Quarterly report on the Spanish economy

1. Overview

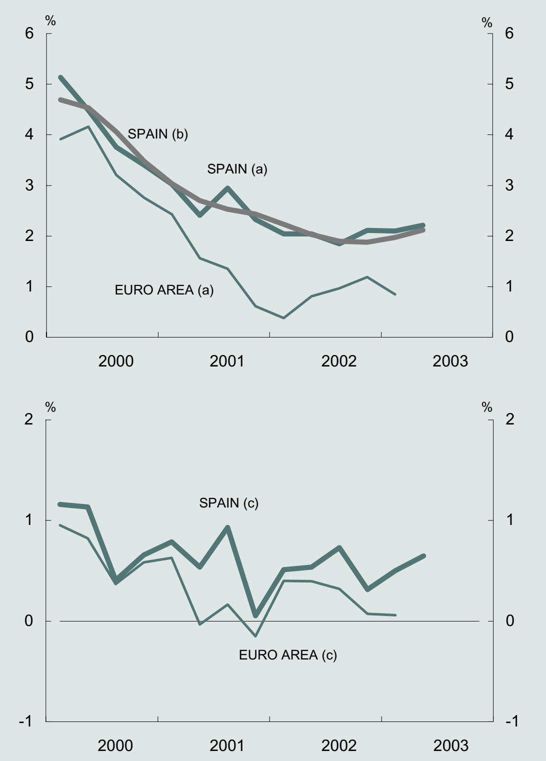
In recent months and following the conclusion of the war in Iraq, some of the uncertainties bearing on the international economic situation have begun to clear, although certain geopolitical tensions remain in place. The impact of the expansionary macroeconomic policies implemented in several regions means that the envisaged scenario of a moderate recovery in the world economy in the second half of 2003 is looking increasingly realistic. The outlook, however, is not free from risk, as there are doubts over whether some of the most dynamic economies are in a position to move firmly onto a sustained growth path. Against this backdrop, growth in the Spanish economy has been rekindled to some extent during 2003 Q2, while its inflation rate has dipped appreciably. On seasonally adjusted series, the real year-on-year rate of change of GDP in this period is estimated to have been around 2.2%, and the quarter-on-quarter rate 0.6%, both 0.1 pp higher than the rates reported by INE for Q1. If current forecasts are met and growth in the euro area in Q2 proves similar to that of the previous quarter, then the divergence between the growth rates of Spain and the euro area as a whole will have been maintained, as will the process of real convergence (see Box 1). The inflation differential with the euro area countries fell to 0.8 pp in June (from 1.3 pp three months earlier), as the rate of increase of the HICP in June was 2.8%, almost 1 pp down on March.

The prospects of growth in the US economy have improved in recent months. The cumulative decline in interest rates, the persistent increase in public spending and the bringing forward of the previously announced tax cuts are expected to contribute to spending expanding in the second half of the year. The financial position of households has already improved appreciably (thanks, above all, to lower interest rates) and consumption may be given fresh momentum by the impact of the tax cuts on disposable income, despite the fact confidence indicators remain negative and the unemployment rate high. Turning to companies, expectations remain hesitant and the low rate of capacity utilisation means that investment spending has yet to take off. In any event, productivity growth is high and the trend of unit wage costs very contained. And this, combined with favourable financial conditions, means there are expectations of a considerable pick-up in corporate earnings.

The US economy might therefore grow in the coming months at a considerable pace, essentially as a result of the strongly expansionary policies implemented. That said, sufficient progress has not been made in correcting the economy's imbalances, which might affect and detract from the intensity of the recovery.

CHART 1

Gross domestic product



Sources: ECB, Instituto Nacional de Estadística and Banco de España.

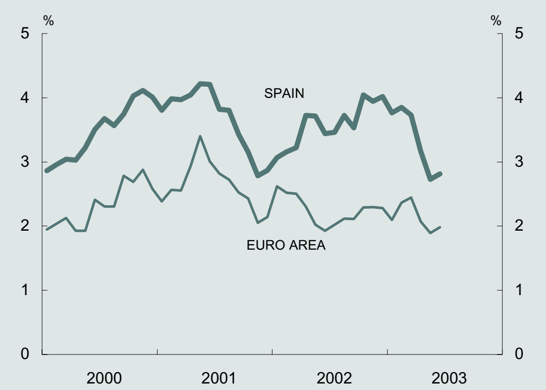
(a) Non-centred year-on-year rate of change calculated on the basis of the seasonally adjusted series.

(b) Non-centred year-on-year rate of change calculated on the basis of the trend-cycle series.

(c) Quarter-on-quarter rate 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) Year-on-year rate of change. To December 2001, the rates relate to those released as at that date.

In other regions outside the euro area the outlook remains uncertain although generally better than a few months back. It would not seem that the recent surge in oil prices will firm, since this is in response above all to the supply difficulties with Iraqi crude, to the interruptions in supplies from certain key regions and to the low level of stocks. In these circumstances, the expected benefits from a sharper fall in crude prices are being deferred.

In Japan, the latest data are more favourable; domestic demand has picked up somewhat and employment has ceased to trend negatively. In the coming months, once it is confirmed that the effects of SARS on the markets in the region are behind, external demand might once again contribute positively to growth. The situation in Latin America and in the European countries poised for EU membership is not substantially different from that set out in the last Report. The improvement previously discernible in the main Latin American financial markets, while it has not reversed, does appear to have come to a halt recently. The countries which had posted increases in their inflation rates have seen an improvement in their results thanks to the greater firmness of exchange rates, which has allowed monetary policies to be eased to some extent. The growth rate of the EU accession candidates has been slightly checked on the whole, although the results differ widely from one country to the next.

The euro area economy has maintained a sluggish pace of growth in recent months, following the situation of virtual stagnation reflected by the National Accounts data for Q1. The only signs of momentum have been in certain consumption indicators, more in response to the favourable financing conditions in the area and to the stabilising impact of fiscal policy than to the behaviour of employment, which remains lacklustre. The inflation rate has eased as a result of the performance of the energy component, since the index measuring underlying inflation has virtually stabilised in recent months. There are favourable expectations that the inflation rate will dip below 2% in the coming months, supported by the foreseeable moderation of other core components of the HICP further to the pass-through of the appreciation of the euro and to the expected normalisation of the oil market. Moreover, productivity gains – derived basically from the deterioration in employment – are containing the increase in unit labour costs.

The ECB Council decision to cut official rates by 50 bp on 5 June, taking the key rate to 2%, fed through to money-market interest rates. This, along with the interruption of the appreciation of the euro, the low level of long-term inter-

BOX 1

Some thoughts on the calculation of per capita GDP

Per capita GDP is a variable that attempts to summarise the level of well-being attained by an economy. As a result, its comparison with the per capita GDP figures of other benchmark countries or regions is the convergence indicator *par excellence*. However, besides the difficulties of correctly measuring it, per capita GDP is not very informative when it comes to examining the underlying factors of convergence processes. Accordingly, analysis is usually enriched by decomposing it into its three constituent variables: the rate of employment, labour productivity and the proportion of the labour force of working age (see the article in the July/August edition of the *Boletín económico* on the monitoring of real convergence on the basis of indicators). This decomposition enables per capita GDP growth to be related to the workings of the labour market, productive efficiency and demographic variables.

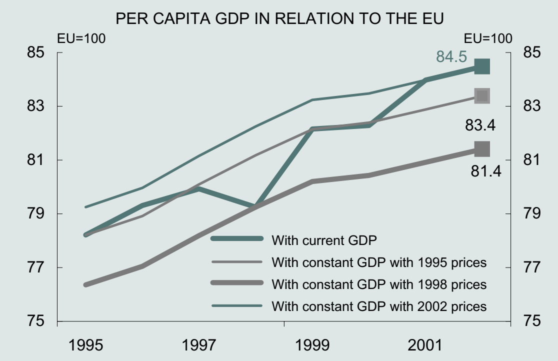
To make comparisons between different economic areas homogeneous, the use of purchasing power parities (PPP) has become widespread. PPP adjust the level of GDP for the structure of relative prices. Moreover, it should be considered whether the valuation is to be at current or constant prices and, in this latter case, which base year is to be used. Measuring GDP in one of these two ways yields results that may differ significantly, without it being possible to determine whether one criterion is better than the other, since it will depend in each case on the aspect it is wished to highlight. Thus, in international comparisons, per capita GDP is frequently valued at current prices and in PPP. This is the method Eurostat uses, which enables Spain's relative position vis-à-vis the EU to be obtained, for each year, with the relative prices of that year. However, this method poses disadvantages when it is wished to decompose per capita GDP into the three aforementioned variables or when it is wished to make comparisons over time, as these are distorted by changes in relative prices.

The use of constant prices for a specific year, valued too in terms of PPP, to measure per capita GDP entails worsening the comparability of the estimates in contemporaneous terms in exchange for obtaining better comparability over time. In this case, a decision must be made on the base year to be taken as a reference. An initial option is to use the latest year presented in the estimates as a base, the advantage of this being that it provides for contemporaneous comparison and uses the most up-to-date relative prices. But there are drawbacks to this option. Firstly, it involves changing the base year each time a new year is incorporated, which involves changing in each update the level of all the series expressed in constant prices. Secondly, it entails using highly provisional series (the deflator and PPP for the latest year) as reference values.

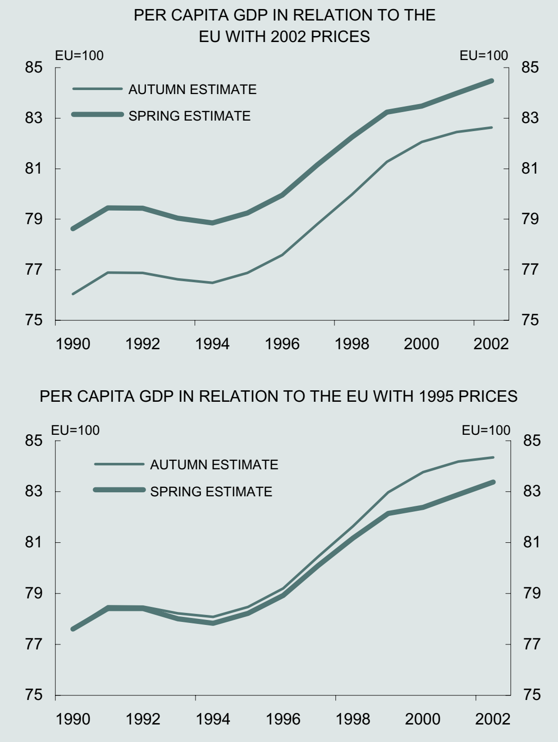
A third option is to take the National Accounts base year, which in Spain's case is 1995. The advantage of this option is that real variables are referenced to the year for which the estimation of the structure of relative prices in each country has been obtained with most accuracy.

The two adjoining charts illustrate the consequences of each of these options. The top chart depicts Spain's per capita GDP relative to the EU, calculated in one case at current prices for each year (and in PPP), and in the other expressed in constant prices, with the base in different years. As can be seen, the relationship between Spanish and EU per capita GDP depends on the year selected as a base for the prices, given that in each of these years the structure of relative prices in the benchmark economy (in this case the EU) has progressively changed.

Comparison of per capita GDP estimated under different assumptions as to the prices used



Revised per capita GDP



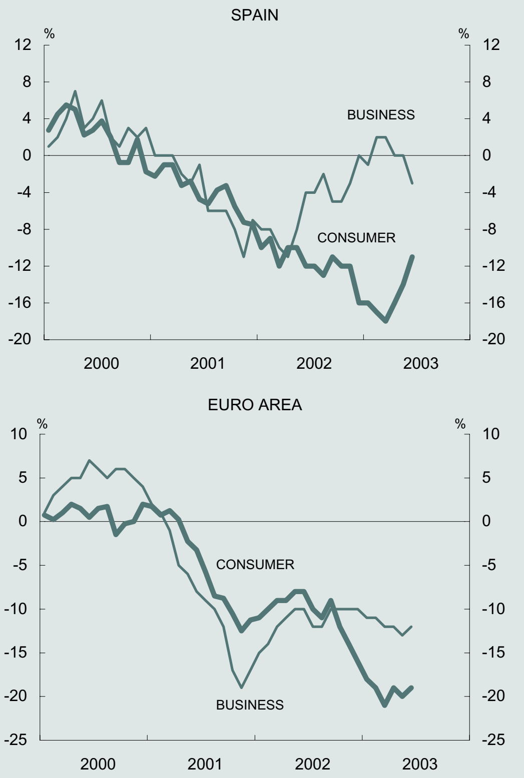
Sources: Ameco and Banco de España.

The lower chart shows the scale of revised estimates of per capita GDP depending on whether the latest available year (2002) or an alternative base year (1995) is used as a base. Note that if the series are expressed in latest-year prices, a bigger revision arises which, moreover, affects the entire series owing to the greater degree of provisionality of the figure taken as a reference.

To resolve all these alternative cases, the Banco de España has, in addition to publishing the series of per capita GDP at current prices (which allows analysis of the position each year with the prices for that year and, in particular, the latest year offered with the most up-to-date structure of relative prices), decided to incorporate the per capita GDP of Spain and the EU-15 with 1995 constant prices into the convergence indicators, with the corresponding decomposition into its determinants, which allows for uniform comparisons over time.

CHART 3

Confidence indicators



Source: European Commission.

est rates, the rise in stock market prices and the narrowing of the spread on corporate bond yields, has set in place monetary and financial conditions conducive to an increase in investment in the coming months, once the ongoing restructuring of balance sheets in certain sectors has been concluded.

This phase of cyclical weakness has prompted a notable increase in the budget deficits of the countries most affected by the diminished buoyancy of activity. In those economies where the budgetary position was furthest off balance, the economic slowdown has placed deficits above the level of 3% established in the Treaty on European Union. The attempt by some of these governments to foment recovery through the adoption of expansion-geared discretionary policies might prolong the excessive deficit procedures initiated at present. At this difficult juncture, it is important that the various countries and European authorities should maintain the consensus on the rules agreed under the Stability and Growth Pact, and on the most appropriate way of applying them in the current situation. In any event, headway in structural reforms, along the lines of the measures recently undertaken in France and, above all, in Germany, would seem a particularly necessary course to follow in the medium term so as to overcome the problems besetting the area and to restore its growth capacity.

All the domestic demand components have contributed to the growth of the Spanish economy during 2003 Q2. If movements in stockbuilding are excluded, the estimated year-on-year growth rate for this aggregate in Q2 is 2.9% (over 3% if the aforementioned movements are included), 0.2 pp up on the previous quarter. In addition to the continuing buoyancy of household and general government expenditure, and that of non-residential construction investment, the latest data are prominent – as well as for employment growth and the slowdown in the inflation rate – for the recovery in investment in equipment and the sustained vigour of goods exports. However, in this latter case, the parallel growth of imports has meant that the contribution of net external demand to real GDP growth has been substantially negative, by a similar amount to that in Q1.

The growth of household income, the loose monetary and financial conditions in which the Spanish economy is moving and, more recently, the increase in net wealth (the combination of the stock market pick-up and the growth of house prices) are other factors that have most contributed to the increase in household expenditure. The rise in consumption is expected to have exceeded the figure for Q1, and most of the leading indicators in the residential construction sector have been showing renewed robustness, which would naturally be indicative of growth in demand.

A series of factors have contributed to the growth of disposable income in the first half of the year, including most notably cuts in income tax rates and the application of wage indexation clauses owing to the deviation of the inflation rate from the official forecast. But it is the buoyancy of employment that provides the soundest and most lasting basis for sustaining disposable income, as reflected by the recently released EPA (Labour Force Survey) figures.

Financing received by households has continued to grow during the first half of the year at a rate of close to 15% year-on-year, slightly up on the related figure last December. While credit for house purchases has continued to show the highest rate of increase (15.6% in May), the latest figures show a slight slowdown. Meanwhile, financing for consumption and other purposes has quickened to 14.6% in May. The provisional data for June confirm these trends. Household debt ratios in respect of their disposable income have continued to increase, although their financial position has been strengthened by the aforementioned increase in their net wealth. Nonetheless, it should be borne in mind that a situation such as the present one, in which saving levels are low and debt ratios are increasing appreciably, entails greater vulnerability to the sharp changes that might arise in one or more of the variables that determine households' ability to meet their debts, such as employment, borrowing costs or the value of their real or financial assets.

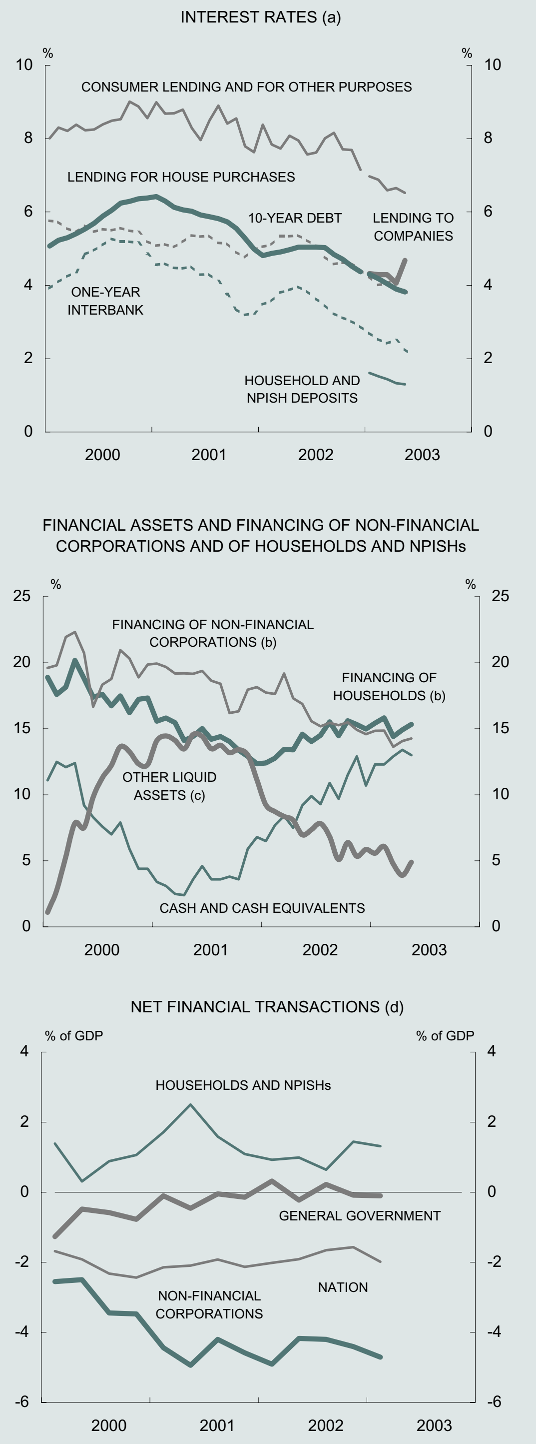
The situation of companies is also proving favourable for a recovery in investment, which had hitherto been confined to activities relating to private and infrastructure construction and to public investment. The latest indicators have offered clearer signs of the recovery perceived in investment in equipment since the start of the year, to the extent that the related year-on-year growth rate is clearly positive in Q2 at around 2.5%. Financing received by companies has held at a high growth rate (14.3% in May), and financing to activities outside the construction sector extended by resident credit institutions has visibly been more buoyant. In any event, corporate debt ratios have continued to increase, albeit at differing rates according to the type of company: while large corporations are restructuring their balance sheets by reducing their relative levels of debt, small and medium-sized companies continue to increase theirs. According to data provided by the companies reporting to the Banco de España Central Balance Sheet Data Office, earnings and profitability and financial-burden ratios in the period to the end of Q1 are at comfortable levels, paving the way for the gradual expansion of productive investment in the near future.

As highlighted, another significant feature of the data for 2003 Q2 is the sustained vigour of goods exports, whose increases in real terms are outgrowing those of their target markets. Most notable has been the performance of exports in several Community countries, since the losses in competitiveness arising from the course of the euro are being felt outside the euro area and the results have been poorer. Although the tourist industry indicators are also looking somewhat livelier, the estimated real increase for exports of goods and services in this period does not differ significantly from that offered for Q1.

The overall growth of domestic demand and exports, comprising final demand in the economy, has fed through in part to imports, which were also boosted by the loss of competitiveness of the domestic market compared with certain foreign regions, as a consequence of

CHART 4

Financial indicators of the Spanish economy



Source: Banco de España.
(a) There is a break, in January 2003, in the series of banking rates owing to changes in the data compilation statistical requirements.
(b) Includes bank lending extended by resident credit institutions, foreign loans and financing through securitisation funds. Financing to non-financial corporations also includes fixed-income securities.
(c) Includes deposits with agreed maturity, repos, bank securities, residents' cross-border deposits and shares in money-market funds.
(d) Cumulative four-quarter data.

the appreciation of the euro. Indeed, the imports/final demand ratio, which had stabilised in recent years owing partly to the structure of demand growth, is picking up once again.

As earlier discussed, the role of general government activity in the growth of the economy in the first half of the year was telling. In addition to its contribution to increasing household disposable income, consumption and public investment have increased at a notable pace. That the financial balance on State accounts should have proven more favourable than the same period a year earlier is logically due to the sound performance of the main taxes, chiefly personal income tax and VAT.

The growth of the Spanish economy has been distributed fairly uniformly across the different productive branches, with the negative exception of agriculture. Naturally, however, it is the construction and non-market services branches which have been most buoyant, while the recovery in industrial activity has been slowing. The employment figures conform to this pattern, and although some of the indicators for June have shown the increase in this variable to have been checked somewhat, the recently released EPA data have confirmed the robustness of job creation.

On EPA figures, employment increased by 2.6% in 2003 Q2, on the same recovering path as the previous quarter. The labour force has also remained notably vigorous and the unemployment rate has slowed once again. Across the different sectors, there was significant employment growth in construction and in services, while it tended to fall and even turn negative in industry, as was already the case in agriculture.

The information on labour costs for Q1 shows the impact of the indexation clauses on wage costs, together with the notable continuing increase in non-wage costs. The pattern of collective bargaining has not varied significantly during Q2 whereby, given the low growth of apparent productivity, the pressure of unit wage costs will have remained high. This pressure has fed through unevenly to the different branches, and while in construction the increase in business margins has remained very high, in industry – and especially in its associated export activity – the trend has been negative. It should be borne in mind that, for several months, export prices have been posting growth rates of virtually zero, so as to lessen the losses in competitiveness in non-Community markets and to hold their ground against the euro area countries.

The decline in the inflation rate in Q2 was, as mentioned, notable. In terms of the CPI, the twelve-month growth rate fell by 1 pp from April to June, having stood at 2.7% in the former month. Although the slowdown in energy prices was the key factor behind this performance, the growth rates of other more stable components of the index also fell, especially processed food and, to a lesser extent, services. The reduction in the inflation differential with the euro area countries, calculated using the respective harmonised indices, is due above all to the behaviour of food prices, which have practically bridged the notable gap that had been in place for over a year, while the differential in respect of non-energy industrial goods has tended to widen.

The Spanish economy should further moderate its inflation rate so that, as international activity recovers, net foreign trade flows do not detract from growth potential but provide rather a boost that passes through to business activity and corporate investment. In this respect, the recent behaviour of labour costs (wage and non-wage alike) and the persistence of muted rates of increase in productivity might act as a brake on the entrenchment of this process.

2. The external environment of the euro area

In 2003 Q2 the main economies of the external environment of the euro area maintained a slow pace of recovery, similar to that in Q1. However, the gradual improvement in underlying conditions, combined with expansionary demand-side policies, gave rise to a moderately optimistic outlook for the second half of the year.

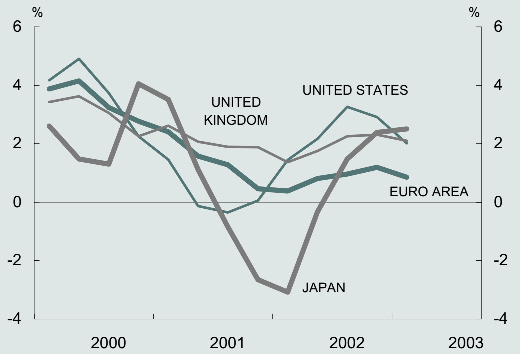
Developments on international financial markets largely reflected this optimism. During 2003 Q2, the equity markets performed favourably and financing conditions for business improved as the spreads on corporate bonds narrowed. Against this background, the dollar depreciated sharply and reached a low against the euro since the inception of the European currency. However, this trend reversed partially in June and July. Interest rates on government debt in the industrialised countries initially declined – despite the deterioration in public finances – supported by expectations of a reduction in official interest rates, among other factors. As the materialisation of these expectations proved more moderate than foreseen, a rapid and significant increase in long-term interest rates ensued as from mid-June, especially in Japan.

In the United States, GDP grew by 1.4% (in annualised quarterly terms) during 2003 Q1. Consumption grew by 2%, while corporate investment resumed a negative rate. The economic indicators released showed ambiguous signs, pointing to growth during Q2 having remained at a moderate pace. The positive retail sales figures in May and June confirmed the gradual pick-up in private consumption, despite consumer confidence falling after posting a notable improvement on the end of the military conflict in Iraq. Corporations showed no signs of harnessing their improved financial position to increase investment and employment, despite the strength of earnings in Q1. The decline in new orders of durable goods in May and the modest monthly increases in industrial production in May and June reflected the slackness of investment. As regards business confidence indicators, the performance across sectors clearly diverged: in manufacturing there was a very gradual increase while in services there was a forceful expansion. As in the previous quarter, the economic recovery occurred against the background of a weak labour market: numbers employed fell by 100,000 between May and June, placing the unemployment rate at 6.4%, the highest in nine years. As for inflation, the monthly rates of the headline indices of consumer prices, production and imports increased slightly in June, in step with the rise in oil prices. The 12-month rate of change of the CPI stood at 2.1%, but the underlying rate dipped to 1.5%, the lowest rate since the sixties. At its meeting

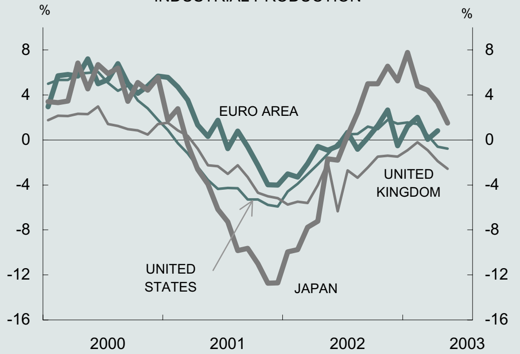
CHART 5

Main macroeconomic indicators
Annual rates of change

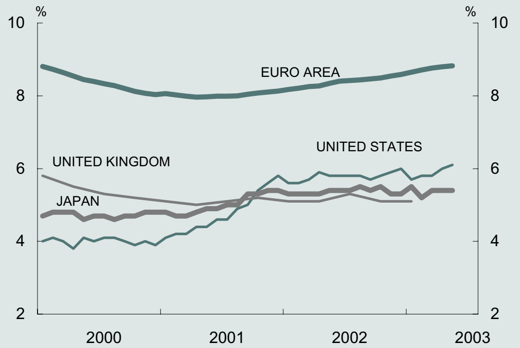
GROSS DOMESTIC PRODUCT



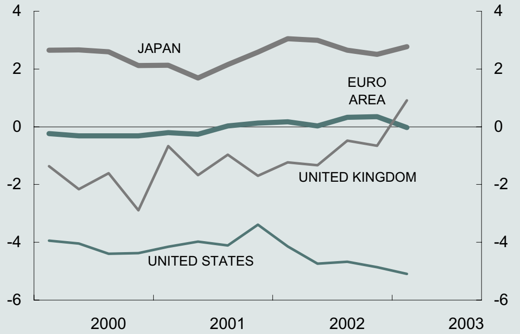
INDUSTRIAL PRODUCTION



UNEMPLOYMENT RATE (a)



CURRENT-ACCOUNT BALANCE
AS A PERCENTAGE OF GDP

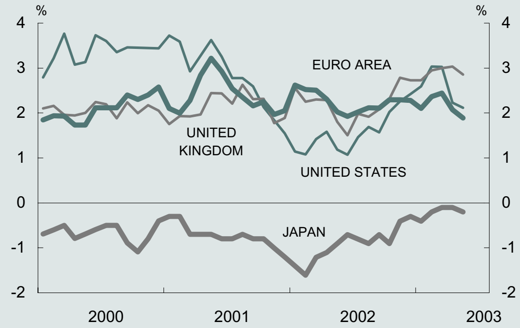


Sources: Banco de España, national statistics and Eurostat.
(a) Percentage of the labour force.

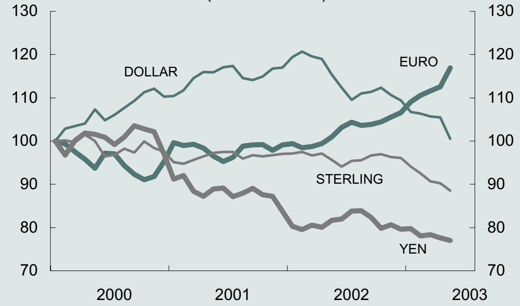
CHART 6

Prices, real exchange rate and interest rates

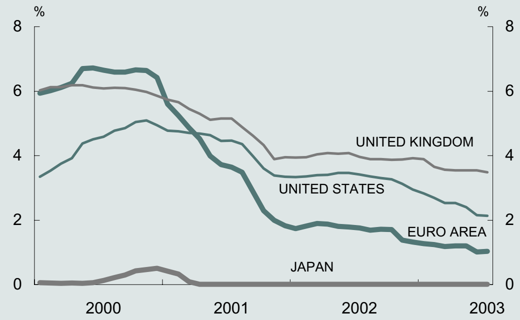
CONSUMER PRICES



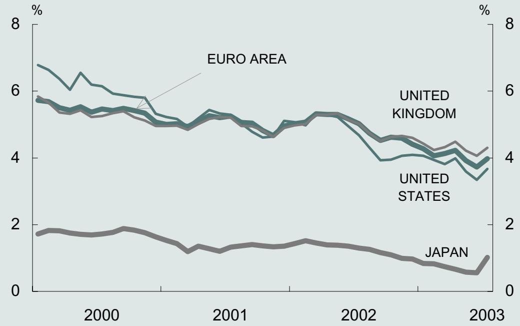
CPI-BASED REAL EFFECTIVE EXCHANGE RATES
VIS-À-VIS DEVELOPED COUNTRIES
(Jan 2000 = 100)



SHORT-TERM INTEREST RATE (a)



LONG-TERM INTEREST RATE (b)



Source: Banco de España.
(a) Three-month interbank market interest rates.
(b) Ten-year government debt yields.

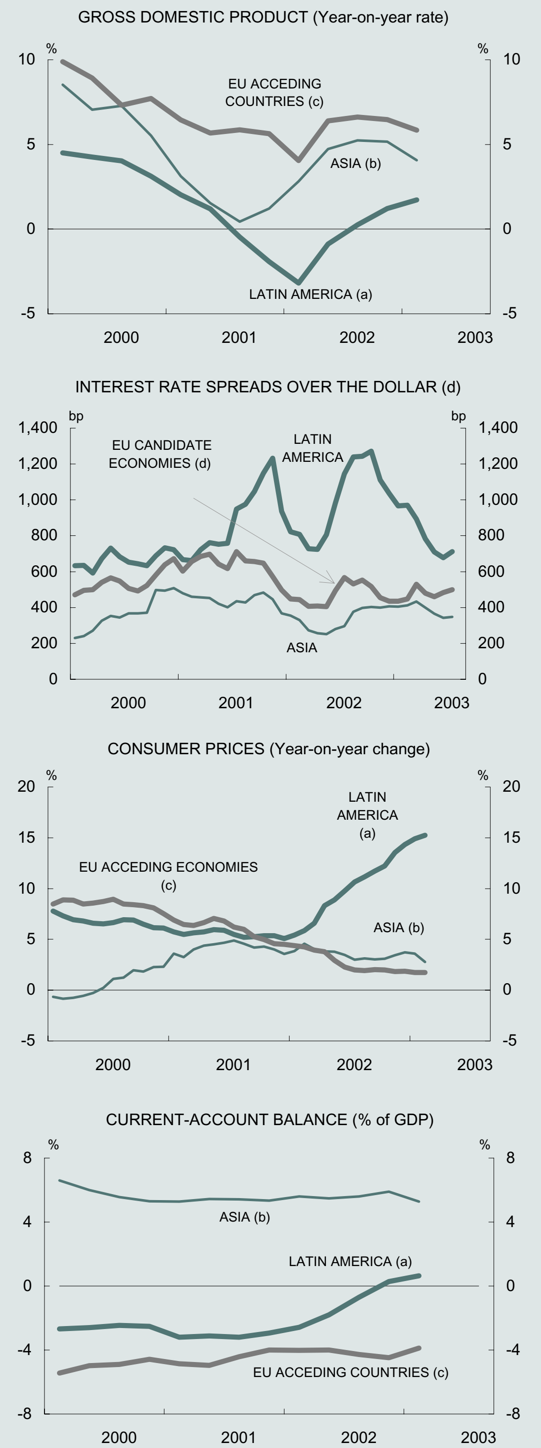
on 25 June, the Federal Reserve cut official interest rates to 1%. In its assessment of risks, the Federal Reserve continued to set great store by those associated with an excessive reduction in the inflation rate. It ratified its commitment to keep official interest rates low so as to stave off any risk of deflation. And it emphasised the favourable prospects of a firmer pick-up in activity in the second half of the year, underpinned by the favourable trend of productivity, the partial correction of households' and firms' financial imbalances and the boost to activity stemming from monetary and fiscal policies.

In Japan, economic activity remained virtually flat during Q1. On National Accounts figures, GDP grew at a non-annualised quarterly rate of 0.1%, driven by a slight rise in consumption and despite the fall in investment. The foreign sector held back Japanese growth, contrary to what was the case in 2002 Q4, owing partly to the adverse effect of SARS on the south-east Asian countries. The indicators available for Q2 showed moderately positive signs, especially on the supply side, such as the increase in industrial output in May. Likewise, the Tankan business sentiment survey posted an increase, while the labour market data showed the rate of job destruction to be stabilising, a somewhat more favourable situation than that in previous quarters. Once the effects of SARS on the region were apparently behind, external demand moved into more favourable territory. Deflationary tendencies, however, remained clearly present in the Japanese economy: the year-on-year fall in the GDP deflator rate was a record one (3.3%) and consumer prices fell in May by 0.2% on 12 months earlier (overall index), with the underlying rate declining by 0.4%. In this setting, the Bank of Japan maintained its strategy and pursued a quantitative expansion of base money.

In the United Kingdom, the year-on-year growth of GDP in Q1 fell by 0.2 pp to 2.1%, owing to the slowdown in private consumption and the fall in investment. During Q2, and on preliminary National Accounts data, this rate fell once more, although the quarterly growth rate accelerated moderately. The partial indicators for this period confirmed a degree of sluggishness in consumption and in industrial activity, while construction and services showed signs of greater strength. The labour market continued to perform favourably, with the unemployment rate falling in May to 5%. The retail price index excluding mortgage interest payments (RPIX) fell by 0.1 pp in both May and June to 2.8% year-on-year, and the harmonised index of consumer prices also dipped to 1.1%. The growth of house prices eased to a year-on-year

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) JP Morgan EMBI spreads. For the EU candidate economies, an in-house estimate drawing on data from Bulgaria, Hungary, Croatia, Turkey and Poland has been made.

rate of close to 20%, which is still very high. Faced with signs of weakness in growth and the prospect of diminishing inflationary pressures, the Bank of England decided to lower the official interest rate in July by one quarter of a point to 3.5%.

In the EU acceding countries, GDP growth in Q1 diverged from country to country. While the Baltic countries posted year-on-year growth of between 5% and 9%, the figures for the central European countries were generally below 3%. Growth was particularly low – at 2.7% – in Hungary, the lowest figure for six years. The inflation rates of these countries generally held at moderate levels, which enabled them to cut their official interest rates. The only exceptions to this trend were Slovakia, whose inflation exceeded 8%, and Hungary, owing to the depreciation of the forint following the devaluation in June of the currency's central parity by 2.2%. In the central European countries, the outlook regarding compliance with the fiscal consolidation targets for 2003 was marred by the scale of the budget deficits built up during the first half of the year. On the political front, EU accession was sanctioned by referendum in four countries: Lithuania, Slovakia, Poland and the Czech Republic.

In Latin America, the favourable trend of financial markets embarked upon in Q1 continued. Sovereign debt spreads narrowed across the board and several local currencies appreciated against the dollar. Several countries, such as Brazil, Mexico and Colombia, took advantage of these circumstances to return to international markets with new debt issues. From June, however, there was a partial reversal in this trend and, in certain countries, spreads widened somewhat. As regards activity, there were differences from country to country: Brazil and Mexico saw a clear slowdown in growth, while other economies benefited from more favourable trends. The generalised moderation of inflationary pressures across the region has allowed for a less restrictive monetary policy stance.

In Argentina the economic recovery continued apace, with growth of 5.4% year-on-year in Q1. Prices held stable and financial variables trended favourably, although uncertainty over the course of economic policy and how to settle some of the serious unresolved problems continued to bear down on the country's situation. In Brazil activity was seen to slow in a setting marked by the restrictiveness of monetary and fiscal policies. The external and fiscal adjustment continued, and the primary surplus reached 4.5% of GDP. The slackness of activity and the moderation of inflation expectations provided, as from June, for a cut of 50 bp in the intervention interest rate (SELIC), which was reinforced with a further cut of 150 bp in July, placing the rate at 24.5%. In Mexico concerns over inflation and peso depreciation were overcome, but a decline in activity was recorded. The Venezuelan economy remained in recession, though high oil prices contributed to reducing the shortfall on public finances. Uruguay successfully completed a swap of its public debt.

3. The euro area and the monetary policy of the ECB

In the second quarter of 2003, economic growth in the euro area was weak. According to the available indicators, this was a result of slack domestic spending and subdued external sales. Inflation moderated, mainly because of the behaviour of the energy component, given the fall in the oil price stemming from a return to normal on the oil market and from the appreciation of the euro. Developments on the financial markets were more favourable than in preceding quarters, possibly indicating increased optimism on the part of economic agents over growth prospects. In addition, the foreseeable recovery in external demand, the low level of interest rates and the moderation in inflation support a scenario in which activity picks up gradually in the second half of the year. That said, there remain certain downside risks. These are linked to a possible continuation of balance sheet rebuilding by companies, with contractionary effects on investment and employment, and to the uncertainty over global economic activity and developments on international financial and foreign exchange markets stemming from the build-up of macroeconomic imbalances in the United States.

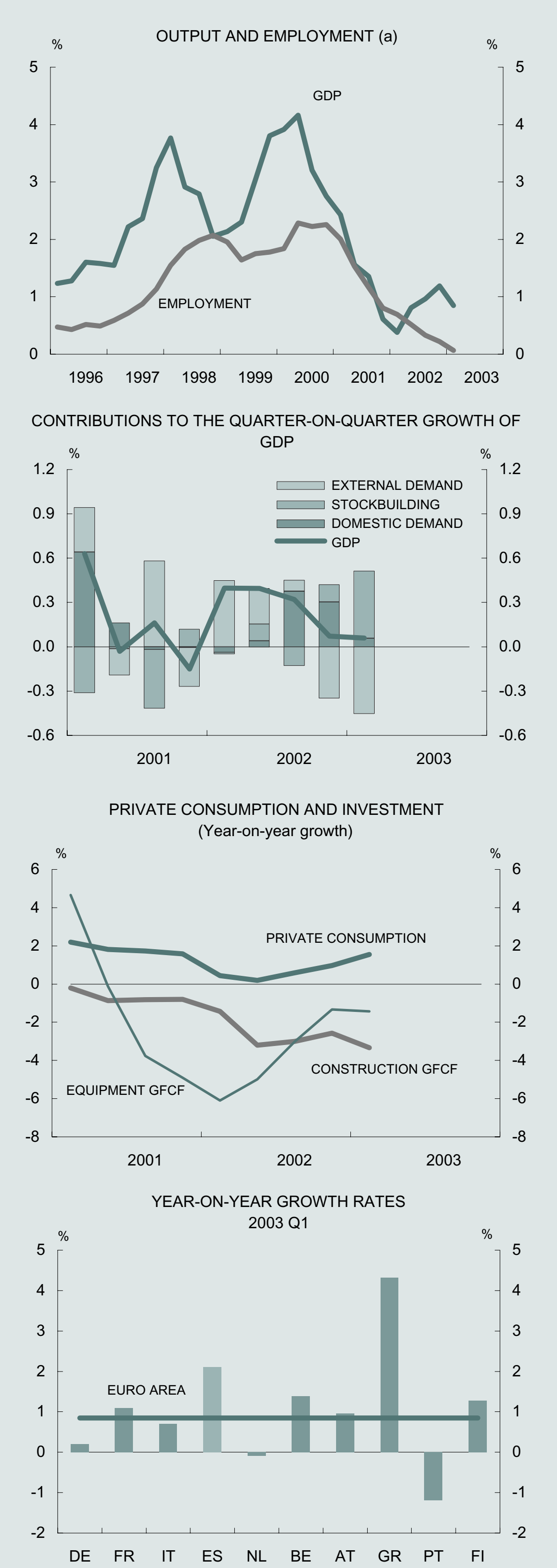
At the beginning of June, given this background of controlled inflation and faltering growth, the ECB reduced interest rates by 50 basis points, taking the interest rate on the Eurosystem's main refinancing operations to 2%, the lowest level of official rates since the introduction of the single currency. As regards fiscal policies, the impact of the operation of automatic stabilisers has aggravated the deterioration already undergone by the budgetary positions of some member countries. This makes it all the more necessary to stress the binding nature of the rules agreed within the framework of the Stability and Growth Pact and to maintain consensus over the best way of applying them in the present situation.

3.1. Economic developments

According to the second National Accounts estimate, the euro area economy grew by 0.1% in 2003 Q1, the same rate as in the previous quarter. This took the year-on-year GDP growth rate to 0.8%, 0.4 pp down from the preceding quarter (see Table 1). The contribution of domestic demand (excluding stocks) to quarter-on-quarter GDP growth fell from 0.3 pp in 2002 Q4 to 0.1 pp in 2003 Q1, as a consequence of the notable deterioration in gross fixed capital formation, which fell by 1.2% (see Chart 8). The sharp contraction in investment is explained by the worsening of its two main components, which suffered quarter-on-quarter falls of 1.5% in the case of capital equipment, and of 1.2% in

CHART 8

Euro area national accounts



Sources: Eurostat and national statistics.
(a) Annual rates of change.

that of construction. It should be stressed that this negative figure is largely a consequence of the anomalous increase in this variable during 2002 Q4 which, as mentioned in the April edition of this bulletin, is related to the atypical data for Germany and Italy. In fact, if we exclude these two countries from the total investment figures, then investment fell by around 0.1% in the quarter, an improvement on its behaviour in late 2002. Private and government consumption, for their part, grew by 0.4% and 0.3% respectively, the same rates as in the previous quarter. The contribution of stockbuilding to quarter-on-quarter GDP growth was 0.5 pp, as against 0.1 pp in the previous quarter. Finally, net external demand trimmed the quarter-on-quarter increase in output by 0.5 pp, owing to the sharp fall in exports (–0.6%) and to the relative strength of imports.

The country breakdown of the National Accounts for the first quarter shows a widening of the national growth differentials. Quarter-on-quarter GDP growth fell in Q1 in Germany (–0.2%), Italy (–0.1%), the Netherlands (–0.1%) and Finland (–1.3%), while in the other countries for which information is available it either held at the same rate as in the preceding quarter or quickened. In all cases the contribution of the external sector to output growth was negative and consumption held relatively strong. Also, in those countries in which GDP fell, gross fixed capital formation and construction investment, in particular, showed pronounced falls. Investment in construction in the euro area and in each of the member countries is broken down into its main components in Box 2.

On the supply side, the weakness of gross value added in Q1 stemmed from the notable contraction in construction (–1.8% quarter-on-quarter) and from the slowdown in services activity, since developments in other industries were more favourable. As regards the labour market, employment was flat for the third consecutive quarter, giving rise to a year-on-year growth rate of 0.1%, the lowest level since 1995. The fact that output decelerated by more than employment relative to 2002 Q1 meant that apparent labour productivity grew more slowly, its rate declining to 0.7%.

The information available on activity indicators in 2003 Q2 points to sustained growth weakness in the euro area. Consequently, the quarter-on-quarter GDP growth rate may lie in the lower half of the 0%-0.4% range estimated by the European Commission (EC) for the quarter (see Table 1). If this estimate is confirmed, the achievement of an average GDP growth rate for 2003 within the interval of 0.4%-1% estimated by the ECB for 2003, which was pub-

BOX 2

The behaviour of construction in the euro area

Despite its moderate weight in output, gross fixed capital formation (GFCF) plays a very important role in its determination, since it is characterised by more intense phases of expansion and contraction than other components of spending, such as private consumption. Since peaking in 1999, GFCF has progressively decelerated, leading the slowdown in GDP by three quarters. As can be seen in the top chart, it reached a smooth turning point last year.

Since mid-2000, when the most recent downturn began, the equipment component of GFCF has lost much more momentum than the rest of GFCF and, moreover, this loss has been contemporaneous with the slowdown in GDP. Construction growth, by contrast, began to fall ahead of output, although from more moderate rates and at a slower pace. Also, while equipment investment seems to have passed its trough already, the annual rate of change of investment in construction has still to pick up. In fact, in 2003 Q1 it was the component of investment with the most negative annual rate of growth, taking 0.3 pp off GDP growth.

As seen in the second chart, residential investment has been growing at negative rates for the last nine quarters, whereas non-residential construction has only recently begun to contract. Given that within this component the determinants of private-sector construction are similar to those of equipment investment, which is recovering, the recent contraction in investment in non-residential construction may be related to the behaviour of its public works component. The latter has possibly been constrained by the budgetary difficulties affecting the Member States as a result of the general economic slowdown.

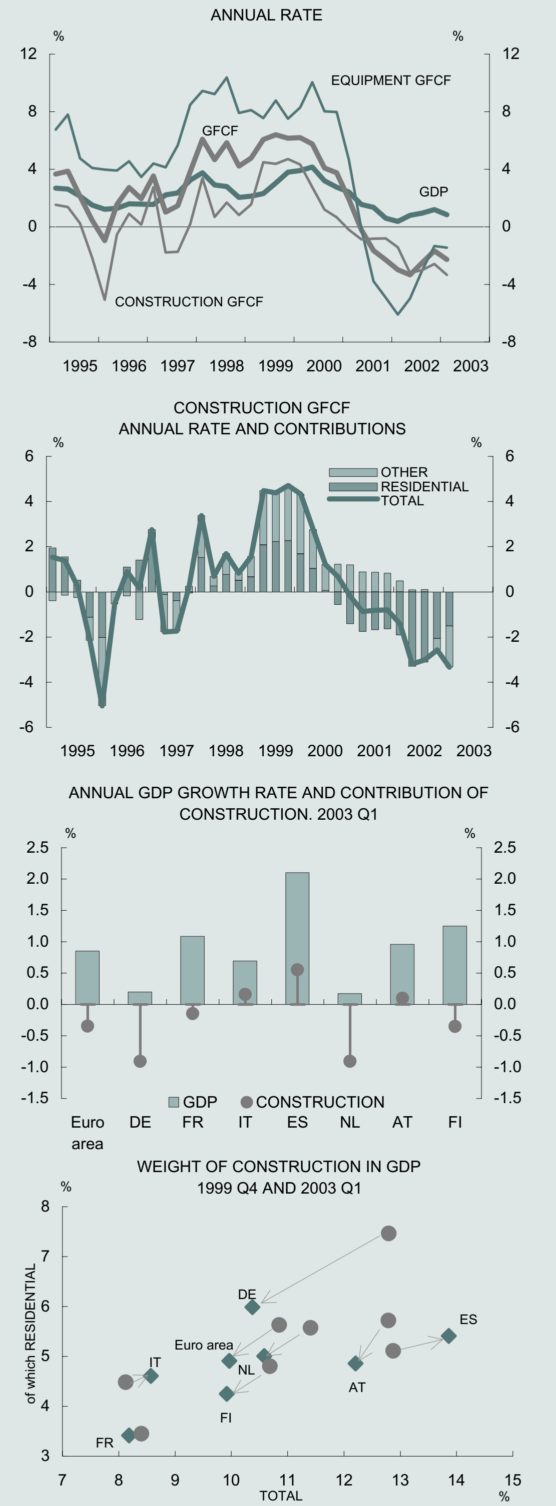
The behaviour of aggregate euro area construction masks significant disparities across the Member States. In particular, as seen in the third chart, construction has been responsible for significant contraction in output growth in Germany and the Netherlands, while in Spain, by contrast, construction added 0.6 pp to GDP growth in Q1.

It should be noted that in Germany these developments are part of a long process of correction of the overinvestment of the first half of the 1990s, a phenomenon that held back the growth of this component in the second half of the decade. As seen in the bottom chart, the weight of construction in GDP has fallen very significantly during the latest downturn, from 12.8% (one of the highest levels in the euro area) to 10.4%. Somewhat more than half of this loss of weight derived from the behaviour of residential investment.

The Netherlands, Austria and Finland have also seen construction investment lose weight in output in recent years. In the Netherlands this phenomenon is relatively recent, since investment in construction only began to display negative growth rates at the beginning of 2002, a year later than on average in the euro area and in countries such as Austria and Finland. In these three countries it is the residential component that accounts for most of this loss of weight.

Finally, the strong dynamics of investment in construction in Spain in recent years, boosted by the low levels of real interest rates, the notable increase in mortgage credit and a relative loosening of the budgetary position, have led to an increase of one percentage point in its weight in GDP, between 2000 and early 2003, to 13.9%, the highest level in the euro area. Most of this increase in its weight in output has been due to the gain by the non-residential component which currently accounts for 8.5% of GDP.

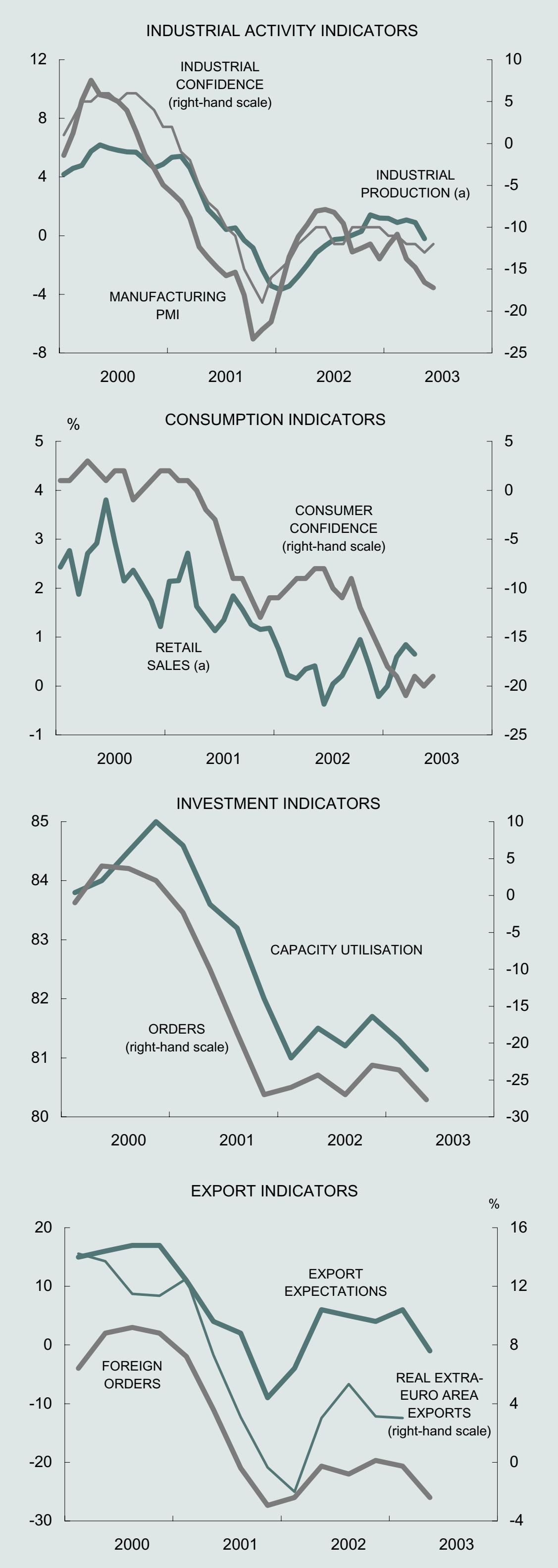
GFCF in construction



Source: European Central Bank and Banco de España.

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.

lished in its June bulletin, would require a moderate pick-up in activity in the second half of the year.

As regards the supply indicators in 2003 Q2, the industrial production index (excluding construction) fell by an average of 0.5% in April and May, relative to Q1, and both the European Commission industrial confidence indicator and the manufacturing purchasing managers index deteriorated relative to 2003 Q1 (see Chart 9). The EC construction confidence indicator also fell. As for services activity, the information available is sending mixed signals; whereas the EC sentiment indicator improved significantly, the services purchasing managers index fell.

From the viewpoint of demand, the trend in private consumption indicators was somewhat more favourable than that in the investment and exports indicators. The EC consumer confidence indicator stood on average in Q2 at the same level as in Q1 and the readiness of consumers to buy consumer durables, an indicator that tends to lead total consumption, improved slightly during the quarter (see Chart 9). Retail sales grew by 1.5% in April relative to the previous month, in contrast to the average quarter-on-quarter fall in car registrations of 3.2% in Q2. Finally, the EC retail confidence indicator improved in Q2 relative to Q1. As regards the demand for capital equipment, according to the EC's six-monthly survey carried out in April, industrial firms estimate that their investment spending will grow by –1% in 2003, which is similar to their November 2002 estimate. Although negative, this estimate for 2003 is much larger than the final figure for 2002. As for the foreseeable trend in investment in Q2, both the assessment of industrial order books and capacity utilisation worsened during the period. In relation to external demand, industrial export expectations were negative for the first time since the beginning of 2002, and the indicator of the assessment of foreign order books deteriorated significantly in that same period (see Chart 9). Finally, the employment indicators, also obtained from opinion surveys, show a further worsening of this variable in most industries (see Chart 10). The slowdown in the rate of generation of employment has led to a slight rise in the rate of unemployment, which stood in May at 8.8%, 0.1 pp above its Q1 level.

Thus, according to the trends in the available indicators, it is foreseeable that the pattern of weak growth in Q2 will not display significant changes with respect to Q1, with growth supported more by consumption than by exports or investment.

TABLE 1

Euro area economic indicators

	2001	2002				2003		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2 (a)	Q3 (b)
GDP								
Year-on-year growth	0.6	0.4	0.8	1.0	1.2	0.8		
Quarter-on-quarter growth	-0.2	0.4	0.4	0.3	0.1	0.1		
European Commission forecasts (c)							(0.0 ; 0.4)	(0.0 ; 0.4)
IPI (d)	-2.9	-2.7	-0.7	-0.2	1.2	1.0	*-0.2*	
Economic sentiment	98.8	99.2	99.5	99.0	98.7	98.2	98.1	
Industrial confidence	-17.3	-13.0	-10.0	-11.3	-10.0	-11.3	-12.3	
Manufacturing PMI	43.6	48.3	51.4	50.5	49.0	49.3	47.0	
Services confidence	-5.3	3.4	5.3	-0.7	-4.3	-5.0	-2.3	
Services PMI	47.9	52.1	52.9	50.9	50.5	48.9	47.9	
Unemployment rate	8.1	8.2	8.3	8.4	8.5	8.7	*8.8*	
Consumer confidence	-11.7	-10.0	-8.3	-10.0	-14.0	-19.3	-19.3	
HICP (d) (e)	2.1	2.5	1.9	2.1	2.3	2.4	2.0	
PPI (d) (e)	-0.7	-0.6	-0.8	0.3	1.6	2.4	*1.4*	
Oil price in USD (e)	18.7	23.7	24.1	28.4	28.2	30.3	27.6	28.5
Loans to the private sector (d) (e)	6.0	5.5	5.4	5.1	4.7	4.7	4.5	
Euro area 10-year bond yield	4.8	5.1	5.3	4.8	4.5	4.2	4.0	4.0
US-euro area 10-year bond spread	-0.02	-0.01	-0.10	-0.46	-0.51	-0.22	-0.32	-0.23
Dollar/euro exchange rate (e)	0.881	0.872	0.998	0.986	1.049	1.090	1.143	1.140
Appreciation/depreciation of the euro (e)	-5.3	-1.0	13.2	11.9	19.0	3.9	9.0	8.7
Dow Jones EURO STOXX Broad index (e)	-19.7	1.6	-15.2	-39.1	-34.5	-12.9	2.9	4.1

Sources: Eurostat, ECB and Banco de España.
(a) The information in *italics* is for only part of the quarter.
(b) Information available to 23 July 2003.
(c) Forecasts of quarter-on-quarter growth.
(d) Year-on-year growth.
(e) End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

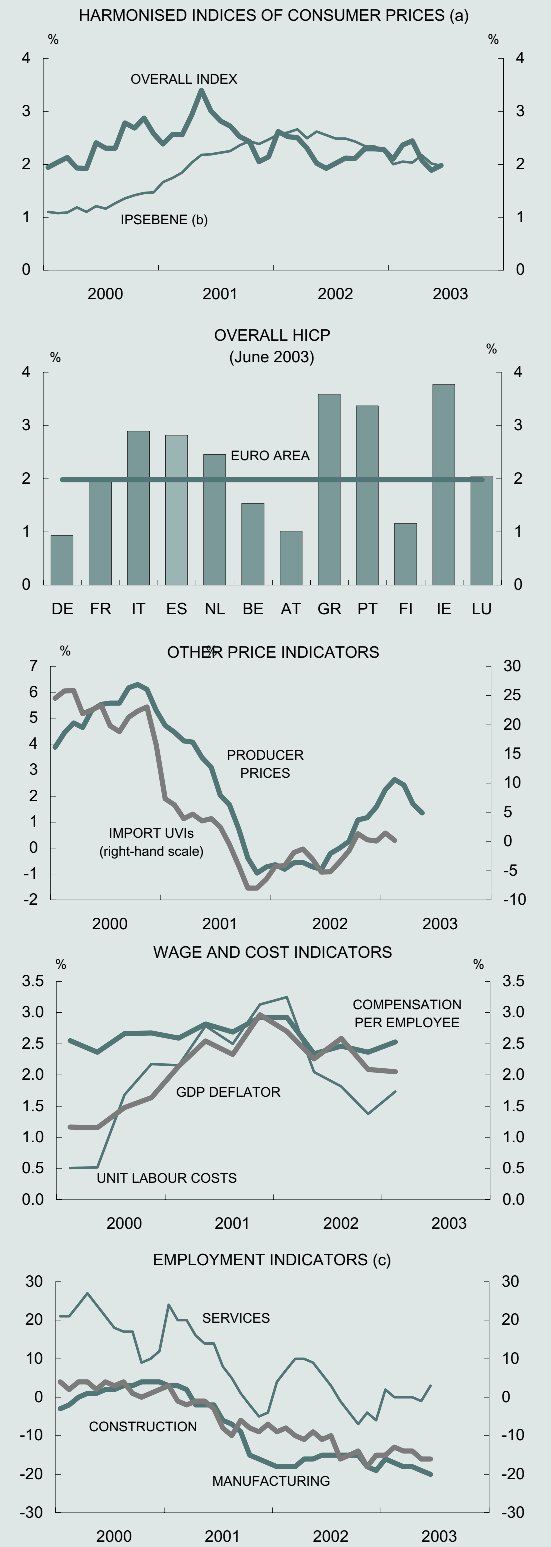
Price indicators in the euro area have decelerated in recent months. As regards the determination of domestic prices, unit labour costs increased in Q1 by somewhat more than in the previous period, owing to a slightly larger increase in compensation per employee and a smaller increase in productivity. However, the rate of growth of the GDP deflator was similar to the previous quarter and faster than that of unit labour costs, so that a further increase in margins is foreseeable (see Chart 10).

Consumer price developments in the euro area in Q2 were marked by a moderation in the rate of change of the Harmonised Index of Consumer Prices (HICP), which fell from 2.4% in March to 2% in June (see Chart 10 and Table 1). However, these developments were basically driven by the behaviour of the energy component, whose rate of growth declined significantly over the period April to June, since the rate of increase in the prices of other groups of goods hardly dipped. Thus, the growth rate of the indicator that includes the prices of services and non-energy goods (IPSEBENE) held steady at 2% between April and June. Meanwhile, the producer prices index rose by 1.4% year-on-year in May, one point less than in March. At the components level, the smooth slowdown in the prices of industrial consumer goods since the beginning of the year was noteworthy.

Despite the downward stickiness of the most stable core of inflation, the medium-term price outlook is favourable. The progressive pass-through of the recent appreciation of the euro to the prices of the less volatile components, the fact that the oil price will foreseeably remain within the price bands set by OPEC and the existence of excess productive capacity should help to contain inflationary pressures. Moreover, wage developments are consistent with inflation levels close to the ECB's definition of price stability, although their current rate of growth (close to 2.5%) does not seem conducive to a rapid pick-up in the rate of growth of employment. As for HICP developments across countries, inflation rates are still showing considerable diver-

CHART 10

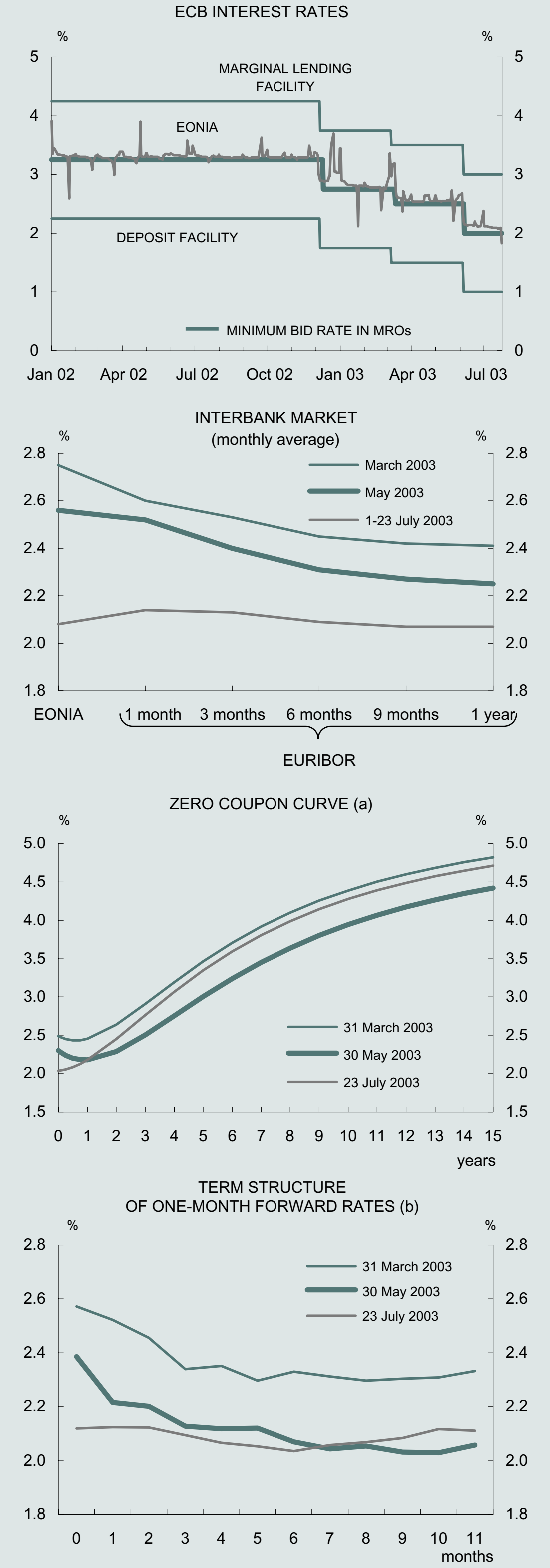
Euro area. Price, wage and employment indicators
Year-on-year percentage changes



Sources: Eurostat and European Central Bank.
(a) There is a break in the series in January 2002 when they were rebased to 2001.
(b) Index of non-energy processed goods and services prices.
(c) Expectations based on European Commission sentiment indicators.

CHART 11

Euro area interest rates



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

TABLE 2

General government budget balances of euro area countries (a)

% GDP

	2000	2001	2002	2003 (b)	2003 (c)
Belgium	0.1	0.2	0.1	-0.2	0.0
Germany	-1.4	-2.8	-3.6	-3.4	-2.8
Greece	-1.9	-1.9	-1.2	-1.1	-0.9
Spain	-0.9	-0.1	-0.1	-0.4	0.0
France	-1.4	-1.6	-3.1	-3.7	-2.6
Ireland	4.3	1.1	-0.3	-0.6	-0.7
Italy	-1.8	-2.6	-2.3	-2.3	-1.5
Luxembourg	6.1	6.4	2.6	-0.2	-0.3
Netherlands	1.5	0.1	-1.1	-1.6	-1.0
Austria	-1.9	0.3	-0.6	-1.1	-1.3
Portugal	-3.1	-4.2	-2.7	-3.5	-2.4
Finland	6.9	5.1	4.7	3.3	2.7
MEMORANDUM ITEM:					
Euro area					
Primary balance	3.0	2.3	1.5	1.1	
Total balance	-1.0	-1.6	-2.2	-2.5	-1.8
Public debt	70.2	69.2	69.2	69.9	

Sources: European Commission, national stability programmes and IMF.
(a) As percentage of GDP. Proceeds from the sale of UMTS licences not included. Deficit (-) / surplus (+).
(b) European Commission forecasts (April 2003).
(c) Targets of the stability programmes presented between November 2002 and January 2003.

gence (see the second panel of Chart 10), although the differential between the highest and lowest country rates tended to narrow in Q2.

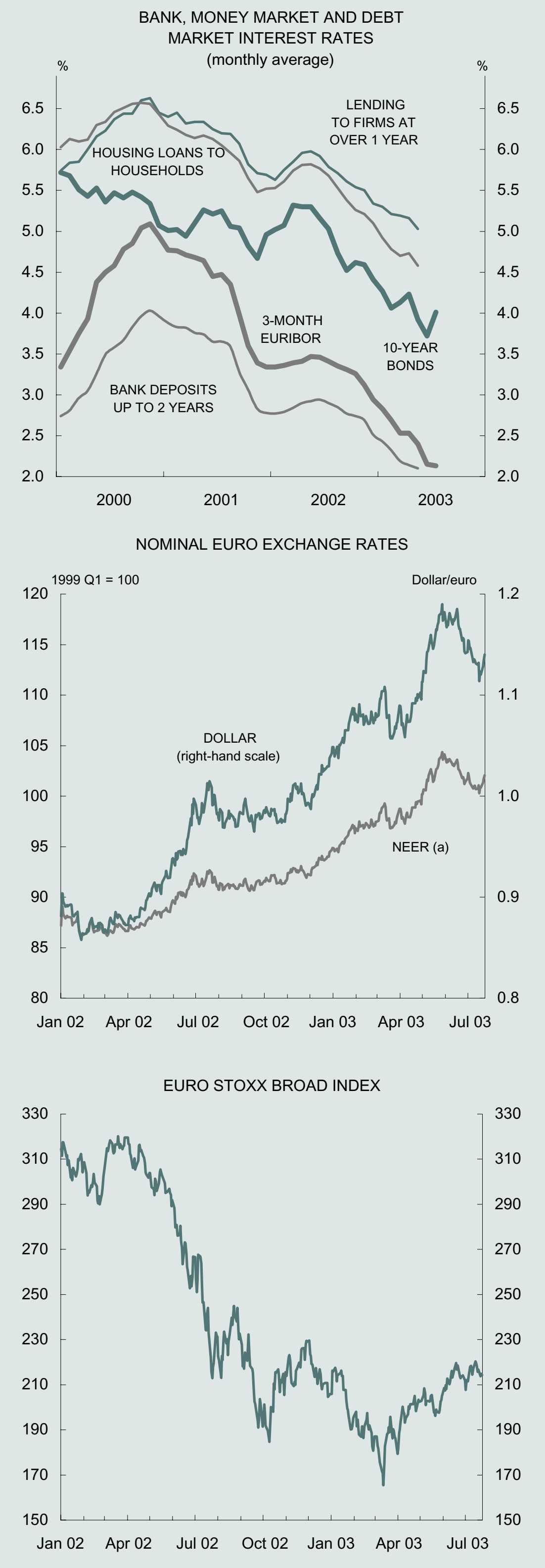
According to estimates published by the ECB, in 2003 Q1 there was a current account deficit of €1.9 billion, in contrast to the surplus of €24.5 billion in the previous quarter and of €12 billion in the same period a year earlier. Although all the sub-balances deteriorated, it was the trade and income balances that drove the overall deterioration, which is basically explained by the notable weakness of the volume of exports, due to the increase in the real terms of trade in Q1. Considering, moreover, that there were net capital inflows in the form of direct and portfolio investment, of €6 billion (in contrast to the net outflows of the other investment item of the financial account), the basic balance, which approximates an economy's financing requirements of a more permanent nature, stood at €4.6 billion in Q1, a significant reduction on the previous quarter (see Chart 13).

The fiscal outlook deteriorated in numerous countries of the euro area in the first half of the year, so that it is very likely that a large majority of Member States will fail to meet the targets set in their stability programmes for 2003 (see Table 2). The expected worsening of the balances can basically be attributed to the direct impact of the weakening of macroeconomic activity on the income and spending components most sensitive to the economies' cyclical position. In particular, for countries in an excessive deficit situation, the action of automatic stabilisers has exacerbated the difficulty involved in correcting the situation promptly. There are currently three countries in this situation, since 3 June, when the ECOFIN Council ratified the existence of an excessive deficit in France, the procedure previously having been set in motion for Germany and Portugal. The Council has given the French authorities a period of four months to take corrective measures, i.e. involving a significantly greater improvement in the cyclically adjusted balance than that planned until now. In addition, in 2004, this country must correct its cyclically adjusted deficit by at least 0.5% of GDP, to ensure that its actual deficit is below 3% of GDP that year.

In response to the persistent weakness in their respective economies, some governments, such as the German and French, are attempting to use the scant leeway available, announcing their intention to introduce tax cuts to stimulate activity. In Germany, the government has proposed bringing forward by one year tax cuts

CHART 12

Euro area interest rates, exchange rate and stock market



Sources: Banco de España and European Central Bank

(a) Nominal effective exchange rate index. Narrow group of currencies defined by the ECB.

initially planned for 2005. For the moment, the details of the ways in which the budgetary cost of the measure (estimated as around 0.9% of GDP) may be financed are not known, with the exception of the elimination of certain transfers to households (such as the tax incentives to purchase first homes). Also, the uncertainty regarding the final content of the proposal is added to by the need to agree it with the opposition and with the federal states. In France, the authorities have also announced their intention of introducing some type of reduction in the tax burden, yet to be specified, some time around the autumn, although they have also advised that the margin available is small, given the unfavourable trend in receipts from corporate income tax and the slippage in health spending.

These fiscal expansion strategies at a time of cyclical weakness may delay the process of correcting the imbalances in the countries concerned, which would prolong the excessive deficit procedures currently open. In this environment, it is important that the commitment to the rules of the Stability and Growth Pact be strengthened, at the same time as the margin of flexibility incorporated therein is used, in line with the Major Economic Policy Guidelines recently adopted by the European Council and the recommendations made in each specific case by the ECOFIN Council.

In any case, a sustained increase in economic growth requires the adoption of ambitious structural reforms. Promising here have been the reforms being made in Germany, where the main political forces have reached a preliminary consensus based on the so-called Agenda 2010, a broad raft of measures that includes reforms to health systems, unemployment benefits and the dismissal legislation applicable to small firms. In France, likewise, a reform of the pension system is in the process of being approved. Among other elements this lengthens the contribution period giving entitlement to a full pension in general government to bring it into line with the private sector. It also provides incentives to delay the age of early retirement, which may help to mitigate the long-term impact of population ageing on the public finances.

3.2. Monetary and financial developments

At its meeting of 5 June 2003, the Governing Council of the ECB, after assessing the inflationary outlook, the absence of signs of significant recovery in activity and the scaling down of expectations for growth in the area, decided to reduce official interest rates again, this time by 50 basis points. The reductions made this year have taken the minimum bid rate on the main

BOX 3

Developments in effective euro exchange rates

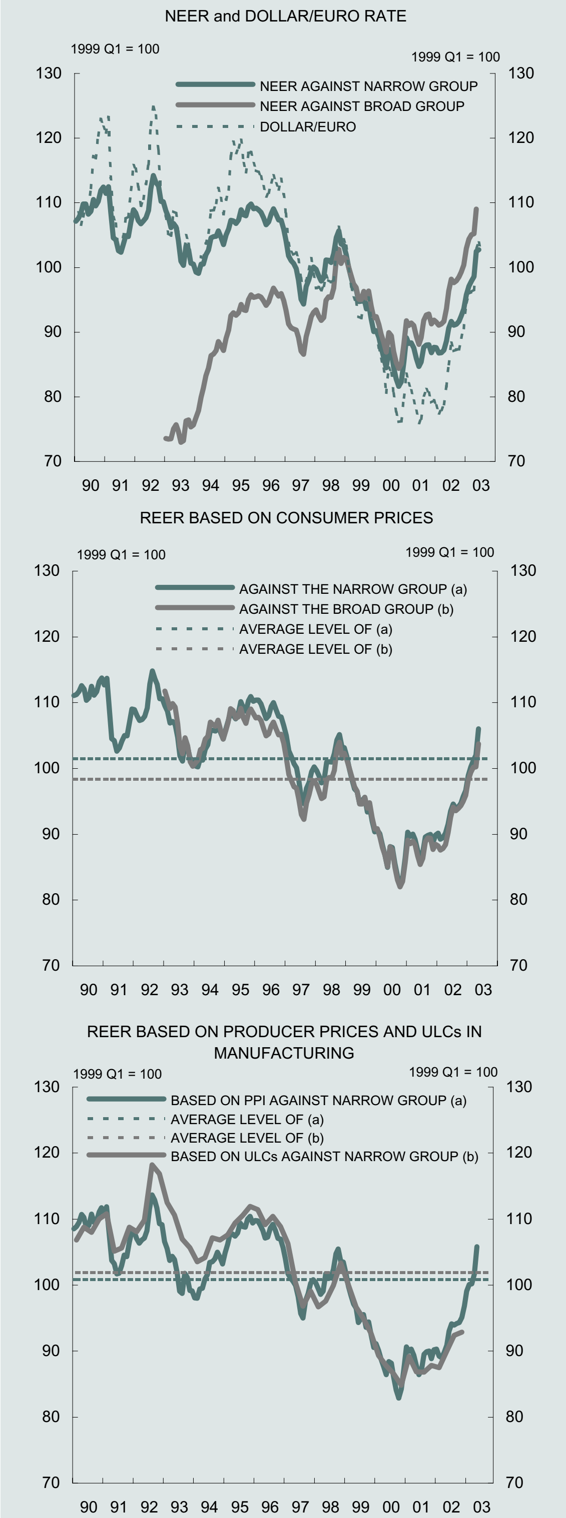
Developments in the competitiveness of the euro area with respect to the main countries with which it trades can be assessed by analysing the behaviour of the real effective exchange rate (REER) of the euro. Competitiveness is a very broad concept, referring to the ability of an economy to maintain or increase its share in different markets (including the domestic market). Analysing the path of the REER only gives a partial view of competitiveness developments, since firms may compete through strategies other than price reductions. Although part of any change in the REER is explained by the changes in its basic determinants (ultimately those variables that generate current and expected yield differentials), the levels of the NEER and the REER observed from time to time frequently display significant deviations from those suggested by their basic long-run determinants.

The REER is constructed using two elements: an indicator of relative prices and costs and the nominal effective exchange rate (NEER). The latter is a measure of the external value of the currency against those of the country's trading partners and, in practice, its movements explain most of the changes in the REER. The price and cost measures commonly used to construct the REER include consumer prices (CPIs), producer prices (PPIs), unit labour costs in manufacturing (ULCM) and in the total economy (ULCT) and GDP. The ECB currently calculates these five measures of the REER (the latter two only since August 2003) vis-à-vis a narrow group of currencies corresponding to 12 countries, most of which belong to the OECD. In addition, it also calculates the REER using the CPI vis-à-vis another broader group of countries, which also includes the currencies of 26 emerging and transition economies. The use of this second grouping is justified by the increasing importance of these countries in world trade. These two groupings represented, on average, 62% and 89%, respectively, of the area's foreign manufacturing trade during the period 1995-1997.

The appreciation of the euro exchange rate against the dollar has been one of the basic features of recent developments on international financial markets. In fact, since October 2000, the European single currency has risen against the US one by approximately 35%, in nominal terms. It is true that during this period (and, in particular, since the beginning of 2002) the euro has tended to strengthen against the main currencies, but its appreciation against the US currency has been greater. Compared with its movement against the dollar, the cumulative appreciation since October 2000 against both groupings of countries, in nominal terms, has been more moderate. Specifically, it was 26%, in the case of the narrow group, and 29%, in that of the broad one (see top chart). The somewhat greater appreciation of the nominal rate against the broad group is explained by the inclusion of economies with a higher inflation rate, which tends to cause their currencies to depreciate.

The recent behaviour of the REER, when the index of relative prices used in its construction is based on the CPI, is very similar to that of the NEER. It is interesting to note, moreover, that although the countries which belong to the broad group but not the narrow group represent around 30% of the area's manufacturing trade, the behaviour of the real effective exchange rate index has been very similar in both cases. In particular, since October 2000, the euro has appreciated by 28.5% against the narrow group and by 26.5% against the broad group (see middle chart). However, if the current appreciation of the euro is viewed from a longer time perspective, the assessment of the current competitiveness situation of the area is less clear. In May 2003, the REER against the narrow group of countries, calculated using consumer prices, was around 4% above its average level since 1990. The results are similar when the PPI and the ULCM are used in its calculation (see bottom chart).

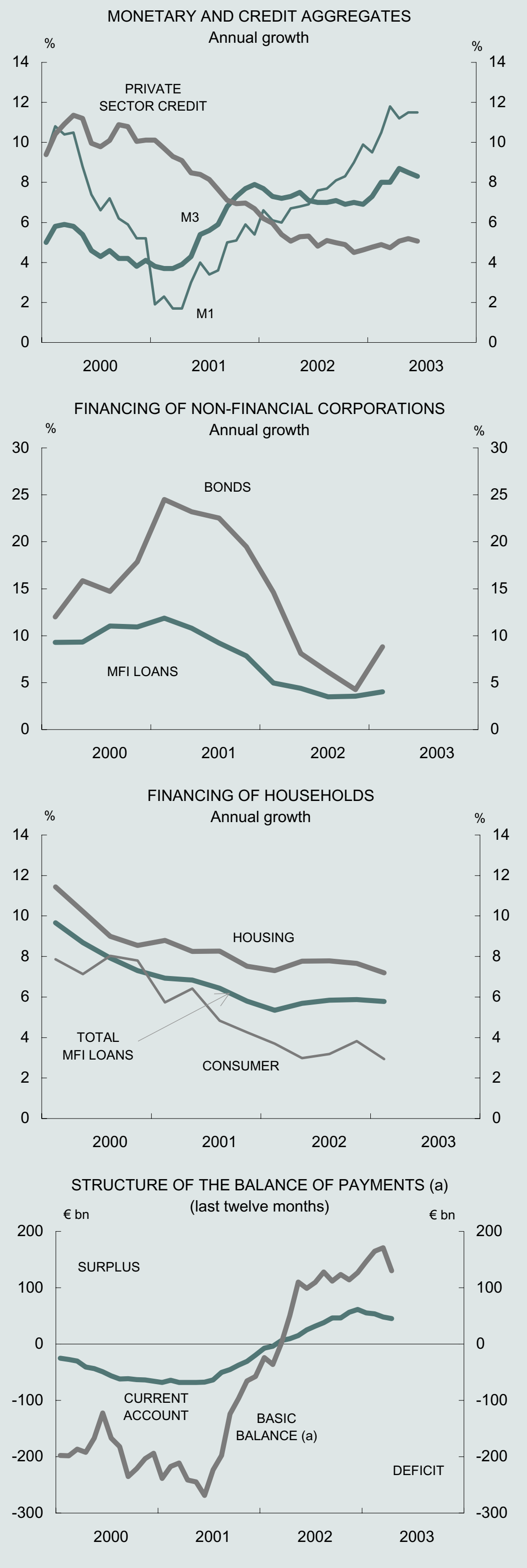
Euro exchange rate



Source: ECB.

CHART 13

Monetary and credit aggregates and balance of payments



Sources: Banco de España and European Central Bank.
(a) The basic balance is approximated by the sum of the balance on current account and direct and portfolio investment.

refinancing operations to 2%, and the rates on the deposit and marginal lending facilities to 1% and 3% respectively (see Chart 11).

As already mentioned at the beginning of this chapter, there was a progressive improvement in Q2 in the general financial conditions in the euro area, only restrained by the appreciation of the euro and by a certain hardening in bank lending terms. In particular, developments in interest rates and in the prices of the equity and fixed-income instruments issued by firms were conducive to the financing of productive activity. Meanwhile, lending to the private sector accelerated slightly, although it was also affected by the balance sheet rebuilding currently going on in certain sectors. In any event, the level of buoyancy attained by issuance on fixed-income markets is significant.

Money market interest rates followed a downward trend in Q2, as expectations of an official interest rate cut, confirmed in June, took root. Subsequently, in mid-July, the EURIBOR yield curve displayed average rates of around 2.1% at all maturities, although with a slight downward slope from three months. On end-July data, the shape of the one-month forward rate curve does not point to expectations of any movement in rates in the coming months (see Chart 11).

As at end-July, the euro-area ten-year bond yield stood at a similar level to the end of March. As seen in Chart 12, yields fell to a low in May and increased thereafter. This pattern of declining yields followed by a recovery was more pronounced in the case of US debt, the spread between the euro area and US being practically nil at end-July. Retail bank interest rates in the euro area held, up until May, on the downward trend that commenced in the middle of last year, in line with movements in money market rates up to that month.

On the foreign exchange markets the upward trend in the euro continued to the beginning of June, when the rate reached about USD 1.19. In the following weeks the European currency gradually weakened against the main currencies and, in particular, against the dollar. This weakening might be related to the improvement in growth prospects in the United States, since neither the interest rate differentials between the two areas, nor the open questions regarding the sustainability of the US external imbalance have undergone any significant changes recently (see Chart 13). Thus, as at end-July, the euro was almost 4% higher against the dollar than at end-March and, in nominal effective terms, about 3% higher. Box 3 analyses the recent changes in the nominal and real effective exchange rate from an historical perspective.

Since mid-March there has been a sustained rise in stock prices, which began in the United States and subsequently spread to other markets. The Euro STOXX broad index has risen by 19% since then (see Chart 12 and Table 1). These developments are in step with the incipient improvement in company profits, which may accelerate the balance sheet rebuilding of listed companies. The low level of interest rates and the general decline in uncertainty on the international political stage may also have contributed to the rise.

In April and May, M3 grew at a higher annual rate than on average in the first quarter. This was conducive to the accumulation of excess liquidity associated with the low level of interest rates and, especially, with agents' preference for highly liquid low risk assets given the uncertainty still prevailing on the markets (see Chart 13). In fact, during these two months the aggregate grew at an average annual rate of 8.6%. Among its components there was still a strong inclination towards the more liquid assets, redeemable deposits were more buoyant, and mutual funds were still the most buoyant component.

As regards financial flows, lending to the private sector strengthened slightly in April and May, to an annual rate of change of 5.1% in May. The breakdown of lending by type of borrower in 2003 Q1 shows that loans to households were somewhat less expansionary (5.4%, as against 5.8% in 2002 Q4), while those to non-financial firms grew by 4.1%, up from 3.5% (see Chart 13). In the case of Spain, financing to the non-financial private sector grew at a strong rate in April and May which, at 13.5%, was therefore well above the euro area rate.

In May, the ECB published for the first time the results of a bank lending survey for the euro area. This makes it easier to monitor and assess credit supply and demand conditions for the non-financial private sector. Although they should be interpreted with great caution owing to the survey's short history, the results of the April survey suggest that in the first few months of 2003 supply conditions continued to harden somewhat, although less strongly than in late 2002, both in the case of lending to firms and to households. As for the demand for loans, the data suggest that loan applications by firms stood at a similar level to January, while household demand for credit increased.

4. The Spanish economy

As mentioned in previous chapters, the Spanish economy's external environment in 2003 Q2 was still dominated by global uncertainty, which meant that the prospects for recovery of the international and, in particular, the European economy receded again. That said, the Spanish economy continued to display notable growth capacity, standing aside from the dominant tide in the euro area. The easy monetary conditions, despite the appreciation of the euro, helped strengthen the trends already apparent in the first quarter. During that period, national demand edged up, growing year-on-year in real terms by 3%. In Q2 it is estimated to have risen further, to 3.2%. As seen in Chart 14, aggregate expenditure in the first half combined a smooth acceleration in private consumption with high growth in general government consumption and a growing stimulus from gross fixed capital formation. The latter was driven by equipment investment, which put behind the negative growth that characterised it from 2001 Q2. The rate of growth of construction, meanwhile, moderated, although it was still notably strong. As for external flows, exports of goods and services sustained relatively high growth rates in the first half as a whole, despite the slackness of tourism. However, the momentum of imports, stemming from the recovery in final demand and the appreciation of the euro, gave net external demand a markedly contractionary complexion. In short, on QNA estimates, the year-on-year growth rate of GDP, which had stabilised in 2003 Q1 at 2.1% (similar to the end-2002 rate), increased slightly in Q2, to 2.2%. This is consistent with also slightly higher quarter-on-quarter growth, of 0.6%.

This GDP growth was the result of uneven behaviour across the productive sectors. In 2003 Q1, the recovery seen in the second half of 2002 in industrial value added continued, while construction decelerated, the value added of market services stabilised at moderate growth rates and in agriculture the contractionary process that continued to hold sway became somewhat less severe. These trends generally continued in Q2 although, given the absence of a firmer improvement in the external outlook, industry's acceleration was checked. Employment growth, measured in terms of the number of full-time equivalent jobs, stepped up significantly in Q1, to a year-on-year rate of 1.5%, 0.4 pp higher than in the previous quarter, and in Q2 it is estimated to have risen somewhat higher. This buoyant job creation in the first half of 2003 led to smaller gains in labour productivity, whose growth fell back below 1%.

Inflation has been receding in Spain during 2003, more sharply than in the rest of the euro area, thereby reducing the competitiveness losses that the Spanish economy has been accumulating. Falling import prices, helped by the appreciation of the euro (23% in the first half) and by the oil price's return to normal levels, have contributed to these developments, exerting a notably moderating impact. However, unit labour costs tended to accelerate at the beginning of the year, not only as a consequence of the smaller productivity gains, but also owing to the higher wage settlements in the current round of collective bargaining and owing to the payments resulting from the triggering of indexation clauses in the 2002 agreements. This greater pressure from labour costs has been largely offset by a smaller widening of profit margins, primarily in the sectors most exposed to foreign competition, so that the domestic component of prices also began to recede slowly. These factors account for the decline in the inflation rate, as measured by the annual rate of change in the CPI, which fell from 3.7% in March to 2.7% in June.

4.1. Demand

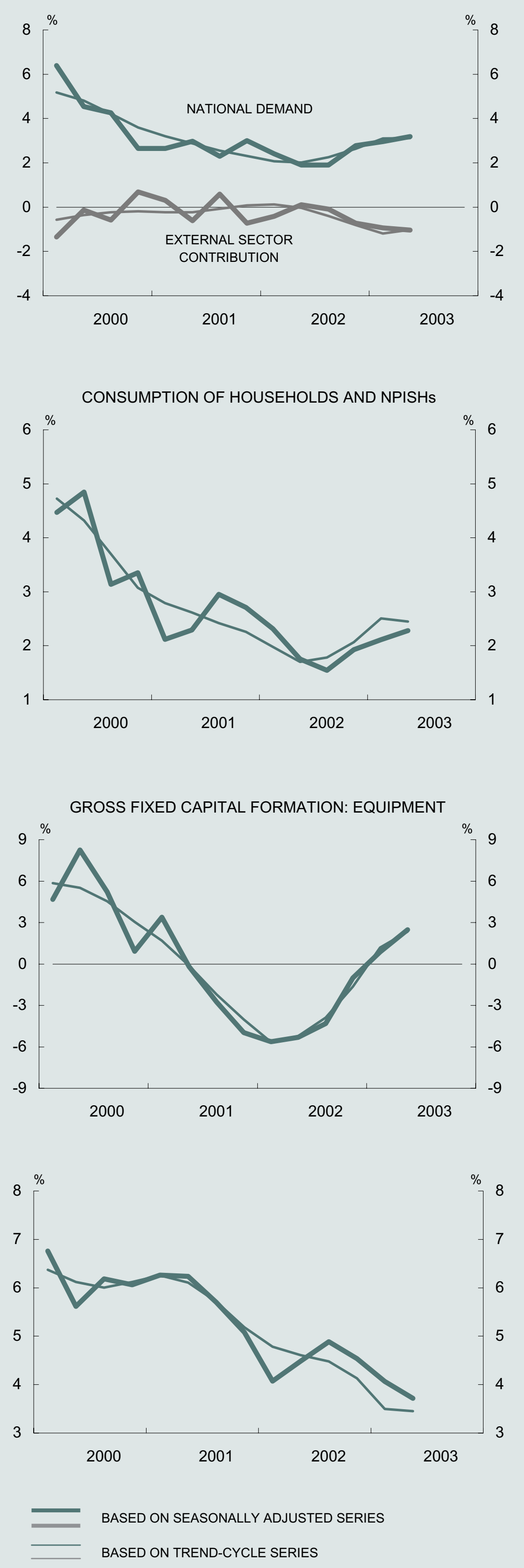
On QNA data, final household consumption accelerated slightly in 2003 Q1, to 2.1%, confirming the change in trend signalled in late 2002. It is estimated on the basis of thye latest information that this smooth acceleration continued into Q2. The strength displayed by private consumption was helped by the growth in household disposable income, by the appearance of real net wealth gains in this sector and by the persistence of loose financial conditions. Even so, the growth in consumption is compatible with an improvement in the savings ratio.

The greater buoyancy of consumption involved smooth growth of spending on services, while spending on goods also seems to have accelerated. However, these trends are not discernible in the indicator of apparent consumption of goods in Q2, estimated using incomplete data (see Chart 15). Other indicators directly related to household spending, such as retail sales, show an upward path, which is steeper in the case of sales of non-food goods. Also, new car registrations seem to have abandoned the contractionary path they followed from early 2002. Meanwhile, the consumer confidence indicator improved in 2003 Q2, drawing away from the lows reached in the first few months of the year and reflecting greater optimism in relation to the economic situation of households in the short term.

As regards the determinants of consumer spending, real disposable income seems to have accelerated slightly in the first half of the

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 percentage change, based on the trend of the indicator.
(b) Deflated by the CPI.

year, as a result of the moderation of the inflation rate and the acceleration in labour compensation, which includes the payments arising from application of the indexation clauses in the 2002 collective agreements. In addition, general government made an expansionary contribution to income growth, linked to the impact of the reform of personal income tax. Moreover, against a background of further interest rate cuts, the household debt-service burden held at moderate levels, despite the growth in consumer credit and in lending for house purchase, and the consequent increase in indebtedness. Household wealth, meanwhile, behaved positively, owing to higher property values and, in Q2, to the upward correction in stock prices, which also helped sustain consumption in that period. If these trends continue, the average saving ratio will recover this year, which would enable the net lending of this sector to rise moderately.

In 2003 Q1, general government final consumption increased, in real terms, at an annual rate of 4.3%, in line with its growth in the final quarter of the previous year. This expansion reflects the typical electoral-cycle spending pattern and the allocation of extraordinary funds for various adverse events. The information available for Q2, obtained from State revenue and expenditure data and from the budget plans for the year as a whole, would suggest that there was a mild moderation of spending, although it remained expansionary, as it has been for the past year.

Following an upward trend, gross fixed capital formation grew at a real year-on-year rate of 2.9% in 2003 Q1, 0.5 pp up on the previous three months. The notable pick-up in equipment investment, to a growth rate of 0.9%, following a fall of 1% in 2002 Q4, contributed to this recovery. Construction expenditure, on the other hand, slowed by 0.4 pp to 4.1%. Finally, other investment, primarily made up of spending on construction-related services, grew by 2.7% (see Chart 14).

Equipment investment, according to the behaviour of almost all the available indicators for this aggregate, continued to accelerate in Q2. In particular, the indicator of apparent equipment investment, on the basis of incomplete Q2 data, is showing positive and rising rates of change (see Chart 16). Business survey data on equipment producers also highlighted the growth between January and March 2003, in step with the improvement in total industrial orders. However, the spring 2003 half yearly survey of industrial investment indicated a similar pattern of planned investment spending to that in 2002 when, according to the same source, such spending fell by 3% in nominal terms. These results provide a note of caution on the continuity and strength of the pick-up in investment, at least in industry.

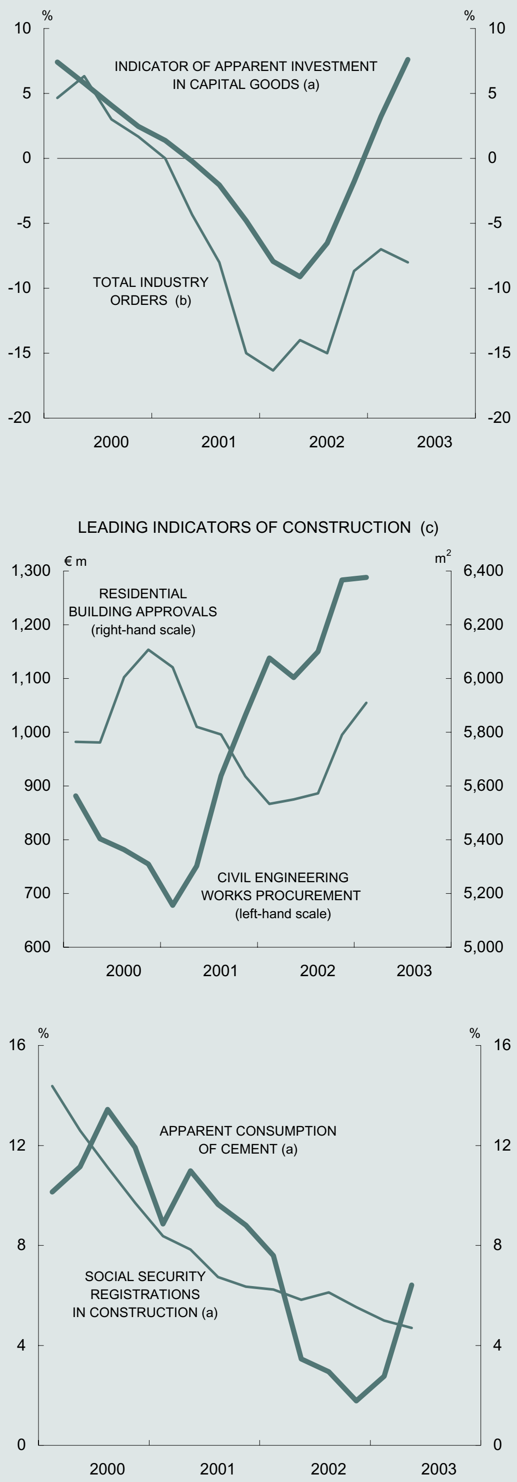
The pick-up in productive investment in the first half of 2003 was consistent with the rising trend of final demand and with the favourable financial conditions. The information on non-financial corporations collected by the Central Balance Sheet Data Office confirms the favourable situation of the respondent firms who increased their activity significantly in 2003 Q1. The ordinary return on equity increased moderately in this period and the spread between the return on investment and the cost of debt remained high. It appears, therefore, that the financial position of firms continues to improve, although their high level of debt may limit the future scope of the investment recovery.

Construction investment is estimated to have followed a trend of mild slowdown in 2003 Q2. Even so, it remained one of the most dynamic components of domestic demand, as confirmed by most of the available indicators. Among the indicators of intermediate consumption, apparent consumption of cement, which is used more intensively in civil engineering, remained on a path of recovery (see Chart 16), like the output of materials used in construction, although the latter grew at a more moderate rate. Among employment indicators, social security registrations were buoyant, but displayed a slight downtrend.

Information from the ECIC construction industry survey for 2003 Q1 shows expansionary behaviour by civil engineering work and, to a greater extent, house building, both of which picked up from the previous quarter, while non-residential building contracted again. The indicators relating to building starts project somewhat different behaviour for civil engineering, residential building and non-residential building in the coming quarters. In the period to March, the strong growth recorded by government civil engineering tenders in 2002 moderated, although they were still at very high levels. On the other hand, residential buildable floor area, according to the permits granted by municipal authorities and architects' associations' approvals, is gaining momentum, with approvals increasing by 22.7% in 2003 Q1. Finally, non-residential buildable floor area is recovering slightly from its previous behaviour. In short, public works (carried out by general government and related firms) can be expected to remain strong, underpinned by the gradual fruition of investment plans already put out to tender, while residential building, primarily, will tend to show greater vigour. Box 4 analyses

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.

the housing stock in Spain, drawing on data from the latest census.

In the medium term, however, the already high level of debt of households who will purchase most of the new houses, the persistence of significant increases in house prices and the stock market recovery should help to moderate residential investment.

On QNA data, inventory investment made a positive contribution of 0.3 pp to GDP in 2003 Q1. The business survey, moreover, recorded an increase in the stocks of finished products relative to desired levels in the first half of the year.

As mentioned above, in the first few months of this year the external environment of the Spanish economy was dominated by the war in Iraq, which increased the uncertainty over a pick-up in world activity and a prompt recovery in international markets, affecting the euro area directly. This situation changed following the end of the Iraqi conflict and, despite the ambiguity of the signals, a slight improvement in the international outlook is discernible. At the same time, the appreciation of the euro during the first half affected the competitive position of Spanish products. In these circumstances, real foreign trade flows were notably buoyant, although more so in the case of imports. On QNA data, in 2003 Q1 exports of goods and services slowed slightly to annual growth of 5.5%. The adverse impact on this growth of the appreciation of the euro was partly offset by the notable restraint of export prices, especially for those products sold to countries outside the EU. Imports of goods and services accelerated to 8%, following the sharp rise of the previous quarter, driven by vigorous demand and the strong euro. In short, net external demand deducted 0.9 pp from output growth, 0.2 pp more than in the preceding quarter. The still incomplete information on 2003 Q2 points to a slight increase in the contractionary bias of net external demand, as a result of stabilising exports and mildly accelerating imports.

QNA data indicate that, in 2003 Q1, goods exports recorded a fall in their annual rate of growth from 8.8% at end-2002 to 7.5%, maintaining notable momentum even so (see Chart 17). Customs data show a similar slowdown over the same months, as a consequence of the trend in sales to non-EU markets. The information on April and May, however, shows renewed vigour on the part of exports, which grew by 10.4% year-on-year, in real terms, during these two months, owing to the significant growth of sales to EU countries, which appear to have grown by more than those to other areas. Assessing these data requires some caution, given the high volatility of the flows and, also, the difficulty of explaining these developments in the context of the marked weakness of the European economies. In any event, during the first five months of the year, goods exports grew by 7.8%, in real terms, compared with a fall of 2.3% in the same period of the previous year. The highlights of this performance were, as regards geographic areas, the significant acceleration of sales to EU markets (which grew on average by 7.6%, in real terms, during the period) and, as regards product groups, the dynamism of exports of capital equipment.

In Q1, services exports were dominated by the contractionary behaviour of tourism. According to the QNA, real tourism receipts fell by 1.8% year-on-year in the period, although this amounts to a recovery from the high negative rates of the previous year, which ended with an average decline of 4%. The behaviour of this aggregate in the first few months of 2003 was determined by the worsening international outlook and, in particular, by the SARS outbreak, which had a negative impact on world tourism demand. At the same time, the appreciation of the euro adversely affected the competitiveness of the Spanish tourist industry. Real indicators of tourism generally confirm the trend in receipts, although they tend to show a somewhat more positive situation in Q2, with a more favourable outlook for the industry opening up. Tourist arrivals at frontiers rose by 5.3% during the fist six months of the year, a larger increase than in 2002, largely thanks to the British market. Survey data on hotel occupancy levels also showed positive figures for travellers staying in hotels and the number of overnight stays in May and June, although the increases in the January-June period were still moderate (1.9% and 1.3%, respectively), revealing an increasing preference on the part of tourists for non-hotel accommodation. Non-tourism services picked up to 4.7% in 2003 Q1, from 2.7% in 2002 Q4, in line with the acceleration also seen in the nominal balance of payments indicator.

In 2003 Q1, the rate of growth of real goods imports stabilised at 8.4%, according to QNA data, cutting short the strong acceleration of the second half of 2002. The positive trend in exports and the recovery in private productive investment and in industrial activity itself, against a background of strong euro appreciation, gave rise to a sustained increase in purchases of goods from abroad. Customs figures, which show a certain deceleration during Q1, rebounded notably in April and May. In the first five months of the year imports increased by 9.6%, in real terms, similar to the increase in

BOX 4

Characteristics of the housing stock according to the latest census

According to the initial results of the housing census for 2001, there are somewhat over 20.8 million houses in Spain. In the past ten years their rate of increase (21%) has been far higher than that of the population (5%) and the structure in terms of end-use has not undergone major changes (1): 68.5% of houses are used as habitual residences, 16% as second homes and 14% remain unoccupied (see adjoining table). It should be noted that, since the sixties, there has been a strong (tenfold) increase in the number of second homes, while those used as habitual – or principal – residences have only doubled in number. The notable increase in second homes is essentially related to socioeconomic factors.

Notable, too, is the high number of houses recorded as unoccupied (2.9 million), a fact linked both to loss of population in certain areas and to the growing significance of the demand for housing on the basis of the high expected return on real estate investment. Regarding the first of these factors, it can be seen that, in the eight provinces with the highest proportion of empty houses, six have seen their population fall since 1991 (see panel A in the adjoining chart). Nonetheless, the biggest pockets of unoccupied housing are concentrated in the major population centres (the provinces of Madrid and Barcelona account for one-fifth of such houses) and in the provinces that are the biggest tourist attractions, notably Valencia and Alicante, where 12% of the national total are located. Given the characteristics in terms of population and activity of these provinces, conceivably the housing market is particularly buoyant in all of them, broadening the possibility of disposal in the event of changes in the relative returns on financial and real assets. In any case, the fact that the owners of these houses prefer to keep them empty rather than rent them out may be indicative of the poor working of the rental market and a rather inadequate use of the housing stock.

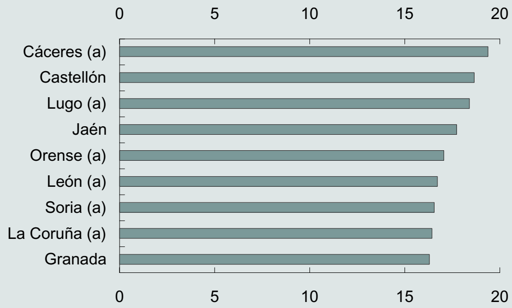
The principal-home ownership structure, in line with the trends witnessed throughout the second half of the 20th century, has changed over the past decade. In particular, the proportion of owner-occupier households has once again risen (to 82%) at the expense of a fresh decline in the proportion of rent-paying households. The latter now account for only 11.5% (see table), when in the middle of the last century the figure was slightly over 40%. The diminished significance of house rental has not only been in relative terms but also in absolute terms. Furthermore, there were more houses empty than rented in 2001 (2.9 million against 1.6 million). Consequently, in principle and under appropriate conditions, the rental market could be considerably expanded.

The fall-off in housing for rent has been widespread across Spain. Even so, substantial contrasts in its geographical distribution are apparent. In absolute terms, the rental segment is concentrated in the major cities; indeed, 35% of total rented houses are concentrated in the provinces of Madrid and Barcelona, a proportion some nine percentage points higher than these cities' share of the total housing stock. In relative terms, house rental amounts to almost 30% in Melilla and exceeds 20% in Ceuta and the Balearic Islands (see panel B), all three being provinces with a strong presence of inhabitants born abroad.

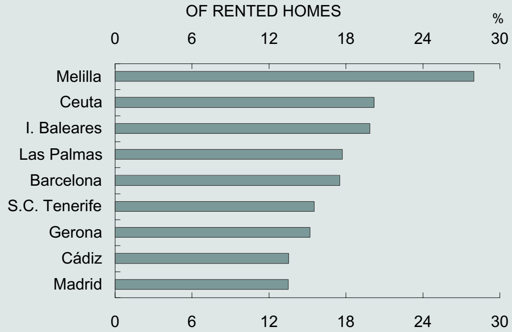
Housing stock

	1991	2001
Homes	17,206,363	20,823,369
HOMES BY TYPE (%):		
Principal	68.2	68.5
Second	17.0	16.0
Unoccupied	14.4	13.9
Other	0.4	1.6
PRINCIPAL HOMES BY TENURE (%):		
Owner occupied	78.3	82.0
Rented	15.2	11.5
Free let	4.5	2.7
Other	2.0	3.8

A. PROVINCES WITH HIGH PERCENTAGE OF EMPTY HOMES



B. PROVINCES WITH HIGH PERCENTAGE OF RENTED HOMES

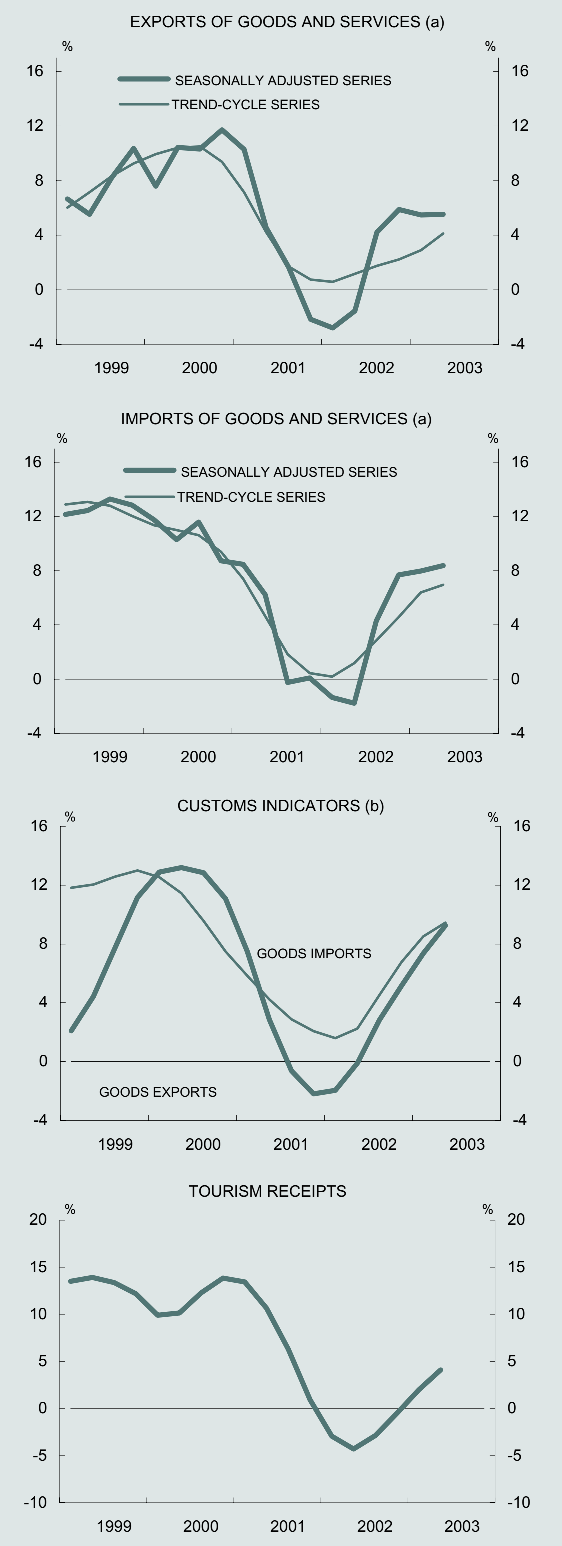


Source: INE.
(a) Province recording fall in population between 1991 and 2001 censuses.

(1) The improved recording in the latest census of second homes and unoccupied houses has meant that the heading "other" has grown notably in relation to the 1991 census data. Second homes and unoccupied houses were most probably biased upwards in the 1991 census.

CHART 17

Foreign trade
Percentage change on year ago



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

the second half of the previous year. The sharp growth in purchases of capital equipment of 16.6% was notable and reflected, in turn, the buoyancy of purchases of transport equipment and, to a lesser extent, of machinery. In the January-May period, real consumer-goods imports increased by less than in the second half of 2002, owing to the significant deceleration in sales of consumer durables. Intermediate goods were buoyant, with the purchases of those used by the chemical industry and by machinery manufacturing being notable. By contrast, energy intermediate goods fell in real terms by 3.5%, affected by the strong rise in oil prices at the beginning of the year.

Finally, real services imports grew by 6% in 2003 Q1, extending the recovery seen in the previous data. This acceleration arose from both non-tourism services (5.9%) and real tourism payments (6.5%), which were driven by the strength of the euro.

4.2. Output and employment

As indicated in the introduction to this chapter, activity has trended unevenly across the different productive branches in 2003 to date. In the January-March period, the contractionary trend prevailing in the primary branches in recent years moderated and value added fell less sharply than in 2002 Q4, signalling a potential turnaround (see Chart 18). In Q2, the forecasts available on winter cereal and pulses yields are fairly favourable, bearing in mind the abundant rainfall recorded at the start of the year, which was above the historical average. Nonetheless, the extreme weather in the past two months might have affected a portion of output in this area. Livestock production is showing signs of recovery, with the exception of milk output, which is clearly contracting.

In the opening months of 2003, the ongoing acceleration in the manufacturing industry and energy branches came to a halt, with the related year-on-year rate of increase dipping by 0.4 pp to 2.5%. Activity in the energy industry slowed significantly, in contrast to manufacturing, which rose to 2%. The information for Q2 would indicate, however, a stabilisation of the growth rate in industry, as the industrial production index has been wavering, with a deceleration in May centred on the production of non-food consumer goods and on intermediate goods. The receding prospects of recovery at the international level coupled with the appreciation of the euro have led the increase in manufacturing industry to stabilise, despite the sustained trend of domestic demand. The confidence indicator compiled by Eurostat was also less expansionary in Q2, and it slipped in June further to a worse assessment of orders, and of foreign orders in particular. However, other conjunctural indicators show a more positive side to manufacturing industry in recent months: non-energy intermediate goods and capital goods imports, which were very buoyant in April and May, and exports of industrial products, which sustained high growth rates during these months.

Value added in construction once again lost momentum in 2003 Q1, posting year-on-year growth of 4%, against 4.9% the previous period. While confidence in the construction industry fell slightly in Q2, it remains high, as testified by other coincident indicators mentioned above when investment in construction was analysed. In line with this latter aggregate, it is estimated that value added in construction may have slowed slightly in Q2, though it remains the most buoyant activity.

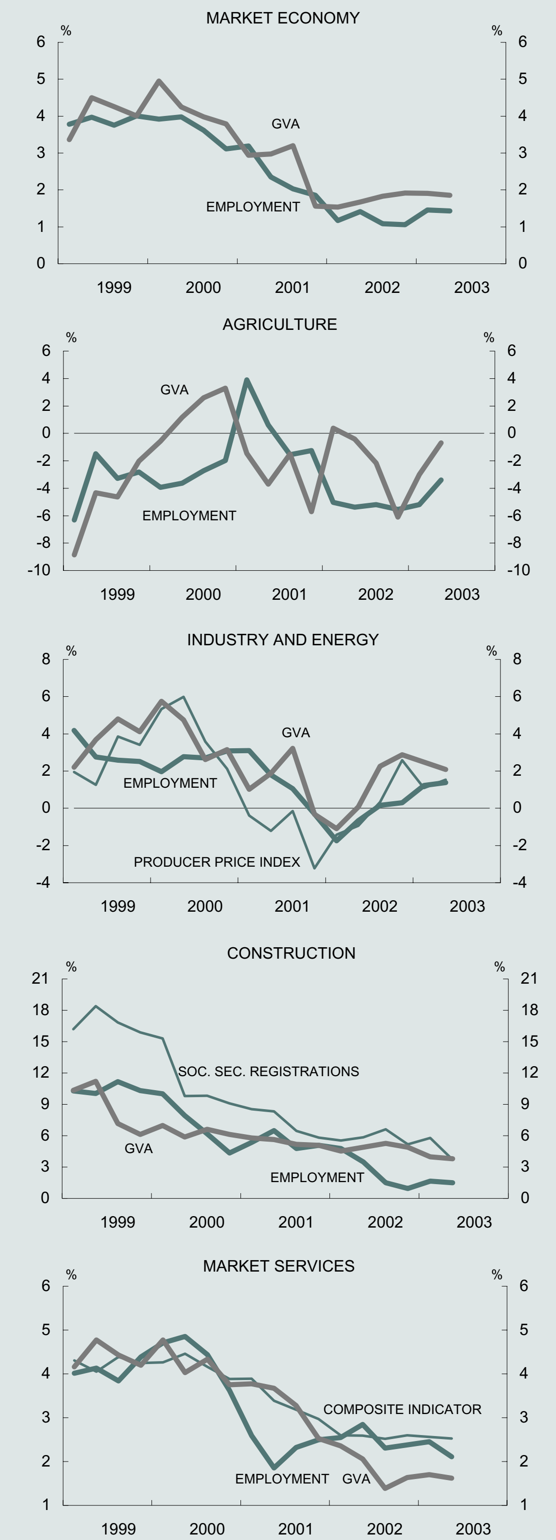
In the opening months of 2003, growth in the tertiary sector stabilised at 2.2% on QNA estimates. The non-market services branch grew by 4% in Q1, a similar figure to that observed in the closing months of 2002. Market services, for their part, accelerated by 0.1 pp to a rate of 1.7% year-on-year. According to the new statistic drawn from the indicators of services activity, which has bridged a significant gap in statistical reporting requirements in this area, the greater robustness in Q1 was in services to businesses, followed by the distribution trade, ICT and transport; the sector performing most sluggishly was tourism, where activity contracted.

The latest conjunctural information shows market activities to have picked up mildly in Q2. Against the background of a slight improvement in the outlook for the sector, the services composite indicator reveals a stable growth pattern. Activity in the distribution trade, in hotels and catering and in transport shows signs of greater momentum, while stability prevails in the other branches. The retail sales index picked up in May, while the retail trade confidence indicator was more positive in Q2 than in Q1. Certain indicators relating to the hotel and catering trade (travellers lodged in hotels, overnight stays) have also improved, leaving behind the contractionary phase of the previous quarters. Lastly, developments in the various transport sub-sectors were uneven.

QNA estimates indicate that employment, measured in terms of equivalent full-time jobs, quickened to a rate of 1.5% year-on-year in 2003 Q1, compared with 1.1% at end-2002. Against a background of stability in the growth of activity, this result led to a slowdown in apparent labour productivity, which did not build

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.

on the increase recorded in 2002 Q4 and fell back to a rate of 0.6%, a figure close to the average for last year. The conjunctural indicators testify to the favourable trend of employment in Q1: the EPA (Labour Force Survey) showed an increase in employment of 2.3%, 0.7 pp up on the previous quarter, while social security registrations revealed a year-on-year increase of 3.3%, 0.3 pp higher than the previous quarter.

The indicators available for 2003 Q2 suggest a continuing and sound process of job creation, which is estimated to have grown at a slightly higher rate than in Q1. The EPA reflects a fresh acceleration in numbers employed, up 2.6% in relation to 2002 Q2, while registrations, after growing at a very similar rate to that of Q1, have increased by 3.2% over the first six months of the year as a whole. Registered unemployment, which posted year-on-year growth of 4.8% between January and March, increased by 1.8% in Q2, despite the fact that the June unemployment figure signified something of a rise in this variable.

As can be seen in Chart 18, employment quickened in all productive activities except services in Q1 according to QNA figures. In the case of services, however, the increase in employment was higher than in the other branches: 2.1%, only 0.1 pp below the increase in value added, which also held stable, meaning that apparent labour productivity remained flat as it had in 2002. For Q2, the EPA points to a higher rate of job creation in these branches, as corroborated by the figures for registrations. Employment in manufacturing industry and energy rose with notable vigour in Q1. Nonetheless, the EPA reflected a fall-off in employment in Q2, in line with the check on activity and with the information drawn from registrations. In construction, productivity gains moderated in Q1 as employment increased against a background of slowing value added, a process which, it is estimated, continued in the spring months. That said, the growth of productivity is still relatively high. Finally, agriculture was the only productive sector to post greater productivity gains in Q1, due to the fact that job destruction continued at a sharper rate (5.2%) than the decline in value added; in Q2 the rate of decline of employment appears to have been contained.

On QNA figures dependent employment grew by 2.1% in Q1, 0.3 p.p. above the end-2002 rate, while the numbers of self-employed continued to shrink at a similar rate to that observed in 2002. The EPA figures on the different forms of hiring show that permanent employment contracts increased significantly both in Q1 and in Q2, when they rose by a year-on-year rate of 4.5%. Temporary employment increased modestly in the first three months compared with a year earlier, and more strongly so in Q2, in contrast to the decline recorded in the second half of 2002; nonetheless, its rate of increase is still considerably below that of permanent employment. Temporary employees as a proportion of the total stood at 30.6% in Q2, 0.6 pp down on the related figure a year earlier. That illustrates the effectiveness of the measures adopted in the past to promote stable employment and should contribute to reducing labour turnover, thereby favouring higher productivity. Part-time employees as a proportion of the total stood at 8.2%, 0.2 pp up on the related level in 2002 Q2.

Although the labour force, measured by the EPA, remains notably vigorous, its growth slowed slightly in 2002 Q4 to 2.7%, a rate posted once again in 2003 Q2. Last year the labour force grew on average by 3%. The increase in the labour force is basically due to the behaviour of the participation rate, which continued to rise, since the growth of the population of working age has moderated. In Q2, the participation rate stood at 54.9%, one percentage point higher than a year earlier. Considering only the population aged 16-64, the rate was 68.3%, in line with the growth path observed in recent years. During this period, the growth of the labour force was practically the same as that of employment, which has led to very similar growth in the numbers of unemployed (2.9% year-on-year) and a stable unemployment rate, relative to 2002 Q2, at 11.1%. In relation to Q1 this year, the unemployment rate fell by 0.6 percentage points, partly for seasonal reasons. The female unemployment rate, which is still twice the male rate, fell relative to a year earlier, while the male rate increased. Finally, the incidence of long-term unemployment (36.9%) continued to decline.

4.3. Costs and prices

Drawing on QNA data, the cost of labour per unit of value added accelerated in 2003 Q1 both in the whole economy and in the activities that make up the market economy, to stand at rates of 3.5% and 3.8%, respectively (see Chart 19). This behaviour reflects, first, the reduction, referred to above, in productivity gains, which failed to build upon the growth recorded in the previous quarter. It also reflected a slight acceleration in compensation per employee, which came on top of that which had taken place at the end of 2002, to make the annual rate of growth of this aggregate in Q1, 4.3% for the whole economy and 4.2% for the market economy. Since productivity is estimated to have slowed further in Q2, while compensation per employee appears to have risen, the unit labour cost probably continued to accelerate in this period.

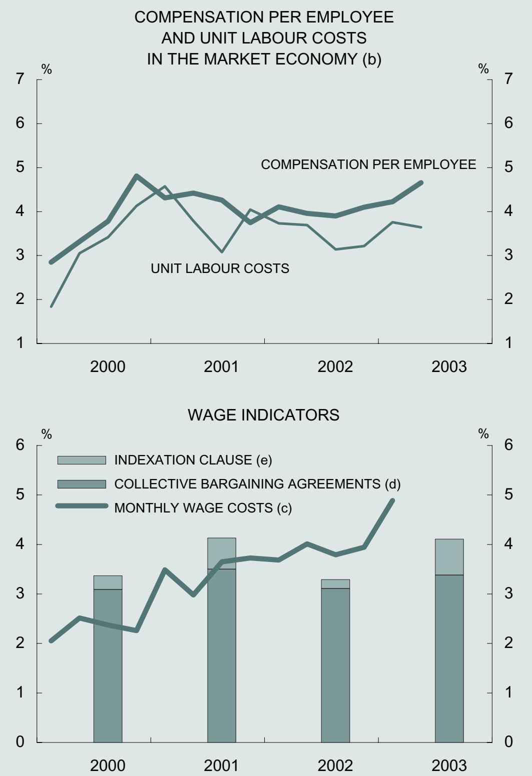
The labour cost index (LCI) data for 2003 Q1 show a somewhat sharper acceleration in compensation than the QNA data for the market economy. The average monthly labour cost per worker increased by 5.2% in that period, 0.6 pp more than in 2002 Q4. Among its components, wage costs accelerated significantly (from 3.9% to 4.9%), reflecting a very pronounced increase in arrears, while non-wage costs moderated slightly, although they continued to grow at very significant rates (6%). At the industry level, the acceleration in labour costs per worker in construction (6.0%) and in services (5.0%) was notable, while in industry the LCI slowed slightly (5.2%).

The information available on collective bargaining in the first five months of 2003 shows an average wage settlement of 3.4%, a figure that has fallen progressively since February, although it is still 0.3 pp higher than the settlement in 2002. To date, the average settlement in revised agreements stands at 3.4%, while in newly signed agreements it is 2.9%, slightly higher than on data to April, although compatible with the terms of the 2003 Inter-confederal Agreement on Collective Bargaining (AINC 2003). However, the representativeness of the newly signed agreement is still low, since the bulk of new agreements are usually signed in the second half of the year. According to data supplied by the ministry of labour and social affairs, the effect of indexation clauses in 2002 agreements (the difference between the average settlement in 2002 when the effect of the clauses is included and when it is not) was approximately 0.7 pp.

The acceleration in unit labour costs in 2003 Q1 was not passed through to the value added deflators, either for the whole economy or the market economy, which grew at similar rates to the two previous quarters (4.3% and 4.7%, respectively). This meant that margins per unit of output, although continuing to widen, did so to a lesser extent (see Chart 20). The behaviour of prices and margins across the main branches of activity was uneven. In industry, the value added deflator slowed in Q1, possibly reflecting the effects of greater external competition, against a background of euro appreciation. This slowdown, combined with the upward trend in unit labour costs, led to stagnation of the unit margin, which will have started to contract in Q2. As mentioned on previous occasions, competitive conditions in this sector mean that growth in compensation is only sustainable over time given parallel growth in labour productivity. In construction, by contrast, the strength of the demand for housing and public works has given rise to a pronounced increase in prices which, despite the upturn in unit labour costs, has enabled margins to continue expanding. Finally, in market services the deflator and costs behaved very similarly, indicating stable margins, against a background of moderate activity growth.

CHART 19

Wages and labour costs (a)



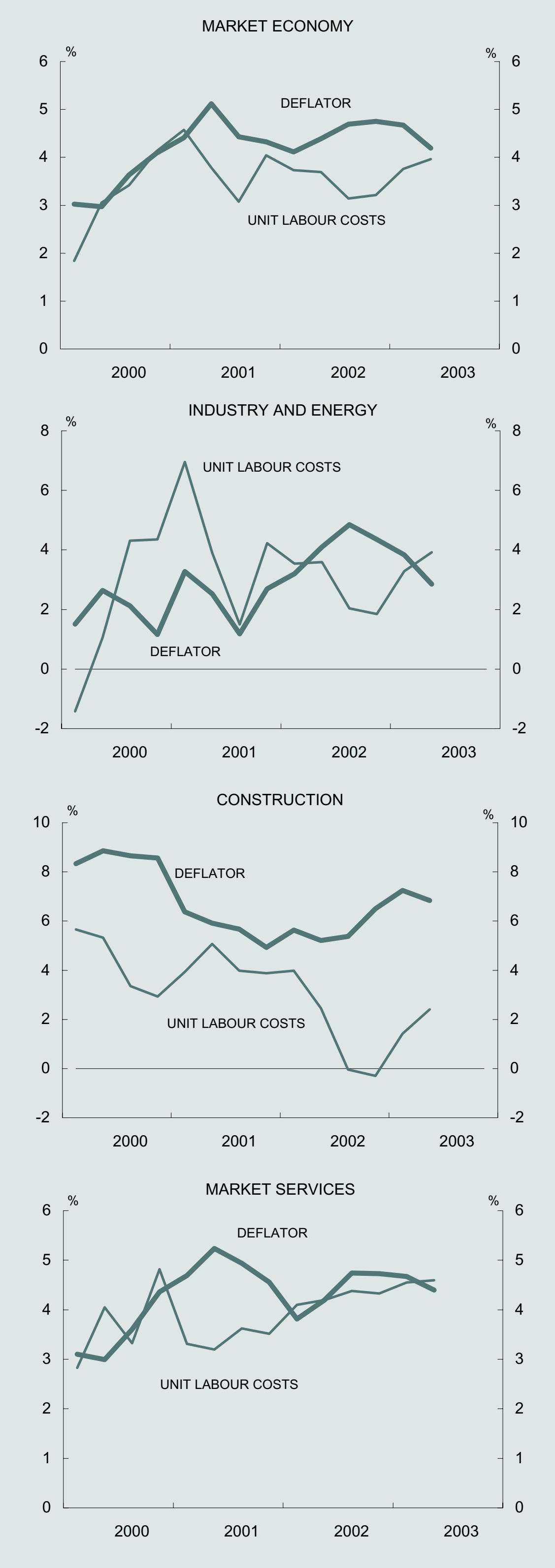
Sources: INE, Ministerio de Trabajo y Asuntos Sociales and Banco de España.
(a) Percentage change on same quarter a year earlier.
(b) Rates based on QNA seasonally adjusted series.
(c) Total earnings.
(d) Settlement in the year to date.
(e) Previous year's indexation clause.

In 2003 Q1, the rate of growth of the final demand deflator stabilised at 3.2%, below that of the GDP deflator (4.5%). This result was again a consequence of the fall in import prices, although the latter was smaller than in the preceding quarter, owing to the rise in energy prices in the first three months of 2003. Other international prices, especially commodity prices, declined significantly on account of the appreciation of the euro and the weakness of demand.

Among the indicators of final prices available for 2003 Q2, the CPI showed a further modera-

CHART 20

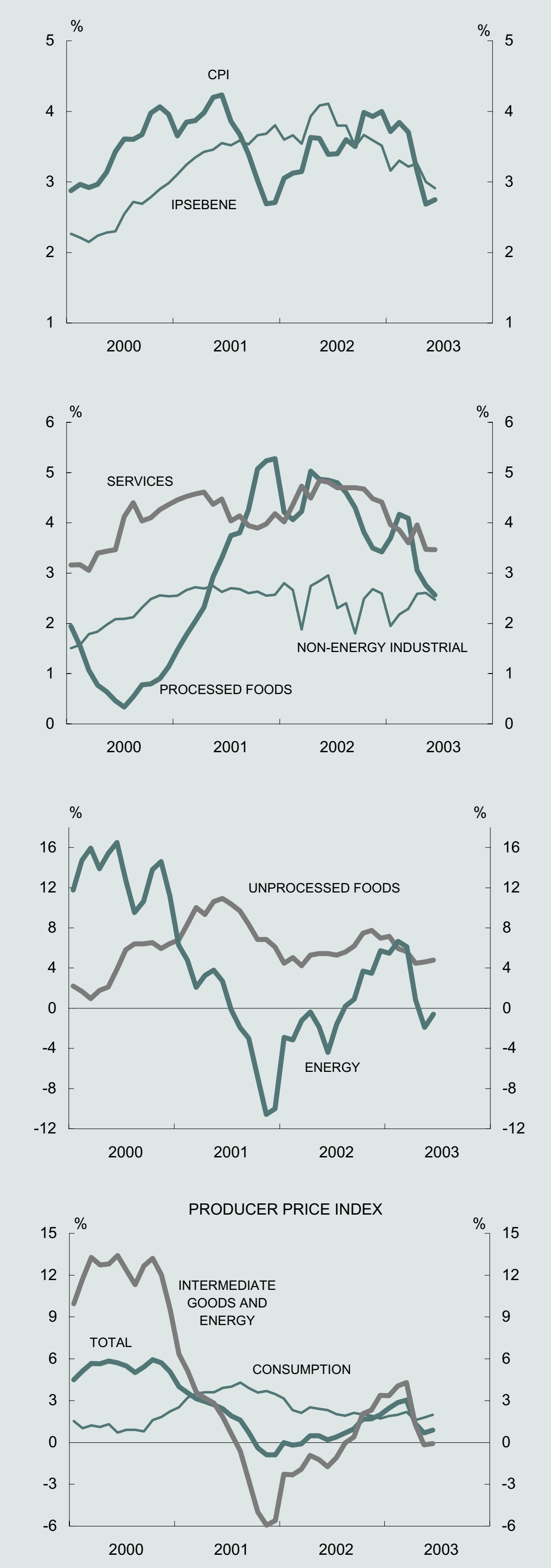
Prices and costs by branch of activity (a)



Sources: INE and Banco de España.
(a) Non-centred percentage change on year ago based on QNA seasonally adjusted data.

CHART 21

Price indicators (a)
Spain



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

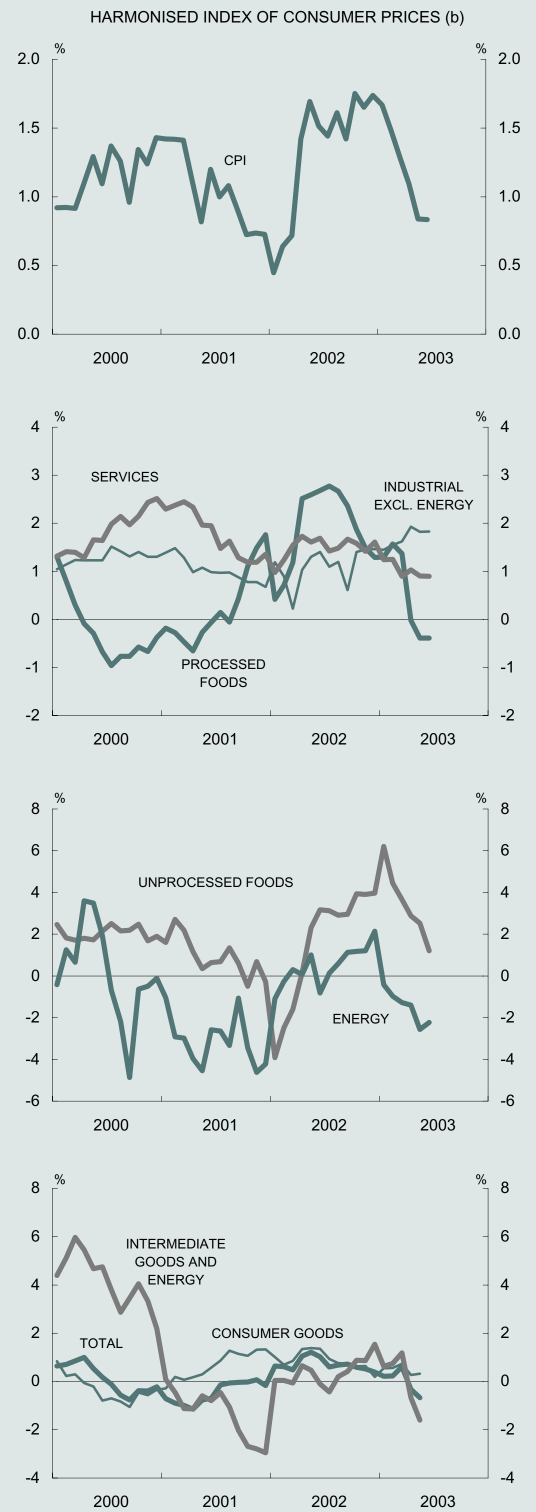
tion in inflationary pressures, its rate of increase declining by 0.9 pp, to 2.7%. One of the factors contributing to this correction was the fall in energy prices, from April, as a consequence of the easing of the tensions that had dominated international oil markets in the run-up to and during the war in Iraq. The energy bill also fell as a consequence of the appreciation of the euro against the dollar. Between April and June, the average annual rate of change of the energy CPI was -0.6%, as against 6.1% in Q1 (see Chart 21). Although the factors primarily responsible for the reduction in inflationary pressures are external, there was also a reduction in the rate of change of the index of non-energy processed goods and services prices (IPSEBENE), to 3.1% in Q2.

The deceleration of consumer prices in Spain in Q2, as measured by the HICP, was sharper than in the euro area as a whole, so that the inflation differential vis-à-vis the euro area fell by 0.6 pp from April, to stand at 0.8 pp in June. The inflation differentials across components behaved unevenly. While those of services, processed food and non-energy industrial goods held steady, that of energy deteriorated slightly and that of unprocessed food improved. In the cases of energy and processed food prices, the inflation differential continues to be favourable to Spain (see Chart 22).

In 2003 Q2, the upward trend in the producer price index (PPI) that began at the beginning of last year came to an end, the annual rate of increase being 1% (0.9% in June), as compared with 2.8% on average in Q1. The slowdown was basically due to the decline in energy producer prices, which fell at an annual rate of 0.6% during the quarter, although this trend came to an end in June. In Q2, there was a progressive deceleration in the producer prices of non-energy intermediate goods. Meanwhile, the producer prices of capital equipment displayed relatively stable rates of increase, like the prices of consumer goods, although the latter were more variable. In the euro area, the deceleration in producer prices to May was less intense than in Spain, giving rise to a 0.6 pp differential in Spain's favour. The behaviour of farm gate prices was favourable, in line with the previous indicators, although they are no longer displaying the negative rates recorded during the previous 12 months. Lastly, hotel prices decelerated slightly, except in April, owing to the Easter effect.

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.

4.4. The State budget

According to the State budget outturn data, based on National Accounts methodology, the State deficit in the period January to June was

TABLE 3

State budget outturn

€ m and %

	Outturn 2002	Percentage change 2002/2001	Budget 2003	Percentage change 2003/2002	Outturn JAN-MAR Percentage change 2003/2002	Outturn 2002 JAN-JUN	Outturn 2003 JAN-JUN	Outturn Percentage change
	1	2	3	4=3/1	5	6	7	8=7/6
1. Revenue	**108,456**	**-13.4**	**105,696**	**-2.5**	**-3.1**	**47,703**	**48,031**	**0.7**
Direct taxes	55,531	-0.3	55,218	-0.6	7.9	19,029	20,427	7.3
Personal income tax	*32,268*	*-11.5*	*32,217*	*-0.2*	*17.2*	*14,075*	*15,742*	*11.8*
Corporate income tax	*21,420*	*24.4*	*21,090*	*-1.5*	—	*4,078*	*3,915*	*-4.0*
Other (a)	*1,843*	*-2.9*	*1,911*	*3.7*	*-2.3*	*875*	*770*	*-12.1*
Indirect taxes	38,026	-28.5	37,741	-0.7	-7.3	21,772	20,948	-3.8
VAT	*25,720*	*-25.8*	*25,742*	*0.1*	*-5.5*	*15,610*	*15,352*	*-1.7*
Excise duties	*10,347*	*-37.7*	*9,880*	*-4.5*	*-16.7*	*5,200*	*4,556*	*-12.4*
Other (b)	*1,959*	*2.5*	*2,119*	*8.2*	*4.7*	*962*	*1,040*	*8.1*
Other net revenue	14,898	-8.8	12,736	-14.5	-17.4	6,902	6,656	-3.6
2. Expenditure (c)	**111,082**	**-13.3**	**114,517**	**3.1**	**-2.9**	**56,188**	**54,924**	**-2.2**
Wages and salaries	17,554	4.3	18,490	5.3	9.3	8,692	9,186	5.7
Goods and services	2,843	11.3	2,491	-12.4	14.6	1,204	1,351	12.2
Interest payments	18,863	3.3	19,672	4.3	1.5	10,286	9,491	-7.7
Current transfers	58,324	-24.4	57,500	-1.4	-11.0	29,929	28,526	-4.7
Contingency fund	—	—	2,290	—	—	—	—	—
Investment	7,043	9.0	7,247	2.9	5.5	3,159	3,374	6.8
Capital transfers	6,455	-5.3	6,827	5.8	8.5	2,918	2,996	2.7
3. Cash-basis balance (3=1–2)	**-2,626**	**—**	**-8,821**	**—**	**—**	**-8,485**	**-6,892**	**-18.8**
MEMORANDUM ITEM: NATIONAL ACCOUNTS								
Revenue	110,819	-12.5	—	—	-0.8	48,208	49,251	2.2
Expenditure	114,395	-12.4	—	—	-2.8	51,639	52,010	0.7
Net lending (+) or net borrowing (–)	**-3,576**	**—**	**-3,620**	**—**	**—**	**-3,431**	**-2,759**	**—**

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

€2,759 million (0.4% of GDP), down from €3,431 million (0.5% of GDP) in the same period of the previous year (see Table 3). Both revenue and expenditure accelerated slightly in Q2, posting smooth growth relative to the first half of the previous year (2.2% in the case of revenue and 0.7% in that of expenditure). Notable on the expenditure side was the sharp growth in certain consumption items and in gross capital formation.

It should be noted, however, that the comparison between the outturn data for 2003 and for 2002 (both in National Accounts and cash-basis terms) is distorted by three factors: first, by the transfer of revenue-raising and spending responsibilities to the regional (autonomous) governments, which took place last year and which may still be affecting this comparison, although to a lesser extent than in the previous year; second, by the change in the timetable for the receipt from general government of the tax withheld on earned income, the revenue now being transferred monthly; and, third, personal income tax revenue in the first few months of the year was not affected by the reduction in

BOX 5

Social Security budget outturn

The Social Security System posted a surplus of €6.25 billion in the period to April 2003, €348 million (5.9%) up on that recorded in the same period a year earlier, and an improvement on the 2003 budget (see table below). Nonetheless, as in the case of the State budget, the year-to-year comparison of these figures is affected by the culmination during 2002 of the effective assignment of health-care management to all the regional (autonomous) governments.

Receipts from social security contributions increased by 9.3% to April, a notably higher growth rate than budgeted and appreciably quicker than in 2002. This acceleration is due only to a minor extent to slightly higher growth (3.2%) in the number of Social Security registrations to June 2003, against a rate of 3% in 2002 as a whole.

Expenditure on contributory pensions posted a growth rate of 6.8% to April, in line with the budgeted rate for the year as a whole and with that for 2002. The number of contributory pensions continues to trend very moderately, and their growth stood at 1% to June, slightly higher than budgeted and up on 2002.

Contributions received by INEM (National Employment Office) increased by 8.7% to March, compared with a budgeted projection of 13.5%. Meanwhile, rebates on contributions in respect of employment-promoting contracts fell by 11.9% in Q1, contrasting with the 0.4% growth budgeted.

INEM expenditure on unemployment benefits rose by 6.3% to June 2003, a significant slowdown on the cumulative growth of 14.6% in 2002. Behind this figure lay both the slowdown in registered unemployment (which grew by 3.5% to June, compared with 7.4% in 2002 as a whole) and the decline in the eligibility ratio, which stood at 71.1% to May against 71.6% at end-2002. As a result, the number of beneficiaries grew by 1.9% to May, against average growth of 12.3% in 2002.

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

€ m and %

	Budget			Outturn JAN-APR		
	2002 (c) 1	2003 2	% change 3=2/1	2002 4	2003 5	% change 6=5/4
1. Revenue	**83,282**	**77,100**	**-7.4**	**27,359**	**26,900**	**-1.7**
Social security contributions (d)	67,852	72,174	6.4	22,987	25,130	9.3
Current transfers	14,389	4,294	-70.2	4,153	1,566	-62.3
Other (e)	1,042	632	-39.4	219	204	-6.7
2. Expenditure	**79,411**	**73,191**	**-7.8**	**21,454**	**20,648**	**-3.8**
Wages and salaries	6,683	1,785	-73.3	1,573	550	-65.0
Goods and services	4,214	1,390	-67.0	742	348	-53.1
Current transfers	67,615	69,568	2.9	19,065	19,711	3.4
Benefits	67,615	69,568	2.9	19,065	19,710	3.4
Contributory pensions	*56,231*	*60,024*	*6.7*	*15,841*	*16,911*	*6.8*
Sickness	*4,027*	*4,623*	*14.8*	*1,195*	*1,376*	*15.1*
Other	*7,358*	*4,922*	*-33.1*	*2,028*	*1,423*	*-29.8*
Other current transfers	0	0	-30.7	0	0	—
Other (f)	899	446	-50.3	74	39	-48.0
3. Balance	**3,871**	**3,909**	**1.0**	**5,904**	**6,252**	**5.9**

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 not available for 2003.

(b) Transfers from the Instituto Social de la Marina to the regional governments to finance transferred health-care and social-services responsibilities have been distributed among the various expenditure captions on the basis of the percentages obtained from the general government accounts for 1997.

(c) The budgetary reference takes the 2002 Budget as its basis for comparison, since the full outturn for that year is not yet available.

(d) Including surcharges and fines.

(e) Excluding surcharges and fines.

(f) Reduced by the disposal of investments.

CHART 4

Balance of payments: summary (a)

€ m

	JANUARY-APRIL	
	2002	2003
	CREDITS	
Current account	**75,182**	**80,626**
Goods	44,158	47,117
Services	18,533	19,543
Tourism	9,072	9,353
Other services	9,461	10,190
Income	6,520	7,274
Current transfers	5,970	6,691
Capital account	**2,909**	**2,216**
	DEBITS	
Current account	**80,005**	**87,340**
Goods	52,875	57,540
Services	12,588	13,328
Tourism	2,002	2,015
Other services	10,586	11,313
Income	10,356	11,617
Current transfers	4,187	4,854
Capital account	**318**	**371**
	BALANCE	
Current account	**-4,823**	**-6,714**
Goods	-8,716	-10,423
Services	5,945	6,215
Tourism	7,070	7,338
Other services	-1,125	-1,123
Income	-3,836	-4,343
Current transfers	1,784	1,837
Capital account	**2,592**	**1,845**

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

withholdings arising from the reform of this tax. The rates of change shown in columns 5 and 8 of Table 3 allow for these factors.

According to the cash-basis data available on the State budget outturn, in the first half of 2003 the deficit declined to €6,892 million, from €8,485 million in the period January-June 2002. This reduction in the cash-basis deficit contrasts with the increase budgeted for the year as a whole (Table 3), although the calendar effects referred to above, which have a bearing on the comparison with the previous year, should be taken into account.

To analyse revenue developments, data are available on the total revenue from the main taxes, including both the portion assigned to the State and that which corresponds to the regional (autonomous) governments, which is not included in Table 3. Total personal income tax receipts grew by 10.5% in the first six months, a notably higher rate than in the previous year as a whole (7.1%), although less than the rate in Q1 (14.7%), since the reduction in withholdings is becoming more important. Indirect taxes, meanwhile, accelerated significantly during these months relative to 2002 as a whole and relative to 2003 Q1, owing to the behaviour of VAT. VAT receipts grew, on a homogeneous basis, by 10.5% (as against 6.4% in 2002 and 6.1% in Q1), while excise taxes increased by 4.3% (4.6% in the preceding year and 5.3% in Q1). Finally, it should be added that the fall in non-tax receipts reflects the reduction in the State's property income and that the data for corporate income tax are affected by the larger rebates made in the first half of the year.

On the expenditure side, there was a fall in the first six months, with respect to the same period a year earlier, owing to the interest and current transfers captions. The latter, still affected by the new regional government financing system, declined by 4.7%, a slowdown from the 11% decline in Q1 (see Table 3). Meanwhile, operating costs (wages and salaries and goods and services) continued to record notable growth, especially in the case of goods and services, which increased by 12.2%, in sharp contrast to the fall of 12.4% budgeted for 2003 as a whole. However, operating costs have begun to slow with respect to the first quarter. Finally, the growth in investment in the period to June was higher than that budgeted for the year as a whole, in contrast to capital transfers, which slowed in this period.

4.5. The balance of payments and the capital account of the economy

In the period January-April 2003, the overall balance on current and capital account was a deficit of €4,869 million, an increase of €2,637 million on the deficit in the same period of the previous year. This outcome is basically explained by the deterioration in the current-account deficit, which widened by €1,891 million to €6,714 million, although the decline of €747 million in the capital-account surplus during this period also played a part. Within the current account, the merchandise deficit worsened significantly as did, to a lesser extent, the income deficit, while the services and current-transfers surpluses improved somewhat.

The trade deficit deteriorated by €1,707 million in the first four months of 2003, relative to the same period of 2002, a rise of 19.6% in year-on-year terms. During the period, the trade deficit continued to widen, basically on account of the burgeoning energy bill (despite the strength of the euro) and the growth differential between real import and export flows.

As for the services account, in the period January-April, it showed a surplus of €6,215 million, up €270 million on a year earlier. This improvement represented a year-on-year increase of 4.5%, which is explained by the increase in the tourism surplus (3.8%) and the stability of the other-services deficit (-0.2%). Tourism receipts during this period maintained the slightly positive trend that commenced in 2002 Q4, with annual growth of 3.1%, in line with the trend in tourist arrivals at frontiers during the first few months of 2003. Tourism payments barely grew by 0.7% in the first four months of 2003, an increase in the moderation seen at the end of the previous year, in line with the decline in consumer confidence and the substitution of domestic for foreign tourism, against a background of global instability.

The deficit on the income account deteriorated by €508 million between January and April 2003, relative to the same period of the previous year, to €4,343 million. Both receipts and payments increased notably (by 11.6% and 12.2%, respectively), reflecting the buoyancy of the income flows of the non-financial private sector.

The current-transfers surplus stood at €1,837 million in the first four months of the year, an increase of €54 million relative to the same period of 2002. Receipts rose by 12.1%, as a result of the expansion of flows to the private sector from the EU's EAGGF Guarantee Section. Payments, meanwhile, grew by 15.9%, owing to the notable increase in those made to the EU in respect of additional GNP resource.

Finally, the capital-account surplus fell by 28.8%, a rate that is explained by the decline in flows of structural funds from the EU, especially those to the ERDF. This is largely due to certain delays that are usual during the first few months of the year.

5. Financial developments

5.1. Overview

In the first half of the year, financial conditions in the Spanish economy have become more favourable for the expansion of private spending, due to a decrease in the cost of financing and a rise in the value of assets held by firms and households. The expansionary monetary policy stance, along with the prospects of moderate economic recovery in the major economies, helped to keep government debt yields on a declining course which took them to record lows, albeit with some episodes of volatility. Thus in June the yield on 10-year debt issued by the Spanish Treasury stood at 3.7%, although it edged up to 4% in mid-July. The credit risk premia of Spanish firms on credit derivatives markets fell significantly, particularly in the oil industry, and the resulting decrease in the cost of financing of these corporations exceeded that in the risk-free rate of interest (see Chart 23). The looser financial conditions were also reflected in the lower interest rates charged by credit institutions on loans to the private sector.

In 2003 Q1 domestic and international stock market prices followed a downward course accompanied by high volatility (see Chart 23). As the doubts over the length and gravity of the Iraq war faded, investors, encouraged by low risk-free interest rates, began to show a greater willingness to assume risks in equity markets following the sharp correction in share prices in the last three years. Thus, despite the uncertainty over the economic outlook, a certain normality was restored to the stock markets. Price volatility decreased significantly and price levels initiated an upward path on the main international stock exchanges. The Madrid Stock Exchange General Index (IGBM by its Spanish abbreviation) rallied after the fall at the beginning of the year and ended the first half with a gain of 13.5%, which was higher than that of the euro area's EURO STOXX index (2.9%) and that of the US S&P 500 index (10.8%).

House prices again grew in 2003 Q1, this time at a year-on-year rate of more than 17% which took the cumulative rise since 1997 to 68% in real terms (see Chart 23).

Against this background, in 2003 Q1 the financial saving of households remained at low levels (1.3% of GDP in cumulative four-quarter terms) and the net borrowing of non-financial corporations rose to 4.7% of GDP, compared with 4.4% in 2002 (see Table 5). The net financial transactions of general government and of financial institutions were unchanged and, as a result, the nation's debit balance worsened to 2% of GDP, against 1.6% in 2002.

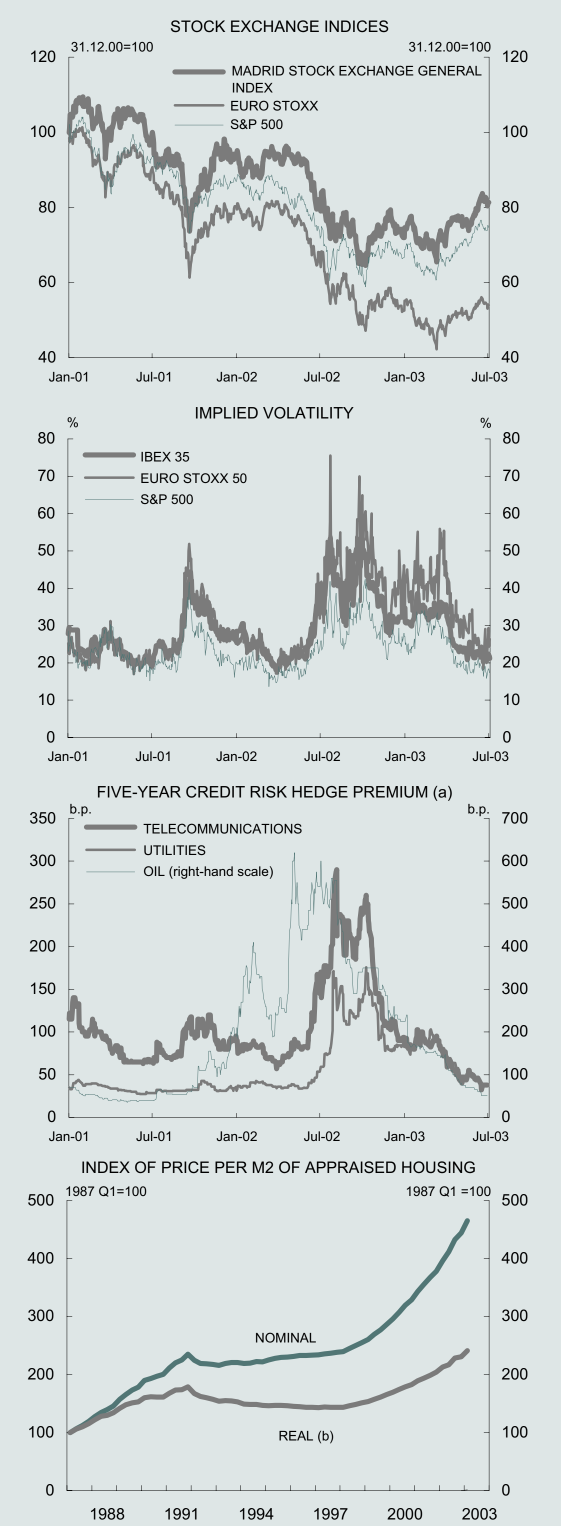
The looser monetary and financial conditions in Spain helped to increase the demand for credit to finance the spending decisions of households and firms, despite the favourable trend in the income of these sectors. The financing extended to households and non-financial corporations continued to grow at high rates, although in the first three months of the year there was a slight slowdown, which has not been confirmed by the provisional information available on Q2. Thus private sector debt grew in June at a year-on-year rate of around 15%, similar to that at end-2002. In the case of bank credit, its behaviour continues to depend on loan purpose, with lending to the property sector – construction, house purchase and real estate services – still being very significant (see Box 6).

The increase in the liabilities of the non-financial private sector led to further rises in its debt ratios. However, the easier conditions under which the new funds were raised allowed the financial burden associated with that debt to remain at moderate levels. The other available indicators of the financial position of households and firms have performed favourably in the year to date. The net wealth of households has continued to increase and their gross saving after debt service, although still low, picked up in Q1. The earnings of corporations showed signs of improvement.

Accordingly, the financial position of the private sector is favourable for the recovery of consumption and investment expenditure. However, some recent financial developments, related basically to the high indebtedness of households and corporations, pose certain risk factors of importance in the assessment of macroeconomic prospects. The marked increase in liabilities suggests that this sector will have to make its spending compatible with less intensive borrowing. Analogously, the higher indebtedness of firms and households also means that, compared with past behaviour, their spending decisions are more sensitive to changes in the determinants of the cost of debt and to the sector's capacity to service that debt. Finally, housing is somewhat overpriced, by an amount similar to that seen in the previous cyclical upturn in the early 1990s, which, like then, can be absorbed in a gradual, orderly fashion through a progressive price correction towards values more consistent with their fundamental determinants. However, the longer that the expected slowdown in the value of property assets is delayed, the greater is the likelihood that there will be a sharper adjustment.

CHART 23

Price indicators of various assets



Sources: Bloomberg, JPMorgan, Credit Trade and Banco de España.

(a) Average asset-weighted premia.

(b) Deflated with the CPI.

TABLE 5

Net financial transactions and inter-sectoral flows (cumulative four-quarter data)

% GDP

	NET FINANCIAL TRANSACTIONS								
	1998	1999	2000	2001	2002 Q1	2002 Q2	2002 Q3	2002 Q4	2003 Q1
National economy	**0.2**	**-1.0**	**-2.4**	**-2.1**	**-2.0**	**-1.9**	**-1.7**	**-1.6**	**-2.0**
Non-financial corporations and households and NPISHs	**2.1**	**-0.3**	**-2.4**	**-3.5**	**-4.0**	**-3.2**	**-3.6**	**-3.0**	**-3.4**
Non-financial corporations	-1.1	-2.3	-3.5	-4.6	-4.9	-4.2	-4.2	-4.4	-4.7
Households and NPISHs	3.3	2.0	1.1	1.1	0.9	1.0	0.6	1.4	1.3
Financial institutions	**1.1**	**0.5**	**0.7**	**1.5**	**1.6**	**1.5**	**1.7**	**1.5**	**1.5**
General government	**-3.0**	**-1.2**	**-0.8**	**-0.1**	**0.3**	**-0.2**	**0.2**	**-0.1**	**-0.1**
	INTER-SECTORAL FLOWS (a)								
Households and NPISHs	**3.3**	**2.0**	**1.1**	**1.1**	**0.9**	**1.0**	**0.6**	**1.4**	**1.3**
Vis-à-vis:									
Credit instituions (b)	-4.6	0.5	-0.2	-1.5	-2.3	-2.9	-3.5	-2.9	-3.4
Institutional investors (c)	7.6	0.9	0.4	3.7	3.4	3.4	3.0	2.9	3.9
Non-financial corporations	**-1.1**	**-2.3**	**-3.5**	**-4.6**	**-4.9**	**-4.2**	**-4.2**	**-4.4**	**-4.7**
Vis-à-vis:									
Credit institutions (b)	-4.5	-4.1	-6.8	-4.0	-4.1	-4.3	-3.9	-3.1	-3.8
Rest of the world	0.7	-0.7	2.0	-2.3	-2.5	-1.5	-1.2	-0.8	-0.9
General government	**-3.0**	**-1.2**	**-0.8**	**-0.1**	**0.3**	**-0.2**	**0.2**	**-0.1**	**-0.1**
Vis-à-vis									
Credit institutions (b)	1.4	1.3	2.2	-2.3	-0.2	-0.3	0.9	1.0	-0.6
Institutional investors (c)	-2.6	1.7	3.9	2.9	1.6	1.3	0.8	0.5	0.7
Rest of the world	-1.1	-4.3	-5.9	-1.6	-1.9	-1.6	-1.6	-1.1	0.1
Rest of the world	**-0.2**	**1.0**	**2.4**	**2.1**	**2.0**	**1.9**	**1.7**	**1.6**	**2.0**
Vis-à-vis:									
Credit institutions (b)	7.1	1.9	5.1	3.8	2.7	3.9	3.3	2.7	4.3
Institutional investors (c)	-6.3	-3.6	-5.7	-4.9	-3.7	-3.7	-3.3	-2.2	-3.5
Non-financial corporations	-0.7	0.7	-2.0	2.3	2.5	1.5	1.2	0.8	0.9
General government	1.1	4.3	5.9	1.6	1.9	1.6	1.6	1.1	-0.1

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

5.2. The household sector

In 2003 Q1 the net financial saving of households was practically zero and, in cumulative four-quarter terms, it remained low at 1.3% of GDP (see Table 5 and Chart 24). The sector's saving after debt service, which excludes the resources used for loan repayment, continued the moderate recovery seen since mid-2001 and stood at 1.7% of its gross disposable income (see Chart 25). The level of indebtedness further increased to 84% of household gross disposable income. However, the associated financial burden held at moderate levels owing to the favourable behaviour of interest rates. Also, net wealth again increased despite higher liabilities, mainly as a result of house price increases. In short, all these indicators show that the overall financial position of households improved in 2003 Q1, although their vulnerability to negative shocks increased as a consequence of the sector's higher debt.

With regard to portfolio decisions, the acquisition of financial assets by households in the first three months of the year amounted to 9.1%

BOX 6

Recent trend in bank credit to the private sector and in its components

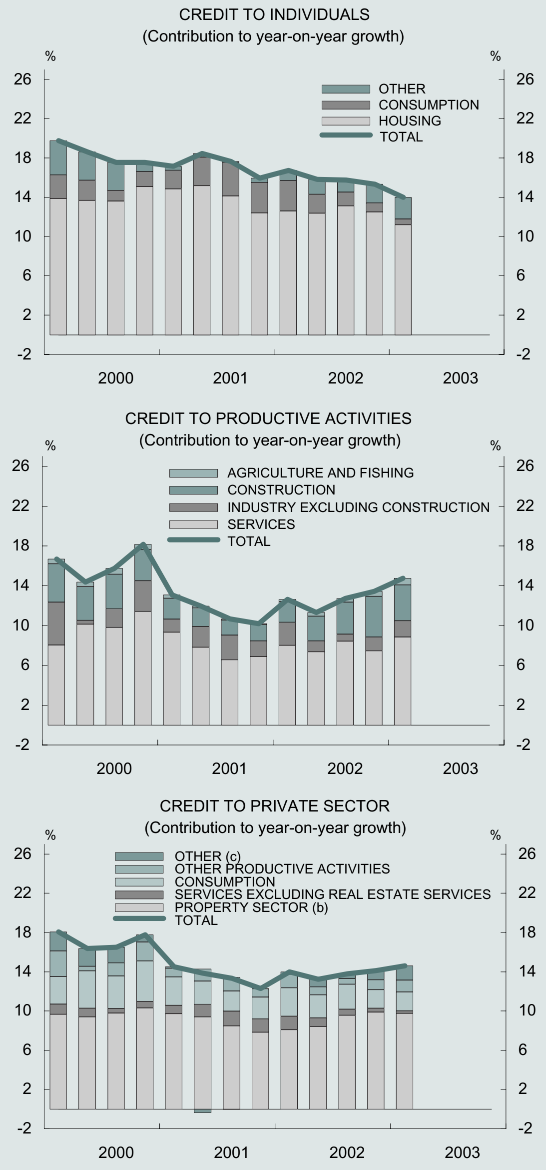
In the last two years, bank credit to households and corporations has continued to expand at high rates despite the moderate economic growth and the uncertain economic outlook that have characterised much of this period. Considering, in addition to the loans to the private sector that are recorded on banks' balance sheets, those that have been transferred to securitisation funds, the year-on-year growth rate of the resulting aggregate has, since 2001, stood at around 14% (1). This expansion of financing in Spain, at a rate far higher than that in most euro area countries, has been underpinned basically by very loose financial conditions in a context of high competition between credit institutions.

This trend in credit is the outcome of disparate behaviour depending on the sector and, more importantly, on the loan purpose (2). Thus, in the case of individuals, the funds received have shown a pattern of mild deceleration since the beginning of 2001 (see top panel). The breakdown by loan purpose shows that credit for house purchase has, on average, accounted for around 77% of the growth of loans to the sector in this period. This behaviour reflects households' greater net property-related borrowing, associated with increased residential investment and higher house prices, along with a moderate expansion in consumer spending. However, the most recent information points to a certain slowdown in this component, which has not been completely offset by consumer and other loans.

With regard to credit for productive activities, after a sharp slowdown in 2001, its momentum has tended to recover since the beginning of 2002 (see middle panel). As regards purpose, loans for construction and for services account for around 82% of the average increase in resources raised for productive activities since 2001. Nearly half of the funds raised in the services sector were for real estate services. By contrast, bank financing to industry grew very moderately in the same period, which made for a lower contribution to the expansion of the aggregate. This behaviour of credit components is in line with the buoyancy of the construction and property sectors and with the sluggishness in manufacturing. The latest information points to a brisker expansion of industry's recourse to bank debt, which seems to confirm the signs of recovery of investment in capital goods. Meanwhile, construction financing has continued to show high year-on-year growth, which in March 2003 exceeded 20%, in step with this sector's level of activity. Finally, the rate of growth of funds raised by the services sector was sustained, mainly due to demand from real estate companies.

In short, the recent trend in credit to the private sector has largely been due to the buoyant activity of the property sector. Thus financing to individuals for house purchase and that for construction and real estate services account for an average of 63% of loan growth since 2001 (see bottom panel). In 2002, the contribution of such loans to the expansion of bank financing to households and corporations tended to accelerate, accounting for 70% at the end of that year. However, the latest information shows a certain moderation in this indicator (67% in 2003 Q1). Thus in March 2003 loans for property-related purposes accounted for 51% of outstanding credit to households and firms, up five percentage points on end-2000.

Credit by purpose (a)



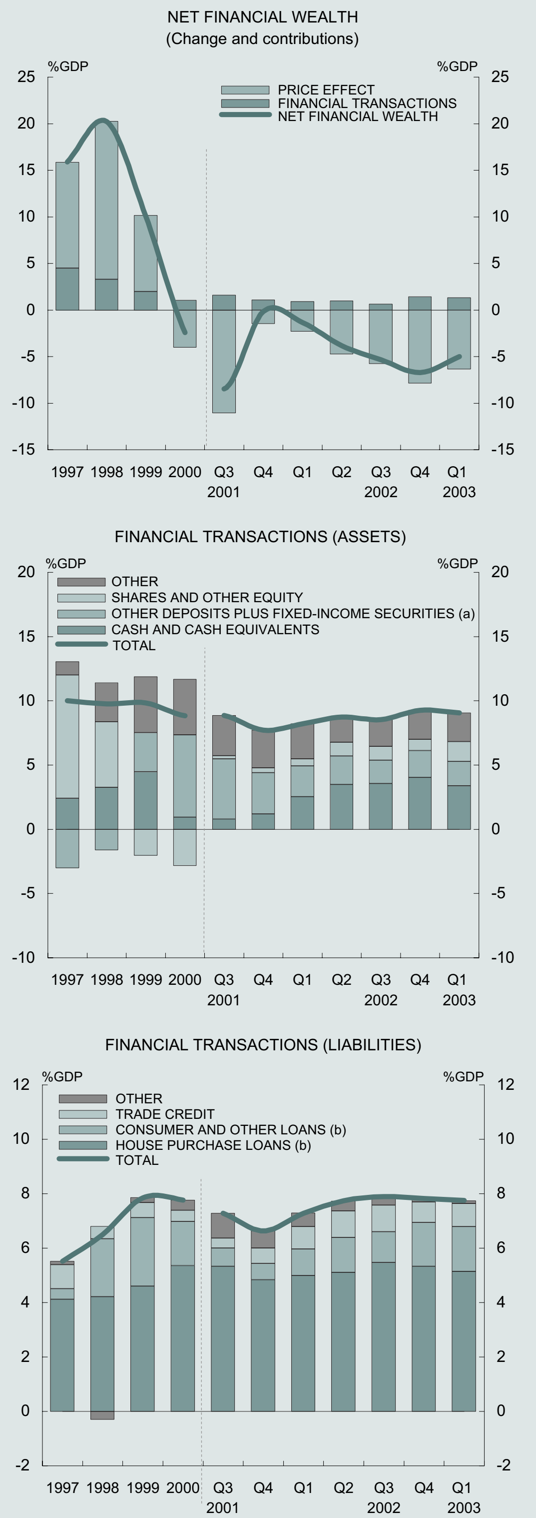
Source: Banco de España.
(a) Includes securitised assets.
(b) Includes housing, construction and real estate activities.
(c) Includes loans for other purposes to individuals plus NPISHs and unclassified items.

(1) References to bank credit in the rest of this box always include that which has been securitised.

(2) This box uses a definition and sectorisation of the private sector which differs from that used in the rest of the chapter. The latter usage follows the National Accounts and the Financial Accounts in distinguishing between non-financial corporations and households, which include individuals, individual entrepreneurs and NPISHs. By contrast, in this box the private sector includes the aforementioned groups as well as non-monetary financial institutions, and is broken down into individuals and productive activities. This sectorisation has been chosen because the information available on credit by purpose does not permit the other one.

CHART 24

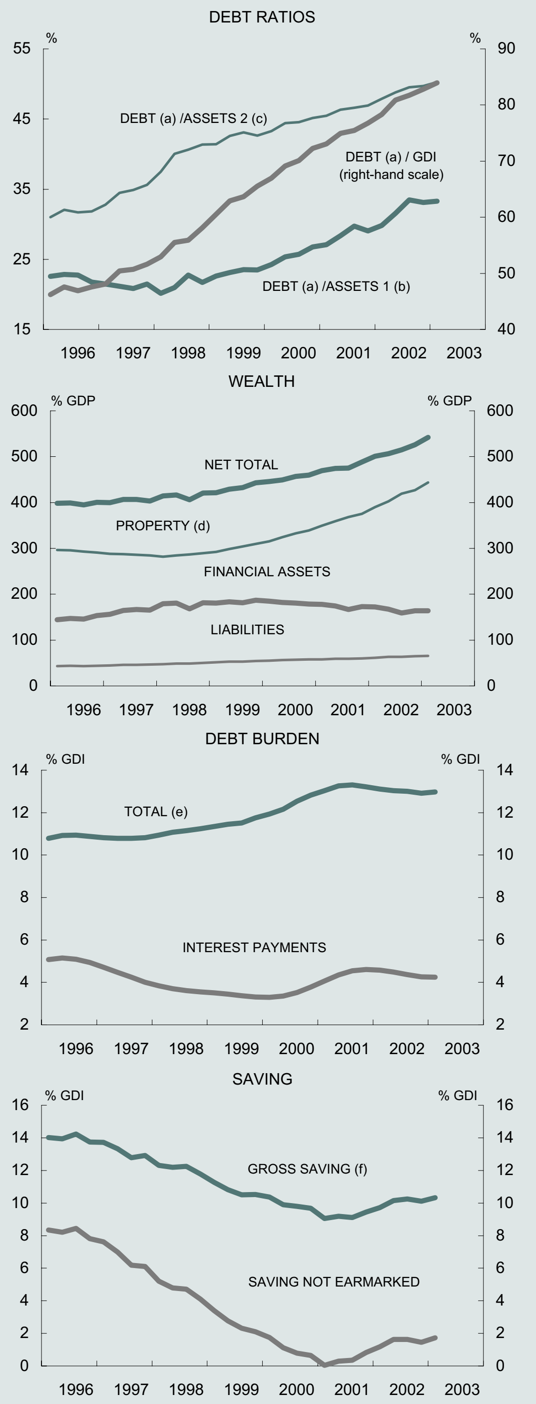
Households and NPISHs
(Cumulative four-quarter data)



Source: Banco de España.
(a) Not including unpaid accrued interest, which is included under "other".
(b) Including securitised loans.

CHART 25

Indicators of the financial position of households and NPISHs



Source: Banco de España.
(a) Includes bank credit, securitisation and fixed-income securities.
(b) Assets 1 = Total financial assets - "other".
(c) Assets 2 = Assets 1 - shares - shares in FIM.
(d) Calculated on the basis of the estimated changes in the stock of housing, in the average area per house and in the price per square metre.
(e) Estimated interest payments plus debt repayments.
(f) Balance of households' use of disposable income account.
(g) Gross saving less estimated debt repayments.

TABLE 6

Financial assets and liabilities of households, NPISHs and non-financial corporations (cumulative four-quarter data)

%GDP

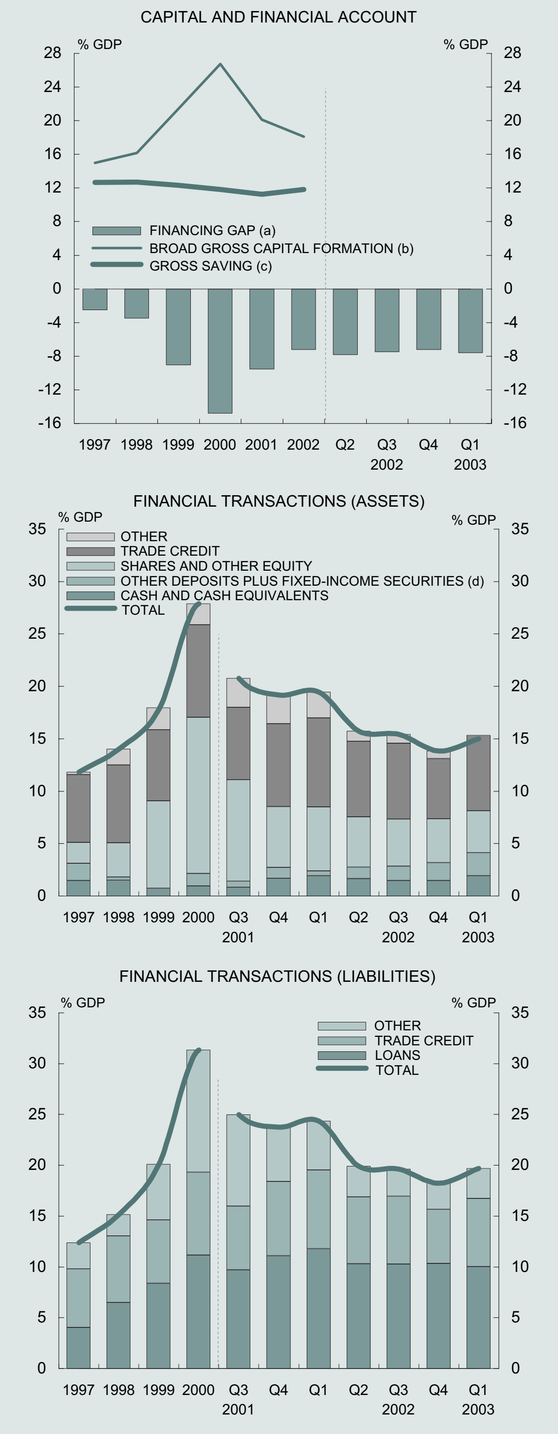
	1999	2000	2001	2002		2003
				Q3	Q4	Q1
HOUSEHOLDS AND NPISHs:						
Financial transactions (assets)	**9.8**	**8.8**	**7.7**	**8.5**	**9.3**	**9.1**
Cash and cash equivalents	4.5	0.9	1.2	3.6	4.0	3.4
Other deposits and fixed-income securities (a)	3.0	6.4	3.2	1.8	2.1	1.9
Shares and other equity (b)	0.1	0.5	-0.4	0.4	0.7	0.5
Mutual funds	-2.1	-3.4	0.8	0.7	0.2	1.1
FIAMM	*-1.4*	*-1.3*	*1.3*	*1.0*	*0.7*	*0.8*
FIM	*-0.8*	*-2.0*	*-0.5*	*-0.4*	*-0.5*	*0.3*
Insurance technical reserves	3.3	3.4	2.5	2.2	2.4	2.5
of which:						
Life assurance	*2.0*	*1.9*	*1.4*	*1.1*	*1.6*	*1.7*
Pension funds	*1.0*	*1.3*	*0.9*	*0.7*	*0.7*	*0.7*
Other	1.0	0.9	0.4	-0.1	-0.2	-0.2
Financial transactions (liabilities)	**7.9**	**7.8**	**6.6**	**7.9**	**7.8**	**7.8**
Credit from resident credit institutions (c)	7.1	7.0	5.4	6.6	6.9	6.8
House purchase credit (c)	4.6	5.4	4.8	5.5	5.3	5.1
Consumer and other credit (c)	2.5	1.6	0.6	1.1	1.6	1.6
Other	0.7	0.8	1.2	1.3	0.9	1.0
NON-FINANCIAL CORPORATIONS:						
Financial transactions (assets)	**17.8**	**27.9**	**19.2**	**15.4**	**13.8**	**15.0**
Cash and cash equivalents	0.7	0.9	1.7	1.5	1.5	1.9
Other deposits and fixed-income securities (a)	-0.1	1.2	1.1	1.4	1.7	2.2
Shares and other equity	8.4	14.9	5.8	4.5	4.2	4.0
of which:						
Vis-à-vis the rest of the world	*6.8*	*11.3*	*4.9*	*3.3*	*2.8*	*2.9*
Other	8.9	10.8	10.7	8.1	6.5	6.9
Financial transactions (liabilities)	**20.1**	**31.4**	**23.8**	**19.6**	**18.2**	**19.7**
Credit from resident credit institutions (c)	5.3	7.6	6.9	6.9	6.8	7.4
Foreign loans	3.0	3.5	4.0	3.2	3.4	2.4
Fixed-income securities (a)	0.5	-0.7	0.1	-0.1	-0.3	-0.3
Shares and other equity	5.1	12.8	5.4	3.1	3.1	3.5
Other	6.2	8.1	7.3	6.5	5.3	6.7
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%)						
Financing (d)	**19.5**	**18.8**	**15.7**	**14.9**	**14.8**	**14.0**
Households and NPISHs	19.6	17.3	12.4	14.5	15.0	14.4
Non-financial corporations	19.4	19.9	18.2	15.3	14.6	13.6

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

of GDP in cumulative four-quarter terms and centred on less risky instruments (see Table 6 and Chart 24). Also, the entry into force of the personal income tax reforms, including the abolition of taxation of capital movements between collective investment instruments, stimulated the purchase of mutual fund shares. Net purchases of these assets amounted to 1.1% of GDP in cumulative four-quarter terms, against 0.2% in 2002. The distribution by category showed a preference for money market funds (FIAMM), which received resources amounting to 0.8% of GDP, against 0.3% received by securities funds (FIM). However, net investment in FIM, measured in cumulative four-quarter terms, turned positive again for the first time

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) Includes gross capital formation, stockbuilding and foreign equities.
(c) Includes capital transfers.
(d) Not including unpaid accrued interest, which is included under "other".

since 1999. Net FIM purchases were concentrated in euro-denominated bond funds and in guaranteed equity funds. The provisional information for June indicates that this process has continued.

Turning to liabilities transactions, the financing received by households continued to grow apace, although in Q1 its rate dipped slightly to 14.4% in year-on-year terms. This expansion, which occurred despite a certain hardening of credit terms to households disclosed by the latest Bank Lending Survey, was underpinned basically by reductions in the cost of financing. Thus, based on the most recent information on bank rates, the interest rates for house purchase and for consumer and other loans decreased by 26 and 38 b.p., respectively, between January and March. In GDP terms, the flow of financing in the last four quarters was 6.8%, 0.1 percentage point less than at end-2002. This decrease is due to the slowdown in lending for house purchases.

The provisional information for Q2 does not confirm the slowdown in the rate of expansion of household credit observed from January to March, but rather puts the year-on-year growth rate at over 15%. The breakdown by component shows that financing for house purchases continues to slow, while that intended for current expenditure seems to have picked up.

5.3. Non-financial corporations

In 2003 Q1, net borrowing by non-financial corporations was high at 2.3% of GDP, and the debit balance in cumulative four-quarter terms rose by 0.3 percentage points to 4.7% of GDP (see Table 5). The financing gap, which refers to the external resources needed to enable real and permanent financial investment to be carried out, also increased slightly to 7.6% of GDP, despite the recovery of gross saving by corporations (see Chart 26).

The financing received by corporations continued to grow at high rates, prompting further increases in the sector's debt ratios. However, according to Central Balance Sheet Data Office (CBSO) information, this development is the result of heterogeneous behaviour by the various types of corporation (see Chart 27). Thus, large corporations, which have a higher relative volume of borrowed funds, reduced their debt ratios slightly. By contrast, small and medium enterprises were the ones responsible for the rise in this indicator.

Interest payments of corporations decreased slightly in Q1 due to the lower cost of financing, and therefore remained moderate (19% of operating profit). On CBSO information, this declining trend was seen in all sectors, although small and medium enterprises recorded a slight increase to what was still a very low level (see Chart 28). Considering short-term debt as well as interest, the financial burden indicator also decreased for the CBSO-reporting corporations as a whole.

The earnings of corporations performed very favourably in Q1. Ordinary net profit, which excludes extraordinary income and expenses, grew by 12.6% for the corporations included in the CBSO Quarterly Survey. This positive performance, which was fairly general among the main sectors of activity, boosted the ordinary return on equity to relatively high levels.

In short, all these indicators show that the aggregate wealth position of corporations continues to be sound, despite growth of their debt, and that their financial position improved in Q1.

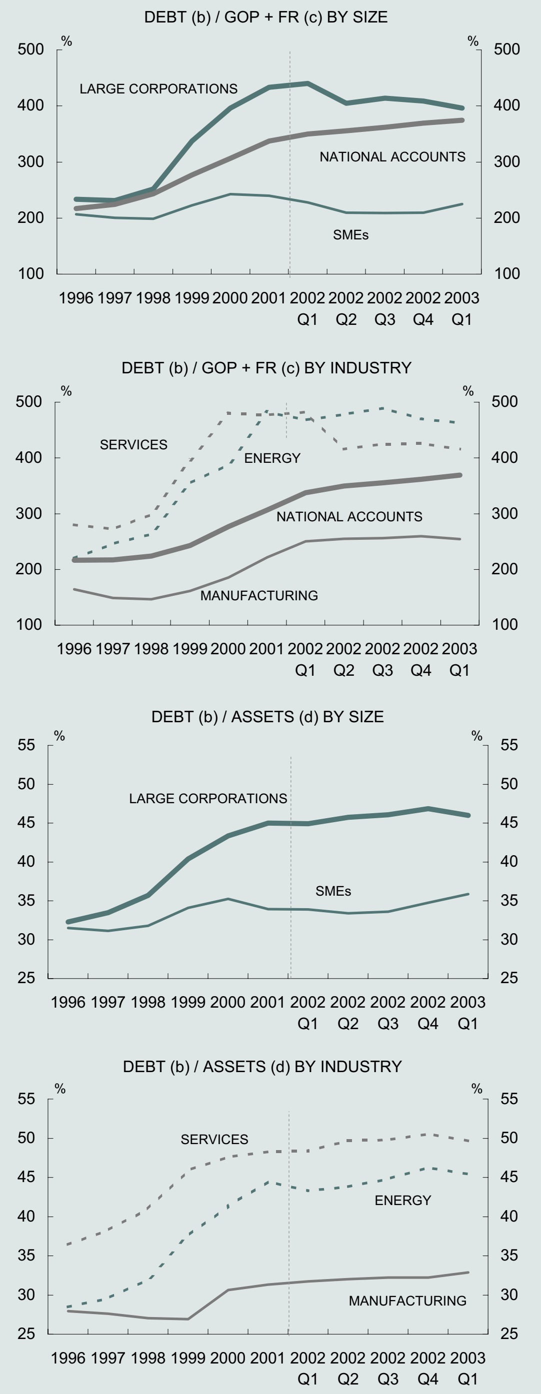
As regards investment in financial assets by non-financial corporations, the recent slowdown was left behind in the first three months of the year and it stood at 15% of GDP in cumulative four-quarter terms (see Table 6 and Chart 26). These investments were, to a greater extent than in the recent past, in the form of more liquid assets (cash, deposits and fixed-income securities), while share purchases amounted to 4% of GDP, down slightly on previous quarters.

Liabilities transactions also reached a high volume at 19.7% of GDP in cumulative four-quarter terms, against 18.2% at end-2002, with uneven behaviour across components. Interest-bearing borrowed funds slowed slightly to growth of 13.6%, against 14.6% at end-2002. The funds raised via foreign loans, a vehicle used more by large corporations, fell to 2.4% of GDP, against 3.4% in the previous quarter, while financing from resident institutions acquired greater weight (7.4% of GDP). Also, net redemptions of fixed-income securities by corporations amounted to 0.3% of GDP, while trade credit, which is included under the heading "Other", increased. Finally, the resources raised through the issuance of shares and other equity, mainly unquoted securities, amounted to 3.5% of GDP.

As in the case of households, the expansion of borrowing took place against a background of somewhat more restrictive supply conditions on the credit market, according to the Bank Lending Survey. Furthermore, it was underpinned by the decrease in the cost of financing.

CHART 27

Debt ratios of non-financial corporations (a)



Source: Banco de España.

(a) All the series, except "National Accounts", are calculated with CBSO information. Up to 2001, the information is from the CBSO annual survey (CBA). Thereafter, the indicators have been estimated drawing on the CBSO quarterly survey (CBQ).

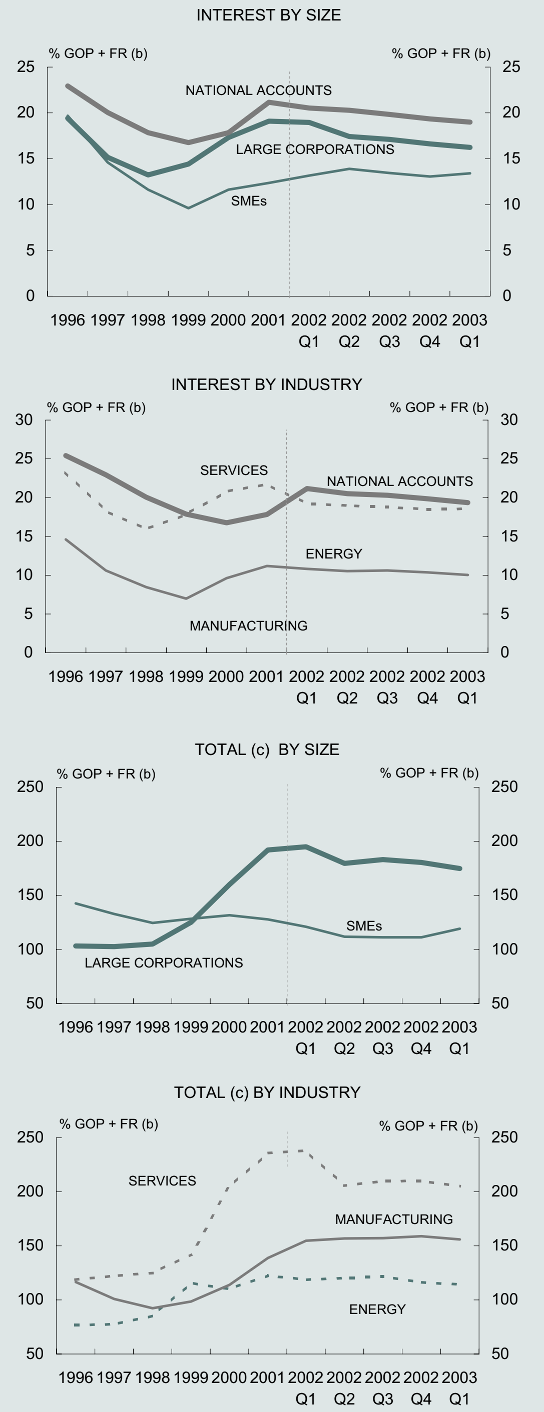
(b) Interest-bearing borrowed funds.

(c) Gross operating profit plus financial revenue.

(d) Defined as total inflation-adjusted assets less non-interest-bearing liabilities.

CHART 28

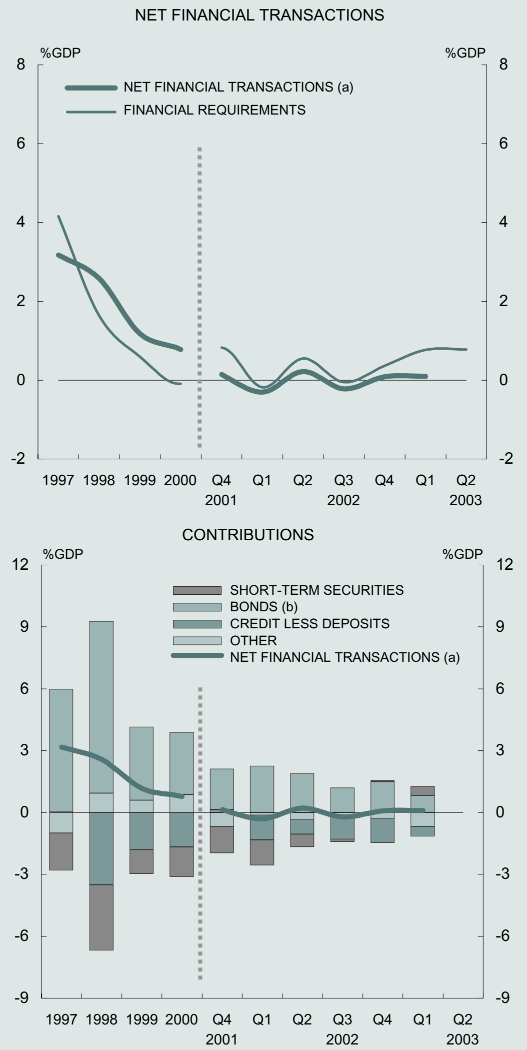
Debt burden of non-financial corporations (a)



Source: Banco de España.
(a) All the series, except "National Accounts", are calculated with CBSO information. Up to 2001 the information is from the CBSO annual survey (CBA). Thereafter, the informtion is from the CBSO quarterly survey (CBQ).
(b) Gross operating profit plus financial revenue.
(c) Includes interest plus interest-bearing short-term debt.

CHART 29

General government
(cumulative four-quarter data)



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

Financing continued to show differing behaviour according to branch of production and company size. Credit extended by resident institutions to the construction sector again grew by 20%, although this represented a certain deceleration. On the other hand, the recovery of industrial production was reflected in a pick-up in the funds received from resident institutions, the rate of expansion of which quickened to 4.8%, against 3.2% at end-2002. Analysis by company size shows that the growth of liabilities was higher in small and medium enterprises (SMEs), while large corporations, with their higher debt ratio, increased their borrowing more moderately. This was partly a reflection of

TABLE 7

Financial transactions of the nation (cumulative four-quarter data)

% GDP

	1999	2000	2001	2002 Q3	2002 Q4	2003 Q1
Net financial transactions	**-1.0**	**-2.4**	**-2.1**	**-1.7**	**-1.6**	**-2.0**
Financial transactions (assets)	**15.3**	**25.2**	**12.2**	**11.7**	**11.9**	**13.5**
Gold and SDRs	**-0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Cash and deposits	**1.7**	**2.8**	**-2.7**	**1.5**	**4.1**	**4.6**
Credit system	3.7	2.5	-2.7	0.2	2.0	2.3
Other resident sectors	-2.1	0.4	0.0	1.4	2.0	2.3
Securities other than shares	**2.9**	**3.9**	**7.2**	**5.7**	**4.3**	**5.4**
Credit system	-0.8	-0.3	2.0	1.2	0.6	0.8
Other resident sectors	3.7	4.2	5.3	4.5	3.7	4.6
Shares and other equity	**10.1**	**15.6**	**5.2**	**3.7**	**3.1**	**3.0**
Credit system	0.8	1.8	0.0	0.1	0.2	0.0
Other resident sectors	9.4	13.9	5.2	3.6	2.9	2.9
of which:						
Non-financial corporations	6.8	11.3	4.9	3.3	2.8	2.9
Loans	**0.7**	**2.8**	**2.5**	**0.7**	**0.4**	**0.5**
Credit system	-0.2	0.5	0.8	0.5	0.0	0.1
Other resident sectors	0.9	2.3	1.7	0.2	0.3	0.4
Financial transactions (liabilities)	**16.3**	**27.7**	**14.3**	**13.4**	**13.4**	**15.5**
Deposits	**4.1**	**6.8**	**2.8**	**4.6**	**4.3**	**5.9**
of which:						
Credit system	4.1	6.8	2.8	4.7	4.3	5.9
Securities other than shares	**5.4**	**7.0**	**3.1**	**3.9**	**4.0**	**3.9**
Credit system	0.9	0.7	0.6	0.7	1.2	1.7
General government	4.3	5.7	1.6	1.6	1.1	-0.1
Other resident sectors	0.2	0.5	0.9	1.6	1.7	2.3
Shares and other equity	**4.2**	**9.4**	**4.7**	**2.3**	**1.8**	**2.5**
Credit system	0.3	1.8	0.5	0.2	0.1	0.2
Other resident sectors	3.9	7.7	4.1	2.1	1.7	2.4
Loans	**3.8**	**4.5**	**4.8**	**3.8**	**3.9**	**2.8**
General government	0.0	0.0	0.1	0.2	0.0	0.0
Other resident sectors	3.7	4.4	4.7	3.6	3.9	2.8
Other, net (a)	**-1.2**	**0.0**	**-1.0**	**-1.2**	**-0.6**	**0.3**

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

the restructuring in process at some of these corporations.

The provisional information for Q2 points to an increase in the expansion of financing obtained by corporations which would take its year-on-year growth rate to levels similar to those at end-2002. As regards components, the expansion of liabilities continued to be underpinned by the momentum of loans from resident credit institutions.

5.4. General government

The net balance of the financial transactions of general government in 2003 Q1 was positive and, in cumulative four-quarter terms, stood at –0.1% of GDP (see Chart 29).

The net issuance of marketable securities by general government was negative between January and March and, in cumulative four-quarter terms, fell to 1.2% of GDP. The volume

TABLE 8

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

% GDP

	1998	1999	2000	2001	2002	2003 (b)
National economy	**-21.8**	**-22.5**	**-20.4**	**-21.8**	**-24.3**	**-22.9**
Non-financial corporations and households and NPISHs	**-8.7**	**-8.7**	**-0.4**	**-1.2**	**-0.3**	**1.3**
Non-financial corporations	-14.9	-16.3	-8.2	-9.2	-9.8	-8.5
Households and NPISHs	6.2	7.6	7.7	7.9	9.4	9.8
Financial institutions	**4.8**	**6.8**	**4.9**	**4.6**	**1.4**	**-0.4**
Credit institutions (b)	-5.5	-7.6	-12.6	-14.6	-15.4	-17.5
Institutional investors (c)	10.7	15.0	18.3	20.9	20.3	21.2
Other financial institutions	-0.4	-0.6	-0.9	-1.8	-3.5	-4.1
General government	**-17.9**	**-20.6**	**-24.8**	**-25.1**	**-25.3**	**-23.8**

Source: Banco de España.
(a) Calculated as the difference between the stocks of financial assets and liabilities vis-à-vis the rest of the world according to quarterly financial accounts data.
(b) Q1 data.
(c) Defined according to the First Banking Directive.
(d) Insurance corporations and collective investment institutions.

of short-term securities issues was relatively high (0.4% of GDP), with a relaunch of three- and six-month Treasury bill tenders. Also, general government redeemed €5.7 billion of medium- and long-term government bonds, so that the net issuance in the last four quarters decreased to 0.8% of GDP. To meet its requirements for funds, general government also had to draw down its deposits, although in cumulative four-quarter terms the net investment in these instruments remained positive.

Provisional information for 2003 Q2 shows an increase in both short-term and, more particularly, long-term issues. Although some of the resources obtained were used to augment the balance of deposits, the *financial requirements*, a leading indicator of the sector's saving, increased in that period.

5.5. The rest of the world

The debit balance of the nation's financial transactions increased in 2003 Q1 and, in cumulative four-quarter terms, stood at 2.2% of GDP, against 1.6% at end-2002. This worsening was basically due to the higher net borrowing of non-financial corporations, since the financial saving of the other institutional sectors did not change significantly. Also, the volume of financial asset and liability transactions increased, despite the fact that the international economic climate was hardly conducive to cross-border financial flows.

Net purchases of foreign assets increased to 13.5% of GDP, against 11.9% three months earlier (see Table 7). This outcome was once again the result of an increase in less risky assets (cash, deposits and fixed-income securities), while the other headings did not change significantly. On provisional Balance of Payments information to April, foreign direct (permanent) investment decreased by more than 80% compared with the same quarter a year earlier, partly due to the negative effect of the uncertainty over the international economic outlook and the consequences of the Iraq war. Portfolio investment abroad continued to be high, given the substantial purchases of bonds issued by the rest of the world.

On the liabilities side, net flows amounted to 15.5% of GDP, against 13.4% three months earlier. Investments by non-residents centred largely on deposits and private-sector fixed-income securities. However, their holdings of government debt declined. According to Balance of Payments information, inward foreign direct investment in Spain in the first four months of the year was slightly more moderate than in the same period a year earlier.

Finally, the provisional information on the debit position of the Spanish economy vis-à-vis the rest of the world shows that at the end of the first quarter it stood at 22.9% of GDP, an improvement of 1.4 percentage points on 2002 (see Table 8).

30.7.2003.