

QUARTERLY REPORT ON THE SPANISH ECONOMY

1 OVERVIEW

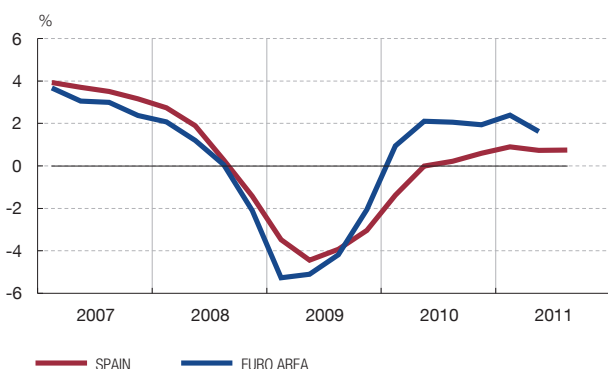
As the year has unfolded, the Spanish economy has progressively weakened following the subdued recovery on which it had embarked in 2010. On Quarterly National Accounts (QNA) figures, the quarter-on-quarter rate of GDP growth slowed in Q2 to 0.2%, placing the year-on-year rate at 0.7%. Behind this lies an acceleration in the decline in national demand (-0.4% in terms of the quarter-on-quarter rate), offset only in part by the improved contribution (to 0.6 pp) of net external demand to output.

The information available for Q3 suggests this pattern of weakening continued mid-year, against a background marked by the worsening euro area sovereign debt crisis. Estimates made on the basis of the as yet partial and incomplete conjunctural information indicate that GDP is expected to have posted a quarter-on-quarter rate of change of zero in Q3, placing its year-on-year rate at 0.7%. However, these rates should be interpreted with more than the habitual caution owing to the statistical differences that may arise with the re-basing of National Accounts. The GDP flash estimates to be published by INE in November will be prepared with the new 2008 base (see Box 4). Domestic demand is estimated to have slipped further in Q3 (with a contribution to GDP of -0.8 pp relative to the April-June period), reflecting the contraction in the government components of spending and the still-declining trajectory of residential investment, while household consumption and business investment showed small increases. In contrast, net external demand remained the chief underpinning of the economy, and its contribution to GDP growth rose (to 0.8 pp) owing to the buoyancy of goods exports and tourism.

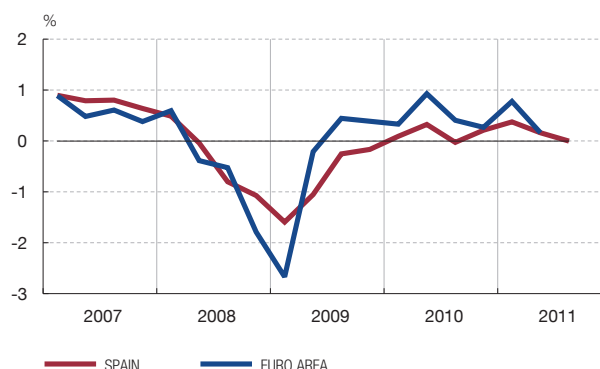
On the supply side, employment showed no signs of improvement compared with the first half of the year. It shrank in net terms by more than in the previous quarter (by 2.1% year-on-year according to EPA figures). This decline in employment prompted an increase in the unemployment rate, which stood at 21.5% in Q3, against the background of the stabilisation of the labour force. Finally, the declining trend in inflation seen in the previous months eased, owing to price rises in processed food and energy which offset the slowdown in the prices of the remaining components further to the stripping out of the base effects linked to the VAT increase the previous year. As a result of these opposing movements, the year-on-year rate of change in the CPI stood at 3.1% in September. That said, the behaviour of inflation was more contained than in the euro area, as a result of which the price spread narrowed in the past quarter to the point of being cancelled out in September.

In the international economic arena, there was a further deterioration in the economic and financial situation worldwide in Q3 as a result of the deepening sovereign debt crisis in Europe and the worsening growth outlook globally. Despite the agreements reached at the Summit of Heads of State and Government on 21 July and progress in the financial assistance programmes in Ireland and Portugal, the instability on the euro area's sovereign debt markets continued over the summer months. In August the tensions passed through to larger economies, such as Spain and Italy and, in September, to Belgium and France, albeit to a lesser extent. The tensions likewise spread to other financial markets, where there was an increase in the demand for safe-haven assets, a most marked rise in interbank market risk premia, heavy falls on stock markets and growing difficulties for the European banking system in obtaining funds on money and capital markets.

YEAR-ON-YEAR RATE OF CHANGE



QUARTER-ON-QUARTER RATE OF CHANGE

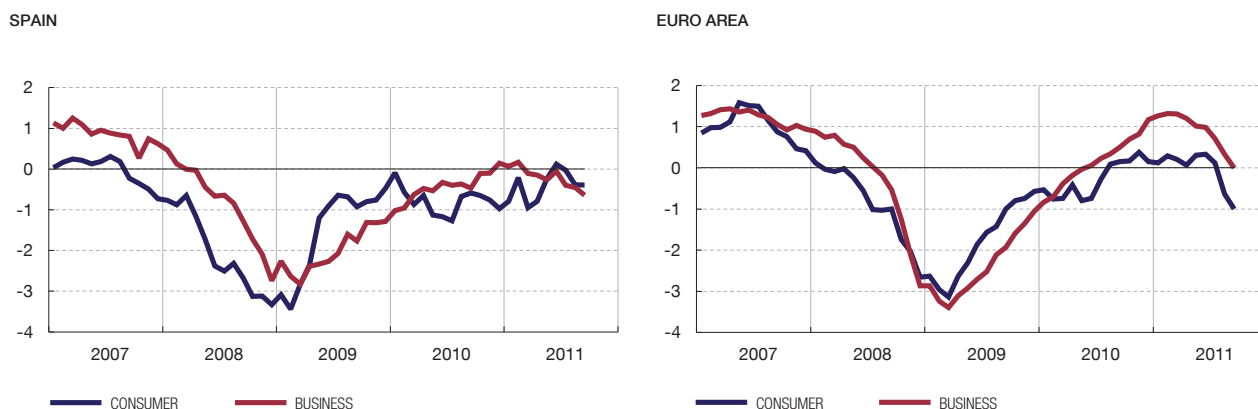


SOURCES: ECB, INE and Banco de España.

a Seasonally adjusted series.

At the root of this marked instability are, first, the heightening difficulties relating to the fiscal adjustment in Greece, in a highly adverse macroeconomic setting; further, the political and legal problems accompanying the application of the resolutions adopted at the Summit on 21 July, in particular in connection with the reform of the European Financial Stability Facility, which is key to containing contagion processes; and finally, greater uncertainty over the exposure of the European banking system to ailing countries.

The euro area response to this worsening of the sovereign debt crisis is taking shape at different levels. On one hand, the ECB resumed its Securities Market Programme as from 5 August, to ensure the correct functioning of the monetary policy transmission mechanism. It also ensured unlimited liquidity provision through the extension in August and September of various non-conventional measures, and in October it set in place a new covered bonds purchase programme, scheduled to run between November 2011 and October 2012. In turn, the European Council, the European Parliament and the European Commission came to a final agreement on 11 September concerning the reform of governance. This marks a significant step towards reinforcing the framework for the monitoring, prevention and correction of macroeconomic imbalances, a step much-needed to minimise the risk of future crises. Finally, the Summit of Heads of State and Government of the euro area countries in late October has seen significant headway in the design of a sufficiently comprehensive strategy to restore and reinforce the financial stability of the area. Although certain specific details have still to be resolved, the agreement addresses the main weaknesses detected and provides for ambitious measures in four areas. First, a new financial aid programme for Greece, which draws on private-sector participation and which should ensure that Greek finances become sustainable again, lowering the public debt ratio to around 120 % of GDP by 2020. Second, the maximisation of efficiency in the use of the available funds of the European Financial Stability Facility (EFSF), enabling it to increase its capacity by up to fivefold and thus establishing an effective mechanism to halt contagion. Third, a plan aimed at restoring confidence in the banking system has been set in place, using on one hand an EU-coordinated programme of guarantees to provide financing for the sector and, on the other, a recapitalisation of the main banks, which will be required to comply with a core tier 1 capital ratio of 9 % by June 2012. Fourth and finally, governments renewed their commitment to continue adopting the measures needed to ensure the sustainability of their public finances and to boost economic growth, observing the approved fiscal targets and pushing through structural reforms. The Heads of State



SOURCE: European Commission.

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

and Government also agreed on additional steps in the reform of governance and in the integration of the euro area to strengthen the economic convergence needed in a monetary union (see Section 3 and Box 3 of this report for more details).

The Member States, for their part, approved new adjustment measures in August, September and October. Italy adopted a budgetary consolidation programme with the intention of bringing forward one year its aim to achieve a balanced budget and, at the Summit at the end of October, it unveiled measures to strengthen competitiveness and liberalise the economy, which are pending application. In Spain, a reform of the Constitution was approved¹, setting limits on the general government structural deficit and on the public debt ratio in line with the provisions of the Treaty on the European Union. This measure legally enshrines the obligation for all tiers of government to adjust their conduct to the principle of budgetary stability, which is particularly appropriate given the high degree of fiscal decentralisation in place. Although this reform will only come into force in relation to the budget deficit and public debt targets in 2020, it does unquestionably reinforce the principle of budgetary stability. In addition, so as to restrict the risks of deviations from budgetary targets, a new fiscal adjustment package² was adopted, with an estimated reducing effect on the budget deficit of 0.5 % of GDP in 2011 and, regarding the labour market³, changes were made to the regulation of training contracts and some of the restrictions on temporary hires were lifted. Lastly, the government approved a reform of the Deposit Guarantee Fund in October.⁴

The climate of financial instability prevailing in Q3 prompted a slowdown in the pace of economic recovery across the board, particularly impacting most of the advanced economies and, especially, the euro area, where the increase in activity was brought to a halt following the buoyancy seen in the first half of the year. It also gave rise to a downward

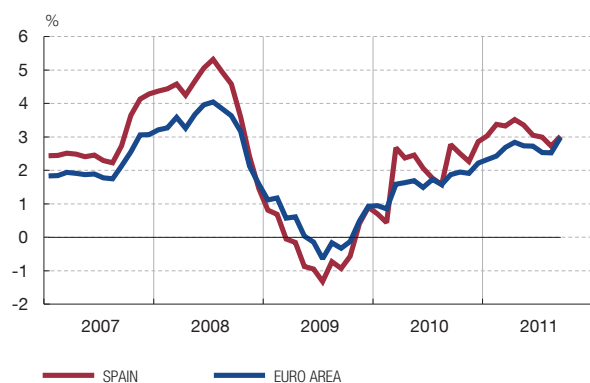
¹ The Official State Gazette of 27 September 2011 published the reform of article 135 of the Spanish Constitution.

² Royal Decree-Law 9/2011 of 19 August 2011 on measures improving the quality and cohesion of the national health system, contributing to fiscal consolidation and raising the maximum amount of State guarantees for 2011.

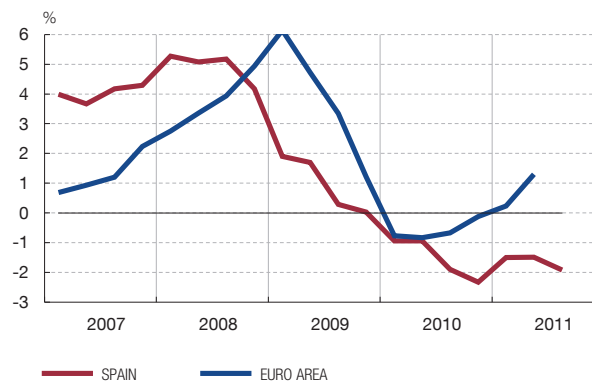
³ Royal Decree-Law 10/2011 of 26 August 2011 on urgent measures for promoting youth employment, fomenting job stability and retaining vocational re-training arrangements for people whose unemployment protection has run out.

⁴ Royal Decree-Law of 14 October 2011 creating the Deposit Guarantee Fund of Credit Institutions.

HARMONISED INDICES OF CONSUMER PRICES (a)



UNIT LABOUR COSTS (b)



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.

revision by international agencies and private analysts of the medium-term growth outlook. In the euro area the absence of inflationary tensions on the relevant monetary policy horizon led the ECB Governing Council to hold interest rates at its August, September and October meetings, leaving them unchanged at 1.5 % for the main refinancing operations, and at 2.25 % and 0.75 %, respectively, for the marginal lending and deposit facilities.

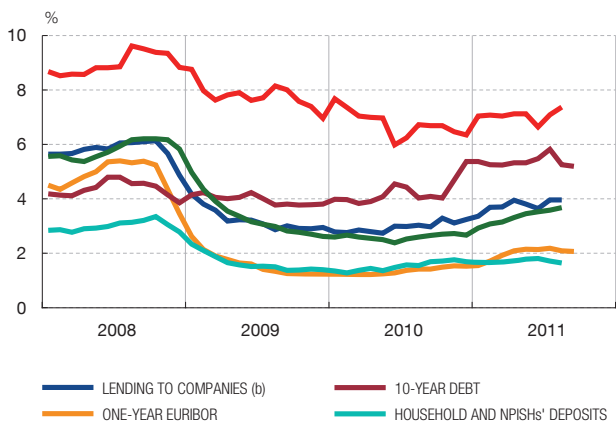
In Spain, the worsening of the sovereign debt crisis ramped up financial tensions, which took the form of an increase in credit risk premia on both general government and private-sector fixed-income securities issues, declines in stock market indices and growing difficulties for banks in obtaining funds on wholesale markets. The reactivation of the Securities Market Programme by the ECB in early August, along with the measures adopted, led the yield on Spanish 10-year bonds, which exceeded 6 % in early August, to fall subsequently and stabilise at a level slightly above 5 %, albeit following a highly volatile trajectory. In the days following the above-mentioned Summit, the spread over German debt stood at around 310 bp. On the equity markets, share prices were also very volatile and fell markedly. Despite the modest rally in indices in the opening weeks of October, the foregoing developments have entailed losses of 15 % in the IBEX 35 since end-June (10.4 % since the start of the year).

On the real estate market, and according to information released by the Spanish Ministry of Development, the rate of decline of house prices quickened in Q3 to a year-on-year rate of 5.6 %. This means there has been a cumulative decline of 18 % in nominal terms (23 % in real terms) from the peak reached in the first half of 2008.

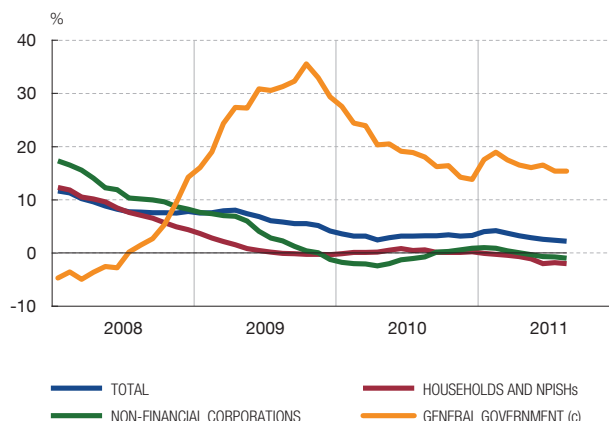
Against this backdrop, financing conditions for the private sector tightened further, since the higher costs incurred by financial institutions in raising funds were reflected in higher interest rates on the loans granted to households and firms. Based on the information in the latest Bank Lending Survey, the various lending criteria established by banks held stable in respect of interest rates, following successive episodes of tightening since 2007.

In these circumstances, household spending decisions were sluggish overall. It is estimated that household consumption has risen marginally in quarter-on-quarter terms, in a

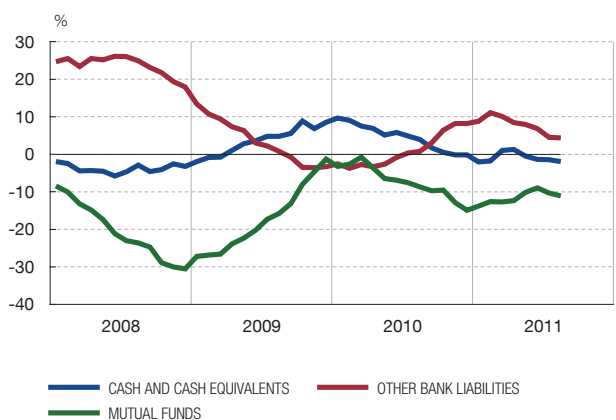
INTEREST RATES (a)



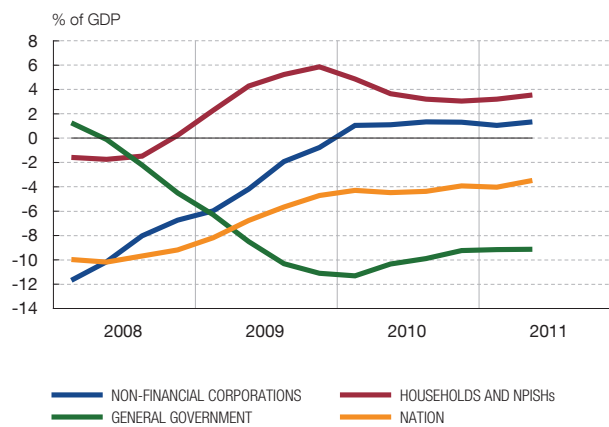
FINANCING TO NON-FINANCIAL RESIDENT SECTORS (year-on-year growth)



FINANCIAL ASSETS OF NON-FINANCIAL CORPORATIONS AND OF HOUSEHOLDS AND NPISHs (year-on-year growth)



NET FINANCIAL TRANSACTIONS (d)



SOURCE: Banco de España.

- a In June 2010 the statistical requirements relating to interest rates applied by credit institutions to their customers were amended, potentially causing breaks in the attendant series. Of particular significance was the change in the interest rates on consumer credit and other loans, as a result of which, from that month, operations transacted using credit cards have not been included. APR for loans (includes commissions and other expenses) and NDER for deposits.
- b Weighted average of interest rates on various transactions grouped according to their volume. For loans exceeding €1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.
- c Consolidated financing: net of securities and loans that are general government assets.
- d Four-quarter cumulated data.

setting marked by the unfavourable labour market performance, heightened uncertainty, the loss of purchasing power due to continuing relatively high inflation rates and the reduction in the value of wealth, in both its financial and real estate components. Information on the accounts of the institutional sectors, available to Q2⁵, appears to confirm the turnaround in nominal household disposable income seen in Q1, since its rate of decline is estimated to have slowed once more, virtually stabilising in cumulated four-quarter terms. All told, households had to resort to saving to smooth their pattern of consumption, as has

5 The data on the financial accounts of the sectors for 2011 Q2 have been published in keeping with the new base 2008 National Accounts, which has entailed some revision in the time series in, inter alia, the imbalances between saving and investment of the various sectors of the economy.

been the case since late 2009. As a result, there was a further decline in the saving ratio to 12.8 % of disposable income in cumulated four-quarter terms. This trend might run to the end of the current year.

Residential investment shrank by a similar magnitude to that of the previous quarter in terms of its quarter-on-quarter rate, meaning that the residential investment/GDP ratio is estimated to have fallen by around 5 pp of GDP⁶ from its peak in 2007. That gives some idea of the scale of the adjustment already made. That said, the demand for residential assets continued to move on a declining path which is delaying the absorption of the supply overhang that has built up in the sector in past years.

Overall, household consumption and investment decisions in Q2 were compatible with the maintenance of a net lending capacity in the sector at levels similar to those of previous quarters (3.5 % of GDP in cumulated four-quarter terms), albeit on a mildly declining trajectory. Households once again reduced their financial liabilities in Q3, at a similar rate (2 % year-on-year) to the preceding months, the result of a contraction that was greater in loans for consumption and other purposes (5 %) than in house purchase loans (1.1 %). It is estimated that this contraction in debt will have provided for a slight reduction in the debt/gross disposable income ratio and for the resumption of the gradual deleveraging process households are undertaking.

Business investment trended similarly to the previous quarter, posting moderately positive figures. It was underpinned by the buoyancy of exports, which offset the deterioration in the economic outlook as the sovereign debt crisis heightened. Looking ahead, however, the continuation of the current climate of uncertainty and lack of confidence might lead to a reduction in business investment. In Q2, non-financial corporations' net lending once again increased, according to figures from the non-financial accounts of the institutional sectors, to 1.5 % of GDP in cumulated four-quarter terms. That might be in response to companies' aim to clean up their balance sheets or to strengthen their self-financing capacity in the face of tighter funding conditions. Companies continued to reduce their indebtedness, to a rate of 1.1 % year-on-year in September, prompting a further decline in the sector's debt ratio.

Turning to foreign trade, the rise in goods and services exports explains the increase in the contribution of net external demand to GDP growth, since the rate of decline of imports eased. Sales abroad were once again underpinned by the expansion still discernible in international trade, by the continuity of the ongoing gradual correction of the losses in price-competitiveness built up during the expansionary phase and by the buoyancy of tourism. Nonetheless, the outlook for the final stretch of the year has worsened owing to the slowdown in the world economy. While goods and services imports turned downwards somewhat less than in the April-May period, their contraction is in line with the sluggishness shown by domestic consumption and business investment.

The correction in net borrowing began to operate again in Q2, taking this variable to 3.5 % of GDP in cumulated four-quarter terms (3.9 % in 2010), according to information provided by the non-financial accounts of the institutional sectors. More recent balance of payments data show that behind this development is the improvement in the non-energy

⁶ Note that this percentage will change following the re-basing of the National Accounts, since part of the investment that was included under investment and other products (such as real estate development, notary services, etc.) in the previous base will be considered as residential investment in the 2008 base.

goods balance, which posted a surplus of 0.2 % of GDP in the January-July period, and in the services balance, which ran a surplus of 3 % of GDP. Conversely, the deficit on the energy goods trade balance and the incomes balance widened.

On the supply side, the slackness of activity in Q3 was due to the steeper contractionary profile of construction, mainly in its public works component, and non-market services. These productive branches are particularly feeling the impact of the budgetary consolidation plans. In contrast, industry rebounded in Q3, once supply conditions and the habitual distribution channels of industrial products were restored, following the interruption in the wake of the Japanese earthquake in March, and against a background of buoyant exports. Market services, which had shown a less hesitant pattern since the recovery began, posted a moderate growth rate, backed by the momentum of tourist services. There are nevertheless doubts about the continuity of this expansion in industry and in market services, given the scaling back in business prospects recently evidenced by the main survey-based indicators. Economy-wide employment fell off once again and is expected to have posted a more significant decline than that of the previous quarter (-1.8 % year-on-year), with a more negative contribution of employment in non-market services, in step with the aforementioned budgetary adjustments. The rate of decline of employment in the market economy also stepped up (-1.9 %), whereby productivity increased substantially.

Labour costs adjusted partially to this weak labour market setting, with economy-wide compensation per employee holding at a rate of increase below 1 % in the first half of the year. However, this moderation largely reflects the effect of the cuts in public-sector wages in 2010 and their subsequent stabilisation, set against the somewhat more inertia-bound behaviour of private-sector wages. For the latter, an increase of around 1 % in Q3 is estimated, similar to that in Q2. If confirmed, that would provide for a further fall in unit labour costs. Once the effect of the reduction in public-sector wages has run its course, prolonging this trend will require collective bargaining – which showed a high increase in wage rates (2.6 %) to September as a result of the prevalence of multi-year agreements being signed – to move on a more clearly defined slowing trend. Cost and price moderation is decisive for entrenching the gains in competitiveness accompanying the severe adjustment being made in the Spanish economy, all the more so against the background of a world economy likely to lose momentum that will no doubt affect our export markets.

The weakness of domestic demand and of activity has affected the rate of reduction of the fiscal imbalance. On the revenue side, the information available on tax takings to September shared by central government and regional and local government, on one hand, and the Social Security system, on the other, indicates that the growth of tax revenue is below the budgetary projection, in particular in the case of social security contributions and of excise duties. On the expenditure side, the information available for the overall general government sector, which is somewhat more lagged (to June in National Accounts terms, according to the new 2008 base), shows a slowdown in spending, albeit one less than projected in the last Stability Programme, given the greater inertia of goods and services purchases in the first half of the year.

The budget outturn has not yet reflected, however, the extraordinary budgetary consolidation measures taken in August (which will see a rise in corporate income tax revenue, reduce health spending and increase revenue by the amount resulting from the tendering of the rights of use of the public domain radio spectrum). Nonetheless, the prevailing trends point to risks that there will be a deviation from the deficit target of 6 % of GDP in 2011, owing to the weakness of tax revenue and to the inertia of spending, chiefly in the re-

gional governments. On the information available as this report was going to press, the scale of the deviation lies within margins that may be corrected by means of proper management of the budget outturn over the rest of the year. In any event, if the budget outturn data for the coming months were to indicate the possibility of these risks materialising, further measures would forcibly have to be adopted in keeping with the unconditional nature of the commitment assumed by the government to comply with the fiscal targets, and in light of the close monitoring to which public finances will be subject during the current sovereign debt crisis. Along these same lines, in the State budget for 2012, which will be approved with some delay as a result of the electoral calendar, the necessary effort should be made to ensure the deficit target for 2012 of 4.4 % of GDP is met.

2 THE EXTERNAL ENVIRONMENT OF THE EURO AREA

In the past quarter, economic and financial developments in the external environment of the euro area took a sharp turn for the worse. Contributing to this were: the escalation of the sovereign crisis in the euro area, the marked loss of tone of economic activity, the fragility of the financial systems of some economies, the perception of scant room for policy response and (as a corollary of all the foregoing) a notable loss of confidence of economic agents. This bout of instability has spread widely and affected the emerging economies significantly. To mitigate the impact of this instability on the financial system and on confidence, the stance of economic –mainly monetary– policies was changed and in some countries turned more expansionary. This was particularly noticeable in the United States and United Kingdom (see Box 1), where full advantage is being taken of all the additional freedom of action available.

The international financial markets reflected this situation markedly. The deepening of the sovereign debt crisis in Europe was the main focus of tension, magnified by the loss of vigour of the recovery and the uncertainties surrounding economic policy. The financial sector was particularly affected and financial institutions' funding problems worsened in terms of both cost and ability to place new issues, while the stock market slumped generally, with particularly sharp falls in bank share prices. In mid-September the US Treasury bond yield hit a low for the last fifty years (around 1.7%) amidst a flight by investors to safer assets. The growing aversion to risk also affected the foreign exchange markets, where some safe-haven currencies appreciated notably. In particular, the dollar appreciated against the euro and traded at the lowest levels since the beginning of the year, standing at \$1.31 per euro in early October. The yen and the Swiss franc appreciated, leading the authorities to intervene in the foreign exchange markets; Switzerland set a minimum parity for the Swiss franc at 1.20 francs per euro. In the emerging markets, the flight to quality was reflected in a sustained rise in risk premia from the first week of August, to levels not seen since 2009 Q2. September brought, moreover, outflows from emerging debt funds, a segment which until then had withstood the turmoil prevailing since the beginning of 2011, and the practical paralysis of fixed-income issuance on the international markets. The search for liquidity led to the unwinding of carry-trade positions in the deepest markets and gave rise to sharp depreciation of currencies against the dollar. All these trends reversed partly in October, although without recouping the previous losses. Meanwhile, commodity prices fell sharply and their volatility rose considerably from August, more markedly in industrial metals than in food or energy. The drop in Brent oil prices was more moderate and from the beginning of August they have fluctuated within a band between \$105 and \$115 per barrel, compared with an average of \$118 in July.

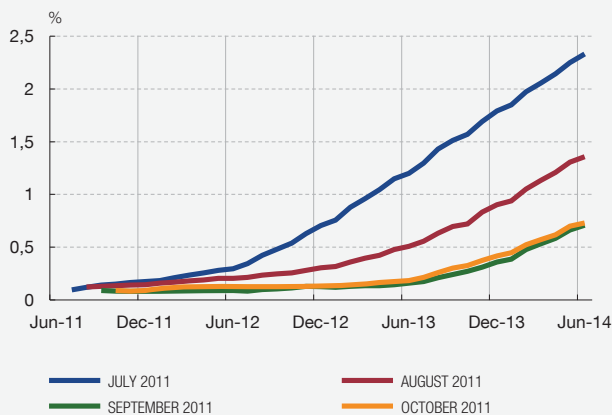
In the United States, the final estimate of GDP in Q2 showed annualised quarterly growth of 1.3%. The array of negative data in the last few months points to weakness in Q3, although the latest indicators are more favourable. Thus industrial production advanced again in September and the business confidence indicators grew moderately in both services and manufacturing. However, consumption remained stagnant, in line with the deterioration of disposable income and the low level of consumer confidence. The tone of the labour market improved in September, with significant net job creation, although the unemployment rate held at 9.1%. Residential real estate market activity remained depressed due to the weak demand, the stagnation of supply, the uncertainty surrounding prices – which continue their downward adjustment– and the tight credit conditions. Inflation, as

Following the first signs of recovery and the appearance of inflationary pressure during the past year and at the beginning of this year, some central banks began to withdraw the monetary stimuli introduced in response to the crisis and others began to consider an exit strategy from those measures. However, in recent quarters the ongoing deterioration in economic and financial conditions globally has prompted an accommodative shift in the monetary policy stance of both developed and emerging countries. This U-turn has been accompanied by a reduction in the expected official interest rates generally, although most noticeably in the developed economies, where they are projected to remain low for a prolonged period (see Charts 1 and 2). The concern for designing exit strategies from the expansionary measures has given way to a search for methods to stimulate demand in a setting of pre-programmed fiscal adjustment and of interest rates which in some cases are near zero. The emerg-

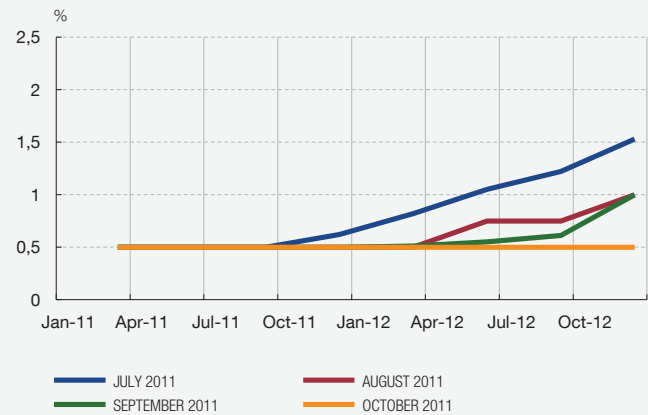
ing countries, some of which had initiated an upward interest rate cycle in 2010 to forestall overheating of their economies, stopped increasing official rates and, in some cases, such as Brazil, Indonesia and Turkey, even decided to cut them. Among the developed countries, similar movements were seen in Sweden, while the ECB reactivated its government debt purchase operations (SMP, Securities Market Programme) and adopted new, unconventional liquidity-providing measures. However, the central banks which resumed their unconventional strategies most strongly were those of the United States and the United Kingdom.

In the United States the Open Market Committee of the Federal Reserve (FOMC) took a first step towards a more accommodative monetary policy in its August 2011 meeting, announcing its commitment to maintaining the current low interest rates over an

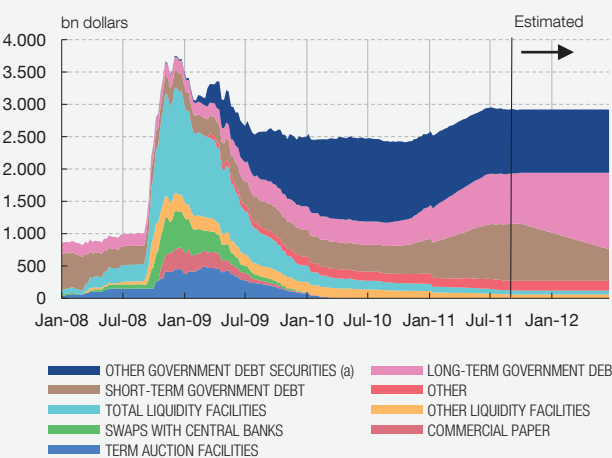
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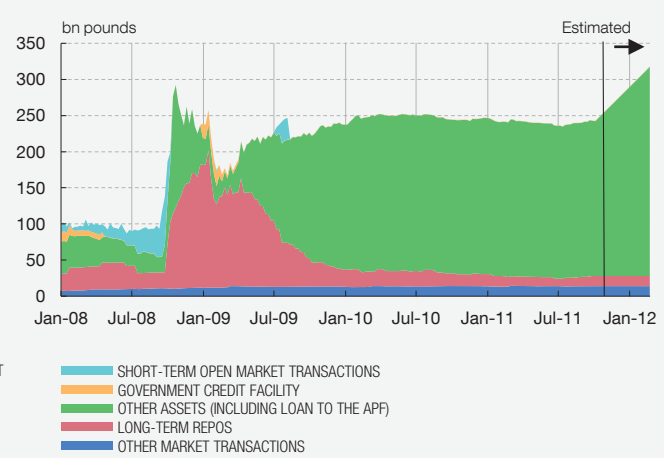
UNITED KINGDOM



UNITED STATES



UNITED KINGDOM



SOURCES: Federal Reserve and Bank of England.

a Debt and debt guaranteed by the federal agencies: Fannie Mae, Freddie Mac and Ginnie Mae.

REASONS AND IMPLICATIONS (cont'd)

explicit time horizon (at least until mid-2013). The following month, the FOMC decided to undertake a strategy to re-weight its debt portfolio, known as Operation Twist, under which it will replace short-term Treasury bonds with longer-term government securities,¹ so as to lengthen the average maturity of its Treasuries portfolio without need for further increasing in the size of its balance sheet. Specifically, before June 2012, \$400 billion of Treasury debt with maturities below three years will be sold and the same amount of bonds with residual maturities between six and thirty years will be purchased (see Chart 3). Also, the FOMC decided to change its policy on reinvestment of funds received from the redemption of debt and agency securitisations (MBS) in its portfolio, which will now be used to purchase new MBS (instead of Treasury bonds as in the past year), in order to ease mortgage market conditions.

For its part, the Monetary Policy Committee (MPC) of the Bank of England initiated a second round of quantitative easing (QE).² Specifically, the MPC decided to increase the size of its asset purchase programme, known as the Asset Purchase Facility (APF) by 75 billion pounds sterling (around 5% of GDP), after having kept it steady at 200 billion pounds sterling since February 2010 (see Chart 4). The purchases will take place over a four-month period up to February 2012 and will focus on UK government debt (gilts) with maturities above three years.³

With these actions, the Federal Reserve and the Bank of England aim to lower interest rates on long-term debt and improve general credit conditions, so as to help re-direct savings flows from

government bonds to other assets. In the UK, the greater liquidity in alleviate bank funding problems, facilitating an increase in credit at a time of high tension in European funding markets. As shown by the charts, the Federal Reserve's measures will not significantly increase its balance sheet, while those of the Bank of England will result in a level above that in 2008 Q4.

It is difficult to say what economic impact these strategies will have. In any event, the effect on the government debt market should be significant, considering the planned volume of purchases. In the US, this volume is approximately 25% of the Treasury's net issuance in 2010. In the UK, it will be equivalent to 62% of total net issuance up to March 2012 and to 45% of issuances planned for the fiscal year. The Federal Reserve estimates that Operation Twist may have a significant impact, reducing long-term interest rates by around 20 basis points (bp). As regards the UK, the Bank of England estimates that the previous QE phase pushed gilt yields down by about 100 bp. A linear extrapolation of the size of the new round of QE points to an effect of roughly 35 bp. Generally speaking, however, there is high uncertainty about the final impact these measures will have on the real economy, since the economic and financial circumstances in which they will be implemented differ from those previously prevailing and a considerable amount of stimulus had already been provided.

Hence the actual impact may be limited in the present environment, characterised by a process of private-sector deleverage, credit restrictions and a highly uncertain economic outlook for both households and firms. It is therefore possible that the extraordinary monetary stimuli may avoid the most extreme risks, but prove to be ineffective in driving economic recovery. This circumstance would be exacerbated if certain problems, such as those derived from the European sovereign debt crisis, persist, since they would limit even more the effect of these unconventional measures.

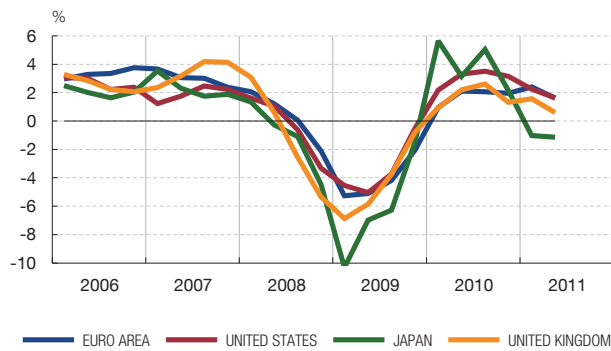
Furthermore, from a longer-term perspective, it cannot be ruled out that these unconventional strategies may end up causing inflation expectations to rise and new bubbles to form. Also, the strong pressure on public finances may push up long-term interest rates in both countries. Although these risks seem minor in the current setting of high uncertainty and economic weakness, the monetary authorities must remain vigilant.

1 Other options are still being discussed by the FOMC: reducing the interest rate on remunerated reserves; changing the communication policy so as to give more information to the public on its objectives and decisions; and the possibility of a third round of monetary expansion through additional purchases of Treasury bonds.

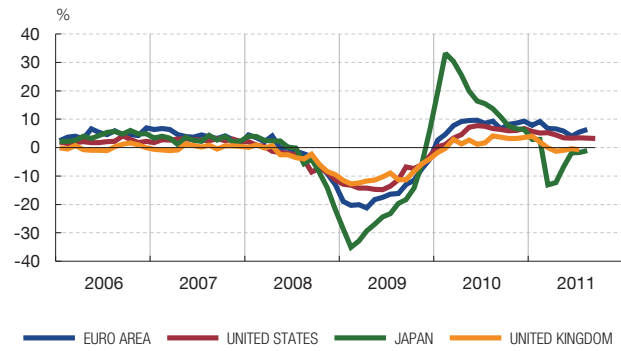
2 The MPC also discussed various alternative the system should lead structuring the Bank of England's balance sheet, reducing the official interest rate and establishing a path marking the future behaviour of the official interest rate.

3 The structure and modus operandi of the APF will remain intact, i.e. they will be implemented via an increase in bank deposits and thus via weekly auctions and financed through the issuance of bank reserves, securities quoted on the secondary market will be purchased, and the possible losses on the portfolio will be borne by the UK Treasury.

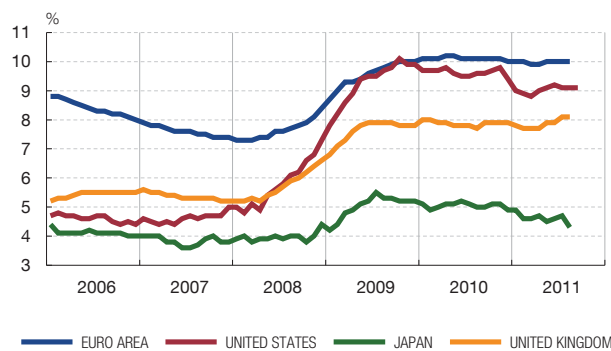
GROSS DOMESTIC PRODUCT
Year-on-year rate of change



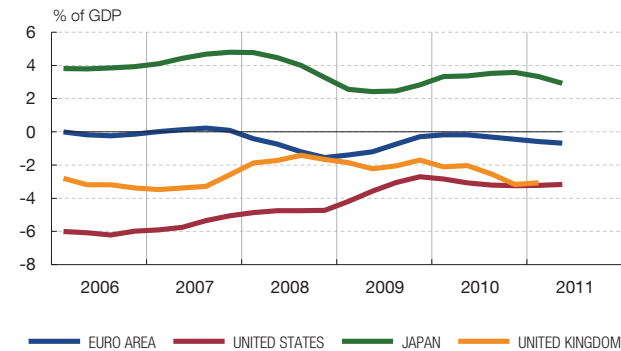
INDUSTRIAL PRODUCTION
Year-on-year rate of change



UNEMPLOYMENT (a)



CURRENT ACCOUNT BALANCE



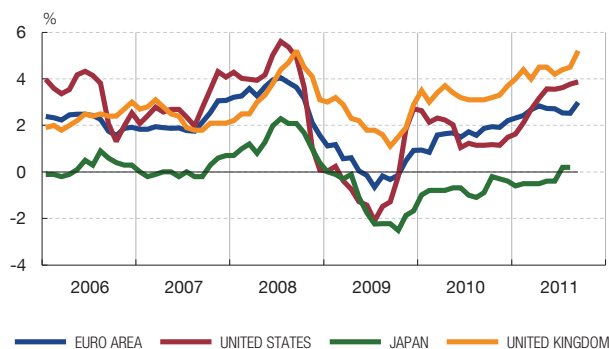
SOURCES: Datastream and Banco de España.

a Percentage of labour force.

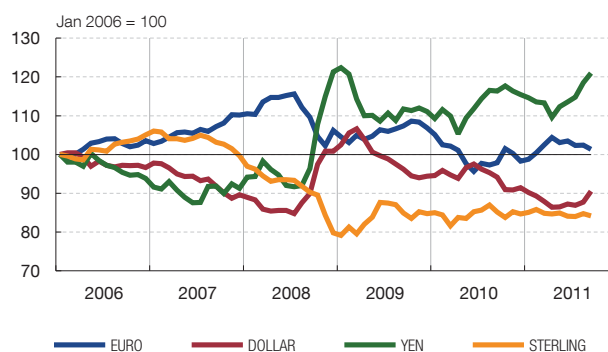
measured by the CPI, increased uninterruptedly and reached 3.9% year-on-year in September, while underlying inflation stood at 2%. In this setting of economic and financial fragility, the Federal Reserve strengthened its expansionary monetary policy stance by committing itself to holding interest rates at the current low levels until mid-2013 and by adopting, in September, a strategy of re-weighting its government debt portfolio towards longer maturities (the so-called “Operation Twist”). Also, it decided to reinvest the mortgage-backed securities (MBS) on its balance sheet in that same type of assets to sustain the real estate market. In the fiscal area, the White House proposed a new \$447 billion support plan focused on employment, the approval of which is uncertain.

In Japan, GDP contracted in Q2 by -0.5% quarter-on-quarter (-1.1% year-on-year), mainly due to the negative contribution of external demand. The first indicators of Q3 pointed to a rapid recovery underpinned by the normalisation of production lines and an improvement in household and corporate sentiment. However, that initial spurt has lost momentum recently: manufacturing activity slowed in the summer due to energy restrictions, and the PMI index points to a fall in September due to the slackening world demand and the appreciation of the yen. Consumption weakened in August as a result of the end of the temporary support measures. On the external front, the trade balance was in deficit during the quarter, since the strength of imports amply offset the recovery of exports. In the labour market, the unemployment rate fell by 0.4 pp in August to 4.3%, although employment decreased for the second month running. The inflation rate was 0.2% in that month,

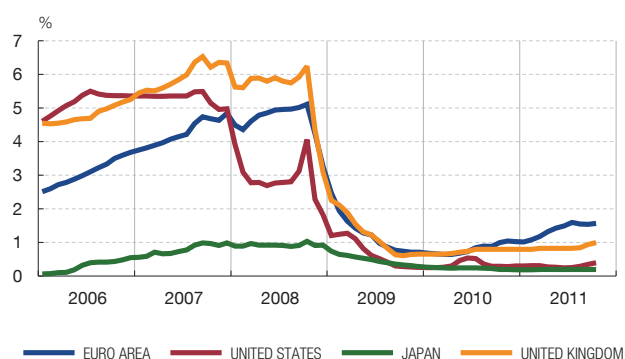
CONSUMER PRICES
Year-on-year rate of change



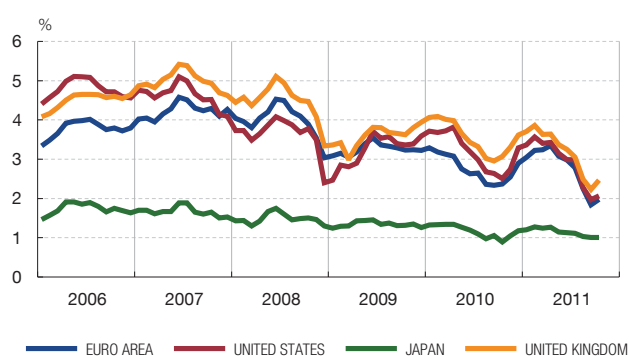
CPI-BASED REAL EFFECTIVE EXCHANGE RATES
VIS-À-VIS DEVELOPED COUNTRIES



SHORT-TERM INTEREST RATES (a)



LONG-TERM INTEREST RATES (b)



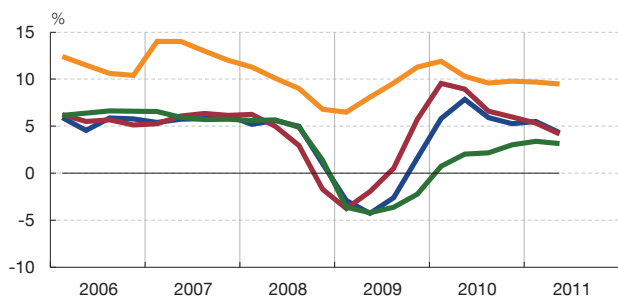
SOURCE: Datastream and Banco de España.

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

although underlying inflation remained negative. Against this background, the Bank of Japan held its official interest rate in the range 0-0.1% and extended its asset purchase programme. Finally, the government prepared a third supplementary budget of 12 trillion yen (2.5% of GDP) to finance reconstruction costs.

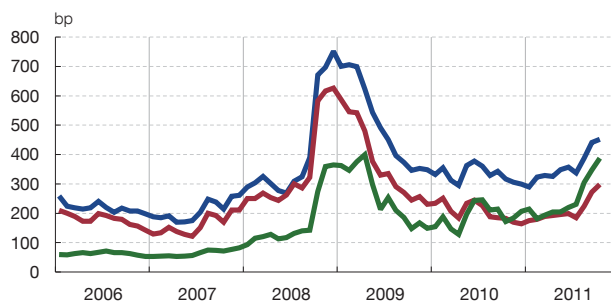
In the United Kingdom, GDP grew by 0.1% quarter-on-quarter (0.6% year-on-year) in Q2, fuelled by government consumption and investment, while private consumption and external demand contributed negatively to growth against a background of across-the-board falls in trade flows. The recent indicators point to a further weakening of activity in Q3, particularly in the manufacturing sector, which was prejudiced by the fall in export orders. Moreover, the labour market showed signs of weakness: the loss of vigour of private-sector employment between June and August meant that it was not possible to offset the public-sector job cuts, so the unemployment rate rose to 8.1%, the highest since 1996. Retail sale figures point to a fresh fall in private consumption, in line with the low level of confidence of households and their loss of purchasing power, against a backdrop of high inflation. Thus the recent increase in the price of household energy supply services pushed inflation up to 5.2% in September, although the core rate remained at 3.3%. The ongoing deterioration in economic and financial conditions led the Bank of England to reactivate its quantitative expansion strategy, despite the high inflation; its October meeting approved new government debt purchases for €75 billion, to be completed in February 2012.

GROSS DOMESTIC PRODUCT
Year-on-year rate



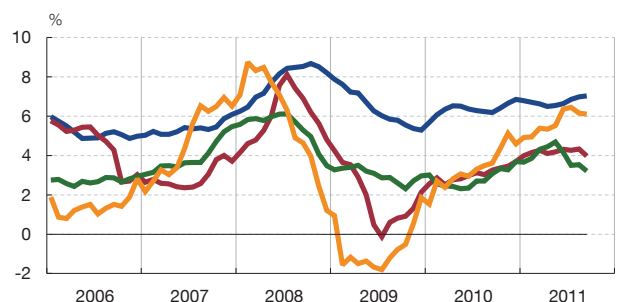
— LATIN AMERICA (b) — OTHER ASIAN ECONOMIES (c)
— NEW EU MEMBER STATES (d) — CHINA

INTEREST RATE SPREADS OVER THE DOLLAR (e)



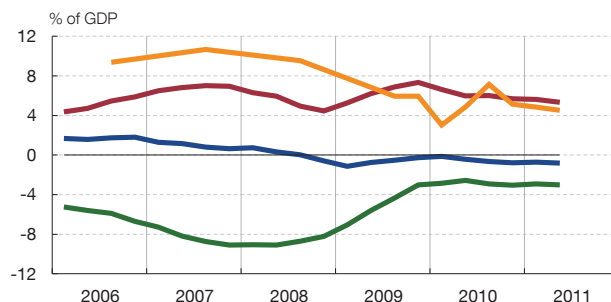
— LATIN AMERICA (EMBI +) — OTHER ASIAN ECONOMIES (EMBI Global)
— NEW EU MEMBER STATES (EMBI Global)

CONSUMER PRICES
Year-on-year rate



— LATIN AMERICA (b) — OTHER ASIAN ECONOMIES (c)
— NEW NON-EURO AREA EU MEMBER STATES (d) — CHINA (f)

CURRENT ACCOUNT BALANCE



— LATIN AMERICA (b) — OTHER ASIAN ECONOMIES (c)
— NEW NON-EURO AREA EU MEMBER STATES (d) — CHINA (f)

SOURCES: Datastream, Banco de España, IMF and JP Morgan.

- a The aggregate of the different areas has been calculated using the weight of the countries that make up these areas in the world economy, drawing on IMF information.
- b Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
- c Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore, Philippines and Taiwan.
- d Poland, Hungary, Czech Republic, Slovak Republic, Latvia, Lithuania, Bulgaria and Romania.
- e JP Morgan EMBI spreads. Latin America includes Argentina, Brazil, Colombia, Ecuador, Mexico, Panama, Peru and Venezuela. Asia includes China, Indonesia, Irak, Kazajistan, Malaysia, Pakistan, Philippines, Sri Lanka and Vietnam. The data on the new EU Member States relate to Hungary and Poland.
- f Annual data until 2009.

The dynamism of the exports and industrial production of the new EU Member States not belonging to the euro area moderated in Q3. Furthermore, there were no signs of recovery of domestic demand in most countries, given the fragility of the labour market and the commitment to fiscal consolidation. Throughout the quarter, inflation fell practically across-the-board due to smaller food price rises, leaving the aggregate inflation rate at 3.3% year-on-year in September. The heightened uncertainty as to whether the recovery will continue, along with a foreseeable period of more moderate inflation, meant that official interest rates were held unchanged. In the financial sphere, mention should be made of the law passed by the Hungarian Parliament in mid-September, which allows early repayment of mortgages in foreign currency at an exchange rate well below the market rate, with banks bearing the losses arising from exchange differences. It is estimated that 20% of these mortgages will be settled, so total bank losses would be around 0.6% of GDP.

In China, GDP was up by 9.1% year-on-year in Q3 (9.5% in the previous quarter), the lowest rate in two years. The outlook is uncertain, owing both to the weak external demand and, above all, to domestic factors (decrease in bank credit quality and doubts about the sustainability of real estate asset prices), although the baseline scenario continues to be one of mild slowdown. Also, although inflation moderated to 6.1% in September, it continues to be well above the target (4%). In this line, the central bank tightened its monetary policy in July, raising the official rate by 25 bp and the bank reserve ratio by 50 bp, although, in the current climate of uncertainty, fresh restraints are not expected. In the rest of emerging Asia, industrial production slowed appreciably in most countries in Q3 and the strong export growth rate moderated, pointing to an additional slowdown in activity. The inflationary pressures persisted due to higher food and energy prices. Despite this, official interest rates were only raised in two countries (Thailand and India, by 25 bp), while in the others they were held steady due to the fear of a fresh slowdown in the advanced economies, and in Indonesia they were even cut by 25 bp in October.

In Latin America the higher frequency indicators point to a moderate slowdown in activity in nearly all countries in Q3. Growth forecasts for the coming quarters were revised downward as the external environment worsened. Inflation rose by 0.4 pp in the quarter to 7% in September. Among the economies with inflation targets, the inflation rate exceeded the upper limit of the target range in Brazil and Peru, although inflation expectations remain anchored. Against this backdrop, the central bank of Brazil cut rates by 50 bp in each of its meetings in August and October, leaving the official interest rate at 11.5%. The central banks of Chile, Mexico and Peru indicate they may cut rates in their coming meetings, depending on international developments. Argentina, Brazil and Peru sold dollars in the foreign exchange markets to ease the downward pressure on their currencies in the second half of September, while Colombia did not renew its programme of daily dollar purchases and announced that it would hold auctions in the spot market if the exchange rate fluctuates by more than 2% from the average in the previous ten days. Finally, Argentina held presidential and legislative elections, in which the current president was re-elected.

3 THE EURO AREA AND THE MONETARY POLICY OF THE EUROPEAN CENTRAL BANK

In the third quarter, the euro area sovereign debt crisis entered a new phase, characterised by the heightening and spreading of tensions across financial markets. During this period, the problems were not confined to countries under financial assistance programmes, whose sovereign differentials continued to widen; in August, they also affected larger economies, such as Spain and Italy, and in September, Belgium and France, although to a lesser extent. Also, the tensions spread to other markets, with particularly severe effects on the European banking system, which was exposed to the debt of the countries in difficulty. Thus, the cost of borrowing for banks rose above the levels reached in 2009, and it became more difficult for them to obtain funds on the money markets. All this led to a significant decline in confidence indicators and a tightening of agents' financing conditions, in an adverse domestic and international macroeconomic setting (see Box 2).

Against this background of financial instability, the latest information available points to very modest activity growth during the summer months, following the rise that occurred in the first half of the year. This weakening of economic indicators, along with the smaller impetus from the external sector, the impact on domestic demand of fiscal consolidation measures and the implications of a resurgence of financial tensions, has led international organisations and private analysts to revise their medium-term economic projections downwards. In addition, they consider that this scenario is subject to a high degree of uncertainty, with a predominance of downside risks, largely relating to the situation of instability on the financial markets, both in the euro area and at the global level.

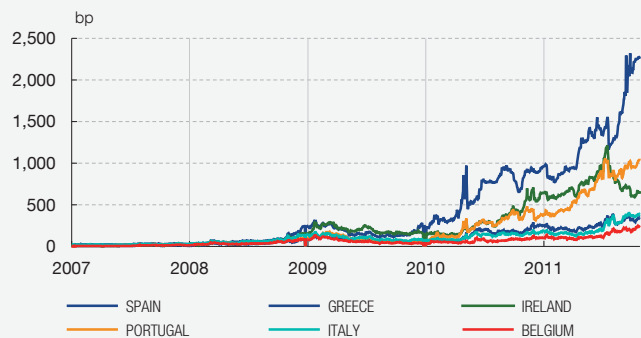
The absence of inflationary pressures over the relevant horizon for monetary policy led the ECB Governing Council to hold interest rates unchanged at its August, September and October meetings. However, the impact of the financial turmoil on the functioning of certain markets prompted the ECB Governing Council to revive certain non-standard measures to ensure an adequate amount of liquidity and to help restore the correct transmission of monetary policy. Notable in this respect were the reactivation of the securities market programme and operations to boost the provision of liquidity in dollars (in coordination with other central banks), and in euro, in the latter case through supplementary longer-term refinancing operations.

The summit of euro area Heads of State and Government held at the end of October constituted a significant step in the design of a sufficiently global strategy to regain and strengthen financial stability in the area. Although certain details have still to be resolved, the agreement addresses the main weaknesses detected and takes the form of ambitious action in four areas. First, a new financial assistance programme for Greece, which increases private sector participation and which must ensure that the country's finances return to a situation of sustainability, with a public debt ratio of around 120% of GDP in 2020. Second, the maximisation of efficiency in the use of the funds available from the European Financial Stability Facility (EFSF), which will permit an increase of up to five times in its capacity to act, thereby making it an effective mechanism to halt contagion. For this purpose two leveraging options are envisaged. These would not be mutually exclusive and their details are to be specified next month: the first consists in granting insurance or a partial guarantee for new issues of sovereign bonds by Member States in difficulty; and the second involves the creation of a special purpose vehicle specifically to attract investment from private and public financial institutions. In addition, cooperation

During the summer the euro area sovereign debt crisis entered a new phase of heightened tensions. These spread beyond the three countries under programmes, to have a severe impact on larger countries, such as Italy and Spain, and to a lesser extent, Belgium and France. Sovereign debt spreads reached record highs since the creation of the single currency, of close to 400 bp in the cases of Italian and Spanish bonds (see Panel 1).

The turmoil had a singular effect on the European banking system, which was highly exposed to the debt of the beleaguered countries. Thus, banks saw their credit risk premia exceed the levels reached in the wake of the collapse of Lehman Brothers (see Panel 2), while the difficulty obtaining funds on the money and wholesale funding markets (particularly in dollars) increased. As in past episodes, the tension was reflected in an increase in the spreads

1 TEN-YEAR SOVEREIGN SPREADS. DAILY DATA



2 FIVE-YEAR TERM ITRAXX INDICES FOR EUROPE (a)



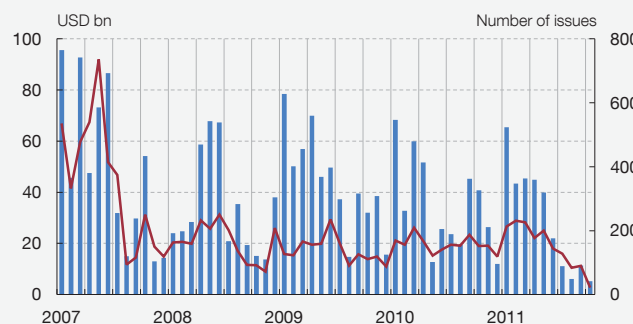
3 EURIBOR-REPO SPREAD



4 USE OF THE ECB'S DEPOSIT FACILITY
Average of 30 calendar years



5 GROSS DEBT ISSUANCE BY THE FINANCIAL SECTOR IN THE EURO AREA (b)



6 BROAD EURO STOXX AND BANKING SECTOR



SOURCE: ECB, Dealogic, Eurosystem, IMF, Markit Economics and Banco de España.

a Traded index of basket of CDS for debt issued by 25 financial institutions.
b Gross issuance of medium and long-term bonds. Covered bonds are not included.

between rates on secured and unsecured deposits (see Panel 3) and an increase in the recourse to Eurosystem financing, which coexists with heavy use of the ECB's deposit facility (see Panel 4). Meanwhile, bank debt issuance clearly declined and institutions that succeeded in issuing debt did so at high rates, while banks based in countries under programmes have had virtually no access to financing on this market since July (see Panel 5).

The financial instability also spread to stock markets (see Panel 6), which, against a background of very high volatility, suffered significant falls. Thus, both the broad EURO STOXX index and the selective EURO STOXX index stood, at the end of October, at comparable levels to those prevailing at the end of 2008, and the losses in 2011 have exceeded 20% in both cases. Bank stocks fell even further, so that the EURO STOXX banking sector index was 39% lower at the end of October than at the beginning of 2011.

The impact on key elements of the monetary policy transmission mechanism required intervention at the beginning of August by the ECB, which reactivated its programme of sovereign debt purchases on the secondary markets. The ECB Governing Council also decided to step up the provision of liquidity in dollars (in coordina-

tion with other central banks) and in euro, in the latter case through the conduct of supplementary longer-term refinancing operations, using the fixed-rate full allotment tender procedure. In addition, a new covered bond purchase programme was launched.

In short, the behaviour of financial stress indicators in Q3 illustrates the systemic nature and gravity of the crisis affecting the euro area. The deterioration of the situation in Greece, the slow implementation of the agreements reached at the European summit of 21 July and market doubts regarding the sufficiency of the countries' financial commitments have exacerbated risk aversion and volatility, affecting agents' confidence at a particularly complicated time, when the process of economic recovery has lost momentum and most governments lack leeway to adopt aggregate demand stimulation policies. It is therefore essential at this juncture that the necessary mechanisms be put in place to permit the risk of a perverse dynamic of negative feedback between sovereign risk, banking risk and loss of economic momentum to be minimised. In this respect, the summit of Heads of State and Government at the end of October set out a global strategy to ensure the financial stability of the area, which attempts to address the weaknesses revealed during the crisis (see the introduction).

with the IMF will be strengthened to boost the financial capacity of the facility. Third, a plan has been established to restore confidence in the banking sector through, on one hand, a programme of guarantees coordinated at the EU level to facilitate the sector's funding and, on the other, recapitalisation of the main banks which will be required to meet a tier 1 capital ratio of 9% by the end of June 2012. Finally, the governments renewed their commitment to continue adopting the measures needed to ensure the sustainability of their public finances and to promote economic growth, while respecting the approved fiscal objectives and accelerating structural reforms.

The Heads of State and Government also agreed further steps in the process of governance reform and euro area integration to promote the economic convergence necessary in a monetary union. The countries of the area noted that the recent approval of the governance reform initiated in 2010 has been an important step in addressing some of the weaknesses detected in the euro area's institutional framework (see Box 3). However, a definitive solution requires more decisive progress towards economic integration, which could require limited reform of the EU Treaty. Accordingly, the Heads of State and Government have charged the president of the Council, in collaboration with the presidents of the European Commission and of the Eurogroup, with studying new initiatives for further progress, in time for the December meeting, and with issuing a report by the end of March 2012.

3.1 Economic developments

On the third national accounts estimate for 2011 Q2, euro area GDP increased by 0.2% quarter-on-quarter, down 0.6 pp from Q1 (see Table 1). The slowdown in output largely reflected the decline in consumption and in construction investment and other investment, while investment in capital goods and external demand performed favourably (see Chart

	2010				2011			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
NATIONAL ACCOUNTS (quarter-on-quarter growth, unless otherwise indicated)								
GDP	0.3	0.9	0.4	0.3	0.8	0.2		
Private consumption	0.4	0.2	0.3	0.3	0.2	-0.2		
Government consumption	-0.4	0.2	0.0	0.0	0.4	-0.1		
GFCF	-0.7	2.2	0.0	-0.2	1.8	0.1		
Imports	3.8	3.9	1.5	1.1	1.6	0.2		
Exports	3.0	4.2	1.8	1.2	1.4	0.7		
Contributions to quarter-on-quarter change in GDP (pp)								
Domestic demand, excluding stocks	0.0	0.6	0.2	0.1	0.5	-0.1		
Stockbuilding	0.6	0.2	0.1	0.1	0.3	0.1		
Net foreign demand	-0.2	0.2	0.2	0.2	0.0	0.3		
GDP (year-on-year rate of change)	0.9	2.1	2.1	1.9	2.4	1.6		
ACTIVITY INDICATORS (quarterly average)								
IPI seasonally and working-day adjusted	2.7	2.7	0.8	1.7	1.1	0.6	1.5	
Economic sentiment	96.4	99.2	102.3	105.7	107.4	105.7	98.8	
Composite PMI	54.4	56.6	55.7	54.9	57.6	55.6	50.3	47.2
Employment	0.0	0.1	0.0	0.1	0.1	0.3		
Unemployment rate	10.1	10.2	10.2	10.1	10.0	10.0	10.0	
PRICE INDICATORS (year-on-year change in end-period data)								
HICP	1.6	1.5	1.9	2.2	2.7	2.7	3.0	
PPI	0.9	3.1	4.3	5.4	6.8	5.9	5.8	
Oil price (USD value)	78.8	75.0	78.4	92.3	115.4	114.9	114.8	110.8
FINANCIAL INDICATORS (end-period data)								
Euro area ten-year bond yield	4.0	3.7	3.5	4.1	4.6	4.4	4.0	4.3
US-euro area ten-year bond spread	-0.1	-0.7	-1.01	-0.78	-1.14	-1.30	-2.06	-2.08
Dollar/euro exchange rate	1.348	1.227	1.365	1.336	1.421	1.445	1.350	1.393
Appreciation/depreciation of the NEER-20 (b)	-4.5	-10.3	-6.3	-8.2	3.5	3.9	0.7	1.9
Dow Jones EURO STOXX 50 index (b)	-1.2	-13.2	-7.4	-5.8	4.2	2.0	-22.0	-16.4

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

a Information to 26 October 2011.

b Percentage change in year to date.

8). Thus, the negative contribution of domestic demand to the change in GDP (-0.1 pp) was offset by the contribution of external demand, which reached 0.3 pp, as a consequence of a sharper slowdown in imports than in exports. For its part, stockbuilding added 0.1 pp to GDP growth. The sector breakdown shows a significant slowdown in the value added of industry and construction, while that of non-market services continued to grow at the same rate. Year-on-year, the seasonally adjusted rate of change of GDP stood at 1.6%, as against 2.4% in the preceding quarter.

By country, the sharp deceleration in GDP in Q2 in Germany and in France, by 1.2 pp and 0.9 pp, respectively, to practically zero growth rates in both cases, was notable. This behaviour was a result of the same factors mentioned above for the euro area, although Germany recorded a negative contribution from external demand and a larger positive contribution from stockbuilding. In Italy, output grew by 0.3%, up 0.2 pp on the previous two quarters, thanks to the expansion of gross fixed capital formation and the large positive contribution from the net external balance, as a consequence of the marked contraction in imports.

On 4 October, the EU Council approved five immediately applicable regulations and a directive that must be transposed by the end of 2012. This legislation incorporates the progress agreed by governments and European authorities in relation to governance reform. The process now culminating was initiated in 2010 with the establishment of the so-called "Van Rompuy task force", which agreed on an initial proposal for reform in October 2010. At the end of March 2011 the European Council endorsed the general principles of this proposal, and a process of tripartite negotiations was initiated between the Council, the European Parliament and the European Commission, with the participation of the ECB.

Taken together, the reforms approved entail a strengthening of the Stability and Growth Pact, to increase control over budget policies. More emphasis is placed on instruments of prevention and harsher sanctioning instruments are established for when commitments are not fulfilled. The supervision is also extended to other macroeconomic and structural policies, with the introduction of a new formal procedure for the surveillance of internal and external macroeconomic imbalances. This will attempt to avoid the emergence of imbalances, such as the excessive growth of private indebtedness and divergences in competitiveness, which have been so damaging to the development of the euro area.

In the fiscal sphere, the reform first strengthens the preventive component of the Pact. Along with the need to make progress towards compliance with the medium-term budgetary objective (generally consisting in achieving a structural balance close to zero), there is now a limit on public spending, the growth of which may not exceed GDP growth in the medium-term.

Second, greater relevance is given to the debt criterion throughout the fiscal supervision process. Thus, with regard to prevention, the structural adjustment required in the process of moving towards the medium-term objectives will be greater for those countries with a debt ratio of more than 60% of GDP. As regards the corrective arm, the possibility of initiating an excessive deficit procedure against countries with debt ratios of more than 60% of GDP is increased, even when the deficit is below 3%, with the specification of a numerical benchmark for what is considered "a satisfactory adjustment of debt". In any event, implementation of the debt criterion is still less automatic than that of the deficit one, since a broad range of factors affecting the dynamics of public debt will be taken into consideration when an EDP is initiated on the basis of the debt criterion. The reform also introduces a three year transition period before this criterion will be fully operational.

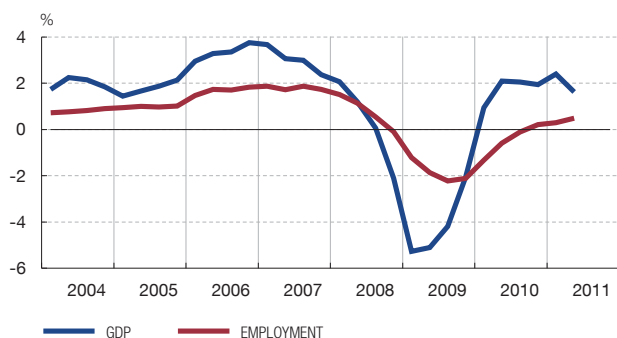
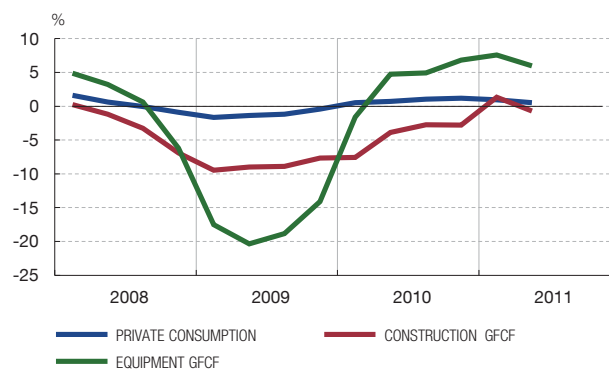
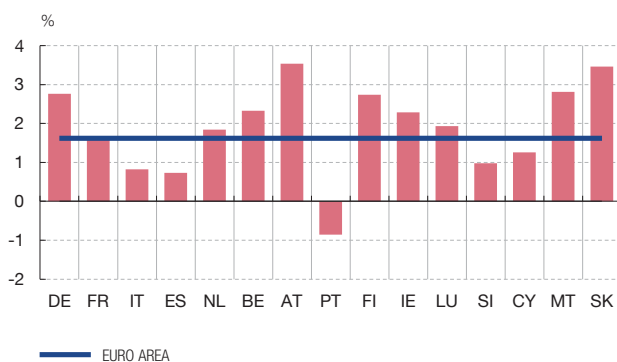
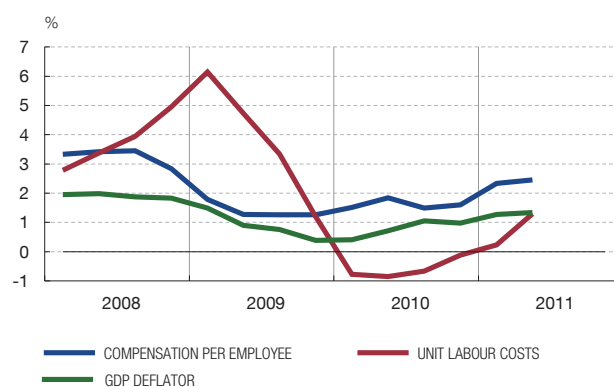
Third, in order to strengthen compliance with commitments, a set of sanctions has been introduced, which will be applied at an earlier stage of the process, generally by means of a reverse voting procedure, in which the proposals of the European Commission are considered adopted unless the Council decides otherwise within ten days by qualified majority. The revenue obtained from these fines will go to the European Financial Stability Facility.

Finally, the fiscal frameworks directive introduces the requirement to establish multiannual budgetary programmes, to improve the quality and availability of fiscal statistics and an obligation on countries to transfer the fiscal rules and commitments acquired within the euro framework to their respective national legal systems. In the area of statistics, it should be mentioned that the new regulation of the preventive arm also specifies certain requirements to make national statistical institutes more independent, which come on top of the measures approved previously to increase the Eurostat's capacity to audit the figures supplied by national authorities.

The framework for the surveillance of macroeconomic imbalances consists in turn of a preventive arm, the alert mechanism, and a corrective arm, in the form of an excessive imbalance procedure. The alert mechanism is made up of a set of economic, financial and structural indicators, which will be regularly reviewed, in order to take into consideration the changing nature of imbalances. Symmetric quantitative limits are established to detect deviations that may be excessive, but exceeding such limits will not automatically lead to the initiation of a procedure, since the specific circumstances of each economy (e.g. the possible existence of real convergence processes) will be taken into consideration. The corrective arm, meanwhile, establishes an obligation to submit to the Commission and to the Council a plan of action to correct imbalances. The council must decide if this plan is sufficient and establish the deadlines for adopting the measures. In the event of repeated failure to comply with these commitments, the process may terminate in the imposition of a fine.

All in all, this reform may not be sufficiently ambitious to eliminate the cracks in the euro project that have emerged during the crisis. That has been the opinion of the Eurosystem, which has demanded greater automatism in the application of all these procedures, so as to reduce the degree of political interference. It has also demanded less symmetry in the application of the excessive imbalance procedure, considering that a current account surplus does not have the same implications as a deficit. The negotiations in the European Parliament concluded with a compromise that somewhat increases the degree of automatism, with respect to the initial proposal of the Van Rompuy task force, while maintaining the symmetry in the application of the excessive imbalance regulation.

Without a doubt the reforms adopted amount to progress towards greater sharing of responsibility and coordination in the design and surveillance of fiscal and structural policies, which may contribute to avoiding the emergence of imbalances. However, the summit of Heads of State and Government at the end of October emphasised the need to make further progress in economic integration in the euro area to promote the necessary convergence within the union. For this purpose it charged the president of the Council, in collaboration with the presidents of the Commission and of the Eurogroup, with studying new initiatives for further progress, in time for the December meeting, without ruling out the possibility of limited treaty reform, and with issuing a report by the end of March 2012.

OUTPUT AND EMPLOYMENT
Year-on-year growthPRIVATE CONSUMPTION AND INVESTMENT
Year-on-year growthYEAR-ON-YEAR GROWTH RATES OF GDP
2011 Q2WAGE AND COST INDICATORS
Year-on-year growth

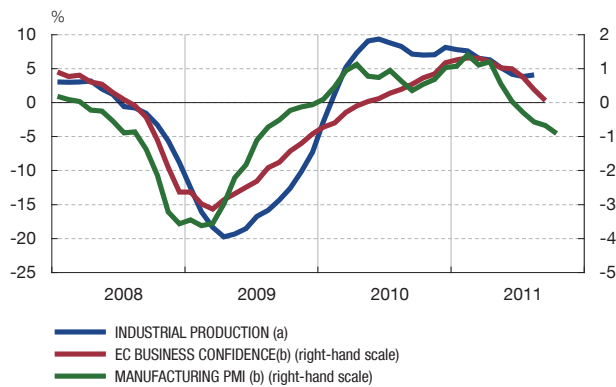
SOURCES: Eurostat and national statistics.

On national accounts data the number of persons employed in the euro area grew by 0.3% in Q2, which increased the year-on-year rate to 0.5%. This behaviour was a result of more buoyant activity in Q1, which tends to be passed through to employment with a certain lag. At the same time, the slowdown in apparent labour productivity in Q2, to 1.1%, and further growth in compensation per employee led to higher growth in unit labour costs. Since the GDP deflator grew at the same rate as unit labour costs, profit margins remained relatively stable (see Chart 8).

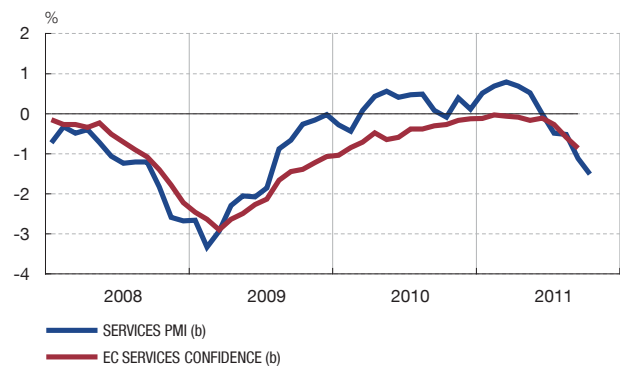
The latest conjunctural information generally shows very modest growth in Q3 (see Chart 9). On the supply side, industrial production and order books accelerated between June and August, although this trend should be assessed with caution since these months are characterised by a high degree of volatility. For its part, construction output contracted. The confidence indicators for the industrial and services sectors compiled by the European Commission and those based on surveys of purchasing managers stood well below their June levels in September and, in practically all cases, below their historical average levels. In the labour market, the rate of unemployment remained unchanged at 10% in Q3, while the survey-based indicators of employment expectations fell between June and September in all sectors.

Demand related indicators are also showing signs of weakness in the second half of the year. In Q3, retail sales were stagnant (on data to August) and new car registrations de-

INDUSTRIAL ACTIVITY INDICATORS



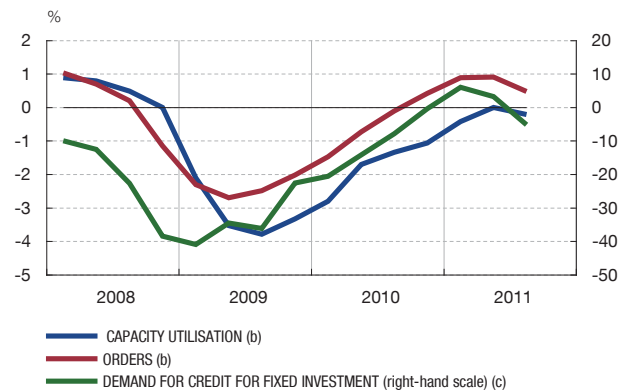
SERVICES SECTOR INDICATORS



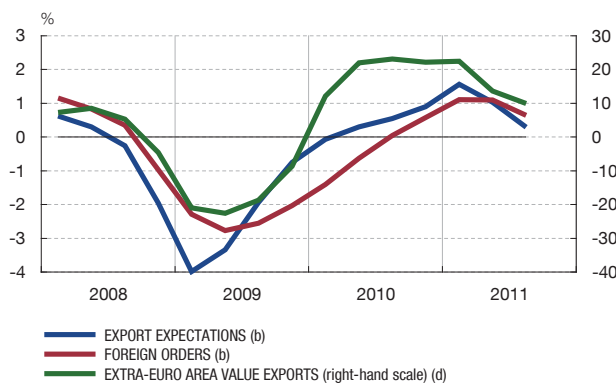
CONSUMPTION INDICATORS



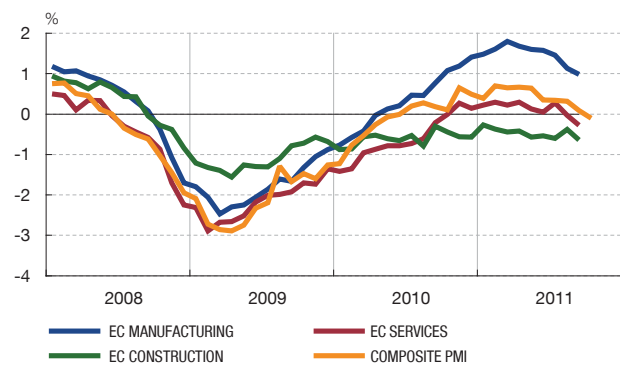
INVESTMENT INDICATORS



EXPORT INDICATORS



EMPLOYMENT EXPECTATIONS INDICATORS (b)



SOURCES: European Commission, Eurostat and Markit Economics.

- a Non-centred annual percentage changes, based on the quarterly moving average of the seasonally adjusted series.
- b Normalised data.
- c Bank Lending Survey. Indicator = percentage of banks reporting a considerable increase + percentage of banks reporting some increase x 0.5 - percentage of banks reporting some decrease x 0.5 - percentage of banks reporting a considerable decrease. A positive value denotes an increase.
- d Year-on-year rates of the original series. Quarterly average.

clined, while consumer confidence dropped substantially between July and October, to well below its long-term average levels. With regard to the European commission's indicators of investment in capital goods, capacity utilisation declined in Q3, following two years of improvement, and the assessment of industrial order books fell. On balance of payments data, exports increased in July and August from the previous quarter, although export expectations and the assessment of export order books deteriorated in Q3. Finally, according to the developments in the European Commission's industrial stock level assessment indicator, the contribution of this component to GDP growth may have declined in Q3.

In short, the latest conjunctural information confirms a deterioration in the economic situation over the summer months, following the buoyancy of the first half of the year (see Table 1). Among the factors that, potentially at least, underlie this moderation in growth, it should be recalled that this quarter was characterised by a heightening of tensions on sovereign debt markets, which were passed through to other financial markets and, in particular, to the banking sector, and that this was accompanied by a sharp rise in volatility and uncertainty, as well as a tightening of financing conditions. Also notable were the slowdown in external demand, the increase in commodity prices and the impact of fiscal consolidation measures. For all these reasons international organisations and private analysts have revised downwards their growth outlook for the second half of 2011 and 2012, so that it now involves a prolonged period of slackness. This scenario, moreover, appears to be surrounded by a high degree of uncertainty, with a predominance of downside risks. Notable among the latter are further intensification of tensions in certain segments of euro area financial markets and at the global level, as well as a more pronounced impact of such tensions on agents' spending decisions (see Box 2).

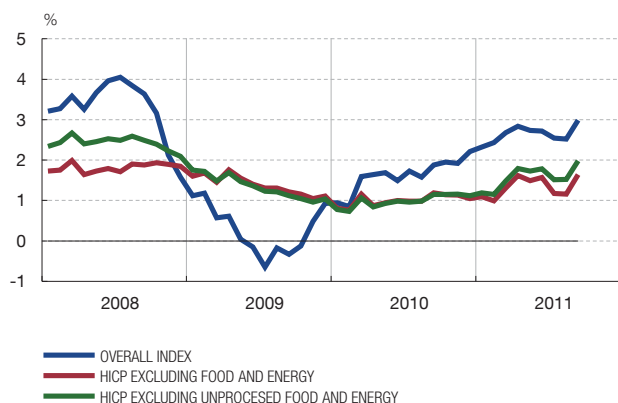
The annual inflation rate stood at 3% in September, 0.3 pp higher than in June, largely due to transitory factors, such as the end of the sales period, which had a larger impact owing to the methodological change in the treatment of seasonal products introduced at the beginning of the year, rises in indirect taxes in Italy, Greece and Portugal, and the depreciation of the euro. Thus, the energy component contributed to the inflation surge, despite the fact that the dollar price of energy commodities did not change significantly. Core inflation, as measured by the CPI excluding unprocessed food and energy, increased by 0.2 pp, to 2%, mainly due to the rise in the prices of non-energy industrial goods, and in particular to the clothing and footwear-related items, on which the change in the treatment of seasonal products had most impact (see Chart 10). The growth rate of industrial prices moderated during the summer months, to stand at 5.9% in August, with a small rise in energy prices. In the medium term, the risks to inflation are generally considered to be balanced, since although further increases in commodity prices or increases in indirect taxes and administered prices cannot be ruled out, these would only be partially passed through to inflation, owing to the poor activity outlook (see Table 2). Against this background, long-term inflation tensions remain anchored.

According to the information published by the ECB, the euro area current account posted a deficit of €59.4 billion (0.9% of GDP) between January and August 2011, which was somewhat higher than the €38 billion recorded in the same period of the previous year (0.6% of GDP). This worsening was mainly due to the change in sign of the goods balance, which moved into deficit, while the services balance improved. Within the financial account in the same period there was a smaller net capital outflow in the form of direct investment (€38 billion, as against €103 billion in 2010) while net inflows of portfolio investment increased by €105 billion to €299 billion. Thus, the basic balance, which combines

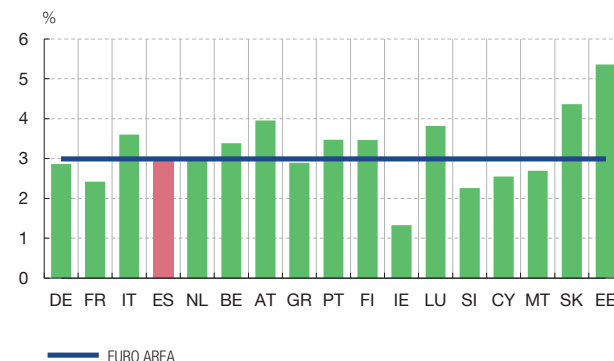
EURO AREA. PRICE INDICATORS
Year-on-year percentage changes

CHART 10

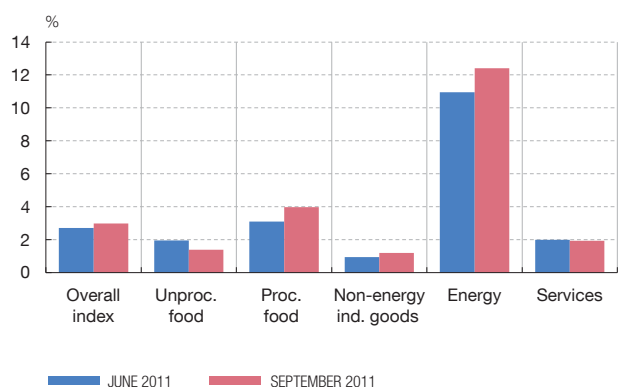
HARMONISED INDICES
OF CONSUMER PRICES



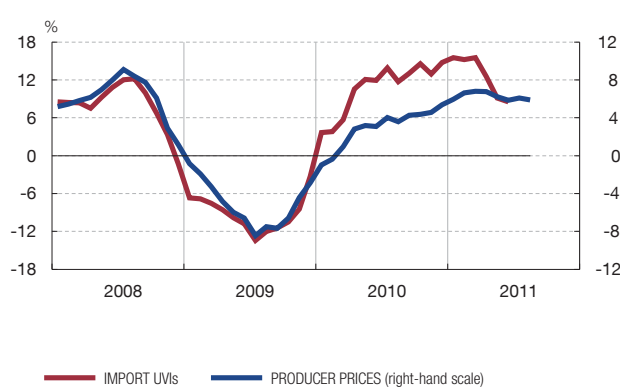
OVERALL HICP
September 2011



HICP AND ITS COMPONENTS



OTHER PRICE INDICATORS



SOURCES: Eurostat and ECB.

GDP AND HICP FORECASTS FOR THE EURO AREA (a)

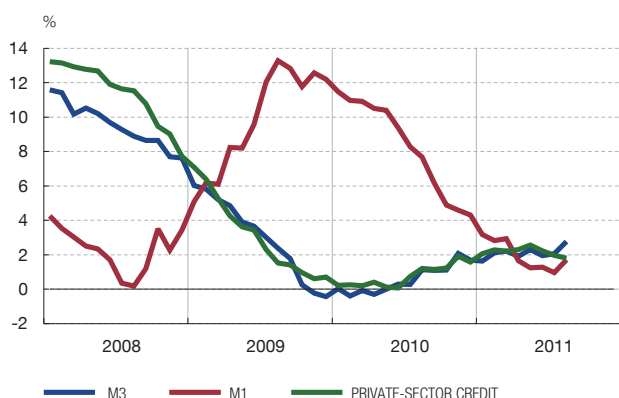
TABLE 2

	2011		2012	
	GDP	HICP	GDP	HICP
ECB (September 2011)	1.4-1.8	2.5-2.7	0.4-2.2	1.2-2.2
European Commission (May 2011)	1.6	2.6	1.8	1.8
Interim update (September 2011)	1.6	2.5		
IMF (September 2011)	1.6	2.5	1.1	1.5
OECD (May 2011)	2.0	2.6	2.0	1.6
Consensus Forecast (October 2011)	1.6	2.6	0.6	1.8
Eurobarometer (October 2011)	1.6	2.6	0.6	1.7

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

a Year-on-year rate of change.

MONETARY AND CREDIT AGGREGATES
Year-on-year growth



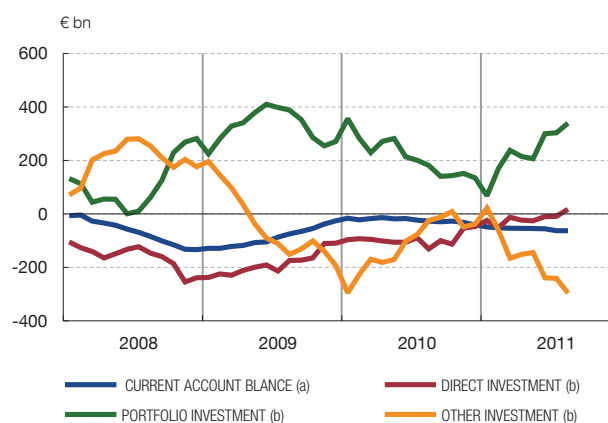
FINANCING OF NON-FINANCIAL CORPORATIONS
Year-on-year growth



FINANCING OF HOUSEHOLDS
Year-on-year growth



BALANCE OF PAYMENTS
(Cumulative amounts for the last twelve months)



SOURCES: ECB and Banco de España.

- a A positive (negative) sign denotes a surplus (deficit) on the current account balance.
- b Capital inflows minus outflows. A positive (negative) sign denotes a net capital inflow (outflow).

these two types of investment with the current account balance, moved from deficit (-€47 billion) in the period January-August 2010 into surplus (€202 billion) in the same period in 2011 (see Chart 11).

With regard to fiscal policy, the information available on the budget outturn and government estimates suggest that, in the euro area as a whole, the clear contractionary stance is being maintained in 2011, in line with the European Commission projections of last spring (see Table 3). The impact on the deficit of fiscal consolidation measures introduced in certain countries in recent months has been offset by the effect of automatic stabilisers and the rise in interest payments, which was especially notable in those economies under most pressure in the sovereign debt markets.

At a disaggregated level, public finances in Germany have performed better than expected and the government is currently projecting a deficit of close to 1.5% of GDP, below the reference value of 3% two years before the deadline established by the Council within the framework of the excessive deficit procedure. By contrast, France, in view of less favour-

% of GDP

	2009	2010		2011		2012	
		EDP (b)	EC (d)	IMF (c)	EDP (b)	EC (d)	IMF (c)
Belgium	-5.9	-4.1	-3.7	-3.5	-3.5	-4.1	-3.5
Germany	-3.0	-4.3	-2.0	-1.7	-1.3	-3.3	-1.1
Estonia	-1.7	0.2	-0.6	-0.1	0.2	0.1	-2.1
Ireland	-14.3	-31.3	-10.5	-10.3	-10.0	-8.8	-8.6
Greece	-15.4	-10.6	-9.5	-8.0	-8.6	-9.3	-6.9
Spain	-11.1	-9.3	-6.3	-6.1	-6.0	-5.3	-5.2
France	-7.5	-7.1	-5.8	-5.9	-5.7	-5.3	-4.6
Italy	-5.4	-4.6	-4.0	-4.0	-3.9	-3.2	-2.4
Cyprus	-6.0	-5.3	-5.1	-6.6	-6.5	-4.9	-4.5
Luxembourg	-0.9	-1.1	-1.0	-0.7	-0.6	-1.1	-1.2
Malta	-3.7	-3.6	-3.0	-2.9	-2.8	-3.0	-2.9
Netherlands	-5.5	-5.1	-3.7	-3.8	-4.2	-2.3	-2.8
Austria	-4.1	-4.4	-3.7	-3.5	-3.6	-3.3	-3.2
Portugal	-10.1	-9.8	-5.9	-5.9	-5.9	-4.5	-4.5
Slovenia	-6.0	-5.8	-5.8	-6.2	-5.5	-5.0	-4.7
Slovakia	-8.0	-7.7	-5.1	-4.9	-5.8	-4.6	-3.8
Finland	-2.6	-2.5	-1.0	-1.0	-1.1	-0.7	0.3
MEMORANDUM ITEM: euro area							
Primary balance	-3.5		-1.3	-1.5		-0.4	-0.3
Total balance	-6.3	-6.2	-4.3	-4.1	-4.0	-3.5	-3.1
Public debt	79.3	85.6	87.7	88.6	87.6	88.5	90.0

SOURCES: European Commission, Eurostat and IMF.

- a Deficit (-)/surplus (+). The deficits that exceed 3% of GDP have been shaded.
b EDP notification (autumn 2011).
c IMF forecasts (September 2011).
d European Commission forecasts (spring 2011).

able growth prospects, decided to adopt additional fiscal adjustment measures for 2011 and 2012 (amounting to approximately 0.5% of GDP), involving an increase in excise duties and taxes on companies, real estate and top incomes. Italy also introduced a set of measures in mid-September with the aim of achieving budget balance by the end of 2013, thus bringing forward one year the initial objective of 2014. Most of the adjustment comes from greater tax revenues and only around one third stems from primary expenditure. Among the measures to be applied immediately in 2011, the increase in VAT and excise duties was notable, while a reform of the tax system and health will be applied in 2012, the effects of which on the accounts are subject to a high degree of uncertainty. At the summit at the end of October it strengthened its commitment, presenting additional measures to improve competitiveness and liberalise the economy that are yet to be implemented.

As for the three euro area countries under financial assistance programmes, the new Portuguese government acted rapidly to introduce various adjustment measures to cover budget deviations that have arisen in certain regions and the risks that the worsening of the economic situation may have generated. Specifically, a temporary increase in personal and corporate income taxes, an increase in VAT on gas and electricity consumption and the transfer of pension funds from private banks to the Social Security system were approved. For the following years (2012-15), wage moderation, public sector employment

reductions and a privatisation plan are envisaged. No additional fiscal measures were approved in Ireland, but, as in the case of Portugal, it received a positive assessment from the Troika (IMF, EC and ECB) in the respective quarterly reviews of the conditionality inherent in the financial assistance programmes.

In Greece, by contrast, the intensity of the economic recession (which led to a decline of 3.4% in public revenues in cash terms to August, as against the target 5.6% annual increase) and the delay in the effective implementation of some of the more structural measures approved, such as privatisations and the reduction in public-sector employment, led the government to acknowledge the impossibility of complying with its 2011 budget commitments. In order to correct these deviations, the Greek government presented at the end of September another set of fiscal adjustment proposals, which was subsequently expanded, in addition to the consolidation measures contained in the so-called “medium-term fiscal strategy”. These measures comprised an increase in VAT on certain items, such as restaurants (from 13% to 23%), the introduction of a solidarity tax on all citizens and an extraordinary tax on the owners of high-value housing, in addition to a further reduction in public-sector wages, cuts in certain pension brackets and a new structural reform and privatisation plan. In mid-October the Troika reported favourably on the extension of the sixth tranche of aid under the assistance plan agreed in May 2010. Also, the summit of Heads of State and Government made progress in establishing the details of the second financial assistance programme, which consists of the contribution of a further €100 billion of official financing and an expansion of the private-sector participation agreed on 1 July, in an attempt to bring Greek public debt down to 120% of GDP in 2012.

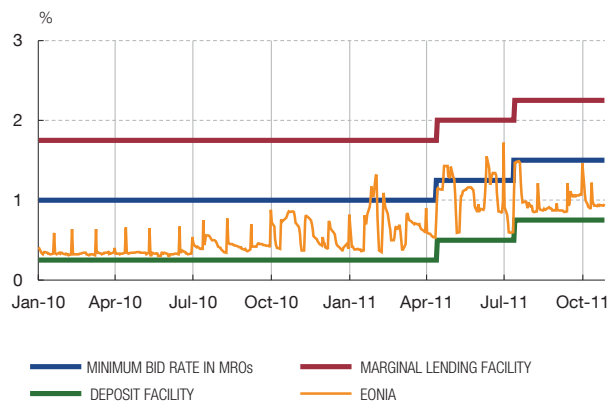
As a whole, the implementation of additional fiscal consolidation measures in certain countries has slowed the deterioration that was taking place in euro area public finances, although there is still much uncertainty regarding the impact on public finances of the deterioration in the macroeconomic scenario and of the ultimate effects of these measures. In this respect, countries that have seen a larger deterioration in their public finances in the past or that have high levels of debt must continue to press ahead with consolidation in their budgets for 2012, which are still in preparation, adopting a well specified and credible strategy that puts greater emphasis on cutting expenditure. Countries that have posted a less adverse economic performance and that have healthier public finances have greater leeway to establish counter-cyclical fiscal policies against a background of global economic deterioration.

3.2 Monetary and financial developments

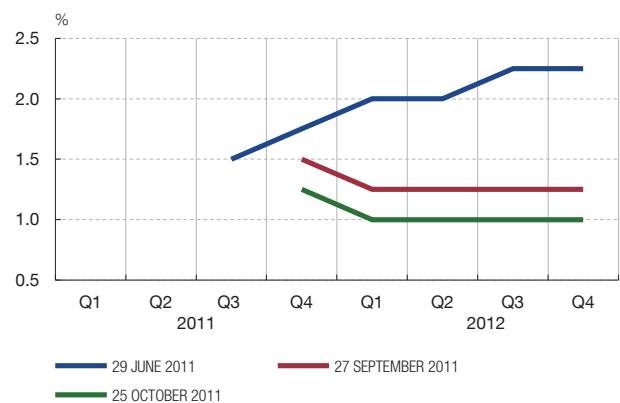
The financial turmoil subsided slightly following the agreement at the summit of the euro area Heads of State and Government on 21 July, which approved Greece’s second bail-out programme and greater flexibility for the European Financial Stability Facility, but flared up again at the beginning of August. Among other factors, this renewed outbreak was a result of the deterioration of the situation in Greece, slow implementation of the agreements of 21 July and doubts regarding the sufficiency of the financial commitments assumed by the governments. All this affected agents’ confidence at a particularly complicated time, just as the economic recovery was losing momentum and when the leeway to adopt expansionary demand policies was for most governments very limited (such leeway is indeed still very limited). Thus, the euro area sovereign debt crisis spread beyond the countries under programmes, to affect larger economies, such as Italy and Spain (and even France), causing the banking system’s financing conditions to deteriorate (see Box 2).

Given the absence of significant inflationary pressures and the fact that medium-term inflation expectations were at levels compatible with the objective of price stability, the ECB

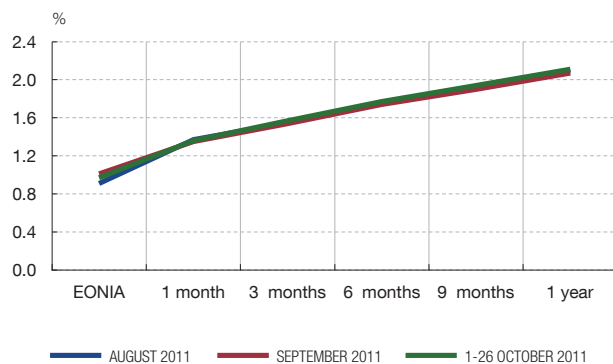
EONIA AND ECB INTEREST RATES



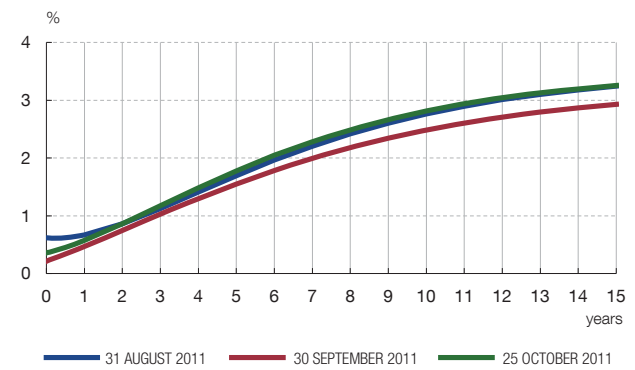
EXPECTED END-QUARTER ECB RATE. REUTERS SURVEYS



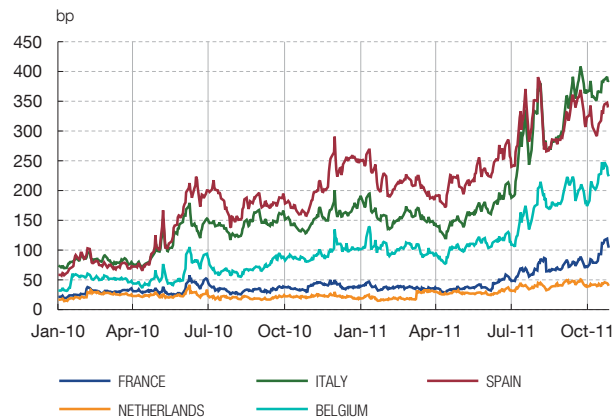
INTERBANK MARKET



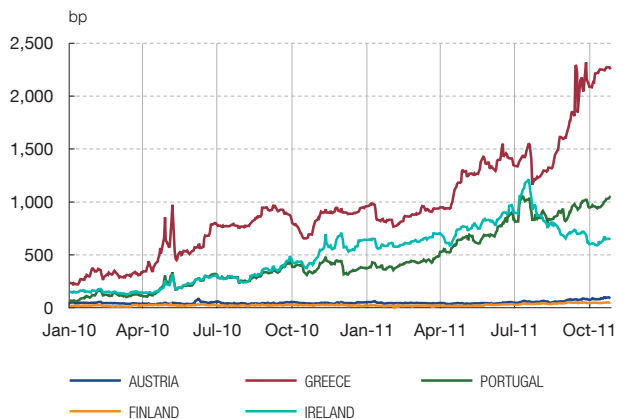
ZERO COUPON CURVE (a)



SOVEREIGN SPREADS OVER GERMANY



SOVEREIGN SPREADS OVER GERMANY

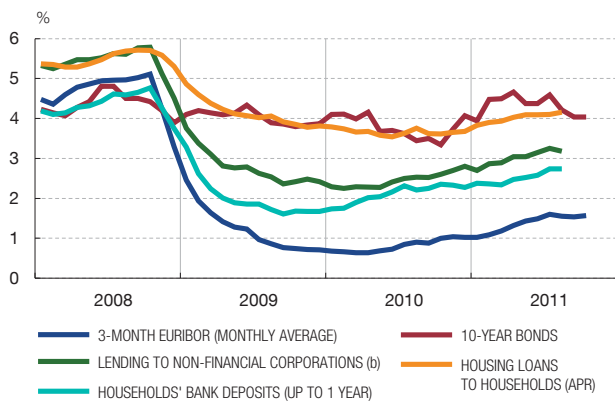


SOURCES: ECB and Banco de España.

a ECB estimate using swap market data.

Governing Council decided at its August, September and October meetings to leave its official interest rates unchanged at 1.5% for main refinancing operations and at 2.25% and 0.75%, respectively, for the credit and deposit facilities (see Chart 12). However, the impact of the financial turmoil on the functioning of certain markets led the ECB Governing Council to revive certain non-standard measures in order to ensure an adequate level of liquidity. Thus, in August, the Governing Council re-activated the Securities Market Pro-

EURIBOR AND BANK INTEREST RATES (a)



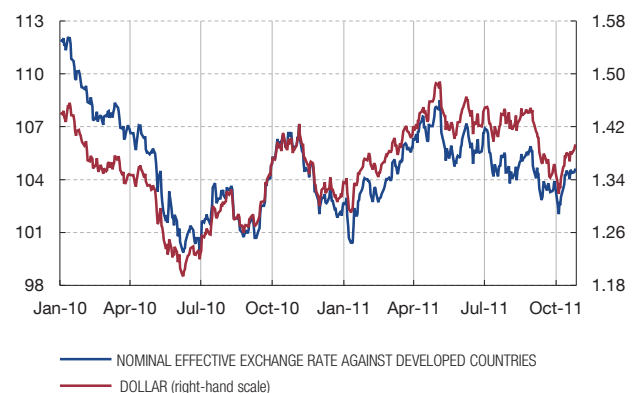
CORPORATE BOND YIELD SPREADS OVER SWAP ASSETS



EURO STOXX 50 INDEX AND VOLATILITY



NOMINAL EXCHANGE RATES OF THE EURO



SOURCES: ECB and Banco de España.

- a On new business.
- b Floating interest rates and up to 1 year initial rate fixation.

programme, stepped up the provision of dollar liquidity (in coordination with other central banks) and conducted a supplementary six-month refinancing operation in euro. In addition, use of the fixed-rate full-allotment tender procedure for all operations was extended in August and again in October, to mid-2012. Also in October, two more supplementary refinancing operations, with maturities of 12 and 13 months, to be conducted in October and December, respectively, and a new €40 billion covered bond purchase programme, to be executed between November 2011 and October 2012, were announced. Finally, the Governing Council highlighted the interaction between the problems arising from the deterioration of sovereign risk and the situation of the banking sector, emphasising the need for the banks to strengthen their balance sheets and recapitalise. Where necessary, the banks may obtain financing from governments in order to do so, and the latter, following the reform approved in July, will be able to obtain loans for such purpose from the European Financial Stability Facility.

Interbank market interest rates were relatively stable between July and September (see Chart 13). EONIA and three-month and one-year EURIBOR stood, respectively, at around 0.9%, 1.6% and 2.1% in October. By contrast, the repo rate declined, probably reflecting expectations of future cuts in official interest rates, which were not passed through to EU-

RIBOR owing to the renewed outbreak of financial tensions. The spread between the repo rate and EURIBOR therefore widened sharply, to 158 bp at the end of September, although it has narrowed slightly in October. In the public debt markets the interest rate on the German bund continued to decline, to stand below 1.7% in September (although it has increased since), owing to the perception of this asset as a safe haven, while other countries were affected to a greater or lesser extent by the turmoil. Among those countries under an assistance programme, from July Greece experienced the largest increase in the spread on its sovereign bonds over the 10-year German bund (more than 900 bp), which reached more than 2,200 bp in October, while the Portuguese spread rose by 197 bp and the Irish one fell significantly (by 257 bp). In Spain and in Italy the spread continued to widen, although the latter did so more sharply, so that the Italian spread exceeded the Spanish one for the first time since the start of the tension (see Chart 12). Belgium and France also saw their spreads increase, by 110 bp and 54 bp, respectively, over this period. Finally, from the beginning of August the interest rate on US debt fell by more than that on German debt, so that the positive differential between these two countries has practically disappeared.

In relation to financing of the private sector, the amount of debt issued by non-financial firms increased again in July, albeit still at a moderate rate, of 4.8% year-on-year. There was no significant change in the growth rate of bank loans to companies and households during the quarter, the year-on-year rate standing in June at 1.6% and 3%, respectively. By contrast, the decline in financing for consumption moderated in August, to -1.6% year-on-year. Against this background, according to the bank lending survey, the criteria for approving new loans to households and companies were tightened in Q3. Banks, for their part, perceived a further decline in the demand for loans from non-financial corporations, while the demand from households improved slightly.

As regards financing costs, risk premiums increased sharply, especially those on financial sector securities and in the countries most affected by the sovereign debt crisis. In relation to credit, the cost of bank loans to the private sector continued to display an upward trend, the interest rate on new lending to non-financial corporations standing at 3.2% in July.

The financial turmoil also spread to stock markets, which showed a clear deterioration up to the end of September, although they recovered part of their losses in October. Thus, since the end of July the EURO STOXX 50 index has declined by around 13% and the banking sector index by more than 27%.

The euro exchange rate was also affected by the financial market turmoil in the area and the loss of investor confidence led to a depreciation in Q3 of 3% in nominal effective terms and 6.6% against the dollar (see Chart 13), against a background of heightened volatility, this movement being partly reversed in October. Finally, the growth rate of M3 increased, to reach 2.8% year-on-year in August, on account of the acceleration in negotiable instruments.

4 THE SPANISH ECONOMY

According to the information available, economic activity is estimated to have stagnated in Q3, with zero quarter-on-quarter growth of GDP (see Chart 14). National demand declined more sharply than in Q2, by 0.7% in quarter-on-quarter terms, weighed down by the contraction in construction investment and by the sharp decline in government consumption. By contrast the positive contribution of net external demand to GDP growth increased, to 0.8 pp, which was 0.2 pp higher than in the previous quarter, thanks to the boost from goods and tourism exports. Year-on-year, output grew by 0.7% in 2011 Q3, the same rate as in Q2. These estimates should be treated with greater caution than usual on account of the statistical differences that may arise from the switch to Spanish National Accounts, base year 2008 (SNA 2008), which was used by the INE when preparing its Q3 GDP estimates.

Employment fell in Q3 by more than in Q2, at a rate of 1.8% year-on-year. Given the estimated output and employment developments, apparent labour productivity growth remained high, at around 2.5%. On the cost side, compensation per employee is estimated to have increased modestly in the economy as a whole, so that unit labour costs continued to fall in year-on-year terms. Finally, the downward trend in consumer prices in previous months moderated in Q3. Annual CPI inflation stood at 3.1% in September, barely 0.1 pp down from June, and the CPI excluding unprocessed food and energy stood at 1.7% at the end of the quarter. The trend slowdown in prices is expected to continue over the coming months, as the comparison affects arising from the rise in oil prices last autumn and the increase in tobacco taxes in December 2010 drop out of the index.

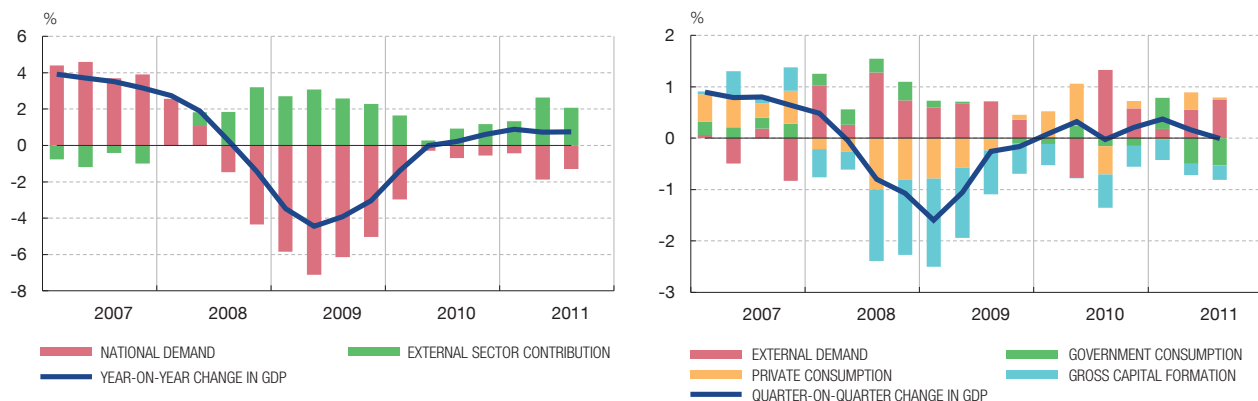
4.1 Demand

Private consumption was somewhat slack in 2011 Q3, growing by 0.1% quarter-on-quarter (see Chart 15). This weakness is explained by an environment that is hardly conducive to household spending, on account of unfavourable labour market developments, relatively tight credit conditions, the decline in wealth and the loss in purchasing power on account of inflation rates that remain high. By component, there was a certain recovery in car purchases by individuals in Q3, in quarter-on-quarter terms, while purchases of other consumer durables declined. The indicators of services consumption were positive, although it is very likely that this reflects the buoyancy of foreign tourism more than the spending decisions of residents. Quantitative indicators, meanwhile, such as the European Commission's consumer and retailer confidence indices, were stable in the quarter on average, although they displayed a significant decline during the quarter, which may have been related to the intensification of the sovereign debt crisis during the summer months. Consumption recovered significantly in year-on-year terms, because in 2010 Q3, the quarter used for the comparison, consumption was notably weak as a result of the rise in VAT rates in July of that year.

The rate of decline in household income eased to -0.1% year-on-year in Q2, according to cumulative four-quarter non-financial account data. This stabilisation of household income was the result of a smaller decline in employee compensation and a larger increase in the gross surplus of self-employed workers. By contrast, the positive contribution of general government towards sustaining household income continued to decrease, while the net contribution of property income remained negative. Households once again posted a higher rate of growth of consumption than of income, so that the saving rate continued to fall, to stand at 12.8% of disposable income on four-quarter cumulative data, down 1.1 pp from the rate in 2010. It should be noted that the sectoral non-financial accounts data

**MAIN DEMAND AGGREGATES.
CONTRIBUTION TO GDP GROWTH**

CHART 14



SOURCES: INE and Banco de España.

PRIVATE CONSUMPTION

CHART 15

PRIVATE CONSUMPTION (QNA)



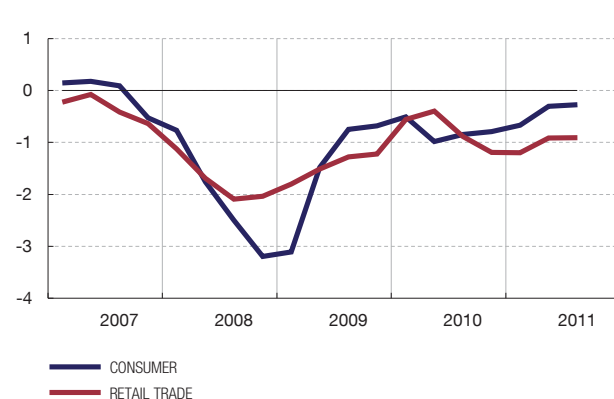
PRIVATE CONSUMPTION INDICATORS (a)



DURABLE CONSUMPTION INDICATORS (a)



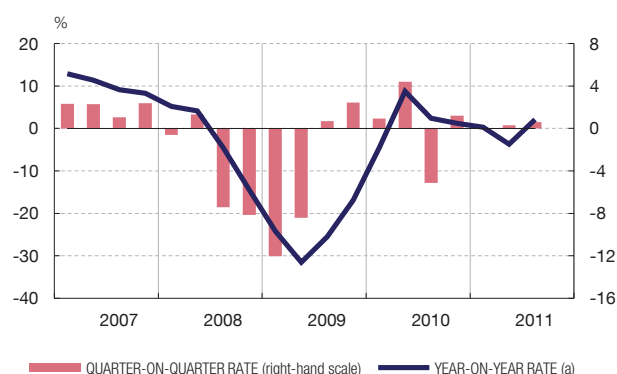
CONFIDENCE INDICATORS (b)



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

- a Year-on-year percentage change based on the seasonally adjusted series.
- b Normalised confidence indicators (difference between the indicator and its mean value, divided by the standard deviation).

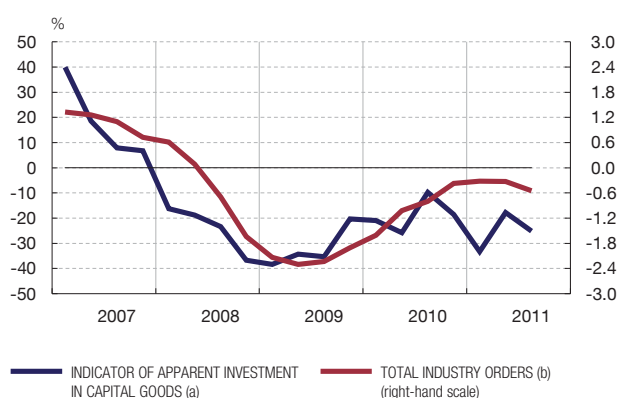
CAPITAL GOODS



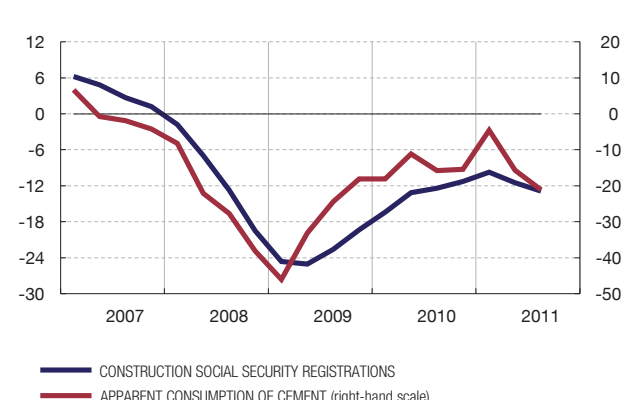
CONSTRUCTION



CAPITAL GOODS INDICATORS



CONSTRUCTION INDICATORS (a)



SOURCES: INE, European Commission, Ministerio de Fomento, OFICEMEN, SPEE and Banco de España.

- a Year-on-year percentage change based on the seasonally adjusted series, except for social security registrations, which are based on the original series.
 b Normalised indicator (difference between the indicator and its mean, divided by the standard deviation).

published for 2011 Q2 are based on the new SNA 2008, which has entailed some revisions to the historical series (see Box 4). In the case of the household saving rate, there has been an upward revision of around 1 pp in recent quarters.

Investment in capital goods grew slightly in Q3, at a quarter-on-quarter rate of 0.6%, while the year-on-year rate increased to 2.1%, as against a decline of 3.7% in Q2 (see Chart 16). Production of capital goods increased in July and August, although it is estimated that a portion of this increase in output was exported. Commercial vehicle registrations also behaved favourably in the quarter as a whole. Looking ahead, it is important to stress the deterioration in business confidence (both in industry as a whole and in the capital goods sector), which may be reflected in a deterioration in business investment in the coming quarters. Likewise, capacity utilisation in manufacturing declined, following several quarters of mild increases, which would suggest a certain slowdown in the rate of recovery of investment.

On non-financial account data for the institutional sectors, the net lending of non-financial corporations increased again in 2011 Q2, to 1.5% of GDP, in cumulative four-quarter terms (which was almost 1 pp more than in 2010). This improvement was based on an expansion of the profit margin, which appears to have been used primarily to rebuild balance sheets and to strengthen self-financing capacity, given the tightening of financing conditions.

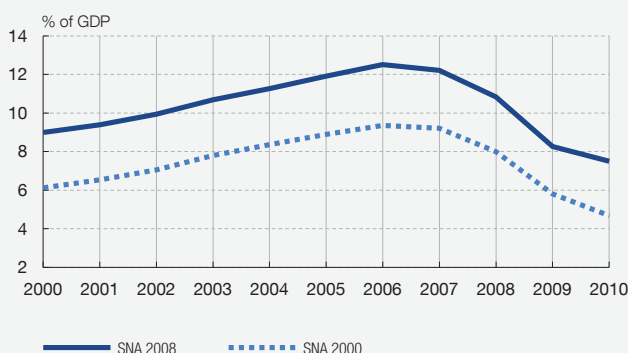
On 14 October the National Statistics Institute (INE) published, for the first time, estimates based on the Spanish National Accounts, base year 2008 (SNA 2008), as part of the regular updates to ensure that the National Accounts provide an accurate estimate of economic reality. These accounts continue to be governed by the principles and rules of the European System of National and Regional Accounts 1995 (ESA 95). On this occasion, the revision of the SNA involves methodological changes stemming from the adoption of new classifications of activities and products. Also, as is normal when the base year is changed, statistical changes have been introduced that arise from changes in the statistical sources and in the estimation procedures.¹ Adaptation to new classifications of activities and products is currently taking place in all EU Member States, pursuant to a Commission Regulation approved in 2010. In the case of Spain, this process will take place progressively, during the months of October and November 2011. For the time being, the INE has published the annual accounts of the main macroeconomic aggregates, with base year 2008, as well as the

quarterly non-financial accounts of the institutional sectors. Finally, it should be noted that some of the changes in the historical series, especially in recent years, arise from the revisions usually made once a year (normally in August) when new structural surveys of previous years are available. In the case of 2011, these had still to be made.

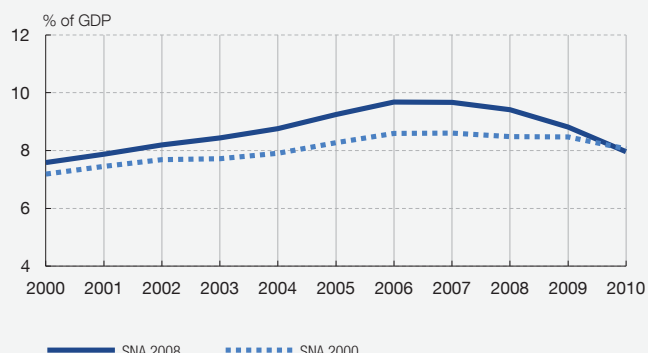
The adoption of the new classifications of activities (Spanish National Classification of Economic Activities 2009) and products (Classification of Products by Activity 2008) entails a more detailed sectoral breakdown, which principally affects the services sector. However, there is no direct correspondence between the old classification and the new one; for example, real estate activities, which were previously included in the market services sector, are now divided up between the construction sector (which includes those corresponding to development and related legal services) and the new real estate activities sector, which includes, inter alia, the activity of real estate agencies. Another important change is that the new classification ignores the market or non-market status of a particular activity. Therefore, the non-market services sector disappears. This sector previously included the activity of general government,

¹ Further details of these changes can be found in Instituto Nacional de Estadística, *Contabilidad Nacional de España Base 2008. Características metodológicas*, October 2011.

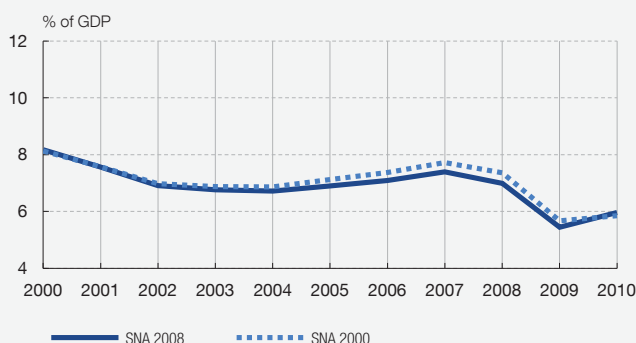
INVESTMENT IN DWELLINGS



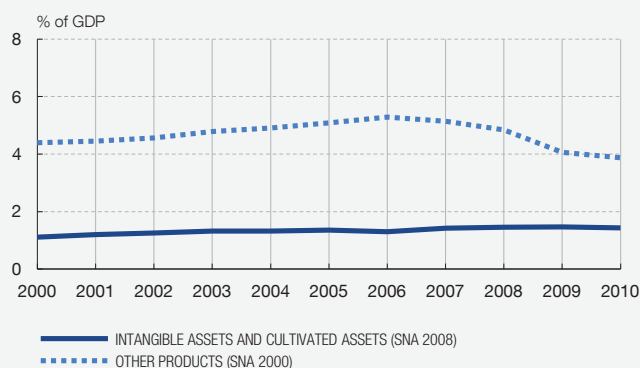
INVESTMENT IN OTHER BUILDINGS AND STRUCTURES



INVESTMENT IN TRANSPORT EQUIPMENT AND OTHER MACHINERY AND EQUIPMENT



OTHER GROSS FIXED CAPITAL FORMATION



SOURCE: INE.

AGGREGATES (cont'd)

which is now included in a new sector, namely public administration and defence; compulsory social security; education; human health and social work activities. This new sector includes the activities of this type that are carried out by both public and private agents. As a consequence of all this, in the case of the quarterly accounts, the new SNA 2008 has eleven sectors instead of six.

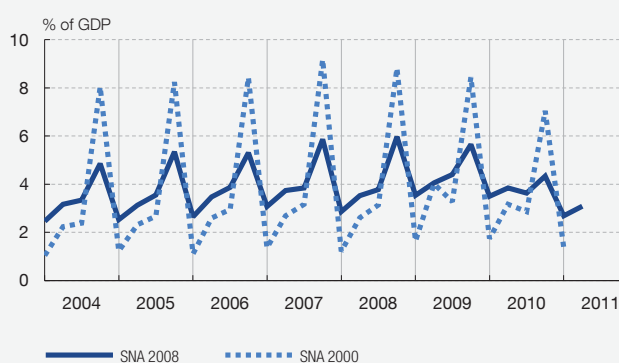
The introduction of the new classifications also means that the breakdown of gross fixed capital formation, which was previously based on products (equipment, buildings and other construction, and other products), is now based on the type of assets, so that, for example, the equipment incorporated into a house would now be included under investment in dwellings. The SNA 2008 distinguishes, at a first level, between tangible and intangible assets (mainly software). Tangible assets are, in turn, classified under: dwellings, other buildings and structures, transport equipment, other machinery and equipment, and cultivated assets. As in the case of the sectoral classification, there is no direct correspondence between the old and new categories, although the names of the assets appear to be similar.² This new classification of gross capital formation is the most quantitatively important change entailed by SNA 2008, since it involves a redistribution of the components of investment, which affects their nominal and real values throughout the series, as well as their weight in GDP (see the first set of panels). In particular, the weight of investment in dwellings in GDP increases by 2-3 pp, as does that of investment in other buildings and structures, although to a lesser extent. The former equipment component, by contrast, has a similar share in GDP to that of transport equipment and other machinery and equipment, which is the most similar category in SNA 2008.

2 Thus, the new definition of housing investment includes, apart from the value of this type of building, real-estate development expenditure, notary expenses and other legal costs relating to house purchase, which were previously included as investment in other products.

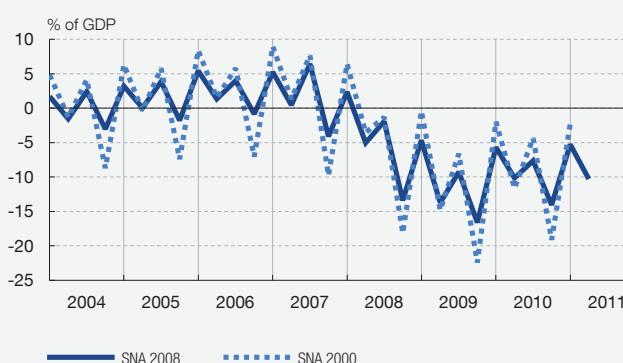
Among the changes of a statistical nature, the most notable are those affecting the general government accounts. The first relates to the timing of gross capital formation during the year. Under the SNA 2000, gross capital formation was recorded at the time the expenditure obligation was recognised by general government, which generally occurred in the fourth quarter of each year. Under SNA 2008, the accounting data have been brought closer into line with actual economic developments, and this has smoothed the amplitude of the year-on-year pattern of gross capital formation in this sector (see the second set of panels), and also in the non-financial corporations sector, in the capital account of which the investment was recorded until the public-sector agents recognised the obligation to pay for the expenditure. A second aspect that has been modified in SNA 2008 relates to the time at which taxes are recorded, which is brought closer into line with economic accrual. Under SNA 2000, receipts from general government taxes were recorded at the time at which the obligation on taxpayers to pay was recognised in the budget. In SNA 2008 this timing has been corrected in order to bring it closer into line with the period of economic accrual. These changes affect general government net borrowing, making its seasonal pattern smoother than it was under SNA 2000 (see the right-hand panel of the second set of panels).

The effect of all these changes on the rate of change of GDP in real terms has been minimal (see the table below). Also, the growth rates of most of the macroeconomic aggregates, except those relating to investment, have been subject to only very small revisions during the period 2000-08, while the changes have been more significant in the last two years. Thus, the change in private consumption has been revised downwards in 2009 and 2010, while the growth of government consumption is higher under SNA 2008. As for gross capital formation, there have been upward revisions to the rate of investment in machinery and transport equipment, and to the rate of housing investment, which now decreases to a lesser extent than under SNA 2000. By contrast, there is now a sharper contraction in other buildings and structures. For its part, the net contribution of external de-

GENERAL GOVERNMENT GROSS CAPITAL FORMATION



GENERAL GOVERNMENT NET LENDING (+)/NET BORROWING (-)



SOURCE: INE.

AGGREGATES (cont'd)

mand remains practically unchanged, with higher growth rates for both exports and imports. The sectoral saving-investment imbalances have also been slightly modified. The household saving rate in recent years has been increased and is almost one

percentage point higher in 2010 than under SNA 2000. As for prices, the private consumption and GDP deflators in 2009 and 2010 have been revised downwards, so that nominal GDP is now lower than previously estimated.

CHANGES IN VOLUME

REVISION OF RATES OF CHANGE (SNA 2008 - SNA 2000)

1. National final consumption expenditure	0.2	-0.1	0.0	0.0	-0.1
1.1 National final consumption of households and NPISHs	0.2	-0.1	0.0	-0.1	-0.5
1.2 General government final consumption expenditure	0.0	0.0	0.1	0.5	0.9
2. Gross capital formation	-0.2	-0.1	0.1	-0.6	0.9
2.1 Transport equipment and other machinery and equipment (equipment, SNA 2000)	-0.6	-0.8	-0.7	1.9	3.4
2.2 Construction	0.7	-0.8	0.1	-3.4	0.9
Dwellings	0.4	-1.0	1.7	2.4	6.9
Other buildings and structures	1.0	-0.4	-0.8	-7.6	-3.2
2.3 Intangible assets and cultivated assets (Other products, SNA 2000)	-4.4	11.3	7.6	13.5	3.8
3. NATIONAL DEMAND (1+2)	0.1	-0.1	0.0	-0.1	0.2
4. Exports of goods and services	0.0	0.0	0.1	1.2	3.2
4.1 Goods	0.0	0.0	0.0	1.6	0.4
4.2 Services	0.0	0.0	0.2	0.2	8.4
5. Imports of goods and services	0.0	0.0	0.1	0.6	3.4
5.1 Goods	0.0	0.0	0.0	0.5	5.1
5.2 Services	0.0	0.0	0.4	0.6	-1.9
Contribution of net external demand	0.0	0.0	0.0	0.1	-0.1
6. GROSS DOMESTIC PRODUCT	0.1	-0.1	0.0	0.0	0.1
MEMORANDUM ITEM					
National net lending (+)/net borrowing (-) (% of GDP)	0.0	0.0	0.0	0.4	-0.1
General government net lending (+)/net borrowing (-) (% of GDP)	0.4	0.0	-0.3	0.0	-0.1
Household saving rate	-0.9	-0.3	0.1	0.5	0.8
GDP deflator	0.0	-0.1	0.0	-0.5	-0.6
Private consumption deflator	0.1	-0.1	0.0	-1.3	-0.4
Total employment (full-time equivalent jobs)	0.2	0.1	0.3	0.2	-0.3
Compensation per employee	-0.2	-0.1	-0.3	0.2	-0.7
Unit labour cost	0.0	0.1	0.0	0.4	-1.0

SOURCE: INE.

Construction investment remained contractionary, as in recent quarters, and may even have become somewhat more so in Q3, given the combination of adjustment processes in the residential segment and fiscal consolidation in the area of civil engineering works (see Chart 16). In more recent months, the indicators for the sector as a whole relating to the use of inputs and to employment displayed quarter-on-quarter falls that were sharper than those in Q2. Also, in Q3 the negative perception of the sector's employers intensified, according to the European Commission's survey indicator, which in September reached its lowest level since 1990.

By type of work, it is estimated that residential investment continued to decline at a similar quarter-on-quarter rate to that of Q2. However, this type of investment is expected to become less contractionary in the coming quarters, as the gap between housing completions and starts is reduced. On the side of the demand for residential assets, transfers of new dwellings in Q2 were somewhat higher than in Q1, although this did not affect their decline in cumulative four-quarter terms. For its part, permits for non-residential construction to July continued to contract sharply in terms of surface area, as did government civil engineering tenders.

Finally, general government spending is estimated to have contracted significantly in Q3, in terms of both final consumption and investment, in line with the budget austerity plans. The fall in government consumption would appear to reflect the cut in public employment and, above all, in expenditure on goods and services, according to the information available on the State budget outturn.

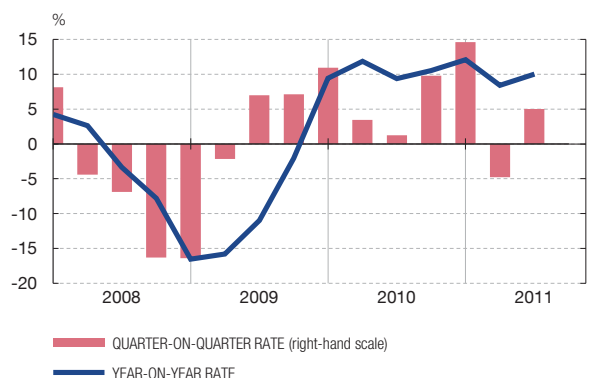
According to the latest information on net external demand, its contribution to quarter-on-quarter GDP growth was 0.8 pp, up 0.2 pp from the previous quarter, while in year-on-year terms the contribution decreased, although it remained large (2.1 pp). This behaviour reflects the expansion of exports, while the quarter-on-quarter rate of decline of imports eased (see Chart 17). Exports continued to be underpinned by the growth of international trade and the cumulative cost-competitiveness gains of recent years, although the outlook for the final quarter of the year has worsened owing to the world economic slowdown. The increase in exports involved a rise in the share of Spanish goods on world markets in the first half of 2011.

On customs data, real goods exports grew by 12.6% year-on-year during the period July-August, a higher rate than in 2011 Q2 (see Chart 17). By product group, the buoyancy was practically across the board, with notable rises in exports of capital goods and of non-energy intermediate goods. Exports of consumer goods slowed slightly, although sales of cars continued to grow at a high rate. By geographical area, notable in the EU were the favourable performance of exports to the United Kingdom, to the countries that joined the EU in 2004 and 2007 and to France, while those to Portugal decelerated. As for the rest of the world, the buoyancy of exports to OPEC members and to Russia was notable.

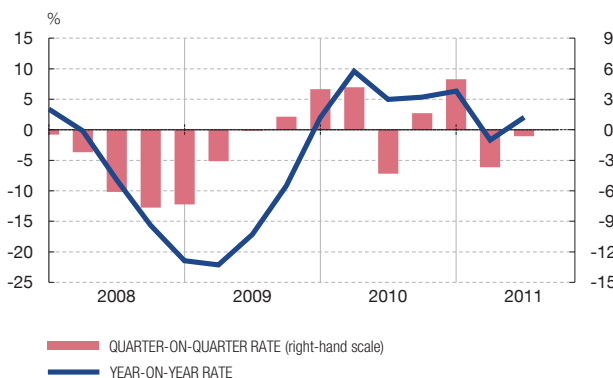
With regard to exports of tourism services, the information available indicates strong growth in the summer months. This can be seen in the buoyancy of tourist inflows and overnight hotel stays, which in Q3 as a whole increased at a year-on-year rate of 8.5% and 12.9%, respectively. The geopolitical instability in North Africa and the Middle East is prompting changes in the composition of tourist inflows, with a recovery in the number of British tourists and highly buoyant inflows of Dutch, Nordic and East European tourists. As for the nominal expenditure of tourists, the EGATUR (tourism expenditure survey) data available for July and August show a year-on-year increase of 8.7% in these two months. Meanwhile, the year-on-year growth of exports of non-tourism services moderated slightly.

Imports, on customs data, fell in July and August at a similar rate to that of Q2 (-0.5%). By product group this decline was concentrated in capital goods and energy products. Imports of consumer goods and non-energy intermediate goods remained practically unchanged at their levels of a year earlier. Among consumer goods, the rise in car imports was notable. Finally real imports of services continued to decline, with decreases in imports of both non-tourism and tourism services.

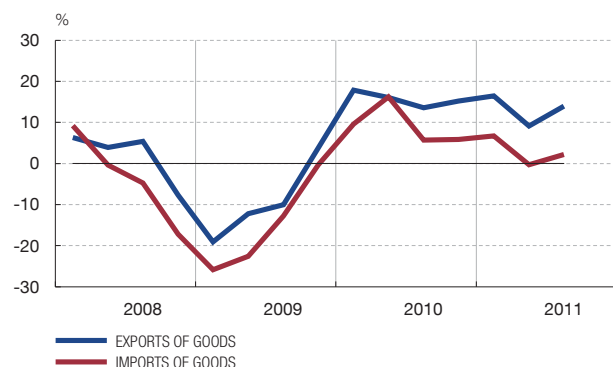
EXPORTS OF GOODS AND SERVICES (a)



IMPORTS OF GOODS AND SERVICES (a)



CUSTOMS INDICATORS (b)



TOURISM INDICATORS (c)



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

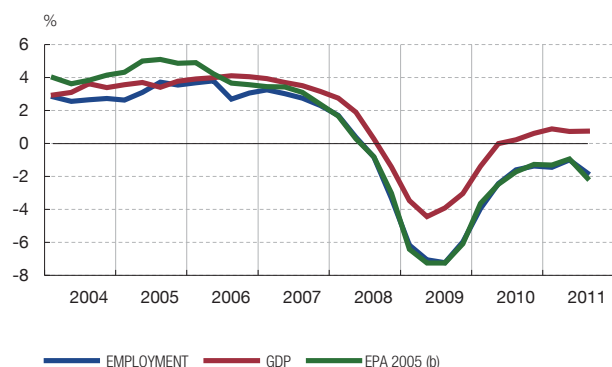
- a QNA data at constant prices. Seasonally adjusted series.
- b Deflated seasonally adjusted series.
- c Seasonally adjusted series.

4.2 Output and employment

In Q3, gross value added in the market economy grew modestly in quarter-on-quarter terms, with mixed developments across sectors. The information available points to a slight increase in industry and energy, in comparison with the previous quarter, and a slight positive rate of growth of value added in market services, while the contraction in construction appears to have intensified (see Chart 18). That said, there are doubts regarding the continuity of the expansion in industry and market services over the coming quarters, given the deterioration in the business outlook according to the recent behaviour of the main survey indicators.

Industrial activity improved in Q3, following the decline in the previous period. The industrial production index increased in the period July-August; in particular there was an increase in the production of capital goods and, to a lesser extent, in that of consumer goods. However, Social Security registrations fell significantly, indicating that employment has adjusted by more than activity. Also the qualitative indicators for the industrial sector showed a clear deterioration in this period. Specifically, the manufacturing PMI declined in Q3, to well below 50, the level that is interpreted as marking the border between a contraction and an expansion. This deterioration, which was broadly based, since it extended to domestic and foreign orders and the employment outlook, suggests that the rise in industrial activity in Q3 may have been transitory, with no sustained recovery in this sector discernible in the short term.

WHOLE ECONOMY



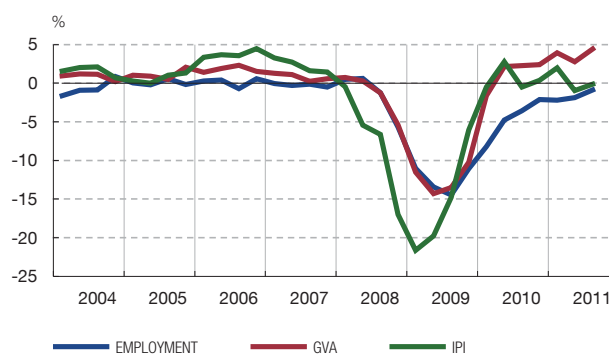
WHOLE ECONOMY (c)



AGRICULTURE



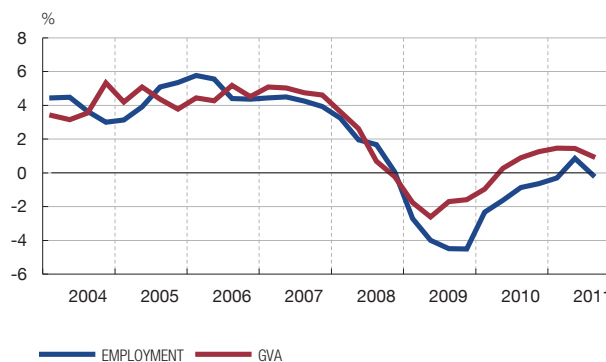
INDUSTRY AND ENERGY



CONSTRUCTION



MARKET SERVICES



SOURCES: INE and Banco de España.

- a Year-on-year percentage rates based on seasonally adjusted series except gross series in EPA. Employment in terms of full-time equivalent jobs. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.
- b Series linked by the DG Economics, Statistics and Research on the basis of the control survey conducted using the methodology applied until 2004 Q4.
- c Quarter-on-quarter rates based on seasonally-adjusted series.

The available market services indicators point to mild quarter-on-quarter growth in the gross value added of this sector in 2011 Q3. Both the index of services sector activity and the sales of large firms, on information to August in both cases, reflect modest year-on-year growth. As in the case of manufacturing, there was a significant deterioration in the outlook for services, according to the European Commission's survey indicators and sur-

veys of purchasing managers. Specifically, the services PMI fell below 50, to stand at its late 2009 levels. These unfavourable developments in confidence in the sector extended to employment, so that, following several months of timid growth, Social Security registrations stagnated in Q3.

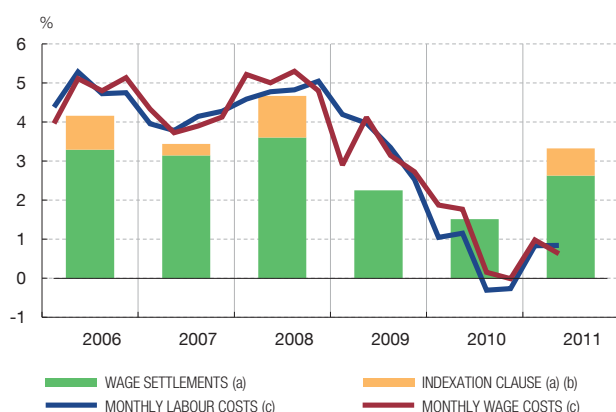
In the labour market, monthly indicators showed an intensification of employment destruction in Q3. Specifically, Social Security registrations declined by 1.2% with respect to the same period a year earlier, a fall that was 0.2 pp higher than the one in Q2. On quarter-on-quarter terms, registrations declined by 0.5%, as against a decline of 0.3% in Q2. At the same time, new hires registered at the National Public Employment Service (SPEE by its Spanish abbreviation) were very slack in Q3, with a year-on-year growth rate of 0.2%, following the 3.1% increase in the preceding period. This slowdown was a consequence of the reduced buoyancy of temporary contracts in the summer of 2011 and the intensification of the decline in permanent contracts, driven in this period by a contraction in conversions, following the growth observed since the end of 2010. The weight of permanent contracts in total hiring fell, as is usual in the summer, to 6.9% in Q3, down more than one percentage point from its level a year earlier.

The EPA figures for Q3 show a year-on-year decline in employment of 2.1%, a 1.2 pp larger fall than in the previous quarter. With the exception of industry, the year-on-year performance of all sectors was worse than in Q2, with a notable year-on-year decline in services employment. This deterioration took place both in market services, where the employment creation of recent quarters was interrupted, and in non-market activities, which posted zero year-on-year growth. The intensification of the fall in employment occurred both among the self-employed (-3.8%) and especially among dependent employees, for whom the rate of decline rose by 1.3 pp to -1.8%. By nationality, job destruction also affected both groups, with a decline of 8.6% among foreigners and of 1.1% among Spaniards. As regards contract duration, the growth rate of temporary employment came to a halt in this quarter, while the year-on-year decline in permanent employment intensified by 1.1 pp to 2.4%. As a result, the ratio of temporary to total employment increased to 26.0%. Finally, the rate of growth of part-time hiring moderated (to 1.1%), while full-time employment fell by 2.6%, 0.9 pp more than in the previous quarter. As a result of these developments the part-time ratio stood at 13.2%, as against 12.8% a year earlier.

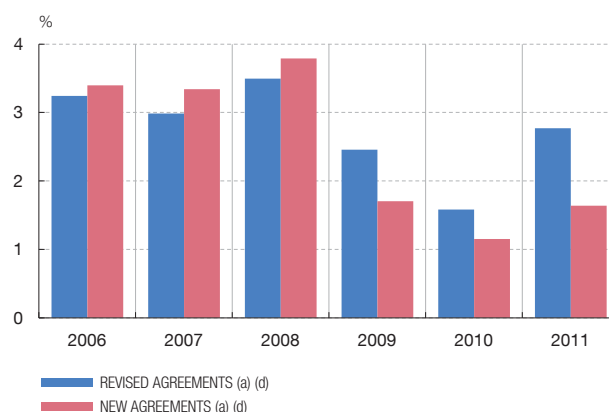
The labour force grew at a slow rate, similar to that of the previous quarter (0.1%), against a background of zero growth in the population over the age of 16, so that the participation rate stabilised at 60.1%. The breakdown by gender shows that the gap between the growth rates for men and women narrowed by several tenths of a percentage point: the female labour force grew by 1.6%, down 0.5 p from Q2, while the male labour force declined by 1.2%, 0.3 pp less than in the previous quarter. By nationality, the decline in the foreign labour force and in the foreign participation rate intensified. The foreign labour force declined by 2.3% (-2% in the previous quarter), while the foreign participation rate fell at a year-on-year rate of 4%, as against -2.2% in Q2. The Spanish-national labour force, by contrast, increased by 0.8%, and the Spanish participation rate rose slightly, to 57.9%.

Finally, the total number of persons unemployed rose by 144,700, from 2011 Q2, to 4,978,300. In year-on-year terms, the rate of growth of unemployment more than doubled, to 8.8%. At the same time, the rate of unemployment rose sharply in Q3, to 21.5% of the labour force, a worsening of 0.6 pp compared with the previous quarter. The year-on-year growth rate of unemployed persons registered with the SPEE rose to 4.6%, which

WAGE INDICATORS



WAGE INCREASE WITHOUT INDEXATION CLAUSE FOR NEW AND REVISED COLLECTIVE BARGAINING AGREEMENTS



SOURCES: INE and Ministerio de Trabajo e Inmigración.

a Latest year, with information on collective bargaining agreements to September 2011.

b Previous year's indexation clause.

c Quarterly labour costs survey (ETCL). Year-on-year rates of change.

d Revised: agreements with economic effects for the current year, but which were entered into in previous years, and are in force for more than one year. New: agreements entered into during the year with economic effects in the same year, this being the first or only year in which they are applicable.

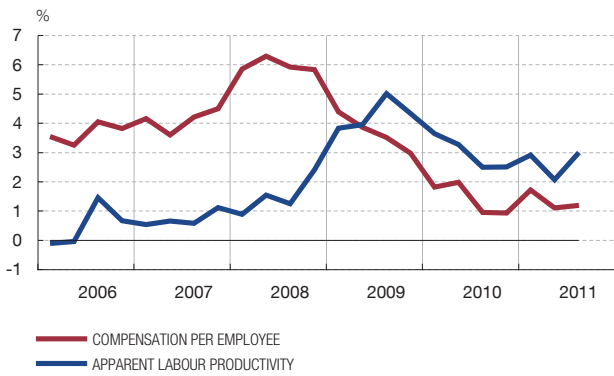
interrupted the moderation in unemployment growth that had been recorded since the second half of 2009.

4.3 Costs and prices

The average wage settlement negotiated in collective agreements in the period January to September was 2.6%, barely 0.1 pp lower than in the period to June. The pace of negotiations remains slow, so that the number of workers affected to September (5.1 million) is the lowest figure for this month in the last 15 years. It should be taken into account, however, that almost all the agreements registered to date correspond to revisions of multi-year agreements signed in previous years, in which the settlements (2.8%) are largely linked to the annual increase in the CPI in December 2010, which was 3%. Meanwhile, the average settlement in newly signed agreements is 1.6%, in line with the mid-point of the wage band recommended by the Agreement on Employment and Collective Bargaining (AENC by its Spanish initials) of February 2010 (see the right-hand panel of Chart 19). Insofar as bargaining over the coming months is concentrated on this second type of agreement, one may expect the average wage settlement agreed to date to moderate in the final quarter of the year. The slowdown in inflation and perhaps the effects of the collective bargaining reform approved in June would contribute to such a development. The effect of wage indexation clauses linked to 2010 inflation, payable in 2011, is estimated to be 0.7 pp. These wage developments contrast with the greater moderation displayed by other indicators, such as the quarterly wage cost survey (ETCL by its Spanish initials), which showed a 0.8% year-on-year increase in 2011 Q2 (see left-hand panel of Chart 19). In 2011 Q3 the year-on-year increase in compensation per employee in the market economy is projected to stabilise at around 1% (see Chart 20). Given that productivity is estimated to have increased by around 3% year-on-year, unit labour costs continued to decline in Q3 at a significant rate.

In 2011 Q3, the deflators of most of the components of demand recorded somewhat lower year-on-year growth than in Q2. The moderation in the growth rates of the deflators was largely a result of the developments in domestic producer prices (as measured by the GDP deflator), the rate of growth of which declined by 0.3 pp with respect to Q2, but also of the developments in the prices of imported goods, which displayed somewhat less vigorous growth.

COMPENSATION PER EMPLOYEE AND PRODUCTIVITY (a)



UNIT LABOUR COSTS AND PRICES (a)

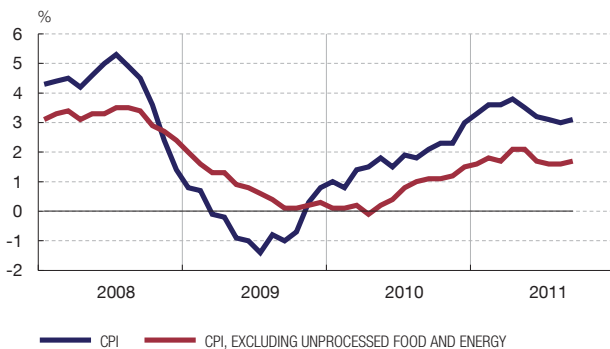


SOURCES: INE and Banco de España.

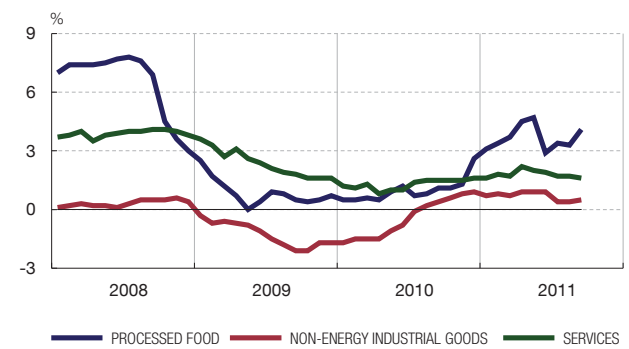
a Year-on-year rates based on seasonally adjusted QNA series.

PRICE INDICATORS (a)
Spain

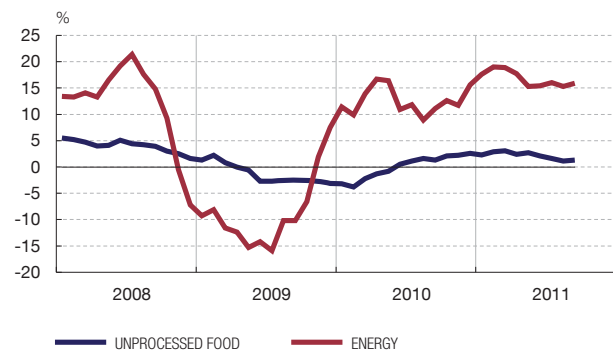
CONSUMER PRICE INDEX



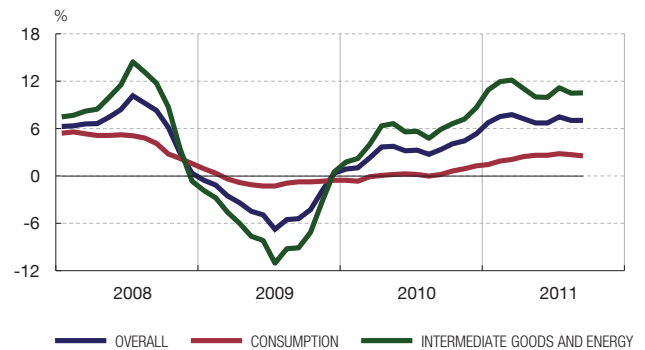
CONSUMER PRICE INDEX



CONSUMER PRICE INDEX



PRODUCER PRICE INDEX



SOURCE: INE.

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

In 2011 Q3, the declining trend in the main consumer price indicators seen in previous months moderated. The annual rate of CPI inflation was 3.5% in September, down 0.1 pp from June (see Chart 21), while the change with respect to the same month of the previous year in the CPI excluding unprocessed food and energy was 1.7%, the same rate as in June. This stability is the result of mixed behaviour across its main components. Thus, processed food prices were driven in September by the rise in the price of tobacco, which offset previous declines. By contrast, the growth rate of the prices of non-energy industrial goods fell, from 0.9% in June to 0.5% in September, despite the higher prices of domestically produced and imported non-energy industrial goods, reflecting the dropping out of the base effect of last year's VAT rate increases. Services prices moderated for the same reason, to 1.6% in September, 0.3 pp down from the June rate. The year-on-year growth rate of the energy component increased by 0.5 pp with respect to June, affected by the depreciation of the euro against the dollar, which raised the price of oil in euro, while the growth rate of unprocessed food prices decreased during the quarter.

The stability of inflation in Spain (as measured by the harmonised index of consumer prices (HICP)) was in contrast to its rise in the euro area, so that the differential decreased between June and September by 0.3 pp, to zero (see Chart 22). The differential in terms of the CPI excluding unprocessed food and energy was negative (-0.5 pp). The services differential, which stood at -0.4 pp in September, was notable. By contrast, the differential in energy price growth remained considerable, partly on account of the larger increases in gas and electricity prices in Spain, but also because fuel prices increased to a greater extent in Spain. Also, there was a larger increase in unprocessed food prices in Spain than in the euro area.

The producer price index rose in Q3, to reach a year-on-year rate of change of 7.1% in September, up 0.4 pp from June. This is attributable to the rise in the price of energy products, which grew by 18.4% in September. The prices of consumer industrial goods and capital goods increased at similar year-on-year rates to those of the previous quarter (2.5% in the first case and 1.2% in the latter), while intermediate goods prices slowed by almost 1 pp, to 5.6% year-on-year in September. For their part, the import and export price indices for industrial products accelerated, to reach year-on-year rates of 8.9% and 5.4% in August, respectively. In both cases the prices of energy products also displayed very high rates of change. On the other hand, the UVIs for exports and imports for August displayed less expansionary growth.

4.4 The State budget

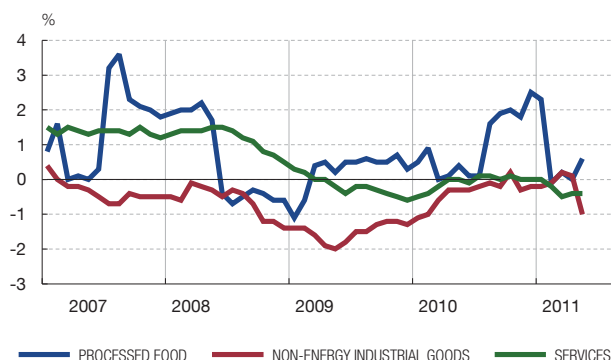
The latest statistical information available for the general government sector as a whole relates to 2011 Q2. This information is based on the new SNA 2008, which introduces changes into the general government accounts, such as a closer approximation to the accrual principle for certain taxes and a more even distribution of public investment expenditure over the year (for further details see Box 4). However, more recent information is available on the budget outturns of the State and of the Social Security system for the periods to September and to August, respectively.

In national accounts terms, on budget outturn data for the period January to September, the State recorded a deficit of €37 billion, as against a deficit of €44.5 billion in the same period of 2010. In cash basis terms, the State posted a deficit between January and September 2011 of €31 billion, an improvement of 18% on the deficit recorded a year earlier (see Table 4). Expenditure fell by 17.3% during the 12 months to September, which in general terms is consistent with the government's target for the State for the year as a whole. The decline observed in the deficit for the period January-September largely reflects the smaller transfers to the regional governments, as a consequence of the new fi-

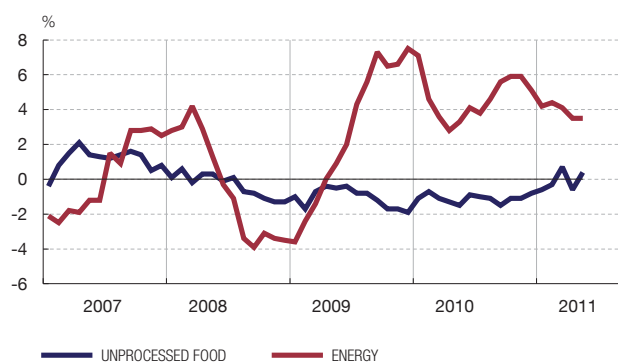
HARMONISED INDEX OF CONSUMER PRICES



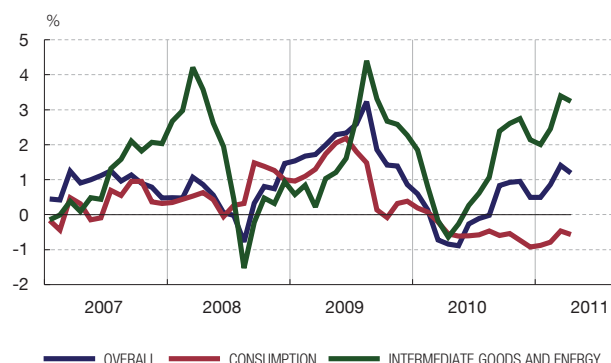
HARMONISED INDEX OF CONSUMER PRICES



HARMONISED INDEX OF CONSUMER PRICES



PRODUCER PRICE INDEX



SOURCES: Eurostat and Banco de España.

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

ancing system. As regards the other items, expenditure on wages and salaries increased by 0.9%, expenditure on goods and services was reduced by 10% and interest payments increased by 5.7%, well below the growth rate projected for 2011 as a whole, of close to 40%. It should also be taken into account that the figures to September do not incorporate the impact of the measures adopted in July and August, in particular the revenue obtained from the tender for the public domain radio spectrum and the modification of the partial payments of corporate income tax.

In terms of total tax revenues, which include those obtained by the State and regional and local governments, the receipts from excise duties and corporate income tax continued to grow at rates well below the budget targets (-3% and -12.3%, respectively, in the period January to September, as against the rates of 5.1% and -1.2% budgeted for 2011), although in the case of corporate income tax an increase in receipts is expected in the final quarter of the year as a result of the changes to the timing of partial payments. VAT receipts continued to perform better than budgeted for the year as a whole, although their rate of growth continued to moderate (1.9% to September), as the base effect associated with the rise in rates in July 2010 dropped out of the comparison. Finally, personal income tax receipts remained weak, with a growth rate of 4.1% in the period to September, which was below the rate budgeted for the year as a whole (7.1%).

STATE BUDGET OUTTURN

TABLE 4

EUR m and %

	Outturn 2010	Percentage change 2010/2009	Initial budget	Percentage change 2011/2010	Outturn Jan-Jun. Percentage change 2011/2010	Outturn		
						2010 Jan-Sep	2011 Jan-Sep	Percentage change
						1	2	3
1 REVENUE	127,337	24.8	106,020	-16.7	-17.5	92,676	74,082	-20.1
Direct taxes	59,262	9.5	55,239	-6.8	-19.9	42,320	36,157	-14.6
Personal income tax	39,326	29.2	35,494	-9.7	-22.4	28,090	23,701	-15.6
Corporate income tax	16,198	-19.8	16,008	-1.2	-15.6	11,334	9,941	-12.3
Other (a)	3,738	7.5	3,737	-0.0	-6.2	2,896	2,515	-13.1
Indirect taxes	51,825	80.8	36,142	-30.3	-21.1	40,131	27,274	-32.0
VAT	38,486	143.8	24,968	-35.1	-17.9	30,090	20,039	-33.4
Excise duties	10,338	1.9	8,179	-20.9	-39.2	7,818	4,993	-36.1
Other (b)	3,001	9.5	2,995	-0.2	3.0	2,223	2,242	0.8
Other net revenue	16,251	-15.7	14,639	-9.9	4.7	10,225	10,650	4.2
2 EXPENDITURE	179,572	-5.1	150,056	-16.4	-19.7	130,616	105,163	-19.5
Wages and salaries	26,975	1.5	26,982	0.0	0.5	19,420	19,595	0.9
Goods and services	4,632	-4.7	3,384	-26.9	-8.5	2,827	2,542	-10.1
Interest payments	19,638	11.3	27,421	39.6	-2.0	16,712	17,665	5.7
Current transfers	104,656	-6.9	74,598	-28.7	-25.8	74,875	54,005	-27.9
Contingency fund	—	—	2,668	—	—	—	—	—
Investment	8,782	-16.1	5,793	-34.0	-26.8	6,157	4,502	-26.9
Capital transfers	14,890	-14.2	9,208	-38.2	-36.6	10,624	6,854	-35.5
3 CASH-BASIS BALANCE (3 = 1 - 2)	-52,235	—	-44,036	—	—	-37,939	-31,081	—
MEMORANDUM ACCOUNT: TOTAL TAXES (State plus share of regional and local governments)								
TOTAL	135,862	16.3	141,538	4.2	6.0	101,785	104,094	2.3
Personal income tax	66,977	4.9	71,761	7.1	6.5	49,453	51,483	4.1
VAT	49,079	46.2	48,952	-0.3	9.4	37,410	38,136	1.9
Excise duties	19,806	2.4	20,825	5.1	-4.0	14,923	14,476	-3.0

SOURCES: 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.

In the case of the regional governments, the outturn data for 2011 Q2 showed a deficit in budgetary accounting terms of 1.2% of GDP (see Table 5). These data point to risks of deviation from the annual target for the sub-sector, although these are difficult to quantify, given that no information is available on the budget outturn for the second half of the year, in which the adjustment measures announced by most regional governments would be concentrated.

The latest budget outturn figures available for the Social Security system are for August 2011 (see Table 6). These figures show a surplus of €3.9 billion, which was €3 billion less than the surplus in the period January-August 2010. On the revenue side, Social Security contributions fell by 1.1%, a significantly worse performance than projected, as a consequence of the unfavourable behaviour of Social Security registrations. Expenditure increased by 3.1%, owing to the 5% rise in spending on contributory pensions, which was partly offset by the reduction in other current transfers. As regards the State Public Employment Service, the data available to August 2011 indicate a decline in unemployment benefit payments of 8.6%, in line with the decline in the number of beneficiaries of the

REGIONAL GOVERNMENT BUDGET OUTTURN

TABLE 5

EUR m and %

	Outturn 2010	Percentage change 2010/2009	Initial budget 2011	Percentage change 2011/2010 (a)	Outturn Jan-Mar. Percentage change 2011/2010	Outturn		
						2010 Jan-Jun	2011 Jan-Jun	Percentage change (b)
	1	2	3	4 = 3/1	5	6	7	8 = 7/6
1 REVENUE	134,318	44.2	138,087	2.8	-2.2	—	60,966	-3.6
Current revenue	127,134	45.9	128,870	1.4	-1.4	—	59,198	-3.8
Direct taxes	29,477	50.0	40,382	37.0	42.5	—	20,211	41.6
Indirect taxes	33,730	46.6	51,050	51.3	45.0	—	23,797	40.1
Charges, prices and other revenue	5,551	44.6	4,942	-11.0	-19.4	—	2,206	-15.8
Current transfers	57,962	39.9	32,006	-44.8	-56.2	—	12,762	-53.6
Interest and dividends	413	45.3	489	18.5	151.5	—	222	40.4
Capital	7,184	19.2	9,217	28.3	-27.2	—	1,768	3.1
Disposal of investments	287	4.5	1,960	583.3	8.0	—	89	1.5
Capital transfers	6,897	23.1	7,257	5.2	-29.1	—	1,679	3.2
2 EXPENDITURE	157,183	48.3	153,170	-2.6	5.4	—	74,032	0.5
Current expenditure	134,812	50.6	130,366	-3.3	5.6	—	65,933	0.3
Wages and salaries	58,795	50.6	56,311	-4.2	-3.3	—	28,474	-3.7
Goods and services	28,011	50.9	27,076	-3.3	22.8	—	13,788	8.7
Interest payments	2,999	44.3	4,554	51.8	75.6	—	2,019	68.0
Current transfers	45,007	51.2	42,309	-6.0	3.9	—	21,652	-3.0
Contingency fund	—	—	—	—	—	—	—	—
Capital	22,371	35.5	22,804	1.9	4.2	—	8,100	2.3
Investment	9,685	35.3	10,015	3.4	11.3	—	3,538	-4.5
Capital transfers	12,686	35.7	12,789	0.8	-2.0	—	4,562	8.4
3 BALANCE (3 = 1 - 2)	-22,866	86.6	-15,083	-34.0	—	—	-13,066	—

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

a The initial budget data for 2011 were obtained taking into account the initial appropriations of the 2010 budget of the Balearic government, since it has extended them.

b These rates published by the Ministry of Economic Affairs and Finance have not been released for 2010 Q2.

SOCIAL SECURITY SYSTEM BUDGET OUTTURN

TABLE 6

EUR m and %

	Initial budget 2010	Percentage change 2010/2009	Initial budget 2011	Percentage change 2011/2010	Outturn Jan-Jun. Percentage change 2011/2010	Outturn		
						2010 Jan-Aug	2011 Jan-Aug	Percentage change 2011/2010
	1	2	3	4 = 3 / 1	5	6	7	8 = 7 / 6
1 REVENUE	119,481	-3.4	123,405	3.3	-0.2	79,793	79,016	-1.0
Social security contributions	108,358	-4.4	111,778	3.2	-0.9	71,115	70,345	-1.1
Current transfers	8,357	12.3	8,154	-2.4	5.3	6,120	6,141	0.3
Other revenue	2,765	-6.7	3,473	25.6	12.2	2,558	2,530	-1.1
2 EXPENDITURE	116,601	1.9	118,826	1.9	3.0	72,863	75,107	3.1
Wages and salaries	2,483	1.2	2,378	-4.2	-2.5	1,547	1,522	-1.6
Goods and services	2,032	1.9	1,719	-15.4	-2.6	1,020	958	-6.0
Current transfers	111,557	1.9	114,279	2.4	3.2	70,166	72,513	3.3
Contributory pensions	95,320	2.1	99,090	4.0	5.0	60,466	63,501	5.0
Sickness	7,373	-9.5	7,009	-4.9	-11.8	3,516	3,184	-9.5
Other	8,864	11.0	8,181	-7.7	-4.9	6,184	5,828	-5.8
Other expenditure	529	-6.1	450	-15.0	-22.7	130	113	-13.2
3 BALANCE (3 = 1 - 2)	2,880	—	4,579	—	—	6,931	3,909	—

SOURCES: Ministerio de Hacienda, Ministerio de Trabajo e Inmigración and Banco de España.

BALANCE OF PAYMENTS: MAIN COMPONENTS (a)

TABLE 7

EUR m

		January-July		Rate of change
		2010	2011	2011/2010 (b)
CREDITS	Current account	192,750	213,519	10.8
	Goods	108,440	127,710	17.8
	Services	53,151	56,623	6.5
	Tourism	21,617	23,722	9.7
	Other services	31,534	32,901	4.3
	Income	22,434	20,802	-7.3
	Current transfers	8,725	8,383	-3.9
	Capital account	5,213	3,772	-27.7
	Current + capital accounts	197,964	217,291	9.8
DEBITS	Current account	224,832	242,438	7.8
	Goods	136,416	151,054	10.7
	Services	38,082	37,895	-0.5
	Tourism	6,660	6,565	-1.4
	Other services	31,422	31,329	-0.3
	Income	35,763	38,977	9.0
	Current transfers	14,571	14,512	-0.4
	Capital account	1,035	746	-27.9
	Current + capital accounts	225,867	243,184	7.7
BALANCES	Current account	-32,082	-28,919	3,163
	Goods	-27,976	-23,344	4,632
	Services	15,069	18,729	3,660
	Tourism	14,957	17,157	2,200
	Other services	112	1,572	1,459
	Income	-13,329	-18,174	-4,845
	Current transfers	-5,846	-6,129	-283
	Capital account	4,178	3,025	-1,153
	Current + capital accounts	-27,904	-25,894	2,010

SOURCE: Banco de España.

a Provisional data.

b Absolute changes for balances.

unemployment insurance system. The coverage rate fell by six percentage points over the period December 2010 to August 2011.

4.5 The balance of payments

During the first seven months of 2011, there was an overall deficit on current and capital account of €25.9 billion, 7% down on the same period of 2010 (see Table 7). This decline is explained by the narrowing of the current account deficit, while the capital account surplus decreased. The reduction in the current account imbalance reflected the fall in the trade deficit and the increase in the services surplus. These developments offset the increases in the current transfers deficit and, above all, in the income deficit.

In the first seven months of 2011, the trade deficit decreased by 17%, to €23.3 billion, owing to the notable correction of the non-energy balance, which offset the increase in the energy bill. The services surplus increased by 24% to €18.7 billion, thanks to the tourism and other services balances. By contrast, the income deficit widened by 36%, to stand at €18.2 billion and the current transfers deficit increased by 5%, to €6.1 billion. Finally, the capital account surplus decreased by 28%, to €3 billion.

5 FINANCIAL DEVELOPMENTS

5.1 Overview

In 2011 Q3 financial developments in the Spanish economy were marked by the heightening of tensions on the international financial markets. These tensions were reflected in further increases in yield spreads on euro area government securities, which reached record highs since the creation of the euro, and extended to other markets and geographical areas. Thus in Spain the credit risk premia on debt securities issued by both public and private sectors increased, stock market indices fell significantly and banks found it more difficult to obtain wholesale funding.

The renewed tensions on European sovereign debt markets led, in early August, to the reactivation of the securities market programme by the ECB. This action, together with the economic policy measures adopted by the Spanish government, allowed the yields on Spanish ten-year bonds, which had nudged above 6%, to ease back and stabilise at around 5%, albeit against a background of high volatility (see Chart 23). At the end of September they stood at 5.14%, down 37 basis points (bp) from the levels at the close of the first half. However, despite this fall, the spread over the German bund rose by 70 bp in the same period to 323 bp due to the larger fall in the interest rate on the German securities of the same term habitually used as a safe haven in bouts of uncertainty. There was also an increase in the risk premia of private-sector debt securities issued by both financial and non-financial corporations. In the part of October leading up to the cut-off date of this report,¹ the yield on ten-year Spanish government bonds, the credit rating of which was revised downward by the three main risk assessment agencies in this period, increased by 36 bp and the spread over the German bond of the same term was up by 19 bp.

Against this backdrop, credit institutions encountered major difficulties in raising funds on the wholesale markets, especially on the unsecured fixed-income and interbank markets. Net issuance on fixed-income markets was negative (according to the information available up to August), as had already occurred following the bankruptcy of Lehman Brothers, with the first tensions derived from the Greek crisis in mid-2010 and subsequently with the Irish crisis at the end of that year. The interbank market also saw substantial tension, as evidenced by the significant increase in this period in the spread between twelve-month euribor and twelve-month eurepo. Thus, although the former decreased by 8 bp in Q3 to 2.08%, this drop was much more moderate than that in the cost of collateralised transactions of the same term (eurepo), which widened the spread between the two to 153 bp, the highest level since end-2008. Financial institutions thus turned to the Eurosystem and to the secured interbank markets (and, specifically, to transactions with central counterparties) to meet their liquidity needs in this period. The measures announced by the ECB in early October (reactivation of the covered bond purchase programme and reintroduction of one-year liquidity tenders) will foreseeably contribute to softening the impact of money market tensions.

In the stock markets, prices fell and volatility rose. Specifically, the IBEX 35 lost 17.5% in Q3, a fall which was smaller than that of the EURO STOXX 50 (23.5%), but larger than that of the S&P 500 (14.3%). However, in October the share prices of the main international markets recovered somewhat and the losses accumulated by the Spanish index so far in 2011 lessened to 10.4%, compared with losses of 16.4% and 1.2% by the European and US indices, respectively.

¹ 26 October 2011.

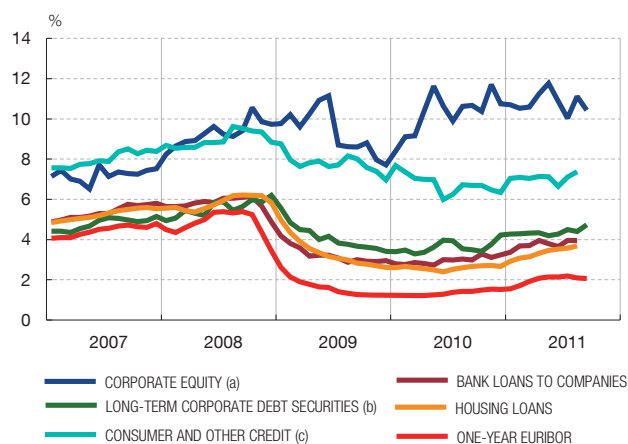
STOCK EXCHANGE INDICES



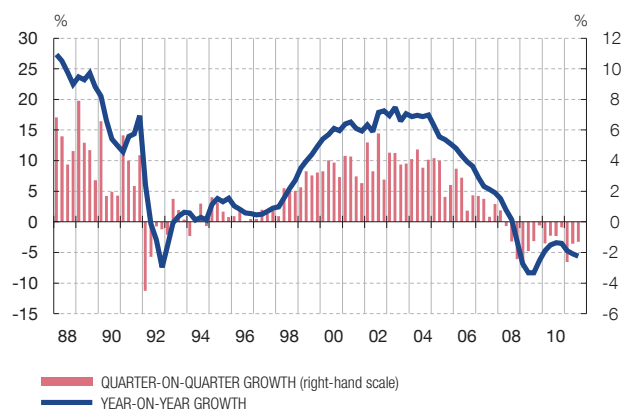
10-YEAR GOVERNMENT BONDS



COST OF FINANCING



PRICE PER SQUARE METRE OF APPRAISED HOUSING (d)



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

- a The cost of equity is based on the three-stage Gordon dividend discount model.
 b The cost of market-based long-term debt is calculated as the sum of the average 5-year CDS premium for Spanish non-financial corporations and the 5-year euro swap rate.
 c In June 2010 the statistical requirements relating to the interest rates applied by credit institutions to their customers were changed, which may cause breaks in the series. Particularly significant was the change in the interest rate on consumer credit and other lending, since, as a result, from that month it no longer includes credit card transactions.
 d Base 2001 to December 2004; base 2005 thereafter.

In the real estate market, the downward movement in the price of open-market housing persisted during 2011 Q3, according to the latest figures published by the Ministry of Infrastructure and Transport. Thus the year-on-year rate of decrease stood at 5.6% in September, compared with a fall of 5.2% at the end of Q1. In quarter-on-quarter terms, the decrease was very similar to that of June (1.3%). As a result, the market value of this asset has now fallen by 18% in total since end-2007 (23% in real terms).

The cost of bank financing to firms and households increased moderately between June and August 2011 (latest figure available). The bulk of this increase relates, in most segments, to a widening of the spreads applied by banks over the benchmark interbank yields, against a background of significant difficulties and higher fund-raising costs for financial institutions in the wholesale markets. Also in Q3 (on information to September), the cost of debt issuance by firms rose, while that of equity issuance decreased.

Based on the results of the October Bank Lending Survey (BLS), the resurgence of the financial tensions did not give rise to a tightening of the credit standards applied to firms, which held steady overall for the fifth successive quarter.² The credit standards applied in consumer credit and other lending did not change either, whereas in house purchase loans banks reported a slight tightening, identical to that in July. Meanwhile, according to the same BLS, loan applications from firms and households decreased. For the closing months of the year, the surveyed banks expect that requests for funds will decrease further and that credit conditions will remain steady in all segments.

Against this background, the latest available data on private-sector financing, which relate to August, show a rate of decline similar to that at the end of Q2 in the case of households and somewhat sharper for firms. In the household sector, the contraction of liabilities held, in year-on-year terms, at 2% as a result of the scant changes in the decline of consumer credit and other lending and of house purchase loans. Borrowing by firms decreased by 1.1%, which was 0.4 pp more than in June. There were, however, significant differences among instruments. Thus, the rate of contraction of loans from resident institutions sharpened somewhat, while other types of debt (those used basically by large firms) continued to show more expansionary behaviour. The most recent data on lending by purpose, which relate to 2011 Q2, show a slowdown in all sectors, since all of them recorded a drop in the outstanding balance of bank loans, although to a varying extent. The provisional information for September indicates that the year-on-year rate of decrease of lending by resident financial institutions to households eased somewhat, while that of lending to firms scarcely changed.

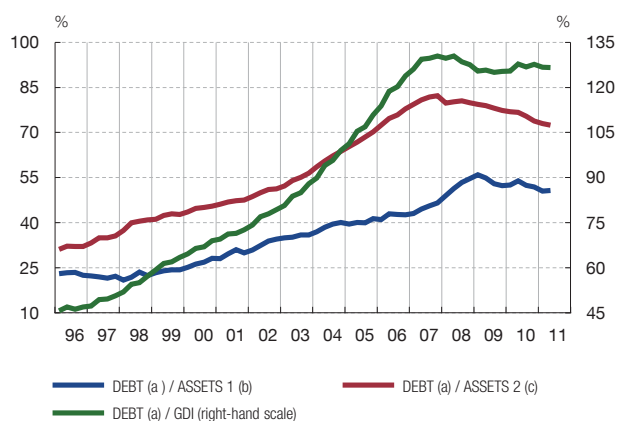
As a result of the stagnation in quarter-on-quarter terms of household liabilities and income in Q2, the ratio of debt to gross disposable income (GDI) scarcely changed (see Chart 24). This, along with a steady average cost of debt, meant that the debt burden indicator held at levels similar to those of three months earlier. For their part, the gross savings ratio and the saving after debt service of households seem to have held on the downward path prevailing since early 2010. That was, however, compatible with an increase in the sector's net lending. The net wealth of these agents continued to decrease in this period, basically as a result of the fall in the real estate component. The provisional information relating to Q3 suggests that between June and September the debt ratio, debt burden and wealth of households fell moderately.

As regards firms, the contraction in liabilities, along with the moderate increase in their income, made for a fresh decrease in the debt ratio. As a result of this and of the slight increase in the average cost of financing, the debt burden remained steady in this period (see Chart 25). Simultaneously, the net lending of this sector rose. For the sample of corporations reporting to the CBQ, among which the biggest have a notable weight, the growth of ordinary profit in 2011 H1 (less than in the same months of 2010) was insufficient to prevent a slight fall in the return on investment with respect to 2010. Analysts consider that the earnings of listed companies will continue to worsen in the next twelve months (see Chart 26). The provisional information for Q3 points to a further fall in the sector's debt ratio and a slight rise in the associated debt burden.

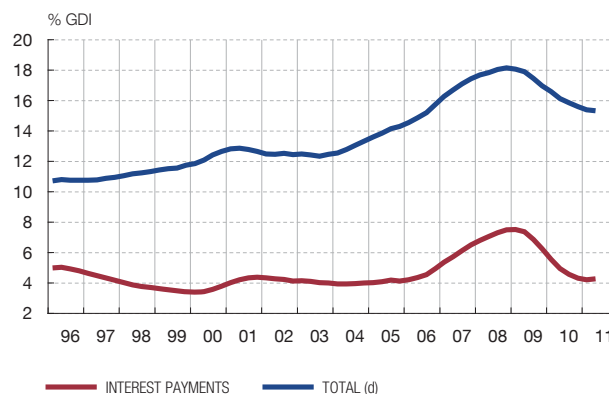
General government debt continued to slow, although its rate of expansion remained very high (15.4% in August, against 16.5% in June). The increase in government debt, along with the weak growth of GDP, was reflected in a fresh rise in the sector's debt ratio, which

² For more details, see the article "Encuesta sobre Préstamos Bancarios en España: octubre de 2011" by Maristela Mulino, in the October 2011 *Boletín Económico* (only in Spanish).

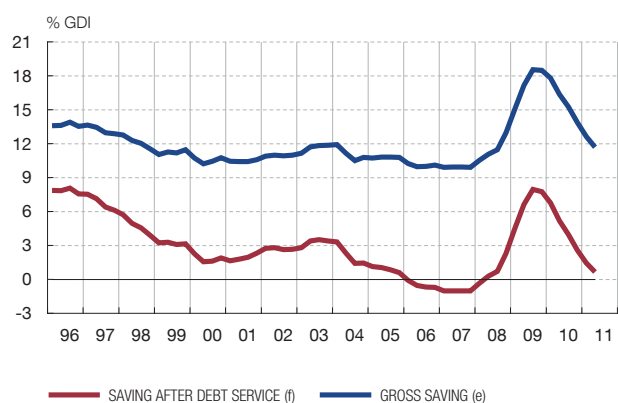
DEBT RATIOS



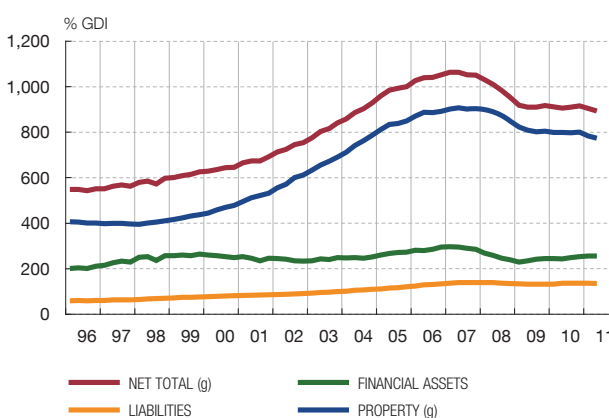
DEBT BURDEN



SAVING



WEALTH



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

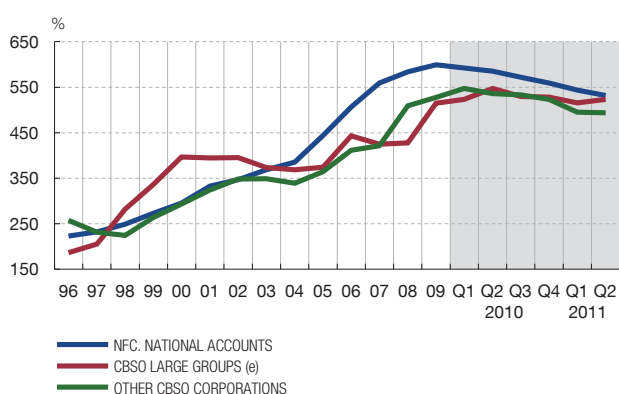
- a Includes bank credit and off-balance-sheet securitised loans.
 b Assets 1 = total financial assets - "other".
 c Assets 2 = assets 1 - shares (excluding mutual fund shares) - shares in FIM.
 d Estimated interest payments plus debt repayments.
 e Balance of households' use of disposable income account.
 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.

in June stood at 65% of GDP, and also, taken in combination with a slightly higher cost of debt, gave rise to an increase in the associated debt burden to 2.3% of GDP (see Chart 27).

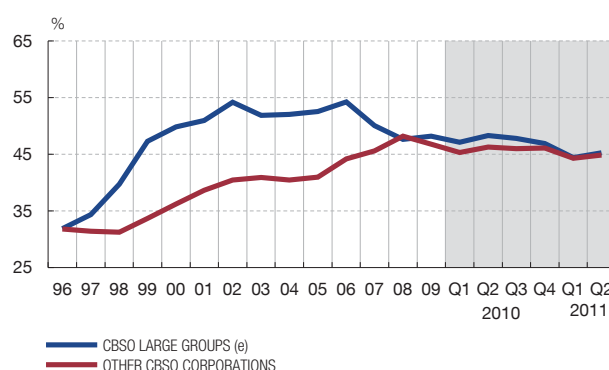
Meanwhile the volume of doubtful assets continued to rise. This, along with the decrease in lending to other resident sectors as a whole, resulted in an increase in the doubtful assets ratio, which in August (the latest figure available) reached 7.1%, up 0.45 pp on June.

The most recent Financial Accounts information, relating to June, shows that the nation's net borrowing decreased further by 3.5% of GDP in twelve-month cumulated terms, 0.6 pp less than in March (see Table 8). Sectorally, this contraction resulted from the increase in net saving by households and non-financial corporations, which offset the slight decrease in the credit balance of financial institutions, while the debt position of general government scarcely changed. The bulk of the funds raised abroad in Q2 were channelled through credit institutions in the interbank market. Contrastingly, the net financial transactions of general government with the rest of the world switched to a credit balance, basically as a result of divestment

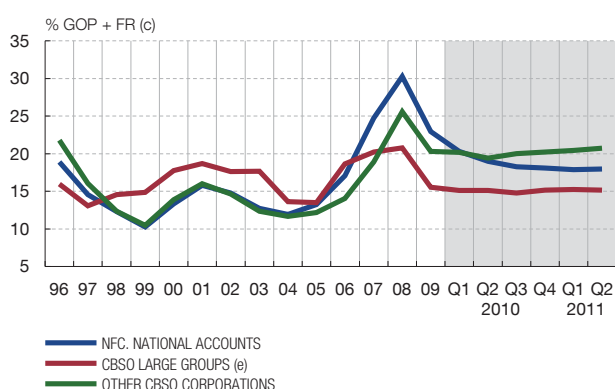
DEBT (b) / GOP + FR (c)



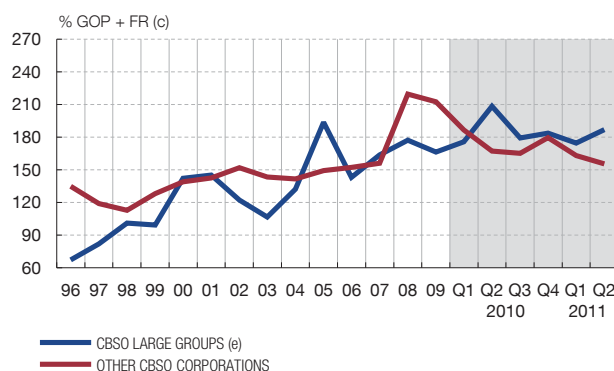
DEBT (b) / ASSETS (d)



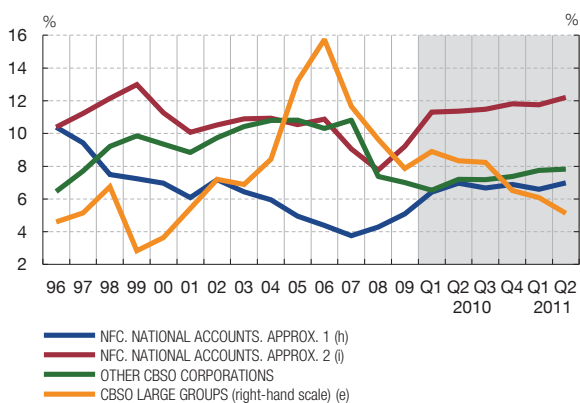
INTEREST DEBT BURDEN



TOTAL DEBT BURDEN (f)



NET ORDINARY PROFIT / OWN FUNDS (g)



SYNTHETIC INDICATORS OF FINANCIAL PRESSURE (j)



SOURCES: INE and Banco de España.

- a The indicators calculated from the CBSO sample were constructed until 2009 using CBA information; thereafter they have been extrapolated using CBQ information.
- b Interest-bearing borrowed funds.
- c Gross operating profit plus financial revenue.
- d Defined as total inflation-adjusted assets less non-interest-bearing liabilities.
- e Aggregate of all corporations reporting to the CBSO that belong to the Endesa, Iberdrola, Repsol and Telefonica groups. Adjusted for intra-group financing to avoid double counting.
- f Includes interest plus interest-bearing short-term debt.
- g NOP, using National Accounts data, is defined as GOS + interest and dividends received - interest paid - fixed capital consumption.
- h Own funds valued at market prices.
- i Own funds calculated by accumulating flows from the 1996 stock onwards.
- j Indicators estimated drawing on the CBA and CBQ surveys. A value above (below) 100 denotes more (less) financial pressure than in the base year.

NET FINANCIAL TRANSACTIONS
Four-quarter data

TABLE 8

% of GDP

	2006	2007	2008	2009	2010			2011	
					Q2	Q3	Q4	Q1	Q2
National economy	-8.4	-9.6	-9.2	-4.7	-4.5	-4.4	-3.9	-4.0	-3.5
Non-financial corporations and households and NPISHs	-11.5	-13.4	-6.5	5.1	4.7	4.5	4.4	4.3	4.9
Non-financial corporations	-9.8	-11.5	-6.7	-0.8	1.1	1.3	1.3	1.1	1.3
Households and NPISHs	-1.7	-1.9	0.2	5.9	3.6	3.2	3.1	3.2	3.5
Financial institutions	0.7	1.9	1.8	1.3	1.1	1.0	0.9	0.9	0.8
General government	2.4	1.9	-4.5	-11.1	-10.3	-9.9	-9.2	-9.2	-9.1
MEMORANDUM ITEM:									
Financing gap of non-financial corporations (a)	-17.8	-15.9	-11.9	-8.9	1.3	-0.2	-0.7	-1.5	-1.1

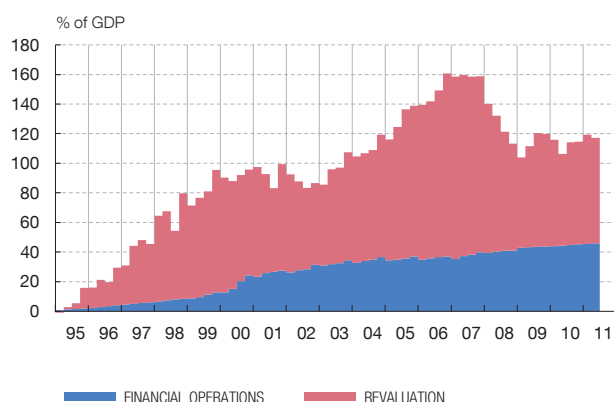
SOURCE: Banco de España.

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

OTHER FINANCIAL INDICATORS OF NON-FINANCIAL CORPORATIONS

CHART 26

CUMULATIVE CHANGE IN NET WORTH (a)



PROFIT GROWTH EXPECTATIONS OF LISTED FIRMS



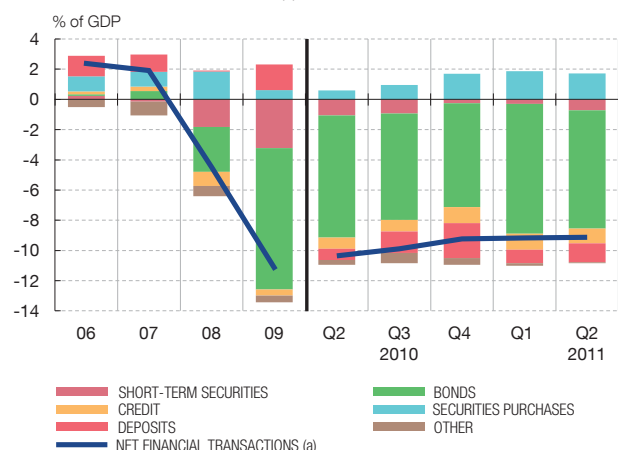
SOURCES: I/B/E/S and Banco de España.

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

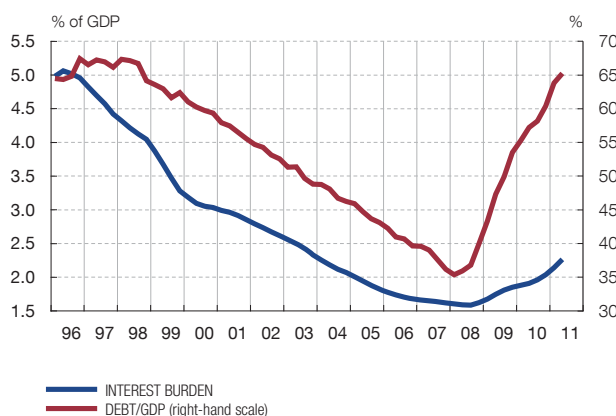
by non-residents of fixed income securities. The net funds raised in the rest of the world by sectors other than the Banco de España were insufficient to cover the borrowing requirements of the nation, so the balance on financial transactions net of the latter vis-à-vis the rest of the world again posted a debit, this time equal to 2% of GDP. The balance of payments information relating to July shows that, in that month, the financing of the Spanish economy was channelled basically through the latter, while the net capital inflows through instruments issued by monetary financial institutions and general government were negative.

In short, during 2011 Q3 financial developments in Spain were marked by the heightening of financial market tensions, which resulted in a significant worsening of the wholesale funding conditions faced by financial institutions. For the time being, these developments seem to have had a moderate impact on the supply of credit, against a background of weak demand (due to the unfavourable income prospects and the need for deleveraging firms and house-

NET-FINANCIAL TRANSACTIONS
CONTRIBUTIONS BY INSTRUMENT (a)



INTEREST BURDEN AND DEBT RATIO



SOURCE: IBanco de España.

a A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.

holds) and of strict initial credit standards, following the progressive tightening since 2007 (see Box 5). In any event, if the difficulties in accessing the wholesale markets persist for a prolonged period of time, it could result in a quickening of the rate of credit contraction.

5.2 Households

Between June and August the cost of bank financing to households increased, both in the case of real estate purchase loans (15 bp) and in the case of consumer credit and other lending (74 bp; see Chart 23). The credit standards for the latter seem to have remained steady in 2011 Q3 according to the October BLS, while banks report a slight tightening in those for the former, identical to that in July. The higher financing costs and the lower availability of funds for loan extension were again the main factors holding back supply in this segment. According to this BLS, applications for both types of loans decreased, more sharply in the case of house purchase loans, and the contraction seems to have been larger than in Q2. For the closing months of the year, the respondent banks anticipate a further decrease in applications for funds and unchanged credit conditions in both cases.

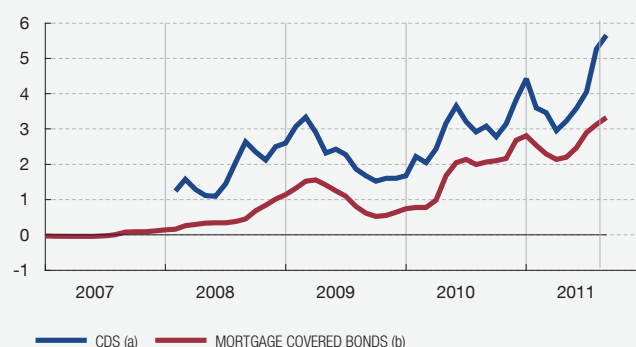
Against this background, household debt decreased again. In August (the latest figure available) the decline remained, in year-on-year terms, at 2%, as a result of scant variations in the contraction of consumer credit and other lending and of house purchase loans, which fell by 5% and 1.1%, respectively. For both components, the annualised quarter-on-quarter change shows falls which are more marked but somewhat smaller than in June.

As a result of the stagnation of income and of liabilities, in 2011 Q2 household debt held around the same level as in March (see Chart 24). This, together with the unchanged average cost of debt, meant that the debt burden ratio scarcely varied. Meanwhile, the gross saving rate and saving after debt service of households seem to have held on the downward path prevailing since the beginning of 2010. However, the net lending of the sector increased by 0.3 pp between March and June to 3.5% of GDP. Household net wealth dropped again in this period, basically as a result of the decrease in its real estate component.

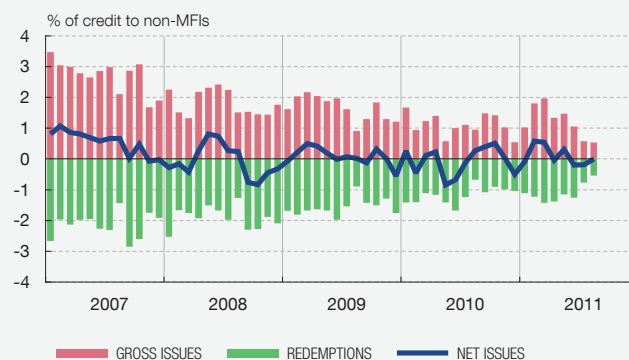
Since the start of the sovereign debt crisis in Europe (in spring 2010), the premium Spanish credit institutions must pay to raise resources on wholesale funding markets has risen substantially, clearly exceeding the levels reached in the months following the bankruptcy of Lehman Brothers in September 2008 (see Panel 1). Indeed, at specific points in time, the possibilities of obtaining funds on the markets at acceptable terms were notably limited for all or most institutions. Panel 2 shows how in several episodes Spanish credit institutions' net issues were negative: first, following the bankruptcy of Lehman Brothers; then, in May-June 2010 with the first Greek crisis; later, in November-December that same year with the Irish crisis, and finally in summer this year with the heightening of tensions on euro area sovereign debt markets.

Notwithstanding this and the importance wholesale funding has acquired in Spanish credit institutions' business in recent years, the evidence available suggests that the effects on the volume and cost of credit will, to date, have been moderate. Thus, while recently the pace of funds extended to households and companies has tended to diminish, according to the equations available at the Banco de España, this pattern does not differ significantly from what might be inferred from the observed behaviour in the fundamental variables that have traditionally determined their growth (among which none reflecting the existence of these tensions are explicitly included). The interest rates applied have tended to rise slightly more than might be inferred from the historical pattern of behaviour; but, once again, the deviations appear to have been

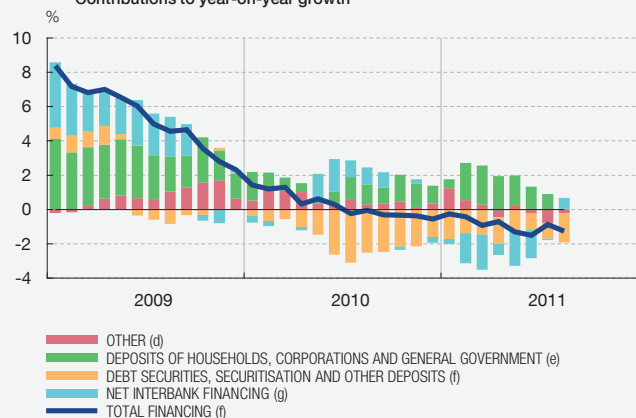
1 CDS PREMIUM AND SPREAD OVER MORTGAGE COVERED BONDS



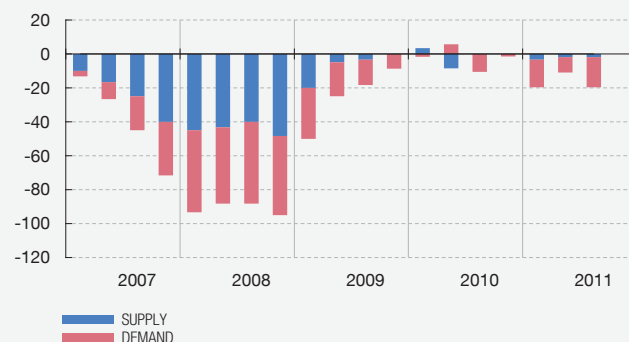
2 CREDIT INSTITUTIONS' FIXED-INCOME SECURITIES (c)



3 FINANCING OF FUNDS EXTENDED TO NON-MFIs. SPANISH CREDIT INSTITUTIONS
Contributions to year-on-year growth



4 BANK LENDING SURVEY. CHANGE IN SUPPLY OF AND DEMAND FOR LOANS IN SPAIN (h)



SOURCES: Datastream and Banco de España.

- a Five-year CDSs. Average of seven institutions.
- b Average asset swap spread at three-five years.
- c Includes resident subsidiaries' issues. Subordinated and preferential issues not included.
- d Own funds net of cash, equities, fixed assets and other assets and liabilities.
- e Resident in Spain.
- f Includes off-balance sheet securitisations.
- g Liabilities less claims on MFIs, including Banco de España. Includes the net balance of operations with central counterparties.
- h Negative values denote a net reduction in supply or demand. The indicators shown are calculated as the average (for loans to corporations, loans to households for house purchases and to households for consumption and other purposes) of the net percentage of institutions that eased their lending standards in the quarter (supply) and the net percentage of institutions that signaled an increase in demand (demand). In the calculation of net percentages, "considerable changes" are weighted by 1 and "certain changes" by 1/2.

minor. Likewise, based on the replies of the Spanish institutions participating in the Bank Lending Survey (BLS), there have been no significant changes since mid-2010 in the standards for approving new loans (see Panel 4).

The factors that might account for these moderate effects of the financial tensions on bank lending in Spain relate essentially to the existence of buffers and alternative sources of financing on the part of Spanish credit institutions. Of note, first, is the fact that the average term of maturity of outstanding securities issued by Spanish institutions, before the crisis, was relatively high, which would have meant that the monthly repayments institutions had to withstand were not very sizeable. Furthermore, despite the tensions, there has at all times been some volume of issuance, meaning that although the contribution of wholesale resources (debt securities, securitisations and other deposits) to the growth of the financing of the funds granted to non-MFIs has been negative since early 2010 (see Panel 3), this negative contribution has at no point exceeded 3 pp in year-on-year terms. These declines were partly offset by the growth of resident customers' deposits which, while not very high, remain positive as from December 2009, driven mainly by household deposits (which account for more than 70% of the total). At specific points in time, at the height of the tensions, the resort to the pledging of available liquid assets, as collateral for interbank market operations (either with the central bank or with other institutions), would also have contributed to some extent to offsetting the negative net issues of debt securities. Lastly, it should further be taken into account that, during this period, set against the slackness of the economy and private-sector deleveraging needs, households' and companies' demand for funds has been relatively scant, thereby limiting the potential contractionary effects of the tensions on lending, as highlighted in the replies by Spanish banks to the BLS (see Panel 4).

In any event, even bearing in mind the long average life of outstanding securities and the slackness of the demand for credit, the protracted continuation of a situation of difficulty for institutions in

raising funds on the markets would tend to deplete the leeway available to counter these effects. For one thing, the possibility of higher growth in customer deposits - or the placement with customers of tradeable securities - is limited by the level of saving of Spanish households and companies and the scope of the potential shifts between assets within these same agents' portfolios. In this respect, in the last eight quarters to 2011 Q2, Spanish households earmarked 70% (60%) of their gross (net) saving to the acquisition of Spanish credit institutions' deposits, while investment funds, the main alternative asset, saw their value fall by 45% from the peak attained in June 2007. Accordingly, a significant acceleration in the rate at which new funds are raised through this channel is complicated and would undoubtedly see the cost of new funds rise.

Furthermore, the volume of liquid assets available for sale or supply as collateral for loans, in July 2011, is estimated to stand at around 9% of Spanish credit institutions' total balance sheet, a figure clearly higher than the average for the years 2005-2007 (5.6%), but one which already reflects the decline from the peak of 11.7% reached in March this year. However, the option of selling these assets to obtain liquidity might not be feasible (not without incurring high losses) for a substantial portion of such assets. The alternative of using them as collateral to obtain funds on the interbank market, in an environment marked by a lack of confidence and by the difficulties of gaining access to wholesale funding, entails an interest-rate and refinancing risk which, given the amounts in question, is not negligible.

In sum, although the tensions on euro area sovereign debt markets do not appear so far to have translated into a significant further tightening of credit supply by Spanish credit institutions, the prolonged continuation of the current situation would tend to exhaust the leeway available to these institutions to counter these effects. While the recent liquidity support measures adopted by the Eurosystem are a substantial help, a scenario of continuing tensions would ultimately see the rate of contraction of credit step up.

On the latest Financial Accounts information, household investment in financial assets decreased by 1.8 pp between March and June to 1.7% of GDP in four-quarter cumulated terms (see Table 9). By instrument, household investment in fixed-income securities posted the largest fall and the flow became negative, equal to 0.6% of GDP. Households also saw, during the past twelve months, a decline in their holdings of shares and mutual fund shares, although the divestment of the latter was somewhat more moderate than in the previous quarter. By contrast, the sector's stock of time deposits increased again, in line with the events three months earlier.

Finally, Q2 did not bring any major changes in the sector's doubtful assets ratios, which stood around 2.52% for house purchase loans and at 6.43% for consumer credit and other lending.

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

TABLE 9

% of GDP

	2007	2008	2009	2010	2011	
				Q4	Q1	Q2
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	7.2	2.5	4.6	3.8	3.4	1.7
Cash and cash equivalents	-1.1	-0.4	4.2	-0.1	0.0	-0.3
Other deposits and fixed-income securities (a)	7.5	6.8	-1.3	3.2	3.3	2.3
Shares and other equity (b)	0.6	-0.2	1.3	0.5	0.4	-0.3
Mutual funds	-1.1	-3.4	0.0	-1.7	-1.5	-1.3
Insurance technical reserves	0.9	0.2	0.9	0.7	0.7	0.9
<i>Of which:</i>						
<i>Life assurance</i>	0.2	-0.2	0.6	0.3	0.4	0.5
<i>Retirement</i>	0.4	0.3	0.3	0.4	0.2	0.4
Other	0.3	-0.4	-0.4	1.3	0.7	0.4
Financial transactions (liabilities)	9.1	2.3	-1.2	0.8	0.2	-1.9
Credit from resident financial institutions (c)	9.4	3.4	-0.5	0.0	-0.5	-1.6
House purchase credit (c)	7.1	2.7	0.1	0.5	-0.1	-0.7
Consumer and other credit (c)	2.1	0.8	-0.4	-0.3	-0.4	-1.0
Other	-0.3	-1.1	-0.7	0.7	0.7	-0.2
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	13.4	1.7	-8.3	7.0	6.0	4.1
Cash and cash equivalents	-0.4	-1.1	-0.3	-0.1	0.4	-0.5
Other deposits and fixed-income securities (a)	2.0	2.3	-0.6	1.3	1.8	2.0
Shares and other equity	8.1	2.9	-0.4	2.6	2.6	1.5
<i>Of which:</i>						
<i>Vis-à-vis the rest of the world</i>	6.6	3.1	0.3	2.2	2.4	2.0
Trade and intercompany credit	2.1	-3.2	-7.3	3.1	1.0	0.3
Other	1.5	0.7	0.3	0.0	0.2	0.8
Financial transactions (liabilities)	24.9	8.4	-7.6	5.7	4.9	2.8
Credit from resident financial institutions (c)	13.8	5.5	-3.0	-0.9	-1.4	-2.4
Foreign loans	2.8	3.0	-0.1	0.7	1.2	1.2
Fixed-income securities (d)	0.5	0.3	1.3	0.7	0.6	0.6
Shares and other equity	5.3	2.3	1.6	1.8	2.6	2.6
Trade and intercompany credit	3.3	-3.3	-7.0	3.3	1.1	0.3
Other	-0.8	0.6	-0.5	0.1	0.9	0.4
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (e)	15.4	6.6	-0.8	0.6	0.1	-1.2
Households and NPISHs	12.5	4.4	-0.3	0.2	-0.5	-2.0
Non-financial corporations	17.7	8.2	-1.2	0.9	0.4	-0.7

SOURCE: Banco de España.

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

b Excluding mutual funds.

c Including derecognised securitised loans.

d Includes the issues of resident financial subsidiaries.

e Defined as the sum of bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation special purpose entities.

5.3 Non-financial corporations

Between June and August 2011 the interest rates on bank financing to firms increased by 6 bp and 28 bp for transactions of less than and more than €1 million, respectively. This increase basically reflects a widening of the spreads applied by financial institutions over the interbank benchmark rates. In line with this development, banks indicated in the latest BLS (October 2011) that in 2011 Q3 the margins applied to new loans to this sector had increased slightly, although the standards for approving those loans remained unchanged. According to this BLS, firms' applications for bank financing dropped in these months. In Q3 the cost of issuing short- and long-term fixed-income securities increased (20 bp and 46 bp, respectively), while that of equity issuance decreased by 45 bp.

Q3 saw a quickening of the rate of contraction of the debt of non-financial corporations, which in August stood, in year-on-year terms, at 1.1%, 0.4 pp more than in June. These are, however, significant differences between instruments. Thus the year-on-year rate of fall of loans by resident institutions quickened to 3.4%, compared with 2.7% at the end of Q1, although in quarter-on-quarter terms the decrease moderated slightly. By contrast, for fixed-income securities and loans from abroad (the means used basically by large companies), the more expansionary behaviour continued. The latest information on lending by loan type, relating to 2011 Q2, reflects an across-the-board deceleration in all sectors, as a result of which all of them showed a contraction in the outstanding balance of bank financing. Once again, the year-on-year fall was particularly sharp in construction (15%) and in real estate services (4.2%), and comparatively more moderate in other services (0.4%). In industry it was 3.9%, against 2.4% in March.

On Financial Accounts information, the credit balance of the corporate sector's net financial transactions increased slightly in 2011 Q2 to 1.3% of GDP in twelve-month cumulated terms, up 0.3 pp on March. This increase was similar to that in the financing gap, which approximates the funds required to bridge the difference between gross corporate saving and gross capital formation plus permanent foreign investment, which posted a negative balance equivalent to 1.1% of GDP, compared with -1.5% in the first three months of the year.

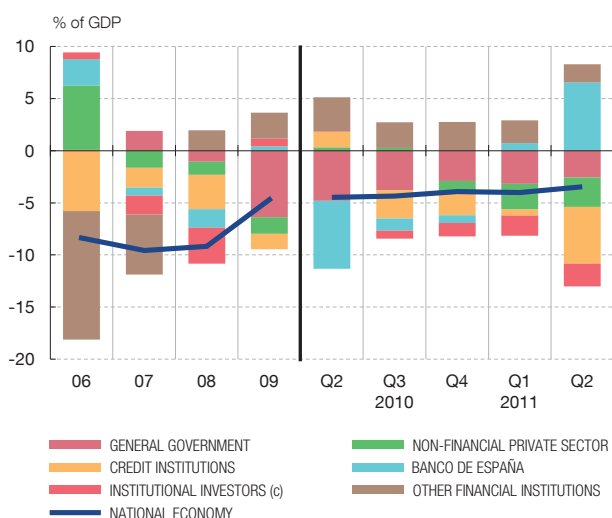
The containment of corporate debt, along with the improved corporate surpluses shown by the National Accounts for 2011 Q2, meant that the sector's debt ratio decreased again. The cumulative fall is now somewhat more than 10% from the high reached in 2009. As a result of this fall-off and of the slight rise in the average cost of financing, the debt burden held steady in this period (see Chart 25). Also, the improvement in income allowed the return on equity to increase. For the sample of CBQ reporting firms, among which the biggest have a notable weight, the data available for 2011 H1 show that gross operating profit (GOP) decreased between January and June by 1.6% with respect to the same period of 2010. Despite this fall in GOP, the notable growth in financial revenue allowed the ordinary net profit of these firms to increase in this period, albeit less than in the same months of 2010 (3.5%, against 8% in 2010), but did not prevent the return on investment dropping, by 0.3 pp with respect to 2010, to 5%. This fall was in all sectors, especially those in which productive activity slumped most, such as wholesale and retail trade, accommodation and food service activities, and information and communication. In 12-month cumulated terms, income held at similar levels to those in March, as did liabilities, so the debt ratio of these firms scarcely changed in Q2. This, along with the higher interest rates, nudged the debt burden up slightly. Nonetheless, the synthetic indicator of financial pressure on investment underwent no significant change, while that of employment decreased slightly. As far as the coming quarters are concerned, analysts revised downward the long-term growth expectations for the profits of listed companies and the same applies even more so to short-term expectations (see Chart 26).

The doubtful assets ratio of non-financial corporations grew again in 2011 Q2, more sharply in lending to construction and real estate services firms (the ratio of which increased by 2.3 pp to 17%) than in other companies (the ratio of which was up by 0.3 bp to 4%).

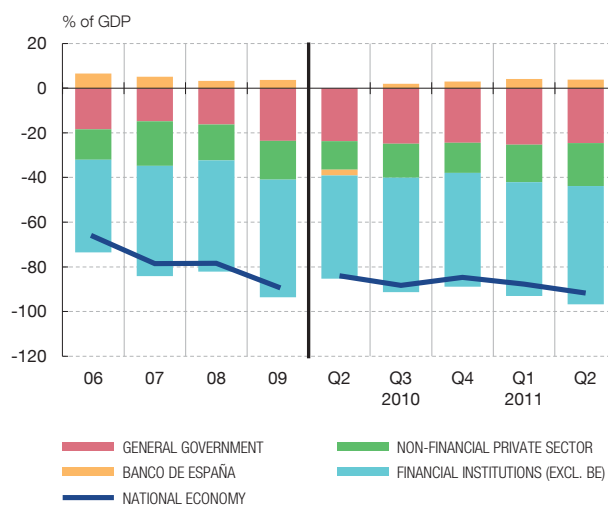
5.4 General government

The Financial Accounts show that in 2011 Q2 general government borrowing scarcely changed, standing, in cumulated annual terms, at 9.1% of GDP, down 0.1 pp from March (see Table 8). Once again, the main way of raising funds was bond issuance, thought

NET FINANCIAL TRANSACTIONS (b)



NET FINANCIAL ASSETS



SOURCE: Banco de España.

a Four-quarter data for transactions. End-period data for stocks. Unsectorised assets and liabilities not included.

b A negative (positive) sign denotes that the rest of the world grants (receives) financing to (from) the counterpart sector.

c Insurance companies and portfolio investment institutions.

which funds equivalent to 7.8% of GDP were obtained, down 0.8 pp from March (see Chart 27). Loans and short-term debt securities contributed another 1.7% of GDP (0.3% more than in Q1) while, on the asset side, net acquisitions of securities decreased slightly to 1.7% of GDP and the stock of deposits dropped by the equivalent of 1.3% of GDP. From the sectoral standpoint, resident financial institutions acquired the largest volume of general government securities, while the rest of the world reduced its holdings of these assets.

The growth rate of general government debt continues to be high (15.4% in August), although it has moderated further (1.1 pp less than in June). The increase in liabilities, along with the weak GDP growth, has been reflected in a fresh rise in the sector's debt ratio, which was up to 65% of GDP at the end of 2011 H1, 1.4 pp more than in March. This, together with the slight rise in the average cost of borrowing, meant that the associated debt burden rose to 2.3% of GDP.

5.5 The rest of the world

The nation's net borrowing fell back again in 2011 Q2 to 3.5% of GDP in 12-month cumulated terms, down 0.6 pp from the figure in March, according to the Financial Accounts (see Table 8). This decrease was due to the higher net saving of households and non-financial corporations, which offset the slight fall in the credit balance of financial institutions, while the debit position of general government scarcely changed.

The sectoral breakdown of financial transactions with the rest of the world shows that between March and June 2011 the bulk of external financing was channelled through credit institutions, the net volume being equivalent to 5.4% of GDP (a figure similar to that for the whole of the past twelve months; see Chart 28), which represents an increase compared with the previous three months. There was also a rise in the capital inflows associated with the activity of institutional investors, which continued to reduce their holdings of foreign assets. By contrast, the other sectors saw a decline in these flows, particularly

FINANCIAL TRANSACTIONS OF THE NATION
Four-quarter data

TABLE 10

% of GDP

	2007	2008	2009	2010		2011	
				Q4	Q1	Q2	
NET FINANCIAL TRANSACTIONS	-9.6	-9.2	-4.7	-3.9	-4.0	-3.5	
Financial transactions (assets)	14.1	0.7	-0.2	-3.4	-1.2	1.7	
Gold and SDRs	0.0	0.0	0.0	0.0	0.0	0.0	
Cash and deposits	1.4	-1.3	-3.2	-1.4	0.7	0.5	
<i>Of which:</i>							
Interbank - credit institutions	4.2	-0.5	-1.7	-1.3	0.5	0.2	
Securities other than shares	1.6	1.3	0.0	-6.9	-7.1	-4.7	
<i>Of which:</i>							
Credit institutions	1.8	1.5	1.2	-3.0	-2.4	-0.4	
Institutional investors	0.0	-1.3	-0.5	-2.8	-3.2	-2.7	
Shares and other equity	8.8	1.7	1.5	2.4	3.0	3.1	
<i>Of which:</i>							
Non-financial corporations	6.6	3.1	0.3	2.2	2.4	2.0	
Institutional investors	-1.1	-1.8	0.0	1.2	0.8	0.4	
Loans	1.2	0.8	0.2	0.3	0.4	1.1	
Financial transactions (liabilities)	23.7	9.9	4.5	0.5	2.8	5.2	
Deposits	6.7	8.0	-0.5	-0.5	-1.3	0.7	
<i>Of which:</i>							
Interbank - credit institutions (a)	6.7	6.2	0.7	-7.3	-7.7	-1.7	
Repos - credit institutions (b)	0.1	0.2	0.1	5.7	6.1	8.2	
Interbank - BE (intra-system position)	-0.3	1.9	-0.8	0.2	-1.1	-6.5	
Securities other than shares	8.1	-2.7	3.7	-1.7	-0.4	0.1	
<i>Of which:</i>							
General government	-1.3	1.1	5.2	2.1	2.7	2.3	
Credit institutions	3.6	-1.9	1.1	-1.3	-1.0	-0.5	
Other non-monetary financial institutions	5.8	-1.9	-2.5	-2.5	-2.1	-1.7	
Shares and other equity	4.6	3.2	1.0	0.9	2.4	2.3	
<i>Of which:</i>							
Non-financial corporations	4.7	2.4	0.3	1.3	2.4	2.3	
Loans	3.1	2.9	0.3	1.2	1.5	1.6	
Other, net (c)	0.2	0.2	-1.4	-1.6	-1.3	-1.3	
MEMORANDUM ITEMS							
Spanish direct investment abroad	9.5	4.7	0.7	1.5	2.9	3.5	
Foreign direct investment in Spain	4.5	4.8	0.6	1.7	2.1	2.4	

SOURCE: Banco de España.

a Includes bilateral repos.

b Including transactions with central counterparty clearing houses.

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

sharp in the case of general government. The net funds raised abroad by agents other than the Banco de España were insufficient to cover the nation's borrowing requirement, so the Banco de España's net financial transactions with the rest of the world again showed a debit balance, equivalent to 2% of GDP. The July balance of payments information shows that the financing of the Spanish economy in that month was covered mainly by this latter means and, to a lesser extent, by the net funds raised in the rest of the world by "other resident sectors" (which include households, non-financial institutions and non-monetary financial institutions), while, by contrast, the net flow of funds obtained by monetary finan-

cial institutions and by general government was negative, basically due to non-residents' divestments of bonds issued by these sectors.

The breakdown by instrument shows that the bulk of capital inflows between March and June was channelled through the interbank market (including transactions with central counterparties), which, in net terms, allowed credit institutions to raise funds for an amount equivalent to 15.5% of GDP (6.2% of GDP in 12-month cumulated terms; see Table 10). By contrast, the flow associated with fixed-income securities fell significantly to the point that it became negative by an amount equivalent to 7.8% of GDP (in four-quarter cumulated terms it was, however, slightly positive at 0.1% of GDP). The divestment by non-residents of securities issued by Spanish agents affected all sectors. Also down were the funds raised through shares and other equity, which showed a negative sign, and foreign direct investment in Spain, although in the period July 2010-June 2011 the latter increased to 2.4% of GDP, up 0.3 pp on March.

Capital outflows increased in 2011 Q2 to 5.6% of GDP (1.7% in four-quarter cumulated terms). Analysis by instrument shows, once again, a divestment by residents of fixed-income securities issued by the rest of the world, albeit less than in the first quarter of the year, an increase in the stock of loans to the rest of the world and a fall in net purchases of shares and other equity. Also down was Spanish foreign direct investment, which stood at 3% of GDP, although in the period July 2010-June 2011 it rose by 0.6 pp to 3.5% of GDP.

These developments in capital inflows and outflows, in asset prices and in exchange rates meant that the value of the Spanish economy's net liabilities to the rest of the world were equivalent to 91.7% of GDP in 2011 Q2, up 4 pp on March (see Chart 28). This increase was due to the rise of 5.8 pp in the debit balance of the non-financial private sector and of financial institutions (excluding the Banco de España) with non-residents, which offset the decline in the net external debt of general government. For its part, the Banco de España's credit position vis-à-vis the rest of the world decreased slightly.

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