



## Financial developments in Spain

### 1 Introduction

Financial developments were influenced by the financial and real international crisis

Financial developments in the Spanish economy during 2008 were largely influenced by the worsening international financial crisis and by the macroeconomic downturn in Spain and in the rest of the world (see Chapter 1 of this Report). Against this background, and in concert with the other European countries, the Spanish government adopted a series of measures to reinforce the financial system. It raised the deposit guarantee threshold to €100,000; it created a fund for the acquisition of high-quality financial assets (FAFA) channelled through auctions among potential interested banks; it agreed on the granting of State guarantees of which intermediaries could avail themselves in order to issue bonds, and it authorised the State purchase of securities to shore up banks' capital, although it has not used this latter option to date. ICO intermediation facilities were also notably reinforced with the aim of providing financing flows to specific agents, such as SMEs, which may have seen their access to regular channels more restricted.

Private-sector financing conditions continued tightening...

In this setting, private-sector financing conditions tightened continuously during the year, via two channels. First, the cost of funds increased both in the case of bank funding, since banks passed through to lending transactions the increase in the risk premia incorporated into non-guaranteed money market rates, and in that of securities issuance (see left-hand panel of Chart 6.1). Conditions other than interest rates also became more demanding, and there was an observable reduction in maturities and an increase in the guarantees required. Further, lending standards also became tighter. The deterioration in the macroeconomic outlook and in borrowers' solvency and, to a lesser extent, the drying up of the wholesale markets and the international trend towards less leverage account for the tightening of the credit supply.

During the closing months of the year the decline in interbank rates began to pass through to the cost of credit, although the tightening of the supply of loans continued and did not begin to show signs of moderation until early 2009.

... which, together with diminished demand, made the slowdown in household and corporate debt more acute

Household and corporate debt slowed notably, not only owing to the above-mentioned supply factors but also in response to other factors operating on the demand side, such as the deterioration in confidence and in future income expectations, greater uncertainty and the attendant high costs, which checked applications for funds. In the case of business credit, which is the main component of the borrowed funds raised by the corporate sector, the decline in the growth rate was particularly marked in the industries linked to the real estate sector (construction and real estate development).

The private-sector debt ratio fell, but the interest burden continued to increase

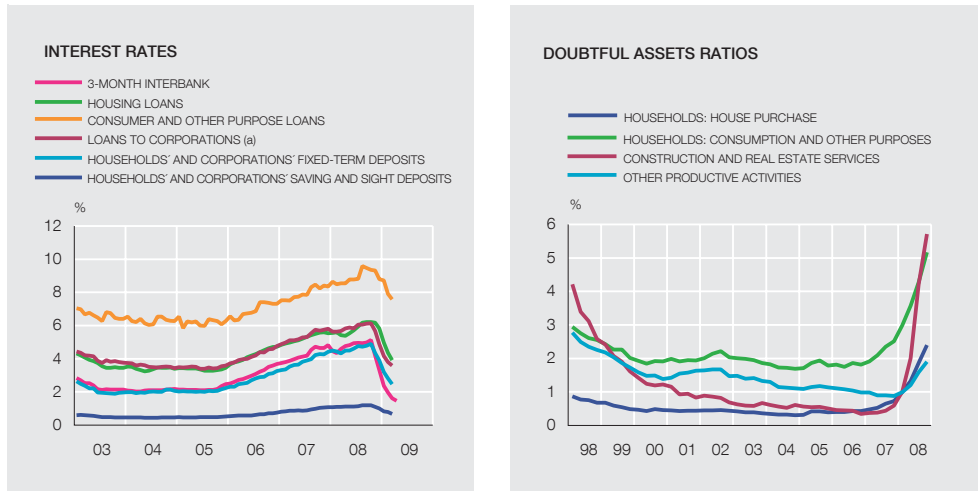
The slowdown in financing raised by the private sector contributed to the slight reduction in the ratios of debt to household and to corporate income, following the strong growth recorded during the upturn (see Chapter 2). Nonetheless, the associated interest burden continued increasing in both sectors due to the rise in the average cost of liabilities.

Household wealth fell

Despite the diminished buoyancy of liabilities, net household wealth fell as a result of the decline in financial asset values and, above all, of the fall in property prices. On Spanish Ministry of Housing figures, this fall began at the end of 2008 and has run into the current year.

Private-sector doubtful assets ratios increased notably...

The growing degree of financial pressure experienced by some private-sector segments was reflected in notable increases in the doubtful assets ratio, defined as the proportion of doubtful to total loans in the credit portfolio (see right-hand panel of Chart 6.1). In the case of loans to



SOURCE: Banco de España.

a. Calculated as a weighted average of interest rates of various operations grouped according to their volume. For loans over € 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 these expenses.

the construction and real estate services industries, this ratio rose to 5.7%, set against the sharp adjustment in the sector following its overdimensioning during the upturn (see Chapter 2).

... prompting a fall in credit institutions' profits, which has lessened the leeway available to absorb further asset impairments

Spanish credit institutions were less prone than those of other developed countries to the adverse effects associated with the direct impact of the turmoil that broke in the summer of 2007, since they were not exposed to toxic products and had no commitments to the structured vehicles investing in such assets. However, the strong rise in doubtful assets ratios accompanying the deterioration in the macroeconomic scenario has led to a decline in profits that has lessened the leeway available to institutions to absorb further asset impairments. Their capital ratios have held at comfortable levels, albeit in an environment in which their international competitors are addressing intense deleveraging processes, accompanied in some cases by government capital injections.

There was a decline in fixed-income issues and in external funds routed through financial institutions

Given the difficulties in resorting to international markets, banks notably reduced their volume of issues, meaning that these were negative in net terms for the year as a whole. In the opening months of 2009, however, the primary markets have been discernibly more buoyant, this being linked in part to operations transacted with State backing.

Accordingly, financial institutions (excluding the Banco de España and institutional investors) contributed to a much lesser extent than in previous years to channeling the Spanish economy's external funding requirements. As this decline was not offset in full by net capital inflows via institutional investors and non-financial corporations or by the foreign resources raised by general government, a portion of the funds needed to finance the current-account deficit was, as in the previous year, covered by a reduction in the credit balance of the Banco de España vis-à-vis the rest of the world. This reflected the foreign financing difficulties faced by other agents.

The macroeconomic downturn is raising the financial pressure on the different sectors of the economy, and it will foreseeably continue to do so

The macroeconomic downturn, along with the rise in the cost of debt, has translated into greater financial pressure on the private sector (especially the most indebted households and firms). These developments have been accompanied, moreover, by a decline in agents' wealth. The prospect of the predominance of contractionary trends in the short term will likely continue contributing to weakening the financial position of households and firms over

the coming quarters. However, the recent reduction in interbank market interest rates will tend to pass through to a sizeable portion of outstanding loans, given the prevalence in Spain of floating-rate operations, thereby easing the interest burden borne by private agents and thus countering, at least in part, the adverse effect arising from the recessionary environment.

Persisting tensions on international financial markets may continue hampering the raising of funds abroad by the Spanish economy, although the fall in private-sector funding requirements, which has already begun and which will foreseeably continue, mitigates these risks to some extent, as does too the application of the financial system support measures adopted in the final quarter of the year. In any event, high private-sector debt and the weak macroeconomic outlook will continue to stifle credit.

Spanish financial intermediaries have to date felt the effects of the financial crisis to a lesser extent than is the case in other financial systems, but they are not immune to the notable macroeconomic downturn. Accordingly, their financial position will be subject to greater pressures over the coming quarters, while the room for manoeuvre they had to withstand these shocks will progressively lessen. Against this background, it is vital to preserve the soundness of the financial system, so that it should not check the recovery in Spain once the obstacles arising from the international financial crisis lift.

## **2 Financial flows in the Spanish economy**

### **2.1 HOUSEHOLDS**

Household net borrowing declined, and a sharp slowdown in credit was discernible...

Households' net financial transactions were slightly positive, in contrast to their net borrowing equivalent to 1.6% of GDP in 2007. This was the result of the marked decline both in asset and, especially, liability flows, which stood at 2.9% and at 2.7% of GDP, respectively (see Chart 6.2).

On the liabilities side, there was a sharp slowdown in financing raised by households, the year-on-year rate of change of which at end-2008 stood at 4% (compared with 12% the previous year). Loans for house purchases and lending for consumption and other purposes trended similarly, growing over the year as a whole at rates of 5% and 4%, respectively, around 8 pp and 7 pp below the related 2007 figures (see the left-hand panel of Chart 6.3).

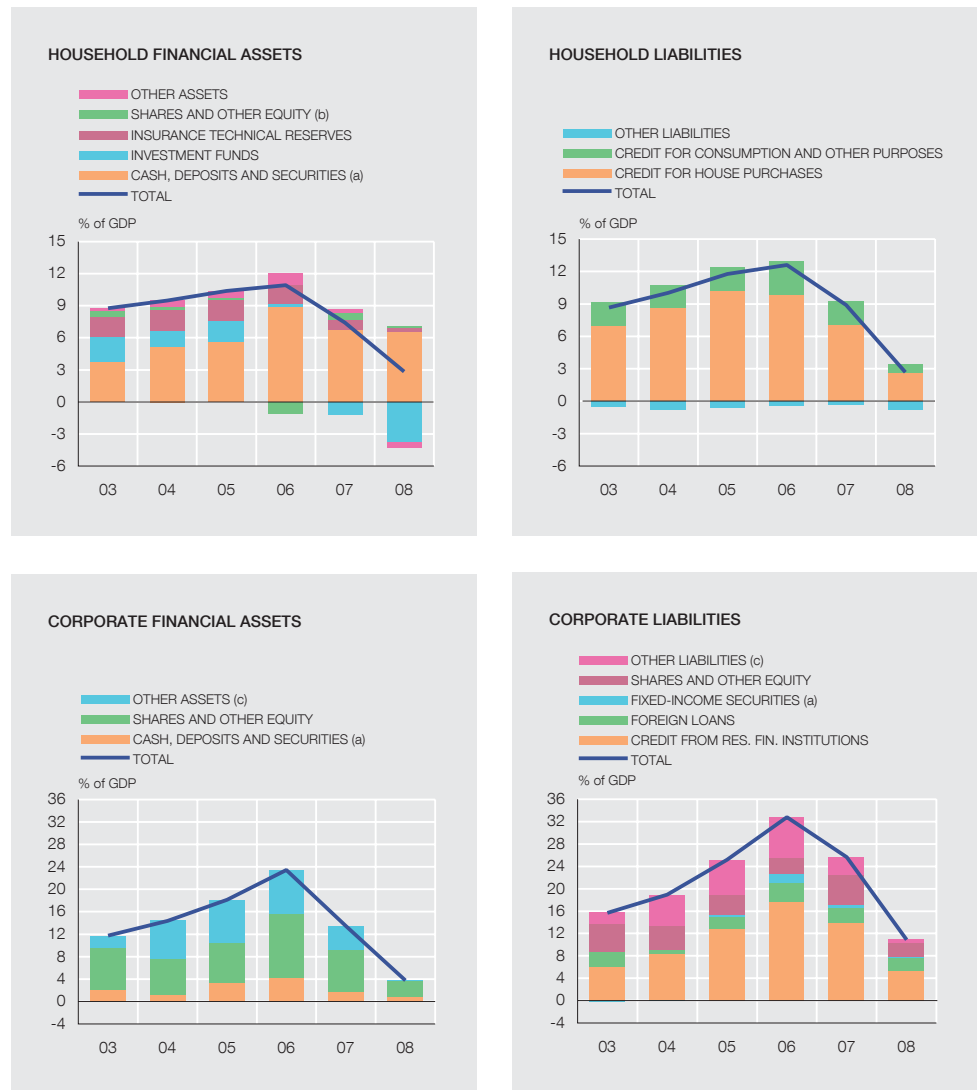
According to the Bank Lending Survey (BLS), the slowdown in credit was in response to the fall-off both in demand – prompted by the decline in consumer confidence, the fall in their wealth and poorer expectations about property prices – and in supply (see the right-hand panel of Chart 6.3). As indicated by the respondent Spanish banks, the worsening outlook for the economic situation in general (and for the housing market in particular) and the deterioration in consumer solvency were the main factors behind the tightening of standards for the approval of new loans to households last year. The problems of access to wholesale funding and their high cost also seem to have contributed, albeit to a lesser extent, to reducing the supply of funds. The contraction was similar in loans for house purchase and in lending for consumption and other purposes.

... and, to a lesser extent, household financial investments fell

In the case of assets, the trends observed the previous year remained in place. Thus, against a backdrop of greater uncertainty and spurred by more attractive yields, much of household investment was concentrated in time deposits. These amounted to a sum equivalent to almost 8% of GDP, to the detriment of holdings of sight deposits and of investment funds, for which negative flows were posted (see Chart 6.2).

**FINANCIAL TRANSACTIONS OF THE NON-FINANCIAL PRIVATE SECTOR**  
(Changes in and contributions of components)

CHART 6.2



SOURCE: Banco de España.

- a. Not including unpaid accrued interest, which is included under "other".
- b. Excluding investment funds.
- c. These are largely made up of commercial loans.

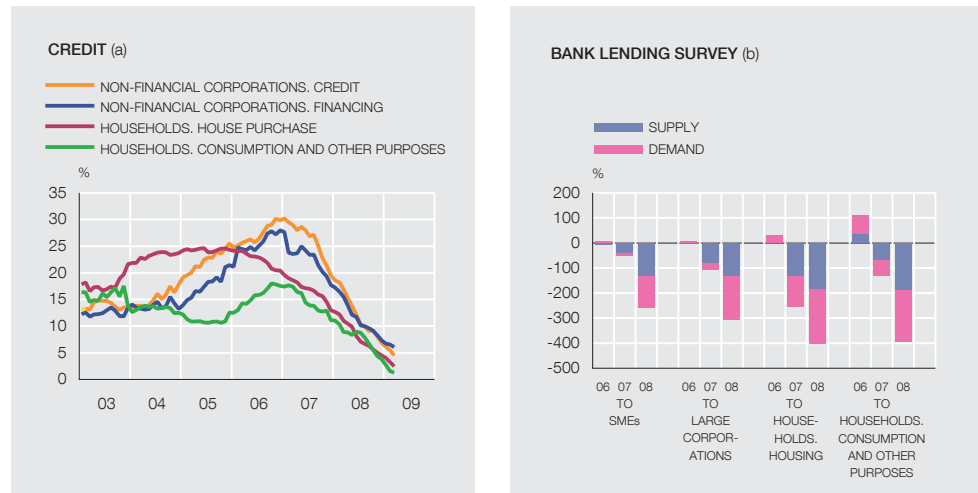
**2.2 NON-FINANCIAL CORPORATIONS**

Corporations' net borrowing declined...

...and both debt and investment in assets slowed

Non-financial corporations' net borrowing relative to GDP fell by 5 pp compared with 2007, as a result of the considerable slowdown in fixed-capital investment. Nonetheless, the sector's net financial transactions continued to show a debit balance of 7% of GDP. The financing gap, which approximates the funds needed to cover the difference between the sector's gross saving and gross capital formation plus foreign investment of a permanent nature, fell by a greater extent (8 pp), to around 10% of GDP, in line with the diminished dynamism of direct investment in the rest of the world.

Corporations' liability flows fell substantially to 11% of GDP (against 26% in 2007). The decline was more or less across the board in terms of instruments. Specifically, the year-on-year rate of increase in the sector's financing dropped significantly to stand at around 7% in December 2008 (against 18% a year earlier). Bank credit, which is the main component here, showed a somewhat more marked slowdown, and its rate of expansion was marginally less than 7% at the close of last year, compared with 20% the previous year (see the left-hand panel of



SOURCES: ECB and Banco de España.

a. Year-on-year rates.

b. Cumulative changes in the diffusion index (with the sign reversed in the case of supply), so a negative sign denotes a decline in the corresponding variable.

Chart 6.3). This easing was discernible in all the productive sectors, but was much more pronounced in the construction and real estate development branches, where the respective year-on-year growth rates were  $-1\%$  and  $4.8\%$ , signifying declines of around 20 pp and 15 pp on 2007.

As in the case of households, the replies to the BLS indicate that the slowdown in credit was in response to a contraction both in demand and in supply (see the right-hand panel of Chart 6.3). The decline in applications for funds is due to the slowdown in investment in fixed capital and to the scant number of mergers, acquisitions and corporate restructuring operations. Meantime, the tightening of credit standards for new loans was brought on primarily by banks' deteriorating expectations regarding the macroeconomic scenario and the particular circumstances of the various sectors and companies, and by the risks associated with the required collateral, and to a lesser extent by the problems of gaining access to funding on markets and the costs related to the level of capital.

In terms of company size, diminished buoyancy in credit to small and medium-sized companies was witnessed in the closing months of 2008, apparently reflecting the more contractionary behaviour of supply in loans to SMEs (see Box 6.1).

Companies' financial investment also contracted significantly. In terms of four-quarter cumulative flows, this variable accounted for  $3.7\%$  of GDP, compared with  $13.5\%$  in 2007 (see Chart 6.2). This decline was across the board in terms of instruments, but particularly marked in the case of equity acquisitions, in an environment not propitious to purchases of these instruments owing to high uncertainty, to financing difficulties and to sales by companies with greater pressure on their balance sheets.

### 2.3 GENERAL GOVERNMENT

The general government budget balance deteriorated most significantly

For the first time since 2005, general government recorded net borrowing equivalent to  $3.8\%$  of GDP (see Chart 6.4). In the previous year there was a surplus of  $2.2\%$  of GDP, entailing a deterioration of around 6 pp. This result was the outcome of the change in the net central government position (which posted a deficit of  $2.7\%$  in 2008), the increase in the territorial government deficit and the slight reduction in Social Security net lending. The breakdown by

As discussed in the main body of the text, credit to non-financial corporations, which retained its still-high buoyancy in 2007, slowed much more clearly during 2008 as a result of declines both in the supply of and demand for funds. This was consistent with the existence of a degree of cross-company heterogeneity. The increase in credit for construction and real estate development companies thus fell to a greater extent, which no doubt reflects the intensity of the correction in the activity of and outlook for these sectors. This box analyses the extent to which there are also divergences linked to company size. This aspect is significant insofar as the dependence on bank credit at small companies is usually greater than at large ones, owing to the fact that the former – in general – cannot resort to the financial markets as an alternative source of funds. However, in the information available on the loans granted by Spanish credit institutions, there is no segregation based on borrower size. Accordingly, other available statistics are used for this study, enabling the issue to be broached.

Firstly, the information contained in the central credit register (CCR) can be used to classify credit granted in terms of the company's total volume of outstanding loans, a variable that can be taken as an approximation to company size. To this end, Panels 1 and 2 show the growth rates of bank credit to companies, for two sectoral groupings (construction and real estate development, on one hand, and other activities, on the other).<sup>1</sup> It can be seen how, in 2008, there was a strong and fairly generalised slowdown, though one sharper in the activities most closely linked to the real estate market and, under the other sectors, in transactions with companies with a lower volume of borrowed funds. In the first instance, and with the exception of companies with debt levels of less than €1 million, the increase in financing last year was virtually zero in all the groups considered. Nonetheless, in the remaining branches differences can be seen on the basis of outstanding loan balances, with still-high growth being observed in the higher categories and very low growth in the lower ones, with the exception once again of the first category included in the panel.

Another source of useful information for analysing the differential behaviour of credit according to company size is that provided by new loans granted. This includes a breakdown based on whether the transactions are below or over €1 million. As Panel 3 shows, from 2007 to mid-2008, the slowdown in credit to companies would have been essentially due to large-value loans (granted to a greater extent to large corporations), which began to decline in late 2007, while small-value transactions (associated essentially with credit to SMEs) held stable or fell only slightly. During the second half of last year there was a turnaround in this behaviour, with positive growth

once again in large-value loans and notable declines in the rest, a trend which became more accentuated in the opening months of 2009.

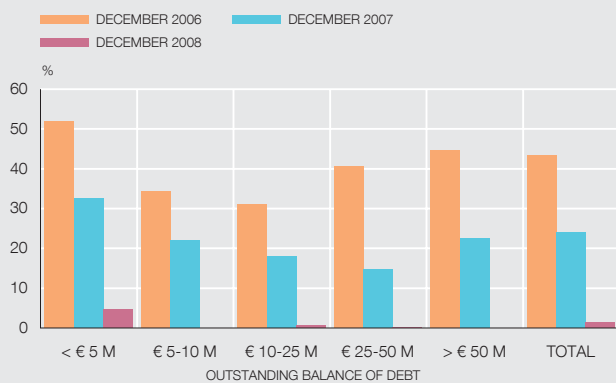
The divergences highlighted may be due to differences in the supply of or demand for funds by type of company. In this respect, the Bank Lending Survey (BLS), although it offers only qualitative information, may help draw a distinction between these two elements. To this end, Panels 4 and 5 offer two indicators which measure, respectively, changes in the supply of and demand for funds, both for small and medium-size enterprises and for large corporations. As can be seen, in the second half of 2007 (at the onset of the financial turmoil) the respondent institutions indicated a greater tightening of lending standards to large corporations during this period. Subsequently, however, no significant differences can be seen from one group to the other. In the case of the demand indicator, the related comparative trend shows less contractionary behaviour in SMEs' applications for funds from mid-2007, but especially in 2008, whereby this factor would appear unable to explain the different behaviour of credit observed recently.

Finally, the findings of a survey commissioned by the Banco de España and conducted between 18 March and 3 April 2009 using 1,385 Spanish companies of different sizes show that, in the six preceding months, the percentage of applicants who did not manage to obtain the funds requested fell in step with the size of the applicant (see Panel 6), indicating greater difficulty for SMEs to raise external funds. Nonetheless, this is probably a structural characteristic, derived from the greater risk entailed by lending to companies with a small volume of assets; accordingly, the absence of a point of comparison at some other moment in time restricts the scope of the possible conclusions. In any event, it can be inferred from the response to the question about the factors that explain why companies have not obtained all the funding they requested that a high proportion of the companies (around 60%) has detected a change in banks' lending policy stance.

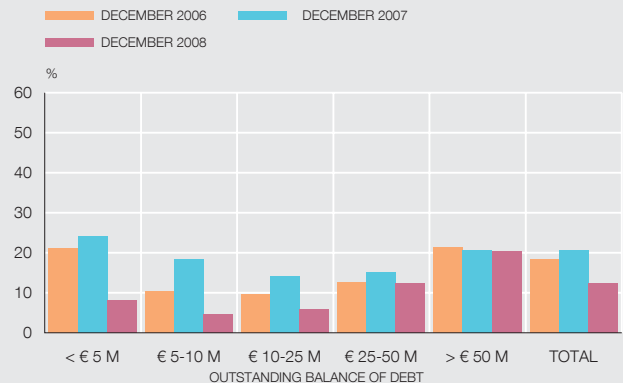
In sum, on the information available – and bearing in mind all the necessary reservations derived from its imperfect nature – it may be concluded that the slowdown in credit to companies seen since mid-2007 was initially and essentially due to the pattern of lending to large corporations. The reason for this would have been the lesser relative dynamism both of the demand for and the supply of funds. However, as the general downturn in the economy became increasingly patent, credit institutions appear to have begun to reduce more markedly new loans to SMEs. According to the BLS, as it seems that this cannot be explained by the behaviour of demand, it may possibly reflect, at least in part, some greater degree of tightness in the requirements made of smaller companies in respect of new loan approvals.

1. The rates of change are calculated controlling for the changes in category arising from the growth of debt.

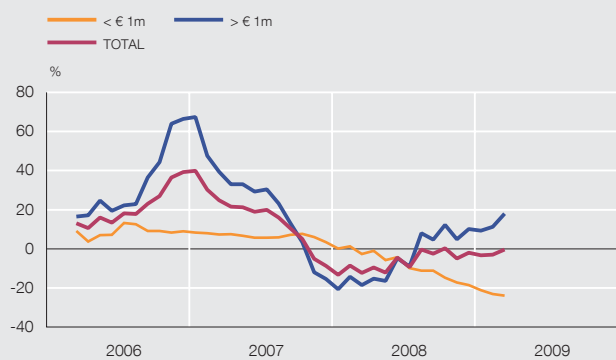
**1 CREDIT TO CONSTRUCTION AND REAL ESTATE DEVELOPMENT COMPANIES (a)**



**2 LENDING TO OTHER SECTORS (a)**



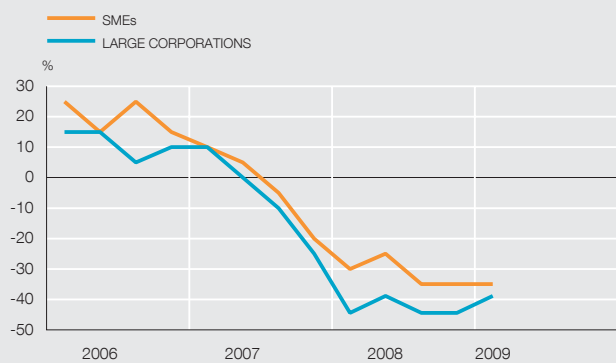
**3 VOLUME OF NEW BUSINESS. Credit to non-financial corporations (NFCs) (b)**



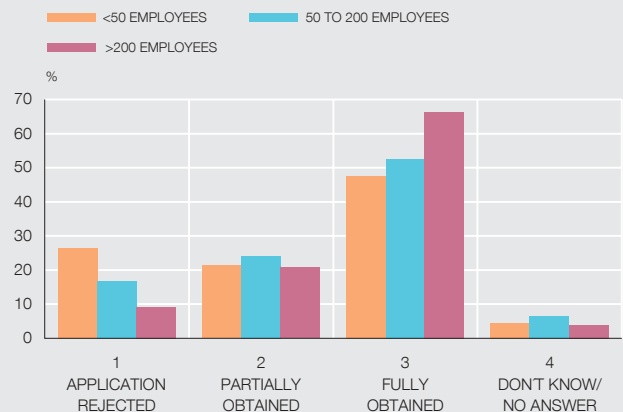
**4 BLS: TIGHTENING OF CREDIT STANDARDS Diffusion index (c)**



**5 BLS: CHANGE IN DEMAND Diffusion index (d)**



**6 RESULTS OF APPLICATIONS FOR FINANCING IN LAST SIX MONTHS (e)**

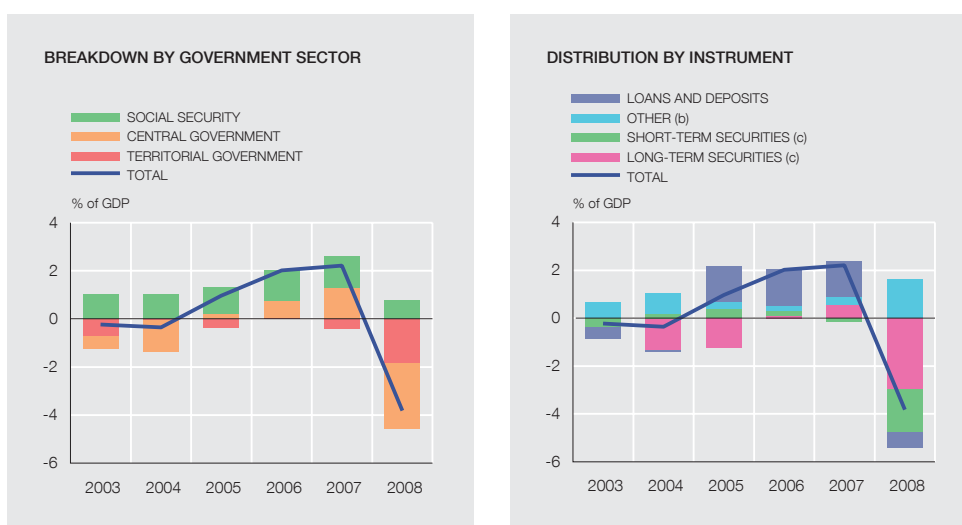


SOURCE: Banco de España.

- a. Year-on-year rate. Credit drawn down.
- b. Year-on-year rates. Three-month moving average.
- c. Percentage of institutions that tighten their new loan approval standards in respect of non-financial corporations less percentage of those that relax such standards, weighted by the intensity of the change in each case.
- d. Percentage of institutions recording increases in the demand by non-financial corporations for loans less percentage of those recording decreases in such demand, weighted by the intensity of the change in each case.
- e. Based on the results of a survey commissioned by the Banco de España and conducted between 18 March and 3 April.

**GENERAL GOVERNMENT NET FINANCIAL TRANSACTIONS (a)**  
**(Changes in and contributions of components)**

CHART 6.4



SOURCE: Banco de España.

- a. A positive (negative) sign denotes an increase (decrease) in assets or a decrease (increase) in liabilities.
- b. Includes unpaid accrued interest on bonds and net investment by the Social Security System in assets issued by other general government sectors.
- c. Includes only liabilities-side transactions.

instrument shows that the funds needed were covered by an increase in securities issuance (both in the short and, in particular, the medium- and long-term segments) and a decline in the outstanding balance of deposits net of lending. This substantial deterioration in the general government budget balance has arisen from the impact of the automatic stabilisers in a recessionary environment, from forgone revenue further to the real estate adjustment and from the discretionary measures adopted to boost the economy.

**2.4 INVESTMENT AND FOREIGN FINANCING OF THE SPANISH ECONOMY**

The Spanish economy's net borrowing was slightly lower than in 2007

The financial sector did not channel sufficient foreign saving to meet the economy's borrowing requirements...

The downturn in general government financial saving largely countered the reduction in the funds required by households and corporations, as a result of which the Spanish economy's net borrowing fell only slightly in relation to 2007, with the debit balance of its net financial transactions standing at 9.1% of GDP (see Table 6.1 and Chart 6.5).

Capital inflows mediated through financial institutions (excluding institutional investors and the Banco de España) fell substantially. Indeed, while credit institutions obtained funds equivalent to 3.3% of GDP (more than 1 pp up on 2007), other financial institutions (excluding institutional investors and the Banco de España), which had been the sector that had obtained most funds from the rest of the world since 2004, channelled net capital outflows valued at 1.8% of GDP (the previous year they raised resources equivalent to 5.8% of GDP). Institutional investors unwound lending positions vis-à-vis the rest of the world, contributing a volume of capital equivalent to 2.3% of GDP in net terms. Companies and general government channelled foreign resources for amounts equivalent to 0.5% and 1.4% of GDP, respectively. As a result of these developments, a portion of the funds needed to finance the current account deficit was covered, as was the case in the previous year, by the reduction in the external credit position of the Banco de España, which declined by 2.7% of GDP (see Chart 6.5).

**FINANCIAL TRANSACTIONS OF THE NATION**  
Cumulative four-quarter data

TABLE 6.1

% of GDP	2005	2006	2007	2008
NET FINANCIAL TRANSACTIONS	-6.5	-8.4	-9.7	-9.1
FINANCIAL TRANSACTIONS (ASSETS)	18.5	17.7	13.9	3.2
Gold and SDRs	0.0	0.0	0.0	0.0
Cash and deposits	2.2	5.2	2.1	-0.3
Of which:				
<i>Interbank (a)</i>	3.1	3.4	4.2	-0.5
Securities other than shares	8.7	-1.2	1.6	1.3
Of which:				
<i>Credit institutions</i>	6.6	-2.1	1.8	1.5
<i>Institutional investors</i>	2.3	0.6	-0.1	-0.4
Shares and other equity	5.1	10.5	8.6	1.9
Of which:				
<i>Non-financial corporations</i>	3.9	8.0	6.3	3.1
<i>Institutional investors</i>	0.9	1.2	-1.0	-1.5
Loans	1.1	2.1	1.2	0.8
FINANCIAL TRANSACTIONS (LIABILITIES)	25.0	26.1	23.6	12.2
Deposits	5.6	0.3	7.3	8.9
Of which:				
<i>Interbank (a)</i>	7.2	0.6	6.7	6.2
Securities other than shares	15.8	21.4	8.1	-2.2
Of which:				
<i>General government</i>	0.2	1.0	-1.3	1.4
<i>Credit institutions</i>	6.3	8.0	3.6	-1.9
<i>Other non-monetary financial institutions</i>	9.3	12.4	5.8	-1.7
Shares and other equity	0.9	0.2	4.5	3.4
Of which:				
<i>Non-financial corporations</i>	1.0	-0.2	4.7	2.5
Loans	2.3	3.5	3.1	2.1
Other, net (b)	-0.9	-0.5	0.1	0.5
MEMORANDUM ITEMS:				
Spanish direct investment abroad	3.7	8.5	9.6	4.8
Foreign direct investment in Spain	2.2	2.5	4.8	4.1

SOURCE: Banco de España.

a. These correspond to credit institutions only, and include repos.

b. Includes, along with other items, the asset-side caption showing insurance technical reserves and the net flow of trade credit.

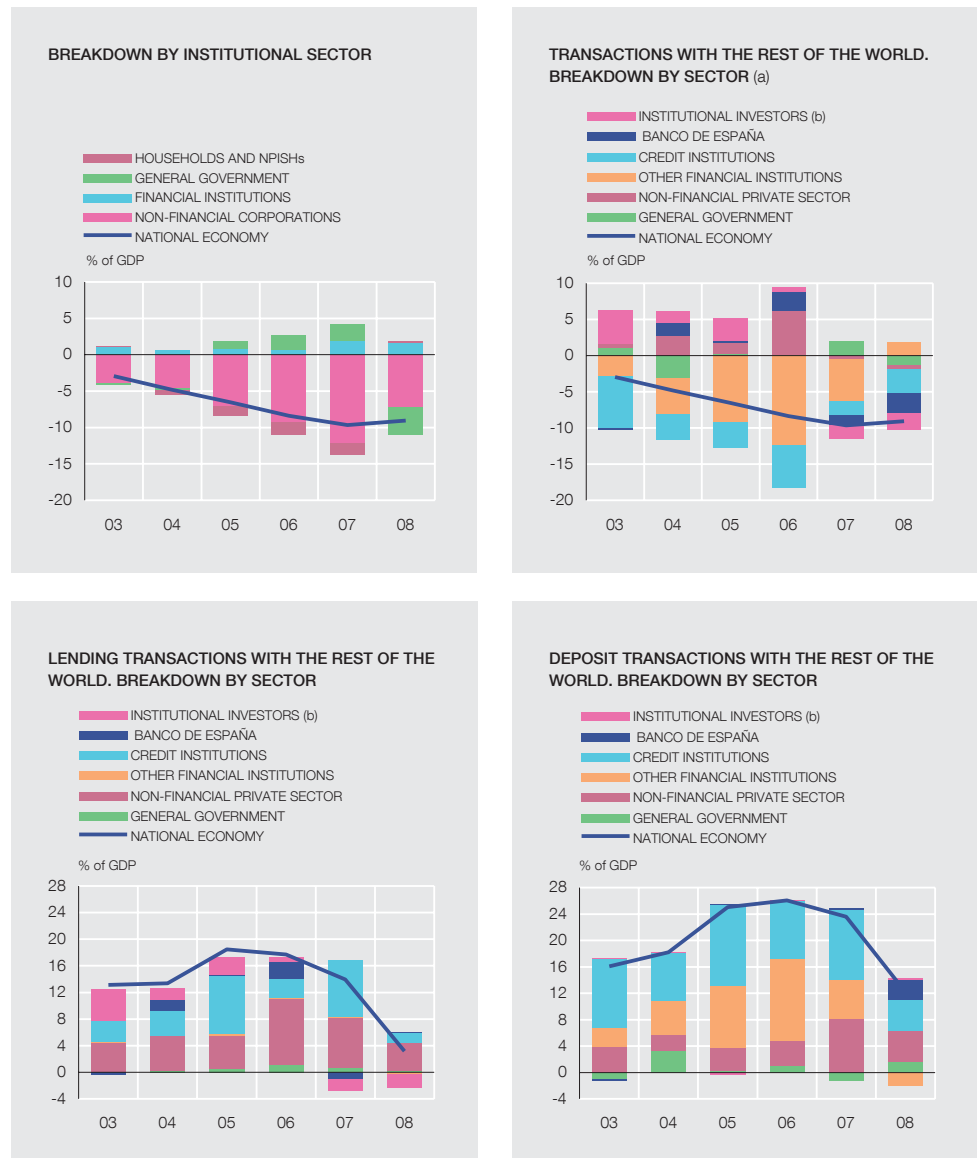
... since the net inflow of funds through fixed-income issues declined

The volume of capital inflows amounted to 12% of GDP, 11 pp down on 2007, evidencing notable changes in their composition. Against a background of significant difficulties in issuing fixed-income securities, the net inflow of funds channelled through securities other than shares issued by domestic financial institutions was negative for an amount close to 4% of GDP, compared with a positive net inflow totalling more than 9% of GDP the previous year (see Table 6.1). In this setting, credit institutions raised financing abroad essentially through the interbank market (including secured transactions), meaning that the funds obtained through this channel in net terms accounted for 6.7% of GDP, compared with 2.5% the previous year. Flows obtained through non-residents' acquisitions of shares and other equity also fell slightly, contributing an amount close to 4% of GDP, in step with the slight decline in foreign direct investment in Spain, which also stood at around 4% of GDP.

Capital outflows also fell by 10 pp to 3% of GDP. As in the previous year, institutional investors unwound positions in net terms in the rest of the world both in fixed income

**NET FINANCIAL TRANSACTIONS (a)**  
(Changes in and contributions of components)

CHART 6.5



SOURCE: Banco de España.

- a. A negative (positive) sign indicates that the rest of the world grants (receives) financing to (from) the counterpart sector.
- b. Insurance companies and collective investment institutions.

and equities. In terms of instruments, the contraction was across the board, but especially significant in the case of shares and other equity (purchases of which fell by 7 pp to 1.9% of GDP). In line with this development, Spanish foreign direct investment fell off to 4.8% of GDP, having accounted for more than 9.6% in 2007.

However, the debit balance of the international investment position scarcely changed

Despite the fact that net capital inflows were positive, the net debit position of the Spanish economy vis-à-vis the rest of the world showed no significant changes, holding at around 80% of GDP, thanks to the favourable effects exerted on it by the changes observed in the prices of financial instruments, which were only partly countered by the adverse impact associated with the changes in the exchange rate.

EUR bn	2005	2006	2007	2008
NET ISSUANCE BY RESIDENTS	184.4	231.6	268.3	148.2
FIXED INCOME	180.2	223.9	222.4	133.3
Monetary financial institutions	78.0	97.2	78.2	-27.3
Other financial intermediaries	95.6	128.5	146.5	107.2
Of which:				
<i>Financial vehicle corporations</i>	53.6	69.7	106.9	93.7
<i>Subsidiaries of monetary financial institutions</i>	27.4	39.4	42.6	24.3
<i>Subsidiaries of non-financial corporations</i>	-2.5	10.9	5.7	1.6
Non-financial corporations	-0.1	1.0	2.0	1.9
Central government	3.9	-4.8	-4.7	50.2
Territorial government	2.8	2.1	0.4	1.4
EQUITIES	4.2	7.8	46.0	14.9
Monetary financial institutions	1.3	3.0	12.0	10.1
Other financial intermediaries	0.0	0.1	3.5	1.4
Non-financial corporations	3.0	4.6	30.5	3.4
PUBLIC OFFERINGS	0.2	2.5	2.1	0.0
MEMORANDUM ITEMS				
Net issuance by foreign subsidiaries	-20.6	-8.5	9.5	12.9
<i>Financial institutions</i>	-15.5	-2.6	8.2	14.3
<i>Non-financial corporations</i>	-5.2	-6.0	1.3	-1.4

SOURCE: Banco de España.

### 3 Spanish financial markets

#### 3.1 PRIMARY MARKETS

##### Net securities issuance declined

In the primary markets for negotiable securities, the net issuance by resident sectors totalled €148 billion, a year-on-year decline of 45% (see Table 6.2) and the first decline in this variable since 2001. Among the reasons behind this strong fall were the relatively unfavourable market setting, given the increase in uncertainty and the rise in issuance costs caused by the climb in risk premia, and lower private-sector net borrowing, stemming from the cuts in expenditure plans.

The net issuance of fixed-income instruments fell by 40% on 2007 to €133 billion. This decline was greater than that in the euro area, meaning that net placements in Spain accounted for 12% of the volume issued in the area as a whole, compared with 22% the previous year.

As can be seen in Table 6.2, issues by financial institutions declined over the year as a whole by more than 64%, against a background of tightening financing conditions on wholesale markets, which was reflected – among other factors – in the considerable increase in credit risk premia. In particular, placements made directly by credit institutions resulted, for the first time since 2000, in net redemptions of €27 billion; conversely, those by other financial intermediaries remained buoyant (€107 billion), though down on previous years. In terms of instruments, asset-backed bonds, as has been habitual in the past four years, accounted for more than 85% of supply, while the weight of uncovered bonds and preference shares fell. However, it should be stressed that the bulk of securitisations was purchased by the originators themselves, so that they might have at hand collateral with which to obtain financing in the Eurosystem. For the second year running, there was a notable increase in transactions conducted by the foreign subsidiaries of financial institutions (€14 billion).

The net issue of fixed-income securities by non-financial corporations, either directly or through subsidiaries, marginally exceeded the figure of €2 billion in 2008, compared with €9 billion a

EUR bn	2005	2006	2007	2008
Public-debt book-entry market (a)	22,220	22,615	22,664	19,944
Spot	2,338	2,903	3,177	2,202
Repos and sell/buy-back agreements	19,572	19,385	19,193	17,477
Forward	310	327	294	265
AIAF fixed-income market	872	900	1,108	2,401
Commercial paper	404	482	555	577
Covered bonds and asset-backed securities	375	329	460	1,740
Other	93	90	93	83
Stock exchange: fixed-income	93	93	90	80
Stock exchange: equities	854	1,156	1,670	1,245
MEFF derivatives markets	584	934	1,451	1,073
Ibex 35	544	883	1,384	989
Stock options	17	23	27	23
Stock futures	23	28	41	61

SOURCES: BME, Federation of European Stock Exchanges and Banco de España.

a. Only includes transactions in State securities.

year earlier. This development primarily reflects the decline in the supply of securities, through both resident and non-resident subsidiaries.

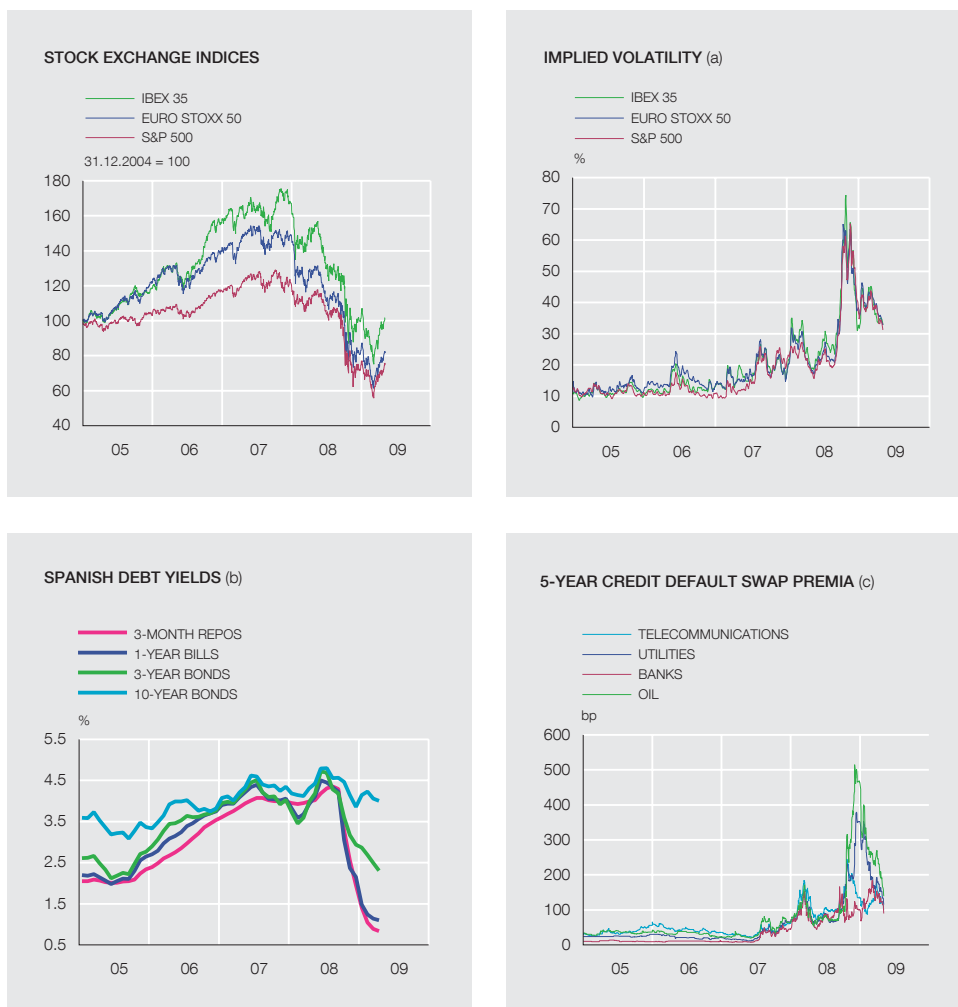
Unlike in recent years, the net supply of securities placed in circulation by general government increased substantially, in line with the rise in the sector's net borrowing. The resulting amount was €52 billion, more than one-third of total net fixed-income placements for 2008. This may be attributed virtually in its entirety to the State, since funds raised by territorial government scarcely exceeded €1 billion. In terms of instruments, there was a significant issuance volume of both medium- and long-term bonds (€32 billion) and of Treasury bills (€19 billion), and there were two changes introduced into Treasury policy: currency-denominated issues, which had not been used since 2005, and six-month bill tenders.

Equity issues amounted to close to €15 billion, marking a considerable decline (68%) on the preceding year. Across the different sectors, and unlike in the past, there was a rise in capital increases by financial institutions, which amounted in net terms to €11 billion. This figure was somewhat lower than in 2007. Meanwhile, capital increases at non-financial corporations fell considerably (89%), although it should be borne in mind that the 2007 figure was influenced by a small number of large-volume one-off operations. In line with this contractionary behaviour, there were no initial public offerings during 2008. Mention should be made of the issuance of equity units by a savings bank, the first operation of this type to be undertaken.

### 3.2 SECONDARY MARKET ACTIVITY

In nominal terms, secondary market activity evidenced great variability across its different segments

Secondary market activity proved very uneven across the different segments (see Table 6.3). Stock exchange share trading totalled €1.2 trillion, a year-on-year fall of over 25%. However, this is essentially due to the decline in share prices, since activity, measured by the number of securities traded or by the number of transactions made, increased by around 8% on 2007. In line with this development, derivatives trading posted a similar decline to the spot market (26%), chiefly as a result of the fall in the evaluation of underlyings. Operations for the year in this segment were, once again, concentrated in IBEX 35-indexed contracts.



SOURCES: Sociedad de Bolsas, Bloomberg, Credit Trade, Datastream and Banco de España.

- a. Five-day moving average.
- b. Monthly averages.
- c. Asset-weighted average premia.

In the public debt market there was a year-on-year decline in turnover of 12%, the outcome of the marked decline (of over 30%) in spot transactions and of the more moderate fall-off in both repo and sell and buy-back transactions, which continue to account for most activity, and in forward transactions.

Conversely, turnover on the AIAF market exceeded €2.4 trillion, entailing year-on-year growth of over 115%, with substantial increases in almost all instruments, especially in uncovered bonds and asset-backed bonds. In terms of transactions, the bulk of the increase in activity was centred on sell and buy-back transactions, including most notably those for which the counterparties were the Treasury (in the context of the management of its liquidity surpluses) and the Banco de España (within the framework of the financing granted by the Eurosystem to credit institutions).

3.3 SECONDARY MARKET PRICES

Share prices fell sharply, and there was a marked increase in volatility

After five years of price rises, there was a sharp fall in share prices accompanied by a marked rise in their implied volatility (see Chart 6.6). Over the year as a whole, the IBEX 35 posted a decline of 39.4%, lower than that of the Eurostoxx 50 of the euro area stock exchanges (44.2%) and similar to that of the US S&P 500 (38.5%). The year was marked by a downtrend

in values, which became sharper in specific episodes. This reflected both investors' greater preference for low-risk assets and the deterioration in listed firms' earnings-growth outlook. Volatility stood at very high levels in late September, following the bankruptcy of Lehman Brothers. This subsequently fell, although it stood at levels higher than the historical average, which highlights the notable uncertainty over the future course of traded prices on the market.

The decline in prices was across the board, albeit with differing intensity. The biggest falls were in the sub-indices of basic materials, industry and construction (51%) and financial services and real estate (49%). The sectors showing the least adverse performance were those of consumer goods (down 26%) and technology and telecommunications (down 29%).

The downtrend on stock exchange indices continued in the opening months of 2009, though a pick-up in prices was seen from mid-March. In early May, therefore, the IBEX 35 stood at a level similar to that at end-2008.

Government debt yields rose to July, falling progressively thereafter to the end of the year...

After rising moderately to July, short-term government debt yields subsequently fell notably, in step with the pronounced cuts in intervention rates. Long-term rates showed a similar profile, rising in the first half of the year and moving on a declining trend from August as a result of investors' greater preference for safe, liquid securities and of the downward revisions in euro area growth and inflation forecasts. Accordingly, the interest rate on ten-year government bonds started at 4.4% in December 2007, peaked at 4.9% in July and thereafter moved on a declining path to end the year at 3.8%. In the second half of the year, yields on German debt declined to a greater extent than those on other euro area sovereign bonds, which meant that the spreads over the German bond increased notably, to 80 bp at the close of the year in the case of the corresponding Spanish bond and to over 120 bp as at mid-February 2009. Nonetheless, spreads subsequently narrowed, to stand at around 70 bp in early May. As detailed in Box 6.2, the widening of sovereign spreads in the euro area is due to the increase in the price of risk, owing to factors linked to liquidity and, in certain cases, to the increase in credit risk. Against this background, Standard & Poor's downgraded the long-term debt issued by Spain, Greece and Portugal in January 2009, and that of Ireland in March.

...while credit risk premia rose strongly throughout the year

Lastly, financial and non-financial corporations' CDS premia increased very sharply as a result of the prevailing greater uncertainty and the deterioration in the macroeconomic outlook. This rise was particularly notable from the end of the summer when, further to the above-mentioned events, intense risk re-pricing took place, taking CDS premia to all-time highs (see Chart 6.6). In line with other developed countries, financial corporations' risk premia have, following the announcement and subsequently approval of the bank system support programmes, held at substantially lower levels than those of non-financial corporations, suggesting that the market's interpretation is that governments have assumed a sizeable portion of the credit risk of the main banks.

Coupled with the course of long-term interest rates, this led to a rise in the cost of financing for firms issuing in the fixed-income markets. However, in 2009 to date CDS premia have fallen, especially those of non-financial companies, although they remain at high levels.

## **4 Spanish financial intermediaries**

### **4.1 CREDIT INSTITUTIONS**

Credit institutions' activity slowed notably

During 2008 the activity of credit institutions slowed notably in response to the diminished dynamism of credit granted to the resident non-financial private sector. By contrast, the rate of change of loans to general government rose significantly, as did the portfolio of fixed-income assets held by institutions. Overall, total assets increased by 6% at the consolidated level, and by 9% at the individual level (see Table 6.4), figures clearly below those in recent years, but still outpacing the growth of nominal GDP.

The yield spread of euro area countries' sovereign debt over German bonds, which traditionally have a lower cost, had moved in recent years in very limited ranges. During the summer of 2007, following the onset of the financial turmoil, the spreads began to widen, albeit very moderately. However, following the worsening of the international financial crisis in mid-September 2008, they increased most markedly (see Panels 1 and 2). In Spain, the spread between the yield on 10-year government bonds and that on the benchmark 10-year German bund widened to a level of around 120 bp, when at the close of 2007 it was scarcely 8 bp. In the other euro area members the trend was the same, although the scale of the change varied from one nation to another (in Ireland and Greece the spread was 260 bp, while in France it was around 60 bp), with the increase in the case of the securities issued by the Spanish Treasury standing at an intermediate position. In the subsequent months there was a widespread decline in these spreads. In early May the Spanish sovereign spread stood at around 70 bp. This box focuses on the analysis of the factors behind the widening of the spreads between December 2007 and February 2009.

In a setting such as the euro area, in which all issues are denominated in the same currency, the explanation for the yield spreads on sovereign debt lies in the compensation the markets demand for the different levels of perceived credit risk and for the differences in the degree of liquidity of the securities.

Credit risk premia can be proxied using the price of CDSs on sovereign debt, which are instruments where one party (that buying protection) receives compensation from the counterparty in the event of default, late payment or other credit events attributable to the issuer of this debt, in exchange for payment of a regular income. In this respect, Panel 3 shows a high positive correlation between the changes in yield spreads and in CDS premia between December 2007 and February 2009, suggesting that the changes in the level of credit risk and in the pricing thereof played a significant role in the setting of prices on bonds issued by the euro area member states during this period. Nonetheless, the points in the panel generally stand above the 45° line, denoting that liquidity-related factors may also have contributed to these developments. In particular, greater activity on the secondary markets for securities issued by the German government may have benefited their relative valuation, in a setting in which investors' preference for more liquid assets had increased.

There are various factors that can explain the increase in credit risk perceived by the markets during the period under analysis. Firstly, the far-reaching deterioration in the growth outlook for the euro area economies in late 2008 tended to reduce these States' tax-raising capacity, while current expenditure increased. Thus, GDP growth for 2009 and 2010 in most euro area members was projected by the European Commission to fall by between 2 pp and 3 pp in cumulative terms in the period from the autumn 2008 forecasting exercise to the January 2009 interim exercise. In two countries the decline was clearly greater than for the rest: Greece (-4.2) and Ireland (-6.5), which are precisely those countries

where sovereign debt spreads most widened between December 2007 and February 2009. In addition, the fiscal measures that the various countries had started to adopt entailed a further increase in public spending and, by extension, a bigger increase in public debt.

Against this background, in January 2009 Standard & Poor's downgraded the debt rating of Greece (on 14 January, from A to A-), Spain (on 19 January, from AAA to AA+) and Portugal (on 21 January, from AA- to A+). In addition, Ireland was placed on the credit watch list and subsequently also saw its debt downgraded from AAA to AA+ on 31 March.

In order to study in greater depth the link between the valuation of sovereign benchmarks and credit risk, Panel 4 relates yield spreads, in December 2007 (in red) and February 2009 (in blue), to the deviation of the debt/GDP ratio vis-à-vis Germany forecast by the European Commission around the same dates for 2009 and 2010, respectively.<sup>1</sup> Generally, the changes in the projections of the debt/GDP ratio were seen to be small (compared with the changes in Germany), except in the case of Ireland, which underwent a very marked rise that may help us understand the greater widening of this country's spread at that time. In Spain the ratio also rose more, a development which may have likewise affected the relative valuation of the securities issued in our country during the period under study.

Panel 4 also shows how, as was to be expected, there is a positive relationship between risk levels (proxied by the debt/GDP ratio) and debt yield (in relative terms vis-à-vis Germany). It can further be seen that the slope of the fitted line increased between the two dates examined, suggesting that the widening of the yield spread between December 2007 and February 2009 may have been partly due to an increase in the price of risk or, what amounts to the same, to agents' greater preference for safer assets.

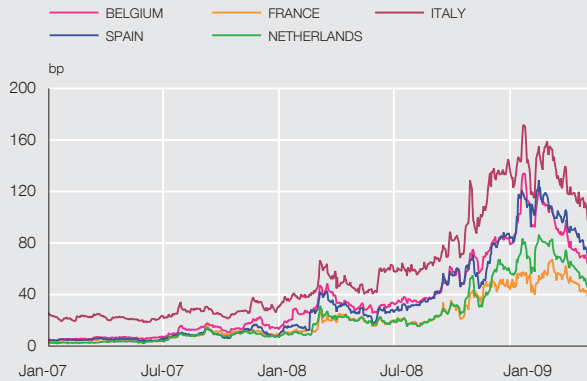
The same panel also shows that in February 2009 the yield spreads of some countries deviated significantly from the fitted line. It should be borne in mind that the debt/GDP ratio approximates only partially the credit risk perceived by the market in some cases. In particular, it does not reflect the member states' exposure to the financial sector, which increased notably following the activation of bank bailouts. In this respect, Panel 5 shows how, following the approval of the first plans, the average risk premium on European sovereign debt in the CDS markets increased significantly in October 2008, drawing close to the level of the iTraxx financial index (which tracks the prices of the main European financial corporations' derivatives). However, the premium fell from March, separating from this index. The changes in this indicator in the second half of 2008 and in the first two months of 2009 suggest that the markets considered that governments were taking on a sizable portion of the credit risk of the main banks. Thus, for instance, the Irish government temporar-

1. The respective European Commission forecasting exercises conducted in spring 2008 and January 2009 have been used.

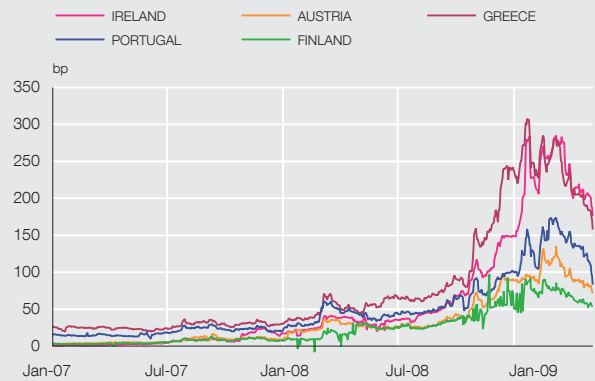
ily guaranteed all the liabilities of the six biggest banks (and subsequently nationalised one of them and recapitalised the rest with public funds). And this, combined with the fact that the weight of the Irish financial sector, in terms of GDP, is higher than in the other

euro area members (see Panel 6)), might explain why the yield spread on Irish sovereign debt stood in February 2009 far above what its level of debt then forecast for 2010 would indicate (see Panel 4).

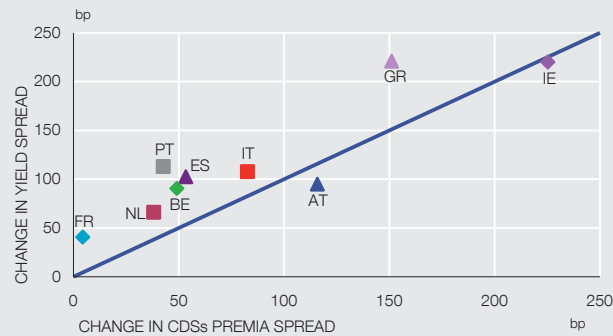
1 10-YEAR SOVEREIGN BOND YIELD SPREAD VIS-À-VIS GERMANY



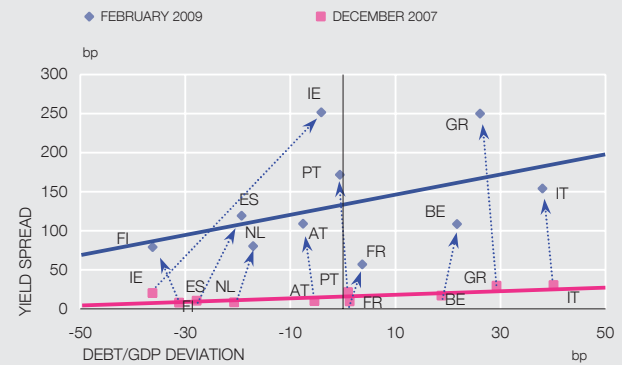
2 10-YEAR SOVEREIGN BOND YIELD SPREAD VIS-À-VIS GERMANY



3 CHANGES IN SOVEREIGN DEBT YIELD SPREADS AND CDS PREMIA BETWEEN DECEMBER 2007 AND FEBRUARY 2009



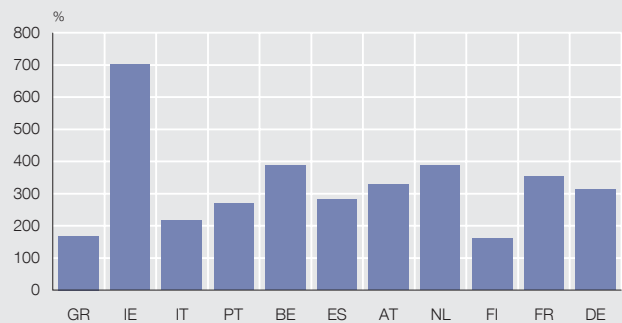
4 SOVEREIGN DEBT YIELD SPREAD AND PUBLIC DEBT/GDP DEVIATION (a)



5 5-YEAR CDS PREMIA



6 CREDIT INSTITUTIONS' ASSETS AS A % OF GDP, 2007



SOURCES: Datastream, European Commission and Banco de España.

a. The data on the debt/GDP ratio deviation for December 2007 and February 2009 are, respectively, the differences in this ratio vis-à-vis Germany, according to the European Commission's spring 2008 and January 2009 forecasting exercises.  
 b. Average of CDS premia on the sovereign debt of countries forming part of the iTraxx financial index with the same weights, except Switzerland.

**CREDIT INSTITUTIONS  
BALANCE SHEET AND INCOME STATEMENT**

TABLE 6.4

	CONSOLIDATED			INDIVIDUAL		
	DEC 2007	DEC 2008	Y-O-Y RATE (%)	DEC 2007	DEC 2008	Y-O-Y RATE (%)
<b>MAIN BALANCE SHEET ITEMS (% of TA)</b>						
Total assets (EUR bn)	3,389.6	3,603.9	6.3	2,892.9	3,142.4	8.6
Credit	67.3	66.8	5.6	64.3	63.2	6.8
<i>Of which: resident private sector in Spain</i>				59.5	57.8	5.6
Debt securities	10.5	10.8	9.0	9.2	10.3	21.1
Other capital instruments and equity interests	4.7	3.0	-33.4	6.3	5.4	-6.9
Other assets	17.4	19.4	18.5	20.2	21.1	13.7
<b>Liabilities</b>						
Banco de España and other central banks	2.8	3.6	39.4	2.9	3.7	41.6
Interbank deposits	14.9	13.1	-6.4	17.7	17.3	6.1
Customer deposits	47.1	48.9	10.4	50.7	51.1	9.4
<i>Of which: households and non-fin.corps. res. in Spain</i>				28.1	28.6	10.5
Marketable securities	19.6	17.9	-3.2	13.2	11.8	-3.1
Other liabilities	12.1	14.5	27.2	12.4	14.1	24.2
Equity	6.3	5.6	-5.0	6.0	5.7	3.2
<b>INCOME STATEMENT (% of ATA)</b>						
(+) Interest income	4.93	5.59	21.33	4.44	4.91	24.42
(-) Interest expenses	3.28	3.84	25.38	3.16	3.67	30.21
Net interest income	1.65	1.75	13.31	1.27	1.25	10.03
(+) Equity yield	0.09	0.09	14.06	0.42	0.40	6.93
(+) Net commissions	0.73	0.67	-1.00	0.53	0.46	-2.75
(+) Profits on financial operations and investees	0.52	0.38	-22.10	0.29	0.19	-23.95
(+) Other operating expenses (net)	0.02	0.02	2.01	0.03	0.03	-0.59
Gross margin	3.01	2.92	3.67	2.54	2.32	2.90
(-) Operating expenses	1.34	1.33	6.47	1.11	1.04	5.39
(-) Write-downs and provisions of financial assets	0.52	0.87	78.38	0.42	0.70	87.53
Operating profit	1.15	0.72	-33.28	1.01	0.59	-34.66
(+) Other income (net)	0.15	0.17	21.60	0.12	0.11	4.89
(-) Taxes	0.26	0.14	-42.20	0.17	0.07	-51.97
After-tax profit	1.04	0.75	-23.24	0.97	0.63	-26.87
Group net profit	1.00	0.70	-24.74			
<b>RATIOS (%)</b>						
Net interbank position/TA (a)	-7.6	-8.4		-6.8	-8.7	
Solvency	10.7	11.3				
Doubtful assets/TA	0.7	2.1		0.6	2.1	
Coverage of doubtful assets	182.8	70.8		209.3	69.5	
Foreign operations/TA	20.8	22.5				
Efficiency (OE/GI)	44.5	45.7		43.6	44.6	
ROE	19.7	12.7		17.7	11.2	

SOURCE: Banco de España

a. Includes net assets with central banks.

Funding difficulties on the markets persisted, offset in part by alternative sources and by the public-sector support measures

Credit institutions did have some success in raising deposits from customers, helped by the attractive remuneration thereon and by savers' search for safer investments. But funding difficulties on the wholesale markets obliged institutions to resort to the interbank market and to the loans granted by the Eurosystem, for an overall amount around 20% higher than that of the previous year. As a result, the net debit position obtained through this channel increased to 8.4% of total assets (from 7.6% at end-2007) and, within this position, the net loan from the Eurosystem accounted on average in December 2008 for 1.8% of total assets, compared with 1.3% twelve months earlier.

In 2009 to date, the reductions in interbank interest rates and the guarantees granted by the government should have provided for some recovery in institutions' funding on the markets, while asset purchases by the Fund for the Acquisition of Financial Assets (FAFA) are also expected to have increased the resources available. Specifically, at the time of this Report going to press, the FAFA had already held four tenders, placing a volume of funds close to €20 billion, while 24 credit institutions had made State-backed issues for a total of €27.4 billion.

The increase in doubtful assets...

Doubtful assets increased significantly and, as a percentage of total credit to other non-resident sectors, rose from 0.9% in December 2007 to 3.4% at the close of last year, with a notable increase being recorded in the dispersion across institutions. The increase was particularly sharp in transactions with construction and real estate companies (see right-hand panel of Chart 6.1). Consequently, the coverage ratio (provisions divided by doubtful assets) fell from 183% to 71%. The cuts in intervention interest rates during the second half of 2008 and early 2009 should contribute to lessening the pace of losses due to asset impairment. However, this effect will no doubt be countered by the adverse impact stemming from the increase in unemployment and by the reduction in the general provisions built up in previous years.

... led to a fall in profits...

As a result of the competition in raising time deposits and of the reduction in sight deposits, the average cost of institutions' liabilities over the course of the year increased to a greater extent than market interest rates (50 bp at the individual level and 57 bp at consolidated level, compared with a 36 bp rise in the three-month interbank interest rate). Nonetheless, the likewise bigger increase in the return on assets meant that net interest income as a proportion of total assets rose by around 10 bp in consolidated statements, and fell by only 2 bp in individual statements (see Table 6.4). This relatively positive result for net interest income was largely countered by the increase in write-downs and provisions, linked to the rise in doubtful assets, and to a lesser extent by the reduction in commissions received for securities services and for the marketing of investment funds, and by the decline in profits on financial transactions, so that institutions' consolidated net profit contracted by 25% on the previous year. Even so, the return on capital held at over 10%.

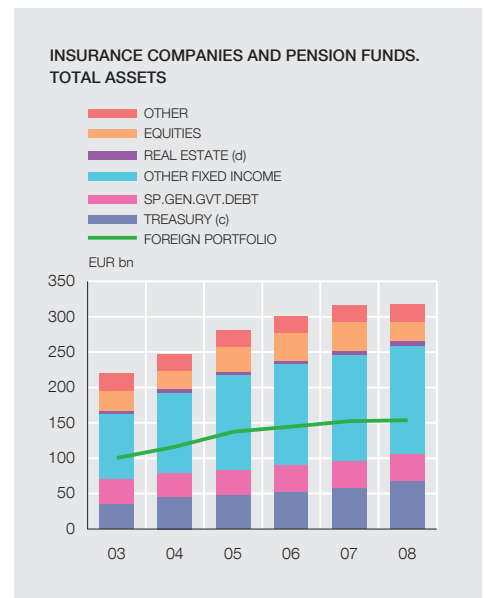
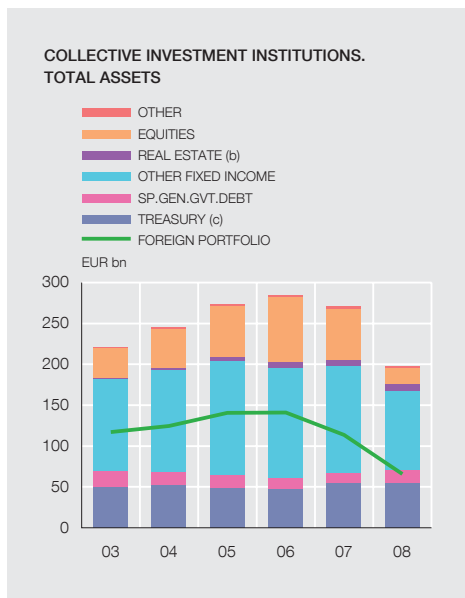
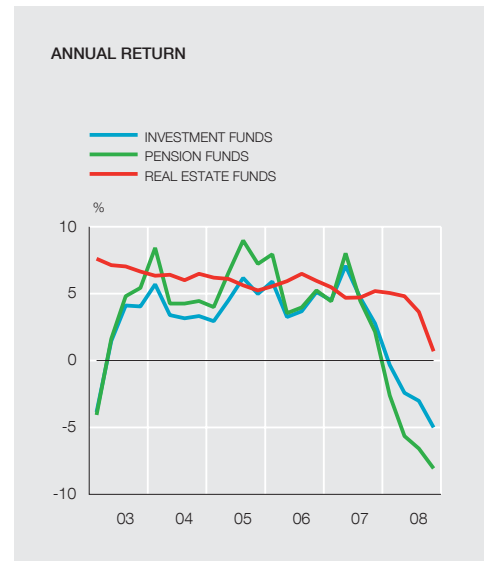
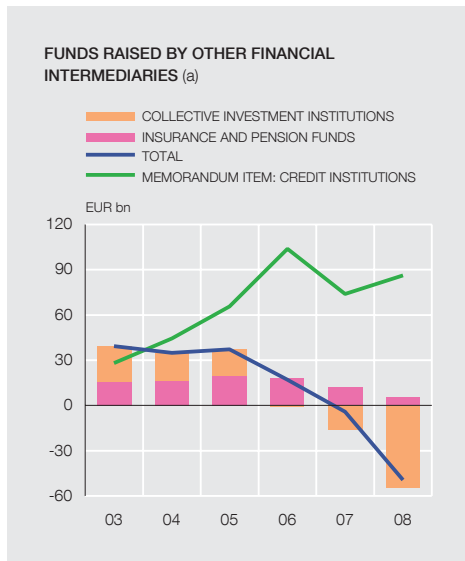
...and the leeway available to absorb further asset impairment has lessened

With the decline in profits and the reduction in the doubtful assets coverage ratio, the leeway available for Spanish credit institutions to absorb further asset impairments has lessened. However, the solvency ratio increased during 2008 to 11.3%, due partly to the introduction of the new capital regulations (stemming from Basel II), but also to more profits being retained, to the lower growth of risk-weighted assets and to the issue of capital for a value close to €10 billion. Compared with other financial systems, the position of Spanish institutions taken as a whole is sounder, though they are not immune either to developments on international markets in general, or to the weakness of the Spanish economy in particular. In this respect, on 28 March the Banco de España assumed control of Caja Castilla-La Mancha (CCM), a small institution, whose assets account for less than 1% of the system's total.

#### 4.2 INSTITUTIONAL INVESTORS

Withdrawal of funds from collective investment companies...

In the collective investment industry, the decline in assets under management seen already the previous year steepened, chiefly as a result of high net redemptions in investment funds (IFs) (see Chart 6.7). Net redemptions were positive in all four quarters of 2008, and were extensive to all types of funds, including money market funds. Although the uncertainty over price developments in securities markets and the capital losses recorded no doubt had an impact on the withdrawal of funds by investors, the widespread nature of such withdrawals suggests that they were also influenced by the competition generated by the campaigns to capture bank deposits with very attractive yields, in a setting in which the coverage guaranteed by the Deposit Guarantee Fund was raised to €100,000 per depositor/investor and institution.



SOURCES: CNMV, Banco de España, Committee of European Insurance and Occupational Pensions Supervisors, Investigación Cooperativa entre Entidades Aseguradoras, Asociación Española de Capital-Riesgo and the Spanish Directorate General of Insurance and Pension Funds.

- a. Shares and other equity in CII and reserves of insurance companies and pension funds. In the case of credit institutions, deposits and repos of households and non-financial corporations.
- b. Properties: latest available data, 2008, Q3.
- c. Includes cash, deposits and repos.
- d. Properties: latest available data, 2008, Q2.

... and diminished activity too at insurance and venture capital companies

Insurance companies and pension funds (PFs) obtained positive but scant net resources. In the life-assurance branch, although premia grew by around 15%, claims (redemptions, mobilisation, maturities and claims payments or agreed income) outpaced them, meaning that the net funds received scarcely increased.

In the venture capital segment, resources raised fell to half the figure obtained the previous year (€2,560 million against €5,131 million) and disinvestment fell by even more, owing to selling difficulties on financial markets. These developments, along with the problems in obtaining borrowed funds (which are greatly used in large-volume transactions), meant that the invest-

ment of these institutions was limited to less than €3 billion (32% down on 2007), with a particularly sharp decline in large-value and leveraged operations.

Yields declined and difficulties arose in certain products whose relative weight is scant

The contraction in new funds raised was accompanied by significant declines in the value of portfolios. Money market funds showed an annual yield of 2.4%, but in other IFs and in PFs the change in value was on the negative side (-5% and -8%, respectively). Further, hedge funds posted significant capital losses (of around 10%) and real estate CIIIs, although they achieved marginally positive profits at the close of 2008 (+0.7%), saw their asset valuations significantly revised in the opening months of 2009, resulting in negative year-on-year yields from January this year. Insurance companies also saw their results diminish in relation to the previous year (-10%), although their profitability and solvency ratios remained high.

In some CIIIs, investor applications to withdraw funds meant that extraordinary measures had to be taken, such as the temporary suspension of redemptions and the winding up of the institutions. However, these situations affected only a small number of institutions (real estate funds and hedge funds) whose assets were relatively negligible in relation to the sectoral total.

Aggregate losses at Spanish CIIIs were moderate, owing to their relatively conservative profile (see Chart 6.7). This conservative approach became more accentuated during 2008, with declines in the relative weight of equities and of foreign assets in Spanish CIIIs' portfolios. Conversely, treasury positions and holdings of Spanish government debt increased.

## **5. The financial position of the non-financial private sector**

### 5.1 HOUSEHOLDS

As indicated, the slowdown in household debt initiated in 2006 intensified in 2008. As a result, its rate of increase stood somewhat below the related rate for household income, meaning that for the first time since the mid-90s, household indebtedness declined slightly, accounting for somewhat less than 130% of household gross disposable income (GDI) (see Chart 6.8).

Household indebtedness fell, although the related interest burden increased

Despite the reduction observed in the household debt ratio, the interest burden on the sector increased to 18% of its GDI, 0.6 pp above the 2007 figure, owing to the increase in interest payments as a result of the higher average cost of liabilities. This did not prevent household saving capacity, once financial expenses were stripped out, from increasing by almost 3 pp, essentially as a result of the notable recovery in gross saving.

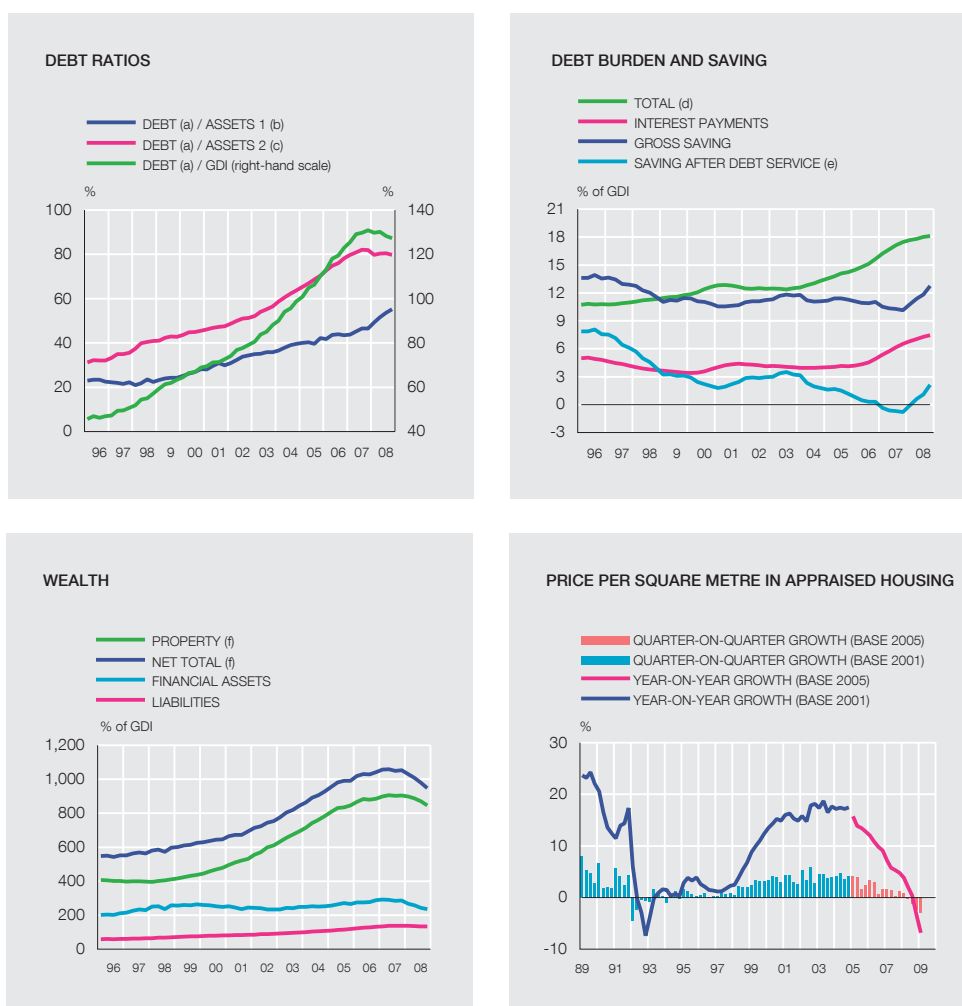
Household wealth fell, and in its financial component there was switching towards lower-risk assets

On the estimates available of household net wealth, this variable fell to 950% of the sector's income, around 100 pp below the 2007 figure. This is due to the reduction seen in the real estate and financial components, as a result of the fall in house and stock market prices. According to Spanish Housing Ministry statistics, the year-on-year growth of property stood at -3.2% in December 2008, compared with 4.8% in the same period of 2007. Nonetheless, as explained in Chapters 1 and 2 of this Report, the decline in the unit value of the stock of housing last year was probably greater and might – taking as a reference the INE date or for second-hand houses – stand at around 10%.

As a result of the fall in asset prices and of the switching towards time deposits, the weight of liquid and lower-risk assets increased in the financial component of the household portfolio.

Financial pressure increased in some segments of the sector

The sizable level of indebtedness attained, along with the fall in employment and the decline in the average cost of outstanding debt, has translated into an increase in the degree of financial pressure on households, especially the most indebted ones. The reflection of this has been a rise in the proportion of indebted households whose loans have now been considered as doubtful by banks (from 3.8% in December 2007 to 6.9% one year later), and an increase in



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

- Includes bank credit and off-balance sheet securitised credit.
- Assets 1 = Total financial assets less "other".
- Assets 2 = Assets 1 less shares less shares in MMFs.
- Estimated interest payments plus debt repayments.
- Gross saving less estimated debt repayments.
- 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.

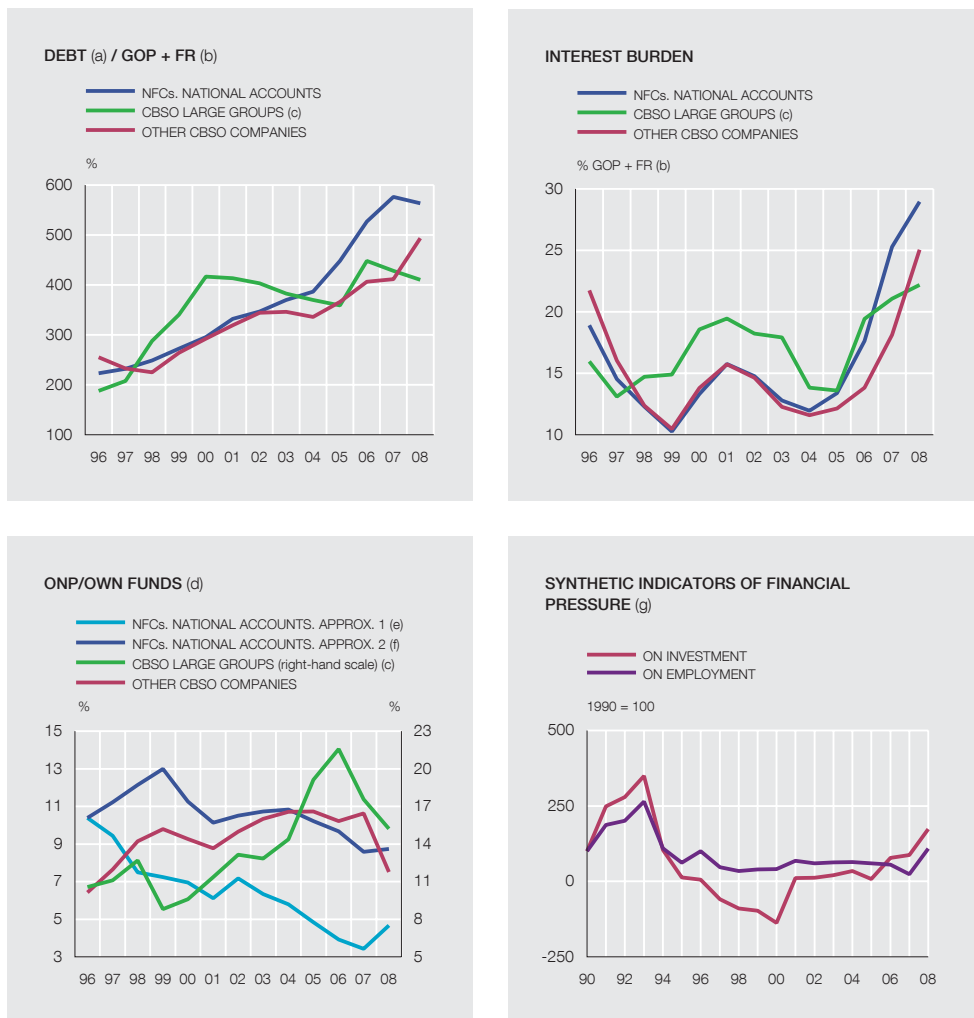
the sector's bad debt ratio, which was more marked for loans for consumption and other purposes than for loans for house purchase (rising to 5.2% in December 2008 for the former, 2.6 pp up on 2007, while the latter increased by almost 1.7 pp to 2.4%) (see Chart 6.1).

## 5.2 NON-FINANCIAL CORPORATIONS

The debt ratio of companies fell slightly, while the interest burden increased

According to the financial accounts of the Spanish economy, the weight of own funds in companies' liabilities fell by almost 8 pp in 2008 to 43%, a development linked essentially to the decline in stock market prices. Conversely, the proportion accounted for by loans granted by resident institutions increased by almost 4pp to over 25%, while that of foreign loans, a funding vehicle normally used by larger corporations, rose by somewhat over 1 pp. There was a slight increase in the relative weight of inter-company loans to 4% of the sector's total balance sheet, thus curtailing the declining trend of the previous years.

External funds raised by non-financial corporations grew at a somewhat lower rate than their income, meaning that the sector's debt ratio in relation to its income fell slightly (see Chart 6.9).



SOURCES: INE and Banco de España.

- a. Interest-bearing borrowed funds.
- b. Gross operating profit plus financial revenue.
- c. Aggregate of all the firms reporting to the CBSO belonging to the groups Endesa, Iberdrola, Repsol and Telefónica. Adjusted for intra-group financing to avoid double counting.
- d. Ordinary net profit (ONP), using National Accounts data = gross operating surplus + interest and dividends received - interest paid - fixed capital consumption.
- e. Own funds valued at market prices.
- f. Own funds calculated on the basis of the 1996 figure and cumulative flows since.
- g. Indicators estimated on the basis of CBSO annual and quarterly survey data. A value of more (less) than 100 indicates higher (lower) financial pressure than in the base year.

Nonetheless, the increase in the average cost of outstanding debt led to a further rise in the debt burden ratio to close to 30%, 3.7 pp above the 2007 figure. The return on capital (measured as the ratio of net ordinary profits to own funds) showed scant changes, since the income estimated by National Accounts continued to evidence notable dynamism, despite the recessionary setting.

Conversely, the gross operating profits of the firms reporting to the Banco de España Central Balance Sheet Data Office's quarterly survey (CBQ) – which, though it refers only to a sample of companies, bases its calculations directly on the companies' income statements – fell by almost 6% in 2008 on a year earlier. Analysis of the activities best represented in the CBQ, which does not include the construction and real estate development sectors, highlights that

the decline was particularly marked in the industrial branch (-24%). As a result, the ordinary return on own funds declined, while the percentage of companies for which this ratio was in negative territory increased. In line with the economic outlook for the coming months, analysts' expectations about listed non-financial corporations' earnings point to a considerable reduction in their growth rate in the short term, which would be in negative figures. Over a longer term, forecasts also point to a reduction – albeit a more moderate one – in the rate of increase of income generated.

The debt/income and debt burden ratios of the firms reporting to the CBQ increased, influenced in part by the unfavourable course of business earnings. The overall trend of profitability, debt and the debt burden translated into an increase in the indicators of financial pressure on investment and employment, which was particularly marked in the industrial sector.

Financial pressure increased in some segments of the sector, especially in the construction and real estate services branches

The deterioration in the economic situation and the increase seen in financing costs over most of the year translated into a rise in the financial pressure on certain segments in the sector. These were particularly notable in construction and in real estate services, where the doubtful assets ratio climbed to 5.7%, more than 5 pp up on 2007 and far above the related rate for the other activities in the sector (1.9%). Along the same lines are the figures on the number of companies going bankrupt and the microeconomic information in the CBQ, which highlights a greater deterioration in companies in a less favourable financial position. Thus, for instance, while the debt burden for the median company increased by 2 pp in 2008, for companies with higher values for this ratio the increase was far greater (specifically, for companies in the 75th percentile the increase was more than 12 pp).