

1 OVERVIEW

1 Overview

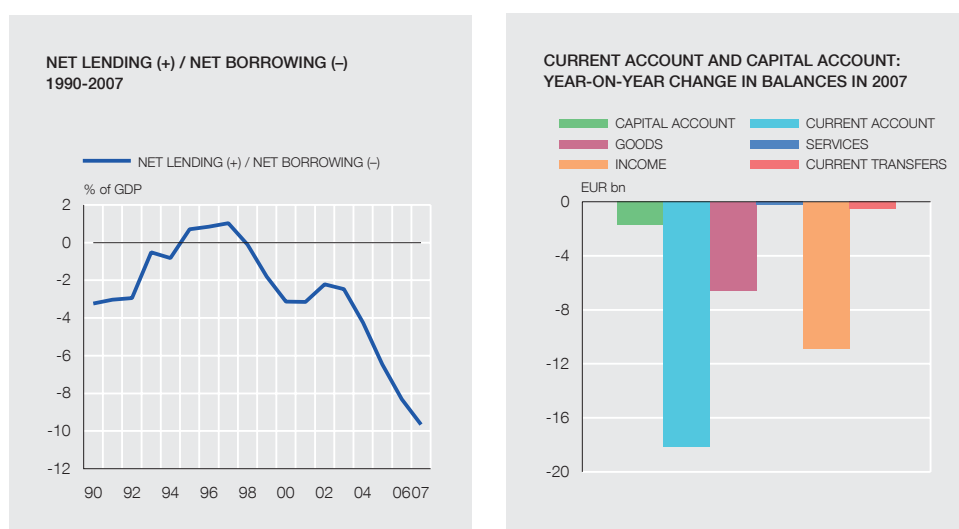
This chapter summarises the most salient developments in the balance of payments and in the international investment position in 2007, and the main changes introduced in connection with the production of these statistics since this report was last published.

In 2007, the world economy remained dynamic, driven as in 2006 by the strength of the emerging countries (especially, China and India), while the main industrialised economies showed signs of slowing, especially in the last quarter of the year. World trade grew at a notable rate, of close to 7%, albeit somewhat below that of the preceding three years. However, the magnitude of the slowdown of activity in the United States, the significant rise in the prices of raw materials and the rapidity with which the financial turbulence that emerged in the US sub-prime mortgage market became a global phenomenon prompted a significant change in the international conjuncture and downward revisions to the growth and world trade forecasts for 2008 of the main international organisations. The crisis of confidence which gave rise to the episode of financial instability was transmitted particularly strongly to the money markets, and also to the other wholesale financial markets, owing to a generalised repricing of risk on capital markets, which led to a tightening of the conditions for access to private sector financing at the world level. At the same time, the euro continued to appreciate against the dollar, a trend which has extended into the first few months of 2008, to reach all-time highs.

During 2007, the Spanish economy entered a slowdown. This was a result, on one hand, of the maturation of the long upswing and, on the other, of the impact in the second half of the year of the instability on international financial markets, which intensified the slowdown in certain spending components. However, the average growth rate for the year as a whole remained high, at 3.8%, down only 0.1 pp from the previous year, while the rebalancing between external and internal sources of growth continued, with the loss of buoyancy of domestic demand being counteracted by an improvement in the contribution of net external demand to GDP growth. The emergence of inflationary pressures at the international level, stemming from rises in energy and food commodity prices led to a substantial rise in the inflation rate in Spain in the final months of the year and in the first few months of 2008, with a widening in the consumer price growth differential vis-à-vis the euro area, following the improvement in the first half of 2007.

Despite the loss of domestic demand buoyancy and the increase in the contribution of the external sector to GDP growth, the Spanish economy's net borrowing from the rest of the world increased again in 2007 to 9.7% of GDP (8.3% in 2006), according to balance of payments methodology [the balance of the rest of the world account of the quarterly national accounts (QNA) recorded a similar increase, of 1.4 pp, to 9.5% of GDP]. However, there was a fall in the rate of expansion of net borrowing in 2007, with respect to previous years, as seen in Chart 1.1, which shows its level since 1990. Accordingly, external savings continued to finance the expansion of gross capital formation, which rose to 31.1% of GDP in 2007, exceeding gross national savings, which represented 21.3% of GDP that year, continuing the downward trend of previous years.

The increase in net borrowing basically reflects the increase in the current-account deficit, which rose to 10.1% of GDP in 2007 (8.9% in 2006) and, to a lesser extent, the decline in the capital account surplus, of 0.2 percentage points of GDP, to 0.4% (see Chart 1.1). The current account components contributing to the increase in the deficit were basically the income balance and, to a lesser extent, travel and goods trade.



SOURCE: Banco de España.

The trade gap amounted to 8.6% of GDP in 2007, which was 0.1 pp larger than in 2006 (see Table 1.1) a significantly smaller increase than in previous years. This reflected the widening of the trade deficit in real terms, in particular the non-energy component, since the terms of trade remained practically unchanged over the year, despite the rise in the price of raw materials. Goods imports in real terms slowed to 6% (down 2 pp from 2006, according to QNA data), in line with the reduced buoyancy of final demand and industrial activity. By contrast, exports were relatively strong (4.7%, a similar rate to 2006), despite the slower growth of Spain's main export markets and the deterioration in price competitiveness indicators. All the same, in 2007 goods imports continued to grow faster than exports, in real terms. As a result of the performance of Spain's exports, export shares in nominal terms, both to the euro area and the rest of the world, recovered somewhat. However, in real terms, export shares relative to the developed countries fell again, although at more moderate rates than in previous years. At the same time, the penetration of goods imports continued to increase, partly reflecting the strong price competitiveness of products exported by countries that have recently entered international trade.

As for the services balance, its nominal surplus fell by 0.2 pp of GDP to 2.1%, according to balance of payments data (see Table 1.1). This decline is explained by the smaller travel surplus, which fell to 2.6% of GDP, since the weight in GDP of the non-tourism services deficit was unchanged (-0.5%). The moderate growth in tourism receipts (3.6%, in nominal terms) confirms the difficulties that the Spanish economy has faced in recent years to increase its share of international tourist flows, specifically in relation to its two main markets, namely Germany and the United Kingdom. These difficulties are closely linked to the emergence of a large number of alternative destinations in the "sun and sand" segment, and the change in the profile of the average tourist, who tends to take a larger number of holidays during the year, but with a shorter duration and a lower average level of spending. The positive note last year was confirmation of recovery in the business and urban segment, which is generally associated with higher average spending per tourist. As a result of all these developments, real tourism receipts in 2007 remained practically unchanged from their 2006 levels, falling by 0.3% according to the QNA. In contrast to the slackness of receipts, tourism payments continued to grow at high rates (by 9.3% in nominal terms, according to balance of payments data, and by 5.8% in real terms, according to the QNA),

% of GDP	2002	2003	2004	2005	2006	2007
NET LENDING (+) / NET BORROWING (-)	-2.2	-2.5	-4.2	-6.5	-8.3	-9.7
Current account	-3.3	-3.5	-5.3	-7.4	-8.9	-10.1
<i>Goods</i>	-5.0	-5.1	-6.4	-7.6	-8.5	-8.6
<i>Services</i>	3.1	3.0	2.6	2.4	2.3	2.1
— Travel	3.5	3.5	3.2	2.9	2.8	2.6
— Other services	-0.4	-0.5	-0.6	-0.5	-0.5	-0.5
<i>Income</i>	-1.7	-1.3	-1.4	-1.9	-2.1	-3.0
— Of which: reinvested earnings	-0.2	0.0	0.0	0.2	0.4	0.5
<i>Current transfers</i>	0.3	-0.1	0.0	-0.4	-0.6	-0.6
Capital account	1.1	1.0	1.0	0.9	0.6	0.4
FINANCIAL ACCOUNT (a)	2.1	2.3	4.1	6.7	8.5	9.3
Excluding Banco de España	1.6	2.1	5.8	6.9	11.1	8.0
<i>Foreign direct investment</i>	0.9	-0.3	-3.4	-1.5	-6.0	-4.6
<i>Portfolio investment</i>	0.6	-3.4	10.2	6.5	20.4	9.9
<i>Other investment</i>	0.7	6.2	-1.0	1.9	-3.5	3.3
<i>Financial derivatives</i>	-0.7	-0.4	0.0	0.0	0.2	-0.7
Banco de España (b)	0.5	0.2	-1.7	-0.2	-2.6	1.4
ERRORS AND OMISSIONS	0.1	0.2	0.1	-0.2	-0.2	0.3

SOURCE: Banco de España.

a. Change in liabilities minus change in assets.

b. A negative (positive) sign denotes an increase (decrease) in the Banco de España's net foreign assets.

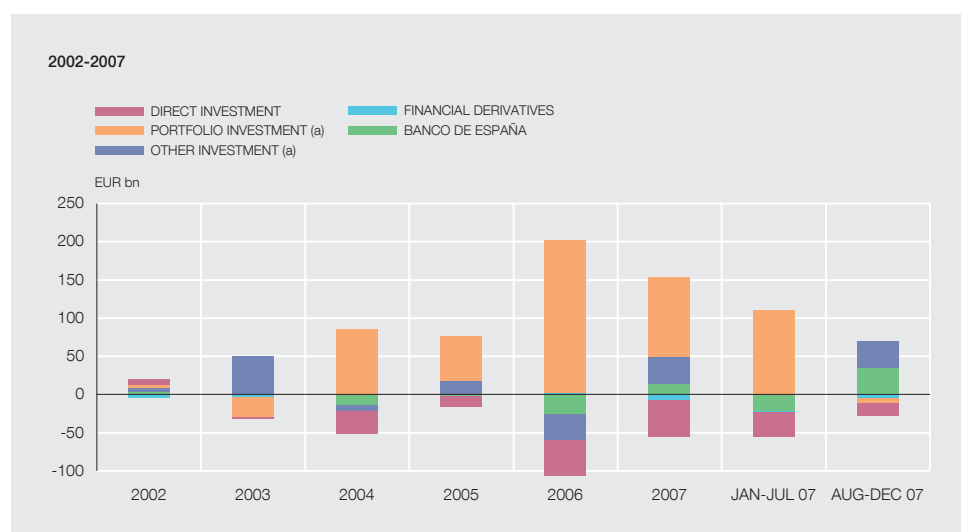
helped by the appreciation of the euro, although confirming the slowdown of recent years. Finally, both receipts and payments for non-tourism services again grew at very high rates (18% and 17%, respectively, in nominal terms), in line with the tendency at the world level for this type of transaction to increase. Notable, in particular, was the widening of the transport and business services deficits and the improvement in construction, financial and IT services. The buoyancy of non-tourism services reflects the progress in the liberalisation of international trade in these activities (which has occurred with some lag relative to goods), the fragmentation of productive processes and technical progress, which increases the possibilities for trade in certain services.

In 2007, the income deficit was the main determinant of the widening in the current-account deficit, its weight in GDP increasing by 0.9 pp, to 3%. This increase is basically explained by the higher indebtedness of the Spanish economy to the rest of the world and, to a lesser extent, by the trend in the spread between the returns on Spain's financial assets and liabilities vis-à-vis the rest of the world. By type of instrument, the increase in net payments of portfolio investment income explains most of the deterioration in the income balance, reflecting the way in which the Spanish economy has covered its borrowing requirement, mainly with bonds issued by Spanish financial institutions. These securities have mostly been issued with coupons indexed to short-term interest rates, which makes income payments especially sensitive to rises in such rates.

Finally, the current transfers balance remained unchanged at around 0.6% of GDP, as the favourable performance of net transfers vis-à-vis the EU almost completely offset the deterioration in workers' remittances and other transfers. Lastly, the capital account surplus, which depends basically on capital transfers vis-à-vis the EU, fell by 0.2 pp of GDP, to 0.4% of GDP.

**NET CROSS-BORDER FINANCIAL TRANSACTIONS,
BY INSTRUMENT (NCL – NCA)**

CHART 1.2



SOURCE: Banco de España

a. Excluding the Banco de España.

In 2007 as a whole, most of the net capital inflows continued to take the form of portfolio investment [mainly in asset-backed securities¹ and in issues of subsidiaries of monetary financial institutions (MFIs), which are classified under other resident sectors (ORSs)] and, to a much lesser extent, of other investment. On the other hand, there were net outflows of funds arising from foreign direct investment (FDI) and financial derivative transactions. However, these annual results do not reflect the change that took place from the summer in the way in which the Spanish economy has covered its borrowing requirement. From August, the financial instability on international markets made it difficult to raise financing on the wholesale markets for long and medium-term debt, and in particular through the issuance of asset-backed securities. Consequently, in the second half of the year, Spanish financial institutions covered their liquidity requirements through the alternative channels of short-term securities issuance and recourse to the interbank market.

Chart 1.2 illustrates the above-mentioned change in the sources of financing. While in the first few months of the year there were net capital inflows in the form of portfolio investment as a consequence of the increase in non-residents' holdings of asset-backed securities and securities issued by the subsidiaries of MFIs, from August portfolio investment transactions with the rest of the world generated net capital outflows. These outflows reflect the reduction in non-residents' holdings of the above-mentioned securities and, to a lesser extent, of public debt, which was only partially offset by the repatriation of funds from abroad and by sales of foreign securities in the portfolios of resident investors (mainly mutual funds). This shift in agents' portfolios towards domestic securities is consistent with the greater uncertainty in international financial markets in the second half of the year. The lower amount of foreign capital raised through portfolio investment was partly offset by financial instruments classified under other investment, especially short-term deposits, which has increased MFIs' refinancing needs during the coming months, although they continue to be moderate given the predominant use made of medium and long-term instruments. However, the favourable reception by non-resi-

1. Asset-backed bonds issued by ORSs and mortgage covered bonds issued by MFIs.

dents of recent issues of Spanish financial institutions of medium and long-term bonds, and in particular covered bonds, suggests that the wholesale financing market is beginning to return to normal.

In 2007, the Banco de España's net foreign assets declined slightly, by 1.9% of GDP, as against an increase of 2.6% in 2006. This change in direction indirectly reflects the effect that the financial turbulence has had on the way in which the Spanish economy has covered its borrowing requirement during 2007. The decline was concentrated among the Banco de España's net assets vis-à-vis the Eurosystem, reflecting the change in the way MFIs have covered their liquidity requirements, since both other net assets and, to a much lesser extent, reserves increased.

The net capital inflows that took place during 2007 increased Spain's debit balance with the rest of the world, although at a lower rate than in the previous year, to 69.3% of GDP as at year-end (up 11.2 pp from end-2006). If the Banco de España is excluded, this percentage increases to 76.8% of GDP in 2007 (67.9% in 2006). Unlike in other years, the estimates made suggest that the contribution of the valuation effect to the deterioration in the Spanish economy's net debit international investment position (IIP) was limited, as the effects of the appreciation of the euro and the developments in the prices of the instruments that make up the foreign financial assets and liabilities offset each other, since they were of a similar size but with the opposite sign. As a result, developments in the IIP in 2007 were determined mainly by the financial transactions carried out during the period. In line with this result, the widening of Spain's net debit IIP, excluding the Banco de España, is mainly explained by the change in the portfolio investment debit balance and, to a lesser extent, by that of other investment and that of financial derivatives. By contrast, the FDI credit position increased.

As regards the new features described in this edition of the report, it should be pointed out that the main changes were not introduced in 2007, but during the first few months of 2008, so that they do not affect the data contained herein. First, as regards the information system used to compile the balance of payments and the IIP, it should be noted that the amount below which residents are exempt from the obligation to report the type of foreign transaction has been raised from €12,500 to €50,000. This has required a search for alternative sources to estimate the amount of certain headings under which a large number of transactions of an amount below the above-mentioned threshold are concentrated, a task on which progress was made during 2007. Second, and in relation to the foregoing, in April 2008 a new timetable came into force for the publication and revision of the balance of payments, basically as a result of the changes being made to the information system used to compile these statistics. These changes have made it necessary to review the periodicity of dissemination of certain headings of the balance of payments whose sources of information are no longer monthly. Finally, among the changes made in this edition, the improvement in the procedure for estimating reinvested earnings on direct investment is notable. Stock data for direct investment from the investment register of the Ministry of Industry, Tourism and Trade and from the Central Balance Sheet Data Office are used for this purpose.