QUARTERLY REPORT ON THE SPANISH ECONOMY

1 Overview

During 2009 Q1, the pace of the contraction in the Spanish economy intensified, in a highly unfavourable international environment and a financial setting marked by substantial tension. GDP fell by 3% in year-on-year terms and its quarter-on-quarter rate stood at –1.9%. The fall-off in economic activity was due to the collapse of national demand (by 5% year-on-year), since the contribution of net external demand to GDP continued to be positive at 2.3 pp, as a result of a slump in imports which exceeded the likewise marked weakening in exports.

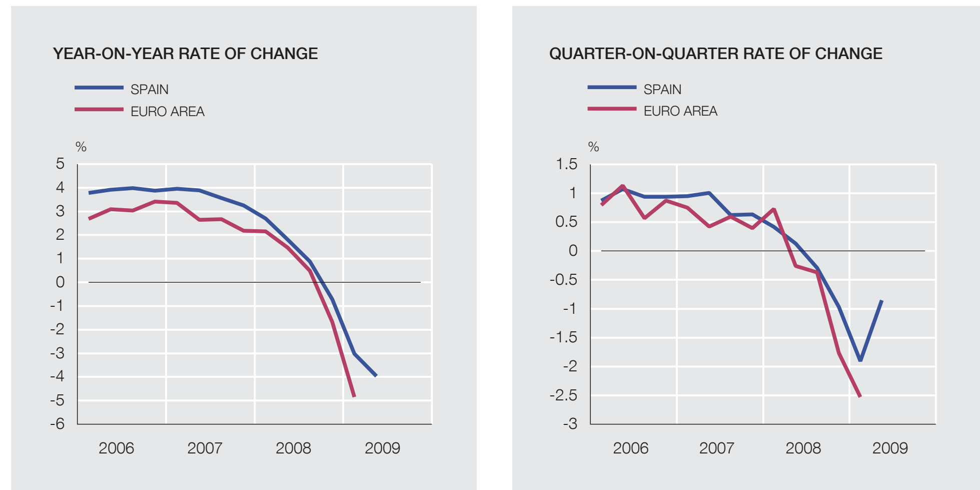
The indicators available for Q2 augur a prolongation of the contractionary trends, albeit at a more contained pace, in an environment marked by some normalisation of financial markets and less severe external conditions. The estimates made drawing on the as yet incomplete conjunctural information available point to a quarter-on-quarter decline in GDP of 0.9% (less pronounced than in the two preceding quarters), although the year-on-year rate, subject by definition to greater inertia, is expected to have continued trending down, posting a decline of 4%. On the expenditure side, there was a further reduction in national demand, with a year-on-year rate of change of –6%, while net external demand showed a slight increase, contributing 2.4 pp to GDP. On the supply side, the bulk of the adjustment fell once again on the manufacturing industry and construction branches, although in this latter case the rate of decline of activity moderated owing to the effects of the start-up of the civil engineering projects included in the State Fund for Local Investment. In the labour market, the rate of decline of employment slowed somewhat, in line with the information provided by the EPA for Q2, which shows a decline of 7.2% year-on-year and a fresh increase – albeit at a lesser pace than in previous quarters – in the unemployment rate to 17.9%, and the rate of increase of compensation per employee once again outpaced inflation. Finally, the rate of change of the CPI fell substantially in the period from April to June, posting a figure of –1% in this latter month, meaning the differential with the euro area was once again negative (–0.9 pp), for the seventh month running.

On the international economic front, the tension on financial markets furthered the correction initiated in March, although global funding conditions remained restrictive, and the sharp declines in trade flows seen in previous months slackened. In these circumstances, GDP in the developed economies is estimated to have fallen once more in Q2, albeit on a somewhat lesser scale than in Q1, and the slowdown in the emerging economies is expected to have moderated in the face of the recovery in the Chinese economy, in response to the large-scale fiscal stimulus and liquidity expansion plans pursued. Global inflation continued to fall, with negative figures being posted in the United States, Japan, the euro area and some emerging economies. Oil and, to a lesser extent, other commodities prices rose notably, though they have eased in recent weeks.

The diminished contraction in activity and the signs of stabilisation on international financial markets have brought the trajectory of continuous downward revisions to growth projections for the world economy to a halt, although the diagnosis of the – foreseeably lengthy – duration of the recession and the – prospectively very gradual – exit therefrom has not substantially altered.

In the period under study, governments and central banks extended the macroeconomic stimulus and financial support and restructuring measures set in train in the previous months. In the United States, the government unveiled a plan for the regulatory reform of the financial

GROSS DOMESTIC PRODUCT (a) CHART 1



SOURCES: ECB, INE and Banco de España.

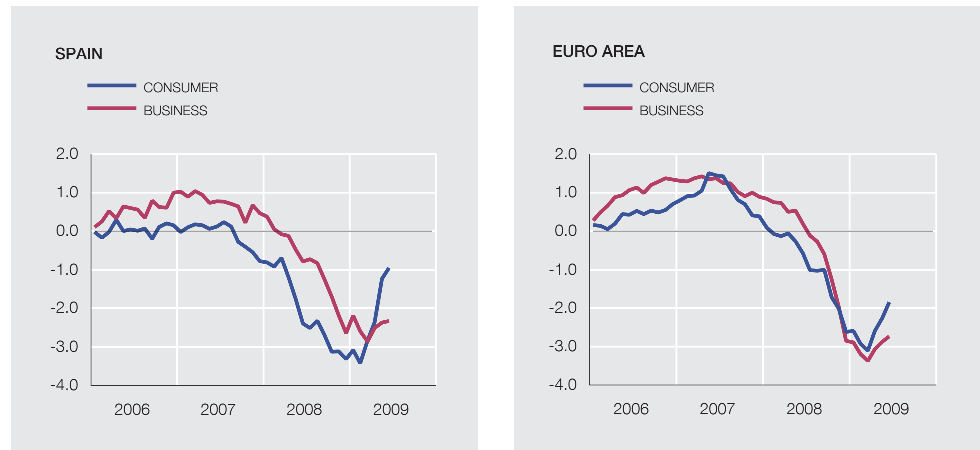
a. Seasonally adjusted series.

system; among other aspects, it will increase the supervisory powers of the Federal Reserve and will provide for tighter control of the risk in complex financial assets. In Europe, the pursuit of bank guarantee and recapitalisation schemes continued, and certain proposals for the restructuring of banks' assets began to take specific shape. On 27 June the Spanish government approved the creation of the Fund for Orderly Bank Restructuring (FROB by its Spanish acronym) with the aim of extending and reinforcing the instruments with which to develop a bank restructuring strategy that will allow for an increase in the resilience and solvency of the Spanish financial system in the face of the potential effects of the recession.

Over the course of the quarter, public finances have deteriorated considerably and globally as a result of the operation of the automatic stabilisers, the discretionary measures to stimulate aggregate demand and the actions to support the financial system. The scale of the change has shifted the economic policy debate towards the need to ensure the compatibility of the stimulus measures with credible fiscal consolidation strategies that will guarantee the sustainability of public finances in the medium term.

Meanwhile, central banks continued to provide an unlimited supply of liquidity and, in some cases, they made further cuts to intervention rates, from what were already very low starting levels, following the forceful cuts made in the preceding months. The US Federal Reserve held its official interest rate in a range of 0% to 0.25% and continued to conduct extraordinary monetary policy operations (essentially through asset purchases), although it began to reduce the amount and frequency of some of them. The Bank of England did not alter the level of its official rate, which has held at 0.5% since January, and continued to pursue its government bond purchase programme. Finally, the ECB Council cut its main refinancing operations (MRO) rate by 25 bp in May, to 1%, while its deposit and marginal lending facility rates were set at 0.25% and 1.75%, respectively. Accordingly, the current MRO rate stands 325 bp below its October 2008 level. In parallel, the ECB reinforced its policy of abundant liquidity provision, establishing a longer-term financing operation maturing at 12 months (the first of these was conducted on 24 June, with somewhat more than €440 billion being allotted). In addition, it began in July to apply extraordinary monetary policy measures that it had earlier announced in May. These involve a programme to purchase guaranteed bonds and covered bonds issued in the euro area.

CONFIDENCE INDICATORS (a) CHART 2



SOURCE: European Commission.

a. Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

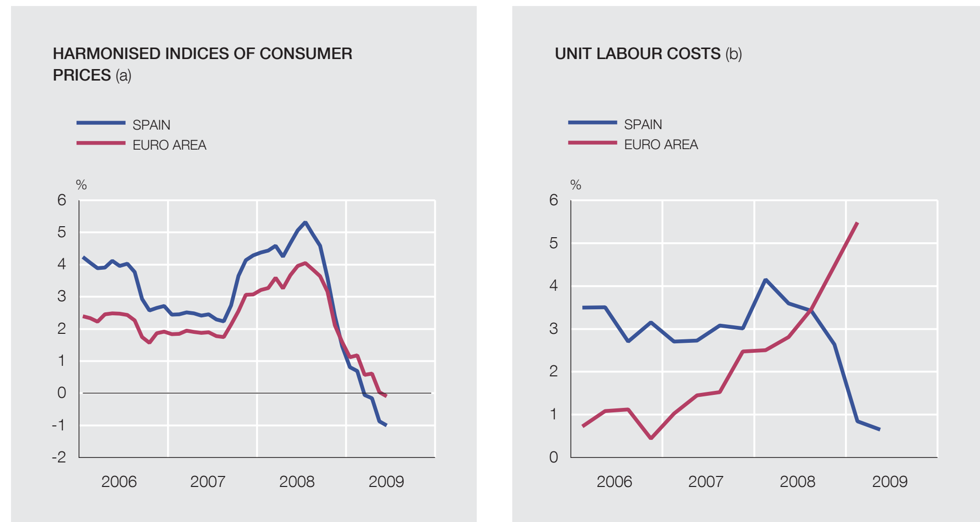
This raft of measures has meant that, during Q2, the improvement in the financial stress indicators dating back to March has continued, in a climate of lessening uncertainty which, in prior months, had begun to stimulate the demand for higher-risk assets. Interbank market interest rates continued to fall, substantially narrowing the spread between these and rates on guaranteed bank transactions. Risk premia on credit derivatives markets also declined notably and, on equity markets, stock market prices continued on the upward trajectory on which they embarked in March, evidencing notably diminished volatility. Finally, on the government debt markets, there was a generalised rise in yields on sovereign bonds, chiefly as a consequence of the return of financial flows towards higher-risk assets and of the greater caution elicited by the increase in public debt.

In the euro area, the conjunctural indicators available also point to some moderation in the rate of decline of activity as a result of a smaller fall in private consumption, a somewhat less negative contribution of external demand and lower destocking. The inflation rate continued to fall in Q2, posting a negative figure in June (–0.1%) for the first time in the history of EMU. The reduction in the inflation rate was essentially in response to base effects in energy prices and, to a lesser extent, to the slowdown in services prices, linked partly to the slackness of demand. The decline in core inflation was much more moderate, standing at 1.3% in June.

Overall, then, the external environment of the Spanish economy has become less contractionary and financing conditions, though they remain restrictive, are showing signs of some improvement. On one hand, the decline in interbank yields continued feeding through to private-sector bank financing costs, unevenly across the different segments; on the other, financial institutions further tightened their lending standards, albeit to a lesser extent than in previous quarters. Elsewhere, the positive trajectory of stock market prices helped to offset the declines recorded in the opening months of the year (the IBEX posted gains of close to 13% in this period) and to recuperate to some extent this component of financial wealth. Conversely, the 1.9% fall in property prices in Q2 (–8.3% in year-on-year terms) led to further declines in the value of private-sector wealth.

Against this background, household spending fell off once more in Q2, although it is estimated that the rate of decline of final consumption will slow, potentially to a year-on-year rate of

PRICES AND COSTS CHART 3



SOURCES: Eurostat, ECB and INE.

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

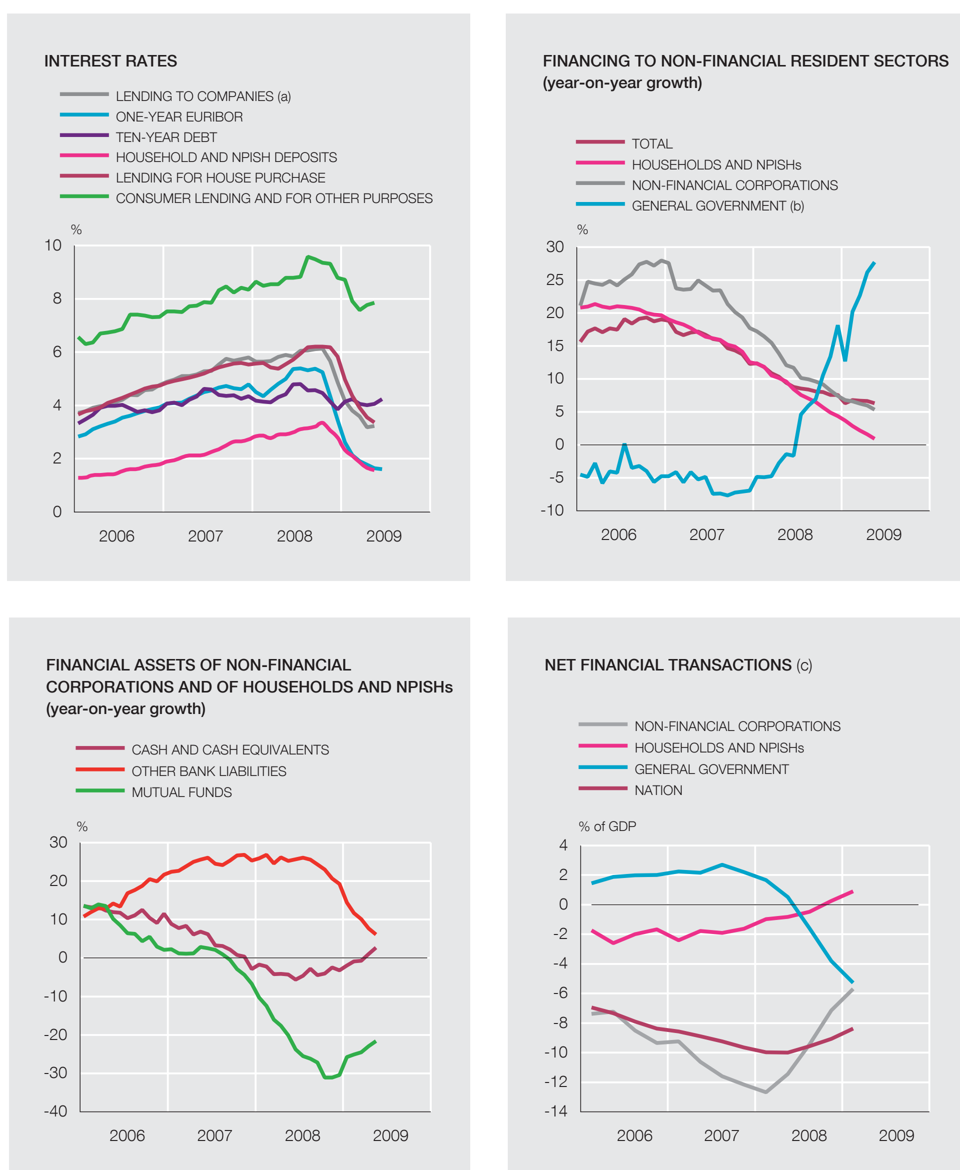
–4.6% (–4% in the previous three months). Consumption decisions continued to be highly influenced by the generalised weakening of the attendant main determinants (disposable income and wealth), although agents' confidence improved substantially during the quarter after having been very depressed since the start of the financial crisis. Developments in disposable income were determined by the deterioration in earnings, as a result of the unfavourable labour market situation. The scale of this effect could not be countered by the impact of general government (through higher social benefits and lower taxes), the decline in interest payments (which, according to the quarterly non-financial accounts, began to be observable already in the previous quarter) and the substantial cut in inflation. The reduction in wealth also continued, above all as a result of developments in its real estate component, as earlier indicated. Consequently, a further increase in the household saving rate is expected, following its rise in Q1 to 14.1% of disposable income in four-quarter cumulated flows, a figure 4 pp up on the same period a year earlier.

On the contrary, the weakness of residential investment intensified, influenced by expectations of falling prices, uncertainty over income growth prospects and continuing restrictive financing conditions globally. That said, some signs of improved access to financing are becoming discernible. Overall, a year-on-year decline in residential investment of around 25% is expected for Q2. The downward revision of household spending plans, along with continuing restrictive financing conditions, drove the slowdown in debt, the growth of which in year-on-year terms stood below 1%, affecting both loans for house purchases and consumer credit and other lending. This, in turn, provided for a slight reduction in the debt/GDI ratio.

Turning to business investment, spending on capital goods contracted once more. That is consistent with the sluggishness of demand, in both its domestic and external components, with continuing restrictive financing conditions (despite the cut in interest rates) and with uncertain prospects concerning economic recovery and very negative earnings expectations. However, it is estimated that other private productive investment fell somewhat less markedly owing to the impulse that is being given to certain infrastructure development plans, as reflected in the National Accounts figures for Q1. The fall in business investment and the restric-

FINANCIAL INDICATORS OF THE SPANISH ECONOMY

CHART 4



SOURCE: Banco de España.

a. Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
b. Consolidated financing: net of securities and loans that are general government assets.
c. Four-quarter cumulated data.

tiveness of the supply of bank funds meant that borrowing by non-financial corporations continued to slow, to a rate of 5%, compared with the same period in 2008. The sector's borrowing needs diminished once again in Q1 to 6.4% of GDP, in terms of four-quarter cumulated flows, 4.6 pp down on a year earlier.

Set against the decline in the various components of private domestic demand, the general government sector contributed to sustaining expenditure by means of sizeable net transfers to households and through public investment, with the start-up of the projects included in the State Fund for Local Investment. The government announced new measures to support economic activity, which will come into force in 2009 and 2010. These include most notably direct

assistance with car purchases (Plan 2000E), given their greater potential impact on the industry in the short term. In this connection, and despite the fact a fresh cut in State spending was also approved, general government spending has increased notably in the year to date, while the declining course of tax revenue has steepened, with very negative rates of change. The interplay of all these factors led to a further deterioration in public finances, prompting the government to raise the projected deficit in 2009 and to announce an adjustment path that might involve posting a budget deficit of 3% in 2012, in line with the guidelines laid down for Spain by the European Council regarding compliance with the Stability and Growth Pact (see Box 1).

As regards the external sector, net external demand once again alleviated the effect of the fall in domestic spending on economic activity, with a positive contribution to GDP growth of 2.4 pp, slightly up on that in Q1. With the phase of the maximum contraction in international trade flows behind, the positive contribution of net exports was mainly due to the reduction in imports, which were more than 20% down, the decline being induced by the collapse in final demand and by industrial production. In any event, exports fell again, albeit less than in Q1, despite the more favourable behaviour of the price-competitiveness indices vis-à-vis the developed countries. This situation spread to some extent to trade in services, with the decline in services revenue easing, particularly in the case of tourist services, although expenditure continued on a declining course.

In step with these developments, the nation's net borrowing once again fell significantly in Q1 to 8.4% of GDP, in terms of four-quarter cumulated flows, 1.6 pp down on a year earlier according to data from the non-financial accounts of the institutional sectors. The Balance of Payments figures to April confirm this trend, as they show a decline in the deficit of almost 40% year-on-year, the result of the intensifying adjustment of the trade deficit, which fell over this period by 51% and, to a lesser extent, of the balances on current transfers and on services, while the incomes deficit widened.

On the supply side, following the substantial deterioration seen in Q1, value added in the market economy contracted in Q2 but, as in the case of GDP, at a somewhat less pronounced rate. The decline in activity was across all the productive branches, except agriculture and fisheries, which showed a recovery. In the construction sector, the slowdown in the rate of deterioration of value added was due to the effects of the start-up of the projects included in the State Fund for Local Investment, which are boosting the civil engineering component; conversely, there is no evidence of the contractionary trends in the residential sector easing. Industrial activity continued to fall, and services, which are generally posting more contained declines, showed no signs of stabilising, beyond what might be related to purely seasonal activities. Against this backdrop the employment adjustment continued in Q2, albeit with somewhat less intensity than in the two previous quarters, in particular in the construction sector, for the reasons stated earlier. Overall, the increases in apparent labour productivity are expected to have held at a relatively high level (3.2%), similar to that in the opening months of the year, chiefly reflecting the decline in employment.

The rate of increase of labour costs fell moderately, though less than might be expected in the face of the severe weakening in the labour market. Moreover, there are some signs that wage restraint might be coming to a halt. For one thing, the wage rates arising from collective bargaining show increases that are practically unchanged since the start of the year (with rates of 2.7% to June), stemming from the fact that, under bargaining, newly signed agreements are registering higher increases than those in revised agreements (2.9% and 2.7%, respectively). For another, the existence of positive wage drift this year, linked to the effects induced by job

Maintaining sound public finances is a necessary condition for sustainable economic growth and for the proper functioning of the Economic and Monetary Union (EMU). Under these tenets, the Maastricht Treaty laid down various provisions with the aim of ensuring the disciplined fiscal behaviour of the Member States. In particular, members must avoid "excessive public deficits", which are assessed in relation to the reference values of 3% and 60% of GDP for the deficit and for public debt, respectively. Further, the Treaty envisages a "procedure" geared to ensuring the prompt correction of excessive deficits, should these arise. The Stability and Growth Pact (SGP), approved by the EU Member States in 1997 and reformed in 2005, establishes a set of "preventive measures" so that excessive deficits should not arise, along with "corrective measures" aimed at ensuring the rapid and rigorous application of the excessive deficit procedure, including the possible imposition of sanctions.

During 2008, the euro area's fiscal policy was influenced by the economic crisis, which strongly impacted the member countries' public finances and led to the adoption of fiscal stimulus measures by the economic authorities. In February 2009, the European Commission decided to initiate the excessive deficit procedure for those countries whose deficit exceeded the Treaty reference value of 3% of GDP in 2008: France, Spain, Ireland, Greece and Malta. In Spain's case, this will be the first time this procedure has been initiated since it joined EMU. This Box summarises how the procedure has unfolded to date and its consequences for Spanish fiscal policy in the coming years.

In January 2009, the Spanish government submitted an update of the Stability Programme (SP). According to the estimate in this update, the general government deficit would have exceeded 3%

Percentages

	2007	2008	2009	2010	2011	2012
REAL GDP (% change)						
Stability Programme (January 2009)	3.7	1.2	-1.6	1.2	2.6	…
Interim Commission Forecasts (January 2009)	3.7	1.2	-2.0	-0.2	…	…
Commission Forecasts (spring 2009)	3.7	1.2	-3.2	-1.0	…	…
Budgetary Stability Objectives (June 2009)	3.7	1.2	-3.6	-0.3	1.8	2.7
OUTPUT GAP (% of potential GDP)						
Stability Programme (January 2009)	1.4	0.3	-2.7	-3.7	-3.6	
Interim Commission Forecasts (January 2009)	1.5	0.8	-2.3	-3.4	…	…
Commission Forecasts (spring 2009)	1.4	0.9	-2.6	-3.7	…	…
Budgetary Stability Objectives (June 2009)	…	…	…	…	…	…
GENERAL GOVERNMENT BALANCE (% of GDP)						
Stability Programme (January 2009)	2.2	-3.4	-5.8	-4.8	-3.9	
Interim Commission Forecasts (January 2009)	2.2	-3.4	-6.2	-5.7	…	…
Commission Forecasts (spring 2009)	2.2	-3.8	-8.6	-9.8	…	…
Budgetary Stability Objectives (June 2009)	2.2	-3.8	…	-7.9	-5.2	-3.0
GENERAL GOVERNMENT STRUCTURAL BALANCE (% of GDP)						
Stability Programme (January 2009)	1.6	-3.5	-4.6	-3.2	-2.3	
Interim Commission Forecasts (January 2009)	1.6	-3.3	-4.6	-4.2	…	…
Commission Forecasts (spring 2009)	1.6	-3.9	-6.8	-8.2	…	…
Budgetary Stability Objectives (June 2009)	…	…	…	…	…	…
GENERAL GOVERMENT DEBT (% of GDP)						
Stability Programme (January 2009)	36.2	39.5	47.3	51.6	53.7	
Interim Commission Forecasts (January 2009)	36.2	39.8	46.9	53.0	…	…
Commission Forecasts (spring 2009)	36.2	39.5	50.8	62.3	…	…
Budgetary Stability Objectives (June 2009)	…	…	…	…	…	…

SOURCES: Stability Programme 2008-2011, Budgetary Stability Objectives 2010-2012 and European Commission.

of GDP in 2008[1] (see accompanying table). Accordingly, the European Commission (EC) decided to initiate the excessive deficit procedure, drafting the mandatory report in February 2009. This report analysed the reasons behind the breach of the 3% threshold and, in particular, it assessed whether this breach could be considered as close to the reference value of 3% of GDP, temporary and due to exceptional circumstances, factors which, should they arise in conjunction, prevent deficits above 3% being considered "excessive". The EC argued that the breaching of the 3% reference value in Spain's case could not be considered exceptional, given that it had not come about from a severe economic downturn that year. Indeed, on the EC estimates available at the time of the report being drafted, GDP had posted growth of 1.2% in 2008, compared with 3.7% the previous year, meaning that the estimated output gap remained positive and close to 1% of GDP. Nor is it considered that the breach could be temporary, given that the deficit will continue widening in 2009. On the basis of this report and of the subsequent opinion of the Economic and Financial Committee and of the EC itself, the European Council came to a decision on 27 April 2009 on the existence of an excessive deficit in Spain.

In parallel, the Council adopted a recommendation[2] with a view to bringing to an end the situation of an excessive public deficit in Spain, setting a deadline for its correction. As a general rule, the SGP establishes that excessive deficits should be corrected in the year following that of the Council's decision as to its existence, unless exceptional circumstances prevail. In this case, the Council considered that there were exceptional circumstances in Spain and has extended the correction deadline to 2012.[3] Moreover, the Council indicated that Spain should rigorously apply the budgetary targets specified in the SPG to 2011 and make an additional budgetary effort in 2012 to reduce the deficit to below 3% in that year.[4] Specifically, Spain should make an annual average fiscal effort equivalent to at least 1.25% of GDP, as submitted in the Stability Programme[5], which should commence in 2010. The Council set a period of six months, to 27 October 2009, in which the Spanish authorities should apply effective budgetary adjustment measures.[6] Finally, it highlighted the importance of achieving the medium-term objectives (a balanced budget in structural terms) once the excessive deficit has been corrected. At the same time it called for the consolidation process to be compatible with an improvement in the quality of public finances, and that the sustainability of public finances be reinforced with the application of further pension system reforms.

Compliance with the European Council's recommendations will require a very great consolidation effort, especially if it is taken into account that a deterioration in the budgetary situation in 2009 greater than that projected in the SP has been forecast. Also, real GDP in the Spanish economy is expected to trend more adversely both in 2009 and in 2010. In this connection, on 8 July 2009 the Spanish Parliament approved the Budgetary Stability Objectives for the three-year period 2010-2012 along with the State non-financial spending ceiling for 2010. The Budgetary Stability Objectives foresee a rise in the public deficit to 7.9% of GDP in 2010 and a subsequent progressive reduction to 3% of GDP in 2012, in line with the guidelines laid down by the European Council. As to State non-financial spending for 2010, the year in which the fiscal consolidation process should commence according to the recommendations of the European Council, the ceiling has been set in cash-basis terms at €182,439 million, up 13.9% on the ceiling approved for 2009. Implicitly, however, the government considers there will be an upward deviation in budgetary spending in 2009[7], meaning that the ceiling approved for 2010 would involve a 4.5% reduction relative to the final budget estimated for 2009.

Compliance with the adjustment path described is very important for retaining agents' confidence in the maintenance of budgetary stability in the medium run. In this respect, the scale of the correction projected in such a short space of time requires a very strict budget outturn and the adoption of ambitious measures. Attention must also be given not only to the scale of the adjustment but also to its composition. Experience shows that for fiscal consolidation processes to be successful, they must include cuts in public spending and, in particular, in unproductive spending. Finally, it is important that all tiers of general government and, given their share in public spending, regional governments in particular, should contribute actively to restoring the path of fiscal consolidation and budgetary stability.

1. At that time the public deficit estimate for 2008 was 3.4% of GDP. Subsequently, at 3.8% of GDP, the deficit exceeded this estimate by 0.4 pp. **2.** On the basis of a prior recommendation by the EC. **3.** These circumstances are, first, the considerable deterioration expected in the economy for 2009 and 2010 which, on Commission estimates, will be accompanied by a reduction in potential growth and a significant decline in the output gap; and, second, the size of the fiscal adjustment, in excess of 3% of GDP, which would require reducing the deficit to below the reference value in 2010. **4.** Moreover, given that in its assessment of the Stability Programme it had identified risks to compliance with budgetary targets, in particular associated with the growth assumptions contained in this Programme's macroeconomic scenario and with the absence of any description of specific deficit-correcting measures, the Council indicated that fiscal efforts additional to those described in the Stability Programme might prove necessary if these risks were to materialise.

5. The fiscal effort is measured drawing on the change in the structural budget balance. **6.** Assessment of the effectiveness of the measures will take into account economic developments compared with those projected by the Commission in its January 2009 interim forecasting exercise. **7.** The upward deviation in spending in 2009 compared with the initial forecast would, according to these estimates, be around €32 billion (3% of GDP), which could be explained by the approval of various measures during 2009 to combat the economic crisis.

destruction in low-paid industries, cannot be ruled out. Bearing in mind all these factors, compensation per employee in the market economy is expected to rise by 3.3% in Q2, and although there might be some further slowdown in the second half of the year, this will involve a significant rise in labour costs in real terms. Economy-wide the estimated increase is somewhat higher, owing to the upward effect exerted by public-sector wages in the current circumstances.

The correction initiated in inflation in the closing months of 2008 proceeded more sharply, with increasingly negative figures in the January-June period. In this latter month the CPI posted a year-on-year rate of change of –1%. As was foreseeable, a very significant portion of this adjustment was due to the marked decline in energy prices on a year earlier. But beyond these base effects, the weakening of inflationary pressures spread to the other components, including services, whereby core inflation slowed to 1% on average during the quarter, 2 pp down on the same period a year earlier. Price adjustments in Spain are proving more acute than in the euro area, which is shaping an outlook free from inflationary pressures and one of negative price differentials with the euro area that it is necessary to preserve in order to entrench a degree of competitive advantage that may underpin the recovery.

2 External environment of the euro area

During 2009 Q2, international financial markets continued on the recovering trend begun in March, moving away from the extreme situation that had previously characterised them. The generalised improvement in confidence made for some increase in the appetite for risk, for less restrictive financial conditions and for a pick-up in international financial flows, from which the emerging countries (especially those with higher credit ratings) also benefited. The sharp fall in the two previous quarters in the macroeconomic indicators eased off and tended to stabilise, although the improvement was more evident in the indicators of expectations than in the coincident indicators. In any event, there was a notable and rapid pick-up in the Chinese economy (see Box 2). However, in general terms the transfer of risks from financial institutions to the public sector has continued and the deterioration in the fiscal position has deepened, as a result of the implementation of stimulus plans and of the decline in economic activity.

The signs of activity stabilising were favourably interpreted by the financial markets and there was a perceptible improvement in the situation of US financial institutions. Significant in this latter respect was the effect of the publication of the results of the stress tests conducted by supervisors on the main institutions in early May, and the favourable results posted by some of the leading banks. Indeed, several US banks managed to raise equity from the private sector and were even able to return some of the aid received from the public sector. Against this background, the Federal Reserve began to redeploy some of its liquidity-providing and financing instruments, though these could be instantly reactivated. In addition, major regulatory reforms in the United States and in the United Kingdom were announced.

During Q2, interbank and credit market spreads narrowed considerably, while private-sector debt issuance increased. The stock markets were less volatile and there was an across-the-board increase in prices, though this was checked in June as optimism over the onset and strength of economic recovery fell off in part. Long-term government debt yields generally rose, set against some recovery in the demand for higher-risk assets, concern over the stability of public finances and, to a lesser extent, something of a rise in long-term inflation expectations. On the foreign exchange markets the dollar depreciated against the main currencies, of developed and emerging countries alike. The performance of the emerging markets during the quarter was even more favourable than that of the developed countries in some segments, as illustrated by the substantial stock market gains and the narrowing of sovereign spreads. On the commodities markets, oil, whose price in March was around $50 per barrel of Brent, climbed in June to $70, although subsequently it resumed a level around $60. The same was the case for the prices of the main industrial metals, in a setting of improved expectations about economic recovery. Food prices held at similar levels to those at the end of the previous quarter.

In the United States, the final GDP estimate for 2009 Q1 showed a decline of 5.5% in annualised quarterly terms, owing essentially to the strong contraction in fixed capital investment and rapid destocking, which was partially offset by the positive contributions of private consumption and of the external sector. The higher-frequency indicators have offered signs of stabilisation in recent months, although the labour market remains immersed in a deep contraction. On the demand side, the consumer confidence indices rose forcefully in Q2, though they eased off in July, while the consumer spending and retail sales indicators continue to suggest a degree of stabilisation. In the real estate market, indicators of sales and housing starts appear to confirm that the decline in the previous quarter has been checked and, at the same time, the

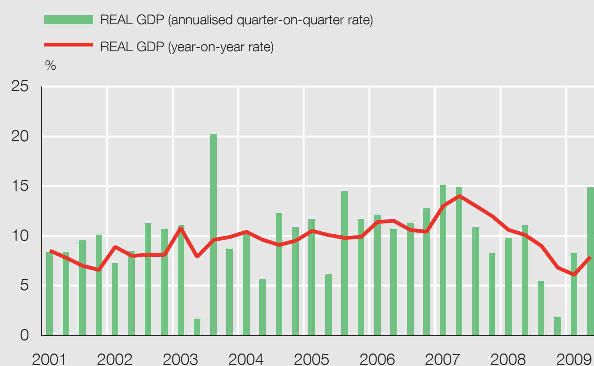
The Chinese economy has proven most resilient in the face of the adverse International economic and financial environment, and it has also been one of the first to show generalised signs of recovery. This relatively favourable behaviour – despite its close trade links with the global economy – might initially be explained by its low degree of financial development and its relative isolation from the international financial system. Also, following the heightening of the international crisis, the Chinese authorities responded with speed and firmness, assisted by the sound cyclical position of China's public finances (despite their contingent liabilities) and its room for manoeuvre in monetary policy. Even so, real GDP growth eased to 9% in 2008, against 13% in 2007. Activity slowed abruptly in year-on-year terms in 2008 Q4, and more sharply in 2009 Q1, down to 6.1%, marking the weakest year-on-year growth in a decade. However, it picked up markedly in Q2 (see Panel 1 and the main body of the text) to 7.9% year-on-year, above all due to the effect induced by the economic policies applied.

The slowdown in activity was not only a reflection of the collapse in international trade; it also stemmed from the notable adjustment in the domestic real estate sector – which accounts for around 10% of GDP and which had expanded markedly until early 2008 – and from the effects induced on agents' confidence. Indeed, the influence of the trade channel on Chinese growth is less than it is habitually considered to be: although exports account for around one-third of GDP, almost half is produced with imported goods. Accordingly, the contribution of net external demand averaged 1.4 pp between 2002 and 2008, i.e. only 12% of GDP growth in this period, which stood at 10.5% per annum. Nonetheless, National Accounts figures underestimate the actual weight of foreign trade in the economy, as they do not consider either its indirect effect on investment, employment and consumer spending, or its role in the productive transformation of the Chinese economy.

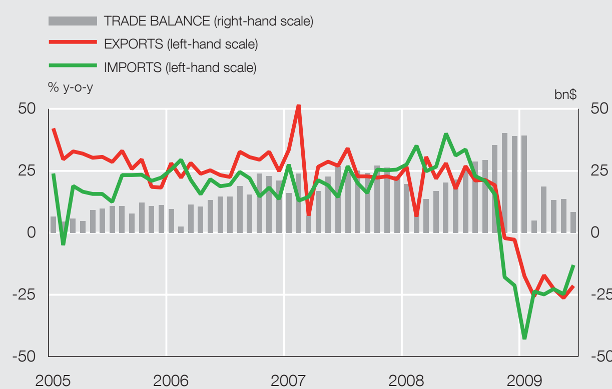
In any event, the trade surplus has diminished considerably due to the strong contraction in exports, despite the most significant fall in prices and import volumes (see Panel 2). The financial transmission channel has so far been the least relevant; however, China has not been immune to the external turmoil, which has translated into high volatility in short-term capital flows and into a reduction in direct investment inflows, which entailed a temporary slowdown in the build-up of international reserves.

The economic policy stance turned expansive as early as the summer of 2008. The first set of measures applied was geared to the export sector to mitigate the effect of the recession that was already

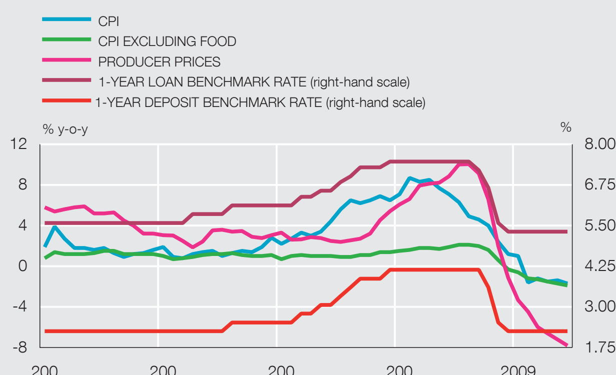
1 REAL GDP GROWTH



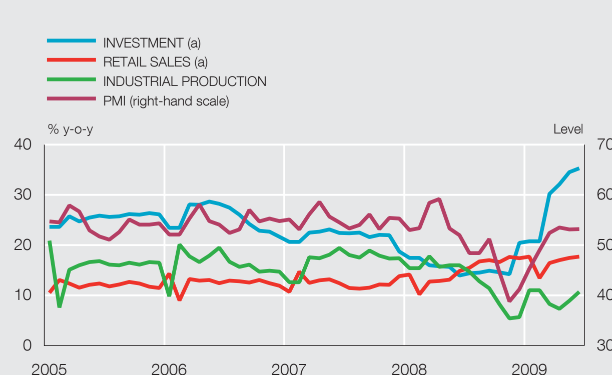
2 INTERNATIONAL TRADE



3 INFLATION AND INTEREST RATES



4 ECONOMIC ACTIVITY AND BUSINESS CONFIDENCE INDICATORS



SOURCES: CEIC, JP Morgan and Datastream.

a. In real terms.

affecting many developed economies. From July 2008, the appreciation of the renminbi against the dollar was halted, coinciding with the appreciation of the US currency. Export VAT rebates also increased on low-value-added and labour-intensive products (which entails an implicit improvement in their competitiveness). These rebates were extended after September, when the contraction in trade spread sharply to consumer durables. The second pillar was the monetary impulse, which was activated on the same day as the bankruptcy of Lehman Brothers in mid-September, adopting a moderately loose stance to promote economic growth in an environment of gradually declining inflation (see Panel 3), which has been in clearly negative territory since early 2009. This policy was implemented by means of an accelerated cycle of cuts in lending and deposit benchmark rates. Although real rates have not fallen, owing to the rapid correction in inflation, the removal of credit controls to make for ready access to financing – especially by households, the rural sector and SMEs – has translated into very marked growth in lending. This rise concerns the authorities given the excessive concentration on public-sector projects and the foreseeable increase in non-performing loans. The third pillar is fiscal policy, the last and most ambitious to be applied. In November a fiscal stimulus plan was announced, whose impulse is estimated to be of the order of 3.1% of GDP in 2009 and 2.7% in 2010. The aim of the plan is to infuse domestic demand with dynamism and restore confidence. The range of measures announced is extensive, though they are essentially geared to infrastructure development, support to the real estate sector and the subsidy of consumer durables, although in March they were re-directed towards social spending. As regards financing, around one-third will be defrayed through the central government budget, and the rest through local government bond issues and bank credit.

The recovery seen in recent months has been based almost exclusively on the effect induced by government policies, since the dynamism of actual private-sector demand has been limited and external demand has been lacklustre (see Panel 4 and the main body of the text). In any event, the main economic institutions foresee a relatively softer landing than initially expected and have revised their growth projections upwards for 2009 and 2010 to 7.5% and 8.4%, respectively, on average. If the policies remain effective, domestic demand might grow vigorously in the second half of this year, against a background of weakness in the external sector. However, the key variable for sustaining the recovery will be private domestic demand in the medium term. As to external demand, it is extremely uncertain what its contribution to growth will be, given the parallel fall in exports and imports; that said, there is not likely to be an abrupt reduction in the trade surplus. Exports will foreseeably fall off less than international trade (for which international organisations project a decline of over 10%), since Chinese products have scope to continue gaining share in export markets, albeit at a diminishing rate. As to imports, there are at least two opposing effects: the substitution of domestic output for imports, and greater external demand for commodities and capital goods following the measures to boost infrastructure. In the financial arena, and despite China's inherent weakness, the impact will be limited owing to the low external exposure of Chinese banks, the low dependence of households and firms on external financing in the short and long run, and financial underdevelopment (a most substantial portion of investment is financed through companies' retained earnings and the wealth effects are estimated to be less than in other emerging economies). It is possible, in any case, that financial stability may be dented – through an increase in non-performing loans – in a setting of weak economic growth, a phenomenon exacerbated by the high dependence on credit to fund the stimulus plan.

In sum, the global crisis has confirmed China's dependence on demand from the developed economies, which goes beyond to the external sector's contribution to growth. Against this background, it is uncertain whether private-sector demand can take up the baton once the public-sector impulse has been exhausted. Accordingly, in the medium term the Chinese economy will require a re-balancing of its growth model towards domestic demand, specifically towards private consumption, given the high weight of investment (45% of GDP). In this process, structural policies in the agricultural, social and financial areas will be pivotal, but so too will foreign exchange policy, which has been a fundamental pillar in China's development strategy in the past decade.

rate of decline of prices has moderated, although the house/sales ratios suggest that part of the adjustment in this market has still to take place. As to economic activity, the ISM indices show lower rates of contraction and, in fact, some of their components have gone above the expansion threshold. Industrial production continued falling during Q2, although durable goods orders increased in April and May. In the labour market, net job destruction declined in Q2, although the pace of this variable remains very high since 1.3 million jobs were lost during the quarter and the rate of unemployment increased to 9.5% (7.2% at end-2008). Prices, meanwhile, continued to post negative year-on-year rates (–1.4% in June), although core inflation remained in positive territory (1.7% in June). As regards the external sector, the correction of the trade deficit continued, standing at $26 billion in May. Against this backdrop, the Federal Reserve kept its target federal funds rate in a range of 0-0 .25% and retained its asset purchase objectives.

In Japan, following a particularly marked collapse in economic activity in Q1 (GDP shrank by 14.2% in annualised quarter-on-quarter terms), the higher-frequency indicators showed improvements in the following months. Yet it is still exports and, stemming from these, industrial production which are posting the biggest recoveries; indeed, this latter variable has registered three consecutive months of improvement. The consumption indicators evidenced some weakness at the beginning of Q2, but there are signs that the fiscal stimulus programme has managed to boost household spending. Prices continued to move on a declining trend: year-on-year inflation in May was -1.1%, and, stripping out the contribution of food and energy, the rate was –0.5%. The current account surplus continued widening, given the dynamism of exports, especially to China. The Bank of Japan held its official interest rate at 0.1% at its meeting on 16 June, and extended the period in which it will retain a series of extraordinary measures such as the purchase of commercial paper and corporate bonds, and operations to facilitate financing to companies.

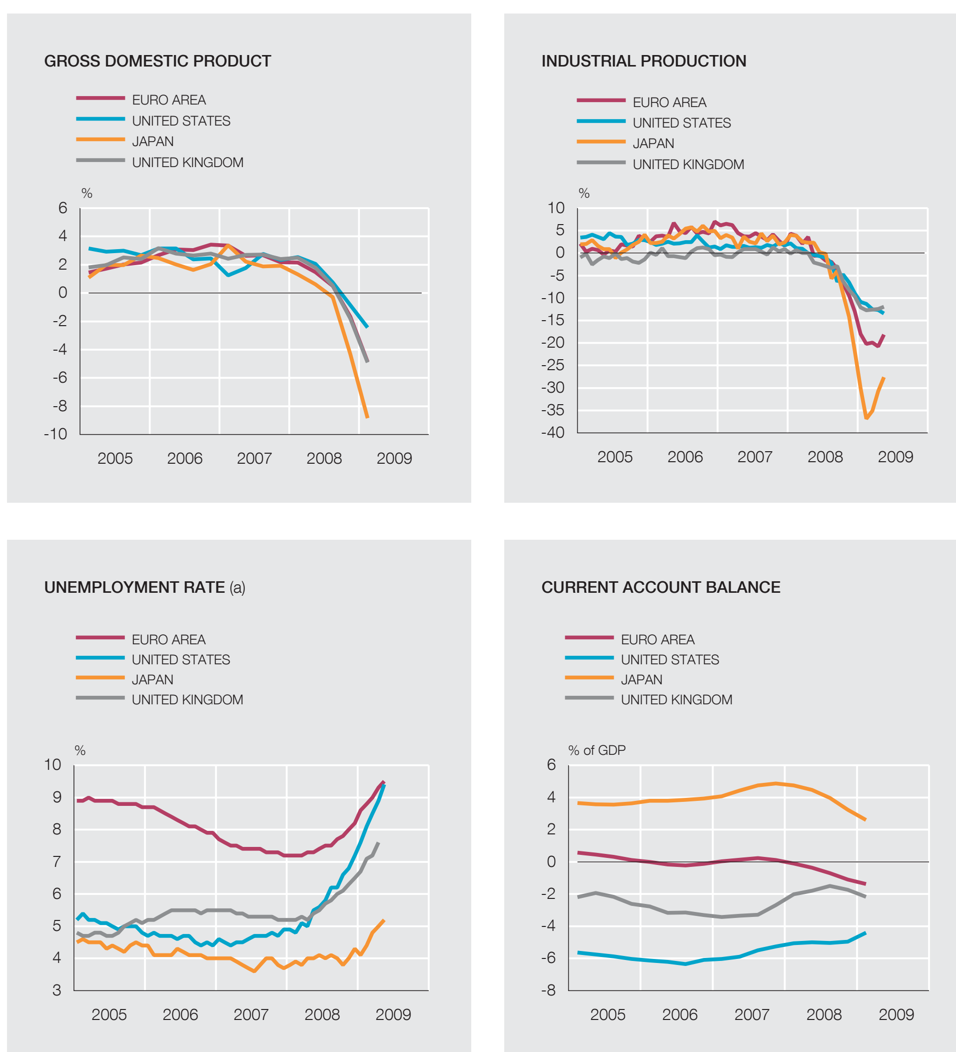
In the United Kingdom, the final GDP estimate for 2009 Q1 showed a strong contraction in activity (9.3% in annualised quarter-on-quarter terms), essentially owing to the decline in domestic demand. In Q2, and as suggested by the higher-frequency indicators, the fall in activity was less than in the previous quarter (3.1% in annualised quarter-on-quarter terms according to the preliminary estimate), although the year-on-year rate stood at –5.6%. The PMI indices for June had already pointed to a mild recovery in economic activity, and this was confirmed by other surveys in July. However, labour market conditions continued to worsen in Q2 and, although the fall in sales and consumer confidence has been checked, a rapid recovery is not yet in sight. There were signs of some stabilisation in the real estate market, with lower year-on-year falls in house prices and some recovery in demand, although there has been no improvement in mortgage credit. In general, credit activity remained weak, despite some improvement in credit availability, offset by still-restrictive access conditions. In this environment, inflation stood at 1.8% in June compared with the same month a year earlier, below the Bank of England target. The central bank held its official interest rate at 0.5% and made no changes to its asset purchase programme.

In the new EU Member States not belonging to the euro area, a sharp and abrupt slowdown across the board in GDP was confirmed in 2009 Q1. On average, GDP fell by 3.6% year-on-year, compared with growth of 0.9% in Q4, though there were marked differences between the 13% year-on-year contraction in the Baltic States and the 0.8% growth in Poland. This negative performance was the result of the deep adjustment in domestic demand, particularly in the Baltic States, compounded by the deterioration in external demand, especially that from the euro area. The industrial production and retail sales indicators for Q2 continued to show a pronounced decline in activity, while current account balances for Q1 improved notably, due above all to the collapse in imports. Over the course of the quarter, the aggregate inflation rate held on a declining path, and in June it stood at 3.6% a year-on-year, which prompted further cuts in official interest rates in all countries. On the financial front, the depreciation pressures on the Latvian lats eased following the Parliamentary approval of new fiscal containment measures. The IMF approved the new pre-emptive Flexible Credit Line (FCL) for Poland, for an amount of $20 billion.

In China, GDP accelerated most sharply in Q2 to a year-on-year rate of 7.9%, 1.8 pp up on the previous quarter. This was due essentially to the impulse provided by macroeconomic policies on domestic demand, as detailed in Box 2. Turning to the supply-side indicators, industrial production accelerated progressively during the quarter and business confidence moved into clearly expansionary territory. The domestic demand indicators have trended favourably in the quarter: investment in fixed assets rose sharply in light of the fiscal stimulus

MAIN MACROECONOMIC INDICATORS
Year-on-year rate of change

CHART 5



SOURCES: Banco de España, national statistics and Eurostat.

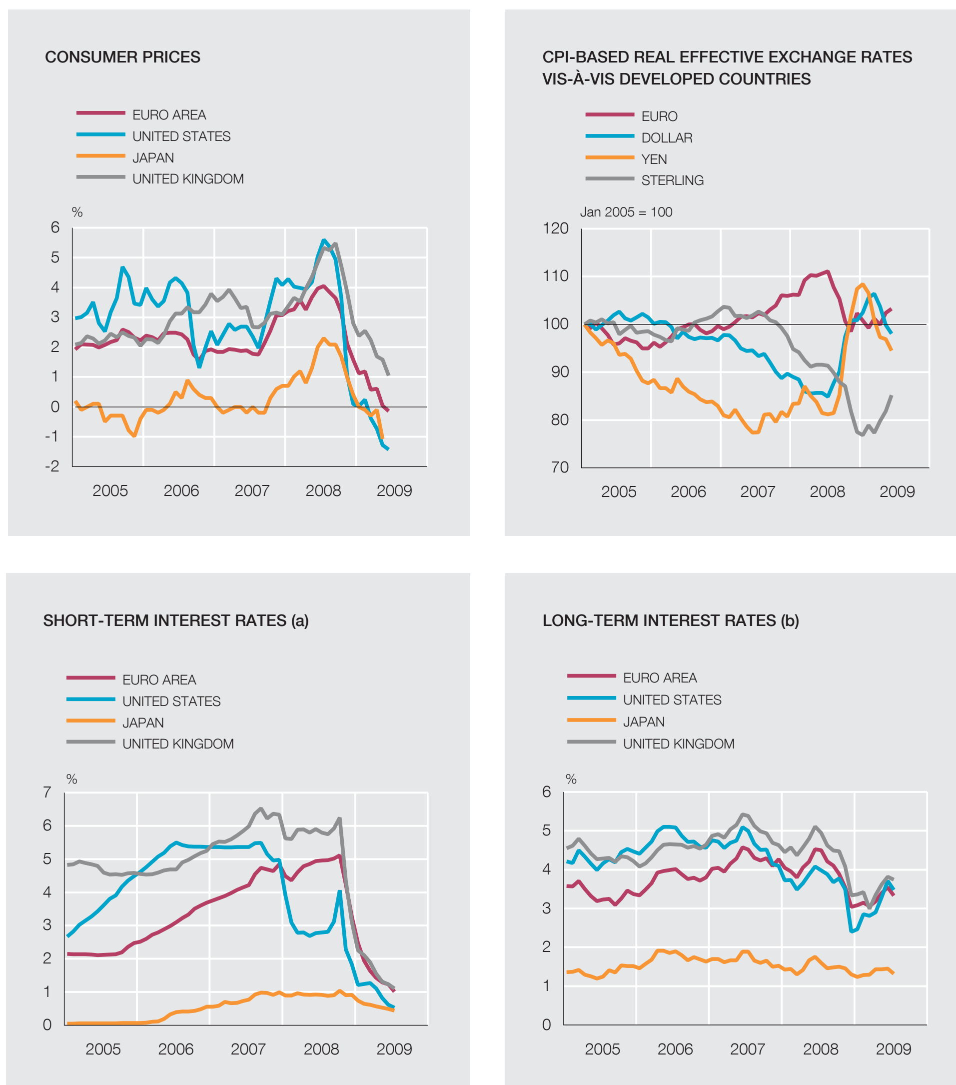
a. Percentage of labour force.

plan and there are even signs of recovery in real estate investment; and retail sales held relatively firm. As to external demand, the trade surplus narrowed substantially, although there are signs that the decline in exports and imports might have touched bottom. Despite this reduction in the trade surplus and in foreign direct investment inflows, the build-up in international reserves – now in excess of $2 trillion – was very sharp, and might suggest an intensification of short-term capital inflows. Year-on-year inflation was in even more negative territory in Q2 (–1.7% in June), owing essentially to the base effect and despite the ongoing and marked rise in credit and in the money supply. Of note in the policy-making realm was the bias of the fiscal stimulus plan towards domestic products and services, and the new measures to lessen dependence on the dollar in Chinese trade transactions.

In 2009 Q1, GDP in the rest of Asia grew at a year-on-year rate of 0.8%, notably down on the figure of 2.2% the previous quarter. There was notable growth in the less open economies – India and Indonesia posted growth rates of 5.8% and 4.4%, respectively – while the other countries saw a contraction in their GDP on a year earlier. In Q2, industrial production and exports continued to show year-on-year declines, although in monthly terms greater dynamism began

PRICES, REAL EXCHANGE RATE AND INTEREST RATES

CHART 6



SOURCE: Banco de España.

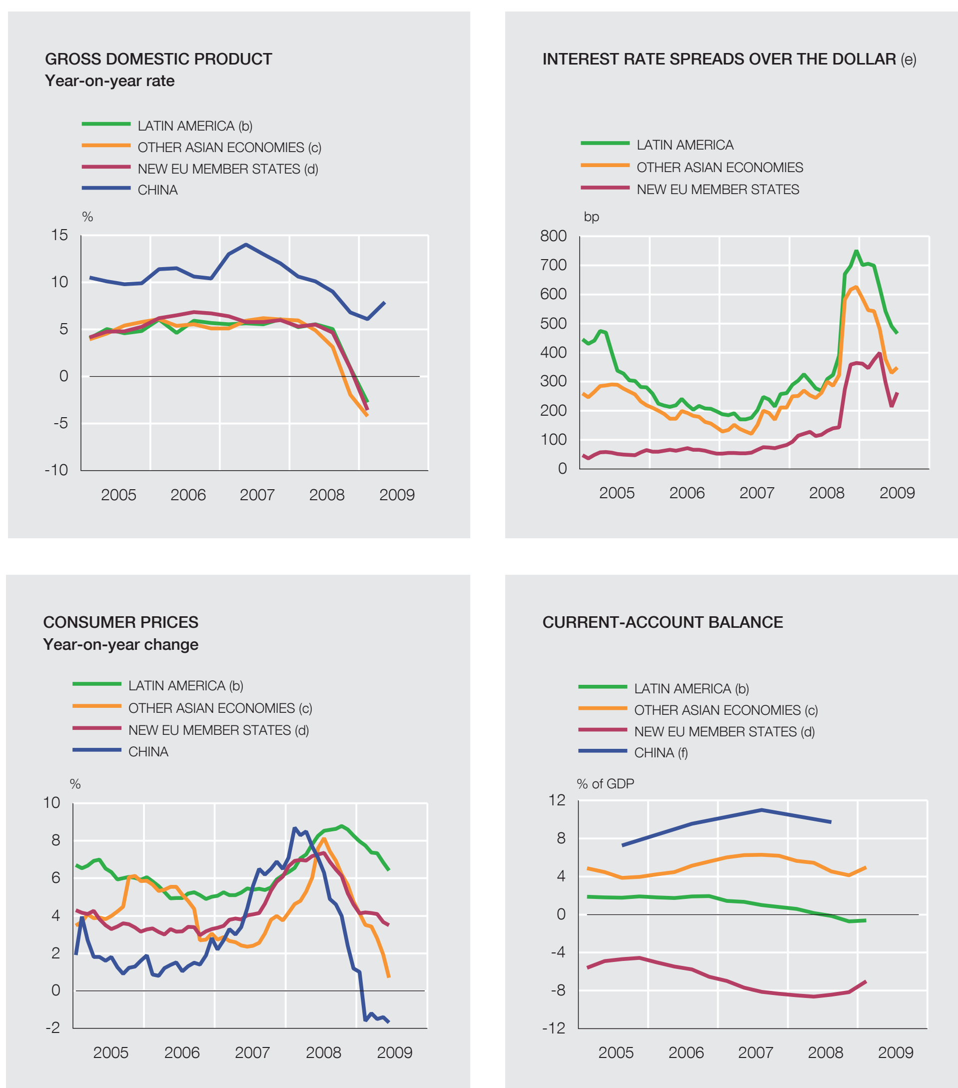
a. Three-month interbank market interest rates.
b. Ten-year government debt yields.

to be discernible in both variables. Inflation continued falling appreciably in Q2, in a setting in which most central banks cut their official interest rates, albeit by a lesser amount than in previous quarters.

Set against growth of 0.9% in 2008 Q4, GDP in Latin America contracted by 2.8% in 2009 Q1 compared with the same period a year earlier, the worst fall since quarterly statistical records began. The contraction was due to the slowdown in domestic demand (which subtracted 3.5 pp from growth), while the contribution of external demand turned positive, adding 0.7 pp, the consequence of the contraction in imports outpacing that in exports. The indicators of activity in 2009 Q2 point to weak growth in most countries in the area, although in Brazil activity is expected to have regained some dynamism. Inflation continued to ease, standing at 6.5% in June, 0.9 pp down on March. In combination with extensive output gaps, this led central banks with inflation targets to continue cutting interest rates at each of the meetings held during Q2. Argentina and Venezuela also relaxed their monetary conditions. Against the background of reduced imports owing to the collapse in domestic demand and price increases in

EMERGING ECONOMIES:
MAIN MACROECONOMIC INDICATORS (a)

CHART 7



SOURCES: National statistics and JP Morgan.

a. The aggregate for the different areas has been calculated using the weight of the countries making up such areas in the world economy. Based on IMF information.
b. Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
c. Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
d. Poland, Hungary, Czech Republic, Estonia, Latvia, Lithuania, Bulgaria and Romania.
e. JP Morgan EMBI spreads. Data on the new euro area Member States are for Poland and Hungary. The Asia aggregate does not include China.
f.Annual data.

certain commodities, there was an improvement in trade balances. Along with some recovery in financial inflows, the improved trade balances gave rise to currency appreciations (which were limited in some cases owing to central bank intervention), except in the cases of Argentina and Venezuela. The IMF approved the granting of the new FCL facility to Colombia (after having previously done so with Mexico), for an amount of $10.5 billion. Finally, there was a notable change, in opposing directions, in the rating agencies' outlook for Brazil (upwards) and Mexico (downwards).

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

In 2009 Q2, economic activity in the euro area continued to worsen, although at a much more subdued rate than in the previous two quarters. This easing in the rate of decline, together with signs of stabilisation on the financial markets (see Box 3) and the relative recovery – based particularly on the expectations component – in agents' confidence indicators (see Box 4) might indicate that a turning point has been reached in the deep economic recession which started in 2008 Q2. However, most of the forecasts available agree in showing a main scenario in which, helped by a more positive international environment and the continued action of economic policies supporting aggregate demand, positive quarter-on-quarter growth rates may be expected to return only in the course of 2010.

This slow upturn scenario continues to be subject to uncertainty and contains significant weak elements. First, the intensity and duration of the recession will put to the test the functioning of the labour market and developments in employment in the coming quarters that so far – supported by temporary measures – have shown themselves to be relatively resilient in the euro area as a whole. Second, public finances have considerably deteriorated as a result of the operation of the automatic stabilisers, discretionary measures to stimulate aggregate demand and action to support the financial system. To underpin the effectiveness of this extraordinary fiscal impulse, it is essential that governments guarantee its compatibility with a strategy of medium-term fiscal consolidation that ensures the sustainability of public finances. And, third, the international financial crisis and the economic recession have severely affected the banking system, which partly depends on support from the public sector and in which leveraging tendencies persist. To make sure that this unfavourable situation does not translate into an episode of contraction of the credit supply beyond what cyclical circumstances would warrant is one of the main challenges facing economic policymakers.

The rate of inflation continued to decline throughout the quarter and turned negative in June (-0.1%) for the first time in the history of EMU. This development responded mainly to the base effects in energy prices and, to a lesser extent, to the slowdown in services prices, resulting partly from very weak demand. According to most experts and analysts, inflation will foreseeably return to positive though very moderate levels towards the end of the year, and would run over a prolonged period in a context in which the high level of slack in productive capacity will tend to limit possible inflationary pressures. In these circumstances, the Governing Council of the ECB again eased its monetary policy stance with a further cut in official interest rates in May, to 1%, i.e. 325 basis points below the October 2008 level. In addition, the ECB strengthened its generous liquidity supply policy to the banking system by establishing a longer-term financing operation with one-year maturity, twice the six-month maximum time span in force until then, and has recently embarked on a programme of acquiring covered bonds and other guaranteed bonds issued in the euro area.

3.1 Economic developments

The second National Accounts estimate confirmed the marked decline in economic activity in the euro area in 2009 Q1. Thus, after the quarter-on-quarter fall of 1.8% in 2008 Q4, the current year started with a sharper-than-envisaged slowdown, (-2.5%, see Box 1). This new fall in activity largely reflects the decline in gross fixed capital formation and in exports, as in the previous quarter, as well as destocking (see Chart 8). Private consumption fell back to a lesser degree, despite the ongoing job destruction, while government consumption was the sole aggregate to post a positive rate of increase. However, domestic demand, excluding stocks, cut 1.1% from GDP growth. The external sector continued to contribute negatively to activity,

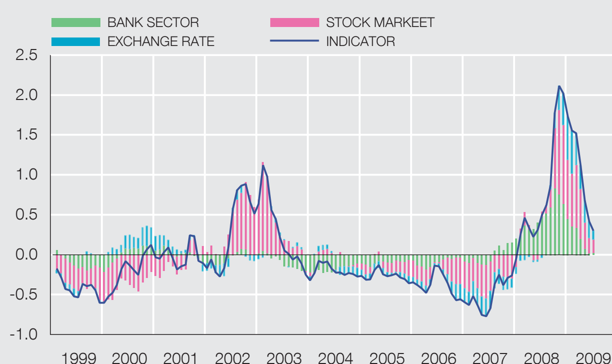
The stabilisation of the financial markets is essential to an efficient allocation of resources in the economy and, in the current economic climate, to the recovery in economic activity. Moreover, markets need to function properly if the impulses from monetary policy are to be effectively transmitted. To assess the degree of easing of tension in the markets since the episode in September 2008 and to identify the financial risks to the macroeconomic scenario, it is useful to construct a synthetic indicator which sums up the not always coincident trend of a set of relevant financial variables.

To this end, a synthetic indicator of financial tension in the euro area is shown in this box, following a similar approach to that proposed by the IMF[1] (see Box 1). This indicator consists of three sub-indices, which respectively refer to the stock exchanges, the banking sector and foreign exchange market (Panels 2 – 4), with each being calculated as an average of a set of previously standardised relevant variables, and available for a sufficiently long period. In the first case, the level (sign reversed) is included and the implied volatility of a stock exchange index and, as a risk assessment measure, the yield spread between private bonds with a BBB credit rating and those with the highest rating, AAA. The banking indicator, shown in Panel 2, consists of the (inverted) price of a sectoral stock exchange index, the slope of the yield curve (sign reversed) and a measure of the counterparty risk in the sector that is calculated as the additional cost of interbank financing without collateral (EURIBOR) in respect of the public government debt. Finally, the third sub-index relating to the foreign exchange market includes the volatility of the euro–dollar exchange rate.

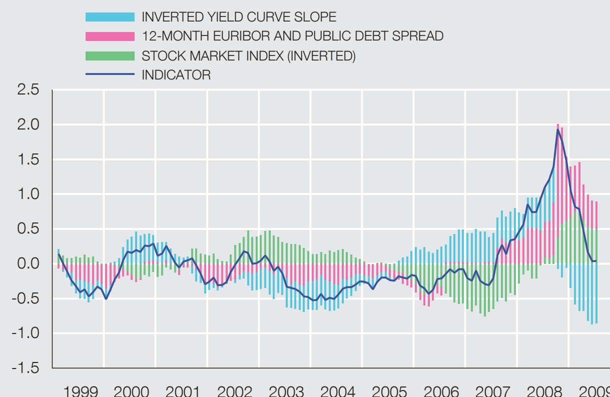
The movement in this synthetic indicator confirms a notable easing of tensions compared with the height of the crisis in September 2008, and has been supported by a broad deployment of measures, some unprecedented in nature and volume, by governments and monetary authorities worldwide, and also by signs that the economic slowdown was starting to abate. The breakdown into components shows that the signs of financial stabilisation starting in March have been reflect-

1. R. Cardarelli, S. Elekdag and S. Lall (2009), *Financial Stress, Downturns, and Recoveries*, WP/09/100, IMF.

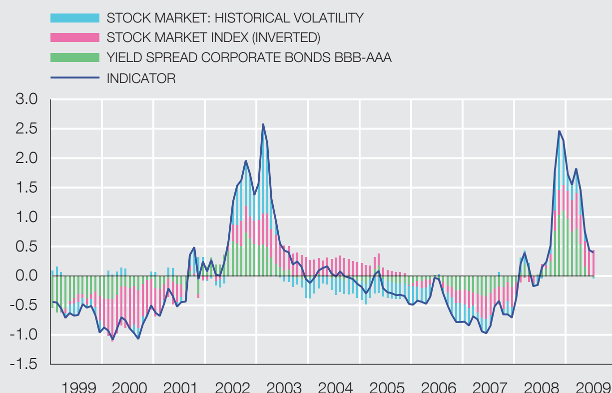
1 FINANCIAL STRESS INDICATOR OF EURO AREA AND CONTRIBUTION OF ITS COMPONENTS



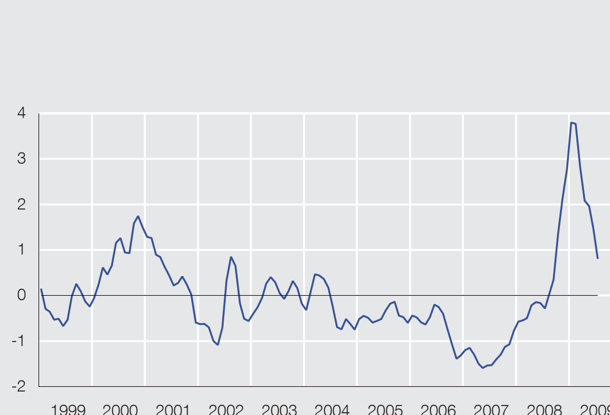
2 FINANCIAL STRESS INDICATOR OF BANK SECTOR AND CONTRIBUTION OF ITS COMPONENTS



3 FINANCIAL STRESS INDICATOR OF SECURITIES MARKET AND CONTRIBUTION OF ITS COMPONENTS



4 DOLLAR/EURO EXCHANGE RATE: HISTORICAL VOLATILITY



SOURCES: Datastream, Bloomberg and Banco de España.

a. The composition of the index follows that of the IMF (see footnote 1) and is constructed as an average of previously normalised financial variables.

ed, above all, in a generalised fall in volatility, which had reached very high levels, and in a reduction in risk premia, both in the non-financial sector and, notably, in the financial sector. In addition, the decline in the banking stress indicator largely reflects the increase in the yield curve, which tends to push up the net interest income of credit institutions[2] – which traditionally take short-term liabilities (e.g. deposits) and convert them into long-term loans. Finally, the improvement was boosted by the rise in stock market indices, although, after the lows of the past decade reached in March, they were still at levels far from those prevailing before the crisis.

Despite the notable fall, the financial tension indicator remains at historically high levels which still point to a situation of relative financial weakness with a high level of uncertainty. It is worth remembering in this context that corporate earnings worsened in Q1 and one-year profit expectations continue to suggest falls, even though they have recovered over longer horizons. With regard to the banks, they have incurred substantial losses, mainly due to structured assets. And problems relating to liquidity, shortage of capital and medium-term financing have been eased by the actions of the monetary authorities and governments. Nevertheless, the wholesale funding markets have not resumed their activities and the pronounced macroeconomic weakness poses additional risks for banks' loan portfolios.

In conclusion, since the start of the year, and especially since March, there has been a reduction in financial tensions, linked in all likelihood with the unprecedented measures taken by governments and central banks, and with evidence that the economic slowdown seems to be losing force. However, tension remains high and far from the pre-crisis levels in mid-2007. Some confirmation in the coming months of the current expectations of economic recovery will be critical in restoring the normal functioning of the financial system.

2. Nevertheless, this effect will depend notably on the term structure of companies' balance sheets and, for example, will be less significant the greater the weight of floating-rate loans on the assets side.

since exports contracted more strongly than imports. Finally, as regards the breakdown by sector, the adjustment was predominantly in industry and services, while construction was down less than in the previous quarter.

The contraction in activity was a common feature of the main economies of the euro area. However, the strength of the downturn varied greatly. Activity fell in Germany in 2009 Q1 by 3.8%, while in France it was down 1.2%, 0.2 pp less than in 2008 Q4. Italy, for its part, posted negative growth of 2.6%, in line with the average for the whole of the euro area. Despite these differences, the items which most impacted economic activity in the three countries were the same: gross fixed capital formation, specifically capital goods and exports. Government consumption and private consumption expanded, except in the case of Italy, contributing positively to GDP.

The decline in employment intensified in 2009 Q1, falling by 0.8%. Given that GDP slowed to a greater extent, apparent labour productivity growth fell to -1.7%. Also, the adjustment observed in employment in the euro area is the result of very different behaviour across the member countries. Thus, while the pace of job destruction in Germany and France stands at 0.3% and 0.8%, respectively, in countries such as Spain and Ireland the slowdown is more acute and in 2009 Q1 posted rates of 3.1% and 3.8%, respectively. The marked fall in productivity resulted in a sharp increase in unit labour costs, even though the growth in compensation per employee moderated (see Chart 8). In addition, the increase in the GDP deflator was more contained, and business margins contracted sharply.

The latest economic data indicate a further decline in activity in 2009 Q2, albeit one more moderate than in Q1. Thus, on the supply side, industrial production fell in April and May to a slower pace than in Q1, a pattern also evident in new industrial orders (see Chart 9). The confidence indicators produced by the European Commission and the PMI industry and services surveys have, after reaching lows in February and March, been recording steady advances, underpinned mainly by the expectations component (see Box 4), although they are still at lev-

THE ASSESSMENT OF THE ACTUAL AND EXPECTED ECONOMIC SITUATION IN CONFIDENCE SURVEYS, AND DEVELOPMENTS IN ECONOMIC ACTIVITY IN THE EURO AREA

The confidence indicators cover the results of surveys of private agents on their perception of the economic situation. Their prompt availability and capacity to anticipate turning points in the business cycle make them very relevant as monitors of the economy.[1] Lately, most indicators for the euro area have recorded considerable improvements which suggest that in recent months there has been a marked slowdown in the worsening of economic activity.

The surveys include questions on the economic situation or on production or demand trends at the time of the respective survey, while others focus on the expectations of respondents in respect of these variables. The components related to the current or recent situation usually show a coincident or even lagged correlation to economic activity, while the indicators of expectations usually show a weaker relationship with the real variables, but of a leading nature. The latter indicators, however, tend to change more frequently, so their short-term movements have to be treated with caution since they can change back more easily.

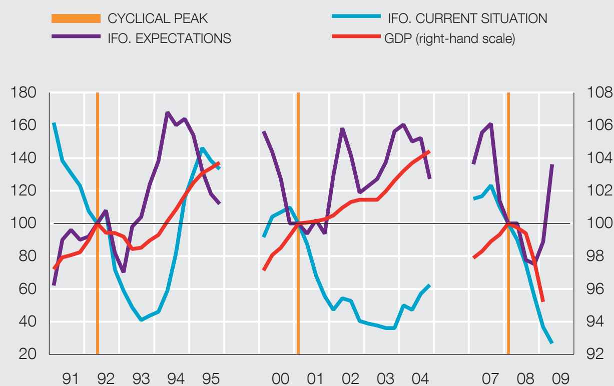
1. See ECB (2004), "Opinion surveys on activity, prices and labour market developments in the euro area: features and uses", Monthly Bulletin, January, and Cuenca and Millaruelo (2006), "Las encuestas de opinión y el análisis de coyuntura de la actividad real de la UEM", Boletín Económico, January, Banco de España.

The panels depict developments during the current recession broken down into assessments of the current and expected economic situation taken from some of the main confidence indicators in the euro area, together with the economic variable with which a stronger relationship in each case may be expected. Moreover, for comparative purposes, the same variables in the recession of the early 1990s[2] are included. That recession spread in a generalised way to the euro area countries, although with less force than the current one, like in the period of low economic growth in the euro area between 2001 and 2003.

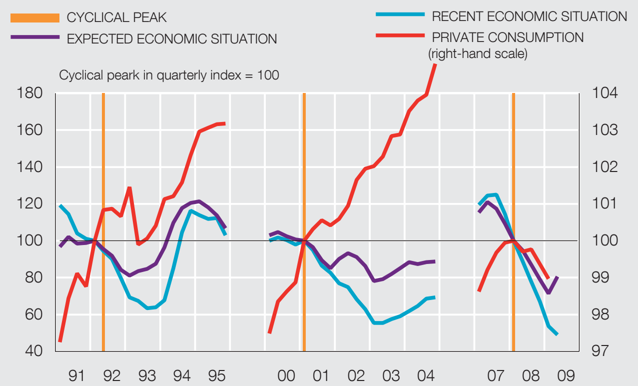
As the panels illustrate, the expectation indicators have recorded generalised increases in the most recent period, while those referring to the current situation have either continued to deteriorate – in the case of the IFO surveys and the European Commission's consumer surveys – or have shown more moderate improvements – like the EC's business confidence and the services PMI surveys. These developments are in line with the experience of the two previous phases, when initially there was a rise in expectations, whereas assessments of the present showed a smaller improvement or continued to worsen. Yet, while in the early 1990s the rise in prospects was continuous and was followed, with a

2. With the exception of the confidence indicators in the services sector, for which there are no data for this period.

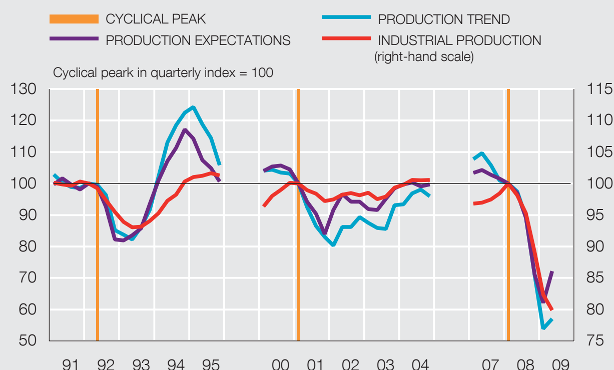
1 IFO SURVEY FOR EURO AREA AND GDP



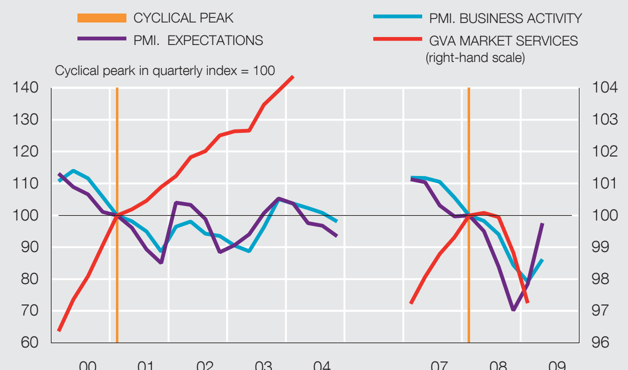
2 EC CONSUMER AND PRIVATE CONSUMPTION SURVEY



3 EC INDUSTRY AND INDUSTRIAL PRODUCTION SURVEY



4 PMI SERVICES AND GVA MARKET SERVICES



SOURCES: European Commission, Eurostat and Markit Economics.

THE ASSESSMENT OF THE ACTUAL AND EXPECTED ECONOMIC SITUATION IN CONFIDENCE SURVEYS, AND DEVELOPMENTS IN ECONOMIC ACTIVITY IN THE EURO AREA (cont'd)

BOX 4

certain lag, by a strengthening of real variables and of the assessment of the economic situation, in the low-growth period at the start of this decade the improved expectations in early 2002 regarding the future went into reverse after a short time and were not accompanied by a pick-up in activity, which remained weak. Subsequently, in 2003, the improvement in expectations was followed by a more optimistic assessment of the situation and by a higher growth rate.

In conclusion, the most recent improvement in confidence in the euro area so far has been based essentially on indicators that include the expectations of economic agents. On the limited evidence available, this behaviour, although reassuring, does not necessarily mean a quick pick-up in activity, as it is fairly common for rises in these indicators to be short-lived. If the favourable responses to the questions on future developments continue in the coming months and feed through to a more positive assessment of the economic situation, it could give greater weight to a recovery scenario. In any event, the comparison with previous situations must be made very carefully given the exceptionally strong nature of the current recession.

els significantly below those associated with positive growth in activity. On the labour front, the unemployment rate has continued to worsen throughout the quarter, while the declining trend of the employment indicators turned round in many cases, although they remain at very low levels in historical terms.

On the demand side, household spending indicators show a lesser deterioration in private consumption. Retail sales were down on average to levels somewhat below those of Q1 this year, while car registrations – boosted by support schemes by various governments – and consumer confidence indicators, after the low in March, continued to progress. As regards investment in capital goods, both the degree of capacity utilisation and the assessment of order books according to the Commission's quarterly survey declined again in Q2. Data relating to external demand have, by contrast, been less negative than in recent months. Thus, the trade balance nominal data show on average a more moderate contraction in exports in April and May, and export expectations drawn from the EC's quarterly industrial opinion survey progressed slightly in Q2. However, the average assessment of order books continued to decline over that period. Finally, the European Commission's stock valuation indicator suggests a slower pace of destocking.

In sum, the recent movements in the economic indicators, which despite the improvement remain at very low levels, point to a further contraction in activity in Q2, but a more limited one than in the opening months. Into the medium term, private analysts and international organisations place the decline in GDP at around 4.5%, with a gradual recovery to positive rates at the end of 2010 (see Box 2). Nevertheless, although uncertainty about the economic prospects has eased slightly, downside risks to this slow recovery scenario exist, mainly due to the degree of normalisation of the financial system and the worsening situation in the labour market.

Euro area inflation slowed gradually in Q2 to a negative year-on-year growth rate of -0.1% in June (see Chart 10). This slowdown was essentially in response to the energy base effects arising from last year's high prices and, to a lesser extent, from the deceleration in services prices, stemming partly from sluggish demand. The growth rate of unprocessed food prices continued its downward trend, as did that of processed food prices, although the latter fell at a slower pace than in the previous quarters. Inflation in non-energy industrial goods was, however, stable throughout the quarter. Thus, core inflation, as measured by the overall index excluding unprocessed food and energy, was much more subdued, falling by only 0.2 pp between March and June to 1.3%. Industrial prices continued their sharp contraction, with a

EURO AREA ECONOMIC INDICATORS (a) TABLE 1

	2007	2008				2009		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
NATIONAL ACCOUNTS (quarter-on-quarter rate of change, unless otherwise indicated)								
GDP	0.4	0.7	-0.3	-0.4	-1.8	-2.5		
Private consumption	0.3	0.1	-0.3	0.0	-0.4	-0.5		
Government consumption	0.4	0.4	0.9	0.5	0.4	0.2		
GFCF	1.0	1.0	-1.3	-1.1	-4.1	-4.1		
Imports	-0.1	1.5	-1.0	0.9	-5.2	-7.6		
Exports	0.7	1.7	-0.3	-0.6	-7.3	-8.8		
Contributions to quarter-on-quarter GDP growth (pp)								
Domestic demand (excl. stocks)	*0.4*	*0.4*	*-0.3*	*-0.2*	*-1.1*	*-1.1*		
Change in stocks	*-0.4*	*0.2*	*-0.2*	*0.4*	*0.3*	*-0.9*		
Net foreign demand	*0.4*	*0.1*	*0.3*	*-0.6*	*-1.0*	*-0.5*		
GDP (year-on-year rate of change)	2.2	2.2	1.5	0.5	-1.7	-4.9		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working-day adjusted	1.0	1.8	-2.2	-2.8	-6.2	-7.4	*-2.7*	
Economic sentiment	105.0	101.4	97.7	89.9	75.6	65.7	70.3	
Composite PMI	54.0	52.1	50.8	47.6	40.2	37.6	43.2	
Employment	0.3	0.4	0.1	-0.2	-0.4	-0.9		
Unemployment rate	7.3	7.2	7.4	7.6	8.0	8.8	*9.4*	
PRICE INDICATORS (year-on-year change in end-period data)								
HICP	3.1	3.6	4.0	3.6	1.6	0.6	-0.1	
PPI	4.6	5.6	7.7	7.6	1.2	-2.9	*-5.7*	
Oil price (USD value)	91.5	104.3	132.0	98.1	40.5	46.8	68.8	*63.2*
FINANCIAL INDICATORS (end-period data)								
Euro area 10-year bond yield	4.4	4.2	4.9	4.5	3.8	4.1	4.2	*4.1*
US-euro area 10-year bond spread	-0.36	-0.69	-0.88	-0.88	-1.76	-1.31	-0.63	*-0.37*
Dollar/euro exchange rate	1.472	1.581	1.576	1.430	1.392	1.331	1.413	*1.423*
Appreciation/ depreciation of the NEER-22 (b)	6.3	3.7	3.5	-0.6	2.7	-0.7	-1.1	*-1.1*
Dow Jones EURO STOXX 50 index (b)	6.8	-17.5	-23.8	-30.9	-44.3	-15.5	-2.0	*5.5*

SOURCES: European Commission, Eurostat, Markit Economics, ECB and Banco de España.

a. Information available to 23 July 2009. The information in italics does not cover the full quarter.
b. Percentage change for year to date.

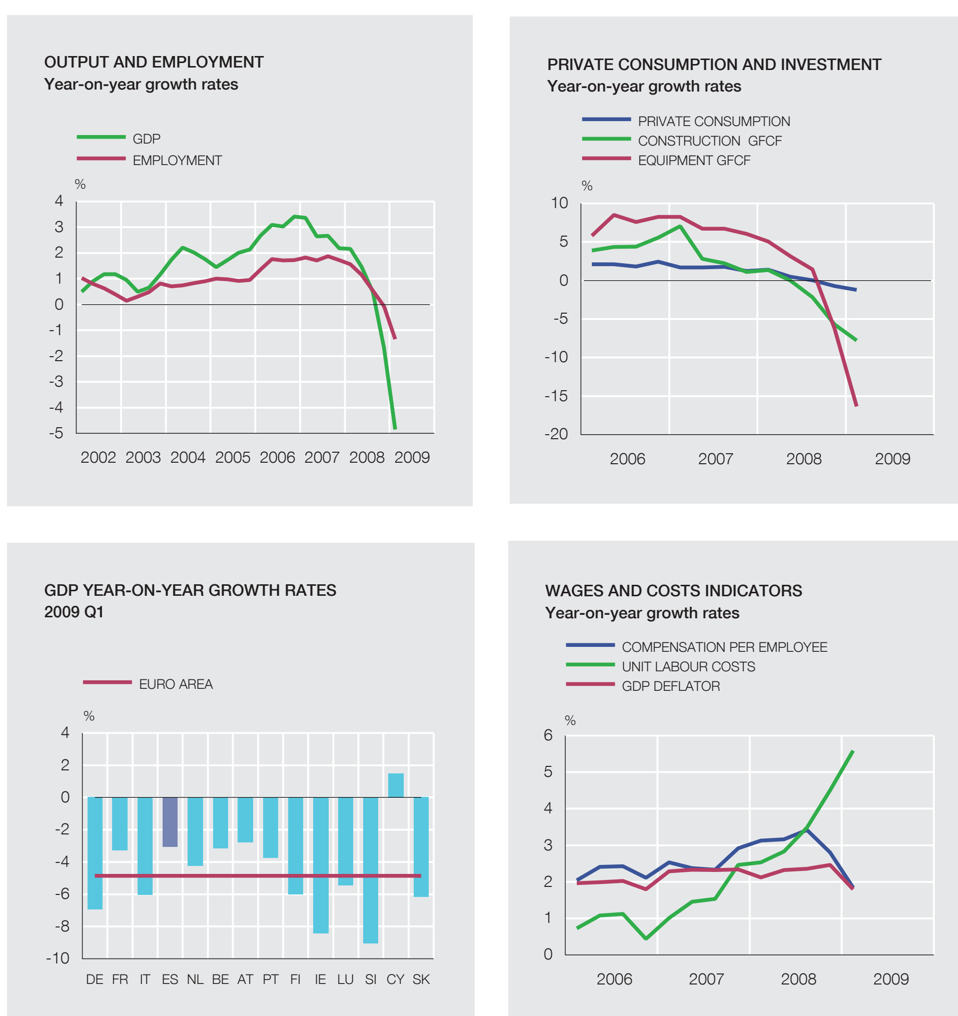
year-on-year drop of 5.8% in May. This marked decline was essentially due to the fall in the prices of energy, non-energy intermediate goods and non-durable consumer goods, but also to the lower growth in the prices of capital goods and consumer durables.

In the coming months, mainly as a result of energy and food price base effects, inflation is expected to hold at a negative rate. However, this base effect will foreseeably wane in the second half of 2009 and positive, albeit moderate, inflation rates may be reached in the final months of the year and should continue in 2010. That inflation is expected to stabilise around 1% next year reflects the high degree of slack in production capacity building up in Europe's economy in the face of weak aggregate demand.

According to information published by the ECB, the euro area current account deficit totalled €65 billion (1.7% of GDP) between January and May 2009, €19 billion more than over the same period last year. The other components, except for the income balance, whose deficit fell slightly, performed less well. Thus, the trade surplus on goods became a deficit, as exports declined more than imports, the services trade surplus narrowed and the deficit on current transfers continued to widen. By contrast, in respect of the financial account, net capital outflows in the form of direct investment rose to €37 billion between January and May, while portfolio investment amounted to net inflows of €224 billion, three times higher than in the

EURO AREA NATIONAL ACCOUNTS

CHART 8



SOURCES: Eurostat and national statistics.

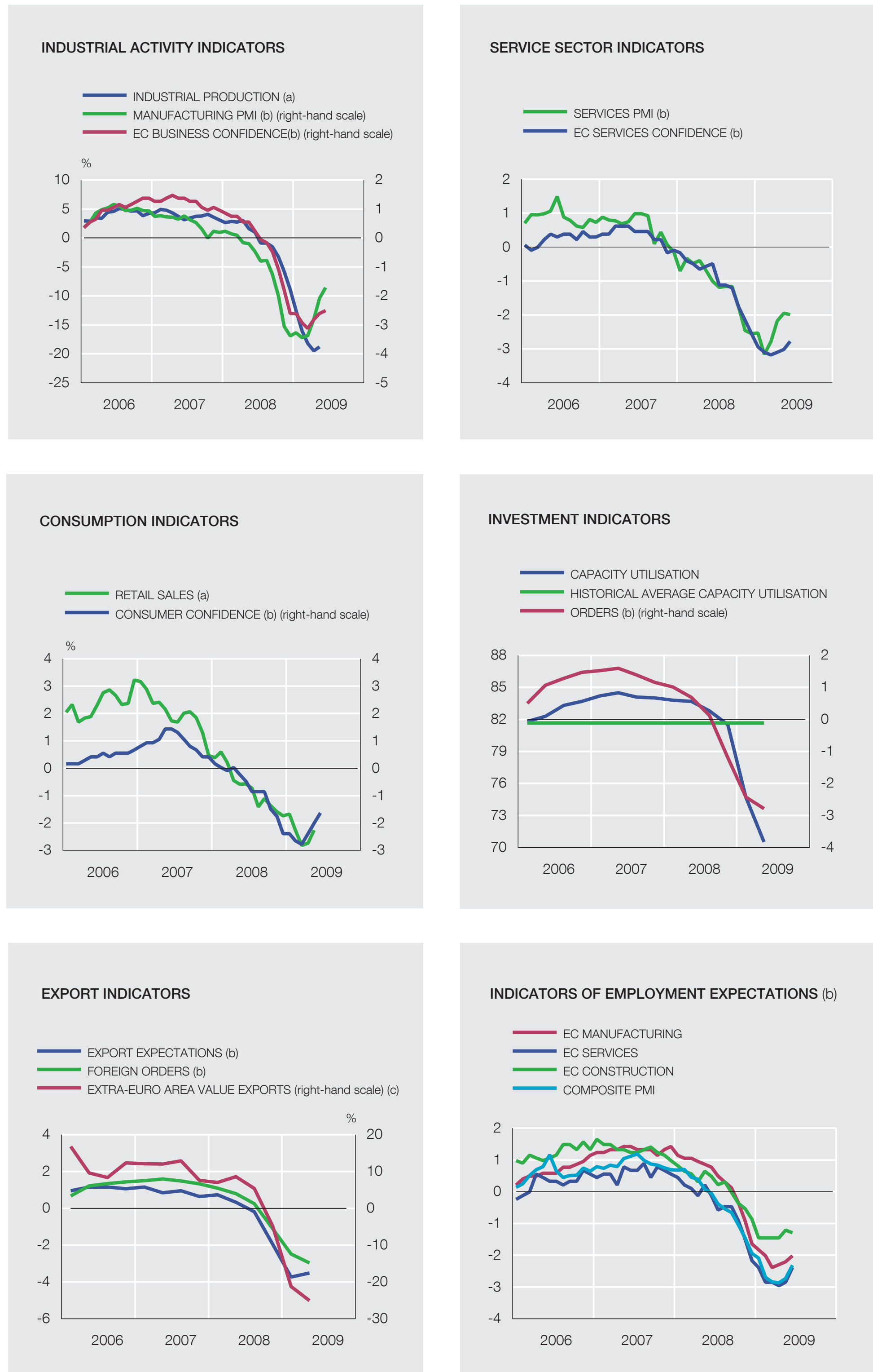
same four-month period of the preceding year. Accordingly, in the opening months of the year, the basic balance, which aggregates the current account balance and these two kinds of investment, was positive to the tune of €123 billion, contrasting with the deficit of €78 billion between January and May 2008 (see Chart 11).

In recent months several countries in the euro area have started to discuss both the budgets for next year, updating the estimates available for 2009, and the medium-term budgetary projections. In general, these new figures reflect the impact of the crisis on public revenues and specifically on corporate income tax takings, given the severe cut in profits. Government spending grew at a strong pace, boosted by the dynamism of the automatic stabilisers, such as unemployment benefits, and by discretionary measures that seek to promote economic activity and limit job destruction. These measures included most notably the income transfers associated with schemes in some countries to shorten the working day.

Specifically, for the year 2009, the European Commission estimates that the general government budget deficit will amount to 5.3% of GDP, compared with 1.9% the previous year (see Table 3). Almost two-thirds of this fiscal impulse, approximated by the change in the deficit between the two years, would be explained by the activation of the automatic stabilisers, while the remaining third, 1.1 pp, would be linked to the discretionary measures to

EURO AREA. ACTIVITY, DEMAND AND EMPLOYMENT INDICATORS

CHART 9



SOURCES: European Commission, Eurostat and Markit Economics.

a. Non-centred year-on-year rates, based on the quarterly moving average of the seasonally adjusted series.
b. Normalised data.
c. Original series year-on-year rates. Quarterly average.

GDP AND HICP PROJECTIONS FOR THE EURO AREA (a)

TABLE 2

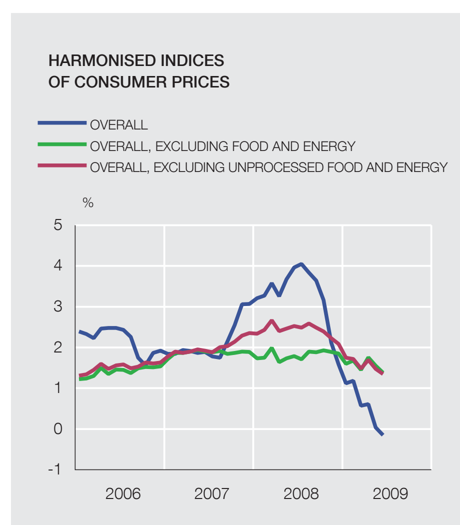
	2009		2010	
	GDP	HICP	GDP	HICP
ECB (June 2009)	-4.6	0.3	-0.3	1.0
European Commission (May 2009)	-4.0	0.4	-0.1	1.2
IMF (July 2009) (b)	-4.8	0.4	-0.3	0.6
OECD (June 2009)	-4.8	0.5	0.0	0.7
Consensus Forecast (July 2009)	-4.4	0.4	0.4	1.2
Eurobarometer (July 2009)	-4.5	0.4	0.4	1.2

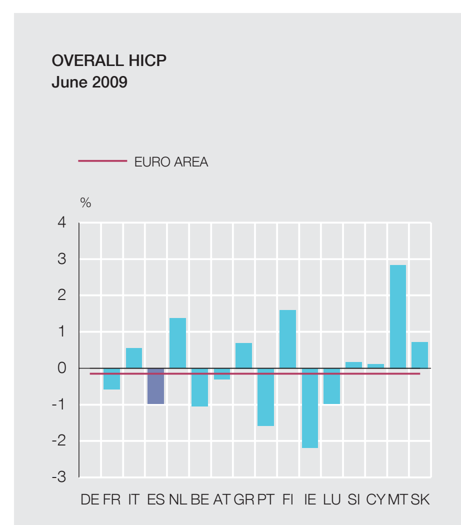
SOURCES: European Commission, *Consensus Forecast* , Eurosystem, IMF, MJ Economics and OECD.

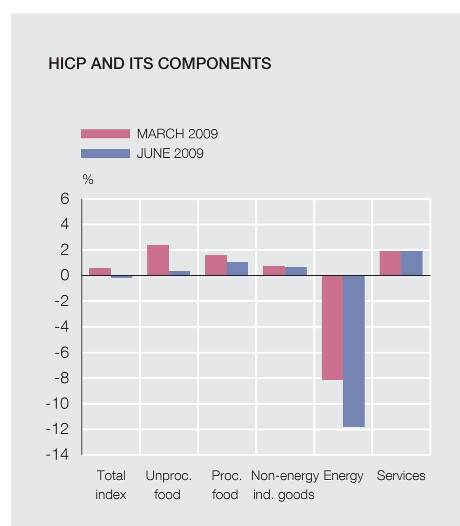
a. Year-on-year rates of change.
b. The inflation data relate to the April projection.

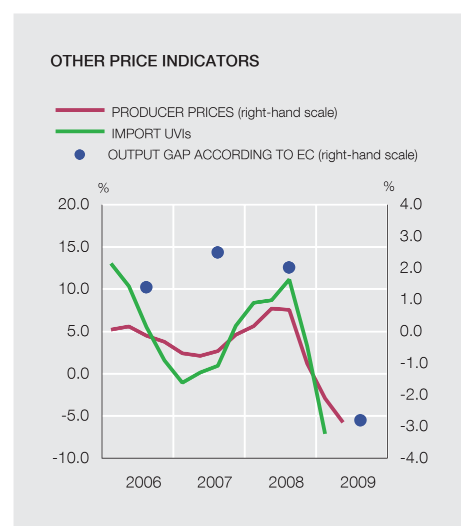
EURO AREA. PRICE INDICATORS
Year-on-year rates of change

CHART 10



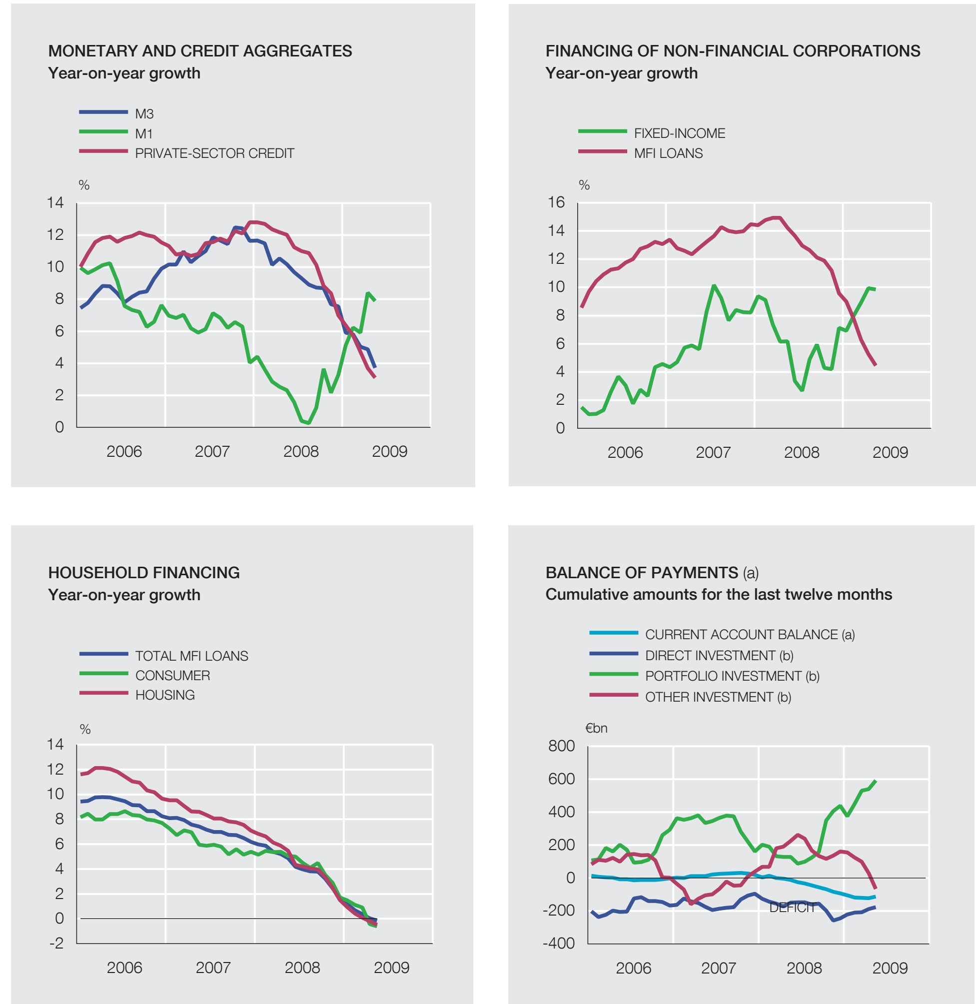






SOURCES: Eurostat and ECB.

MONETARY AND CREDIT AGGREGATES AND BALANCE OF PAYMENTS CHART 11



SOURCES: ECB and Banco de España.

a. A positive (negative) sign denotes a current account surplus (deficit).
b. Capital Inflows less capital outflows. A positive (negative) sign denotes a net capital inflow (outflow).

stimulate demand agreed under the framework of the European Economic Recovery Plan.

The European Council approved last April the excessive deficit procedure for those Member States – France, Spain, Ireland and Greece – whose deficits exceeded the reference value of 3% of GDP in 2008, and, in June, the European Commission relaunched the procedure for Malta and other EU members. This group of countries could become considerably larger in the coming months since, according to the latest Commission forecasts shown in Table 3, virtually all the members of the euro area will have budget deficits above the 3%-of-GDP ceiling laid down in the Stability and Growth Pact.

Public debt could approach 80% of GDP in 2009, as a result of the high budget deficits and the financial system support measures applied by governments. This increase in debt poses a major challenge for the euro area countries in the next few years, for it adds to the costs which an ageing population will generate. Thus, the latest estimates by the European Commission are for an increase in public spending resulting from the inversion of the age pyramid over the medium term. By 2060 it might amount to 5.2% of the euro area's GDP, mainly due to spend-

EURO AREA GENERAL GOVERNMENT BUDGET BALANCES (a)

TABLE 3

% of GDP

	BUDGET BALANCES (a)							
	2007	2008		2009			2010	
		SP (b)	EDP (c)	SP (b)	EDP (c)	EC (d)	SP (b)	EC (d)
Belgium	-0.3	0.0	-1.2	0.3	-3.4	-4.5	0.7	-6.1
Germany	-0.2	0.0	-0.1	-3.0	-2.9	-3.9	-4.0	-5.9
Greece	-3.8	-3.7	-5.0	-3.7	-3.7	-5.1	-3.2	-5.7
Spain	2.2	-3.4	-3.8	-5.8	-5.8	-8.6	-4.8	-9.8
France	-2.7	-2.9	-3.4	-3.9	-5.6	-6.6	-2.7	-7.0
Ireland	0.2	-6.3	-7.1	-9.5	-9.9	-12.0	-9.0	-15.6
Italy	-1.5	-2.6	-2.7	-3.7	-3.7	-4.5	-3.3	-4.8
Luxembourg	3.2	2.0	2.6	-0.6	-1.7	-1.5	-1.5	-2.8
Netherlands	0.3	1.2	1.0	-1.2	-3.3	-3.4	-2.4	-6.1
Austria	-0.5	-0.6	-0.4	-0.2	NA	-4.2	0.4	-5.3
Portugal	-2.7	-2.2	-2.6	-3.9	-3.9	-6.5	-2.9	-6.7
Slovenia	0.5	-0.9	-0.9	-0.6	-3.7	-5.5	0.0	-6.5
Finland	5.3	4.4	4.2	2.1	-1.9	-0.8	1.1	-2.9
Malta	-1.8	-3.3	-4.7	-1.5	-1.5	-3.6	-0.3	-3.2
Cyprus	3.5	0.5	0.9	0.5	-0.8	-1.9	0.7	-2.6
Slovakia	-2.0	-2.3	-2.2	-1.8	-2.1	-4.7	-0.8	-5.4
MEMORANDUM ITEM: Euro area (including Malta and Cyprus)								
Primary balance	2.3		1.1			-2.3		-3.3
Total balance	-0.7		-1.9			-5.3		-6.5
Public debt	66.1		69.3			77.7		83.8

SOURCES: European Commission and national stability programmes.

a. Deficit (–)/surplus (+). Cells in which the deficit exceeds 3% of GDP have been shaded.
b. Stability programme objectives submitted in spring 2009.
c. Spring 2009 notification of Excessive Deficit Procedure.
d. European Commission April 2009 projections.

ing on pensions, health care and long-term care. In this context, countries need to draw up a credible fiscal consolidation strategy without withdrawing fiscal stimulus measures that might contribute to the economic recovery at too early a stage. In view of the looming high debt levels, the members should set medium-term objectives that are more ambitious than in the past and commit themselves accordingly to achieving the compromises needed to achieve them as soon as possible.

3.2 Monetary and financial developments

After the extreme tension of recent months, the international financial markets showed signs of stabilising in Q2. As Box 3 illustrates, the improvements in the financial tension indicators have been notable and fairly generalised across markets, although they have still not attained levels which could be described as normal. The greater degree of confidence brought about an unwinding of flight-to-quality investments, in particular into government debt, and a stronger preference for higher-risk assets. These movements pushed up sovereign bond yields, while stock prices rose significantly, and risk premia in bond markets and particularly in the interbank market narrowed. Although the cost of credit continued to fall, reflecting the more accommodating monetary policy stance, financing for the private sector continued its marked decline, only partly offset by some pick-up in bonds issued by non-financial corporations.

The financial markets have been further stabilised by the actions taken by governments and the measures taken by the monetary authorities. The euro area governments continued to draw up

plans to support and restructure the financial sector. Thus, according to the latest figures from the European Commission, the effective aid given between June 2008 and April 2009 would be equivalent to almost 12% of the euro area's GDP, around one-half of the maximum package envisaged in the plans. In the last few months, in addition to the ongoing bank guarantee and recapitalisation schemes, various proposals to consolidate banks' assets have started to take shape. The initiatives, some of which are still under parliamentary review, notably include the creation of a public agency in Ireland (the National Asset Management Agency, NAMA), which will buy loans to developers from Irish banks, and the legislative amendment which will permit German banks to create 'bad banks' for illiquid and non-strategic assets.

The ECB maintained its ample liquidity supply policy, meeting all requests for funds for open market operations, and amended its operational framework. First, it established longer-term refinancing operations with a maturity of 12 months, doubling the maximum period of six months in force until then. In the first auction on 24 June, the ECB lent a record amount of more than €440 billion, which resulted in a sharp increase in the deposit facility, remunerated at a rate of 0.25%. Moreover, in July, the ECB embarked on a purchase programme for covered bonds issued in the euro area. This initiative was announced in May and aims to improve the funding of banks and, ultimately, to make access to credit easier for the rest of the economy. It will last until June 2010 and involves outright purchases, both in the primary and secondary markets, of up to €60 billion. Finally, it should be emphasised that the ECB extended its currency arrangements with the Federal Reserve and other central banks until 30 October 2009 as well as the validity of the broader list of eligible collateral until the end of 2010, and it also included the European Investment Bank as a counterparty for the Eurosystem's monetary policy operations.

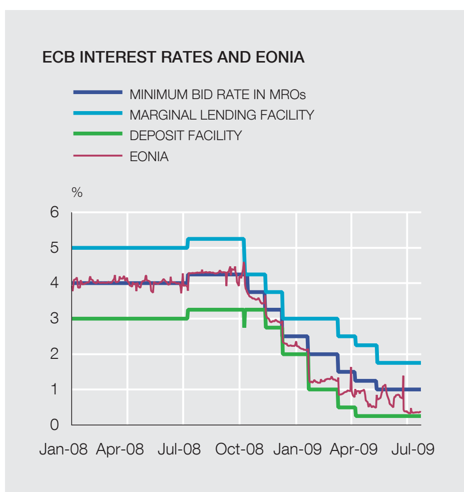
In a similar vein, the Governing Council again eased the ECB monetary policy stance with a reduction in its official rates of 25 bp in May, bringing the overall cut since October 2008 to 325 bp. Thus, the rate for the main refinancing operations stood at 1%, while those for the deposit and marginal credit facilities were at 0.25% and 1.75%, respectively (see Chart 12). Furthermore, the Governing Council reiterated throughout the quarter that medium and long-term expectations remain anchored, in line with the inflation rate objective of below, but close to, 2%, pointing out that the negative rates expected in the coming months largely reflect temporary base effects.

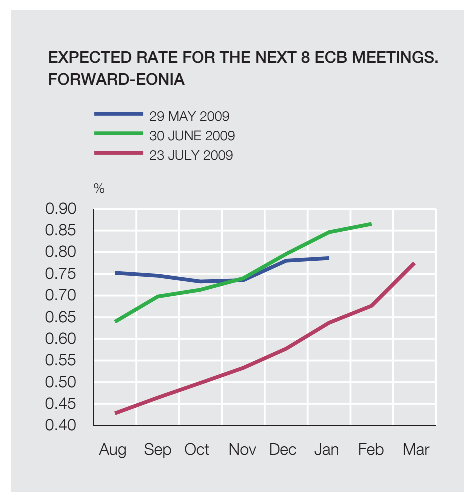
Against this background, the interbank interest rates continued to fall in Q2, mainly due to the reduction in the risk premia. The EURIBOR fell in July to below 1% and to 1.4% for maturities of between three months and one year, respectively, the lowest levels since the start of monetary union (see Chart 13). Movements in short-term rates continued to fed through to the cost of bank funding. The strongest falls occurred in variable-rate loans, which are prevalent in corporate financing, and also in home loans in some countries. However, the interest rate for consumer credit remained at relatively high levels.

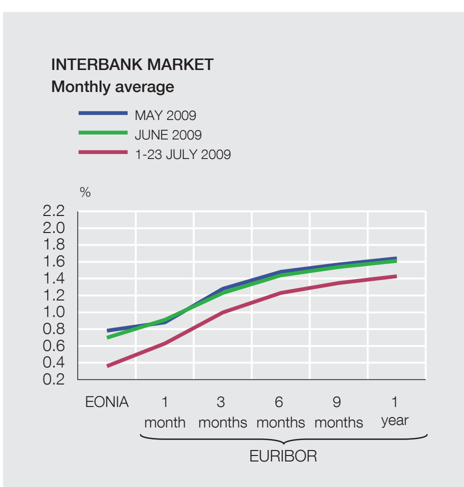
Despite the decline in the cost of financing, the predominance of stricter lending standards, as indicated in the July Bank Lending Survey, and the contraction in demand continued to make for a sharp slowdown in euro area bank lending. The year-on-year growth rate of loans to companies stood at 4.4% in May, compared with 9% at end-2008, while in the case of households, slight falls were posted in year-on-year terms in finance for both housing and consumption (figures which might be biased downwards by the sale of loans via securitisation). In the case of companies, the slower pace of bank loans was partly offset by a substantial increase in debt issuance, particularly long-term instruments, the year-on-year increase in which stood in May at over 16%.

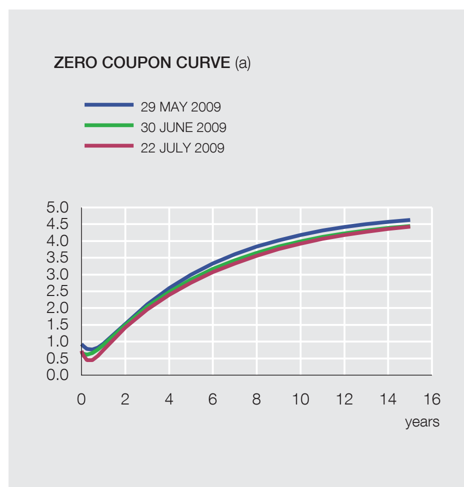
EURO AREA INTEREST RATES

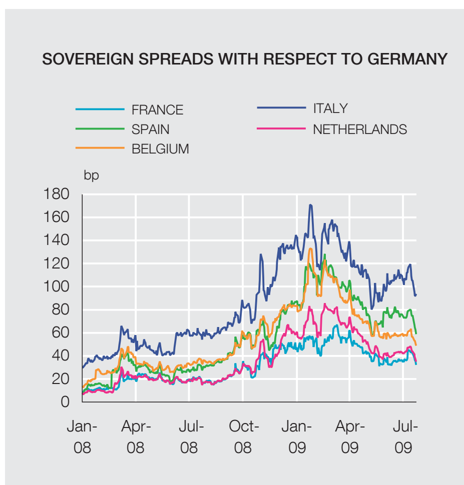
CHART 12

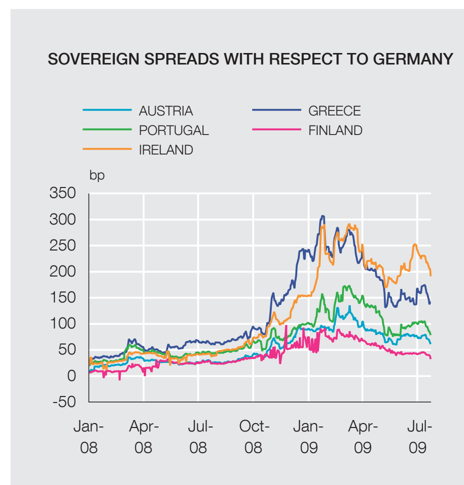










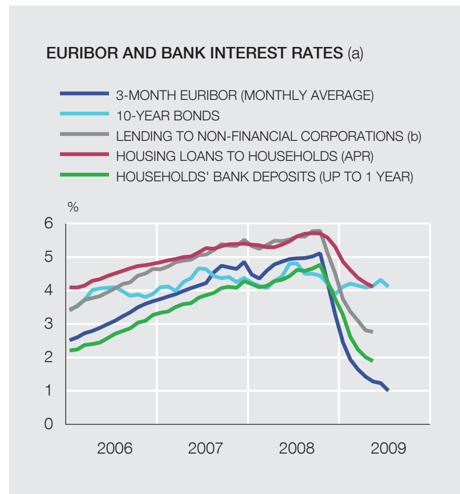


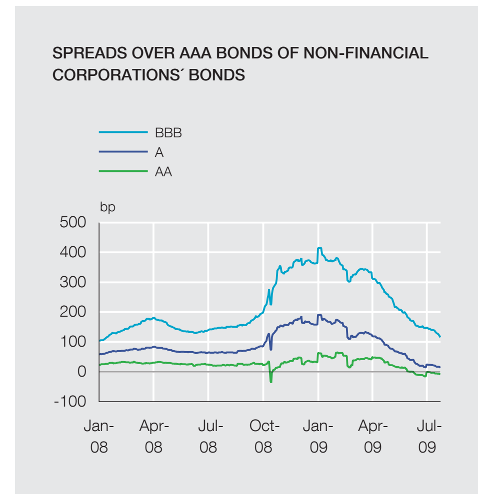
SOURCES: ECB and Banco de España.

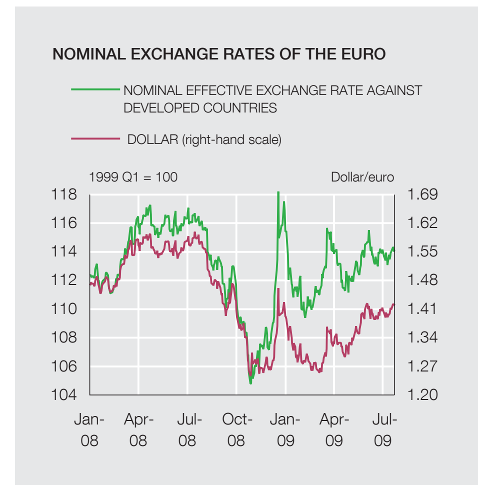
a. Estimated by the ECB using swap market data.

EURO AREA INTEREST RATES, STOCK MARKET INDEX AND EXCHANGE RATE

CHART 13







SOURCES: ECB and Banco de España.

a. For new business.
b. Floating interest rates with initial rate fixation of up to one year.

In the government debt markets, long-term interest rates started to rise, essentially reflecting the impact of the reversal of the shifts towards this safe-haven asset made at the height of the instability. The turnaround took place in mid-June, whereby long-term rates stood at 4.2% on average between April and June, a level very similar to that of the previous quarter. In the United States, despite the purchases of government debt by the Federal Reserve, the greater appetite for risk had an upward impact on benchmark rates. The yield on US sovereign bonds averaged 3.3% on average in Q2, which entailed a narrowing of the spread vis-à-vis that of the euro area. The decline in risk premia as from March, which exerted downward pressure on long rates in the euro area, was reflected in a fall in the yield spreads of the sovereign debt of various euro area countries with respect to the German benchmark. Nevertheless, this decline ended in May and risk premia remained at high levels, evidencing wide cross-country disparity.

The improvement in confidence was also apparent in a contraction in the risk premia in the private fixed-income markets, both for financial and non-financial corporations, and in a more marked way for lower-graded securities. In the same way, risk spreads in the covered bond market fell considerably after the ECB's purchase programme was announced.

The signs of stabilisation became clearer in the international equity markets, where prices started to rise across the board, particularly bank stocks, and entailed in the case of the EURO STOXX 50 index a gain of almost 25%, offsetting the declines in the first two months of the year. In addition, the reduced uncertainty contributed to the decline in volatility in Q1, steepening as from March, although it remains at high levels from a historical perspective (see Chart 13).

In the foreign exchange markets, the euro rose by 7.2% against the dollar between the end of March and the date this Bulletin went to press, until it stabilised at around $1.40 (see Chart 13). However, in nominal effective terms, the euro remained relatively stable throughout Q2, since its appreciation vis-à-vis the dollar was offset by its depreciation against other currencies, such as sterling.

Finally, the growth rate of the broad monetary aggregate M3 continued to decline, to less than 4% year-on-year in May. Lower rates of interest and the steeper slope of the yield curve led to investment switching out of M3 towards better rates of return, a move reflected in the redemption of fixed-term deposits and of marketable securities. At the same time, the fall in the opportunity cost also supported a shift in assets included in M3 towards M1 (currency and deposits).

On Quarterly National Accounts (QNA) estimates, the rate of contraction of Spanish economic activity intensified in 2009 Q1, with real GDP posting a decline of 3%, compared with a fall of 0.7% in 2008 Q4. The quarter-on-quarter rate was negative for the third consecutive quarter at –1.9%, down 0.9 pp on the previous quarter. The fall-off in economic activity reflected the sharp contraction in national demand, which declined by 5% in year-on-year terms. By contrast, net external demand continued to make a positive contribution to GDP growth (2.3 pp), against a background in which both imports and exports of goods and services declined considerably. On the supply side, value added fell across all branches of activity, including market services. In line with this deterioration in activity, the pace of job destruction quickened, posting a year-on-year rate of change of –6% on QNA figures, taking productivity growth to 3.1%.

According to the available information, the Spanish economy continued to shrink in 2009 Q2, although at a more moderate pace, against a background marked by a certain degree of normalisation on the financial markets and a slightly less adverse macroeconomic outlook at an international level. Specifically, the estimated year-on-year change in GDP in 2009 Q2 was –4%, down by more than 1 pp on that seen in 2009 Q1 (see Chart 14). In quarter-on-quarter terms, GDP is estimated to have declined by –0.9%, as opposed to –1.9% in Q1. This would reflect the contraction in national demand, which is estimated to have fallen by 6% in comparison with the same quarter a year earlier. The contribution to GDP growth from the external sector is estimated to have risen slightly, to 2.4 pp, although the intense fluctuations in world trade, with a sharp fall in the previous quarters and a better performance more recently, continue to severely hamper this estimate.

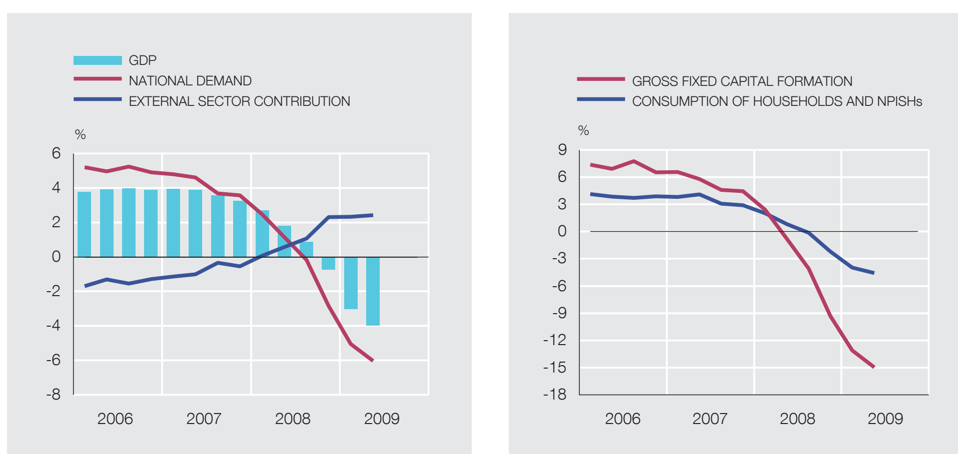
Also on the supply side, the most recent indicators point to a degree of slowdown in the rate of decline of GDP and in the rate of labour market adjustment. On these estimates, employment growth could drop by some 6.8% in year-on-year terms, while apparent labour productivity growth – due, fundamentally, to extensive job destruction – seems to have stabilised at a high level, following the sharp rebound seen since the start of 2008. Compensation per employee continued to rise at a much higher pace than inflation, with only a minor decrease in the rate of change of unit labour costs. Lastly, turning to inflation, the year-on-year rate of change in the CPI fell substantially in the period between April and June, standing at –1% at end-June. This prompted further narrowing of the inflation differential with the euro area, which stood at –0.9 pp at the end of H1, the lowest value since the start of monetary union.

4.1 Demand

The slowdown in final consumption spending of households and NPISHs seen in previous quarters continued in 2009 Q2 (see Chart 14). The various indicators continued to record sharp declines, although at a more moderate pace than in the opening months of the year (see Chart 15). Among the qualitative indicators, consumer confidence made a partial recovery in the last few months, after posting an all-time low in February; retail confidence also improved in Q2. In the case of the quantitative indicators, the tax authorities' data on large corporations for April and May recorded further sharp declines in year-on-year terms in domestic sales of consumer goods and services, while the rate of contraction of the retail trade index moderated somewhat in April-May. Lastly, the positive impact of the government's Plan 2000E on car purchases by individuals in June is noteworthy, as although new car registrations declined by 15.9% year-on-year in the month, this was the most moderate drop since May 2008.

MAIN DEMAND AGGREGATES (a)

CHART 14



SOURCES: INE and Banco de España.

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

Weak household consumption spending reflects the significant deterioration in the labour market, the high economic uncertainty and the continued tight credit conditions, although the latter may have been offset to some extent by the cut in bank interest rates. Household wage income has decreased as a result of job losses, offsetting the positive impact that lower tax payments and higher welfare-related benefits have had on household disposable income. Financial wealth was boosted in 2009 Q2 by the recovery in the stock markets, recording gains on end-2008, although real estate wealth, which is the most important component of household wealth, continued to be adversely affected by falling house prices. According to the latest data of the non-financial accounts of the institutional sectors, the household saving rate rose again in 2009 Q1 to 14.1% of disposable income in cumulative four-quarter data, an increase of 1.1 pp on end-2008 and of 4 pp on a year earlier.

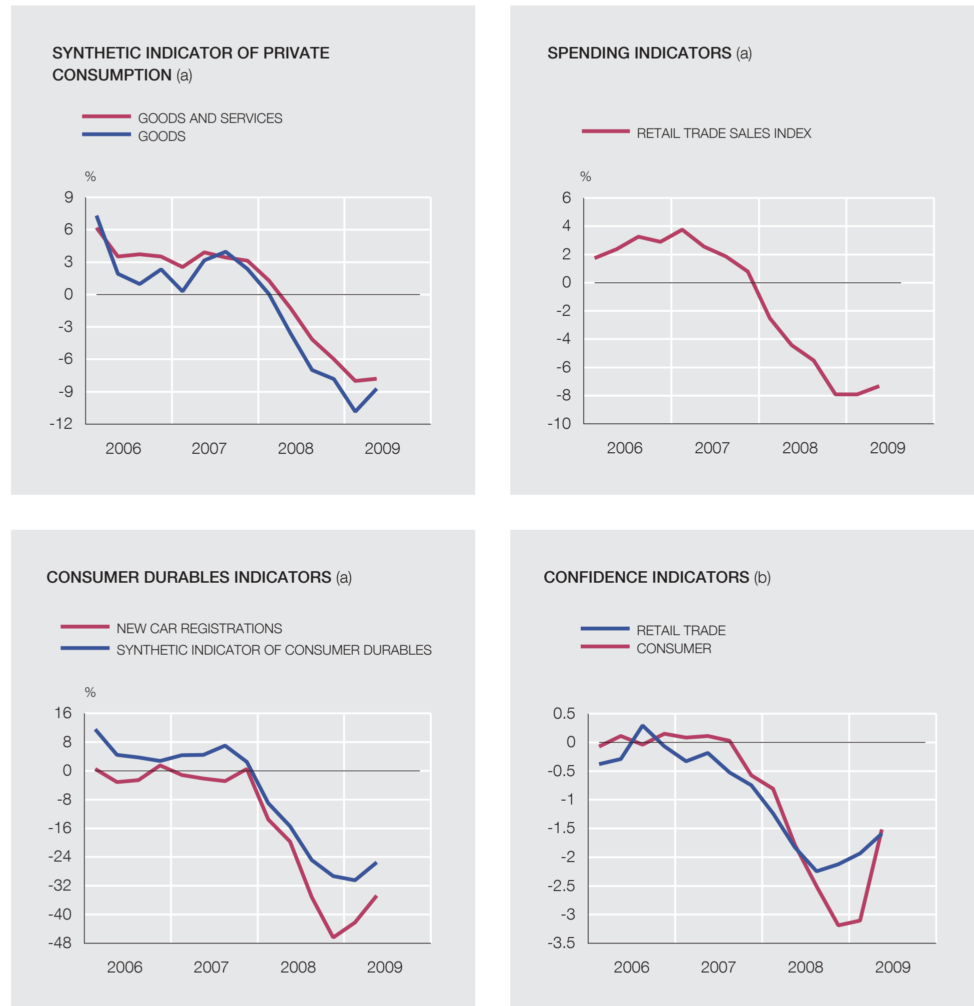
General government final consumption continued to grow substantially in 2009 Q2, albeit more slowly than in the previous quarter, according to available information on net purchases of goods and services drawn from the State budget outturn.

On the available economic information, the decline in investment in capital goods quickened in 2009 Q2 (see Chart 16). In this respect, apparent investment in capital goods and new commercial vehicle registrations continued to contract sharply. Business confidence, in industry overall and, in particular, in the capital goods sector, remained very low, despite a minor rebound, especially in the component reflecting future production expectations. The decline in both national and external demand, the uncertain economic recovery outlook and the persistently tight bank credit conditions continued to deter non-financial corporations from undertaking new investment projects, despite the interest rate cuts. According to the non-financial accounts of the institutional sectors, the decline in business investment prompted a decrease in the sector's net borrowing in 2009 Q1, down to 6.4% of GDP in cumulative four-quarter data (1.1 pp less than in 2008 Q4). Firms' higher saving, driven by lower net interest payments and lower tax disbursements, also contributed in this respect, although to a lesser extent.

The rate of decline of investment in construction moderated in 2009 Q2, although it remained very high (see Chart 16). Labour market indicators in this branch (Social Security registrations and registered unemployment) and input indicators (apparent consumption of cement and domestic production of construction materials) all fell in the quarter at a more moderate pace

PRIVATE CONSUMPTION INDICATORS

CHART 15



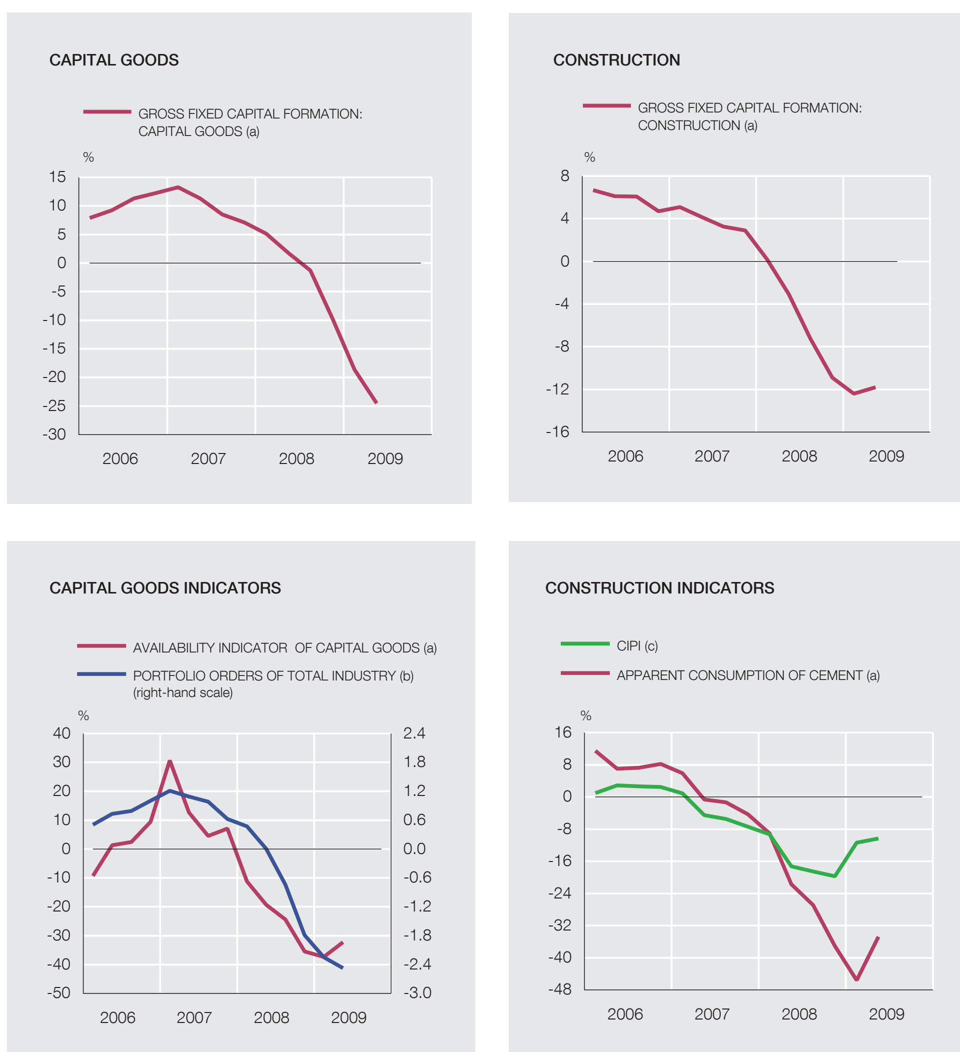
SOURCES: INE, European Commission, ANFAC and Banco de España.

a. Year-on-year percentage change based on the seasonally-adjusted series.
b. Normalised indicators (deviation from the mean, divided by the standard deviation).

than in previous months, while construction firms' qualitative indicators showed some improvement in confidence.

This pattern of investment in construction overall in 2009 Q2 reflected a disparate performance by component, as the rebound in investment in civil engineering projects offset the heightened slowdown in residential investment. In fact the adjustment in residential investment seems to have accentuated in 2009 Q2, as a result of the significant decline in the number of housing starts in previous quarters and, possibly, of the increase in lead times of work already under way. This reflects the behaviour of unsubsidised housing starts, as the number of subsidised housing starts has risen and these now account for almost half of the total. On the demand side, in recent months there has been a certain slowdown in the rate of decline of property transactions, in accordance with transactions figures and the number of mortgages granted. As in previous quarters, the continuing tight credit conditions, the expectations of price falls and the worsening outlook for household income growth are all acting as a deterrent to housing demand, although the drop both in prices and interest rates has meant that affordability indicators have improved. The data on new project approvals reflect further contraction in non-residential construction, while civil engineering

GROSS FIXED CAPITAL FORMATION CHART 16



SOURCES: INE, European Commission, Eurostat, OFICEMEN and Banco de España.

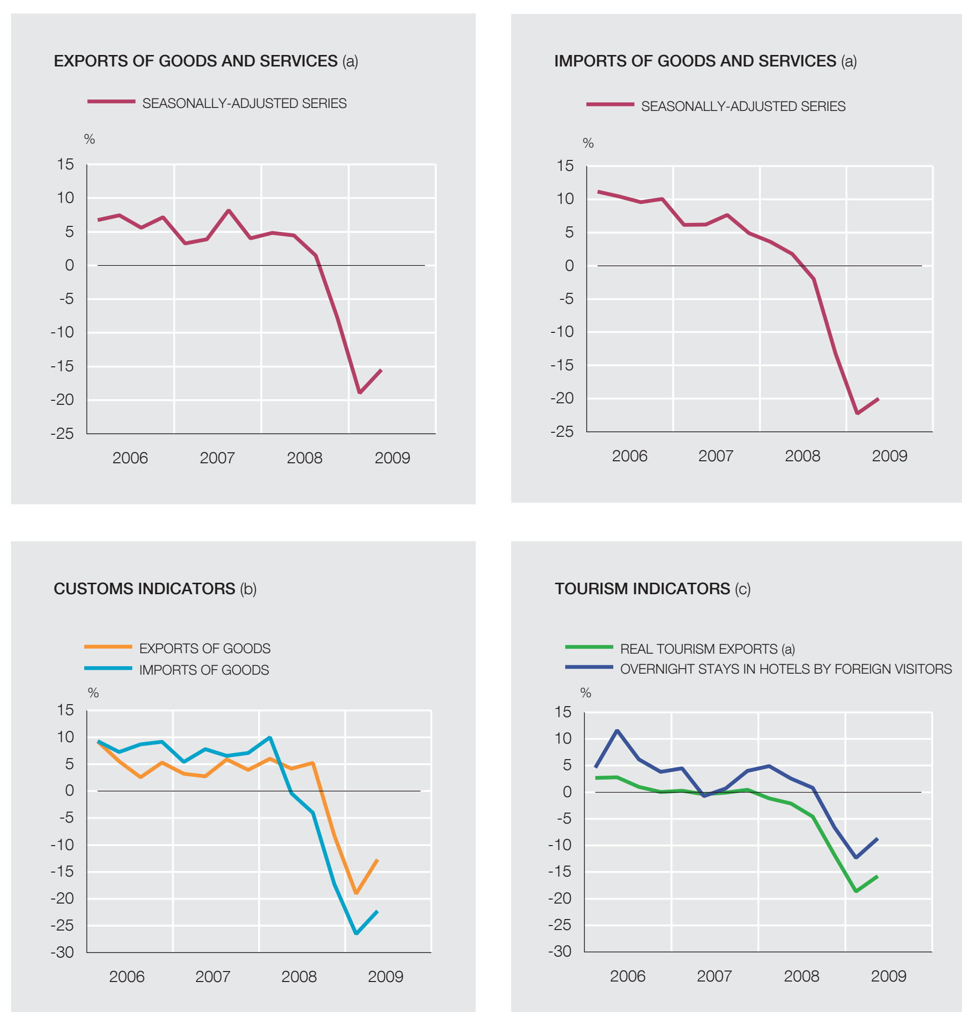
a. Year-on-year percentage change based on the seasonally-adjusted series.
b. Normalised indicator (deviation from the mean, divided by the standard deviation).
c. Construction input price index (Eurostat). Year-on-year percentage change based on the original series.

works rebounded significantly due to the increase in rail works – in light of the tenders issued in 2008 – and of local government investments linked to the State Fund for Local Investment.

In light of the latest information available for Q2, as yet incomplete, the contribution of net external demand to GDP growth could possibly be up slightly on the previous quarter, continuing in the positive tone seen since the start of 2008. This reflects the marked declines in year-on-year terms both in imports and exports, although both seem to have moderated somewhat when compared with Q1 (see Chart 17). The fall in imports was in step with the poor performance of consumption, investment in capital goods and exports and with the sharp adjustment in industrial production. For their part, exports continued to record high rates of decline in year-on-year terms, against a backdrop of continued notable weakness in world trade, although most recently there appear to be some signs of recovery. In any case it should be noted that the decline in relative prices in 2009 H1 resulted in improvements in the price-competitiveness indices vis-à-vis the developed countries.

FOREIGN TRADE
Year-on-year percentage change

CHART 17



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

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

On Customs data, real goods exports fell by almost 20% year-on-year in April and May, very much in line with the decline seen in 2009 Q1. By product group, exports fell across the board, but especially exports of intermediate products, consumer durables and capital goods. By geographical area, the decline was equally pronounced in real exports to the rest of the EU and to the rest of the world. As regards real services exports, the balance of payments figures to April point to a more moderate decline in the rate of fall of tourism services. This is backed up by real tourism indicators, which include numbers of tourists entering Spain and numbers of overnight hotel stays, whose rate of decline fell in 2009 Q2, as did that of nominal spending by foreign visitors. By contrast, also on balance of payments figures, non-tourism services exports may have deteriorated further in Q2.

In the case of imports, Customs data show that purchases of goods abroad fell by around 24% year-on-year in the period April-May, slightly less than in Q1. By product group, the biggest decreases, approaching 30%, were in capital goods and non-energy intermediate goods, while food imports – which are less sensitive to the cycle – continued to record more moderate declines. Lastly, real imports of services continued to fall in 2009 Q2, at a pace similar to that seen in Q1.

4.2 Output and employment

The year-on-year rate of decline of the gross value added of the market economy as a whole quickened in 2009 Q2, although, as in the case of GDP, the quarter-on-quarter rate of contraction was less pronounced than in the opening months of 2009. This was seen in all branches of activity, with the exception of construction, which contracted at a lower year-on-year rate, and agriculture, which posted positive year-on-year rates in the period April-June (see Chart 18).

The value added of industry as a whole is expected to fall significantly year-on-year in Q2. The industrial production index (IPI) contracted in April-May, at a rate similar to that seen in Q1. By product type, decreases were seen across the board, but especially in the industries producing capital goods and non-energy intermediate goods. Labour market indicators, such as Social Security registrations, continued to decline year-on-year, although at a more moderate pace. At the same time, the main industry sentiment indicators, such as the manufacturing PMI and the business confidence index, showed minor signs of improvement, despite remaining close to the lows recorded at the start of the year (which were, in turn, close to the all-time lows).

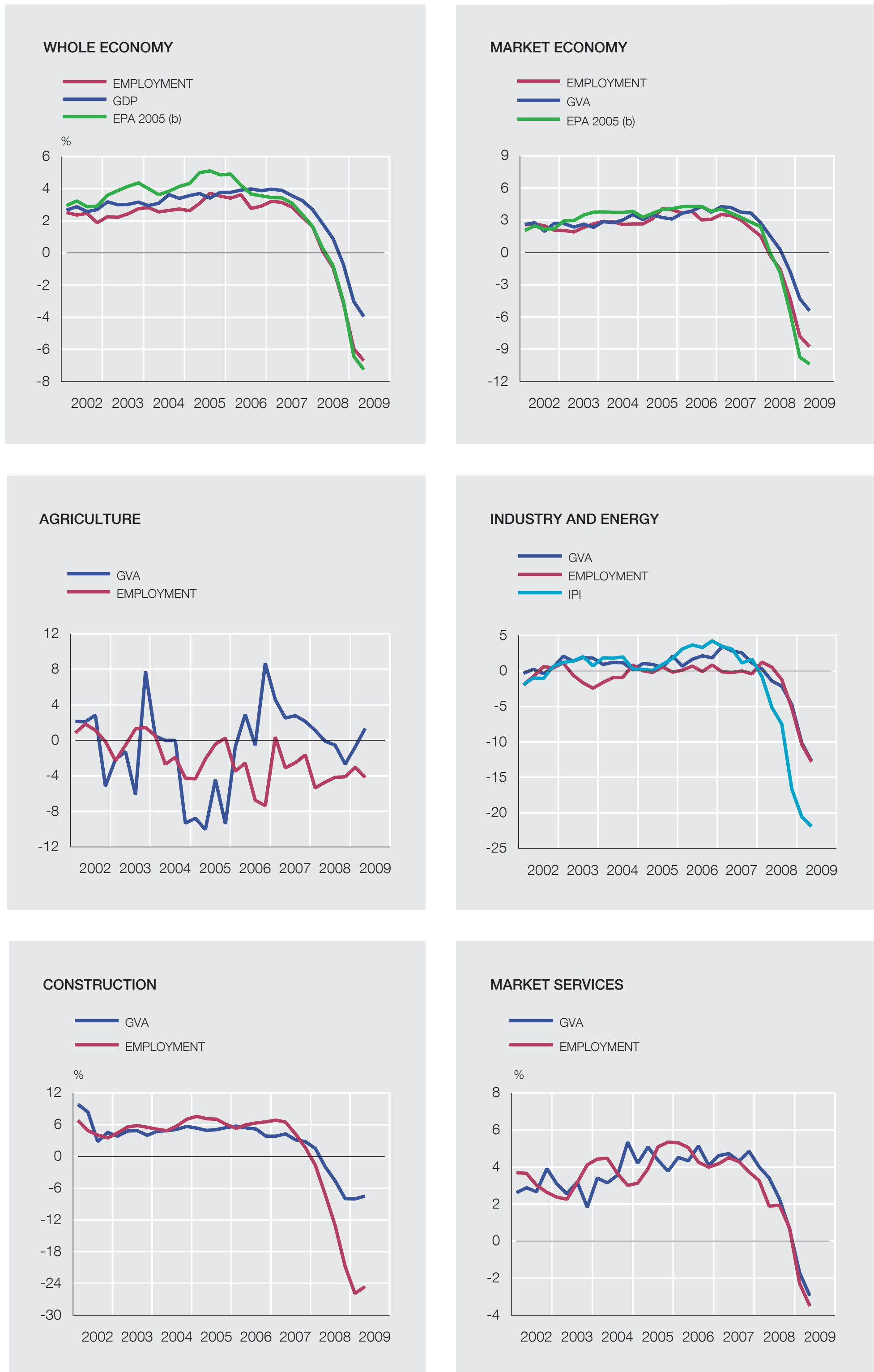
Construction activity declined at a slightly more moderate pace in 2009 Q2, as reflected by the information available from the main coincident indicators. As mentioned earlier, it is estimated that this minor slowdown in the rate of contraction in this branch is connected with the projects implemented under the State Fund for Local Investment.

In the case of the services sector, the latest conjunctural information available points to a sharper year-on-year decline in 2009 Q2 than in the previous quarter, although the various indicators record different behaviour. Thus, among the quantitative indicators, the rate of decline of turnover moderated slightly in May, but sales of large corporations worsened somewhat, both in real and seasonally-adjusted terms, in comparison with the previous quarter, while employment indicators continued weak. In terms of sentiment indicators, services sector confidence remained at the low level seen in Q1, while the retail confidence indicator and the PMI indicator both gave signs of a minor improvement. By branch of activity, the deterioration was across the board, but most especially in transport and business services, while retail fell at a similar rate to that seen in Q1 and IT and communications services showed less weakness.

The labour market indicators available point to a deceleration in the pace of job destruction in 2009 Q2. Specifically, although the year-on-year rate of change in Social Security registrations declined by a further 0.8 pp, to –6.7%, this decrease was less pronounced than in the two previous quarters. The monthly changes, according to the seasonally-adjusted series, were also lower than in previous months. Moreover, the year-on-year decline in hires drawing on INEM (National Public Employment Service) figures was less pronounced in April-May than in Q1 (–19.9% and –25.4%, respectively). Lastly, the Spanish Labour Force Survey for Q2 indicates a year-on-year fall in employment of –7.2%, down 0.8 pp on the previous period. The decrease in employment seems to have affected all branches of the market economy, especially industry (–13.7%) and construction (–24.6%), although in the case of the latter, the sharp year-on-year rate of decline moderated somewhat, most likely as a result of the activities connected with the State Fund for Local Investment.

On Spanish Labour Force Survey data, the decline in employment affected not only dependent employees (– 6.6%) but also the self-employed (–10.3%). As in Q1, job destruction was most pronounced among foreign workers (–9.2%), although employment among Spanish nationals also fell sharply (–6.9%). As regards contract duration, the year-on-year rate of decline among temporary employees moderated slightly (–19.8%), although this group continued to account for almost all the labour market adjustment, while the year-on-year rate of change among permanent workers turned negative (–1.1%). As a result, the temporary employment

GROSS VALUE ADDED AND EMPLOYMENT BY BRANCH OF ACTIVITY (a) CHART 18



SOURCES: INE, Ministerio de Fomento and Banco de España.

a. Year-on-year rates based on seasonally-adjusted series, except for the EPA which is based on crude series. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.
b. Series linked by the Banco de España's DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied up to 2004 Q4.

WAGE INDICATORS AND LABOUR COSTS

CHART 19

SOURCES: INE and Ministerio de Trabajo e Inmigración.

a. The last year, with information of collective bargaining agreements until June 2009.
b. Previous year's indexation clause.
c. ETCL (quarterly labour costs survey). Year-on-year rates of change.
d. Revised: collective bargaining agreements with economic effects in the year but which were signed in previous years and are in force for more than one year. New: collective bargaining agreements signed and with economic effects in the year, this being the first or only year they are in force.

ratio stood at 25.2%, some 4 pp less than a year earlier. Lastly, part-time hires increased slightly, in contrast to the sharp reduction in full-time hires, so that, as in the last few quarters, the part-time employment ratio rose, to 12.9% from 12% a year earlier.

The slowdown in the rate of growth of the labour force first seen in 2009 Q1 quickened in Q2, to 1.2% year-on-year, almost 1 pp less than at the start of the year. This was due to the deceleration in the rate of growth of the population over 16 years of age, which rose by 0.7% (0.3 pp less than in the previous quarter) and to the sharp drop in the year-on-year rate of growth of the participation rate (0.3 pp less than in the last few quarters). This moderation was seen in both the male and female workforce, although the female segment continued to record strong momentum (3.4%), while the male segment recorded slightly negative figures (–0.4%). By nationality, the growth rate of foreign nationals in the workforce slowed to 5.3%, mainly as a result of smaller immigrant inflows (4.2%, in comparison with 6.3% in Q1). The rate of growth of Spanish nationals in the workforce also moderated, rising by 0.5% year-on-year (against 1.3% in Q1).

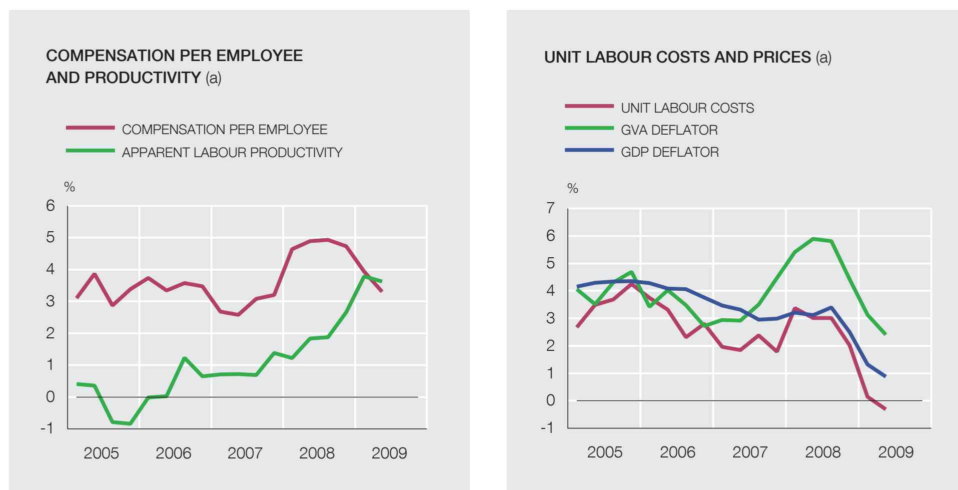
Lastly, unemployment rose again in 2009 Q2, although at a slower pace than in previous quarters. The ranks of the unemployed swelled by 126,000 people in Q2, bringing the year-on-year rate of growth down to 73.7% as a result of the lower momentum in job destruction and the slowdown in the rate of growth of the labour force. Nevertheless, the unemployment rate rose again, to 17.9%, up 0.5 pp on the previous quarter. The INEM registered unemployment figures rose by 52.9% on average in Q2, above the increase recorded in Q1, although the rate of growth of the numbers of registered employed has moderated somewhat in recent months.

4.3 Costs and prices

The data available on collective bargaining agreements registered to June 2009 show an average increase in wage settlements of 2.7% in 2009 H1, as opposed to the 3.6% increase in wage settlements in 2008 (following compilation of the data received subsequent to the 2008 close) (see Chart 19). These agreements affect some 7.5 million workers (almost 70% of the

PRICES AND LABOUR COSTS IN THE MARKET ECONOMY

CHART 20



SOURCES: INE and Banco de España.

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

numbers affected in 2008). However, it is estimated that the indexation clauses will have no effect on wage costs in 2009, as inflation stood at 1.4% at end-2008, below the 2% threshold above which these clauses generally come into effect.

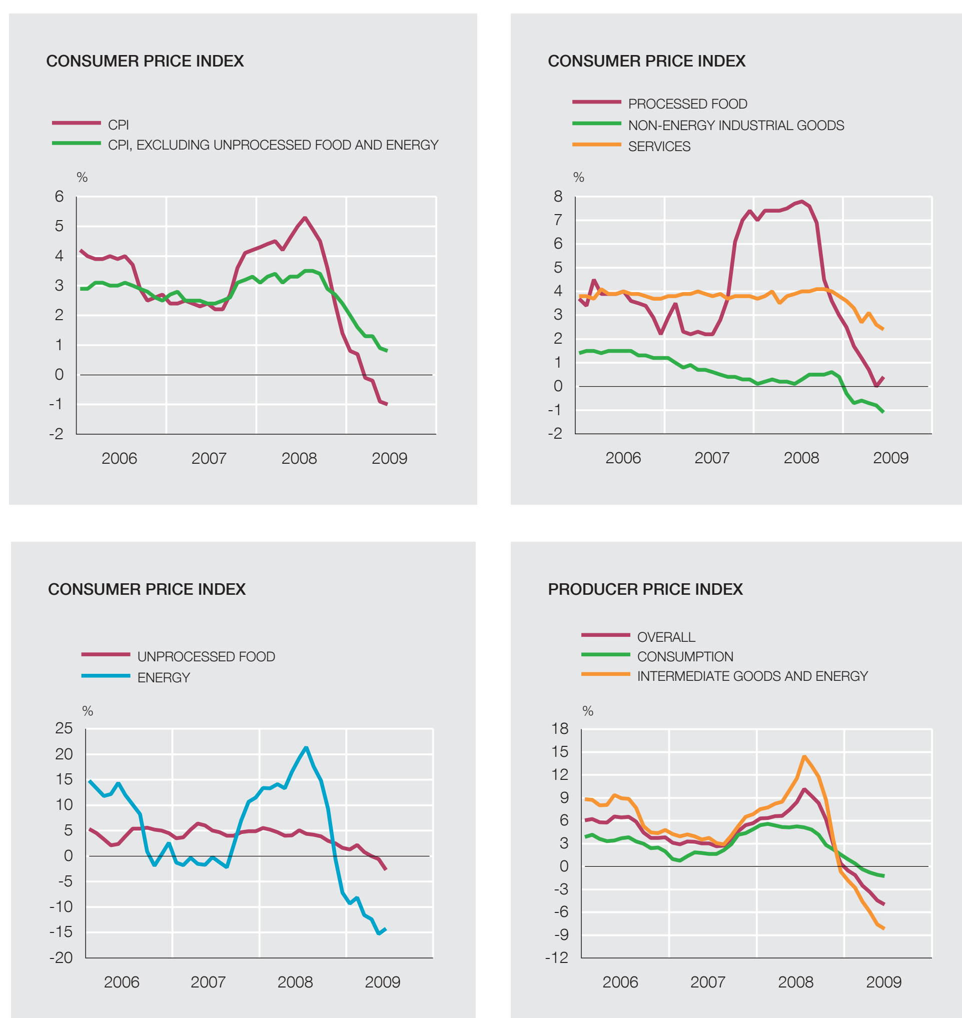
Consequently, owing to the smaller wage settlements and to the absence of inflation deviation payments, QNA figures for 2009 Q1 recorded a decrease in the rate of growth of compensation per employee: specifically, compensation rose by 4% year-on-year in Q1 in the economy as a whole, and by 3.9% in the market economy, down 1.2 pp and 0.8 pp, respectively, on 2008 Q4. The rate of growth of compensation per employee is expected to decline slightly again in 2009 Q2, albeit while continuing to rise considerably faster than prices. This slightly lower rate of growth estimated for nominal wages in Q2, together with stabilisation of the rate of growth of productivity, should lead to a minor deceleration in unit labour costs (see Chart 20).

The domestic component of inflation (measured by the GDP deflator) is expected to have grown at a slower pace in 2009 Q2, while import prices are expected to have fallen, affected, inter alia, by the fluctuations in the oil price. Both factors would have made a major contribution to the significant reduction in the year-on-year rate of change of the final demand deflator. By component, the decline in the goods exports deflator is expected to have quickened, while the rate of growth of the various components of national demand is expected to have fallen. The residential investment deflator is expected to have fallen sharply – in line with house prices – while the private consumption deflator will foreseeably record a negative rate of change.

In effect, consumer prices continued to decelerate notably in Q2. Thus, the year-on-year rate of change of the CPI, which turned negative in March, declined further, recording a rate of –0.7% on average in the quarter and of –1% in June 2009 (see Chart 21). Inflationary pressures weakened across the board. Especially significant in June was the decline in the prices of energy goods, which fell by 14.2%, a decrease of almost 3 pp more than that recorded at end-March. This was a result of the lower oil prices on the international markets, although the depreciation in year-on-year terms of the euro against the dollar continued to moderate the impact on domestic prices. The prices of non-energy industrial goods and unprocessed food also recorded negative rates of change at the end of Q2 (–1.1% and –2.7%, respectively), while processed food prices continued to post positive rates of change (0.4% in June), albeit

PRICE INDICATORS (a)
Spain

CHART 21



SOURCE: INE.

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

significantly lower than those seen at the start of the year. Lastly, services prices, which have traditionally shown little sensitivity to cyclical changes, decelerated significantly, to 2.4% in June. As a result, the CPI excluding unprocessed food and energy prices continued in the downward pattern first seen at the end of 2008, closing the quarter at a year-on-year rate of 0.8%, 0.5 pp below the end-March figure.

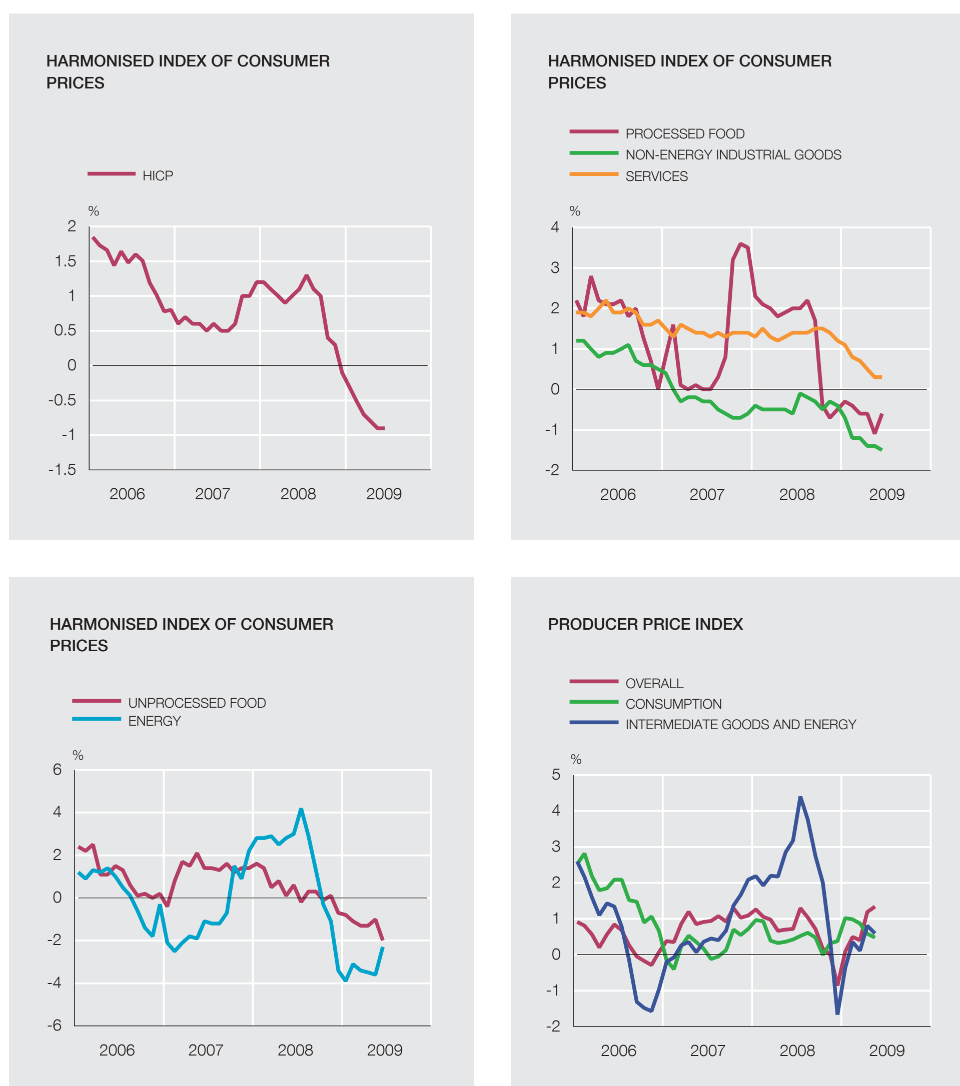
Price adjustments in Spain are proving more intense than in the euro area. Thus, since December 2008, the inflation differential – as measured by the harmonised index of consumer prices (HICP) – has been negative for the first time since the start of monetary union, and it has continued to widen, standing at –0.9 pp in June (see Chart 22). All the components showed rates of change below those of the euro area, with the exception of services, although this differential has also narrowed substantially since December (see Box 5 for comments on the latest regulatory changes in connection with the services sector). In light of these developments, Spanish core inflation was lower than that of the euro area for the second consecutive quarter.

The rate of growth of the producer price index moderated further in 2009 Q2, standing at –5% in June (2.5 pp down on March), thus continuing in the deflationary pattern first seen in sum-

PRICE INDICATORS

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

CHART 22



SOURCES: Eurostat and Banco de España.

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

mer 2008. The moderation in the index in Q2 affected its various components, although the slowdown in prices of energy goods was particularly notable. Prices also fell in all other product groups, with the sole exception of capital goods. To May, the rate of growth of producer prices in the euro area as a whole decelerated more sharply than in Spain, widening the positive differential. The rate of decline of trade price indices intensified for both imports and exports, chiefly as a result of the behaviour of intermediate and energy goods.

4.4 The State budget

The cash-basis figures for 2009 H1 show an amplified State deficit of €36,819 million, as opposed to a deficit of €2,065 million in 2008 H1 (see Table 4). This deterioration is due: on the one hand, to the sharp fall (29.4%) in tax receipts, reflecting not only the impact of the economic slowdown on tax revenue but also the effect of the measures approved by the government (relating primarily to withholdings on earned income and VAT); and on the other, to strong expenditure growth (22.9%) in comparison with the same period a year earlier, driven by the impact of the transfers to the State Fund for Local Investment. In light of the income and expenditure patterns seen, and of the outlook for H2, significant differences may be expected for

LIBERALISATION OF THE SERVICES SECTOR IN SPAIN IN THE CONTEXT OF TRANSPOSITION OF THE SERVICES DIRECTIVE

BOX 5

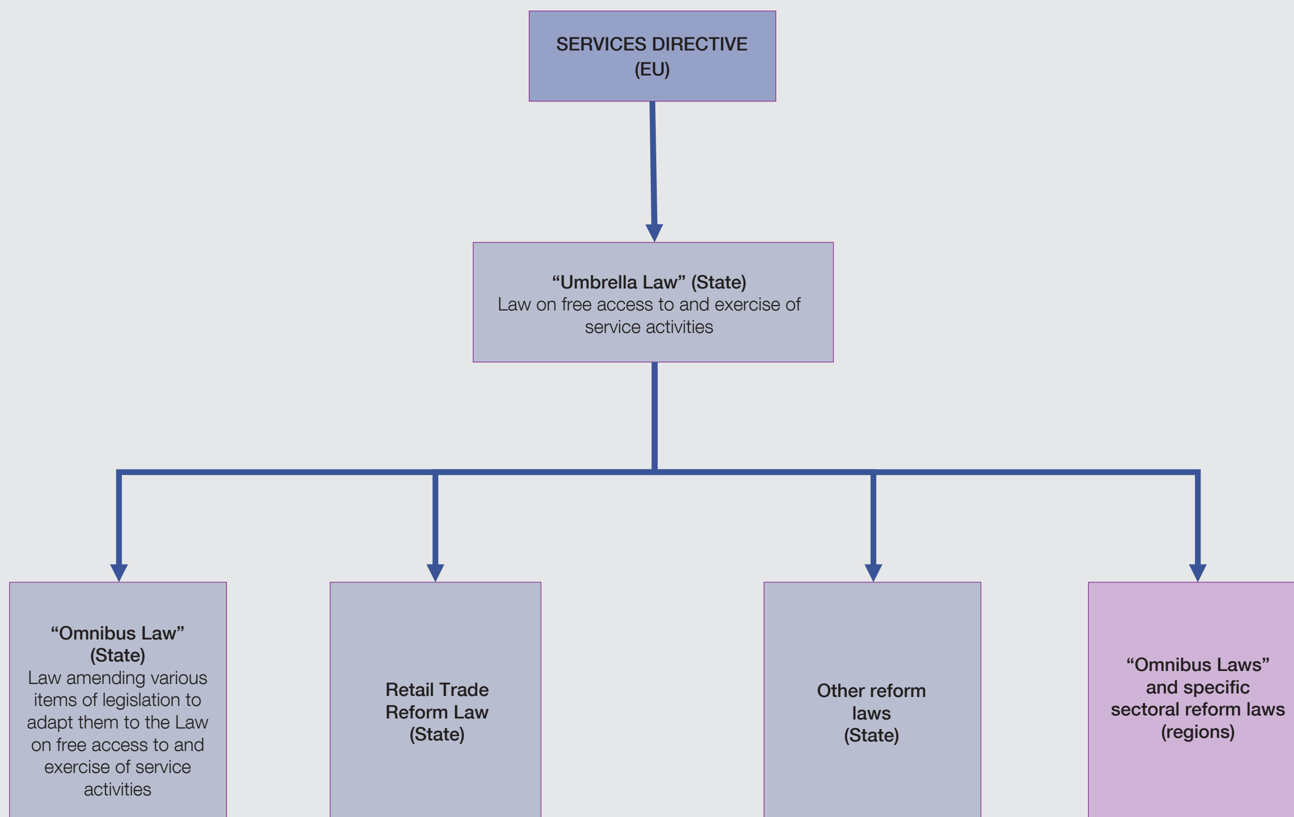
On 12 December 2006, the European Parliament and Council approved Directive 2006/123/EC on services in the internal market, in response to the concern that over-regulation of markets for services could be creating barriers to entry in the different sectors and could, therefore, be reducing competition in the European economies. The Directive[1] aims to liberalise market services in the EU, by reducing administrative burdens and removing conditions on entry for new firms, particularly conditions connected with restrictions on companies becoming established on grounds of nationality.

Correct transposition of the Services Directive is essential for enhanced competition and liberalisation of sectors that represent a very high proportion of value added (44%) and employment (42%) in the Spanish economy (albeit still below the figures seen in the more highly-developed economies) and that include particularly dynamic activities in terms of job creation. Moreover, this sector constitutes the core of inflationary pressure in the Spanish economy.

1. The Directive must be transposed into national law, by 28 December 2009 at the latest, before it can affect firms and consumers.

The process of transposition of the Directive in Spain is particularly complex, as it involves reform of both State and regional legislation (see adjoining diagram).On 27 March 2009, the Council of Ministers approved the draft law on free access to and exercise of service activities. This draft law, known as the "Umbrella Law", reflects the Directive's "generic" liberalisation mandate, laying the foundations for more specific reforms at sectoral level. The essential contents of the draft bill are threefold. First, it sets out the general principle of freedom of establishment, which may only be limited on grounds of "general interest", proposing a review of all the conditions and authorisations required in Spain for establishment of new competitors. Second, it simplifies the administrative procedures in general, for example, backing the introduction of online contact with the administration and of "points of single contact". Third, it encourages cooperation between administrations, both at national and international level, to improve their relationship with the services sector and achieve effective communication of information on the exceptions to the free establishment of companies.

In addition to this general liberalisation, transposition of the Directive will require reform of specific sectoral legislation. Some of these reforms will affect State legislation, while many others will



SOURCE: Banco de España.

LIBERALISATION OF THE SERVICES SECTOR IN SPAIN IN THE CONTEXT OF TRANSPOSITION OF THE SERVICES DIRECTIVE (cont'd)

BOX 5

affect regional legislation, in accordance with the distribution of powers. The main package of State legislation reforms is contained in the "Omnibus Law", whose draft, approved by the Council of Ministers on 12 June, amends 47 existing laws on matters as wide-ranging as patent registrations and the sale of hydrocarbons.

The draft "Omnibus Law" introduces a number of "horizontal measures" that affect firms in all sectors and are closely connected with the general objectives of the draft "Umbrella Law". Thus, inter alia, the Law regulating the Bases of Local Government is amended, to introduce a (virtual) "point of single contact" for companies and permit online contact with local authorities. The Law on Online Access to Public Services for the Public is amended likewise. For its part, Law 30/1992 on General Government and the Common Administrative Procedure is amended to extend the scope of deemed authorisations owing to the absence of a negative decision ("affirmative administrative silence"). The Law on Professional Institutions and the Law on Professional Associations are also amended, removing restrictions on advertising of professional services, together with some of the existing limitations on the joint exercise of several professions and the fee schedule guidelines. Furthermore, a ceiling is placed on professional association membership costs, which may not exceed the costs associated with processing of the inscription. For the time being, however, membership of the corresponding professional institution or association and obtaining of the corresponding licence remain obligatory. These two aspects will be dealt with at a later date in further legislation, once the "Omnibus Law" has been passed.

Also under the draft "Omnibus Law", 16 authorisation processes are abolished and another 32 are replaced by less restrictive conditions, such as "prior notice" of start-up of an activity or "responsible statements". In these cases, administrative control over the activity conducted becomes ex post rather than ex ante.

It should be stressed that the "Omnibus Law" does not cover all the reforms of State legislation affected by the Directive, as some, owing to their complexity, require specific reform measures. For example, retail trade legislation; in this case, the Council of Ministers approved another draft law on 10 July[2] which, in accordance with the provisions of the Directive, establishes that the regional (autonomous) governments may no longer cite economic grounds as the basis for refusal to grant permission for new openings of certain retail formats. However, the draft law does not abolish the authorisation process, which has, in fact, become stricter in recent years,[3] and includes the possibility of it being tightened on "grounds of general interest", with no limitation on the scope of this concept.

In general, the above-mentioned draft laws contain elements that should facilitate access to service activities and reduce the administrative burdens borne by companies, in particular in connection with removal, not only of the need for authorisation for access to and exercise of a service activity, but also of the obstacles hindering the free movement of services by providers with no permanent establishment in Spain. However, the success of the reform, in terms of greater liberalisation of services, will depend on its correct application in key sectors, such as professional services or retail trade, where the current barriers to entry may be especially restrictive of competition, and on strict delimitation of the exceptions permitted, for which purpose the regional (autonomous) and local governments will have to work in their respective areas of responsibility. In the case of retail trade, the draft law amending the Retail Trade Law may prove insufficient to bring about a significant change in the present systems of authorisation in the retail sector approved by the regional (autonomous) governments and which restrict competition.

2. Draft law amending Retail Trade Law 7/1996, of 15 January 1996. **3.** M. Ll. Matea and J. S. Mora (2009), "*La evolución de la regulación del comercio minorista en España y sus implicaciones macroeconómicas",* Working Paper no.0908, Banco de España.

the whole of 2009 between projected and actual tax revenue. The Social Security budget outturn also worsened, as described in Box 6.

For the description of revenue, information is available on total takings under the main taxes, for the portion assigned to the State and for that relating to the ordinary-regime regional governments. On this information, revenue declined by 19.1% in Q2 compared with the same period a year earlier, due to the weakness of tax receipts. However, in the case of direct taxes, this weakness is influenced by the differential impact on personal income tax, in 2009 H1, of the rebate of up to €400 (without any equivalent in the corresponding period of the previous year) and which will be offset, in part, in H2, and by the impact of the reduction of 2 pp in the rate of withholding tax on mortgage expenses for persons earning less than €30,000 introduced in 2009. Nevertheless, the impact of the economic crisis was reflected in withholdings on earned income and, above all, in withholdings on gains from mutual funds, which fell by 45.1%. Notable among the indirect taxes is the fall in VAT (–35.8% in comparison with 2008 Q2); in this

STATE BUDGET OUTTURN

TABLE 4

€m and %	Outturn 2008	Percentage change 2008/2007	Outturn projection 2009	Percentage change 2009/2008	Outturn 2008 JAN-MAR	Outturn 2009 JAN-MAR	Percentage change
	1	2	3	4 = 3/1	5	6	7 = 6/5
1 REVENUE	129,335	-19.1	141,110	9.1	65,624	46,352	-29.4
Direct taxes	74,096	-23.6	77,041	4.0	33,398	21,941	-34.3
Personal income tax	*43,413*	*-10.7*	*43,167*	*-0.6*	*24,378*	*14,626*	*-40.0*
Corporate income tax	*27,301*	*-39.1*	*30,085*	*10.2*	*7,368*	*5,548*	*-24.7*
Other (a)	*3,382*	*-4.2*	*3,789*	*12.0*	*1,651*	*1,767*	*7.0*
Indirect taxes	39,229	-19.0	50,202	28.0	24,989	15,218	-39.1
VAT	*24,923*	*-26.2*	*35,531*	*42.6*	*18,192*	*9,202*	*-49.4*
Excise duties	*11,220*	*-2.2*	*11,253*	*0.3*	*5,243*	*4,655*	*-11.2*
Other (b)	*3,086*	*-4.3*	*3,418*	*10.8*	*1,554*	*1,361*	*-12.4*
Other net revenue (c)	16,010	11.1	13,867	-13.4	7,237	9,194	27.0
2 EXPENDITURE	148,082	6.0	157,904	6.6	67,689	83,171	22.9
Wages and salaries	25,266	6.7	26,848	6.3	12,601	13,196	4.7
Goods and services	4,553	2.2	3,502	-23.1	1,906	1,881	-1.3
Interest payments	15,929	9.6	17,424	9.4	7,519	7,414	-1.4
Current transfers	82,755	6.5	85,754	3.6	38,111	46,309	21.5
Contingency fund and other unforeseen expenditure	—	—	3,251	—	—	—	—
Investment	10,656	5.4	10,408	-2.3	4,452	4,909	10.3
Capital transfers	8,923	-3.5	10,717	20.1	3,101	9,462	—
3 CASH-BASIS BALANCE (3 = 1 – 2)	-18,747	—	-16,794	—	-2,065	-36,819	—
MEMORANDUM ITEM: TOTAL TAXES (State plus share of regional and local governments)							
Personal income tax	71,341	-1.8	77,444	8.6	36,220	29,276	-19.2
VAT	48,015	-14.0	53,323	11.1	29,011	18,632	-35.8
Excise duties	19,570	-1.1	20,461	4.6	9,609	9,138	-4.9

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.

case, the figures are affected not only by the decline in consumption and in real estate transactions, but also by the increase in monthly refunds in light of the new rules. In turn, excise duties decreased by 4.9%, largely due to the decline in the tax on hydrocarbons, which would have continued to reflect the impact of the low level of activity on transport and the collapse of the automobile market. The items aggregated under the "Other State revenue" heading recorded high growth, primarily due to "charges, public prices and other receipts", especially those relating to surcharges and default interest.

State cash-basis expenditure increased by 22.9%, well above the budget forecast for the year as a whole (6.6%). In fact, with the exception of personnel costs and interest payments, all the other items continued to record higher rates of change than envisaged in the budget. Particularly notable was the strong growth in current transfers, mainly to other tiers of general government, which accelerated considerably throughout Q2. Also worthy of mention is the large increase in capital transfers, owing to those made to local government for the State Fund for Local Investment.

4.5 Balance of payments

The overall balance on current and capital account in the first four months of 2009 was a deficit of €23,889 million, down 39% on the same period a year earlier (see Table 5). This is primarily due to the lower trade deficit and, to a much lesser extent, to the im-

SOCIAL SECURITY BUDGET OUTTURN

BOX 6

The Social Security system posted a non-financial surplus of €10,420 million to May 2009, down 19.7% on the same period of 2008. Non-financial revenue fell by 1.1% to May in comparison with the figure a year earlier, while expenditure rose by 5.5% (see accompanying table).

Revenue from Social Security contributions declined by 2.4% to May, in sharp contrast to the increase of 7.8% budgeted for the year as a whole. This decrease is a direct reflection of the adverse employment performance, which has resulted in a continued decline in Social Security registrations since June 2008; in 2009 Q2 as a whole, Social Security registrations fell, on average, by 6.7%.

Turning to expenditure, that earmarked for contributory pensions rose by 6.8% to May, below the figure budgeted for 2009 as a whole. However, in the first six months of the year, the number of contributory pensions rose faster than in the previous year (1.7%, as opposed to 1.4% for 2008 as a whole). Expenditure on sickness benefits fell by 27.9% to May, meaning that, to date, this item is also below the figure budgeted for the year as a whole.

As regards the National Public Employment Service (SPEE, by its Spanish abbreviation), the deficit rose considerably, standing at €2,816 million at May 2009, as opposed to a deficit of €41 million for the same period a year earlier. Revenue rose by 27.1% but expenditure by 56.9%, due to the poor labour market performance. Accordingly, the growth of expenditure earmarked for unemployment benefits accelerated sharply in 2009 H1, increasing by 68.5% year-on-year to June. Also at June, the coverage ratio stood at 73.6%, approximately 1.5 pp above that recorded in June 2008. On data to April, the number of beneficiaries rose by 66.7% on the same month a year earlier, while to June, registered unemployment grew by 55.4% year-on-year.

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

€m and %

	Budget	Budget		Outturn JAN-MAY		
	2008	2009	% change	2008	2009	% change
	1	2	3=2/1	5	6	7=6/5
1 REVENUE	114,113	123,726	8.4	50,066	49,534	-1.1
1.1 Social Security contributions	105,107	113,324	7.8	45,379	44,269	-2.4
1.2 Current transfers	6,796	7,439	9.5	3,419	3,810	11.4
1.3 Other	2,209	2,963	34.1	1,267	1,455	14.8
2 EXPENDITURE	106,080	114,476	7.9	37,089	39,114	5.5
2.1 Wages and salaries	2,390	2,453	2.7	901	946	5.0
2.2 Goods and services	1,996	1,995	-0.1	686	608	-11.3
2.3 Current transfers	101,095	109,465	8.3	35,400	37,305	5.4
Contributory pensions	*86,041*	*93,339*	*8.5*	*29,872*	*31,901*	*6.8*
Sickness benefits	*7,716*	*8,144*	*5.6*	*2,724*	*1,964*	*-27.9*
Other	*7,339*	*7,982*	*8.8*	*2,804*	*3,440*	*22.7*
2.4 Other	599	563	-6.0	102	254	148.7
3 BALANCE	8,033	9,250	15.2	12,977	10,420	-19.7

SOURCES: Ministerio de Hacienda, Ministerio de Trabajo e Inmigración 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 until October 2008.
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.

provement in the current transfers and services balances, while the income deficit widened.

In the period January-April 2009, the deficit on the trade balance declined by 51% year-on-year, to €16,058 million, signifying considerable quickening of the rate of adjustment. Exports and, to a greater extent, imports decreased more rapidly, as the real terms of trade improved. The improvement in the trade deficit reflected both the lower energy bill, stemming from the drop in real net imports of energy goods and the sharp decline in oil prices, and the decrease in the non-energy trade deficit.

BALANCE OF PAYMENTS: MAIN COMPONENTS (a) TABLE 5

€m

		JANUARY-APRIL		RATE OF CHANGE
		2008	2009	2009/2008 (b)
CREDITS	Current account	120,325	99,649	-17.2
	Goods	*67,424*	*51,982*	*-22.9*
	Services	*28,075*	*25,825*	*-8.0*
	— Tourism	10,785	9,524	-11.7
	— Other services	17,290	16,301	-5.7
	Income	*19,979*	*17,299*	*-13.4*
	Current transfers	*4,846*	*4,543*	*-6.3*
	Capital account	2,919	2,346	-19.6
	Current + capital accounts	123,244	101,995	-17.2
DEBITS	Current account	161,776	125,402	-22.5
	Goods	*100,004*	*68,040*	*-32.0*
	Services	*22,957*	*20,346*	*-11.4*
	— Tourism	4,368	3,613	-17.3
	— Other services	18,589	16,733	-10.0
	Income	*28,632*	*27,804*	*-2.9*
	Current transfers	*10,184*	*9,211*	*-9.6*
	Capital account	421	482	14.4
	Current + capital accounts	162,198	125,884	-22.4
BALANCES	Current account	-41,452	-25,753	15,699
	Goods	*-32,580*	*-16,058*	*16,522*
	Services	*5,119*	*5,479*	*360*
	— Tourism	6,417	5,911	-507
	— Other services	-1,299	-432	867
	Income	*-8,652*	*-10,505*	*-1,853*
	Current transfers	*-5,338*	*-4,667*	*671*
	Capital account	2,498	1,864	-634
	Current + capital accounts	-38,954	-23,889	15,065

SOURCE: Banco de España.

a. Provisional data.
b. Absolute changes for balances.

The surplus of €5,479 million on the services balance in the first four months of 2009 was 7% more than in the same period of 2008, as a result of the sharp decrease in the deficit on non-tourism services (67%), offsetting the deterioration of the tourism surplus, which fell by 8% to €5,911 million. Nominal tourism receipts decreased by 11.7% in the first four months of the year. In other services, both receipts (–5.7%) and, in particular, expenditure (–10%) decreased in the period.

The deficit on the income balance grew by 21% in the first four months of the year, while the deficit on the current transfers balance decreased by 12.5%, in a setting in which remittance payments sent abroad fell more sharply than those received. Lastly, in the first four months of the year the surplus on capital account declined by 25% in comparison with the same period of 2008, to €1,864 million, reflecting the decline in general government receipts from Community funds.

5.1 *Overview*

There was a certain degree of normalisation on domestic and international financial markets in 2009 Q2. Stock market indices rose and market volatility continued to decline, returning to the levels seen before the collapse of Lehman Brothers exacerbated the crisis. At the date of this report going to press, the IBEX 35 was up 32.7% on end-March, while the EURO STOXX 50 index of European companies was up 24.8% and the S&P 500 for US companies 22.4%. Thus, in 2009 to date, the Spanish index has gained 12.8%, ahead of both the S&P 500 (8.1%) and the EURO STOXX 50 (5.5%) (see Chart 23).

On the interbank market, risk premia continued to decline. Thus, the spread between 12-month EURIBOR and the cost of secured financing operations (repos) at the same maturity narrowed by 29 bp between end-March and the date of this report going to press, although, at 67 bp, it remains quite wide. During this period, 12-month interest rate expectations barely changed, meaning that 12-month interbank market yields declined by a similar amount. Moreover, long-term fixed-income issuance by credit institutions showed some signs of recovery (see Box 7), reflecting the more favourable credit conditions.

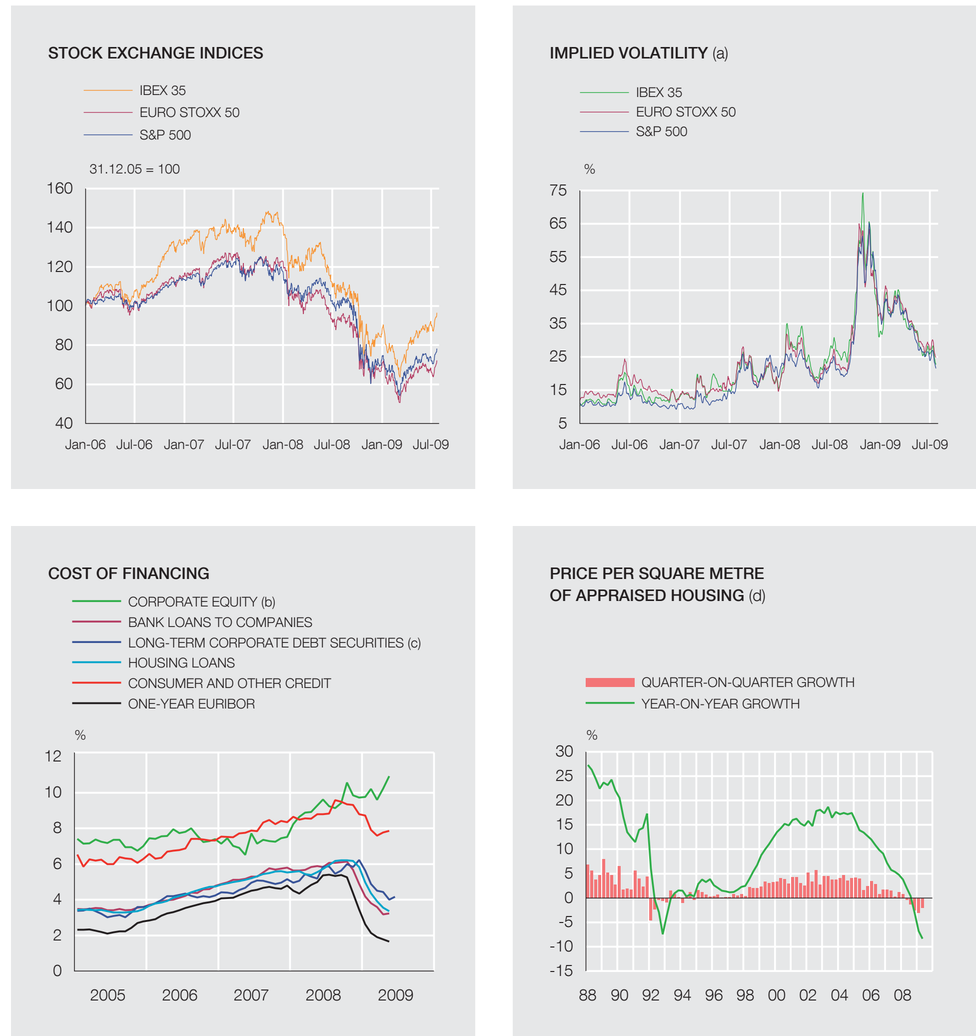
Public debt yields performed differently by maturity. Thus, the return on Spanish Treasury bills fell from 1.4% at end-March to 0.8% at the date of this report going to press, in line with the official rate cuts in the Eurosystem's main refinancing operations. However, the return on ten-year bonds fell by barely 3 bp, remaining at around 4%. This pattern, which was also seen on the main sovereign debt markets worldwide, was basically due to the reversal of the flight to quality that occurred at the peak of the crisis. In line with the recovery in investor confidence, long-term yield spreads between euro area sovereign bonds and the German bund narrowed; in the case of Spanish bonds, the spread stood at 56 bp, down 41 bp on the Q1 close. Credit risk premia for Spanish non-financial corporations traded on the derivatives markets also fell (by 110 bp on average, standing at 91 bp).

On the real estate market, according to the latest data available from the Ministry of Housing corresponding to 2009 Q2, the price of unsubsidised housing fell by 1.9% in the quarter, bringing the year-on-year rate of growth to –8.3% in June, as opposed to –6.8% in March (see Chart 23).

The drop in interbank yields continued to pass through to the cost of bank credit to the private sector, although unevenly in the different segments (see Chart 23). Thus, between March and May, spreads between bank and market rates widened on new loans to households for consumption and other purposes (62 bp) and on new loans to corporations of less than €1 million (13 bp), which are those generally deemed to entail the most risk, while in the case of housing loans to households and new loans to corporations of more than €1 million, spreads narrowed by 19 bp and 5 bp, respectively. This seems to confirm that the latest increase in spreads is not only due to the delay in pass-through of market rates to bank rates, but that there is also a permanent component connected with the higher risk perceived by the financial institutions in their lending activities. The cost of financing for corporations via issuance of fixed-income securities also fell in 2009 Q2, while the cost of equity rose. In addition, according to the July Bank Lending Survey (BLS), the banks' approval criteria tightened slightly (to a lesser extent than was expected in April) and are expected to remain relatively stable over the next three months, in contrast to the sharp tightening of credit standards seen throughout 2008.[2] Other

2. For more details, see the article entitled "Encuesta sobre Préstamos bancarios en España: julio de 2009", by Jorge Martínez Pagés, in *Boletín Económico*, July-August 2009, Banco de España.

FINANCING CONDITIONS AND ASSET PRICES CHART 23



SOURCES: Bloomberg, Credit Trade, Datastream, MSCI Blue Book, Ministerio de 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 long-term debt is calculated as the sum of the weighted average 5-year CDS spread for Spanish non-financial corporations and the 5-year euro swap rate.
d. Base 2001 until December 2004; base 2005 from that date.

lending conditions (term, security required) were seemingly somewhat less favourable than in the previous quarter.

In line with the credit supply pattern and the lower demand for external funds, private sector debt continued to moderate in 2009 Q2. The year-on-year growth rate of household financing dropped below 1% in May, 1.5 pp less than two months earlier. This lower momentum was seen both in housing loans and consumer and other credit. In turn, corporate borrowing grew by 5% relative to the same period of 2008, almost 1 pp down on March. The latest data on lending by purpose, corresponding to March, shows a widespread slowdown, but especially in construction (where credit fell by 8% in the previous 12 months), while bank loans in industry and non-real estate services continued to grow by more than 10% year-on-year.

The moderation in household credit led to a minor decrease in the ratio of debt to gross disposable income (GDI) in 2009 Q1, even though the debt burden in annual terms remained

The onset of financial turmoil in the summer of 2007, and its subsequent intensification and globalisation, made it far more difficult for financial institutions to access medium- and long-term financing on the wholesale markets. Spanish credit institutions had had frequent recourse to these markets during the last cyclical upturn, to finance the notable expansion in lending.

The international securitisation markets, which were at the heart of the financial crisis, were those most severely affected. In Spain, both gross and net issues of asset-backed securities have remained high since mid-2007 (see the accompanying table), but the bulk of these securities have stayed in the banking sector, to be used as collateral in liquidity-providing operations with the ECB. In fact, the volume of asset-backed securities held outside bank portfolios has decreased continuously since 2007 Q3.

Although to a somewhat lesser extent, the problems of confidence that arose in the wake of the financial crisis also hindered the functioning of the other medium- and long-term financing markets. Thus, as the accompanying table shows, issues of fixed-income securities with maturities of more than one year, which were, to that date, the main alternative to deposits as a source of funds, decreased considerably as from mid-2007, both in gross and net terms.

In light of the difficulties in obtaining long-term funding on the wholesale markets, credit institutions turned instead to the short-term funding markets. Thus, from 2007 Q3 to mid-2008, the volume of net funding obtained via issues of fixed-income securities with maturities of no more than one year exceeded that obtained from issues with longer maturities. During this period, subsidiaries, and specifically

€bn

	SHORT-TERM FIXED INCOME (a)				LONG-TERM FIXED INCOME (excluding ABS)		ASSET-BACKED SECURITIES		SUBORDINATED BONDS AND PREFERENCE AND LISTED SHARES	
	Gross issues		Net issues		Gross issues	Net issues	Gross issues	Net issues	Gross issues	Net issues
	Total	Non-resident subsidiaries	Total	Non-resident subsidiaries	Total	Total			Total	Total
2006 Q1	76.9	0.0	2.9	-0.5	55.0	47.7	18.6	7.6	2.2	1.9
2006 Q2	75.1	0.2	2.6	-0.1	37.9	28.9	30.8	20.0	1.8	1.5
2006 Q3	86.9	0.0	7.3	0.0	29.7	23.0	16.9	6.0	2.1	1.6
2006 Q4	89.9	2.5	3.8	1.9	30.1	16.2	45.1	36.3	3.7	3.5
2007 Q1	118.1	2.3	9.9	0.0	43.1	36.1	41.2	28.6	1.2	0.8
2007 Q2	104.0	1.4	3.3	-0.5	41.8	32.5	39.6	27.6	1.0	-0.7
2007 Q3	132.6	8.6	25.3	6.9	19.7	4.1	18.6	7.2	0.0	0.0
2007 Q4	113.9	11.1	7.8	3.1	22.3	4.5	55.4	43.8	0.4	0.2
2008 Q1	128.8	38.0	16.6	22.0	7.9	-12.4	23.9	15.6	0.2	0.0
2008 Q2	124.4	28.1	12.8	0.4	39.7	22.7	37.8	27.4	0.0	-0.1
2008 Q3	114.8	18.8	-8.3	-6.0	9.6	-6.0	14.2	4.5	0.6	-0.8
2008 Q4	128.9	50.6	-22.6	6.0	15.3	-6.9	62.9	46.9	8.4	7.6
2009 Q1	118.8	32.7	4.2	-2.0	30.9	5.4	27.9	14.8	3.0	2.8
FEB-MAY 08	160.2	45.7	17.8	15.7	28.9	6.2	46.8	34.5	0.2	-0.1
FEB-MAY 09	148.3	46.7	2.2	0.5	59.9	26.2	44.2	24.3	1.0	0.4
AUG 08	32.3	4.9	1.8	-3.1	2.5	-1.7	3.8	1.5	0.2	0.1
SEP 08	30.6	3.3	-12.3	-1.2	3.5	-3.9	2.5	-0.7	0.0	-0.7
OCT 08	41.8	15.7	-8.5	2.4	3.0	-5.6	7.1	1.8	0.1	0.0
NOV 08	49.6	22.1	1.6	8.9	1.6	-4.5	32.1	25.5	7.6	7.4
DEC 08	37.5	12.8	-15.7	-5.3	10.6	3.2	23.7	19.6	0.6	0.2
JAN 09	39.8	10.3	-1.6	-3.1	3.1	-2.8	2.4	-2.0	2.4	2.4
FEB 09	38.4	11.5	-3.8	-3.8	13.8	3.0	13.0	9.2	0.6	0.6
MAR 09	40.6	11.0	9.6	4.8	14.0	5.2	12.4	7.7	0.0	-0.1
APR 09	33.9	10.0	-4.1	-1.8	17.3	10.7	9.6	4.3	0.0	0.0
MAY 09	35.4	14.2	-4.2	1.3	14.8	7.2	9.2	3.1	0.4	0.0

SOURCE: Banco de España.

a. Only credit institutions. Includes issues by resident and non-resident subsidiaries.

non-resident subsidiaries, played an important part in raising this funding.

The collapse of Lehman Brothers in September 2008 signified a qualitative change in the international financial landscape and the perceived risk of a systemic collapse rose considerably (see left-hand panel). In this setting, it became notably more difficult for financial institutions to access funding, as the risk premia borne by them rose significantly. As a result, from mid-2008 to January 2009, net funding via both short-and long-term fixed-income securities was negative; in the case of those with maturities of less than one year, this may also have been related to the changes made in spring 2008 in the Eurosystem's framework for monetary policy implementation and, specifically, to the inclusion of 6-month liquidity-providing operations, which broadened the range of financing possibilities open to credit institutions. There was also an increase in subordinated bond and share issues in the last three months of 2008 and January 2009, in response to the financial institutions' aim to bolster their capital adequacy ratios, in line with market demand, against a backdrop of high uncertainty regarding the strength of financial institutions' balance sheets worldwide and high risk aversion.

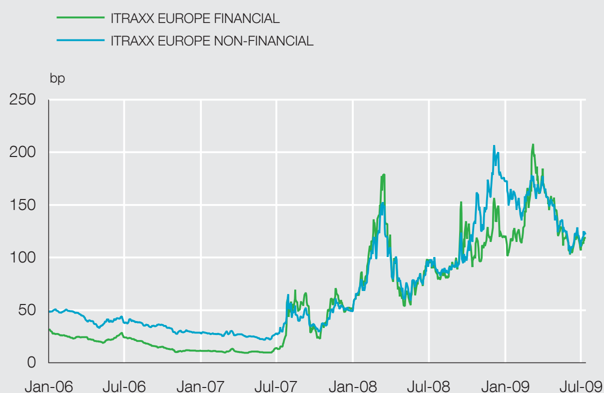
Since February 2009, the situation on the financial markets has improved considerably, thanks to the brighter investor outlook, reflected in lower risk premia, and to the financial system support measures introduced. Accordingly, long-term fixed-income issues have regained momentum, becoming positive again in net terms after posting a negative balance throughout most of 2008. The granting of State guarantees for new bank debt issues, a measure adopted by various EU countries to alleviate the refinancing difficulties facing their banking systems, is one of the key factors behind the higher placement volume of these issues in recent months. Thus, as at 10 July 2009, 40 Spanish financial institutions had launched issues backed by State guarantee, amounting to some €38 billion in total.[1]

Funding via mortgage covered bonds, one of the main sources of funding used by Spanish financial institutions in the years of strong credit expansion, has also recovered somewhat in recent months. Thus, between February and April, the number of mortgage covered bond issues – mainly low-volume private placements – rose. Following the ECB announcement in May on the purchase of covered bonds issued by banks in the euro area, a number of issues have been launched in the market, as the spreads borne by these instruments have fallen sharply (see right-hand panel). By contrast, net issues of short-term fixed-income securities have remained very limited, possibly as a result of the favourable conditions under which liquidity may be obtained within the Eurosystem. Lastly, the securitisation markets remain frozen, with all operations recorded being retained in full by the originators.

In short, the latest data show a certain degree of normalisation on the wholesale markets, with the exception of the securitisation markets. This is due not only to the more favourable outlook, reflected in the easier conditions for access to funding by the financial institutions, but also to the financial system support measures – especially the granting of State guarantees for fixed-income issues, which have been very well received by the market – and to the announcement by the ECB that it would purchase covered bonds issued by banks in the euro area, which seems to have encouraged activity in this market.

1. Between February and May, 52% of all gross issues of long-term fixed-income securities made were backed by State guarantee.

1 5-YEAR CDS SPREADS



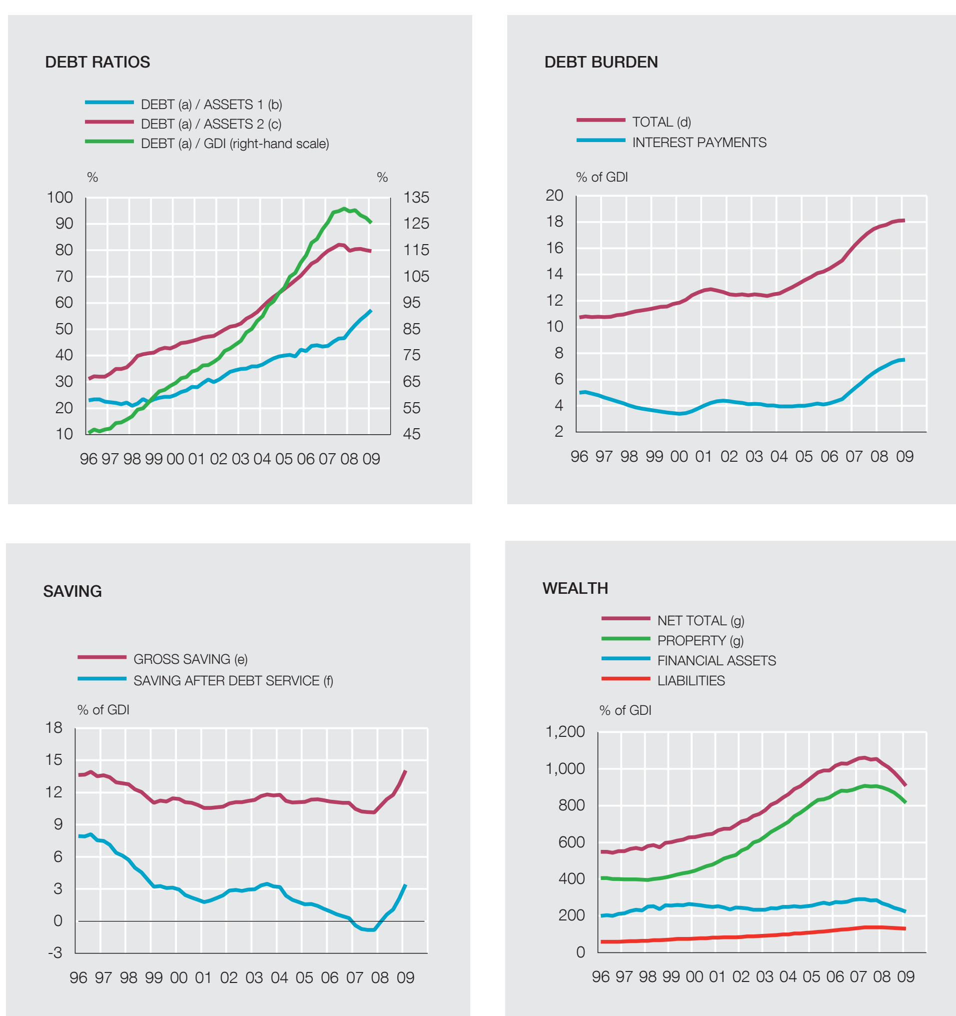
2 EUROPEAN MORTGAGE COVERED BOND ASSET SWAP SPREAD (a)

SOURCE: Datastream.

a. Spread between yields on covered bonds (which include Spanish mortgage covered bonds) in the index and returns on swap curve rates, weighted by portfolio duration.

INDICATORS OF THE FINANCIAL POSITION OF HOUSEHOLDS AND NPISHs

CHART 24



SOURCES: Ministerio de Vivienda, INE and Banco de España.

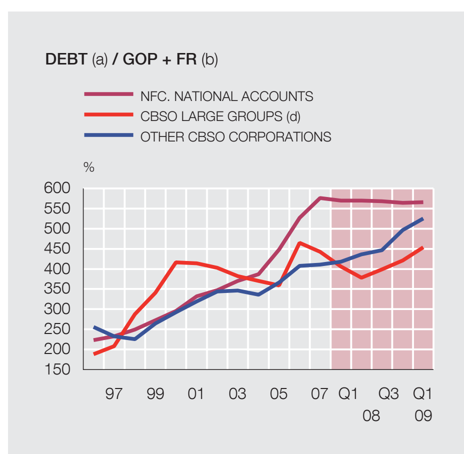
a. Includes bank credit and off-balance-sheet securitised loans.
b. Assets 1 = total financial assets less "Other".
c. Assets 2 = assets 1 less shares less holdings in mutual funds.
d. Estimated interest payments plus debt repayments.
e. Balance of households' use of disposable income account.
f. Gross saving less estimated debt repayments.
g. 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.

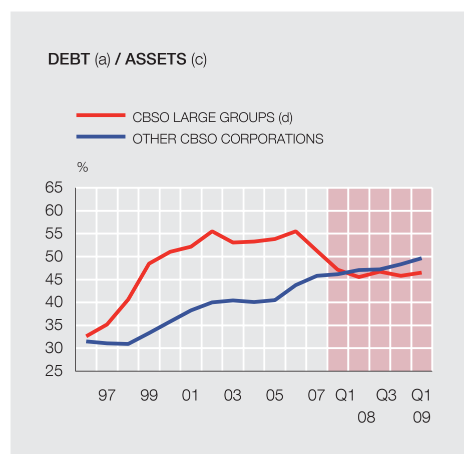
stable, as the average cost of on-balance-sheet liabilities was similar to that recorded in the same period a year earlier (see Chart 24). Moreover, the ability to save, after debt servicing, rose, largely due to the recovery in the sector's gross saving ratio. It should be noted that all these ratios were also affected by the loss of momentum in GDI. In line with these developments, the Financial Accounts reflect an increase of 0.6 pp, in cumulative four-quarter terms, in the sector's net borrowing, to 0.9% of GDP. For its part, household net wealth continued to contract relative to GDI, as the prices of financial and real estate assets headed down. The latest preliminary estimates indicate that debt, the debt burden and net wealth will all have declined in 2009 Q2.

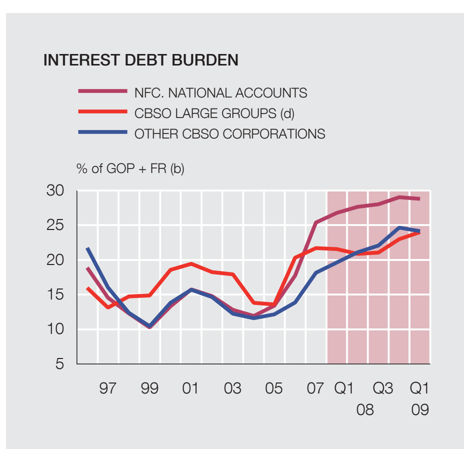
Turning to firms, in 2009 Q1 both the debt and the debt burden ratio continued at similar levels to those seen at end-2008 (see Chart 25). However, the latest preliminary estimates available point to a decline in the debt burden in Q2. According to the Financial Accounts data for Q1, the sector's net borrowing was equivalent to 5.7% of GDP in cumulative 12-month terms,

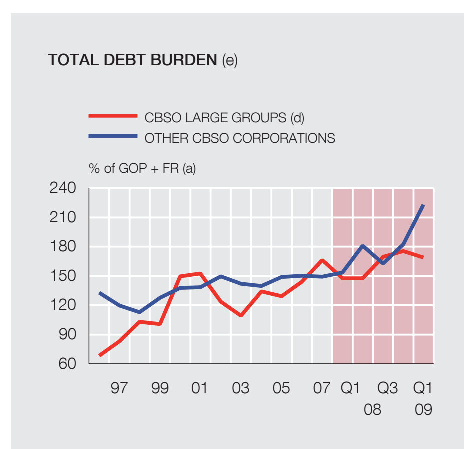
INDICATORS OF THE FINANCIAL POSITION OF NON-FINANCIAL CORPORATIONS

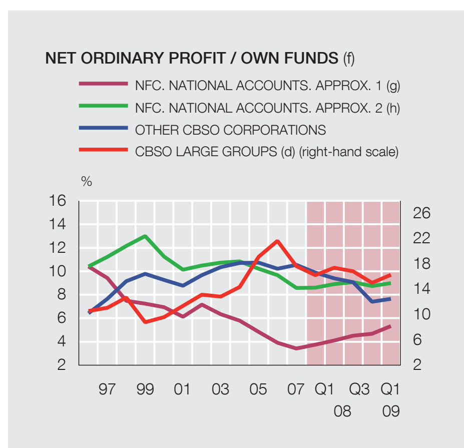
CHART 25

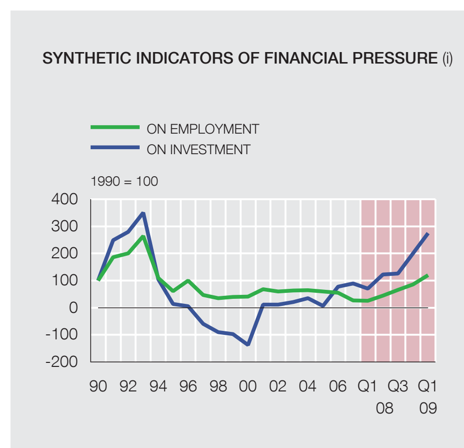












SOURCES: INE and Banco de España.

a. Interest-bearing borrowed funds.
b. Gross operating profit plus financial revenue.
c. Defined as total inflation-adjusted assets les non-interest-bearing liabilities.
d. 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.
e. Includes interest plus interest-bearing short-term debt.
f. NOP, using National Accounts data, is defined as GOS plus interest and dividends received less interest paid less fixed capital consumption.
g. Own funds at market price.
h. Own funds calculated by accumulating flows as from the 1996 balance.
i. Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 6

% of GDP

	2004	2005	2006	2007	2008				2009
					Q1	Q2	Q3	Q4	Q1
National economy	-4.8	-6.5	-8.4	-9.7	-10.0	-10.0	-9.6	-9.1	-8.4
Non-financial corporations and households and NPISHs	-5.1	-8.4	-11.0	-13.8	-13.7	-12.3	-9.9	-6.9	-4.8
Non-financial corporations	*-4.5*	*-7.1*	*-9.4*	*-12.2*	*-12.7*	*-11.4*	*-9.4*	*-7.2*	*-5.7*
Households and NPISHs	*-0.6*	*-1.3*	*-1.7*	*-1.6*	*-1.0*	*-0.8*	*-0.5*	*0.3*	*0.9*
Financial institutions	0.6	0.9	0.6	1.9	2.0	1.7	1.9	1.7	1.7
General government	-0.4	1.0	2.0	2.2	1.7	0.5	-1.6	-3.8	-5.3
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-8.7	-11.4	-17.4	-15.4	-19.8	-17.1	-15.2	-10.8	-8.7

SOURCE: Banco de España.

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

1.5 pp below the end-2008 figure. According to the latest National Accounts estimates, also as at March 2009, profits recorded a further slowdown; thus, although the year-on-year rate of growth was still quite high, the quarter-on-quarter rate of growth of the seasonally-adjusted series was close to zero. Similarly, the information from the Central Balance Sheet Data Office Quarterly Survey (CBQ), based on a sample in which large corporations predominate, shows that most firms reported a deterioration in profits in 2009 Q1, helping drive up debt ratios and interest payments. As a result of all these developments, the indicators of financial pressure on investment and employment rose once again.

The deteriorating economic situation prompted a further increase in the financial pressure borne by certain private-sector agents. This was reflected in the widespread increase in doubtful asset ratios, which for the other resident sectors as a whole (including, in addition to households and corporations, financial intermediaries other than credit institutions) stood at 4.6% in May, 0.4 pp higher than in March and 1.3 pp higher than in December 2008.

The most recent Financial Accounts data (see Table 6) show that the nation's net borrowing declined again in 2009 Q1 (to 8.4% of GDP in cumulative annual terms, from 9.1% in December). This decrease was lower than that recorded by the non-financial private sector, which was partly offset by the sharp increase in the general government deficit (up 1.5 pp at 5.3% of GDP). The funds required to cover the external deficit were raised, in part, by the general government (3.1% of GDP) and, to a lesser extent than in previous quarters, by credit institutions and institutional investors (1.2% and 1.5%, respectively, of GDP). However, these funds were insufficient to cover the nation's overspending relative to revenue, with the result that, once again, the Banco de España's net asset flows vis-à-vis non-residents were negative, in an amount equivalent, in cumulative 12-month terms, to slightly less than 3% of GDP.

In short, the cost of borrowing for households and firms continued to decline throughout the quarter, although other credit conditions continued to tighten, albeit less so than since the start of the crisis. The macroeconomic deterioration and the decline in value of real estate assets (the main component of household wealth) were again reflected in a worsening of the aggregate financial position of the private sector; this will naturally have had most impact on the

agents most exposed to these developments, raising the financial pressure borne by some segments.

5.2 Households

According to the latest data (relating to May) on interest rates on new loans, interest rates on housing loans fell by 56 bp relative to March, while those on consumer and other loans, which are more volatile, rose by 28 bp. This is a drop of some 280 bp and 170 bp, respectively, from the highs recorded in the summer of 2008 and is, in both cases, short of the fall in market rates. Spreads between bank interest rates and the reference interbank rate widened, in particular, in consumer loans, which are, a priori, higher risk.

The latest data available also show that lending conditions other than interest rates, such as security required (which has increased) or maturities (which have shortened), continued to tighten. Thus, the respondents to the latest BLS, compiled in July, confirmed that spreads widened slightly in 2009 Q2 and that repayment periods and the ratio between the principal and the value of collateral decreased. However, lending standards were only marginally more demanding than in 2009 Q1, and less demanding than was anticipated in the previous BLS.

In this setting, household debt continued to decelerate, growing by less than 1% year-on-year in May, almost 1.5 pp lower than in March. This slowdown was seen across the board: thus, housing loans rose by 1% in May relative to the same period a year earlier, while consumer and other loans were flat in 12-month terms. In fact, in seasonally-adjusted quarter-on-quarter terms, growth rates were negative, both for household borrowing as a whole and for its two components, each of which was close to –2% in annualised terms.

According to the latest Financial Accounts data (for 2009 Q1), investment in financial assets continued to decline (see Table 7), amounting, in cumulative annual terms, to approximately 1% of GDP, almost 1.5 pp below the end-2008 level. This was mainly a result of the decline in investment in time deposits (from 6.6% to 3.9% of GDP), which was only partly offset by the lower net outflows from mutual funds (–3.1% of GDP, against –3.7% in December) and by the increase in holdings of cash and cash equivalents (0.3% in March, against –0.5% three months earlier).

In 2009 Q1, the household debt ratio dropped slightly, to around 125% of GDI. By contrast, the debt burden ratio seems to have remained close to 18% of GDI, as the average cost of on-balance-sheet liabilities was quite similar to that recorded a year earlier. The moderation in debt servicing payments, together with the slowdown in household consumption, is the reason behind the increase in households' saving, net of the expenses associated with their liabilities. The sector's net wealth decreased again as a percentage of GDI, as the prices of financial assets, and especially of real estate assets, fell. The latest preliminary estimates indicate that debt, the debt burden and net wealth will all have declined in 2009 Q2. It is important to note that these ratios have also been affected by the loss of momentum in their respective denominators.

Despite the moderation in the household debt burden, the worsening economic conditions – especially the surge in the unemployment rate – contributed to the increase in the proportion of households facing difficulties in servicing their debts. Thus, in 2009 Q1, the percentage of persons with past due loans rose by 1 pp to 5.7%. As a result, during the same period the doubtful asset ratio for households rose by 0.6 pp to 3.6%. By type of loan, both the ratio and the rate of increase are higher in the case of consumer and other loans (6.6%, from 5.2% in December) than in the case of housing (purchase and refurbishment) loans (2.8%, up 0.4 pp on the 2008 close).

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

TABLE 7

% of GDP

	2005	2006	2007	2008		2009
				Q3	Q4	Q1
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	10.4	10.9	7.4	3.8	2.8	1.3
Cash and cash equivalents	4.0	3.1	-1.0	-1.5	-0.5	0.3
Other deposits and fixed-income securities (a)	1.6	5.8	7.8	7.9	6.6	3.9
Shares and other equity (b)	0.2	-1.1	0.6	0.4	0.1	0.2
Investment funds	1.9	0.2	-1.2	-3.5	-3.7	-3.1
Insurance technical reserves	2.0	1.8	0.9	0.7	0.5	0.5
Of which:						
Life assurance	*0.7*	*0.6*	*0.2*	*0.1*	*-0.1*	*0.0*
Retirement	*1.0*	*0.9*	*0.6*	*0.4*	*0.5*	*0.4*
Other	0.6	1.1	0.3	-0.2	-0.2	-0.4
Financial transactions (liabilities)	11.7	12.6	9.0	4.3	2.5	0.4
Credit from resident financial institutions (c)	12.3	13.0	9.4	5.1	3.4	1.6
House purchase credit (c)	*10.2*	*9.9*	*7.0*	*3.7*	*2.7*	*1.5*
Consumer and other credit (c)	*2.2*	*3.1*	*2.2*	*1.4*	*0.8*	*0.3*
Other	-0.6	-0.4	-0.4	-0.8	-0.9	-1.2
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	18.1	23.4	13.5	6.1	3.9	3.4
Cash and cash equivalents	2.0	2.3	-0.4	-0.6	-1.1	-0.7
Other deposits and fixed-income securities (a)	1.2	2.0	2.1	1.9	2.0	1.0
Shares and other equity	7.3	11.4	7.7	3.0	2.7	2.7
Of which:						
Vis-à-vis the rest of the world	*3.9*	*8.0*	*6.3*	*4.8*	*3.1*	*2.7*
Other	7.6	7.8	4.1	1.8	0.4	0.3
Financial transactions (liabilities)	25.2	32.8	25.7	15.6	11.1	9.1
Credit from resident financial institutions (c)	12.9	17.6	13.9	7.1	5.5	3.7
Foreign loans	2.1	3.3	2.8	2.9	2.2	2.5
Fixed-income securities (d)	0.3	1.8	0.5	0.1	0.3	0.7
Shares and other equity	3.7	2.9	5.3	3.6	2.3	1.9
Other	6.2	7.2	3.2	1.8	0.7	0.2
MEMORANDUM ITEMS, YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	21.2	24.2	15.5	8.3	6.1	4.6
Households and NPISHs	20.9	19.6	12.5	6.5	4.4	2.2
Non-financial corporations	21.4	27.9	17.7	9.6	7.4	6.3

SOURCE: Banco de España.

a. Not including unpaid accrued interest, which is included under "Other".
b. Excluding mutual funds.
c. Including off-balance-sheet securitised loans.
d. Including 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.

5.3 Non-financial corporations

The latest available data on interest rates on new loans to corporations, corresponding to May, show a decline in comparison with March, both in loans under €1 million (21 bp) and over €1 million (40 bp). Since the cost of credit began to fall in September 2008, the larger loans have seen the biggest cut in interest rates (312 bp, as opposed to a cut of 207 bp for the smaller loans that are generally more common among SMEs). The cost of borrowing via issuance of fixed-income securities also declined, both in short-term securities (by 23 bp relative to March) and long-term securities (by 49 bp in the same period), while in contrast, return on equity demanded by the market rose by 133 bp.

However, the July BLS shows that all other credit conditions applied by the banks were less favourable than in 2009 Q1, and that lending standards also tightened, albeit marginally and to a lesser extent than was envisaged in the April BLS. The decline in the rate of contraction was similar in lending to SMEs and to large corporations, being slightly more noticeable in short-term rather than long-term loans. Moreover, according to the BLS, credit institutions envisaged no changes in their credit standards in the following three months.

According to the business confidence index compiled by the Chambers of Commerce, the percentage of firms pointing to difficulties obtaining credit as a factor limiting their activity rose again (to 30%) in 2009 Q1. Moreover, the survey on access to financing for SMEs, also compiled by the Chambers of Commerce, showed an increase, in April and May, in the number of firms with fewer than 250 employees that had seen their credit supply squeezed (43% in May, up from 27% in March), while 88% of SMEs had faced higher demands in terms of collateral and guarantees.

In this setting, corporate borrowing continued to lose momentum, growing by some 5% year-on-year in May, down almost 1 pp on March. Credit from resident institutions, which is the main source of financing for corporations, rose at a slower pace (around 3% year-on-year, and close to 0% in annualised quarter-on-quarter terms). By contrast, other sources of financing (credit from non-residents and fixed-income securities), which are mainly used by the larger corporations, showed greater momentum.

The latest data on credit breakdown by productive activity, relating to 2009 Q1, show widespread deceleration save in industry, where bank liabilities grew by around 10% year-on-year, virtually the same as three months earlier. Construction and agriculture posted the sharpest fall year-on-year, with negative growth rates of –8% and –2%, respectively, while the rate of growth of credit to real estate sector firms (4% in March 2009, down from 5% at end-2008) and to other services (down from 14% to 12% in the same period) also moderated.

Against this backdrop, and according to the Financial Accounts for 2009 Q1, the sector's net borrowing fell by more than 1.5 pp, to slightly less than 6% of GDP, while the *financing gap*, the indicator that approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, also fell (by 2 pp), to slightly less than 9% of GDP.

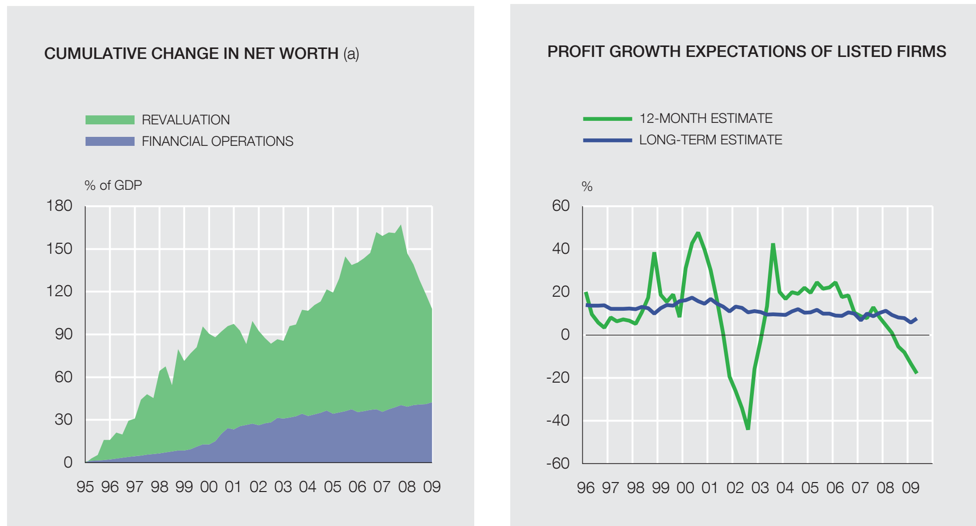
Despite the moderation in the rate of growth of sector liabilities, the corporate debt-to-earnings ratio was stable in 2009 Q1, due to the poor earnings performance. Interest payments relative to profit were also virtually unchanged on end-2008 at around 29%. However, the latest preliminary estimates available point to a decline in the debt burden in Q2, in line with the decline in the cost of lending. In turn, the latest National Accounts earnings estimates, corresponding to March 2009, point to a further slowdown. Thus, although the year-on-year rate of growth was still relatively high, the quarter-on-quarter rate of the seasonally-adjusted series was practically flat.

In addition, analysts again downgraded their earnings growth expectations for listed non-financial corporations for the next 12 months (see Chart 26), although they raised their preliminary earnings forecasts for the longer term, for the first time since end-2007.

The Central Balance Sheet Data Office Quarterly Survey (CBQ) information for 2009 Q1, based on a sample in which large corporations predominate, shows a sharp contraction (of around 30%) in ordinary profits in 2009 Q1 in comparison with the same period a year earlier; this is

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 26

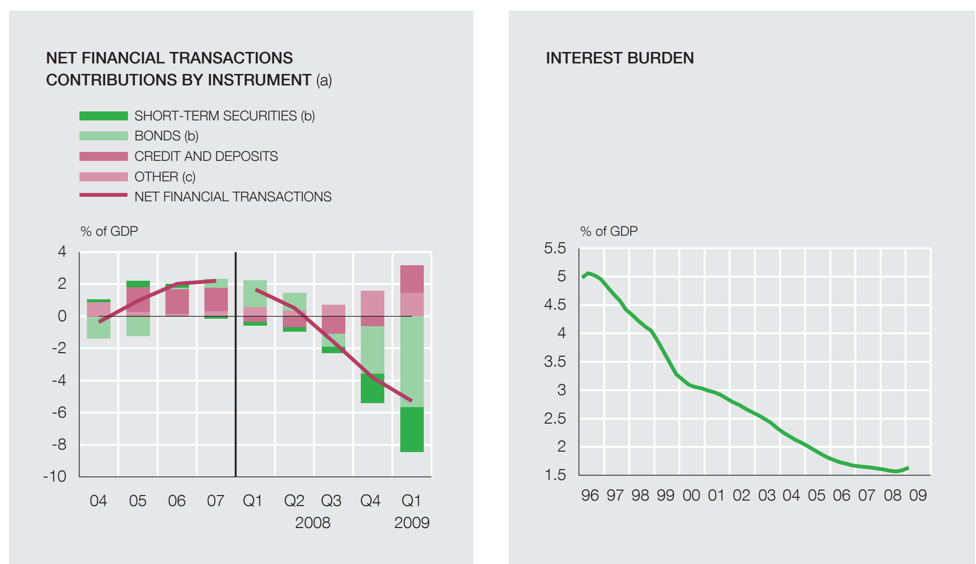


SOURCES: I/B/E/S and Banco de España.

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

GENERAL GOVERNMENT
Four-quarter data

CHART 27



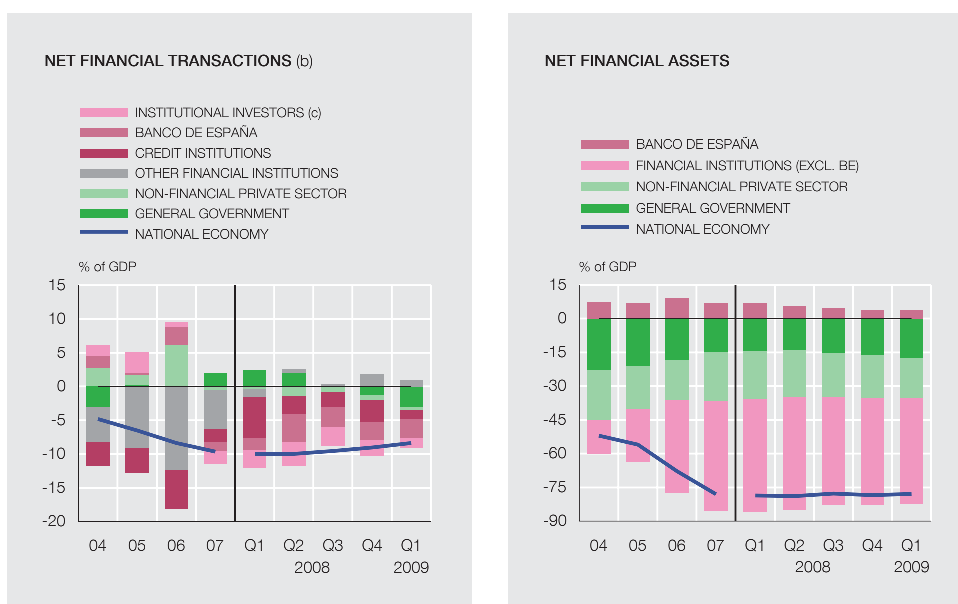
SOURCE: Banco de España.

a. A postive (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.

the most negative change in this variable throughout the CBQ series. Analysis of the activities with most representation in the CBQ, which includes neither construction nor property development, shows that, once again, the decline was particularly notable in industry (–68%) and, in line with this decline, industry was the sector that posted the sharpest drop in ordinary return on equity (ROE). This, together with the growth in liabilities, was reflected in an increase both in the debt and the debt burden ratio. As a consequence of all these developments, the synthetic indicators of financial pressure on investment and employment rose once again.

NET FINANCIAL TRANSACTIONS AND NET FINANCIAL ASSETS VIS-À-VIS THE REST OF THE WORLD (a)

CHART 28



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 collective investment institutions.

Non-financial corporations' doubtful asset ratios rose in Q1, standing at 4.8% in March, up 1.1 pp on end-2008, continuing to reflect the adverse earnings performance. Real estate services and construction firms, with an overall doubtful asset ratio of 7.3% at the end of 2009 Q1, in comparison with 5.7% at end-2008, experienced the greatest difficulties in servicing their debts, while in all other branches of activity the ratio rose to a lesser extent (from 1.9% to 2.6%) in the period.

5.4 General government

General government net borrowing rose significantly in 2009 Q1, to 5.3% of GDP in cumulative 12-month terms, an increase of 1.5 pp on end-2008 (see Table 6 and Chart 27). The breakdown by instrument shows that the deficit was covered by issuing short-term, and especially medium- and long-term, securities. In contrast to the previous year, the balance of deposits net of lending increased. Moreover, despite the higher debt, the drop in the average cost of funds held interest payments steady as a proportion of GDP at 1.6%.

5.5 The rest of the world

The debit balance of the nation's net financial transactions fell, in cumulative 12-month terms, in 2009 Q1 to 8.4% of GDP, from 9.1% in December. This moderation was accompanied by a restructuring by institutional sector, as firms and households (the latter, posting a positive balance for the second consecutive quarter) recorded lower borrowing, while the general government deficit rose (see Table 6).

The breakdown of financial transactions vis-à-vis the rest of the world by sector shows that net capital inflows channelled through the general government rose substantially in 2009 Q1, representing, in cumulative 12-month terms, 3.1% of GDP, against a backdrop of high public debt issues. By contrast, the funds raised by credit institutions, institutional investors and non-financial corporations decreased, although in all three cases they remained positive (equivalent to 1.2%, 1.5% and 0.7%, respectively, of GDP). At the same time, the other non-financial institu-

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 8

% of GDP

	2005	2006	2007	2008		2009
				Q3	Q4	Q1
NET FINANCIAL TRANSACTIONS	-6.5	-8.4	-9.7	-9.6	-9.1	-8.4
FINANCIAL TRANSACTIONS (ASSETS)	18.5	17.7	13.9	7.5	3.2	0.5
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0
Cash and deposits	2.2	5.2	2.1	1.3	-0.3	-2.1
Of which:						
Interbank (a)	*3.1*	*3.4*	*4.2*	*2.1*	*-0.5*	*-2.3*
Securities other than shares	8.7	-1.2	1.6	1.1	1.3	-0.2
Of which:						
Credit institutions	*6.6*	*-2.1*	*1.8*	*1.7*	*1.5*	*0.7*
Institutional investors (b)	*2.3*	*0.6*	*-0.1*	*-0.6*	*-0.4*	*-0.9*
Shares and other equity	5.1	10.5	8.6	4.3	1.9	2.5
Of which:						
Non-financial corporations	*3.9*	*8.0*	*6.3*	*4.8*	*3.1*	*2.7*
Institutional investors (b)	*0.9*	*1.2*	*-1.0*	*-2.1*	*-1.5*	*-0.8*
Loans	1.1	2.1	1.2	1.7	0.9	1.0
FINANCIAL TRANSACTIONS (LIABILITIES)	25.0	26.1	23.6	17.1	12.3	8.8
Deposits	5.6	0.3	7.3	11.3	9.0	4.3
Of which:						
Interbank (a)	*7.2*	*0.6*	*6.7*	*8.6*	*6.2*	*2.0*
Securities other than shares	15.8	21.4	8.1	-1.5	-2.2	0.5
Of which:						
General government	*0.2*	*1.0*	*-1.3*	*0.2*	*1.4*	*2.6*
Credit institutions	*6.3*	*8.0*	*3.6*	*-1.4*	*-1.9*	*-1.1*
Other non-monetary financial institutions	*9.3*	*12.4*	*5.8*	*-0.3*	*-1.7*	*-1.0*
Shares and other equity	0.9	0.2	4.5	4.4	3.4	1.9
Of which:						
Non-financial corporations	*1.0*	*-0.2*	*4.7*	*4.0*	*2.5*	*1.2*
Loans	2.3	3.5	3.1	2.8	2.1	2.5
Other, net (c)	-0.9	-0.5	0.1	1.1	0.5	0.3
MEMORANDUM ITEMS:						
Spanish direct investment abroad	3.7	8.5	9.6	7.7	5.0	4.8
Foreign direct investment in Spain	2.2	2.5	4.8	7.0	4.4	2.9

SOURCE: Banco de España.

a. Correspond only to credit institutions and include repos.
b. Insurance corporations and collective investment institutions.
c. Includes, in addition to other items, the asset-side caption reflecting insurance technical reserves and the net flow of trade credit.

tions, including securitisation SPEs, once again recorded negative flows. Despite the decrease in the nation's net borrowing, funds raised abroad by sectors other than the Banco de España were insufficient to cover it, with the result that, once again, the Banco de España's net asset flows vis-à-vis non-residents were negative, amounting to 2.8% of GDP in cumulative annual terms (see Chart 28).

Capital inflows fell in 2009 Q1 to 8.8% of GDP, in cumulative 12-month terms, a decrease of 3.5 pp on December (see Table 8). By instrument, there was a notable drop in purchases of shares and other equity by non-residents (1.9% of GDP, down 1.5 pp on three months earlier) and in deposits (particularly interbank deposits: 2% of GDP, down 4.2 pp on end-2008). Net

financing obtained through this channel recorded a more moderate decline (2.4 pp). This contrasted with the growth in net financing obtained from securities other than shares, which had been negative in previous periods, due especially to the increase in funds obtained through securities issued by general government. Relative to GDP, foreign direct investment in Spain declined again, by 1.5 pp to 2.9%.

Capital outflows fell to 0.5% of GDP, in cumulative 12-month terms, in 2009 Q1, a decrease of 2.7 pp on December 2008 (see Table 8). By instrument, investment in fixed-income securities declined, while net acquisitions of shares and other equity showed greater momentum (2.5% of GDP, up 0.6 pp on three months earlier). However, Spanish direct investment abroad fell slightly, going below 5% of GDP.

As a result of cross-border financial flows and of changes in asset prices and the exchange rate, the Spanish economy's accumulated net debt vis-à-vis the rest of the world remained at around 80% of GDP (see Chart 28). By sector, this was essentially the result of the improvement in the debit positions of the financial institutions and the non-financial private sector, which was offset by the increase in general government liabilities.

24.7.2009.