Quarterly report on the Spanish economy

1. Overview

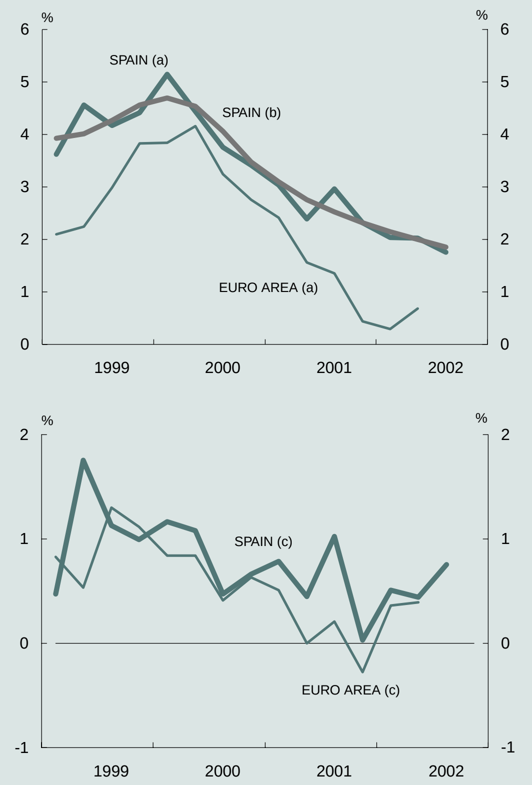
Recent data on the international economic environment are relatively contradictory, and have still to signal the cyclical turning point that will once again place the world economy on a path of sustained growth. The financial markets have been prone to heightened uncertainty and are showing signs of marked instability, reflecting both geopolitical tension and the poor results of certain economies or business sectors, or the lack of confidence in them. Real indicators have generally been more favourable, especially those relating to consumption, while the confidence indicators reveal greater pessimism, which is manifest in the slackness of investment. In these circumstances, global markets remain lacklustre. Economic policies have retained an expansionary stance and the low interest rates prevailing have acted as a stimulus for certain household expenditure components. Real household income, for its part, is being sustained in some cases by general government measures and, in others, by low inflation rates or by employment growth.

Against this international background, the Spanish economy has sustained a steady growth rate which is, primarily, still underpinned by household spending and, to a lesser extent, by the public sector, while an increase in trade flows with the rest of the world is discernible. The seasonally adjusted growth rate of the Spanish economy's real GDP series has shown a degree of variability, as can be seen in Chart 1. The quarter-on-quarter rate of this series is estimated to have picked up in Q3 in relation to previous quarters, rising to approximately 0.8%. Nonetheless, given the previous year's profile, the annual growth rate may have been around 1.8%, below the figure of 2% posted during the first half of the year. In view of their much greater stability, the trend-cycle series show a much more sustained profile according to which the Spanish economy's annual growth rate would have stabilised during the current year at around 2%. If there are no significant changes in the current growth pattern, this value could be the final growth rate for the year 2002 as a whole.

In these circumstances, employment growth has tended to moderate and apparent labour productivity has recovered slightly. Unit labour costs have slowed marginally and corporate surpluses in certain productive branches remain high, without the growth rate of prices having diminished. Indeed, the 12-month growth rate of the harmonised index of consumer prices (HICP) for Q3 as a whole was unchanged on that of the previous quarter (3.6%), and the inflation gap with the euro area countries has likewise held stable at 1.5 percentage points.

CHART 1

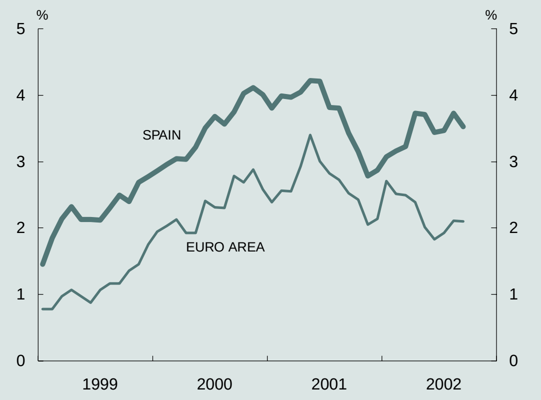
Gross domestic product



Sources: ECB, INE and Banco de España.
(a) Non-centred annual rate of change calculated on the basis of the seasonally adjusted series.
(b) Non-centred annual rate of change calculated on the basis of the trend-cycle series.
(c) Quarter-on-quarter rates of change calculated on the basis of the seasonally adjusted series.

CHART 2

Harmonised indices of consumer prices (a)



Sources: Eurostat and European Central Bank.
(a) Annual rates of change. To December 2001, the rates relate to those released as at that date.

The information on the US economy for 2002 Q3 has been subject to the aforementioned uncertainty. The improved labour market, the low rate of inflation and low interest rates have boosted certain private consumption components, while the business and consumer confidence indicators and the data on business investment remain notably depressed, despite the fact that productivity gains and the decline in costs have made for an improvement in the margins of certain business sectors. The current-account deficit has continued to widen and the exchange rate of the dollar has stabilised, while the burgeoning budget deficit will run beyond this year.

The sluggishness of international markets is affecting certain economies. Such is the case of Japan (whose incipient recovery is once more being held down by the falling off of exports, despite the depreciation of the yen), of other Asian regions and of some central and eastern European countries. What is involved in this latter case, however, are economies which, in many cases, are already close to European Union accession, which has buoyed them considerably. This is not the case in Latin America, where the economic problems beleaguering certain countries have been compounded by political uncertainty in others and by the difficulties building up in this region at a time of tension on international financial markets.

The absence of a stimulus from abroad is delaying recovery in the euro area. The confidence indicators remain at low levels and there are no signs of a pick-up in business investment. The demand component underpinning the modest growth in the area is thus private (along with government) consumption. The latest data point to a slowdown in the rate of increase of consumption that was already patent in the National Accounts figures for Q2. This may be due to the accumulating wealth losses by households and to the slowdown in employment. Although labour productivity is expected to have recovered and the strong growth of unit labour costs to have moderated in Q1, the growth of business margins remains fairly low.

The course of the HICP for the euro area during the year essentially reflects the fluctuations in the prices of energy and unprocessed food, with the more stable components of the index maintaining a higher and more sustained growth rate. The 12-month growth rate of the IPSEBENE (the index of services and non-energy manufactured goods prices) in Q3 is, at 2.5%, only one-tenth of a point lower than that recorded the previous quarter.

Given these developments, the ECB has held its intervention rates unchanged since last

November, to a backdrop of downward expectations spreading through all markets and declining bank lending and deposit rates and bond yields. The growth of the monetary aggregates has turned down slightly and the rate of increase of financing to the private sector has stabilised at slightly over 5%. The stock markets have slumped further since the summer and, finally, the euro exchange rate against the dollar has not changed significantly.

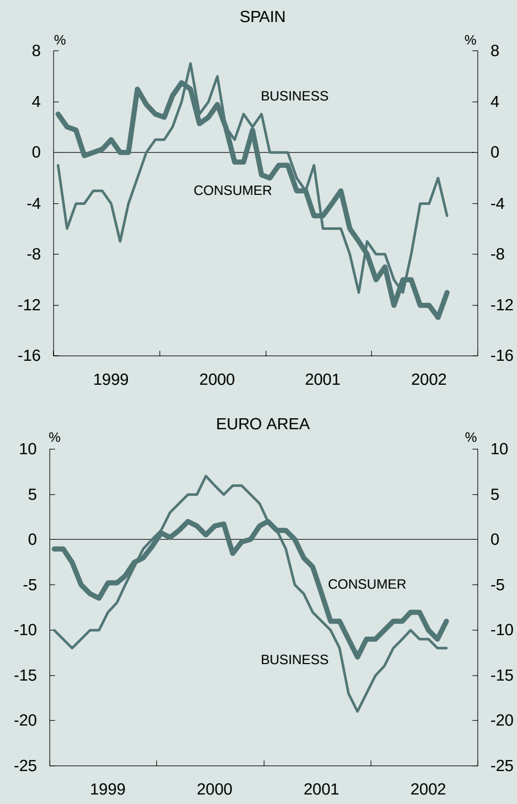
These more adverse than expected economic developments have seen several Member States run up budgetary imbalances exceeding the targets set in their Stability and Growth Programmes. In some cases, the sluggishness of activity, along with the insufficient fiscal consolidation implemented in the previous expansionary phase of the cycle, have prompted the emergence of deficits that might next year be close to or above the ceiling set in the Treaty on European Union, thereby hampering the attainment of balanced budgets over the envisaged horizon. It is highly desirable that compliance by these countries with the structural adjustments agreed upon recently on the initiative of the European Commission should place their public finances in the near future in a position compatible with the fiscal discipline that the proper functioning of EMU requires.

The estimated real growth rate of national demand in the Spanish economy in 2002 Q3 coincides with the preliminary estimate for GDP, namely 1.8% year-on-year, with the contribution of net external demand expected to be slightly negative. The recent course of national demand has been partly influenced by the INE-estimated movements in stockbuilding. If regard is not had to these movements, which are difficult to assess on the scant information at hand, the slowdown in demand in Q2 can be seen to have been a consequence basically of the loss of momentum of household consumption, while now, in Q3, it is the rate of capital investment which has once again fallen. Both investment in construction and private consumption have held more stable in recent months, with year-on-year growth rates similar to those posted in the preceding quarter.

Despite the losses in financial wealth and the lack of confidence reflected in the related surveys, the growth of consumption in Q3 is due to some extent to the increase in real disposable income. Contributing notably to this is employment, despite it having slowed, and general government measures. Gains in non-financial wealth (associated with the rise in house prices) and the low interest rates prevailing have also contributed to sustaining consumption, with the pick-up in the saving ratio proving very limited to date.

CHART 3

Confidence indicators



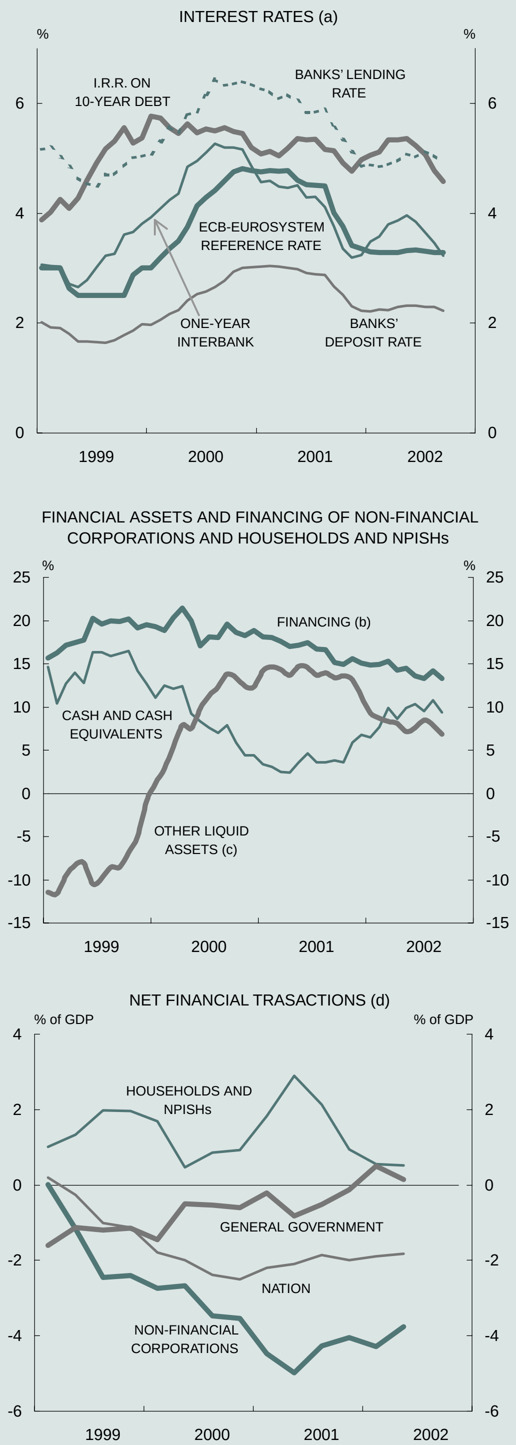
Source: European Commission.

The current and foreseeable growth of household income has sustained the increase in investment in housing, which has also benefited from expectations of rising prices against a background of heavy declines in equity prices and from very favourable financing conditions. In the latest official survey (Ministerio de Fomento) covering Q2, there are signs of a loss of steam in the growth of private residential investment, possibly as a result of the high price levels already reached. Investment in construction in Q3 has remained resilient thanks to the significant contribution of both public- and private-sector civil engineering works.

The expansionary monetary conditions in the Spanish economy have boosted household spending and raised their debt levels. Provisional data from the Financial Accounts for Q2 show that Spanish household net lending is very low, and the partial information for Q3 would suggest that this situation will not change significantly. Indeed, the growth of financing to the non-financial private sector increased by 14.2% in August, slightly up on the rate for Q2, confirming the growing robustness of financing to households, while that extended to corporations is slowing.

CHART 4

Financial indicators of the Spanish economy



Source: Banco de España.

(a) The series are averages of daily data.

(b) Includes bank loans extended by resident and non-resident credit institutions, foreign loans, fixed-income securities and financing through securitisation funds.

(c) Includes deposits with agreed maturity, repos, bank securities, residents' cross-border deposits and shares in money-market funds.

(d) Cumulative four-quarter data.

Naturally, a breakdown of the figures on credit to the private sector by end-use also reveals this pattern. Household credit for house purchases is holding at a growth rate of 17%, while consumer lending stands at around 14% and on a slowing trend. This loss of momentum is all the more evident in the case of lending to non-financial corporations, especially in industry and to a lesser extent in services, although credit financing activity in the construction industry continues to expand.

A further key feature of the Spanish economy in 2002 Q3 has been the recovery in merchandise trade flows with the rest of the world. The figures for July and August show a notable pick-up in exports in virtually all regions, with the significant exception of the Americas. On the imports side, purchases of consumer and intermediate goods have been notable, while capital goods imports have remained sluggish. Admittedly, the data for the coming months will be needed to ascertain whether, at a time of notable slackness in world markets, these patterns take root. But the fact that the export unit value index should have posted negative rates of change in recent months gives some idea of the efforts exporting companies are making to increase their sales in such adverse economic circumstances and of the squeeze on margins that this involves, given the growth of unit labour costs.

Given that the improvement in levels of competitiveness is an essential element if the Spanish economy is to benefit from the expected recovery in world markets, then sustaining positive employment growth rates will prove pivotal if headway is to continue to be made in the process of real convergence with the EU countries during this downturn. Here it will be necessary to step up liberalisation and promote the efficient functioning of markets so that wage growth, productivity gains and the rate of increase of prices may be brought into line with those prevailing in the core EU countries. In this respect, it is a cause for concern that, as highlighted at the beginning of this introduction, there remains a high differential in the growth rate of the HICP in relation to that of our euro area partners. Indeed, this differential has, for Q3 on average, stood at around one percentage point in the case of non-energy industrial goods and at almost one and a half percentage points in the case of services. The widespread use of inflation-adjustment clauses in Spanish collective bargaining may seriously hamper the correction of these differentials.

It will also be important for fiscal policy to remain committed to macroeconomic stability. In this respect, the budget outturn during the quarter has remained in line with the target of an overall general government balanced budget for 2002, as established in the latest update of the Stability Programme and as recently confirmed in the draft State Budget for 2003.

During Q3, however, tax (in particular VAT) revenue has weakened somewhat, marking a contrast with the buoyancy of VAT in the first half of the year. The growth of social security contributions has also been notably down on the previous year. This slowdown has been partly offset by the increase in direct taxes and, above all, by the strong acceleration in corporate income tax. However, this latter development has been due to a change in tax regulations, which will only affect takings for this year. On the expenditure side, welfare benefits have remained buoyant, while operating expenses have trended at a moderate rate below that of nominal GDP. The initial projection of State revenue and expenditure for the year as a whole entails a steeper rate of decline of revenue and expenditure in the remaining months of the year.

Turning to fiscal policy targets for 2003, the draft State Budget estimates that general government transactions will be balanced once again and that this will be as a result of attaining a balanced budget at the various governmental tiers, in accordance with the guidelines of the Budgetary Stability Law. In the preparation of this Budget, regard has been had to the entry into force next year of the personal income tax reform and the full operativeness of the new regional government financing arrangements, both of which factors will no doubt bear on the budget outturn next year. The co-ordination effort between the different tiers of general government should be strengthened in the light of the recently approved changes in local government financing arrangements.

2. The external environment of the euro area

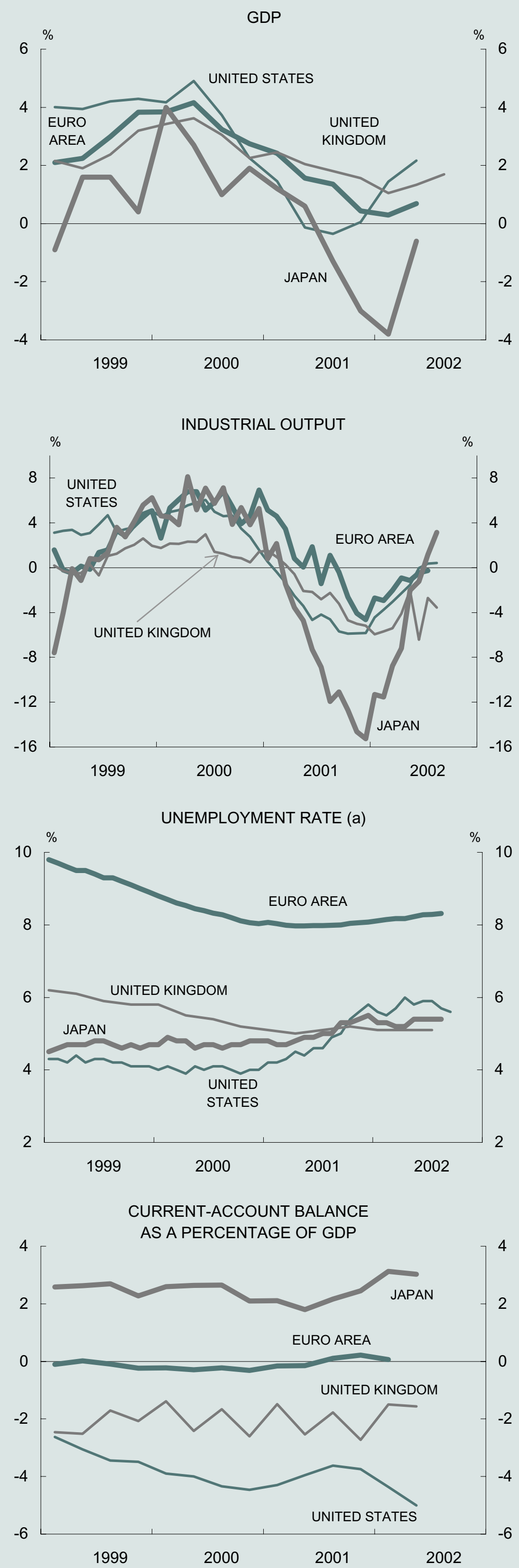
The world economy continued to move on a growth path in 2002 Q3, albeit at a more moderate rate, further to the slowdown in the demand for imports in the United States. In parallel, the scaling back of growth prospects in other regions has accentuated the leading role of the US economy in the current economic circumstances. The doubts over the resilience of the economic recovery in the United States (centred on the divergence between the relatively more favourable real indicators, on one hand, and the more negative financial and confidence indicators, on the other) have, along with the current geopolitical risks, led to an increase in risk aversion and oil price pressures.

There have been heavy losses on the financial markets in equities and high-risk bonds, against a background of marked volatility. At the same time, sovereign debt yields in the advanced economies, which have acted as a safe haven against the high uncertainty prevailing, have declined significantly. On the foreign exchange markets, the dollar has ceased to depreciate and its current levels have firmed, fluctuating in a narrow range. The vulnerability of the Japanese economy prompted a reversal, at the end of the quarter, in the tendency of the yen to appreciate. Turning to the emerging economies, the difference has widened between the sovereign debt of the Latin-American countries, which has worsened significantly albeit with sizeable differences across the region, and the rest of the economies in this group, where it has trended more favourably. Likewise, most Latin American currencies have continued to depreciate, in contrast to the stable or appreciating trend of the currencies of other emerging countries.

In the United States, GDP in Q2 posted annualised quarterly growth of 1.3%, led once more by consumption (which grew 1.8%) and, above all, by inventories, which contributed 1.31 percentage points to output growth. These data show a slowdown in activity in relation to Q1 that appears to have been turned around in Q3. On the basis of the partial indicators available, there has been a moderate improvement in consumption and in capital investment in Q3. There have, however, also been negative figures, such as the successive falls in the leading composite indicator and the latest data on retail sales and industrial output, both of which showed a monthly decline in September (–1.2% and –0.1%, respectively). This has been accompanied by a significant deterioration in consumer and, to a lesser extent, business confidence indicators. The Conference Board consumer confidence index fell to the levels of last December, and the University of Michigan index

CHART 5

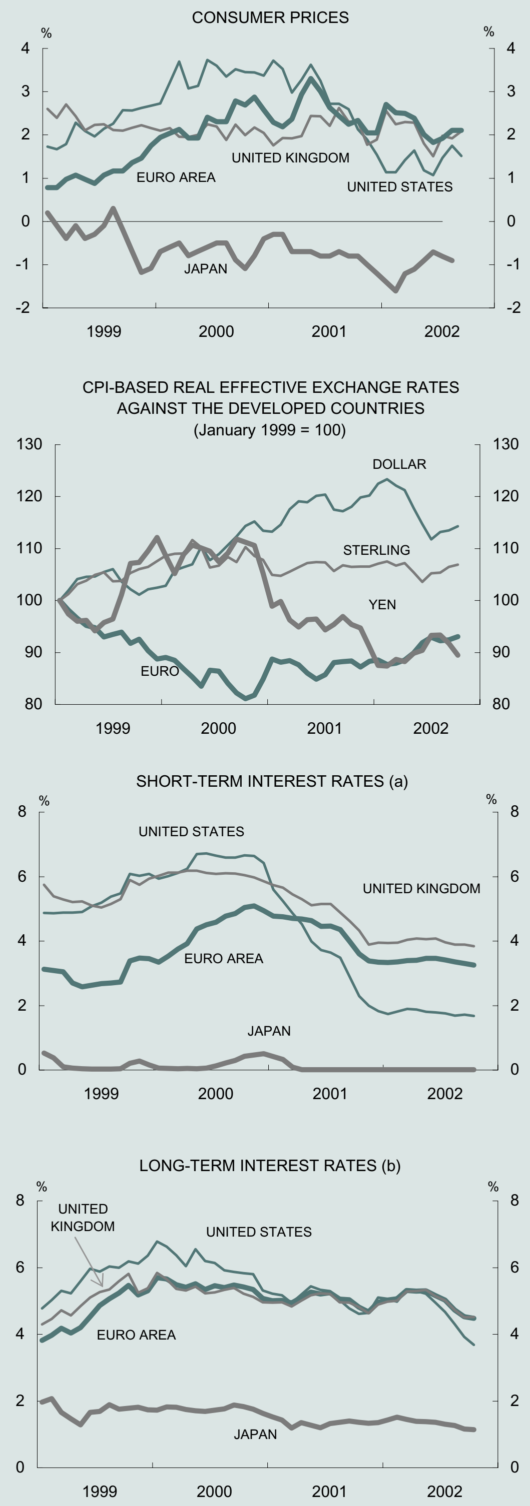
Main macroeconomic indicators
Annual rates of change



Sources: Banco de España, national statistics and Eurostat.
(a) As a percentage of the labour force.

CHART 6

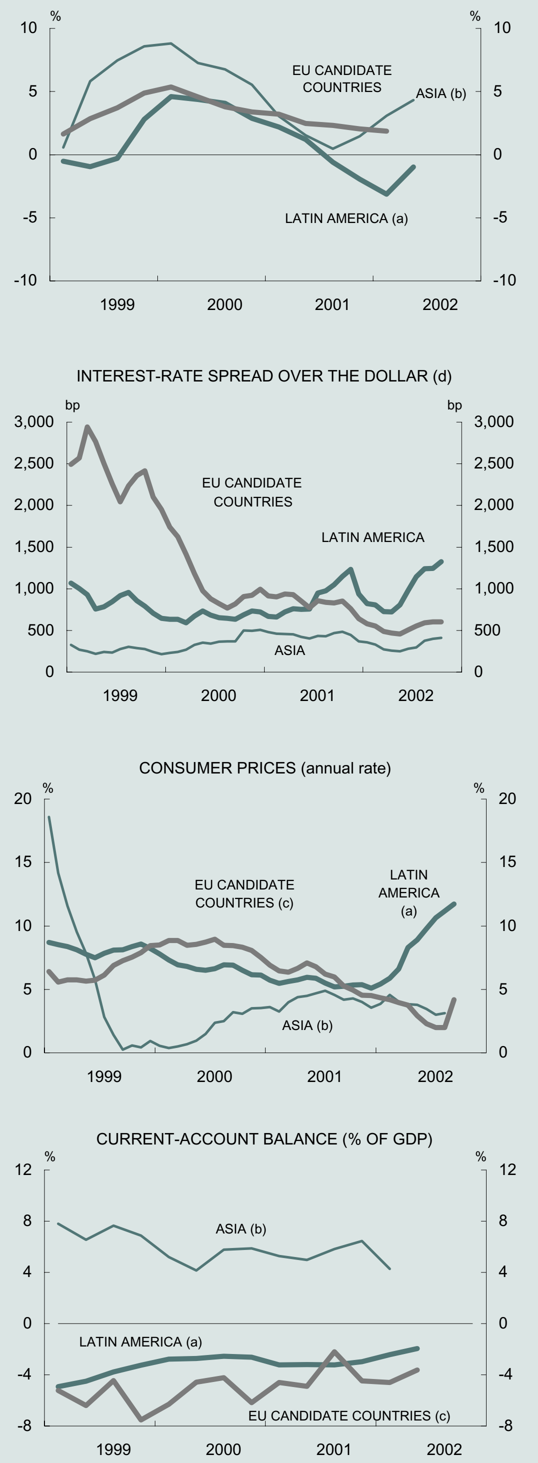
Prices, real exchange rates and interest rates



Source: Banco de España.
(a) Three-month interest rates on the interbank market. Euro area: weighted average of the eleven countries to December 1998. As from 1999: three-month EURIBOR.
(b) 10-year government bond yields. Euro area: weighted average of the eleven countries to December 1998.

CHART 7

Emerging economies: main macroeconomic indicators



Sources: National statistics and JP Morgan.
(a) Argentina, Brazil, Chile, Mexico, Colombia, Venezuela, Peru.
(b) Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
(c) Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.
(d) Spreads according to JP Morgan's EMBI+ index. The EU candidate economies include Russia.

to those immediately prior to 11 September. The divergence between the expenditure and confidence indicators is characteristic of recent months, and appears to be related to the above-mentioned stock market instability and geopolitical risks.

Nonetheless, a series of factors continue to sustain the economy. The real estate sector remains notably buoyant, and there are positive signs in the labour market in the form of an increase in hours worked compared with previous quarters and a reduction in the number of unemployment benefit claims. In addition, productivity gains and headway in containing costs have eased unit labour costs – leading business margins to pick up – without adversely influencing real wages, thanks among other factors to the moderation of inflation (at an annual rate of 1.5% in September). In terms of businesses, this has contributed to higher profits and to a reduction in financial dependence (which has prompted something of a rally on stock markets in October), and in respect of households, to improved real incomes. The overall result is growing resources with which to invest and consume.

The current-account deficit continued to widen and stood in Q2 at 5% of GDP. Meantime, the expansionary fiscal stance and the growth in security spending will mean that, for the first time since 1997, there will be an annual government deficit in 2002 of 1.5%, which will very probably increase in the following years.

In Japan, following positive quarter-on-quarter growth of 0.6% in Q2, activity has once more slowed because of the gradual slowdown in the growth of exports, calling into question the incipient economic recovery. On the supply side, external demand has adversely affected the manufacturing sector judging by the industrial output and business expectations indicators. In parallel, the consumption indicators reveal sluggish and irregular activity in most cases. Against this background, deflationary pressures remain in place (annual inflation stands at –0.9%) and the labour market continues to be slack, since the recent stability of the unemployment rate at 5.4% of the labour force essentially responds to the gradual fall in the labour force brought about by the discouragement effect on job-seekers.

The uncertainty over economic developments in Japan has made for a significant stock market correction, especially in the banking sector. That has led the Bank of Japan to implement a plan to purchase shares held by banks. Also, the government has postponed the lifting of full backing for sight deposits, which had been planned for April next year, and has announced fresh measures to restructure the banking system, along with an anti- deflationary package, the details of which should be disclosed shortly.

In the United Kingdom, the economy grew by 0.6% in 2002 Q2 (1.3% year-on-year), led by private consumption and exports (which posted respective quarterly rates of 1.4% and 3.5%). Gross capital formation fell for the sixth quarter running, this time by 0.1%. In 2002 Q3, the economic indicators are pointing once again to divergence between relatively robust domestic demand, especially private consumption (retail sales in August grew by 5% year-on-year), and an industrial sector which has yet to recover (industrial output in August fell by 3.5% year-on-year). Moreover, preliminary figures for GDP in Q3 confirm the recovery, with quarter-on-quarter growth of 0.7% (1.7% in year-on-year terms). Labour market developments are contributing to sustaining buoyant consumption, since the unemployment rate has remained stable at 5.2%, while wage growth has held at a growth rate of around 4% year-on-year, outpacing inflation, which stands at a moderate level of 2.1%. The behaviour of consumer prices is in contrast to the sharp growth of house prices, which are running at an annual rate of over 20%.

Turning to the central and eastern European countries, the highlight has been the recommendation by the European Commission on 9 October that ten of the candidate countries should conclude accession negotiations this year, meaning they may join the EU in 2004. As regards the other candidate countries, the Commission has indicated the year 2007 as a possible accession date for Bulgaria and Romania, while no date has been set for negotiations with Turkey. With respect to economic developments, growth has slowed slightly overall as a result of the flatness of external demand. The factors underpinning activity are, essentially, domestic demand and the implementation of discretionary fiscal policies of an expansionary nature, which has prompted a widening of current-account deficits. These developments limit the degree of fiscal flexibility needed to absorb the future costs of enlargement and hinder the fiscal consolidation required within the EU. Country by country, the adverse effects of flooding on the Czech Republic (along with the strong appreciation of its currency) have led to a slight down-scaling of growth prospects for this year and to an increase in the budget deficit. In Poland, recovery is proving very weak, despite the strong reduction in official interest rates, owing to the slackness of external demand and to the flatness of investment and industrial output. The situation in Turkey has stabilised, in relative terms, pending the November parliamentary elections. The Turkish economic indicators have continued to improve, while the terms of the IMF programme are being strictly met.

In Latin America, recovery is not only proving slower than expected; there has even been backsliding in certain countries, such as Brazil and Venezuela, owing to political and financial uncertainty. The external environment is also bearing adversely on the region's growth capacity due to high risk aversion and to doubts over the US economy. Both these factors are compounding the vulnerability inherent in certain Latin American economies. In Argentina, the economic indicators show the real sector to have stabilised to some extent (the decline in GDP eased in Q2 to 13.6% year-on-year), but its underpinnings are still very fragile. Headway has been made in bringing the banking system back on to a normal footing, with measures such as the partial freeing of fixed-term deposits and the start of a new voluntary deposits-for-bonds programme. Nevertheless, an overall plan to restructure the financial system has still to be defined and the conflict between the legislative and judiciary branches has not yet been conclusively resolved. Such uncertainty has complicated negotiations with the IMF, which are needed to help stabilise the Argentine economy.

In Brazil, political uncertainty continued during Q3 in the run-up to the elections at the end of October. Reflecting this, there has been a substantial increase in sovereign risk and a marked depreciation of the Brazilian currency, to an historical high and low, respectively. This situation has not only generated fiscal pressures; it has also led the monetary authorities to adopt a more activist stance, in the form of measures geared to restricting liquidity and a 300 basis points increase in the intervention rate. In the economic domain, the indicators show a slower-than-expected recovery subject to downside risks arising from worsening financial conditions and heightened uncertainty.

In other Latin American countries, including most notably Mexico and Chile, developments have been more favourable. However, unlike in previous quarters, Mexico has also seen a slight deterioration in its financial variables, linked to the instability in Brazil and to uncertainty over the performance of the US economy. Although indicators continue to show a gradual recovery in the economy, there are signs of a slight slowdown linked to the export sector. The authorities have tightened the monetary policy stance in the light of the relative downward stickiness of inflation. In Chile, the slowdown in growth has been confirmed, although it remains at higher levels than the rest of the region. The outlook for Chile is subject to trends in the global environment, given the economy's extensive openness and the flatness of its domestic demand. As to the remaining countries, a favourable mention may be made of Peru, whose economy grew on average in the period to August at an annual rate of 4.1%. That said, the weakness of investment casts doubt on the sustainability of this expansion.

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

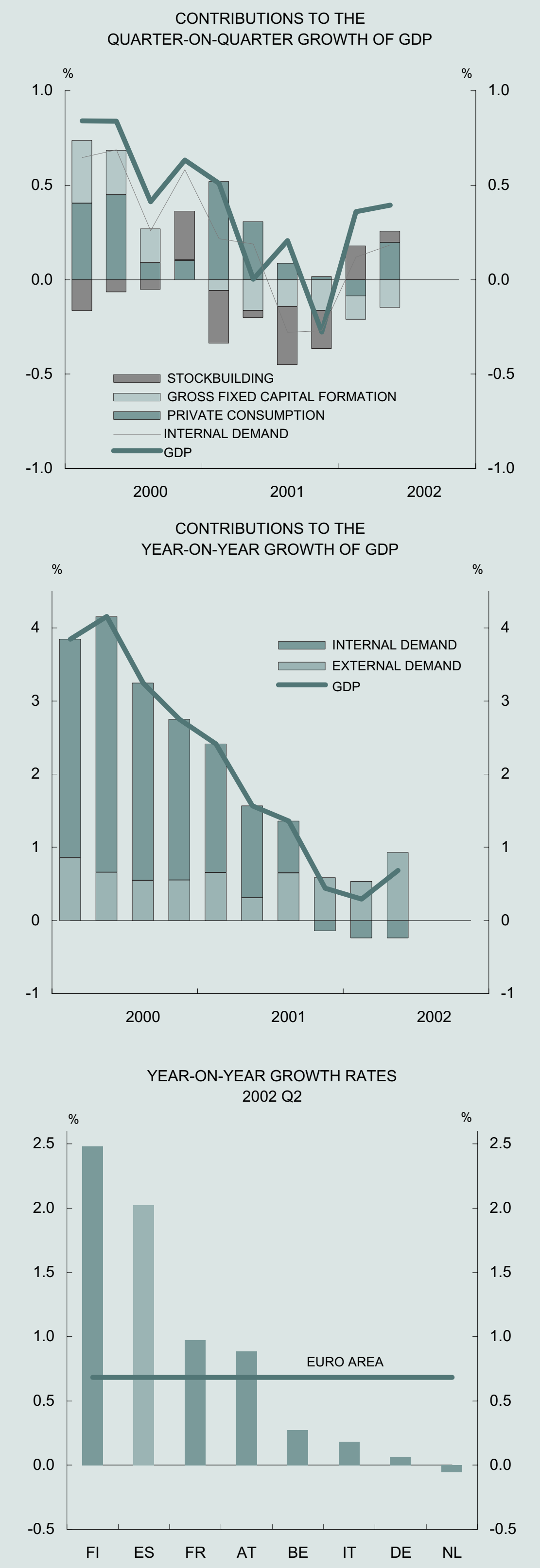
The euro area economy has been influenced during Q3 by the international economic and financial environment, which has been marked by a substantial correction of stock market prices and heightened uncertainty. These factors have made for a slide in confidence and a significant rebound in oil prices, which in turn has led internal demand and GDP in the euro area to be less buoyant than was expected at the start of the year. Accordingly, most international agencies have scaled back their GDP growth forecasts for 2002 and 2003 in relation to those published in the spring. Against this background of sluggish demand, the inflation outlook has improved slightly, despite the fact that the increase in oil prices and flooding pushed the inflation rate upwards during the summer months. On the fiscal policy front, budgetary balances have worsened in a large number of countries, a development attributable only in part to the operation of the automatic stabilisers. Finally, against this backdrop of uncertainty over the strength of the economic recovery and a somewhat brighter inflation picture, the ECB governing council has not altered its monetary policy stance in its meetings to date. The interest rate on its main refinancing operations has held unchanged since November 2001 and currently stands at 3.25%.

3.1. Economic developments

According to the second euro area National Accounts estimate for 2002 Q2, GDP grew by 0.4% in quarter-on-quarter terms, unchanged on the previous quarter. In year-on-year terms, this relative stability of activity translated into an increase in output of 0.7%, four-tenths of a point up on the rate for the preceding quarter (see Chart 8). For the first time since mid-2001, internal demand, excluding stocks, posted a positive though very moderate quarter-on-quarter rate of 0.1%. This was due to the pick-up in private consumption, which offset the lesser momentum of government consumption. Gross fixed capital formation showed a negative rate of 0.7%, similar to that of the previous quarter. The quarter-on-quarter reduction in gross fixed capital formation for the sixth quarter running placed the related year-on-year rate at around –3%, as a result of capital investment being somewhat more depressed than construction. The contribution of the external sector to GDP growth was marginally positive at 0.2% and, although this coincides with the figure for Q1, it is the outcome of a substantial recovery in both exports and imports in relation to previous quarters. Finally, the change in stocks made a positive contribution of one-tenth of a point to economic growth for the second consecutive quarter. This marked the start of a stockbuilding

CHART 8

GDP in the euro area



Sources: Eurostat and national statistics.

process after over a year of negative contributions.

National accounts data across the euro area highlight different cyclical positions. Among the countries with quarterly national accounts, annual GDP growth in Germany, Italy, the Netherlands and Belgium was virtually zero in Q2; in France and Austria it was 1%; and in Spain and Finland it stood at 2% or above. Broadly, these differences in GDP growth rates are determined by internal demand, since the performance of external demand and of the contribution of stockbuilding show a more uniform pattern across the groups of countries indicated. In particular, the high-growth countries are those where consumption is more buoyant and where gross fixed capital formation has fallen back to a lesser extent.

The stability of the GDP growth rate in 2002 Q2 is the result of a relative slowdown in industry and of greater robustness in services. In turn, the weakness of productive activity over recent quarters has led to a gradual reduction in the pace of job creation, which flattened out in Q2. In any event, the course of outputs and of employment during this period meant something of a recovery in apparent labour productivity, which resumed marginally positive year-on-year rates of change.

The latest information available on the euro area for Q3 points to a pause in the process of recovery of economic activity. In particular, the European Commission’s confidence indicators and the purchasing managers’ surveys from the manufacturing sector and services were lower in Q3 than in Q2, which brought the rising path embarked upon at the end of last year to a halt. The EU construction survey indicator has also lost momentum in the summer months. As for the industrial production index, its rate of increase eased off in the July-August period (see upper panel of Chart 9).

From the demand standpoint, the consumption indicators have not offered such clearly defined signs of deceleration over the summer months as those reflected by the activity indicators. Thus, although consumer confidence slipped in the July-September period, the September figure marked an advance on the deterioration in August. This was linked to somewhat brighter prospects for the overall situation of the economy (see Chart 9). According to the same survey, the retail confidence indicator began to improve slightly during the summer months. That appears to corroborate the as yet incomplete data available on retail sales for the euro area as a whole. The indicator of new car registrations picked up in Q3, although its year-on-year rate is still negative. On the investment front, the data available show no change in the sluggishness characterising this aggregate. Indicators such as orders in industry or production expectations drawn from the EC confidence survey showed a fall in the summer months, following the rise previously recorded. In turn, capacity utilisation has remained virtually flat in recent quarters. The picture blackens even further in the construction sector where, according to the European Commission's surveys, orders worsened notably in Q3. The fragility of the recovery in world demand may be affecting exports. Industrial orders from abroad duly worsened in Q3 in relation to Q2, confirming the trend evidenced by the export expectations indicator of the quarterly survey of industry at the beginning of the period under study.

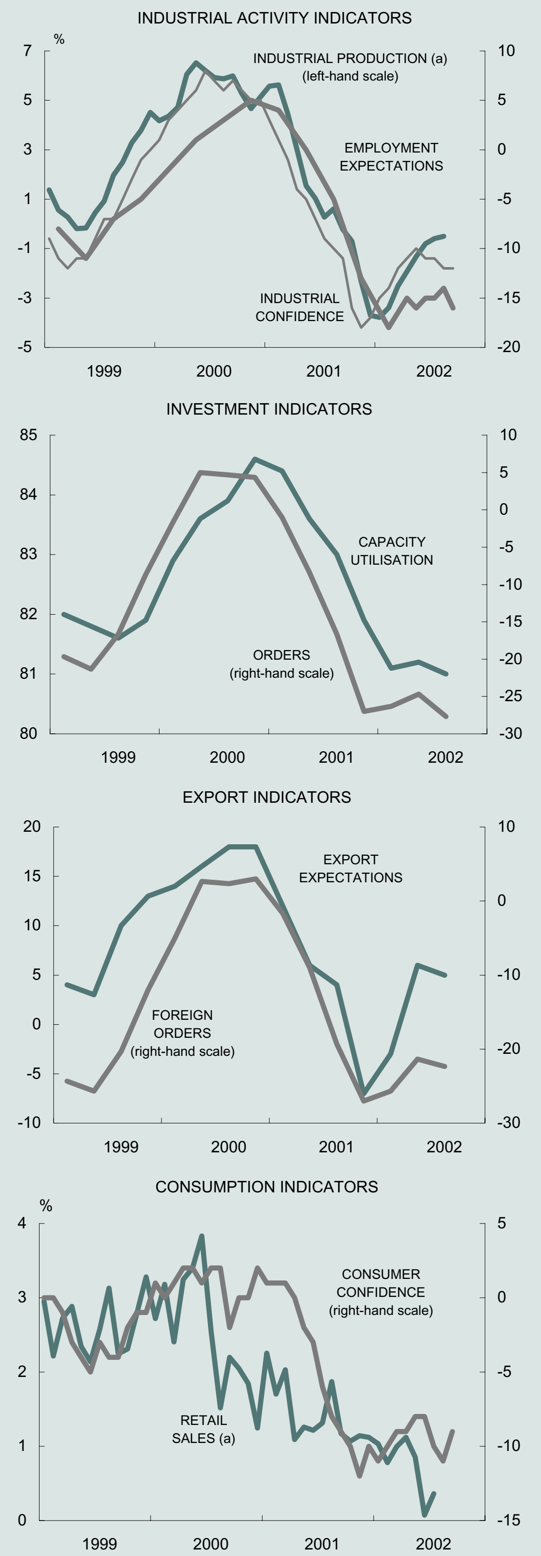
Turning to the labour market, the employment indicators drawn from business confidence surveys trended unfavourably in Q3, especially in construction and in services. Yet this has barely been reflected in the unemployment figures. The unemployment rate has risen to 8.3%, only one-tenth of a point up on the previous quarter.

In sum, the foregoing outlook points to GDP growth in Q3 similar to or slightly below that for the first half of the year, within the growth range estimated by DG-ECFIN (0.2%-0.5%) for the period. With regard to expenditure, there will foreseeably be a repeat of, or an increase in, the positive contribution by internal demand, along with a lesser contribution by foreign demand. Nonetheless, the decline in stock market prices coupled with heightened uncertainty is hindering a firm pick-up in private expenditure. In particular, the loss of value of household financial wealth is affecting consumption, whereby a slight recovery in the household saving ratio is to be expected. Moreover, the declining trend of private debt prices (accompanied by an increase in the associated risk premia) has made it more costly and difficult for companies to finance themselves. In turn, the deterioration in margins and the substantial uncertainty over the international political situation and the strength of the recovery are leading companies to defer decisions on acquiring capital goods.

The various price indicators for the area have increased slightly during Q3 owing largely to the rise in oil prices and to the effects of flooding in central Europe on crop yields. As regards the determination of internal prices, information on unit labour costs is only available for some of the euro area countries to 2002 Q2. On these data, unit labour costs have grown by slightly over 2.5% year-on-year dur-

CHART 9

Euro area. Real indicators

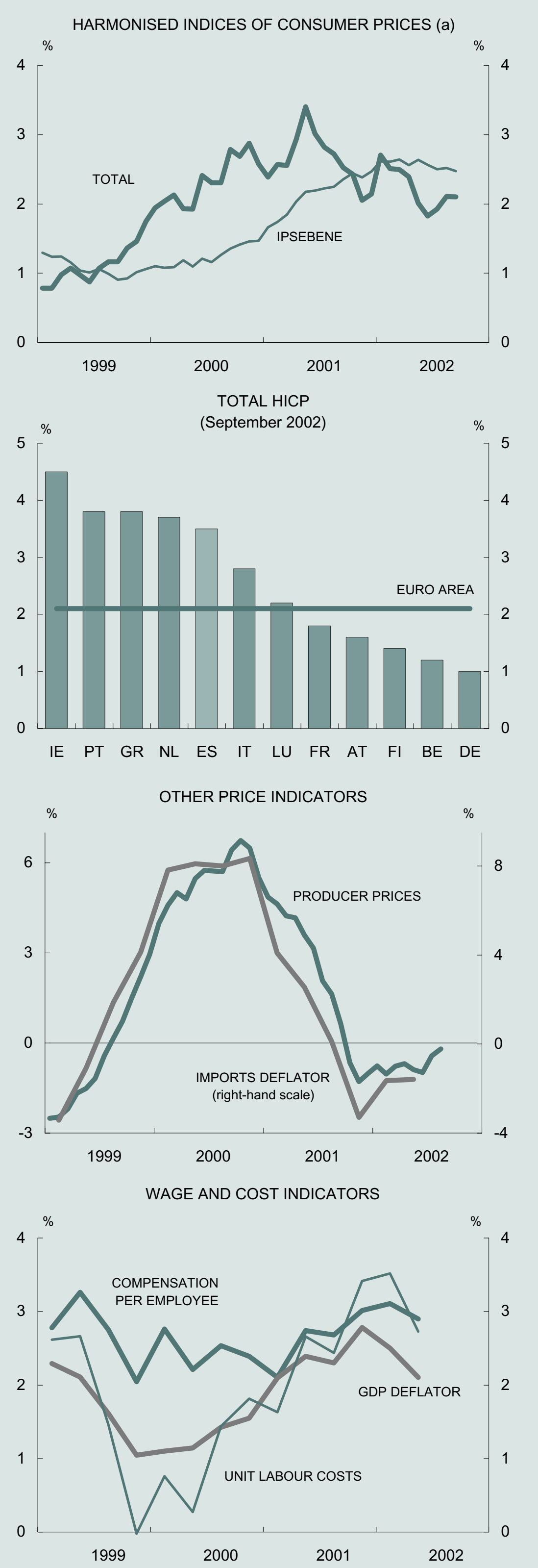


Sources: Eurostat and European Commission.

(a) Non-centred annual percentage changes calculated on the basis of the quarterly moving average of the seasonally-adjusted series.

CHART 10

Euro area. Price, wage and cost indicators
Year-on-year percentage changes



Sources: Eurostat and European Central Bank.
(a) There is a break in January 2002, as the 2001 baseline begins.

ing this period. Their rate has eased off notably compared with previous quarters, when it exceeded 3%, as a result of the aforementioned recovery in productivity. Consequently, given that the GDP deflator increased in the same period by 2.1%, margins have once again been squeezed, albeit to a lesser extent than in the previous quarter. Box 1 analyses employment and cost developments in the current recovery phase.

As to consumer prices, inflation in the euro area, measured in terms of the 12-month growth rate of the HICP, stood at 2.1%, three-tenths of a point above the figure in June. This was partly in response to transitory factors, such as the rebound in unprocessed food prices, associated with the effects of the bad weather affecting much of Europe late in the summer and with the interruption of the downward trend of the energy component, in the light of heightening tension in the Middle East. Nevertheless, the services component continued to grow at a rate of over 3%, meaning that underlying inflation, measured by the index that excludes energy and fresh food prices, stood at 2.5%. Behind this downward stickiness of the indicator of core inflation remain the delayed effects of the series of adverse disturbances in recent years, the changeover to the euro, tax increases and the high growth of unit labour costs. The HICP increased in all member states in relation to June, with the exception of Ireland, the Netherlands and Finland. As can be seen in the second panel of Chart 10, there are sizable differences in inflation rates across the euro area countries. There is one group of countries whose inflation exceeds 3%, and another in which consumer prices are growing at below 1.5%. As regards producer prices, their decline during the quarter has slowed: in August they posted a rate of –0.2% year-on-year, against a rate of –1% in June, owing to the unfavourable trend of the energy component, as the increase in consumer goods prices held stable.

Inflation in the coming months will depend on the momentum economic activity gathers and on wage developments, and also on oil prices, which will be closely linked to the Iraq conflict. Furthermore, the recent course of the exchange rate may lessen current inflationary pressures.

Turning to the euro area's foreign trade transactions, the trade balance ran a surplus of €71 billion in the January-July period, compared with €32 billion the same period a year earlier, as a result of the favourable export performance. As regards the financial account, net capital outflows relating to direct and port-

BOX 1

Unit labour costs in the euro area in the current cyclical upturn

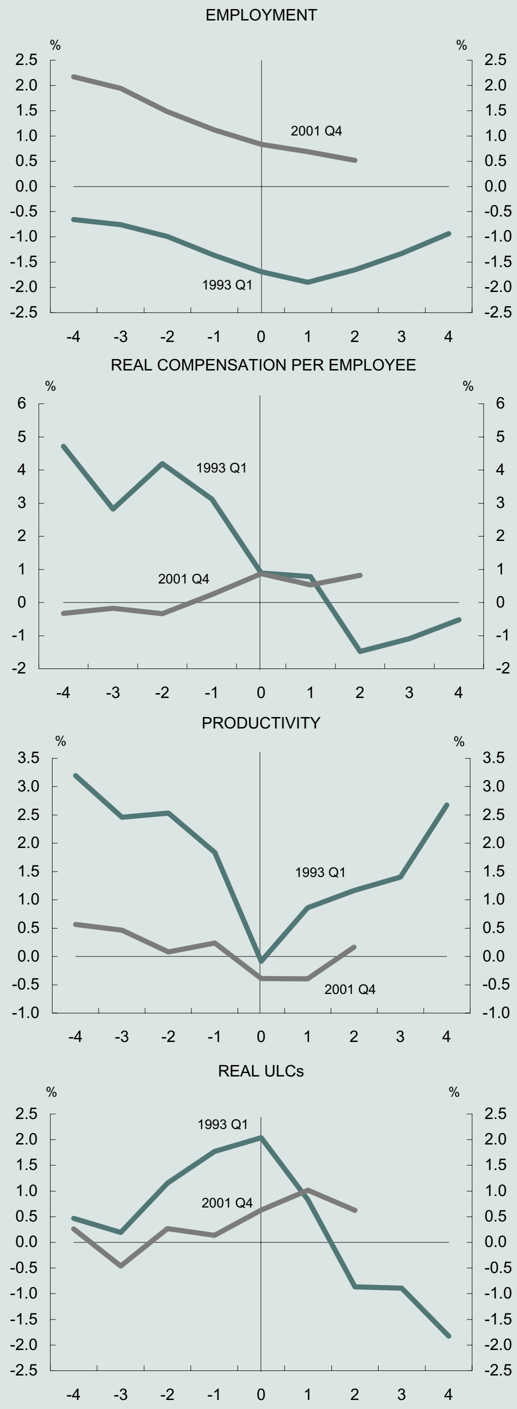
The data available appear to confirm that the cyclical slowdown in activity in the euro area bottomed out in 2001 Q4. The recovery initiated in 2002 is however wavering, judging by the deterioration in certain indicators in recent months. To assess the economic outlook, labour costs, productivity and business margins must be analysed, since the interaction of these variables is one of the main determinants of GDP growth in the medium term.

During the deceleration unfolding at the time of the 1993 cyclical trough, there was intense job destruction in the euro area. Numbers employed fell by around 3% and the unemployment rate increased by two percentage points between 1992 and 1994 to 11%. The increase in productivity was very marked during these years, although it was due above all to the fall in employment, with no genuine gains in efficiency in the use of the labour factor actually observed. Indeed, the scant sensitivity of wages to the slowdown in activity led to a heavy deterioration in margins and prompted the substitution of capital for labour. Only following intense labour shedding was a degree of wage restraint and the rebuilding of margins seen, thanks to the sharp increase in productivity. Thus, wage dynamics meant that employment was the principal adjustment variable, which had unfavourable consequences for private consumption and, generally, for domestic demand.

Conversely, in the recent period of cyclical weakness, the adjustment of the labour market has been confined to a progressive slowdown in job creation, without there having been any net destruction of jobs. As a result, the unemployment rate has risen by scarcely two-tenths of a point to 8.3% over the course of the cycle. The sound performance of employment has been linked, at least partly, to reforms such as the reduction of non-wage labour costs, the progressive introduction of flexible hiring arrangements and the refinement of the incentives for labour market participation adopted in certain countries. However, wage increases –though more moderate than those seen in the early nineties– have proven somewhat excessive, given the scant growth of productivity. This has seen real ULCs post positive and rising rates of expansion over the past year, with the subsequent deterioration in margins, and that may have held back the development of new investment projects.

The as yet incomplete information available for 2002 Q2 points to a correction of these trends, with a certain pick-up in productivity and a slowdown in nominal and real ULCs. However, some doubts remain over wage developments in the coming months since there is a continuing risk that workers will seek to make up for the lower purchasing power gains obtained in recent years as a result of the various transitory shocks (including most notably that of oil) that affected the inflation rate. Departing from the path of wage moderation would naturally have adverse consequences for investment and employment. And this, in short, would pose an obstacle to a sustained recovery in economic activity.

Employment and labour costs in the euro area (a)



Sources: ECB and Eurostat.
(a) Year-on-year rates of change. The period "0" represents the quarters in which GDP was at a cyclical trough, corresponding to 1993 Q1 and 2001 Q4, respectively.

TABLE 1

General government budget balances of euro area countries (a)

% of GDP

	1998	1999	2000	2001	2002 (b)	2002 (c)
Belgium	-0.7	-0.5	0.1	0.3	0.0	-0.1
Germany	-2.2	-1.5	-1.3	-2.8	-2.0	-2.9
Greece	-2.5	-1.9	-0.8	-0.4	0.8	0.8
Spain	-2.7	-1.1	-0.7	-0.1	0.0	0.0
France	-2.7	-1.6	-1.3	-1.5	-1.4	-2.5
Ireland	2.4	2.2	4.4	1.5	0.7	-0.4
Italy	-2.8	-1.8	-1.7	-2.2	-0.5	-2.0
Luxembourg	3.1	3.6	5.6	6.1	2.8	1.0
Netherlands	-0.8	0.7	1.5	0.1	1.0	-0.8
Austria	-2.4	-2.3	-1.9	0.1	0.0	-0.5
Portugal	-2.6	-2.4	-3.3	-4.1	-1.8	-3.6
Finland	1.3	1.9	7.0	4.9	2.6	3.1
MEMORANDUM ITEM:						
Euro area						
Primary balance	2.5	2.9	3.1	2.4	2.7	
Total balance	-2.2	-1.3	-0.9	-1.5	-0.9	-1.9
Public debt	73.5	71.9	69.4	69.2	67.2	

Sources: European Commission, National Stability Programmes and IMF.
(a) As a percentage of GDP. Proceeds from the sale of UMTS licences not included. Deficit (-) / surplus (+).
(b) Targets of the stability programmes presented between November and December 2001.
(c) Forecasts in the IMF World Economic Outlook (September 2002). The methodology underlying these figures may not be fully consistent with the figures presented for the period 1988-2001.

folio investment have fallen notably: from a figure of over €100 billion recorded in the same period a year earlier, they have declined to €6 billion. This composition of the trade balance and the financial account has led to a more balanced trajectory of the basic balance, developments in which are analysed in greater detail in Box 2.

In respect of fiscal policy, there has been a significant deterioration in the budgetary positions of certain Member States, which have overshot the budget deficit targets set in their stability programmes (see Table 1). First, in France, Italy and Portugal, the authorities have raised their deficit targets for the current year considerably, to 2.6%, 2.1% and 2.8% of GDP, respectively. In Portugal, moreover, the budget deficit in 2001 has been revised substantially upwards to 4.1% of GDP. This breach of the deficit ceiling, set at 3% of GDP, has triggered the European Commission's excessive deficit procedure. The German authorities, meanwhile, acknowledge that their budget deficit may exceed 3% in 2002. The delicate budgetary position of these countries in terms of their actual balances, which has arisen owing to their lack of ambition during the period of higher growth, has been exacerbated in the current phase of relatively sluggish activity.

Against this background, the European Commission has put forward an initiative in which it suggests a fiscal policy adjustment path in Member States still showing imbalances. This initiative, which has been backed almost unanimously by the euro area countries, proposes that the States in question should commit themselves to applying a credible budgetary consolidation strategy as from 2003, leading in the medium term to a position close to a balanced budget. The strategy should be underpinned by a detailed specification of the measures that will enable the target to be met and by realistic assumptions on the macroeconomic environment.

In recent weeks, budgets have been unveiled for the coming year in most euro area countries. The French government has set a deficit target of 2.6% for 2003. The French budget responds to some of the priorities formulated by the authorities, such as the increase in military spending and in homeland security and justice, and the reduction – albeit modest – in income tax. The Italian budget envisages a reduction in the deficit to 1.5% of GDP in 2003. The attainment of this target resides on a reduction in transfers to regional and local authorities, the public-sector employment freeze and the extraordinary income derived from a tax

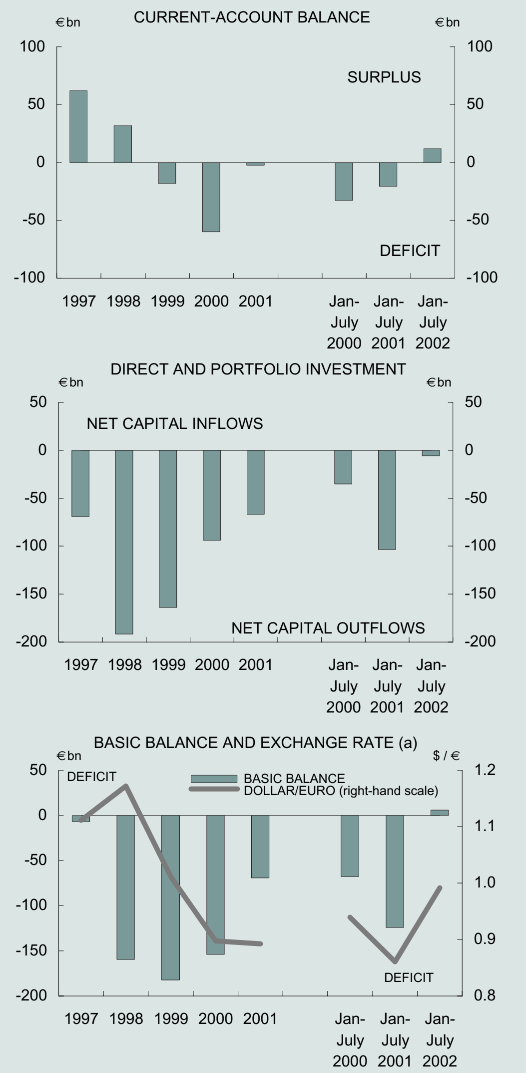
BOX 2

Recent developments in the euro area balance of payments

From the start of Monetary Union to end-2001, the euro area balance of payments posted a combination of current-account deficits with considerable net capital outflows relating to direct and portfolio investment. The sum of this current-account balance and these net capital flows is called the *basic balance*, a concept that allows an approximation to the financing requirements of an economy induced by trade in goods and services and long-term foreign investment. In the three-year period from 1999 to 2001, the cumulative deficit on the euro area current account amounted to €80 billion and net capital outflows relating to direct and portfolio investment were €204 billion and €121 billion, respectively, meaning the basic balance showed a deficit of €405 billion in cumulative terms. The main source of financing of this balance was the foreign indebtedness of euro area Monetary Financial Institutions.

However, as can be seen in the accompanying chart, the balance of payments has undergone significant changes recently. Firstly, the current account was in balance in 2001, and has moved into surplus in 2002 over the period for which information is available (January-July). The main determinant of this improvement has been the trade balance, which has been greatly influenced by the changes in trade volumes and by the terms of trade. In 2001, the effect on the merchandise balance arising from the decline in trade was virtually zero, since it affected both the volume of exports and that of imports, whereas the indicators available for the first half of 2002 have shown greater buoyancy in exports than in imports. Moreover, the terms of trade improved during 2001, showing positive rates of change in the second half of that year and in the first half of 2002 as a result of the lesser growth of import prices compared with export prices. However, this trend may be discontinued owing to the rise in oil prices seen in recent months.

Euro area balance of payments



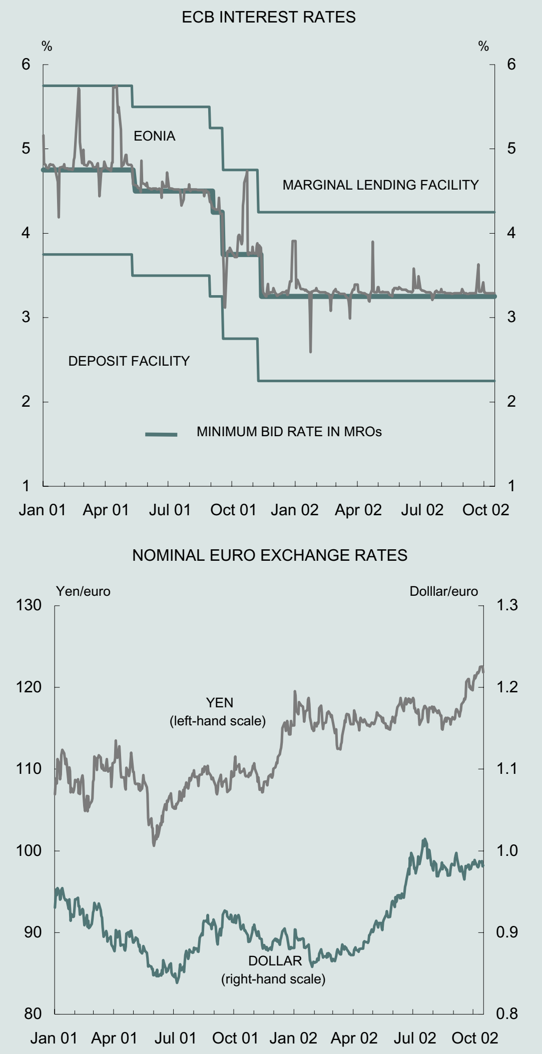
Sources: European Central Bank and Banco de España.
(a) The exchange rate data are the average for the last month of each period considered.

Secondly, net capital outflows via direct and portfolio investment have abated considerably recently. Until the start of 2001, net acquisitions of foreign assets were influenced by the favourable outlook for the US economy which was, in turn, the result of this country's prolonged growth phase, the significant increase in productivity and the surging stock market. Nonetheless, since mid-2001 there has been a reduction in both inflows to and outflows from the euro area, along with a high variability of the direction of these flows in net terms. These movements are set against the background of a bleaker outlook for corporate earnings, greater uncertainty on international financial markets and widespread falls on stock markets, which is also in line with lesser mergers and acquisitions-related activity of foreign corporations. In net terms, the changes in cross-border financial flows have resulted in fewer net capital outflows relating to direct and portfolio investment by the non-resident private sector in 2001 and to date in 2002. And this, along with the results of the current-account balance, has made for a more balanced trajectory of the basic balance.

This performance may partly explain the rising trend of the euro against the dollar in the first half of the current year. Likewise, exchange rate movements may have been conducive to greater net capital inflows into the euro area, insofar as they may have fuelled expectations of further increases in the value of the euro.

CHART 11

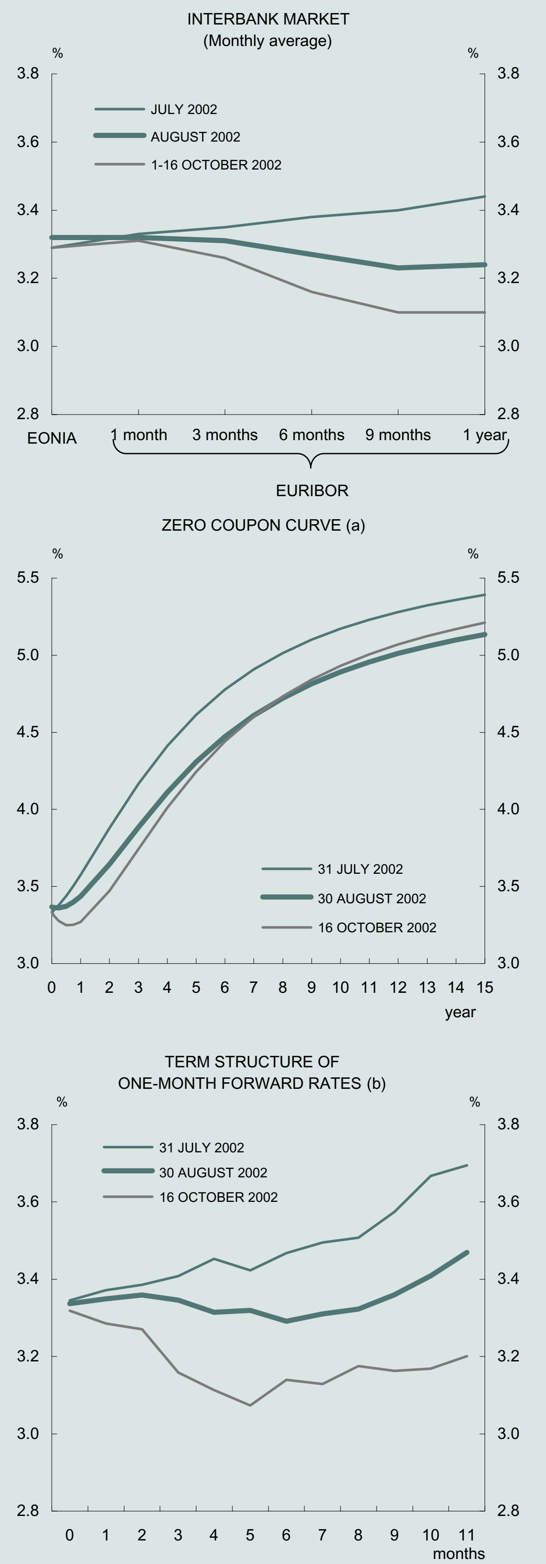
ECB interest rates and euro exchange rates



Sources: Banco de España and European Central Bank.

CHART 12

Euro area yield curve



Sources: Banco de España and European Central Bank.
(a) Estimated using swap market data.
(b) Estimated using Euribor data.

amnesty. At the same time, the budget bill includes a reduction in income tax rates for the lowest-income groups. In Portugal, where the authorities are engaged in real estate assets disposals that will allow them to meet the revised deficit target for this year, the shortfall in public finances will diminish, according to the draft budget, to 2.4% of GDP in 2003. Finally, in Germany, the acting government has announced that reconstruction work following the damage caused by the recent floods will be financed by a temporary increase of 1.5 percentage points in corporate income tax and by deferring the tax reform that was to come into force at the beginning of the coming year. Moreover, the provisional agreement between the coalition parties making up the new government includes various budgetary consolidation measures.

3.2. Monetary and financial developments

Set against the uncertainty over the resilience of the economic recovery and price moderation, with an inflationary outlook conditioned in the short term by international political conflicts, the ECB Governing Council has kept its official interest rates unchanged. Consequently, the rates on the main refinancing operations, on the deposit facility and on the marginal lending facility continue to stand at 3.25%, 2.25% and 4.25%, respectively (see Chart 11).

During Q3 there has been a reduction in interest rates both on the money and banking markets. This may have fuelled the demand for credit, despite the relative weakness of activity. The M3 monetary aggregate continues to show a high growth rate, affected by portfolio shifts toward short-term assets. Nevertheless, the notable decline in stock market prices in the year to date, the increase in risk premia on private debt and the appreciation of the euro have probably more than offset the favourable effects of lower interest rates on the economy's spending. Given the cyclical position of the Spanish economy in relation to the euro area average and its inflation rate, financial conditions remained generous judging, for example, by the more expansionary profile sustained by credit to the private sector.

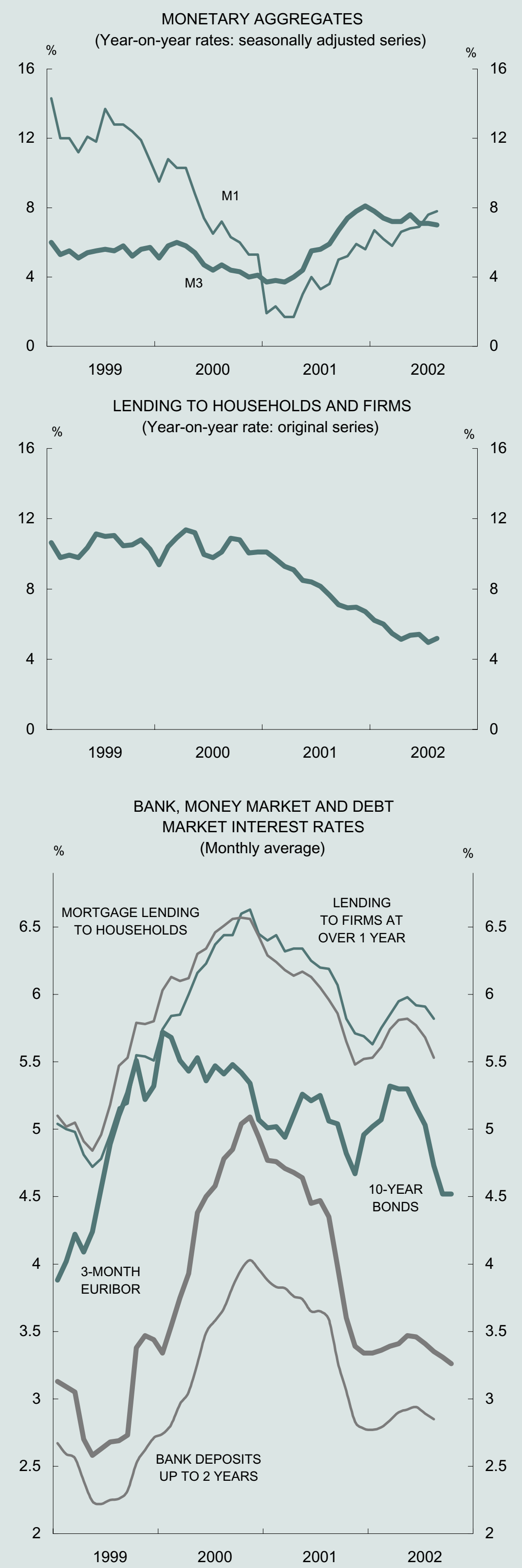
Money market interest rates have been subject to a progressive change in expectations. The upper panel of Chart 12 shows that, as the perception that the recovery in activity would be delayed took hold, there was a reduction in interest rates as from the three-month maturity. This same message is conveyed more firmly and accurately in one-month forward rates; after having forecast an increase at the beginning of the summer, they now envisage lower interest rates for 2003 Q1 (see the lower panel of Chart 12).

Long-term interest rates have also declined over the past three months by approximately half a point. As a result, ten-year government bond yields have stood at around 4.5% in October to date. This downward trajectory has been less marked than in the United States, meaning that the negative differential vis-à-vis the euro area has increased to 80 basis points (bp) (see Table 2). Given that the inflation outlook for both economies does not differ particularly, the justification for these developments is essentially associated with a downward revision of growth prospects, more steeply so in the United States than in Europe.

As can be seen in the bottom panel of Chart 13, the interest rates applied by credit institu-

CHART 13

Monetary and credit aggregates and interest rates in the euro area



Sources: Banco de España and European Central Bank.

TABLE 2

Monetary and financial situation in the euro area and Spain

%

	2000	2001	2002					
	DEC	DEC	MAY	JUN	JUL	AUG	SEP	OCT (a)
MONETARY VARIABLES (b):								
Euro area								
M3	4.0	8.0	7.6	7.1	7.1	7.0	7.4	
M1	5.2	5.5	6.8	6.8	7.6	7.6	8.2	
Credit to private sector	10.1	6.7	5.3	5.4	4.9	5.1	5.1	
SPAIN								
Cash and cash equivalents	4.4	6.8	9.9	10.3	9.5	10.8	9.4	
Other bank liabilities	19.8	8.4	4.0	4.8	5.9	5.3	4.6	
Mutual funds (c)	-27.1	26.2	23.8	23.0	21.5	20.4	18.3	
Financing to the private sector	18.9	15.1	14.5	13.6	13.3	14.2	13.3	
FINANCIAL MARKETS (d):								
EONIA	4.83	3.36	3.31	3.35	3.30	3.29	3.32	3.29
Three-month EURIBOR	4.94	3.35	3.47	3.46	3.41	3.35	3.31	3.26
Public debt								
Euro-area ten-year bond yields	5.07	4.96	5.30	5.17	5.03	4.73	4.52	4.52
US/euro-area ten-year bond spread	0.25	0.16	-0.08	-0.22	-0.35	-0.43	-0.60	-0.80
Spain/Germany ten-year bond spread	0.31	0.23	0.19	0.21	0.20	0.19	0.18	0.16
Bank rates in Spain								
Synthetic deposit rate	3.02	2.22	2.32	2.31	2.30	2.28		
Synthetic lending rate	6.35	4.86	5.08	5.02	5.12	5.11		
USD/EUR exchange rate	0.897	0.892	0.917	0.955	0.992	0.978	0.981	0.984
Equities (e)								
Dow Jones EURO STOXX broad index	-5.9	-19.7	-7.2	-15.2	-26.4	-26.0	-39.1	-33.1
Madrid Stock Exchange General Index	-12.7	-6.4	-1.2	-12.3	-20.5	-18.8	-30.1	-25.2

Sources: European Central Bank and Banco de España.
(a) Monthly average to 16 October 2002.
(b) Annual percentage change.
(c) Include euro-denominated fixed-income FIAMMs and FIMs.
(d) Monthly averages.
(e) Cumulative percentage change during the year. End-of-month data. Latest month: 15 October for the EURO STOXX and 16 October for the Madrid Stock Exchange.

tions also fell in the summer months. Compared with June, the reduction in interest rates has been more pronounced in loans for house purchases (by around 30 bp) than in loans to corporations (10 bp). With respect to deposit rates, banks have also passed through a moderate 10 bp reduction.

On the foreign exchange markets, the euro has held relatively stable following its progressive appreciation during the first half of 2002, moving in a narrow range around $0.98/€1. Against the yen, the European currency has also strengthened over the past quarter by around 3%. Whereas the exchange rate of the euro against the dollar has appreciated by around 10% since the start of the year, the nominal effective exchange rate has done so by around 5%.

The downward trend seen in stock market prices since the start of the year intensified between July and September. In October, however, share prices rose slightly. The fall in prices in Europe (which has been steeper in the year to date than in the United States and in Spain) has, in addition to the revised earnings forecasts for technological firms and mistrust concerning accounting practices, been related to certain specific factors. It thus reflects the difficulties certain major corporations have faced in obtaining returns from their strategic operations, such as mergers or acquisitions, or third-generation mobile telephony licences. Furthermore, the floods that affected much of central Europe last summer have prompted a downward revision of the earnings expectations of insurance companies, whose balance sheets have further been affected by the loss of value of their financial assets. Box 5 analyses in greater detail the differing behaviour of the US, euro area and Spanish stock markets.

The monetary aggregates remained very buoyant during Q3. The M3 measure posted a growth rate of 7.4% year-on-year in September. The continuing resilience of this aggregate is largely due to the persistence of portfolio shifts towards assets included in the definition of M3, as a result of the heightened uncertainty prevailing on financial markets. In addition to cash, sight deposits and negotiable instruments are the components that have grown most sharply in relation to the previous quarter.

Finally, the growth of credit to the resident private sector in the euro area appears to have stabilised at a rate of around 5%. In terms of agents, and with data to Q2, it can be seen that whereas credit to non-financial corporations continued slowing, loans to households picked up slightly. In the case of Spain, credit has held at a relatively high year-on-year growth rate, which exceeded 13% at the end of Q3 (see section 5 of this Report).

4. The Spanish economy

On QNA data, domestic demand in the Spanish economy slowed significantly in 2002 Q2, to a real year-on-year growth rate of 1.6%, from 2.2% in the previous quarter (1). Both consumption (private and public) and stockbuilding contributed to this slowdown. However, the effect on GDP growth was offset by a significant improvement in the contribution from net external demand, so that output continued to grow at a rate of 2%. The data available for Q3 indicate somewhat different results, which must be interpreted in the light of the greater variability displayed by the seasonally adjusted QNA figures, in comparison with the trend-cycle ones (see Chart 14). Growth in domestic demand is estimated to have recovered slightly in Q3, to 1.8%, underpinned by steady growth in household final consumption and a larger contribution from stocks. However, capital investment was contractionary and the notable buoyancy of construction flattened off, with signs of a mild slowdown in quarter-on-quarter terms. Net external demand meanwhile made a slightly negative contribution to growth since, although the recovery in exports that began in the first half strengthened considerably, imports also picked up significantly. In consequence, GDP growth is estimated to have stood at year-on-year rates of close to 1.8% over the summer.

From the standpoint of the value added by the different productive sectors, the year-on-year declines in activity, agriculture and industry steepened in Q2, while growth quickened in construction and market services. The information available for Q3 points to a recovery in the primary sector, further retraction in industry and the appearance of some signs of slowdown in services, which overall would have led to a slight loss of buoyancy in the market economy in that period. Employment, meanwhile, which grew at a more-or-less stable rate of 1.3% to 1.4% in the first half of the year, following its slowdown in 2001, would seem to have held at a similar rate in Q3, although the information for September seems to indicate a somewhat less positive performance for the final part of the year. In any event, apparent labour productivity has been growing very slowly in recent quarters, which shows that the current pattern of growth continues to be accompanied by a high rate of job creation.

QNA estimates show that in the first two quarters of 2002 labour costs per unit of output decelerated slightly. A contributing factor here were the lower wage settlements in the current round of collective bargaining, which is subject to the terms of the Interconfederal Agreement

(1) Rates are calculated on the basis of seasonally adjusted series unless otherwise indicated.

on Collective Bargaining (AINC) signed by the social agents. The prices of imported products also had a moderating impact on final prices, as a result of the favourable trend in oil prices up to August, and of the notable appreciation of the euro from April. However, final prices have grown at high rates, which in the case of consumer prices have been rising, and operating margins have continued to widen. In the coming months imported products can be expected to exert upward pressure on costs, linked to the recent rise in oil prices. Moreover, it is likely that application of the indexation clauses in 2002 collective agreements will have a significant upward impact on wage growth. All this may hamper the return to lower inflation rates, despite the lower demand pressure. The inflation rate, as measured by the year-on-year change in the CPI, reached a high of 3.6% in April and remained at around that level to September.

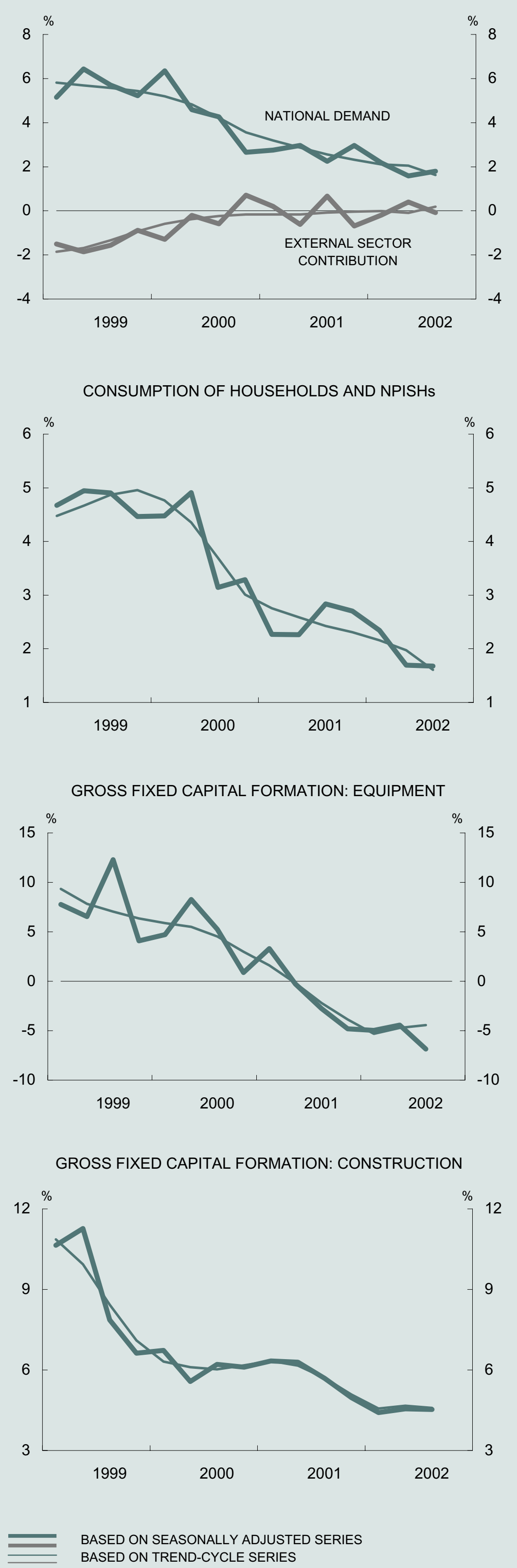
4.1. Demand

In the first half of the current year, the real growth rate of household final consumption expenditure continued to fall, standing at 1.7% year-on-year in Q2. The information available for the latest months shows somewhat disparate signs that would be consistent with a flattening out of the growth rate of consumption in Q3. The sustaining of spending, while confidence has deteriorated rapidly, in an adverse international environment that has worsened the crisis on financial markets, would appear to be based on the strength still retained by employment creation. In any event, consumption is estimated to have moderated by more than disposable income in 2002, giving rise to a pick-up in the household saving ratio.

Among the indicators of household expenditure, apparent consumption of goods and services has displayed an upward trend centred on the goods component, reflecting both the improvement in the domestic production of consumer goods and the upturn in the imports of such goods (see Chart 15). However, other indicators more directly related to spending have performed less positively. The general index of retail sales has slowed somewhat over the year to date and the Spanish Household Expenditure Survey, on data to Q2, has also shown a loss of momentum, as well as a reduction in the percentage of households with a favourable perception of the economic situation. Only in car sales, which were highly contractionary in the first half, has there been some hint of a change in trend in the latest data. Despite its mild recovery in September, the consumer confidence indicator remained at very low levels in Q3, held down by the worsening outlook for the econom-

CHART 14

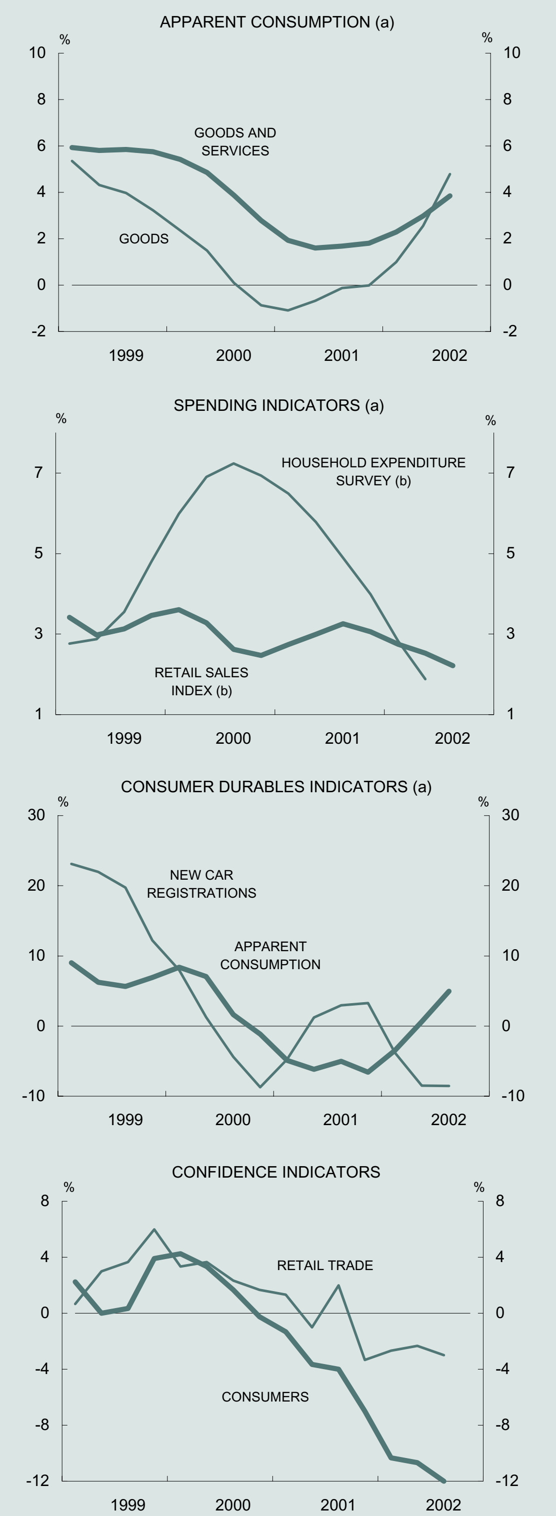
Main demand aggregates
Percentage change on year ago



Sources: INE and Banco de España.

CHART 15

Private consumption indicators



Sources: INE, European Commission, Dirección General de Tráfico and Banco de España.
(a) Non-centred annual percentage change, based on the trend of the indicator.
(b) Deflated by the CPI.

ic situation at the national and household level, although the outlook for unemployment has not worsened to the same extent.

The reduced buoyancy of consumption in the year to date, relative to 2001, is only partly explained by the slowdown in real disposable income available for spending. This slowdown, attributable in part to the higher rate of change in consumer prices, was basically the result of lower growth in compensation per employee and employment combined with more expansionary general government net transfers and other non-wage income. Assessing the effects of changes in the value of wealth is more complex. The fall in stock markets, with the consequent decline in the financial wealth of households, would help to explain the contraction of spending and the increase in saving, but there has also been a significant rise in the value of property which would be exerting an opposite effect. It is possible that financial turmoil has had an additional adverse effect on consumer expectations and their economic outlook, reinforcing the contractionary effect on spending.

In 2002 Q2 general government final consumption grew at a year-on-year rate of 1.5%, in real terms, down 0.3 percentage points from Q1. The information available for Q3, obtained from State revenue and expenditure data, and from the budget plans for the whole year, points to a slight acceleration, without this amounting to a departure from the restraint that has characterised government consumption in recent years.

Gross fixed capital formation grew in real terms by 1.3% year-on-year in 2002 Q2, up 0.2 percentage points on the previous quarter, following a long slowdown. Both investment in capital goods and construction spending helped to check the loss of investor momentum. The former became less contractionary (although it still declined at a year-on-year rate of 4.4%) while construction accelerated by 0.2 percentage points (to 4.6%). Investment in other products, which basically includes spending on services relating to construction, continued to lose momentum during this period. As can be seen in Chart 14, it is estimated that investment in capital goods weakened further in Q3, while construction continued to grow at a high rate.

Although the most recent data on imports of capital goods (and in particular the August data) have shown a recovery, the strong contractionary trend in the domestic production of these goods has not changed, so the indicator of apparent investment in capital goods has been strongly negative (see Chart 16). Some indicators of demand pressure have for several months been recording more favourable data, as is the case of the assessment of order books of capital-goods producers and, to a lesser extent, of industry in general, yet capacity utilisation is clearly below its historical average levels. In sum, there are as yet no signs of a change in the downward path of spending on capital goods.

A significant recovery in productive investment is unlikely to occur without an improvement in economic expectations at the international level and a reduction in global uncertainty. Firms are particularly vulnerable to turmoil on financial markets, which hampers their access to sources of financing, reduces the value of assets potentially available for use as collateral and, via the effect on risk premia, raises the cost of capital. According to the information provided by the Central Balance Sheet Data Office of the Banco de España and the Financial Accounts, the debt ratios of non-financial corporations have increased in recent years, but their debt service burden has not done so to the same extent, owing to the decline in interest rates. Moreover, the returns on firms' ordinary activity remain high. In sum, firms are in a position to reactivate their investment plans, once the uncertainty over the international economic environment has dissipated and capital markets have overcome their current crisis.

Construction investment continued to be the most dynamic component of demand in the first half of 2002 and, on available estimates, also in Q3, when it appears to have grown at a similar rate to Q2. The most up-to-date information supports these estimates: apparent cement consumption increased over the summer months at rates close to those of Q2 and the trend in the employment indicators for the sector has also been sustained, with a slight acceleration in the number of Social Security registrations (see Chart 16). However, the construction confidence indicator has been following a declining trend, which was extended in Q3.

According to ECIC (Construction Industry Survey) data to Q2, the value of work completed by construction firms increased by 5.4%, in real year-on-year terms, almost two percentage points less than in the preceding quarter. Completed civil engineering projects recovered slightly, growing by 4%, as did non-residential building (3%), while residential building, despite its deceleration, continued to be the most dynamic component (it grew by 6.6%). The indicators relating to construction starts appear to confirm an extension of these trends (see Chart 16). In the case of private sector building, the rate of increase in surface area to be built, whether according to the licences granted by lo-

CHART 16

Gross fixed capital formation indicators

Sources: INE, European Commission, Ministerio de Fomento, OFICEMEN, Instituto Nacional de Empleo and Banco de España.

(a) Non-centred percentage change on same quarter a year earlier, based on the trend of the indicator.

(b) Level of original series.

(c) Annual moving averages.

CHART 17

Foreign trade
Percentage change on year ago

Sources: INE, Ministerio de Economía, Ministerio de Hacienda and Banco de España.
(a) QNA data at constant prices.
(b) Trend-cycle deflated series.
(c) Nominal trend-cycle series.

cal councils or to architect association approvals, decreased with respect to 2001 as a whole, although in the case of housing both indicators picked up in 2002 Q2. Government civil engineering tenders grew by 30% over the first seven months of the year, a larger increase than in the same period of 2001, although their course was highly erratic.

As a result, although a slowdown can be projected for construction investment in the coming quarters, its rate of growth will remain high, sustained by the gradual materialisation of public works investment plans and by residential building, which is showing notable resilience. In this respect, property is still an attractive investment option compared to financial assets, owing to expectations of rising prices and the possibilities of entering the rental market. On the other hand, non-residential building remains depressed, in line with private productive investment.

The contribution of stockbuilding to output growth has been highly variable, especially when it is measured using seasonally adjusted series. In 2002 Q2, unlike in the two previous quarters, stockbuilding made no contribution to the year-on-year growth rate of GDP, while its contribution to the quarter-on-quarter rate was very negative. Among the few indicators available, the business survey shows a decline in the level of stocks in Q2, relative to the desired level, which continued in a milder form over the summer months. As a result, it is estimated that the contribution of stockbuilding to GDP growth in Q3 was more neutral, with a recovery in year-on-year terms.

In 2002 Q2 net external demand increased the year-on-year GDP growth rate by 0.4 percentage points, in real terms, having made negative contributions in the previous two quarters. The year-on-year rate of decline in exports of goods and services fell to –1.4%, from –2.5% in the two preceding quarters. The recovery, albeit weaker than expected, in the US and south-east Asian economies in the first half prompted sales to these markets to pick up, but this did not feed through to EU exports. These were affected by the economic stagnation in the EU and by the cumulative competitiveness losses sustained by Spanish products on these markets due to price and cost changes. The slowdown in imports of goods and services intensified in Q2, with a year-on-year fall of 2.5%, the progressive weakening of domestic demand being a contributory factor here. The still incomplete information on 2002 Q3 shows that the improvement in exports continued and a positive rate of change was recorded. Also imports were boosted by the recovery in exports and by the fall in their relative prices, against a background of appreciation of the euro. In all, the contribution of external demand to GDP growth appears to have returned to slightly negative values (see Chart 14).

The year-on-year rate of decline in goods exports, which had reached –4.3% in the final quarter of 2001, fell to –2.5% in 2002 Q2, according to QNA data. Customs data confirm the positive behaviour of merchandise exports, which in July and August increased by 7.6% in real terms, following the declines recorded in the first half (see Chart 17). The continuity of these results, which appear to be in line with the progressive recovery on world markets, could be jeopardised by the continued existence of significant price and cost growth differentials between Spain and its competitor countries, compounded by the appreciation of the euro.

In the first eight months of the year, exports to non-EU countries increased by 1.7% in real terms. This increase, which contrasts with the significant declines recorded since 2001 Q2, reflects the recovery in sales to the US and south-east Asia, as well as the notable buoyancy of those to central and east European countries, while the Japanese and Latin American markets continued to weaken. Meanwhile, real exports to the EU declined by 1.8% between January and August, although the significant slowdown in the first half was followed by a general pick-up in sales to almost all EU countries in July and August. By product group, both sales of consumer manufacturers and non-energy intermediate goods recovered during these months, while exports of equipment continued to fall, despite the more favourable behaviour of sales of transport equipment. Over the first eight months of the year exports of equipment fell by 15.7%, while exports of consumer goods and intermediate goods grew moderately (by 0.9% and 2.9% respectively).

On QNA data, the consumption of non-residents in 2002 Q2 continued to display the weakness seen in the previous quarter, with a year-on-year decline of 4.9%, against a background of notable moderation in global tourist demand. This moderation was prompted by the attacks of 11 September and was prolonged by the world economic slowdown and the consequent deterioration in consumer confidence. The real indicators reflect this negative performance, which was only interrupted in August owing to the summer price offers. Thus, tourists entering Spain at borders increased by 2.3% in the first eight months of the year, following a 10.9% increase in August, and the number of foreign visitors staying in hotels declined by 2.1% over the period. The poor performance of tourism receipts reflects the weakness of the European economy (the main source of tourists visiting Spain), compounded by competition from other Mediterranean countries and shifts in tourist preferences towards shorter stays and closer destinations which can be reached by car. Thus, in the first eight months of 2002 there was a decline in the number of German tourists and a slowdown in British tourists, while numbers of tourists from France and the Netherlands, who tend to prefer staying at campsites, were highly buoyant. Exports of other services continued to grow at a high rate of 9.1% in 2002 Q2, in line with balance of payments information.

Having been extremely slack in the second half of 2001, real goods imports declined sharply in the first two quarters of 2002, as a consequence of the slowdown in final demand and the weakness of industrial output. However, according to customs data, there was a change of course in July and August, when real imports increased by 10.3% year-on-year, partly driven by the recovery of exports and by the appreciation of the euro. By product group, there was a notable pick-up in imports of non-food consumer goods in July and August, especially in the case of their non-durable component, while imports of non-energy intermediate goods were vigorous. Over the whole period January to August the main components of non-energy imports decelerated, with a notable decline in capital goods imports (–8.9%). Imports of consumer goods reflected the negative performance of cars, while imports of non-energy intermediate goods grew at a moderate rate, in line with the weakness of their domestic production. Finally, energy imports were particularly strong in the first half, driven by the sharp reduction in their prices in euro and the need to replace stocks.

Services imports, in real terms, became more contractionary in 2002 Q2, with a year-on-year decline of 3.4%, according to QNA data. Other services declined by 4.2% in the same period, in line with the fall in merchandise imports and the weakness of foreign investment flows, while tourism payments grew by 0.7%, after falling by 1.4% in the previous quarter. However, in the balance payments nominal tourism payments continued to decelerate in Q2, in line with the performance of the consumer confidence indicator.

4.2. Output and employment

As mentioned in the introduction to this chapter, activity in the primary branches was contractionary in the first half of 2002, declining in Q2 by

CHART 18

Gross value added and employment by branch of activity
Percentage change on year ago (a)

Sources: INE and Banco de España.
(a) Seasonally adjusted series. Employment in terms of full-time equivalent jobs.

3.8% year-on-year (see Chart 18). However, in the last few months there has been a recovery in arable output, helped by recent rainfall (not so much the amount as its distribution and timing). In particular, cereal and leguminous crops grew at double-digit rates, and only citrus fruit is expected to show output losses.

The expected recovery in industrial activity has been held back by the subdued international situation and pessimistic expectations regarding the course of domestic demand. Against this background, according to QNA estimates, industrial activity contracted again in 2002 Q2, by 0.8% year-on-year, following the fall of 0.7% in the first three months of the year. Excluding energy gives declines of 2.4% and 2% respectively. As regards Q3, sentiment indicators have improved. This has involved a notable increase in the industrial confidence index, as well as being apparent in the upward trend in expected output. Also Social Security registrations and imports of intermediate goods have picked up. However, the industrial production index (IPI), the basic indicator of industrial activity, again recorded negative rates of change, when corrected for calendar effects, in the period spanning July and August. Among the activities contributing to these poor results were energy production, following its healthy performance in the first half, textiles and clothing, and machinery manufacturing.

The latest QNA figures indicate that the gradual decline in the value added of the construction branch was interrupted in 2002 Q2 by an increase of 0.2 percentage points in its year-on-year growth rate to 4.8%. By contrast, the ECIC has estimated a slowdown in the value of work carried out by the sector in the same period. The loss of momentum was limited to the residential subsector, which in any case continued to grow at high rates. In line with the analysis of construction investment, the most advanced leading indicators suggest that the rate of growth of construction activity in Q3 was more or less steady and that it will now return to the path of gradual slowdown.

In the tertiary sector, the year-on-year growth rate of value added is estimated by the QNA to have picked up to 2.8% in 2002 Q2. That said, growth in the tertiary sector has been following a path of slowdown, in step with the industrial sector and with the moderation of domestic demand. The growth profile of GVA for all services was similar to that of market services activity (see Chart 18). According to the available indicators for the various services activities, the wholesale and retail trade and repairs are the only activities to have shown signs of recovery in Q3, as reflected in the path of Social Security registrations and in a smaller decline in vehicle sales. The poor performance of tourism meant that hotels and restaurants continued to decelerate although, according to the statistics on overnight stays and Social Security registrations, the growth rate tended to flatten out in the summer months. The loss of momentum in real estate, renting and business activities is also reflected in Social Security registrations. This gradual slowdown stems mainly from the unfavourable developments in computer and related activities and in research and development, reflecting the crisis in the IT industry. Finally, growth in transport, storage and information held steady, since the slight pick-up in transport was offset by a loss of momentum in post and telecommunications.

On QNA estimates employment (2) grew by 1.4% year-on-year in 2002 Q2, very close to the rate of the preceding quarter (1.3%), enabling apparent labour productivity to recover slightly to 0.4%, from 0.3% in Q1 and in 2001 on average. This stability in employment growth was confirmed by the Spanish labour force survey (EPA), according to which employment increased by 2.3% in Q2, up 0.1 percentage points on Q1, and by Social Security registrations, which showed steady annual growth of 3% over the first half. Between July and September, employment growth appears to have been similar, according to registrations (which grew by 3.2% in this period) and by the slowdown in registered unemployment. However, the latest figures (for September) for both these variables show a deterioration, which could mean slower employment growth in Q4.

Employment, as measured by the QNA, has grown in line with GVA in the different branches of activity. In 2002 Q2, construction and services, whose GVA accelerated, at least slightly, recorded net job creation, along with greater productivity gains. In construction, the number of workers increased by 3.7%, down 1.2 percentage points on the Q1 rate, and also below that estimated by the EPA. In the tertiary sector as a whole, the rate of net generation of jobs (2.4%) was relatively steady, basically reflecting employment growth in market activities. By contrast, employment fell in agriculture, which sustained a steep decline in GVA, and in industry, although the loss of momentum of output tended to be checked. Apparent labour productivity slowed in both these sectors, and actually fell in industry. In Q3, Social Security registrations (provisional September data) show an extension of the trend referred to above for agriculture, stability of industrial employment and a slight deceleration in services, while in construction this indicator had an accelerating profile, in contrast to the slowdown recorded by the QNA and the EPA in Q2.

Net job creation has been concentrated among dependent employees. On QNA data, their growth rate rose to 2.2% in Q2 (2% in Q1). Meanwhile, the numbers of self-employed continued to decline, at a rate of 2.4% year-on-year. EPA data show that the numbers of employees with permanent contracts and temporary contracts both accelerated in Q2, to growth rates of 3.8% and 1.9%, respectively, so that the proportion of temporary employees held at the same level as in the previous quarter (31.2%), down 0.4 percentage points on the same period a year earlier. The lower incidence of temporary work only benefited male employees. In terms of working hours, the number of full-time employees grew faster than that of part-time employees. Despite the legislative changes introduced in recent years there was still no significant boost to part-time employment and the proportion of part-time employees held at around 8%. In Q2 the number of permanent employees working part-time grew by more than the number of part-time temporary workers (6.7%, as against 1.9%), the proportion of temporary employees being 55.9% for part-time workers, which was lower than in the same period of 2001.

According to the EPA, the labour force accelerated further in 2002 Q2, with year-on-year growth of 3.1%. The rise in the participation rate to 53.8%, up 1.2 percentage points from a year earlier, contributed to this growth. If only the population between the ages of 16 and 64 is considered the participation rate reached 66.9%. The greater buoyancy of the labour force led to an increase in the number of persons unemployed and the rate of unemployment, which stood at 11.1% in Q2, up 0.7 percentage points on the level a year earlier. For their part, the total number of unemployed persons rose by 10.5%, more than in Q1. Registered unemployment had a similar profile, since after growing by 3.5% in Q1, it accelerated to 7.1% in Q2, although it moderated slightly in Q3. By sex, the growth in the rate of unemployment was more moderate among men and, by age group, only the over 45s did not record a fall in their rate of unemployment. Finally, long-term unemployment fell again, to 37% of all the unemployed, as against a rate of 40.5% in 2001 Q2.

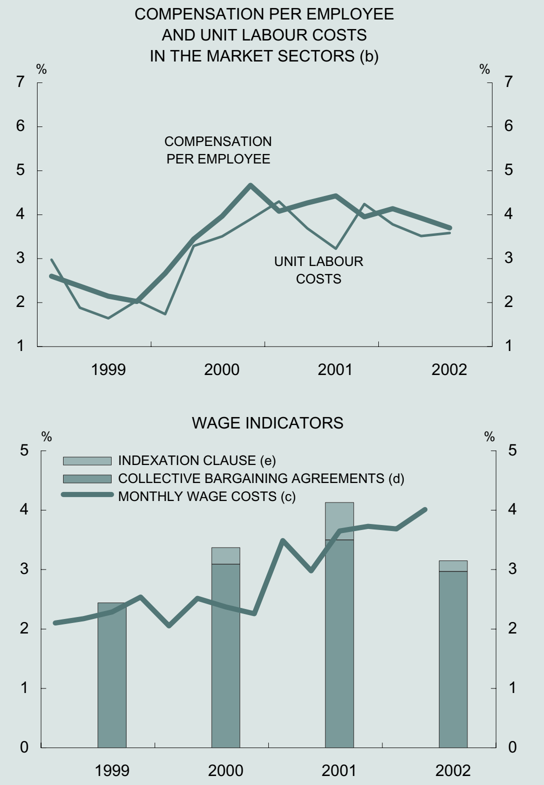
4.3. Costs and prices

The latest QNA data incorporate a revision to the estimates of compensation of employees for 2000 and 2001, and to its distribution be-

(2) Measured in terms of full-time equivalent jobs

CHART 19

Wages and labour costs (a)



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

(a) Percentage change on same quarter a year earlier.
(b) Rates based on QNA seasonally adjusted series.
(c) Total earnings.
(d) Average settlement in the year to date.
(e) Previous year's indexation clause.

tween market and non-market activities. This revision, which has significantly moderated the estimated growth of compensation per employee in the market economy in 2001, bringing it closer to that of the labour cost index, means that the figures for 2002 must be analysed from a different perspective. In particular, the moderation in the first half of the year now seems less pronounced (see Chart 19). As seen in the chart, compensation per employee in market activities increased by 3.9% year-on-year in Q2, down 0.2 percentage points on Q1 and down 0.3 percentage points on the average for 2001. Unit labour costs decelerated somewhat more strongly, owing to the mild recovery in productivity, to stand 3.5% above their level in the previous year. In the economy as a whole, compensation per employee grew by 3.5% in Q2 as a consequence of the more moderate growth in general government compensation.

The slowdown in compensation per employee in 2002 has taken place against a background of lower wage settlements in collective agreements during the year. These have been subject this year to the AINC, under which the social agents have agreed to take the official inflation forecast (2%) as the reference for collective bargaining. According to information from the Ministry of Work and Social Affairs, the average settlement in collective agreements registered to 31 August was 3%, as against 3.5% in 2001 (see Chart 19). The agreements signed up to that date affected some 6 million workers, most of whom were subject to agreements signed in previous years. In fact, the progress made in the negotiation of newly signed agreements up to August was considerably less than in the same period of 2001. The average settlement in these agreements was 4.2%, the trend being one of gradual deceleration. The average settlement in revised agreements, whose registration is practically completed, was 2.8%. That said, 74% of workers have indexation clauses under which their wages will be automatically adjusted if, as is likely, the December inflation rate exceeds the reference rate (see Box 3).

In line with QNA estimates, the labour cost index (ICL) accelerated in 2002 Q2, with total monthly costs per worker increasing by 4.6%, 0.6 percentage points more than in Q1. This acceleration was basically due to the component of non-wage costs, which grew by 6.5%, although wage costs also increased by 4%, 0.3 percentage points more than in Q1. By branch of activity, labour costs in industry rose by 5.1%, 1.4 percentage points more than in Q1, while in services they accelerated by 0.3 percentage points to 4.7%. Finally, in construction, they decelerated by 0.1 percentage point, to rise by 4.5%.

Despite the slower rate of increase in unit labour costs, the value-added deflator for the market economy, which indicates domestic cost pressures, continued to increase at a rate of more than 4% in the first half of 2002, so that unit margins were constantly widening. It can be seen in Chart 20, which shows these variables for the main branches of activity, that the rate of increase of unit labour costs in industry and energy was almost always above that of the deflator, which for its part, was below the rate of increase of the deflators for other branches, in which the degree of competition is lower. As a result there was a systematic contraction of margins in these activities, which limits the possibilities for their recovery, owing to the ongoing loss of competitiveness. On the other hand, despite having decelerated in 2002, the rate of increase in the deflator for market services held above that of costs, enabling the unit surplus to widen further. Finally, in construction, the notable slowdown in unit labour

BOX 3

The effect of indexation clauses in collective bargaining

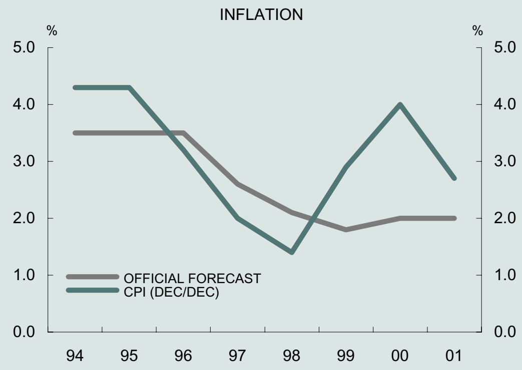
One of the most important aspects of Spanish collective bargaining is the widespread inclusion of indexation clauses in agreements. These clauses guarantee the purchasing power of nominal wages when actual inflation exceeds the reference rate taken in the agreement, and their effect is therefore to adjust wages automatically to past increases in inflation, thereby contributing to the persistence of price increases and hindering a return to more moderate rates of inflation. In the last three years the triggering of these clauses has had significant effects on wage growth (with an average impact of around 0.4 percentage points per annum), and in 2002 the impact may be close to one percentage point.

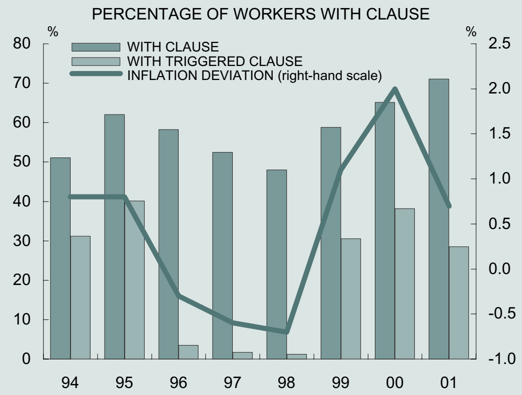
The clauses take various forms and are triggered by different events, although generally they apply when the actual inflation rate exceeds either the rate of increase in prices taken as the reference rate in the agreement (which in many cases coincides with the official inflation forecast), or the wage settlement itself. At the same time, the clauses differ in certain respects, including as regards whether or not there is any limit to the adjustment, whether or not there can be a downward adjustment, whether or not there is a margin above the reference rate within which the clause does not apply, and whether or not its effects are retroactive and/or built in to future wages.

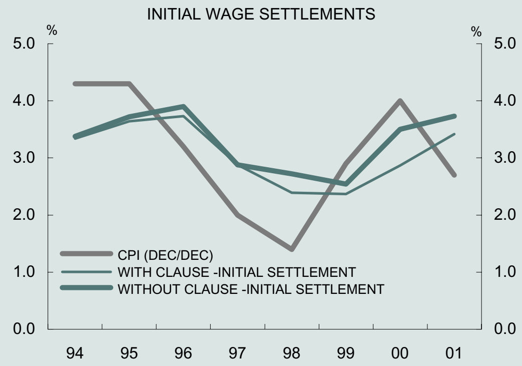
To analyse the effect that these clauses have had on wage dynamics it is helpful to separate agreements into those that contain and those that do not contain the clause and in the case of the former, those in which the clause was triggered and those in which it was not. As can be seen in the second of the adjoining charts, the proportion of workers subject to agreements with indexation clauses changes over time. Specifically, there has been a progressive increase in this proportion over the last three years, associated with the increase in the inflation rate. At the same time, the extent to which these clauses have been triggered has depended on the overshooting of official inflation forecasts. Thus, in those years in which the inflation target was easily met (1996-1998), the proportion of workers with triggered clauses was naturally very small, but it increased rapidly with the appearance of more or less significant overshoots. In any case this proportion is significantly below the percentage of agreements that initially contain clauses: in 2000 these clauses were triggered for only 38% of workers, as against 65% of workers who had such clauses in their agreements, while in 2001 these proportions were 28% and 71% respectively.

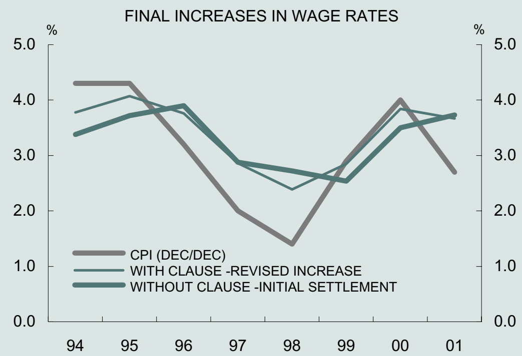
As seen in the charts, in the last few years, when inflationary pressures have increased, the initial wage settlements in agreements with clauses have been lower than those in agreements without clauses. The clauses have therefore been used as insurance enabling relatively moderate wage increases to be agreed, despite the upside risks to inflation. However, when actual inflation has ended up exceeding the official forecast and the indexation clauses have been applied, the increases in wage rates, having incorporated the adjustments, have been larger than those in agreements without these clauses, and very close to or higher than the actual rate of inflation. In agreements without indexation clauses wages have also been adjusted to deviations from inflation targets, but the adjustment has occurred with a lag, through the following years' agreements.

In short, the automatic nature of indexation clauses means that – even if moderate rates of increase in prices are taken as reference and the initial wage settlements reflect them – any increase in inflation, even if temporary, is recovered through a higher wage increase, often with retroactive effects. Thus, price accelerations, irrespective of their origin, are passed on in the form of larger wage increases, which introduces inertia into price formation and hinders the return to low inflation rates. Moreover, downward adjustments, when the actual inflation rate is lower than forecast, are rarely seen. By contrast, the reaction of wages agreed in agreements without indexation clauses to deviations from inflation targets is not automatic, which may ease their adaptation to changes in the macroeconomic setting.





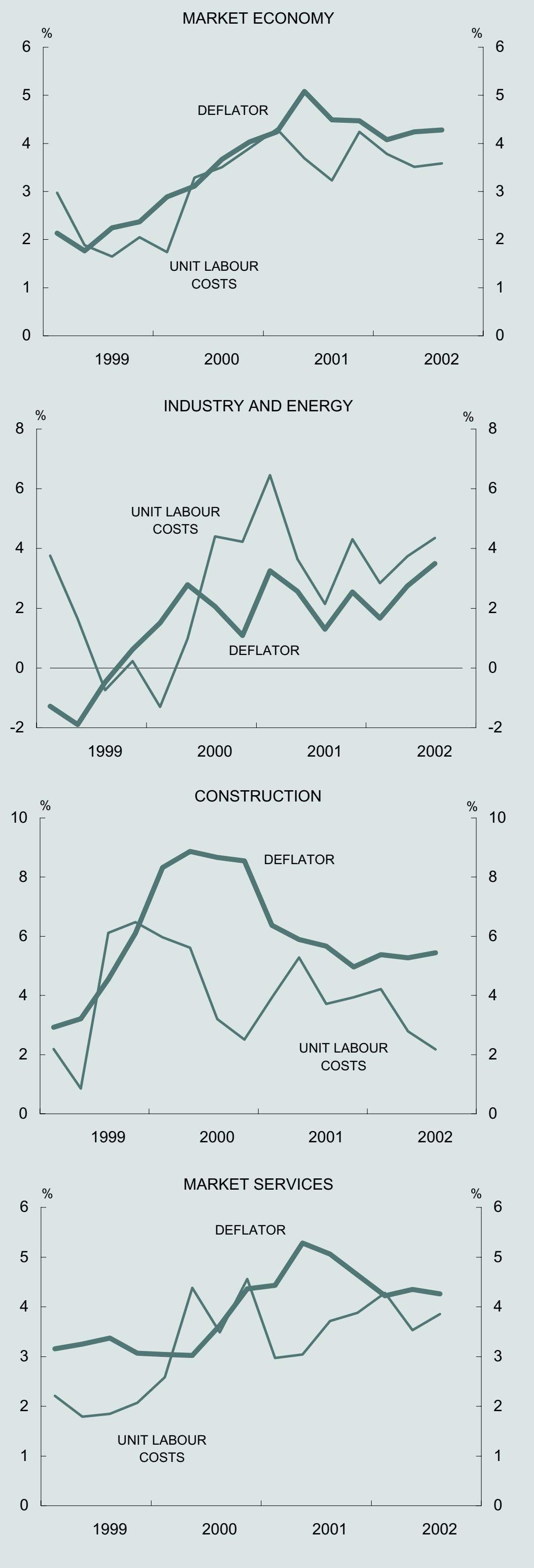




Sources: Ministerio de Trabajo y Asuntos Sociales, INE and Banco de España.

CHART 20

Prices and costs by branch of activity (a)



Sources: INE and Banco de España.
(a) Non-centred annual percentage changes based on the QNA seasonally adjusted series.

costs, along with the mild moderation in the deflator, led to a significant widening of the unit surplus in the first half of the year, in line with the recent period of expansion of this activity.

Import costs, as measured by the imports deflator helped to moderate the rate of increase in final prices in the economy during the first half of the year. Having fallen by 0.9% in Q1, import prices fell by 0.1% in Q2. This behaviour stemmed from the favourable developments in international prices, in particular those for energy and commodities, although the latter accelerated significantly during the summer months. The impact of these increases was smoothed by the appreciation of the euro in the spring. Overall, the final demand deflator increased by 3% year-on-year in Q2, having risen by 2.7% in Q1. Similar increases, in any event below those of the GVA deflator, are estimated for Q3.

In 2002 Q2, the CPI, the main indicator of final prices in the Spanish economy, accelerated to a year-on-year rate of increase of 3.5% (3.4% in June), that held unchanged in Q3 (see Chart 21). For its part, the IPSEBENE (the index of non-energy processed goods and services prices; a common measure of underlying inflation) increased by 4% on average in Q2, thereafter moderating to a rate of increase of 3.5% at the end of Q3, which was similar to that of the CPI. Perhaps the most notable development in the components of the CPI in the summer months was the deceleration in the prices of non-energy industrial goods and processed food, which explains the behaviour of the IPSEBENE. In the case of non-energy industrial goods prices, the slowdown seems to be linked to the impact of special offers and sales, which are included for the first year in the index, adding uncertainty to its future course. Also notable was the acceleration in energy prices which were increasing at a positive rate of 0.9% at the end of Q3, after falling by 2.2% in Q2. These rates reflect a base effect, arising from the sharp falls of a year earlier, and also the rise in oil prices referred to above. Meanwhile, unprocessed food prices rose significantly in Q3, primarily on account of the larger increases in meat and fish prices. In the case of service prices, whose rate of increase held at 4.7% in the summer months, prices for services relating to tourism and hotels and restaurants were restrained, showing the reduced buoyancy of tourist demand, although they remained at year-on-year rates of around 6%.

The year-on-year rate of increase in the harmonised index of consumer prices (HICP) stood at 3.5% at the end of Q3, making the inflation differential vis-à-vis the euro area 1.4 percentage points, which is above the average for recent years. As seen in Chart 22, there were particularly large differentials at the end of the quarter in food prices, following their sharp increase in the first half of the year and in service prices. In the case of energy, the differential also widened over the summer months, while it tended to narrow in the case of non-energy industrial goods, owing to the moderation of the consumer prices for these goods in Spain (see Chart 22).

Finally, the producer price index held relatively steady between June and August (see Chart 21). The year-on-year rate of increase in the producer prices of food consumer goods slowed by almost one percentage point. The producer prices of capital goods also slowed, but to a lesser extent. The prices of intermediate goods, on the other hand, especially energy, accelerated significantly. However, the producer price inflation differential vis-à-vis the euro area narrowed during these months

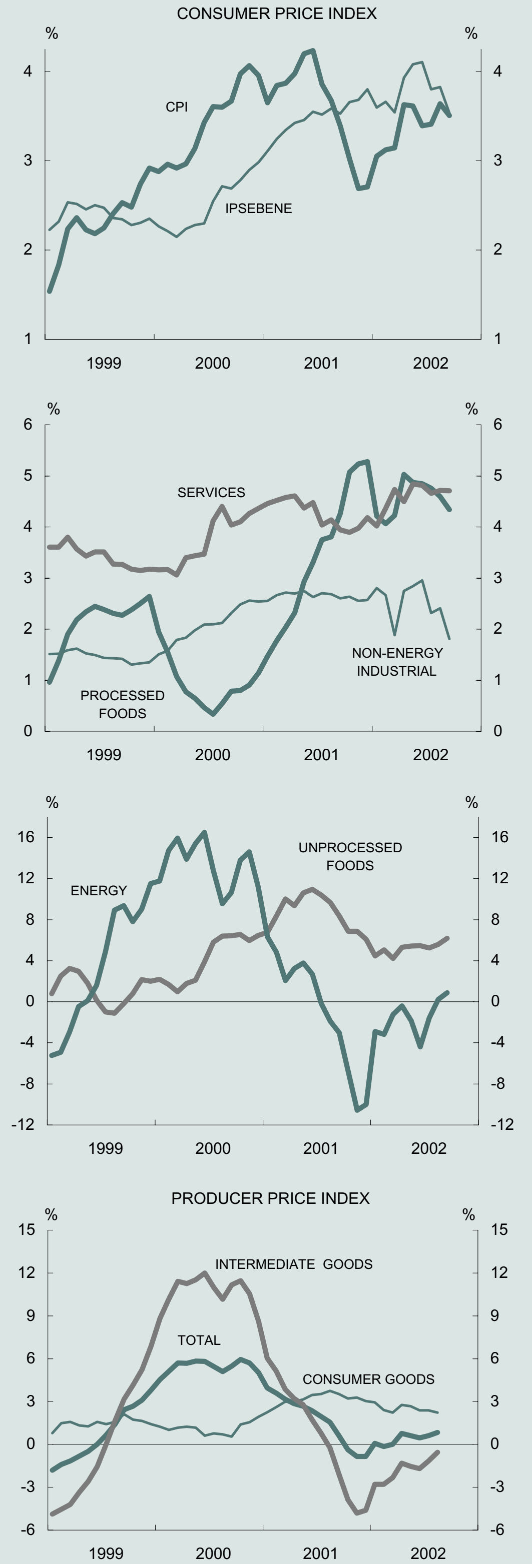
4.4. The State budget

The draft State budget for 2003, currently before Parliament, is the first to have been drawn up under the guidelines of the Budgetary Stability Law. Following the procedure established by that law, Parliament, in the first four months of the year, set a budgetary stability target for general government as a whole and for each of its agents for the period 2003-2005, as well as the limit on State expenditure for 2003. Against this background, it is estimated in the draft budget that, in national accounts terms, general government non-financial transactions will be in balance in 2003. The draft budget has taken into account the entry into force next year of the personal income tax reform, which it is estimated will have a revenue impact of 0.5 percentage points of GDP, and the full operation of the new system of regional government financing, which is being gradually introduced over the course of this year. As for 2002, the closure of the general government account also means the achievement of budget balance. By agent, the State will record a deficit of 0.5 percentage points of GDP, which will be offset by a Social Security System surplus of the same amount (see Box 4 for information on the budget outturn of this agent), while regional and local government finances will be in balance, meeting the targets set in the last Stability Programme Update.

The draft State budget also incorporates the initial projection of State revenues and expenditure, in cash terms, for 2002 (see columns 3 and 4 of Table 3). According to this projection, the State will raise and spend around 5% less

CHART 21

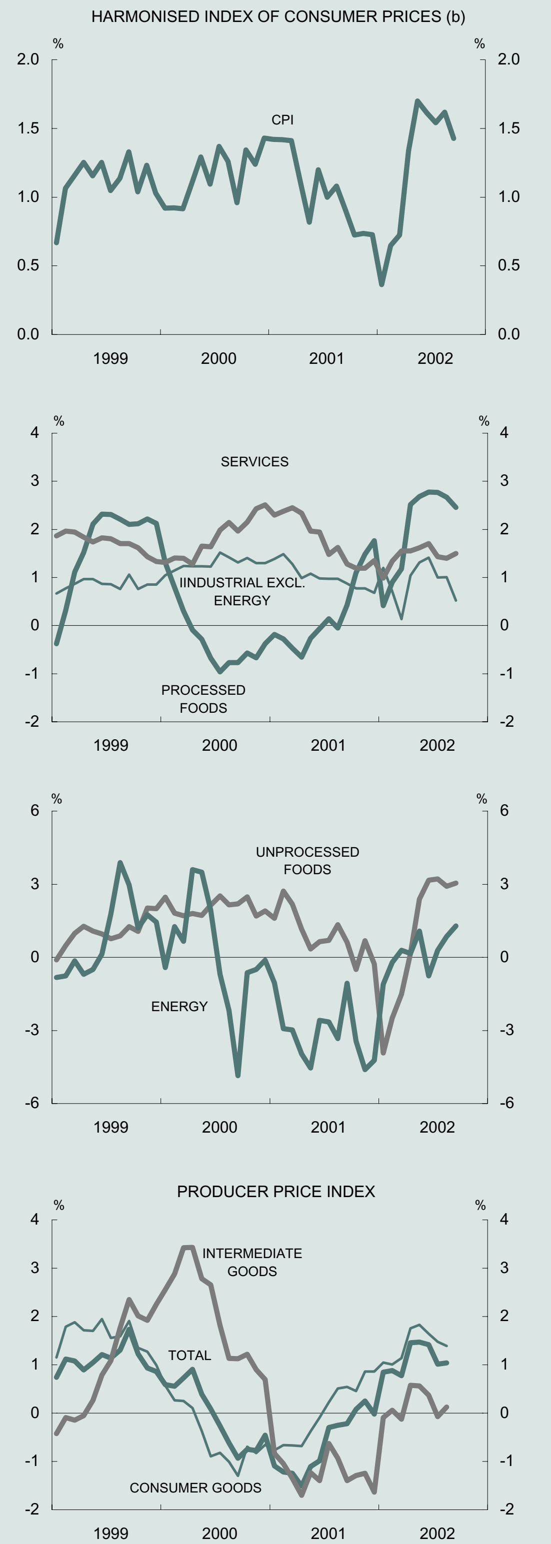
Price indicators (a)
Spain



Source: INE.
(a) Twelve-month percentage change based on the original series.

CHART 22

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



Sources: Eurostat and Banco de España.
(a) Twelve-month percentage change based on the original series.
(b) To December 2001, the series are those published at that date.

than initially budgeted, so that the cash deficit will be practically the same as budgeted. However, it should be noted that a significant part of this deviation is due to the fact that the 2002 Budget only partially incorporated the effects on revenue and expenditure of the new regional government financing arrangements, while the initial projection takes them fully into account, given that the assumption of health responsibilities by all the regional governments has been completed and the new Financing System has therefore been approved. In comparison with the budget outturn figures to September, which are discussed below, the initial projection entails a strengthening of the rates of decline of revenue and expenditure, which will be particularly notable in the case of revenues (3).

In cash terms, meanwhile, the State budget outturn to September was a deficit of € 6,606 million, 33.4% less than that recorded in the same period a year earlier. The improvement in the deficit over the summer months was attributable to the recovery in revenue, its rate of decline falling to 12.5% (from 16.7% in the first half), and, to a lesser extent, to the acceleration in the rate of decline of expenditure to 14.6%.

For the purpose of analysing revenue developments, information is available on the total receipts from the main taxes, both the share assigned to the State and that corresponding to other general government agents, which is not shown in Table 3. The figures for total receipts indicate that direct taxes accelerated significantly in Q3, in contrast to indirect taxes. In both cases, this reflects the behaviour of the main taxes. Personal income tax receipts rose by 7.1% to September, in contrast to the decline of 5.8% in the first half of the year, although this decline was mainly due to changes in the collection timetable in 2002, which delayed the receipt of a large part of the net tax payable to the third quarter of the year (from the second quarter of the previous year). Corporate income tax receipts, for their part, accelerated significantly (to 19%), owing to the exceptional revenues linked to the use by some of the firms of transitional provision three of the Law accompanying the 2002 Budget, which gives firms incentives to include extraordinary profits pending declaration in their tax base for 2002. By contrast, VAT slowed during Q3 to a rate of 7.4%, from 9.5% in the first half, while the rate of increase of excise duties also fell. Finally, the rate of growth of other net revenue accelerated

(3) After this bulletin had gone to press data were received for the State budget outturn to September, in national accounts terms, showing a surplus of € 1,313 million (0.2% of GDP), as against a deficit of € 4,097 million (-0.6% of GDP) in the same period of 2001.

BOX 4

Social Security budget outturn

According to budget outturn data, the Social Security System posted a surplus of €5,138 million in the period to July 2002, €594 million (10.4%) down on that recorded in the same period of the previous year (see the table below) This decline in the surplus to July was less sharp than projected in the initial 2002 budget in relation to the outturn for 2001 and than that recorded to April. As in the case of the State Budget, these data are affected by the new regional financing arrangements, which entail a reduction in both receipts (owing to the transfers INSALUD – the Spanish national health service – receives from the State) and expenditure (owing to the transfers to finance the health-care and social services assumed). In the period to July, these reductions proved much higher than those projected in the Budget, although they were somewhat less sharp than those recorded in the first four months of the year.

Receipts from social security contributions grew by 5.6% to July, a considerable slowdown in relation to 2001, partly due to the lower growth in the number of Social Security registrations, which was 3.1% to September (3.9% in 2001 as a whole). This rate of growth of contributions in the first seven months of 2002, although much higher than budgeted, in comparison with the outturn of the previous year, is in line with the official outturn estimates for the year as a whole (1). The other main source of receipts, namely current transfers, virtually all of which are from the State, fell by 72.7% to July (more sharply than budgeted) as a result of the new regional government financing arrangements.

Expenditure on contributory pensions grew by only 3.6% to July, which may be due to the different criterion for time allocation, with respect to July 2001, which will be corrected in August. However, its rate of growth in the first half, at 5.2%, is in line with both that of the outturn for the first four months and the budgeted rate for the year as a whole. The number of contributory pensions continues to trend very moderately. Their growth rate in the period to July was 0.8%, in line with forecasts and slightly below the growth recorded in 2001. Spending on sick pay, meanwhile, grew at a rate of 12.3%, in contrast to the fall projected in the budget.

With regard to INEM (National Employment Office) expenditure, that on unemployment benefits slowed significantly in September, although it is still growing at a very high rate of 11.2% (11% in 2001). Behind this behaviour were the increase in registered unemployment (7.2% to September, against 0.1% in 2001) and the rise in the eligibility ratio, which stood at 72.6% in August, as against 68.5% at end-2001. As a result, the number of beneficiaries grew by 13.2% to August, compared with 5.9% average growth in 2001.

Contributions received by INEM rose by 5.1% to June, against a budgeted projection of 9.4%, while employment-promoting concessions on employers' contributions were up 5.5% to May, in line with projections.

(1) The draft 2003 Social Security Budget estimates an increase of 6.1% in regular contributions to the general regime for the whole of 2002.

Social Security System (a)
(Transfers to regional governments allocated) (b)
(Current and capital transactions, in terms of recognised entitlements and obligations)

Basis points

	Outturn	Budget		Outturn JAN-APR	Outturn JAN-JUL		
	2001	2002	% change	% change	2001	2002	% change
	1	2	3=2/1	4	5	6	7=6/5
Revenue	**100,265**	**83,282**	**-16.94**	**-23.7**	**59,871**	**46,768**	**-21.9**
Social security contributions (c)	67,350	67,852	0.75	5.5	38,697	40,874	5.6
Current transfers	31,383	14,389	-54.15	-73.5	20,313	5,551	-72.7
Other (d)	1,533	1,042	-32.02	-48.2	861	343	-60.1
Expenditure	**93,941**	**79,411**	**-15.47**	**-24.6**	**54,139**	**41,630**	**-23.1**
Wages and salaries	14,545	6,683	-54.05	-69.4	8,806	2,433	-72.4
Goods and services	9,188	4,214	-54.14	-75.6	5,330	1,355	-74.6
Current transfers	68,784	67,615	-1.70	-4.6	39,426	37,684	-4.4
Benefits	68,326	67,615	-1.04	-4.4	39,379	37,683	-4.3
Contributory pensions	*53,375*	*56,231*	*5.35*	*5.4*	*30,619*	*31,736*	*3.6*
Sickness	*4,278*	*4,027*	*-5.88*	*3.4*	*2,204*	*2,475*	*12.3*
Other	*10,673*	*7,358*	*-31.06*	*-46.0*	*6,555*	*3,472*	*-47.0*
Other current transfers	457	0	-100.00	-98.7	48	1	-98.4
Other (e)	1,424	899	-36.86	-76.3	576	158	-72.5
Balance	**6,324**	**3,871**	**-38.79**	**-19.8**	**5,732**	**5,138**	**-10.4**

Sources : Ministerio de Hacienda, Ministerio de Trabajo y Asuntos Sociales and Banco de España.
(a) Only data relating to the System, not to the entire Social Security Funds sector, are given. This is because the figures for Other Social Security Funds are only available for 2002.
(b) Transfers to regional (autonomous) governments to finance the health-care and social-services responsibilities they have assumed have been distributed among the various expenditure captions on the basis of the percentages resulting from the general government accounts for 1997.
(c) Including surcharges and fines.
(d) Excluding surcharges and fines.
(e) Reduced by the disposal of investments.

TABLE 3

State Budget outturn

€ millions and %

	Outturn 2001	Percentage change 2001/2000	Budget 2002	Percentage change 2002/2001	Outturn JAN-JUN Percentage change 2002/2001	Outturn 2001 JAN-SEP	Outturn 2002 JAN-SEP	Outturn Percentage change
	1	2	3	4=3/1	5	6	7	8=7/6
1. Revenue	**125,187**	**5.5**	**104,953**	**-16.2**	**-16.7**	**86,081**	**75,358**	**-12.5**
Direct taxes	55,697	8.3	53,999	-3.0	-20.2	38,013	36,267	-4.6
Personal income tax	*36,469*	*13.4*	*32,464*	*-11.0*	*-25.8*	*25,321*	*21,900*	*-13.5*
Corporate income tax	*17,217*	*0.1*	*19,703*	*14.4*	*6.8*	*10,900*	*12,974*	*19.0*
Other (a)	*2,012*	*-3.0*	*1,832*	*-9.0*	*-17.7*	*1,792*	*1,393*	*-22.3*
Indirect taxes	53,157	3.7	37,276	-29.9	-20.3	39,752	29,412	-26.0
VAT	*34,674*	*3.8*	*24,977*	*-28.0*	*-15.2*	*25,905*	*20,069*	*-22.5*
Excise duties	*16,612*	*3.5*	*10,333*	*-37.8*	*-34.9*	*12,444*	*7,874*	*-36.7*
Other (b)	*1,871*	*2.5*	*1,966*	*5.1*	*4.1*	*1,403*	*1,469*	*4.7*
Other net revenue	16,333	2.1	13,678	-16.3	12.9	8,316	9,679	16.4
2. Expenditure (c)	**128,072**	**5.7**	**108,602**	**-15.2**	**-14.0**	**95,994**	**81,964**	**-14.6**
Wages	16,827	3.5	17,643	4.8	2.9	12,204	12,650	3.7
Goods and services	2,554	7.7	2,680	4.9	-2.5	1,733	1,799	3.8
Interest payments	18,264	3.1	19,070	4.4	-12.4	16,601	16,018	-3.5
Current transfers	77,151	5.9	57,038	-26.1	-20.4	57,040	42,838	-24.9
Investment	6,461	7.1	6,263	-3.1	-2.0	4,058	4,493	10.7
Capital transfers	6,815	15.2	5,908	-13.3	-4.1	4,358	4,166	-4.4
3. Cash basis balance (3=1–2)	**-2,884**	**18.7**	**-3,649**	**26.5**	**5.8**	**-9,913**	**-6,607**	**-33.4**
MEMORANDUM ITEM: NATIONAL ACCOUNTS:								
Revenue	126,611	6.1	107,808	-14.9	-15.2	87,296	77,999	-10.6
Expenditure	129,945	4.6	111,288	-14.4	-16.5	91,393	76,686	-16.1
Net lending (+) or borrowing (–)	**-3,334**	**-31.8**	**-3,480**	**4.4**	**-36.7**	**-4,097**	**1,313**	**—**

Source: Ministerio de Hacienda.
(a) Includes the revenue from the tax on the income for non-residents.
(b) Includes taxes on insurance premiums and tariffs.
(c) Includes unclassified expenditure.

slightly in Q3 to 16.4%. In comparison with these figures the initial projection for the whole of the year entails a further slowdown in VAT receipts and, above all, a sharp deceleration in other net revenue in the final part of the year, which affects practically all the items included under this heading.

On the expenditure side, almost all the headings recorded an acceleration in the last quarter, except transfers. That said, operating costs (personnel and goods and services) still displayed notable moderation, with growth of less than nominal GDP. Interest payments, meanwhile, continued to show negative rates of change, although they followed an accelerating path determined by the schedule of public debt maturities. As regards investment, it accelerated significantly to grow by 10.7%, having fallen by 2% in the first half. As for transfer payments, there was an increase in the rate of decline of both current and capital transfers. In general, the initial projection confirms the trends described in connection with the budget outturn, with the exception of investment and capital transfers which, according to the projection, will slow drastically in the final months of the year.

4.5. The Spanish balance of payments and capital account

In the period January-July 2002, the current and capital accounts of the balance of payments ran a combined deficit of € 3,749 million, as against a deficit of € 4,793 million in the same period of the previous year. This significant improvement of around € 1,045 million is basically explained by the favourable trend in the current-account deficit, stemming from a notable decline in the trade deficit and an increase in the current transfers surplus, since the services and income accounts deteriorated. The capital-account surplus increased moderately.

In the first seven months of the year, the cumulative trade deficit improved by € 1,988 million from its level in the same period of 2001. This 10.4% reduction was larger than that for the whole of 2001 (–6.7%). The strong improvement in the terms of trade against a background of appreciation of the euro, along with the slowdown in real imports during the period, prompted a notable correction in the goods trade imbalance.

As for services, there was a surplus in the period January-July of € 14,560 million, as against € 15,151 million in the same period of 2001, which amounts to a reduction of 3.9%. These results reflect the smaller tourism and travel surplus (–7.1%), since the deficit on other services fell by 31%. The slowdown in tourist flows steepened in this period, especially in the case of receipts, which fell by 5.1%, in line with the slackness of foreign tourist arrivals in the first seven months of the year, influenced by the weakness of consumer confidence and the shift from foreign to domestic tourism, against a background of international instability.

The deterioration in the income account intensified considerably in the period January-July, with a deficit of € 7,718 million, which was € 703 million higher than in the same period of 2001. Receipts declined by 11.2%, owing to the reduction in flows of investment abroad since 2001, given the weakness of the world economy and the increase in uncertainty in financial markets, aggravated by the crisis in certain Latin American countries. Payments also fell in this period, although at a slower rate (–3.9%). They were also influenced by the weakness of foreign investment in Spain in 2001. In 2002, although flows of direct investment are still falling, there has been an increase in flows of portfolio investment and short-term deposits.

The current transfers surplus stood at € 2,174 million in the period January-July, up € 170 million on the same period a year earlier. Receipts rose by 1.6%, despite the decline in flows from the EU under the EAGGF Guarantee Section and, to a lesser extent, the European Social Fund, since in the previous year there had been significant payments on account of the New Programming period 2000-2006. Meanwhile, payments dipped slightly (–0.3%), although there was a further notable increase in emigrants' remittances.

Finally, the surplus on capital account stood at € 4,343 million in the period January-July, up € 181 million on the same period of 2001. In terms of year-on-year rates, the rise was 4.3%. It stemmed from the notable increase in flows from the EU, specifically from the Cohesion Fund and, to a lesser extent, from the EAGGF Guidance Section, while those from the ERDF, also affected by the payments made during the previous year on account of the New Programming period 2000-2006, decreased slightly.

TABLE 4

Balance of payments: summary table (a)

€ m

	JAN-JUL 2001	JAN-JUL 2002
	RECEIPTS	
Current account	**138,521**	**135,735**
Goods	79,056	77,471
Services	36,926	37,065
Tourism	*20,888*	*19,815*
Other services	*16,038*	*17,250*
Income	13,223	11,737
Current transfers	9,316	9,462
Capital account	**4,755**	**4,940**
	PAYMENTS	
Current account	**147,477**	**143,826**
Goods	98,152	94,579
Services	21,775	22,504
Tourism	*3,709*	*3,856*
Other services	*18,066*	*18,648*
Income	20,239	19,455
Current transfers	7,311	7,288
Capital account	**593**	**596**
	BALANCE	
Current account	**-8,956**	**-8,092**
Goods	-19,095	-17,108
Services	15,151	14,560
Tourism	*17,179*	*15,959*
Other services	*-2,028*	*-1,399*
Income	-7,016	-7,718
Current transfers	2,004	2,174
Capital account	**4,162**	**4,343**

Source: Banco de España.
(a) First provisional results.

5. Financial flows in the Spanish economy

5.1. Overview

In 2002 Q2, against a backdrop of relatively sluggish economic activity, uncertainty over the recovery in the world economy and the worsening crisis in certain Latin American countries, national stock markets (influenced as well by investor mistrust following fresh instances of accounting irregularities at US corporations emerging) saw prices fall moderately. As a result, in the first half of the year there were cumulative losses on the Madrid Stock Exchange General Index of 12.3%. However, it was during Q3 when, further to some of the aforementioned features worsening, and given the fears of war in Iraq, instability on financial markets heightened. This led to an increase in price volatility up to the levels recorded following the September 11th terrorist attacks. Moreover, the losses on the Madrid Stock Exchange General Index during Q3 amounted to 20.3%, although there has been something of a rally in October. Nonetheless, the Spanish stock market has performed less unfavourably than its European counterparts on average (see Box 5).

In these circumstances, financing to the non-financial private sector (particularly that extended by resident credit institutions) continued to grow at a high rate during Q2. In the case of households, there was even a slight acceleration in the rate of expansion of credit. Specifically, loans by resident credit institutions to households increased by 13.8% year-on-year during Q2, against 13.3% the previous quarter. In the case of non-financial corporations, this growth rate, though slowing somewhat, has remained considerable given the cyclical position of the Spanish economy. Moreover, the provisional data for Q3 do not point to a significant moderation of financing to the private sector.

In step with the trend of financing, the net financial saving of the private sector has not picked up so far this year. This development, unlike previous economic slowdowns, has cushioned against the intensity of the slowdown in activity in our economy. Against this, however, the debt ratios of non-financial corporations and of households have increased significantly. This is all leading to a heightened degree of exposure of the non-financial private sector to potential shocks that may adversely affect their wealth, their income or the cost of refinancing their debt.

During 2002 Q2, in line with developments the previous quarter and with the trend observed throughout 2001, the debit balance of the nation’s net financial transactions fell slightly to 1.8% of GDP in cumulative four-quarter

BOX 5

A comparative sectoral analysis of the recent decline in stock market prices

As at October 14th, equity prices on Spanish markets, measured by the Madrid Stock Exchange General Index, had lost 27.5% of their value at the start of the year. This change is similar to that recorded over the same period by the S&P 500 (27.2%), which groups US listed companies, and is lower than the reduction in the Euro Stoxx (36.4%), comprising the prices of listed euro area companies. These declines are not distributed uniformly across the different sectors making up the indices, a fact apparent in the accompanying table, which lists 13 groupings in terms of sectoral activities.

As has been the case since March 2000, when the main indices peaked, the sectors showing the worst performances in respect of prices were those relating to technology, telecommunications and the media. In addition to these, other companies faring particularly badly in the year to date have been utilities, banks (Spanish and euro-area institutions alike) and insurance companies (in the euro area).

A comparison of Spanish stock markets with those in the euro area as a whole highlights the fact that the groups made up principally of companies with a significant presence in Latin America (banking, telecommunications, utilities and energy, which are, moreover, those with most weight in our markets) performed only slightly worse in Spain than they did on average in the euro area. The opposite was, however, the case in almost all the other sectors. A comparison with US stock markets shows a more even relationship: in five of the twelve groups present on both countries' markets, the performance in Spain was worse.

Sectoral contributions to the declines in indices differed greatly in the three groups of stock markets studied. In Spain, the four weightiest sectors account for almost 92% of the change in the Madrid Stock Exchange General Index, reflecting the high sectoral concentration of our markets. In the other two indices, the contributions were more spread out, with that of the technological sector to the fore. In addition to this group, the adverse performance of the traded prices of banks and telecommunications companies and, in the case of the euro area, of insurance companies, were also of great significance in explaining the fall in the indices.

However, if the weights relating to the composition of the Euro Stoxx and the S&P 500 were applied to the changes in the sectoral prices of the Madrid Stock Exchange General Index, the Spanish market's index (–25.5% and –27.5%, respectively) would show a very similar change to that actually observed (–27.5%). That would suggest the differences in the sectoral composition of our respective markets would not appear to have played a significant role in the differing trends seen over this period. Rather, the less unfavourable performance of the Spanish stock market appears to show a somewhat brighter outlook for our economy, despite the exposure of certain national companies to how the situation may develop in Latin America.

Stock market performance in 2002 (a)

%

	SPAIN			EURO AREA			UNITED STATES		
	Change 1	Weight 2	Contribution 3=1x2	Change 4	Weight 5	Contribution 6=4x5	Change 7	Weight 8	Contribution 9=7x8
Banks	-35.2	31.8	-11.2	-33.7	15.4	-5.2	-22.1	13.4	-3.0
Telecommunications	-41.9	20.1	-8.4	-40.4	8.6	-3.5	-46.0	5.5	-2.5
Utilities	-33.3	12.5	-4.2	-30.8	5.9	-1.8	-42.3	3.1	-1.3
Energy	-19.2	7.5	-1.4	-16.1	11.0	-1.8	-15.5	6.3	-1.0
Construction	2.2	4.1	0.1	-28.4	2.2	-0.6	-22.6	0.1	0.0
Food	13.0	2.8	0.4	-21.3	6.9	-1.5	-4.4	5.0	-0.2
Investment goods	-15.4	3.4	-0.5	-29.7	7.2	-2.1	-28.6	11.1	-3.2
Technology	-46.9	2.7	-1.2	-56.2	11.8	-6.7	-45.1	17.6	-7.9
Insurance	-14.1	0.5	-0.1	-53.1	7.4	-3.9	-21.9	4.2	-0.9
Health care	-37.6	0.5	-0.2	-37.2	5.1	-1.9	-20.6	14.4	-2.9
Media	-46.7	1.7	-0.8	-55.5	4.5	-2.5	-34.6	4.1	-1.4
Retail trade	-5.1	6.3	-0.3	-28.7	2.4	-0.7	-22.3	6.2	-1.4
Automobiles	—	0.0	—	-23.3	3.5	-0.8	-27.5	1.0	-0.3
Other	-8.5	6.1	-0.5	-38.2	8.1	-3.1	-13.1	8.0	-1.0
Market index (b)	-27.5	100.0	-27.5	-36.4	100.0	-36.4	-27.2	100.0	-27.2
Unexplained (c)	—	—	1.0	—	—	-0.3	—	—	-0.1

Sources: Bloomberg and Banco de España.
(a) To 11th October 2002.
(b) Madrid Stock Exchange General Index for Spain, Euro Stoxx for the euro area and S&P 500 for the United States.
(c) The totals for contributions differ from those for the decline in market indices owing to changes in the composition of the indices during the period.

TABLE 5

Net financial transactions and inter-sectoral flows
Cumulative data for the last four quarters

% of GDP

	1997	1998	1999	2000	2001 Q2	2001 Q3	2001 Q4	2002 Q1	2002 Q2
	NET FINANCIAL TRANSACTIONS								
Total economy	**1.6**	**0.5**	**-1.1**	**-2.5**	**-2.1**	**-1.9**	**-2.0**	**-1.9**	**-1.8**
Non-financial corporations and households and NPISHs	**4.0**	**2.2**	**-0.4**	**-2.6**	**-2.1**	**-2.1**	**-3.1**	**-3.7**	**-3.2**
Non-financial corporations	-0.5	-1.1	-2.4	-3.5	-5.0	-4.3	-4.0	-4.3	-3.8
Households and NPISHs	4.5	3.3	2.0	0.9	2.9	2.1	0.9	0.5	0.5
Financial institutions	**0.7**	**1.0**	**0.5**	**0.7**	**0.8**	**0.8**	**1.2**	**1.3**	**1.3**
General government	**-3.2**	**-2.7**	**-1.1**	**-0.6**	**-0.8**	**-0.5**	**-0.1**	**0.5**	**0.1**
	INTER-SECTORAL FLOWS (a)								
Households and NPISHs	**4.5**	**3.3**	**2.0**	**0.9**	**2.9**	**2.1**	**0.9**	**0.5**	**0.5**
Vis-à-vis:									
Credit institutions (b)	-6.7	-4.4	0.2	-0.1	0.1	-0.5	-1.5	-2.3	-2.7
Institutional investors (c)	10.8	7.5	0.8	0.5	2.7	3.1	3.6	3.2	3.2
Non-financial corporations	**-0.5**	**-1.1**	**-2.4**	**-3.5**	**-5.0**	**-4.3**	**-4.0**	**-4.3**	**-3.8**
Vis-à-vis:									
Credit institutions (b)	-3.2	-4.3	-3.8	-6.7	-4.4	-4.3	-3.8	-4.1	-4.2
Rest of the world	1.7	0.9	-0.8	1.7	-0.3	-0.1	-1.9	-1.9	-1.1
General government	**-3.2**	**-2.7**	**-1.1**	**-0.6**	**-0.8**	**-0.5**	**-0.1**	**0.5**	**0.1**
Vis-à-vis:									
Credit institutions (b)	1.4	1.4	1.4	2.2	-0.3	-0.8	-2.5	-0.3	-0.4
Institutional investors (c)	-3.9	-2.6	1.7	3.9	3.8	3.0	2.9	1.6	1.3
Rest of the world	-2.0	-1.1	-4.4	-6.0	-4.5	-3.1	-1.7	-1.9	-1.5
Rest of the world	**-1.6**	**-0.5**	**1.1**	**2.5**	**2.1**	**1.9**	**2.0**	**1.9**	**1.8**
Vis-à-vis:									
Credit institutions (b)	2.8	7.1	2.0	5.2	3.3	4.6	3.9	2.7	3.9
Institutional investors (c)	-2.5	-6.3	-3.6	-5.6	-5.1	-4.9	-4.7	-3.4	-3.6
Non-financial corporations	-1.7	-0.9	0.8	-1.7	0.3	0.1	1.9	1.9	1.1
General government	2.0	1.1	4.4	6.0	4.5	3.1	1.7	1.9	1.5

Source: Banco de España.
(a) A positive sign indicates the extension of financing to the counterpart sector. A negative sign denotes financing received from the counterpart sector.
(b) Defined in accordance with the First Banking Directive.
(c) Insurance corporations and collective investment undertakings.

terms (5) (see Table 5). This moderate reduction in the net resort to saving generated abroad was the outcome of differing behaviour by the various resident sectors. First, the general government sector showed a debit balance on its financial transactions in Q2, meaning its cumulative four-quarter net financial saving declined to 0.1% of GDP. Further, the non-financial private sector's financial requirements fell to 3.2% of GDP. The net balance of this latter sector was determined by the behaviour of non-financial corporations, for which the absorption of net resources from other sectors declined to 3.8% of GDP. In the case of households, the value of their net financial transactions was similar to that in the same quarter a year earlier and, consequently, their net financial saving, in cumulative four-quarter terms, held at 0.5% of GDP, an historical low.

The information on net inter-sectoral flows (see lower panel of Table 5) highlights

(5) Throughout this section, and in keeping with the information in the tables and charts, the figures refer to cumulative four-quarter data, unless otherwise stated.

TABLE 6

Financial assets and liabilities of households, NPISHs and non-financial corporations
Cumulative data for the last four quarters

% of GDP

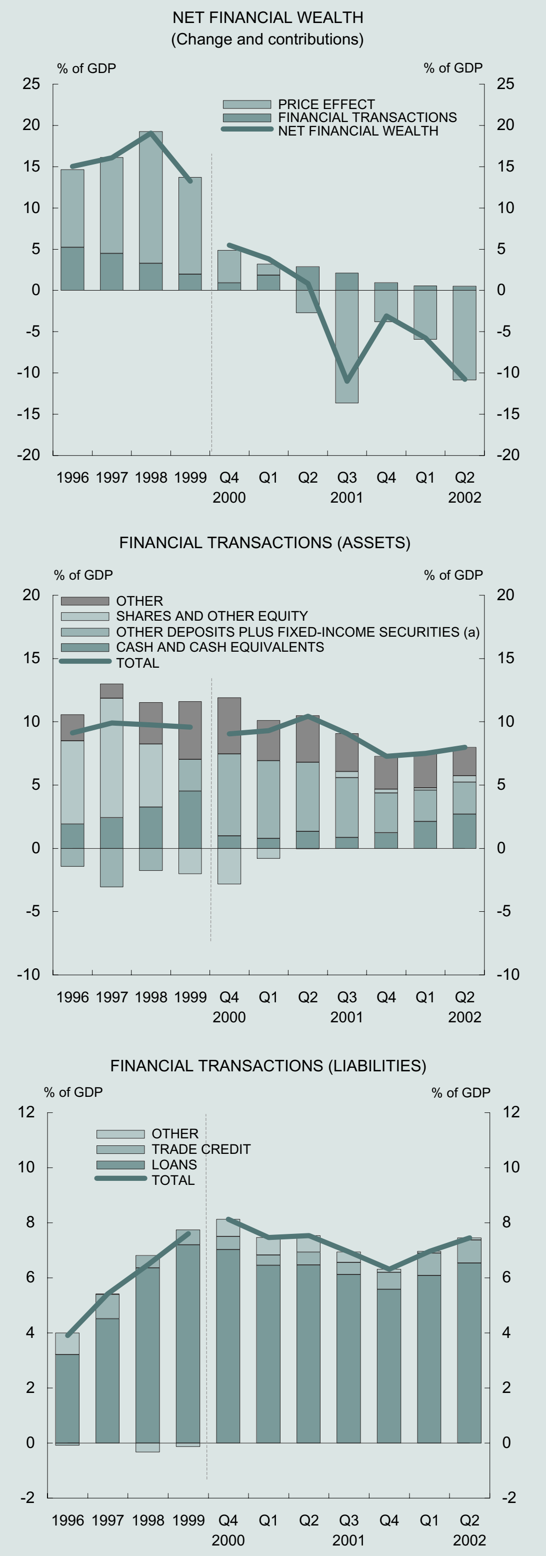
	1998	1999	2000	2001	2002	
				Q4	Q1	Q2
HOUSEHOLDS AND NPISHs:						
Financial transactions (assets)	**9.8**	**9.6**	**9.1**	**7.3**	**7.5**	**8.0**
Cash and cash equivalents	3.2	4.5	1.0	1.2	2.1	2.7
Other deposits and fixed-income securities (a)	-1.8	2.5	6.5	3.1	2.5	2.5
Shares and other equity (b)	0.0	0.1	0.5	-0.5	-0.3	-0.1
Mutual funds	5.0	-2.2	-3.4	0.8	0.4	0.6
FIAMM	*-1.1*	*-1.4*	*-1.4*	*1.3*	*1.4*	*1.2*
FIM	*6.1*	*-0.8*	*-2.0*	*-0.5*	*-0.9*	*-0.6*
Insurance technical reserves	2.4	3.3	3.5	2.2	2.2	2.0
Of which:						
Life assurance	*1.2*	*2.0*	*1.9*	*1.5*	*1.5*	*1.3*
Pension funds	*1.0*	*1.0*	*1.4*	*0.5*	*0.5*	*0.5*
Other	0.8	1.2	1.0	0.4	0.6	0.2
Financial transactions (liabilities)	**6.5**	**7.6**	**8.1**	**6.3**	**7.0**	**7.5**
Credit from resident credit institutions	5.9	6.5	6.8	5.1	5.7	6.1
Securitisation funds	0.5	0.6	0.1	0.3	0.2	0.3
Other	0.1	0.5	1.1	0.9	1.0	1.0
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	**14.0**	**17.8**	**27.4**	**17.5**	**17.4**	**14.0**
Cash and cash equivalents	1.5	0.7	0.9	1.6	1.9	1.6
Other deposits and fixed-income securities (a)	0.2	-0.2	1.3	0.8	0.2	0.5
Shares and other equity	3.1	8.2	14.1	4.2	4.5	3.6
Of which:						
Vis-à-vis rest of the world	*2.2*	*6.5*	*10.9*	*3.7*	*3.7*	*2.8*
Other	9.2	9.2	11.1	10.9	10.9	8.3
Financial transactions (liabilities)	**15.1**	**20.2**	**30.9**	**21.6**	**21.7**	**17.8**
Credit from resident credit institutions	4.6	4.8	6.7	6.0	6.5	5.4
Securitisation funds	0.2	0.4	0.9	0.8	1.0	1.3
Foreign loans	1.6	3.0	3.5	3.6	2.8	2.1
Fixed-income securities (a)	0.0	0.5	-0.5	0.1	0.1	0.0
Shares and other equity	2.5	5.0	12.1	3.8	3.9	3.4
Other	6.2	6.3	8.1	7.3	7.6	5.7
MEMORANDUM ITEMS: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (c)	**16.7**	**19.5**	**18.9**	**15.1**	**15.3**	**13.6**
Households and NPISHs	19.3	19.6	17.3	12.4	13.4	14.0
Non-financial corporations	14.7	19.4	20.0	17.1	16.7	13.2

Source: Banco de España.
(a) Not including unpaid accrued interest, which is included under "Other".
(b) Not including mutual funds.
(c) Including bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation funds.

the fact that net resources received from resident credit institutions increased in all non-financial sectors. This rise was more pronounced in the case of households, the debit balance of whose net financial transactions vis-à-vis resident credit institutions amounted to 2.7% of GDP. Set against this, the debit balance of credit institutions increased considerably vis-à-vis the rest of the world, to 3.9% of GDP. That said, this volume is still considerably below that observed in the 1998-2000 period. There was a reduction in the amount of net resources received by non-financial corporations from the rest of the world to 1.1% of GDP. The general government sector also received less net financing from abroad, with the related figure standing at 1.5% of GDP.

CHART 23

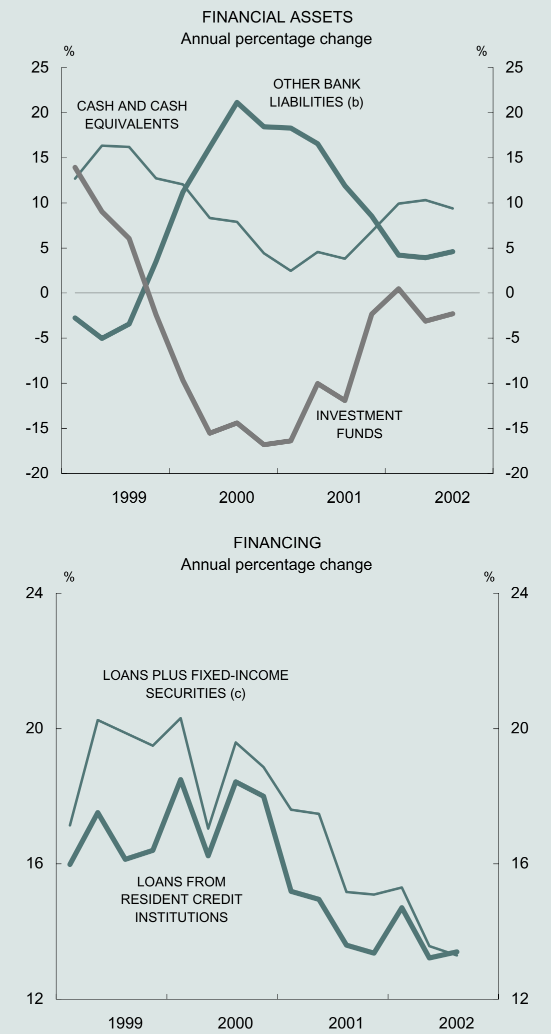
Households and NPISHs
(Cumulative four-quarter data)



Source: Banco de España.
(a) Not including unpaid accrued interest, which is included under "Other".

CHART 24

Non-financial corporations.
Households and NPISHs (a)



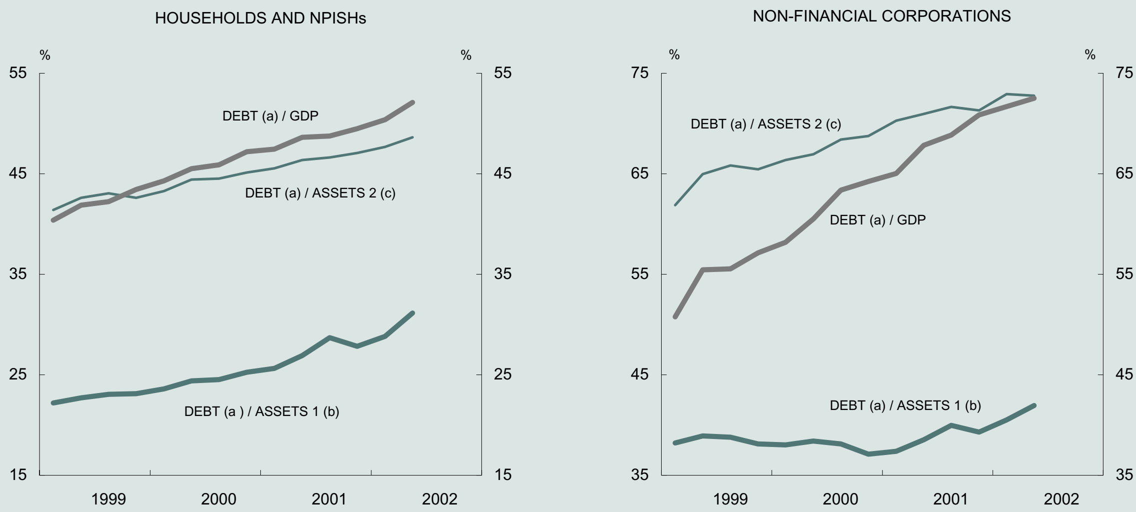
Source: Banco de España.
(a) The data for 2002 Q3 are provisional..
(b) Includes deposits with an agreed maturity, repos, bank securities and deposits abroad.
(c) Including loans from resident and non-resident credit institutions, securities issuance and financing through securitisation funds.

5.2. Financial flows of households

In 2002 Q2, households showed positive net financial saving for a value of 0.3% of GDP, unlike the case in the two preceding quarters in which they raised net resources from other sectors of the economy. Nonetheless, in cumulative four-quarter terms, their financial saving remained at 0.5% of GDP, an historical low (see Table 5) that is striking given the uncertain setting and the slowdown in activity characterising that quarter. The easing off of household spending during the first half of 2002 has not been accompanied by an equivalent slowdown in household demand for financing which, as

CHART 25

Debt ratios



Source: Banco de España.
(a) Including bank credit extended by resident credit institutions, foreign loans, fixed-income securities and financing through securitisation funds.
(b) Assets 1 = Total financial assets - "Other".
(c) Assets 2= Assets 1 - shares - shares in FIM.

discussed in the previous report, has continued to be fuelled by low interest rates and by the continuous rise in house prices (6).

The acquisition of financial assets by households was slightly higher than in the same quarter in 2001. Thus, in cumulative four-quarter terms, this item stood at 8% of GDP, compared with 7.5% the previous quarter. The composition of the household financial assets portfolio continued to evidence similar trends to those seen in the preceding quarters (see Table 6 and Chart 23). In particular, there continued to be a shift in household portfolios towards more liquid and less risky assets. Saving in the form of cash and cash equivalents quickened slightly (it grew at a rate of 10.3% year-on-year, compared with 9.9% the previous quarter), rising to 2.7% of GDP. Net purchases of shares and other equity was marginally positive and made up to a greater extent of unlisted shares, and the negative value of cumulative four-quarter investment diminished to –0.1% of GDP. Unlike the previous quarter, net subscriptions of shares in mutual funds were slightly positive and, in cumulative four-quarter terms, amounted to 0.6% of GDP. Finally, investment in technical insurance reserves fell moderately in relation to the same quarter in 2001 and stood at 2% of GDP.

(6) For a more detailed analysis of the housing market, see the article by J. Martínez and L.Matea, entitled “The housing market in Spain», in this *Economic Bulletin*.

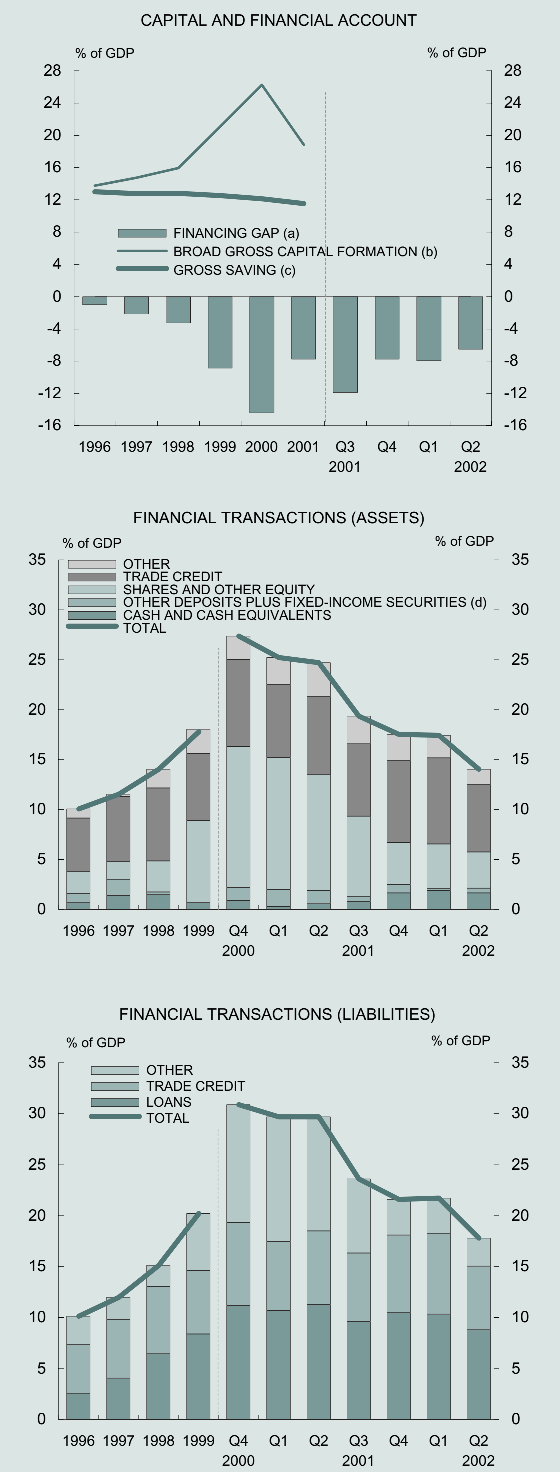
On the liabilities side, households saw an increase in the flow of financing received from other sectors (7.5% of GDP, compared with 7% the previous quarter). This increase was largely the outcome of the rise in bank credit, which climbed to a high volume of 6.1% of GDP compared with 5.7% the previous quarter. Total financing – considering bank loans and resources intermediated by securitisation funds – accelerated further on the previous quarter to 14%, from 13.4% (see memorandum item in Table 6).

The information on the breakdown of credit by end-use in Q2 shows notable differences from component to component. On one hand, loans for house purchases held at a high growth rate (16.6% year-on-year). Differentiating by type of institution, savings banks continued to gain market share in this segment and increased their portfolio of this type of loan by 19%, while banks did so by 13.5%. On the other, credit earmarked for expenditure on current and durable goods slowed sharply to 13.9% year-on-year, after posting rates of over 20% in the four preceding quarters. Nonetheless, their weight in total loans extended to individuals is lower than 15%.

The provisional information on financial flows in the Spanish economy in 2002 Q3 suggests something of a rebound in the growth rates of household financial assets and liabili-

CHART 26

Non-financial corporations
(Cumulative four-quarter data)



Source: Banco de España.
(a) Financial resources that cover the gap between real and permanent financial investment and gross saving.
(b) Including gross capital formation, stockbuilding and foreign equities.
(c) Including capital transfers.
(d) Not including unpaid accrued interest, which is included under "Other".

ties (7) (see Chart 24). With regard to investment in financial assets, cash and cash equivalents and other bank liabilities have continued to increase at similar rates to those recorded in Q2. However, mutual fund holdings, though they have once again shrunk as a result of deteriorating stock market prices, have slowed less than was the case three months earlier. As to financing, resident institutions have expanded their private-sector lending, which is growing at a rate of 13.4%, compared with 13.2% in Q2. The continuing brisk pace of house price rises may have been conducive to this latter development.

Finally, household wealth was adversely affected at the end of Q2 by the loss of value of their holdings of equity and mutual fund shares, owing to the fall in stock market prices. The loss of net financial wealth thus exceeded 10% of GDP taking the information available for the latest four quarters. Likewise, the level of household debt increased both in terms of the value of the most liquid component of their financial wealth (52.1%, against 50.4% the previous quarter) and in terms of GDP (48.6%, compared with 47.7% the previous quarter) (see Chart 25).

5.3. The financial flows of non-financial corporations

In 2002 Q2, the balance of the financial transactions of non-financial corporations was –0.6% of GDP, compared with –1.1% in the same quarter in 2001. In cumulative four-quarter terms, this balance amounted to 3.8% of GDP, against 4.3% the previous quarter (see Table 5). This reduction reflects the fall in this sector's financing gap, i.e. the borrowed funds needed to undertake investment at home and abroad (see Chart 26). Despite its declining trend in recent quarters, the net financial dissaving of corporations remains at an historically high level which, given the current situation of sluggish investment (domestic and foreign investment alike), might denote the persistence of diminished cash-flow capacity, as discussed in previous reports.

Investment in financial assets continued to slow and stood at 14% of GDP, while one quarter earlier it was at 17.4% (see Table 6). This reduction took the form, firstly, of a reduction in relation to the same quarter in 2001 in the purchase of shares and other equity (essentially

(7) Note that these indicators provide aggregate information on the sectors households and non-financial corporations. Consequently, conclusions on household transactions should be interpreted with due caution.

abroad). Further, cash and cash equivalents fell slightly to 1.6% of GDP. Conversely, the demand for other liquid assets, included under other deposits and fixed-income securities, rebounded slightly following the reduction seen in the two previous quarters. Finally, there has also been less investment in assets grouped under the heading “Other” in Table 6, including trade credit, which grew by 8.3%, against 10.9% the previous quarter. However, these movements have been offset by a slowdown on a similar scale in trade financing flows received, grouped under the heading “Other” on the liabilities side. Consequently, no significant change has been seen in net flows of inter-company financing.

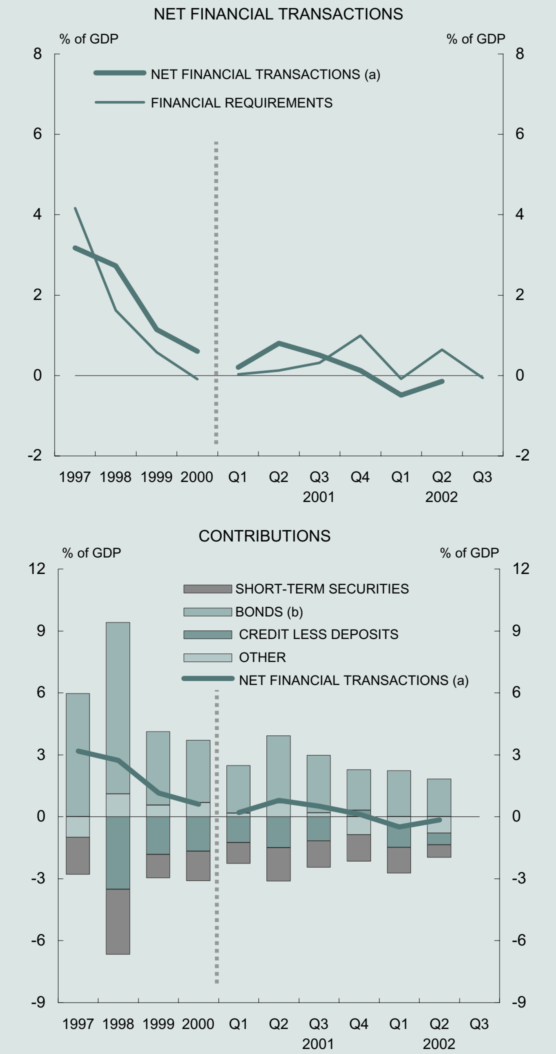
As regards liabilities-side transactions, and excluding those routed via securitisation funds, fewer volumes were seen than those recorded in the same quarter a year earlier. Thus, financing obtained via shares and other equity contracted moderately. Loans from resident institutions and financing intermediated via securitisation funds fell overall from 7.5% of GDP in the preceding three months to 6.7%, meaning that the increase recorded in the previous quarter was offset. Foreign loans continued to slow (2.1% of GDP against 2.8% the previous quarter), perhaps reflecting the lesser resort to this type of financing by large corporations. In this way, the year-on-year growth of financing extended to corporations stood at 13.2%, meaning the slowdown initiated in early 2001 is continuing (see memorandum item in Table 6).

The information on the breakdown of resident credit institutions by productive activity shows how the slowdown in credit was centred on industry (excluding construction) and the service sector. In particular, the growth rate of credit for the service sector, which is the main component of lending intended for productive activities, fell in the second half of 2002 to 11.6%, from 13.6% the previous quarter. Conversely, loans intended for the construction industry quickened to a rate of 13.6%, up from 12.1% the previous quarter.

Although the volume of financing – via loans and securities other than shares – slowed slightly during 2002 Q2, its expansion remains high in relation to economic growth. Consequently, the sector’s indebtedness, measured by the debt/GDP ratio, held on a growing path and rose to 72.5%, compared with 55.4% only three years earlier. Finally, the value of debt relative to corporations’ financial assets portfolio increased to 41.9%, up from 40.5% the previous quarter. These trends highlight the greater exposure of Spanish corporations to potential adverse circumstances, with such exposure not being distributed uniformly across the different corporations making up the sector (see Box 6).

CHART 27

General government (Cumulative four-quarter data)



Source: Banco de España.
(a) Sign changed.
(b) Not including unpaid accrued interest, which is included under "Other".

5.4. General government financial flows

The balance of general government financial transactions was negative in 2002 Q2. In cumulative four-quarter terms, this entailed a reduction of four-tenths of a point in the sector’s net financial saving, to 0.1% of GDP (see Chart 27).

During Q2, the Treasury made a net issue of long-term bonds for a total of €5.5 billion. As a result, and in cumulative four-quarter terms, the

TABLE 7

Financial transactions of the nation. Cumulative data for the last four quarters

% of GDP

	1998	1999	2000	2001 Q4	2002 Q1	2002 Q2
Net financial transactions	**0.5**	**-1.1**	**-2.5**	**-2.0**	**-1.9**	**-1.8**
Financial transactions (assets)	**12.3**	**14.8**	**24.5**	**10.8**	**8.7**	**9.9**
Gold and SDRs	**0.0**	**-0.2**	**0.0**	**0.0**	**0.0**	**0.0**
Cash and deposits	**3.2**	**1.7**	**2.8**	**-2.6**	**-3.8**	**-0.4**
Credit system	0.0	3.7	2.5	-2.7	-3.3	-0.6
Other resident sectors	3.2	-2.0	0.4	0.1	-0.6	0.2
Securities other than shares	**3.4**	**2.8**	**3.8**	**7.1**	**7.4**	**5.8**
Credit system	-1.4	-0.9	-0.3	2.0	2.3	1.0
Other resident sectors	4.7	3.7	4.1	5.1	5.1	4.9
Shares and other equity	**4.3**	**9.8**	**15.1**	**3.7**	**3.1**	**2.7**
Credit system	0.4	0.7	1.7	-0.1	-0.4	0.1
Other resident sectors	3.9	9.1	13.4	3.8	3.4	2.6
Of which:						
Non-financial corporations	*2.2*	*6.5*	*10.9*	*3.7*	*3.7*	*2.8*
Loans	**1.4**	**0.7**	**2.7**	**2.6**	**2.1**	**1.8**
Credit system	0.2	-0.2	0.5	0.8	0.6	0.6
Other resident sectors	1.2	0.9	2.1	1.9	1.5	1.2
Financial transactions (liabilities)	**11.8**	**15.9**	**27.0**	**12.8**	**10.6**	**11.7**
Deposits	**5.9**	**4.1**	**6.8**	**2.8**	**1.2**	**4.5**
Of which:						
Credit system	5.9	4.1	6.8	2.8	1.1	4.5
Debt securities issued	**1.0**	**5.4**	**7.0**	**3.1**	**3.2**	**2.9**
Credit system	0.2	0.9	0.7	0.6	0.8	0.2
General government	1.0	4.3	5.7	1.6	1.7	1.3
Other resident sectors	-0.2	0.2	0.5	0.9	0.8	1.4
Shares and other equity	**2.9**	**3.9**	**9.1**	**3.5**	**3.7**	**3.0**
Credit system	0.1	0.3	1.7	0.5	0.2	0.3
Other resident sectors	2.8	3.6	7.3	3.0	3.5	2.7
Loans	**2.2**	**3.8**	**4.5**	**4.4**	**3.8**	**2.9**
General government	0.1	0.1	0.1	0.1	0.2	0.2
Other resident sectors	2.1	3.7	4.4	4.3	3.6	2.7
Other, net (a)	**-0.2**	**-1.4**	**-0.3**	**-1.0**	**-1.2**	**-1.6**

Source: Banco de España.
(a) Includes the asset-side caption reflecting insurance technical reserves.

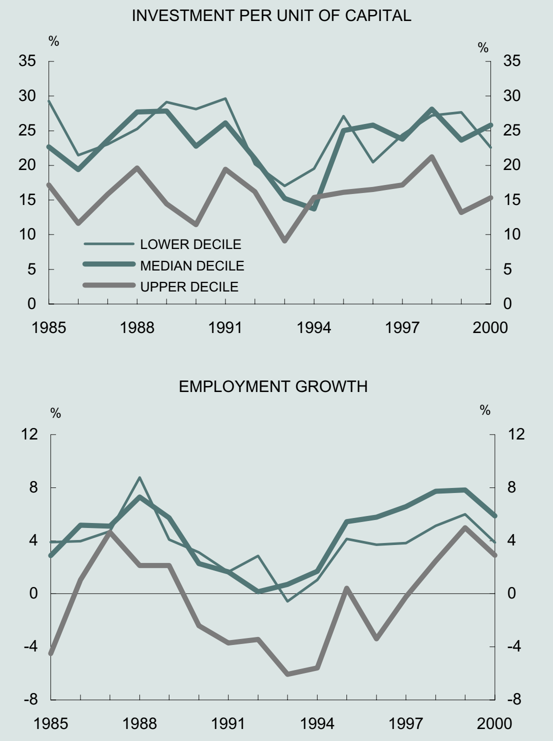
outstanding balance of general government bonds increased by 1.8% of GDP, compared with 2.2% the previous quarter. Net issues of short-term securities were virtually zero and, again in cumulative four-quarter terms, amounted to –0.6% of GDP. Net resources raised from issues contributed to the increase in deposits (net of loans) amounting to 0.6% of GDP. Finally, there were no significant changes in Q2 in the distribution of the public debt portfolio among different investors. Non-residents' holdings of medium- and long-term bonds thus continued to account for around 50% of the total outstanding balance issued.

The provisional information for Q3 indicates an increase in funds obtained via the issuance of short-term securities and the increase in loans extended by financial institutions. This raising of resources is offset by re-

BOX 6

Financial position and level of activity: a microeconomic analysis

The financial position of firms influences a country's macroeconomic conditions and the stability of its financial system by means of its contribution to aggregate demand and of its links to the banking system and capital markets. Thus, for instance, excessive indebtedness may adversely affect investment spending or, in the face of an unexpected shock, prompt sharp portfolio switching. However, from the standpoint of identifying the risks to macroeconomic and financial stability, it should be borne in mind that the fragility of certain firms need not be offset by the soundness of others. In this way, basing the assessment of the financial position of companies on an analysis of aggregate sectoral indices may, while being informative, occasionally cover up vulnerability that only a study at a greater level of detail could reveal. Indeed, the behaviour of the companies most exposed financially is, for these purposes, as relevant (if not more so) as the average behaviour of the sector.



Source: Banco de España.

Note: Each line depicts the average value of the corresponding variable (investment per unit of capital or employment growth) for the set of firms belonging to the decile specified (lower, median or upper), defined in terms of the distribution of the financial costs/gross operating profit ratio.

Specifically, using itemised data of the corporations reporting to the Banco de España Central Balance Sheet Data Office Annual Database for the period 1985-2000, a comparison is made of the rate of use of productive factors (labour and physical capital) of various sets of firms defined in terms of their financial position.

The financial position of firms is usually characterised by means of a relatively broad set of indicators which are often referred to as financial pressure indicators. Among these can normally be found ratios providing information on corporate profitability, indebtedness (or leverage) and liquidity, variables which have, in many theoretical and empirical papers, determined corporate bankruptcy risk. It is thus more likely for a firm to go bankrupt or suspend payments to creditors if its debt is very high, its profitability very low or if it does not have enough liquidity. An approximation can be made to the financial position of firms by means of a measure of the relative burden of debt (or, what amounts to the same, of the firm's capacity to meet interest payments), which is defined as the ratio of financial costs to gross operating profit. This variable, being the net result of changes in interest rates, in corporate profitability and in corporate debt, is a relevant indicator of the financial pressure firms may be facing.

The accompanying charts give, for each year, the average value of investment per unit of capital and of the growth rate of employment for the sets of firms relating to three different deciles of the distribution of firms in terms of the financial costs/gross operating profit ratio. Hence, the median decile (which groups firms between the percentiles 45 and 55) may be considered representative of the behaviour of a firm with an average financial position. Likewise, the firms belonging to the upper (lower) decile are those facing higher (lower) financial pressure.

As the charts show, there are no significant differences regarding the use of productive factors between firms in a more comfortable financial position (lower decile) and those subject to average financial pressure. However, firms with a higher financial burden in relation to their capacity to generate funds from operations have substantially lower investment and employment-growth rates. Further, in the case of employment, this feature appears to be accentuated in downturns.

This descriptive evidence suggests that the impact of the financial position on business activity is not linear and becomes relatively more intense when financial pressure exceeds a certain threshold. Therefore, the risk of the rising debt levels evident in Spanish non-financial corporations affecting economic activity hinges, for a large number of firms, on financial pressure breaching this threshold.

TABLE 8

Net financial assets vis-à-vis the rest of the world (a)
Q4 data

% of GDP

	1997	1998	1999	2000	2001	2002 (b)
Total economy	-20.9	-21.6	-22.3	-20.6	-22.3	-21.0
Non-financial corporations and households and NPISHs	-10.8	-8.6	-8.7	-0.8	-1.7	1.6
Non-financial corporations	-17.1	-14.8	-16.3	-8.5	-9.3	-6.4
Households and NPISHs	6.3	6.2	7.6	7.6	7.5	8.0
Financial institutions	6.9	4.8	6.9	5.1	4.6	1.7
Credit institutions (c)	2.4	-5.4	-7.5	-12.5	-14.5	-16.5
Institutional investors (d)	4.6	10.7	15.0	18.3	20.7	20.7
Other financial institutions	-0.1	-0.4	-0.6	-0.8	-1.6	-2.5
General government	-17.0	-17.9	-20.5	-24.8	-25.1	-24.4

Source: Banco de España.
(a) Calculated as the difference between the stocks of financial assets and of liabilities vis-à-vis the rest of the world according to quarterly financial accounts data.
(b) Q2 data.
(c) Defined according to the First Banking Directive.
(d) Insurance corporations and collective investment undertakings.

demptions of medium- and long-term bonds. As a result, the *financial requirements* indicator, which reflects general government resort to the financial markets and proxies saving in the sector, fell to –0.05% of GDP in Q3, compared with 0.65% the previous quarter (see Chart 27). Lastly and significantly, the Treasury has benefited in recent months from the decline in the yields on its issues, prompted by the shift by investors towards lower-risk instruments.

5.5. Financial flows between the Spanish economy and the rest of the world

Between April and June 2002, the balance of the nation's financial transactions was more favourable than in the same quarter a year earlier, standing at –1.8% of GDP in cumulative four-quarter terms (see Table 7). Unlike the trend seen in recent quarters, flows of net acquisitions of external financial assets and liabilities increased slightly. Likewise, flows of external assets and liabilities invested in securities slipped somewhat in step with the less conducive environment for these types of instruments, owing to the instability of the markets and the climate of uncertainty. Nonetheless, this slide might be merely temporary, and it should be pointed out that these flows continue to show historically high volumes.

Net acquisitions of external assets amounted to 9.9% of GDP, compared with 8.7% the previous quarter, thanks essentially to the increase in deposits abroad. Unlike the two preceding quarters, both credit institutions and other resident sectors increased their holdings of foreign deposits and reduced their investments in fixed-income securities. Acquisitions of securities other than shares thus fell to 5.8% of GDP, down from 7.4% the previous quarter. Equity purchases were lower at 2.7% of GDP, against 3.1% the previous quarter. This was basically the outcome of the reduction in this type of investment by non-financial corporations, as the credit system increased its holdings of equities abroad. According to Balance of Payments data, durable foreign direct investment accounted for approximately 50% of investment in the same quarter a year earlier. Portfolio investment fell by 30% in relation to that recorded in 2001 Q2. Lastly, loans abroad extended by non-financial corporations amounted to 1.2% of GDP, down from 1.5% in Q1.

As mentioned, the volume of cross-border transactions on the liabilities side was also greater, standing at 11.7% of GDP, compared with 10.6% the previous quarter. This increase was a result of greater investment in deposits by non-residents, totalling 4.5%, and of uneven reductions in the other headings. There was thus a slight reduction in non-residents' acquisitions of fixed-income securities, and more pronounced reductions in foreign loans received (in particular those received by non-financial corporations) and in non-residents' investment in shares and other equity. There was a particularly marked decline in direct investment, which stood at close to 40% of that recorded in the same quarter a year earlier. Conversely, portfolio investment climbed slightly. Over the quarter as a whole, the volume of foreign direct investment in Spain was less than Spanish outward foreign direct investment. However, this pattern does not appear to be taking root judging by the latest provisional Balance of Payments information for July.

As a result of foreign financial transactions and of changes in financial asset prices and in the exchange rate, the national economy's debit balance of net external assets has improved over the first half of the year to –21% of GDP (see Table 8). The deterioration in financial institutions' net external assets (and those of credit institutions in particular) was more than offset by the improved position of the non-financial sectors. In particular, general government and, above all, non-financial corporations saw notable reductions in their external debit balances.

30.10.2002.