Quarterly report on the Spanish economy

1. Overview

The expansionary phase initiated in the world economy in the second half of 2003 has progressively firmed in 2004 to date. In this period, however, geopolitical tensions in the Middle East have been rekindled. And this, along with the terrorist bombings on 11 March in Madrid, may have prompted some uncertainty, especially in Europe, where the upturn is weakest and lagging. For the moment, those indicators already released containing informatin subsequent to these events – including the European Commission's confidence surveys for April, released once this Bulletin had gone to press scarcely show effects attributable to the bombings, either in Europe or in Spain.

The buoyancy of global economic activity has been heightened in the United States, Asia – including Japan – and Eastern Europe, and it has gradually spread to other regions such as Latin America and the euro area. In the latter case, however, the pace of growth has remained relatively moderate, while on a defined path of recovery. The expansionary stance of macroeconomic policies has not been altered and monetary and financial conditions have remained generous, as indicated by the trend of short and long-term interest rates. Their levels, which had held at a historical low for most of the quarter, have begun to rise slightly since early April, coinciding with the release of very favourable indicators on the US economic situation and signs of a turnaround in its inflation rate. The stock market performance remained favourable for virtually the entire period, although gains were less pronounced than in the closing months of 2003 and were temporarily hit by the terrorist bombings on 11 March, more intensely so in Spain and the EU. On the currency markets the dollar ceased to depreciate as from mid-February, partly offsetting thereby the appreciation in the euro in recent years. Oil and other commodity prices rose considerably, partly as a result of tensions in the Middle East but also due to the resilient demand of certain countries.

Against this background, the Spanish economy has sustained similar growth in 2004 to date to that in 2003 Q4. On Banco de España estimates, Spanish real GDP growth in 2004 Q1 on the same period a year earlier was 2.8%, in terms of the seasonally adjusted series, a similar figure to the QNA release for 2003 Q4 (2.7%). In quarter-on-quarter terms the growth rate was also virtually identical, as the estimate of 0.6% for 2004 Q1 is only 0.1 pp down on the figure for end-2003. These results signify the prolongation of the patterns marking recent developments in the Spanish economy: firmness in the increase in domestic demand and a negative contribution of the net external balance.

CHART 1

Gross domestic product

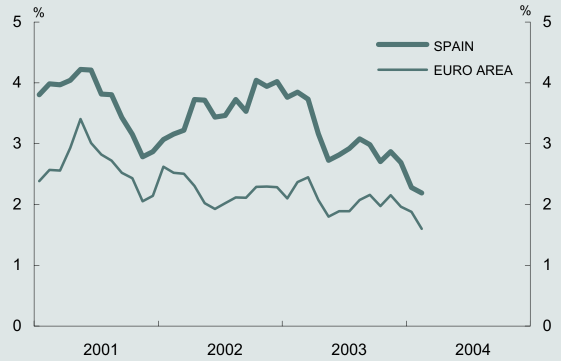
Sources: ECB, Instituto Nacional de Estadística and Banco de España.
(a) Non-centred year-on-year rate of change calculated on the basis of the seasonally adjusted series.
(b) Quarter-on-quarter rate of change calculated on the basis of the seasonally adjusted series.

Specifically, the estimates for Q1 are growth of around 3.5% in domestic demand and a negative contribution of external demand slightly below 1 pp. Essentially underpinning the momentum of demand have been consumption and construction, along with certain general government expenditure items, while imports of goods and services appear to be posting higher rates of increase than those of exports. In this expansionary setting, employment – in National Accounts terms – is estimated to have sustained a similar growth rate to that in the closing months of 2003, namely 2%, providing for a moderate recovery in apparent labour productivity. Finally, the 12-month growth rate of the CPI fell to 2.1% in March and the differential with the euro area, in terms of the HICP, narrowed to 0.5 pp. Given this situation, wage growth is expected to be contained and the rise in business margins to stabilise.

As indicated, the US economy has remained markedly buoyant in 2004 to date, as the latest

CHART 2

Harmonised indices of consumer prices (a)



Sources: Eurostat and ECB.
(a) Year-on-year rate of change. To December 2001, the rates relate to those released as at that date.

activity and demand indicators testify. Employment, in particular, rebounded in March after a long period of slackness that had contrasted with the resilience of other indicators. If this recovery in employment is confirmed in the coming months, that will dispel some of the uncertainty surrounding the soundness of household expenditure and the sustainability of the current upturn. Still pending in this connection is the start of a firm correction of the balance of payments deficit and the towering budget deficit.

The expansion has proven compatible with a moderate inflation rate to March of around 1.7% which, though it is not yet reflecting the latest oil and commodity price rises, does show the slight rise in underlying inflation. Against this backdrop, money and debt market interest rates have remained very low and, at its March meeting, the Federal Reserve kept its official intervention rate at 1%, now unchanged for 10 months. Since early April, however, the improved growth prospects for the US economy and the slight turnaround in the inflation outlook have made for a small rise in interbank market and Treasury bond interest rates, in anticipation of an increase in intervention rates in the second half of the year.

The Japanese economy is also growing vigorously in early 2004, underpinned by the strength of exports and industrial output and by improved business expectations, set against an accommodating monetary policy. The rate of expansion has likewise stepped up in the south-east Asian economies, driven by export buoyancy. There has been robust growth in China, which posted a real rate of over 9% in 2003 Q4 and might be showing incipient signs of overheating.

In the months prior to joining the EU on 1 May, the acceding countries have been posting high growth rates. That said, their inflation has climbed further to the liberalisation of administered prices and rises in certain taxes, and their public finances have worsened. Finally, the economic outlook in Latin America has improved following a relatively prolonged phase of uncertainty. The determinant here has been the favourable behaviour of the external sector, in response to the effect of the cumulative depreciations in recent years and to commodity price rises.

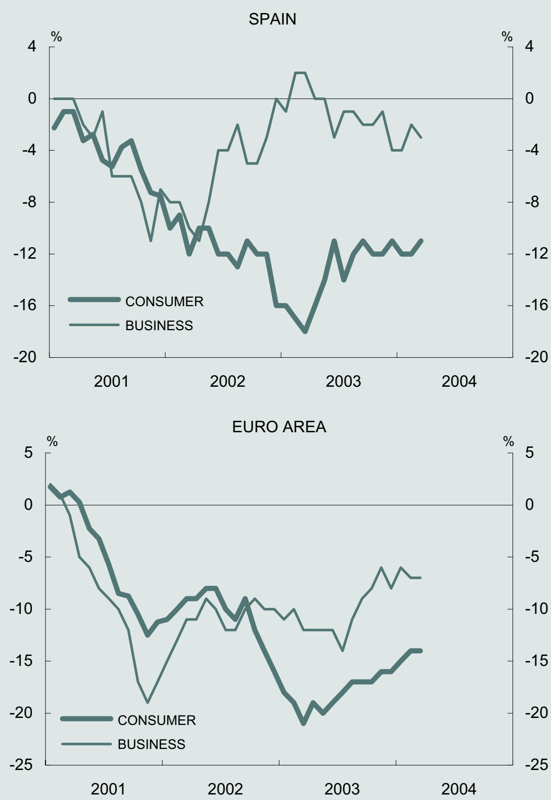
In the euro area, the information available for the opening months of 2004 points to a continuation of the moderate economic recovery that began in the second half of 2003. The expansion in GDP in Q1 will foreseeably be similar to that of 2003 Q4. And higher growth rates should become embedded over the rest of the year as a result of the vigour of the external sector, the maintenance of generous monetary and financial conditions and the trend of the exchange rate of the euro. However, some of the indicators released in recent months show only a wavering improvement. Consequently, doubts remain about how robust this incipient phase of recovery will be, in particular as regards private-sector expenditure and, more specifically, consumption.

Inflation slowed in the opening months of the year – the HICP stood at 1.7% in March – largely as a result of the decline in the 12-month rate of the energy component, which had risen most significantly in early 2003. Underlying inflation held on a steadier course, with a slightly higher rate of around 2%, towards which the HICP might move in the coming months. Against this backdrop, the ECB did not alter the single monetary policy stance, holding the minimum bid rate on its main refinancing operations at 2%, and the respective interest rates on its marginal lending facility and deposit facility at 1% and 3%.

In the fiscal policy realm, the preliminary budget deficit and public debt figures for 2003 were notified in the context of the excessive deficit procedure (EDP). According to this information, public finances in the euro area in 2003 worsened for the third year running, which was reflected in an increase in the budget deficit for the area as a whole to 2.7% of GDP (2.3% the previous year). This result is essentially due to the deterioration in the cyclical position of the Member States' economies, with the fiscal policy for the area as a whole practically retaining a neutral stance. As may be recalled, the information provided by the countries in their updated Stability and Growth Programmes – discussed

CHART 3

Confidence indicators



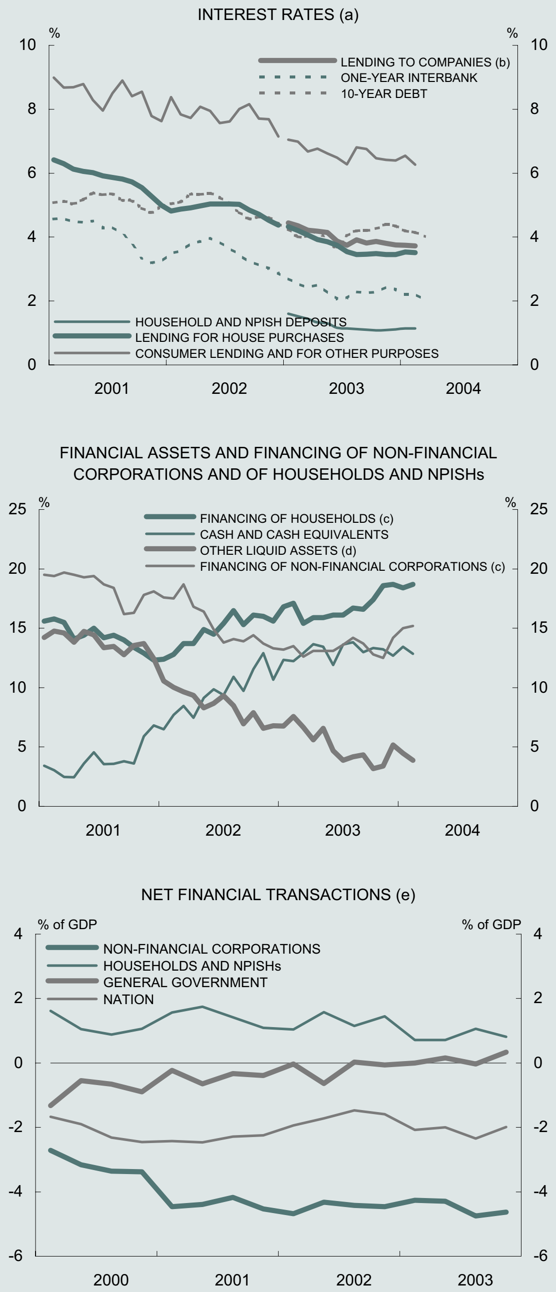
Source: European Commission.

at the ECOFIN Council early in the year – augured some correction of this situation in 2004. However, the latest forecasts point to worse results and to a larger number of countries potentially falling foul of the Stability and Growth Pact. In this respect, the European Commission and the Council will discuss in the coming weeks activating the EDP in the case of the Netherlands and the United Kingdom, whose deficits exceeded 3% of GDP in 2003, and the possibility of warning Italy to adopt measures to prevent its budget deficit overstepping this limit in 2004.

Interest rates on euro area money markets continued to decline mildly until early April when, in step with developments on US money markets, Euribor rates began to rise at all terms, to over 2%. Long-term interest rates followed a similar course, declining in the opening months of 2004 and rising slightly in April, to around 4.2%. Bank interest rates, the information on which is available with a greater lag, held stable in these months. In this setting, the year-on-year growth of the M3 monetary aggregate continued to ease until February (with growth of 6.3% on

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) Calculated as a weighted average of the interest rates on various transactions grouped according to their volume. For loans exceeding 1 million, the interest rate is obtained by adding to the NDER (Narrowly Defined Effective Rate), which does not include commission and other expenses, a moving average of such expenses.

(c) Includes bank lending extended by resident credit institutions, foreign loans and financing through securitisation vehicles. Financing to non-financial corporations also includes fixed-income securities.

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

(e) Cumulative four-quarter data.

the same month a year earlier), while the rate of increase or private-sector lending held at 5.8% that same month.

The external environment is, despite the above-mentioned uncertainty, perceptibly more favourable, a fact which should broaden the bases for growth in the coming months. And, against this background, the Spanish economy in early 2004 has continued to grow, as seen, under generous financing conditions that have contributed to sustaining private-sector expenditure, especially that of households. General government conduct, for its part, has so far been in step with the guidelines laid down in the State budget.

The key factor behind financing to households and firms in Q1 was the persistence of an environment of low interest rates on the euro area money market and the declining trajectory of medium and long-term yields on Spanish public debt. In the light of this, the interest rates applied by credit institutions to their customers held at the levels seen in late 2003. As indicated, stock markets continued to rise, despite the temporary interruption caused by the terrorist attacks on 11 March. In the period of 2004 to mid-April, the Madrid Stock Exchange General Index had risen by 9.1%, a higher figure than on other European and US bourses. Although there is no information available on changes in the value of real-estate assets in the opening months of 2004, house prices surged in the final months of 2003 to a year-on-year rate of 17.3%.

The persistence of these financing conditions means households and firms can more readily commit more spending than they could with their current resources and thus continue increasing their levels of indebtedness. Indeed, the household debt ratio increased once again in the opening months of 2004, as did the corporate debt ratio. In this latter case, however, the interest burden continued to decline. Nonetheless, the wealth position of households and firms has remained sound, though a limit is discernible in their scope to continue increasing their resort to borrowed funds at this pace.

As stated, households have sustained high rates of consumption and investment in housing in early 2004 against this background of highly favourable financial conditions. Underpinning this has been the expansion of their real disposable income – based essentially on the strength of employment and on the decline in the inflation rate – and the notable increases in the value of their financial and, above all, non-financial wealth. The consumption indicators available are consistent with this trajectory, and the private residential investment indicators show a very subdued slowdown from what are high rates, this being offset by other components of investment in construction. The information on investment in equipment points to a pick-up from the signs of weakening observed in the second half of 2003, suggesting a path of recovery – albeit a modest and hesitant one – has been resumed. In any event, the possible reinvigoration of final demand (once the greater robustness of exports has combined with the momentum of domestic spending), the prevailing financial conditions and companies' renewed capacity to generate funds all frame a favourable picture for the greater buoyancy of this business investment component.

The contribution of the various productive branches to growth in Q1 has been uneven, with a prolongation of the trends defined during the previous year. In this respect, the greater momentum of market services and the resilience of construction, which has maintained a high rate of expansion, have been notable. Conversely, industry and energy have continued to show some sluggishness. The composition of employment, set against the aforementioned pattern of stability, has moved along these same lines. In industry, however, and on the partial information available, the rate of decline of employment has slowed somewhat after falling markedly last year.

The deceleration in Spanish inflation in the second half of last year ran into early 2004, providing for the continuing reduction of the consumer price differential with the EU. The improved inflation outlook should feed through to collective bargaining, allowing wage moderation to continue, although the data available to date are but partial. Despite this favourable overall performance of prices, underlying inflation is still above 2% and the recent energy price rises are adding upward cost pressures which might ultimately be reflected in an inflation surge in the coming months.

2. The external environment of the euro area

Economic developments in the external environment of the euro area in early 2004 appear to point to the continuing buoyancy of activity that firmed in the second half of 2003. Prices have remained favourable overall, although there are indications for the first time in the United States of a pass-through (albeit moderate) of the rise in intermediate prices to consumer prices, due to the strong increase in commodity prices and to the depreciation of the dollar. In this respect, the oil price moved to a new annual high in April of over $34 per barrel (Brent), after increasing by 13% over the quarter as a whole. Demand-side factors appear to have contributed here, in particular the momentum of the Chinese economy and the low level of inventories in the United States, while on the supply side the OPEC decision to cut output as from 1 April was influential.

Global financial conditions remained favourable overall, in the industrialised and emerging countries alike, with low interest rates for risk-free assets and private fixed income and a relatively favourable stock market performance. Only towards early April was there a noticeable rise in bond yields, linked to the emergence of expectations about higher interest rates in United States which were in turn induced by some of the latest indicators on activity and prices. After the G7 meeting at Boca Ratón, the dollar began to appreciate against the euro, climbing from a low in recent years. It reached a level below 1.20 in mid-April, signifying a 9% appreciation from its mid-February level of 1.30. The yen, after depreciating to 112 yen per dollar in March, partly as a result of intervention by the Bank of Japan, stood below 110. Sovereign debt spreads in emerging countries tended to widen moderately in the opening months of the year after having reached their lowest levels in 2003 since the 1998 Russian crisis.

In the United States, the third revision of GDP for 2003 Q4 confirmed that GDP grew at an annual average rate of 3.1% in 2003, against 2.2% in 2002. The latest economic indicators, after exhibiting sluggishness in February, clearly improved in March. In this connection there was a strong surge in employment in March, with 308,000 new jobs created, and an upward revision of 87,000 jobs in January and February. This figure should be interpreted with due caution owing to the frequent revisions of the series, to the presence of certain exceptional factors and to the increase in the unemployment rate to 5.7% from its previous level of 5.6%. But confirmation in the coming months of the pick-up in employment would lend support to the firmness of private consumption and would, finally, anchor the buoyancy of the current upturn.

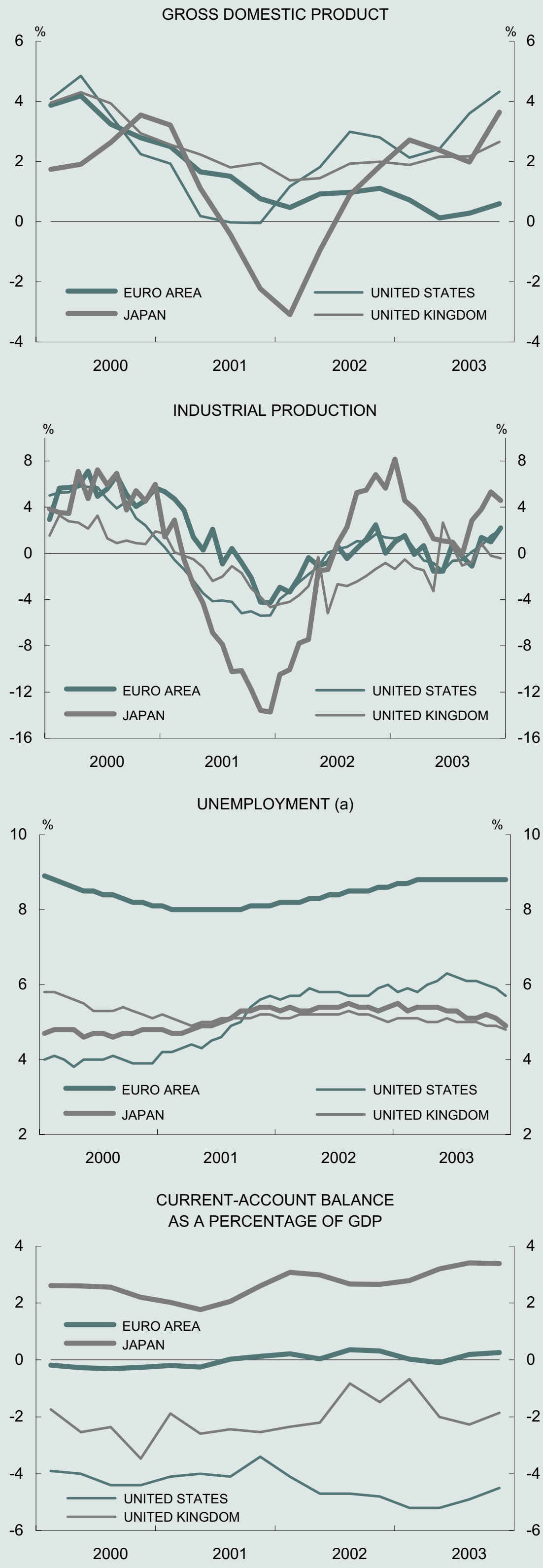
Retail sales in March also increased strongly, at a monthly rate of 1.7% in the component excluding cars, signifying the highest growth for the past four years. As mentioned, the consumer price index rose by 0.5% in March on a month earlier, partly as a result of the increase in oil prices, although its year-on-year rate held at 1.7%. However, underlying inflation stood at a 12-month rate of 1.6%, up from 1.2% in February, the highest rate since May 2003. Before the latest employment and inflation data were released, the Federal Reserve kept its official interest rate unchanged at 1% at its March meeting, indicating that upside and downside risks to inflation were practically balanced. Nonetheless, following the recent upward correction of market expectations, the yield curve is beginning to anticipate the possibility that the cycle of rising Federal Reserve rates will begin towards mid-year, and not in the closing months as was previously factored in.

Japan posted average GDP growth of 2.7% in 2003, against -0.4% in 2002. The indicators available for 2004 Q1 appear to support the idea that the growth rate will be sustained, underpinned by industrial output and exports (4.2% and 7.8%, respectively, in February compared with a year earlier), and by improved business expectations. Moreover, there have been positive signals in private consumption, such as the performance of retail sales (0.9% year-on-year in February), personal income and household expenditure (4.1% and 5.2%, respectively, on a year earlier) and consumer confidence. The Japanese labour market, however, saw the destruction of 10,000 net jobs in February. The consumer price index and underlying inflation both posted a year-on-year rate of zero, compared with their moderately negative rates the previous year, which would appear to confirm the slackening of deflationary pressures.

In the United Kingdom, GDP growth was revised downwards by 0.1 pp to 2.2%. The latest indicators are generally favourable. Despite a slight fall-off in consumer confidence, the growth of retail sales held at 6.5% year-on-year in February, consumer credit grew at a rate of over 14% and house prices climbed once more after their year-on-year growth had slowed towards the end of 2003. Furthermore, the unemployment rate held at a historical low (4.8% in January). The supply-side indicators offered mixed signals: industrial output fell by 0.6% in February (-1.2% year-on-year), but the March PMI, covering manufacturing, construction and services, signalled a widespread expansion in activity. Turning to prices, the rate of increase of the harmonised index of consumer prices fell from 1.3% to 1.1% in March on a year earlier, below

CHART 5

Main macroeconomic indicators
Annual rates of change

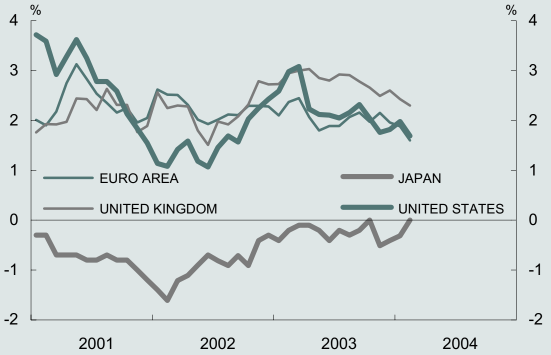


Sources: Banco de España, national statistics and Eurostat.
(a) Percentage of the labour force.

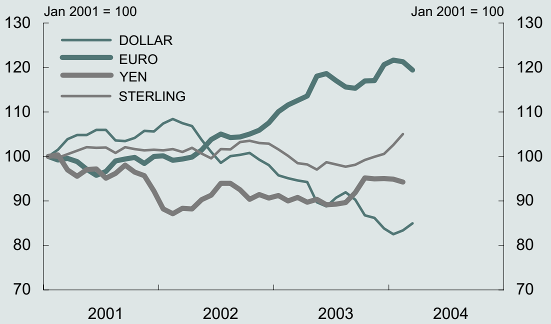
CHART 6

Prices, real exchange rate and interest rates

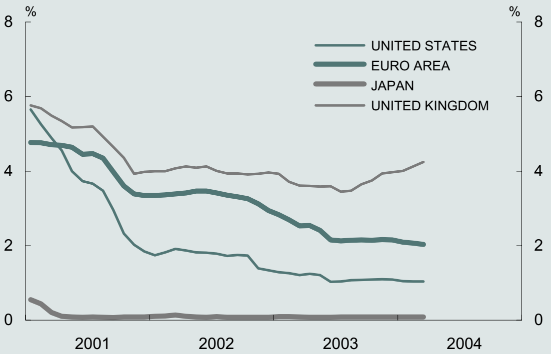
CONSUMER PRICES



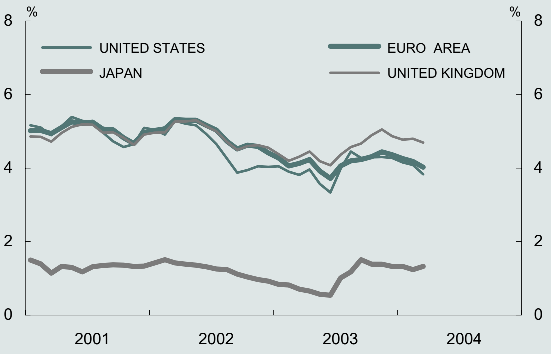
CPI-BASED REAL EFFECTIVE EXCHANGE RATES
VIS-À-VIS DEVELOPED COUNTRIES



SHORT-TERM INTEREST RATES (a)



LONG-TERM INTEREST RATES (b)

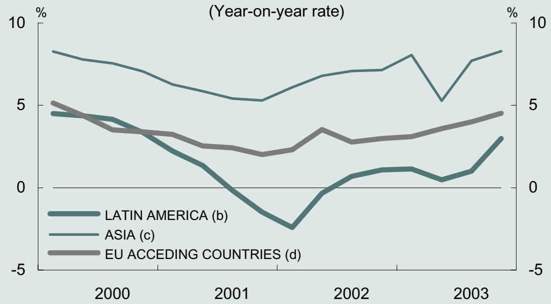


Source: Banco de España.
(a) Three-month interbank market interest rates.
(b) Ten-year government debt yields.

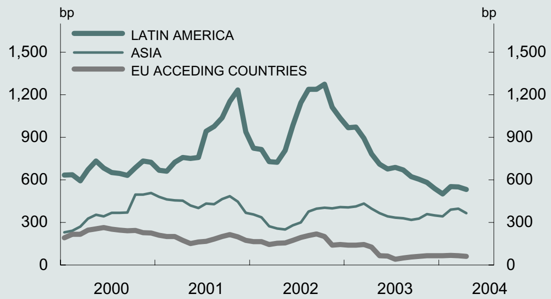
CHART 7

**Emerging economies:
main macroeconomic indicators** (a)

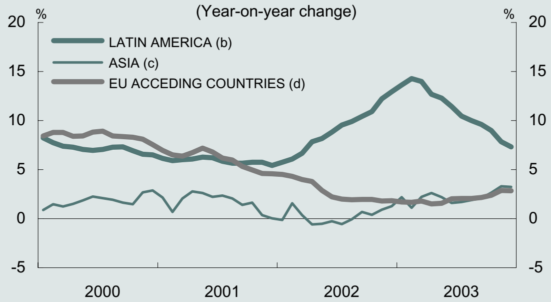
GROSS DOMESTIC PRODUCT
(Year-on-year rate)



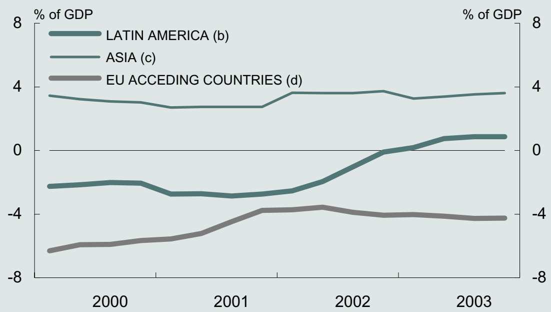
INTEREST RATE SPREADS OVER THE DOLLAR (e)



CONSUMER PRICES
(Year-on-year change)



CURRENT-ACCOUNT BALANCE



Sources: National statistics and JP Morgan.
(a) The aggregate of the various areas has been calculated using the weight that their component countries have in the world economy, according to IMF information.
(b) Argentina, Brazil, Chile, Mexico, Colombia, Venezuela and Peru.
(c) China, Malaysia, Korea, Indonesia, Thailand, Hong Kong, Singapore and Taiwan.
(d) Latvia, Lithuania, Estonia, Czech Republic, Hungary, Poland, Slovenia and Slovakia.
(e) JP Morgan EMBI spreads. The EU acceding country data relate to Hungary and Poland.

the government's target (2%). Lastly, the Treasury unveiled the budget for fiscal year 2004-2005, with a deficit of 2.8% of GDP, below the figure of 3.3% estimated for 2003-2004.

In the EU acceding countries, average GDP growth in 2003 was 3.6%, up from 2.4% in 2002. In the opening months of 2004, the activity indicators continued to perform well, with strong increases in the industrial output of most countries. Inflation rates tended to rise due, among other factors, to the liberalisation of certain administered prices and indirect tax rises. Budget deficits, which rose on average from 4.9% to 5.7% of GDP in 2003, were one of the most significant and worrying aspects of economic developments in these countries, since there were substantial deviations from the targets set in their respective macroeconomic programmes.

The pace of growth in the emerging economies in Asia increased further in 2004 Q1, generally led by export growth. In China, GDP in 2004 Q1 grew by 9.7% - a higher rate than expected - on the same quarter a year earlier, after posting average growth of 9.1% in 2003. Inflation showed signs of acceleration between 2003 Q4 and 2004 Q1, standing in March at a 12-month rate of 3%. That led the Chinese central bank to adopt certain measures to tighten its monetary stance (a rise in the discount rate and in the lending rate to commercial banks, in addition to an increase in reserve requirements) so as to forestall a potential overheating in the economy.

Finally, in Latin America, GDP grew by 1.3% on average in 2003, although the rate for 2003 Q4 revealed a more patent acceleration in activity (3% year-on-year). The external sector continued to be the driving force behind recovery, as a result of the cumulative depreciations in previous years, the marked growth of commodities prices and the acceleration in global demand. The economic indicators for Q1 confirm that the recovery is taking root, despite the fact that the sluggish performance of employment and, in certain cases, of industrial production (in Brazil) or manufacturing (in Mexico) appear to show that the recovery is not very dynamic so far. In respect of prices, there was something of a rise early in the year which, however, does not seem to constitute a turnaround. That has enabled countries like Brazil to resume a rate-cutting process (seen in two reductions of 25 bp, to 16%, between March and April), although others, such as Mexico, appear to have embarked on a contractionary phase of the monetary policy cycle. The data on activity in Argentina have remained very favourable, as seen in the growth of 11.3% in Q4 on a year earlier. Further, the short-term indicators reveal that the buoyancy of activity continued into early 2004. However, the recent energy crisis is a reminder of the difficulties of cementing sustained growth in an excessively interventionist regulatory framework.

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

According to the information available, in the first few months of 2004 the gradual recovery in activity in the euro area continued. Although the central scenario of accelerating growth over the year has not been significantly altered, the unsteady path of certain economic indicators (particularly confidence indicators) casts some doubt on the strength of this process. Recent developments also offer favourable signs, such as the buoyancy of world demand and, domestically, the pick-up in investment, which suggests that euro area companies have made substantial progress in strengthening their financial structure. The demand component whose future path is subject to most uncertainty is still private consumption, although some indicators show encouraging signs. As for prices, in the first few months of the year the rate of increase in the HICP has moderated. This is primarily the result of specific factors, such as the year-on-year fall in energy prices, although there was also a certain slowdown in wages in the final quarter of last year, which has had a favourable effect on the medium-term inflation outlook.

Monetary and financial conditions remained favourable for economic activity in the first quarter, mainly as a consequence of the low level of interest rates. Also, the trend appreciation in the euro exchange rate came to a halt in mid-February. As regards economic policies, the increase in the imbalances in the public finances of many countries of the area has been a disappointing development. In 2003, the fiscal deficit of the area as a whole was 2.7% of GDP and, according to the spring forecasts of the European Commission, may not be reduced in 2004. The Commission has also forecast that half the countries of the euro area will run excessive deficits this year, so that the procedures established in the Treaty and in the Stability and Growth Pact must be activated and urgent measures taken to contain the budgetary deterioration. In particular, in the next few weeks, the European Commission will initiate the Excessive Deficit Procedure against the Netherlands and the United Kingdom, for having exceeded the deficit limit of 3% of GDP in 2003, and will discuss the desirability of issuing a warning to Italy, to avoid its fiscal imbalance exceeding that level in 2004.

3.1. Economic developments

On the latest estimates, the quarter-on-quarter GDP growth rate for the euro area decelerated slightly in 2003 Q4 to 0.3% (as against 0.4% in Q3), so that the moderate recovery in activity that commenced in the summer continued (see Table 1). This took the year-on-year growth rate to 0.6%, 0.3 percentage points up

TABLE 1

Euro area economic indicators

	2002		2003				2004	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1 (a)	Q2 (b)
GDP								
Year-on-year growth	1.0	1.1	0.7	0.1	0.3	0.6		
Quarter-on-quarter growth	0.2	0.0	0.0	-0.1	0.4	0.3		
European Commission forecasts (c)							(0.3 ; 0.7)	(0.3 ; 0.7)
IPI (d)	0.1	1.1	0.8	-0.6	-0.1	1.3	*0.6*	
Economic sentiment	95.4	95.3	94.9	94.8	95.0	95.7	96.0	
Industrial confidence	-11.3	-9.7	-11.0	-12.0	-11.0	-7.3	-6.7	
Manufacturing PMI	50.5	49.0	49.3	47.1	49.1	52.0	52.8	
Services confidence	-0.7	-4.3	-5.7	-2.0	5.3	10.3	10.7	
Services PMI	50.9	50.5	48.9	47.9	51.9	56.7	56.0	
Unemployment rate	8.5	8.6	8.7	8.8	8.8	8.8	*8.8*	
Consumer confidence	-10.0	-14.0	-19.3	-19.3	-17.3	-16.0	-14.3	
HICP (d) (e)	2.1	2.3	2.4	1.9	2.2	2.0	*1.7*	
PPI (d) (e)	0.2	1.5	2.4	1.4	1.1	1.0	*0.0*	
Oil price in USD (e)	28.4	28.2	30.3	27.6	27.1	29.9	33.8	33.0
Loans to the private sector (d) (e)	5.2	4.8	4.7	4.6	4.9	5.5	*5.5*	
Euro area ten-year bond yield	4.8	4.5	4.2	4.0	4.2	4.4	4.2	4.2
US-euro area ten-year bond spread	-0.46	-0.51	-0.22	-0.32	0.09	-0.05	-0.11	0.03
Dollar/euro exchange rate (e)	0.986	1.049	1.090	1.143	1.165	1.263	1.222	1.204
Appreciation/depreciation of the euro (e)	11.9	19.0	3.9	9.0	11.1	20.4	-3.2	-4.6
Dow Jones EURO STOXX Broad index (e)	-39.1	-34.5	-12.9	2.9	4.1	18.1	1.9	4.7

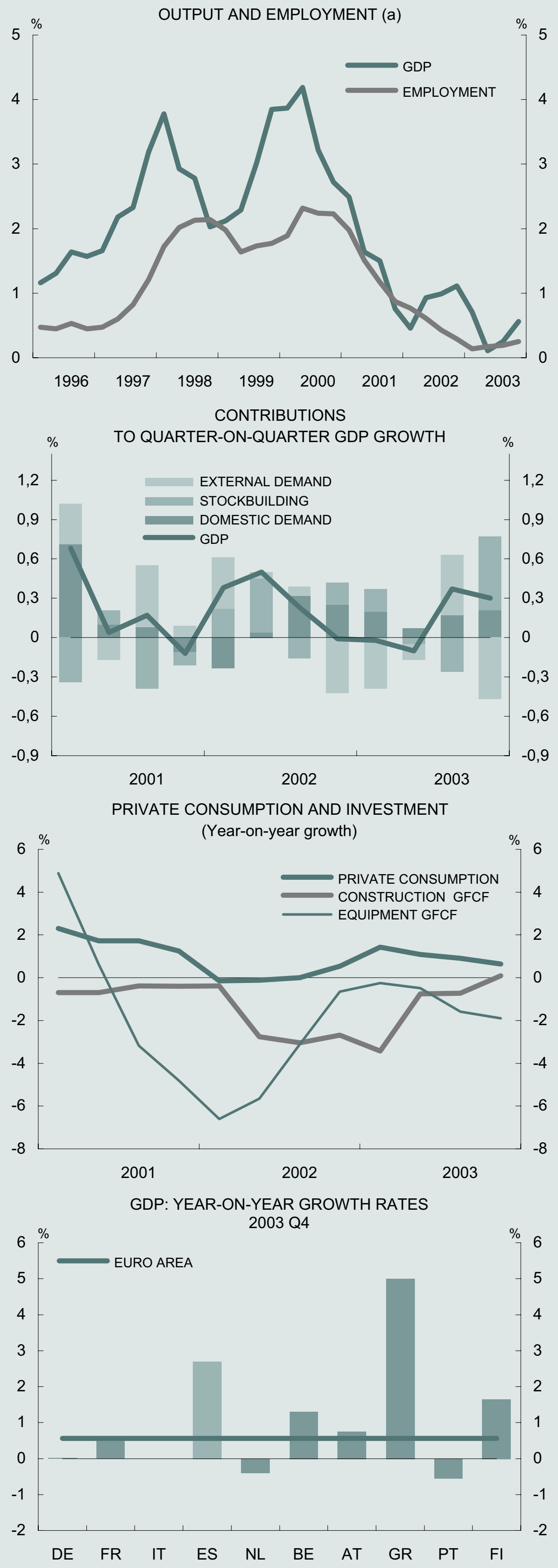
Sources: Eurostat, ECB and Banco de España.
(a) The information in italics does not cover a full quarter.
(b) Information available up to 20 April 2004.
(c) Quarter-on-quarter growth forecasts.
(d) Year-on-year growth.
(e) End-period data. Figures for exchange rates and the stock market are percentage changes over the year.

on the previous quarter. The contribution of domestic demand (excluding inventories) to quarter-on-quarter output growth was unchanged at 0.2 percentage points, while that of the external sector, which had been a positive one of 0.5 percentage points in the previous quarter, became a negative contribution of 0.5 percentage points. Thus the growth achieved was only possible thanks to the notable contribution of 0.6 percentage points made by the change in inventories (see Chart 8). The breakdown of domestic demand reveals that the most favourable development was the greater buoyancy of investment (both in capital equipment and construction), which recorded positive growth rates for the first time in several quarters. In contrast, private consumption remained slack, and failed to grow in this quarter. As regards net external demand, the drastic reduction in its contribution to output growth is explained by the acceleration in imports and, especially, by the sharp slowdown in exports. Having picked up significantly in Q3, the latter hardly increased in Q4. In 2003 as a whole, euro area GDP grew at a rate of 0.4%, down 0.5 percentage points on the previous year.

National Accounts data broken down by country show that in most countries output growth either held steady or accelerated in Q4. Among the larger economies of the area, developments were particularly unfavourable in Italy, where GDP stagnated after having grown by 0.4% in Q3. This was primarily a result of the sharp decline in domestic demand, which saw a notable deterioration in private consumption and the absence of any recovery in investment. In Germany and in France the negative contribution of the external sector was neutralised by the strength of inventories. Moreover, in Germany, the strength of the pick up in capital goods investment was also notable, with a 1.7% increase, in quarter-on-quarter terms, following almost three years of negative growth. By branch of activity, the lower rate of growth of value added in the euro area stemmed from the slowdown in services, since industry and construction were more stable. In the labour market

CHART 8

Euro area national accounts



Sources: Eurostat and national statistics.
(a) Year-on-year rates of change.

there was a slight pick-up in employment, which had been stagnant in Q3, but this did not prevent the year-on-year change in apparent labour productivity from rising by 0.3 percentage points to 0.4%. Finally, the rate of unemployment was unchanged at 8.8% of the labour force.

The information available on the latest indicators points overall to a continuation of moderate GDP growth in 2004 Q1. However, some of these indicators seem to show a loss of momentum in activity in recent months. In particular, the industrial production index recorded an unfavourable trend in January and February. Meanwhile, the services confidence indicator compiled by the European Commission remained unchanged on average in Q1 and the purchasing managers' index for this sector deteriorated in both February and March. Manufacturing confidence indicators improved slightly in Q1, even in the case of the purchasing managers' index for March which, like that for services, was based on surveys carried out after the Madrid attacks (see Chart 9). Although it is too early to draw firm conclusions, the impact of these events on confidence in the services sector is consistent with the view that the industries that may be most affected include those connected with tourism and transport.

From the viewpoint of demand, the available indicators generally point to a certain recovery in private consumption and investment. The consumer and retail trade confidence indicators improved slightly in Q1, while retail sales picked up in the first two months of the year. As for investment indicators, the latest data on the assessment of industrial order books are relatively optimistic, although the degree of capacity utilisation has fallen at the same time. For their part, both the quarterly indicator of industrial export expectations compiled by the European Commission and the monthly indicator of the assessment of export order books improved in Q1, although at a slower rate than in the preceding months. Finally, according to the industrial confidence survey, inventories continued to increase above desired levels.

The outlook for growth during the rest of the year is underpinned by the notable buoyancy of world trade, as a consequence of the strengthening of activity in the main geographical areas, which may offset the loss of competitiveness arising from the significant appreciation in the euro exchange rate over the last two years. As for domestic demand, the uncertainty is somewhat greater, especially as regards private consumption, although the available indicators show, as indicated above, certain signs of recovery in this component of demand. The increase in credit to households, the maintenance

BOX 1

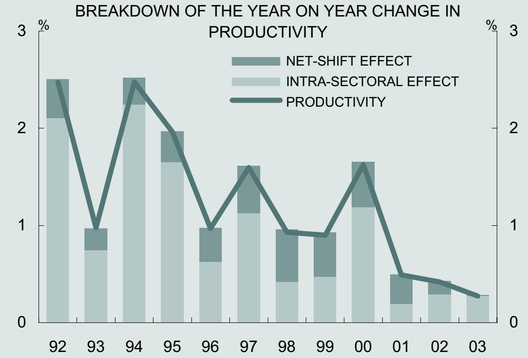
A sectoral approach to the slowdown in apparent labour productivity in the euro area

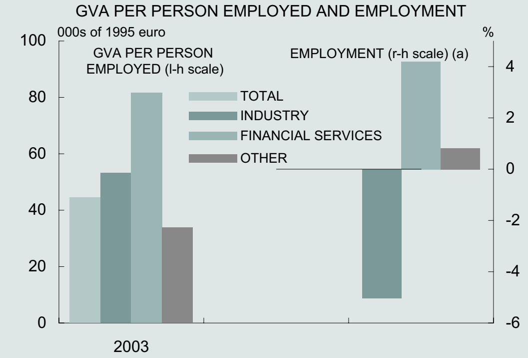
Since the beginning of the 1990s, the rate of growth of apparent labour productivity in the euro area (measured in terms of gross value added per person employed) has, along with cyclical fluctuations, exhibited a downward trend. From a sectoral viewpoint, this behaviour can be broken down into two different effects. First, it may stem from the slowdown in productivity in each sector of the economy or in the main sectors (intra-sectoral effect). Second, it may be the result of changes in the sectoral composition of employment (net-shift effect). For example, a relative increase in employment in sectors with lower levels of productivity would reduce the economy's overall productivity. The top chart shows that both components made positive contributions to productivity growth throughout the period. The contribution of the intra-sectoral effect was generally larger, although this component was also the main cause of the slowdown in productivity during the period. The net-shift effect made a relatively stable contribution to the year-on-year change in productivity until 2001, which means that relatively more jobs were created in higher-productivity sectors. However, in recent years, the contribution of this effect has declined, to reach zero in 2003.

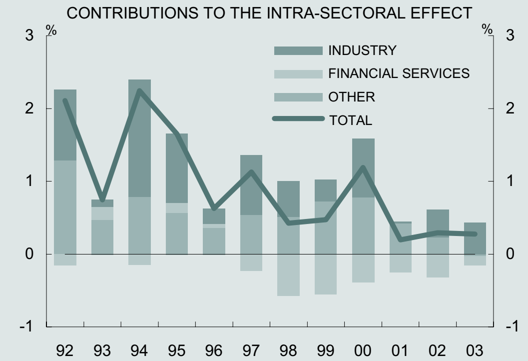
For a detailed approximation of these effects, the level of productivity needs to be examined in each sector. The second chart represents productivity levels and the change in the share in total employment of each of the three sectors into which the euro area economy has been broken down: industry, excluding construction (industry); financial intermediation, real estate and business activities (financial services); the rest of the economy (agriculture, construction, non-market services and the wholesale and retail trade, hotels and restaurants, repairs and transport). As can be seen, the level of productivity in the financial services sector is well above average, after which comes industry. Moreover, it can be seen that the share of financial services in total employment has increased significantly, while that of industry has declined.

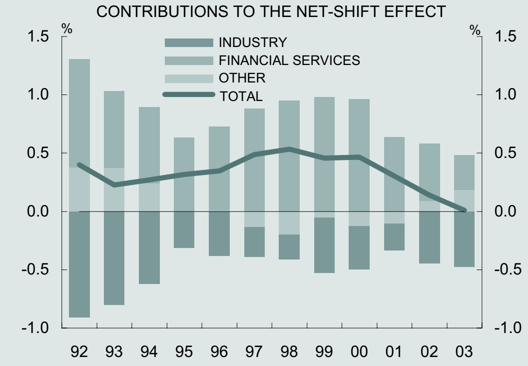
The progressive decline in the intra-sectoral effect is partly explained by the smaller contribution from the industrial sector. The contribution of financial services to the intra-sectoral effect has generally been negative, although in recent years its size has moderated. As regards the net-shift effect, financial services made a large positive contribution throughout (see the bottom chart), as a consequence of the sharp increase in employment in this sector during the period considered (50%, as against the total increase of 2% in the rest of the sectors). In fact, the recent reduction in the net-shift effect in the economy as a whole is explained by the sharp decline in the job creation in this sector (the year-on-year rate of increase fell from over 5% in 2000 to close to 1% in 2003). Meanwhile, industry made a negative contribution to the net-shift effect as a consequence of the combination of a relatively high level of productivity and intense job destruction, with a 15% decline in employment over the period considered.

In sum, the slowdown in productivity in the euro area in recent yeas stems primarily from the trend in its intra-sectoral component. This suggests that technological progress and the incorporation of capital into the productive process stagnated in the main branches of activity. However, the evidence presented shows that the movement of employment between sectors in the first few years of the present decade has also led to a slowdown in the rate of growth of productivity, since the relative weight in total employment of the less productive branches has increased.







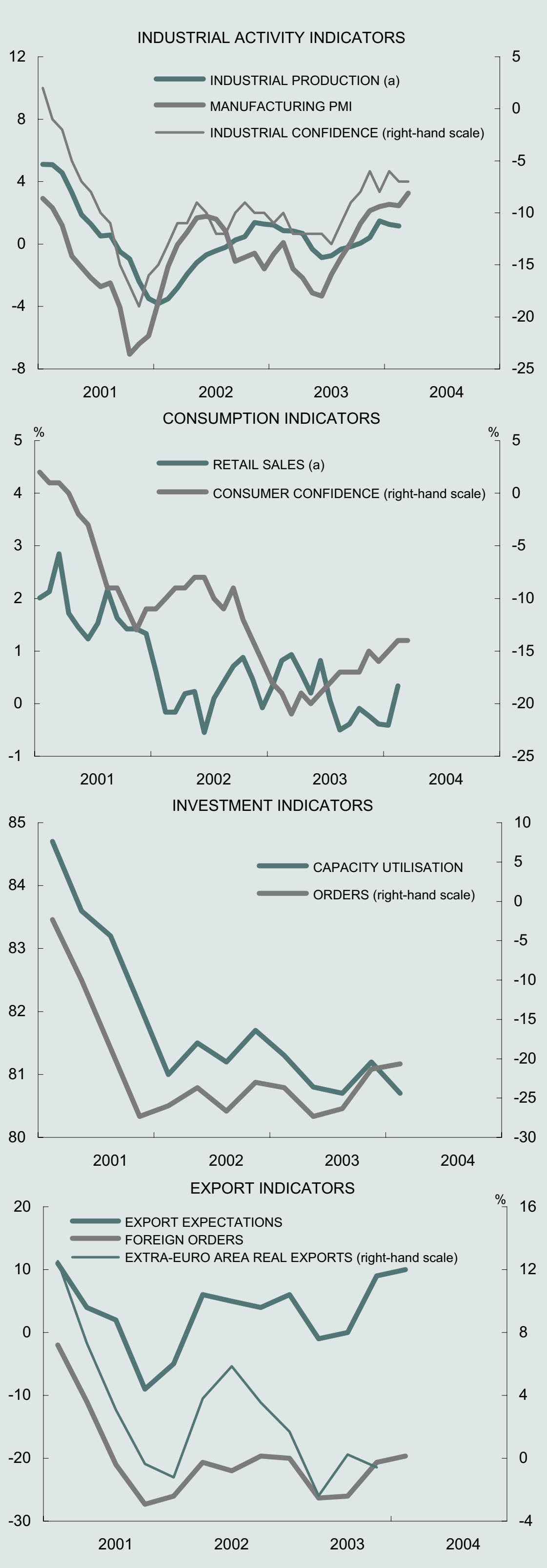


Sources: ECB and Banco de España.

(a) The change in the share of each sector in total employment between 1991 and 2003.

CHART 9

Euro area. Real indicators



Sources: Eurostat and European Commission.

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

of low interest rates and the increase in financial wealth as a consequence of the positive stock-market performance are further factors that may boost this component, although the uncertainty generated by the fear of fresh terrorist attacks may lead households, in the short term, to show greater caution in their spending decisions. At the same time, investment, whose expected recovery seems to have begun to take shape at the end of 2003, should benefit from the positive trend in world trade and the favourable financial conditions. That said, the moderation in the flows of financing obtained by companies raises questions as to the strength of the recovery in capital expenditure.

In March, the HICP increased year-on-year by 1.7%, down 0.3 percentage points from December. This slowdown in consumer prices in Q1 stems from the behaviour of the two most volatile components, namely unprocessed food and, above all, energy, as a result of the base effect arising from the increase in oil prices in 2003, prior to the start of the war in Iraq. In contrast, the other three components (processed food, non-energy industrial goods and services) edged up in Q1, so that the CPI excluding unprocessed food and energy rose by 0.2 percentage points between December 2003 and March 2004 to 2.1% (see Chart 10). However, it should be clarified that this trend in the CPI excluding unprocessed food and energy was basically a result of the impact of administrative decisions taken in certain Member States, which should, in principle, only have a temporary effect on inflation dynamics. This is the case of the increases in tobacco taxes in various countries and the reform to health system financing arrangements in Germany and the Netherlands. As regards industrial prices, their year-on-year rate of increase in February was zero, as against 1% in December. This stagnation was due to the slowdown in the energy component, since the prices of almost all the other components increased in year-on-year terms.

From the viewpoint of costs, it is important to note the slowdown in unit labour costs in 2003 Q4, when they increased by 1.8%, down 0.6 percentage points on the Q3 rate. This behaviour was not only based on the cyclical recovery in productivity, but also on the lower growth in compensation per employee, which suggests an easing of inflationary pressures. However, in terms of the HICP, the disappearance of the base effect of oil prices could result in a rise in the rates of increase in this indicator in the coming months. In addition, oil prices may remain at high levels as a consequence of the strength of the demand for oil and the negative effects that geopolitical uncertainty in the Middle East may have on supply.

The analysis of the external sector in Q1 is highly tentative as balance of payments information is only available for January. The current account of the euro area showed a surplus of 2.5 billion that month, slightly above the level recorded a year earlier. This positive balance reflected the surpluses in both the goods and services balances that were partly offset by deficits in the income and current transfers balances. The current account surplus in the twelve months to January 2004 totalled 29 billion, which was less than half of that recorded a year earlier. During the same period, the basic balance, which together with the current account balance, includes net direct and portfolio investment was practically zero.

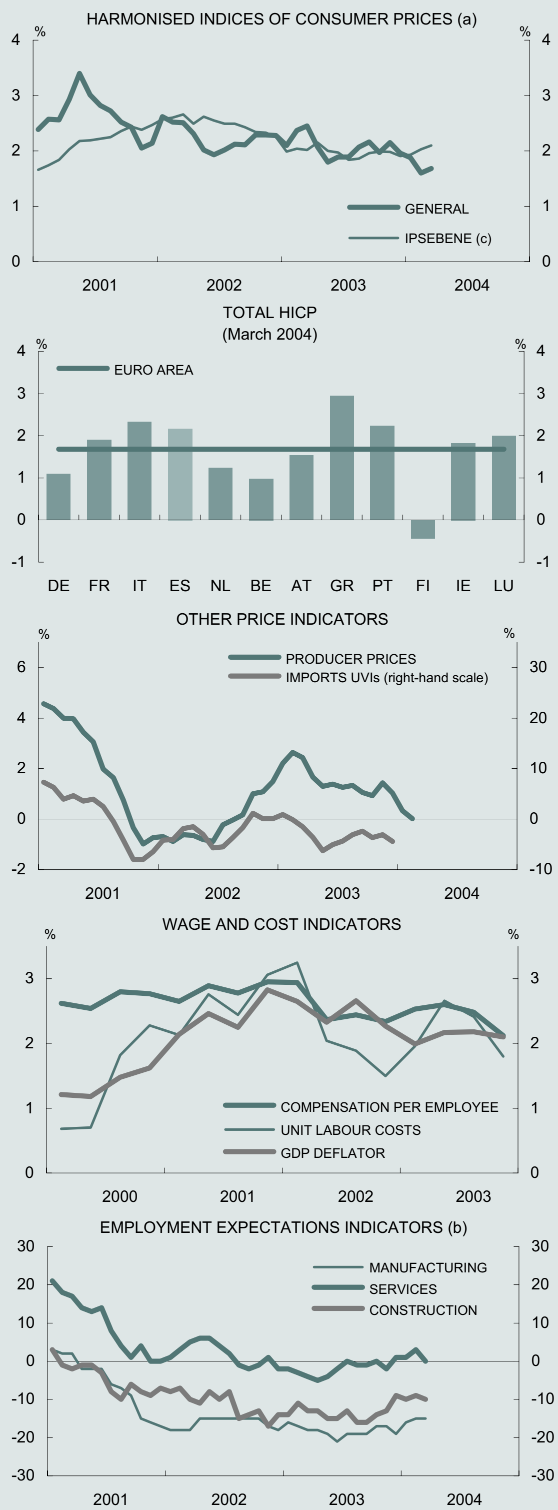
Turning to fiscal policy, at the beginning of March the Member States reported their preliminary budget and debt data for 2003, in the context of the excessive deficit procedure. Aggregating the reported figures produces a budget deficit for the euro area as a whole of 2.7% of GDP last year, as against 2.3% in 2002 (see Table 2). In many countries, as well as deteriorating for the third year running, the budget balance moved further from the targets set in the Stability Programmes presented in at the end of 2002 or in early 2003. The figures reported for 2003 are in line with the spring forecasts of the European Commission, except in the case of Greece, where a second government notification raised the budget deficit to 3% of GDP in 2003, although these data have still to be verified by Eurostat.

The European Commission and the ECOFIN Council completed their examination of the updated stability programme submitted by the countries between the end of 2003 and early 2004. These documents, which reflect the medium-term budget strategies of each Member State, point to a moderate change of trend in the aggregate deficit for the area as a whole, which would be reduced to 2.4% and 1.7% of GDP in 2004 and 2005, respectively. However, the European Commission spring forecasts paint a more pessimistic scenario in which, despite the forecast acceleration in economic activity, the budget deficit of the euro area would remain in 2004 at 2.7% of GDP and would only be reduced by 0.1 percentage points in 2005. The discrepancy between these forecasts and the targets set in the stability programmes is partly explained by the fact that the former only consider the impact on public finances of fiscal policy measures that have already been approved or, at least, announced in sufficient detail.

The forecasts of the European Commission also imply that in the absence of additional measures, a total of six euro area countries

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 January 2002 when the series was rebased to 2001.
(b) Expectations based on European Commission sentiment indicators.
(c) CPI excluding unprocessed food and energy.

TABLE 2

General government budget balances of euro area countries (a)

% of GDP

	2000	2001	2002	2003 (b)	2003 (c)	2004 (d)	2004 (c)	2005 (c)
Belgium	0.2	0.5	0.1	0.2	0.2	0.0	-0.5	-0.7
Germany	1.3	-2.8	-3.5	-3.9	-3.9	-3.5	-3.6	-2.8
Greece	-2.0	-1.4	-1.4	-1.7	-3.0	-1.2	-3.2	-2.8
Spain	-0.9	-0.4	0.0	0.3	0.3	0.0	0.4	0.6
France	-1.4	-1.5	-3.2	-4.1	-4.1	-3.6	-3.7	-3.6
Ireland	4.4	1.1	-0.2	0.2	0.2	-1.1	-0.8	-1.0
Italy	-0.6	-2.6	-2.3	-2.4	-2.4	-2.2	-3.2	-4.0
Luxembourg	6.3	6.3	2.7	-0.1	-0.1	-1.8	-2.0	-2.3
Netherlands	2.2	0.0	-1.9	-3.0	-3.2	-2.3	-3.5	-3.3
Austria	-1.5	0.2	-0.2	-1.1	-1.1	-0.7	-1.1	-1.9
Portugal	-2.8	-4.4	-2.7	-2.8	-2.8	-2.8	-3.4	-3.8
Finland	7.1	5.2	4.3	2.3	2.3	1.7	2.0	2.1
MEMORANDUM ITEM:								
Euro area								
Primary balance	4.2	2.4	1.3	0.8	0.8		0.7	0.8
Total balance	0.1	-1.6	-2.3	-2.7	-2.7	-2.4	-2.7	-2.6
Public debt	70.4	69.4	69.3	70.4	70.5	70.0	71.0	71.0

Sources: European Commission, national stability programmes and Banco de España.
(a) As a percentage of GDP. Proceeds from the sale of UMTS licences not included. Deficit (-) / surplus (+). The deficits that exceed 3% of GDP have been shaded.
(b) March 2004 report.
(c) European Commission forecasts (spring 2004).
(d) Targets of the stability programmes presented between November 2003 and January 2004.

(Germany, Greece, France, Italy, the Netherlands and Portugal) will have excessive deficits in 2004. Of these countries, only Greece and Germany would correct this situation in 2005, the latter thereby complying with the recommendations made in the ECOFIN Council conclusions of November 2003. In France, by contrast, the risk that the budget deficit will remain above 3% in 2005 is high, although the forecasts do not include the positive impact of the likely reform of the health system, the full details of which are still to be determined. In Portugal, the government managed to place the budget deficit below 3% of GDP in 2003 by resorting to extraordinary income from certain operations with temporary effects. This will possibly lead to termination of the excessive deficit procedure (EDP) initiated against this country in 2002. However, the EDP may be activated again, since European Commission forecasts point to a deficit of more than 3% of GDP in 2004 and 2005. In the case of the Netherlands and the United Kingdom, the latest available information shows an excessive deficit in 2003 and, in consequence, the EDP will be activated, starting with the preparation of a report by the European Commission, as established in Article 104 (3) of the Treaty. In the Netherlands, the excessive deficit will not be corrected in 2004, according to the Commission forecasts, even though these incorporate budgetary consolidation measures amounting to 1.2% of GDP. However, the Dutch government seems to be determined to bring the deficit below the 3% level, by taking additional measures to those envisaged. Finally, although the Italian budget deficit did not exceed 3% of GDP in 2003 thanks to extraordinary income from specific operations, the Commission forecasts that this level will be exceeded in 2004 and 2005, and will study the desirability of activating the early warning procedure so that the Italian authorities take the necessary adjustment measures.

3.2. Monetary and financial developments

At its meetings in the first quarter, the Governing Council of the ECB judged that the monetary policy stance continued to be in line with the maintenance of price stability over the medium term, while also being consistent with a moderate recovery in activity. Accordingly, the interest rates on the main refinancing operations, the deposit facility and the marginal lending facility were left unchanged at 2%, 1% and 3% respectively (see Chart 11).

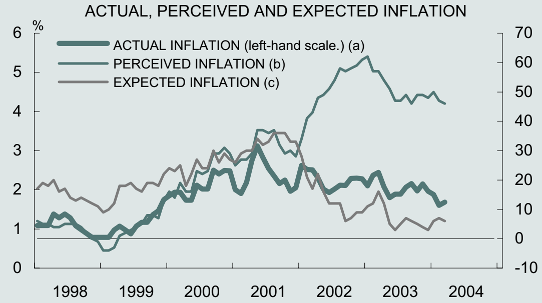
BOX 2

Perceived and actual inflation in the euro area

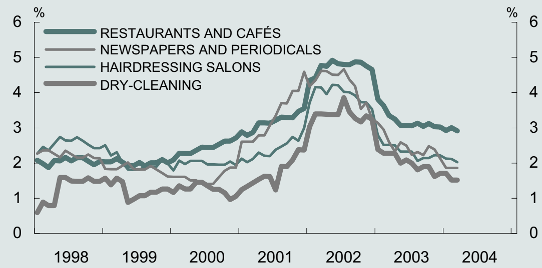
Each month, the European Commission gathers information on the inflation perceived by euro area consumers during the preceding twelve months and the inflation they are expecting during the next twelve months in its Consumer Survey. The possible implications of these indicators for the behaviour of certain macroeconomic variables mean that it is important to analyse them. If the inflation perceived by consumers is higher than actual inflation, then they will tend to underestimate their real income. This may weaken consumer demand and boost wage demands, to recover the purchasing power they believe they have lost. If, moreover, consumers expect an increase in inflation in the future, this will put further pressure on wages. On the other hand, if consumers expect a gradual reduction in inflation in future months, while still perceiving that the recent increase in prices has been larger than it really was, then the negative consequences of this gap between perceived and actual inflation will be smaller.

This is exactly what has happened in the euro area in the last two years. As can be seen in the top chart, having followed a similar path since 1998, perceived inflation and the actual rate of increase in the HICP began to diverge in January 2002, moving further apart over the year. One possible explanation for this divergence is that consumers' perception of recent inflation is dominated by the behaviour of the prices of the goods and services that they consume most frequently. Accordingly, the price rises that were recorded following the introduction of euro notes and coins in certain frequently consumed items with a low weight in the HICP may have prompted the perception by euro area consumers of rising inflation, in contrast to the path of the actual annual rate of change in the HICP, which slowed in the months following the upturn at the beginning of 2002 (see the middle chart). The gap between these two indicators narrowed during the first half of 2003, but it has remained relatively large. This persistence is more difficult to justify, although it is possible that it has been caused by other temporary shocks that have affected frequently consumed goods and services, such as the rise in energy prices, the large increases in unprocessed food prices as a consequence of the heatwave last summer in Europe, and the increases in indirect taxes in certain euro area countries.

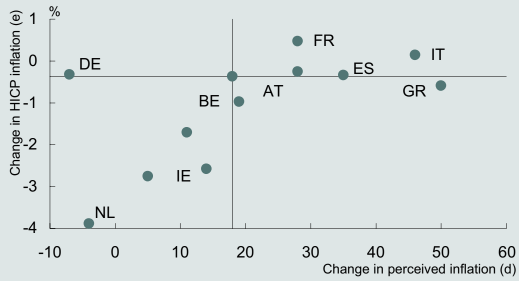
ACTUAL, PERCEIVED AND EXPECTED INFLATION



PRICES OF CERTAIN HICP ITEMS (year-on-year rates of change)



PERCEIVED AND ACTUAL INFLATION BY COUNTRY



Source: Eurostat and European Commision Consumer Survey.
(a) Year-on-year rate of change in euro area HICP.
(b) Price trends over the last twelve months.
(c) Price trends over the next twelve months.
(d) Increase in the indicator of perceived inflation between December 2001 and March 2004.
(e) Change in inflation measured by the HICP between December 2001 and March 2004 (percentage points).

Meanwhile, since the beginning of 2002, the indicator of inflation expectations has been diverging from that of perceived inflation, with an ongoing moderation. This suggests that consumers believe that the phenomena described above are generally temporary.

This divergence between the indicator of perceived inflation and the growth of the HICP is common to most euro area countries. As can be seen in the bottom chart, the larger the increase in the inflation rate between December 2001 and March 2004, the greater the increase in the indicator of perceived inflation over the same period. The smallest changes are seen in Germany, where the level of perception of past price trends is in fact currently below that prevailing in December 2001. The sharpest increases in that perception have been recorded in Italy and Greece, although actual inflation in that period was unchanged in one of them and fell slightly in the other. This behaviour may be linked to the fact that euro coins have a much higher value than the coins of the national legacy currencies of these two countries had, which may have led to an unwarranted increase in the prices of certain frequently used goods and services that, however, has not been reflected in the total HICP.

CHART 11

Euro area interest rates

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

During the first three months of the year money market interest rates continued their progressive decline, as a consequence of the improvement in the outlook for euro area inflation. However, at the beginning of April, with the publication of favourable US labour market data, there was a moderate upward shift in the yield curve at all maturities, probably stemming from the perception that the strengthening of US economic prospects could help to support recovery in the euro area. As seen in the lower panel of Chart 11, this movement caused the expectations of official interest rate reductions that prevailed in the early months of the year to evaporate. On the debt markets, ten-year yields, which had fallen in Q1 by almost 40 basis points, rebounded strongly in the first half of April, recovering more than half of this decline to stand at around 4.2% (see Chart 12). On information to February, the interest rates applied by credit institutions to their lending and deposit transactions were generally unchanged. The interest rate on loans to households for house purchase extended its downward trend, to stand at 4.3% in February.

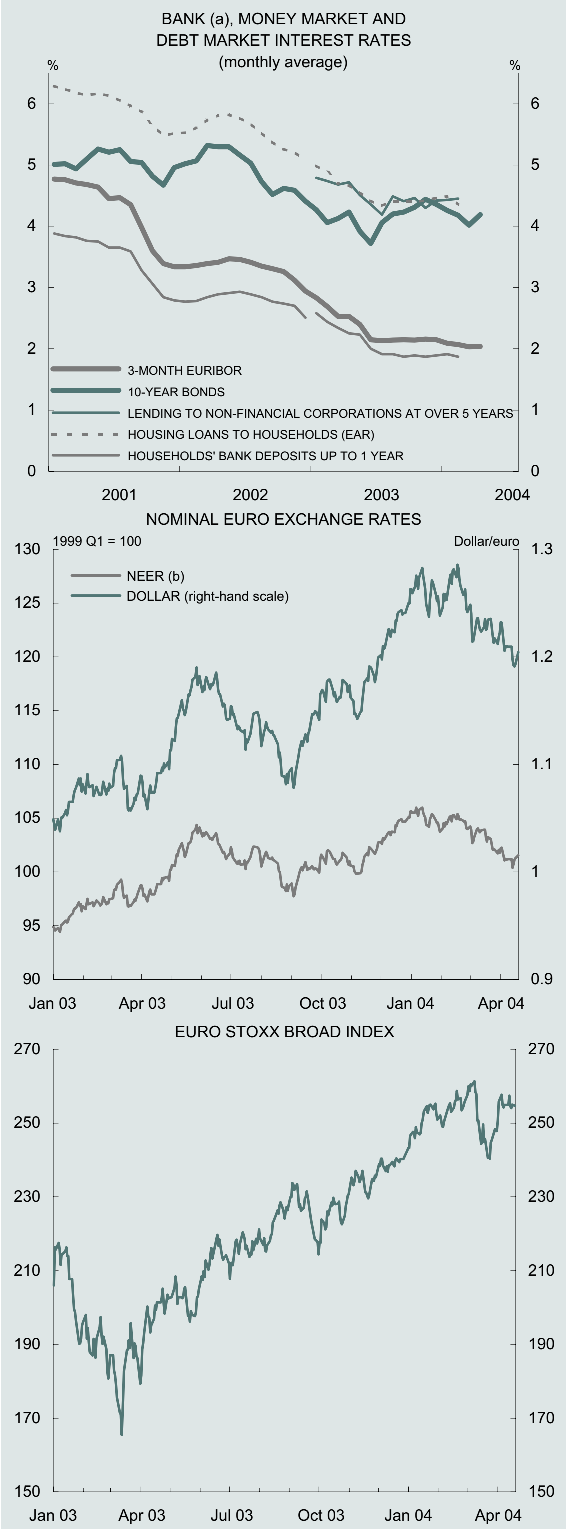
On the foreign-exchange markets, the euro exchange rate tended to appreciate moderately against the dollar and the yen in the first two months of the year, to reach highs for recent years. However, since then, following the G7 meeting at Boca Ratón, the trend against the US and Japanese currencies reversed, helped by favourable data on developments in these two economies and, in the case of the yen, the information that emerged regarding the possibility that the Japanese monetary authorities may have stopped intervening in the foreign exchange markets. As a result, the euro has depreciated by around 5% against the dollar since the beginning of the year. In nominal effective terms, the European currency has depreciated by 4.5% during the same period (see the middle panel of Chart 12).

The recovery on euro area equity markets that commenced in spring 2003 was temporarily interrupted by the Madrid terrorist attacks, which led to a pronounced fall in prices and a sharp rise in volatility. The Dow Jones EURO STOXX broad index, for example, fell by around 7% between 10th and 24th March. By mid-April, however, this indicator had recovered to its pre-attack levels, with an increase since the beginning of the year of almost 5%. The behaviour of the various sectors was far from uniform during this period. The size of the advances in pharmaceuticals and technology were notable, while the sectoral indices for basic industry, energy and banking showed more moderate increases.

During the first two months of the year the rate of growth of M3 continued to slow, extend-

CHART 12

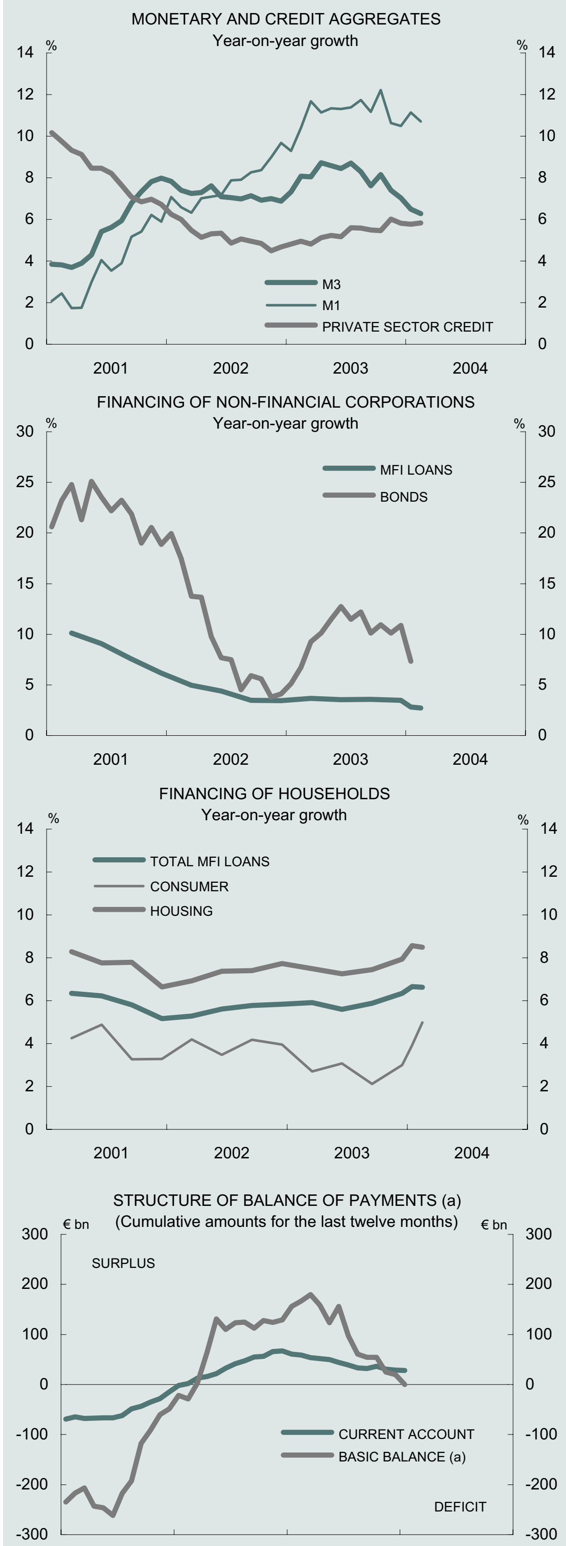
Euro area interest rates, exchange rate and stock market index



Sources: Banco de España and European Central Bank.
(a) Data drawn from new statistics on interest rates compiled by the ECB for new business.
(b) Nominal effective exchange rate index. Narrow group of currencies defined by the 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.

ing a trend that began in the summer of 2003 (see Chart 13). In February, M3 grew at a year-on-year rate of 6.3%, down 0.7 percentage points from December. The slowdown was concentrated primarily in less liquid instruments, in a context in which agents seemed to be adjusting their portfolios to increase the weight of financial instruments, such as equities, which do not form part of the aggregate and which combine a higher expected return with a higher risk. That said, the demand for the more liquid components of M3 continued to grow at very high rates, as a consequence of the low opportunity cost of holding these assets, given the low level of interest rates. The annual rate of growth of credit to the private sector held steady during the first two months of the year at 5.8%. Whereas credit to non-financial corporations, which was already growing at very low rates in December, slowed further to 2.7% in February, the rate of increase of bank credit to households accelerated at the beginning of 2004, to rates of 5% in the case of consumer credit and 8.5% in that of loans for house purchase. In Spain, credit to non-financial corporations and households continued to increase at very high rates, well above those of the euro area as a whole.

4. The Spanish economy

As discussed in previous sections, developments in the international economy in 2004 Q1 were dominated by the firming expansion in the United States and in Asia, and by the timid recovery discerned in the euro area. In this context, the Spanish economy continued to grow at above the average euro area rate. On the information available, Spanish real GDP is estimated to have grown by 2.8% (1) year-on-year in Q1, up 0.1 pp on 2003 Q4. This outcome resulted from the strengthening of national demand, the annual growth rate of which is estimated to have risen to 3.5%, while the negative contribution of external demand to real output growth is estimated to have increased significantly (see Chart 14). The more expansionary behaviour of national demand was, in turn, a result of the boost to private consumption (which is still underpinned by employment generation and the increase in real wages) and the higher annual growth in gross fixed capital formation, which stemmed from both investment in capital equipment and, to a lesser extent, construction expenditure. The contribution of inventories was, moreover, no longer negative. At the same time, it is estimated that the trend slowdown in exports and imports of goods and services since mid-2003 came to a halt in 2004 Q1, giving way to a recovery that was more apparent in the case of imports.

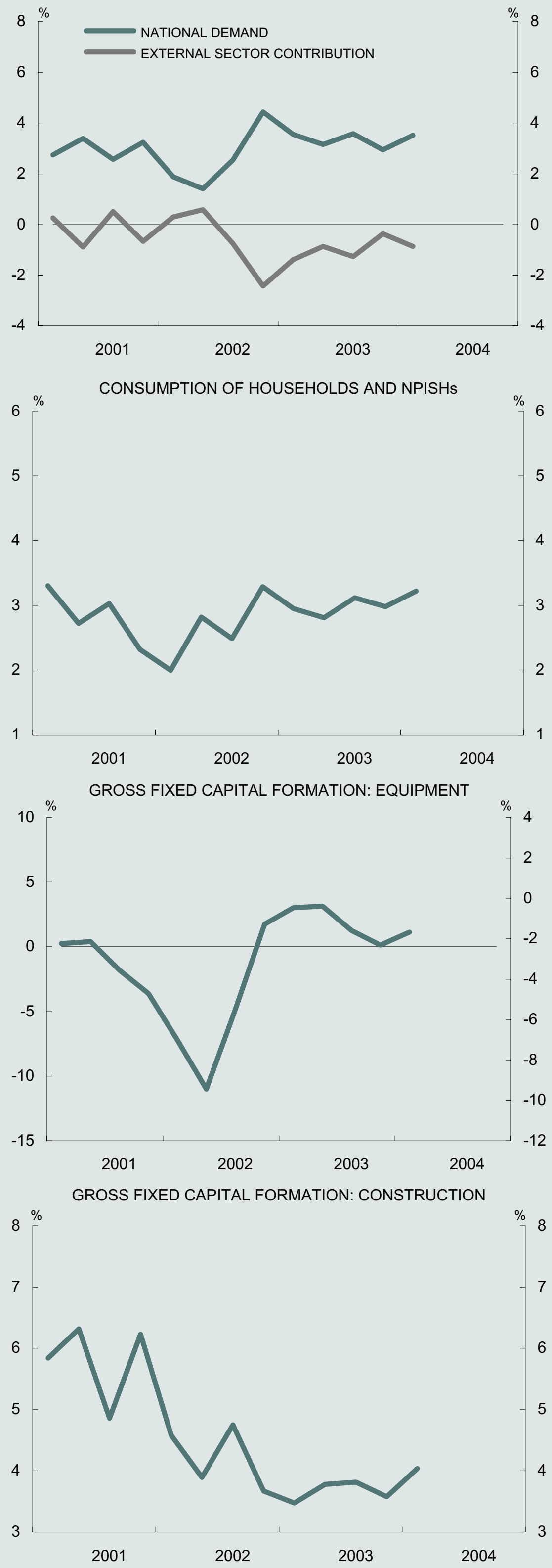
It is worth noting that these estimates contain no effect whatsoever on demand or output of the attacks of 11 March in Madrid. Although there may have been some effect on the consumption of residents and of non-residents in the short run (mainly affecting services activities) there is no information to confirm this. The first partial indicators received with information subsequent to the attacks (such as new car and Social Security registrations) generally show no significant impact, except for the odd indicator of tourism that slowed in March.

From the viewpoint of value added, it is estimated that the slight acceleration of GDP in 2004 Q1 was the result of expansionary behaviour in most of the activities included in the market economy, which was more buoyant than in 2003 Q4. Growth in Q1 is estimated to have stepped up in all branches (except in the primary sectors and in non-market services), including in industry, which continues to show signs of having put behind the slackness of early 2003. Meanwhile, the growth rate of employment is estimated to have stabilised during 2004 Q1 at rates somewhat higher than 2% in the economy as a whole, being slightly higher in

(1) Unless otherwise indicated, rates are calculated on the basis of QNA series adjusted for seasonal and calendar effects.

CHART 14

Main demand aggregates
Percentage change on year ago (a)



Sources: INE and Banco de España.
(a) Calculated using the seasonally adjusted series.

the market economy. This would be compatible with a pick-up in apparent labour productivity which, in the market economy, is estimated to have recovered from its contractionary behaviour in 2003.

Finally, in 2004 Q1, amid lower inflationary pressures, the growth rate of compensation per employee has shown signs of moderating. This, together with the recovery in productivity mentioned above, is estimated to have led to a significant slowdown in labour costs per unit of output. Moreover, in a context of moderate demand pressures, although business margins are still widening, they are estimated to be doing so less strongly. The reduction in domestic inflationary pressures and the contraction in import prices, which reflects the appreciation in the euro since the end of 2003, would be behind the significant slowdown in final prices in early 2004. The CPI inflation rate continued to edge downwards in Q1, from 2.6% year-on-year at end-2003 to 2.1% in March.

4.1. Demand

Household final consumption expenditure ended 2003 at a year-on-year growth rate of 3%, in real terms. It followed an expansionary path that, on the latest conjunctural information, is estimated to have accelerated slightly in 2004 (see Chart 14), taking the year-on-year growth rate to 3.2% in Q1. The growth of consumption in Q1 was basically underpinned by the increase in real household income, as well as by the continued favourable monetary conditions and by the firming of the increase in the wealth of the sector, and would have also been compatible with a rise in the household saving ratio.

On the available indicators, the buoyancy of consumption in Q1 was based on more robust expenditure on goods, especially durable goods, as shown by the apparent consumption indicator in Chart 15. Likewise, the index of retail sales increased by almost 5%, in real terms, in January and February, relative to the same months of 2003, and new car registrations increased by more than 20% in Q1. For its part, the consumer confidence indicator held at the same levels in 2004 as in the second half of 2003, still well below those reached in the most expansionary phase of the cycle. Sentiment regarding the general economic situation tended to improve, as did that relating to purchases of durables and the possibility of saving.

The expansionary behaviour or consumption is primarily underpinned by the sustained increase in household real disposable income. If the current rates of increase in the latter variable are maintained, its growth in 2004 may surpass the estimate for 2003. The favourable behaviour of income is explained by the greater contribution from real wages, boosted by greater moderation in consumer prices than in wages, against a background of robust employment. For its part, the contribution from general government continues to reflect the personal income tax reform introduced in 2003, and remained highly positive, although somewhat smaller than in the preceding years. Apart from income, the fact that housing wealth continued to rise, owing to the rises in house prices (in real terms) and to the expansion in the stock of property, while the value of financial wealth has been benefiting from the upward trend in share prices. Finally, the recent path of interest rates has given rise to further improvements in the financing conditions for households, although this aspect is more relevant to decisions relating to house purchase.

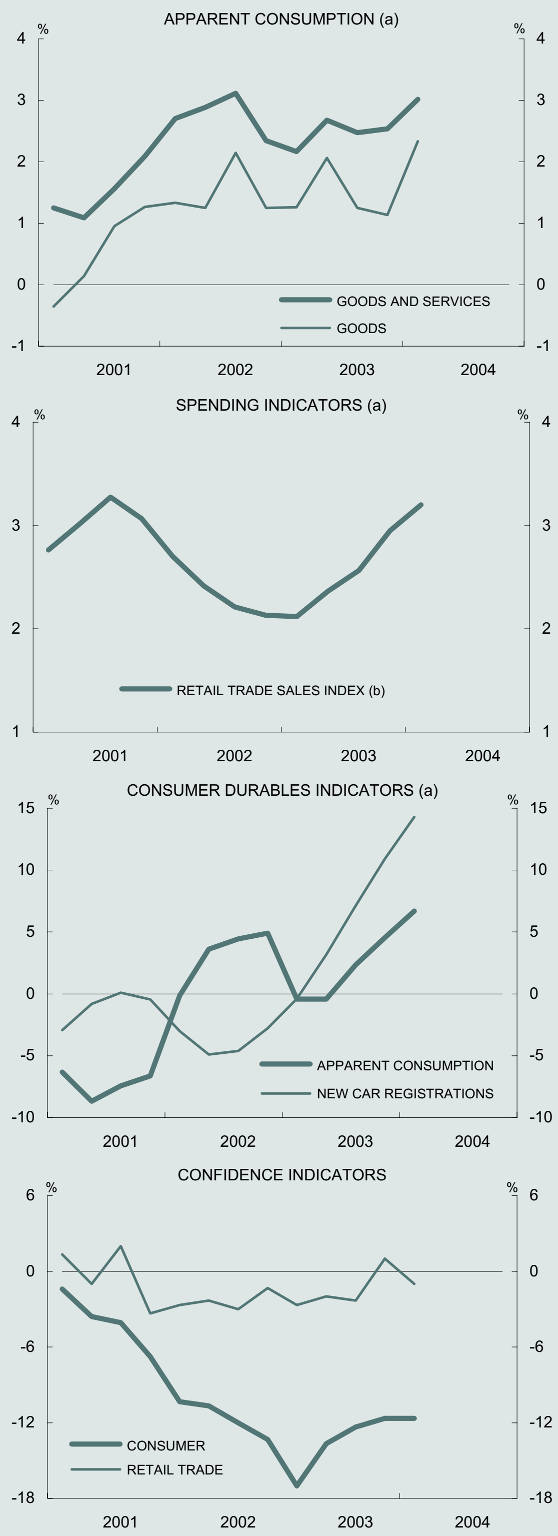
In 2003 Q4, general government final consumption increased strongly, at a year-on-year rate of 4.8%, similar to that in the previous quarter. It is estimated that this aggregate decelerated slightly, although the momentum it retains makes it the most expansionary component of national demand. The growth in wages and salaries and in other extraordinary expenses at the beginning of this year was higher than initially budgeted.

According to the QNA, in 2003 Q4, real gross fixed capital formation grew in real terms at a year-on-year rate of 2.5%, 0.5 pp down from the previous quarter, owing to a loss of momentum in equipment investment, which ended the year stagnant. Construction investment dipped in 2003 Q4 to 3.6%, while investment in other products (mostly spending on construction-related services) picked up slightly. According to the available information, gross fixed capital formation turned upward again in Q1, underpinned by the acceleration in all its components, although investment in capital goods continued to be the least expansionary component.

Among capital goods indicators, the rate of growth of apparent investment in capital goods showed a mild recovery in Q1. This is consistent with the autumn results of the half-yearly survey of industrial investment, which showed employers willing to increase their investment in 2004 (after it fell off in 2003), on the basis of favourable demand expectations (see Chart 16). Other sentiment indicators, however, provided less positive information, such as the business confidence indicator and the expected orders of capital goods producers, which fell in 2004 Q1, and those relating to the pressure of demand in

CHART 15

Private consumption indicators



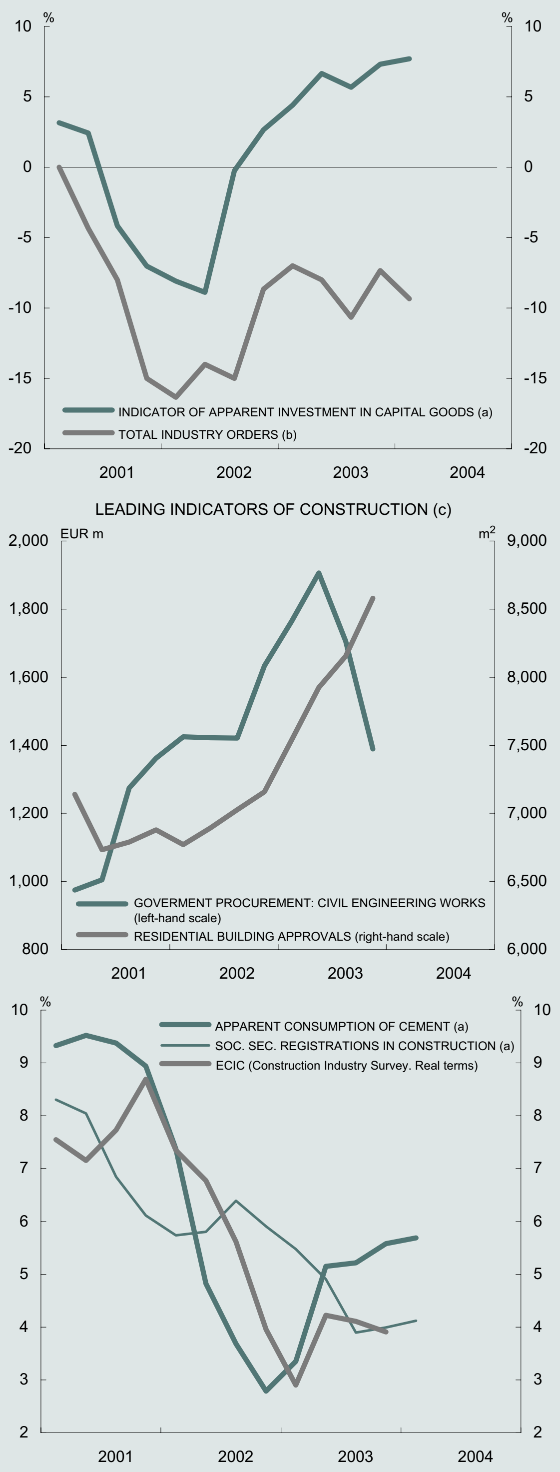
Sources: INE, European Commission, Dirección General de Tráfico and Banco de España.

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

(b) Deflated by the CPI.

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 year-on-year percentage change based on the trend of the indicator.

(b) Level of original series.

(c) Annual moving averages.

(d) General government + state-owned enterprises

industry, in general, such as the adequacy of productive capacity, which has tended to increase, or capacity utilisation, the latest figure for which was 77%, below its historical average.

In any event, the incipient recovery in capital goods investment is in step with the buoyancy of final demand and with the persistence of very favourable financing conditions for business. At the same time, the quarterly information on the situation of non-financial corporations gathered by the Central Balance Sheet Data Office confirms that Spanish firms increased their productive activity and their surpluses significantly last year, which enabled them to sustain high levels of profitability. The greater fund-generating capacity shown by the sample firms in 2003 was partly used to reduce their debt. Moreover, the decline in interest rates was conducive to a further fall in the cost of borrowing, and during the year the spread between the profit rate and the cost of borrowing widened. The financial position of firms generally improved last year and provides a good base for higher investment. However, according to the CBQ, the industrial branches were an exception to this improvement, since their ordinary profit was flat in 2003, after growing slightly the previous year. This indicates that euro appreciation may be restricting their ability to join a more broad-based recovery.

As for construction investment, after slowing mildly last year, it may have accelerated slightly in Q1, as indicated by the expansionary behaviour of the coincident indicators, including apparent cement consumption and the Social Security registrations in the sector (see Chart 16). The survey of activity in the construction industry (ECIC), with data to Q4, shows a slight increase already in that quarter in the real value of the work carried out by the firms in the sector, which extended to civil engineering and to building. On the other hand, the indicator of confidence in the sector was less favourable in 2004 Q1, continuing its tendency to moderate progressively.

Turning to the leading indicators, which enable the path of investment by type of work to be projected, the increase in the new surface area to be built (according to the project approvals signed in 2003) would be sufficient to sustain a high rate of residential building in the coming quarters. However, the initial data for the current year point to a lower rate of residential building starts, accompanied by greater buoyancy of non-residential building. For its part, the value of the civil engineering work tendered by general government and state-owned enterprises fell sharply in the second half of 2003, ending the year with a decline of close to 15%, despite the high growth recorded in the first half. Finally, house prices rose by 17.3% in 2003 Q4. On data published by the Ministry for Development, the average increase in 2003 as a whole was 17%, 0.4 pp more than in 2002.

On QNA results, stockbuilding made a negative contribution of 0.2 pp to annual GDP growth in 2003 Q4. The information provided by the monthly business survey indicates that inventories of finished products were above desired levels in Q1, which would have involved a slight increase in the positive contribution from this component.

As indicated above, in the second half of 2003, exports of goods and services slowed somewhat. According to the QNA, they grew by 1.8% year-on-year in Q4, as against 4% in the year as a whole. It should be pointed out that this export growth occurred against a background of euro appreciation and deterioration in the competitiveness of Spanish products. Meanwhile, imports of goods and services grew at a year-on-year rate of 2.7% in Q4, which was also below the average rate for the year. The slackness of industrial firms, which increased at the end of the period, must have played a part in the slowdown of imports at the end of the year. Taken together, the behaviour of exports and imports reduced output growth by 0.4 pp. The available conjunctural information points to a recovery in both foreign trade flows in 2004 Q1 that was stronger in the case of imports, giving rise to a larger negative contribution to GDP growth (see Chart 17).

On QNA estimates, the rate of growth of real goods exports fell in 2003 Q4 to 3%. These figures are consistent with Customs figures, which show the slowdown that commenced in the previous quarter continuing in Q4. The Customs data for January are compatible with a certain recovery in sales abroad, which increased in real terms by 5.7% that month. In clear contrast to developments in 2003, exports to euro area countries picked up notably, while sales to non-EU countries slowed. In terms of product group, exports of capital goods accelerated significantly, in real terms, following notable growth in 2003 as a whole. Exports of consumer goods decelerated somewhat, partly owing to the moderation of those of cars, while exports of non-energy intermediate goods recovered slightly, though they remained the least dynamic component.

In 2003 Q4, according to the QNA, exports of services fell more steeply than in the previous quarter, owing to the sharp fall in the aggregate other services. Meanwhile, non-residents' consumption grew by a modest 0.4%, year-on-year, prolonging its previous weakness. This

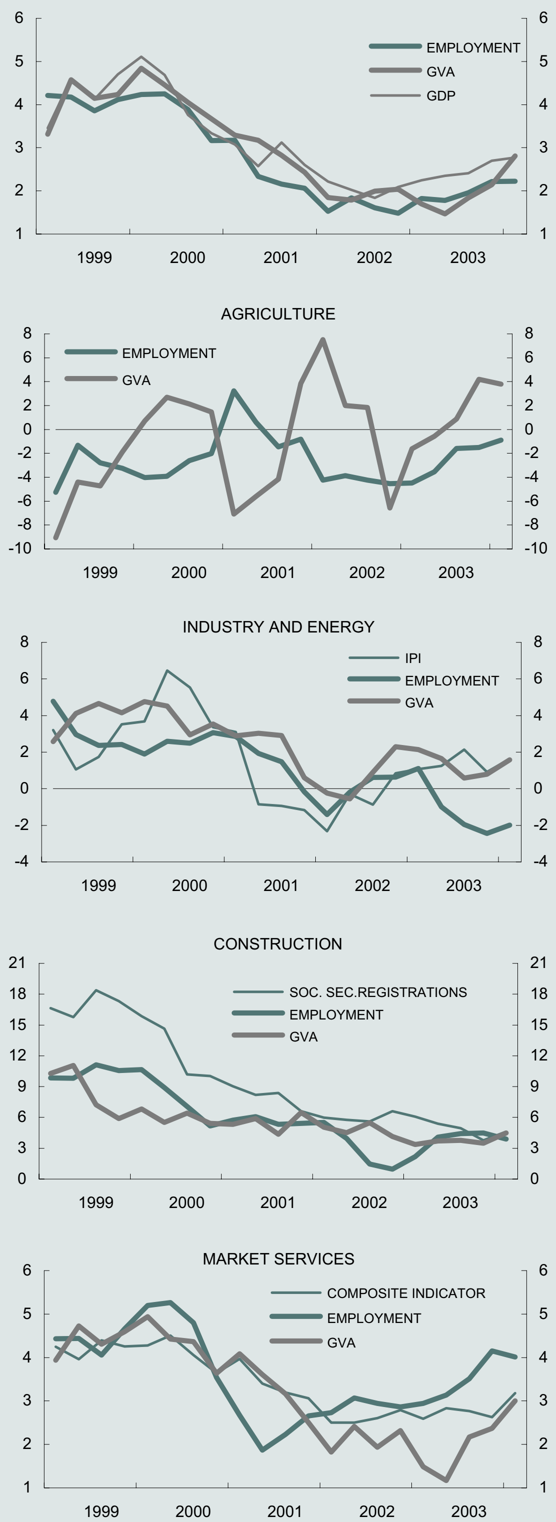
CHART 17

Foreign trade
Percentage change on year ago

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

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. For incomplete quarters, the year-on-year rate for the period available within the quarter is taken.

behaviour reflects not only the weakness of world tourism demand, but the collapse of consumer confidence in some of the main customer countries and the appreciation of the euro, which will have led to a deterioration in competitiveness relative to Spain's main customers. The conjunctural information available for 2004 Q1 shows a notable recovery in the number of foreign travellers staying in hotels (5.1%) and an increase in the total number of foreign tourists entering Spain during these months (5.4%), extending the recovery already apparent at end-2003. However, the overnight stays in hotels of non-residents declined by 0.8% year-on-year between January and March, reflecting a significant fall in the latter month, which may incorporate a short-term effect of the 11 March attacks in Madrid on the demand for tourism. In any event, the future buoyancy of tourism in Spain will basically depend on the capacity of the sector to strengthen its competitiveness.

According to the QNA, real goods imports increased by 4.2% in 2003 Q4, as against 7.4% in the year as a whole. In January 2004, Customs data show a pick-up in real goods imports, which grew by 8.9%, year-on-year, cutting short the previous trend deceleration. By product group, purchases of capital equipment remained highly buoyant, as a result of the increase in machinery imports, especially for use in construction and data processing. Real imports of consumer goods accelerated, with the strength of car purchases and the significant growth of other consumer manufactures (especially textiles and footwear) standing out. Meanwhile, imports of non-energy intermediate goods grew at a very moderate rate that, nonetheless, put behind the contractionary behaviour of 2003 Q4. Imports of energy intermediate goods also picked up, while their prices in euro were declining. Finally, according to the QNA, real services imports contracted at an increasing rate in the second half of 2003, falling by 4.8% in Q4. That said, the behaviour of tourism was highly expansionary, partly owing to the notable strength of the euro, and in the first few months of the current year the declining trend in services imports appears to have moderated.

4.2. Output and employment

As indicated at the beginning of this section, on QNA estimates, the value added of the main productive branches in 2003 Q4 was expansionary. This behaviour is estimated to have continued into 2004 Q1 (see Chart 18). Thus, activity in agriculture and fishing picked up strongly in the final months of 2003, so that the upward trend seen throughout the year became more pronounced, taking the year-on-year growth rate to 3.7%. This behaviour reflects the excellent olive and grape production, two of the few vegetable products to show a positive performance in 2003. Among animal products, milk production stabilised at the end of the year, following several quarters of contraction. Hardly any information is available on the behaviour of this sector in Q1 of the present year, although the unemployment figures and Social Security registrations provide no support for a further improvement in activity in that period.

Following weakness in the middle quarters of 2003, industry and energy began to recover at the end of 2003, despite the slowdown in exports and capital investment. According to the QNA, the year-on-year growth rate in Q4 was 0.8%, 0.2 pp up from the previous quarter, and the conjunctural information points to a certain improvement in the first few months of 2004. In January and February, the trend rate of growth in the industrial production index (IPI) edged up from 2003 Q4. Among its components, the contraction of consumer goods production and the sustained growth of capital and intermediate goods were notable. However, the industrial confidence indicator compiled by Eurostat dipped slightly in 2004 Q1 since, despite the recovery in employers' production expectations, inventories rose and the deterioration in orders (especially foreign orders) became more pronounced. As for employment, the rate of decline in Social Security registrations decreased in 2004 Q1.

The year-on-year growth rate of construction was 3.5% in 2003 Q4, 0.3 pp less than in the previous quarter. Despite its high rate of growth, construction in this period ceased to be the most buoyant activity, growing less briskly than agriculture and non-market services. As mentioned when discussing spending, the available indicators for 2004 Q1 show a certain recovery in this activity, which is appreciated both in the information of a coincident nature and in the leading indicators, which project a favourable outlook, at least in the short term.

Activity in services accelerated at the end of 2003, extending the expansionary profile already apparent in Q3. On QNA data, it is estimated to have grown by 2.7%, as a result of the impetus from both its components: non-market services, the growth rate of which rose by 0.4 pp to 3.9%; and market services, whose growth rate increased by 0.2 pp to 2.4%. The composite market services indicator (ISIS) for 2004 Q1 pointed to a further acceleration in this sector, with a positive contribution from the wholesale and retail trade, hotels and restaurants, transport and communications, as well as in financial and property activities. In relation to the former, it has already been mentioned that tourism indicators were favourable in Q1. Social Security registrations sustained a growth rate of more than 4% in Q1 and the confidence indicator held steady at similar levels to the previous year.

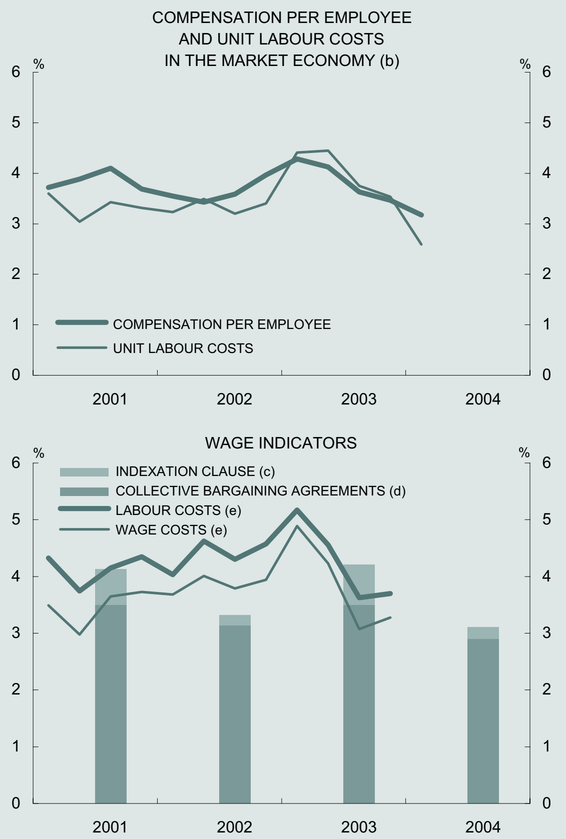
In step with the gradual expansion in activity during 2003, the year-on-year rate of change of employment, measured in terms of full-time equivalent jobs, accelerated to 2.1% in the final quarter, according to QNA data. Consequently, the apparent labour productivity of the economy as a whole rose by 0.6%, which was the same as for the year as a whole. In the market economy, employment put in a similar performance, ending the year with growth of 0.2%, so that apparent labour productivity, calculated in terms of value added, continued to contract slightly. The moderate expansion of employment in 2003 Q4 was noticeable in the various economic indicators, albeit to varying extents. Thus, on Labour Force Survey (EPA) data, employment rose by 3%, 0.3 pp more than the average for the year, while Social Security registrations rose by 3%, down 0.1 pp on the previous quarter.

Employment in 2004 Q1 is estimated to have grown somewhat less than in the preceding quarter which, against a background of more expansionary activity, will have meant a slight recovery in productivity gains. According to the EPA for Q1, employment grew by 2.6% year-on-year in that period, down 0.4 pp on end-2003. Social Security registrations grew steadily in this quarter (2.9%), while National Employment Office (INEM) hiring statistics showed an acceleration in the number of contracts signed, which grew by nearly 14%, following the already significant rise in the final months of 2003.

By branch of activity, the QNA data show that 2003 Q4 saw a prolongation of the previous employment trends, as shown in Chart 18. In market services and in construction, employment expanded significantly and, as a result, apparent labour productivity contracted. In agriculture the process of job destruction continued, although more slowly; in industry, however, jobs were being shed at a faster rate. In 2004 Q1, these trends are estimated to have changed to some extent. EPA and Social Security registrations data indicate that in agriculture the contractionary profile of employment seems to have steepened, whereas in industry, by contrast, the reduction in numbers employed has apparently eased, correcting the markedly downward path of 2003. Further, the EPA data show that the numbers employed have decelerated in construction and grown steadily in market services, although employment growth remained high in both cases.

CHART 19

Wages and labour costs (a)



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

(a) Percentage change on year ago.
(b) Rates based on QNA seasonally adjusted series.
(c) Previous year's indexation clause.
(d) Increase in year to date.
(e) Per employee per month.

On QNA data, the number of wage-earners grew faster than total employees during 2003, while the fall in the number of non-wage-earners eased, a profile which coincides with that shown by EPA data. This survey shows that 2004 Q1 saw a prolongation of the upward trend in non-wage-earners, while the growth rate of wage-earners slowed to 2.8%, slightly higher than that for total employment. Analysis by contract term shows that wage-earners on permanent contracts and temporary contracts decelerated in Q1, although the slowdown was sharper among temporary workers and thus the ratio of temporary to permanent workers decreased to 31.1%, below its level a year earlier. INEM statistics on contracts indicate that the number of temporary contracts continued to accelerate in 2004 Q1, rising by 14.4%, although permanent contracts also accelerated significantly to 10%. Regarding length of working day, the number of full-time employees grew by 2.2% in 2004 Q1, continuing the slowdown shown in the previous quarter, while part-time employees (6.7%) maintained the high rates achieved following their sharp acceleration at the end of the previous year. The ratio of part-time to total employees stood at 8.4%, up 0.3 pp on 2003 Q1.

The labour force ended 2003 up 2.7% year-on-year, spurred by a further rise in the participation rate, which stood at 55.4%. At the beginning of 2004, however, the process of incorporation of the population into the labour market slowed, and the growth rate of the labour force decreased to 2.2%, while the participation rate remained at 55.4%, a level which is, nonetheless, 0.8 pp higher than in the same quarter of 2003. The participation rate calculated as a percentage of the population below age 65 remained at 69%. The participation rate with respect to 2003 Q1 rose more sharply among women, whose rate increased to 44.1% in the period January-March, although it was still notably below the 67.4% rate of men. The diverse incentives in place to promote the hiring of women on permanent employment contracts are currently available to all unemployed women and have helped women to join more fully in the labour market. Notable regarding educational level is the rise in the participation rate of university graduates, thereby extending to March 2004 the increase seen in 2003. Finally, given the behaviour of the labour force and of employment in Q1, the number of unemployed decreased by 0.8% with respect to 2003 Q1. Consequently, the unemployment rate stood at 11.4%, 0.3 pp less than a year earlier. On EPA data, the number of unemployed increased in 2004 Q1 at a rate of 1.2%, down 0.2 pp on the preceding quarter.

4.3. Costs and prices

The year-on-year growth rate of labour costs per unit of value added held steady at 3.8% at end-2003. This development, which interrupted the gradual deceleration of this variable, came about because the mild acceleration in compensation per employee was offset by a similar increase in productivity gains. In the market economy, the deceleration in labour costs was prolonged up to 2003 Q4, since the modest slowdown in compensation per employee was not accompanied, in this case, by changes in the behaviour of productivity, which, as mentioned earlier, continued to show negative rates of change (see Chart 19). In 2004 Q1 the growth rate of unit labour costs in the market economy is estimated to have continued to moderate, as a result of a correction in the contractionary behaviour of productivity and of an additional slowdown in compensation per employee.

The slight acceleration in compensation per employee reflected by the QNA in 2003 Q4 can also be appreciated in the monthly labour costs per employee, which, according to the Labour Costs Index (LCI), grew by 3.7% in 2003 Q4, up 0.1 pp on the previous quarter. By component, wage costs rose by 3.3%, 0.2 pp more than in the previous quarter, while other costs slowed, although holding at higher rates of change (5%). The main component of other costs, i.e. mandatory contributions, grew by 3.7%, 0.5 pp less than in the year as a whole.

There is still little information available on collective bargaining developments in 2004. The agreements registered up to 31 March 2004 included an average increase in wage rates of 2.8%, against the 3.5% at which collective bargaining ended the year 2003 (before wage indexation). The vast majority of these agreements are revised agreements and they apply to a total of 4,102,000 workers. It should be mentioned here that, for the year 2004, the social partners have renewed the Intersectoral Agreement for Collective Bargaining Agreement (AINC), taking as a reference point the official inflation forecast of 2% and including a spread thereon associated with possible productivity gains.

The moderation of labour costs in the final part of 2003 did not feed through to the value added deflators of the total economy or of the market economy, which accelerated by 0.3 pp to 4.3% and 4.4%, respectively, reflecting the boost to the operating surpluses per unit of output. The behaviour of unit margins in 2003 Q4, like that of unit labour costs, was uneven across the various branches, as seen in Chart 20. Margins grew significantly in the agricultural branches (characterised by their volatility), in industry and in construction, while decelerating in market services. Mention should be made of the behaviour of this variable in industry where, against a background of growing competitive pressure that has strongly contained price rises, margins are widening as a result of a moderation in unit labour costs, achieved by cutting staff.

In 2003 Q4, the final demand deflator accelerated again, this time by 3.2%, 0.2 pp more than in the previous quarter. This growth was similar to that of the GDP deflator, which increased by 4.2% year-on-year, and also to that of the import deflator, which went from a decrease of 0.1% to growth of the same amount. The upturn in the final demand deflator reflects the higher growth rates of deflators of capital goods investment, of construction and of exports.

CHART 20

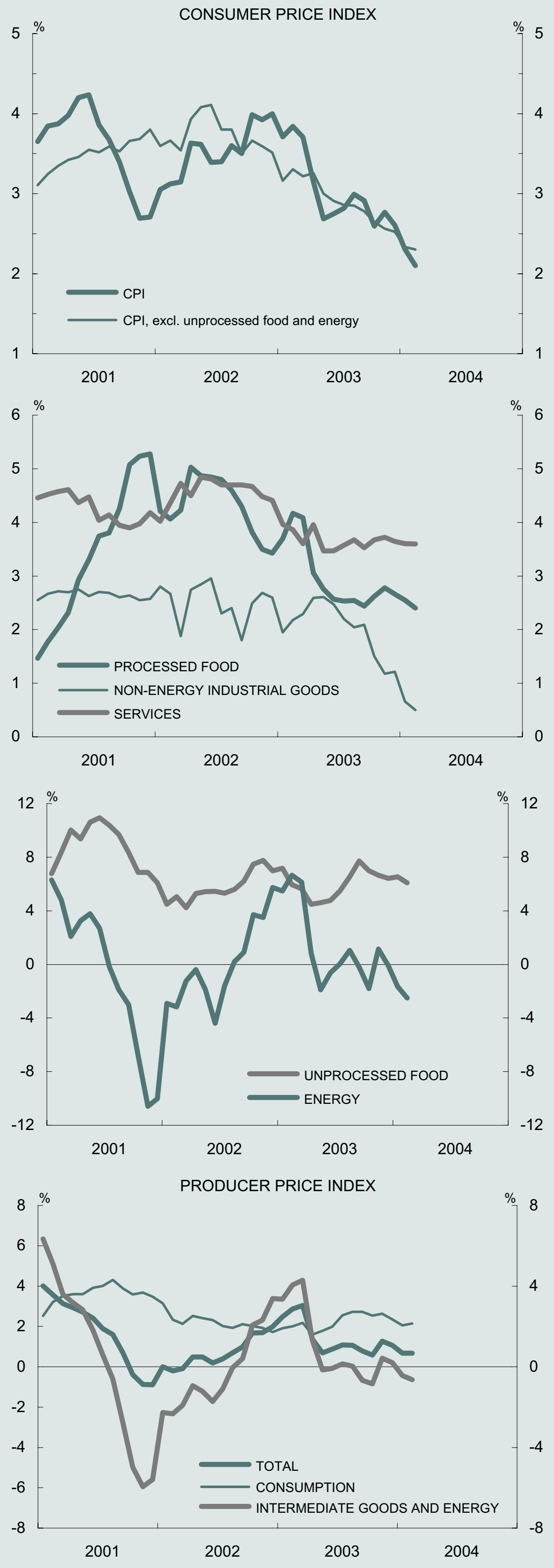
Prices and costs by branch of activity (a)

Sources: INE and Banco de España.

(a) Non-centred percentage change on a year ago based on QNA seasonally adjusted series.

CHART 21

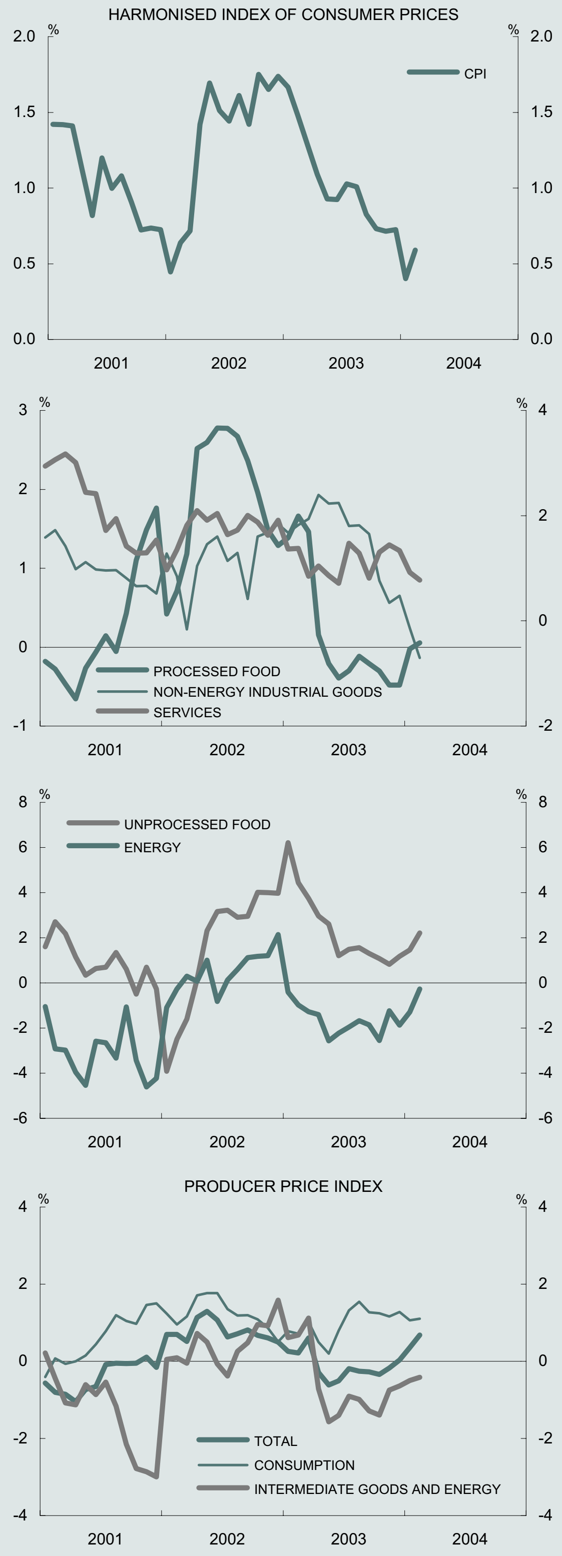
Price indicators (a)
Spain



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

CHART 22

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



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

Among final prices, in 2003 Q4 the private consumption deflator decelerated by 0.1 pp to 3.0%, a similar rate to that for the year as a whole. The relatively steady path of this deflator in recent quarters is similar to that of its principal indicator, namely the consumer price (CPI), the year-on-year growth of which fell to 2.7% after a sustained increase in the middle months of the year (see Chart 21). The growth rate of the CPI decreased by a further 0.5 pp in 2004 Q1. This reflected a notable moderation in the goods component, which was affected by the major year-on-year fall in energy prices and by a significant containment of the increase in non-energy industrial goods prices and, to a lesser extent, in food prices. Regarding energy, the depreciation of the dollar amply offset the oil price pressures, which intensified notably in the 2004 Q1, rising above $34 per barrel in the international markets. Finally, the growth rate of services prices moderated by 0.1 pp compared with end-2003 and held at 3.6% between January and March. The CPI excluding unprocessed food and energy, which had held on a downward path in 2003 (the year-on-year rate at the end of the year was 2.6%), continued on this trend in 2004 Q1, when its growth rate decreased by 0.3 pp.

The year-on-year growth rate of the Spanish HIPC decreased by 0.6 pp between January and March, while that of the euro area as a whole decreased by 0.3 pp, so the inflation differential narrowed further to 0.5 pp (see Chart 22). This improvement in the differential is explained by the narrowing of the gap relating to the services component, since that relating to goods widened very slightly. This outcome was due to the notable widening of the unprocessed food differential, as behaviour varied from one food to another in the channelling of upward pressure on fruit and vegetable prices in the summer months. The prices of industrial goods excluding energy recouped, after more than two years, a favourable inflation differential; the negative differential of energy prices decreased slightly in 2004 Q1.

Among the other price indicators, the producer price index (PPI) saw an appreciable decrease in its year-on-year growth rate at the beginning of 2003, due particularly to the behaviour of energy producer prices. The latest available figure, for March, brought the year-on-year rate to 0.8%, which continues to compare favourably with the 1.1% at the end of the previous year. Intermediate goods prices are showing signs of greater buoyancy and their year-on-year rate of growth has accelerated by more than 1.5 pp since the beginning of the year. Consumer durables are another component whose year-on-year rate of growth has risen appreciably in this period. In the euro area, industrial producer prices were more restrained: as a result of a change of 0.4% in February, the growth differential between the index in Spain and in the euro area stood at 0.7 pp, whereas it had been zero at end-2003. The fall in energy producer prices was somewhat sharper in the euro area, so the favourable inflation differential narrowed slightly. Meanwhile, the narrowing of the positive consumer price gap did not offset the widening of the intermediate goods growth differential. Also, the growth rate of prices received by farmers declined and that of hotel prices, amid notably weaker demand, continued to slow in 2004 Q1.

4.4. The State budget

According to National Accounts methodology, the figures released on the State budget outturn for 2004 Q1 show a surplus of €1.17 billion (0.1% of GDP), compared with €3.63 billion (0.5% of GDP) in the same period a year earlier. This was the result of a 4.5% decline in revenue, while expenditure climbed by 5% in the first three months of the year. These figures are in contrast to the cash-basis results, in respect both of the sign and the trend; under this convention the State posted a deficit of €2.3 billion in 2004 Q1, down from €2.81 billion in the same period in 2003 (see Table 3). The different trend of the cash-basis balance compared with that under National Accounts methodology is mainly in response to the adjustment due to the different interest allocation criterion used.

Comparisons with the figures for 2003 are, however, influenced by certain circumstances that affect both years differently. First, the change in the timetable for the receipt from general government of the tax withheld on earned income, the revenue having been transferred monthly (as opposed to quarterly, as was previously the case) since early 2003. Further, a significant portion of personal income tax revenue in the opening months of 2003 was not yet affected by the reduction in withholdings arising from the reform of this tax. Adding to this in 2004 are the effects of the change in local government financing arrangements; a share in certain taxes has been ceded to this layer of government in exchange for fewer State transfers. The rates of change in the last column of Table 3 reflect these events, which is why the figures presented are not fully comparable.

On the revenue side, and given the partial transfer of certain taxes to territorial government, the analysis of the cash-basis outturn hereafter takes total revenue raised by the main taxes, both in the portion assigned to the State

TABLE 3

State budget outturn

EUR m and %

	Outturn	Percentage change	Budget	Percentage change	Outturn		
	2003	2003/2002	2004	2004/2003	2003 JAN-MAR	2004 JAN-MAR	Percentage change
	1	2	3	4=3/1	5	6	7=6/5
1. Revenue	**109,655**	**1.1**	**110,496**	**0.8**	**27,085**	**27,259**	**0.6**
Direct taxes	56,510	1.8	58,087	2.8	11,147	10,138	-9.1
Personal income tax	*32,824*	*1.7*	*31,974*	*-2.6*	*10,930*	*9,513*	*-13.0*
Corporate income tax	*21,912*	*2.3*	*24,109*	*10.0*	*-173*	*115*	*...*
Other (a)	*1,774*	*-3.7*	*2,004*	*13.0*	*391*	*510*	*30.5*
Indirect taxes	39,084	2.8	39,836	1.9	12,740	13,179	3.4
VAT	*27,130*	*5.5*	*27,490*	*1.3*	*10,015*	*10,394*	*3.8*
Excise duties	*9,787*	*-5.4*	*9,996*	*2.1*	*2,233*	*2,203*	*-1.3*
Other (a)	*2,167*	*10.6*	*2,350*	*8.4*	*493*	*582*	*18.1*
Other net revenue	14,061	-5.6	12,573	-10.6	3,197	3,942	23.3
2. Expenditure	**113,787**	**2.4**	**117,260**	**3.1**	**29,891**	**29,556**	**-1.1**
Wages and salaries	18,450	5.1	19,486	5.6	4,200	4,371	4.1
Goods and services	2,996	5.4	2,740	-8.6	648	965	49.0
Interest payments	19,788	4.9	19,047	-3.7	7,575	6,003	-20.7
Current transfers	58,078	-0.4	58,859	1.3	13,682	14,531	6.2
Contingency fund	...	...	2,345.2	...	...	...	...
Investment	7,535	7.0	7,611	1.0	2,211	2,012	-9.0
Capital transfers	6,940	7.5	7,172	3.3	1,576	1,673	6.2
3. Cash-basis balance	**-4,132**	...	**-6,764**	...	**-2,807**	**-2,297**	...
MEMORANDUM ITEM: NATIONAL ACCOUNTS							
Revenue	110,449	1.9	...	...	27,742	26,491	-4.5
Expenditure	112,566	0.7	...	...	24,111	25,320	5.0
Net lending (+) or borrowing (-) (c)	**-2,117**	...	**-3,470**	...	**3,631**	**1,171**	...

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) Figures in accordance with the method used in the Excessive Deficit Procedure.

and in that relating to territorial government, the latter not being included in Table 3. Thus, in aggregate terms, personal income tax revenue declined by 6.6% in Q1 on the same period in 2003. This fall was due to the calendar affect mentioned in relation to the withholdings on earned income and to the personal income tax reform. A significant amount will not be shown for corporate income tax until the April prepayment, the negative figure for the year 2003 being due to the high volume of refunds. Indirect tax takings likewise slowed in relation to 2003 as a whole, albeit in line with the figure budgeted. VAT grew, in homogeneous terms, by 6.1% (compared with 9.9% in 2003), while excise duties, the rates on which have been frozen, increased by 1.6% (4.6% the previous year). Finally, the strong increase in non-tax revenue reflects the bigger transfers received by the State both from administrative bodies and from the European Union.

On the expenditure side, there was a fall in Q1 in relation to the same period a year earlier, owing essentially to the interest payments caption. As a result of the government debt redemption timetable, this caption declined by 20.7% during Q1 (see Table 3). Conversely, the

BOX 3

The recovery in investment in capital goods in 2003: an assessment

In 2003 investment in capital goods increased by 2.2% after having declined by 5.4% in 2002. As can be seen in the accompanying chart, the pick-up in 2003 was apparently weaker than on previous occasions when this aggregate had contracted strongly (for instance in 1984 and in 1993). In the years preceding the cyclical trough in 2002, investment in capital goods appeared to increase less sharply than it had in previous cycles. To assess these developments the factors behind companies' productive investment decisions must be analysed. The concept of private productive investment (PPI) includes, in addition to expenditure on equipment, corporate spending on construction, the trend of which is very close to that of investment in equipment (see chart).

A good starting point for assessing the behaviour of PPI in recent years is the investment equation of the MTBE (Banco de España Quarterly Model). The equation expresses the rate of change of PPI on the basis of several determinants, the most relevant of which are the value added of the market economy (PYER) and the user cost of capital in real terms (PUC/PYED). As can be seen in the second panel, the positive contributions of both factors explain sufficiently the expansion of PPI to 1999. Thereafter, however, investment has grown systematically below the growth plotted by the equation. In 2000 there was a significant mismatch as PPI slowed by almost 3 pp when its determinants pointed to a fresh acceleration. It might be recalled that in 1999-2000 there was a notable increase in foreign direct investment by Spanish firms, which may have partly influenced the financing of projects in Spain (1). In 2001 the rise in companies' cost of capital, associated in part with the increase in risk premia and interest rate developments, accounted for most of the slowdown in investment, which took place against the backdrop of considerable uncertainty over the international outlook. In 2002 and 2003 the behaviour of PPI once again fell below what its determinants would have indicated: although the slowdown in activity would have warranted weak growth in business investment, the notable contraction in 2002 and the moderate recovery subsequently appeared to be associated with other factors not considered in this analysis.

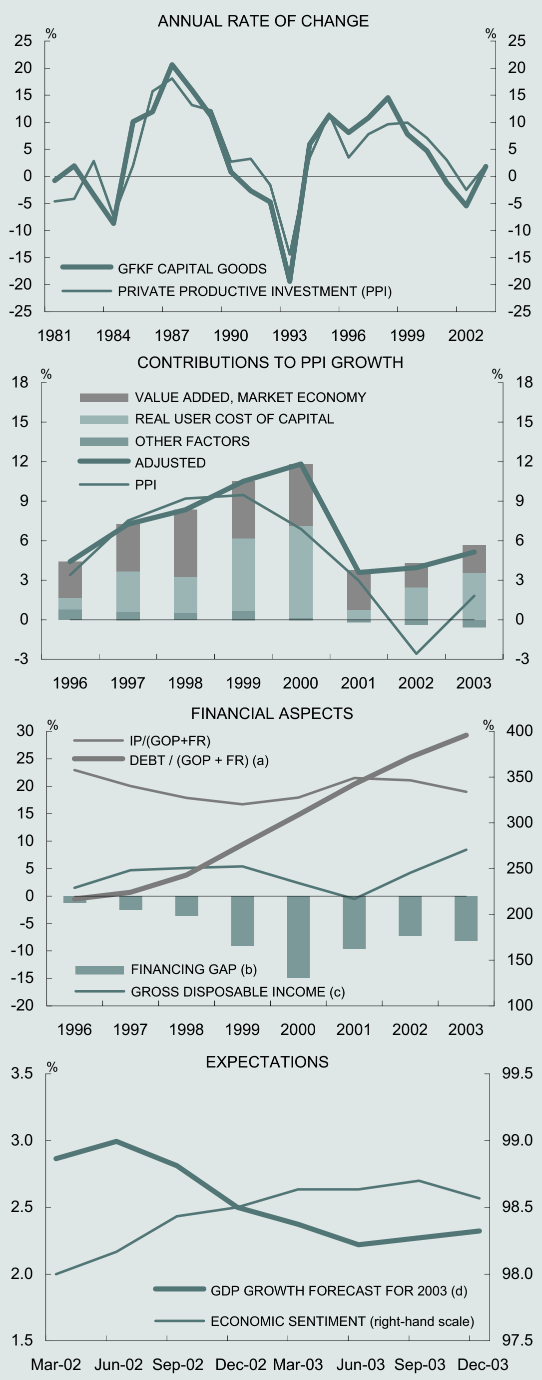
Numerous papers highlight the fact that financial factors, which are not included in the MTBE equation, are important in Spanish companies' decision-making. The third panel depicts the course of certain potentially relevant variables for investment from this standpoint, calculated with National Accounts data for the non-financial corporations sector: the debt ratio, the interest burden, gross saving and an additional variable, the financing gap, which is a measure of the financial resources companies need to cover their real and financial investments of a permanent nature. These variables offer a stylised view of the financial context in which companies have moved in recent years. As can be seen, the notable increase in this financing gap to 2000 (the outcome of the expansion of PPI and of foreign direct investment) led to a significant increase in the sector's debt ratio. And this, combined with the rise in the cost of financing around 2001, gave rise to an increase in the interest burden and to a contraction of gross saving. In these circumstances, non-financial corporations as a whole would appear to have assigned a substantial portion of the funds they generated in 2002 and 2003 to restoring their financial health before increasing their productive investment.

Another factor that may have borne on the behaviour of PPI and which is not adequately reflected in the MTBE equation is business expectations regarding the economic situation. The bottom panel depicts certain indicators of expectations: the European Commission's economic sentiment indicator, and average forecast growth for 2003 according to Consensus Forecast. To differing degrees, both measures showed a check on expectations of a recovery during 2003.

In sum, the financial restructuring needs of certain business sectors and something of a halt in expectations of an economic recovery may have led productive investment spending by companies in 2002 and 2003 to recede to an extent beyond what might be explained by the cyclical slowdown in output and its as-yet incipient recovery. Companies that have made sufficient headway in restructuring will be well poised to harness a clear recovery in the economic outlook, by undertaking investment projects.

(1) See the article "Productive investment in the recent cycle" in the October 2002 Economic bulletin.

Private productive investment



Sources: INE and Banco de España.

(a) Interest-bearing borrowed funds / (gross operating profit plus financial revenue).

(b) Interest paid / (gross operating profit plus financial revenue).

(c) Annual rate of change.

(d) Consensus Forecast.

TABLE 4

Balance of payments: summary (a)

EURm

	JANUARY-JANUARY	
	2003	2004
	Credits	Credits
Current account	**19,978**	**20,173**
Goods	10,520	10,814
Services	4,674	4,583
Tourism	*2,121*	*2,214*
Other services	*2,553*	*2,369*
Income	2,029	1,563
Current transfers	2,755	3,213
Capital account	**1,381**	**270**
	Debits	Debits
Current account	**20,894**	**20,982**
Goods	13,211	13,803
Services	3,408	3,291
Tourism	*578*	*632*
Other services	*2,829*	*2,659*
Income	2,565	2,203
Current transfers	1,710	1,685
Capital account	**93**	**95**
	Balance	Balance
Current account	**-916**	**-809**
Goods	-2,692	-2,989
Services	1,267	1,292
Tourism	*1,543*	*1,582*
Other services	*-276*	*-290*
Income	-536	-640
Current transfers	1,046	1,528
Capital account	**1,288**	**176**

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

current transfers caption (which grew by 6.2% as a result of the increase in the contribution to the European Union in connection with the Additional resource (GNP)) and the goods and services heading (up 49% due to the high volume of expenditure relating to the years prior to 2004) posted far higher than budgeted rates of change (1.3% and -8.6%, respectively). Finally, the components of capital transfers performed unevenly: real investment fell by 9% during the quarter (against budgeted growth of 1%) and capital transfers increased by 6.2% (against an envisaged increase of 3.3%).

Turning to the Social Security budget outturn, information for January and - for certain items - for February is available for the System. Social security contributions rose by 7.7% in relation to January 2003, having been upheld by an increase in the number of Social Security registrations which, in Q1, maintained a similar growth rate to that recorded over the past two years (3%). On the expenditure side, pensions increased by 6.5% to February 2004, somewhat below the figure budgeted for the year as a whole. The number of contributory pensions trended very moderately, the related growth rate standing at 0.8% in January. Unemployment benefits accelerated to a growth rate of 9.3% in the period to March (having increased by 6% in 2003 as a whole), while the growth of registered unemployment eased to 1.9% in Q1 (2.8% in 2003). Preliminary figures point to an increase in the eligibility ratio from 71.9% at end-2003 to 73.1% in January.

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

In January 2004, the overall balance on current and capital account was a deficit of €633 million, compared with the surplus of €372 million in the same month the previous year. This result is attributable to the notable deterioration in the balance on capital account, the surplus of which declined by €1.01 billion, since the current-account deficit was €107 million lower in relation to the figure posted in the same month in 2003. Among the current-account items, the sizable increase in the surplus on current transfers and the slight improvement in the tourism balance cancelled out the wider trade and income deficits.

In January 2004 the deficit on the trade balance showed a deterioration of €298 million compared with the level attained in the same month a year earlier. In year-on-year terms the deficit widened by 11.7%, resuming the sharply worsening path that had characterised it during the first three quarters of the previous year. The latest month's result was due to the notable acceleration in real import flows. These were more marked than real export flows as the terms of trade improved in this period thanks to the strength of the euro, which enabled the rise in oil prices on international markets to be offset.

The surplus on the services balance in January 2004 stood at €1.29 billion, €25 million up on that recorded twelve months earlier. This slight improvement made for a year-on-year increase of 2%, which is due to the increase in the tourism surplus, since the deficit on the non-tourism services balance widened. Tourist flows improved in January: receipts grew by 4.4%, interrupting the slowing path on which they had moved since the second half of the

BOX 4

Spain/euro area inflation differential: recent developments

The narrowing of the Spanish economy's inflation differential with the euro area since late 2002 has been notable. Indeed, as the accompanying table shows, the growth differential of consumer prices measured via the HICP fell from 1.7 pp in December 2002 to 0.5 pp last March. This reduction is largely due to the decline in the Spanish inflation rate during this period (1.8 pp), which far exceeded that of the euro area as a whole (0.6 pp). Further, the reduction in the differential in the main price components was relatively uniform and continuous.

Many factors help explain the narrowing of the inflation differential with the euro area. From an aggregate standpoint, mention may be made of the uneven influence of direct general government action on prices. Indeed, the freeze on indirect taxes in Spain in 2003 contrasted with the increases made the previous year. Conversely, the influence of indirect taxes in the euro area in 2003 was the same as the previous year. Moreover, the contribution to inflation of administered prices also fell slightly in Spain last year, while it was stable in the euro area. Lastly, the restraining influence on the inflation rate exerted by the appreciation of the euro might have been more marked in Spain since the econometric models available estimate a higher elasticity of prices to the exchange rate in Spain than in the euro area as a whole.

A component-based analysis of this process shows that, in the period under study, the slowdown in Spanish consumer prices affected the main components and, in particular, energy. In the euro area, however, food prices quickened and the reduction in the growth rate of the remaining groups was less marked than in Spain. Accordingly, the narrowing of the inflation differential has been generalised, but particularly significant in the energy group.

Spain/euro area inflation differential: recent developments

% and pp

	Spain %	Euro area %	Differential pp
1. Total			
December 2002	4.0	2.3	1.7
March 2004	2.2	1.7	0.5
Reduction	1.8	0.6	1.2
2. Unprocessed food			
December 2002	5.4	1.4	4.0
March 2004	4.4	1.7	2.7
Reduction	1.0	-0.3	1.3
3. Processed food			
December 2002	3.9	2.7	1.2
March 2004	3.1	4.1	-1.0
Reduction	0.8	-1.4	2.2
4. Non-energy industrial goods			
December 2002	2.7	1.1	1.6
March 2004	0.6	0.8	-0.2
Reduction	2.1	0.3	1.8
5. Energy			
December 2002	5.8	3.7	2.1
March 2004	-2.5	-2.0	-0.5
Reduction	8.3	5.7	2.6
6. Services			
December 2002	4.6	3.0	1.6
March 2004	3.5	2.5	1.0
Reduction	1.1	0.5	0.6

Source: Eurostat.

Indeed, energy prices slowed more sharply in Spain than in the euro area, whereby the differential narrowed by more than 2.5 pp. Contributing to this, above all, were fuel and lubricants, partly because of the tax increases in certain euro area countries. It should further be borne in mind that the greater weight of the energy component in the overall index, in the case of the Spanish economy, accentuates the impact of the result for this group in the aggregate HICP.

Non-energy industrial goods prices also slowed significantly in Spain, by more than 2 pp, while they held relatively stable in the euro area. The differential narrowed by 1.8 pp and turned favourable to our country last March, for the first time in recent years. The reduction in this differential largely reflects the marked slowdown in clothing and footwear prices, which account for a higher percentage of household spending in Spain than in the euro area.

As to foodstuffs, although the slowdown in processed food prices in Spain was not very pronounced, there was a considerable acceleration in the euro area, making for a reduction in the inflation differential of over 2 pp. Relatively speaking, tobacco prices played a key role here since, while there was a slowdown in Spain as a result of the base effect arising from the increase in April 2002, there were notable rises in certain euro area countries, generally further to associated tax increases. A similar performance was seen for unprocessed food prices, although in this case the reduction of the related differential was less. The performance of the prices of pulses, vegetables and potatoes was notable in this group, increasing markedly in the euro area owing to the poor weather.

Finally, the contribution of services prices to the narrowing of the inflation differential with the euro area was scant, since the slight slowdown in these prices in the Spanish economy was only marginally greater than that which took place in the euro area. The persistence of a positive and significant inflation differential between the growth rate of services prices in Spain and in the euro area is one of the salient characteristics of inflation developments in recent years.

previous year, in line with the renewed firmness of tourists entering Spain at borders in early 2003 and with the increase in overnight stays in hotels. Tourism payments grew by 9.3% in January 2004, accentuating the accelerating path of the preceding months, against the background of the notable appreciation of the euro.

The deficit on the income account deteriorated by €103 million in January 2004 compared with the same month a year earlier to a level of €640 million. Receipts declined by 23%, affected by the reduction in foreign investment earnings and by the fall in such investment in the Latin American countries in recent years. Payments also declined, by 14.1%, in line with the lesser foreign direct investment attracted to Spain last year.

The current-transfers surplus stood at €1.53 billion in the opening month of 2004, notably up €483 million on the related level in January 2003. Receipts climbed by 16.6%, the outcome of the forceful momentum of flows from the EU, especially those targeted on the private sector via the EAGGF Guarantee Fund. Payments, by contrast, fell by 1.4%, reflecting the decline in those to the private sector.

Finally, the capital-account surplus stood at €176 million in January 2004, down €1.11 billion on the same month in 2003. This heavy deterioration, signifying a decline of 86.4% in year-on-year terms, is due to the fall-off in structural funds from the EU; however, these funds are usually delayed in the opening months of the year.

5. Financial developments

5.1. Overview

The backdrop to financial conditions in the private sector in 2004 Q1 was one in which money-market interest rates in the euro area and medium- and long-term yields on Spanish public debt followed a descending path. Thus at end-March, three-month and ten-year interest rates stood, respectively, at 2.03% and 3.96%, down 9 and 30 basis points (bp) on the levels at end-2003. The credit risk premia negotiated by firms on the derivatives markets increased slightly, but their levels remained low (see Chart 23). Retail bank interest rates and non-financial corporations' costs of financing with debt securities remained very moderate.

During most of the quarter, domestic and international stock market prices continued to show the upward path and the low volatility seen in the second half of 2003. The uncertainty generated following the terrorist attack of 11 March in Madrid triggered a bout of instability reflected in decreasing stock market indices and rising volatilities. However, in the days following the attack the markets tended to return to normality. Thus by mid-April the Madrid Stock Exchange General Index had posted a 9.1% rise in the year, topping that of the broad Euro Stoxx euro area stock market index (5.8%) and that of the US S&P 500 (1.5%).

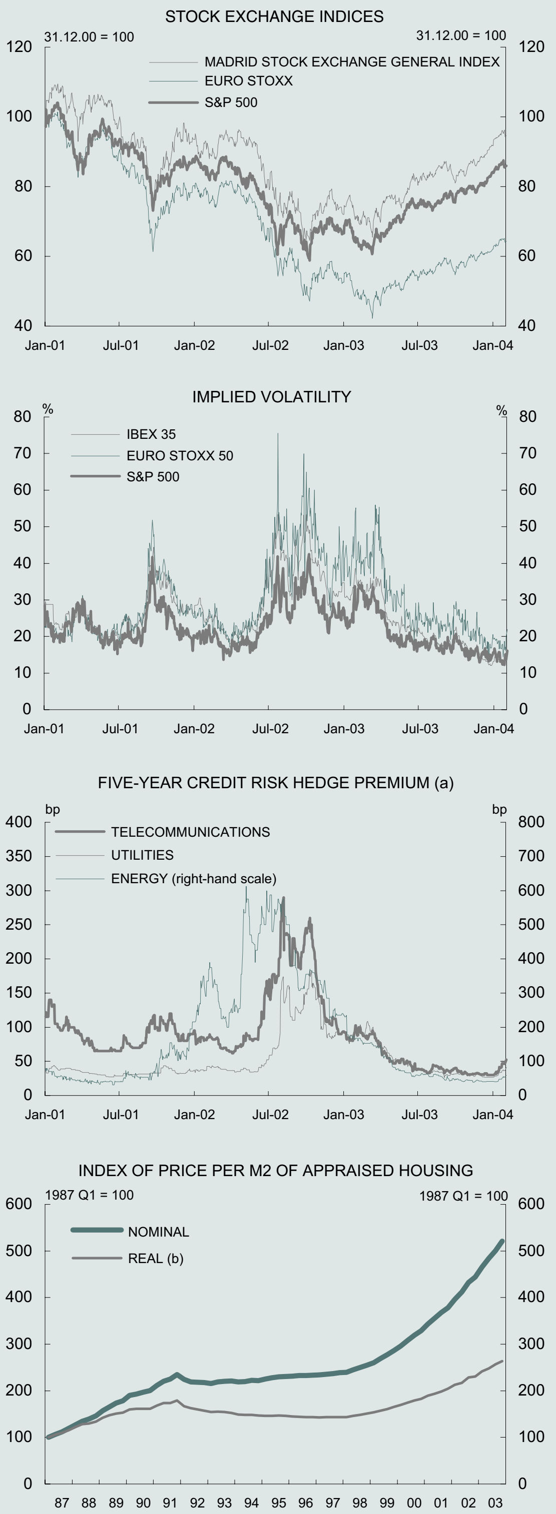
The most recent information on the housing market shows that prices accelerated between September and December last year as the year-on-year growth rate rose by 1.7 pp to stand at 17.3%. On this occasion the rise in the growth rate of real estate asset values was basically due to the performance of this market in municipalities of more than 500,000 inhabitants and in those along the coast.

In this setting, the non-financial private-sector continued to resort heavily to borrowing in 2003 Q4 and 2004 Q1 to finance a part of its spending decisions. The financing received by households grew by 18.7% in 2003 Q4 in year-on-year terms, a rise of more than 2 pp with respect to September. The growth rate of borrowing by corporations was lower (by 0.5 pp) and stood at 14.2% in the same period. The provisional information on 2004 Q1 points to a certain acceleration in the rate of expansion of the debt taken on by households and corporations.

The most recent indicators on the financial position of households show that their net wealth continued to grow in Q4 thanks to rising real estate and financial asset prices. During the same period, however, the financial saving of this sector and its gross saving after debt

CHART 23

Price indicators for various assets



Sources: Bloomberg, Credit Trade and Banco de España.

(a) Average asset-weighted premia. On 22.6.03 a change came into effect in the contractual terms of European firms. The new contract carries lower associated premia (around 10%).

(b) Deflated by the CPI.

service contracted and, accordingly, continued to stand at low levels. The ratio of debt to gross disposable income (GDI) continued its upward path, which, despite the unchanged cost of debt, resulted in an increase in the associated debt burden. This measure of indebtedness, however, held at moderate levels. The provisional information on the first few months of 2004 points to further growth in the level and cost of debt in terms of household income.

The debt burden of corporations continued to fall in 2003 Q4 and their economic results were fairly favourable in 2003 as a whole. The synthetic indicators of financial pressure obtained from the corporations reporting to the Central Balance Sheet Data Office (CBSO) also point to an improvement between October and December and, accordingly, they remain below their historical averages. To this favourable performance should be added the lower need for external financing to cater for real investment decisions and long-term financial initiatives abroad. However, the level of aggregate indebtedness of corporations increased in 2003 Q4 and, on available data, also rose in 2004 Q1. It therefore continues at relatively high levels.

Overall, the aggregate financial position of corporations and households should not represent a significant obstacle to the continuing strength of consumption and to the improved buoyancy of the productive investment of corporations. However, the high level of indebtedness reached by these sectors means that the margin left to them, especially households, to continue sustaining their spending by further resort to credit has now shrunk. Therefore, the behaviour of these variables will depend to a larger extent on the performance of their income. As already pointed out on other occasions, their decisions in this respect will be more sensitive than in the past to unanticipated adverse shocks to income, wealth or financing cost.

5.2. Households

The financing terms of households continued to be easy in 2004 Q1. The retail bank interest rate on house purchase loans rose slightly to 3.51% in February, up 5 bp on end-2003, while that on consumer and other loans fell in the same period by 14 bp to 6.26%. However, the institutions' forecast based on the Bank Lending Survey for 2003 Q4 were for the overall terms on loans offered from January to March 2004 to be somewhat tighter in house financing and similar in consumer and other lending.

TABLE 5

Net financial transactions
(cumulative four-quarter data)

% GDP

	NET FINANCIAL TRANSACTIONS								
	1998	1999	2000	2001	2002 Q4	2003 Q1	2003 Q2	2003 Q3	2003 Q4
National economy	**0.2**	**-1.0**	**-2.5**	**-2.2**	**-1.6**	**-2.1**	**-2.0**	**-2.3**	**-2.0**
Non-financial corporations and households and NPISHs	**2.1**	**-0.3**	**-2.3**	**-3.4**	**-3.0**	**-3.6**	**-3.6**	**-3.7**	**-3.8**
Non-financial corporations	-1.1	-2.3	-3.4	-4.5	-4.5	-4.3	-4.3	-4.8	-4.6
Households and NPISHs	3.3	2.0	1.1	1.1	1.5	0.7	0.7	1.1	0.8
Financial institutions	**1.1**	**0.5**	**0.8**	**1.6**	**1.5**	**1.5**	**1.4**	**1.4**	**1.5**
General government	**-3.0**	**-1.2**	**-0.9**	**-0.4**	**-0.1**	**0.0**	**0.2**	**0.0**	**0.3**

Source: Banco de España.

The year-on-year growth rate of financing received by the sector increased in 2003 Q4 by more than 2 pp to 18.7% (see Table 6). In cumulative 12-month terms, the fresh funds received represented 10% of GDP, up 1.6 pp on September. This rise was the net result of an acceleration in lending for house purchase and a decline in the rate of expansion of consumer and other lending. On provisional information for 2004 Q1, this pattern of household debt growth has held steady.

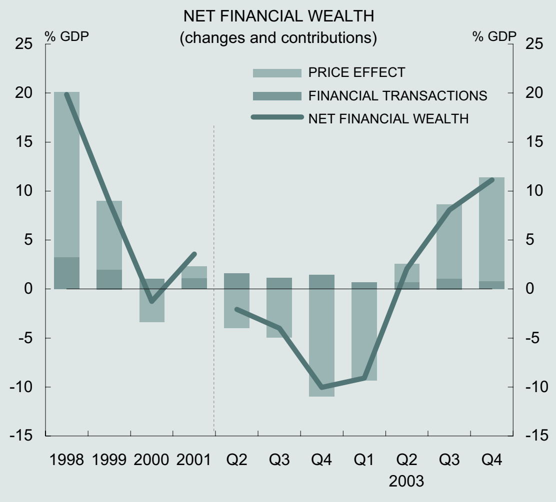
Regarding portfolio decisions, in December the financial assets acquired by households stood at 10.8% of GDP in cumulative 12-month terms (see Table 6). The breakdown by instrument showed a certain preference for greater liquidity, as provided, for instance, by payment instruments and mutual funds, although in the latter case with a composition different from that in the previous quarter. Thus in cumulative terms, net purchases of FIM (capital market) mutual funds rose by 0.6 pp to 1.8% of GDP and those of money market mutual funds decreased by 0.3 pp to 0.6% of GDP, in a shift caused by low interest rates and the favourable performance of equity markets. This same factor probably also contributed to the slight recovery in the purchase of shares and other equity.

The rises in stock market and house prices outstripped those in the sector's liabilities, so its net wealth continued to grow (see Charts 24 and 25). However, household financial saving in 2003 as a whole stood at 0.8% of GDP which, in cumulative twelve-month terms, was lower than in September (see Table 5). Meanwhile, in 2003 Q4 the sector's gross saving after debt service decreased slightly – in contrast to the recovery seen in the last three quarters – and thus accounted for less than 2% of GDI (see Chart 25). A further rise in household relative indebtedness took it above 90% of GDI. This meant that, despite the lower cost of debt, the household debt burden increased slightly, although it continued to be relatively moderate.

Overall, the aggregate wealth position of the sector will not restrain the buoyancy of consumption and residential investment in the short and medium term. However, the low level of saving after debt service means that the cushion available to the sector to meet a hypo-

CHART 24

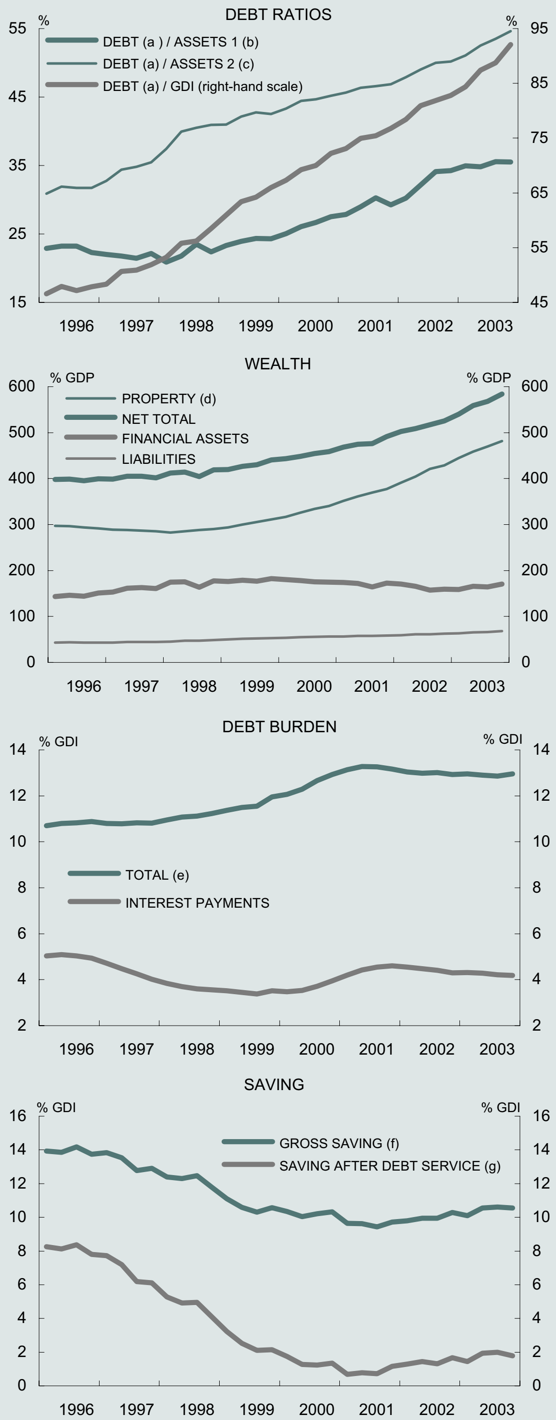
Households and NPISHs
(cumulative four-quarter data)



Source: Banco de España.

CHART 25

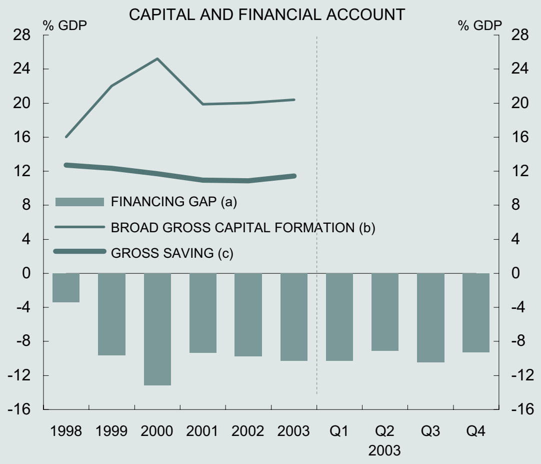
Indicators of the financial position of households and NPISHs



Source: Banco de España.
(a) Includes bank credit and securitisation.
(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.

CHART 26

Non-financial corporations (cumlative 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.

thetical adverse change in its wealth, in its income or in the cost of debt without changing its spending decisions is now smaller than in the past. Also, as pointed out several times before, the impact of this shock would be greater in a setting of high indebtedness like that at present. In this same line, the microeconomic information available from the Household Budget Survey shows that a growing percentage of households are finding it difficult to save, so the proportion of households that is more vulnerable to unfavourable changes in the macroeconomic environment has probably grown.

5.3. Non-financial corporations

Financing terms for corporations continued to be generous in 2004 Q1. Thus lending rates held at around the low levels reached during the previous year. Specifically, the interest rate on loans of up to €1 million stood at 4.22% in February (4.25% in December), while that on loans of higher amounts decreased to 3.27% (13 bp less than in December). The risk premia required in corporate financing rose slightly although by less than the decline in public debt yields, so the average cost of financing via fixed-income securities continued to be moderate. Similarly, the conditions for raising funds on equity markets generally continued to improve thanks to rising stock market prices and decreasing volatility.

TABLE 6

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

% GDP

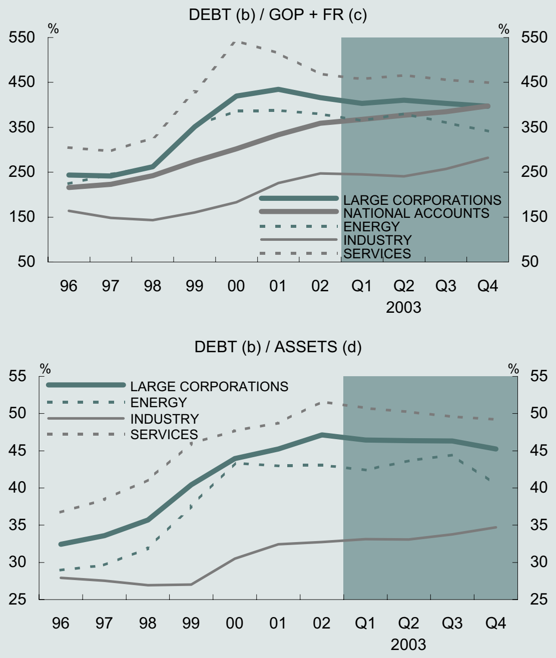
	2000	2001	2002	2003 Q2	2003 Q3	2003 Q4
HOUSEHOLDS AND NPISHs						
Financial transactions (assets)	**9.4**	**7.9**	**9.0**	**8.7**	**9.4**	**10.8**
Cash and cash equivalents	0.9	1.2	3.9	3.7	4.2	4.7
Other deposits and fixed-income securities (a)	5.9	3.4	1.5	0.2	-0.1	0.1
Shares and other equity (b)	1.4	-0.1	0.9	0.4	0.4	0.7
Mutual funds	-3.2	0.8	0.2	1.3	2.0	2.3
FIAMM	*-1.2*	*1.3*	*0.7*	*0.7*	*0.9*	*0.6*
FIM	*-2.0*	*-0.5*	*-0.5*	*0.6*	*1.2*	*1.8*
Insurance technical reserves	3.3	2.6	2.6	2.5	2.4	2.1
Of which:						
Life assurance	*1.9*	*1.4*	*1.5*	*1.3*	*1.2*	*0.5*
Pension funds	*1.1*	*0.9*	*0.9*	*0.8*	*0.7*	*0.9*
Other	1.1	0.0	-0.1	0.6	0.6	1.0
Financial transactions (liabilities)	**8.3**	**6.8**	**7.5**	**7.9**	**8.4**	**10.0**
Credit from resident financial institutions (c)	7.0	5.4	7.2	7.8	8.1	9.4
House purchase credit (c)	5.4	4.8	5.2	5.4	5.6	7.2
Consumer and other credit (c)	1.6	0.6	2.1	2.5	2.5	2.1
Other	1.3	1.3	0.3	0.2	0.2	0.7
NON-FINANCIAL CORPORATIONS						
Financial transactions (assets)	**25.9**	**16.7**	**16.4**	**18.3**	**17.5**	**17.2**
Cash and cash equivalents	0.9	1.7	1.6	1.4	1.3	0.9
Other deposits and fixed-income securities (a)	0.5	0.4	1.5	1.0	1.4	1.3
Shares and other equity	13.4	6.4	7.0	7.1	7.1	6.7
Of which:						
Vis-à-vis the rest of the world	*9.7*	*4.7*	*5.3*	*4.8*	*5.6*	*4.6*
Other	11.0	8.3	6.3	8.7	7.6	8.3
Financial transactions (liabilities)	**29.2**	**21.3**	**20.9**	**22.6**	**22.2**	**21.8**
Credit from resident financial institutions (c)	7.5	6.5	6.3	7.3	7.0	7.1
Foreign loans	3.5	4.0	3.0	1.9	2.7	2.8
Fixed-income securities (a)	-1.2	0.0	-0.4	-0.3	-0.2	-0.2
Shares and other equity	12.8	5.3	6.0	6.6	6.5	5.1
Other	6.6	5.4	6.0	7.1	6.3	7.0
MEMORANDUM ITEM: YEAR-ON-YEAR GROWTH RATES (%):						
Financing (d)	**18.1**	**15.6**	**14.3**	**14.4**	**14.9**	**16.1**
Households and NPISHs	17.3	12.4	15.7	16.1	16.6	18.7
Non-financial corporations	18.7	18.1	13.3	13.1	13.7	14.2

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, foreign loans, fixed-income securities and financing through securitisation vehicles.

In 2003 Q4 the volume of liabilities-side transactions in cumulative twelve-month terms stood at 21.8% of GDP, down 0.4 pp on September (see Chart 6). In terms of components, the year-on-year growth rate of interest-bearing borrowed funds rose slightly to 14.2% and, on provisional information for 2004 Q1, this trend looks set to continue. The funds obtained in this way between October and December last year represented, in cumulative twelve-month terms, 9.7% of GDP, up slightly on September, with a very similar composition by instrument. The funds raised by corporations through share and other equity issues amounted to 5.1% of GDP, which was 1.4 pp less than in the previous quarter.

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 2002, the information is from the CBSO annual survey (CBA). Thereafter, the indicators have been estimated drawing on the CBSO quarterly survey (CBQ).

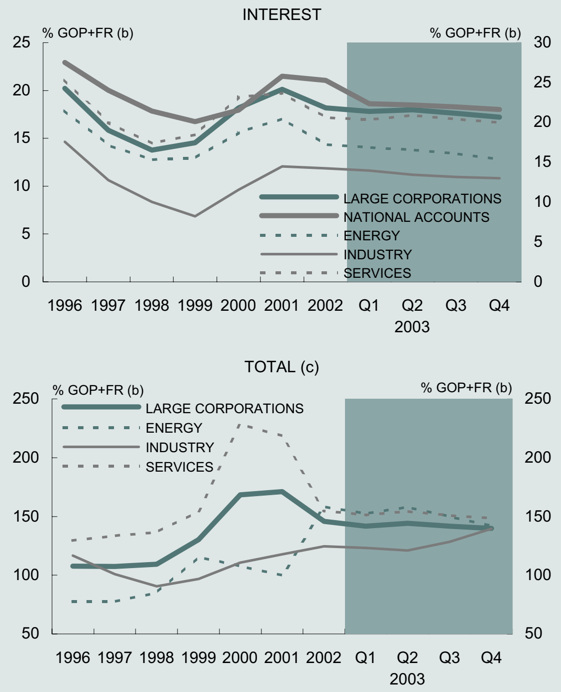
(b) Interest-bearing borrowed funds.

(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 2002, the information is from the CBSO annual survey (CBA). Thereafter, the indicators have been estimated drawing on the CBSO quarterly survey (CBQ).

(b) Gross operating profit plus financial revenue.

(c) Includes interest plus interest-bearing short-term debt.

The bank credit extended for most productive activities decelerated in Q4, with the main exception of non-real estate services. This trend did not prevent the credit for construction and real estate services from continuing to expand at high rates. Credit to industry was clearly sluggish, probably due to the scant momentum of investment by this sector.

In 2003 Q4, as in the quarter preceding it, the acquisition of financial assets by non-financial corporations decreased and, in cumulative twelve-month terms, financial investment amounted to 17.2% of GDP (see Table 6). Most noteworthy as regards components was the decrease in the percentage of GDP represented by payment instruments and by the acquisition of shares and other equity, the latter being the net result of an increase in Spain and a contraction abroad.

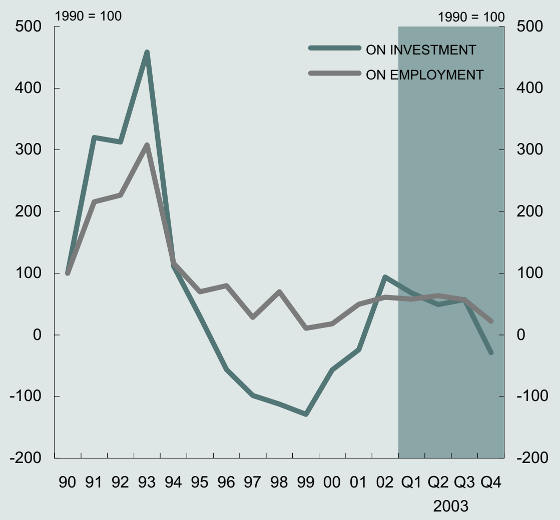
The net borrowing of corporations between October and December in cumulative twelve-month terms represented 4.6% of GDP, down slightly on the previous quarter (see Table 5). The financing gap, which is the external funds required to enable permanent financial and real investment, contracted during the same period by more than 1 pp to stand at 9.3% of GDP (see Chart 26).

The debt ratios of non-financial corporations increased slightly from September to December last year, and the provisional data for 2004 Q1 point to fresh increases (see Chart 27). On Central Balance Sheet Data Office (CBSO) data for Q4, this behaviour was not homogeneous across corporations, since, in certain cases such as that of the larger corporations, indebtedness continued to decline. Meanwhile, in all sectors the debt burden arising from interest showed the same downward trend seen in previous quarters, reflecting the low cost of debt (see Chart 28). If short-term debt is added to interest, the resulting debt burden indicator also decreased slightly in Q4 in all sectors except the industrial sector.

On CBSO data, corporate earnings performed very favourably in 2003. Thus ordinary

CHART 29

Synthetic indicators of financial pressure on non-financial corporations (a)



Source: Banco de España.

(a) A value higher (lower) than 100 indicates more (less) financial pressure than the reference level.

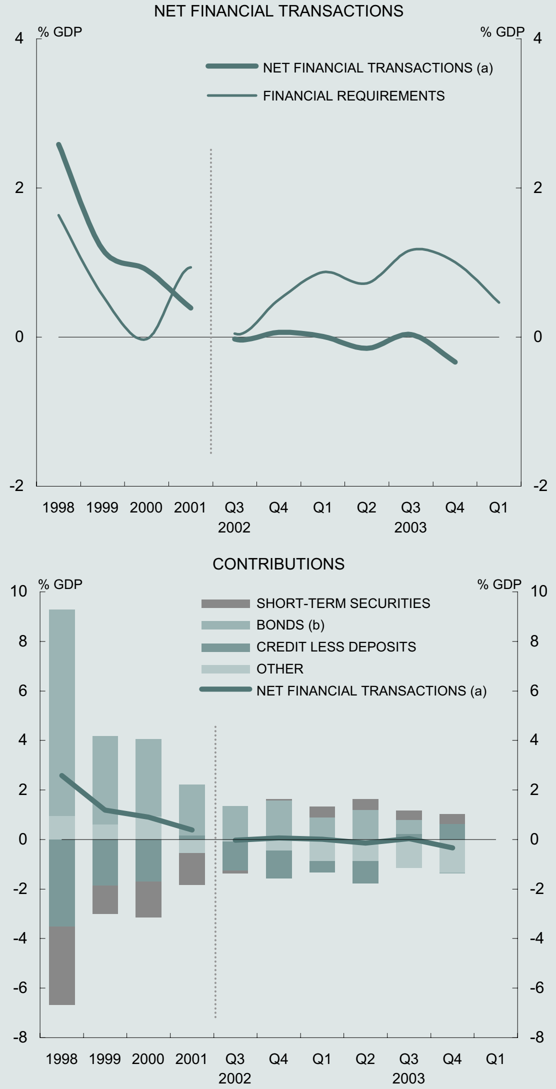
net profit, which excludes extraordinary revenue and expenses, increased by 15.9% for the reporting corporations as a whole, well above the 1.2% recorded in 2002. Moreover, this improvement was fairly general across sectors, except for industry, which showed practically zero earnings growth. This performance brought a recovery of ordinary return on equity, which stood at 12.1%. Meanwhile, analysts' short-term expectations regarding listed corporations' profits recovered during 2003, although the same cannot be said for the longer term (Box 5).

As a result of the performance of the aforementioned variables, the aggregate synthetic indicators of financial pressure on investment and employment obtained from CBSO information decreased in 2003 Q4, thereby holding at historically low levels (see Chart 29).

In sum, the aggregate financial position of corporations remains sound, which, together with the improvement in short-term earnings expectations, means that conditions are favourable for the recovery of productive investment. However, the performance of this variable will also depend on the extent to which the balance sheet adjustment by some highly indebted corporations, such as the larger ones, has or has not been completed and on long-term earnings expectations which, as mentioned above, still show no sign of recovery. In any event, as with households, the high level

CHART 30

General government (cumulative four-quarter data)



Source: Banco de España.

(a) Sign changed.

(b) Not including unpaid accrued interest, which is included under "other".

of indebtedness means that the sensitivity of spending and hiring decisions to unforeseen shocks in the cost of debt and in earnings is greater than in the past.

5.4. General government

From October to December 2003, the net balance of the financial transactions of general government was negative, although in cumulative twelve-month terms it stood at 0.3% of GDP, up slightly on the previous quarter (see Chart 30).

TABLE 7

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

% GDP

	2000	2001	2002	2003 Q2	2003 Q3	2003 Q4
Net financial transactions	**-2.5**	**-2.2**	**-1.6**	**-2.0**	**-2.3**	**-2.0**
Financial transactions (assets)	**24.5**	**12.2**	**13.8**	**14.1**	**15.4**	**13.9**
Gold and SDRs	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
Cash and deposits	**2.8**	**-2.7**	**3.5**	**2.8**	**0.7**	**1.1**
Credit system	2.5	-2.7	2.0	1.6	-0.4	0.2
Other resident sectors	0.4	0.0	1.5	1.2	1.1	0.9
Securities other than shares	**3.9**	**7.2**	**4.3**	**5.5**	**7.8**	**7.1**
Credit system	-0.3	2.0	0.5	1.9	4.1	3.7
Other resident sectors	4.2	5.2	3.8	3.5	3.8	3.4
Shares and other equity	**15.0**	**5.2**	**5.3**	**4.6**	**6.0**	**4.8**
Credit system	1.8	0.0	0.2	-0.4	-0.3	-1.1
Other resident sectors	13.2	5.2	5.2	4.9	6.3	5.9
Of which:						
Non-financial corporations	9.7	4.7	5.3	4.8	5.6	4.6
Loans	**2.7**	**2.5**	**0.6**	**1.3**	**0.9**	**1.0**
Credit system	0.5	0.8	0.1	0.2	0.3	0.3
Other resident sectors	2.1	1.7	0.5	1.1	0.6	0.7
Financial transactions (liabilities)	**26.9**	**14.4**	**15.4**	**16.1**	**17.7**	**15.9**
Deposits	**6.7**	**2.8**	**4.4**	**4.5**	**6.5**	**7.6**
Of which:						
Credit system	6.8	2.8	4.4	4.5	6.4	7.5
Securities other than shares	**7.2**	**3.2**	**4.5**	**5.3**	**4.5**	**5.6**
Credit system	0.7	0.6	1.4	2.8	3.0	3.7
General government	5.8	1.6	1.2	0.4	-0.9	-1.0
Other resident sectors	0.6	0.9	1.8	2.1	2.4	3.0
Shares and other equity	**9.4**	**4.6**	**4.2**	**4.6**	**4.3**	**0.9**
Credit system	1.8	0.5	0.1	-0.1	0.0	-0.2
Other resident sectors	7.7	4.1	4.1	4.6	4.4	1.1
Loans	**4.1**	**4.3**	**3.5**	**2.4**	**3.0**	**3.2**
General government	0.0	0.1	0.1	0.0	-0.1	-0.1
Other resident sectors	4.1	4.3	3.4	2.5	3.1	3.3
Other, net (a)	**-0.5**	**-0.5**	**-1.1**	**-0.8**	**-0.7**	**-1.3**

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

In 2003 Q4 the net issuance of marketable securities by general government was positive in both short-term instruments (€125 million) and long-term instruments (€223 million). The stock of net deposits decreased by €891 million in the same period. This did not prevent the net issuance of marketable securities from decreasing significantly in cumulative twelve-month terms to 0.4% of GDP as a result of the lower contribution of funds obtained from medium- and long-term securities and of the unchanged contribution from short-term issues.

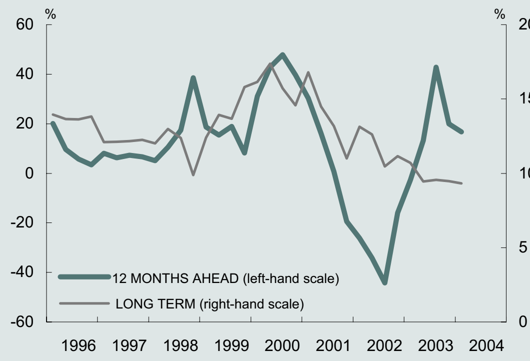
Provisional information for 2004 Q1, evaluated from the standpoint of *financial requirements*, which represent recourse by general government to financial markets and are a leading indicator of the sector's saving, points to a decrease in funding requirements in cumulative twelve-month terms. The breakdown by

BOX 5

Change in business earnings expectations

One of the factors that most influences the investment decisions of firms is their earnings expectations. A source customarily used to measure them is the survey of stock market analysts' earnings forecasts for listed companies conducted by the Institutional Brokers Estimate System (I/B/E/S), which includes individual, sectoral and, in some cases, national-aggregate information on expected short- and long-term earnings (1). The adjacent chart shows the annual growth rates of expected short-and long-term earnings of Spanish corporations (2).

Earnings growth expectations of listed non-financial corporations.



Source: I/B/E/S and BE calculation.

As can be seen, in mid-2000 expectations worsened, especially in the short term, with the year-on-year change slumping to negative values. The international economic slowdown and the heightened uncertainty during that period probably explain this behaviour. By contrast, short-term corporate earnings growth expectations recovered from 2002, turning positive again in 2003. Furthermore, this recovery was general, since it affected all branches, although it was particularly notable in those, such as technology and energy, where the deterioration had been sharpest.

However, this improvement has still not flowed through to longer-term expectations, which continued to deteriorate, although in the last two quarters of 2003 the downward trend seems to have been detained. Thus, the earnings growth expectations over this time horizon currently stand at historically low values. Consequently, despite the favourable performance of the earnings published by Spanish corporations and of their earnings expectations for the coming months, the expectations of profit in the longer term have yet to show clear signs of recovery. This could be one of the factors holding back corporate spending decisions. Against this background, the present lower uncertainty, the firming of an environment of intensified international economic activity and the headway made in certain structural reforms seem to be emerging as the major factors that could lead to an upward revision of earnings expectations and, along with it, to the prompt arrival of the favourable prospects for productive investment heralded by the generous financial conditions enjoyed by this sector.

(1) Short term is defined as a twelve-month horizon. No express horizon is defined for long term.
(2) More specifically, the chart plots the related averages weighted by the capitalisation of each sector.

instrument shows a certain recovery in long-term liabilities along with a decrease in short-term liabilities.

5.5. The rest of the world

From October to December 2003 the debit balance of the nation's financial transactions in cumulative twelve-month terms decreased to stand at 2% of GDP, down 0.3 pp on the previous quarter. This was the result of increased saving by general government and financial institutions, which outweighed the growth in dissaving by the non-financial private sector. Asset and liability flows, measured in cumulative twelve-month terms, decreased again in Q4 following the recovery from June to September.

Net purchases of foreign assets contracted to 13.9% of GDP in cumulative twelve-month terms, against 15.4% in the previous quarter (see Table 7). This resulted from a decline in flows of both debt and equity marketable securities, which was not offset by the increases in other items. On provisional Balance of Pay-

TABLE 8

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

% GDP

	1998	1999	2000	2001	2002	2003
National economy	**-29.4**	**-30.0**	**-26.6**	**-27.5**	**-31.7**	**-38.6**
Non-financial corporations and households	**-17.8**	**-17.7**	**-9.8**	**-10.5**	**-12.2**	**-15.0**
Non-financial corporations	-23.7	-24.4	-17.1	-17.9	-20.0	-23.9
Households and NPISHs	5.9	6.7	7.3	7.4	7.8	8.9
Financial institutions	**6.3**	**8.1**	**8.2**	**8.4**	**6.3**	**-1.7**
Credit institutions (b)	-5.4	-7.5	-11.6	-13.9	-14.5	-22.2
Institutional investors (c)	12.0	16.3	20.8	24.2	24.4	26.8
Other financial institutions	-0.4	-0.6	-0.9	-1.8	-3.6	-6.3
General government	**-17.9**	**-20.5**	**-25.1**	**-25.4**	**-25.8**	**-21.8**

(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) Defined in accordance with the First Banking Directive.
(c) Insurance corporations and portfolio investment institutions.

ments data, in 2003 as a whole foreign long-term (direct) investment contracted by nearly 40% with respect to the previous year, whereas portfolio investment abroad accelerated with respect to 2002.

On the liabilities side, net flows amounted to 15.9% of GDP in cumulative twelve-month terms, down 1.8 pp on the previous quarter. By instrument, most headings showed increases, although their overall amount was less than the notable decrease in the flows of shares and other equities. According to Balance of Payments data, inward foreign direct investment in Spain in 2003 as a whole fell by nearly 40%.

Finally, the provisional information on the debit position of the Spanish economy vis-à-vis the rest of the world shows that it stood at 38.6% of GDP at end-2003, a deterioration of 6.9 pp relative to December 2002 (see Table 8).

28.04.2004