

QUARTERLY REPORT ON THE SPANISH ECONOMY

## 1 Overview

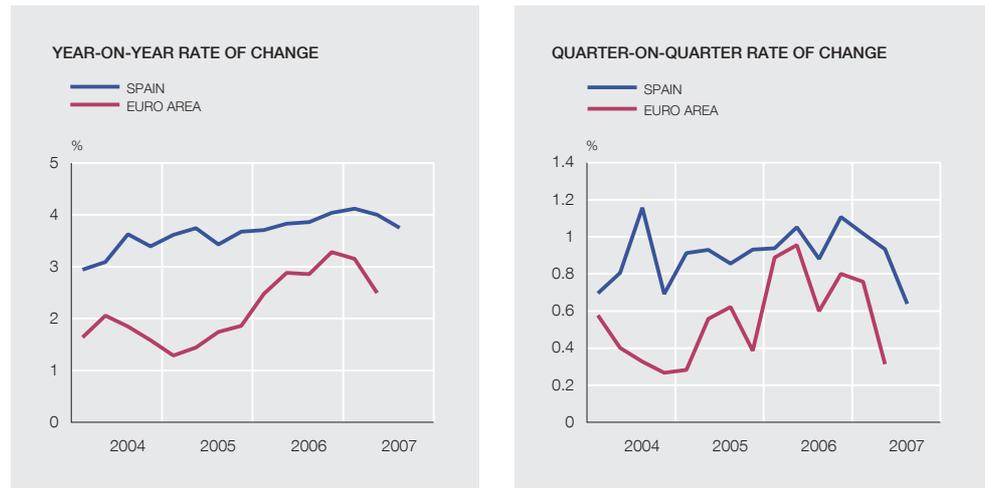
The period to date in 2007 has seen the prolongation of the phase of buoyant activity and employment in the Spanish economy, though there has been a mild slowdown in the pace of both variables since Q2. At the same time, the ongoing rebalancing of the contributions of national demand and of net exports to growth has continued. On QNA data, the year-on-year growth rate of GDP stood at 4% in 2007 Q2, 0.1 pp down on Q1. This was due to the somewhat more contained behaviour of national demand, since the contribution of net external demand to GDP growth stood at the level of the previous quarter, at -0.9 pp.

The information for 2007 Q3, though still incomplete and fragmentary, suggests that activity will have continued easing slightly. As a result, the growth rate of GDP should be standing at 3.7%, with a quarter-on-quarter rate of 0.6% (see Chart 1). The year-on-year growth rate of national demand is estimated to have declined by 0.3 pp to 4.3%, the result of more contained increases in its various components, especially investment in construction. In contrast, the contribution of net external demand to GDP growth is estimated to have risen by 0.1 pp to -0.8 pp, as a result of a greater recovery in exports than in imports. On the supply side, the mild slowdown in value added affected the various productive branches, although it impacted more sharply the construction and energy industries, and the rate of increase of employment fell off moderately. Consumer price growth was low in July and August, mainly reflecting a base effect linked to oil price developments. However, consumer prices rebounded in September to a year-on-year rate of 2.7%, a movement which may extend into the coming months owing to the pressures being exerted both by food prices and the latest rises in oil prices. As this report was going to press, the flash estimate of the HICP for October was released, showing a significant deterioration to 3.6% year-on-year. For the quarter as a whole, there was scarcely any change in the core inflation rate, which held at around 2.5%, and the inflation differential with the euro area stood at 0.6 pp on average.

The key development on the international economic stage during this period has been the bout of turbulence on international financial markets that began in the summer, and which has not fully abated at the time of this report going to press. The data released continue to show notable dynamism in the world economy, driven in particular by the strength of the emerging economies and the resilience of growth in the European economies. As described below, although this episode has not impacted the short-term behaviour of the main countries, it is contributing to clouding the outlook for the external environment and the Spanish economy.

The above-mentioned episode of financial instability originated in the increase in defaults on US sub-prime mortgage loans, a phenomenon initially perceptible in late 2005 but which heightened last spring. The origin of this crisis was relatively local, and began by affecting a limited number of specialised US financial intermediaries. But the high volume of financial transactions on international markets in recent years and, above all, the development of credit risk transfer instruments and the strong interdependence between these markets and the financial institutions of different countries have seen the financial turbulence take on a global dimension, impacting the main industrialised economies and a large number of financial markets.

Over the course of the summer these incidents triggered an upward revision of liquidity and credit risk premia, falls in stock market values, increases in the volatility of a large number of financial assets and a reduction in government debt yields. Subsequently, these movements



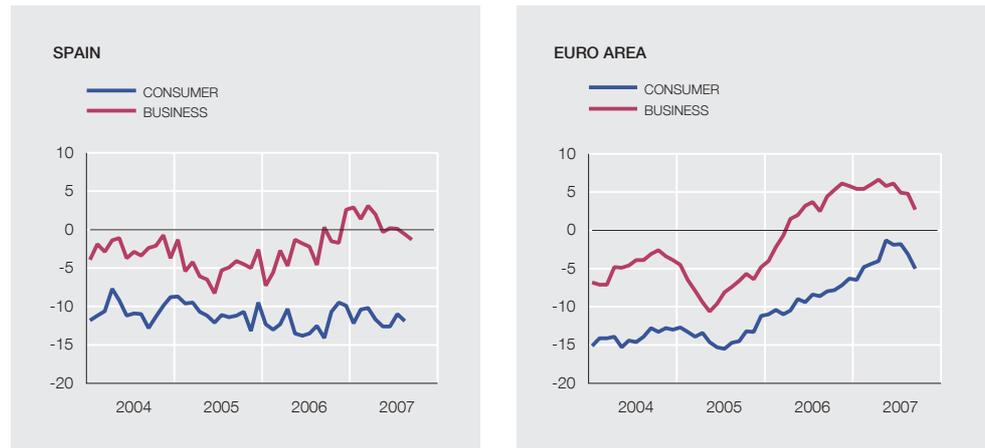
SOURCES: ECB, INE and Banco de España.

a. Seasonally adjusted series.

were partially reversed, although difficulties have persisted in the trading of structured and low-credit-quality products. In turn, the greater liquidity requirements associated with the refinancing of some of the financial instruments affected by sub-prime mortgages were ultimately reflected in money markets, where there were rather acute liquidity shortages and significant rises in interbank interest rates. In response to these events on money markets, the main central banks – the Federal Reserve, the ECB and the Bank of Japan, in particular – increased the supply of liquidity through the various mechanisms at their disposal, providing for some normalisation of monetary conditions, although pressures have not yet fully disappeared. On the foreign exchange markets, the dollar appreciated at the start of this episode, as a result of its safe-haven status. But it subsequently resumed the depreciating trajectory it had followed since early 2007, and at end-October it had fallen to a level of \$1.43 against the euro. Finally, the oil price picked up sharply as from late August, and at the close of October it stood once again at over \$83 per barrel.

Despite the instability of financial markets, the world economy has continued to show signs of considerable dynamism in Q3, driven by the strength of the emerging economies, whose financial markets have scarcely been affected by recent developments, and by the relative soundness of the European economies. Meanwhile, the Japanese economy picked up slightly following its poor figures the previous quarter, and the phase of moderate growth in United States continued, linked to the adjustment in the real estate sector, which has gathered pace in recent months owing to the sub-prime mortgage crisis. Against this background, it is estimated that US residential investment has fallen once more, and that consumption and employment, which had been underpinning spending and activity, have begun to show (albeit incipient) signs of being contained. Nonetheless, the industrial sector is strong and the external sector has improved, owing partly to the depreciation of the dollar.

Inflation rates in the developed economies eased slightly during the quarter and this, combined with the pressures arising on money markets, led the central banks to act. The Federal Reserve cut its official rates by 50 bp on 18 September to 4.75%, while the Bank of Japan and the Bank of England held their intervention rates unchanged at 0.5% and 5.75%, respectively, at their October meetings.

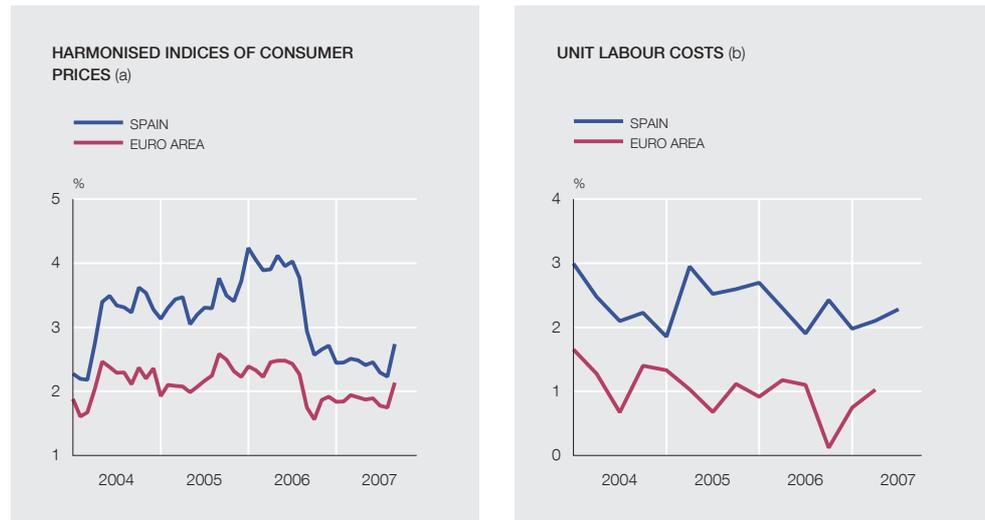


SOURCE: European Commission.

The strong growth phase in train in the euro area since late 2005 continued according to the still-incomplete information available, underpinned by external demand and by the greater momentum of employment. That said, there is some discrepancy between the quantitative and qualitative information at hand (the latter is more pessimistic), which is illustrative of the uncertainty surrounding these forecasts. As to inflation, the year-on-year rate of change of the HICP in September was 2.1%, somewhat higher than at the end of Q2, owing to a base effect associated with the behaviour of oil prices in the first half of 2006 and with the recent rise in the price of this latter commodity and that of foodstuffs. Stripping out the effect of the more volatile components, the core inflation rate rose slightly in Q2, taking it up to a year-on-year rate of 2% in September. This was due to the increases in processed food prices in the face of the strong rise in agricultural commodities prices and the demand pressures on international markets. Given this situation, at its September and October meetings the ECB considered that the inflation outlook in the euro area was compatible with price stability in the medium term, although the upside risks detected before the summer remained in place. In any event, faced with the pressures on money markets and greater uncertainty, the ECB held its intervention rates unchanged at its August, September and October meetings, with a view to gathering more information on the effects of the episode of financial stability on the European economy.

In sum, the events unfolding on international financial markets are having a relatively limited effect on the world economy in the second half of 2007, but their impact might be somewhat greater in 2008. Indeed, this is reflected in the growth forecasts for world output by the main international agencies in recent weeks.

The external environment of the Spanish economy in Q3 was, naturally, marked by the aforementioned episode of financial turbulence. Spanish financial markets experienced these pressures, and the reflection of this has been a certain tightening of monetary and financial conditions in the light of the rise seen in forward interbank market interest rates (which rose to high levels in August and September, but have turned downwards somewhat in October). Set against the high volatility of securities markets throughout the quarter, stock market prices have picked up considerably since mid-September, meaning there will have been a moderate rise in financial wealth between June and October. The rises in real estate values continued to slow, given the gradual deceleration in house prices, which increased in Q3 at a year-on-year rate of 5.3%, 4.5 pp down on a year earlier.



SOURCES: Eurostat, ECB and INE.

a. Year-on-year rate of change.

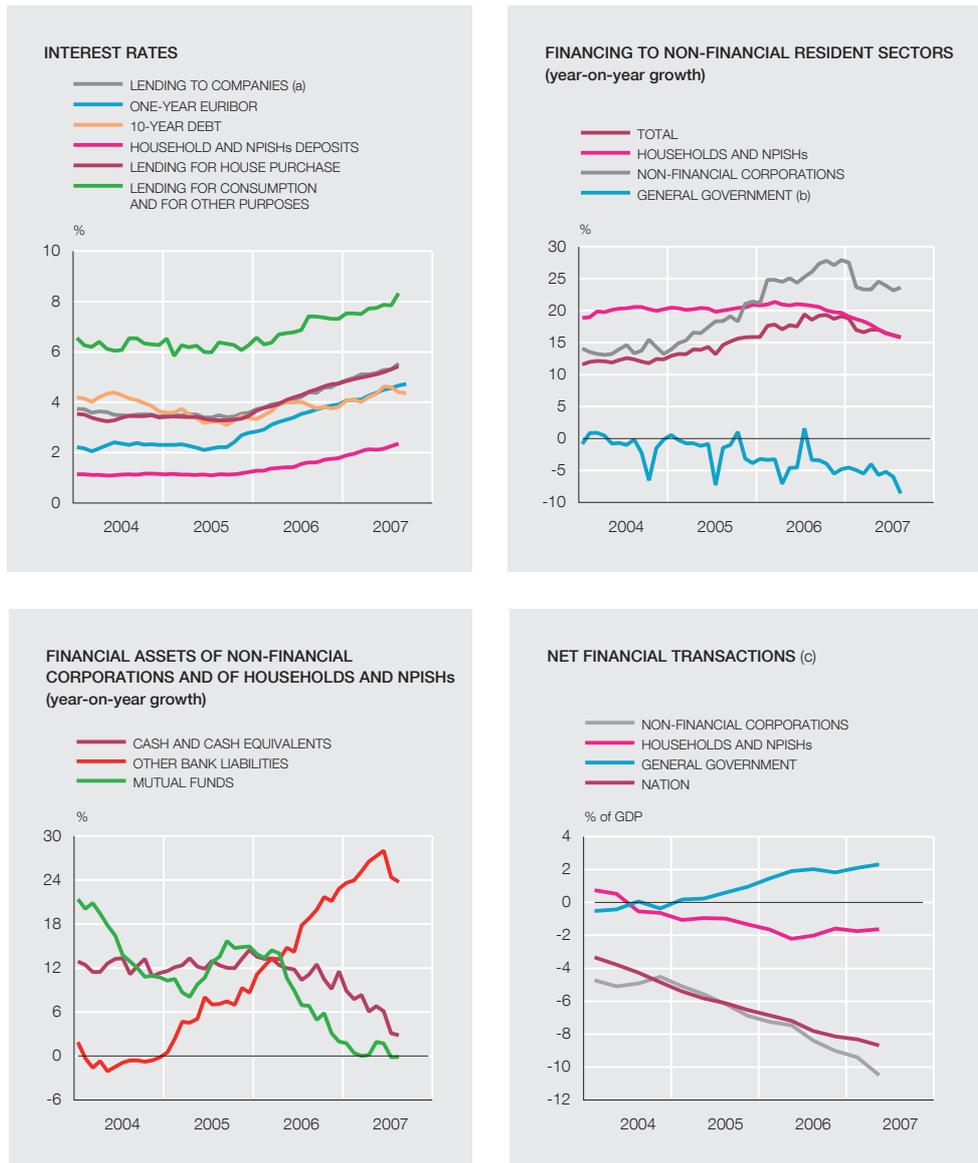
b. Per unit of output. Year-on-year rate of change calculated on the basis of seasonally adjusted series.

As earlier described, there have been no appreciable changes in Q3 in the dynamism of the world economy, and of the euro area in particular. Accordingly, the external environment of the Spanish economy remains favourable. Overall, this combination of factors has enabled the gradually slowing path of activity to continue in recent months, on the basis of the moderation of domestic demand and of a rebalancing of the contribution of net external demand to growth.

Household spending continued on the gradually slowing trajectory on which it has been moving since late 2006, albeit within a pattern of dynamism underpinned by the strength of employment. Household consumption slowed moderately in a setting in which, as developments in disposable income in the first half of the year would suggest, the high growth of tax revenue and the rise in interest payments limited the increase in wage income and curtailed the expansionary effect on spending capacity of the favourable inflation figures. The growth rate of residential investment declined somewhat more sharply, continuing on the gradually slowing path on which it embarked in early 2006, in the face of the increase in the user cost of investment in housing and of the reduced expectations of property price rises.

The lesser momentum of spending, along with the rise in borrowing costs, led the rate of increase of household debt to fall during the quarter, in line with the behaviour observed in the preceding months. As a result, the year-on-year growth rate of credit to households stood below 16% in August, somewhat over 0.5 pp less than in June. This was thanks to the slow-down both in house purchase loans and in loans intended for consumption and other purposes. Overall, the household saving ratio eased once again in the first half of the year and net household borrowing held stable in terms of GDP; however, the change in financial conditions may possibly lead the saving ratio to stabilise in the future.

Corporate spending remained robust, albeit on a mildly moderating path. During Q3 investment in equipment continued to be buoyant, and it was once again the most dynamic component of national demand, running at a rate of over 10%. The maintenance of a highly favourable outlook for earnings, following the sound results in Q2 (particularly in the industrial sector),



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. Cumulative four-quarter data.

the strength of national demand and a pick-up in exports all lent support to corporate investment plans. Investment in other construction slowed more severely following the high rate of expansion of the previous quarters. On the whole, the resort by corporations to borrowed funds began to reflect the relative tightening of financial conditions. As a result, the year-on-year rate of increase of credit to firms eased to around 24% in August, somewhat less than 0.5 pp below the June rate. That said, the sector's net borrowing continued to increase in the first half of the year.

Foreign trade flows – in terms of both export and import volumes – recovered to some extent in Q3 following a first half of the year marked by moderate growth. Nevertheless, in 2007 to

date the increase in exports has been lower than that for the previous year, against a backdrop in which export markets are, on the whole, proving somewhat less expansionary than in 2006 and in which the appreciation of the euro might be adversely bearing on the price-competitiveness of exports, affecting particularly those targeted on the rest of the world. In terms of products, exports of non-energy intermediate goods and, to a lesser extent, of non-food consumer goods were relatively strong. The tourism indicators performed somewhat more favourably in the summer months, which made for a mild recovery in tourism receipts in this period.

Goods imports in real terms also quickened in Q3, although for the year as a whole their growth is slightly down on that of 2006, which is consistent with the mild slowdown in final demand; that said, there has at the same time been an appreciable improvement in the competitiveness of imported products, owing to the appreciation of the euro. Of note has been the strength of purchases of capital goods and of non-energy intermediate goods, in line with the buoyancy of industrial activity. Services imports also rose in Q3, as a result of the increase in non-tourist expenditure.

In any event, the trade deficit has continued to rise in 2007 to date, albeit at a lower rate than in the past. Underpinning this lesser pace, to some extent, has been the fall in oil prices in the first half of the year and the appreciation of the euro. The net borrowing of the nation continued to increase, standing at 8.8% of GDP in Q2.

On the supply side, the mild slowdown in the rate of increase of value added in Q3 was mainly due to some loss of momentum in activity in the construction industry, both in the residential construction component and, to a somewhat greater extent, in public works and other construction. The latter was temporarily affected by the completion of numerous projects in the quarters prior to the last local and regional elections. However, the infrastructure development commitments entered into in the PEIT (infrastructure strategic plan) and the spending programmes envisaged in the 2008 Budget, in partnership with the private sector in the case of many projects, augur a recovery in this type of investment in the coming quarters. Output in the remaining non-farm productive branches held on a similar path to that of the first half of the year, although industry showed signs of an incipient easing in activity.

The mild slowdown in GDP passed through with similar intensity to the pace of employment creation, although the loss of momentum in job generation was somewhat greater in construction. The EPA figures for Q3 are along the same lines, as numbers employed grew at a year-on-year rate of 3.1%, compared with 3.4% the previous quarter. Labour supply rose smoothly in the June-September period, after having moderated in the preceding quarters. The resulting rate of increase is, in any event, somewhat slacker than that posted in recent years.

Turning to labour costs, estimates for Q3 suggest compensation per employee in the market economy held at a rate of increase – marginally below 3% – virtually unchanged from the first half of the year. This would indicate that the pace of wages is slowing following the rise observed in 2006. The easing in labour costs would reflect collectively bargained wage rates lower than those of the previous year (around 2.9% on the information to September). But it would, above all, be indicative of the lesser impact of indexation clauses due to the deviation by actual inflation in 2006 from its forecast target, which might raise labour costs by around 0.3 pp in 2007, compared with the impact of almost 1 pp estimated last year. Foreseeably, the remaining factors that account for the gap between wage rates and increases in compensation per employee – in particular the composition effects that have come about as a result of the major changes in labour supply – may become less important in the coming quarters,

partly offsetting the moderation introduced by the foregoing effects. Owing to the rise observed in productivity, this scenario of wage moderation is feeding through to unit labour costs, which are undergoing negative changes in the case of industry, prompting improvements in the price-competitiveness indices constructed with these indicators.

On average for the quarter, consumer prices have held at a growth rate of 2.4%, similar to that in the previous quarter. Nonetheless, the CPI rose in September to a year-on-year growth rate of 2.7%. A significant portion of the easing seen in consumer prices in July and August reflects the fall in the prices of the energy component compared with a year earlier; however, the prices of non-energy industrial goods also behaved very favourably, perhaps reflecting the effect of the appreciation of the euro on import prices. In contrast, services prices remained at a level close to 4% and food prices, especially those of processed food, quickened somewhat. The stripping out of the above-mentioned base effects, the oil price rises in September and October, and the risk of further increases in food prices may heighten inflationary pressures in the remainder of the year, with the risk that the indexing mechanisms in place may help these price rises spread, temporarily, to the rest of the economy.

The Spanish economy is witnessing a phase of gradual moderation in the dynamism of its domestic demand which reflects the effect of the tightening of financial conditions on Spanish household and corporate spending decisions, and which presages private-sector indebtedness that will be more sustainable over time. The short-term growth outlook is therefore favourable but, as indicated, it is subject to greater uncertainty owing to the doubts over the duration of the episode of financial stability. Its duration will determine the final impact on real growth in the world economy and, therefore, on the dynamism of the external environment of the Spanish economy, in which headway towards a more balanced growth pattern is firming. Moreover, if the international financial instability were to continue, it might manifest itself in a more durable tightening of financial conditions, thereby affecting future private sector spending plans.

In these circumstances, economic policies geared to budgetary stability and structural reform have an important role to play in fomenting an environment of certainty and in improving the economy's degree of flexibility. In recent months the draft State budget for 2008 and the annual progress report on the PNR (National Reforms Programme) have been presented. The draft budget targets an overall general government surplus of 1.15% in 2008, thereby complying with the budgetary stability requirements laid down in the Stability and Growth Pact and in the Law on Budgetary Stability. Insofar as its preparation is based on a very prudent end-2007 forecast on the revenue side, any upward deviation in revenue should be used to bring about a likewise higher-than-budgeted surplus, preventing it from resulting in an increase in spending. The PNR progress report highlights how the implementation of the plan has progressed soundly and how convergence in terms of per capita GDP with the European Union has been maintained. Since the approximation of economic welfare levels closer has been essentially based on the increase in the rate of employment, further reforms must be pushed through to allow the ongoing buoyancy of job creation to be maintained and, at the same time, provide for greater efficiency gains in the economy.

## 2 The external environment of the euro area

Since early August there has been a period of turbulence in international financial markets. This has been manifest in a strong increase in the risk premia on the structured financial assets associated with the financing of US sub-prime mortgages and in a drastic decline in liquidity in numerous financial market segments, especially in structured instruments. These problems also fed through to money markets, prompting intervention by the main central banks, which provided emergency liquidity assistance. The flight to quality initially led to a significant reduction in long-term government bond yields, the appreciation of the dollar and, above all, of the yen (owing to the closing out of carry-trades), and corrections on stock markets. Subsequently, these movements were largely reversed, in particular following the 50 bp cut in US official interest rates on 18 September. In any event, the pressures in money markets and in the markets for structured products and for the lowest-graded assets persist. As to the foreign exchange markets, after the initial reaction the yen and the dollar once again showed marked weakness, which in the case of the latter led to an historical low against the euro of \$1.43, while the main recipient currencies of carry trade flows, such as the Brazilian real and the Turkish lira, appreciated strongly. In this episode the emerging markets have shown notable resilience (see Box 1); while they were adversely affected at first, the stock markets of all the emerging regions have recovered notably and sovereign yields have narrowed, though there was an across-the-board reduction in issues in September, following record placements in the previous months. Finally, the price of Brent oil fell forcefully at the start of the bout of turbulence, but its robust recovery since late August - coinciding with the hurricane season in the Gulf of Mexico, negative stocks data and instability in certain producer regions - has placed it at new highs, at over \$89 per barrel.

In the United States, the final GDP figures for Q2 showed a substantial acceleration in the pace of economic activity, with annualised quarterly growth of 3.8%, compared with 0.6% in Q1. The acceleration stemmed from the improvement in the external sector and in non-residential investment. However, there was a slowdown in private consumption, which had acted as the driving force of growth in the preceding quarters, and the contribution of residential investment remained negative. Regarding the outlook for Q3, the latest indicators confirm the sluggishness of the real estate sector, which is indeed exceeding expectations. In July and August, the slide in house sales continued, the stock of unsold new and second-hand housing held at historically high levels, and in September housing starts reached a 14-year low. Likewise, to August, house prices continued slowing significantly. On the demand side, employment figures point to some slowing in the labour market in Q3 (when 97,000 jobs were created on average per month, down on the average of 134,000 in the first half of the year), and certain dispersed indicators of consumption would suggest a slowdown in September and October. The most favourable signs for the economy continue to arise in the industrial sector, where production and the manufacturing and services PMI indices suggest a moderate expansion in activity during Q3. Finally, in the external sector, there was an improvement in the trade balance in August as a result of the acceleration in exports. The behaviour of prices over the quarter as a whole has generally been positive. The personal consumption spending deflator - in both the overall and the core index - eased to 1.8% in August, and core inflation measured by the CPI stood in September at 2.1%, despite the overall index rising to 2.8%. The September cut in official interest rates contributed to a gradual but limited restoring of normality on interbank markets.

In Japan, the indicators of consumption and industrial activity rose in August after their unfavourable performance in July and following the contraction of GDP in Q2, owing to the unexpected decline in investment. On the supply side, the Tankan survey for Q3 was generally positive and

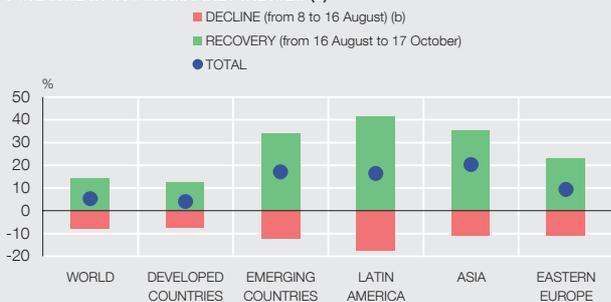
The emerging economies were not initially immune to the impact of the financial turbulence stemming from the US mortgage market. However, and unlike previous periods of global instability, the impact on the financial markets has been a fleeting one, and the initial losses have been more than recouped.

Panels 1 and 2 respectively compare stock market developments and the interest rate spreads of the emerging countries with similar variables in the developed economies in three periods and up to 17 October. The first reference period runs from 8 August, when the pressures - which had already initiated in July - heightened, up to the point of the maximum asset price losses (as at 16 August), the second spans the subsequent recovery and the third the complete period. The initial losses, both on stock markets and in the yield spreads of comparable assets (low-grade bonds in the United States and sovereign bonds in the emerging economies), were somewhat bigger in the emerging markets, but their recovery was clearly greater, whereby the overall balance is more favourable for the latter economies. The emerging stock markets, measured by the MSCI index,

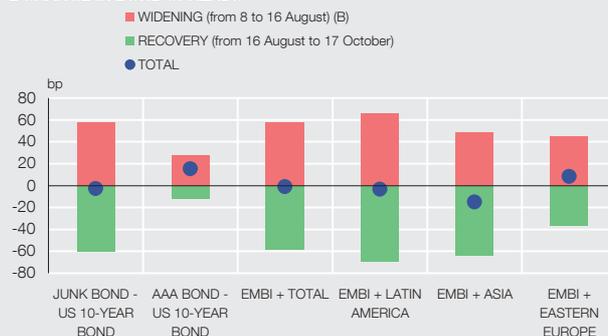
posted gains of around 30% from 16 August, more than offsetting the losses in previous weeks. Regarding sovereign spreads, the EMBI+ for the emerging countries had fallen again to around 190 bp, the level prior to the bout of turbulence. It should be underscored, however, that the recovery in sovereign spreads and on stock markets was greater in Asia and Latin America than in Central and Eastern Europe. On the foreign exchange markets, most currencies had appreciated significantly against the dollar, especially those which, in the first half of the episode of turbulence, had undergone greater depreciations. These were currencies which had been recipients of carry trade flows, as is the case of the Brazilian real and the Turkish lira. Lastly, the resilience of the financial variables in China throughout the entire episode was notable, probably because Chinese financial markets are more isolated from international developments, owing to the existence of capital controls. In particular, the gains posted on the Chinese market since early August have exceeded 40%.

A counterpoint to these favourable developments has been the sharp reduction in Q3 in debt issues (public and private alike) by the emerg-

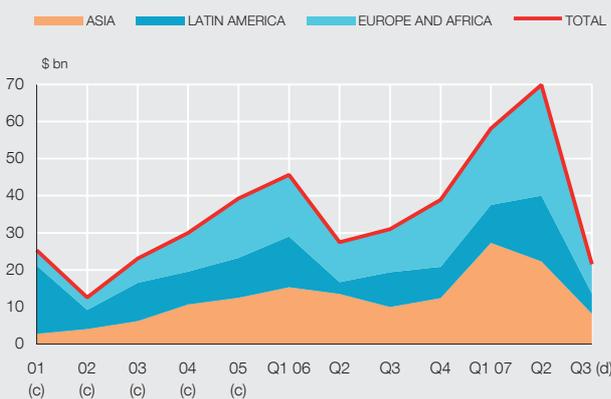
1 CHANGE IN STOCK MARKET INDICES (a)



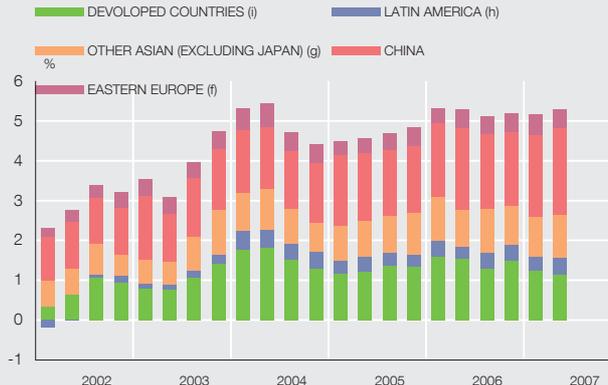
2 CHANGE IN BOND SPREADS



3 ISSUES ON INTERNATIONAL MARKETS



4 CONTRIBUTION TO WORLD GDP GROWTH (e)



SOURCES: National statistics, IMF, MSCI and Datastream.

- a. MSCI indices.
- b. The financial variables posted their worst figures on 16 August.
- c. Quarterly average.
- d. Data to August and estimate for September 2007.
- e. Contribution, in percentage points, to the year-on-year change in world GDP, calculated drawing on data from 56 countries accounting for 91% of world GDP.
- f. Russia, Ukraine, Turkey, Poland, Czech Republic, Hungary, Estonia, Latvia, Lithuania, Slovenia, Slovak Republic, Bulgaria and Croatia.
- g. India, Singapore, Malaysia, South Korea, Indonesia, Thailand, Hong Kong, Taiwan and the Philippines.
- h. Argentina, Brazil, Chile, Colombia, Mexico, Peru and Venezuela.
- i. Western Europe, United States, Canada, Japan, Australia and New Zealand.

ing economies on international markets (see panel 3). In any event, these figures should be interpreted with caution, as what is involved is a correction of the previous sharp growth, taking advantage of the sound financing conditions, and they do not necessarily reflect the impossibility of issuing debt. In contrast, this pause in issues might be interpreted as a reasonable strategy in a more uncertain setting, given that borrowing requirements are not pressing.

Several reasons, relating both to the emerging economies and to the international context, explain this recovery and justify the lesser financial vulnerability of these economies on this occasion. Firstly, the economic fundamentals of most of these economies have improved significantly (strong economic growth, contained inflation, moderate fiscal deficits). Secondly, the financial fundamentals are also sounder: most of these countries currently boast a comfortable external position, with the exception of the Eastern European economies where, perhaps because of this, the recovery has been more muted; capital inflows have also been substantial, but the traditionally more stable foreign direct investment has played a most substantial role over the last five years in practically all the emerging regions; further, these countries have sharply built up reserves, which act as an additional buffer against potential financial shocks; moreover, some governments, especially in Latin America, have reduced their exposure to foreign-currency-denominated foreign debt, applying highly active financial management policies; lastly, the commodities and oil exporting countries are enjoying an additional increase in the already-high prices of these products.

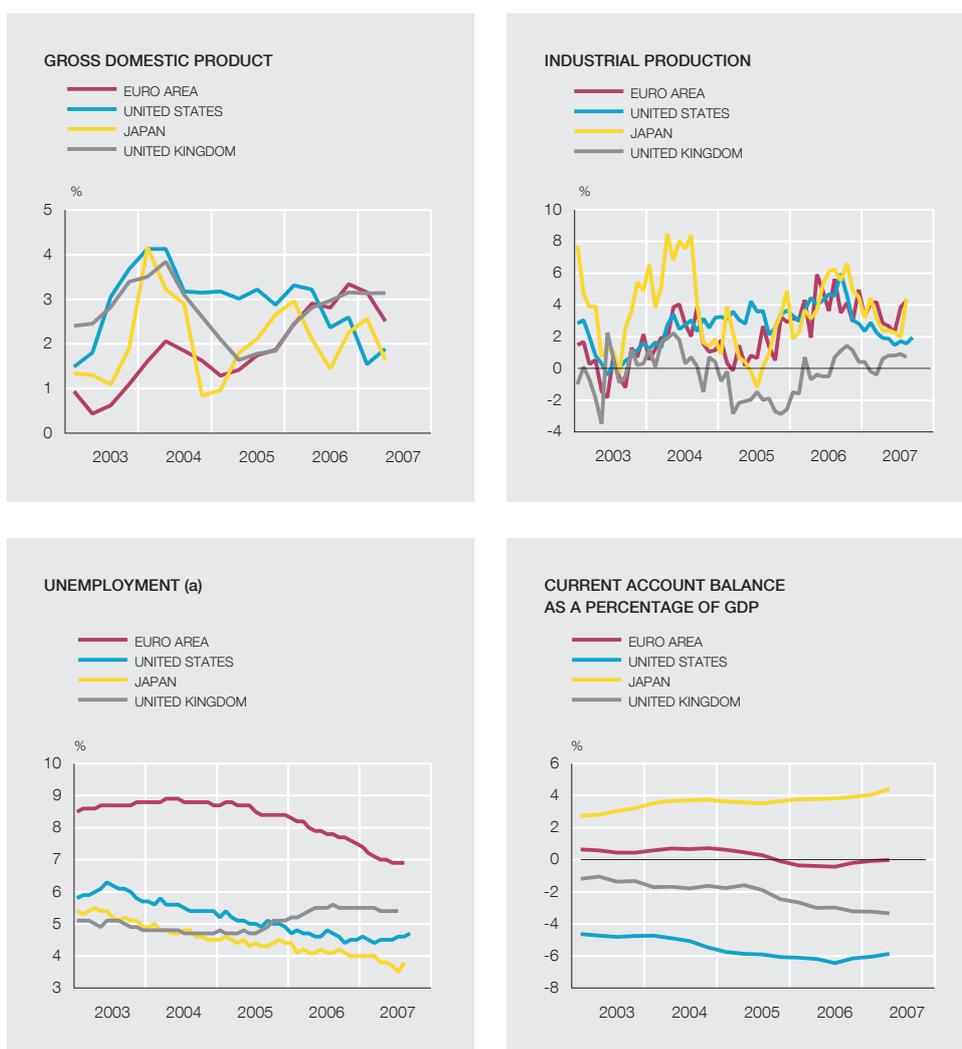
The growth prospects for these economies remain robust, partly due to their resilience in the face of financial turbulence, and partly because domestic demand has been firming in recent years. This positive growth outlook for the emerging economies may prove to be a

key underpinning for global growth in the short and medium term, if the foreseeable slowdown in the pace of activity in the developed countries occurs. The emerging economies already account for half of world output (measured in PPPs) and their contribution to the growth of global GDP has exceeded 70% in the last six years (75% in 2006) (see panel 4). Moreover, the fact that the external position of this group of countries is in surplus means that they are net financiers of the developed countries.

In any event, it should be noted that this greater resilience of the emerging economies has come about in a highly favourable international setting, in both real and financial terms (since low interest rates have been conducive to the search for higher returns by international investors, some of whom have targeted the emerging countries). Accordingly, these economies are exposed to economic and financial risks that need to be monitored. Among the economic risks, there is the possibility that the global economic slowdown may be sharper than foreseen. In that case, despite the strengthening of domestic demand in the emerging economies, their diminishing but continuing financial dependence on the rest of the world and on buoyant commodities markets would make the envisaged maintenance of growth rates inviable. Another factor of risk is the growing inflationary pressures, which might give rise to economic policy dilemmas in some of these countries. Among the financial risks, many of the emerging economies have posted strong credit growth and/or a significant increase in private-sector foreign debt (occasionally via structured products) against a background of ample liquidity and very favourable borrowing conditions. In some regions such as Eastern Europe, a high proportion of this debt has been taken out in foreign currency. Accordingly, it is crucial for these economies to pursue economic and financial policies that enable them to continue reducing their vulnerability and that ensure sound fundamentals.

industrial output in August more than offset the fall the previous month, while the PMI index increased once again in September. Overall, this would suggest a recovery in manufacturing activity following the sluggishness shown in the first half of the year. On the consumption side, most of the spending indicators rose in August, despite the ongoing deterioration in consumer confidence. In the labour market, the unemployment rate edged up by 0.2 pp in August to 3.8%, owing to a slowdown in the pace of job creation, although the ratio of job vacancies to applications held at a high level. The current account surplus improved in August, thanks to the notable momentum of the trade balance, assisted by the strength of exports to the rest of Asia. On the negative side, the construction indicators posted notable declines in terms both of housing starts and of orders in August. As to the inflation indicators, the August figures placed the year-on-year rate of the overall index at -0.2%, while the core rate held at -0.1% for the fifth consecutive month. Against this background, the Bank of Japan kept its official interest rate at 0.5% at its October meeting, at which level it has held unchanged since February.

In the United Kingdom, GDP grew by 3% in Q2 compared with the same period a year earlier and, on preliminary estimates, by 3.3% in Q3, in keeping with the buoyancy of the industrial production and consumption indicators in this period. The rise in consumer and house prices, along with

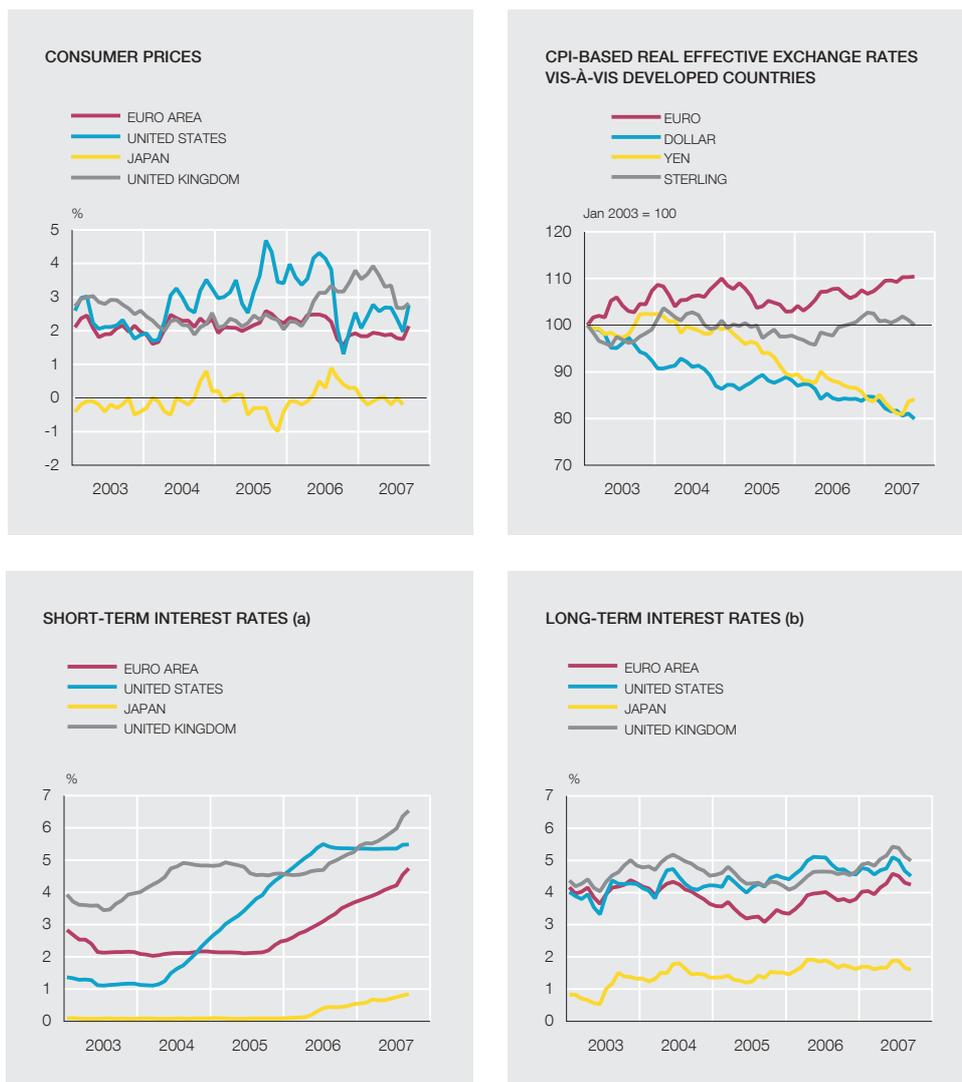


SOURCES: Banco de España, national statistics and Eurostat.

a. Percentage of labour force.

wages, showed signs of easing during Q3, while producer prices rose slightly in September. In this setting and against the backdrop of the financial turbulence, the Bank of England held official rates at 5.75% at its October meeting and, following the financial problems at a mortgage bank on 14 September, it became more active in providing liquidity assistance to the banking system. Notwithstanding, normality has not been fully restored in the interbank market.

The notable dynamism of activity in the new European Union members continued in Q2, when year-on-year GDP growth of 6% was recorded. However, the latest indicators of activity in demand would suggest a slight easing, especially so in Hungary, owing to the fiscal adjustment programme. The strength of domestic demand in most countries continues to exert pressure on consumer prices, which has led to an upward revision of inflation expectations, and has also widened current account deficits, especially in the Baltic States and in Bulgaria. There was no change in official interest rates, except in Hungary, where they were cut by 25 bp to 7.50%. Following the market turbulence, the main currencies with flexible exchange rates appreciated against the euro. The ERM II remained relatively stable, with some downward pressure on the Latvian lats, which nevertheless held within the central fluctuation bands against the euro.



SOURCE: Banco de España.

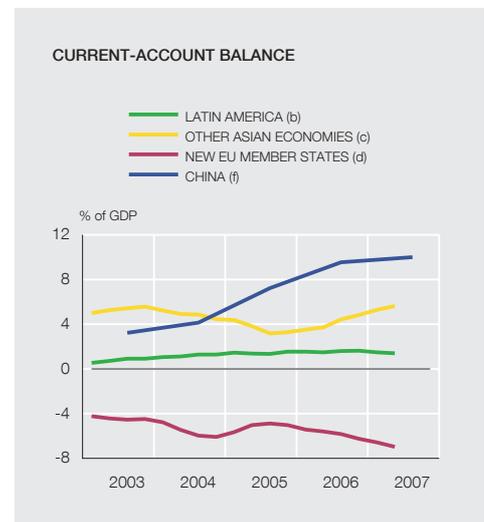
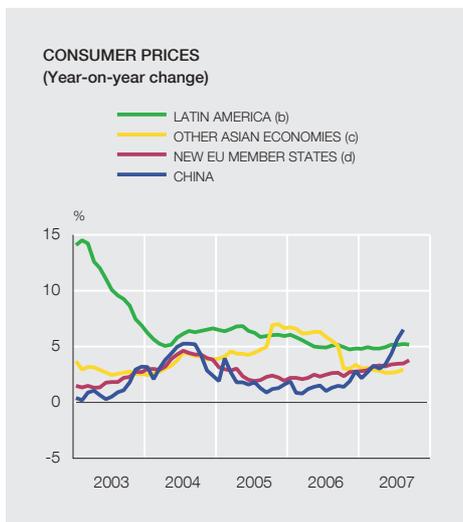
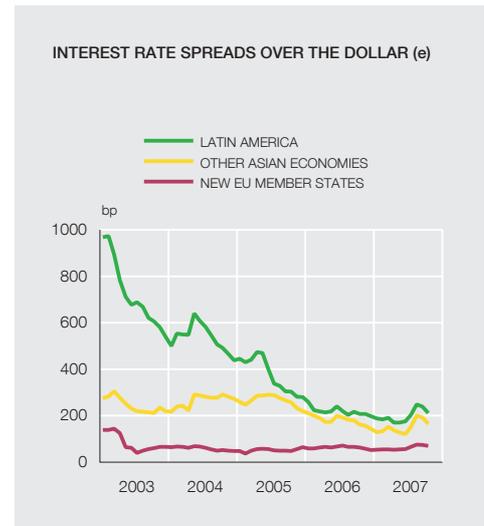
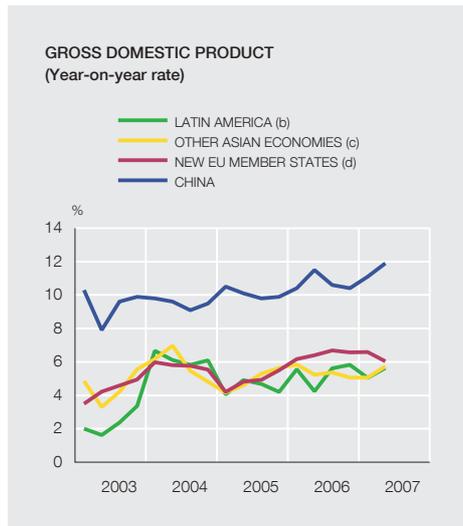
- a. Three-month interbank market interest rates.
- b. Ten-year government debt yields.

In China, growth quickened during Q2 to 11.9%, and in Q3 the indicators of industrial activity and demand would suggest that the growth rate will be maintained. The trade surplus remained high in Q3, following the record figure in June, against the background of the ongoing but moderate appreciation of the renminbi against the dollar. Notable throughout the quarter was the rise in inflation to 5.6% year-on-year in July and 6.5% in August (an 11-year high). This increase was largely driven by the rise in food prices, since core inflation held stable. Given this situation the central bank continued to tighten monetary policy, which was reflected in an increase over the last quarter in benchmark lending and deposit rates by a total of 45 bp and 54 bp, respectively, and by a rise in the bank reserve ratio in September and October. In the rest of Asia, the available data on economic activity would suggest that its pace eased in July and August, while inflation tended to rise across the board in September, with the notable exception of India.

In Latin America, year-on-year GDP growth in Q2 rose to 5.6%, compared with 5.2% the previous quarter. This increase in activity in the region was centred on Brazil, Argentina and, to a lesser extent, Chile, while in other economies in the area growth slowed, though the related

**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, Slovak Republic, Estonia, Latvia, Lithuania, Cyprus, Malta, Bulgaria and Romania.
- 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.

rates remain very high. Domestic demand was the main driving force of activity, and there has been a notable and fresh acceleration in the growth rate of investment. The initial data for Q3 suggest the pace of growth will be maintained in most countries, with the exception of Chile and Mexico. Turning to prices, regional inflation climbed by 0.2 pp to 5.3% in August, and held at this figure in September. The biggest increases were in Brazil and Chile, and largely stemmed from food price developments. As to monetary policy, there was a 25 bp increase in official rates in Colombia, and one of 50 bp in Chile and Peru. Brazil, however, cut its rates by 50 bp in July and by 25 bp in September, but held them unchanged in October. The Mexican Congress gave final approval to the fiscal reform presented by the Executive, with slight amendments. This measure led to the upgrading of Mexican sovereign debt. Brazil's credit rating also improved, standing at investment-grade level.

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

The period of buoyancy initiated in late 2005 in the euro area continued in the first half of 2007. The latest activity and employment indicators point to the prolongation of this scenario in the second half of the year, although the economic conditions have changed substantially due to three factors: the notable increase in raw materials prices, the sustained appreciation of the euro and the more restrictive financial conditions, which, as indicated by the Bank Lending Survey (BLS), could tighten in the last quarter of the year. The combined action of these three factors seems to be having a significant impact – at least in the short-term – on agents' confidence (see Box 2) and could give rise to a certain slowdown in growth at the end of the year. In any event, it seems that the average GDP growth rate in 2007 will not differ from the 2.5% recorded in Q2, a figure which is in line with the estimates of certain international agencies.

In summer the problems sparked by sub-prime mortgages in the United States spread to the international financial markets, giving rise to a significant change in the valuation of and attitude to risk, an increase in volatility and greater demand for liquidity. The financial shocks particularly affected the money markets, including the euro area interbank market, which saw a marked decline in the volume of longer-term transactions and a substantial increase in yields (see Box 3). Against this background, the action of the ECB – and that of other central banks – has focused on preventing the lack of liquidity from adding to the tensions, which, despite a certain normalisation, have been more persistent than initially expected.

These circumstances have notably heightened the uncertainty over the economic outlook for the euro area, since the information available for arriving at firm conclusions on the duration of the situation of instability in certain financial markets and its potential macroeconomic effects is still far from complete. All told, the moderation of the euro area's economic growth in 2008 will probably be somewhat sharper than anticipated some months ago, although output growth should not differ from potential growth. Such is the picture beginning to emerge in light of the most recent updates of international agencies' forecasts. At the same time, the downside risks to this central scenario have risen substantially.

As regards inflation, the year-on-year rate of change of the HICP increased to 2.1% in September, although this rise was largely anticipated due to the past oil price behaviour. In the medium term, the inflation outlook is compatible with price stability. Nevertheless, upside risks remain, highlighted by oil and food price rises, although the foreseeable moderation in activity and the sustained appreciation of the euro will tend to mitigate this pressure.

Against this backdrop, the ECB Governing Council held the minimum bid rate on main refinancing operations unchanged at 4% in its September and October meetings, while it gathered information to more accurately assess the impact of the financial turbulence.

#### **3.1 Economic developments**

According to National Accounts data, the quarter-on-quarter GDP growth rate of the euro area fell by 0.5 pp to 0.3% in Q2 (see Table 1). The year-on-year rate of 2.5% was 0.7 pp less than in Q1. This moderation stemmed from the lesser momentum of domestic demand and, above all, from the change in inventories, the contribution of which to GDP growth fell by 0.3 pp and 0.5 pp to 0.3 pp and -0.2 pp, respectively (see Chart 8). Domestic demand was notable for the uneven behaviour of its components. Private consumption recovered, although its year-on-year growth remained low at 1.5%. By contrast, government consumption and gross fixed capital formation slowed significantly. In the latter there was a fall due to the adjustment of

Most euro area confidence indicators fell significantly in September this year, as exemplified by the behaviour of those published by the European Commission (see panel 1) and of the PMIs (see panel 2). Coinciding with the bout of financial market instability initiated in the summer, all EU indicators (except those relating to construction) fell, the sharpest decline being in retail trade. The deterioration identified by PMI surveys was particularly sharp in the services sector, which saw the largest monthly fall-off since the series commenced in July 1998, largely due to lower confidence in the financial services sub-sector. This decline was corrected slightly in October, while the manufacturing PMI recorded an additional fall, according to preliminary information.

One of the advantages of confidence indicators is that they are available soon after the end of the survey period. They are thus very useful for making an initial assessment of the economic situation. Moreover, as seen in panel 3, there is a high, practically contemporaneous, correlation between the behaviour of economic activity (measured as the year-on-year rate of change of GDP) and these indicators.<sup>1</sup> However, confidence indicators reflect the subjective opinion of agents on the economic situation and may therefore contain biases of judgement. In particular, at certain times when uncertainty rises for economic or non-economic reasons (military tensions, natural disasters, political changes), they may reflect disproportionate reactions of a more or less transitory nature,<sup>2</sup> which partially alter their usual high correlation with quantitative benchmarks (GDP, industrial production, consumption, etc.).

To evaluate this possibility, it is useful to observe the behaviour of these confidence indicators in past bouts of instability. Specifically,

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1. The graph plots the economic sentiment indicator compiled by the European Commission (which is a combination of the Commission's confidence indicators for industry, services, construction, retail trade and consumers) and the composite PMI based on the manufacturing and services PMIs. 2. Further evidence of bias in confidence indicators is that the long-term average of many of these indicators is often lower than the value considered neutral or reflecting no change (zero in EC indicators and 50 in PMIs), which signals the predominance of pessimistic opinions of economic agents.

panels 4 to 7 show the paths of a selected group of confidence indicators one year before and after the following events: the October 1987 stock market crash, the Russian debt and LTCM fund crises in August 1998 and the bursting of the technology bubble in September 2000,<sup>3</sup> in which the instability had its source in the financial markets themselves; and the invasion of Kuwait by Iraq in August 1990 and the terrorist attacks in the US in September 2001, related to geopolitical tensions. As seen in these panels, the fall-off in the indicators from August 2007 is in line with what happened on past occasions. Also apparent is that the initial impact on consumer confidence is smaller than the effect on supply indicators such as industrial confidence and PMIs, as in previous bouts of instability.

The panels show that on various occasions the indicators recovered rapidly after an initial fall. In other cases, however, various quarters may pass before a temporary fall-off can be distinguished from the start of a change of trend. Confidence indicators recovered very promptly after the 2001 terrorist attacks and somewhat more slowly after the 1998 crisis. By contrast, the moderation of confidence indicators after the 1990 invasion of Kuwait and the 2000 stock market fall was not very sharp in the initial stages, but was not corrected in the following year. The 1987 stock market crash is a clear exception, since no noteworthy impact on confidence surveys can be discerned.

In conclusion, the rapid availability of confidence indicators makes them a useful tool for monitoring the economic conjuncture. However, the available evidence advises some caution in considering their very short-term movements in the periods immediately following major bouts of economic or geopolitical turbulence. At such times, to assess the medium-term performance of the economy, it is advisable to wait until the confidence surveys can be supplemented with the information provided by quantitative indicators.

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3. Although many stock exchange indices peaked in March 2000, the fall-offs in market prices sharpened in September of that year.

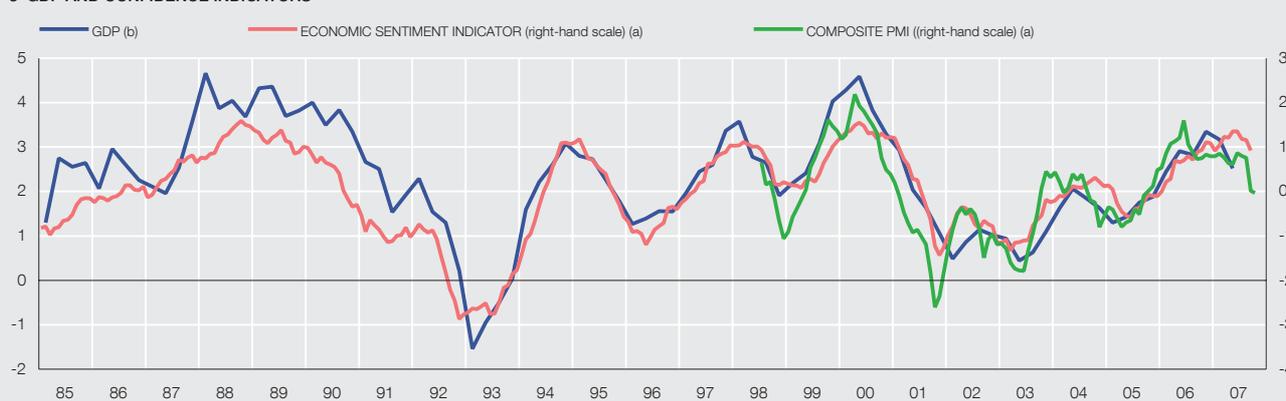
1 EUROPEAN COMMISSION CONFIDENCE INDICATORS (a)



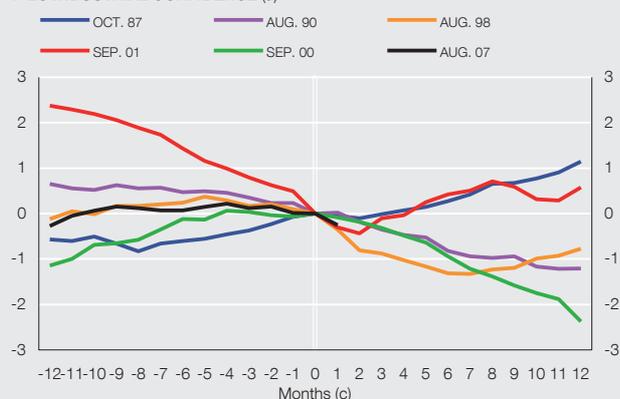
2 PMI CONFIDENCE INDICATORS (a)



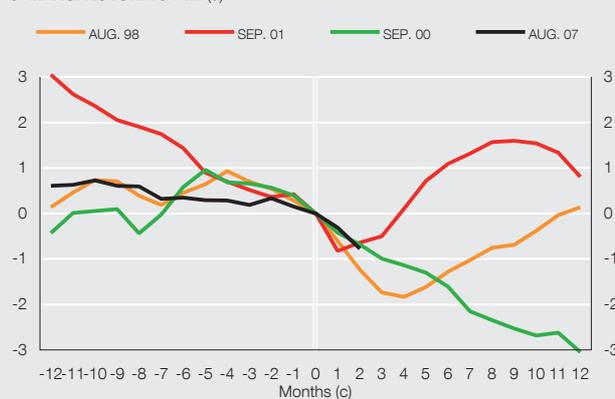
3 GDP AND CONFIDENCE INDICATORS



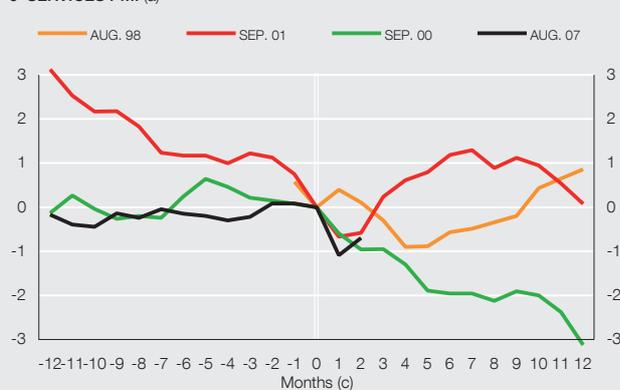
4 EC INDUSTRIAL CONFIDENCE (a)



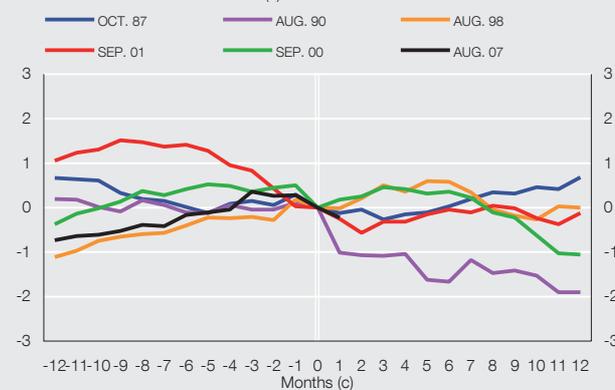
5 MANUFACTURING PMI (a)



6 SERVICES PMI (a)



7 EC CONSUMER CONFIDENCE (a)



SOURCES: Banco de España, European Commission, Eurostat and Reuters.

a. Normalised data.

b. Year-on-year rate of change.

c. Number of months from the reference period.

The rise in defaults on sub-prime mortgage loans in the US ended up causing tensions in the international credit markets. Two major features contributing to this were the complexity of the structured products used in recent years to transfer the risks associated with those loans and the scant transparency of investors' exposures to these products. A general re-assessment of risk thus took place which, as can be seen in panel 1, was more marked in the financial sector given its direct and indirect exposure to turbulence and the strong interdependence of institutions.

Additionally, some banks had committed themselves to providing liquidity in the event of need to certain financial vehicles (conduits) which had been issuing short-term commercial paper (ABCP) to finance their acquisitions of securities linked to US sub-prime mortgages. The difficulties of these vehicles in obtaining funds in the markets and their consequent recourse to the lines of credit committed by banks gave rise to tensions in most interbank markets of the industrialised countries, including that of the euro area. Interest rates rose, particularly those for maturities of more than one month, and transactions with these maturities declined in volume. In the euro area, the EONIA rate tended to move away from the minimum bid

rate on main financing operations in the opening days of August and, at the same time, as seen in panel 2, the 3-month spread between unsecured transactions (EURIBOR) and secured ones (EUREPO) reached a very high level of more than 70 bp, after having stood at less than 10 bp.

To normalise the situation in these markets, the ECB resorted to a number of measures designed to provide additional liquidity. First, from 9 to 14 August four fine-tuning operations were carried out in which funds were injected via overnight reverse repos, the first of them being an unlimited-volume fixed-rate tender and the others being variable-rate (see panel 3). Also, in addition to the scheduled longer-term financing operations (with 3-month maturities), on 22 August and 11 September two supplementary tenders were conducted with the same maturity. In this same vein, as part of its main financing operations in this period the ECB implemented a more generous liquidity management policy in order to accommodate the desire of institutions to comply in excess with their minimum reserve obligations, especially at the beginning of the reserve calculation period. Thus, as can be appreciated in panel 3, the volumes allocated in these tenders were above the benchmark calculated by the ECB to

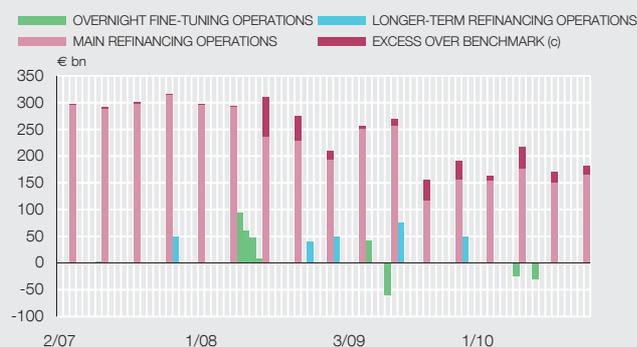
1 FINANCIAL AND NON-FINANCIAL ITRAXX (a)



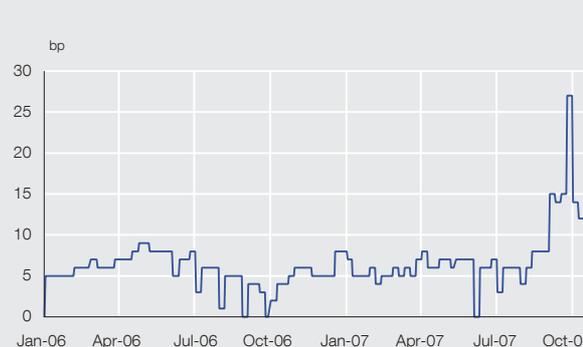
2 3-MONTH EURIBOR-EUREPO SPREAD



3 VOLUMES ALLOTTED IN ECB OPEN-MARKET OPERATIONS (b)



4 SPREAD BETWEEN MARGINAL RATE AND ECB MINIMUM BID RATE (d)



SOURCES: ECB and Bloomberg.

- a. Indices traded in a basket composed of different types of credit risk insurance.
- b. Includes periodic transactions with weekly maturity (main refinancing operations) and 3-month maturity (longer-term refinancing operations), as well as non-periodic fine-tuning operations.
- c. Excess between allotted volumes and the benchmark calculated by the ECB for institutions' liquidity needs.
- d. Spread between the recorded maximum rate and the minimum bid rate in weekly tenders.

meet the system's liquidity needs. Despite this, the marginal rates of these tenders reached high levels with respect to the minimum rate (see panel 4).

Thanks to these measures, the EONIA did not, on average, depart significantly from the minimum bid rate on main financing operations, although it was more volatile than usual (see Chart 12 in main text). However, the interest rates on unsecured longer-term interbank de-

posits remained high, considerably above those on transactions backed by public debt securities. Although recently there has been a certain correction, the implicit interest rates on forward transactions at different time horizons suggest that this spread may remain high in the coming months. This seems to indicate that, at the data cut-off date of this article, the problems in this market persist, reflecting banks' greater preception of counterparty risk and their increased precautionary liquidity demands.

construction investment, which declined by 1.6% with respect to Q1, while capital goods expenditure accelerated slightly to 2%. Finally, the net contribution of the external sector increased by 0.2 pp due to the lesser vigour of imports, since exports held at a similar pace to that at the beginning of the year.

The breakdown by branch of activity shows a significant loss of momentum in construction and in agriculture, where there were falls in value added with respect to Q1. In industry, production also slowed, but held at a robust increase of 0.6% with respect to Q1. Retail and wholesale trade and intermediation services showed greater buoyancy.

The moderation of GDP in Q2 was quite widespread across countries. It signifies a slight downward revision of growth in 2007 which has already been included in the latest forecasts of international agencies. In the larger economies this slowdown exhibited some features worthy of note. The German economy's quarter-on-quarter growth of 0.3% was driven by investment in machinery, exports and private consumption. By contrast, as expected, construction activity fell sharply, due largely to its exceptional buoyancy in Q1 because of the favourable weather. The weakness of the French economy, however, reflected a slowdown in exports and, above all, the unexpected stagnation of investment, especially in capital goods. Lastly, Italy's GDP grew by just 0.1%, the main culprit being the external sector.

The labour market recovery continued to firm in Q2, with employment up by 0.5% after Q1 growth was revised upward to 0.6%. The rate of job creation in year-on-year terms stood at 1.7%, albeit with notable differences across sectors. The slowdown in activity and the behaviour of employment resulted in a deceleration in productivity, up 0.8% against 1.4% in Q1.

Wage pressure continued to be contained despite the favourable performance of the labour market (see Chart 9). Year-on-year growth of compensation per employee stood below 2% in Q2, with a slowdown in services to a rate of expansion around 1.2% and less significant changes in industry and construction, where rates above 3% were posted. This meant that, despite the slowdown in productivity, the increase in unit labour costs in the total economy held at a moderate rate, near 1% year-on-year. Meanwhile, the steady growth of the GDP deflator at around 2% led to a further deceleration of business margins.

As regards Q3, the available indicators point to an economic scenario very similar to that in the first half of the year, although there is some discrepancy between the quantitative and the qualitative information, especially on the supply side (see Chart 10). Hence in summer industrial production picked up notably and industrial orders, despite falling off, kept up a high year-

	2006				2007			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3 (a)	Q4 (b)
<b>GDP</b>								
Year-on-year growth	2.5	2.9	2.9	3.3	3.2	2.5		
Quarter-on-quarter growth	0.9	1.0	0.6	0.8	0.8	0.3		
European Commission forecasts (c)							(0.3 ; 0.8)	(0.2 ; 0.8)
<b>IPI (d)</b>								
Economic sentiment	102.6	106.8	108.2	109.9	110.0	111.6	109.4	
Industrial confidence	-2.3	2.3	3.7	5.7	5.3	6.3	4.3	
Manufacturing PMI	54.7	57.1	56.9	56.7	55.5	55.3	54.2	<i>51.5</i>
Services confidence	14.7	18.7	19.0	19.7	20.7	22.3	20.0	
Services PMI	57.8	59.2	57.3	57.1	57.6	57.5	56.9	<i>55.6</i>
Unemployment rate	8.2	7.9	7.8	7.6	7.3	7.0	6.9	
Consumer confidence	-10.7	-9.7	-8.3	-7.0	-5.3	-2.3	-3.7	
<b>HICP (annual growth) (e)</b>								
HICP (annual growth) (e)	2.2	2.5	1.7	1.9	1.9	1.9	2.1	
PPI (annual growth) (e)	5.1	5.8	4.6	4.1	2.8	2.2	1.7	
Oil price in USD (e)	61.6	68.1	61.2	62.8	62.3	71.8	78.2	<i>81.7</i>
<b>Loans to the private sector (annual growth) (e)</b>								
Loans to the private sector (annual growth) (e)	10.8	11.0	11.4	10.8	10.6	10.8	11.0	
<b>Euro area ten-year bond yield</b>								
Euro area ten-year bond yield	3.6	4.0	4.0	3.9	4.1	4.4	4.5	<i>4.4</i>
<b>US-euro area ten-year bond spread</b>								
US-euro area ten-year bond spread	1.06	1.08	1.00	0.82	0.67	0.47	0.32	<i>0.19</i>
<b>Dollar/euro exchange rate (e)</b>								
Dollar/euro exchange rate (e)	1.210	1.271	1.266	1.317	1.332	1.351	1.418	<i>1.431</i>
<b>Appreciation/depreciation of the dollar/euro (e)</b>								
Appreciation/depreciation of the dollar/euro (e)	2.6	7.8	7.3	11.6	1.1	2.5	7.7	<i>8.6</i>
<b>Dow Jones EURO STOXX Broad index (e)</b>								
Dow Jones EURO STOXX Broad index (e)	10.3	4.2	11.9	20.3	3.4	9.9	6.1	<i>7.6</i>

SOURCES: Eurostat, ECB and Banco de España.

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

b. Information available up to 25 October 2007.

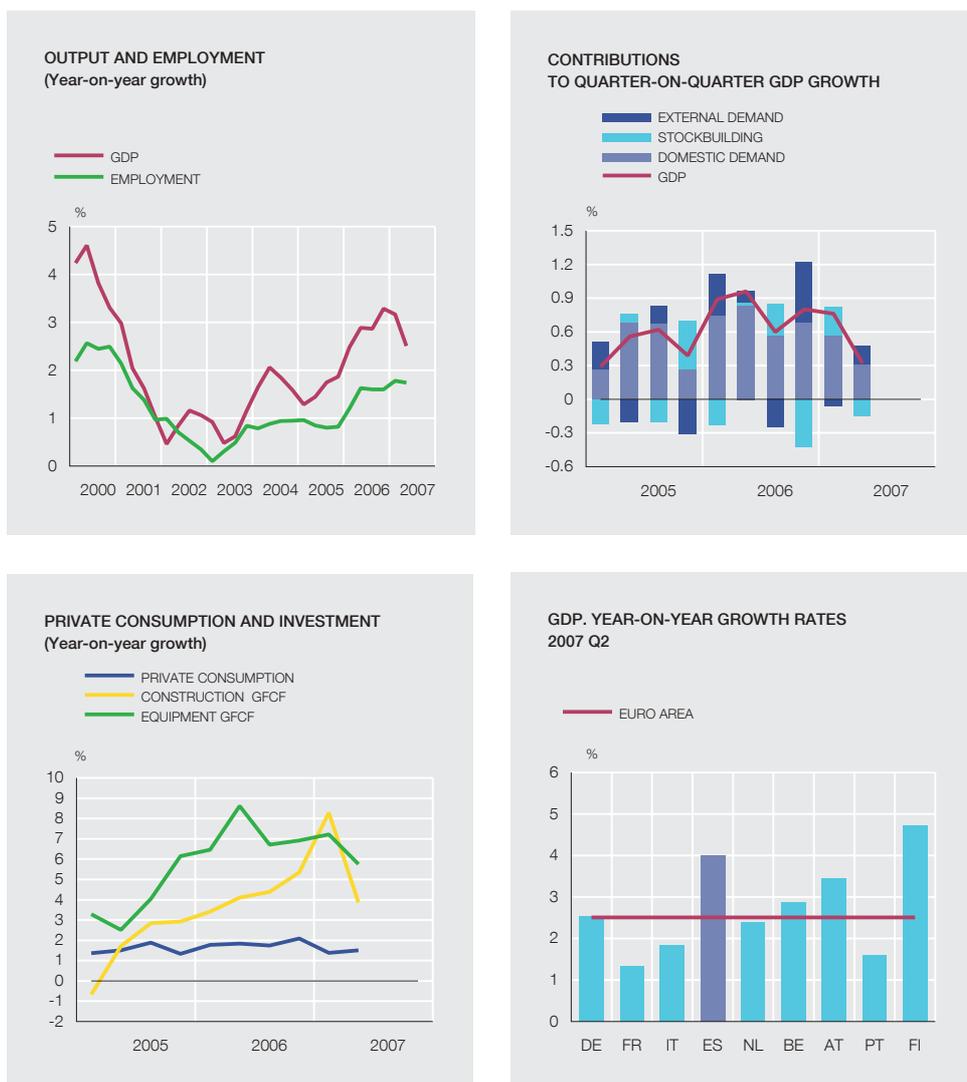
c. Quarter-on-quarter growth forecasts.

d. Year-on-year growth rates of working days adjusted data.

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

on-year growth rate. By contrast, confidence indicators, which are more sensitive to financial uncertainty, reacted with a sharp downturn. In September, the deterioration observed during the quarter in both European Commission surveys and purchasing managers indices (PMI) sharpened significantly, although, as illustrated in Box 2, this fall-off was of a size comparable to that in past bouts of turbulence and, on this occasion, the confidence indicators started from a reasonably high level. In October, the preliminary composite PMI figure pointed to a new fall-off in sentiment, despite a recovery of the services sector index. It was also notable that employers' hiring intentions remained at a high level, although easing moderately in manufacturing and services in the third quarter as a whole. The unemployment rate stood at 6.9% in August, similar to the level in June; this represents a fall of nearly one percentage point in the past year.

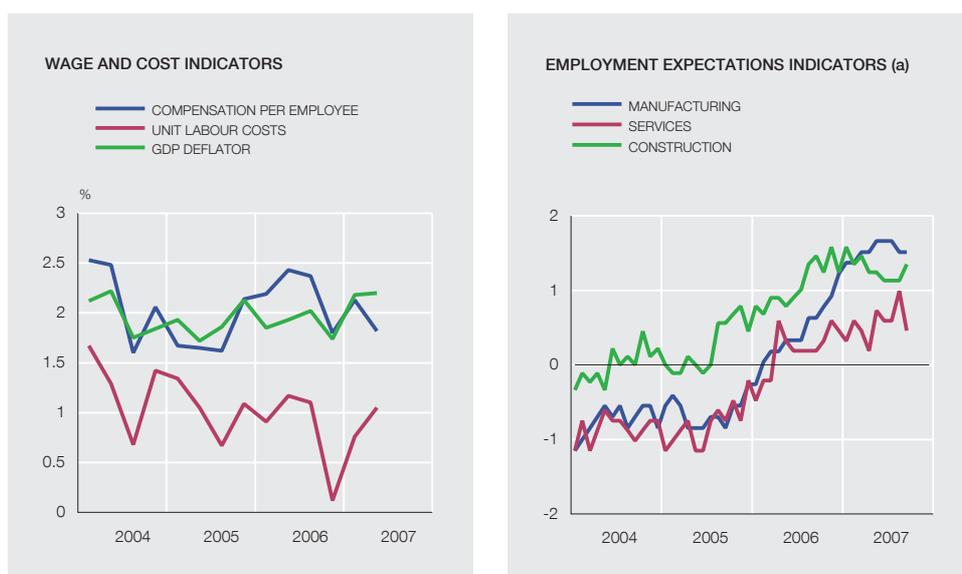
On the demand side, the private consumption indicators for July to September suggest behaviour in line with that in Q2. Retail sales in July and August and new car sales to September were, on average, higher than in Q2, although with respect to the previous year they were up by nearly 1%. Consumer and retail trade confidence indicators deteriorated due to the financial uncertainty, although remaining at relatively high levels. Turning to investment, capacity utilisation and the order book showed a certain downturn in Q3, although continuing to be consistent with a solid expansion of capital goods expenditure. Finally, regarding foreign trade, the July figures point to highly buoyant exports, while export expectations and the industrial order book remain at high levels.



Sources: Eurostat and national statistics.

The euro area as a whole is in a relatively favourable position to face the consequences of the financial tension. Notable in this respect are the robust financial situation of the private sector and the strong pace of job creation, and, in regard to investment, the sharp rise in business profits may mitigate the possible adverse effect of the tighter financial conditions. Against this background, the short-term forecasts of international agencies and private analysts coincide in putting expected GDP growth in 2007 at healthy levels of around 2.5%. Nevertheless, downside risks due to the possible impact of the financial turbulence could start to materialise at the end of the year.

In the medium term, the growth outlook has moderated as a result of the change in the financial and economic situation of the euro area. Thus the sustained appreciation of the euro, the higher commodity prices and the tighter financial conditions will tend to slow activity growth, as indicated by the most recent updates of international agencies' forecasts. Moreover, the bout of financial instability following the past summer notably heightened the uncertainty over the long-term growth outlook, since it is still early to assess the macroeconomic impact and, in particular, the extent of the US slowdown and its impact on world trade and exchange rates, the degree of tightening of credit conditions and the possible effects on agents' confidence.



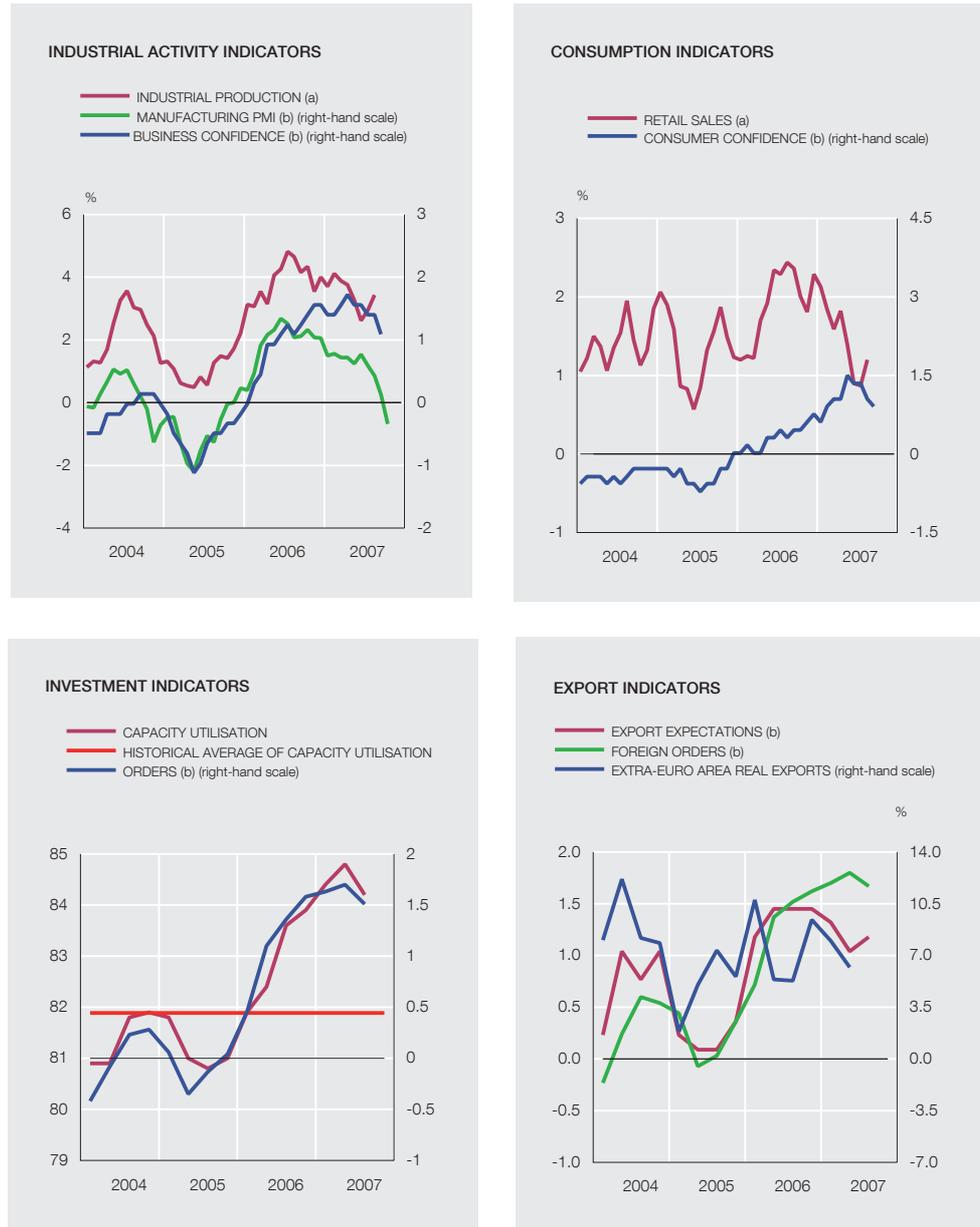
SOURCES: Eurostat and European Central Bank.

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

Turning to prices, the year-on-year HICP growth of 2.1% in September was 0.2 pp more than at the end of Q2 (see Chart 11). This behaviour was again strongly influenced by energy, which showed year-on-year growth of 3%, compared with less than 1% in Q2, reflecting the base effect of its behaviour in 2006 and the recent upward energy price trend. The HICP excluding the more volatile components (energy and unprocessed food) grew by 2% year-on-year, up 0.1 pp on June, with notable unevenness among its components. Thus processed food became the most inflationary component, with prices up 3% relative to the same month a year earlier, against a background of high demand pressure in international markets. By contrast, the price of services decelerated by 0.1 pp with respect to June to a pace of 2.5% and that of non-energy industrial goods grew moderately by 1%. Meanwhile, the selling price indicators derived from the September surveys point to an easing of the inflationary outlook for industry and services, albeit within high values. Nevertheless, the European Commission's consumer confidence survey suggests an increase in perceived and expected inflation, which could be partly related to the rising prices of staple consumer products.

The inflation forecasts of international agencies and private institutions for 2007 remain within the range 1.7%-2% and do not exceed 2% for 2008. Although this outlook is compatible with price stability, the upside risks relating largely to the oil price hikes remain in place. Other forces that may act in the same direction are agricultural commodity price movements, possible unannounced increases in indirect taxes or regulated prices and the appearance of wage pressures or increases in margins in markets less exposed to competition. In any event, these risks are more constrained than in the past, due to the foreseeable moderation of activity and to the countervailing effect of the appreciation of the euro.

The current account recorded a surplus of €4 billion from January to August (around 0.1% of GDP), compared with a deficit of €27.4 billion in the same period of 2006 (0.5% of GDP). This swing was caused by the larger surplus on the goods balance (exports were more buoyant than imports, with year-on-year growth of 9.8% and 5.8%, respectively, in the first eight months of the year) and, to a lesser extent, on the services balance, which more than offset

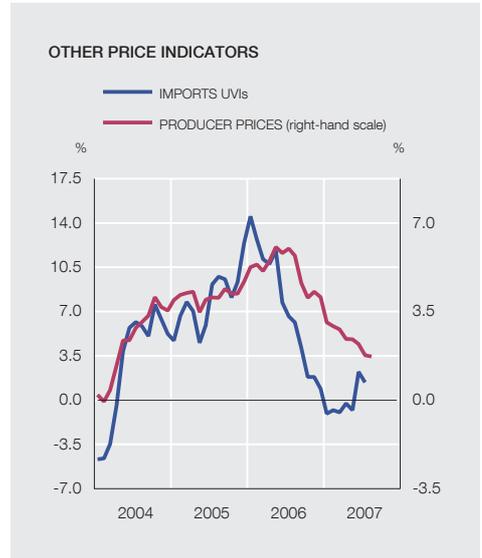
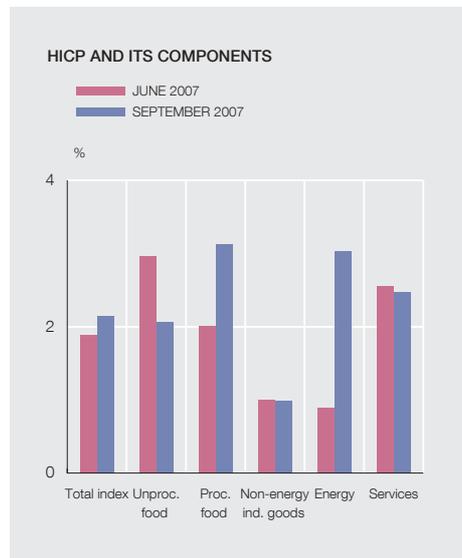
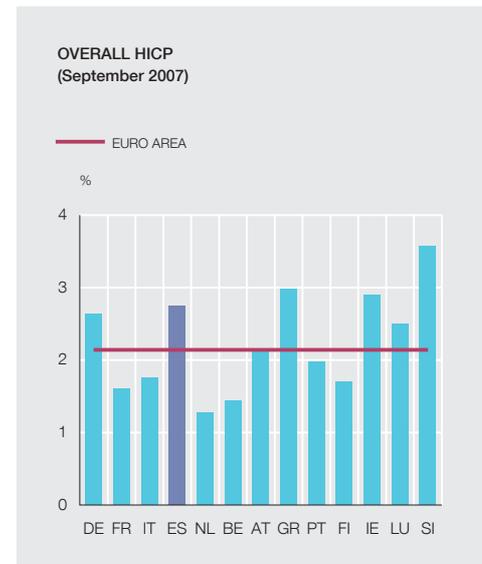
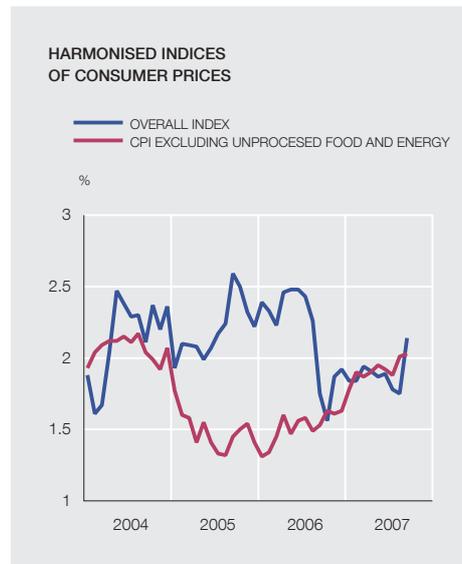


SOURCES: Eurostat and European Commission.

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

the small rise in the deficits on the income and transfers balances. As regards the financial account, the reporting period saw a net inflow of portfolio investment amounting to €242.8 billion (more than twice that in the same period a year earlier), and a net outflow of direct investment of €92.2 billion (against nearly €72 billion in 2006). As a result, the basic balance recorded a surplus of €154.6 billion, far exceeding the €4 billion in the period January-August 2006.

Turning to fiscal policy, the information on the budget outturn points to relatively buoyant tax revenue in the year to date. As a result, the 2007 budget deficit will foreseeably improve more than is envisaged in the stability programmes (see Table 2). Specifically, the deficit of the euro



SOURCES: Eurostat and European Central Bank.

area as a whole could stand at around the 1% of GDP estimated by the European Commission in spring, against the 1.4% resulting from aggregation of the programmes. This improvement can be attributed mainly to the German economy, which may post a deficit of around one percentage point below the target of 1.5% of GDP.

The budgets for 2008 currently before Parliament generally point to insufficient progress towards budgetary balance in the countries that are still far from achieving it. In the case of France, the draft budget includes limited expenditure containment measures and a tax cut approved last August, the cost of which for 2008 is estimated at 0.5% of GDP. Thus the budget deficit target would stand at 2.3% of GDP, just 0.1 pp below that for 2007. This target would not comply with the provisions of the code of conduct included in the reformed Stability and Growth Pact (SGP), under which there is a commitment (reiterated by the October ECOFIN Council) to correct the structural balance by at least 0.5% of GDP per year. Moreover, the French government seems to have distanced itself from the Eurogroup's agreement whereby the Member States undertake to

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

TABLE 2

% of GDP					
	2005	2006	2007 (b)	2007 (c)	2008 (c)
Belgium	-2.3	0.4	0.3	-0.1	-0.3
Germany	-3.4	-1.6	-1.5	-0.6	-0.3
Greece	-5.1	-2.5	-2.4	-2.4	-2.8
Spain	1.0	1.8	1.0	1.4	1.2
France	-2.9	-2.5	-2.5	-2.4	-2.0
Ireland	1.2	2.9	1.2	1.5	0.9
Italy	-4.2	-4.4	-2.8	-2.1	-2.2
Luxembourg	-0.1	0.7	-0.9	0.4	0.6
Netherlands	-0.3	0.6	0.2	-0.7	0.0
Austria	-1.6	-1.4	-0.8	-0.9	-0.9
Portugal	-6.1	-3.9	-3.7	-3.5	-3.2
Slovenia	-1.5	-1.2	-1.5	-1.5	-1.5
Finland	2.7	3.8	2.8	3.7	3.5
MEMORANDUM ITEMS: Euro area (including Slovenia)					
Primary balance	0.5	1.3		1.9	2.1
Total balance	-2.5	-1.5	-1.4	-1.0	-0.8
Public debt	70.3	68.6	68.0	66.9	65.1

SOURCES: European Commission and national stability programmes.

- a. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.  
 b. Targets of the stability programmes presented between the end of 2006 and the beginning of 2007.  
 c. European Commission forecasts (spring 2007).

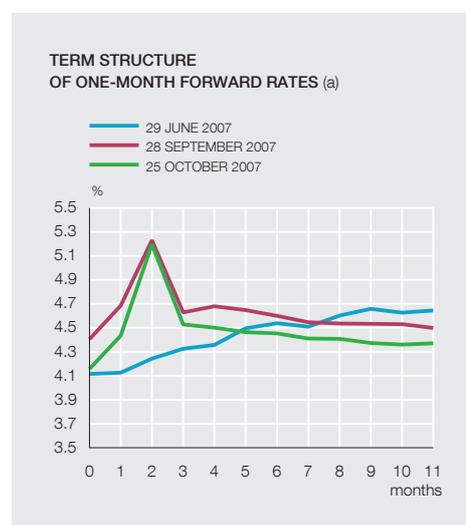
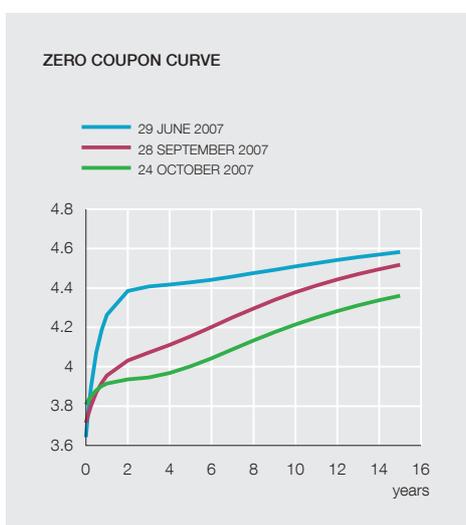
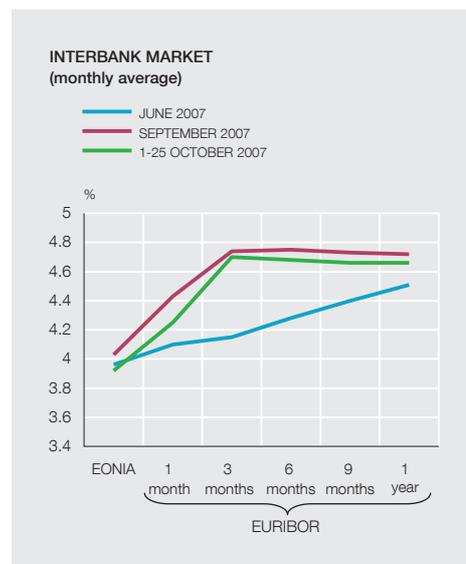
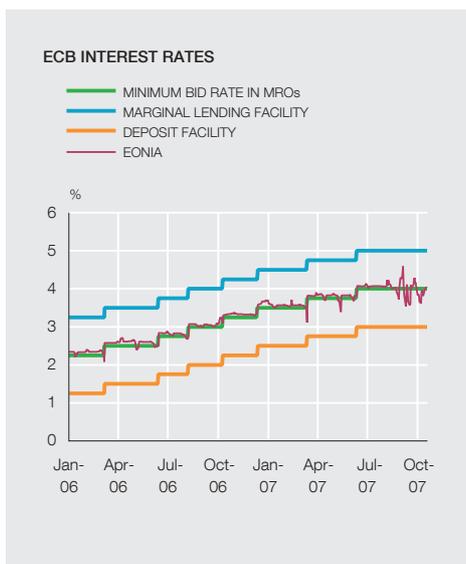
achieve their medium-term budgetary objectives by 2010 at the latest. In Italy the budget before Parliament – which envisages a deficit of 2.2% of GDP – does not guarantee compliance with the provisions of the reformed SGP. In Germany, the draft budget does not include major progress in terms of fiscal consolidation once the foreseeable loss of revenue upon the entry into force of the corporate income tax reform in 2008 is taken into account.

### **3.2 Monetary and financial developments**

During the past summer the crisis in the US sub-prime mortgage market had a major impact on the international financial markets. The re-assessment of risks gave rise to significant fluctuations in asset prices, increased volatility and liquidity problems in some markets, although after mid-September there was a certain normalisation.

Against this background, the ECB Governing Council halted the gradual withdrawal of monetary stimulus under way since late 2005, although it stated that upside risks to medium-term price stability were still apparent. The financial market tensions made it advisable to gather and assess further information on the possible implications of this bout of turbulence and led the ECB to hold official interest rates unchanged in its September and October meetings. As a result, the minimum bid rate on main refinancing operations stood at 4% (see Chart 12).

From mid-August the European interbank market saw an increase in liquidity needs, which, along with problems of confidence between institutions, made it necessary for emergency injections of funds by the ECB (for more details, see Box 3). The tensions were manifested in increased volatility of the EONIA and in higher yields at all maturities, despite the fact that expectations of fresh rises in official interest rates had faded. The sharpest rise was in 3-month EURIBOR, which reached 4.8% in September. At the information cut-off date of this bulletin, it stood at 4.6%, very similar to 1-year EURIBOR.

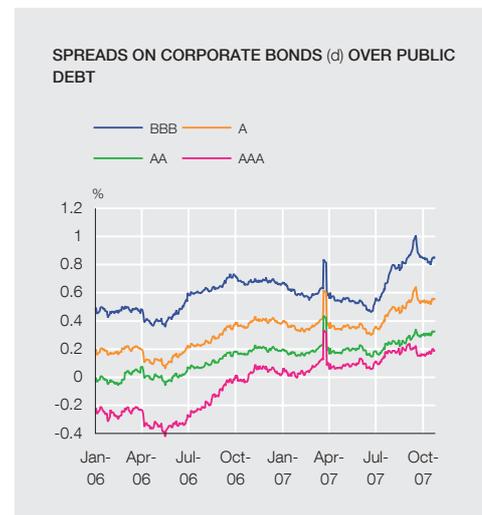
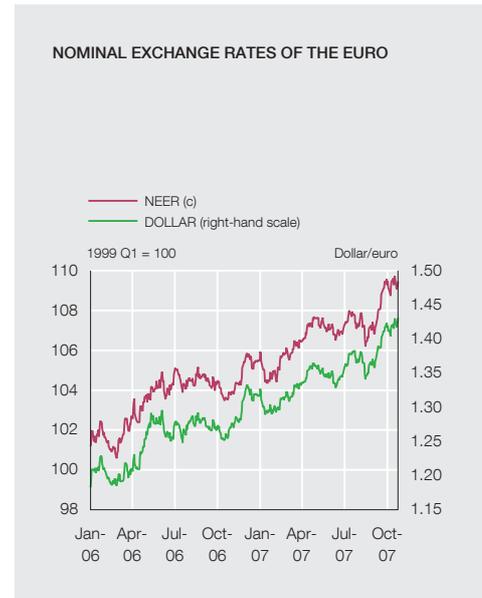
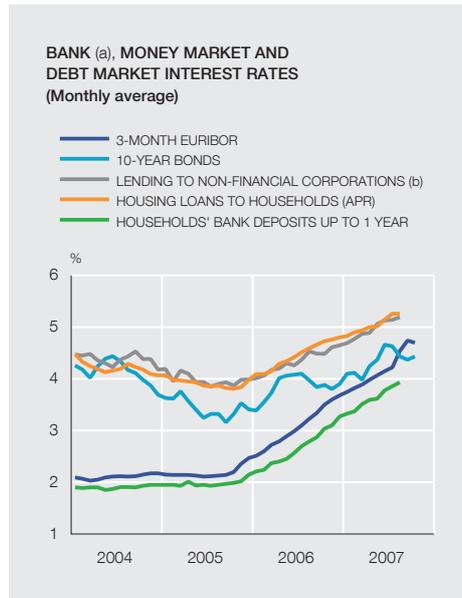


SOURCES: European Central Bank and Banco de España.

a. Estimated using Euribor data.

Public debt acted as a safe haven and the greater demand for it led to a temporary fall in yields in the summer, partially corrected since mid-September. As a result, 10-year bond rates, expressed as the average during Q4 to date, stood at relatively low levels of 4.4% in the euro area, with the spread with respect to the US narrowing to 20 bp. In private fixed income, by contrast, the yield spreads on lower-rated non-financial corporate bonds widened during the summer. In particular, the interest rate on A and BBB rated bonds reached as much as approximately 0.5 pp and 0.7 pp, respectively, above the yield of higher-rated private debt. Although these values are much higher than those seen at the beginning of the year, they are low from a historical standpoint. Asset-backed bond and structured product issues have also been affected, with a significant drop in the volumes issued.

Equity market prices also reacted initially with notable declines and increased volatility, against a backdrop of great uncertainty over firms' exposure to the crisis and its possible impact on the real economy (see Chart 13). The greatest tensions were concentrated in the construction and financial sectors, as a reflection of their exposure to issues of asset-backed securi-

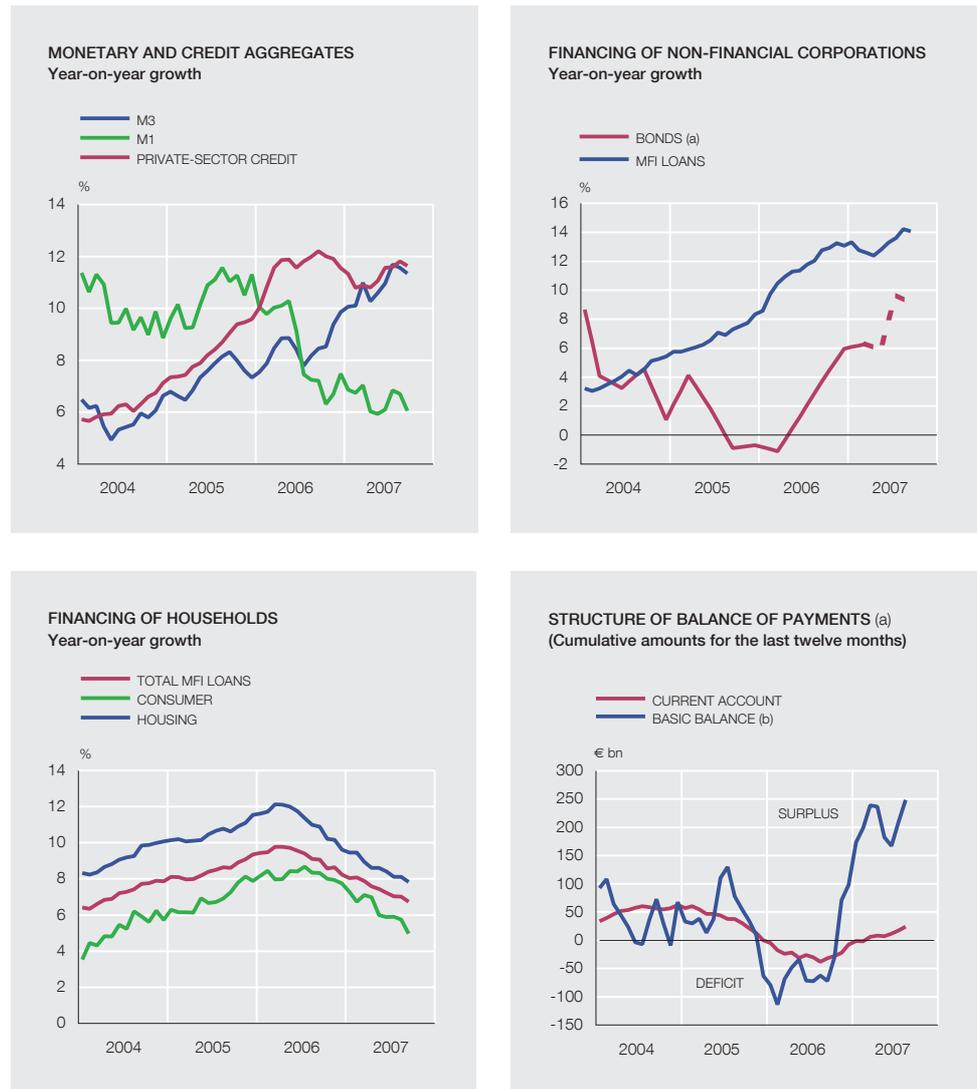


SOURCES: European Central Bank and Banco de España.

- a. Interest rate statistics compiled by the ECB for new operations.
- b. Interest rates on loans of 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.

ties and structured products, which are the instruments that have most suffered in terms of price and liquidity. Thus, whereas the Eurostoxx index fell by around 4% in August and the first half of September, the bank and financial services firms component dropped by 10% and construction sector share prices were down by around 14%. Following the US Federal Reserve decision to cut interest rates, equity markets progressively stabilised, stock market indices recovered and volatilities decreased. The broad Eurostoxx index rose by more than 7% from the start of the year, in a movement based on continued expectations of favourable corporate earnings.

Instability was also present in the currency markets, where from late August the euro appreciated sustainedly against the dollar. It currently stands at nearly \$1.43. In the year to date it has thus risen by nearly 4% in effective terms and by 8.6% with respect to the dollar.



SOURCES: European Central Bank and Banco de España.

a. The broken line is an estimate calculated using fixed income held by MFIs.

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

The performance of the monetary aggregates to September was a prolongation of their recent behaviour, shaped by a more restrictive monetary policy and a relatively flat yield curve which is sustaining the demand for some liquid assets for investment purposes. Moreover, it cannot be ruled out that the lower risk tolerance has also contributed to sustaining monetary expansion. Thus, in September the year-on-year growth of the M3 monetary aggregate continued to be high (above 11%) with rates varying widely among the asset types (see Chart 14). While the M1 aggregate, which is the most liquid, posted year-on-year growth of 6%, other short-term deposits showed great buoyancy, with increases of more than 15%.

Meanwhile, lending by financial and monetary institutions to the private sector continued to grow in September at a year-on-year rate exceeding 11%. No significant changes in this trend by any type of borrower were discernable. Hence loans to non-financial corporations continued to expand rapidly at more than 14% year-on-year, while those to households prolonged their slowing trend apparent since 2006, with a year-on-year growth rate of 6.7%. This moderation encompassed both house purchase loans, with year-on-year growth of 7.8% in Sep-

tember, and consumer loans, whose growth rate was 5%. It is possible that lending behaviour in August and September was affected by financial market developments. Thus the greater difficulty in issuing securities and repaying bridge loans by non-financial corporations or in removing loans from the balance sheet through securitisation might have pushed lending figures upward. In any event, the October BLS, which includes specific questions on the impact of financial shocks, points to more restrictive credit supply conditions in Q3, becoming tighter towards the end of the year.<sup>1</sup> This tighter credit supply, which is largely due to the lesser availability of the usual sources of financing, is more marked in the case of non-financial corporations and particularly in that of longer-term financing of large corporations. In the case of households, the tightening is slighter and due to deterioration of the property market and of the general economic outlook, against a background in which the demand for house purchase credit continues to show signs of weakening.

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1. For more details, see the article *Encuesta sobre Préstamos Bancarios en España: octubre de 2007* (Bank Lending Survey in Spain: October 2007) in the *Boletín Económico* of October 2007.

## 4 The Spanish economy

On QNA estimates, GDP grew in 2007 Q2 by 4% year-on-year, 0.1 pp less than in Q1. In quarter-on-quarter terms there was also a slight slowdown, with growth of 0.9%. Coinciding with the publication of the information for Q2, the INE revised the annual accounts figures back to 2003. At the aggregate level, the GDP growth rate was revised slightly upwards, by 0.1 pp, in 2003, 2004 and 2005, with the rate initially estimated for 2006 remaining unchanged. With regard to the composition of this growth, however, there have been more significant changes in some variables, as well as in the quarterly profile of the accounts.

The information available for 2007 Q3 suggests that GDP slowed by 0.3 pp in that period, to 3.7% year-on-year, with a similar reduction in the quarter-on-quarter rate, to 0.6%. This was the result of less buoyant national demand, which is estimated to have grown by 4.3% year-on-year, 0.3 pp less than in the previous quarter, as a consequence of the moderation of private consumption and of investment in equipment and construction (see Chart 15). Meanwhile, the external sector's contribution to GDP growth improved slightly (by 0.1 pp, to -0.8 pp), as exports were more dynamic than imports.

The mild slowdown in value added growth affected all sectors in Q3, especially construction and energy. The main employment indicators also reflect a certain loss of momentum in relation to the first half of the year. Against this background, apparent labour productivity is estimated to have decelerated slightly in Q3 which, together with the slight increase in compensation per employee, led to a small rise in unit labour costs, although wage settlements and unit labour costs have been lower in the year to date than in 2006. In the case of consumer prices, the year-on-year growth rate of the CPI remained at 2.4% on average in Q3 although, following two months of relatively contained growth, inflation rose to 2.7% in September, as a consequence of the rise in energy prices linked to a base effect and the price rises in processed food, common to other countries.

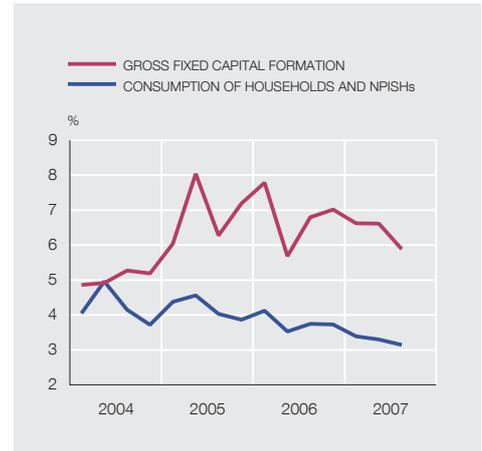
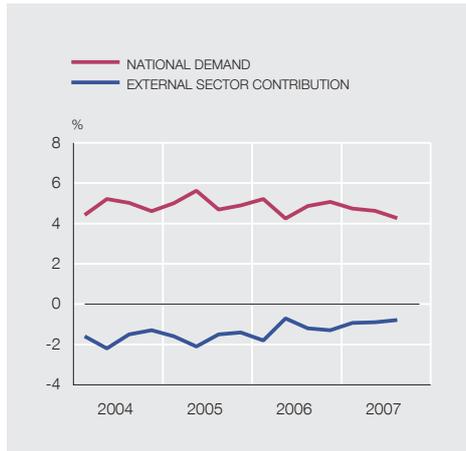
### 4.1 Demand

In 2007 Q2, the final consumption spending of households and NPISHs grew by 3.3% year-on-year, 0.1 pp less than in the previous quarter, extending the slowdown that began in 2005 (see Chart 16). The most recent conjunctural information points to a continuation of this mild slowdown in Spanish household final consumption in Q3. Specifically, the tax authorities' data on the sales of large corporations in July and August show less buoyant consumption, especially of services. New car registrations fell for the third consecutive quarter, at a year-on-year rate of close to 3% (which was faster than in Q2). As for the confidence indicators, consumer sentiment was relatively stable during the summer, while retail confidence fell in Q3, with an especially negative figure in September, possibly prompted by the uncertainty produced by financial market turbulence.

In 2007 to date, household consumption growth has continued to be sustained by the strength of employment creation and by the moderation of inflation with respect to 2006. Both factors have been conducive to the maintenance of relatively high real income growth rates, according to the non-financial accounts for 2007 Q2, although these accounts also show that the household saving ratio fell to 10% in Q2 (in cumulative four-quarter terms), having stood at 10.5% at end 2006. However, the more contained rate of growth of household real-estate and financial wealth, along with tighter financial conditions can be expected to result in a reduction in the household propensity to consume and greater stability in the saving ratio, following various years of decline.

MAIN DEMAND AGGREGATES (a)

CHART 15

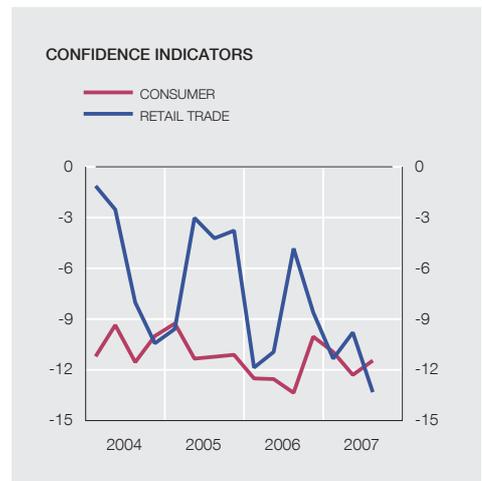
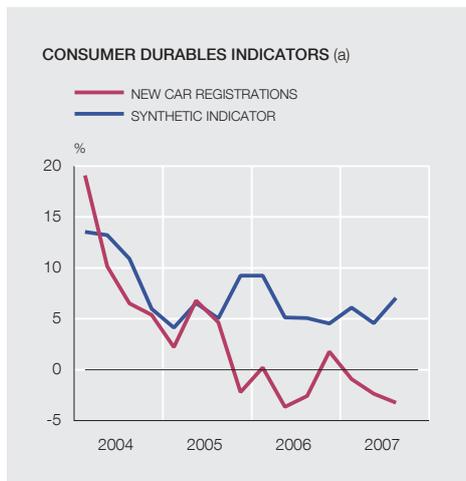
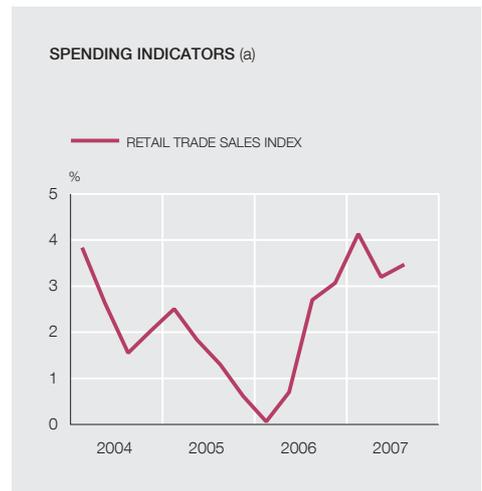
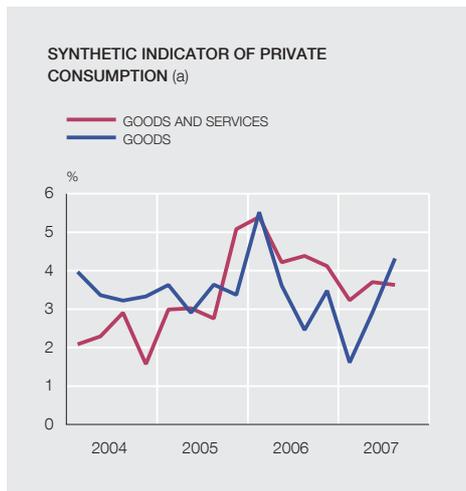


SOURCES: INE and Banco de España.

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

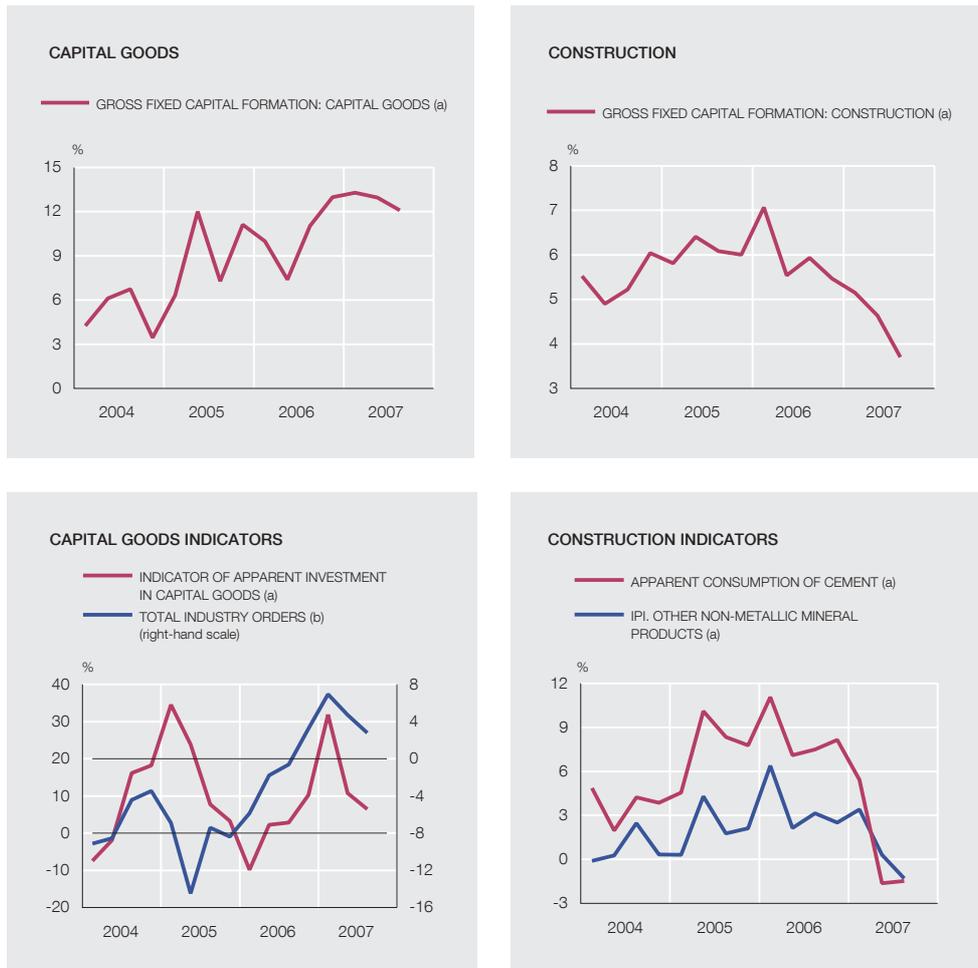
PRIVATE CONSUMPTION INDICATORS

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.

General government final consumption maintained its strength in 2007 Q2, although it slowed by 0.2 pp, to 5.5%. The information available would suggest that this buoyant growth continued in Q3, basically as a result of the information provided on net purchases of goods and services by the State budget outturn.

Gross fixed capital formation remained notably buoyant in 2007 Q2, its year-on-year growth rate remaining unchanged from the previous quarter at 6.6% (see Chart 17). The strong growth in investment in other products (a component linked to real-estate promotion and intermediation and to software acquisition) offset the slight reduction in both investment in equipment and, to a greater extent, in investment in construction, which grew by 13% and 4.6%, respectively, down 0.3 and 0.6 pp from the previous period. The information provided by the indicators for Q3 suggests that the strong growth rate of fixed capital investment declined to around 6%, as a result of a slowdown in investment in construction and spending on equipment, although the latter remained the most dynamic component of demand.

The available indicators of investment in equipment continue to point to an outlook of relative strength, albeit somewhat less strong than in previous quarters. Thus, the indicator of apparent investment, on data to August, showed a moderation of growth, given the re-

duced strength of imports of such goods. Meanwhile, opinion indicators have shown less optimism, as seen in the business and sentiment indicators for the equipment industry, with a substantial reduction in August in the latter indicator and in the forecast order book. The recent trend in investment in equipment continues to be sustained by buoyant activity and company profits, despite the growth of interest charges caused by higher interest rates and the greater recourse to external sources of financing, as indicated by Central Balance Sheet Data Office data to 2007 Q2. The further rise in the rate of capacity utilisation in Q3 suggests that investment continues to be needed to sustain economic growth. However, the progressive increase in the financing needs of non-financial corporations (which, in cumulative four-quarter terms, reached 9.4% of GDP in 2007 Q2) could act as a brake on their investment plans.

Investment in construction in Q2 continued the slowdown that commenced in early 2006. The conjunctural information available suggests that this trend will continue in 2007 Q3. This is the direction in which the most important contemporaneous indicators (which show less buoyant construction) and the sector's sentiment indicators are pointing. Apparent cement consumption, and other indicators of the production of intermediate products, fell in July and August. Meanwhile, the year-on-year growth rate of Social Security registrations in this industry declined by around three percentage points in Q3, while its registered unemployment rose significantly in year-on-year terms in the same quarter.

By type of work, investment in housing and other construction slowed in Q2, to rates of 3.7% and 5.7%, respectively. The leading indicators of investment in housing (such as approvals) and the path of demand which may be proxied by transactions suggests that the slowdown in this component continued in Q3. Housing starts also declined, which means that residential investment can be expected to moderate further in future. As regards other construction, the outlook for non-residential building is also of greater moderation in the light of the latest data on approvals for this type of construction. Meanwhile, civil engineering works are expected to maintain some buoyancy, albeit less than in previous quarters, as a consequence of the particularly high official tendering figures in 2006, the execution of which will be reflected in government investment in the current year.

In 2007 Q2, the negative net contribution to GDP growth of net external demand remained unchanged at 0.9 pp. During this period, the year-on-year growth rates of real exports and imports of goods and services rose by around one percentage point to 4.8% and 6.7%, respectively (see Chart 18). In Q3 imports, and especially exports, are estimated to have accelerated, with an improvement of 0.1 pp in the contribution of net external demand to GDP growth. Specifically, exports are estimated to have grown by around 6% year-on-year in Q3, thanks to an across-the-board improvement in their components, with significant growth estimated for sales of non-tourism goods and services, while real tourism receipts are estimated to have recovered from the negative rates seen in Q2. Meanwhile, imports are estimated to have grown by slightly more than 7%, boosted by the decline in their prices in terms of euros, owing to the appreciation of this currency.

According to customs figures for foreign trade, real goods exports performed very positively in July and August, growing at a year-on-year rate of 8.5% over this two-month period, as against 3% in the first half. By product group, the most dynamic items were exports of non-food consumer goods (especially cars) and intermediate goods. In the period January-August, real goods exports grew by slightly more than 4%, which was less than in 2006 (5.6%) and less than the estimated growth in Spain's external markets (see Box 4). By geographical area and in nominal terms, exports grew at a faster rate in July and August in markets outside the EU



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.

(12.6%), with especially high rates recorded in the case of those to China, Russia and its associated countries and the OPEC countries, although these areas still represent only a small part of Spanish foreign trade, while exports to Latin America declined. Within the euro area, exports to France and Italy grew at notable rates of above 10%.

Real exports of tourist services contracted (by 2.3% year-on-year) in 2007 Q2 in line with the unfavourable trend in the main real tourism indicators during that period, partly reflecting the adverse spring weather. The information available for Q3 is more favourable, with a recovery in overnight stays, incoming tourists and nominal spending, according to the tourism expenditure survey (EGATUR). These data warrant expectations of improvement in this sector, which has been somewhat slack since the second half of 2006.

As for real exports of non-tourist services, QNA data show growth of 12.2% in 2007 Q2, as against 6.5% in the previous quarter, in line with the upward trend in the nominal balance of payments indicator in that period. According to the incomplete information of this indicator, the strength of this component of external demand was sustained in Q3, underpinned by the buoyancy of business and transport services.

The correction in the negative contribution of net external demand to GDP growth displayed by Spain's quarterly National Accounts data (from -1.6 pp in 2005 to -1.2 pp in 2006 and -0.9 pp in the first half of 2007) is partly explained by the recovery in exports, especially in comparison with their slackness in 2005. Identifying the products and geographical areas underpinning this recovery provides important information on the factors that have governed its course in recent quarters and, therefore, on the possibilities for consolidation of this pattern in future.

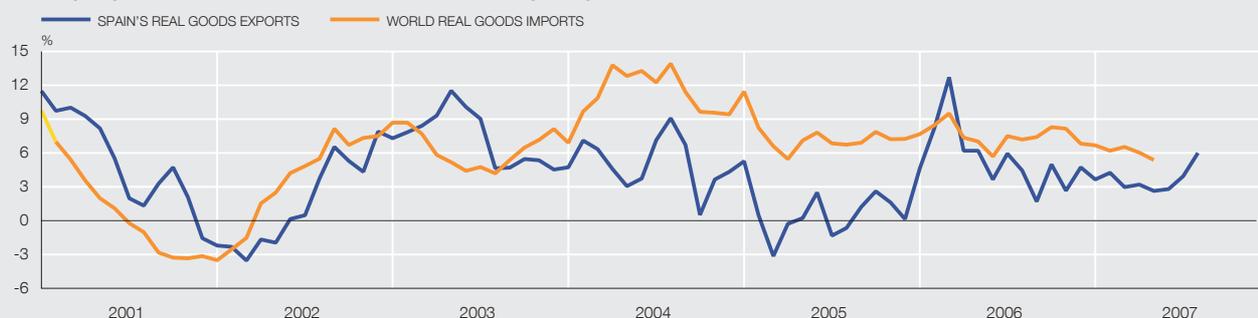
The improvement in the sales of goods abroad in 2006 took place worldwide, with exports to non-European Union countries making a notable contribution (see the table below). By contrast, the mild slowdown in the first seven months of 2007 is explained entirely by the correction in goods exports to non-European Union countries, since sales to the euro area grew at a somewhat faster rate than in the previous year. The country-by-country information available in nominal terms, shows the broad-based nature of the recovery in sales to the euro area. By contrast, the behaviour of those to the rest of the world was more mixed, with sales highly buoyant to China, Russia and its associated countries and the EU enlargement countries, which points to a certain diversification of Spanish exports towards markets with more dynamic demand, while those to the American

continent have generally displayed moderate growth. The second chart below shows how the structure of Spanish goods exports by geographical area, in nominal terms, changed between 2000 and 2006. While the weight in total Spanish goods exports of sales to the euro area fell by more than three percentage points, the proportion of those to emerging countries and areas increased. This geographical diversification of exports should be viewed positively, particularly at a time, like the present, of uncertainty in the international context, since it reduces exposure to certain markets, while enabling advantage to be taken of the higher growth of the emerging economies. Nonetheless, the euro area is still, by a wide margin, the main destination of Spanish goods exports, accounting for 56% of the total.

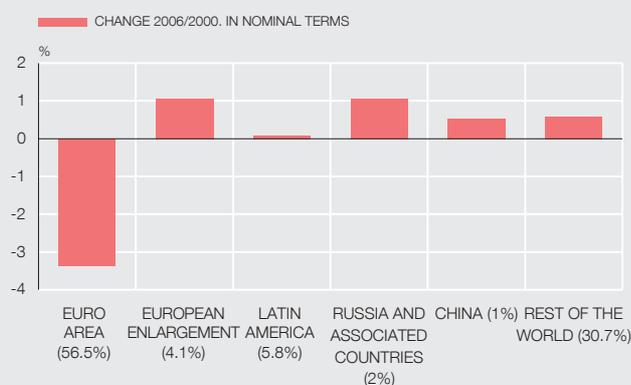
The greater orientation of Spanish exports towards emerging areas has helped to stem the decline in Spanish products' external market share. The first chart of the adjoining panel shows that, in recent quarters, the growth rate of Spanish goods exports, in real terms, has drawn nearer to that of world imports, although it is still below it. The deterioration in Spanish export price competitiveness indicators is one of the factors explaining the lower relative buoyancy of Spanish sales abroad, although in recent quarters the fall in manufacturing unit labour costs points to a more favourable price competitiveness performance in future. In addition, it should be noted that the appear-

1 SPAIN'S WORLD EXPORT SHARE, IN REAL TERMS

Year-on-year growth rate, based on a non-centred three-month moving average



2 CHANGE IN THE STRUCTURE OF SPANISH EXPORTS BY GEOGRAPHICAL AREA. 2000-2006 (a)



3 SPANISH EXPORTS BY GEOGRAPHICAL AREA AND PRODUCT

	2005	2006	2007 JAN-JUL
TOTAL EXPORTS, in real terms			
Year-on-year rate of change (%)	0.2	5.6	4.1
CONTRIBUTIONS TO GROWTH (%)			
By geographical area			
— Euro area	-0.8	1.8	2.1
— Rest of the EU	-0.2	0.5	0.0
— Rest of the world	1.0	3.3	1.9
BY PRODUCT GROUP <sup>a</sup>			
— Consumer goods	-0.8	1.9	0.6
— Equipment	0.6	1.2	-0.2
— Intermediate goods	0.4	2.6	3.6

SOURCES: IMF and Ministerio de Economía y Hacienda.

a. The share of each group of countries in Spanish exports in 2006 is shown in brackets.

ance of emerging countries on international markets has meant that the industrialised economies have generally had difficulty maintaining their export shares.

Analysis of exports by product group shows that non-energy intermediate goods are those that have made the greatest contribution to the growth of goods exports, both in 2006 and in 2007 to date. The country-by-country study confirms the general nature of the growth in the sales of this type of good, since it covers both the main countries of the euro area (Germany in particular) and the new EU enlargement countries and China. The buoyancy of the trade in this type of good is common to other countries and is related to the fragmentation of chains of production and the expansion of world industrial production. Along with non-energy intermediate goods, Spanish exports were sustained by cars in the first seven months of 2007, with a certain diversification in the sales of this sector towards the new EU enlargement countries and towards Russia and its associated countries being discerned. That said, sales to the euro area and, in particular, to France continue to represent a very high proportion of Spanish car exports. The specialisation of Spanish exports in this

sector was one of the factors that held back growth in sales abroad in the first few years of the current decade, given the weakness of private consumption in the euro area at that time, while advantage is being taken of the better outlook for consumption in the area at present. Finally, equipment exports have performed least favourably in 2007 to date, primarily on account of the decline in sales of transport equipment.

In short, the latest data on Spain's external trade are compatible with a firming of the recovery in goods exports. The diversification in external sales towards emerging markets, as well as reducing the vulnerability of the external sector to the economic situation in certain areas, will enable them to benefit from the greater buoyancy of demand in these countries. However, this process is necessarily slow and, in the short and medium-term, Spanish export growth will continue to depend mainly on the growth of sales to the euro area, so that its course over the coming quarters will depend upon the behaviour of the relative prices of Spanish production vis-à-vis those of European competitors and on the economic situation in the euro area, which may be jeopardised if the recent financial turbulence affects real activity.

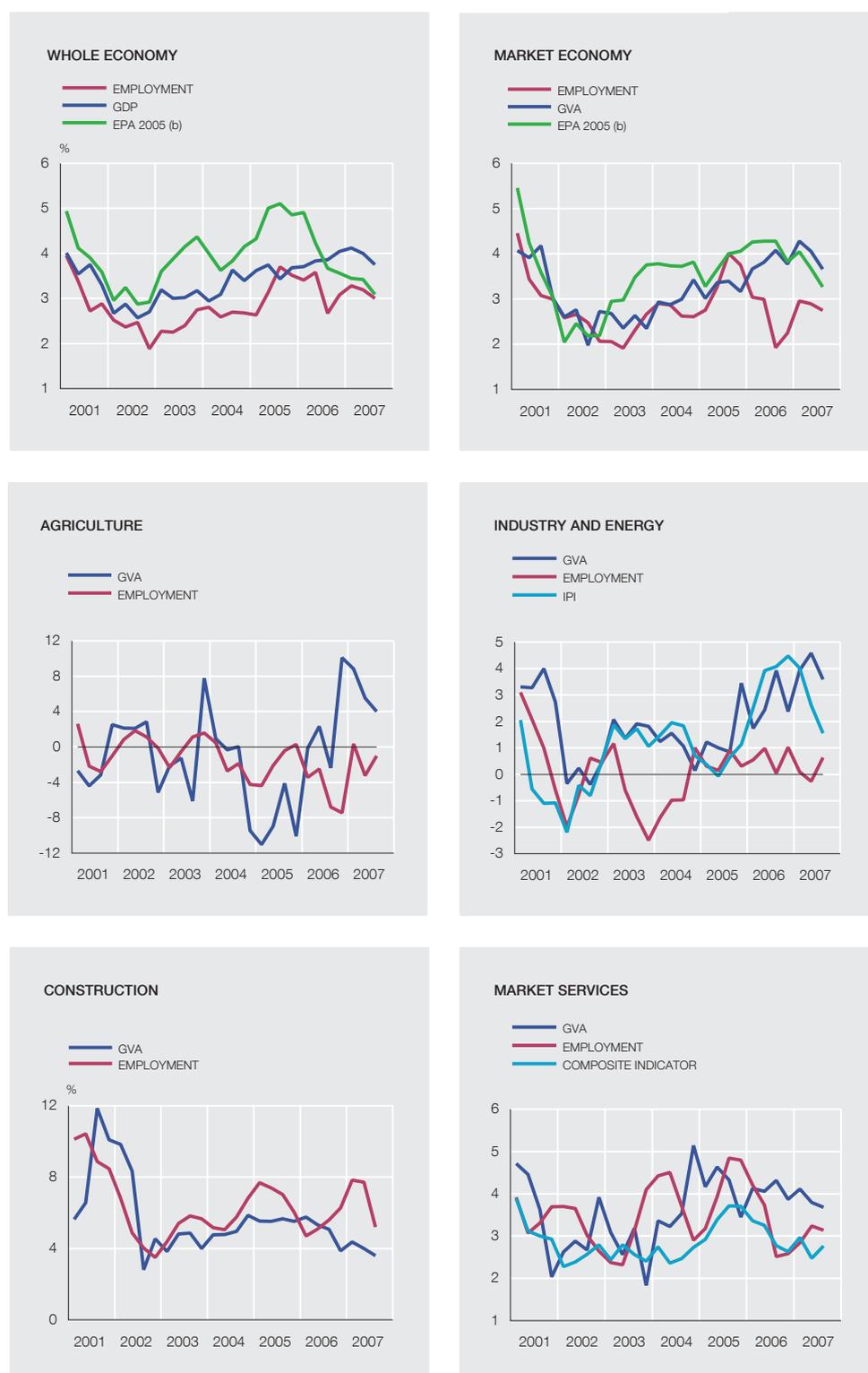
With regard to real goods imports, the QNA data for 2007 Q2 recorded an improvement in their year-on-year rate of growth to 6.3%, from 5.6% in the previous quarter. According to the most recent customs data, real imports continued to accelerate in July and August, owing to the rise in purchases of consumer goods and non-energy intermediate products. In the first eight months of the year real imports remained strong, growing by almost 7%, albeit below their average rate in 2006 (8.6%). Notable during this period was the acceleration in external purchases of equipment, to growth rates of more than 11%, while consumer goods purchases moderated, to around 4%. Meanwhile, imports of non-energy intermediate goods maintained the strength that characterised them in 2006, linked to buoyancy of industrial production.

Finally, real services imports accelerated in 2007 Q2, to a year-on-year rate of 8.5%, from 6.8% in Q1. This was a result of the increase in purchases of non-tourist services, in line with the upward trend in the nominal balance of payments indicator. As in the case of imports, transport and business services were the main forces behind this growth. Royalties declined for the fourth consecutive quarter. Real imports of tourist services lost momentum in Q2, in line with the decline in the buoyancy of other components of final consumption demand.

## **4.2 Output and employment**

In 2007 Q2, activity in the market economy was slightly less dynamic, so that its gross value added moderated to a year-on-year rate of 4.1%, 0.2 pp less than in the previous quarter. This loss of strength was experienced across the various sectors (agriculture, industry, construction and market services), with the exception of energy (see Chart 19). According to the available information, in Q3 value added declined by around 0.3 pp year-on-year, also as a result of the lower buoyancy recorded in all sectors, but especially in construction and energy.

Output in agriculture and fishing has recently had the benefit of favourable weather, which was conducive to notable growth in the first half of the year, the heavy floods and storms in the



SOURCES: INE, 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. Employment in terms of full-time equivalent jobs. EPA in terms of persons. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.

b. Series linked by the Banco de España on the basis of the control survey conducted using the methodology applied until 2004 Q4.

second half of May only partially reversing this effect. Thus, despite having slowed by somewhat more than 3 pp in Q2, its growth rate stood at 5.5%, exceeding that of other productive activities.

Overall, activity in the industrial and energy sectors accelerated by 0.7 pp in Q2 to 4.6%, driven by the energy sector, which offset the moderation in manufacturing output. Specifically, the industrial sectors lost momentum in Q2 in response to the reduced vigour of domestic consumption and other sectors (construction and market services), posting a year-on-year rate of 4.8%, below the notable growth recorded in Q1 (5.5%). The conjunctural information available for Q3 points to continuation of the slowdown in industrial activity. The industrial production index (IPI) grew in July and August by around 0.7% year-on-year, in calendar adjusted terms, as against almost 2.5% in Q2, when its growth was already moderating. The employment indicators, such as the number of Social Security registrations in industry, slowed somewhat in Q3, relative to Q2, albeit mildly, while the European Commission's opinion indicators, like industrial confidence, and those of purchasing managers showed falls in the quarter as a whole. By contrast, non-energy intermediate goods imports, which are strongly linked to industrial activity, accelerated in July and August, while the euro area industrial production index, an indicator closely related to its Spanish equivalent, was also quickening at the beginning of Q3.

Construction, which began the year on an accelerating path, lost momentum in Q2, its rate of growth falling to 4%, down 0.4 pp from Q1. As mentioned in the previous section, this loss of buoyancy reflected the lower pace of building, particularly in the residential investment segment, and can be expected to continue in Q3.

Services were less dynamic in Q2, growing at a year on year rate of 3.9% (down 4.2 pp from Q1). Market and non-market services behaved differently, the moderation of the former predominating over the acceleration in the latter. As for the most recent information, the sales of large corporations, Social Security registrations, the sector's confidence indicator compiled by the European Commission and the index of business activity of the PMI point to a slowdown in market services. Although this pattern is common to all sectors, the loss of momentum in transport and communications, which had until this quarter been the most dynamic, should be noted.

Employment creation in the economy as a whole in 2007 Q2 decelerated slightly, although it remained highly buoyant, with year-on-year employment growth of 3.2%, 0.1 pp less than in the previous quarter. Given the slowdown, of a similar magnitude, in activity in that same quarter the growth of apparent labour productivity remained just below 1% throughout the first half of the year.

In Q3 the indicators continued to point to moderation in employment growth. The number of Social Security registrations, calculated using average data, decelerated by 0.3 pp in Q3, with respect to Q2, to a year-on-year rate of 2.9%. According to the EPA (Labour Force survey) data for Q3, employment grew at a year on year rate of 3.1%, also slowing by 0.3 pp with respect to the previous quarter.

The only sector in which there was a clear acceleration in the rate of job creation in the first half of the year was market services (with an increase of 3.2%, as against 2.8% in Q1), although it should also be noted that employment in construction showed no signs of weakness according to the QNA data, maintaining high rates of job creation, of close to 8%. In contrast, the number of employees in agriculture and industry fell in Q2, in year-on-year terms. The most

recent indicators for Q3 point to a slowdown in employment in the market economy, especially in construction, as a result of the reduced buoyancy of activity. In Q3, the slowdown in employment displayed by the EPA was concentrated in construction, where employment grew by 4.9%, almost 3 percentage points less than three months earlier. In services, employment remained highly buoyant (4.2%), as in the previous quarter, the high rate of job creation posted by market sectors being notable (5.1%). Meanwhile, employment in agriculture and industry again recorded negative year-on-year rates in Q3 (of -3% and -0.9% respectively), although in both cases, at a somewhat less intense rate than in the previous quarter. Overall, employment in the market economy grew at a rate of 3.3% in Q3, displaying a slightly more pronounced slowdown than the economy as a whole.

On QNA data, dependent employment remained more buoyant than self-employment in Q2, although the latter ceased declining in Q3, with a small positive change (0.2%). By contrast, dependent employment grew at a year-on-year rate of 2.9%, which rises to 3.2% in the case of the market economy alone. Social Security registrations also showed slower growth in self-employment (1% in Q3) than in dependent (3.1% in that period), although the latter has been decelerating, while the rate of increase in registrations of self-employed workers rose. The EPA data for Q3 show a certain deceleration in dependent employment which grew by 3.1%, down 1 pp from the previous quarter, while the growth rate of self-employment rose to 3.3% year-on-year.

According to the EPA for Q3, the slowdown in employment was passed through to both Spanish and foreign workers although, as in recent years, the employment of foreigners was much more buoyant. By type of contract, in the summer months permanent employment maintained the notable expansion of the previous quarters, with year-on-year growth of 7.3%. Also, the decline in temporary employment that began at the beginning of the year intensified, to a rate of 4.8% year-on-year. As a result, the ratio of temporary to total employment stood at 31.9% in Q3, 2.7 pp less than in the same quarter of 2006, although slightly higher than in Q2. The most recent INEM data on permanent employment show a pattern of slowdown during 2007.

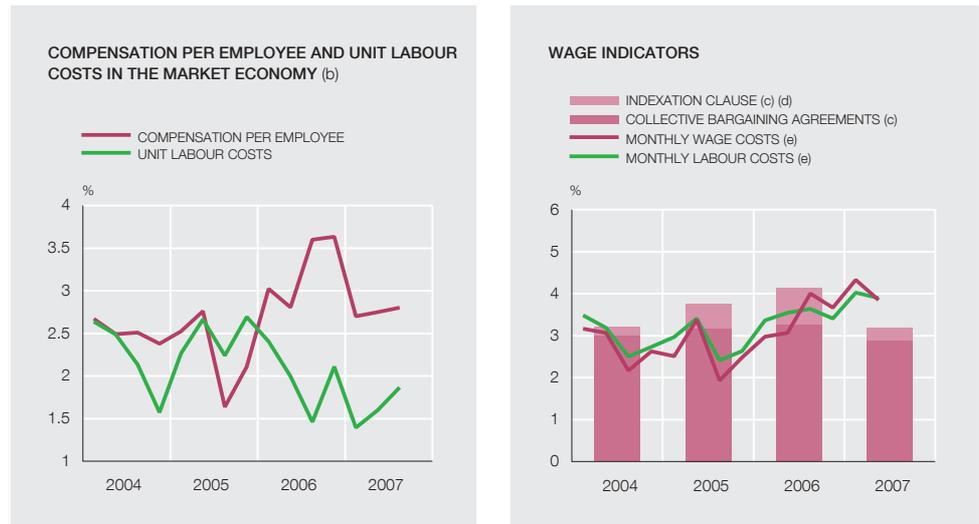
By length of working day, full-time employment (3.4%) continued to grow faster than part-time employment (1%), leading to a fall in the ratio of part-time to total employment, to 11%, 0.3 pp below its level a year earlier.

The rate of growth of the labour force rose in 2007 Q3, to 3%, following the moderation in Q2 (2.8%), as a result of maintenance of the high rate of growth of the population over the age of 16 (1.8%) and the increase in the participation rate, which rose to 59.1%. As usual the female participation rate rose by more than the male one, to reach 49%, 1.2 pp higher than a year earlier, but still significantly below the male rate (69.6%).

As a result of this rise in the labour force and the above-mentioned slowdown in employment, the number of unemployed persons increased by 31,900 in Q3. This increase entailed a positive annual rate of change (1.5%) in the numbers of unemployed, as against the declines recorded in the first half of the year. However, the rate of unemployment remained unchanged from its Q2 level of 8%, down 0.1 pp from its level in the same quarter of 2006. The behaviour of registered unemployment was also unfavourable in the summer, returning to positive growth rates, which had not been recorded for more than a year. Registered unemployment grew by 1.9% on average in Q3.

### **4.3 Costs and prices**

In the second quarter of 2007, compensation per employee continued to grow at more moderate rates than in 2006 (see Chart 20). Specifically, in the economy as a whole, compensation per employee grew at a year-on-year rate of 2.9%, up barely 0.1 pp from Q1. In the market



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

- a. Percentage change on same quarter a year earlier.
- b. Rates based on QNA seasonally adjusted series.
- c. Information from collective bargaining agreements to September 2007.
- d. Previous year's indexation clause.
- e. ETCL (quarterly labour costs survey).

economy, the growth of compensation per employee remained somewhat lower, at 2.7%. The information available for Q3 points to the maintenance of growth rates of compensation per employee at around 3%. The information on wage settlements in collective bargaining agreements shows an average rise in 2007, in both newly signed and revised agreements, of around 2.9%, which represents a fall of 0.3 pp with respect to the same period the previous year in the case of revised agreements and of 0.4 pp in that of newly signed ones. The impact of indexation clauses corresponding to 2007 is estimated to be 0.3 pp, much smaller than in the preceding year (0.9 pp). The incidence of these clauses continues to be significant in the present year, affecting about 60% of workers with agreements registered between January and August 2007 (see Box 5).

Unchanged growth rates for compensation per employee, in conjunction with a slight fall in productivity, may have led to a small increase in unit labour costs (ULCs) in Q3 (see Chart 21). It is estimated that this growth of ULCs was not passed through to the growth rate of the value-added deflator, which actually declined slightly, in which case there will have been a certain reduction in operating margins. These results may be extrapolated approximately to the market economy. It should be noted that unit labour costs in industry continued to post negative growth rates in Q3, so that the gross operating surplus continued to widen in this sector.

As regards the final demand deflator, it is estimated to have remained at 2.6% during 2007 Q3, as a result of mixed behaviour among its components. The growth rate of the imports deflator was also unchanged from the previous quarter (0.8%), thanks to the low year-on-year rates of increase in oil prices and the decline in the prices of imported products in euro owing to the appreciation of this currency. As regards the GDP deflator, its growth declined by 0.1 pp, to 3.1%. If confirmed, this would be the lowest rate recorded in recent years.

The moderation in demand deflators observed in recent quarters appears to have continued in Q3, albeit less strongly, especially because of the stagnation of the private consumption

The widespread presence of inflation indexation clauses is one of the distinctive characteristics of the Spanish collective bargaining system. In fact, this is one of the basic elements of the successive Inter-confederal Agreements for Collective Bargaining (AINC) which the social agents have been signing since 2002. These clauses operate by giving rise to an ex-post adjustment of wages to actual inflation, when the latter exceeds the projection taken as the reference rate in the agreement.

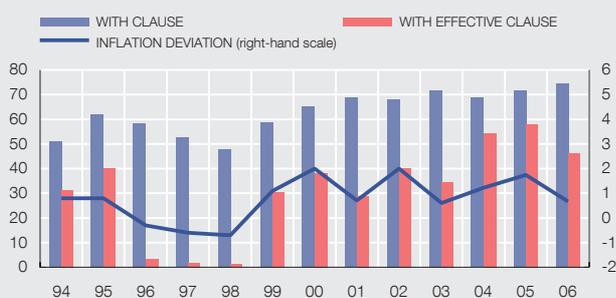
In 2006, according to preliminary data from the *Anuario de Estadísticas Laborales* (Labour Statistics Annual), agreements with this type of clause affected 74.4% of workers, a similar percentage to previous years (see Charts 1 and 2). As regards the percentage of workers for whom the clause was triggered, it fell from 58% in 2005 to 46.2% in 2006, owing to the fact that the inflation deviation in 2006 was smaller than in 2005. In any event, this percentage is higher than that observed in recent years, with similar inflation deviations to 2001 and 2003, when it reached 29% and 35%, respectively. The successive renewals of the AINC signed since 2002 have not, therefore, significantly increased the percentage of agreements with indexation clauses, but they do seem to be making such clauses progressively more effective. This greater effectiveness is a result of the fact that the inflation threshold above which these clauses are activated has been drawing closer and closer to 2%.

Two effects may be distinguished in the impact of the clauses on wage increases. First, insofar as these clauses can be interpreted as insurance for workers against inflation deviations, their presence might be expected to enable lower ex-ante wage increases to be

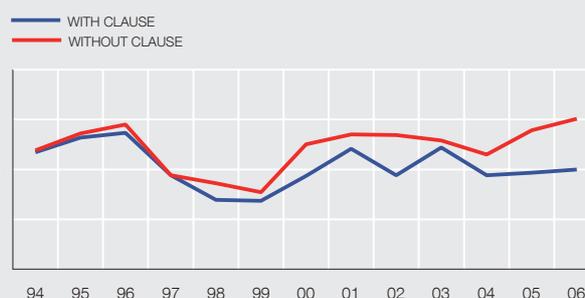
agreed. In this respect, in 2006 the average initially agreed wage-rate increase was 3.2%, the result of an increase of 3% in agreements including these clauses and of 4% in agreements without such clauses (see Chart 2). Among the agreements including the inflation adjustment mechanism a large difference is appreciated between those agreements in which it is activated and those in which it is not. Thus, the ex-ante wage increase agreed in the former was 2.7%, as against 3.6% in the latter. As in other years, therefore, wage settlement moderation is seen in those agreements that include indexation clauses, and this is even greater when the agreements contain clauses that are eventually activated when the year-end inflation rate is published.

Second, insofar as there is a positive deviation by actual inflation from the inflation thresholds in the agreements, the presence of clauses will lead to an upward adjustment of wage increases. Generally, this second effect has meant that agreements with clauses give rise to higher wage increases than agreements that do not include such clauses (see Chart 4). In 2006, however, the smaller year-end inflation deviation (the CPI again exceeded the official reference rate (3%), but by a substantially smaller amount (0.7 pp) than in the previous year (1.7 pp)) meant that the amount of the revision of the wage increases of agreements with clauses was not large enough for the final wage increase to exceed the wage increase in agreements without a revision mechanism. Thus, the final wage increase was 3.4% in agreements with clauses, as against 4% in those without clauses. If only those agreements with an effective revision mechanism are analysed, the effect of the clause rises to 0.67 pp, i.e. a practically complete pass-through of the 2006 inflation deviation.

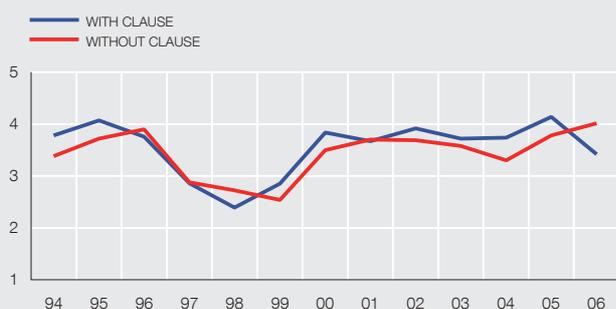
1 PERCENTAGE OF WORKERS WITH CLAUSE



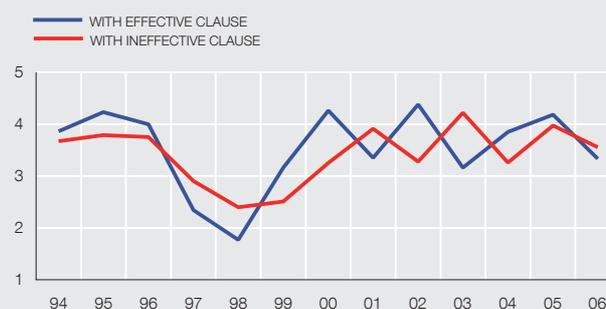
2 INITIAL WAGE INCREASES



3 FINAL WAGE INCREASES



4 FINAL WAGE INCREASES



SOURCES: INE and Ministerio de Trabajo y Asuntos Sociales

In 2006, the presence of indexation clauses led to an overall upward revision of 0.3 pp in the wage increases agreed in collective agreements, which was significantly smaller than the 0.9 pp revision in 2005. In terms of the compensation per employee estimated in the National Accounts, this smaller impact of indexation clauses in 2006 will help to moderate wage growth in 2007, when the back-pay generated is received. In the event, this has indeed been reflected in the data for the first half of the year, with average growth of 2.7% in the market economy, as against 3.3% estimated for 2006. This wage moderation has been favoured, again this year, by the presence of negative wage drift linked to the high rate

of job creation and the lower average wages paid to new labour market entrants.

In short, indexation clauses enable more moderate initial wage increases to be agreed, but subsequently involve automatic adjustment of wages to past inflation, which introduces a high degree of stickiness into wage increases and inflation rates. At moments like the present, when large increases occur in energy prices, the widespread presence of indexation clauses means that wages may incorporate these price rises, hampering the necessary adjustment of the economy to such shocks.

deflator in Q2, while the progressive slowdown in the construction deflator is estimated to have continued. During Q3, the consumer price index grew at a year-on-year rate of 2.4%, although this was the result of mixed behaviour across its components. The growth rates of unprocessed food and non-energy manufactured products were 1.6 pp and 0.3 pp lower respectively in Q3 than in the previous quarter, at 4.2% and 0.5%. In the case of industrial goods, the favourable behaviour of the prices of electronic and computer products, which continued to post reductions in their year-on-year rates, and of cars was notable. As regards unprocessed food prices, their deceleration was mainly a result of the smaller increases in some meat prices. Services inflation improved by only 0.1 pp (3.8%), while processed food inflation rose by 0.7 pp to 2.9%, bread and milk prices and the smaller falls in oil prices contributing to this acceleration. The year-on-year rate of decline in energy prices became less pronounced as a result of the rise in the price of crude oil during the quarter. In fact, the price of oil, after falling in August, rose in September to almost 78 dollars per barrel, a price that was exceeded by a wide margin in October, when it was above 80 dollars. In any event, the rise in the euro against the dollar helped to moderate the impact of rising oil prices. Consequently, the CPI excluding unprocessed food and energy remained unchanged at 2.5% (see Chart 22).

Inflation in Spain, as measured by the HICP, was 2.4% in Q3, while in the euro area as a whole it was 1.9%, so that the differential vis-à-vis the euro area remained at a three-year low, even improving by 0.1 pp with respect to the previous quarter (see Chart 23). By component, while the unprocessed food and services differentials narrowed in Q3, the acceleration of processed food prices in Spain led to a 0.3 pp increase in the corresponding differential. Meanwhile, the sharper slowdown in energy prices in the euro area reduced the negative differential that was being recorded for this component. Finally, the year-on-year growth rate of non-energy industrial goods prices slowed in Spain, while remaining unchanged in the euro area, so that the price increases of this component continued to be lower in Spain.

The producer price index (PPI) grew at moderate rates of around 2.3% in July and August, albeit rising to 3.4% in September. The increase in the latter month was marked by the greater dynamism of the producer prices of consumer goods (especially food) and by the increase in energy prices, which had been growing at negative rates for several months. Meanwhile, the producer prices of equipment grew during the period at slightly more than 3%. In the euro area as a whole the behaviour of producer prices to August was somewhat more favourable, so that the negative differential for Spain was around 0.6 pp. Finally, the index of prices for farm produce began to move downwards in May and June, and continued to do so over the follow-



SOURCES: INE and Banco de España.

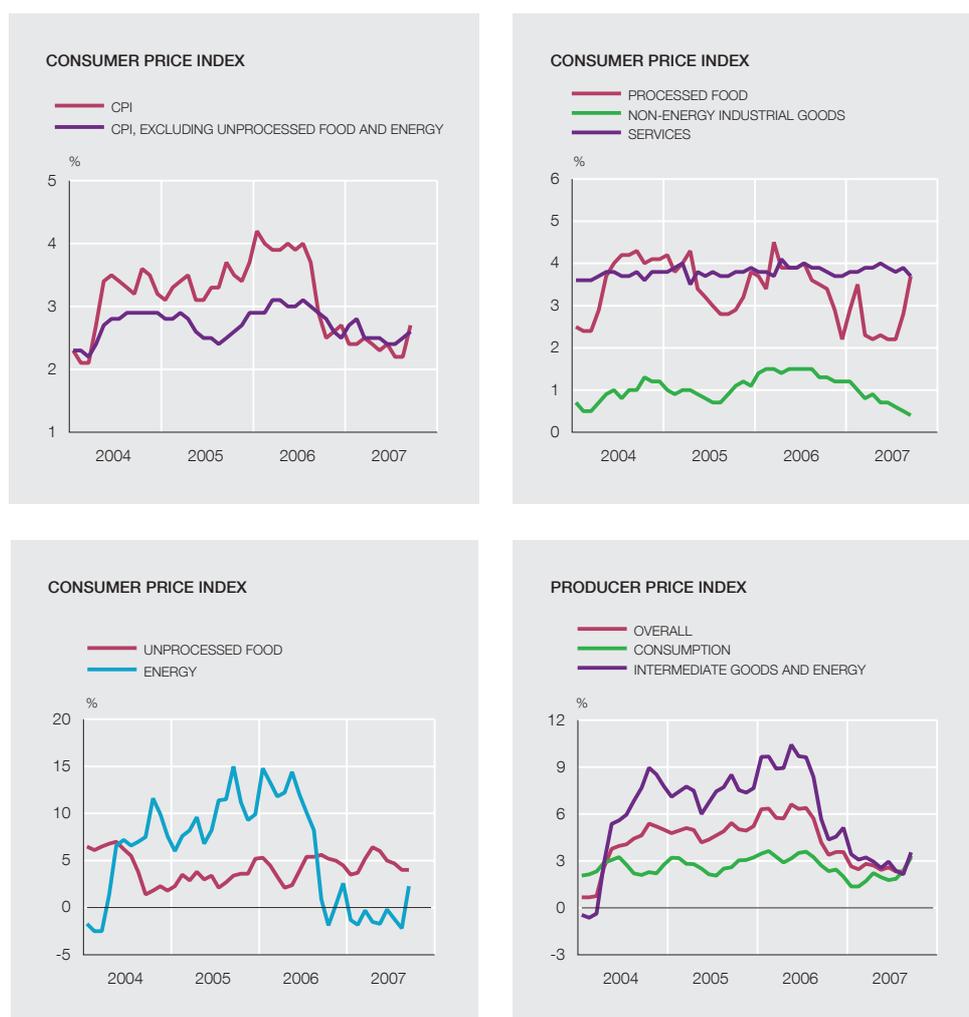
a. Percentage change on a year ago based on QNA seasonally adjusted series.

ing months. Further increases in cereal prices were offset by the reductions in most meat prices.

#### 4.4 The State budget

On 21 September, the Spanish government's Council of Ministers approved the draft State budget (PGE) for 2008, which includes a target surplus for general government as a whole of 1.15% of GDP. This target does not include the deficit permitted by the Budget Stability Law for regional government investment (0.25% of GDP), although it does include that of the State (0.20%) and that of local government (0.05%) in that year. The draft PGE confirms the projections established in the latest Stability Programme Update and the Budgetary Stability Targets approved last June for 2008-2010. At the same time, the PGE forecasts that the year-end balance, in National Accounts terms, of the general government sector will be a surplus of 1.3% of GDP, a slight improvement on the initial forecast. By sub-sector, central government will post a surplus of 0.3% of GDP, while both the regional and local governments will end the year with deficits of 0.05% of GDP. As regards the Social Security system, its accounts are forecast to show a surplus of 1.1% of GDP.

The budget also offers an outturn projection of State revenues and expenditure in 2007. In accordance with National Accounts methodology, the outturn projection envisages a State surplus of €2,101 million (0.2% of GDP), which rises to €7,486 million in cash-basis terms, significantly exceeding the surplus of €3,620 million projected in the initial budget document.



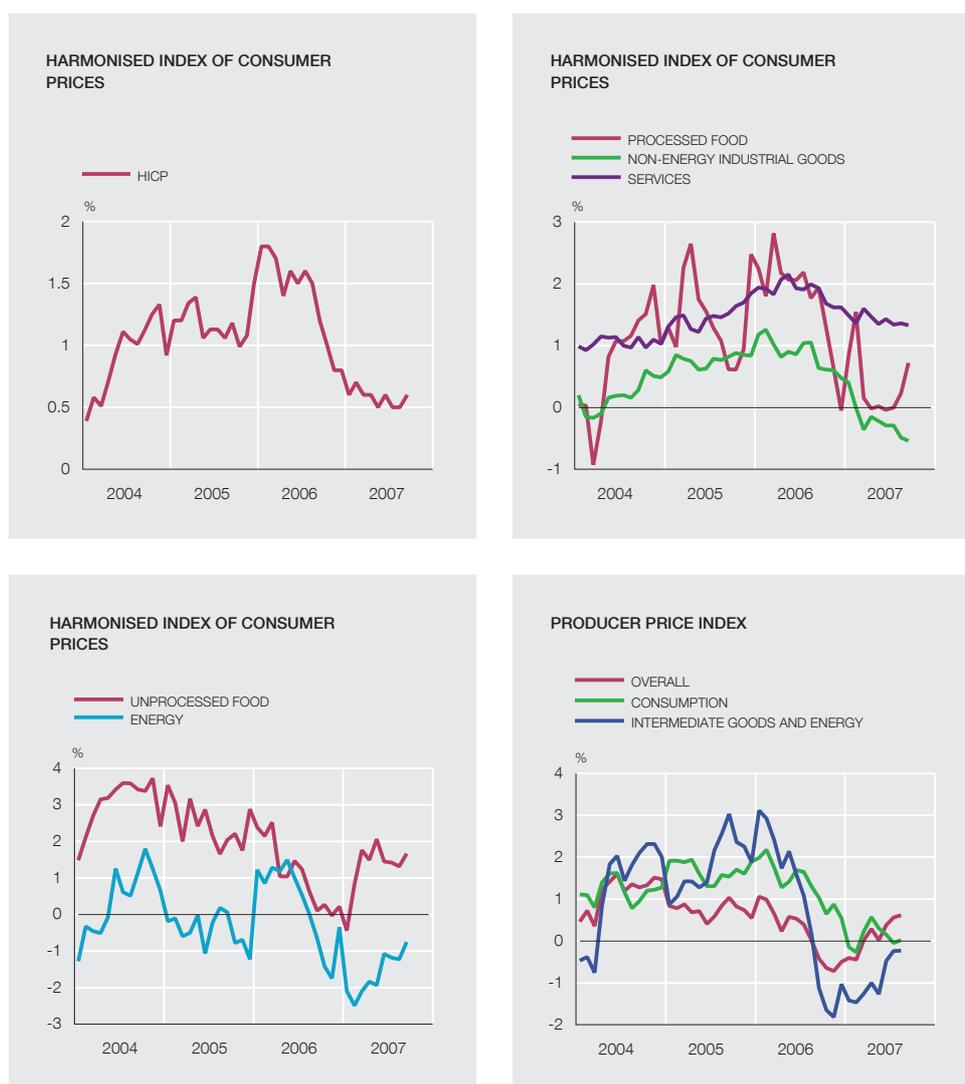
SOURCE: INE.

a. Year-on-year percentage change based on the original series.

This improvement would be a consequence of the larger revenues from direct taxes and other revenues, especially profits and dividends.

Information is also available on the budget outturn to September. According to this information, the State accounts showed a surplus of €12,857 million (1.2% of GDP), in National Accounts terms, which exceeded the surplus of €10,716 million (1.1% of GDP) in the same period of 2006 (see Table 3), owing to growth of 10.8% in resources, while uses increased by 9.7%. In cash-basis terms, the surplus was €10,169 million, which exceeded that of €6,913 million recorded in the same period of the previous year. Revenues increased by 11.9%, while payments accelerated to 9.3%. These results point to a higher surplus for the year as a whole than the budget outturn projection.

To analyse revenue, information is available on receipts from the main taxes, both the portion assigned to the State, the only one shown in Table 3, and that corresponding to the ordinary-regime regional governments. This aggregate information is more illustrative for evaluating tax receipts. The figures for total receipts indicate that tax revenues accelerated slightly in Q3 as a consequence of the behaviour of direct taxes, while indirect taxes decelerated. Other reve-



SOURCES: Eurostat and Banco de España.

a. Year-on-year percentage change based on the original series.

nues, meanwhile, maintained virtually unchanged their high growth rates of the first half of the year. The growth rates of receipts of both personal income tax (with a 16.4% increase to September) and corporate income tax (with an increase of 31.8%) rose further in this quarter with respect to the first half of the year. In the first case they were underpinned by the withholdings on income from work (with growth of around 10%) and, in the second case, by the growth of net tax payable (which was not affected by the reform, since it corresponds to the previous year's profits). Both taxes were also influenced by the growth in withholdings on income from capital (which grew by 42.7%) and the withholdings on gains on mutual funds (with growth of 73.3% to September). Receipts of both taxes will have to slow drastically in the final quarter, which appears unlikely, if the outturn projection for growth in the whole of 2007 of 6.9% in the personal income tax and 12.5% in the corporate income tax is to be fulfilled. As regards indirect taxes, VAT decelerated notably, to 1.9%, basically as rebates were made earlier. As a result, the rate of growth of VAT receipts is expected to accelerate in the final months of the year, to around 5.5%, according to the outturn projection. Excise duties have been posting sustained rates of growth throughout the year, of around 7%, a certain recovery with respect to the weak

EUR m and %

	Outturn							
	Outturn 2006	Percentage change 2006/2005	Outturn projection 2007	Percentage change 2007/2006	Outturn JAN-JUN Percentage change 2007/2006	2006 JAN-SEP	2007 JAN-SEP	Percentage change
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
<b>1 REVENUE</b>	141,846	10.1	151,329	6.7	12.7	99,683	111,524	12.7
Direct taxes	81,130	14.8	87,716	8.1	18.0	54,929	65,957	18.0
<i>Personal income tax</i>	41,451	15.3	43,000	3.7	15.3	30,780	33,978	15.3
<i>Corporate income tax</i>	37,207	14.5	41,842	12.5	22.5	22,280	29,372	22.5
<i>Other (a)</i>	2,472	11.5	2,874	16.3	30.3	1,869	2,606	30.3
Indirect taxes	48,328	8.3	49,739	2.9	6.9	36,520	35,950	6.9
VAT	35,424	10.7	35,491	0.2	5.5	27,006	24,940	5.5
<i>Excise duties</i>	9,895	1.0	11,015	11.3	14.4	7,251	8,588	14.4
<i>Other (b)</i>	3,009	7.0	3,233	7.5	4.2	2,264	2,422	4.2
Other net revenue (c)	12,388	-8.2	13,874	12.0	17.1	8,234	9,617	17.1
<b>2 EXPENDITURE</b>	130,375	6.2	143,843	10.3	8.0	92,771	101,354	8.0
Wages and salaries	22,209	7.4	23,859	7.4	6.6	15,912	16,937	6.6
Goods and services	3,799	12.1	4,319	13.7	19.3	2,386	2,788	19.3
Interest payments	15,619	-12.4	14,607	-6.5	-12.9	13,139	12,182	-12.9
Current transfers	72,225	11.9	79,560	10.2	9.8	51,490	57,581	9.8
Investment	9,037	0.7	11,357	25.7	18.3	5,466	6,314	18.3
Capital transfers	7,487	2.0	10,141	35.4	25.4	4,377	5,552	25.4
<b>3 CASH-BASIS BALANCE (3 = 1 - 2)</b>	11,471	—	7,486	—	—	6,913	10,169	—
<b>MEMORANDUM ITEM: NATIONAL ACCOUNTS (EDP)</b>								
Resources	147,201	13.1	156,377	6.2	12.4	102,898	113,983	12.4
Uses	142,422	10.8	154,276	8.3	7.0	92,182	101,126	7.0
<b>NET LENDING (+) OR BORROWING (-)</b>	4,779	—	2,101	—	—	10,716	12,857	—
(as a percentage of GDP)	0.5	—	0.2	—	—	1.1	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.  
 c. Includes charges and other revenues, current transfers, profits and dividends, capital transfers and other unclassified transactions.

increases of previous years. The outturn projection envisages a certain slowdown in receipts, to growth of 4.1% in the year as a whole. Finally, the items grouped under other revenues were highly buoyant to September, owing, above all, to the profits and dividends and to the capital transfers from the ERDF. The outturn projection envisages a certain slowdown in the last quarter, partly due to charges, for which a negative rate of change is forecast for the year as a whole.

With regard to State expenditure, the acceleration in Q3 was marked by that in current expenditure, specifically, interest payments and current transfers. Meanwhile the growth rates of wages and salaries and goods and services (the latter owing to the strong growth in spending linked to the electoral process in the first half of the year) moderated. Capital expenditure continued to increase at high rates, especially in the case of capital transfers. The outturn projection envisages a slight acceleration in total expenditure in the final quarter, which would be linked to expenditure on wages and salaries, interest and, above all, the capital expenditure items.

The Social Security system posted a surplus of €10,800 million in the period January-July 2007, up 20.1% on the same period a year earlier, which was a more favourable result than in the period to April. Both revenues and payments have accelerated in recent months to 9% and 7%, respectively.

Revenue from social security contributions increased by 7.5% to July, the same rate as recorded to April. The growth in the number of Social Security registrations has slowed in recent months, reaching a rate of 2.6% to September 2007, below the rate recorded for the whole of the previous year, highlighting a certain loss of buoyancy in the labour market.

Turning to expenditure, there was a mild slowdown in that on contributory pensions, which increased by 6.5% to July, as against 6.7% to April and in marked contrast to the 8.5% increase budgeted for the year as a whole. The growth rate in the number of contributory pensions has stabilised at around 1.3%, below the average rate in 2006 (2.3%). Meanwhile, expenditure on sick-

ness benefits slowed significantly, to 3.8% in July, well below budget.

As regards the SPEE (National Public Employment Service), the data for which are not included in the adjoining table, contributions received increased by 6.7% to May, above budget, while rebates on contributions in respect of employment-promoting contracts increased by 15.4% to the same month, in this case below budget.

SPEE expenditure on unemployment benefits grew in August by 5.8%, in cumulative year-on-year terms (less than the 7.6% increase recorded in 2006 as a whole and also less than the increase of 6.5% budgeted for the year as a whole), while the number of beneficiaries increased by 12.1% in the same period (as against 3% average growth in 2006). In addition, registered unemployment, which increased by 2.1% year-on-year to August, accelerated further in September to 2.6%, in contrast to the average fall of 1.1% in 2006. This gave rise to a further increase in the coverage ratio, which stood at 71.8% in August 2007, as against 66.6% at end-2006.

## 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		
	2006	2007	% change	% change	2006	2007	% change	
	1	2	3 = 2/1	4	5	6	7 = 6/5	
1 REVENUE	97,547	106,142	8.8	8.5	59,652	65,008	9.0	
1.1 Social security contributions (c)	90,625	97,942	8.1	7.5	55,556	59,738	7.5	
1.2 Current transfers	5,295	5,963	12.6	13.8	3,177	3,588	13.0	
Other (d)	1,628	2,237	37.5	38.6	920	1,682	82.8	
2 EXPENDITURE	90,562	98,390	8.6	6.4	50,657	54,208	7.0	
2.1 Wages and salaries	2,165	2,253	4.1	-2.7	1,242	1,252	0.8	
2.2 Goods and services	1,733	1,807	4.2	0.0	986	990	0.4	
2.3 Current transfers	86,133	93,743	8.8	6.7	48,276	51,551	6.8	
Contributory pensions	73,832	80,099	8.5	6.7	41,592	44,301	6.5	
Sickness benefits	6,656	7,313	9.9	8.7	3,604	3,741	3.8	
Other benefits	5,646	6,331	12.1	4.5	3,080	3,509	13.9	
2.4 Other (e)	530	588	10.8	68.2	152	415	172.7	
3 BALANCE	6,986	7,752	11.0	14.8	8,995	10,800	20.1	

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 2007.

b. Transfers from the ISM to the regional governments to finance transferred health-care and social services have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.

c. Including surcharges and fines.

d. Excluding surcharges and fines.

e. Reduced by the disposal of investments.

EUR m		JANUARY-JULY	
		2006	2007
CREDITS	Current account	177,693	197,505
	Goods	101,138	108,660
	Services	47,043	51,847
	Tourism	22,290	23,041
	Other services	24,753	28,806
	Income	21,347	27,482
	Current transfers	8,166	9,515
	Capital account	3,370	3,243
	Current + capital accounts	181,063	200,748
	DEBITS	Current account	227,405
Goods		145,951	157,160
Services		35,315	39,857
Tourism		7,026	7,676
Other services		28,289	32,181
Income		33,712	45,393
Current transfers		12,427	15,177
Capital account		863	934
Current + capital accounts		228,268	258,521
BALANCES		Current account	-49,711
	Goods	-44,812	-48,500
	Services	11,728	11,991
	Tourism	15,264	15,366
	Other services	-3,536	-3,375
	Income	-12,366	-17,911
	Current transfers	-4,261	-5,661
	Capital account	2,507	2,309
	Current + capital accounts	-47,204	-57,773

SOURCE: Banco de España.

a. Provisional data.

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

In the first seven months of 2007, the overall balance on current and capital account was a deficit of €57,773 million, up 22.4% on the same period of the previous year (see Table 4). The current account deficit widened by 20.9% in this period, to €60,082 million, basically owing to the widening that took place in Q2. Meanwhile, the surplus on capital transactions declined by 7.9% to €2,309 million. The balances of the main components of the current account deteriorated in the first seven months of 2007, with the exception of services, which improved, as a result of the growth in the tourism surplus and the partial correction of the other services deficit. The trade deficit continued to widen, albeit at a more moderate rate (8.2%), while the income deficit increased significantly (45%).

In fact, the moderate expansion in the trade deficit in the period January-July contrasts with the strong deterioration seen in recent years. This is because the energy bill fell in this period, in line with the trend in oil prices on international markets and with the appreciation of the euro against the dollar, since the non-energy trade imbalance widened at a faster rate than in 2006.

As for the services balance, the first seven months of the year showed a slight improvement in the surplus relative to the previous year, stemming from a modest recovery in net tourism rev-

venues and a small correction in the other services deficit. Nominal tourism revenues increased by 3.4% to July, less than the average rate in the previous year, reflecting their slackness in Q2, although, according to the available conjunctural indicators, they recovered slightly over the summer. Tourism payments, meanwhile, increased by 9.2% in the period January-July, in line with the average increase in 2006. Yet, despite the rise during the summer, they continue to follow a path of slowdown, in step with the trend in their main determinants. As for other services, revenues were more buoyant than payments, with growth rates of 16.4% and 13.8%, respectively.

The income deficit widened notably in the first seven months of 2007, to €17,911 million, a deterioration of €5,545 million in relation to the level in the same period of the previous year. Both revenues and payments were highly expansionary in the first seven months of 2007, with year-on-year growth rates of 28.7% and 34.7%, respectively. By institutional sector, financial institutions and, in particular, other resident sectors saw their deficits expand notably, while there was a mild correction in the general government deficit.

Current transfers showed a deficit of €5,661 million in the period January-July 2007, up €1,400 million from that recorded in the same period of the previous year. Revenues increased by 16.5% year-on-year, thanks to the favourable trend in EU flows connected to the European Social Fund, as well as other transfers received by the private sector. Meanwhile, the buoyancy of payments exceeded that of receipts, reflecting the significant growth in both the payments made by the public sector and those made by other resident sectors, the notable growth in migrant remittance payments (25.4%) standing out.

Finally, the capital account surplus amounted to €2,309 million in the first seven months of 2007, a decline of 7.9% with respect to the same period of the previous year. This deterioration is basically explained by the decline in the revenues received by general government, mainly in relation to debt forgiveness and from the Cohesion Fund. This offset the expansionary behaviour of structural funds received from the ERDF.

## 5 Financial developments

### 5.1 Highlights

Financial developments in the Spanish economy in 2007 Q3 were influenced by the bout of turbulence on international financial markets arising from the increase in defaults on US sub-prime mortgage loans. Higher liquidity requirements associated with the refinancing difficulties of certain vehicles that were investing in mortgage-backed securities were, in conjunction with the confidence crisis, reflected in a rise in interbank market interest rates. Consequently, in September the one-year Euribor averaged a rate of 4.72%, 21 bp higher than in June.

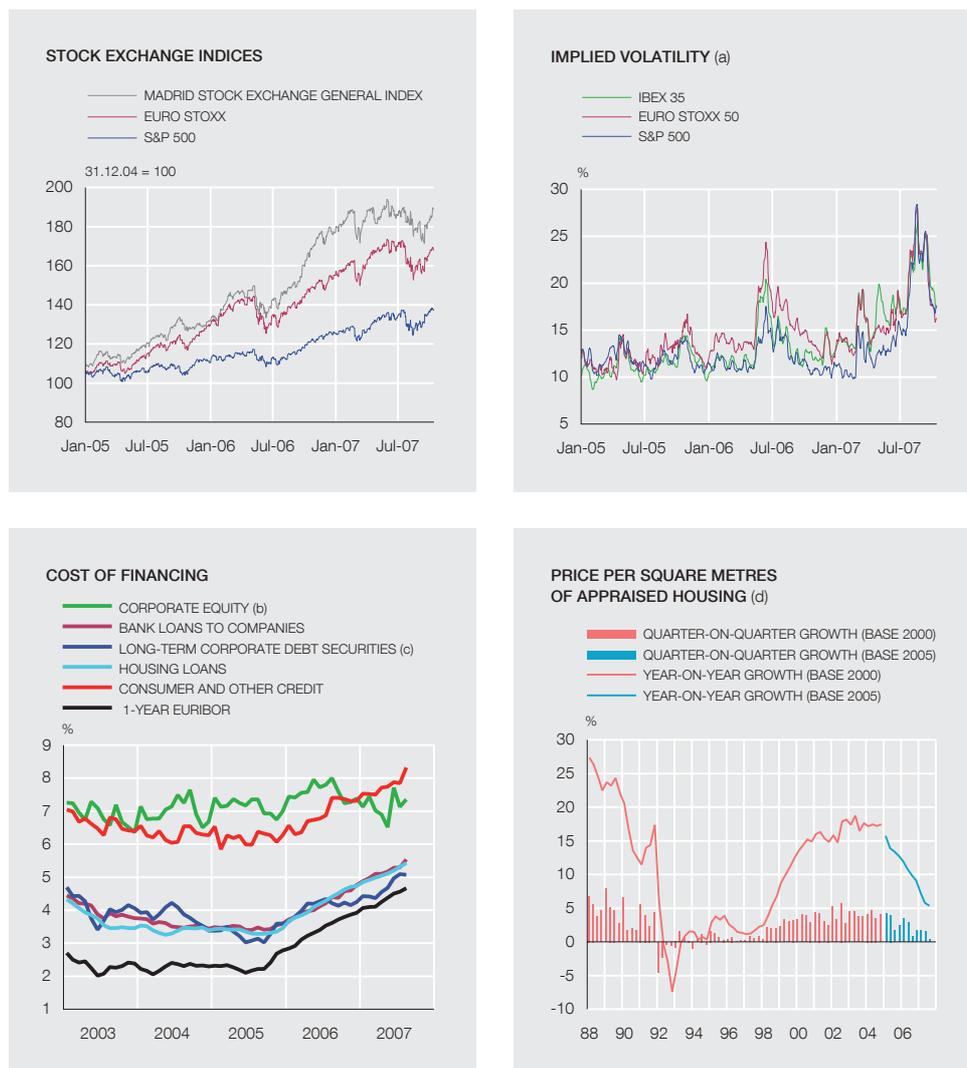
The turbulence also hit other financial markets. On credit markets there was a widespread re-pricing of risk, which pushed premiums higher and was more pronounced for the lowest-quality securities. In any event, credit spreads had dropped to historically low levels and, therefore, recent developments to a certain extent represent a process of normalisation, albeit a sudden one. As a result of heightened uncertainty, some investors showed greater preference for safer assets, and government debt yields fell. Stock prices became more volatile at the same time as valuations dropped more sharply for banks and construction companies (see Chart 24). However, after the main central banks intervened to alleviate the credit squeeze, some of the above-mentioned movements were fully or partially reversed. Government debt yields rose again, credit risk premiums fell and stock prices increased. On the cut-off date of this article, the Madrid Stock Exchange General Index was 1.7% higher than at the end of June, with gains of 7.3% for the year as a whole, similar to those reached in the same period by the EuroStoxx Broad Index (7.7%) and by the S&P 500 of US firms (8.5%). Conversely, forward interest rates on interbank markets remained high even though part of the rise was corrected.

Against this backdrop, private-sector financing conditions tightened in Q3. As for households, between June and August (the last month for which information is available) interest rates on bank loans for house purchases rose 23 bp and those on consumer and other loans climbed 45 bp. The price of funds provided by banks to companies increased by 25 bp over the same period and the cost of fixed-income issues was up by 10 bp (in the long-term bracket) and by 23 bp (short-term). In contrast, the indicator which approximates the cost of own funds dropped slightly. According to the latest Bank Lending Survey (BLS), conducted in September, financial turbulence contributed to tightening loan qualifying standards, especially for corporations. Institutions expected the credit supply to continue to be increasingly more restrictive in the last three months of the year, partly as a result of greater difficulties in obtaining funds on the markets, as anticipated by these intermediaries.

On the latest Spanish Ministry of Housing figures, year-on-year growth in appraised unsubsidised housing stood at 5.3% in 2007 Q3, 0.5 pp lower than in June and 4.5 pp lower than in the same period a year earlier. Thus, the gradual normalisation of prices on property markets continues.

In this setting, the deceleration in private-sector debt in the preceding months continued. For households, the year-on-year growth rate in credit posted a rise of nearly 16%, just over 0.5 pp less than in June. The breakdown of credit by purpose shows that the expansion of liabilities was more moderate in both house-purchase loans and in consumer and other loans, with growth rates of around 17% and 14%, respectively. The provisional data to September indicate that these trends will continue.

Corporate debt grew by around 24% in August in comparison with the same period a year earlier and was just under 0.5 pp lower than the figure for the end of Q2. The provisional infor-



SOURCES: Bloomberg, Credit Trade, Datastream, MSCI Blue Book, Ministerio de la Vivienda and Banco de España.

a. Five-day moving averages.

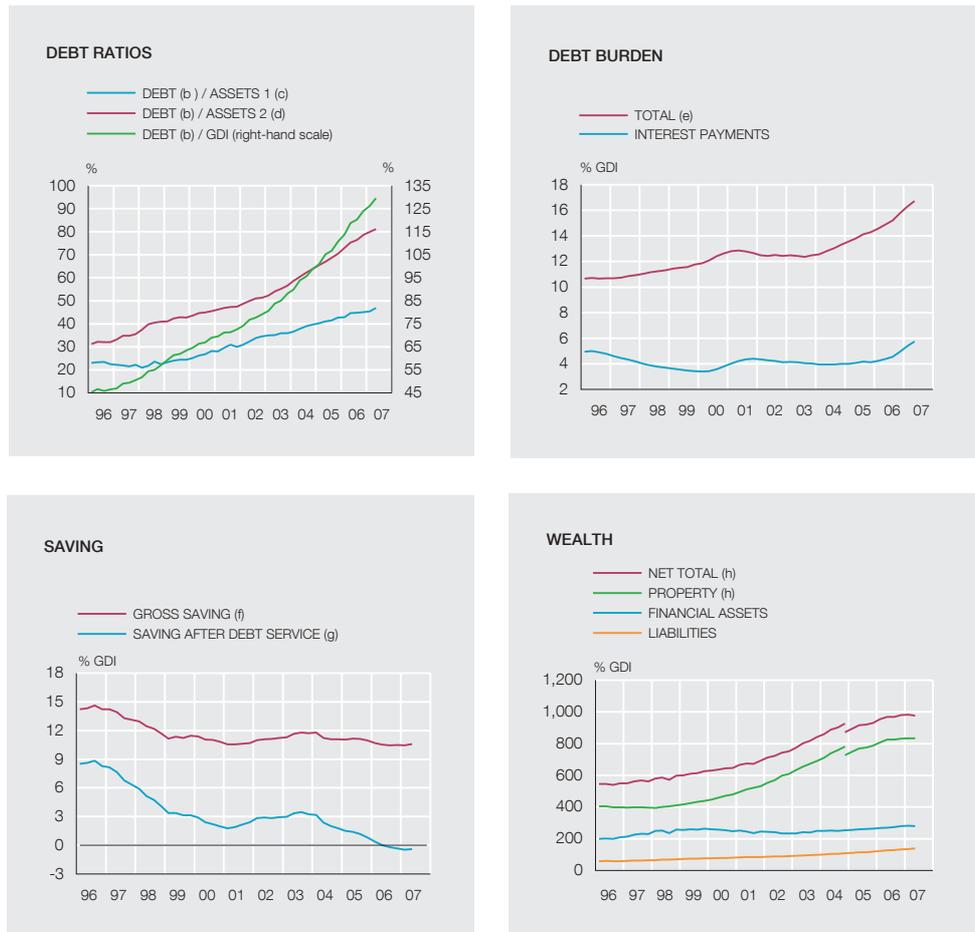
b. The cost of equity is based on the three-stage Gordon dividend discount model.

c. The cost of market-based long-term debt is calculated as the addition of the average 5-year CDS premium for the non-financial corporations to the 5-year euro swap rate.

d. New statistic from 2005.

mation for September indicates that the deceleration in corporate borrowing continued in that month. The latest data on the breakdown of credit for June show that funds earmarked for construction and real estate services slowed, although they continue to grow at a brisk pace, which was more or less offset by more buoyant funds borrowed by the other sectors and, in particular, by industry, whose funds increased by 20% in year-on-year terms in comparison with 15% in March.

Although household liabilities slowed, they continued to outpace growth in household income. Consequently, between March and June, the debt and debt burden ratios rose once again, this being due also in the latter case to the rise in interest rates (see Chart 25). On the provisional data available, these trends continued in Q3. However, the recovery in gross saving, in cumulative twelve-month terms, prevented another reduction in the sector's saving capacity, after stripping out debt repayment obligations. In line with this trend, the sector's net borrowing

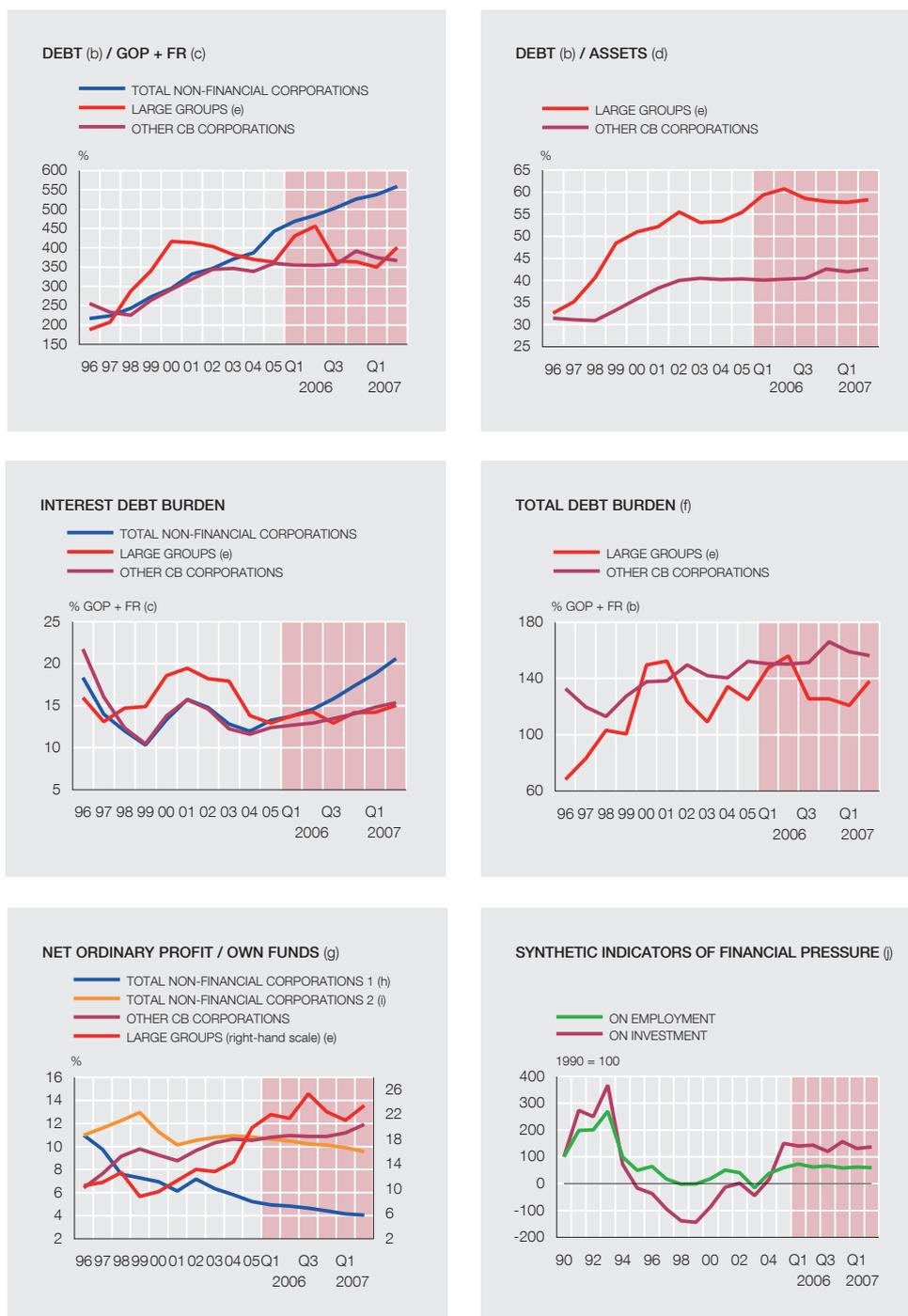


SOURCE: Banco de España.

- 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 off-balance-sheet securitised loans.
- 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 from 2005.

indicated by the Financial Accounts did not show significant changes. Households' net wealth progressed at a similar pace to their revenue and, consequently, in relation to gross disposable income (GDI), it remained around the comfortable levels seen in the first half of the year.

Corporate aggregate debt and debt burden ratios also remained on a rising course in Q2, a trend which, on the provisional data available, continued in the summer months. Higher financial costs curbed the sector's income growth, resulting in slightly lower returns on capital. On Financial Accounts data, the sector's net borrowing continued to increase in the same period to 10.5% of GDP in cumulative twelve-month terms. The sample of companies reporting to the Central Balance Sheet Data Office Quarterly Survey (CBQ), in which larger companies have a sizeable weight, reveals that debt and interest payments followed a similar path. The effect of this on the indicators of financial pressure on investment and employment was, however, offset by the improvement in earnings (which was particularly pronounced in the industrial sector) and, consequently, they remained at similar levels to March (see Chart 26).



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,  $NOP = GOS + \text{interest and dividends received} - \text{interest paid} - \text{fixed capital consumption}$ .

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.

% GDP	2002	2003	2004	2005	2006			2007	
					Q2	Q3	Q4	Q1	Q2
					National economy	-2.7	-2.9	-4.8	-6.5
Non-financial corporations and households and NPISHs	-3.3	-3.8	-5.1	-8.2	-9.7	-10.4	-10.6	-11.1	-12.1
<i>Non-financial corporations</i>	-4.0	-3.9	-4.5	-6.9	-7.5	-8.4	-9.0	-9.4	-10.5
<i>Households and NPISHs</i>	0.7	0.1	-0.6	-1.3	-2.2	-2.0	-1.6	-1.7	-1.6
Financial institutions	1.2	1.0	0.6	0.7	0.6	0.6	0.6	0.7	1.1
General government	-0.5	-0.2	-0.4	1.0	1.9	2.0	1.8	2.1	2.3
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.5	-8.2	-8.7	-11.1	-14.3	-15.6	-15.9	-13.8	-15.6

SOURCE: Banco de España.

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

The increase in the shortfall in corporations' funds was not entirely offset by the improvement in the financial saving of other sectors which, on the latest Financial Accounts data for Q2, drove the nation's net borrowing higher to the equivalent of 8.7% of GDP in cumulative twelve-month terms (see Table 5). The funds required from the rest of the world to cover the Spanish economy's expenditure in excess of its income continued to be channelled basically through the financial system.

In short, the financial position of households and corporations has not changed significantly in recent months. And this, in conjunction with the strength of credit institutions, is a major factor of the Spanish economy's resilience against the recent turbulence on international financial markets. In particular, the favourable situation of the Spanish financial system and the high quality of the securities issued are factors which contribute to cushioning the effect of this turbulence on the availability and cost of borrowing for households and corporations (see Box 7). However, in view of Spain's high requirements of foreign capital, this episode could, if prolonged, ultimately affect the terms of these agents' borrowing.

## 5.2 Households

In 2007 Q3 household financing conditions tightened. In line with money market developments, the interest rates on new credit transactions for house purchases increased by 23 bp between June and August, at the same time as those on consumer and other purpose loans rose 45 bp (see Chart 24). According to the latest BLS conducted in September, financial institutions were more restrictive than in the preceding three months regarding qualifying standards for both types of loans and augured further tightening in the closing months of the year, due partly to the difficulties of raising funds on wholesale markets.

Tougher financing conditions contributed to the ongoing gradual slowdown in household debt, with the result that the rate of increase of this variable fell by approximately 0.5 pp to 16% in August. By purpose, the diminished dynamism of liabilities was visible both in house purchase loans and in funds earmarked for consumption and other purposes, whose growth rates dropped to below 17% and 14%, respectively. On BLS projections, financial institutions anticipate that in 2007 Q4 weaker growth in loans to this sector will continue as a result of lower expected demand and less generous credit standards.

During the summer months, the problems caused by the growing number of sub-prime mortgage defaults in the United States and uncertainty over the holders of these assets, and the securities linked to them, resulted in a widespread re-assessment of global credit spreads and in fewer investors and intermediaries being prepared to lend funds, even to apparently solvent institutions (such as, for example, Northern Rock in the United Kingdom). Consequently, the financial position of a large number of international banks has been affected in three ways: firstly, as a result of losses associated with their direct and indirect exposure to US sub-prime mortgages; secondly, by the increased use of credit line commitments to various vehicles (conduits, SIVs); and, thirdly, by the difficulties of obtaining fresh funds on wholesale markets, including the interbank market. In this setting, an important debate has arisen about the possible impact that this deterioration in the capital and liquidity of these international financial intermediaries might have on private-sector financing conditions and its macroeconomic implications. The purpose of this box is precisely to analyse this aspect applied to Spanish credit institutions.

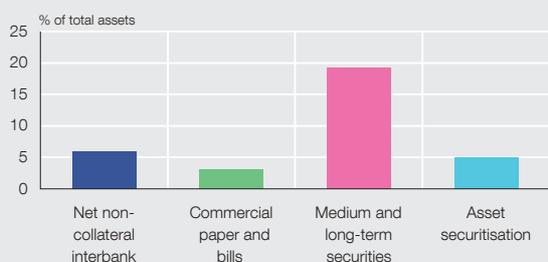
In this respect, the initial point to be made is that the first two ways in which this episode can affect Spain are essentially irrelevant, since Spanish credit institutions' direct and indirect exposure to

the US sub-prime market is absolutely marginal and there are no financing commitments to structured vehicles which invested in these assets. Consequently, the analysis will focus on the third channel (the difficulties of obtaining new financing on wholesale markets).

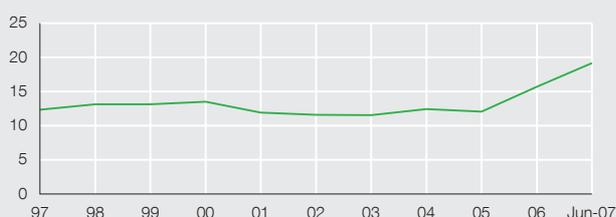
With credit in recent years consistently outgrowing traditional funds (customer deposits), institutions were forced to resort to a greater extent to the markets. They regularly borrow funds through this channel, both to refinance liabilities which are maturing and to obtain new funds to increase their assets. However, as shown in panel 1, the bulk of wholesale financing was obtained through medium and long-term securities and securitisation, this latter channel also entailing, first and foremost, the issue of securities at these terms (95% of the outstanding amount). Accordingly, in June 2007 the outstanding amount of the two means mentioned accounted for approximately 25% of assets, in comparison with the figure of under 10% represented by the sum of the non-collateralised net debit position in the interbank market plus short-term securities (6% in the interbank market and 3% in commercial paper and bills). Also, 77% of the debt raised on the interbank market related to foreign banks which, in addition to representing only 7% of total credit to households and firms, had the financial backing of their parents. Therefore, the short-term refinancing requirements of domestic banks are relatively small, which explains why they have hardly been affected by recent money market tensions.

1. These vehicles invested in assets linked to US subprime mortgages with financing obtained through the issue of short-term securities.

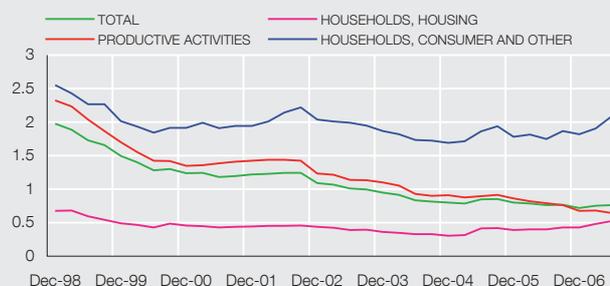
1 FINANCING ON MARKETS. JUNE 2007 (a)



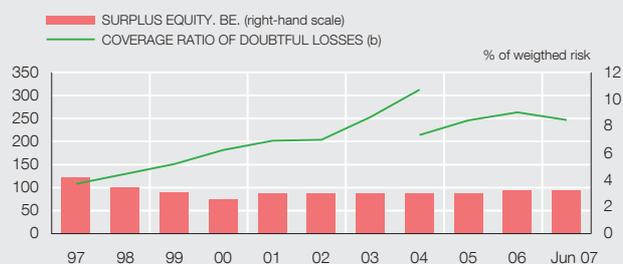
3 RETURN ON EQUITY (a)



2 DOUBTFUL ASSETS. CREDIT TO ORS (a) (b)



4 SOLVENCY AND PROVISIONS (a)



SOURCE: Banco de España.

a. Individual data except for solvency which is calculated at consolidated level.

b. In June 2004 the volume of doubtful loans increased and the coverage ratio changed due to the implementation of Accounting Circular 4/2004.

In the medium and long term, Spanish institutions' ability to continue to increase credit more than deposits will be determined by the conditions in which they can finance themselves on the fixed-income markets. The availability and cost of these funds will essentially hinge on the risk for investors of the securities issued by these institutions. Mention should be made in this connection of the soundness of the Spanish financial system, characterised by high-quality assets, high rates of return and solvency, and ample provisioning for doubtful loans with the provisions built up during the boom years (see panels 2 to 4). The quality of assets is backed, moreover, by the fact there is no "sub-prime" segment in Spain comparable to that in the United States. The percentage of doubtful mortgage loans, though on the increase, is notably small (see panel 2). Part of the reason for this is certainly that Spanish institutions did not use securitisation as a means of removing credit risks from their balance sheets, since the vast majority are still on-balance-sheet; rather, they used it as an al-

ternative source of financing, which has avoided a conflict of interest between the institution which originates the credit and that which ultimately bears the risks.

This favourable financial position should, once the worst of the crisis is over, allow Spanish institutions to continue obtaining funds on international markets, perhaps at a higher cost than in the past, but within levels that can be assumed given current returns. It is worth bearing in mind that the gap between growth in credits and that in deposits had already been narrowing since before the summer as a result of the interest rate rise in the Eurosystem and the subsequent decline in the demand for loans. Consequently, the need to resort to the markets to obtain funds is tending to ease off compared with the previous years. Potential risks lie, in any event, in the possibility that current tensions will not be resolved within a reasonable period of time.

According to the latest Financial Accounts data for 2007 Q2, purchases of financial assets by households slowed slightly and in cumulative annual terms accounted for 10.3% of GDP, 1 pp less than in March (see Table 6). As for the breakdown by instrument, the preference for lower-risk instruments (cash and deposits) continued. In particular, there was a continuing and significant increase in term deposits, which are included under the heading of other deposits and fixed-income securities (the flows hereunder amounted to 7.2% of GDP). By contrast, net mutual fund subscriptions were once again negative of the order of 0.6% of GDP. Lastly, households continued to sell shares in net terms (0.2% of GDP), while the weight of saving in the form of insurance technical reserves held steady (1.5% of GDP).

The still-high dynamism of borrowing spurred on continued growth in the household debt ratio, albeit at a lesser pace. It stood at approximately 130% of GDI in June (see Chart 25). This development, together with the rising course of interest rates in recent months, pushed the associated debt burden higher, with the result that as at the same date it stood at approximately 17% of GDI.

However, the favourable trend in gross saving, in cumulative twelve-month terms, stemmed the ongoing decline in households' ability to save, once borrowing expenses had been stripped out, although this variable remained negative. In the same vein, on Financial Accounts data, net household borrowing as a percentage of GDP in Q2 remained at around the same levels as three months earlier in cumulative annual terms. Finally, the latest information on household net wealth for June shows few changes relative to their GDI and, accordingly, this ratio remains at comfortable levels.

### **5.3 Non-financial corporations**

Financing conditions were also tighter for corporations in Q3 (see Chart 24). Interest rates on bank loans of up to €1 million rose by 16 bp between June and August, whereas those on higher amounts climbed 19 bp. Similarly, according to the BLS, institutions were more demanding in all conditions applied to new transactions in comparison with the preceding three months, while they expected, as with households, that credit standards would become tighter until the end of the year, partly as a result of the difficulties of obtaining funds on wholesale markets. Higher risk premiums meant that, although government debt yields declined, the

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

TABLE 6

% GDP	2003	2004	2005	2006	2007	
				Q4	Q1	Q2
<b>HOUSEHOLDS AND NPISHs</b>						
Financial transactions (assets)	8.6	9.5	10.1	11.7	11.3	10.3
Cash and cash equivalents	4.1	3.9	-13.0	3.2	2.2	1.8
Other deposits and fixed-income securities (a)	-0.3	1.2	18.8	5.9	6.8	7.2
Shares and other equity (b)	0.5	0.3	0.2	-0.9	-0.1	-0.2
Mutual funds	2.3	1.5	1.9	0.2	-0.5	-0.6
Insurance technical reserves	1.8	1.8	1.9	1.6	1.6	1.5
<i>Of which:</i>						
<i>Life assurance</i>	0.7	0.7	0.7	0.6	0.6	0.6
<i>Retirement</i>	0.9	0.8	1.0	0.8	0.8	0.8
<i>Other</i>	0.1	0.6	0.4	1.7	1.3	0.7
Financial transactions (liabilities)	8.5	10.1	11.5	13.3	13.0	11.9
Credit from resident financial institutions (c)	9.2	10.8	12.3	13.0	12.5	11.7
<i>House purchase credit (c)</i>	7.0	8.7	10.2	9.9	9.3	8.9
<i>Consumer and other credit (c)</i>	2.2	2.1	2.2	3.1	3.1	2.7
<i>Other</i>	-0.7	-0.8	-0.8	0.3	0.6	0.3
<b>NON-FINANCIAL CORPORATIONS</b>						
Financial transactions (assets)	12.1	12.3	17.2	22.5	19.4	20.1
Cash and cash equivalents	0.9	1.0	2.0	2.2	1.7	1.2
Other deposits and fixed-income securities (a)	1.2	0.3	1.5	2.4	2.7	4.3
Shares and other equity	7.4	6.4	7.2	10.3	7.8	8.9
<i>Of which:</i>						
<i>Vis-à-vis the rest of the world</i>	4.5	3.8	3.9	6.8	4.2	5.6
<i>Other</i>	2.6	4.7	6.5	7.7	7.3	5.7
Financial transactions (liabilities)	16.0	16.8	24.0	31.5	28.8	30.6
Credit from resident financial institutions (c)	6.1	8.3	12.9	17.7	17.7	17.9
Foreign loans	2.6	0.7	2.1	3.3	1.2	2.7
Fixed-income securities (d)	-0.2	0.0	0.3	1.8	1.2	0.8
Shares and other equity	4.9	4.2	3.4	2.1	2.2	3.3
<i>Other</i>	2.5	3.6	5.4	6.7	6.5	5.9
<b>MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):</b>						
Financing (e)	15.8	16.3	21.2	24.2	21.1	20.6
Households and NPISHs	19.1	20.2	20.9	19.6	18.3	16.4
Non-financial corporations	13.4	13.2	21.4	27.9	23.3	23.9

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.

cost of short-term and long-term fixed-income issues rose by 23 bp and 10 bp, respectively. Conversely, the indicator which approximates the cost of own funds declined slightly, since lower stock market valuations were offset by a downward revision of long-term earnings growth expected by analysts.

In this setting of tighter financing conditions, corporate debt slowed slightly, although it continued to grow at a high rate of approximately 24% in August, in year-on-year terms, just under 0.5 pp lower than the June figure. By instrument, this development was due above all to the easing back in credit from resident institutions, which is the largest item.

As for the breakdown of credit by productive activity, the latest data referring to June show a further deceleration in funds earmarked for real estate services and construction which, however, remain the most expansionary sectors, with respective year-on-year growth rates of 42% and 24%. This weakening was practically offset by a higher rate of expansion in funds raised by other services (22%, 2 pp up on Q1) and, especially, industry, whose loans grew 20% in year-on-year terms as against 15% in March, which is in line with the greater economic dynamism of this branch.

The volume of corporate asset-side transactions increased in June 2007 to more than 20% of GDP in cumulative twelve-month terms (up 0.7 pp on the previous quarter). By instrument, the bulk of purchases were of shares and other equity, although the relative significance of deposits and fixed-income securities continued to increase (see Table 6).

On Financial Accounts data, corporate liabilities continued to grow in Q2 more quickly than financial assets and, consequently, this sector's net borrowing rose to 10.5% of GDP in cumulative twelve-month terms (see Table 5). This increase, together with the rise in financial acquisitions in the rest of the world, triggered greater growth in the financing gap, an indicator which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment.

The high pace of growth in corporate borrowing in Q2 led to a further increase in the sector's debt-to-earnings ratio (see Chart 26). Together with the higher cost of funds, this prompted further growth in interest payments<sup>2</sup>. The rise in financial costs curbed the increase in the sector's income, resulting in a slight fall in the return on capital.

The latest information from the sample of companies reporting to the CBQ, among which large corporations predominate, also shows an increase in the debt and debt burden ratios in Q2. However, the impact of these developments on the synthetic indicators of financial pressure on employment and investment was offset by the improved return on equity of these corporations, which remained around its March levels. By branch of activity, industrial sector earnings were particularly notable, as reflected in the marked recovery in profitability which prevented the attendant debt ratio from increasing, despite the dynamism of borrowed funds.

Lastly, in Q3 analysts revised upwards their projections of earnings growth at listed non-financial corporations over the next twelve months, revising long-term projections downwards, although in this latter case the pace of growth remains above 8% (see Chart 27).

#### **5.4 General government**

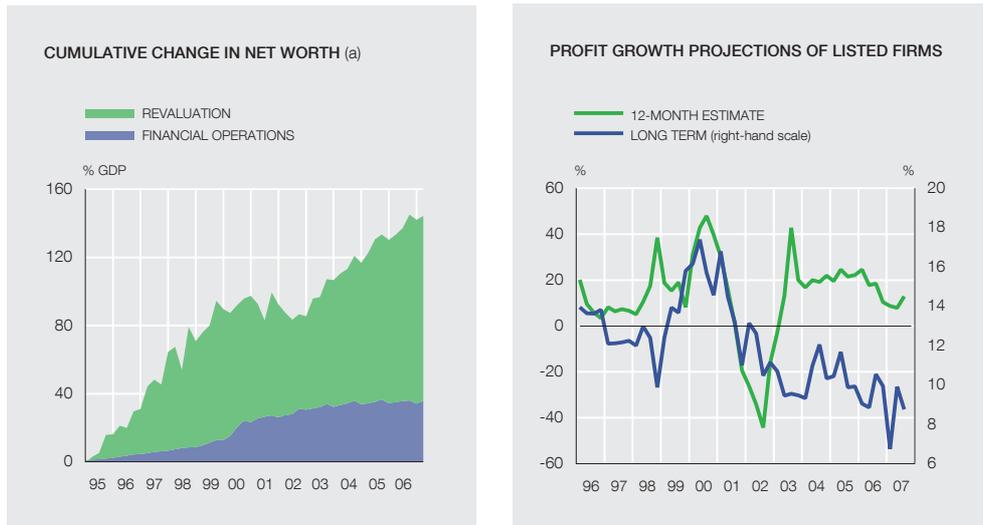
General government net lending in June stood in cumulative twelve-month terms at 2.3% of GDP, 0.2 pp higher than in Q1 2007 (see Chart 28). By instrument, there was an increase in the outstanding balance of deposits net of lending, a net redemption of short-term securities and a net issue of medium and long-term securities. The fall in the debt ratio meant that, despite the rise in the cost of funds, interest payments relative to GDP remained at 1.6%.

#### **5.5 The rest of the world**

In 2007 Q2 the net debit balance of the nation's financial transactions increased again to stand, in cumulative four-quarter terms, at 8.7% of GDP, compared with 8.3% in March. By sector, firms increased their net borrowing by approximately 1 pp of GDP, household net borrowing did not show any significant changes and both general government and financial institutions increased their surplus, although they could not offset in full the increased shortfall of firms.

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2. The estimate of company interest payments was revised. The new series shows a lower level, yet with a similar profile to the previous level.

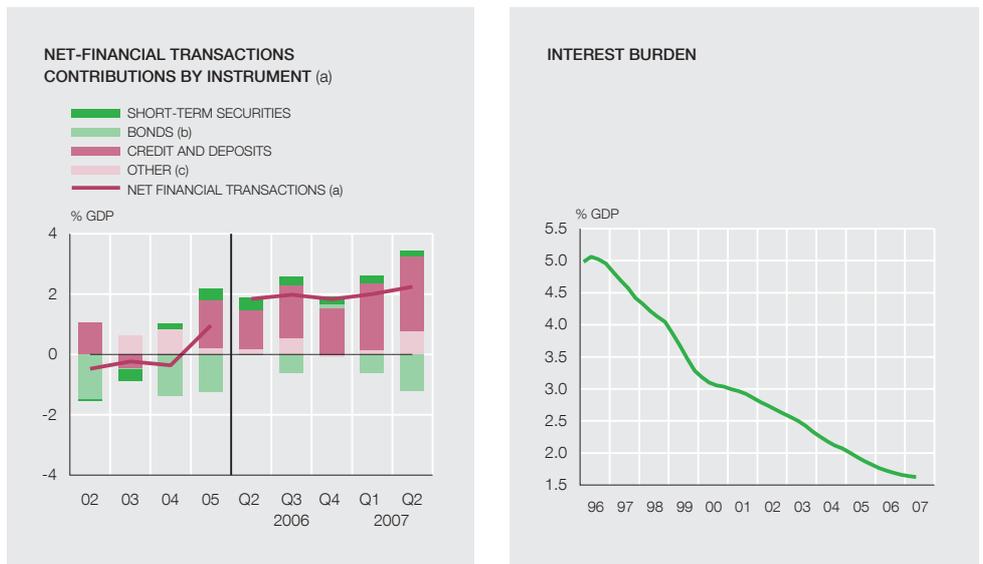


SOURCES: I/B/E/S and Banco de España.

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

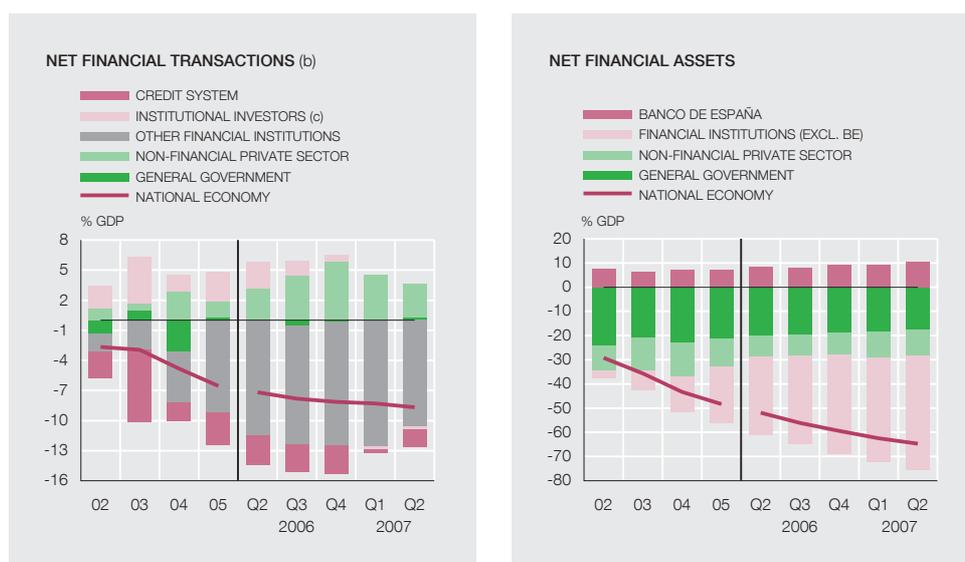
GENERAL GOVERNMENT

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.



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.

Financial institutions, particularly those other than credit institutions (FVCs and the subsidiaries of financial and non-financial firms specialising in securities issuance), continued to channel most funds received from abroad, although in relation to previous quarters, the relative weight of funds obtained by the latter declined in favour of the credit system. Overall, the new net liabilities raised by this sector amounted to 15.2% of GDP, up 0.2 pp on March 2007 (see Chart 29).

Capital inflows grew in Q2 to 25.4% of GDP in cumulative twelve-month terms (see Table 7). The bulk of these funds continued to be invested in securities other than shares, meaning that these instruments and, more specifically, those issued by financial institutions, remained the principal vehicle channelling the foreign saving needed to cover the Spanish economy's borrowing requirements, although the amount fell with respect to March by 2.1 pp of GDP. In contrast, non-residents' investments in loans and acquisitions of shares and other equity increased, a fact partly linked to the rise in foreign direct investment in Spain. Furthermore, the financing raised through the interbank market increased, although these flows continued to show a net credit balance.

The acquisition of foreign assets also grew and accounted for 16.7% of GDP in cumulative twelve-month terms, 3 pp more than in March. By instrument, net purchases of fixed-income securities, shares and other equity increased. This was linked to the recovery in direct investment in the rest of the world, which amounted to 5.8% of GDP, 1 pp higher than the previous quarter.

As a result of the developments in financial inflows and outflows, and of the changes in asset prices and in the exchange rate, the value of net liabilities accumulated vis-à-vis the rest of the world continued to increase (see Chart 29). By sector, this was basically a result of the increase

**FINANCIAL TRANSACTIONS OF THE NATION**  
**Four-quarter data**

TABLE 7

% GDP	2003	2004	2005	2006			2007					
				Q4			Q1			Q2		
				Q4	Q1	Q2	Q4	Q1	Q2	Q4	Q1	Q2
NET FINANCIAL TRANSACTIONS	-2.9	-4.8	-6.5	-8.1	-8.3	-8.7						
FINANCIAL TRANSACTIONS (ASSETS)	13.1	13.3	18.4	16.4	13.7	16.7						
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0						
Cash and deposits	0.7	3.2	2.2	5.5	7.3	6.3						
<i>Of which:</i>												
<i>Interbank (a)</i>	0.5	0.7	3.1	3.4	6.1	4.7						
Securities other than shares	6.5	1.8	8.8	-1.2	-1.0	2.2						
<i>Of which:</i>												
<i>Credit institutions</i>	3.5	1.0	6.6	-2.0	-1.5	1.4						
<i>Institutional investors (b)</i>	3.5	0.3	2.2	0.7	0.5	0.3						
Shares and other equity	4.7	6.8	5.1	9.2	5.9	7.5						
<i>Of which:</i>												
<i>Non-financial corporations</i>	4.5	3.8	3.9	6.8	4.2	5.6						
<i>Institutional investors (b)</i>	1.1	0.8	0.9	1.2	0.2	0.5						
Loans	0.3	0.8	1.1	2.1	0.9	0.3						
FINANCIAL TRANSACTIONS (LIABILITIES)	16.0	18.1	24.9	24.5	22.0	25.4						
Deposits	6.9	1.7	5.6	0.3	0.4	3.6						
<i>Of which:</i>												
<i>Interbank (a)</i>	5.3	5.0	7.2	0.6	0.4	4.1						
Securities other than shares	5.3	12.4	15.8	21.3	20.4	18.3						
<i>Of which:</i>												
<i>General government</i>	-1.0	2.7	0.2	1.3	1.0	0.6						
<i>Credit institutions</i>	3.5	4.6	6.3	7.7	6.8	7.0						
<i>Other non-monetary financial institutions</i>	2.8	5.1	9.3	12.3	12.6	10.6						
Shares and other equity	1.1	2.7	0.9	-0.7	-0.3	0.4						
<i>Of which:</i>												
<i>Non-financial corporations</i>	1.3	1.7	1.0	-1.1	-0.2	0.6						
Loans	2.8	1.3	2.3	3.5	1.4	3.0						
Other, net (c)	-0.9	-0.6	-0.9	-0.6	-0.3	-0.2						
MEMORANDUM ITEMS												
Spanish direct investment abroad	3.2	5.8	3.7	7.3	4.8	5.8						
Foreign direct investment in Spain	2.9	2.4	2.2	1.6	1.6	2.1						

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.

in the debit balance of financial institutions (excluding the Banco de España), which exceeds 47% of GDP; these agents have played a key role in the channelling of saving from the rest of the world to the Spanish economy.

26.10.2007.