflect the sound course of corporate earnings with growth exceeding 23% being recorded. Turning to indirect taxes, VAT continued decelerating in the final months to a level of 11.3%, while the growth rate of excise duties rose slightly to 3.4%, still below the projected outturn for the year as a whole. Finally, other revenue slowed in the closing months of the year and remains very sluggish owing to lower revenue relating to government debt premiums, Banco de España profits and transfers of funds from the European Union.

On the State expenditure side, wages and salaries and capital charges grew above the initially projected outturn, while other current expenditure grew less than estimated for the year

2. This tax is not affected by the transfer of revenue to the territorial governments.

as a whole. In particular, there were significant slowdowns in these months in interest payments and in current transfers, due in this latter case to the one-off event in October 2004 involving the cancellation of the Andalusian regional government's outstanding debt. As regards capital expenditure, the growth rate of real investment (due to the RENFE effect[3]) and the strong acceleration in transfers were both notable.

Box 6 outlines the main aspects of the Social Security budgetary outturn to October.

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

In the first ten months of 2005, the overall balance on the current and capital account resulted in a deficit of €48,099 million, 79% up on a year earlier. This was due to the notable widening of the current account deficit (62%) to €54,110 million and, to a lesser extent, to the slight decline in the surplus on capital transactions (–7%), which stood at €6,011 million. Among the main current account items, there was a notable deterioration in the trade deficit, although the negative balance on income also widened, the surplus on tourism diminished and the balance on current transfers turned negative. Conversely, the deficit on non-tourist services improved slightly.

In the period January-October 2005, the deficit on the trade balance widened by €14,448 million in relation to the level attained in the same period a year earlier, rising to a figure of €56,867 million. In year-on-year terms, the deficit widened by 34%, prolonging the deteriorating course characterising it the previous year. This significant widening in the trade deficit is due to the slackness shown by real export flows in this period, as opposed to the robustness of imports, along with the strong rise in the energy bill. Nonetheless, the pace at which the trade deficit is widening slowed from Q2 this year, as a result of the slight pick-up in exports in this period and a certain loss of steam in imports.

Turning to the services balance, the surplus recorded in the first 10 months of 2005 stood at €19,026 million, €941 million below the figure recorded in the same period a year earlier. This deterioration is due to the €994 million decline (–4.2%) in the tourism surplus, since there was a slight correction in the non-tourist services deficit, to €53 million. Tourist revenue ran at a moderately positive rate to October of 3.3%, in line with the momentum that some of the main real tourism indicators have been gathering. Tourist expenditure, for its part, rose by 25.5% in the ten months to October, extending the substantial buoyancy of the previous year.

The deficit on the income balance stood at €15,497 million in the first ten months of 2005, entailing a deterioration of €4,323 million in relation to the level observed in the same period in 2004. Revenue moved on a rising path (11.6%), with financial-sector revenue proving buoyant, although expenditure underwent a far higher increase of 21.4% owing to the higher growth of payments by all sectors, especially monetary financial institutions. Foreign direct investment flows in Spain picked up slightly in this period, although non-resident investment in property, which account for more than 45% of direct inflows in the period, continued to decline while portfolio investment and other investment from abroad grew notably. As regards Spanish investment flows abroad, direct investment fell off slightly, while portfolio investment grew very sharply.

There was a deficit on the balance of current transfers of €772 million in the January-October period, in contrast to the surplus of 261 million recorded in the same period in 2004. Revenue

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3. Note that a strong increase in this expenditure was budgeted owing to the expenses associated with the conventional railway network, the responsibility for which fell to the State as from January 2005. This operation is linked to the railway system restructuring process, which was carried out through the assumption of RENFE debt by the State in 2004. This operation had no effect on the cash-basis balance in 2004.

The Social Security system posted a surplus of €13,137 million in the ten months to end-October 2005, €1,297 million (11%) up on the same period a year earlier, which signifies a more favourable outturn than in the period to July (see accompanying table). The slight acceleration in revenue and the mild slowdown in expenditure in recent months, to growth rates of 7.6% and 7%, respectively, account for the improvement in the balance.

Receipts from Social Security contributions have been growing at a rate of around 7.3% in recent months, despite the rise in the number of Social Security registrations. But it is not possible to say whether the slight acceleration seen in the period to October (see accompanying table) will continue in the coming months. Specifically, the growth rate of the number of registrations has risen to 4.4% to December, compared with growth of 3.6% to July, partly as a result of the immigrant worker regularisation process. If the 465,000 new registrations to December as a result of this process are discounted, growth in the number of registrations in 2005 as a whole would have held at around 2.9%, in line with the rate recorded the previous year. Also notable is the strong growth of interest received, included under the heading of other revenue, owing to returns on assets in the Reserve Fund.

Turning to expenditure, that earmarked for contributory pensions quickened very slightly and increased by 7% to October, in line with the budgeted figure but somewhat below that for the year 2004 as a whole (7.2%). The number of contributory pensions increased from the summer, reaching a growth rate of 1.3% to December, compared with a rate of increase of 0.8% in July, this being partly due to the effect of the former Elderly and Disability Insurance pensions being recognised as compatible with widowhood pensions[1]. As these pensioners receive low pensions, the effect on the growth of expenditure has been limited. Spending on sickness benefits continued to grow at a high rate of 10.3% to October, far above the budgeted figure.

As regards the State Employment Public Service, the information on which is not included in the accompanying table, contributions received held at a rate of 8.2% to August, above the initially budgeted figure. Rebates on contributions in respect of employment-promoting contracts, meanwhile, increased by 13.7% in the same period, set against the virtually zero growth budgeted. Expenditure on unemployment benefits held steady at a growth rate of 7% to October, compared with the increase of 9.2% in 2004 as a whole. This lower growth compared with the previous year came about as a result of the change in the number of beneficiaries, which grew by 2.9% to September, compared with average growth of 5.6% in 2004. This was in turn due to a decline in registered unemployment (of around 1.2% in recent months, compared with 1.6% growth in 2004 as a whole) and to a rise in the eligibility ratio, which stood at 60.2% in September 2005 compared with 58.1% in 2004.

1. Law 9/2005 of 6 June 2005.

SOCIAL SECURITY SYSTEM (a)
Transfers to regional governments allocated (b)
Current and capital transactions, in terms of recognised entitlements and obligations

EUR m and %	Outturn	Budget		Outturn JAN-JUL	Outturn JAN-OCT		
	2004	2005	% change h	% change	2004	2005	% change
	1	2	3=2/1	4	5	6	7=6/5
1 REVENUE	88,571	90,040	1.7	7.2	73,021	78,571	7.6
1.1 Social security contributions (c)	82,675	83,915	1.5	7.3	68,322	73,352	7.4
1.2 Current transfers	4,618	4,874	5.5	0.2	3,989	4,057	1.7
Other (d)	1,278	1,251	-2.1	48.2	710	1,162	63.5
2 EXPENDITURE	79,105	84,100	6.3	7.3	61,181	65,434	7.0
2.1 Wages and salaries	1,909	1,998	4.7	10.6	1,505	1,641	9.0
2.2 Goods and services	1,556	1,566	0.6	9.2	1,109	1,192	7.5
2.3 Current transfers	75,226	80,060	6.4	7.3	58,369	62,464	7.0
Benefits	75,225	80,059	6.4	7.3	58,369	62,463	7.0
Contributory pensions	64,453	68,905	6.9	6.7	49,876	53,343	7.0
Sickness	5,830	5,925	1.6	13.5	4,468	4,928	10.3
Other	4,942	5,229	5.8	8.9	4,025	4,191	4.1
Other current transfers	1	1	-3.1	—	0	1	--
2.4 Other (e)	414	476	15.0	-31.1	198	138	-30.5
3 BALANCE	9,466	5,940	-37.2	6.7	11,840	13,137	11.0

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

a. Only data relating to the system, not to the entire Social Security Funds sector are given. This is because the figures for other Social Security funds are not available.
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.

increased by scarcely 3.6% despite the favourable trend of flows from the EU under the EAGGF-Guarantee heading. However, Community transfers to the European Social Fund fell off. Expenditure grew at a higher rate (11.8%) due, in part, to the notable increase in expenditure earmarked for Community coffers under the additional resource (GNP) and VAT resource headings, and also to the continuing robustness of emigrants' remittance payments (9.6%), although the strong increase seen the previous year (20%) has slowed.

Finally, the surplus on capital account was €6,011 million in the first ten months of 2005, €443 million down on the same period a year earlier. This deterioration is due to the notable fall-off in Community transfers under the Cohesion Fund and the ERDF, while structural funds relating to the EAGGF-Guidance fund trended favourably.

5 Financial developments

5.1 Overview

Financing conditions for Spanish households and firms continued to be generous in 2005 Q4, although less so than at the end of the summer. From October onwards there was a progressive rise in market interest rates, which was more pronounced in the shorter maturities, reflecting expectations of a rise in the euro area's official interest rates, as finally happened in early December. Thus in December 2005, one-year EURIBOR stood at an average of 2.78%, up 54 basis points (bp) on the September figure, while in the same period the 10-year Spanish bond yield rose by 31 bp to 3.4%. These debt market developments, along with the slight rise in the risk premiums of Spanish firms, raised the cost of issuing fixed-income securities for these companies, although it remained at moderate levels (see Chart 24). The most recent information on the cost of bank financing to firms and households, which relates to November, only partially reflects the impact of the changes that have taken place in the markets.

After the summer upturn in the Spanish stock market, prices followed a markedly downward trend in October. However, the ensuing months saw a certain recovery. At end-December, the Madrid Stock Market General Index stood slightly below the end-September levels, in contrast to the appreciation recorded by the main international stock markets in the same period. After these movements, the Spanish index showed a cumulative gain of 20.6% in the year as a whole, similar to that of the euro area's broad Euro Stoxx (23%) and much higher than that of the United States' S&P 500 (3%).

The latest real estate market data published by the Ministry of Housing, which relate to Q4, confirm the decelerating pattern of the preceding months in the price of real estate assets. Specifically, the year-on-year rate of expansion of appraised unsubsidised house prices was 12.8% [0.6 percentage point (pp) less than in September and 4.4 pp less than at end-2004]. These figures seem to support the expectation of a gradual and orderly absorption of the current overpricing of real estate assets.

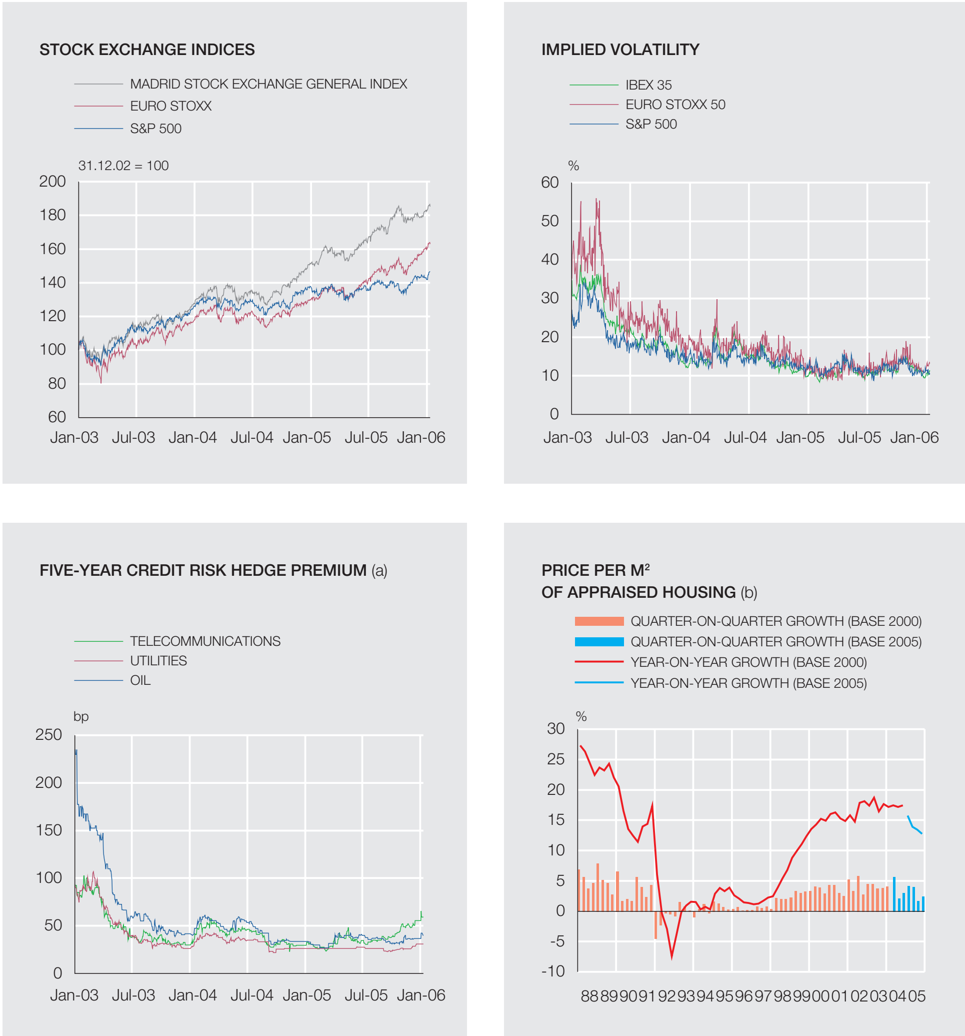
Against this backdrop, the volume of financing to households again grew briskly in Q3 at nearly 21% year-on-year, while the funds extended to corporations continued to accelerate and their rate of expansion in the same period stood at around 18%[4]. The provisional information available for the last few months of the year points to the persistence of these trends. The vigorous accumulation of liabilities by households and firms was reflected in the growth of private sector net borrowing, which could not be offset by the positive performance of the general government surplus. As a result, the debit balance of the nation's financial transactions stood, in cumulative twelve-month terms, at 6.2% of GDP, 0.2 pp more than in June (see Table 5). The bulk of the external deficit continued to be financed through the acquisition by non-residents of fixed-income assets issued by resident financial institutions. Accordingly, Spanish institutions again increased their recourse to the saving of the rest of the world in order to finance the rise in domestic credit.

The expansion of household liabilities continued to be led by lending for house purchase, which between July and September grew at year-on-year rates exceeding 24%. The buoyancy of debt meant that the indicators of financial pressure on the sector deteriorated fur-

4. Box 7 describes the behaviour in recent years of bank financing to the private sector, with a breakdown at provincial level.

PRICE INDICATORS FOR VARIOUS ASSETS

CHART 24



SOURCES: Bloomberg, Credit Trade, Ministerio de Vivienda and Banco de España.

a. Average asset-weighted premia. On 22.6.03 a change in the contractual condition of European firms came into force. The new contract carries lower premia (around 10%).
b. New statistic from 2004.

ther in this period, a trend which, according to the provisional information available for the last half of the year, has continued in the ensuing months. Thus both debt and debt burden again increased with respect to gross disposable income (GDI), while saving after debt service decreased. Also, household net lending became more negative and in 2005 Q3 amounted to -0.9% of GDP in cumulative twelve-month terms (see Table 5). The property prices published by the Ministry of Housing and the stock market prices indicate that household net wealth relative to GDP does not seem to have changed greatly from the June levels.

In the case of non-financial corporations, the debt/gross disposable income (GDI) and debt burden/GDI ratios also followed an upward course between July and September, which seems to have persisted during the last part of the year. Also, in accordance with the Financial Accounts, the debit balance of the sector's financial transactions increased further in Q3 and, in cumulative twelve-month terms, amounted to 7.1% of GDP, against 6.7% in June. In contrast, the information provided by the corporations reporting to the Central Balance Sheet Data Office quarterly survey (CBQ) shows a favourable economic perform-

Spanish household and corporate debt has grown notably in recent years, driven by the prolonged economic upturn and the generous financing conditions. Specifically, in the period 1995-2005, the credit extended by deposit institutions to households and firms has grown at an average annual rate of nearly 15%. This is substantially higher than the nominal expansion of GDP and has naturally raised the debt ratio of the sector, which now exceeds 100% of GDP, whereas in the middle of the past decade it had not reached 60%.

That said, from the standpoint of macroeconomic and financial stability, it is important to know, as a statistic complementing the aggregate figures of the sector as a whole, the distribution of debt among the agents. With this purpose in mind, this Box explores the behaviour of credit at provincial level. The information used comes from the data sent to the Banco de España by deposit institutions (banks, savings banks and credit co-operatives) on loans extended to the private sector of the economy, mainly households and non-financial corporations. It should be noted that the assignment criteria used for this variable may introduce some errors, which probably affect more its levels than the changes therein[1].

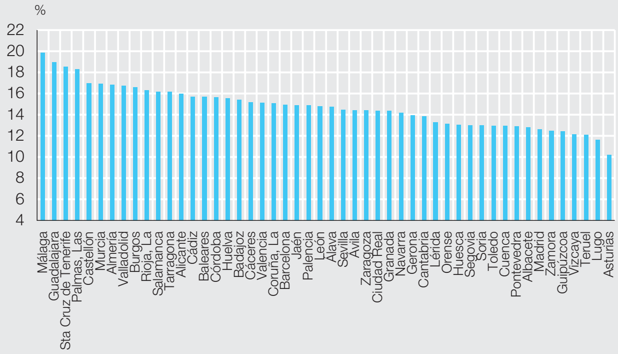
As shown in Chart 1, between 1995 and 2004 household and corporate debt to deposit institutions expanded rapidly in all Spanish provinces. However, it has not grown evenly and the average annual rates vary widely, ranging from 10% to 20%. Thus Málaga and Guadalajara showed the greatest buoyancy, with average growth of more than 19%, as compared with Lugo and Asturias, where, in annual terms, it was less than 12%.

This relatively high dispersion reflects the distinct economic realities that influence the financing decisions of the agents in each geographical area. In this regard, Chart 2 shows a positive correlation between average credit growth and house prices, illustrating how real estate market developments have been one of the conditioning factors of private-sector debt, both that of households, via funds for house purchase, and that of firms, via loans for real estate activities and construction.

Hence, although the strong growth of private-sector debt in the Spanish economy extends to all geographical areas, it has been accompanied by specific developments derived from the economic situation of some regions. The behaviour of the real estate market may be an important conditioning factor in this respect.

1. The loan classification criteria used by institutions in reporting information establish that balances are assigned to the province of the place in which the funds are invested, if identifiable and known, or, if not, to the province of the place of payment or extension. The application of this latter criterion may cause some distortions in the calculation of provincial debt ratios. Thus provinces in which banks' central services or non-financial corporations' registered offices are located may be assigned higher amounts of credit than were actually invested in those geographical areas.

1 BANK CREDIT TO OTHER RESIDENT SECTORS. PROVINCIAL DATA
(Average annual growth rates in the period December 1995-December 2004)



2 PROVINCIAL ANALYSIS OF BANK CREDIT AND OF HOUSE PRICES
(Average annual growth rates in the period December 1995-December 2004)

SOURCES: Ministerio de Vivienda and Banco de España.

NET FINANCIAL TRANSACTIONS
Cumulative four-quarter data

TABLE 5

% GDP (a)	2000	2001	2002	2003	2004		2005		
					Q3	Q4	Q1	Q2	Q3
National economy	-3.2	-3.4	-2.6	-3.0	-4.2	-4.8	-5.5	-6.0	-6.2
Non-financial corporations and households and NPISHs	-3.1	-4.3	-3.7	-4.2	-5.7	-5.4	-6.4	-7.1	-8.0
Non-financial corporations	-4.5	-5.4	-4.4	-4.4	-5.5	-4.7	-5.4	-6.7	-7.1
Households and NPISHs	1.4	1.1	0.7	0.1	-0.2	-0.6	-1.0	-0.4	-0.9
Financial institutions	0.8	1.4	1.4	1.3	1.2	0.7	0.6	0.6	0.6
General government	-0.9	-0.5	-0.3	0.0	0.2	-0.2	0.3	0.5	1.2
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (b)	-14.4	-8.9	-8.7	-8.5	-8.8	-7.3	-8.8	-9.8	-10.3

SOURCE: Banco de España.

a. Spanish National Accounts, base 2000 (CNE-2000)
b. Financial resources that cover the gap between expanded gross capital formation (real and permanent financial investment) and gross saving.

ance in that same period, which, however, was insufficient to prevent a certain rise in the synthetic indicators of financial pressure on investment and on employment, although these still stand at low values.

Overall, although financial conditions are still favourable for sustained household spending, the fresh deterioration of the financial pressure indicators has further raised the medium-term risk for consumption and residential investment signalled in previous reports. Conversely, the mild slowdown in house prices mitigates the risk associated with a possible sharp price correction.

In the case of corporations, although their financial position continues not to pose a significant obstacle for corporate spending and recruitment decisions, the rise in interest rates, against a background of rapid expansion of debt, has slightly raised the level of financial pressure on the sector.

5.2 Households

According to the information available on Q4, the financing conditions of households continued to be generous during that period. Thus in November the interest rates applied to new house and consumer credit transactions stood at 3.4% and 6.1%, respectively (the former were up by 7 bp, while the latter fell by 15 bp with respect to September). The latest available Bank Lending Survey shows that the terms of credit remained unchanged for house purchase loans and were slightly easier for consumer credit.

Households continued to take advantage of the generous financing conditions to raise their levels of debt. As a result, in September its year-on-year rate of growth of nearly 21% was slightly higher than the June figure. House purchase credit was again the most expansionary component. Its rate of expansion in the same period was nearly 25%, which represents a flow equal to 9.9% of GDP in cumulative twelve-month terms, 0.4 pp more than in June. Funds for consumer and other purposes grew more moderately, although significantly, with a year-on-year rate of change of around 11%. Provisional information to November on financing extended to the sector shows a continuation of the patterns seen in Q3.

TRANSACTIONS OF HOUSEHOLDS, NPISHs AND NON-FINANCIAL CORPORATIONS
Cumulative four-quarter data

TABLE 6

% GDP (a)	2002	2003	2004	2005		
				Q1	Q2	Q3
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	8.3	9.2	9.9	9.6	10.0	10.3
Cash and cash equivalents	3.5	4.1	4.0	4.2	4.3	4.2
Other deposits and fixed-income securities (b)	1.8	-0.1	2.0	1.7	2.4	2.1
Shares and other equity (c)	0.6	0.6	0.0	-0.1	-0.3	-0.2
Mutual funds	0.2	2.3	1.5	1.3	1.4	1.8
FIAMM	0.7	0.6	-0.2	-0.1	0.0	0.2
FIM	-0.5	1.7	1.6	1.2	1.3	1.4
Insurance technical reserves	2.5	1.8	1.7	1.8	2.0	2.0
Of which:						
Life assurance	1.4	0.7	0.6	0.7	0.7	0.7
Retirement	0.9	0.9	0.9	0.9	1.2	1.2
Other	-0.3	0.5	0.6	0.6	0.1	0.5
Financial transactions (liabilities)	7.7	9.0	10.5	10.6	10.4	11.3
Credit from resident financial institutions (d)	7.2	9.2	10.8	11.0	11.4	11.9
House purchase credit (d)	5.1	7.0	8.7	9.2	9.5	9.9
Consumer and other credit (d)	2.1	2.2	2.0	1.8	1.9	1.9
Other	0.5	-0.1	-0.3	-0.4	-1.1	-0.7
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	14.4	16.2	14.0	16.1	17.1	18.9
Cash and cash equivalents	1.6	0.9	1.0	1.1	1.1	1.2
Other deposits and fixed-income securities (b)	1.5	1.4	0.8	0.9	1.3	1.4
Shares and other equity	6.6	7.5	4.3	4.9	4.4	5.3
Of which:						
Vis-à-vis the rest of the world	4.6	4.5	2.6	3.4	3.1	3.2
Other	4.7	6.5	7.9	9.2	10.3	11.1
Financial transactions (liabilities)	18.8	20.6	18.7	21.5	23.8	26.0
Credit from resident financial institutions (d)	5.4	6.4	8.6	9.7	10.8	11.7
Foreign loans	2.7	2.7	0.5	0.9	0.8	1.1
Fixed-income securities (b)	-0.4	-0.2	0.0	0.0	0.0	-0.1
Shares and other equity	5.9	5.2	2.7	2.7	2.4	2.5
Other	5.1	6.5	6.9	8.3	9.8	10.8
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	14.0	15.9	16.1	17.3	18.0	19.2
Households and NPISHs	16.2	19.0	20.1	20.1	20.0	20.6
Non-financial corporations	12.4	13.5	12.9	15.0	16.4	18.1

SOURCE: Banco de España.

a. Spanish National Accounts, base 2000 (CNE-2000).
b. Not including unpaid accrued interest, which is included under "other".
c. Excluding mutual funds.
d. Including off-balance-sheet securitised credit.
e. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation vehicles.

As regards households' portfolio decisions, in September the volume of financial asset purchases equalled 10.3% of GDP in cumulative twelve-month terms, up 0.3 pp on Q2 (see Table 6). However, this increase was uneven and differed from one product to another. Thus transactions involving the more liquid, lower-risk instruments (cash and deposits) decreased to 6.3% of GDP. By contrast, purchases of mutual fund shares rose by 0.4 pp with respect to GDP to stand at 1.8%. Finally, the net divestment of shares continued, this time by an amount equal to 0.2% of GDP, while the amounts held in the form

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 25

SOURCE: Banco de España.

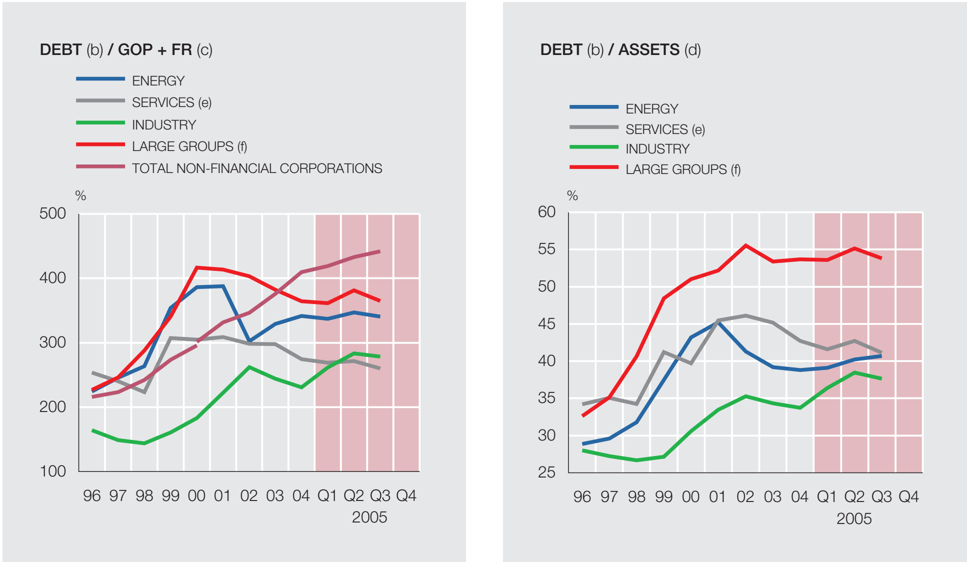
a. Until 2000, the sectoral National Accounts data correspond to the CNE with base 1995. Between 2000 and 2004 they are drawn from the CNE-2000. In 2005, a provisional estimate consistent with the CNE-2000 is used.
b. Includes bank credit and securitisation.
c. Assets 1 = Total financial assets – "other".
d. Assets 2 = Assets 1 – shares – shares in FIM.
e. 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.
f. Spanish National Accounts, base 2000 (CNE-2000).
g. Estimated interest payments plus debt repayments.
h. Balance of households' use of disposable income account.
i. Gross saving less estimated debt repayments.

of technical insurance reserves remained at similar levels to those of mid-2005 (2% of GDP).

As a result of the movements in financial asset and liability flows, the sector's net lending according to the Q3 Financial Accounts again decreased and, in cumulative twelve-month terms, amounted to -0.9% of GDP, against -0.4% in June 2005.

The buoyancy of lending resulted in fresh rises in household debt and in the associated debt burden, the values of which, measured in terms of GDI, stood at nearly 110% and at above 14%, respectively, in September (see Chart 25). The estimated fresh decrease in gross saving in this period, along with the higher payments on the liabilities assumed, made for an additional decline in saving after debt service. Nevertheless, the Spanish family expenditure survey for Q3 does not show significant changes in the percentage of households able to save or having difficulty in making ends meet.

DEBT RATIOS OF NON-FINANCIAL CORPORATIONS (a) CHART 26



SOURCE: Banco de España.

a. Indicators calculated drawing on the CBSO annual and quarterly surveys (CBA and CBQ), except the series «total non-financial corporations», which was obtained from the National Accounts (CNE and FASE). Until 2000, the income of the sector correspond to the CNE with base 1995. In 2005. Between 2000 and 2004 they are drawn from the CNE-2000. In 2005 a privisional estimate consistent with the CNE-2000 was used.
b. Interest-bearing borrowed funds.
c. Gross operating profit plus financial revenue.
d. Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
e. Excluding holding companies.
f. Aggregate of all the firms belonging to Endesa, Iberdrola, Repsol and Telefónica groups. Adjusted for intra-group financing to avoid double counting.

In September, the sector's net wealth with respect to GDP probably held similar to that in June, given the moderate quarter-on-quarter growth of real estate asset prices made public by the Ministry of Housing.

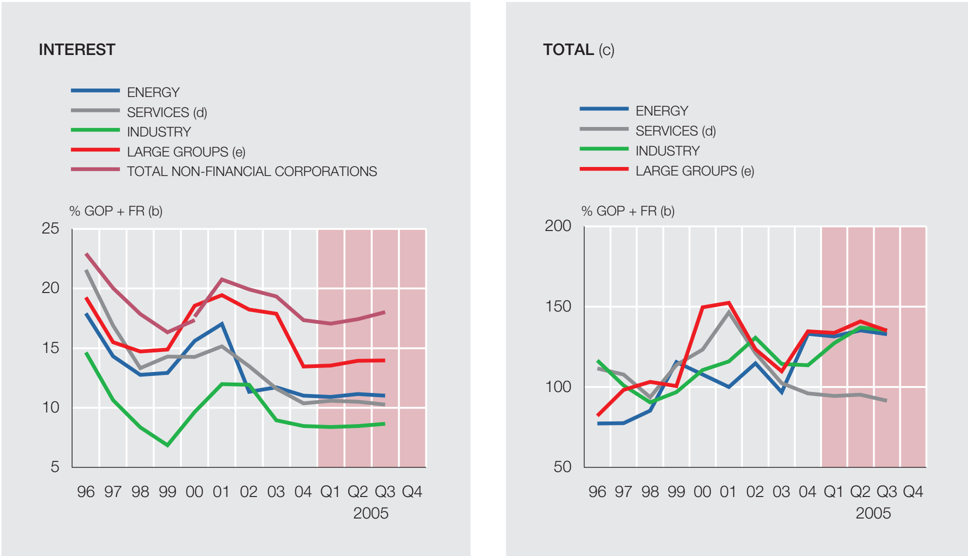
5.3 Non-financial corporations

The financing conditions of corporations also remained easy in Q4, although less so than in the preceding months. The interest rates applied by credit institutions to new loans in November were scarcely higher than those in September and held at low levels (between 3.2% and 3.9%, depending on the volume of the transaction). According to the Bank Lending Survey, financial institutions expected the lending terms offered by them to hold unchanged in that period. Also, the increase in public debt yields and the slight rise in risk premiums made financing via fixed-income securities somewhat more costly. Lastly, the conditions for raising funds on equity markets did not change significantly.

Against this backdrop, corporations' liabilities-side transactions again expanded and in September reached a volume equal to 26% of GDP in cumulative twelve-month terms, up 2.2 pp on June (see Table 6). These funds were again mostly in the form of borrowings, particularly credit from resident financial institutions, which accounted for a flow equal to 11.7% of GDP, while new loans from foreign lenders rose to 1.1% of GDP. Funds raised in the form of shares and other equity increased slightly by 0.1 pp to 2.5% of GDP.

The sectoral breakdown of bank financing shows that the funds extended to the construction sector and, in particular, to real estate activities continued to expand at high year-on-year rates, approaching 25% and 41%, respectively. Notable in the other sectors was the pick-up

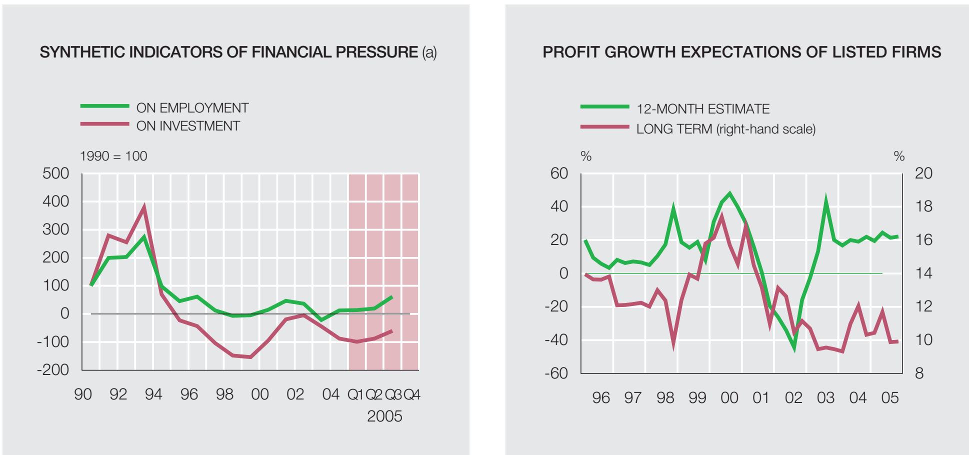
DEBT BURDEN OF NON-FINANCIAL CORPORATIONS (a) CHART 27



SOURCE: Banco de España.

a. Indicators calculated drawing on the CBSO annual and quarterly surveys (CBA and CBQ), except the series "total non-financial corporations" which was obtained from the National Accounts (CNE and FASE). Until 2000, the income of the sector corresponds to the CNE with base 1995. In 2005, a provisional estimate consistent with the CNE withe base 2000 was used. Between 2000 and 2004 they are drawn from the CNE-2000.
b. Gross operating profit plus financial revenue.
c. Includes interest plus interest-bearing short-term debt.
d. Excluding holding companies.
e. Aggregate of all the firms belonging to the Endesa, Iberdrola, Repsol and Telefónica groups. Adjusted for intra-group financing to avoid double counting.

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS CHART 28



SOURCES: I/B/E/S and Banco de España.

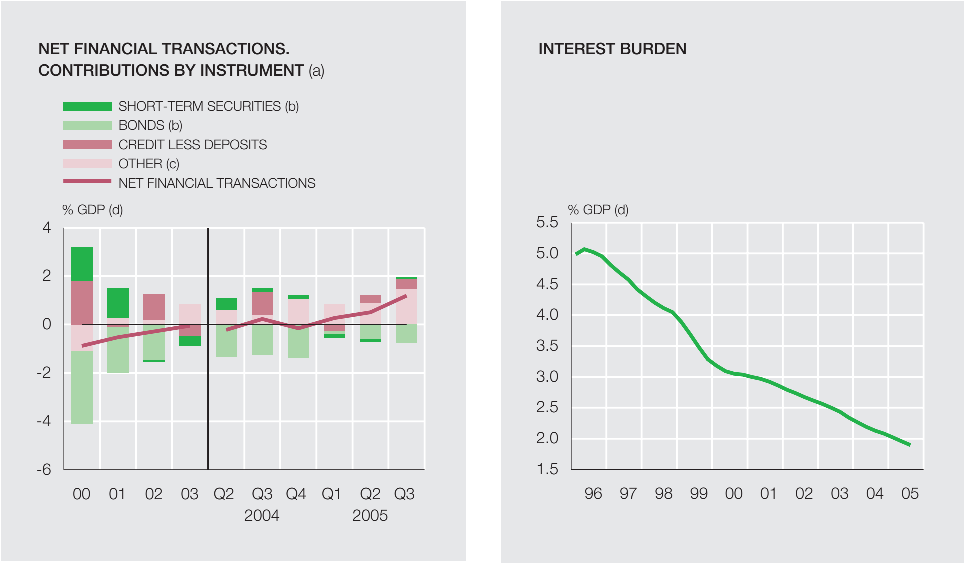
a. Indicators estimated drawing on the CBSO annual and quarterly surveys. A value above (below) 100 indicates more (less) financial pressure than the reference level.

in credit to other services and the slight quickening in credit to industry, which grew by more than 13% with respect to the same period of the previous year.

In terms of rates of change, the year-on-year growth of the debt of non-financial corporations at the end of Q3 stood at around 18%, nearly 2 pp higher than in June. The most recent provisional information points to a continuation of the accelerating trend shown by this variable since early 2005.

GENERAL GOVERNMENT
Cumulative four-quarter data

CHART 29



SOURCE: Banco de España.

a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.
b. Includes only liabilities transactions
c. Includes unpaid accrued interest on bonds and net investment of social security funds in assets issued by the rest of general government.
d. Spanish National Accounts, base 2000 (CNE-2000).

The sector's financial investment also grew significantly to 18.9% of GDP in cumulative twelve-month terms, up 1.8 pp on June. The most significant changes were in share purchases, particularly assets issued by residents, which rose by 0.9 pp to 5.3% of GDP, and in the caption that includes trade credit (included in the item "Other" of Table 6), the volume of which stood at 11.1% of GDP (up 0.8 pp on the previous figure). For their part, funds held in the form of cash and cash equivalents and under the caption "Other deposits and fixed-income securities" increased by 0.1 pp to reach 1.2% and 1.4% of GDP, respectively.

According to the Financial Accounts for Q3, between July and September there was a further increase in corporations' net borrowing to 7.1% of GDP in cumulative 12-month terms, up 0.4 pp on the June figure (see Table 5). This same development was repeated in the financing gap, an indicator which approximates the funds needed to undertake real and financial investment of a long-term nature, which grew to 10.3% of GDP.

The fresh accumulation of borrowed funds by corporations meant that the sector's aggregate debt and its interest payments grew further to stand in September at 440% and at 18% of gross operating profit plus financial revenue, respectively (see Charts 26 and 27). The ordinary net profit of the CBQ reporting corporations grew at 9.7% in the first two quarters of the year, which, although less than the 15.7% recorded in the same period of the previous year, was sufficient to raise the returns on investment (8.5%) and on equity (4.5%). The overall result of the changes in these variables was that the synthetic indicators of financial pressure on investment and on employment worsened slightly, although they remain at low levels (see Chart 28).

Finally, analysts' expectations as to the earnings growth of listed non-financial corporations did not change significantly in Q4, with those for the short term remaining higher than those for the long term.

FINANCIAL TRANSACTIONS OF THE NATION
Cumulative four-quarter data

TABLE 7

% GDP (a)	2002	2003	2004	2005		
				Q1	Q2	Q3
NET FINANCIAL TRANSACTIONS	-2.6	-3.0	-4.8	-5.5	-6.0	-6.2
FINANCIAL TRANSACTIONS (ASSETS)	13.0	12.9	12.0	13.1	12.7	15.0
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	3.3	0.7	3.4	3.4	2.6	1.7
Securities other than shares	4.1	6.5	1.7	2.4	3.4	6.2
Of which:						
Credit institutions	0.5	3.5	1.0	0.6	1.9	4.2
Institutional investors (b)	3.1	3.1	0.0	1.2	1.0	1.7
Shares and other equity	5.0	4.7	5.7	5.8	5.1	5.7
Of which:						
Non-financial corporations	4.6	4.5	2.6	3.4	3.1	3.2
Institutional investors (b)	-0.1	1.1	1.0	1.0	0.6	0.9
Loans	0.6	0.9	1.3	1.6	1.7	1.5
FINANCIAL TRANSACTIONS (LIABILITIES)	15.6	16.0	16.8	18.6	18.7	21.3
Deposits	4.0	6.9	1.7	2.2	0.5	3.4
Securities other than shares	4.3	5.3	12.2	12.6	15.1	14.3
Financial institutions	3.1	6.4	9.6	11.3	14.1	14.5
Other national sectors	1.2	-1.1	2.6	1.4	1.0	-0.1
Shares and other equity	4.0	1.1	1.9	2.1	1.8	2.1
Of which:						
Non-financial corporations	3.3	1.3	0.9	1.3	0.9	0.7
Loans	3.3	3.2	1.5	2.1	2.0	2.2
Other, net (c)	0.0	-0.6	-0.5	-0.5	-0.7	-0.8

SOURCE: Banco de España.

a. Spanish National Accounts, base 2000.
b. Insurance corporations and portfolio investment institutions.
c. Includes the asset-side caption reflecting insurance technical reserves.

5.4 General government

Between July and September 2005, and as in the previous quarters of the year, the balance of general government's financial transactions remained positive, so the sector's financial saving, expressed in cumulative 12-month terms, improve significantly to 1.2% of GDP, against 0.5% in June (see Chart 29).

By instrument and in cumulative 12-month terms, net issuance of long-term securities by general government was positive and not offset by net redemption of short-term securities. At the same time, the balance of its deposits increased with respect to the same period of the previous year, and the social security system purchased assets issued by the rest of the sector, an item which is not consolidated in Chart 29, where it is included in the caption "Other". Interest payments continued to decrease with respect to GDP, mainly as a result of the downward path of the debt ratio, and stood below 2%.

5.5 The rest of the world

The debit balance of the nation's financial transactions worsened further in 2005 Q3 and, in cumulative 12-month terms, stood at 6.2% of GDP, up 0.2 pp on June. The sectoral figures show that this again resulted from increased net borrowing by non-financial corporations and households not offset by the improvement in general government saving.

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

TABLE 8

% GDP (b)

	2000	2001	2002	2003	2004	2005 (c)
National economy	-26.1	-27.1	-30.0	-36.0	-42.1	-46.5
Non-financial corporations and households and NPISHs	-9.6	-10.6	-11.2	-13.6	-12.4	-11.2
Non-financial corporations	-16.6	-17.7	-18.2	-21.2	-20.8	-20.2
Households and NPISHs	6.9	7.0	6.9	7.6	8.4	9.0
Financial institutions	7.3	7.4	5.6	-1.3	-6.7	-14.0
Credit institutions (d)	-11.9	-14.1	-14.3	-21.7	-22.9	-25.4
Institutional investors (e)	20.1	23.3	23.4	26.4	26.6	27.8
Other financial institutions	-0.9	-1.8	-3.4	-6.0	-10.4	-16.4
General government	-23.7	-23.9	-24.4	-21.1	-23.0	-21.3

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. Spanish National Accounts, base 2000 (CNE-2000).
c. Q3 data.
d. Defined in accordance with the First Banking Directive.
e. Insurance corporations and portfolio investment institutions.

Net purchases of external assets by resident sectors stood, in cumulative 12-month terms, at 15% of GDP in September, up 2.3 pp on June (see Table 7). The buoyancy of this investment was largely due to a notable increase in the holdings of securities other than shares, which reached 6.2% of GDP (against 3.4% in Q2), mainly as a result of purchases of foreign public debt by financial institutions. Further, the volume invested in shares and other equity abroad increased to 5.7% of GDP. Conversely, funds held in the form of cash and deposits decreased by 0.9 pp to 1.7% of GDP.

The volume of liabilities vis-à-vis the rest of the world, expressed in cumulative 12-month terms, amounted to 21.3% of GDP in Q3, against 18.7% in June. Financial institutions continued to play a central role in raising funds abroad to finance the growing borrowing requirement of the Spanish economy. Issues of securities other than shares by this sector were again the main instrument through which these funds were channelled, and their volume in September amounted to 14.5% of GDP (up 0.4% on the previous quarter). In addition, this period saw a significant increase in deposits by non-residents, which grew by 2.9 pp with respect to June and accounted for 3.4% of GDP.

On balance of payments information, between January and October 2005 net foreign direct investment in Spain continued to be negative, although less so than in the same period a year earlier (-€7.5 billion, against -€12.4 billion). This resulted from an increase of 26.4% in inflows and a decrease of 11.2% in outflows.

Finally, the debit position of the Spanish economy vis-à-vis the rest of the world worsened and stood in September at 46.5% of GDP (see Table 8). This resulted from a notable increase in the debit balance of financial institutions which could not be offset by the improvement in the rest of the sectors.

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