

QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

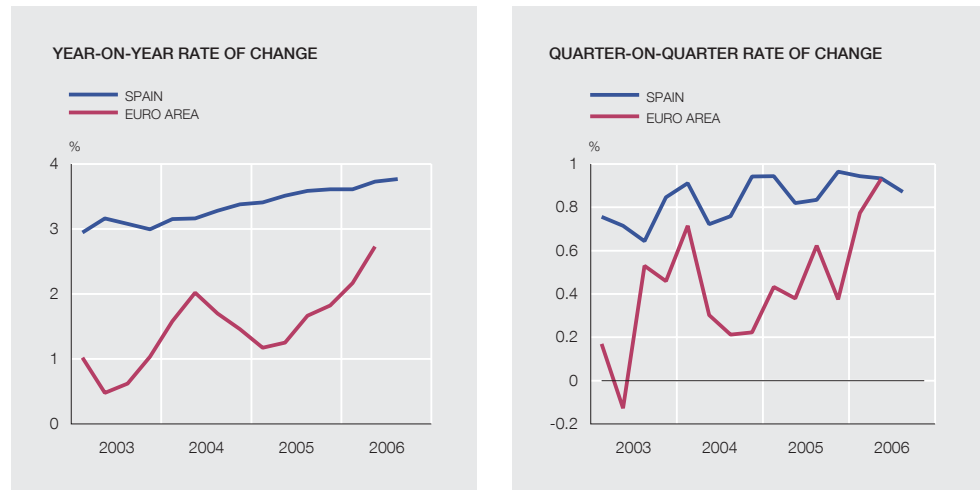
The past two quarters have seen a prolongation of the phase of buoyant activity and employment in the Spanish economy. The rate of increase in both variables has moved on a mildly accelerating path which has been compatible with some re-balancing of the contribution of national demand and of net exports to growth. During 2006 Q2, on QNA figures, the year-on-year growth rate of GDP rose to 3.7%, 0.1 pp up on Q1, thanks to the improved contribution of net external demand to GDP, which offset the small reduction in national demand.

The information available for Q3 this year indicates that output has continued to gain in dynamism, taking its growth rate to 3.8% and signifying a quarter-on-quarter rate of 0.9%, similar to that in Q2 (see Chart 1). Underpinning the rise in GDP is the continuing relative momentum of domestic expenditure, following the slow deceleration that had marked this component since the first half of 2005, and the further improvement in the contribution of external demand, which is more modest than in the previous quarter. National demand is estimated to have grown at a year-on-year rate of 4.6% in this quarter, with the negative contribution of external demand having dipped from 1.1 pp in Q2 to 1 pp in Q3.

Apparent under national demand were the robustness of household consumption, the rate of increase in which held stable in Q3, and the buoyancy of investment in construction, which may have increased slightly, against a background of resilient residential investment, civil engineering works and non-residential building. Investment in equipment may have eased off slightly, though it should continue to expand sharply at a year-on-year rate of around 9%. On the supply side, industrial output continued to quicken in Q3, driven by the pick-up in exports and the sustained increase in investment in equipment. Employment also accelerated, in a setting in which the population and the participation rate have continued to grow forcefully. The unemployment rate fell further to 8.1%. Turning to inflation, there has been a very significant cut since August in the 12-month growth rate of the CPI, which stood below 3% in September, compared with a rate of close to 4% in Q2. The cause of this slowdown is essentially the marked decline in energy prices, although in the past two months there has been a slight slowdown in underlying inflation which, in any event, remains close to 3%. The inflation differential with the euro area in terms of the HICP was 1.2 pp in September, a reduction of almost half a percentage point on the differential observed in the first half of the year.

The international economic outlook in recent months has been marked by the substantial fall in oil prices since August and by the clearer signs of a slowdown in the United States and, to a lesser extent, in Japan. In the case of the US economy, the loss of momentum in Q2 was confirmed in Q3, with a deceleration based more on investment (residential and business investment alike) and on external demand than on household expenditure, which continued to show resilience. In Japan, uncertainty was centred on private consumption, which displayed signs of sluggishness in Q3. In contrast to the lesser momentum of these developed economies, the emerging economies have sustained fairly robust growth rates, particularly China and other Asian economies but also most of the Latin American and eastern European countries. Regarding this latter group of countries, it should be highlighted that the European Commission approved the entry of Bulgaria and Romania into the EU on 1 January 2007, which will take the number of Member States up to 27.

Oil prices, after reaching an all-time high in early August of around \$78 per barrel of Brent, underwent a marked fall of around 20%. This reduction in price is connected with the lesser



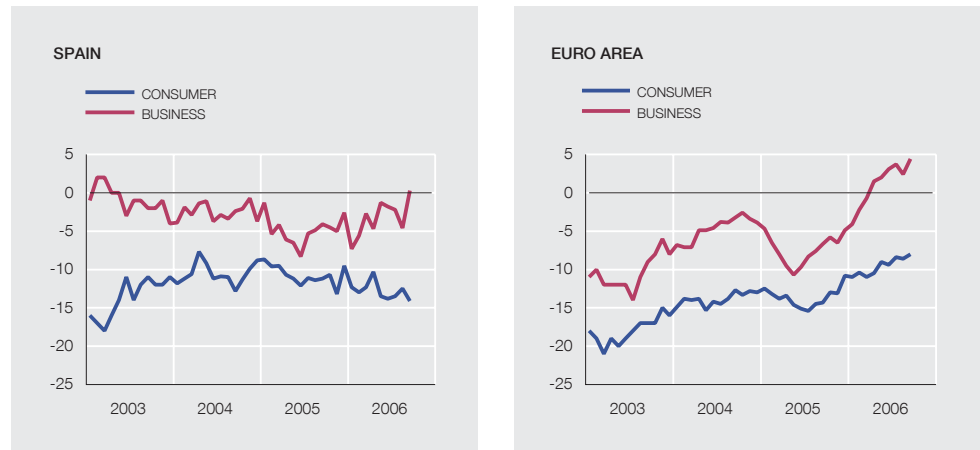
SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

dynamism of activity expected in certain industrialised countries, although further influential factors have been the easing of geopolitical pressures, especially in the Middle East, the favourable inventories figures in the United States and the end of the summer season, entailing less demand. However, the futures curve continued to evidence similar or higher prices than the spot price.

The prospect of lesser inflationary pressures entailed by the slowdown in activity and cheaper oil has prompted some change in market expectations about official interest rate movements in certain countries, and also about a fresh decline in long-term interest rates. Nonetheless, in the case of the United States, the Federal Reserve has continued to show concern about the high level of the underlying inflation rate. In the United Kingdom, the Bank of England has kept the official interest rate at 4.75% since it raised it in August, although the outlook is for a fresh rise in the future. In the emerging Asian countries and in the eastern European economies, the monetary policy stance generally continued to tighten. During Q3 the international financial markets trended favourably, with rises on equity markets and a narrowing of sovereign spreads on the emerging markets. In sum, the outlook for the global economy remains favourable, although there is uncertainty over how long oil prices will remain at their lower level and over the capacity of the emerging economies and those in other developed areas to maintain robust and autonomous growth in the absence of a more appreciable contribution by the United States to this dynamism.

In the euro area, the economic recovery initiated in 2005 has continued with some intensity, with a year-on-year growth rate in Q2 of 2.7%, the highest since 2001. The expansion was fairly widespread across the area, though not in terms of components, since a greater contribution by investment (both in equipment and in construction) was seen, but private consumption continued to show signs of weakness. The European economies are expected to maintain robust growth in Q3, although this will probably be less in quarter-on-quarter terms than in the first half of the year, as it would not seem that the sharp expansion in Q2 in some countries, such as Germany and France, can be sustained in Q3. However, average GDP growth in 2006 will foreseeably be above 2.5%, in line with the estimates by certain international agencies. The main source of uncertainty is the behaviour of private consumption, which has been greatly affected by the poor results in Germany and Italy, where there is a perceptibly looser connec-



SOURCE: European Commission.

tion than in the past between job creation, which has been relatively vigorous, and household expenditure. In any event, the improvement in disposable income attributable to cheaper energy and the brighter outlook apparently augured by the confidence indicators might boost private consumption in the future (see Chart 2). The increase in the VAT rate in Germany in January 2007 is a factor that may affect the profile of demand, providing a greater prop to activity in 2006 but, above all, detracting from its momentum the following year. Although the buoyancy of national demand has played a more relevant role in growth in recent quarters, the main risk to activity in the euro area is related to the effects that a sharper slowdown in the US economy might have and to the possibility that such a circumstance might lead to a disorderly correction of global external imbalances.

Despite the momentum of activity, underlying inflation has held relatively stable in the euro area in recent quarters. Moreover, the recent reduction in oil prices has been reflected in a rapid decline in the HICP, whose rate was substantially below 2% in September. Nonetheless, the risks to inflation in the medium term remain on the upside, owing both to uncertainty over the continuity of cheaper oil and to the potential pass-through to consumer prices of past increases in energy prices. The ECB Governing Council's assessment of these risks, particularly against the background of growing buoyancy in demand, led it to raise once more its official interest rate by 25 bp at its meeting on 3 August and again at that on 5 October, meaning it stands at present at 3.25%. Financial conditions may, however, continue to be viewed as relatively loose.

Fiscal policy has broadly retained a neutral stance in the euro area as a whole. Moreover, it is likely that the favourable trend of tax revenue will see the related budgetary balances for 2006 exceed those contained in the stability programmes, although some countries will still be posting deficits of over 3% of GDP this year. The experience of the early years of the present decade, when the economic slowdown led some Member States to overstep rather too readily the deficit thresholds established in the Treaty and in the Stability Pact, advises harnessing the current greater economic dynamism to make more resolute headway in fiscal consolidation, so there may be sufficient leeway in the future to withstand any losses in the vigour of activity.

This fairly favourable international scenario, with world economic growth broadly holding up and, in particular, a clear recovery in the euro area, has seen a significant improvement in the

contribution of the external sector to the expansion of the Spanish economy; and this, throughout 2006, has offset the greater moderation in national demand. As indicated at the start of this report, this pattern has prevailed during Q3, although the slowdown in national demand came to a halt in this period and the gradual improvement in the contribution of the external sector to GDP growth was somewhat lower than in the previous quarter. The robustness of industrial activity and of exports continued to be a distinctive feature of the growth pattern in Q3, which contrasts with the slackness of these items the previous year. Further, investment in both equipment and in construction remained very resilient, as did private consumption, meaning that the relative tightening of monetary and financial conditions – which took the form of an increase of somewhat over 30 bp in one-year interbank market rates in Q4 and of an increase in the cost of bank loans to households and firms – has not yet clearly impacted agents' spending decisions.

The rate of increase in private consumption held at a similar rate to that of the previous quarter, owing to the continuing vigour of job creation and the persistence of a significant wealth effect. This effect was due to the fact that, although house prices continued on a gradually slowing path in Q3 (at a year-on-year rate of 9.8%, 1 pp down on the rate the previous quarter), there was also a significant rise in the value of stock market assets, reflecting sound corporate earnings, the positive effects of the fall in oil prices on the economic outlook, and the mergers and acquisitions that have been taking place in recent quarters. The net outcome has been that consumption has outgrown disposable income, whereby it is estimated that the household saving ratio has continued to decline. Since the resilience of residential investment has in turn been prolonged, the financing requirements of this sector have continued to increase, meaning that households' resort to debt to finance their expenditure has been maintained. In this respect, the year-on-year increase in credit was similar to that seen during the first half of the year, with rates at somewhat over 20%. That said, a downturn in the rate of expansion of mortgage lending and an acceleration in resources for financing consumption have begun to be discernible, perhaps as a consequence of the greater recorded expenditure on consumer durables other than cars.

Investment in equipment has also continued to show marked vigour in recent months, underpinned by greater export activity – predominantly centred on sales abroad of this type of good – and by the momentum of the industrial sector. As with households, the financing of business activity was through growing resort to debt, with a year-on-year growth rate of financing obtained standing at slightly over 26%. That made for a rising trajectory in both the debt ratio and in the debt burden of non-financial corporations. In any event, this evidence should be qualified by the figures for bank credit extended to the different productive branches, where the highest growth rates can be seen to be those in financing to construction and real estate activities, while in the other branches the expansion of credit was at a more moderate year-on-year rate of around 10%-15%.

As to investment in construction, the high figures for previous quarters were maintained in Q3, with a rate close to 6%. This was against a background in which the demand for housing remained very strong, while activity in non-residential building and, in particular, civil engineering works showed signs of being intense. In the case of residential investment, it is difficult to determine to what extent its current dynamism may be in response to the bringing forward of specific investment decisions as a result of certain regulatory changes.

Foreign trade flows followed a similar pattern in Q3 to that of the previous quarter, with export growth rates more in keeping with the growth of export markets and with a sharp increase in imports. As a result, a clear pick-up in exports has been observable in 2006 to date, following

the poor results in 2005. The reason is to be found in the strong increase in global trade and in the take-off in the European countries' economic activity, since no improvements in price-competitiveness indices have been observed. Product by product, the greater buoyancy of exports has been across the board, though the expansion in sales of capital goods and of textiles has been notable, while that in cars showed some sluggishness, but not to the same extent as in 2005. Despite the recovery in the euro area, the main increases in exports in 2006 have been in non-euro area markets. The tourist industry indicators performed favourably during the summer and tourism receipts improved on the previous quarter, with a pick-up in average expenditure per tourist.

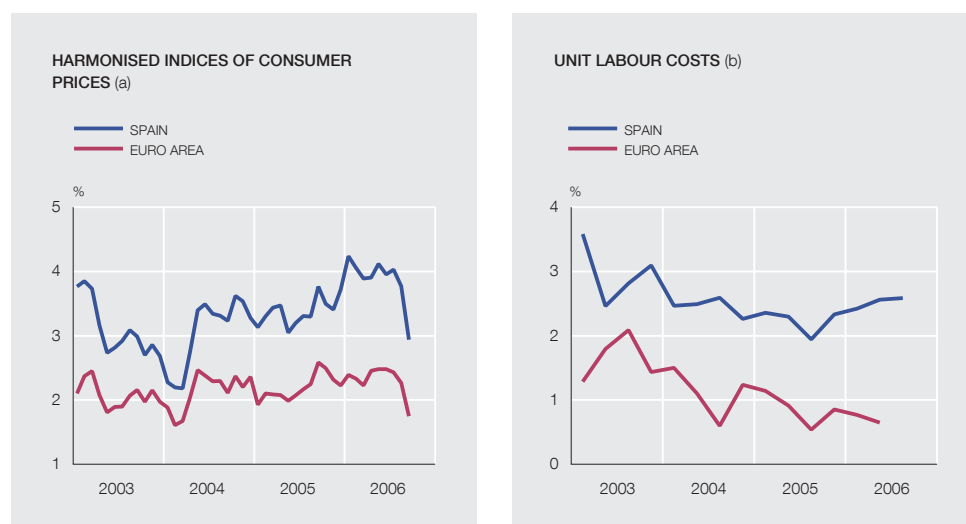
The strong growth rate of imports in real terms in Q3 is consistent with the rise in final demand, the high import content of exports and of investment in capital goods, and the improved competitiveness of imported as opposed to domestic products. In terms of products, the expansionary behaviour of imports of capital goods and of non-energy intermediate products was notable, which is in step with the dynamism of both investment and industrial activity. Tourist service imports may have continued on the slowing path observed since late 2005.

In the light of these figures, and on the provisional information available on the growth of world trade, the Spanish export share would be tending to stabilise in 2006 after the fall-off recorded in the two previous years, although import penetration would have continued increasing. In any event, the gap between the growth rates of exports and imports has continued to give rise to a widening of the external deficit.

Employment in the Spanish economy has remained very dynamic. As in previous quarters, the recovery in industrial output did not significantly boost job creation in this branch, meaning that construction and services were once again the sectors where employment showed the highest rate of expansion. Accordingly, there have been no substantial changes apparent in productivity either across the different sectors, where the increase taking root in the industrial sector remains prominent, or in the economy as a whole.

Compensation per employee quickened in the first half of the year in the market economy, posting a rate of 2.7% in Q2, 0.7 pp up on end-2005. This trajectory, which is partly in response to the activation of the 2005 wage indexation clauses, has probably continued into Q3. In any event, it should be stressed that the pace of growth of compensation is running below wages negotiated in collective bargaining agreements, which reflects the importance of the effects of the incorporation of new workers into the labour market on the aggregate. However, low productivity rates have meant that the increases in compensation largely pass through to unit labour costs, which are moving on a significantly more expansionary path than in the euro area countries (see Chart 3). This, combined with the behaviour of margins, which have increased sharply, has contributed to inflation holding at relatively high levels during Q3.

In terms of the CPI, however, most of the cheaper oil since August has swiftly been reflected in the figures for the past two months, meaning that the 12-month rate of the CPI in September fell to 2.9%, compared with 4% in June. This rapid pass-through, together with the greater weight of the energy component in the Spanish consumer price basket and with the slight easing in parallel in underlying inflation, has led to a narrowing of the price differential with the euro area from an average of 1.6 pp in the first half of the year to 1.2 pp in September. While this slowdown in prices has an evident transitory component, it also has significant implications both for public finances, since it will entail a reduction in spending on pensions in 2007, and for labour costs in the coming year, since it will lessen the impact of the activation of the wage indexation clauses. Further, it is possible that wage bargaining in 2007 will take place



SOURCES: Eurostat, ECB and INE.

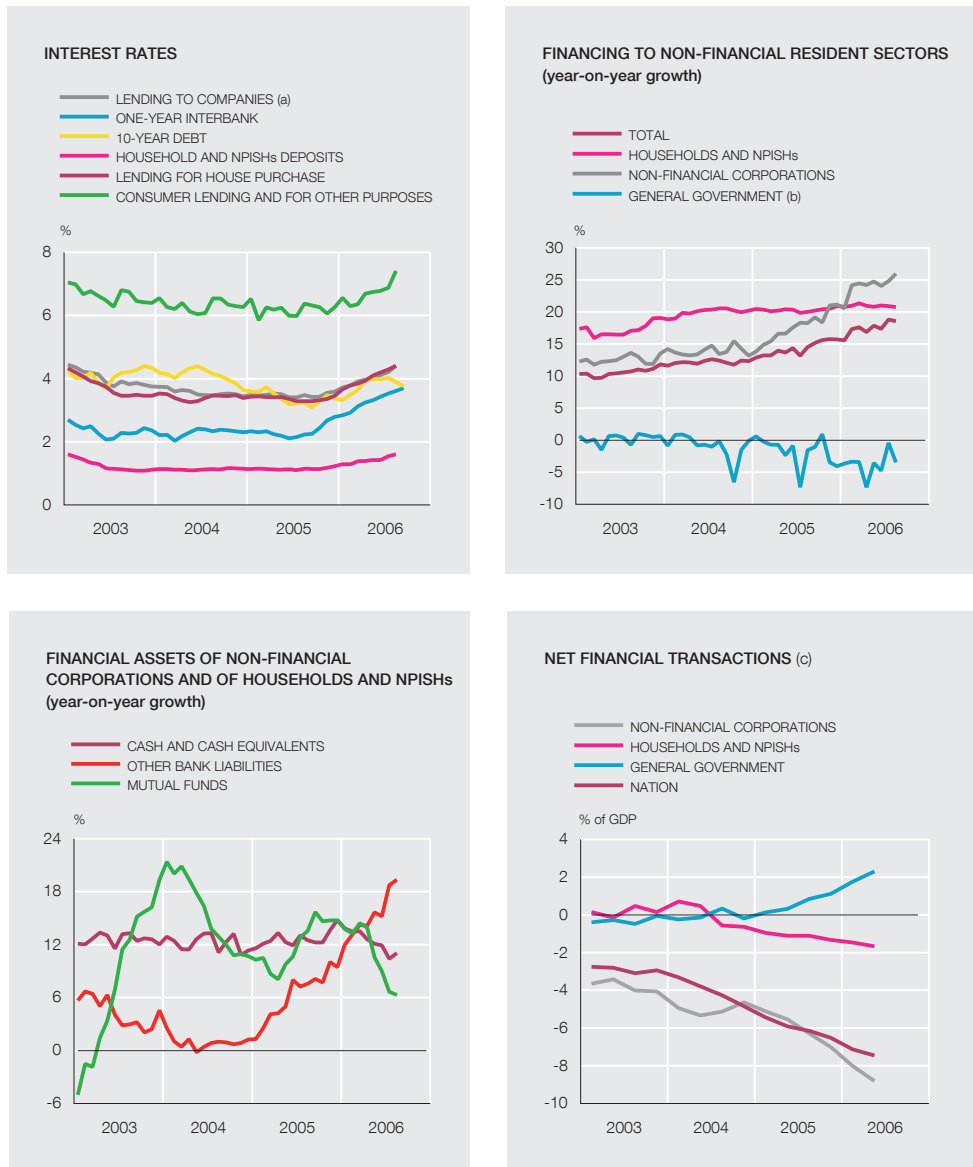
a. Year-on-year rate of change.

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

while the main inflation reference is at a rate of less than 3%, a substantially more moderate rate than that in the first half of 2006. Accordingly, it would be important for this reduction in the CPI to be fully incorporated into the price formation process and to translate into a moderation in inflation expectations, which would enable it to exert a permanent effect on future inflation and, thereby, provide for further progress in the narrowing of our price differential with the euro area.

In sum, the Spanish economy has been seen to be gaining momentum in Q3. While this has been supported by some re-balancing of the sources of growth in favour of external demand, it continues to be essentially underpinned by very robust national demand. Moreover, the improved contribution of the external sector appears to respond more to the vigour of the international environment than to favourable price-competitiveness developments in Spain. In this respect, the continuation of the process of strong economic growth has not been accompanied by a reduction in the imbalances observed in previous years, in the form of a high external deficit, a persistent inflation differential with the euro area and sharp increases in the indebtedness of the private sector (see Chart 4). Faced with this situation, the contribution of economic policies, tempering the impulse of demand and improving supply-side workings, is fundamental.

In recent weeks the draft State budget for 2007 was unveiled, and the expected budgetary balance for 2006 was provided as part of the Excessive Deficit Procedure notification. The balances furnished for these two years – representing surpluses of 1.1% of GDP in 2006 and 0.7% of GDP in 2007 – would, if reached, entail a relatively expansionary budgetary policy stance. However, the buoyancy of tax revenue in 2006 to date augurs a better balance than indicated, whereby the fiscal policy stance would tend to be neutral this year. As regards 2007, the better starting point the present year represents should also entail a higher-than-projected surplus, although in this case the application of the personal income tax and corporate income tax reform will foreseeably involve a certain expansionary bias in the fiscal policy stance. Against this background, it would be advisable to use the potential upward deviations in tax revenue, in line with what is happening in the current expansionary setting, to improve the



SOURCE: Banco de España.

a. 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 NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.

b. Consolidated financing: net of securities and loans that are general government assets.

c. Four-quarter data.

budget balance and thus contribute to alleviating the tendency to imbalance caused by the pressure of national demand.

As to the recent labour market reform, it is still too early to assess its impact in detail. Nonetheless, information from the INEM figures on employment contracts shows an appreciable rise in permanent hiring since July, due above all to the conversion of temporary contracts. The reform includes an exceptional period running to 31 December this year in which these conversions entail a rebate in the related social security contributions, which means that this high dynamism may be expected to continue in the coming months. The EPA (Labour Force Survey) data for Q3, which have recently been published by INE, show that the proportion of temporary to total employees rose to 34.6%, 0.2 pp up on the previous quarter, although in

the summer there is usually something of an increase in this ratio for seasonal reasons and this year the increase has been lower than that observed for the same period in the two previous years.

Finally, on 13 October the Council of Ministers approved the Annual Progress Report for 2006 of the National Reform Programme (NRP). The NRP shows the economic policy strategy for the period 2005-2010, whose two fundamental goals for the end of the current decade are full convergence in per capita income with the European Union (EU 25) and to reach an employment rate of 66%¹. In 2005, the figures for the foregoing variables were 98.8% in the case of per capita income and 63.2% in that of the employment rate. Both the NRP and the current Progress Report stressed the poor results obtained in respect of productivity, which is growing more slowly than in the EU and thereby hampering convergence in income with this area. The implementation of the Plan is moving soundly ahead, since during its first year in force somewhat more than half of the 310 measures contained in it have been approved. In any event, given the nature of this Programme, the effects of the bulk of these measures will foreseeably unfold in this and the following years; accordingly, its results should be evaluated over a somewhat longer time horizon. A prompt and ambitious application of the guidelines of this Plan is very important for ensuring the sustainability of economic growth under the demanding conditions stemming from membership of the euro area and from ongoing globalisation.

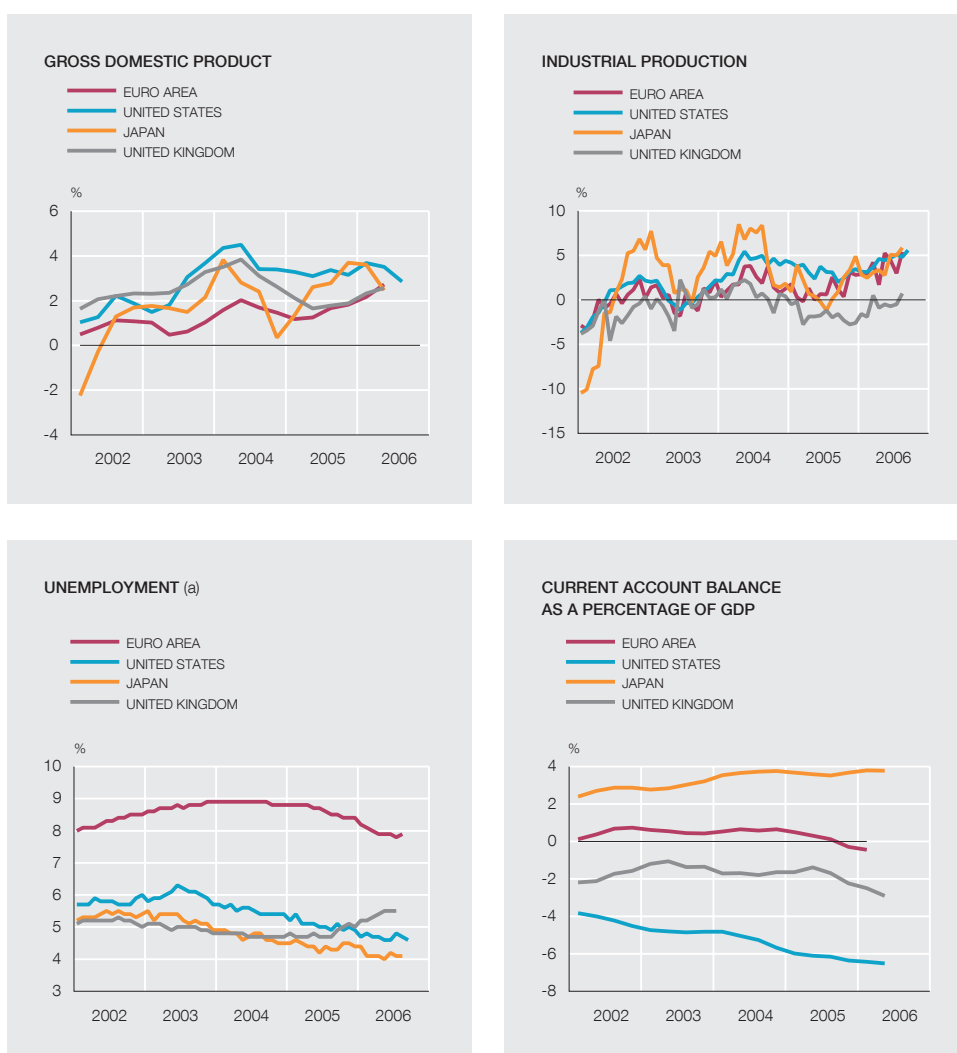
1. More information on the NRP can be found in Box 1.4 of the 2005 Banco de España *Annual Report*.

2 The external environment of the euro area

During the last quarter, developments in the external environment of the euro area were essentially marked by the economic slowdown in the United States and, to a lesser extent, in Japan. Combined with the prospect of lesser inflationary pressures, this prompted a fresh decline in long-term interest rates and changes in expectations on financial markets regarding movements in official interest rates. The slowdown in economic activity spread to most of the emerging economies, which nevertheless maintained fairly high rates of increase, especially China and other Asian economies. As to the behaviour of the markets, the most relevant development was the notable fall in oil prices from mid-August.

The revised market expectations about movements in official interest rates in the United States – where the futures markets began to incorporate downward movements, after the Federal Reserve had kept its federal funds rate target at 5.25% at its last three meetings – and in Japan were accompanied by gains in stock market indices and reductions in the credit spreads on corporate bonds. On the foreign exchange markets, the dollar hovered between 1.29 and 1.25 against the euro, while the yen depreciated against both currencies and reached all-time lows against the euro. The emerging markets recovered from the period of volatility they underwent in Q2, despite limited and transitory corrections being observed in some countries as a result of domestic factors. Oil prices, after reaching an all-time high of \$78 per barrel in early August, stood at below \$60 per barrel at the end of September, 20% below the spot price three months earlier. Conducive to this fall were the diminished geopolitical tensions, the favourable US inventories figures and the end of the summer season, and these coincided with declines in the prices of certain precious metal commodities, especially gold. In mid-October the OPEC members agreed on a reduction in the oil supply of 1.2 million barrels per day (1.4% of world consumption) as from 1 November. This caused only a slight and temporary rise in prices, which are holding at around \$60 per barrel.

GDP in the United States grew by 1.6% in Q3, in annualised quarterly terms, 1 pp down on the previous quarter; the related year-on-year rate dipped from 3.5% to 2.9%. This slowdown was due to the strong decline in residential investment, which subtracted 1.1 pp from GDP growth, and to the negative contribution of external demand, as a result of the acceleration in imports. Conversely, both private consumption and non-residential investment quickened. Against the background of the slowdown in activity and the correction in the real estate market (with year-on-year falls in the main indicators of house prices), the fall in petrol prices was propitious to the firmness of private consumption and of consumer confidence. The labour market data were also relatively favourable. The significant reduction in the pace of job creation in September was offset by strong upward revisions of the figures for the previous months; moreover, the unemployment rate held at 4.6% of the labour force. Looking ahead, the course of private consumption poses the main risk to growth, linked to the possible contractionary impact of the adjustment of house prices and to uncertainty over the capacity of other forces – such as the reduction in energy prices, the favourable financing conditions or labour market developments – to offset that impact. Turning to inflation, the decline in energy prices prompted a significant easing in the CPI in September, which posted a month-on-month fall of 0.5%, with its year-on-year rate falling to 2.1%, compared with 3.8% the previous month. The base effect of the strong increase in prices in September 2005 also contributed to this cut. Nonetheless, the underlying inflation rate rose by 0.1 pp to 2.9%, against a background of accelerating labour costs, and the risk remains that these increases may pass through to agents' inflation expectations, as several Federal Reserve comments have indicated. With regard to

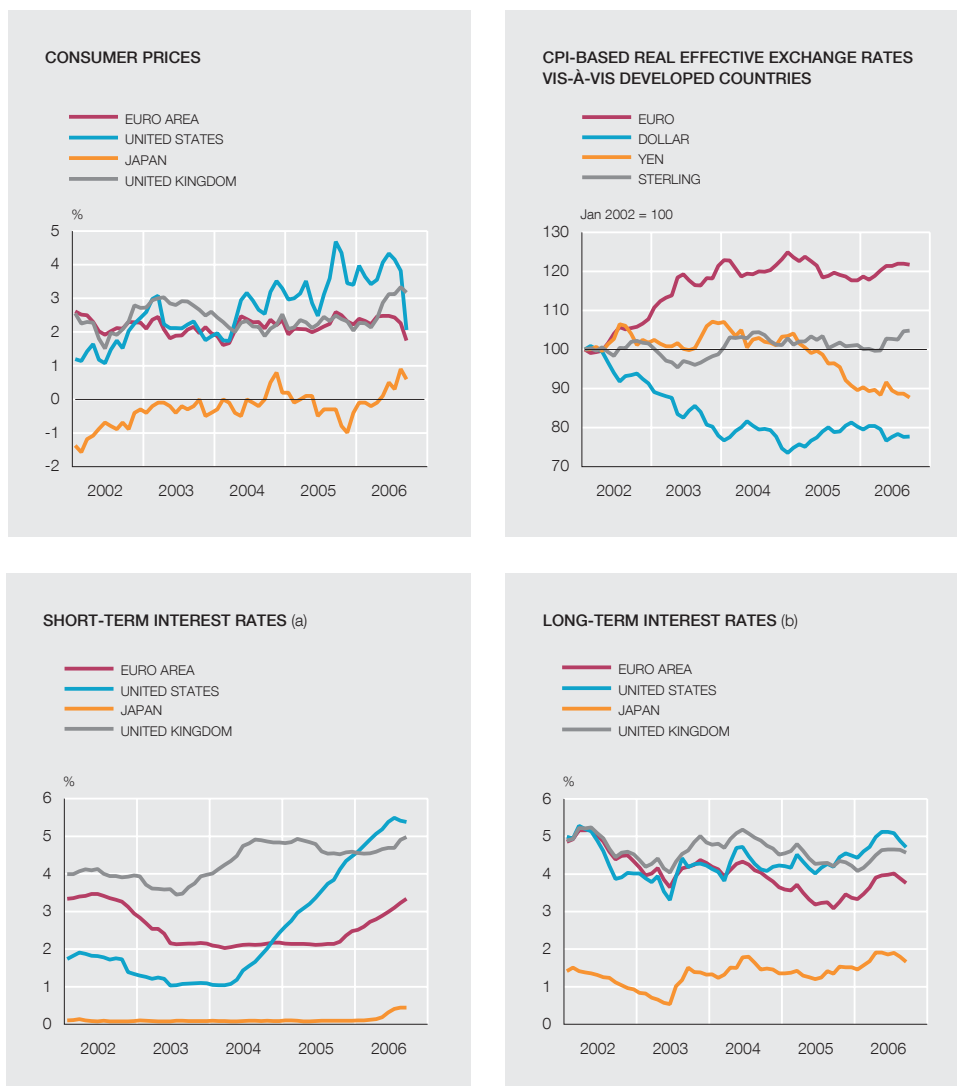


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

fiscal policy, the Federal deficit for fiscal 2006 stood at 1.9% of GDP, compared with 2.6% of GDP in 2005, thanks to the buoyancy of revenue.

In Japan, following a hesitant start to the quarter, economic activity regained greater momentum, with positive supply-side indicators – in particular the Tankan business confidence survey and machinery orders – and favourable labour market developments, which placed the unemployment rate at 4.2% of the labour force in September. Despite employment growth, private consumption showed signs of less steam during Q3 owing to a deterioration in confidence and to the flatness of wage remuneration. On the external front, the acceleration in exports and the easing of the pace of expansion of imports in recent months gave rise to an improvement in the external balance. As to prices, the September CPI eased off by 0.3 pp to 0.6% year-on-year, while underlying inflation declined by 0.1 pp to 0.2%, due largely to the slowdown in energy prices. Wholesale prices moved surprisingly up in September, posting year-on-year growth of 3.6%. Lastly, the Bank of Japan held its official interest rates unchanged at 0.25% at its October monetary policy meeting.



SOURCE: Banco de España.

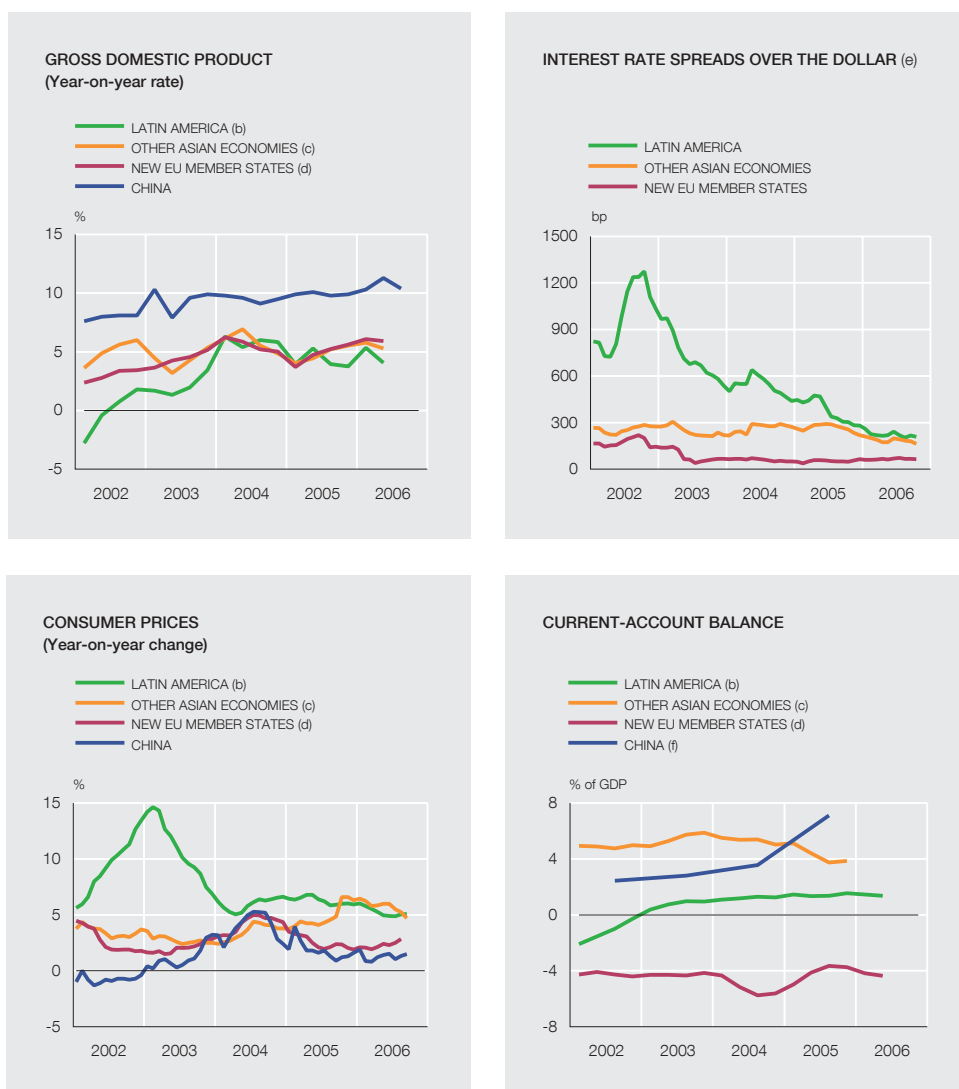
- a. Three-month interbank market interest rates.
- b. Ten-year government debt yields.

In the United Kingdom, GDP grew at a quarterly rate of 0.7% in Q3, the same as in the first two quarters of the year (in year-on-year terms the rate edged up from 2.6% to 2.8%), showing signs of the robustness of the economy and confirming the positive message emitted by recent supply-side indicators such as industrial output and the PMI. Private consumption also tended relatively favourably during the quarter, although there was some sluggishness in retail sales in September. Turning to the labour market, the unemployment rate increased during the quarter to 5.5% of the labour force. As to prices, inflation dipped by 0.1 pp in September to 2.4% year-on-year, while producer prices slowed notably to 1.8%. The rate of expansion of house prices firmed and grew at over 8% in September compared with a year earlier. Against this backdrop, the Bank of England held its official interest rate at 4.75% in September and October, following the 25 bp rise in August.

GDP slowed in almost all the new EU Member States in Q2, although it sustained a very robust rate of increase, averaging 5.6% year-on-year compared with 6% in Q1. Once again, the buoyancy of domestic demand offset the negative contribution of the external sector. The in-

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

CHART 7



SOURCES: National statistics and JP Morgan.

- a. The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
- b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
- d. Poland, Hungary, Czech Republic, Slovakia, Slovenia, Estonia, Latvia and Lithuania.
- e. JP Morgan EMBI spreads. The data on the new EU Member States relate to Hungary and Poland. The aggregate for Asia does not include China.
- f. Annual data.

indicators of activity and of demand in 2006 Q3 generally remained firm. Inflation rates continued on an upward path in most cases owing to the rise in energy and food prices, although notable variability persists from one country to another (from 1.4% year-on-year in Poland to 5.9% in Latvia and Hungary). Prices eased in some of these countries in September owing to lower energy prices. As a result of the rise in inflation, there were increases in official interest rates in several countries, such as the Czech Republic and Slovakia, and also in Hungary, where in addition to the rise in inflation expectations there was a notable deterioration in public finances. The new convergence programme presented by the Hungarian government envisages a budget deficit of 10.1% of GDP in 2006, which will fall to 3% in 2009. The bulk of the fiscal adjustment – over 6 pp – is foreseen for 2007 and 2008, and would entail a significant

contractionary effect on domestic demand. In Turkey, GDP rose in Q2 from 6.5% to 7.5% year-on-year, despite the financial turbulence in May and June. Although the financial markets appear to have stabilised, the deterioration in the current account deficit and in inflation has continued in recent months. Finally, the European Commission approved EU entry for Bulgaria and Romania on 1 January 2007.

In China, GDP in Q3 grew at a year-on-year rate of 10.4%, 0.9 pp down on Q2, confirming the signs of deceleration shown by certain indicators of activity such as investment in fixed assets or industrial output, following the measures adopted from April to combat the risks of overheating. The money supply and domestic credit also moved along these lines and resumed more sustainable paths of expansion. The exchange rate of the renminbi appreciated significantly in Q3 (by 1.1% against the dollar), although there was a record trade surplus of \$48.7 billion, 57% higher in the first nine months of 2006 than in the same period a year earlier. However, foreign direct investment inflows continued to decline, albeit slightly. The inflation rate fluctuated during the quarter: after dipping in July, it rose in August and September to 1.5% year-on-year, while producer prices oscillated at around 3.5%. In most of the other big Asian countries, GDP in Q2 slowed moderately, the result of the lesser increase in exports and, in certain cases, in domestic demand. Even so, growth rates were very high, especially in India, which posted a year-on-year growth of 8.9%. In July and August, economic activity was generally firm, and exports were considerably dynamic, especially in India and South Korea. Inflation posted a high for the year in August in several countries in the region, although it fell in some others as a result of the easing off in the growth of energy prices, a trend which continued in September. Against this background, the moderate tightening of monetary policies in the area continued.

In Latin America, the indicators of activity released for July and August suggest that the general trends observed in Q2 in the two biggest economies in the region were maintained in Q3: sluggish activity in Brazil, albeit with a slight recovery, and greater dynamism in Mexico. Likewise, activity slowed even further in Chile and quickened slightly in Argentina, Colombia and Peru. The favourable behaviour of the trade balance figures and sound fiscal results were factors that bore on the improved sovereign ratings for Argentina, Brazil, Chile, Peru and Uruguay. On the prices front, the year-on-year inflation rate for the region as a whole rose by 0.2 pp in Q3 to 5.1% in September, from the historical low attained in June. Nonetheless, the inflation performance was heterogeneous, since it declined in Argentina, Brazil and, notably so, in Chile, while it increased in Peru, Colombia, Mexico (by almost 1 pp in the quarter) and, especially, in Venezuela, where it climbed from a rate of 11.8% in June to 15.3% in September. Interest rates rose in Q3 in Colombia, Chile and Argentina, while they fell in Brazil (by 150 bp to 13.75%).

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

The National Accounts information for the first half of 2006 confirmed the soundness of the recovery in activity in the euro area. In that period, economic dynamism was more generalised across countries and branches of activity. Also, the pattern of growth was more balanced, with a greater contribution by domestic demand, making growth more sustained and less dependent on the external environment. The mainly qualitative indicators of activity and employment available for Q3 reflect the extension of this scenario into the second half of the year, albeit at a somewhat lesser rate than in the first six months. Accordingly, GDP will foreseeably post an average growth rate in 2006 above 2.5%, in line with the estimates by some international agencies.

Beyond this time horizon, the scale of the upturn will largely depend on the course of private consumption, which still shows no firm signs of recovery in some countries, although it is expected that the increase in employment and the decline in oil prices, should they firm, will give an upward impulse to disposable income and, potentially, to household spending. In the medium and long run, the risks to the economic outlook in the euro area remain on the downside and are related to the effects that a greater-than-anticipated slowdown in the US economy might have on Europe and to the possibility of a disorderly correction of global external imbalances.

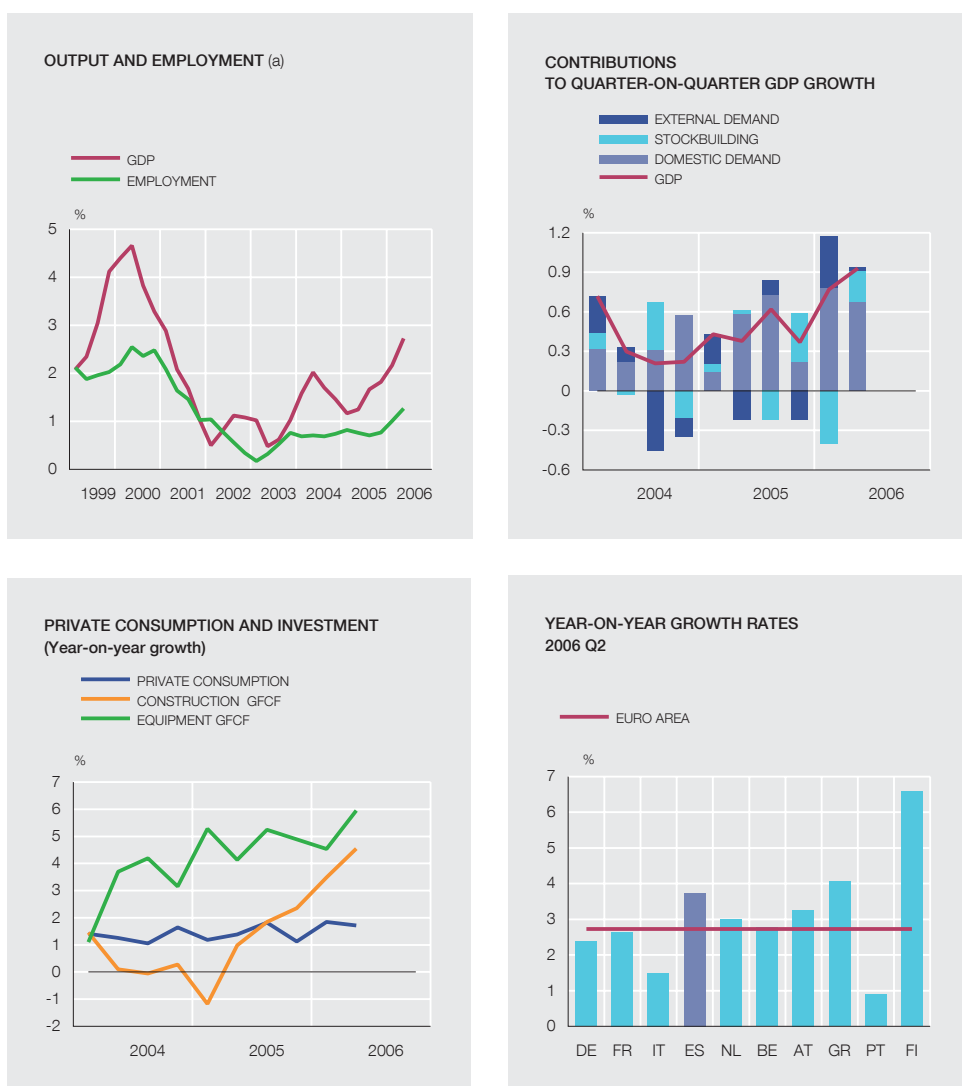
As regards prices, no underlying inflationary pressures are perceptible so far. Moreover, the reduction in oil prices since mid-August, along with the base effect derived from their high growth in the summer of 2005, has had a significant impact on the HICP, whose 12-month rate of increase stood clearly below 2% in September. This slowdown in consumer prices, though partly temporary, is a factor acting in favour of the containment of wage demands in the collective bargaining that will take place shortly in some countries. Nonetheless, medium-term inflation risks remain on the upside, owing to the uncertainty over the recent fall in oil prices continuing and to the possible pass-through to consumer prices of past rises in the price of energy products.

On the economic policy front, the emergence of risks to price stability in the medium term, against a background of increasingly buoyant activity, led the ECB Governing Council gradually to increase its official interest rate, which currently stands at 3.25%. That said, interest rates remain at relatively low levels. Fiscal policy has retained a neutral stance in the euro area as a whole and the favourable course of tax receipts will probably result in higher budgetary balances for 2006 than those contained in the stability programmes and in the European Commission's spring forecasts. In this respect, the context of greater economic dynamism offers an opportunity that should be harnessed so that certain euro area countries may make further progress in terms of fiscal consolidation.

3.1 Economic developments

National Accounts data for the euro area confirmed the strength of economic activity in the first half of 2006. GDP growth in Q1 was 0.8% in quarter-on-quarter terms, a figure revised upwards from the initial estimate of 0.6%, due mainly to the revision of the German figures. The second National Accounts estimate substantiated the robustness of GDP during the April-June period, with growth of 0.9% in relation to the previous quarter. As a result, year-on-year growth of output in the euro area stood at 2.7% in Q2, compared with 2.2% in Q1.

The increase in GDP in Q2 was largely underpinned by the sound behaviour of domestic demand (excluding inventories), whose contribution to quarter-on-quarter growth in output

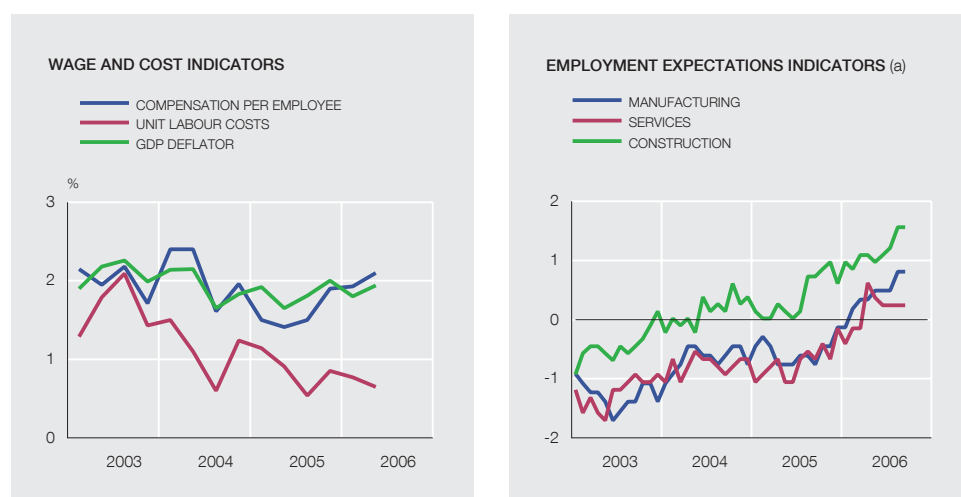


SOURCES: Eurostat and national statistics.

a. Year-on-year rates of change.

was 0.7 pp (see Chart 8). In particular, the main impulse to activity was from gross fixed capital formation (both in capital goods and in construction), which grew at a quarter-on-quarter rate of 2.1%. Nonetheless, behind this acceleration are some exceptional factors relating to the behaviour of investment in construction in Germany. Conversely, both government and private consumption were somewhat sluggish, with their respective quarter-on-quarter growth rates declining by 0.4 pp to 0.5% and 0.3%. The contribution to the quarterly change in GDP of net external demand was virtually nil, compared with 0.4 pp in Q1. This behaviour was in response to the sharper slowdown in exports than in imports. Finally, the contribution of stockbuilding to GDP growth was 0.2 pp, above the negative contribution of -0.4 pp in Q1.

Output accelerated in all branches of activity, although the biggest increase in gross value added at constant prices was in agriculture, construction and the distributive trade. National Accounts country-by-country analysis also suggests that the greater economic dynamism in Q2 was generalised. Most countries posted high quarter-on-quarter GDP growth, between 0.8% and 1.2%. The exception was Italy, where GDP increased by 0.5% (1.5% in year-on-year



SOURCES: Eurostat and ECB.

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

terms), which entailed a slight slowdown on Q1 attributable to the weakness of domestic demand. By contrast, the increase in French and German GDP growth was very high (0.9% and 1.2% quarter-on-quarter, respectively). However, much of the economic acceleration in these two countries is due to the high contribution of stockbuilding, which respectively contributed 0.5 pp and 0.7 pp to the quarterly growth of output. In Germany's case, moreover, the improvement was also due to the exceptional buoyancy of investment in construction, which came about as a result of the unfavourable weather in Q1 and the effect of the elimination of subsidies for owner-occupied housing construction in January 2006, and which countered the deterioration in private consumption.

As regards the labour market, signs of - albeit mild - improvement continued to be seen during Q2. First, employment grew by 0.4% in quarter-on-quarter terms, placing the year-on-year increase at 1.3%, 0.3 pp up on Q1. Nonetheless, the growing weight of part-time hiring means that the rate of increase in employment in equivalent full-time terms is more modest. Further, the euro area unemployment rate continued to decline, though at a lesser pace in recent months, standing at 7.9% in August, a similar level to Q1 and 0.7 pp less than a year earlier. The strong momentum of activity steepened the accelerating profile of productivity, which posted growth of 1.4% in Q2, 0.3 pp up on Q1.

Turning to wages, the related indicators rose slightly during Q2 against the backdrop of the prolonged phase of wage moderation whose determinants are explored in Box 1. In the April-June period, compensation per employee increased by 2.1% in year-on-year terms, 0.2 pp more than in Q1 (see Chart 9). Nonetheless, significant divergences can be seen across the different countries. Whereas there was a marked acceleration in Italy, Spain and Finland, where the year-on-year increase stood at around 3%-4%, the related rate held at virtually zero in Germany. In Q2 the growth of the GDP deflator increased by almost 0.2 pp to 1.9%, which, combined with the further slowdown in unit labour costs to a year-on-year rate of 0.6%, resulted once again in a widening of business margins.

The latest economic indicators for Q3 point to continuing economic dynamism, but perhaps at a somewhat slower growth rate than in the first half of the year (see Chart 10). On the supply

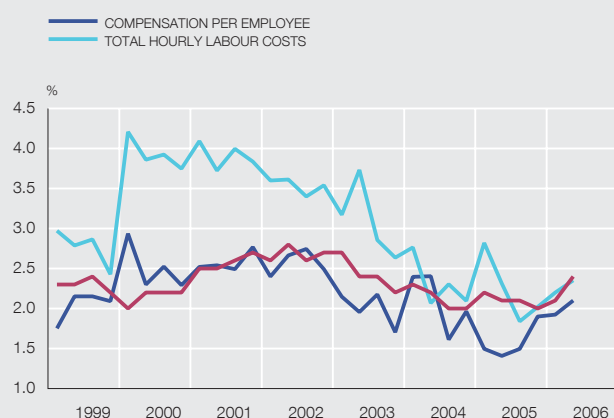
The recent trend of the set of labour costs indicators available in the euro area has moved on a decelerating path in recent years (see panel 1). The year-on-year growth rate of compensation per employee stood at 2% in the first half of 2006, below the average recorded since 1999, although inflation in the euro area has held persistently above 2% virtually throughout the period analysed. Despite undergoing some short-term volatility (and, in particular, a certain rise in the past two quarters), the wage-containment scenario is reflected in other indicators such as negotiated wages or hourly labour costs. Moreover, the moderate growth of compensation per employee has meant that, despite the scant rise in productivity, unit labour costs have slowed, as have real wages (see panel 2).

A simple model for determining wage developments in the euro area suggests that a significant portion of wage growth can be explained by labour productivity and inflation developments, and the positive

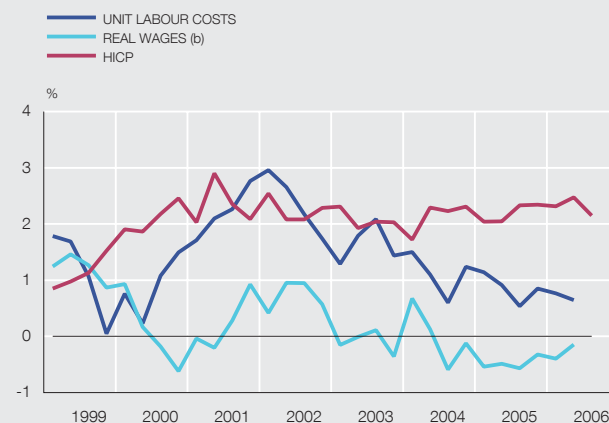
contributions both variables have made to wage growth in recent years confirm this (see panel 3). The situation of greater or lesser dynamism in the labour market -proxied in this equation by the difference between the actual unemployment rate and an estimate of the NAIRU - has also contributed appreciably to the behaviour of wages, meaning that since mid-2003 the slack in the labour market has helped push wages downwards and may account for some of the recent wage moderation.

Nonetheless, panel 3 also shows that, in the most recent period, wages have grown less than would be warranted by the performance of the determinants described in the foregoing paragraph, which points to the existence of other factors potentially behind the wage moderation observed. Firstly, it is possible that the degree of slack in the labour market is not very well reflected by the indicator used in the equation shown. In this respect, it is worth observing the changes in

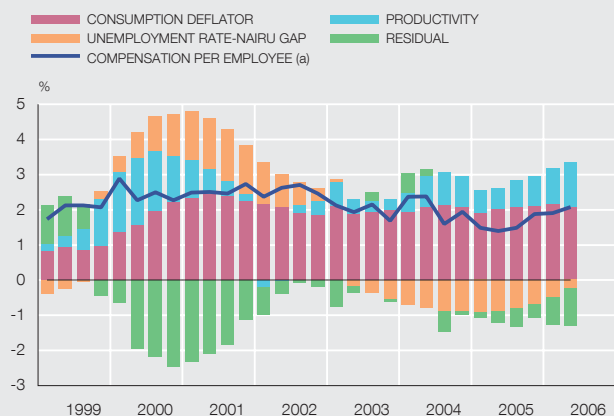
1 RECENT WAGE DEVELOPMENTS IN THE EURO AREA (a)



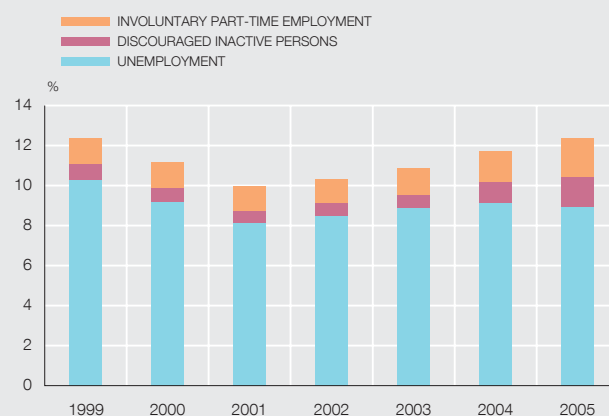
2 LABOUR COSTS, REAL WAGES AND INFLATION (a)



3 CONTRIBUTIONS TO WAGE GROWTH



4 BREAKDOWN OF EXCESS LABOUR SUPPLY (d)



SOURCES: EUROSTAT, ECB and Banco de España.

- a. Year-on-year rates of change.
- b. Compensation per employee deflated by the private consumption deflator.
- c. Contributions to the year-on-year growth rate of compensation per employee obtained from an equation estimated for this variable using the consumption deflator, labour productivity and the gap between the unemployment rate and the NAIRU as explanatory variables.
- d. The aggregate for the euro area has been obtained with figures from the European Labour Force Survey, excluding Belgium, Ireland and Luxembourg, for Q2 each year. The magnitudes are shown as a percentage of an adjusted labour force which, in addition to total employed and unemployed, includes discouraged inactive persons.

excess labour supply when, in addition to the unemployed, other resources available in the labour market, such as the so-called discouraged inactive workers¹ and also part-time workers who state that they would prefer a full-time job, are taken into account (see panel 4). Thus, while the Eurostat official unemployment rate has fallen by more than 1 pp in the past two years, to 7.9% in August 2006, this alternative indicator suggests that the real slackness of the labour market continued and even trended upwards at least until mid-2005, which may have contributed to restraining wage growth. The European Commission's quarterly industrial survey confirms this picture, since the percentage of firms reporting a constraint to production due to labour shortages held at low and stable levels between 2003 and 2005, although this figure has begun to rise appreciably since early 2006.

Secondly, the slowdown in wage growth has taken place despite the fact that the annual average inflation rate has held persistently above 2% in recent years. Actually, behind this persistence has been a series of temporary shocks which have not significantly affected inflation expectations or wage demands insofar as they do not appear to have been interpreted by workers as lasting. Between 1999 and 2002, the influence of high oil prices was intensified by the depreciation of the euro and by other adverse shocks relating to livestock diseases and to the euro cash changeover. Since 2003, fresh shocks

1. Discouraged workers are inactive people who state that they would like to have a job but do not actively look for one because they think they will have no chance of finding one.

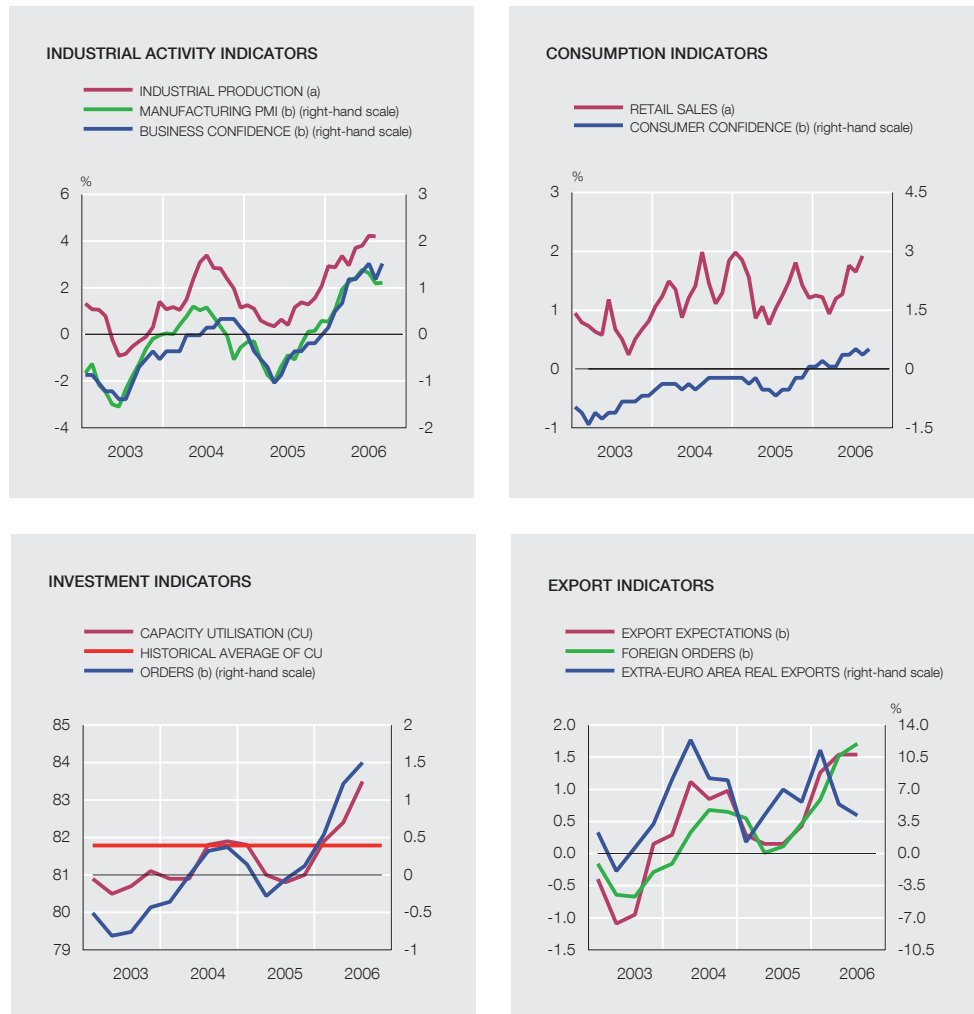
- such as the rise in excise duties on tobacco and in administered prices (e.g. relating to health care), and the recent increases in oil prices - have pushed the euro area inflation rate upwards. The credibility achieved by the European Central Bank in ensuring compliance with its price stability target may have contributed favourably to anchoring these inflation expectations. Further, the absence in most euro area countries of wage indexation systems, combined with the weakness of domestic demand in the recent period, has prompted less wage pressure.

Finally, other factors that might have influenced wage behaviour in recent years should be mentioned. These include most notably some of the reforms recently introduced in European labour markets aimed at making them more flexible, which may have moderated wage growth. Likewise, it cannot be ruled out that the effects of heightening global competition, e.g. the threat of delocalisation, may have increased workers' sense of vulnerability, contributing to keeping their wage demands contained, against the background of the gradual weakening of European trade unions' bargaining power.

On the basis of the information currently available on collective bargaining agreements already signed in the euro area for 2006 and 2007, and bearing in mind the amount of resources still available in the labour market, in the short run slow growth in wage pressures may be expected. However, in the medium and long term, and set against a brighter outlook for the labour market and economic growth, the risks of an increase in wage pressures are on the upside.

side, the industrial production index quickened in August and its year-on-year growth stood at 5.4%, up from 4.5% at the end of Q2. The trend of the qualitative indicators, however, was uneven. On average in Q3, the European Commission's confidence surveys were up on Q2, with bigger increases in industry and construction. However, the Purchasing Managers Indices (PMI) for the manufacturing sector and services fell off in Q3, though they are holding at high levels consistent with robustly expanding activity. The improvement to date in 2006 in job creation expectations in industry and construction continued, while in services there was a slight fall from the maximum levels attained at the start of Q2.

On the demand side, the indicators are also consistent with the expansionary course of activity. The average value of the retail sales index in July and August was 0.8% above the average figure for Q2. New car registrations, by contrast, declined significantly in July, though this was offset partly in August and September. Further, the rise in this indicator in September in Germany might be reflecting the bringing forward of expenditure in the face of the increase in VAT envisaged for January 2007. As regards the Commission's qualitative indicators, intentions to purchase vehicles and housing in the coming 12 months increased. Moreover, consumer and retail trade confidence indicators generally improved in Q3. As to investment in capital goods, the outlook for Q3 is also relatively favourable, as may be deduced from the indicators of industrial orders and their main determinants. The degree of capacity utilisation continued growing to a peak not recorded since 2001, corporate earnings improved and the cost of financing is holding at a low level. However, the European Commission's quarterly business survey for

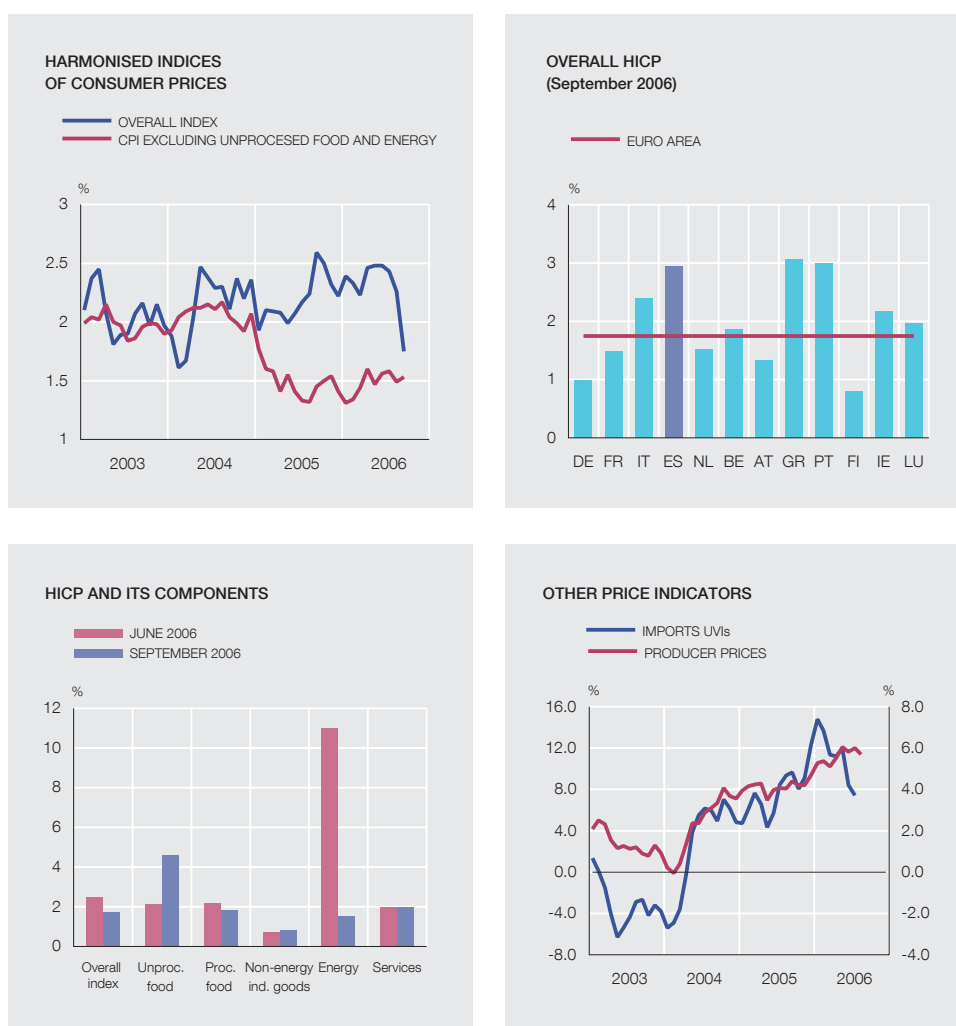


SOURCES: Eurostat and European Commission.

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

the July-September period points to a slight fall in the level of new orders, down from the peak recorded in Q2. On the external demand front, expectations concerning both exports and foreign industrial orders remained in Q3 at the high level attained in Q2, while real extra-euro area exports slowed in July and August.

In view of the foregoing, it seems likely that GDP growth in the area in Q3 and Q4 will be in the upper half of the forecasting interval published by the European Commission, the bounds of which entail a quarter-on-quarter rate of change in GDP of between 0.4%-0.8% in Q3 and 0.2%-0.7% in Q4. Some exceptional developments in the first half of the year and the recent trend of certain variables justify this less sharp GDP growth compared with that observed to June. This would be compatible with annual average growth of over 2.5%, in line with the estimates of most international agencies. In any event, the growth pattern in the short run is subject to sizeable uncertainties relating to the potential anticipatory effects on consumption and investment plans owing to the increase in VAT in Germany in January 2007. In the medium term, economic dynamism in the euro area may be expected to continue, despite the fact that factors such as the foreseeable slowdown in global activity and the restrictiveness of fiscal policy in some euro area countries may dampen it. Nevertheless, this macroeconomic sce-



SOURCES: Eurostat and ECB.

nario is exposed to other downside risks to the economic outlook. There is uncertainty over the future course of energy product prices and, above all, over the importance of the slowdown in the US economy. Finally, the foreseeable course of economic activity in the longer term is affected by the risk of a disorderly correction of global imbalances.

In respect of prices, inflation in the euro area in 2006 Q3 eased - particularly sharply so in September - as a result of the slowdown in the energy component and, to a lesser extent, of the lower growth in processed food prices. The 12-month growth rate of the HICP stood at 1.7% in September, 0.8 pp down on the June figure (see Chart 11). This reduction was seen in all the member states, except in Portugal and Italy, where the effect of the easing in oil prices might be perceived with a delay. The year-on-year growth rate of underlying inflation, proxied by the CPI excluding unprocessed food and energy, held at a moderate figure of 1.5%. The absence so far of underlying inflationary pressures is also apparent in the moderate trend of labour costs and of the indicators of inflationary expectations.

As illustrated in Box 2, growing globalisation and heightened international competition have contributed to containing the inflationary pressures derived from dearer energy products. Nonetheless, the latest information points to some pass-through of the energy bill to certain

	2005				2006			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
GDP								
Year-on-year growth	1.2	1.3	1.7	1.8	2.2	2.7		
Quarter-on-quarter growth	0.4	0.4	0.6	0.4	0.8	0.9		
European Commission forecasts (c)							(0.4 ; 0.8)	(0.2 ; 0.7)
IPI (d)								
Economic sentiment	98.9	96.1	97.9	100.6	103.1	107.2	108.7	
Industrial confidence	-6.7	-10.0	-7.3	-5.7	-2.3	2.3	3.3	
Manufacturing PMI	51.4	49.3	51.0	53.0	54.7	57.1	56.9	
Services confidence	10.7	8.7	10.7	14.0	14.7	19.0	19.7	
Services PMI	53.1	53.1	53.8	55.6	57.8	59.2	57.3	
Unemployment rate	8.8	8.7	8.5	8.4	8.1	7.9	7.8	
Consumer confidence	-13.3	-14.3	-15.3	-12.3	-10.7	-9.7	-8.3	
HICP (d) (e)								
HICP (d) (e)	2.1	2.1	2.6	2.2	2.2	2.5	1.7	
PPI (d) (e)	4.2	4.0	4.4	4.7	5.1	5.8	5.7	
Oil price in USD (e)	53.3	54.0	62.6	56.5	61.6	68.1	61.2	57.4
Loans to the private sector (d) (e)								
Loans to the private sector (d) (e)	7.6	8.1	8.8	9.2	10.9	11.0	11.3	
Euro area ten-year bond yield								
Euro area ten-year bond yield	3.7	3.4	3.3	3.4	3.6	4.0	4.0	3.9
US-euro area ten-year bond spread								
US-euro area ten-year bond spread	0.67	0.80	0.98	1.12	1.06	1.08	1.00	0.90
Dollar/euro exchange rate (e)								
Dollar/euro exchange rate (e)	1.296	1.209	1.204	1.180	1.210	1.271	1.266	1.262
Appreciation/ depreciation of the euro (e)								
Appreciation/ depreciation of the euro (e)	-4.8	-11.2	-11.6	-13.4	2.6	7.8	7.3	7.0
Dow Jones EURO STOXX Broad Index (e)								
Dow Jones EURO STOXX Broad Index (e)	4.3	8.9	17.7	23.0	10.3	4.2	11.9	15.0

SOURCES: Eurostat, ECB and Banco de España.

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

b. Information available up to 20 October 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.

underlying components of inflation, and in particular to non-energy industrial prices, which remain on a rising trend. Second-round effects appear relatively insignificant, given the moderate current increase in wage costs. In any event, risks to inflation in the medium term remain on the upside, since the more dynamic economic setting might be conducive to increasing the intensity of the indirect effects of past rises in oil prices and increased wage demands on the non-energy components of the HICP.

On ECB estimates, the balance of payments deficit on current account was €22 billion in the period from January to August, €13 billion up on the same period in 2005. This increase was the outcome of a smaller surplus on the merchandise balance, as a consequence of the bigger increase in imports than in exports. By contrast, the same period saw net capital inflows in the form of portfolio investment for an amount of €107 billion, which exceeded net outflows under the direct investment heading (€56 billion). Accordingly, in the period of 2006 under study, the basic balance posted a surplus of €29.4 billion, compared with the somewhat higher balance of €34.2 billion in the same period in 2005.

Turning to fiscal policy, the information available on the budget outturn indicates that the buoyancy of the main tax bases is providing for greater-than-forecast tax takings. This will probably lead in most countries to somewhat more favourable budget balances for 2006 than those contained in the stability programmes and in the European Commission's spring forecasts, which point respectively to aggregate deficits for the area as a whole of 2.3% and 2.4% of GDP (see Table 2).

The past decade has seen an intensification of the process known as “globalisation”, a term encompassing a set of diverse developments behind a large-scale and sustained increase in trade, capital and migratory flows, which affect not only the industrialised countries but also some less developed nations. The effect of globalisation on euro area prices may be through various channels, which are illustrated below.

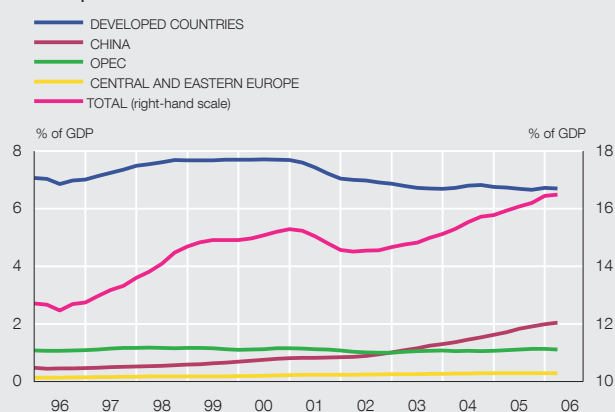
Firstly, globalisation has entailed a notable increase in the relative significance of purchases from less advanced economies, including most notably those from China, whose exports to the euro area have quadrupled in terms of their weight in the area’s GDP (see panel 1). The prices of imported goods exert a direct effect on the HICP, inasmuch as they affect its industrial goods (both energy and non-energy goods alike) component. As can be seen in panel 2, total import prices of manufactured consumer goods have - mainly as a result of changes in the exchange rate of the euro - fluctuated strongly in recent years, which has successively pushed consumer prices in the euro area up and down. If the analysis is confined to the prices of consumer goods imported from the emerging economies (proxied by the prices of manufactures from China), a declining trend is appreciable in the opening years of the century that stabilises subsequently,

which may have contributed to containing inflation in the euro area. In any event, the final impact on euro area inflation would have been quantitatively low, given the weight of consumer goods imports in the private consumption of non-energy industrial goods (around 20%), and the weight of these in the overall HICP (30.7%). The import prices of energy products increased notably, driven by the strong demand for energy from the emerging economies, associated with their high growth rate and with the low energy efficiency of their productive processes. And that exerted a significant upward effect on the euro area HICP (see panel 2).

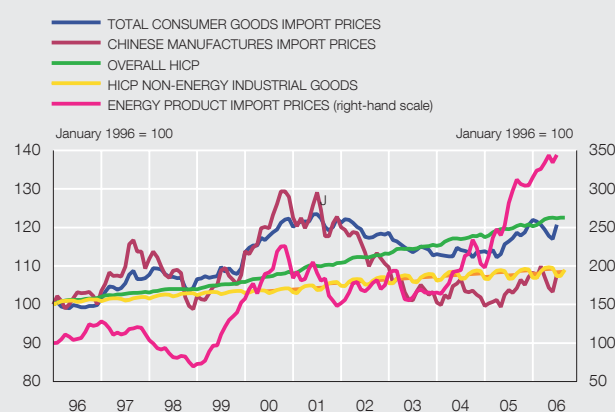
Secondly, a series of indirect effects of globalisation on euro area inflation may be expected. On one hand, greater import penetration means heightened competitive pressure on euro area-located producers of goods similar to those imported, which might translate into narrower margins, insofar as national producers seek to maintain their market share. This competitive pressure may also have boosted productivity as a result of less efficient companies (or production centres) closing. As panel 3 shows, the increase in margins has been greater in the industrial branches, contrary to what might have been expected. That might be related to euro area companies harnessing the advantages of globalisation, shifting some of their production to

1 EURO AREA. GOODS IMPORTS

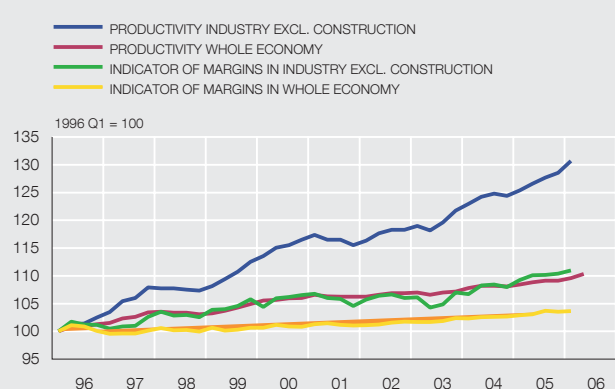
Constant prices



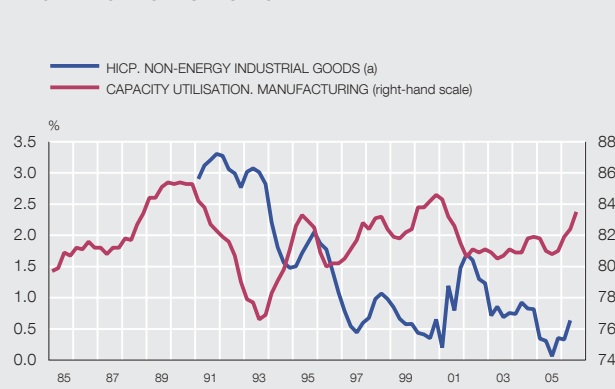
2 HICP AND IMPORT PRICES



3 PRODUCTIVITY AND INDICATORS OF MARGINS



4 HICP AND CAPACITY UTILISATION



SOURCES: European Commission and ECB

a. Year-on-year rate of change.

countries with lower costs, which has enabled them to widen their margins, despite the containment of their product selling prices. While productivity in the branches most exposed to foreign competition has increased by a far superior proportion than that of the rest of the economy, this is a secular trend which, therefore, is not necessarily linked to the process of globalisation. Nonetheless, studies conducted with disaggregated data appeared to indicate that the increase in productivity is actually greater in those industrial sectors in which import penetration has increased at a higher rate¹.

One additional indirect effect of globalisation on inflation would arise as a result of the increase in labour supply (owing to the influx of immigrant labour), which may help contain wages, especially in the least skilled jobs. Moreover, relocating (or the possibility of relocating) production activities to other countries may, in some cases, be an incentive for accepting lower wage increases (or reductions) in exchange for maintaining the level of employment. In this respect, the role of globalisation would, as discussed in Box 1, help account for the unexplained part of recent wage developments in the euro area.

1. See, for example, chapter 3 ("How has Globalisation Affected Inflation?") of the *World Economic Outlook*, International Monetary Fund, April 2006.

Lastly, globalisation may have lessened the influence of internal economic conditions in the euro area on the inflation rate, insofar as demand pressures, for many products, should not be measured by comparing demand with domestic supply but with the global supply of such goods. Accordingly, it is possible that persistent positive values in respect of the output gap will not be accompanied by inflationary pressures if this excess demand is covered by foreign production. Conversely, low capacity utilisation at the local level may be accompanied by an increase in inflation if, at the global level, the output gap is positive. In this respect, this effect does not appear to be perceptible in the case of the euro area, since a relatively close link is maintained between excess demand in the area and inflation, as reflected in panel 4.

In conclusion, the effects of globalisation on euro area inflation have broadly been favourable, but difficult to quantify. However, there is no guarantee this influence will continue to be benign in the future. In particular, at the current juncture, the maintenance of a prolonged period of high growth in the world economy may ultimately exert pressure on the productive capacity of both the developed countries and, in particular, the emerging economies, which may translate into inflationary pressures arising.

GENERAL GOVERNMENT BUDGET BALANCES OF EURO AREA COUNTRIES (a)

TABLE 2

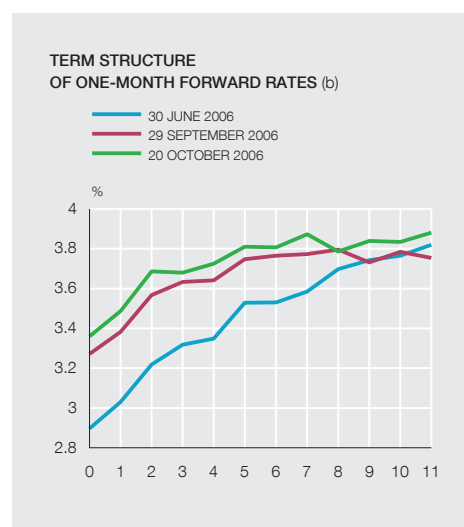
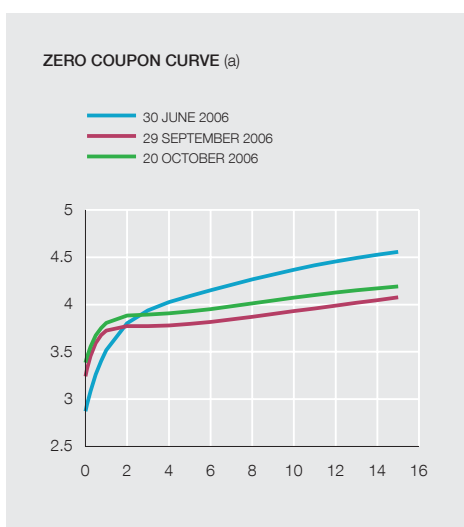
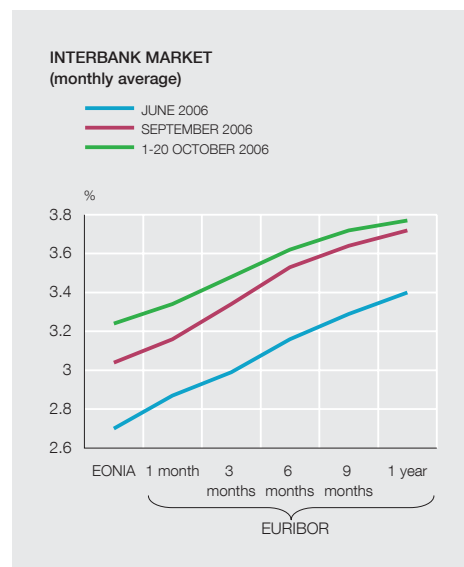
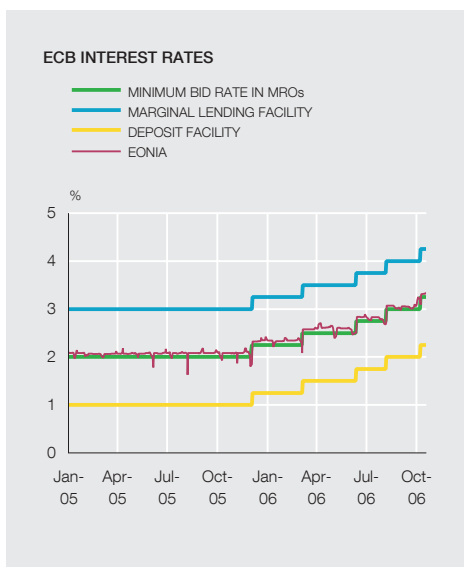
% of GDP					
	2003	2004	2005	2006 (b)	2006 (c)
Belgium	0.0	-0.1	-2.3	0.0	-0.5
Germany	-4.0	-3.7	-3.2	-3.3	-3.1
Greece	-5.8	-6.8	-5.2	-2.6	-2.9
Spain	-0.1	-0.2	1.1	0.9	0.9
France	-4.2	-3.7	-2.9	-2.9	-3.0
Ireland	0.2	1.6	1.1	-0.6	0.1
Italy	-3.5	-3.5	-4.1	-3.5	-4.1
Luxembourg	0.2	-1.1	-1.0	-1.8	-1.8
Netherlands	-3.2	-2.1	-0.3	-1.5	-1.2
Austria	-1.7	-1.2	-1.5	-1.7	-2.0
Portugal	-3.0	-3.2	-6.0	-4.6	-5.0
Finland	2.4	2.1	2.7	1.6	2.6
MEMORANDUM ITEM: Euro area					
Primary balance	0.3	0.3	0.6	0.7	0.6
Total balance	-3.1	-2.8	-2.4	-2.3	-2.4
Public debt	69.3	69.8	70.8	70.8	70.5

SOURCES: European Commission and National Stability Programmes.

a. As a percentage of GDP. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.

b. Stability Programme targets.

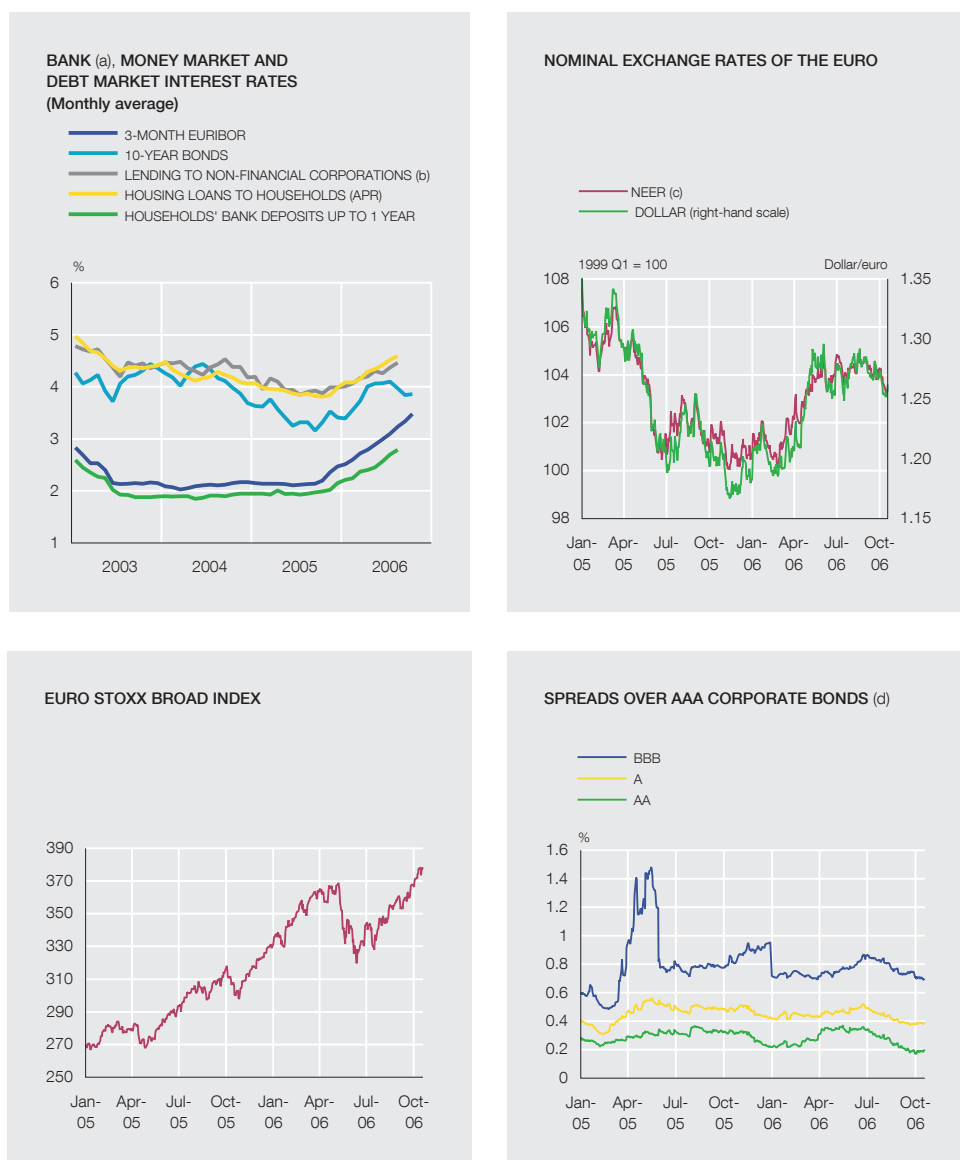
c. European Commission forecasts (spring 2006).



SOURCES: ECB and Banco de España.

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

In the five countries with an excessive deficit procedure open, significant progress is generally expected owing to the combination of the favourable effect of the economic situation and greater fiscal discipline. In the case of Germany, the Ecofin Council concluded at its meeting on 9 September that the measures proposed by this country to correct the excessive deficit were acceptable. Further, the German government has announced that higher-than-forecast tax receipts will mean that the budget deficit may stand below 3% in 2006, bringing forward by one year the term set in the Council's recommendation. In France, the draft budget for 2007 has been unveiled. It includes a tax reform with a reduction in revenue and a containment of expenditure that resides, above all, on lower public-sector employment. Finally, Italy presented in September a draft budget for 2007 that envisages a reduction in the budget deficit to below 3%, with measures residing essentially on the revenue side and which also give priority to redistributive goals. In any event, there is much uncertainty over the final text, which requires consensus on the part of the governing coalition. Following the publication of the draft budget, two credit rating agencies decided to downgrade Italy's government debt.



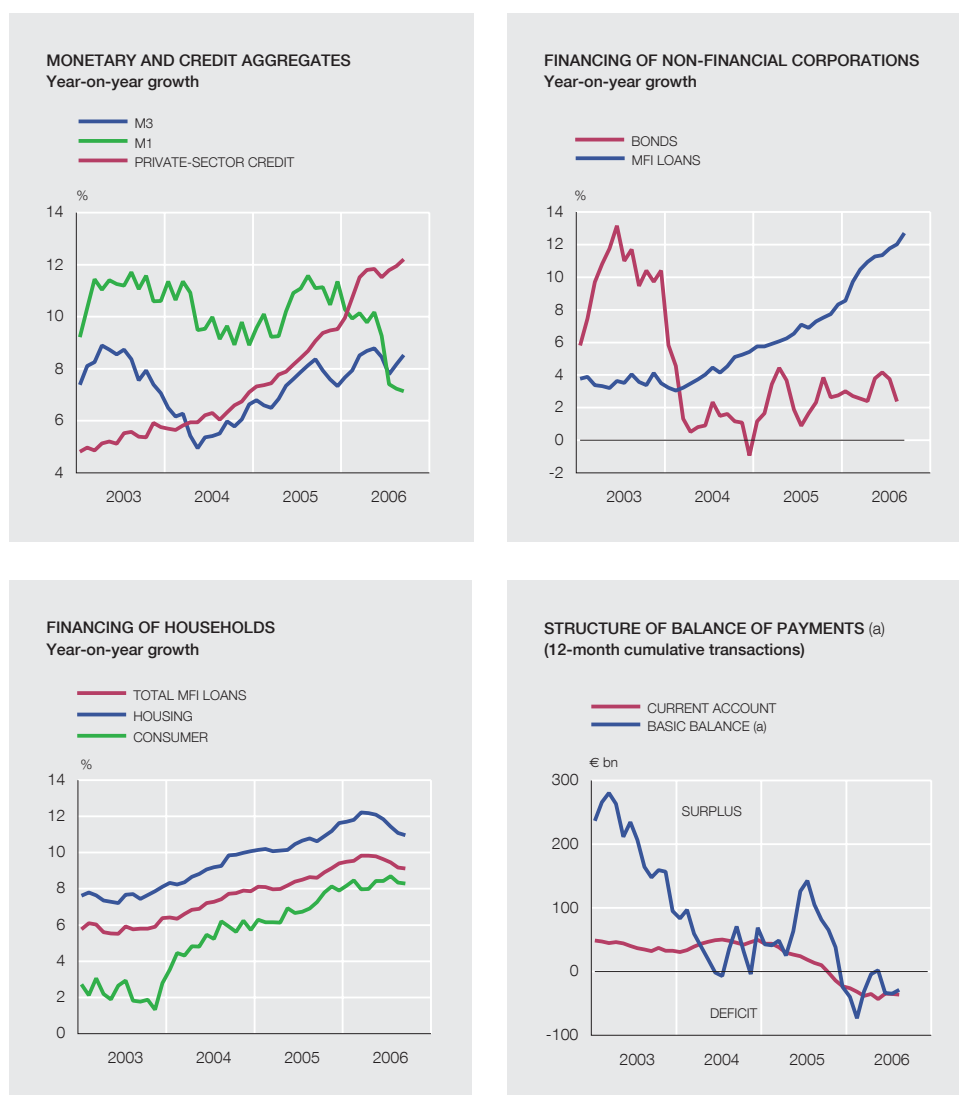
SOURCES: Banco de España and ECB.

- a. Data drawn from new statistics on interest rates compiled by the ECB for new business.
- b. Interest rates over five years.
- c. Nominal effective exchange rate index (EER-23). Narrow group of currencies defined by the ECB.
- d. Euro-denominated bonds issued by non-financial corporations.

As regards the long-term sustainability of public finances, the European Commission's first report dedicated exclusively to this matter, which was released in October, has once again highlighted the scale of the pressure posed by population ageing. According to the report's predictions, the risks to sustaining public finances in the long run are medium to high for all euro area countries except Austria, Finland and the Netherlands. Consequently, the current greater economic dynamism in the euro area should be harnessed by the member states to make more resolute headway in the process of fiscal consolidation.

3.2 Monetary and financial developments

The continuing high risks to price stability in the medium term, against a background of growing economic strength, led the ECB Governing Council to continue gradually withdrawing the monetary stimulus. At its meetings on 3 August and 5 October, it thus decided to raise the minimum interest rate on its main refinancing operations by 25 bp on each oc-



SOURCES: Banco de España and ECB.

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

cession, taking the rate to its current level of 3.25%. Interest rates on the marginal lending facility and the deposit facility increased by the same amount to 2.25% and 4.25%, respectively (see Chart 12). Despite these rises, the monetary policy stance remains accommodative, whereby these decisions do not pose an obstacle to the continuation of the current upturn.

On the interbank market, the expectations of increases to benchmark interest rates during Q3 gave rise to a gradual upward shift in the curve. Conversely, longer-dated government debt market yields declined significantly in August and September, this being offset partly in October to date, giving rise to a most significant flattening of the curve. These developments were similar - but more marked - in the United States, resulting in a narrowing of the 10-year debt spread to around 0.9 pp. Lastly, the interest rates applied by credit institutions in their lending and deposit transactions in July and August extended the upward trend in such rates seen since end-2005, in step with the successive rises in official rates (see Chart 13).

With regard to the exchange rate of the euro, fluctuations against the dollar and in terms of the nominal effective exchange rate (NEER) were limited. Over the quarter as a whole there was a slight depreciation in the euro, meaning that its rise since the start of the year in relation to the dollar and the NEER is around 7% and 3%, respectively. Indices in the euro area equity markets moved on a marked rising trend, supported by the abatement of uncertainty and the soundness of current and expected corporate earnings. The EURO STOXX index duly offset the strong declines in May and June, and shows a rise of close to 15% in the year to date.

The M3 monetary aggregate remained expansionary during Q3, with a year-on-year growth rate of 8.5% in September, a similar level to June (see Chart 14). Moreover, past rate rises and expectations of fresh ones appear to have introduced some changes into the composition of M3, with a notable slowdown in the most liquid components and greater strength in other deposits (other than overnight deposits) and in negotiable instruments. Monetary financial institutions' loans to the private sector continued to quicken, in particular those to non-financial corporations, which increased by 12.7% year-on-year in September, compared with 11.4% at the end of Q1. Bank lending surveys conducted during Q2 lend support to the ongoing expansion of credit to companies. In addition to low interest rates, investment in fixed capital and stocks, mergers and acquisitions and corporate restructuring were also significant drivers. Loans to households remained very buoyant, with year-on-year growth of 9.1% in September, as part of a mild slowing trend which is due to the moderation in the growth of credit for house purchases. According to the bank lending survey for the euro area, the acceleration in consumer credit during Q2 was in response to the greater demand for durable goods, against the background of a slight easing in credit approval criteria. Finally, as regards country-by-country developments in credit to the private sector, this variable seems to be becoming more dynamic in Spain, France, Italy and, more modestly, in Germany, where the year-on-year rate of increase stands at around 4.5%, far below the euro area average.

4 The Spanish economy

On QNA estimates, GDP growth in 2006 Q2 was 3.7%, 0.1 pp up on the previous quarter. In quarter-on-quarter terms, the increase was 0.9%, unchanged on Q1. During this period national demand continued to post lower rates of increase, while net external demand contributed 0.3 pp to the acceleration in output. The information available for Q3 suggests that the year-on-year growth rate of GDP has continued rising up to 3.8%, likewise entailing quarter-on-quarter growth of 0.9%. Behind this performance was the continuing buoyancy of national demand – since household consumption and gross fixed capital formation were broadly estimated to have held stable – and the fresh positive contribution of the external sector to the change in GDP growth (see Chart 15). This improved contribution of external trade transactions was, in turn, the outcome of a rate of increase in exports similar to that of the previous quarter and of the lesser momentum of goods and services imports, although these continued to grow at higher rates than sales abroad.

Activity across the various branches shows that the greater dynamism of the Spanish economy is generalised, with notable momentum in manufacturing industry value added. The main employment indicators for Q3 also show a continuing sharp rate of increase. Against this background, apparent labour productivity is estimated to have expanded at a moderate rate (0.4%), although the lesser pace of compensation per employee in the market economy meant that unit labour costs eased back slightly. Conversely, the operating surplus per unit of output has sustained a relatively high growth rate, whereby price increases have continued at a comparatively high rate. Consumer prices moderated substantially in August and, especially, in September, due above all to cheaper oil. As a result, the 12-month growth rate of the CPI stood in September at 2.9%, 1 pp below the rate in June, returning to levels not seen since the opening months of 2004. The CPI excluding unprocessed food and energy likewise posted growth of 2.9% in September, although in this case the decline in relation to June was only 0.1 pp.

4.1 Demand

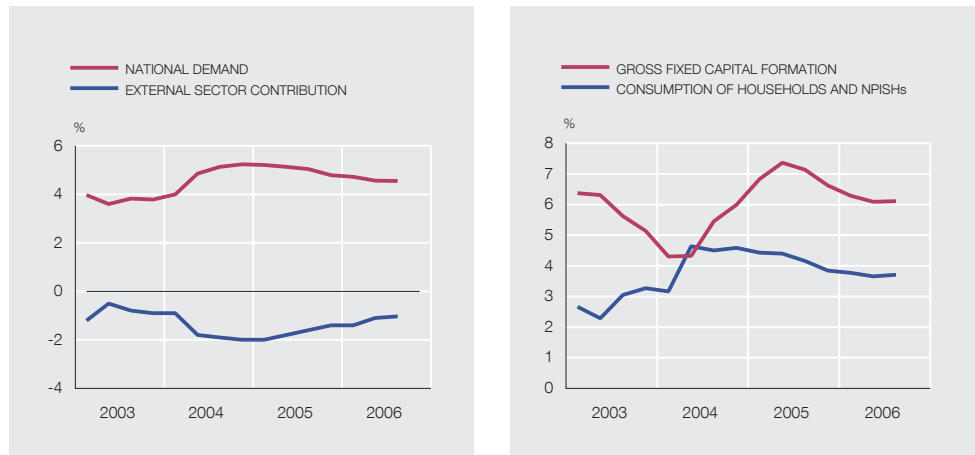
In 2006 Q2, private consumption grew at a year-on-year rate of 3.7%, 0.1 pp down on the previous quarter. It thus continued on the mildly slowing path on which it embarked at the start of the previous year. The latest conjunctural information, though incomplete as far as the data for Q3 are concerned, does not show any significant changes in the pattern of behaviour of Spanish households' final consumption (see Chart 16).

The synthetic indicator of private consumption of goods and services showed very similar growth to that of the previous quarter. The retail sales index improved notably, especially in its non-food component, which is in step with the surveyed business opinions in the sector. Car sales fell once more in Q3, albeit at a lesser rate than in the spring months. Finally, consumer confidence worsened slightly in relation to the first half of the year.

In 2006 to date, household consumption has been against a background marked by the diminished buoyancy of their disposable income in real terms, due among other reasons to the fall in net interest received (in a context of rising interest rates and greater household debt), to the increase in tax payments and to the deterioration in purchasing power caused by the rise in the inflation rate. However, household wealth has continued to increase at a high rate, reflecting the appreciable rise in stock market prices, which have grown by more than 20% in the first nine months of the year, and the notable increase in property wealth, despite the smaller rise in house prices. In view of these determinants, and as highlighted by the non-financial accounts of the institutional sectors to Q2, whose results are analysed in Box 3, house-

MAIN DEMAND AGGREGATES (a)

CHART 15

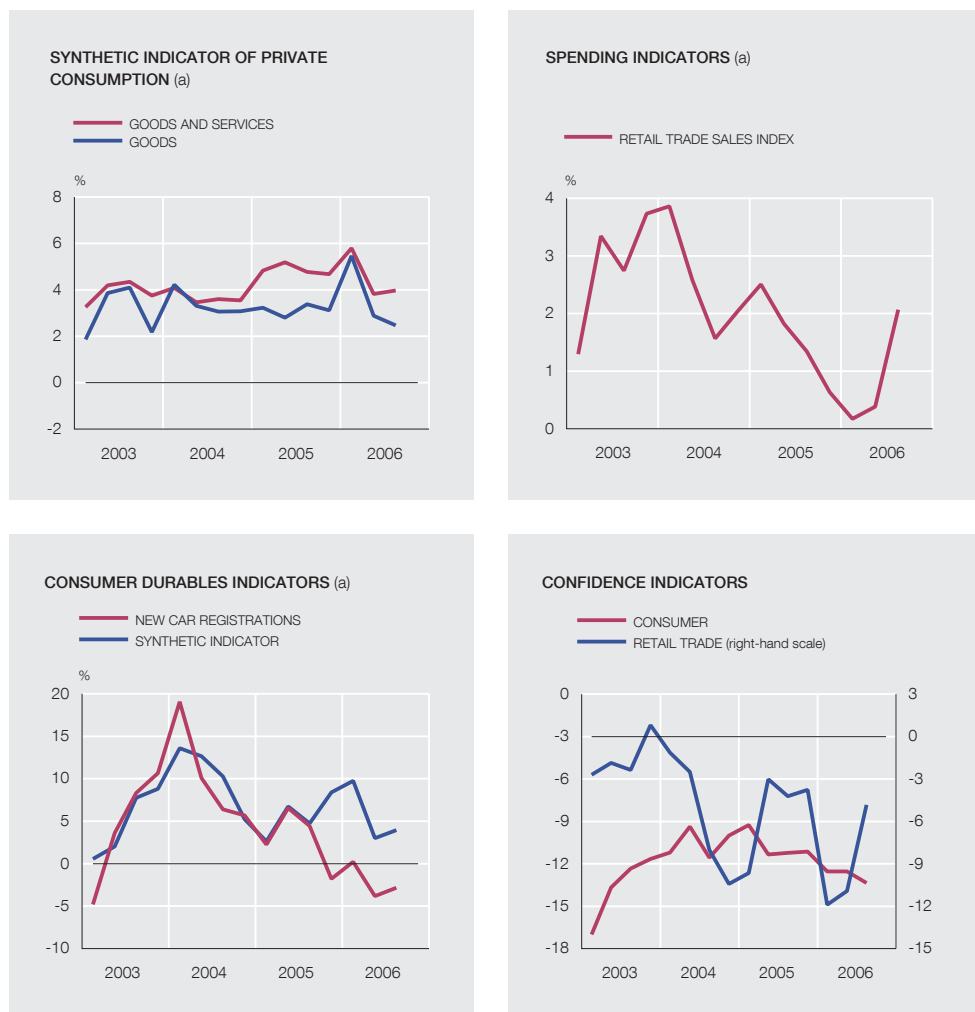


SOURCES: INE and Banco de España.

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

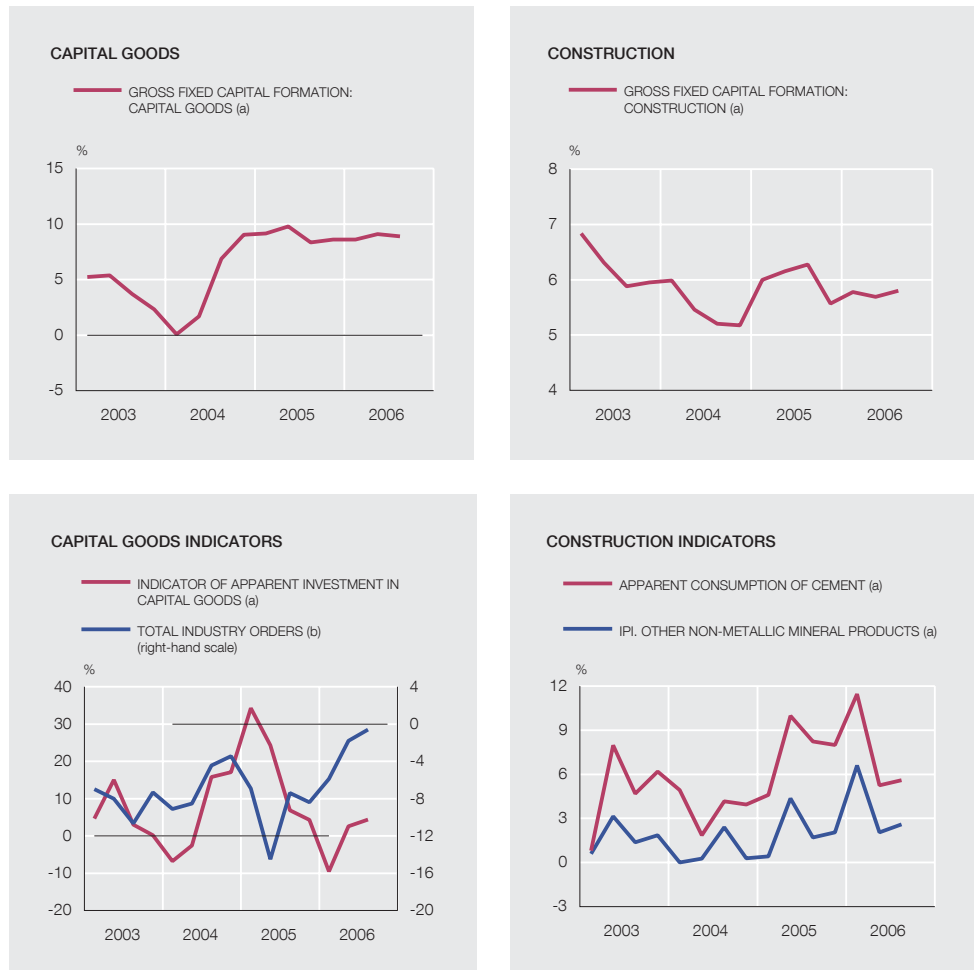
PRIVATE CONSUMPTION INDICATORS

CHART 16



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

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



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.

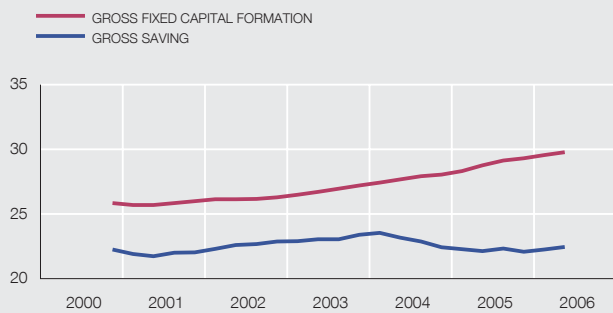
hold consumption is estimated to have continued growing at a higher rate than household disposable income, meaning that the saving ratio has continued to decline. In any event, the substantial reduction in inflation in recent months should improve the purchasing power of household income and draw the growth of household spending closer to the rate of expansion of their disposable income.

In 2006 Q2, final general government consumption posted an increase of 4.4%, unchanged on Q1. The information available points to some acceleration in this spending component in Q3 that is related to its trend in territorial government.

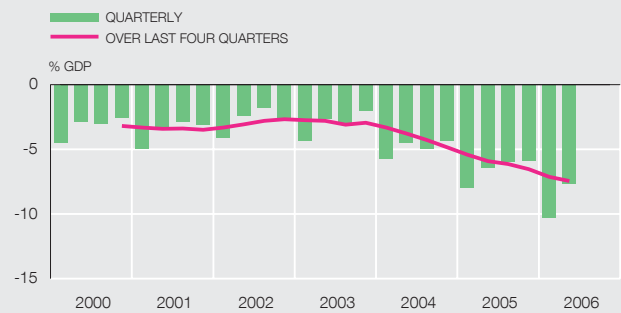
The forceful pace of gross fixed capital formation eased once again in Q2 to 6.1%, 0.2 pp down on Q1. This slowdown was the result, above all, of the lesser increase in investment in other products (a component linked to property promotion and intermediation and to software acquisition), whose year-on-year rate dipped by 1.5 pp to 3.3%, while investment in construction slowed slightly, posting growth of 5.7%. Investment in capital goods rose to 9.1%, 0.5 pp up on the previous quarter (see Chart 17). The information provided by the indicators for Q3 suggests that gross fixed capital formation continued to expand at a similar rate to that in Q2, as a

TOTAL ECONOMY

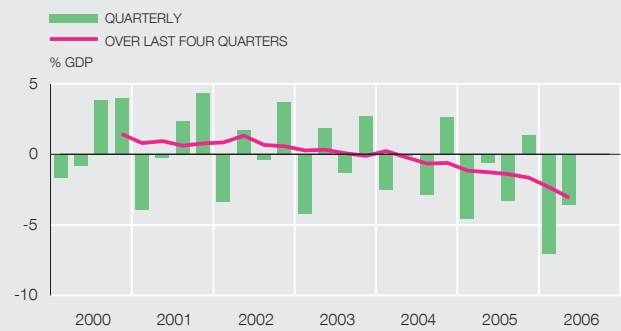
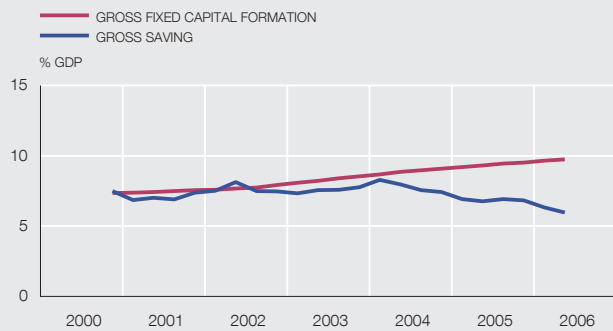
1. GROSS SAVING AND GROSS FIXED CAPITAL FORMATION (a)



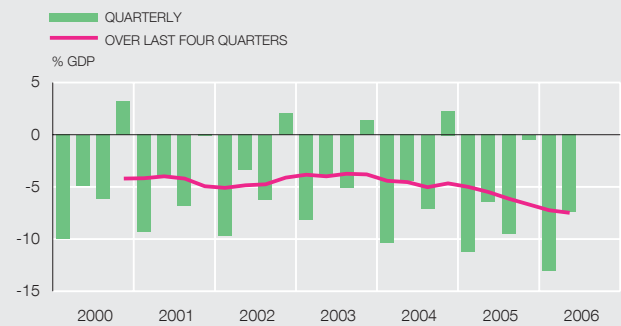
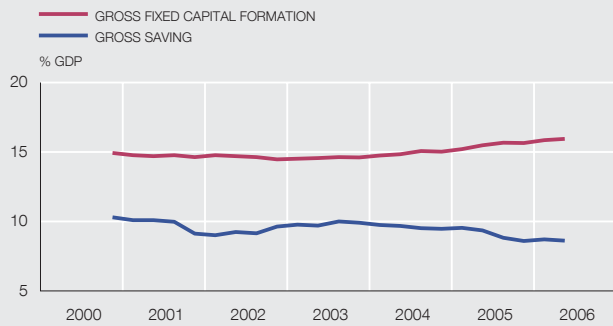
2. NET LENDING / NET BORROWING



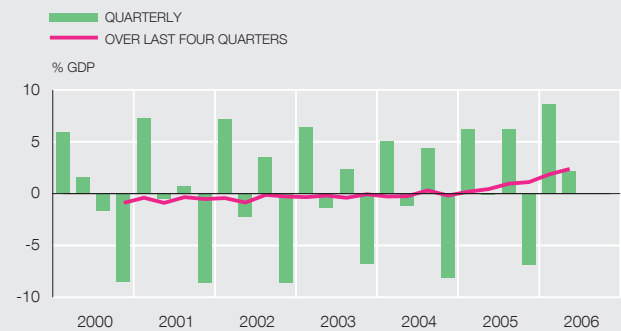
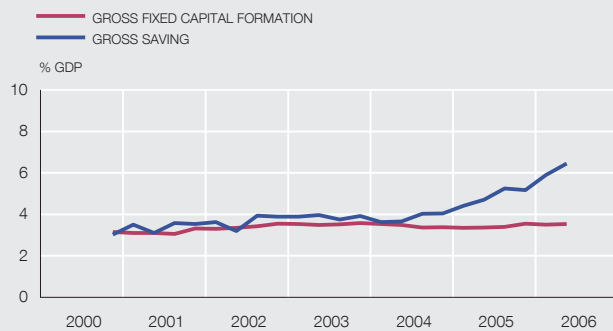
HOUSEHOLDS AND NPISHs



NON-FINANCIAL CORPORATIONS



GENERAL GOVERNMENT



SOURCE: INE.

a. Over last four quarters.

In January 2006, INE began to publish quarterly non-financial accounts of the institutional sectors of the Spanish economy, as part of a wider objective to set in place a system of European Union and euro area annual and quarterly accounts¹. This system covers in a consistent and integrated fashion the main macroeconomic aggregates from the standpoint of demand, supply and income, along with the transactions of the institutional sectors, whether financial (compiled in the quarterly financial accounts published by the Banco de España) or non-financial (those that the INE began to disseminate in January). Currently, these non-financial accounts are published with a lag of approximately one quarter, whereby the latest figure available is for 2006 Q2. This means that, for the first time, comprehensive information is available on the non-financial balances of all sectors of the Spanish economy for the current year.

The series published consist of raw data that have not been seasonally adjusted, meaning that comparisons between two quarters are not very informative, owing to the marked seasonal profile of most of these series (e.g. general government gross fixed capital formation surges in the last quarter of each year and falls, likewise sharply, in the following quarter, owing to public works expenditure recognition procedures). One possible approach to circumvent this problem is to examine the cumulative figures over the last four quarters.

According to the quarterly data of the sectoral accounts, the deterioration in the Spanish economy's net borrowing continued in 2006, accounting for 7.4% of GDP on cumulative data to Q2, 0.9 pp above the 2005 figure (see accompanying panel). The recovery in national saving in the first half of 2006 proved insufficient to finance the increase in

gross fixed capital formation. This shortfall was exacerbated by the reduction in capital transfers from abroad during the first half of the year.

The increase in the nation's net borrowing during the first half of 2006 was due to the widening of the gap between the saving and investment of the non-financial private sector (households and NPISHs, and non-financial corporations), since their borrowing requirements increased by 2.2 pp of GDP in relation to the end of 2005, which has been partly offset by an increase in general government lending capacity. Financial institutions' lending capacity has remained similar to that in 2005.

Net borrowing of households and NPISHs increased in the first two quarters of 2006 to 3.1% of GDP, on cumulative data to Q2. This figure, which entails an increase of 1.4 pp of GDP compared with the 2005 figure, was the outcome of a decline in household gross saving in the first half of the year (the saving ratio, which was 9.4% drawing on cumulative data, fell by 1.2 pp in relation to 2005) and of the ongoing uptrend in gross capital formation. The slowdown in income in recent quarters (with a rate of increase of 6.1%, against 6.9% in 2005), which has fed through only in part to consumption, accounts for the reduction in household saving.

Non-financial corporations maintained a level of saving in relation to GDP similar to that at the end of 2005. However, investment by the sector expressed as a share in GDP has continued to increase in recent quarters, whereby the related borrowing requirements have remained on the up, rising to 7.5% of GDP in 2006 Q2, compared with 6.7% in 2005.

Finally, general government net lending has increased in the opening quarters of 2006 to 2.4% of GDP, 1.3 pp above the figure for 2005. The increase in public saving in this period (1.3 pp of GDP) was the factor behind this development.

1. The quarterly non-financial accounts of the institutional sectors can be found at www.ine.es and also, with the source indicated, in the first chapter of the financial accounts of the Spanish economy, at www.bde.es.

result of the resilience of spending on capital goods, which remains the most buoyant component of domestic demand, and of investment in construction, the dynamism of which might even increase.

The indicators relating to expenditure on capital goods in Q3 generally paint a positive picture. The indicator of apparent investment in capital goods, calculated with incomplete data for this period, showed more momentum than in the first half of the year. This was thanks to the strength of the domestic production of capital goods (growth to August in 2006 of close to 10%), which has replaced imports of capital goods as the basic means of incorporating new productive capital. Orders for industry as a whole improved somewhat in this period, as did the indices of turnover and incoming orders for capital goods, while the number of companies that consider their plant capacity excessive fell. Conversely, survey-based indicators for this branch of industry, such as the business climate and orders surveys, worsened somewhat in Q3. The level of capacity utilisation declined during this quarter, which would denote a less positive assessment about the need to increase investment in capital to raise output.

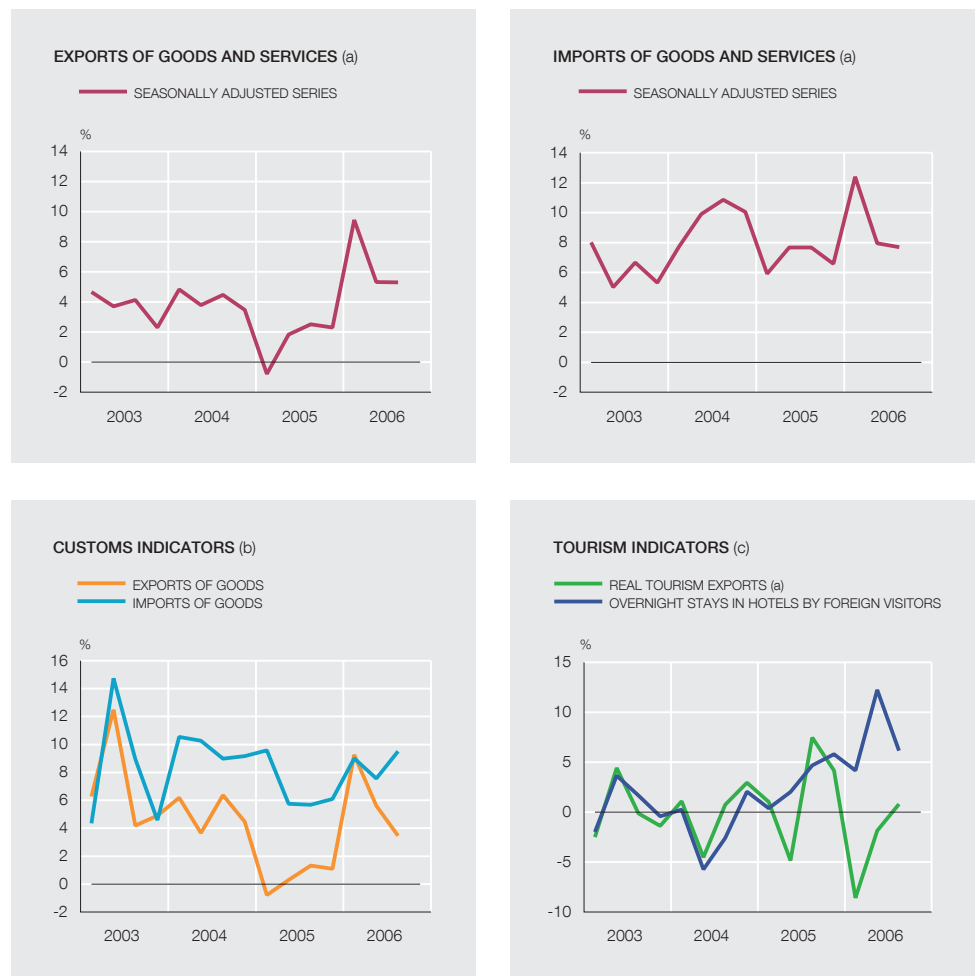
Investment in construction increased by 5.7% in 2006 Q2, in line with the high growth rate observed in the preceding quarters. Judging by the latest conjunctural information, this dynamism may continue in the coming quarters. The favourable trend of the confidence and employment indicators in September confirms the intensity of construction activity in Q3 as a whole. The indicators of building materials used, with information to August, also point to a more favourable trend than in the previous quarter.

By type of work, investment in housing increased by 6.5% in Q2, meaning its average growth in the first six months of 2006 exceeded that of the preceding years. According to the leading information provided by the Ministerio de Fomento's work approvals statistic, allocated in time according to a project execution schedule, residential construction might quicken somewhat in the second half of 2006. Conversely, investment in other construction segments – non-residential building and civil engineering works – grew by 4.8% in Q2, notably down on 2005. The conjunctural information is scater and more uncertain for this type of work. Non-residential building appears to be exhibiting a degree of stability which is based on the strong growth of works executed by general government. Civil engineering works, in the absence of full information on private sector-promoted works, is also proving more robust in the second half of 2006, in keeping with the period-adjusted data on government procurement.

Regarding the financial position of companies, figures from the Banco de España Central Balance Sheet Data Office's quarterly survey (CBQ) for the first two quarters of 2006 show an acceleration in activity and employment at the companies reporting to this survey, to which all sectors have contributed, particularly the distributive sector and industry. The momentum of business activity has been accompanied by a slight increase in the return on investment and by the maintenance of the cost of borrowed funds, which increases the attractiveness of making new investments. The financial pressure indicators, calculated with CBQ data, are holding at favourable levels, having improved slightly in the recent period. Nonetheless, these results largely reflect the position of major corporations (which are predominant in the CBQ survey), and the financial position of smaller corporations may be subject to greater pressures arising from dearer borrowed funds. The changes in the borrowing requirements of non-financial corporations, which increased once again in 2006 Q2, are along these lines.

In 2006 Q2, net external demand contributed 0.3 pp to the acceleration in GDP, although its contribution to GDP growth was still negative (–1.1 pp). External trade flows eased back during this period in relation to the unusually high rates recorded in Q1. Real exports of goods and services continued to trend favourably, posting a year-on-year growth rate of 5.3%, although their rate of increase fell in relation to the figure of 9.5% in Q1. Real imports of goods and services moderated to a year-on-year rate of 7.9%, against 12.4% the previous quarter, but this was nevertheless above the average growth for 2005. The as yet incomplete information for 2006 Q3 suggests net external demand may have continued contributing slightly to the acceleration in GDP, thanks to the firmness of exports, in line with the trend observed in the spring months, and to a slight loss of momentum in imports (see Chart 18).

Real goods exports grew by 4.7% in 2006 Q2 compared with the same period a year earlier, following their notable increase the previous quarter (13%). The latest Customs foreign trade figures for July and August show somewhat less dynamism than in Q2 owing to the slackness of real exports in July, since sales abroad in August resumed high rates of increase. By geographical area, sales to the EU quickened in the summer months, with a notable increase in exports to some of our main markets, such as Italy and France. That said, exports have grown



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.

at substantially higher rates in non-Community markets, in particular in the United States, Latin America and Russia.

In 2006 Q2, the year-on-year rate of decline of real exports of tourist services fell to -1.8%, from -8.6% the previous quarter. During the summer months, when tourist inflows are at their highest, the main tourism indicators in real terms were favourable. In Q3, overnight stays by foreign visitors in hotels grew by 5.6%, while the number of tourists rose by 3.7%; that said, these figures are somewhat down on Q2. According to EGATUR, total tourism expenditure in nominal terms in July and August increased by 4.6%, with a slight rise in average spending per tourist, albeit at a low rate (1.4%). This downtrend in average spending per tourist is affected by shorter stays, but also by the greater use of lodging off the habitual tourist circuit or stays in own property. That said, the possibility that there is some downward bias in the survey data during 2006, particularly in the opening months, should not be ruled out. Regarding Spain's main markets of origin for tourists, the British and German markets performed moderately in Q3, while French tourism fell off. As a result, tourists from Italy and from outside the euro area were those that most increased in the summer months.

Real exports of non-tourist services grew by 14.8% in 2006 Q2, prolonging the uptrend of the previous quarters. In this period both foreign sales of transport services and exports of business services, which are the main items, maintained high rates of increase.

In 2006 Q2, the year-on-year growth rate of real goods imports eased to 7.5%, down from 11.3% the previous quarter. The Customs data available for Q3 suggests that purchases abroad will retain the momentum of the previous months. By product group, purchases abroad of intermediate goods (energy and non-energy alike) and of capital goods, particularly machinery, were highly dynamic in July and August, while imports of consumer goods grew at a more modest rate, down on the first half of the year.

Finally, the pace of real imports of services slackened in 2006 Q2 to 9.5%, down from 16.8% in Q1, thereby interrupting the notably accelerating profile they had shown since the previous year. This was due to the more moderate trend of both tourist services and other services.

4.2 Output and employment

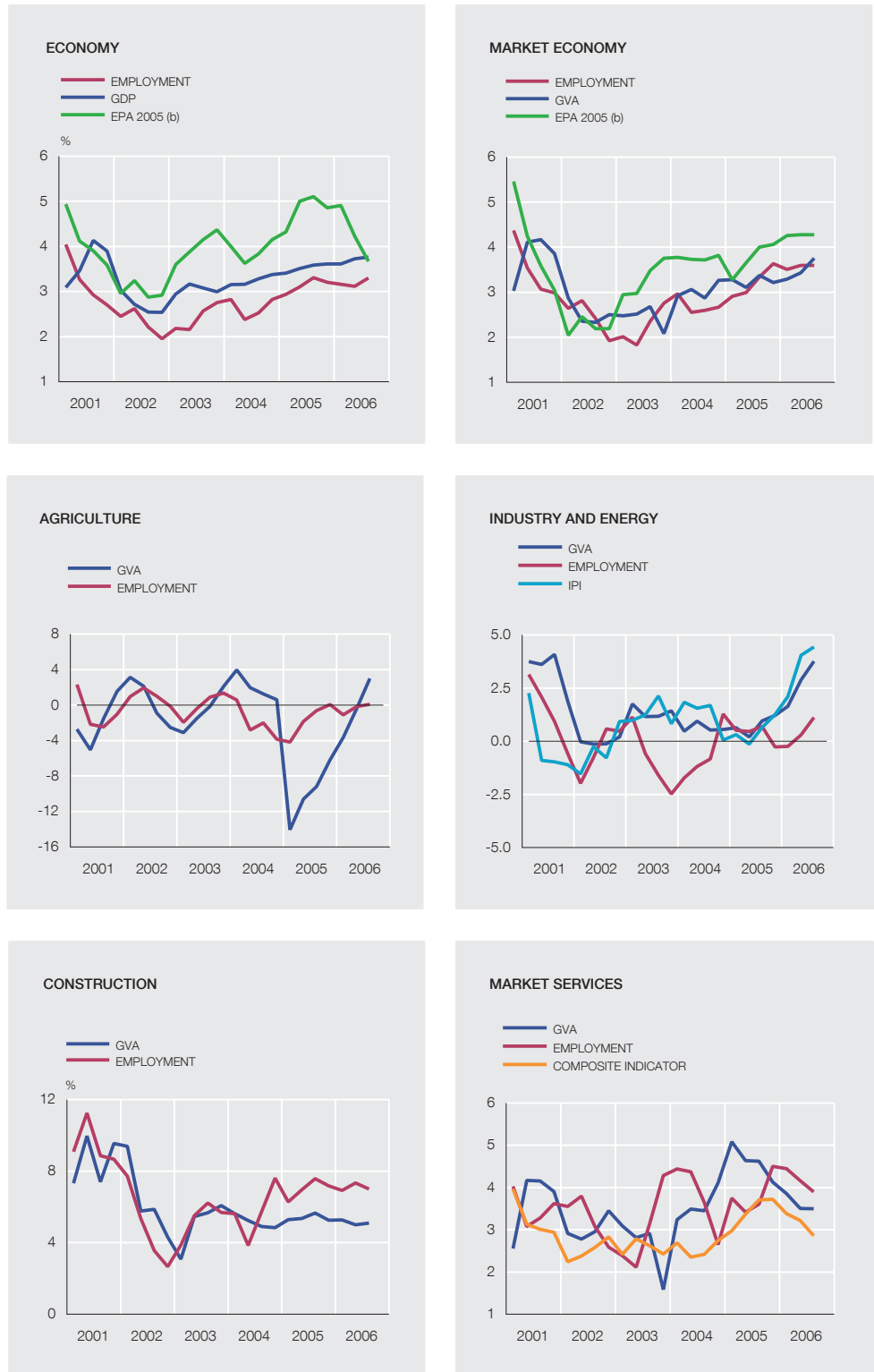
The market economy showed fresh momentum in 2006 Q2, and its gross value added increased by 3.4%, 0.1 pp up on Q1. Behind this greater robustness were the increases in the industrial and energy branches and, to a lesser extent, in agriculture, in contrast to the diminished dynamism of construction and market services (see Chart 19). According to the information available, value added would have continued accelerating in Q3 thanks to the recovery in the agricultural branches and to the continuing vigour of industry.

Less unfavourable weather than in 2005 allowed for the pick-up in the agriculture and fisheries branches. Specifically, these branches posted year-on-year growth of -0.4% in Q2, 3.3 pp more than in Q1. This trend is expected to continue in Q3 in view of the improvements envisaged in most crop yields.

The recovery dating back to mid-2005 in the industrial and energy branches also continued in Q2. Here, the related year-on-year growth rate stood at 2.9%, 1.3 pp up on the previous quarter. The increase was centred on the industrial branches, since the growth rate in the energy branches held stable at 3.2%. The expansion of output was across the board, though it was particularly sharp in capital goods, which benefited both from high domestic demand and from the recovery in sales abroad. The conjunctural information available indicates that the dynamism of industrial activity has continued into Q3. The industrial production index increased by 4.6% in the July-August period, in year-on-year and calendar-adjusted terms, a higher rate than in Q2. The employment indicators, such as numbers registered with the Social Security system, showed a similar performance in Q3 to that in the previous quarter, while the European Commission's confidence index posted an increase of 1 pp and the manufacturing PMI scarcely varied.

The marked momentum of construction continued in Q2, though some moderation was observed. Gross value added in this branch increased by 5% over the period from April to June, 0.3 pp down on Q1. As discussed in the previous section, this loss of steam in Q2 reflected the lesser momentum of building, particularly in the non-residential segment. As regards Q3, the greater vigour of residential building in the summer will be underpinning higher growth in value added in this branch. Both Social Security registrations, which grew at a slightly higher rate in Q3 than in Q2 (once adjusted for the distortions caused by the immigrant regularisation process), and the information on certain imports, such as apparent consumption of cement, are along these lines.

The gradual easing of activity in the services branches continued during Q2. Growth in this quarter was 3.5%, 0.3 pp less than in the first three months of the year. This slowdown was



SOURCES: Instituto Nacional de Estadística, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

a. Year-on-year percentage rates based on seasonally adjusted series except in the case of the EPA, when they are based on gross series. EPA figures refer to numbers of persons. 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 DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied until 2004 Q4.

seen both in market and other services. There are perceptible signs of stability in market services for Q3. According to figures drawn from the tax authorities, sales by large services companies, once deflated and adjusted for calendar effects, showed similar growth over the months of July and August to that in Q2, while the number of Social Security registrations in this branch quickened slightly in Q3. As to the survey-based indicators, the European Commission's services confidence indicator improved slightly and the PMI index held stable in Q3. Among the tertiary branches, the greater dynamism in the distributive trade and the stability in the transport and communications branches were notable, while the hotel and restaurant trade, and real estate and business services moderated somewhat.

In the economy as a whole, job creation remained robust in 2006 Q2, increasing at a year-on-year rate of 3.1%, 0.1 pp less than in Q1. In combination with the greater vigour of GDP, this led to an increase in the total economy's apparent labour productivity, which stood at 0.6% in Q2 compared with 0.4% in Q1. In the market economy, the year-on-year growth rate of employment was 3.6%, 0.1 pp up on the previous quarter; in this case, the performance of value added led to a 0.2 pp slide in apparent labour productivity. Into Q3, the conjunctural indicators available indicate that employment has once again risen, with an improvement in productivity in the market economy.

In this respect, Social Security registrations, calculated with month-end data and with the effect of immigrant regularisation stripped out, showed greater vigour in Q3, with a year-on-year rate of 3.3%, 0.5 pp higher than the previous quarter. According to the Labour Force Survey (EPA) figures for Q3, employment growth in relation to the same period a year earlier was 3.7%, 0.5 pp down on Q2. Nonetheless, this slowdown in employment was concentrated in the non-market services branches, while employment in the overall market economy increased once more, as in the two previous quarters, by 4.3%.

By branch of activity, and on QNA estimates for Q2, there was a notable loss of steam in job creation in the services branch and, especially, in non-market activities, which was partially offset by greater momentum in the other branches. Specifically, the year-on-year rate of increase in employment in non-market services declined by 0.6 pp to 1%. Conversely, in other services, the moderation in job creation was not as acute, and the year-on-year rate stood at 4.2%, 0.2 pp down on the previous quarter. In agriculture, meanwhile, the pace of job destruction slackened, while in industry employment underwent modest growth, following two quarters of decline. Employment in construction continued to be particularly dynamic, with a year-on-year rate of 7.3%. According to the EPA, employment was fairly robust in construction and in the services branches in Q3, while negative rates of change were observed in agriculture and in industry. Employment in agriculture fell by 8% year-on-year, stepping up the rate of decline experienced in the first half of the year. In industry, employment fell once again in year-on-year terms (-0.7%), after the mild recovery witnessed in the first half of the year. In the case of construction, the year-on-year growth rate of employment rose to 8.1%. Finally, employment increased by 4.9% in the services branches, 0.1 pp down on the previous quarter, the result of the marked slowdown in the non-market branches, where employment grew by 1.9%, compared with 4.1% the previous quarter. Conversely, employment in market services quickened, posting year-on-year growth of 6.9%, 1.2 pp more than the previous quarter.

The QNA figures for Q2 continued to show greater vigour for dependent employment than for self-employment, although there was a strong recovery in the latter group. The year-on-year growth rate for dependent employees was 3.1% economy-wide, and 3.7% in the market-economy branches, entailing a slowdown of 0.4 pp in relation to the previous quarter. The self-employment segment showed growth of 3%, far above the figure of 0.9% in Q1. The latest

EPA figures for Q3 continue to show higher growth for the group of dependent employees (3.9%) than among the self-employed (2.8%). These developments entail a fresh increase to 82.3% in dependent employees as a proportion of total numbers employed in the economy, 0.6 pp higher than the figure recorded a year earlier. In the figures for Social Security registrations, there was also a smaller increase in the self-employment category than among dependent employees.

According to the EPA figures, there was considerable dynamism in the numbers of foreign employees, with year-on-year growth of 17.4%; however, this variable held on the mildly moderating profile seen in previous quarters. Numbers of Spanish employees, meanwhile, grew by 2%, 0.5 pp less than in the previous quarter. In terms of contract length, the number of part-time employees grew at a higher rate than that of permanent employees in this quarter, despite the entry into force of the labour reform on 1 July. Nonetheless, the rate of expansion of workers with a part-time contract eased off to 4.5%, against 7.9% the previous quarter, while permanent employment quickened to a year-on-year growth rate of 3.6%. Overall, these developments prompted a fresh increase in the ratio of temporary to total employees, as is habitual during the summer months, taking the proportion up to 34.6% compared with 34.4% the previous quarter, although this rise was less than that recorded in the same quarter in the past two years. Information drawn from the INEM statistics on contracts shows a rise in permanent hiring in the July-September period, due above all to the conversion of temporary contracts (with an increase of over 80% in this period). The marked pace of these conversions will foreseeably be maintained until the end of the year, which marks the deadline for employers to avail themselves of the related rebates.

Growth was 1.1% among part-time workers in Q3, following the high rates recorded in 2005, while growth among full-time workers was more dynamic at 4%. As a result, the proportion of part-time employees fell by 0.9 pp on the preceding quarter to 11.3%.

The labour force grew by 3.4% in 2006 Q3, in line with its recent course (3.3% on Q2). Behind this trend in labour supply is the progressive increase in the participation rate, which stood at 58.4%, 1 pp up on the same period a year earlier, and the sustained dynamism of the population, which grew once more by 1.6%, as in the previous quarter. By sex, the increase in the labour force was higher among women (4.7%, against 2.4% for men), and the female participation rate rose by 1.5 pp on the same quarter in 2005 to 47.8%. The male participation rate stood at 69.5%, 0.4 pp up on a year ago.

Finally, the EPA figures indicate a fresh decline in unemployment in Q3, with 72,000 fewer unemployed than three months ago. In year-on-year terms, however, the number of unemployed stabilised following several quarters of marked falls. The unemployment rate dipped to 8.1%, 0.4 pp less than in Q2. The registered unemployment statistics indicate a fall of 1.9% in the number of unemployed in Q3 compared with the same period a year earlier.

4.3 Costs and prices

In 2006 Q2, compensation per employee continued on the rising path embarked on in the second half of the previous year (see Chart 20). Specifically, in the economy as a whole, compensation per employee rose by 0.3 pp to 3.2%. In the market economy, the acceleration was more marked (0.4 pp), placing the rate of increase at 2.7%. By branch of activity, there was a generalised increase in the growth of average compensation, with the exception of construction, where the year-on-year rate of increase fell to 3.5%. The biggest rise – 0.6 pp – was in market services, with much more moderate increases in the other branches. The Quarterly Labour Costs Survey showed an increase in monthly labour costs per employee of 3.5% year-on-year, 0.1 pp up on the previous period. The wage component also quickened moderately, edging up from 3% to 3.1%, while non-wage costs once again increased substantially, to 4.9%.



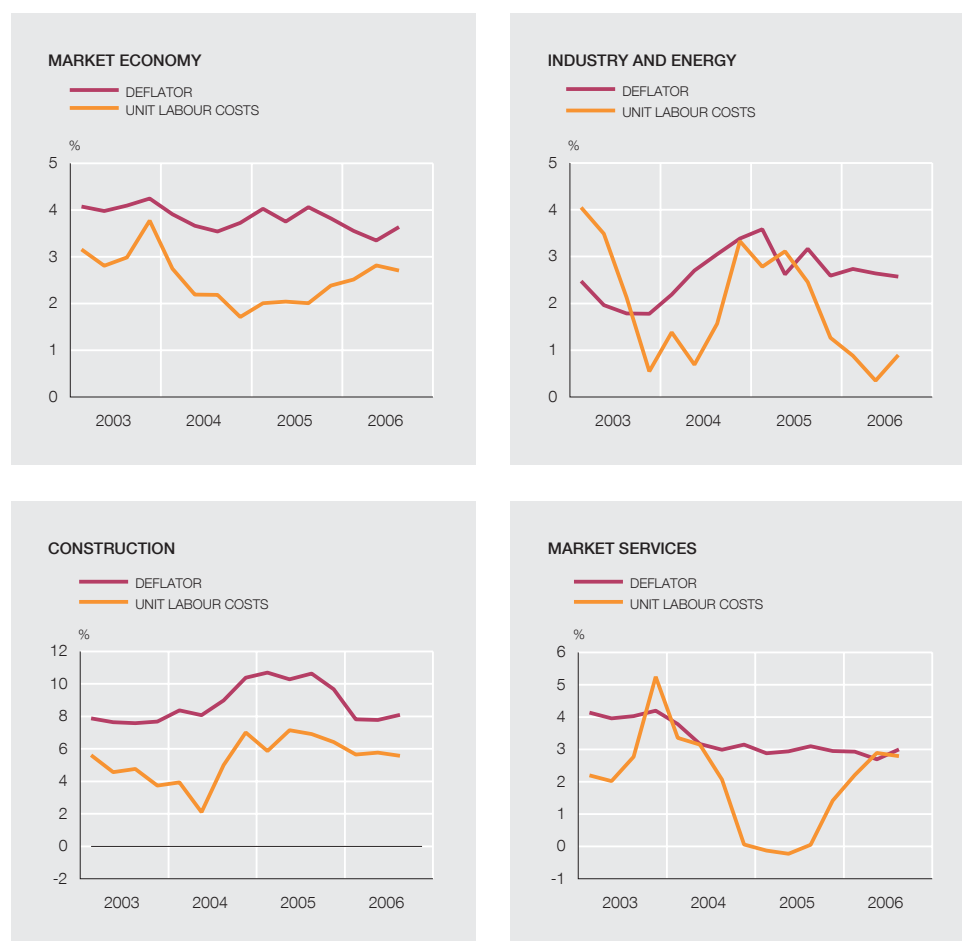
SOURCES: Instituto Nacional de Estadística, Ministerio de Trabajo y Asuntos Sociales and Banco de España.

- Percentage change on same quarter a year earlier.
- Rates based on QNA seasonally adjusted series.
- Information on collective bargaining agreements to September 2006.
- Previous year's indexation clause.
- ETCL.

The information on wage settlements under collective bargaining agreements showed an increase in wage rates of 3.2% for the current year, a figure somewhat higher than the previous year before including the impact of the indexation clauses (3.1%). In revised agreements, the increase recorded to August is 3.16%, up on the same period a year ago, while in newly signed agreements a slightly higher rise has been agreed (3.27%). In the current year, workers have received back-pay relating to 2005 further to the activation of indexation clauses, the impact of which will, it is estimated, have an effect on compensation per employee of the order of 0.9 pp. Indexation clauses are present in most of the revised agreements to August, affecting 81% of workers.

The bigger increase in compensation per employee in 2006 Q2 was only partly offset by a bigger increase in value added per employee, meaning that the year-on-year growth rate of labour costs per unit of value added increased by 0.2 pp to 2.6% for the economy as a whole. The growth of the value added deflator, by contrast, fell by 0.2 pp to 3.4% year-on-year, reflecting the less expansionary behaviour of the surplus.

In the market economy, the diminished pace of the value added deflator in Q2 was the outcome of a slowdown in the deflator in all branches, with the exception of construction, where the rate of increase was stable (see Chart 21). The reduction in price growth was particularly sharp in agriculture, although this continued to be the activity showing the most moderate increases. The acceleration in unit labour costs was due to the strong rise in market services and, to a lesser extent, in construction, with the rate of increase falling in the other branches. As a result of these differences, surpluses declined in market services and in agriculture. The indicators available for Q3 suggest some slowing in unit labour costs, except in industry, owing to the acceleration in compensation per employee in this sector, since its productivity has continued to rise at a sharp rate. Unlike the previous quarter, the growth of the deflators in all branches was above that of unit labour costs, whereby the improvement in the surplus was across the board, which may be interpreted as a sign of the vigour of demand in this period.



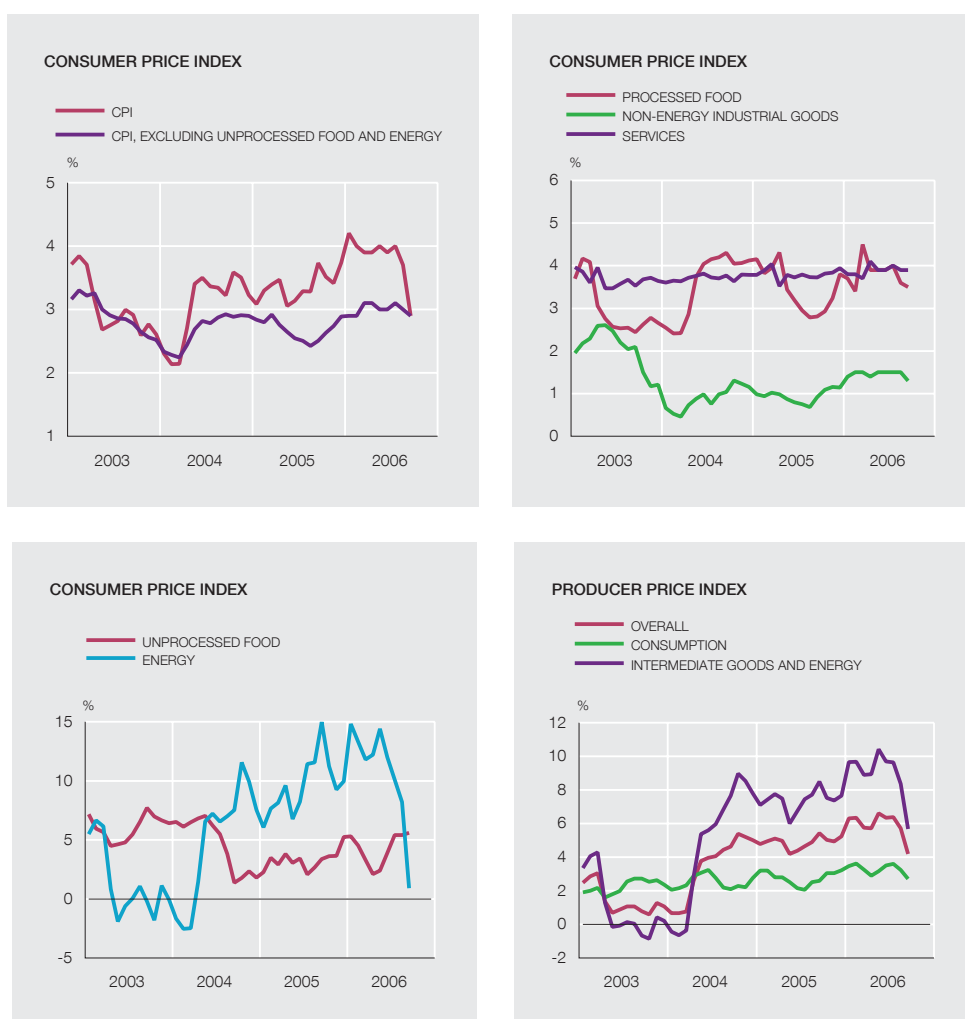
SOURCES: INE and Banco de España.

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

In 2006 Q2, the year-on-year rate of the final demand deflator fell by 0.1 pp to 4.1%. The imports deflator also eased to 4.4%, compared with 4.5% the previous quarter. The GDP deflator was likewise less expansionary, since it slowed by 0.1 pp to a year-on-year rate of 4.3%. On the expenditure side, the increase in the private consumption deflator moderated, in line with the CPI, and its rate of change fell by 0.1 pp in relation to the same period a year earlier to 3.9%. The gross fixed capital formation and exports deflators maintained their year-on-year rates of change at 5% and 3.9% respectively.

The 12-month growth rate of the consumer price index eased slightly in Q2 to 3.9%, against 4% in the opening months of the year. The slowing path of consumer prices intensified in Q3, with their rate of increase being trimmed by a further 0.4 pp to 3.5%, owing essentially to the less expansionary course of oil prices but also, to a lesser extent, to the other components. Since August oil prices have declined notably, which has fed through to fuel prices, meaning that the CPI in September posted a 12-month rate of 2.9%, a figure not seen since the opening months of 2004. The growth of the CPI excluding unprocessed food and energy held stable in Q2 and Q3 at 3%, although it dipped in September to 2.9% (see Chart 22).

The 12-month growth rate of processed food prices dipped by 0.2 pp in Q3 to 3.7%. The slowdown initiated in the April-June period in olive and other oil prices intensified in August and



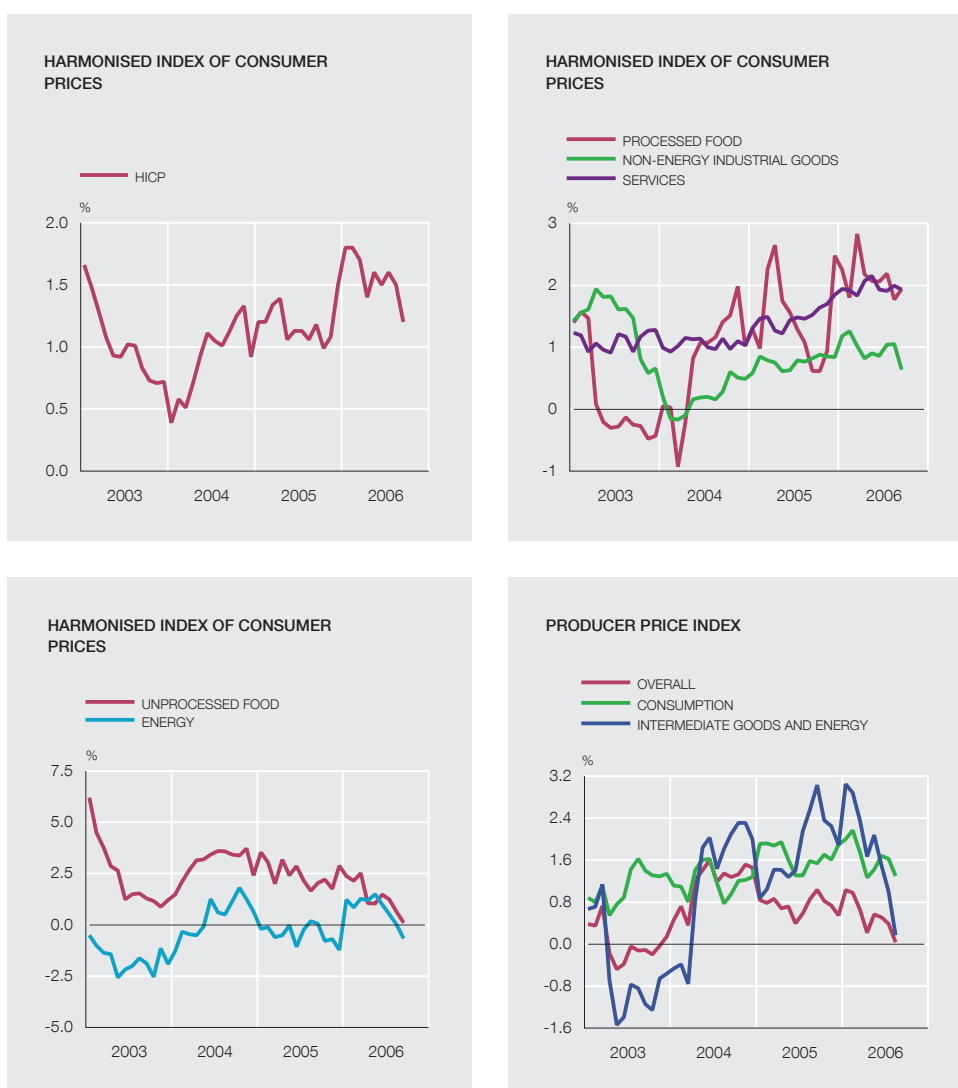
SOURCE: INE.

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

September, though the 12-month growth of this component still exceeds 23%. The prices of non-energy industrial goods posted growth of 1.4% on average in Q3, a similar figure to the previous quarter. The lesser increase in car prices was offset by the buoyancy of furniture prices, with the rate of change of clothing and footwear prices holding stable. Finally, services prices were unchanged in Q3 at an average year-on-year rate of 4%, with transport services prices having lost steam (the result of the favourable behaviour of fuel prices) but with the ongoing fall in telecommunications prices having slowed.

As to the more volatile CPI components, unprocessed food prices rose notably in Q3 to an average rate of 5.5%, owing particularly to higher meat and fruit prices. In the July-September period, the year-on-year rate of the energy component eased to 6.4%, 6.5 pp below the related Q2 rate, although the 12-month increase in September fell to 0.9%.

Inflation in Spain, measured by the HICP, underwent a 0.4 pp cut in Q3, taking the average year-on-year rate in this period to 3.6%. The decline was particularly sharp in September, when a 12-month rate of 2.9% was recorded. In the euro area as a whole, inflation in Q3 also fell by 0.4 pp



SOURCES: Eurostat and Banco de España.

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

to 2.1%, and the differential for the quarter on average therefore held at around 1.5 pp. However, the greater slowdown in prices in Spain in September translated into a narrowing of the differential to 1.2 pp that month (see Chart 23). Component by component, the biggest differentials were recorded in services and processed food, where they stand at around 2 pp. In the recent period, a considerable decline in the differentials for the most volatile components has been observed, standing in September at 0.1 pp for unprocessed food and at -0.7 pp for energy. Lastly, the differential for non-energy industrial goods narrowed appreciably in September to 0.6 pp.

The rising path on which the producer price index had been moving for slightly more than two years was interrupted in 2006 Q3. The year-on-year growth rate of this index thus stood at 4.2% in September, 2.1 pp below the June figure. This lesser dynamism largely reflects the lower rate of increase of energy production prices, which posted a decline of 10.5 pp in relation to June to 4.1%. Among the other components of the producer price index, consumer goods prices also slowed; their rate of change in September was 2.7%, 0.8 pp down on June. The manufacturing

EUR m and %

	Outturn 2005	Percentage change 2005/2004	Outturn projection 2006	Percentage change 2006/2005	Outturn JAN- JUN Percentage change 2006/2005	Outturn		
						2005 JAN-SEP	2006 JAN-SEP	Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	128,777	12.2	138,167	7.3	9.9	92,093	99,683	8.2
Direct taxes	70,665	20.4	78,482	11.1	15.0	47,896	54,929	14.7
<i>Personal income tax</i>	35,953	18.2	38,445	6.9	12.2	27,372	30,780	12.5
<i>Corporate income tax</i>	32,496	24.9	37,478	15.3	21.3	18,888	22,280	18.0
<i>Other (a)</i>	2,215	-1.3	2,559	15.5	23.3	1,636	1,869	14.2
Indirect taxes	44,618	7.9	47,427	6.3	12.3	34,672	36,520	5.3
VAT	32,009	10.0	34,452	7.6	15.6	25,116	27,006	7.5
<i>Excise duties</i>	9,795	0.5	9,932	1.4	-0.5	7,456	7,251	-2.8
<i>Other (b)</i>	2,813	12.9	3,043	8.2	9.7	2,100	2,264	7.8
Other net revenue	13,494	-8.7	12,258	-9.2	-16.6	9,526	8,234	-13.6
2 EXPENDITURE	122,755	7.0	130,951	6.7	1.5	88,494	92,771	4.8
Wages and salaries	20,677	6.1	22,439	8.5	7.7	14,861	15,912	7.1
Goods and services	3,388	-3.5	3,834	13.2	3.7	2,223	2,386	7.3
Interest payments	17,831	6.4	15,520	-13.0	-19.2	15,421	13,139	-14.8
Current transfers	64,541	5.8	71,661	11.0	5.9	46,002	51,490	11.9
Contingency fund	...	...	...	...	...	...	...	...
Investment	8,978	26.4	9,258	3.1	4.8	5,446	5,466	0.4
Capital transfers	7,341	6.8	8,238	12.2	-7.1	4,541	4,377	-3.6
3 CASH-BASIS BALANCE (3 = 1 - 2)	6,022	...	7,216	...	...	3,599	6,913	...
MEMORANDUM ITEMS: NATIONAL ACCOUNTS								
Resources	126,811	11.9	143,587	13.2	13.7	91,978	102,543	11.5
Uses	123,550	0.7	140,933	14.1	6.7	83,739	90,735	8.4
NET LENDING (+) OR BORROWING (-)	3,261	...	2,654	...	...	8,239	11,808	...
(as a percentage of GDP)	0.4		0.3			0.9	1.2	

SOURCE: Ministerio de Economía y Hacienda.

- a. Includes revenue from the tax on the income of non-residents.
b. Includes taxes on insurance premiums and tariffs.

prices of intermediate goods held stable, while the rate of increase of those of capital goods edged up to 2.5%. On information to August, the moderation of producer prices was somewhat less intense in the euro area than in Spain, whereby the related differential was zero that month. The pace of prices received by farmers stepped up, standing at 3.8% in July. Finally, hotel prices held at a very moderate year-on-year growth rate, increasing by 2.2% in August.

4.4 The State budget

On 22 September the Spanish government's Council of Ministers approved the draft State Budget for 2007. The budget targets an overall general government surplus of 0.7% for 2007, in line with the Pluriannual Budgetary Stability Programme for the 2007-2009 period. Drawing on figures from the September Excessive Deficit Protocol Notification, the balance in National Accounts terms for the General Government sector is envisaged to close the present year with a surplus of 1.1% of GDP, the same as in 2005. As regards the sub-sectors, Central Government will post a surplus of 0.3% of GDP in 2006, while Regional Governments will close the year with a deficit of 0.1% of GDP and Local Governments will remain in balance. As to the Social Security system, it is expected to post a surplus of 0.9% of GDP.

The Social Security system posted a surplus of €8,994 million in the seven months to end-July 2006, €1,561 million up (21%) on the same period a year earlier, making for a more favourable outturn than to end-April. Revenue quickened slightly in the latter months of the period, with growth standing at 9.5%, while the growth rate of expenditure held at 7.7%.

Revenue from Social Security contributions increased by 9% to July, up on the figure of 8.6% to April. The growth of the number of Social Security registrations has slowed in recent months, insofar as it is no longer affected by the immigrant regularisation timetable; the rate to September 2006 was 4.6%. However, this is a slightly higher rate than for the whole of 2005, which reflects the dynamism observed in the labour market.

Turning to expenditure, that earmarked for contributory pensions accelerated marginally and rose by 7.8% to July, up on the figure of 7.2% budgeted for the year as a whole. The number of contributory pensions is sustaining a high growth rate, standing at 2.6% to July April, far above that posted in 2005 as a whole (1.3%). This is partly

due to the effect of the former Elderly and Disability Insurance pensions (SOVI) being recognised as compatible with widowhood pensions¹. Expenditure on sickness benefits quickened to a rate of 10.2% in July, which is still below the budgeted figure.

As regards the SPEE (State Employment Public Service), the information on which is shown in the accompanying table, contributions received rose by 9.7% to May, above budget. Rebates on contributions in respect of employment-promoting contracts, meanwhile, increased by 15.6% to May, also above the initial budget projection.

SPEE expenditure on unemployment benefits rose by 6.9% to July (a growth rate higher than the 6.7% increase recorded in 2005 as a whole), and the number of beneficiaries grew by 3.1% (3.3% in 2005). This was due to the increase in the eligibility rate, which stood at 62.5% to July 2006, above the end-2005 level (60.7%), and despite the decline in registered unemployment, which fell by 1.2% in July 2006 compared with the 1.1% fall over 2005 as a whole.

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 %

	Budget			JAN-APR		Outturn JAN-JUL		
	2005	2006	% change	% change	2005	2006	% change	
	1	2	3=2/1	4	5	6	7=6/5	
1 REVENUE	90,040	97,547	8.3	9.1	54,461	59,652	9.5	
1.1 Social security contributions (c)	83,915	90,625	8.0	8.6	50,973	55,556	9.0	
1.2 Current transfers	4,874	5,295	8.6	9.0	2,906	3,177	9.3	
Other (d)	1,251	1,628	30.1	45.7	582	920	58.1	
2 EXPENDITURE	84,100	90,562	7.7	8.0	47,028	50,658	7.7	
2.1 Wages and salaries	1,998	2,165	8.4	4.4	1,186	1,242	4.7	
2.2 Goods and services	1,566	1,733	10.7	16.6	857	986	15.1	
2.3 Current transfers	80,060	86,133	7.6	8.0	44,883	48,277	7.6	
Benefits	80,059	80,059	7.6	8.0	44,883	48,276	7.6	
<i>Contributory pensions</i>	68,905	73,832	7.2	7.7	38,569	41,592	7.8	
<i>Sickness</i>	5,925	6,656	12.3	6.2	3,271	3,604	10.2	
<i>Other</i>	5,229	5,644	7.9	13.9	3,042	3,080	1.2	
2.4 Other (e)	476	530	11.4	-18.7	102	152	49.2	
3 BALANCE	5,940	6,986	17.6	12.6	7,433	8,994	21.0	

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 to July 2006.

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.

According to National Accounts methodology, the State accounts recorded a surplus in the nine months to end-September of €11,800 million (1.2% of GDP), up on the figure of €8,239 million (0.9% of GDP) for the same period in 2005 (see Table 3). The cumulative growth of resources in the January-September period amounted to 11.5%, while uses increased by 8.4%; in both cases, the figures were lower than the forecast for the year as a whole offered in the outturn projection in the draft budget, though it is in uses where the containment experienced to date is most marked. The outturn projection is for a State surplus of €2,654 million (0.3% of GDP). Box 4 addresses the Social Security budget outturn.

In cash-basis terms, the State will run a surplus of €7,216 million according to the outturn projection, in marked contrast to the deficit forecast in the initial budgetary document, estimated at €5,360 million. This difference arises as a result of higher revenue from tax takings (especially in indirect taxes and VAT) and from other revenue, and of lower-than-budgeted expenditure, mainly due to the effect of lower interest and, probably, of the only partial use of the Contingency Fund.

The State budget outturn to September resulted in a surplus of €6,913 million, notably up on the surplus of 3,599 million recorded in the same period the previous year. In Q3 there was a slowdown in revenue, which increased by 8.2% in the nine months to end-September, compared with 9.9% to June, while expenditure quickened, rising to growth of 4.8% compared with 1.5% in the first half of the year.

For the analysis of revenue, information is available on takings relating to the main taxes, both the portion assigned to the State, the only portion shown in Table 3, and that corresponding to the regional governments. This aggregate information is more illustrative for evaluating tax revenue. The figures for total takings indicate that tax revenue slowed slightly in Q3 as a result of the lesser momentum of indirect tax, while direct taxes accelerated. The declines seen in other revenue during the first half of the year eased. Both personal income tax and corporate income tax sustained rates of over 13%: in the first case these were underpinned by withholdings on income from work (with growth exceeding 10%), by withholdings on movable capital (which grew by 27.7%) and by withholdings on gains on mutual funds (with growth of over 35% to September); in the second case they were sustained by corporate earnings. In both taxes, takings should increase at a substantially lower rate in Q4, if the projection outturn is to be met, which points to growth for 2006 as a whole of 9.4% in personal income tax and 15.3% in corporate income tax. As regards indirect taxes, VAT slowed notably to 8.2% owing to the application of requests for refunds. The growth rate of VAT takings is expected to hold stable in the final months, drawing close to 7.7% according to the outturn projection. Excise duties posted a modest increase in relation to the same period in 2005. This was largely due to the moderation of tobacco consumption and to the trend of prices in the case of the special tax on hydrocarbons. By contrast, the outturn projection foresees greater vigour in the growth of takings of excise duties, of up to 3.5% for the year as a whole. Finally, the rate of decline of the items grouped under the heading Other revenue eased, with a reduction of 13.6% to September due to the fact that the increase in current transfers, interest received and the disposal of real investments offset the declines in charges and capital transfers. The outturn projection estimates an additional improvement in the second half of the year, due above all to the captions encompassing charges and capital transfers.

With regard to expenditure, the acceleration in Q3 was marked mainly by that in current expenditure. Whereas the growth rate of wages and salaries eased back, the rates of decline in interest payments recorded in the first half of the year fell, and current transfers and goods and services quickened notably in these months, with their growth rates almost doubling. In all

EUR m		JANUARY-JULY	
		2005	2006
CREDITS	Current account	155,206	173,563
	<i>Goods</i>	90,686	100,973
	<i>Services</i>	41,177	43,945
	— Tourism	20,204	19,959
	— Other services	20,973	23,985
	<i>Income</i>	15,868	20,490
	<i>Current transfers</i>	7,476	8,155
	Capital account	4,767	3,322
	Current + capital accounts	159,973	176,885
DEBITS	Current account	194,889	226,068
	<i>Goods</i>	128,035	146,015
	<i>Services</i>	29,424	35,531
	— Tourism	6,495	7,270
	— Other services	22,929	28,261
	<i>Income</i>	26,451	32,497
	<i>Current transfers</i>	10,978	12,025
	Capital account	491	950
	Current + capital accounts	195,380	227,018
BALANCES	Current account	-39,683	-52,505
	<i>Goods</i>	-37,350	-45,042
	<i>Services</i>	11,752	8,414
	— Tourism	13,709	12,689
	— Other services	-1,956	-4,275
	<i>Income</i>	-10,583	-12,007
	<i>Current transfers</i>	-3,502	-3,870
	Capital account	4,276	2,372
	Current + capital accounts	-35,407	-50,132

SOURCE: Banco de España.

a. Provisional data.

instances, except for the case of wages and salaries, which had also shown less momentum in the final months, these same trends may continue in the second half of 2006, according to the figures provided by the outturn projection for the close of the year. Finally, the decline in capital transfers steepened in this quarter, owing to the strong slowdown in real investment, which remained virtually flat. As with current transfers, the outturn projection foresees acceleration in this expenditure item in the second half of the year.

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

In the first seven months of 2006, the overall balance on current and capital account was a deficit of €50,132 million, 42% up on the same period in 2005 (see Table 4). During this seven-month period the current account deficit widened by 32%, rising to €52,505 million, while the surplus on capital transactions declined (-45%) to €2,372 million. Under current transactions, there was a generalised deterioration in the balances of the main items, proving especially acute in the case of the trade deficit, the surplus on services, the income deficit and, to a lesser extent, net current transfers.

The trade balance deficit increased by €7,692 million in the January-July period compared with the same period a year earlier, up to a figure of €45,042 million. In year-on-year terms, the

deficit increased by 21%, prolonging the deterioration of the two previous years. Despite the significant pick-up in real export flows in this period, the rise in real imports and the strong deterioration in the terms of trade – owing to dearer oil – prompted the unfavourable course of the deficit in nominal terms. Nonetheless, the rate of increase in the trade deficit has slackened since 2006 Q2 thanks to the more moderate growth of the deficit on the non-energy trade balance.

The services balance posted a surplus of €8,414 million euro in the first seven months of 2006, €3,338 million down on the figure recorded in the same period a year earlier. This deterioration was due to the €1,019 million decline in the tourist surplus and, to a greater extent, to the increase in the deficit on the non-tourist services balance, which increased by €2,319 million. Tourist revenue fell by 1.2% in the January-July period, in nominal terms, although the latest figures have shown some improvement, with positive rates of 4.5% in June and 1% in July. Tourist expenditure rose by 11.9% to July, although the strong rate of increase that had marked them in the two previous years has slowed from Q2. As a result of these revenue and expenditure developments, the tourist surplus declined by 7.4%.

The deficit on the income balance widened by 14% over the course of the first seven months of 2006 to a negative figure of €12,007 million, €1,424 million more than the same period a year earlier. Revenue grew at a very high rate in this period (29%), with a notable rise in that relating to the financial sector, while expenditure also posted a very strong increase (23%), reflecting the dynamism of expenditure by monetary financial institutions and, to a greater extent, by the non-financial private sector, which offset the decline in general government expenditure.

In the seven months to July, the current transfers deficit totalled €3,870 million, €367 million up on the deficit recorded in the same period in 2005. Revenue increased by 9.1%, owing to the favourable course of flows from the EU under EAGGF-Guarantee (one of the main items), while Community transfers from the European Social Fund fell off. Expenditure, meanwhile, grew at a similar rate (9.5%), driven once again by the strong increase in emigrants' remittances (36.1%) and by the rise in expenditure earmarked for Community coffers under the VAT resource and Traditional own resources, which was offset by the decline in expenditure under the GNP Resource.

Finally, the capital account surplus amounted to €2,372 million over the course of the first seven months of 2006, a decline of €1,904 million on the same period a year earlier. This deterioration was partly due to the decline in various structural funds, especially from the ERDF, although transfers from the EAGGF-Guarantee and from the Cohesion Fund also fell. Furthermore, expenditure increased most notably, especially in connection with disposals of intangible assets and capital transfers by the private sector.

5 Financial developments

5.1 Overview

in 2006 Q3, the pattern of progressive rises in money market interest rates continued. Thus, in September, the average level of twelve-month EURIBOR stood at 3.7%, up 31 bp from the end of the first half of the year. In line with these developments, the cost of bank loans for households and firms increased during July and August. By contrast, the downward path in the price of long-term Spanish debt came to an end and the yield on the 10-year bond reached 3.8%, down 22 bp from June. This, combined with the stability of Spanish firms' credit default swap premia, led to a reduction in firms' average cost of financing through the issuance of long-term fixed income securities.

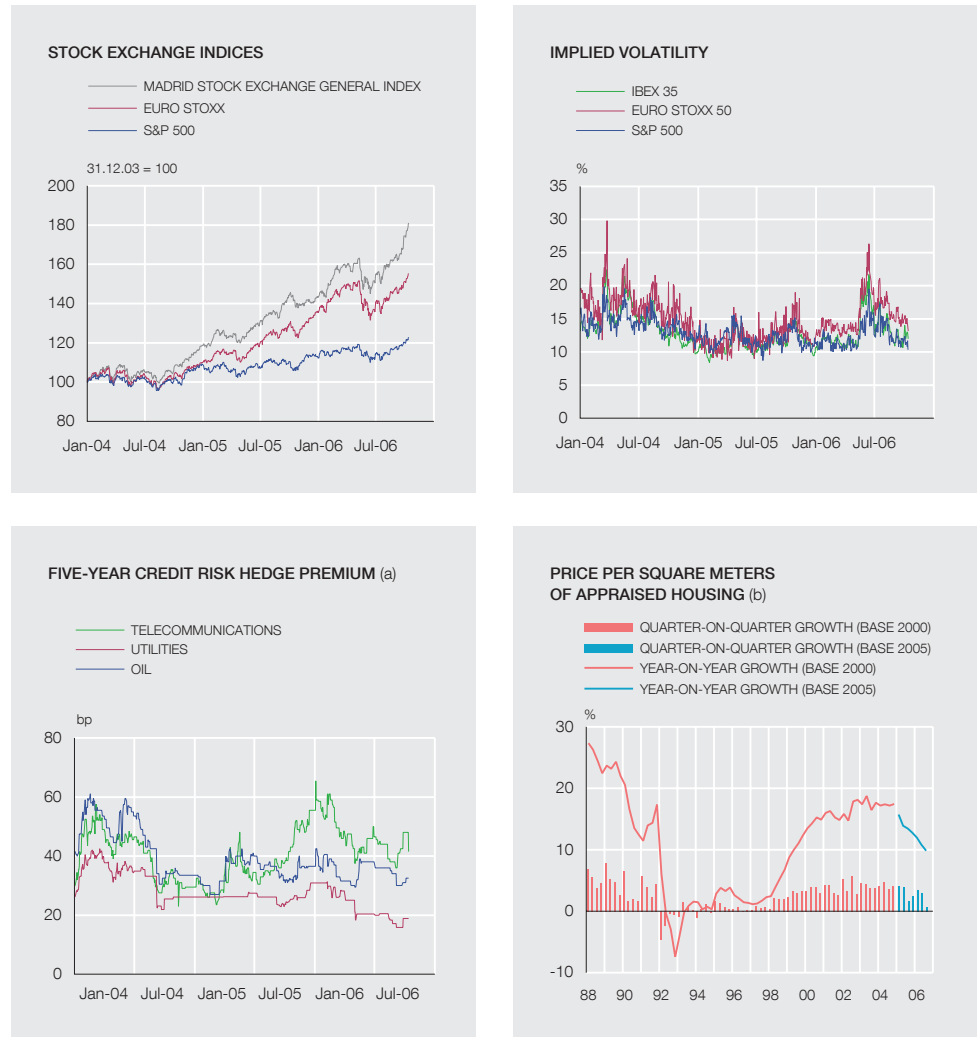
On domestic and international stock markets, the expansionary behaviour of company results and the oil price falls in the second half of Q3 prompted share prices to rise and their volatility to fall. Spanish market indices were also benefited by certain company operations. Thus, at end-September, the Madrid Stock Exchange General Index was 21.9% higher than at the beginning of the year, a much more favourable performance than that of the EURO STOXX Broad Index of euro area stock exchanges, which increased by 11.9% over the same period, and that of the S&P 500 of American companies, which rose by 7% (see Chart 24).

According to the latest data published by the Housing Ministry, the trend in prices on the property market observed since the beginning of last year, continued during Q3. Thus, the year-on-year growth rate of unsubsidised housing stood at 9.8% in September, down one percentage point from March, confirming the trend slowdown, and raising the likelihood of an orderly and gradual adjustment in this market.

Despite the rise in interest rates, the liabilities of the private sector continued to increase at a high rate between April and June. In the case of households, the year-on-year increase was similar to that in Q1 (close to 21%). Component by component, the smooth slowdown since the beginning of the year in debt for house purchase continued, although it still grew by 23%. By contrast, financing to households for consumption and other purposes was again highly buoyant, and expanded by around 16% relative to the same period of 2005. Company debt, meanwhile, grew by around 24%, basically as a result of the behaviour of loans granted by resident institutions, although the renewed boom in fixed-income securities issuance was also significant. The breakdown of bank lending by productive activity shows that loans to construction and, in particular, to property services companies again recorded high rates of growth. The provisional information available suggests that between July and September the same trends were maintained as in the previous quarter as regards financing, although a certain acceleration in business debt was discerned.

The buoyancy of funds received by households, which greatly exceeded that of their income, and the increase in the cost of financing meant that the degree of financial pressure on households increased once again in Q2. This trend, according to the provisional information available, continued between July and September. Thus the debt and debt burden ratios, relative to gross disposable income (GDI), continued to rise, while net saving after debt service fell again and household net borrowing increased again (see Table 5). Even so, the net wealth of these agents rose further, owing to the rise in house prices, which helped bolster their financial position.

The debt and debt burden ratios of non-financial corporations also continued to rise in Q2, while the return on equity remained at similar levels to March. The provisional information for



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

- a. Average asset-weighted premia.
- b. New statistic from 2005.

Q3 shows these same trends continuing. Meanwhile, according to the Financial Accounts, company net borrowing increased again in Q2. The data, for the same period, of firms reporting to the quarterly survey of the Central Balance Sheet Data Office (CBQ), in which large companies have a high weight, showed similar behaviour to that observed for the sector as a whole in terms of the volume of financing and interest payments relative to profits. However, the effect of these variables on synthetic indicators of financial pressure was more than offset by the improvement in the return on capital.

The additional contraction in the financial saving of firms and households was not fully offset by the increase in the financial resources of general government, so the nation's net borrowing, in cumulative twelve-month terms, rose to 7.5% of GDP, as against 7.1% in March. These funds continued to be channelled basically through borrowing by financial institutions from the rest of the world.

In short, the financial situation of households and firms remains solid, although it is increasingly exposed to adverse changes in certain variables such as income, asset prices and the cost of

% GDP (a)	2001	2002	2003	2004	2005			2006	
					Q2	Q3	Q4	Q1	Q2
					National economy	-3.5	-2.7	-2.9	-4.8	-5.9	-6.1	-6.5	-7.1	-7.5
Non-financial corporations and households and NPISHs	-4.2	-3.5	-3.9	-5.3	-6.7	-7.4	-8.4	-9.5	-10.5
<i>Non-financial corporations</i>	-5.2	-4.2	-4.1	-4.6	-5.5	-6.3	-7.0	-8.0	-8.8
<i>Households and NPISHs</i>	1.1	0.7	0.1	-0.6	-1.1	-1.1	-1.3	-1.5	-1.7
Financial institutions	1.2	1.2	1.0	0.6	0.4	0.4	0.7	0.6	0.7
General government	-0.5	-0.3	0.0	-0.2	0.3	0.8	1.1	1.8	2.3
MEMORANDUM ITEM:									
Financing gap (b)	-10.0	-8.6	-8.4	-8.9	-10.5	-11.0	-11.2	-14.4	-15.1

SOURCE: Banco de España.

a. CNE base 2000.

b. Financial resources that cover the gap between expanded gross capital formation (real investment and permanent foreign financial investment) and gross saving.

financing, which is especially significant in scenarios characterised by decelerating house values and rising interest rates. Accordingly, the medium-term macroeconomic outlook remains subject to the risk factors of a financial nature discussed in previous reports.

5.2 Households

In 2006 Q3, the gradual rise in the cost of household debt continued. During July and August, the interest rates charged by banks on new loans for house purchase and for consumption and other purposes increased by 22 bp and 63 bp respectively, making the rise in the cost of such funds since end-2005 around one percentage point. As regards credit standards, according to the bank lending survey (BLS), institutions did not expect significant changes in the same period. Also, the recent developments in the ratio between the funds received and the value of the property in mortgage loans imply that credit supply conditions remained unchanged (see Box 5).

The tightening of financing conditions since the end of 2005 has not prevented household debt remaining highly buoyant. In June it grew by 21%, relative to the same period of 2005, a similar rate to previous months. Credit for house purchase continued to be the most expansionary element of this aggregate since, despite a mild slowdown, its year-on-year growth rate is still high (23%). Meanwhile funds for consumption and other purposes accelerated further to a growth rate of around 16%. The information available does not enable the final use of these funds to be identified more precisely, but their growth appears to be consistent with the increase in the demand for loans perceived in Q2 by institutions participating in the BLS, linked to spending on durable goods.

Investment in financial assets increased slightly between April and June, to 10.7% of GDP, in cumulative twelve-month terms, up 0.1 bp from March (see Table 6). By instrument, these purchases continued to be concentrated in the lowest risk assets (cash and deposits). Among the latter, time deposits, which are included under the heading other deposits and fixed-income securities, were notably buoyant, while cash and cash equivalents decelerated. As in the previous quarter, net equity purchases were equal to zero and the relative importance of net subscriptions for mutual fund shares and flows in the form of insurance technical reserves fell again.

The relationship between the amount of a mortgage loan and the value of the property securing the loan, known as the “loan-to-value ratio” (LTV), is a useful indicator for analysing changes in the credit standards applied by lending institutions. An increase in the ratio will normally reflect a relaxation of the supply conditions, although demand elements (for instance, whether borrowers have other resources accumulated previously) also play a part in determining its level. The LTV is also relevant to know the risk borne by borrowers in this type of transaction.

The mortgage-loan database prepared by the Association of Property and Mercantile Registrars (CRPME) enables the trend and level of the LTV to be analysed in considerable detail, since it includes both the amount of the loan and the appraisal value of the property for all transactions entered into from 2004¹.

The left-hand panel of the adjoining chart contains an LTV histogram for all mortgage loans granted to individuals in respect of unsubsidised housing in the first half of 2006. The mean and median values of the ratio in this period were 63% and 65%, respectively. Most of the data are around these values, but there is a wide dispersion. Thus, for example, more than 24% of transactions had an LTV of less than 50%. Also, there was a notable concentration of transactions with LTVs of around 80% and 100%. The concentration at the 80% level is explained by regulatory factors. Above this level, institutions are required to increase their provisions (Circular 4/2004) and to have more capital (Circular 5/1993)². Also, under the Mortgage Market Law (Law 2/1981), loans with an LTV above this level generally cannot be used to secure issues of mortgage covered bonds. The 100%

1. Specifically, the appraisal value is included after deducting the expenses associated with a possible auction of the property. 2. The whole amount of any loan exceeding this threshold will be subject to this less favourable treatment, not just the amount by which it exceeds such limit.

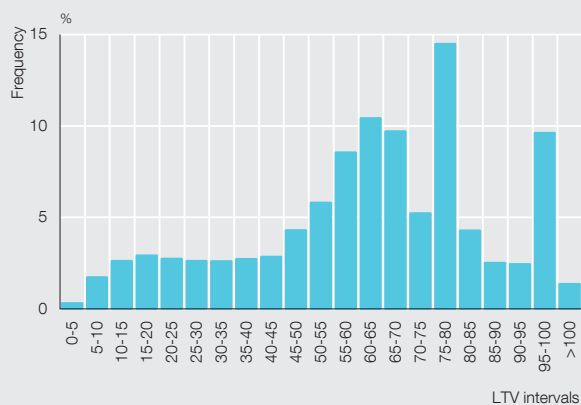
limit is obviously for reasons of prudence in the internal management of risk by the institutions. In fact the latter usually require supplementary security for granting such loans and even insure them as well.

The right-hand panel of the adjoining chart shows the values of certain percentiles of the LTV distribution over the period January 2004 to June 2006. The most notable characteristic of these statistics is their stability during the sample period. For example, the percentage of loans with an LTV of more than 80% fluctuated within a narrow range around the 19% level. The low variability of the distribution suggests that there were no major changes during this period in either the demand conditions or institutions’ credit standards.

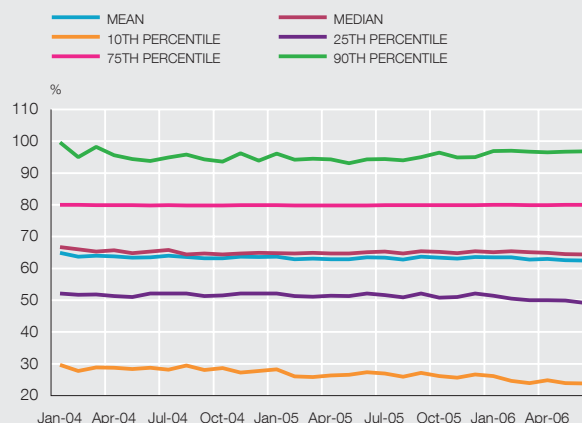
The CRPME statistic does not, however, contain information on characteristics that might be expected to affect the LTV, such as the type of housing subject to the mortgage. In this respect, surveys carried out by the Spanish Mortgage Association (AHE) among its members, with data for the period 2004-2005, reveal that the mean LTV is somewhat higher in the case of principal residences (72%, as against 65% in the case of second residences). The ratio is also higher in the case of a first-time purchase of a principal residence (80%, as against 55% in the case of second and subsequent transactions). It is also interesting to note the consistency between these data and those of the CRPME, since they give an average LTV that was relatively stable during 2004 and 2005, of around 65%.

The difference between the LTV for principal and second residences is probably a result, essentially, of supply-side factors, given that mortgages for the latter normally involve greater risk. However, the discrepancy between the ratio for first and subsequent purchases may be explained to a greater extent by demand factors, since people who change their principal residence are likely to have a larger volume of accumulated funds.

1 DISTRIBUTION OF MORTGAGE LTVs (a) (b)



2 MORTGAGE LTVs OVER TIME (a)



SOURCES: Colegio de Registradores de la Propiedad y Mercantiles de España and Banco de España.

a. Mortgage loans granted to individuals in respect of unsubsidised housing.
 b. Data based on loans granted between January and June 2006.

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

TABLE 6

% GDP	2002	2003	2004	2005	2006	
				Q4	Q1	Q2
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	8.6	8.9	9.7	10.6	10.6	10.7
Cash and cash equivalents	3.5	4.1	4.0	4.4	3.8	3.6
Other deposits and fixed-income securities (a)	2.0	-0.3	1.3	2.0	3.2	3.5
Shares and other equity (b)	0.6	0.6	0.5	0.2	0.0	0.0
Mutual funds	0.2	2.3	1.5	1.9	1.8	1.6
Insurance technical reserves	2.5	1.8	1.8	1.8	1.7	1.5
<i>Of which:</i>						
<i>Life assurance</i>	1.4	0.7	0.7	0.8	0.7	0.6
<i>Retirement</i>	0.9	0.9	0.8	0.8	0.8	0.7
<i>Other</i>	-0.3	0.5	0.7	0.4	0.1	0.4
Financial transactions (liabilities)	8.0	8.8	10.3	11.9	12.1	12.4
Credit from resident financial institutions (c)	7.2	9.2	10.8	12.3	12.9	13.2
<i>House purchase credit (c)</i>	5.1	7.0	8.7	10.3	10.5	10.5
<i>Consumer and other credit (c)</i>	2.1	2.2	2.1	2.2	2.4	2.8
<i>Other</i>	0.7	-0.4	-0.5	-0.4	-0.8	-0.8
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	14.6	15.9	15.6	18.5	19.7	19.3
Cash and cash equivalents	1.6	0.9	1.0	2.1	2.1	2.0
Other deposits and fixed-income securities (a)	1.6	1.2	0.3	1.3	1.6	1.1
Shares and other equity	6.6	7.4	6.4	6.6	8.6	8.8
<i>Of which:</i>						
<i>Vis-à-vis the rest of the world</i>	4.6	4.5	3.8	3.8	6.2	5.7
<i>Other</i>	4.7	6.4	7.9	8.5	7.5	7.4
Financial transactions (liabilities)	18.8	20.0	20.3	25.6	27.8	28.1
Credit from resident financial institutions (c)	5.4	6.1	8.3	13.0	13.5	14.4
Foreign loans	2.7	2.7	0.7	2.0	3.7	3.0
Fixed-income securities (d)	-0.4	-0.2	0.0	0.3	0.9	1.2
Shares and other equity	5.9	5.1	4.6	3.2	3.2	3.2
<i>Other</i>	5.1	6.2	6.6	7.2	6.5	6.3
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	14.0	15.9	16.3	21.0	23.0	22.7
Households and NPISHs	16.3	19.1	20.2	20.9	21.3	21.0
Non-financial corporations	12.4	13.5	13.2	21.1	24.4	24.0

SOURCE: Banco de España.

- a. Not including unpaid accrued interest, which is included under "other".
- b. Excluding mutual funds.
- c. Including derecognised securitised loans.
- d. Includes the issues of resident financial subsidiaries.
- e. Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation special purpose entities.

The rapid rate of expansion of financing meant that the household debt ratio continued rise to stand in June at 120% of GDI (see Chart 25). This, combined with the increase in the cost of funds, explains why the related debt burden increased again, to stand, as at the same date, at almost 15% of GDI. The increase in the repayments on the debt assumed relative to GDI, along with the stability in the gross saving ratio, led to a further reduction in saving after debt service. Also, according to the Financial Accounts, net borrowing increased again in this period to 1.7% of GDP, in cumulative twelve-month terms. However, the continuing high buoyancy of house prices meant that, despite the increase in liabilities, the sector's net wealth conti-



SOURCE: Banco de España.

a. From 1999, the sectoral National Accounts data correspond to the CNE base 2000. For prior periods, an estimate consistent with this base is used.

b. Includes bank credit and securitisation.

c. Assets 1 = total financial assets – “other”.

d. Assets 2 = Assets 1 – shares (excluding mutual fund shares) – shares in FIM.

e. Estimated interest payments plus debt repayments.

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

g. Gross saving less estimated debt repayments.

h. 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. There is a new house price statistic for 2005.

i. CNE base 2000.

nued to rise, although at a lower rate than in recent years, thus alleviating the degree of financial pressure inferred from the above indicators.

5.3 Non-financial corporations

The cost of bank debt for corporations also continued to increase in Q3. The rate of interest on loans of up to €1 million rose during July and August by 27 bp, similar to the rise observed in the case of larger loans (21 bp). Meanwhile, according to the BLS, institutions were not expecting changes in credit standards during Q3. This rise in the cost of financing was not observed, however, in the case of either long-term fixed-income securities issuance, thanks to the decline in the yield on public debt and to the stability of credit default swap premia, or of funds obtained on equity markets, given the upward path of share prices and the decline in their volatility.

Despite the less favourable environment for debt financing, the volume of external funds received by firms continued to grow at a high rate (close to 24%, year-on-year, in June). By instrument, credit from resident institutions continued to be the main item although, as in the previous quarter, fixed-income securities issuance, which still has a low weight in corporate liabilities, grew notably. Flows in the form of foreign loans, by contrast, fell by 0.7 pp of GDP over the 12 months to June.

As regards the breakdown of credit by productive activity, between April and June behaviour across sectors was again mixed. The year-on-year growth rates of credit to property services and construction remained high (close to 47% and 30% respectively). In the case of industry, despite buoyant productive investment, the rate of growth of these liabilities fell again, to 10% year-on-year, while that for services (excluding property services) stood at close to 17%, a rise of almost 2 pp from the previous quarter. Meanwhile, CBQ information shows that the debt of large corporate groups accelerated, so that its level at end-June was more than 30% higher than a year earlier.

The financing raised over the twelve months to June through the issuance of shares and other equity remained at the same level, in terms of GDP, as in the previous two quarters (3.2%).

By contrast, the volume of company assets-side transactions moderated somewhat to 19.3% of GDP in June, in cumulative twelve-month terms. By instrument, the net acquisition of shares and other equity increased slightly, to 8.8% of GDP (as against 8.6% in March), while the flow in the form of liquid assets and fixed-income securities was somewhat smaller than in Q1.

As a result of the decline in asset flows and the increase in liability ones, the net borrowing of corporations and the financing gap, which approximates the funds needed to undertake real investment and permanent foreign financial investment, increased relative to GDP by around 0.8 pp, to 8.8% and 15.1%, respectively, in cumulative twelve-month terms (see Table 5).

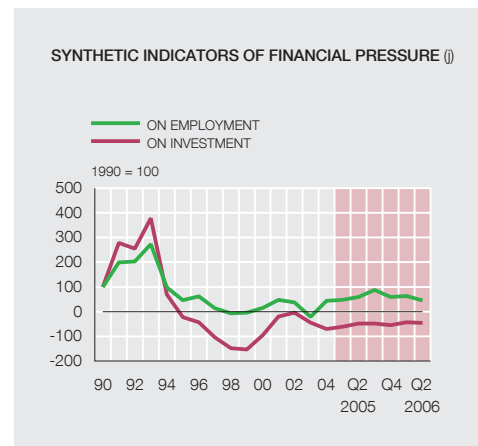
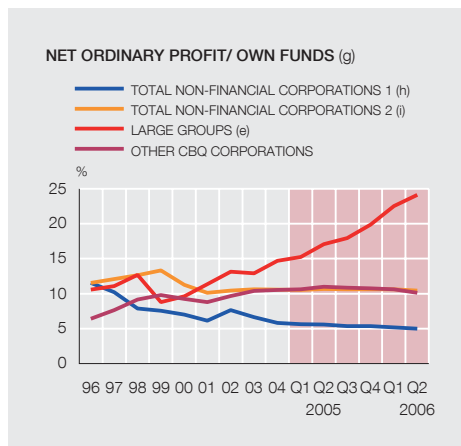
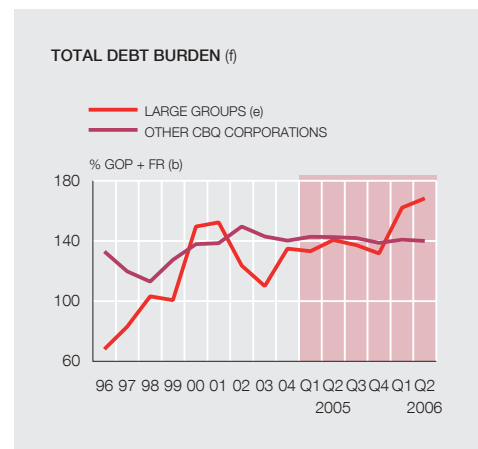
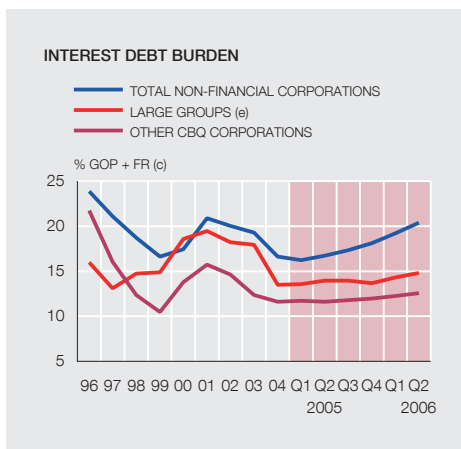
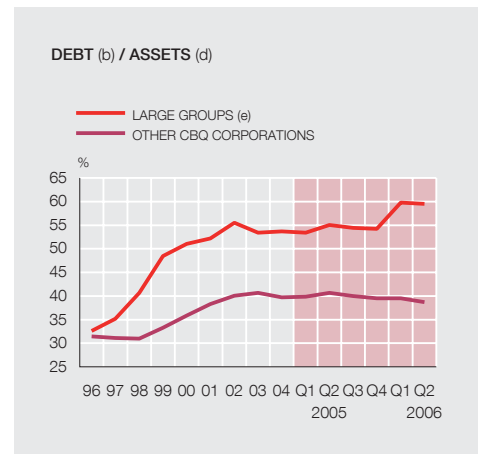
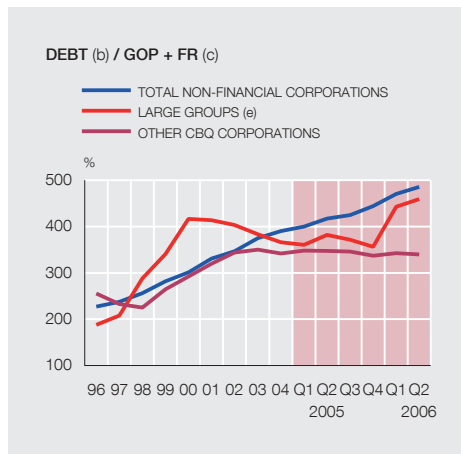
The buoyancy of the external financing of corporations led to a further increase in the sector's debt-to-profit ratio (see Chart 26). This, along with the increase in the cost of funds, caused interest payments to rise again relative to GDP (to 20%). However, the favourable trend in the sector's income during this period meant that the return on capital remained at similar levels to March.

The data for the sample of firms reporting to the CBQ, among which large companies predominate, also show a rise in the debt and debt burden ratios in Q2. However, the ordinary return on equity of these companies continued to increase, thanks to the behaviour of the large groups, helping to reduce the synthetic indicators of financial pressure on investment and employment.

Finally, according to analysts' expectations, the favourable trend in the profits of listed non-financial corporations, amongst which large ones also predominate, will be sustained over the coming quarters. Thus the growth forecast for this variable over the next 12 months is around 18%. For longer time horizons the estimated growth is obviously lower, although the upward revision to these projections made in the summer was notable (see Chart 27).

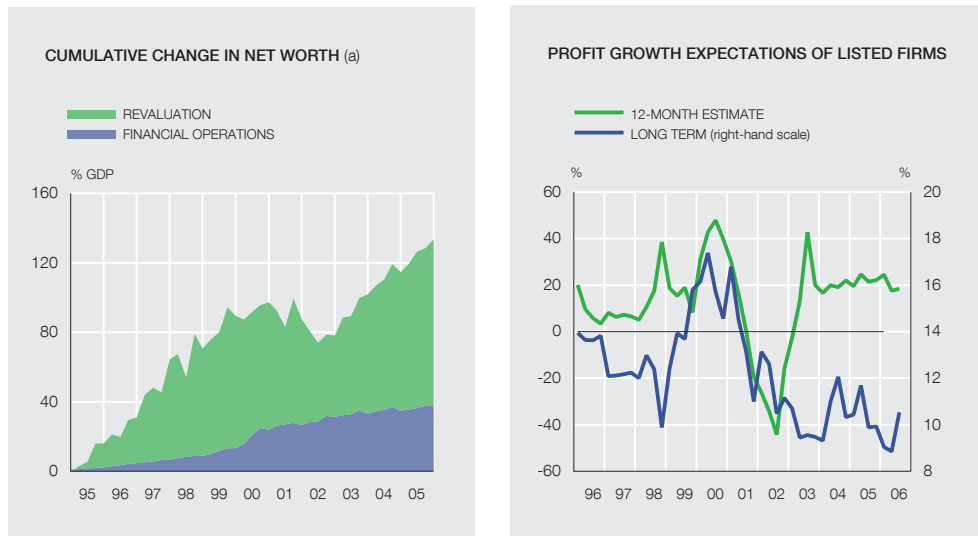
5.4 General government

General government net lending increased again in Q2, to stand, in cumulative twelve-month terms, at 2.3% of GDP (see Chart 28). By instrument, general government continued to make a net redemption of short-term securities, while its net issuance of long-term securities was very small. Also, there was a rise in the sector's deposits and a fall in its loans, so that the heading that reflects the changes in the net balance of these two items was positive, although by a smaller amount than in the previous quarter. Interest payments continued to decline relative to GDP, thanks to the reduction in the debt ratio, to stand at less than 2%.



SOURCE: Banco de España.

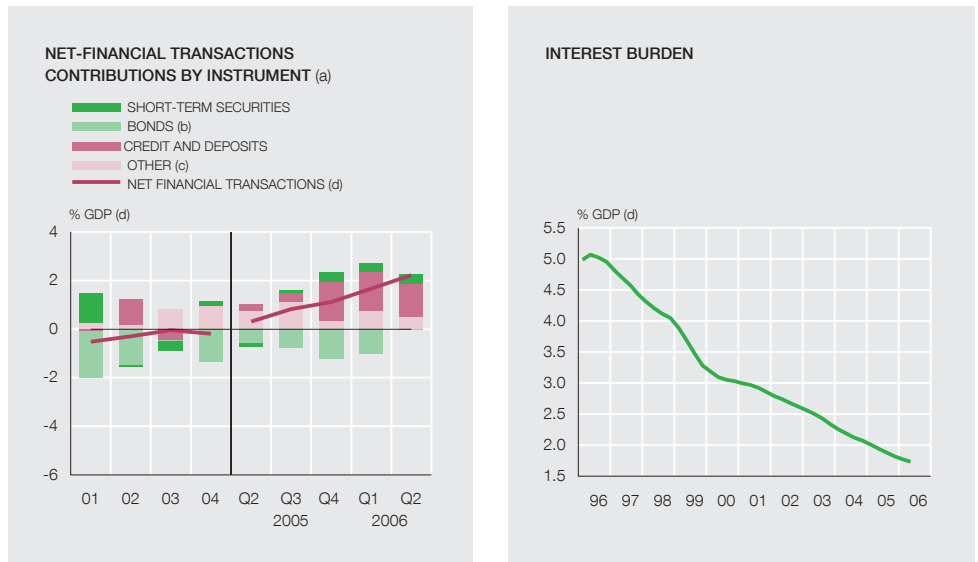
- a. Based on CBSO annual and quarterly survey data, except in the case of the "total non-financial corporations" series, which is based on the National Accounts (CNE and FASE). From 1999, the income of the sector corresponds to the CNE base 2000. For prior periods, an estimate consistent with this base is 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. Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefónica groups. Adjusted for intra-group financing to avoid double counting.
- f. Includes interest plus interest-bearing short-term debt.
- g. For total non-financial corporations, NOP = GOS + interest and dividends received – interest paid – fixed capital consumption.
- h. Own funds valued at market prices.
- i. Own funds calculated by accumulating flows from the 1996 stock onwards.
- j. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.



SOURCES: I/B/E/S and Banco de España.

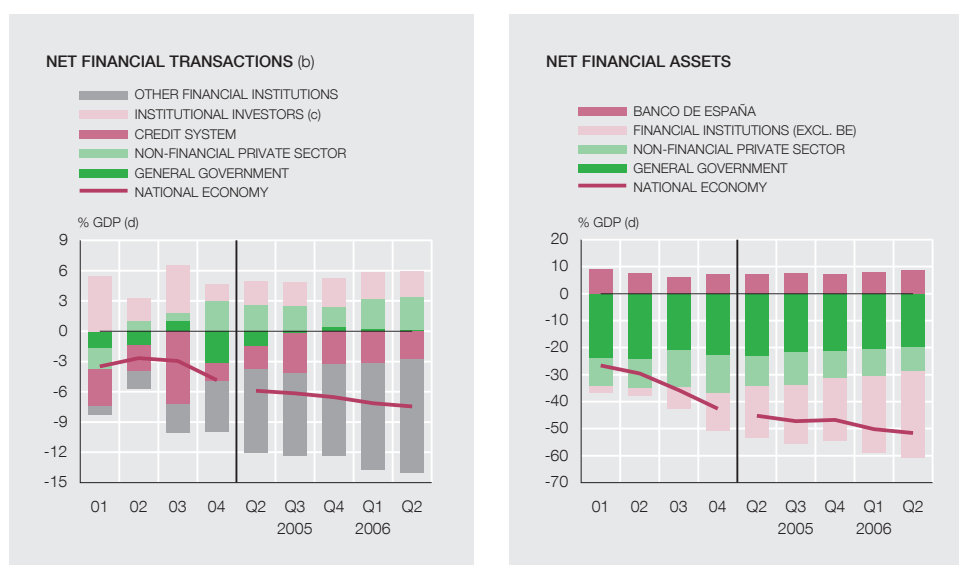
a. Net worth proxied by the valuation at market price of shares and other equity issued by non-financial corporations.

GENERAL GOVERNMENT
Four-quarter data



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. Unpaid accrued interest on bonds and net investment of Social Security funds in assets issued by the rest of general government.
- d. CNE base 2000.



SOURCE: Banco de España.

- a. Four-quarter data for transactions. End-period data for stocks. Unsectorised assets and liabilities not included.
- b. A negative (positive) sign denotes that the rest of the world grants (receives) financing to (from) the counterpart sector.
- c. Insurance companies and portfolio investment institutions.
- d. CNE base 2000.

5.5 The rest of the world

In 2006 Q2, the net debit balance of the nation's financial transactions expanded again to represent, in cumulative twelve-month terms, 7.5% of GDP. This was a result of the additional increase in the net borrowing of households and firms, which was not offset by the higher net lending of general government.

Financial institutions continued to play a central role in the channelling of funds from the rest of the world. In particular the relative importance of non-monetary financial intermediaries in the financing of the external deficit continued to grow, so that in June the debit balance of their net transactions vis-à-vis non-residents amounted to 11.3% of GDP, as against 10.6% in Q1 (see Chart 29).

Investment in foreign assets by resident sectors was 19.4% of GDP in June, in cumulative twelve-month terms, down 3.5 pp from March 2006 (see Table 7). By instrument, the most notable development was the decline in the net purchases of fixed-income securities and, especially, of those made by credit institutions. The main destination of the flows was the acquisition of shares and other equity, primarily representing direct investment.

Net capital inflows also moderated, to 26.9% of GDP in Q2, in cumulative twelve-month terms, down 3.2 pp from March. Nonetheless, the funds raised through securities other than shares continued to grow, to reach around 20% of GDP. Thus, the importance of these instruments, and in particular of those issued by financial institutions, in the financing of the external deficit increased again. By contrast, the flows in the form of interbank deposits fell in net terms to only 0.2% of GDP, from 5.2% in March.

Between April and June the progressive decline in foreign direct investment in Spain came to a halt, its level of 1.9% of GDP, in cumulative twelve-month terms, being slightly higher than in Q1.

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 7

% GDP	2002	2003	2004	2005			2006					
				Q4			Q1			Q2		
				Q4	Q1	Q2	Q4	Q1	Q2	Q4	Q1	Q2
NET FINANCIAL TRANSACTIONS	-2.7	-2.9	-4.8	-6.5	-7.1	-7.5						
FINANCIAL TRANSACTIONS (ASSETS)	12.8	13.5	13.7	18.2	22.9	19.4						
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0						
Cash and deposits	3.3	0.7	3.2	2.4	3.3	4.3						
<i>Of which:</i>												
<i>Interbank (a)</i>	2.3	0.5	0.7	3.2	2.3	2.6						
Securities other than shares	4.1	6.5	1.8	8.7	8.5	3.4						
<i>Of which:</i>												
<i>Credit institutions</i>	0.5	3.5	1.0	6.6	6.2	1.9						
<i>Institutional investors (b)</i>	2.7	3.5	0.3	2.1	2.0	1.5						
Shares and other equity	5.0	4.7	6.8	4.9	8.1	8.6						
<i>Of which:</i>												
<i>Non-financial corporations</i>	4.6	4.5	3.8	3.8	6.2	5.7						
<i>Institutional investors (b)</i>	-0.1	1.1	0.8	0.8	1.6	1.7						
Loans	0.1	0.3	0.8	1.1	1.8	2.0						
FINANCIAL TRANSACTIONS (LIABILITIES)	15.5	16.4	18.5	24.7	30.1	26.9						
Deposits	4.0	6.9	1.7	5.7	6.2	2.6						
<i>Of which:</i>												
<i>Interbank (a)</i>	3.1	5.3	5.0	7.2	7.5	2.8						
Securities other than shares	4.3	5.3	12.4	15.6	18.9	19.5						
<i>Of which:</i>												
<i>General government</i>	1.2	-1.0	2.7	0.1	1.0	0.8						
<i>Credit institutions</i>	1.3	3.5	4.6	6.3	7.1	7.4						
<i>Other non-monetary financial institutions</i>	1.8	2.8	5.1	9.3	10.8	11.3						
Shares and other equity	4.0	1.1	2.7	0.8	0.9	1.2						
<i>Of which:</i>												
<i>Non-financial corporations</i>	3.3	1.3	1.7	1.0	0.8	1.0						
Loans	3.0	2.8	1.3	2.0	3.6	3.1						
Other, net (c)	0.0	-0.8	-0.6	-0.6	-0.7	-0.7						
MEMORANDUM ITEMS												
Spanish direct investment abroad	4.8	3.3	5.8	3.4	5.5	5.9						
Foreign direct investment in Spain	5.7	2.9	2.4	2.0	1.8	1.9						

SOURCE: Banco de España.

a. Correspond only to credit institutions and include repos.

b. Insurance corporations and portfolio investment institutions.

c. Includes, in addition to other items, the asset-side caption reflecting insurance technical reserves and the net flow of trade credit.

Meanwhile, Spanish foreign direct investment abroad continued to grow, to represent almost 6% of GDP in the same period.

As a result of the behaviour of the financial flows with the rest of the world and the changes in asset prices and the exchange rate, the debit position of the economy continued to expand, to stand at more than 51% of GDP (see Chart 29). By sector, this was the result of an increase in the debit balance of financial institutions, which was not offset by the changes in the other groupings.

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